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ECONOMIC OUTLOOK

A STRENGTHENING GLOBAL RECOVERY. ITALY FOLLOWS RIGHT BEHIND

EUROPE: INTEGRATION OR DISAFFECTION?

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FOREWORD

We are suffering from a bad attack of pessimism.
It is common to hear people say that the epoch of enormous economic progress is over.
I think this is a totally wrong interpretation of what is happening.

John M. Keynes, *Economic Possibilities for Our Grandchildren*, 1930

The turning point in the **global scenario**, which was anticipated six months ago, has now been confirmed by the data. Yet, there are also indications of fragility and risk.

In fact, some of the variables indicated by CSC as **signs of change** went beyond expectations, others moved less or even in the opposite direction with respect to previous forecasts.

World trade has accelerated and this is among the boosts to growth; this was prompted by the wide synchronization of the international recovery, which sees the participation of both advanced and emerging countries. Something that had not been happening for a long time. As in an orchestra, the rise in the number of elements amplifies the power of music, thus **synchronization** strengthens recovery by multiplying the expansionary impulses that are mutually transmitted through the foreign channel: the imports of a country are the exports of the other ones, and vice versa.

Furthermore, the start of a new **global investment cycle** has strengthened international trade. This was the missing link to come out of the crisis, generating greater demand and increasing growth potential, thus extending the expansionary phase.

Confidence has increased further, as shown by the record hike in share prices and, above all, by the restored confidence of firms, which is back to the peak of 2005 in advanced economies.

As expected, **inflation** has moved away from the minimum level reached one year ago. However, net of food and energy prices, it remains relatively low: it has been being slowed down by global competition, rapid innovations and widespread under-utilization of human capital.

Budget policies are among the variables that have had a less pronounced change than expected. Even though, due to the European electoral cycle, fiscal policy has turned less austere, there have not yet been measures to support demand, so as to alleviate the burden on monetary policy.

In line with the new global trend, the rise of long-term **interest rates** has stopped and it has made significant steps backwards compared to the peaks in the early months of 2017. This reverse has certainly been assisted by the **central banks**, which operate cautiously in order to make the exit

from the extraordinary expansionary measures as smooth and gradual as possible, and to avoid destabilizing turbulence. The **FED** has now entered into the exit process in a more resolute way.

Real rates remain almost null on the American ten-year Treasuries and negative on the German Bunds. These levels are difficult to be reconciled with the strong growth prospects expressed by stock prices (overvalued beyond the Atlantic). A unifying explanation of low real rates and high shares is the **large amount of liquidity** in circulation, which is the other side of the huge central bank balance sheets. Low real rates, however, reveal **doubts** about the strength and duration of the recovery.

The same doubts are influencing the trend in **oil** prices and of other important raw materials, which turned out to be weak. As far as oil is concerned, surely this was due to the evolution of supply, on the brink between the cuts made by the producers, OPEC countries and not, and the technological advances, which lower the break-even point in the exploitation of American shale-oil. Equally important is the dynamics of demand, which is slower than it would be implied by the wide diversification of sources and energy saving policies would justify.

In the lack of a significant reduction in huge stocks, there is a risk of a **new drop** in the cost of crude oil; while the sudden deflagration of geo-political tensions in the Middle East would cause its sudden upswing.

Finally, **three elements** have noteworthy changed in comparison to the scenario described six months ago: dollar, protectionism and populism.

The **dollar** has lost appeal and ground, not just against the euro. It is the effect of the rebalancing of world growth (more synchronized and less dependent upon the United States), the dispelling of fears about the currencies of some emerging economies, the agreement reached in January by G20 about not to use the **weapon of devaluation**, to boost one's growth at the expense of the others, and the overcome of the expectations of the Eurozone disintegration. If all this is confirmed, the American currency will hardly come back at the top; nevertheless since 2015 it has moved within a very narrow fluctuation band.

The impetus for political legitimization of rampant **protectionism** has been confirmed by statements in favor of fair-trade rather than free-trade and pro-liberalization omitted points at the world summits. However, pragmatism has led to the signing of new, even multilateral, agreements, which reduce barriers to trade and there are now rumors about the relaunch of the EU-US negotiations on TTIP.

Finally, **populism** appeared rather downsized following the 2017 election rounds. This does not mean that it has ceased to influence policies, and not always in a negative way; for instance, the focus on growth and social issues has gained momentum at the expenses of austerity measures.

However, the rate of **instability** has risen even in unsuspected nations; in the UK there have been two elections and a referendum in two years, the parliament is with a weak majority and new short-term consultations are likely to take place. This keeps **political uncertainty** high.

The relaunch of **European integration**, which implies the transfer of sovereignty and less nationalism in the name of the common greater good, will be a crucial test.

