# ITALY IN THE GLOBAL ECONOMY
# PROMETEIA BRIEF

prometeia ASSOCIAZIONE

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## Executive summary

### *Global growth remains solid, but risks are looming*

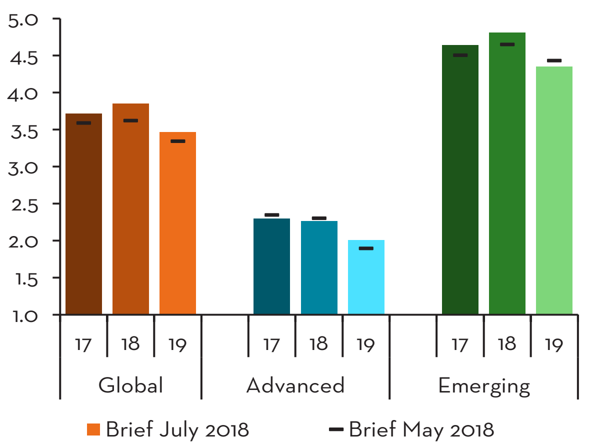
- Risks of escalating trade tensions are increasing. Nevertheless, the global economy continues to grow at a good pace and we reconfirm our forecast of a sound global growth in 2018 with a deceleration in 2019 (Chart 1), while revising downward trade growth (from 4.6 to 4.3 per cent).
- The US economy is expanding at a fast pace supported by significant fiscal stimulus introduced by the Trump administration. China continues to grow as expected while the Euro area economy slowed in 2018 Q1, following very high growth in 2017.
- On average, in the first four months of 2018, world trade increased above 4 per cent yoy with renewed vigour mainly in Asian developing countries, despite fears of rising tariffs (see InFocus 1).
- Oil prices reached $75 per barrel as the market continued to expect supply restrictions: the Iran ban and disruptions to Libyan and Venezuelan outputs are threatening to curb total supply. In our scenario, OPEC and Russia will increase their supply to an amount sufficient to avoid further strain on prices.
- Some emerging markets are facing difficulties in the international capital markets as the strength of the US dollar puts pressure on their foreign currency denominated debt.

### *Italy is struggling with political uncertainty*

- We have revised 2018 GDP growth downward to 1.2 per cent (from 1.4 per cent), due to the less supportive external environment and increased domestic uncertainty.
- During the last part of May, discussion of budgetary policies by the incoming government put serious strain on the Italian government bond and stock markets.
- The BTP-Bund spread is not expected to fall back to the levels experienced at the beginning of 2018, given the uncertainty linked to the definition of the budget law for 2019, which will be resolved by the end of 2018.
- We expect the government to deliver on some of its electoral promises and to allocate some resources to households and public investment, while keeping the public debt on a slightly declining path. The deficit-to-GDP ratio is projected at 2 per cent in 2019, about 1 percentage point of GDP higher than the target at unchanged legislation.
- Our second InFocus highlights the impact of different budget policies on the trajectory of the public debt-to-GDP ratio and gross financing needs.

**Chart 1 – Real GDP**

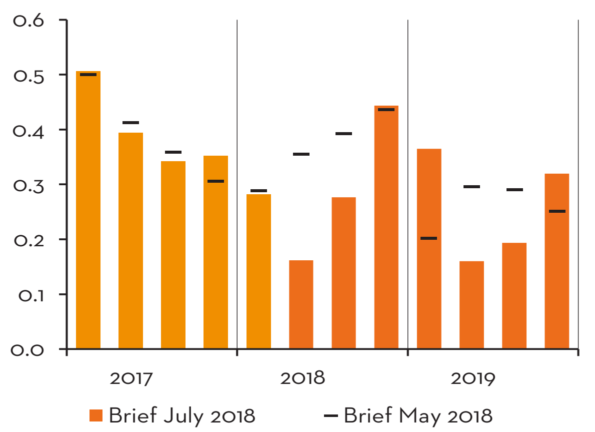
*% change yoy*




*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

**The US economy grew at a fast pace in 2018Q1**, at 2.8 per cent yoy with the usual deceleration in Q1 (0.5 per cent qoq vs 0.7 in 2017 Q4). The deceleration was broad-based, but did not involve business investment which grew at 7 per cent yoy. Recent indicators show that the economy is in good shape and that both households and firms should contribute to an accelerated GDP growth in Q2. CPI inflation in May was 2.7 per cent, due only partly to the higher oil price (Chart 3).

