Summary[*]

The global economy appears to be heading towards the recovery. Nevertheless, in some countries the coronavirus is still widespread and in those where the peak was passed some time ago the risk of a second wave remains high. In June, the International Monetary Fund lowered its April forecasts, which had already pointed to an unprecedented global recession. The sharp decline in oil prices and the drop in demand have lowered inflation expectations. Central banks have responded proactively with highly expansionary monetary policies.

Italy was one of the first Western countries to be hit by the pandemic, and in the first half of the year GDP fell by more than a sixth. The recession has heavily impacted the use of labour, but jobs have largely been preserved by the extension of the wage supplementation scheme and a temporary moratorium on firing. According to the available indicators, the cycle should turn upwards in the third quarter, but the rebound will be partial.

According to PBO forecasts, Italian GDP will contract by 10.4 per cent this year, compared with the decline of 7.8 per cent projected in April during the endorsement exercise for the Government's forecasts. The downward revision is mainly due to the longer-than-expected duration of the lockdown and the further deterioration of international conditions. This still considers the substantial stimulus of fiscal policy, which is expected to add about 2.5 percentage points of support to GDP this year. Assuming that there are no new waves of the epidemic in Italy, GDP is projected to expand by 5.6 per cent next year.

Considering the decrees already approved and the additional budget deviation recently requested, the budget deficit, which was 1.6 per cent of GDP in 2019, is expected to be around 13 per cent in 2020, before falling by almost half next year. The ratio of debt to GDP is put at over 160 per cent in 2020 (from 134.8 per cent in 2019), while next year the ratio is expected to decline – mainly thanks to growth in output – but would still remain above 160 per cent.

The macroeconomic environment in which the Italian economy is operating is shadowed by extraordinarily high uncertainty, with the risks mainly oriented towards the downside. A resurgence of the pandemic cannot be ruled out even in countries where the spread of the virus currently appears modest. Furthermore, even when an effective vaccine will be available to enable the beginning of a solid global recovery, any cyclical divergences between countries or the premature normalisation of economic policies would impact the risk premiums of sovereign issuers with high debt levels, such as Italy.

[*] *Prepared by the Macroeconomic Analysis Department. Information updated to 4 August 2020.*

The international environment

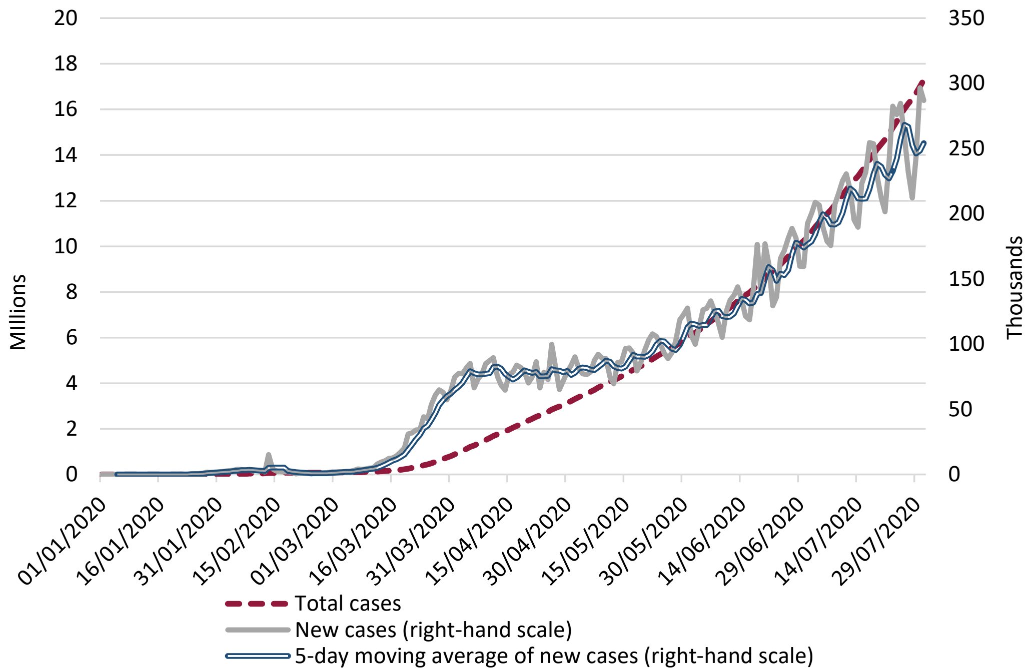
Economic conditions begin to normalise, but the pandemic is in an explosive phase

Some seven months from the outbreak of the pandemic, leading indicators suggest that the global economy is heading towards recovery. However, the spread of COVID-19 (Figure 1) in various countries remains exponential, and even in those where the peak has long since passed, the risk of a second wave remains high.

After plunging well below 50 (the dividing line between the zone indicating a contraction and that indicating an expansion) in April, the global purchasing managers' confidence indices (PMIs) began to point to a recovery in economic activity in May and June (Figure 2). In China, where the pandemic originated, the containment measures have allowed the national economy to restart relatively quickly, and the PMI returned to the expansion zone in May. However, the first signs of growth in the Western countries only appeared in July, when the flash PMIs in the United States, the euro area and the United Kingdom rose above 50.

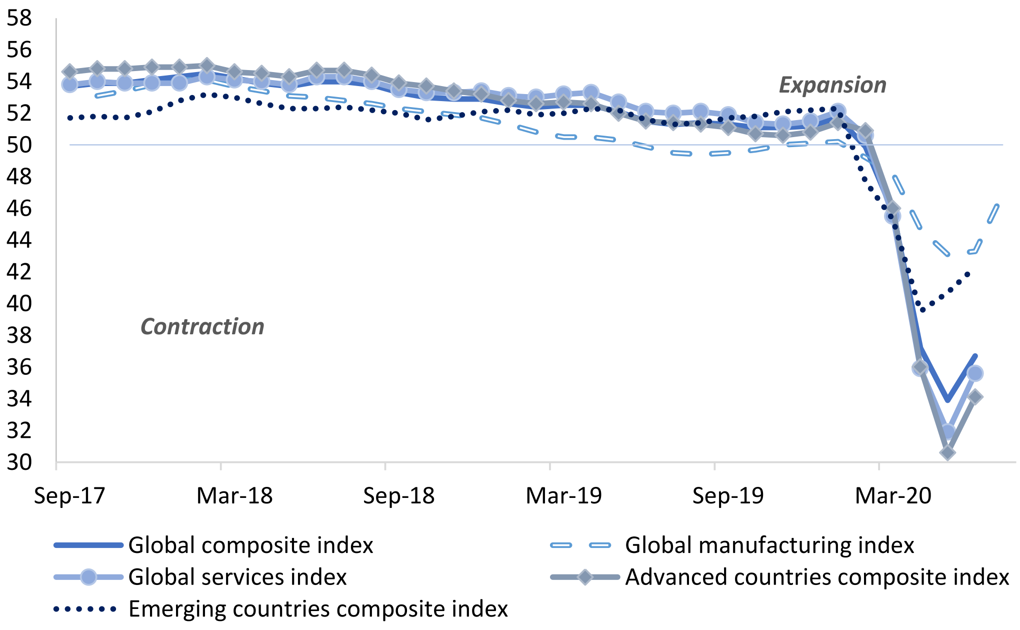
Gross domestic product has returned to growth in China. After contracting by 6.8 per cent on an annual basis in the first three months of the year, in the second quarter GDP rebounded by 3.2 per cent, driven in particular by the industrial sector. In the United States and Europe, where the epidemic spread with a lag, the second quarter was the hardest hit, with quarter-on-quarter contractions in GDP of 12.1 per cent for the euro area

Figure 1 – Spread of COVID-19 around the world



Source: European Centre for Disease Prevention and Control.

Figure 2 – JP Morgan Global PMI (1)
(three-month moving average)



Source: IHS Markit.
(1) Confidence indicators based on the assessments of corporate purchasing managers. A value of more than 50 indicates an expansion.

and 9.5 per cent for the United States. In March and April, payrolls in the United States fell by 22 million and the unemployment rate rose to 14.7 per cent (from 3.5 per cent in February); in May and June there was a recovery of about 7.5 million jobs and the unemployment rate fell to 11.1 per cent. In the euro area, where the social protection system provides greater protection to workers, the rise in unemployment has been relatively limited (going from 7.1 per cent in March to 7.8 per cent in June).

The equity markets have reacted sharply, swiftly and, initially, in synchrony. From the beginning of the year until the low posted on 18 March, the equity indices of the major markets lost about 30 per cent on average. A slow recovery began thereafter, and by the end of July losses had narrowed to 7 per cent for the German index (DAX) and about twice that for US stocks.

