ITALY
2023-2024 SCENARIO

A YEAR OF GROWTH DESPITE THE SHOCK

January 2023

Sofia Tozy

WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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OVERVIEW

A YEAR OF GROWTH DESPITE THE SHOCK

Shocks and changes dominated once again in 2022. **After the euphoria of 2021 and record growth, 2022 began amid price and supply pressures, thought at the time to be transitory. The invasion of Ukraine in February and the ensuing energy crisis quickly created a new challenge for Italy.** As in Germany, the war in Ukraine highlighted the vulnerability of Italy's energy strategy and the country's susceptibility to soaring gas prices. Price increases aside, Mario Draghi's government had to respond swiftly to supply risks and find alternatives to Russian gas. Thanks to a diversified infrastructure network, the government was able to increase imports from other countries, primarily Algeria and Azerbaijan. At the same time, it was obliged to raise funds to enable businesses and households to cope with the sharp rise in their energy bills. Government support measures taken in 2022 to address inflation totalled nearly €51 billion.

Despite annual inflation of 8%, Italian growth held up well, with three consecutive quarters of growth. While momentum in 2021 was driven mainly by investment and, above all, the construction sector, **consumption has been the main growth driver since second-quarter 2022.** The lifting of all COVID-related restrictions and the return of foreign tourists led to a rapid recovery in services, despite rising inflation. While the rise in prices affected household purchasing power, it was concentrated at the beginning of the year on energy and food items. Consumption has also held up strongly thanks to public support. From the start of the crisis, the government implemented a set of measures aimed at limiting the impacts of rising energy costs on the most vulnerable households. The government also introduced several measures aimed at supporting household income on a lasting basis, reducing statutory contributions and introducing a one-time allowance for families. These measures kept real disposable income from declining in the first nine months of 2022. Households were also able to rely on the savings accumulated during the two years of the pandemic, when health restrictions substantially limited consumption. With this performance, Italian GDP is largely catching up with pre-crisis levels and ranks number one in Europe when comparing third-quarter 2022 with fourth-quarter 2019.

Other key changes include a new prime minister. The government crisis triggered by the withdrawal of M5S put an end to the national union led by Mario Draghi. Draghi's resignation in July was followed by early elections in September, with an emphatic victory for the centre-right coalition. Although doubts were rife over Giorgia Meloni's accession to office, her first steps as prime minister were consistent with those of her predecessor and have reassured both Europe and the markets. **But Meloni faces complicated challenges, required to support growth while addressing inflation, as well as maintaining a *Pax Romana* among her coalition.**

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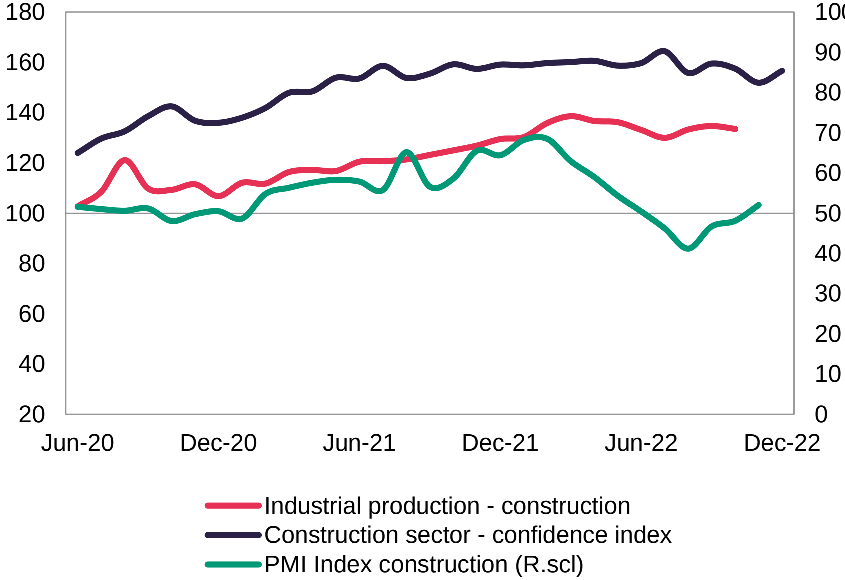
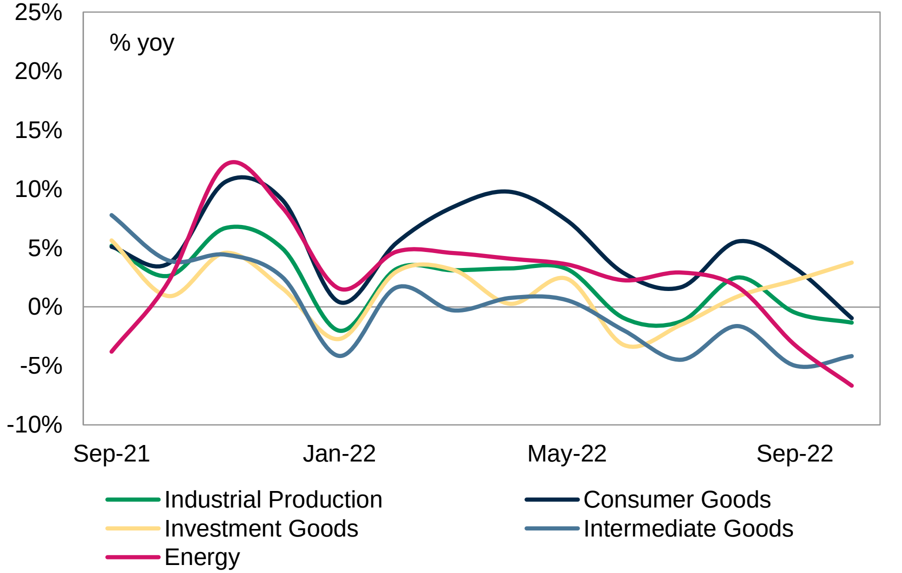
RECENT ECONOMIC TRENDS

