ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

OCTOBER 2019 – No. 19/6

Executive summary

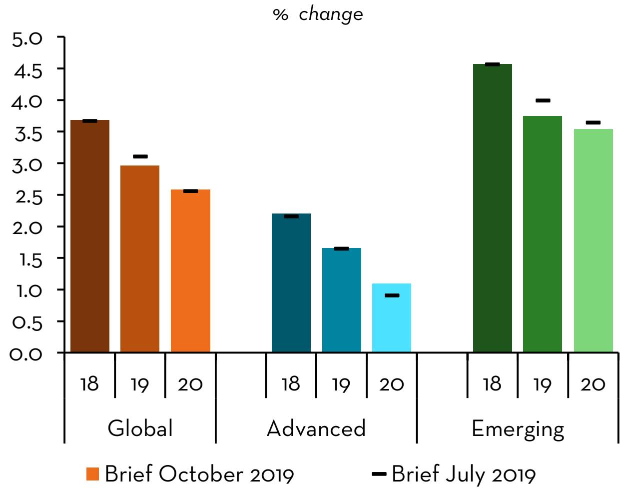
Policy makers are rushing to avoid recession

- World trade further decelerated at the end of July, leading to a contraction on annual basis. This is a rare event, testifying the ongoing weaknesses, particularly in industrial production.
- Low inflation and declining global manufacturing activity resulted in a swift reaction by major central banks. In China, the authorities are managing a depreciation of the renminbi against the dollar.
- In this context, we expect the very favourable global financial conditions to be accompanied by new demand-side policies, especially in EMU countries with fiscal space and facing a major slowdown, like Germany (InFocus 1). Activity will prove more resilient in the United States and China than in Europe.
- In our central scenario, stress in Turkey and Argentina will not spread to other emerging markets (Chart 1).

Italy: a new window of opportunity, perhaps

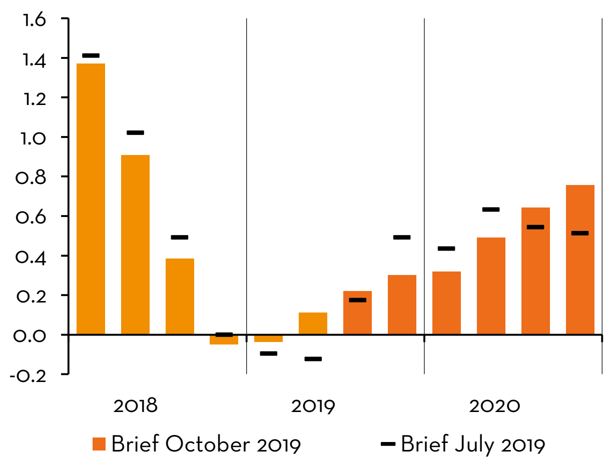
- The National Statistical Institute released new quarterly data on 4 October, following the recent revision of the National Economic Accounts.
- The new data are slightly more positive than the previous ones: Q2-2019 GDP growth was revised from 0% to 0.1% qoq and from -0.1% to 0.1% yoy.
- Good news from exports, which held up in the first half of 2019 despite the weakening of world trade.
- We forecast a modest GDP growth in the second half of 2019, driven by household consumption supported by the Citizens Income scheme. We confirm a GDP annual growth of 0.1% in 2019 (Chart 2).
- In 2020, GDP growth should accelerate to 0.6%, benefiting from the restored confidence and the modest expansionary contribution provided by budgetary policy.
- The recent Update of the government's fiscal plans is described in the second InFocus of this Brief.

