

ITALIAN ECONOMIC OUTLOOK 2019-2020 AND THE ECONOMIC POLICY SCENARIO

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SUMMARY AND MAIN CONCLUSIONS

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Italy teetering between recovery and recession. The Research Department of Confindustria (Centro Studi Confindustria - CSC) confirms the stagnation of the Italian economy, as already outlined in the spring forecast (Table A). More than previously, much will depend on economic policy choices, and especially on how the Italian Parliament will manage the safeguard clauses that provides for a €23.1 billion increase in VAT and excise duties from January 1st, 2020.

	2018	2019	2020
 Gross domestic product <i>without VAT and excise increases</i>	0.9	0.0	0.0 <i>0.4</i>
 Exports of goods and services	1.8	2.6	2.2
 Unemployment rate ¹	10.6	9.8	9.7
 Consumer prices	1.2	0.7	1.8
 Government net lending ² <i>without VAT and excise increases</i>	2.1	1.8	1.7 <i>2.8</i>
 Government Debt ²	134.8	135.7	135.5

¹ Percentage values; ² as a percentage of GDP.

The CSC scenario, calculated on a "no policy change" basis, assumes that the VAT safeguard clauses will be triggered in 2020.

Source: Research Department of Confindustria estimates.

In a "no policy change" scenario, including the rises in VAT and excise duties and non-deferrable expenditures, GDP will be at a standstill not only in 2019 but also in 2020. Instead, if the increase in indirect taxes were to be cancelled and entirely financed through deficit, GDP would grow by 0.4 per cent in 2020. However, this would raise the deficit-to-GDP ratio close to 3 per cent, with an indirect negative effect on growth. It would only stay below this threshold if savings from lower-than-expected use of the "Quota 100" (early retirement scheme) and *Reddito di cittadinanza* (Rdc, a new minimum income guarantee scheme) were entirely earmarked for structural reduction of the deficit. According to the Government's intentions - set out in the *Nota di aggiornamento al Documento di Economia e Finanza* (NaDEF) released at the beginning of October - despite the stripping out of VAT increases, the deficit will stand at 2.2% of GDP. It will be up to the draft Budget law to specify exactly how it will be covered.

Therefore, the Italian economy is still bordering on zero growth, and it risks falling into recession if any new shocks were to crop up. This is always a possibility, especially on the overseas front, as witnessed by the very high level of uncertainty on financial markets.

Several factors have held back the Italian economy during the course of this year and are likely to continue to weigh negatively on growth.

Firstly, the contribution of **Rdc** to household consumption growth is lower. Far fewer applications than expected have been received, and there could be 200,000 fewer beneficiary households at the end of this year.

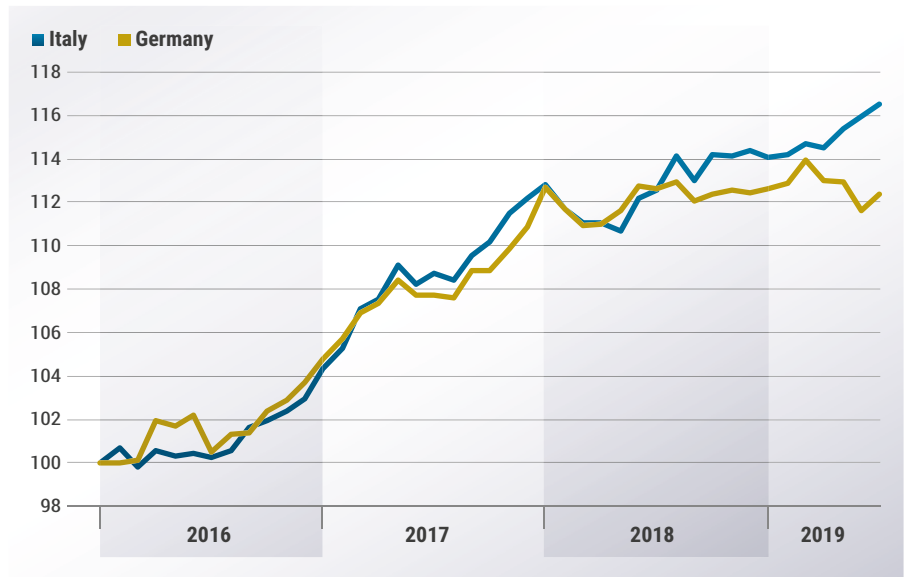
Secondly, the **slowdown in Germany** is deeper and longer lasting than expected. Germany's difficulties, especially in the automotive sector, have had significant repercussions on Italy's industrial output due to the strong links between manufacturers in the two countries. This has also affected Italian

