ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia

MAY 2020 – No. 20/4

Executive summary

COVID-19: huge human and economic costs to the global economy…

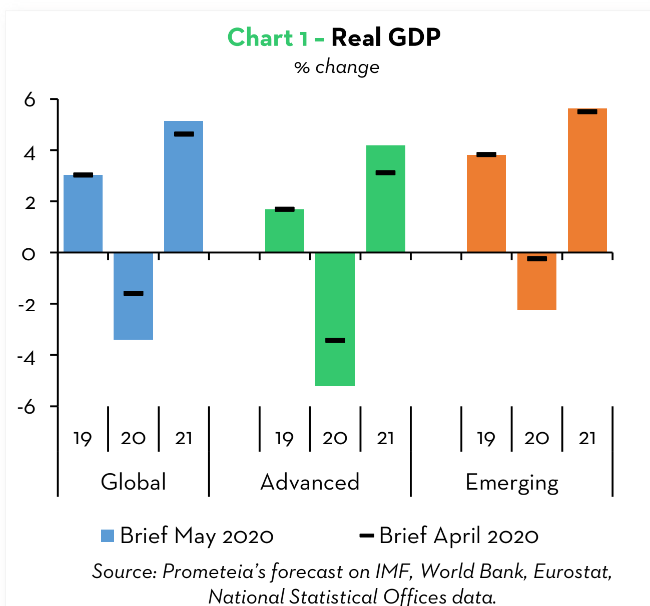
- The coronavirus outbreak and the measures to contain its spread (physical distancing and lockdowns) are now affecting those countries, which, only a month ago, seemed only marginally involved.
- In Q1, US and Chinese real GDP were in line with our April forecasts (-1.2% qoq and -10.6% qoq, respectively). However, the deterioration in the US labour market and the slow recovery in China, especially in the service sectors, have led us to revise their GDP projections downwards.
- In the euro area, the economic impact of the containment measures is higher than we expected. GDP fell by 3.8% qoq in Q1, with France and Spain below -5% qoq.
- Overall, we have revised global growth downward (Chart 1), but maintained the assumption of a gradual phase-out of the containment measures in all countries in May, in line with the reduction and stabilization of daily contagions.
- The risk of a second wave of infections, and hence more lockdowns and the halting of economic activities, remains significant and further downward revisions cannot be excluded.

… and for Italy too

- In Q1 2020, Italy's GDP fell by 4.7% qoq, in line with our forecast (-4.5%, Table 4). Nevertheless, we have revised our projected GDP growth for 2020 downwards, from -6.5% (April Brief) to -8.5% (Chart 2). This revision is based on a longer lockdown than assumed initially, and a slower than expected recovery, especially in some service activities.
- Government has approved a new package of fiscal measures as part of the 2020 Economic and Financial Document. These measures are worth €55 billion (3.3% of GDP) (see InFocus 1), bringing the overall fiscal measures for 2020 to fight the COVID-19 crisis to €75 billion (4.5% of GDP).
- The fall in GDP and the discretionary measures will increase public debt to 155.4% of GDP in 2020 (134.8% in 2019) and this could pose obvious risks to its sustainability. The second InFocus in this Brief shows how a significant share of the 2020 financing needs will be covered by the ECB's purchases.
- Despite substantial monetary policy measures, the BTP-Bund yield spread remains relatively high, increasing the vulnerability of public accounts.

