ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

FEBRUARY 2020 – No. 20/2

Executive summary

Coronavirus exacerbates the global slowdown

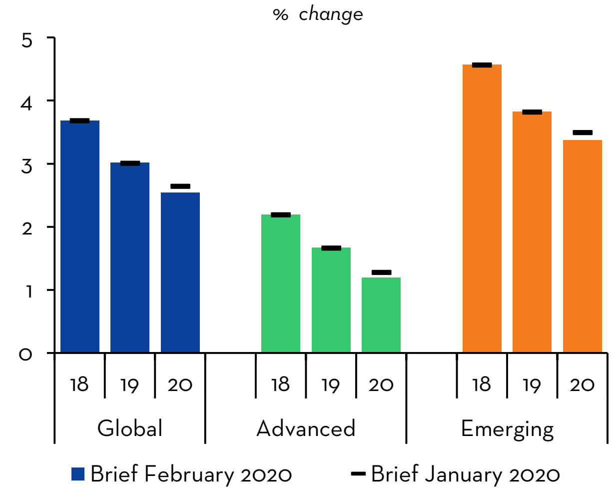
- The timeline and intensity of the spread of the new coronavirus are still subject to considerable uncertainty. However, the postponement of the reopening of activities after the Chinese New Year will exert significant negative effects in H1 2020, especially on the supply side. Chinese authorities are implementing measures to fight the slowdown, but they are unlikely to be effective in supporting production.
- Our scenario is based on the assumption that new spreads will start to reduce and economic activity to improve in Q2 2020, with a rebound in Q3. In the first InFocus, we discuss the implications for the Chinese and global economy.
- We still see a global deceleration in 2020, not very different from what we had in January (Chart 1). The negative effects of the coronavirus are partly compensated by the better than expected Q4 2019 in the US and China, exerting positive base effects.
- EMU Q4 2019 GDP was weak, in line with our January forecasts. In the second InFocus we discuss the poor performance of German exports, one reason behind the weak EMU performance.

Italy: substantial downward revision for 2020

- The possibility of an Italian recovery in 2020 is now less likely. A lower than expected preliminary GDP estimate for Q4 2019 (-0.3% qoq vs our forecast of 0%) added to the concern about the prospects of the German automotive industry, to which the Italian one is particularly interconnected, both directly but also through production value chains. More recently, the outbreak and spread of the coronavirus, which casts a shadow on the prospect for the global economy, will have implications also for Italy.
- However, there are some bright spots. First, Q4 2019 GDP growth, although disappointing, was likely due to one-off factors common to most other euro area countries (see Italy section). Also, Italian 10-year sovereign bond yields have recently decreased to near historic lows (0.95% in February), thanks to an accommodative ECB policy and the apparent resilience of the current pro-EU government.
- Overall, we have revised our projections for this year downward (to 0.1% from 0.5%) as a result of the carryover effect of Q4 2019 and the expected global effects of the coronavirus. Needless to say, the uncertainty around this forecast is higher than usual.

Chart 1 – Real GDP

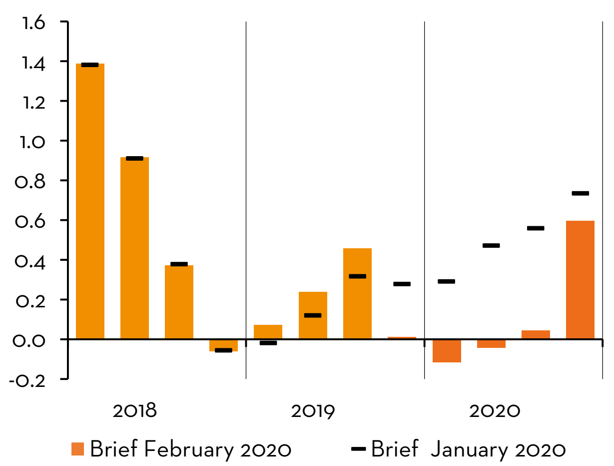
% change



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

Chart 2 – Italy: real GDP

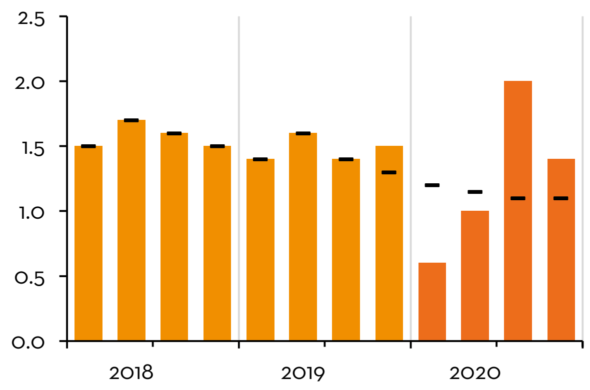
% change yoy



Source: Prometeia's forecast on Istat data.

