ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia ASSOCIAZIONE

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Executive summary

Global growth gained momentum, but underlying weakness persists

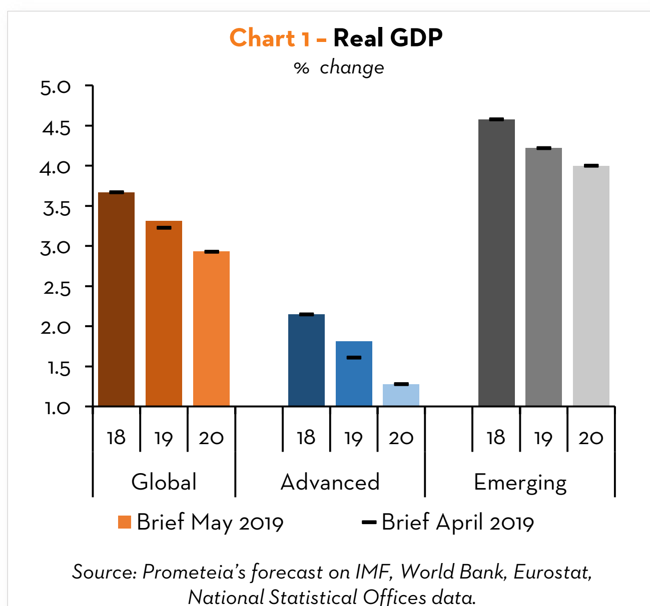
- GDP first releases for Q1 2019 point to positive surprises in the US (0.8% qoq) and the EMU (0.4%). However, a closer look at the underlying components for the US, France and Spain suggests that the rebound may be short-lived.
- In the first months of 2019, global trade stagnated yoy - the result of a sharp decline in the Asian countries, especially China.
- The Brent oil price increased above $70/brl in Q1 2019, in response to limited supply and tighter restrictions in some countries. We expect this spike to be reabsorbed in H2 2019 as demand weakens.
- Overall, global growth in 2019 (Chart 1) will remain subdued, reflecting world trade growth at 2.9% (Table 1), lack of traction in German activity and renewed trade tensions.
- Our current baseline does not yet include the effects of the US tariff increase entered into force on Friday 10 May and of those announced in retaliation by the Chinese authorities. We present separate simulations to assess their effects.

Italy: new stagnation expected over the spring months

- Q1 2019 data showed a recovery in economic activity (0.2% compared to Q4 2018, Chart 2), after two quarters of mild decline. This improvement is due, in part, to temporary factors. Therefore, in line with the worsening economic indicators and the increase in macroeconomic uncertainty, we expect stagnation in Q2.
- GDP growth in the second half of 2019 will be supported slightly by fiscal policy (citizenship income, in particular, is estimated to increase household spending) and by the recent reintroduction of fiscal incentives for investment.
- Overall, due mainly to the better than expected Q1, we have revised our GDP growth forecast for 2019 slightly, from 0.1% to 0.2% (Tables 2-4).
- This projection incorporates the assumption of a moderate increase of Italy's sovereign spread in the autumn, during the process leading to the 2020 Budget Law. Our InFocus presents the latest information on Italy's budgetary policy.