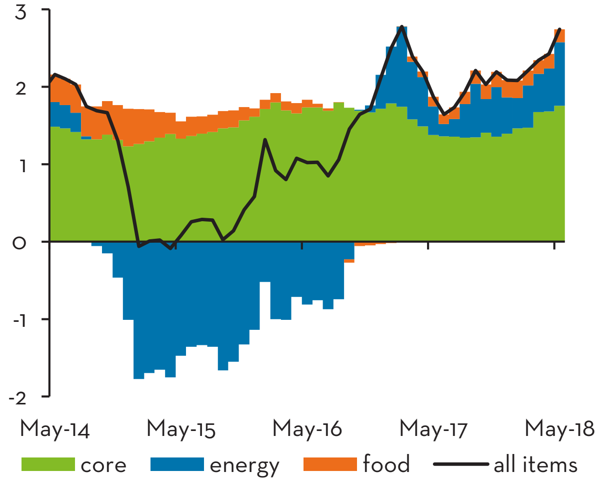
**All the major euro area countries fell short of expectations in 2018 Q1** reflecting the poor performance of exports, probably affected by the strengthening of the euro in 2017, weak investment and some exceptional factors. Most recent indicators show some stabilization of confidence among firms but uncertainty about external demand could limit investment. In the meantime, consumption continues to be the main driver of growth thanks to a healthy labour market and improvements in real incomes. A mild downward revision of GDP growth (2.1 per cent vs 2.3 forecast in the May Brief) reflects the weak first quarter followed by an expected stabilization in subsequent quarters.

**Monetary policy remains supportive worldwide.** ECB will end QE in December and, most likely, will increase interest rates in December 2019 following an increase in the deposit facility rate in September 2019 aimed to restore policy rate corridor symmetry. Even China, despite its aim to reduce credit growth, has proven more committed to GDP growth, freeing around $150 billion from required reserves in anticipation of the possible negative impact of protectionism on Chinese firms. On the contrary in the US, the Fed has raised policy rates and has expressed its intention to continue the gradual reduction of its portfolio assets.

**Expansionary or neutral fiscal policy in major economies.** In the US, fiscal policy is replacing monetary policy to support growth; in Japan, they continue to work in tandem; while in the EMU a mild fiscal expansion is expected as some measures to support investment and real income are expected to be enacted in Germany. In many emerging countries, fiscal policy also remains supportive and focused on investments.

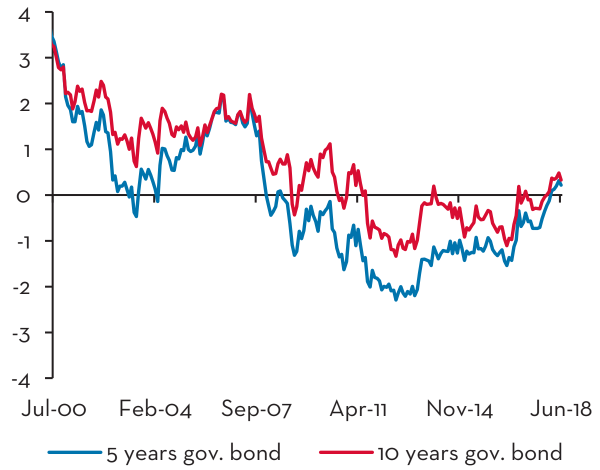
**On July 7th, the first shot was fired in a commercial war between the US and China**, with tariffs imposed on $34 billion of imports. The US

**Chart 3 – US: CPI headline inflation and contributions** - *% change yoy, pp*




*Source: Bureau of Labor Statistics.*

**Chart 4 – US: Real long-term yields** - *pp, deflated with 5 year ahead expected inflation*




*Source: Prometeia's calculations, Thomson Reuters, Univ. of Michigan.*

administration is ready to hit a further $400 billion of imports from China plus imports related to the automotive sector from Europe, and is trying to discuss new conditions with NAFTA partners while threatening to impose more tariffs. So far, we view the US stance as a negotiating strategy, aimed at bringing the trading partners to the negotiating table. The economic consequences of the measures taken so far are relatively limited.

