

Views on the Italian Economy

Research Department
July 2019

Sample

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Monthly note

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Evolution of the economic picture

Public finances: danger averted (for now)

The good news on public finances is not that the Commission has refrained from proposing the launching of an infraction procedure, but that the deficit for 2019 was restored to 2%, in part as a result of structural factors. Furthermore, the plunge in rate spreads, while not entirely due to the announcement of the Commission, proves that caution in handling public accounts can produce additional benefits in terms of interest expenditure, freeing up fiscal leeway. A lesson which, we hope, will be kept in mind in drafting the 2020 Budget. The latter remains a major obstacle to overcome.

Paolo Mameli

With a [press release](#) issued on 3 July, the EU Commission has announced it will not propose to the Council the opening of an excessive debt procedure against Italy. According to the Commission, the 7.6 billion euro adjustment proposed by the Italian government is worth 0.4% of GDP in nominal terms, but even more in structural terms (8.2 billion. i.e. 0.45% of GDP). Therefore, the package will allow a reduction of the 2019 deficit from 2.5% as estimated by the Commission in its Spring 2019 Economic Forecasts, to 2%¹, and most importantly implies a two-tenth structural improvement this year (rather than a worsening by the same amount as previously estimated). Taking into account the 0.18% flexibility margin already allowed for “unusual events” (to be confirmed *ex post* based on final 2019 data), the trend of the structural balance this year would be adjusted by 0.4%, and therefore be “broadly compliant” with the rule for the present year, balancing albeit “in part” the 2018 deterioration. In essence, “broad compliance” with the structural balance principle (including the flexibility clause) in 2019 has persuaded the Commission to “turn the other way” on failure to respect the structural balance rule in 2018 and the debt rule in 2019 (which, based on our estimates, is expected to grow by over one point this year, as there is still no trace of the expected privatisations package, worth one per cent of GDP).

The government has averted the danger of a European infraction procedure being opened against Italy

The Commission acknowledged the efforts made by the Italian government, that on 1st July approved the so-called “budget consolidation” (mid-year budget + decree-law “freezing” welfare savings). Rather than an actual emergency budget, this is an update of public finance balances which highlights the improvement of several items, totalling 7.6 billion euros. The “savings” stem from:

- **Higher revenues** by 6.2 billion: 1) taxes (2.9 billion), thanks to the effects on VAT revenues of the new electronic invoicing system and to anti-tax evasion operations (1.25 billion from the settlement of the dispute with the Kering Group); 2) social security contributions (0.6 billion); 3) other revenues (2.7 billion), including dividends from the Bank of Italy, Cassa Depositi and Prestiti, and other state-participated companies.
- **Spending cuts** worth 1.5 billion euros stemming from the fewer than expected applications for the citizen’s income and early retirement measures: Legislative Decree No. 61 of 2 July firmly sets aside 1.5 billion euros (a conservative estimate of savings, in our view) to cut the deficit (the decree also includes a safeguard clause which “freezes” appropriations for Ministries by the same amount, to be used if savings fall short of the estimated amount).
- Lastly, the government has “re-modulated” the previous clause on spending, worth 2 billion euros (which had been included in the December agreement with the EU), abolishing the 300 million euros in spending cuts on local public transport, “saving” the “coming-of-age” bonus for 18-year-olds, integrating 500 million euros into the Development and Cohesion Fund, and stepping up by 50 million euros appropriations for the functioning of the tax revenue agency (Agenzia delle Entrate).

¹ Taking into account the effects of the recent budget “consolidation” (7.6 Bn), on top of the 2019 target deficit included in the DEF (42.1 Bn), the result is a new 2019 no-policy-change deficit at 34.5 Bn, ie 1.9% as a % of the target GDP growth according to the DEF (2.1% of GDP based on our own estimate on 2019 nominal GDP growth)

For 2020, the Commission:

- acknowledges the reassurances offered by the Italian government, which in a [letter](#) sent on 2 July to Brussels reasserted its commitment to make a further structural effort in line with the rules of the Stability and Growth Pact, in particular through a new spending review process and a revision of tax expenditures, combined with an improvement in the no-policy-change trend of balances resulting from a better than expected performance this year;
- in addition to monitoring the implementation of the measures proposed for this year, the Commission will ensure that the 2020 Budget is in respect of the rules of the Pact, and verify, within the context of the European Semester, the implementation of the structural reforms included in the country-specific recommendations.

In essence, the government has cut out three months for itself, although the confrontation with the Commission could heighten again on occasion of the next Budget session. In theory, according to the latest [country-specific recommendations](#), Italy is asked to reduce its structural deficit in 2020 by 0.6%, and net primary public spending by 0.1% of GDP. As the structural deficit was estimated to worsen by 1.2% in the Spring Economic Forecasts, the budget consolidation to implement in order to achieve full respect of the Pact would amount to 1.8% of GDP, i.e. around 33 billion euros. While the Commission seems unlikely to impose such a large budget, it seems equally unlikely to accept a deterioration of the structural balance (therefore the bar would be set at 1.3% of GDP at its lowest, roughly in line with the worth of the safeguard clauses on indirect taxes, i.e. 23 billion).

Tab. 1 – The measures approved by the Italian government on 1st July 2019

	EUR million	% of GDP
Higher revenues	6,240	0.4
of which:		
taxes	2,900	0.2
contributions	600	0.0
other revenues	2,740	0.2
Spending cuts	1,020	0.1
Higher expenditure	-1,154	-0.1
of which:		
Development and Cohesion Fund	-500	0.0
"Coming of age Bonus"	-100	0.0
Tax revenue agency functioning	-50	0.0
Local public transport	-300	0.0
Other spending items	-204	0.0
Savings on citizen's income and "quota 100" schemes	1,500	0.1
Total consolidation	7,606	0.4

Source: Ministry of the Economy

Tab. 2 – Funding required to confirm the DEF policy framework (consistent with a 0.2% improvement of the structural budget in 2020)

	% of GDP		
Gap between policy framework deficit and unchanged legislation:	2020	2021	2022
Safeguard clauses	1.3	1.5	1.5
Spending under unchanged policies	0.1	0.3	0.4
Deficit correction	-0.1	0.0	0.3
Total funding requirements	1.3	1.8	2.2
Funding included in the DEF (to be detailed):			
Higher revenues	0.0	0.1	0.4
Spending cuts	0.1	0.3	0.4
Total funding	0.1	0.4	0.8
Further expansionary measures:			
Public investments (included in the DEF)	0.1	0.1	0.1
"Flat tax" (possible)	0.8	0.8	0.8
Total further expansionary measures	0.9	0.9	0.9
Total resources needed with expansionary measures	2.2	2.7	3.1
Total resources needed with expansionary measures and funding	2.1	2.3	2.3

Source: Intesa Sanpaolo elaborations on MEF data

Based on the government's forecasts laid out in the April DEF economic and financial planning document, it would be enough to fully fund the safeguard clauses to obtain a slight improvement of the structural balance. However, the positive effects on balances of the stronger than expected performance achieved this year need to be taken into account, as they project a more favourable deficit in 2020 than indicated in the DEF. More in detail, an updated estimate of the no-policy-change 2020 deficit must take into account the following factors:

- 1) The **rollover effects** of the recently approved "budget adjustment":
 - a. **Higher revenues:** not all of the 6.2 billion euros in higher revenues highlighted for 2019 in the "budget adjustment" are structural; in particular, we believe tax revenues should not include, to say the least, the one billion deriving from the settlement of the dispute with the Kering Group, and, among non fiscal revenues, 1.4 Bn from dividends from

Savings will have positive effects on 2020 as well...

state-participated companies² : in total, higher revenues for 2020 would amount at 3.8 billions;

- b. **Lower spending:** for the time being, the government has not yet released an official estimate of the savings on the “citizen’s income” and “Quota 100” programmes (or better the various new early retirement measures provided for in the 2019-21 three-year period). In our view, the 1.5 billion set aside as per DL 61/2019 is an even cautious forecast for the current year: using INPS projections on the number of applications for the two programmes, we estimate possible savings (compared to what included in DL 4/2019) at 2.3 Bn this year and 3.8 Bn next year;
- 2) Review of **interest expenditure:** compared to the date of compilation of the DEF, the shock on the Italian yield curve has been rising along the curve, from around 20 bps on 2Y BTSP to over 80 bps from 7 years up. This shift means savings on interest spending, compared to the figures included in the DEF, of about 0.5 EUR Bn in 2019 and 1.7 EUR Bn in 2020;
- 3) The effects on budget balances of the **revision of growth estimates:** our current forecast of GDP growth in 2020 is 0.5%, only slightly lower than the projection included in the DEF (0.6%), therefore the impact on the no-policy-change balance should be limited to around 0.05% of GDP (although the final impact could be greater, as risks to the forecast are skewed to the downside³).

Taking into account all these factors, which imply savings compared to the estimates provided in the DEF of around 8.3 billion euros, i.e. around half a point of GDP, **the no-policy-change deficit in 2020 could be favourably revised in the next public finance documents from 2.1% (policy framework) as indicated in the DEF, to 1.6-1.7%** (a value which obviously includes the activation of the safeguard clauses on indirect clauses provided for under existing legislation). This would be consistent with a slight structural improvement in 2020 compared to 2019, by 0.2-0.3%.

This implies that, in order to obtain a slight improvement of the structural balance in 2020, the bar could be lowered from around 23 billion as per the clauses, to **around 15 billion. However, if in addition to these resources the need to fund the first instalment of the so-called flat tax for families should arise, the worth of the budget would increase back, close to 30 billion.**

Tab. 3 – Updated estimates of net PA borrowing, 2019 and 2020 (data in billion euros if not indicated otherwise)

	2019 (gov. estimate)	2019 (our estimate)	2020 (our estimate)
Effects of the 2019 budget adjustment	7.6	8.4	7.5
- Higher revenues	6.2	6.2	3.8
- Citizen’s income and “Quota 100”	1.5	2.3	3.8
- Other	-0.1	-0.1	-0.1
Effects of growth forecast revisions	0.0	0.0	-0.9
Effects of interest expenditure revision	0.0	0.5	1.7
CHANGE IN DEFICIT	7.6	8.9	8.3
DEF policy framework deficit (% of GDP)	-2.4	-2.4	-2.1
New no-policy-change deficit (% of GDP)	-1.9*	-2.1	-1.7

Note: *keeping nominal GDP growth as per the DEF policy framework. Source: Intesa Sanpaolo estimates and elaborations on MEF data

² In particular, in the case of Cassa Depositi e Prestiti, it seems unlikely that in the next few years as well the assembly will vote for an almost full distribution of net profits (as was the case on the major shareholder’s request in 2019, for a further 960 million in addition to the sum provided for previously). By contrast, distribution of the Bank of Italy’s profits (1.7 billion more than previously forecast) could remain high next year as well, as it is tied to the expansion of the central bank’s balance sheet following the public asset purchase programme.

³ Consensus forecast for Italian GDP growth in 2020 is 0.4% (source: *Consensus Forecasts* by *Consensus Economics*, July issue).

To date, there is no information on what funding measures the government intends to rely on. Both the April DEF and the letter just sent to Brussels explicitly mention:

...but the Budget Law for next year remains challenging

- **An organic review of public spending:** press sources mention a target (very ambitious, in our view) of 4-5 billion in 2020, on top of the 2 billion already targeted (which according to the government's DEF would increase to 8 billion in 2022); however, for the time being there is no news of any effective programmes being opened in this direction;
- **Higher tax revenues that would mostly be generated by measures aimed at strengthening the fight against tax evasion:** however, the government's DEF only forecasts higher revenues from the fight against tax evasion starting in 2021 (2 billion, on the rise to 8 billion from 2022);
- **A review of tax expenditures** (including the so-called "Renzi bonus"), which, however, only seems likely within the framework of a re-modulation of the Irpef personal income tax in an expansionary mode.

