ufficio parlamentare di bilancio

Summary

This report examines recent economic developments in the light of national accounts data for the first quarter and available information for subsequent months. The data show economic activity evolving in line with the forecasts contained in the Economic and Financial Document (EFD) published in April (+0.7 per cent), despite an international environment that has diverged in part from expectations last spring.

The largest difference regards world trade, which contracted in the first five months of the year. In view of this decline, it would seem difficult – in the absence of a strong acceleration in the second half of the year – to achieve the growth in world demand assumed in the EFD. However, the worse-than-expected performance is attributable to emerging economies that do not represent large markets for Italian exports, implying that the demand for Italian goods should be somewhat more resilient than overall external demand.

As forecast in the EFD, the weakness of the euro and of the price of oil have been confirmed, although developments in the first seven months of 2015 show a smaller depreciation of the euro against the dollar and higher oil prices than expected in the spring. Downward pressure in recent weeks could bring oil prices closer to the level expected in April.

The deterioration of the crisis in Greece, which was not explicitly considered in the spring forecasts, has had limited repercussions for risk premia in the euro area. The expanded asset purchase programme launched in March by the Eurosystem has had a positive impact on interest rates, while the impact on inflation has been less certain.

Although the pace of Italian GDP growth would appear to be in line with the April forecasts, the composition of demand differs somewhat. The slowdown in consumption in the first quarter has affected the average for the year, foreshadowing slower growth than that assumed in the EFD. Conversely, capital expenditure, which has been driven by investment in transport equipment, could turn out to be stronger than expected. Exports have only been partly affected by the slowdown in the emerging economies thanks to the depreciation of the euro and the focus on growing markets. The contribution of net external demand to GDP growth could be smaller than forecast in the EFD, however, as the result of a stronger acceleration in imports. Although inventories are highly volatile, they could make a positive contribution to GDP growth. Trends in the labour market are improving slowly. Inflation is rising more slowly than expected by the Government in April.

Prepared by the Macroeconomic Analysis Department. Information updated to 28 July 2015.

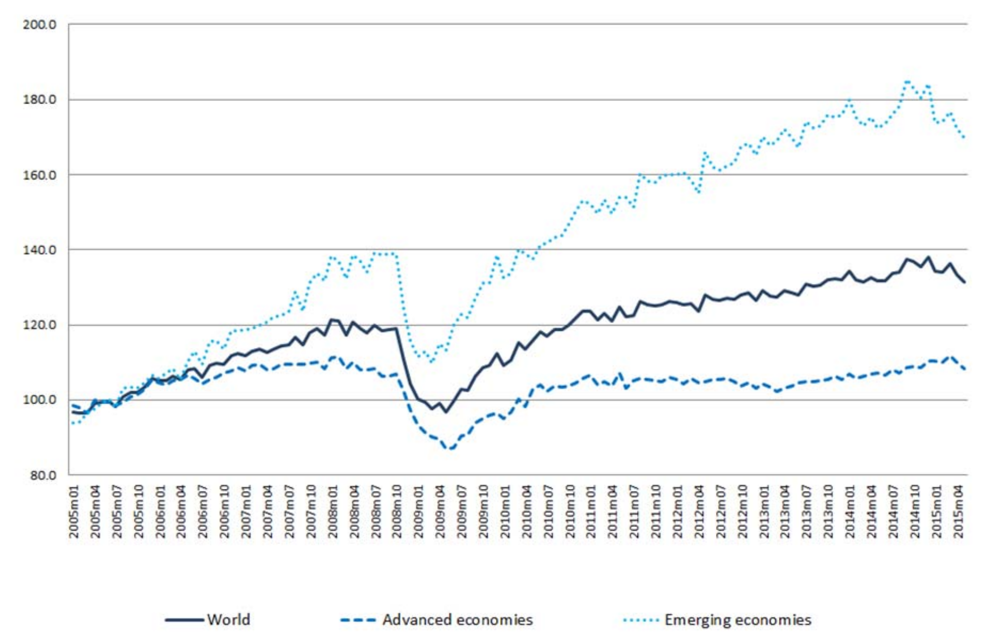
The international environment

Global trade contracts

The world economy slowed in the early months of 2015, giving rise to a contraction in world trade: global imports declined by 1 per cent between January and May compared with the second half of 2014. In view of this decline, the forecast for an increase of 4 per cent in world demand in 2015 formulated by international institutions and adopted in the EFD implies a sharp acceleration in the second half of the year, with an increase in world imports of 7-8 per cent over their level in the previous six months.

The contraction in trade reflected the decline in the imports of the emerging countries (Fig. 1). Contributing factors included geopolitical tensions in Eastern Europe and North Africa, the deterioration in the terms of trade of producers of energy raw materials, the recession in Brazil and slowing growth in China. In the latter country, GDP growth in April-June over the previous period (+1.3 per cent) slowed even further from its pace in previous quarters. Leading indicators point to a continuation of the deceleration in the second half of the year. The stock market turbulence that erupted during the summer could impact developments in the broader economy. Although equity remains a marginal source of financing for Chinese businesses and accounts for a modest, albeit rapidly expanding, portion of household investment, a continuation of steep declines in the market would have an impact on the financial sector and would interfere with the objective of founding growth on stronger development of the capital market.