Chart 1 – Real GDP
% change



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

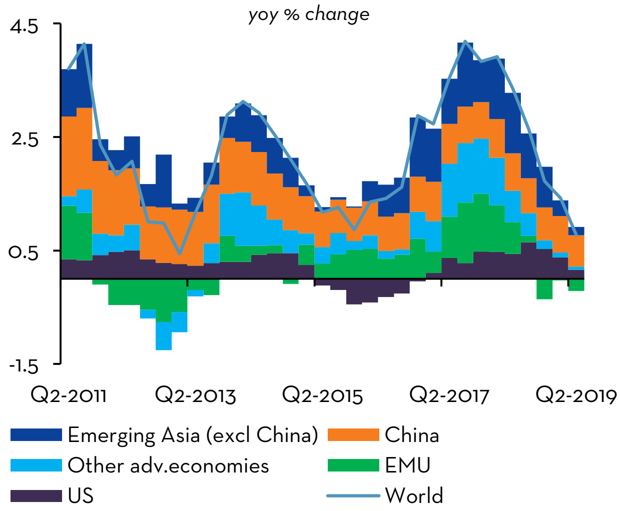
Chart 2 – Italy: real GDP
% change yoy



Source: Prometeia's forecast on Istat data.

Global scenario

Chart 3 – Global industrial production index
yoy % change



Source: Prometeia's calculations on Central Planning Bureau data.

Chart 4 – Manufacturing production indexes
*% change August 2019 – December 2018**

*Austria and Belgium to July
Source: Prometeia's calculations on Eurostat data.

Downward risks in our central scenario have intensified. The effects of US-China trade tensions, their persistence and other unresolved trade issues (i.e. automotive and agricultural product tariffs) continue to deteriorate confidence while industrial activity hit its lowest level since 2013 (Chart 3). Long-term interest rates have reached a historic low, financial market volatility has increased and activity in services only continued to support growth. In the short run global business investment growth is unlikely to regain traction and support global trade; expansionary economic policies are expected to support domestic demand.

In China, the authorities' policy response could help stabilize GDP growth at around 5% in 2020. Because there is little evidence that the monetary and fiscal policy are stimulating further the GDP expansion, downside risks pushed the authorities to allow substantial depreciation in the renminbi exchange rate against the US dollar.

Among the largest EMU economies, the persistence of trade tensions is significantly affecting the German manufacturing sector, in contrast with France (Chart 4), where the reduced importance of capital goods production in the economy and a major state-owned presence in the automotive industry also play a role. Germany's economy shrank by 0.1% qoq in the second quarter of this year and our nowcasting models predict it will enter a technical recession in the third quarter (-0.2% qoq). However, German fiscal policy has sufficient space to sustain the economy without endangering its sound budgetary policy (InFocus 1). In our baseline scenario, the government will use part of this fiscal space in the form of additional public investments up to €20 billion (0.6% of GDP) in 2020-2021. This implies a mild acceleration in GDP growth in 2020 to 0.7% (0.4% in 2019).

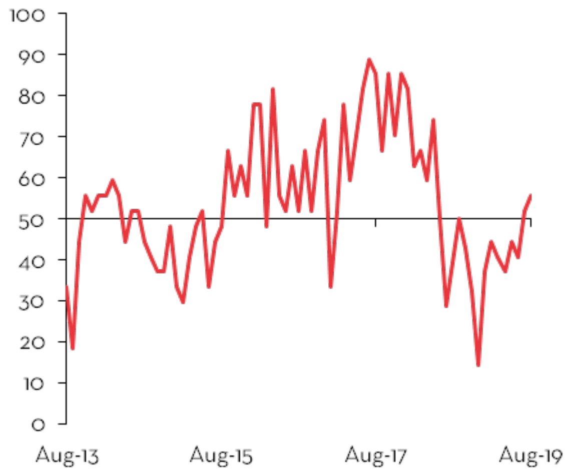
In the last meeting, the ECB adopted a substantial package of monetary policy measures that complement each other in providing additional monetary stimulus. A mild expansionary fiscal stance at the euro area level and this new monetary boost should provide support to EMU activity and stabilize GDP at 1.1% in 2020.

