ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia ASSOCIAZIONE

APRIL 2019 – No. 19/3

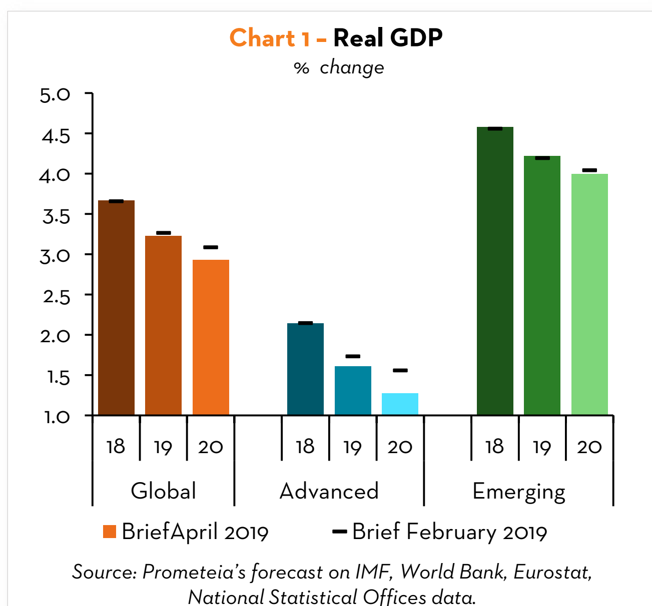
Executive summary

Global activity weakening, economic policies to the rescue

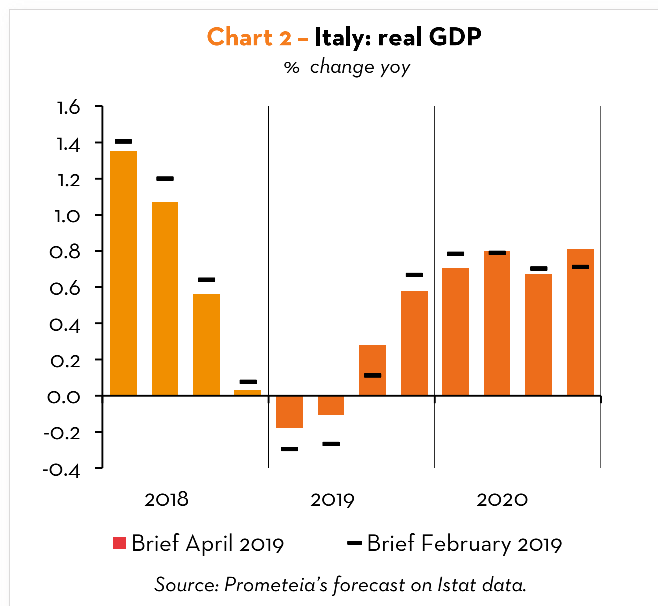
- During the last quarter of 2018, world trade contracted qoq, leading to our downward revision of global growth in 2019 and 2020 (Chart 1).
- Uncertainty about China's growth path has intensified, evident in the powerful fiscal, monetary and financial stimuli adopted by the authorities to manage the deceleration of the economy.
- In the EMU, the latest indicators are cautiously suggesting some stabilization of activity, but uncertainty persists about the adoption by the US of new protectionist tariffs on automobile imports. We expect a modest recovery in the second half of the year, with support for the cycle provided by accommodative policies.
- Despite a continuing strong labour market, insufficient domestic inflationary pressures have led the Fed to opt for a precautionary halt to its policy normalisation. Going forward, the fiscal stimulus will disappear and we expect the Fed to cut its policy rate by 50bp in the first part of 2020.
- In InFocus 1 we investigate the effects of possible new tariffs by the US Administration on car imports from other countries; in InFocus 2 we consider the threat of a 'Japanization' of the EMU.

Italy: emerging from the recession, but entering an uncertain path ahead

- After two quarters of negative growth in 2018, we forecast zero growth in Q1 2019.
- We confirm expectation of annual growth in 2019 of 0.1%, improving to 0.7% in 2020 (Chart 2).
- Economic activity will be supported by a favourable international backdrop and a moderate boost from its expansionary fiscal policy in 2019.
- There is uncertainty around the fiscal policy position in 2020; it will be proposed in the April Economic and Financial Document and confirmed by the September 2019 Budget Law.
- Our scenario assumes that in 2019 the BTP-Bund spread will not fall below 250bp.

