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THE IMPACT OF THE COVID-19 PANDEMIC ON THE ITALIAN ECONOMY: ILLUSTRATIVE SCENARIOS

Uncertainty on the economic impact of the COVID-19 pandemic is very high. Italian GDP fell by 4.7 per cent in the first quarter of 2020. The available information suggests an even larger contraction of economic activity in the current quarter, which is expected to be particularly severe in the service sector, followed by a recovery in the second half of the year. The timing and strength of the recovery will depend on several factors that are hard to predict: the duration and geographical spread of infection, developments in the global economy, the impact on confidence and hence on household spending and firms' investment decisions, possible financial repercussions. They will also depend, to a significant degree, on the effectiveness of economic policies.

In these circumstances, economic forecasting becomes extremely challenging.[1] Macroeconomic simulations have to rely mainly on scenario analyses, based on the assessment of the impact of alternative, for the most part inevitably arbitrary, epidemiological and economic assumptions. The range of forecasters' estimates for Italian GDP growth in 2020 and 2021 is indeed exceptionally wide: the output fall projected for this year ranges between -6 to -15 per cent, the recovery in 2021 from 2 to 13 per cent.[2] Uncertainty is similarly high in the other euro-area countries.

An assessment of the possible effects of the epidemic on the Italian economy can be made by exploring illustrative scenarios. It should be noted that these exercises do not pre-empt in any way the results of the detailed macroeconomic projections for Italy that will be prepared by the Bank of Italy staff as part of the Eurosystem Staff Macroeconomic Projections and published on 5 June.

A central scenario can be based on the hypothesis that the easing of the containment measures introduced in May will proceed at a gradual pace, and with this the easing of the economic repercussions, and that the pandemic will be mostly kept under control in the coming quarters – in Italy, Europe and worldwide – allowing an exit from the recession and the relatively quick resumption of economic activity.

In this scenario it is assumed that the share of economic activities suspended by law in order to contain the spread of infection (representing around one third of value added in April) declines to around one tenth of value added in May, further decreases in June, and that activity goes back to normal relatively quickly in the second half of the year. It is further assumed that: global trade falls by 12 per cent in the current year, in line with the estimates of most forecasters, and only partially recovers in 2021; arrivals of foreign tourists are negligible for the remainder of the year and gradually increase in 2021;

[1] See, for example, the note *Forecasting in the time of coronavirus*, available on the Bank of Italy's website (in Italian only).

[2] Source: Consensus Economics, *Consensus Forecasts*, 9 April 2020.

the indicators of firms' confidence, already substantially down, record a comparable decline to that observed during the global financial crisis.[3]

Under these assumptions, Italian GDP declines by 9.0 per cent on average in the current year and then increases by 4.8 per cent in 2021 (see Table 1), broadly in line with the mean of the range of estimates by the main forecasters. The fall in economic activity in 2020 is a consequence both of a steep decline in foreign demand and in international tourism, and of a significant drop in domestic demand, due to the nationwide lockdown measures to limit the spread of the virus and their repercussions on employment and household income. Starting in the second half of 2020, GDP is assumed to recover mostly as a result of the dissipation of the lockdown effects. In contrast, the impact of the epidemic on foreign demand, tourism flows and on the behaviour of households and firms is assumed to be more long-lasting, slowing the return of economic activity towards pre-crisis levels.

The fiscal policy measures that directly support domestic demand included in Decree Law 18/2020 ('Cura Italia'), and subsequent measures that go in this direction, will help to counter the drop in GDP this year. Based on the typical fiscal multipliers, their contribution to GDP growth is assessed at around 2 percentage points this year. [4] Some measures, such as the moratorium on outstanding bank loans and the public guarantees on new loans, are also crucial to prevent potentially very serious and nonlinear negative developments, averting a liquidity crisis, keeping firms' credit lines open, and responding to the financial needs brought about by the crisis.

Among the components of demand, household consumption is mostly suffering from the lockdown measures and the squeeze on disposable income following the fall in employment, although this has been mitigated by the Government's expansionary measures. In this scenario, investment drops by more than 12 per cent in 2020, recouping only part of its losses next year, in a context of increased uncertainty on future economic activity. Exports of goods and services decline by around 15 per cent in 2020, reflecting the fall in foreign demand and the sudden stop of international tourism flows; they then expand by 8 per cent in 2021. Imports follow a similar path, with a reduction of more than 17 per cent this year and a partial recovery the next.

