Italy in the Global Economy
Prometeia Brief

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prometeia associazione

Executive summary

Global growth is solid but markets are concerned about US inflation

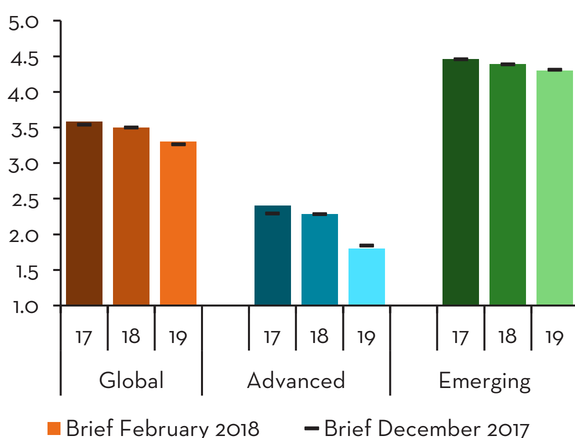
- Even if signals of increasing inflation are far from clear, long term yields have reacted strongly to recent data releases on US earnings and inflation above expectations.
- Economic growth remains solid and broad-based worldwide. Preliminary data on Q4 confirm our 2017 growth forecasts for the main countries presented in the December Brief (Chart 1).
- GDP data and high frequency indicators confirm solid growth for the US. The tax reform will produce limited effects on economic growth and so will the recent agreement to raise the debt ceiling. A plan was announced to significantly increase spending but it is unlikely to be approved in the current form.
- Euro area growth remains strong and expectations for the coming months have improved further, supported by favourable conditions both in monetary policy and external demand, despite a stronger euro.
- Chinese data point to stable growth while in other emerging markets there are increasing signs of solid or improving momentum.

Italy's recovery on track

- The GDP preliminary estimate for 2017 Q4 (+0.3 per cent qoq and 1.6 per cent yoy, Chart 2) confirms that Italy's recovery is on track, even if at a slower pace compared to previous quarters and to the other euro area countries. In 2017 overall GDP rose by 1.5 per cent, slightly lower than our December expectation (1.6 per cent) but still one of the fastest growth rates since 2000.
- Both domestic demand and net exports drove the recovery and are expected to support the expansion going forward.
- In 2018 Italy will continue to benefit from low interest rates, global growth, and fiscal measures supporting household disposable incomes and firms' technological investments.
- The Italian economic outlook remains positive, despite being two weeks away from very uncertain parliamentary elections. In 2018 we expect the same growth as observed last year (1.5 per cent) and a further reduction of public sector deficit and debt, while a moderation of growth is on the cards for 2019.
- In the two InFocus sections, we present our analysis on the perspectives of inflation in the US and in the euro area, and in Italy in particular.

Chart 1 — Real GDP

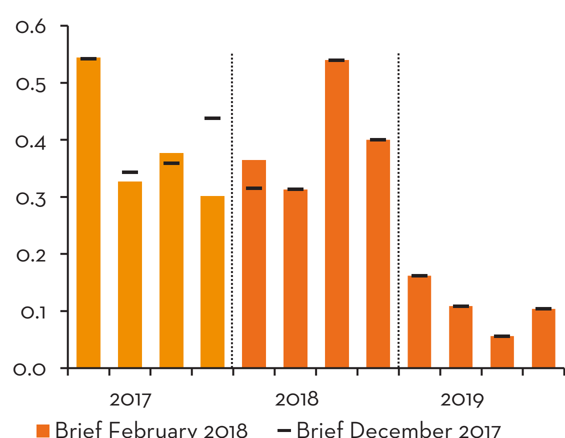
% change yoy



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

Chart 2 — Italy: real GDP

% change qoq

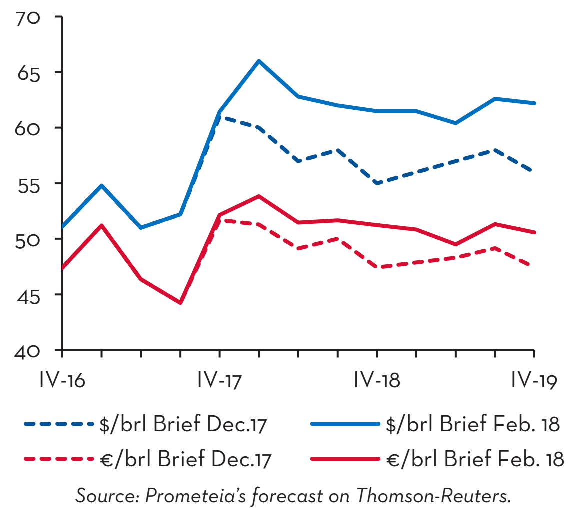


Source: Prometeia's forecast on Istat data.

