ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia
ASSOCIAZIONE

OCTOBER 2018 — No. 18/5

Executive summary

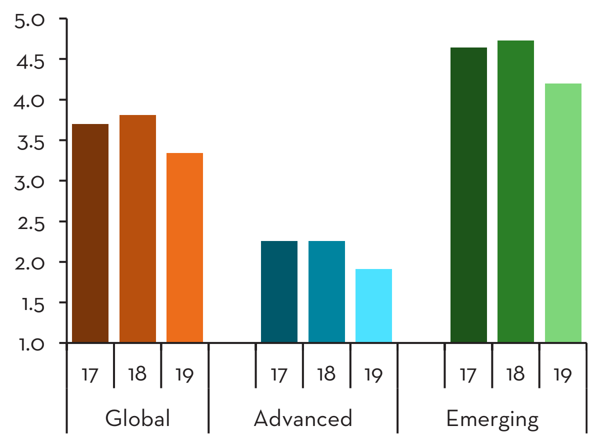
Global growth is moderating amid heightened risks

- The US and Chinese economies showed a surprising upturn in the second quarter of the year, driven in both cases by pro-cyclical policies. US GDP grew by 2.9 per cent yoy, whereas China's economic activity grew by 6.7 per cent.
- The most updated indicators point to a slowdown in world trade in recent months. According to the Central Planning Bureau, global real trade in 2018 Q2 decelerated to 3.9 per cent yoy from 4.3 per cent in 2018 Q1.
- Also, the euro area countries experienced a broad-based moderation although domestic demand remained solid.
- A number of emerging economies suffered significant depreciations while financial conditions have been tightening (InFocus 1).

Italy is moving forward at a slower pace

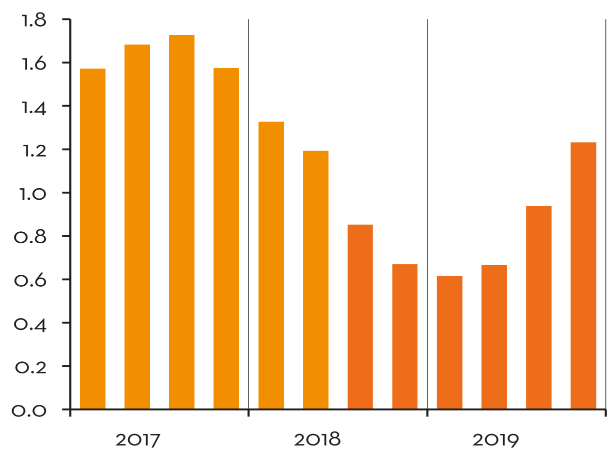
- Italy's GDP growth declined from a peak of 1.7 per cent yoy in 2017 Q3 to 1.2 per cent in 2018 Q2 (Chart 2), led mainly by strongly decelerating exports triggered by the euro appreciation in effective terms and the slowdown experienced by main trading partners.
- Italy's economy is slowing more quickly than those of its European partners, in part because of its major trade links with some emerging economies which are under stress (InFocus 1). We forecast GDP growth to be at 1 per cent in 2018 (1.6 per cent in 2017).
- For 2019 the new government's plans entail a shift towards an expansionary fiscal policy (InFocus 2). Due to the increase in domestic uncertainty and borrowing costs (BTP-Bund 10Y spread now is at about 300bp), the positive effects on activity will be modest and we expect GDP to grow at 0.9 per cent in 2019.

Chart 1 – Real GDP
% change yoy



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

Chart 2 – Italy: real GDP
% change yoy



Source: Prometeia's forecast on Istat data.

