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ECONOMIC OUTLOOK

THE CHALLENGES OF ECONOMIC POLICY

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FOREWORD

In a minute there is time
For decisions and revisions which a minute will reverse.
Thomas S. Eliot, 1911

The economic trend looks very **favourable** at the beginning of Autumn.

Global growth is strong: in 2Q-17 it hit its record speed since 2010. It is more broad-based across countries and it shows a more uniform growth pace. In the advanced economies as a whole **unemployment** is at its lowest level since 2Q-08.

Data suggest upward revisions of forecasts, while last year's data pushed towards downward ones.

CSC estimates global growth at current high rates in 2018, as a whole and in all major countries. **International trade** continues to benefit from the global investment cycle, and is forecast up by 4.1% this year and 3.5% the next (+3.9% and +3.3% estimated in June).

Italian GDP is further revised upward: +1.5% in 2017 and +1.3% in 2018 (from +1.3% and +1.1% in June). On the one hand, the revision is explained by a marginally better increase than that expected in 2Q-17 (+0.4% vs. +0.3%); this result is going to dispel some analysts' doubts about previous data. On the other hand, it is consistent with the high level of **qualitative indicators** (especially the ones regarding orders).

GDP will fully recover the ground lost in the second recession (2011-13) by the end of 2018. It will still be 4.7% lower than its highest peak in 2008.

These forecasts may turn out cautious. On the one hand, information regarding the Summer is limited as far as the crucial service sector is concerned (tourist sector has a high seasonal value). With an higher-than-expected dynamic in the second half of this year, the 2017 average would rise, and would be fully transferred on next year's situation.

On the other hand, CSC forecasts do not include the effects of the forthcoming **budget Law** (which is expected to cut the deficit by 0.5% of GDP) since its actual amount and composition cannot be envisaged now. The 2018 outcome will also depend on investment fiscal incentives, on their effective duration and additional resources to be put on them.

Italy is tightly led by the world recovery, and is driven by **export** growth. In addition, Made in Italy keeps gaining market shares, as it is now being fully acknowledged. In 2018 export will be +15% above 2008 levels and will reach 32.5% of GDP, thanks to business strategies, aimed at the qualitative upgrading of goods, innovation, marketing and the most dynamic markets, strategies supported by government and associative **internationalization** policies.

Investments are on a good growth path. The new cycle of purchases of instrumental goods began in 2014 and afterwards expanded and intensified thanks to a combination of factors: better demand expectations, low cost of capital, plant saturation, profit margins recovery (thanks to the decrease of imported input costs), the need to introduce innovations, greater competitiveness resulting from euro devaluation, the effects of tax relief, and more recently, the rising trend of the building sector. According to our forecasts, investments ex-construction will reach 9.5% of GDP in 2018, equivalent to its 1999-2007 years average (9.9% is the pre-crisis peak).

Investments strengthen the economic cycle but, above all, increase the growth potential both broadening and technologically updating production capacity. This is especially true when investments are directed by a strategic **industrial policy plan** as last year's one focused on Industry 4.0, which encompasses several digital and cross-cutting enabling technologies across all sectors.

The recovery of the Italian economy is marked by a relevant **job creation**. Since its start in 2014 to the 2Q-2017, the cumulated GDP growth has been 3.0%, the employment one 3.7% and the working hours growth 4.3%. The number of **employed people** increased as well: +815k; it will be +160k the 2008 peak at the end of 2018. **Real wages** will be below the 2007 levels by 0.9% in 2018 (but above 9.0% in the industrial sector), while per capita GDP will still be lower by 7.2%.

The labor market is certainly not the outsider of the current recovery, as shown. Nevertheless two more data must be taken into account.

The number of unemployed (partially or totally) is still 7.7 million, thus undermining the **perception** of the improvements and fostering the need to focus on labor market. Low **youth employment** is the Achill heel of the Italian economic and social system. There is a 10 to 17 p.p. gap (depending on the age range) with the Euro area employment rate average, thus fueling increasing **migration** flows and a consequent loss of human capital equivalent to a p.p. of GDP per year, according to CSC estimates, thus lowering growth potential. This is a crucial emergency.

The increased performance of the Italian economy is urging to reach even **better results** so as to make up quickly for what has been lost in terms of production, income and jobs, and narrow the gap with other European countries, both in the dynamics and levels.

The growth **gap** with the rest of the Euro area has dropped significantly compared to two years ago (from 1.5% to 0.8%) but still remains negative and broadens the gap in absolute values, as it had been the case before the crisis. Compared to 2000, Euro area GDP (net of Italy) rose by 24.4%, while Italy's one by 0.8%. Similar differences also emerge from comparisons with 2007 and 2013, the last year of the recession.

The tenth anniversary of the world crisis passed last August but there is not yet full recovery as proved by the unusual loose monetary policies. Nowadays momentum, rather than remove some structural restraint to the **Italian growth**, is due to the cyclical positive phase of the European economy (while, for instance, Spain stands out in front of the group). This does not encourage investors' confidence in the country.

