ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Forecast on the Italian Economy

Introduction and Synthesis

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CREDITS

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Introduction and synthesis

The large scale adoption by all principal countries of fiscal and monetary measures which contrast the economic cycle and support the banking systems has contributed to slowing down the free-fall of the economic crisis: what initially appeared to be a drop of the global economy comparable to the Great Depression could result, thanks to major public intervention, in being “only” a very deep recession, the greatest experienced since World War II by most of the great systems. Governments have reacted in different ways: in the United States and China, public intervention was greater than in Europe where, as shown in ISAE’s report last February, fragmentation and insufficient coordination limited the scope and efficacy of measures. However, government intervention has been successful nearly everywhere -even in Europe- in creating a dam against a trend that appeared to be continuously worsening after the summer of 2008. This was also made possible thanks to the positive spillover effects that economic policies had on productive and commercial globalization, thereby prevailing over nationalistic tendencies and encroaching protectionist influxes in the different countries. This is a fundamental difference with the 1930’s. The stimulus measures will continue yielding their positive results in the second half of the year and the expansive trend will persist, as emphasized in the recent G8 held in Aquila, until the cycle will have reached a stable positive level. This will guarantee necessary support for the recovery process and will increasingly ward off fears of deflation.

After the new, strong slump in the first three months of the year, the world recession has softened. Financial and credit markets have followed more encouraging trends. The major stock markets have shown marked increases. In the interbank markets, especially in Europe, three-month rates have returned to pre-crisis levels. Less negative indications have emerged since the Spring from the surveys on entrepreneur and consumer confidence. These indications have also fuelled the OECD Composite Leading Indicator which has begun showing “tangible signs of improvement in the outlook,” forecasting that a low point in the growth in different economies will have been overcome between the Summer and the Fall.

Both quantitative and qualitative data have recently begun being less unfavourable. The drop in industrial output has slowed down in the United States and Europe. Indications seem to point to a stabilization of the American real estate market. The cycle in Asia appears to be strengthening substantially. In China, the strong fiscal and monetary stimulus measures have boosted domestic demand (especially investments) and brought economic activity back to levels of high expansion. Considerable cyclical improvements can be witnessed also in the other emerging economies of the Far East (especially Korea and Singapore), in India and in Japan itself. In a global scenario that is still very weak, at least one area, Asia, could have begun to gain momentum towards recovery.

But the Recovery Will Be Slow

This nearly homogeneous positive trend, however, does not lead to the prospect of a rapid recovery, especially in advanced countries. Recent productive trends appear to be partly dependent on inventory cycles after the strong decumulation at the end of 2008 and early 2009, as well as on government fiscal stimulus measures, such as incentives to the European car industry. But indications of growth of the independent components of the domestic expenditure are weak. These indications are weighed down by the tightening of the credit flow to the economy both in terms of quantity and price. The more onerous bank loans conditions, resulting from a worsening of budgets, could slow down the economic recovery when the demand for financing picks up. The speed with which the crisis will be overcome will also be affected by the lack of demand from large segments of private industry – primarily American consumers, who are engaged in stabilizing their previous, excessive debt position. The trend in consumption expenditure will slow down to different degrees in various economies not only because of the effects of deleveraging but also because of the recession’s (delayed) impact on the labour market, which is expected to deteriorate everywhere. The magnitude of this effect will increase proportionately to the slowness of medium-term recovery of economic activity and productive capacity.

Medium-Long Term Uncertainties

The biggest uncertainties concern medium-term prospects. The gradual overcoming of the worst part of the crisis and the beginning of discussions regarding exit strategies from the emergency measures readdresses the issue of the great global imbalances which was temporarily set aside because of fears of financial collapse. The correction of imbalances in the deficit countries (first of all the United States but also the United Kingdom, Spain and Ireland) compared to the reduction of surpluses in countries with excess savings (primarily China, but also Japan and Germany), does not appear to have a linear trend. This is true especially if we consider that in the post crisis scenario, different economies will find themselves having to simultaneously correct the increase in budget deficits which originated from the adoption of discretional measures.

