EY Italian Macroeconomic Bulletin

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Index

Executive summary

‣ Global growth is expected at 3.1% in 2024, accelerating moderately to 3.2% in 2025. Global inflation is expected to decline from 6.9% in 2023 to 5.8% in 2024 and 4.6% in 2025.

‣ The international scenario is still characterized by high uncertainty, due to a fragile geopolitical situation and mixed signals coming from the world's major economies: for example, a sluggish economy is expected in the UK and Germany but stronger growth in the US, uncertainties over the situation of global supply chains continue, and the pace of normalization of monetary policies of the major central banks is still uncertain.

‣ Inflation in the Eurozone is declining and coming under control: in January 2024 the price index rose by 2.8% (2.7% if we consider the average price level of the last three available months - November, December, and January – compared to the same period 12 months ago). Core inflation is more persistent (3.6%; 3.9% in the three months previously considered), especially in its services component. Restrictive monetary policy thus continues to have its effect on inflation and, at the same time, on economic activity, as shown by the zero growth in the Eurozone in the last quarter of 2023. Industrial activity in the major European countries is suffering, especially in Germany. Moreover, industrial production and other higher-frequency indicators do not point to an improvement in the short term.

‣ Low inflation rate is recorded in Italy, despite a slight increase in January (0.8% compared to 0.6% recorded in December, confirming in any case a scenario of inflation below 2% from October 2023). Growth in total wages in recent quarters has resulted in a slight recovery in household purchasing power, thereby partly supporting consumption. On the other hand, however, the savings accumulated during the pandemic period, which partly supported consumption in previous quarters, is being depleted, thus reducing its positive contribution to consumptions.

‣ The fragile geopolitical framework has resulted in a partial change in the Italian trade relations, which in recent years have been redirected towards geopolitically "closer" countries, such as North American countries. Moreover, trade relations are becoming increasingly complex, with trade in goods crossing several borders before reaching their destination market.

‣ In this context, EY forecasts point at real GDP growth for Italy of 0.7% in 2024 and 1.2% in 2025, while the inflation rate will rise from 5.6% in 2023 to 1.9% in 2024 and 1.8% in 2025. Forecasts are subject to a high degree of uncertainty, considering the mixed signals coming from the data currently available, as well as the latest geopolitical events.

‣ Two simulations carried out with the EY's model on possible scenarios of a partial utilization of the NRP (National Recovery Program) funds underline their importance for growth even in the short to medium term. Specifically, a utilization of 70% and 90% of the planned resources in 2024 and 2025, respectively, would result in a cumulative reduction in economic growth in 2025 of about 0.6 percentage points with respect to the full utilization of these resources; a utilization of 50% and 70% of the resources in the two years of analysis would result in an even more pronounced cumulative reduction (1 percentage point).
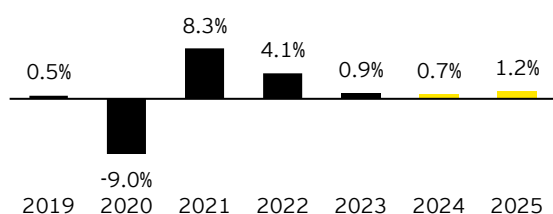
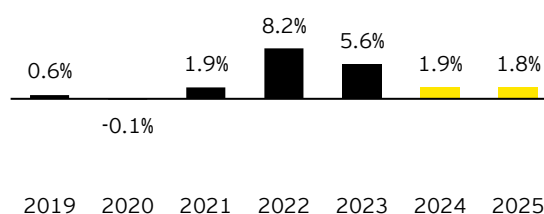*Figure 1: Real GDP, Italy - % change*

Figure 2: Consumer prices, Italy - % change

Source: ISTAT and forecasts from EY Italy's Macroeconometric Model, 'HEY-MoM' (see Technical Appendix for details). The yellow bars represent the forecast horizon.

The Global Scenario

The World Economy

In its latest World Economic Outlook (WEO) published in January 2024, the International Monetary Fund (IMF) forecasts a growth of the world economy of 3.1% in 2023, followed by a growth of similar magnitude in the following two years (3.1% and 3.2% in 2024 and 2025 respectively).[1]

Although economic growth remains below the average for the two decades preceding the pandemic crisis (3.8% between 2000 and 2019), it is slightly higher than in the year before the pandemic (2.8% in 2019). It is also important to consider how, for 2024, the latest forecast represents an improvement, globally, over the previous forecast.[2]

Overall, however, different trends can be highlighted for the major global economies. On the one hand, the forecast for the US shows a growth of 2.5% in 2023, followed by 2.1% and 1.7% in the following two years. The forecast for 2024 was characterized by a major revision compared to the previous October forecast, a revision that gives the idea of the US economy's performance in recent months: between October 2023 and January 2024, the International Monetary Fund (IMF) increased its forecast by 0.6 percentage points (p.p.).

On the other side, Eurozone is in a different situation, showing a subdued economy and a slower recovery. In January 2024, the IMF forecasted an economic growth of 0.5% for 2023, with a slight recovery in 2024 (0.9%) followed by an acceleration in 2025 (1.7%). These projections represent a downward revision from the October 2023 forecast of -0.3 and -0.1 percentage points, respectively.

The Organisation for Economic Co-operation and Development (OECD) also came to similar conclusions in its February forecast (specifically, growth in the US is expected at 2.5% in 2023,

2.1% in 2024 and 1.7% in 2025; less optimistic growth for the Eurozone, with expected growth of 0.5% in 2023, 0.6% in 2024 and 1.3% in 2025).[3]
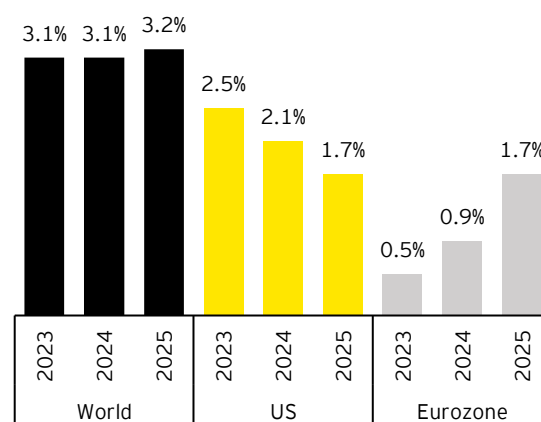
Figure 3: Real GDP - % change

Figure 4: Consumer prices - % change
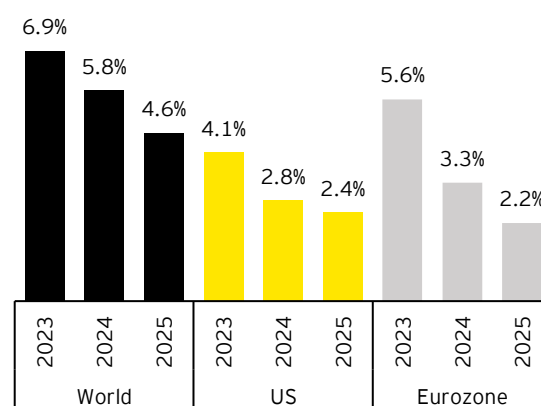
Source: EY elaborations on IMF World Economic Outlook data and forecasts, January 2024. Consumer price figures refer to the October 2023 edition.

With regard to the global inflation rate, a reduction from the peaks reached in 2022 is generally expected, although values will remain

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[1] IMF World Economic Outlook, January 2024.
[2] IMF World Economic Outlook, October 2023.

[3] OECD Economic Outlook, Interim Report February 2024.

higher than the average recorded over the previous two decades (3.9% in the period 2000-2019). Overall, a slightly lower inflation rate of 7.0% is expected in 2023, with a reduction to 5.8% in 2024 and a further reduction of 1.2 percentage points in 2025 (to 4.6%).

Annual inflation in the United States is expected at 4.1% in 2023, followed by a decrease to 2.8% in 2024 and 2.4% in 2025, a value closer to the price stability target identified by the Federal Reserve. A similar trajectory is expected for the eurozone (5.6% in 2023, followed by a decline to 3.3% in 2024 and 2.2% in 2025).

The combination of a lower growth of the world economy than in the previous two decades, with some important regions showing subdued economic growth, results in a reduction in the global demand, which in turn leads to a slowdown in world trade.[4]

Figure 5: Volume of trade, world - index, 2010=100
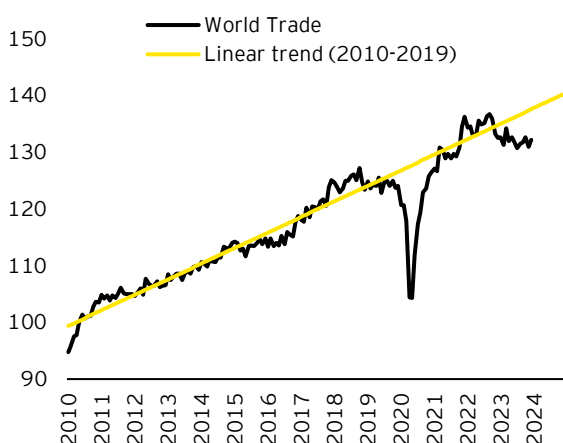
Source: EY elaborations on CPB Netherlands Bureau for Economic Policy Analysis data. Refers to trade in goods. Latest available data: December 2023.

The trend in international trade is also the result of increased geopolitical risks and re-ignition of conflicts over the years,[5] as well as specific environmental situations.

Consider, in this regard, the complexities experienced in two of the most important global trade hubs, namely the Suez Canal and the Panama Canal.

Figure 6: Volume of trade transiting the Panama Canal and Suez Canal - index, 2020=100
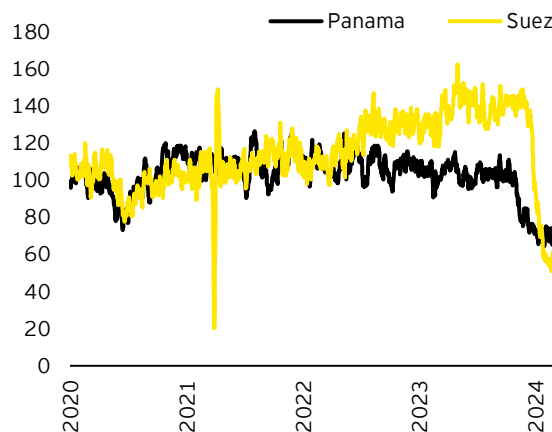
Source: EY elaborations on IMF PortWatch data. Data are represented as an index of the 7-day moving average of trade volume expressed in thousands of metric tonnes. Latest available data: 17 March 2024.

In the Suez Canal, the difficulties have a geopolitical nature, stemming from a partial escalation of the conflict between Hamas and Israel. It is important to note that 90% of the global trade volume takes place by sea and of this, before the crisis, 12% transited the Suez Canal.[6]

In the Panama Canal, however, the complexities are mainly related to natural causes. The drought caused by insufficient rainfall on Lake Gatún, which feeds the canal, has reduced trade flows significantly (by about 30%) since the beginning of the year, as evident in Figure 6.[7]

While the scenario described represents a risk factor for trade developments and potentially also for inflation due to imbalances between supply and demand of goods, the prices of the

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[4] Attinasi, M. G., Boeckelmann, L., Hespert, L., Linzenich, J., Meunier, B. (2024). Global trade in the post-pandemic environment. ECB Issue 1, 2024. Box 1.
[5] Caldara, D., & Iacoviello, M. (2022). Measuring geopolitical risk. American Economic Review, 112(4), 1194-1225.

[6] Confindustria, Congiuntura Flash, January 2024.
[7] Arslanalp, S., Koepke, R., Sozzi, A., Verschuur, J. (2023). Climate Change is Disrupting Global Trade, IMF Blog, November 2023.

main commodities do not seem to have experienced any significant upward movement.

After the increase recorded in October, the price of natural gas quoted on the European market took a downward direction (8.15 $/mmbtu[8] in February 2024, against 14.57 $/mmbtu in October 2023), bringing quotations back towards values more in line with those recorded in the pre-pandemic period. Also in line was the price of gas quoted on the US market[9] (1.72 $/mmbtu in February 2024, compared to 2.99 $/mmbtu in October 2023, after a peak of 3.18 $/mmbtu in January 2024).

Substantially stable instead was the price of Brent crude oil, which, after an increase towards the end of the year (91.1 $/bbl[10] in October), turned back to lower values (83.8 $/bbl in February 2024, up from 80.2 $/bbl in January 2024).

By analyzing energy price movements in detail, and taking a shorter-term perspective, the effects of the recent geopolitical turmoil can be assessed more accurately.

It is interesting, in this regard, to note that after the rekindling of tensions in the Middle East, the price of natural gas quoted on the European markets rose, while oil (Brent) remained basically unchanged or fell, a dynamic mainly explained by the presence of gas fields off the coast of Gaza.

The opposite effect seems to occur because of the tensions with the Houthis (rising oil prices and falling gas prices), Yemen being an important oil production site.

Looking at the agricultural prices index, this continues to show a downward direction. In this regard, however, it is important to consider that the invasion of Ukraine by Russia and the reduction of Ukraine's export capacity, for example through the destruction of agricultural land and facilities and the partial blocking of the country's exports, has reduced an important global source of grain supply.[11] An escalation of the conflict in the Middle East, with associated

disruptions in energy supplies and the consequent increase in energy prices, could substantially exacerbate food insecurity by increasing food production costs.[12]

Figure 7: Energy commodity prices ($) and agricultural prices index (2010=100)
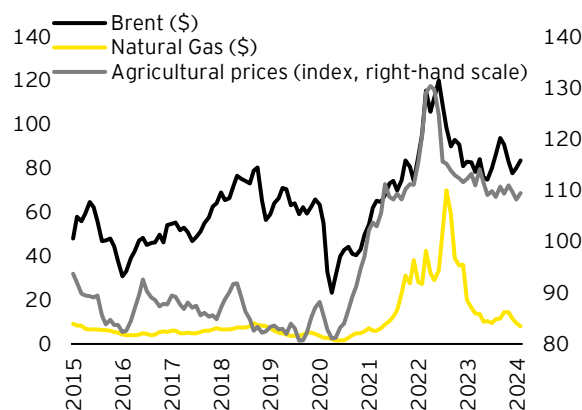
Source: EY elaborations on World Bank data. Brent and natural gas prices are expressed in $/bbl and $/mmbtu, respectively. The natural gas price refers to natural gas quoted in the Title Transfer Facility (TTF). The agricultural price index considers the price of various goods and derivatives related to agriculture globally (e.g., the price of wheat). Latest available data: February 2024.

In any case, the level remains well above the levels recorded in the period between 2015 and the onset of the pandemic crisis, creating potential instability from the perspective of both global inflation and food security,[13,14] even though the overall improvement in global supply conditions is having a positive effect on the price level.[15]

High price levels and increased uncertainty are potential source of low growth for the global economy: a further increase in energy prices could drive up inflation, reduce business and consumer confidence, and lead to a tightening of financial conditions, dampening investment and overall economic activity. On the importance of energy price developments, consider, for example, that oil price fluctuations have been the main cause of global inflation volatility over the past fifty years, especially in the last two

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[8] Dollars for one million British thermal units, which is a measure of the amount of gas.
[9] For the European figure, we refer to natural gas quoted in the Title Transfer Facility (TTF). For the American figure, we refer to the spot price at the Henry Hub, Louisiana.
[10] Dollars per barrel of oil. One barrel is equivalent to about 159 litres.
[11] Mottaleb, K. A., G. Kruseman, and S. Snapp. (2022). "Potential Impacts of Ukraine-Russia Armed Conflict on Global Wheat Food Security: A Quantitative Exploration." Global Food Security 35: 12.

