EY Italian Macroeconomic Bulletin

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EY

Building a better working world

Index

Executive summary

‣ Between 2024 and 2025, world growth is expected to stabilize slightly above 3% (3.2% in 2024 and 3.3% in 2025), broadly in line with pre-pandemic values, while the inflation rate continues following its downward trend (from 6.8% in 2023 to 5.9% in 2024 and 4.5% in 2025).

‣ However, the international scenario remains characterized by substantial uncertainty: from energy and commodity prices influenced by geopolitical tensions to uneven growth among the world's major economies, to a monetary policy interest rates path that is difficult to predict, to a robust but slowing labor market in the US and Eurozone that could generate inflationary pressures, there are several elements of uncertainty that characterize the global economic landscape.

‣ The Eurozone continues to show a subdued economy (growth in second quarter of 2024 at 0.2% compared to the previous quarter), mainly due to the challenges industrial sector is facing (especially in Italy and Germany where the outlook remains negative) and still high energy prices and interest rates, albeit declining. Inflation appears to be lower than in the previous year but remains above the 2% level. In this context, at its meeting on the 18th of September, the European Central Bank reduced its monetary policy reference interest rates, bringing them within a range of 3.90% to 3.50%.

‣ In addition to cyclical issues, the Eurozone faces additional challenges, such as the sustainability of public debt in the long run, which are rooted in structural factors, e.g., demographic dynamics (ageing population), and the increased investment needed in digitization and sustainability issues for competitiveness.

‣ In Italy, inflation seems to have stabilized around values close to or slightly above 1%, thanks to a downward contribution of the energy component and despite the fact that core inflation is more persistent (around 2% in August 2024).

‣ In this context, EY forecasts points at a 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 1.3% in 2024 and 1.9% in 2025. The forecasts are subject to a high degree of uncertainty, considering the sometimes-conflicting signals coming from the data currently available, as well as the latest geopolitical events.

‣ Two simulations performed with EY's econometric model on possible scenarios of a partial utilization of the NRP funds (PNRR) underline their importance for growth. Specifically, a utilization of 70% and 90% of the planned resources in 2024 and 2025, respectively, would result in a cumulative reduction in growth in 2025 of about 0.7 percentage points compared 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 (1.8 percentage points).
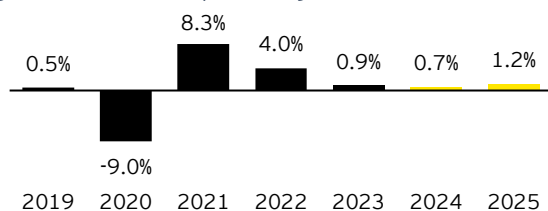
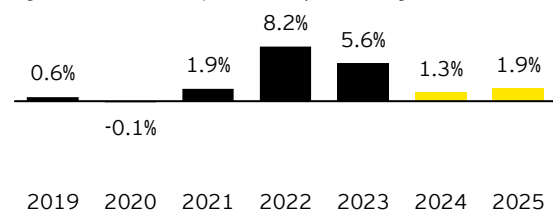*Figure 1: Real GDP, Italy - % change*

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, the International Monetary Fund confirms global growth at 3.2% in 2024, which is broadly in line with what was experienced in 2023 (3.3%) and what is expected for 2025 (3.3%). The forecast for 2025 has been revised upwards, albeit only moderately (by about 0.1 percentage points).[1] The forecasts of the International Monetary Fund also appear to be consistent with those of the Organisation for Economic Cooperation and Development (OECD), which in its Economic Outlook of May 2024 expects global growth of 3.1% for 2024 (in line with the values experienced in 2023), which is expected to be followed by growth of 3.2% in 2025.[2]

Forecasts for the world economy consider a certain heterogeneity within the major economies. Looking at actual and expected growth in the US and the Eurozone, for example, we can observe substantially different economic dynamics.

Specifically, the US showed robust growth in 2023 (2.5%), which is expected to be followed by equally dynamic growth in 2024 (2.6%) and then slowing slightly in 2025 (1.9%). The health of the US economy can be appreciated considering previous growth expectations, especially with reference to 2024: in the World Economic Outlook of January 2024, the International Monetary Fund forecast a 2.1% growth in 2024 (1.7% in 2025),[3] about 0.5 percentage points lower than the latest projections.

On the other side, the overall picture for the Eurozone appears different: after the low growth recorded in 2023 (0.5%), an acceleration is expected in 2024 and 2025 (with a growth rate of 0.9% and 1.5% respectively). There is also cautious optimism for the Eurozone in the forecast for 2024, which has been revised upwards by 0.1 percentage points compared to the International Monetary Fund's April 2024 forecast.
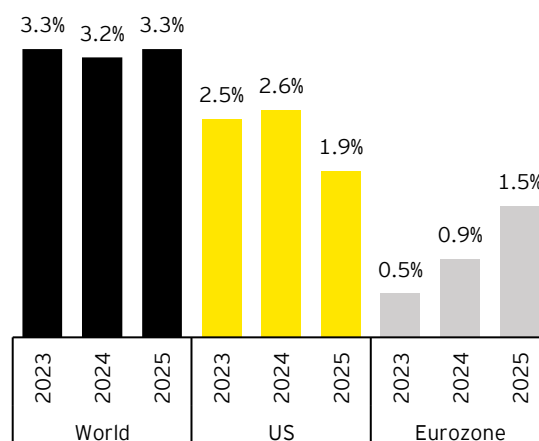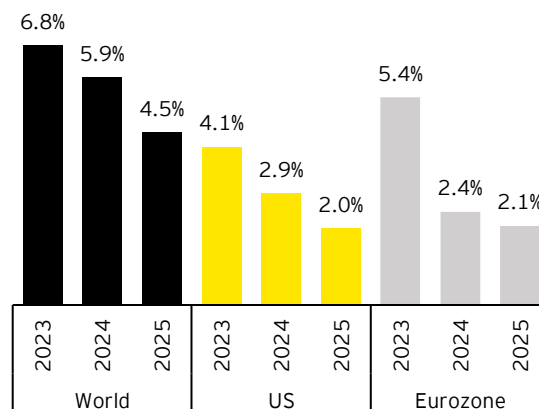
Figure 3: Real GDP - % change

Figure 4: Consumer prices - % change

Source: EY elaborations on data and forecasts from IMF World Economic Outlook, July 2024. For consumer prices, reference is made to forecasts from IMF World Economic Outlook, April 2024.

When analyzing growth trends in the US and the Eurozone, it is important to emphasize the

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[1] IMF World Economic Outlook, July 2024.
[2] OECD Economic Outlook, May 2024.

[3] IMF World Economic Outlook, January 2024.

substantial differences that have characterized the two economies in recent years.

Specifically, the gap is attributable, firstly, to the weakening of private consumption in the Eurozone compared to the US, where specific policy to support consumer and a relatively higher utilization of excess savings have provided a strong boost to the US economy.

Regarding the latter, it is important to emphasize that the composition of the assets that constituted the savings surplus played a key role in sustaining consumption, given that, unlike US consumers, Eurozone households accumulated a relatively small amount of liquid assets, resulting in a not easy utilization of these assets for consumption.[4]

The Eurozone also suffered a terms-of-trade shock, i.e., a shock in the relationship between the prices of exported and imported goods,[5] after the invasion of Ukraine, the following energy crisis and subsequent price increases. All these factors undermine European competitiveness.[6]

A further element to be considered when trying to point out the main differences behind the US and Eurozone performance relates to the trend in labor productivity, which in the US has grown significantly faster. Consider, for example, that between the fourth quarter of 2019 and the fourth quarter of 2023, labor productivity per hour worked increased by only 0.6% in the Eurozone, compared to 6.0% in the US. This divergent path in productivity growth started in the second quarter of 2020, when total labor input adjusted more significantly in the US than in the Eurozone, a phenomenon partly due to the implementation of employment maintenance programs in the Eurozone, as opposed to rising unemployment in the US.[7]

Regarding the development of the inflation rate at global level, a further reduction is expected, although values will continue to remain higher than the average recorded over the previous two decades (3.9% in the period 2000-2019). Overall, the inflation rate is expected to decrease from 7.0% in 2023 to 5.9% in 2024, and further to 4.5% in 2025.

For the US, annual inflation is expected at 2.9% in 2024 and 2.0% in 2025, which is in line with the Federal Reserve's price stability target. A normalization is also expected for the eurozone, with an estimated inflation rate of 2.4% in 2024 and 2.1% in 2025.

Although world economic growth is relatively stable above 3% even in the forecast period, this figure remains lower than that experienced in the two decades preceding the pandemic (2000-2019, when the world growth rate was around 3.7% per annum): it is precisely the lower world economic demand that is one of the factors behind the slowdown in world trade, which shows a major downward deviation from the trend between 2000 and 2019. [8]

Another factor behind the trend in international trade is related to new or rekindled geopolitical risks in recent years,[9] as well as specific environmental situations. The recent attacks on commercial vessels in the Red Sea, together with weather-related disruptions in the Panama Canal, have had a negative effect on maritime transit and transport rates along these crucial routes.[10]

[4] Battistini, N., Di Nino, V., & Gareis, J. (2023). The consumption impulse from pandemic savings-does the composition matter?. Economic Bulletin Boxes, 4.
[5] For more information, https://www.istat.it/storage/IstatData/Coeweb/Glossario.pdf.
[6] de Soyres, F., Garcia-Cabo Herrero, J., Goernemann, N., Jeon, S., Lofstrom, G., and Moore, D., "Why is the U.S. GDP recovering faster than other advanced economies?", FEDS Notes, Board of Governors of the Federal Reserve System, Washington, 17 May 2024.
[7] Andersson, M., Checherita-Westphal, C., Da Silva, A. D., & Soudan, M. (2024). The post-pandemic recovery-why is the euro area growing more slowly than the United States?. Economic Bulletin Boxes, 4.

[8] 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.
[9] Caldara, D., & Iacoviello, M. (2022). Measuring geopolitical risk. American Economic Review, 112(4), 1194-1225.
[10] Bogetic, Z., L. Zhao, H. Krambeck, E. A. Chamorro, S. Sarva, J. Matossian, and Y. Zhao. 2024. "Dire Strait: The Far-Reaching Impact of the Red Sea Shipping Crisis." MENA FCV Economic Series Brief, World Bank.
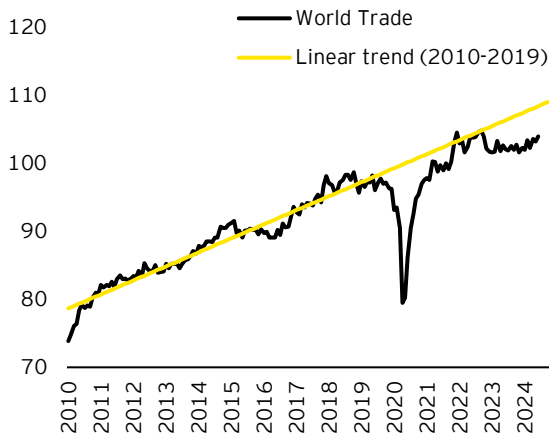
These events, however, have not yet translated into a significant increase in global supply chain pressures, as shown by the analysis of two of the possible indicators representing these phenomena, namely the Global Supply Chain Pressure Index and the Baltic Dry Index (Figure 6).

In addition to these geopolitical and environmental challenges, there are further complications related to the uncertainty surrounding political issues and the presence of a significant number of trade restrictions compared to previous years.

With reference to the first point, analyzing the level of trade uncertainty experienced in the past in connection with elections in some of the world's major countries, we can see that there are currently significantly higher levels of uncertainty than in other reference years (such as 2004 and 2012, years of major elections):[11] these levels are also and mainly due to the US elections to be held in November 2024, which could be followed by changes in some major geopolitical issues.

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[11] Caldara, D., Iacoviello, M., Molligo, P., Prestipino, A., & Raffo, A. (2020). The economic effects of trade policy uncertainty. Journal of Monetary Economics, 109, 38-59.

*Figure 7: Trade policy uncertainty during major political events*
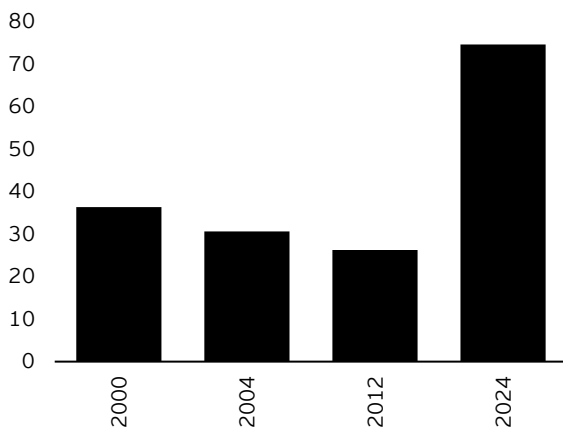
With regard to trade restrictions and, more generally, potentially trade-distorting measures, it is important to notice that three times as many measures were recorded in the years between 2022 and 2024 than in the period, for example, between 2017 and 2019. These measures refer to specific subsidies (e.g., loan guarantees), contingent trade-protective measures (e.g., antidumping measures), and other measures.

Increased geopolitical tensions and general uncertainty not only have a negative effect on trade developments, but also on the development of foreign direct investment (FDI). Following Russia's invasion of Ukraine, for example, trade and FDI flows between countries belonging to "geopolitically distant" blocs decreased significantly compared to flows between "aligned" and "geopolitically related" countries.[12, 13]

Moreover, trade-distorting policies aimed at reducing dependence on specific suppliers do not necessarily lead to effective diversification, since these policies may lead to stronger indirect links, as trade relations may be "diverted" to third countries, resulting in more complex and less efficient supply chains. [14]

Figure 8: Number of trade distorting measures affecting trade in goods
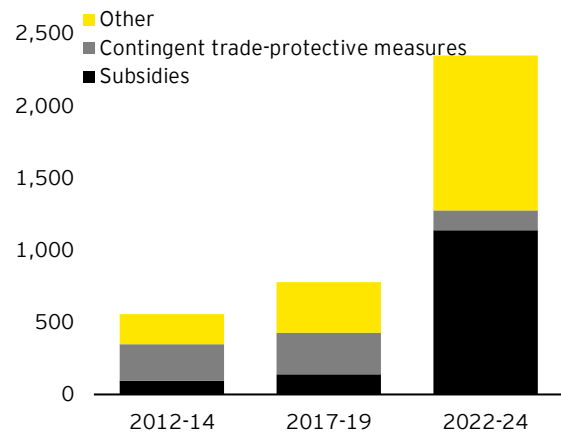
It should be considered that the reconfiguration of supply chains is often costly and can result in economic losses for companies in specific countries, as they devote a portion of resources to finding alternative suppliers.[15]

Finally, increased trade policy uncertainty and a further weakening of the multilateral trading system, both resulting from the tightening of trade restrictions, could have negative effects on global economic growth. In the short term, increased trade policy uncertainty could indeed slow down business investment in both advanced economies and emerging and developing countries.[16,17] In the long run, less efficient supply chains could lead to lower returns on capital, possibly hampering productivity growth. Internationally oriented firms might in fact implement nearshoring policies, shifting some production processes back to closer countries due to low expectations of trade tensions being

[12] Blanga-Gubbay, M., and S. Rubínová. 2023. "Is the Global Economy Fragmenting?" WTO Staff Working Paper ERSD-2023-10, Economic Research and Statistics Division, World Trade Organization, Geneva.
[13] Gopinath, G., P. Gourinchas, F. A. Presbitero, and P. Topalova. 2024. "Changing Global Linkages: A New Cold War?" IMF Working Paper 24/76, International Monetary Fund, Washington, DC.
[14] Freund, C., A. Mattoo, A. Mulabdic, and M. Ruta. 2023. "Is US Trade Policy Reshaping Global Supply Chains?" Policy Research Working Paper 10593, World Bank, Washington, DC.

[15] Grossman, G. M., E. Helpman, and S. J. Redding. 2024. "When Tariffs Disrupt Global Supply Chains." American Economic Review 114 (4): 988-1029.
[16] Caldara, D., M. Iacoviello, P. Molligo, A. Prestipino, and A. Raffo. 2019. "Does Trade Policy Uncertainty Affect Global Economic Activity?" FEDS Notes, Board of Governors of the Federal Reserve System, Washington, DC.
[17] Caldara, D., M. Iacoviello, P. Molligo, A. Prestipino, and A. Raffo. 2020. "The Economic Effects of Trade Policy Uncertainty." Journal of Monetary Economics 109 (January): 38-59.

resolved, even if this were to result in less efficient production processes.[18]

Regarding the development of commodity prices, these are also influenced by recent geopolitical dynamics, which therefore represent a potential factor of uncertainty.

