ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

JANUARY 2021 – No. 21/1

Executive summary

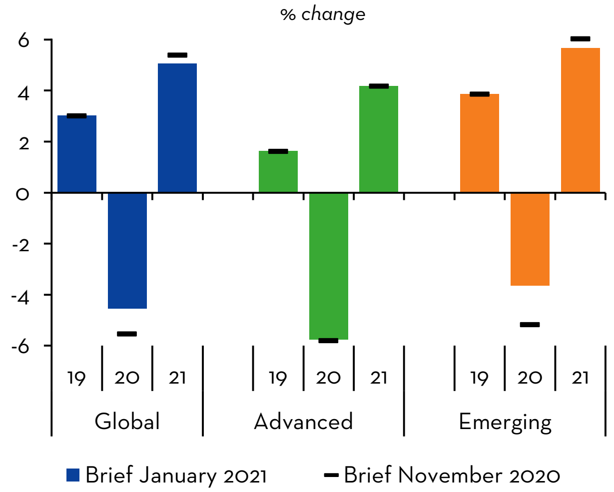
The second wave of COVID-19 is hitting EU activity ...

- Activity in Q3-2020 was higher than expected and led us to revise our global GDP forecasts for 2020 upwards (-4.5% compared to -5.5% in the November Brief, Chart 1).
- However, the worsening of the epidemiological situation in most countries in the last few months will negatively affect global growth in Q4-2020 and in 2021, and we have revised our forecast for 2021 downwards (5.1% compared to 5.4% in the November Brief).
- It is anticipated that China's GDP will grow 2.0% in 2020 (1.8% in the November Brief), with positive contributions from all economic sectors. In 2021, the Chinese economy is expected to grow by 8.8% (8.6% in the November Brief).
- The UK economic outlook is gloomy following the announcement of another round of lockdown to contain the pandemic and finalization of Brexit.
- We expect a gradual improvement in public health conditions, starting from mid-2021, when at least the most vulnerable segments of the population should have received the COVID-19 vaccine.

... in Italy the vaccination campaign and the European funds will help reverse the downturn

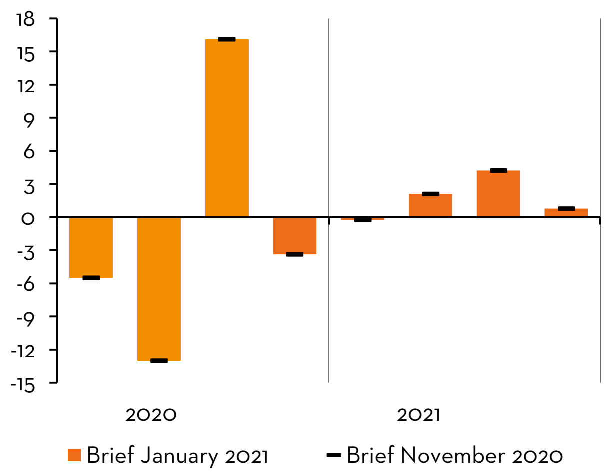
- After the rebound in economic activity in Q3-2020, Italy's GDP in Q4 is estimated to decline again (-3.2% qoq, Chart 2), due to the second wave of the pandemic and the restrictions adopted to contain its spread. The estimated fall in GDP in 2020 is -9.1%.
- New fiscal measures have been adopted recently by the government in a bid to limit the negative effects on the economy. The total discretionary measures to address the COVID-19 emergency in 2020 amount to €108 billion.
- The recovery will strengthen in the second half of 2021 as the vaccination campaign progresses and NGEU resources are deployed. We expect GDP to increase by 4.8% in 2021 (5% in the November Brief).
- The Italian Recovery and Resilience Plan is under discussion. The proposal recently approved by the government (in InFocus 2) is consistent with our projections, which consider additional spending of €10 billion in 2021.

Chart 1 – Real GDP
% change



Source: Prometeia's forecast on IMF, World Bank, Eurostat, National Statistical Offices data.

