ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

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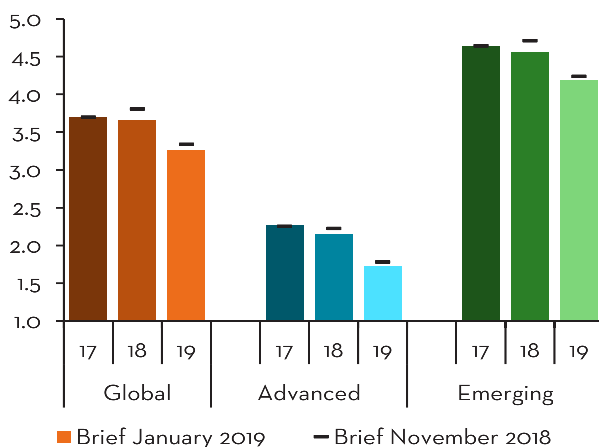
Executive summary

Signs of activity moderation are mounting

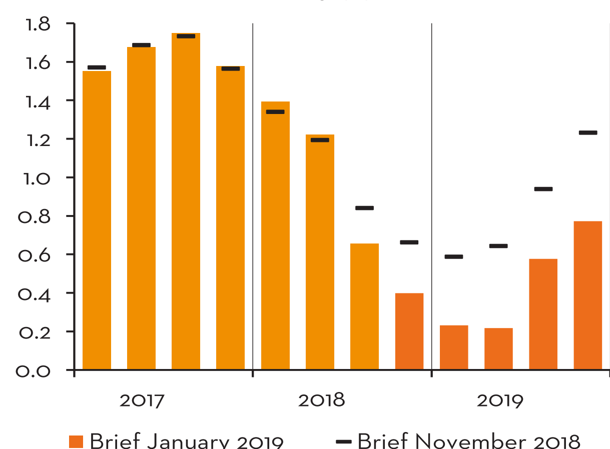
- Some of the risks signalled in our November Brief have partially materialised, in particular those related to the effects of trade tensions and more restrictive global financial conditions.
- We have revised the expected world GDP growth in 2019 downwards by 0.1pp (Chart 1) because of the weaker outlook for emerging market economies and the euro zone, while the outlook for US activity is broadly unchanged. China is expected to continue the transition to lower growth rates, amid domestic imbalances and rising trade pressures.
- The main central banks, ECB and the FED included, are showing signs of a more cautious attitude towards normalizing monetary policy, which could limit the extent of the slowdown expected in 2019.
- In our scenario, the current trading relationship between the UK and the EU27 will be extended, but the other Europe-centred political risks will be a source of uncertainty.

Italy: increasing risks of a technical recession, growth halved in 2019

- After the sharp slowdown of GDP in Q3 2018 (-0.1 per cent qoq), risks are increasing that GDP would contract also in Q4 (after the mild fall in October, the November industrial production came out at -1.6 mom). We have revised annual GDP growth to 0.9 per cent in 2018 (1.0 per cent in the November Brief; Chart 2).
- The agreement with the European Commission has eased tensions, but the risk of embarking on an excessive deficit procedure has not been definitively dismissed. As a consequence, the BTP-Bund spread is expected to remain on average around 280pb in the first half of 2019 from 292pb in 2018 Q4.
- Compared to the November Brief forecast, we have revised 2019 GDP growth from 0.9 per cent to 0.5 per cent. The downward revision is significant, reflecting both the negative legacy of the last six months of 2018 and the lower expansive impulse expected from the budget package compared to the first draft of the budget. In our InFocus, we describe the budget law approved on 30 December.



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



Source: Prometeia's forecast on Istat data.