Chart 1 – Real GDP

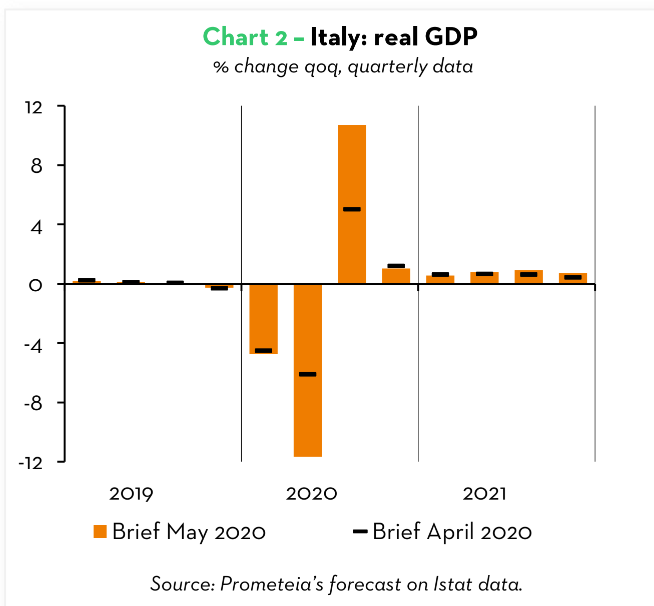
% change



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

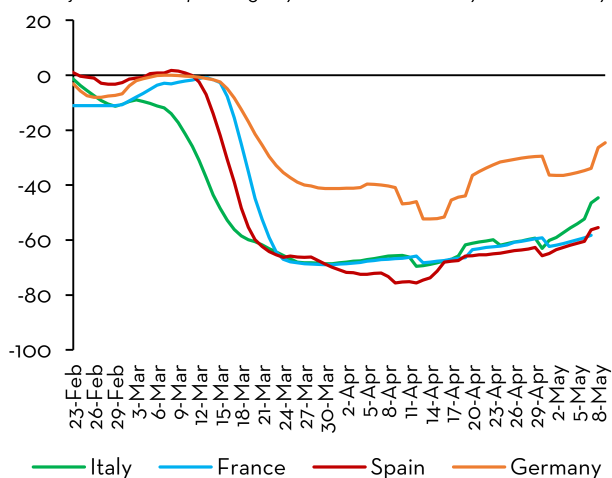
Chart 2 – Italy: real GDP

% change qoq, quarterly data

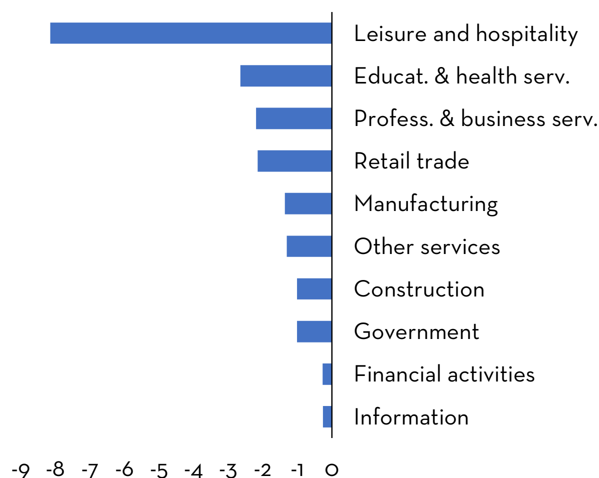


Source: Prometeia's forecast on Istat data.

Global scenario



Source: Google Mobility Report.



Source: Prometeia's calculation on BLS data.

A price war in the oil market and hence more suffering for net oil exporters has been avoided. The Brent oil price bounced back above 30 dollars per barrel, in reaction to the agreement reached by the OPEC+ group of countries to cut daily production by 10 million barrels from 1st May. The higher than expected reductions in US production and early signs of a mild recovery in demand for oil and gasoline have worked in the same direction.

In the euro area, the lockdown costs are high and uneven across countries. While GDP fell hugely in France, Spain and Italy, in Germany it fell by 2.2% qoq. Real time data on the mobility suggest a less stringent lockdown in Germany (Chart 3). Based on Q1 data and in line with the fall in confidence in April, we have revised Q2 EMU GDP growth downward (see Tables 1, 2). The large expected fall in output in Q2 is, of course, related to the fact that the lockdowns were in place for longer compared to Q1 (April and at least a part of May, in most cases). For the whole year, we expect euro area GDP to fall by 7.3% with a bounce back of 4.9% in 2021.

