

# ITALIAN ECONOMIC OUTLOOK 2019-2020 AND THE GEO-ECONOMIC SCENARIOS

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# SUMMARY AND MAIN CONCLUSIONS

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**Italy at a standstill** Economic stagnation is expected in Italy during 2019 with a slight recovery in 2020 (Table A). Compared to the forecasts made in October 2018, growth has been revised sharply downwards for 2019 (-0.9 percentage points): three fourths of the revision are due to lower domestic demand, one fourth to lower foreign demand. In October 2018, the Confindustria Research Department (CSC) had already reduced its growth estimate and highlighted a long series of risks, both internal and external, some of which actually occurred. In particular:

- a budget plan that is not sufficiently growth-oriented;
- no strong evidence of a clear reduction in the government debt-to-GDP ratio, with inevitable repercussions on the attractiveness of Italian bonds for financial markets;
- lower household consumption and increasing propensity to save;
- a European car market facing difficulties, threatened by US duties.

	2018		2019		2020
Gross domestic product	0,9	-0,2	0,0	-0,9	0,4
Export of goods and services	1,9	1,2	2,6	-0,7	3,4
Unemployment rate <sup>1</sup>	10,6	-0,3	10,7	0,1	10,6
Consumer prices	1,2	-0,2	0,9	-0,4	1,9
Government net borrowing <sup>2</sup>	2,1	0,3	2,6	0,6	2,6
Government gross debt <sup>2</sup>	132,1	1,2	133,4	2,7	133,6

<sup>1</sup> Percentage values; <sup>2</sup> as a percentage of GDP.

In October 2018 the outlook assumed the safeguard clauses wouldn't apply in 2019.

Source: CSC calculations and estimates.

In 2019 domestic demand will be fundamentally at a standstill, and recession can be avoided only through an increase (even if modest) in foreign demand. This stagnation will occur unless the desired changes in national economic policy are achieved quickly.

Statistically, the average GDP for 2019 is also affected by the negative close of 2018. In fact, in the first half of 2018, the Italian economy grew steadily, albeit at very low rates, but in the second half of the year, all indicators turned negative, reducing GDP slightly.

The negative outlook was made worse by two unfavorable events that occurred in the middle of 2018, both of which remain present in 2019, thus still negatively affecting economic activity on the forecast horizon:

1. an increase of about one percentage point in **sovereign yields**, compared to the lows of the early months of 2018, which persists; this reflects the increase in the risk premium that investors require to hold Italian public bonds;
2. a progressive fall in business **confidence**, especially that of manufacturing companies, resulting from a very uncertain economic climate, and a more recent worsening of consumer confidence.

The confidence of economic operators is crucial: a lack of confidence affects the spending decisions of families and businesses. Moreover, low confidence risks jeopardizing the transmission of expansionary policy measures to the economy.

According to the CSC outlook, 2019 and 2020 will be dominated by substantial differences in the trends of the main components of GDP. This is partly due to the fact that significant new policy measures will characterize each of the two years.

**Table A**  
**CSC forecast for Italy**

(Percentage variation and diff. compared to CSC forecast of October 2018)

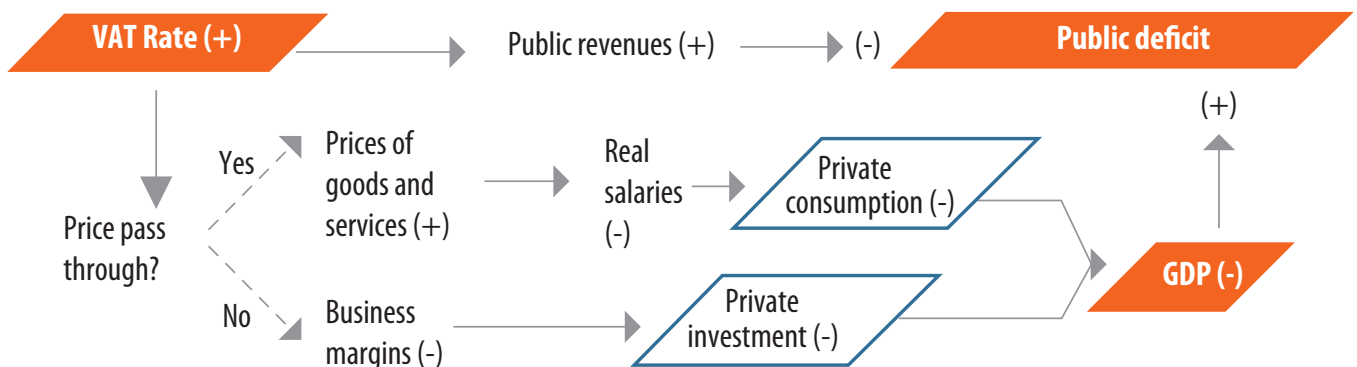
In 2019, two measures will come into force:

1. The Citizenship Income, a structural income support scheme;
2. The so-called "Quota 100", a new option for early retirement, which is a temporary measure introduced over the three-year period 2019-2021.