Global scenario

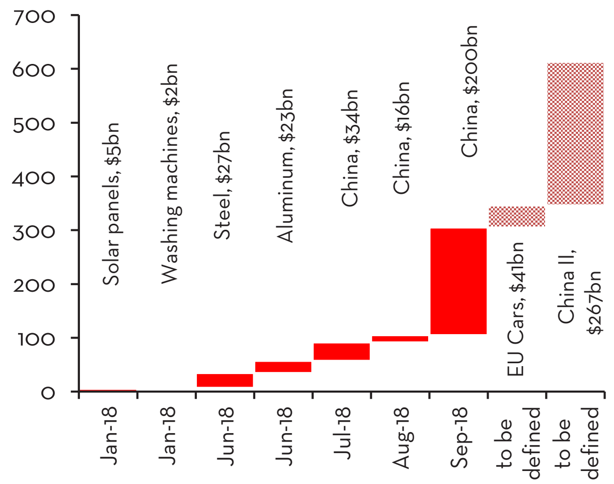
Among advanced economies, the US is the most buoyant. The US economy rebounded from a dip in growth in Q1, expanding by 1 per cent qoq in Q2. This expansion was driven by strong domestic demand and a bigger contribution compared to Q1 from net trade. Because of the strong outlook, higher core inflation and a strong labour market, we expect the FOMC to continue to tighten monetary policy raising the Federal funds rate by 25bp to 2.25-2.5 per cent in December. A further 25bp hike is expected at the beginning of 2019.

In the euro area activity has slowed after its 2017 peak. In the second quarter of 2018 activity growth remained stable (+0.4 per cent qoq) due to the reduced contribution of net external demand to GDP growth, compared to solid domestic demand. The confidence indicators worsened in recent months, but remained consistent with resilient, although more modest, growth than a year ago. Weakening world trade combined with the impact of past euro appreciations is raising concerns about the negative effects on confidence of protectionism. However, financial conditions are expected to remain accommodative to the end of 2019, and domestic demand resilient. We expect an annual GDP growth of 2 per cent in 2018 falling to 1.6 per cent in 2019, which is still above potential but weaker than our forecast in the July Brief.

China appears to be suffering from trade tensions. Quarterly GDP growth accelerated to 1.8 per cent in Q2, but the tariffs already imposed by the US, including those that came into force on 24 September, are affecting some $250 billion worth of Chinese exports (Chart 3) and have been weighting on asset prices. An expansionary economic policy and continued robust credit growth are expected to support activity in the near term, compensating for negative effects linked to the high dependency on US imports. However, the need for China to control its very high domestic debt will continue to be a priority and a drag on growth.

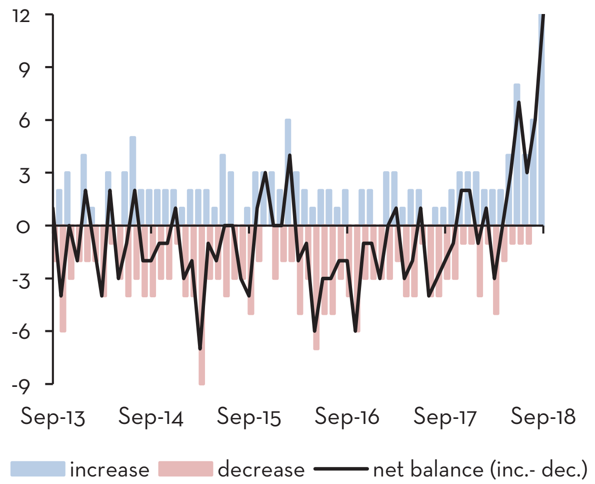
The economic policy mix in the US, characterized by the monetary policy normalization and a fiscal expansion, is bringing about an increase in US interest rates and having strong adverse effects on the currencies of some fragile Emerging Market Economies (EME; InFocus 1), contributing to a further tightening of their financial conditions (Chart 4).

Chart 3 – Timeline of US protectionist measures
$bn, approved and under discussion



Source: US Department of Commerce.

Chart 4 – Monetary policy in Emerging Markets
number of Central banks that modified policy rates



Source: Prometeia's calculations on Central banks data.

Commodities. Brent oil is trading at above 80 dollar per barrel because supply factors seem to offset the factors depressing world demand. In contrast, since June metals prices have been falling, against a backdrop of downside risks to international economic activity stemming from uncertainty and higher tariffs impacting on trade and EME domestic demand.

