ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia ASSOCIAZIONE

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Executive summary

Harder times for global growth

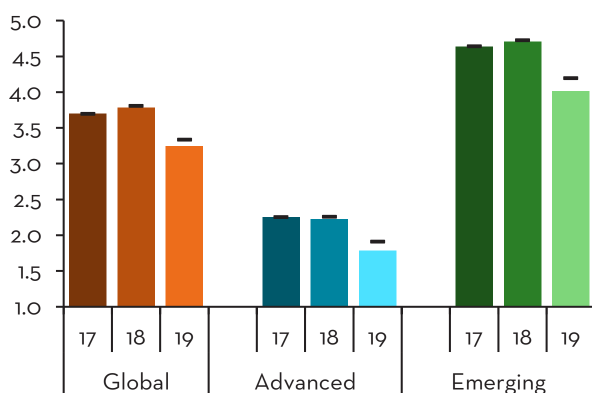
- In 2018 Q3, US fixed investments stagnated, euro area GDP decelerated more than expected as German GDP fell.
- During October, the S&P index dropped by 7 per cent; the number of emerging countries tightening their monetary policy has been increasing, and the persistent fall of the yuan suggests more difficulties in China than those anticipated by a smooth GDP deceleration.
- Some bright spots have emerged recently: despite sanctions on Iran and Saudi Arabia's efforts to keep them high, oil prices fell on the back of sustained supply and fears of weaker demand.
- Emerging country currencies have stabilized and some have partly offset the falls in the first part of the year.
- Overall, industrialized and emerging economies' recent developments support expectation of lower global growth in 2019 as anticipated in the October Brief (Chart 1).
- In our first InFocus, we argue that the end of ECB QE will not lead to significant euro appreciation.

Italian stagnation, disappointing, but not surprising

- In 2018 Q3, as we forecast in October, Italian GDP growth was nil qoq (0.8 per cent yoy; Chart 2). The cyclical indicators anticipate a slight increase of 0.1 per cent qoq in Q4. We confirm annual GDP growth of 1 per cent in 2018.
- Despite the expansionary Budget Law, we expect a modest slowdown in GDP growth in 2019 to 0.9 per cent. We estimate a 0.5pp fiscal impulse on GDP growth; however, increasing domestic uncertainty and risk premium, combined with an expected delay to budget implementation, will reduce the size of the impulse from the fiscal measure to 0.1pp (InFocus 2).
- A revised Draft Budgetary Plan has been presented on November 13th,, confirming the deficit targets. The Commission requests have been addressed by increasing to 1 per cent of GDP the privatization revenues in 2019 and ascribing to exceptional events (not affecting the structural balance) 0.25 of GDP of the already planned investment. We, hence, expect a negative assessment on the part of the Commission, scheduled on November 21st. In addition, it increases the possibility that the Commission will activate an Excessive Deficit Procedure, due to non-compliance with the debt rule.