Lastly, as mentioned in the letter to the Commission, the government counts on a roll-over effect on next year as well of the stronger than expected performance achieved this year. **In any case, funding requirements, even following the recent budget "correction", remain very large.**

In essence, crunch time has been pushed back, and could come with the 2020 Budget Law. The task of avoiding an infraction procedure in the autumn seems challenging, unless the government coalition parties decide to afford priority to financial stability over their understandable concerns tied to domestic political consensus. However, the plunge in rate spreads, while not entirely due to the announcement of the Commission, proves that caution in handling public accounts can produce additional benefits in terms of interest expenditure, freeing up fiscal leeway. A lesson which, we hope, will be kept in mind in drafting the 2020 Budget.

Summary of macroeconomic forecasts

Macroeconomic forecasts													
	2018	2019f	2020f	2018		2019				2020			
				Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
GDP (at constant prices, y/y)	0.7	0.2	0.5	0.5	0.0	-0.1	-0.1	0.3	0.5	0.5	0.6	0.5	0.5
- % q/q change				-0.1	-0.1	0.1	0.0	0.2	0.1	0.1	0.1	0.2	0.2
Households' consumption	0.6	0.5	0.5	0.0	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.2	0.2
Public consumption	0.2	0.1	0.0	-0.2	-0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Fixed investments	3.2	0.4	0.1	-1.2	0.6	0.6	-0.7	-0.2	-0.1	0.1	0.2	0.3	0.4
- Investments in machinery	2.0	-1.0	-0.3	-2.8	0.6	-0.2	-0.5	-0.5	-0.5	0.0	0.2	0.4	0.4
- Investments in means of transport	14.5	-4.9	0.2	-3.0	1.4	-5.0	0.0	-0.5	0.0	0.0	0.2	0.4	0.4
- Investments in construction	2.2	3.1	0.5	0.9	0.4	2.6	-1.0	0.2	0.2	0.2	0.2	0.2	0.3
Exports	1.4	2.7	2.3	1.1	1.4	0.2	0.3	0.6	0.6	0.6	0.6	0.6	0.5
Imports	1.8	1.1	2.3	0.4	1.3	-1.5	0.8	0.6	0.6	0.5	0.5	0.6	0.6
Contribution % GDP													
Foreign trade	-0.1	0.5	0.1	0.2	0.1	0.5	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Final domestic demand	1.0	0.4	0.3	-0.3	0.2	0.2	0.0	0.1	0.1	0.1	0.1	0.2	0.2
Inventories chg.	-0.1	-0.8	0.1	-0.1	-0.3	-0.7	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Production activity													
Industrial output	0.5	-0.1	1.3	-0.4	-1.0	1.0	-0.6	0.5	0.4	0.4	0.5	0.3	0.0
Prices, wages and incomes													
Consumer prices (y/y)	1.1	0.8	1.3	1.5	1.4	1.0	0.8	0.5	0.8	1.1	1.1	1.4	1.6
- excluding food, energy (y/y)	0.7	0.6	1.3	0.7	0.7	0.4	0.5	0.4	1.1	1.4	1.0	1.2	1.5
PPI (y/y)	3.3	0.9	0.8	4.5	4.8	3.2	1.6	-0.1	-1.2	-0.3	1.1	1.2	1.2
Unemployment (%)	10.6	10.2	10.2	10.3	10.6	10.4	10.0	10.1	10.2	10.3	10.3	10.2	10.1
Total employed workers	0.9	0.4	0.3	-0.2	-0.1	0.1	0.4	0.0	0.0	0.0	0.1	0.1	0.1
Contract-based wages	1.5	1.2	1.1										
Real disposable income	0.8	0.4	1.0										
Savings rate (%)	8.0	8.3	8.3										
Balance of payments													
Current account (% of GDP)	2.5	2.9	2.9										
Public finance*													
PA budget balance (% of GDP)	-2.1	-2.1	-3.1										
Debt (% of GDP)	132.2	133.3	134.4										
Financial variables													
3-month Euribor (%)	-0.31	-0.40	-0.40	-0.32	-0.31	-0.31	-0.33	-0.39	-0.40	-0.40	-0.39	-0.40	-0.40
10Y BTP (%)	2.95	2.82	2.97	2.80	2.95	2.54	2.45	2.65	2.82	2.99	2.99	3.01	2.97
BTP/Bund spread (%)	2.15	2.74	3.20	2.50	2.92	2.61	2.57	2.78	3.01	3.19	3.21	3.20	3.18

Note: (*) 2020 no-policy change projections ie net of safeguard clauses and privatizations. Source: Istat, Thomson Reuters-Datastream, Intesa Sanpaolo elaborations and forecasts

Industrial production rebounds more than expected in May

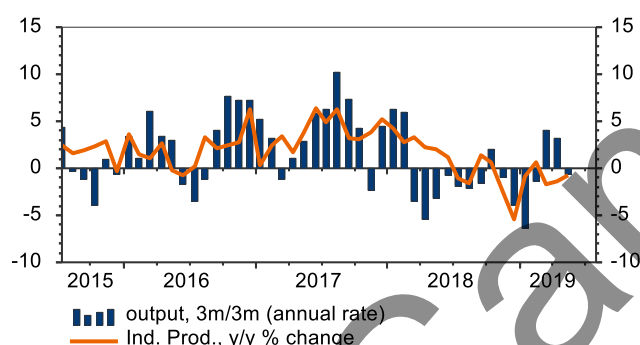
Industrial production rebounded more than expected in May (+0.9% m/m), after declining over the two previous months. The trend is similar to Germany and France, suggesting that calendar and weather effects may have played a role in the m/m volatility observed in recent months.

The recovery was led by the sectors hit hard in April ie consumer durable goods (+3.4% m/m after -1.8% previous), and capital goods (+1.9% m/m after -2.5% previous). The rise would have been even stronger net of energy (dropping by -2.1% m/m, as expected). In year-on-year terms, output remained in the red at -0.7% adjusted by calendar effects (from -1.5% previous).

The data is encouraging, although one-off effects may have played a role in recent months. In any case, production is on course for a drop of -0.6% q/q in the Spring quarter, confirming downside risks to GDP growth, due to be released by Istat on 31 July.

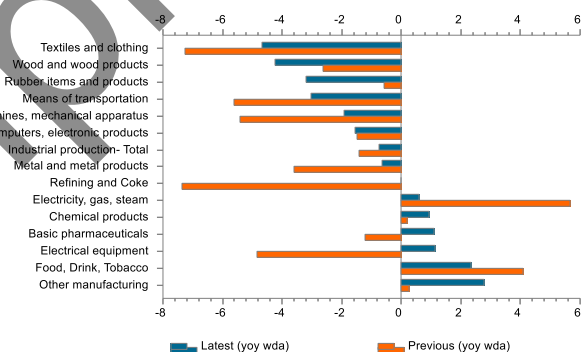
As industry and constructions dragged economic activity (and services do not seem to have offset this weakness), a negative figure remains likely. A rebound is possible in Q3, which is a necessary condition to see GDP rising this year overall.

IP rebounds in May, but the recent trend net of monthly volatility remains weak



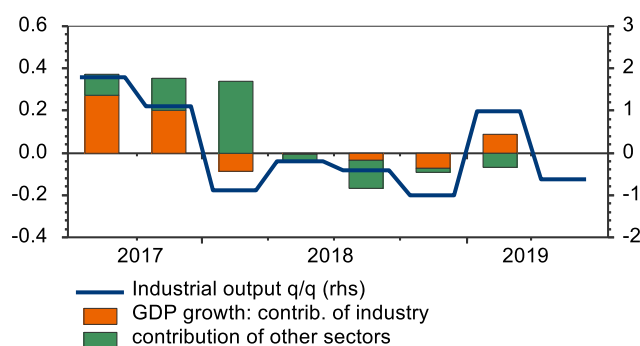
Source: Thomson Reuters-Datastream Charting

Most sectors maintain a year-on-year decline



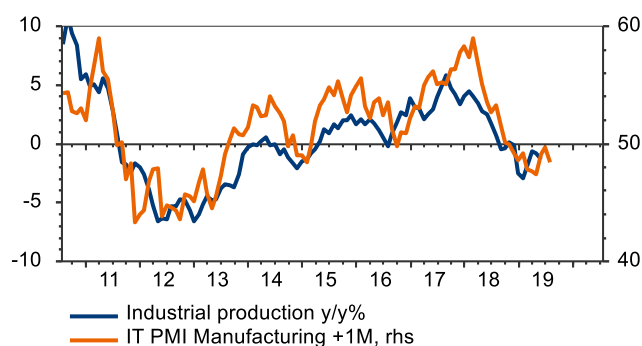
Source: Thomson Reuters-Datastream Charting

Industry should have dragged GDP in Q2



Source: Thomson Reuters-Datastream Charting

Survey data, at least for now, are not signalling a stable expansionary trend



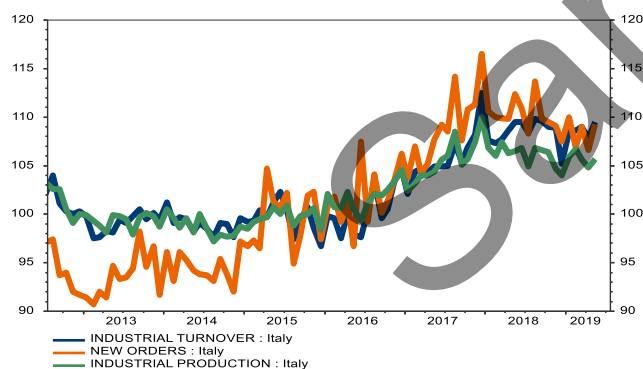
Source: Thomson Reuters-Datastream Charting

Factory orders and turnover back up, but confidence on the decline

Industrial revenues and orders climbed back up in May (by +1.6% and +1.5% m/m respectively), after dropping in April. Revenues edged back up in year-on-year terms (+0.3% adjusted by calendar effects), whereas orders stayed in the red (-2.5% y/y, due to a contraction in foreign orders). Broken down data outlined an encouraging monthly recovery of revenues in the capital goods sector (and durable consumer goods, which are driving the annual trend). Standout year-on-year revenues growth was achieved by computers and electronics, and by extraction activities (+19.1% and +15.6% y/y respectively), whereas on the orders side the only segments to avoid a decline were electric appliances (+8.9%) and textiles (+2.1%). In a nutshell, the recovery of revenues and orders is of similar size to the recovery of industrial output in the same month, confirming that calendar effects may have weighed on April-May volatility (net of which the trend of economic activity in the industrial sector would have been essentially stagnant).

