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ITALIAN ECONOMIC OUTLOOK 2018-2019 AND A PROPOSAL TO REFORM THE EUROZONE ECONOMIC GOVERNANCE

Summary and main conclusions

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Full Report in Italian https://goo.gl/xwTe7B

Italy is growing, but too slowly. For 2018-2019, the Confindustria Research Department (CSC) forecasts an anticipated and more pronounced **slowdown of the Italian economy,** compared with December 2017 estimates**.** The GDP expected growth rate is at 1.3 percent in real terms this year (from 1.5 per cent in 2017) and will further decelerate to 1.1 percent in 2019 (Table 1).

Table 1

CSC forecasts for Italy
(% change and diff. wrt CSC December 2017 forecasts)

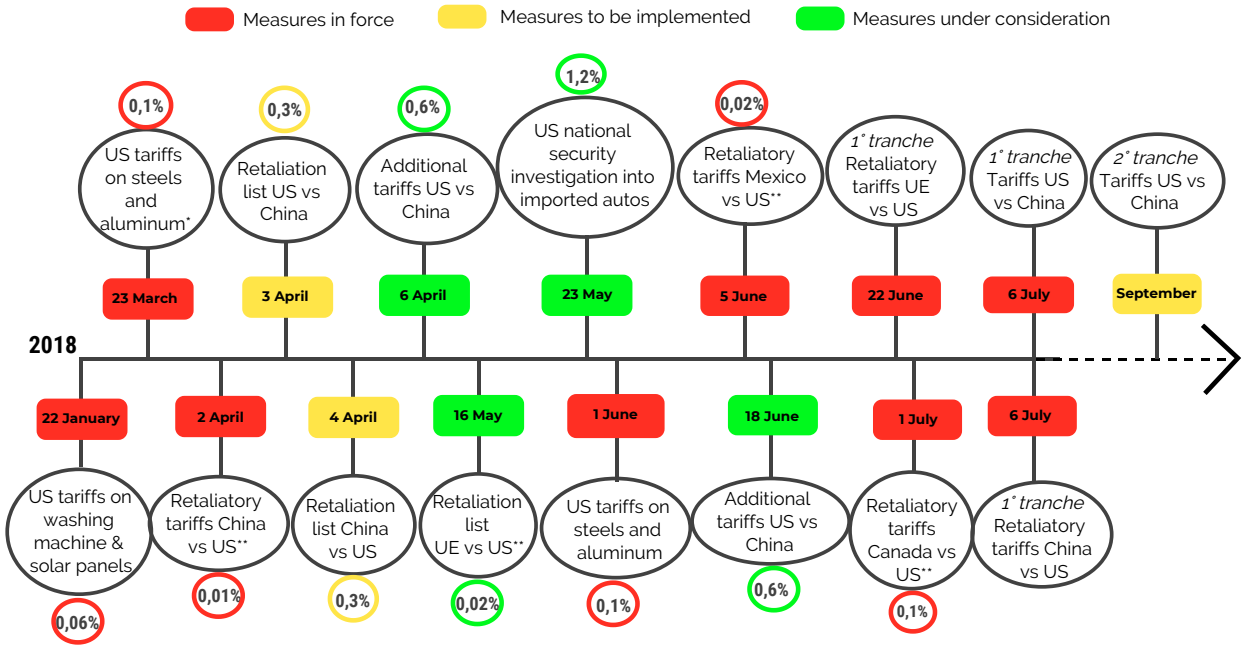
	2017		2018		2019	
Gross domestic product	1,5	*(0,0)*	1,3	*(-0,2)*	1,1	*(-0,1)*
Exports of goods and services	5,4	*(0,2)*	2,7	*(-1,5)*	3,9	*(0,2)*
Unemployment rate[1]	11,2	*(-0,1)*	10,9	*(0,0)*	10,6	*(0,1)*
Consumer prices	1,2	*(0,0)*	1,0	*(0,0)*	1,3	*(0,0)*
Government net lending[2]	2,3	*(0,2)*	1,9	*(0,2)*	1,4	*(-0,5)*
Government Debt[2]	131,8	*(0,2)*	131,6	*(1,1)*	130,7	*(1,1)*

[1] Percentage values; [2] as a percentage of GDP.
The December 2017 outlook assumed the cancellation of the safeguard clause in deficit.
Source: CSC estimates.

