

July 23th 2019

ITALY

2019-2020 SCENARIO

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“Slack growth, a razor-thin
budget and political
compromise”

ITALY

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The **recessionary phase** of the Italian economy observed in the second half of 2018 seems to be behind but the rate of expansion of activity remains sluggish and contained compared to its European partners. Growth will not strengthen in the second quarter.

The **recovery in the growth rate** of the Italian economy in Q1 (+0.1%) was driven by both external and domestic demand. Net exports contributed positively to growth (0.5 points of GDP after 0.1 points in Q4 2018) because while export growth was modest, **imports** declined (-1.5%)

The contribution of domestic demand was nearly stable at 0.2 points, driven mainly by investment in **construction** (+2.6% in the quarter), while the pace of consumption growth slowed from 0.2% in Q4 2018 to 0.1% in Q1. On the other hand, the **change in inventories** contributed negatively, taking 0.6 percentage points of GDP away from growth in Q1 (after -0.3 percentage points in Q4 2018). The destocking of companies shows that the cumulative stock of vehicles awaiting approval tests is starting to run out, but also that the level of uncertainty is high, which encourages caution when formulating production plans.

The rebound in exports and industrial production at the beginning of the year will be difficult to

strengthen in the coming months. If the **industrial production** index rose by 1% in the first quarter, during the second, the increase would be lower; the increase in May only offset the fall in April. In Q1 2019, the growth rate of exports was positive but very low (+0.3). Exports to major partners have recovered since early 2019, but business surveys on orders from abroad are still too volatile to read precise signals. Downside risks associated with the slowdown in international trade remain. In anticipation, **PMI surveys** of purchasing managers report a smaller decline in activity in industry, but new orders received in April were down by 1.4%, driven by a significant contraction in orders from abroad. On the other hand, activity is reported to be still expanding in services and construction.

The **positive labour market situation** continues to support the growth of household disposable income. The **unemployment rate** continues to fall (9.9% in April) and the employment rate is at its highest, exceeding its pre-crisis level. The acceleration in wages has been clearly visible for a year and is gaining momentum in early 2019. **Wages** increased by 2.8% in Q1, driven by industry and construction. The **low consumption** is explained by an **increase in the savings rate in progress** since the end of 2018, which continued in Q1.

Investment growth was still positive in Q1 2019 (0.6% in the quarter), as a result of the strong acceleration in **construction** investment (+2.6%) in both its residential and non-residential components. This development benefits from particularly favourable weather conditions but also from an improvement in demand. This is reflected in the increasing number of residential transactions, which have returned to the level of 2010. On the other hand, **productive investment** is down (-1.29% for machinery and equipment and -5% for transport). Non-financial companies have seen their **margin rate** decline since the peak in 2017. It is above all the **uncertainty** on demand that weighs on investment decisions, as well as the poor readability of government policy, which has significantly reduced tax incentives for investment.

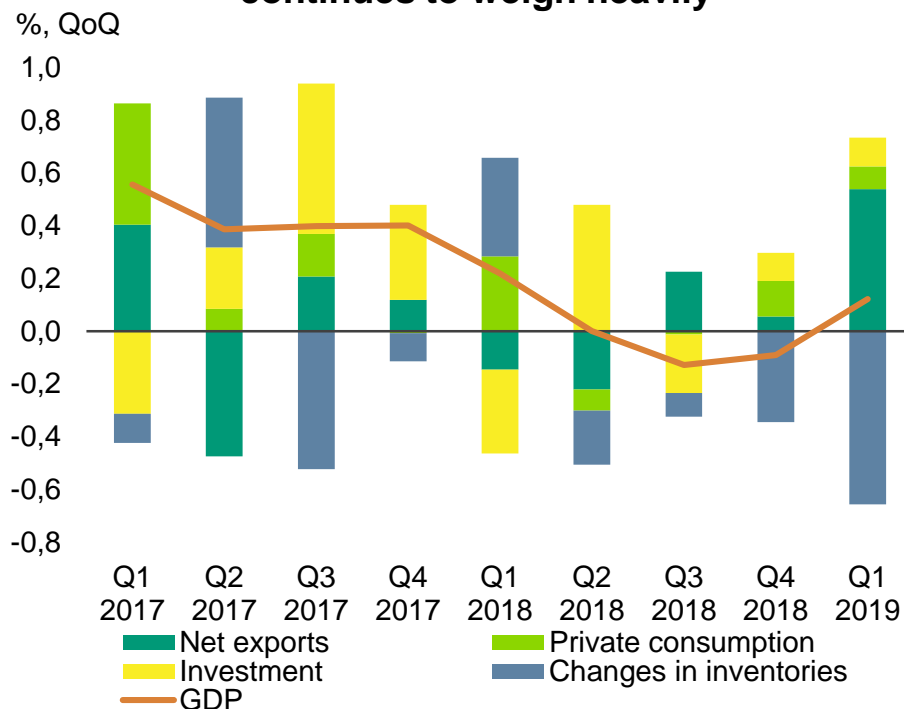
The growth rate for 2019 is -0.01%. **Leading indicators point to zero growth at best in Q2 2019**. A potential for revitalizing growth can come from the end of the destocking process that has been underway for six months. The contribution of consumption and external demand would remain modest. **We expect growth to average 0.2% for the current year and 0.4% for 2020.**

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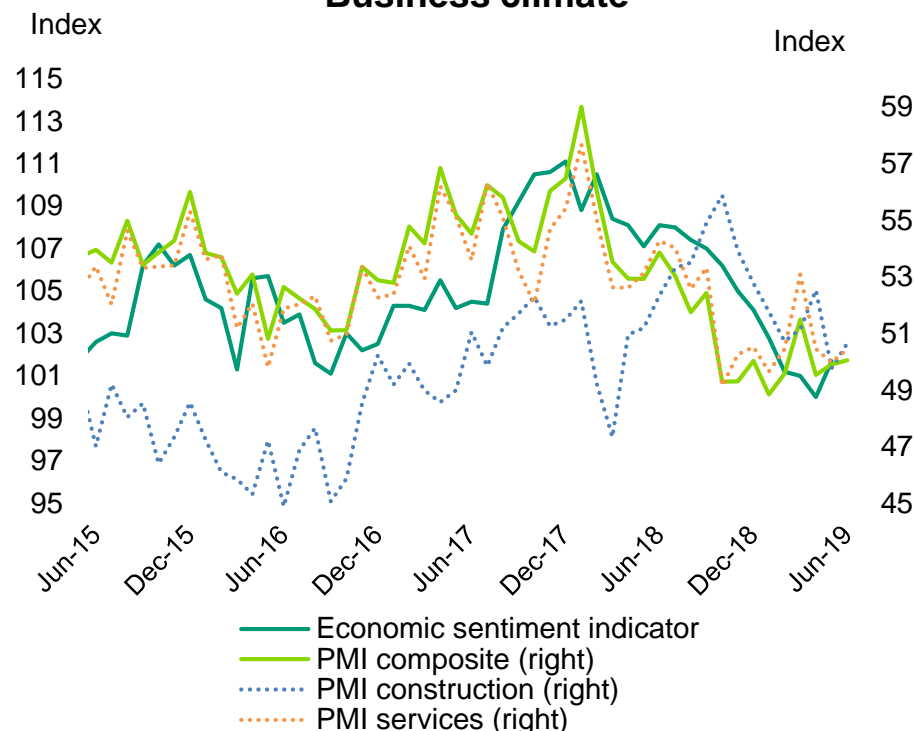
Contributions to growth, destocking continues to weigh heavily



