Italy in the Global Economy
Prometeia Brief

May 2017 – No. 17/4

Executive summary

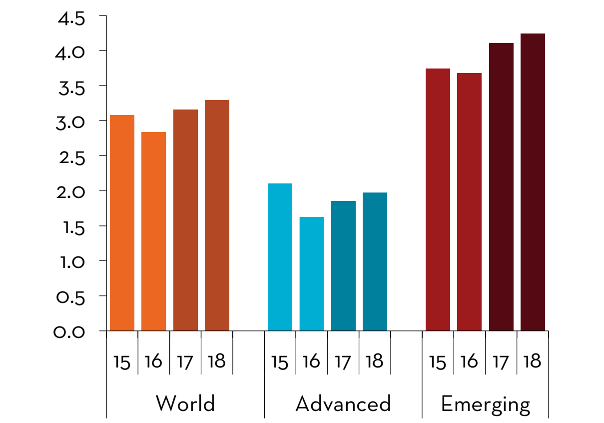
Global growth not so brilliant

- The most recent data confirm our forecast of the recovery of the world economy at moderate pace (Chart 1).
- US GDP growth in the first quarter disappointed. Business cycle indicators and fiscal policy plans suggest a slight downward revision in our US forecast for 2017-2018.
- Chinese economy accelerated in Q1 (6.9 per cent) although growth still supported by public sector with mounting pressures on debt. Some clouds moving in.
- Main emerging countries in different cyclical position: stable growth for India, recovery in Russia, Brazil still in deep recession. Inflation pressures are fading, leaving room for expansionary monetary policies.
- World trade improving with a strong contribution of emerging market imports, China included.
- Oil prices weak due to insufficient production cuts and shale production increases, in a context of steady demand.

Italy is staying on course

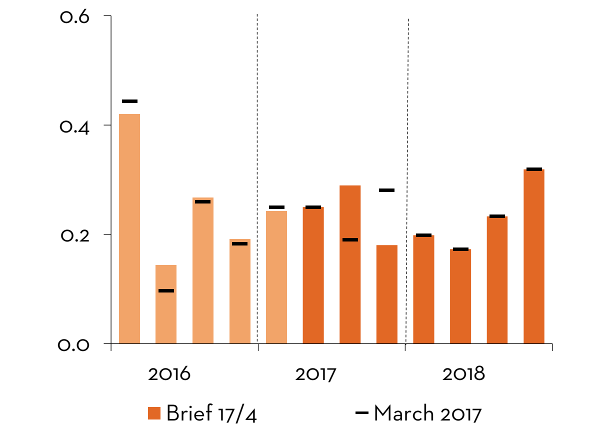
- As in our baseline scenario, the French election did not result in any negative surprise and the recently released euro-area GDP growth for 2017 Q1 confirms our expectations (0.5 per cent qoq).
- In Italy as well the first release of GDP Q1 growth rate at 0.2 per cent is in line with our expectation of a recovery... Italian style!
- This confirms our projections of GDP to grow by 0.9 per cent this year (Chart 2).
- EU unemployment is slowly decreasing but indicators of social stress are still on the rise (see our first InFocus).
- Following the European Commission recommendations, the supplementary budget measures adopted in April aim at reducing the 2017 deficit by 0.2 pp of GDP to 2.1 per cent, unlikely to be reached in our view (see second InFocus).

Chart 1 **Real GDP**
% change



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

Chart 2 **Italy real GDP**
% change qoq



Source: Prometeia's forecasts on Istat.