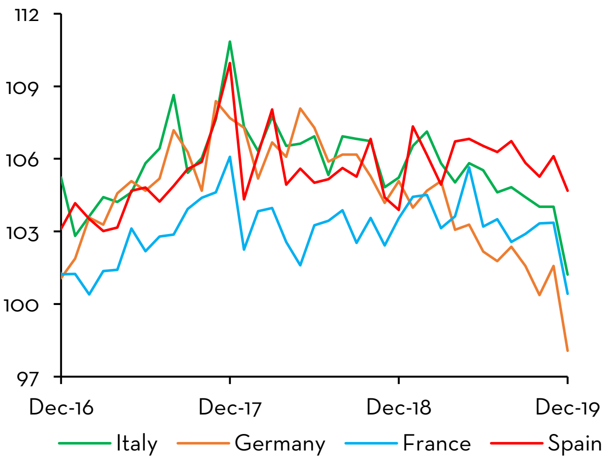
Global scenario

Chart 3 - China real GDP
% changes qoq



Source: Prometeia's forecasts on China Bureau of Statistics data.

Chart 4 - Industrial production index
2015 = 100



Source: Eurostat.

Chinese GDP is expected to decelerate strongly in Q1 2020 (0.6% qoq, Chart 3) due to the precautionary measures taken to limit coronavirus contagion which have brought economic activity to a quasi-halt in the Hubei region and are having a major effect on the rest of China. Under the assumption that the coronavirus timeline will see new cases decelerating in Q2 (a profile of contagion similar to that of SARS), and that economic policies will continue to sustain domestic demand, we foresee economic activity rebounding in Q3 2020 (Chart 3). In the first Infocus we discuss in details these projections. The better than expected GDP outcome in 2019 Q4, on one side, and the predicted negative impact of the coronavirus, on the other, have led us to foresee a small revision to Chinese GDP growth in 2020 compared to what we forecast in the January Brief (Table 1).

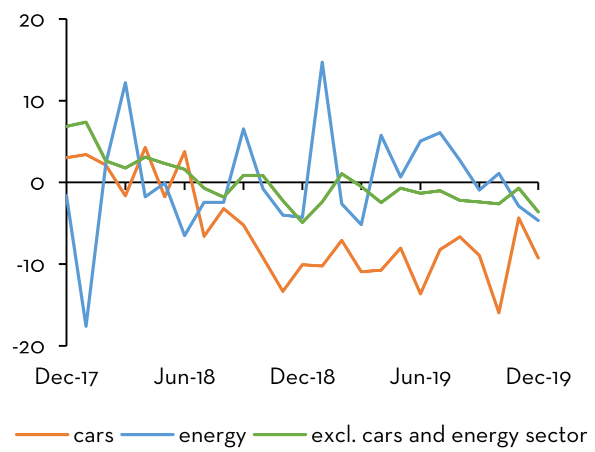
We have revised US GDP growth in 2020 upward as the result of a better than expected Q4 2019 (Table 4) and an upward revision to our forecast for Q1 2020. However, the annual growth rate (1.7% vs 1.5% in the January Brief) will continue to be mostly in line with the potential growth rate. GDP based on expenditure items suggests a less robust dynamics since growth was determined in part by reduced imports and, also, non-residential investments stagnated for the third consecutive quarter. The qoq reduction in imports (-2.3%) is likely related to expectation of the phase-one trade deal, which could have led to the postponement of foreign product purchases to 2020. Overall, we expect that the improved confidence linked to the phase-one deal and negligible negative effects of the coronavirus for the US will bring qoq growth in Q2 2020 to 0.4%.

Euro area: persistent weakness. The deceleration of GDP in Q4 2019 (0.1% qoq, 0.2% in Q3) was most likely be due to the smaller number of days worked compared to 2018 since many workers extended their Christmas holiday to include Friday 27 December. In France, a sequence of strikes affected manufacturing activity. All of this more than compensated for the rapid growth of confidence in the last months of 2019. Among the biggest countries, Q4 GDP qoq growth ranged from -0.3% in Italy to 0.5% in Spain, -0.1% in France and 0% in Germany. The increasing global uncertainty promoted by the emergence of the coronavirus has delayed any strengthening of the economy and, as yet, there are no clear signs of recovery in the manufacturing sector (Chart 4). We expect average annual euro area GDP growth to be 0.9% in 2020, down from our forecast of 1.1% in the January Brief.

