prometeia
associazione

Italy in the Global Economy
Prometeia Brief

December 2017 – No. 17/8

Executive summary

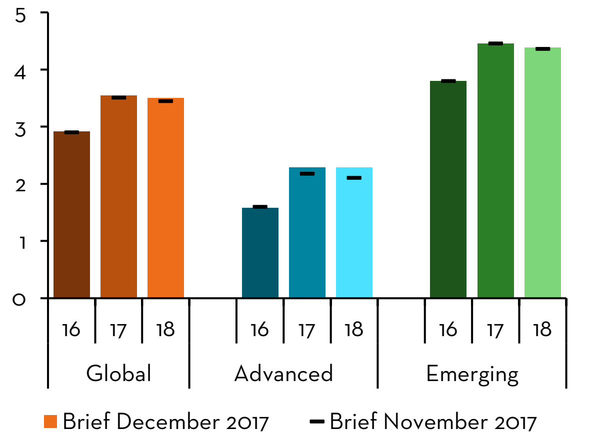
We expect a strong 2018 globally…

- The most recent data suggest that the healthy growth of the global economy will continue in the coming months (Chart 1). Activity is broad based, across regions and sectors, and supported by policies.
- The growth effects of the US fiscal reform are likely, however, to be limited, as the tax reductions on personal incomes will be temporary and the cut of the statutory corporate tax rate comes together with reduced deductions.
- The euro area continues to surprise on the upside. GDP growth in Q3 proved to be solid and broad-based. Survey results and favourable monetary policy conditions anticipate further strengthening.
- Among emerging economies, several signs anticipate a moderate deceleration in China, in line with our expectations, as the reform process becomes further strengthened following the party congress, …
- …. while India is expected to accelerate in 2018, as the negative effects of the demonetisation and fiscal reforms fade.

…and in Italy as well

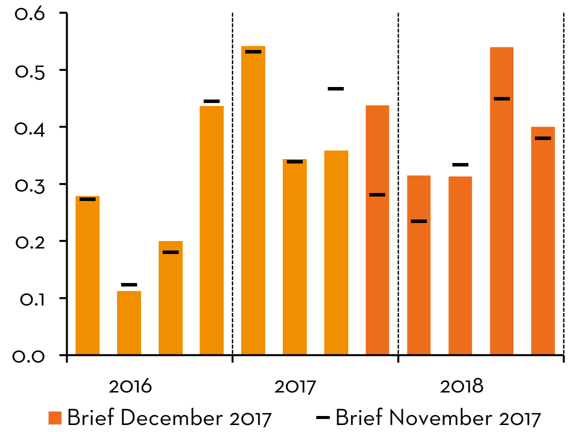
- 2017 will be one of the best in the last 20 years, with sustained GDP growth and decreasing fiscal deficit. 2017Q3 growth was 0.4 per cent qoq and 1.7 per cent in annual terms (Chart 2). We expect it to continue broadly at the same pace over the winter delivering 1.6 per cent growth for the whole of 2017.
- The upswing has been driven by exports and business investments, while consumer spending has levelled out and constructions and public spending are still subdued.
- We expect foreign demand and tax incentives to continue to support an expansionary cycle of investments (+12 per cent in 2017-18).
- In 2018, we expect only a mild slowdown of growth to 1.5 per cent, due to a lower liveliness of exports.
- In 2018 fiscal policy will shift to a moderately restrictive stance and the high government debt will accelerate the decline, although more gradually than requested in the Stability Pact.
- In the first InFocus we discuss the 2018 Italian Budget and in the second we present the main features of the new Italian electoral law.

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

We revised US GDP upward for 2018 partially due to the fiscal reform. The fiscal reform is expected to provide an impulse to economic growth, but it will likely be a temporary one as it does not directly address the persistent low growth of productivity. The upward revision of GDP in 2018 (2.5 per cent, 2.3 in the November Brief) is for one tenth due to a base effect and for the other one tenth to the expansionary effects of the fiscal reform. According to the version approved by the Senate at the beginning of December and to which we refer to in our scenario, in 2018 only the measures relating to personal income will come into force, whereas the new system of taxation for firms will come into force in 2019.