Chart 1 – Real GDP

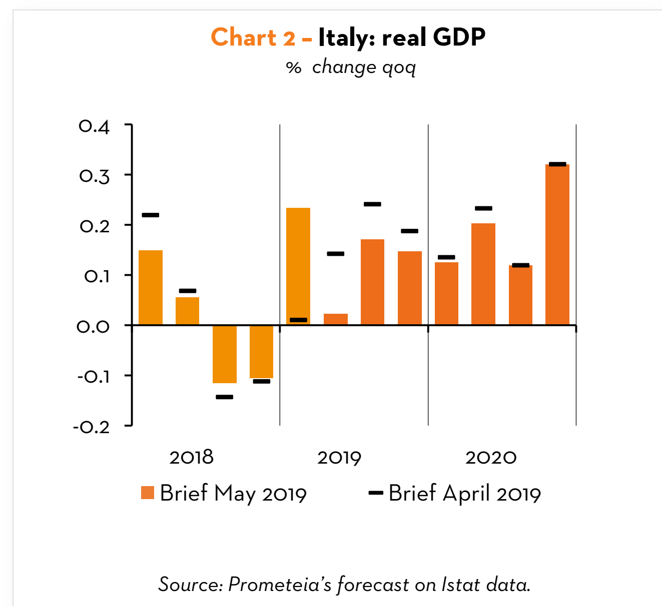
% change



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

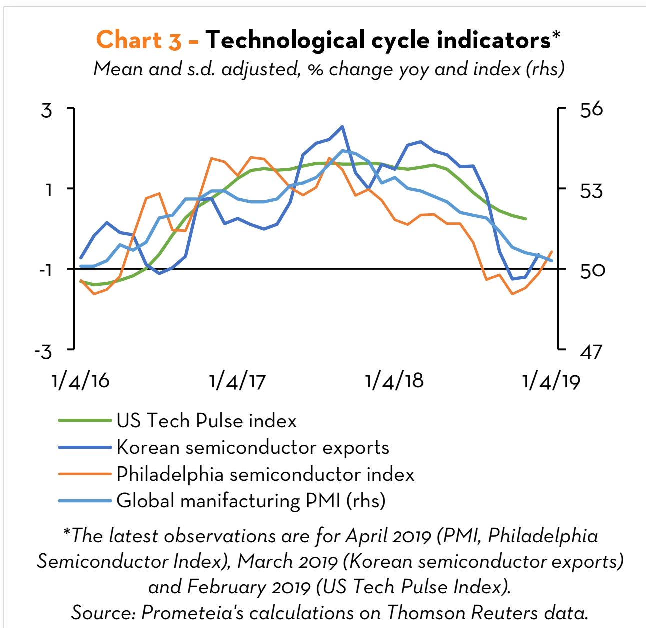
Chart 2 – Italy: real GDP

% change qoq

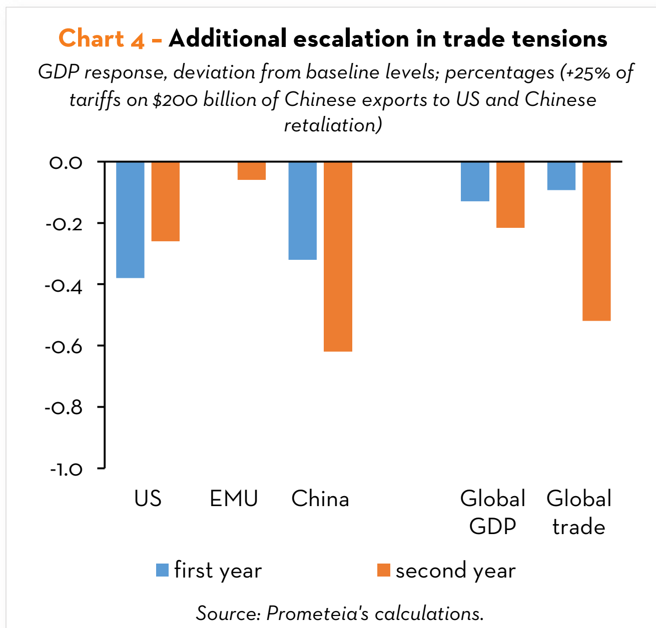


Source: Prometeia's forecast on Istat data.

Global scenario



*The latest observations are for April 2019 (PMI, Philadelphia Semiconductor Index), March 2019 (Korean semiconductor exports) and February 2019 (US Tech Pulse Index).
Source: Prometeia's calculations on Thomson Reuters data.



Source: Prometeia's calculations.