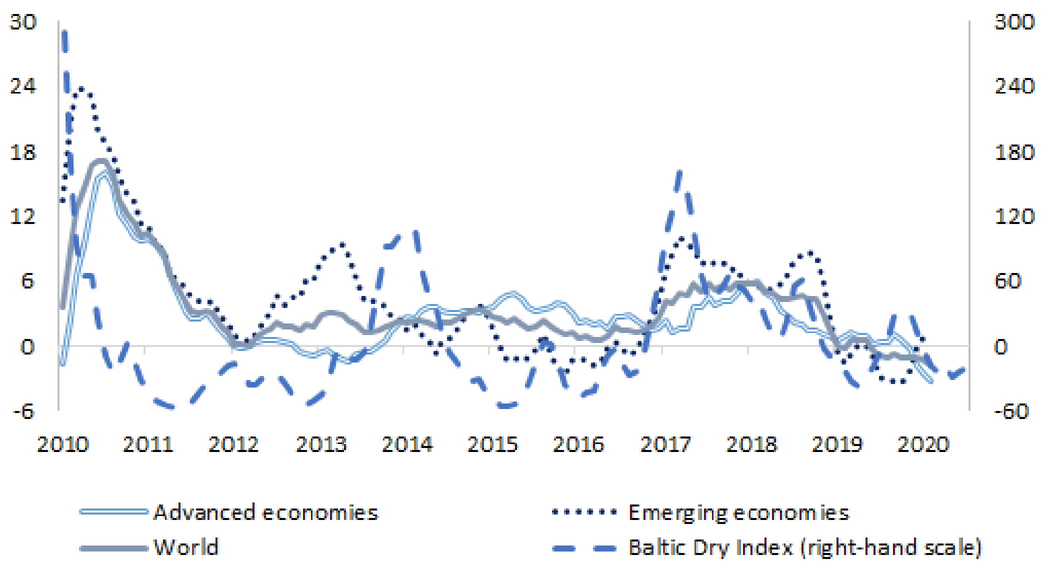
From the agreement between the United States and China to the collapse in trade as a result of the pandemic

The year 2020 had opened with encouraging signs for international trade. After two years of escalating trade tensions between the United States and China, the two countries signed an agreement in January for an initial phase of easing tensions. The agreement headed off the introduction of further restrictions and removed some of the US tariffs on Chinese products that had already been introduced, while the Chinese authorities committed to improve protection of intellectual property rights, to liberalise the financial markets and to increase imports of US goods (by $200 billion a year). In January, the International Monetary Fund (IMF) forecast that international trade would strengthen this year, with an elasticity in respect of output returning close to one. The outbreak of the pandemic in March dramatically altered the outlook. Globalisation and close links between countries in global value chains generated bottlenecks in the production of goods that make significant use of imported intermediate inputs and conditions deteriorated rapidly. The year-on-year change in the three-month moving average of the maritime freight rates indicated in the Baltic Dry Index (Figure 3) went from 31 per cent in November 2019 to -18 per cent in July 2020. According to data from the Central Planning Bureau, in May the world trade index fell by 13.6 per cent.

The International Monetary Fund revises its forecasts downwards again

In the June update in the *World Economic Outlook*, the IMF again lowered its April forecasts (Table 1), which had already delineated an unprecedented global recession. In 2020, GDP is expected to contract in all the advanced economies and in most developing nations. One of the few countries that should record positive growth is China (1.0 per cent), although output will decline in per capita terms. World GDP is set to contract by 4.9 per cent, a downward revision of 1.9 percentage points compared with the April estimates. The advanced economies are expected to see output decrease by 8.0 per cent, while the emerging markets would post a fall of 3.0 per cent. The IMF's forecasts for trade are even more pessimistic, as they point to a contraction of 11.9 per cent, a drop not seen since the global financial crisis.

Figure 3 – Growth rate of imports and index of maritime freight costs
(annual percentage change in 3-month moving average)



Source: based on CPB and Refinitiv data.

Table 1 – IMF forecasts
(percentage change and difference in percentage points)

	WEO update June 2020			Difference with WEO April 2020	
	2019	2020	2021	2020	2021
World GDP	2.9	-4.9	5.4	-1.9	-0.4
Advanced economies	*1.7*	*-8.0*	*4.8*	-1.9	*0.3*
United States	*2.3*	*-8.0*	*4.5*	-2.1	*-0.2*
Euro area	*1.3*	*-10.2*	*6.0*	-2.7	*1.3*
Emerging economies	*3.7*	*-3.0*	*5.9*	*-2.0*	*-0.7*
World trade	0.9	-11.9	8.0	-0.9	-0.4

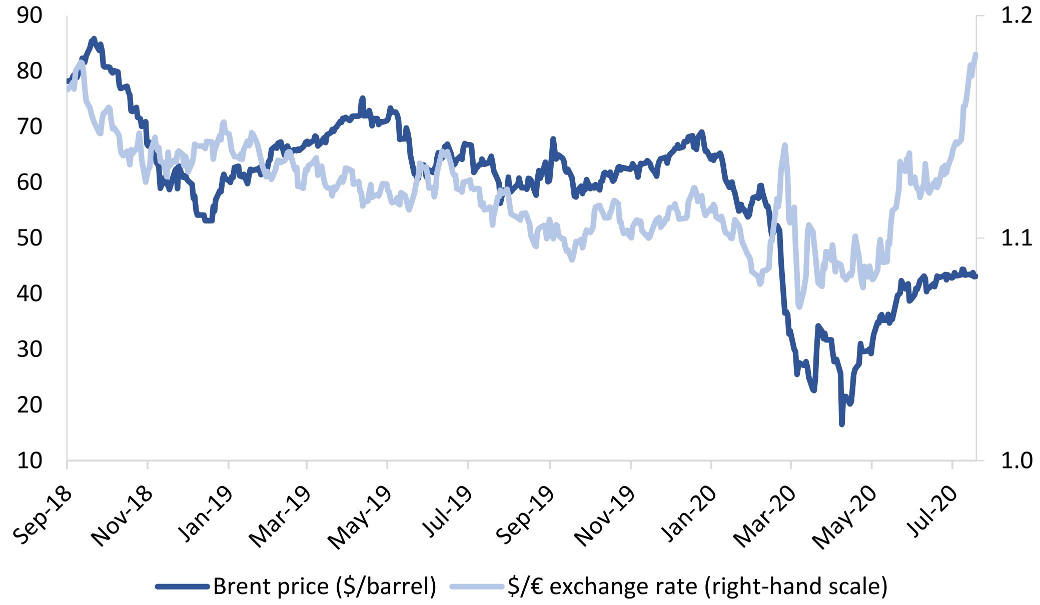
Source: IMF (2020), World Economic Outlook update, June.

Oil prices remain weak and the euro strengthens

The pandemic has had a major impact on the oil market. Already in early February, expectations of a substantial contraction in demand produced strong downward pressure on prices. To contain this pressure, the OPEC+ countries sought an agreement to reduce supply. The initial rejection of the deal by Russia had prompted Saudi Arabia to threaten to increase output and sell its oil at a discount. The oversupply caused a significant reduction in available storage capacity, especially in the United States, leading to negative prices for WTI with delivery in May. With the support of the US administration, motivated by the fear that excessively low prices would cause a wave of bankruptcies among American producers (whose breakeven point is much higher than that of the Middle Eastern countries), in mid-April OPEC+ committed to reduce output by 9.7 million barrels per day, about 10 per cent of global supply. The price of oil has slowly recovered since, with the price of Brent returning above $40 a barrel in the second half of June (Figure 4). Finally, in mid-July, the prospects of a slow recovery led to a reduction of the production cuts agreed three months earlier to 7.7 million barrels a day, without significantly affecting prices. In the second half of July, Brent was stably above $43 a barrel.

Since the beginning of 2018, the exchange rate of the euro against the dollar had displayed a weak negative trend, albeit interspersed with short periods of strengthening. From the beginning of May, however, the euro began to appreciate against the dollar and, to a lesser extent, against other currencies. It was initially driven by the aggressive monetary policy of the Federal Reserve, while more recently it has strengthened due to the optimism of operators regarding approval of the Recovery Fund within the Next Generation EU instrument and the worsening of the spread of the pandemic in United States. From $1.08 per euro at the beginning of May, the European currency appreciated by about 9 per cent by the end of July, reaching around $1.18 to the euro.

Figure 4 – Oil prices and dollar/euro exchange rate



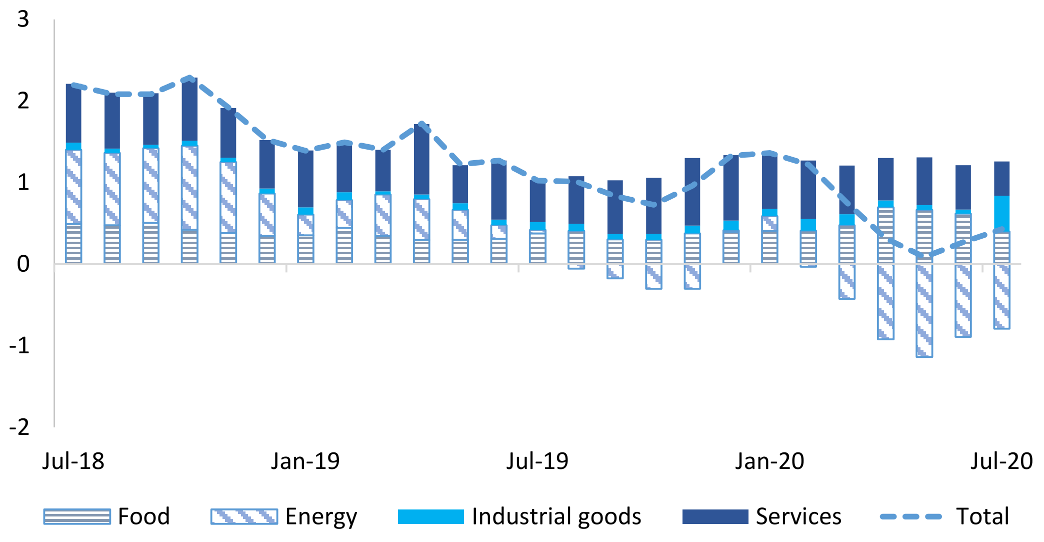
Source: Refinitiv.

Euro-area inflation expectations have fallen sharply

Between the end of 2019 and February 2020, euro-area inflation fluctuated between 1.2 and 1.4 per cent on an annual basis, similar to developments in core inflation. With the spread of the pandemic, the collapse in oil prices and the contraction in demand, inflation began to decline, falling to 0.1 per cent in May before rising to 0.3 per cent in July (Figure 5). The slowdown in consumer prices mainly reflected the energy component. Excluding energy, food and tobacco, core inflation accelerated to its February pace in July (1.2 per cent).