Sources: ISTAT, Crédit Agricole S.A. / ECO

The growth rate of the Italian economy returned to positive territory in Q1 2019 (+0.1%) after two quarters of contraction in activity. External demand contributed positively to growth: exports increased by 0.2%, while imports fell by 1.5%. Private consumption grew at a rate of 0.1%, driven by services and semi-durable goods. Investment grew by 0.6%, thanks to the dynamism of residential (2.5%) and non-residential (2.8%) construction. Investment in machinery and equipment fell by 2.2% and

Business climate



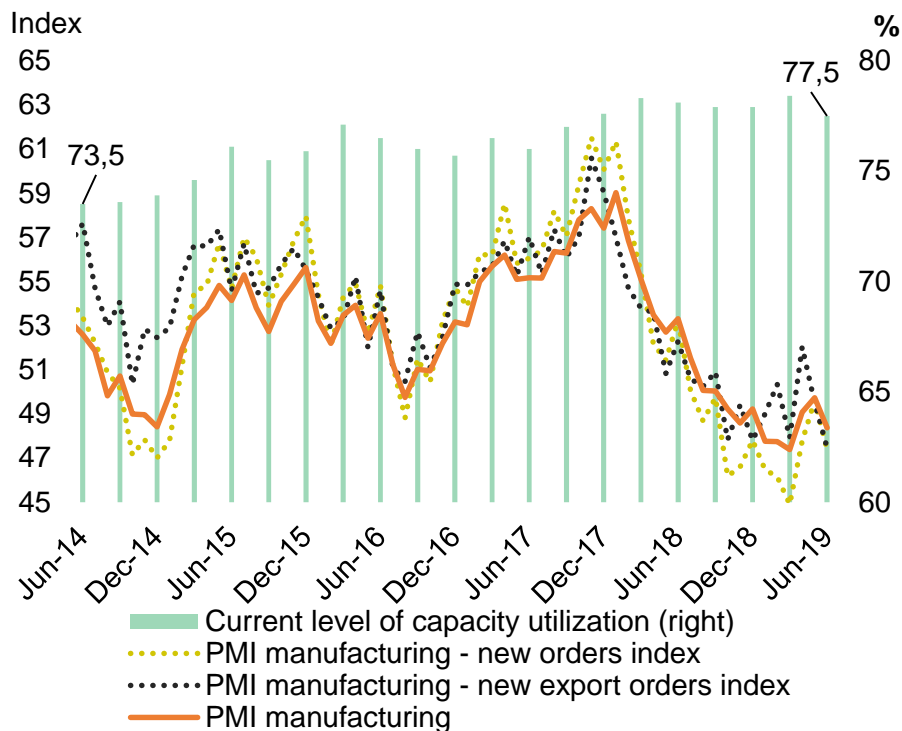
Sources: Commission européenne, Markit, Crédit Agricole S.A./ECO

investment in transport goods by 5%. As in the fourth quarter, the change in inventories had a very significant impact on growth. Business inventory reduction reduced GDP growth by 0.6 percentage points in the first quarter. The business climate continues to deteriorate due to the weakness of the industry and the composite PMI has stabilized. The PMI services and construction still suggest an expansion of activity in these sectors.

LATEST ECONOMIC DEVELOPMENTS

MANUFACTURING SECTOR: CLOSE TO THE LIMITS

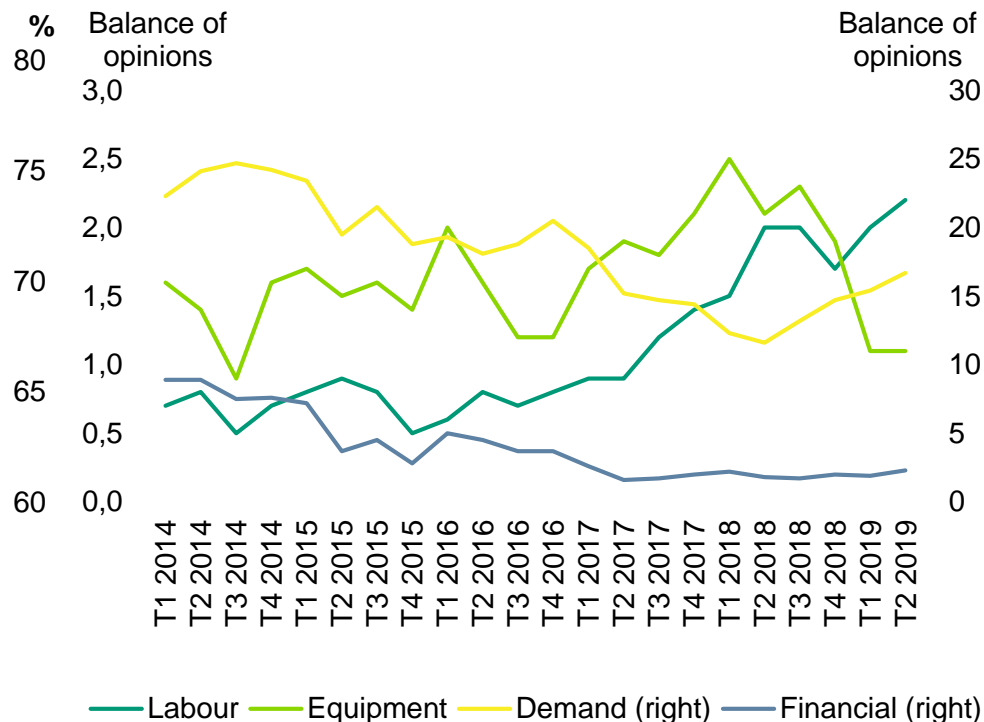
Manufacturing sector surveys



Sources: Markit, Commission Européenne Crédit Agricole S.A. / ECO

The industrial sector has been slowing since last summer. The PMI business surveys report a very marked deterioration in managers' expectations of manufacturing activity. Opinions on orders and, in particular, orders from abroad are also deteriorating. At 77.5%, the European Commission's quarterly surveys report that installed capacity is being used at very high historical levels. According to companies, the