Global scenario

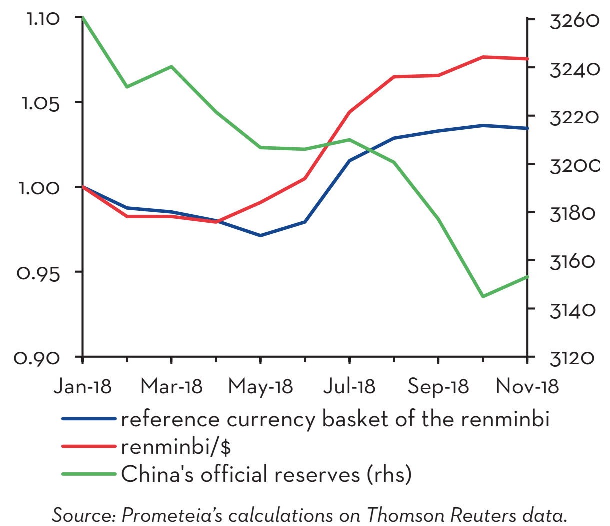
Growing global interdependence and vulnerabilities in emerging markets. Most Emerging Market Economies (EME) are suffering a tightening of international financial conditions prompted by the policy mix in the US and the dollar appreciation. Conversely, China's financial conditions have remained accommodative, but trade confrontation with US is eating into growth. Looking ahead, trade tensions between China and the US are likely to begin to weigh on other emerging markets. China is not stepping in to counter the yuan depreciation to help offset the US tariff effects (Chart 3), which is exacerbating competitive tensions with its main partners. Against this backdrop, we expected a decrease in the pace of import growth in most EME and have revised global trade growth downward by 0.3pp to 2.9 per cent yoy in 2019.

Risks stemming from the more fragile emerging economies are still balanced. Higher volumes of reserves with respect to the past, and a healthier external position, could help to mitigate the potential risks stemming from further tightening of global financial conditions and uncertainty over the US-China trade dispute.

A weakening external setting for the EMU is causing further moderation in 2019. The unexpected slowdown in real GDP in 2018 Q3 (0.2 per cent qoq, 0.4 per cent in Q2) was due, partly, to the temporary impact on the car industry of a new vehicle emission pollutants regulation, which affected Germany, in particular (given its high share of the automotive industry in total industrial production, 20 per cent). However, there are signs of more persistent negative factors in the EMU cycle, linked to the weakening of the euro area's external environment and increased political uncertainties. We have revised downward GDP growth in 2019 (1.2 per cent from 1.4 per cent in the November Brief). The deceleration of economic growth is hampering the normalization of the ECB's monetary policy. We expect new long-term re-financing operations to begin in the next months while policy interest rates are expected to remain at their present levels until the end of the 2019.

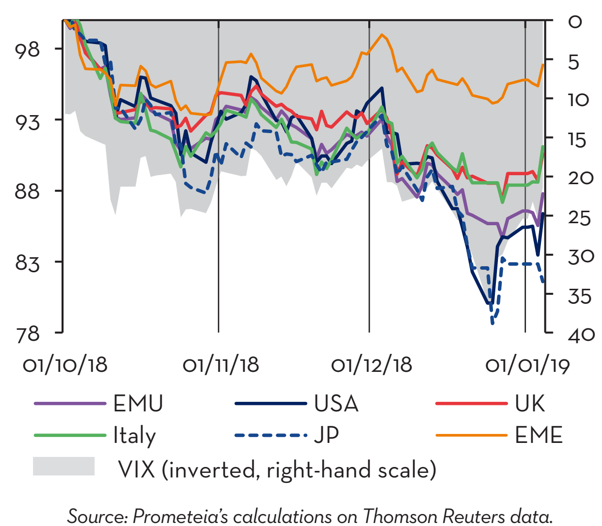
The US economic cycle is approaching being one of the longest on record. Activity in the US in 2018 Q3 (0.9 per cent qoq) was supported by solid growth of household consumption and a fall-off in investment. Non-financial corporation debt is high, however, signalling an increase in specific financial fragilities for some US corporations while episodes of volatility resulting in falls in share prices persist (Chart 4). Looking ahead, we expect CPI inflation to remain at around the 2 per cent target in the near term and a more cautious attitude of the FED monetary policy normalization, as emerged from the December's FOMC minutes. In the case of fiscal policy, the impact of the expansionary measures will fade gradually until later this year when GDP growth is expected to be 2.3 per cent yoy.

Chart 3 – Chinese renminbi and official reserves
indexes 1/2018=100, billion US dollars



Source: Prometeia's calculations on Thomson Reuters data.

Chart 4 – Equity markets and volatility index VIX
percentage values, index 01/10/20018=100



Source: Prometeia's calculations on Thomson Reuters data.

