# ITALY – 2022-2023 SCENARIO

## THE ENERGY CRISIS
## CHAPTER 2

**July 2022**

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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# OVERVIEW

## THE MOMENT OF TRUTH

The effects of the war in Ukraine are becoming more evident in the data, even though growth in the first quarter proved resilient, largely thanks to investment, which continues to perform well. The adverse effects of inflation on consumption are, however, already visible. Consumer spending declined in the first quarter, boosting savings in an environment marked by uncertainty.

Signals for the second quarter are difficult to interpret, still blurred by carry-over effects. Consumer and business confidence is certainly deteriorating, but the slowdown in production could be less pronounced than expected. Meanwhile, inflation has reached new heights. The very strong government support provided to households and businesses has helped to mitigate the effects of rising costs by preserving, in particular, household disposable income. Employment is slowing, but the unemployment rate continues to fall.

However, consumption is expected to fall further, significantly impacted by the high degree of consumer uncertainty and a sharp increase in prices. Indeed, it would seem that the price surge is only in its early stages and that the coming months should see a further acceleration in inflation. The replacement of supplies from Russia, which have fallen sharply, and the use of more costly alternative sources are leading to a new surge in energy inflation. The rise in prices could even be accompanied by a risk of rationing in the coming months, if supply is unable to meet the needs of this winter. In this case, the industrial sector would be the first to suffer. The Commission has also asked the Member States to review their energy emergency plans in order to better deal with this possibility.

Investment remains the major unknown. It is strongly benefiting from the stimulus package, but the end of the Superbonus schemes is likely to lead to a sharp slowdown in construction, which was the driving force behind the 2021 recovery. In addition, tighter financing conditions are expected to have an adverse impact on corporate financing costs.

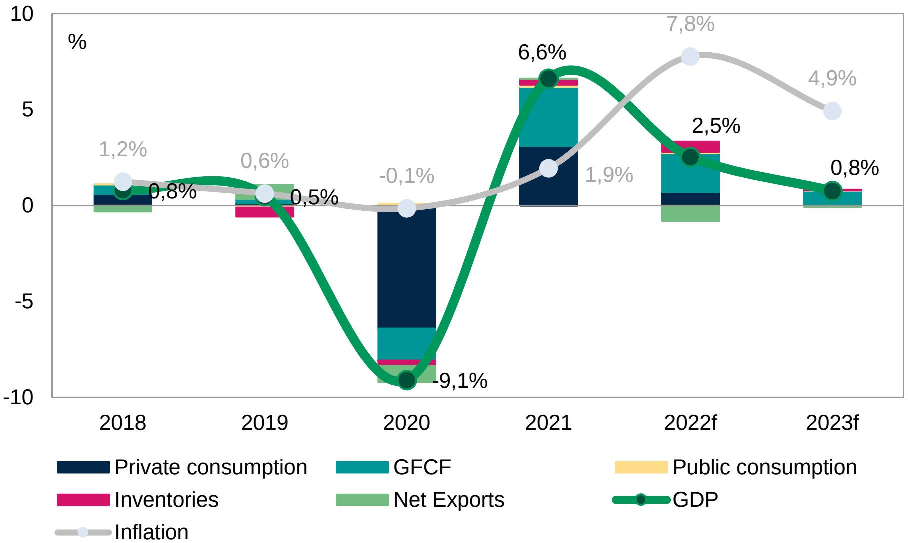
Exports continue to recover, but the surge in import costs has partially offset the positive effect of the recovery in external sales. Exports will also likely remain subject to high volatility in a slowing global environment.

The carry-over effects are likely to continue to mask the actual impact of the inflationary environment on activity. The confidence shock, although present, appears to be more diffuse and gradual alongside the rise in inflation. The prospect of a return to more moderate inflation rates is also growing more unlikely, with inflation forecasts for 2023 significantly revised upwards. As a result, GDP growth of nearly 2.5% this year should give way to a sharp slowdown in activity in 2023 to 0.8%. The continuation of the stimulus plan is likely to support activity enough to maintain investment momentum, but the impact of the plan in terms of growth is significantly revised downwards.

Finally, in an environment where risks are mostly trending upwards, the government's course of action will be decisive. However, the increase in the ECB's key rates is *de facto* generating upward pressure on Italian rates, placing constraints on the financing conditions of fiscal policy. This is due both to a general rise in rates, which is illustrated by an increase in the German Bund and a widening of spreads (the difference between the Italian ten-year rate and the German yield), which measures the inherently Italian risk.