Figure 9: Energy commodity prices ($) and agricultural price index (2010=100)
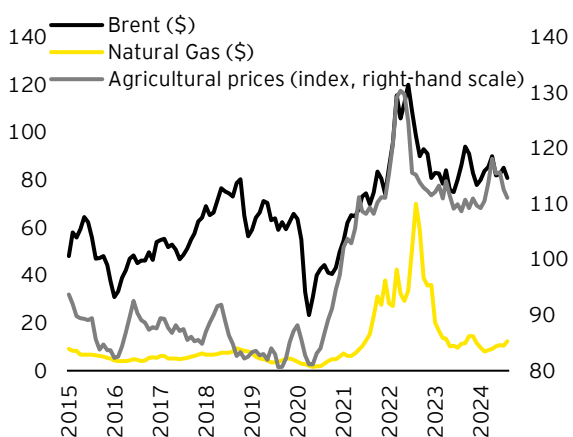
Source: EY elaborations on World Bank data. Brent and natural gas prices are expressed in $/bbl and $/mmbtu, respectively. The natural gas price refers to natural gas quoted in the Title Transfer Facility (TTF). The agricultural price index considers the price of various goods and derivatives related to agriculture globally (e.g. the price of wheat). Last observation: August 2024.

With reference to the price of oil, and specifically Brent crude oil, a price of $80.9/bbl was recorded in August 2024,[19] down from June and July 2024 ($82.6 and $85.3/bbl, respectively).

When discussing oil price trend, it is important to emphasize that there are multiple factors influencing its dynamic.

On the one hand, the prolonged and confirmed supply cuts by OPEC+[20,21] are putting upside pressure on the oil price, which is partly offset by increased supply from non-OPEC+ countries, especially the US.[22]

On the other hand, the widening of the conflict in the Middle East is likely to pose new challanges. Consider, for example, that through the Strait of Hormuz (located between the Persian Gulf and the Gulf of Oman) passes approximately 30% of the world's oil trade, and 20% of natural gas trade. Although at the moment the possibility of complications in the strait is remote, even short-term adverse events could have a very important effect on energy prices and, consequently, on world growth. For example, the OECD estimates that in the event of a shock involving a 25% increase in oil prices in the first year, followed by a 10% increase in the following year, world growth would fall by 0.4 percentage points in the first year, with the greatest effect in advanced economies. This would be coupled with a one percentage point increase in global inflation and a consequent increase in monetary policy interest rates by 50 basis points in several economies. [23]

A similar analysis on oil price developments under different scenarios of worsening conflict in the Middle East is provided by the World Bank. Specifically, the institution identifies two scenarios: a first scenario in which the supply of oil is moderately affected by the course of the conflict, which would lead to an increase in the price of oil to above $90/bbl (about 10% more than the baseline scenario); a second scenario in which a more significant impact on the supply of oil is assumed, with Brent prices rising above $100/bbl (about 20% more than the baseline scenario).

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[18] Alexandria, A. G., Y. S. Khan, A. Khederlarian, J. K. Ruhl, and B. J. Steinberg. 2024. "Trade War and Peace: U.S.-China Trade and Tariff Risk from 2015-2050." NBER Working Paper 32150, National Bureau of Economic Research, Cambridge, MA.
[19] Dollars per barrel of oil. One barrel is equivalent to about 159 litres.
[20] 55th JMMC Meeting Highlights Commitment to Production Conformity and Continued Oil Market Assessment. For more information, https://www.opec.org/opec_web/en/press_room/7359.htm.
[21] Organisation of the Petroleum Exporting Countries (OPEC). It is the grouping of oil exporting countries, whose aim is to coordinate and unify oil policies among member countries in order to ensure fair and

stable prices for oil producers, an efficient, cheap and regular supply of oil to consumer countries and a fair return on capital for those who invest in the sector. OPEC's current member countries are Algeria, Angola, Congo, Equatorial Guinea, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia, United Arab Emirates, and Venezuela. For more information, https://www.opec.org/opec_web/en/about_us/24.htm. OPEC+ is the group formed by the OPEC countries and other oil exporting countries, of which Russia is one of the main exponents.
[22] U.S. Energy Information Administration, short-term energy outlook, September 2024. For more information, https://www.eia.gov/outlooks/steo/pdf/steo_full.pdf.
[23] OECD Economic Outlook, May 2024.

Figure 10: Brent price in different supply reduction scenarios - $/bbl

Legend:
- Historical values
- Baseline scenario
- Moderate disruption scenario
- More severe disruption scenario

Values: 2020: 42.3; 2021: 70.4; 2022: 99.8; 2023: 82.6; 2024: 84.0 (Baseline), 93.3 (Moderate disruption), 102.7 (More severe disruption)
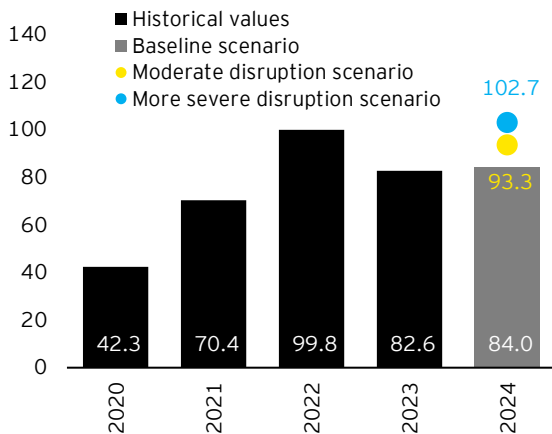
Source: World Bank.

With reference to the price of gas quoted on the European market, a price of 12.4 $/mmbtu[24] was recorded in August, up from the value recorded in July (10.3 $/mmbtu) but higher than the first months of 2024 (average of 8.8 $/mmbtu in the first three months of the year).

With reference to gas quoted on the US market, a different dynamic has been recorded in recent months compared to the European market, with a drop in quotations in August compared to July ($1.99/mmbtu in August compared to $2.08/mmbtu in July and $2.51/mmbtu in June), more in line with the levels of the first months of 2024 (with the exception of January, where the average price in the month had reached $3.2/mmbtu).

Overall, energy commodity prices remain substantially higher than in the pre-pandemic period, despite a partial reduction: it would therefore seem possible to speak of a potential new normal scenario compared to the years before 2020. There are four key elements behind this trend: reduced oil supply, high demand for raw materials (e.g., from China) despite weak economic growth, increased demand for raw materials related to the energy and digital transition and increased geopolitical tensions.[25]

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

The international picture is characterised by heterogeneous trends in the world's major economies even in the shortest-term analysis.

United States

The US recorded growth of 0.7% in the second quarter of 2024 compared to the previous quarter, following growth in the previous quarter of 0.4%. Specifically, the second quarter was characterized by sustained growth in private consumption (rising from an economic growth of 0.4% in the first quarter of 2024 to a growth of 0.7% in the second quarter), reflecting a similar magnitude of growth in consumption of goods and services (0.7% in both cases).

With reference to the consumption of goods, a 0.5% growth has been recorded in the consumption of non-durable goods together with a more substantial growth in the consumption of durable goods (1.2%). Significant growth was recorded for private investment (1.8%), following a quarter of moderate but still significant growth (1.1%). With regard to international trade, exports recorded a cyclical growth of 0.4%, coupled with a much more pronounced growth in imports (1.7%).[26]
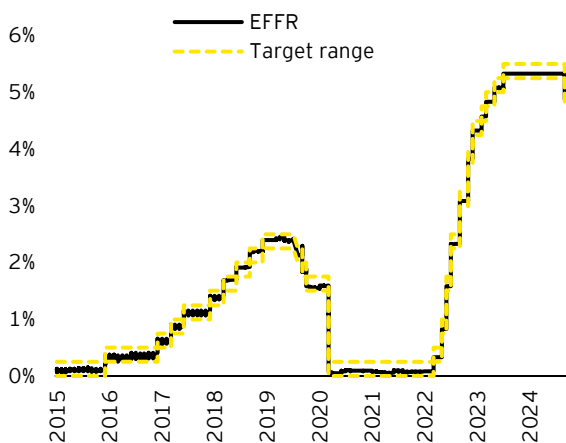
With regard to price level developments, inflation in the US continues on its downward path, albeit at a slower pace than the decline recorded in the months following the peak in mid-2022. In July 2024, consumer price index recorded a 2.9% growth (2.5% based on the Personal Consumer Expenditure Index).

The reduction in the inflation rate, although less rapid in recent months, was reflected in the US central bank's (Federal Reserve) decision to reduce its benchmark monetary policy interest rates for the first time since March 2022. The upper and lower bounds of the Federal Reserve's rate corridor was reduced from 5.50%-5.25% to 5.00%-4.75% at the September meeting.[27]

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[24] Dollars for one million British thermal units, which is a measure of the amount of gas.
[25] Arteta, C., Kenworthy, P., Kose, M. A. (2024). Why global growth is tepid, but commodity prices remain high, World Bank Blogs, July 01, 2024.
[26] Gross Domestic Product (Second Estimate), Corporate Profits (Preliminary Estimate), Second Quarter 2024,

https://www.bea.gov/news/2024/gross-domestic-product-second-estimate-corporate-profits-preliminary-estimate-second.
[27] Federal Reserve issues FOMC statement, 18 September 2024, https://www.federalreserve.gov/newsevents/pressreleases/monetary20240918a.htm.

Source: EY elaborations based on Federal Reserve Bank of New York data. EFFR: Effective Federal Fund Rate; EFFR is calculated as the volume-weighted median of reported overnight transactions. For more information, https://www.newyorkfed.org/markets/reference-rates/effr.

With reference to the details of the economy's performance in recent months, the most recent data show that in July 2024 consumer spending grew compared to the previous month (0.4% compared to 0.3% in June and 0.5% in May).[28] This growth is mainly due to a positive trend in expenditure on goods (0.7% in July, after 0.3% and 1.1% in the two previous months), while the increase in expenditure on services appears more limited (0.2% in July, after stable growth of 0.3% in the two previous months). With reference to goods, however, it is important to emphasize that there is some heterogeneity between the consumption of durable and non-durable goods, with the former registering significant monthly growth (1.7%) and the latter showing more moderate growth (0.2%).

These data come together with a robust labor market, the dynamism of which, however, appears more contained: in August, in fact, the number of nonfarm payroll employees in the United States was 142,000 higher than the previous month, while the unemployment rate was around 4.2%. These values show, as already mentioned, a partial slowdown in the dynamics of the labor market: in July the number of nonfarm payroll employees was 89,000 higher compared

to the previous month (while a 118,000 units increase was recorded in June).[29] At the same time, job openings data show a downward trend after the peak reached in 2022.

Figure 12: Change in the number of non-farm payrolls and job openings – United States
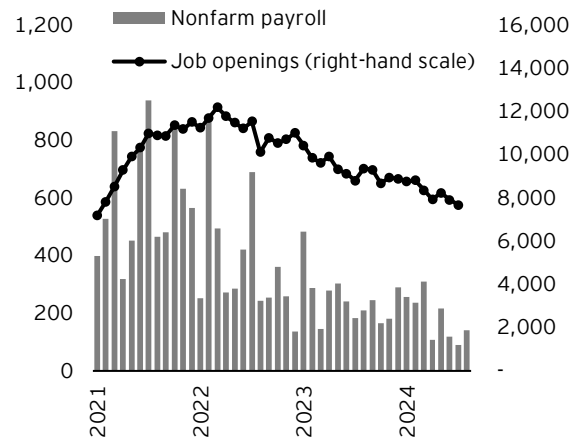
Source: EY elaborations based on Bureau of Labor Statistics (BLS) data. *Non-farm payroll* refers to the number of US workers in the economy excluding business owners, household employees, unpaid volunteers, farm employees and unincorporated self-employed workers. This measure represents about 80% of workers contributing to the Gross Domestic Product (GDP). For more information, https://fred.stlouisfed.org/series/PAYEMS.

Industrial and manufacturing activity is contracting, with the former declining by 0.6% in July 2024 compared to the previous month (after growth of 0.8% and 0.3% in May and June, respectively), and manufacturing declining by 0.3% (after growth of 0.8% in May and stagnation in June). Compared to the previous year, industrial and manufacturing production shows a less encouraging trend, with a 0.2% decrease for industry and a modest 0.1% growth for manufacturing in July 2024.[30]

For what concern the following quarters, the Federal Reserve Bank of New York's latest projections for September 2024 indicate average GDP growth over the next four quarters in a range of +1.73% to +3.09%, with a median of 1.55%,[31] demonstrating a dynamic economy. In particular, the Federal Reserve Bank of New York's short-term forecast for the US economy shows an

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[28] Personal Income and Outlays, July 2024. For more information, https://www.bea.gov/news/2024/personal-income-and-outlays-july-2024.
[29] U.S. Bureau of Labor Statistics, Employment Situation Summary. For more information, https://www.bls.gov/bls/news-release/empsit.htm#2024.

[30] Industrial Production and Capacity Utilisation, July 2024. For more information, https://www.federalreserve.gov/releases/g17/current/default.htm.
[31] 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.

annualized growth rate[32] of 2.6% for the third quarter of 2024, and 2.2% for the fourth quarter.[33]

Figure 13: GDP 2024 - USA, annualized QoQ % change

Q1	1.4%
Q2	3.0%
Q3	2.6%
Q4	2.2%
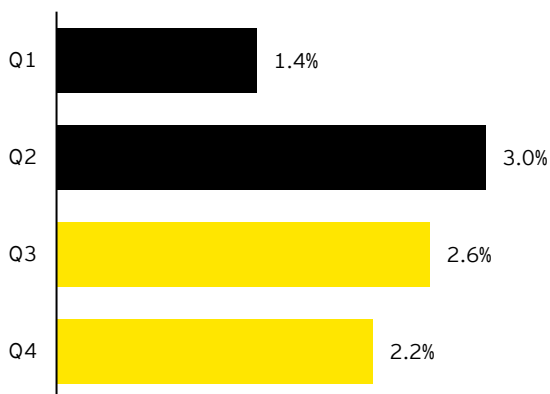
Source: EY elaborations based on Federal Reserve Bank of New York, U.S. Bureau of Economic Analysis (BEA) data. The bars in yellow represent the available forecasts for the coming quarters (New York Fed Staff Nowcast). Rates of change are annualised. Last observation: 6 September 2024.

United Kingdom

With reference to the other major global economies, the UK recorded a 0.6% growth in the second quarter of 2024, after a 0.7% growth in the first quarter and a 0.3% contraction in the fourth quarter of 2023. The performance in the first quarter is due to a growth in private consumption (0.2%), government consumption (1.4%), and investment (0.4%).[34]

Cyclical data show a faint sign of improvement: in July, the services sector grew by 0.1% compared to the previous month, following a slight contraction (-0.1%).[35]

On the other hand, a contraction was recorded in the construction sector (0.4% in July, following 0.5% growth in the previous month), in addition to a contraction in the industrial sector of 0.8% compared to the previous month (contraction following 0.8% growth in June 2024).[36, 37]

Inflation rate is close to the inflation target of 2% but remains broadly stable (or rising) in recent months: in August, an overall (*headline*) rate of 2.2% was recorded, in line with July and up from May and June (2.0%). Core inflation, on the other hand, rose from 3.3% in July to 3.6% in August. [38]

China

The Chinese economy grew by 4.7% in the second quarter of 2024 compared to the same quarter of the previous year, corresponding to a quarter-on-quarter growth of 0.7%.[39]

Regarding the industrial sector, value added grew by 5.1% in July, after 5.3% growth in June. This performance was partly due to the growth in value added in the electronics sector (e.g., manufacture of computers and other equipment, 14.3%), the manufacture of other transport equipment (12.7%) and the manufacture of metal products (9.3%). [40]

For what concern the expectations of operators in the industry sector, mixed trends are recorded. Overall, the Purchasing Managers' Index (PMI) released by the National Bureau of Statistics of China for manufacturing and non-manufacturing activities[41] shows, for the former, values slightly below the expansion threshold (50) compared to the previous month's activity, while the latter (non-manufacturing activities) show substantially neutral expectations (value close to the reference threshold).

