ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

FEBRUARY 2019 – No. 19/2

Executive summary

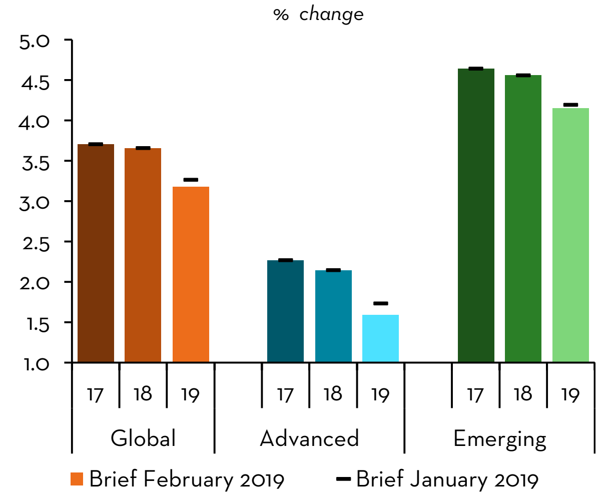
Further global deceleration ongoing

- The end of 2018 produced gloomy GDP and global trade data. This together with the ongoing deteriorating expectations and sentiment indicators bodes ill for 2019.
- The Chinese authorities are implementing fiscal and monetary expansionary policies to tackle the slowdown in domestic demand.
- The Renminbi appreciated recently, confirming the willingness of China's economic policy authorities not to use currency as a tool to support growth.
- The shutdown in the US could dent activity in the first quarter of 2019, but its effect on annual growth should be negligible.
- We have revised EMU GDP growth in 2019 downwards in light of 2018 Q4 results, weaker foreign demand and persisting signs of unresolved industry activity problems.
- Trade disputes, Brexit and the European elections continue to weigh on expectations and be a source of significant uncertainty.

No respite for Italy's economy, already slipped into recession

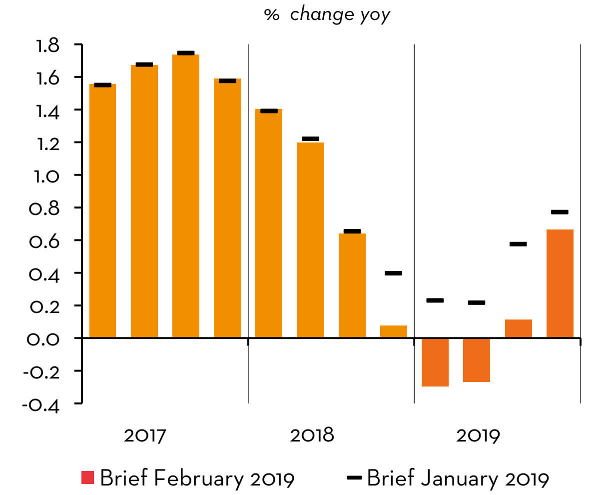
- In the second semester of 2018, Italy entered a "technical" recession: preliminary data confirms that following the GDP slowdown in Q3 2018 (-0.1% qoq), growth declined also in Q4 (-0.2%).
- In January, following agreement with the European Commission that the 2019 budget deficit be scaled back to 2% of GDP, and EDP be avoided (at least for the present), the BTP-Bund spread decreased to 260bp. The disappointing growth figures have raised fears about public finances and increased the spread in the first days of February (288bp). We confirm the January Brief's forecast of a spread remaining around 280bp until the May European elections, thereafter converging gradually towards 250bp by the end of the year (Table 3).
- Economic indicators highlight that economic weakness has continued into Q1 (we expect GDP to contract slightly, -0.1% qoq), but the stability of the international cycle and implementation of the income support measures provided by the budget law (see our first InFocus) will return GDP growth to positive territory later. We have revised the average growth for 2019 downward to 0.1% (0.5% in the January Brief).

Chart 1 – Real GDP



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

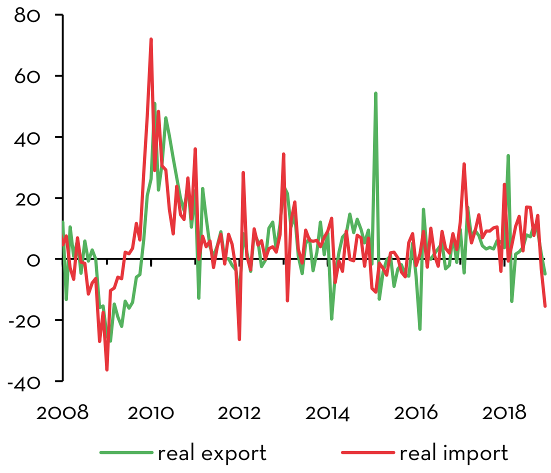
Chart 2 – Italy: real GDP



Source: Prometeia's forecast on Istat data.