Table A
CSC forecasts for Italy

(% changes)

Chart A Italian exports better than German ones

(Goods, monthly data, three-term moving averages, index Jan. 2016=100)



Source: Research Department of Confindustria calculations on Eurostat data.

exports, although they have performed better than German ones in the last year (Chart A), due to a series of sectoral and geographical factors that are analysed below.

Thirdly, confidence in Italy is at very low levels, driving households to increase their precautionary saving and firms to limit their investments. The decline has been more marked among manufacturing companies than households. Restoring confidence is a crucial factor in creating favourable growth conditions.

Fourthly, the impact of a **VAT increase** of the magnitude currently provided for by legislation would be significant. Indeed, it would generate negative effects on household spending and private investment as, based on the realistic assumption that the increase would be partially passed through final prices, it would lead to an erosion of both disposable income and corporate margins.

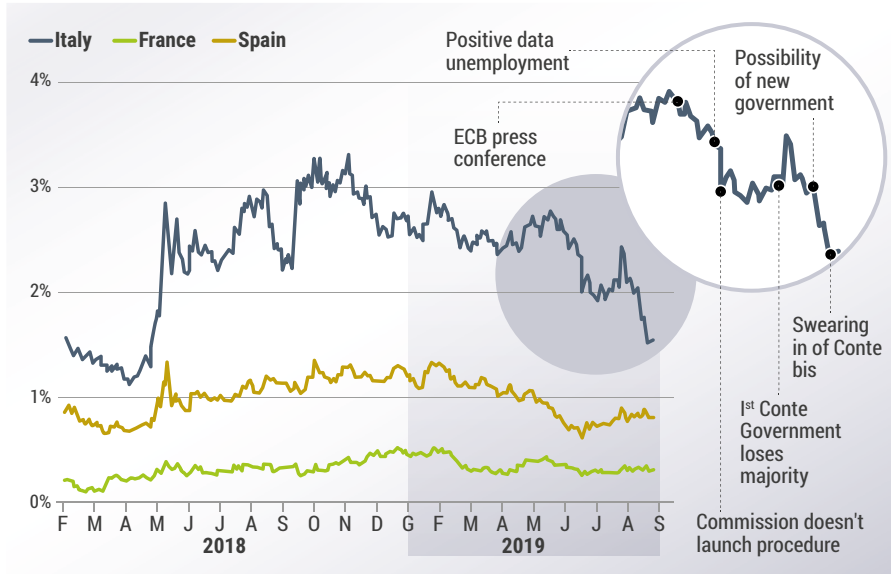
However, two positive aspects come into play.

Firstly, the perception of a different approach to Europe and a consequent drop in sovereign debt interest rates. The sharp fall in government bond **yields** that began in June favours economic activity, because it facilitates access to credit, as well as curbing the government interest expenditure. Without this favourable factor, the CSC scenario would have displayed a minor recession in 2020.

Since June, the abrupt **monetary policy** turnaround decided by the European Central Bank (ECB), given the increased downside risks to the economy, has contributed to the fall in Italian interest rates. A similar scenario in the United States led to a similar monetary U-turn. Therefore, in the two-year forecast period, there will be no monetary normalisation, which was still being discussed in the spring. Instead, monetary stimulus to the economy will increase, with the Federal Reserve cutting interest rates and the ECB once again starting to purchase public and private securities.

This trend has been accompanied by an improvement in investors' assessment of Italy, which has been helped by the formation of a more pro-European government. Between August 9th and September 4th, Italian interest rates fell by 100 basis points, while, for example, Spanish and French interest rates fell by 10 basis points only (Chart B).