[12] World Bank. 2023a. Commodity Markets Outlook: Under the Shadow of Geopolitical Risks. October. Washington, DC: World Bank.
[13] Vos, R., Glauber, J., Hernandez, M., Laborde D. (2022). COVID-19 and Rising Global Food Prices: What's Really Happening? IFPRI. Washington, DC.
[14] WFP & FAO. 2022. Hunger Hotspots: FAO-WFP early warnings on acute food insecurity. October 2022 to January 2023 Outlook.
[15] World Bank Global Economic Prospects, January 2024.

decades.[16] Increased uncertainty about the geopolitical scenario and conflict outcomes could exacerbate these effects.[17]

Growth in the world's major economies: the latest data

As anticipated, the International Monetary Fund's forecast revisions for global growth, especially in 2024, conceals important differences between the world's major economies.

Figure 8: Revisions to IMF GDP growth forecasts to 2024 in January 2024 compared to October 2023 (percentage points)
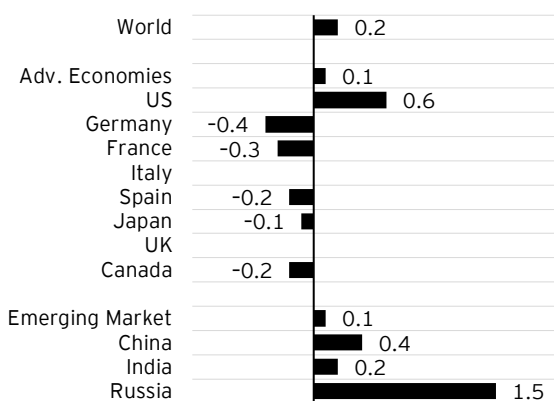
Source: EY elaborations on IMF World Economic Outlook data and forecasts, January 2024. Emerging economies refers to emerging economies and developing countries.

With reference to the advanced economies, while the US is expected to grow significantly stronger in 2024 than expected in October 2023, this is balanced by a downward revision of growth expectations for the major Eurozone countries. Prominent among these are France and Germany, with a reduction in growth prospects of 0.3 and 0.4 percentage points, respectively.

A similar scenario is shown for emerging economies, where improvements in growth

prospects are particularly important for China and Russia.

United States

The US recorded a 0.8% growth in the fourth quarter of 2023 compared to the previous one, following a growth of 1.2% in the third quarter. Specifically, the fourth quarter was characterized by strong growth in private consumption (rising from 0.8% year-on-year growth in the third quarter to 0.7% growth in the fourth quarter), reflecting similarly strong growth in consumption of goods and services (0.8% and 0.7%, respectively). With regard to the consumption of goods, a similar growth rate was recorded for the two components of durable and non-durable goods (0.8% in both cases). On the other hand, modest growth is recorded for investments (0.2%), after two quarters of strong acceleration (1.3% and 2.4% in the second and third quarter of 2023 respectively). Overall, 2023 records a 2.2% growth in private consumption, a 1.2% contraction in private investment, a growth in exports (2.7%) accompanied by a reduction in imports (-1.6%), and a significant growth in public consumption and investment (4.0%).[18]

The most recent data also show that in January 2024 consumer spending contracted slightly compared to the previous month (-0.1% compared to 0.6% in December 2023 and 0.4% in November).[19] The slowdown can partly be explained by the reduction of the excess savings that households had accumulated in the pandemic years between 2020 and 2021. These savings probably supported household consumption between 2022 and 2023, which may also partly explain the resilience of the US economy, despite the many uncertainties stemming from the economic and geopolitical environment.[20,21]

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[16] Ha, J., Kose, M. A., Ohnsorge, F., Yilmazkuday, H. (2023). "What Explains Global Inflation." Policy Research Working Paper 10648, World Bank, Washington, DC.
[17] Caldara, D., Conlisk, S., Iacoviello, M., Penn, M. (2023). "Do Geopolitical Risks Raise or Lower Inflation?" Federal Reserve Board, Washington, DC.
[18] Gross Domestic Product, Fourth Quarter and Year 2023 (Second Estimate), Fourth Quarter 2023, https://www.bea.gov/news/2024/gross-domestic-product-fourth-quarter-and-year-2023-second-estimate.

[19] Bureau of Economic Analysis (BEA), Personal Income and Outlays, January 2024. For more information, https://www.bea.gov/news/2024/personal-income-and-outlays-january-2024.
[20] Abdelrahman, Hamza, and Luiz E. Oliveira. 2023a. "Data Revisions and Pandemic-Era Excess Savings." SF Fed Blog, November 8.
[21] Abdelrahman, Hamza, and Luiz E. Oliveira. 2023b. "Excess No More? Dwindling Pandemic Savings." SF Fed Blog, August 16.

Figure 9: Excess savings (billions, $), US
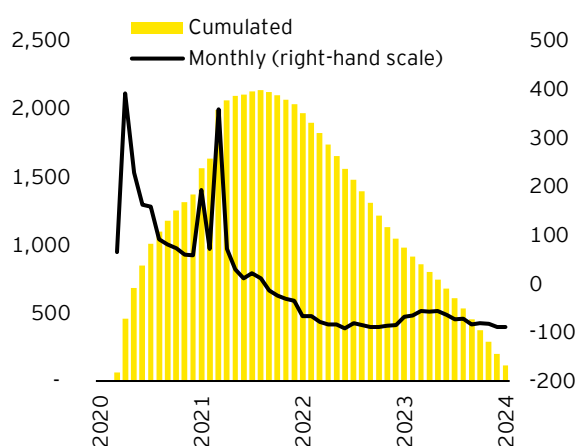
Source: EY elaborations on Federal Reserve Bank of San Francisco data.

These data were accompanied by a dynamic labor market: in February, the number of employed people in the US grew by 275,000 compared to the previous month, which was accompanied by a stable unemployment rate below 4% (3.9%).[22]

Industrial activity was also stable, while manufacturing activity increased: the former grew by 0.1% in February 2024 compared to the previous month, while the latter showed a faster growth (0.8%). In trend terms, however, industrial and manufacturing production are contracting, falling by 0.2% and 0.7% respectively in February 2024.[23]

Regarding the expectations for the coming quarters, the Federal Reserve Bank of New York's latest projections for February 2024 show average GDP growth over the next four quarters in a range of -0.3% to +2.86%, with a median of 1.36%,[24] reflecting high uncertainty about the course of economic activity, albeit with more positive values than previously experienced.

Also, with regard to the expectations of the Federal Reserve Bank of New York, the short-term forecast for the US economy shows an annualized growth rate[25] of 1.78% for the first quarter of 2024 and 2.09% for the second quarter. [26]

United Kingdom

With reference to the other major global economies, UK experienced a 0.3% contraction in the fourth quarter of 2023, following the more modest 0.1% contraction in the third quarter. The performance in the final quarter was due to a negative contribution from private and government consumption and net exports, while investment grew after a decline in the previous quarter. Overall, 2023 closes with a modest growth of 0.1% year-on-year. [27]

Cyclical data show a weak sign of improvement: in January, the services sector grew on a monthly basis by 0.2%, following a slight contraction in the previous month (-0.1%).[28]

More pronounced growth was recorded in the construction sector (1.1% in January, a growth after three months of contraction), while industrial production fell by 0.2% compared to December 2023 (contraction following 0.6% growth in December).[29, 30]

The rate of inflation continues to remain high, albeit on a downward trend: an overall (headline) rate of 3.4% was recorded in February, 0.6

[22] U.S. Bureau of Labor Statistics, Employment Situation Summary. For more information, https://www.bls.gov/bls/news-release/empsit.htm#2024.
[23] Industrial Production and Capacity Utilisation, January 2024. For more information, https://www.federalreserve.gov/releases/g17/current/default.htm.
[24] Federal Reserve Bank of New York, Outlook-at-Risk: Real GDP Growth, Unemployment, and Inflation, https://www.newyorkfed.org/research/policy/outlook-at-risk#root:growth-at-risk.
[25] For more information, https://www.bea.gov/help/faq/463.
[26] For more information, https://www.newyorkfed.org/research/policy/nowcast#overview.
[27] Office for National Statistics (ONS), GDP first quarterly estimate, UK: October to December 2023,

https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/octobertodecember2023.
[28] Office for National Statistics, Index of Services, UK: January 2024, https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/indexofservices/january2024.
[29] Office for National Statistics, Construction output in Great Britain: January 2024, https://www.ons.gov.uk/businessindustryandtrade/constructionindustry/bulletins/constructionoutputingreatbritain/january2023.
[30] Office for National Statistics, Index of Production, UK: January 2024, https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/indexofproduction/january2023.

percentage points lower than the previous month's figure (at 4.0%). Core inflation also fell, from 5.1% in January to 4.5% in February.[31]

China

Moving to the Asian front, the Chinese economy's performance remained subdued compared to the pre-pandemic period, showing growth in the fourth quarter of 5.2% year-on-year, up from the third quarter (4.9%). This corresponds to an economic growth (quarter-on-quarter) of 1.0%, following the 1.5% growth recorded in the third quarter. Overall, the Chinese economy closes 2023 with 5.2% growth over 2022.[32]

With respect to industrial production, it grew by 6.8% in December compared to the same month of the previous year, while the overall figure for 2023 shows a growth of 4.6% compared to 2022. This performance is partly due to the significant growth in the automotive industry (20% growth compared to December 2022, and 13% compared to the whole 2022) and in the production of the chemical industry (11% on a trend basis and 9.6% comparing 2023 to 2022). [33]

There is also a significant contraction in real estate investments, which fell by 9.6% in 2023 compared to last year. This downward trend is also confirmed by data in previous months, demonstrating a sector that is strongly in crisis.[34]

With reference to retail sales, after the first four months of 2023, the year-on-year growth gradually decreased, up to 2.5% growth in July, followed by a strong recovery up to November (10.1%) and a 7.4% growth in December 2023. Thus, despite the deceleration in the last month of 2023, retail sales seem to be following a positive trend, closing the year with an overall growth of 7.2%.[35]

It is important to emphasize, in this regard, that to support economic activity, China's central bank has put in place an expansionary monetary policy through a reduction in benchmark interest rates. The one- and five-year Loan Prime Rate (LPR, i.e., the rate used by commercial banks to define the cost of lending to customers with the highest credit standards) stood at 3.45% and 3.95% respectively in February 2024. The five-year LPR was reduced by 25 basis points in February, following a 10-basis point cut in June 2023. By contrast, the MLF (Medium-term policy loan rate, i.e., the rate at which commercial banks and other banks - such as the China Development Bank - borrow from the central bank in the medium term) remains constant at 2.50%. [36]

[31] Office for National Statistics, Consumer price inflation, UK: January 2024, https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/january2024.
[32] National Economy Witnessed Momentum of Recovery with Solid Progress in High-quality Development in 2023, https://www.stats.gov.cn/english/PressRelease/202401/t20240117_1946605.html.
[33] Industrial Production Operation in December 2023, https://www.stats.gov.cn/english/PressRelease/202401/t20240125_1946873.html.

[34] Investment in Real Estate Development in 2023, https://www.stats.gov.cn/english/PressRelease/202402/t20240201_1947107.html.
[35] Total Retail Sales of Consumer Goods in December 2023. For more information, https://www.stats.gov.cn/english/PressRelease/202402/t20240201_1947119.html.
[36] For more information, http://www.pbc.gov.cn/en/3688229/3688335/3883798/index.html.

Figure 10: 1- and 5-year Loan Prime Rate (LPR), China
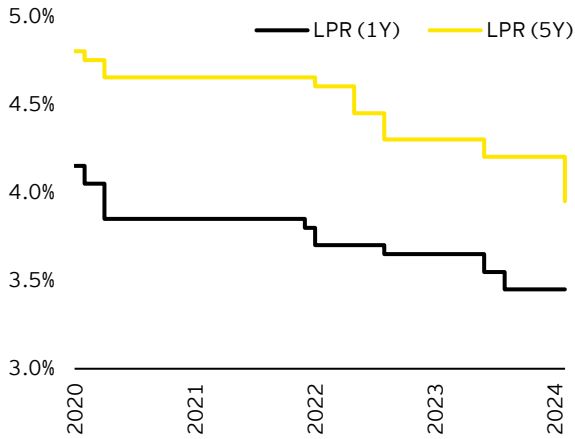
Source: EY elaborations on People Bank of China data.

The recovery in consumer demand is also reflected in a positive performance of imports, which grew by 6.7% year-on-year in January and February 2024.[37] This is also accompanied by a more dynamic foreign demand (10.3% growth in exports expressed in Chinese currency compared to the same month last year), which translates into an overall growth in net foreign demand of around 9.9%.[38]

Overall, therefore, an international scenario is emerging in recovery, but with still important elements of uncertainty that will potentially characterize the global economic landscape in the short-to-medium term.

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[37] For more information, http://english.customs.gov.cn/Statics/2261b480-870f-4ffb-826e-e11b7cbe1813.html. Growth stands at 3.5% when considering imports expressed in dollars. For more information,

http://english.customs.gov.cn/Statics/74d8dc53-e3c9-4e77-87a2-85eaf168fffd.html.
[38] About 7.1% in dollar values.

The European Framework

The Eurozone economic framework and economic indicators

In the fourth quarter of 2023, the Eurozone recorded a flat (0.0%) economic growth compared to the previous quarter, after a slight contraction in the third quarter (-0.1%). The zero growth in the fourth quarter was mainly due to the negative performance of Germany (-0.3%, after two quarters of zero growth) offset by modest growth in France and Italy (0.1% and 0.2% respectively) and stronger growth in Spain (0.6%). From a year-on-year perspective, Germany contracted by 0.2% after a third quarter with a -0.3% growth; on the other hand, France and Italy performed better (0.7% and 0.6% respectively), with Spain recording the highest growth rate among the major economies (2.0%).

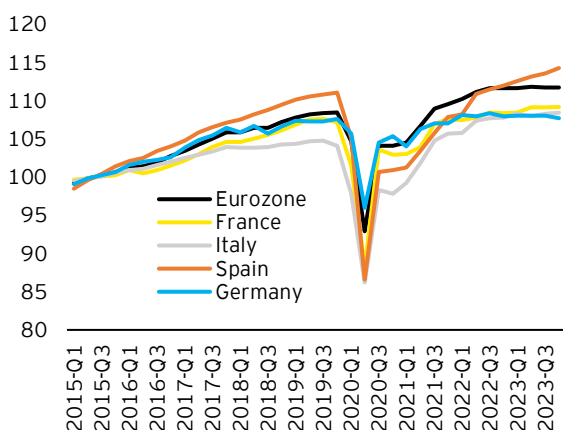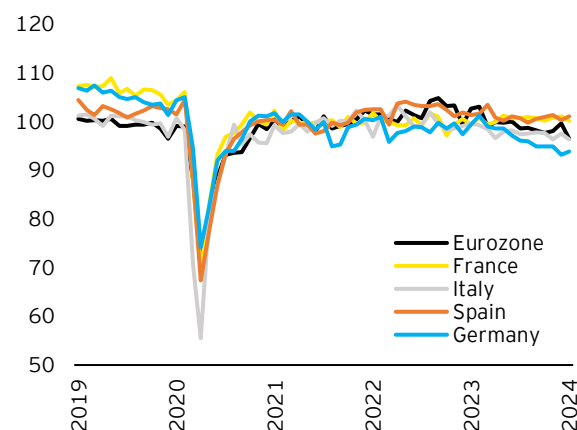*Figure 11: GDP - index, 2015=100*

Figure 12: Industrial production - index, 2021=100

Source: EY elaborations on data from Eurostat, European Commission (*Business and consumer surveys*). For industrial production, we refer to NACE Rev. 2 B-D codes (*Mining* and *quarrying; manufacturing; electricity, gas, steam and air conditioning supply*). Latest available data for GDP: 2023-Q4; for industrial production: January 2024.