Factors limiting industrial production



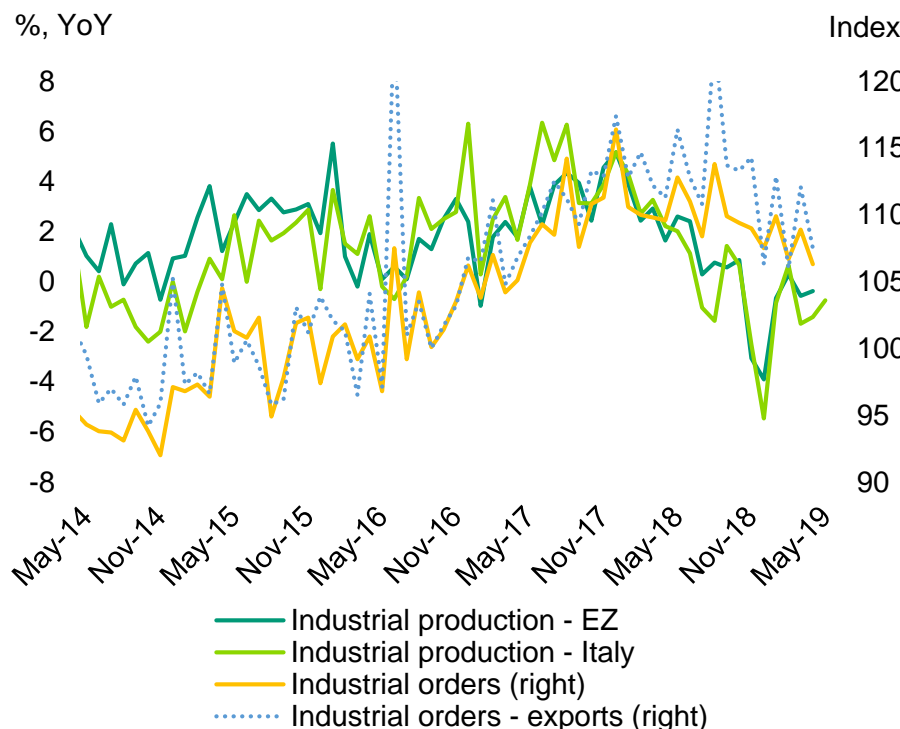
Sources: Commission européenne, Crédit Agricole S.A./ECO

factors limiting manufacturing output are increasingly focused on demand and personnel. Indeed, unemployment has fallen sharply and companies have already absorbed the most skilled workers, who are becoming fewer and more expensive. The aspects related to financing and the level of installed capacity would not be a constraint for the activity.

LATEST ECONOMIC DEVELOPMENTS

FINALLY, NO RECOVERY IN THE INDUSTRY

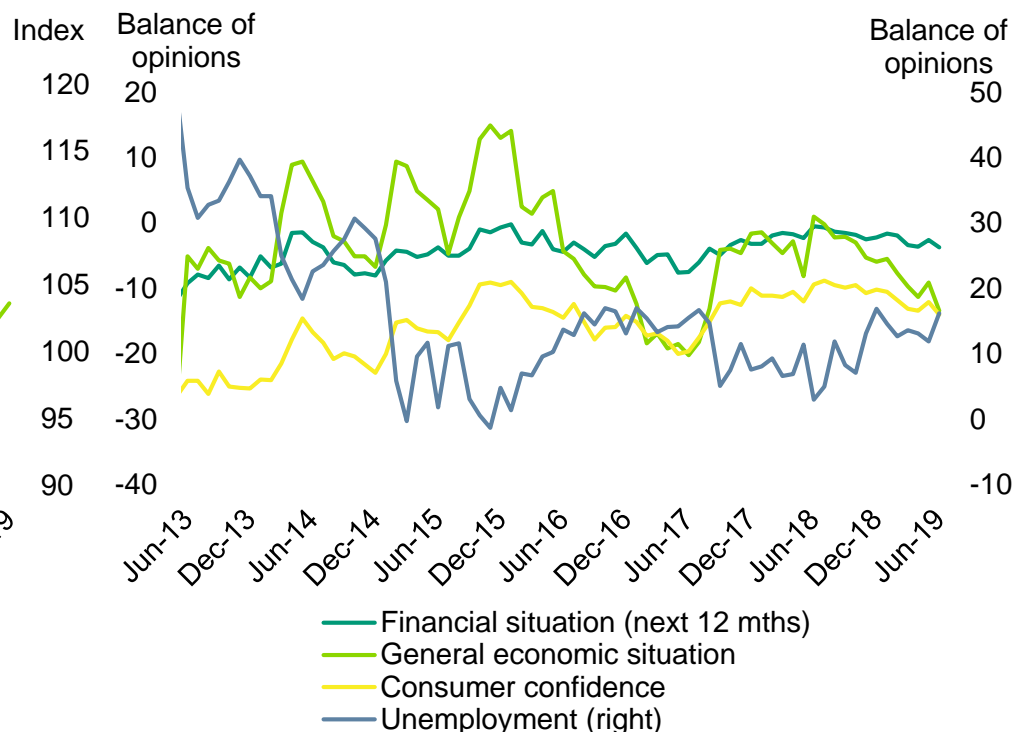
Industrial production, the decline continues



Sources: ISTAT, Eurostat, Crédit Agricole S.A. / ECO

The industrial production index rose by 1% in Q1 2019. New European standards for vehicle gas emissions paralysed production last summer, mainly affecting Germany and Italy. However, the recovery observed at the beginning of the year did not last: the index fell in the following months and stood at -0.7% year-on-year in May. Orders to industry were also down 3% year-on-year in May. Consumer confidence continues to

Household confidence is gradually deteriorating



Sources: ISTAT, Crédit Agricole S.A. / ECO

deteriorate gradually, particularly the outlook for the country's economic situation. Labour market expectations have improved, in line with unemployment indicators, and the outlook for the financial situation of households is slightly down. These indicators do not allow us to expect a sustained contribution from private consumption.

ITALY

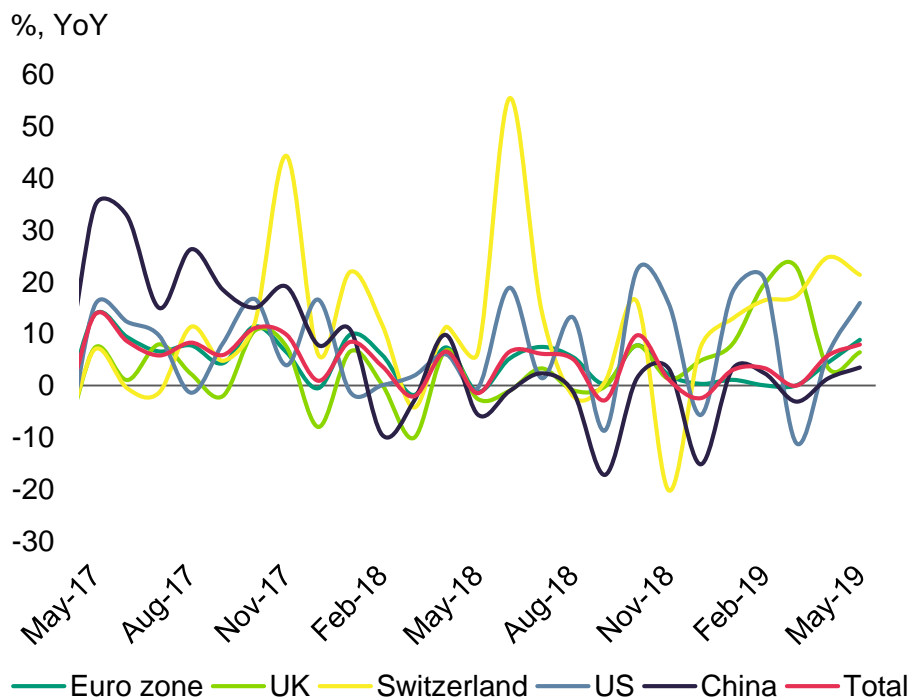
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THE MAIN LINES OF OUR SCENARIO