Chart B
Sovereign spread with respect to Germany, 10-year bonds



Source: Research Department of Confindustria calculations on Thomson Reuters data.

Secondly, the ability of companies located in Italy to quickly adapt to changing international scenarios, continues to sustain export growth at a faster pace than global demand. The performance of **world trade** fell significantly short of projections made in previous months, due to increased protectionist tensions (especially between the USA and China) and geo-economic uncertainty, which is currently at record levels, with epicenters in several countries (the United Kingdom, Iran, Venezuela, Libya and Argentina). Against this backdrop, Italian exports continue to be a positive factor, thanks to the support of various elements:

- geographical specialisation - Italy has a relatively small presence in non-EU markets where the slowdown has been more marked;
- strategies of multinationals - they have generated new export flows, especially from some Italian regions;
- international policies - opportunities created by US duties to replace Chinese products that were previously exported to the United States; anticipation of sales to the UK in the expectation that Brexit will take place on October 31st; trade agreements with important countries such as Japan.

In particular, according to CSC estimates higher US tariffs on Chinese products have enabled an increase of Italian exports of the affected products to the US market by around 7 percentage points in the three quarters following the introduction of duties.

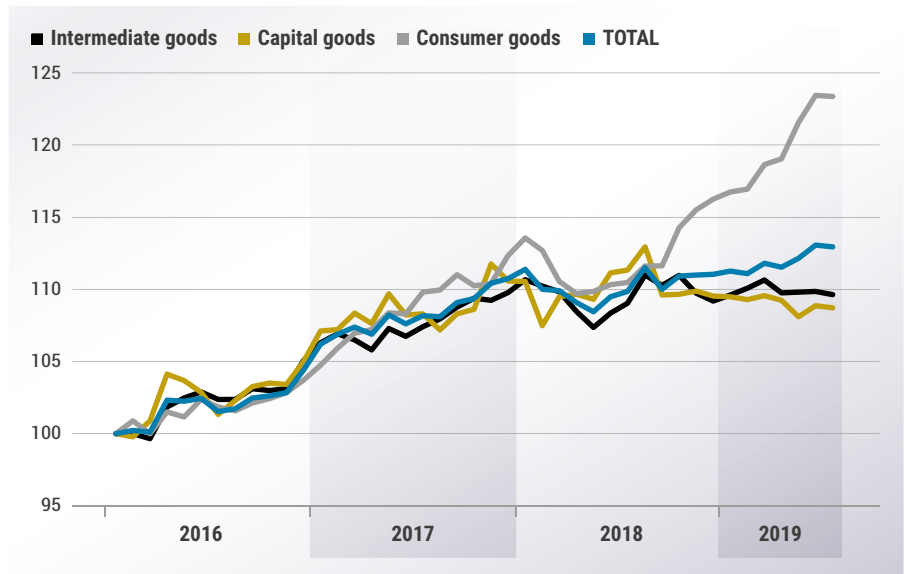
Exports of intermediate and investment goods have registered a poor performance this year, as these goods are more integrated into global value chains. Italian export growth has been solely driven by consumer goods (Chart C): pharmaceuticals, wearing apparel and leather products, and food and beverages have all performed very well.

In Italy, even more so today, the weak component of the economy is the domestic demand.

- Private consumption.** Households' consumption has been sluggish for more than a year. Several factors, most of them negative, have affected and will affect the consumption trend this year and next year, with the net effect of bringing it down to just below zero in 2020, according to the CSC scenario.

Chart C Consumer goods are driving export growth

(Italy, monthly data at constant prices, seasonal adjusted, index January 2016 = 100, three-term moving averages)



Source: Research Department of Confindustria calculations on ISTAT data.

On a positive note, there were resources from Rdc - albeit with more limited and delayed effects than initially expected, penalising consumption growth in the second half of 2019 and therefore, statistically, the average change in 2020. Also, the rise in employment this year has helped to bolster disposable income, albeit with an overall effect that was undermined by the reduction in working times, and it is doomed to disappear next year if economic growth remains anaemic.

