ITALY 2022-2023 SCENARIO

AVOIDING THE PERFECT STORM

October 2022

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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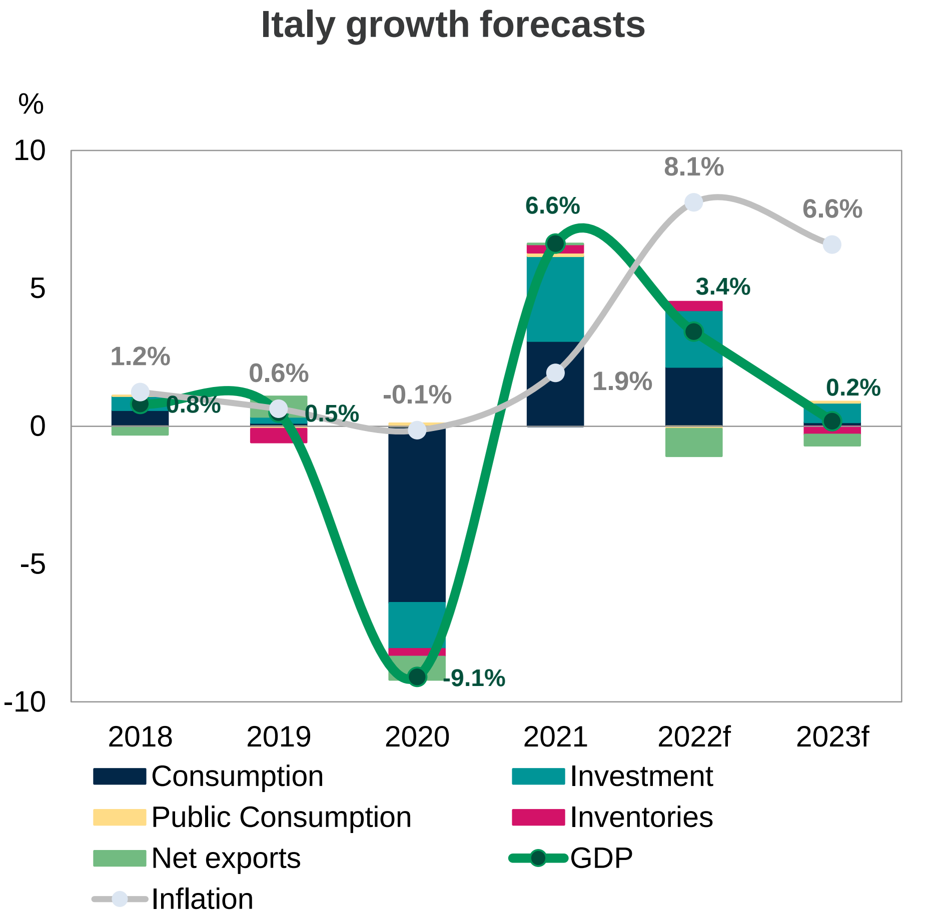
SUMMARY

AVOIDING THE PERFECT STORM

The Italian economy showed resilience in 2022. Despite the dual shock linked to the rise in energy prices and the deterioration in economic sentiment due to the Russian invasion in Ukraine, the ongoing post-Covid recovery as well as the significant public support package (€57.1 billion or 3.0% of GDP) aimed at mitigating the impact of inflation should enable growth to increase to 3.4% in 2022. The country has been able to partially reduce its exposure to Russian gas imports, the latter having decreased from 40% of its total consumption in 2021 to 20% this year. However, ever-increasing inflationary pressures should lead to a decline in activity in the fourth quarter of 2022 and the first quarter of 2023. The deterioration in financing conditions for businesses and households as well as the climate of uncertainty should lead to a slowdown in demand impacting employment and household income. The effects of all these cumulative factors are reflected in our scenario by a sharp slowdown in activity with growth close to zero in 2023. This scenario is based on the assumption of continued fiscal support with a deficit projected in 2023 at 6.5%, compared with a trend deficit (unchanged) of 3.5%.

The early elections on 25 September resulted in the victory of the centre-right coalition led by Giorgia Meloni of the far-right *Fratelli d'Italia* party. Giorgia Meloni's government, which relies on a strong majority in Parliament, will face many challenges while having limited room for fiscal manoeuvre. Against the backdrop of a sharp rise in **sovereign rates and a slowdown exacerbated by the energy shock, it will have the difficult task of limiting the recession.**



Sources: Istat, Crédit Agricole SA/ECO

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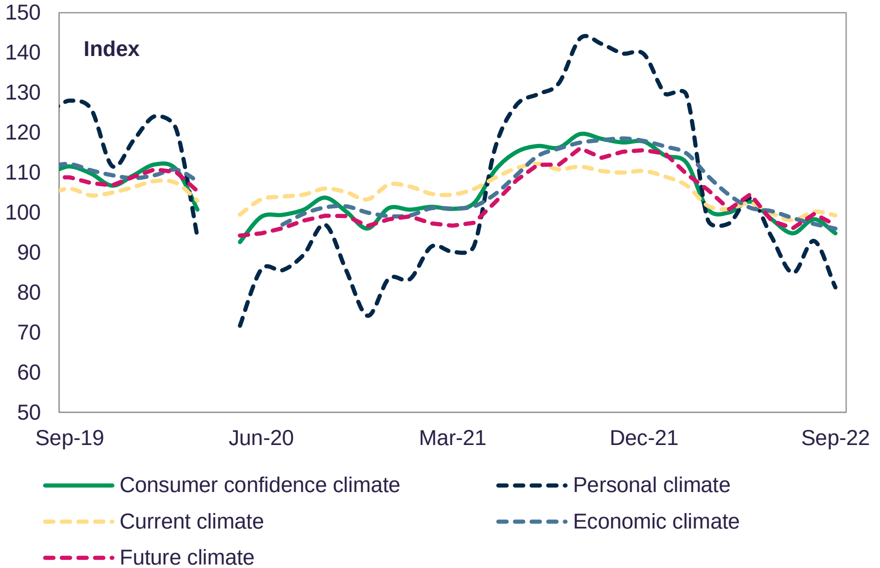
RECENT ECONOMIC TRENDS