TRADE RECOVERY IN Q1

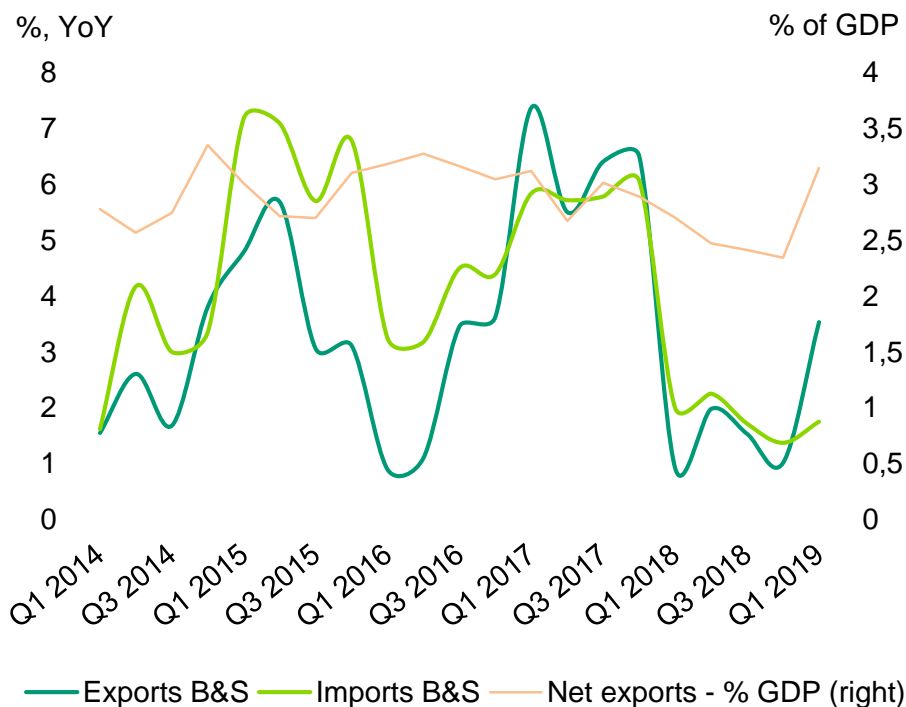
Exports by main partners



Sources: ISTAT, Crédit Agricole S.A. / ECO

The slowdown in exports (from 7.6% in 2017 to 3.1% in 2018) stabilized in Q1 2019. Exports increased by a cumulative 2.9% over the period January-April 2019 compared to the same period in 2018. The increase is confirmed for both flows to EU (2.6%) and extra-EU (3.5%) partners. However, it was supported by time factors: the sale of a ship to the United States and an impressive increase in exports to the United Kingdom (+13%), with the aim of accumulating stocks of goods due to

Export dynamics outpaced import dynamics in Q4 and Q1



Sources: ISTAT, Crédit Agricole S.A. / ECO

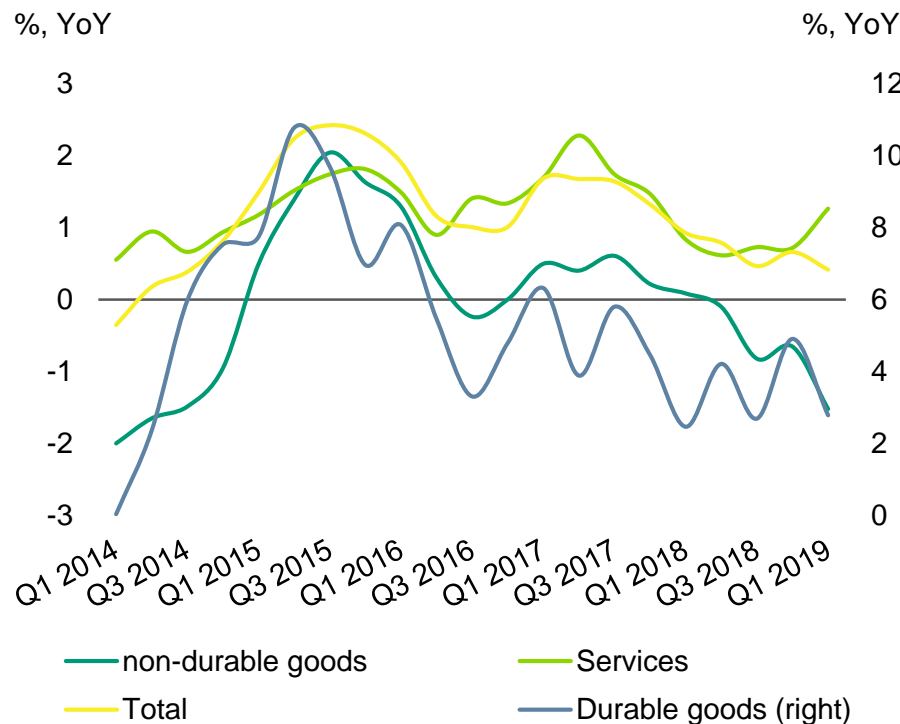
the fear of leaving the EU without an agreement. The contribution of foreign demand to growth returned to positive territory in Q4 and Q1, but the downside risks associated with the slowdown in international trade and the Sino-American trade war remain. Similarly, foreign orders surveys are decreasing. We do not expect a significant contribution from external demand in 2019.