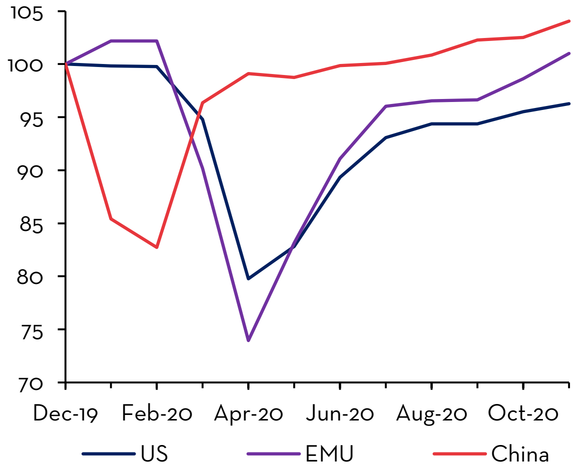
Chart 2 – Italy: real GDP
% change qoq



Source: Prometeia's forecast on Istat data.

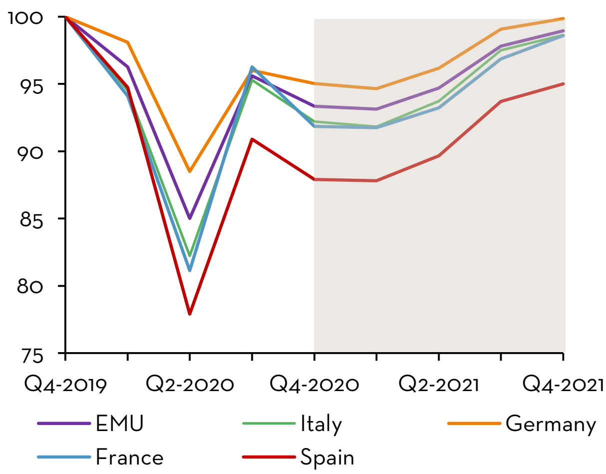
Global scenario

Chart 3 – Industrial production
December 2019 = 100



Source: Prometeia's calculations on National Statistical Offices data.

Chart 4 – Real GDP
Q4-2019 = 100



Source: Prometeia's forecast on National Statistical Offices data.

China is leading the global recovery. China and the rest of the world are progressing at different speeds, with the former being the main contributor to global trade in 2020 (InFocus 1). China escaped a second wave of coronavirus infections and is the only major economy that was able to regain pre-crisis GDP levels in 2020. The continued growth of industrial production and an economic structure leaning more towards manufacturing than services, have contributed to this result (Chart 3). Nevertheless, the pandemic highlighted some weaknesses that might hamper China's growth going forward. These include the predominance of investment over consumption in terms of the contribution to GDP, and a large pool of unemployed from the accommodation and food service sectors which will not rapidly be absorbed by the fast-growing sectors (e.g. high-tech).

In the US, following the rebound in Q3, growth should have decelerated in Q4-2020 (at 0.7% qoq). The worsening of the epidemiological situation and a sluggish labour market in the last part of the year will weigh on consumer expectations. In the wake of intense debate, the US Congress finally approved a $900 billion stimulus bill (The Coronavirus Response and Relief Supplemental Appropriations Act of 2021) to provide support for small businesses and relief to low-income households. The package includes an extension to the supplemental unemployment benefit and another round of direct payments of $600 per person. The runoff elections in Georgia have reshaped the balance of power in the Senate in favour of the Democratic Party, which has increased the possibility of more budget stimuli (not incorporated in our current projection); therefore, some more expansionary effects in 2021 should be expected.

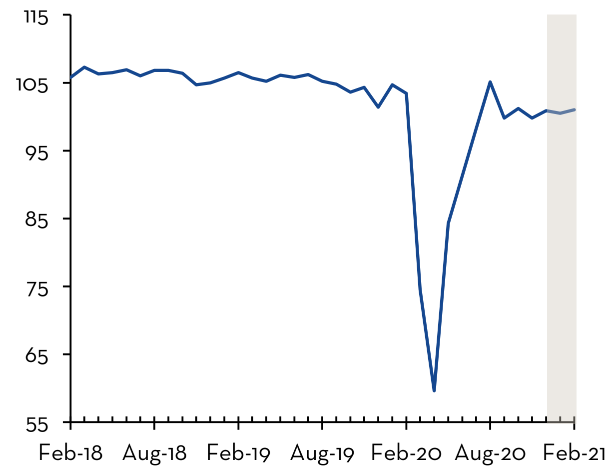
Monetary policy. In line with the announcement by the Fed in the December Federal Open Market Committee meeting, the monetary policy stance in the US remains unchanged. Meanwhile, the ECB has recalibrated its monetary policy instruments and increased their flexibility to secure the smooth functioning of financial markets, while keeping interest rates unchanged. As expected, the Pandemic Emergency Purchase Programme has been increased by €500 billion and extended to March 2022, while the Targeted Longer-Term Refinancing Operations have been extended to June 2022. These measures will allow banks to provide liquidity to firms and households on very favourable terms. However, the ECB has pledged to adjust these terms as the health crisis evolves.

