THE ITALIAN ECONOMY BETWEEN RISING RATES AND HIGH INFLATION

SPRING 2023

CONFINDUSTRIA
Centro Studi

INTRODUCTION

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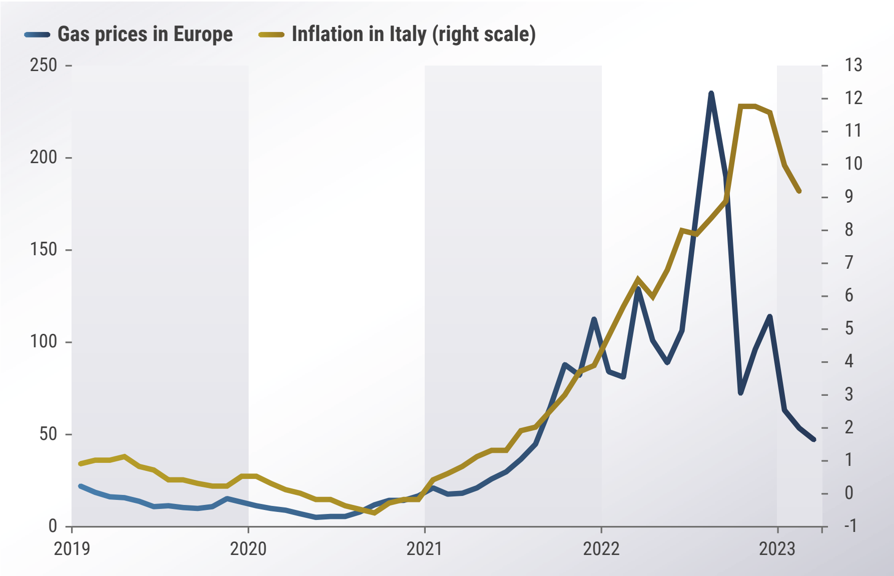
Lower energy prices, inflation still high The sharp drop in the gas price in Europe from the end of 2022 is extremely positive news for our economy and all European economies. If inflation were to fall instantly, thanks to this drop, the economic scenario could be considered normalized. However, in economics, there are sometimes lags in the cause-and-effect relationships between different variables.

One of the main delays, although its length is changing due to the continuous evolution of economic systems, concerns the transmission of changes in international energy prices to consumer prices (Chart A). The fall of gas price to around 50 euro/mwh, from over 330 at its peak in 2022, has certainly eased the inflation's fall but we are only at the beginning of consumer price moderation, both in Italy and in the Eurozone, and the process will take time.

Chart A
Gas prices falling sharply but inflation still high
(International quotations and consumer price index, monthly data)



TTF: euro per mwh.
Source: Centro Studi Confindustria elaborations on Refinitiv data.

Just as burning wood continues to burn for a while even if it is no longer fueled, so inflation remains high for some months even after the original cause of its soaring has disappeared. According to the forecasts of almost all major international institutions, only in 2024 total inflation will return closer to the +2% per annum threshold to which the central banks aspire. This means that in 2023 we will still have to deal with high, albeit falling, inflation.

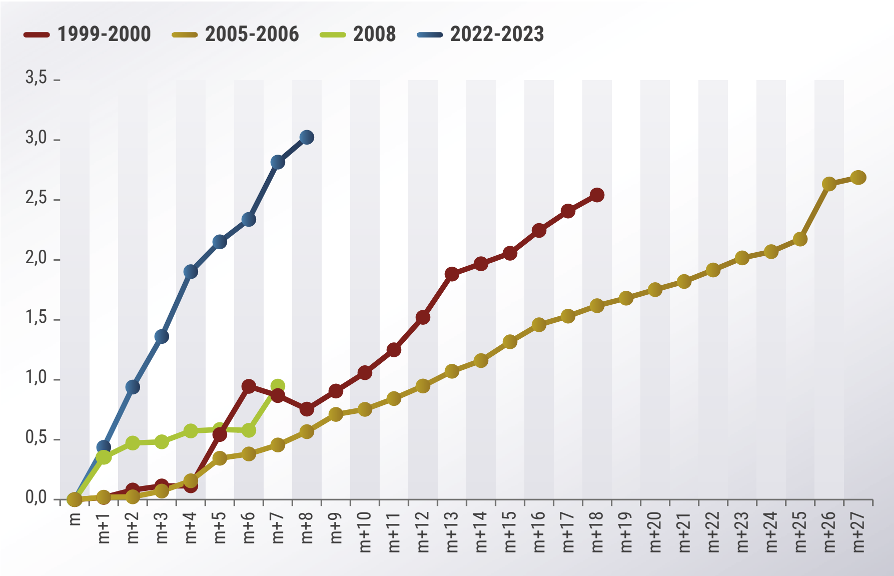
The price of gas has remained high for too long, raising the costs for companies, and long enough to have an influence not only on energy bills but also on prices of transport services and eventually the sales prices of many industrial goods. Some of these prices are included in the calculation of core inflation, measured net of energy and food, and that is why this measure of core inflation has started, slowly but relentlessly, to rise both in Italy and Europe, as well as in the US. This process will continue, at least for the current year, keeping total inflation high despite the reduction of the energy component.