Italy

In 2018 Q2 Italy's GDP growth slowed. GDP grew by 0.2 per cent qoq, at a slightly slower pace than in 2018 Q1 (0.3 per cent). Domestic demand supported economic growth, thanks to a rebound in investment in machinery and transport equipment (7 per cent qoq), following the drop in the previous quarter (-2.5 per cent qoq). Household spending stagnated, likely driven by the worsening stock market. The contribution of the foreign sector was negative (-0.5pp) as a result of stagnant exports and increased imports.

Exports disappointed in the first half of 2018. Annual real growth fell from 6.4 per cent at the end of 2017 to 0.9 per cent in 2018 Q2. The slowdown involved almost all sectors and destination markets, but affected exports to extra-EU countries in particular. The growth rate declined to 2.3 per cent in the first seven months of 2018, from 8.4 per cent in the corresponding period of 2017, for exports outside the EU evaluated at current prices, and to 5.6 per cent, from 6.4 per cent, for exports within the EU (Chart 5).

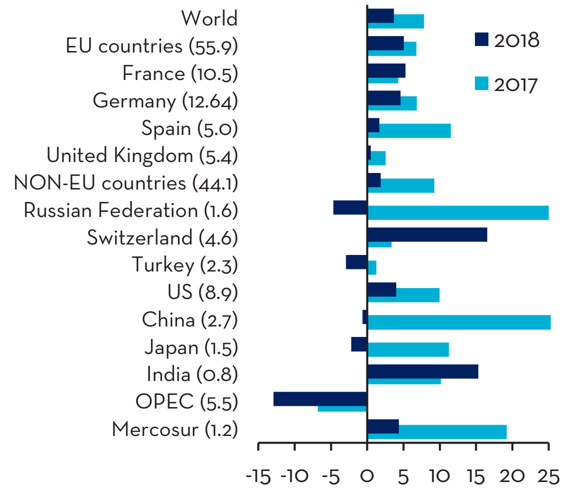
Industrial production and qualitative indicators signal a stagnation of GDP in 2018 Q3. In the summer months, industrial production was characterized by high volatility: in July, it fell by 1.6 per cent mom and in August it rebounded by 1.7 per cent. The number of expanding sectors increased, but is still below 50 per cent (Chart 6). In September, manufacturing PMI remained around 50, as in August. Taking all this information into account, our models show a further drop in industrial production in Q3 compared to Q2, and moderate GDP growth in the last months of the year.

Labour market still healthy. In August, employment was 358 thousand units higher than the 2017 average. Temporary contracts were the driving force of this improvement (+423 thousand units), while permanent contracts declined (-46 thousand units). Alongside a reduction in labour supply, the unemployment rate reached its minimum since January 2012, 9.7 per cent.

Inflation sustained by energy and food prices. In September, inflation decreased slightly to 1.5 per cent (from the 1.6 per cent achieved in August), due mainly to the unprocessed food, transport services and non-regulated energy products prices. Similar to the previous few months, inflation was driven

Chart 5 – Italy: exports of goods*

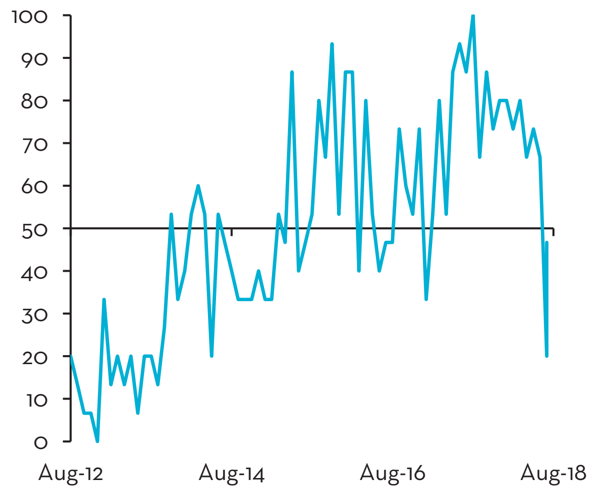
% change yoy January-July, current prices



** In brackets, shares calculated on 2017 total Italian exports.*

Source: Istat data.

