prometeia associazione

Italy Prometeia Brief

April 2017 — No. 17/3

Executive summary

- The Italian recovery is progressing, although at a modest pace
- 2016 growth turned out better than expected
- We have revised 2017 growth upwards to 0.9 per cent
- Non-performing loans are expected to decrease by €51 billion in 2017
- Our two InFocus topics are: migration flows into the EU...
- ...and how higher economic insecurity might influence populism

GDP and inflation

In March the National Statistical Institute released revised national account data showing higher-than-expected growth in 2016. This has led us to revise our projections upward for 2017 and 2018. Inflation will increase to 1.5 per cent in 2017.

Based on the revised data, in Q4 2016 the Italian economic recovery continued, although at a slower pace compared to the other major European countries. The upturn was supported mainly by investments – especially transport and housing – and exports, favoured by the recovery in foreign demand and the weak euro. Growth in household consumption decelerated, reflecting the slowdown in semi-durable goods, while durable consumption speeded up (+1.1 per cent) thanks to fiscal incentives and low interest rates.

Inflation surged between the last months of 2016 and the beginning of 2017 as a consequence of the oil price increase (+20 per cent) and the unexpected rise in fresh food prices caused by the adverse winter weather conditions. It is expected to remain at around 1.5 per cent in 2017, and then to converge to the core inflation in 2018 (+1 per cent), as unit labour costs are expected to slow down significantly, mainly as a consequence of wage moderation. During 2016, unemployment remained relatively stable in Italy (while it continued to decrease overall in the EMU), reflecting the increase in labour supply (+1.5 per cent) that more than offset the increase in employment (+1.1 per cent). ■

Table 1 GDP growth quarterly profile

	2016q4	2017q1	2017q2	2017q3
GDP (% change q-o-q)	**0.2**	0.2	0.3	0.2

in bold historical data.

Public finances

In 2016 the deficit-to-GDP ratio was 2.4 per cent, in line with both the Government target and our forecast. We forecast deficit levels of around 2.4 per cent of GDP for both 2017 and 2018.

In 2016 the deficit-to-GDP ratio decreased for the third consecutive year, thanks to the economic recovery and lower interest payments, which compensated the mild expansionary stance of the budgetary policy. The primary surplus increased moderately from 1.4 to 1.5 per cent of GDP, reflecting the lower incidence of the primary expenditure in terms of GDP (-0.7pp compared to 2015). Meanwhile, the tax burden declined marginally from 43.3 per cent in 2015 to 43 per cent of GDP, due mainly to lower indirect taxes (-3.1 per cent).

In the Draft Budgetary Plan (October 2016) the Government set the deficit target at 2.3 per cent in 2017 with a reduction to 1.2 per cent in 2018 based on an increase of 3pp in the VAT rates. The 2017 Economic and Financial Document (DEF 2017), to be presented by the end of April, should confirm these objectives, thereby entailing a contractionary fiscal stance for 2018. It will also incorporate the 2017 corrective budgetary measures requested by the European Commission, equal to 0.2 per cent of GDP (around €3.4 billion), which will likely be achieved mainly via an increase in excise duties on tobacco products.

Nevertheless, we forecast a deficit level of around 2.4 per cent of GDP both in 2017 and 2018. Our projections consider the corrective budget measures but not the planned VAT increase because, as happened in the past two years, its impact would be too costly in terms of growth. We therefore expect also in 2017 a mild expansionary stance of the budget policy which will benefit firms and investment, as well as support households' disposable income via higher social transfers. Overall, the deficit and the debt-to-GDP ratio are expected to remain broadly stable until 2019. ■

Credit and banks

Credit to households and firms continued to increase in January (+1.2 per cent y-o-y), although below the EU average (+2.4 per cent). The increase in non-performing loans is slowing down.

In both January and February credit[1] to households increased to 2.2 per cent y-o-y, more than in December and in line with the euro area average. The positive real estate sector outlook and the stabilization of market prices boosted mortgages.

Net credit flow to firms intensified in January (+0.9 per cent y-o-y, +0.2 in December), reducing the gap with the euro average (+2.3 per cent). The recovery is still fragile and not broad based: only loans between one and five years are rising while loans with maturity at either less than one year or more than five continued to decline. A fragility confirmed by the latest ECB data referring to February, showing that net credit flows slowed down.

In 2017, the stock of bad loans is expected to

Table 2 Italy: macroeconomic scenario *(% change)*

	2016	2017	2018		2016	2017	2018
GDP	1.0	0.9	0.9	Consumer prices	-0.1	1.5	1.0
Imports	3.1	3.7	2.8	Household disposable income	2.2	0.6	1.2
Household consumption	1.3	0.5	0.9	Total employment	1.4	0.6	0.4
Government expenditure	0.6	0.3	-0.1				
Gross fixed capital formation:				General government fiscal balance*	-2.7	-2.4	-2.4
- machinery and equipment	4.6	3.9	1.9	Structural balance*	-1.5	-1.9	-2.0
- constructions	1.4	1.0	1.0	General government debt*	132.6	132.5	132.6
Exports	2.6	3.4	2.8	10 year government bond yield	1.48	2.30	2.62

** % of GDP*
National Accounts Aggregates based on ESA 2010.

1 ECB statistics; credit growth to both households and firms has been adjusted for statistical discontinuities and securitizations.