This scenario shows a less dynamic trend compared with the official figures included in the Stability Programme (SP) issued by the previous Government last April.

Figure 1

Escalation of trade war in 2018
(% of goods trade hit by tariffs)



* Argentina, Australia, Brazil and South Korea exempt. Canada, Mexico and EU no longer exempt from the 1st of June.
** Retaliation to steels and aluminum tariffs.

This trend is affected by the deceleration of foreign demand and by the end of the positive domestic investment cycle, both connected to the domestic and international climate of uncertainty (Figure 1). In both cases, a physiological adjustment relative to the strong dynamics registered in recent years must also be taken into account.

- **Export**. **Global growth** remains strong in the two-year forecast period, despite world exports have slowed down in the first months of 2018. We are not at the end of the cycle of a global expansion. World trade and GDP are now in the so-called *new normal*: the former is growing less than the high pre-crisis average, while the latter fluctuates around long-term values.

However, there are **downside risks** in the dynamics of global trade, due to i) a possible protectionist *escalation* between the US and its main partners (China, but also Europe); ii) an exacerbation of geopolitical tensions that would fuel the climate of uncertainty; and (iii) a deterioration of the financial turmoil in emerging markets, in the wake of the Federal Reserve interest rates hikes.

The CSC outlook strongly revises downward the 2018 estimates about **Italian exports** of goods and services (which account for about 32 percent of GDP), after the marked increase in 2017. Exports will grow less than world demand in 2018-2019, for the first time since 2013. Therefore, Italy will lose market shares again.

Italian exports decreased in 1Q 2018 (Figure 2). Especially weak were those to some extra-euro area countries, due mainly to the strengthening of the euro in 2017 and in the first months of 2018. Furthermore, foreign trade of all European countries has weakened, and this slowdown will particularly penalize Italian exports throughout the two-year forecast period, due to the specialization in intermediate and capital goods that react more quickly to cyclical fluctuations. However, the behavior of exports should be evaluated on a longer period, given the normal volatility of trade and taking into account the strong expansion in 2017.

Figure 2

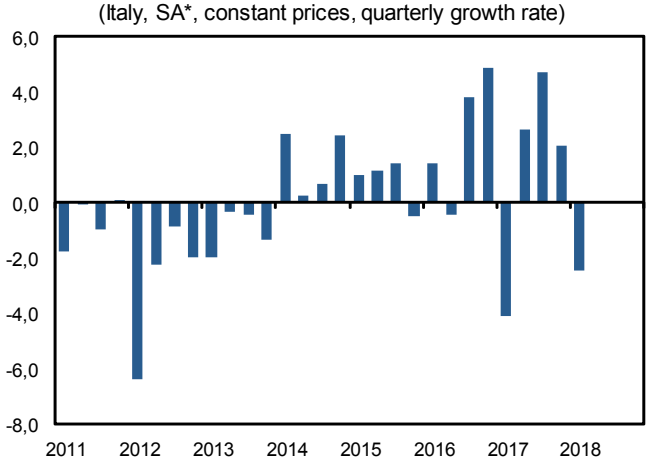
Italian exports and export new orders
(SA*, constant prices, quarterly growth rate; 50=no change)

2Q 2018: April-May. *Seasonally adjusted.
Source: CSC calculations on ISTAT and Markit data.

- **Private investment**. Regarding investment (about 16 percent of GDP), the expansionary phase is going to end. Investment is being held back due to overcapacity and to the end of targeted tax incentives in 2019. In the first quarter of 2018 there has been a sharp contraction, mainly due to the domestic uncertainty during the electoral period, and the international uncertainty fueled by the trade policies of the Trump administration (Figure 3). The contraction at the beginning of 2018 has led to a significant downward revision of the annual growth rate, compared to December estimates.

Figure 3

Investment in machinery and transport equipment
(Italy, SA*, constant prices, quarterly growth rate)



* Seasonally adjusted.
Source: CSC calculations on ISTAT data.

The CSC forecast assumes that the decline is temporary and foresees an immediate restart of purchases of capital goods, albeit at a slower pace than last year: the high growth of 2017 is difficult to continue also this year and next year.