Fig. 1 **–** World imports by major country group
(volume indices, 2005=100)



Growth in the advanced economies

The advanced economies have continued to grow. After a temporary pause in the first quarter, the United States has resumed its expansion. The stimulus imparted by an improvement in household disposable income has been curbed by the appreciation of the dollar against other currencies, keeping the size of the recovery smaller than forecast some months ago. The Federal Reserve confirmed its intention to begin raising interest rates by the end of 2015 after seven years (December 2008) of rates close to zero. However, this is likely to occur more slowly than expected last spring, partly owing to the limited upward strains on wages and weak inflationary pressures.

In Japan, growth in the first quarter (+1 per cent) was faster than expected, buoyed by stockbuilding and stronger investment growth. Cyclical indicators suggest that growth slowed in subsequent months.

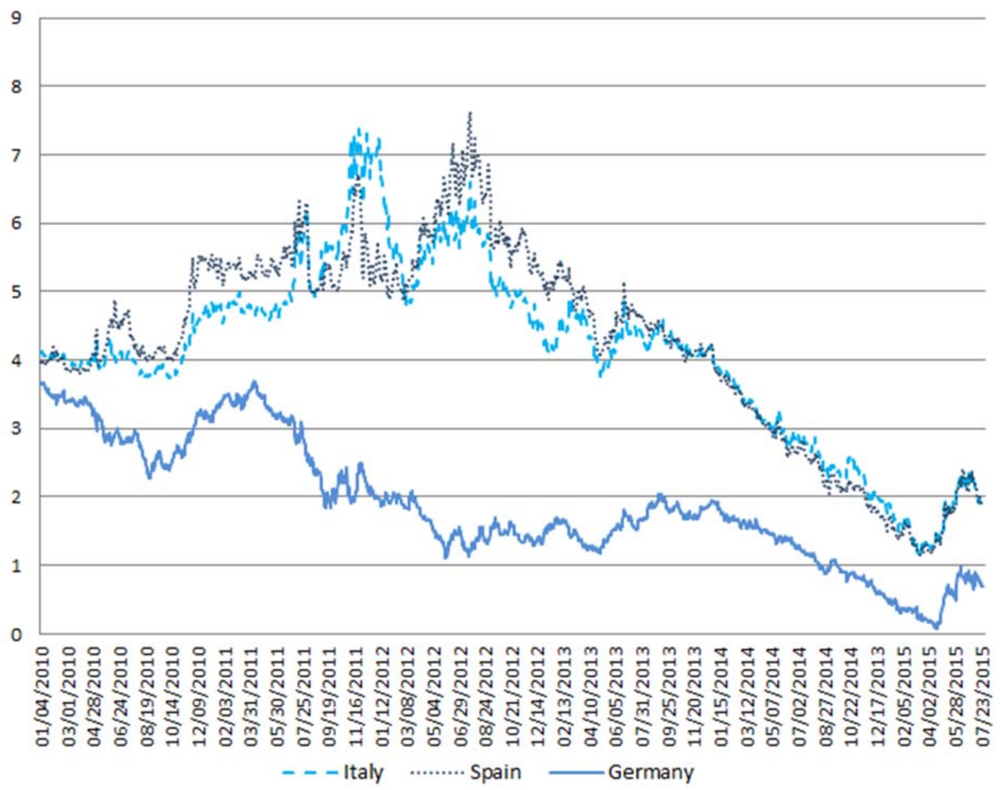
The Greek crisis and the recovery of the euro

In the euro area, the increase in uncertainty fuelled by developments in Greek debt negotiations boosted volatility in the financial and equity markets, but had a limited impact on risk premiums for sovereign debt issues by area countries. For Italy, the spread between rates on 10-year Treasury bonds and those on the corresponding German Bund, which in March had narrowed to around 110 basis points, rose to a peak of 163 basis points in the days following the Greek referendum of 5 July. The agreement reached on 13 July triggered a rapid easing of tensions, with the spread over German rates returning close to its level at the end of March (Fig. 2).

Helping to contain the repercussions of the re-emergence of the Greek debt crisis, unlike the situation in 2010-2011, was the safety net put in place by the ECB in September 2012 with the OMT programme and the launch of banking union. These measures were supported by the positive effects of the greater liquidity provided through refinancing operations with the banking system and, from March, the Eurosystem’s expanded asset purchase programme. The agreement between creditors and the Greek government helped ease the acute phase of political and financial tension within the euro area. It does not remove all uncertainty, however. In the conditions prevailing following the July agreement, it remains to be seen whether the accord has laid the foundation for a lasting solution to the Greek crisis in terms of the sustainability of the debt and the growth of the Greek economy.

The financial instability of recent months does not appear to have had a significant impact on the gradual recovery under way in the euro area. In the first quarter, GDP expanded by 0.4 per cent, with growth registered in most of the Member States.