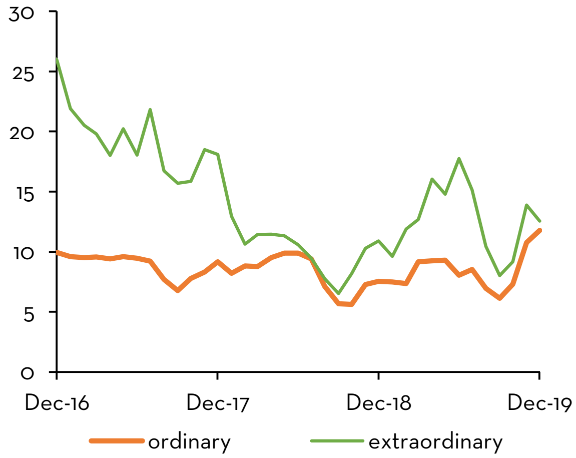
Central banks in several emerging countries are reducing their monetary policy rates in order to counterbalance the expected deceleration in demand. These countries include Brazil, Thailand and the Philippines which rely heavily on Chinese demand. The reduction in monetary policy interest rates will not help to reverse capital flight to better quality investments to US dollar denominated assets, which will threaten these countries terms of trade and diminish them further, with a negative effect on their domestic demand.

Commodity prices falling. Expectations of weaker demand from China, the main player in several commodity markets, is contributing to a reduction in the prices of metals and energy. We expect the Brent oil price to remain below $60 per barrel in H1 2020. Few of the oil producing countries can afford the cut in production which Saudi Arabia is calling for since that would imply fewer resources from the sale of oil.

Italy



Source: Prometeia's calculations on Istat data.



Source: Inps.

Explaining the disappointing Q4 2019. In our January Brief, we forecast stable GDP in Q4 2019 compared to the previous quarter and, therefore, the flash estimate of -0.3% was a very disappointing result. It confirms, also, that the Italian economy is still stagnating and that signs of improvement are fragile. However, a closer examination suggests that part of that fall may be transitory. First, as in the case of other European countries, December's industrial production may have been negatively affected by the 27 December effect. Second, the weather (hot and rainy in November and December) may have had a negative impact on agricultural activity, construction and electricity production (Chart 5). Overall, we consider these data to be disappointing but not hugely, and we await the detailed sectoral breakdown (to be released on 4 March). Nevertheless, following a year of generally zero growth, the Q4 fall lowers the 2020 recovery starting point (the carryover is -0.2), leaving a quite steep GDP growth path for 2020 if a contraction for the year is to be avoided.

Coronavirus effect. In an already difficult situation, the emergence of the new coronavirus is likely to produce an additional negative effect. Based on our assumptions discussed in the first InFocus, we estimate for Italy a Q1 reduction in growth of 0.1pp followed by a recovery similar to the one we predicted for January, pre the coronavirus.

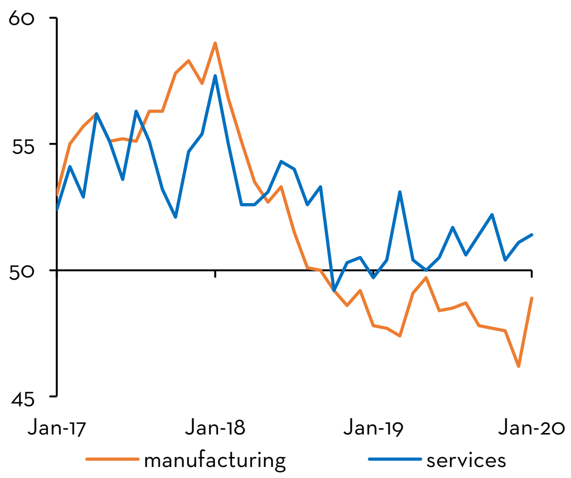
Inflation. The signs of a recovery in consumer inflation that emerged at the end of 2019 seem to be persisting, but their intensity has been reduced. In January, the headline index increased by 0.6% yoy, which is still low (it was 0.5% in December). The increase has been affected by higher oil prices in the last few months of 2019, which upset some prices related to energy production and transport services. Further upward pressure was induced by higher prices for processed food products. Also, core inflation recorded an upward movement (+0.8% in January, from +0.6% in December), with inflation in non-energy industrial goods positive. However, overall, inflation prospects are not good.