Italy

In 2018 Q3, GDP growth contracted (-0.1 per cent qoq), in line with the European deceleration. The slowdown in Italy is the result of a slowing down in domestic demand, while exports improved (+1.1 per cent qoq). On the supply side, industrial production fell for the third consecutive quarter, although moderately (-0.1 per cent qoq); according to November figures the contraction has continued in Q4. After the drop in Q3, the risks of a moderate GDP contraction in Q4 are increasing.

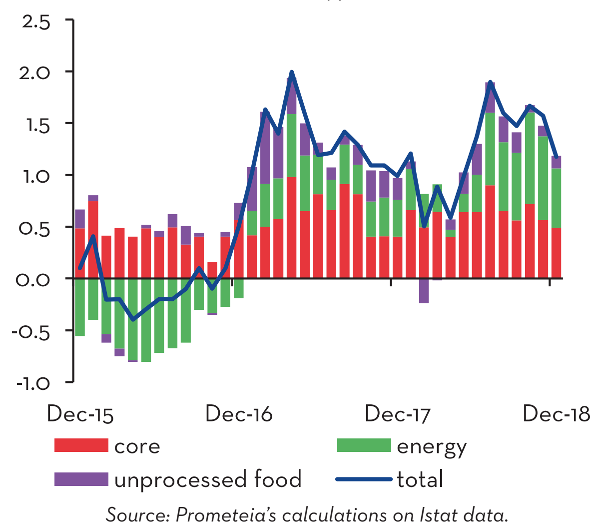
Declining consumer and firm spending. With the exception of investments in construction, which seem to have started a modest expansionary cycle (0.5 per cent qoq in Q3, 0.7 per cent in Q2), investments in machinery and equipment have decreased (-2.2 per cent qoq). The contraction in consumer spending has been concentrated in durable and non-durable goods (-0.1 per cent and -0.5 per cent qoq respectively), while expenditure on services has continued to grow, albeit at a slower pace (0.2 per cent qoq).

Consumer and business confidence is deteriorating. Business confidence continued to deteriorate in the final months of 2018, falling below the levels recorded in the 3rd quarter. The latest data show that consumer confidence has also declined, influenced both by domestic factors, such as uncertainties about the economic policy of the new government and the resulting increase in the spread, and by the slowdown in international trade (in particular, with Germany, Italy's main trading partner) and the expected normalization of monetary policy.

Inflation is decreasing. After an acceleration of more than 1 percentage point compared to the lows of February, driven by fluctuations in volatile components, i.e. oil and unprocessed food products, consumer inflation fell to 1.1 per cent in December 2018 (Chart 5). The contribution of the core components is still well below 1 per cent. Headline inflation is expected to fall below 1 per cent from spring 2019 onwards, as a result of falling oil prices and the strengthening of the euro against the dollar, which will reduce imported inflation.

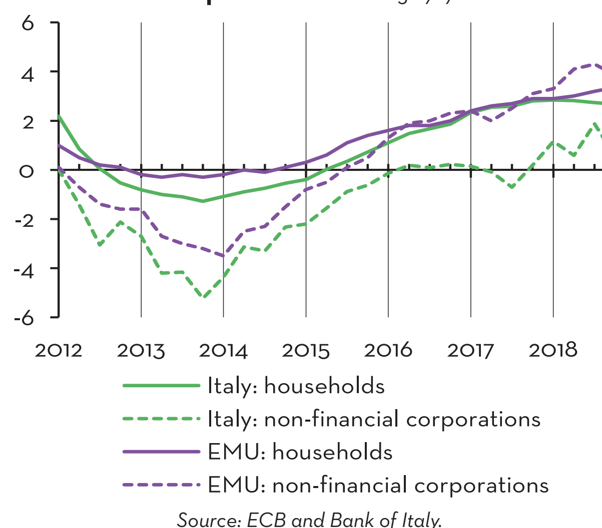
The labour market weakened slightly in 2018 Q3. Employment fell slightly (-0.2 per cent on the previous quarter): the number of employees has continued to grow in both the industry and service sectors, while the self-employed workers have fallen. The increase in the number of employees reflects the increase in open-ended positions, while, for the first time since mid-2016, the number of fixed-term contracts has reduced. November figures confirm a picture of substantially stable employment levels.

Chart 5 – Italy: contributions to headline inflation
% and pp



Source: Prometeia's calculations on Istat data.

Chart 6 – MFI loans to households and non-financial corporations - *% change yoy*



Source: ECB and Bank of Italy.