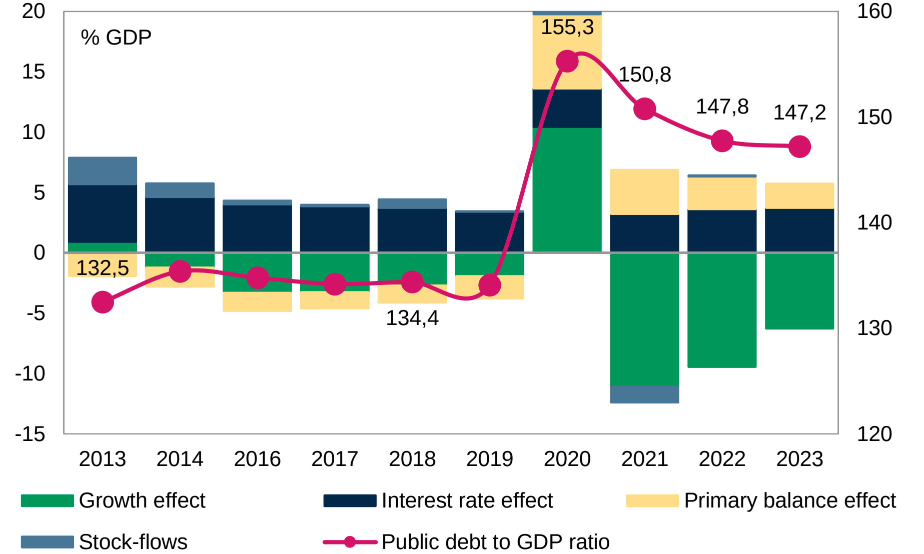
## THE MOMENT OF TRUTH

### GDP and inflation forecasts




*Sources: ISTAT, Crédit Agricole SA CACIB, Crédit Agricole SA/ECO forecasts*

### Public Finance Forecasts




*Sources: AMECO, Crédit Agricole SA forecasts CACIB, CA SA/ECO*

The ECB has announced the implementation of an *ad hoc* tool aimed precisely at limiting the risk of discrimination on the Italian BTP, but the yield curve will also depend on the market's reading of this tool. The risk of a very sharp rise in interest rates due to a poor market assessment of the country's fiscal and political situation is therefore very present. This is all the more true as the Covid-19 crisis has significantly deteriorated the balance of Italian public finances. This does not mean that Italian debt is "unsustainable". Indeed, the composition and maturity of Italian debt makes it possible to partially absorb the effect of the rise in rates.

Even if ten-year rates remained above 4% over the next two years, the main effect would be a sharp increase in debt servicing, which would offset the drop in the implied interest rate recorded over the last three years. Against this backdrop, even if the government sticks to its initial deficit targets set out in the stability programme, the debt-to-GDP ratio would continue to fall, but its pace of decline would slow down significantly, delaying the return to pre-Covid debt levels beyond 2030.

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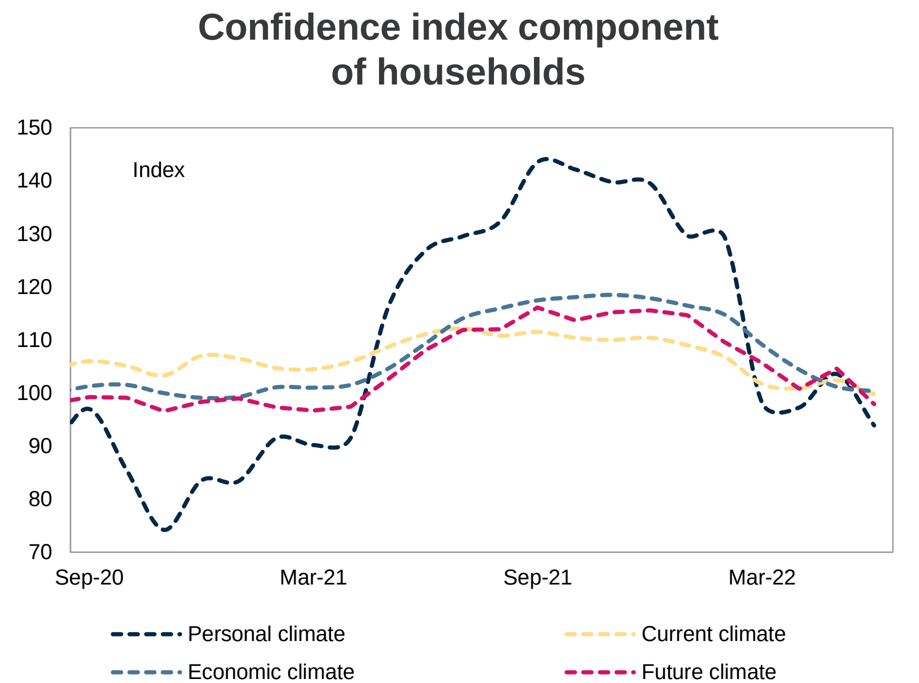
# RECENT ECONOMIC TRENDS

## CONSUMER CONFIDENCE HAS DETERIORATED


*Sources: Istat, Crédit Agricole SA/ECO*



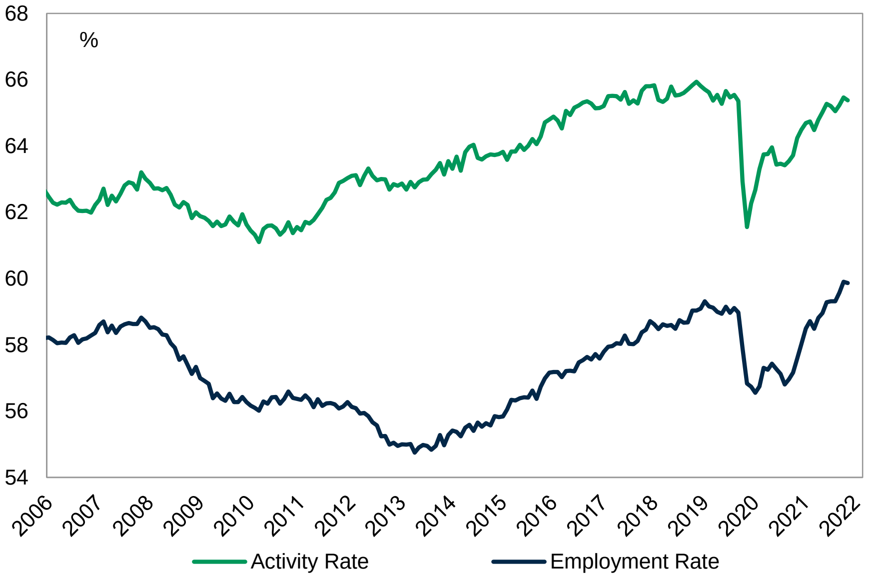

*Sources: Istat, Crédit Agricole SA/ECO*

The deterioration of the economic environment is increasingly impacting households. Against a backdrop of strong inflationary pressures, consumer confidence has deteriorated sharply since the beginning of the year to its lowest level since November 2020. All components of the index have fallen. Households are not only seeing a deterioration in the current economic climate, but they expect a more marked slowdown in the coming months, which will ultimately have consequences on their personal situation. Only the savings component appears to be improving, which indicates a trend towards precautionary savings rather than an expectation of improvement in household income. While concerns about the deterioration in labour market conditions have tended to dissipate since May with an improvement in unemployment forecasts, the labour market does show signs of a slowdown.