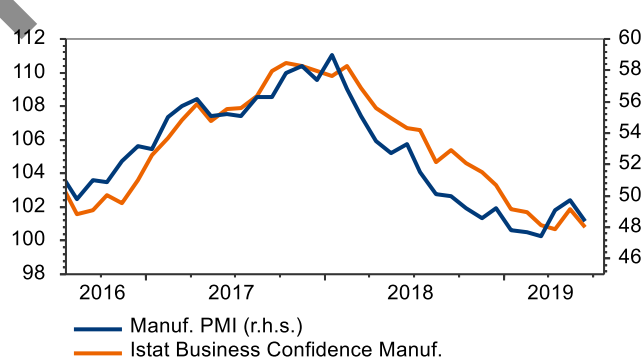
In the meantime, confidence surveys in the manufacturing sector are still not pointing to a stable expansion. The Istat survey index decreased in June, to 100.8 from 101.9 previous. The level is very close to the lowest since February 2015. The decline was mostly due to current orders, reaching the lowest level since September 2016. Also, the manufacturing PMI fell back in June, after rising the previous two months. It was the ninth month in a row in recessionary territory. The drop was more marked than expected, to 48.4 from May's 49.7. The breakdown of the survey shows a sharp fall in new orders, to 47.4 from 49.6, with foreign orders declining to the same extent, to 47.5 from 49.5: it is a record low since August 2012. The production reading decreased less sharply to 49 from 49.7, and employment fell below the 50 threshold, to 48.2 (second lowest level since July 2013) from 50.2 previous. Input prices decreased, to a new low since April 2016, while final prices rebounded (the mark-up is the widest since February 2016). In a nutshell, the level of business confidence indices is not yet consistent with a recovery in industrial activity, and signals downward risks to the recovery that most observers are expecting from the Summer quarter (after a weak Spring).

Stagnant trend for output, orders and revenues



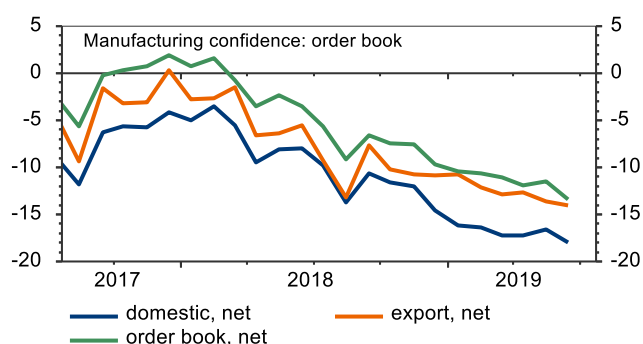
Source: Thomson Reuters-Datastream Charting

Survey data still not stably in expansionary territory



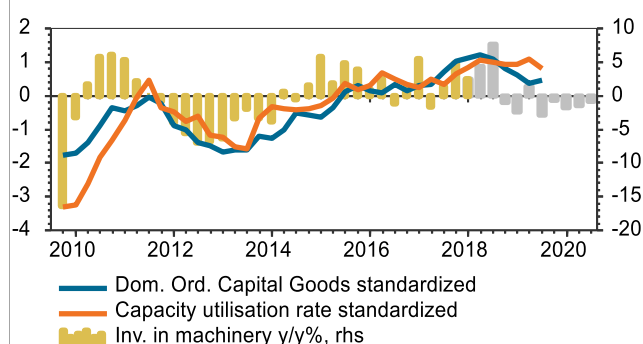
Source: Thomson Reuters-Datastream Charting

Manufacturing companies take a more pessimistic outlook on orders



Source: Thomson Reuters-Datastream Charting

Orders of capital goods and capacity utilisation both on the decline



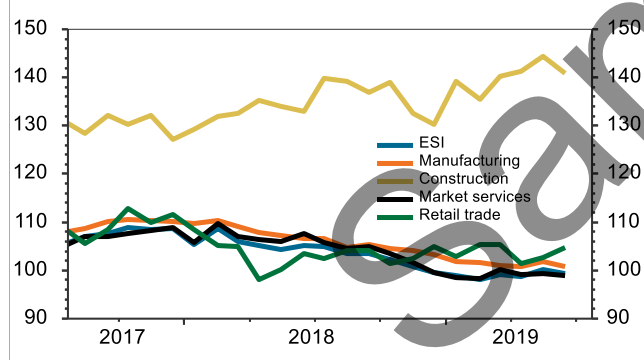
Source: Thomson Reuters-Datastream Charting

Services still experiencing an essentially stagnant phase

Revenues in the services sector dropped by 0.2% q/q in 1Q 2019, and by -0.5% y/y (first negative changes since 2014). In the quarter, performance was held back in particular by professional, scientific and technical activities (-1.2%) and by travel agencies and business services companies (-0.8%), as opposed to higher revenues in information and communication services (+0.9%). In year-on-year terms, the only segment which made significant progress were hotel and restaurant services (+1.8%), as opposed to a sharp drop in professional, scientific and technical activities (-5.6%); in particular, the wholesale trade and motor vehicle sales and repair segments incurred the first negative change since 1Q 2014.

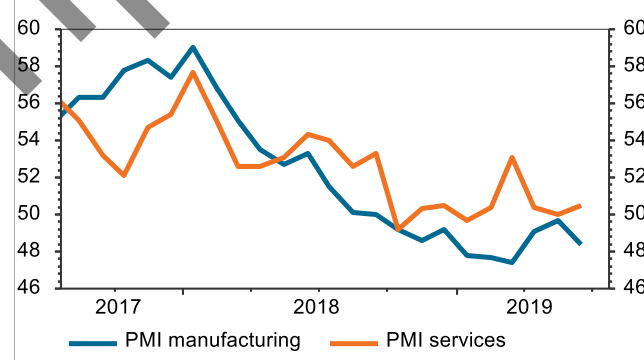
In the past year, services have held back GDP growth, contributing to value added by -0.1% on average per quarter. Only the rebound of the manufacturing sector enabled GDP growth to return into positive territory at the beginning of 2019. In the present quarter, industry will in all likelihood resume making a negative contribution, which is unlikely to be balanced by services, as the levels of survey indices remain consistent at best with a stagnant trend in the sector: 1) in June, the services PMI improved from 50 to 50.5, roughly back in line with April levels and with the average for the past six months. In particular, new orders rebounded (from 49.2 to 50.6), as well as business expectations (to 65.4, a high in over a year), and most importantly employment (to 53.8, a high since 2007); overall, the PMI survey suggests that Italian GDP growth in 2Q 2019 could be zero or marginally negative; 2) business confidence in the services sector, as measured by the Istat survey, was down modestly in June, all considered, from 99.3 to 98.9, staying above the lows hit in the opening two months of the year. The worsening of the index was due to current views on orders and on the business trend, whereas expectations for the orders trend improved.

Business confidence in the main sectors of activity



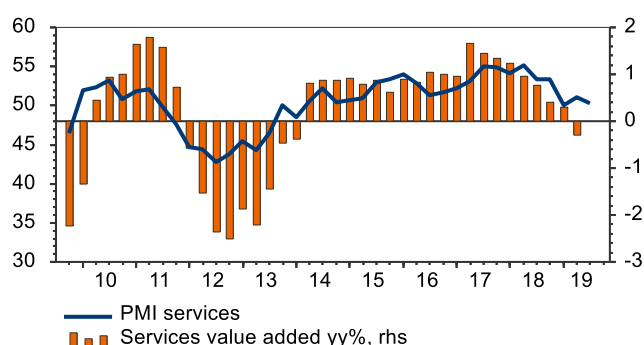
Source: Thomson Reuters-Datastream Charting

Services still more upbeat than manufacturing



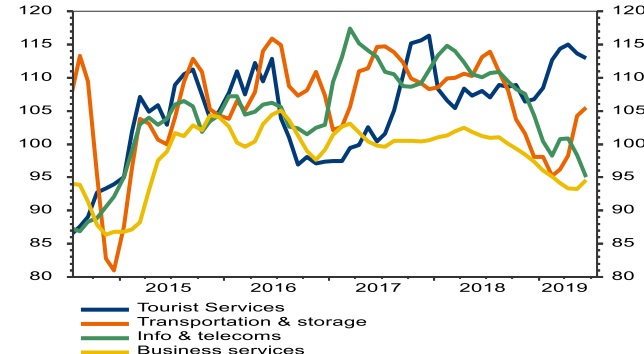
Source: Thomson Reuters-Datastream Charting

Survey data signal that the contribution of services to value added is essentially zero in the present phase



Source: Thomson Reuters-Datastream Charting

Sentiment recovering in the forwarding and warehousing, worsening in IT and communication



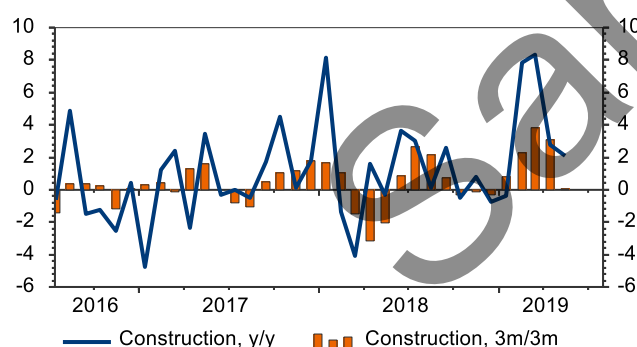
Note: 3-month moving averages. Source: Thomson Reuters-Datastream Charting

Construction sector still on an uptrend, but losing steam

Construction sector output was little changed in May (-0.1% m/m), after declining over the two previous months (-3.1% m/m in April). The year-on-year change slowed down further, to 2% from 2.8% in April (adjusted for calendar effects) and from 8.6% in March, which marked a high in almost 12 years. Following the surge in 1Q (+3.8% q/q), output is on course for a -2.4% q/q correction in the three following months. This means that construction, which made a significantly positive contribution to value added at the beginning of the year, is expected to have held back GDP growth in the spring months, adding evidence to a possible slowdown in economic activity in the second quarter. To date, monthly performances in 2019 seem to have been distorted by weather conditions, which were very favourable in the opening months of the year but then took a turn for the worse until May. Therefore, a recovery is possible in June. In any case, the level of builders' confidence (which, despite dropping in June, remains close to its 21-year highs) is consistent with ongoing expansion in the sector.

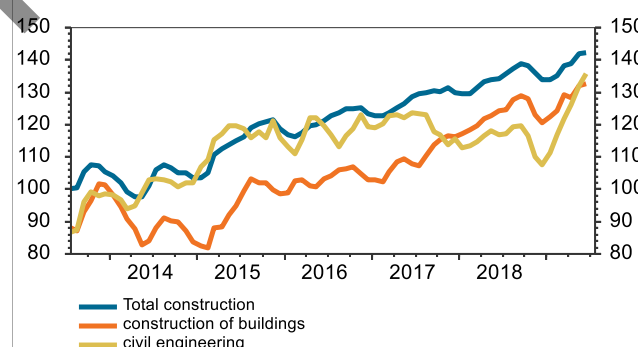
Home prices dropped again in 1Q 2019, by -0.5% q/q, placing the year-on-year rate at -0.8% (from -0.5% y/y in the previous quarter). The quarterly decline was explained in roughly equal measure by new and existing home sales, although the former are still on an uptrend in year-on-year terms, and in fact accelerated to +1.7% y/y, a high in almost three years (marking the sixth consecutive quarterly rise). Compared to the average in 2010 (the first year of the historical data series), home prices have decreased by 17.2% (existing homes -23.7%, new homes +0.8%), in a phase in which residential real estate transactions are still recovering (+8.8% y/y).

Construction sector output corrected recently, but trend remains expansionary...