Chart 6 – Italy: Prometeia Industrial Production Diffusion Index - %



Source: Prometeia's calculations on Istat data.

largely by energy and food prices. Core inflation remained below 1 per cent.

Credit to the private sector continues to expand and in August grew by 2.6 per cent yoy. Its growth was sustained by loans to households, which increased by 2.7 per cent yoy, lower than the EMU average (Chart 7). Corporate loans continue to show weak growth (1.2 per cent yoy), suggesting that firms are financing their investments by using mainly their internal resources.

The reduction in the stock of gross non-performing loans persists. In the first eight months of 2018, NPLs decreased by €41 billion, due to major sales, and are expected to fall by €56 billion overall by the end of the year.

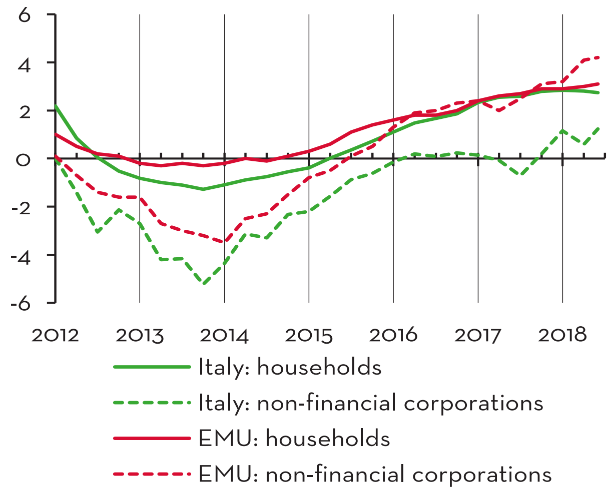
Banking sector profitability is improving steadily. In the first semester of 2018, the balance sheets of almost all significant groups were positive, with net revenues amounting to €5.6 billion (€0.4 billion in the first half of 2017). This was driven by a decrease in both loan loss provisions and operational costs, respectively -61 per cent and -5.1 per cent.

Public accounts for 2018 are on a favourable trend, backed by the recovery in revenues and the moderate growth of expenditure. In the last 12 months, both general government and state sector borrowing requirements have been at a minimum (Chart 8).

The increase in the average yield at issue is starting to impose a burden on public finances and the tensions in the government securities market have been an adverse factor since last May. The increase in the spread BTP-Bund 10Y yields in May and subsequently on 28 September following the announcement of the budget target for 2019 of 2.4 per cent (from 120bp at the beginning of May to 300bp at the beginning of October) was accompanied by a sharp rise in the average weighted yields at issue. This rise has yet to translate into higher average borrowing costs (currently still below 3 per cent because of the high average maturity of the outstanding debt). Therefore, in 2018, interest expenditure will continue to fall (-0.1pp of GDP), to reach 3.7 per cent of GDP. The deficit-to-GDP ratio is forecast to settle at 1.7 per cent in 2018, 0.6pp less than in 2017, mainly because of the decline in capital and interest expenditures.