The challenges in the real estate sector continue, where a contraction of 10.2% was recorded in January-July 2024 compared with the same period of the previous year. This downward trend is also confirmed by the data for

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[32] For more information, https://www.bea.gov/help/faq/463.
[33] For more information, https://www.newyorkfed.org/research/policy/nowcast#/overview.
[34] GDP first quarterly estimate, UK: April to June 2024, https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/apriltojune2024.
[35] Office for National Statistics, Index of Services, UK: July 2024, https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/indexofservices/july2024.
[36] Office for National Statistics, Construction output in Great Britain: July 2024, https://www.ons.gov.uk/businessindustryandtrade/constructionindustry/bulletins/constructionoutputingreatbritain/july2024.
[37] Office for National Statistics, Index of Production, UK: July 2024, https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/indexofproduction/july2024.

[38] Office for National Statistics, Consumer price inflation, UK: August 2024, https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/august2024.
[39] Preliminary Accounting Results of GDP for the Second Quarter and First Half of 2024, https://www.stats.gov.cn/english/PressRelease/202407/t20240730_1955894.html.
[40] Industrial Production Operation in July 2024, https://www.stats.gov.cn/english/PressRelease/202408/t20240822_1956037.html.
[41] For more information, https://www.stats.gov.cn/english/PressRelease/202408/t20240806_1955936.html.

the previous months, demonstrating deep complexities in the sector.[42] Broadening the spectrum of analysis to total investments, a 3.6% growth in the first seven months of the year compared to the same period of the previous year was recorded, with significant growth in the other transport equipment industry (30.1%), the energy production industry (23.8%) and the food industry (26.8%).[43]

Figure 14: Purchasing Managers' Index (PMI), manufacturing and non-manufacturing activities - China
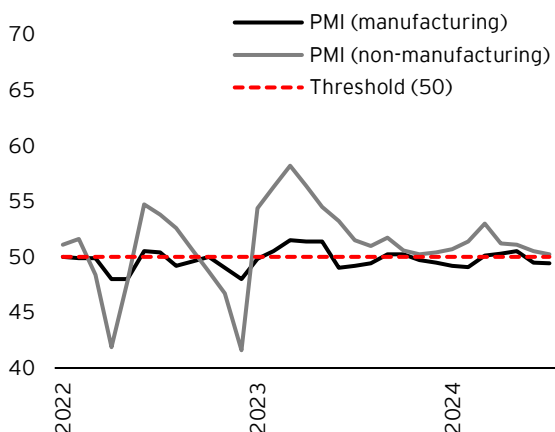
Source: EY elaborations based on National Bureau of Statistics of China data. Last observation: July 2024.

Retail sales annual growth rate is gradually decreasing since the end of 2023, with a few exceptions, reaching a 2.7% growth in July. This follows a 3.7% and 2.0% growth in May and June respectively.[44]

A positive contribution to growth comes from net exports (exports recorded a year-on-year growth of 6.5% in July 2024, while imports grew by 6.6%).[45] The positive contribution of exports to growth is also confirmed when analyzing the performance in the first seven months of 2024, thanks to higher export growth than import growth (6.7% and 5.4% respectively).

By broadening the spectrum of the analysis and shifting the focus to structural rather than cyclical factors, it is possible to identify some important elements for understanding the performance of the Chinese economy.

China's economic growth is in fact strongly linked to its investment-led growth model, investment that has been partly financed by high levels of domestic savings, in turn supported by a series of *ad hoc* economic policies. However, this investment-led growth model is coming under increasing pressure.

Firstly, falling rates of return mean that it will be increasingly difficult to generate growth from higher investment; secondly, the severe downturn in China's real estate sector, which accounted for around 30% of GDP before the 2021 property crisis, could structurally reduce the importance of this pillar within the Chinese economy. A further problem is the slowdown in external demand, mainly due to trade tensions (e.g., an increasing number of trading partners are less willing to accept further trade deficits with China). In addition, there are other structural challenges, including an ageing population and low productivity growth, which add to the above complexities faced by the Chinese economy.[46]

Overall, therefore, a recovering international scenario is emerging, but with still significant elements of uncertainty, which will characterize the global economic landscape in the short to medium term.

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[42] Investment in Real Estate Development for Jan-Jul 2024, https://www.stats.gov.cn/english/PressRelease/202408/t20240822 _1956035.html.
[43] Investment in Fixed Assets from January to July 2024. For more information, https://www.stats.gov.cn/english/PressRelease/202408/t20240822 _1956036.html.
[44] Total Retail Sales of Consumer Goods in July 2024. For more information,

https://www.stats.gov.cn/english/PressRelease/202408/t20240822 _1956034.html.
[45] For more information, http://english.customs.gov.cn/statics/report/preliminary.html. The annual growth of exports stands at 7.0% when considering exports expressed in US dollars, while that of imports stands at 7.2%.
[46] ECB Economic Bulletin Issue 5, July 2024.

The European Framework

The Eurozone framework and economic indicators

In the second quarter of 2024 the Eurozone recorded a quarter-on-quarter growth of 0.3%, after a quarter of similar growth (0.3% growth in the first quarter of 2024) and one of substantial stagnation (0.0% in the fourth quarter of 2023). The slight acceleration in the second 2024 is mainly due to a positive performance of Spain, which continues to show sustained economic growth (0.8% in the first and second quarter of 2024), and more modest growth for France (0.2%) and Italy (0.2%). By contrast, the picture is different for Germany, which shows a contraction of 0.1% in the second quarter of 2024.

Turning from a quarter-on-quarter perspective to a year-on-year perspective, Spain and France emerged as the two most dynamic countries (2.9% and 1.0% growth respectively), followed by Italy (0.9%). In contrast, German economic activity remained stable after three quarters of contraction (-0.1% in the second quarter of 2024, after negative trend growth of 0.3% and 0.2% in the first quarter of 2024 and fourth quarter of 2023, respectively). Overall, the Eurozone shows a year-on-year growth of 0,2% in the second quarter of 2024.

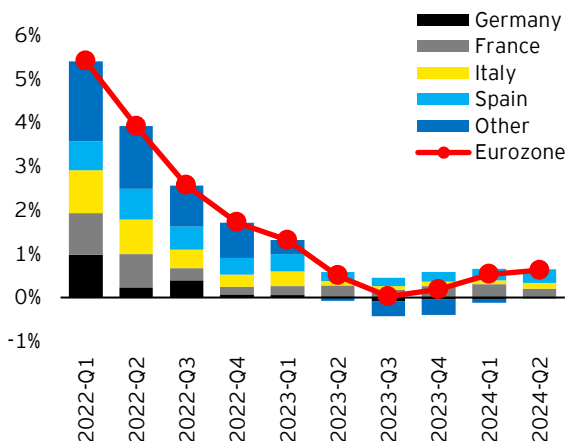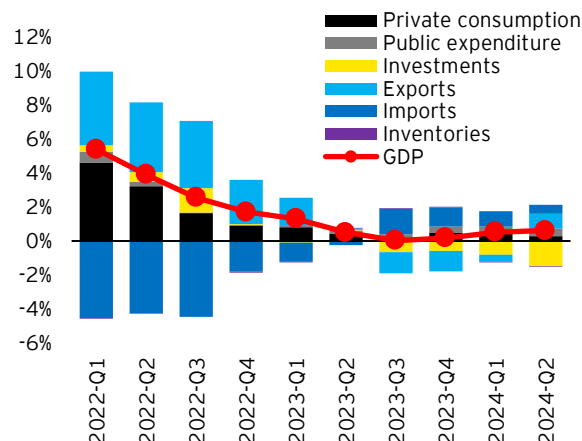*Figure 15: GDP and contributions by countries, Eurozone - % change YoY*

Figure 16: GDP and contributions by components, Eurozone - % change YoY

Source: EY elaborations on Eurostat data.

The industrial sector in the Eurozone continued to show signs of weakness. In June, the industrial production index slightly reduced (-0.1%) compared to the previous month, after a contraction of 0.9% in May and -0.1% in April. With reference to the main economies, Germany recorded a rebound in growth with a 1.6% growth, after a contraction of 3.1%; the growth rates of the other Eurozone economies were more modest, with France, Italy and Spain recording growth of 0.7%, 0.5% and 0.4% respectively in June 2024. The Eurozone's overall negative figure is consistent with the positive values just described when considering the performance of some other member countries. Specifically, Ireland recorded a cyclical contraction (compared to the previous month) of 7.8%. This sharp decline and, in general, the volatility of the Irish industrial production indicator, is basically explained by the central role that Ireland plays for many multinationals. This, however, translates into strong volatility in industrial production numbers, as fluctuations in international activity result in strong fluctuations in Irish industrial production.
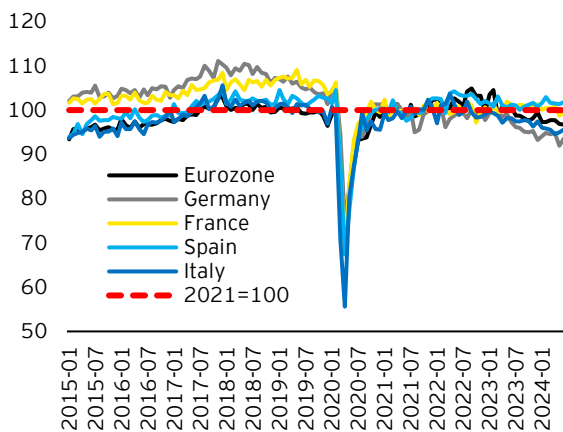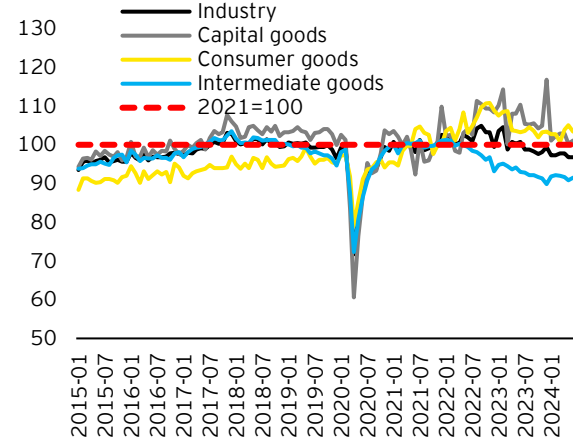
Source: EY elaborations on Eurostat data. For industrial production, reference is made to NACE Rev. 2 B-D codes (*Mining* and
quarrying; manufacturing; electricity, gas, steam and air conditioning supply). Last observation: June 2024.

Analysing the main macro-categories of industrial goods, the production of intermediate goods represents the most critical category, confirming in these months the negative trend in place since 2022. June 2024 represents, in fact, the 28th consecutive month of year-on-year contraction. From a cyclical point of view (month-on-month), on the other hand, June recorded a growth of 0.7%, after three months of contraction (-0.2%, -0.3% and -0.9% in March, April and May respectively).

The weakness of the Eurozone economy is also reflected in the development of retail turnover. While the development of the turnover index in nominal terms shows a positive trend, albeit decelerating in recent months, it is important to consider this data together with the deflated index, i.e., adjusted for price increases, thus expressing the development of turnover in real terms. In this case, the overall turnover is following a downward trajectory, representing a slowing economy. The overall performance of the Eurozone is dictated by the non-positive performance of two of the largest economies of the Monetary Union, namely Germany and Italy. In the opposite side are Spain, which shows an increase in the index, and France, where despite a broadly stable performance in recent years, the index remains above the level recorded in the pre-pandemic period (2019).

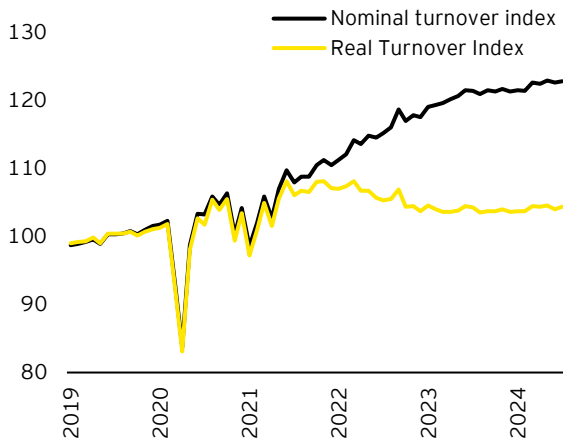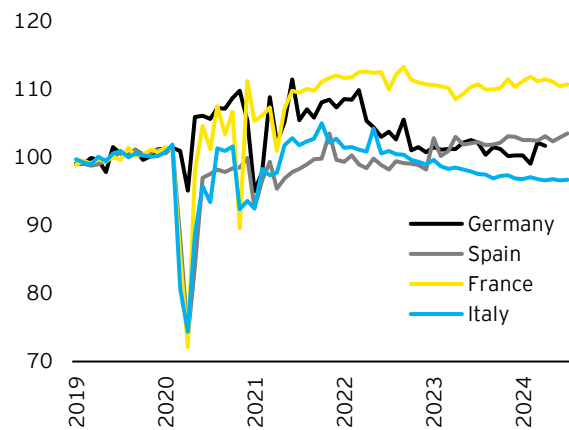Figure 19: Retail trade turnover, Eurozone - index, 2019=100

Figure 20: Real turnover in retail trade - index, 2019=100

Source: EY elaborations on Eurostat data. The graph refers to retail trade excluding vehicle and fuel trade (code: G47_X_G473). Last observation: July 2024.

The analysis of the PMI indicator[47] for manufacturing and services shows some interesting and timely details of developments in the main sectors of the economy. The latest findings of the manufacturing PMI show an overall less than optimistic climate, but with mixed signals from the main economies. Spain is the only one of the four major Eurozone countries in which the manufacturing PMI index recorded values above the expansion level (defined by a value of 50) although declining in recent months. Italy, on the other hand, showed values below the expansion line, but improving compared to previous surveys. In contrast, the situation in France and Germany appears more complex, where the overall perception is negative.

Better expectations are recorded in the service sector, where the four major Eurozone countries are above the expansion line.

Figure 21: Purchasing Managers Index (PMI), manufacturing
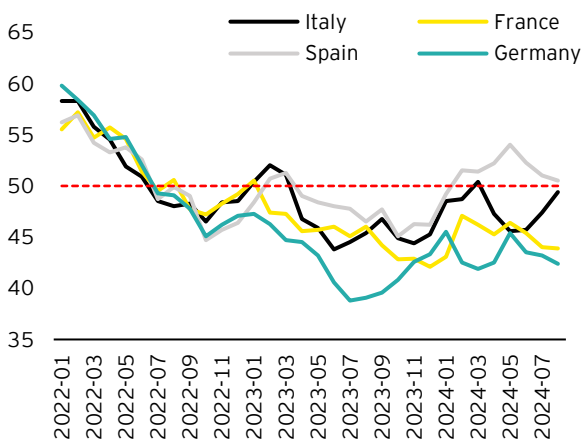
Figure 22: Purchasing Managers Index (PMI), services
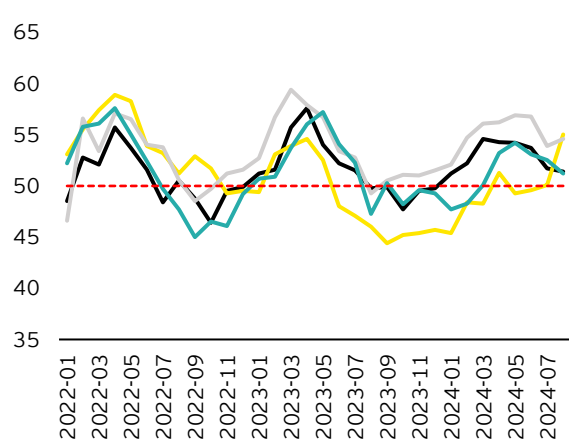
Source: EY elaborations based on S&P Global data. Last observation: August 2024.

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[47] 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 an upward trend in economic activity, values below 50 a downward trend.

Monetary policy and prices in the Eurozone

With the meeting of 12 September 2024, the European Central Bank marks the second cut in the monetary policy interest rates,[48] after the one in June 2024.[49] The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and on deposits with the central bank[50] thus stand at 3.65%, 3.90% and 3.50% respectively. The spread between the interest rate on the main refinancing operations and the interest rate on the marginal lending facility thus remains at 25 basis points, while the spread between the interest rate on the main refinancing operations and the interest rate on deposits with the central bank decreases from 25 to 15 basis points.