# RECENT ECONOMIC TRENDS

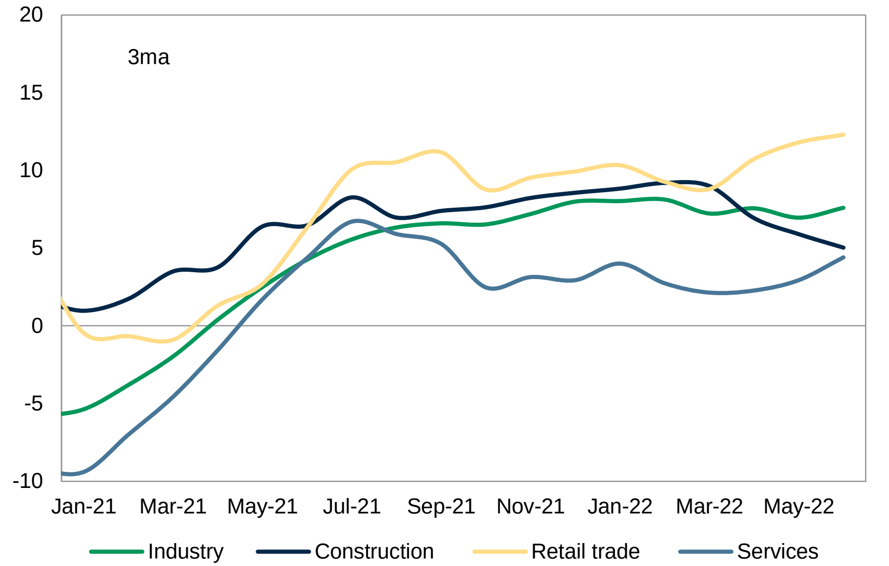
## EMPLOYMENT IS SLOWING

### Employment rate and workforce participation rate




*Sources: Istat, Crédit Agricole SA/ECO*

### Employment expectations by sector



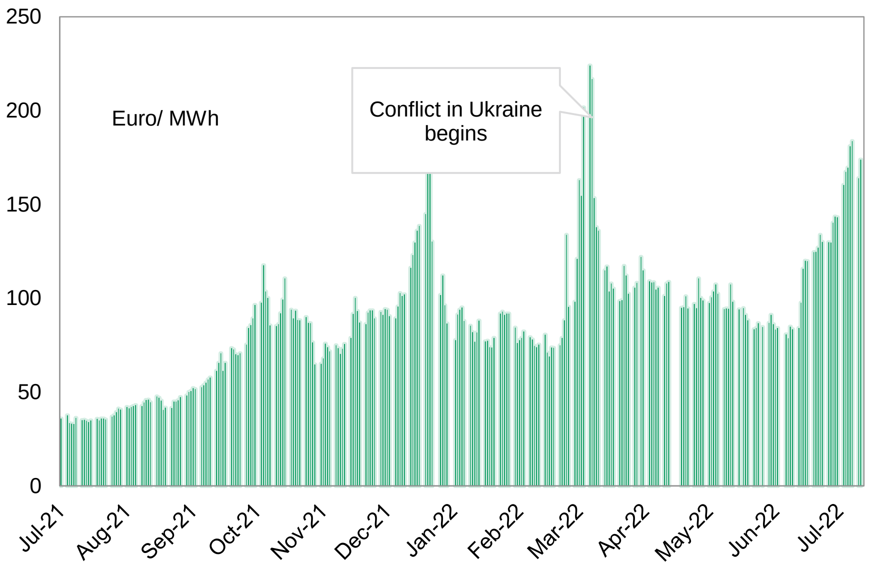

*Sources: Istat, Crédit Agricole SA/ECO*

After demonstrating some resilience in the first quarter, the labour market seems to be showing the first signs of moderation. After a first drop of -0.1% in April, employment fell again in May by -0.2%, i.e. -49,000 units. This decline in employment is not associated with an increase in the number of unemployed people, but with a slight increase in inactivity. The number of unemployed people fell -2.1% in May after a -0.8% decrease in April, bringing the unemployment rate to 8.1% in May, its lowest level since 2011 excluding the lockdown period in 2020. Despite the reversal in the trend of employment, the employment rate remains at record high levels, at close to 60%. Regarding the inactivity rate, it stands at 34.6%, still close to pre-pandemic levels.

With regard to the employment outlook, a stabilisation is in sight after the slight decline in previous months. The employment outlook is tending to improve for services and industry, but is deteriorating in the construction sector, consistent with the slowdown in the sector since the beginning of the second quarter.