There are signs of global trade stabilization, but the risks remain downward skewed. According to the Central Planning Bureau Trade Monitor, in the last few months, trade weakness has been concentrated among the Asian economies, which are tech intensive and highly integrated in the tech production supply chain. The decline in the global manufacturing tech cycle during 2018 is showing signs of a levelling off, in line with several indicators (Chart 3). In addition, China's higher imports in April (11.4% yoy) are further reassurance of some trade stabilization. The diversion of some US imports towards non-Chinese suppliers in East Asia will likely play a role in the near future. Our preliminary estimate of a tariff rise to 25% on $200 billion of Chinese goods, without factoring in possible effects of the deterioration in expectations, suggests a world trade loss of 0.5pp in 2020 (Chart 4) corresponding to annual growth rates of 2.8% in 2019 (instead of 2.9%) and 2.5% in 2020 (instead of 2.9%), whereas global GDP growth would not exceed 2.7% in 2020.

Concerns continue over the sustainability of US economic expansion. In Q1 2019, GDP accelerated by 0.8% qoq thanks to a rebound in stocks and lower imports (contributing respectively 0.2 and 0.1pp to GDP growth). In contrast, private consumption and business investments continued to decelerate. In April, labour market conditions remained tight, but without any signs of overshooting inflation. We have revised our US GDP growth forecast for 2019 slightly to reflect the stronger than expected Q1 2019, but we continue to see a deceleration in the second part of 2019 as the fiscal stimulus fades (Table 4).

Q1 Eurozone GDP reveals a mixed picture. GDP increased by 0.4% qoq in Q1 2019, accelerating compared to the previous quarter and overtaking our forecast (0.2%). This acceleration occurred in all the major EMU economies, although the detailed results are less reassuring. The notable dynamism in the Spanish economy (0.7% qoq) was based on a contraction in imports, while its better business investment record came after a faltering path in recent quarters. In France, domestic demand strengthened after the winter strikes, but the rebound in consumer spending was quite limited. For Germany (0.4% qoq) detailed components are not yet available. Under the assumption of no US tariffs on imported vehicles and a slight fiscal easing in main EMU countries, GDP might accelerate slightly to stabilize growth at just below potential at 1.2% and 1.3% respectively in 2019 and 2020 (Table 1).

No reversal in the short term safe bond yields. Inflation in the EMU peaked in April (1.7% yoy), but due mainly to seasonal effects related to Easter week. At the same time, risk aversion is increasing, leading to the 10-year Bund yields below zero (Table 3). In light of the prolonged uncertainty, we have downward revised the long- term Treasuries and Bunds yields. We expect the Fed to cut its policy rate by 25bp in each of the first two quarters of 2020, while the ECB will maintain refi at zero until the end of 2020, with the first hike by 25pb expected in Q2 2021.

Italy

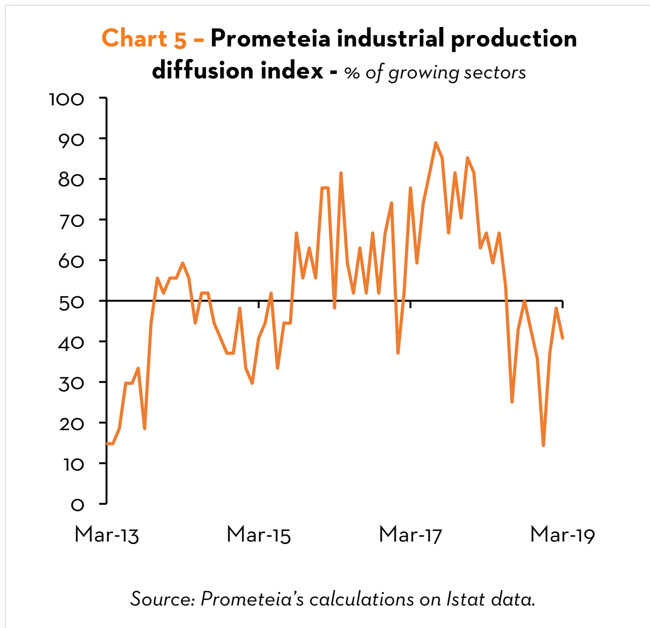


Chart 5 - Prometeia industrial production diffusion index - *% of growing sectors*

Source: Prometeia's calculations on Istat data.