The unemployment rate has fallen to 10.2 per cent in Q3 from 10.7 per cent in Q2, reaching the lowest value since 2012 Q1. This reflects the shrinking labour force due partly to the increase in inactivity, especially for women. According to November data, the reduction of unemployment rate halted.

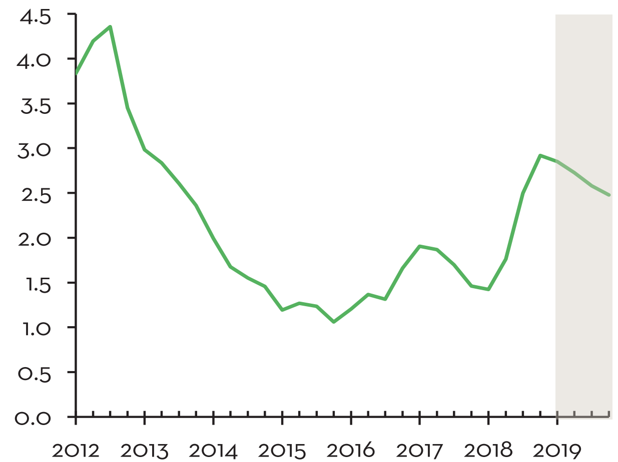
Loans to firms weakened in November. Although financing conditions are still relaxed, there is evidence of slightly worsening financing conditions for firms, mainly small and medium-sized enterprises. This, as well as the weakness of the economic situation, has

affected demand for credit: loans to firms have slowed to 1.1 per cent yoy, while loans to households have remained broadly stable (2.7 per cent yoy, Chart 6). Confirmation of less positive loan conditions came from the cost of credit which, although kept low by competition among the banks, has been increasing in the last two months for new lendings.

The gross stock of bad loans has further decreased. In October and November, the reduction was €5 billion, due almost entirely to major sales. According to our estimates, the deterioration in market conditions will not interrupt the process of convergence of the asset quality parameters of Italian banks towards the European averages; the tensions on the stock market for banks is one more reason to speed up the de-risking process and try to bring the cost of capital back to more sustainable levels. Gross bad loans are expected to fall by €55 billion in 2018 and by €38 billion in the current year.

In 2018, public deficit fell. The state sector borrowing requirement in 2018 was €45.5 billion, around €7 billion less than in 2017 and the general government to GDP ratio was 1.9 per cent in the first three quarters of 2018 (2.6 per cent in the first three quarters of 2017). Public deficit benefited from a reduction in expenditure on both capital and interest, despite the higher spread (Chart 7), especially in the second part of the year. We estimate that the increase in interest rates on the €226 billion of government securities issued between May and December 2018 will cost around €1 billion in 2018.

Chart 7 – Spread BTP-Bund 10y - %



Source: Prometeia's forecasts on Thomson Reuters data.

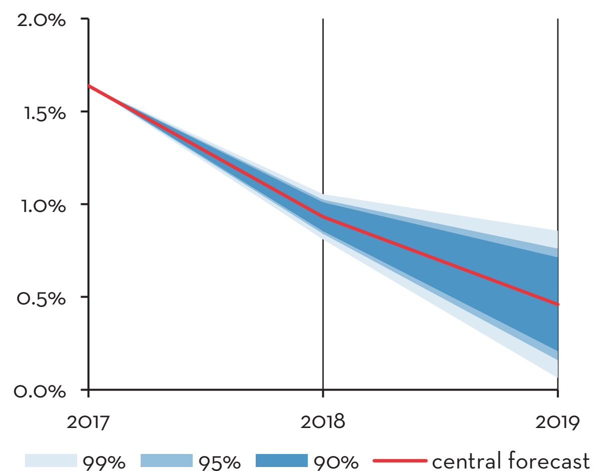
In 2019, higher expenditure will increase the deficit. In line with the content of the 2019 budget law, growth in public expenditure will accelerate sharply in 2019, supported by higher social benefits and public employment compensations. We expect the 2019 deficit to reach 2.3 per cent of GDP.

Negotiations to avoid the excessive deficit procedure have greatly reduced the expected expansionary effects of the budget. Compared to the November Brief forecast, we have reduced the expansionary impact of the fiscal package (see below the InFocus describing the budget law for 2019). Italy is expected to grow more slowly in 2019: GDP growth is forecast to be 0.5 per cent, compared to 0.9 per cent in 2018.