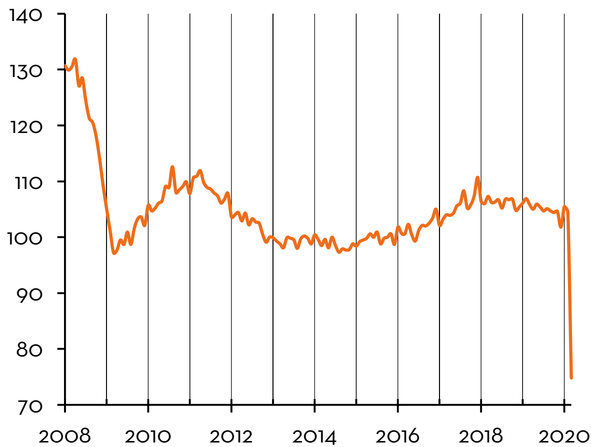
Some measures have been announced at the European level. The agreement at EU level is based on: use of ESM funds up to 2% of national GDP (€240 billion overall); establishment of a temporary lending facility to protect employment (SURE, €100 billion); and mobilization of financing for businesses, mainly SMEs, by the EIB (€200 billion). In addition, a new instrument to boost the European economy - the Recovery Fund - is under discussion.

The strong deterioration of the US labour market will put a higher than expected burden on domestic demand. According to the Bureau of Labor Statistics, since February, more than 25 million people have lost their jobs and 8 million have left the labour market (Chart 4). Despite huge fiscal policy efforts to sustain household income (almost $600 billion, according to the measures adopted since March, around 23% of the additional spending excluding guarantees for firms), we expect a huge fall in private consumption which will contribute to a fall in GDP of 10% qoq in Q2.

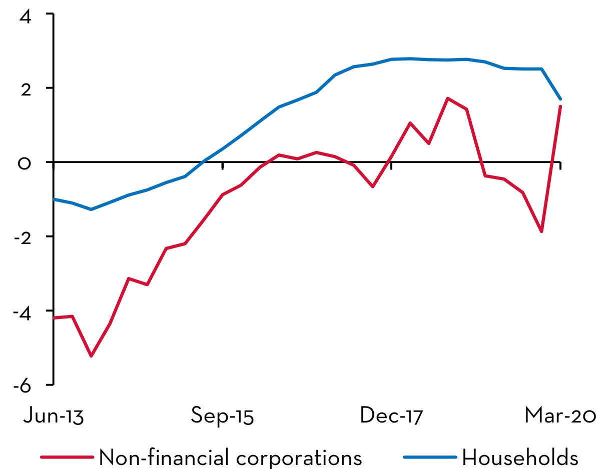
China is planning further fiscal stimulus, adding 1.2 trillion yuan to the already announced 1.3 trillion yuan of funds that local governments can collect via the issue of special bonds to finance new projects. China's economic authorities are targeting infrastructure investments to support the recovery since uncertainty will curtail household consumption and exports will suffer from the global economic slowdown. However, so far, local governments have not exploited this source to the full, which suggests some caution in predicting the effects of public spending on growth.

The strong commitment of the Fed and ECB to keep credit markets liquid has pushed market rates to historic lows. In the US, since mid-April, the three-month market rate decreased by more than 50bp on the back of the Fed's determination to avoid a credit crunch and guarantee abundant liquidity. In parallel, the new measures put in place by the ECB (PELTROs and further ease of the conditions on the TLTROIII operations) has contained the risk in the European liquidity market. In the euro area, the three-month market rate returned to -30bp, (it remained above the -20bp in the second half of April). In the second half of 2020, in line with a mild recovery, we expect the credit risk to drop further and the three-month market rate to stabilize around -35bp (Table 3).

Italy



Source: Istat.



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

The latest available data confirm the dramatic effects on Italy's GDP of the COVID-19 pandemic and the containment measures put in place to curb its spread. According to preliminary data and in line with our forecast (-4.5%), Italian GDP fell by 4.7% in Q1 2020 compared to the previous quarter. With the exception of macro aggregates, information on the composition of GDP is not yet available. On the demand side, both domestic and net foreign demand contributed to the deep contraction. On the supply side, the output of all main sectors fell.