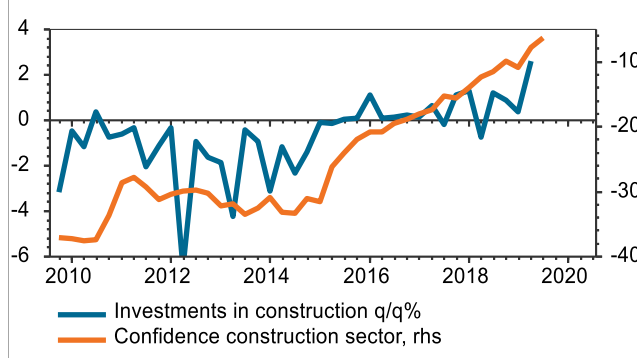
Source: Thomson Reuters-Datastream Charting

...in civil engineering in particular



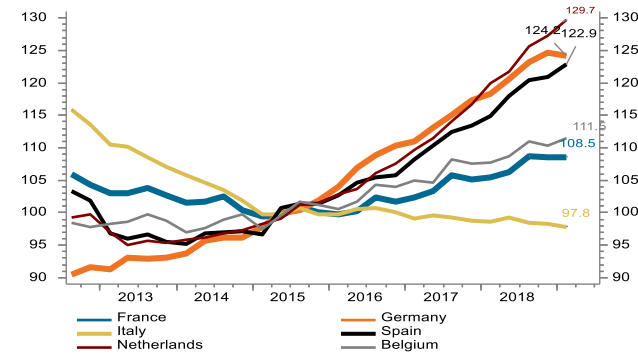
Note: 3-month moving averages. Source: Thomson Reuters-Datastream Charting

Business confidence at its highest in years...



Source: Thomson Reuters-Datastream Charting

...but home prices are still failing to show a recovery

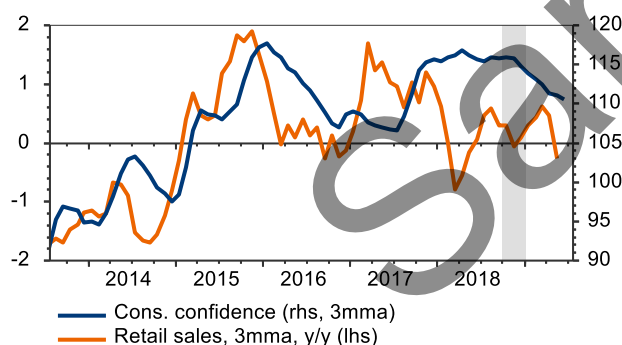


Source: Thomson Reuters-Datastream Charting

Trend of households' consumption remains moderate

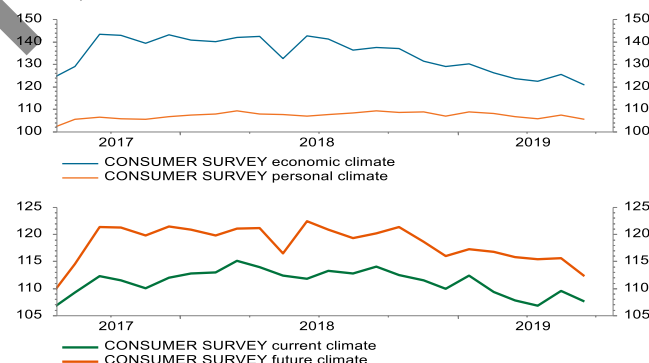
In 1Q, the disposable income of consumer households increased by a hefty +0.9% q/q, after dropping by -0.2% q/q at the end of 2018. The change was the same in real terms (in this case, the decline was -0.5% q/q in 4Q 2018 and -0.1% in 3Q 2018). In the same period, consumption in nominal terms increased by only 0.2% q/q, therefore the savings rate rose by an impressive seven tenths compared to the previous quarter, to 8.4%. In a nutshell, **the income of families recovered after decreasing at the end of 2018 but has not translated into stronger consumption. Retail sales decreased in May**, by -0.7% m/m in value and -0.8% m/m in volume (after remaining stable in April). **The last positive change was recorded in January.** The decline affected both food and non-food items. The year-on-year change dropped back into negative territory, to -1.8% from +4.2% previously. Istat found a widening of the growth differential between businesses operating on small surfaces and chain retail stores; the only segment of retail to record significant progress significant progress in annual terms were food discount outlets (+2.2% y/y) and e-commerce (also on the decline nonetheless, to +10.6%). The only group of products which scored an increase in year-on-year sales were equipment for computers, telecommunications and telephone services (+2.3%); vice versa, the worst performances were recorded by clothing and furs (-4.9%) and shoe-wear, leather and travel goods (-4.8%). In a nutshell, the reading confirms that the April increase (driven by food) was tied to the late Easter. **Consumer confidence declined in June**, to 109.6 from 111.6 previous: it is the lowest reading since July 2017. The breakdown shows that the deterioration affects all the main components of the survey, in particular the **national economic climate and unemployment expectations.** In short, **consumption may continue to grow at a moderate pace in the upcoming quarters** (by 0.1-0.2% q/q in 2Q, on a par with, or marginally better, than the three previous months). **We do not expect a significant acceleration next year**, as the employment trend is slowing, and the impact of the citizen's income will be smaller than forecast.

Both retail sales and consumer confidence on the decline



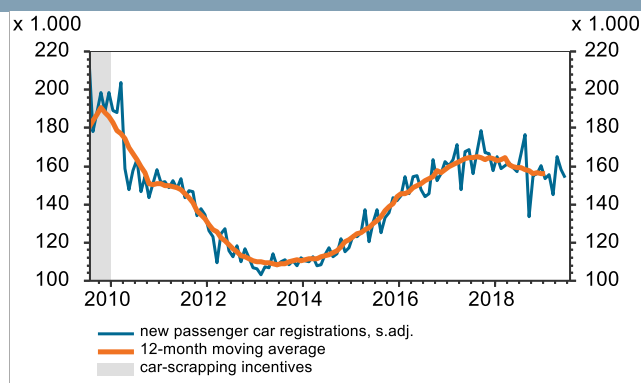
Note: shaded area = recession. Source: Thomson Reuters-Datastream Charting

Households less optimistic on future prospects



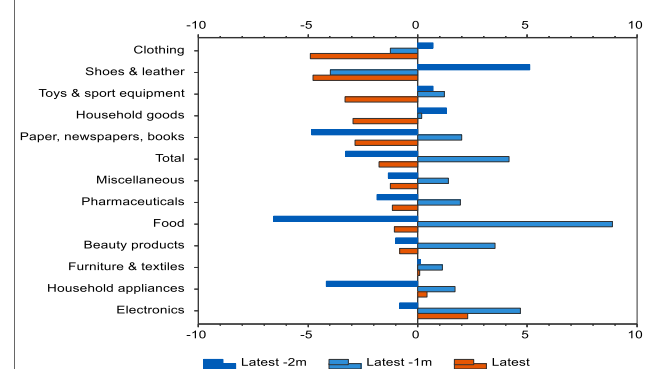
Source: Thomson Reuters-Datastream Charting

Motor vehicle registrations still on a negative trend



Source: Thomson Reuters-Datastream Charting

Only electronic equipment achieved an appreciable year-on-year increase in retail sales



Source: Thomson Reuters-Datastream Charting

Unemployment down to below 10% for the first time since 2012

The unemployment rate fell surprisingly in May, to 9.9% from 10.1% previous (revised from a preliminary estimate at 10.2%). It is the lowest level in more than 7 years.

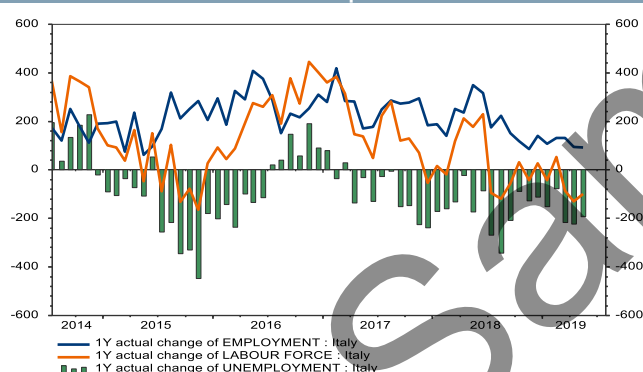
The drop was mainly due to job creation (+67k payrolls), with the employment rate rising to an all-time record 59% (albeit much lower than in other developed countries). The inactivity rate was stable at a record low (34.3%).

In the month, job creation was due all to men (+66k), while the stability of the inactivity rate was the result of decrease among men (-29k) and increase for women (+33k). The increase of employment involved both employees (permanent and temporary) and self-employed people.

The youth unemployment rate (15-24 years) fell significantly, to 30.5% from 31.1% previous. It is the second lowest level since October 2011 (again, albeit much higher than in other Eurozone countries, with the exception of Greece and Spain). Yet, once again, job gains were concentrated in the 50-64 years bracket (+88 k in the month).

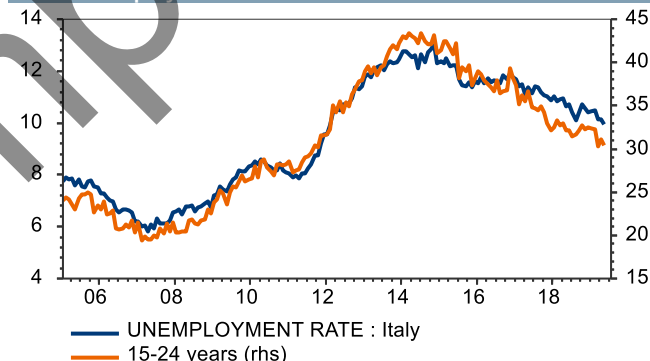
Overall, May's preliminary data ease fears of a U-turn in labour market conditions.

Job creation has lost steam in the past few months...



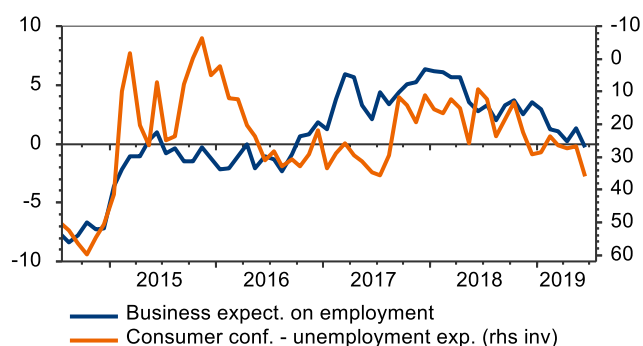
Source: Thomson Reuters-Datastream Charting

...but unemployment remains on a downtrend



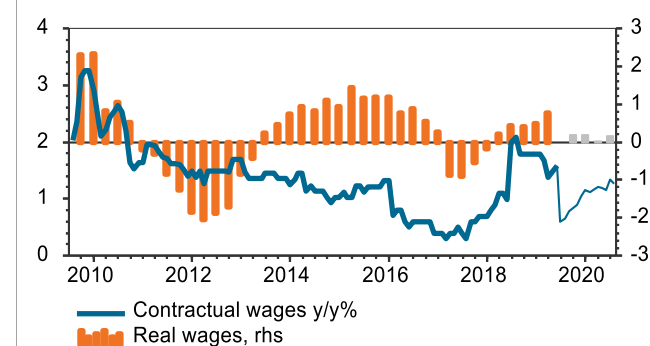
Source: Thomson Reuters-Datastream Charting

Views of households and businesses less optimistic on employment



Source: Thomson Reuters-Datastream Charting

Contract-based wages may have peaked



Source: Thomson Reuters-Datastream Charting

Foreign trade recovering moderately

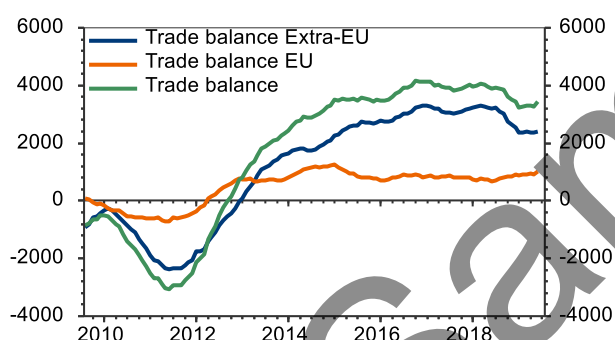
In May, trade flows increased for the third month in a row. Unlike in the two previous months, exports proved more upbeat (+1.3% m/m, to the EU in particular) than imports (+0.7% m/m). The strengthening of flows in both directions was driven by non-durable consumer goods.

