ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

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Executive summary

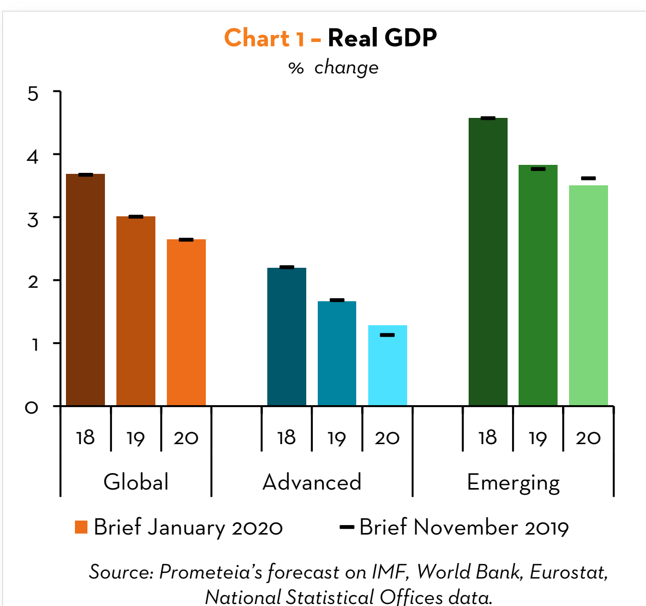
The global economy: surfing a small wave

- In the final months of 2019, the global economy showed some signs of stabilization, with GDP growth in the main countries and areas ceasing to decelerate and world trade posting positive growth following three successive quarters of negative qoq percentage changes. The stock markets reacted to this news with exuberance.
- Nevertheless, these improvements are not sufficient to avoid a deceleration of global (and main countries) growth (Chart 1).
- Although the latest truce between the US and China on bilateral trade (Phase 1) seems more substantial than many of the previous announcements, it will not improve confidence hugely because of the many deeply rooted issues and tensions that remain. We confirm our forecast of a mild recovery in trade.
- Thus, global growth will largely rely on expansive fiscal and monetary policies, but these might have reached their limits and any further support may be riskier and less effective.
- The mounting tensions between the US and Iran are an additional risk to the global economy. So far, despite some spikes, financial markets and the oil price have reacted fairly mildly.

Italy: ending 2019 low and edging up in 2020

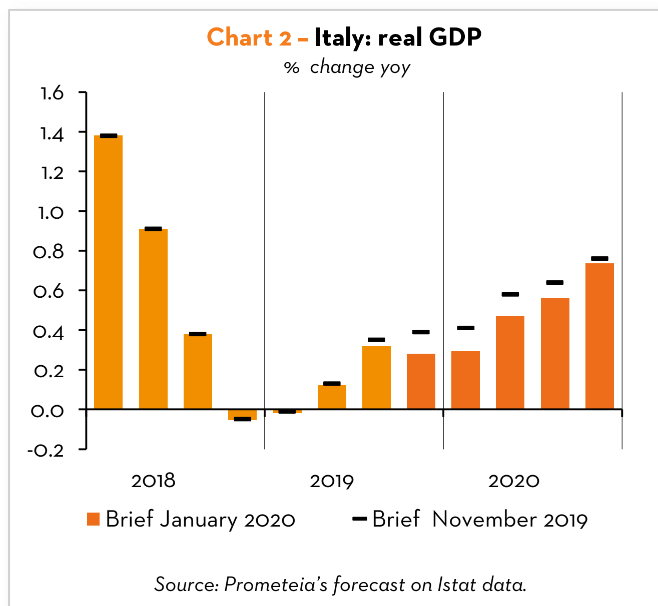
- In a global context that continues to be uncertain, we confirm our forecast of a slow cyclical recovery in Italy despite the increase in domestic political uncertainty in the last months of 2019, which widened the government bond yield spread, and some worsened activity indicators.
- According to our now-casting models, industrial activity again fell in 2019-Q4 and was -1.1% over the year. It is expected to remain flat in the first quarter of 2020.
- We expect zero qoq GDP growth in Q4 (it was at 0.1% in our November Brief), which will prolong the stagnation that started in early 2018.
- Following 0.2% GDP growth in 2019, in 2020 it is projected to accelerate to 0.5%, due in part to the moderate expansionary effect of the budgetary policy (+0.1% in our estimations).
- Household consumption will be boosted in 2020 by full implementation of Citizenship Income and the reduction in the tax wedge planned from next summer, while private investments will be supported by tax credits, tax incentives for building renovations and eco-bonuses. The InFocus in this Brief analyses the recently approved 2020 Budget Law.

