ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

NOVEMBER 2019 — No. 19/7

Executive summary

Signs of stabilization of the global economy

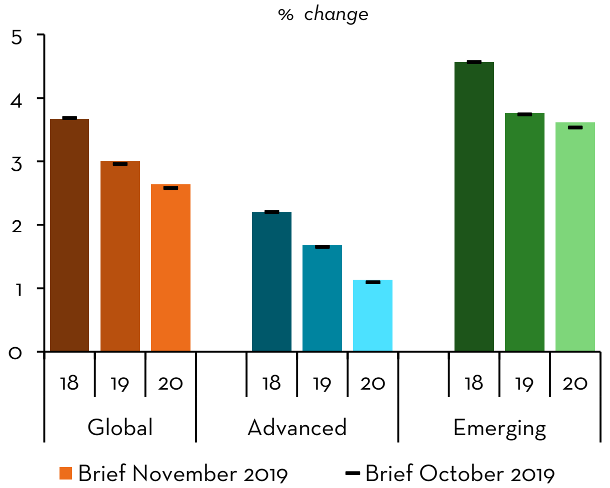
- Available data for Q3-2019 and survey information on Q4-2019 lead us to confirm some improvement at the end of 2019 - not enough to avoid a global deceleration of GDP in 2020 (Chart 1), but enough to reduce the risk of a further downturn.
- In the US and the euro area, qoq GDP growth in Q3-2019 was the same as in Q2 (0.5% and 0.2% respectively), in line with our October Brief.
- In Q3-2019, China decelerated further with annual GDP growth of 6%, the lowest so far, although consistent with the Chinese Government's projections of progressive deceleration.
- Global trade remains very weak. CPB releases for July and August suggest another contraction yoy in Q3-2019, following the fall in Q2.
- Expansionary monetary policy in the US and the euro area will continue to sustain growth, but, on their own, as Draghi has been pointing out for several years, are not sufficient to lead the recovery now (InFocus).

Italy moving at a snail's pace

- Amid a still weak international environment and domestic political uncertainty, in Q3-2019 Italian GDP has continued moderate growth of 0.1% qoq (0.3% yoy), marginally better than forecast in our October Brief (0.0% qoq and 0.2% yoy, Chart 2).
- The temporary factors that supported exports in the first part of 2019 appear to have faded and exports weakened in the summer months in line with world trade dynamics.
- We anticipate very limited GDP growth in Q4-2019 (0.1 % qoq), due to lower support from the service sector compared to Q3 and a moderate positive contribution from the industrial sector.
- We have revised 2019 annual GDP growth from 0.1% to 0.2%, due to the marginally better than expected Q3-2019 outturn.
- We confirm growth in 2020 to recover to 0.6% - as in the October Brief – thanks to improving confidence, more favourable credit conditions and a moderately supporting fiscal policy. However, compared to October, there are some additional risks related to the domestic political context.

Chart 1 – Real GDP

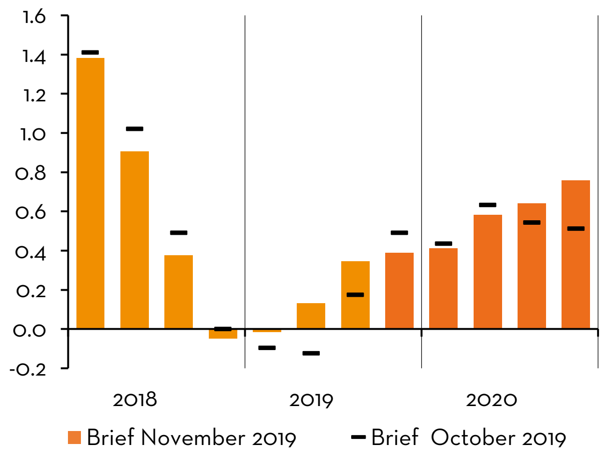
% change



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

Chart 2 – Italy: real GDP

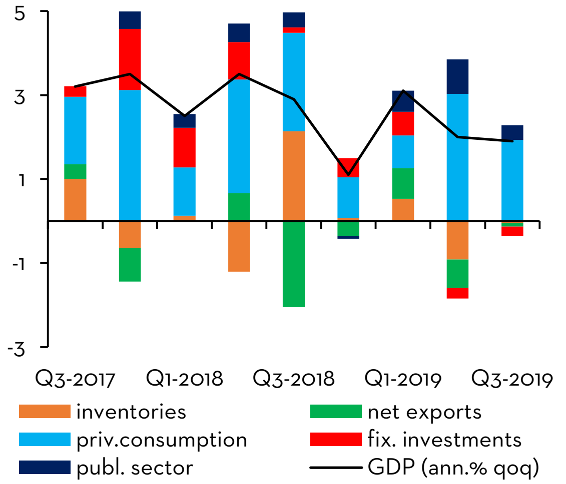
% change yoy



Source: Prometeia's forecast on Istat data.