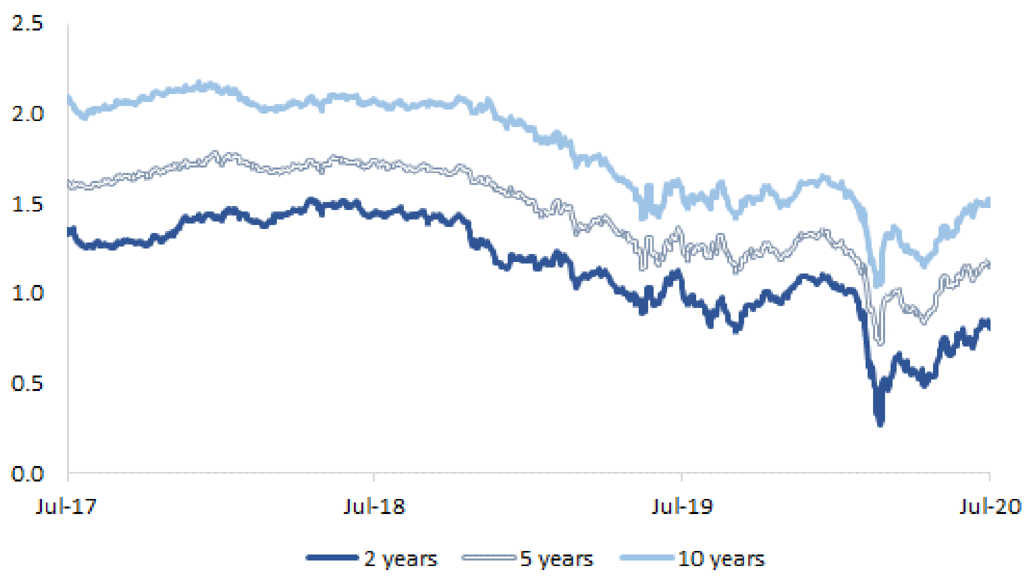
Inflation expectations had already experienced a decline in January, only to fall further with the spread of the pandemic in Europe. Countercyclical economic and monetary policy measures reversed this trend, and expectations have recovered since the end of March. At the end of July, 5-year expectations stood at around 1.2 per cent, while those at 2 and 10 years were about 35 basis points below and above that level, respectively (Figure 6).

Figure 5 – Inflation in the euro area
(percentage year-on-year change and contributions)



Source: based on Eurostat data.

Figure 6 – Inflation expectations implicit in inflation swaps
(percentages)

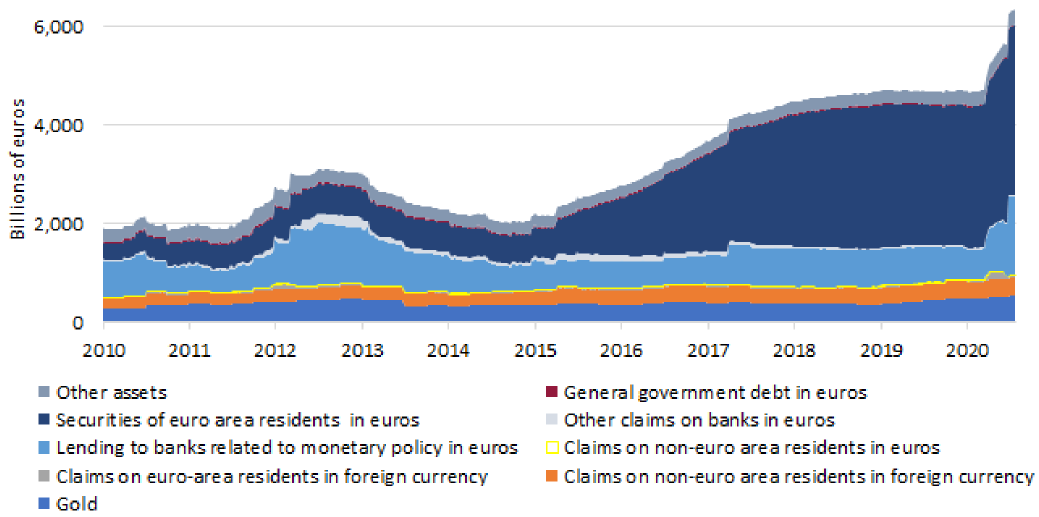


Source: Refinitiv.

At the last meeting of the Governing Council, on 16 July, the ECB left its official rates for main and marginal refinancing, as well as that for deposits, unchanged at 0.00, 0.25 and -0.50 per cent, respectively. At the same meeting, the ECB also reaffirmed that the Pandemic Emergency Purchase Programme (PEPP) would continue, with total resources of €1,350 billion. These purchases accentuate the expansionary tilt of monetary policy

(Figure 7), thus helping to offset the downward pressure on inflation. In addition, the asset purchase programme (APP) will also continue at a monthly pace of €20 billion until the end of the year. The Council also reaffirmed its commitment to reinvest principal repayments on maturing securities under both the PEPP and the APP.

Figure 7 – Eurosystem consolidated assets
(billions of euros)



Source: ECB.

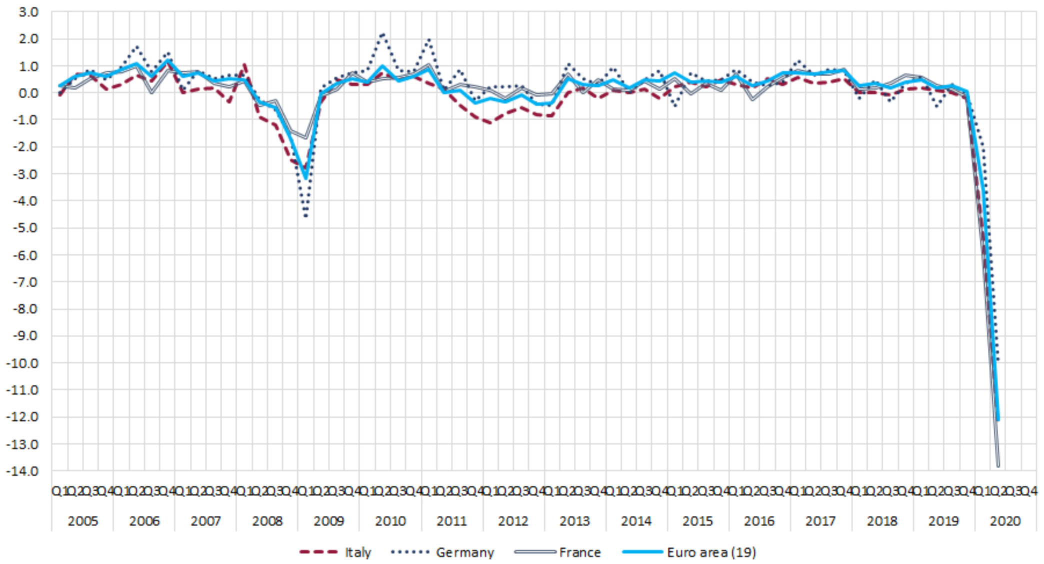
The Italian economy

GDP contracts sharply in the second quarter, in line with the euro area

Conditions in the Italian economy, which stagnated overall last year, deteriorated rapidly in the first quarter due to the COVID-19 pandemic. GDP contracted by 5.4 per cent on the previous quarter, more than half a percentage point more than indicated by preliminary estimates (released on 30 April).

The initial GDP data for the second quarter, published by Istat at the end of July, show an unprecedented decrease in GDP (-12.4 per cent on the previous quarter; -17.4 on the corresponding period of 2019). The contraction of the Italian economy is almost in line with that of the euro area (-12.1 per cent; Figure 8), compared with a smaller decline in Germany (-10.1 per cent) and a larger one in France (-13.8 per cent) and Spain (-18.5 per cent). The contraction of economic activity in Italy in the second quarter of the year reflected the loss of production in all major sectors. On the demand side, the negative contribution of net exports is likely to have been smaller than that of the national component (before inventories). The decrease in Italy's GDP already acquired for 2020 is 14.3 per cent.

Figure 8 – GDP of euro area and its three largest economies
(percentage change on previous quarter)



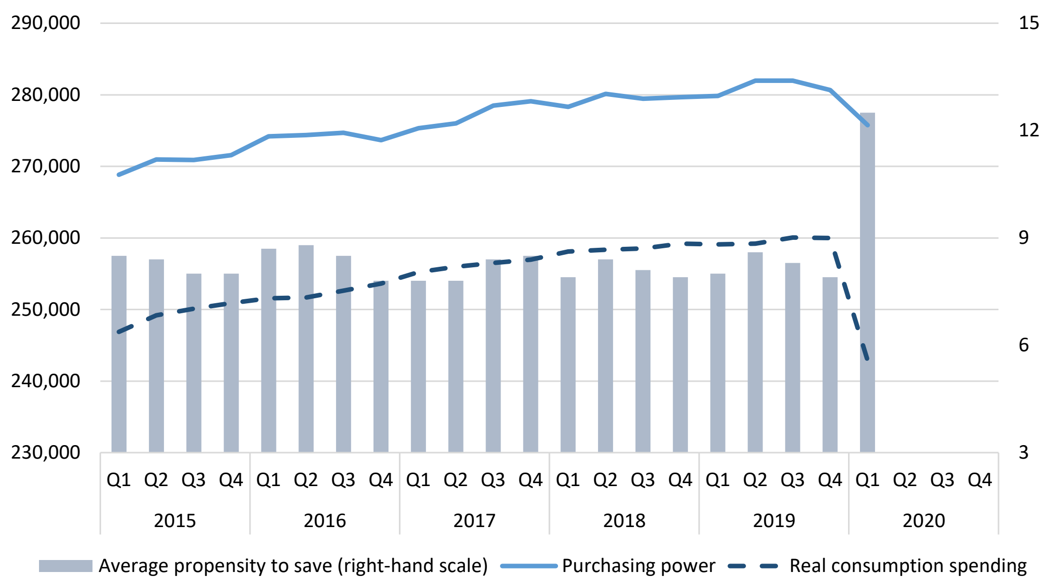
Source: Eurostat.

Consumption spending also reflects an increase in the propensity to save

The spread of the pandemic and the consequent containment measures imposed in March had a strong impact on household spending decisions. Demand stalled with the exception of a few items of expenditure, mainly food and pharmaceuticals. This produced a pronounced quarterly decrease in final consumption expenditure in the first quarter (-6.4 per cent). The contraction in household purchasing power (-1.6 per cent compared with the previous quarter) was attenuated by the recently implemented economic policy measures, such as the expansion of the Wage Supplementation Fund and the temporary ban on firing. Household propensity to save jumped in January-March to 12.5 per cent of disposable income, more than four points higher than the average for 2019 (Figure 9).