If the rise in consumer prices were to enter fully into the medium-term expectations of economic agents, to the extent that it also triggers a price-wage spiral, the duration of the inflationary process would become even longer. Indeed, total inflation would risk remaining high, not falling at all, not even with a delay. This risk is very small in Italy and Europe, less so in the US.

Rising rates, drag on the economy It has been specifically the central banks' fear of price expectations moving away from the +2% per annum threshold that led the ECB to continue raising interest rates. The rise is already the largest and also the fastest since its creation in 1999 (Chart B): so far rates in the Eurozone have risen +3.5 points in just nine months. For comparison, in the 2005-2006 ECB hike phase, the rate took more than two years to rise about 3.0 points. Meanwhile, 12-month inflation expectations in the Eurozone fell to +2.7 per cent in February, not far off the stability threshold, from a peak of +7.5 per cent in August 2022. Western central banks started to raise rates when energy was very expensive and was igniting inflation (in July 2022 the ECB, a few months earlier the Fed) and kept raising them even when oil and gas prices fell.

Chart B
The current one is the largest and fastest rise in ECB rates

(Euribor 3M change since the start of the rises, monthly data, % values)



Source: Centro Studi Confindustria elaborations on S&P Global data.

This is where the problem of expectations and the slow falling of the rate of inflation come into play. Central bankers want to solve the problem completely before it can cause more serious damage and so the economic scenario must deal not only with such high rates but also with the possibility that the rises will continue. If their level rises too much in the Eurozone, which is a monetary union and not a federal country, it can lead to greater risks than in the US (fragmentation, financial instability), even beyond the drag on economic growth. After the latest ECB decisions, the risks appear more balanced.

When the long path of easing inflation approaches its target, Central Banks will have the opportunity to loosen their grip a bit. Inflation expectations are gradually decelerating, and our forecast scenario includes a reversal of rates towards the end of this year, with no further hikes at least in Europe until then (in line with market expectations). However, the cut is only expected to be significant in the US, much less so in the Eurozone. Therefore, next year the monetary policy for Italy and the other countries in the area will remain restrictive.

This increase in reference rates is gradually being reflected in the credit channel, which is becoming more expensive and less accessible. In this way, the monetary grip will dampen business investment and household consumption. The full impact in Italy is estimated to take place with a delay of about a year, according to estimates by the Centro Studi Confindustria presented in a Focus of this report, a delay similar to that expected for the Eurozone. Thus, the ECB hike, started in mid-2022, will hamper Italian GDP growth mainly in the second half of this year.

The rates paid by Italian companies have already risen sharply, with +2.60 points until the beginning of 2023 on average, and the cost of credit is expected to rise further after the ECB's latest hikes. This worsens the financial situation of companies, since (with same level of debt) it increases the weight of financial charges and discourages new investment projects. And the same applies to families and interests on variable rate mortgages.

A complex international scenario for 2023 In 2023, the international scenario is expected to benefit from an easing of some of the tensions that marked 2022, from price increases - especially energy - to pressures on supply chains. While, on the supply side, constraints thus appear less stringent, world demand is seen weakening due to the slowdown of advanced economies, affected by inflation and restrictive monetary policy, that have supported world trade growth in the last two years, while emerging countries have slowed down overall.

A change in the drivers of global trade growth is therefore expected in 2023, as emerging markets will regain momentum. After a difficult 2023, the US and Eurozone economies are expected to accelerate in 2024. Emerging countries in aggregate will do better in both years, but this is nothing new. China, after last year's slowdown related to zero-Covid policies, is rebounding very quickly. The economic impact on Russia after the launch of sanctions is evident but not as disruptive as imagined. By including such dynamics, world trade is expected to suffer this year but recover next year, at a pace around the historical pre-crisis average (Table A).

Table A
International exogenous variables of the forecast
(% change)

	2022	2023	2024
World trade	3.2	2.0	3.0
GDP - United States	2.1	0.7	1.6
GDP - Eurozone	3.5	0.5	1.2
GDP - Emerging Markets	3.9	4.1	4.5
Oil price[1]	101	83	78
Gas price (Europe)	124	50	50
Dollar/euro exchange rate[2]	1.05	1.07	1.07
Effective FED rate[3]	1.68	5.08	4.63
ECB rate[3]	0.58	3.56	3.54

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

The scenario outlined by the CSC excludes new significant economic impacts of the pandemic in Italy and in the World and assumes that the economic consequences of the war in Ukraine have already been internalized by families, companies and financial markets.

Among the risks, besides those connected with the correct calibration of monetary policy, there is the possibility of an increase in financial instability that may involve, as it has recently emerged, the international banking system (after the episodes in the USA and Switzerland) and real estate markets that could be affected more than expected by the rise in interest rates, as the 2008 subprime mortgage crisis reminds us.