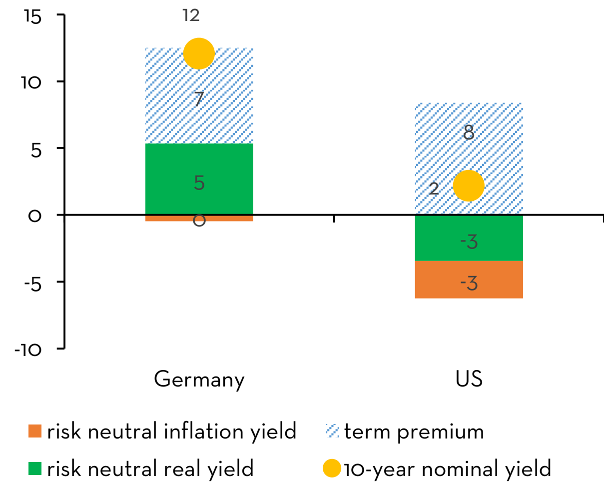
Global scenario

Chart 3 - US: contributions to GDP growth
annual rates and percentage points



Source: Bureau of Economic Analysis.

Chart 4 - Decomposition of the 10y government bond yield - *basis points, differences between October and September*



Source: Prometeia's calculations.

We confirm a modest acceleration of global trade in 2020. In our October Brief, under the assumption of no tariffs on US imports of auto vehicles and parts, we anticipated a moderate recovery of global trade, to reach annual growth rates of 0.5% and 1.2% in 2019 and 2020 respectively. This scenario seems to be supported by the recent news on the US-China trade dispute.

Persistent difficulties for US industry. In Q3-2019, non-residential investments contracted qoq for the second successive quarter (Chart 3), confirming the difficulties experienced in the industrial sector. In contrast, household consumption has remained buoyant thanks to good labour market conditions, the above 3.5% yoy increase in hourly earnings and the low level of inflation which is supporting purchasing power.

Differences remain among euro area countries. The 0.2% qoq growth of EMU GDP in Q3-2019 is the result of the combination of not negligible differences among the main countries. Spain and France registered growth above the EMU average (0.4% and 0.3% qoq respectively), whereas Italy stood at 0.1%. Data on Germany will be released on 14 November, but the available information suggests a moderate contraction.

Some positive signs from surveys in Europe... In October, manufacturing PMI improved in France and stabilized in Germany, where, in addition, the CESifo and ZEW indices respectively stabilized and improved. Household confidence remained substantially stable at high levels in almost all countries.

...and worldwide. Global industry PMI remains below the 50 threshold but improved in September and October. In China, the Caixin PMI, based on a broader sample of medium/small firms, is above 50 from August and increased further in October, signalling that a large part of the economy is responding to the economic policy stimulus.

Upward revision for China, on the back of the observed moderate deceleration in 2019, helped by economic policy, and the recent data suggesting improvements. If, as in our scenario, the trade dispute with the US does not escalate, a soft landing could follow. However, China's contribution to the global economy will reduce.

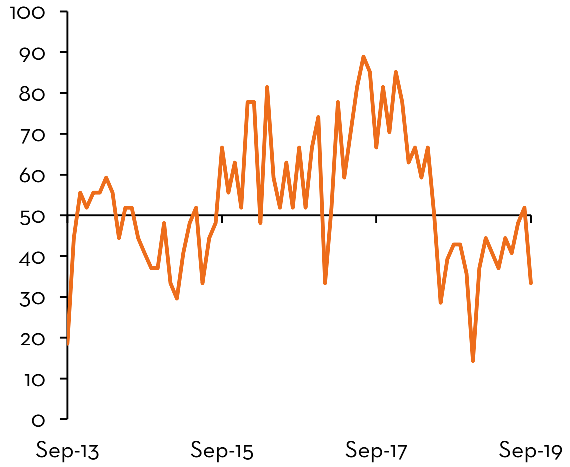
We expect another Fed fund rate cut in 2020. The Fed has stated clearly that the recent reductions in the policy rate are aimed at anticipating negative effects from the worsening external environment, given the good domestic economy conditions. The 25bp cut at the end of October follows this logic and should not be considered as representing a more expansive monetary stance than previously expected. The October cut anticipated what we had forecast for December, and we think it is consistent with a further 25bp reduction at the beginning of 2020, when we expect the US economy to decelerate further, as a result of weaknesses in the manufacturing sector.