Industrial production plummeted in March. The impact of the lockdown measures, in some areas already in place since early March and extended to the entire national territory in the last week of March, has resulted in a higher than expected decline in industrial production, -28.4% mom and -29.3% yoy (Chart 5), and far greater than observed in other European countries. In Q1 industrial production dropped by 8.4% qoq. No sector has been spared, but some, such as food, chemicals and pharmaceuticals, have suffered less. The sectors most affected by the lockdown are automotive and textiles, down by 50% mom in March.

New car registrations fell again in April. In March there was a drastic fall in new car registrations of almost 90% over 12 months, with a similar fall recorded in April.

Fall in exports. In March, Italian goods exports fell by 16.8% mom, due to the combined effect of Italy's closures, the collapse in international trade and some interruptions to supply chains. February data on tourism, one of the sectors hit hard by the crisis, show reduced expenditure by both foreigners in Italy and Italians abroad (-13.2% and -11.3% yoy). An indicator of the crisis in this sector is air traffic, which, in March, fell overall in Italy by 66.3% yoy.

The labour market shows the first signs of weakness with the number of inactive people increasing as a result of the COVID-19 crisis. Because workers under the government-subsidized furlough scheme (Cassa Integrazione Guadagni), which has been extended to all firms, are classified as employed, the available and provisional labour market data still do not fully capture the potential negative effects of the coronavirus crisis on employment, which, in March, fell by only 0.1% mom. So far, the effects of the epidemic on the labour market are being seen in the sharp increase in the number of inactive people, which has led to a 1pp reduction in the unemployment rate, from 9.3% in February to 8.4%. The worsening employment expectations are reflected in both firm level survey data and the significant increase in claims for furloughed employees.

Consumer inflation fell to zero in April. According to preliminary estimates, annual inflation fell to zero in April, after a 0.1% increase in March. The decrease in inflation was the result of two competing forces: on the one hand, the rapid decline in energy prices (-9.6%) due to sinking global oil prices; and on the other hand, an increase in the price of unprocessed food (4.3%), related, in part, to declining supply and strong demand due to the lockdown measures implemented to contain COVID-19.

Loans to non-financial corporations rose in March. The crisis has led to a reduction in companies' financial needs as a result of the deep contraction in investment, but has increased the demand for liquidity, required to avoid a massive series of default,

especially in the service sectors. Government loan guarantees and monetary measures to ensure abundant liquidity in the banking sector along with the easing of banking regulation have been supporting both demand for and supply of loans in the lockdown phase. This is reflected in the increased loans to firms in March of more than €17 billion (1.4% yoy compared to -1.2% in February, Chart 6). However, loans growth to households slowed (1.7% yoy compared to 2.5% in February), due to the drastic contraction in durable consumption as a result of the lockdowns, increased uncertainty about future incomes and less generous liquidity support measures for households compared to firms.

The Italian scenario: large fall in GDP in 2020 ... We expect GDP to fall by 8.5% in 2020 and rebound to 4.5% in 2021 (Table 2). All demand components will contribute to this fall with the exception of public spending, which will reflect the outlays related to the health care system. We expect a technical recovery in activity in Q3 2020, when a gradual return to normality should prevail and the effects of the economic policies to support households and firms will come into effect. In 2020, we foresee a strong contraction in the number of full-time equivalents (-5.4%) and a successive rebound (2.8%) in 2021. Support for private sector liquidity will not be lacking in 2020. The growth in loans to firms, thanks to the important measures in support of liquidity, are expected to grow (2% yoy), although to a different degree between sectors and business size, while loans to households are expected to decrease by -0.2%.

... and a historic increase in public debt. In 2020, the general government deficit is expected to rise sizeably, up to nearly 10% of GDP from 1.6% in 2019. The drop in economic activity will have a very large impact on automatic stabilizers (around 4pp of GDP), due mainly to the reduction in fiscal revenues, which will fall by 7% compared to 2019.