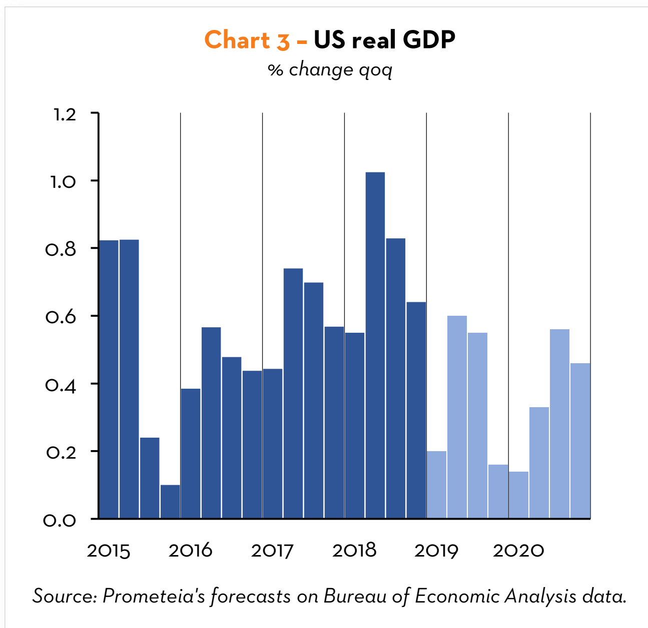


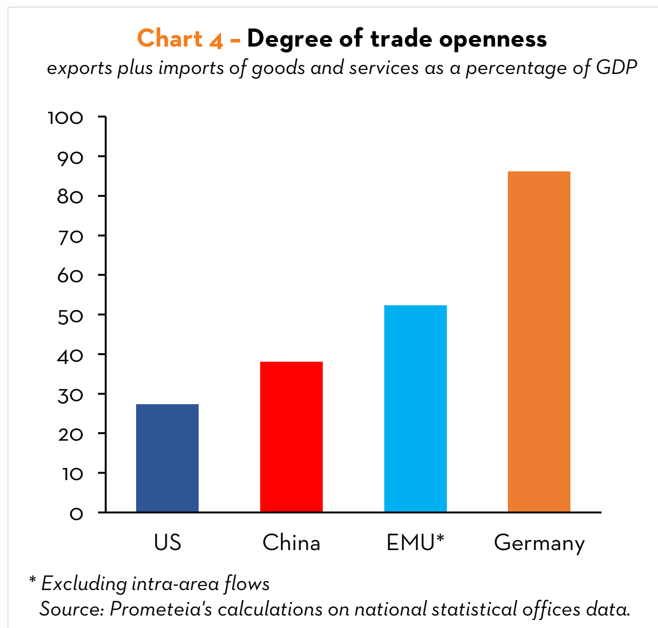
Source: Prometeia's forecast on IMF, World Bank, Eurostat, National Statistical Offices data.



Source: Prometeia's forecast on Istat data.

Global scenario





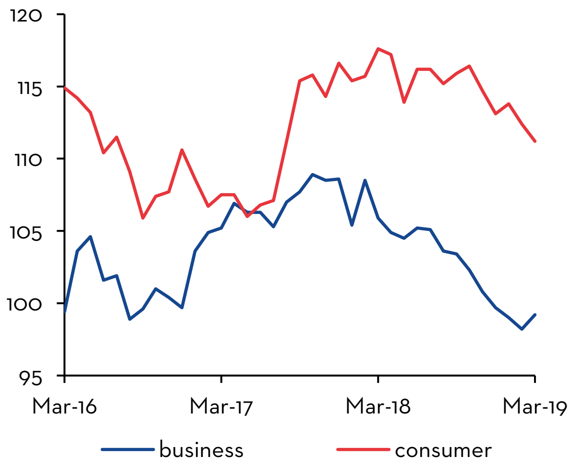
Growth in **emerging market economies** took a hit at the end of 2018. However, in the first part of 2019, exchange rates have been fairly stable, reflecting a slower pace of US monetary policy tightening and some level of optimism regarding the trade agreement between the US and China. However, Argentina and, especially, Turkey, continue to be in recession in 2019 and are experiencing high inflationary pressures.