On the negative side there are: the increase in the propensity to save, which the CSC has been highlighting for some time, that is linked to a growing precautionary attitude; the erosion of disposable income in 2020, due to a reduction in interest income and income deriving from the distribution of corporate profits; and the previously mentioned increase in VAT rates and excise duties (incorporated in the baseline scenario), which would erode the purchasing power of households.

- **Private investment.** The growth rate of private fixed gross capital formation is forecast to slow down gradually in 2019 and 2020. Several factors will tend to hold back entrepreneurs' spending decisions in the two-year forecast period, while other factors will have a positive impact.

Unfavourable factors include: the increase in indirect taxes which, given the assumption of a partial pass-through on final prices, reduces companies' profits and liquidity; and a partly natural downward readjustment in capital expenditure, after the incentives of previous years.

In addition, the decline in companies' domestic and overseas demand expectations, which is the main "determining" factor for investment, has slowed down 2019 dynamics. In 2020, on the other hand, the purported technical rebound in overseas demand is expected to have a slight favourable impact on investment.

Credit availability for firms, an important prerequisite for triggering investment, will pan out in a similar way: posing an obstacle in 2019, it is expected to recover in 2020. Indeed, two of the elements that have weighed on credit supply this year are improving: sovereign yields and banks' non-performing loans.

- **Public investment.** The contribution of the public sector is expected to be low over the two-year forecast period. The amendments contained in the 2019 Budget Law regarding local finance and the measures provided for in the *DL Crescita* (Growth Decree) and the *DL Sblocca cantieri* (Public Procurement Decree) could have a positive effect on public investment, but there is no evidence of this yet.

Public finances Even though the Italian economy has been at a standstill for more than a year, public finances have not been negatively affected. Some factors have influenced this year's outcome, which will be much better than the projections set out in the NaDEF published few days ago (deficit-to-GDP ratio of 2.2 per cent). This will keep the deficit at unchanged policies, even without a VAT increase, below the 3 per cent of GDP threshold in 2020.

This improvement is due to:

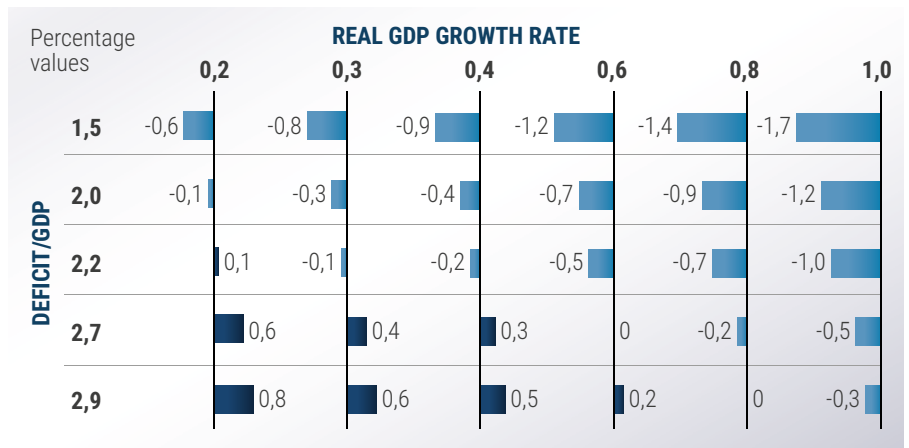
- the positive trend in tax revenues, supported by the increase in the number of persons employed and the positive effects of the extension of electronic invoicing, which generate a reduction in tax evasion estimated at just under €5 billion at the end of the year;
- an increase in other non-tax revenues (dividends distributed by the Bank of Italy and *Cassa Depositi e Prestiti*, €3.1 billion higher than what the Government has forecast in the DEF of April);
- lower interest expenditures which, compared to a situation in which rates would have remained at the levels of the first half of 2019, will lead to estimated savings of €3 billion this year and a further €3.8 billion in 2020;
- savings on the *Quota 100* and *Reddito di cittadinanza* schemes - reaching €2.6 billion in 2019 and €3.4 billion in 2020 - which are linked to the lower use of these instruments compared to expectations at the time they were introduced.