Fig. 2 **–** Yields on 10-year government bonds
(daily data; percentages)



Source: Bloomberg

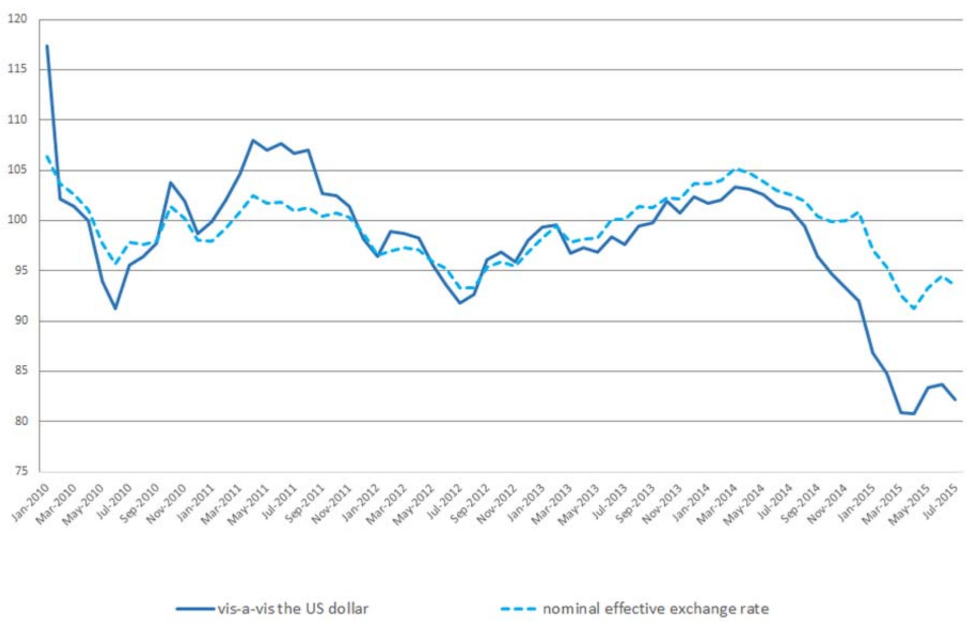
The rise was fostered by the strengthening of domestic demand, both in consumption and investment. Cyclical data point to the continuation of the recovery in the second quarter. The Bank of Italy's €-coin indicator, which provides a monthly estimate of GDP growth in the euro area, rose for the seventh consecutive month in June. Similarly, the purchasing managers index (PMI) for euro-area firms remained above the threshold consistent with an expansion of activity. Industrial production slowed in May and June, but not to an extent that would compromise the growth trend in manufacturing activity in the second quarter.

Euro-area policies more favourable for recovery

The change in the stance of macroeconomic policies helped foster the emergence of a broad, albeit modest, recovery in the euro area. Fiscal policies became less restrictive than in the recent past, while on the monetary policy front, the ECB's action became markedly more expansionary with the broad programme of purchases of public and private-sector securities begun in March. The effects had already begun to manifest themselves following the announcement of the programme, with the start of a rapid decline in interest rates and the depreciation of the euro. After reaching a low in the last ten days of April, yields on government securities began to rise again, recouping part of the earlier fall (see Fig. 2). In foreign exchange markets, the euro, which declined from 1.23 to 1.08 against the dollar between December and April, appreciated somewhat in subsequent months, before again depreciating in recent weeks to a level close to the lows registered in April. Between December and July, the euro depreciated by about 10.5 per cent against the dollar and by 6.5 per cent against a broader basket of currencies (Fig. 3). Given the average dollar/euro exchange rate in the first seven months of the year (1.114), in order for the euro to trade at par with the dollar in 2015, an assumption adopted by forecasters last spring (the EFD projected a rate of 1.081 dollars per euro), the single currency would have to depreciate in the remaining five months of the year by an average of 4-5 per cent from the value posted in the last weeks of July.

The primary purpose of the ECB's decision to purchase securities is to foster an increase in inflation expectations, which have been below the ECB's official target for some time now (i.e. consumer price inflation in the euro area close to 2 per cent) and thereby recover some ability to impact the cycle through conventional monetary policy tools.

Fig. 3 **–** Exchange rate of the euro
(index: 2010=100)