In the **US**, activity at the beginning of 2019 was conditioned by temporary factors such as the partial federal government shutdown and the adverse weather conditions. We expect the effects of these factors to diminish in the coming quarters (Chart 3), while weak inflationary pressures in a strong labour market should help to increase household purchasing power. US GDP is projected to stabilize at 2.2% in 2019, from 2.9% in 2018, but there are certain elements that suggest the possibility of a slowdown at the end of 2019. The sizeable pro-cyclical fiscal stimulus that accompanied the start of the Trump administration will start to peter out, while non-financial corporate indebtedness will remain at high levels. In this fragile context, we expect the Fed to cut its policy rate by 25bp in the first two quarters of 2020, which should help to stabilize activity at 1.3% - below potential - at the end of 2020.

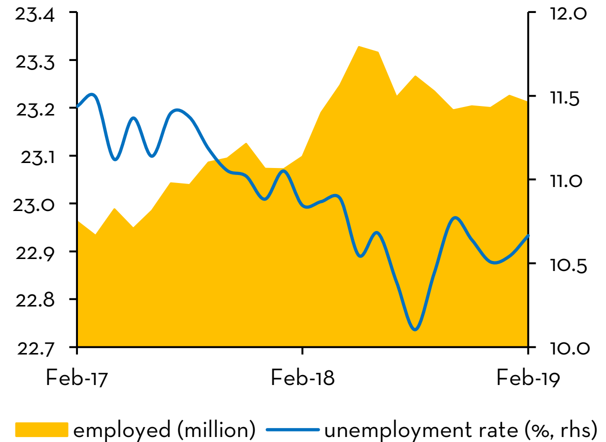
China's authorities are implementing several measures to support growth. In our scenario, GDP is expected to decelerate in line with the 2019 target and to continue this slowdown in 2020 (to 6.0% and 5.3% respectively). The authorities should be able to avoid a stronger slowdown and manage the transition to a model based more on consumption and less on investment, but the vulnerabilities surrounding this transition will remain elevated.

The euro area has been particularly sensitive to the slowdown in world trade, due to its greater openness compared to other regions (Chart 4) and because it exports to areas that have seen the greatest declines in imports. Up to March, there are no clear signs of business and consumer confidence indicators being diverted from their current negative trends. However, other quantitative indicators, such as the January Industrial Production Indexes (IPI) and our nowcasting models, are forecasting a slight rebound in the coming few months. We believe that this latest slowdown is temporary and should stabilize in the second half of the year. In this scenario it is assumed that the US will not impose higher tariffs on EMU car imports (InFocus 1), which will have a positive effect on confidence and investments. A slightly accommodative fiscal and monetary policy in 2019 will support private consumption. However, the European car industry will have to deal, also, with a number of structural changes including increased demand for electric cars based on trend in the world's biggest car market – China. All of these factors will be a barrier to sustained growth in 2020 (1.3%).

Italy



Source: Istat.



Source: Istat.

The Italian economy contracted in the second part of 2018. In Q4 2018, GDP contracted slightly (-0.1%, equal to Q3), showing a less favourable movement compared to the main European partners. Alongside weak domestic demand, Q4 was affected heavily by the negative contribution to GDP growth of inventories (-0.4pp in Q4 2018). This might, in part, reflect firms increased caution when formulating production plans in a situation of internal and international uncertainty. Instead, exports increased (+1.3% in Q4 2018 qoq) in line with the previous quarter, which contributed positively to GDP growth.

Investment continues to play a leading role. Favourable financing conditions and a continued high level of capacity utilisation contributed to supporting the accumulation of capital goods in Q4 following the sharp drop in Q3, due, most likely, to anticipation of capital spending resulting from the abolition of the tax incentives in force in 2018. Investment in transport equipment continued to be dynamic (0.8% in Q4 2018), while investment in residential and non-residential construction moderated (respectively, 0.1% and -0.2%, compared to 0.7% and 0.5% in Q3 2018).

Consumption recovered marginally (0.1% in Q4 2018, compared to 0% in Q3) mainly due to spending on durable goods (from 0.8% to 1.8%). The moderate level of consumer spending would seem to reflect consumers' restraint due to uncertainty about budgetary policy, increased spread and losses in the market value of financial wealth.

