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Italy in the Global Economy
Prometeia Brief

October 2017 – No. 17/6

Executive summary

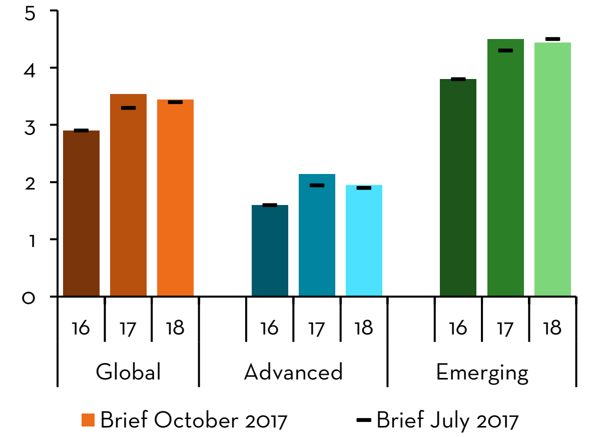
A stronger global recovery with a softer inflation outlook

- Global trade in 2017 Q2 continued to be surprisingly positive, thanks to the contribution of Europe and Asia, supporting our world trade revision with positive effects on global economic activity too (Chart 1).
- Inflation is edging up only gradually, and this trend is largely widespread in advanced and emerging economies, reflecting subdued wage pressures (see our first InFocus).
- In the EMU, the renewed dynamism of world trade and the increase in consumption support exports and reinforce a synchronized investment cycle.
- In the US we expect an annualized pace of growth in line with its potential in the next quarters, thanks to buoyant consumer and business confidence, despite political uncertainties.
- China is coming closer to the Party's national congress. In our opinion, after the October congress the government will tackle the reform agenda once again bringing about a moderate slowdown of economic growth.

Still good news for Italian growth

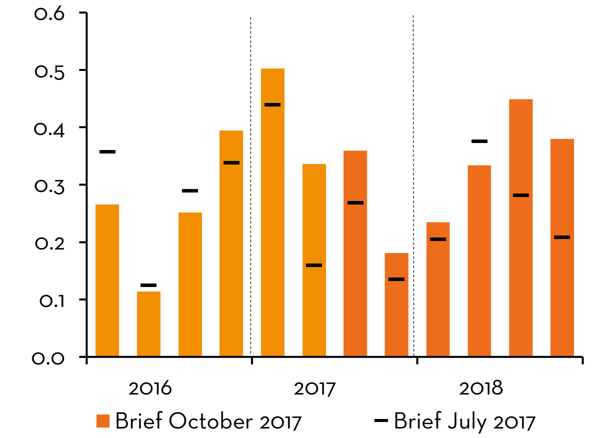
- In 2017 Q2 GDP was up to 0.3 per cent qoq, a slightly slower pace compared to the previous quarters; available information on the summer months is consistent with +0.4 per cent in Q3 (Chart 2).
- We have revised 2017 GDP growth upwards to +1.4 per cent from +1.2 per cent estimated in July, because of revisions of official historical data and a better than expected international context.
- In 2018, political uncertainty along with less favourable economic policies and the expected slowdown in global trade will slightly bring down growth to 1.2 per cent.
- Last summer, the stock of bad loans fell thanks to the sales carried out by a large Italian bank (UniCredit). More securitizations are currently under way and will lead to a further drop.
- Our two InFocus explore the weakness of inflation in the EMU and, the second, lays down a tapering scenario for the ECB.

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

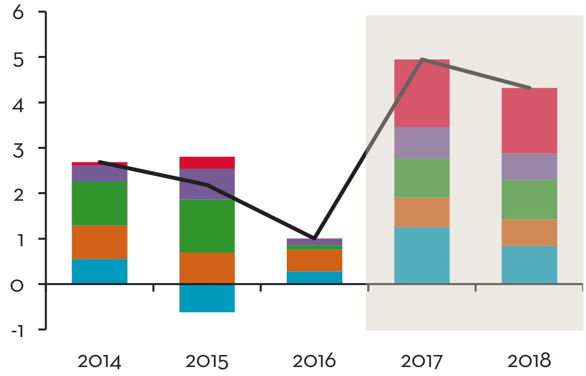
Resilient world trade … Prometeia's nowcasting models suggest an acceleration in world trade growth for the 2017 Q3, while August and September PMI show that economic growth remains robust in advanced countries and in most important emerging countries, supporting a synchronized expansion in global trade in the second part of 2017 and also in 2018 (Chart 3).