The Government is assuming a less favourable scenario for 2019, and a more favourable scenario than the one forecast for 2020 by the CSC. Such a profile would enable achievement of a marginal structural improvement in public finances between 2019 and 2020 but this depends on the actual economic growth on the feasibility of expenditure cuts and revenue increases.

Economic policy scenarios for the autumn A number of factors need to be taken into account when drawing up the 2020 Budget Law:

1. A particularly weak economic performance at both national and international level. On the one hand, this requires appropriate measures to boost economic growth, which is crucial to maintain social cohesion and ensure the sustainability of public finances, and, on the other hand, it considerably limits the possibility of substantial budget restrictions. In particular, Italy needs to put public debt on a downward path, albeit gradually. Given the estimates that can currently be made regarding the real growth rate of the economy and the GDP deflator, it is unlikely that a deficit-to-GDP ratio of more than 2.2% would allow the debt-to-GDP ratio to be reduced. However, an increase in the latter ratio would once again put Italy back in the global limelight and risk thwarting the fall in interest rates that occurred in the second half of the year (Table B).
2. The tricky management of the increases in VAT rates and excise duties provided for by the safeguard clause, which the previous Government raised with the 2019 Budget Law. Indeed, given the magnitude of the expected increases, both the full activation and the full deficit financing would have negative effects.

Table B
Variation in government debt-to-GDP ratio: 2020 vs 2019
(As a percentage of GDP)

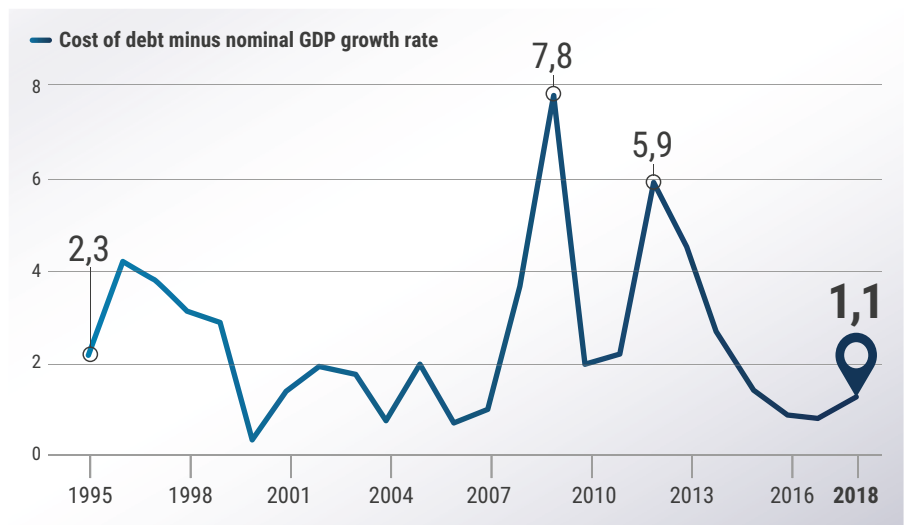


* NaDEF data. GDP deflator: 1.3%. Debt/GDP ratio 2019: 135.7%.
 Stock-flow adjustment: -0.1% of GDP.
 Source: Research Department of Confindustria estimates and calculations.

- The need to further lower the rates of return on Italian government bonds. The latest developments are favourable. Since mid-August, the decline in sovereign interest rates in Italy has reached record lows: 0.82 percent, down from 2.57 per cent in the first half of 2019. However, sovereign spreads are still wide: approximately 70 basis points with Spain, and 142 with Germany.
- The need to adopt economic policy choices in line with European fiscal rules in order to avoid tensions with EU Institutions that could worsen the perception of financial markets. In this regard, the Government, in the Na-DEF, assumes that EU institutions will grant Italy a lot of flexibility, which will have to be negotiated.

Overall, economic policy actions must succeed in raising the growth rate of the economy above the average cost of public debt (Chart D). Currently, with the fall in interest rates, this target is within reach if the right policies - implemented gradually over a period of at least three years - manage to drive growth upwards. Currently, this difference is favourable in all the other 27 countries of the European Union.

Chart D
In Italy the cost of public debt is always higher than growth
(Percentage values)



Source: Research Department of Confindustria calculations on European Commission data.