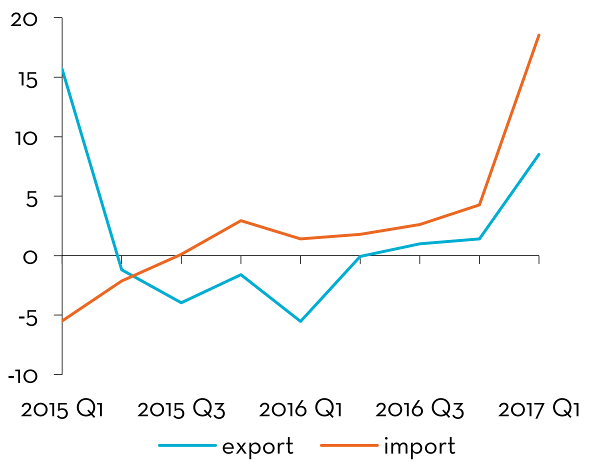
Global Scenario

China – deceleration on the horizon. The latest GDP data show a positive contribution of net exports for the first time after six quarters in a row. The good news is the double-digit growth of imports in January-March (Chart 3), helping growth in many exporting countries. The recent recovery in domestic demand was sustained by a large contribution from the state controlled part of the economy, mainly through investments of the state-owned enterprises. Current data show an ongoing deceleration of these investments, and of domestic credit too, but their yoy growth rate is still high and is likely to be sustained at least till the congress of the Chinese Communist Party in November. In addition, the industrial production in April was weaker than expected. The People's Bank of China is implementing restrictive policy in terms of money supply trying to contain domestic demand, inflationary risk and depreciation pressures.

United States – taking a break. Growth (Chart 4) in the first quarter was a disappointing 0.2 per cent qoq, lower than our expectations (0.4 per cent). Consumption's contribution to GDP almost vanished despite the continuous fall in the unemployment rate. This is partly due to one-off effects: fall in vehicle purchases after the spike at the end of 2016 and low consumption of utilities due to a mild winter. The fiscal plan unveiled by the Trump administration at the end of April was poorly detailed, likely less expansionary than expected, and still uncertainly funded. Moreover, the difficulties of the administration in approving the desired measures are becoming visible. Measures of current activity and confidence point to moderate downward revision for the year (0.1 pp for yearly growth compared to our March forecast), after a rebound in the second quarter. In our view the Federal Reserve will maintain a cautious stance with a single further hike in 2017. Since March the dollar has depreciated vis à vis euro and yen, while the 10-year government bond yields have declined by almost 25 bp. We expect a stable exchange rate in the coming months against the euro.

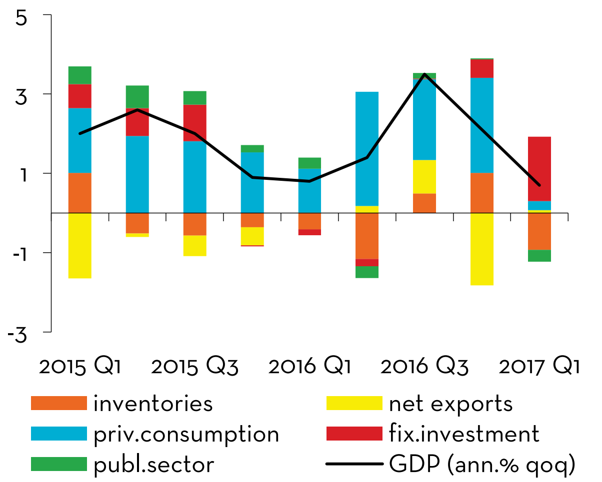
EMU in good shape. Besides the recent release for 2017 Q1, the update of the historical data revised upward 2016 Q4 GDP now growing by 0.5 per cent qoq (0.4 per cent, in the previous release).

Chart 3 **China: real external trade of goods**
% change yoy



Source: Prometeia's calculations on China Customs.

Chart 4 **US: contributions to GDP growth and GDP**
% point and annualized % change



Source: BEA.

Commodities – stabilization of prices. International prices have been decelerating in recent weeks, mainly for metals, with some tentative decline also for oil. For metals the deceleration may be attributed to reduced Chinese imports of these commodities. Oil prices reacted to American inventories, higher than expected, and to the surging production of shale oil, in a scenario which broadly confirms the expected global growth. The ability of OPEC to control prices via production quotas (also agreed with Russia) proved insufficient. We confirm a stable path of oil prices in the coming quarters.

