Prospects

No. 19/193 – 15 November 2019

ITALY – Economic Environment

Macroeconomic review

- Italian growth has stagnated since Q2 2018. There has now been a stagnation in activity for six quarters. After the technical recession observed during Q3 and Q4 2018, Italian GDP rose 0.1% in Q1 and Q2 2019. The initial GDP estimate for Q3 confirms the same trend, with an increase of 0.1%, leaving a positive growth overhang of 0.2% in 2019. This mid-year overhang largely determines the results for the year, especially as we do not expect any acceleration in activity. GDP growth is forecast to be 0.2% in 2019 and 0.4% in 2020.
- Domestic demand's resilience to the slowdown in activity is based on private agents' good economic and financial health.
- Households have still not returned to their pre-crisis income level. However, the income level has continued to rise since 2014 and the increase in their financial wealth has now offset the decline in real estate wealth, no longer justifying the recent rise in the savings rate aimed at reconstituting losses in the valuation of assets. However, the goal of rebuilding real estate wealth has become a priority again and households' ability to afford a residential investment is only increasing, especially as their debt rate remains low.
- Companies continue to invest despite the gradual erosion of margins. They have relatively little debt and have substantially increased their self-funding rate since the crisis. For the moment, the slowdown in manufacturing activity has not had an impact on the number of bankruptcies which remains low, at its pre-crisis level. The decline in charges and the extension of tax incentives for investment in machinery and innovation will help support job creations and investment.
- Italian exports are benefiting from substitution effects with respect to the US market following the tariff increases on Chinese goods. However, the export outlook remains weak.
- Italy has resumed its "fine line" policy which aims to combine observance of European fiscal rules with a certain flexibility in order to maintain a neutral fiscal policy approach while at the same time ensuring the stabilisation, or even a modest decline in the debt/GDP ratio.
- Against a backdrop of economic stagnation and weak inflation, the only support comes from monetary policy. The ECB's low interest rate environment realigns financial conditions with the macroeconomic conditions of weak growth. The only policies available to Italy in order to support growth are supply-side policies. The structural reform process has come to a halt and needs a more stable political environment and leeway for support policies, which are not currently available, in order to resume.
- The exit of eurosceptic forces from the government and investors' renewed confidence has enabled Italy to benefit fully from the low interest rate environment without being penalised by a discrimination cost. This environment has improved the outlook for debt sustainability and reduced the prospective difference between the average cost of debt and the rate of growth which continues to weigh on the accumulation of debt due to past unfavourable financing conditions.

Paola Monperrus-Veroni
01 43 23 67 55
paola.monperrus-veroni@credit-agricole-sa.fr

Ticiano Brunello
01 43 23 07 69
ticiano.brunello@credit-agricole-sa.fr

Macroeconomics

Italian growth has stagnated since Q2 2018. There has now been a stagnation in activity for six quarters. After the technical recession observed during Q3 and Q4 2018, Italian GDP rose 0.1% in Q1 and Q2 2019. The initial GDP estimate for Q3 confirms the same trend, with an increase of 0.1%, leaving a positive growth overhang of 0.2% in 2019. This mid-year overhang largely determines the results for the year, especially as we do not expect any acceleration in activity. **GDP growth is forecast to be 0.2% in 2019 and 0.4% in 2020.**

GDP's economic momentum during H1 was the combination of still positive but weakening growth in domestic demand and a small but positive contribution from foreign trade, driven by the gradual strengthening of exports. However, negative inventory changes were a decisive drag on growth. Inventory reductions have had an adverse effect for four consecutive quarters, diminishing growth by 1.5 points since Q3 2018.

A veritable recession in industry

The manufacturing sector has been in a veritable recessionary phase since the beginning of 2018. Private services' activity has been weakening. The growth in activity is therefore supported by construction and non-market services.

The decline in the manufacturing sector's added value accelerated again in Q2 (-0.9% year-on-year after -0.5% in Q1 and -1.2% in the last quarter of 2018). The latest industrial production figures are not particularly encouraging: in August 2019, the industrial production index rose 0.3% during the month but it was still 1.8% lower year-on-year. The average for the quarter from June-August showed a further decline of 0.3% compared with the three previous months.