Chart 3 - **China: external trade**

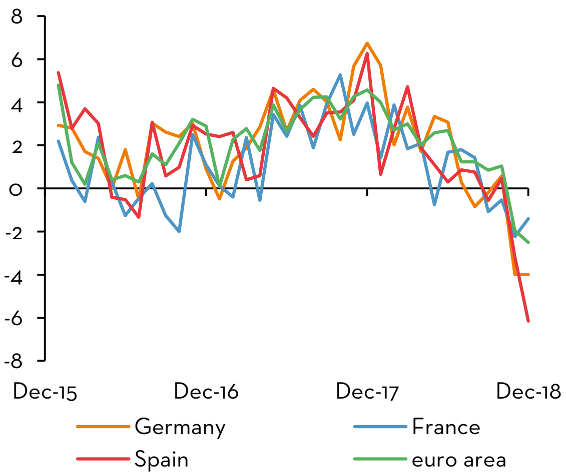
% change yoy



Source: Prometeia's calculations on China Customs data.

Chart 4 - **Euro area: industrial production**

% change yoy



Source: Prometeia's calculations on national data.

Expansionary policy targets weak momentum in China. China's GDP growth was stable in 2018 Q4 (6.4% yoy), but the main indicators of activity show weak momentum which now is affecting imports (negative growth in the last months of 2018, Chart 3). The authorities are implementing a number of measures to support growth, ranging from monetary expansion and injections of liquidity to new infrastructure expenditure, lower taxes and higher debt quotas for local governments, aimed at promoting investment. We expect these measures will allow GDP to grow close to target at about 6%, in line with our January Brief.

External demand denting US growth. In the US, 2019 started with the longest shutdown of the public sector in history combined with exceptionally bad weather conditions, on top of other signs of slowing demand, mainly from abroad. Unresolved trade disputes with China continue to affect external demand along with euro area weakness. The declining confidence of producers and consumers suggests a mild revision of growth in 2019 (2.2%, 2.3% in the January Brief). This takes into account a halt in the Fed's monetary policy normalization process, with the Fed expected to avoid further increases in interest rates (the January Brief forecast one hike in March 2019).

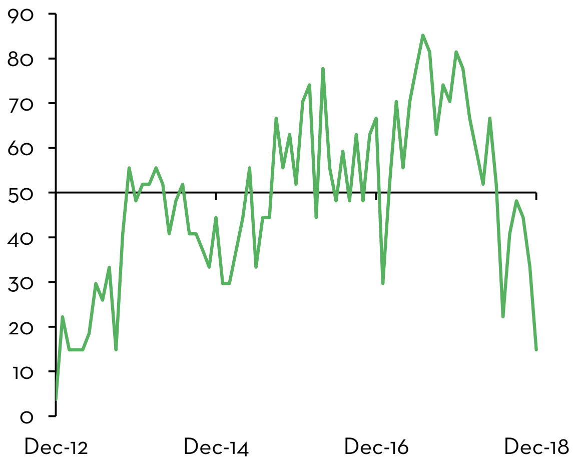
Large revisions for euro area growth. Euro area GDP data in 2018 Q4 confirmed the qoq growth of Q3 (0.2%). In Spain and France, the good Q4 outcome was due mainly to one-off factors. In Germany, the decline in car production related to the new emission standards for automakers, effective from September 2018, continued until the end of the year. Despite the rebound in automotives production in December, total industrial production growth that month remained negative, with export data suggesting weak demand from abroad as the main culprit. In Germany, investment conditions are good in terms of high capacity utilization and low financing costs. On the other hand, as in the rest of euro area, expected weaker external demand due, among other things, to the continued mounting uncertainty about trade disputes and Brexit, is preventing significant investment growth. Also, industrial production (Chart 4) and the consumer confidence indicators suggests very weak momentum in most countries.

The ECB will postpone rate hikes. As in the US, in the euro area the conditions for monetary policy normalization are expected to fade, due also to the subdued inflation rate. We think that the ECB will postpone the first interest rate hike to past 2019 (the January Brief forecast one hike at the end of 2019).