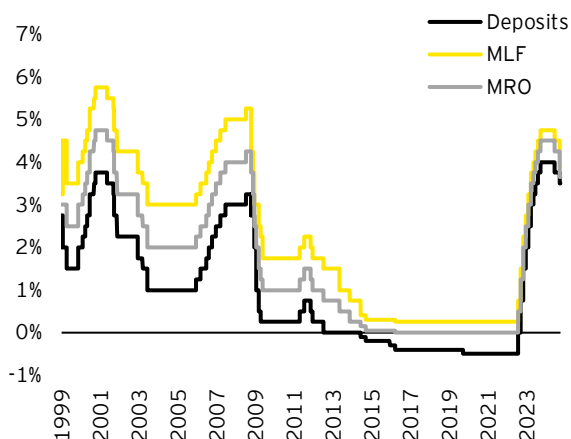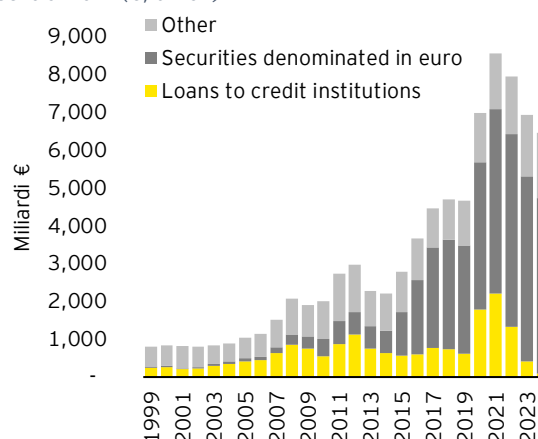*Figure 23: Monetary policy interest rates, European Central Bank*

Figure 24: 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 Eurozone 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 Eurozone 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 Eurozone residents and non- Eurozone residents. The last observation for 2024 refers to the *weekly financial statement* of 6 September 2024.

As already announced in previous meetings, the ECB is flanking an increase in key interest rates with a reduction in *assets* on its balance sheet. With regard to the APP,[51] the size of the portfolio is decreasing at a measured and predictable pace, with the Eurosystem no longer reinvesting principal payments on maturing securities. With reference to the PEPP,[52] the Governing Council intends to continue reinvesting principal payments 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 EUR 7.5 billion per month (currently the cumulative value of purchases under the PEPP program amounts to around EUR 1.7 trillion),

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[48] ECB, Monetary policy decisions, 12 September 2024. For more information, https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240912~67cb23badb.en.html.
[49] ECB, Monetary policy decisions, 6 June 2024. For more information, https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240606~2148ecdb3c.en.html.
[50] 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 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.
[51] 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.
[52] 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.

discontinuing reinvestments at the end of 2024. A reduction of this magnitude and pace translates into a reduction of reinvestments of around EUR 45 billion in the second half of the year.

Monetary policy developments in the Eurozone show similarities and differences to those of other major central banks (such as the Federal Reserve and the Bank of England), mainly due to the underlying factors of inflation dynamics and the process of inflation retraction experienced in recent months and quarters.[53]

Figure 25: Inflation and monetary policy rates - Eurozone, United States and United Kingdom
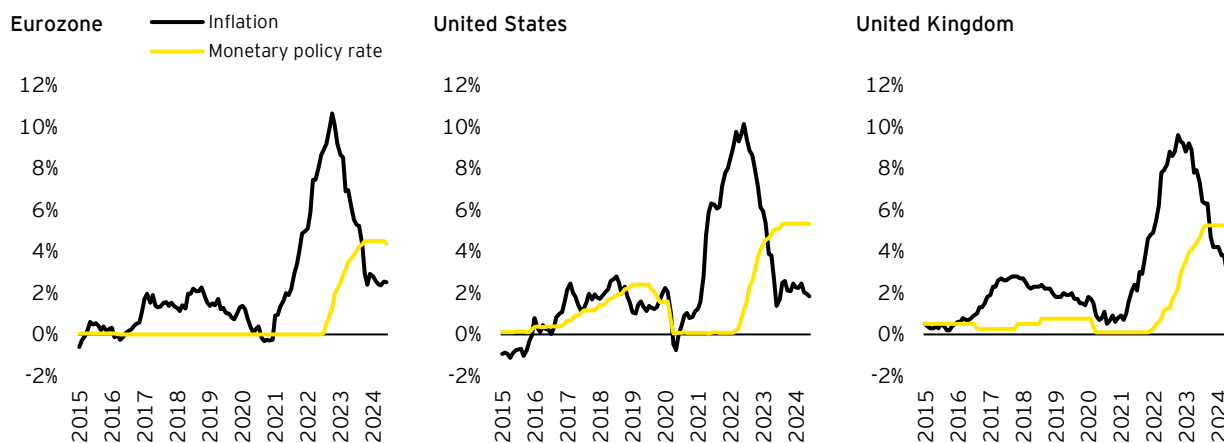
Source: EY elaborations on data from Eurostat, Office of National Statistics, Federal Reserve Bank of New York, European Central Bank, Banck of England. Inflation is calculated on harmonized interest rates. Monetary policy rates are shown as monthly averages. For the Eurozone, reference is made to the marginal lending rate of the European Central Bank; for the US, reference is made to the Effective Federal Fund Rate of the Federal Reserve; for the UK, reference is made to the Official Bank Rate of the Bank of England. Last observation: June 2024.

In this regard, it should be noted how, for example, the European Central Bank began its monetary easing a few months earlier than the Federal Reserve and the bank of England (BoE), which is due both to a different trend in inflation rates (higher in the United Kingdom, for example, than in the Eurozone, and with a different reduction profile), and to a different trend in the economies themselves. With regard to the latter, it should be noted that the US has continued to record significant GDP growth rates (2.5% in 2023) despite high interest rates, which is the opposite of the Eurozone (0.5% in 2023) and the UK (0.1% in 2023).

Despite the latest choices of the European Central Bank, interest rates remain high. Among the various channels through which monetary policy reverberates in the real economy, it is interesting to focus on the bank lending channel. In this regard, the information provided by the latest edition of the Eurozone Bank Lending Survey[54] offers important insights.[55]

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[53] de Soyres, F., Lofstrom, G., Lott, M., Machol, C., & Saijid, Z. (2024). Disinflation Progress: A Comparison of Advanced Economies. FEDs Notes, August 02, 2024.
[54] The Bank Lending Survey (BLS) has been conducted since January 2003 by the national central banks of the countries that have adopted the single currency in cooperation with the European Central Bank. It is addressed to the credit policy makers of the major banks in the area (about 150). The survey provides a separate insight into the factors influencing the supply of credit and the terms and conditions applied to customers, on the one hand, and the development of credit demand and its determinants, on the other.
[55] The euro area bank lending survey - Second quarter of 2024.

Figure 26: Bank lending conditions for businesses, Eurozone - net percentage of respondents
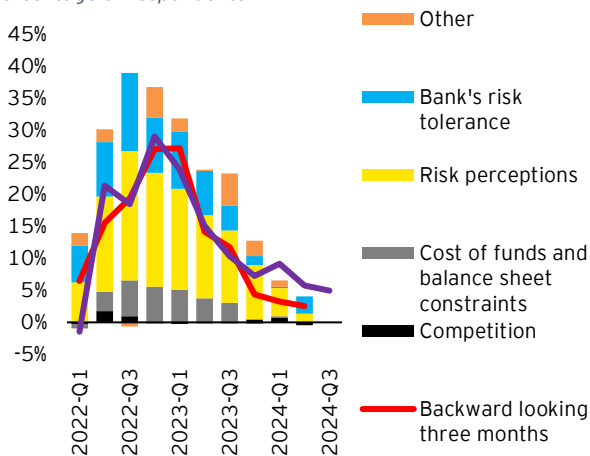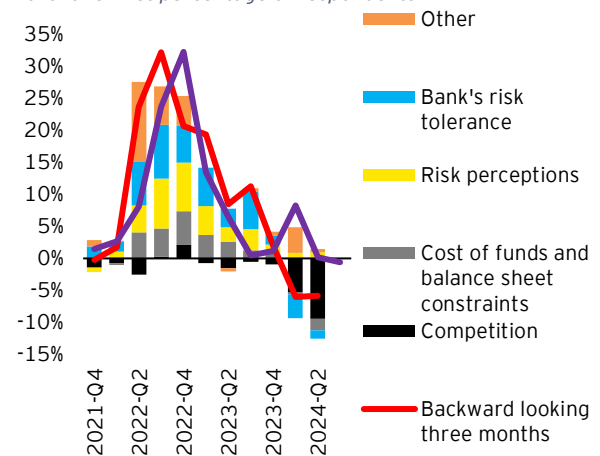

Figure 27: Bank lending conditions for households, Eurozone - net percentage of respondents

Source: EY elaborations based on European Central Bank data (Bank Lending Survey). For households, this refers to the supply conditions for home loans. Net percentages are defined as the difference between the sum of the percentages of banks responding "significantly tightened" and "slightly tightened" and the sum of the percentages of banks responding 'slightly loosened' and "significantly loosened" in reference to the change in credit conditions. Net percentages for responses to questions on contributing factors are defined as the difference between the percentage of banks reporting that a particular factor contributed to tightening and the percentage of banks reporting that it contributed to loosening.

With regard to the supply of bank credit to businesses, banks in the Eurozone reported a further tightening of conditions in the second quarter of 2024 (net percentage of banks around 3%), although not particularly pronounced. This was mainly reported in France and Germany, while Italian banks reported a loosening of conditions. The aggregate figure was largely unchanged compared to the previous quarter, but lower than in the past two years.

Banks' risk tolerance was the main factor behind the tightening, while the risk perception factor was less pronounced, especially when compared to previous quarters. The cost of funding and banks' balance sheet constraints, as well as competition, had essentially no impact, similar to previous quarters.

For what concerned the loans to households and, specifically, loans for house purchases, banks in the Eurozone reported a further moderate loosening of supply conditions (net percentage of banks reporting tightening around -6%). This quarter marks the second quarter of moderate net easing after several quarters of tightening that coincided with the monetary policy tightening cycle. It should also be noted that this net easing had not been expected in the previous quarter, during which banks had expected credit standards to remain essentially unchanged. This phenomenon was largely driven by developments in France (net rate of -33%), to which the developments in Italy (-9%) also contributed, albeit to a lesser extent. In contrast, German and Spanish banks experienced a moderate tightening of lending conditions.

Competition was the main factor behind the loosening of credit standards for home loans in the Eurozone. Again, it was mainly French banks and, to a lesser extent, Italian banks, that cited competition as a key factor, particularly that of other banks (rather than non-banks). The perception of risk had a slight impact of tightening supply conditions, while the impact of the cost of funds, balance sheet constraints and banks' risk tolerance had essentially no effect.

For the third quarter of 2024, Eurozone banks expect conditions for bank lending to households for home purchases to remain broadly unchanged. It should be noted, however, that among the four largest economies, expectations for the next quarter remain mixed, with Spanish and Italian banks anticipating a loosening of supply conditions, German banks anticipating a tightening and French banks showing expectations in line with what was recorded this quarter.

Still with regard to loans, it is also noteworthy that credit risk has gradually increased in recent quarters, although it has not reached the deterioration levels suggested by leading measures of bank credit risk based on historical regularities in the face of a weak economic outlook for the Eurozone, higher interest rates and

an increasing number of bank failures. Part of this containment of credit risk on bank balance sheets can be attributed to the fact that, since the start of the monetary tightening cycle, banks have actively reallocated their portfolios to safer assets, thereby reducing potential balance sheet risks.[56]

The high interest rates also pose major challenges in terms of the sustainability of public debt, which, although in relation to GDP is falling, remains above the levels experienced before the pandemic.

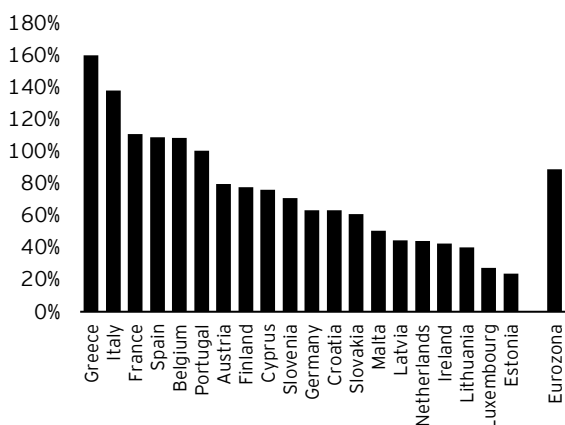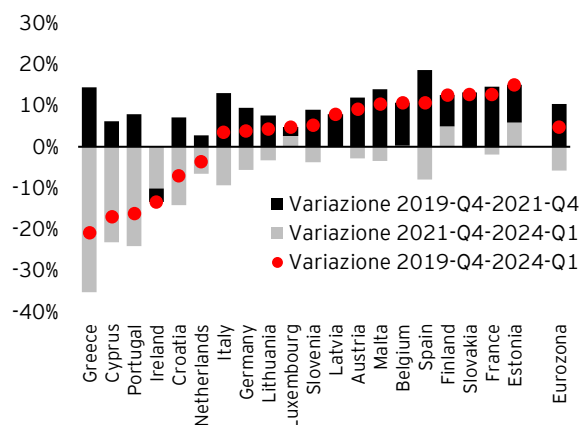*Figure 28: Public debt-to-GDP ratio, 2024-Q1 - % GDP*

Figure 29: Changes in public debt-to-GDP ratio, 2019-Q4-2024-Q1

Source: EY elaborations on European Central Bank data.

High interest rates, however, are not the only complexity for the sustainability of public debt: there are additional challenges related to economic growth, of a more structural and long-term nature, which are expected to have significant implications for the evolution of public debt-to-GDP ratio. Specifically, the main challenges are demographic trends, the so-called "peace dividend", digitalization and climate change.[57]

With respect to demographic trends, the increase in the number of senior citizens relative to the working-age population means that pay-as-you-go pension systems will face increasing financial pressures. Moreover, an ageing population generally requires more extensive health services and long-term care. Developments in age-related public spending are expected to vary across Eurozone countries.[58]

Figure 30: Age-related expenditure and projections, Eurozone - % GDP
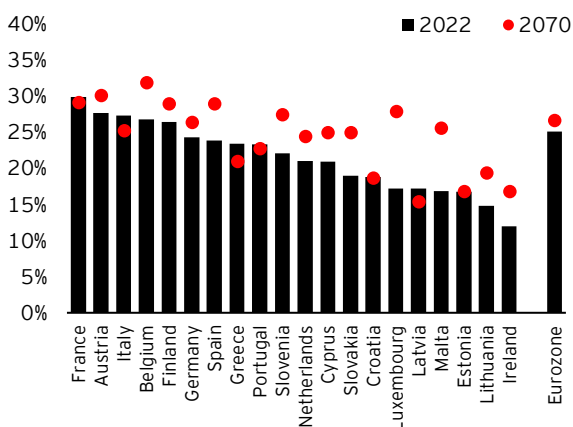
Figure 31: Change in age-related public expenditure (2022-2070), Eurozone - % GDP
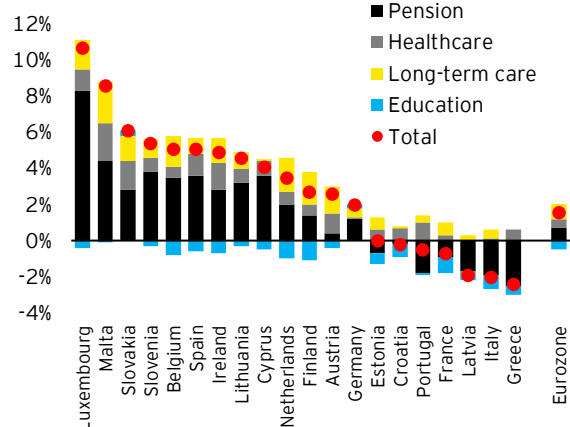
Source: EY elaborations on data from the European Commission (2024 Ageing Report: Economic & Budgetary Projections for the EU Member States (2022-2070)).

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[56] Barbiero, F., & Dimou, M. (2024). Credit risk and bank lending conditions. Economic Bulletin Boxes, 4.
[57] Moshammer, E. (2024). Longer-term challenges for fiscal policy in the euro area. Economic Bulletin Articles, 4.
[58] European Commission, '2024 Ageing Report: Economic & Budgetary Projections for the EU Member States (2022-2070)', European Economy - Institutional Papers, No 279, April 2024.