Towards a form of secular stagnation in the US. In the US, real GDP growth in annual terms moderated to 2.3% in the second quarter, reflecting the unwinding of temporary factors, while private consumption and government spending remained robust. The Fed has already reduced its target range for the reference rate by 25bp on two occasions (in July and September) and we expect two further cuts by 25bp each: one before the end of 2019 and then again in Q1-2020, as preventive measures against the global slowdown and the risks arising from the trade conflict. The lifting of spending caps for the 2020 and 2021 fiscal years and the two-year suspension of the federal debt limit agreed by Congress in August reduce the risk of recession but will not avoid a GDP slowdown at the end of 2019 and in 2020. We expect that US growth will stabilize below its potential rate, at 1.3%, for an extended period of time.

Italy

Chart 5 - Industrial production diffusion index

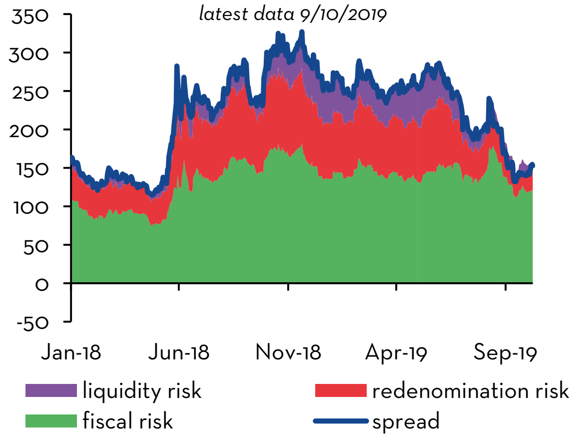
% of growing sectors



Source: Prometeia's calculations on Istat data.

Chart 6 - 10Y BTP-Bund spread decomposition*

latest data 9/10/2019



** It is obtained from the difference between CDS on German and Italian government bonds. Fiscal risk is obtained from the ISDA 2003 CDS and the redenomination risk from the difference between the ISDA2014 and ISDA2003 CDS.*

Source: Prometeia's calculations on Refinitiv data.

The slow growth of economic activity continued in Q2 2019. Held back by industrial production reduction, GDP grew only by 0.1% qoq (as in Q1), as a result of a positive contribution of 0.3pp in domestic demand (excluding inventories) and net exports, and a negative contribution of 0.2pp in inventories. Investment in capital goods was the most dynamic component (1.9% qoq), while household consumption growth was very modest (0.1% qoq). The weakness of the industrial sector did not extend to the services sector, whose value added increased by 0.3%.

Leading indicators suggest a stagnation in Q3, consistent with a further expected reduction in industrial production (-0.5%). In August, the industrial production index (excluding construction) increased slightly (0.3% mom) after two months in reduction. Nevertheless, 56% of sectors recorded a positive growth rate in annual terms (Chart 5).

Recent data point to some difficulties in the labour market. In comparison to the slight GDP growth (0.1% from Q2-2018 to Q2-2019), total employment measured in terms of standard units increased by 0.4% and the unemployment rate fell to 9.7% in June 2019 from an average of 10.6% in 2018. Nevertheless, the labour force survey shows a deterioration during the summer months, suggesting a delayed reaction of the labour market to the worsened growth prospects.

Inflation in Italy, as well as in the EMU, remains very low, and well below the ECB's target, reflecting structural elements and not just temporary factors. In September, the annual growth rate of the consumer price index was 0.4%. The index decreased by 0.5% on a monthly basis, affected mainly by seasonal factors. The absence of inflationary pressure stems primarily from core inflation that has not exceeded 1% since 2013 (0.6% in September). With regard to energy price inflation, the weakening of the global economic cycle kept oil prices low until the summer, bringing inflation down from the peaks reached in the middle of last year. Energy price inflation declined from 5.5% in March to -2.8% in September and the spike in oil prices occurred at the beginning of September will likely not affect consumer energy prices. On the contrary, food inflation did not show a clear trend (1.5% in March and 1.1% in September).