No pressures on oil prices. Oil prices moved recently and are in the range $60-65 per barrel amid the weakening of the global outlook. We do not foresee any significant pressure that might push prices in the coming quarters and have revised our forecast annual Brent price downward to $63.7 per barrel on average for 2019 (from $67.5 in the January Brief).

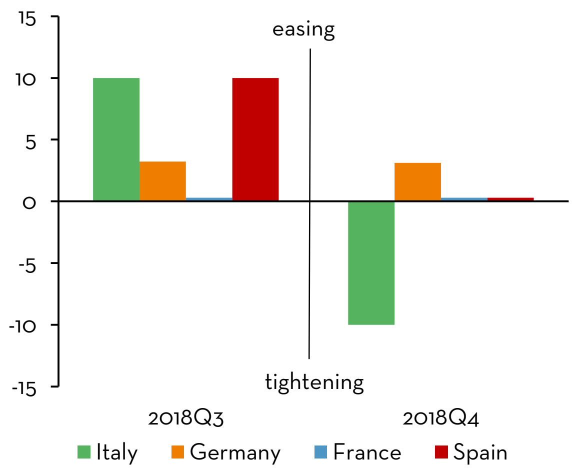
Italy

Chart 5 – Industrial production: diffusion index
% of growing sectors



Source: Prometeia's calculations on Istat data.

Chart 6 – Changes in credit standards
net percentages of banks reporting an easing



Source: ECB, Bank Lending Survey.

Signs of recession are spreading to domestic demand... While net exports made a positive contribution to growth in Q4, domestic demand dropped (detailed data on GDP composition will be released on 5 March). Thus, the external context is playing a role in the downturn, but much rests, also, on the domestic macro/fiscal uncertainty which has likely choked consumption and investments.

... and industrial production ... The reduction in industrial production recorded in December was higher than expected (-0.8% mom, -0.3% our forecast). The decline was greater for consumer goods, while capital and intermediate goods stagnated. In December, only about 10% of the industry sectors were still expanding, 38% in November and 80% at the beginning of 2018 (Chart 5). Overall, Q4 2018 saw a sharp deceleration in industrial activity and, according to available indicators, our assessment is that the first quarter of this year will also show negative growth (-1.5% qoq and -3.4% yoy), implying a strong negative carryover on 2019 growth (around -3%).

... to the labour market. After peaking in May 2018, employment fell by about 75,000 during the summer and stabilised at the levels seen in the final months of last year. Unemployment shifted accordingly, although with wide fluctuations due to labour supply, and the unemployment rate was 10.3% in December (10.1% minimum reached in August). The reduction in employment was due almost equally to the reduction in the numbers of self-employed and employees. However, the latter underwent a large re-composition: temporary workers increased substantially (+84,000) while those employed on permanent contracts fell much more (-125,000). So far, it seems that the effects of the slowdown in economic activity and uncertainty about the future are outweighing the impact of the "Dignity Decree", which came into force last autumn and was aimed at limiting the use of fixed-term contracts.

Inflation remains subdued. In January, consumer inflation returned to below 1%, a rapid decline from its peak of 1.6% last autumn, which was driven by the most volatile components (energy and fresh food) but was short lived. Core inflation has always remained at below 1% and now that prices are reflecting the reduction in oil prices, overall inflation is converging to the level of core inflation. Weak demand and wage dynamics (in 2018 the negotiated nominal wages index increased by 1.1% in the private sector) kept Italian inflation subdued, about 1pp lower than the EMU average.

Banking sector has improved... The last part of 2018 remained positive for Italy's banking sector. The expansion of bank lending to the private sector continued in December: loans to households remained in line with the growth in the previous months (2.7% yoy) and loans to firms remained in line with the 2018 average (1.3% yoy). The stock of gross non-performing loans was further reduced and in December reached a level not seen since mid-2011 (€100 billion). This was due to sizeable sales amounting to approximately €65 billion.

In relation to funding, in 2018 deposits played the main role (+66 billion, 3.9% yoy).

Although net bond issuances remained negative throughout 2018 (-€42 billion, -12.3% yoy), in December they increased by €5 billion, due to institutional investors in the wholesale segment.

The better condition of Italy's banks is confirmed by the just released budgetary results of Systemic Institutions (SI): individual capital requirements (Srep) have been met and the SI have a positive capital margin compared to the minimum, while (with one exception) profits also increased compared to 2017.