Chart 1 – Real GDP



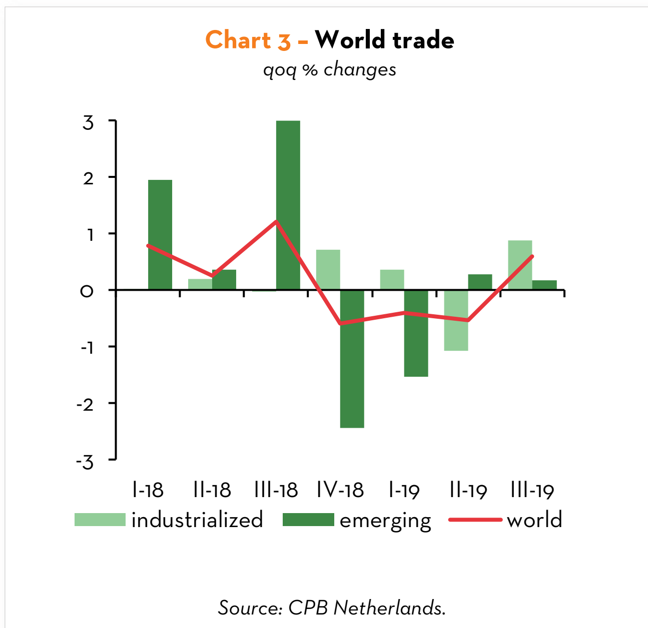
Source: Prometeia's forecast on IMF, World Bank, Eurostat, National Statistical Offices data.

Chart 2 – Italy: real GDP

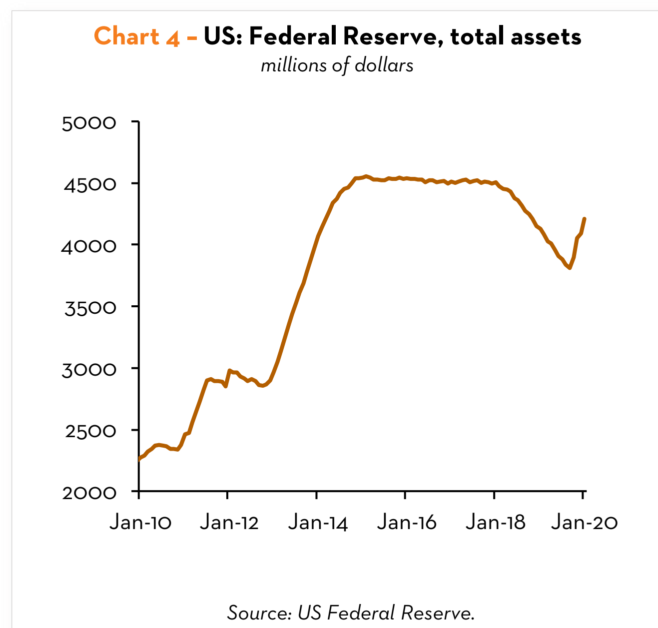


Source: Prometeia's forecast on Istat data.

Global scenario



Source: CPB Netherlands.



Source: US Federal Reserve.

In 2019-Q3, household consumption was the only driver of US GDP growth, with investment remaining generally flat. The persistent manufacturing difficulties dominating in US the consumer and industry sectors are at the root of the expected deceleration in GDP in 2020 (1.5%, Table 1). Inflation remains contained and free from upward tensions, and continues to appear to be only poorly related to labour market developments. In this context, fiscal and monetary policies will continue to make a substantial contribution to growth.