The industrial trend is due primarily to the fall in the production of intermediate and capital goods. These sectors have been hit by weak domestic and foreign demand (a third of production is exported) and in particular the crisis in the German automotive sector. The weakness of the German economy (13% of Italian exports are intended for this market) has had a particularly negative effect especially in the automotive sector (22% of Italian exports) and the metal and plastic product sectors. Uncertainty over the global economy has generated a response to demand based more on inventory reduction than production. However, the production of consumer goods has held up well, especially the production of durable goods. The worst performing sectors were vehicles, machinery and equipment, metals and electrical appliances. However, the pharmaceutical and food industries made a positive contribution to the growth in production.

The business climate in manufacturing continued to deteriorate in Q3, reflecting the corporate sector's more negative opinion on orders and production prospects. **That said, the latest surveys in October highlight an improvement in opinions on orders and better production prospects. The survey among purchasing managers in the sector merely confirms very weak activity in Q3 and Q4,** since the PMI shows a decline in October. Orders placed with companies are reported to be lower. It is primarily capital goods manufacturers who are experiencing a more gloomy outlook, since activity in intermediate and consumer goods is expected to have picked up.

In contrast, the recent weakening in services activity does not look set to continue in Q3 and Q4. Surveys highlight an improvement in orders and the business climate in October. Confidence has also risen in the construction sector**. The good performance of the service sector is essential to maintain positive growth, since the sector is highly employment-intensive and the main contributor to employment growth. It is therefore vital in order to sustain a virtuous employment-income-consumption circle capable of supporting domestic demand and offsetting foreign demand that is at best uncertain.**

Reasons for the slowdown

Domestic demand made a positive contribution to growth in Q2 (of 0.1 points of GDP) driven by investment, whereas household and general government consumption posted very modest growth (+0.1% over the quarter). **Domestic demand continues to lose momentum (0.4% year-on-year) due to private consumption running out of steam**, a situation that has been under way since 2018 (0.8%) after a growth peak in 2017 (1.7%). The still positive momentum in the labour market is supporting the growth in households' disposable income through job creations (+0.5% year-on-year in Q2) which are proving resilient to weakening activity and a still strong increase in wages, albeit decelerating (0.9% year-on-year). Coupled with very low inflation, it contributed to a sharp rise in purchasing power in the first half (0.6% year-on-year) of 2019. **The end of the durable goods consumption cycle and the increase in precautionary savings** (at 8.9%, the savings rate has returned to its highest level for three years) **have** nevertheless **constrained households' spending** momentum. **The rise in financial savings is also explained by the need to reconstitute the level of financial assets after the declines in asset valuations at end-2018**. The recovery in financial asset valuations underpinned by the reduction in sovereign risk and declines in recent and anticipated rates are strengthening the prospect of an increase in net wealth and reducing the need for savings for these purposes. However, **increased savings also reflect better accessibility to housing investment, and the balance between consumption and housing investment has shifted in**

favour of the latter. The crisis made Italian households poorer. Their net wealth declined between 2014 and 2016, mainly due to the loss in value of their real estate assets under way since 2012. Since 2017, the increase in their financial wealth has offset both the fall in real estate wealth and the rise in debt. However, debt continues to decline when compared to the trend in disposable income (61%). The goal of rebuilding real estate wealth has become a priority again and today, it is again possible for households to generate both positive financial and real estate investment.

In contrast, the durable goods consumption cycle is unlikely to support the growth in household spending. There has been further confirmation of the slowdown in the durable goods consumption cycle and surveys highlight a decline in automobile and housing purchase intentions in Q3. Semi-durable goods consumption was also lower in Q2 (-2.7% over the quarter) whereas consumption of non-durable goods and services was up 0.4% and 0.3% respectively. However, the sharp decline in consumer confidence observed from 2018 seems to have stabilised since the arrival in power of the new coalition, notably the expectations on the country's economic situation. While the initial payments of the "citizens' income" expected at the end of the 3rd quarter are likely to timidly support consumption, the real questions relate to the future trend in disposable income and particularly employment.