…comes together with a robust economic recovery in the euro zone. One of the surprises of the last few months is the strengthening of the European recovery. Compared with the July Brief, we have revised euro zone GDP growth up from 1.9 per cent to 2.2 per cent in 2017 and from 1.7 to 1.9 per cent in 2018 (see Table 1). The improved outlook stems in part from the revision of the Germany historical GDP data that deliver an investment performance in line with a buoyant cyclical expansion. At the same time, there has been a strengthening of the business investment cycle for most euro zone countries, positively affecting prospects for 2018. There are growing expectations regarding the reforms of the European governance, which should increase its cohesion and risk sharing. Slow progress in European integration is our baseline scenario, although the outcome of the German elections and the Catalan independence referendum pose some additional risks.

The beginning of balance sheet normalization is approaching, but inflation is still feeble in many countries. Modest inflation in the EMU (see first InFocus) and in the US will prevent a quick central bank policies normalization, while at the same time price dynamics are stabilizing in some important emerging market countries (Chart 4). In the EMU, the recent appreciation of the euro exchange rate and the need to avoid a taper tantrum suggest that the ECB will extend QE until the end of 2018, starting next January a gradual reduction of the amount purchased per month (see second InFocus), while policy rates will not be tightened until 2019. In the US, the Fed announced the start of balance sheet unwinding from October. We forecast one rate hike at the end of 2017 and two rate hikes in 2018 of 25bp each, less than those included in FOMC September projections.

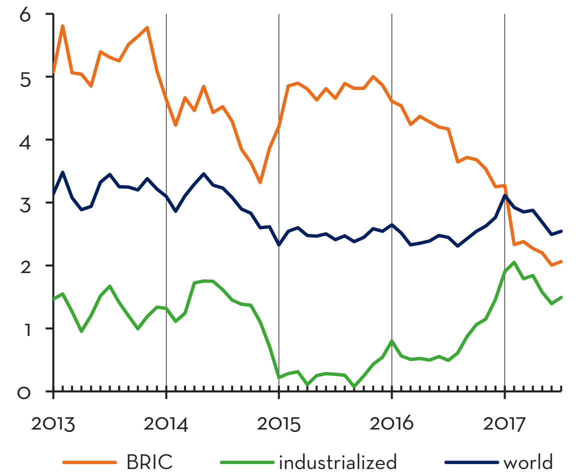
The dollar remains weak. Another surprise is represented by the depreciation of the US dollar in the last few months against the euro, a trend only briefly reversed by the German election and the Catalan independence referendum. We expect a weaker US dollar over all the forecasting period compared to our July projection, at about 1.17 against the euro until the end of 2018. The euro appreciation over the summer is partly explained by the overall reduction of political risks in Europe, as well as the simultaneous weakening of the Trump administration, marked by the emblematic failure of the Obama-care reform in Congress at the end of July.

Chart 3 World trade
% change yoy and pp contributions



Source: Prometeia's forecast.
** Includes intra-area trade.*

Chart 4 Consumer price inflation *
% change yoy



Source: Prometeia's calculations on National Statistical Offices.
** Weighted average of individual inflation rates based on PPP.*

Italy

The recovery is taking hold. The latest data show a GDP growth rate of 0.3 per cent in 2017 Q2, bringing the yoy growth rate up to 1.5 per cent. Investment in capital goods started to increase after the drop registered in the first quarter thanks to a number of factors, including fiscal incentives, improved demand prospects and favourable financial conditions. The greater contribution in the second quarter as compared to the first came from machinery and equipment expenditure (0.9 per cent vs. -5.1 per cent) and especially transport (8.9 per cent vs. 0.8 per cent), which remains the most dynamic component also in comparison to that of the other major European countries. Even if with a moderate pace compared to the previous quarters, household consumption growth was surprisingly positive, given that the rebound of inflation has contained real wages.