Global scenario

Oil and commodity prices have increased more than expected in the last few months. The weakness of the dollar vis-à-vis all the other currencies is an important element in explaining this outcome. Moreover, the production cuts planned by OPEC and Russia have proved to be more effective than expected, demand for oil higher and a significant amount of speculative positions contributed further to move the price persistently above 60 dollars per barrel. We have revised our oil price forecast up to incorporate a more depreciated dollar and a slightly higher world activity growth (Chart 3 and Table 1).

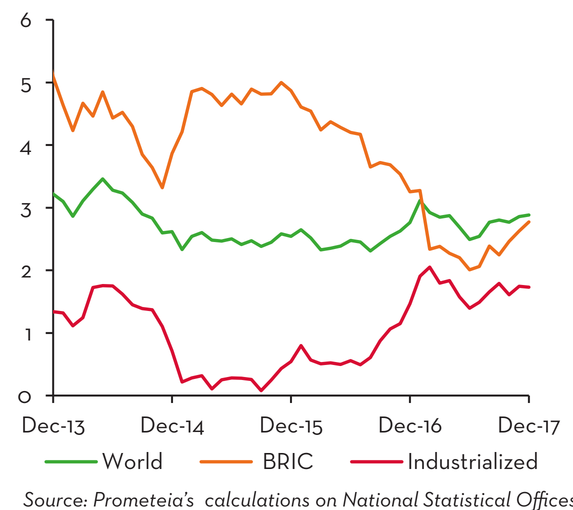
Chart 3 – Oil prices
$, € per barrel



Source: Prometeia's forecast on Thomson-Reuters.

Recently financial markets have reacted significantly to US data on wages and inflation. The weaker US dollar and higher international commodity prices led us to revise slightly US all-urban-headline-inflation in 2018 to 2.3 percent (from 2.1; Table1 and InFocus1). Accordingly, we now expect three Fed Fund hikes by 25bp each in 2018 (compared to two in the December Brief) and we keep our view of only one in 2019. We have also revised long term yields upward slightly following the higher than expected inflation, as we expect the FED moves to soften their increase and flatten the yield curve in 2019. The fiscal reform approved in December by the Congress, the agreement to raise the debt ceiling and the fiscal year budget proposal for 2019 will seriously increase the federal deficit which, according to the Committee for a Responsible Budget, could increase to over 5 per cent of GDP in 2019.

Chart 4 – Inflation
% change yoy



Source: Prometeia's calculations on National Statistical Offices.

Growth in the euro area remains buoyant (0.6 per cent qoq in the fourth quarter). Also, the geographical breakdown confirms our expected growth for 2017 in different countries. The most recent data on industrial production (5.2 per cent yoy, 0.4 mom, in December) and soft data like PMI and expectations of both firms and households in January, suggest that the activity could remain buoyant in the coming months. Monetary policy conditions are expected to remain supportive and were left unchanged in the last ECB meeting in January.

Chinese GDP grew in line with expectations in the fourth quarter. The main data on domestic demand remain stable at the recent subdued levels and real import growth became negative in December. We confirm the path of mild deceleration of activity in 2018 outlined in the December Brief, relating to the authorities' attempts to curb credit and tackle surging debt problems.

Growth is solid in the other emerging markets with few showing signs of further acceleration. A common feature is a pick-up in inflation rates that could be attributed mainly to volatile components of the index (energy and food), not yet transferred onto core prices (Chart 4). In general, inflation remains below the targets of the central banks and the risk of overheating appears low.