Employment has maintained a certain momentum in the face of the slowdown in activity. This trend can be attributed to the usual timeframes related to adjustment costs, which mean that companies only gradually adapt the level of production factors and do not immediately achieve their "desired" level, especially as there may be uncertainty regarding this level in the long term. And it is first and foremost working hours that are adjusted, before the headcount.

However, this trend can be attributed to other factors. A more structural factor that concerns the growing weight of tertiary activities, in particular personal services, which are highly labour-intensive. Another factor is more temporary and related to the recent restrictions on the use of fixed-term contracts (July 2018 "Dignity Decree") which have accelerated the transformation to permanent contracts. The reversal in the trend between permanent employment and fixed-term employment has been confirmed: the annualised balance for permanent employment has shifted from -2,400 (August 2018) to +366,000 (August 2019) and for fixed-term employment from +218,000 to -178,000. However, it is a short-term positive effect and it is not possible to rely on this. A major (5.2% of new permanent contracts) and more sustainable (3 years) effect is attributable to the introduction of contribution exemptions scheduled for employees less than 35 years old. **In September, there was a first rise in the unemployment rate to 9.9% (from 9.5% in August). This is due in part to the introduction of the citizens' income (and the fact that it is conditional on the active search for employment) which has boosted the number of people seeking employment. Hours worked continue to increase and the number of short-time working hours remains very low and at the pre-crisis level.** In terms of forecasts, and in line with the economic slowdown and the decline in corporate margins, the employment momentum is expected to start to slow. October PMI surveys continue to highlight an expansion in employment in the services, construction and retail sectors, but still not in industry.

The healthy employment momentum against the backdrop of stagnation reduced apparent labour productivity in H1 2019, leading to a rise in costs per unit produced and the erosion of margins. This decline in profitability, under way since 2017, has wiped out all the gains generated since 2013.

Our forecast

For the moment, corporate investment is proving resilient. It even started to rise again in 2019 (2.3% in Q1 and 0.3% in Q2), and the investment rate is at its highest level since 2011**. Therefore, the decline in investment observed at end-2018 has not continued. The reasons for the decline were an increase in the cost of financing conditions related to the increase in the risk premium, the recession in the manufacturing sector and the end of investment tax incentives. Investment tax incentives were re-established in the spring and financing conditions have since eased** due to both the stabilisation of the political situation and the new monetary policy measures announced by the ECB. The equipment utilisation rate remains high and justifies continued investment. That said, weak domestic demand and European demand as well as the uncertainties adversely affecting the global economy are all factors which may hamper the accumulation of capital.

Foreign demand made a positive contribution to growth in Q2 (0.1 points of GDP), due to exports which were more dynamic than imports. During the first eight months of the year, exports grew by 2.6% year-on-year, demonstrating a greater momentum for exports to non-EU markets, especially to the United States. Already since the first few quarters that followed the outbreak of the trade war between the United States and China, there was a sharp increase in Italian manufacturing exports to the US market (+13.5% in value on average year-on-year for the period from Q4 2018 to Q2 2019). **Italy therefore seems to have benefited from weaker Chinese penetration in the US market** particularly with regard to the transport equipment, mechanical engineering goods, plastics and food sectors. Exports to European Union countries were also higher, especially to the United Kingdom. However, there was a lack of German demand (+0.4%). Despite the substitution effect referred to limiting the negative impact of weaker global trade, the outlook remains gloomy for foreign demand. PMI surveys among purchasing managers highlight still declining foreign orders, albeit at a lower rate. ISTAT surveys also show weaker export prospects.

Therefore, our forecast cannot count on the contribution of foreign demand to boost growth. However, it relies on the stabilisation of activity, which is highlighted by the cycle's leading indicators. A potential boost for growth may come from the end of the inventory reduction process that has been under way for four quarters now. This originated from the dislocation of car production during the summer which caused a substantial accumulation in inventories. It was reinforced by the gradual deterioration in the outlook for the industry. This inventory reduction has significantly impacted growth and its normalisation should have a positive impact on activity over the next few quarters. We have maintained our growth forecasts of 0.2% on average in 2019 and 0.4% in 2020. The contribution of consumption and foreign demand are likely to remain modest and investment is expected to return to barely positive growth.