... but signs of less favourable financial conditions are mounting. However, the recession and the expectation of tighter liquidity conditions (related also to the increasing need for funding to comply with regulatory constraints) are having an effect on the banks. The Bank Lending Survey (BLS) highlights the increased caution displayed by Italian banks at the end of last year, in relation to granting credit, while in the main European countries supply conditions remain relaxed (Chart 6). This is further confirmation of our assessment of a likely new TLTRO to limit funding tensions as the redemption dates for TLTROII come closer.

In 2018, public deficit improved, despite weaker growth and higher sovereign rates. State sector borrowing requirements fell by €7 billion compared to 2017. We expect the government deficit to be below 2% of GDP in 2018.

An increase in the deficit is expected in 2019 as a result of negative cyclical effects coupled with the budget plans. We estimate the deficit-to-GDP ratio will reach 2.5%, an upward revision from 2.3% in the January Brief, due to the worse economic scenario. The budget will translate mainly into higher expenditure on social benefits as a result of the introduction of the citizenship income and the new rules on early retirement (see our first InFocus).

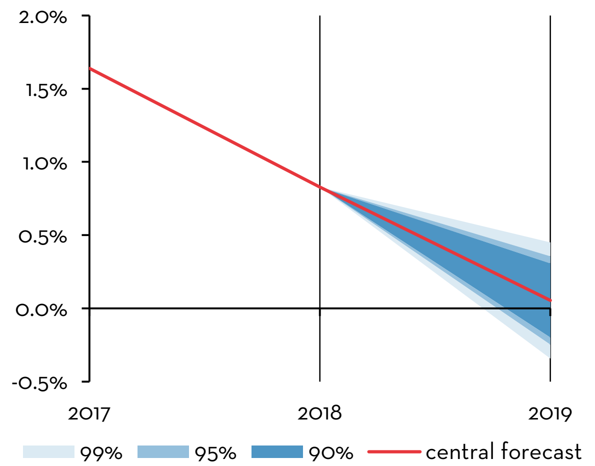
Summing up. Italy suffered a sudden and drastic slowdown, especially in the second part of last year. This was triggered by external shocks, including Brexit, the Turkish crisis, Russian sanctions, and the new rules regarding auto emissions, combined with the increased uncertainty about Italy's 2019 budget law, which amplified the sovereign risk and prompted a fall in the equity index, especially the banks'. Private investments and consumption also fell.

We expect these weaknesses will continue to weigh on 2019 Q1, then to fade as the year progresses. Fiscal policy will support domestic demand, especially household consumption, starting from 2019 Q2. According to our estimates, it will contribute 0.2pp to 2019 GDP growth. Overall, we expect GDP to grow by a modest 0.1% in 2019, on an accelerating path over the year (Table 4), rising from -0.3% yoy in Q1 to +0.7% in Q4 (Chart 2).

Risk to the projection

- Trade disputes between the US and China are ongoing and the US is considering extending its protectionism to the auto sector, to the detriment, in particular, of European carmakers.
- Chinese fiscal and monetary support for growth is increasing debt and distorting domestic asset prices, raising the risk of a disorderly deleveraging.
- A prolonged period of uncertainty and/or a hard Brexit could adversely affect investment and trade in the UK and its main trading partners.
- If the effects of the Italian expansionary budget measures prove to be less effective than expected, e.g., because of problems related to implementing the Citizenship Income, the expected recovery in the second semester of this year could be jeopardized.
- If anti-EU rhetoric gains strength in Italy in the run-up to the May elections, sovereign spread and stocks might come under pressure again, reducing firms' and households' confidence.

Chart 7 - Italy: Prometeia's forecast of annual GDP growth – *central projection and confidence levels*



Source: Prometeia's calculations.

Citizenship income and pension reform approved by government

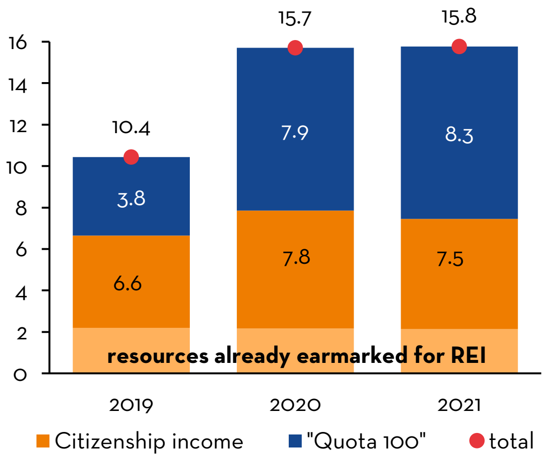
Starting from April, the two flagship measures of the new government's budgetary policy, citizenship income and pension reform (so-called "Quota 100"), will become effective. Following approval at the end of December 2018 of the budget law, which allocated a total of **€11 billion in 2019 and about €16 billion in the succeeding years**, the decree setting out the detailed beneficiaries and operating procedures was presented on 18 January 2019.