With reference to the industrial production, after the positive figure in December 2023 (1.6% growth compared to November), in January the Eurozone industry recorded a reduction of 3.2%, bringing it back in line with the downward trajectory recorded over the past year. The economic data for December and January for the Eurozone appear peculiar in light of the performance of the main Eurozone countries: on the one hand, Germany remains on its downward trajectory, even though it recorded a growth of 0.6% in January 2024; a similar performance was also recorded in Spain (0.9% in January 2024); on the other hand, industrial production in France and Italy recorded a -1.0% and -1.2% growth compared to the previous month. The Eurozone contraction of -3.2% thus seems to be far from the performances of the main member states. In this respect, the change recorded in December 2023 and the subsequent drop in January 2024 seems to be partly related to the performance of Ireland, whose industry recorded a month-on-month growth of 19% in December, followed by a drop of 29% in January 2024. This variability can be explained by the central role played by Ireland for many multinational corporations, which have their headquarters in Ireland to benefit from favorable taxation. This, however, results in a high volatility of industrial production numbers, as revenues from international activities refer to the Irish headquarters, and fluctuations in international activity result in fluctuations in industrial production itself.

The weakness of the Eurozone economy is also reflected in the development of the retail turnover. While the development of the turnover index in nominal terms shows a positive trend, albeit at a slower pace in recent months, it is important to compare this measure with its deflated counterpart, i.e., the index without considering the price increases, thus expressed in real terms. In this case, the turnover is following a downward trajectory, indicating a slowing economy. The overall performance of the Eurozone is following the non-positive performance of two of the largest economies in the Monetary Union, namely Germany and Italy. In the opposite direction are Spain, which shows an increase in the index, and France which remains above the level recorded in the pre-pandemic period (2019) despite a broadly stable performance in recent years.

Figure 13: Retail trade index of turnover, Eurozone – index, 2019=100
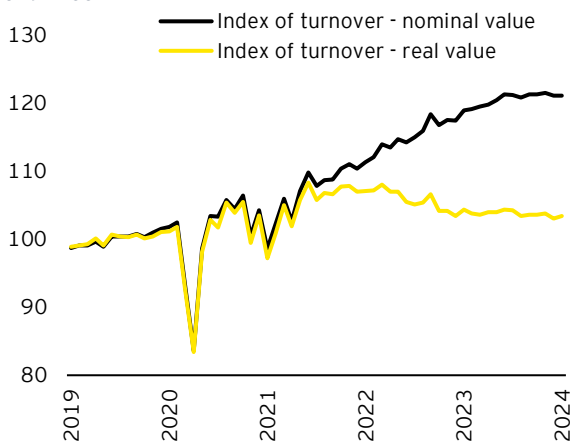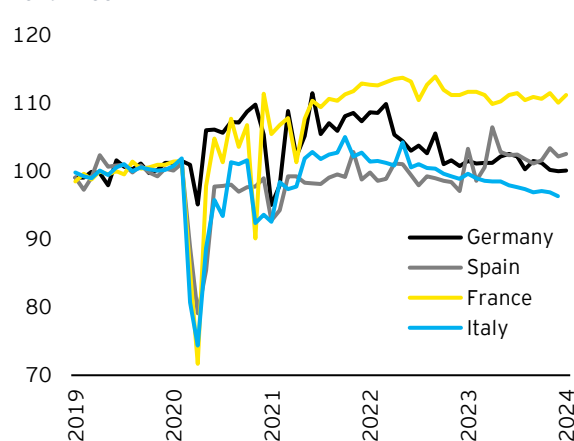

Figure 14: Real retail trade index of turnover– index, 2019=100

Source: EY elaborations on Eurostat data. The graph refers to retail trade excluding vehicle and fuel trade (code: G47_X_G473). Latest available data: January 2024.

The analysis of the PMI indicator[39] for manufacturing and services shows some interesting and more timely details of the performance of the two main sectors of the Eurozone economy. The latest figures of the manufacturing PMI show a less optimistic (but improving) sentiment for the main Eurozone member countries, with the important exception of Germany. Spain is the only major Eurozone countries where the manufacturing PMI index recorded values above the expansion level (identified by a value of 50). Overall, therefore, the general perception is that of a complex environment with no great performance in the industrial sector.

The perception in the service sector in Italy and Spain is positive, while in France and Germany the overall perception is improving despite being still below the expansion threshold (identified by the value 50).

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[39] The Purchasing Managers' Index (PMI) is one of the most popular business cycle indices, i.e., an index of the prevailing direction of economic trends in the manufacturing, construction and service sectors, obtained through timely surveys of the most representative companies in the relevant sectors. Values above 50 indicate a positive overall economic sentiment, values below 50 a negative overall economic sentiment.

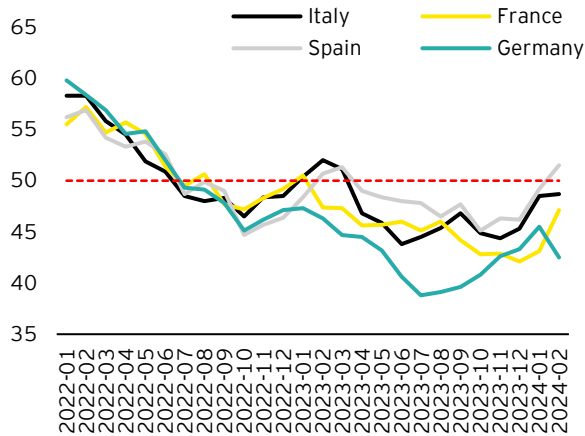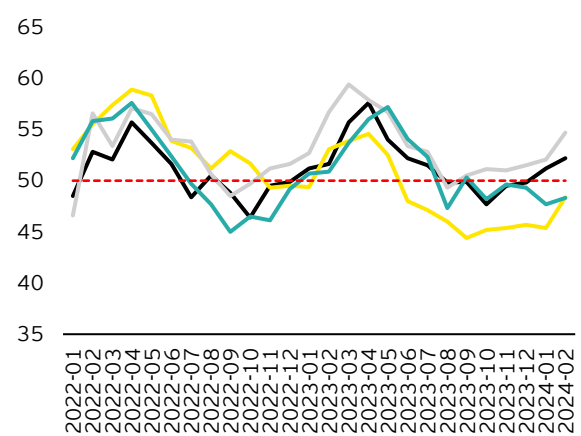*Figure 15: Purchasing Managers Index (PMI), manufacturing*

Figure 16: Purchasing Managers Index (PMI), services

Source: EY elaborations on S&P Global data. Latest available data: February 2024.

Monetary policy and prices in the Eurozone

A drag on the Eurozone economy is the restrictive monetary policy put in place by the European Central Bank (ECB) to cope with inflation rates, which has been at record high levels in the past months. At its meeting on 7 March 2024, the European Central Bank decided to keep the level of monetary policy interest rates in the Eurozone stable.[40]

Figure 17: Reference interest rates of the European Central Bank's monetary policy
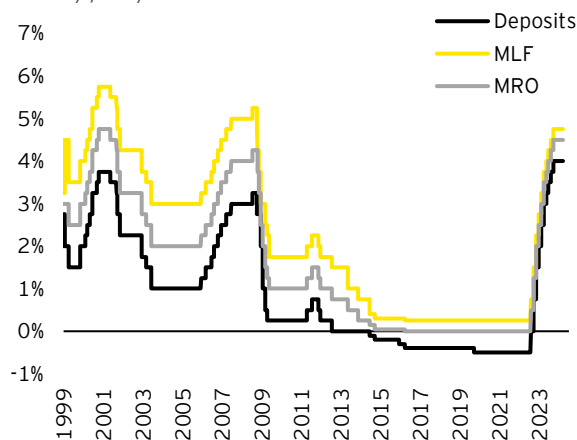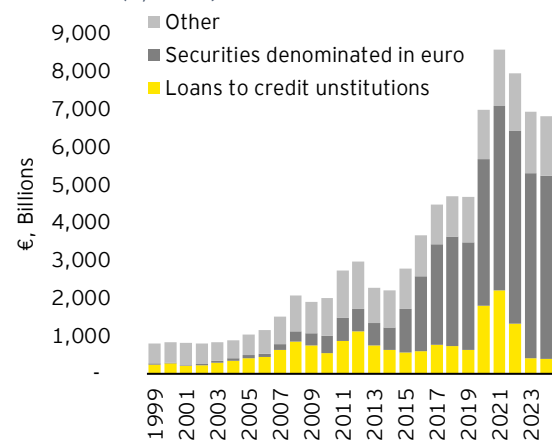

Figure 18: Main balance sheet items of the European Central Bank (€, billion)

Source: EY elaborations on European Central Bank (ECB) data. MLF = marginal lending facility; MRO = main refinancing operation. The deposit rate refers to deposits at the central bank. Balance sheet items - loans to credit institutions: it refers to loans to euro area credit institutions related to monetary policy operations denominated in euro (the different items include main refinancing operations and LTROs); securities denominated in euro: it refers to euro area residents' securities denominated in euro (the different items include assets acquired for monetary policy purposes); other: the different items include gold and claims denominated in foreign currency on euro area residents and non-euro area residents. The latest available data for monetary policy interest rates: February 2024; ECB balance sheet: weekly financial statement of 12 March 2024.

The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and on deposits with the central bank[41] thus remained stable at 4.50%, 4.75% and 4.00% respectively.

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[40] For more information, https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240307~a5fa52b82b.en.html.
[41] The interest rate on deposits with the central bank is one of three reference rates that the ECB sets every six weeks as part of its monetary policy decisions. This rate defines the interest that banks receive on their overnight deposits (for the duration of one business day) with the central bank. The

In addition, on the 13 March the European Central Bank decided to make changes to the operational framework used to conduct its monetary policy, following the announcement made at the end of 2022.[42] The new business model will focus on the principles of effectiveness (of the implementation of monetary policy), robustness (of the operational set-up in case of different monetary policy configurations and financial environments), flexibility (in channeling liquidity throughout the euro area banking system), and efficiency (i.e., being able to implement the desired monetary policy stance without interfering with it). One of the changes resulting from the new business model is the one referring to the main refinancing operations rate (MRO, i.e., the short-term refinancing operations aimed at meeting the liquidity needs of banks), which "will be adjusted such that the spread between the rate on the MROs and the DFR (Deposit facility rate) will be reduced to 15 basis points from the current spread of 50 basis points. This narrower spread will incentivize bidding in the weekly operations, so that short-term money market rates are likely to evolve in the vicinity of the DFR, and it will limit the potential scope for volatility in short-term money market rates. At the same time, it will leave room for money market activity and provide incentives for banks to seek market-based funding solutions. The rate on the marginal lending facility (MLF) will also be adjusted such that the spread between the rate on the MLF and the rate on the MROs will remain unchanged at 25 basis points. These changes will come into effect with the sixth maintenance period of 2024, which begins on 18 September 2024."[43]

Although inflation has been revised downwards in the latest ECB projections (in particular for 2024), mainly due to a lower contribution of energy prices, the ECB expects inflation in the Eurozone at 2.3% in 2024, still slightly above the price stability target (2%). This is expected to be followed by inflation rates of 2.0% and 1.9% in 2025 and 2026, respectively. Although most components of core inflation are slowing down, price pressures remain high, in part due to total wages growth pressure[44] (with a nominal growth of 6.4% in the fourth quarter of 2023). High interest rates and, consequently, restrictive financing conditions are therefore still in place to keep inflation in its current downward trajectory, avoiding potential accelerations.

As already announced in previous meetings, the ECB is combining high interest rates with a reduction of its balance sheet. With regard to the APP,[45] the size of the portfolio is decreasing at a predictable pace, with the Eurosystem no longer reinvesting interests on maturing securities. With reference to the PEPP,[46] the Governing Council intends to continue reinvesting interests of maturing securities purchased under the PEPP in the first half of 2024. In the second half of the year, it intends to reduce the PEPP portfolio by an average of 7.5 billion € per month (currently the cumulative value of purchases under the PEPP amounts to around 1.7 trillion €), discontinuing reinvestments at the end of 2024. A reduction of this magnitude and pace translates into a reduction of reinvestments of around 45 billion € in the second half of the year.

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other two reference rates are the rate on the main refinancing operations (MRO) and the rate on the marginal lending operations (MRO). The MRO rate defines the cost at which banks can obtain credit from the central bank with a maturity of one week. If banks need overnight liquidity, they can use the marginal lending facility at a higher rate. For more information, see https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.it.html.

[42] European Central Bank, Combines monetary policy decisions and statement, 15 December 2022. For more information, https://www.ecb.europa.eu/press/pressconf/shared/pdf/ecb.ds221215~db4079c498.en.pdf.

[43] European Central Bank, Changes to the operational framework for implementing monetary policy. For more information, https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.pr240313~807e240020.en.html.

[44] ECB staff macroeconomic projections for the euro area, March 2024. For more information, https://www.ecb.europa.eu/pub/projections/html/ecb.projections202403_ecbstaff~f2f2d34d5a.en.html.

[45] The ECB's Asset Purchase Programme (APP) is part of a package of unconventional monetary policy measures that also includes targeted longer-term refinancing operations and was launched in mid-2014 to support the monetary policy transmission mechanism and provide the amount of accommodation needed to ensure price stability. The programme consists of: Corporate Sector Purchase Programme (CSPP), Public Sector Purchase Programme (PSPP), Asset-Backed Securities Purchase Programme (ABSPP), third Covered Bond Purchase Programme (CBPP3). For more information, see https://www.ecb.europa.eu/mopo/implement/app/html/index.it.html.

[46] The ECB's Pandemic Emergency Purchase Programme (PEPP) is a non-standard monetary policy measure launched in March 2020 to counter potential risks to the proper functioning of the monetary policy transmission mechanism following the outbreak of the pandemic. The PEPP is a temporary programme to purchase private and public sector assets. For more information, https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html.
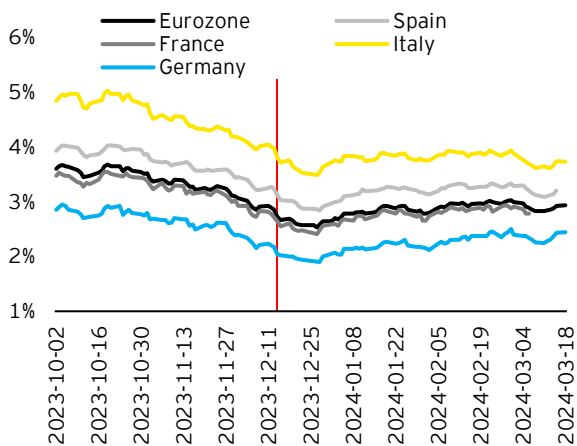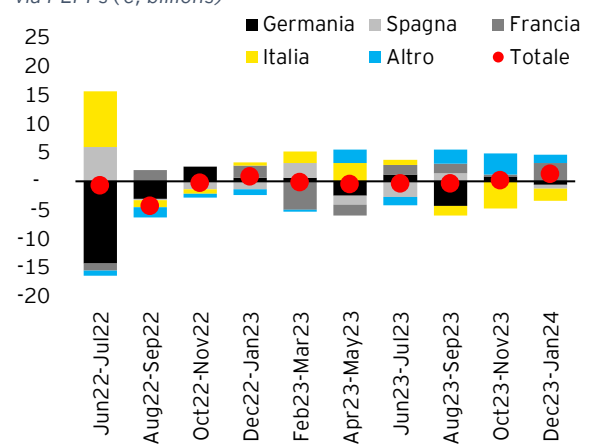
Source: EY elaborations on Eurostat data, European Central Bank (ECB). The red bar indicates 14 December 2023, the date of the ECB's monetary policy decision to reduce the PEPP at an average rate of 7.5 billion € per month (for more information, https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.mp231214~9846e62f62.en.html). Latest available data: 18 March 2024.