ECB monetary policy is boosting confidence, evidenced by the 12bp increase in the ten-year Bund yield, due mainly to an increase in the term premium (Chart 4). We still expect an expansionary stance for a prolonged period, with the ten-year Bund yield stabilizing at around -0.4% in 2020.

Italy

Chart 5 – Industrial production

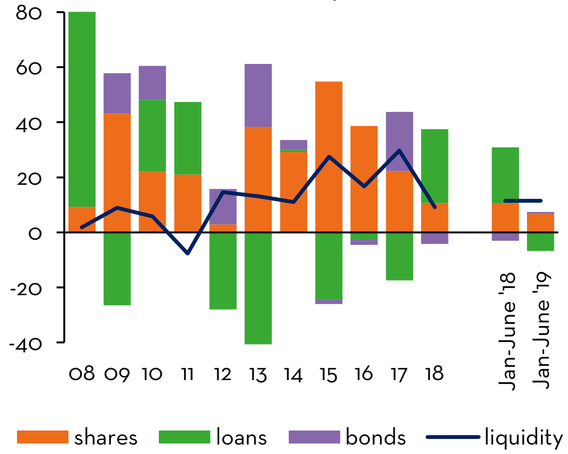
% of growing sectors



Source: Prometeia's calculations on Istat data.

Chart 6 – Sources of funding for non-financial corporations

Flows, billions of euros



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

Weak growth in Q3-2019 also... According to the preliminary data, GDP has increased by 0.1% qoq for the third quarter running. Net exports contributed negatively, but domestic demand increased. We assume that the negative contribution of net exports derives from the estimated reduction in exports (detailed data on the composition of GDP will be released on 29 November). The domestic political uncertainty over the summer has likely had negative effects on investment, while the Citizenship Income, the slow reaction of employment to the worsened growth prospects and the low inflation are sustaining consumer spending.

...owing to the struggling manufacturing sector. On the supply side, in Q3 indicators suggest a moderate contribution to GDP growth from the construction sector and a negative contribution from the industrial sector. As expected industrial production has declined by 0.5% qoq in Q3 and in September it decreased by 2.1% yoy (-0.4% mom). The number of sectors that recorded a positive growth rate in annual terms declined significantly compared to August, from 55% to 33% (Chart 5).

Over the summer, exports have been held back by euro area slow down, particularly Germany. The expansion of foreign sales to the UK, in anticipation of a no-deal Brexit, subsided. Export growth to the US strengthened and exports to Japan were boosted by the coming into force of a free trade agreement with the EU. However, these positive factors were not sufficient to compensate the weakening against the euro area countries.

Early effects of cyclical weakness in the labour market. In Q3-2019, employment stabilized, while the unemployment rate increased from 9.6% in August to 9.9% in September. Self-employed decreased by 50,000 units compared to the previous quarter, while the number of employees has increased.

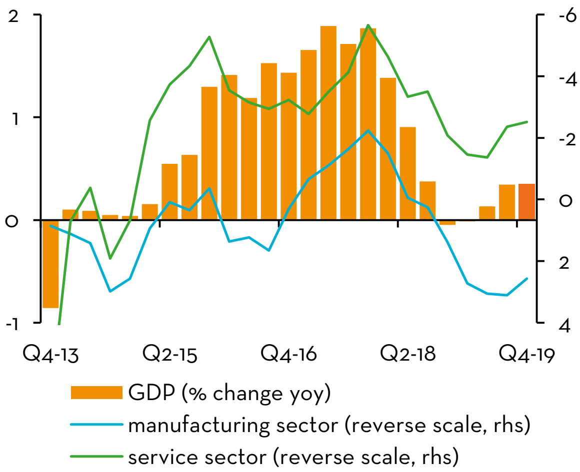
Consumer inflation remains subdued. In October, it was stable at 0.3% yoy (0% mom). This was mainly the result of a further reduction in prices of regulated energy products, from -5.3% in September to -8.2%, and the acceleration of prices of services related to transport, from 0.4% to 1.9%. Core inflation increased from 0.6% to 0.8%, the highest level in the first ten months of 2019.

The more favourable credit supply conditions... The drastic reduction in the risk premium on Italian government securities has led, in the recent months, to a reduction in the cost of funding for the banks and a further reduction in the cost of credit. According to the Bank Lending Survey, in Q3-2019, credit supply standards eased, due, especially, to improvements in the liquidity position of the banks, thanks to the most recent ECB's measures.