CONSTRUCTION HOLDS UP, MANUFACTURING STRUGGLES



Sources: Markit, Istat, Crédit Agricole SA / ECO



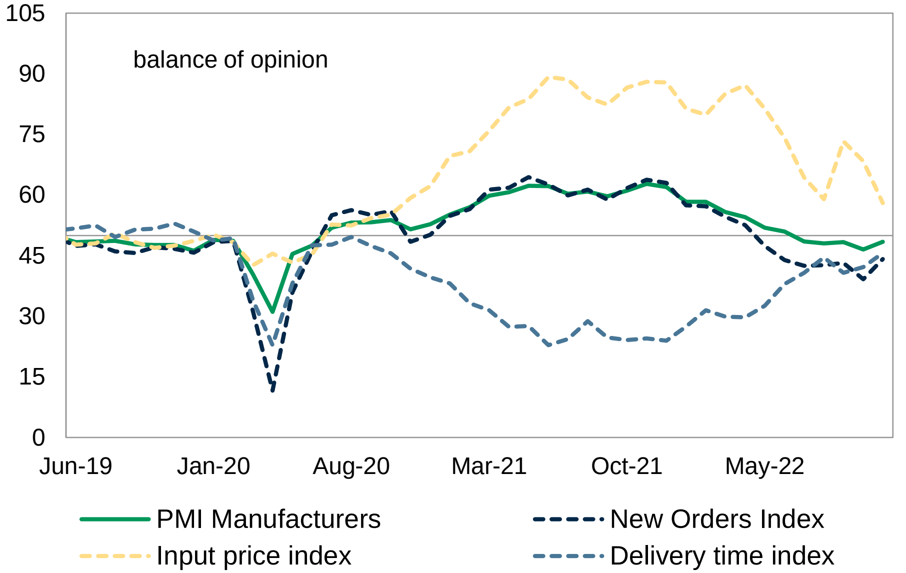
Sources: Istat, Crédit Agricole SA / ECO

Construction production dipped slightly in October after rebounding in September. This was in line with the PMI survey of the same month, showing a contraction in the sector owing to supply tensions. The November PMI surveys point to a rebound in activity, the index exceeding the expansion threshold and rising to 52. While some restrictions continue to weigh on supply, companies are reporting a recovery in their current and future activity as well as more favourable labour market conditions. While the business confidence index sent out a contradictory message with a 5.6-point slip in November, it posted a 4.7-point rebound in December.

Meanwhile, industrial production declined once again in October, by 1%, after a 1.7% decrease in September. Production declined across all industry sectors apart from investment goods, which posted a slight 0.2% increase. The contraction in activity maintained a negative 1.5% overhang in the fourth quarter. The segment posting the biggest one-month decline was the pharma industry, down 5.4%, while the extractive, plastic and chemical industries were the only ones to report positive growth. Production suffered in particular from a downturn in demand, as illustrated by the October PMI survey, showing a decline in new orders and stable finished product inventories.

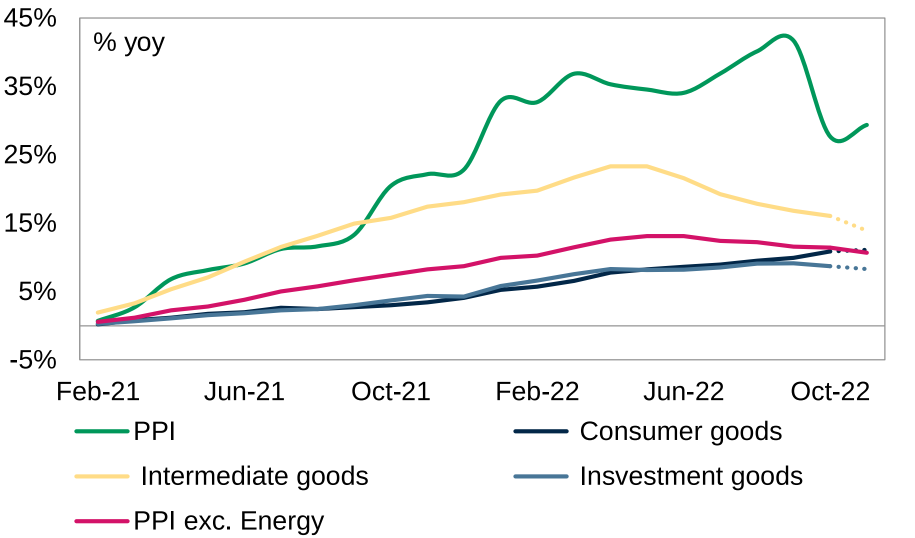
MANUFACTURING SUPPLY CONSTRAINTS EASE: BETTER DAYS TO COME?

PMI and supply constraints



Sources: Markit, Istat, Crédit Agricole SA / ECO

Industrial producer prices



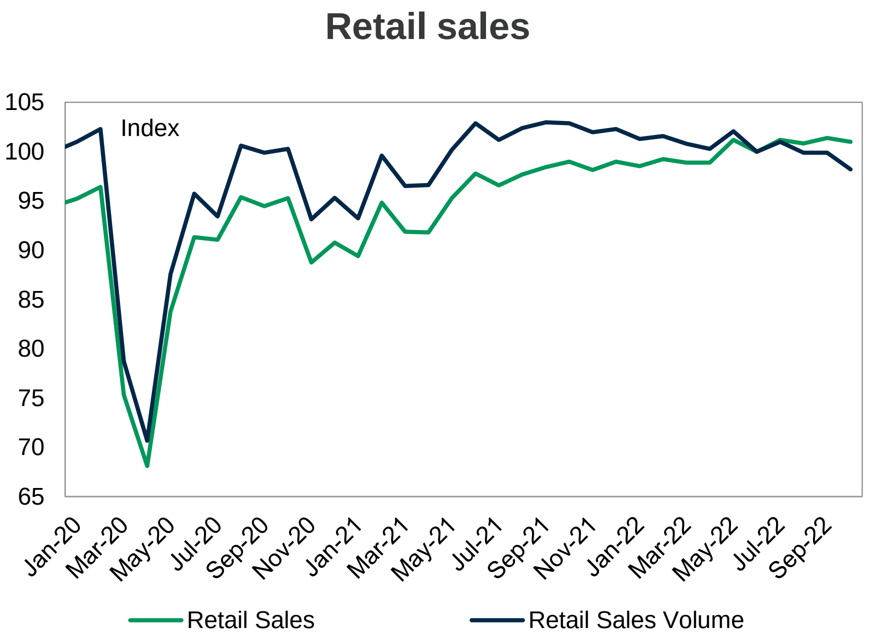
Sources: Istat, Crédit Agricole SA / ECO

