The current European and Italian economic outlook

Overview:

- **Italy and Europe are beginning to show signs of economic recovery**
- **In Italy in particular, investment is decelerating and foreign orders, followed by domestic orders, have been rising since the end of 2012, indicating that companies will have to increase output in order to satisfy rising demand**
- **According to the World Trade Organisation (WTO), we can expect globally a "gradual recovery in coming months" as "conditions for improved trade are... falling into place"[1]**
- **Several factors favour recovery in Italy and Europe, namely stronger world trade, solid growth in the US, recovery in the Eurozone, continuation of growth in emerging countries, less restrictive public budgets in most of the advanced economies, and lower oil prices**
- **Obstacles to recovery in Italy and Europe include political instability, adverse monetary policies, the persisting credit crunch, high unemployment, the ongoing housing adjustment, and national-level structural imbalances**
- **The recovery of the Italian economy will be extremely slow, but stabilisation of economic activity is certainly underway.**

1st article in Afera's Sicily conference presentation series

Mr. Pasquale Capretta's presentation "The European and Italian Economic Outlook" kicked off the lecture programme at Afera's recent Annual Conference in Sicily. Currently a Senior Economist in Confindustria's Research Department (Centro Studi) in Rome, Mr. Capretta is responsible for econometric modelling and forecasting and actively participates in the preparation of the CSC forecast of the Italian economy.

The bottom line: Mr. Capretta demonstrated through his deep analysis of extensive data that Italy and Europe are showing signs of very gradual economic recovery. In Italy in particular, the dip in investment is decelerating and foreign orders, followed by domestic orders, have been rising since the end of 2012. In his words, companies will have to increase output in order to replenish their stock of finished goods to satisfy rising demand.

World economy

If we look back over the last few months, we notice that across the globe, extraordinary interventions by central banks and governments have been diminishing gradually. The situation in advanced countries remains critical however. Tens of millions of people are unemployed and countless businesses are closing. Much uncertainty remains because of political developments (e.g., in Italy, Germany and the Middle East) and policy decisions (by the Federal Reserve, US President and Congress, and EC and ECB). Despite these factors, the world economy is moving along.

Italy's economy

In Italy, the signs of cyclical rebound strengthened in the summer months of 2013. Economic activity is no longer declining, if not altogether increasing. Confidence among both households and businesses has improved significantly; however, recovery is much more evident in survey indexes than in actual data, which provides a contrasting and uncertain picture. Mr. Capretta shared that in their projections, they assumed that economic activity stabilised in the third quarter of 2013 and an inversion of the downward trend in GDP growth would only occur during the fourth quarter. The recovery is then expected to consolidate over the course of 2014, driven by exports, which were expected to increase by 1.4% in 2013 and 2.9% in 2014.

Positive signs

- The PMI indexes (the Purchasing Managers' Indexes which measure the level of private sector activity in a country) have inverted their downward trend and are now near or above 50, the threshold that

[1] http://www.wto.org/english/news_e/pres13_e/pr694_e.htm.

separates recession from expansion (services is at 48.8 and manufacturing 51.3). Export orders in advanced economies (weighted average of the US, Eurozone and Japan's indexes) are picking up again.

It should be noted, however, that "imports of the EU from the rest of the world fell 2% in the first half of 2013 compared to the same period in 2012, hitting the exports of its trading partners."[2] "Imports of developing economies and CIS have continued to grow strongly in 2013 (up 5% for the year to date), partly cushioning the drop in the EU and stagnation in the US."[3]

World merchandise trade was set to grow 2.5% in 2013, slightly higher than the 2.3% rate seen in 2012. Growth in world trade, which was rather subdued in 2012, was expected to accelerate slightly in 2013 and even more in 2014 (by 4.5%), although this is still below the average rate of 5.4% for the last 20 years (1982-2012).[4]

The WTO ultimately "sees gradual recovery in coming months" and says "conditions for improved trade are gradually falling into place."[5]

- The economic sentiment calculated by Eurostat on the basis of Istat opinion surveys among businesses and consumers rose from 91.3 to 100 in the second half of 2013 alone.[6] Even when corrected for recent methodological revisions, the data shows that confidence has improved significantly among both businesses and consumers, although it is still far from long-term averages.

- In Italy, consumption dropped by 0.4% in the second quarter with respect to the first quarter of 2013. Household expectations regarding their future economic situation have been improving constantly since the last quarter of 2012. Here too, consumer perception is still far lower than long-term averages but certainly less negative than a few months ago.

- In Italy, the dip in investment is decelerating. Data for investment in machinery and equipment, as well as total investment, is still negative but falling at a slower rate. Companies' assessment of new orders for investment goods is turning positive, a trend which preludes a stabilisation of investment in the coming months. Foreign orders, followed by domestic orders, have been rising since the end of 2012. This is clearly a sign for future activity: Firms will have to increase output in order to replenish their stock of finished goods to satisfy rising demand.

- The OECD leading economic indicator has been predicting for months an inversion of the downward trend in Italy during the second half of 2013.

Elements of recovery in Italy and Europe

Several factors favour recovery in Italy, including stronger world trade, solid growth in the US, recovery in the Eurozone, continuation of growth in emerging countries, less restrictive public budgets in most of the advanced economies, and lower oil prices.