CONSUMER CONFIDENCE AT ITS LOWEST POINT

Consumer confidence



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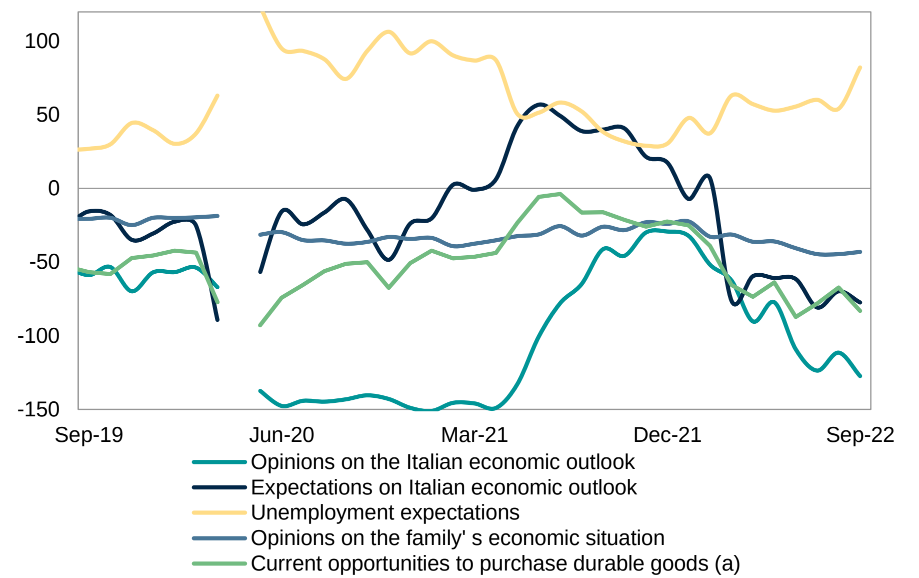
Household confidence survey