In aggregate, demographic-related public expenditure is expected to increase by about 1.6 percentage points as a percentage of GDP by 2070, driven mainly by an increase in spending on pensions (0.7 percentage points), healthcare (0.5 percentage points) and long-term care (0.8 percentage points), while spending on education is expected to contribute negatively (-0.5 percentage points). Luxembourg, Malta, Slovakia and Slovenia are the countries in which spending on demographic trends is expected to grow the most in relation to GDP, although it is important to emphasize that these countries are characterized by spending in line with or below the Eurozone average.

Turning to the second element, the "peace dividend", this term refers to the new military expenditure incurred and to be put in place by the Eurozone NATO countries to cope with recent geopolitical dynamics and potential future risks. This phenomenon represents a significant turnaround from the past: with the waning of the Cold War, all major economies have reduced their defense spending (e.g. the US and the UK have more than halved their spending, reducing it from over 10% of GDP in the 1950s to less than 5% in the 1990s; Germany and France, in turn, have reduced spending from over 4% of GDP to less than 2% today). The "peace dividend" has therefore allowed governments to redirect their resources towards other priorities such as increasing social spending. [59]

After Russia's annexation of Crimea in 2014, all NATO members agreed to spend at least 2% of GDP on defense. Since then - and especially after Russia's large-scale invasion of Ukraine - most Eurozone countries have further increased their defense spending. If all Eurozone countries (including those that are not NATO members) increased their defense spending to 2% of GDP, this would result in an estimated additional expenditure of EUR 71 billion per year, or 0.5% of Eurozone GDP.[60] Finally, it should be noted that additional defense spending could potentially increase GDP growth, with positive implications for long-term public debt sustainability, if (i) it were concentrated in R&D-intensive investments and (ii) resources were not diverted away from other productive investments.

The third factor that represents a potential challenge for public finances in the long term is the increasing investments in digitization. These investments are in fact strategic investments to maintain competitiveness in the medium to long term. Prior to the Recovery and Resilience Facility (RRF) in 2021, the European Commission estimated the EU's digital investment gap compared to the US and China at around EUR 125 billion per year (around 0.9% of EU GDP).[61] Again, in a similar way to what has been described above, a proper allocation of resources could result in higher economic growth, leading to higher tax revenues.

In addition to the factors just listed, there is a fourth factor, namely climate change. Extreme weather events, which may become increasingly frequent due to climate change, pose immediate and tangible risks in human and economic terms: the latter, in particular, have increased dramatically in recent decades, placing a considerable financial burden on the various economies concerned.[62] In addition to the economic damage directly inflicted by extreme weather events, the cost of the transition to a development model with lower greenhouse gas emissions must also be taken into account. Indeed, the current and future measures (such as investments in renewable energy infrastructure, energy efficiency improvements and other emission reduction strategies) require substantial resources, as well as long-term planning.

In this regard, it is interesting to note that, in the October 2023 Fiscal Monitor, the International Monetary Fund estimated an increase in public debt in advanced economies, by 2050, in a range between 10 and 15% of GDP (equivalent to an increase in primary deficits of 0.4 percentage points of GDP per year on average, on average, until 2050) due to the implementation of policies to promote innovation and the diffusion of low greenhouse gas emission technologies, as well as possible fiscal transfers to the most vulnerable households and communities to reduce the possible effects of higher energy prices.[63]

[59] Rodríguez-Vives, M., & Kezbere, L. (2019). Social spending, a euro area cross-country comparison. Economic Bulletin Articles, 5.
[60] Freier, M., Ioannou, D. and Vergara Caffarelli, F., 'The EU's Open Strategic Autonomy from a Central Banking Perspective. Challenges to the Monetary Policy Landscape from a Changing Geopolitical Environment', Box 16, Occasional Paper Series, No 311, ECB, March 2023.
[61] European Commission, "Identifying Europe's recovery needs" (SWD/2020/98 final), 27 May 2020.
[62] World Meteorological Organisation, 'Atlas of Mortality and Economic Losses from Weather, Climate and Water-related Hazards (1970-2021)', 22 May 2023
[63] IMF Fiscal Monitor, 'Climate Crossroads: Fiscal Policies in a Warming World', October 2023.

While the restrictive monetary policy of recent years adds a greater complexity to the sustainability of the public finances of the Eurozone states, to which more structural challenges are added, at the same time a timely and decisive effort to reduce inflation has been an important element in ensuring its relatively quick return.[64]

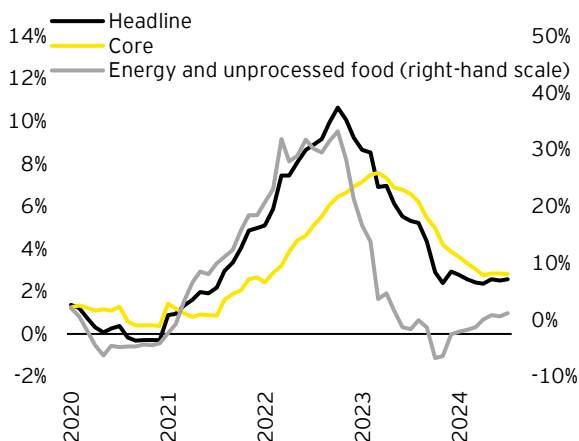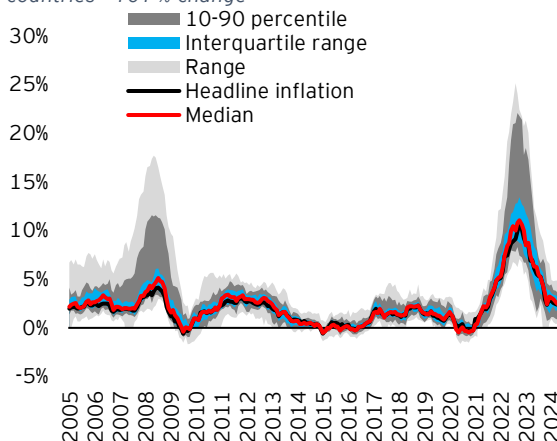Figure 32: Inflation rate, Eurozone - YoY % change

Figure 33: Inflation rates in the different Eurozone countries - YoY % change

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 harmonized rates. Last observation: July 2024.

In July 2024, headline inflation (inflation that takes into account all the goods in the basket used to monitor price trends) stood at 2.6% in the Eurozone, broadly in line with what was experienced in the first part of the year (average between January and June 2024 of 2.5%), while core inflation (i.e., the underlying component)[65] continued to show slightly higher values (2.8% in July, with a January-June average of 3.1%). 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 rate higher than the headline inflation rate indicates a higher rate of change in the core component than in energy and fresh food.

While the data just described refer to the Eurozone as a whole, it should be considered that the individual member countries of the Monetary Union experienced a certain heterogeneity of inflation dynamics. Energy and food prices played an important role in the dispersion of inflation rates: although the shocks experienced in the Eurozone countries were common (the pandemic and the war in Ukraine), the different exposure to these shocks had different effects on the development of the consumer price index. A greater weight of the energy and food component within the index basket led, for example, to a greater impact of these shocks on the price level. However, the most recent data show that the heterogeneity experienced before the pandemic is now returning to levels more in line with historical values.[66]

When talking about inflation, it is interesting to note that the downward trend in recent months has been slower (in the case of headline inflation) or has shown a reversal (in the case of core inflation) in the Eurozone. This is what emerges from the analysis of annualized six-month inflation rates, and it is not a phenomenon that only concern the Eurozone, but also other major advanced economies such as the US and the UK. A more detailed analysis shows that one of the main causes of this phenomenon is to be found in the development of service prices and wage dynamics, although differences persist across advanced economies.[67]

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[64] Romer, C. D., & Romer, D. H. (2024). Lessons from history for successful disinflation (No. w32666). National Bureau of Economic Research.
[65] Reference is made to ISTAT's definition of core inflation, which considers the consumer price index net of changes in energy goods and fresh foodstuffs.
[66] Allayioti, A., & Beschin, A. (2024). The dynamics of inflation differentials in the euro area. *Economic Bulletin Boxes*, 5.
[67] de Soyres, F., Lofstrom, G., Lott, M., Machol, C., & Saijid, Z. (2024). Disinflation Progress: A Comparison of Advanced Economies. FEDs Notes, August 02, 2024.
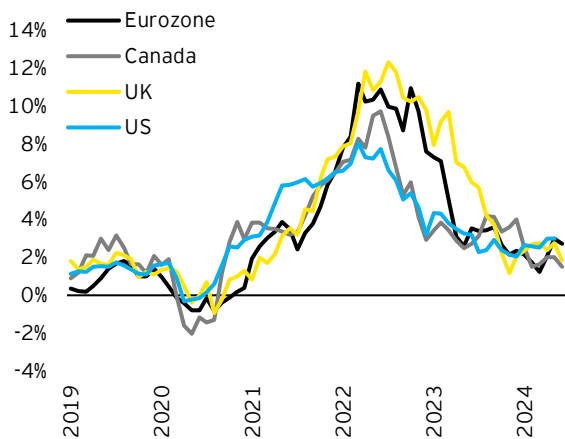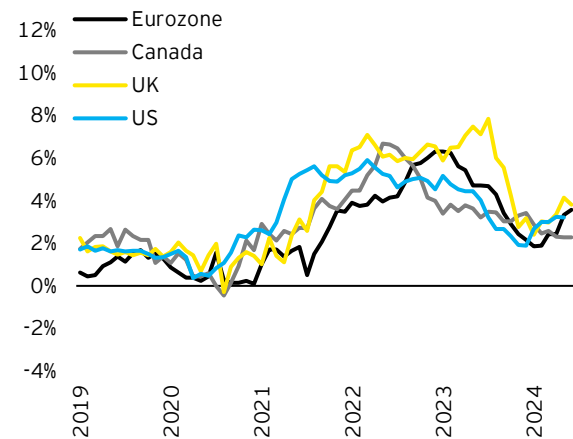
Source: Federal Reserve Bank of New York. Inflation rates were calculated on the Consumer Price Index for the Eurozone, Canada and the United Kingdom, while for the United States the Personal Consumption Expenditures Price Index (PCE) was used - for more information, https://www.bea.gov/data/personal-consumption-expenditures-price-index. Last observation: June 2024.

This trend can be partly explained by the labor market developments. Analyzing the latest data available, in fact, it can be seen that compared to the pre-pandemic period (average values as of 2019), real wages per hour worked recorded in the first quarter of 2024 an increase of 1.7%, mainly supported by a positive dynamic in the services sector (2.4%), in contrast to what was recorded in industry (-0.6%).

Figure 36: Real wages by main branches of activity, Eurozone - % change 2019-2024-Q1
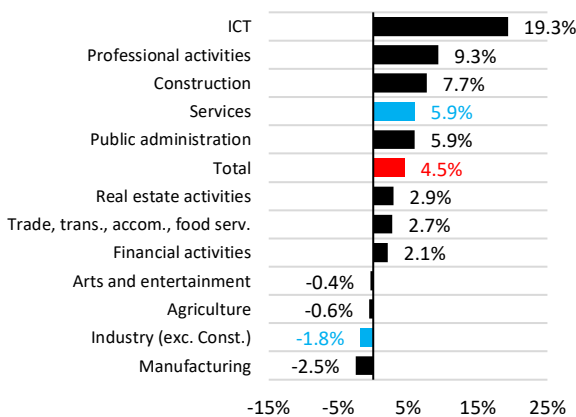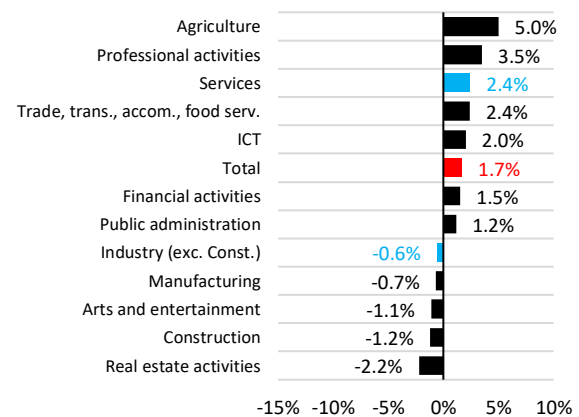

Figure 37: Real hourly wage by main industry, Eurozone - % change 2019-2024-Q1

Source: EY elaborations on Eurostat data.

Wages are also expected to continue to show positive growth in 2024 and 2025, albeit at a slower pace than previously experienced. While wage growth is thus expected to be one of the main factors behind the inflation dynamics in 2024, the lower contribution of profits to the rise in the price level could result in a more restrained inflation dynamic. In particular, by reducing demand and containing inflation expectations, the European Central Bank's restrictive monetary policy is able to limit the pass-through of corporate costs to consumer prices.[68]

Overall, the economic landscape in the Eurozone remains very complex. On the one hand, economic activity is stagnant, with the industrial sector showing no particular signs of improvement. The restrictive monetary policy has played an important role in reducing the increase in the price level, but the process of

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[68] ECB (2024). 'Monetary policy and the disinflation process', Speech by Philip R. Lane, Member of the Executive Board of the ECB, at the Banking & Payments Federation Ireland (BPFI) National Banking Conference.

inflation recovery seems to be proceeding at a reduced pace in recent months, also due to the positive dynamics of the labor market and wages; at the same time, high interest rates pose challenges regarding the sustainability of public debt in the Eurozone, to which are added challenges of a more structural nature such as demographic dynamics, climate change and the digital transition.

The Italian Economy

Real economy dynamics in Italy

Italian industry continues to face significant challenges, made evident by the trend of the industrial production index in recent months. Specifically, compared to the average values recorded in the pre-pandemic period (average 2019=100), the industrial production index is about 6 percentage points lower (July 2024=94.3); the index is below the pre-pandemic level since the second half of 2022.

The complex situation of the Italian industry is confirmed by the annual trend of the index, which in July 2024 marks its 18th month of negative annual growth (-3.3%, after a contraction of 3.3% and 2.9% in May and June respectively).

Figure 38: Industrial production index (average 2019=100) and % change YoY, Italy
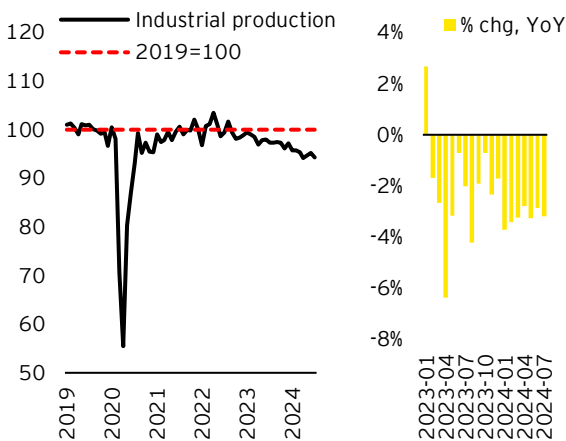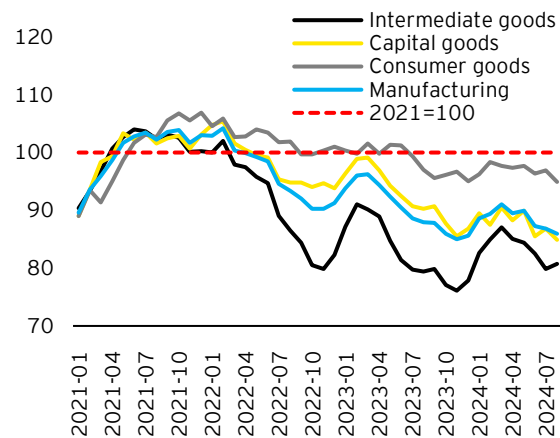

Source: EY elaborations on ISTAT data. Indices refer to seasonally adjusted indices. Last observation: July 2024.

Negative signs also appear in the analysis of the month-on-month growth: in July, the index contracted by 0.9% after a 0.5% growth of June 2024.

The non-positive performance of Italian industry is also confirmed by the downward trend in business confidence, which is also below the average levels experienced during 2019, as shown by the latest results of the manufacturing business confidence survey. [69]

Figure 39: Manufacturing business confidence, Italy - index, 2021=100

Source: EY elaborations on ISTAT data. Intermediate goods: goods used as inputs to a production process; Capital goods: goods used for the production of other goods (machines, means of transport, etc.), intended to be used for a period of more than one year; Consumer goods: goods used without further transformation for the direct satisfaction of individual or collective needs (according to their durability, they are distinguished into consumer durables and consumer non-durables). For more information, https://www.istat.it/storage/IstatData/Coeweb/Glossario.pdf .

