Italy in the Global Economy
Prometeia Brief

April 2018 – No. 18/2

Executive summary

Global economy: good start in 2018 but risks from the US are increasing

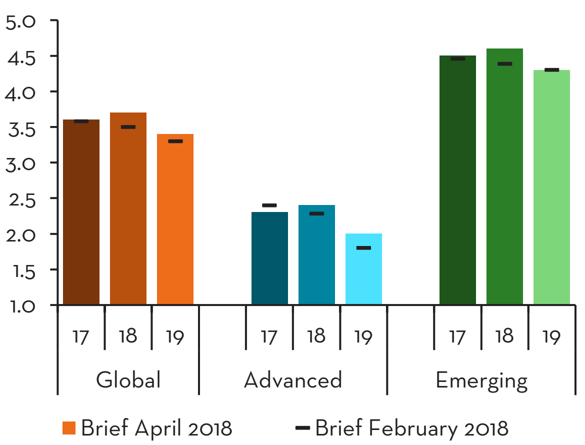
- World trade and global GDP have maintained their good pace since the beginning of the year. Despite volatility recently picking up, the outlook for 2018 indicates a continuation of the expansionary phase (Chart 1).
- In the US, robust domestic demand has been further boosted by the optimism regarding the short-run impact of fiscal policy; the strength of the economic expansion, however, may face setbacks should the inflation rise more sharply or protectionist threats be followed by widespread retaliation measures.
- In the EU, hard and soft data have decelerated somewhat in early 2018, but growth prospects remain solid in the near term.
- In emerging markets, PMIs survey showed improvement in the first quarter of 2018, confirming the gain in dynamism in some emerging countries, especially India and Eastern Europe.

Italy: moving forward at a slightly slower pace

- GDP growth in 2017, at 1.5 per cent, was one of the best in the last 15 years. Growth was sustained mainly by business investments, which were still supported by tax incentives, and by exports, despite the euro appreciation. Exports were favoured by an increase of world trade and a moderate price policy towards extra-EMU markets.
- In 2018, GDP growth is expected to be 1.4 per cent. We upward revised 2019 growth (Chart 2) due to a projected stronger world demand and a less restrictive fiscal policy.
- The recent general election resulted in a hung parliament. It will take some time to form a new government, which we expect will implement a mild fiscal relaxation compared to the plans of the previous governments.
- In the first InFocus, we examine alternative measures that have been proposed to support Italian households' income and in the second we discuss the impact of Italy's political uncertainty on the BTP-Bund spread.

Chart 1 – Real GDP

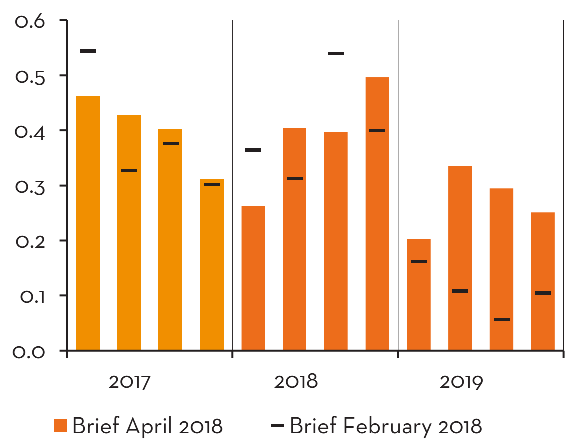
% change yoy



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

We see oil and raw material prices stabilizing at levels close to or slightly lower than the current ones during 2018, as supply is expected to return in line with projected consumption (Chart 3).

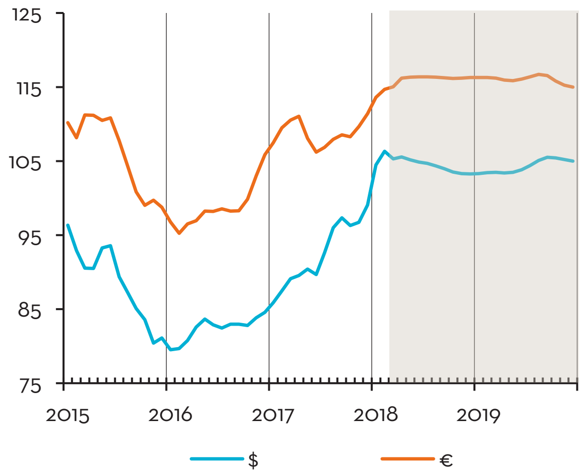
Increasing uncertainties on global trade. The hypothesis that the rising wave of US protectionism may trigger a spiral of retaliation measures in other countries, with significant adverse effects on world trade, remains unlikely, but still it increases uncertainties on the outlook for global trade.