**Monetary policy normalization and growing US public debt are pushing up long-term yields and supporting a strengthening dollar** (Chart 4). This modifies the risk/return mix in international markets in an unfavourable way for the emerging countries. Mainly for the most heavily indebted, the pressure on the currencies will increase, limiting their growth.

# Italy

**In 2018 Q1, GDP growth slowed** to 0.3 per cent qoq from 0.4 per cent in 2017 Q4, as a result of a reduction in exports (-2.1 per cent) and investment (-2.4 per cent). In contrast, the largest contribution to GDP growth came from the marked build-up of stock inventories (Chart 5) and from private consumption expenditure, which accelerated to 0.4 per cent qoq, after coming to a halt at the end of 2017. A favourable wealth effect (due to stock-market dynamic) and improved consumer confidence had sustained the propensity to consume despite the mild decline in real household disposable income.

**Investment at a standstill.** While the reduction in exports was shared by the major European countries, the reduction in investments hit Italy in particular. Specifically, investment in machinery and equipment fell by 5.1 per cent qoq, confirming the difficult recovery from the crisis despite tax incentives, while the positive transport equipment cycle continued (Chart 6).

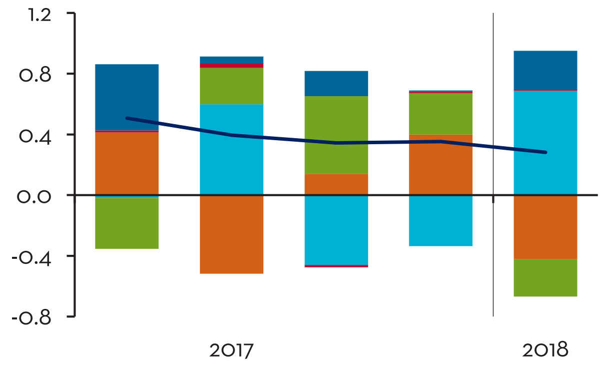
**A further slowdown is expected in 2018 Q2**, suggested by the negative industrial production dynamic (-0.4 per cent according to our forecast for 2018 Q2, despite the May rebound) and the stabilization of survey indicators. As in the rest of euro area, the deceleration over the last few months has been due to temporary factors. We expect GDP growth to recover to 0.3-0.4 per cent over Q3 and Q4. Average annual GDP is expected to grow at 1.2 per cent in 2018 after a peak of 1.6 per cent in 2017, with moderate growth forecast for 2019.

**The cost of political uncertainty.** Uncertainty, at the end of May, about the new government's economic policy, led to a sharp worsening in the country's risk assessments. The spread BTP-Bund increased by more than 100bp, back to 2013 levels, and the stock market index fell by 12 per cent (-19 per cent for banking sector shares), a deterioration that likely will not be fully reversed in the coming months. This will result in a 0.2pp lower GDP growth in 2019 than we had previously estimated, and in an increase in public interest expenditure of €2 billion.

**The still-to-be-defined 2019 budgetary policy.** The 2019 budget will be defined in September, when the Update of the Economic and Financial Document (EFD) is published. The new government is expected to make its budgetary targets less restrictive compared to those set in the April 2018 EFD, which entailed a reduction in the headline deficit to 0.8 per cent of GDP in 2019, underpinned by the so-called "safeguard clause" (a previously legislated increase in VAT rates), worth €12.5 billion of additional VAT revenues.

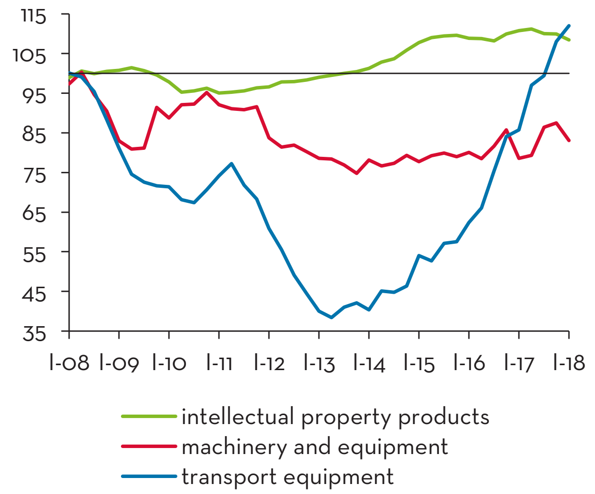
**Slightly expansionary fiscal stance in our scenario.** In line with the Minister of the Economy's statements, we consider the objective of reducing the debt-to-GDP ratio to be paramount. At the same time, we expect measures to be implemented to support household incomes (especially through the strengthening of the income inclusion programme,