Italy

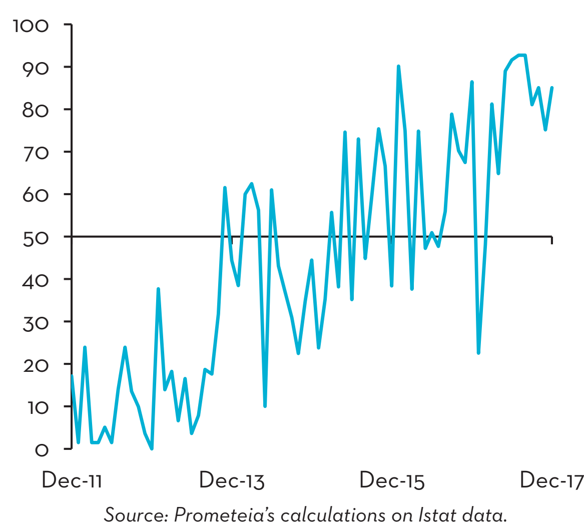
Recovery still on its way. The pace of recovery slowed somewhat in 2017Q4: from 0.4 per cent in Q3 to 0.3 per cent qoq in Q4 (1.7 per cent to 1.6 per cent yoy). While more detailed data will be released at the beginning of March, we anticipate that Q4 growth was driven by the strength of business investment and exports, while investment in construction remained subdued. In our estimate, household consumption growth decelerated along with the weaker increase in disposable income.

Industrial production surprised on the upside. On the contrary, in December industrial production hiked by 1.6 per cent on a monthly basis (+4.9 per cent yoy), a jump that brings the index to the highest value recorded since 2011. With the exclusion of energy (-1.3 per cent) and pharmaceuticals (-0.5 per cent), all business sectors grew, driven in particular by those producing capital goods (+4.7 per cent). In fact, the Prometeia Diffusion Index (Chart 5) measures a widening of the perimeter of the expanding sectors and is near to its maximum (85 per cent).

Prospects for 2018 remain positive... The positive carryover into 2018 of both GDP and industrial production will guarantee a first quarter growth at least at the same pace as 2017Q4. Looking ahead, we expect the investment cycle to gain momentum, driven by continuing favourable financial conditions, good demand prospects, and fiscal incentives in ICT investments (Industria 4.0). Consumption growth will continue to support activity, even if at a slower pace due to less supportive fiscal policy and job creation.

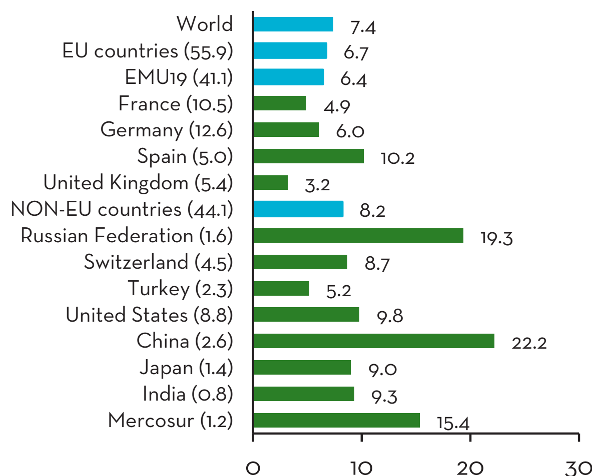
... also for exports, despite the weak dollar. Exports will continue to benefit from strong external demand, even if the weak dollar will weigh on competitiveness. Nevertheless, it should be noted that exports of manufactured goods increased by 7.4 per cent last year, driven almost 50 per cent by sales in non-EU markets despite the appreciation of the euro (Chart 6). The contribution of the United States, China and Russia was particularly important. Manufacturing performance was also positive in terms of market share: on average, the Italian industry maintained its global market share and some sectors managed to increase theirs in non-European markets. This is the case of pharmaceuticals, motor vehicles and motorcycles, the fashion sector, metal products.

Chart 5 – Italy: Prometeia Industrial Production Diffusion Index *2010=100*



Source: Prometeia's calculations on Istat data.

Chart 6 – Italy: exports of goods
*% changes in 2017**



Source: Prometeia's calculations on Istat data.
**In brackets, shares calculated on 2016 total Italian exports.*

In general, the restructuring process undertaken by Italian firms over the last 15 years seems to have resulted in an industrial sector which is more resilient to price competitiveness and also to the negative effects of a strong euro.