Tensions in financial markets in February suggest that the process of monetary policy normalisation is not without risk, especially in the United States. Indeed, the Trump administration's recent fiscal measures might exacerbate inflationary risks. Compared to the February Brief, we have revised US headline consumer inflation (CPI) up to 2.5 per cent this year and we expect two other Fed funds rate hikes of 25bp each in 2018. For 2019, we keep the view of only one additional Fed funds rate hike and a flatter yield curve as GDP growth will start to decelerate (Table 3).

The euro area economy is expected to slow down marginally in 2018. Some soft data like manufacturing and services PMI in February and March seem to have peaked but a number of favourable factors have still sustained domestic demand beyond monthly volatility. Business investments will continue to expand and will be joined by the residential component, because the adjustment processes in the housing markets appear to have finally ended in a number of major eurozone countries. GDP growth rate is expected to slow but it will still outpace the estimated growth of potential output. Despite some signs of price pressures, core inflation remains muted and the ECB will patiently adjust its forward guidance. In our baseline scenario QE will end in 2018 Q4 and policy interest rates will hike in 2019: first the deposit facility rate by 15bp in July and then 25bp on all interest rate levels in 2019 Q3.

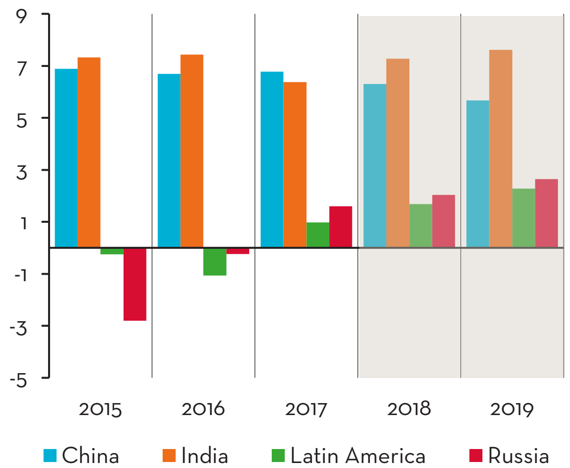
Activity across emerging economies will be supported by resilient growth in China and India, while Brazil and Russia continue the gradual recovery from deep recession thanks also to the improved purchasing power prompted by the rise in commodity prices. We confirm the path of

Chart 3 – Prometeia Commodity Price Index
monthly average, 2010=100



Source: Prometeia's forecast.

Chart 4 – Emerging countries GDP
% change yoy



Source: Prometeia's forecasts on National Statistical Offices.

mild deceleration starting in 2018 for China's GDP growth rate (Chart 4).

In 2019 a minor slowdown in world activity is expected due to less expansionary economic policies in advanced countries and more neutral ones in emerging markets (Tables 1 and 2).

Italy

Economic growth holds on, but is slowing down. In 2017 Q4 the GDP growth rate decreased slightly to 0.3 per cent from 0.4 per cent of the previous quarter. This deceleration was caused by final domestic demand, reflecting a moderation in investment (especially capital goods and non-residential construction) and private consumption (Chart 5). We expect the growth of industrial production to slowdown to 0.2 per cent qoq in 2018 Q1 (it was 0.9 per cent in 2017 Q4).

The main economic indicators suggest that the favourable cyclical phase will continue in 2018 at a pace similar to the last months of 2017 (1.4 per cent on average in 2018 compared to 1.5 per cent in 2017), reflecting the deceleration of world trade and the euro strength. This year and in the years to come, consumption will be supported by employment increases, the strengthening of income support policies (see first InFocus) and stable inflation, while investment and advanced digital technologies will continue to benefit from tax incentives.