Going into details and looking at some of the main components of the industrial production, the level of confidence for manufacturing companies

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[69] The purpose of the survey is to collect qualitative variables such as short-term (3 months) judgments and expectations of the main business variables (such as judgments and expectations on orders, production and liquidity; judgments on stocks of finished goods; expectations on employment and sales prices) and assessments of the general situation of the Italian economy. Quarterly, additional

information is requested on various business aspects of the enterprise (such as production capacity, number of hours worked, new orders, raw material stocks, export volume, production barriers, duration of assured production and degree of capacity utilisation) and on the competitive position of the enterprise. The unit of measurement and analysis is the enterprise.

producing intermediate goods is experiencing a more pronounced decline than for the other components.

This dynamic is potentially linked to the overall weakness of the Eurozone industry and, in particular, of Germany, which represents one of the main markets for Italian intermediate products. A negative performance of German industry therefore translates into a lower demand for intermediate goods, which in turn leads to a slowdown in the Italian sector.

Some of the factors characterizing the Italian economic scenario, i.e., the weakness of industry and high interest rates, translate into greater difficulties in accessing credit for companies operating in the manufacturing sector.

Figure 40: Access to credit for enterprises in the manufacturing sector, Italy – net percentage of respondents
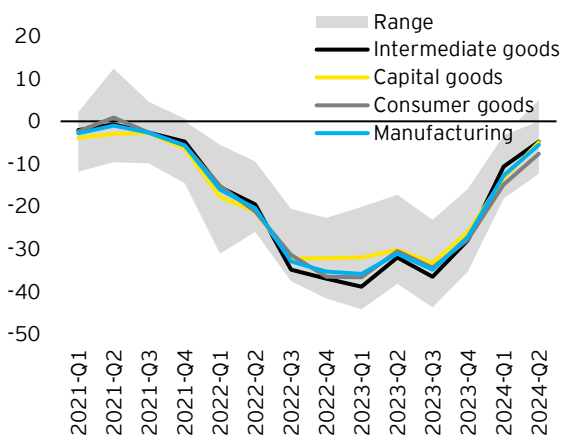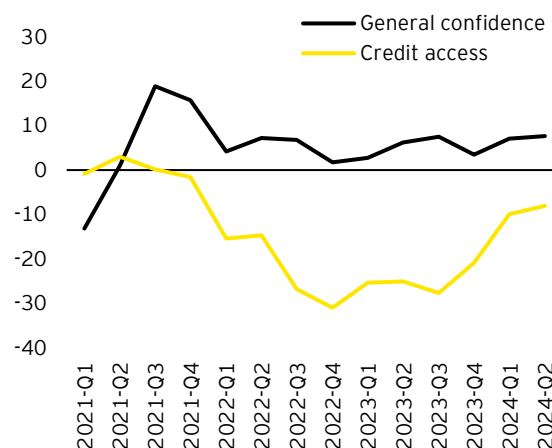

Source: EY elaborations on ISTAT data. The area in grey represents the range within which the values of the different industries are contained. The series shown refer to the net balance of respondents according to the answers given (access to credit more favorable, constant, less favorable, don't know).

Indeed, the latest data show a net percentage of respondents to the survey on manufacturing business confidence (in relation to access to credit) still negative, which translates into more respondents being characterized by less favorable credit access conditions than those characterized by more favorable credit access. It should be noted, however, that the balance has been increasingly less negative in recent quarters.

The less favorable access to credit does not only affect the manufacturing sector, but also the service sector, despite an overall positive trend in economic activity in the sector.

Figure 41: Climate of confidence in the services sector and access to credit, Italy – net percentage of respondents

Source: EY elaborations on ISTAT data.

A similar picture is also suggested by the latest results of the bank credit survey conducted in Italy.

In the second quarter of 2024, in fact, the supply criteria for corporate loans are slightly relaxed. This represents an important change considering what has happened in recent quarters, the second quarter of 2024 being the first loosening since December 2021. Among the main factors contributing to this result are higher risk tolerance and lower funding costs. Expectations for the next quarter are, moreover, for a net percentage of banks loosening lending conditions similar to the second quarter of 2024.[70]

The higher interest rates and tighter credit conditions experienced in recent quarters have led to a reduction in bank loans to companies. In this regard, the annual rate of change in bank loans to non-financial companies resident in Italy was -3.9% in July 2024, marking the 18th month of contraction (since February 2023).

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[70] Bank of Italy, Bank Credit Survey in the Euro Area - Main results for Italian banks, Q2 2024 and outlook for Q3 2024. For more information,

https://www.bancaditalia.it/statistiche/tematiche/moneta-intermediari-finanza/intermediari-finanziari/indagine-credito-bancario/index.html.

*Figure 42: YoY % change in bank loans to non-financial corporations resident in Italy and interest rate on loans, Italy*
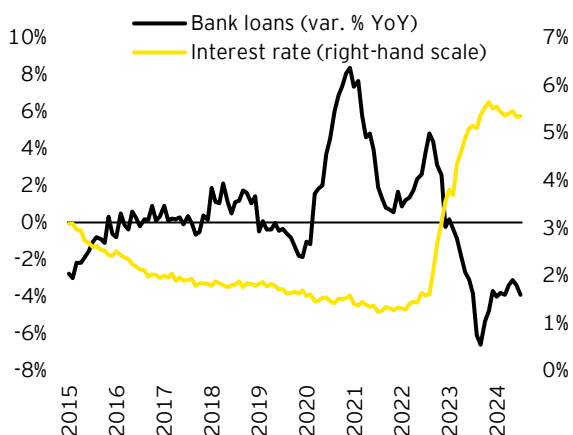
Source: EY elaborations on Bank of Italy data. Bank loans to non-financial corporations resident in Italy are adjusted on the basis of the ESCB methodology. Last observation: July 2024.

However, the decline in bank lending is not only a phenomenon affecting non-financial companies, but also Italian households, for whom June represents the 12th month of contraction (-1.0% after -1.1% and -1.2% in May and April 2024 respectively).

Figure 43: Gross fixed capital formation by type of activity and components, Italy - % change YoY
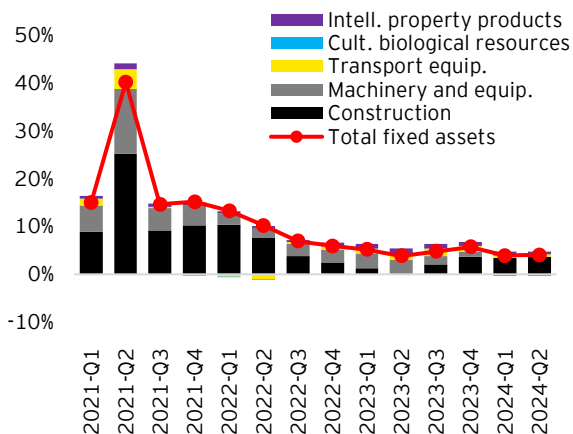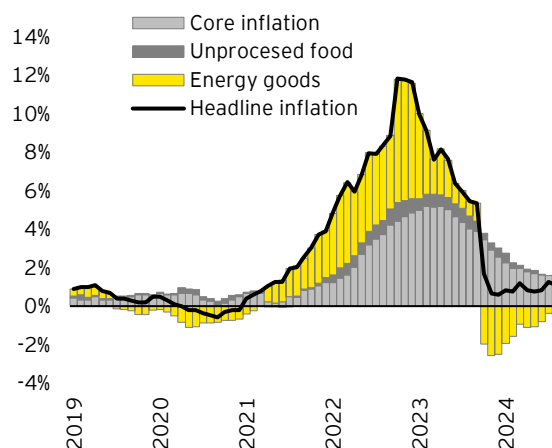

Source: EY elaborations on ISTAT data.

Despite the reduction in lending, investment is maintaining a positive trend. This is mainly the result of growth in investment in construction (which in turn contains both investment in housing and non-residential buildings and other works) and, to a lesser extent, growth in investment in transport equipment and intellectual property products.

Price trends in Italy

The growth of the consumer price index remains subdued, although increasing compared to the first months of 2024. From January to June 2024, in fact, the average inflation rate stood at around 0.9%, while in July 2024 the inflation rate accelerated slightly (1.3%), only to decline again in August (1.1%). In spite of the modest rise in the price level, it is important to emphasize that we are currently at much lower values than those recorded between 2022 and 2023, which are more in line with the European Central Bank's price stability target (2%).

Figure 44: Inflation and components, Italy - % change YoY

Source: EY elaborations on ISTAT data. Last observation: August 2024.

The acceleration of the consumer price index compared to the first months of the year is mainly due to a lower positive contribution from the energy component, a component that has been one of the main inflation-reducing factors in recent months.

The lower negative contribution of the energy component was, in turn, due to an increase in the price index for regulated energy goods (14.0% in August 2024, after growth in June and July of 3.5% and 11.7% respectively), as opposed to a still negative trend in inflation for non-regulated energy goods (-8.6%, after decreasing by 10.3% and 6.0% in June and July respectively).

On the other hand, the contribution of unprocessed food price was virtually zero, while the core inflation component persisted, contributing about 1.7 percentage points to overall inflation.

Going into more detail, core inflation stood at 2.0% in August 2024, a value broadly in line with that experienced in June and July (1.9% in both cases). The essentially stable but slightly declining value was due to a slightly higher level of the services component (3.2% in August, after 3.0% recorded in July) and a concomitant increase in the price level of the processed food component (1.8% in August, after 1.6% recorded in July).

Figure 45: Core and component inflation, Italy - % change YoY

Source: EY elaborations on ISTAT data. Last observation: August 2024.

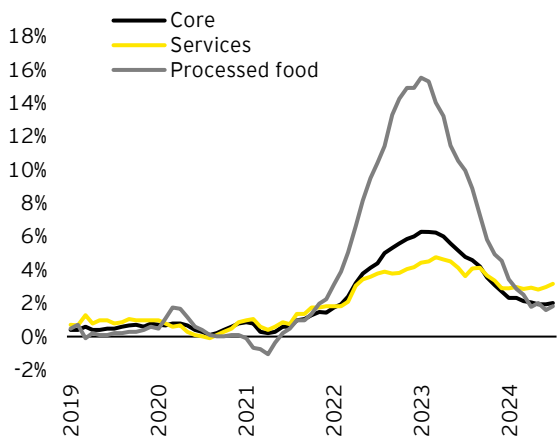The significant role of the food and energy component in inflation trends in recent years is also confirmed by recent studies.[71] Moreover, this phenomenon is not specific to Italy: given the international nature of the pandemic and geopolitical shock associated with Russia's invasion of Ukraine,[72] potential inflation triggers are essentially common to all major Eurozone countries and beyond. The list includes significant increases in energy and food prices, disruptions in supply chains, corporate attempts to increase profit margins, rising short- and long-term inflation expectations, tight labor markets and rigid real wages.

It is also important to emphasize that in Italy, in contrast to what happened in the 1970s, the mechanism that could have triggered a wage-price spiral (an initial supply shock leading to an increase in prices, which in turn propagates

through wages and takes root in inflation expectations) did not materialize. The increases in inflation due to commodity price shocks were indeed substantial, but also relatively short-lived.[73]

Labor market tightness has therefore not translated into strong wage pressures at the moment. This suggests that the cooling of the labor market in Italy and the Eurozone does not seem to be the primary factor in the analysis of inflationary pressures.[74]

Still in relation to the labor market, the latest figures show an employment rate at an all-time high (around 24 million) and an unemployment rate of 6.5%. Moreover, since the beginning of 2022, new employees (around 1.1 million) have been predominantly placed with a permanent contract, which is also a positive in supporting consumption and growth.

Figure 46: Number of employed and unemployment rate, Italy
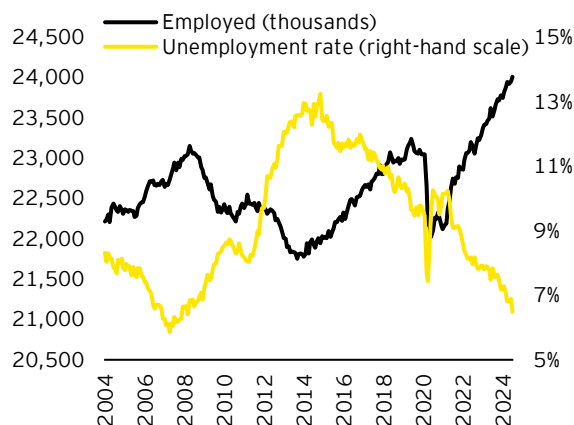
Source: EY elaborations on ISTAT data. Last observation: July 2024.

Regarding household consumption, growth rate in the last few quarters has been progressively decreasing compared to what was recorded in 2021, the year after the pandemic. The low growth rate is mainly due to a reduction in the purchase of services, and a reduction in expenditure on semi-durable and non-durable goods. On the other hand, a positive contribution comes from the consumption of durable goods.

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[71] Pisani, M., Tagliabracci, A. (2023). What Caused the Post-Pandemic Inflation in Italy? An Application of Bernanke and Blanchard (2023). An Application of Bernanke and Blanchard.

[72] Ropele, T., Tagliabracci, A. (2024). 'Perceived economic effects of the war in Ukraine: survey-based evidence from Italian firms', Applied Economics Letters, vol. 31(4), pages 275-280, February.

[73] Corsello, F., Gomellini, M., Pellegrino, D. (2023). 'Inflation and energy price shocks: lessons from the 1970s', Questioni di Economia e Finanza (Occasional Papers) 790, Bank of Italy, Economic Research and International Relations Area.

[74] Lo Bello, S., & Viviano, E. (2024). Some considerations on the Phillips Curve after the pandemic. Bank of Italy Occasional Paper, (842).
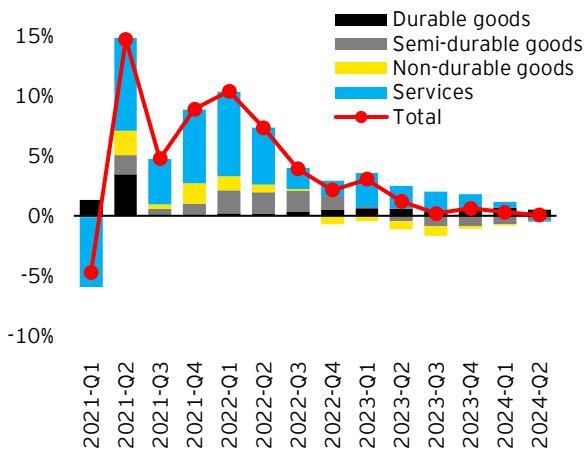
Source: EY elaborations on ISTAT data.

The reduction in household consumption is related to several factors, such as the reduction in purchasing power due to the rise in price levels and the reduction in the amount of forced savings accumulated during the pandemic.

Overall, therefore, the Italian economy remains characterized on the one hand by substantial weakness, due to a context of high interest rates, weak industry and stagnant consumption. On the other hand, the signals coming from the labor market appear encouraging, with the number of employed people at an all-time high; inflation also remains contained, despite a slight acceleration experienced in July.

Focus: economic dynamics of the macro-regions in Italy

Main messages:

1. *A more detailed analysis of the development of the Italian economy shows a certain heterogeneity within the macro-regions (North, Center, South). While the North and the South have, in 2022, exceeded the gross domestic product levels recorded in 2019, the Center is back in line with pre-pandemic values.*
2. *The sectoral structure of the economies of the macro-regions shows important differences. Consider that in the North, industry (excluding construction) accounts for about 23% of added value, while in the South for roughly 12% of value added. The challenges of the industrial sector due to geopolitical dynamics are therefore likely to have an asymmetric impact.*
3. *The labor market proves to be more dynamic in the northern and southern regions, less so in the central regions.*
4. *Labor productivity remains a central issue for the south of Italy. The gap with the rest of Italy remains a structural factor. However, the ability of the south to attract start-ups and innovative SMEs represents an opportunity for future growth.*

The analysis of the performance of the Italian economy hides the heterogeneity of the country's individual macro-regions and regions, which can be analyzed by dwelling on a higher level of detail.

