Crédit Agricole Group economic and sector analysis

Prospects

Monthly – No.19/079 – 6 May 2019

ITALY – Monthly News Digest

Italy Monthly News Digest is a compilation of articles originally published in the Group Economic Research weekly.

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Orders and industrial production

Following the January rebound, the industrial orders index fell by 2.9% in February. The average of the last three months, compared with that of the previous three, shows a drop of 1.3%. Over 12 months, orders are down 2.9% as the uptick in orders from the domestic market (0.6%) was not enough to offset the fall in orders from outside Italy (-7.7%).

In the manufacturing sector, the highest growth was registered in the electronics sector, up 1.4% over 12 months, while the worst result was again posted by the pharmaceuticals industry (-8.4%).

On a more optimistic note, and for the second consecutive month, Italian industrial production convincingly beat the consensus with a surprise upside move in February. Forecast at -0.8%, it posted growth of 0.8% over January. Over 12 months, the index has risen 0.7%. February left a positive growth overhang of 0.7% for 2019 (compared with -2% in 2018).

Consumer goods production rose 3.2% over the month thanks to a marked rebound in the production of non-durable consumer goods (+3.9%), while consumer durables production was still falling (-0.1% over the month). Capital and intermediate goods saw a smaller increase of respectively 1.1% and 0.2%, but the recovery in capital goods is marked, in the wake of the drop at end-2018. Energy production was down 2.4%.

Over 12 months, the best performing sectors were textiles (+11.7%), pharmaceuticals (+5.3%), and electronic, optical and computer equipment manufacture (+4.4%). The poorest performing sectors were coke and refined petroleum products, (-13.9%), the timber, paper and printing industry (-5.4%) and energy (-2.8%). Vehicle production, which had peaked in June 2018 only to plunge 16% three months later, has rebounded sharply and posted month-on-month growth of 13%.

☑ **Our opinion –** *What with the slowdown in international trade, political uncertainties, a recession over two consecutive quarters, low growth comparable to that of its European partners in 2018 and confidence surveys that are falling steadily month after month, Italy is not currently enjoying the best outlook. That mix has had repercussions: the IMF has revised Italy's 2019 growth forecasts down to 0.1% (as has Prometeia), while the OECD is forecasting a -0.2% recession. Confindustria has gone even further, switching from a forecast of 0% to one of -0.9%.*

We are predicting growth of 0.1% in 2019, with a domestic demand-led recovery as of Q2: we have seen encouraging industrial production data from the first two months of the year, which could contain part of the downside risks in our scenario. Looking at the confidence surveys, the composite PMI picked up in February and March and is now above the 50 threshold signalling that activity is expanding. Confidence in the services and construction sectors is also rising, at 51.5 and 51.2 respectively. It is industry that is still struggling : the March surveys point to a further erosion of confidence, with a contraction in order books, especially in orders from outside Italy. ISTAT's April surveys show a slight drop in business confidence. While it is improving in construction, confidence in the manufacturing sector has continued its steady decline since September 2018, as have business's sentiment and outlook about their order books. However, unlike the March PMI surveys, ISTAT flagged up a recovery in foreign demand in April, with an improvement in sentiment around orders from outside Italy.

Originally published on 19 April 2019

The government, under pressure, puts off difficult decisions until the summer

The outline of the annual public finances programme has been published prior to the publication of the Stability Programme but does not provide much information as to the government's economic policy strategy. It is seeking to sound cautious, reassuring and in line (if you don't interpret it too literally) with the commitments given to the European Commission. What it does *not* say is how it aims to achieve the public finance targets.

First off, the government devotes itself to a truth-telling operation. It acknowledges the undeniably weak growth and revises its 2019 forecasts down to 0.2% (from the 1% announced in December 2018). It also confirms what observers had expected, namely that the stimulus measures (the citizen's income and *Quota 100*) will only have a very marginal impact of 0.1 of a point on growth, taking the trend growth rate of 0.1% in 2019 and 0.6% in 2020 to the target of 0.2% in 2019 and 0.7% in 2020 – which is scarcely higher.

The growth differential against the forecasts will also mean an increase in the public deficit in 2019 from the 2% negotiated with the Commission to 2.4%. That impact is thought to be due only to the impact of a weaker economy. Absent that effect, the expected deterioration in the structural deficit would only be 0.1 of a point – a very small difference relative to the 0.1-point improvement required by the European Commission. In this way, the government hopes that the European Commission will show clemency. It is nevertheless implementing measures that can reassure the Commission. The first of these is a

"Growth Decree", featuring measures to support investment and business, ranging from administrative simplification to support funds for bond issuance by mid-sized companies, the return of accelerated depreciation for investment, and a gradual decrease in corporate income tax. The second is a "unblock construction decree" that should help to kick-start large-scale public and private construction projects. The two measures could lead to a 0.1-point improvement in the deficit. If this proves insufficient, then the 2019 budget has a number of clauses that can be activated: a €2 billion freeze on current spending, and a €950 million sell-off of public buildings. It is also possible that demands for the citizen's income will be less than the €500 million included in the budget.

In this way, the government is playing for time, and deferring the real issues until the budget for 2020. In 2020, the government is also forecasting a higher deficit (2.1%) than that negotiated with the EC (1.8%). But this is felt to be no more than the legacy of the slippage in 2019, as the deficit has been forecast to be less than the previous year's, with a 0.2-point structural improvement in the balance, in line with the Stability Pact predictions. But that outcome is likely to be achieved through the €23 billion increase in VAT (1.3 point of GDP, or a further 3.2-point increase in the normal rate, and a 3-point increase in the reduced rate). That kind of increase in indirect taxation can clearly not be countenanced in such a low-growth environment. And the forces of government were unanimous in announcing that the increase in VAT would not take place. Nor does the government show much inclination for tackling spending. The spending cuts already set out in the balance sheet are highly realistic and in line with past practice, so that there is a high risk of deficit slippage in 2020. Lacking additional information about the possible replacement for the VAT increase, we are forecasting a partial implementation of the hike (a 1-point increase in the normal rate and reduced rate, garnering 0.4 of a point of GDP) and a rise in the deficit, to 2.7%, in 2020.