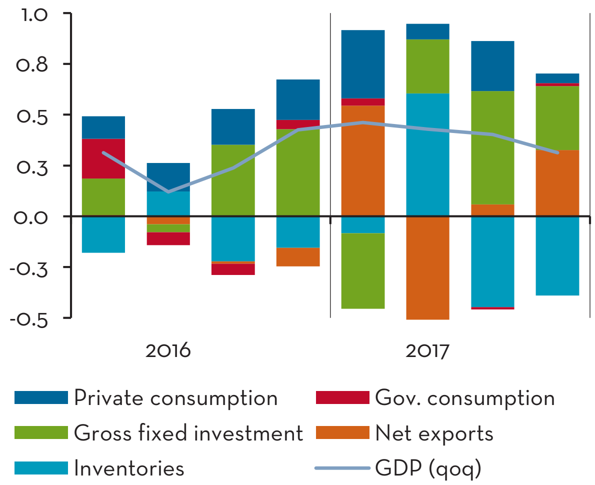
There are no signs of acceleration in inflation. Core inflation in Italy was 0.6 per cent in February (0.9 per cent in March), compared with 1.6 per cent in Germany, reflecting the current different cyclical phase and the recent reduction in non-energy and processed food inflation in Italy (Chart 6). Headline inflation is expected to remain subdued, slightly higher than 1 per cent in 2018.

Unemployment fell from 11.7 per cent in 2016 to 11.2 per cent in 2017 and is expected to reach 10.9 per cent in 2018. Employment is rising, but the pace of growth is slowing down. Among the employed, the number of those with fixed-term contracts is increasing.

Credit to the private sector increased in early 2018. Bank loans grew in January both in the euro area (3.2 per cent from 2.9 per cent per cent yoy in December 2017) and in Italy, where the increase was significant (2.7 per cent from 1.8 per cent yoy at the end of 2017). The growth in loans to households remained in line with the average of the euro area (2.8 per cent and 2.9 per cent yoy, respectively; Chart 7). The increase in loans to non-financial corporations was likely related to the banks' objective to exceed the ECB benchmark by 2.5 per cent, thus obtaining the lowest rate (-0.4 per cent) for the repayment of liquidity borrowed with the TLTROII. In fact, according to an analysis of Italian banks, up to the end of 2017 loans to businesses and households, net of mortgages, had not exceeded the benchmark, which, instead, was exceeded in January.

Chart 5 – Italy: contributions to GDP growth

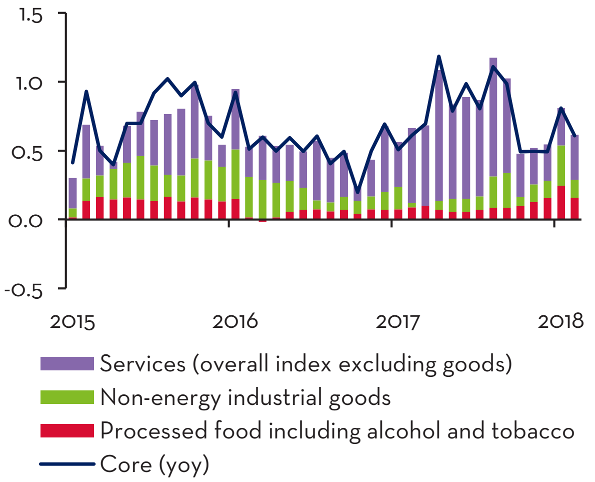
% change qoq, pp



Source: Prometeia's calculations on Istat data.

Chart 6 – Italy: contributions to core inflation

% change yoy, pp (latest data available February 2018)



Source: Prometeia's calculations on Eurostat data.

Credit supply conditions are stable, interest rates are at historical lows, real estate market prospects are improving and tax incentives[1] are still in place. However, the weakness of corporate

1 *Tax measures to support capital investment (super ammortamento), business capitalisation (ACE) and investment in advanced technologies.*

lending is expected to persist, particularly for SMEs, as a result of both supply and demand forces. On the one hand, banks remain cautious because of high capital absorption. On the other hand, firms have wide availability of internal resources. In addition, in 2017 corporate bond issues increased significantly (€34 billion of gross issues, €22 billion if net of redemptions) as well as Mini-Bond issues. Finally, since 2012 companies have accumulated more than €100 billion of liquidity to finance firms' economic activity.

