Italy in the Global Economy
Prometeia Brief

May 2018 – No. 18/3

Executive summary

Global growth remains robust amid increasing risks

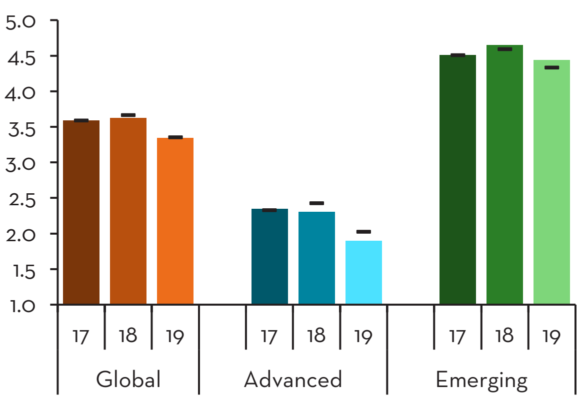
- Global growth remains solid, despite the growing uncertainty over trade developments due to the ongoing threats of protectionism.
- Still, real global trade grew above 5 per cent yoy in January and February, according to the Central Planning Bureau Trade Monitor.
- In 2018 Q1, Chinese and US GDP growth was slightly stronger than expected, while the euro area surprised on the downside (0.4 per cent qoq, we expected 0.5 per cent in the April Brief). All these countries are growing at above potential, supporting robust global growth in 2018 (Chart 1, Table 1).
- Oil prices soared in response to the decreasing Venezuelan supply, the uncertainty regarding Iran and the elimination of surplus inventories in OECD countries. We forecast that this spike will be slowly reabsorbed starting from the summer, as we expect the quotas to be increased at the OPEC and Russia meeting in June.
- Uncertainty over trade will continue to bite, diminishing confidence. We expect the US-EU tug-of-war on duties to escalate with regard to vehicles, contributing to the already expected deceleration of the EMU (see first InFocus).

Italy's recovery is underway, but the political situation could create some uncertainty

- Data for 2018 Q1 confirmed our April estimate of GDP growth at 0.3 per cent qoq (Chart 2). We maintain our forecast for 2018 unchanged at 1.4 per cent, slightly below 2017 growth (1.6 per cent, revised in April from the March estimate of 1.5) mainly due to a less favorable external environment.
- At the time of writing, talks are ongoing to form a new government. Assuming the political parties will be able to find an agreement, we expect some widening of the fiscal accounts in 2019 to be likely, but without a reversal of the moderately decreasing trajectory of public debt to GDP.
- In 2019, the widening of the fiscal accounts will not be sufficient to offset the impact of the less favorable external scenario on activity. We expect Italy's 2019 GDP growth at 1.2 per cent (revised from the 1.3 we had in April, Tables 2-4).
- The first real test for the economic policies of the new government will be the drafting of the budget law for 2019 starting in October. At that time, with the ECB QE close to an end, possible policy uncertainties might create some nervousness in financial markets.
- Our second InFocus looks at the differences in income inequality across Italian regions.

Chart 1 – Real GDP

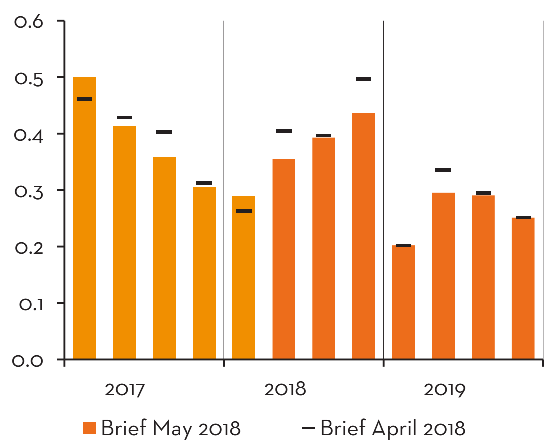
% change yoy



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

Chart 2 – Italy: real GDP

% change qoq



Source: Prometeia's forecast on Istat data.

Global scenario

US economy on a sustained path. In 2018 Q1 GDP grew by 0.6 per cent qoq thanks to strong non-residential investments (1.5 per cent qoq), weak imports and inventory accumulation. In contrast, private consumption decelerated (0.3 per cent qoq) possibly due to bad weather conditions.