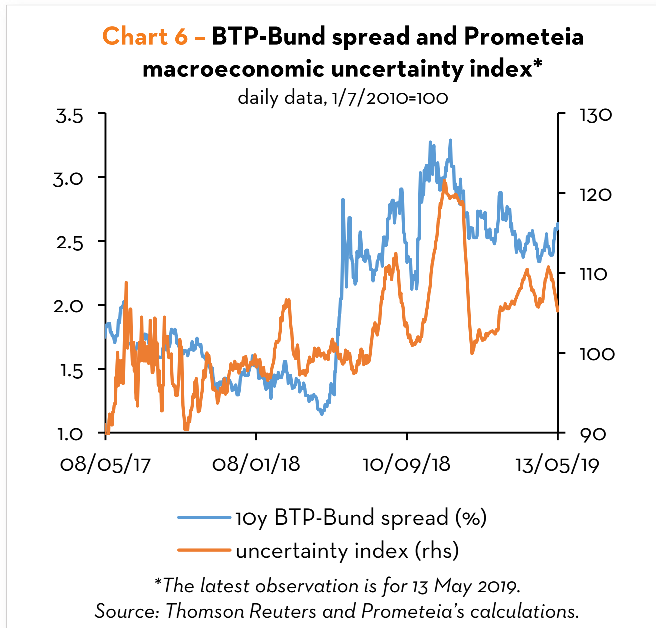


Chart 6 - BTP-Bund spread and Prometeia macroeconomic uncertainty index*

daily data, 1/7/2010=100

**The latest observation is for 13 May 2019.*

Source: Thomson Reuters and Prometeia's calculations.

Q1 better than expected. According to official preliminary estimates, GDP in Q1 2019 grew by 0.2% on the previous quarter (0.1% on the corresponding quarter). The recovery has been widespread and affected all macro-sectors (detailed data will be released on 31 May) and has been driven by a positive contribution from net exports, larger than the negative contribution from domestic demand.

Exports growth and imports decline. The available data on foreign trade suggest that the positive contribution of net exports might stem from an expansion in goods exports and a fall in goods imports. Export growth is supported, partly, by the sale of a ship to the US and greatly increased imports by the UK, most probably associated to British companies stockpiling in anticipation of the risk of a no-deal Brexit. Capital goods led the decline in imports, probably related to the reduction in domestic demand.

Strengthening of the construction sector. Increased demand for construction permits in the residential sector in Q3 2018 (a leading indicator of production) and the mild weather in early 2019, boosted construction, which rose in the first two months of 2019 by 1.3% and 3.4% mom, respectively. Consequently, demand for construction investment could have made a positive contribution to GDP growth in Q1 2019.

Reversal of the positive trend in industrial production. In February, there was a second consecutive marked positive change in industrial production mom, but in March it declined by 0.9%. The number of sectors that grew decreased to 48% (Chart 5), similar to the other main European countries. Despite the March deterioration, industrial production increased in Q1 by 1% qoq, the first quarterly increase after one year.

Stagnation expected during the spring months. All in all, the recovery of economic activity in Q1 2019 may have been affected by temporary factors such as the increase in stocks after the sharp fall in Q4 2018, the mild weather during the winter months, exceptional exports to the US and the UK. Based on these considerations, the worsening of recent economic indicators and deterioration in macroeconomic uncertainty index since the beginning of this year (Chart 6), we forecast GDP stagnation in Q2.

Positive developments in the labour market. Employment in Q1 2019 grew by 46000 units compared to Q4 2018, corresponding to an increase of 0.2%. Following this growth, employment numbers at the end of March 2019 almost reached the high observed in mid-2018. This outcome was led by the increase in permanent contracts (0.4% qoq, 64000 units) and a fall in temporary contracts (-1% qoq, -31000 units). This perhaps was due to the incentive effect of the so-called Dignity Decree (D.L. No. 87/2018), introduced in 2018 by the current government, to encourage companies to switch their temporary workers to permanent contracts. The unemployment rate fell by 0.2pp reaching 10.2% in March, still higher than the Euro area average (7.7% in Q1 2019).