Less buoyant labour market. Despite the stagnation in economic activity from the second half of 2018 (since then GDP contracted by -0.1%), in 2019 employment continued to grow: full-time equivalent grew by 0.5% and the unemployment rate fell to 9.9%. Nevertheless, in the second part of 2019, showing a typical lagged reaction, the slowdown in the business cycle began to be reflected in job creation: employment faltered and hours paid by the Redundancy Fund (CIG) increased (Chart 6).

Credit and banks. In 2019, banks further increased their funding on the domestic market compared to the previous year, supported, on the one hand, by the weak business cycle which led to an increase in the liquidity deposited by firms, and on the other hand, by low interest rates which prompted households to increase their deposits. Notwithstanding these favourable funding conditions, loans to firms continued to be very weak and, in the latter part of the year, fell in all sectors and, especially, construction. This trend reflects low demand for loans due to the prolonged stagnation and, also, a reduction in the elasticity of loans to economic activity, due less to restrictive supply policies and more to a change in companies' choices about forms of financing.

On the contrary, the growth in loans to households remains solid.

Chart 7 - PMI, manufacturing and services sectors
level



Source: Refinitiv.

Strengthening the banking sector. The reduction in NPLs continues, thanks in part to the prosecution of sales; at the same time, and despite the stagnant economic activity, default probabilities decreased and, currently, are at historically low levels. This is reflected in banks' balance sheets, which, according to the preliminary results, are showing increasing operating margins.

Public deficit under control. The 2020 Budget Law (see InFocus in the January Brief no. 20/01) was approved at the end of last December, following constructive discussion with the European Commission, which allowed to avoid the start of the EU's Excessive Deficit Procedure and reassured financial markets. Preliminary data for 2019, based on cash borrowing requirements, point to a better than expected deficit and public debt. In 2020, Italy's budgetary policy is expected to provide increased support to families. In addition to the Citizenship income measure (whose cost will increase by 0.2pp of GDP in 2020 compared to 2019), there are resources earmarked in the new Budget to reduce the labour income tax wedge by about 0.2pp of GDP in 2020 and 0.3pp in 2021. This tax cut was presented to parliament quite recently and provides for an extension of the so-called "€80 Bonus" (€100 for annual incomes up to €28,000 instead of €26,600) and the new tax relief, at a decreasing level up to €40,000.

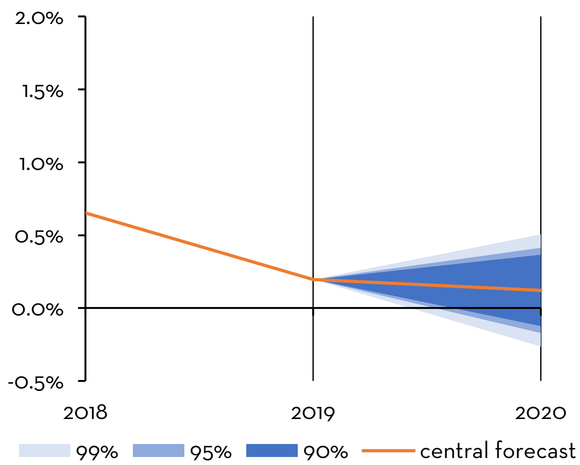
GDP growth in 2020: can another recession be avoided? We continue to see signs, albeit weak, supporting a recovery in 2020: very low interest rates which will support both household consumption and investment in construction; fiscal incentives that will foster investment; the slightly redistributive fiscal policy which favours lower-income households and might increase consumption; reduction in the probability of an early elections (following the elections in Emilia-Romagna it is more likely, now, that the current government will remain in office at least until the presidential election in 2022). In fact, the most recent PMI was showing signs of a tentative turnaround (Chart 7).

In summary. We have downward revised our growth forecast for Italy to 0.1% (from the 0.5% forecast in January): 0.1pp due to the effects of the coronavirus and 0.3pp due to the negative drag of Q4 2019 GDP results. It should be noted that the quarterly GDP profile is revised fairly substantially and frequently by the National Statistical Institute (Istat), thus, this estimate should be considered rather uncertain, as the revision is largely based on the preliminary Q4 estimate.

Risks to the projection

- The cost in terms of lower growth could be higher for the global economy if the timeline of the Covid-19 emergency is longer and the measures to fight it are less effective than our assumptions.
- Italy is exposed to several specific risks in addition to the general global uncertainty. If the German car industry recovers at a slower pace than expected and if China continues to be affected by the coronavirus for longer than expected, Italy's relatively higher exposure in relation to the automobile industry value chain and, more generally, to mechanical goods could increase the risk of a further drop in its industrial production.
- Despite the results of the recent regional elections, the political risks in Italy remain high, as tensions within the government are mounting.