The current environment is characterized by significant uncertainty, forcing policymakers to carefully analyse the latest global economic and political dynamics and their potential impact on inflation developments. Therefore, while it is not possible to pinpoint the precise timing of a possible pivot by the ECB, it is crucial that, whatever the future choice, it is made through effective communication.

Among the various effects of a restrictive monetary policy (i.e., one characterized by an increase in interest rates), one of the most important for companies and households is the tightening of loans conditions, changes that come on top of the increase in the cost of debt. Indeed, because of rising benchmark interest rates, banks have tightened the terms and conditions for approving loans, whether for households or businesses. The latest results of the European Central Bank's *Bank Lending Survey* show that, in the first quarter of 2024, more banks tightened credit conditions for businesses than those that loosened them; in contrast, a slightly different situation exists for households. These data take on even more relevance when compared to previous quarters, in the midst of the central bank's rate hike, reflecting the fact that, if fewer and fewer banks now continue to tighten financial conditions on loans, it is also because significant tightening has already been implemented in previous quarters.

Figure 21: Net percentage of respondents tightening terms and conditions for business loan approval
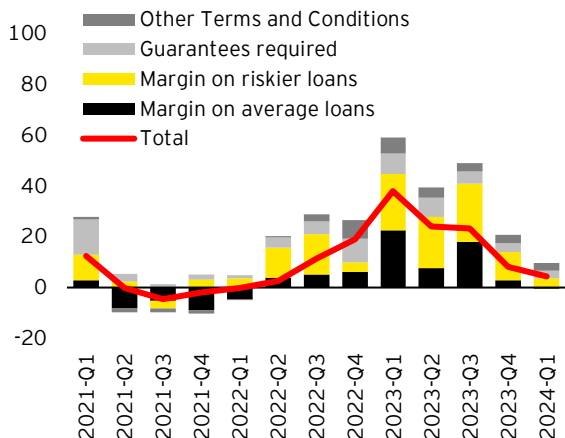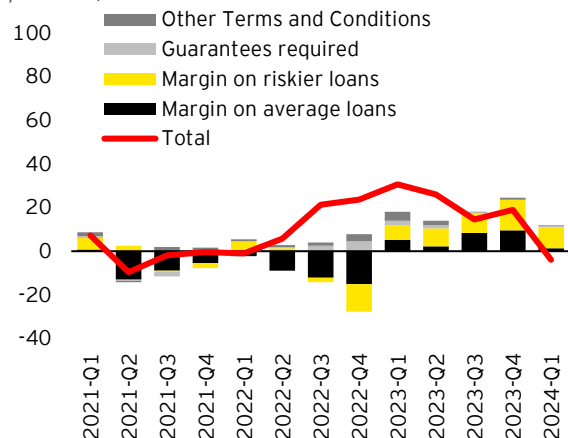

Figure 22: Net percentage of respondents tightening terms and conditions for household loan approval (home purchase)

Source: EY elaborations on European Central Bank (ECB) data. Other terms and conditions - business: the figure is calculated as an unweighted average of additional factors such as maturity, loan amount, additional charges on top of interest, and particular contractual clauses; other terms and conditions - households: the figure is calculated as an unweighted average of additional factors such as maturity, other limits on loan amount, additional charges on top of interest, and the ratio of loan to collateral value. The values represented indicate the net percentage of respondents; negative values indicate a contribution to a loosening of loan conditions; vice versa for positive values.

It is precisely the tightening of financial conditions one of the channels through which a central bank can act to reduce inflation by reducing investment, household and business consumption, leading to a slowdown in economic activity and an increase in unemployment.[47,48] The central bank's objective and the instruments put in place to reduce inflation also play a further role through a different channel: it is in fact also households' expectations of a reduction in inflation that lead to an actual reduction in inflation.

Indeed, recent studies show that households' inflation expectations are important for consumption and saving decisions[49,50,51] as well as for house purchase decisions.[52,53,54] It has also been shown that household expectations have similar characteristics to those of small and medium-sized enterprises[55,56] and, as such, could be a proxy for the inflation expectations that inform the investment, hiring and pricing decisions of smaller firms.

Expectations, moreover, are not only important drivers of current inflation,[57] but also provide important signals on future inflation:[58,59] consider, for example, the case where economic agents expect an increase in inflation of one percentage point - this could potentially lead businesses to increase their

[47] Borraccia, G., Espinoza, R. A., Guzzo, V., Jiang, F., Lafarguette, R., Nguyen H. V., Basurto M. S., and Wingender, P. 'Financial Conditions in Europe: Dynamics, Drivers, and Macroeconomic Implications.' (2023).

[48] Gertler, Mark and Peter Karadi, 2015, 'Monetary Surprises, Credit Costs, and Economic Activity,' American Economic Journal: Macroeconomics, 7(1):44-76.

[49] D'Acunto, F., Malmendier, U., and Weber, M., (2022). "What Do the Data Tell Us About Inflation Expectations?" NBER Working Paper No. 29825, (Cambridge, National Bureau of Economic Research).

[50] Andrade, P., Gautier, E., and Mengus, E., (2020). "What Matters in Households' Inflation Expectations?" FRBB, Research Department Working Papers No. 20-18, (Boston, Federal Reserve Bank of Boston).

[51] Duca-Radu, I., Kenny, G., and Reuter, A., (2021). "Inflation Expectations, Consumption and the Lower Bound: Micro Evidence from a Large Multi-Country Survey," Journal of Monetary Economics, Vol. 118, Pp. 120- 134.

[52] Botsch, M. J., and Malmendier, U., (2021). "The Long Shadows of the Great Inflation: Evidence from Residential Mortgages" CEPR Discussion Paper No. DP14934 (London, Centre for Economic Policy Research).

[53] Malmendier, U., and Nagel, S., (2016). "Learning from Inflation Experiences," The Quarterly Journal of Economics, Vol. 131(1), Pp. 53-87.

[54] Malmendier, U., and Wellsjo, A., (2020). "DP14935 Rent or Buy? The Role of Lifetime Experiences on Homeownership Within and Across Countries,' CEPR Press Discussion Paper No. 14935, (London, Centre for Economic Policy Research).

[55] Coibion, O., Gorodnichenko, Y., and Kumar, S., (2018). "How Do Firms Form Their Expectations? New Survey Evidence," American Economic Review, Vol. 108(9), No. 9, Pp. 2671-2713.

[56] Candia, B., Coibion, O., and Gorodnichenko, Y., (2021). "The Inflation Expectations of US Firms: Evidence from a New Survey" NBER Working Paper No. 28836, (Cambridge, National Bureau of Economic Research).

[57] Meeks, R., and Monti, F., (2022). "Heterogeneous Beliefs and the Phillips Curve" CAMA Working Paper No. 51/2022, September 2022 (Acton, Center for Applied Macroeconomic Analysis ANU).

[58] Reis, R., (2021). "Losing the Inflation Anchor," CEPR Discussion Paper No. DP16664, (London, Centre for Economic Policy Research).

[59] Marques, L. B., Gelos, G., Hofman, D., Otten, J., Pasricha, G. K., Strauss, Z. (2024). Household expectations help predict inflation, VoxEU, 26 January 2024.

prices, or workers to demand a wage adjustment of the same magnitude, resulting in an actual increase in prices.[60]

This is reflected in the inflation dynamics and inflation expectations of Eurozone consumers.

Figure 23: Headline inflation and 12-month consumer inflation expectations, Eurozone
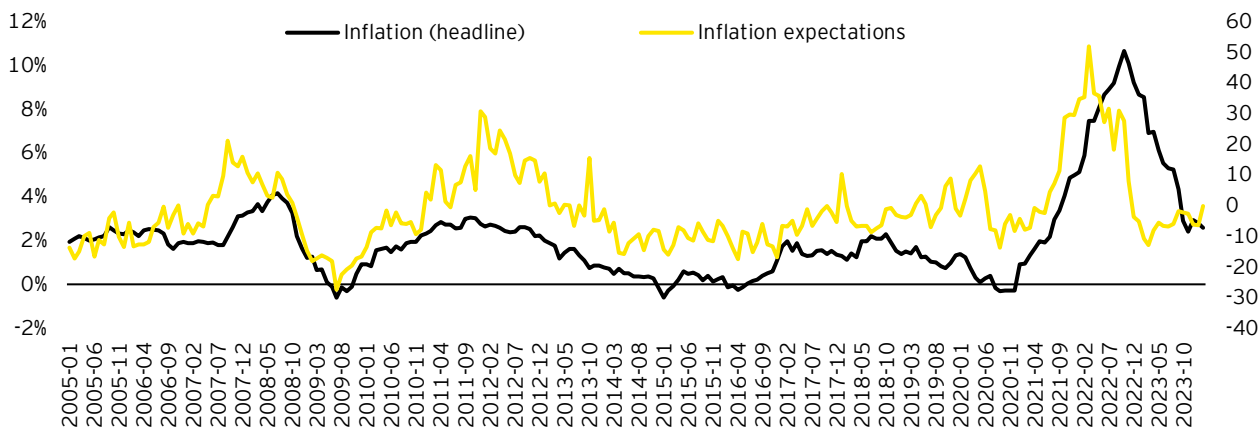
Source: EY elaborations on data from European Commission, Eurostat. Latest available data: February 2024.

A reduction in inflation expectations by Monetary Union consumers over the next twelve months is coupled with a reduction in headline inflation, which is getting closer to the 2% inflation target. While this relationship should not be interpreted as one of direct and immediate causality, it is interesting to note how expectations move ahead of inflation; it is also interesting to note the reversal of expectations in the second half of 2023.

The European Central Bank's maintenance of its restrictive monetary policy is based on the presence of an inflation rate that is still too high compared to the ECB's own target, and the consequent desire to keep interest rates high as long as necessary to bring inflation back to 2% in the medium term.[61] It is interesting to note that, in the Eurozone, core inflation (i.e., the underlying component)[62] continues to register higher values than headline inflation (inflation that considers all the goods in the basket used to monitor price trends). A similar phenomenon occurred during the pandemic crisis, when the price of energy fell significantly due to the slowdown in global economic activity: a core inflation higher than the headline inflation reflects a higher rate of change in the core component than in energy and fresh food.

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[60] Lee, J., Powell, T., Wessel, D. (2020). "What are inflation expectations? Why do they matter?" Brookings, https://www.brookings.edu/articles/what-are-inflation-expectations-why-do-they-matter/..

[61] For more information, https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.mp230914~aab39f8c21.en.html.

[62] We refer to ISTAT's definition of core inflation, which considers the consumer price index net of changes in energy goods and fresh foodstuffs.

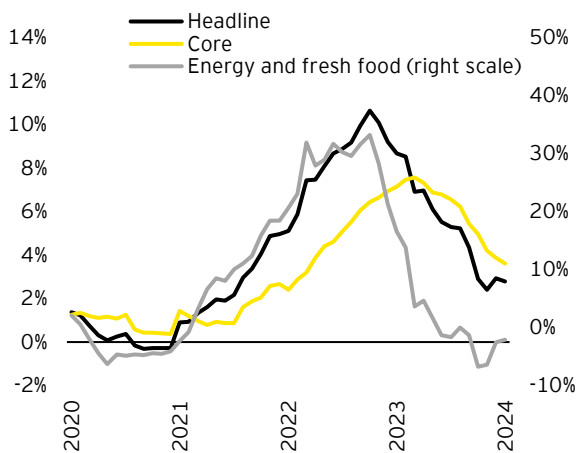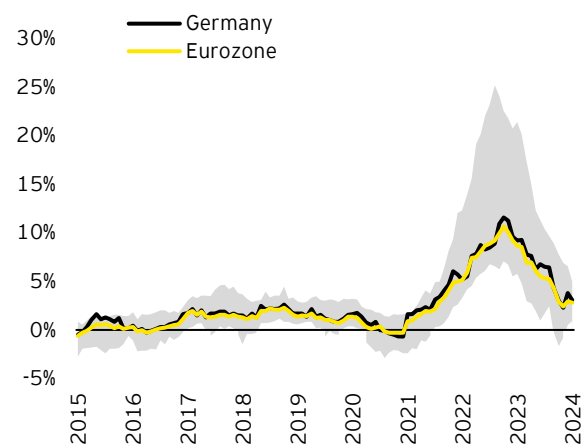*Figure 24: Inflation rate, Eurozone - % change YoY*

Figure 25: Inflation rates in the different Eurozone countries - % change YoY

Source: EY elaborations on Eurostat data. The *headline* measure considers all goods in the basket for calculating the price change; the *core* measure considers goods in the *headline* basket net of energy and fresh food. Rates refer to harmonised rates. Latest available data: January 2024.

In January 2024, *headline* inflation for the Eurozone stood at 2.8%, not far from December 2023 (2.9%) and higher than the low of November 2023 (2.4%). The acceleration experienced was partly due to an increase in the inflation rate in Germany (the latter accounts for about 28% of the total Eurozone inflation). While one might think of this as a consequence of geopolitical tensions and renewed difficulties along supply chains, this reversal of the trend refers to the decay of some measures to contain the level of energy prices, thus making them more expensive. [63]

A significant reduction in the inflation rate in recent months is also coupled with a reduction in the core inflation rate, albeit at a slower pace. However, one must consider the possibility that some of the underlying elements may show different dynamics than expected in the short to medium term, such as a faster growth in labor costs or a higher level of corporate profit margins. The differences within the Eurozone and the European Union in the dynamics related to the above-mentioned variables entails major challenges of a broader nature. Consider, for example, the combined developments in price levels, unit labor costs and productivity: for most emerging economies in Europe, the combination of low productivity and loss of business competitiveness caused by relatively faster wage growth could hinder economic convergence with the continent's more advanced economies.[64]

The heterogeneity of inflation rates within the euro area can be explained by several factors, including the varying effectiveness of monetary policy transmission mechanisms: it has been shown, for example, that monetary policy effects are more pronounced in economies with a more developed financial system (which allows for a higher efficiency of the credit channel, one of the main channels of monetary policy transmission), or where the level of uncertainty is lower (consistent with the idea that uncertainty not only reduces levels of investment, labor demand and consumption, but also makes economic actors less sensitive to changes in economic conditions and interest rates).[65] Less important, however, is the level of economic development (i.e., whether we consider an economy to be emerging or advanced).[66] A further crucial element for the correct transmission of monetary policy, and thus partly explanatory of the differences in inflation levels, is the coordination of monetary policy with fiscal policy. [67,68]

[63] DESTATIS, Press release No. 020 of 16 January 2024. For more information, https://www.destatis.de/EN/Press/2024/01/PE24_020_611.html.
[64] Europe Must Succeed in Restoring Price Stability, IMF Blog, October 13, 2023.
[65] Bloom, N. (2009). The impact of uncertainty shocks. econometrica, 77(3), 623-685.
[66] Deb, P., Flores, J. E., Firat, M., & Furceri, D. (2023). Monetary Policy Transmission Heterogeneity: Cross-Country Evidence.
[67] Bianchi, F., Faccini, R., Melosi, L. (2020). Monetary and fiscal policies in times of large debt: Unity is strength (No. w27112). National Bureau of Economic Research.
[68] Beyer, R., Duttagupta, R., Fotiou, A., Honjo, K., Horton, M., Jakab, Z., Lindé J. (2023). 'Shared Problem, Shared Solution: Benefits from Fiscal-Monetary Interactions in the Euro Area'.

