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ECONOMIC OUTLOOK

THE GLOBAL RECOVERY CONTINUES

WHY AFRICA IS CRUCIAL: OPPORTUNITIES AND CRITICAL ISSUES

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FOREWORD

The **global recovery** continues. The pace of growth is the highest since 2010 and accelerated further towards the end of 2017.

Global growth is set to remain solid in the next two years. Only potential exogenous shocks, such as developments in one of the several **geopolitical tensions** that crowd the current international scenario, could derail it.

Its **solidity** is based above all on the **global investment spending pick-up**, which started in the last part of 2016, as the CSC has been reporting since March[1].

The investment pick-up was the missing link for the economic exit from the crisis. Once **triggered** it does not stop in the short time and tends to perpetuate, generating income and demand that justifies new investments.

On the other hand, the **conditions** for investment look very favorable: production capacity is saturated, profit margins are good, expectations of higher demand are widespread, the cost of capital (debt and risk) is at historical lows. The technological revolution in the wake of digitalization encourages companies to modernize the plants. These factors are bound to last for a long time.

This pace of world growth exceeding expectations is also due to the boost the **manufacturing** sector has started to provide again, to the global economy as a whole and to almost all major advanced and emerging countries[2]. Such boost also tends to perpetuate itself, thanks to the transmission through global value chains.

The production and demand for investment goods and manufacturing activity are strong activators of **international trade**, due to the organization of supply chains and the specialization of some economies in the production of machinery and equipment (among these, Germany and Italy stand out).

This activation accounts for a large part of the stronger pick-up in **world trade** recorded this year, along with the additional contribution of the increased growth of Chinese domestic demand, which was stimulated by expansionary measures in view of the Communist Party Congress held in October.

While the latter is bound to subside, now that the political event is over, the activation depending on investment and manufacturing will go on in the two-year forecast horizon. Moreover, the robust growth in the **Euro area**, where integration among economies is at the peak and the network of trades and supply chains is heavy, is supported by a stronger trade dynamics and the increase in the purchasing power of countries exporting raw materials, thanks to the significant increase in commodity prices.

Furthermore, world trade acts as a lift for global recovery, propagating the **expansion** to different countries. The upturn is indeed becoming increasingly synchronized across countries.

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[1] CSC (March 2017), *Congiuntura Flash*.

[2] CSC (2017), Innovation: the effects on jobs performance. Italy in global value chains, *Scenari industriali* n. 8, Roma, SIPI.

Italy participates completely to the full speed of global growth, on the one hand thanks to the excellent performance of **exports** (which have been recently gaining market shares), on the other with the increase in **investment** (encouraged by far-sighted government policies).

Italy has managed to reduce, but not at all to close, the **gap** in GDP growth with respect to the rest of the Euro area. The distance from the pre-crisis peak is still wide.

Central banks have played and will continue to play a decisive role, thanks to extraordinarily accommodative monetary policies able to start the recovery and to consolidate it with a gradual, patient and prudent normalization.

The **FED** will gradually raise interest rates and withdraw the liquidity injected with the purchase of securities.

The **ECB** will begin to reduce asset purchases but will continue its QE at least until the end of 2018, while it will raise interest rates only in 2019. The consequences on the cost of money, however, will start already in 2018, because of anticipation effects.

What are the **consequences** on the economy of having capital at null or zero cost? Limited effects, because this would be the reflection of the renewed **strength of the economy**: the patient would no longer need intensive care.

Instead, this could affect the financial markets, which have **"rich" asset prices**, to use a euphemism by the President of the Federal Reserve Board, Janet Yellen. It is not a bubble, but probably an overvaluation justified by the low short-term rates. A displaced decrease of stock and bond prices would certainly create turbulence, but not such as to derail the world economy, given its solid fundamentals.

Low inflation is one of them, allowing to control the rise in the cost of money in a very measured way. The extraordinarily limited increase of consumer prices has, as already reported several times, both cyclical and structural origins.

Among the cyclical and decreasing ones, leaving inflation close to the objective of the central banks, we can cite the strong and prolonged fall in the prices of raw materials, the large number of **unemployed** or underemployed people and the deeply rooted expectations of low price dynamics, due to long years of crisis.

Global competition and rapid and pervasive **technological progress** are the brakes that act structurally on prices formation, also on labor cost. They represent a sort of threshold to the increase of inflation.