Chart 8 - Italy: Prometeia's forecast of annual GDP growth - *central projection and confidence levels*



Source: Prometeia's calculations.

Covid-19: a non-negligible impact on the global economy

The almost complete stop to activity in Wuhan and the domino effects on the rest of China are increasing the risk of a sharp slowdown in the Chinese economy in the first part of the year. The Hubei region, at the center of the epidemic, is an industrial hub, which represents more than 5% of total Chinese investments, more than 6% of China's total private consumption and is an important global supply chain hub (Table 1a). Given China's relevance in the global economy, the risk of a worldwide shock is not negligible. Uncertainty over outcomes remains high and our preliminary estimates necessarily depend on the available data and some assumptions. In what follows, we discuss the relevance of China in international trade, the main channel of the economic effects to other countries.

Table 1a – China and the province of Hubei

*China in the global economy**	
Real GDP	17.2
*Hubei in China***	
Population	4.2
Pig Iron	3.3
Cars	8.6
Motor Vehicles	8.7
Cloth	8.8
Air Conditioners	9.0
Plain Glass	10.7
Chemical Fertilizers	11.8
Ind. Prod. Hydrop. Elec.	12.0
Sulfuric Acid	13.3

** 2018, shares on world, $ 2015*
*** 2018, shares on total output*
Source: Prometeia's calculation on World Bank, IMF, and China Bureau of National Statistics.

Table 1b – The costs of 1% lower Chinese total demand

World trade	-0.49
World GDP	-0.24
Real GDP	
US	-0.03
Japan	-0.11
Euro area	-0.04
S-E Asia	-0.18
India	-0.05
Latin America	-0.17
Russia	-0.12
Middle East	-0.30
Africa	-0.16

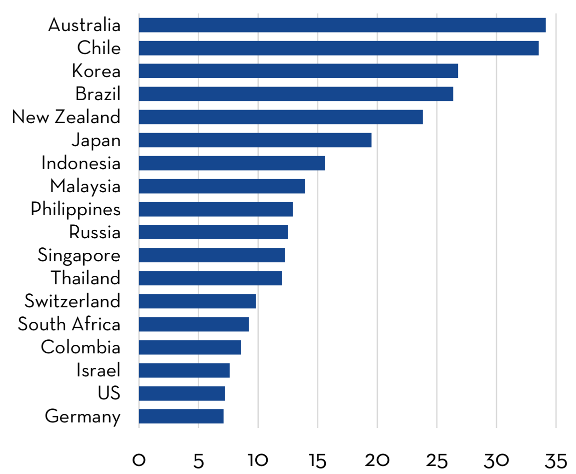
Source: Prometeia.

The effects of the epidemic on the Chinese economy will be felt in the form of shocks to both demand and supply. The choice/obligation to remain at home in the Hubei province in order to reduce the risk of contagion, will reduce the demand for goods and services in China, translating into fewer imports. But the biggest and more persistent effect is going to be on the supply side, as the much reduced working hours is decreasing total Chinese production, with potential effects on production worldwide.

There will be relevant international spillovers. According to the geographical distribution of goods exports to China, net exporters of raw materials and agricultural products, such as Chile, Brazil, Australia and New Zealand, are the most exposed to Chinese demand. Also, given their close production links with China, South Korea and Japan are at risk, while the US and the main European countries are less exposed, at least at the aggregate level (Chart A). In addition, China is an important supplier of goods, especially to the Asian countries, given the strong interconnections in production processes (Chart B). European countries are relatively less dependent on Chinese goods; in 2018, around 7% of total imports in Germany and Italy and 5% of French imports, came from China.

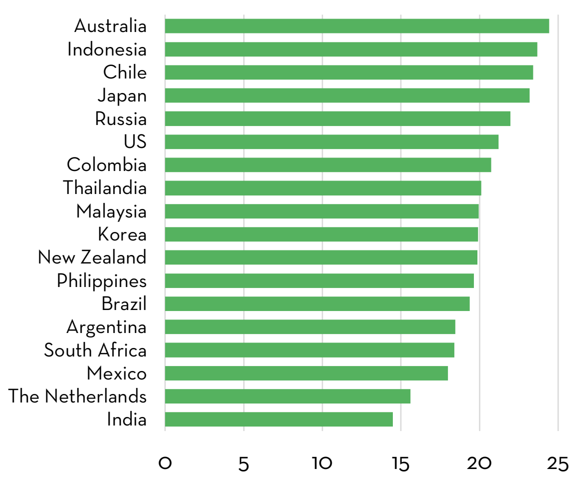
Nevertheless, the Hubei region is a crucial supplier for some of the world's (not just China's) biggest

Chart A - Exports to China
exports of goods, shares on national total exports, 2018



Source: Prometeia's calculation on IMF data.