U.S. Adjustment and Need for Coordination

As already mentioned, in the U.S. a stabilization of families' excessive debt position has occurred through an increase of interest rates. This has been compensated substantially by the reduction of expense of the public sector in order to support internal demand and contrast the economic crisis. The fiscal stimulus measure and the resulting worsening of the federal budget cannot, however, permanently compensate low domestic demand without penalizing government debt, endangering the very growth of the U.S. economy and having negative repercussions on the financial markets. After 2010, once the recovery is underway, the U.S. will need to adjust public finances. This report, thanks to the simulations used, provides a scenario in which the crisis is overcome in 2011 and the deficit reaches 3% of GDP in one quarter. This simulation highlights the fact that a similar correction would greatly hinder growth, spur a strong cyclical volatility (with a new recessionary fall on the corrective measure) and negatively affect international recovery.

This discussion leads to the other aspect of the dilemma of global imbalances: the behaviour of countries with excessive debt positions, starting with China. As recently analyzed by Olivier Blanchard, this issue is as -if not more –important than the reduction of excesses of expenditure. An adjustment towards a greater international equilibrium that does penalize growth would require that the Asian giant (and proportionately also those Asian countries which have a structural surplus in current expenses) abandon a development model based on exports. The emergency of the economic crisis caused a need for the adoption of this model: in order to guarantee the country's development, Chinese authorities had to stimulate domestic demand vis à vis the collapse of global trade. The question is if, with the normalization of the international situation, this attitude will be maintained and, possibly, improved, thereby shifting public intervention from direct support of investments to the preparation of an adequate social safety net (including heath and social security) that would favour the lowering of the saving propensity of the Chinese.

Forecast for 2010: the Asian Engine

All of these considerations lead to hypothesize a very slow world recovery, creating a curve that is somewhere in the middle between an "L" and a "U", and that varies according to geographic location: in advanced countries, the shape of productive recovery would be closer to the former rather than to the latter.

An initial negative 2009 semester for international economic activity would be followed by a slow adjustment and an eventual improvement starting in the Summer. Gross world product would drop by 1.7% on average in 2009 and then grow to 2.5% in 2010. In the course of this year, the recession in industrialized countries (-3% in the United States, -6% in Japan, -4.7% in the Euro area), would be mirrored by a considerable slowing down of less developed economies. In 2010, emerging Asian countries would provide the main thrust (+6.4%) towards international recovery. Advanced economies would be pulled by this engine and achieve modest annual average growth results: in the U.S., GDP would grow by 0.9%; in the Euro zone it would remain substantially stagnant and in Japan, the closest geographically and economically to the Asian engine, economic growth could nearly reach 1%.

The Recovery of Trade

World trade, which dropped much more than gross world product in 2009, (-14% according to ISAE estimates), should recover substantially. The great vacuum which occurred at the end of 2008 and in early 2009 (almost -20% between October 2008 and March 2009), seems to have been overcome during the second quarter. Such a serious decline was caused by a number of different factors. The fact that the crisis hit primarily the manufacturing industry helps explain the greater fall in the exchange of goods compared to an indicator of economic activity, such as world product, which includes services. A further element could have been the heavy destocking in industrialized economies. Since this implies a reduction in the demand of imported components and semi-finished goods, could have amplified the response elasticity of world trade in relation to production variation. Finally, financial intermediaries' greater aversion to risk could have penalized credit supply especially to very internationally-oriented firms which, in this context, became more exposed to cyclical deterioration.

Some of these factors, especially those linked to the weakening of manufacturing activity, have become less pronounced in the last few months among more advanced economies. The simultaneous need for restocking has produced opposite effects to those discussed previously concerning trade elasticity in relation to production. The strengthening of the Asian economic cycle has also provided a new, substantial stimulus to trade, especially among Far Eastern countries. These considerations lead us to forecast an acceleration of world trade that is relatively quicker than that for production, with an approximate average 4% increase in 2010.