GDP in the euro area recovered more than anticipated in Q3-2020, but it is expected to fall by 2.3% qoq in Q4-2020 due to the new round of lockdowns, introduced to contain the second wave of COVID-19. Although these lockdowns are less severe than those enforced in spring 2020, these containment measures, combined with the increased uncertainty about the development of the pandemic, have caused an unprecedented spike in household savings. Overall, GDP in 2020 is expected to fall by 7.2%. The approval of the EU's long-term budget for 2021-2027 represents a step forward towards the implementation of the NGEU, which should be deployed and accelerate growth in the second part of 2021. Nevertheless, at the end of 2021, GDP will remain below its pre-crisis level with significant differences among countries (Chart 4).

Italy

Chart 5 – **Industrial production**

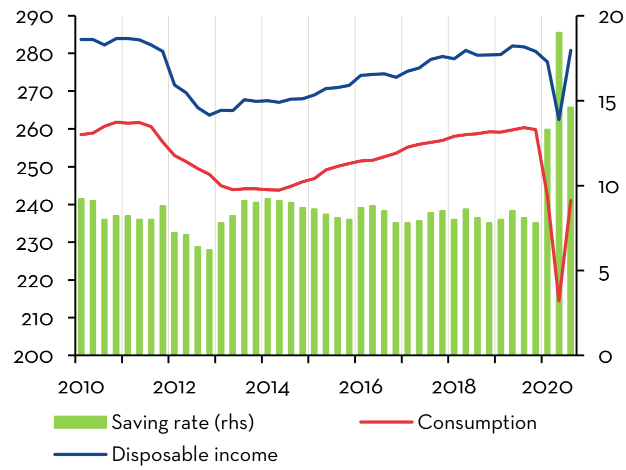
2015=100



Source: Prometeia's forecast on Istat data.

Chart 6 – **Household saving rate, consumption and disposable income**

% and billions of euros (2015)



Source: Istat data.

Italy has also experienced a sharp rebound, 15.9% in Q3-2020 compared to Q2, the strongest in Europe. Manufacturing (in August) and construction activity returned to their pre-pandemic level, while sectors that rely on social interaction (tourism, hotels, restaurants, catering, and entertainment) continue to show strong signs of distress, despite some improvement during last summer. The rebound was based on a strong positive contribution from domestic demand (12pp) and a less intense contribution from net exports (3.9pp). The positive contribution of exports was driven by goods and services, particularly tourism, whose value increased fivefold over the previous quarter, although being still 38.7% lower than in Q3-2019.

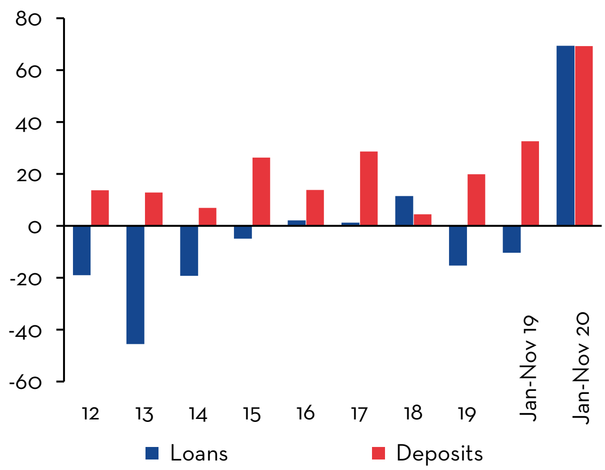
The resurgence of the virus has halted the recovery in Q4-2020. News about the approval of a vaccine in November 2020 bolstered the stock market, while the 10-year Italian sovereign spread reached its lowest level. However, this optimism has been tempered by a second wave of infections, which has put health systems under renewed stress, requiring restrictions and social distancing measures. We estimate that economic activity contracted by 3.2% qoq in Q4-2020, and will remain stagnant until the spring. The reduction in Q4 is mainly driven by private services, while we estimate a only mild decrease of industrial output. After having recovered in October, industrial production fell in November (-1.4% on monthly basis) due to the new restrictions, but the outlook for December continues to be mildly positive (Chart 5).