3

THE MAIN LINES OF OUR SCENARIO

CONSUMPTION OF DURABLE GOODS

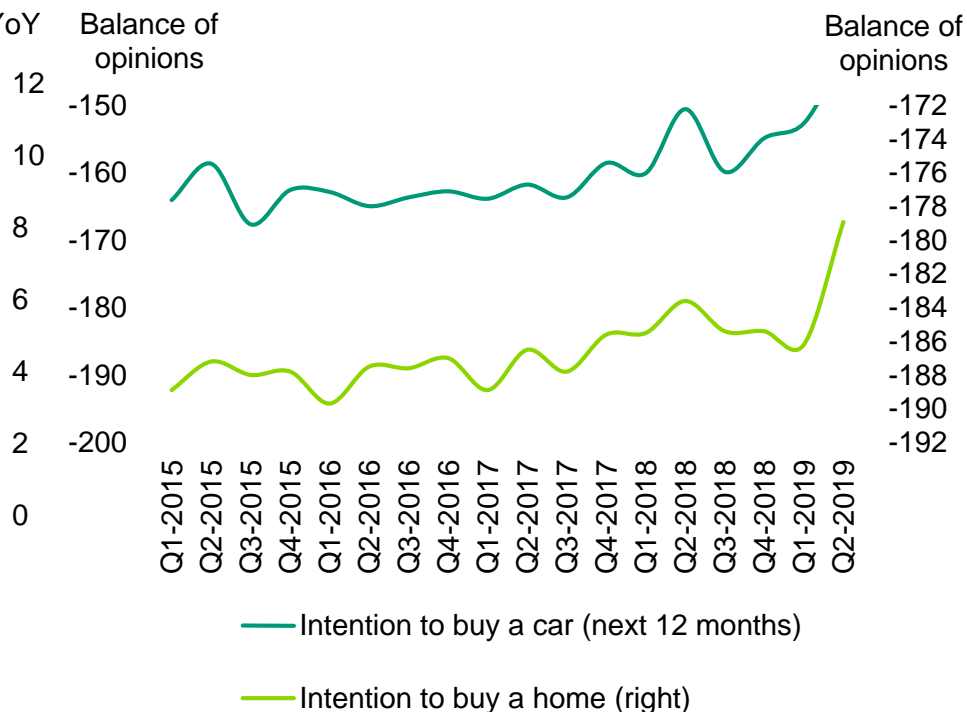
Consumption of durable goods remains stable



Sources: ISTAT, Crédit Agricole S.A. / ECO

Private consumption slowed in the first quarter (0.1% after 0.2% in Q4 2018 and 0.2% year-on-year) and its growth rate remained contained and lower than that of the main European partners. The consumption cycle of durable goods is already in an advanced phase, but purchasing intentions for this type of good remain high. Motor vehicle registrations, down -2% year-on-year in June, were disrupted by the new European

Households wish to continue purchasing durable goods



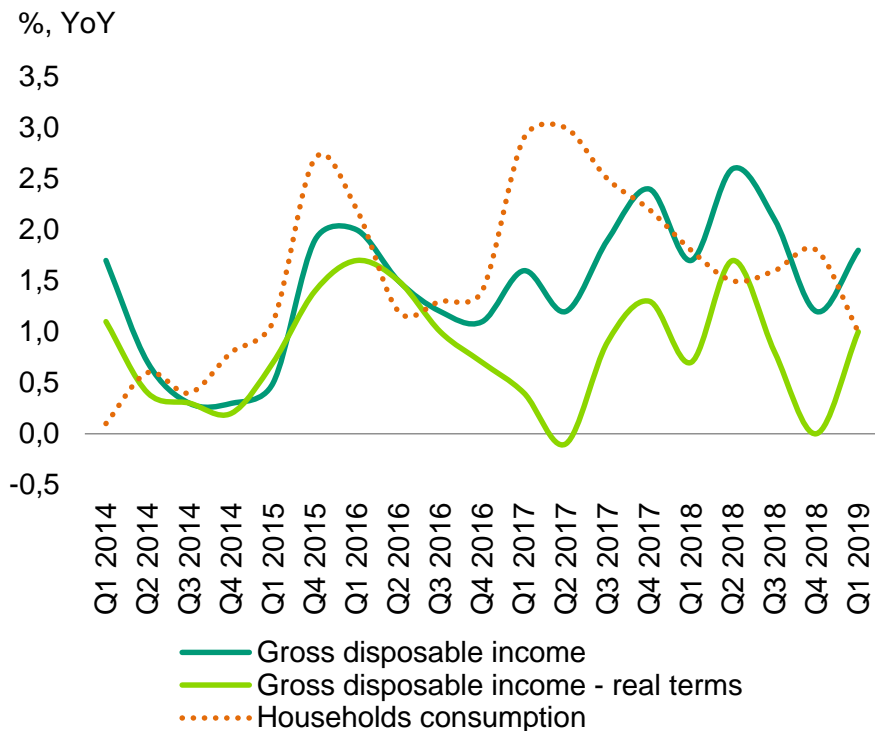
Sources: ISTAT, Crédit Agricole S.A. / ECO

regulations, but the age of the fleet is still high. Housing purchase intentions started to rise again in the second quarter. The sustained rate of growth in disposable income observed in the first quarter, coupled with stable inflation, allowed purchasing power to accelerate without translating into more household consumption. This reveals the degree of consumer uncertainty, in line with the weakness of confidence surveys.

THE MAIN LINES OF OUR SCENARIO

INCREASE IN HOUSEHOLD PURCHASING POWER IN Q1

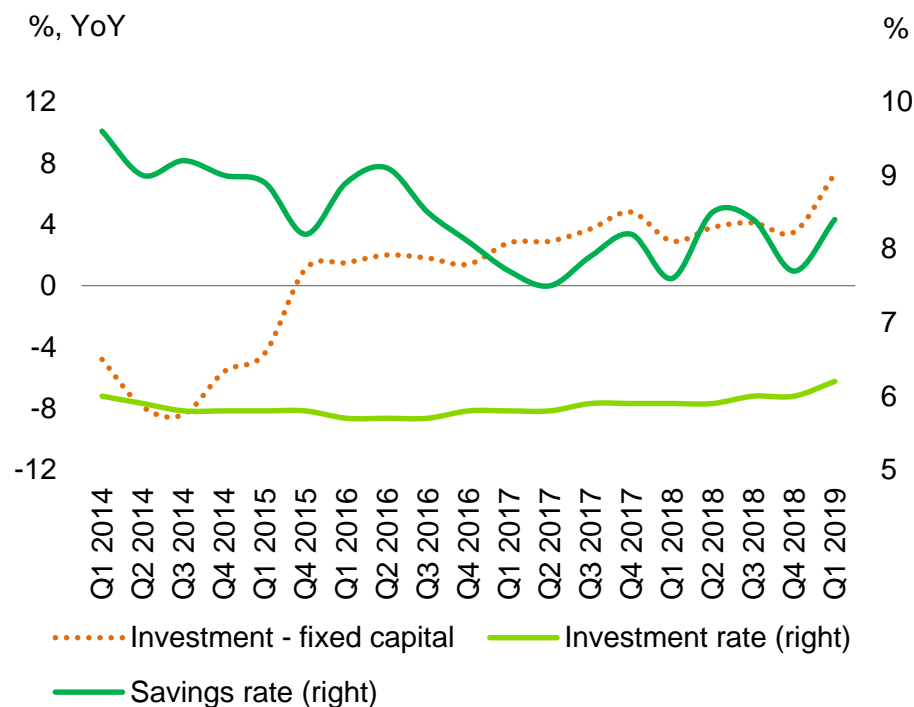
Disposable income continues to grow...



Sources: ISTAT, Crédit Agricole S.A. / ECO

The purchasing power of Italian households increased by 0.9% in the first quarter (1% year-on-year), as a result of the acceleration in gross disposable income and the stability of the consumption deflator. Household consumption grew by only 0.2% in value in Q1 (1% over one year), so households preferred to save. The savings rate rose from 7.7%

to fuel savings rather than consumption.