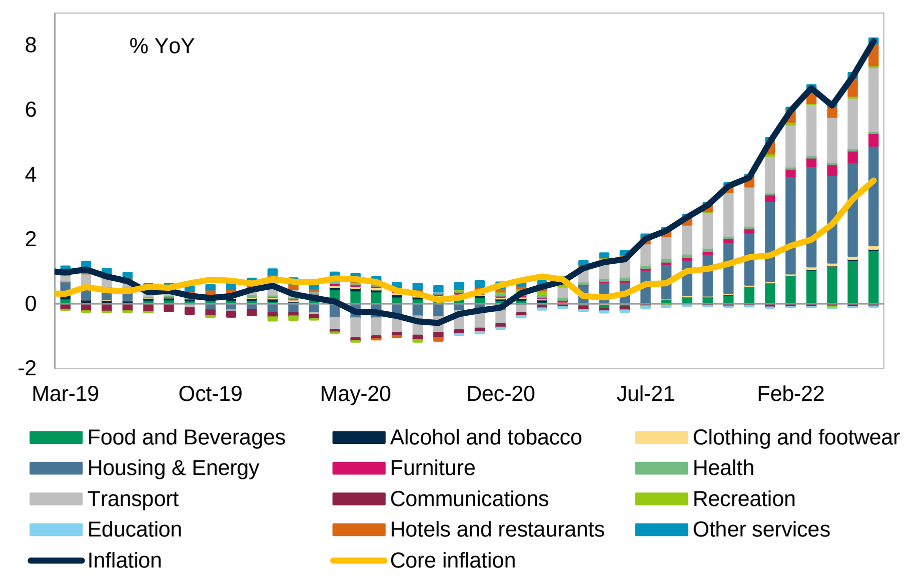
## INFLATION HITS A NEW PEAK IN MAY

### Spot gas prices on the European market




*Sources: Eikon Crédit Agricole SA/ECO*

### Inflation by type of goods




*Sources: Istat, Crédit Agricole SA/ECO*

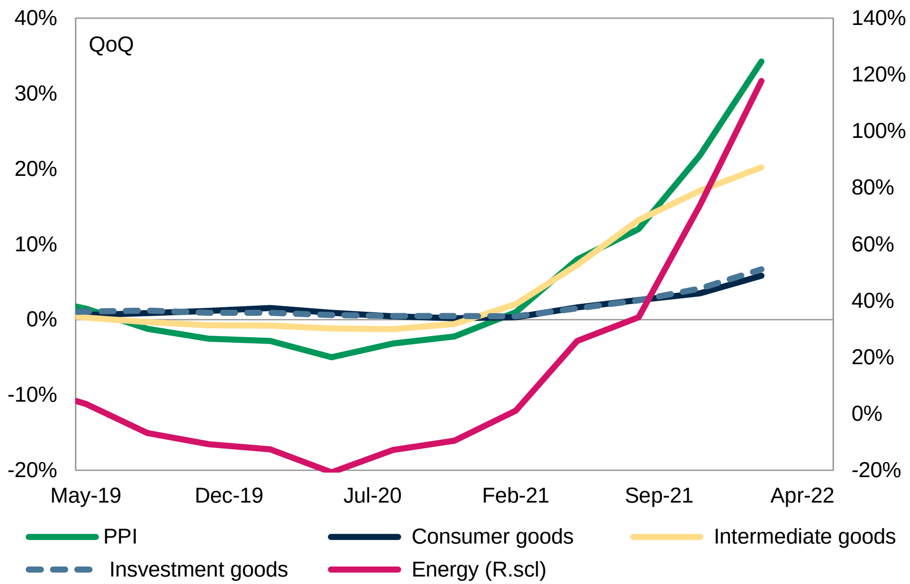
Italian consumer price inflation reached a new high in June, exceeding 8% YoY, after 6.8% YoY in May. Inflation remains driven by the acceleration in oil prices (+39.9% YoY, up from +32.9% YoY in May) and to a lesser extent by gas and electricity, which continued to record very high but stable inflation rate (+64.3% YoY). The rise in prices is also fuelled by the acceleration in the prices of food products, both processed (up from +6.6% YoY in May to +8.2% YoY in June) and unprocessed (from +7.9% YoY to +9.6% YoY).

In addition, the contagion effects between the most volatile components of the headline consumer price index and other categories of goods are tending to strengthen, leading to a further acceleration in core inflation, which approached 4% YoY in June (at 3.8% YoY after 3.2% YoY in May). The trend in the gas market suggests that the June bull market is just the beginning of a further surge in regulated energy prices. The regulatory authority has announced a 14% increase in gas prices on the regulated market.

# RECENT ECONOMIC TRENDS

## AFTER PRICE CONSTRAINTS, INDUSTRY FACED WITH FALLING DEMAND

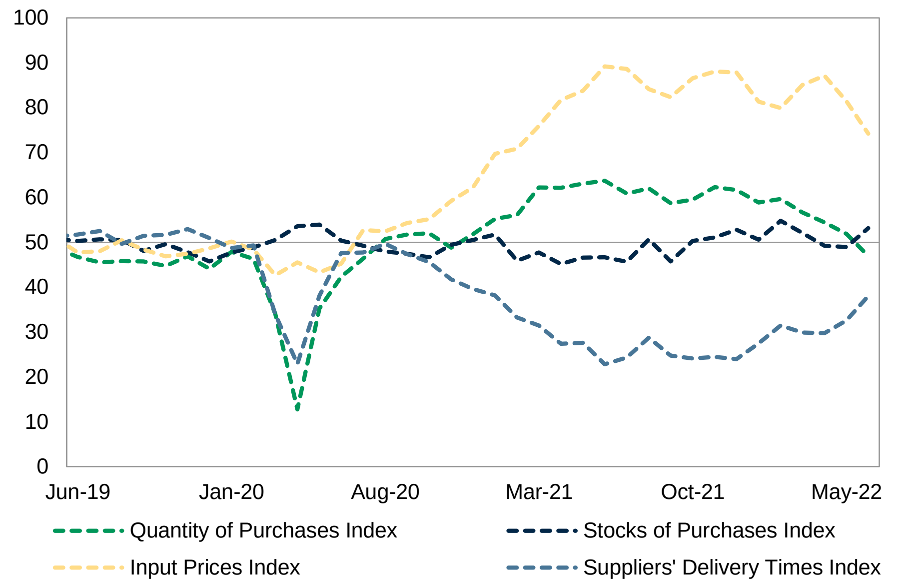
### Industrial production prices




*Sources: Istat, Crédit Agricole SA/ECO*

Industrial production prices are also dynamic. They increased by 0.6% between April and May, reaching 34.6% YoY growth, down slightly from the previous month (+35.3% YoY). In all sectors, the most significant increase in production costs is mainly in transport costs, which affect production costs in both services and construction. In addition to transportation costs, manufacturers are seeing continued growth in metals, chemicals and wood/paper prices.