The signing of the trade agreement between the US and China (Phase 1) will not significantly change the two countries' existing tariff levels, which for the time being appear to be 'the new normal'. There continue to be large areas of disagreement suggesting that a complete deal is a long way off. The still high uncertainty about world trade will limit investment (Chart 3; October CPB data show a new contraction mom). We expect trade to grow by 1.4% in 2020.

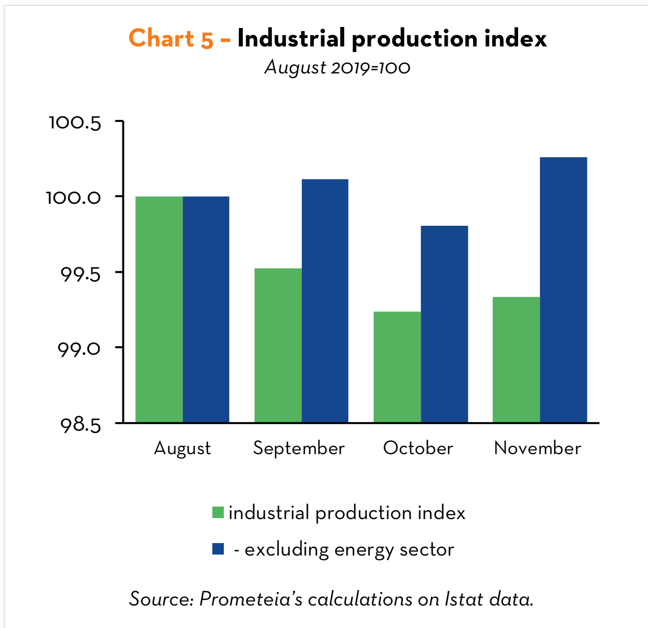
The Chinese authorities supported the 6% growth in Q3 through extensive use of economic and exchange rate policy instruments. The final months of 2019 were characterized by some signs of industrial production recovery and investment stabilization. We confirm our prediction of a further growth slowdown in 2020 (to 5.1%), based on weak international trade and the high level of domestic debt which is reducing the effectiveness of fiscal stimuli and posing increasing risk in this phase of economic slowdown.

In the euro area and, particularly, in Germany, the industry sector remains weak, despite some positive business confidence indicators. Domestic consumption and labour market resilience is deterring the German government's use of fiscal instruments, making public investment likely to be substantially lower than our previous forecast. Going forward, even the most dynamic economies (the largest being France and Spain) could be held back by Germany's persistent weakness (we expect 0.7% GDP growth in 2020), leading to overall EMU 2020 GDP growth of 1.1%, 0.1pp lower than in 2019.

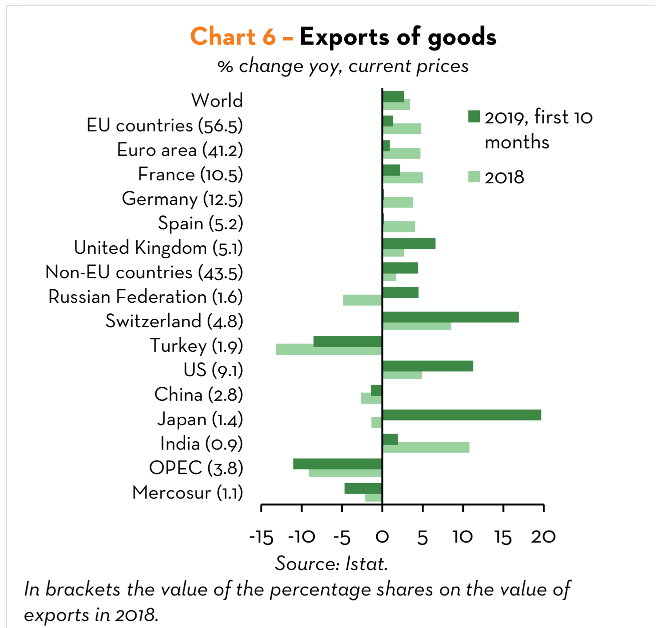
Monetary policy remains expansionary almost everywhere, in both the industrialized and emerging economies. We believe that the growth deceleration in the US will lead to a further 25bps cut in the Fed fund target rate in 2020-Q2, which will help, also, to ease the debt pressures on the corporate sector. Liquidity shortages in the interbank market have led the Fed to intervene on an exceptional scale (Chart 4) and are feeding fears that the accumulation of debt positions, maturity mismatches and risk assumptions could trigger liquidity crises.

