Rapporti di previsione - Centro Studi Confindustria

THE ITALIAN ECONOMY AT THE TEST OF THE CONFLICT IN UKRAINE

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SUMMARY AND MAIN CONCLUSIONS

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An asymmetric supply shock... The global scenario is dominated by the extreme tensions and uncertainties generated by the Russian invasion of Ukraine. The impact on economic activity acts as a deep supply shock, which is currently difficult to quantify as the scenario is constantly evolving.

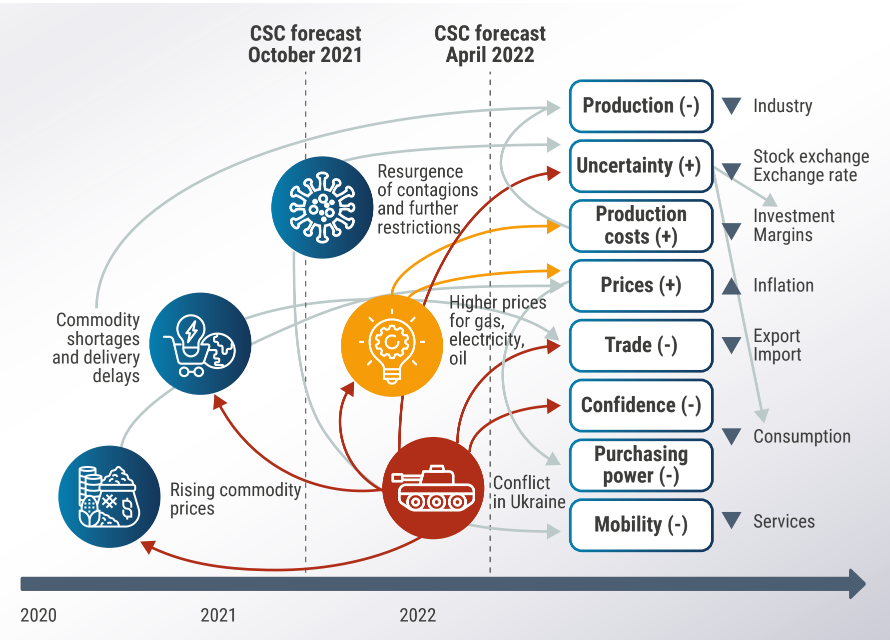
The military crisis, moreover, comes on top of a framework already made difficult by the ongoing pandemic, upward pressures on various commodity prices, and production bottlenecks in some global supply chains.

The effects of the crisis at a global level are strongly heterogeneous across areas and sectors, based on proximity to the conflict, dependence on oil, gas, and other commodities, and, in general, production and financial connections with the countries directly involved in the war (Russia, Ukraine, and Belarus).

Among the main macro-areas, the European Union is the most affected, as shown by the depreciation of the euro and the losses recorded on the main financial markets in the first days of the conflict. Among the most affected sectors, there are energy-intensive sectors, such as metals, chemicals, ceramics, and glass, and other highly internationalised sectors such as transport (motor vehicles, aircraft, boats).

... which is transmitted through different channels The impacts of the war shock on productive activity, both direct and indirect, already visible or expected, well identifiable or uncertain in intensity and duration, are multiple (Chart A). In this regard, a quick survey conducted on Confindustria member companies shows relevant first-hand evidence of pervasive effects of the war on the Italian production system. In this regard, a quick survey conducted on around 2.000 companies associated to Confindustria shows first-hand information of already pervasive effects on the Italian production system in the first month since the start of the conflict.

Chart A
3+2 shocks: in addition to the pre-existing difficulties for the economy, energy price shock and the impact of the conflict have also been added



Source: Centro Studi Confindustria elaborations.

The main consequence is a further increase in energy, agricultural, and metal prices. The tightening of tensions in markets of these commodities was due to the fact that Russia, Ukraine, and Belarus are among the world's main suppliers. Two examples: in 2020-21 Russia exported 38 million tonnes of wheat, accounting for 14.8% of the world total, and was the world's 7th largest producer of copper, accounting for 3.8% of the total. As for gas, markets are pricing in uncertainty over supplies to Europe, given the continent's high dependence on Russian imports of this source. In Italy, Russian gas covers 38% of consumption. At the beginning of March, the price of gas rose to a peak of 227 euros per MWh, compared to 72 euros on the eve of the conflict, 20 euros in January 2021, and 9 euros in February 2020. The price of oil rose to 133 dollars per barrel, from 99 dollars before the conflict and 55 dollars per barrel in February 2020, and there has been a very partial recovery since then. A similar dynamic affected many other commodities: the price of wheat rose by more than 34% in two weeks and then fell but without returning to pre-war levels, while the price of maize rose by 10%. The prices of metals, such as copper, aluminium, and nickel, also rose further in March.