Chart 1 — Real GDP

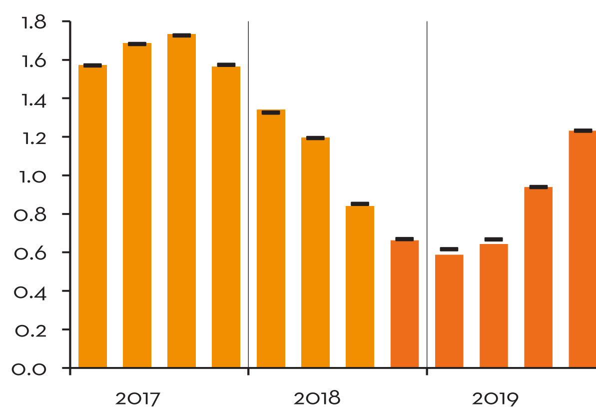
% change



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

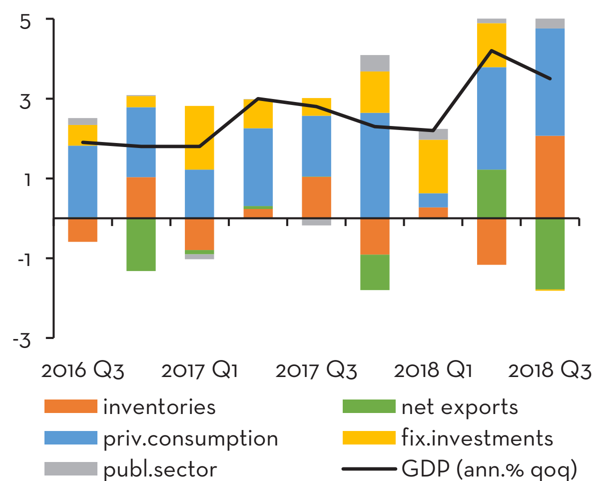
In the US, uncertainty about trade policy is weighing on investments and imports. The stagnation in US fixed investments in 2018 Q3 (Chart 3) unexpectedly involved non-residential investments. According to the September Beige Book, uncertainty about future trade policy induced several firms to reduce and/or postpone their investment plans. In addition, firms have increased their imports and accumulated inventories in anticipation of higher prices of imported goods resulting from the expected introduction of tariffs on China.

China shows a modest deceleration, but expectations are worsening. The most recent information confirms that both GDP and industrial production are decelerating, but are still in line with government targets. Trade flows in real terms remain buoyant (around 10 per cent yoy), meaning that Chinese deceleration is not yet hampering global trade. However, the reduction in the balance of payments current account surplus has pushed the yuan downwards (Chart 4). We expect the yuan to depreciate further in 2019, reflecting difficulties in the domestic economy even in the case of a positive outcome for trade from G20 meeting at the end of November. A weaker yuan will put pressure on China's trading partners and it leads to a modest downward revision of global GDP and trade in 2019.

Weaker than expected EMU (German) GDP in 2018 Q3... Within euro area countries, Germany and Italy were the most fragile. Their GDP fell and stagnated respectively, in France it accelerated and in Spain confirmed the quarterly growth of Q2 (0.6 per cent). According to the German statistical office, the fall of GDP was mainly due to weak exports and high imports. Household consumption suffered of higher inflation linked to energy prices, while investments apparently have not been hurt by the fall of production in the automotive sector. Overall, the negative effects on domestic demand are likely to depend on temporary factors and, according to our now-casting models, German (and euro area) GDP will accelerate in 2018 Q4.

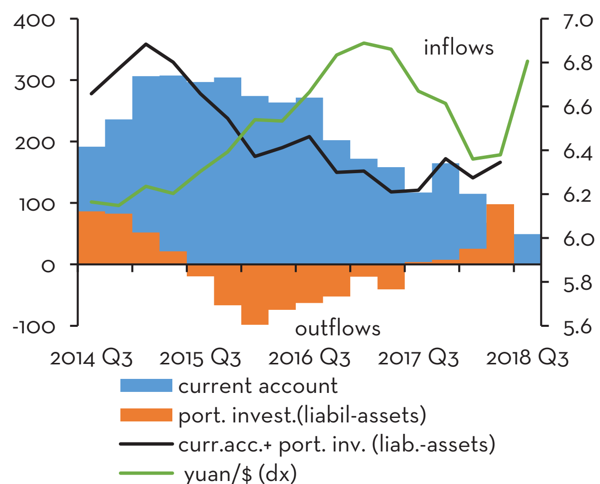
... implies a downward revision of euro area GDP growth. However, this rebound will be insufficient to avoid a downward revision in an increasingly fragile environment. We expect euro area GDP to grow by 1.9 per cent in 2018 (compared to 2.0 per cent in the October Brief) and by 1.4 per cent in 2019 (1.6 per cent in the October Brief).

Chart 3 – US: contributions to real GDP growth
percentage points and annualized % qoq



Source: Bureau of Economic Analysis.

Chart 4 – China: balance of payments and yuan/$
rolling-4 quarters, billions of dollars



Source: Prometeia's calculations on State Administration of Foreign Exchange data and Thomson Reuters.