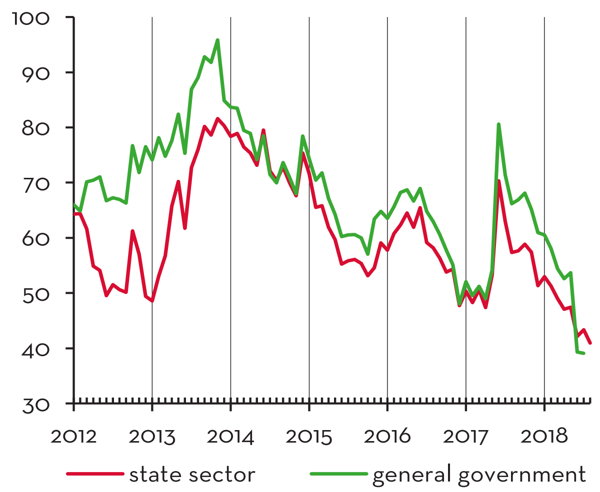
The expansionary policy planned by the new government for 2019 (InFocus 2) will lead to a worsening of public finance indicators: based on our estimates, the deficit will increase to 2.4 per cent of GDP and the debt to 131.5 per cent. Our scenario includes a budget package consistent with government's plans. The additional measures are worth a net total of 0.6pp of GDP. The increase in public expenditure is about 0.7pp of GDP; more than 60 per cent of the additional expenditure is earmarked to fund social benefits (9 billion in 2019), the remaining 40 per cent being devoted to public consumption and investment. Tax relief is provided for, especially for small businesses (0.1pp of GDP). Financing obtained from higher tax revenues is estimated at around 0.2pp of GDP.

Chart 7 – MFI loans to households and non-financial corporations *% change yoy*



Source: ECB and Bank of Italy.

Chart 8 – Rolling 12-month borrowing requirement *billion euro*



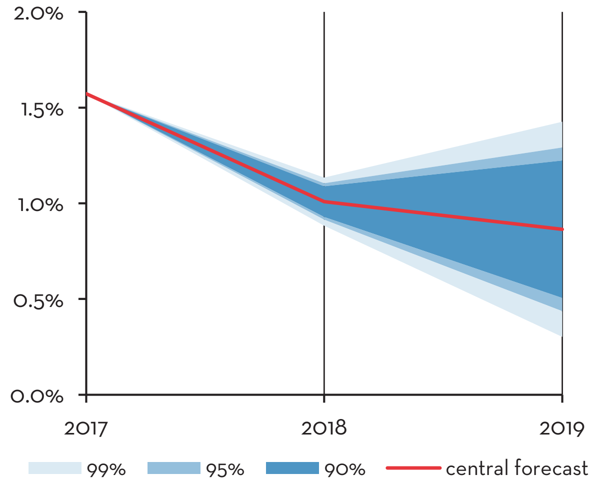
Source: Prometeia's calculations on Ministry of the Economy and Finance and Bank of Italy data.

The fiscal impulse downsized by uncertainty. The new budget should have an expansionary effect on activity of around 0.3pp with respect to the estimated growth in the no-policy-change scenario. However, increased uncertainty about the fiscal consolidation plans and the delayed debt reduction are causing an increase in debt refinancing costs. This is leading to stock market losses and an increase in the government bonds spread (expected to remain at about 300bp on average in 2019), which will lead in turn to lower growth, affecting household consumption and corporate investment plans. We estimate that these adverse effects will largely compensate for the fiscal impulse.

Risks to the projection

- On the global front, threats of further protectionist measures are looming, with effects on global trade which could suffer a major relapse.
- Among the other risks arising from the global environment, we note the intensified tightening of global financial conditions, leading, possibly, to episodes of further instability in the most vulnerable emerging markets and to a disorderly deleveraging process in China.
- The risks in the case of Italy are related to the tensions in financial markets and their potential negative effects on household and business behaviours, hindering the economic recovery.

Chart 9 – Italy: Prometeia's forecast of annual GDP growth - *central projection and confidence levels*



Source: Prometeia's calculations.