In 2019, the public deficit will be lower than expected thanks to higher revenues and lower expenditures. The most recent data confirm the improvement of public accounts compared to the target envisaged in April's Economic and Financial Document. This trend was already noticeable in the mid-year and was crucial for the success of Italy's government pre-summer negotiations with the EU. The budgetary adjustment decided by the government on 1 July established a reduction of €7.6 billion to the public deficit preventing the opening of the Excessive Deficit Procedure. The bulk of this correction, €6 billion, is the result of fiscal and non-fiscal revenues. The former was driven by the extension of mandatory electronic invoicing to the private sector and by more dynamic growth in social security contributions; the latter benefited from higher dividends paid by the Bank of Italy and by Cassa Depositi e Prestiti, as well as higher proceeds from the auction of European CO2 emission allowances. The rest of the correction, €1.5 billion, is due to the lower expenditure for Citizenship Income and Quota 100.

Large positive effects of the new political scenario on the 10Y sovereign bond yield. The political crisis and the prospects of imminent new elections caused the spread vis-à-vis German bonds to rise to 240bp at the beginning of August, but in mid-September, driven by a reduction of fiscal and redenomination risk premia (Chart 6), the spread fell below 150bp when an alternative coalition more open to cooperation with the EU was formed (Chart 6).

Credit to the private sector is expanding. In July, bank loans increased in both the EMU and Italy. However, the annual growth rate in Italy (0.8%) is considerably lower than in the EMU (3.8%). The growth gap is mainly due to the weak loan provision to Italian non-financial corporations (-0.4%), while loans to households increased by 2.5%.

Bank funding increased in the first seven months of 2019 by almost €31 billion (2.4% yoy), due to an increase in all funding items. Uncertainty in the first part of 2019 and low interest rates supported demand for current accounts, which rose by more than €38 billion (6.6% yoy in July).

Profitability of banks. In the first half of 2019, the profits of significant banks increased more than last year. Overall, net profits amounted to €6.6 billion compared to €5.6 billion in the first half of 2018. Profits were sustained by extraordinary income for more than €2.7 billion, while core revenues fell, penalised by net interest income and commissions.

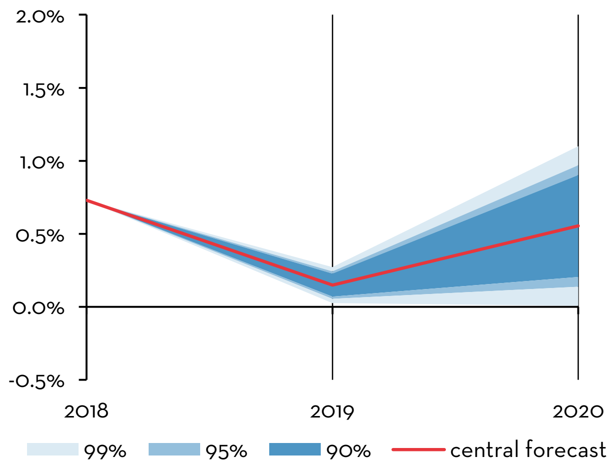
The scenario: slightly expansionary budgetary policy and lower political uncertainty… We forecast a positive contribution of domestic demand at the end of 2019 and a negative contribution of exports, mainly due to world trade weakness. Consumer spending should benefit from the disbursements for the Citizenship Income scheme, and investment from the reduction of domestic uncertainty, reflected in the substantial reduction in the spread. In addition, the new monetary policy measures should help maintain high liquidity in the banking sector and reduce the cost of funding for banks, with a further decline in lending rates to the private sector.

…will mitigate the negative effects of the international scenario on GDP growth. In 2020, GDP growth will continue to be affected by an unfavorable international environment (low growth in world trade and depreciation of the US dollar), while the improvement in Italy's domestic demand will consolidate. Fiscal spaces for the budgetary policy will benefit from declining interest spending, as the sovereign spread will remain below 150pb and interest rates on newly issued government securities will stay at a historically low level. The interest savings are expected in 0.25pp of GDP at the end of 2020 and will be earmarked for income support measures, with positive effects on consumer demand (see InFocus 2).