We confirm our forecasts for US and euro area monetary policy, that is, two more 25bp hikes in the Fed funds target rate, in December 2018 and at the beginning of 2019, and an increase in ECB monetary policy interest rates at the end of 2019. Therefore, the spread between dollar and euro asset yield will not reduce, and it will challenge the upward pressure on the euro resulting from QE being discontinued (see InFocus 1).

Italy

In 2018 Q3, Italy's GDP growth came to a standstill. Italian GDP growth has decelerated, but, for the first time since 2014 Q4, this slowdown translated into stagnation. Annual growth has continued to decline from its 2017 Q3 peak (1.7 per cent) to less than 1 per cent. This GDP stagnation is the result of an industry contraction which was compensated by increased value added in the agriculture and services sectors (the complete breakdown will be published at the end of November). On the demand side, the contribution to growth from both net exports and domestic demand was null. This picture is broadly in line with our October forecast.

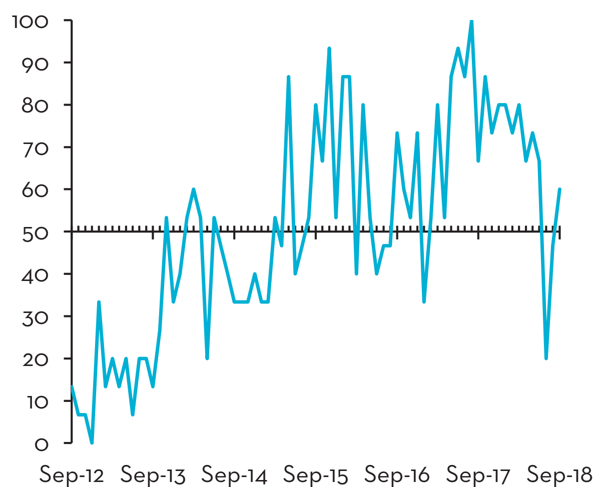
Further decline in industrial production. In 2018 Q3, industrial production fell by 0.2 per cent qoq and 0.3 yoy. This negative result did not affect production in the investment and energy sectors which increased. Following the high volatility recorded in July and August, industrial production in September declined slightly mom (-0.2 per cent). However, in annual terms, it grew by 1.3 per cent and the share of industrial sectors posting annual growth rates raised from 20 per cent in August to 60 per cent in September (Chart 5).

Not good news for exports in the recent data. The growth of exports of goods at current prices reduced to 0.3 per cent qoq in 2018 Q3, from 0.7 per cent in Q2. Given the available information on trade prices, this could imply a stagnation in real terms. The deceleration at current prices is the result of a contraction by 1.2 per cent qoq in non-EU markets, due to the appreciation of the euro in nominal effective terms and the weak global trade, and a strengthening of growth in EU markets.

In 2018 Q4, we expect sluggish GDP growth of 0.1 per cent qoq. Industrial production will rebound (0.9 per cent qoq) after three consecutive quarters of no growth, but more than half of this improvement will be due to positive carry-over effects. In terms of household and business confidence, the latter continues to deteriorate in all economic sectors except construction (Chart 6).

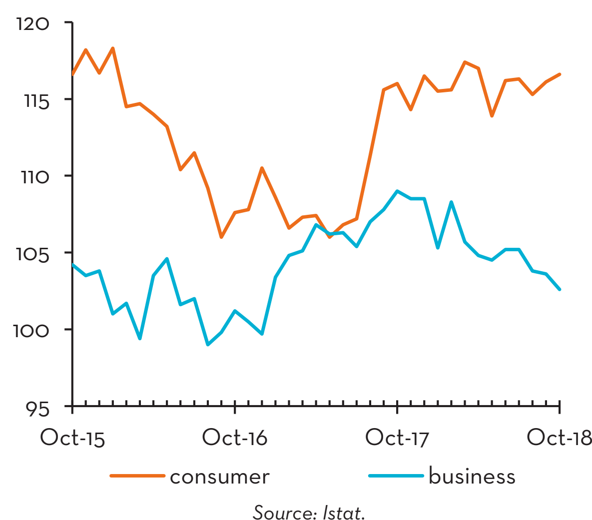
In line with economic activity, the labour market stagnated over the summer months due to a

Chart 5 – Prometeia industrial production diffusion index - %



Source: Prometeia's calculations on Istat data..