Industrial production shows signs of recovery with an increase of +1.7% in January mom. However, the downward trend in manufacturing production plans would seem to indicate persistence of elements of economic fragility.

Consumer and producer confidence indicators remain weak. The latest data show (overall) business confidence recovering slightly (March 2019). However, in the manufacturing sector it continues to decline, reflecting uncertainties regarding the trade dispute with the US over car imports. The consumer confidence index has also deteriorated further (Chart 5).

Growth in hours worked declined from 1.3% in Q2 2018 to 0.4% in Q4 2018. The unemployment rate at the end of last year reached 10.6% and even in the beginning of this year it has continued to increase (10.7% in February) (Chart 6). Although the effect on the labour market of the measures that are due to enter into force this year (Reddito di cittadinanza and Quota 100) is still uncertain, it is unlikely that the unemployment rate will decrease.

Headline inflation still dominated by energy. During 2018, energy inflation fluctuated considerably, rising from 1% to over 10% mid-year before falling back to 3% at the end of the year. Inflation related to unprocessed food increased from Q4 2018 to the beginning of 2019 and is contributing to headline inflation remaining above the core, which is low and shows a downward trend (0.5% in February).

In early 2019, credit to the private sector continued to grow at a moderate pace. In January, bank loans grew in both the euro area (3% yoy) and in Italy, although here the increase was smaller (1% yoy). In Italy, this poor performance is, in part, a statistical effect, which stems from the significant increased credit available to non-financial corporations recorded in January 2018, the end of the reference

period for computing the TLTROII interest rate. Therefore, we observed a widening gap in Italy between growth in loans to firms (-0.7% yoy) compared to the EMU countries (3.4% yoy) (Chart 7). Despite this negative yoy growth, in Italy the January credit flow towards non-financial corporations was positive and above €2 billion. Instead, credit to households is increasing and only slightly below as in the euro area.

Throughout 2019, credit growth is expected to slow until the September 2019 TLTROIII, after which credit will grow again and we expect it to reach a yearly average of 2.2% for households and 0.1% for non-financial corporations.

After the significant reduction in bad loans in 2018, these stabilised in January, with the ratio to total loans remaining unchanged compared to the value at the end of 2018. Overall, we estimate that sales of bad loans will amount to €40 billion in 2019.

Credit supply conditions for non-financial corporations are worsening. All survey data point to stricter criteria for granting credit in Italy, which contrasts with the evidence available for the main euro area countries. This contraction is particularly evident for SMEs. On the contrary, credit supply conditions for households remain unchanged.

In 2020, credit supply conditions will remain relaxed, due to interest rate stability and because the TLTROIII auctions will guarantee adequate liquidity for the banking sector. However, credit dynamics will be affected by the continuing bank disintermediation process. Overall, financing to businesses will show a low elasticity to economic activity (0.3), while elasticity for households is forecast to be 1.1; both values are below their historical averages.

In 2018, public finance indicators did not fully reflect the economic downturn. The budget deficit decreased from 2.4% of GDP in 2017 to 2.1% in 2018. However, this reduction is smaller than planned and reflects the end of the one-off bank rescue measures. Similarly, the net borrowing requirement continued its annual decline, although showing a slight increase in the last quarter of 2018. For the first time in four years, the weight of current expenditure increased as a result of public sector contract renewals and higher welfare-related expenditure, while public investment continued its downward trend.

The economic slowdown contributed to an increased public debt to GDP ratio, from 131.3% in 2017 to 132.1% in 2018.

In 2019, some factors are expected to weigh on the deficit, such as the economic slowdown, the likely effects of a higher cost of borrowing on interest spending and the expansionary fiscal policy stance.

The expansionary fiscal policy position is due mainly to two measures: Reddito di cittadinanza (minimum income) and Quota 100 (related to early retirement). These two measures will be operationalised via an increase in household disposable income and their effects should begin to be seen in the second half of the year. The cost of these measures in 2019 is covered only partially by higher taxes on the financial sector and smaller capital transfers. The overall effect on GDP of the 2019 budget can be quantified as 0.1pp.