The saving rate remains high despite some recent reductions. In Italy, as in other countries, the inability to consume due to the lockdowns, combined with precautionary behaviour, led to a sharp increase in the household saving rate in the first half of 2020: the saving rate more than doubled between Q4-2019 and Q2-2020, from 7.8% to 19%, the highest level in the 2000s. In Q3-2020, the stronger recovery of consumption compared to disposable income reversed this trend, but the saving rate remained high (14.6%, Chart 6).

Deflationary outlook confirmed. In December (preliminary data), consumer inflation was negative (-0.1% yoy) for the eighth consecutive month. Overall, in 2020, prices dropped by 0.2%, the third yearly drop since the beginning of the historical series in 1954. The reduction of energy prices (-8.4%) was the main contributor. Despite the increase in November and December, core inflation remains low as a result of weak demand and changing household consumption patterns. In the summer and the subsequent months, when the second wave of the pandemic hit Italy, demand for goods and, especially, leisure related services dropped affecting their prices. Fresh food prices have followed a different path: they rose sharply during the spring lockdown, reflecting supply constraints due to mobility restrictions and agricultural labour shortages; then, starting from June, they decreased on a monthly basis, but have increased again in October and November.

The effects of the pandemic on the labour market: compared to Q4-2019, full-time equivalent jobs decreased by 1 million 120 thousand in Q3-2020, and the number of employed workers by 380 thousand in October-November. The most heavily affected are the youngest workers, women and those employed on temporary contracts.

Chart 7 – Bank loans and bank deposits of non-financial corporations *- billions of euros*



Source: Prometeia's calculations on Bank of Italy data.

With the exception of the public sector, where the crisis has not had an effect on employment, in the rest of the economy, hours worked dropped although the number of employees remained more stable thanks to the extension of the furlough schemes and of the temporary ban on layoffs. Due to the recovery that occurred in the summer months, the number of hours worked in the construction sector and in manufacturing have recovered to their pre-crisis levels. In November (preliminary data), employment growth was restored, 0.3% per month, but the number of inactive people increased, reflecting the negative effects of the weak economic cycle on the labour market.

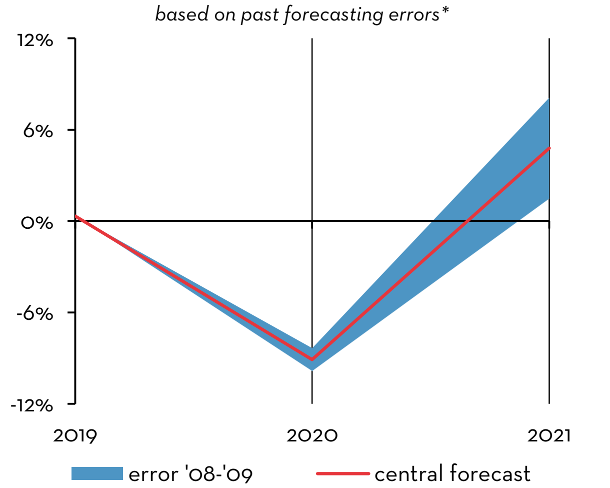
Risks to the projection

- There are several risks that might affect the recovery in 2021, including a worsening of the pandemic and further severe consequences on household and corporate incomes; the private and public debt overhangs; misalignment between the stock market and real economic performance; and delays in availability and administration of the COVID-19 vaccines.
- The Italian outlook could be affected by problems related to the NGEU funds and the difficulties related to the preparation of projects and securing of European funds by the Italian administration combined with high uncertainty related to the current government crisis.
- On the positive side, the results of the US runoff elections in the State of Georgia have provided the Democrats with more room to push forward the plans set out by President-elect Biden during his presidential campaign, with possible positive effects also for the global economy.

This crisis is characterized by increased borrowing and deposits by firms. Despite the sharp decline in business investment expenditure, falling turnover and the need for liquidity have increased firms' bank loans, incentivized by substantial new government guarantees and low interest rates. At the same time, firms' bank deposits have also grown considerably. This is a signal that the business sectors, as a whole, needs to have a liquidity cushion to cope with the very high uncertainty about future demand. The flow of bank loans in the first eleven months of 2020 reached €69.2 billion, compared to a negative value of €10.3 billion during the same period in 2019 (Chart 7). We estimate that in 2020 loans grew by around €80 billion, the highest value in the last 20 years with the exception of 2007.