**Chart 5 – Italy: Contributions to quarterly GDP growth** *% change qoq, pp*




*Source: Prometeia's calculations on Istat data.*

**Chart 6 – Italy: Gross fixed capital formation - Machinery and equipment breakdown**
*indexes 2007-Q4=100*




*Source: Prometeia's calculations on Istat data.*

REI) and economic activity (by increasing public investment). Overall, these additional measures could cost €8 billion in 2019. As stated in the May Brief, we see no prospect of a VAT increase. The headline deficit is therefore projected to increase to 2 per cent of GDP in 2019 from 1.8 per cent in 2018, corresponding to a worsening in the structural primary balance by 0.3pp. The effect on economic growth of this fiscal easing will contribute to offsetting the effects of a less supportive external environment (due to a less expansionary monetary policy and lower growth of world demand) and an increase in the expected consumer price inflation.

**Headline inflation accelerates due to higher oil prices.** The increased prices of energy products raised headline inflation to 1.5 per cent in June, well below the EMU average (2 per cent in May). However, there are no clear signs of an acceleration in core inflation, which has fluctuated around 0.8 per cent since the beginning of 2018, reflecting the high variability of services, especially travel and tourism. Imported inflation is expected to support domestic inflation, which should increase up to 2.1 per cent by 2018 Q4, with an average of 1.4 per cent in 2018 and 1.5 per cent in 2019.

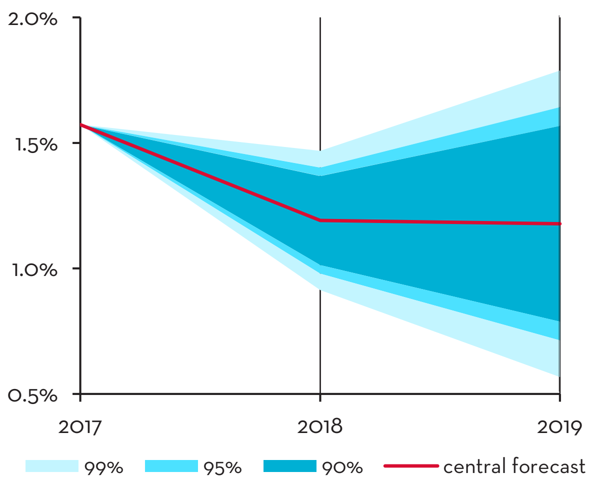
**Labour market conditions are improving, but sectoral differences are increasing.** The unemployment rate fell to 11.1 per cent in 2018 Q1, still above the pre-crisis level. The number of manufacturing sector employees decreased, in line with weak industrial production dynamics, while private services and public administration employment continued to grow, in the latter case, based on increased recruitment following ten years of continuous contraction. The number of self-employed workers has continued to fall. The outlook remains positive, but perhaps is more uncertain for two main reasons. Economic activity will continue to grow, but at a slower pace than in the last three years, implying lower demand for labour, and the fiscal incentives introduced in 2018 to support youth employment on permanent contracts are less generous than those introduced in 2015 (which are due to expire by the end of 2018).

**Credit supply conditions continue to be favourable** due to increased competition among banks: interest rates on loans decreased further, while access to credit increased for both households and most businesses, except those in the construction sector and small and medium-sized enterprises. The effects of the increased sovereign risk following the tensions in May are expected to increase funding costs but not to have a significant impact on banking aggregates. Credit to firms should remain fairly contained due to more self-financing options and equity and bond issues.

## Risks to the projection

- The trade war could spread further, with possible disruptions to global trade and activity given the larger amount of goods and of trading partners that could be involved.
- The dollar could strengthen further, putting additional pressure on emerging countries.
- Oil prices could rise higher than forecast, triggering faster inflation growth, denting households purchasing power and more rapid response of monetary policies, thus, limiting growth.
- The worsening of the international context could exacerbate the fragilities in the Italian economy, which already is exposed to an increased sovereign risk.