Risks to the projection

- Risks related to trade tensions and the possibility of tighter than expected global financial conditions remain central to the global scenario.
- A more pronounced deepening of the deceleration in the Chinese economy is a possibility and would affect global trade adversely.
- In the EU, the ultimate deal related to Brexit remains unclear and further negative surprises cannot be excluded. In addition, the spring European elections could represent an element of political instability, with possible repercussions especially for the more fragile euro area countries.
- Negative signs came from the euro area manufacturing output in November, increasing the risk of a deceleration stronger than expected.
- All these factors could have considerable negative impacts on Italy's recovery prospects, and will add to the risks associated to internal political uncertainty.

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



Source: Prometeia's calculations.

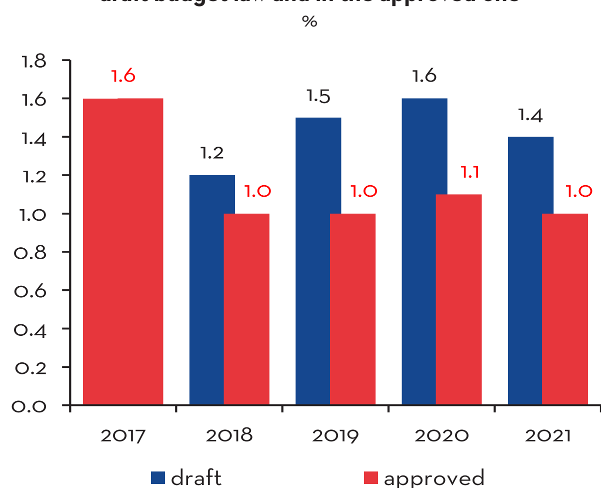
InFocus

THE 2019 ITALY'S BUDGET: NOT-IDEAL DEAL

The 2019 budget session ended on 30 December with the approval of a substantially amended budgetary package compared to the initial version (Brief 18/6)**, aimed at preventing the opening of an Excessive Deficit Procedure**. The opinion adopted by the Commission on Italy's Draft Budgetary Plan (DBP) identified a "particularly serious non-compliance with the Stability and Growth Pact", which was confirmed with respect, also, to the revised DBP. In particular, there was a deviation with respect to the structural adjustment, and a risk of backtracking on reforms. In addition, the overly optimistic macroeconomic scenario posed a further risk to the budgetary targets. These conditions would have warranted the opening of an excessive deficit procedure for the debt criterion, as stated by the Commission on 21 November.

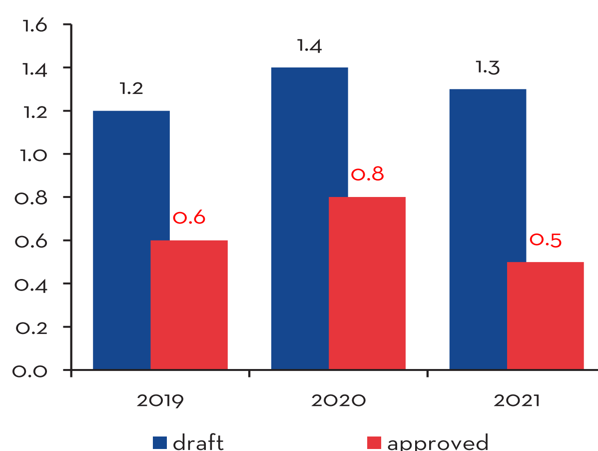
Subsequent negotiations led the Italian government to reassess the policy scenario. **GDP growth in 2019 has been revised downwards to 1 per cent** (Chart A), a scenario now defined as "plausible" by the Commission. **The expansive scope of the budget has been almost halved to 0.6 per cent of GDP** (Chart B) and a safeguard clause ("freezing" mechanism) has been included in relation to the expenditure provisions of the Ministries. The headline deficit target has been reduced from 2.4 per cent of GDP to 2.0 per cent of GDP, and structural deterioration has been reduced from 0.8 per cent to zero. A European Commission letter dated 19 December states that **these amendments "would allow the European Commission not to recommend the opening of an Excessive Deficit Procedure at this stage".**[1] However, the agreement achieved was defined as **"not-ideal"** and, therefore, the Commission will continue to monitor budgetary developments in Italy closely, and, in particular, the implementation of the 2019 budget. An important issue will be the content and implementation of the decrees on citizenship income and on the new pension rules, which are funded by the budget law, but have yet to be presented to the Parliament.