Social restriction measures are expected to ease gradually in spring 2021. In Q2-2021 GDP growth should resume a positive value and the recovery should strengthen in the second half of the year based on NGEU resources and the ongoing vaccination campaign. Therefore, we project an annual increase in GDP of 4.8%. The resources put in place by the Italian government for 2021 will also contribute: we estimate the discretionary fiscal measures this year to be around €70 billion, 4% of GDP, including €10 billion of additional spending related to the NGEU. Therefore, although lower than in 2020, the fiscal policy impulse in 2021 will continue to be important.

Chart 8 – Italy: Prometeia's forecast of annual GDP growth *– central value and uncertainty based on past forecasting errors**



** The confidence interval for 2020 is based on the forecast errors of 2008 and the confidence interval for 2021 on the 2009 forecast errors. Source: Prometeia's calculations.*

Global Trade and COVID-19

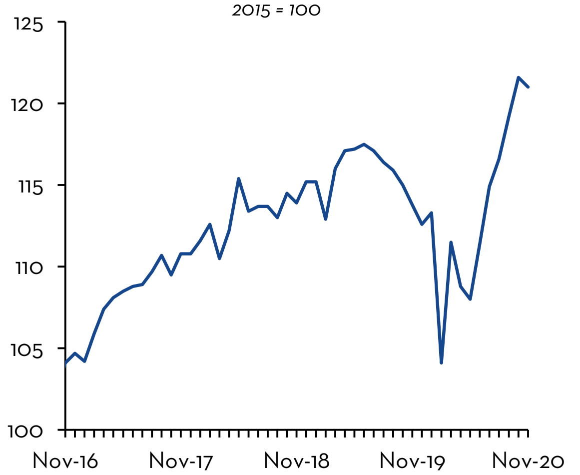
Global trade in goods is likely to register an average annual fall of around 9% in 2020. This is less severe than anticipated during the most acute phase of the crisis (-11.9% in the July 2020 IMF World Economic Outlook) and less severe than observed during the 2009 recession (-12%). According to the CPB World Trade Monitor, in October, world goods imports almost recovered to their pre-crisis levels, due, especially, to the contribution of China. Also, the RWI/ISL Container Throughput Index, which covers more than 60% of world container handling, regained its pre-crisis level in July (Chart A).

The Asian countries are benefiting the most from the Chinese recovery since China is one of their main export destination markets. In Q2-2020, potential external qoq demand of some Asian countries dropped less than external demand of US and European countries (Chart B), which confirms the pre-COVID-19 trend towards trade regionalization in Asia, which is supported further by the recently approved Regional Comprehensive Economic Plan.

While Chinese growth is key to global recovery, it is not sufficient for the euro zone countries' recovery. The share of exports to China does not exceed 7% of total exports (13% towards Asia as a whole) for any European country, while intra-euro area trade accounts for between 30% and 40% of total exports.

Chart A – RWI/ISL Container Throughput Index

2015 = 100

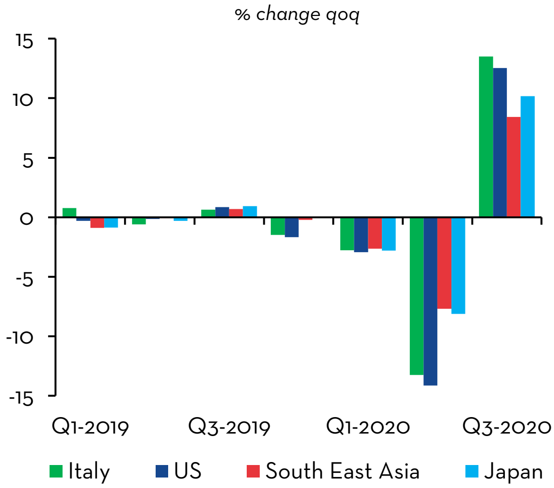


Source: Leibniz Institute for Economic Research and the Institute for Shipping Economics and Logistics.

It is not surprising that, for the euro area countries, potential foreign demand from the EMU follows the dynamics of the European countries production cycles. In the case of Italy (Chart C), in Q2-2020, the fall in potential foreign demand from the euro area countries was steeper than the fall in extra-EMU potential demand. However, the rebound in Q3 was stronger in the euro area countries, which helped to accelerate exports. Hence, the multiplier effect of intra-area trade in the European countries may be greater than the effect of Chinese growth. This will be strengthened by the launch of the NGEU investment plans, which will promote increased investment and, also, trigger imports across European countries.

