ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia

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Executive summary

The second wave of CODIV-19, after the rebound in Q3, interrupts the recovery in Europe ...

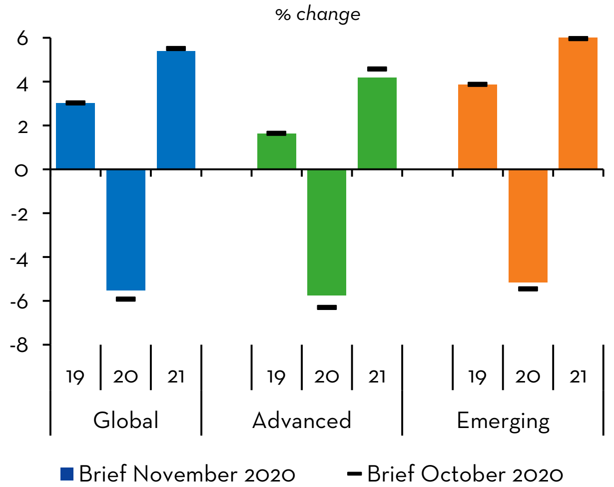
- In China, GDP grew by 4.9% yoy in Q3, in line with our forecasts, the result of 6% yoy growth in industry and a weaker performance of the service sector (4.3% yoy).
- In the OECD countries, the Q3 rebound of GDP was stronger than expected, leading to an upward revision for 2020 with respect to our October estimates (Chart 1), but the level of GDP remained well below 2019 values.
- The available information for Q4-2020 indicates that the global economy maintained momentum in October, despite some uncertainties.
- In Europe, as the number of cases and hospitalizations increase, the risk of a new health crisis is pushing governments to adopt new partial lockdowns and curfews, which, inevitably, will weigh on activity in Q4. It will partly counter the Q3 rebound and will hamper growth in 2021.
- In the rest of the world, COVID-19 continues to cause extensive human and economic hardships, which are requiring major economic policy interventions to help the population and support the economy.

... and in Italy

- The better than expected results for Italy in Q3 (Chart 2) is likely to support activity levels in 2020 despite the negative outlook for Q4. We have therefore revised our forecast for 2020 GDP growth upward to -9% from the -9.6% projected in our October release. This better than expected rebound in Q3 is making us more optimistic about the resilience of the Italian economy in the coming months, although the challenges to come have grown in recent weeks.
- The question now is what 2021 GDP growth will look like. Given the assumption of a slower carry-over into next year and expectations of a series of stop-and-go lockdowns to limit the spread of the virus continuing until late spring, 2021 economic growth will likely be more subdued than expected. Therefore, we have revised our forecast for 2021 downward from 6.2% to 5%.
- The importance of being able to keep the virus under control, but also the adequacy and timeliness of policy support for the most affected sectors (i.e. HoReCa workers, see our first InFocus) and the receipt of EU funding, are fundamental to preventing the health crisis from spiralling into an economic depression.