Italy

GDP on course in the first quarter. The GDP flash estimate confirmed that in the first quarter the Italian economy continued to expand, as expected, gaining 0.2 per cent compared with the previous quarter (Table 4). The expansion of activity in services more than offset the weakening in manufacturing (indeed industrial production dropped heavily in January after the spike in December). Moreover, in March Prometeia's Index of growth diffusion among industrial sectors (see Chart 5) reached its highest level since 2010. Exports rose, driven above all by the expansion of non-EU markets. Surveys among firms suggest that foreign order prospects remain favourable and recent information on business and household sentiment points to an extension of the recovery for the coming months.

The labour market keeps recovering. Employment kept on rising in the first quarter, albeit at a slower pace than in 2016, notwithstanding the expiry at the end of last year of the fiscal incentive on new-hires. The increase in the number of employees (both permanent and fixed-term) more than offset the decline in self-employment. The unemployment rate slightly decreased, mainly due to a reduction in labour force participation.

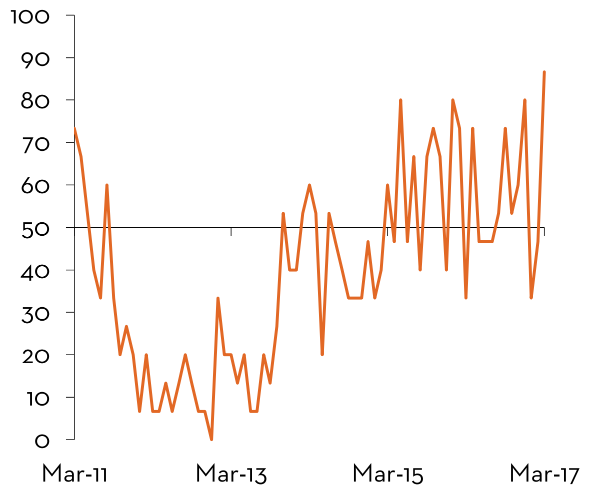
Inflation accelerates. In April, consumer price inflation rose to 1.9 per cent (Chart 6), the highest level in the last four years, and core inflation reached 1.1 per cent (it was 0.7 per cent in March), mostly due to a seasonal rise of leisure and tourist service prices. We expect inflation to be back nearer 1.5 per cent over the next few months. Overall, the inflation forecast is confirmed at 1.5 per cent in 2017 (from -0.1 per cent in 2016) before returning to 1.0 per cent in 2018 as the base effect of oil prices fades away.

Fiscal targets have been confirmed... The preliminary data available up to April are in line with our March forecast of a deficit of 2.4 per cent of GDP in 2017 (equal to that of 2016). Nevertheless, the additional budgetary measures recently approved should allow the 2017 deficit to reach 2.3 per cent (Table 2).

The 2017 Stability Programme adopted by the Government on 11th April has not revised the fiscal targets for 2018 and 2019 planned in the Draft Budgetary Plan of October 2016. It confirms a target of 1.2 per cent of GDP for 2018, and of 0.2 per cent for 2019, to reach a balanced position in 2020. In our view, the Government is likely to revise the 2018 fiscal deficit upward with the next Stability Programme Update (due in September 2017), as has happened over the last four years.

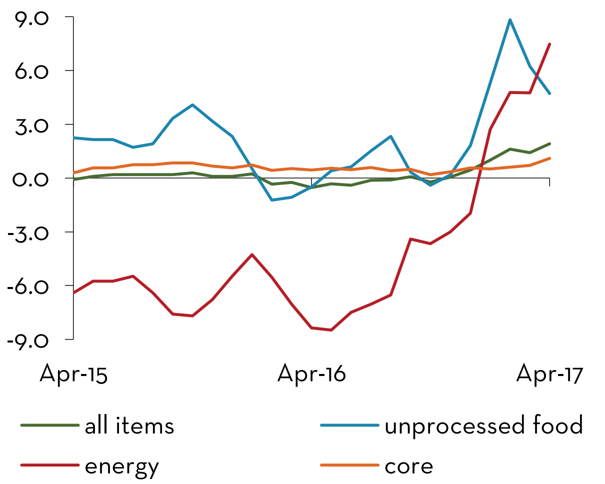
...and negotiations with the European Commission are ongoing. The Directorate General for Economic and Financial Affairs of the European Commission will publish the assessment on the 2017 Stability Programme as well as provide specific recommendations for each Member State in May. On that occasion, it will also provide a reply

Chart 5 **Italy: Prometeia's index of industrial production diffusion** *number of sectors with a positive yoy growth rate in % of total*



Source: Prometeia's calculations on Istat.