Citizenship income is the new income support scheme, aimed at alleviating poverty**. Eligibility depends on residence, income, savings and property ownership.** Its beneficiaries will be EU or non-EU citizens, resident in Italy for at least 10 years (including continuous residence in the most recent 2 years) with a value of the ISEE (equivalent economic situation indicator) below €9,360 per year, real estate assets other than the first home not exceeding €30,000 and movable assets not exceeding €6,000. **The benefit ranges from a minimum of €480 per year to a maximum of €15,960 per year**, depending on income conditions and household composition. A single person can receive a maximum of €780 per month, while a household of four or more can receive a maximum of €1,330 per month. The transfers will be made monthly via an electronic payments card, which can be used (at the latest in the following month) for limited cash withdrawals, to pay rent and to make purchases.

Quota 100 is being implemented on an experimental **basis for the three-year period 2019-2021. It allows workers with a minimum 38 years of pension contributions to retire as early as 62 years of age.** Compared to the previous legislation, it reduces the retirement age for those who qualify, by of up to five years (the statutory retirement age is 67), with a corresponding penalty on the pension benefit linked to the contributions paid.

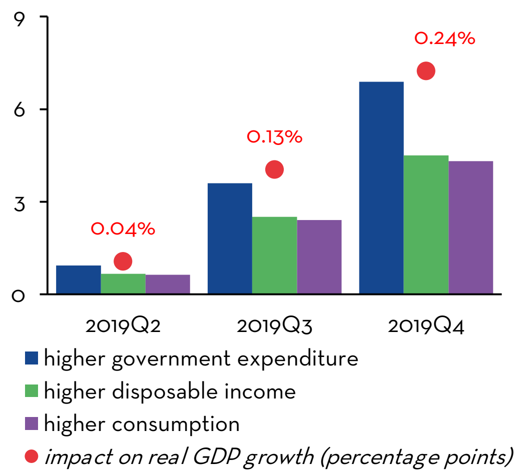
Government expects these measures to boost growth of domestic demand starting in the second quarter of the current year. However, there is a deal of uncertainty related to take-up rates, complexity of implementation of the citizenship income, its possible disincentive effects in finding a job, possible abuses of the new system and replacement of workers who opt for the "Quota 100". All of these factors will affect how

Chart A – Social benefit for Citizenship income and "Quota 100" in the government estimation
billions of euros



Source: Technical Report, Decree 4/2019.

Chart B – Estimated cumulated impact in 2019
billions of euros and pp



Source: Prometeia's calculations.

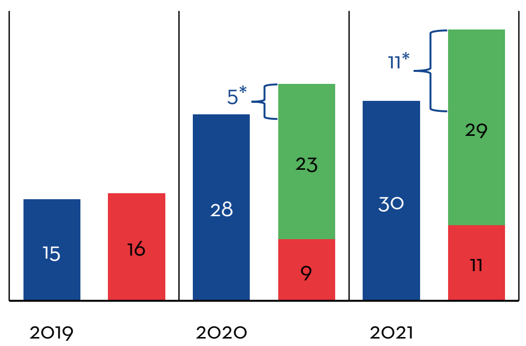
much of the allocated resources will result in additional employment and disposable income and, therefore, greater consumption in 2019 compared to 2018.

Government estimates that "Quota 100" retirees will number 290,000 in 2019 (356,000 in 2021) and that the citizenship income will benefit some 1.37 million households. The cost of "Quota 100" is estimated at around €3.8 billion and the cost of the new income support is estimated at some €6.6 billion. However, since the latter will replace the previous inclusion income scheme (REI), which amounted to some €2 billion per year, the net additional outlay will be around €4.6 billion. Total costs in 2019 are estimated to be €10.4 billion, €8.4 billion net of the resources already earmarked for REI (Chart A).