ITALIAN ENERGY BILL TO RISE BY

EUR 68 BN
total

EUR 27 BN
for manufacturing

In Italy, increases in oil, gas, and coal prices are driving up the costs of businesses. According to an analysis carried out using input-output tables, the incidence of energy costs on total production costs (assuming constant non-energy costs) would increase by 77% for the total Italian economy, from 4.6% in the pre-pandemic period (average 2018-19) to 8.2% in 2022. In euros, this impact would translate into an increase in Italy's energy bill of 5.7 billion on a monthly basis, i.e. an additional burden of 68 billion on an annual basis. By far the most affected sector is metallurgy, where the incidence could reach 23% by the end of 2022, followed by non-metallic mineral production (refractory products, cement, concrete, plaster, glass, ceramics), where the incidence of energy costs could reach 16%, wood processing (10%), rubber-plastics (9%) and paper production (8%).

Companies have largely absorbed these cost increases into their margins, even cancelling them out in some cases, instead of passing them on to the next stages of production. The eroded margins explain why core inflation in Italy is low, much more than elsewhere. The only positive aspect is that this trend in prices and margins has safeguarded the competitiveness of Italian companies compared to those in other countries, but it is not sustainable. This is why several companies are stopping production or plan to do so in the coming months.

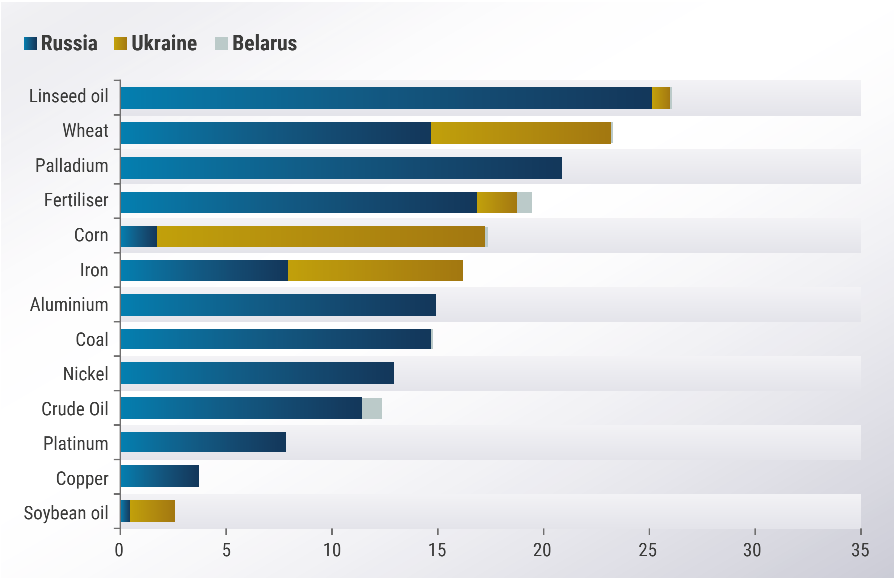
ITALY'S ECONOMIC POLICY UNCERTAINTY INDEX

IN EARLY 2022
+21,1%

On the other hand, rising energy prices (+52.9% p.a. in February) are reducing households' purchasing power and will affect the extent and pace of consumption growth, whose recovery has been hampered first by the increase in contagions and now also by the greater uncertainty affecting confidence, which plummeted in March. The normalisation of households' propensity to save, which is still high in 2021 (13.5% on average until the third quarter), therefore appears to be postponed. Families and companies will have to cautiously review their consumption and investment decisions. The economic policy uncertainty index for Italy rose by 21.1% on average in the first two months of 2022 compared to the fourth quarter of 2021 and is set to increase further from March. After the bankruptcy of Lehman Brothers it had risen by 30.7%; after the attack on the Twin Towers by 85.0%.