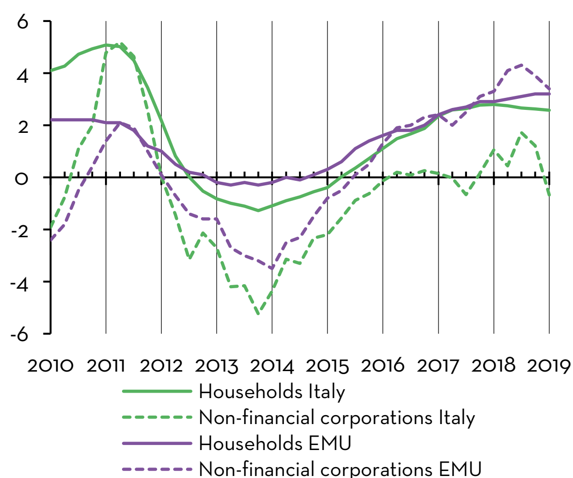


Chart 7 – MFI loans to households and non-financial corporations - *% change yoy*

Source: Source: ECB and Bank of Italy.

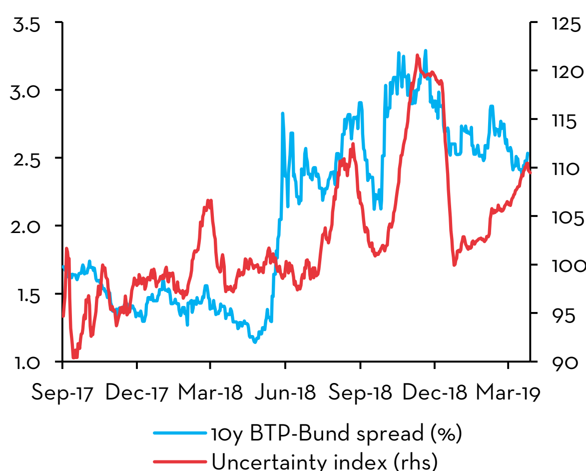


Chart 8 – BTP-Bund spread and Prometeia macroeconomic uncertainty index - *1/7/2017=100*

Source: Thomson Reuters and Prometeia's calculations.

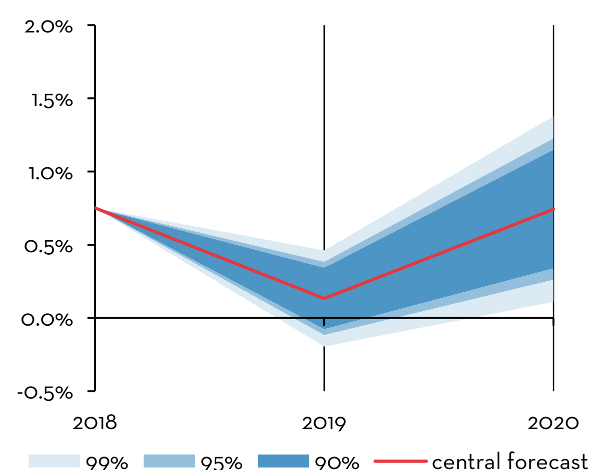
In 2020, public accounts will be threatened by the uncertainty surrounding the legislated VAT increases. The Budget Law foresees 2020 revenues as increasing by €23 billion due to VAT rate increases; however, it is unlikely that these increases will be implemented by the government.

The deficit is forecast to reach 2.6%, due to higher welfare-related expenditure and higher public sector wages. This scenario leaves no room for inverting public debt to GDP growth, which will reach 132.8%. The 2019 Economic and Financial Document will be published at the end of April, but we expect details of government's plans for 2020 to be revealed in September when the discussion of the 2020 budget law will start. Our scenario assumes that the higher level of spending will lead to a higher than planned deficit (1.8%), requiring financing measures for about €12 billion (0.7% of GDP): a small increase in the lower level of VAT rates will bring a total of €6 billion; another €6 billion is expected to come from other funding measures.

Risks to the projection

- Private and public debt is one of the main threats to the global economy, from the high levels reached in the US corporate sector to the rise in China's private and public indebtedness. Excessive debt can expose financial systems to sharp price readjustments and widespread increased volatility with negative repercussions for agents' confidence and global growth.
- The escalating US protectionist measures related to European car exports continue to be a major source of risk for the euro area activity in 2019, especially in a context of worsening global economic prospects.
- Brexit remains a risk, but a no-deal exit seems less likely because of the internal political crisis.
- Further political risks are associated to the next European election outcomes, which could endanger Euro-governance reforms.
- Uncertainty about fiscal policy measures in Italy is posing risks regarding the correction of the structural deficit to avoid the onset of a European procedure in 2020.
- In March, Prometeia macroeconomic uncertainty index for Italy accelerated significantly despite the stability of the BTP-Bund spread (Chart 8). This might signal a growing risk regarding the expected recovery intensity in 2019.