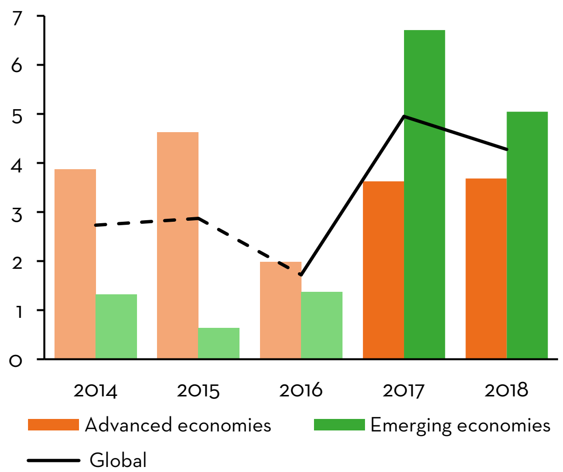
China GDP expected to decelerate in 2018. Despite a GDP growth rate above target in the third quarter (6.8 per cent), several macroeconomic variables anticipate a forthcoming deceleration. Real exports and imports are growing by roughly half the intensity they had at the beginning of the year. Investments in urban area deflated by producer prices are decreasing yoy and the credit to the economy has been slowing and it is now growing in line with nominal GDP. All this leads us to confirm a deceleration of the Chinese economy in 2018 with its downward effects on international trade (Chart 3).

Strong momentum for the euro area. The positive momentum is widespread across EMU countries and to both domestic demand and net exports. In the third quarter household consumption kept growing close to 2 per cent yoy and most importantly the investment cycle further strengthened (machinery and equipment investments grew by 2.9 per cent qoq, 1.7 in the second quarter). The most recent information suggests an acceleration in the fourth quarter and a robust growth at the beginning of 2018 (Chart 4). We have revised GDP growth upward to 2.4 per cent in 2017 and to 2.3 per cent in 2018 (2.3 and 2.1 respectively in the November Brief).

Inflation subdued and monetary policy still easy. Both in the US and the euro area, core inflation remains stable, well below 2 per cent, while headline inflation mainly follows energy prices. In our scenario the Fed will maintain its gradual approach to increasing the Federal Fund rate, with two hikes in 2018 of 25bp each. In Europe, the continuation of QE in 2018 with net asset purchases of 30 billion euros a month till September and its open-ended feature imply that policy interest rates will remain at their present minimum values for the whole of 2018. Budget policy is expected to maintain a neutral stance overall at the euro area level, which means further moderate reductions of public sector deficit and debt in relation to GDP.

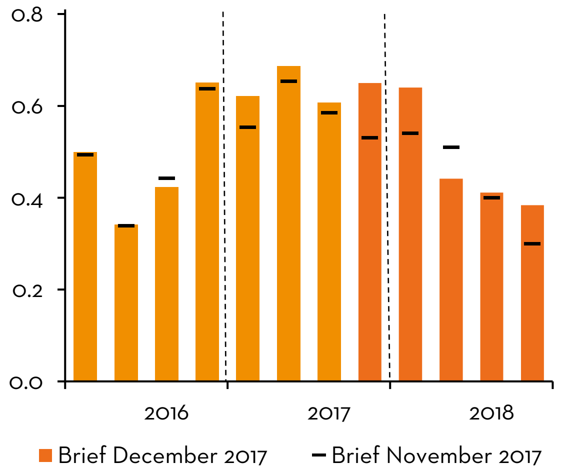
Recovery in the other BRICS. Brazil, Russia and South Africa confirmed in Q3 that their recovery is gradually taking hold.