Mark-up of industrial companies in the first few months of 2018 remained stable on the values reached in 2016, beyond pre-crisis levels. Thus, the possibilities of self-financing are kept high. Bank **credit** is growing at a slow pace, providing scarce support for business investment. Investment costs, however, will remain at its lowest for more than a year.

In fact, the ECB has just clarified the sequence of monetary normalization, according to the timing expected by CSC. Net purchases of public and private securities should finish at the end of 2018, official rates should start to rise from zero towards the end of 2019, after almost four years. Frankfurt still has some margins of flexibility, depending on the data that will be released in the next few months.

- **Household consumption**. Also the dynamics of household consumption is expected to slow down in the two-year forecast period, as already anticipated in the CSC December outlook; in particular, the weak trend of the disposable income will have an impact next year. The downward revision of the dynamics of consumption in both years, however, is marginal: since consumption accounts for the largest part of GDP (60 percent), the implied effect of this revision on the overall growth is small.

  Household income is boosted, but less than in the past, by employment growth. **Employment** (calculated on full-time equivalents) is growing less than GDP, at a rate below +1.0 percent in 2017, and it will grow even more slowly in the current and next year. The number of employed people is increasing especially in services, while in the industrial sector working hours are lengthening too. In 2017 and in the first five months of 2018 permanent jobs have stopped growing, while temporary jobs have registered a further surge, driving the rise in employment. Yet, there are too many other explanatory factors at play, and we should not worry, at least for now, that a structural increase of precarious work is taking place.

  Wage growth will strengthen in 2018-2019 compared to the very low rates registered in 2016-2017, pushed at first by the recent contract renewals in the public employment sector. This acceleration should also be transmitted to the private sector next year, following the rise in inflation, which, however, will remain far from the ECB's target. Real wages will decrease in the two-year period 2018-2019, as in 2017, partly eroding the gains of previous years, which were particularly large in the private sector.

  As a result of these expected employment and wage trends, **disposable income** in real terms is growing at a good pace this year, but it will slow down markedly in the next one. Therefore, the slow expansion of consumption in 2019 is also fragile, linked to a probable new reduction of the savings rate, which was already largely eroded during the crisis. An important support for household consumption is bank credit, which expands significantly and at very low costs.

- **Public investment and public consumption.** Fluctuations of public investment and consumption (equal to 21 percent of GDP) could hinder GDP growth. This year, public investment will continue to fall in nominal terms (-12.5 percent), raising again but at a slow pace in 2019. Public consumption will rise to 17.8 percent of GDP (from 17.7 percent) in 2018, driven by contract renewals and payment of arrears, and will go down to 17.4 percent next year.

Public finance slowly improving The less favorable GDP dynamics can have an impact on budget balance. Much will depend on whether and how the safeguard clause will be cancelled and on the actual economic policies taken by the Government as opposed to those announced in the so-called "Government contract", the agreement signed by the parties representing the current parliamentary majority. The view on the SP provided last June 19th by the current majority includes the willingness of deleting the clause, implementing some expansionary measures and complying with the Stability and Growth Pact fiscal rules. It is not clear how these things can be reconciled.

On this matter, Italy will be judged by the financial operators who buy the debt, both the sovereign and the one of large private companies. Looking at markets reactions in the weeks ahead of Government formation, it is clear that Italy is seen as an element of potential global instability. The attention of the operators is high, above all due to the repercussions that an increase in the financing costs would have on other Eurozone countries (mainly Portugal, Spain and Greece), and therefore on the long-term strength of the currency area as well.

The spread between the Italian and the German 10-year sovereign bond yields decreased in mid-June below 220 basis points (bps), from a peak of 283 at the end of May. It remains, however, about 100 basis points higher than the average values registered in the first 4 months of 2018. The widening of the Italian spread in May has led upwards also the yields in the so-called "peripheral" European countries. In June these spreads have diminished again, in parallel with the performance of the Italian one. Compared to the first 4 months, Spain has almost realigned (+5 bps), while a widening still remains in Portugal (+24) and in Greece (+45).