InFocus 1

EMERGING COUNTRIES TENSIONS: EFFECTS ON THE GLOBAL AND THE ITALIAN ECONOMIES

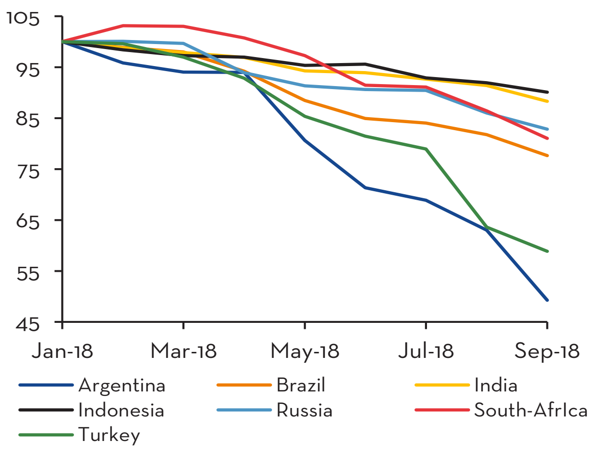
Over the summer months, expectation of a tighter monetary policy in the US led to strong dollar appreciation and EME capital outflows, which exacerbated the depreciation of their currencies (Chart A). Those countries with strong external imbalances, in the form of high levels of corporate or government debt denominated in dollars (respectively Turkey and Argentina), high exposure to rising energy prices despite solid growth (India), or persistent balance of payments deficits (Indonesia and South Africa), were the most sensitive to US financial conditions.

In response to the depreciation of their national currencies and reduced demand for their assets, a number of emerging countries' central banks increased their interest rates, which tightened internal financing conditions even more.

This backdrop is reminiscent of the crises that hit several emerging countries in the second half of the 1990s, from the 1995 Tequila effect in Mexico to the 1997 and 1998 Asian crises and the repercussions for Russia and other emerging countries. These events demonstrated the relevance of both external debt and trade deficit in a context of ever tighter global financial conditions. However, in the present case, some factors are alleviating the effects of the current volatility, including higher exchange rate flexibility and larger international reserves.

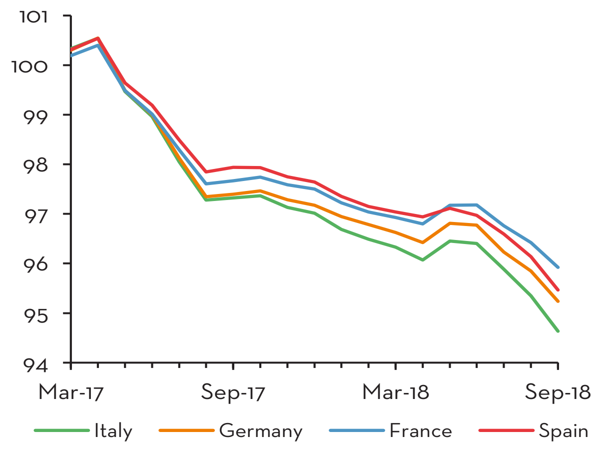
Using the Prometeia international model, we evaluated the effects on the global economy of the recent emerging economies tensions. We assume that the currency depreciations observed since the beginning of the year will persist and be accompanied by a less supportive monetary policy and worsening confidence, which will reduce EMEs' domestic demand. The simulations point to reductions over a 12 month period of around 1pp in the global trade growth rate and about 0.5pp in global GDP.

Chart A – Exchange rates to US dollar
January 2018 = 100



Source: Prometeia's calculations on Thomson Reuters data.

Chart B – Nominal effective exchange rate
January 2017 = 100



Source: Prometeia's calculations on IMF and Thomson Reuters data.

Among the biggest eurozone countries, Italy has the largest share of exports to these fragile EMEs and the highest nominal effective exchange rate appreciation (Chart B). Between January 2017 and September 2018, Italy's nominal effective exchange rate appreciated by 5.4 per cent compared to 4.8 per cent, 4.5 per cent and 4.1 per cent respectively in Germany, Spain and France.

Evaluating the contribution of this global scenario to Italy's GDP growth using the Prometeia Italian econometric model, we find that the export transmission channel could dampen activity by 0.3 per cent annually. This assessment does not consider financial sector linkages. However, in terms of banking institutions – the only sector for which data are available – Italy's exposure to these countries is very limited.