In year-on-year terms, exports accelerated to +8% and imports slowed to +3.4%. Further progress was made by the **pharmaceutical sector** (+49.8%, especially in terms of sales to the United States, Belgium and Germany) and leatherwear (+19.8%, with Switzerland leading the way); engineering exports also increased (+4.3%).

By country, in addition to the aforementioned **double-digit growth in sales to the United States and Switzerland** (+16% and +21.4% respectively), a solid increase in sales was recorded towards Italy's two main trade partners, namely Germany and France (+8.4% in both cases). Sales remain in red to the OPEC countries (-14.3%), ASEAN (+7.3%) and Turkey (-6.2%).

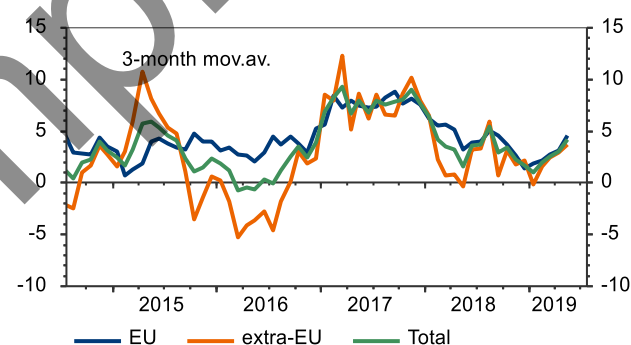
In a nutshell, **foreign trade is experiencing a moderate recovery phase, although in the Spring quarter contribution to GDP could prove negative.**

Trade surplus retreating somewhat from all-time highs



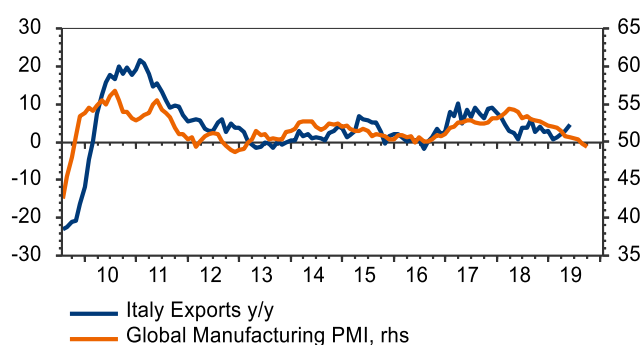
Source: Thomson Reuters-Datastream Charting

Exports recovering moderately



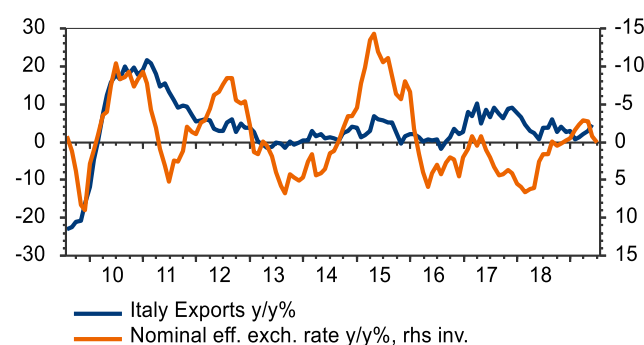
Source: Thomson Reuters-Datastream Charting

Global demand still slowing...



Source: Thomson Reuters-Datastream Charting

...with a roughly neutral exchange rate



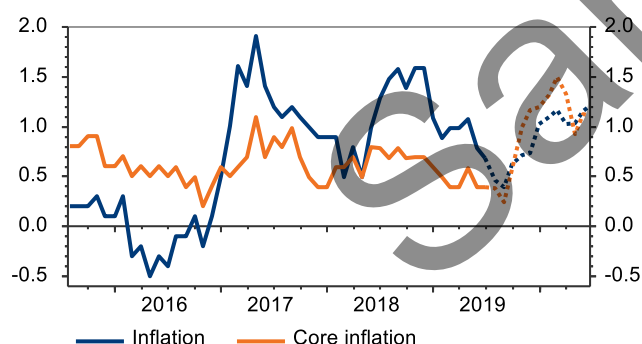
Source: Thomson Reuters-Datastream Charting

Inflation still on a downtrend

Inflation was 0.7% y/y based on the national index and 0.8% y/y harmonised in June, down by one tenth compared to the previous month. In the month, prices increased by one tenth based on both indices. In the month, according to the national index, as expected the strongest contribution to the monthly increase in prices was made by transport (+0.8% m/m). The price increases seem to be seasonal, as they are mostly driven by transport services (+2.1% m/m), despite the drop in fuel prices (diesel fuel -1.2%, petrol -1% m/m). Price increase in the hotel and restaurant services segment (+0.3% m/m) and in "leisure, entertainment and culture" (+0.1% m/m) also appear to be of a seasonal nature. Vice versa, prices dropped further and significantly in the communications segment (-1.6% m/m, -9.4% y/y). Food prices also decreased (-0.4% m/m). Underlying inflation remained stable at 0.4% y/y (core prices in the month grew more than the overall index, by 0.2% m/m). The so-called "shopping basket" dropped on a monthly basis (-0.3% m/m) as a result of lower food prices; the year-on-year trend slowed to 0.2% from 0.3%. We believe the CPI may hit a low at 0.4-0.5% in August, before rebounding in the following months, to close to 1% at the end of the year. We think risks on the inflation outlook are tilted to the downside.

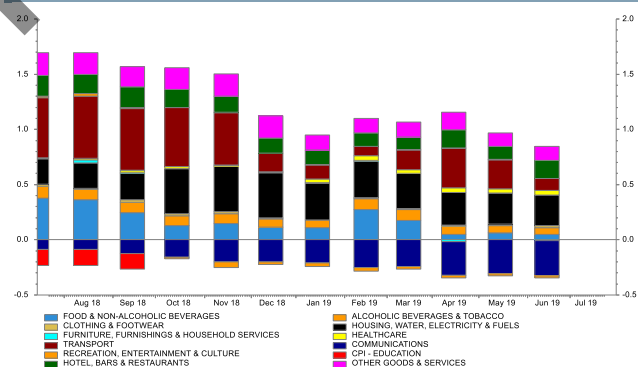
Producer prices were stable in March, after dropping by one tenth in February, despite growing by 0.2% m/m on the foreign market (mostly in the euro area). In the month, the prices of energy and consumer goods dropped marginally, as opposed to higher durable goods prices. The year-on-year trend slowed further, from 3.1% to 2.9% (3.7% on the domestic market), after peaking at 5.8% last October. Net of energy, producer prices were little more than stagnant (0.6% y/y on the domestic market). The reading confirms the absence of core pressures upstream of the production chain.

Inflation is expected to stay on a downtrend for a few further months, before rising back in the closing months of the year



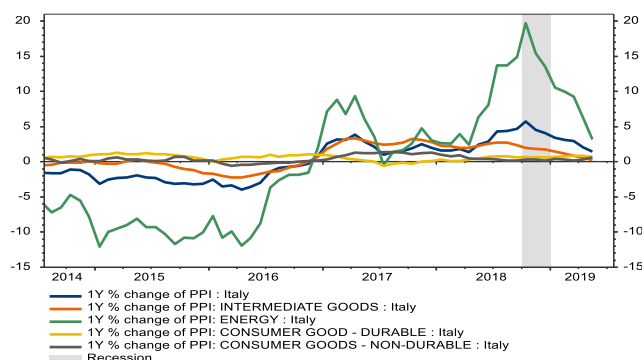
Source: Thomson Reuters-Datastream Charting

Recent deceleration mostly explained by transport



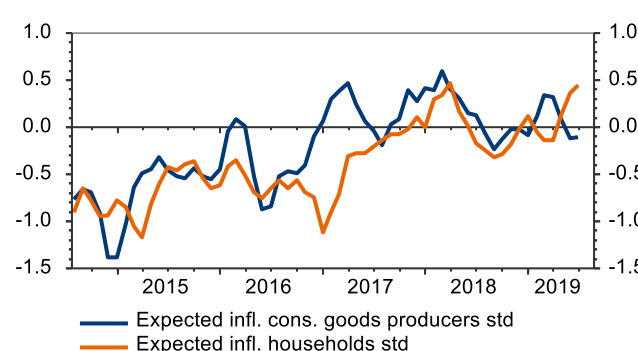
Source: Thomson Reuters-Datastream Charting

The PPI (+1.5% y/y in May) signals easing pressures upstream of the production chain, in the energy segment in particular



Source: Thomson Reuters-Datastream Charting

Inflation expectations of households back on the rise



Source: Thomson Reuters-Datastream Charting

Trends in the Italian banking sector

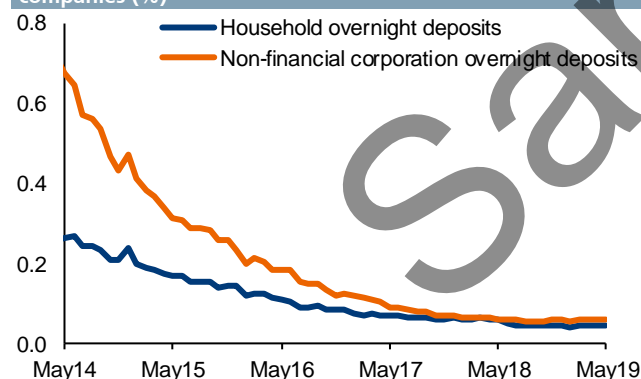
Rates on new loans stable or down, increases came to an end

In May, the cost of customer funding stocks recorded a small rebound that, however, is due to a sudden increase in the rate on household deposits redeemable upon prior notice, a category which includes the forms of Cassa Depositi e Prestiti postal savings. The continuous rise in rates on new deposits with agreed maturity offered to households on the longer maturities, which experience a surge, is more significant. For rates on new loans, the situation ranges between stability and a downward turn. In May, the average rate on disbursements to non-financial companies recorded a fall, which almost nullified all of April's increase, while the average rate on new loans to households for house purchases was stable. ABI estimates for June show a considerable drop in both the average rate on new loans to businesses and the rate for disbursements to households for house purchases.