Chart A – Real GDP growth foreseen in the 2019 Italy's draft budget law and in the approved one
%



Source: Ministry of Economy and Finance, Aggiornamento del quadro macroeconomico e di finanza pubblica, December 2018.

Chart B – Deficit-increasing measures (in net terms) foreseen in the 2019 Italy's draft budget law and in the approved one - *% of GDP*



Source: Ministry of Economy and Finance, Aggiornamento del quadro macroeconomico e di finanza pubblica, December 2018.

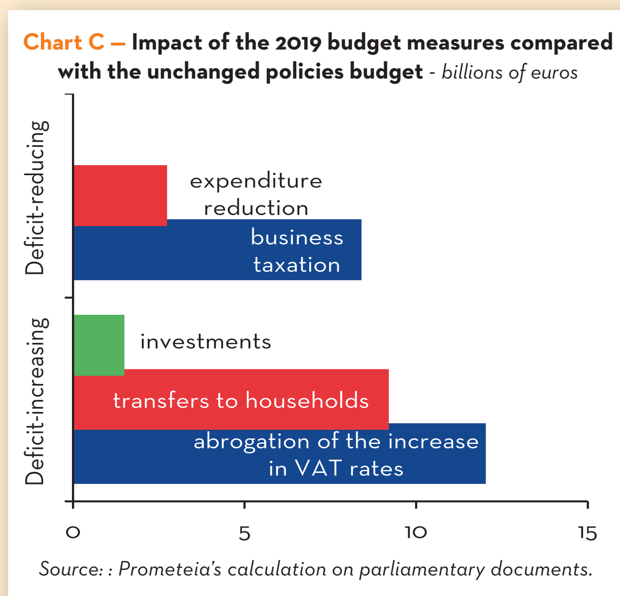
1 *https://ec.europa.eu/info/sites/info/files/economy-finance/7351969_letter_to_prime_minister_conte_and_minister_tria.pdf*

The revisions to the 2019 fiscal measures implied a reduction in their cost of about €10 billion (from €21.8 billion to €11.6 billion), implemented mainly through a €9 billion reduction in **expenditure**. The start of the two main expansionary measures, the citizenship income and the rolling back of pension reforms (the so called "Quota100"), has been delayed and the respective funds allocated to them have been reduced by €1.9 billion and €2.7 billion. Measures have been taken, also, to contain some pension entitlements. In addition, capital expenditure has been reduced by approximately €3.5 billion: the investment fund has been reduced from €3 billion to €1.5 billion, the cut in investment grants increased by €1 billion and a target of approximately €1 billion in real estate disposals has been included. On the **revenue** side, higher taxes amounting to some €1.7 billion are expected via the introduction of a web-tax, repeal of some tax credits and higher taxation on gambling.

Overall, although reduced by the amendments, **the fiscal package remains expansive for households**, which will benefit from an increase in transfers of around €9 billion, **and includes a small increase in investments** (Chart C). Financing will come mainly from the higher taxes imposed on firms, as foreseen in the original draft budget (and even higher in the final budget), and less from the reduction in expenditures.

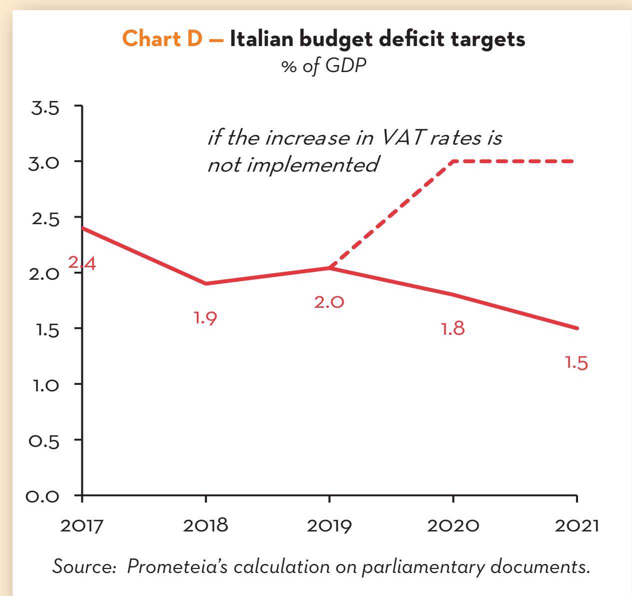
In 2020 and 2021, the net impacts of the budget on the deficit are expected to be €14 billion and €9 billion respectively, consistent with a small reduction in the target deficits. However, it should be noted that this scenario depends strongly on the VAT increases envisaged by the safeguard clause. To finance the increased resources allocated to current expenditure and investments, the expected proceeds from the increase in VAT rates are €23 billion, 1.2 per cent of GDP, in 2020 and €29 billion, 1.5 per cent of GDP in 2021. Net of these increases, the deficit will reach 3 per cent of GDP (Chart D).