Chart 6 – Consumer and business confidence
2015=100



Source: Istat.

reduction in the number of self-employed and a slight increase in the number of employees, still led by fixed-term contracts.

The unemployment rate has continued to decline: from 10.6 per cent in 2018 Q2 to 10 per cent in 2018 Q3, reflecting the shrinking labour force.

Inflation continues to be driven by exogenous factors. In October 2018, consumer prices increased by 1.6 per cent yoy (from 1.4 per cent yoy in September), due mainly to regulated energy product prices, which were affected by

past oil price increases. Core inflation remained below 1 per cent.

Uncertainty following Italy's political elections reduced non-residents' purchases of government securities. In contrast to the positive trend in the first months of 2018, net purchases of Italian bonds and shares by foreign investors declined by €77 billion in May and June (mainly government securities, €58 billion). After a brief respite in July, purchases of government securities decreased by a further €17 billion in August, resulting in the share of government bonds held by non-residents reaching a historical low of 32.2 per cent since early 2000s.

Growth in loans to firms strengthened in September while growth in loans to households remained stable at 2.8 per cent yoy (Chart 7). Corporate loans increased by 1.9 per cent due, mainly, to loans with maturity of more than 12 months, supported by low interest rates. According to the most recent surveys, credit standard conditions have deteriorated since June, particularly for small businesses.

Reductions in the stock of gross non-performing loans continued. In 2018 Q3, due to major sales, NPLs shrank by a further €8 billion and are expected to fall by €70 billion (€56 billion being firm loans) over the whole of 2018.

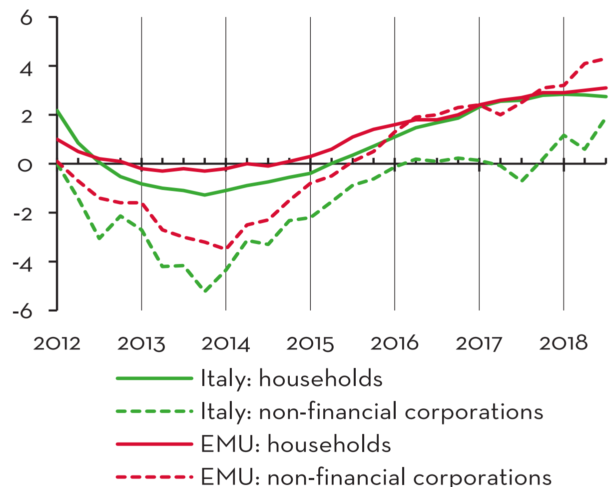
Reassuring results for the Italian banking system from the recent EBA and ECB stress tests. In the adverse scenario, the reduction in the CET1 ratio in Italy is 50bp lower than the European average, although the results vary within banks.

In 2018, the general government deficit is expected to reduce to 1.8 per cent of GDP from 2.4 per cent of GDP in 2017. Between January and October, state sector borrowing requirement decreased by almost €12 billion compared to the same period in 2017 due to the recovery in revenues and the significant reduction in capital expenditure (resulting from absence of extraordinary costs to support the banking sector, €6.5 billion in 2017). Conversely, current expenditure is increasing, sustained by higher costs related to the renewal of labour contracts for public employees.

General government interest expenditure continued to fall in 2018 to 3.7 per cent of GDP from 3.8 per cent of GDP in 2017, despite higher debt financing costs. The sharp rise in yields at issue since May (Chart 8) has increased spending on the €180 billion of public securities issued since then by about €1 billion and stronger effects are expected in 2019.