Chart 6 **Italy: CPI** *% change yoy*



Source: Istat.

to the letter jointly sent by the Finance Ministries of Italy, Portugal, France and Spain at the beginning of May.[1] The letter proposes a revision of the methodology used to evaluate each country's fiscal policy in light of the current economic juncture and the persistent effects of the economic and financial crisis.

Conditions on the credit markets are slowly improving. Credit to households was getting stronger in March (2.4 per cent yoy, 1.9 per cent at the end of 2016) and was in line with the EMU average. Consumer credit and mortgages contributed positively to growth thanks to the improved real estate sector outlook. The Bank Lending Survey (BLS) confirms both that credit standards are easing and that demand for loans is increasing, sustained by low interest rates and improved consumer confidence. Credit to firms stopped declining but it is still very weak and is not gaining momentum: it grew in March by 0.3 per cent yoy (0.2 per cent in December), widening the gap with the euro area (2.1 pp in March). While credit standards for loans eased slightly, the weak demand for loans by large enterprises reflects limited needs to finance investments and M&A operations.

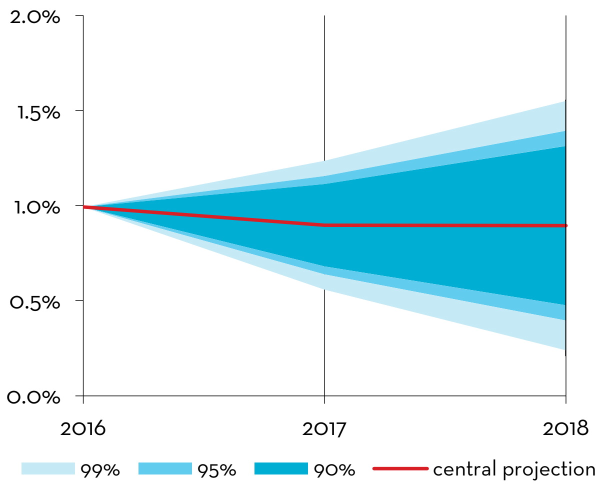
Interest rates broadly stable. The cost of new loans increased slightly, even if this has not yet been reflected in the average rate on outstanding loans, as new loans account for only about 5 per cent of the outstanding amounts. At the same time the BTP/Bund spread dropped to 185 bp and we do not expect it to deviate significantly from this level in the coming few months.

Banking sector slowly improving. The recently published first quarter results of the 10 listed Italian banks are positive overall. On aggregate, operating profits are at around 1.9 billion Euros: revenues are higher than the previous quarter and costs are down also when compared to the same quarter of last year. Banks booked lower provisions while at the same time increasing the coverage ratios of deteriorated loans. Is the worst behind us? It is too early to say whether we are at a turning point but the performance of the sector in the first three months of the year gives some reason for (cautious) optimism.

Risks to the projection

- The global recovery and the increase in inflation (abating deflation risks) are reflected in very low volatility in financial markets. For example, the VIX has been extremely low in recent weeks. An excess of confidence that can lead to a sudden reversal of the mood.
- Moreover, even if risks stemming from emerging markets seem contained, Chinese growth resting on public sector and debt casts some doubt on its sustainability.
- Notwithstanding the "comfortable" results of recent European elections, the risks related to poverty and income distribution have not disappeared and they could suddenly emerge again in political contexts.
- Global cooperation is weakening. Protectionism has not yet taken centre stage, but it cannot be ruled out given the still unclear US trade policy.
- Italy's recovery is on track but growth is still much lower than the Euro area average, mirroring the numerous weaknesses still present, from public debt to banks. The uncertainty around the central forecast is high (Chart 7).