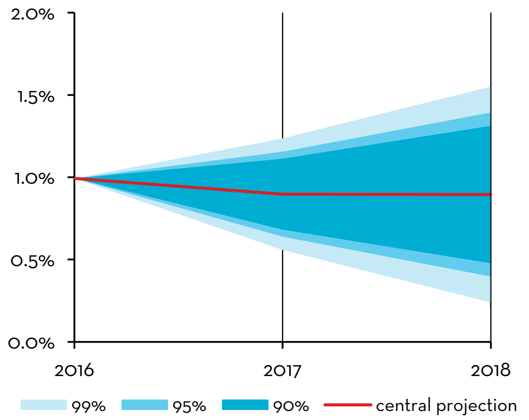
decrease by €51 billion, as Italian banks have planned to implement write-offs for more than €60 billion. Over the next three years, the amount of bad loans is expected to shrink significantly, from 10.6 per cent of credit to 6.7 per cent in 2019.

Italy's banks exploited the opportunity to borrow from the ECB for 4 years at negative rates in March (TLTRO II) collecting most of the potential take-up (over €60 billion). Retail funding fell in January by €43 billion (-1 per cent y-o-y). ■

Risks to the projection

- The possibility of US protectionism measures is still on the table with potential negative effects on the Italian economy (see Prometeia Brief February 2017)
- French presidential elections are approaching and any tension that may affect the French sovereign bonds would spill over to Italy's
- While the ECB monetary policy stance remains extremely easy, an earlier-than-expected tightening could have repercussions on the Italian economy

Figure 1 **Prometeia forecast of annual GDP growth** *(central projection and confidence levels)*



Prometeia calculations (see 2015 December Brief for methodology).

InFocus

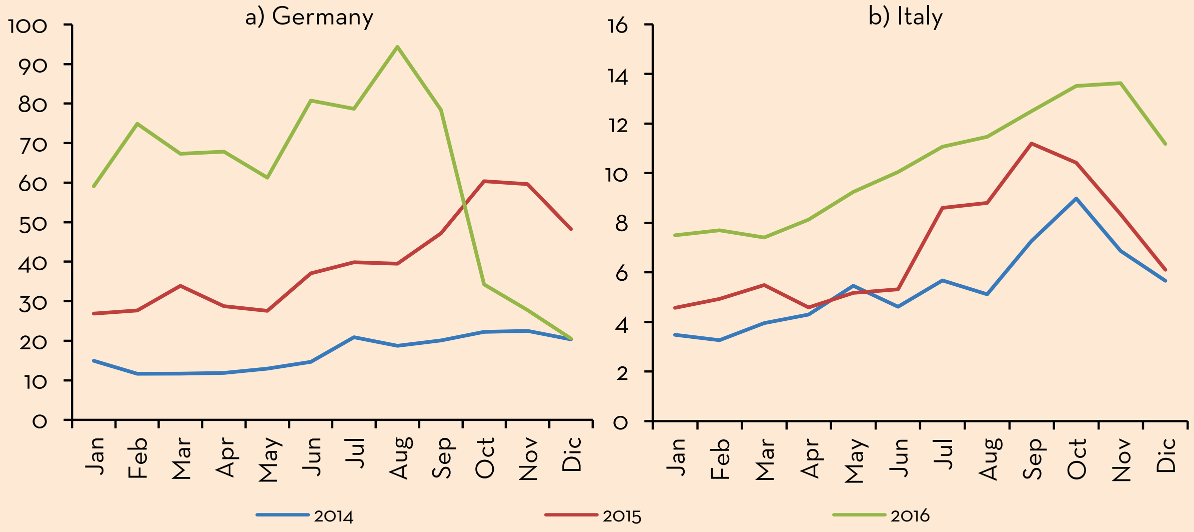
Europe and Italy should prepare for the rising influx of African migrants

Despite being the weakest among the developed countries, in 2016 Italian growth– measured in per-capita terms - was higher than that of Germany. This result was the effect of the increasing German population caused by the massive inflows of asylum seekers in 2016, mainly from Syria (Fig. 2), while Italy recorded a drop in population (-0.2 per cent), despite the asylum seekers increased in Italy as well. However, the scenario for the coming years could change rapidly as a result of the increasing migratory pressure from Africa through the central Mediterranean route, where Italy is likely the main entrance spot.

After the EU-Turkey refugee deal in March 2016, the number of migrants to Europe across the Western Balkans (mainly from Syria, Iraq and Afghanistan) in 2016 fell to 123 thousands from 764 thousands in 2015.[1] On the contrary, inflows in Italy began to increase significantly from April 2016, with an increase of 118 per cent in 2016 compared to the previous year. The increase concerned mainly migrants from Sub-Saharan Africa (SSA), especially Nigerians (20 per cent) and Eritreans (11 per cent).