Chart 1 – Real GDP

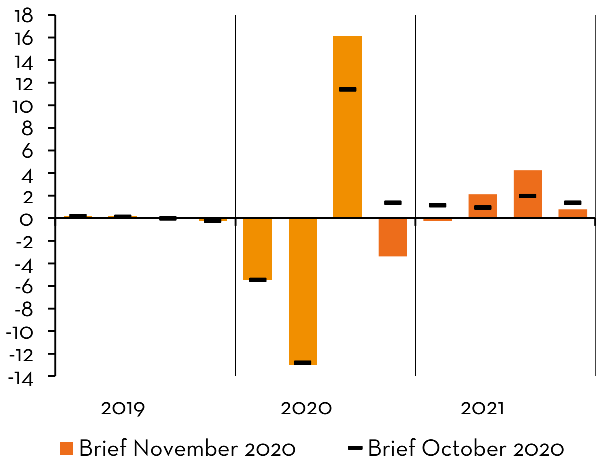
% change



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

Chart 2 – Italy: real GDP

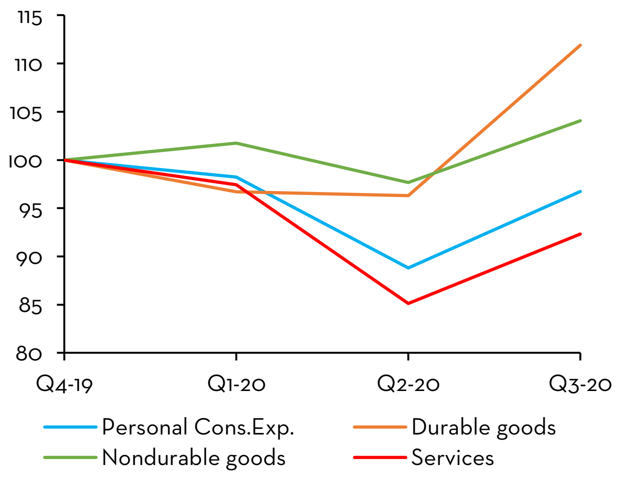
% change qoq, quarterly data



Source: Prometeia's forecast on Istat data.

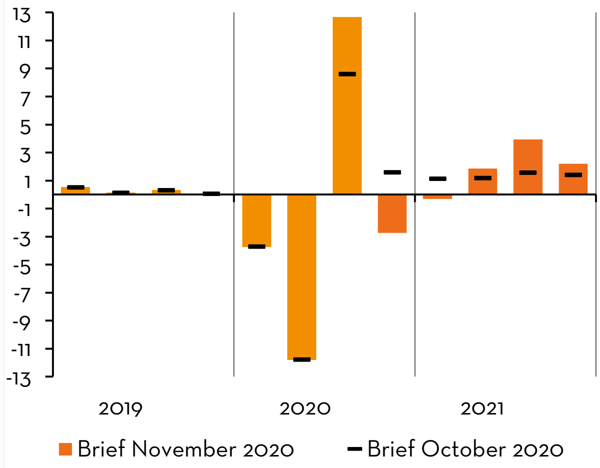
Global scenario

Chart 3 – US household consumption by major type of product *chained US dollar, Q4 2019 = 100*



Source: Prometeia calculations on Bureau of Economic Analysis data.

Chart 4 – Euro area: real GDP *% change qoq, quarterly data*



Source: Prometeia's forecast on Eurostat data.

In July and August, global trade grew faster than expected amidst a recovery of industrial production worldwide. Combined with the strong GDP growth in Q3, this has led us to revise our estimates for 2020 upward (-10.2% compared to -13.4% in the October Brief).

In the US, COVID-19 continues to hamper growth, despite the GDP bounce in Q3… (7.4% qoq, higher than expected), supported by both domestic demand and exports. However, it should be noted that non-residential investments grew by only 4.7% qoq, reflecting firms' uncertainty about future demand. Private consumption grew by 8.9% qoq, with a significantly different pattern of consumption due to the pandemic. Services remain 8% below 2019 levels, but durable goods posted a 16.2% qoq growth surpassing pre-crisis levels in Q3 (Chart. 3).

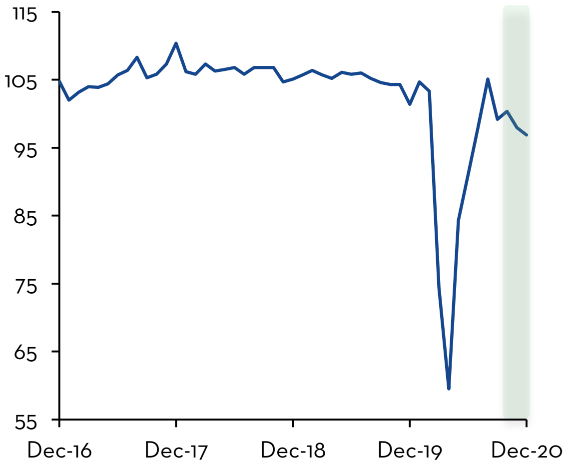
… and is the main concern for economic policy. In the November Federal Open Market Committee meeting, the Fed kept monetary policy unchanged, but declared itself ready to intervene were risks to emerge that might impede attainment of the Committee's goals of full employment and price stability. A new package to support the economy will be the priority for the new president and the new Congress since, so far, the parties have reached no agreement, despite acknowledging the need for intervention. Our forecasts assume that, given the persistent weak labour market, in 2021 around $500 billion could be spent on income support measures for the most vulnerable parts of the population (see InFocus 2).