By way of example, three hypothetical economic policy scenarios for the autumn may be set out, for which no specific likelihood of implementation is provided. All of them revolve around the way in which the VAT safeguard clauses will be managed.

A. Complete deficit financing of the safeguard clauses

In this scenario, Parliament decides not to increase indirect taxes by financing the cancellation of the clauses entirely through deficit. In this case, there would be no direct negative effect on economic growth, but the public-deficit-to-GDP ratio would rise close to 3 per cent and would almost certainly meet with opposition from the European Commission, which could launch an excessive deficit procedure. This could lead to a new increase in government bond yields, which would have a negative effect on the deficit, further increasing it and, in addition, having recessionary effects, as it would worsen credit access conditions for households and businesses. Moreover, there would be no further room to pursue growth policies.

B. Full compliance with EU rules

In this scenario, Italy would fully comply with the preventive part of the Stability and Growth Pact. The correction requested from Italy would be 0.4 points of GDP for next year. The next Budget Law would amount to 1.1 points of GDP, around €20 billion. The deficit-to-GDP ratio would fall to 1.7 per cent of GDP in 2020. This would implicate a large fiscal consolidation, which could have far-reaching negative effects on an already fragile economy.

C. A slower fiscal consolidation

An intermediate scenario, compared to the previous ones, could be one that would ensure the necessary efforts to achieve a slow but steady reduction of the debt-to-GDP ratio spread over several years, by pursuing effective policies to increase the growth rate of the economy. A plan organised over the next three years could be launched, precisely to avoid an overly restrictive policy in the immediate future. A reasonable policy framework could set a deficit target such to stabilise the debt-to-GDP ratio in the first year, and then bring it down in the following years. For example, a deficit-to-GDP ratio of 2.2 per cent, as that planned by the Government, could ensure stabilisation of the debt-to-GDP ratio in 2020, even with a GDP growth rate of around 0.2-0.3 per cent, well under the 0.6 estimated in the NaDEF. The deficit-to-GDP ratio would reach 1.9 per cent in 2021, which can be achieved through a correction of €9.9 billion, thus bringing the debt-to-GDP ratio down by around 1.4 points of GDP. In 2022, with a deficit-to-GDP ratio of 1.6, the debt would fall by additional 1.2 points of GDP and the correction would amount to €3.6 billion.

Then there is a fourth scenario, outlined by the Government, which involves not activating the safeguard clauses, financed partly through deficit and partly through hypothetical revenue increases and expenditure cuts. It will be necessary to await parliamentary approval of the Budget Law to make an overall assessment.

A range of possible interventions in line with these objectives, and from the perspective of a three-year plan, could include a series of measures to support growth and ensure the sustainability of Italian public debt. This is not a comprehensive programme, which obviously requires a number of other actions and an overall assessment of compatibility, and rather than specific proposals it merely puts forward useful elements to fuel debate. These include:

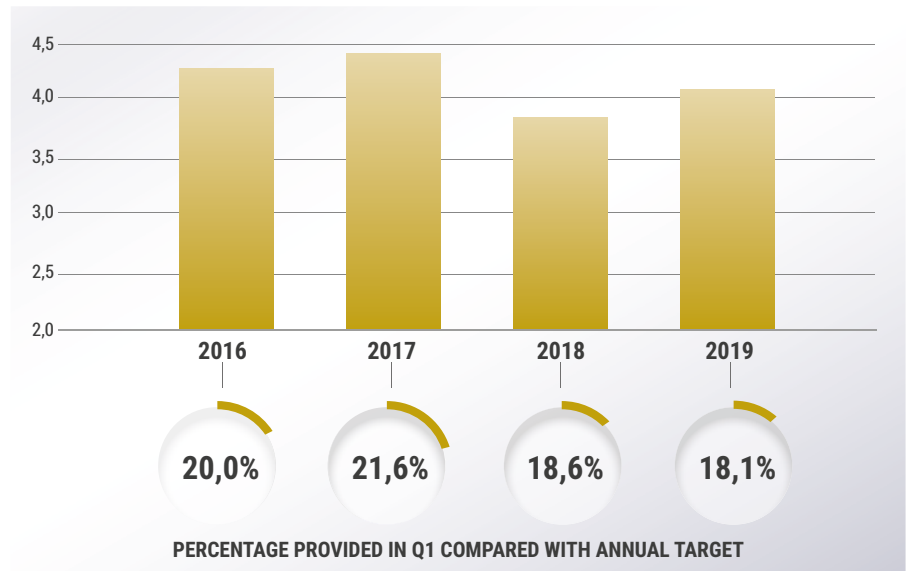
- 1. support for private investment:** fiscal measures that have proved effective should be continued. In particular, *iper-ammortamento* (enhanced tax depreciation allowances) for the purchase of capital goods incorporating