InFocus 2

THE NEW ITALIAN GOVERNMENT'S FISCAL PLANS

At the end of September, the Italian Council of Ministers reached agreement about the fiscal policy objectives, setting deficit targets of 2.4 per cent of GDP in 2019, 2.1 per cent in 2020 and 1.8 per cent in 2021. Based on official estimates, the structural balance will worsen by 0.8pp of GDP in 2019, but shows no change in subsequent years, thus, deviating from the Fiscal Compact requirements.

Compared to the April Economic and Financial Document (Documento di Economia e Finanza, DEF) projections of a 0.8 per cent deficit in 2019 (with a structural adjustment of 0.6 per cent) and a budget balance in 2020, **the Update to the DEF (Nota di Aggiornamento to the DEF, NADEF) presented on 4 October entails a shift towards an expansionary fiscal policy**. This shift, according to government plans, should address the expected economic slowdown and the need to fund the first phase in the measures included in the government programme. The new fiscal policy is expected to result in an annual 0.5pp higher GDP growth compared to the unchanged legislation scenario, thus, increasing to 1.5 per cent in 2019, 1.6 per cent in 2020 and 1.4 per cent in 2021 (Chart C). Despite higher GDP, **the debt reduction outlook is less**

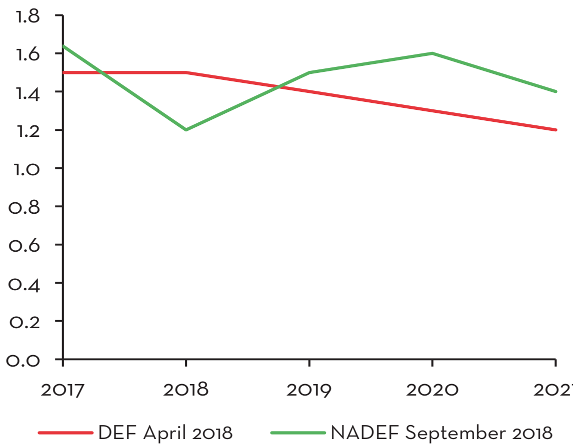
favourable compared to the official April plans. In the NADEF, debt to GDP stands at 126.7 per cent in 2021 compared to 122 per cent in the April DEF (Chart D).

The main points highlighted in the Update are: cancellation of the legislated VAT increase in 2019 (worth €12.5 billion) and a reduction in the forecast increases for 2020 and 2021; introduction of a basic citizenship income (Reddito di cittadinanza); job centre reform; introduction of early retirement measures to encourage employment of young workers (countering the "Fornero reform"); first phase in the introduction of a flat rate tax involving a rise in minimum thresholds to achieve a simplified taxation scheme for small enterprises, professionals and craftsmen; corporate income tax cuts for companies that reinvest their profits and hire additional workers; increased public investment; compensation for savers who lost money in the recent bank crises. These measures will be financed partly by the so-called "fiscal peace" (essentially a partial tax amnesty) and other revenue recovery measures, and partly by an increase in the deficit.

The draft Budget Law, which should provide more details on these measures, will be presented and submitted to Brussels **on 15 October** for review by the European Commission.

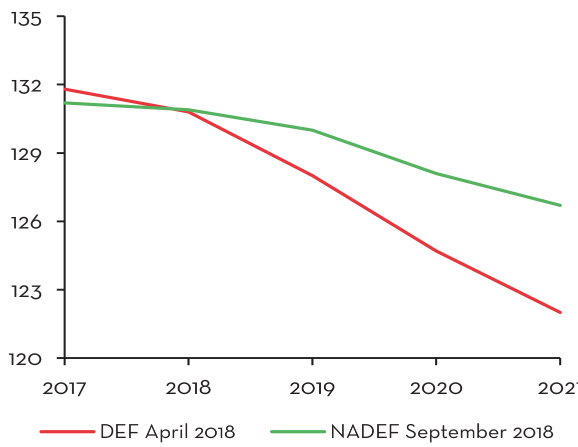
Overall, in the official scenario, the new policies will determine a deficit increase, with respect to the no-policy-change scenario, of roughly 1.2 per cent of GDP in 2019 (0.5pp not including the VAT reduction), 1.4 per cent in 2020 and 1.3 per cent in 2021 (€22 billion in 2019 and €26 billion in the following two years). The increase in VAT in 2020 and 2021 is around €14 billion (instead of the previously legislated €19 billion). The decision to maintain the VAT increase for the last two years of the programming period is in line with the actions of previous governments in recent years. However, the NADEF does not envisage the achievement of a balanced budget, but rather measures that will allow the deficit to remain at around 2 per cent of GDP.