Chart B – Potential external demand

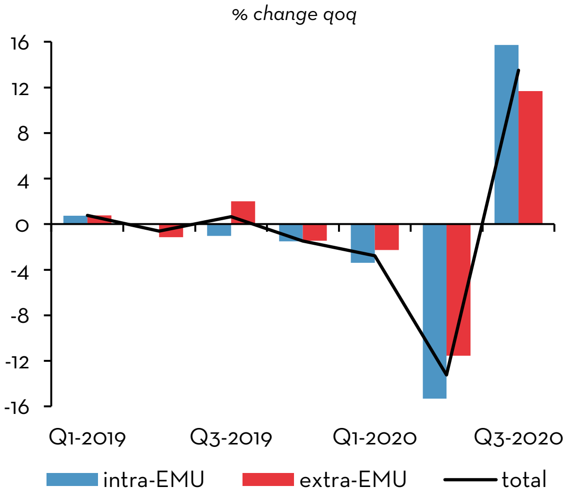
% change qoq



Source: Prometeia's calculations on CPB and IMF data.

Chart C – Potential external demand to Italy

% change qoq



Source: Prometeia's calculations on CPB and IMF data.

The Italian National Recovery and Resilience Plan

The common European response to the coronavirus outbreak will strongly affect the EU's 2021-2027 financial framework, in which the Next Generation EU (NGEU) is the main novelty. This InFocus summarizes the main features of the NGEU and the latest information on how Italy plans to allocate the NGEU funds.

On December 2020, the European Council reached agreement about the new 2021-2027 EU budget and the NGEU recovery package, worth a total of €1.8 trillion. Together with other financial instruments adopted in response to the COVID-19 pandemic, e.g., the SURE temporary unemployment support scheme, the ESM Pandemic Crisis Support to finance health expenditure and the EIB Pan-European Guarantee Fund to support business investment, the available resources amount to €2.34 trillion or 18% of EU GDP.

A significant share (more than €270 billion) of the funds earmarked for the crisis has potentially been allocated to Italy: SURE will provide €27.4 billion of loans, of which €16.5 billion have already been disbursed; the ESM could provide €36 billion of loans; and the NGEU will make available up to €209 billion measured in 2018 prices. The €209 billion NGEU funding is comprised of around €80 billion in grants and €129 billion in loans related mostly (90%) to the Recovery and Resilience Facility (RRF). To access these funds, countries have to submit National Recovery and Resilience Plans (NRRP), by latest 30 April 2021, for assessment by the European Commission. These plans will set out a coherent package of reforms and public investment projects that should be fully committed by end 2023 and implemented by 2026. The European Commission assessment criteria require the plans include a minimum of 37% of expenditure related to achieving climate targets and a minimum of 20% of expenditure to enable the digital transition, as well as

Table 1 – NGEU: breakdown in Missions and Components according the draft of the Italian Government's plans
billions of euros in 2018 prices

	RRF			React-EU	NGEU-total
	Total	*Existing projects*	*New projects*		
Digitalisation, innovation, competitiveness and culture	45.4	10.1	35.3	0.8	46.2
Digitalisation, innovation and security in Public Administration	*11.5*	*5.6*	*5.8*	-	*11.5*
Digitalisation and innovation of the production system	*25.9*	*4.2*	*21.7*	*0.8*	*26.7*
Tourism and culture	*8.0*	*0.3*	*7.7*	-	*8.0*
Green deal and green transition	66.6	30.2	36.4	2.3	68.9
Green Enterprise and Circular Economy	*5.2*	-	*5.2*	*1.1*	*6.3*
Energy transition and sustainable local mobility	*17.5*	*3.0*	*14.6*	*0.7*	*18.2*
Energy efficiency and building renovation	*29.0*	*16.4*	*12.7*	*0.3*	*29.4*
Protection and valorisation of the territory and water resources	*14.8*	*10.9*	*4.0*	*0.2*	*15.0*
Infrastructures for sustainable mobility	32.0	11.7	20.3	-	32.0
High-speed rail network and road maintenance 4.0	*28.3*	*11.2*	*17.1*	-	*28.3*
Intermodality and integrated logistics	*3.7*	*0.5*	*3.2*	-	*3.7*
Education & research	26.7	4.4	22.3	1.8	28.5
Educational enhancement and right to education	*15.4*	*3.0*	*12.4*	*1.4*	*16.7*
From research to business	*11.3*	*1.4*	*9.9*	*0.5*	*11.8*
Inclusion and cohesion	21.3	4.1	17.2	6.4	27.6
Lobour market policies	*6.7*	*0.8*	*5.9*	*6.0*	*12.6*
Social infrastructures, Households, Communities and Third Sector	*10.5*	*3.3*	*7.2*	*0.4*	*10.8*
Special interventions for regional cohesion	*4.2*	-	*4.2*	-	*4.2*
Health	18.0	5.3	12.7	1.7	19.7
Neighbourhood care and telemedicine	*7.5*	-	*7.5*	*0.4*	*7.9*
Innovation, research and digitalisation of healthcare	*10.5*	*5.3*	*5.2*	*1.3*	*11.8*
Total resources	209.9	65.7	144.2	13.0	222.9

Source: NRRP draft of 12 January 2021.