Risks to the projection

- The further escalation of trade and geopolitical tensions might prolong the current phase of uncertainty; it might imply that developments in the services sector will start converging towards those in the manufacturing sector, with negative implications for global output growth in the next quarters.
- In China, a sharper slowdown than the one foreseen could be harder to counteract with further policy stimuli and might prove a challenge to the ongoing rebalancing process.
- Also, a possible disorderly Brexit could entail a negative shock with potentially negative effects for euro area activity.
- A more intense than expected slowdown in the international cycle could offset the expansionary effects of budgetary and monetary policies on Italy's GDP growth, leading to a stagnation also in 2020.

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



Source: Prometeia's calculations.

"Governments with fiscal space should act…": estimated effect on EMU countries

The President of the ECB has recently recommended that governments with fiscal space facing a slowdown act in an effective and timely manner.

But, **what is the fiscal space, how can it be used and how can it affect the EMU activity?**

There is no single definition of fiscal space; **it can be described as a country's ability to take budgetary discretionary actions without jeopardizing the sustainability of its public finances.** For the EMU countries, the fiscal space cannot be separated from the European and national fiscal rules designed to ensure sound public finances.

We approximate the potential fiscal space for 2020 in all major EMU countries using two different metrics, as reported in Table 1. In case (a) fiscal space is obtained as the gap between the European Commission (EC) estimated primary balance at unchanged policies for 2020 – for Italy we use our forecast – and our estimation of debt-stabilizing primary balance. In case (b) fiscal space is defined as the gap between the EC projected structural balance in 2020 – again for Italy we use our projections – and the country specific medium-term budgetary objective (MTOs); i.e. the country specific budgetary target set in the Stability Pact and that all EU countries are expected to reach or be heading towards.

Case (a) can be seen as a mechanical tool for gauging consolidation needs under unchanged economic conditions, given a certain debt/GDP ratio. Accordingly, in the group of ten countries considered, only Italy and Spain would have no margin for any intervention. **Case (b) is a more prudent interpretation of fiscal space; it is derived from a systematic in-depth assessment of country specific structural conditions,**

Table 1 – Fiscal Space in main EMU countries
Billions of euros and % of GDP

	(a) fiscal space as difference between 2020 primary balance* and debt-stabilizing primary balance**		(b) fiscal space as difference between 2020 structural balance and MTO for 2020-2022***	
	% GDP	*billions of euros*	*% GDP*	*billions of euros*
Germany	2.4	**83.4**	**1.8**	**62.1**
France	0.1	**3.2**	-1.5	-36.2
Italy*	-0.2	-4.2	-2.5	-44.4
Spain	-0.4	-4.7	-2.2	-27.4
The Netherlands	2.1	**16.6**	**1.2**	**9.6**
Belgium	0.3	**1.2**	-1.8	-8.3
Ireland	1.8	**6.1**	**0.5**	**1.7**
Portugal	1.5	**3.1**	-0.5	-1.0
Austria	1.7	**6.9**	**0.8**	**3.0**
Finland	1.2	**3.0**	-0.4	-0.8

*European Commission-April 2019 and Prometeia forecast for Italy

** debt-stabilizing primary balance at 2018 value is derived using Prometeia estimation of structural long term nominal growth and the nominal interest rate paid on the existing debt in 2018.

**MTO are given in "Vade Mecum on the Stability and Growth Pact – 2019 Edition" for the period 2020-2022

Source: Prometeia's calculations on EC data.

and it takes into account the need to achieve sustainable debt level, while ensuring governments have enough room of manoeuvre. In this case, there would be only four countries - Germany, the Netherlands, Ireland and Austria - that could carry out public interventions contrasting the economic slowdown being experienced by the economy (as in the case of Germany) without affecting the sustainability of public debt.

If governments decide to use their fiscal spaces, as defined by the two metrics, in the form of public investment, it would represent a spending boost of around €120 billion and €80 billion respectively, i.e. 1% and 0.6% of 2019 EMU GDP of 2019.