Persistently low inflation has some important **consequences** on the economic system: it keeps real interest rates high, making the repayment of debts more complex both in the public and in the private sector, forcing firms not to transfer the cost increases down in the value chain, thus keeping companies' margins under pressure.

The strength of global growth is resizing the impact of **political uncertainty** on the economy. In spite of recent **electoral results** which induced governability issues even in Germany, demand and production continue to grow in a seemingly unperturbed way.

One explanation is that the **weight** of uncertainty is higher in phases of recession or stagnation, when uncertainty adds up to objective difficulties and there are other institutional weaknesses (inefficient bureaucracy, a slow justice system, and so on).

On the other hand, **political instability** and consensus-seeking populist measures have medium-long term consequences, lowering potential growth, also because important reforms that could increase such potential are not put in place.

This is particularly true for Italy, both as an explanation of the ancient origins of its **slow growth** and as a risk of not persevering during the next legislature along the lines of economic policy and changes which have been painfully undertaken in recent years.

In this respect, the next **political elections** represent a very important test and draw a line for the country, whether to continue along the path of reforms or do nothing, which, in relative terms, would mean to go back.

It is certain is that the **clarity** of the objectives and the simplicity of the tools, pursued and adopted consistently for a protracted period, encourage investment and consumption because they provide an anchoring to positive expectations.

Finally, in the global scenario there are **two risks** not included into our forecasts: oil prices rising more than expected and a stronger euro.

A higher **oil price**, if stemming from a robust world demand, as it would be the case in the next two years (there is no danger of supply shortages, but there is curtailment, with the renewal of the OPEC cut), is a sign of strength and therefore not worrisome.

However, this can change the **relative prices** and the terms of trade and therefore the composition of the final demand, in favor of exports (thanks to income gains in the exporting countries) and at the expense of consumption and investment (given lower household purchasing power and profit margins).

A **stronger euro**, on the other hand, goes in the opposite direction, penalizing sales abroad and increasing domestic purchasing power, with a net negative impact. CSC estimates that, compared to the baseline scenario, an appreciation by 5% in the effective nominal exchange rate would lower Italian GDP by 0.3 p.p. in a two-year horizon.

Given the data released in the meantime, the provisions of the Budget Law and the improved international prospects, the CSC revises upwards its forecast for **Italy's GDP** growth in 2018 to 1.5% (from 1.3% in September) and expects a slowdown in 2019, to 1.2%.

Risks remain on the upside, linked in particular to a stronger rise in public investments and an improvement in credit that would support business investments. Furthermore, **exports** could grow more than expected thanks to the Italian sectoral specialization.

Finally, there is a statistical aspect concerning the trend in **inventories**, which after the summer decline, indicating a dynamic of demand that is much stronger than supply, and could rebound at the end of the year, making a positive contribution to GDP which would also affect 2018. On the other hand, the qualitative indicators available so far point to a change in the fourth quarter which may turn out to be higher than the profile estimated by the CSC.

Employment forecasts are revised upwards as well. Labor market performance, in fact, exceeds expectations and confirms that the ongoing economic recovery does not leave workers behind. In fact, employment is the only economic variable together with exports that has exceeded the pre-crisis peak.

This does not mean that the worst is behind us: **7.7 million** people are still totally or partially without a job.

The issue of low **youth employment** is particularly alarming and, unlike the past, it leads to emigration. The migration of young people out of Italy, many of them holding high school diplomas or bachelor degrees, continued in 2016 at a higher rate: 61 thousands of 18 to 39 years-old people left, +19.1% with respect to 2015, with a total of 115 thousands of people emigrating, +12.0%. 25,000 graduates of all ages have gone abroad in 2016.

The recovery of the Italian economy is still not supported by the **banking system**: loans, even taking into account the sale of bad loans, remain stationary, or even decrease. Long **repayment deadlines**, both for the public sector and for private individuals, determine an extraordinarily high need for circulating capital relative to international standards.

On the other hand, companies have understood that the challenges of the "new normal" situation require a **cultural change** in corporate management and the adoption of strategies aimed at quantitative and qualitative growth. The extraordinary success of the "*Contratti di rete*" (*Network contracts*), which nowadays are economically relevant in size, testifies how much this awareness is spreading, thanks to the results of these networks in terms of employment and turnover gains.

Finally, the **Italian public accounts** continue along the path of consolidation and the public debt has started to decrease.