**Chart 7 — Italy: Prometeia's forecast of annual GDP growth -** *Central projection and confidence levels*




*Source: Prometeia's calculations.*

# COSTS OF PROTECTIONISM: SOME MACROECONOMIC ASSESSMENTS

**International investors consider a trade war to be the event that would jeopardize global growth the most.** The risk of a trade war is growing in line with US announcements of new rounds of tariff increases on imports from China and, possibly, on the European automobile sector.

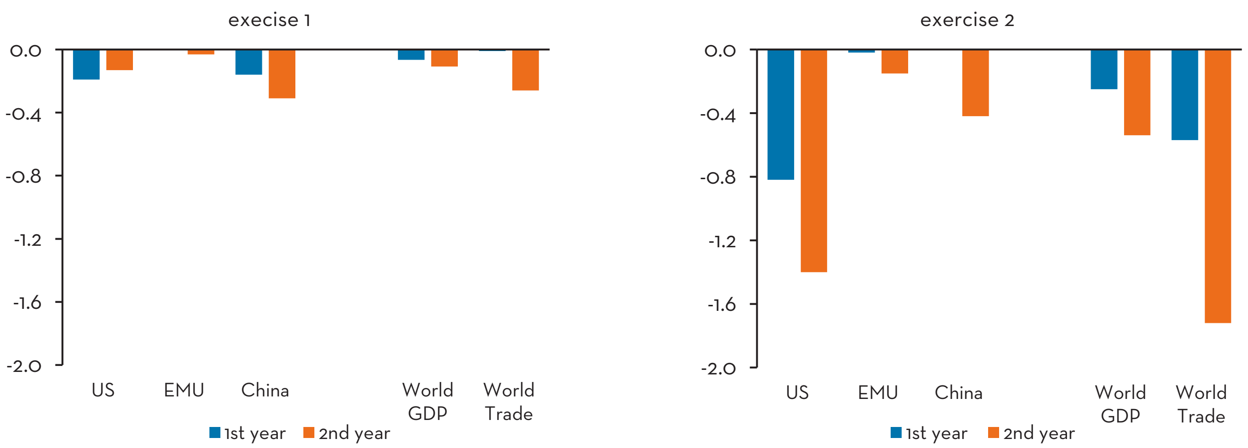
**Using the Prometeia international model we have tried to evaluate the effects on the global economy of these protectionist measures.** This assessment does not include the possible effects of increased uncertainty and of expectation of lower growth. In a first step, we simulated a 10 per cent US tariff on $250 billion worth of imports from China, and a Chinese retaliation of the same amount. In a second step, we assumed a 10 per cent US tariff on imports from all its trade partners, which also retaliate by imposing a 10 per cent tariff on all their imports from the US, but not from other partners.

**In both exercises, global GDP and international trade growth would be lower than in the baseline.** In the case of a bilateral US-China "war", the higher cost (measured as lower GDP growth after the first 2 years) would be paid by China (Chart A exercise 1) since the export value involved ($250 billion) is a larger share of China's GDP than of US GDP. In the case of a multilateral "war" (US vs all its main trading partners), the loss of GDP growth for the US would be higher compared to the trading partners (Chart A exercise 2) since the US would impose tariffs on all its imports and would face tariffs on all its exports, while the other areas (China, EMU, NAFTA) would face tariffs only on the bilateral trade with the US.

**The effects of higher tariffs would spread through higher import prices affecting the expenditure decisions of both households and firms.** In absence of a rapid substitution of imported goods by domestic production or imports from other (perhaps duty free) countries, the rise in import prices would trigger a rise in domestic prices. Domestic companies production costs would increase and households' purchasing power would decrease, producing a negative effect on investment and consumption growth. For firms, higher production costs could reduce their ability to compete internationally with negative effects on exports. Higher domestic inflation, especially in second round effects on wages, could put pressure on the central banks to hike policy rates, giving a further and widespread contractionary impulse to domestic demand.

**But there are also other consequences**: higher uncertainty and worsening of growth expectations could increase risk aversion and risk premiums, and reduce confidence among both households and companies, with a negative effect on consumption and investment growth prospects.