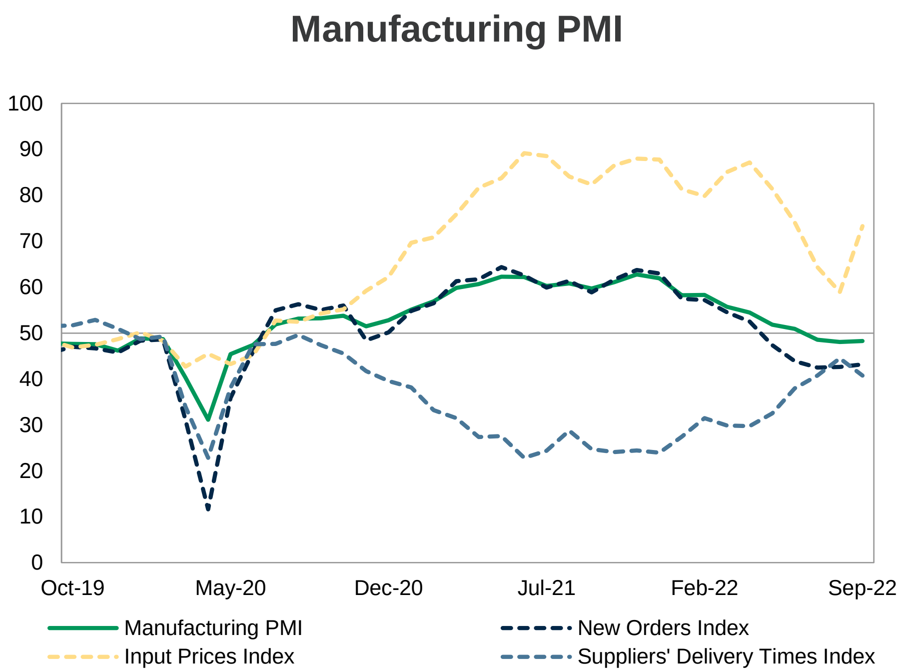


Sources: Istat, Crédit Agricole SA/ECO

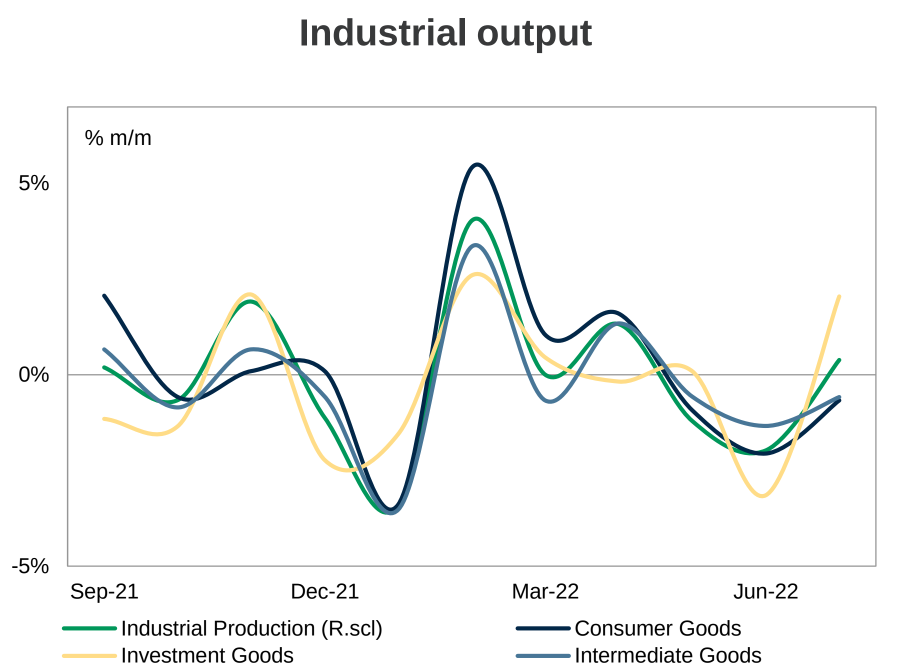
Consumer confidence continued to deteriorate during the third quarter, with news arriving from the war in Ukraine, concerns about gas shortages during the winter, and inflation rates reaching new highs. The index rose from an average of 100 in Q2 to 95 in Q3. Expectations about the future growth of the Italian economy and households' perception of their personal situation have also deteriorated sharply, indicating growing concerns about an increasingly uncertain climate. In addition, more households are anticipating the impact of the economic slowdown on the labour market, pushing unemployment expectations higher since August.

RECENT ECONOMIC TRENDS

DECLINE IN INDUSTRY CONFIDENCE



Sources: Markit, Crédit Agricole SA/ECO



Sources: Istat, Crédit Agricole SA/ECO

In August, industrial production showed a clear rebound, ending the decline in activity that began in the spring. The industrial production index thus increased by +2.3% compared to the previous month. The month's recovery represented a positive development in the third quarter, but this could prove short-lived.

Indeed, business confidence surveys continue to point to a deterioration. After a slight improvement in Q2, business confidence fell from 110 in Q2 to 108 in Q3. All sectors, with the exception of construction, were affected by the decline, which was, however, more pronounced in manufacturing, where the index fell from 109 to 104. The trend seemed to be continuing in October, as confidence in industry deteriorated once more. In September, the industrial confidence index was the lowest since February 2021. This was also reflected in the PMI surveys whose index has been below the 50 threshold since July and reached 46.5 in October, the same level as in May 2020.

RECENT ECONOMIC TRENDS

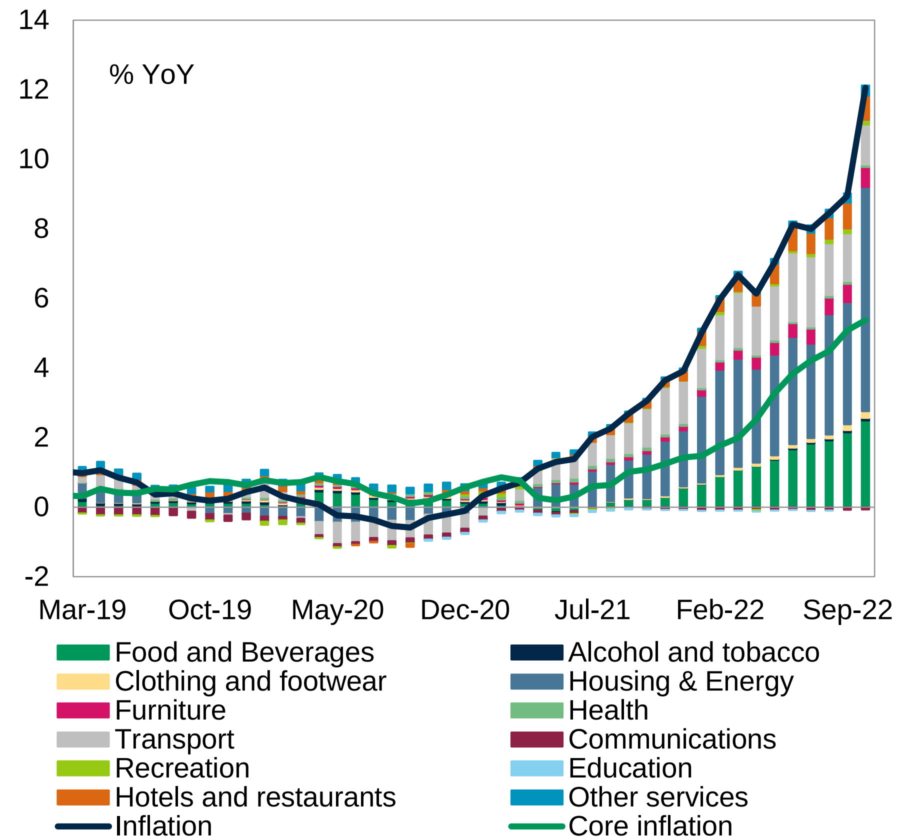
INFLATION: WHEN THE PEAK IS REACHED

Inflation reached a new high in October. The acceleration in energy prices pushed the overall price level up 3.5% from the previous month, bringing year-on-year inflation to 11.9%, its highest level since 1984.