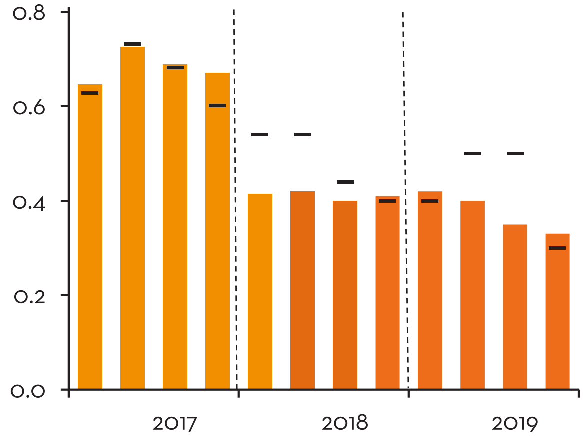
EMU decelerating. The deceleration of the euro area GDP in 2018 Q1 is shared by France and Germany. meanwhile Spain and Italy remained on the 2017 Q4 per cent qoq growth levels. The deceleration was in line with the deterioration in confidence indicators, which in April almost stabilized (although at historically high levels). Against this background, we estimate a stable GDP growth qoq in 2018 Q2 (Chart 3 and Table 4). We do not exclude negative effects on investments from the tug-of-war with the US on vehicle duties, which could penalize the EMU as a whole, but mostly Germany (see first Infocus).

Higher oil prices will exert upward pressure on headline inflation, but the core remains weak both in the US... The higher oil price (8 per cent above that in the April Brief in 2018) could increase US inflation by roughly 20bp, all other things being equal. In March, US PCE headline inflation was 2 per cent yoy and core inflation 1.9 per cent yoy (1.7 per cent in February). The increase in core inflation was expected[1] and is largely due to the fading of temporary effects linked to communications that contributed to keeping inflation low in 2017 and therefore are likely to be short-lived.

...and in the euro area. Inflation surprised downwards in April, according to the Eurostat flash estimate. Headline HICP inflation was 1.2 per cent (1.3 per cent in March) and core inflation was 0.7 per cent (1 per cent in March), not easing the task of the ECB. Higher oil prices and a weaker euro will contribute to an increase in total inflation, but the pass-through on core items might be slow, due to labour market slack.

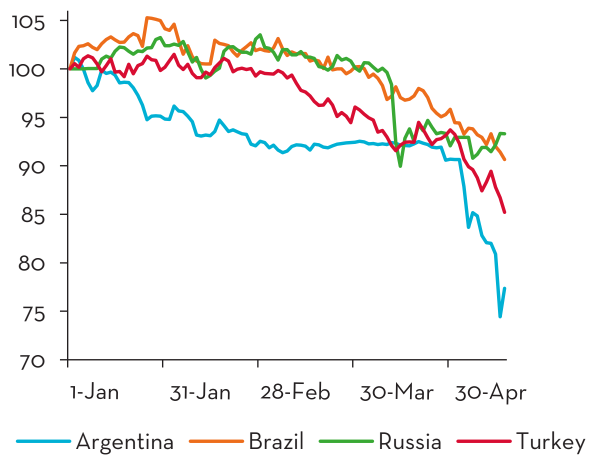
We confirm cautious US and EMU monetary policies. Given that the increase in US core inflation mostly reflects temporary factors, we maintain our forecast of two further increases of 25bp in 2018 and an additional one at the beginning of 2019. Also, we are not changing our forecasts concerning ECB monetary policy, expecting QE to end in 2018 after some tapering, with the first increase of the refi in the second part of 2019 (Table 3).

Chart 3 – EMU: real GDP
% change qoq



Source: Prometeia's forecasts on Eurostat data.

Chart 4 – National currency vs US $ in 2018
1 January 2018 = 100 (latest data 15 May)



Source: Prometeia's calculations on Thomson Reuters.