In Europe, curfews and partial lockdowns are being implemented to limit the spread of the virus. These measures are less strict than those implemented in March and April and, in this scenario, we assume they will be sufficient to control the pandemic. Most of the current restrictions are planned to expire in December, but since there is no clear solution to the health crisis expected in the short term, we foresee constraints on activity to continue in Q1-2021.

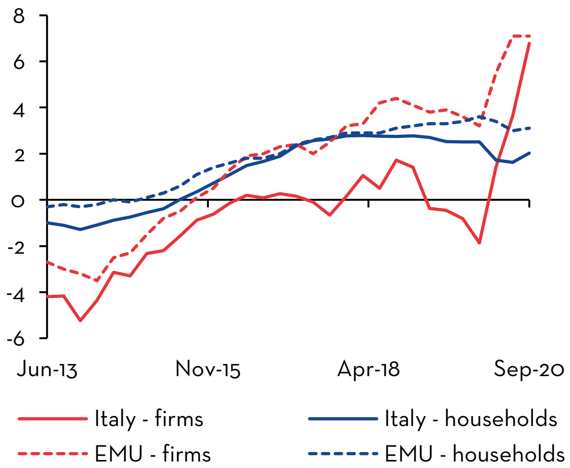
We expect euro area GDP to fall in Q4-2020 and Q1 2021, although less severely than in Q2-2020 and with differences among countries, depending on the stringency and duration of the constraints and the relative weight of the most exposed sectors (see InFocus 1). In the euro area, GDP is expected to fall by 2.7% qoq in Q4-2020; but, given the strong rebound in Q3 we have revised the annual growth rate upward (to -7.3%, from -8% in the October Brief). We expect a weak start to 2021 due to the health emergency. However, in the second half of 2021, implementation of the NGEU should accelerate GDP growth although this will not be enough to compensate for the loss of growth due to the second wave of COVID-19 (Chart 4): annual 2021 GDP growth is expected to be stuck at 4.3% (5.3% in the October Brief).

More support from the ECB which has declared itself ready to expand its monetary policy further from December, if necessary. We confirm our expectation of enlargement of the Pandemic Emergency Purchase Programme to allow for additional ECB's securities purchase (to €400 billion compared to the €300 billion foreseen in the October Brief), and the extension of the programme until the end of 2021. In addition, we expect more favourable Targeted Longer-Term Refinancing Operations conditions in terms of both their cost and their duration.

Italy



Source: Prometeia's forecast on Istat data.



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

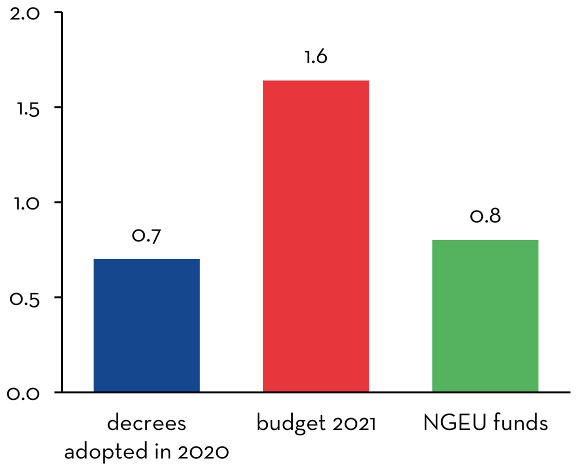
Q3 and Q4 in summary. Following the end of the spring lockdowns, in Q3-2020 Italy's GDP experienced a strong and widespread rebound (16.1% qoq), which encompassed manufacturing (Chart 5), construction, several service sectors (but primarily tourism) and durable goods (furniture, vehicles, electronic devices). However, in many sectors the recovery has not equalled the fall: manufacturing recovered to its pre-crisis levels in the summer, construction exceeded them, but services remain generally below pre-crisis levels. The latest measures implemented to limit the spread of the virus are likely to increase these gaps, although the response to the second wave has, so far, not involved the very strict lockdowns implemented last spring. However, the physical distancing measures reintroduced in Italy (and throughout Europe) are likely to lead to an estimated fall in GDP in Q4 of -3.4% qoq.