The sum of public and private debt is very low in relation to GDP compared to all other major economies (with the exception of Germany) and Italy is, through its current account surplus, a net saving supplier to other nations. These facts should not be used as an alibi to stop the **spending review** and the reorientation of state intervention, to increase its effectiveness and efficiency and to reduce the risk of a destabilizing crisis of confidence.

Italy’s relationship with **Africa** poses important medium-long-term challenges.

The continent is facing unprecedented **opportunities** and **headwinds**.

In the first three decades of the **new millennium**, its economy has grown in a sustained manner, leaving behind a quarter of a century of stagnation and retreat in the per capita income.

Unlike what happened in emerging Asian countries, the main driver of development was not industrialization, but the **transition** from agriculture to the tertiary sector. This allows some African economies to be less dependent on foreign demand.

However, productivity growth is slower in the service sectors and it is not easy to predict which economic model can guarantee further and lasting development.

Demographics will play a crucial role. With 1 billion and 256 million inhabitants (17% of the world's population) Africa is already a giant. And it will be so more and more in the coming decades: in 2050 the population will have exploded to 2 billion and 528 million and, demographically, a quarter of the planet will be African.

If in the same period of time, together with the dividend of the strong increase in population, the **per capita GDP** reached today's China, the African economy would be five times bigger than today. At the same time, the GDP of advanced countries will grow only slightly more than twice.

This suggests that **environmental** and **migratory issues** will become crucial and that economic and political relations with Africa are already decisive.

Italy has further reasons (geographical, demographic and geopolitical) to strengthen them. It can do so within the Africa-EU partnership, renewed at the end of November 2017 at the Abidjan summit. Also because the United States and China, which have been effectively pursuing strategies for Africa for a long time, are the main players with whom it is difficult to compete without EU intervention.

Confindustria proposes an **Italian plan for Africa** that integrates the European objectives. The main actions are: the linguistic, technical and managerial training of young Africans in Italian companies; the spread of high schools for African industrial and banking executives; the financing of industrial start-ups in the countries of the continent; the use of African immigration in Italy as an agent for knowledge and development of local markets.

In this way, Italy intends to be a bridge between Europe and Africa, a role that it can naturally play successfully.

1 FORECASTS

Summary

- **GDP and domestic demand** – CSC confirms Italian **GDP** growth at 1.5% in 2017, revises it up to 1.5% in 2018 (from +1.3%) and foresees a +1.2% in 2019. **Household consumption** is expected to increase by 1.5% in 2017, 1.3% in 2018 and 1.1% in 2019. **Business investment** growth is projected to remain robust: +3.4% in 2017, +3.3% in 2018 and +2.4% in 2019. Purchases of machinery and transport equipment will continue to grow at a good pace: +5.3% in 2017, +4.4% in 2018 and +2.6% in 2019. Construction investment will start to recover, as predicted: +1.2% in 2017, +2.0% in 2018 and +2.2% in 2019.

- **Foreign trade** – **Italian exports** are projected to grow at high speed gaining further market share: +5.2% in 2017, +4.2% in 2018 and +3.7% in 2019. They are sustained by the strengthening of global trade. **Imports** as well are set to rise rapidly (+5.5%, +4.4% and +3.6%), fueled by the robust export performance itself, which incorporates goods and services purchased abroad, and by the investment pick-up. Foreign trade level will be much higher in 2019 compared to the pre-crisis maximum reached in 2007. Trade and current account **surpluses** remain high (3.4% and 2.5% of GDP in 2019 respectively); therefore foreign debt continues to decline.

- **Credit** – **Corporate loans** are not yet supporting the Italian recovery. Some factors sustain the supply (as ECB ultra easy monetary policy), but others act in the opposite direction (the uncertainty over the regulation and the increased banks' aversion towards risk). Interest rates are at the minimum and demand of credit is at pre-crisis values, while supply remains tight. **Loans to household** are growing (+2.3% per year), with looser supply conditions and an increasing demand.

- **Employment, Wages and ULC** – **Italian employment** will grow by 1.1% in 2018 and by 1.0% in 2019 (+500k FTEs) after a rise of 1.2% in 2017 and 1.4% in 2016. The number of employed persons will increase by 1.0% in 2018 and by 0.9% in 2019 (+1.1% in 2017), exceeding pre-crisis levels (Spring 2008) by 370k at the end of 2019. The unemployment rate will drop to 11.3% this year, 10.9% in 2018 and 10.5% in 2019. The crucial problem is the low employment rate of young people: 40.5% for those aged 15-34, among the lowest in the Eurozone. Total **wage dynamics** will continue to be driven by the contractual one, however exceeding it as in the previous two-year period. Given the increase in inflation, real wages per FTE will grow only slightly in 2018-2019 (+0.1% combined total), after rising by 1.6% between 2013-2017 period. The **ULC** will increase both in 2018 and 2019.