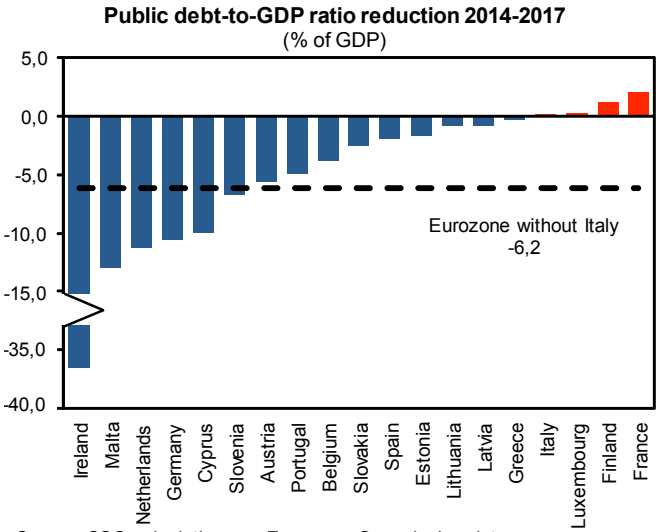
As for the sovereign bonds yields, CSC forecasts that in 2018-2019 there will be a small rise due to the end of the Quantitative Easing but that the market turmoil of the weeks before the formation of the new Government will subside and will not affect in an abnormal way the cost of financing. Interest payments on sovereign debt will continue to decline, as a result of the replacement of old stocks that paid high returns with new bonds issued at lower rates.

This normalization derives from our outlook, which assumes the **VAT safeguard clause cancellation (12.5 bn euros for 2019)** balanced out by an increase of direct taxes. Therefore, our scenario does not envisage deficit financing, as it has been widely done in the past. Since 2012, a little less than 40 percent of the cancelled increases in VAT rates was covered through negotiation of budget flexibility with European Insitutions. This approach was particularly abused in the last three years (three quarters of the non-increases in VAT has been offset through deficit).

Under these assumptions, the **public deficit** remains on a slow descent path, from 2.3 per cent of GDP in 2017 to 1.9 percent this year and to 1.4 percent in the next one.

The **public debt / GDP ratio** will slightly decrease, at 131.6 percent in 2018 (from 131.8 percent in 2017) and at 130.7 percent in 2019. This is still a very high level, resulting from a partial consolidation of public balance in the last three years of economic recovery. Between 2014 and 2017 Italy was one of the very few European countries that did not reduce public debt to GDP ratio (Figure 4). Now, Italy risks of having to deal with the global and domestic economic slowdown, without having fully secured public finances.

Figure 4



Source: CSC calculations on European Commission data.

In defining the economic policies in view of the Budget Law, it should be emphasized that the room for maneuvers granted by the EU fiscal rules seems very limited for Italy. On the contrary, this year the compliance with the Stability and Growth Pact (looking at the numbers presented in the Budget Law) is doubtful and corrective actions during the year will be likely needed.

In view of the Budget Law, if Italy had to fully respect the path towards budgetary balance, a structural correction of 0.2 points of GDP (around 3.5 billion euros) would be needed in 2018, which would reduce the deficit by 1.4 percent of GDP. In fact, according to the rules, the correction should have been of 0.6 GDP points and the European Commission at the end of 2017 agreed to reduce it to 0.3 points; but in the SP of last April the reduction of the structural balance is estimated at only 0.1 points of GDP. In CSC forecast scenario, which is worse than that of the SP, the required correction would rise to 0.5 points of GDP, approximately equal to 9 billion euros.

In 2019, the correction should amount to 0.6 points of GDP (almost 11 billion). Assuming the increase of indirect taxation foreseen by the safeguard clause, the rule on the structural balance would be fully respected. But it would not be possible to take advantage of additional budget flexibility to finance in deficit the even partial sterilization of the clause, nor to implement expansionary measures.

In our outlook we introduce, as a mere example, some alternative hypotheses with regards to the VAT safeguard clause. The CSC has estimated the effects on GDP and budget balance of various hedging hypotheses, highlighting that deficit financing would have an impact on both in the medium term. On the contrary, an increase in the VAT used to finance additional public investment would enhance growth, eventually succeeding, in the medium run, in accelerating debt reduction in relation to GDP.