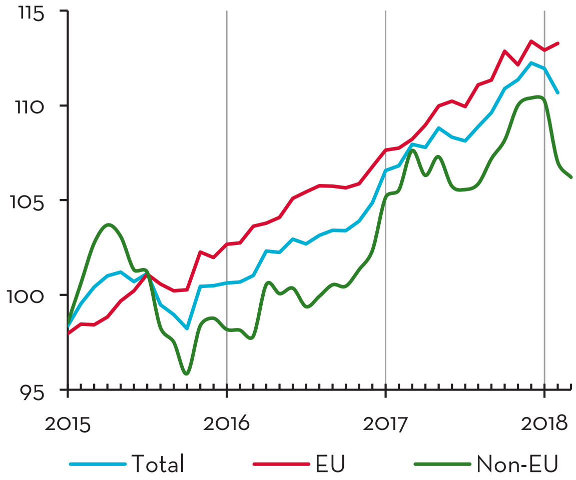
Potential financial risks for some EMs. Capital outflows and currency depreciation have hit some emerging countries with severe fragilities in the last few weeks. In particular, since the beginning of the year the national currency has depreciated significantly in Argentina, which is suffering from both internal and external imbalances, in Turkey, which is experiencing a severe current account deficit, in Brazil, where political uncertainty is rising and in Russia, characterized by increasing financing difficulties in international markets partly related to sanctions (Chart 4).

1 See Prometeia Discussion Note n.5/2018

Italy

Italy's GDP growth stable in 2018 Q1. According to preliminary data from the national institute of statistics, in the first quarter of 2018 GDP increased as in the last quarter of 2017, at 0.3 per cent qoq. This result stems from an increasing value added in agricultural and service sectors and a stable value added in the industrial sector (complete data will be available on June 1). Industrial production in fact stagnated in the first quarter. On the demand side, the contribution of domestic demand was positive, while the contribution of the external sector was negative. Partial information on goods exports points to a reduction, in particular towards non-European countries (as is happening in other EMU countries), driven by the strengthening of the euro (Chart 5).

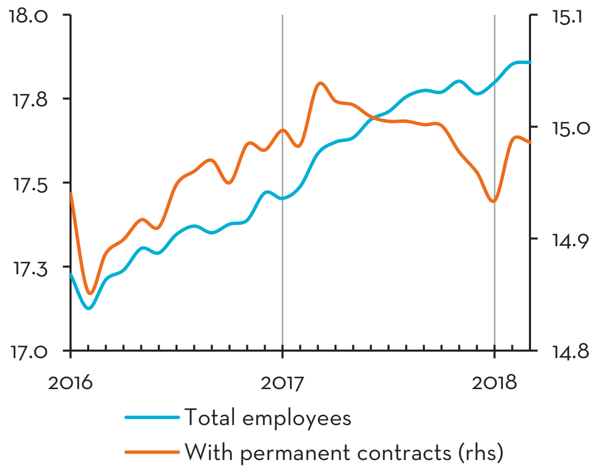
Chart 5 – Italy: goods export (*)
3-month moving averages on seasonally adjusted data, 2015=100



Source: Prometeia's calculations on Istat data.
(*) Latest data available February 2018 for total and European exports, March for non-European ones

The delayed effects on inflation of past oil price reductions. In April, the consumer inflation decelerated to 0.5 per cent from 0.8 per cent yoy in March. This evolution was affected by services relating to transport and communication, and by delayed effects of the past drop in energy prices on utility bills. With regard to core inflation, it decelerated to 0.5 per cent from 0.7 per cent yoy. Despite the recent oil price increase, we confirm our April forecast consumer inflation for 2018 at 1.2 per cent because of lower than expected inflation in the first part of the year.

Chart 6 – Employees
millions (latest data available March 2018)



Source: Istat.

The number of permanent contracts increased for the first time since March 2017. On the average of February and March, employment grew by 0.2 per cent (46 thousand) compared to January due to the recovery in the number of permanent employees (53 thousand, Chart 6). This recovery was partly driven by the new fiscal incentives on hiring young workers introduced by the 2018 budget law. Overall, the consolidation of the recovery is supporting employment, which has continued to grow in the first few months of 2018, although at a slower pace, as indicated by the modest increase compared to 2017 (to 0.7 per cent in 2018 Q1 yoy vs. 1.1 per cent in 2017). In March, the unemployment rate remained stable at 11 per cent compared to February.