After the slight decline in August, energy goods prices accelerated again, recording an increase of 73.2% year-on-year under the cumulative pressure on prices of regulated goods (from +47.7% to +62.1%) and unregulated goods (from +41.2% to +79.5%). The rebound in inflation also concerned food prices, which rose from +11.4% in September to +13.1% in October. The increase affected both processed food goods (from +11.4% to +13.4%) and unprocessed food goods (from +11.0% to +12.9%).

Contagion effects continue to impact other categories of goods. Property prices rose from +4% in September to +4.5% in October. The increase concerned all categories from +4.6% to +5.1% for durable goods, from +4.6% to +5.2% for non-durable goods and from +2.8% to +3.2% for semi-durable goods. Conversely, service prices decelerated (from +3.9% in September to +3.7%), partly due to the slowdown in the prices of recreational services linked to seasonal factors (+5.7% in September to +5.1% in October) and those of accommodation services (from +16.0% to +12.4%, i.e. -6.0% on a monthly basis). Despite this slight deceleration in services, core inflation continued to rise from +5.0% to +5.3%. The overhang for 2022 also increased to 8% for the general price index and to 3.7% for core inflation.

Year-on-year inflation



Sources: Istat, Crédit Agricole SA/ECO

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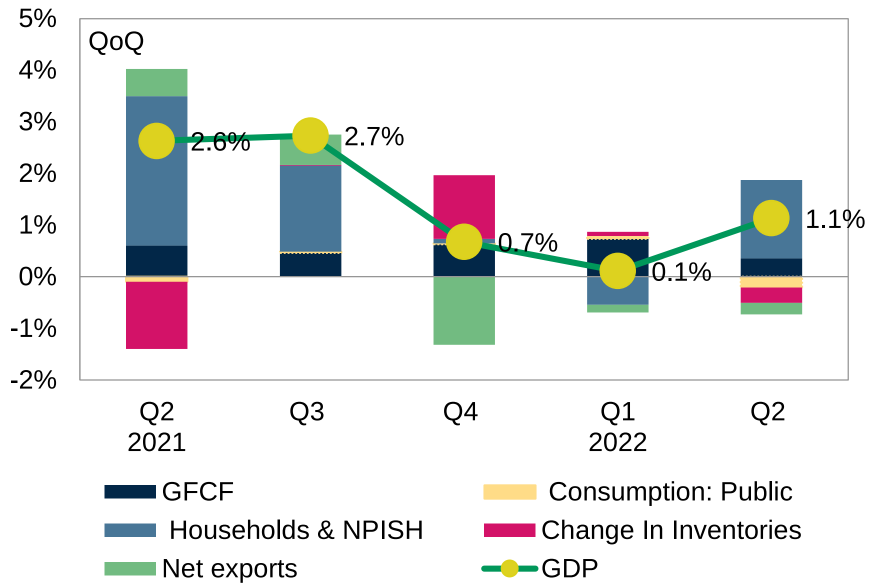
THE BASIS OF OUR SCENARIO