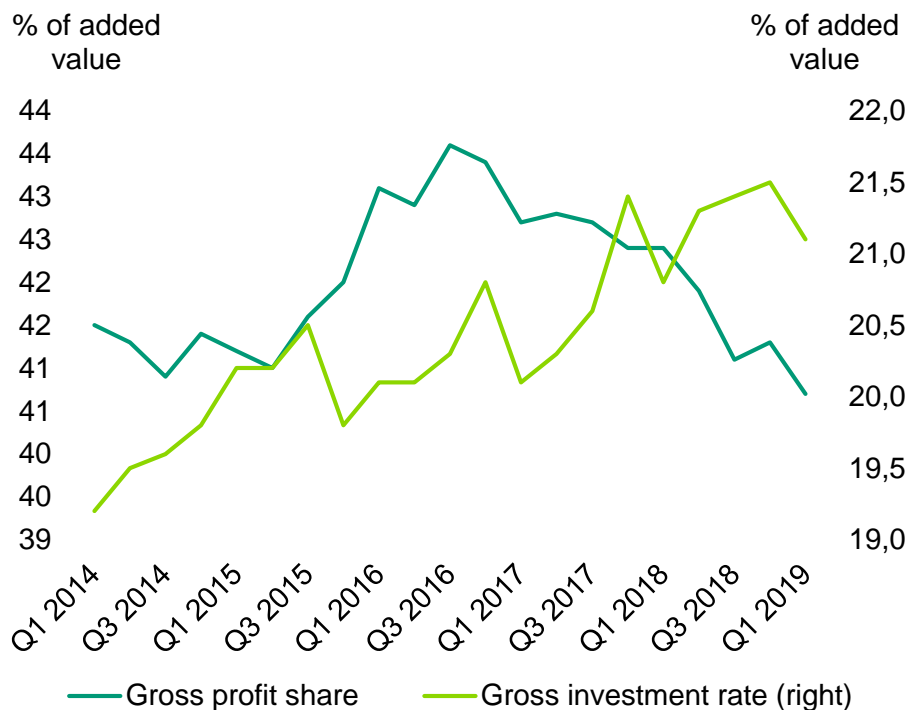
Sources: ISTAT, Crédit Agricole S.A. / ECO

in Q4 2018 to 8.4%. These savings partly feed into investment, which accelerated significantly (3.2% in value over the quarter, 7.3% over the year). The household investment rate therefore reached a new high of 6.2% of disposable income.

THE MAIN LINES OF OUR SCENARIO

DECLINE IN PRODUCTIVE INVESTMENT IN Q1

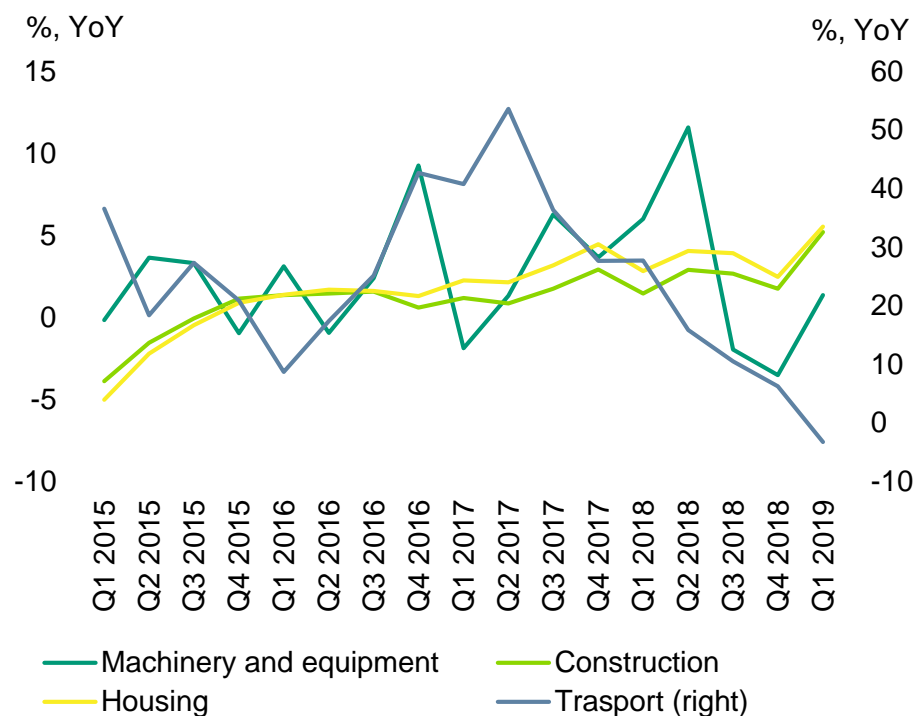
Margin rate and investments down



Sources: ISTAT, Crédit Agricole S.A. / ECO

In Q1, non-financial companies saw their margin rate decline to 40.7%. The decline in gross operating income (-1%) also led to a contraction in fixed investments (-1.4%) and the investment rate fell to 21.1%. Companies face a double problem related to the slowdown in the growth phase of the cycle: the acceleration of wages and the high level of use of

Construction at the heart of investment growth in Q1



Sources: ISTAT, Crédit Agricole S.A. / ECO

installed capacity. The rise in labour costs, combined with low productivity, is worsening their profitability. The slowdown in demand for them is coupled with this higher pressure from unit labour costs and justifies the decline in productive investment in Q1 (-2.24% in Q1).

THE MAIN LINES OF OUR SCENARIO

FORECASTS: RISKS ON THE DOWNSIDE

A moderately optimistic scenario



Yearly average
(YoY, %)

| Italy | 2018 | 2019 | 2020 | 2021 |
|--------------------------|------------|------------|------------|------------|
| GDP | 0,7 | 0,2 | 0,4 | 0,6 |
| Households consumption | 0,6 | 0,5 | 0,6 | 0,6 |
| Investment | 3,2 | 1,6 | 1,3 | 2,4 |
| Change in inventories* | -0,1 | -1,0 | 0,1 | 0,0 |
| Net exports* | -0,1 | 0,6 | -0,1 | -0,0 |
| Unemployment | 10,6 | 10,3 | 10,2 | 10,1 |
| CPI | 0,8 | 0,6 | 0,7 | 0,9 |
| Government net borrowing | 2,1 | 2,1 | 2,3 | 2,7 |

* Contributions to GDP growth

Sources: Crédit Agricole SA, forecast

The carry-over effect for 2019 is -0.01%. Leading indicators point to zero growth at best in Q2 2019. A potential for revitalizing growth can come from the end of the destocking process that has been underway for six months. This originated in the dislocation of automobile production during the summer, which had caused a sharp accumulation of stocks. It had been reinforced by the gradual deterioration of the outlook for the industry. This destocking has had a significant impact on growth and its