Demand weighed on industrial activity in October, but manufacturing firms expect a smaller contraction in new orders and production in December. Supply-side tensions continue to ease as the percentage of companies facing rising input prices continues to fall and delivery times have shortened since September. Overall, the PMI for the sector rose to 48.5, approaching the expansion threshold. This renewed optimism was also reflected in the manufacturing business confidence index, which trended upwards in November. However, business confidence eroded slightly in December, the index losing 1.1 points.

Producer prices rose 2.6% in November after falling 3.3% in October, the first decline since November 2020. Variations in the producer price index remain largely dependent on changes in energy prices, the decline in the index in October having resulted from the decrease in gas prices. Demand was curbed by high autumn temperatures combined with energy-saving measures, while LNG supply remained abundant. According to initial Istat estimates, energy sector prices rose 6% in November, generating higher producer prices over the month. Excluding energy prices, the IPPI continued to grow in November, gaining a modest 0.2%, and increased 10.7% year on year.

RECENT ECONOMIC TRENDS

UNEXPECTED RECOVERY IN HOUSEHOLD CONFIDENCE



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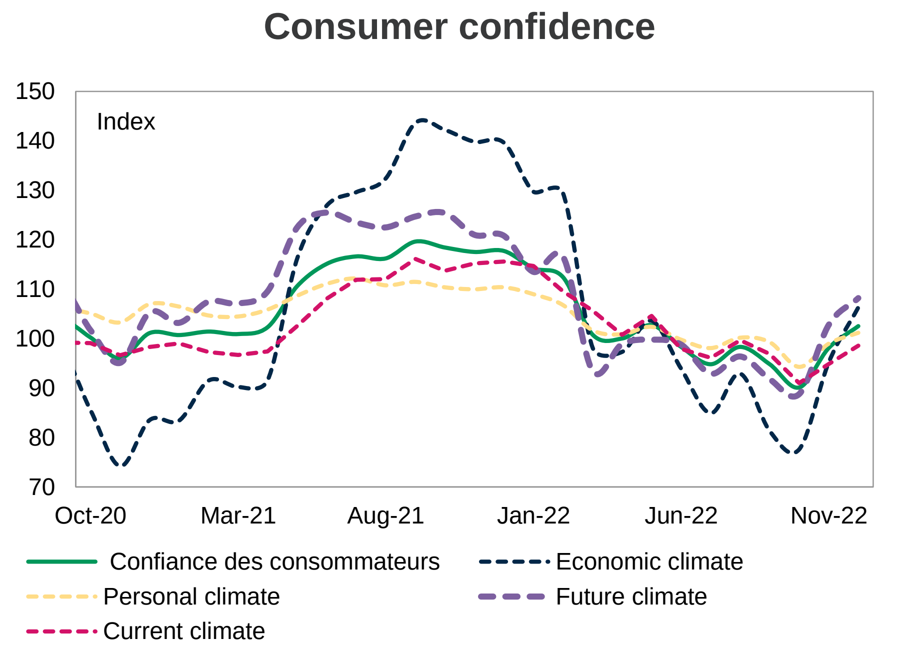


Sources: Istat, Crédit Agricole SA / ECO

Turning to consumption, retail sales declined 0.4% in value and 1.2% in volume in October after a slight recovery in September. Year on year, sales fell 6.3% in volume and rose 1.3% in value, driven by higher prices. The overhang in the fourth quarter remained strongly negative. While signals are in the red, with retail sales down and continued growth in the harmonised consumer price index, at 11.8%, household confidence is not weakening. After rising to 98.1 in November, the index reached 102.5 in December, exceeding its long-term average.

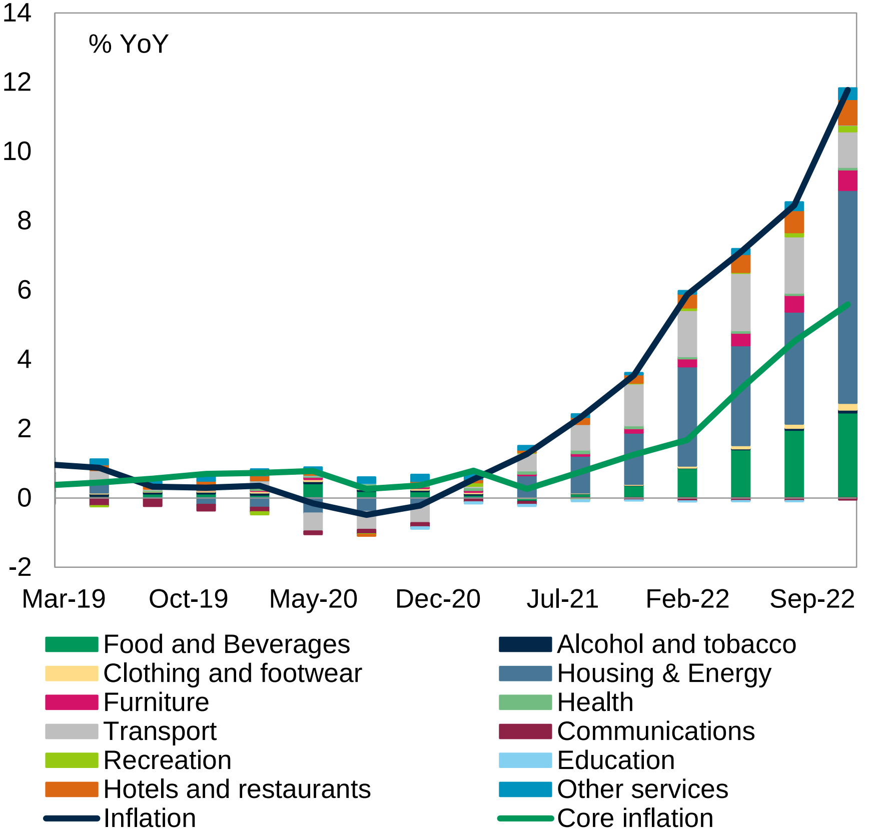
This renewed confidence concerns all components of the index. Households are seeing an improvement in both the current and future economic climate. Long-standing concerns over deteriorating labour market conditions have also receded significantly, with a decline in unemployment expectations. This optimism is consistent with the latest labour market figures, with the unemployment rate falling to 7.8% at the end of October.