Public finances: return to “fine line” policy

Italy has resumed its “fine line” policy which aims to combine observance of European fiscal rules with a certain flexibility in order to maintain **a neutral fiscal policy approach** while at the same time ensuring the stabilisation, or even a modest decline in the debt/GDP ratio.

Against a backdrop of economic stagnation and weak inflation, the only support comes from monetary policy. **The ECB’s low interest rate environment realigns financial conditions with the macroeconomic conditions of weak growth**. The only policies available to Italy in order to support growth are supply-side policies. **The structural reform process has come to a halt and needs a more stable political environment and leeway for support policies,** which are not currently available, in order to resume.

The government has promised to stabilise its budget deficit at 2.2% for the third year in a row, no small feat when growth is so limp. Debt servicing will be smaller by 0.1 points of GDP, offsetting the 2020 decrease in its primary surplus to 1.1%. Lower risk premiums on Italian sovereign debt and the broader decline in sovereign yields throughout the eurozone have already saved €2.7bn in 2019, and are expected to provide at least €2.1bn next year.

The public deficit remains below the 3% limit, but that's not what matters for Italy. In reality, the country is failing the debt rule, because the debt/GDP ratio is not falling at the pace required by other European rules. It is therefore up to the government to prove it's reducing the structural deficit (outside of cyclical factors) at the pace of 0.5 points of GDP per year. Italy's structural deficit in 2019 is 1.2%, which needs to converge toward the 0.5% surplus medium-term objective established by European rules. **To get on track, the structural deficit must be reduced by 0.5 point per year until the objective is reached. The 2020 budget fails to keep to this convergence track, because it projects a 0.1-point rise in the structural deficit.**

However, European rules do call for a certain margin, and only allow for a procedure to begin if the deviation from the required pace is significant, i.e. larger than 0.5 points. **To avoid a significant deviation**, **the Italian government is planning to use its available flexibility to exempt from the structural deficit any one-time spending on environmental sustainability and hydrogeological or earthquake risks**. This margin of 0.2% of GDP had already been granted in previous years, and the European Commission seems inclined to allow it to continue.

The 2020 draft budget is unlikely to be very different from previous budgets. A bigger deficit, few spending cuts, and a crackdown on tax evasion to increase revenue and avoid raising VAT.

The measures to support growth are very limited and can be summarised by a payroll tax cut for employees and very little public investment.

Nonetheless, the tone is different, especially with regard to Europe. Not enough to raise a dispute, but still a rather flexible interpretation of the budget rules in order to shore up this finance bill.

Compared to a budget without changes in legislation, which would have cut the deficit by 2.2% in 2019 and 1.4% in 2020 (owing to a VAT increase of 1.3 points of GDP), the government chose to stabilise the deficit in 2020. It must find a way to finance €30bn, including €26bn in reduced revenue (mainly €23bn in VAT, but also €3bn in payroll tax cuts) and nearly €4bn in additional spending (including €700 million in public investment). It found €16bn to do so, and for the rest, the government is fine with a €14bn deficit increase, or 0.8% of GDP relative to what the budget would be with no changes in legislation. The sources of financing include €14bn in additional revenue, including €3bn in new revenue received in 2019 that is considered structural, €3.8bn from gambling revenue and cracking down on tax evasion, and €1.8bn in environmental taxes. Note that the banking industry is expected to contribute €1.6bn due to the (temporary) suspension of the asset impairment deduction. ■

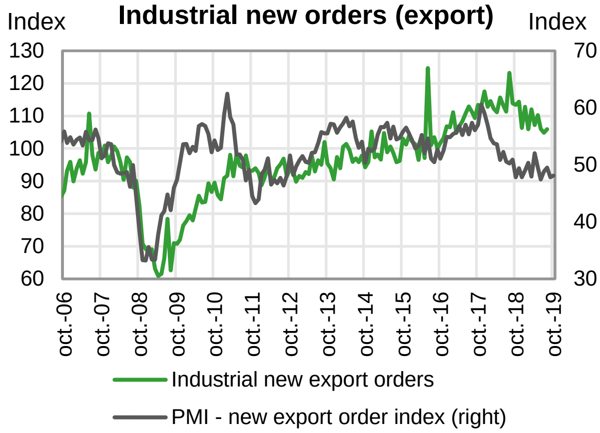
Written on 7 November 2019

Italy: economic overview at 7 November 2019

CRÉDIT AGRICOLE S.A.