Chart 3 **International Trade***
% change yoy



Source: Source : Prometeia's forecasts on IMF, OECD, World Bank and National Statistical Offices.
** merchandise real imports.*

Chart 4 **Euro area: real GDP**
% change qoq

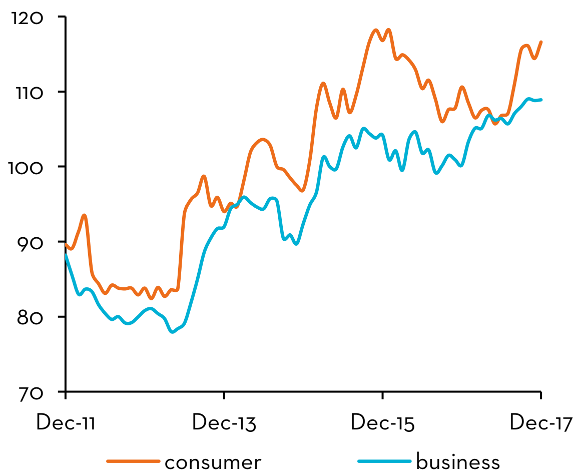


Source: Prometeia's forecast on Eurostat data.

Italy

Recovery momentum stronger than expected. The pace of the recovery strengthened in 2017Q3 (to 0.4 per cent from 0.3 per cent in Q2), while remaining below that of the major European partners. The acceleration in GDP was driven by the consolidation of domestic demand and the rebound in exports, which outpaced that of external demand even with an appreciated euro. The growth in capital goods investment accelerated significantly thanks in particular to expenditure in machinery and equipment, which increased by 6 per cent compared to the previous quarter. Consumption growth accelerated slightly in the third quarter (from 0.2 to 0.3 per cent) thanks to the increase in durable (2.3 per cent against -0.5) and semi-durable (0.4 against -0.5 per cent) goods spending.

Chart 5 Italy: confidence climate index
indeces 2010=100

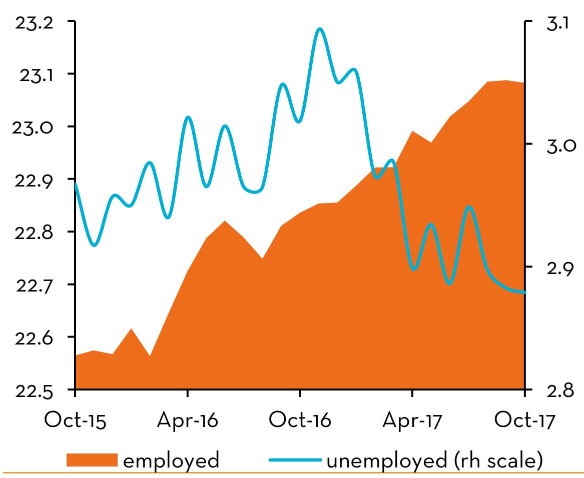


Source: Istat.

Favourable prospects for the coming quarters. The positive investment cycle is expected to continue in the next quarters supported by favourable financial conditions, improved demand prospects and firms' confidence (Chart 5), and a further reduction in spare capacity margins. Last but not least, fiscal incentives in ICT investment goods (Industria 4.0) are expected to provide strong support for those firms embarking on a technological upgrade. Consumption growth is expected to stabilize over the next few months and to grow steadily in 2018.

Core inflation subdued despite oil price hike. Headline inflation slowed to 0.9 per cent in November despite the acceleration of volatile components. Oil prices increased rapidly, in the wake of increased political tensions in Saudi Arabia, reaching 60 dollars per barrel from an average of 50 dollars in the previous months. This increase has already been reflected in domestic consumer prices of energy products (which rose by 4.4 per cent in annual terms in November from 3.4 per cent in September). Fresh food prices have also accelerated (reaching 3.8 per cent), while core inflation has remained weak (0.4 per cent). This reflects some idiosyncratic factors (such as the sharp reduction in University fees, -39 per cent), but also the continuing weak labour market conditions, with stagnant wage growth coupled with a continuing high unemployment rate.

Chart 6 Italy: employed and unemployed
millions



Source: Istat.

Employment still on the rise. Unemployment decreased to 11.1 per cent in October, at a slow pace compared to the still buoyant increase in employment (1.3 per cent in the third quarter yoy, +291,000 people in one year, Chart 6), as the labour supply also increased (by 0.8 per cent).