GDP is expected to grow by 0.4 per cent in 2017 Q3, according to the most recent releases of survey indicators and industrial production (Chart 5 and 6).

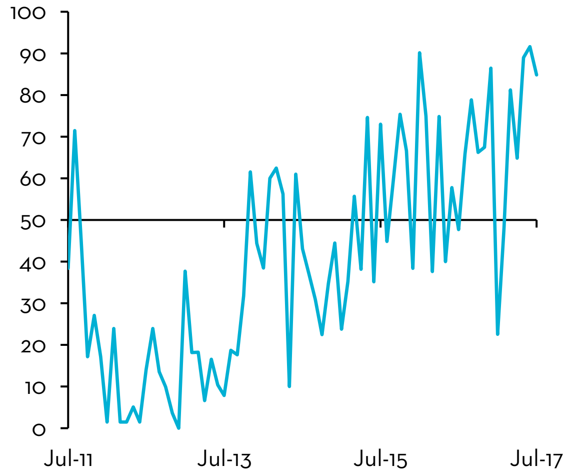
Some caution is needed for 2018. We expect GDP growth to slow down in 2018 from 1.4 per cent to 1.2 per cent, due to a less favourable foreign context and less expansionary fiscal policy at national level and monetary policy at EMU level.

The narrow path of fiscal policy. The budgetary policy will become mildly restrictive from 2018. As we predicted in July, in the recent Update of the 2017 Economic and Financial Document, the Government set the structural fiscal adjustment for 2018 at 0.3pp of GDP, well below both the 0.8pp set previously in April and the 0.6pp prescribed by the Fiscal Compact. In July, the European Commission accepted more flexibility in order to pursue an "appropriate balance between preserving current and future growth and ensuring fiscal sustainability". In our forecast, the fiscal stance is similar to that of the government, but the headline deficit will be higher, due to a slower GDP growth. The budget deficit is predicted to decrease to 1.8 per cent of GDP in 2018 from 2.1 per cent in 2017. The debt-to-GDP ratio will remain almost unchanged in 2017, but will start to decline from 2018.

Employment growth is still ongoing. The recent data show that the number of jobs with fixed-term contracts is rising again, partly due to the end of the fiscal incentives in favour of new permanent positions. Nevertheless, hours worked per capita have recently increased showing a reversal compared to the downward trend observed in the initial phase of the recovery. The increase in labour supply that has characterized the recent economic recovery – both in Italy and in the rest of the euro area – is expected to continue over the next few months. Although this is a positive element – especially for Italy with a very low participation rate – it will curb the reduction in the unemployment rate.

Consumer price inflation driven by energy and services. The recent fluctuations in headline inflation are the result of the rise in both the volatile component of energy and in core inflation.

Chart 5 **Italy: Prometeia's index of industrial production diffusion** *percentage weight of sectors with a positively yoy growth rate*



Source: Prometeia's calculations on Istat data.

Chart 6 **Italy: confidence climate index** *indexes 2010=100*

Source: Istat data.

In Italy, the recovery of core inflation over the last months was mainly driven by air transport and leisure services. However, in September, according to preliminary estimates, the growth rate of these prices slowed down significantly (services related to transport -4.6 per cent, services related to recreation -0.8 per cent), partially offsetting the increase in prices of unprocessed food (+1.2 per cent). Both of them were affected by seasonal factors. The base effects on volatile components - energy and unprocessed food - are expected to have the greatest influence on the dynamics of headline inflation in the coming months. In particular, we expect the energy component of inflation to fall from +6.1 per cent in 2017 Q2 to -1.2 per cent in the first half of next year, while the unprocessed food one to drop from +6.8 per cent in 2017 Q1 to -4.4 per cent in 2018 Q1. Overall, we expect headline inflation to fall to around 0.7 per cent in 2018 Q1 and to recover rapidly later on.