According to the consumption indicator developed by Confcommercio, household spending in March and April decreased on average by about half in volume terms compared with February and to an even greater extent for some types of durable goods, such as automobiles. Spending recovered in May, with further consolidation in June. The most recent surveys for July show a slight decrease in the climate of consumer confidence compared with the previous month, due primarily to household caution about economic conditions and the outlook. A breakdown of the findings by current/future outlook and views of the general economic situation/personal financial circumstances highlights how the decline in the aggregate index in the last month was induced by a deterioration in expectations for the state of the economy, while assessments of personal circumstances improved. A possible increase in precautionary savings could slow consumer spending in the second half of the year.

Figure 9 – Household purchasing power, consumption and saving
(millions of euros, chain-linked values, 2015 and percentage shares)



Source: Istat.

Investment is held back by unused capacity and the uncertain outlook

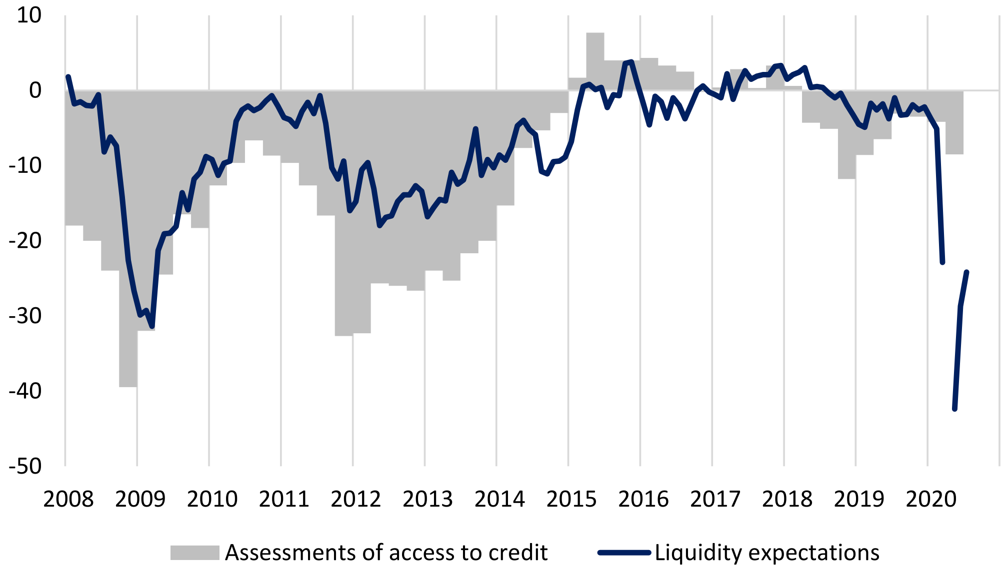
The quarterly growth in capital accumulation gradually weakened in 2019 before stagnating in the final part of the year. The spread of the pandemic in the first quarter of 2020 initially interrupted global supply chains and then required the temporary closure of non-essential industries in Italy. Investment spending was sharply affected, with an average decline in January-March of 8.1 per cent compared with the previous quarter. The investment rate (the ratio of gross fixed capital formation to value added) fell to 20.9 per cent, continuing the trend that has characterised the last two years. Profitability (measured as the ratio of gross operating profit to value added at basic prices for non-financial corporations) stood at 42.3 per cent, virtually unchanged on the average for the last two years.

The most recent surveys point to a recovery, albeit a very moderate one. The Bank of Italy-Sole 24 Ore Survey on Inflation and Growth Expectations for May-June reveals a pronounced downward revision of current assessments of the general economic situation compared with the findings of the March survey. Short-term expectations for sales and operating conditions for businesses are less pessimistic, but a contraction in investment is expected in the second half of the year, due in part to the uncertainty perceived by firms. Istat’s July survey of business confidence showed an improvement in the indicator of domestic orders for capital goods compared with the previous two months, although it remained below pre-crisis levels. According to the Istat survey on capacity utilisation and the obstacles to production by manufacturing firms, capacity utilisation in the second quarter stood at 63.6 per cent, about fifteen points less than the average for the last two years. At the same time, there was a jump in the share of companies that reported facing obstacles to production (46.3 per cent compared with 24.6 per cent in 2018-2019), in particular because of insufficient demand.

The liquidity conditions for the manufacturing sector improved slightly in July (-24.2 compared with -28.7 in June and the historic low of -42.4 in May), but remain at values close to those recorded during the global financial crisis. Lending conditions deteriorated moderately (Figure 10).

These dynamics appear less favourable than those found in the Bank of Italy’s July survey of bank lending, which indicates an easing of the lending conditions for firms thanks to an increase in the risk tolerance of lenders. On the demand side, borrowing by businesses increased significantly due to the huge liquidity requirements associated with the health emergency, while household borrowing decreased in reflection of the deterioration in the prospects for the real estate market.

Figure 10 – Assessments of credit conditions and liquidity expectations in manufacturing
(difference between percentage shares of positive and negative responses)



Source: Istat.

The most recent quantitative indicators show average growth in lending to firms in February-May of 11.5 per cent compared with the same period of the previous year, facilitated by the expansionary policies of the ECB and by the measures to support bank lending deployed by the Government.[2] The increase in the flow of credit mainly involved medium- and long-term loans, initially for larger companies and subsequently also for the small businesses. In the first quarter, some progress was also made in consolidating bank balance sheets, reflecting better lending policies. The flow of new impaired loans as a proportion of total lending was unchanged compared with the previous period, while the ratio of impaired loans to total lending by significant banking groups decreased, both gross and net of value adjustments.

Exports are affected by the decline in trade and tourist flows

The contraction in international trade following the pandemic led to a sharp slowdown in the volume of exports in the first quarter of the year (-8.0 per cent on the previous quarter; -7.5 per cent compared with the same quarter of 2019). Italian foreign trade was also significantly affected by the impact of the pandemic on tourism, with a very large contraction in the services segment (-21.8 per cent compared with the previous quarter).

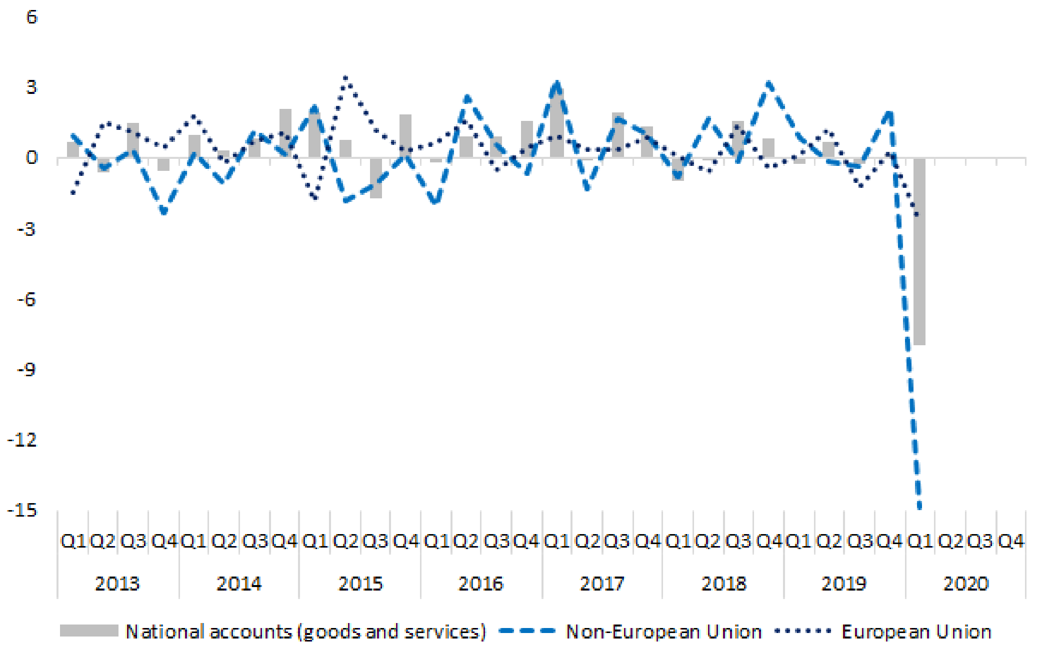
[2] See the memorandum of the Chairman of the PBO on Bill AC 2461 ratifying Decree Law 23 of 8 April 2020 (the Liquidity Decree), available at http://en.upbilancio.it/memorandum-of-the-chairman-of-the-pbo-on-bill-ac-2461-ratifying-decree-law-8-april-2020-n-23-the-liquidity-decree/ (Summary only. Full text in Italian)

With regard to export markets (Figure 11), sales of goods outside the European Union decreased much more than exports within the EU.

On average in April-May, the volume of foreign sales of goods registered a further steep decline (-28.2 per cent compared with the average for the first quarter), with virtually identical contractions in the two areas considered. The most recent data from June on exports in value terms to non-EU countries indicate a substantial increase on the previous period (14.9 per cent), although the year-on-year decline is still significant (-15.6 per cent). Surveys appear to anticipate a recovery in foreign demand in the summer: current assessments of foreign orders in July were less pessimistic and short-term expectations for turnover from exports improved (from -16.0 in January-March to 8.2 in the second quarter).

Imports decreased significantly in the first quarter of the year (-6.2 per cent), although the fall was still less pronounced than that in exports. The outlook for the volume of imports remains highly negative. Interrupting the decline that began in February, imports in value terms from non-EU economies also showed an initial sharp increase in June (20.0 per cent compared with May), although they remained at levels well below those of the corresponding month in 2019 (-17.0 per cent).

Figure 11 – Change in exports (total and by geographical area) (1)
(percentage change on previous period)



Source: Istat.
(1) The histograms represent changes on the previous period in the chain-linked values of total exports drawn from the national accounts. The lines show changes on the previous period in the volume of exports of internationally traded goods.

The latest economic indicators point to a partial rebound

Industrial production in March and April recorded two unprecedented contractions (respectively 20.5 per cent and 28.4 per cent on the previous period) due to the lockdown. With the reopening of the economy in May, the trend reversed decisively (with an increase of 42.1 per cent compared with April), but the level of activity is still about a fifth lower than the corresponding level in 2019. The PMI for the manufacturing sector returned to expansionary territory in July, at 51.9 (from 47.5 in June), consolidating the recovery from the historic low registered in April (31.1). The Istat index of manufacturing confidence also rose in July, reflecting the improvement in all the components of the aggregate indicator, continuing the recovery that began the previous month.