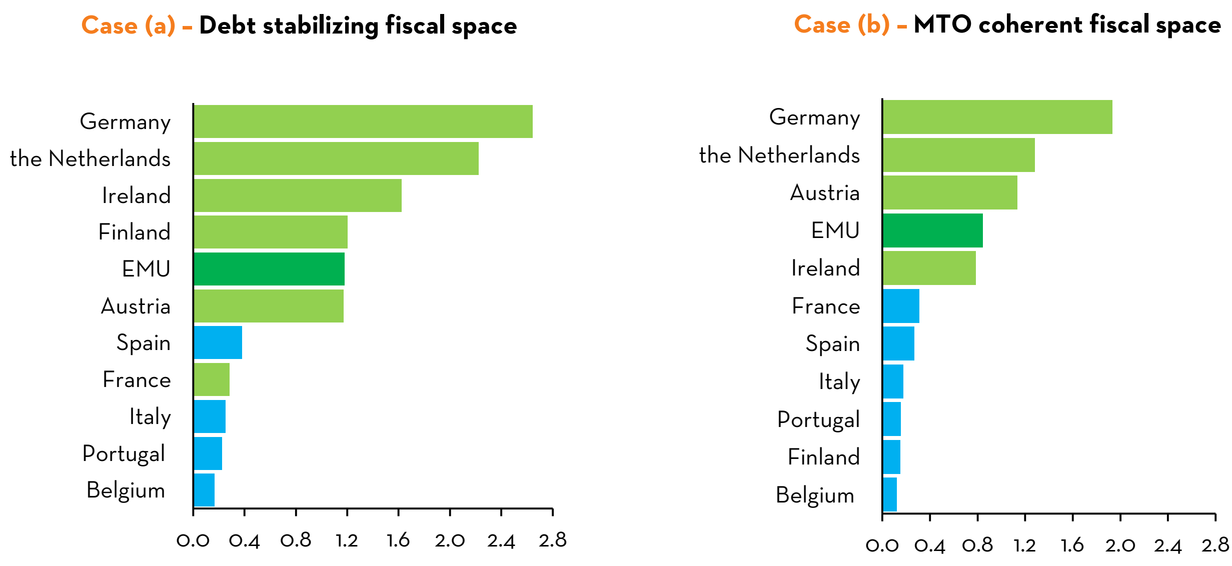
To approximate the economic effect of higher public investments distributed over three years, a simulation exercise with Prometeia's International model has been run. The results show that the increase in public investments would entail a significant expansion in cumulative terms, taking EMU GDP respectively 1.2% and 0.8% above the baseline scenario after 3 years (Chart A).

The main beneficiaries would be the countries that have adopted the measures to support the economy – in particular Germany – but the positive spillovers into the rest of the euro area would not be negligible. In particular, Italian GDP would expand by 0.2% above the baseline scenario after three years.

Summing up: the potential impact on the economy of effective and timely higher public investments in countries with fiscal space could be significant. In particular, German GDP is estimated to expand by 1.9% above the baseline scenario at the end of the third year in the case of interventions in line with the MTO budgetary target, at the cost of worsening the budget balance by 0.5pp of GDP on average per year, an amount that would not imply taking on additional public debt.

Chart A – Simulations: effects of an increase in public investments on GDP after three years*

% of deviation from baseline scenario with no fiscal impulse



*Countries in light green are those who effectively increased public investments in accordance with the fiscal space metric as quantified in Table 1 – Portugal and Belgium have not been taken into account because of their high debt/GDP ratio.

