Italy: Economic Update – Summer Beats Expectations but Winter is Coming

Market Report

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NEW ZEALAND FOREIGN AFFAIRS & TRADE
Manatū Aorere

Prepared by the New Zealand Embassy in Rome

Summary

- Italy's economy performed ahead of predictions in the third quarter, with manufacturing output expanding and stronger than expected activity in the construction, agriculture and retail sectors, although a sharp drop in tourists has hit the services sector hard.
- As its second wave sets in, Italy's economy looks set to contract by more than 10% in 2020, with a recovery of 5-6% predicted for 2021. The tourism, hospitality and entertainment sectors are expected to remain the worst affected. Prospects for Italy's manufacturing and export sectors appear better, although these will be strongly linked to business confidence, consumer spending and demand in key global markets. Italy's public debt, which is projected to reach 163% of GDP by the end of 2020, will remain a vulnerability for its economy going forward.
- The government has committed almost €160 billion to mitigate the economic impacts of the crisis. Its response has included investments in strengthening health systems and delivery of core services, measures to support businesses through deferring tax, debt servicing and social security payments and underwriting business loans, initiatives to maintain employment and incomes, and tax breaks to incentivize consumption. These measures represent the largest economic stimulus in Italy's history, and have had some success in maintaining employment and sustaining domestic demand.
- The government has signaled its intention to extend these measures as required in response to pandemic's second wave, and appears determined avoid extreme measures that would smother growth. The economic impacts of the crisis are increasingly being felt across Italian society, with the latest nationwide restrictions triggering demonstrations in many Italian cities.
- Italy is developing a recovery plan to make use of the loans and grants available to it under the EU Recovery Fund. Initial priorities identified include: digitalization and innovation; health; education, science and research; transport infrastructure; social, gender and regional equity; and green growth. The plan needs to be submitted to the European Union by April next year.
- The crisis has impacted negatively on New Zealand's exports to Italy, with goods exports down 5% and services down 12% in the year to June. The services sector will remain seriously affected in the year ahead, particularly travel and tourism. Prospects for goods trade are more promising, particularly for businesses supplying Italy's manufacturing sector, which continues to hold untapped opportunities for New Zealand companies. Businesses supplying the hard-hit food services trade are seeking to offset a collapse in orders by exploring opportunities in Italy's growing retail grocery, specialty retail and e-commerce sectors.

Report

As one of the countries hardest hit in the first wave of the Covid-19 pandemic, Italy's economy was projected to be amongst the most severely affected. In fact its performance exceeded expectations over the summer. Following a 13% contraction in the second quarter, it posted 16.1% growth in the three months to September, although it was still 4.7% down on the same period in 2019. The unemployment rate also tracked below expectations, holding below 10% and indeed falling slightly in September to 9.6%. While Italy recorded its sixth consecutive month of deflation in October, with prices down 0.3% on a year earlier, it posted modest inflation on a monthly basis.

2 Despite these encouraging signs, the economic forecasts look grim. The latest *World Economic Outlook* suggests that Italy remains on track be the worst-affected Eurozone economy after Spain. The International Monetary Fund's October outlook predicts GDP to contract 10.6% in 2020, up from its June forecast of -12.8% but with a slower recovery (+5.2%) in 2021. It projects Italy's deficit to reach 13%, with public debt reaching 163% of GDP. The government's forecasts are rosier, anticipating a 9% contraction in 2020 followed by 6% growth in 2021, a deficit of 10.8% and public debt of 158% of GDP. But Italy's economy has since been hit by the second wave of its pandemic, causing its stock market to shed 5.6% of its value in October, reaching levels last seen at the end of the lockdown in May.

3 The impact of the crisis has not been evenly felt across Italy's economy. The **manufacturing sector** has bounced back well, experiencing its most robust expansion in two and a half years in October, a performance second only to Germany amongst Eurozone economies. The agriculture and construction sectors also performed ahead of expectations, while healthy domestic spending drove a rally in retail. While these sectors have not been directly targeted by the latest public health measures and the government is wary of introducing new restrictions (such as a second national lockdown) that could smother growth, their prospects are strongly linked to demand in key external markets, as well as the impact of the latest surge in cases on domestic business confidence and consumer spending.

4 By contrast, the past nine months have taken a heavy toll on Italy's **service industries**, particularly the tourism, hospitality and entertainment sectors. International tourist numbers are down an estimated 60% in 2020, with 37 million fewer visitors, while domestic tourists have dropped by 16 million (down 31%). Restaurant reservations have fallen an estimated 41% in the same period. These sectors are again expected to be the most affected by the recent spike in Covid-19 cases and the nationwide restrictions imposed in response.