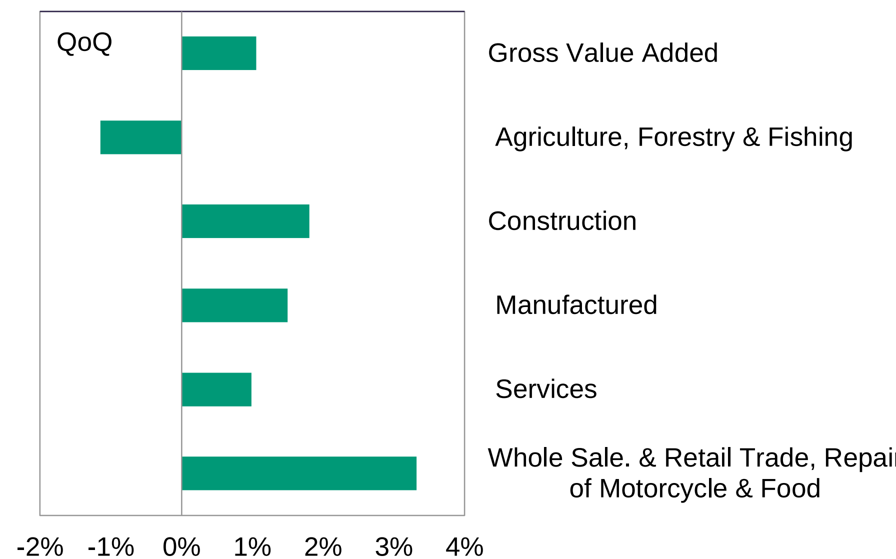
THE END OF THE PANDEMIC SUPPORTS CONSUMPTION DESPITE INFLATION

Contributions to growth



Sources: Istat, Crédit Agricole SA/ECO

Added value



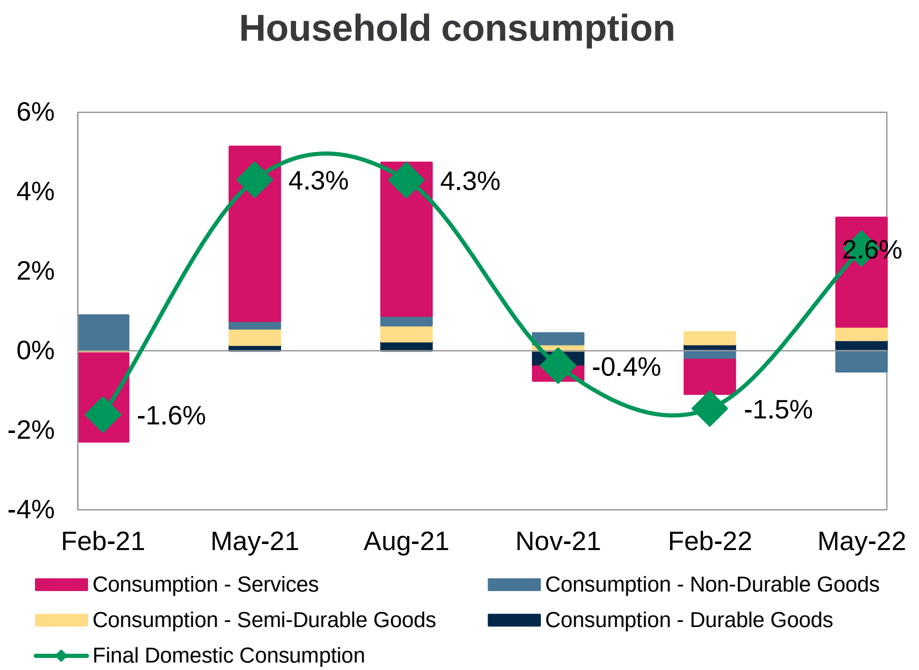
Sources: Istat, Crédit Agricole SA/ECO

Contrary to consensus estimates from forecasters, which suggested a slowdown, GDP increased by 1.1%, bringing the level of GDP to 0.6 points above the 2019 average. GDP momentum was supported by net domestic inventory demand, which contributed more strongly in the second quarter. On the other hand, net external demand, negatively impacted by the energy crisis, contributed negatively to GDP growth.

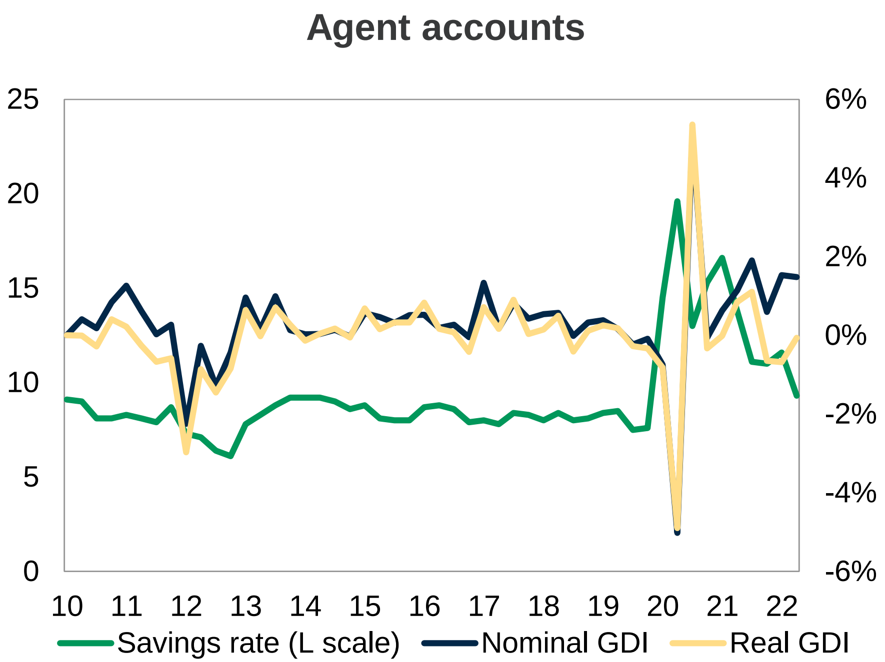
Supply constraints and the increase in energy costs had asymmetrical impacts on the various business segments. The added value of the manufacturing industry, after posting a decline in Q1 (-0.8%), recovered in Q2 (+1.3%). At the same time, the construction sector has started to slow down. After a robust performance in Q1 (5.6%), construction production slowed down (1.8% in Q2). Finally, services, which benefited from a gradual return to normal operating conditions, saw a recovery in Q2 (1.0%).

THE BASIS OF OUR SCENARIO

THE END OF THE PANDEMIC SUPPORTS CONSUMPTION DESPITE INFLATION



Sources: Istat, Crédit Agricole SA/ECO



Sources: Istat, Crédit Agricole SA/ECO

After a decline in Q1, household consumption recovered in Q2, posting an increase of +2.6%. The normalisation of post-pandemic consumer behaviour first favoured a sharp recovery in spending on services, which increased by 5.3%, contributing 2.6% to total household spending. Consumption of goods was also up sharply, fuelled by the increase in consumption of durable goods (+4.1%) and semi-durable goods (+3.7%), while non-durable goods, much more vulnerable to the price effect, dropped 1.3%.

The recovery in tourist flows from spring onwards also led to a sharp acceleration in non-resident spending (26.9% q/q). The recovery in consumption was accompanied, on the one hand, by an increase in household disposable income of +1.5% and a significant decrease in the propensity to save, which reached 9.3%, down -2.3 percentage points compared to the previous quarter. However, the household savings rate remains higher than before the crisis, and the accumulated savings surplus has not been hindered.