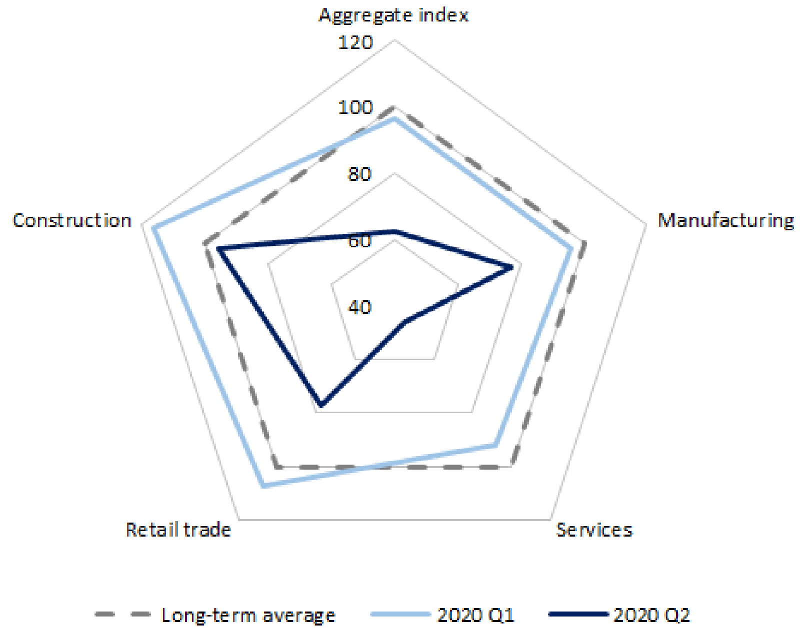
Similarly, activity in construction more than doubled in May (up 168.0 per cent on the previous period), but remained more than a fifth lower than in the same period of 2019. In the first quarter, the volume of sales decreased by 15.3 per cent compared with the previous three months, with the outlook still oriented downwards on average for the second quarter. In the housing market survey conducted in May and June by the Revenue Agency, the Bank of Italy and Tecnoborsa about two-thirds of the real estate agents interviewed forecast that house prices would continue to decline through this year and into the next.

The consequences of the health emergency for the services sector have been even more severe, especially with regard to international tourism. By the end of January, the number of visitors had already fallen sharply, reflecting restrictions on arrivals of visitors from China, limitations that were then extended to other areas as well. The subsequent lockdown required a shut down for restaurants, trade fairs and conferences, air and rail transport and the logistics sector as a whole. After posting a record low in April (at 10.8), the PMI for the sector reached a level (46.4) close to stabilisation in June.

For all sectors, the composite index of business confidence deteriorated significantly in the second quarter, falling to well below the long-term average, with the sole exception of construction (Figure 12). The data for July show signs of widespread recovery, but at a level still below those recorded before the pandemic.

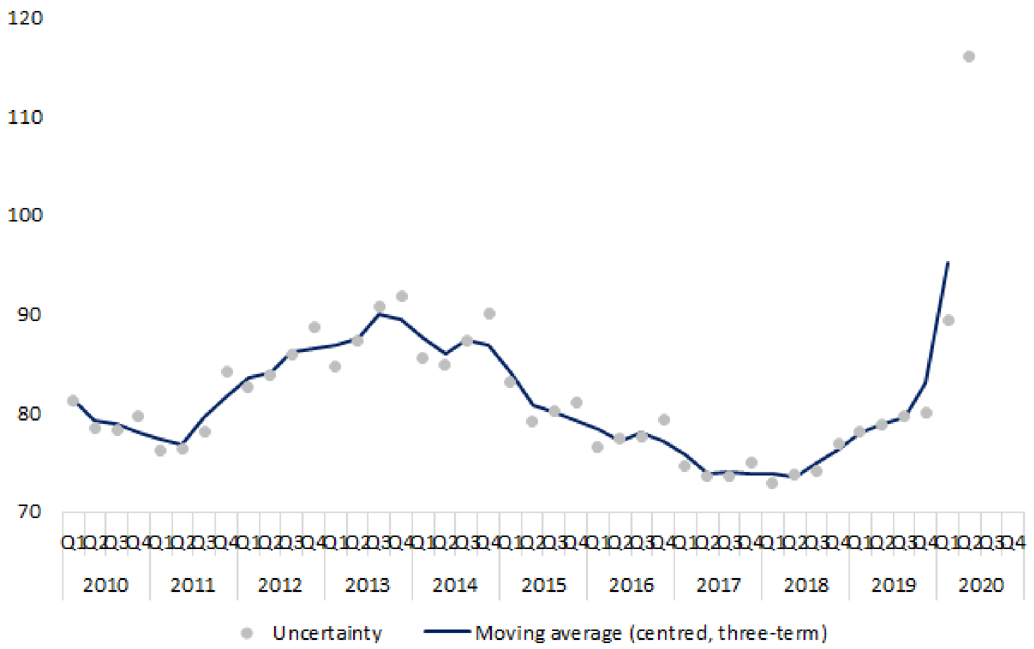
The uncertainty of households and firms increased for the ninth consecutive quarter: the PBO index of uncertainty registered historically high values, even above those seen in the most significant crises of the last thirty years (such as the exit of the lira from the EMS in 1992, the global financial crisis of 2008-2009 and the sovereign debt crisis of 2012), reflecting in particular the jump recorded by the market services and retail trade components (Figure 13).

Figure 12 – Confidence in productive sectors (1)
(index; average January 1998 – June 2020 =100)



Source: based on European Commission and Istat data.
(1) The aggregate confidence indicator is constructed by applying the weights used by Istat to produce the Istat Economic Sentiment Indicator (IESI) to the time series (standardised) of sectoral confidence indicators of the European Commission.

Figure 13 – PBO indicator of uncertainty (1)
(index; 1993 Q1=100)



Source: based on Istat data.

The recovery in economic activity now under way, although partially and unevenly spread across sectors, is also reflected in the most timely monthly variables (Figure 14). The consumption of gas for industrial uses in June increased for the second consecutive month, but remains almost fifteen percentage points lower than in the same month of 2019, with a similar pattern in electricity consumption. Automobile registrations, after having almost disappeared during the lockdown, recovered in May and June but are still far from their pre-pandemic levels (-23.1 per cent in June compared with the same month in 2019).

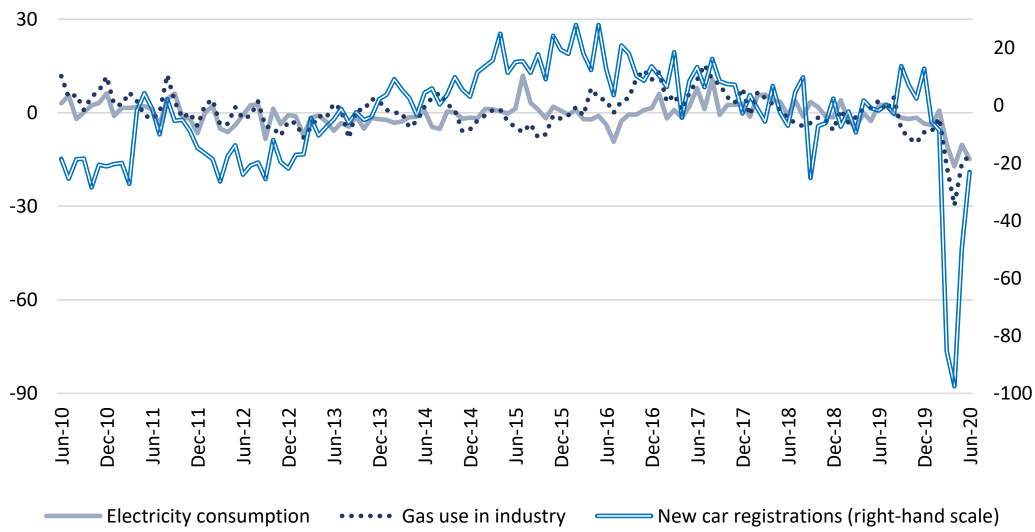
Fixed-term employment collapses and volatility of labour market participation increases

The labour market has also been severely impacted by the pandemic. The closure of a significant portion of the production base reduced the number of hours worked per person in employment in the first quarter (-7.2 per cent on the previous period according to national accounts data) by even more than the contraction in GDP. In the same period, the decrease in the number of persons in employment was markedly less pronounced (-0.5 per cent), albeit with a significant contraction in the fixed-term component.

The decline in employment intensified in April, when the permanent component also began to deteriorate and the fixed-term component fell sharply. In May, with the gradual reopening of economic activity, the contraction in employment began to slow (-0.6 per cent). This development continued in June, when it decreased only slightly.

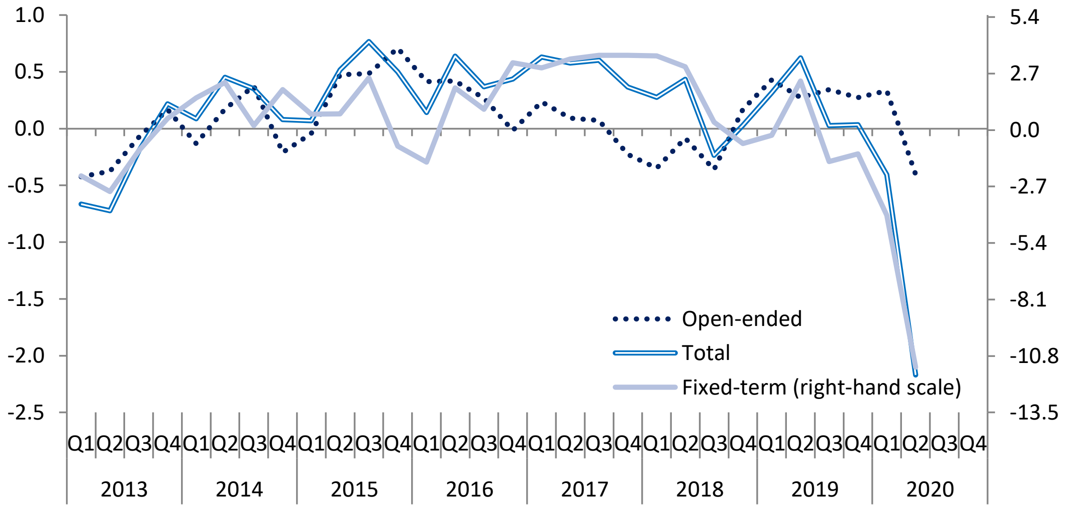
On average in the second quarter employment decreased by 2.0 per cent compared with the first (about 460,000 fewer people). The fall in the number of payroll employees (Figure 15)

Figure 14 – Real-time indicators of economic activity
(percentage year-on-year change)



Source: Terna, Snam and ANFIA.