While a common fiscal response to external shocks that is coordinated with monetary policy is not easy to implement within the Eurozone due to the independence that each member state has in fiscal matters, it is possible to say that an early example of coordination for the Eurozone has been provided by the Next Generation EU. This has been accompanied by further fiscal responses, varying in magnitude between the member states.[69,70]

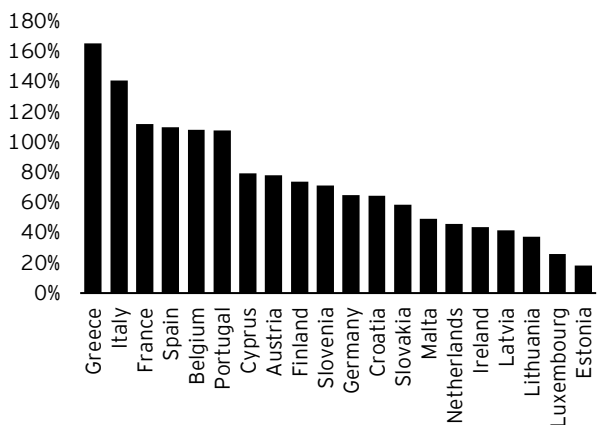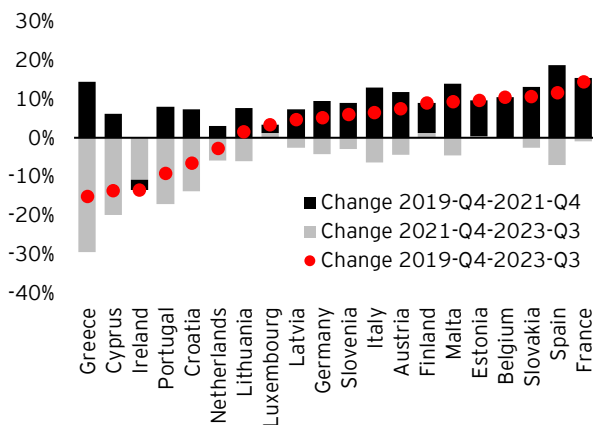Figure 26: Public debt - % GDP, 2023-Q3

Figure 27: Changes in debt-to-GDP ratio, 2019-Q4-2023-Q3

Source: EY elaborations on European Central Bank data.

While these fiscal measures were effective in offsetting the negative effects of inflation household welfare,[71] without which average household wealth would have fallen by around 7% in terms of equivalent income,[72] they also led to an increase in overall debt and inflation.[73] The subsequent recovery of economic activity, coupled with rising inflation reducing the debt/GDP ratio through an increase in the value of GDP itself, partly allowed a rapid return of the debt accumulated in the pandemic years and afterwards. However, it is important to note that most Eurozone member countries record debt-to-GDP ratios at the end of 2023 higher than pre-pandemic.

In conclusion, the economic scenario for the Eurozone is characterized by a significant uncertainty: on the one hand, high interest rates are slowing down the growth of the price level, bringing it back to values consistent with price stability, while at the same time slowing down the economic growth of member countries; on the other hand, despite high interest rates and a falling inflation rate, a potential comeback of inflation in the short to medium term cannot be ruled out, especially considering the increase in wages recorded in recent quarters. Finally, a further factor to be considered is the high level of public debt which, despite having benefited from high inflation, is still higher than pre-pandemic levels, thus reducing the scope for action by the various countries should the need arise.

[69] Sgaravatti, G., Tagliapietra, S., Trasi, C., Zachmann, G. (2021). 'National policies to shield consumers from rising energy prices', Bruegel Datasets, first published 4 November 2021, available at https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices..
[70] Update on euro area fiscal policy responses to the energy crisis and high inflation, https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202302_09~37755e445d.en.html.
[71] Amores, A. F., Basso, H. S., Bischl, J. S., De Agostini, P., Poli, S. D., Dicarlo, E., Flevotomou, M., Freier, M., Maier, S., García-Miralles, E. and Pidkuyko, M., (2023), 'Inflation, fiscal policy and inequality: The distributional impact of fiscal measures to compensate consumer inflation', ECB Occasional Paper.
[72] Freier, M., Ricci, M., 'Fiscal policy to the rescue: How governments shielded households from inflation' (ECB Blog, 23 November 2023). Equivalised disposable income is the total income of a household, net of taxes and other deductions, available for spending or saving, divided by the number of household members converted to equalised adults; household members are equalised or made equivalent by weighting each according to their age, using the modified OECD equivalence scale. For more information, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:Equivalised_disposable_income.
[73] Firat, M., & Hao, O. (2023). "Demand vs. Supply Decomposition of Inflation: Cross-Country Evidence with Applications".

The Italian Economy

Real economy and credit trends in Italy

The industrial activity in Italy continues toward a downward path interspersed with moments of growth. After the 1.2% growth in December compared to the previous month, the industrial production index contracted by 1.2% in January 2024. The month-on-month figure comes together with a year-on-year decline (i.e., compared to the same month of the previous year): indeed, industrial activity recorded a contraction of 1.6% and 3.3% in December 2023 and January 2024 respectively, marking the twelfth consecutive month of contraction (since February 2023).

Figure 28: Industrial production index (average 2019-Q4=100) and % change YoY, Italy
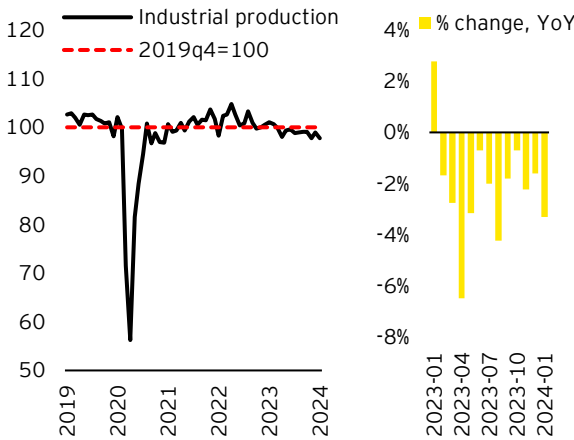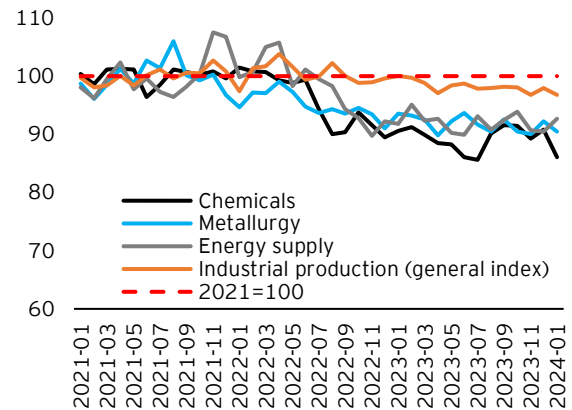

Source: EY elaborations on ISTAT data. Indices refer to seasonally adjusted indices. Latest available data: January 2024.

While the industrial production index is a summary indicator of industrial dynamics in Italy, it is possible to add further details by analyzing the differences across industrial sectors. Specifically, the high price of energy goods is mainly affecting energy-intensive industries, e.g., the chemical industry, metallurgy, and the energy industry, resulting in a bad performance of these industries.

Considering the 2021 value of the respective indices as a reference, it can be noted that while the overall industrial production index remained substantially close to the values of 2021 (albeit declining) the industries abovementioned have not yet reached the level of production recorded in 2021 and seem to continue following a downward trajectory.

Figure 29: Industrial production index by specific sectors and general industrial production index, Italy - index, 2021=100

Source: EY elaborations on ISTAT data. Indices refer to seasonally adjusted indices. Latest available data: January 2024.

The subdued performance of industrial activity in Italy is also reflected in the lower energy consumption recorded in recent months. In fact, by analyzing the IMCEI index, i.e., the monthly index of industrial electricity consumption that monitors the consumption of around 1,000 industrial operators in Italy directly connected to the national electricity transmission grid (the so-called 'energy-intensive' industries), a downward trend in consumption after the pandemic can be observed (roughly from 2022 onwards).
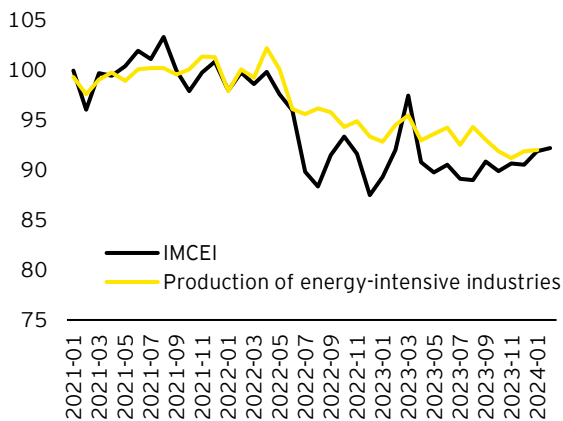
Source: EY elaborations on data from ISTAT, Terna. Energy-intensive industries include iron and steel, manufacture of chemical products, production of cement, lime and gypsum, metal treatment and coating, general mechanical engineering, manufacture of transport equipment, food industries, manufacture of paper and cardboard articles, manufacture of glass and glass products, manufacture of other porcelain and ceramic products, production of precious base metals and other non-ferrous metals, treatment of nuclear fuels. For more information the monthly index of industrial electricity consumption, please refer to https://www.terna.it/en/electric-system/statistical-data-forecast/imcei/imcei-seasonally-adjusted. Latest available data - IMCEI: February 2024; Industrial production index energy-intensive industries: January 2024.

Several factors are behind the Italian economy's not-so-positive performance, e.g., the rising cost of energy, the weakness of its main trading partners (mainly Germany), and the supply chains pressures experienced in recent years. With reference to this last point, in addition to the difficulties generated by events such as the pandemic, geo-economic fragmentation plays an important role.

The effects of geo-economic fragmentation on a country's economy depend mainly on two factors, namely the degree of substitution of goods imported, and firm-specific elements (such as exposure to external shocks and spending on goods from abroad). A recent study on Italian companies estimates that when the degree of substitution is low (i.e., it is not easy to replace goods from abroad with other goods produced within the country in which one operates), the estimated reduction in value added is roughly

35%; on the other side, in case of high degree of substitution, the effect on the value added is significantly smaller (around 2%).[74]

A further factor behind the recent industry weakness is the higher cost of money, i.e., the high level of interest rates, which affects the demand for goods and services from companies and households.

Consider, for example, the cost of new bank loans for households: from December 2019 (taken as a reference as the pre-pandemic period) to January 2024, there was an increase of between 2.5 percentage points (loans for house purchases) and 3.3 percentage points (loans for other purposes), with rates being higher that the peaks reached in 2012.
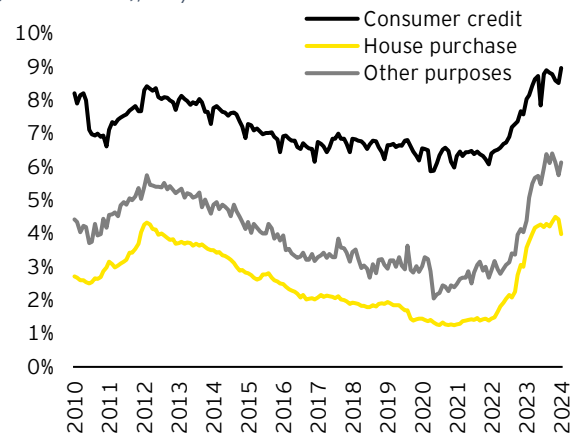
Source: EY elaborations on Bank of Italy data. We refer to harmonized interest rates. Latest available data: January 2024.

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[74] Borin, A., Cariola, G., Gentili, E., Linarello, A., Mancini, M., Padellini, T., Panon, L. and Sette, E. (2023). 'Inputs in geopolitical distress: a risk assessment based on micro data' (No. 819). Bank of Italy, Economic Research and International Relations Area. The impact estimates refer to a scenario of a 50 per cent reduction in the supply/purchase of products from abroad, and considers only firms in the manufacturing sector.

Price trends in Italy

In January, the change in the consumer price index slightly reversed the trend showed in previous months. In fact, inflation increased to 0.8%, a slight increase compared to the 0.6% recorded in December 2023, but still below the price stability target (2%). The moderate acceleration in the pace of price growth reflects the dynamics in the prices of regulated energy goods, whose reduction compared to the same period of the previous year was mitigated in January due to the statistical effect of the comparison with January 2023, as commented by the Italian National Institute of Statistics.[75] Overall, the energy component is still an important factor in the reduction of the *headline* inflation rate.

*Figure 32: Inflation and components, Italy - % change YoY*
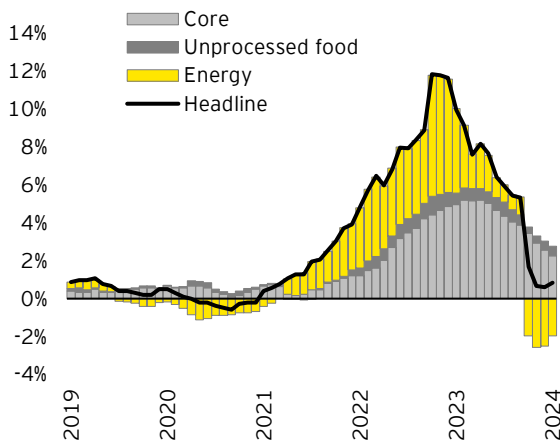
Source: EY elaborations on ISTAT data. Latest available data: January 2024.

More persistent on the other hand is the underlying component, which is still decreasing although at a different pace than the headline inflation.

The January figure shows an annual change in the underlying component (core inflation) of 2.7%, roughly 0.4 percentage points less than in December. While the trajectory shows a downward trend, the analysis of the two main components, i.e., the services and energy component, provides further interesting details. Indeed, the decline in core inflation is due to a slowdown in the increase of processed food

prices in recent months, which adds to the slower pace in the growth of the price level of services. When assessing the role of service and processed food price developments on core inflation, it is important to consider that the former account for about 50% of the composition of the core price index basket, while the latter account for roughly 14%.

Figure 33: Core inflation and components, Italy - % change YoY
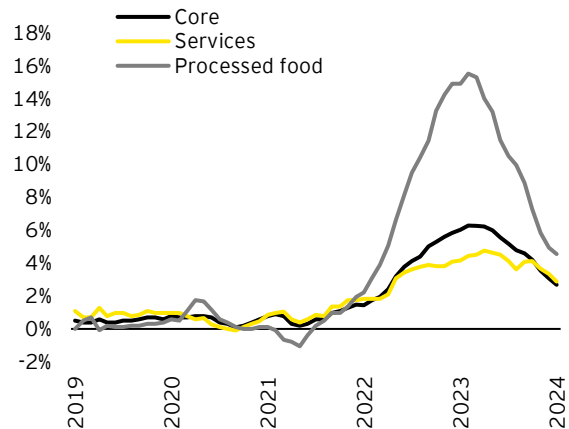
Source: EY elaborations on ISTAT data. Latest available data: January 2024.

The development of the consumer price index could also be partly explained by the development of the producer price index. In fact, the producer price index for industry has been showing negative values since April 2023, mainly driven by lower energy price.

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[75] Consumer prices, January 2024, ISTAT. For more information, https://www.istat.it/it/files//2024/02/CS_Prezzi-al-consumo_Prov_Gennaio2024.pdf.

Figure 34: Producer price index - Italy, % change YoY
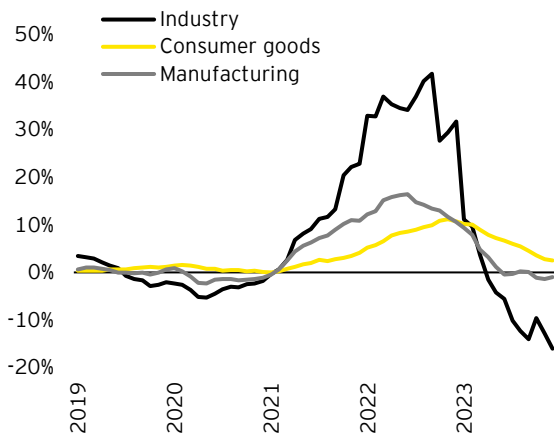
Source: EY elaborations on ISTAT data. Latest available data: December 2023.