A peculiarity of the crisis is the sharp drop in households' propensity to consume. The combination of the effects of the shutdowns and uncertainty about the future resulted in a fall in household consumption in H1-2020, reaching the -17.3% yoy in Q2. Households' disposable income has also dropped considerably (-7.0% yoy), due mainly to the sharp contraction in the number of hours worked. As a result, household propensity to consume fell by 10.4pp yoy, to reach an even lower level (81.9%) than observed during the double dip recessions in 2008-09 and 2011-12, with exceptionally high saving flows (€50 billion in Q2, more than twice the pre-crisis level). Although consumption picked up over the summer months, the recent increase in coronavirus cases and the new measures implemented to curb its spread are likely to depress household spending going forward, especially on dining and leisure activities.

The available information points to a very reactive labour market. The most recent labour market data trigger two observations. First, in the first half of 2020, alongside a fall in value added of -17.8%, the number of full-time equivalent (ULA) employees fell by -19.4%, while hours worked fell by -22%. The Italian government furlough scheme (Cassa Integrazione Guadagni, whose coverage was extended) made it possible to limit employee layoffs to "only" -2.5% while allowing businesses to maintain some level of profitability and remain in the market despite the lockdowns. Second, there is confirmation of a strong asymmetry between types of workers, with drops in the numbers of employed and self-employed ULA falling by respectively -16% and -28%. There is asymmetry, also, among sectors, with ULA in construction and self-employment in services being the most negatively affected with the loss of a third of their workers (-33%), compared to increase in public sector employment. Information for Q3 is limited to employees and the labour force, and shows an increase of 0.5% in employment compared to Q2, still not sufficient to recover past losses. At the same time, the easing of the first lockdown measures brought many discouraged workers back into the labour market, increasing supply and, thus, pushing up unemployment rate from 8.3% in Q2 to 9.6% in October 2020.

Inflation remains subdued. The evolution of prices continues to be shaped not only by low oil prices but also by the different sub-indices dynamics resulting from the asymmetrical effects of the crisis. In October, headline inflation remained negative (-0.3% yoy, 0.2 mom), while core inflation was positive (0.6%). However, inflation fell by half compared to September (-0.6%) because of the large increase in the price of

Chart 7 – Budgetary impact of Government discretionary measures in 2021 *% of GDP*



Source: Prometeia's forecast on Italian Ministry of Economy and Finance data

electricity (12.2% mom) and of natural gas (5.0% mom) on the regulated market enacted by the competent Authority, and due, also, to an acceleration in unprocessed food prices (0.9% mom). The contribution of services continues to be negative (-0.5% mom).

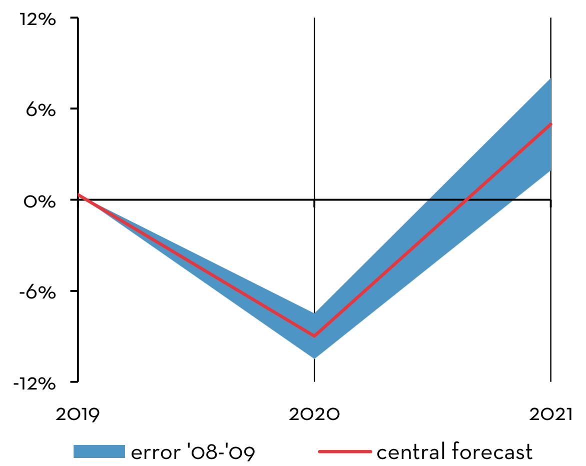
Bank loans on the rise and NPL still in safe territory. Loans continue to increase and the rate of growth of loans to businesses is now close to the EMU average (Chart 6), with the pre-crisis gap being reduced considerably by Italy's more generous (compared to other euro area countries) measures. A substantial portion of these loans remains in current accounts and provide an important buffer for companies faced with the ongoing difficulties provoked by this crisis. In addition, banks have increased their precautionary provisions so that, despite worsening economic balance sheets in Q1 and Q2, they appear able to cope with the difficulties expected in the winter, which are likely to lead to some insolvencies. In fact, we expect the ratio of NPLs to increase in 2021, but to remain well below the highs reached during the sovereign debt crisis.