Overall, for the first time since 2011, global growth **forecasts** are revised upward. Geopolitical tensions and the actual amount of tax cuts that will be actually made by the Trump Administration are the biggest downside **risks**.

CSC raises the estimates of the increase in **world trade** to 3.9% from 2.4% in 2007 and to 3.3% from 2.7%, in 2018; the revision is more pronounced than the one of the global GDP, which is estimated to grow by 2.9% this year and 3.0% the next one (from 2.7% and 2.9%, respectively).

The growth projections of all **major countries** and economic areas are revised upward and to a greater extent those for the Eurozone.

Italy follows closely behind. The new CSC forecast for Italian GDP is +1.3% in 2017 (+0.8% previously) and +1.1% in 2018 (+1.0%). Two-thirds of this year upward revision are due to the higher statistics released by the ISTAT; a third incorporates the further increase in the qualitative indicators, which show stronger growth than what expected in the central quarters.

The **growth differential** with the rest of the Euro countries is halved: from 1.4 percentage points in 2015 to 0.7 in 2017-18. However, it remains large and widens the gap that has been accumulated in the total and per capita GDP levels (for both almost 18 percentage points since 2000).

The **acceleration** of the Italian economy is driven by exports and investments.

In 2017 and 2018, **exports** will increase by 4.6% and 3.9%. Businesses have been quick to react to the improved foreign demand, with sales abroad that for some years have been continuing rising more than the reference markets (since 2010 +3.1% per annum vs. +2.3%), gaining market shares. They will continue to gain market shares in the next two years.

The gains in market share are achieved thanks to the increased **quality of exported goods**: +31.3% since 2000, according to CSC estimates, against +20.8% by German exports.

In addition, the weight of exports on GDP continues to rise, approaching 32% next year, from 27% in 2011. This increases the degree of **internationalization** of the Italian economy, as a result of corporate strategies and government and associative policies.

Investments have begun to rise in 2014. The trend is progressive: starting from the means of transport, it has extended to machinery and from last year also to the construction sector. Each type benefits with a different intensity from a number of conditions that have become more favorable.

First of all, a greater confidence in the growth of **future demand**, which is validated by the improvement of the scenario. Then, the saturation of the plants, whose **use** is at its highest since 2008. In addition, the revamped **profitability**, due to the fall in the cost of raw materials (while the ULC continued to rise, albeit very slowly). Still, the **cost of capital** is at its historical lowest. In

addition, **public** spending on **infrastructure** has been refinanced and private spending in **houses** is stimulated by high accessibility (doubled since 2008, according to CSC). Lastly, the strengthening of fiscal measures put in place by the last two budget laws to finance **capital depreciation** has proven effective: + 3.5% its cumulated effect in 2016-18 on the purchase of instrumental goods (Bank of Italy estimates).

The scenario, however, will become **less favorable** to investment: profit margins have already started to decline, mirroring the rise in raw materials prices, and this erodes self-financing while credit is still very selective; the higher capital depreciation, in current regulations, is valid for orders made by the end of 2017; in 2018, fears about the electoral outcome will tend to make company decisions more cautious.

The disappearance of important **braking elements** has given more room for the growth of Italian GDP: the stalemate of world trade through the end of 2015 and the beginning of 2016; the grinding credit crunch; the long and deep fall of the building sector output; the substantial fiscal measures to reduce the public deficit.

With regard to fiscal policy, the CSC forecast does not take into account any possible measures that might be passed in 2018 fiscal law in order to reduce the public deficit (without triggering VAT increases), while continuing to support economic growth. Even if such measures costed less than 8 billion (thanks to further European flexibility), this would lower GDP growth below 1%.

Household **consumption** increases at a very low pace, albeit in line with the GDP growth rate. It is affected by the rise in prices due to the increase in the energy bill. They are supported by progress in the labor market, in quantity and quality, as shown by the highest quota of permanent **contracts** on new jobs, as a result of the implemented reforms.

Indeed, the **employment results** are remarkable. They are themselves extraordinary and in relation to the performance of the economy: +730 thousand employees in comparison to the lowest point in the second half of 2013, +3.3% (+2.6% the GDP).

However, one must not forget about the 7.7 million partially or totally unemployed people, nor the high long-term **unemployment** (i.e. at least for 12 months, almost 60% of the total) nor high youth unemployment, which is fueling a strong emigration from Italy towards foreign destination and, within Italy, from South to North.

The rise in **inflation** is related to the worsening of terms of trade. Wage dynamics are moderate and follow the contracted mechanisms of indexation to consumer prices rather than labor market conditions. In the 2017-18 period, **real wages** fall back by 0.5%, after +1.4% cumulated in 2013-16.

