Italian Economic Outlook 2023-2024, Introduction – Centro Studi Confindustria

IS THE ITALIAN ECONOMY BACK TO LOW GROWTH?

AUTUMN 2023

CONFINDUSTRIA
Centro Studi

CONFINDUSTRIA
Centro Studi

IS THE ITALIAN ECONOMY BACK TO LOW GROWTH?

Autumn 2023

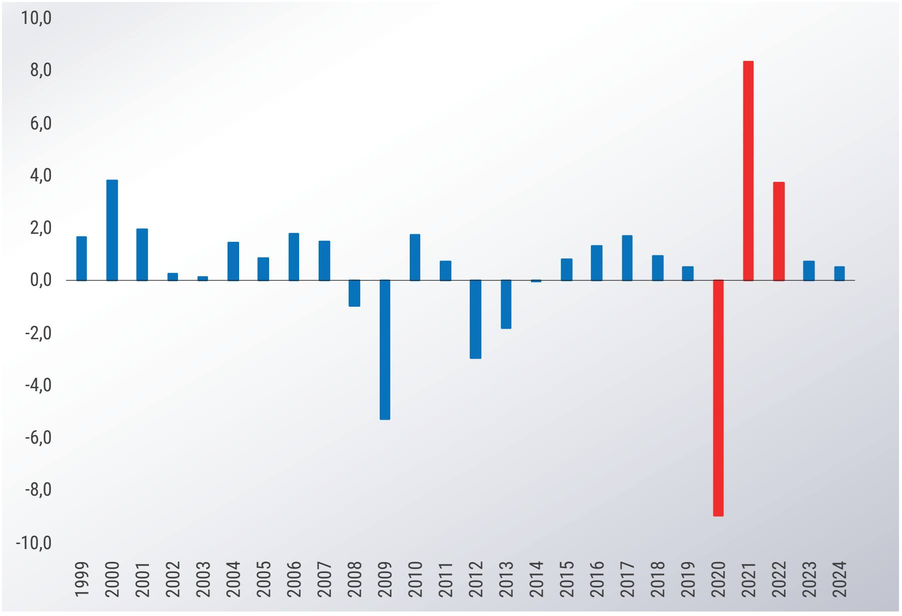
INTRODUCTION

Alessandro Fontana
Chief Economist of Confindustria

GDP growth slows down After the perilous rollercoaster ride of the last three years, the Italian economy is once again sliding towards the modest growth rates that characterized it in the previous decades (Graph A). The European economy is also experiencing the same slowdown.

Italy returns to low growth after the anomalous years (in red)

(GDP, annual data, at constant prices, % changes)



Source: Centro Studi Confindustria elaborations based on ISTAT data.

This is not due to new disruptions, which have not been lacking in 2023, the impact of which is, however, limited compared to the pandemic and the energy crisis. Instead, it is the result of the main policy response to these previous adverse events and to the inflation that these events have generated: the rise in interest rates. Inflation and high interest rates are, in fact, the main reasons for the ongoing weakening of the Italian and European economies. In Italy, the gradual waning of the momentum stemming from the post-pandemic recovery has also played a role. Once the spending levels that had to be sacrificed were reached again, consumption growth rates began to decline, falling in 2023 to about one-fourth of those in 2022. A similar phenomenon is affecting the services sector.

WEAK MOMENTUM FOR THE ITALIAN ECONOMY

DUE TO INFLATION AND HIGH RATES

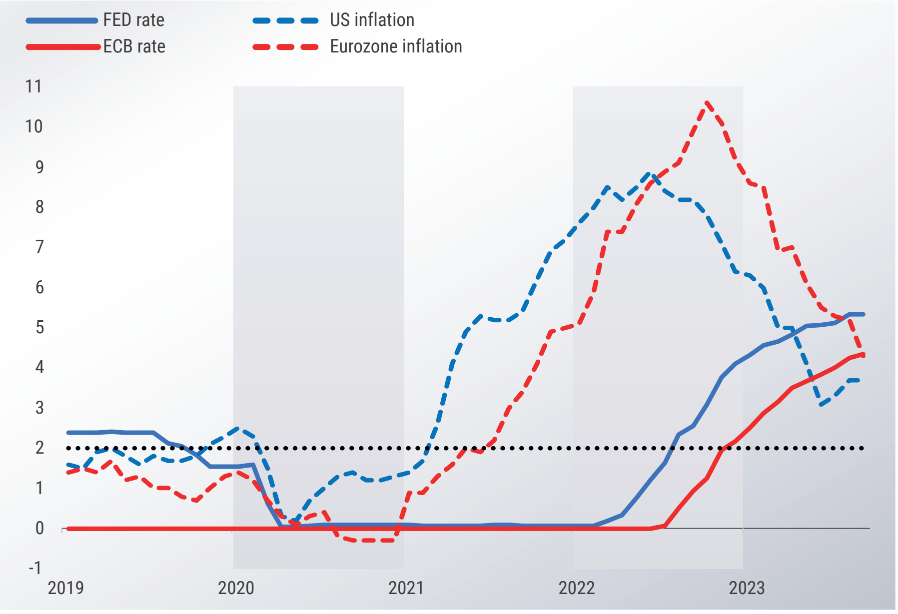
Rates up, inflation down As expected, inflation in both Europe and America has decelerated but remains "sticky", that is, resistant, compared to the speed at which gas prices have fallen. The downward descent to the shared target of +2.0% annual inflation is still incomplete. A year has already passed since the peaks were reached during the last months of 2022 and a year since gas prices sharply dropped, which have allowed for a decline in inflation (Graph B).