The thrust for the strengthening of world demand would originate in Asia, an area which will be characterized by increasingly strong manufacturing and trade relationships and by a growing propensity to trade within the region. Advanced economies will be able to benefit indirectly from the Asian growth engine. The possibility to draw advantages from the greater development of that region will rest with the ability of individual firms to insert themselves within the productive relations of the region and to interpret the needs of a growing portion of a population whose spending power is progressively increasing.

Oil

Oil and other raw materials have experienced a marked acceleration since the Spring. The initial signs of international recovery and the thrust provided by greater Chinese demand, coupled with positive stock market performances and the weakening of the dollar, have fuelled expectations for a recovery of demand, thereby encouraging speculative activity. Fundamentals (inventory and forecasts for oil demand) point to weaker oil prices in the future. In the international scenario used for the forecast, oil price trends reflect the contraction of world demand in 2009 and the expectation of moderate recovery in 2010. Specifically, average oil prices in the second half of this year are expected to be close to current ones. This would mean a drop of over 38% for the yearly average. In 2010 the acceleration of international growth would favour a further growth of oil prices amounting to 25% on average.

The Dollar

Between the end of 2008 and the beginning of 2009, the dollar - still seen as a safe harbour in the midst of the financial crisis- has benefited from the reshuffling of operators' international portfolios. This tendency was later redressed by a contrasting trend. In the long term, the underlying elements of American weakness could affect the recomposition of international reserves. China and Russia would favourably see the emission of Special Drawing Rights Bonds by the IMF. These attitudes highlight concerns over the performance of the dollar and the will to reduce exposure towards it. Nonetheless, this process is complex and ripe with contradictions (the reduction of dollar reserves would cause losses in capital expenses), requiring a high capability (and determination) to coordinate among the main international actors.

We therefore believe that this can only exert a marginal influence during the forecast period. The dollar would appreciate by 7.6% on average in 2009 with respect to the euro. In 2010, the dollar/euro exchange rate would remain substantially the same as 2009 levels and would oscillate within a narrow range. This would result in a modest weakening of the dollar amounting to 3.9% on average.

Italy

At the beginning of 2009 Italian economic activity experienced a new downward slump, thereby extending the contraction of the second quarter of last year. The negative trend in production manifested itself in all sectors, but the heaviest toll was taken, once again, by the manufacturing industry, on account of its vulnerability to the collapse of world trade. On the expenditure side, the trend was fuelled, as it had been at the end of 2008, by exports and investments. Household consumption, although less negative than other expenses, has considerably dropped once again.

Conditions of the Cycle

The improvement of cyclical indicators which emerged recently also in Italy signals the weakening of the fall in production. Indices of the economic cycle elaborated by different organizations and with different methodologies have begun showing a possible turning point for the Italian economy between the Summer and the Fall. Cyclical conditions appear to be gradually stabilizing in the industrial sector. The confidence level of firms stopped deteriorating in March, after having fallen for over one year, and has reached average levels of

FORECASTS FOR THE ITALIAN ECONOMY: SUMMARY
(Percentage changes, unless otherwise indicated))