THE BASIS OF OUR SCENARIO

THE LABOUR MARKET IS SHOWING RESILIENCE

The increase in activity was accompanied by positive performances in terms of employment. This applies to all sectors, but employment growth has been more pronounced in construction and services. The number of people employed increased by 0.8% in Q2, exceeding the 23 million mark. The growth in salaried employment continued over the quarter, driven by the dynamism of fixed-term contracts, which exceeded the 3 million mark, and by the less sustained increase in permanent contracts. The employment of freelancers did not perform as well and remains below its level in the pre-pandemic period. The employment rate, which had fallen sharply during the pandemic period, reached 60.2% in Q2, up 0.5 points from the previous quarter.

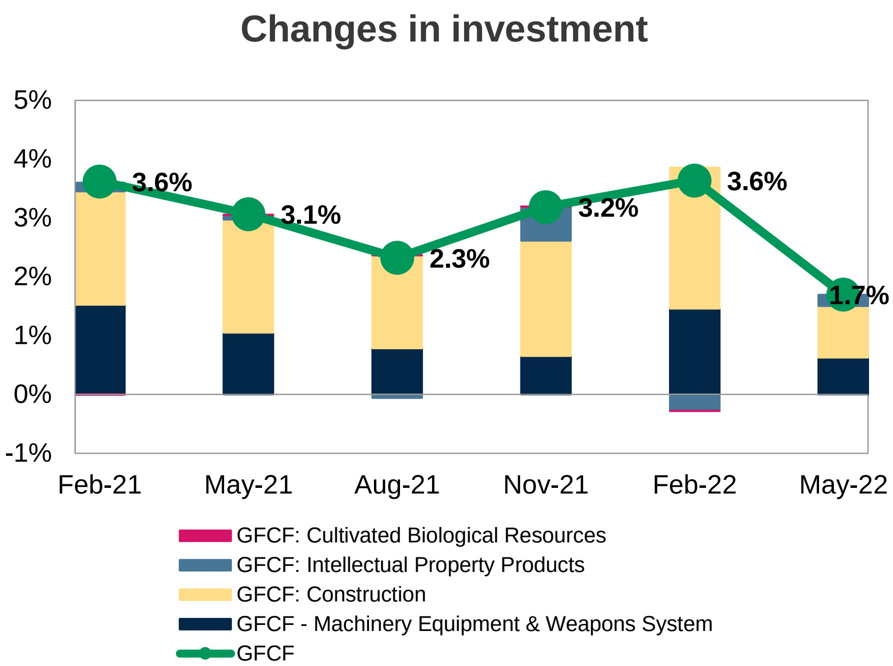
At the same time, the number of job seekers continued to decline (-4.6% in Q2), bringing the unemployment rate to 8.1% in the second quarter, its lowest point over the past decade. Compared to 2021, the number of unemployed has decreased by 407,000 people. At the same time as the increase in employment, the continued decline in the unemployment rate is also linked to the weak momentum of the working population (inactivity rate of 34.4% in Q2), which, in the second quarter of the year, was still 338,600 people behind the pre-crisis period.

The cumulative effect of the rising labour demand and falling unemployment has been accompanied by moderate wage growth. Wages per capita, after remaining essentially unchanged in the first quarter of 2022, increased more sharply in industry than in commercial services. Wages grew 1.5% in the second quarter.

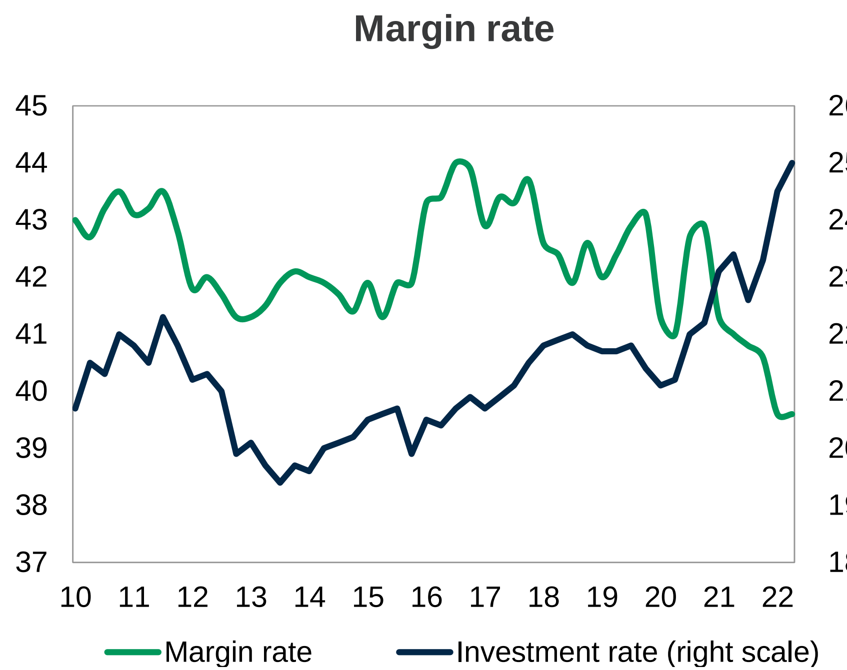
Sources: Istat, Crédit Agricole SA/ECO

THE BASIS OF OUR SCENARIO

AFTER TWO YEARS OF STRONG GROWTH, INVESTMENT IS SLOWING DOWN



Sources: Istat, Crédit Agricole SA/ECO



Sources: Istat, Crédit Agricole SA/ECO

Despite an environment marked by uncertainty, investment continues to be resilient. After growth of more than 3% in Q1, it posted growth of 1.7% in Q2. With the exception of investment in transport goods, all components of gross fixed capital formation (GFCF) were up. Productive investment expanded by 1.8%. Still supported by the *Superbonus*, investment in construction also increased by 1.8%, driven by investment in housing (+2%) and public works (1.6%).