Such measures, especially the Citizenship Income, will contribute – albeit slightly – to economic growth, mainly within the first year of implementation. However, they are the two main pillars of the Budget Law – as announced in the spring of 2018 by the Government Contract – and, due to the expected high impact on public finances, contributed to the above-mentioned unfavorable increase in sovereign yields and the fall in business confidence.

By 2020 a rise of about three percentage points in both ordinary and reduced VAT rates is expected. Economic activity will be negatively affected via several channels (Figure A). According to CSC estimates, GDP growth will be lower next year (-0.3 percentage points) due to the activation of the safeguard clauses; meanwhile, government net borrowing-to-GDP ratio will improve by 0.9 points compared to the trend.

**Figure A - What if VAT increases?**



**Public finance** appears to be at a crossroad. Net borrowing-to-GDP ratio will increase by a half point this year. With the latest Budget Law, the Government has substantially jeopardized public finances for 2020. There are no easy or pain-free options: choices are either increasing VAT rates (as provided for by safeguard clauses) or increasing the public deficit. The drafting of the next Budget Law will be a hard task.

Avoiding VAT increases would be the option with less direct recessionary effects. Nevertheless, it is not a feasible option as the net borrowing-to-GDP ratio would go dangerously over 3 percent, which would not be sustainable under the current confidence and reliability conditions. In fact, a full cancellation of the safeguard clauses (1.3 points of GDP) would drive net borrowing up to 3.5 percent and may cause a further increase in yields on government bonds. Not only would this have a retroactive impact on deficit, but also additional recessionary effects.

Moreover, if the public finance framework had to be the one outlined by the Government, even if the safeguard clauses were activated, in order to be compliant with the commitments with European partners, a further correction would be required in 2020, thus expanding the recessionary impact of the next budget plan.

Looking at the main components of GDP, domestic demand appears to be an urgent issue. Investment will be held back and household consumption will fluctuate.

tuate depending on a number of factors: a fall in confidence, changes in propensity to save, resources deriving from the Citizenship Income, and VAT increases.

- **Private consumption.** Household spending is not expected to grow much in 2019, despite an increasing quarterly profile during the year; a sharp slow-down is expected in 2020. This forecast results from two factors, with different impacts over the two years.

First, in 2019 an increase in family income is expected to occur, partly thanks to the entry into force of the Citizenship Income and *Quota 100*. In 2020, by contrast, the expected sharp increase in VAT will have repercussions – through price increases – on purchasing power, which is expected to decline.

Second, in order for the additional income to turn into consumption and not into savings – thus resulting in an expansive effect on the economy – the fall in consumer confidence needs to be checked and reversed. Since last year, there has already been an uptick in the propensity to save, mainly for precautionary reasons linked to high uncertainty about the future.

Taking these factors into consideration, according to the CSC outlook, the savings rate will register a further increase in 2019, reducing the positive impact on consumption that would come from higher income. On the other hand, in 2020 a change of course is expected, with an erosion of the savings rate, due to the attempt by households to support consumption, despite the reduction of income in real terms.

- **Private investments.** After increasing over the past four years, capital expenditure is expected to decline in 2019. The forecast for 2020 shows a weak upturn, insufficient to allow investments to recover to pre-crisis values.

The standstill expected in 2019 can be explained by several factors. The main one is low business confidence which, as mentioned above, weakens the stimulus measures put in place as well. Other factors to be considered are:

- high uncertainty about demand,
- no confirmation of the “super-amortisation” in the last Budget Law,
- low effectiveness of the provisions of the last Budget Law (especially the *mini-IRES* tax on company revenue),
- expected rebalancing following the fiscal incentives in recent years.