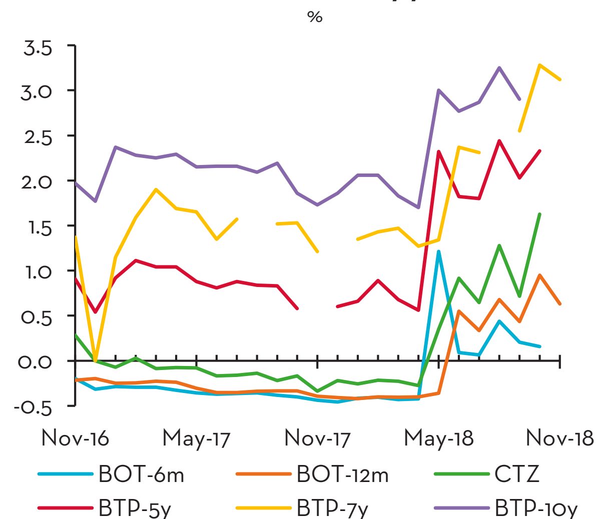
Expansionary fiscal policy will lead to an increase in the deficit in 2019. The expected delay in implementation of the Budget Law measures (InFocus 2) is likely to reduce the increased expenditure envisaged by the official estimates. However, expenditure on social benefits and investments are expected to increase sharply, bringing the expected deficit to 2.5 per cent of GDP.

Chart 7 – MFI loans to households and non-financial corporations - *% change yoy*



Source: ECB and Bank of Italy.

Chart 8 – Government security yields at issue
%

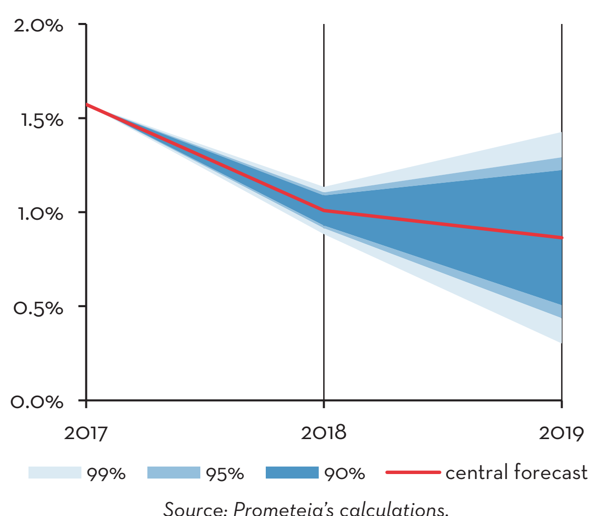


Source: Ministry of the Economy and Finance.

Risks to the projection

- Trade protectionism remains one of the biggest risks for the global economy with negative effects on the US economy (further reductions in investment plans, upward pressure on inflation) and, at the global level, deteriorating confidence. Since Italy is a very open economy it will be affected.
- US stock market volatility remains high and other price corrections could damage confidence and domestic demand.
- If China chooses to use yuan depreciation to counter US trade protectionism, the consequences in international markets will not be negligible.
- In Italy, a reversal in growth of domestic demand, in particular business investment, cannot be excluded as a result of increased uncertainty about future fiscal policy.

Chart 9 – Italy: Prometeia's forecast of annual GDP growth - *central projection and confidence levels*



Source: Prometeia's calculations.

InFocus 1

THE END OF ECB QE: EURO APPRECIATION ON THE HORIZON?

Will the end of the ECB's QE programme in December prompt a euro appreciation? If it follows the US dollar pattern then the answer should be yes. The end of QE in the US was accompanied by a solid economy and more optimistic expectations about growth – especially also compared to its main partners. In the 12 months from October 2014, the last month of Fed QE, the dollar strengthened by approximately 12 per cent in both nominal trade weighted exchange rate terms, and with respect to the euro.

For the euro, expectations are less clear-cut.

The end of QE is likely to reduce European demand for foreign portfolio assets (outflows), which were triggered by QE (Chart A) and, other things equal, this will exert upward pressure on the euro. In particular, the correlation between the euro dollar exchange rate and EMU capital movements (based on portfolio investments and trade in goods and services; Chart B) suggests a possible strengthening of the euro with respect to the dollar in 2019.