The extent of the international crisis between the US and Iran is difficult to assess, as the muted reaction of the financial markets suggests. We would stress that any shock would heighten the dangers in a context of many global level imbalances and fragilities.

Italy



Source: Prometeia's calculations on Istat data.



Source: Istat.
In brackets the value of the percentage shares on the value of exports in 2018.

The latest data confirm the sluggishness of the economy in 2019-Q3... GDP grew by 0.1% qoq in the 2019-Q3, at the same pace as in the previous three quarters. This is the result of resilient domestic demand and increased inventories, which contributed to GDP growth by 0.2pp and 0.3pp respectively (the latter following several negative contributions), and a negative contribution from net exports (-0.4pp). Lasting political uncertainty weighed on the sluggish momentum of business investment. On the other hand, household spending accelerated (+0.4%), underpinned by the Citizenship Income programme.

...due to the weakness of industry sector. On the supply side, in 2019-Q3 the construction and services sectors grew moderately qoq while the manufacturing sector declined. However, signs of stabilization are emerging. The industrial production index, after a fall of 0.5% qoq in Q3 and 0.3% mom in October, grew by only 0.1% in November, curbed by the fall in the energy sector that has been recorded since July. In fact, industrial production excluding energy stabilized in the last months of 2019 (Chart 5) and the share of sectors showing positive annual growth increased in November, from 30% to 48%.

Exports to EU countries were disappointing, but were better to non-EU countries. The widespread weakness affecting European countries' exports also affects Italy, whose foreign sales stagnated in Q3 compared to the previous quarter. This poor performance is tied to the sharp deceleration in exports to EU countries, notably to Germany and Spain, and especially in the case of machinery and equipment, transport and chemical products. In contrast, exports to non-EU countries grew quite substantially in 2019 (Chart 6).

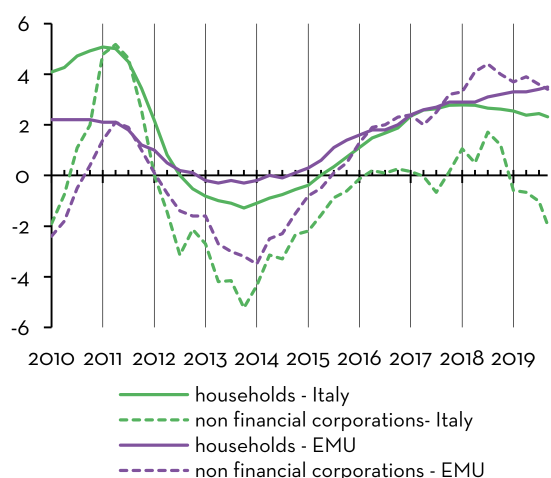
The economic activity stagnation is constraining but not stopping employment growth. In 2019-Q3, the unemployment rate fell further to 9.8% and was 9.7% according to the monthly data for October and November. Total employment growth accelerated to 0.3% qoq, but industry sector employment still fell (-0.3%). In this uncertain phase, support for employment stemmed from the translation of the many fixed-term contracts into permanent contracts, accelerated by the so-called "Dignity decree" entered into force in autumn 2018.

Increasing uncertainty related to inflation dynamics. In December 2019, consumer prices increased by 0.5% yoy, rising from the 0.2% recorded in October (the lowest level in the last 2 years), while the core component stood at 0.7%.