The weak investment recovery in 2020 is explained by the net effect of two opposing forces: the expectation that the global economic context will improve, which will lead to higher demand and support business confidence; and an increase in VAT, which will reduce margins and liquidity of companies to the extent that it is not shifted onto consumer prices.

Furthermore, **credit** might be once again a restraining factor throughout the two-year period after supporting – although slightly – economic activity in 2018. In fact, even if delayed compared to past cases, the prolonged period of higher sovereign rates is showing its first restrictive effects on credit volumes to business. In addition, an upward impact on the cost of credit is expected to occur in 2019. The new loans just launched by the ECB (the so-called TLTRO-3) are crucial to avoid problems in bank funding in 2020 and, therefore, worse credit scenarios – certainly not easing credit conditions with regards to the current situation.

- **Public investments.** According to the CSC outlook, public capital expenditure does not support economic activity: in line with Government perspectives, a further reduction is expected in 2019, only to register a rebound later in 2020. The risk is that public investments will be even less *ex-post*, as recorded in the final balance of the three-year period 2016-2018.

Any initiative aimed at unlocking the allocated resources needs to be sup-

ported and pushed through, as well as any other initiative to support private investments and credit.

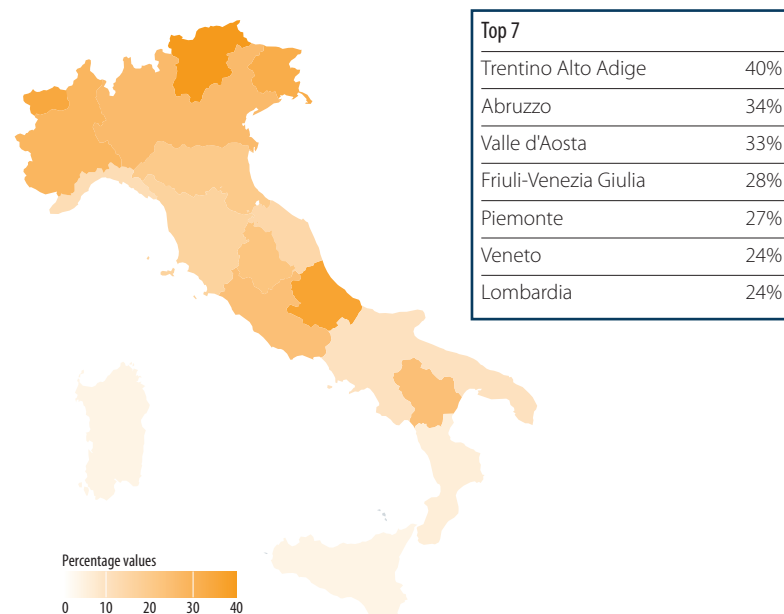
- **Export.** Export growth is expected to speed up in 2019. Statistically, that is also thanks to the good performance recorded at the end of 2018. A further acceleration is expected in 2020, although at a slower pace with respect to that of post-second-recession years.

However, for the year 2019 the estimate for export growth is revised downward compared to the outlook as of October 2018. This is coherent with the supposed minor expansion in world trade this year, as it is still affected by the critical phase experienced in 2018 – especially after new duties imposed by the US. A minor expansion in world trade occurs together with growth slowdown involving all main regions – mostly the Eurozone and emerging markets, and the USA to a lesser extent.

The slowdown phase affecting Europe – Germany in particular – is relevant also for the role held by Italian production in the continent’s value chains. Italy is not only an exporter of finished goods, but it also has an important role as supplier of intermediate goods, most of which are embedded in German manufactured products. Exports of goods to Germany account for more than 20 per cent of the manufacturing value added for eleven Italian regions (see Figure B). Therefore, the strong manufacturing integration between the two countries that occurred over the last two decades and that contributed to the success of Italian exports in the past few years is today holding back export sales.

**Figure B**  
**Many Italian Regions**  
**export to Germany**

(Export on value added, %, manufacturing, 2015)