Chart C – Impact of the 2019 budget measures compared with the unchanged policies budget - *billions of euros*



Source: : Prometeia's calculation on parliamentary documents.

Chart D – Italian budget deficit targets
% of GDP



Source: Prometeia's calculation on parliamentary documents.

Table 1 The world economy main indicators *% change*

	2017	2018	2019
World real GDP	3.7	3.7	3.3
World Trade	4.8	4.1	2.9
Manufacturing prices $	2.9	1.9	-0.7
Brent oil price ($/brl, level)	54.9	72.0	67.5
GDP			
- United States	2.2	2.9	2.3
- Japan	1.7	0.7	0.7
- EMU	2.5	1.9	1.2
- China	6.8	6.6	6.0
Consumer prices			
- United States	2.1	2.3	1.9
- Japan	0.5	0.9	1.2
- EMU	1.5	1.7	1.5
- China	2.9	2.0	3.4
$/€ exchange rate (level)	1.13	1.18	1.15
£/€ exchange rate (level)	0.879	0.884	0.894

Table 2 Italy main indicators *% change*

	2017	2018	2019
GDP	1.6	0.9	0.5
Imports of goods fob and services	5.6	2.0	1.9
Private consumption	1.5	0.6	0.6
Government consumption	-0.1	0.1	0.8
Gross fixed investment:	4.4	4.1	-0.2
- machinery, equipment, other prod.	6.5	5.5	-1.0
- constructions	1.9	2.2	0.9
Exports of goods fob and services	6.3	1.0	2.4
Domestic demand	1.4	1.2	0.3
Industrial production	3.7	1.2	0.8
Trade balance (% of GDP)	3.2	2.6	3.1
Terms of trade	-2.2	-1.6	0.8
Consumer prices	1.2	1.1	0.9
Per capita wages - manufacturing	0.5	1.0	1.5
Total employment	0.9	0.5	0.1
General government balance (% of GDP)	-2.4	-1.8	-2.3

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	1.13	1.14	1.16	1.17
	Yen	133.1	130.1	129.7	128.6	127.1	127.7	128.8	129.1
3 month interest rates (%)	US libor	2.00	2.40	2.40	2.67	2.73	2.80	2.85	2.85
	Euribor	-0.33	-0.33	-0.32	-0.32	-0.31	-0.30	-0.22	-0.07
10 year government bond yields (%)	US	2.76	2.92	2.93	3.04	3.18	3.30	3.30	3.29
	Germany	0.59	0.48	0.33	0.37	0.39	0.42	0.44	0.54
	Italy	2.01	2.24	2.83	3.29	3.24	3.14	3.02	3.02

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 Nov. 2018	**0.5**	**1.0**	**0.9**	0.7	2.9	0.5	0.5	0.4	0.4	2.4
	Brief Jan. 2019	**0.5**	**1.0**	**0.9**	0.6	2.9	0.5	0.5	0.4	0.4	2.3
EMU	Brief Nov. 2018	**0.4**	**0.4**	**0.2**	0.3	1.9	0.4	0.3	0.4	0.3	1.4
	Brief Jan. 2019	**0.4**	**0.4**	**0.2**	0.3	1.9	0.2	0.3	0.3	0.3	1.2
Italy	Brief Nov. 2018	**0.3**	**0.2**	**0.0**	0.1	1.0	0.2	0.3	0.3	0.4	0.9
	Brief Jan. 2019	**0.3**	**0.2**	**-0.1**	0.0	0.9	0.1	0.1	0.2	0.2	0.5

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based on data available up to 11th January 2019

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