### PMI Supply Constraints Indicator



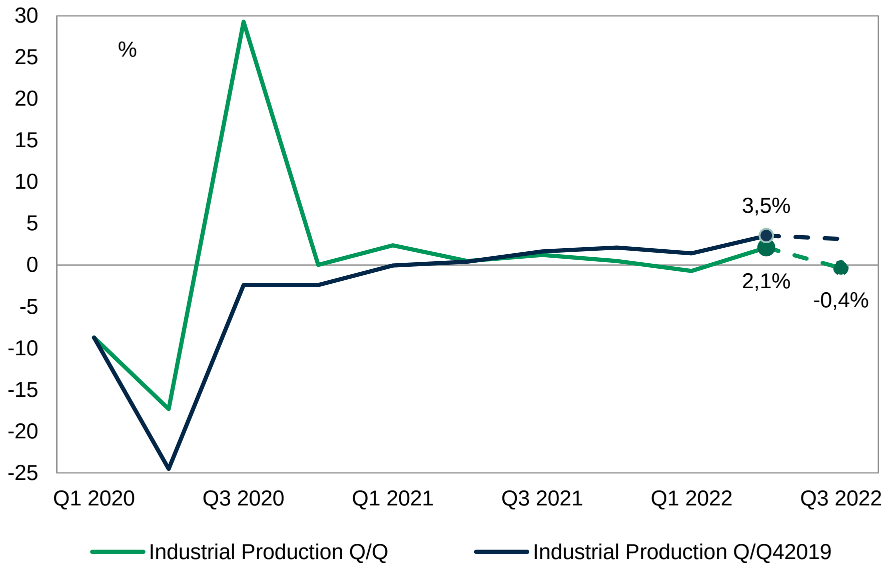

*Sources: IHS Markit, Crédit Agricole SA/ECO*

While these various price pressures are increasingly reported in business surveys, the latter send contradictory signs about the state of business confidence. Indeed, the PMI surveys are increasingly pointing to a clear turnaround in the cycle, with the manufacturing PMI recording its sixth drop (by 50.9, vs. 51.9 in May) since the start of the year, but the Istat confidence index for industry has improved slightly. That said, with the exception of June, surveys do show a downward trend in demand with a slowdown in order books.

# RECENT ECONOMIC TRENDS

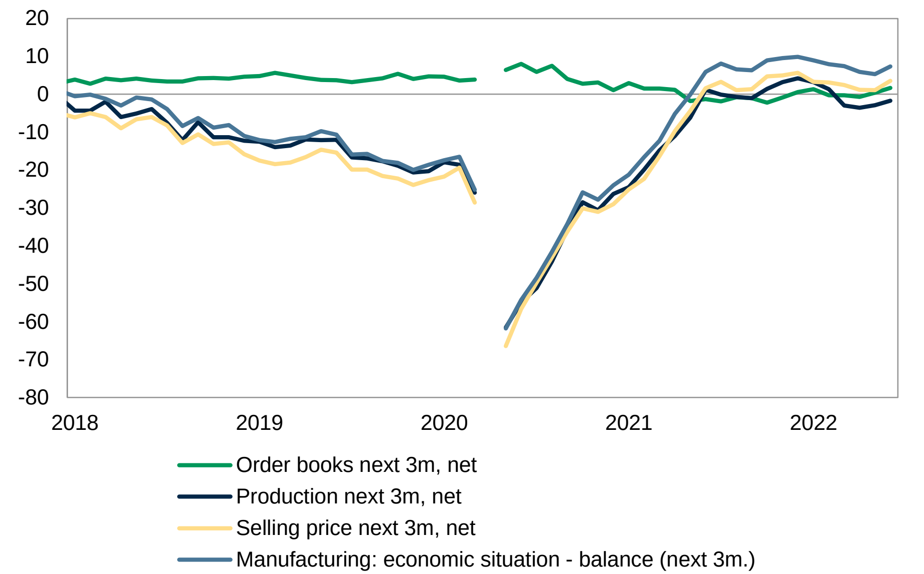
## AFTER PRICE CONSTRAINTS, INDUSTRY FACED WITH FALLING DEMAND

### Industrial output




*Sources: Istat, Crédit Agricole SA/ECO*

### Order books and level of production




*Sources: Istat, Crédit Agricole SA/ECO*

Hard data in the industrial sector exhibits some resilience despite the tone of pessimism found in the surveys. After a fall in the first quarter, industrial production is expected to grow in the second quarter thanks to a rebound in April and despite a decline in May. Indeed, the carry-over effect as of May left for the second quarter is strongly positive at +2.1%.

Production of consumer goods is expected to post the strongest increase with a carry-over effect of +4%, followed by investment goods (carry-over of +1.8%) and intermediate goods. Despite a decline in May, the carry-over effect in the energy sector is also positive at 0.4%.