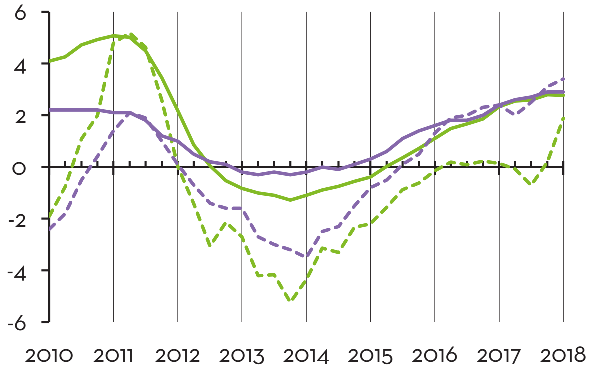
Asset quality has improved. The reduction in gross bad-loans continued in January, after a decrease of more than €33 billion in 2017, due to important bad loan write-offs. The construction and real estate service sectors, which account for almost half of the stock of gross bad-loans, are still characterized by a higher level of risk than the average of the whole economy (the ratio of bad-loans to loans is 32.2 per cent in the construction sector, more than twice as much as the economy as a whole, Chart 8). In 2017, the reduction in risky assets, profits and recapitalization operations allowed significant Italian banks (SFI) to increase their capitalization by 300bp, thus raising the Cet1 ratio of the nine banking groups to 13.3 per cent at the end of 2017.

Between 2016 and 2017, public finance indicators outperformed expectations. The deficit-to-GDP ratio fell from 2.5 per cent to 2.3 per cent.[2] Without taking into account the cash outflows provided to the Italian banking system the ratio is 1.9 per cent, whereas it was forecast to reach 2.1 per cent. The debt ratio fell from 132 per cent to 131.8 per cent of GDP. Moreover, the average cost of debt is at an all-time low, below 3 per cent. This has further pushed down interest expenditure, which reached 3.8 per cent of GDP, from 4.0 per cent.

The targets of the last government would imply a fiscal tightening, aiming for a balanced budget by 2020. Specifically, the sharp reduction of the deficit-to-GDP ratio expected in 2019 was supposed to be achieved through the legislated VAT increase (€12.5 billion of extra VAT revenues). For the time being, the fiscal policy targets of the new, not-yet-formed, government are still unknown.

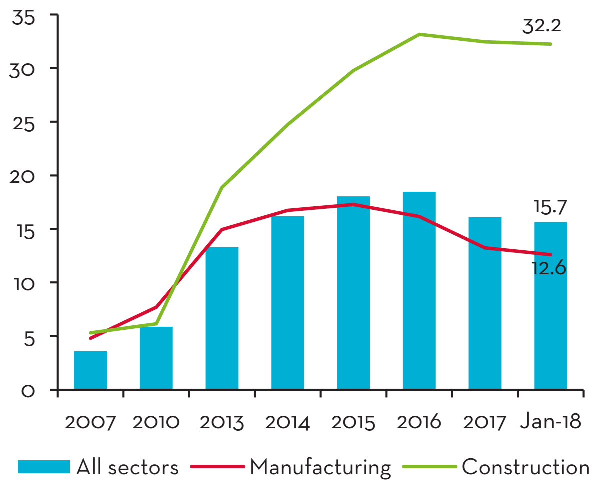
2 *On 4th April, following the opinion provided by Eurostat on the recording of transactions related to the resolution of Banca Popolare di Vicenza S.p.A and Veneto Banca S.p.A, Istat revised up the 2017 deficit-to-GDP ratio from 1.9% to 2.3%. Since these cash outflows are one-off expenses, they do not affect neither the structural balance nor the prospects for the results of the current year.*

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



Source: ECB and Bank of Italy.

Chart 8 – Ratio of bad loans to loans to non-financial corporations - %



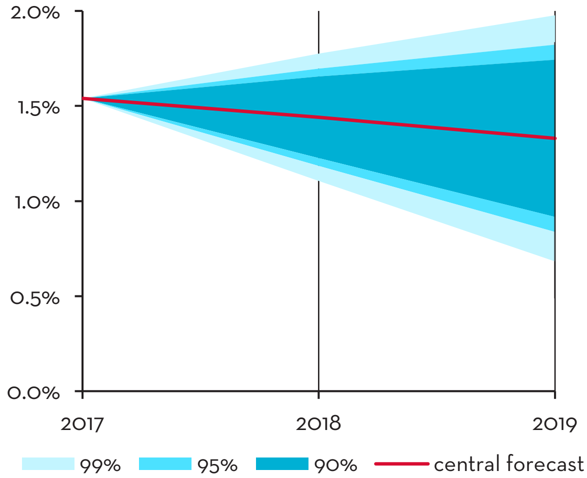
Source: Prometeia's calculations on Bank of Italy data.