Figure 48: GDP by macro-region, Italy - billion €
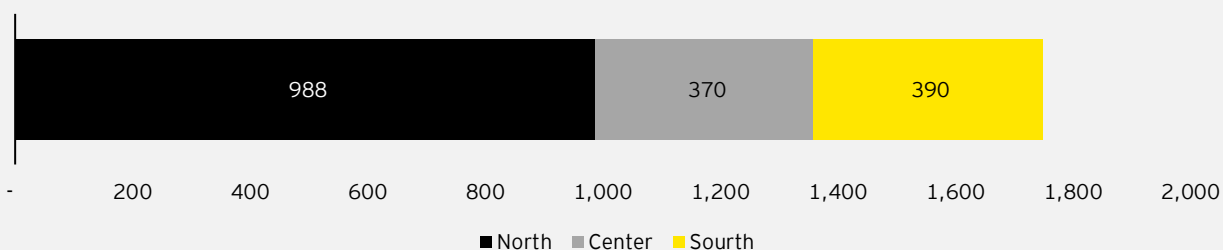
Source: EY elaborations on ISTAT data.

First of all, the economic growth in recent years in the individual macro-regions of Italy has been uneven: considering GDP level in 2019 equal to 100, by 2022 the North and the South had exceeded their pre-pandemic levels (by 3.6% and 2.6% respectively), while the Center had barely recovered what had been lost in previous years (GDP 0.3% higher in 2022 than in 2019). This dynamic is also partly due to the effects that the pandemic had on the macro-regions, effects that were more pronounced in the Center (where a contraction of 9.7 points was recorded), compared to the North and the South (which recorded a drop of 8.4 percentage points and 8 percentage points, respectively).

The growth recorded between 2019 and 2022 was, both nationally and by macro-region, characterized by important sectoral differences. On the one hand, in fact, it is interesting to note that the construction sector is the one that has recorded the highest growth everywhere in the years under analysis, growth ranging from 28% in the South to 21% in the Center (Italy average 25%); on the other hand, industry is weak, especially in the Center and in the South, with a reduction of 1.5% and 2.1% respectively. The services sector, on the other hand, remains more dynamic, with growth in the North and in the South of Italy of 3.3% and 2.1% respectively, accompanied by a contraction in the Center (-0.2%).
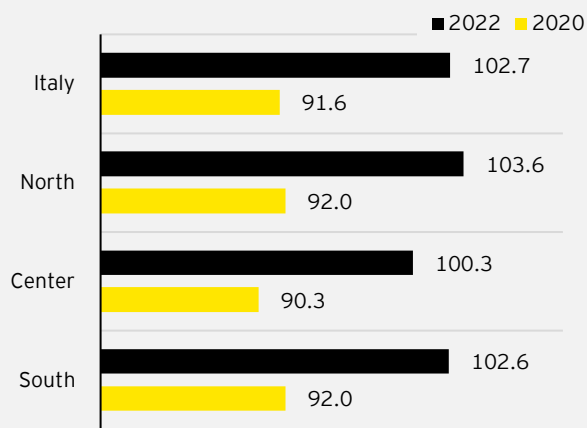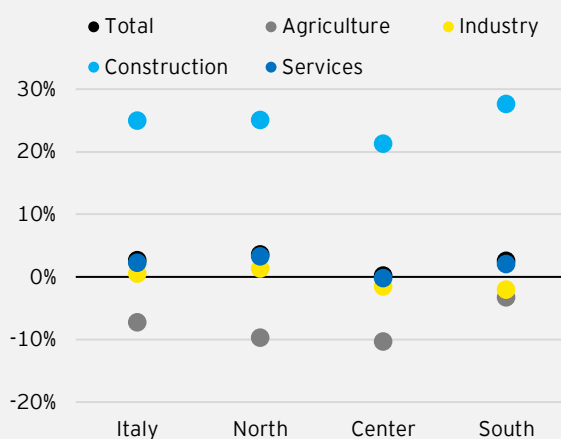
Source: EY elaborations on ISTAT data. Agriculture: Agriculture, forestry and fishing; Industry: Mining and quarrying, manufacturing, electricity, gas, steam and air conditioning supply, water supply, sewerage, waste management and remediation activities, Services: wholesale and retail trade, repair of motor vehicles and motorbikes, transport and storage, accommodation and food services, information and communication services, financial and insurance activities, real estate activities, professional, scientific and technical activities, administration and support services, public administration and defense, compulsory social insurance, education, health and social work, public administration and defense, compulsory social insurance, education, health and social work, arts, entertainment and recreation activities, repair of household goods and other services.

When considering GDP growth at national and macro-regional level, it is important to note that the construction sector accounts for only a small portion of the total economy, while the major part is related to the services sector (between 70% and 78% of the total). The higher share of total GDP related to the services sector in the central and southern regions means that, in the current context of weak manufacturing and better performance of the services sector, this can be a positive factor for economic growth in the short to medium term. The greater presence of industry in the North makes the economy of these regions more exposed to recent external dynamics (such as the weakness of German industry and high energy prices).

Figure 51: GDP composition by macro-region, Italy (2022)
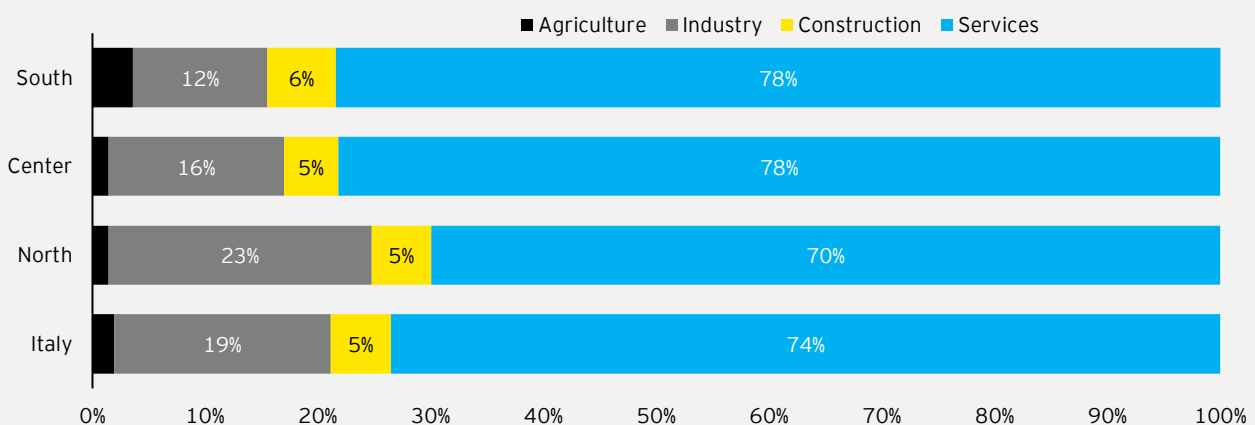
Source: EY elaborations on ISTAT data. For the definition of sectors see preceding note.

A further differentiating factor between Italy's macro-regions in the last quarters is the export performance. After the sharp slowdown experienced in the aftermath of the pandemic, exports recovered to pre-COVID levels between the end of 2020 and the first quarters of 2021, before accelerating again in

2022. This acceleration then slowed down and marked a slight decline in the Northern and Central regions, unlike in the South, where the value of exports continues to perform better. However, it should be considered that the exports of the southern regions account for about 11% of the country's exports, with the North accounting for about 70%.
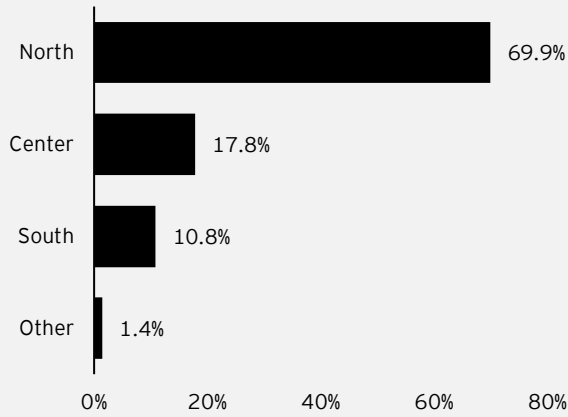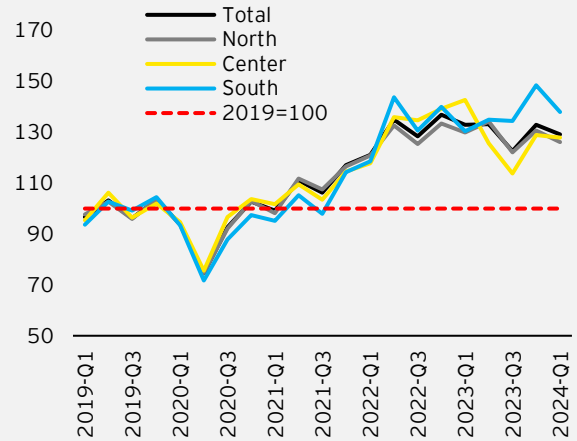
Source: EY elaborations on ISTAT data.

Going down to a greater level of detail, the southern regions experienced a more dynamic growth in the value of exports between 2019 and the first quarter of 2024 than the other regions in the Center and North of the peninsula. Among the regions of Southern Italy, the figure for Campania, the leading region in terms of export value in Southern Italy (approximately €5.38 billion in the first quarter of 2024), appears particularly significant, with a growth of 74% during the period of analysis.
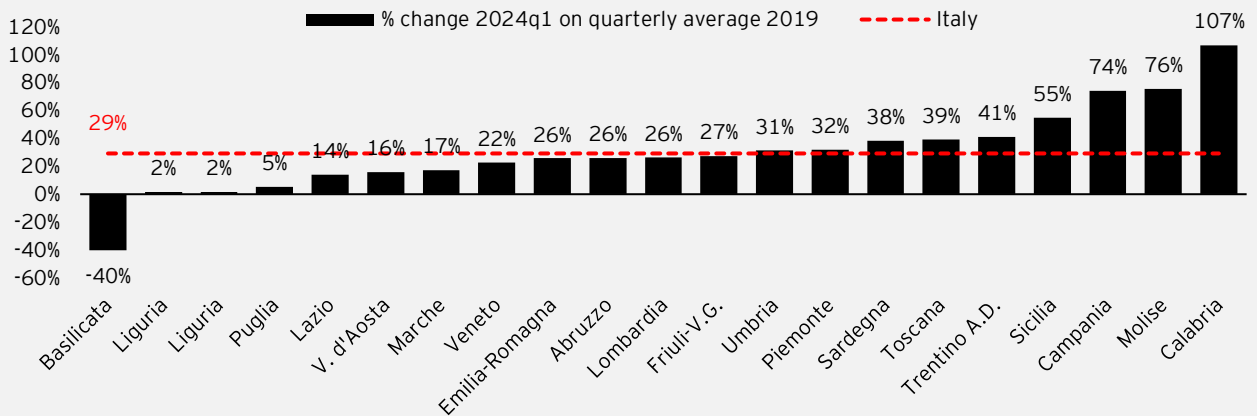
Source: EY elaborations on ISTAT data.

For what concern the labor market, the South shows more dynamic growth than the North and the Center, with about 6% more employed than in 2019 (against roughly 4% in the Center and 2% in the Northern regions). The construction sector was supporting the growth in employment between 2019 and 2022, thanks to the strong expansion recorded by the sector, while manufacturing and services contributed to a contraction in employment during the period considered.
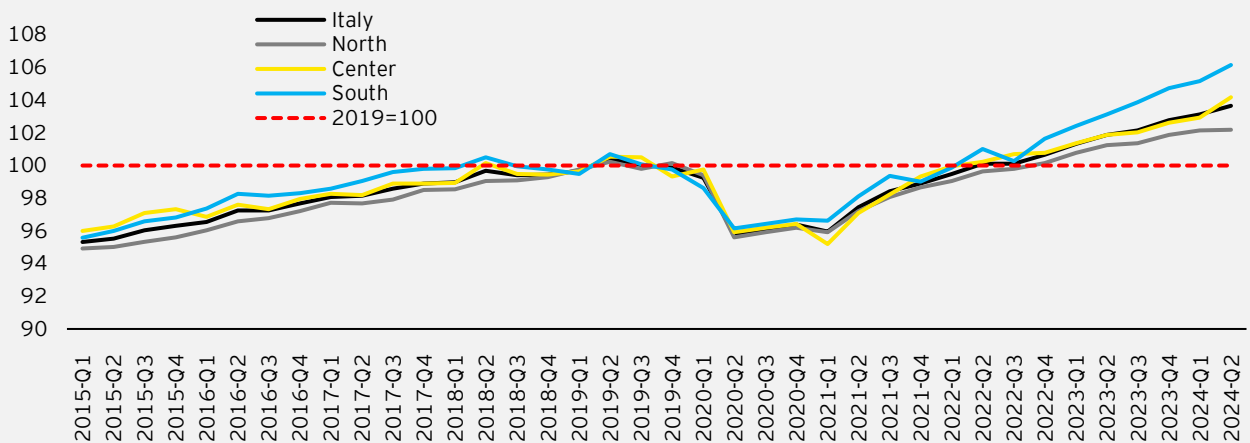
Source: EY elaborations on ISTAT data.

While the regions in the South of Italy show a higher growth in the number of employees than the other regions, it is still important to consider the presence of an unemployment rate that is almost double the Italian average (12.8% in the second quarter of 2024 compared to 6.8%) and much higher than that of the regions of the Center (5.6%) and the North (3.9%). The dynamics, however, remain positive, with the unemployment rate in the South of Italy falling by about 5 percentage points compared to the average for the South of Italy in 2019.

Labor productivity per hour worked remains a crucial factor to the disadvantage of the South, showing values that are substantially lower than the Italian average, with the sole exception of the public administration and defense sector. The gap between the southern regions and the rest of Italy is still a structural gap that is not narrowing.

Figure 56: Productivity per hour worked (€/hour worked)
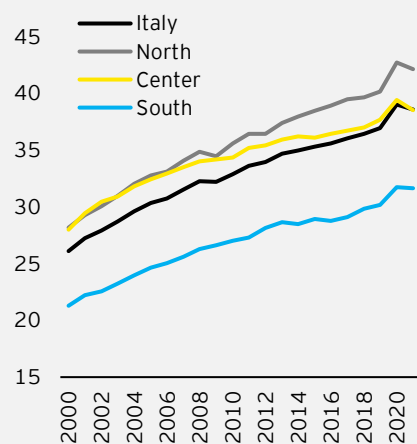
Figure 57: Productivity per hour worked by macro-sectors, Italy - 2021

	Italy	North	Center	South
Veg. and animal products	14.5	17.9	15.5	11.8
Fishing and aquaculture	14.7	15.8	18.8	13.3
Industry	46.3	49.9	43.6	35.2
Construction	27.1	29.6	26.3	23.3
Trade., trans., accom., ICT	32.5	35.9	33.4	25.6
Financial and professional activities	65.5	68.0	64.1	60.6
Public administration and defence	31.3	30.3	31.4	32.7

Source: EY elaborations on ISTAT data.

