Sunday Wrap

Happy Sunday,

This is Marco Valli from Milan, UniCredit's Global Head of Research. With Erik off for a few weekends, today I want to share with you my thoughts on the challenges and opportunities Italy faces in an increasingly complex global and European landscape. I will do so with the support of a number of slides I presented this past week to an audience of MPs and members of institutions at a UniCredit event in Rome (with many thanks to Corriere della Sera's Federico Fubini for his role of discussant and to Loredana Federico, our Chief Italian Economist, for her help with the charts).

Link to the presentation slides: Italy: challenges and opportunities

Participants in the roundtable were constructive overall, which largely reflects the better-than-expected performance of the Italian economy after the outburst of COVID-19 and prospects for an acceleration of implementation of NGEU-related investment. However, I also noted rising concern that Europe's policy response to the new challenges posed by a rapidly changing world might come late and prove underwhelming. I share this assessment. In the following, I will first provide a quick overview of the global and European situation, moving then to the outlook for Italy in greater detail.

This past week saw an acceleration of the hawkish repricing of rate expectations that had started with a massive upside surprise in the latest US payrolls report. This fresh selloff was triggered by doubts about the pace of disinflation in the US after CPI and PPI data pointed to sticky price pressure. Tough rhetoric from the Fed and a number of ECB hawks provided additional tailwind to the market move. Investors now price in a peak rate of 5.5% for the Fed and 3.75% for the ECB, with rate cuts for this year almost completely priced out. For central banks, underlying inflation will be the decisive factor to assess the right time to stop raising rates and how long to keep them at their peaks in restrictive territory.

Slide 2 shows that global inflation is decelerating, but this mainly reflects an easing of energy prices, while the turning point in core inflation is more elusive and not yet visible across all major economies – in the eurozone, we are not there yet. The global economy weathering the inflation shock and monetary tightening better than expected (at least so far) complicates the job of central banks. If tightness in labor markets persists, they will find it even more difficult to project with reasonable confidence the landing zone for underlying inflation once supply-side shocks that are deemed as temporary fade.

Therefore, after having been badly surprised by the inflation outbreak, most central banks might prefer to push rates a bit higher and hold them there for longer than would be necessary, reversing course only when disinflation towards the target is well on track. Almost by definition, this strategy raises the risk of overtightening and unnecessary economic damage down the road, especially where energy and food price shocks have accounted for a large share of the jump in inflation.

In the eurozone, more interest-rate pain lies ahead. Slide 3 shows that at the end of last year (latest available data), bank lending rates for firms and households were about 160-200bp higher than their end-2021 levels, reflecting up to 80% of the cumulative increase in ECB policy rates at that time. This swift repricing is likely to continue as the ECB seems set to hike its deposit rate to 3.5% by June, while TLTRO support fades. QT will add to the tighter stance, although a large part of its impact is probably already priced in. The credit cycle is reacting strongly to the ECB's impulse. The latest Bank Lending Survey for the eurozone signaled a surprisingly fast deterioration in loan demand, particularly for mortgages, while banks are tightening credit standards amid higher uncertainty and risk aversion.

The ECB seems relatively relaxed and sees these developments as an indication that monetary policy and its transmission to the real economy are working effectively. I am more nervous, largely because of the high uncertainty that surrounds the impact (and its time lag) of the massive, globally synchronized, cumulative tightening already implemented and in the pipeline. Philip Lane's excellent speech on Thursday providing an interim assessment of the ECB's hiking cycle has not eased my concerns (you can find his speech here The euro area hiking cycle: an interim assessment.)

Slide 4 summarizes what we regard as Europe's main challenges in a world characterized by deteriorating geopolitics and increasing state intervention. It mainly reflects the points made by Erik in recent issues of the Sunday Wrap. The changing international landscape creates a strong need for a shift towards European industrial policies. Recent developments show that big differences are already emerging among member states on how to pursue this goal. It will be extremely important that these

new policies are implemented at a European level in a coordinated fashion, instead of being left to the fiscal space and the good will of individual member states. This is a matter of preserving the Single Market and minimizing the risk of macroeconomic divergence across the bloc.