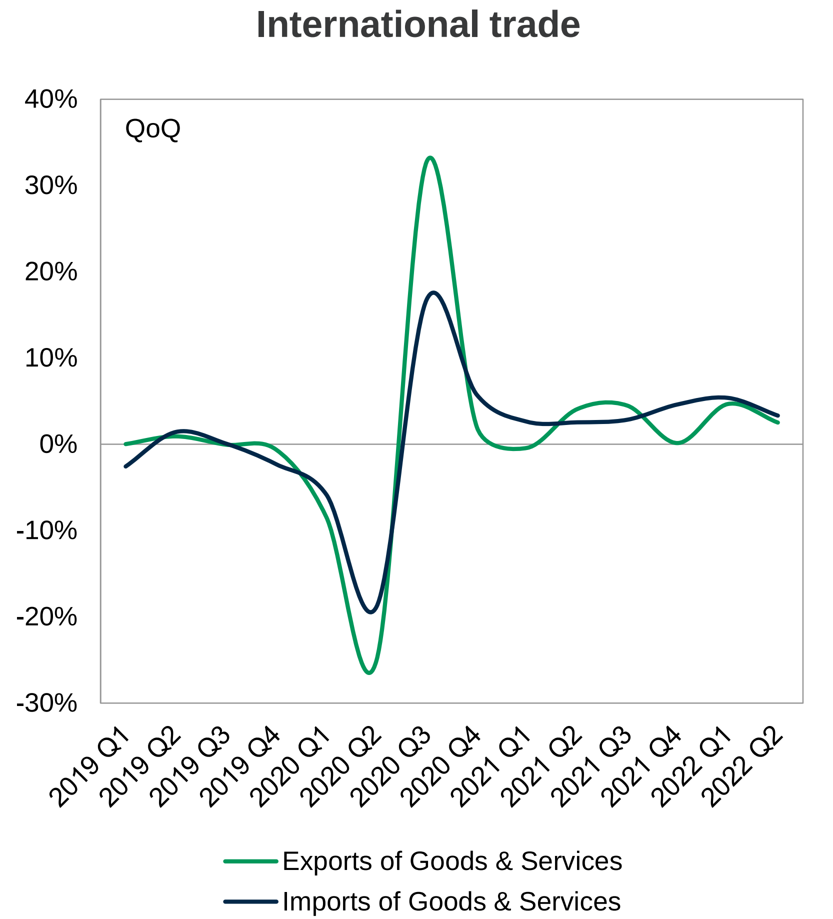
The upward trend in the investment rate of non-financial companies was confirmed with an increase of 0.5 points, while the increase in gross fixed capital formation (+4.8%) was more pronounced than that of added value (+2.5%). The corporate margin remained stable compared to the previous quarter at 39.6%. However, it is at its lowest level since 1999.

THE BASIS OF OUR SCENARIO

THE ENERGY SHOCK DETERIORATES THE TRADE BALANCE

During the second quarter, export growth slowed slightly from 4.7% in Q1 to 2.5% in Q2. Indeed, the acceleration in service exports only partially offset the slowdown in exports of goods, which were much more affected by the current context of rising costs. Although the pace of export growth was rather strong in the first half of the year, the solid momentum in imports led to a negative contribution from external demand. After an increase of 5.4% in Q1, imports grew by 3.3% in Q2.

The increase in imports also resulted in a sharp deterioration in the Italian trade balance which, in the second quarter, posted a deficit of around EUR 5.9 billion, penalised by a further deterioration in the energy balance (€ -26.7 billion in the second quarter, compared to € -21.8 billion over the previous three months). During the first seven months of 2022, the trade balance recorded a deficit of €13.7 billion, compared with a surplus of €37.5 billion over the same period last year. The energy shock is largely reflected in the energy balance, with a deficit of €60 billion in the first seven months. The deterioration in terms of trade as well as the stronger growth in import volumes led to a deterioration in the trade balance excluding energy, which, although surplus, fell by around €10 billion compared to the same period in 2021.



Sources: Istat, Crédit Agricole SA/ECO

ITALY: AVOIDING THE PERFECT STORM

2022-2023 SCENARIO OUTLOOK

Italy	2021	2022	2023	2022				2023			
%				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	6,6	3,4	0,2	0,1	1,1	0,5	-0,4	-0,3	0,3	0,3	0,2
Households consumption	5,2	3,7	0,3	-0,9	2,6	0,1	-0,5	-0,4	0,2	0,3	0,2
Investment	17,0	10,4	3,3	3,6	1,7	1,2	0,8	0,7	0,5	0,7	0,7
Change in inventories*	0,3	0,3	-0,3	0,0	-0,3	-0,2	-0,1	-0,1	0,1	0,0	-0,1
Net export*	0,0	-1,0	-0,4	-0,2	-0,2	-0,1	-0,2	-0,1	-0,1	0,0	0,0
Unemployment	9,5	8,9	9,8	8,5	8,1	9,4	9,5	9,5	9,5	9,9	10,2
Government net lending	-7,2	-5,1	-3,6								

* Contributions to GDP growth

Inflation should remain high in light of the supply constraints still very present on the gas market, while the continuation of the Russian-Ukraine conflict and the tightening of monetary policy should constrain growth in 2023, bringing our new forecast **to 0.2%, from 0.8% in June.**

Growth in Q3 is expected to remain positive despite the surge in inflation, thanks in particular to the performance of the tourist season. **Growth is expected to decline in Q4 (-0.4%)**, while inflation is expected to peak at 9.9%. Pressure on prices should lead to a decline in consumption over the quarter. The deterioration in economic sentiment and the tightening of financing conditions resulting from the rise in interest rates are likely to constrain growth and investment, which would nevertheless continue to benefit from the investments in the stimulus plan.