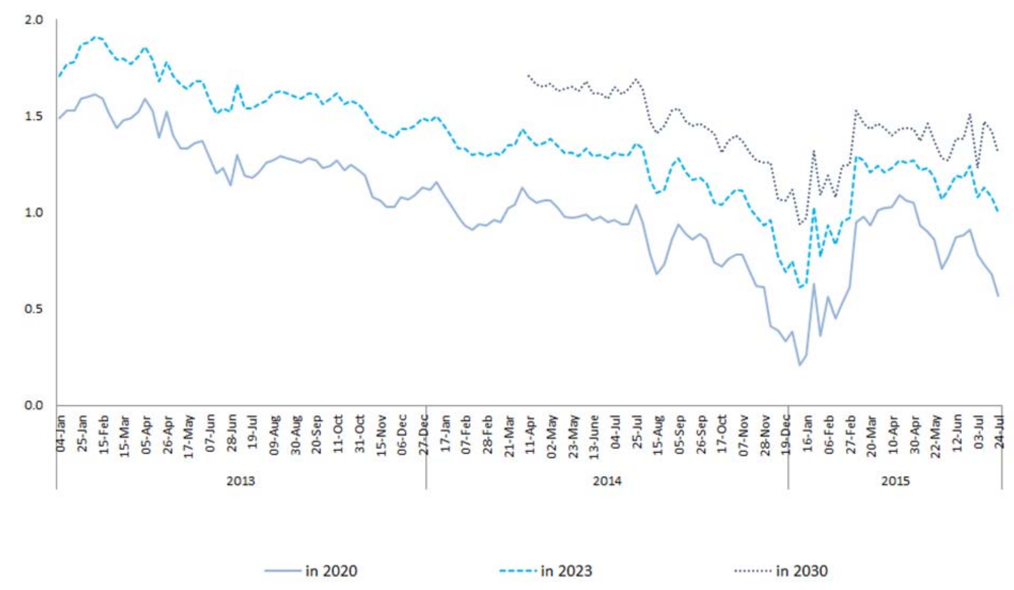


Source: ECB, BIS and PBO estimate for July.

Inflation in the area has in fact begun to rise slightly (from 0.6 to 0.8 per cent between January and June), but remains low. Inflation expectations, as signalled by yields on financial instruments, have also risen after reaching very low levels between the end of 2014 and early 2015. Nevertheless, the correction of expectations has slowed more recently and in the last few months has virtually come to a halt. This is especially clear in expectations over a five-year horizon (2020) for break-even inflation (the difference between the yield on ordinary Bunds and those linked to euro-area inflation), which as from April began to turn downwards again (Fig. 4).

In examining these developments, we must bear in mind the fact that the Eurosystem's asset purchase programme has been under way for five months and is scheduled to continue until at least September 2016. It will be continued beyond that date if inflation does not return to a path compatible with the ECB's target. However, developments in these early months of the programme indicate that increasing inflation expectations, which have been depressed by the long recession, is a complex process that will take time.

Fig. 4 **–** Inflation expectations for the euro area based on break-even inflation [1]
(weekly figures; percentages)



Source: based on Bundesbank data.
1) Difference between the secondary market yield on ordinary Bunds and Bunds of equal maturity linked to euro-area inflation.

Oversupply of crude oil

After reaching a low of less than \$50 a barrel (for Brent) at the start of the year, oil prices returned to \$65 in June before subsiding in recent weeks to below \$55 (the average price for 2015 used in the EFD is \$56.7). The high rate of oil production continues to fuel an oversupply in the world market, exerting downwards pressure on prices. This imbalance could expand with the removal of sanctions on Iran and the consequent increase in supply from that country.