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



Source: Prometeia's calculations.

US tariffs and the automotive sector value chains

In mid-February, a report by the US Department of Commerce concluded that US car imports pose a threat to national security. This set the stage for the possible imposition of tariffs by the White House, which now has 90 days to decide whether or not to impose. Levying duties on European cars does not affect only the exporting countries, it also has an impact on those countries involved in automotive value chains that are not direct exporters to the US. Also, a new trade war could promote an escalation in protectionist measures with dangerous effects for global confidence and investments.

In 2017, the value of US imported vehicles, parts and components was around $270 billion ($56 billion from the EU), and to November 2018 (latest available figure) it was $257 billion. However, the automotive sector is more important than these export figures would suggest since it involves successive exchanges among various firms located in different countries.

In this InFocus, we investigate the contribution of some important countries to the automotive value chain. We break down car exports to the US into the fractions related to foreign value added (imported content) and domestic value added, that is, the contributions of non-resident and US local production factors to total value added. **This decomposition shows that even countries that are not direct exporters of cars to the US could be damaged by supplementary US duties. It shows, also, that part of the cost of these tariffs would be borne by the US economy.**

Table A reports participation in the Value Added (VA) exported to the US by exporting country. For example, in the cases of Italy and Germany, the number 1.4 indicates that 1.4% of the German automotive VA exported to the US originates in Italy. Clearly, domestic VA is the most important component, but imported VA also matters. In Germany, 75% of car exports are domestic VA, with the remaining 25% from other countries. In general, in the EMU countries, between 80% and 90% of domestic VA is produced within Europe and only 10% to 20% is imported, including a share from the US (2% on average, although 8% in the case of France). If we look at overall automotive exports to the US (last column) we see that the contribution to VA provided by the US exceeds 12% compared to 27% for the whole EU. The analysis is based on 2015 OECD data on automotive value chains, but it is reasonable to assume that the composition of these data is relatively stable and can be used to reflect the current composition.

In the US, we can quantify in about $32 billion the "self-taxed" domestic VA if new car duties are imposed on all partners, almost as much as Germany (for Italy the figure would be about $6 billion). **Selecting the EU as the only trade partner on which to impose tariffs would decrease the impact of "self-taxed" VA in the US but, also, the alleged improvement in the US trade balance.**

Table A – Automotive exports to the US: share of value added for selected exporters - %

	Country Exporter to the US				
	France	Germany	Italy	Spain	World
Value Chain participation					
EU 28	80.1	89.0	86.3	86.1	27.4
France	59.5	2.2	3.0	5.6	3.0
Germany	9.0	75.1	6.6	7.4	12.0
Italy	2.1	1.4	66.4	2.4	2.3
Spain	1.8	1.1	2.0	61.7	1.3
US	8.4	2.3	2.1	2.0	12.4
Japan	0.9	0.8	0.7	1.1	14.1
South Korea	0.5	0.4	0.8	0.7	6.7
China	2.7	2.0	2.5	2.8	10.2

Source: Prometeia's calculations on OECD, TiVA database.

Towards a 'Japanization' of the Eurozone?

The deceleration of GDP in the Eurozone in the second half of 2018, stronger than expected, and inflation, still far from the ECB's target, have fuelled **fears that the euro area might be converging towards a steady state of weak growth, low inflation and low interest rates**, similar to what happened in Japan following the 1990's housing bubble burst. Any potential 'Japanization' of the euro area would have significant **implications for the ECB's monetary policy and the European banking system prospects**: there would be persistent low (or even negative) interest rates, which would negatively affect bank profitability, possibly requiring further mergers and acquisitions, changes to business models and a re-formulation of balance sheets to include riskier activities.[1]

There are many similarities between the euro area and Japan. First, in **demographic terms**: the euro area is facing the population ageing that has been happening in Japan since the mid-1990s. The increase in the dependency ratio implies a labour force contraction and higher expenditure on social benefits.[2] Second, the **banking sectors** in both countries have recorded low levels of profitability in the last ten years (Chart A), in both absolute terms and relative to the best performing US banking institutions.