Figure 15 – Change in payroll employment
(percentage change on previous period)



Source: Istat.

was mainly affected by the exceptional decline in fixed-term work (-10.4 per cent). The worst affected were employed persons aged under 35 (-5.3 per cent) and holders of fixed-term contracts that were not renewed upon expiry or the self-employed.

Data from the mandatory reporting of new hirings, terminations or contract transformations[3] indicate that between the outbreak of the pandemic (23 February) and the end of the closure of economic activity (3 May) the change in net employment was sharply negative (585,000 fewer than in the same period of 2019). The contraction in activations of new contracts was much more severe than that in terminations, as the latter were reduced by the moratorium on firings. In May, with the reopening of economic activity, net employment showed a slight increase, entirely attributable to permanent contracts. Looking forward, the postponement to 30 August of the possibility of extending or renewing of expiring fixed-term contracts, even in the absence of the reasons provided for in the "Dignity Decree", could limit the negative impact on employment of contract terminations expected in the coming months (approximately 600,000 in June-July, more than half of which are in industry, retail trade and tourist services).

The impact of the COVID-19 crisis on the number of persons in employment has been limited by the exceptional extension of the wage supplementation programmes to all companies, regardless of the industry or number of employees. According to INPS data, the hours of wage supplementation for COVID-19-related reason authorized in the second quarter amounted to over 2 billion, an exceptionally high value in historical terms. The actual use of the hours of wage supplementation authorised in April-May is estimated to be 63.0 per cent.[4]

[3] See ANPAL (2020), "Approfondimenti COVID-19", Nota periodica n. 3.

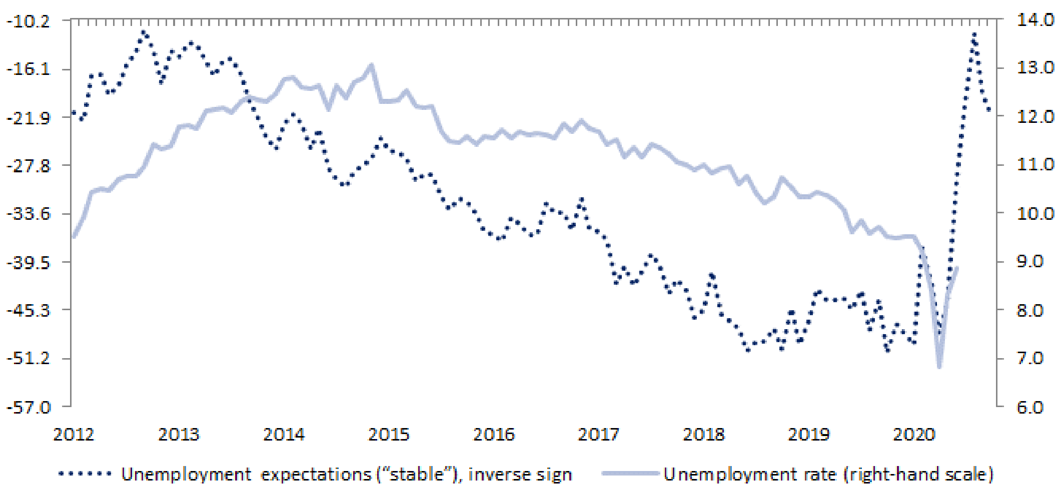
[4] See Ufficio parlamentare di bilancio (2020), "Informal hearing of the Chairman of the Parliamentary Budget Office as part of the fact-finding enquires preliminary to the examination of the NPR", July (Summary only. Full text in Italian).

The extension of wage supplementation, combined with the moratorium on initiating collective or individual dismissal procedures (effective from 17 March), has preserved the employment base, maintaining the professional skills of workers within firms. However, the extension of the moratorium during the recovery could delay the adjustment within companies, in the light of the new market conditions. If the moratorium gradually becomes more selective, the job search effort of unemployed could benefit from the economic recovery, however moderate, with possible benefits in the reallocation of workers already in employment.[5]

The dynamics of people seeking employment during the health emergency (-21.1 per cent on average in March and April compared with the previous two months) was considerably affected by social distancing measures. As job search was more expensive and less effective, the unemployed temporarily withdrew to full inactive status. The rise in the number of inactive individuals in March-April (5.7 per cent, or over 760,000 people) therefore produced to a steep drop in the unemployment rate, to 7.6 per cent, despite the concomitant decline in employment.

With the restart of economic activity and the removal of restrictions on individual movement in May, participation in the labour market revived, increasing further in June. On the average for the second quarter, the unemployment rate (8.0 per cent) was still lower than its level in the first three months, but according to consumer expectations it points to a sharp increase (Figure 16). At the same time, the number of inactive persons began to decline, although it remains considerably larger than before the health crisis (about 770,000 more individuals in June than in January).

Figure 16 – Unemployment rate and consumer unemployment expectations
(percentages and balances)



Source: Istat.

[5] See Ufficio parlamentare di bilancio (2020), " Budgetary Planning Report", Chapter 3.

The slowdown in labour costs continued in the first quarter of the year (0.7 per cent year-on-year growth, from 1.0 per cent in the fourth quarter of 2019). This reflected a reduction in the private sector, probably attributable to the suspension of the deadlines for the payment of social contributions (in place until 31 May). In the same period, the rise in hourly contractual wages (0.6 per cent) was unchanged on the final figures for 2019. With the outbreak of the pandemic, wage growth has been very moderate, with the pace in the second quarter around the values registered in the first three months for the economy as a whole, the net effect of substantially no change in the private sector and persistently low values in public employment.

Wage growth is also expected to remain moderate in the coming months. According to estimates performed by Istat on the basis of the contracts in force until June, the index of hourly contractual wages will increase by 0.5 per cent on average for the year. Wage moderation would also be encouraged by the large number of contracts to be renewed, with wage bargaining affected by the low volume of activity.

The jump in hourly productivity in the first quarter (2.5 per cent on an annual basis) reflected the sharper contraction in hours worked, subsidised in part by the wage supplementation scheme, than the decline in value added. The use of flexible working arrangements during the health emergency mainly involved workers with a high level of educational attainment, while this was not an option for those with duties that cannot be performed "remotely", which on average have a lower level of productivity.[6] The full advantages of flexible working, which are associated with the greater freedom workers have to organise their working time, may not have been achieved during the emergency conditions in recent months, since they require a planned and organic reorganisation of work activities.

Consumer inflation turns negative

Inflation in Italy has been negative over the last three months. The steep decline in the prices of energy commodities and weak aggregate demand have kept the pressure on prices low.

In July, the national consumer price index (NIC) decreased by 0.3 per cent on an annual basis, a tenth of a point lower than the previous month. The decline in the prices of energy goods (-9.7 per cent year-on-year, from -12.1 per cent in June) was offset by increases in food prices (1.5 per cent, from 2.3 in the previous month). In both cases, the pace of change was easing due to the gradual dissipation of the exceptional conditions prevailing in the pandemic emergency. Core inflation, which excludes the prices of energy and unprocessed food, remains positive but has slowed by two-tenths of a point from the

[6] See Madio, L., Mantovani, A., Reggiani, C., "Se lo smart working diventa la nuova normalità", www.lavoce.info.

previous month (0.5 per cent). The carry-over of inflation (NIC) in July for 2020 as a whole is slightly negative at -0.1 per cent.

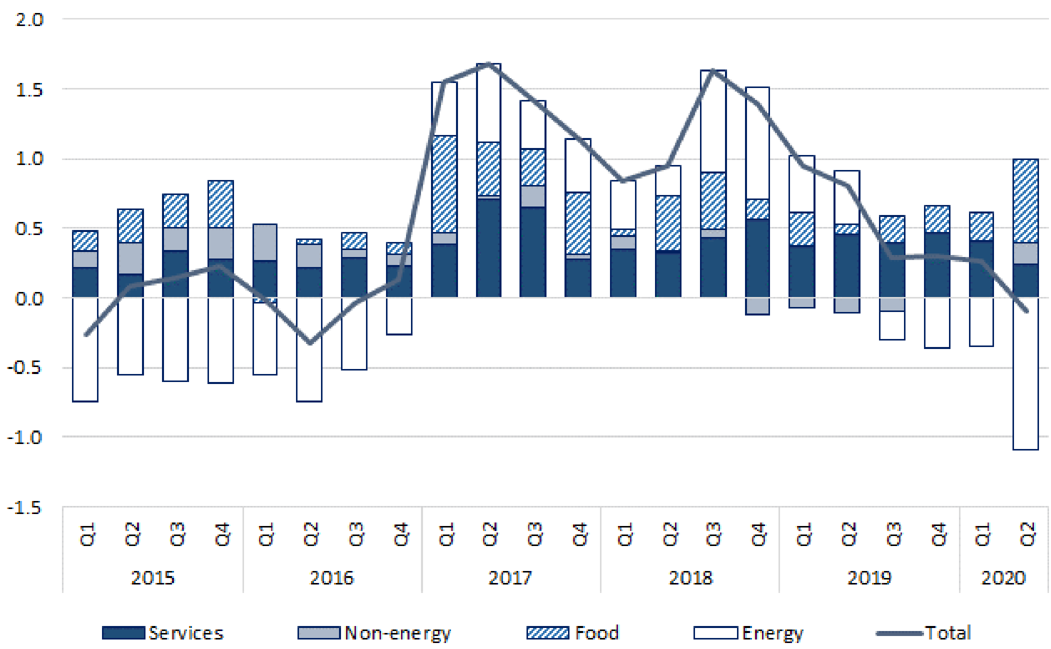
The decline in inflation observed in the second quarter of 2020 (Figure 17) may have benefited less well-off households more (-0.5 per cent for households in the first income quintile), as it was mainly concentrated in the prices of goods rather than services, of which households with higher incomes make greater use.