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

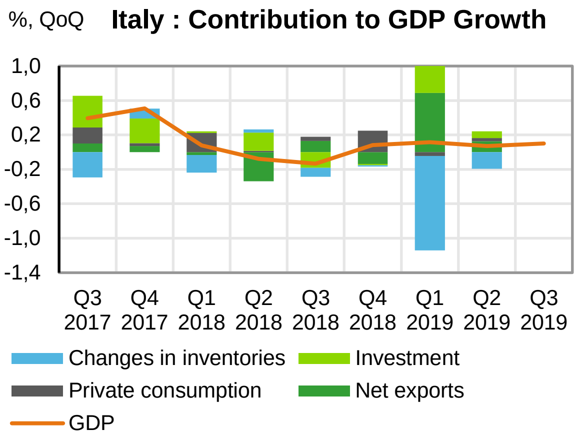
** Contributions to GDP growth*
Source : Crédit Agricole SA, forecast



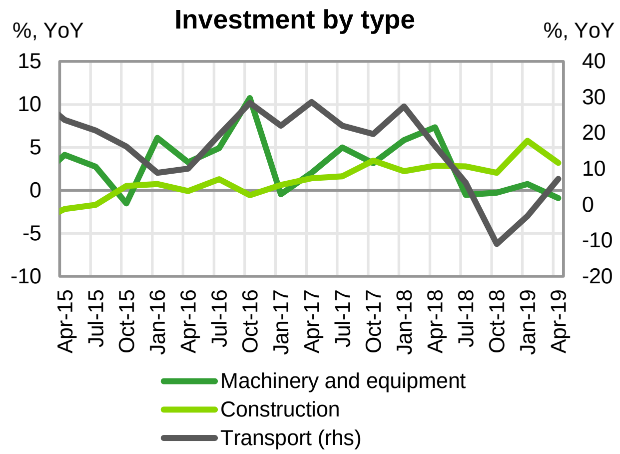
Source : Istat, Markit, Crédit Agricole S.A. Base 2015 = 100

We have maintained our growth forecasts of 0.2% on average in 2019 and 0.4% in 2020. The contribution of consumption and foreign demand are likely to remain modest.

The latest surveys in October highlight an improvement in opinions on orders and better production prospects.



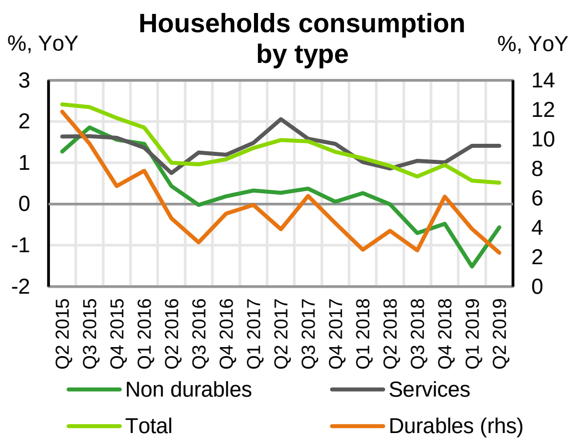
Sources : Istat, Crédit Agricole S.A.



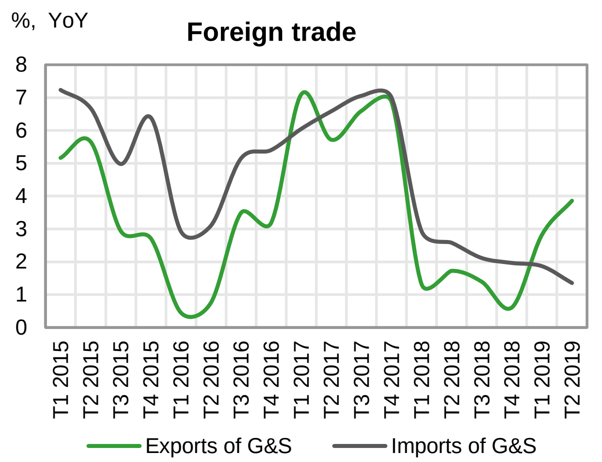
Sources : Istat, Crédit Agricole S.A.