**Chart A — Trade protectionism: effects on real GDP** - *% difference from baseline*




*+10% US tariffs on 250 bln$ of imports from China and Chinese retaliation of the same scale*

*+10% US tariffs on all imports from all trade partners and retaliation of the same scale*

*Source: Prometeia's calculations.*

InFocus 2

# ITALY'S PUBLIC DEBT IN DIFFERENT DEFICIT SCENARIOS

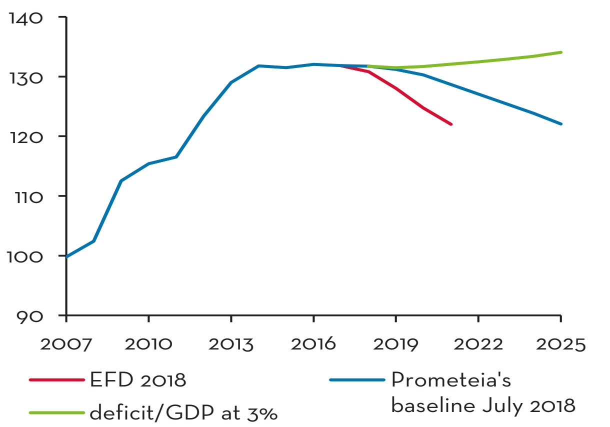
**The high level of public debt remains a major source of vulnerability for the Italian economy.** While refinancing risks are contained in the short term, thanks to the continuing effects of the ECB's QE and the high average residual life of debt (7.4 years in April), reversal of the super-easy monetary policy stance would surely increase the cost of government bonds. In addition, the risk premium, which increased in May when the new government took office, might decline only slowly.

**Weaker budgetary positions than those outlined in our forecasts would worsen the debt profile and the related risk.** Chart A shows three different scenarios for the debt-to-GDP ratio evaluated using the Prometeia quarterly model: 1) our baseline scenario; 2) a scenario with a deficit at the limit level of 3 per cent of GDP, and 3) the 2018 Economic and Financial Document (EFD) scenario.[1]

**As expected, the 3 per cent of GDP deficit scenario is not consistent with a reduction in the debt-to-GDP ratio.** The debt-to-GDP ratio remains relatively stable in the first few years, due to the higher level of nominal output, and increases thereafter as the impact of the higher deficit on economic activity fades away while it accumulates on the debt. Compared to the baseline, this scenario implies an increased debt of €85 billion after three years and €220 billion after seven years. In turn, this implies substantial additional debt issuances: €50 billion in the third year and €90 billion in the seventh, equal, respectively, to 12 per cent and 19 per cent of the total baseline rollover (Chart B).

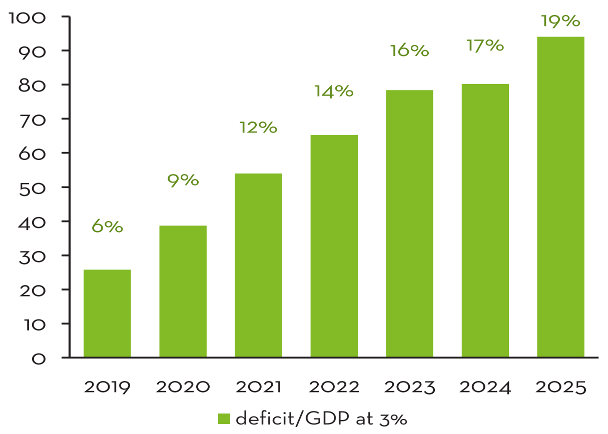
**Moreover, the risk premium on government bonds would remain high and increasing.** Based on our estimates, the spread BTP-Bund would increase 10pb in first year and 60bp after five years. Overall, this is a limited increase, which reflects the historically low elasticity of the spread to the debt level. However, the event of a debt that remains at such high levels for a long time due to the weakening of the budgetary position increases the sustainability risk and is likely to lead to a further increase in risk premiums.