INFLATION STILL HIGH IN Q4

Inflation stood at 11.6% year-on-year at end-December, down slightly from November but still above 11% for the third consecutive month. Price pressures thus failed to ease at the end of the year as expected, but should do so in early 2023. While energy goods prices slowed slightly, from +67.6% in November to +64.7% in December, the acceleration in the prices of processed food (+14.3% to +14.9%) and recreational and cultural services continued to fuel inflation. For the quarter as a whole, inflation stood at 11.7%, after a year-on-year increase of 8.4% in the third quarter, while core inflation rose 1.1 points from 4.5% in Q3 to 5.6% in Q4. Price increases continued to be fuelled by soaring energy prices, mainly gas and electricity, but are increasingly being driven by other categories of goods. Energy prices rose 67% over the quarter, driven by the non-regulated component. Food prices accelerated by more than 13%, with processed food prices rising particularly strongly. However, some encouraging signs point to a likely easing of tensions in Q1 2023. The contraction in gas prices in December is expected to have an impact on the prices paid by households in the coming months, with the Italian energy authority estimating a 20% decrease.

For 2022 as a whole, the inflation rate is expected to reach 8.1%, the highest since 1985, and core inflation 3.7%. The inflation overhang for 2023 stands at a consequential +5.1%.

Contributions to quarterly inflation



Sources: Istat, Crédit Agricole SA / ECO

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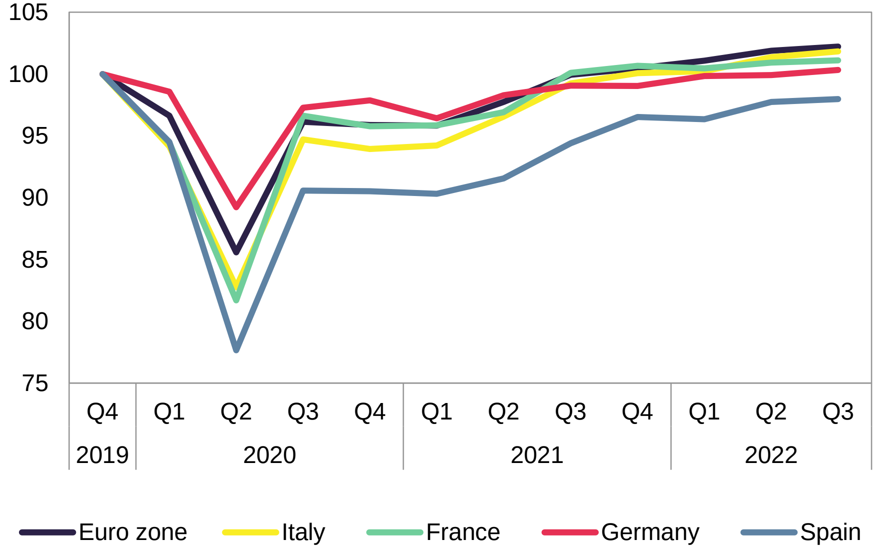
THE BASIS OF OUR SCENARIO

THE END OF THE PANDEMIC SUPPORTS CONSUMPTION DESPITE INFLATION

GDP trends in major European countries since the start of the pandemic



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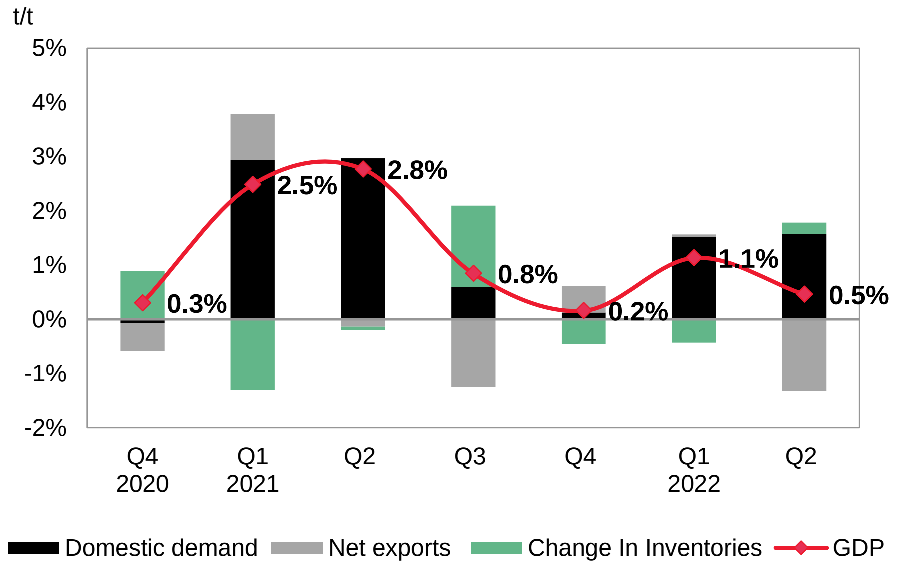
Contribution to growth