Credit supply conditions to firms is easing slightly... The Bank Lending Survey indicates easing credit supply conditions in 2019-Q3 and an expectation of stabilization in Q4 as a result of an improvement in the liquidity position of banks and increased bank competition. Bank's financing conditions remain good, although, in Q4, the increase in swap rates and the BTP-Bund spread led to an increase in the cost of issuing bank bonds and a consequent increase in the cost of funding. A positive contribution to containing the cost of funding could come from the liquidity obtained from the most recent TLTRO auctions.

...but credit to firms is still declining. In November, net new loans to firms stood at €2.4 billion (-2% yoy). In the first eleven months of 2019, net new loans reduced by €11 billion, almost half of which is attributable to the construction and real estate sectors. It is difficult to identify the reasons for the persistent weakness in the flow of loans

Chart 7 - MFI loans to households and non-financial corporations



Source: ECB and Bank of Italy.

to businesses, which is even more marked than the level of economic activity would suggest and which, perhaps, indicates a structural change in the credit market (Chart 7).

The reduction in the stock of bad loans continues. In the eleven months to November 2019, bad loans decreased by over €19 billion (-31.7% yoy, due mainly to securitizations) and accounted for 4.4% of total loans, a decrease of 1.1pp compared to the end of 2018. These securitizations are expected to amount to around €26 billion in both 2019 and 2020.

In 2019, public accounts were in line with the target of a stable deficit at 2.2% of GDP, but the debt-to GDP ratio increased further. In the first three quarters of 2019, the general government balance benefited from a reduction in interest expenditure and a significant increase in revenues also from the higher dividends paid by the Bank of Italy and the Cassa Depositi e Prestiti. Primary expenditure rose, due to higher investment and, especially, social benefits related to Citizenship Income and the new pension rules ("Quota 100") that came into force in the second half of 2019. Notwithstanding the stability of the deficit, debt is projected to increase by 1pp of GDP in 2019, peaking at 135.8% of GDP, as a result also of the increase in the Treasury's liquid balance.

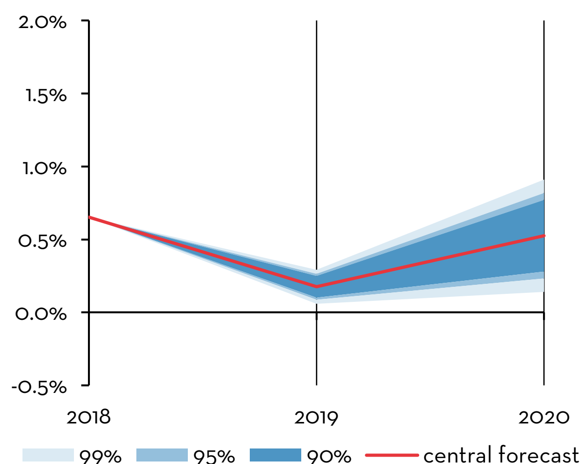
In 2020, we expect the deficit to be 2.3% of GDP. Social expenditure will increase further, as a result of full implementation of the measures mentioned above and the new arrangements to support families included in the 2020 budget package (see InFocus). Similarly, investment will also increase further. Overall outlays are expected to remain roughly stable (due to interest spending reductions and spending review), as the tax burden. The revenue expected from anti-evasion measures and, to a lesser extent, from new corporate taxes, will compensate for the other tax reductions (especially the cut in the tax-wedge for low-income employees, which will become effective from July).

A slightly expansionary fiscal policy. We estimate that the government fiscal policy will support GDP growth by about 0.1% in 2020. As in 2019, households will be supported by budgetary policy and, therefore, the impulse for growth will come mainly from private consumption, although the boost to the existing investment incentives will also play a role, as will the expected increase in public investment.