Nevertheless, there will continue to be divergence between the ECB and Fed monetary policies and this will partly offset upward pressure on the euro. The Federal Reserve remains committed to reaching the natural rate of interest, estimated at 3.5 per cent, at least as long as the economy expands above potential growth. According to the latest FOMC projections,[1] this means a 100bp higher Federal fund target rate at the end of 2019, whereas the ECB predicts that the end of QE will be followed by a long period

1 September 2018.

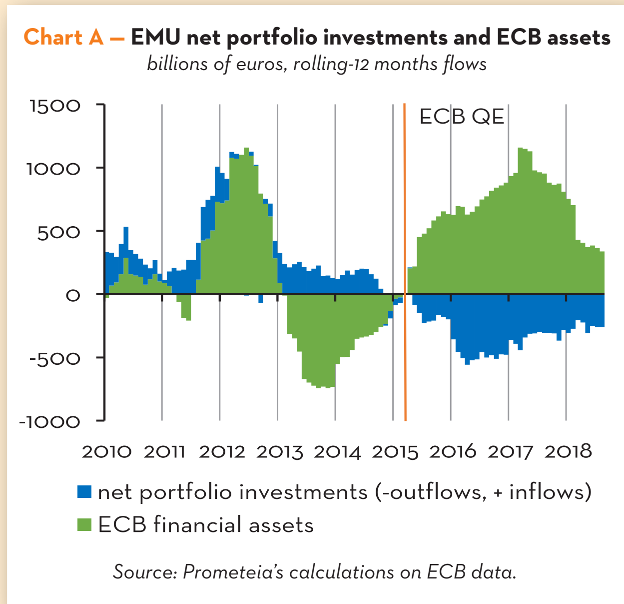


Chart A – EMU net portfolio investments and ECB assets
billions of euros, rolling-12 months flows

Source: Prometeia's calculations on ECB data.

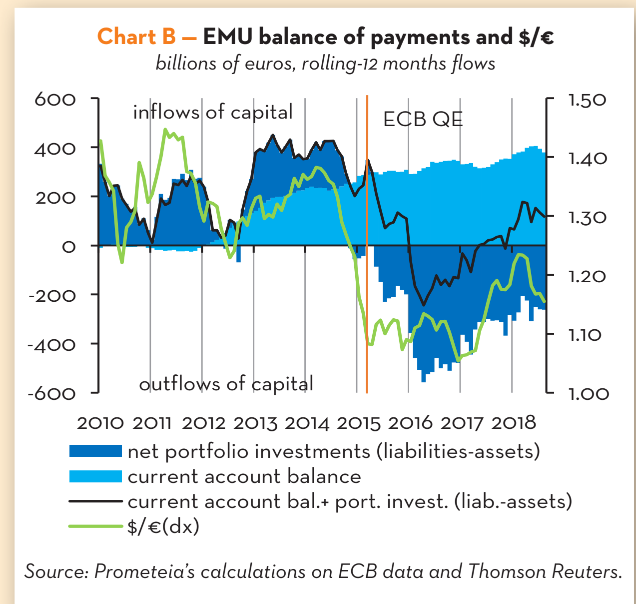


Chart B – EMU balance of payments and $/€
billions of euros, rolling-12 months flows

Source: Prometeia's calculations on ECB data and Thomson Reuters.

(at least until end of summer 2019) of stable interest rates at present minimum values. The difference in yields expected as a result of the divergence between EMU and US monetary policies will contribute to supporting the preference for US assets including from European investors, which will mitigate the upward pressures on the euro.

To sum-up. The end of QE is likely to exert upward pressure on the euro, but the divergence between the Fed and the ECB monetary policies will persist and we expect it will, in part, counterbalance these pressures. In addition, the expected deceleration in the global economic growth in 2019 is likely to affect Europe more than the US, where fiscal policy will remain expansionary, and this will contribute to feeding demand for US assets.

InFocus 2

ITALY'S 2019 BUDGET: HIGHER DEFICIT, LOWER GROWTH

The 2019 budget has been signed by the President and sent to Parliament. The planned measures, which are embodied in a fiscal law decree and in the draft budget law, should increase net borrowing by €21.8 billion in 2019, €27 billion in 2020 and €25 billion in 2021 (1.2 per cent of GDP in 2019, 1.4 per cent and 1.3 per cent in 2020 and 2021) compared to the no-policy-change scenario.