We expect delays in implementation of the citizenship income (monthly payments will start only in June not April) and a less than one-by-one replacement of retirees with new employees. Our evaluation suggests that the higher government expenditure on citizenship income in 2019 will be around €3.6 billion and will largely translate into higher consumption. The higher expenditure on "Quota 100" – €3.8 billion – will increase households disposable income by a fraction of that amount (workers who retire will see their disposable income fall since the pension benefits will not replace the income they derived from their paid employment, while new hires – assumed to be 50 per cent of the additional retirees – will be paid only an entry level wage). Overall, we estimate the total increase in disposable income will be around €4.7 billion. Assuming a high propensity to consume, the effect on 2019 GDP growth is estimated to be 0.24pp (Chart B).

In relation to the risks for the public accounts, the funds provided by the budget law are sufficient to finance the costs of the measures in 2019 (they are slightly higher than the estimated costs of the citizenship income while it is expected that other financial measures will contribute to the Quota 100 scheme). The Decree includes rules related to monitoring and action in the event of deviation of the expenditure from forecasts, due, for instance, to higher than expected take-up rates. In the case of Quota 100, other spending will be reduced while, in the case of citizenship income, the benefits will be recalculated. However, **it is important to note that the 2020 and 2021 funding is based on the VAT rate increases**, which will be worth €23 billion and €29 billion respectively (Chart C) whereas government has already expressed its intention not to implement these increases. However, in the absence of other comparable measures the deficit to GDP ratio will increase to 3% or more (Chart D).

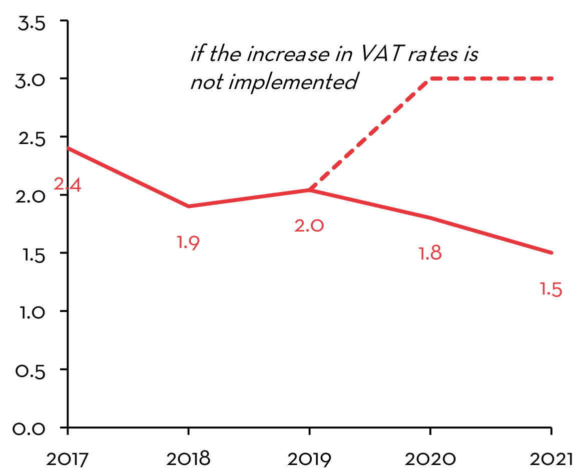
Chart C – The new government budgetary measures
billions of euros



** Share of VAT financing deficit reduction*

Source: Prometeia's calculations.

Chart D – Italian budget deficit, government targets
% of GDP



Source: MEF.

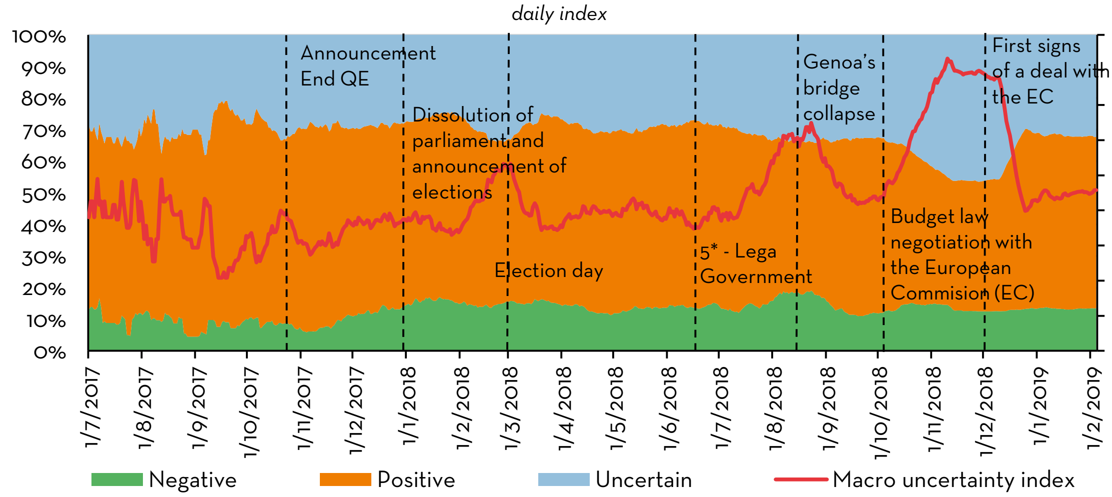
A new macroeconomic uncertainty index for Italy

In the second part of 2018 Italy experienced an elevated degree of economic and political uncertainty. At the beginning of June, following the 4 March 2018 elections, a government was formed and discussion on the policy position in relation to several issues, but mainly the 2019 budget, has been centre stage. The 10-year government bond spread began to soar and passed the 300bp mark several times during autumn 2018 before partial normalization in late December 2018 when the European Commission agreed the 2019 budget. In phases of sudden and sustained increases in uncertainty, as happened in Italy in 2018, the economy usually slows and indeed in the second half of 2018 the Italian economy recorded a technical recession.