The producer price index for manufacturing also contracted, showing a year-on-year decrease of 1% in December 2023 (compared to the same month of the previous year), after a month-on-month change of -1.4% in November 2023. On the other side, the year-on-year change in December 2023 for the consumer goods production index was 2.5%, down from 2.8% in November 2023.

It is also important to notice that prices are closely linked to labor market: for example, an increase in the price level generally results in a demand for wage adjustments, which in turn results in a potential increase in household consumption, pushing the price level up.

By breaking down the GDP deflator[76] from an income perspective,[77] it is possible to identify some interesting elements that have characterized the last few quarters of the Italian economy. In fact, since the outbreak of the pandemic, global supply chains have been under severe pressure and energy prices have soared dramatically, causing a significant increase in input costs. In general, companies can react to this increase in two ways: either by passing it on to consumers to avoid a reduction in profits and margins, or by reducing production resulting in

job losses, a slowdown in economic growth and possibly affecting the financial sector and public finances. Companies seem to have been able to cope with the cost pressures by keeping nominal profits in line, if not by increasing them:[78] they have partly increased the prices of their final products, thus offsetting the increase in costs (with considerable heterogeneity across sectors) in a period of slowing economic activity.[79]

Figure 35: Contributions to GDP deflator growth, Italy (percentage points)

Figure 35: Contributions to GDP deflator growth, Italy (percentage points)
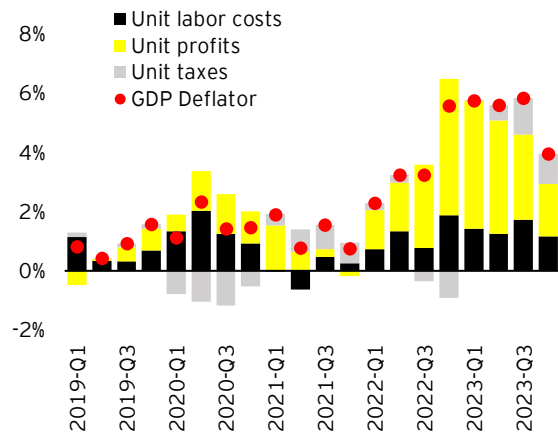
Source: EY elaborations on Eurostat data. Contributions are calculated as the weighted sum of the changes in the individual components of GDP (income approach). The weights are given by the ratio of the values of the individual components in real terms to nominal GDP. Net unit taxes are the difference of taxes on products and imports minus subsidies.

Rising corporate profits accounted for almost half of the increase in inflation in Europe over the past two years, as companies have raised prices more than the rising costs of inputs. Now that workers are seeking wage increases to recover lost purchasing power, companies may have to accept a smaller profit share if inflation is to remain at levels around the 2% target. These profit share adjustment movements are physiological and rather slow phenomena, but they tend to bring the system back into 'equilibrium'. Enterprises have thus far been more 'protected' than workers from adverse cost shocks, which does not necessarily mean that

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[76] A deflator is a value expressing the change in prices over a period of time for a product or basket of products, used to deflate (adjust prices) a measure of value changes for the same period (e.g. sales of this product or basket), thus eliminating price increases or decreases and leaving only volume changes. For more information, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:Deflator.

[77] The income-side analysis of gross domestic product (GDP) considers compensation of employees, taxes on production and imports minus production subsidies, gross operating surplus and other income. The

income approach shows how GDP is distributed among the different participants in the production process. For more information, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:Income_approach.

[78] ECB, Inflation and monetary policy, May 2023, https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230508~7014c100eb.en.pdf?57d7ec165307b4e2182ad256dca0d992.

[79] Firms' profits: cure or curse?, https://www.esm.europa.eu/blog/firms-profits-cure-or-curse.

profitability has increased: while nominal profits have increased, this is not necessarily true for profitability (increase in markup or profit margin). A study conducted by the Bank of Italy[80] carefully analyses the relationship between profit share and markup and illustrates the conditions under which they can move in opposite directions. However, firms in the short run may enjoy more upward price flexibility than wages: firms are able to adjust prices quickly to protect their profitability, whereas wages are subject to more rigidity because they are often fixed by previous wage negotiations.[81] However, this phenomenon tends to balance itself out in the medium term; this is the reason why monetary policy also pays special attention to wage increases and their possible consequences on price level.

A more specific analysis of markup trends by industry reveals strong sectoral heterogeneity.

If a recovery in markups is observed from the end of 2022 for the total economic sectors, preceded by a reduction in the post-COVID period (2021-2022), on the other hand, different dynamics are noted within the sectors of the Italian economy, especially during and after the pandemic.

During the pandemic (2020), trade (retail and wholesale) and agriculture experienced the most significant reduction in markups, which fell below the levels recorded in 2019; in contrast, financial activities and, to some extent, industry, increased compared to the pre-pandemic period. In the years following the pandemic (2021 and 2022), markups in financial services declined, in contrast to markups in trade (exceeding the 2019 level) and industry, although the latter approached pre-pandemic levels. From 2023, on the other hand, basically all sectors have seen their markups increase significantly: financial services and agriculture stand out here, a phenomenon probably linked to the reduction experienced previously.

Figure 36: Markups by industry, Italy - index, 2019=100
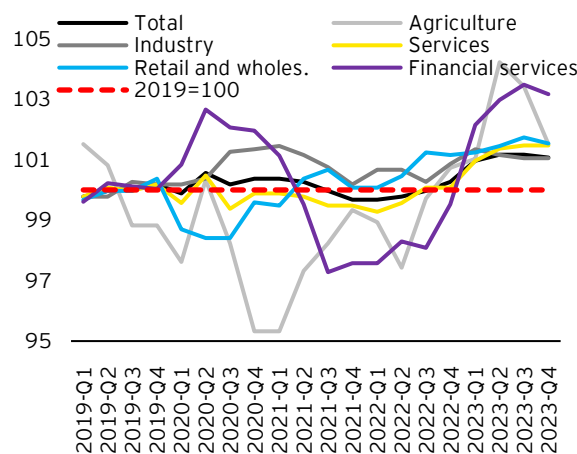
Source: EY elaborations on ISTAT data. The markup is calculated as the ratio between the output deflator and variable unit costs. With reference to sectors: for agriculture, we refer to the sector "agriculture, forestry and fishing"; for industry, we refer to the sector "mining and quarrying, manufacturing, electricity, gas, steam and air conditioning supply, water supply, sewerage, waste treatment and sanitation, construction"; for trade, we refer to the sector 'wholesale and retail trade, repair of motor vehicles and motorbikes, transport and storage, accommodation and food services, information and communication services'; for financial activities, we refer to the sector 'financial and insurance activities, real estate activities, professional, scientific and technical activities, administration and support services'; for services, we refer to all other services.

With regard to the development of the overall amount of wages in real terms, in the fourth quarter of 2023 they increased significantly, after a period of contraction that started around mid-2022. By contrast, the overall amount of

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[80] Colonna, F. Torrini, R. and E. Viviano, 2023, "The profit share and firm mark-up: how to interpret them?" Bank of Italy Occasional Papers, May 2023.

[81] Hansen, N. J., Toscani, F., & Zhou, J. (2023). Euro area inflation after the pandemic and energy shock: Import prices, profits and wages.

nominal wages have been growing since 2021, although now decelerating.

While growth in total real wages results in a recovery of household purchasing power, an increase in wages, as mentioned above, may be reflected in higher inflationary pressures.

Figure 37: Total wages, Italy - % change YoY
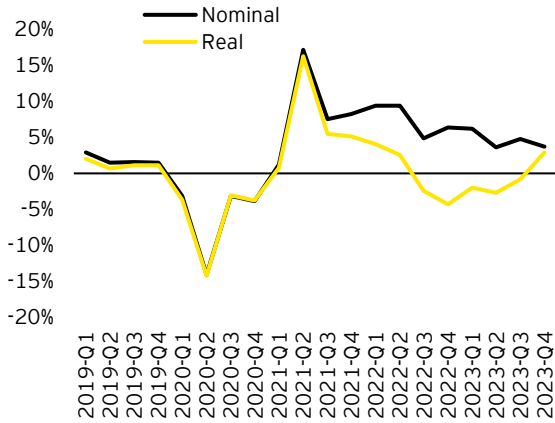
Source: EY elaborations on ISTAT data. Real wages are deflated by the household and non-profit institutions consumption deflator.

Overall, it can be stated that while economic activity remains subdued, resulting in a reduction in the inflation rate, the decline in inflation together with the increase in total nominal wages translates into a recovery in household purchasing power. The cost of new loans continues to remain high, representing in any case a brake on economic activity, household consumption and business investment.

Focus: some dynamics of Italian trade

Key takeaways:

1. *Italy started recording a surplus of net exports of goods (positive difference between exports and imports of goods) in merchandise trade again in 2023. The surplus is mainly due to an improvement in net exports to non-EU countries, while a situation of substantial parity with European counterparts (intra-EU trade) remains;*
2. *From 2010, America and Europe have been an increasingly important market for Italy, growing in terms of percentage share of total Italian trade;*
3. *In recent years (2022-2023), basic metals and chemical products accounted for an increasingly smaller share of total trade in goods. There has also been an important reduction in the share of mining goods traded with Russia (category which also considers gas and oil production);*
4. *Since the pandemic, supply chains for Italy have become more complex and interconnected, with more and more goods crossing more than one border before arriving in the final target market. This could result in increased exposure of Italian trade to pressures along supply chains.*

The geopolitical events that have characterized the world economy in recent years play an important role in reshaping global trade trajectories. From the introduction of protectionist trade policies to the pandemic, to the recent geopolitical tensions arising from the outbreak of war between Ukraine and Russia and the rekindling of tensions in the Middle East, the overall uncertainty of the current geopolitical framework has affected previous trade patterns.

In dealing with this topic with a specific focus on Italy, the first element to consider is the direction of trade in goods by macro-areas. For our purposes, two macro-areas are identified: the European Union (intra-EU trade), and the rest of the world (extra-EU trade). Over the last two years, Italy has maintained a relationship of substantial parity in terms of trade value (identified as the total value of imports and exports) with the two areas identified (without considering the short-term fluctuations) i.e., the value of trade in goods within the European Union is similar in value to that with the rest of the world. Overall, however, the European Union represents the main reference market for merchandise trade for Italy, with about 50-55% of the exchanges taking place within the area (about 55 billion € per month out of a total of about 100 billion €).

Italy's net exports of goods, i.e., the difference between exported and imported goods, have been recording positive values since the beginning of 2023 (i.e., exports of goods are greater than imports of goods), after negative values in 2022. While the overall position with respect to partners within the European Union is substantially stable, the position with the non-EU counterparts has changed significantly, from a deficit in 2022 to a surplus in 2023.
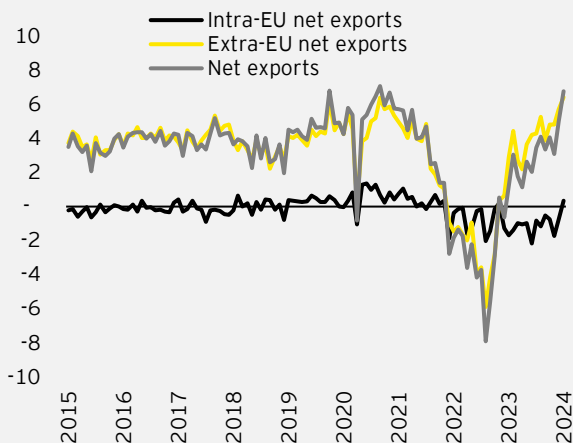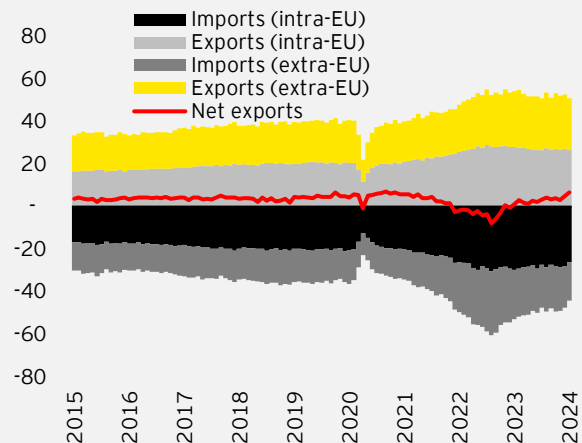
Source: EY elaborations on ISTAT data. Data refer to merchandise trade. The value of trade is calculated as the sum of exports and imports. Exports are valued at the FOB (Free On Board) value, which corresponds to the market price at the border of the exporting country. This price includes the ex-factory price, trade margins, international transport costs and any export duties; imports are valued at the CIF (cost, insurance, freight) value, which includes: the FOB value of the goods, transport costs and insurance between the border of the exporting country and the border of the importing country. Latest available data: December 2023.

Global dynamics and geopolitical challenges not only impact the value of Italy's net exports, but also its composition. Analyzing the latter in the three historical phases that have characterized the last 10-15 years, it is possible to reach some interesting conclusions about the change in the direction of trade in goods for Italy.

In this regard, Figures 40 and 41 show the change in the composition of the goods trade basket for Italy in three defined periods, namely (i) the period following the great financial crisis up to the pre-pandemic period (2010-2019), (ii) the pandemic period (2020-2021), (iii) the post-pandemic period (2022-2023). The figures show specifically what the overall change in the basket of trade in goods by geographic area has been, i.e., how much the direction of trade in goods (again expressed as the sum of imports and exports) has changed towards the identified areas.

Some insights can be derived from these two figures: on the one hand, it is possible to state that in the period prior to the pandemic (2010-2019), Italian trade in goods was increasingly directed towards America and Europe (excluding Russia) at the expense of Russia, Asia, and Africa. Specifically, the share of goods trade with America increased by about 2 percentage points of the basket total (total basket = 100), while the share of trade to Europe (excluding Russia) increased by about 1.6 percentage points. The pandemic period slightly changed this, reducing trade in goods with America on the one hand and increasing trade flows with Europe (excluding Russia) and Oceania on the other.