Elisa Coletti

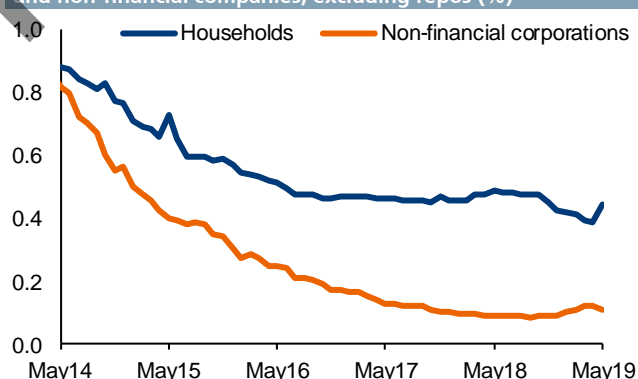
In May, the average rate on the stock of deposits was 0.38%, from 0.33% in April (0.35% in the first quarter), and is expected to be stable in June, according to ABI estimates. The highest level compared to the previous months is due to the rise in the rate on the stock of household deposits (+6bps mom following six months of decline for a total of -9bps), in turn driven by the rebound in the rate on deposits redeemable upon prior notice of 23bps mom, which follows six months of back-to-back decline for a total of -31bps (please note that this category of deposits includes the forms of Cassa Depositi e Prestiti postal savings). On the other hand, in the same period, the average rate on the stock of deposits with agreed maturity decreased by 4bps following the turnaround of the rate paid to non-financial companies (-23bps mom after an increase of 26bps in six months). The average rate on overnight deposits continued to be stable at 0.05%, which is expected to remain the same in June according to ABI forecasts.

Rates on overnight deposits of households and non-financial companies (%)



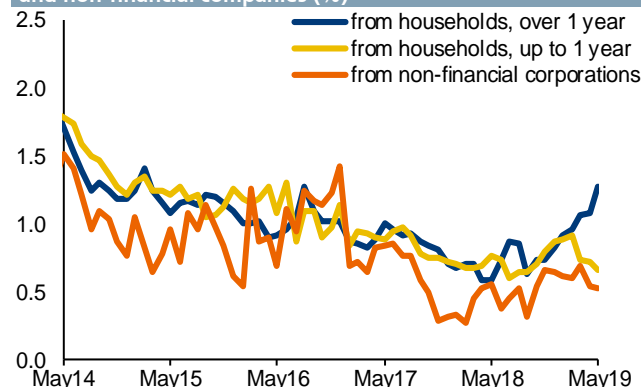
Source: Bank of Italy

Average rates on overall outstanding deposits of households and non-financial companies, excluding repos (%)



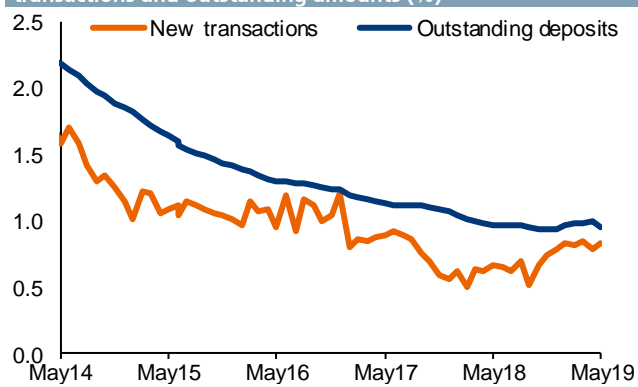
Source: Bank of Italy

Rates on new deposits with agreed maturity of households and non-financial companies (%)



Source: Bank of Italy

Average rates on deposits with agreed maturity: new transactions and outstanding amounts (%)

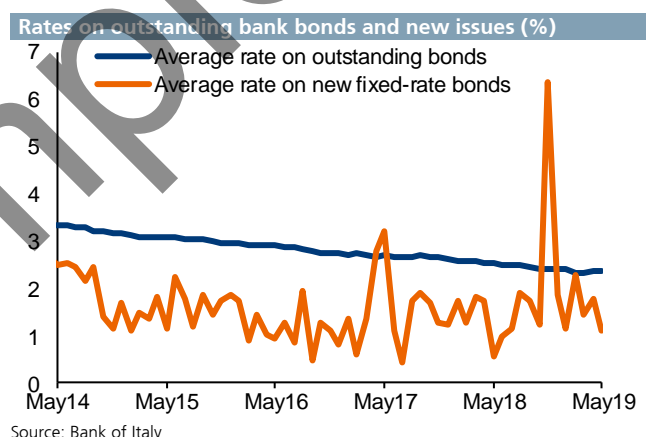
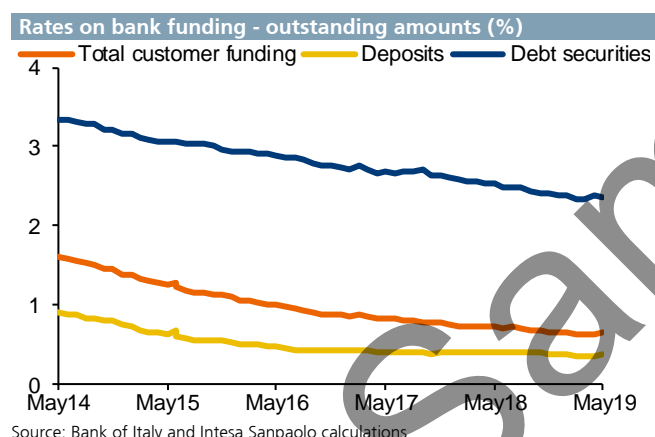


Source: Bank of Italy

With regard to the rates on new deposits with agreed maturity, in May, **for the eighth month running, the rates paid to households on longer maturities continued to surge**. In detail, the average rate on maturities exceeding 1 year increased by as much as 20bps mom to 1.27%, reaching a total of +65bps in eight months, taking the rate to the highest level since February 2015. On the other hand, in May the rate offered to households on shorter maturities (those up to 1 year) continued to fall for the third consecutive month, by -5bps mom to 0.65%, while the rate on deposits with agreed maturity to businesses fell slightly from 0.53% to 0.51%. The result of these movements is a slight increase in the overall rate on new deposits with agreed maturity of households and businesses, by 4bps mom to 0.82%, in line with the average of the first four months of 2019, well above last year's levels (0.64% over the whole of 2018).

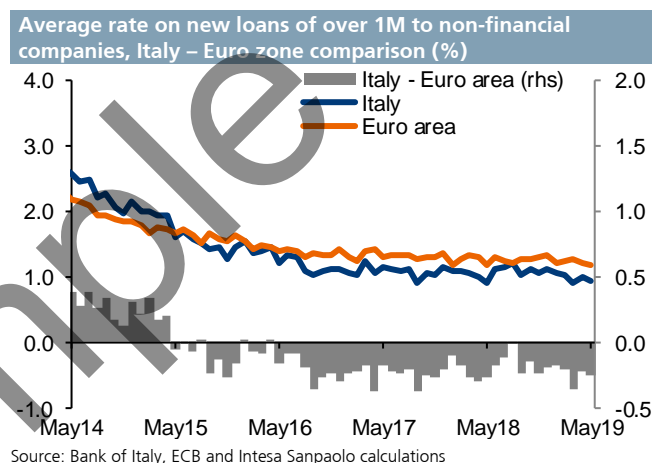
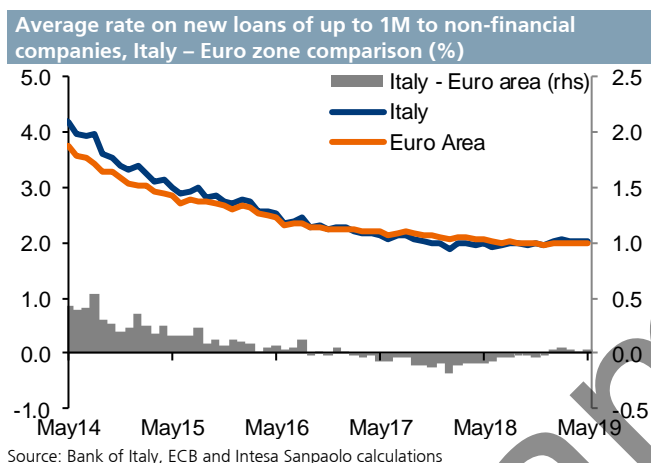
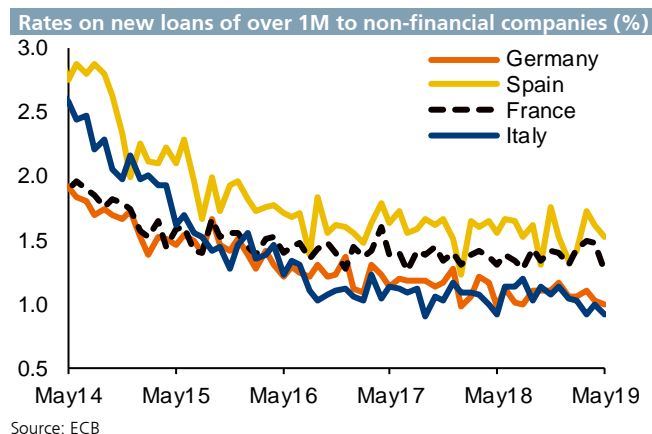
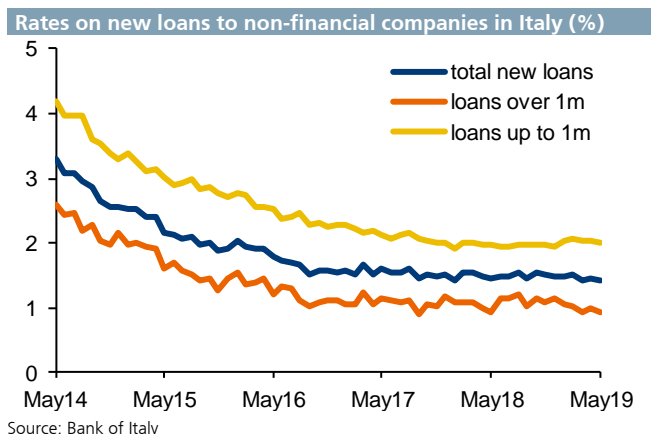
Following April's increase to 2.38%, the average rate on the stock of bonds settled down to 2.37%, confirmed also for June according to ABI estimates.

As a result of the above, **the total cost of customer funding rose** to 0.65%, with a recovery of 3bps mom, whereas it is expected to fall again slightly in June, by 1bp mom according to ABI estimates. May's level is lower than the level for last year, by 5bps in comparison with the 0.70% average for 2018, even if higher when compared with the figures for the first four months of 2019 (0.62% average).