digital technologies, should be refinanced. Green investments favouring the transition towards sustainability should be explicitly targeted.

- lifting restrictions on public investment:** restrictions on construction sites that are still idle should be lifted, in order to spend the public funds that have been allocated, as well as completing implementation of recently adopted measures (*Decreto Sblocca-cantieri* - Public Procurement Decree) and eliminating other still existing obstacles (Chart E);

Chart E The implementation of public investments is still slow

(Payments made for public investments,
Q1, €bn)



Source: Research Department of Confindustria calculations on General Government consolidated cash budget.

- launching tax reform:** it is crucial to reduce the tax burden on labour, by putting more money in workers' pockets, in order to boost labour supply and consumption, and by reducing labour costs for employers, in order to increase competitiveness and labour demand.

Given the current stringent public budget constraints, but also in view of the urgent need for measures to maximise Italy's growth prospects, a viable option could be a targeted and gradual intervention on several fronts that would stimulate growth in complementary areas:

- Lowering personal income tax (IRPEF) rates in the first brackets, which would boost average incomes, above all those of employees, who are currently penalized compared to other taxpayers because of alternative tax regimes on other forms of income.

Simulations carried out by the CSC using the tax-benefit EUROMOD model show that replacing the nominal marginal tax rate currently applied to the second IRPEF bracket with the rate applied to the first bracket would result in tax savings for 56 per cent of IRPEF taxpayers and would entail a revenue loss of around €8 billion. This hypothesis seems more reasonable than alternatives discussed recently in the public debate, including: (i) merging the second and third IRPEF brackets, which would increase the revenue loss by an additional €4 billion but would result in savings for less than a quarter of taxpayers; and ii) the introduction of a fixed rate of 15 per cent up to €55 thousand, which would either cost too much (€80 billion), or, if financed by the abolition of the €80 monthly bonus for low-medium income earners and all other existing tax expenditures, would cost less (€17 billion) but would generate a higher tax burden for more than 20 million taxpayers, most of whom are on low incomes.

- A targeted intervention regarding labour income aimed at increasing take-home pay for employees with very low incomes, with the introduction of a negative tax that provides for transfers also to people that do not pay taxes.

In Italy today there are around 4 million low-income employees who are able to write off all of their taxable income with personal deductions and, as such, are excluded from the €80 monthly bonus. One option to increase their take-home pay would be to redesign the structure of the bonus, introducing a phase-in that starts from the first euro of wage income, up to the annual €960 bonus. The estimated cost of the measure is €2 billion, in addition to the €9.5 billion already earmarked for the current €80 monthly bonus.

Increasing low-income workers' net pay would boost consumption (as they are likely to have an above-average propensity to consume) and the incentive to work (including for people with low salary prospects and for secondary earners, primarily married women).

- Strengthening the existing tax incentives regarding performance bonuses, in order to further stimulate the spread of variable compensation schemes and the achievement of productivity gains.
- Extension of the current incentives for young people to enter the labour market, in terms of tax relief on both open-ended contracts and apprenticeships.

- 4. reshaping the VAT system:** if it were absolutely necessary to take actions in order to ensure the sustainability of Italian public finances and to avoid other restrictive measures, then the current VAT system should be reorganised. The action plan should involve goods consumed primarily by high-income households, as to mitigate or at least not increase the tax burden on low-income households which have a larger propensity to consume.