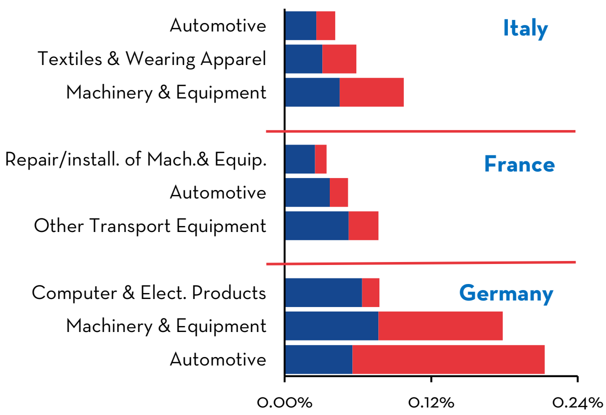
Chart B - Imports from China
imports of goods, shares on national total imports, 2018



Source: Prometeia's calculation on IMF data.

carmakers. Therefore, **significant negative spillover effects from China cannot be excluded at both the sectoral level and even at the aggregate level.**

Chart C – Dependency on Chinese inputs
value of intermediate goods from China as % of national production



Source: Prometeia's calculations on World Input Output Database.

A preliminary analysis of the role of China as a direct and indirect supplier of intermediate goods confirms the major exposure to the Chinese economy of Asian countries compared to the main industrialized nations. In the case of South Korea, the share of direct and indirect inputs from China is higher than 5% of total intermediate inputs, in Japan it is 2.3%, and in Germany, the US, France, Spain and Italy this share is below 2%. These results are based on a combination of the different shares of Chinese inputs in different sectors, and the different weights of these sectors. For instance, in Germany, three sectors (automotive, machinery and equipment, computer and electronics) absorb more than a quarter of total inputs from China (Chart C); however, in Italy and France, dependence on Chinese inputs is less concentrated in specific sectors.

With respect to **services**, it should be noted that, in 2018, Chinese tourism abroad represented 10.6% of global tourism, corresponding to $277 billion.

A simulation of Prometeia's international model suggests that a **1% reduction in Chinese total demand with respect to a baseline scenario without the shock would reduce world trade by almost 0.5pp and would reduce global GDP by 0.3pp, with uneven effects across countries,** penalizing more emerging economies, and under the assumption of no economic policy accommodation and no exchange rate variations (Table1b).

It is clear that **the total cost of the coronavirus will depend on how long it lasts** and the economic policy support - especially after it begins to subside.

With respect to economic policy, the People's Bank of China has already taken actions to support the economy. It has increased liquidity in the domestic market, eased credit conditions especially for enterprises engaged in seeking a cure for the virus and producing medications for pneumonia (pharmaceuticals, medical goods, etc.), has facilitated bond issues, and reduced interest rates on the medium-term loans. In general, **the reaction of economic policy authorities** to the virus, in terms of expenditure for hospitals, medicines, research, etc., **suggests that public expenditure will increase and will not be constrained by the amount of debt.** This is reassuring in terms of avoiding a recession, but we are aware, nevertheless, that growth could be constrained in the medium term.

Overall, we expect the measures implemented so far will limit contagion and succeed in containing the most risky period to Q1 and Q2 of 2020, and that this will be followed by improved confidence worldwide and a rebound of Chinese economic activity in Q3 2020, in line with the experience of previous cases of infection (including among others SARS). Nevertheless, even if the coronavirus emergency is not long lasting, **the global economy will suffer negative effects**, given the high trade integration of China. **According to our scenario, in 2020 global trade will grow by 1.1%, a downward correction of 0.3pp with respect to the January Brief, and annual global GDP growth will halt at 2.5%, the lowest rate since the great recession.**

Focusing on Italy, the correction to world trade growth reduces average GDP growth by about -0.02%. In addition to this average impact via the trade channel, two other sectorial effects should be considered in the case of Italy. First, the travel restrictions resulting from the virus epidemic could significantly reduce the number of tourists from China: since the annual expenditure of Chinese tourists in Italy amounts (in 2018) to 1.6% of total foreign tourist expenditure, this represents 0.04% of GDP. Second, there may be problems, and quite substantial ones, in certain specific production sectors, due to Italy's relative exposure to some automotive and mechanical engineering value chains.