Credit growth is supported by a favourable economic environment. In July, household credit growth was in line with the EMU average (2.7 per cent yoy). On the other hand, loans to firms registered an annual growth of just above zero (0.5 per cent yoy), well below the EMU average (2.4 per cent yoy). However, improved confidence, fuelled by higher than expected GDP growth and the recovery observed in almost all sectors, may encourage banks to relax their lending criteria and supply credit to otherwise excluded firms. Positive signs are coming from the demand side of credit as well. The low interest rates and the improved real estate sector outlook have continued to support the demand for mortgages (2.1 per cent). Sustained household spending growth rates are also positively affecting the demand for consumer credit (8.9 per cent). Likewise, credit demand from non-financial corporations has increased, mainly supported by higher investment in capital goods.

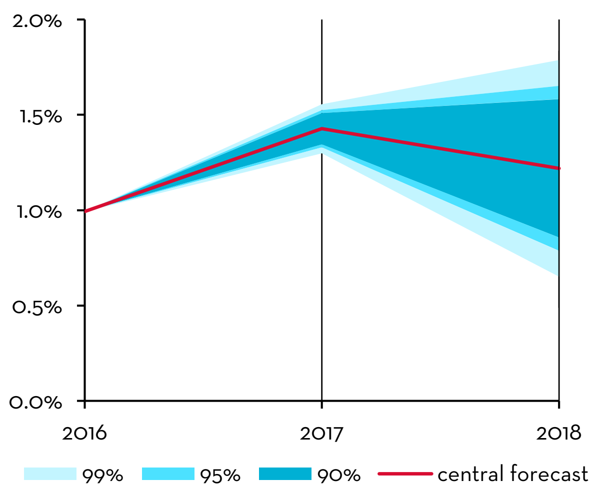
Interest rates remain unchanged. In July, interest rates for new loans to firms and for consumer credit remained unchanged. Meanwhile, interest rates for mortgages have continued to drop, although moderately (-3bp). In September, the 10-year BTP-Bund spread dropped to 166bp but it is expected to increase over the next months together with political uncertainty. After the general election, likely due next spring, the spread should fall slowly towards 160bp.

Banking sector shows positive signs. Investors have generally regained trust in the Italian banking sector. Among the contributing factors in this are the resolution of the recent banking crisis through the recapitalization of Monte dei Paschi and the liquidation of the two Venetian banks. Over recent months the stock of bad loans has fallen: in July, it fell to €174 billion, a level last seen in 2014, with a reduction of the stock by €27.3 billion (-12.4 per cent yoy) from the beginning of the year, including a reduction by €18.4 billion registered in July and associated with the operation carried out by UniCredit. We expect a further reduction of NPLs in 2018 thanks to the sales planned by the larger Italian banks and anticipated improvement of the economic cycle.

Risks to the projection

- Several risks arise from the political situation: the potential development of North Korea's nuclear programme; the Trump administration is still a source of uncertainty; the German elections and the Catalan independence referendum raise concerns on the prospect of European reforms.
- The situation in the international financial markets also may raises concerns because of developments in foreign exchange markets. Credit spreads are at a record low in the US and very compressed in the EMU as well.
- On the positive side, in Europe and in Italy in particular, the 2018 slowdown could be less intense than forecasted if emerging markets (China in particular) remain stable and keep supporting global trade.

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



Source: Prometeia's calculations.