Risks to the projection

- The threats to the scenario arise from the possibility that the trade truce between the US and China may break down and may be reversed, while tensions in the Middle East may increase as a result of the tensions between Iran and the US.
- Risks could stem, also, from the management of economic policies, which have almost reached their limits, leaving less room to support economies further and increasing the impact of a possible future shock. In addition, the political fragmentation and "populist" movements are increasing the risk of political deadlocks.
- In the Italian scenario, apart from the impact of possible higher global tensions, there remains the risk associated to internal political uncertainty, which could reduce confidence and hold back spending decisions.

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



Source: Prometeia's calculations.

The 2020 Italy's Budget

On 24 December, the Italian Parliament approved the Budget Law for years 2020-2022, following long debate within the government resulting in some amendments to certain measures. However, these amendments did not change the design of the overall budget, which is **consistent with the targets of the Draft Budgetary Plan** sent to the European Commission in mid-October 2019.

In line with previous years, **the general government deficit is projected to remain stable in 2020, at 2.2% of GDP, and to decline only from 2021 onwards, to 1.4% of GDP in 2022.**

This path does not follow the structural adjustment required by the Stability and Growth Pact, even in the context of the flexibility granted for extraordinary expenditures. The European Commission's assessment highlights the risk of a significant deviation in 2020, although, so far, they have not made any demands for a change to the budget.

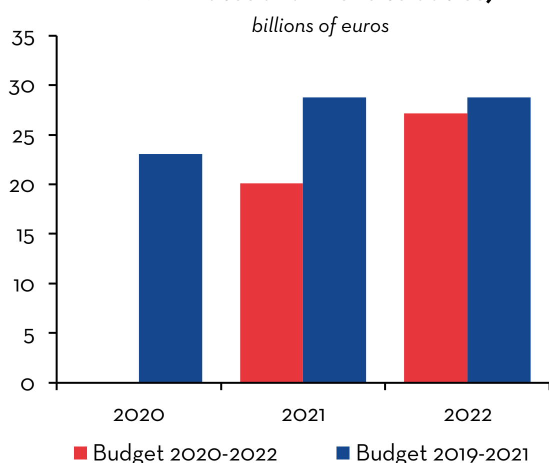
Moreover, **the deficit reduction projected from 2021 continues to be based on the safeguard clause**: the budget includes repeal of VAT and excise duty increases in 2020 (1.3% of GDP in total) although they will still apply in 2021 and 2022 and will amount respectively to €20.1 billion and €27.1 billion (1.1% and 1.4% of GDP, Chart A). Without these increases in VAT and excise duties, the 2021-22 deficit will increase to close to 3% of GDP (Chart B), significantly undermining the planned debt reduction (Chart C). Preventing these increases will require new funding next year.

Excluding the repeal of the previously legislated VAT increase, the 2020 budget will have a deficit-reducing impact of 0.4% of GDP in 2020 and a deficit-increasing impact in the succeeding years, of 0.2% of GDP in 2021 and 0.5% in 2022 (Chart D).

The 2020 budget growth enhancing measures are aimed mainly at supporting households' disposable income. A reduction in the tax wedge for low-income employees is planned from July, and will be worth €3 billion in 2020 and €5 billion from 2021 onwards. The way this reduction will be implemented will be defined in subsequent legislation and will likely take the form of higher tax deductions for earnings of up to €35,000, and a review of the so-called "€80 Bonus". An increase in the average current expenditure of 1 billion a year is allocated to measures to support families and includes two birth-related interventions and the establishment of a structural fund for "universal family allowance and childcare services". New resources are allocated, also, to public employment and pensions, including an extension to the early retirement opportunities for women and certain vulnerable groups, and an increased income limit at which total indexation to inflation is granted.