Chart C – Real GDP
% change



Source: Ministry of Economy and Finance.

Chart D – Public debt-to-GDP ratio
%



Source: Ministry of Economy and Finance.

Table 1 The World Economy main indicators *% change*

	2017	2018	2019
World real GDP	3.7	3.8	3.3
World Trade	4.8	4.1	3.3
Manufacturing prices $	2.9	3.1	0.8
Brent oil price ($/brl, level)	54.9	73.7	72.5
GDP			
- United States	2.2	2.9	2.4
- Japan	1.7	1.1	1.1
- EMU	2.5	2.0	1.6
- China	6.8	6.6	5.9
Consumer prices			
- United States	2.1	2.4	2.1
- Japan	0.5	0.9	1.4
- EMU	1.5	1.7	1.8
- China	2.9	1.4	2.4
$/€ exchange rate (level)	1.13	1.18	1.15
£/€ exchange rate (level)	0.876	0.887	0.895

Table 2 Italy main indicators *% change*

	2017	2018	2019
GDP*	1.6	1.0	0.9
Imports of goods fob and services	5.6	1.6	3.7
Private consumption	1.5	0.8	1.1
Government consumption	-0.1	0.0	0.9
Gross fixed investment:	4.4	4.0	1.9
- machinery, equipment, other prod.	6.5	5.6	1.9
- constructions	1.9	1.9	1.7
Exports of goods fob and services	6.3	0.6	2.8
Domestic demand	1.4	1.3	1.1
Industrial production	3.7	1.1	1.3
Trade balance (% of GDP)	3.3	2.9	2.6
Terms of trade	-1.6	-0.9	-0.9
Consumer prices	1.2	1.2	1.3
Per capita wages - manufacturing	0.5	1.0	1.6
Total employment	0.9	0.7	0.3
General government balance (% of GDP)	-2.4	-1.7	-2.4

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

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	1.14	1.15	1.16	1.17
	Yen	133.1	130.0	129.0	128.3	128.3	128.2	128.2	128.5
3 month interest rates (%)	US libor	2.00	2.40	2.40	2.46	2.67	2.80	2.85	2.85
	Euribor	-0.33	-0.33	-0.32	-0.32	-0.31	-0.30	-0.22	-0.02
10 year government bond yields (%)	US	2.76	2.92	2.91	3.00	3.07	3.10	3.10	3.05
	Germany	0.59	0.48	0.32	0.44	0.56	0.65	0.78	0.87
	Italy	2.01	2.24	2.83	3.54	3.66	3.76	3.79	3.69

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 July 2018	**0.5**	0.9	0.8	0.6	2.9	0.4	0.6	0.6	0.5	2.4
	Brief Oct. 2018	**0.5**	**1.0**	0.8	0.7	2.9	0.5	0.5	0.4	0.4	2.4
EMU	Brief July 2018	**0.4**	0.4	0.4	0.5	2.1	0.5	0.4	0.4	0.3	1.8
	Brief Oct. 2018	**0.4**	**0.4**	0.3	0.5	2.0	0.4	0.3	0.4	0.4	1.6
Italy	Brief July 2018	**0.3**	0.2	0.3	0.4	1.2	0.4	0.2	0.2	0.3	1.2
	Brief Oct. 2018	**0.3**	**0.2**	0.0	0.1	1.0	0.2	0.3	0.3	0.4	0.9

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