Inflation remained subdued. Despite the increase in more volatile components (oil, unprocessed food), inflation has remained weak (0.8 per cent yoy in January), because of the still very low core (0.6 per cent) compared to the past and to the euro area average (1.3 per cent). See the second InFocus for more details.

Labour market still very healthy, but with signs of a slowdown. According to the national statistical institute (Istat), some 260 thousand net new jobs were created in 2017 compared to 2016 (+1.2 percent), but the unemployment rate decreased by only 0.4pp, as labour supply increased as well (+172 thousand), especially among women. The segment of self-employed continued to shrink (-100 thousand) while employees picked up (+361 thousand). Thus, there is still a healthy labour market, which since the start of the recovery in 2013 has created about 900 thousand jobs. Nevertheless, signs of a slowdown are emerging, as new jobs in 2017 were mainly on a temporary basis (+295 thousand) and job creation narrowed in the fourth quarter to a mere +13 thousand.

Tax incentives due to expire. In 2018, the tax incentives on new hires with open-ended contracts (a cut in social contributions for three years introduced in 2015) is due to expire. Although we do not expect this to result in massive redundancies, job creation is likely to slow down significantly, notwithstanding the new incentives (introduced by the 2018 Budget Law) for newly-hired young people.

Spread BTP-Bund lower than expected. The spread between the BTP10Y and the corresponding Bund averaged in February 142 points against 150 points in the last days of December 2017. The 10-year rate is 2.11 per cent (1.91 in late December) while the yield of the 10-year German Bund increased to 0.70. This squeeze has benefited from positive sentiment towards all euro area peripheral countries, and is partly due to the expectation that a market-friendly result will emerge from the March 4 Italian general elections. Nevertheless, we still expect some tension to emerge in the aftermath of the elections and to last until a new government is formed, most likely at the beginning of the summer. The BTP-Bund spread is expected to increase to reach 180bp and decrease thereafter, down to 1.47 at the end of 2019.

Public finance on a positive path. The available data for 2017 show an improvement in public finance indicators higher than targeted by the Italian Government in the September Update of the Economic and Financial Document. Public debt increased to €2256 billion (2259 in the Update), up by €34 billion compared to 2016. The debt-to-GDP ratio (based on preliminary data) declined to 131.4 per cent (down from 132.0 per cent in 2016), below the 131.6 per cent government targeted. A significant reduction, taking into account the additional resources earmarked for public support to the banking sector (around €10bln, 0.6 per cent of GDP) and without the receipts from privatizations (0.2 per cent of GDP in government original plans). The State sector borrowing requirement too was below the expected level by €5 billion, due to the good tax revenue performance. We confirm our forecast that the planned deficit of 2.1 per cent of GDP for 2017 will be achieved.

In 2018, the deficit is expected to decrease slightly to 1.8 per cent of GDP. The budget law, which was approved without significant changes compared to what was described in the December Brief, is still under examination by the European Commission (EC). The EC opinion on the Draft Budgetary Plan in November has highlighted a risk of non-compliance with the Stability and Growth Pact, emphasising the need to implement the budget carefully and the importance of avoiding backtracking on structural reforms, notably on pensions. Next spring the EC will make a new assessment, with the potential request for additional intervention.

At the end of 2017 the weakness of corporate loans was confirmed. Despite the good performance of the economy and lending rates at historical lows, corporate loan growth remained positive but weak (0.2 per cent yoy in December) when compared to the average of the EMU countries (3.0 per cent yoy). The increased reliance on alternative sources of funding continues to contain loan growth, but some signs of improvement have recently emerged. In fact, since the middle of last year, loans to producer households have started to grow again and the reduction of loans to SMEs, the most vulnerable enterprises, has been less marked than in previous years. Regarding lending to households, it continued to increase in line with the EMU average (2.8 per cent yoy), as consumption growth supported consumer credit (8.8 per cent yoy) and the growth of mortgages continued to be positive (2.1 per cent yoy).

Besides fundamentals, one factor that could have supported bank loans in the last months of 2017 is the possibility to take advantage of the minimum interest rate (-0.4 per cent) for the repayment of the liquidity borrowed under TLTROIIs: banks could have increased loans to firms and households, net of mortgages, in order to exceed

the ECB benchmark[1] by 2.5 per cent.