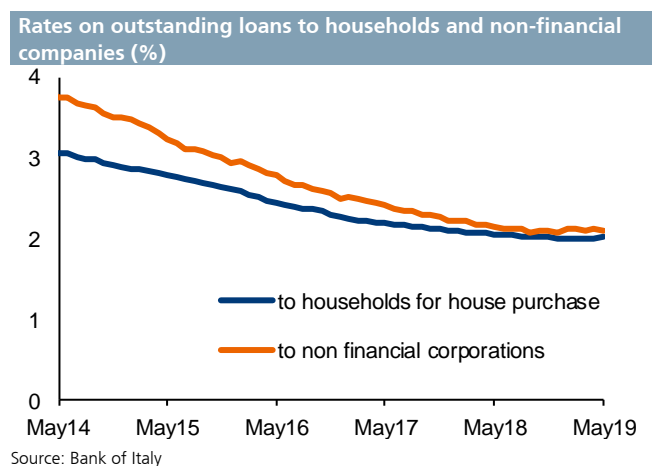
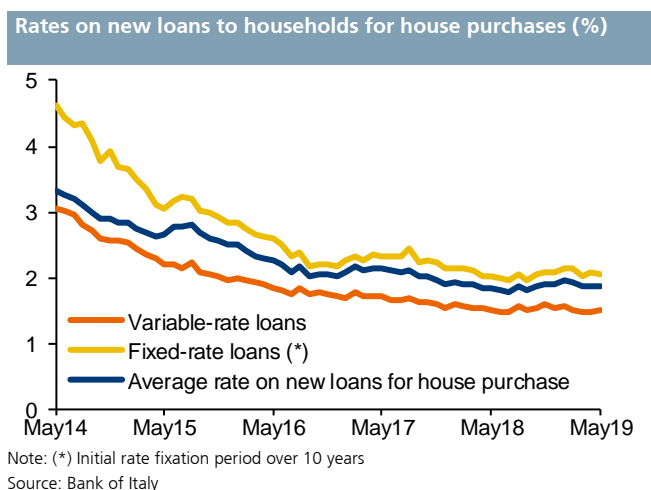


The situation for rates on new loans is **essentially stable, or at the very most veering downwards, while the increases seem to have come to an end**. In May **the average rate on disbursements to non-financial companies declined slightly**, by -3 bps mom, almost completely nullifying the 4bps increase recorded in April. According to ABI estimates, from May's level of 1.43% the rate is to drop to 1.36% in June. Looking at the components, as usual, the trend in the rate on new larger loans was decisive, having fallen in May by 8bps mom to 0.92% mom, after rising in April by 9bps mom. In contrast, the rate on loans below 1M was stable at 2.02% for the third month in a row, remaining higher than the values recorded over 2018, that were always below 2%.

Consequently, with respect to Europe, **the spread between the Italian rate on loans of up to 1M and the Euro zone average remained slightly positive, for the 5th month running**, equal to 3bps. For the rate on new loans of over 1M, the negative spread with the Euro zone remained wide at -25bps.

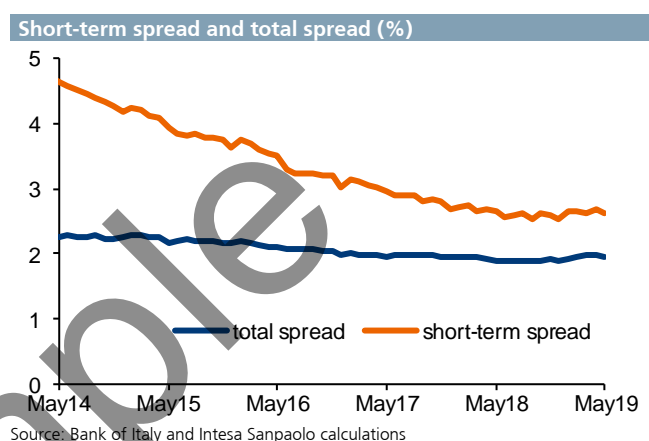
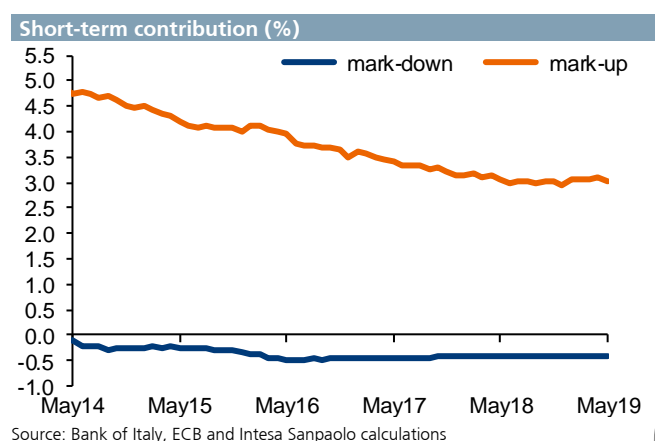


With regard to rates on new loans to households for house purchases, in May the average rate remained stable at 1.85%, for the third month in a row after the increase recorded in January 2019 and the downward readjustment in the following months. In contrast, a significant decline to 1.78% is apparent for June, according to ABI estimates. With regard to the components, the stability of the average figure recorded in May is the result of a slight increase in the floating rate to 1.51%, after two months at 1.47%. Meanwhile, the fixed rate dropped to 2.05% from 2.08% in April.



As regards the average rate on the stock of loans, after the rise in January to 2.58%, the level was confirmed in the following months at 2.59% in May and April and with little change in June, at 2.57% according to ABI estimates.

In May, considering the small rise in the cost of funding, there was a **worsening in the spread between lending and funding rates, from 1.98% to 1.94%, to be followed by a stabilisation in June**, according to ABI estimates. The contribution of demand deposits remained essentially unchanged again in May, with the mark-down⁴ at -0.42%, in line with the previous months. The mark-up on short-term lending rates remained above 3%, falling from 3.10% to 3.03% due to the drop in short-term rates, returning to March's level after April's rebound.



⁴ Spread between the 1-month Euribor and the rate on overnight deposits of households and businesses.

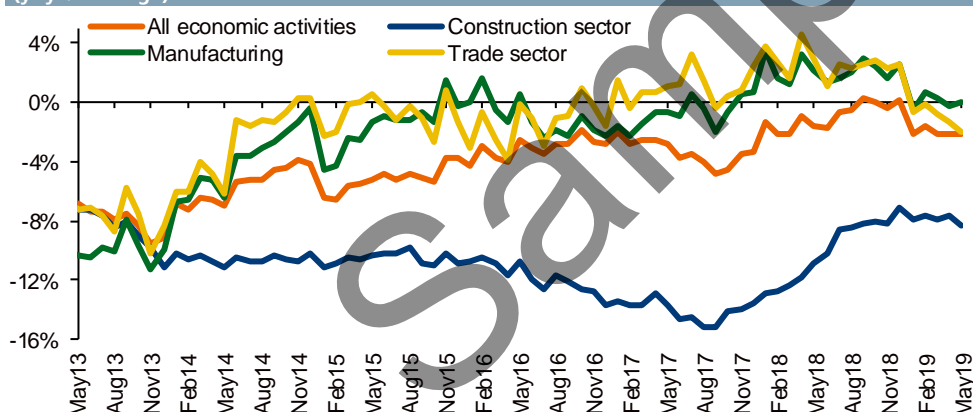
Sharp drop in disbursements of loans to households for house purchases

In May, the decline in loans to non-financial companies continued while the growth in the stock of loans to households remained solid, at +2.6% yoy for the sixth month running. A sharp drop was observed in the disbursements of mortgage loans due to a significant decrease in renegotiations also accompanied by a notable decline in new contracts. Likewise, a significant reduction was recorded in both fixed-rate and floating-rate mortgage loans. Overall, the increase in the stock of loans to the private sector was equal to +1.0% yoy, changing little compared with the previous months (+0.8% in April and +1% being the average of the first 4 months of the year). With a growth of +0.5% yoy for June, ABI estimates point to an additional weakening of the trend.

Elisa Coletti

Loans to non-financial companies continue to be weak, falling for the fifth month running, though by less than in the previous two months (-0.2% yoy in May, figures adjusted for securitisations, compared to -0.6% yoy in March-April). However, excluding bad loans (performing loans), the -2.1% yoy reduction was the same as in April (these figures include family businesses). In detail, performing loans to the manufacturing sector remained stable confirming a change that has fluctuated around zero since the beginning of the year. Performing loans to the trade sector worsened further on the other hand, falling to -2.0% yoy from -1.3% in April. Likewise, the drop was compounded for performing construction loans, at -8.4% from -7.7% yoy in April.

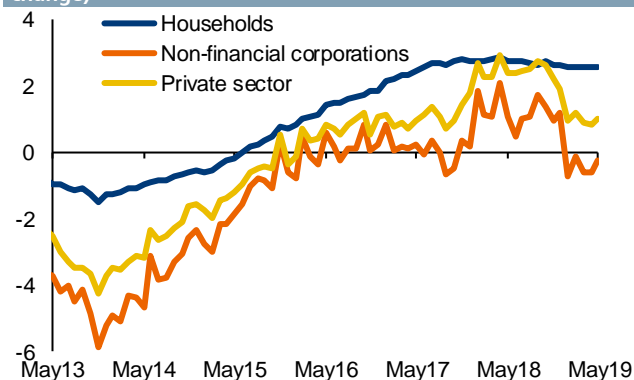
Performing loans in the main economic sectors, non-financial companies and family businesses (yoy % change)



Source: Bank of Italy and Intesa Sanpaolo calculations

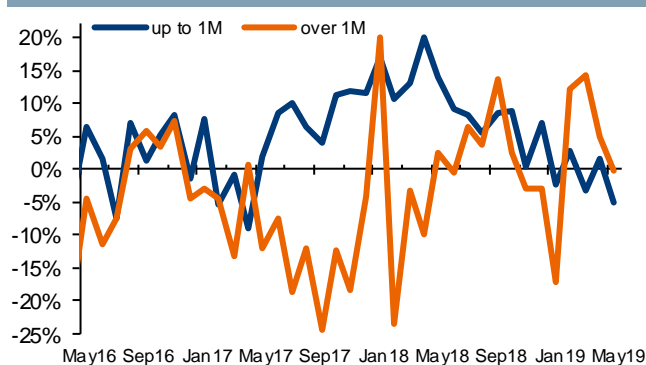
Monthly net flows of loans to non-financial companies also show a depressed picture. In May, after increasing for three months, **gross disbursements fell again, by -2.7% yoy, resulting in the cumulative flow from the beginning of the year essentially not changing** (-0.2% yoy). The components of the overall aggregate continue to show wide fluctuations in flows of over 1M, which dropped slightly in May (-0.4% yoy) after increasing for three months, so much so that the cumulative flow of the first five months of the year continued to grow by 0.9% yoy. In contrast, **for the disbursements of up to 1M, the drop since the beginning of the year was confirmed, equal to -1.5% yoy, which is affected by the deterioration recorded in May at -5.1% yoy** (from +1.5% in April).

Loans to the private sector resident in Italy, figures adjusted for securitisations and net of central counterparties (yoy % change)



Source: Bank of Italy

Disbursements to non-financial companies - flows net of renegotiations (yoy % change)



Source: Bank of Italy and Intesa Sanpaolo calculations

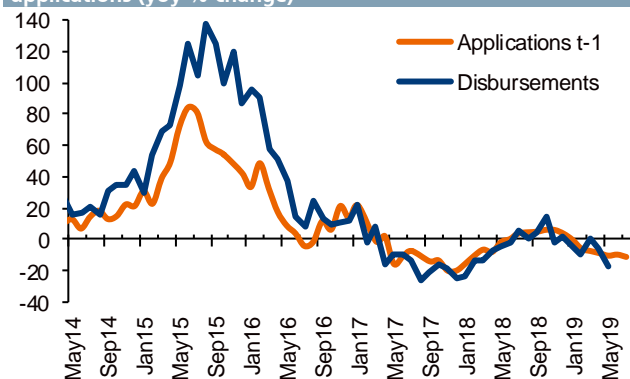
For the sixth month running, the growth rate of loans to households stood at **+2.6% yoy** (figures adjusted for securitisations). Consumer credit disbursed by banks continues to record **positive results**, posting an **all-time high in monthly disbursements** in May, just above EUR 4Bn, although only growing by 1% yoy. The **stock of consumer credit** maintained a sustained pace of **+8.9% yoy**, in line with 9% in April.