Public debt in comparison to GDP does not decline: 133.2% in 2017 (132.6%) and 133.7% in 2018. The main cause is the nominal increase of the denominator, which is much lower than the average cost of public debt, with a positive primary balance equal to the German one.

The large gap between the average yield on new sovereign bonds and the implied interest rate paid on Italian public bond stock suggest that there will be no immediate risk of greater **interest expenditure** after the change in the ECB policy, which is, however, not imminent.

Greater growth is also the key to lower public debt as well as, and above all, to raise welfare and reduce poverty. This is why **structural reforms** and budget policies are needed, in order to promote investment and reduce labor taxation. This would result in greater flexibility at European level and improved confidence of the financial markets.

The field where we should play the game of Italian development is, however, not only domestic. The **European Union** is a much wider arena that goes far beyond the economy to embrace its own **core values**: democracy, peace, freedom, security, solidarity. All **public goods** that European citizens have enjoyed while population was increasing for both demographic trends and the larger number of Member States. Together, the **economic well-being**, used by founding fathers as a glue, has greatly increased the opportunity of overcoming cultural barriers and historical divisions.

A glue that is less powerful today, in the face of the fears of globalization and new technologies and the disenchantment generated by the effects of the crisis, which nourish nationalisms and closures. The reasons for **greater integration** must then be sought again in the values that are most heartfelt by the citizens.

For the first time since its launch, the European project is **at a crossroads**: it can move forward, with greater integration and putting in common the sovereignty in new fields, or it can retreat, undermining the achievements, which have been attained after hard and long-lasting efforts. Brexit makes it clear that the second possibility is not a school hypothesis at all; the **voters** of other countries who resisted the sovereign sirens understood it well. And, perhaps, the English themselves.

In the special part devoted to Europe, CSC has, first and foremost, focused on the **size** of the EU, compared to other World powers (USA, China, India, Russia). The comparison underlines the positive aspects of the European economy (whose cornerstone is the single market), but also the obstacles encountered in reducing the gap with the United States and the divergence between countries.

Secondly, there is an **increased disaffection** in the European project and the factors behind its realization. The **benefits** of the Union and those that could be obtained from the completion of the integration projects that have been already started (banking and capital union, completion of the single market, infrastructure, energy) are explained. Again, the European reaction to the **multiple crises** (economic, migratory, terrorist) has been described, highlighting the flaws of institutional architecture.

From this analysis several **proposals** come out, explained also in terms of efficiency and effectiveness. More Europe is better for the control of borders, migration, defense, foreign policy and diplomacy, development cooperation, security, research and industrial policy, support of investment. The creation of a common Eurozone fiscal policy is needed.

Some of these new integration policies could be achieved inside the legal framework of current **treaties**, others would require its revision. Without forgetting the need, one day, to start drafting a constitutional chart. Since not all the Member States are available to give up additional slices of national sovereignty (enlargement in this sense has been at the expense of deepening the Union), one should start from those who are already prepared to do so. In fact, today Europe looks like fragmented in multiple countries clubs, in which there is the risk that Member start up advancing requests *à la carte*, without any concern for the funding principle of solidarity.

Lastly, in order to bring citizens closer to European institutions, it is necessary to fill the real or perceived **lack of democracy**. Starting with the direct election of the President of the European Commission, who should also be the President of the European Council.

European disunity would not solve any of the problems that citizens experience or fear. If anything, it would exacerbate them because they are so big that none of the 27 countries, individually, can deal with them effectively.

However, the wall of mutual mistrust that the crisis and its management left behind must be overcome, not on the basis of the demonization of returning each one on one's own, but with the clear explanation of the **benefits** of staying together in the European Union. Only then the adhesion to the project can be firm and convinced.