Part of the expansionary plan is earmarked for the cancellation in 2019 of the previously legislated increases in VAT and excise duty rates that is expected to generate a loss of €12.5 billion in revenues. The VAT increases will remain active in 2020 and 2021, consistent with revenue increases of around €15 billion.

The new provisions focus mainly on increases in public expenditure. €13 billion of resources have been allocated to the introduction of a **minimum income scheme** and a more flexible **early retirement scheme**, the most important measures in the government's programme. Increased funds for **public investment** will account for €3.5 billion in 2019, €5.6 billion in 2020 and €6.5 billion in 2021, and resources of around €1.2 billion per year are planned for **public employment**, especially new recruitment.

On the revenue side, the budget foresees several changes in firms' tax regime, which will overall provide temporary support for revenues. It will extend the simplified tax regime for self-employed, reduce corporate tax rates for firms that increase their investment or hiring and from 2020 it will introduce a substitute taxation for individual entrepreneurs and the self-employed. These measures will replace the previously budgeted simplified tax regime for small firms (IRI) and the tax incentives for firms' capital uplifts (ACE). Finally, tighter taxation of the financial sector is envisaged, especially in 2019, providing funding of more than €4 billion.

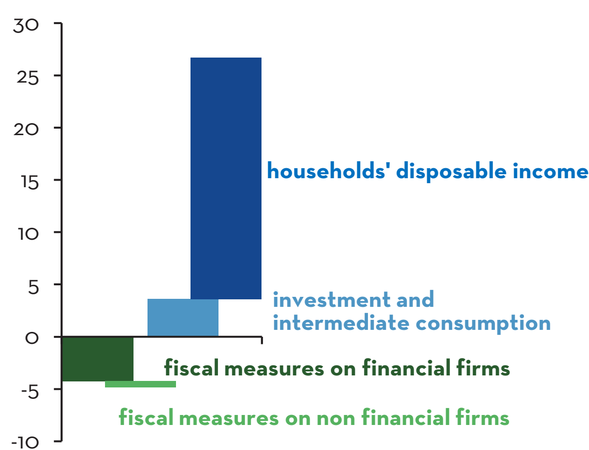
The spending review will provide only modest funding: about €1.1 billion in 2019, €3.5 billion, on average, in 2020-2021.

Overall, **in 2019, the expansionary effects will translate into net support for households**, the main beneficiaries of the fiscal expansion (Chart C). Public spending on investment and intermediate consumption will provide an expansionary boost, while the net effect on corporate taxes will contribute around €5 billion to reducing the deficit.

The official assessment shows that the new budget will have an expansionary effect on activity of 0.6pp in 2019, increasing GDP growth from 0.9 to 1.5 per cent. **Our estimates show that** the measures would have a similar effect on growth, around 0.5 per cent in 2019; however, we believe the government growth target is unlikely to be achieved both for a less favourable valuation of the unchanged-policy GDP growth and for two other reasons, more specifically linked to the evaluation of the budget.

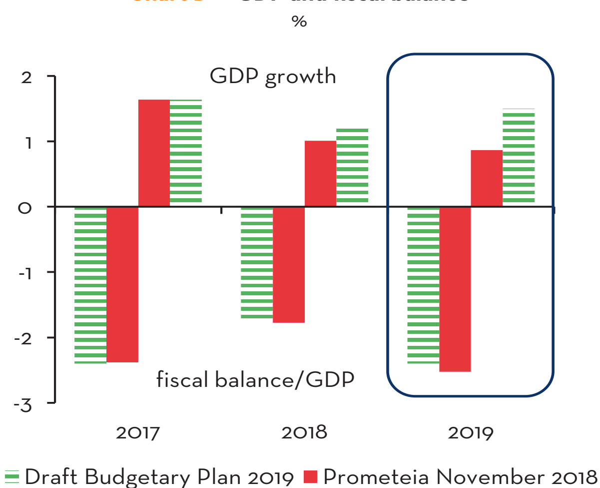
First, **we believe that the planned higher expenditure** on investment, minimum income scheme and pensions **will not be fully implemented at the start of 2019**. In the former case, past experience shows that it is difficult to translate quickly increased budget allocations into actual expenditure. In the latter cases, the budget has set the spending limit so far, but government has yet to define the implementation procedure and details of the measures. Second, **the increased uncertainty** on the fiscal consolidation plans is leading to stock market losses and an increase in the government bond spread (expected to remain at about 300bp on average in 2019), which **will limit the expansionary effects** of the budgetary policy. It follows that, despite the worsening of public sector deficit to around 2.5 per cent of GDP, we expect GDP growth to be 0.9 per cent (Chart D).