...are not sufficient to restart lending to corporations... In September, the annual growth of loans to non-financial corporations remained negative -1.0% (-0.7% in June). More recourse to alternative sources of funding (firms' internal liquidity levels remain high, Chart 6) and the de-risking process being followed by the banks, continue, together with the decline in investment in the recent months, to be the factors limiting lending.

...while lending to households is still growing. Credit growth to households has remained stable since the beginning of the year (2.5% yoy) supported by credit consumption and mortgages (financing about 80% of house purchases).

Chart 7 – GDP and Prometeia sectoral indicators



Source: Prometeia's calculations on Istat data.

The increase in bank funding continues. In September, total funding increased by 1.7% yoy due to the preference for liquidity among households (the reduction in firm's deposits is due to a fiscal deadline), the start of TLTRO III, a positive net flow of bond issues as a result of more placements in wholesale market, and the reduction in funding costs. The effects of these factors will continue into 2020. However, we expect a reallocation of private sector saving to instruments with higher risk-return profiles.

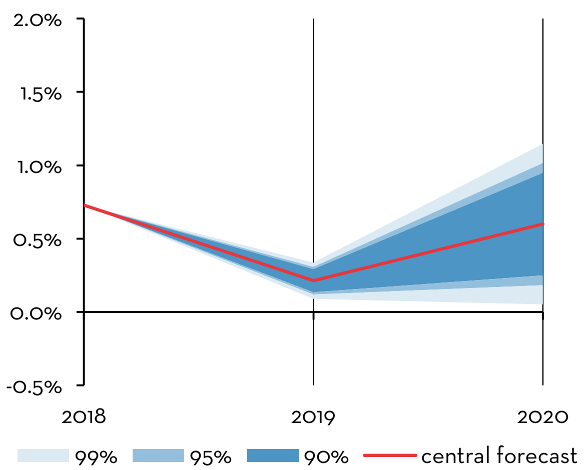
The new budget for 2020 that was presented to parliament envisages a reduction in the deficit-to-GDP ratio of 0.4pp with respect to the current legislation (excluding previously legislated VAT hikes). This would maintain the deficit at 2.2% of GDP, the same level as in 2019. In 2020, the tax burden and primary expenditure are expected to remain broadly constant, in term of GDP, compared to 2019. There will be an increase in social benefits, due to the higher expenses for Citizenship Income and Quota 100, whose full cost will start showing up in 2020, compensated by a slight fall in compensation of employee and other transfers in term of GDP. Both revenue and expenditure measures have a redistributive objective in favour of low-income households, as well as aiming at incentivizing investment. Financing comes mainly from the fight against tax evasion and other revenue increases.

Outlook. According to the most recent data, we expect GDP to continue to grow by 0.1% qoq in Q4-2019, with less support from the service sector (Chart 7) and a moderate positive contribution from the industrial sector. GDP growth is forecast to strengthen to 0.6% in 2020, thanks to improving confidence, more favourable credit conditions and a moderate fiscal policy support. We have revised the composition of GDP growth in 2020 compared to the October Brief: a lower contribution from exports and a higher contribution from domestic demand. Exports will be affected, above all, by the absence of some factors that supported them in 2019 such as the increased sales to the UK and the strong performance in the Japanese market. In terms of domestic demand, household spending has been revised slightly downward on the assumption of postponement of the reduction in the tax wedge. Investments - in capital goods and residential construction - have been revised slightly upward. The former will be favoured by the extension of tax incentives and the latter by the strengthening of the existing tax incentives.

Risks to the projection

- Before 13th November, the US administration is expected to make a decision about imports tariffs on the automotive sector, which constitutes a major risk for the European economy given the high relevance of this sector.
- The restructuring of the German automotive sector will continue for several more years and negative repercussions on the euro area cannot be excluded.
- In Italy, in addition to the risk related to a different international environment, there is a risk of lower GDP growth associated to a possible increase in domestic political uncertainty.

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



Source: Prometeia's calculations.

On Draghi's legacy

Mario Draghi stepped down as ECB President on 31st October. **His legacy will be the subject of history books** (and we expect many to be written!). This InFocus discusses one specific point he made repeatedly over the last few years, which is that it is essential that EMU governments intervene to complement and support monetary policy actions at the current juncture.