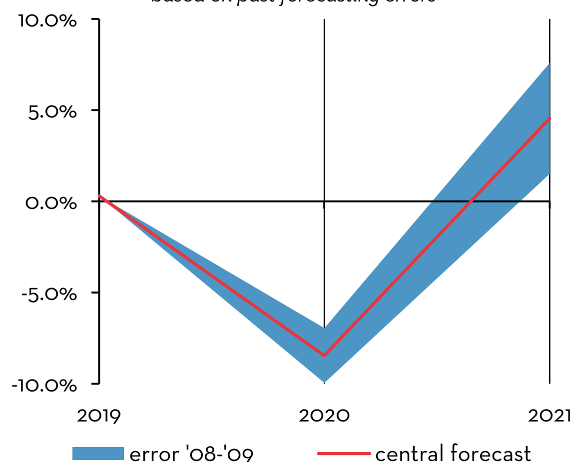
The overall amount of discretionary measures will be about 4.5% of GDP. The cyclical effects will be amplified by the effects of discretionary measures, which are projected to be around €75 billion higher net public expenditure. The fiscal package adopted in March (Cura Italia Decree) is worth €20 billion (1.2% of GDP) and the newly approved package will add measures worth €55 billion (3.3% of GDP). We estimate that these measures will sustain GDP growth by about 3pp in 2020. In 2021, the rebound in economic activity will support revenue and the phase-out of the temporary measures will contain expenditure. The primary balance is expected to remain negative (-6.2% of GDP in 2020 and -1.4% in 2021), weighing on the debt ratio.

The government debt-to-GDP ratio is expected to reach 155.4% in 2020 and to decline to 153% in 2021. The high level of debt poses obvious risks to its sustainability. InFocus 2 discusses how a significant share of the 2020 financing needs will be covered by the ECB.

Risks to the projection

- The risk of a slower than expected recovery and/or of a second wave of contagion and, hence, of another halt to production, remains high.
- The disruptions to global value chains could prove more painful than expected, resulting in a deeper global trade recession.
- Several emerging countries with high domestic and external debt have limited resources to cope with the pandemic. Possible further devaluations, in addition to impoverishing national economies, could trigger financial crisis hotspots.
- If Europe does not reach an agreement on a common policy response, further steps towards integration could be hindered significantly.
- In Italy, the sharp increase in public debt, due to the emergency measures to support households and firms, could create tensions in financial markets creating further headwinds against a recovery.

Chart 7 – Italy: Prometeia's forecast of annual GDP growth – *central value and uncertainty based on past forecasting errors*



Source: Prometeia's calculations.

The Italian government response to the coronavirus pandemic

On 24 April 2020, the Italian government submitted the 2020 Economic and Financial Document (EFD 2020) with the updated economic and public finance forecasts. In accordance with the minimum guidelines provided by the European Commission in light of the exceptional circumstances related to COVID-19, the EFD presents only part of the usual forecasting frameworks. The current legislation projections are limited to the years 2020 and 2021 and the policy scenario provides information only on the budgetary effect of planned "new policies" to support the economy.

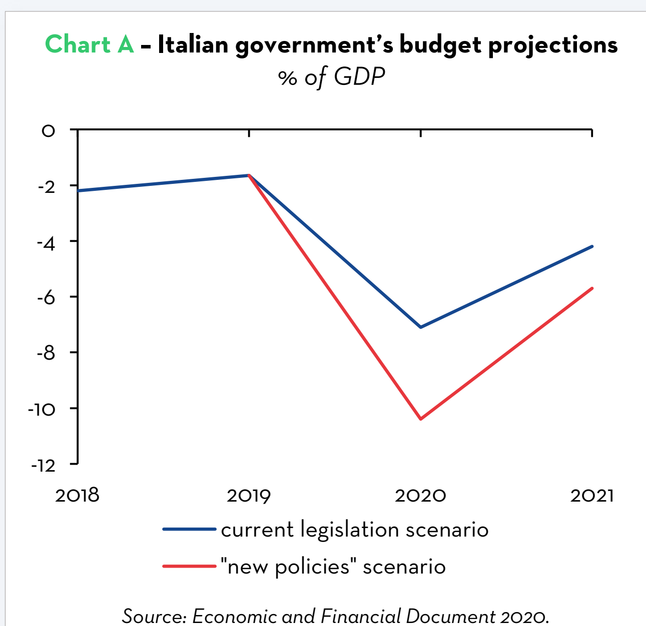
In the current legislation projections, which assume a phase-out of the lockdowns starting in May, and an end to the economic impact of the epidemic in Q1-2021, **GDP growth is set at -8% in 2020 and 4.5% in 2021, while the budget deficit will surge to 7.1% of GDP in 2020 before falling to 4.2% of GDP in 2021** (Chart A). In the current year, the projections include the impact of the "Cura Italia" Decree approved on 18 March (see April Brief), which is expected to increase the deficit by 1.2% of GDP and have a positive effect on GDP of 0.5pp. In 2021, the scenario foresees the phasing out of the 2020 extraordinary measures and the activations of the previously legislated increases in VAT rates and excise duties (implying higher revenues of about €20 billion). Debt-to-GDP ratio is expected to jump to 151.8% in 2020 and decline to 147.5 in 2021.