- **Prices and profit margins** – **Inflation** in Italy is expected to increase gradually, at +1.0% in 2018 on average and +1.3% in 2019. It rises slightly net of food and energy, from the minimum registered in November (+0.3%). Profit margins result eroded again, but keeping good levels, due to rise in raw material prices and ULC.

- **Fiscal policy** – Italy's **public deficit** decreases to 2.1% of GDP this year (from 2.5% in 2016), 1.7% in 2018 and 1.9% in 2019. CSC forecasts incorporate the measures that will be part of the 2018 Budget Law and exclude safeguard clauses in 2019. The **debt-to-GDP ratio** declines to 131.6% in 2017 (from 132.0% in 2016), 130.5% in 2018 and 129.6% in 2019. The

Budget Law is expected to sustain growth. The implementation of structural reforms is necessary in order to increase potential growth and accelerate public debt reduction.

- **World trade** – **Global trade** momentum is strengthening, supported by manufacturing and investment. CSC foresees +4.3% in 2017, +3.9% in 2018 and +3.6% in 2019.
- **Eurozone** – Euro area registers strong economic expansion in 2017. Following consumption and investment acceleration, CSC revises GDP forecasts up for 2017 (+2.4%) and 2018 (+2.1%), edging it down towards potential growth in 2019 (+1.9%).
- **United States** – GDP growth performance for this year looks even stronger than predicted, thanks to consumption solidity and investment expansion. CSC expects +2.3% in 2017, +2.5% in 2018 and +2.1% in 2019.
- **Japan** – GDP growth accelerates thanks to foreign demand and private investment. Industrial production keeps driving growth.
- **United Kingdom** – CSC keeps GDP forecasts unchanged in 2017 at +1.6% and revises it down in 2018 from +1.5% to +1.3%, a pace of growth that is expected to continue in 2019. Household consumption shows a weak trend.
- **Emerging economies** – CSC keeps unchanged GDP growth forecasts for the emerging countries in 2017 (+4.7%) and 2018 (+4.8%), a slight acceleration is expected in 2019 (+4.9%). **China** continues going on the soft landing trajectory: GDP growth is revised up both in 2017 (+6.7 from +6.6%) and 2018 (+6.4% from 6.2%), slowing down to 6.1% in 2019. CSC revises down estimates for **India** in 2017 (+6.7% from +7.3%); GDP growth will accelerates in 2018 (+7.4%) and 2019 (+7.5%). **Brazil** grows beyond expectations (+0.6% in 2017, +2.0% in 2018 and +2.5% in 2019) due to the increase in commodity prices. The positive economic outlook in **Russia** is confirmed: +1.9% in 2017, +2.0% in 2018 and +1.6% in 2019.
- **Raw material prices** – **Oil price** climbs, reaching the OPEC target: CSC estimates 63$ on average in 2018 (from 54 in 2017) and 65$ in 2019. The US extraction increases, while OPEC and several non-OPEC countries agreed on prolonging the freeze of production. Prices of other **raw materials** are volatile and divergent in 2017, due to the unstable balance between demand and supply; limited price increases are expected over the two-year forecast horizon.
- **Monetary policy** – **ECB** rates remain at the present minimum for the whole 2018 and most of 2019: CSC expects the first hike in 4Q-19. The QE has been extended until September 2018 at a lower monthly rate and CSC expects it to end in 1Q-19. The **FED** goes on raising rates: one hike in December (1.25-1.50%), other two in 2018 and another in 2019. It has just started reducing the huge stock of securities (4.239 billion of dollars).
- **Rates, Stocks and exchange rates** – Long-term interest rates increase, but they are still under the maximum levels reached at the end of 2016 (yield on 10-year Treasury is at 2.4%). Stock markets are still rising (S&P 500 +15.3% since the beginning of the year). The **euro** exchange rate has climbed to 1.18 against the dollar last month on average, strengthened by the robust European recovery, while the higher political uncertainty does not affect financial markets.