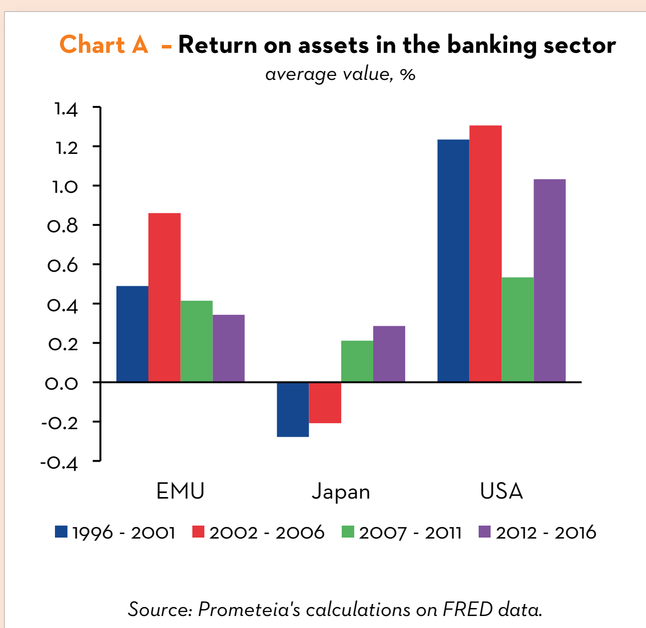
However, there are some significant differences. First, after the crisis, when the output gap almost closed, **inflation in the EMU returned to positive values**, while in Japan price dynamics still struggle to maintain a level above zero (Chart B). Second, the euro area benefited from **prompt and decisive action by the ECB** and a **fiscal policy committed to control public finances**, which prevented an explosion of debt, whereas it took time for the Bank of Japan to intervene.

Hence, the possibility of 'Japanization' of the euro area cannot be excluded, but we believe it to be unlikely. Unlike Japan, the EMU still has available spare capacity in the labour market, which we expect to be gradually absorbed, supporting growth in domestic demand and contributing to adjustment of inflation towards the ECB target.

---

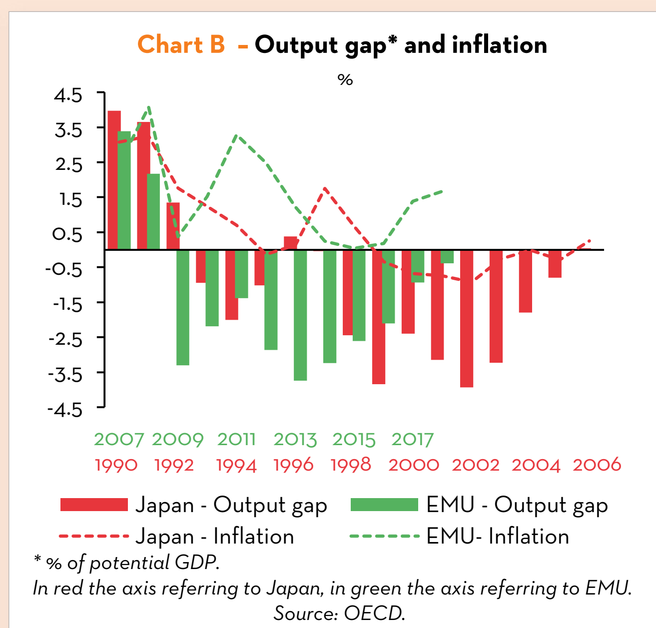
[1] See, e.g., *Global Financial Stability Report: Getting the Policy Mix Right*, IMF, April 2017.
[2] The dependency ratio is defined as the percentage of the population aged under 15 and over 64 to the working-age population (15-64).

Chart A - Return on assets in the banking sector
average value, %



Source: Prometeia's calculations on FRED data.