	2008	2009*	2010*
National framework			
Gross domestic product	-1,0	-5,3	0,2
-North-West	-0,9	-5,4	0,5
-North-East	-0,8	-4,9	0,8
-Centre	-1,0	-5,2	0,1
-Mezzogiorno	-1,5	-5,7	-0,7
GDP (not adjusted for seasonality and working days)	-1,0	-5,2	0,3
Imports of goods and services	-4,5	-13,8	2,0
Exports of goods and services	-3,7	-18,5	2,0
Resident households' expenditure for consumption	-0,9	-2,2	0,1
Expenditure of Public Administration and Isp	0,6	0,3	0,3
Gross fixed investments	-2,9	-11,2	0,7
Contribution to GDP growth			
-domestic demand	-0,4	-1,2	0,1
-total investments	-0,6	-2,4	0,1
-net exports	0,2	-1,3	0,0
-of stock changes and valuable objects	-0,2	-0,3	0,0
Consumer prices	3,3	1,0	2,0
Producer prices	5,8	-4,4	2,8
Per capita gross earnings in the Economy	3,3	1,3	1,5
Total employment (1)	-0,1	-2,7	-0,8
Unemployment rate	6,7	7,9	9,3
Average propensity to consume (percentage)	87,8	86,3	86,4
Net borrowing of public administration (as a % of GDP)	-2,7	-5,3	-5,1
Primary surplus of public administration (as a % of GDP)	2,4	-0,3	0,1
Tax burden of the public Administration	42,8	43,1	42,8
Debt of the public administration (as a % of GDP)	105,7	114,6	117,7
12-month Treasury Bill yield (2)	2,6	1,0	2,0
Nominal GDP (millions of euros) (3)	1.572.244	1.530.422	1.558.593
International framework			
Gross domestic product			
- World	3,0	-1,7	2,5
- USA	1,1	-3,0	0,9
- Euro area	0,6	-4,7	0,0
Dollar/Euro exchange rate (level)	1,47	1,36	1,41
World demand	2,2	-13,8	4,3
Official exchange rates (2)			
- ECB	2,50	0,50	1,25
- Federal Reserve	0,50	0,10	1,50
Prices of raw materials (in dollars)			
- non energy	13,7	-24,1	11,8
- energy	27,6	-28,0	20,0
of which: Brent ($/barrel)	97,3	60,1	75,0

Sources: ISTAT, Bank of Italy, ECB, Federal Reserve, IMF, HWWA.
*ISAE forecasts
(1) In standard labour units.
(2) End-of-year annual yields. Gross compound for Treasury yield bills.
(3) Annual GDP, not working day adjusted.

November-December 2008, which were historically low. The improvement in confidence has been fuelled by more positive assessments of the levels of inventory and less negative prospects for short-term demand (and orders). This leads us to believe that inventory decumulation, which had strongly affected the fall in industrial production, has probably come to an end. As of March, confidence has improved especially among manufacturers of intermediate products, which usually anticipate the overall economic cycles. Consumer goods and financial products have also witnessed a rise in confidence levels. Entrepreneurs' attitudes towards the prospects of the overall economy have been less negative.

In the Spring, qualitative signals coming from the manufacturing sector have been mirrored by the first less unfavourable quantitative indications. The sharp drop in industrial production came to a halt in April-May. This does not preclude another negative quarter, but it could signal a technical improvement in July-September. Subsequently, given the slow international recovery, the trend of the manufacturing sector should return to moderate levels, nonetheless maintaining a generally positive evolution.

Access to Credit

ISAE's monthly surveys indicate a drop in the percentage of industrial firms which at the beginning of the Summer state they have experienced greater difficulty in accessing credit from banks in order to request or renegotiate a loan. The survey's sample shows that about 13% declared a worsening of conditions in June compared to 19% in February and April, and 9% in March of last year. The situation appears to be less favourable with respect to quantitative rationing as more firms have experienced a worsening of conditions. In June, 8% of those interviewed stated that their request for credit had been unmet while at the beginning of the year the figure was 6.5% and in March of 2008 it was 4%. Differences appear to be related to the size of the firms: quantitative rationing seems to be less marked in the case of large firms, while it is increasing for small and medium-size firms. Large firms, on the other hand, have been penalized in recent months by requests for greater guarantees, more onerous accessory expenses and, especially, higher interest rates.

Confidence of Households

The ISAE June survey shows that the confidence of households, which has been on an upward trend for the past few months, is still increasing. Consumer confidence regarding the overall economic scenario and the future has increased. Concerns over the labour market, which had grown in the middle of last year, have diminished. At the same time, household expectations about the reduction of inflation have decreased.

In general, the evolution of the indicator of consumer confidence in this recession (which started growing last Fall), would appear to signal the perception of a lower exposure to the international financial elements of the crisis and a closer focus, instead, on the aspects that directly affect household budgets. This helps explain the increase in answers regarding the advisability to save, which can be seen as a precaution in expectation of a worsening of the economic and job-related scenario. The confidence of households (especially middle-low income) appears to have been influenced most by the perception and anticipation of a reduction in prices rather than by "unfavourable" factors.