Credit dynamic is still affected by the weakness of corporate loans. Despite the economic recovery and strong investment growth, credit to non-financial firms decreased in the third quarter (-0.7 per cent yoy in September) and also in October (-0.5 per cent yoy). This prolonged weakness can be explained by several factors. Credit has been suffering from a mismatch between supply and demand: banks finance the most solid large-scale companies, which, however, are also those that have the least need for financing, being able to count on internal resources and funding on the market. Loans have only recently increased to vulnerable enterprises but limited to larger ones. There is also a process of bank disintermediation, following increased reliance on alternative sources of funding, including the large amount of liquidity available and increased access to the market. On the contrary, lending to households continued to increase in October. Durable consumption supported growth in consumer credit (9.6 per cent yoy) and the growth of mortgages continued to be positive (2.2 per cent yoy). The growth of total loans to households is slightly above the EMU average.

Interest rates on new loans still decreasing and BTP-Bund spread easing. In October, interest rates for new loans reached new lows: they decreased for household mortgages by 4bp (to 1.98 per cent) whereas they remained substantially stable for corporate. The more marked reduction of the 10-year Italian government bond yields compared to the reduction of the Bund interest rate led to a reduction in the spread of 21bp. The uncertainty regarding the outcome of the parliamentary elections will probably reverse this trend and we expect the spread to reach 180bp during next Spring.

Gross bad loans decreased during the year. Despite the increase of almost €1 billion in bad loans in September-October, gross bad loans have decreased since the beginning of the year by €27 billion (-12.5 per cent yoy), of which about 80 per cent is attributable to the corporate sector. The fall in bad loans is mainly due to sales and write-offs from bank balance sheets, but also to the improvement in economic activity, and to the new regulations on property executions introduced in 2015.

The 2018 budget law. Currently under approval, the budget law needs to find a compromise between supporting GDP growth and reducing public debt. To pursue its objective, the budget law is allocating more resources to support households and businesses (e.g. strengthening of the new "Inclusion income" scheme[1] and providing continued support for investments in technology) by increasing revenues through the strengthening of measures against tax evasion as well as the revision of government expenditure (See first InFocus).

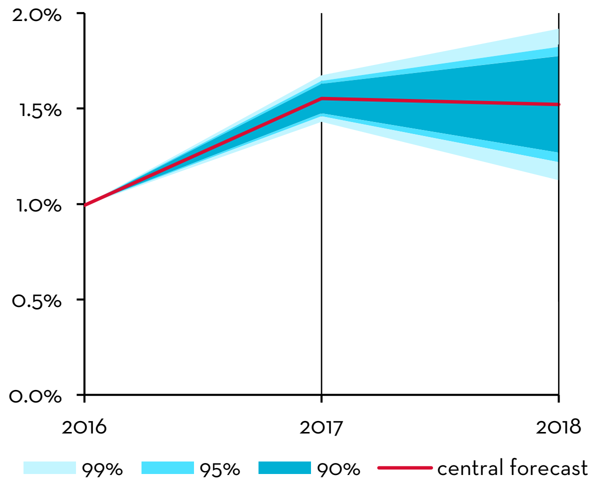
Budget deficit down to 2.1 per cent of GDP in 2017. In 2017, the general government deficit is expected to decline to 2.1 per cent of GDP from 2.5 per cent in 2016. Lower growth of primary expenditure is the main contributor to this reduction (0.3pp out of 0.4pp), while lower interest expenditure contributed to a lesser extent (0.1pp). We expect a further reduction to 1.8 per cent in 2018, which is, however, higher than the government's target (1.6 per cent). Among the reasons for this gap is that we expect a lower-than-hoped-for efficacy of the financing measures, due also to technical delays connected to the change of government, and a lower nominal GDP growth in comparison with that included in the official documents (due to different estimates of the GDP deflator). The debt-to-GDP ratio is expected to fall only marginally in 2017 reaching 131.8 per cent, due to the halt in the privatisation programme and extraordinary support measures for the banking sector for a total amount of €9 billion. The lower deficit and the economic recovery will allow the debt-to-GDP ratio to fall to 130.5 per cent in 2018. After four years of expansionary stance, budgetary policy in 2018 will be substantially neutral, as the structural balance is expected to improve by 0.1pp.

Risks to the projection

- The geopolitical tensions in the Middle-East and between North Korea and the US could deteriorate rapidly leading to market reactions worldwide.
- The approval of the US budget law, combined with the deterioration of the government accounts, could bring about higher medium/long-term yields, tightening monetary conditions for households and business, in an economy in its eighth year of expansion.