The **manufacturing** sector is the driving force, thanks both to the composition of demand growth (led by tradable goods and investments) and to its pivotal role in economic development.

Bank credit is no longer a drag on growth, as it has been until last year, but also not a supporting factor. Nevertheless business loans are slowly increasing in some sectors.

Risks are still on the way, and are eventually **challenges** for economic policies.

The first risk depends on the exit from the emergency measures of **monetary policy**. Such measures have been very successful in takling deflation and have contributed fundamentally to support demand and employment. In the Eurozone they have been essential against its own dissolution.

Well aware of the good performance, central bankers are now about to settle the tuning of policy instrument without creating turmoil in the financial markets. For instance, several stock prices are at record levels due to the massive liquidity and interest rates, which historically have never been so low.

The same applies to bonds, starting with government ones, whose **net purchases** by major central banks will fall from the actual $ 100 billion monthly to below zero by the end of 2018.

The Fed has already stated clearly how it will proceed and the ECB will announce it shortly. **Inflation** remains persistently low because of both cyclical factors (due to slack in labour market) and structural ones (such as global competition and the acceleration of technological revolution). But this does not seem likely to change the central bankers' decision.

The stability of the US and Eurozone recovery makes the economy able to sustain the decrease of monetary support. On the contrary, unavoidable tensions and price adjustments of many assets will emerge. The challenge is to avoid **sudden downturns** that undermine the confidence of households and companies.

The second risk lies in a self-satisfied attitude because of good economic performance that might relax the government **reformist action**. Inside each country and at the European Union level and, above all, the Monetary union.

Nationalisms and **populisms** have not exhausted their boost, even if defeated in the latest electoral consultations. They will come back if impoverishment and social exclusion are not properly dealt with.

Italy has to increase the **potential growth** of its economy, which has been further diminished by the deep and long recession. The political parties are called upon to propose sustainable solutions to that issue, in view of the national elections, which outcome looks particularly uncertain and might affect the economic development.

The third risk is that of bringing back simultaneous restrictive fiscal **policies** in Europe. After the big tightening phase (2011-2014), since last year they have become somewhat expansive, helping the

recovery. The policies that will be launched in the coming weeks, aimed at curbing deficit, will eventually turn out as restrictive.

Consolidation of public finances is inevitable, especially in positive economic phases, and for the high-debt countries such as Italy. Taking into account the negative output gap, this consolidation must go along with a combination of policies that foster growth, supporting public and private investments and promoting innovation and social inclusion.

In order to increase investors' confidence (and expecting ECB tapering of QE) it is crucial that Italy focuses on a permanent and convincing reduction of **public debt**, which will diminish in 2018 as a ratio to GDP, albeit more gradually than the unrealistic and counterproductive prescription of the Stability and Growth Pact.

In the United States the risk is also associated with fiscal policy: the **Trump Administration** could not deliver the promised expansive measures.

Other risks may significantly change the international framework in the next two years: a further weakening of the dollar, a new fall of oil prices and a marked slowdown in China.

The devaluation of the **US currency** may be triggered by the loss of confidence in American outlook (according to the measures that the Trump Administration will be able to put in place) and the consolidation of European fundamentals. A particularly large and intense depreciation would hinder the growth of the Euro area. The effects can vary widely depending on the cause and type of currency movement, whether it is a weakening of the dollar or a strengthening of the euro. In the first case, the lost competitiveness is lower since the single currency remains stable compared to other currencies, in the second case it appreciates against all of them. CSC estimates that a dollar weakening by 5% (bilateral exchange rate with euro to 1.24) reduces Italian GDP by 0.1% in two years; a strengthening of the euro of the same amount would lower it by 0.4%.

Historically, the devaluation of the dollar has been correlated with a rise in the **commodity dollar price**. **Oil** has fluctuated for some months without direction. The supply is now expected to remain above demand in 2H-17 and even more in 2018, but it is unlikely that will cause a price collapse.

China has so far targeted growth instead of financial sustainability, and debt has continued to swell. It will unlikely change its order of priorities.