The Italian economy

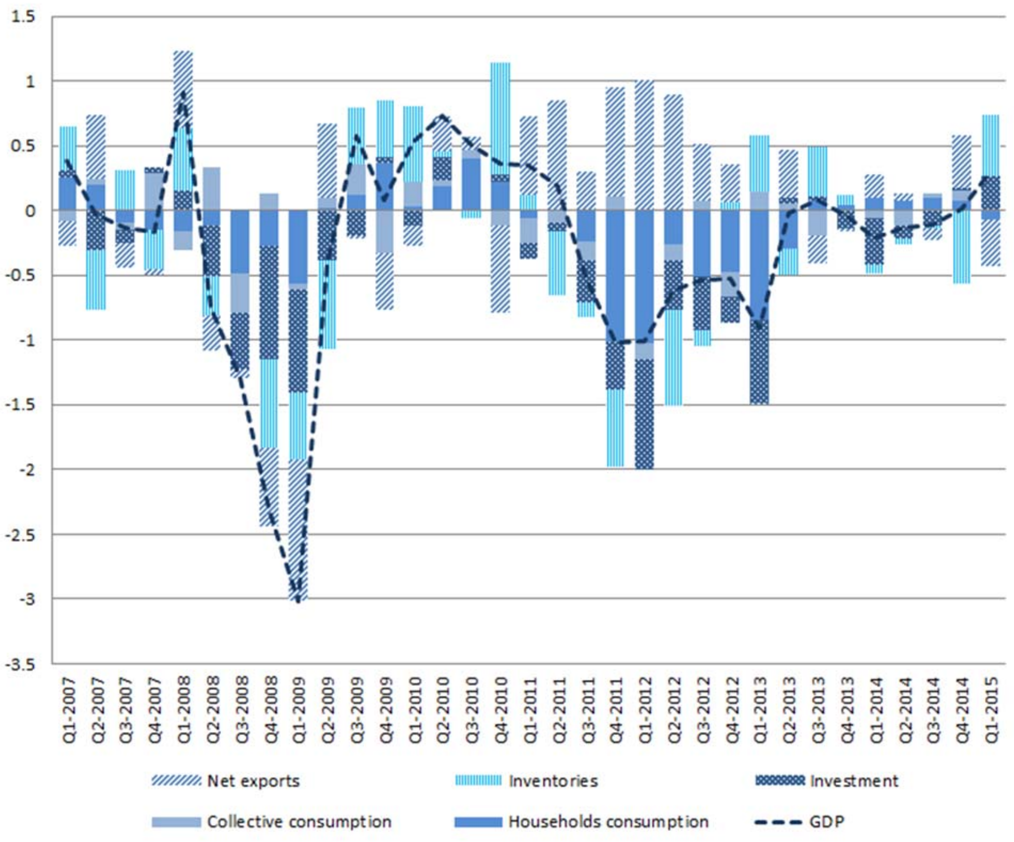
Uneven recovery in the first quarter

After five quarters of decline, GDP resumed growing in the first three months of the year, beating expectations by posting an increase of +0.3 per cent (Fig. 5). The composition of demand nevertheless underscored the uneven character of the recovery. Household consumption contracted marginally, while investment in plant and machinery weakened and exports of goods and services slowed in reflection of the deceleration in world trade. Economic activity was driven by the expansion of demand for transport equipment, signs of a turnaround in construction and the positive contribution of stockbuilding after the destocking experienced in the previous months. The sharp acceleration in investment in transport equipment (+28.7 per cent on the previous quarter) and the re-emergence of growth in construction (+0.5 per cent) may in part reflect the favourable impact of the Universal Exposition in Milan. Excluding stockbuilding, aggregate final demand contracted slightly in the first quarter (-0.2 per cent), after having expanded in the final three months of 2014 (+0.6 per cent).

Confidence and actual performance

Recent economic conditions have been characterized by rising indicators of business and, above all, household confidence. These significant improvements have been accompanied by smaller improvements in the hard data. This is clear in industry, where the gap between the climate of confidence (and the PMI) and the performance of industrial production (Fig. 6) has begun to widen again, as it did between mid-2013 and early 2014. The divergence could reflect a decline, attributable to the length of the crisis, in the level of economic activity considered "normal" by businesses. In this situation, even small increases in output could be perceived as consistent with structurally lower "normal" levels.

Fig. 5 **–** Change in GDP on previous quarter and contributions of the components of demand to the change in GDP
(percentage changes and contributions in percentage points)

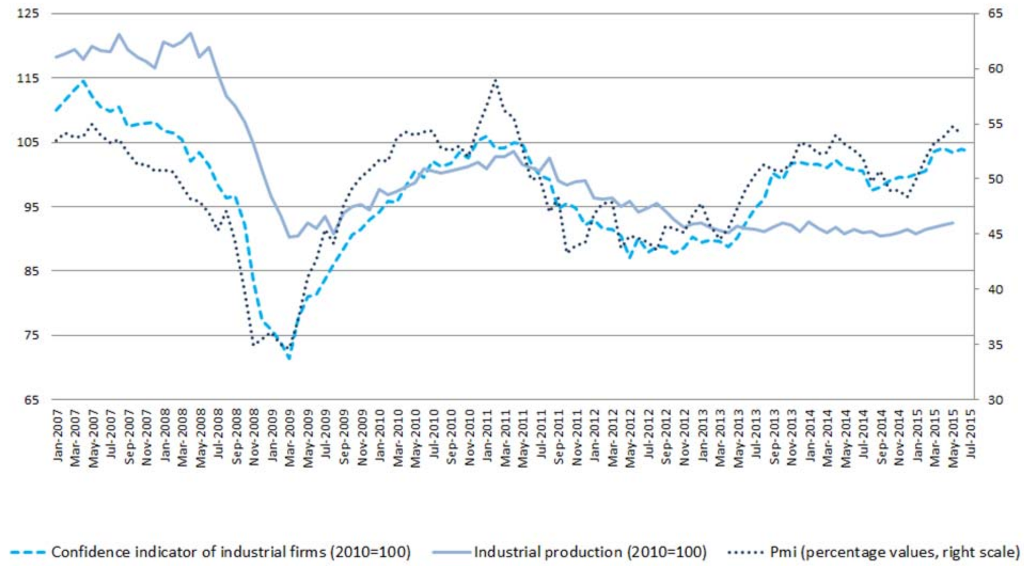


Source: Istat

In addition, it is possible that the recession has increased the dispersion of firms between those in better or worse condition. As a consequence, in the early stages of the recovery, growing firms are flanked by a group of predominately small businesses that continue to lag behind. Sample surveys of confidence might not capture this group of still-struggling enterprises. As the recovery spreads, this potential cause of the divergence between soft and hard data should be attenuated.