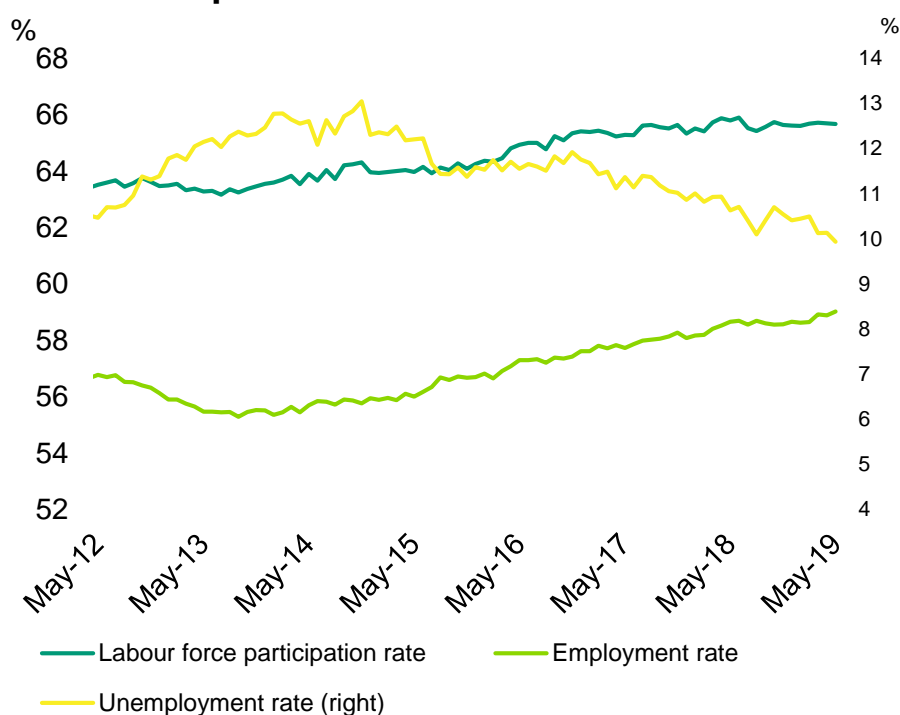
normalization should have a positive impact on business in the coming quarters. Due to stronger than expected growth in the first quarter, we have revised our forecast for 2019 slightly upwards to 0.2% on average. The contribution of consumption and external demand would remain modest. Investment would return to barely positive growth. We expect the same dynamics in 2020 with growth revised downwards to 0.4%.

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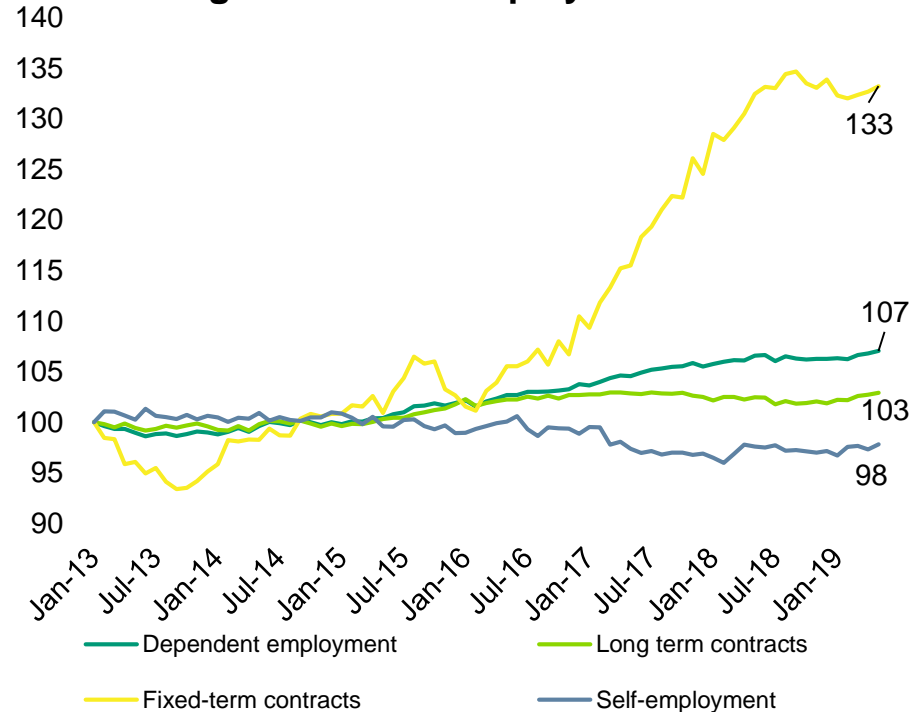
Net improvement in the labour market ...



Sources: ISTAT, Crédit Agricole S.A. / ECO

Although still far from its pre-crisis levels (the Italian unemployment rate stood at 6% in 2007), Italy has experienced a very significant decline in the number of unemployed. Since the peak of 13% at the end of 2013, the decline has been uninterrupted and the unemployment rate reached 9.9% in May 2019, a level that has not been observed since February 2012. The employment rate, at 59%, also reached a peak. The unemployment rate for 15-24 year olds, well above the European average, is slowly declining from 42.8% in May 2014 to 30.5% in May

... through fixed-term employment contracts.



Sources: ISTAT, Crédit Agricole S.A. / ECO. Base 01/2013=100.

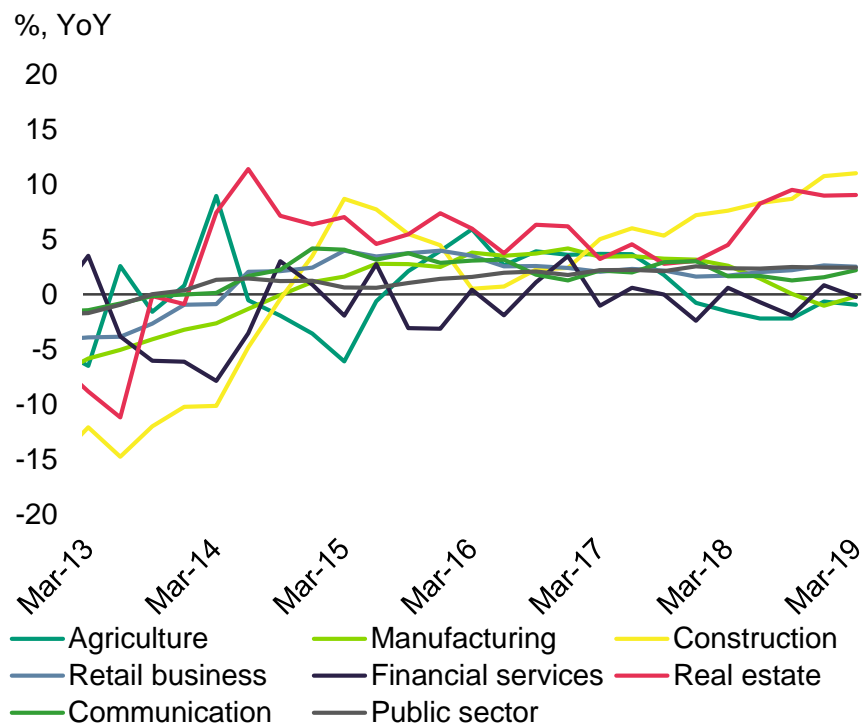
2019. However, over the period 2013-2019, the number of employees on permanent contracts remained virtually unchanged (+3%). The number of employees with fixed-term contracts increased by 33% over the same period with a strong acceleration at the end of 2017. It is therefore long-term employment, more volatile and precarious, that has been the driving force behind the recovery in employment in Italy. The number of self-employed workers, on the other hand, has decreased.