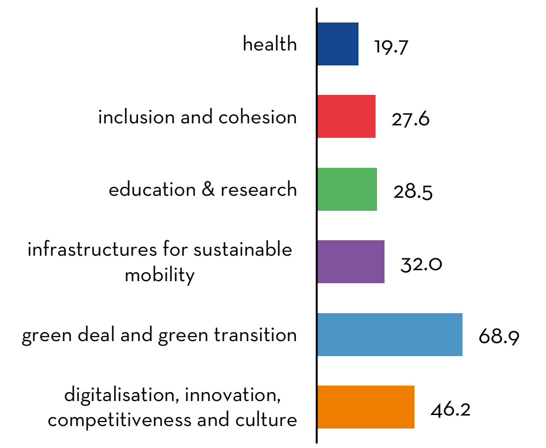
complying with EU competition and state aid rules and adhering to the European Green Deal "do no significant harm principle". The plans must include relevant milestones and targets whose satisfactory completion will trigger the grants and loans instalments.

The Italian NRRP is currently being finalized. Following the circulation of the first draft on 7 December 2020, updates were released on 7 January, which have been incorporated into the second draft approved by the Government on 12 January, as a basis for Parliament debate and for discussion with the local and economic institutions. According to the current draft, the plan includes a total of €223 billion NGEU funding, €210 billion of which is related to the RRF and €13 billion to React-EU. The €223 billion indicated is higher than the potential (€209 billion for the NGEU, €196.5 billion for the RRF) as the government wants to maintain a safety margin to ensure full use of the European resources available to Italy.

The NRRP draft allocates the funds across six Missions (Chart A). These six Missions, include 16 Components which comprise 47 lines of action for homogeneous projects and coherent reforms. Overall, 39% of the funding is accounted for by green transition projects and 31.4% is dedicated to the digital transition, which is in line with the criteria. The breakdown includes provision of €65.7 billion of RRF to finance measures already undertaken, nearly 50% of which are aimed at the green transition, and €144.2 billion are earmarked for new projects (Table 1). Besides the allocation of NGEU funds, the NRRP adds other spending programs to the Missions and Components, in order to have a comprehensive view by areas of intervention and to ensure coherence in the overall programming framework, which totals €310.6 billion. For example, part of the 2021-2027 European and national cohesion funding cycle (around €20 billion) has been integrated in the NRRP, to further strengthen activities related to inclusive growth and regional cohesion. The assumed schedule of the disbursements of the 209 billion shows an increasing profile from €24.9 billion in 2021 to €44.7 billion in 2023 (compared to an annual average of €35 billion), giving priority to grants in the first three years (Chart B).

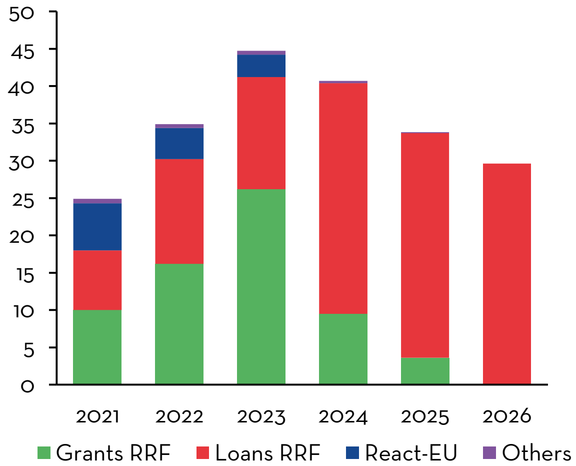
The NRRP draft confirms the main objective of increasing the resources devoted to public investment. The planned increase in investment represents 70% of the funds provided by the NGEU while the remaining 30% would be allocated to business incentives, labour tax cuts and, to a limited extent, current public spending and household transfers. Under these assumptions, a preliminary assessment reported in the NRRP estimates the overall impact of NGEU's funds on GDP at 0.6% in 2021 and gradually increasing to 3% in 2026. The impact on GDP of the yearly expenditure flows increases considerably over time, due to the assumed lasting effect on the productivity of public capital beyond the implementation period.