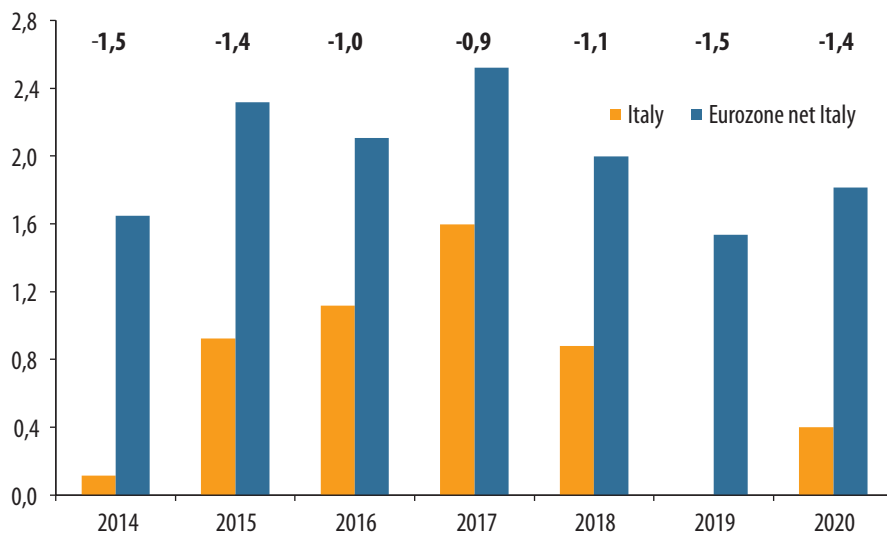
Source: CSC calculations on ISTAT data.

Italy's GDP growth rate gap with the other Eurozone countries will still be wide in the next two years (higher than one percentage point). Thus, when the Eurozone slows down, Italy stops (see Figure C).

The CSC outlook assumes a normalization of protectionist tensions and trade relations at international level – especially between the USA and China – thus favoring a gradual recovery of foreign exchanges. The positive effect of this recovery in terms of annual average figures will be evident in 2020.

This is a crucial hypothesis, given that the fluctuating trend of Italian exports in 2018 was mainly due to the weakness of non-EU demand for European products. The 2019-2020 prospects for sales in some non-EU markets are





**Figure C**  
**A wide growth gap between Italy and the Eurozone**

(GDP, percentage variations)

In bold: Italy - "Eurozone net Italy".

2019-2020: Eurozone, EU Commission forecast, Italy, CSC forecast.

Source: CSC calculations on Eurostat data.

already better. The possible developments of China's current slowdown are very important: the country might be able to prevent a sharp slowdown, in which case imports into China would kick-off over the two-year period.

Nevertheless, geo-economic scenarios are complex and highly uncertain. For this reason, one cannot take for granted the possibility that Italian GDP will be flat this year and get (marginally) stronger next year.

**Major international issues are crucial** Relying on a rational behavior of all parties involved, an improvement in foreign market conditions is a reasonable scenario as the escalation of international tensions would damage everyone. The CSC outlook assumes, in particular, that:

- the US and China close an agreement ensuring a roadmap to reducing tariff and non-tariff barriers;
- negotiations between the US and the European Union prevent new US import duties on motor vehicles;
- economic relations between Europe and China become stronger, with no breach with the US ally;
- the next European elections do not lead to a backing down from the EU reform process;
- Brexit takes place in an orderly manner;
- geo-political crises in the Middle East (Iran) and South America (Venezuela) do not destabilize the surrounding regions;
- no excessive economic slowdowns take place in the Eurozone or in the US: a recession in one of these two areas would lead to a recession in Italy as well.

Considering the long series of hypotheses, there is a high risk that something may not go as expected, so conditions for Italian exports may worsen during the two-year period. In particular, a further weakening of intra-European demand for goods – in line with the slowdown already occurring in the area – is a significant downside risk factor. Many other clouds of uncertainty are gathering on the horizon, including: Wall Street instability, the imminent European elections, extreme uncertainty about Brexit, and trade war or peace.

The events that occurred in 2018 negatively shocked analysts and operators on several occasions. A climate of deep uncertainty evolved, also given analysts' inability to assign precise probabilities of occurrence to different outcomes. Such outcomes could cause serious discontinuities in international economic relations.

Therefore, the analysis of these alternative scenarios becomes a useful and necessary "stress-test" of the Italian economy, allowing the evaluation of growth forecast risk factors as well as the analysis of appropriate policy responses at Italian, European and multilateral level.