FOCUS: LABOUR MARKET

POSITIVE HIRING PROSPECTS IN ALL SECTORS (EXCEPT INDUSTRY)

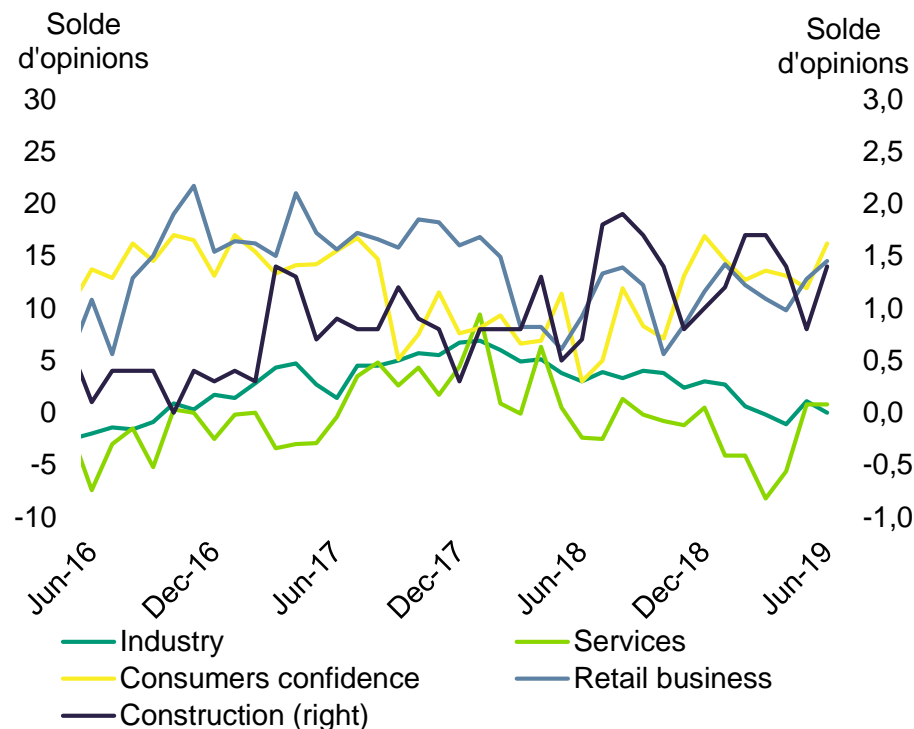
Employment growth by industry



Sources: Eurostat, Crédit Agricole S.A. / ECO

Hiring in construction and real estate activities has been accelerating since 2016. Employment in the public sector and in trade has been growing at an annual average rate of about 2.5%, stable for several years. On the other hand, job creation in industry has slowed sharply since the beginning of 2018 and declined in 2019. Overall, job creation is decelerating and continues at a moderate pace (0.4% year-on-year in

Surveys of hiring prospects



Sources: ESI, Crédit Agricole S.A. / ECO

May). However, even if companies start to worry about hiring barriers, it remains confined to certain qualifications and the labour market still has room for improvement. Indeed, the European Commission's ESI surveys report encouraging prospects in the service, retail and construction sectors. Consumers are also confident, but employment prospects in the industry are deteriorating, in line with the sector's activity.

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PUBLIC FINANCES

FISCAL LULL

2019 : back to normal

The European Commission has decided not to recommend the opening of a procedure for excessive debt against Italy at the next ECOFIN meeting on 8 and 9 July. The Italian Government has finally provided the necessary and sufficient answers. With a budget collective of €7.6 billion (0.42 GDP points), it compensates for the slippage in the deficit in 2018 and 2019 and offers guarantees on the evolution of public finances in 2020 that is more in line with the objectives. Thus, the deficit for 2019 is expected to fall from 2.4% projected in last April's stability programme to 2% in line with the target set with the EC at the end of 2018, when the opening of an excessive deficit procedure had been avoided. Finally, the adjustment made to the 2019 structural deficit by this budget group would be 0.45 percentage point of GDP, allowing a 0.2 point reduction in the structural deficit in 2019, in accordance with the criteria of European rules.

2020 : an agreement is possible

This budgetary collective also makes it possible to reassure on the evolution of the deficit for 2020, making it possible to start from a lower level of deficit. It also provides signals on the architecture of the 2020 Finance Act. Indeed, €1.5 billion in additional tax revenues recorded in 2019 would be structural and renewable in 2020. Also, the lower spending on the two flagship measures could amount to €5-6 billion in 2020. Public accounts in 2020 could also benefit from lower interest charges due to a decline in long-term rates in the euro zone, as well as the recent decline in the risk premium on Italian debt.

The letter sent to the EC by the government detailing these measures does not mention the flat tax reform project announced by the League. If the project remains relevant, its implementation may be more progressive and less extensive than initially anticipated.

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The reversal of the balance of power between the two parties in government is recorded by the result of the European elections. The league doubled its votes compared to the legislative elections of March 2018 and 34.3% of the votes became the first party. The M5S received only 17.1% of the votes, 15.8% less than the legislative elections and fell from the first to the third party position. Most of the votes won by the League come from the M5S and abstention, but also from Forza Italia. Most of the voters lost by the M5S took refuge in abstention, few of them having joined the Democratic Party.

Finally, the result of the election was more positive than expected for the League, which now has its hands free to dictate its agenda: the differentiated autonomy of the regions, the flat tax (flat-rate tax), the relaunch of major infrastructure projects, including the controversial Lyon-Turin line.

To date, the M5S seems to have agreed to lower its voice and choose between implosion in the polls (in the

event of early elections) or in government. For the League, it is convenient to have a sleeping partner with whom you can possibly still siphon votes. But its progress is for the moment virtual, since the Chambers still have the majority of March 2018 (with only 4 votes in advance in the Senate) and the volatility of the electorate is a risk to be taken into account in the choice not to consolidate the result of the Europeans in the polls. Time could be useful for the M5S to get back on track by finding a favourite battle horse at its base, which it could still ride during the legislature.

If an alternative majority exists (with the support of Fratelli d'Italia and defectors from Forza Italia), the League seems to want to take its time. It missed the 20 July deadline for a dissolution of the Chambers and elections in October. Nevertheless, the situation between the two ruling parties now seems very tense. If it is simply a matter of cabinet shuffle, one may wonder how long this government team can last.



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