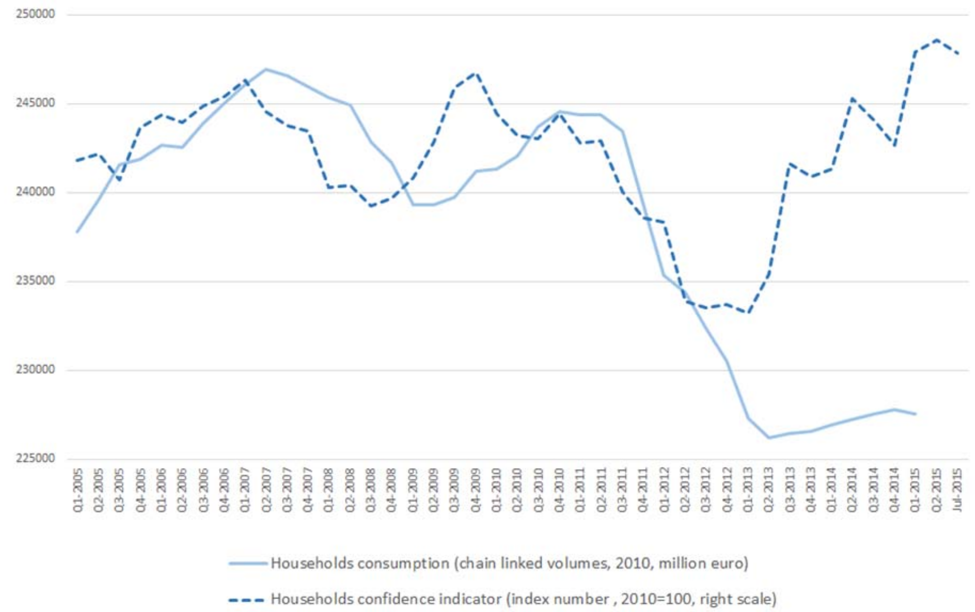
A gap between confidence indicators and actual performance can also be found among households (fig. 7). The improvement in the climate of confidence among consumers, under way since 2013, has been significant and was only partially corrected by the decline in July. The rise has been accompanied by modest growth in expenditure. Here, too, the emergence of households from the recession in dissimilar financial condition has had an impact. In addition, consumption spending has been held back by the need to rebuild the savings eroded during the crisis: in the two years ending in the first quarter of 2015, the purchasing power of households rose by 1.4 per cent, while their spending contracted by 0.4 per cent, with the propensity to save rising by 1.5 percentage points (to 9.2 per cent).

Fig. 6 **–** Industrial production, climate of confidence and PMI
(indices and percentages)



Source: Istat and MakitEconomics

Fig. 7 **–** Consumption expenditure and household confidence
(millions of euros and indices)



Source: Istat

A broader recovery in the second quarter

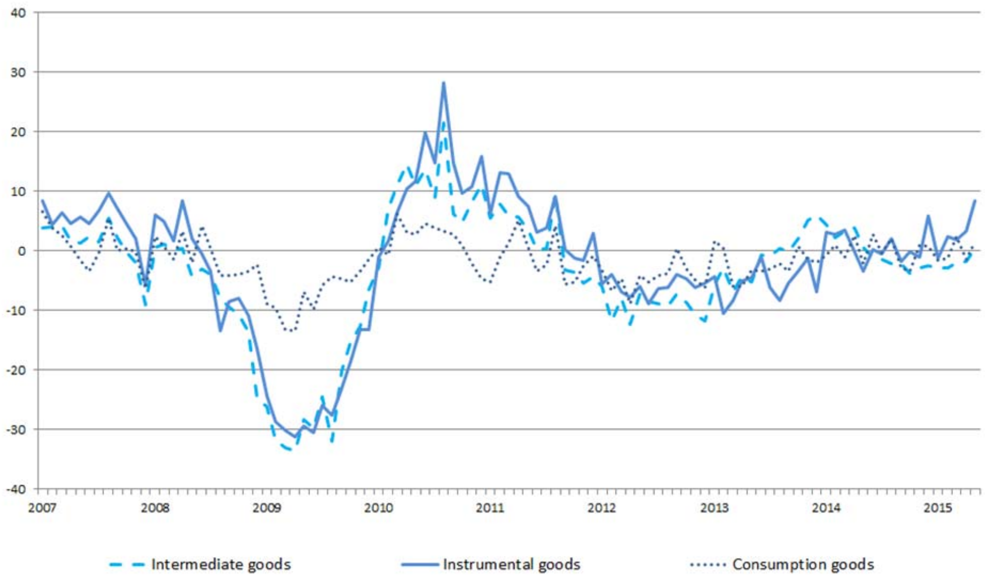
The cyclical indicators for April-June signal the continuation of the gradual recovery in the economy, at a pace close to that registered in the first quarter (between 0.2 and 0.3 per cent), with broader signs of growth among the components of demand. The improvement would be facilitated by the gradual easing of credit conditions for both households and businesses. The strong expansion in investment in transport equipment continued, driving the process of capital accumulation overall. By contrast, investment in construction slowed as the impetus of the temporary factors at work in the first quarter dissipated. Household consumption returned to the moderately positive path that characterised the slow recovery over the past year, benefiting on the one hand from an improvement in purchasing power but constrained, on the other, by the increase in the propensity to save. Exports were impacted only in part by the slowdown in the emerging economies, thanks to the depreciation of the euro and the geographical focus on the growing markets of North America and Europe. The contribution of net external demand to GDP growth could, however, be curbed by the acceleration in imports driven by part of the rise in internal demand, especially that for transport equipment.