In this InFocus, we introduce a new macroeconomic uncertainty indicator developed at Prometeia and show how this indicator is correlated to the recent economic evolution. The indicator builds on news texts and on sentiment analysis, i.e. a measure of the distribution of heterogeneous sentiment levels. Chart A shows the index's daily development and how it reflects certain important political (and non-political) events. In particular, it shows the recent reduction in the level of measured uncertainty.

Chart A – Macroeconomic uncertainty index and sentiment shares

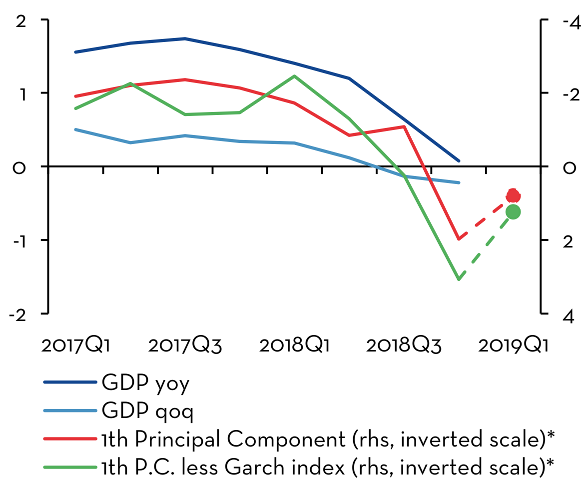
daily index



Source: Prometeia's calculations.

We complement this index with other three indicators: 1) (an in-house replication of) the economic policy uncertainty indicator proposed by Bloom and Davis (2015); 2) survey-based uncertainty indicators and 3) a financial market volatility index (Garch index). Finally, we build a composite index based on a principal component analysis, which aggregates these different indicators. **Chart B shows that the composite index captures well the macroeconomic developments in 2018.**

Chart B – Italian GDP and the Macroeconomic uncertainty index *% change and levels*

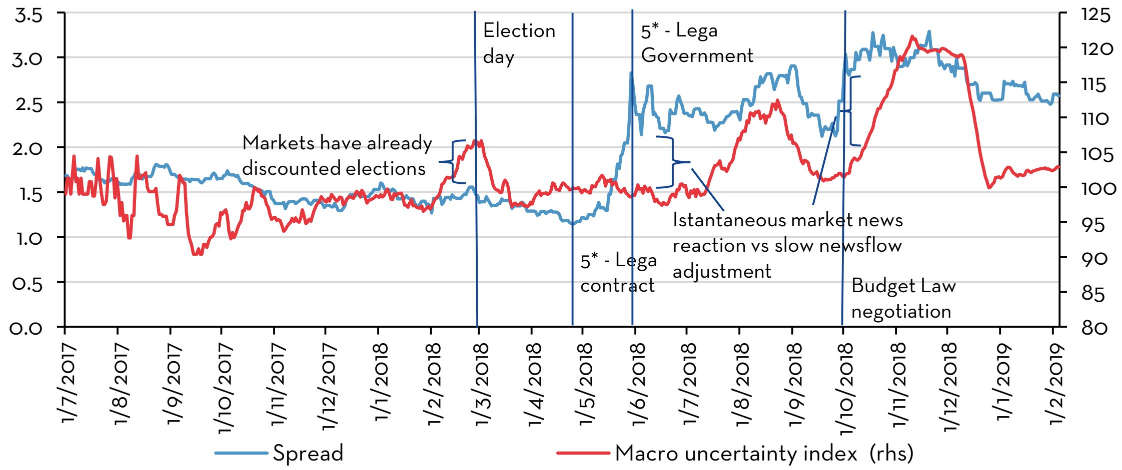


Source: Prometeia's calculations.

* Note: The *1th Principal Component Index* is calculated as the principal component of 4 uncertainty indexes (Macro Uncertainty Index, Economic Policy Uncertainty Index, Uncertainty from Surveys, Financial Market Volatility Index). *1th Principal Component Index less financial market* computes the principal component of 3 uncertainty indexes excluding the Financial Market Volatility Index.