Overall, we are revising our global GDP forecast for the whole of 2020 down by 0.1pp due to the new coronavirus outbreak and on the assumption that its effects will be limited to the first half of the year.

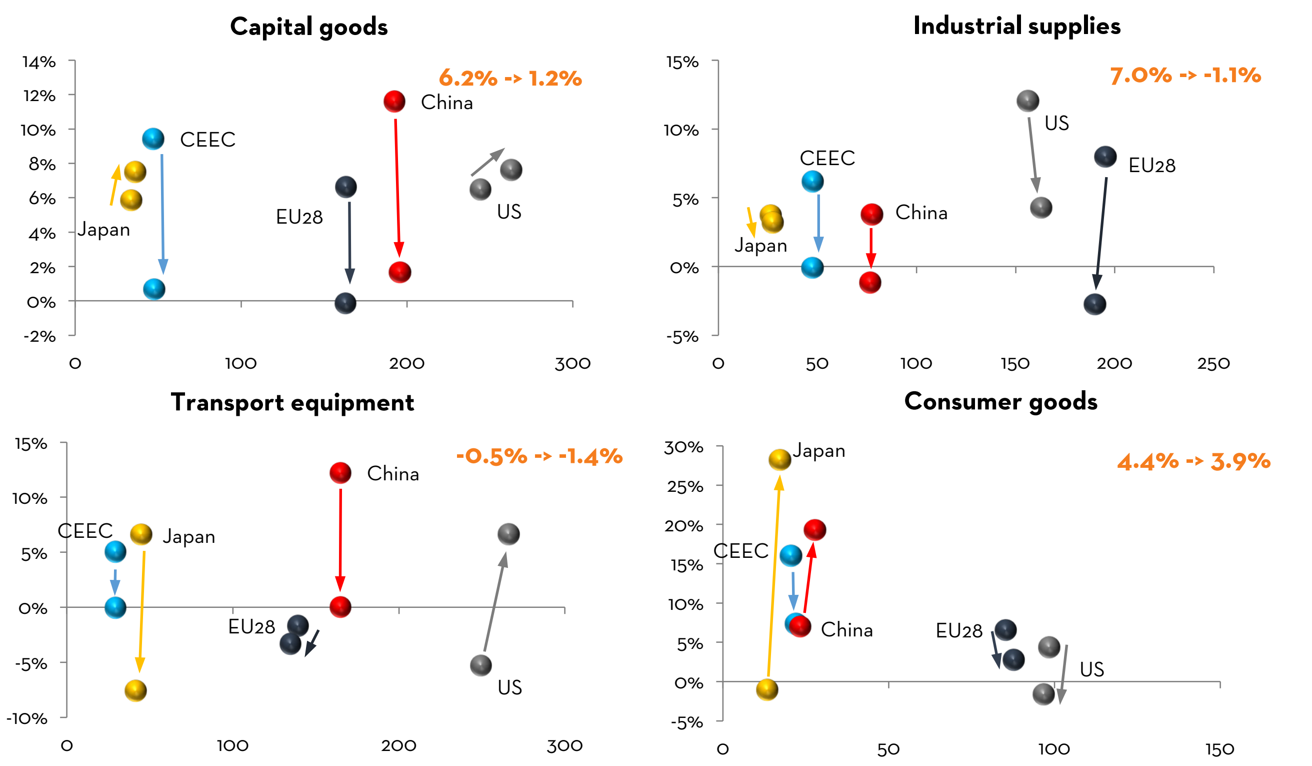
Widespread weakness of German exports

Traditionally, exports are one of the main drivers of the German economy. In 2019, they decelerated in nominal terms: available (10 month) data show exports growing at a rate of around 0.9% yoy while in the same period of 2018 they grew by 4.1%. We analysed German export flows to identify some stylized facts, using detailed by product and by partner data (CN8, 8-digit Combined Nomenclature), aggregating them in significant macro-sectors following the BEC (Broad Economic Category) classification. **The results show widespread weakness in exports for the most important industrial sectors and to most economic areas, in particular to the EU28.**

Chart A shows the value in euros of German goods exports (horizontal axis) and their growth rate (vertical axis), for each macro-sector. The labels indicate the export destination countries/areas (we selected the most relevant ones). The arrows indicate the change in the rate of export growth from 2018 to 2019 (growth rates are computed on the first 10 months), to provide a better/worse picture in 2019 with respect to the previous year. The horizontal position shows the relevance of the sector.