The sluggishness of this process is due to the fact that, despite the central banks' interventions aimed at curbing inflation expectations, the usual second-round effects of previous energy price increases have manifested on non-energy goods and services. This has also fueled core inflation, a measure of domestic price pressures, which reached a peak at the beginning of 2023 and has only recently begun to decline again.

Core inflation is also declining in Italy, although internal pressures that impede its descent remain: in 2024, labor costs will still make a significant contribution due to the strengthening of contractual wages which are expected to increase with a delay with respect to inflation.

Rates at their highest, inflation still high

(Monthly data, % values and yoy % changes)



Source: Centro Studi Confindustria elaborations based on Refinitiv, Eurostat and BLS data.

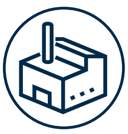
We have now reached a point where both the Fed, the leader, and the ECB, the follower, which have raised rates by 4-5 percentage points, are considering whether these rate hikes are sufficient to curb inflation. Markets believe they are. At very high and significantly restrictive levels, when measured against the zero level to which economic activities had become accustomed to until the first half of 2022.

The interest rates profile incorporated into the CSC scenario confirms this reading: there will be no further rate hikes. From the middle of next year, we will see limited cuts, still at restrictive levels. The risks compared to this hypothesis are oriented both downward and upward.

There is a non-negligible probability that the ECB may anticipate the start of rate cuts to the early months of 2024, once the next inflation data in the Eurozone and especially in Italy (where a favorable "base effect" in October would help) show that the +2.0% target is now very close, if not already reached. This would be beneficial for our economy.

On the other hand, however, there is also a significant probability that, across the ocean, counting on the demonstrated resilience of the American economy, the Fed may decide to deal another blow to inflation, which is still above +3.0%. At that point, the risk is that, despite the Eurozone's significantly different economic conditions compared to the USA, the ECB may decide to follow the path of "further rate hikes" to avoid repercussions on the dollar/euro exchange rate. This could risk fueling inflation again which would be a severe blow to our economy and to an already weakened European economy as well.

LOANS TO ITALIAN COMPANIES DECREASE



-6,2% in a year

Costly and scarce credit Bank credit for households and businesses is the channel through which rate hikes are impacting domestic demand and, therefore, GDP. On the business side, the cost of credit has increased suddenly, which has reduced business credit demand. Furthermore, some businesses did not obtain the requested loans because the lending criteria have also been tightened in the past year, given the deterioration in economic expectations and some difficulties faced by banks in the markets at the beginning of 2023, as shown by the BLS survey conducted by the ECB. The result is a significant reduction in the stock of loans to Italian businesses (-6.2% annually) and a simultaneous sharp increase in financial charges (+10.3 billion euros over the twelve months, CSC estimates). Liquidity available to companies is also suffering, as businesses have used up any excess liquidity over the past year.

All of this impacts investment decisions: fewer investments are made because, without sufficient equity, investments are more costly, and there is not enough debt financing available to pay for them. This is nothing new. On the household side, the path is quite similar, and it is reflected in housing mortgages and consumer credit.

As if this were not enough, the tightening of interest rates is bringing back problems that we had stopped worrying about. Firstly, non-performing loans (NPLs), which are loans "in distress," have started to rise again in recent months, as the deterioration rate of old loans has increased: an alarm bell that could further disrupt delicate credit mechanisms. Secondly, liquidity for many companies may soon run low, limiting current operations as well as investments. As a result, delayed payments between companies are increasing again, a symptom and consequence of the fact that liquid resources in companies are quickly running out.