1 See the Prometeia Discussion Note "The Introduction of Minimum Income in Italy: Challenges and Outcomes", https://www.prometeia.it/en/research-insights/position-note

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



Source: Prometeia's calculations.

▶ Politics *per se* is also a source of uncertainty in both the US and Europe. In the US the ongoing investigations into the relations with Russia involving the President could feed that uncertainty. In Europe the debate on European reforms is not taking off and could create a disillusionment effect.

▶ In Italy, election results that would leave the economy without leadership for too long could have possible negative consequences on growth, affecting households and firms' confidence and hiking BTP-Bund spreads.

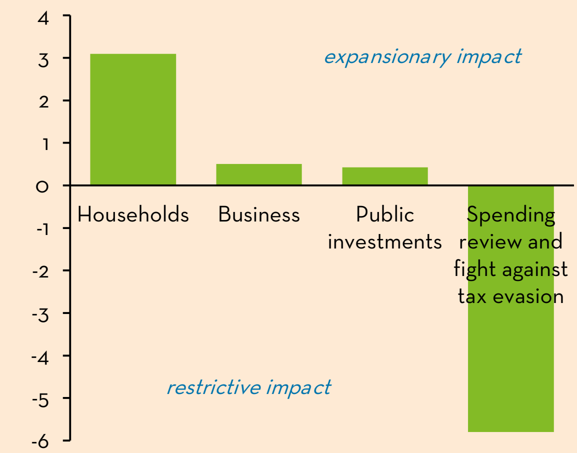
InFocus

Italy's 2018 Budget

Parliament is approving the 2018 Budget. The Budget consist of two parts, the Decree Law, passed on November 30, that anticipated some of the revenue-increasing measures, and the Budget Law, currently under approval. The overall effect on the balance, as indicated in the Draft Budgetary Plan (DBP2018) sent to the European institutions in mid-October, is an increase in the deficit compared to a current legislation scenario of about €11 billion in 2018 and 2019, and of about €2 billion in 2020.

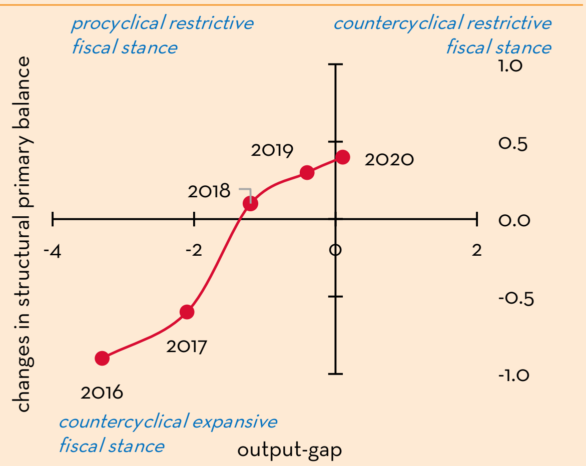
The new interventions are in line with the actions taken in recent years. Among the expansionary measures, supplementary funds are allocated to public employment, mainly for contract renewals

Chart A **Net impact of the budgetary measures (minus sign = recovery of resources)**
billions of Euros



Source: Prometeia's calculation on parlamentary documents.
Note: excluding the postponement of the safeguard claus.

Chart B **Fiscal Stance programmed by the government (2018 Draft Budgetary Plan)**
% of GDP



Source: Prometeia's calculation on Ministry of Economy and Finance data.

but also for new recruitments, and to social policies. These include additional resources for the new "Inclusion Income" scheme and for young people and families. In addition, the Budget extends the incentives to private investment, such as accelerated amortization and other incentives for innovation included in the Industry 4.0 National Plan[1], and confirms tax incentives for improving housing energy efficiency and for housing renovation. Social contribution relief is provided to support youth employment, and a new tax credit on spending on training activities is introduced. Finally, to strengthen public investment, the Budget raises the level of resources allocated to both the State Investment Fund and the local authorities. Part of the financing comes from spending cuts and, more significantly, from revenue gains expected from anti-tax evasion and collection measures.