Chart A – Mission-based allocation of NGEU funds
billions of euros in 2018 prices



Source: NRRP draft of 12 January 2021.

Chart B – NGEU: breakdown and time profile in the Italian Government's plans
billions of euros in 2018 prices



Source: NRRP draft of 12 January 2021.

Table 1 - The world economy main indicators (% change)

	2019	2020	2021
World real GDP	3.0	-4.5	5.1
World Trade	-0.5	-9.3	7.6
Manufacturing prices $	-2.6	0.4	4.7
Brent oil price ($/brl, level)	64.2	43.4	45.5
GDP			
- United States	2.2	-3.6	3.7
- Japan	0.7	-6.0	4.0
- EMU	1.3	-7.2	3.9
- China	6.1	2.0	8.8
Consumer prices			
- United States	1.8	1.2	1.8
- Japan	0.5	0.1	0.4
- EMU	1.2	0.2	0.7
- China	4.0	2.8	1.7
$/€ exchange rate (level)	1.12	1.14	1.21
£/€ exchange rate (level)	0.877	0.890	0.907

Table 2 – Italy: main indicators (% change)

	2019	2020	2021
GDP*	0.3	-9.1	4.8
Imports of goods fob and services	-0.4	-13.4	10.0
Private consumption	0.5	-10.3	4.3
Government consumption	-0.2	-0.4	2.8
Gross fixed investment:	1.6	-7.9	10.3
- machinery, equipment, other products	0.9	-8.9	9.1
- constructions	2.5	-6.6	11.7
Exports of goods fob and services	1.3	-15.2	8.4
Domestic demand	-0.2	-8.4	5.2
Industrial production	-1.1	-11.2	8.8
Trade balance (% of GDP)	3.2	4.1	3.7
Terms of trade	1.3	5.1	0.2
Consumer prices	0.6	-0.2	0.2
Per capita wages - manufacturing	1.6	0.3	0.4
Total employment	0.2	-9.2	3.3
General government balance (% of GDP)	-1.6	-11.1	-8.1

** Chain-linked values; data adjusted for seasonal and calendar effects.*

Table 3 - Exchange Rates and Interest Rates

		20 Q1	20 Q2	20 Q3	20 Q4	21 Q1	21 Q2	21 Q3	21 Q4
Exchange rates vs euro	US dollar	1.10	1.10	1.17	1.19	1.21	1.21	1.21	1.21
	Yen	120.1	118.3	124.1	124.2	126.8	127.4	127.5	126.9
3 month interest rates %	US libor	1.51	0.58	0.26	0.22	0.23	0.24	0.26	0.27
	Euribor	-0.37	-0.30	-0.45	-0.51	-0.52	-0.50	-0.49	-0.49
10 year government bond yields %	US	1.39	0.69	0.65	0.87	0.93	0.84	0.86	0.90
	Germany	-0.44	-0.47	-0.52	-0.60	-0.61	-0.58	-0.56	-0.53
	Italy	1.25	1.64	1.01	0.62	0.55	0.65	0.66	0.69

Table 4 – Real GDP: comparison of the forecast – % qoq and annual % change (historical data in bold)

		20 Q1	20 Q2	20 Q3	20 Q4	2020	21 Q1	21 Q2	21 Q3	21 Q4	2021
United States	Brief November 2020	**-1.3**	**-9.0**	**7.4**	0.6	-3.6	0.7	0.9	1.2	0.6	3.8
	Brief January 2021	**-1.3**	**-9.0**	**7.5**	0.7	-3.6	0.5	0.9	1.2	0.8	3.7
EMU	Brief November 2020	**-3.7**	**-11.8**	**12.7**	-2.7	-7.3	-0.3	1.9	3.9	2.2	4.3
	Brief January 2021	**-3.7**	**-11.7**	**12.5**	-2.3	-7.2	-0.2	1.7	3.3	1.1	3.9
Italy	Brief November 2020	**-5.5**	**-13.0**	**16.1**	-3.4	-9.0	-0.2	2.1	4.2	0.8	5.0
	Brief January 2021	**-5.5**	**-13.0**	**15.9**	-3.2	-9.1	-0.4	2.1	4.0	1.2	4.8

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based on data available up to 13th January 2021

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