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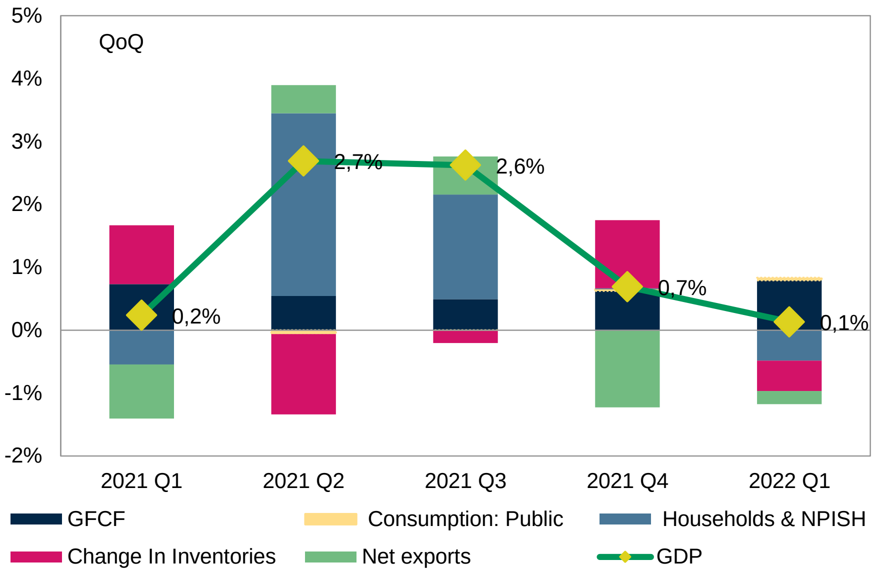
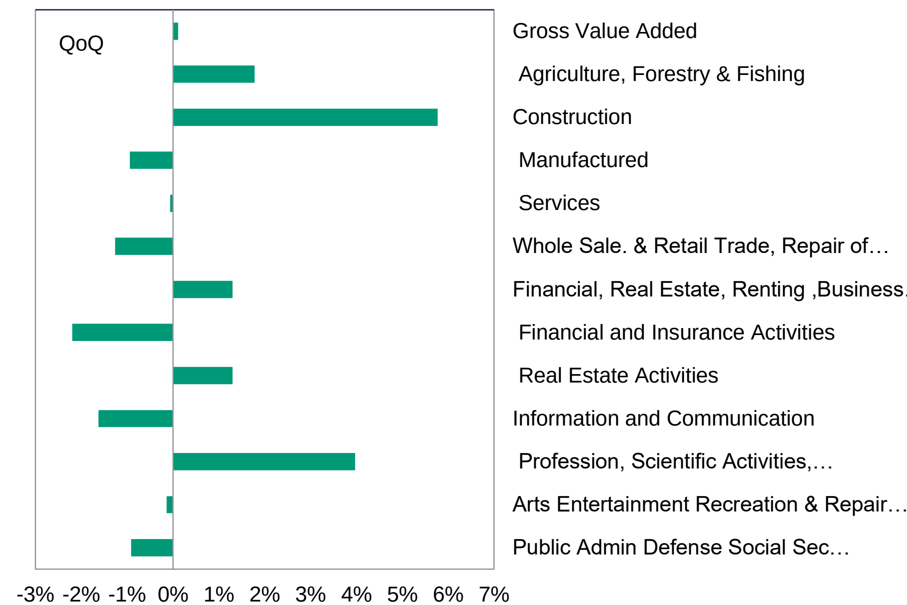
## THE ECONOMY PROVED RESILIENT IN Q1

### Contribution to growth




*Sources: Istat, Crédit Agricole SA/ECO.*

### Trend in value added in the first quarter




*Sources: Istat, Crédit Agricole SA/ECO*

Against the backdrop of skyrocketing inflation, activity was unexpectedly resilient in the first quarter. GDP growth was revised upwards in the second estimate of national accounts to +0.1% QoQ from -0.2% QoQ in the initial estimate, bringing the carry-over effect for annual 2022 growth to +2.6%. Due to a sustained rise in imports (+4.3% QoQ), net exports continued to make a negative contribution to quarterly GDP growth, shaving 0.3 percentage points from growth. Domestic demand contributed positively thanks to continued buoyant investment.

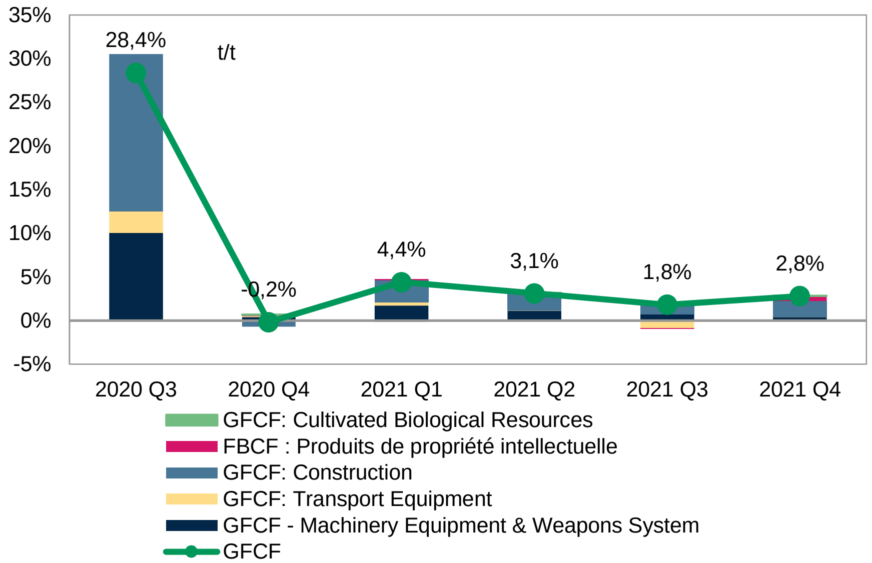
By sectors, GDP growth was largely attributable to the construction sector (+5.8 QoQ), as well as to real estate services (+1.3% QoQ) and to scientific activities (+4.3% QoQ). In line with the weak performances in industrial production, value added of industry (excluding construction) fell by 0.9% QoQ.

Hours worked are continuing their gradual recovery and increased by 1.5% QoQ. This was attributable to a rebound in agriculture, forestry and fisheries (+2.1% QoQ), in industry excluding construction (+1.2% QoQ), in construction (+5% QoQ) and in services (+1.2% QoQ).