Erik estimates that the EU will need additional public resources worth about 2.5% of GDP (some EUR 360bn) per year just to achieve its green objectives by 2030, upgrade its defense spending and enhance its educational capabilities (note that this estimate includes the public money needed to provide fiscal incentives for private-sector investment). Spending of such magnitude simply cannot be fiscally neutral. Given that funds already available through the EU budget and NGEU will not be enough to cover new financing needs, additional joint EU borrowing is necessary, along with a provision in the revised Stability and Growth Pact allowing for preferential treatment of EU-coordinated public investment and spending. This should be complemented by the creation of a European sovereign fund to inject equity into strategically important projects and a well-functioning Capital Market Union.

In slide 5, I start zooming in on Italy. I argue that my country plays a very important role in the new European context outlined above and that an effective implementation of NGEU is essential, mainly for three reasons.

First, supply-side reforms that come with the National Recovery and Resilience Plan (Piano Nazionale di Ripresa e Resilienza, PNRR) are even more important now that the ECB's tightening is set to erode most, if not all, of the cyclical impulse from the Plan. Second, Italy delivering on the PNRR would be positive for mutual trust across member states. Once the perceived risk of free-riding abates, it would become easier to find a political agreement on the future road map for Europe, including the needed shift towards European-level policies and their financing. Third, compliance with the PNRR is one of the key pillars of conditionality in the set-up of the ECB's Transmission Protection Instrument (TPI), which until now has been extremely effective in shielding government bond spreads of vulnerable countries from market speculation. Similarly to what happened with OMT, investors have not dared to challenge the ECB's unlimited firepower when there is a credible commitment by governments to follow sound budgetary and structural policies.

In slide 6, I look at the performance of the industrial sector in Italy after the outbreak of the pandemic, comparing it with that of its main eurozone peers. The outcome has been remarkably positive, both for production and exports (in volume terms). The only exception is represented by production of non-durable consumer goods, which has been dragged down by a large contraction in the textile sector. I suspect that Italy's broad outperformance stems both from a genuine improvement in productivity that had started well before COVID-19, and one-off factors that will likely fade going forward.

The former might reflect the impulse of past government policies, especially those aimed at promoting investments in innovation, technology and skills development (the so-called Industria 4.0 plan). The latter include a number of pandemic-related developments, such as low reliance of Italian firms on long and complex supply chains, comparatively limited exposure to shortages of semiconductors, and the boost in global consumption of durable goods. Last but not least, Italian manufacturers have benefitted from the post-pandemic surge in domestic construction investment, which has supported production in a number of sectors. Encouragingly, Italian manufacturers' comparatively high exposure to the gas-price shock does not seem to have left any clear scars.

Speaking about the construction industry conveniently takes me to slide 7, where I outline my expectations for this sector. In a nutshell, the impressive rebound seen after the first pandemic wave is likely to lose steam (signs of this are already visible), because the boom was mainly fueled by extremely generous fiscal measures for improving energy efficiency of residential buildings, which will be phased out. With interest rates rising strongly, construction investment would be at risk of a setback if it were not for the strengthening support of PNRR-related investment, which this year will see an acceleration of implementation following the adoption of several preparatory measures in the earlier stages of the Plan. As (highly subsidized) construction investment in the private sector passes the baton to infrastructure investment, Italy targets a meaningful increase of public investment as a share of GDP over the next few years, to above levels prevailing before the GFC. This is expected to contribute to enhancing the country's potential growth.