The gradual return to normality has improved the conditions for measuring inflation, which during the lockdown were affected both by the closure of municipal statistical offices and by restrictions on trade in certain goods. Accordingly, it had been necessary to impute data and formulate assumptions about the prices of goods for which there was no market, which could have affected the estimates for the spring months.

The proportion of items in the basket experiencing deflation remained stable in June (28 per cent), while for more than 80 per cent of items inflation was less than 2 per cent.

The effects of the decrease in the prices of raw materials continue to affect the upstream segment of the production process. Imported inflation declined slightly again in May (-0.1 on the previous period), combining with the strong contractions registered in the previous two months to produce an annual variation close to that observed in spring 2009 (-8.6 per

Figure 17 – Consumer price index and contributions of components (1)
(percentage year-on-year change and contributions)



Source: based on Eurostat data.
(1) The chart shows the contribution to growth of the sectoral components of the harmonised consumer price index.

cent year-on-year). Producer prices in industry, which had been falling since last summer, showed the first signs of recovery in June (0.5 per cent on the previous period). However, the decline compared with the previous year remains pronounced (-4.5 per cent). In the services sector, producer prices in the first quarter fell more (-1.3 per cent year-on-year) than at any other time in the last decade, reflecting the decreases in telecommunications and air transport. By contrast, the trend in construction is almost stable, both for residential building and for roads and railways.

The inflation expectations of businesses and households reported in Istat surveys remain cautious. On average in June and July, about half of consumers (53.3 per cent) expected stable prices, while the share of those who anticipate an acceleration compared with previous months decreased (15.3 per cent in July, compared with 26.0 on average between March and May), most likely reflecting the reversal of price increases for certain goods assets affected by lockdown restrictions. The expectations of firms show stable prices in the 84.4 per cent of the cases. The proportion of those expecting falling prices (around 10 per cent) has decreased, but still remains twice the level registered at the beginning of the year. The future dynamics of prices are affected by various pressures, including countervailing factors. The restrictions imposed during the lockdown are comparable to a supply shock, which should produce an increase in prices. They were accompanied by a demand shock with the opposite effect, connected both with the change in consumer habits and the effects of the closure of various activities or restrictions on the delivery of services. These factors were compounded by the additional costs imposed by sanitisation and social distancing measures, which offset the sharp reduction in the prices of commodities. The ultimate outcome of the action of these factors will differ across products and will unfold completely only in the coming months.

Medium-term forecasts for the Italian economy

This section presents the PBO's macroeconomic forecasts for the Italian economy in the 2020-2021 period. In consideration of the significant effects of the recession on the public accounts, forecasts for the public finances are also presented in this edition of the Report.

Compared with the macroeconomic scenario in April, as prepared for the endorsement of the forecasts contained in the 2020 EFD, here we consider updated figures for the international exogenous variables and the most recent information on economic conditions, in particular second quarter GDP. With regard to fiscal policy, the forecasts take account of the measures already adopted with Decree Laws 18, 23 and 34 of 2020, including the elimination of the indirect tax increases provided for in the safeguard clauses. Account is also taken of the budget deviation just authorised in Parliament, although the measures for which the authority will be used have not yet been specified by the Government.

Economic activity in 2020-2021

The forecasts for 2020 come against the background of an unprecedented contraction in GDP in the second quarter (-12.4 per cent), which followed the decrease already registered in the first three months. According to the PBO's short-term forecasting models, economic activity is expected to return to growth in the second half of the year, but the timing and intensity of that upturn remains highly uncertain. The recovery recorded in May in some sectors (manufacturing and construction) mainly reflected the lifting of the measures suspending economic activity and did not fully offset the losses recorded in March and April. The pandemic seems to have had a persistent impact on household consumption and business investment decisions, slowing the recovery of domestic demand in the forecast period. The growing international spread of the pandemic will also have additional adverse repercussions for foreign trade.

Overall, GDP is forecast to decrease by 10.4 per cent this year (Table 2). However, the recession will be significantly mitigated by fiscal policy, which is expected to support GDP with measures worth around 2.5 percentage points (see the Box). In 2021, economic activity will rebound, also benefiting from the statistical carry-over impact of the recovery in the second half of this year. However, the expected 5.6 per cent increase in GDP will not be sufficient to return output to a level close to that recorded before the start of the pandemic. Gross domestic product will be about five percentage points lower than in 2019 (in both real and nominal terms).

Table 2 – Forecasts for the Italian economy (1)

	2019	2020	2021
INTERNATIONAL EXOGENOUS VARIABLES			
World trade	1.7	-11.2	8.4
Oil price (Brent, dollars per barrel)	64.3	41.8	45.5
Dollar/euro exchange rate	1.12	1.13	1.17
ITALIAN ECONOMY			
GDP	0.3	-10.4	5.6
Imports of goods and services	-0.4	-5.2	6.2
Final domestic consumption	0.2	-6.6	3.8
- Consumption of households and non-profit institutions serving households	0.4	-9.4	5.4
- General government expenditure	-0.4	3.2	-1.0
Investment	1.4	-15.0	8.9
Exports of goods and services	1.2	-11.1	6.8
CONTRIBUTIONS TO GDP GROWTH			
Net exports	0.5	-2.0	0.3
Inventories	-0.6	-0.6	0.8
Domestic demand net of inventories	0.4	-7.8	4.5
PRICES AND NOMINAL GROWTH			
Import deflator	-0.2	-0.8	0.8
Export deflator	0.5	-0.9	0.9
Consumption deflator	0.5	0.0	0.3
GDP deflator	0.9	0.5	0.4
Nominal GDP	1.2	-10.0	6.0
LABOUR MARKET			
Unit labour costs	1.6	1.2	0.7
Employment (FTEs)	0.3	-8.9	4.3
Unemployment rate	9.9	10.7	11.8

(1) Percentage changes except for contributions to GDP growth (percentage points), the unemployment rate, the exchange rate and the oil price. Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

The forecasts presented in this Report take account of the data on the contraction in GDP in the second quarter of 2020, released by Istat on 31 July, and the budget deviation approved by Parliament in the same week. The projections of other forecasters (Table 3) were finalised earlier, so they are not fully comparable, especially with regard to 2020. The forecasts for next year instead appear qualitatively consistent. In making comparisons, however, it is necessary to take account of the considerable differences in the assumptions adopted by the forecasters for international exogenous variables and public finance aggregates.

Table 3 – Recent forecasts for Italian GDP growth
(percentage changes)

	2020	2021
PBO (5 August), unadjusted	-10.4	5.6
Oxford Economics (23 July), adjusted for calendar effects (1)	-9.3	5.7
REF (13 July), adjusted for calendar effects (1)	-9.2	5.4
Bank of Italy (10 July), adjusted for calendar effects (1)	-9.5	4.8
European Commission (7 July), unadjusted	-11.2	6.1
Prometeia (3 July), adjusted for calendar effects (1)	-10.1	5.9
IMF (24 June), unadjusted	-12.8	6.3
OECD (10 June), adjusted for calendar effects (1)	-11.3	7.7
Memorandum item		
MEF (24 April), unadjusted (2)	-8.0	4.7
PBO (30 June, PBO Report), unadjusted	-9.0	6.8

(1) 2020 has two more working days than 2019 and 2021 had the same number of working days as 2020. (2) The forecasts assume the activation of the safeguard clauses in 2021.

Forecasts for the components of expenditure

The recession that the Italian economy is experiencing this year is largely attributable to the reduction in final domestic demand (net of inventories), which is expected to subtract 7.8 percentage points from GDP growth. The contribution of net foreign demand will also be negative, albeit to a lesser extent (-2.0 percentage points). Conversely, next year the expansion of output would mainly be driven by the internal components of demand (4.5 percentage points), while the contribution of net exports and inventories would be limited to about one percentage point.

Household consumption is forecast to plunge by 9.4 per cent this year, although this is a smaller decrease than that in GDP thanks in part to the support afforded by disposable income given the expansionary fiscal policies adopted. At the same time, the deterioration in household expectations foreshadows caution in spending decisions and possible postponements of purchases of inessential items even after the end of the lockdown. Consumption of Italian products by non-residents, which was held back by the freeze on international tourist flows during the months of the health emergency, would continue to be affected by the progress of the pandemic. Developments in consumption by Italian tourists abroad would be substantially similar. The propensity to consume was affected by the temporary constraints on the purchase of some goods and services during the lockdown. However, it could remain low even in 2021 for precautionary reasons attributable to the high level of uncertainty and the need for households to preserve their financial wealth, whose prices have been eroded by the crisis. The measures introduced to support disposable income are expected to limit the contraction in purchasing power on average over the two-year forecast period, attenuating the reduction in private consumption expenditure this year and helping to sustain its recovery next year (5.4 per cent).

The severe deterioration in investment in 2020 (-15.0 per cent) reflects the high level of uncertainty concerning demand conditions and expected profits, as well as the increase in unused capacity. Expenditure on capital goods is forecast to expand again next year (8.9 per cent). The coronavirus shock is expected to cause a sharp fall in capital spending on machinery and equipment in 2020, which would then recover about half of the decrease the following year, benefiting from the persistence of expansionary financial conditions and the recovery in international economic environment. Construction is forecast to contract less sharply this year, while the recovery next year is expected to be more gradual, supported above all by the contribution of the public component.

Exports of goods and services are forecast to decrease substantially this year (-11.1 per cent), in line with the drop in foreign demand. The reduction in imports (-5.2 per cent) is expected to be less marked, as during the period in which domestic production was suspended part of demand was temporarily directed abroad. The essential shutdown of international tourism will worsen the surplus on the tourism balance. In 2021 exports are expected to expand at a rate close to the pace of world trade. Import growth will also tend to normalise, falling into line with the growth in demand components that involve a high proportion of imported goods.