5 Under normal circumstances, Italy's options for responding to the crisis would be constrained by its high levels of public debt. However, the European Council's decision in March to temporarily suspend EU spending rules and the agreement on a Covid-19 recovery package for member states worth €750 billion in grants and cheap loans has provided the government with some breathing space. Together with European Central Bank policies that have kept borrowing costs low, these measures have helped maintain confidence in the Italian economy. Demand for government debt remains healthy, while the spread between Italian and German bonds has returned to pre-crisis levels, dropping to 125.4 bp in early October. Last week S&P Global reaffirmed Italy's debt grade as BBB, and unexpectedly upgraded its outlook from "Negative" to "Stable".

6 This has enabled the government to implement an extensive set of measures to mitigate the worst impacts of the crisis on businesses, workers and families, and to strengthen the health sector and other core services. These measures have been set out in a series of four decrees between March and October which have to date committed almost €160 billion in spending to sustain the recovery. Collectively these measures represent Italy's largest ever economic stimulus. Key elements include:

- Significant investments to strengthen Italy's health sector by doubling intensive care capacities and tripling the number of sub-intensive care beds available, recruiting more than 20,000 new healthcare workers, and increasing stocks of PPE and essential medical equipment.
- Funding regional, provincial and local authorities to strengthen local transport services, public schools and critical infrastructure such as bridges and roads, as well as a cash injection to improve the liquidity of businesses by helping local authorities resolve their debts.
- Supporting private sector liquidity by providing guarantees for up to €400 in loans for small and medium businesses and up to €200 billion in export credits.
- Supporting businesses by suspending or postponing tax and social security payments in the most affected sectors and regions, suspending all tax inspection, collection and liquidation activities until 15 October, and offering a moratorium on the foreclosure of business debt until January 2021 (and until March for tourism-based businesses).
- Sustaining employment and incomes through schemes allowing businesses to forgo paying employees provided they do not make them redundant, while the government partially covers employee salaries.
- One-off payments to the self-employed and employees in the worst affected sectors, as well as payments to support working parents affected by school closures by subsidizing child care services and extended parental leave.
- Tax-based bonuses to boost consumption, including tax deductions for improving the energy efficiency and seismic resilience of buildings, tax credits to promote vacations in Italy and the consumption of Italian food products,

incentives to purchase bicycles, electric scooters, electric or hybrid cars and computers, and tax credits to adapt and sanitise work environments.

7 The government has also introduced measures to combat Italy's black economy and broaden its tax base by providing incentives for companies to use traceable payment methods and for customers to request a receipt. It is also seeking to address the illicit use of illegal foreign workers as domestic workers and in the agricultural sector by declaring an amnesty for existing off-the-books foreign workers and providing opportunities to transform these into legal contracts.

8 In July the government adopted a Decree to facilitate the rapid implementation of public projects. This raised the threshold for projects that can be approved without public tender to €150,000 and streamlined procedures for tenders between €150,000 and €5 million; as well as limiting potential legal sanctions against public officials that currently deter approval of public projects. The Decree also seeks to accelerate investment in priority areas, notably digital infrastructure.

9 While the government's measures to date have focused on addressing immediate economic impacts, its attention is now shifting to plans for longer term recovery making use of available EU loans and grants. The Government presented initial guidelines for its National Plan for Recovery and Resiliency to Parliament on 15 September. The Plan sets out six priority focus areas: digitalization, innovation and competitive production (including development of the 5G network, completion of the national fibre optic rollout, and the strengthening of e-government systems); green revolution and ecological transition; transport infrastructure (including expanding the high-speed railway network and securing its aging network of bridges, roads and tunnels); education, training, research and culture; social, gender and regional equity; and health. It also sets quantitative goals for bringing Italy up to the European average for growth and employment, as well as strengthening investment and research. Initial spending proposals will need to be prioritized and focused on measures that will improve Italy's long term economic performance before the plan is submitted to Brussels in April 2021.

Implications for New Zealand Businesses

10 Trade statistics for the year to June indicate that the economic crisis and two month lockdown have had a negative impact on New Zealand's exports to Italy. Goods exports are down almost 5% to NZ$278 million from the same period last year, largely due to a 30% drop in hides and skins and a 20% drop in wool by value; while services are down 12% thanks to a 15% fall in tourism and travel. Exporters supplying the food services sector have been severely hit by a collapse in orders, although some are exploring opportunities in specialty retail and e-commerce, as well as Italy's €187 billion retail grocery sector.

11 Services imports are likely to remain severely affected in the coming year given ongoing travel restrictions. Prospects appear more promising for goods trade, with inputs to Italy's resilient manufacturing sector (particularly its fashion and design industries) representing around half of New Zealand's merchandise trade. More broadly, Italy's manufacturing sector continues to hold untapped opportunities for New Zealand companies with niche expertise to offer its lucrative value chains.

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