In the policy scenario, new expansive measures to contain the effect of the pandemic are planned to be 3.3pp of GDP (€55 billion). The estimated impact on GDP growth of such additional measures**, which would bring the deficit to 10.4% of GDP in 2020,** is not provided for in the document. In 2021, the government plans not to increase the VAT rates and excise duties provided for in the current legislation, further weighing on the planned deficit-to-GDP ratio which will reach 5.7%.

The new measures are aimed at strengthening and extending those announced in March. Parliament has authorized a budget deviation of €55 billion, bringing **the total amount of the discretionary budgetary response to the pandemic crisis to €75 billion, 4.5% of GDP. The new decree, so-called "Rilancio"** (Relaunch Decree), **will cover higher expenses related mainly to strengthening social protection schemes and supporting firms** (Chart B). Support for firms will include mainly SMEs, and include a non-refundable grant for businesses and self-employed people who have suffered a more than 30% reduction in turnover, rent relief, reductions to electricity bills and cancellation of the June IRAP (the regional business tax) instalment It will also include tax incentives to strengthen companies' capital bases, and a range of state aid measures including wage subsidies and support for production and R&D activities related to COVID-19. In addition, the decree will provide financing for Emergency Income for vulnerable households, a 110% bonus for energy requalification and anti-seismic interventions, higher school expenses and a holiday bonus to support the tourism sector.

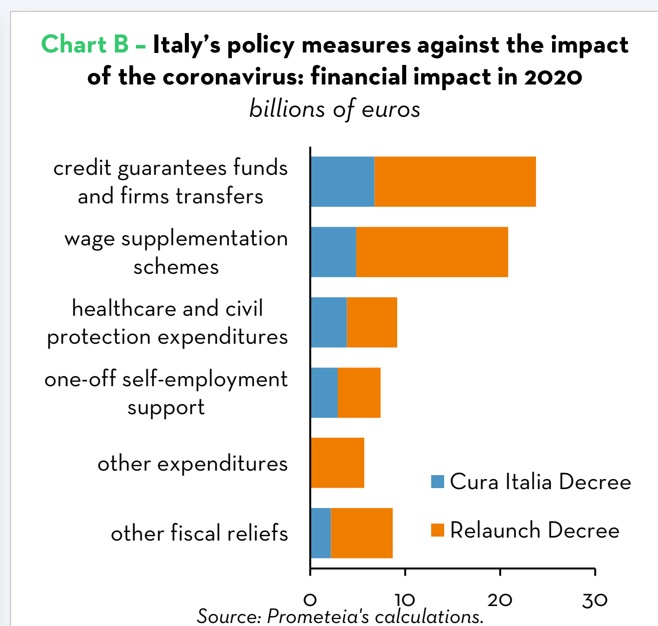
In our estimates, the whole fiscal package will provide about 3% support for 2020 GDP, which should help to contain the deficit by around 1.5% of GDP.

Chart A - Italian government's budget projections
% of GDP



Source: Economic and Financial Document 2020.