Chart C – BTP-Bund spread and the Macroeconomic uncertainty index

daily index and %



Source: Thomson Reuters and Prometeia's calculations.

It suggests, also, that the reduced uncertainty following the agreement with the European Commission in late December 2018, could contribute positively to GDP growth going forward. Moreover, while it shows a high correlation to the BTP-Bund spread during the second half of last year (Chart C), since that time, this link seems to have weakened. The spread remains high, while the uncertainty index has reduced. This might suggest that **the uncertainty perceived by the public in response to media reports may have abated, but the level of uncertainty perceived by the market participants has not.** It will be interesting to observe how this conundrum is resolved in the coming months.

Table 1 - The world economy main indicators % change

	2017	2018	2019
World real GDP	3.7	3.7	3.2
World Trade	4.8	3.9	2.7
Manufacturing prices $	2.9	1.9	-0.8
Brent oil price ($/brl, level)	54.9	71.7	63.6
GDP			
- United States	2.2	2.9	2.2
- Japan	1.9	0.7	0.7
- EMU	2.5	1.8	1.0
- China	6.8	6.6	6.0
Consumer prices			
- United States	2.1	2.3	2.4
- Japan	0.5	1.0	1.0
- EMU	1.5	1.7	1.4
- China	2.9	2.2	3.0
$/€ exchange rate (level)	1.13	1.17	1.15
£/€ exchange rate (level)	0.876	0.884	0.893

Table 2 – Italy: main indicators % change

	2017	2018	2019
GDP	1.6	0.8	0.1
Imports of goods fob and services	5.6	1.9	1.3
Private consumption	1.5	0.6	0.4
Government consumption	-0.1	0.1	0.5
Gross fixed investment:	4.4	3.5	-1.7
- machinery, equipment, other products	6.6	4.8	-3.3
- constructions	1.9	2.0	0.3
Exports of goods fob and services	6.3	1.0	2.2
Domestic demand	1.4	1.1	-0.3
Industrial production	3.7	0.7	-0.3
Trade balance (% of GDP)	3.2	2.7	3.2
Terms of trade	-2.2	-1.4	0.8
Consumer prices	1.2	1.1	0.8
Per capita wages - manufacturing	0.5	1.0	1.4
Total employment	0.9	0.5	-0.1
General government balance (% of GDP)	-2.4	-1.9	-2.5

GDP and components are adjusted for seasonal and calendar effects; chain-linked values.

Table 3 - Exchange rates and interest rates

		18 Q1	18 Q2	18 Q3	18 Q4	19 Q1	19 Q2	19 Q3	19 Q4
Exchange rates vs euro	US dollar	1.23	1.19	1.16	1.14	1.13	1.14	1.16	1.17
	Yen	132.8	130.1	129.7	128.6	123.8	126.0	127.6	128.7
3 month interest rates %	US libor	1.93	2.34	2.34	2.63	2.72	2.66	2.65	2.65
	Euribor	-0.33	-0.33	-0.32	-0.32	-0.31	-0.31	-0.31	-0.31
10 year government bond yields %	US	2.76	2.92	2.93	3.04	2.68	2.65	2.73	2.70
	Germany	0.59	0.48	0.33	0.36	0.14	0.15	0.23	0.35
	Italy	2.01	2.24	2.83	3.29	2.86	2.87	2.81	2.83

Table 4 – Real GDP comparison of the forecasts – *% qoq and annual % change – historical data in bold*

		18 Q1	18 Q2	18 Q3	18 Q4	2018	19 Q1	19 Q2	19 Q3	19 Q4	2019
United States	Brief Jan. 2019	**0.5**	**1.0**	**0.9**	0.6	2.9	0.5	0.5	0.4	0.4	2.3
	Brief Feb. 2019	**0.5**	**1.0**	**0.9**	0.6	2.9	0.2	0.6	0.6	0.4	2.2
EMU	Brief Jan. 2019	**0.4**	**0.4**	**0.2**	0.3	1.9	0.2	0.3	0.3	0.3	1.2
	Brief Feb. 2019	**0.4**	**0.4**	**0.2**	**0.2**	1.8	0.1	0.3	0.4	0.4	1.0
Italy	Brief Jan. 2019	**0.3**	**0.2**	**-0.1**	0.1	0.9	0.1	0.1	0.2	0.2	0.5
	Brief Feb. 2019	**0.3**	**0.1**	**-0.1**	**-0.2**	0.8	-0.1	0.1	0.2	0.3	0.1

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