New Risks from Energy and Raw Materials Energy commodities have recently once again become a cause for concern. After two years of closely following sudden spikes in gas prices, which few were familiar with but everyone quickly learned to fear, in recent months markets seem to have returned to focus on the price of oil. The Brent oil price has suddenly started to rise again during the summer months, topping again $90 per barrel: a decidedly high and counterproductive price for the global economy. In particular, for importing countries like Italy, where households are already feeling the impact on transportation expenses through the rapid increase in fuel prices. These expenses are immediately factored into inflation, in the energy component.

This occurred before the new Israeli-Palestinian conflict, which so far doesn't seem to have further impacted the price of oil. However, this outbreak, combined with the ongoing Russian invasion of Ukraine which has been lasting for more than a year and a half, increases uncertainty in the global scenario. It also risks inflaming both gas and oil prices in the event of an expansion of the conflict to neighboring countries.

International prices of other commodities, particularly metals and agricultural raw materials, remain, for now, on a downward trend due to the global economic slowdown. This is a normal adjustment mechanism in the economic system. However, the declines have been modest so far, compared to the previous price increases, so non-energy prices remain elevated compared to pre-pandemic levels, resulting in additional costs for households and businesses.

A highly complex international scenario The shift in consumption from goods to services, the weakening of the European industry, which revolves around German industry, and the more challenging conditions for demand, especially for investments, due to monetary tightening and persistently high inflation, are slowing down global manufacturing. This is reflected in the decline in global trade, which is also influenced by China's slowdown, the strengthening of the dollar (a key reference currency in most trading markets), and the proliferation of trade barriers (over 3,000 in 2022, up from less than a thousand in 2019).

The contraction of trade in 2023 is already implied by the latest available data, and the CSC -1,0% hypothesis actually implies a recovery in the final months of the year (Table A). If this materializes as expected, 2024 should see a return to global trade expansion, albeit at modest rates. This can only be good news for a manufacturing and export-driven economy like Italy's.

The second significant factor is that the heterogeneous locomotive of emerging countries, the real engine of global growth, continues to expand. Among these, China, despite recent uncertainties, continues to grow at rates several percentage points higher than those recorded by the major advanced countries. India, often overlooked as the second-largest emerging economy is, instead, gaining increasing importance and progressively becoming a manufacturing powerhouse capable of attracting significant global production phases, even at the expense of its well-known neighbor, as demonstrated by the assembly of smartphones designed in the USA.

International exogenous variables of the forecast

(% changes)

	2022	2023	2024
World trade	3.2	-1.0	2.0
GDP - United States	2.1	2.1	1.4
GDP - Eurozone	3.5	0.5	0.6
GDP - Emerging Markets	4.1	3.9	4.0
Oil price[1]	101	85	90
Gas price (Europe)	124	40	44
Dollar/euro exchange rate[2]	1.05	1.08	1.06
Effective FED rate3	1.68	5.02	5.08
ECB rate[3]	0.58	3.80	4.31

[1] Brent, dollars per barrel; [2] levels; [3] % values.
Source: Centro Studi Confindustria elaborations based on Refinitiv, IMF, CPB data.

A third important point is that the gap is widening significantly between the growth rate of the US economy, which is strong and surprisingly resilient even to American forecasters like the Fed, and that of the Eurozone, which is struggling and not doing better than Italy's. The main difference in the recent developments that have affected the two economies is that the US was much less affected in 2022 by the shock in gas prices. It did not have to face the difficult and still incomplete transition to reduce dependence on Russian gas.

In Europe, Germany's difficulty stands out, as it had the highest dependence on Russian gas and slipped into a moderate recession in 2023. The CSC analyses show that the ongoing crisis in Germany should have a more limited impact on Italy compared to past episodes. There are two reasons for this. First, it's mainly a recession due to declining consumption and a slowdown in services, rather than weakness in the industry, which nevertheless remains. Second, the interconnections between Italy and Germany, while still strong, are weaker today than in the past.

Italy: only consumption and employment hold up In the CSC scenario, Italian GDP is expected to grow by only 0.7% in 2023 (Table B). This percentage change was already fully reached by midyear. In 2024, average growth will be even weaker, at 0.5%, despite an expected quarterly recovery profile.

This low growth is almost entirely driven by household consumption but even this will slow down both in 2023 and 2024, following the high growth rates recorded in 2022, when consumers were eager to recover pre-pandemic spending levels for a variety of items, especially services. Given weak real income and more restrictive financial conditions, this year, consumption has been financed by a decrease in savings rates, while in 2024, it will benefit from the recovery of purchasing power, thanks to higher wages and declining inflation.

Italian employment, measured in terms of full-time equivalent (FTE), grows in line with GDP, on average, in the two-year forecast period, with slightly faster growth this year thanks to the positive momentum shown in the first half of the year, and slightly lower growth the next. In terms of employed persons, it grows at a faster pace in both years. The expansion in 2023 is already fully accounted for and should be read in light of the time lag with respect to the

GDP expansion recorded earlier. The number of employed people, which had already almost stopped rising in the summer, will remain essentially stable in the coming quarters, before starting to rise again in the second half of 2024. Overall, these are data and forecasts that indicate a good performance of the Italian labour market.