The war is amplifying the difficulties in obtaining raw materials and other commodities, particularly for those coming from the three countries involved. These countries have a high global share of many commodities: coal and other minerals (clay, used in ceramics), metals such as nickel, platinum, palladium, and other semi-finished iron and steel products, which are necessary inputs for the electronics and automotive industries, as well as wheat, maize, and seed oil, used in the food industry (Chart B). This firstly implies a shock concentrated in specific productions. Secondly, since these are upstream inputs in global value chains that are used in numerous downstream productions, the effects of deceleration of the production rhythms will amplify along supply chains, all the way to consumer and investment goods.

Chart B
Exports from Russia and Ukraine
(2020, % of world exports)



Source: Centro Studi Confindustria elaborations on UN-Comtrade data.

Another impact of the war is caused by sanctions and counter-sanctions. The direct impact of sanctions on Russia, on Italian exports, is overall modest. The export blockade affects 686 million euros of sales in Russia, equal to 8.9% of Italian exports to the country, which in turn are equal to 1.5% of total Italian exports. What is worrying is that there are some specific Italian products (e.g. some machinery) for which the weight of the Russian market exceeds 10%.

But exports of goods are also penalised by the conflict because it will tend to reinforce the production bottlenecks in the global supply network that already appeared in 2021. The geographical specialisation of Italian exports, which are more focused on EU countries, will not help. The same goes for the commodities specialisation of Italian exports, in which, for example, the metal products sector is very important.

In this context, the positive effects of the implementation of the National Recovery and Resilience Plan (NRRP) are also at risk because some of the planned investments may be difficult to realise at current prices. In addition, the scarcity of various materials may make it difficult to realise some of the investments on schedule. It is therefore likely that some projects will have to be revised in the light of the current context in order for the Plan to be effectively implemented.

Basic assumptions and CSC forecast With respect to the framework outlined above, it is difficult to predict the dynamics of the Italian economy since the various key variables are constantly evolving. The duration of the war is a crucial variable, but even an early resolution of the conflict would have the effect of mitigating the impacts, but not zeroing them out.

The forecast scenario, much more than on other occasions, is therefore anchored to a series of assumptions: it has been assumed that from next July the war will end or at least uncertainty and tensions will start to reduce, in particular on gas and oil prices, which will fall, although remaining above the levels of the beginning of 2021; any hypothesis of energy rationing for the production sector is excluded, obviously it would have very negative impacts; lastly, it would assumed that the spread of Covid would remain effectively contained and have gradually decreasing impacts, and that, despite the worsening situation, Italy would be able to meet its NRRP targets on schedule, possibly revising some projects that might no longer be feasible.

In this deteriorated scenario, Italy's GDP performance in 2022 is much less favourable (Table A): GDP would increase by +1.9% this year, with a large downward revision (-2.2 points) compared to the scenario outlined in October, before the new shocks, when all forecasters agreed on +4.0%.

DOWNWARD REVISION OF GDP GROWTH IN 2022

-2,2 p.p.

Table A
Forecasts for Italy
(% changes)

	2021	2022	2023
Gross domestic product	6.6	1.9	1.6
Consumption of resident households	5.2	1.7	2.1
Gross fixed capital formation	17.0	4.5	3.2
Exports of goods and services	13.3	2.8	4.2
Total employment FTEs	7.6	1.5	1.7
Consumer prices	1.9	6.1	2.0
Government net borrowing[1]	7.2	4.9	3.1

[1] Values in % of GDP.
FTEs = full-time equivalent work units.
Source: Centro Studi Confindustria elaborations and estimates on ISTAT data.