The initial GDP estimate for Q3 confirms the same trend, with an increase of 0.1%, leaving a positive growth overhang of 0.2% in 2019.

Investment rose in Q2, driven by transport investments.



Sources : Istat, Crédit Agricole S.A.



Sources : Istat, Crédit Agricole S.A.

The durable goods consumption cycle continues to run out of steam.

Net exports have made a positive contribution to growth but the global environment remains hostile.

Budget October 2020					
	€ Billions	% GDP		€ Billions	% GDP
Total to fund	**29,8**	**1,6**	**Total funding**	**16,3**	**0,9**
Lower revenue	**26,1**	**1,4**	**New revenues**	**13,6**	**0,7**
Payroll tax cuts	3,0	0,165	Tax evasion and gambling	3,8	0,209
VAT	23	1,266	Structural revenue	3	0,162
Fiscal incentives Industry 4.0	0,0	0,007	Limits in flat tax to self-employe	0,25	0,014
Others	0,1	0,007	Eco tax, funding reorganisation subventions	1,8	0,099
			Subventions revision	0,2	0,011
			Blocking deduction depreciation losses	1,6	0,088
			Other revenues	3	0,165
Additional expenses	**3,74**	**0,2**	**Lower spending**	**2,7**	**0,1**
Birth and childhood support	0,6	0,033	Spending revision	2,4	0,132
disables	0,1	0,006	Other lower spending	0,3	0,017
Investment	0,7	0,039			
Health care (compensation red. Ticket)	0,17	0,009			
Reorganisation of local communities	0,27	0,015			
Other additional expenses	1,9	0,105			
			Deficit	**13,5**	**0,7**

Compared to a budget without changes in legislation, which would have cut the deficit by 2.2% in 2019 and 1.4% in 2020, the government chose to stabilise the deficit in 2020. It must find a way to finance €26bn in reduced revenue and €4bn in additional spending.

Consult our last publications in free access

Date	Title	Theme
05/11/2019	Italy – Residential real estate	Italy, estate
05/11/2019	Lebanon: a delayed Arab Spring	Lebanon
05/11/2019	Italy – Monthly News Digest	Italy
29/10/2019	Spain - 2019-2020 scenario: toward a smooth braking?	Spain
24/10/2019	Germany – 2019-2020 Scenario : Q3-2019 Outlook	Germany
23/10/2019	Poland: fresh success for the conservatives	Poland
21/10/2019	France – Scenario 2019-2020: robust growth despite the global slowdown	France
16/10/2019	The central bank trap	Europe, USA
09/10/2019	World – Macroeconomic Scenario for 2019-2020: keeping heads above water, just about	World
08/10/2019	France – Finance Bill for 2020: The public deficit is reduced to 2.2% of GDP	France
03/10/2019	Italy – Monthly News Digest	Italy
25/092019	Oil: panic in the House of Saud	Sectorial
18/092019	The laborious transformation of the Spanish political system	Spain
11/09/2019	Italy: to speak of political normalisation is saying a bit much	Italy
03/09/2019	Europe: post-summer agenda	Europe

Crédit Agricole S.A. — Group Economic Research
12 place des Etats Unis – 92127 Montrouge Cedex

Publication Manager: Isabelle Job-Bazille - **Chief Editor:** Armelle Sarda
Information center: Dominique Petit - **Statistics:** Robin Mourier
Sub-editor: Véronique Champion
Contact: *publication.eco@credit-agricole-sa.fr*

Access and subscribe to our free online publications:

Website: http://economic-research.credit-agricole.com

iPad: Etudes ECO application available in App store platform

Androïd: Etudes ECO application available in Google Play platform