Our baseline scenario for Italy incorporates a slowdown in the process of fiscal consolidation to partially address pre-election announcements. In 2019, the general government deficit is forecast at 1.6 per cent of GDP (the last government target was 0.9 per cent). This forecast is based on the assumption that the legislated VAT increase will not be implemented and that the resulting revenue loss will be compensated partially by higher revenues from increased tax compliance and partially by an increase in the deficit. The slowdown in the adjustment would open up room for additional expenditure of around €5 billion in 2019, which would include the enhancement of the Income inclusion programme (REI; see our first InFocus for an assessment of the recently approved REI and a comparison with the “citizenship income” proposed by the Five Star Movement). The underlying hypothesis of our baseline scenario is that the slowdown will not cause a confidence crisis, since, given current macro prospects, Italy’s debt is sustainable and the primary surplus is improving. Moreover, some factors are expected to shield the BTP-Bund yield spread from tensions, at least in the short run (see second InFocus).

Risk to the projection

- The protectionist measures introduced so far will have limited effects on world trade, but an escalation to a genuine trade war cannot be completely ruled out.
- Inflationary pressures in the US remain contained, however the scenario might change should the dollar depreciate sharply.
- The debate on European reforms could see opposition to deeper integration prevail, even though political leaders are aware of the need to develop risk-sharing and crisis management instruments to shield Europe from the threat of “redenomination” risks.
- The path we have outlined for Italy is based on the assumption that political leaders will find a way to reach governability and that the executive power will make sensible choices, especially regarding fiscal policy.

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



Source: Prometeia’s calculations.

InFocus 1

POVERTY ALLEVIATION IN ITALY: REI (INCOME INCLUSION PROGRAMME) VS “CITIZENSHIP INCOME”[1]

In the years following the financial crisis, poverty in Italy has increased and the economic and political debate has focused on how best to respond to the issue.

In 2017, the Italian Government introduced the Income inclusion programme (REI), a national minimum income scheme.[2] REI is a categorical measure, subject to means-testing – the criterion is based both on assets and income – and is conditional on participation in a job placement scheme. Our simulations show that REI would ensure support to 45.8 per cent of absolute poor households and 22.5 per cent of households at risk of poverty.

In order to reach a larger proportion of the poor and lift them out of poverty, some are in favour of

1 *All simulations are performed on the 2016 Italian module of EU-SILC (European Union Statistics on Income and Living Conditions) survey data (Istat-Eurostat).*

2 *For more details on REI as outlined in Legislative decree no. 147/2017, see: Prometeia (2017), “The introduction of minimum income in Italy: challenges and outcomes”, Prometeia Discussion Note No. 03, available at https://www.prometeia.it/en/research/position-note/archive.*

strengthening the measure, while others have put forward alternative schemes. Currently, the most discussed alternative is the introduction of a "citizenship income", which, according to the economic theory, should be universal, unconditional and not subject to means-testing.

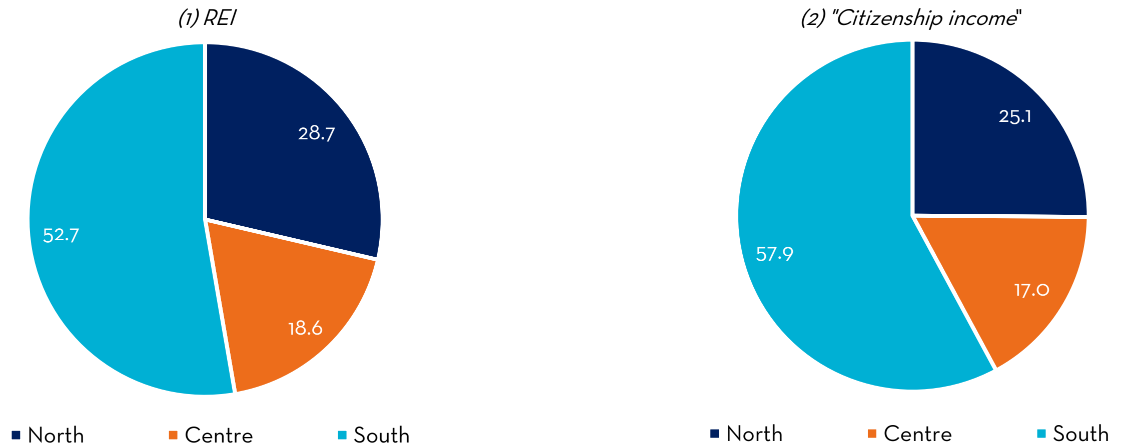
However, in practice "citizenship income" – in the form outlined in a bill submitted by the Five Star Movement in 2013 – falls within the category of minimum income.[3] The proposed version of "citizenship income" is selective, i.e. targeted at households with an income below the at-risk-of-poverty threshold. It is conditional on participation in a job placement scheme when the benefit is provided to unemployed people.[4] It is means-tested, even though, in contrast to REI, the means-testing criterion is based only on income (and not also on wealth).