Chart 7 **Italy: Prometeia forecast of annual GDP growth** *(central projection and confidence levels)*



Source: Prometeia's calculations.

1 http://www.mef.gov.it/inevidenza/documenti/Joint_letter_FR_IT_PT_SP.PDF

Indicators of social stress point to weaknesses in the European social model

The latest ECB Economic Bulletin (May 2017) draws attention to the labour market slack in the EU. An alternative measure of unemployment is suggested that accounts for those who are without work but - unlike those officially defined as unemployed - are not available to start working shortly or are not actively seeking a job, and those who are employed on a part-time basis but want to work more hours. Based on this criterion, the unemployment rate in the EU almost doubles. This may have caused wage growth to remain subdued. It may also explain why poverty levels are not following a descending path, since official labour market statistics may have hidden underemployment.

The poverty rate points to a tightening of socio-economic conditions in the Euro area: the incidence of poverty grew from 16.1 per cent in 2007 to 17.2 per cent in 2015 (Chart A).[1] Despite some swings, the latest available data point to an overall increase in the poverty incidence in the last years: from 18.9 per cent in 2007 to 19.4 per cent in 2015 in Italy, from 13.1 per cent to 13.6 per cent in France (with a peak of 14.1 per cent in 2012), from 15.2 per cent to 16.7 per cent in Germany and from 10.2 per cent to 11.5 per cent in the Netherlands, respectively. There is also evidence of increasing in-work poverty, i.e. the percentage of individuals who, despite having a job, fall below the poverty threshold. This is particularly true in Germany, where in-work poverty increased from 7.4 per cent in 2007 to 9.7 per cent in 2015, reaching a peak of 9.9 per cent in 2014 (Chart B), likely related to the "mini-jobs" introduced in 2003. In Italy, the rate rose by 2 percentage points, from 9.3 to 11.5 per cent between 2007 and 2015, while in France the increase was of 1 percentage point, from 6.5 per cent to 7.5 per cent.

In April 2014, the European Commission recommended the implementation of well-designed and adequate income support schemes as tools to fight poverty and increase labour market participation in order to reach the Europe 2020 target of reducing the number of people in poverty and social exclusion by at least 20 million by 2020. It looks like in the last few years redistribution policies did not have the room they deserved because of public finance constraints and, contrary to public announcements, poverty is drifting higher.

Chart A Poverty rates
percentage of the total population

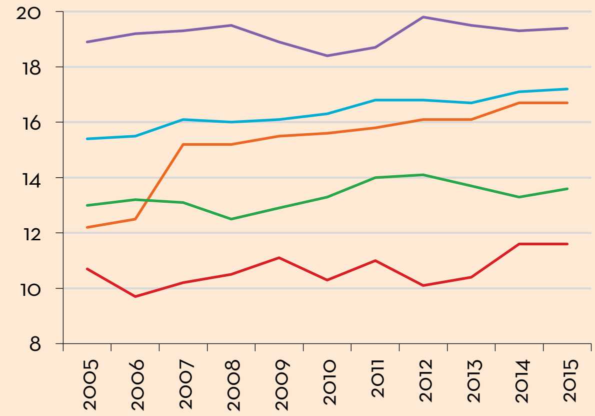
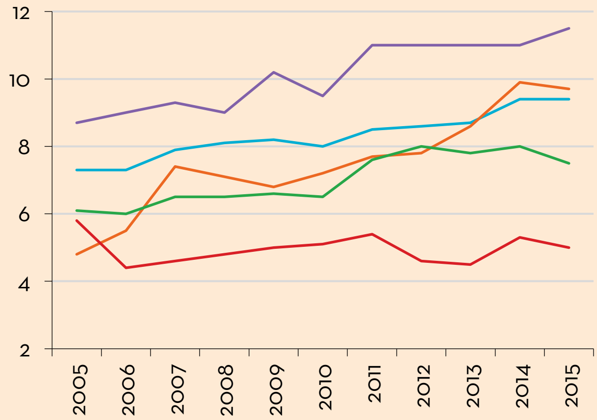


Chart B In-work poverty rates
percentage of the total population



Euro area — Germany — France — Netherlands — Italy

Source: Eurostat

1 The poverty rate - as officially measured by Eurostat with the at-risk-of-poverty rate - is the percentage of people over the total population with an equivalised disposable income below the risk-of-poverty threshold, which is conventionally set at 60% of the national median equivalised disposable income. Equivalised income is a measure of household income adjusted to take account of household size and composition. For definitions, see: http://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:At-risk-of-poverty_rate.