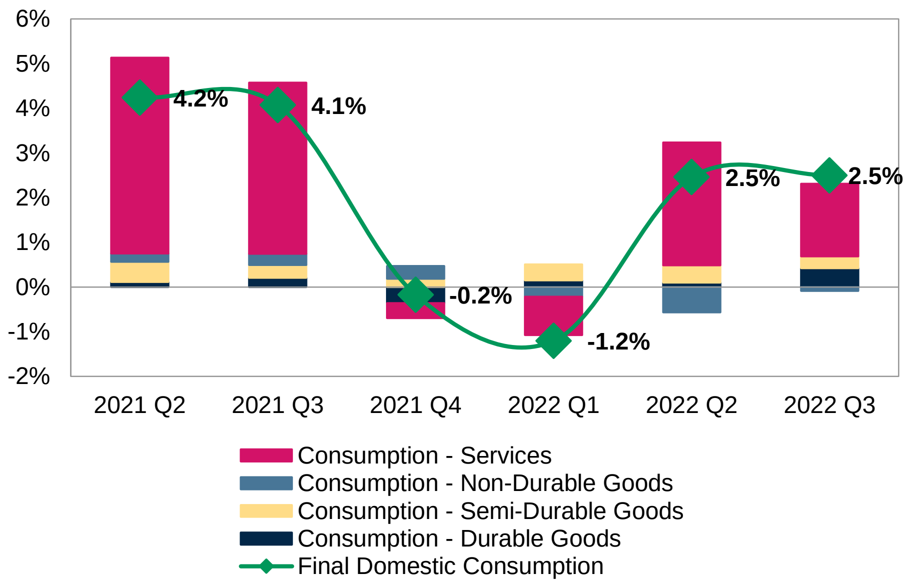
Sources: Istat, Crédit Agricole SA / ECO

Italian growth continues to show resilience despite skyrocketing inflation. GDP increased 0.5% in the third quarter, bringing the growth overhang to 3.9% for 2022. Italian GDP growth exceeded that of the eurozone, up 0.3%, and outperformed its major European partners, with +0.4% in Germany and +0.2% in France and Spain. The three consecutive quarters of growth have enabled Italy to exceed its level and post the strongest GDP recovery among European countries.

Italian GDP in Q3 2022 was 1.8% higher than before the COVID crisis, compared with +1.1% for France, +0.3% for Germany, and -2% for Spain. This increase comprises major trends that cancel each other out. Domestic demand contributed 1.6 percentage points to growth, supplemented by a 0.2 percentage point contribution from inventories. But the negative contribution from external demand takes 1.3 points off growth.