ITALIAN GDP RETURNS TO PRE-PANDEMIC LEVELS IN

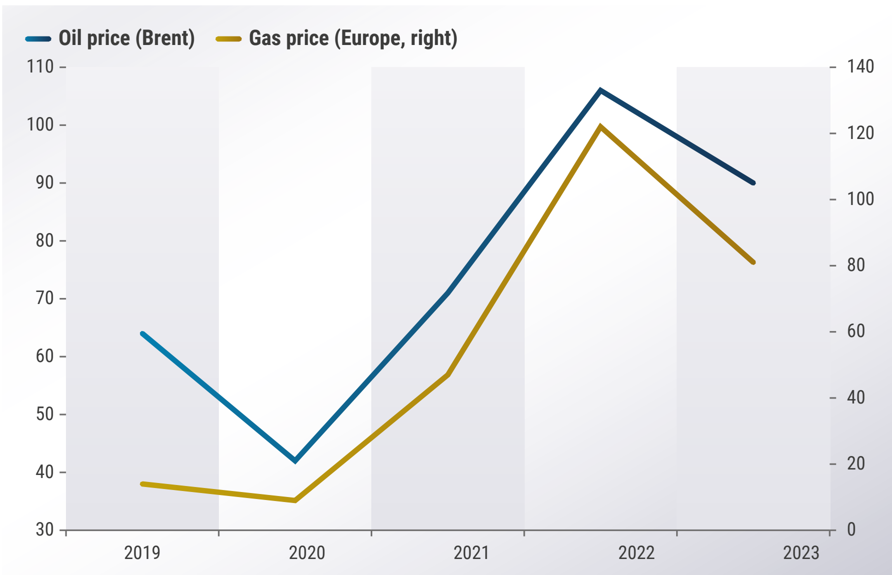
Q1 2023

The reduced positive variation in 2022, moreover, is entirely due to that already "acquired" thanks to last year's excellent rebound (+2.3%): in the first two quarters, indeed, the Italian economy would enter a "technical recession", albeit of limited size. This would not be fully offset by the recovery expected in the second half of the year.

This would be followed by growth of +1.6% in 2023, thanks to a fully increasing GDP profile over the year. In this worsened scenario, Italy's return to pre-pandemic levels slips from the second quarter of this year to the first quarter of next year.

Heavy commodity price shock As mentioned, the forecast scenario, based on future prices, assumes that oil prices will remain at their post-invasion highs (114 dollars on average since 24 February) until June 2022. This would be followed by a very partial decline, continuing in 2023 and reaching 85 dollars by the end of the year, a rather high value compared to the "equilibrium" value (60-70 dollars). In this scenario, Brent would average 106 dollars in 2022 (up from 71 dollars in 2021) and 90 dollars in 2023 (down 15%). A similar profile is assumed for gas prices: at their current high level (136 euros per MWh) until mid-2022; then a slow, partial decline to still very high levels by the end of 2023 (75 euros). Under these assumptions, European gas would stand at 122 euros in 2022 (up from 47 euros) and 81 euros in 2023 (down 33%; Chart C).

Chart C
Energy prices, peak in 2022, still very high in 2023
(Dollars per barrel, euros per MWh)

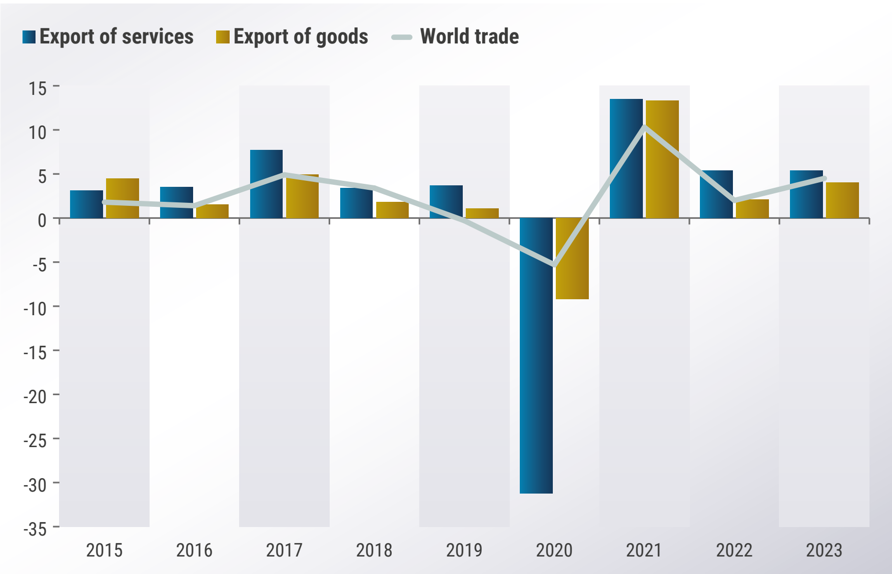


Source: Centro Studi Confindustria elaborations on Thomson Reuters data.