The fundamental support of fiscal policy and EU funds. As pointed out in our October Brief, EU funds and the support from Italy's fiscal policy will be crucial for shaping the speed of the country's exit from the crisis in Q2-2021. In the meantime, the economic policy response to the new round of lockdowns is underway and is likely to involve also the 2021 budget, expected to be presented to Parliament in the next few days. In the past week, the Italian government already approved the two so-called Ristori decrees, which include grants to support affected businesses in the hospitality and entertainment industries and an extension of the wage supplement schemes, up to a total of around €8 billion. These measures should have no effect on the targeted deficit because they represent a reallocation of funds not previously used; however, they should have an economic impact in the last months of this year (which we estimate to be 0.5pp of GDP). These measures, together with a 2021 budget larger than expected in our October Brief, will reinforce the expansionary fiscal response for the coming year (Chart 7).
For the time being, we are maintaining the assumptions made in the October Brief regarding the investment impulse provided by the EU funds. This should play an important role in the expected recovery starting from Q3-2021.

Risks to the projection

- If current measures prove insufficient to contain the spread of the virus and more restrictions are implemented, the COVID-19 pandemic could put a further burden on the European and global recovery.
- The effectiveness of current fiscal and monetary policies support might diminish over time, while its side effects in terms of increased leverage could leave a heavy legacy.
- Materialization of EU funds is one of the pre-conditions for a robust recovery in the second half of 2021. However, the structural weaknesses of the Italian administration in planning and executing projects, on the one hand, and possible delays in EU finalization of its programme, on the other, constitute a threat to any pick-up in economic activity in 2021.
- In the US, a split Senate could extend the time required to reach agreement on a new fiscal plan and further weaken the economy and postponing recovery.

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.

Sectoral differences keep widening

The second wave of coronavirus infections has led European countries to introduce **new lockdown measures,** ranging from restrictions on mobility and physical contact, to the closing of some activities. These containment measures differ across countries and are not always correlated to the severity of the health crisis. For example, although its public health situation is quite serious, Spain has not yet introduced a real lockdown, while the measures imposed in Germany are relatively harsh. In Italy, lockdown measures vary across regions and are based, largely, on the severity of the health crisis.

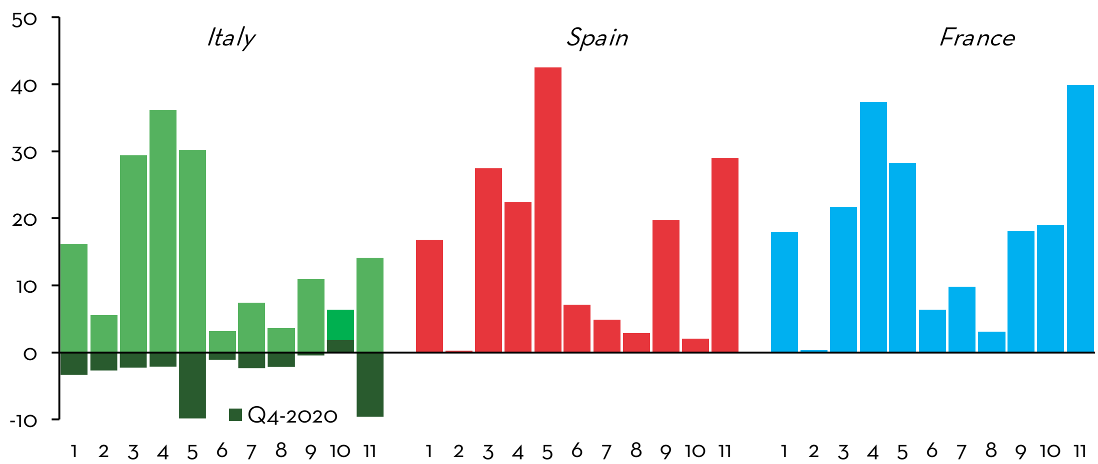
In Italy, the current restrictions are less severe than those imposed in March and April and do not include the industry sector. **The sectors that will suffer most from these second lockdowns are again food and entertainment services, and services related to tourism.** For these sectors, the current measures are a setback after the rebound experienced in the Q3 when the containment measures were gradually being lifted.