Despite the gap described, the South is nevertheless able to attract innovative enterprises and host centres of excellence in the Italian economy. In this regard, it should be noted that at the end of 2023, start-ups and innovative SMEs in the South accounted for around 28% (around 4,500 enterprises) of the total number in Italy, compared to 50% in the North (around 8,000 enterprises). While in numerical terms, therefore, the South cannot be considered the leading region in terms of the number of start-ups and

innovative enterprises, when the number of these organizations is compared to the number of employees per macro-region and added value, the regions of the South play a leading role.[75]

Figure 58: Start-ups and innovative SMEs as a percentage of the total territory

Italy	100%
North-west	35%
North-east	17%
Center	21%
South	28%
Lombardia	27%
Lazio	12%
Campania	11%
Emilia-Romagna	7%
Veneto	6%
Piemonte	6%
Sicilia	5%
Puglia	5%
Toscana	5%
Abruzzo	2%
Other	14%
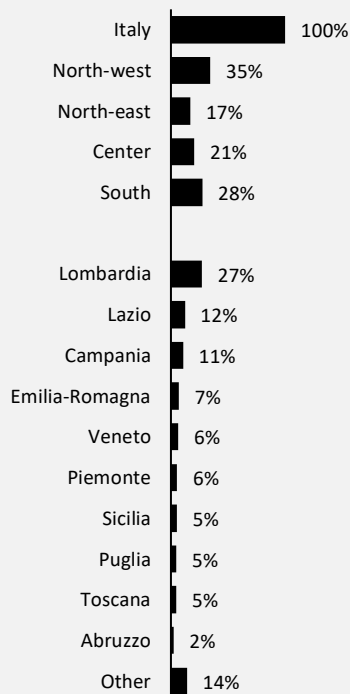
Figure 59: Start-ups and innovative SMEs per 1000 employees in active enterprises (2022)

Italy	0.9
North-west	0.9
North-east	0.6
Center	0.9
South	1.1
Lombardia	1.0
Lazio	1.1
Campania	1.5
Emilia-Romagna	0.7
Veneto	0.6
Piemonte	0.6
Sicilia	1.1
Puglia	0.9
Toscana	0.6
Abruzzo	1.1
Other	-
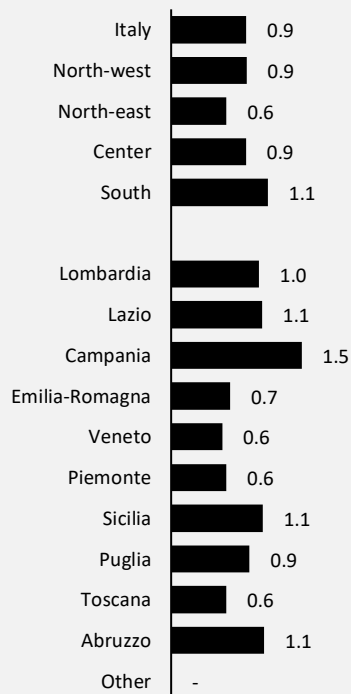
Figure 60: Start-ups and innovative SMEs per billion value added of the region (2022)

Italy	9.1
North-west	9.6
North-east	6.7
Center	8.9
South	11.4
Lombardia	11.1
Lazio	10.3
Campania	15.9
Emilia-Romagna	7.0
Veneto	6.3
Piemonte	6.7
Sicilia	9.5
Puglia	9.5
Toscana	6.2
Abruzzo	11.3
Other	-
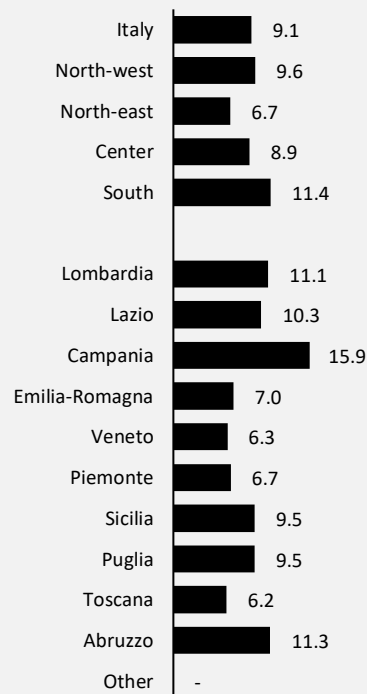
Source: EY elaborations on ISTAT data, iCribis.

The South's ability to attract start-ups and innovative companies is a reflection of an area that hosts districts of excellence throughout the country. Take, for example, Campania, which hosts an important aerospace (DAC - Distretto Aerospaziale della Campania) and pharmaceutical district; Apulia, with poles of excellence in mechatronics and physics; Sicily, with the important ICT and pharmaceutical poles of Catania, Etna Valley for research and innovation, and the various industrial food districts.

In conclusion, therefore, it is possible to state that a more detailed and punctual analysis of the Italian economy makes it possible to identify differences between macro-regions, some of which are better known (lower labor productivity, lower presence of industry) and others less obvious (such as the role of the Mezzogiorno in the panorama of innovative companies or the positive reaction to the pandemic crisis in terms of overall growth and labor market performance).

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[75] For more information, https://www.contenuti.icribis.com/osservatorio/2024/startup-innovative-2023.

The Italian economy: GDP and EY forecasts

The second quarter of 2024 recorded quarter-on-quarter growth of 0.2%, which translated into a year-on-year growth (compared to the same period of the previous year) of 0.9%. The cyclical growth was mainly driven by domestic demand factors: we witnessed a similar magnitude (0.2% growth) in household consumption growth and investments (0.3% growth), while there was a reduction in exports (-1.5%) that was not offset by a reduction in imports (-0.6%).

For what concern private consumption, they experienced a subdued growth. The slowdown is mainly due to still high interest rates, and to a reduction in the 'extra savings' generated during the pandemic period, which had partly supported consumption in previous quarters.

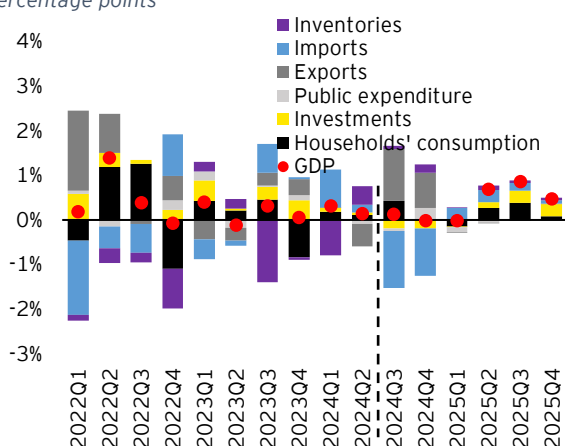*Figure 61: GDP components, Italy - contributions to growth, percentage points*

Figure 62: GDP components, Italy - index, quarterly average 2019 = 100
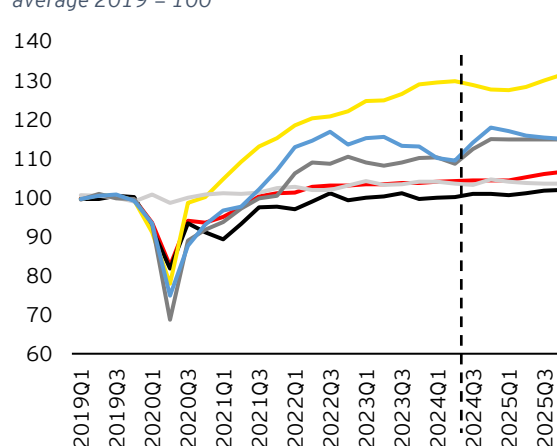
Source: EY elaborations based on Eurostat data and EY forecasts. EY forecasts start from the third quarter of 2024. Investment refers to public and private investment, and includes gross fixed capital formation, acquisitions less disposals of valuables and depreciation.

The dynamics of consumption are also reflected in the imports, which reduced, making a positive contribution to GDP growth. Looking at investments, high interest rates and general uncertainty continue to weigh on their dynamics, which in any case also remain positive. The fading effects of fiscal stimulus in previous years, particularly in the construction sector, contribute to the slowdown.

Based on the information in the previous sections and the latest available data, it is possible to outline EY's outlook for the Italian economy. After the growth recorded in the second quarter of 2024, GDP growth in the third quarter of 2024 is expected to be 0.1%, followed by stagnation in the last quarter of 2024 (0.0%). The current year is thus expected to close with an overall growth of 0.7%, followed by a more dynamic growth in 2025 (1.2%).

It is estimated that the performance in 2024 will be due to a subdued trend in consumption (0.2%) and a slowdown of investments (2.1% in 2024 and 0,3% in 2025), in addition to a significant positive contribution from net exports (about 1.1 percentage points). On the other hand, 2025 will be characterized by an acceleration of consumption (0.9%) and a slowdown of investments (0.3%), mainly due to the increasingly marked reduction of the positive effects of tax incentives (e.g., "Superbonus 110%").

Table 1: Italian economic forecasts

	2020	2021	2022	2023	2024	2025
GDP, % change	-9.0%	8.3%	4.0%	0.9%	0.7%	1.2%
Household consumption, % change	-10.4%	5.5%	4.9%	1.2%	0.2%	0.9%
Investments, % change	-8.0%	20.3%	8.9%	4.9%	2.1%	0.3%
Exports, % change	-14.3%	14.1%	11.0%	0.5%	2.3%	3.0%
Imports, % change	-12.7%	15.6%	13.5%	-0.2%	-1.2%	2.6%
Unemployment rate	9.3%	9.5%	8.1%	7.7%	6.9%	6.8%
Consumer price index, % change	-0.1%	1.9%	8.2%	5.6%	1.3%	1.9%
Deficit, % of GDP	-9.3%	-8.7%	-8.3%	-7.2%	-3.8%	-2.5%
Public debt, % of GDP	155.1%	147.3%	140.5%	137.1%	138.0%	136.1%

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.

The labor market looks solid, with the unemployment rate in the two years of analysis decreasing to below 7%. Inflation is also improving and is expected to fall from 5.6% in 2023 to 1.3% in 2024 and then accelerate slightly to 1.9% in 2025.

The public deficit is expected to be 3.8% in 2024 and 2.5% in 2025, while the public debt-to-GDP ratio will decrease slightly due to nominal GDP growth, to around 136.1% in 2025. The forecasts remain subject to a scenario of high uncertainty and therefore present important risks, mainly related to the global macroeconomic environment, both to the downside and upside.

Going into the details of investments, high interest rates are compounded, as mentioned above, by the reduction of the positive effect of incentives, with a negative effect on private investments. Specifically, in 2024 and 2025, private investments in housing are expected to register weak growth followed by a sharp contraction (0.4% and -12.9% respectively); different dynamics for investments in non-residential buildings (8.0% and 4.3% respectively) and for machinery (-0.5% in 2024 and recovery in 2025, with a growth rate of 5.1%). A different trend can be observed for investments in intangible assets, which increasingly represent a distinctive element of companies to stay competitive in the market. These investments (which include, for example, investments in research and development and software) continue to grow, even though the total amount still remains 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).[76] In a scenario of shrinking private investment in 2025, public investment, expected to grow by 7.9% 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 (PNRR) 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 PNRR according to the information available in the Court of Auditors' report on the state of implementation of the PNRR of May 2024.[77] The six-monthly report on the state of implementation of the PNRR of July 2024 shows a total expenditure between 2020 and the first half of 2024 of about €51.4

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[76] 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.
[77] Implementation Status Report on the Recovery and Resilience Plan (RRP), May 2024. For more information, https://www.corteconti.it/Download?id=7c438424-a7db-4a5f-99a0-3e55c2875447.

billion[78] out of about 90 planned in the timetable shown in the document. Based on this information, it is possible to assume that the difference between what was actually spent and what was planned by the end of 2024 will be used in the following semesters (from the second half of 2024 to the second half of 2026).

Taking into account the context just described, econometric estimates were carried out on two alternative scenarios, to identify the potential growth impacts of a partial implementation of the plan in the coming years. Specifically, the exercise to analyze the impacts of the PNRR on growth in the possible implementation scenarios was carried out as follows:

1. Starting from the actual expenditure incurred quantified in the half-yearly report on the implementation of the PNRR of July 2024 (€51.4 billion), the differential to be spent (roughly €38.5 billion) was calculated in order to be in line, at the end of 2024, with the spending plan shown in the report on the implementation of the PNRR of the Court of Auditors of May 2024 (roughly €90 billion).

2. The differential calculated was divided equally over the remaining five semesters (from the second semester of 2024 to the second semester of 2026). To this is added, for 2025 and 2026, the investments according to the spending plan shown in the Court of Auditors' report.

3. The values estimated 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.[79] 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).[80]

5. The scenario incorporated in the above forecasts, of full implementation of the plan (*baseline* scenario), is flanked by two further scenarios in which partial implementation of the PNRR is assumed. More specifically:
   a. *Scenario 1*: Plan implementation at 70% of estimated resources in 2024 and 90% in 2025;
   b. *Scenario 2*: Plan implementation at 50% of estimated resources in 2024 and 70% in 2025.

Figure 63: Real GDP and deviation in the two scenarios from baseline, Italy (€ million and percentage points)
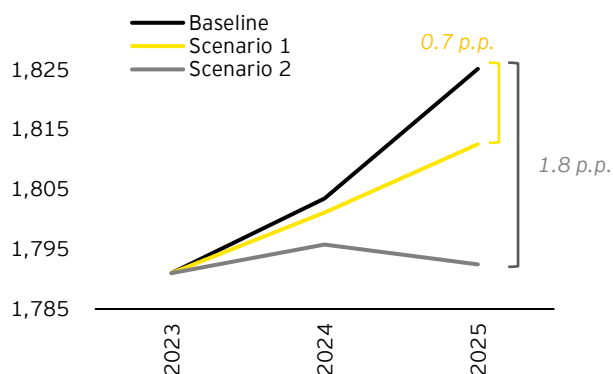

Table 64: Real GDP growth in the two scenarios, Italy - % change

	2024	2025
Baseline	0,7%	1,2%
Scenario 1	0,6%	0,6%
Scenario 2	0,3%	-0,2%

Source: EY Italy's Macroeconometric Model, "HEY-MoM". The percentages represent the deviation in the two scenarios compared to the baseline scenario (0.7% in Scenario 1; 1.8% in Scenario 2).

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[78] Fifth progress report on the implementation of the National Recovery and Resilience Plan. For more information, https://www.italiadomani.gov.it/content/sogei-ng/it/it/strumenti/documenti/archivio-documenti/quinta-relazione-al-parlamento-sullo-stato-di-attuazione-del-pia.html.

[79] For more information, 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.

[80] 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.

Taking these two scenarios into account, it is estimated that in Scenario 1 (plan implementation at 70% of the 2024 resource estimate and 90% in 2025), GDP would grow by 0.6% in 2024 and 2025. This would result in a cumulative growth to 2025 that is 0.7 percentage points lower than the baseline.

In Scenario 2 (plan implementation at 50% for 2024 and 70% for 2025), the Italian economy would experience growth of 0.3% in 2024 and a subsequent contraction of -0.2% in 2025. This would translate into a cumulative growth to 2025 1.8 percentage points lower than the baseline. As already mentioned, therefore, the resources of the PNRR represent an important lever of Italian GDP growth in 2024 and 2025, in a context of high interest rates that discourage private consumption and investment. What is crucial is that these resources are also spent productively to stimulate medium- to long-term growth.

Forecast assumptions

Forecasts are based on the data available as of 16 September 2024.

The forecasts described above are based on a series of assumptions outlining the reference 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 over 3% growth;

▸ **Natural gas**: the price of natural gas (referred to the Dutch Title Transfer Facility) is assumed to be just below $10.0/mmbtu by the end of 2024, and around $10.5/mmbtu by the end of 2025;

▸ **Oil**: the price of oil is assumed to be around $84 per barrel at the end of 2024,[81] and to decline gradually in 2025 to around $79.5 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,[82] modified to take into account our estimates of the allocation of PNRR resources;

▸ **Monetary policy and interest rates**: we assume a path of interest rate reduction that will lead to a 0.25 percentage point reduction in key interest rates by the end of 2024, and a further 0.75 point reduction in 2025. It is also expected that the long-term interest rate (10 years) will follow a similar trend but showing a gradually increasing differential with the short-term rate.

Risks to the upside

▸ 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 spillovers on the prices of energy goods (mainly oil) and other commodities;

▸ Labor market: less pressure of the wage component on the price level, reducing the risk of inflation rate persistence;

▸ Monetary policy: acceleration of monetary policy easing by the European Central Bank and less pressure on domestic demand;

▸ Readjustment of supply chains: a faster readjustment of European and global value chains would lead to less pressure along them, bringing with it greater security of supply and world trade;

▸ 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;

▸ New European legislature: The policy choices of the new European legislature could support the growth of EU countries through specific interventions, benefiting the different economies.

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[81] Reference is made to the price of Brent.
[82] Economic and Financial Document, Update Note, 2023.

Downside risks

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

‣ Stronger effects of restrictive monetary policy on the real economy: the ECB and other global central banks may maintain a restrictive monetary policy stance for longer than expected if inflation shows to be persistent at high levels. This may result in 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;

‣ PNRR: the failure to fully achieve the objectives of the PNRR (national recovery plan) 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: the high level of interest rates worldwide may impact emerging economies through several channels (depreciation of emerging country currencies, potentially raising 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; [83]

‣ 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;

‣ 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;

‣ New European legislature: The new European legislature may face difficulties in implementing its political agenda, with potential negative effects on the economies of EU countries.

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[83] 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[84]

The construction of a new macro-econometric model required the optimization of an inevitable trade-off between building a model that emphasizes 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).[85] This trade-off has been emphasized 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), in an attempt 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. 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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[84] The model was developed in collaboration with the Department of Economic Sciences of the University of Bologna.
[85] "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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