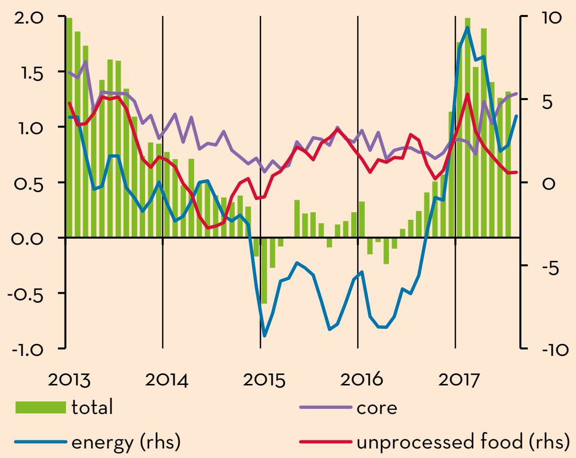
Euro area: waiting for inflation

Inflation in the euro area increased rather quickly in the early months of the year, reaching 2 per cent in February, but then fell again, stabilizing at 1.5 per cent in August. These fluctuations were driven by the most volatile components of headline inflation, i.e. energy and unprocessed food prices (Chart A). Conversely, there was a slow but steady increase in the core component, the one to which the ECB pays closer attention. Core inflation increased from values lower than 1 per cent in 2014 to the recent 1.3 per cent, showing a similar pattern in the major EMU countries. The greater positive contribution to the growth of core inflation came from services, compared to the contribution of processed food and non-energy industrial products, which was quite limited. In particular, the inflation acceleration from March to May 2017 was stronger in transport services (especially air transport) and leisure and tourism services (package holidays, hotels and restaurants). Within the euro area, Spain and Italy have accounted the most for the recent increase in services inflation, given their marked tourism vocation, compared to the stable and decreasing contributions of Germany and France.

The case of Germany continues to surprise. Being the country in the most advanced cyclical phase and closer to full employment, inflationary pressures should have appeared earlier and more intensively. This is partly happening for non-durable goods, but not in the services sector. The reasons explaining this behaviour are closely related to the labour market. The presence of a historically low unemployment rate (3.8 per cent) and an increase in labour market participation, suggest that the available labour force is gradually decreasing – despite rising migration flows in the last two years. This translates into an average wage increase higher than that of the euro area (Chart B). Studies on the Phillips curve show that the parameter that links the unemployment rate to inflation is lower in Germany compared to the parameter for other countries.[1] Under these circumstances, it seems difficult to imagine strong accelerations in wage growth in Germany. One should rather expect a slow adjustment of prices to this modest impulse deriving from labour costs.

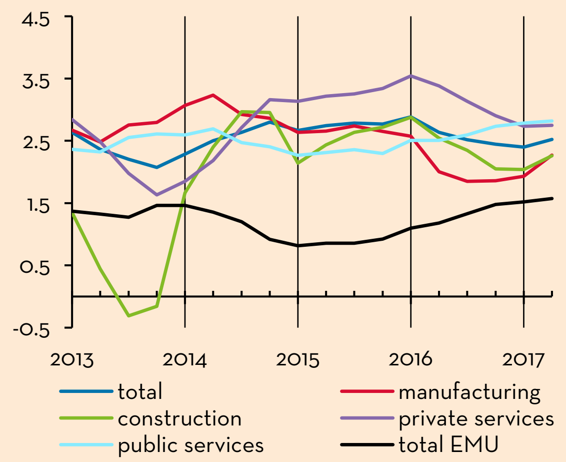
Therefore, a rise in inflation will have to rely mainly on the continuation of the euro-zone recovery, which will eventually affect wage growth. However, this process is expected to take time, justifying the ECB's cautious withdrawal of the current expansionary policies. We forecast that inflation will return to around 2 per cent only in 2019, when the end of tapering will leave room for the first rise in policy rates after 8 years.

Chart A EMU - Harmonized Index of Consumer Prices (HICP) *% change yoy*



Source: Eurostat.

Chart B Germany: per capita wage *% change yoy – 4 quarter moving average*



Source: Eurostat.

1 Blanchard, O., E. Cerutti and L. Summers (2015), Inflation and Activity: Two Explorations and Their Monetary Policy Implications, No WP15-19, Working Paper Series, Peterson Institute for International Economics; "Inflation and unemployment: the return of the Phillips curve?" June 17th 2016 Atlante Prometeia.