**Global geo-economic scenario** impacts on Italy are amplified by its deep commercial, productive, financial, energy and technological links with foreign countries as well as by the role played by Italy in the main multilateral Institutions. Six main channels that transmit shocks from foreign countries into the Italian economy, and vice-versa, may be identified:

1. **trade in goods:** the sum of imports and exports in goods is equal to about 50 percent of Italian GDP; most trade involves intermediate and investment goods, reflecting the strong integration of Italian firms into European and global value chains;
2. **foreign direct investment flows:** multinational companies in Italy – both nationally- and foreign-controlled – produce two thirds of manufacturing exports and almost three fourths of imports (reaching 90 per cent and over in the motor vehicle, other transport, and pharmaceutical sectors);
3. **financial links:** Italian assets and liabilities with the rest of the world amount to about 150 per cent of GDP; in particular, the foreign channel plays a central role in bank funding and Italian public debt financing;
4. **fossil fuel imports:** more than 90 percent of oil and natural gas consumed in Italy comes from abroad; increased energy bills weigh on household and business balance sheets;
5. **trade in technology:** Italy has been a net exporter of technology since 2012, enhancing exports in research and development, IT, architecture and engineering services and increasing returns from intellectual property. Technological cooperation – especially in the digital and mobile connection fields – represents Italy's main competitiveness and is a long-term growth driver;
6. **growth in destination markets:** as foreign economies continue to expand – with regards to imports in particular – higher potential demand for Italian products is expected. This is also true considering that in recent years Italian firms have proven to be able to direct their sales towards the most dynamic markets.








Based on these six transmission channels, Confindustria Research Department developed a **Geo-economic Relevance Index** for over 100 countries, drawing a global map of the most important strategic areas for the Italian economy.

The geo-economic map reveals three main areas:

1. **Europe:** Europe is Italy's strategic reference area. The European single market represents the largest economic area in the world and is essential for a globally competitive Italian industry. France is Italy's main financial partner and so is Germany in the commercial field; the United Kingdom is an integral part of the area – especially from a financial point of view – and it is therefore crucial that Brexit is managed in an orderly way (*following*);
2. **Emerging:** European countries are far behind with regard to energy and market growth. For energy, Italy mainly depends on Russia and the Middle East; for growth in demand, the obvious course is to deal with China, the most dynamic global economy;

3. **USA:** the United States remains Italy's main geo-economic partner; it is first for technological cooperation, important in all fields, and still represents the largest destination market in the world and the second most dynamic one (see Table B).

**Table B**  
**The 7 most relevant countries for Italian economy**  
*(Geo-economic Relevance Index, total ranking and 6 sub-indexes, 2019)*

Rank	Country	Financial links	Trade in goods	Foreign direct investment flows	Fossil fuel imports	Technological cooperation	Destination markets' growth
1°	 United States	7°	3°	6°	12°	1°	2°
2°	 France	1°	2°	3°		3°	30°
3°	 Germany	4°	1°	4°		2°	26°
4°	 UK	3°	6°	5°		5°	9°
5°	 Netherlands	11°	9°	1°	15°	7°	75°
6°	 Russia	31°	16°	11°	1°	20°	5°
7°	 China	29°	5°	17°		11°	1°

Source: CSC calculations on data by International Monetary Fund, Bank for International Settlements, UN-Comtrade, Bank of Italy, Italian Ministry for Economic Development, IHS.

**CSC Geo-economic Scenarios** Considering the above-mentioned transmission channels, CSC identified 11 global events – either that occurred in 2018 or that may occur in 2019, and partly connected to each other – as having a possible influence on the Italian economy.

The five events that took place in 2018 that are also affecting the current year are:

- US import tariffs.** Although mainly affecting Chinese products, the recently introduced or possible new US tariff barriers to imports led to a feeling of strong uncertainty among all operators, and resulted in being one of the key factors causing the world trade slowdown in 2018-2019. Italian manufacturing is particularly exposed to the US market, both directly and through global value chains (just to mention, in particular: German exports embed many Italian semi-finished products). US duties also threaten Italian motor vehicle exports, one third of which depend on US demand. A new European agreement with the United States is needed, possibly taking advantage of the shared basis of the TTIP (Transatlantic Trade and Investment Partnership) negotiations.
- Emerging countries financial crises.** Some emerging economies largely depend on US financial conditions. In 2018, US interest rates increased and US dollar appreciation caused a deep financial crisis in Argentina and Turkey. Other countries – such as Russia and Brazil – were also partially involved, although without any real contagion effect that may have caused a sharper slowdown of emerging countries' imports and, subsequently, that of world trade.