Indeed, one of the **leitmotifs of the second half of his mandate was an adequate policy mix to avoid monetary policy being 'the only game in town'**. On 14th December, 2015, when he was the guest speaker at the celebrations for Prometeia's 40th anniversary, Draghi devoted the final part of his speech to exactly this point:

"Together monetary policy and structural reforms support demand, the process of debt reduction and confidence. All these factors, as we have seen, are fundamental to the recovery of investment. But **the issue is putting the reform agenda into practice, while in many Eurozone countries it would seem that hesitation prevails over determination**. It is certainly important also to remember that the necessary changes are so far-reaching that their implementation requires a broad consensus. However, it must be remembered, that **delay in implementing important structural reforms to make a country richer and more capable of meeting today's challenges, sometimes can have political explanations, but never economic ones**. Thank you."[1]

Let us recall the context in which this speech was made. At that time, Draghi was hoping to kick start a recovery in a medium run and sustainable way, but no coordinated policy mix resulted from the many international meetings, and monetary policy alone supported the recovery. A few years later, exogenous international factors were slowing activity and the prospect of normalization of the monetary policy aborted.

Five years have passed since the recalled Draghi's speech, but his words are even more applicable today, which is testament to his abilities to foresee over the long term. **More recently, Draghi seems to be in agreement with the notion of a secular stagnation and the implied lower nominal and real interest rates over the long term. He has reiterated the need for governments to step up their actions to support demand**. The extract below is from Draghi's last ECB press conference (24 October, 2019):

"In order to reap the full benefits of our monetary policy measures, other policy areas must contribute more to raising the longer-term growth potential, supporting aggregate demand at the current juncture and reducing vulnerabilities. The implementation of structural policies in euro area countries needs to be substantially stepped up to boost euro area productivity and growth potential, reduce structural unemployment and increase resilience. ...In view of the weakening economic outlook and the continued prominence of downside risks, **governments with fiscal space should act in an affective and timely manner**."

The message is clear. The euro area countries are likely to continue to struggle for a while, before achieving the common determination to act, but the ball is now unequivocally in their court.

1 *Our translation from the original video in Italian: https://www.youtube.com/watch?v=LOFFCRIskyQ.*

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 $	5.3	-0.7	1.6
Brent oil price ($/brl, level)	71.6	63.8	62.8
GDP			
- United States	2.9	2.3	1.4
- Japan	0.8	0.6	0.4
- EMU	1.9	1.2	1.2
- China	6.6	6.1	5.2
Consumer prices			
- United States	2.4	1.7	1.8
- Japan	0.9	0.7	1.3
- EMU	1.8	1.2	1.1
- China	2.3	3.2	2.9
$/€ exchange rate (level)	1.18	1.12	1.15
£/€ exchange rate (level)	0.885	0.882	0.883

Table 2 – Italy: main indicators (% change)

	2018	2019	2020
GDP*	0.7	0.2	0.6
Imports of goods fob and services	2.4	0.9	2.5
Private consumption	0.8	0.5	0.8
Government consumption	0.4	0.2	-0.2
Gross fixed investment:	3.0	2.5	2.4
- machinery, equipment, other products	3.4	1.6	1.9
- constructions	2.5	3.6	3.0
Exports of goods fob and services	1.3	2.2	0.9
Domestic demand	1.0	-0.2	1.1
Industrial production	0.6	-0.8	0.9
Trade balance (% of GDP)	2.7	3.1	3.2
Terms of trade	-1.4	0.1	2.2
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	-2.2	-2.2

** 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	123.3	119.2	120.6	122.0	123.6	124.5	124.5
3 month interest rates %	US libor	2.70	2.51	2.14	1.89	1.68	1.50	1.50	1.50
	Euribor	-0.29	-0.29	-0.38	-0.40	-0.40	-0.40	-0.40	-0.40
10 year government bond yields %	US	2.64	2.33	1.79	1.73	1.59	1.48	1.48	1.48
	Germany	0.08	-0.14	-0.54	-0.41	-0.41	-0.41	-0.41	-0.40
	Italy	2.71	2.43	1.32	1.08	0.98	0.90	0.83	0.81

*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 October '19	**0.8**	**0.5**	0.5	0.3	2.3	0.3	0.2	0.3	0.3	1.3
	Brief November '19	**0.8**	**0.5**	**0.5**	0.3	2.3	0.3	0.3	0.3	0.3	1.4
EMU	Brief October '19	**0.4**	**0.2**	0.1	0.2	1.1	0.2	0.3	0.4	0.3	1.1
	Brief November '19	**0.4**	**0.2**	**0.2**	0.2	1.2	0.3	0.3	0.4	0.3	1.2
Italy	Brief October '19	**0.1**	**0.1**	0.0	0.1	0.1	0.1	0.2	0.1	0.2	0.6
	Brief November '19	**0.1**	**0.1**	**0.1**	0.1	0.2	0.1	0.2	0.1	0.2	0.6

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