1 FORECASTS

Summary

- **GDP and domestic demand** - CSC revises Italian **GDP growth** up to 1.5% in 2017 and 1.3% in 2018 (from +1.3% and +1.1%). **Household consumption** is expected to increase by 1.3% in 2017 and 1.2% in 2018, **investment** by 2.3% and 3.1%. Purchases of machinery and transport equipment continue to grow at a good pace: 3.1% in 2017 and 4.1% in 2018. Construction recovery is forecast gaining traction: +1.5% in 2017 and +2.0% in 2018.
- **Foreign trade - Exports** accelerate (+4.9% in 2017 and +3.8% in 2018), gaining market share. They are supported by the strengthening of global demand; while the euro appreciation will act as a dampening factor, especially in 2018. **Imports** continues to rise rapidly (+5.8% and +4.1%), fueled by export performance itself, which incorporates goods and services purchased abroad, along the global value chains, and by the increase in domestic demand. Compared to the pre-crisis levels of 2007, in 2018 imports will be 6.4% higher and exports 15.0%. Trade and current account **surpluses** are falling from the 20-year record levels reached in 2016 (mainly due to the fall of terms of trade) but remain high (3.3% and 2.3% of GDP in 2018), therefore foreign debt continues to decline (it has almost halved).
- **Credit** – **Corporate loans** are no longer a strong drag to the recovery, but they do not support it either. Some crisis situations have been resolved, reducing uncertainty. Various factors support new corporate loans, but others act in the opposite direction. Supply is less tight, interest rates are at the minimum and demand of credit is at pre-crisis values. **Loans to household** are growing (+0.3% per month), with looser supply conditions and an increasing demand.
- **Employment, Wages and ULC** - **Employment** will grow by 1.1% in 2017 and 1.0% in 2018 (+500k additional FTEs) after a rise of 1.4% in 2016. The increase in working hours will slow job creation, especially in the industrial sector. At the end of 2018 employed people will exceed pre-crisis level by 160k, while FTEs will still be at 780k below (from a 2 million drop at the minimum), following a widespread job reallocation across sectors (towards services). The unemployment rate will drop to 10.4%. Effective **wage dynamics** exceeds the one of negotiated wages. Given rising inflation, real wages per FTE will fall back by 0.6% in 2017-2018, after having risen by 0.8% in 2016. The **ULC** will increase in both 2017 and 2018.
- **Prices and margins** - **Inflation** is expected to remain stable around current levels (+1.4% in 2017, +1.2% in 2018 CPI index). It accelerates to 1.2% net of food and energy, from 0.5% in 2016. Profit margins fall back again due to rise in raw materials prices and ULC, but keeping good levels.
- **Fiscal policy** – Deficit will improve this year: 2.1% of GDP, and 2.3% in 2018 (from 2.4% in 2016), gross of the budget Law and safeguard clauses. The **debt-to-GDP ratio** will begin to decline, from 132.6% in 2017 (as in 2016) to 131.8% in 2018. CSC forecast does not incorporate the measures that will be part of the next budget Law, which are expected to have a net positive impact on the deficit by 0.5 GDP points, and to reduce the growth rate by 0.2%. That is a further good reason to focus on measures that support and increase potential growth.

- **World trade** – Robust **global trade** momentum continues. CSC forecasts are revised up: +4.1% in 2017 and +3.5% in 2018, with both upward and downward risks. The dynamics is positive in mid-2017 and prospects are good for the second half of the year. High current account **disequilibria** are still there: those of the emerging countries are diminishing but they are still wide among the advanced ones (especially with regard to the German surplus).
- **Eurozone** – CSC revises GDP forecasts up for 2017 (+2.2%) and 2018 (+1.8%), due to the solid growth in the first half of the year, driven by household spending and investment. Germany leads the EU members states.
- **United States** - Domestic demand is the main driver of current solid growth. CSC keeps growth forecast unchanged in 2017 (+2.2%), while revises it down for 2018 (2.4%) due to fiscal policy uncertainty.
- **Japan** - GDP growth accelerated in the first half of the year, but the medium to long-term trend remains weak; industrial production keeps expanding thanks to exports to Asia.
- **United Kingdom** - CSC keeps GDP forecasts unchanged: +1.6% in 2017 and +1.5% in 2018. Household consumption and investment begin to be affected by Brexit consequences.
- **Emerging economies** - CSC revises upwards GDP growth forecasts for the emerging countries in 2017 (+4.7%) and leaves it unchanged in 2018 (+4.8%). **China** continues going on the soft landing trajectory (+6.6% and + 6.2%), thanks to the further acceleration in global trade. CSC revises down estimates for **India** (+7.3% and +7.4%) due to the delayed effects of demonetization. **Brazil** grows beyond expectations (+0.5% and +1.9%) having overcome political uncertainty. **Russia** economic outlook is further improved (+1.8% and +2.0%).
- **Raw material prices** - **Oil** remains stable at 52 dollars in both 2017 and 2018 (from 45 in 2016), below the OPEC target and vulnerable to downside risks. The US extraction continues increasing and it is close to reach its record levels, while several OPEC countries do not comply with the agreed freezing of production. Which is, anyway, insufficient to sustain a lasting price increase. Prices of other **raw materials** remain volatile and divergent, with unstable balance between demand and supply; limited prices increase is expected in the two-year horizon.
- **Monetary policy** - **ECB** rates remain stable at present minimum for the whole 2018 and the QE is expected to be extended, at least, for much of the next year, at a lower monthly rate. Banks' deposits with the ECB continue to rise, a symptom of the fragmented interbank market. The **FED** goes on raising rates (1.00-1.25% in September): CSC expects one hike in December and other two by the end of 2018. FED is going to begin reducing the huge stock of securities by October 2017 (4.251 billions of dollars).
- **Rates, Stocks and exchange rates**- Long-term interest rates fluctuates under the level reached at the beginning of 2017 (ten-year Treasury yield at 2.1%), Stock markets are at record levels (S&P 500 +9.5% from the beginning of the year). The **euro** exchange rate has climbed to 1.18 against the dollar, last month on average, also due to the stronger-than-expected European recovery and the high US political uncertainty.