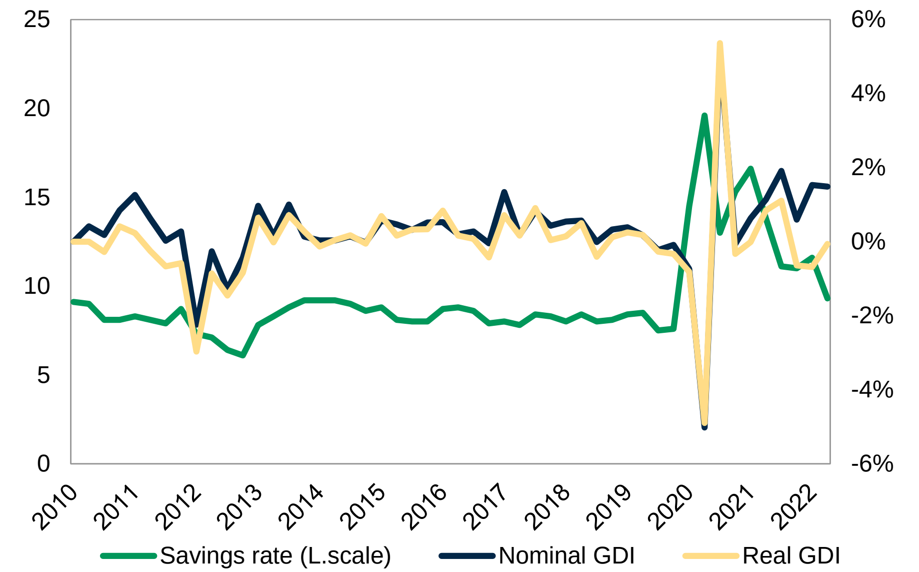
THE END OF THE PANDEMIC SUPPORTS CONSUMPTION DESPITE INFLATION

Household consumption



Sources: Istat, Crédit Agricole SA / ECO

Household economic situation



Sources: Istat, Crédit Agricole SA / ECO

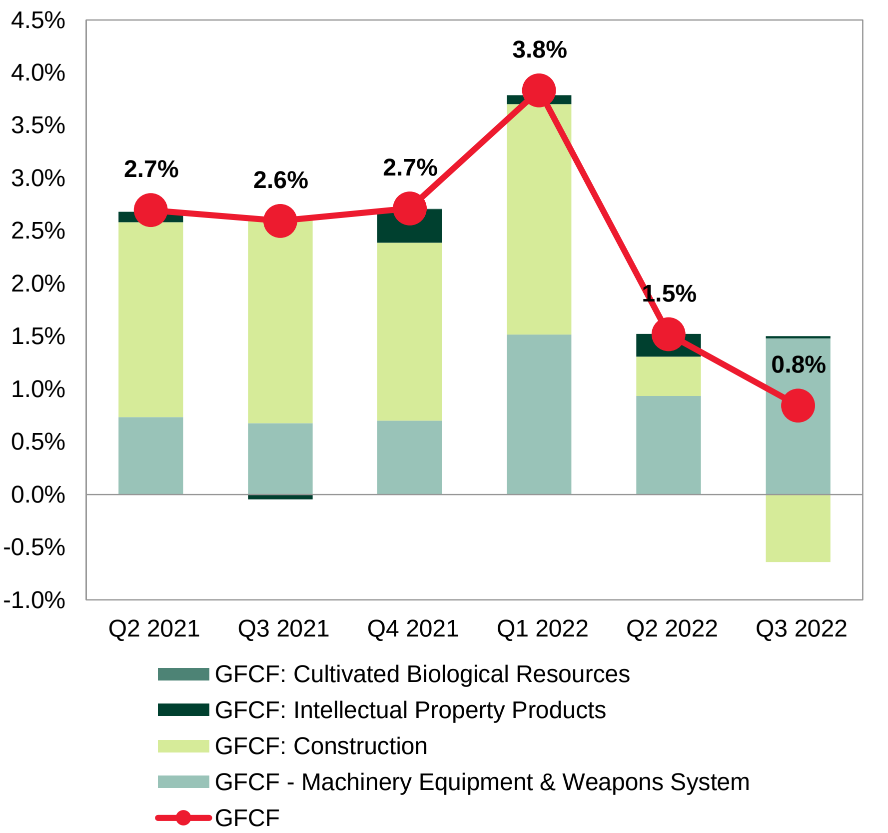
The increase in final demand was driven by household consumption, which rose 2.5% in Q3 for the second consecutive quarter. Despite inflation of 8%, consumption continues to benefit positively from the return to normal of household behaviour post-COVID, filling the lag accumulated during the pandemic. As in other European countries (Germany and France), consumption in Italy was bolstered by services, which continued to rise strongly in Q3 (+3.1% in Q3, after +5.5% in Q2). The increase in consumer spending also benefited the durable goods sector, with clothing spending posting a substantial recovery. Despite a drop in purchasing power, Italian households were able to fall back on part of the savings built up over the past two years. This led to a sharp contraction in the household savings rate in Q3 (7.1%).

THE BASIS OF OUR SCENARIO

INVESTMENT SLOWDOWN CONFIRMED

After several consecutive quarters of strong growth, investment is showing clear signs of a slowdown, impacted by negative performances in construction. Stimulated in particular by tax incentives, the latter has benefited from substantial growth since the end of the COVID crisis. The sector's value added in Q3 2022 was over 25% higher than in Q4 2019. Investment in construction, all sub-sectors combined, is 25% higher than before the crisis. The slowdown can be attributed to the rise in the cost of commodities, particularly metals and energy, as well as the gradual withdrawal of some of the "super bonuses", notably for individual homes. At the same time, business investment continued to grow, rising 4% in Q3. Transport, which was hit hard by COVID, also posted a 10% quarter-on-quarter increase but remains lower than in December 2019. Investment growth came out at 10.8% in Italy in the first nine months of the year, remaining significantly higher than that of its European partners. Italy considerably outperformed France, Germany and Spain, with +2.0%, +0.2% and +4.8%, respectively. With monetary tightening expected to gradually undermine corporate cash positions, and strong pressure to remain on production costs and high uncertainties, investment momentum will wane in the coming quarters. But investment will continue to be driven by the national recovery plan, which should continue to fuel growth in public investment.

Contributions to investment growth



Sources: Istat, Crédit Agricole SA / ECO

THE BASIS OF OUR SCENARIO

NET EXPORTS HURT GROWTH

The strong contribution of foreign trade in Q3 was due not just to a sharp increase in imports but also to a sharp decrease in exports. While Italian imports grew 4.2% quarter on quarter, exports rose 0.1%, after 2.1% in Q2 and 5.2% in Q1.

Surprisingly, an analysis of external accounts shows a deterioration in exports of services, which dipped 0.8%, while exports of goods posted a slightly positive trend. This contrasts with the recovery in tourism, with the number of foreign tourists continuing to rise in Italy. Tourist inflows rebounded significantly during the year, by 25%, but are still lower than before the COVID crisis.

Italian export performance is expected to be weak once again in the fourth quarter. The slight recovery in exports in September gave way to a 1.6% contraction in October, leaving a negative overhang of 1.3% for the quarter. Surveys also show a decline in export order books for December.

Foreign trade

Sources: Istat, Crédit Agricole SA / ECO

THE BASIS OF OUR SCENARIO

2022-2023 SCENARIO OUTLOOK

Italy	2021	2022	2023	2022				2023			
%				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	6,7	3,9	0,0	0,2	1,1	0,5	-0,1	-0,6	-0,1	0,3	0,1
Households consumption	5,1	4,7	0,5	-1,2	2,5	2,5	-0,3	-1,2	-0,1	0,2	0,2
Investment	16,5	9,7	1,7	3,8	1,5	0,8	0,2	0,0	0,4	0,5	0,5
Change in inventories*	0,4	0,1	0,1	-0,5	-0,4	0,2	0,1	0,1	-0,1	0,1	-0,1
Net export*	-0,1	-1,0	-0,7	0,5	0,0	-1,3	-0,1	0,0	0,0	0,0	0,0
Unemployment	9,5	8,3	8,5	8,5	8,1	8,2	8,2	8,4	8,6	8,4	8,4
Government net lending	-7,2	-5,1	-5,0								

* Contributions to GDP growth

Data for the third quarter confirmed the robustness of Italian economic activity despite a continued strong increase in prices. GDP rose 0.5% in the third quarter, bringing the growth overhang to 3.9%. However, growth is expected to slow in the fourth quarter on persistently high inflation and resilience factors that are losing steam. Growth is expected to remain moderate according to the main indicators, which show a reversal – but not a collapse – in the trend. Confidence picked up slightly between October and December, from 90.1 to 102.5 for households and 104 to 107.8 for businesses. Many of the latter still expect demand to dip but also expect finished product inventories to increase and the production outlook to improve. The same is true for the manufacturing PMIs, which, though they remain below the expansion threshold of 50, rose from 46.6 to 48.5 for manufacturing and from 46.9 to 49.9 for services between October and December.

Growth is expected to fall sharply in 2023. The factors supporting Italian activity are expected to weaken further in the first half of 2023, leading to three consecutive quarters of decline including Q4 2022. But this technical recession is unlikely to give way to a recession over the year, with a forecast of zero growth for 2023. The scenario nevertheless remains subject to downside risks. Against this backdrop, the resilience of economic activity owes largely to Italy's fiscal support policy, which, in a tense financial market, could prove more timid than in 2022. The ECB could also be more aggressive in its monetary tightening if high inflation were to linger. Given the context, the gas market is not immune to a fresh surge in prices, which could be fuelled by weather uncertainties and a deterioration in the geopolitical environment.