The amount granted by the "citizenship income" is higher than that of REI because, unlike REI, it aims to fill the gap with the at-risk-of-poverty threshold, which in 2016 amounted to €812 for one person and gradually increased with the number of household components according to the equivalence scale.

We estimate that, when fully operational, REI will cost €2.4 billion, and a beneficiary household would receive, on average, €2500 per year. "Citizenship income" would cost €29 billion and the annual benefit amount would be €5800 per household, on average. If, on the other hand, it was granted only to at-risk-of-poverty households in which at least one member is unemployed, the cost is estimated at €12.8 billion, with an average annual benefit of €8200 per household. The distribution of expenditure by geographical area (Chart A) shows that both for REI and "citizenship income" more than half of the resources are distributed to the South (52.7 per cent and 57.9 per cent, respectively).

Chart A — The distribution of expenditure by area: with both schemes, more than half is directed to the South of the country

%



Source: Prometeia's simulations on EU-SILC.

3 *Bill No. 1148 of 29 October 2013.*

4 *It seems that for employed individuals, the benefit is conditional on the participation, for a limited number of hours per week, in socio-cultural projects at local level.*

InFocus 2

IS THE SPREAD NO LONGER CAUSING CONCERNS?

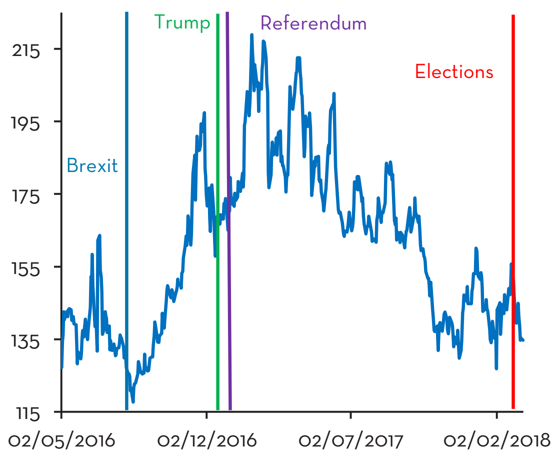
After the 2011 crisis, Italy's public debt market was not affected by other acute tensions, mainly thanks to the monetary policies implemented by the ECB. The likely end of the ECB's purchases from September 2018, together with the increased uncertainties created by the outcome of the recent general elections, suggest that conditions would be less favourable this year, and volatility, together with the risk premium, might increase. This has not been the case so far. Even after the election outcome, the spread fell (Chart B).

The question is whether the deterioration in the risk premium of Italian sovereign bonds can be expected to remain limited. The coming institutional deadlines (i.e. the update of the Economic and financial document due next September and the new budget law in the autumn) might highlight the stalemate in forming a new government or a possible change of the fiscal policy stance if a government is in place.

There are a number of elements that might contain the spread going forward. Firstly, debt is currently decreasing, although at a very slow pace, and the debt dynamic points to further reductions (the primary surplus is close to 2 per cent, while the average cost of the debt is below 3 per cent, therefore a nominal growth of about 1.5 per cent is enough to stabilize the debt ratio). Moreover, the volume of Italian sovereign bonds held for short-term investment activities has declined significantly in recent years as more than 50 per cent of Italian government bonds are in the portfolios of so-called "patient" holders and the exposure to foreign investors, potentially less stable, is now at a relatively low level: the share of Italian securities held by non-residents fell from 50 per cent in 2009 to 35.8 per cent at the end of 2017 (33 per cent if we do not consider those on the ECB's balance sheet). Government bonds held by the Bank of Italy and financial and monetary institutions reached €670 billion at the end of 2017 (36.5 of the total, Chart C). In addition, medium/long-term gross Treasury issues in 2018 will be lower than in 2017.