Chart B - Italy's policy measures against the impact of the coronavirus: financial impact in 2020
billions of euros



Source: Prometeia's calculations.

ECB QE will ease the Italian debt rollover risks: will it be enough?

The explosive effects of the pandemic and the difficulty in foreseeing a definite end to the emergency, have necessitated **numerous measures to support economic activity.** These will increase public sector borrowing requirements and, consequently, recourse to the market, which may be reflected in an increase in government's financing risks.

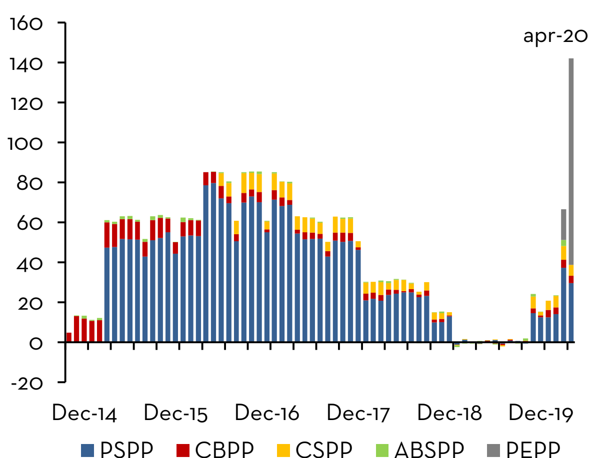
Even in "normal times", refinancing the Italian debt requires large amounts of securities every year, more than €400 billion; the effects of the pandemic will increase this amount considerably in 2020. Compared to 2019, while renewals of maturing securities will be similar, **borrowing requirements could rise to around €190 billion (from €43 billion in 2019), bringing overall financing needs to around €550 billion. This implies that investors will need to increase their exposure to Italian government bonds and confirm** their confidence by increasing the securities held in their portfolios. However, there are **some considerations that might mitigate this rollover risk**.

First, **a significant proportion of maturing securities are held by institutional and domestic investors** (almost 70% according to our estimates), which, given market conditions and home bias, should reconfirm their exposure. Second, **the Eurosystem's contribution will be much higher than in recent years** (Chart. A). While there were no net purchases in 2019, at the beginning of 2020, purchases of EMU securities under APP (Asset Purchase Programmes) amounted to €20 billion per month and, as the crisis worsened, it was decided to expand the quantitative easing programme from mid-March, involving both an additional net purchases plan of €120 billion up to end 2020 and the launch of the PEPP (Pandemic Emergency Purchase Programme), which will result in a further increase in purchased securities of €750 billion by the end of 2020.

In this context, in 2020**, total purchases of Italian government bonds by the Eurosystem are estimated at €191 billion,** assuming that the share of government bonds purchased in the overall programme is in line with Italy's capital key and that possible deviations will be temporary. **Net purchases will be €154 billion in the current year, which will cover a large part of the new borrowing requirement, and reinvestments will be around €36 billion. Thus, the residual amount of Italian securities to be placed on the private market will be around €356 billion, lower than in 2019** (€386 billion; see Chart B).

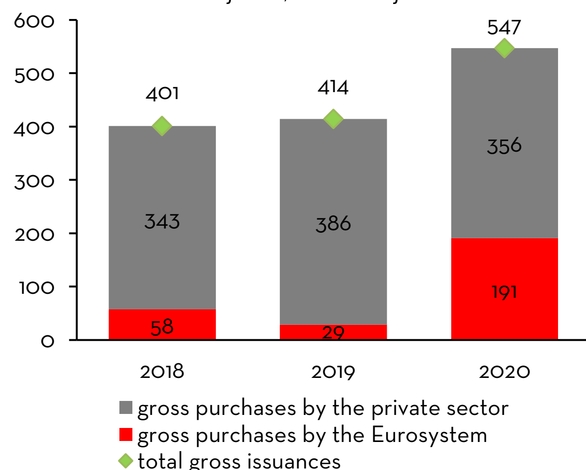
The ECB's purchase programmes seem adequate, therefore, to meet the financing needs of Italy's debt in 2020 and the amount of gross issuances on the private market could even decrease compared to previous years, containing rollover risks. This reduction could become more marked if funds provided by European institutions are used to partly cover the deficit, including the ESM and the programme SURE, which would reduce net issuances by around €50 billion.