According to the most recent indicators (disaggregated data are not yet available), we estimate that, **in Italy, the service sector,** excluding the public sector, defence, education, health and social work activities, **contributed almost half to GDP growth qoq in Q3**: GDP growth was 16.1% with 7.4pp from the service sector. The pattern is similar in Spain and France (the only EU countries for which data are available). In all three countries (data for Italy are our estimates), the growth in value-added from wholesale and retail trade, transport, accommodation and food service activities and in the sector including arts and entertainment was particularly strong in Q3 (Chart A). Nevertheless, levels of output at the end of Q3 in these two sectors were still below pre-COVID-19 levels, at -7.5% and -4% in Italy, -22.6% and -19% in Spain, -8% and -9.5% in France.

The new containment measures will halt the recovery and **Italy's GDP is expected to fall by 3.4% qoq in Q4 2020. This will be driven by the service sector whose contribution will be around -3pp.** The wholesale and retail trade, transport, accommodation and food service activities, and arts and entertainment sectors will experience the largest fall, about twice that of services as a whole.

The crisis continues to be characterized by huge disparities at both the sectoral and, also, the geographical and employment levels, and this is increasing the inequalities in populations. In Italy, the recent fiscal measures included in the two so-called Ristori decrees aim to limit the economic damage to those sectors most exposed to the new lockdown, **which are also very vulnerable because they include many small firms and low-skill workers.**

Chart A – Real value added in Q3-2020 (Q3 and Q4 our calculations for Italy) *% change qoq*



1 Total; 2 Agriculture; 3 Industry (except construction); 4 Construction; 5 Wholesale and retail trade, transport, accommodation and food service activities; 6 Information and communication; 7 Financial and insurance activities; 8 Real estate activities; 9 Professional, scientific and technical activities; administrative and support service activities; 10 Public administration, defence, education, human health and social work activities; 11 Arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies.

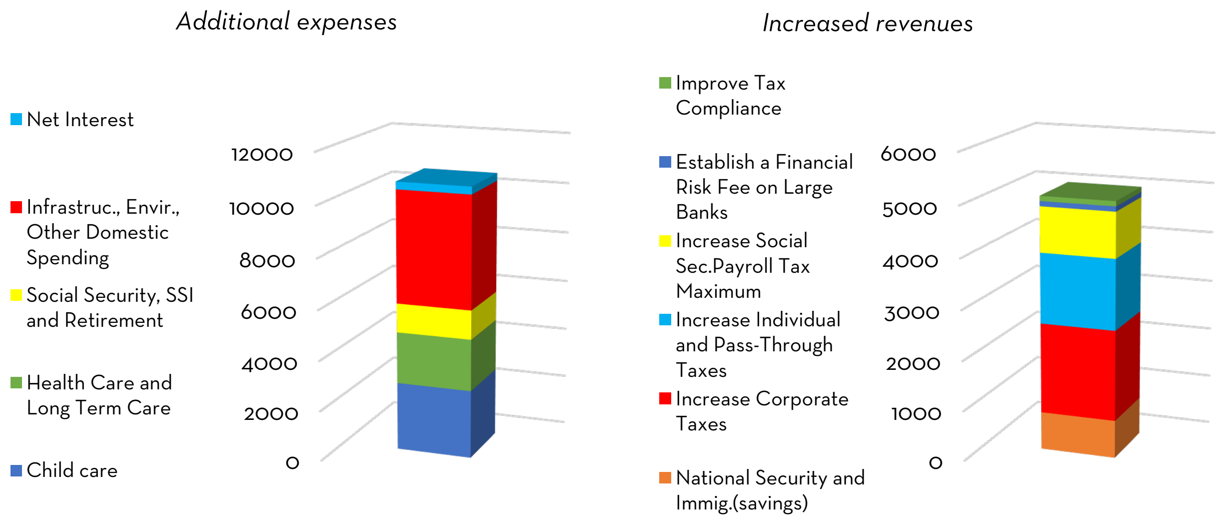
Source: Prometeia's calculations and forecast on Eurostat data.