Mr. Capretta says that US growth is accelerating and that growth prospects are good. According to *The New York Times*,

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[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Ibid.
[6] http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=teibs010&plugin=0.

> The United States economy grew at a surprisingly robust 4.1 percent annual pace in the third quarter, the Commerce Department said on Friday. It was the strongest advance in nearly two years and only the third time the economy had expanded that quickly from one quarter to the next since 2006.[7]

Consumer spending will continue to be sustained by gradual recovery in the housing sector. The increase in house and stock prices have greatly contributed to replenishing household wealth. Household finances have also improved. This bodes well for confidence and consumption.

In Europe, GDP picked up in the second and third quarters of 2013, ending 6 quarters of consecutive declines. Despite last July's outcome, when production in the Eurozone dropped by 1.5%, expectations are positive for the manufacturing sector and consumer confidence is improving. Following two years of negative growth, Europe is expected to recover modestly in 2014 (+1.1% in the euro area[8]). Italian GDP is expected to drop by another 1.6% this year and to recover slightly in 2014 (+0.7%).

Growth in emerging countries slowed down during the spring and summer months and was expected to decelerate slightly on average by the end of 2013. China's slowdown in exports has ended, however, because of the government decision to rebalance growth in favour of domestic demand. Keep in mind that despite the slowdown, emerging economies continue to contribute by almost 80% to overall world GDP growth. Furthermore, according to IMF projections, the slowdown in emerging economies will be temporary: Their growth rates are expected to accelerate again in 2014.

Mr. Capretta's forecast for Italian and Eurozone growth is based on the important assumption that public deficit restrictions will have a lower impact on GDP. The drag that public budgets have on consumer and investment spending will gradually fade. Structural budget balances (-1.4% in 2012, -0.8% in 2013) will turn positive in key Eurozone countries in 2014, providing a positive contribution to GDP growth.

Increases in oil prices were recorded in 2013 because of the worsening of the political situation in Syria and other Middle Eastern countries. Oil prices are expected to drop from an average of $112 per barrel in 2012 to $100 in 2014 (current BTI price is $108[9]). According to the US Energy Information Administration in 2014, supply is expected to top demand again. We assume that the civil war in Syria remains limited and that political trouble in the Middle East will not extend to other countries.

Obstacles to recovery in Italy and Europe

Mr. Capretta identified the major possible obstacles to recovery in Italy and Europe: political instability, adverse monetary policies, the persisting credit crunch, high unemployment, ongoing housing adjustment, and national-level structural imbalances.

The lack of stability in Italy caused by the uncertainty surrounding the government coalition is a real problem. Political developments in Europe—especially Germany—and the US are also important, due to their influence on European policies. This also includes outside intervention (i.e., rescue plans) in Greece, Portugal, Ireland and Spain.

Monetary policies must stay loose. An untimely decision to raise interest rates by the Fed or the ECB may dampen economic recovery which has just begun and is still very weak. Faster repayment of accumulated debt by Italian public administration can alleviate the problem, allowing for more bank financing for businesses and the unleashing of much-needed cash for immediate investment.

High unemployment rates, which can still be found in the US and at record levels in Europe, could undermine recovery by lowering confidence and restraining income growth.

[7] http://www.nytimes.com/2013/12/21/business/economy/third-quarter-us-growth-at-4-1-rate-in-new-estimate.html?_r=0.

[8] http://www.nytimes.com/2013/11/06/business/eu-predicts-anemic-growth-and-high-unemployment-in-2014.html?_r=0.

[9] http://oil-price.net/.

The adjustment in the housing sector is not over yet and is not going to play a positive role in European recovery for quite a while. House prices to income ratios tell us that the adjustment is still underway in many countries, including Spain, the UK, the Netherlands, France and Belgium. Without an increase in employment and incomes, house prices in these countries will have to adjust further downward.

One last obstacle to renewed growth is the persisting balances among countries. A reduction of Eurozone imbalances requires an adjustment not just on the part of deficit countries but surplus countries, like Germany, as well. The reduction in unlimited liability corporations (ULC) in most of the peripheral countries should be mirrored by a similar increase in German labour cost. Thus an increase in Germany domestic demand would favour peripheral Europe's exports and reduce imbalances.

Italian economy is looking toward stabilisation

Economic activity in Italy is stabilising. The economy is set to recover gradually in 2014, driven by rising demand from Italy's major trading partners, a less restrictive fiscal policy, improving financial conditions, and payment of past and overdue commercial credit by the public administration. Mr. Capretta sees the main risk to economic recovery in Italy as the political instability which could increase uncertainty regarding the country's ability to meet its international financial obligations. The consequent loss in confidence would lead to higher interest rates and higher public deficits, prolonging the credit crunch and dampening economic activity.

About Pasquale Capretta

Mr. Pasquale Capretta is a senior economist in Confindustria's Research Department (Centro Studi), where he has been working since 1983. He is currently responsible for econometric modelling and forecasting and actively participates in the preparation of CSC forecast of the Italian economy. Prior to working for Confindustria, Mr. Capretta was a research assistant and later an Associate Economist at Wharton Econometric Forecasting Associates, Inc. (WEFA) in Philadelphia (USA), where he worked on both the Latin American Model (1982-83) and the World Model (1979-82). He has a BA in economics from the University of Minnesota, Minneapolis (USA), and an MA in economics from Temple University in Philadelphia.

Questions and comments?

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