Figure 40: Change in the composition of trade by geography, Italy (total trade=100)
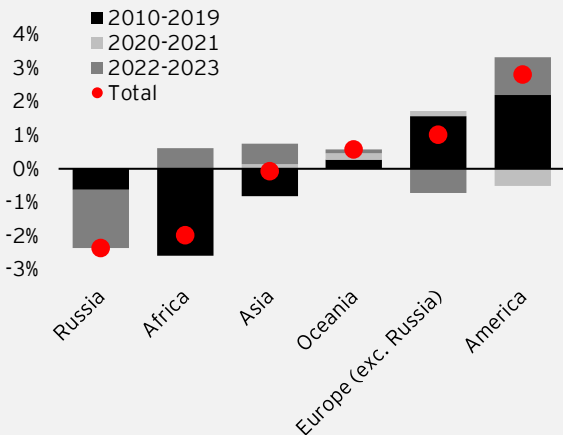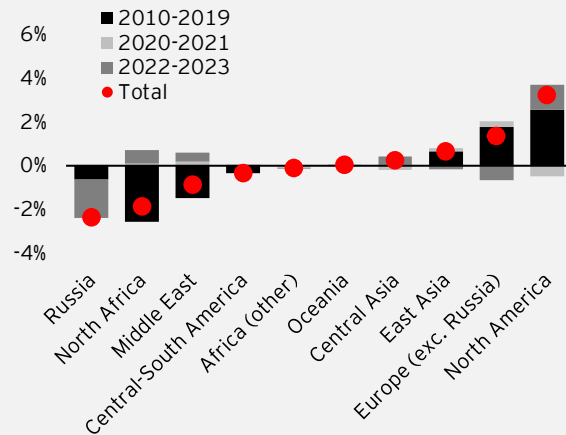
Figure 41: More detail on the change in the composition of trade by geography, Italy (total trade=100)
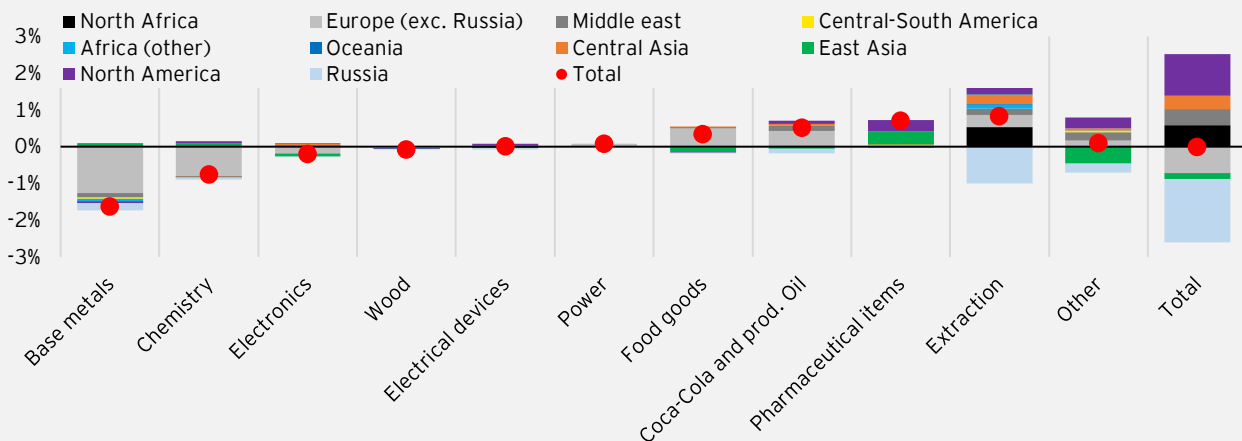
Source: EY elaborations on COEWEB data. Data refer to merchandise trade. The value of trade is calculated as the sum of exports and imports.

As a result of the complexities along the supply chains generated by the pandemic crisis, subsequently compounded by geopolitical tensions due to the renewed conflict between Russia and Ukraine, and other recent global geopolitical developments, Italy's trade in goods in the post-pandemic period appears to have been partly characterized by a shift in trade routes towards 'friendly' countries. Considering the total trade basket, in fact, trade with America grew by about 1 percentage point, at the expense of a reduction in trade with Russia (-1.7 percentage points) and partly with Europe (excluding Russia) and East Asia. Trade with North Africa also grew in the post-pandemic period.

This simple analysis of the composition of Italian goods trade would thus seem to only partially support the narrative of recent nearshoring and friendshoring, i.e., on the one hand the rapprochement of supply chains (nearshoring) and on the other the shifting of supply chains to countries considered allies from a geopolitical point of view (friendshoring). Starting from this, it is possible to add a further degree of complexity analyzing which categories of goods were involved in these changes, with a specific focus on the post-pandemic years.

Specifically, over the past two years, trade in Italian goods has shrunk, especially with reference to base metals, chemicals and electronics, while an increase in the category of food products, coke and refined petroleum products, pharmaceuticals, and mining goods was experienced. The latter category includes the most important energy goods, such as natural gas and oil, whose trade with Russia decreased significantly, against an increase from other regions and trading partners.

Source: EY elaborations on COEWEB data. Data refer to merchandise trade. The value of trade is calculated as the sum of exports and imports per goods category.

Finally, a further element that has characterized Italian merchandise trade in recent years is the change in the complexity of its supply chains. Total trade can in fact be broken down into trade in goods crossing a single border (traditional trade) and trade in goods crossing more than one border (Global Value Chains, GVCs), the latter representing more complex trade relations than the former. Thus, breaking down Italian trade into traditional trade and trade in Global Value Chains, it can be observed that, while in past years there was a substantial balance between the two types of trade, in the years of the pandemic and afterwards there has been a significant increase in trade crossing more than one border.

In order to understand the reasons underlying this significant increase in recent years, it is important to break down trade in goods along the GVCs into its three components, i.e., an import component (*backward*, i.e., the value of goods imported from the reference country and subsequently exported to the country of destination), an export component (*forward*, i.e., the value added in goods entirely generated within the domestic supply chains - without any border crossing - exported to the trading partner which, in turn, re-exports it to other markets) and two-way (*mix*, i.e., the value of goods and services produced with imported inputs, exported to the trading partner which, in turn, re-exports them to other markets).[82]

This decomposition thus allows us to identify which direction of trade along the GVCs has increased most in recent years: while on the one hand the percentage of the forward export component of total trade in goods has remained substantially constant or in moderate growth, on the other hand there has been an important increase in the import and two-way component. This means that the goods traded by Italy with its trading partners are produced with imported goods whose value chain is increasingly complex and involves more and more countries (even if nothing tells us about the distance of the supply chain). This message is also confirmed by the significant growth of the "mix" component.

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[82] WITS, GVC Data User Guide. For more information, https://wits.worldbank.org/docs/gvc-data-usage-guide.pdf.

Figure 43: Traditional trade and Global Value Chains, Italy (percentage of total trade)
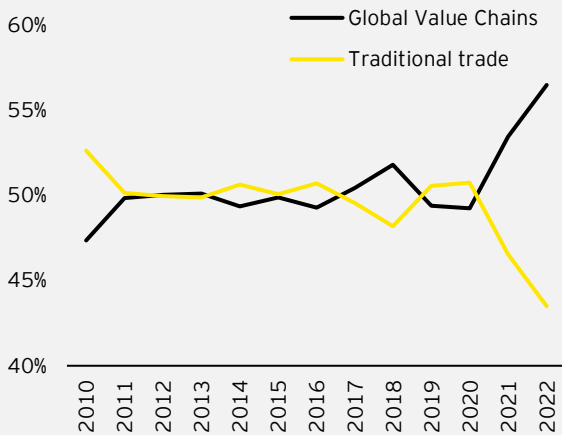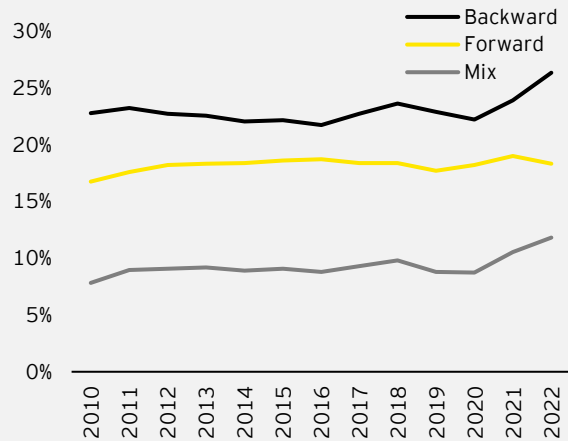

Figure 44: Direction of Global Value Chains, Italy (percentage of total trade)

Source: EY elaborations on World Integrated Trade Solution (WITS) data. Data refer to manufacture goods only. Traditional trade: refers to the value of goods crossing only one border; Global Value Chains: refers to the value of goods crossing more than one border; Backward: refers to value of goods imported from the reference country and subsequently exported to the destination country ; Forward: refers to value added in goods entirely generated within the domestic supply chains - without any border crossing - exported to the trading partner who, in turn, re-export them to other markets ; Mix: value of goods and services produced with imported inputs, exported to the trading partner who, in turn, re-export them to other markets .

Finally, broadening the analysis to both goods and services, it can be observed that, after having recorded a negative trade balance after the pandemic, Italy has substantially returned to balance. In this regard, consider that the 27-member European Union countries recorded a positive trade balance in goods and services of around 2% in the third quarter of 2023, while the OECD and G7 countries were in neutral (0.2%) and negative (-0.9%) territory respectively in the same quarter.

Figure 45: Trade balance (goods and services) - % GDP
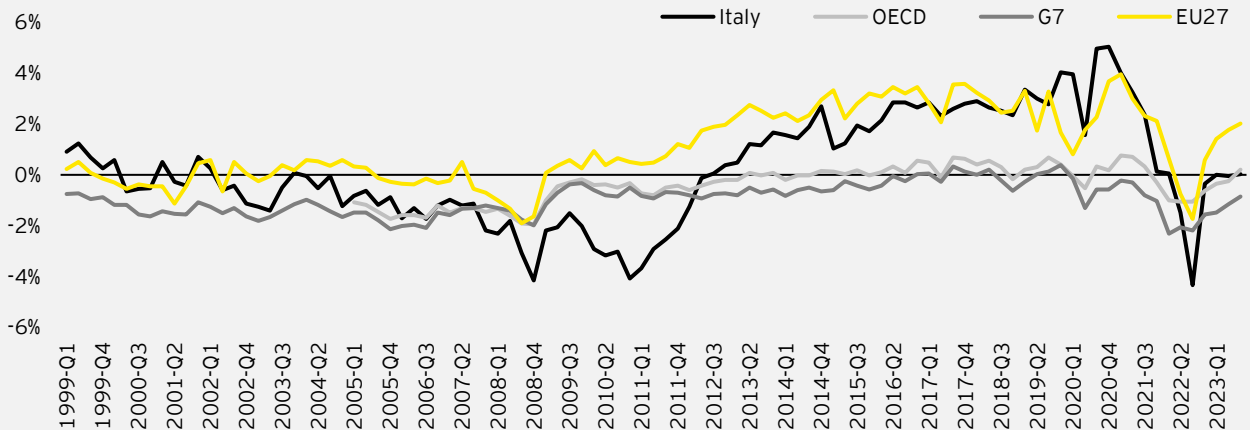
Source: EY elaborations on OECD data. We refer to trade in both goods and services.

In conclusion, therefore, it is possible to say that, while Italy's trade flows since 2010 have been increasingly concentrated in Europe and America (and, in recent years, especially in America, potentially demonstrating a process of *friendshoring*), recent years have seen a greater level of integration and complexity of Italian trade supply chains. This could result in an increased exposure of Italian trade to risks related to issues along global supply chains.

The Italian economy: GDP and EY forecasts

In the fourth quarter of 2023 Italy recorded an economic growth of 0.2% compared to the previous quarter, which is reflected in a year-on-year growth (compared to the same period of the previous year) of 0.6%. The year 2023 thus closes with a growth of 0.9% compared to 2022. The quarter-on-quarter economic growth is the result of a significant slowdown in household consumption (-1.4%, which also consider consumptions of non-profit institutions serving households) on the one hand and, on the other hand, of an acceleration in investments (2.4%). In addition to investments, a positive contribution came from net foreign demand and public consumption, which contributed for 0.4 and 0.1 percentage points respectively (private consumption, on the other hand, negatively contributed for 0.8 percentage points).[83]

The consumption dynamics are affected by the reduction in household purchasing power due to high inflation and the high cost of money, which discourages consumer credit. Added to this are the dynamics of Italians' savings. Indeed, the savings accumulated during the pandemic period have potentially sustained private consumption in the following quarters, despite the not always favorable economic conditions and high uncertainty due to the geopolitical context. The gradual depletion of the 'extra-savings' accumulated during the pandemic period has meant less support for private consumption in recent months.

Figure 46: GDP components, Italy - contributions to growth, percentage points
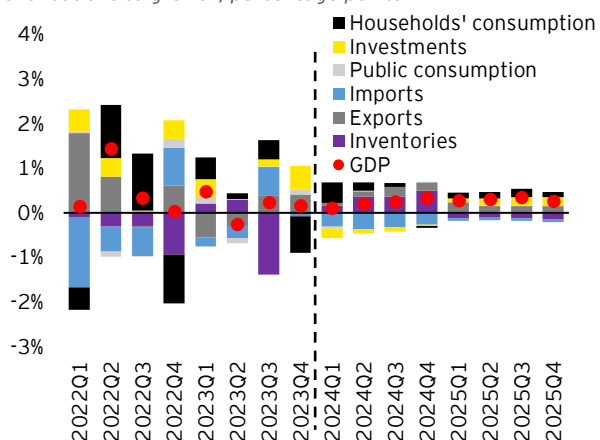
Figure 47: GDP components, Italy - index, 2019-Q4 = 100
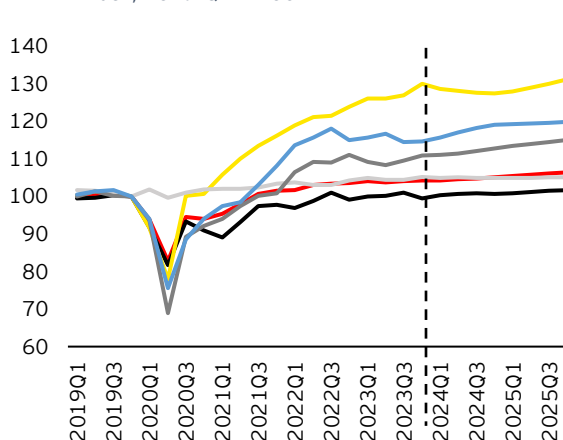
Source: EY elaborations on Eurostat data and EY forecasts. EY forecasts start from 2024-Q1. Investment refers to public and private investment, and includes gross fixed capital formation, acquisitions less disposals of valuables and depreciation. Household consumption also consider the consumption of non-profit institutions serving households.

Based on the information shared in the previous sections and the latest available data, it is possible to outline EY's outlook for the Italian economy. After the weak growth recorded in the fourth quarter of 2023, GDP is expected to grow by 0.1% in the first quarter of 2024, followed by slightly more dynamic growth for the rest of 2024 (between 0.2% and 0.3%) until the year ends at 0.7%. In contrast, 2025 will be characterized by more dynamic growth (1.2%).

It is estimated that the performance in 2024 will be linked to a subdued trend in consumption (0.4%) and investment (0.6%), plus a slight positive contribution from net exports (around 0.1 percentage points). On the other hand, 2025 will be characterized by a slight acceleration in consumption (0.7%

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[83] ISTAT, Quarterly Economic Accounts, Q4 2023. For more information, https://www.istat.it/it/files//2024/03/CET_244.pdf.

estimated growth compared to the previous year) and a rebound in investments (1.2%), mainly due to an expected reduction in the level of interest rates following a normalization of the inflation rate.

Table 1: Economic forecasts for the Italian economy

	2020	2021	2022	2023	2024	2025
GDP, % change	-9.0%	8.3%	4.1%	0.9%	0.7%	1.2%
Household consumption, % change	-10.4%	5.5%	4.9%	1.2%	0.4%	0.7%
Total investments, % change	-8.0%	20.3%	8.9%	4.9%	0.6%	1.2%
Exports, var. %	-14.3%	14.1%	11.0%	0.5%	2.1%	2.2%
Imports, % change	-12.7%	15.6%	13.5%	-0.2%	1.9%	1.7%
Unemployment rate	9.4%	9.5%	8.1%	7.7%	7.5%	7.2%
Consumer price index, % change	-0.1%	1.9%	8.2%	5.6%	1.9%	1.8%
Deficit, % of GDP	-9.5%	-8.8%	-8.4%	-6.8%	-4.7%	-3.5%
Public debt, % of GDP	155.1%	147.3%	140.4%	137.0%	139.9%	139.1%

Source: Forecasts from EY Italy's Macroeconometric Model, 'HEY-MoM'. The area in grey represents the forecast horizon. Changes in GDP and its components are calculated on the basis of values expressed in real terms. Investment refers to public and private investment, and includes gross fixed capital formation, acquisitions less disposals of valuables and depreciation. Household consumption also consider the consumption of non-profit institutions serving households.