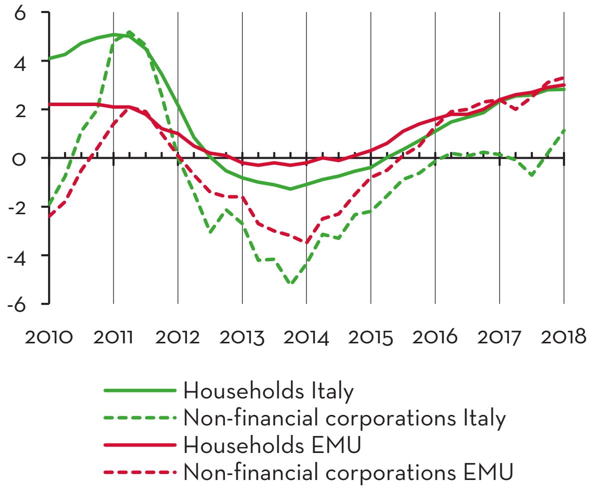
Both in February and March loans to firms declined. After almost one year of stagnation, in January 2018, lending grew by more than 2 per cent yoy (Chart 7) thanks especially to the banks' efforts to exceed the ECB benchmark by 2.5 per cent, thus obtaining the lowest rate for the repayment of liquidity borrowed under the TLTRO program. In February and March loans to firms decreased by 7.2 billion. In March, the growth of loans to households was still in line with the average of euro area (2.8 per cent and 3 per cent yoy, respectively).

The central government borrowing requirement is down in the first four months of the year. In the first four months, the state sector borrowing requirement decreased by over €4 billion compared to the corresponding period in 2017. Tax revenues accelerated, confirming the positive economic situation, and outlays benefited from a further contraction in interest paid on government securities, down by €1.5 billion. For the whole of 2018 the headline deficit is expected to decline to 1.8 per cent of GDP, from 2.3 per cent reached in 2017, when the cost of the support to the banking sector accounted for 0.4pp of GDP. The improvement of the deficit is supported by economic growth as well as by some measures included in the 2018 budget (provisions aimed at collecting unsettled tax liabilities and fighting tax evasion; spending review measures).

The direction of budgetary policies for the coming years is uncertain... The Economic and Financial Document (EFD 2018) recently released only includes forecasts under current legislation, thus the new budgetary targets merely reflect the revision of the macroeconomic scenario. These targets include the legislated increase in VAT rates (the so-called "safeguard clause") worth €12.5 billion of revenues in 2019 and over €19 billion in 2020 (respectively 0.7 and 1 per cent of GDP).

...but a further decrease of deficit is unlikely. While waiting for the new government, our baseline scenario considers unlikely a further decrease of deficit in 2019, due to the announcement of the major parties electoral programs. We expect the legislated VAT increase to be ruled out and additional expenditure directed at supporting households, especially for the strengthening of the Income inclusion programme (REI). Higher revenues from measures to fight tax evasion will compensate only partially, so that we expect the deficit to remain stable at 1.8 per cent of GDP (1pp over the EFD target). Compared to current legislation, our scenario foresees the budget to support growth by 0.4pp in 2019.

Chart 7 – MFI loans to households and non-financial corporations *% change yoy (latest data available March 2018)*

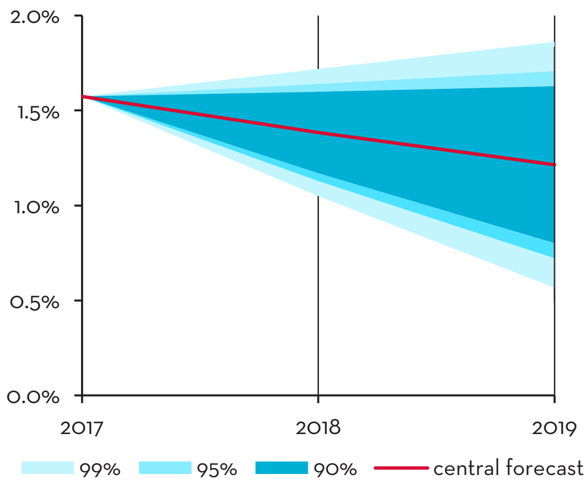


Source: ECB and Bank of Italy.