Inflation remains weak and dominated by volatile items. The slight increase in consumer price inflation in April 2019 (preliminary estimated data) to 1.1% from

1% in March, is due in part to seasonal and calendar effects. These factors have affected inflation in services, which increased from 0.7% to 1.2%, driven by transport and recreation prices. Also, petrol and electricity price increases have contributed to the acceleration of inflation.

Bank credit to businesses has dropped sharply. The tighter credit access conditions, which emerged from the bank lending survey, and the decline in non-financial corporation loans (€5 billion in Q1 2019 compared to end 2018) seem to suggest a decline in demand for capital goods at the beginning of the year. Expectation of a normalization of supply criteria, driven probably by new measures of monetary policy (TLTRO III), and interest rates on new loans continuing to fall (to 1.42% in March from 1.51% in February) will contribute to the recovery of loans in the second part of this year.

In 2019, public finance indicators are expected to deteriorate. The general government headline deficit is forecast to increase from 2.1% of GDP in 2018 to 2.5% in 2019 and the debt-to-GDP ratio is expected to increase from 132.2% to 132.9%, reflecting the slowdown in GDP growth and the increase in public spending envisaged by the 2019 Budget Law. The increased expenditure will be related, mainly, to the increase in transfers to households, driven by the citizenship income and early retirement pensions measures that became effective in April.

Citizenship income could support household spending in the second half of the year. If actual expenditure equals government plans, we estimate a positive effect on GDP growth of 0.2pp. However, preliminary data on disbursements for the first month seem to suggest potential underspending.

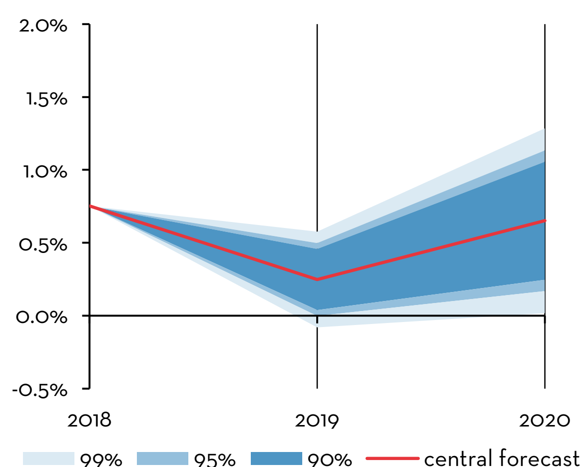
The so-called "growth decree law", currently before Parliament for final approval, foresees limited resources to support private investment. The main measures include the extension for 2019 of the super-amortisation for the purchase of capital goods (with a ceiling of €2.5 million), revised tax relief for companies that reinvest their profits and other measures aimed at extending some facilities already in place.

A fiscal loosening is expected in 2020. We expect the public deficit to reach 2.6% of GDP in 2020, 0.5pp higher than the 2.1% target set in the 2019 Economic and Financial Document approved on 9 April (see InFocus). In its policy scenario, government envisages implementation of the VAT safeguard clause (worth €23 billion), while confirms its intention to replace it in the future with equivalent funding measures, which have yet to be detailed. In our scenario, this replacement is considered as only partial (as forecast in the April Brief), leading to a higher deficit and bringing the total funding required to about €12 billion.

Risks to the projection

- An escalating trade war remains the greatest risk for the global economy. Trump's threat to introduce levies on all Chinese exports, combined with the expected retaliation, is likely to create widespread uncertainties in international trade.
- Should oil prices remain above $70/brl, negative effects on net importing countries cannot be excluded.
- The manufacturing sector in Germany could become a source of vulnerability if world markets continue to be less buoyant. German companies could postpone investments, with spillover effects for first Italy and Spain and then other EMU economies.
- Italian fiscal policy is a source of risk because it does not comply with the European debt rule and does not include a clear public debt reduction strategy.

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



Source: Prometeia's calculations.

