Feb-2021

Macroeconomic and Energy Demand Outlook

Osservatorio energia

REF4E

The Italian GDP recovers pre-crisis levels by 2023, with the government's handling of the over 200 billion of euros of European funds seen as key for achieving the latter target.

Electricity demand recovery faster than GDP, with the industrial sector resilience supporting.

Gas demand recovers most of the 2020 loss in 2021 too, coherently with the thermoelectric request resumption and the industrial sector positive outlook.

Both monetary and real economy policies favour a recovery of prices, with **yearly inflation averages for Italy back above zero starting from 2021**.

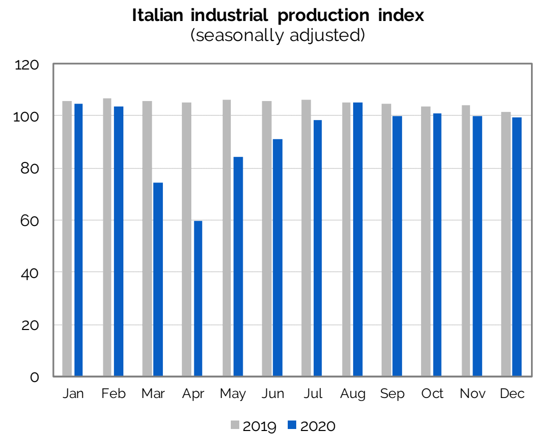
Central banks responses to COVID-19 favor a **stabilization of the EUR-USD in the short term**

ITALIAN MACROECONOMIC OUTLOOK: RECOVERY IS UNDERWAY

The pandemic second wave has delayed the path to recovery, putting on hold the Q3-20 significant rebound. 2021's GDP forecasts have been downward revised accordingly, but GDP is still assumed to fully recover pre-crisis levels by 2023. The government's handling of the over 200 billion of euros of European funds will be key for achieving the latter target, while the virus persistence still represents the main uncertainty factor.

Q4 2020: the Industrial Sector Limits the GDP Fall

ISTAT'S preliminary data shows 2020's Italian GDP falling 8.8% below 2019's level, with a 2% drop between the third and the fourth quarter due to the new tightening of containment measures. The second wave of restrictions had a more limited impact compared to previous one and mainly involved the contact-intensive services, while no direct limitation was imposed on the industrial or construction sectors. This allowed the Italian industrial production index (seasonally adjusted) to settle only 2% below pre-crisis levels in December 2020. The recovery of manufacturing benefited, at least in part, from the support of foreign demand, with the value of Italian exports in November and in December 2020 moving above 2019's same months levels (+1% and +3%, respectively). The recent resumption of exports limited 2020's overall year on year drop to roughly 10%.

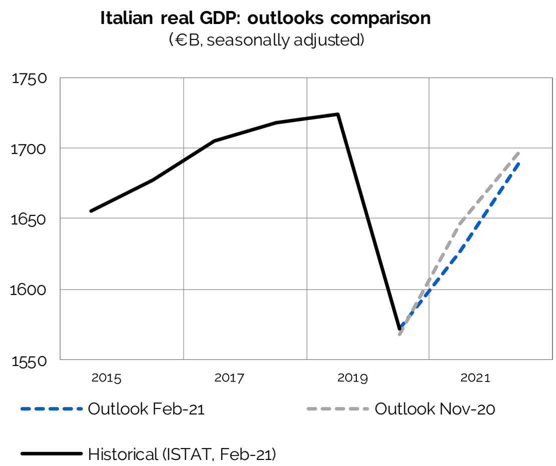


Source: ISTAT

2021-2022 Outlook: the Pandemic's Come-Back Weigths on the Recovery Speed

Last autumn containment measures weakened the Q4-20 economic performance, weighing on 2021 recovery potential. Our growth outlook for 2021 was revised lower accordingly, but a positive correction of the GDP outlook for 2022 paired. In our new *Reference* scenario, the 2021 GDP growth is 3.5% and 4% for 2022 (-1.5 and +0.8 percentage points than the previous update respectively). 2023 GDP is assumed to be roughly 1% higher than in 2019.