# THE BASIS OF OUR SCENARIO

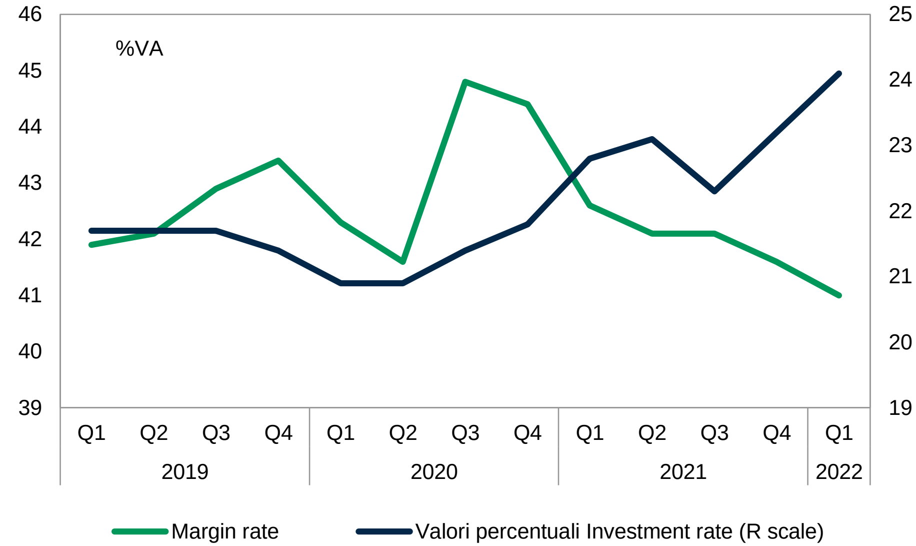
## COMPANIES CONTINUE TO INVEST

### Breakdown of investment




*Sources: Istat, Crédit Agricole SA/ECO*

### Trend in investment rates

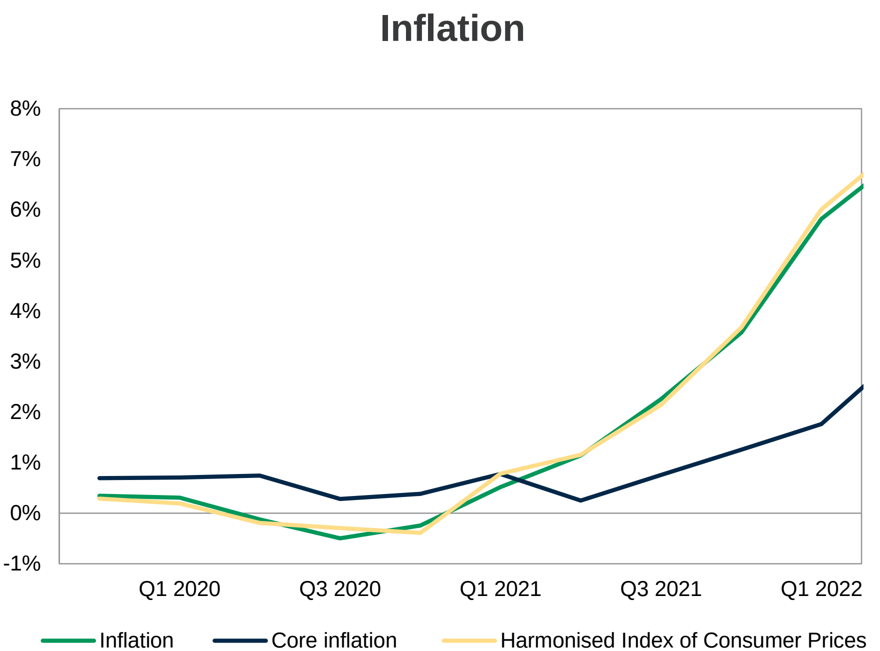



*Sources: Istat, Crédit Agricole SA/ECO*

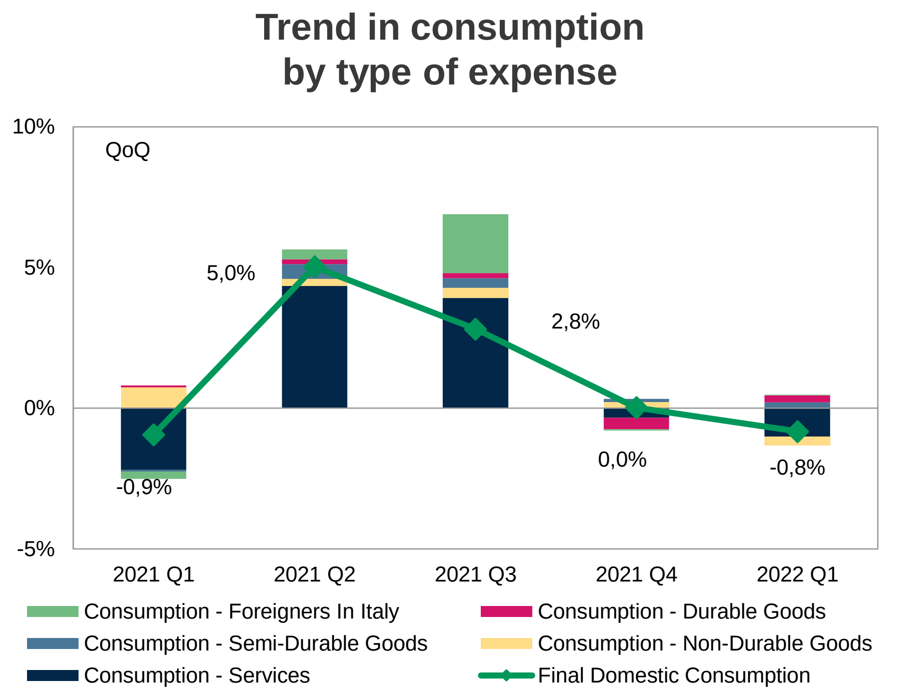
After increasing by more than 3% QoQ in the fourth quarter 2021, gross fixed capital formation continued to perform well in the first quarter 2022, posting a 3.9% QoQ increase. In detail, the acceleration in investment remained driven by the strong momentum in the construction sector (+5.5% QoQ in Q1, after +4.3% QoQ in Q4 2021), which contributed by 2.6 percentage points to overall investment growth. The sector's strength can be attributed to both the construction and public works component (+5.3% QoQ) and housing (+5.7% QoQ). At the same time, the decline in business confidence does not seem to have had an effect on productive investment, whose growth rate more than doubled, increasing from +1.6% QoQ in the fourth quarter 2021 to +4.3% QoQ in the first quarter 2022.