Forecasts for 2009-2010

Overall cyclical indications point to the fact that the worst phase of the cycle should be over in Italy as well. The recovery will however get underway very slowly, materializing into yearly average figures only starting in 2010. The sluggishness expected to characterize Italian recovery mirrors that anticipated for international demand which, in turn, should provide the acceleration for the thrust of Italian domestic recovery. In particular, the second quarter of 2009 will still be negative because of the carry-over effect of the fall in January-March. A positive indication of the evolution of the gross domestic product should return in the third quarter. This improvement will allow economic activity in the second quarter to return to the levels of the first six months. Average GDP for the current year should drop by 5.3% (5.2% in rough terms) according to adjusted figures. The progressive improvement of world trade should have a positive effect on the evolution of 2010. Measures included in the Summer manoeuver should provide support for domestic demand. GDP should increase next year by 0.2% according to data adjusted for working days (and by 0.3% without any adjustment).

Components of the Demand

Consumption should drop by 2.2% this year and then remain almost stagnant (+0.2%) in the comimng year. Households' gross disposable income should be penalized by the worsening of employment conditions. Budget measures in support of the most economically disadvantaged groups should soften the blow of the worsening situation. The drop in inflation in 2009 should help reduce the drop in purchasing power. Precautionary attitudes should continue among consumers on account of uncertain economic prospects. The need to rebuild wealth should strengthen the propensity to save that will eventually stabilize during 2010.

Investment spending suffered significantly (-11.2%) as a result of the worsening of the economic cycle, lower profitability and more onerous financing conditions. The unprecedented drop of productive capacity represents an additional obstacle in the extension of plants. Fiscal measures included in the July manoeuver in support of the purchase of machinery will kick in gradually: they should begin taking effect by the end of the year and yield a positive impact in 2010, when greater stimulus to expenditure should derive from improved cyclical conditions. Overall investment growth on average should grow by 0.7%, while investment in machinery, equipment and immaterial goods should increase by 1.4% (-15.5% in 2009).

Exports should experience a sharp decline (-18.5%) in 2009, mirroring lower world demand. This considerably negative average result should nonetheless leave room for a positive recovery of Italian exports in the second semester as a result of the process of stabilization and eventual recovery of international demand. The positive evolution should materialize in 2010, when exports should have grown to 2%. The fall of our share of the volume of world exports, which is expected to increase in 2009, could ease in the coming year, thereby reflecting the competitive recovery of Italian firms that was underway before the occurrence of the crisis.

The Report examines the competitive performance of the Italian industrial sector after 2005, when benefits from company reorganizations of preceding years began kicking in as a response to greater global competitive pressures. The considerable increase in the growth and productivity of Italian manufacturing during this period has been highlighted by the last two releases of revised ISTAT data. However, these studies also indicate that the Italian industrial sector continues to drag behind the rest of Europe, with an inevitable loss in competitiveness. This Report hypothesizes that the negative performance after 2005 may be an effect of the overestimation of the export deflator and a resulting underestimation of volume trends. This statistical problem is similar to that raised by analysts previously and which seemed to have been overcome with the revision of foreign trade indices in February 2008. It now appears to have resurfaced with relation to post-2005 trends. The estimates that can be obtained by deflationing exports with alternative price indices (those of industrial products for export) yield considerably better trends than Italian volume exports after 2005, even compared to European partners. Better trends would also be achieved for growth indicators, productivity and manufacturing competitiveness, thereby improving Italy's position in relation to major European countries.

As for imports, the purchase of goods and services should drop by 13.8% in 2009 and then grow by 2% in 2010, mirroring the improved trend in domestic demand and exports themselves, which are highly import-intensive. Imports net of the variation of GDP would therefore be negative (-1.3%) in the current year and would be null in 2010.