A complete resumption of GDP in 2021 is limited by the **domestic demand** weakness. The increase in households' savings rates keeps weighting on private consumption, in combination with social inequality increase and disposable incomes contraction, which is only partially mitigated by public interventions (subsidies to independent workers, redundancy funds and job-places safeguarding measures) In December, the number of workers was 2% lower compared to February 2020 and while the new lockdown had only limited effect on employment, the number of job seekers fell again by almost 6%. Supportive measures for firms and workers, introduced in spring 2020, have been prolonged until March 2021. Their end will lead to an increase in job dismissals in the sectors more strongly hit by the

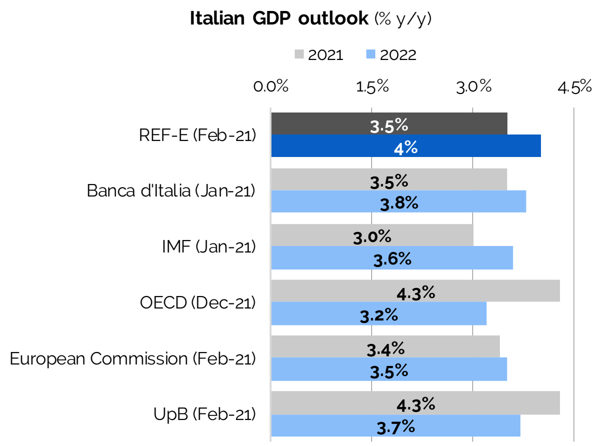


Source: ISTAT

containment measures. Policy measures aiming at supporting the income of these workers or their transition to better performing sectors will be fundamental to sustain demand.

Foreign Demand of Italian goods should support the GDP rebound, but tourism weakness will continue to limit foreign demand for services.

Investments are expected to recover in the short term, with housing investments supported by public incentives (such as the *Superbonus 110%*) and business investments favored by easy access to credit conditions and drawn by the prospect of increasing demand. Both in the short and medium-term, the National Recovery and Resilience Plan (PNRR), and the Italian institutions compliance to the plan, will largely affect investments and, most importantly, the economic recovery.



Source: REF-E eleborations

The **PNRR** resources allocation, which the new Draghi-led government will have to enforce, is largely influenced by the EU, with 70% weight of public investments expected to be confirmed under the implementation phase. Many key forecasters (of which Banca d'Italia, Cassa Depositi e Prestiti and the Budget Parliamentary Office) made estimates for the PNRR macroeconomic impact, mainly in terms of extra GDP growth. Most of them focus on the plan short-term benefits (next three years). Benefits that may arise from other areas collateral reforms such as justice, jobs, public finance, and administration are generally neglected though, resulting in a possible underestimation of the GDP short and medium-term growth potential. Our short-term forecast is in fact slightly more optimistic than consensus, counting on a more significant positive impact of the PNRR resources, although still cautious on the latter policy impact on private investments.

To account for uncertainty coming from the evolution of the pandemic spread and from the effectiveness of the PNRR, the *Reference* scenario is complemented with two alternative scenarios. According to the scenario *Low*, which assume a longer persistence of COVID-19's restrictions and a failure in investing a large part of the PNRR funds, the annual increase of GDP will be limited to 3% in 2021 and to 2% in 2022, with GDP remaining below 2019 level after 2023. The *High* scenario assumes a quicker ending of the pandemic impact and a more effective investment of European funds instead. These will be reflected in a 4% increase of GDP in 2021, followed by an additional 4.6% increase in 2022, and a return to 2019 levels between 2022 and 2023. Given the cautious approach chosen to elaborate the *Reference* scenario, the possibility of a revision towards the more optimistic scenario is quite significant.

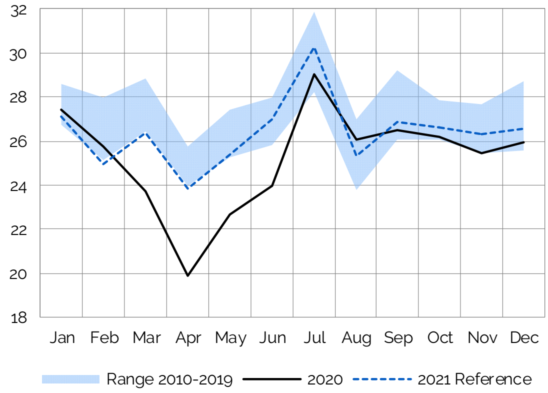
ITALIAN DEMAND MIRRORS THE ECONOMIC PICTURE

The Italian electricity and natural gas demand 2021 and 2022 resumption are in line with the GDP expected recovery, with the industrial sector resilience seen as key and this winter lower than average temperatures offering some additional support.