US fiscal policy in our scenario

Although Joe Biden seems set to become the 46th President-elect of the US, the competition for a Democrat Senate majority will not be decided until the beginning of January 2021. The outcome of the two Georgia State runoff elections for the Senate in January is very consequential for and will contribute to shape the new administration's fiscal policy. The plans set out by the Democrats during the presidential campaign include additional expense of over $10 trillion in 2021-2030, 40% which in investments, and increased revenues of around $5 trillion in the same period, based on higher taxes on firms and the richest parts of the population (Chart A). Hence, discussion in Congress is likely to produce tensions and these plans might change if the Republicans retain control of the Senate.

In our forecasts, we assume that in 2021 around $500 billion will be spent on income support for the most vulnerable parts of the population. In October, total employment was 9 million units lower than in December 2019 and it is unlikely to improve substantially given the way that the pandemic is progressing. In addition, funds to expand social security are almost exhausted. In particular, the funds allocated to increase the unemployment benefits by $600 per week were exhausted in July, but also those for the most recent increase by $400 per week were almost over by the end of October.

Chart A – Biden's agenda on Budgetary Policy - *central estimate, billions of US dollars*



Source: Committee for a Responsible Federal Budget, October 2020 .

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

	2019	2020	2021
World real GDP	3.0	-5.5	5.4
World Trade	-0.5	-10.2	8.5
Manufacturing prices $	-2.6	0.0	1.4
Brent oil price ($/brl, level)	64.2	43.2	44.0
GDP			
- United States	2.2	-3.6	3.8
- Japan	0.7	-6.8	4.3
- EMU	1.3	-7.3	4.3
- China	6.1	1.8	8.6
Consumer prices			
- United States	1.8	1.3	1.6
- Japan	0.5	0.1	0.1
- EMU	1.2	0.3	0.6
- China	4.0	2.8	2.3
$/€ exchange rate (level)	1.12	1.14	1.13
£/€ exchange rate (level)	0.877	0.889	0.904

Table 2 – Italy: main indicators (% change)

	2019	2020	2021
GDP*	0.3	-9.0	5.0
Imports of goods fob and services	-0.4	-14.3	10.1
Private consumption	0.5	-10.0	3.8
Government consumption	-0.2	0.7	2.7
Gross fixed investment:	1.6	-12.3	8.1
- machinery, equipment, other products	0.9	-14.0	4.9
- constructions	2.5	-10.1	12.0
Exports of goods fob and services	1.3	-16.5	10.0
Domestic demand	-0.2	-8.1	4.9
Industrial production	-1.1	-11.6	13.9
Trade balance (% of GDP)	3.2	3.9	3.7
Terms of trade	1.3	4.6	-0.6
Consumer prices	0.6	-0.2	0.5
Per capita wages - manufacturing	1.6	0.3	0.5
Total employment	0.2	-11.7	4.2
General government balance (% of GDP)	-1.6	-10.8	-7.4

** 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	1.18	1.16	1.13	1.12	1.13
	Yen	120.1	118.3	124.1	124.0	122.8	119.8	119.8	120.6
3 month interest rates %	US libor	1.51	0.58	0.26	0.22	0.25	0.25	0.26	0.27
	Euribor	-0.37	-0.30	-0.45	-0.51	-0.50	-0.50	-0.49	-0.49
10 year government bond yields %	US	1.39	0.69	0.65	0.79	0.75	0.73	0.78	0.83
	Germany	-0.44	-0.47	-0.52	-0.62	-0.62	-0.58	-0.56	-0.53
	Italy	1.25	1.64	1.01	0.67	0.67	0.77	0.77	0.80

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 October 2020	**-1.3**	**-9.1**	5.9	1.6	-4.2	1.1	0.8	0.8	0.7	3.9
	Brief November 2020	**-1.3**	**-9.0**	**7.4**	0.6	-3.6	0.7	0.9	1.2	0.6	3.8
EMU	Brief October 2020	**-3.7**	**-11.8**	8.6	1.6	-8.0	1.1	1.2	1.6	1.4	5.3
	Brief November 2020	**-3.7**	**-11.8**	**12.7**	-2.7	-7.3	-0.3	1.9	3.9	2.2	4.3
Italy	Brief October 2020	**-5.5**	**-12.8**	11.4	1.4	-9.6	1.2	1.0	2.0	1.4	6.2
	Brief November 2020	**-5.5**	**-13.0**	**16.1**	-3.4	-9.0	-0.2	2.1	4.2	0.8	5.0

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