Risk to the projection

- In the absence of effective progress in the trade talks between the US and its main partners (China and EU), the likelihood of tough negotiating stances from both the US and China, and to a certain extent from Europe, is increasing.
- Should OPEC and Russia limit production further and/or political uncertainty on Iran deal increase, persistent higher oil prices could put global economic growth at risk.
- For Italy, the main risk stems from the prospect of a policy mistake on the part of an inexperienced new government.

Chart 8 – Italy: Prometeia's forecast of annual GDP growth - *Central projection and confidence levels*



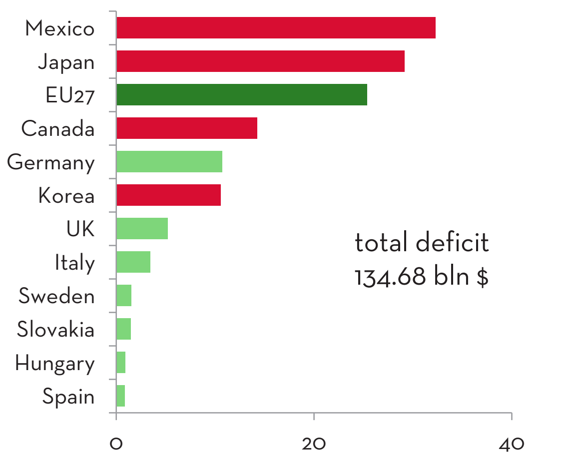
Source: Prometeia's calculations.

InFocus 1

US TARIFFS ON EU VEHICLES: ESCALATION BEFORE A DEAL?

In its efforts to solve the US trade deficit problem, the Trump Administration has already targeted many products and several trade partners including the EU. For now, tariffs on EU products have only affected aluminium and steel and have been suspended until the end of May. A bigger threat is currently looming on tariffs on US automotive imports. This is a very important sector and the US administration has two main concerns: 1) the bilateral deficit with the EU is around 35 billion dollars (Chart A); 2) there is an asymmetry in the automotive tariff structure with EU exports to the US paying a 2.5 per cent tariff and US exports to the EU paying a 10 per cent tariff. This structure is not "fair" in the words of the US administration, disregarding the fact that this tariff structure stems from years of talks and agreements, involving many sectors and countries and producing these asymmetries in tariffs that favour in turn one partner/sector in exchange for another. In any case, the sector is economically very important and the "unfairness" makes it a very easy target.

Chart A – US bilateral deficit in the passenger car sector as a share of US total deficit in the sector - %



Source: Prometeia's calculations on US Department of Commerce data.

The production of vehicles involves many countries as major companies try to exploit the cheapest costs and to reach the largest markets, given also the landscape of trade agreements and rules shaping trade between countries. A large share of vehicles of European car manufacturers sold in the US are produced in plants in the US (BMW is a net exporter from the US!) and another large amount is produced in Canada (by Japanese brands in particular) and Mexico. One year ago, the Trump Administration had already threatened NAFTA countries with the imposition of tariffs on car exports but the threat did not materialize, maybe because also a large amount of US cars are produced in Canada and Mexico and exported to the US.

Given the geography of production it is not surprising that Mexico and Canada lead the ranking of major vehicle exporters to the US, even without national car manufacturers, together with Japanese producers. US imports from the EU correspond to about a quarter of the US automotive trade deficit and mainly come from Germany and Italy (although FCA is an italo-american group). The UK is also an important EU exporter, producing mainly Japanese and Indian cars (Indian TATA owns the historical Jaguar and Land Rover brands), followed by eastern European countries (mostly German brands) and Spain where cars of many brands are made. Cars of French producers are almost completely absent in the US market.

This means that tariffs on US imports of vehicles from the EU would mainly hit German exporters with some friendly-fire victims (FCA) and some other Asian casualties (via the UK) bringing further advantages to US car manufacturers. A further issue regards the common position of the EU against such a US trade policy. Germany would be the country hardest hit by tariffs while an escalation in retaliations and counter-retaliations involving other sectors could mean losses all over the EU. This will probably put some pressure on European countries to weaken their common position. Some escalation cannot be excluded but before a true trade war takes place, a deal is likely to be reached.