The path towards the end of QE

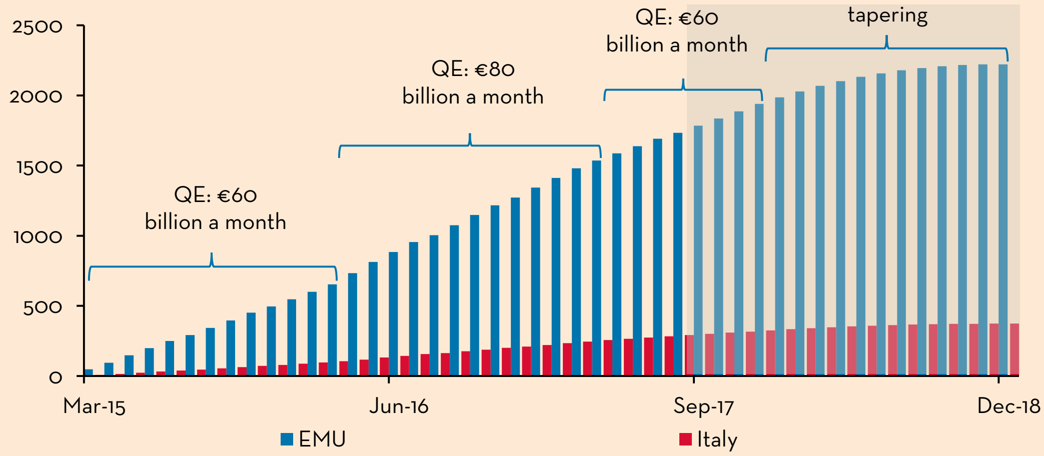
The Eurozone's recovery allows the ECB to begin discussions on tapering QE. However, the change of the Eurosystem's asset purchase programs after 2017 will need to be closely monitored because of its potential restrictive effects arising from the increase of market rates as well as an additional exchange rate appreciation.

Beginning from 2018, we assume a gradual reduction of the amount of bonds purchased. Until the end of 2017, the Eurosystem will continue to buy bonds for a value of €60 billion a month. Afterwards we expect new monthly purchases amounting to €5 billion less than those of the previous month until December 2018 when the asset purchase program will end. Under this scenario, according to our estimates, there is no shortage of bonds to purchase, German bonds in particular. Moreover, this bond-buying plan complies with both the capital key and the issue and issuer limits of 33 per cent. Nevertheless, some pressure may emerge from the supply side if German bonds holders are unwilling to sell - despite high prices - because of the lack of alternative low risk investment opportunities.

Since the beginning of QE in March 2015 and up to August 2017, the total amount of Italian government bonds purchased was equal to €291 billion with a remaining weighted-average maturity of 8.5 years. In August, the stock of Italian bonds purchased represented 18.6 per cent of the total eligible bonds for QE, i.e. those with a remaining maturity between 2 and 30 years. It should reach a total of around €326 billion by the end of 2017 (with a flow of €34.6 billion between August and December) and increase in 2018 by an additional €47.5 billion under our scenario (the estimated stock at the end 2018 is of €373 billion, Chart C).

What effect will the end of the ECB purchase programme have on the Italian government bonds market? In 2018, tapering will reduce the amount of Italian government bonds purchased to €47.5 billion, €69 billion less than those purchased in 2017. According to our calculations, in 2018 the ECB's operation will reduce the stock of bonds "available" to other investors by 0.7 per cent, compared to 5 per cent in 2017.[2] Some tension on the market may arise instead in the last two years of the forecast period, i.e. 2019 and 2020 when the additional net purchases will end. A

Chart C Purchase of government bonds under the PSPP
stock in billions of euros, latest available data August 2017



Source: Prometeia on ECB data.