Chart A - Safeguard clause (legislated increases in VAT rates and in excite duties)

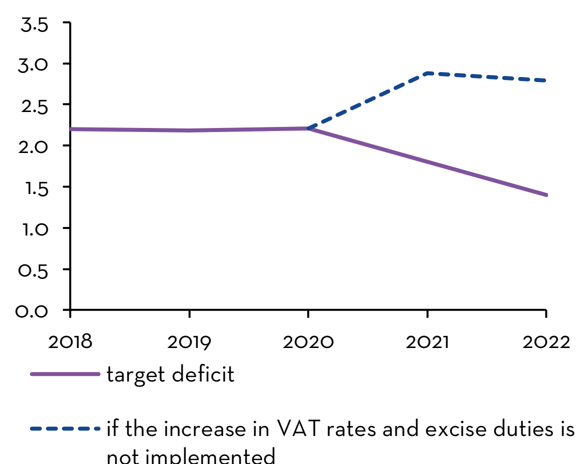
billions of euros



Source: Prometeia's calculations on parliamentary documents.

Chart B - Italian budget deficit targets

% of GDP



Source: Prometeia's calculations on parliamentary documents.

In order to increase private investment, the budget allocates about €3 billion over the three-year period for tax credits on new investments, with particular attention to technological improvements and the circular economy. Tax deductions for energy-efficiency enhancing expenditures and building renovations are confirmed, including an increase of up to 90% in the tax deduction for renovations to building facades.

A number of measures are dedicated to public investment expenditure in infrastructure and transport. However, in 2020, in particular, the funding will come from the revisions to previous appropriations, such that, in terms of net borrowing, earmarked resources will not increase until 2021.

Funding of the expansionary measures comes mainly from higher revenues. An important part of these measures includes increasing **the fight against tax evasion.** This involves several measures focused on VAT fraud and the fuel sector, the general obligation for electronic transmission of sales data, the lottery on sales receipt, incentives for payment traceability, tightening of administrative and penal sanctions and provisions to allow the Revenue Agency to integrate tax data with financial transactions data to allow development of general risk profiles. It is estimated that these measures will bring an additional €3 billion revenue in 2020, and €3.7 and €3.5 billion respectively in 2021 and 2022.

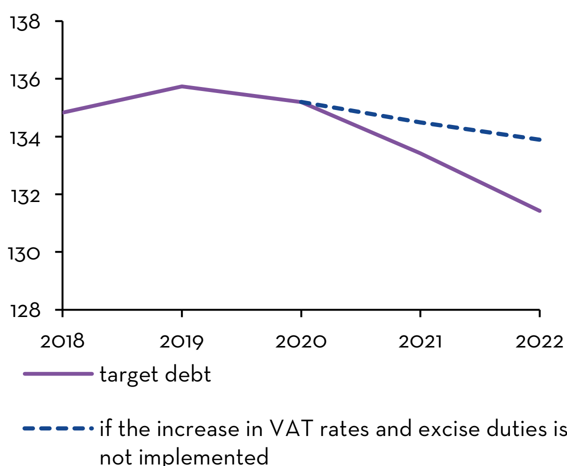
Other revenue increases will come from tobacco and gambling taxes and the revision to the flat-rate scheme. The planned new taxes on plastics and sugar have been reduced significantly compared to the original proposal and now will have modest revenue effects. **A significant share of the increased revenues in 2020 will come from one-off interventions**, such as the deferral of taxes to be paid in 2019 by certain categories of self-employed workers and the temporary suspension of deductions in the banking sector. Finally, the 20% flat-tax rate on self-employed individuals with incomes between €65,000 and €100,000 (which should have come into force in 2020) has been repealed.

On the expenditure side, savings are expected to be around €3 billion, related to spending review measures and the redirection of some funds and transfers within the state budget, in addition to savings due to lower than expected requests for "Quota 100" and other minor measures.

In 2020, we estimate that the budgetary policy will support GDP by 0.1%, due to a higher multiplier of the spending measures compared to the multiplier of the financing measures.