InFocus 2

DIFFERENCES IN INCOME INEQUALITY ACROSS ITALIAN REGIONS

There is a wealth of indicators measuring income inequality, but the most commonly used are the Gini index[1] and the interquintile ratio, the latter being calculated as the ratio between the average equivalised income received by the top 20 per cent of the population and that received by the bottom 20 per cent.[2] Although each of these measures capture different aspects of income inequality, they generally provide similar insights.

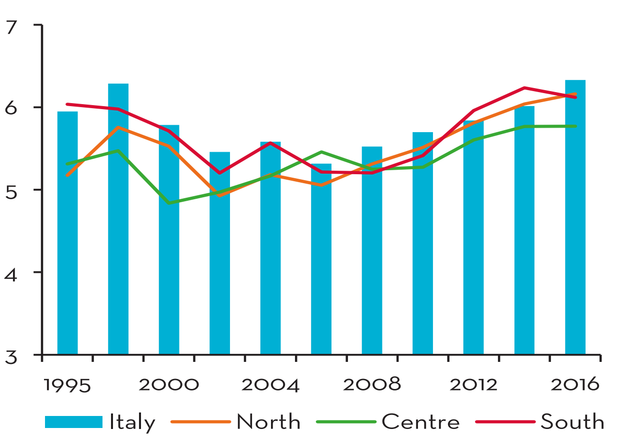
Using the recent release (12 March 2018) of the household survey of the Bank of Italy (Survey of Income and Wealth, SHIW), we have constructed the interquintile ratio and compared it to the Gini index. There are differences at regional level both in the level of measured inequality and in the changes in recent years. The interquintile ratio is higher in both the North and the South compared to the Centre (Chart B). The Gini instead highlights a higher level of inequality concentrated in the South (Chart C).

The interquintile ratio grew steadily from the outbreak of the 2007-2008 financial crisis up to 2016. Between 2014 and 2016, the ratio grew from 6 to 6.3, meaning that the average income of the richest 20 per cent of the population was more than six times that of the poorest 20 per cent. In the North, inequality continued to grow up to 2016, although at a slower pace, while in the Centre it remained stable. On the contrary, in the South, the interquintile ratio declined moderately in 2016.

These observations are confirmed by the Gini index, which grew, for Italy as a whole, from 32.9 per cent in 2014 to 33.6 in 2016. At regional level, the Gini index suggests increasing inequality in the North (from 29.2 cent to 30.7) and declining inequality in the South (from 34.6 per cent to 34). Nevertheless, the index also declined in the Centre (from 29.8 per cent to 28.9 per cent). This difference in comparison with the interquintile ratio could be due to the fact that the Gini index is more sensitive to incomes located in the middle of the distribution rather than those at its extremes.

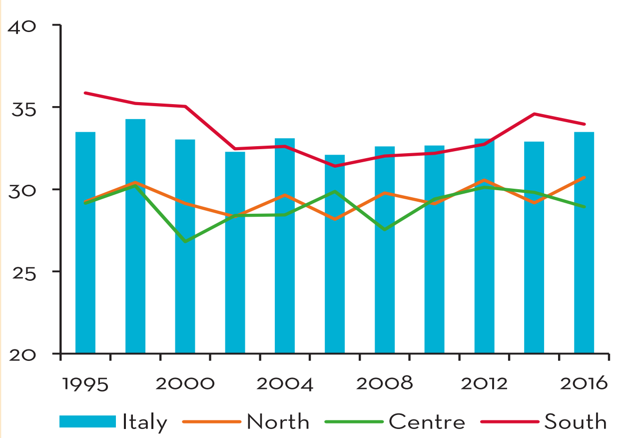
Overall, since 2008 inequality has been growing in Italy in all geographical areas, more so for the interquintile ratio than for the Gini index. The growth in inequality observed in 2016 seems to have been driven by increasing income inequality in the North of the country, as pointed by the breakdown of both indexes at regional level.[3] Inequality remains higher in the South of the country.