2 As there is no detailed information on the ECB's portfolio composition, our calculations are based on the assumption that the purchases made under the PSPP mirror the composition of the stock of government bonds currently on the market.

further source of tension may arise between June 2020 and March 2021 when the Italian banks will have to repay the €243 billion borrowed during the four TLTRO II, of which €175 billion due in 2020. The liquid assets needed to repay the loan will affect banks' balance sheets and will also cause a reduction of bonds held in their portfolios, by an estimated €67 billion, which will go on the secondary market. This may have an impact on the long-term yield curve. We expect that the 10-year BTP-Bund spread will not fall below 150bp even until the end of 2020.

Table 1 The World Economy main indicators *% change*

	2016	2017	2018
World real GDP	2.9	3.5	3.4
World Trade	1.5	4.9	4.2
Manufactures prices $	-3.4	3.4	4.1
Brent oil price ($/brl, level)	45.1	52.7	53.3
GDP			
- United States	1.6	2.2	2.1
- Japan	1.0	1.4	1.3
- EMU	1.7	2.2	1.9
- China	6.7	6.9	6.3
Consumer prices			
- United States	1.3	1.7	2.2
- Japan	-0.1	0.4	0.6
- EMU	0.2	1.5	1.3
- China	1.9	2.8	2.7
$/€ exchange rate (level)	1.11	1.14	1.17
£/€ exchange rate (level)	0.818	0.873	0.861

Table 2 Italy main indicators *% change*

	2016	2017	2018
GDP	1.1	1.4	1.2
Imports of goods fob and services	3.3	5.3	4.0
Private consumption	1.5	1.4	1.2
Government consumption	0.5	0.7	-0.3
Gross fixed investment:	2.9	2.2	3.1
- machinery, equipment, other prod.	4.4	3.2	3.6
- costructions	1.4	1.1	2.5
Exports of goods fob and services	2.6	4.5	3.4
Domestic demand	1.2	1.6	1.4
Industrial production	1.9	2.6	2.4
Trade balance (% of GDP)	3.6	3.3	3.4
Terms of trade	3.2	0.1	0.3
Consumer prices	-0.1	1.3	0.9
Per capita wages - manufacturing	0.2	0.9	1.3
Total employment	1.4	1.0	0.4
General government balance (% of GDP)	-2.5	-2.1	-1.8

Table 3 Exchange Rates and Interest Rates

		17 Q1	17 Q2	17 Q3	17 Q4	18 Q1	18 Q2	18 Q3	18 Q4
Exchange rates vs euro	US dollar	1.07	1.10	1.18	1.19	1.18	1.17	1.17	1.17
	Yen	121.0	122.2	130.4	131.1	131.0	131.0	132.2	132.2
3 month interest rates	US libor	1.07	1.20	1.37	1.41	1.68	1.82	1.95	2.08
	Euribor	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.31
10 year government bond yields	US	2.44	2.26	2.24	2.27	2.39	2.58	2.65	2.75
	Germany	0.25	0.31	0.39	0.44	0.45	0.46	0.50	0.59
	Italy	2.15	2.17	2.09	2.16	2.32	2.41	2.25	2.25

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 July 2017	**0.4**	0.7	0.4	0.6	2.1	0.4	0.7	0.6	0.5	2.2
	Brief Oct 2017	**0.4**	**0.8**	0.5	0.4	2.2	0.4	0.7	0.6	0.5	2.1
EMU	Brief July 2017	**0.6**	0.5	0.4	0.4	1.9	0.5	0.3	0.4	0.3	1.7
	Brief Oct 2017	**0.5**	**0.6**	0.5	0.4	2.2	0.5	0.5	0.4	0.3	1.9
Italy	Brief July 2017	**0.4**	0.2	0.3	0.1	1.2	0.2	0.4	0.3	0.2	1.0
	Brief Oct 2017	**0.5**	**0.3**	0.4	0.2	1.4	0.2	0.3	0.4	0.4	1.2

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 6th October 2017

contributors: Maria Valentina Bresciani, Elizabeth Casabianca, Lucia Cossaro, Emilia Pezzolla

contact person: Stefania.Tomasini@prometeia.com, Lorena.Vincenzi@prometeia.com
tel. +39 051 648 0927 — +39 051 648 0933