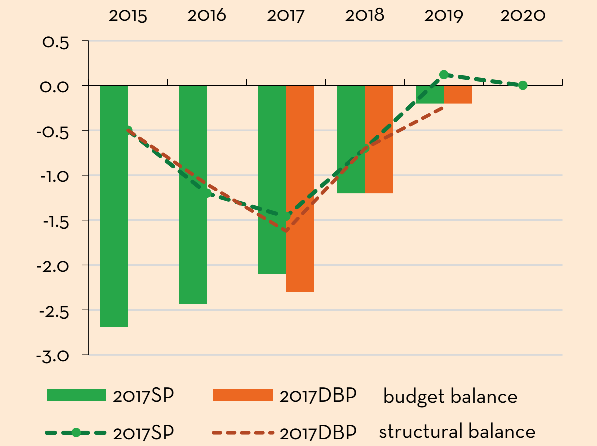
Italy's fiscal targets and the 2017 supplementary budget

The 2017 target includes an additional consolidation effort of 0.2 per cent of GDP, as requested by the European Commission in January to "reduce the gap to broad compliance in 2017 and hence avoid the opening of an Excessive Deficit Procedure for non-compliance with the debt-rule based on notified data for 2015".[2] To ensure total fulfillment of this goal, the Government approved a Decree Law on 24th April (DL 50/2017) (Table A), which is now under examination in the Budget Commission before arriving at the final vote in the Parliament. The text of the Decree is likely to be amended by the parliamentary process; however, it should not change the overall net impact of the measures on the deficit. Table A reports the measures as currently envisaged. It should be noted that the impact is not limited to 2017 but has some lasting effects in subsequent years. In fact, part of the additional resources will be devoted to finance the restructuring of VAT safeguard clauses for 2018. In this respect, the DL50/2017 can be considered as a first step of the Budget Law for next year.

As far as 2018-2020 are concerned, in the 2017 Stability Programme adopted in April, the Italian Government confirmed its commitment to respecting the deficit adjustment path required by European rules (Chart C). The headline deficit is projected to decline to zero in 2020 and the medium-term objective (MTO) of zero structural balance will be achieved in 2019. It is worth noting that, although the headline deficit in 2018-2020 is unchanged, the planned structural balance is now more ambitious in both 2017 and 2019 than the scenario presented in the 2017 Draft Budgetary Plan of October 2016.

For the forthcoming years, the Government announced additional measures aimed at enhancing growth and competitiveness as well as boosting public investment. Further measures aim at lowering the tax burden for households and firms as well as fighting poverty. Other measures include selected reductions of social security contributions. The Government intends to raise around €16 billion to repeal the VAT rates increase (the so-called "safeguard clauses", legislated to guarantee reaching planned fiscal targets), €2 billion to fight poverty, plus the costs of other announced measures (not yet quantified). The exact amount of additional resources needed for this ambitious plan will depend on the ongoing negotiations with the European Commission regarding the appropriate deficit adjustment path for Italy.

Chart C Government balance projections
% of GDP



Source: Italian Ministry of Economy and Finance.