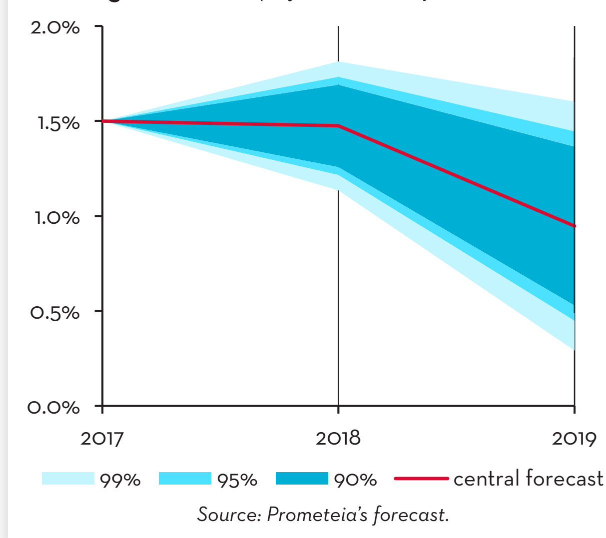
2017 represented a positive turnaround for the Italian banking system. In December, the dismissal of bad loans continued (by nearly €6 billion), for a total of €34 billion in 2017. This is mainly due to the reduction of bad loans in the corporate sector (-€26 billion, -18.4 per cent yoy) and to write-offs from bank balance sheets for over €39 billion. Ten years on from the beginning of the financial crisis, Italian banks (at least the largest groups, excluding MPS, Creval and Carige) are finally starting to regain their profitability, as emerges from the latest earning reports. The improvement of economic activity is contributing to limiting the growth of non-performing loans, while provisions are falling.

1 *The benchmark is the stock of eligible loans as at the end of January 2016 augmented by the flow of loans over the previous 12 months.*

Risk to the projection

- Financial markets are nervous with regard to the next moves of the Federal Reserve, which could trigger further corrections in asset prices.
- A rapid increase in the FED policy rate could also contribute to slowing down growth in the US and could put some pressure on emerging markets' financing.
- Politics per se is also a source of uncertainty in both the US and Europe. In the US, the ongoing investigations into the relations with Russia involving the President could feed uncertainty. In Europe, the debate on European reforms is still unresolved and could create a disillusionment effect.
- In Italy, if the formation of a new government after the next general elections proves to be particularly difficult, it would negatively influence the expectations of financial markets, households and firms.

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



Source: Prometeia's forecast.

InFocus 1

US INFLATION ON TEMPORARY RISE

Markets are nervous regarding US inflation. The publication of the January US data on inflation and real earnings (released the same day) is a good example of the widespread nervousness in financial markets. All-urban-headline-inflation exceeded expectations by 20bp (2.1 per cent yoy, 1.9 in Bloomberg's expectation; 0.5 per cent on a monthly basis, 0.3 in Reuters' poll), but real earnings for the total economy decreased on the previous month and confirmed the yoy growth rate at below 1 per cent as in the last sixteen months. January core inflation came at 1.8 per cent, as in December, but with a higher contribution to headline inflation of 7bp (Chart A). These releases pushed the dollar down against major currencies and the 10-year Treasury yield up to 2.9 per cent. The stock market lost ground anticipating a more aggressive monetary policy, but the day of the inflation release closed with gains, helped by the publication of the drop in retail sales in January. The economy has to grow but not "too much"!

On the whole, inflation remains low in a historical perspective, given that the US economy is in its ninth year of expansion and the unemployment rate is at 4.1 per cent, suggesting a situation of full employment. However, market nervousness will not disappear in the coming months, as several factors are likely to push up inflation.