Chart C – Italian public debt targets

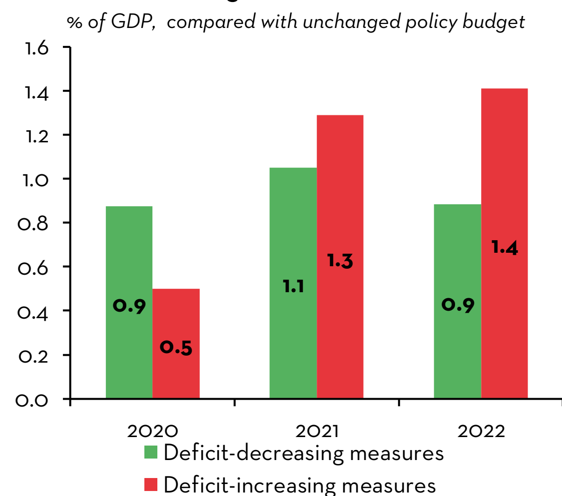
% of GDP



Source: Prometeia's calculations on parliamentary documents.

Chart D – Impact of the budget measures net of changes in VAT rates

% of GDP, compared with unchanged policy budget



Source: Prometeia's calculations on parliamentary documents.

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

	2018	2019	2020
World real GDP	3.7	3.0	2.6
World Trade	3.4	0.3	1.4
Manufacturing prices $	5.4	-0.5	1.8
Brent oil price ($/brl, level)	71.6	63.7	62.8
GDP			
- United States	2.9	2.3	1.5
- Japan	0.8	0.9	0.6
- EMU	1.9	1.2	1.1
- China	6.6	6.2	5.1
Consumer prices			
- United States	2.4	1.8	2.0
- Japan	0.9	1.0	1.4
- EMU	1.8	1.2	1.2
- China	2.3	3.3	3.0
$/€ exchange rate (level)	1.18	1.12	1.15
£/€ exchange rate (level)	0.885	0.877	0.839

Table 2 – Italy: main indicators (% change)

	2018	2019	2020
GDP*	0.7	0.2	0.5
Imports of goods fob and services	2.4	1.0	3.0
Private consumption	0.8	0.6	0.8
Government consumption	0.4	0.5	-0.1
Gross fixed investment:	3.0	2.4	2.0
- machinery, equipment, other products	3.4	1.6	2.2
- constructions	2.5	3.3	1.8
Exports of goods fob and services	1.3	1.7	1.4
Domestic demand	1.0	0.0	1.0
Industrial production	0.6	-1.1	0.1
Trade balance (% of GDP)	2.7	3.3	3.2
Terms of trade	-1.4	1.5	1.4
Consumer prices	1.1	0.6	0.9
Per capita wages - manufacturing	0.5	1.3	0.9
Total employment	0.8	0.6	0.3
General government balance (% of GDP)	-2.2	-2.2	-2.3

** 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	1.11	1.13	1.15	1.16	1.16
	Yen	125.1	123.5	119.3	120.4	122.5	123.8	124.7	124.9
3 month interest rates %	US libor	2.70	2.51	2.18	1.90	1.78	1.60	1.53	1.53
	Euribor	-0.29	-0.29	-0.38	-0.37	-0.37	-0.37	-0.37	-0.37
10 year government bond yields %	US	2.64	2.33	1.79	1.80	1.75	1.64	1.58	1.59
	Germany	0.08	-0.14	-0.54	-0.37	-0.31	-0.30	-0.30	-0.30
	Italy	2.71	2.43	1.32	1.19	1.31	1.24	1.19	1.29

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 November 2019	**0.8**	**0.5**	**0.5**	0.3	2.3	0.3	0.3	0.3	0.3	1.4
	Brief January 2020	**0.8**	**0.5**	**0.5**	0.4	2.3	0.3	0.3	0.4	0.4	1.5
EMU	Brief November 2019	**0.4**	**0.2**	**0.2**	0.2	1.2	0.3	0.3	0.4	0.3	1.2
	Brief January 2020	**0.4**	**0.2**	**0.2**	0.2	1.2	0.3	0.3	0.4	0.3	1.1
Italy	Brief November 2019	**0.1**	**0.1**	**0.1**	0.1	0.2	0.1	0.2	0.1	0.2	0.6
	Brief January 2020	**0.1**	**0.1**	**0.1**	0.0	0.2	0.1	0.2	0.1	0.2	0.5

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