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DESPITE THE DECLINE IN Q3, THE LABOUR MARKET IS HOLDING UP WELL AND CONTINUES TO RECOVER

After an intense catch-up phase post-COVID, the labour market showed signs of slowing down in third-quarter 2022. Though hours worked remained stable, employment fell, albeit marginally, by 0.05% compared with the previous quarter. But this was the first contraction since first-quarter 2021. The decline in employment in Q3 can be attributed to the negative performance of both salaried employment and self-employment.

Having driven the recovery in the labour market, fixed-term contracts fell for the first time since Q2 2020, dipping nearly 2%. Meanwhile, growth in permanent contracts continued, at 0.2% for the third consecutive quarter, but failed to offset the sharp decline in fixed-term contracts. However, the latter are still much higher than before the crisis (+1.1%). Permanent contracts have also increased significantly over the last two quarters and currently stand at 1.7% higher than in Q4 2019. Self-employment remains the poor relative of the recovery. The timid momentum in place since Q4 2021 – confirmed in Q3 2022 with growth of 0.2% – still fails to offset the losses accumulated during the COVID-19 crisis. Self-employment in Q4 remained 4.4% lower than before the crisis.

Industry is the sole sector to continue creating jobs. The number of employed people in industry rose +0.3% in Q3, after +0.8% in Q1 and +0.3% in Q2. Employment in other sectors is contracting, down 1% in the primary sector and 0.1% in construction and services. Following the poor performance in construction in Q3, the sector posted a decline in its workforce for the first time since Q2 2020, after nine quarters of robust growth (+2.3% on average). However, employment in construction remains nearly 20% higher than before COVID. In industry, employment is struggling to reach pre-COVID levels; in services, it is 1% lower than in Q4 2019.

The labour market recovery is demonstrated in the stability of the employment rate in Q3 2022, at 60.2%, 3 percentage points higher than at the height of the crisis in 2020. Employment in 2022 matched its record level in 2004. And, for the first time since early 2021, the inactivity rate – an adjustment variable of the labour market over the last three years – is increasing. The number of economically inactive people increased by 30,000 units (+0.2%). Surprisingly, the increase in inactivity in Q3 was mostly attributable to men. The number of economically inactive people increased more for men than for women. The inactivity rate of women, though increasing slightly in Q3, from 43.5% to 43.6%, was largely back to its pre-crisis level.

The signs are encouraging. In Q3, the number of economically inactive people continued to decrease, falling below 2 million. The unemployment rate has also dipped below 8% (7.9% for the quarter) with 52,000 fewer unemployed. This is the lowest unemployment rate since the start of the Great Recession of 2009. Labour market dynamics appear to be benefiting the most precarious categories, with the unemployment rate for 15-34 year-olds having fallen to its lowest level, 14.2%, in 20 years. Although the trend mainly applies to 25-34 year-olds, the situation is also improving slightly for people who are “not in employment, education or training”.

FOCUS: LABOUR MARKET

DESPITE THE DECLINE IN Q3, THE LABOUR MARKET IS HOLDING UP WELL AND CONTINUES TO RECOVER

The unemployment rate is decreasing across all Italian regions. The north of the country continues to stand out, with an unemployment rate of 5%, well below the national average and at its lowest since 2009. The decline in unemployment is also noticeable in the centre (7%) and in the south (13%), the lowest level since 2011.

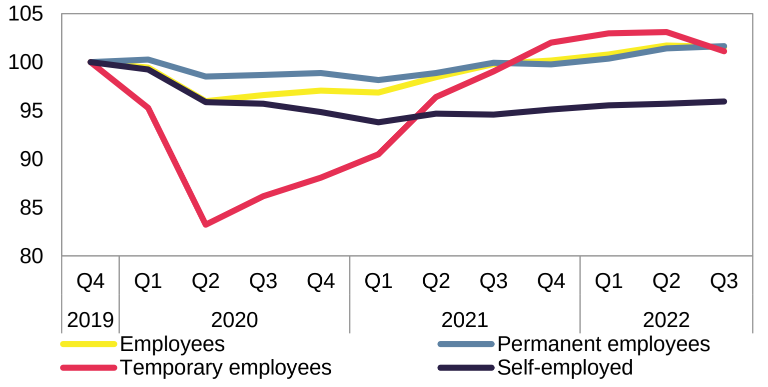
The Italian labour market may continue to surprise in the coming months. The decline in Q3 resulted primarily from poor employment performance in July and August, and the labour market has recovered slightly since September. Employment rose in September (+0.3%) and October (+0.4%, i.e. +84,000 units), particularly among employees on permanent contracts, while continuing to fall for employees on fixed-term contracts and independent professionals. Thanks to the employment rate, which crossed a new threshold of 60.5%, and the inactivity rate, which contracted once again, to 34.3%, the unemployment rate fell to 7.8%. Surveys in November were less pessimistic than those in October. Employment expectations are improving for businesses and households alike. This is true in industry and services but not in construction, which remains a depressed sector. Their confidence having improved slightly in November, fewer households expect an increase in unemployment in the coming months. The labour market is therefore holding up well. Current data shows that the Italian labour market has not been this healthy since the 2009 crisis, despite high inflation. The question that remains is whether these performances will last and withstand the expected slowdown.