Chart B - Output gap* and inflation
%



** % of potential GDP.*
In red the axis referring to Japan, in green the axis referring to EMU.
Source: OECD.

Table 1 - The world economy main indicators % change

	2018	2019	2020
World real GDP	3.7	3.2	2.9
World Trade	4.2	3.1	3.0
Manufacturing prices $	2.9	-0.6	5.1
Brent oil price ($/brl, level)	72.0	64.5	65.8
GDP			
- United States	2.9	2.2	1.3
- Japan	0.8	0.8	0.6
- EMU	1.8	1.1	1.3
- China	6.6	6.0	5.3
Consumer prices			
- United States	2.4	1.9	2.0
- Japan	0.9	1.2	1.4
- EMU	1.7	1.3	1.5
- China	2.3	2.0	2.5
$/€ exchange rate (level)	1.18	1.15	1.24
£/€ exchange rate (level)	0.885	0.881	0.892

Table 2 - Italy: main indicators % change

	2018	2019	2020
GDP	0.8	0.1	0.7
Imports of goods fob and services	1.8	1.4	3.1
Private consumption	0.6	0.5	0.9
Government consumption	0.2	0.3	0.0
Gross fixed investment:	3.2	-1.6	1.7
- machinery, equipment, other products	4.0	-3.4	1.6
- constructions	2.3	0.7	1.8
Exports of goods fob and services	1.4	2.4	2.1
Domestic demand	0.9	-0.2	1.0
Industrial production	0.7	-0.1	1.3
Trade balance (% of GDP)	2.8	3.4	3.7
Terms of trade	-1.6	1.1	2.4
Consumer prices	1.1	0.7	1.1
Per capita wages - manufacturing	0.8	1.2	1.5
Total employment	0.8	-0.2	-0.2
General government balance (% of GDP)	-2.1	-2.5	-2.6

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

Table 3 - Exchange rates and interest rates

		19 Q1	19 Q2	19 Q3	19 Q4	20 Q1	20 Q2	20 Q3	20 Q4
Exchange rates vs euro	US dollar	1.14	1.14	1.15	1.18	1.21	1.25	1.25	1.24
	Yen	124.9	125.9	126.8	130.0	131.9	133.1	133.1	132.7
3 month interest rates %	US libor	2.70	2.64	2.60	2.51	2.30	2.15	2.00	2.00
	Euribor	-0.30	-0.30	-0.30	-0.30	-0.30	-0.29	-0.23	-0.09
10 year government bond yields %	US	2.66	2.63	2.59	2.44	2.28	2.12	2.00	2.00
	Germany	0.10	0.10	0.19	0.24	0.22	0.20	0.23	0.38
	Italy	2.70	2.76	2.76	2.71	2.59	2.51	2.47	2.57

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

		19 Q1	19 Q2	19 Q3	19 Q4	2019	20 Q1	20 Q2	20 Q3	20 Q4	2020
United States	Brief Feb. 2019	0.2	0.6	0.6	0.4	2.3	0.4	0.6	0.5	0.4	2.0
	Brief April 2019	0.2	0.6	0.6	0.2	2.2	0.1	0.3	0.6	0.5	1.3
EMU	Brief Feb. 2019	0.1	0.3	0.4	0.4	1.0	0.3	0.3	0.3	0.3	1.2
	Brief April 2019	0.2	0.3	0.4	0.4	1.1	0.3	0.3	0.3	0.3	1.3
Italy	Brief Feb. 2019	-0.1	0.1	0.2	0.3	0.1	0.1	0.2	0.2	0.3	0.7
	Brief April 2019	0.0	0.1	0.2	0.2	0.1	0.1	0.2	0.1	0.3	0.7

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 1st April 2019
contributors: Maria Valentina Bresciani, Elena Giarda, Emilia Pezzolla
contact persons: Lorenzo.Forni@prometeia.com, Stefania.Tomasini@prometeia.com, Lorena.Vincenzi@prometeia.com
tel. +39 051 648 0927 - +39 051 648 0933

Copyright © 2019 by Prometeia, Bologna, Italy

Disclaimer:
This material is intended as a source of information and research and cannot, under any circumstances, be considered as an offer or solicitation for the purchase or sale of any financial instruments.
Every statement of financial markets trend is based on past and current market conditions. Any reference to future returns of a financial market does not constitute an estimate of the actual returns that the financial market may achieve in the future.
The information and opinions contained herein are compiled or arrived at from sources by third parties. Prometeia does not accept responsibility for their use or make any representation as its accuracy and completeness.
All rights are reserved by Prometeia Associazione. Any reproduction is authorized only if indicated the copyright owner.