3. **US sanctions to Iran.** The unilateral withdrawal of the US from the Iran Nuclear Deal, along with the reintroduction of economic sanctions, mainly affects European companies, which are relatively more exposed to the Iranian market. This is especially true for Italy, which is the source of one sixth of products and almost half of the financial capital going from Europe to Iran. Furthermore, US policy favors the shifting of Iran (and the Middle East) towards the Chinese sphere of influence.
4. **Higher energy prices.** Oil and gas prices increased in 2018, partly due to tensions concerning Iran, and their high volatility fueled uncertainty. In the same year, the energy bill charged to Italian businesses and families rose to 2.3 percent of GDP, reducing spending and investment capacity. Italy needs to make the most of its fossil fuel reserves, support the domestic production of electricity from renewable sources, and create the necessary energy infrastructures to diversify imports.
5. **No European reforms.** The European Institutions' reform process stopped in 2018 in all fields. Without reforms, Europe's competitiveness gap with the United States will endure: availability of non-bank risk capital is 7 times lower, electricity prices are 30 percent higher, gas prices are 100 percent higher, and the lack of a digital single market costs Europe 400 billion euros a year. Given high public debt and low growth, the Italian economy is particularly vulnerable within the current European framework.

The six factors to be monitored for 2019 as constituting risks (especially downwards) to the economy in the two-year forecast period, are:

1. **Political developments in the European Union.** Brexit and the European elections present uncertain and unprecedented scenarios ranging from substantial continuity to complete breakdown. The British Parliament voted against a disorderly "no deal" exit from the European Union and in favor of a postponement of Brexit after the March 29 deadline. As for the scenario following the European Parliament elections in May 2019, a much broader coalition than previously will certainly be needed in order to create a parliamentary majority that can define a shared reform agenda, otherwise there will be high uncertainty regarding the driving force that Parliament will be able to provide. As the Italian political forces that will get the most seats are likely not to be part of the majority in the European Parliament, Italy could run the risk of standing alone.
2. **Eurozone recession.** What if the Eurozone falls into recession? In the event of a negative shock in Germany or in other European countries, Italy would be vulnerable not only on the commercial and financial front, but also on the front regarding the Government balance sheet: over 150 billion euros of Italian public debt is held by the banks of the 10 largest EU countries. The lack of European reforms with regards to instruments for the stabilization of the business cycle and the conclusion of the Banking Union as well as the Capital Market Union are a burden.
3. **Escalation of cyber attacks.** With 20 billion connected computers in the world, cyber-attacks on a global scale will increase. Ranking 25th (out of 28) in Europe for digital skills, Italy is particularly vulnerable to this, also due to little or no specific investments in the field. It is necessary to support private investments in computer security (especially among small and medium-sized enterprises) through public incentive measures, starting from tax relief for the purchase of cyber-security services already put in place by the Government.
4. **Wall Street crash.** US economic expansion has lasted almost 10 years (by June 2019, it will be the longest ever recorded) and once again the Wall Street index is reaching its highest levels after dropping at the end of 2018. What if the US engine breaks down? The Italian as well as the European economy

and stock exchange are closely linked to US dynamics. In an extreme scenario of a US financial crisis like that of 2007-2009, the negative impact on Italian GDP would be higher than one percentage point.

5. **US-China: (trade) war or peace.** The US and China seem to be close to a trade deal. Will this stop the strategic tensions between the two largest world economies? Two opposite scenarios can be considered: a “deep” deal would reduce uncertainty and boost world trade, although the risk would be for Italy and Europe to be marginalized; on the other hand, a protectionist escalation would rapidly spread to the rest of the world, with destructive effects on global value chains and costing up to three percentage points of world GDP. The global governance stalemate needs to be overcome as soon as possible, starting from the World Trade Organization reform proposal presented by the European Union.
6. **Italy and the Chinese Belt and Road Initiative (BRI).** Even if a US-China bilateral agreement was reached, their strategic tensions would pour into Europe: ranging from Chinese investments in the BRI – the New Silk Road – to the digital issue (Huawei’s 5G), along with the underlying threat of US duties on the automotive sector. Chinese demand and investments are, first and foremost, an opportunity for Europe, and Italy is in a privileged position along the New Silk Road (60 percent of European trade with China is by sea). However, Italian exports to China are lagging behind those of other countries and Italian ports have lost market share: from 2008 to 2018 Italy dropped from 2<sup>nd</sup> to 10<sup>th</sup> place as a destination or origin of goods north of the Suez Canal (behind Greece, Spain and Turkey). Greater cooperation with China is necessary, with no break-ups with our main Atlantic ally and above all by building a strong negotiating position.