Chart A European securities purchased, APP programme - *monthly flows, billions of euros*



Source: Prometeia's calculations on ECB data.

Chart B – Gross Italian government bond issuances and ECB purchases
annual flows, billions of euros



Source: Prometeia's calculations on ECB and MEF data.

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

	2019	2020	2021
World real GDP	3.0	-3.4	5.1
World Trade	0.3	-14.0	9.2
Manufacturing prices $	-1.1	0.0	1.5
Brent oil price ($/brl, level)	64.2	36.9	37.8
GDP			
- United States	2.3	-3.5	3.4
- Japan	0.8	-4.9	4.1
- EMU	1.2	-7.3	4.9
- China	6.2	1.4	9.2
Consumer prices			
- United States	1.8	0.4	0.6
- Japan	1.0	0.1	0.2
- EMU	1.2	-0.2	0.5
- China	3.3	2.2	2.6
$/€ exchange rate (level)	1.12	1.09	1.10
£/€ exchange rate (level)	0.877	0.882	0.904

Table 2 – Italy: main indicators (% change)

	2019	2020	2021
GDP*	0.3	-8.5	4.5
Imports of goods fob and services	-0.2	-9.6	8.4
Private consumption	0.4	-5.7	3.9
Government consumption	-0.4	2.3	-1.6
Gross fixed investment:	1.4	-13.9	5.6
- machinery, equipment, other products	0.4	-16.2	6.9
- constructions	2.6	-11.1	4.1
Exports of goods fob and services	1.4	-15.3	8.1
Domestic demand	-0.2	-6.5	4.6
Industrial production	-1.0	-16.9	10.7
Trade balance (% of GDP)	3.4	2.7	2.8
Terms of trade	1.5	3.0	0.0
Consumer prices	0.6	-0.3	1.0
Per capita wages - manufacturing	1.9	-0.1	1.1
Total employment	0.3	-5.4	2.8
General government balance (% of GDP)	-1.6	-9.8	-4.9

** 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	1.09	1.09	1.10	1.10	1.11	1.11	1.11
	Yen	120.1	117.1	115.5	115.4	117.2	118.2	118.8	119.3
3 month interest rates %	US libor	1.51	0.66	0.49	0.50	0.50	0.54	0.57	0.69
	Euribor	-0.37	-0.29	-0.32	-0.34	-0.35	-0.35	-0.35	-0.35
10 year government bond yields %	US	1.39	0.67	0.70	0.75	0.81	0.92	1.10	1.33
	Germany	-0.44	-0.51	-0.55	-0.52	-0.46	-0.37	-0.33	-0.27
	Italy	1.25	1.86	1.70	1.68	1.59	1.60	1.63	1.68

Table 4 – Real GDP: comparison of the forecast – % qoq and annual % change

		20 Q1	20 Q2	20 Q3	20 Q4	2020	21 Q1	21 Q2	21 Q3	21 Q4	2021
United States	Brief April2020	-1.1	-8.9	9.5	0.4	-2.5	0.4	0.3	0.3	0.6	3.6
	Brief May 2020	**-1.2**	-10.0	9.6	0.4	-3.5	0.4	0.4	0.5	0.6	3.4
EMU	Brief April 2020	-0.8	-8.4	3.3	0.6	-5.1	1.2	1.6	1.4	1.3	3.4
	Brief May 2020	**-3.8**	-10.7	8.4	1.7	-7.3	0.7	0.9	1.1	1.8	4.9
Italy	Brief April 2020	-4.5	-6.1	5.0	1.2	-6.5	0.6	0.7	0.6	0.4	3.3
	Brief May 2020	**-4.7**	-11.7	10.7	1.0	-8.5	0.6	0.8	0.9	0.7	4.5

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based on data available up to 15th May 2020

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