The CSC forecast for Italy

(% changes)

	2022	2023	2024
Gross domestic product	3.7	0.7	0.5
Household consumption	5.0	1.2	0.6
Public consumption	0.7	0.5	-0.5
Gross fixed capital formation	9.7	0.5	-0.1
Exports of goods and services	9.9	0.8	2.3
Imports of goods and services	12.4	0.8	1.9
Employment (FTEs)	3.5	1.1	0.3
Total employment (headcount)	2.4	1.5	0.8
Per capita wages	3.6	2.8	3.9
Consumer price index	8.1	5.8	2.1
Government net borrowing[1]	8.0	5.3	3.8

[1] Percent of GDP.
FTEs = full-time equivalent work units.
Source: Centro Studi Confindustria elaborations and estimates based on ISTAT and Bank of Italy's data.

Investments, on the other hand, which were the main source of economic growth in 2021 and 2022, slow down abruptly this year and will come to a halt next year. This represents a significant downward revision of the 2024 figures with respect to the CSC March forecast. There are multiple reasons for this. Construction will no longer act as a driving force as it did in the past two years when the sector's investments recorded extraordinary growth, thanks to powerful tax incentives. Public investments are expected to decline in 2023 and only slightly increase in 2024: they do not show the strong growth profile that could have been expected with the launch of the National Recovery and Resilience Plan (PNRR).

A positive contribution from the PNRR is indeed incorporated into these forecasts. Impact assessments of the plan indicate that the full implementation of the investments included in the PNRR could provide a significant stimulus to growth in the two-year forecast period as well as in later years. However, the delay in project implementation, as indicated in the "Update to the Economic and Finance Document" (NaDEF), suggests that the actual stimulus in the two-year forecast period will be much lower than what was planned no later than last April. On the other hand, the opportunity represented by this Plan should not be wasted: raising the economy's medium to long-term growth potential with the implementation of the various planned reforms and investments is the crucial challenge in coming years in order to avoid permanently returning to low growth. And also to reduce the huge public debt with respect to GDP.

These recent years show how sustained growth rates can have a positive impact on public debt. Between 2020 and 2022, public support exceeded 410 billion euros, almost 23 percentage points of GDP, in 3 years. However, the debt/GDP ratio increased by just over 5 percentage points between 2019 and 2023. It would have been sufficient to limit the recipients of some bonuses to safeguard the economic productive system and maintain the ratio at 2019 levels.

In the coming year, the Stability and Growth Pact will be reinstated on the basis of the new rules proposed by the European Commission or by reactivating the old ones. Although the new rules appear to be a clear improvement compared to the past, in the absence of a centralized fiscal instrument at the European level that can stabilize the economy during downturns, there is a high risk that the European fiscal stance (the sum of national budget policies) will be inadequate for the economic context, i.e., restrictive during a negative cyclical phase, as happened in the first half of the last decade, and push the region into recession. The long-term risks associated with the incomplete design of the economic governance appear to be very high, especially for a high-debt country like Italy.

Exports are not driving growth Italy's terms of trade has significantly improved in 2023 after the sharp decline recorded in 2022. This is because average gas and oil prices for the year are much lower than recent peaks. Meanwhile, Italian export prices continue to show a moderate upward trend. This improvement in the terms of trade is very positive because, even if volumes of sales and purchases with other economies stay the same, it improves the country's trade balance, bringing its foreign accounts back into surplus. Thus, these are once again becoming a source of strength for the Italian economy.

With some variation depending on the specific indicator used to measure trends, recent data suggests that Italian productions are essentially maintaining their price competitiveness. While it is true that, on average, Italian export prices increased in 2023 as compared to the previous year, it is also true that this change is rather similar to the trend recorded by the prices of major competitors in international markets.

In this scenario in which international trade is expected to decrease this year, the trend of Italian exports remains only slightly positive in 2023 to, then, align with the recovery of global demand in 2024. This alignment in 2024 occurs after years when the growth of our exports exceeded that of global trade, i.e., years when we gained market shares. This process is expected to stop next year, but it's not likely to reverse: a signal that the competitiveness of Italian products remains high, both in terms of prices and quality.

The contribution to GDP growth that comes from exports, measured net of import performance, is zero in 2023. It then becomes slightly positive in the following year. Therefore, international trade does not provide the strong stimulus to economic growth that has been recorded in recent years, and that is now even more necessary.

Full Report in Italian is available here