Table A DL 50/2017: net impact
billions of euros

	2017	2018	2019	2020
Additional resources	**-3.9**	**-5.3**	**-5.6**	**-4.5**
- Anti-tax evasion and collection measures	-2.5	-4.0	-3.9	-2.9
- Other revenue increases: gambling, tobacco excise, ACE, short-term rents	-0.6	-1.1	-1.5	-1.3
- Expenditure savings	-0.8	-0.2	-0.2	-0.3
Use of resources	**0.8**	**5.3**	**5.6**	**4.5**
- Investment expenditures and tax relief in areas affected by seismic events	0.6	1.0	1.0	0.1
- Provision related to the VAT safeguard clauses	0.0	3.8	4.4	4.1
- Other	0.2	0.5	0.2	0.3
Change in net borrowing	**-3.1**	**0.0**	**0.0**	**0.0**

Source: Prometeia's calculations on parliamentary documents.

2 http://www.mef.gov.it/inevidenza/documenti/Letter_17012017.pdf

Table 1 The World Economy main indicators *% change*

	2016	2017	2018
World real GDP	2.8	3.2	3.2
World Trade	1.4	3.1	3.4
Manufactures prices $	-4.1	-0.4	2.5
Brent oil price ($/brl, level)	45.0	52.1	53.3
GDP			
- United States	1.6	2.1	2.5
- Japan	1.0	1.1	1.1
- EMU	1.7	1.7	1.4
- China	6.7	6.5	6.2
Consumer prices			
- United States	1.3	2.2	2.1
- Japan	-0.1	-0.1	0.4
- EMU	0.2	1.8	1.6
- China	1.9	2.2	2.0
$/€ exchange rate (level)	1.11	1.08	1.08
£/€ exchange rate (level)	0.818	0.855	0.866

Table 2 Italy main indicators *% change*

	2016	2017	2018
GDP	1.0	0.9	0.9
Imports of goods fob and services	3.1	4.3	2.6
Private consumption	1.3	0.6	1.0
Government consumption	0.6	0.3	-0.1
Gross fixed investment:	3.1	2.7	1.5
- machinery, equipment, other prod.	4.6	4.1	1.9
- costructions	1.4	1.1	1.0
Exports of goods fob and services	2.6	3.9	2.8
Domestic demand	1.1	1.0	0.8
Industrial production	1.9	2.0	1.7
Trade balance (% of GDP)	3.6	3.1	3.0
Terms of trade	3.2	-2.3	-1.0
Consumer prices	-0.1	1.5	1.0
Per capita wages - manufacturing	0.2	1.0	1.3
Total employment	1.4	0.6	0.4
General government balance (% of GDP)	-2.4	-2.3	-2.3

Table 3 Exchange Rates and Interest Rates

		17 Q1	17 Q2	17 Q3	17 Q4	18 Q1	18 Q2	18 Q3	18 Q4
Exchange rates vs euro	US dollar	1.07	1.09	1.08	1.08	1.08	1.08	1.08	1.08
	Yen	121.1	121.9	121.5	121.2	123.1	124.2	125.3	125.3
3 month interest rates	US libor	1.07	1.18	1.32	1.39	1.60	1.80	1.95	2.07
	Euribor	-0.33	-0.33	-0.33	-0.33	-0.32	-0.30	-0.25	-0.16
10 year government bond yields	US	2.44	2.36	2.53	2.72	2.92	3.13	3.16	3.27
	Germany	0.25	0.35	0.40	0.41	0.51	0.77	0.98	1.08
	Italy	2.15	2.26	2.32	2.41	2.48	2.62	2.70	2.70

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

		17 Q1	17 Q2	17 Q3	17 Q4	2017	18 Q1	18 Q2	18 Q3	18 Q4	2018
US	March 2017	0.4	0.6	0.7	0.6	2.2	0.6	0.8	0.7	0.6	2.7
	Brief 17/4	**0.2**	0.6	0.7	0.6	2.1	0.5	0.7	0.7	0.6	2.5
EMU	March 2017	0.5	0.4	0.4	0.3	1.7	0.3	0.4	0.4	0.3	1.4
	Brief 17/4	**0.5**	0.4	0.4	0.3	1.7	0.3	0.4	0.4	0.3	1.4
Italy	March 2017	0.2	0.3	0.2	0.3	0.9	0.2	0.2	0.2	0.3	0.9
	Brief 17/4	**0.2**	0.3	0.3	0.2	0.9	0.2	0.2	0.2	0.3	0.9

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