Consumer price inflation is affected by the fall in oil prices as well as by the sharp decline in capacity utilization. Employment, measured by full-time equivalents,[5] would come down by almost 10 per cent this year, and then recover half of this fall in 2021. The number of persons in employment would, however, decrease to a lesser extent, by around 4 per cent in 2020, thanks to the extensive use of wage supplementation (*Cassa integrazione guadagni*).

A second, more severe scenario is instrumental to illustrate the implications of less favourable assumptions. More adverse developments could result from: the protraction of the epidemic, and the associated need to counter new outbreaks, with repercussions on confidence, spending decisions and

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[3] The firms' confidence indicator included in the econometric model used to produce these scenarios declined between 3 and 4 standard deviations during the global financial crisis. The assumptions underlying the scenario for interest rates, exchange rates and oil prices are those calculated based on the spot and forward prices observed in the markets in the first half of May. The scenario incorporates the measures set out in Decree Law 18/2020 ('Cura Italia') and the additional ones presented in the 2020 Economic and Financial Document.

[4] This estimate is based on the 'Cura Italia' Decree Law and on the main features of the subsequent measures sketched out in the 2020 Economic and Financial Document. The estimate of the effects of the latter may be revised as details of the package are made available (the so-called 'Rilancio' Decree Law had not yet been published when this note was finalized).

[5] Full-time equivalent is a unit to measure the volume of work performed in all jobs. It is obtained by reducing to full-time equivalent (the unit value of) part-time jobs and temporary agency jobs.

investment plans; a more marked decline in world trade and extensive disruptions in global supply chains; a significant worsening of financial conditions.

Table 1. An illustrative macroeconomic scenario for the Italian economy.
(*percentage changes*)

	2019	2020	2021
GDP	0.3	-9.0	4.8
Household consumption	0.4	-8.8	4.6
Gross fixed capital formation	1.4	-12.4	3.2
Exports	1.4	-15.4	8.0
Imports	-0.2	-17.3	9.7
Employment (full-time equivalents)	0.3	-9.8	5.0
Employment (persons)	0.6	-3.8	2.7
Consumer price inflation (HICP)	0.6	-0.1	0.0

More specifically, in this second scenario the following technical assumptions are introduced: world trade falls by about 20 per cent in the current year; as new outbreaks occur, the effects of containment measures also weigh on economic activity in the second half of the current year, with a more protracted impact on GDP, though still less than that of the measures introduced in March and April; financial conditions worsen, leading to an increase of 100 basis points in long-term yields and a tightening of credit supply conditions, about half as large as that observed during the global financial crisis. These assumptions result in additional declines of -1.5, -1.3 and -1.2 percentage points in GDP in 2020, respectively (Table 2). Taking all these effects together, the fall in GDP in 2020 would be four points larger than in the first scenario and the recovery in 2021 more gradual. Still, this scenario stops short of incorporating the non-linear and difficult to quantify effects that could stem from widespread insolvencies among the firms that are key to the economy's productive capacity, and from further waves of the pandemic.

Adverse scenarios for the euro area have been investigated by other institutions. According to an ECB staff study published at the beginning of May,[6] in a severe scenario GDP in the euro area could contract this year by 12 per cent. The European Commission[7] reported the results of two alternative simulations under unfavourable assumptions, in which GDP loss in 2020 would be of the order of 10 and 15 percentage points, respectively. These scenarios do not include extreme assumptions, such as a new global pandemic wave or a serious deterioration in financial stability.

[6] See, on the website of the European Central Bank, 'Alternative scenarios for the impact of the COVID-19 pandemic on economic activity in the euro area'.

[7] Source: European Commission, *European Economic Forecast. Spring 2020*, May 2020.

Table 2. Effects on GDP growth of different assumptions in less favourable scenarios
(*percentage points*)

	2020	2021
External environment(1)	-1.5	-0.2
Duration of the epidemic(2)	-1.3	-0.8
Financial factors(3)	-1.2	-0.3

(1) World trade is assumed to fall by 20 per cent in 2020.
(2) It is assumed that further containment measures will entail suspensions of economic activity accounting for 5 per cent of value added for 4 weeks in the summer months, and for around 15 per cent for 6 weeks between the end of 2020 and early 2021.
(3) It is assumed that long-term bond yields increase by around 100 basis points and that credit conditions are tightened by about half as much as during the global financial crisis.