Sources: Istat, Crédit Agricole SA / ECO

FOCUS: LABOUR MARKET

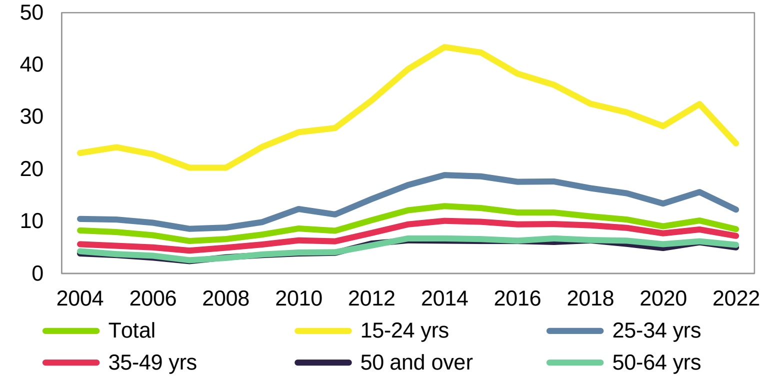
DESPITE THE DECLINE IN Q3, THE LABOUR MARKET IS HOLDING UP WELL AND CONTINUES TO RECOVER

Employment by type of contract



Sources: Istat, Crédit Agricole SA / ECO

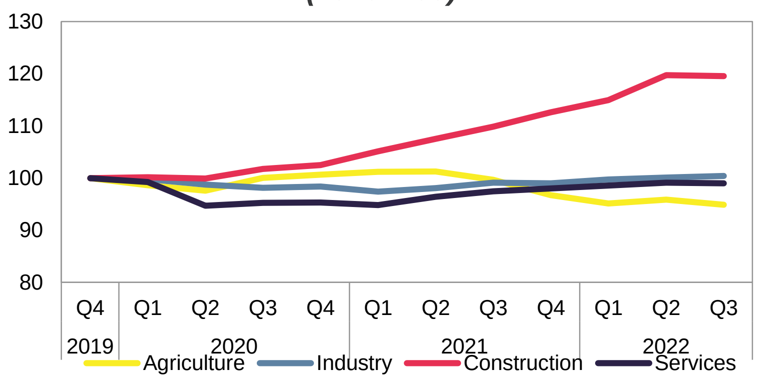
Employment rate by age bracket



Sources: Istat, Crédit Agricole SA / ECO

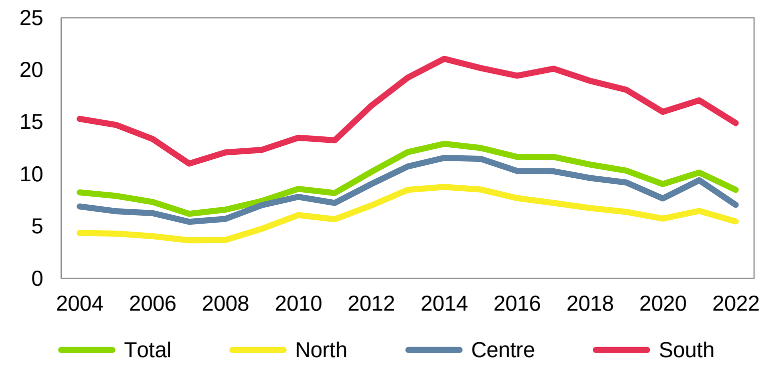
Employment by sector

(2019=100)



Sources: Istat, Crédit Agricole SA / ECO

Unemployment rate by region



Sources: Istat, Crédit Agricole SA / ECO

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FOCUS: FINANCE ACT

ONE-THIRD POLITICS, TWO-THIRDS SUPPORT

Prime Minister Giorgia Meloni appears to have opted for prudence and balance in her finance bill, aimed at responding to the challenges of high inflation while reducing the public deficit (4.5% in 2023) and the debt ratio (144.6% in 2023).

Adopted by the Senate on 31 December, with no change to the bill presented to the House, the 2023 budget is largely consistent with that of the previous government. Of the total €35 billion, €21 billion will be allocated to measures aimed at combating inflation. A number of these measures were already implemented as part of the plan of Mario Draghi's government. Corporate tax credits for the purchase of electricity and natural gas have been extended through 30 March 2023. They will be increased from 30% to 35% for restaurants and retail and from 40% to 45% for energy-intensive businesses. In addition, €3.1bn was allocated to the healthcare sector and local authorities. For families, the social bonus, which aims to limit the impact of rising energy bills on household budgets, was extended with an increase in the threshold of the Equivalent Economic Situation Indicator (EESI) from €12,000 to €15,000.

The rest of the budget package has a more political dimension and includes some of the measures put forward in the election campaign. Universal basic income will be eliminated by 2024 and eligibility conditions for the benefit will be strengthened for "employable" people in 2023. According to Giorgia Meloni, support for families and the birth rate is a strong focus of the government, the prime minister having declared that "demographics and birth rates are a top priority for us and an economic issue." The single family allowance introduced in 2022 will be increased by 50%, with a supplement for families with three or more children. Parental leave has been increased from 30% to 80% for one additional month and the VAT rate on certain products intended for early childhood, such as nappies, powdered milk and baby chairs, will be reduced to 5%. Among other measures intended to boost purchasing power, the government is expected to pursue reforms on reducing mandatory contributions, with a 3% decrease for incomes below €25,000 and a 2% decrease for those up to €35,000. According to the government, the measure will cover nearly 13 million employees and generate a net annual gain of €178 for annual incomes of €12,000 and €435 for those up to €35,000. And this is just the initial phase of the reduction in mandatory contributions; Giorgia Meloni has announced that she intends to increase the tax cut to 5% by the end of her term of office.

While most of the measures for households remain fairly consensual, some policy decisions more focused on the centre-right electoral base have generated greater debate, such as the increase in the acceptance threshold for card payments to €60 or the cash payment threshold, increased to €5,000. Combined with modest tax amnesties and the implementation of a flat tax for self-employed persons earning less than €85,000, these measures appear to undermine the considerable efforts made to combat tax evasion.

Regarding the issue of pensions, the government has submitted a proposed Quota 103 to replace Quota 102. This should enable economically active individuals to take early retirement at the age of 62 with 41 years of contributions (adding up to 103), rather than at the age of 64 with 38 years of contributions (102).

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Completed on January 16th 2023

Sofia TOZY

sofia.tozy@credit-agricole-sa,fr

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