Electricity Demand Recovery Faster than GDP

In 2020, electricity demand fell 5.3% below 2019 levels, with the North and Central-North zones having registered the largest year on year drops (-5.7% and -8.4%, respectively). The yearly contraction of demand was roughly 3.5 percentage points lower compared to the GDP's, following a fast rebound of electricity demand over Q3 and Q4. The electricity demand progressively closed the gap with previous year's levels to -0.5% in Q4-20, while the year on year drop of GDP remained above 5% in Q3 and increased to above 6% in Q4-20. The different evolution of GDP's and electricity demand is at least partially explained by a heterogeneous response to the pandemic by different economic sectors. Indeed, after the first lockdown, restrictive measures on the energy intensive industrial sector were largely softened, while strict limits continued to be imposed on the less energy intensive service sector.

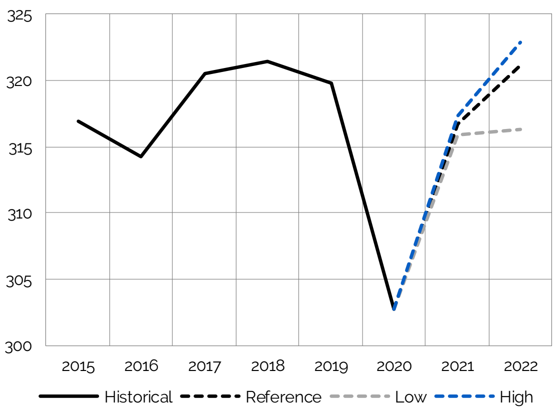
Italian monthly electricity demand and 2021 forecast (TWh)



Source: Terna data processing

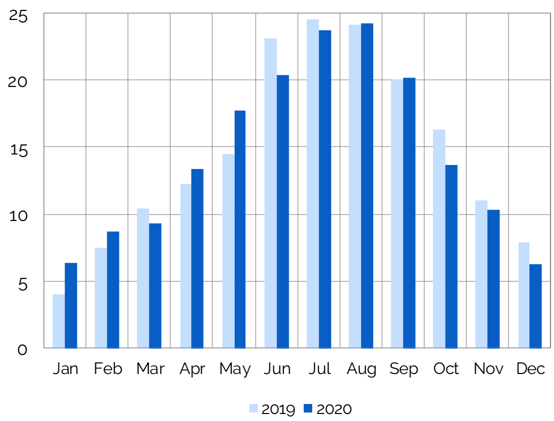
The industrial activity contribution to power demand recovery is highlighted by the evolution of Terna's index of monthly consumption of electricity in the industrial sector (IMCEI), whose seasonally adjusted value moved above 2019's level starting from November 2020. Lower temperatures in the last months of 2020, compared to 2019, also supported the recovery of 2020 electricity demand.

Italian annual demand: forecast scenarios (TWh)



Source: Terna data processing

Average Temperatures (C°)



Source: Reuters data

The 2021-2022 electricity demand scenario depends on the GDP outlook, assuming temperatures in line with the past five years average. Under the Reference scenario, we year 2021 power demand is 316.7 TWh, 14 TWh above 2020 demand (302.8 TWh) and 3 TWh below 2019's (319.6 TWh). Our expectations remain in line with the previous update, despite the downward revision of 2021's GDP recovery. This is based on the evidence of a faster recovery of electricity demand compared to GDP and on the positive signals coming from industry sector's electricity consumption (Jan-21 IMCEI index showed industry's electricity consumption to be 3.8% higher compared to Jan-20). In accordance with this evidence, demand forecast for 2022 is set to be equal 321.2 TWh, 0.2% above Nov-20 update.

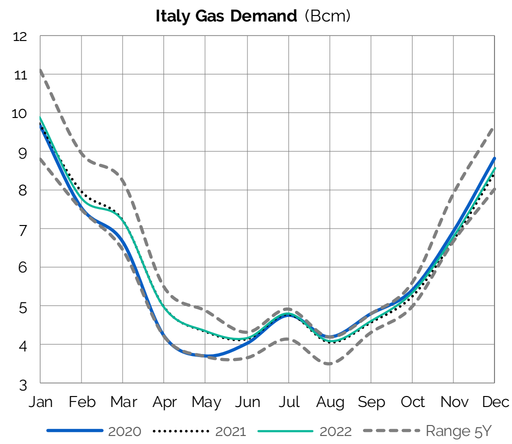
Should the economic framework align with the scenario High's forecasts, demand will be 317.4 TWh in 2021 and 322.9 TWh in 2022. On the contrary, should economic conditions assumed under the scenario Low prevail, demand will be 315.9 TWh in 2021 and 316.3 TWh in 2022.