1 http://frontex.europa.eu/news/fewer-migrants-at-eu-borders-in-2016-HWnC1J

Figure 2 Asylum seekers in Europe
(thousands)



Source: Eurostat

Indeed, the more significant flow of refugees in the long term will come from the Libyan route through the corridor between SSA and Italy. Some studies compare the characteristics of migration flows from SSA to OECD countries with other migration flows and conclude that the current migration process from SSA is much more severe than others and is expected to be the most persistent over the next few years.[2] The SSA region doubled its population between 1990 and 2013, recording the fastest population growth in the world. As a result, the proportion of immigrants from SSA countries to the total population in OECD countries is expected to increase from 0.4 per cent in 2010 to 2.4 per cent by 2050. In prospect, this implies that Europe as a whole needs to strengthen the relocation mechanism to distribute refugees among the Member States and to control the massive influx of migrants.

To this end, in line with the agreement with Turkey, the summit of Malta in February 2017 ratified European support to the Italy-Libya Memorandum aiming at reducing the illegal flows from North Africa. The purpose is to manage the migration route from Africa to Europe by promoting the economic and political stabilization of Libya and the Libyan ability to increase border control and refugee hospitality, with the European partnership and financial support. But this will take time and in the meanwhile the pressure, and the related costs, for Italy are expected to rise.

Indicators of social stress, where Italy fares rather poorly, are correlated with support for populist parties

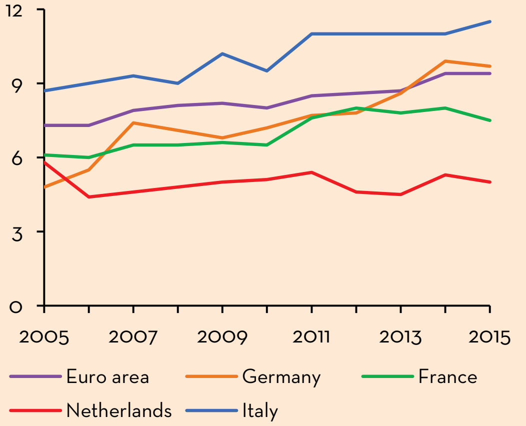
The increase in unemployment and poverty has paralleled the rise of radical political parties, especially in areas mostly affected by the recent economic crisis. Even in a country with very low unemployment on average, such as the US, Donald Trump received more support in areas with higher unemployment rates. Meanwhile, "populist" parties in Europe have gained increased support since the outbreak of the economic crises.[3] The growing popularity of these movements among European voters appears to be driven by similar forces to those that have led to the election of President Trump.

2 Azose, J. J., Ševčíková , H. and Raftery, A.E. (2016), "Probabilistic population projections with migration uncertainty", PNAS, June 2016, 113 no.23.

3 For example, opinion polls for Italy show that support for the Five Star Movement and Lega Nord increased from 10% in 2010 to 43% in 2016. In France, the Front National stands at 25% up from 18% in 2010.

Even though social-political phenomena are complex and develop differently in different contexts, a recent study empirically demonstrates that lower incomes and financial distress are significant determinants of increased voter preference for "populist" parties in Europe and that this effect is magnified by negative economic shocks, such as the 2008 crisis and its aftermath (Guiso et al., 2017).[4] From this point of view, Italy, where unemployment and in-work poverty levels (Fig. 3) are higher than the European average, seems to be particularly exposed. Although other euro member states have experienced an increase in economic insecurity in the last few years, the rise of "populism" in some of these countries is less of a concern.[5]

Figure 3 In-work poverty rates
(% of total population)



Source: Eurostat

Overall, the euro area experienced growing unemployment after the outburst of the economic crisis. After 2013, the unemployment rate started decreasing and reached 10 per cent in 2016, a level higher than pre-crisis values. In Italy unemployment reached 11.9 per cent in 2015[6] from 6.1 per cent in 2007, in France it was 10.1 per cent in 2016 (close to the euro area average), growing from 8 per cent in 2007. Despite low levels of unemployment, the Netherlands also experienced an increase in unemployment rates in the post-crisis period from 3.2 per cent in 2007 to 6 per cent in 2016. Worthy of note is the case of Germany where, unlike other EU countries, the unemployment rate fell steadily from 8.7 per cent in 2007 to 4.1 per cent in 2016. The German political elections, to be held in September, are actually those where the main Eurosceptic party, the Alternative für Deutschland (AfD), has gained only a marginal consent in the last few years.[7]

4 Guiso, L., Herrera H., Morelli M. and Sonno T. (2017), Demand and Supply of Populism, EIEF Working Paper 17/03, February 2017.

5 See Prometeia (2017) "Euro in 2017 and beyond: risks and opportunites for Italy", Prometeia Position Note n.1, March 2017.

6 Latest available data on Eurostat.

7 The AfD currently stands at 8%.

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 11 April 2017

contact person: Stefania Tomasini
tel. +39 051 648 0927 —