German global exports of Capital Goods, Industrial Supplies and Transport Equipment, which are very similar in volume, grew at zero or less in (the first 10 months of) 2019 with a significant deceleration compared to 2018 (see the figures in orange in the top right corner of each panel). In these three sectors, the rates of growth of exports to EU countries (in particular, to the Central and East European Countries, CEEC) and China, fell significantly in 2019 compared to 2018. However, exports to the US, especially in the Transport and Equipment sector grew. The Consumer Goods sector is about half the size of the other sectors mentioned, and its growth, high especially in terms of exports to Asia in 2019, was not sufficient to offset the losses experienced by Germany's exports from the other three sectors.

Chart A – German exports by sector and partner: level and dynamics in 2018 and 2019
*billion of euro and % change yoy (first 10 months cumulated)**



*On the top right corner of each panel, in orange, the change in the growth rate of German export to all countries for each macro-sector.

Source: Prometeia's calculations on Eurostat data.

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

	2018	2019	2020
World real GDP	3.7	3.0	2.5
World Trade	3.4	0.2	1.1
Manufacturing prices $	5.4	-0.5	1.0
Brent oil price ($/brl, level)	71.6	63.7	61.1
GDP			
- United States	2.9	2.3	1.7
- Japan	0.8	0.8	0.3
- EMU	1.9	1.2	0.9
- China	6.6	6.2	5.0
Consumer prices			
- United States	2.4	1.8	2.0
- Japan	0.9	1.0	1.4
- EMU	1.8	1.2	1.2
- China	2.3	3.3	3.0
$/€ exchange rate (level)	1.18	1.12	1.10
£/€ exchange rate (level)	0.885	0.877	0.859

Table 2 - Italy: main indicators (% change)

	2018	2019	2020
GDP*	0.7	0.2	0.1
Imports of goods fob and services	2.4	0.7	1.4
Private consumption	0.8	0.5	0.6
Government consumption	0.4	0.4	-0.3
Gross fixed investment:	3.0	1.9	1.0
- machinery, equipment, other products	3.4	1.1	0.9
- constructions	2.5	2.8	1.1
Exports of goods fob and services	1.3	1.7	1.2
Domestic demand	1.0	-0.1	0.2
Industrial production	0.6	-1.4	-0.6
Trade balance (% of GDP)	2.7	3.4	3.6
Terms of trade	-1.4	1.4	1.1
Consumer prices	1.1	0.6	0.8
Per capita wages - manufacturing	0.5	1.3	0.9
Total employment	0.8	0.6	0.1
General government balance (% of GDP)	-2.2	-2.1	-2.3

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

Table 3 - Exchange Rates and Interest Rates

		19 Q1	19 Q2	19 Q3	19 Q4	20 Q1	20 Q2	20 Q3	20 Q4
Exchange rates vs euro	US dollar	1.14	1.12	1.11	1.11	1.10	1.09	1.10	1.11
	Yen	125.1	123.3	119.2	120.4	120.0	119.7	120.8	121.0
3 month interest rates %	US libor	2.70	2.51	2.18	1.90	1.74	1.60	1.53	1.53
	Euribor	-0.29	-0.29	-0.38	-0.37	-0.35	-0.35	-0.35	-0.35
10 year government bond yields %	US	2.64	2.33	1.79	1.80	1.65	1.59	1.61	1.63
	Germany	0.08	-0.14	-0.54	-0.37	-0.38	-0.37	-0.31	-0.29
	Italy	2.71	2.43	1.32	1.19	1.07	1.01	1.14	1.30

Table 4 - Real GDP: comparison of the forecast - *% qoq and annual % change - historical data in bold*

		19 Q1	19 Q2	19 Q3	19 Q4	2019	20 Q1	20 Q2	20 Q3	20 Q4	2020
United States	Brief January 2020	**0.8**	**0.5**	**0.5**	0.4	2.3	0.3	0.3	0.4	0.4	1.5
	Brief February 2020	**0.8**	**0.5**	**0.5**	**0.5**	2.3	0.4	0.3	0.4	0.4	1.7
EMU	Brief January 2020	**0.4**	**0.2**	**0.2**	0.2	1.2	0.3	0.3	0.4	0.3	1.1
	Brief February 2020	**0.4**	**0.2**	**0.3**	**0.1**	1.2	0.2	0.2	0.4	0.3	0.9
Italy	Brief January 2020	**0.1**	**0.1**	**0.1**	0.0	0.2	0.1	0.2	0.1	0.2	0.5
	Brief February 2020	**0.2**	**0.0**	**0.1**	**-0.3**	**0.2**	0.1	0.1	0.2	0.2	0.1

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based on data available up to 17th February 2020

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