The new Italian fiscal plans: fighting tax evasion to find room for growth enhancing policies

On 30 September, Italy's new coalition government updated its forecasts and defined the policy framework for the 2020 budget law. The details will be disclosed on 15 October, when the Draft Budgetary Plan will be submitted to Brussels. Compared to the April Economic and Financial Document (DEF), the Update of the DEF (NADEF) projects a **lower trend deficit while the targets remain almost unchanged.**

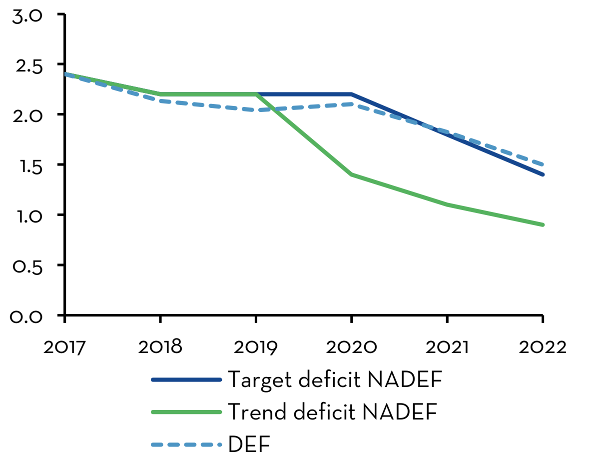
Under current legislation, the deficit is 1.4% of GDP in 2020 and below 1% in 2022, marking **an average improvement of 0.7pp compared to the April estimates, mainly due to the lower sovereign yields projections** (Chart B). Net of additional revenues from the VAT safeguard clause (1.3% of GDP), the trend deficit/GDP is at 2.7% in 2020, while it was 3.4% in the DEF. In government's plans, the VAT increase will not be enacted. The better than expected trend will reduce the required alternative financing measures since **the target deficit is confirmed stable at 2.2% of GDP** (2.1% in the DEF). The net deficit reduction expected from the 2020 budget is therefore only 0.5pp of GDP (Chart C).

Further deficit-increasing measures are planned for 0.3pp of GDP and include the renewal of some expiring policies (including Industry 4.0 incentives) together with new measures aimed at stimulating growth: the **cut of the tax wedge on labour** (0.15pp of GDP), higher green **investment**, increased resources for education, technological **research** and the universal **health care system. The financing (0.8pp of GDP) comes mainly from revenue-increasing measures: half from the fight to tax evasion** (0.4pp of GDP, with some risk of overestimation); 0.1pp from the revision of tax expenditures and environmental taxes; 0.1pp from other fiscal measures. On the expenditure side, savings of 0.1pp are expected from the spending review.

In our scenario, we include a budget package consistent with the NADEF's plans. Additional revenues from anti-tax evasion measures and tax expenditure review alongside some spending savings will bring deficit/GDP down to 2.1/2.2% of GDP while at the same time leaving room for a cut in the tax wedge on labour for low income households. In this scenario, **the stance of budgetary policy will be slightly expansionary in 2020,** due to the higher effect of the social spending measure that came into force in 2019 (mainly Citizenship Income), higher investments and favorable redistributive effect of the new measures.

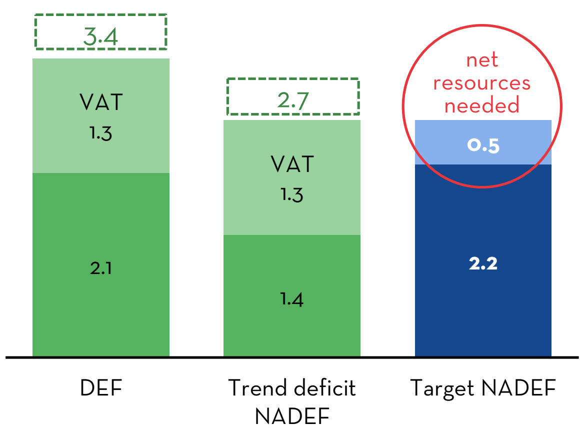
The Update of the DEF shows that the budgetary policy is less restrictive than previously planned. Indeed, **it is a consolidated practice to postpone the fiscal consolidation to the following years, slowing down its intensity, as well as the call for flexibility with regard to European rules.** These would require Italy to reduce the structural deficit by 0.6pp of GDP each year to arrive at a surplus of 0.5% of GDP, which is the Medium-Term Objective (more ambitious than that of other countries, which are not under the burden of a public debt at 135% of GDP). The NADEF envisages a structural deterioration of 0.1pp of GDP in 2020 and, therefore, the implicit flexibility requested is around 0.7pp of GDP, €14 billion.