Forecasts for the labour market and inflation

The labour market is affected by the severe recession to different extents depending on the indicators. The extensive use of the wage supplementation scheme has so far limited the impact on the number of persons in employment as measured by the Labour Force Survey (in which the beneficiaries of wage supplementation are counted as employed), but the effects in the national accounts measures for labour inputs have unfolded fully. Overall in 2020, employment measured in terms of full-time equivalents (FTEs) is expected to decrease by 8.9 per cent, with the number of hours actually worked decreasing by much more than the number of jobs. FTEs are projected to increase again in 2021, recouping about half of the decline. During the months of the lockdown, the suspension of a significant proportion of economic activity and the restrictions on movement sharply discouraged active job searches, causing a temporary jump in the inactive population and therefore a decrease in the unemployment rate. With the removal of these restrictions, participation in the labour market is expected to gain momentum starting from the summer, growing at a faster rate than the recovery in the number of persons in employment. The unemployment rate would stand at 10.7 per cent this year and rise by about one point next year.

Inflation, as measured by the consumption deflator, is expected to decrease to zero this year (from 0.5 per cent in 2019), reflecting the absence of both external drivers (raw material prices) and domestic demand pressures. Inflation is forecast to increase very moderately in 2021. The change in the GDP deflator will remain larger than that in the consumption deflator in the forecast period, barely decreasing next year due to the continuation of the contraction in firms' profit margins and the weakness wage pressures. Nominal GDP, in steep decline this year, is expected to recover in 2021.

The public finances

In consideration of the exceptional situation created with the health emergency and its significant effects on the public accounts, the public finance forecasts are included in this edition of the Report.

Given the economic environment delineated here and considering the effects of the measures taken to counter the emergency, including the deviation requested by the Government with its July Report to Parliament, the public deficit will worsen considerably this year and then partially recover in 2021. Developments in the ratio of debt to GDP would follow a similar pattern. After the 1.6 per cent of GDP recorded in 2019, general government net borrowing would be around 13 per cent in 2020, before narrowing by almost half in 2021. The forecast reflects the financial effects of the deterioration in the deficit deriving from the legislation approved earlier this year (Decree Laws 18, 23 and 34 of 2020) at their face value, equal to €75.3 billion this year and €26.1 billion next year,[7] in addition to the €25 billion for 2020 and €6.1 billion for 2021 attributable to the deviation just authorised. With regard to the composition of the deviation, the forecast was based on the information contained in the Report to Parliament and in the hearing of the Minister for Economy and Finance of 28 July 2020 as well as media reports.

In 2020, the deterioration compared with the deficit recorded in 2019 would be substantially attributable, to similar extents, to the quantitative impact of the emergency measures (approximately €100 billion, equal to 6.2 points of GDP estimated by the PBO) and the combination of underlying trends in the public budget with the impact on the public accounts of the economic deterioration connected with the measures to contain the spread of COVID-19 (the lockdown).

After having stabilised the debt to GDP ratio at 134.8 per cent in 2019, the ratio is expected to rise to over 160 per cent in 2020. More than half of the increase compared with 2019 can be attributed to the decline in nominal GDP in the denominator. In 2021 the debt to GDP ratio is forecast to decrease, mainly due to GDP growth, but would still remain above 160 per cent. The estimate of the impact reflects the increases in borrowing connected with the decrees approved, in the amount of €87 billion in 2020 and €26 billion

[7] With regard to the financial effects of the decree laws already approved, see Ufficio parlamentare di bilancio (2020), "2020 Budgetary Planning Report", section 2.6 and tab. 2.11, page 72, July.

in 2021, in addition to those deriving from the authorised budget variance, equal to €32 billion this year and €6.1 billion next year.[8]

Finally, we must emphasize the significant uncertainty characterising the forecasts at both the macroeconomic level – as already highlighted – and for the public finances, given the exceptional situation associated with the health emergency. For the public accounts, the uncertainties of the macroeconomic environment are compounded by those surrounding the information from the ordinary monthly monitoring of the main aggregates. In fact, both for expenditure and revenue it is difficult to extract information from the available data. Periodic monitoring of revenue developments – for which a comprehensive understanding is affected by the information on self-assessed tax payments, which is not yet available at this time of year – has been made more challenging by the monthly impacts of the payment suspensions introduced with the various decrees. As regards expenditure, monitoring data is not very indicative owing to the lack of information about the implementation and effective use of the numerous tools deployed, especially those in support of workers. The upside and downside risks to the public finance forecast appear equally probable: the former are linked to the performance of the economy and certain financial transactions, while the latter are connected with possible savings compared with the information in the Technical Reports accompanying the decrees already implemented, as in the case of fewer-than-expected applications for advances from local governments for the payment of outstanding debts or less-than-expected recourse to wage supplementation support.

Main revisions of previous macroeconomic forecasts

Compared with the macroeconomic scenario formulated by the PBO during the endorsement exercise for the EFD forecasts, GDP growth was revised downwards by about 2.5 percentage points this year and upwards by over one point in 2021. The revision in the 2020 figure mainly reflected the deterioration in the contribution of domestic demand, due to the fact that the lockdown lasted longer than forecast at the beginning of April. The upward correction of growth forecasts for 2021 is mainly the result of a base effect associated with the larger decline in the previous year.

The risks to the forecasts

The forecast scenario presented in this Report signals a gradual but definitive recovery in economic activity, and therefore rules out the possibility of a second wave of contagion

[8] The information on the deficit and the debt are not directly comparable with that given in the Report to Parliament in July, which indicated a deficit of 11.9 per cent of GDP and a debt ratio of 157.6 of GDP for 2020. Those values were calculated "mechanically" on the basis of the GDP forecast in the EFD in April with regard to the trend scenario, which only incorporated the financial effects of Decree Laws 18 and 23 of 2020.

that would make it necessary to implement new measures to restrict movement. The expansionary economic and monetary policy measures are also assumed to be fully effective in limiting sovereign debt yields and sustaining the liquidity of firms and households. Any failure of one of these conditions to obtain would represent a non-negligible downside risk to the forecast.

Regardless of the assumptions adopted, the medium-term outlook is affected by extraordinarily high uncertainty, with risks mainly oriented downwards both for the international scenario and for financial balances.

There are various possible causes for a further weakening of international economic conditions. The pandemic is currently spreading rapidly around the world and a resurgence of infections cannot be excluded even in countries where the virus now appears under control. The uncertainty of economic operators concerning the duration and repercussions of the pandemic will remain high at least until a vaccine or effective treatment methods are available. The effects of the strong and synchronous global macroeconomic shock could differ between economies, accentuating existing vulnerabilities.

Expansionary fiscal and monetary policies are limiting the impact of the crisis on the economies of various countries through the expansion of the balance sheets of governments, central banks and international financial institutions. When the virus is controlled with the introduction of a vaccine and the world economy returns to a stable growth path, it will be necessary to reduce the high levels of debt accumulated. Shifts in the cyclical phases of the various European economies and any premature normalisation of economic policy would affect the sovereign risk premiums required for economies lagging behind with a slower recovery. If this were to involve Italy, whose large stock of debt was further increased by the crisis, financial tensions could be reflected in a sudden deterioration in growth expectations.

Box – The assumptions adopted in the forecasting exercise and the impact of fiscal policy

Assumptions about the international environment. – The exercise covers the 2020-2021 period and is based on updated international exogenous variables (based on technical assumptions applied to market figures available at 27 July 2020). More specifically, we assume: 1) world trade in goods and services in sharp decline this year (-11.2 per cent) and partially recovering next year (8.4 per cent); 2) the continuation of extremely expansionary monetary conditions, with a negative short-term interest rate in the euro area over the forecast horizon; 3) a slight appreciation of the euro this year followed by a stronger gain next year, consistent with the signals offered by forward rates, with an exchange rate for the dollar against the euro of 1.13 this year and 1.17 in 2021; 4) lower oil prices compared with 2019: according to prices on the futures markets, the price will fall to $41.8 a barrel this, then rises to €45.5 a barrel in 2021.

Assumptions about the public finances. –The public finance scenario incorporates the effects of the recession and those, at their face value, of the measures introduced with Decree Laws 18, 23 and 34 in response to the health emergency. Consistent with the latter measure, the safeguard clauses providing for an increase in indirect taxes (VAT and excise duties) are assumed to be deactivated in the forecast period. The effects of the other measures approved during the crisis, such as the debt repayment moratorium and public guarantees on loans to businesses, although not directly considered in terms of their impact on GDP growth, are incorporated into the projections as they underpin the assumptions of stable financial conditions over the forecast horizon. The estimates also take account of the budget deviation just authorised by Parliament.

Effects of recent public finance measures. – Decree Law 18/2020 ("Cura Italia") includes measures worth over one percentage point of GDP in 2020 to support the health system, measures in favour of businesses, workers and professionals, and measures to support liquidity.[9] The expansionary effect would manifest itself in consumption (public and private) and, to a greater extent, investment.

Decree Law 34/2020 ("Rilancio") introduces measures worth almost three and a half points of GDP, which on the one hand strengthen and extend the duration of some of the provisions of Decree Law 18/2020, and on the other expand the sectoral measures. To a very large extent, these are transfers and tax relief measures, which offer generalised but mainly temporary support for disposable income. In macroeconomic terms, as for the previous decree, the legislation imparts a broad stimulus to the components of domestic demand.[10]

Finally, last week, the Government obtained authorisation for a new budget deviation of €25 billion for 2020 and €6.1 billion for 2021. The decree specifying the measures to which these resources will be allocated has not yet been presented, but it appears that the measures will again include extensive use of transfers, as well as deferrals and tax relief.

On the basis of simulations carried out by the PBO using the Memo-It model, the two measures already enacted and the one that will follow the recent budget deviation would provide support to the Italian economy on the order of 2.5 percentage points of GDP in 2020.

[9] See Ufficio parlamentare di bilancio (2020) "Memorandum of the Chairman of the Parliamentary Budget Office on Bill AS 1766 ratifying Decree Law 18 of 17 March 2020", March (Summary only. Full text in Italian.
[10] See Ufficio parlamentare di bilancio (2020), "Budgetary Planning Report", July.