The increase in investment is also observable in the financial accounts of non-financial companies (NFC). The investment rate of NFC rose by 0.9 percentage points to 24.1% in the first quarter. By contrast, financial companies recorded a 0.6 point drop in their margin rate.

## CONSUMPTION FALLS UNDER THE WEIGHT OF INFLATION




*Sources: Istat, Crédit Agricole SA/ECO*



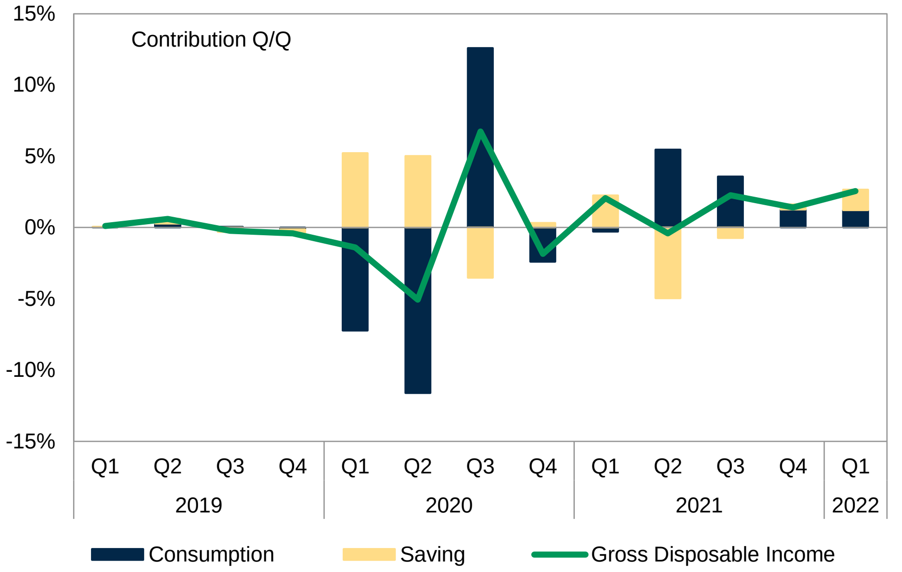

*Sources: Istat, Crédit Agricole SA/ECO*

The effects of inflation on household consumption are much more pronounced than in investment. In the first quarter, the consumer price index rose 5.8% YoY, compared to 3.9% YoY in the previous quarter. At the same time, consumer spending declined by 0.8% over the quarter, after being stable in the last quarter of 2021. While consumption of durable and semi-durable goods increased by 2.7% QoQ and 2.4% QoQ respectively, consumer spending was more negatively impacted by the rise in prices of services and non-durable goods and fell in those sectors (by -2% QoQ in the former and -1% QoQ in the latter).

# THE BASIS OF OUR SCENARIO

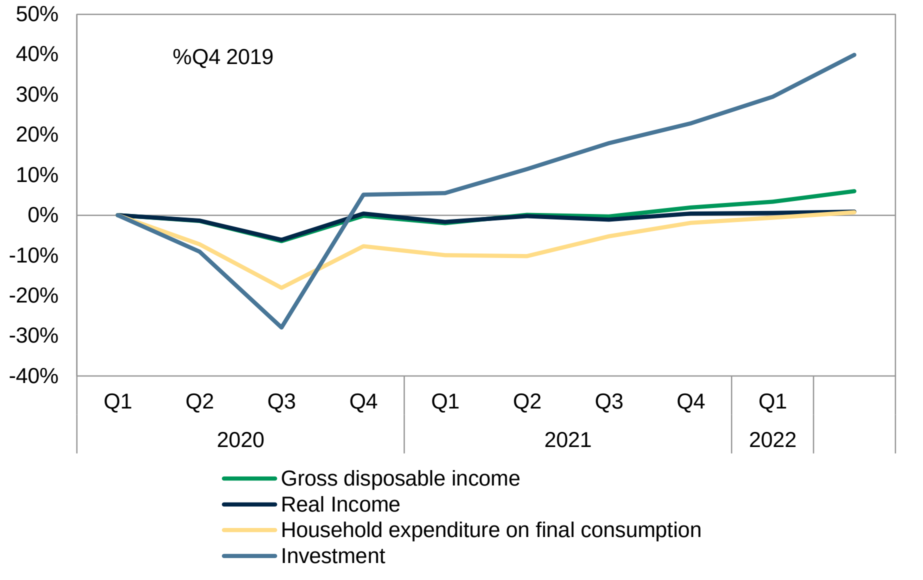
## HOUSEHOLD DISPOSABLE INCOME IS GROWING SLIGHTLY

### Savings-consumption arbitrage




*Sources: Istat, Crédit Agricole SA/ECO*

### GDI returns to its pre-crisis level




*Sources: Istat, Crédit Agricole SA/ECO*

Household disposable income increased by 2.6% in the first quarter in nominal terms, but income growth remained more contained in real terms, improving only +0.3% after rising 0.2% in the previous quarter. In a context of high uncertainty, households seems to have favoured precautionary savings in their consumption choices. While consumer spending in current terms increased by 1.4%, the propensity to save increased +1.1 percentage points more than in Q4 2021, to 12.6%. The household investment rate was also up slightly, from 6.8% to 7.2%.

During 2021, nominal household disposable income largely recovered losses related to the Covid-19 crisis. As at the end of the year, it stood 6% above its Q4-2019 level. However, the increase in inflation largely offset this rise and, in real terms, household disposable income exceeded the pre-crisis level by 0.9% only. The same observation can be made for household consumption spending, which exceeded its level of Q4-2019 by only 0.7%. At the same time, the savings rate, although it has fallen from the 2020 peak, remains well above its historical average of around 8% between 2010 and 2019.

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