In contrast, **new loans for house purchases** sharply declined year on year in May (-17.5% yoy in from -5.8% in April). This is in line with the **signs emerging from the demand, which was very negative throughout all of the first half of 2019**, with a decline in the number of mortgage loan applications up to -11.6% yoy in June and -9.4% from the beginning of the year (source CRIF), with the prospect of lower disbursements in the summer months as well.

The breakdown of disbursements of mortgage loans by type of contract shows a **very marked drop in renegotiations, equal to -43.5% yoy**, combined with the **-9.7% in new contracts**. The monthly flow of renegotiations is the lowest since February 2015. In terms of the share of total disbursements, renegotiations dropped to 15.8%, the lowest since the end of 2014, i.e. since the beginning of the historical series of this figure.

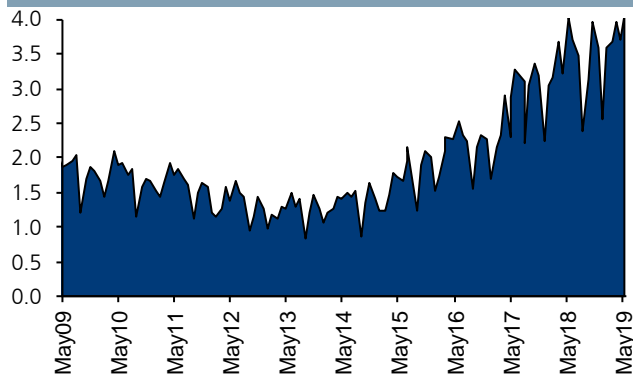
In line with this, in May the **fixed-rate disbursements** also recorded a significant drop, **-17% yoy**, from -7% in April. The **decrease in floating-rate disbursements** was similar in magnitude, in negative territory for the twelfth month running (-17.7% yoy).

Gross flows of loans for house purchases and mortgage loan applications (yoy % change)



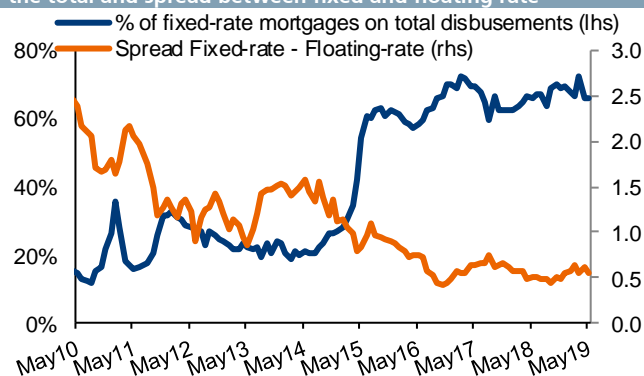
Source: Bank of Italy, CRIF and Intesa Sanpaolo Research Department calculations

Disbursements to households for consumer credit (EUR Bn)



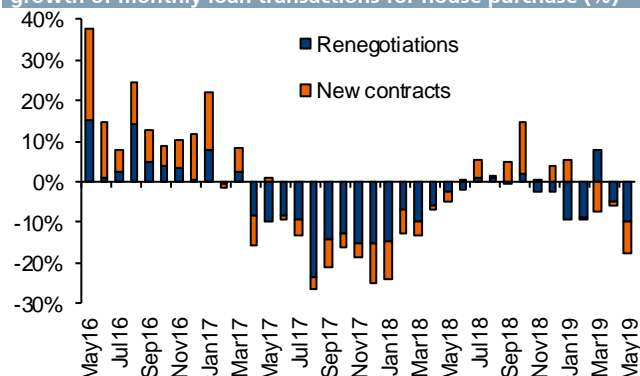
Source: Bank of Italy

Disbursements of loans for house purchase: fixed-rate as % of the total and spread between fixed and floating rate



Source: Bank of Italy and Intesa Sanpaolo calculations

Contribution of renegotiations and new contracts to the growth of monthly loan transactions for house purchase (%)



Source: ECB and Intesa Sanpaolo calculations

Lastly, in May, the increase in loans to the private sector was +1.0% yoy, changing little compared with the previous months (+0.8% in April and +1% being the average of the first 4 months of the year, figures net of central counterparty transactions and adjusted for securitisations). With a growth of +0.5% yoy for June, ABI preliminary figures point to an additional weakening of the trend, even though the estimated slowdown for the smallest aggregate of the loans to households and businesses is much more limited, from +1.1% in May to +1.0% in June.

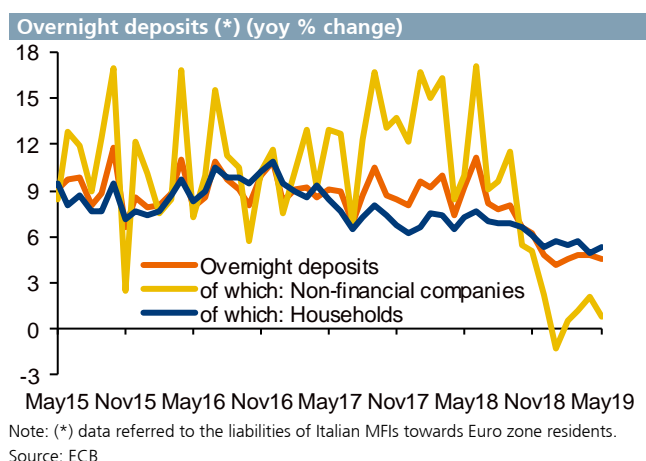
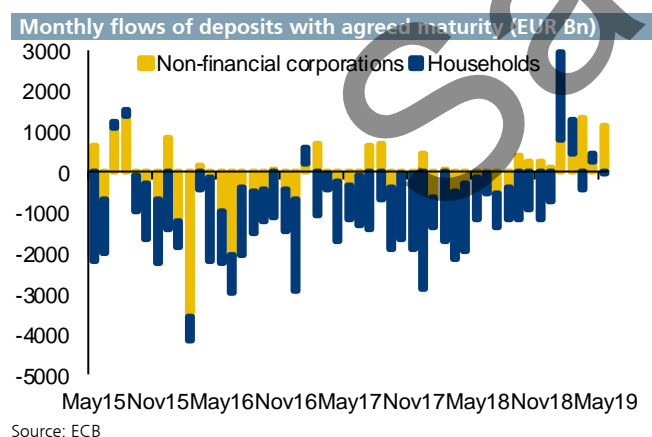
The growth of time deposits of non-financial companies gained momentum

The robust growth in overnight deposits continues, although at a slower pace than in 2018. At the same time, deposits with agreed maturity of non-financial companies continue to grow and recorded positive net flows for the ninth month running in May. Total deposits therefore maintained their growth rate of 3.5% yoy already seen in April, which should essentially also be the case in June according to ABI estimates. Furthermore, bonds continued to experience an increasingly moderate decline. This performance contributed to improving the growth in total customer funding, at +1.9% yoy in May, from +1.8% in April, and gradually recovering from 0.2% at the end of 2018. The strengthening of this trend looks set to continue in June, according to ABI estimates.

Elisa Coletti

Also in May, bank funding continued to present the dynamics seen in previous months. **Overnight deposits confirmed a rate exceeding 4% yoy**, equal to +4.4% yoy in May, in line with the average of the four previous months (+4.5%). The trend was **supported by household overnight deposits which recorded a growth of 5.2% yoy in May**, although this was slightly lower than in the first four months of the year (+5.4%) and the 2018 average. The **overnight deposits of non-financial companies continued to increase**, both in terms of net monthly flow (EUR +1.7Bn yoy) and on an annual basis (+0.8% yoy), though with the usual wide fluctuations of the rate of change, following the sharp slowdown at the beginning of the year.

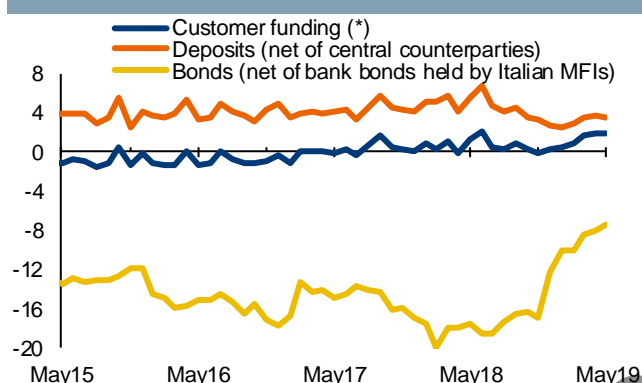
The trend of deposits with agreed maturity continued to be more dynamic for non-financial companies, which recorded positive net flows for the ninth month running, equalling EUR 1.3Bn, a particularly positive volume, in line with the March figure. The growth rate strengthened further to +31.8% yoy (from +21.6% yoy in April). For household deposits with agreed maturity, the rate of change remained down but with a continued improvement on the previous months (-5.2% yoy in May from -6.7% in April, and -18% at the end of 2018), as a result of net flows that were marginally positive in May and that had been significant since the beginning of the year (EUR 59M and EUR 2.8Bn, respectively).



Supported by the trend in overnight deposits, the **household deposits aggregate maintained a good growth rate, of 3.6% yoy in May**, slightly stronger than the 3.2% average of the first four months of the year and the 3% recorded in 2018. Deposits from non-financial companies are up, 2.2% yoy and net EUR 3Bn over the course of the month. Overall, the growth in deposits from resident customers remained in line with the previous month, equal to +3.5% yoy, at a rate that should continue also in June, according to ABI preliminary figures (+3.7% the estimated changed, from 3.8% in May on a consistent basis).

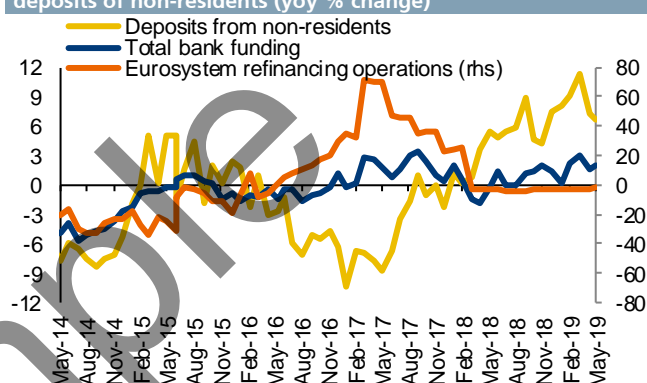
For bonds, the decline continued to slow down considerably, at -7.6% yoy from -8.1% in April, compared to a negative trend remaining in double figures until February. ABI estimates point to a further improvement in June, with a figure of -6.4% yoy. This performance contributed to improving the **growth in total customer funding**, at +1.9% yoy in May, from +1.8% in April, and recovering from 0.2% at the end of 2018. The gradual strengthening of this trend looks set to continue in June, according to ABI estimates. For the total funding aggregate, which includes ECB refinancing and deposits from abroad, the trend is still growing, at 2% yoy in June, also benefiting from the **sustained trend of the deposits of non-residents – including the interbank market – which have been increasing continuously since 2018**, at a pace accelerating up to 11.3% yoy in March and lower in April and May, when it was +6.8% yoy. At the same time, ECB refinancing remains stable month-on-month and slightly down year on year (-2.1% yoy).

Customer funding at Italian banks (yoy % change) (*)



excluding deposits with central counterparties and bonds purchased by Italian MFIs. Total deposits and funding exclude liabilities related to loans sold and not cancelled.
Source: Bank of Italy and Intesa Sanpaolo calculations

Rate of change in total funding, of which ECB refinancing and deposits of non-residents (yoy % change)



Source: Bank of Italy.

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Appendix

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