Italy's budgetary policy still shrouded in mist

The 2019 Economic and Financial Document (EFD), the first published by the new government, was approved on 9 April. Compared to the scenario underlying the 2019 Budget Law, **government has revised downwards its real GDP growth estimates** (from 1% to 0.2% in 2019, and from an average of 1% to an annual growth of 0.8% in 2020 and 2021), which are now broadly in line with the consensus forecasts. **Deficit targets have also worsened**, to 2.4% of GDP in 2019, 2.1% in 2020, 1.8% and 1.5% in the following two years.

Implementation of the VAT safeguard clause remains part of the scenario, driving the decline in the projected deficit. At the same time, government has declared its intention not to activate this clause and has said that measures to replace the VAT increase will be defined in the 2020 Budget Law.

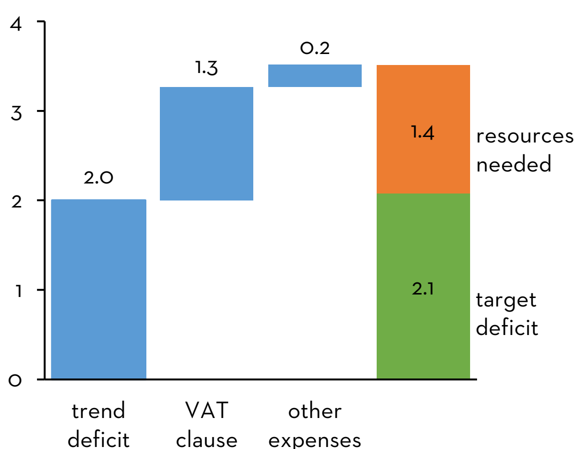
Given the scenario outlined in the EFD, a sizeable package of corrective measures should be included in the next budget law: financing measures equalling 1.3pp of GDP to replace the VAT increase, funds equal to 0.2pp to finance the so-called "unchanged policies", which include international peacekeeping missions and contract renewals for civil servants, and 0.1pp to finance the additional investments included in the policy scenario. On the basis of these programmes, the trend deficit in 2020 would be 3.5% of GDP. Therefore, **the resources required to achieve the 2.1% deficit target sum up to 1.4pp of GDP, €27.6 billion** (Chart A).

This figure will increase further if we take into account government's willingness, announced in the EFD, to pursue new policies to support the economy through an income tax reform aimed at reducing the tax burden on labour (a second step towards a flat-tax system).

Even were government to find these other resources and meet its target, **the structural balance adjustment would not comply with European fiscal rules since it would impose a further delay on achievement of the Medium-Term Objective** (which will become stricter in 2020, moving from a structural balance to a structural surplus of 0.5% of GDP). Such a delay would be significant: it is estimated that the structural corrections agreed over the last two years would imply a 2020 deficit 0.7% of GDP lower than that envisaged in the EFD. Also, in the EFD scenario, **the debt rule is not satisfied**.

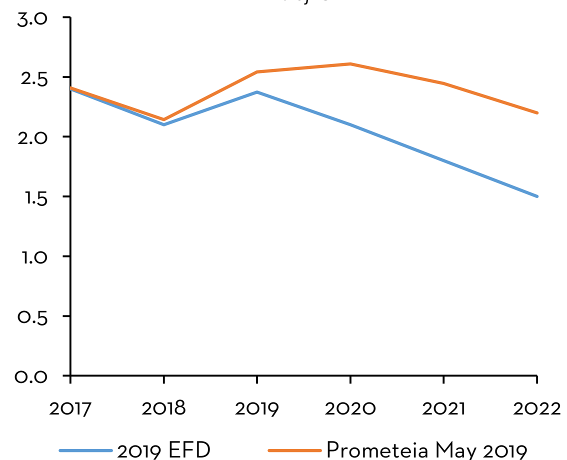
In our scenario, we consider corrective measures in 2020 amounting to around €12 billion or 0.7pp of GDP, consistent with a deficit of 2.6% of GDP (Chart B). Compared to the EFD scenario, we expect a slightly more favourable deficit trend (reflecting the expected ineffectiveness of some of the expenditure measures included in the 2019 budget) and the absence of further expansionary measures.