Labour Market

The repercussions of the crisis on the labour market, which were already evident in 2008, will come fully into effect in 2009 and will persist, although to a lesser degree, until the first half of 2010. On the basis of its surveys, ISAE estimates that work input, which had experienced a sharp drop in the first quarter of 2009, should continue dropping, albeit more gradually, in the second quarter. It would then begin a gradual but progressive stabilization. The surveys specifically point to a slow increase in the level of employment of industrial firms. Although still remaining negative, they would indicate an easing of this unfavourable trend. A similar evolution is expected, starting at the end of 2008, in the construction sector. More recent surveys have instead shown a likely worsening of the services industry, especially in commercial activity.

The fall in work input in 2009 will occur in all economic sectors. The level of employment in the industrial sector will be most hit, with a 5.3% drop in work units. Heavy recourse to the Redundancy Fund (Cassa Integrazione Guadagni) and the substantial increase in part-time work should ease the effects on the decline of total jobs; rather, these factors will actually have a buffering effect in a substantial reduction in the total amount of hours. On average, a decline in equivalent full time work units of 2.7% for the overall economy (equivalent to 664,000 units less than 2008), compares to an overall fall in the total number of employed people of about 1.3% (about 300,000 less jobs). Results for 2010 will reflect the negative carry-over effects of the current year and the tardiness with which the labour market responds to the economic cycle. The drop in work input should therefore continue less markedly (-0.8%) also in the coming year. The unemployment rate is expected to grow to 9.3% in 2010 vs. 6.7% in 2008, thereby returning to a slightly higher level than 2001.

National economic accounting figures for the first quarter indicate that the economic crisis is affecting not only the reduction of jobs but also a sharp drop in actual wages regardless of the continued sustained growth of contractual wages. These trends reflect the virtual annulment of the wage drift and, in the industrial sector, of the effects on the total wage bill resulting from the heavy recourse to the CIG. Wage dynamics should bear the brunt of these events in coming months. Furthermore, the effects of the 2007-2008 season of contractual bargaining should die out against a backdrop of a limited number of job renewals. The overall result of these effects should result in a considerably moderate gross wage dynamics per employee in 2009 (+1.3%). In 2010, gross wages per employee, although following historically low trends, should begin recovering (+1.5%) mostly as a result of important contractual renewals and the progressive exit of workers from the CIG. Forecasts of the wage component linked to contractual bargaining have taken into account the IPCA index net of imported energy products, as communicated by ISAE last March 30th (available on www.isae.it) to the Government and social partners, according to the January 2009 framework agreement on contractual wages.

Inflation

The inflation rate should amount to 1% on average in 2009, or 2.3 percentage points less than 2008. After a level close to zero in the Summer, inflation should begin to grow in the Fall, reaching by the end of 2009 growth rates similar to those of the beginning of the year. In 2010, after the sharp swings that had occurred in mid-2007, the inflation scenario should stabilize. A slow increase in inflation should begin in the coming year as a result of the foreign components of costs and gradual strengthening of the economic cycle. Inflation should reach 2% on average in 2010. The Italian inflation differential vs. Euro area partners would thus be unfavourable in both forecast years and amount to seven and eight tenths of a percentage point respectively.

Public Finances

Deficit forecasts are substantially in agreement with the Budget (DPEF) although only slightly lower for 2010. The decline in economic activity in 2009 and its substantial stagnation in 2010 result in a worsening of public finances. In 2009 Public Administrations are expected to almost double their deficit (5.3% of GDP) compared to 2008. In 2010 net debt should drop to 5.1%. After adjustments for the economic cycle and one-off measures, the deficit should drop in both forecast years. The Government debt to GDP ratio, which had continued rising in 2008, will considerably rise in the current year as a result of the double effect of the worsening of the Public Administration requirements (which double the nominator of the ratio), and of the contraction of nominal GDP, which lowers the denominator. After having reached a peak of 105.7% in 2008, Government debt show increase to 114.6% of GDP and then to 117.7% in 2010.