Chart C — Net impact of the budgetary measures (minus sign = increase of resources) - *billions of euros*



Source: Prometeia's calculations on Ministry of Economy and Finance data.

Chart D — GDP and fiscal balance
%



Source: Prometeia's calculation on Istat and Ministry of Economy and Finance data.

Table 1 The world economy main indicators *% change*

	2017	2018	2019
World real GDP	3.7	3.8	3.2
World Trade	4.8	4.1	3.2
Manufacturing prices $	2.9	3.1	0.8
Brent oil price ($/brl, level)	54.9	73.2	71.8
GDP			
- United States	2.2	2.9	2.4
- Japan	1.7	0.9	1.0
- EMU	2.5	1.9	1.4
- China	6.8	6.6	5.9
Consumer prices			
- United States	2.1	2.4	2.1
- Japan	0.5	1.0	1.4
- EMU	1.5	1.8	1.8
- China	2.9	1.4	2.4
$/€ exchange rate (level)	1.13	1.18	1.15
£/€ exchange rate (level)	0.876	0.885	0.895

Table 2 Italy main indicators *% change*

	2017	2018	2019
GDP	1.6	1.0	0.9
Imports of goods fob and services	5.6	1.6	3.7
Private consumption	1.5	0.8	1.1
Government consumption	-0.1	0.0	0.9
Gross fixed investment:	4.4	4.0	1.8
- machinery, equipment, other prod.	6.6	5.8	1.9
- constructions	1.9	1.9	1.7
Exports of goods fob and services	6.3	0.5	2.7
Domestic demand	1.4	1.3	1.1
Industrial production	3.7	1.4	1.3
Trade balance (% of GDP)	3.2	2.7	2.4
Terms of trade	-2.2	-1.2	-0.8
Consumer prices	1.2	1.2	1.3
Per capita wages - manufacturing	0.5	1.0	1.6
Total employment	0.9	0.7	0.3
General government balance (% of GDP)	-2.4	-1.8	-2.5

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

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	1.19	1.16	1.14	1.14	1.15	1.16	1.17
	Yen	133.1	129.9	129.7	129.0	129.0	130.3	131.7	132.6
3 month interest rates (%)	US libor	2.00	2.40	2.40	2.56	2.68	2.80	2.85	2.85
	Euribor	-0.33	-0.33	-0.32	-0.32	-0.31	-0.30	-0.22	-0.02
10 year government bond yields (%)	US	2.76	2.92	2.91	3.23	3.37	3.41	3.39	3.35
	Germany	0.59	0.48	0.32	0.45	0.56	0.65	0.78	0.91
	Italy	2.01	2.24	2.83	3.53	3.66	3.76	3.79	3.73

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

		18 Q1	18 Q2	18 Q3	18 Q4	2018	19 Q1	19 Q2	19 Q3	19 Q4	2019
United States	Brief Oct. 2018	**0.5**	**1.0**	0.9	0.7	2.9	0.5	0.5	0.4	0.4	2.4
	Brief Nov. 2018	**0.5**	**1.0**	**0.9**	0.7	2.9	0.5	0.5	0.4	0.4	2.4
EMU	Brief Oct. 2018	**0.4**	**0.4**	0.3	0.5	2.0	0.4	0.3	0.4	0.4	1.6
	Brief Nov. 2018	**0.4**	**0.4**	**0.2**	0.3	1.9	0.4	0.3	0.4	0.3	1.4
Italy	Brief Oct. 2018	**0.3**	**0.2**	0.0	0.1	1.0	0.2	0.3	0.3	0.4	0.9
	Brief Nov. 2018	**0.3**	**0.2**	**0.0**	0.1	1.0	0.2	0.3	0.3	0.4	0.9

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