1 FORECASTS

Summary

- **GDP and domestic demand** - CSC predicts that the Italian GDP will grow by 1.3% in 2017 and 1.1% in 2018. Household **consumption** will increase by 1.2% in 2017 and by 1.1% in 2018. The dynamics of **investment** continue to grow steadily: +2.6% in 2017 and + 2.9% in 2018. In particular, purchases of machinery and means of transport are expected to continue to grow at a good pace (+3.6% and +3.5% in the two years); those in construction show higher increases (+1.6% in 2017 and +2.2% in 2018).
- **Foreign trade** - **Export** accelerates (+4.6% in 2017 and + 3.9% in 2018), in direct link with international trade. **Import** grows up faster (+ 5.7% and + 4.1%), fueled by the same export performance, which increasingly incorporate goods and services purchased abroad, along the global value chains, and by an increase in domestic demand. Compared to the pre-crisis levels of 2007, in 2018 the level of imports will be higher by 6.3% and exports by 14.9%. Trade and current account surpluses are falling, mainly because of the reduction in terms of trade, from the record 20-year levels in 2016, but remain high (3.3% and 2.1% of GDP in 2018), foreign debt continues to decline.
- **Credit** – Corporate loans are still weak (-0.2% monthly average in the first 4 months of 2017) and NPLs still steady. Various factors support it, but others act in the opposite direction. The supply is less tight, the demand is at pre-crisis values and the interest rate extremely low. Loans to households are growing (+0.4% on average per month) with a looser supply and a demand in expansion.
- **Employment, Wages and ULC** - In 2017 and 2018 employment will slow down to 0.9% and to 0.8% (+390.000 additional FTE units), from +1.4% in 2016. The increase in worked hours will slow jobs creation. At the end of the two-year forecast period, employed people will return to pre-crisis levels, while FTE units will still be at 900.000 below it. The unemployment rate will be just below 10%. The dynamic of wages will surpass that of the contractual rate. Against the rise in inflation, due to food and energy, real wages will fall back in 2017-2018 by 0.5%, after rising 0.9% in 2016. The ULC will, however, rise in both 2017 and 2018.
- **Prices and margins** - Inflation is expected to remain stable around current values (+1.3% in 2017, +1.1% in 2018) and rise slowly to 1,0% net of food and energy. Profit margins are falling back, eroding self-financing, due to the expected rise in raw materials prices.
- **Fiscal policy** - Public deficit is almost unchanged: 2.3% of GDP this year and 2.4% in 2018 (gross of the safeguard clauses worth 0.9 points of GDP). While the debt-to-GDP ratio does not reduce: 133.2% and 133.7%, from 132.6%. Its performance depends on the nominal GDP, which is curbed by low inflation. CSC forecast does not incorporate the measures that will be in the next budget law. The goals set by the Government appear ambitious and challenging. It is needed to keep on focusing on the reforms to increase the performance potential, gain more flexibility from the European authorities and strengthen market confidence.

- **World trade** - **Global trade** has restarted growing rapidly but the pace remains below pre-crisis levels. CSC forecast is revised up: +3.9% in 2017 and + 3.3% in 2018, with both upward and downward risks. The positive dynamic is robust at the beginning of 2017 and prospects are good for the central part of the year. High **disequilibria** are still present in current account balances: diminishing those of the emerging economies but wide among the advanced ones.
- **Eurozone** – CSC revised upward to 1.9% the forecast of GDP growth for 2017; the revision concerns countries and sectors in a widespread manner; in 2018 it is expected a contained deceleration to 1.7%, due to the end of political cycle and the exchange rate appreciation.
- **United States** - CSC keeps growth forecast unchanged to 2.2% in 2017 and revises it up to 2.5% for 2018. A positive contribution from fiscal policy is expected but political uncertainty still remains.
- **Japan** - In 2017 CSC expects a weak recovery in the Japanese economy: +1.4%. Such an increase will halve in 2018 and return to the potential growth path.
- **United Kingdom** - Brexit hinders consumption and investment; CSC expects British GDP to grow by 1.2% in both 2017 and 2018.
- **Emerging economies** - Estimates for emerging countries are revised up to 4.6% in 2017 and 4.8% in 2018. **China** will continue on the soft landing trajectory (+6.5% and +6.1%), using budget and monetary policy to achieve the objectives. After the shock of demonetization, **India** returns to sustained growth (+7.4% and +7.6%). In **Brazil** the slow recovery (+0.3% and +1.9%) is due to the political uncertainty surrounding the future of President Temer, involved in a judicial inquiry. In **Russia** the recovery consolidates more rapidly (+1.2% and +1.4%), but remains exposed to fluctuations in oil prices.
- **Raw material prices** - **Oil** slightly increases (51 dollars in 2017 and 52 in 2018) with downside risks, because the US extraction has risen (to 9.3 million barrels per day in May from a minimum of 8.5 touched in the last Autumn), along with OPEC unused capacity, making the freeze made by the Cartel insufficient to sustain a lasting price increase, whose volatility decreases but remains high. Prices of other **raw materials** rise, with unstable equilibrium between demand and supply.
- **Monetary policy** - **ECB** rates remain unchanged and will not be reviewed before the second half of 2018, with the QE that is going to be extended at least for much of the next year, with a lower monthly amount. Banks' deposits with the ECB continue rising, a symptom of the fragmented interbank market. The **FED** is going to raise rates (from 1.00-1.25% in June): the CSC expects three more hikes by the end of 2018; and it will reduce the huge stock of securities ($ 4.245 billion).
- **Rates, Stocks and Exchange Rates**- Long-term interest rates are below the maximum reached in last January (ten-year *Treasury* yield at 2.2% in June) and Stock market are at record levels (S&P 500 + 8.8% since the beginning of the year). The euro exchange rate climbs to $ 1.12 on the dollar, also due to US policy uncertainty.