As usual, the resources involved in the budget are considerable. The expansionary measures planned for 2018 are worth more than €26 billion and the financing ones about €15 billion. The impact of modifying[2] the so-called "safeguard clause" is significant. In 2018, the deactivation of the clause is worth €16 billion, 0.9 per cent of GDP. It is considered an expansionary measure (i.e. a tax reduction) in the official evaluation, which compares its impact to the revenues foreseen under current legislation. However, this measure should not be taken into account when considering the differential impact that fiscal policy will have in 2018 compared to 2017.

Therefore, in order to assess the actual impact on the economy of the 2018 Budget, figures presented in Chart A do not take into account changes to the safeguard clause or other measures that do not entail any variations in relation to 2017. Based on this approach, most of the resources are redistributed to households, while the additional resources for investment and business are limited in 2018 (planning to become more substantial starting from 2019).

According to the Government's programmes, the budget in nominal and structural terms will achieve a balance only in 2020. The planned fiscal stance, as measured by the change of the primary structural balance, reverses the sign and turns restrictive, albeit only slightly, already in 2018 (Chart B).

The new electoral law

Italy's parliamentary election will be held in Spring 2018 (likely in early March) with a new electoral law (Law 165/2017). The new electoral law was approved with the support of the parties in the ruling coalition and some of the opposition. It required some votes of confidence in the Senate, as several aspects were strongly criticized. The law is called Rosatellum bis, from the name of Ettore Rosatello, a member of parliament of the Democratic party, who presented a previous and different version of the law. The new law favours party coalitions as well as individual parties/candidates strong enough to win in local constituencies. Therefore, it will be difficult for an anti-establishment party, such as the Five Star Movement reluctant to form alliances, to reach the majority without forming alliances with other parties. Indeed, according to current polls, the outcome of the election will likely be a hung parliament.

A mixed voting system with the prevalence of proportional representation. The new electoral law envisages a mixed system for both Houses of Parliament, with the predominance of the proportional system: 61 per cent of seats is allocated proportionally, 37 per cent with the majority method and

1 Launched in 2016, Industry 4.0 National Plan is a set of interventions designed to boost investment and promote productive technological change over the period 2017-2020, aiming at improving competitiveness.

2 The safeguard clause is a provision entailing an increase in VAT rates worth €15.7 billion in 2018, €18.9 billion in 2019 and €19.2 billion in 2020. The 2018 Budget law cancels the increase in 2018 and maintains an increase of €10.4 billion in 2019 and €19.2 billion in 2020.

the remaining 2 per cent is reserved for Italians who live abroad. With regard to the majority share, in each constituency the candidate who receives more votes wins, therefore a one-vote majority is sufficient to obtain a seat in parliament (first-past-the-post). Each candidate can be supported by a single party or a coalition of parties (or lists). With regard to the proportional method, the seats will be distributed to parties according to results obtained in multi-constituencies.

The redefinition of constituencies. The new law has imposed a redefinition of constituencies. A task that, according to the new electoral law, is a government responsibility. As the criteria to be met could give rise to arbitrary choices (gerrymandering) with the risk of influencing the election results, the government asked the advice of a panel of experts including the chairman of the Italian national statistical institute.

Coalitions and lists. Each list must deposit its program, declare its political leader and if it belongs to a coalition. The coalition must be the same within the national territory. As far as the proportional share is concerned, each party may indicate from 2 to 4 people. Lists are blocked, as voters cannot express a preference and the elected candidates will follow the order in which they are listed on the ballot.

Voting thresholds. With the exception of language minority lists, the thresholds below which no allocation of seats is permitted are the same for the Low Chamber and the Senate and set at 3 per cent of the valid votes obtained at national level for each list and 10 per cent for the coalitions (provided that at least one participating list reaches 3 per cent of the votes). For the election of the Senate, there is an additional threshold for coalition lists of 20 per cent of the valid votes obtained in at least one of the regions, even if the coalition has not reached the 10 per cent threshold at national level.