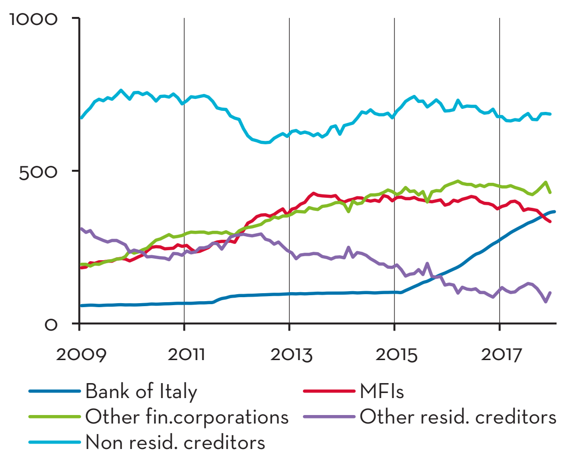
However, the end of Quantitative Easing will certainly have an impact. In 2017, the €126 billion used by the ECB for net purchases and renewals of Italian sovereign bonds covered 48 per cent of gross bond issues with a maturity of more than two years. This amount is estimated to decrease to around €50 billion (25 per cent of gross issues) in 2018 and to €35 billion (16 per cent of the total) in 2019.

Chart B – BTP-Bund spread (10Y)
daily data in basis points



Source: Thomson Reuters.

Chart C – Government bonds by holder
billion euro



Source: Bank of Italy.

Table 1 The World Economy main indicators *% change*

	2017	2018	2019
World real GDP	3.6	3.7	3.4
World Trade	4.9	4.6	4.2
Manufacturing prices $	3.6	6.1	1.9
Brent oil price ($/brl, level)	54.9	64.1	63.4
GDP			
- United States	2.3	2.8	2.3
- Japan	1.7	1.5	1.1
- EMU	2.5	2.3	1.8
- China	6.8	6.3	5.7
Consumer prices			
- United States	2.1	2.5	2.0
- Japan	0.5	0.8	1.2
- EMU	1.5	1.6	1.5
- China	2.9	2.6	2.3
$/€ exchange rate (level)	1.13	1.20	1.20
£/€ exchange rate (level)	0.876	0.889	0.894

Table 2 Italy main indicators *% change*

	2017	2018	2019
GDP	1.5	1.4	1.3
Imports of goods fob and services	5.7	4.7	4.3
Private consumption	1.3	1.3	1.3
Government consumption	0.1	0.3	0.1
Gross fixed investment:	3.9	3.8	2.5
- machinery, equipment, other prod.	6.0	5.7	3.2
- constructions	1.4	1.6	1.5
Exports of goods fob and services	6.0	4.1	4.1
Domestic demand	1.4	1.6	1.4
Industrial production	3.7	3.3	2.5
Trade balance (% of GDP)	3.3	3.2	3.0
Terms of trade	-1.6	-0.2	-0.6
Consumer prices	1.2	1.2	1.2
Per capita wages - manufacturing	0.5	1.3	1.6
Total employment	0.9	0.5	0.3
General government balance (% of GDP)	-2.3	-1.8	-1.6

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	1.20	1.19	1.18	1.18	1.19	1.20	1.21
	Yen	134.4	130.8	133.3	133.7	134.5	13.6.3	137.4	137.9
3 month interest rates (%)	US libor	1.89	2.10	2.33	2.40	2.60	2.60	2.60	2.55
	Euribor	-0.33	-0.33	-0.33	-0.32	-0.32	-0.32	-0.09	0.08
10 year government bond yields (%)	US	2.77	2.90	2.99	3.07	3.20	3.19	3.17	3.17
	Germany	0.60	0.67	0.69	0.80	0.95	1.10	1.18	1.26
	Italy	2.01	2.30	2.24	2.60	2.75	2.90	2.97	3.00

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 Feb 2018	0.4	0.8	0.7	0.5	2.6	0.5	0.7	0.4	0.5	2.3
	Brief April 2018	0.5	0.8	0.8	0.6	2.8	0.4	0.6	0.6	0.5	2.3
EMU	Brief Feb 2018	0.6	0.5	0.4	0.4	2.3	0.4	0.4	0.4	0.3	1.6
	Brief April 2018	0.5	0.5	0.4	0.4	2.3	0.4	0.5	0.5	0.3	1.8
Italy	Brief Feb 2018	0.4	0.3	0.5	0.4	1.5	0.2	0.1	0.1	0.1	0.9
	Brief April 2018	0.3	0.4	0.4	0.5	1.4	0.2	0.3	0.3	0.3	1.3

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