At the industry level, the positive signals displayed by the manufacturing sector were confirmed. After a modest contraction in April, the index of industrial production jumped in May, increasing cumulative growth in the second quarter to about 0.9 per cent, accelerating from the pace in the first three months. If this were to continue, it could presage a gradual narrowing of the divergence between the qualitative indicators shown in Figure 6. The engine of growth in industry remains the production of capital goods, thanks to the marked recovery in the manufacture of automobiles in response to increased internal and external demand. Intermediate goods registered a more moderate recovery. Overall, in May the year-on-year trend in the general production index improved significantly (+3 per cent), reaching the pace of growth last seen in mid-2011 (Fig. 8).

The pattern of economic activity remains uneven in construction, where in May the production index slipped again (-0.6 per cent). The cyclical signals in the segment are highly fragmentary, suggesting a very gradual recovery. In the service sector, the information for the second quarter is still incomplete. In May, retail sales came to a halt after having performed well in April, owing to the adverse contribution of food products and a stagnating non-food segment. According to qualitative survey data, in July the climate of confidence in the market services segment improved further after its sharp rise the previous month, thanks to the strong performance of expectations for orders and the recovery in short-term expectations for demand (Fig. 9).

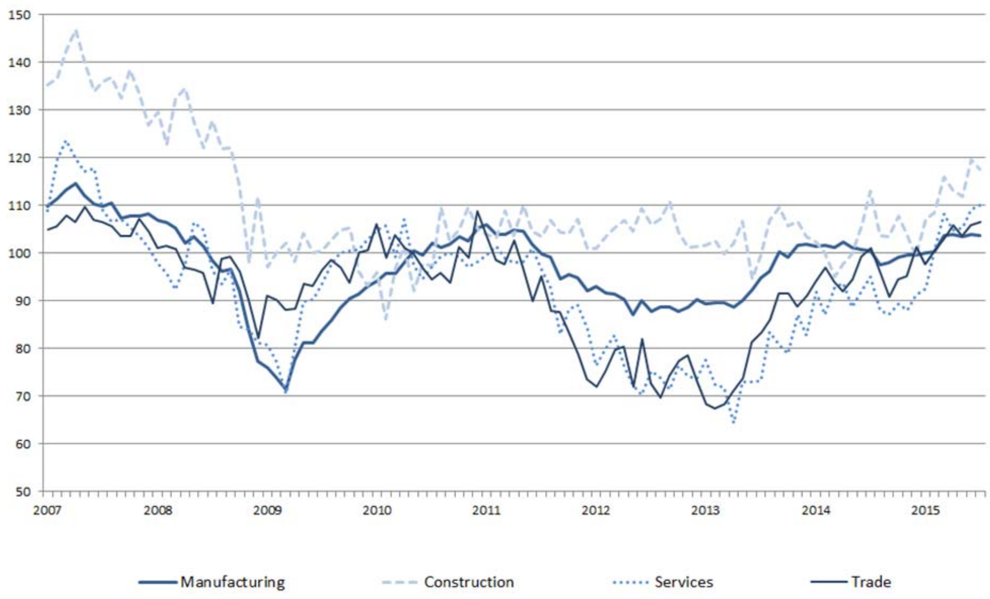
Overall, these developments appear consistent with GDP growth of 0.7 per cent, as forecast in the EFD in April. The more recent projections of forecasters do in fact tend to converge on this value.

Fig. 8 **–** Industrial production
(year-on-year percentage changes)



Source: Istat

Fig. 9 **–** Business confidence
(seasonally adjusted)



Source: Istat

Low inflation

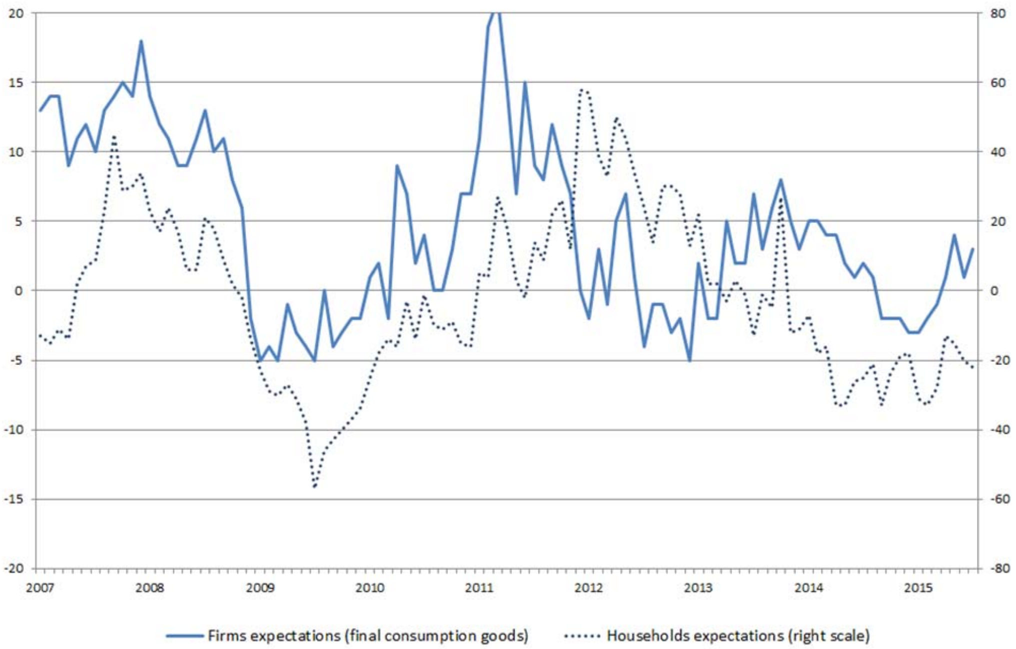
The moderation of the recovery and the slow growth in consumption have helped keep inflation very low, despite the weakening of the euro and the temporary rise in the prices of raw materials. In June, the year-on-year change in the general consumer price index was 0.2 per cent, a slight acceleration on the previous month (+0.1 per cent). Net of the most volatile components, core inflation remained unchanged at 0.6 per cent. The price expectations of businesses and consumers assume very small rises in the coming months. In July, the proportion of households expecting constant increases decreased, while the proportion expecting stability increased. Among firms, the surveys reveal no significant changes, with producers of consumer goods adopting a cautious approach to their pricing policies (Fig.10).