Inflation in Italy will remain around its current high level for most of 2022 and will average +6.1%, an upward revision of +4.7 points from the October scenario. In 2023, on the other hand, total inflation is expected to fall, to +2.0%, due to the reversal of the two trajectories currently in place: a significant increase in core inflation is expected in Italy as well, with a large lag, thanks to the recovery of GDP; and the gradual exhaustion of the impact of higher oil and gas prices on the change in energy consumer prices calculated over 12 months, even though price levels fall slightly and remain very high as assumed. Wage dynamics, while rising, are not expected to exert excessive inflationary pressures.

Foreign trade hampered, but not blocked Italian exports will slow down significantly in 2022 (+2.8%), after a very good 2021. For this year, the growth of both exports and imports is revised down by about 5 points compared to the October CSC scenario (Chart D).

Chart D
Foreign trade slowing down
(Growth rates)



Sources: Centro Studi Confindustria elaborations and estimates on ISTAT and CPB data.

Italian exports of goods, expected to accelerate in 2023, will nevertheless manage to stay in line with world trade in the two-year period. World trade is expected to grow by just 2.0% in 2022, revised down by 2.5 points compared to the autumn CSC report, before strengthening in 2023.

In addition, exports of services remain weak, due to losses in the travel and transport sectors. The outlook has become more uncertain, due to the continuing pandemic and also the possible negative effects of the conflict in Ukraine on long-haul international tourism.

All GDP components slow down Italian household consumption is expected to grow by just +1.7% in 2022 and +2.1% in 2023, continuing at a more moderate pace on the path of partial recovery, still below pre-Covid values. Italian household consumption will be driven by increased spending on durable goods. The upturn is being held back by the many critical issues that emerged in late 2021 and early 2022. The partial resurgence of infections led to a new halt in consumption in Q4 2021, weighing particularly on spending on services. A waning climate of confidence, rising inflation, in particular higher energy bills, and reduced real purchasing power of households, all work against a recovery in consumption in 2022. However, the savings accumulated over the last two years will play an important role in sustaining expenditure.

Investment is also expected to slow this year, after booming in 2021. It has been the driving force behind the Italian recovery, far exceeding the pre-Covid level. The most significant contribution in 2022 will continue to come from construction, thanks to tax incentives. Business investment in plants and machinery, which has also fully recovered after the pandemic, will instead be held back by various factors: declining confidence, rising commodity prices, prolonged uncertainty. NRRP resources will continue to support them.

The industry is heavily affected by high energy prices and other factors. The CSC forecasts modest growth in production activity in 2022, with a very difficult first half and a rebound in the second half. And then a more sustained pace in 2023. The trend in production has been characterised by decreasing growth rates already during 2021. Between the end of last year and the beginning of 2022, indicators pointed to a deterioration in industrial activity, driven by difficulties in the supply of raw materials and labour and then by rising energy prices. This was reflected in the fall in industrial activity in December and even more so in January. Problems with cost pressures and input supply delays, exacerbated by the conflict, will continue to hamper production, especially in the first half of 2022.

The collapse in services due to the pandemic has been only partially recovered in 2021. One of the main factors contributing to the impact on the services sector is the reduced mobility of people (as well as goods). Reduced mobility affects spending on various types of services, leading to consumption that is 'lost' (e.g. dinner at a restaurant) and not 'deferred' as in the case of goods (e.g. purchase of household appliances). In 2021, mobility had returned to around pre-Covid levels, but with significant heterogeneity: mobility to recreational places (bars, restaurants, museums) remained low. The first half of 2022 could see a new slowdown: despite fewer anti-Covid restrictions, which favour the recovery of consumption in services related to leisure, catering, travel, some changes in habits have occurred, probably structural (e.g. more smart working) that penalise spending outside home. There are also new fears that have emerged with the conflict in Ukraine and also the higher cost of transport due to high energy prices.

EMPLOYMENT IN 2023 WILL BE

+190 thousand workers
COMPARED TO THE END OF 2019

During the Covid crisis labor input has moved almost simultaneously with economic activity, and nearly one-to-one in terms of magnitude, both in the downturn and in the recovery. The CSC scenario assumes that this will also happen over the forecast horizon: thus, employment (in terms of FTE's) will contract in the first half of 2022, during the brief technical recession, but it will start to grow again from the summer and throughout 2023. In 2022, the number of persons employed is expected to grow, while hours worked per capita would not on average for the year, as a result of a decline at the beginning and a recovery afterwards. In 2023, however, there will also be a lengthening of hours worked, together with a further increase in employment. In this scenario, 2023 will close with 190,000 more employed people than at the end of 2019, i.e. a full recovery after the deep crisis caused by the pandemic.