Separate voting is not possible. The voter will receive two equal ballots (except in colour), one for the Low Chamber and one for the Senate. The candidates of the constituency will be indicated on the ballot, with the list (or the lists in the case of a coalition) supporting them. The ballot will also list the candidates who will be elected according to the proportional system. Having only one vote for each branch of Parliament, the voter will not be able to vote for a candidate in the single-member constituency and a different list in the proportional part, i.e. it will not be possible to cast a separate vote. This aspect of the law, along with blocked lists, has been the subject of much criticism, because it has been seen as reducing voters' freedom of expression.

Governability. Current polls do not identify a party or a coalition able to gain a majority sufficient to govern. Even if a stalemate now looks likely, things may change. For example, the alliances are still unclear and can be formed at a later date. Moreover, there is a large share of voters that are undecided and could decide at the last minute whether to vote and for whom to vote on the basis of the election campaign.

Table 1 The World Economy main indicators *% change*

	2016	2017	2018
World real GDP	2.9	3.5	3.5
World Trade	1.7	4.9	4.3
Manufacturing prices $	-3.5	2.8	3.9
Brent oil price ($/brl, level)	45.1	54.8	57.5
GDP			
- United States	1.5	2.3	2.5
- Japan	0.9	1.7	1.3
- EMU	1.8	2.4	2.3
- China	6.7	6.8	6.3
Consumer prices			
- United States	1.3	1.7	2.1
- Japan	-0.1	0.4	0.7
- EMU	0.2	1.5	1.4
- China	1.9	2.9	2.6
$/€ exchange rate (level)	1.11	1.13	1.16
£/€ exchange rate (level)	0.818	0.876	0.891

Table 2 Italy main indicators *% change*

	2016	2017	2018
GDP	1.1	1.6	1.5
Imports of goods fob and services	3.3	5.5	4.8
Private consumption	1.5	1.4	1.4
Government consumption	0.5	0.9	0.3
Gross fixed investment:	3.3	3.9	1.8
- machinery, equipment, other prod.	4.2	5.0	6.0
- costructions	1.4	1.2	1.3
Exports of goods fob and services	2.6	5.1	4.4
Domestic demand	1.2	1.6	1.6
Industrial production	1.9	3.1	3.0
Trade balance (% of GDP)	3.6	3.4	3.4
Terms of trade	3.3	-1.3	0.2
Consumer prices	-0.1	1.2	1.0
Per capita wages - manufacturing	0.2	0.8	1.3
Total employment	1.4	1.2	0.6
General government balance (% of GDP)	-2.5	-2.1	-1.8

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	1.10	1.18	1.18	1.17	1.16	1.16	1.16
	Yen	121.0	122.2	130.4	132.8	132.2	131.7	131.7	131.4
3 month interest rates	US libor	1.07	1.20	1.32	1.47	1.68	1.82	1.95	2.08
	Euribor	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32
10 year government bond yields	US	2.44	2.26	2.24	2.37	2.47	2.60	2.71	2.80
	Germany	0.25	0.31	0.40	0.37	0.43	0.46	0.50	0.59
	Italy	2.15	2.17	2.09	1.83	2.14	2.29	2.09	2.22

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
United States	Brief Nov 2017	**0.3**	**0.8**	**0.7**	0.6	2.2	0.4	0.7	0.6	0.5	2.3
	Brief Dec 2017	**0.3**	**0.8**	**0.8**	0.6	2.3	0.4	0.8	0.6	0.6	2.5
EMU	Brief Nov 2017	**0.6**	**0.7**	**0.6**	0.5	2.3	0.5	0.5	0.4	0.3	2.1
	Brief Dec 2017	**0.6**	**0.7**	**0.6**	0.6	2.4	0.6	0.4	0.4	0.4	2.3
Italy	Brief Nov 2017	**0.5**	**0.3**	**0.5**	0.3	1.6	0.2	0.3	0.4	0.4	1.3
	Brief Dec 2017	**0.5**	**0.3**	**0.4**	0.4	1.6	0.3	0.3	0.5	0.4	1.5

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 22th December 2017

contributors: Elizabeth J. Casabianca, Lucia Cossaro, Monica Ferrari, Mariagiulia Folloni, Emilia Pezzolla

contact person: Stefania.Tomasini@prometeia.com, Lorena.Vincenzi@prometeia.com
tel. +39 051 648 0927 — +39 051 648 0933