Chart A - 2020 Budget developments in the 2019 EFD scenario - *% of GDP*



Source: Prometeia's calculations on 2019 EFD, Ministry of Economy and Finance

Chart B - General government budget balance
% of GDP



Source: Prometeia's calculations on 2019 EFD and Istat data

*Table 1 - **The world economy: main indicators*** *% change*

	2018	2019	2020
World real GDP	3.7	3.3	2.9
World Trade	4.2	2.9	2.9
Manufacturing prices $	2.9	-0.6	5.1
Brent oil price ($/brl, level)	71.6	67.1	65.8
GDP			
- United States	2.9	2.5	1.3
- Japan	0.8	0.8	0.6
- EMU	1.8	1.2	1.3
- China	6.6	6.0	5.3
Consumer prices			
- United States	2.4	1.9	2.0
- Japan	0.9	1.2	1.4
- EMU	1.7	1.3	1.5
- China	2.3	2.0	2.5
$/€ exchange rate (level)	1.18	1.14	1.24
£/€ exchange rate (level)	0.885	0.881	0.892

*Table 2 – **Italy: main indicators*** *% change*

	2018	2019	2020
GDP	0.7	0.2	0.6
Imports of goods fob and services	1.8	1.3	2.8
Private consumption	0.6	0.4	0.8
Government consumption	0.2	0.0	0.1
Gross fixed investment:	3.2	-1.1	1.7
- machinery, equipment, other products	3.9	-2.9	1.6
- constructions	2.2	1.1	1.8
Exports of goods fob and services	1.4	2.6	1.9
Domestic demand	0.9	-0.2	0.9
Industrial production	0.5	0.1	1.2
Trade balance (% of GDP)	2.7	3.3	3.6
Terms of trade	-1.7	0.9	2.4
Consumer prices	1.1	0.9	1.1
Per capita wages - manufacturing	0.8	1.2	1.5
Total employment	0.8	-0.2	-0.2
General government balance (% of GDP)	-2.1	-2.5	-2.6

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

*Table 3 - **Exchange rates and interest rates***

		19 Q1	19 Q2	19 Q3	19 Q4	20 Q1	20 Q2	20 Q3	20 Q4
Exchange rates vs euro	US dollar	1.14	1.12	1.13	1.16	1.21	1.25	1.25	1.24
	Yen	125.1	124.8	124.9	127.8	131.9	133.1	133.1	132.7
3 month interest rates %	US libor	2.70	2.59	2.57	2.50	2.30	2.15	2.00	2.00
	Euribor	-0.30	-0.29	-0.30	-0.30	-0.30	-0.29	-0.25	-0.07
10 year government bond yields %	US	2.64	2.52	2.49	2.41	2.28	2.13	2.00	2.00
	Germany	0.08	-0.02	0.00	0.02	0.03	0.03	0.05	0.19
	Italy	2.71	2.62	2.74	2.65	2.40	2.34	2.29	2.38

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

		19 Q1	19 Q2	19 Q3	19 Q4	2019	20 Q1	20 Q2	20 Q3	20 Q4	2020
United States	Brief April 2019	0.2	0.6	0.6	0.2	2.2	0.1	0.3	0.6	0.5	1.3
	Brief May 2019	**0.8**	0.5	0.5	0.2	2.5	0.1	0.3	0.6	0.5	1.3
EMU	Brief April 2019	0.2	0.3	0.4	0.4	1.1	0.3	0.3	0.3	0.3	1.3
	Brief May 2019	**0.4**	0.3	0.4	0.4	1.2	0.3	0.3	0.3	0.3	1.3
Italy	Brief April 2019	0.0	0.1	0.2	0.2	0.1	0.1	0.2	0.1	0.3	0.7
	Brief May 2019	**0.2**	0.0	0.2	0.1	0.2	0.1	0.2	0.1	0.3	0.6

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based on data available up to 15th May 2019

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