Chart B — Interquintile ratio



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

Chart C — Gini index - %



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

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1 *The Gini index ranges between 0 and 100, where 0 corresponds to complete equality (everyone has the same amount of income), while 100 corresponds to complete inequality (one individual has all the income available).*

2 *The analysis of inequality is based on equivalised income, a measure of disposable household income that accounts for household composition.*

3 *The 2018 EFD calculates the interquintile ratio using Istat survey data from IT-SILC (Statistics of Income and Living Conditions). In the IT-SILC the income reference period is the year preceding the survey, while in the SHIW, it is the survey year itself. So, for example, our calculations based on SHIW data for 2014 should be compared to those based on IT-SILC data for 2015. When accounting for this discrepancy between the IT-SILC and SHIW, our calculations give the same insights as those presented in the 2018 EFD.*

Table 1 The World Economy main indicators *% change*

	2017	2018	2019
World real GDP	3.6	3.6	3.3
World Trade	4.9	4.5	4.1
Manufacturing prices $	3.6	6.2	1.9
Brent oil price ($/brl, level)	54.9	69.2	65.5
GDP			
- United States	2.3	2.9	2.3
- Japan	1.7	1.0	0.9
- EMU	2.5	2.1	1.6
- China	6.8	6.5	6.0
Consumer prices			
- United States	2.1	2.6	2.1
- Japan	0.5	1.0	1.2
- EMU	1.5	1.7	1.5
- China	2.9	2.7	2.3
$/€ exchange rate (level)	1.13	1.20	1.20
£/€ exchange rate (level)	0.876	0.887	0.894

Table 2 Italy main indicators *% change*

	2017	2018	2019
GDP	1.6	1.4	1.2
Imports of goods fob and services	5.7	4.1	4.0
Private consumption	1.4	1.3	1.3
Government consumption	0.1	0.4	0.3
Gross fixed investment:	3.9	3.7	2.3
- machinery, equipment, other prod.	6.0	5.4	2.9
- constructions	1.5	1.6	1.6
Exports of goods fob and services	6.0	3.6	3.6
Domestic demand	1.4	1.5	1.3
Industrial production	3.7	3.0	2.3
Trade balance (% of GDP)	3.2	3.2	3.0
Terms of trade	-1.6	-0.3	-0.7
Consumer prices	1.2	1.2	1.3
Per capita wages - manufacturing	0.5	1.3	1.6
Total employment	0.9	0.5	0.2
General government balance (% of GDP)	-2.3	-1.8	-1.8

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	1.20	1.19	1.18	1.18	1.19	1.20	1.21
	Yen	133.1	130.8	133.3	133.7	134.5	136.9	138.0	137.9
3 month interest rates (%)	US libor	1.93	2.36	2.38	2.47	2.60	2.60	2.60	2.55
	Euribor	-0.33	-0.33	-0.33	-0.32	-0.32	-0.32	-0.09	0.08
10 year government bond yields (%)	US	2.76	2.94	3.01	3.07	3.20	3.19	3.17	3.17
	Germany	0.58	0.58	0.67	0.80	0.95	1.10	1.18	1.26
	Italy	2.01	1.88	2.00	2.50	2.75	2.90	2.97	3.00

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 April 2018	0.5	0.8	0.8	0.6	2.8	0.4	0.6	0.6	0.5	2.3
	Brief May 2018	**0.6**	0.8	0.8	0.6	2.9	0.4	0.6	0.6	0.5	2.3
EMU	Brief April 2018	0.5	0.5	0.4	0.4	2.3	0.4	0.5	0.5	0.3	1.8
	Brief May 2018	**0.4**	0.4	0.4	0.4	2.1	0.4	0.4	0.4	0.3	1.6
Italy	Brief April 2018	0.3	0.4	0.4	0.5	1.4	0.2	0.3	0.3	0.3	1.3
	Brief May 2018	**0.3**	0.4	0.4	0.4	1.4	0.2	0.3	0.3	0.3	1.2

prometeia associazione per le previsioni econometriche

via g. marconi 43, 40122 bologna, italia — tel. +39 051 648 0911 — fax +39 051 220 753
info_associazione@prometeia.com — www.prometeia.com

based on data available up to 15th May 2018

contributors: Michele Burattoni, Elizabeth Jane Casabianca, Lucia Cossaro, Monica Ferrari
contact persons: **Stefania.Tomasini@prometeia.com, Lorena.Vincenzi@prometeia.com**
tel. +39 051 648 0927 - +39 051 648 0933