**Chart A — Debt-to-GDP ratio**
%




*Source: Prometeia's calculations on Istat, Bank of Italy and Ministry of Economy and Finance data.*

**Chart B — Gross issuances of government bonds, deviations from the baseline** - *billions of euro and percentage of total issues*




*Source: Prometeia's calculations.*

*1 The 3 per cent deficit scenario is constructed such that the deficit level is reached ex-post, taking into account the effects of the higher deficit on the economy.*

**Table 1 The World Economy main indicators** *% change*

| | 2017 | 2018 | 2019 |
|---|---|---|---|
| World real GDP | 3.7 | 3.9 | 3.5 |
| World Trade | 5.0 | 4.3 | 3.8 |
| Manufacturing prices $ | 2.8 | 4.5 | 1.5 |
| Brent oil price ($/brl, level) | 54.9 | 71.4 | 71.6 |
| GDP | | | |
| - United States | 2.3 | 2.9 | 2.4 |
| - Japan | 1.7 | 0.8 | 1.2 |
| - EMU | 2.6 | 2.1 | 1.8 |
| - China | 6.8 | 6.5 | 5.9 |
| Consumer prices | | | |
| - United States | 2.1 | 2.7 | 2.2 |
| - Japan | 0.5 | 1.0 | 1.4 |
| - EMU | 1.5 | 1.7 | 1.8 |
| - China | 2.9 | 2.5 | 2.6 |
| $/€ exchange rate (level) | 1.13 | 1.18 | 1.15 |
| £/€ exchange rate (level) | 0.876 | 0.877 | 0.887 |

**Table 2 Italy main indicators** *% change*

| | 2017 | 2018 | 2019 |
|---|---|---|---|
| GDP | 1.6 | 1.2 | 1.2 |
| Imports of goods fob and services | 5.7 | 2.9 | 4.7 |
| Private consumption | 1.4 | 1.0 | 1.3 |
| Government consumption | 0.1 | 0.1 | 0.5 |
| Gross fixed investment: | 3.9 | 2.6 | 3.0 |
| - machinery, equipment, other prod. | 6.0 | 3.6 | 3.9 |
| - constructions | 1.5 | 1.3 | 1.8 |
| Exports of goods fob and services | 6.0 | 2.3 | 3.9 |
| Domestic demand | 1.4 | 1.4 | 1.4 |
| Industrial production | 3.7 | 1.6 | 2.0 |
| Trade balance (% of GDP) | 3.3 | 2.9 | 2.3 |
| Terms of trade | -1.6 | -1.7 | -1.7 |
| Consumer prices | 1.2 | 1.4 | 1.5 |
| Per capita wages - manufacturing | 0.5 | 1.0 | 1.6 |
| Total employment | 0.9 | 0.4 | 0.3 |
| General government balance (% of GDP) | -2.3 | -1.8 | -2.0 |

**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 | 1.15 | 1.14 | 1.14 | 1.15 | 1.16 | 1.17 |
| | Yen | 133.1 | 129.9 | 127.7 | 127.7 | 127.7 | 127.7 | 128.2 | 128.5 |
| 3 month interest rates (%) | US libor | 1.93 | 2.35 | 2.38 | 2.46 | 2.67 | 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 | 2.93 | 3.00 | 3.10 | 3.25 | 3.22 | 3.20 | 3.18 |
| | Germany | 0.59 | 0.49 | 0.51 | 0.68 | 0.89 | 1.02 | 1.18 | 1.25 |
| | Italy | 2.01 | 2.25 | 2.91 | 3.48 | 3.53 | 3.58 | 3.61 | 3.58 |

**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 May 2018 | **0.6** | 0.8 | 0.8 | 0.6 | 2.9 | 0.4 | 0.6 | 0.6 | 0.5 | 2.3 |
| | Brief July 2018 | **0.5** | 0.9 | 0.8 | 0.6 | 2.9 | 0.4 | 0.6 | 0.6 | 0.5 | 2.4 |
| EMU | Brief May 2018 | **0.4** | 0.4 | 0.4 | 0.4 | 2.1 | 0.4 | 0.4 | 0.4 | 0.3 | 1.6 |
| | Brief July 2018 | **0.4** | 0.4 | 0.4 | 0.5 | 2.1 | 0.5 | 0.4 | 0.4 | 0.3 | 1.8 |
| Italy | Brief May 2018 | **0.3** | 0.4 | 0.4 | 0.4 | 1.4 | 0.2 | 0.3 | 0.3 | 0.3 | 1.2 |
| | Brief July 2018 | **0.3** | 0.2 | 0.3 | 0.4 | 1.2 | 0.4 | 0.2 | 0.2 | 0.3 | 1.2 |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based on data available up to 10th July 2018


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