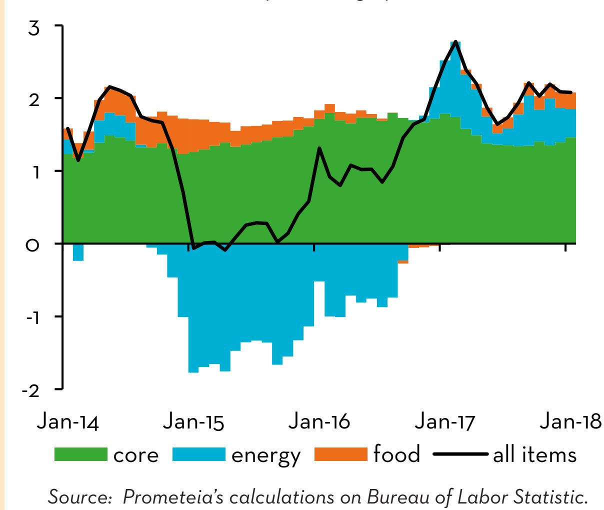
Upward factors are likely to materialize in 2018... A weak dollar could have an effect on domestic prices via import prices. In January, the nominal trade-weighted dollar exchange rate declined around 8.5 per cent yoy. Higher oil and commodity prices could feed into headline inflation as well. The WTI oil price since the beginning of the year on average has been 20 per cent higher than in the corresponding period of 2017 and the energy components represent around 7 per cent of the total CPI basket of goods and services. Transitory factors that contributed to keeping inflation low in 2017 are going to fade away, the most significant being in communications and medical care sectors. Communication prices reflected the move to the flat rate for unlimited download data that Verizon offered to its wireless customers at the beginning of 2017 and that is behind the negative contribution (-0.22pp, January) of communication to core inflation growth (Chart B). Similarly, mandate cuts to Medicare payment in 2017 contributed to keeping the growth of service prices in the health sector low, reducing the contribution of this item to core inflation.

... but little evidence of higher labour costs yet. On the other hand, looking at wages, there is not yet any evidence of near term demand pressures and/or transfer of higher labour costs to prices, as unit labour costs are still trending downwards. With regard to hourly earnings in the macro sectors, only financial services show a clear upward trend but this sector represents only 7.4 per cent of total worked hours. Larger sectors, such as educational and health services (17.8 per cent of total worked hours) and professional and business services (17.3 per cent), show growth rates of hourly earnings around 2.5 per cent without a clear upward trend. In contrast, wholesale trade (11.5 per cent share of total worked hours) and durable goods (4.4 per cent) show a clear downward trend of hourly earnings growth.

To sum-up. Several factors are likely to push-up US inflation in 2018, but some of them will be temporary. We expect inflation to increase in 2018 to 2.3, and to ease to 1.9 in 2019. This will not prevent financial markets from being nervous, with consequent persistent high volatility.

Chart A – Contributions to US headline inflation

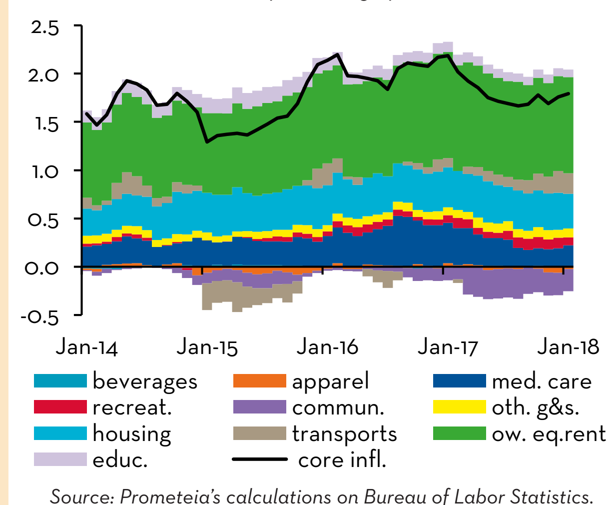
%, and percentage points



Source: Prometeia's calculations on Bureau of Labor Statistic.

Chart B – Contributions to US core inflation

%, and percentage points



Source: Prometeia's calculations on Bureau of Labor Statistics.