The labor market looks robust, with an unemployment rate in the two years of analysis (2024 and 2025) decreasing from values closer to 8% to values closer to 7%. Also improving are the estimates for inflation, which is expected to fall from 5.6% in 2023 to 1.9% in 2024 and 1.8% in 2025.

Public deficit is expected at 4.7% in 2024 and 3.5% in 2025, while the public debt-to-GDP ratio will be affected by low nominal GDP growth, being close to 139% in 2025. Forecasts remain subject to a scenario of high uncertainty and therefore present important risks, mainly related to the global macroeconomic environment, both downward and upward.

Going into the details of investments, the high interest rates are also compounded by the reduction of public incentives put in place in the past quarters, resulting in a negative effect on private investments. Specifically, in 2024 and 2025, private investment in dwellings is expected to contract sharply (-4.3% and -13.4%, respectively); a similar, albeit more subdued, trend is expected for private investment in machinery in 2024 (-0.3%), recovering in 2025 (5.6%). A different trend can be seen for intangible assets, which increasingly represent a key and distinctive element for companies to maintain their competitiveness on the market. In fact, these investments (which include, for example, investments in research and development, software) continue to grow, even though the total amount is still small compared to total investments and their 'driving effect' is therefore still not very significant overall, even though their contribution is fundamental for the economic system (e.g., with reference to productivity).[84] Against a backdrop of shrinking private investment, public investment, which is expected to grow at 6.7% in 2024 and 3.0% in 2025, is therefore the real driver of national investment.

In this regard, it is therefore important to emphasize the role of the National Recovery and Resilience Plan (NRP) for growth not only in the medium to long term, thanks to an increase in potential growth due in part to the complex program of reforms that is part of the Plan, but also in the short term, representing an important driving force in a context of private investment held back by high interest rates.

The forecasts just described assume, in fact, the actual implementation of the reforms and projects of the NRP according to the information available in the Third Report on the state of implementation of the

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[84] Greco, R. (2023). A structural analysis of productivity in Italy: a cross-industry, cross-country perspective. Questioni di Economia e Finanza, Occasional Paper, Number 825, December 2023.

PNRR of July 2023.[85] The Fourth Report on the state of implementation of the PNRR of February 2024, shows a total expenditure between 2020 and 2023 of about 43 billion € out of the 58 billion € planned in the timetable described in the Third Report.[86] Based on this information, it is possible to assume that the difference between what was spent and what was achieved at the end of 2023 will be used in the following years.

In this context, we can outline specific scenarios to identify the potential impact on growth in the event of partial implementation of the plan in the coming years. Specifically, the estimates of the impacts of the NRP on growth in the different implementation scenarios were carried out as follows:

1. On the basis of the timetable contained in the Third Report of July 2023, a new timetable was estimated, incorporating the latest changes made to the NRP at the end of 2023. [87]
2. For 2023, only the resources actually accrued in 2023 were taken into account, which can be deduced from the comparison between the expenditure incurred as of 31/12/2023 and the expenditure incurred as of 31/12/2022. The difference between the resources actually accruing in 2023 and those in the previous timeframe (a difference of about 15 billion €) was assumed to be accrued in the following years (from 2024 to 2026) and distributed over the years equally.
3. The amounts for the years after 2023 were then broken down by expenditure categories, taking into account the shares of the different purposes of the budget to be allocated as described in the Fourth Report. Specifically, the following distribution of resources is assumed: for the purchase of goods and services 33% of total expenditure; for public investments 46%; for social benefits 1%; for granting incentives to production units 19%; and for other spending purposes 1%.
4. A delay in the actual spending of public investments ('*time to spend'*), taking into account the necessary bureaucratic requirements, was assumed to be around four quarters, in line with the assumption in a work by the European Commission (Pfeiffer et al., 2021).[88]
5. This scenario (*baseline*) is complemented by two further scenarios in which a partial implementation of the NRP is assumed. More specifically:
   a. *Scenario 1*: Plan implementation at 70% of the planned resource estimate in 2024 and 90% in 2025;
   b. *Scenario 2*: Implementation of the plan at 50% of the planned resource estimate in 2024 and 70% in 2025.

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[85] PNRR – La terza relazione sullo stato di attuazione del PNRR. Per maggiori informazioni, https://temi.camera.it/leg19/dossier/OCD18-18399/pnrr-terza-relazione-sullo-stato-attuazione-del-pnrr.html.
[86] Quarta relazione al Parlamento sullo stato di attuazione del Piano Nazionale di Ripresa e Resilienza., Sez. I, pag. 113. Per maggiori informazioni, https://www.italiadomani.gov.it/content/sogei-ng/it/it/strumenti/documenti/archivio-documenti/quarta-relazione-al-parlamento-sullo-stato-di-attuazione-del-pia.html.
[87] Specifically, we refer to the increase in resources under the NRP from 191.5 billion € to 194.4 billion €. For more information, https://temi.camera.it/leg19/pnrr.html.
[88] Pfeiffer, P., & Varga, J. (2021). Quantifying spillovers of next generation EU investment (No. 144). Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. This paper in turn refers to Leeper, E.M., T.B. Walker, and S-C.S. Yang, 2010, Government Investment and Fiscal Stimulus, Journal of Monetary Economics, 57, 1000-12.

Figure 48: Real GDP and growth deviation in the two scenarios compared to baseline, Italy (€ million and percentage points)
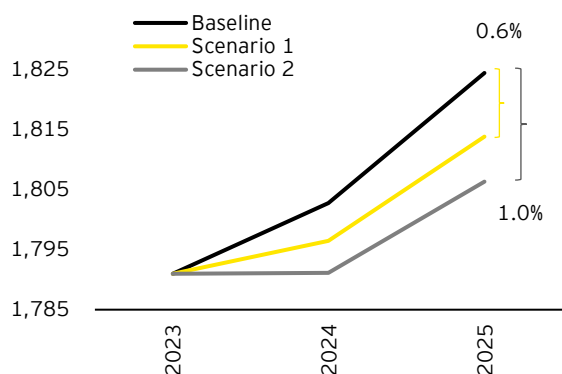
Table 49: Real GDP growth in simulation scenarios, Italy - % change

	2024	2025
Baseline	0.7%	1.2%
Scenario 1	0.3%	1.0%
Scenario 2	0.0%	0.8%

Source: EY Italy's Macroeconometric Model, "HEY-MoM". The percentages represent the deviation in the two scenarios from the baseline scenario (0.6% in Scenario 1; 1.0% in Scenario 2).

Taking these two scenarios into account, we estimate that in Scenario 1 (implementation at 70% of the 2024 resource and 90% in 2025), GDP would grow by 0.3% in 2024 and 1.0% in 2025. This would result in a cumulative growth in 2025 that is 0.6 percentage points lower than the baseline.

In Scenario 2 (implementation at 50% for 2024 and 70% for 2025), the Italian economy would experience a flat growth (0.0%) in 2024 and 0.8% in 2025. This would translate into a 1 percentage point lower cumulative growth in 2025 compared the baseline. As already mentioned, therefore, the PNRR resources represent an important lever of GDP growth for Italy in 2024 and 2025, in a context of high interest rates that discourage private consumption and investment. It is also crucial that these resources are spent efficiently to stimulate medium- to long-term growth.

Assumptions to forecasts

The forecasts described above are based on a series of assumptions outlining the baseline scenario. Specifically, the following assumptions are considered:

▸ **Foreign demand for Italian goods**: foreign demand for Italian goods is assumed to pick up in 2024, with a further acceleration in 2025 to 3% growth;

▸ **Natural gas**: the price of natural gas (referred to the Dutch Title Transfer Facility) is assumed to be around 15.0 $/mmbtu by the end of 2024, and around 14 $/mmbtu by the end of 2025;

▸ **Oil**: the price of oil is assumed to be around $82 per barrel at the end of 2024,[89] and to decline gradually in 2025 to $80 per barrel;

▸ **Exchange rate**: the euro/dollar exchange rate is assumed to be 1.09;

▸ **Public expenditure**: we take as our starting point the projections contained in the latest Update Note of the Ministry of Economy and Finance's Economic and Financial Document,[90] modified to take into account our estimates of the allocation of NRP resources (PNRR);

▸ **Monetary policy and interest rates:** we assume a reduction in interest rates in mid-2024, leading to a 1 percentage point reduction in key interest rates by the end of 2024, and a further reduction of half a point in 2025. The long-term interest rate (10 years) is also expected to follow a similar trend but showing a gradually narrowing differential with the short-term rate.

Assumptions are made on the basis of data available as of 20 March 2024. The data in the analysis are updated to 20 March 2024.

Finally, considering the current scenario and the very high uncertainty, some downside and upside risks are listed below to support a more complete view of what might happen in the future.

Upside risks

▸ **Reduction of geopolitical tensions**: tensions related to the ongoing conflicts, specifically the Russian-Ukrainian and Israeli-Palestinian ones, could decrease in the short/medium term, thus reducing instability in the macroeconomic framework, with potential positive repercussions on the prices of energy goods (mainly oil) and other commodities;

▸ **Labour market:** low pressure of wages on price level, reducing the risk of inflation rate persistence;

▸ **Monetary policy:** acceleration of monetary policy easing by the European Central Bank with lower pressure on domestic demand;

▸ **Readjustment of supply chains**: a faster readjustment of European and global value chains would lead to lower complexities resulting in greater security of supply and world trade acceleration;

▸ **Acceleration of foreign demand**: higher economic growth for important trading partners such as China and the US, which would result in a higher contribution of foreign trade to Italian growth.

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[89] We refer to the price of Brent.
[90] Documento di Economia e Finanza, Nota di aggiornamento 2023.

Downside risks

▸ **Increased geopolitical tensions**: the Russia-Ukraine conflict may not find a solution in the short/medium term, perpetuating geopolitical insecurity. To this could be added a worsening of the Israeli-Palestinian issue, which, if other countries were to be involved, would have even more significant humanitarian and economic repercussions, with potential negative consequences on the prices of energy goods (mainly oil) and other commodities;

▸ **Stronger-than-expected impact of restrictive monetary policy on the real economy**: the ECB and other global central banks may maintain a restrictive monetary policy for longer than expected if inflation persists. This may translate into a risk of prolonged low growth, due to lower consumption and investment discouraged by high interest rates;

▸ **Stress in the financial system**: high interest rates can translate into increased stress for financial institutions, with a consequent impact on savers and a tightening of credit conditions, both in the US and in the Eurozone;

▸ **High public debt**: the post-pandemic increase in public debt, together with the current high interest rates, poses new challenges to its sustainability in Eurozone economies, especially in the most indebted ones such as Italy. This could ultimately translate into higher risks of stress in financial markets;

▸ **National Recovery Plan (PNRR)**: failing to fully achieve the objectives of the NRP and its partial implementation could slow down the pace of growth of investments, and thus of the Italian economy as a whole; the issue could also have repercussions on potential GDP and thus on medium- to long-term growth prospects;

▸ **Emerging economies**: rising global interest rates may impact emerging economies through several channels (low US growth; depreciation of emerging country currencies, potentially leading to higher interest rates to avoid excessive depreciation; increased financial fragility);

▸ **Monetary policy transmission channels**: some structural factors such as the presence of a high proportion of households with fixed-rate debt, or an economy where the service sector is predominant, may hamper the transmission mechanisms of monetary policy, thus requiring more time for its effects to be felt; [91]

▸ **Increased distress in the real estate sector**: maintaining interest rates at a high level may add further pressure on the real estate market, discouraging home and property purchases;

▸ **Lower international growth**: less sustained growth in China and the US could result in reduced growth in foreign demand for Italian goods;

▸ **US elections**: the November 2024 US elections increase uncertainty about potential future developments and expectations on major geopolitical issues.

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[91] ECB, the risks of a stubborn inflation, June 2023, https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230619_1~2c0bdf2422.en.html.

Technical Appendix

HEY-MOM: Hybrid EY MOdel for the Macroeconomy[92]

The construction of a new macro-econometric model required the optimisation of an inevitable trade-off between building a model that emphasises data information (such as the ARIMA and VAR models, which make no use of economic theory) or a model that only pays attention to the foundations on which its relationships are based (in the extreme case, the calibrated RBC-DSGE models that pay no attention to the data of their variables).[93] This trade-off has been emphasised several times in the literature, see for example the reflections in Granger (1999) and Pagan (2003).

In the construction of HEY-MOM, an attempt was made not to neglect either of the above two ingredients (economic theory and data), with the aim to produce a hybrid model with a careful balance in specifying relationships (a) based on micro-founded economic behavior and at the same time (b) careful in the application of rigorous statistical information evaluation techniques. An example of a hybrid model is MARTIN, the model currently in use at the Australian Central Bank (see Cusbert and Kendall, 2018).

In a nutshell, the role of HEY-MOM is to unify the analytical framework of macroeconomics in EY. In order to do so, the model refers to the main aggregates of the Italian economy, based on empirical data, non-monetary in nature, with explicit long-run relations between the variables it studies, and mainly oriented towards the definition of short-term forecasts (over a two-year horizon).

Economic foundations

Rigidity in the movement of prices and wages implies rigidity in the speed with which macroeconomic systems adjust to unexpected shocks. Thus, in the model, market demand drives short-term fluctuations, as outlined by Keynesian theories, while in the long run, supply determinants drive the state of the economy.

The long-run output (the potential of the economy) depends on the combined effect of trends in total factor productivity, labor supply and duration in hours and, finally, the capital stock. These factors are combined by a Cobb-Douglas-type technology with constant returns to scale. The demand for factors of production is that which minimizes the cost given a planned level of output in the context of an economy in which oligopolistic forms of competition prevail, in which firms are free to set prices on the basis of a margin over labor costs and, at those prices, are prepared to collectively meet any level of market demand. Wages are defined on the basis of a 'Phillips curve' driven by the inertia of the inflation rate, labor productivity, and the distance between actual and natural unemployment rates (defined by the long-run state of the labor market). Actual output is composed of the following domestic and foreign demand items: private (household) and public consumption; private and public investment by type of asset (residential and non-residential buildings, machinery and equipment, and expenditure on research and development); imports and exports.

In each period, the gap between actual and potential output affects prices (through changes in margins) which, in turn, interact with the demand components. In this way, an equilibrium between supply and demand is achieved.

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[92] The model was developed in collaboration with the Department of Economic Sciences of the University of Bologna.
[93] "ARIMA" stands for "Autoregressive integrated moving average", "VAR" for "Vector autoregression", "RBC-DSGE" for "Real Business Cycle - Dynamic. Stochastic General Equilibrium'.

Data evaluation techniques

The speed at which the economic dynamics outlined above evolve over time is estimated using econometric methods based on the actual time series of the variables of interest in the model.

To this end, the model uses a combination of the London School of Economics approaches and Fair's (2004) review of the Yale Cowles Commission approach. The synthesis carried out in HEY-MOM uses cointegration methods (Engle and Granger, 1987, and Johansen, 1995) to estimate long-run relationships between non-stationary variables (Dickey and Fuller, 1979), which can be interpreted in light of economic theory and identified by state relationships whose parameters are estimated on the basis of error-corrected models (Hendry et al., 1984, and Pesaran et al., 2001). In the absence of exogeneity of some explanatory variables in the model, the relationships are first inspected following the instrumental variables estimation approach, and then definitively estimated at three stages (Hsiao, 1997).

The overall result is a model consisting of 74 equations, of which 29 are stochastic and 45 are accounting identities. The forecasts and analyses performed are conditional on the delineation of scenarios for 65 exogenous variables that can be classified as: fiscal and monetary policy instruments, foreign bloc, and economic indicators.

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Contacts

Mario Rocco
Partner, Valuation, Modelling and Economics Leader, EY
mario.rocco@it.ey.com

Alberto Caruso
Senior Manager, EY
alberto.caruso@it.ey.com

Luca Butiniello
Senior Analyst, EY
luca.butiniello@it.ey.com