The labour market is slowly improving. After the stagnation registered between the end of 2014 and early 2015, the number of employed in April and May began to increase again (+0.3 per cent on the first quarter), while the unemployment rate was unchanged at the level to which it had fallen in the first quarter (12.4 per cent). More detailed information on employment developments from the Istat labour force survey is only available for the first quarter and diverges in part from that available from government sources of data on firms (Ministry of Labour and INPS). The Istat figures show that growth in the first quarter with respect to the same quarter of 2014 was driven by over-50s (with contractions registered in the other age classes) and, among employees, those on fixed-term contracts. By contrast, government sources show a substantial increase in hirings on permanent contracts in the first part of the year, consistent with the contribution relief introduced in January and the entry into force (as from March) of the new rules on individual layoffs. The discrepancies between sources regard year-on-year developments in the first quarter. A more uniform view could begin to emerge with the publication of the Istat survey for the second quarter.

Labour demand increasing

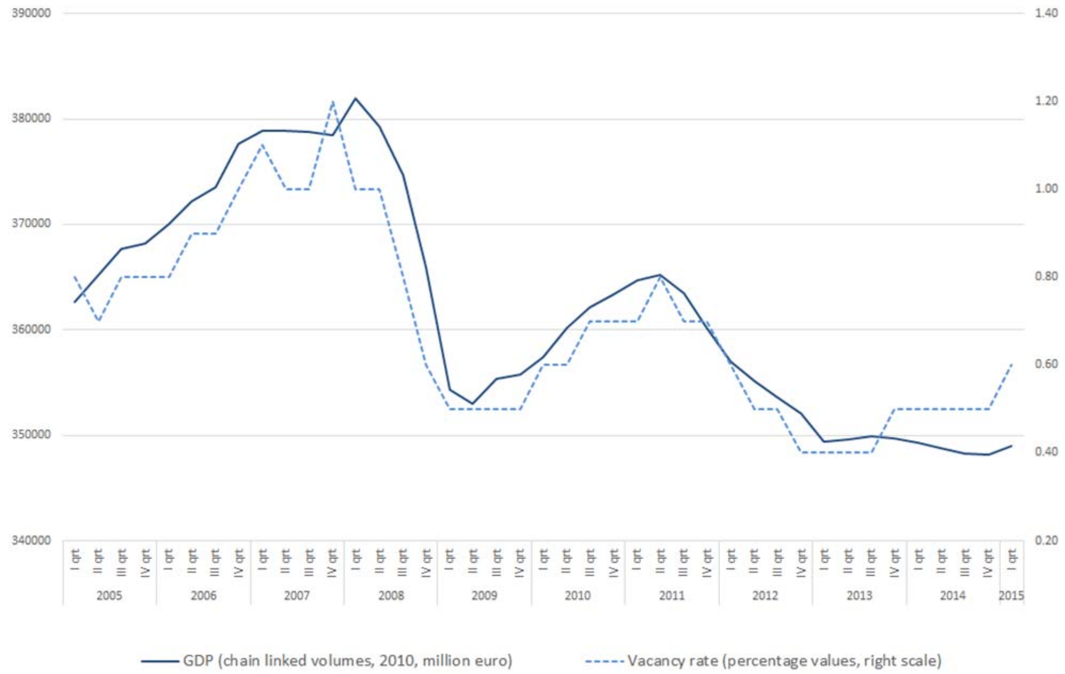
Positive signals have emerged for the demand for labour. Indicators point to the emergence of greater labour demand (as approximated by the vacancy rate, i.e. the share of unsatisfied demand) as long ago as the end of 2013, ahead of the economic recovery. A new increase in demand for labour was registered at the start of this year (Fig. 11). The increase in the vacancy rate, accompanied by the stabilization of the unemployment rate, does not appear to indicate heightened strains in the labour market as a result of mismatching with supply, and could in fact be a prelude to improvements in employment data as well.

Fig. 10 **–** Price expectations of businesses and households
(seasonally adjusted)



Source: Istat

Fig. 11 **–** GDP and job vacancies
(millions of euros and percentages)



Source: Istat