InFocus 2

UEM: INFLATION STILL MISSING

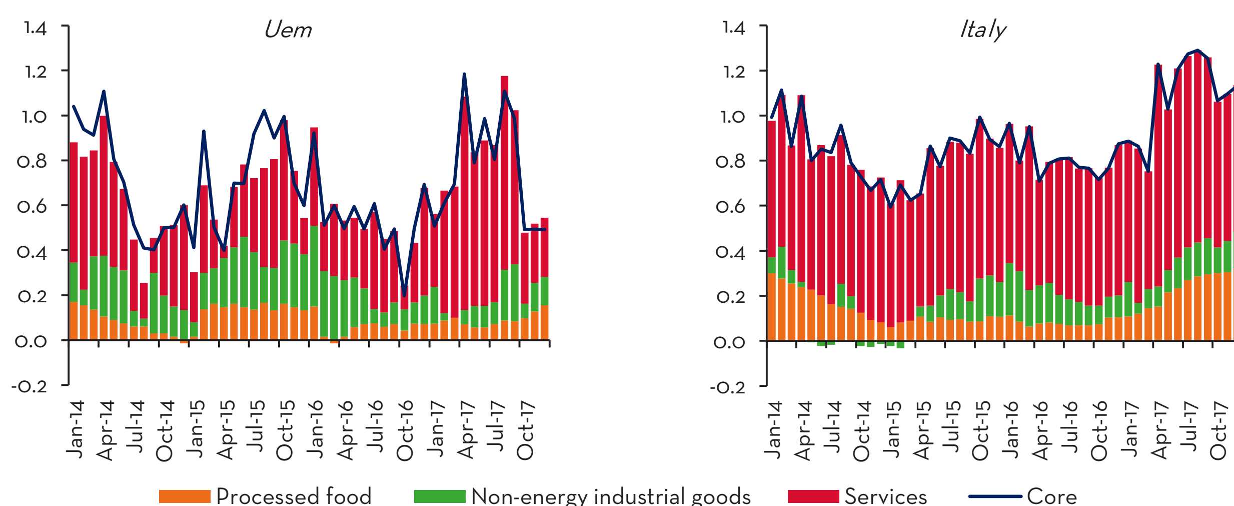
Time has gone by, but inflation is still unexpectedly low... More than four months have passed since the October Brief, where we discussed why inflation in the euro area was so low despite the strong business cycle momentum. Now headline inflation is still low (1.3 per cent in January flash estimate down from 1.5 per cent in August) and core inflation is even lower (1.2 per cent down from 1.3 per cent in August). Actually, the headline inflation softening was mainly driven by the core component, as energy and food price contributions remained broadly flat. Could this be a sign that the process for moving towards the target inflation level is not proceeding and that monetary policy is likely to stay very accommodative for longer than expected? Data presented in this InFocus point to the conclusion that inflationary pressures are still very low indeed in the euro area on average, and in Italy especially. The risk that an inflation surprises could cause a faster-than-expected tightening of the ECB monetary policy now seems very low.

... in the euro area ... Focusing on core inflation, in fact, its deceleration can be attributed to the drop of the contribution of services not compensated by increasing contributions of the two other main components (Chart C). Among services, the trend is mostly related to transport, package holidays and accommodation components, which declined strongly, more than seasonal factors could explain. On the other hand, the increase of processed food contribution reflects the upsurge of some specific goods (oil, milk), due to idiosyncratic factors, set to disappear, and not to the pressure of demand. The mild increase of non-energy industrial goods contribution can be attributable to some transmission from the oil price rise.

... and in Italy. In the case of Italy, the absence of any sign of tension is striking, even taking into account the considerable drop in university fees which occurred in October 2017, which alone accounts for 0.5pp of the reduction in services inflation.

Overall, considering the improvement in the labour market, wage growth has remained unusually contained (1.5 per cent and 0.7 per cent in the UEM and Italy, respectively) and unit labour cost growth flat, reflecting the cyclical improvement in productivity. This has compensated the still mild pressures coming from raw materials and international prices. These factors are set to change in the near future, as the synchronised upswings in economic activity, negotiated wage increases in some countries (i.e. Germany), and oil prices are expected to exert a positive impact in both 2018 and 2019, even if somewhat contained by the strong euro. All in all, we expect headline inflation to rise modestly with a hump-shaped profile in 2018, mainly driven by the pass-through of oil price movements. We also expect inflation differentials across euro area countries to narrow. Italy, among the countries with the lowest inflation rates reflecting the still negative output gap, is expected to converge very slowly towards the euro area average.

Chart C – Contributions to core inflation *%, and percentage points*



Source: Prometeia's calculation on Eurostat data - Based on the Harmonised Index of Consumer Prices.