☑ **Our opinion –** *The 2020 budget is playing like a three-sided game of billiards. One side is the negation of any increase in VAT (the two parties in government, although the League is less convinced). The second side is compliance with the commitments made to the EC, or at least a limited slippage having a limited impact on public debt and compatible with market lenience. This line is the one defended by the Economy Minister with strong support from the Italian President. The third side is that of making good on electoral promises, especially those of the League, with the introduction of a flat tax with two rates (15% and 20%) for households and businesses. A first component was rolled out in 2019 with the extension of the 15% flat rate to self-employed people earning less than €65,000 in annual income.*

The League intends to tackle households in 2020. There are scant details about the proposal, as yet. The introduction of a genuine 2-rate system would be very expensive, at €50 billion. The shortfall in receipts announced by the League is well below this, at €12 billion, which seems compatible with the replacement of the first three tax bands (23%, 27% and 38%) by a single 15% rate for incomes of less than €50,000 and a switch for those tax bands to family rather than individual taxation (as it is already the case for income tax in Italy). The overhaul of the system of deductions and exemptions would be accompanied by reform in order to reduce its impact on revenues. The financing of this proposal seems impossible at a time when it is already necessary to identify significant resources to avoid VAT increases.

The M5S does not seem to be fiercely opposed to this proposal. It simply points to the oxymoron of a progressive flat tax (read a single rate for the first bands and the continuation of a sliding scale for the higher bands). The flat tax is enshrined in the "government contract", and the shift in the balance of power within the government towards the League is forcing the M5S to go along with this direction. It will be the necessary price of continuing the coalition agreement, which is clearly desired by the two parties. Oxymorons and soft compromises are the easy solution to the inherent divisiveness in this executive. The markets will judge whether they are economically coherent or not.

Originally published on 12 April 2019

☞ February rise in unemployment rate

In February, Italy's unemployment rate saw a halt in its steady decline. It was back at its June 2018 level of 10.7% and gained 0.1% relative to January. This can be explained by a fall in employment and an increase in the workforce.

The employment ratio was down at 58.6% (down 0.1% from January) due to an increase in self-employment, which was insufficient to offset the drop in waged employment. Over the past three months, employment was stable, but showed an increase in long-term contracts and a drop in short-term ones. On an annual basis, employment saw a further increase of 0.5% but it has slowed down. The expansion affects both women and men and is substantially concentrated in short-term contracts. Growth in employment has gone hand-in-hand with a drop in jobless numbers (-1.4% or-39,000 units) and in unwaged people aged 15-64 (-1.3%, -169,000).

☑ **Our opinion –** *The economic slowdown observed during the second half of last year resulted in a fall in the number of hours worked in Italy (from +1.3% in Q2 to 0.4% in the Q4). The slowdown is common to all countries in the Eurozone, but France and Germany are experiencing a smaller slowdown. Similarly, the unemployment rate continues to fall in the other countries, where employment is seeing a slower deceleration.*

Two measures will have an impact on the labour market in Italy as of the second half of the current year: the "Citizen's income" and the "Quota 100". The former, a flagship promise of the M5S will finally be subject to more restrictive conditions and will be primarily targeted at the unemployed and unwaged, who will be required to sign up as jobseekers, and will consequently have an impact on the country's unemployment rate. Among the unwaged, we find a large number of homemakers in low income, low-education households with scant work experience and hence a low probability of being hired. This category is mainly located in the "Mezzogiorno". The "Quota 100" programme, for its part, which will allow some people to retire early, will help to reduce the workforce.

Originally published on 5 April 2019

☞ Q4 improvement in firms' margin ratio

After eight consecutive quarters of positive growth, households' gross disposable income declined by 0.2% in Q4 2018 relative to the previous quarter. Households' purchasing power also fell, by 0.5%, due to a 0.3% increase in the consumption deflator. The savings ratio in Q4 2018 stood at 7.6%, down 0.6% on Q3, leading to an increase in end-consumption of 0.5% by value. Growth in household investment has slowed but is still sufficient to stabilise the investment ratio at 6.0%.

The deterioration in non-financial company profitability has temporarily stopped. In Q4 2018, the margin ratio stood at 41.4%, up 0.3 of a point on Q3 2018, even if it is down overall in 2018. The positive trend in this indicator is the result of a more sustained increase in EBITDA than in added value (+1.0% and +0.3% respectively). The investment ratio of non-financial companies in Q4 was up slightly at 21.9%, although the annual rate of investment was slowing.

☑ **Our opinion –** *The acceleration in households' end consumption fuelled by durable goods consumption in Q4 shows that the consumption cycle, although well advanced, retains its modest, but positive momentum. The gradual decline in purchasing power is forcing people to run down their savings to finance their rate of spending. This year, uncertainties about fiscal policy and possible VAT hikes will have an adverse effect on consumption. The recent halt to job creations needs to be watched and is the main downside risk affecting our scenario. If inflation was lower and the citizen's income was rolled out, this could sustain consumption in the second half of the year, but the effect will probably be contained.*

Non-financial companies have seen their profitability fall since peaking in 2016, when the margin ratio stood at 43.6%. The recovery in Q4 is not good news, as the rise in EBITDA is linked to lower employment, enabling productivity gains to offset the acceleration in wage costs. This could mean an improvement in cost management, but the environment is still on the downside.

Originally published on 5 April 2019

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