Italy: modest growth According to the CSC's forecasts (Table B), the Italian GDP growth in 2023 (+0.4%) is sharply lower compared to the average for 2022, but it is more favorable than assumed just a few months ago, when a zero annual change in the Italian economy was forecast. In 2024, on the other hand, thanks to the slowdown of inflation, the less restrictive monetary policy and the improvement in the international context, Italy will record a better dynamic (+1.2% per year).

Table B
Forecasts for Italy
(% change)

	2022	2023	2024
Gross domestic product	3.7	0.4	1.2
Household consumption	4.6	0.2	1.4
Gross fixed capital formation	9.4	0.2	2.0
Exports of goods and services	9.4	1.6	2.3
Employment (FTEs)	3.5	0.4	0.8
Retail price index (NIC)	8.2	6.3	2.3
Government net borrowing[1]	8.0	4.9	4.2

[1] Values in % of GDP.
FTEs = full-time equivalent work units.
Source: Centro Studi Confindustria elaborations and estimates on ISTAT data.

The upward revision for 2023 compared to last October's CSC scenario (by +0.4 points) is entirely explained by the better-than-expected performance in the second half of 2022, despite the energy shock, thus raising the positive carry-over effect for GDP in the new year. Italy limited the downward adjustment to a minimum in Q4 2022.

The GDP path, however, is tortuous. The Italian economy is estimated to have contracted slightly again in the first quarter of 2023, due mainly to the delayed effects of inflation on consumption and a pause in investment after the jump at the end of 2022. From the second half of 2023, the easing of inflationary pressures and a cut of interest rates should favor positive GDP dynamics until the end of 2024. A moderate growth profile, but slightly above the pre-crisis average, thanks to the first positive effects of investments and reforms of the National Recovery and Resilience Plan on the expansion potential of our economy.

In 2023 a slow-down in consumption and investment… Despite the jump in inflation, the drop in real disposable income in 2022 was relatively small (see Focus no. 1), limiting the impact on private spending. Thanks to a positive carry-over from the previous year, household consumption will remain almost unchanged in 2023 (+0.2% on average). There is evidence that families financed their consumption in 2022 also by resorting to accumulated extra savings. This left few resources for 2023, at a time when higher rates for home mortgages and consumer credit will also have a negative impact on spending in goods and services. Only subsequently, in the wake of slowly falling inflation and a recovery in real income, consumption will pick-up in the second half of 2023, to then further accelerate in 2024.

Total investments as well are expected to grow at very modest rates in 2023, mainly because of the sharp reduction in tax incentives in the construction sector and the impact of tighter financing conditions. The annual figure hides, as for household consumption, a very weak start in 2023 and a subsequent recovery, which will then strengthen in 2024. But the pace will remain well below the one experienced in 2022, which was largely due to the building investment boom.

… as well as in exports and imports In the CSC scenario, after the strong expansion in 2022, Italian exports and imports of goods and services will not avoid the general slowdown in 2023. Exports will be mainly limited by the weakening of the world trade. In 2024 they will be only slightly better, returning to the average growth rates of the pre-Covid period.

The reasons for last year extraordinary performance of Italian exports, which occurred despite the energy shock and was significantly better than the one recorded by Germany and France, are analyzed in Focus no. 4 of this report: a strengthened manufacturing base, broad diversification in products and along value chains, competitive improvement in costs and qualitative composition of produced goods.

This strength in exports contributed to the great resilience of the Italian industry in 2022, which was also sustained by the solidity shown by SMEs (analyzed in Focus no. 6), and by the limited reductions in margins in many manufacturing sectors (estimated at sector level in Focus no. 5), thus allowing the financing of production and investments. Particular attention must be paid to the loss of competitiveness to which the energy intensive sectors are exposed to. The large contractions in production registered in these sectors contributed the most to the reduction in energy consumption last year (see Focus no. 2). Energy prices, although significantly lower than last year, are still historically high at the beginning of 2023, and higher than those in many economies outside Europe.

Thanks to a resilient economy, employment rose strongly in Italy in 2022 – increasing at a pace almost as fast as GDP - albeit with large differences between sectors in terms of labor intensity. Total employment is expected to increase in line with the growth of economic activity in 2023 as well (+0.4%), but its rate of growth will remain somewhat below it next year (+0.8%), when the efficiency gains resulting from the implementation of the National Recovery and Resilience Plan are expected to begin to show their effects on the production system.

The higher interest expenditure due to rising interest rates contributes to deteriorate Italy's public accounts. The deficit is expected at 4.9% in 2023 and at 4.2% in 2024. Higher interest rates and rising public debt (at 143.4 % of GDP in 2024) limit the fiscal policy options in 2024, also due to the expected reintroduction of the constraints of the Stability and Growth Pact.

Full Report in Italian is available here