Table 1 The World Economy main indicators *% change*

	2017	2018	2019
World real GDP	3.6	3.5	3.3
World Trade	4.9	4.3	3.8
Manufacturing prices $	2.8	4.7	3.5
Brent oil price ($/brl, level)	54.9	63.1	61.7
GDP			
- United States	2.3	2.6	2.3
- Japan	1.6	1.3	0.8
- EMU	2.5	2.3	1.6
- China	6.8	6.3	5.8
Consumer prices			
- United States	2.0	2.3	1.9
- Japan	0.5	1.1	1.3
- EMU	1.5	1.6	1.6
- China	2.9	2.6	2.3
$/€ exchange rate (level)	1.13	1.21	1.22
£/€ exchange rate (level)	0.876	0.891	0.900

Table 2 Italy main indicators *% change*

	2017	2018	2019
GDP	1.5	1.5	0.9
Imports of goods fob and services	5.6	5.0	4.3
Private consumption	1.4	1.4	1.0
Government consumption	0.8	0.3	0.2
Gross fixed investment:	3.2	3.7	2.0
- machinery, equipment, other prod.	5.1	6.2	2.5
- costructions	1.1	0.7	1.5
Exports of goods fob and services	5.4	5.3	3.6
Domestic demand	1.5	1.3	1.1
Industrial production	3.1	3.5	1.9
Trade balance (% of GDP)	3.3	3.5	3.4
Terms of trade	-1.4	0.3	0.0
Consumer prices	1.2	1.1	1.3
Per capita wages - manufacturing	0.8	1.2	1.6
Total employment	1.2	0.4	0.3
General government balance (% of GDP)	-2.1	-1.8	-1.6

Table 3 Exchange Rates and Interest Rates

		18 Q1	18 Q2	18 Q3	18 Q4	19 Q1	19 Q2	19 Q3	19 Q4
Exchange rates vs euro	US dollar	1.23	1.22	1.20	1.20	1.21	1.22	1.22	1.23
	Yen	134.4	133.0	134.4	135.6	134.3	134.2	133.0	131.6
3 month interest rates (%)	US libor	1.79	1.93	2.18	2.37	2.58	2.60	2.60	2.40
	Euribor	-0.33	-0.33	-0.33	-0.32	-0.28	-0.15	-0.07	0.08
10 year government bond yields (%)	US	2.76	2.90	2.95	2.97	3.08	3.07	3.05	3.03
	Germany	0.64	0.77	0.80	0.91	0.95	1.05	1.16	1.21
	Italy	2.21	2.50	2.28	2.42	2.50	2.56	2.66	2.70

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

		17 Q1	17 Q2	17 Q3	17 Q4	2017	18 Q1	18 Q2	18 Q3	18 Q4	2018
United States	Brief Dec 2017	**0.3**	**0.8**	**0.8**	0.6	2.3	0.4	0.8	0.6	0.6	2.5
	Brief Feb 2018	**0.3**	**0.8**	**0.8**	**0.6**	**2.3**	0.4	0.8	0.7	0.5	2.6
EMU	Brief Dec 2017	**0.6**	**0.7**	**0.6**	0.6	2.4	0.6	0.4	0.4	0.4	2.3
	Brief Feb 2018	**0.6**	**0.7**	**0.7**	**0.6**	**2.5**	0.6	0.5	0.4	0.4	2.3
Italy	Brief Dec 2017	**0.5**	**0.3**	**0.4**	0.4	1.6	0.3	0.3	0.5	0.4	1.5
	Brief Feb 2018	**0.5**	**0.3**	**0.4**	**0.3**	**1.5**	0.4	0.3	0.5	0.4	1.5

prometeia associazione per le previsioni econometriche

via g. marconi 43, 40122 bologna, italia — tel. +39 051 648 0911 — fax +39 051 220 753
info_associazione@prometeia.com — www.prometeia.com
based on data available up to 19th February 2018

contributors: Michele Burattoni, Lucia Cossaro, Mariagiulia Folloni
contact person: **Stefania.Tomasini@prometeia.com, Lorena.Vincenzi@prometeia.com**
tel. +39 051 648 0927 - +39 051 648 0933

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