On slide 8 I highlight a key issue to keep an eye on, namely the weak profitability of Italian non-financial corporations (NFCs) after the pandemic-induced slump. This stands in contrast to developments in the rest of the euro area. While the gross operating surplus (the national-account equivalent of EBITDA) of eurozone NFCs has already recovered its pre-pandemic trend, that of Italian firms still struggles to reach its pre-pandemic level. This seems to indicate limited capability on the part of Italian firms to pass on to final customers higher costs of energy and intermediate inputs. The lack of more granular data makes it difficult to understand which sectors have been more affected. I suspect that exporters have done well, given that Italy's

outperformance shown in slide 6 is broadly confirmed when exports are expressed in value terms (instead of volume). My gut feeling is that weak profitability might largely be a feature of the services sector, where productivity tends to be lower.

Weak corporate profits have the following main implications. First, given that profitability is a key driver of fixed investment and hiring, we might expect some effects on capex and employment over the coming quarters, also because thin margins increase the vulnerability of Italian firms to ECB rate hikes despite their low stock of debt. Second, Italian firms have limited scope for raising wages, as shown on the right chart.

Slide 9 looks at the behavior of Italian households vis-à-vis eurozone peers. I focus on savings because of their key role in fueling spending after the economy reopened, and in shielding consumers from the energy shock and higher mortgage rates. The good news is that Italian households can enjoy a large buffer of "excess savings" worth about 8% of GDP, broadly in line with the eurozone average. The not-so-good news is that depletion of these excess savings seems to have started, as one can infer from the drop in the savings rate (slightly) below its pre-pandemic level. This drop probably reflects the behavior of budget-constrained households, while the extra savings in the hands of the wealthy part of the population – which account for most of the total stock – are less likely to be spent.

Luckily enough, Italian consumers will be supported by a faster pace of disinflation than what we expect in the other large eurozone countries. The reason is simple and clearly explained in slide 10. Energy inflation has risen much more in Italy than in its main peers, explaining a large part of the positive inflation gap between Italy and the eurozone as a whole. With gas prices declining strongly in recent months, this trend is likely to reverse and inflation is set to post a steeper decline in Italy than in other countries. Subdued wage growth will also contribute to supporting a gradual easing of underlying price pressure while the indirect effects of the energy shock start fading.

In the final chart of my presentation, slide 11, I simulate the trajectory of Italy's public debt-to-GDP ratio under the assumptions that real GDP growth will average 1% (reflecting the view that the PNRR will help raise the country's potential growth rate by a few tenths), inflation and the GDP deflator average 2%, and the marginal cost of debt refinancing settles at 3.25% (consistent with an ECB deposit rate of 2%, which I regard as the upper end of a neutral range).

I consider three scenarios for the primary budget balance: 1. stabilization at around the current deficit of about 1.5% of GDP; 2. an improvement to a balanced position, and 3. an improvement to a surplus of 2%, broadly in line with the pre-pandemic level.

The debt-to-GDP ratio enters an upward-sloping trajectory in the first scenario, tends to stabilize in the second scenario and declines steadily in the third scenario. This simple simulation shows the importance of gradually steering Italy's fiscal stance toward a primary surplus, at a time when high uncertainty surrounds the long-term impact of the PNRR on the economy and the ECB's policy stance that will be needed to ensure a lasting convergence of inflation to the 2% target.

While Italy should fix its primary balance, Europe should move towards new fiscal rules that set the right pace of fiscal adjustment for each individual country and create the necessary room for needed investment. Judging from the news of this past week, member states' positions remain distant, and the stalemate might continue also in the coming months, potentially preventing an agreement on a legislative proposal before year-end. Given that the general escape clause that suspends enforcement of the Stability and Growth Pact is highly unlikely to be extended to next year, the European Commission would then need to issue guidance on the conduct of fiscal policy for 2024 or, much worse, we might end up using some slightly revised version of the old fiscal rules in a completely different economic environment compared to before COVID (and the conflict in Ukraine).

The main challenge is generally related to the need of combining the required national fiscal adjustments with a commitment to reform and investment (in the twin transitions, defense and, in general, EU goods), acknowledging that positive spillover of the latter would play an important role in facilitating the achievement of the former objective.

Best

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