The beginning of the year will be marked by a technical recession in Q1 caused by a persistent high general level of prices. Starting in Q2 2023, growth should see a moderate recovery (+0.3% on average), in response to a gradual decline in inflation. However, price levels could remain high due to constraints on the global gas supply. This could lead to stagflation with the start of a downward cycle in demand and an increase in corporate bankruptcies, repercussions on the labour market that would limit the recovery in 2024 (+0.9% in 2024).

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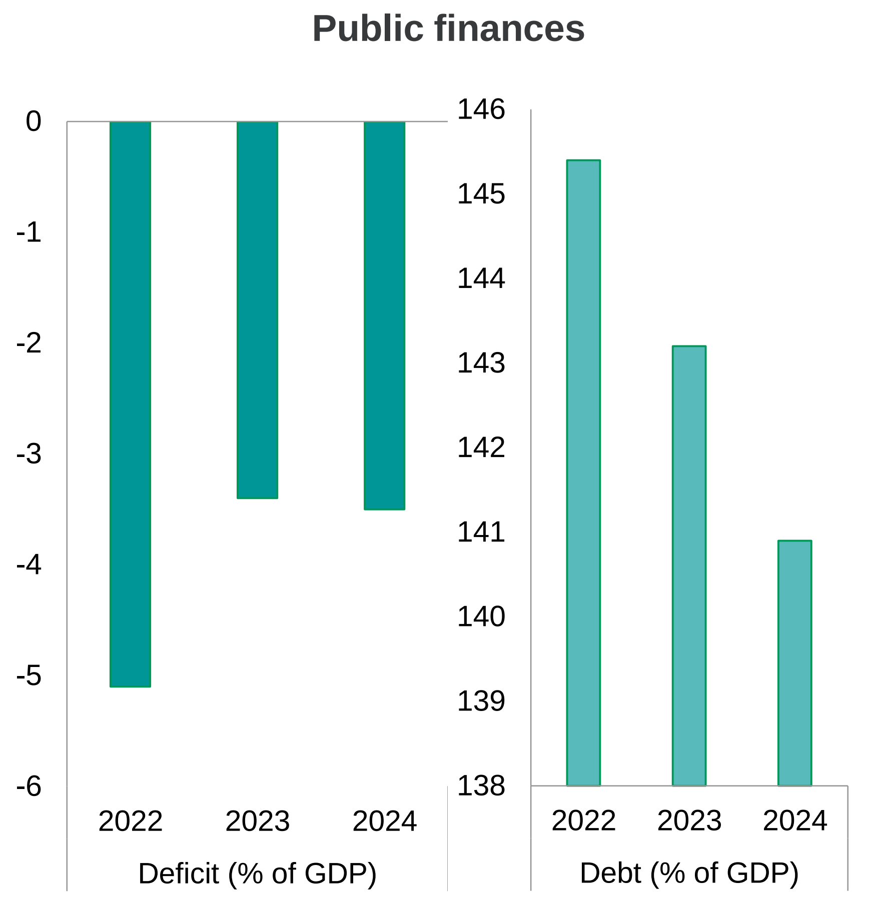
FOCUS: PUBLIC FINANCES

A DEFICIT BELOW EXPECTATIONS

Despite the significant fiscal support effort, the public deficit was expected to decrease to 5.1% in 2022. In the first seven months of 2022, the change in tax revenue surprised on the upside. Despite the large amounts granted in the form of tax credits aimed at helping companies absorb energy costs, tax revenues increased by 7.9% in 2022. The increase in revenue was largely driven by the increase in indirect taxes (+8%), whose growth was partly fuelled by the strong momentum in VAT revenue. VAT on imports, in particular, increased by 63.7% in the first six months of the year. Robust growth in the first seven months of the year, as well as the subsequent improvement in labour market conditions, also supported strong growth in direct tax revenues (6.6%), offsetting the impact of the social security contribution reform. At the same time, current spending rose 7.1% in 2022. The increase in current spending is largely due to the significant fiscal support deployed to mitigate the impact of the energy shock on households and businesses.

The primary deficit is therefore expected to narrow to 1.1% of GDP, compared to 3.7% in 2021. At the same time, the tightening of the ECB's monetary policy led to upward pressure on sovereign rates, which automatically led to an overshooting of the Italian government's financing conditions. The increase linked to the rise in the cost of debt in 2022 is estimated at €4.5 billion by the government, plus €7.4 billion attributable to the effect of inflation on indexed bonds. As a result, debt-to-GDP service is expected to reach 4% in 2022, after 3.5% in 2021. However, nominal GDP growth should lead to a reduction in the level of public debt to 150% of GDP in 2022.



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