It should also be said that the CSC scenario does not entail the several policy measures that are currently debated, and are still subject to a high degree of uncertainty. The

Government Contract indicates some priorities: tax reform, with the reduction of the number of tax rates (flat tax); reform of income supporting tools for the less wealthy ("citizenship income"); the overcoming of the latest pension reform.

These measures, potentially, can have a high impact on macroeconomic variables and on confidence. The success of these expansionary policies is linked to the hypothesis of high fiscal multipliers and to the preservation of a positive climate of confidence towards the country by domestic and international investors. The outcome will also depend on the way and on the timeline with which the measures will be implemented. In particular, those measures must be linked together in order to avoid unwanted effects and must be gradually introduced, to test their effects on the economy and to avoid a negative impact on public accounts.

More Europe, but not "this" Europe In such a scenario of still too slow economic growth, it is even more evident how the chessboard on which the game of Italian development is played cannot be just the domestic one but it must necessarily be the European one too. Europe represents an opportunity for all member countries, including Italy, to solve the unresolved problems of low growth, to improve the stabilization capacity, and to better manage future economic and financial crisis.

Being fully aware that only a strengthening of the Eurozone, and not its exit, can generate further wealth, CSC suggests to focus on three specific areas where European integration can be beneficial for all countries: boosting growth, stabilization of the business cycle, management of the financial crises of the member countries. The analysis included in the second chapter of the present report aims to be a contribution of ideas for the creation of an Italian proposal for the economic reform of the governance of the Eurozone.

The proposed measures are ambitious but achievable. Put together, they outline a well-balanced “carrot and stick" model of greater European integration that goes beyond the German vision, now mainstream in the actual debate and causing the current deadlock, which, prior to agreeing to a further risk sharing, asks for a reduction in risk, through greater austerity by the most "unruly" countries.

The joint declaration of intents by the French President Emmanuel Macron and the German Chancellor Angela Merkel of 19th June contains some steps forward (Eurozone budget balance able to invest in innovation and human capital, backstop for banking resolutions), but leaves several problematic issues unchanged (risk reduction in banking, governance and accountability of the ESM) or delays the analyses (amplitude of the new budget, stabilization of the business cycle, common insurance of bank deposits).

On this basis CSC suggests possible venues to build an Italian proposal, which is currently missing. Confindustria suggests moving along four main lines:

1) First, the work in progress must be finished, **starting from the completion of the banking union and capital union**, crucial for having a fully integrated internal market. In particular, the problem of banks' exposure to domestic sovereign bonds should be solved, since it is blocking the progress of the Eurozone reform. This must not be dealt with by imposing counter-productive limits to the holding of securities, but by pursuing

a greater diversification of portfolios. Such result can be obtained by issuing new synthetic European bonds based on domestic ones that banks could buy.
The completion of the banking and capital union **is also a priority because it would guarantee a substantial increase** in the stabilization capacity through the risk sharing operated by the markets.

On the other hand, even in the United States, where capital markets play the lion's share in absorbing cyclical shocks and where market adjustments are much more fluid (for example through labor mobility), federal tax policy has played a crucial role in the crisis. It is therefore equally important for the euro area to have a “second leg” represented by a mechanism for sharing risks through fiscal policy.

2) It is therefore necessary to create a **European stabilization instrument**, complementary to domestic ones, which can finance or co-finance investments and / or unemployment benefits, against negative economic shocks affecting one or more member countries.

   In order to effectively counteract also symmetrical shocks, the tool must rely on a new Eurozone budget, financed by EU own resources and national contributions, well above the hypotheses that have emerged so far in the debate (1 per cent of the GDP of the Area) and that it can be indebted, through the issuance of supranational titles.

3) The new budget of the euro area should also serve to finance a major **European investment plan**. European Union and each member country need it, to fill the gap accumulated during the crisis and to increase growth potential, avoiding a marginalization in comparison to economic giants like the USA and China.

   These investments should be concentrated in **infrastructure, research and development, training**. Europe is already going in the right direction, with the Juncker Plan and Horizon 2020, but it seems not enough. The available data shows that these programs have not been able to finance many additional, innovative and risky projects. A well-designed European investment plan, which also takes advantage of the resources and skills of the European Investment Bank, would achieve multiple goals, such as the strengthening of the single market, increasing economic integration and overcoming the problem of free riding in the financing of European public goods.