Chart B – Target and trend deficit-to-GDP ratio
%



Source: Prometeia's calculations on Istat and Ministry of Economy and Finance.

Chart C – 2020: trend deficit-to-GDP ratio without VAT clause and target – %



Source: Prometeia's calculations on Istat and Ministry of Economy and Finance.

Table 1 - The world economy: main indicators (% change)

	2018	2019	2020
World real GDP	3.7	3.0	2.6
World trade	3.3	0.5	1.2
Manufacturing prices $	5.1	-0.7	1.6
Brent oil price ($/brl, level)	71.6	65.0	64.3
GDP			
- United States	2.9	2.3	1.3
- Japan	0.8	0.6	0.4
- EMU	1.9	1.1	1.1
- China	6.6	5.9	5.0
Consumer prices			
- United States	2.4	1.7	2.0
- Japan	0.9	1.0	1.4
- EMU	1.8	1.2	1.1
- China	2.3	3.2	2.9
$/€ exchange rate (level)	1.18	1.12	1.17
£/€ exchange rate (level)	0.885	0.892	0.944

Table 2 – Italy: main indicators (% change)

	2018	2019	2020
GDP*	0.7	0.1	0.6
Imports of goods fob and services	2.4	0.7	2.4
Private consumption	0.8	0.5	0.9
Government consumption	0.4	0.2	-0.4
Gross fixed investment:	3.0	2.5	2.0
- machinery, equipment, other products	3.4	1.5	1.7
- constructions	2.5	3.6	2.3
Exports of goods and services	1.3	2.5	1.2
Domestic demand	1.0	-0.4	0.9
Industrial production	0.5	-0.9	0.8
Trade balance (% of GDP)	2.7	3.3	3.5
Terms of trade	-1.7	0.6	2.5
Consumer prices	1.1	0.6	0.7
Per capita wages - manufacturing	0.5	1.1	0.9
Total employment	0.8	0.5	0.2
General government balance (% of GDP)	-2.2	-2.0	-2.1

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

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	1.12	1.11	1.13	1.16	1.17	1.18	1.18
	Yen	125.1	123.3	119.2	120.8	123.9	125.0	126.0	126.6
3 month interest rates %	US	2.70	2.51	2.20	1.87	1.65	1.50	1.49	1.49
	Euro area	-0.28	-0.29	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
10 year government bond yields %	US	2.64	2.34	2.06	2.04	2.02	2.00	1.46	1.46
	Germany	0.08	-0.14	-0.53	-0.60	-0.63	-0.64	-0.63	-0.61
	Italy	2.71	2.43	1.29	0.90	0.69	0.63	0.59	0.59

Table 4 – Real GDP: comparison of the forecast – % 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 July 2019	**0.8**	0.4	0.4	0.1	2.3	0.1	0.2	0.4	0.4	0.9
	Brief October 2019	**0.8**	**0.5**	0.5	0.3	2.3	0.3	0.2	0.3	0.3	1.3
EMU	Brief July 2019	**0.4**	0.2	0.2	0.2	1.1	0.2	0.3	0.3	0.3	1.0
	Brief October 2019	**0.4**	**0.2**	0.1	0.2	1.1	0.2	0.3	0.4	0.3	1.1
Italy	Brief July 2019	**0.1**	0.0	0.2	0.2	0.1	0.1	0.2	0.1	0.2	0.5
	Brief October 2019	**0.1**	**0.1**	0.0	0.1	0.1	0.1	0.2	0.1	0.2	0.6

Prometeia Associazione per le Previsioni Econometriche

Piazza Trento e Trieste 3, 40137 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 10th October 2019

contributors: Maria Valentina Bresciani, Lucia Cossaro, Monica Ferrari, Elena Giarda
contact persons: Lorenzo.Forni@prometeia.com, Stefania.Tomasini@prometeia.com, Lorena.Vincenzi@prometeia.com
tel. +39 051 648 0911