The contribution of policies Since even the conclusion of the war will not lead to a substantial reversal of the current trends, the policies that will be adopted will be crucial. In particular, the ability of the Italian Government and the European institutions to intervene to reduce the impact of the war on businesses and families will be decisive. The less effective and less timely the measures adopted, the worse the consequences for the economy will be.

These interventions include choices to diversify energy imports and change the energy mix. The conflict finds Italy in a situation where the mix of available energy sources makes it more vulnerable to extreme supply cuts or shortages, which are excluded in the CSC scenario. Italy uses much more natural gas than other sources, compared to other European economies (Table B): the problem is that most of this gas is imported, significantly from

Russia. This dependence on foreign (Russian) gas suggests that energy policy in Italy, and in Europe, can and must follow different paths, each of which can make an important contribution. In the short to medium term, it is important to increase domestic gas extraction and diversify gas imports more, reducing Russia's share and possibly temporarily resuming coal-fired power generation. In the long term, it is necessary to increase energy independence; on the one hand, by increasing the share of energy produced from renewable sources and also bio-energy and reconsidering nuclear power, which is already a source of imported electricity; on the other hand, by continuing on the path of greater energy efficiency.

ITALY'S ENERGY MIX FAVOURS GAS

42% of the total

Table B - Primary energy: consumption by source

(% shares, 2020 data)

		Fossil sources			Other sources	
		Crude Oil	Natural gas	Coal	Nuclear	Renewables
Advanced	USA	37	34	10	8	10
	Japan	38	22	27	2	11
	UK	35	38	3	6	18
	Germany	35	26	15	5	20
	France	31	17	2	36	14
	Italy	36	42	4	0	19
	Spain	44	23	1	10	20
Emerging	Russia	23	52	12	7	7
	China	20	8	57	2	13
	India	28	7	55	1	9
	World	31	25	27	4	13

Sources: Centro Studi Confindustria elaborations on BP data.

With regard to monetary policies, in the CSC scenario, unlike the Fed, the ECB, given the weakness of the Eurozone economy, which is most affected by the conflict, will be very cautious, both on bond purchases and on official rates. It will keep the latter at zero until the end of 2022. Only in 2023, the first rise in rates is expected, and this will help, at least this year, countries with high debts, such as Italy.

Risks of the scenario almost all to the downside The biggest risk, compared to the baseline scenario outlined so far, relates to the main assumption: the limited duration of the conflict and its main effects. The CSC has estimated the possible further negative impact on Italy's GDP in an 'adverse' scenario, in which the conflict would continue throughout 2022 or, at least, gas and oil prices would remain at the average levels recorded in the first month of the war, until the end of the year. In this scenario, GDP dynamics would be 0.3% lower in 2022 and 0.6% lower in 2023.

ITALY'S GDP VARIATION IN THE ADVERSE SCENARIO WILL LOWER:

IN 2022
0.3%

IN 2023
0.6%

A more 'severe' scenario has also been studied, in which the conflict and its effects continue until the end of 2023. The difference with the previous one is almost all in the second year, when energy and other commodity prices would remain at post-invasion levels: the simulation consistently shows that the additional impact on GDP is low in 2022, while in 2023 it is such that it cancels out the growth of the economy.

The degree in uncertainty in the economy, already priced in the markets, especially the financial markets, could increase further this year. This would come in the wake of the current conflict and its possible prolongation: this risk, therefore, is closely linked to the first one. Higher uncertainty could mean a further reduction in the confidence of investors, businesses, and households, compared with the decline already recorded in recent months. This would weigh even more heavily than expected on the dynamics of key variables: consumption, investment, and industrial production.

There are also a number of risks that are not new, already present in the October CSC scenario, but have partly increased: a postponement in the timing of the implementation of the NRRP or its reduced effectiveness in raising potential growth; a possible new resurgence of the pandemic, again increasing its negative impact on the economy; a premature increase in interest rates in the Eurozone, in the wake of higher and/or more persistent inflation than expected at the moment, in particular by the ECB.