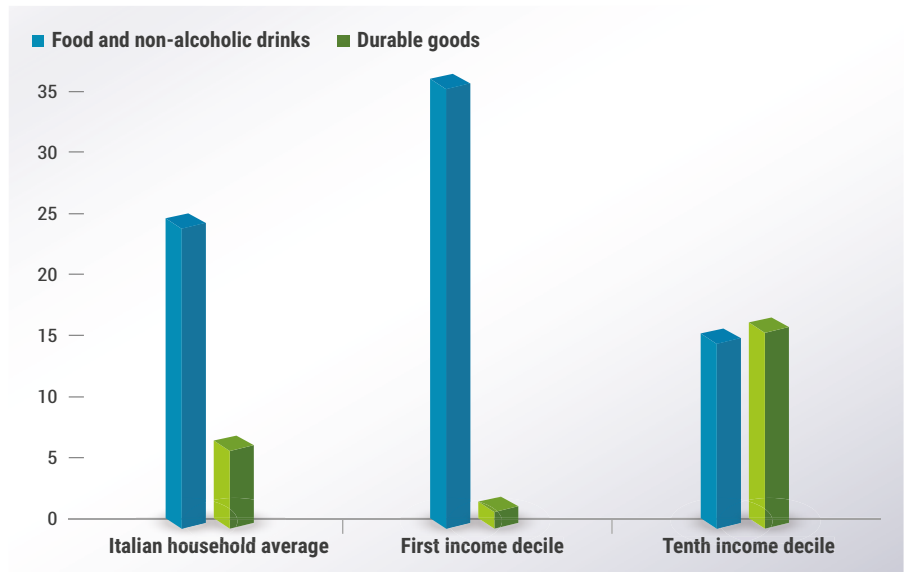
As a matter of fact, distributive analysis shows how indirect taxes are regressive, if considered as a percentage of income. Households in the first income decile allocate more than 18 per cent of their disposable income to the payment of VAT and excise duties, while for households with higher incomes (in the last decile) the figure is around 12 per cent.

In the average household consumption bundle, food and non-alcoholic beverages are the most important items, amounting to 23 per cent of the total. These are followed by housing costs (domestic expenses and rents) at 14.4 per cent, private transport at 11.5 per cent, and clothing and footwear at 8.2 per cent, while restaurants and hotels stand at 7.4 per cent. However, disaggregating the analysis by household income decile shows that food accounts for almost 34 per cent of the consumption bundle for households in the first decile, compared with only 14 per cent for households with higher income. On the other hand, durable goods account for 17 per cent of expenditure for the latter, compared with 2 per cent for the former. (Chart F).

An increase of one percentage point in both the standard and the reduced VAT rates (but not the minimum rate) would affect more than 76 per cent of the goods consumed by households. Assuming that the VAT increase is fully transferred to prices, average household expenditure would increase by around €169 per year. Therefore, for the same consumption bundle, generalised increases in VAT rates, along the lines of the provisions of the safeguard clauses, would surely increase government revenues but would have negative effects on economic growth and also in terms of income inequality.

Chart F Composition of the household consumption bundle

(Selected items, % values by spending
category and income decile)



Source: Research Department of Confindustria calculations with EUROMOD-ITT on IT-SILC/HBS data.

5. **introduction of measures to fight tax evasion:** one option is to incentivise the use of electronic money, which is not widespread in Italy, through a tax rebate for people who use it. In the hypothesis drawn up by the CSC, it would be a tax credit proportional to the value of the transaction.
6. **the savings derived from lower-than-expected use of the Quota 100 and Rdc schemes should be used entirely to reduce net borrowing.** The last budget law allocated higher amounts than what is now deemed necessary on the basis of the applications received, with savings beyond those assumed by the Government in Decree Law 61/2019. It is essential that these savings are entirely earmarked for deficit reduction, as assumed in the CSC forecast scenario.
7. **a rebalancing of the taxation of investment income:** taxation on financial profits from government bonds could be increased and the resources earmarked for a training and employment plan for young people.

Next year could be a turning point for the Italian economy provided that the benefit of interest rates at historic lows is used to rebuild confidence, boost private investments, start reducing the tax burden on workers and set public debt-to-GDP ratio on a downward path. Waiting for the international geo-economic scenario to brighten up.