Yes to **Eurobonds** for growth and stabilization, but not to the mutualisation of national public debts. In order to be effective, Eurobonds for growth should represent at least 3 percent of the Eurozone GDP.

However, countries' access to funds should be subject to compliance with fiscal rules, to avoid moral hazard. Furthermore, transferring part of the stabilization function and of investment support to a supranational budget would justify, almost automatically, compliance with the rules of the Stability and Growth Pact and a more stringent supranational control on national budgetary policies, which goes beyond the current mechanism of Council Recommendations (Table 2).

4) The rescue function of countries in crisis already exists, but it was designed during the emergency of the sovereign debt crisis. Now there is a window of opportunity to strengthen the European Stability Mechanism (ESM) and transform it into a European Monetary Fund (EMF). The ESM needs to be improved for a number of reasons: now it is an intergovernmental body, not integrated into EU legislation; it has a low democratic accountability towards the European and national parliaments; it takes politicized decisions, entrusted to finance ministers of the individual euro countries; its decision-making sometimes take too long, as it was the case for Cyprus in 2012-2013.

Table 2

Breaches of the European rule on public deficit

	Years in the SGP	Years with deficit/GDP>3%	Excessive deficit procedures
Greece	21	19	2004-17
Portugal	21	19	2005-8; 2009-17
France	21	14	2003-7; 2009-*
Poland	14	9	2004-8; 2009-15
Spain	21	11	2009-*
Hungary	14	7	2004-13
Romania	10	5	2009-13
Italy	21	10	2005-8; 2009-13
Cyprus	14	6	2004-6; 2010-16
Slovenia	14	6	2009-16
Croatia	5	2	2013-17
Lithuania	14	5	2009-13
Slovakia	14	5	2004-8; 2010-14
Germany	21	7	2002-7; 2009-12
Ireland	21	7	2009-16
Latvia	14	4	2009-13
Belgium	21	6	2010-14
Bulgaria	11	3	2010-12
Netherlands	21	5	2002-5; 2010-14
Malta	14	3	2004-7; 2009-12; 2013-15
Czech Republic	14	3	2004-8; 2009-14
Austria	21	3	2009-14
Denmark	21	1	2010-14
Finland	21	1	2010-13
Estonia	14	0	
Luxembourg	21	0	
Sweden	21	0	
Total		**171**	

The order of the countries depends on the ratio between the number of breaches and the number of years in which the country should have respected the Stability and Growth Pact (SGP).
* Ongoing procedures
Fonte: CSC calculations on European Commission data.

But what should the EMF do? And how should it work? First of all, it must be fully integrated in EU legislation. Its functions should be: i) to continue to provide financial aid to member countries and ii) to also provide a backstop for the Single Resolution Fund. The EMF should be a very specialized technical structure. Its decisions should be taken independently from the member countries, voted by majority, motivated and made public. Moreover, the European Council and Parliament should have the power to vote motions of no confidence towards the President or members of the EMF Board.

Such broader functions attributed to the Eurozone require an institutional reform. We could set up a **European Minister of Economy and Finance** to manage the new Eurozone budget, responsible for i) the functioning of the stabilization tools, ii) the plan of supranational investments, iii) the budget financing mechanisms, for example deciding the timing of Eurobond issues and *maturity* structure. The minister would be at the same time responsible for the institution that deals with the rescue of member states.

The new economic minister should be independent from member countries to guarantee the overcoming of the prevailing intergovernmental method, and should be able to enforce the European rules also having strong authority over draft national budgetary plans. To this purpose, an amendment of the Treaties would be necessary. But one can also proceed stepwise, starting from next year, thus establishing the function of the minister as

Commissioner for Economic Affairs and Vice-President of the next European Commission, as of November 2019. In this way, the minister would derive supranational democratic legitimacy, being accountable towards the European Parliament, through the usual nomination procedures. The Eurogroup, an informal body made up by the finance ministers of the member states of the Area, could then elect her/him as its president, and this would make her/him accountable towards national governments.