Gas Demand Recovers Most of the 2020 Loss in 2021

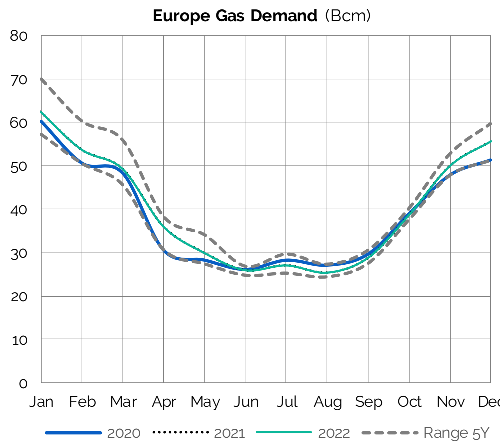
2020 Italian gas demand was 71 Bcm (-4.2% compared to 2019), with the pandemic effects having weighed mainly in the first half of the year. 2021 cumulative Italian gas demand till now is higher than both the same period in 2020 (+4%) and the historical average (+1% compared to

2015-2019) mainly due to colder than average winter temperatures which keep sustaining distribution network consumption. An incomplete economic recovery still affects both the industrial and thermoelectric gas demand though.

The Italian gas demand is expected to grow by nearly 3% y/y in 2021 (slightly exceeding 72 Bcm) and +0.5% y/y in 2022. In 2021, the industrial natural gas consumption recovery forecast is based on GDP growth expectations along with a normalization of thermoelectric and distribution network gas consumption, under the base case assumptions of temperatures remaining in line with seasonal averages. 2021 gas consumption for thermoelectric power plants could decrease slightly amid a growing contribution from renewable sources (settling at 24 Bcm in 2022).



Source: REF-E Elaborations

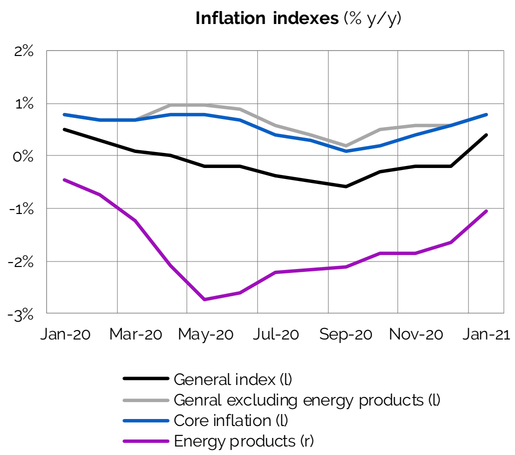


Source: REF-E Elaborations

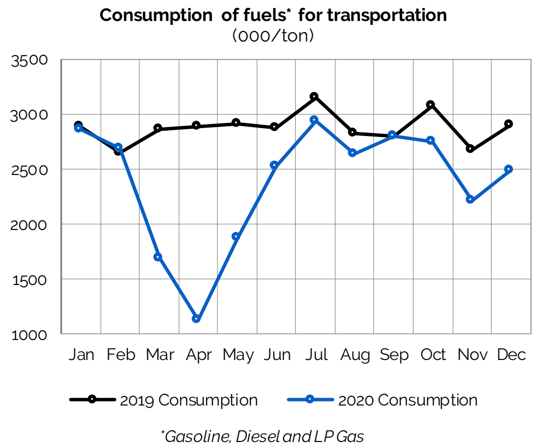
INFLATION, MONETARY POLICIES AND THE EXCHANGE RATE

The PNRR, the European Recovery Fund and any other measure put in place by governments and European institutions aim at supporting the economy and prices. With inflation being a pivotal factor for the economic system going back on a healthy trac, both the ECB and the FED will maintain fully accommodative stances, leaving the exchange rate stable in the short-term.

Inflation: Short-Term Forecasts Are Cautiously Encouraging



Source: ISTAT



Source: MiSE

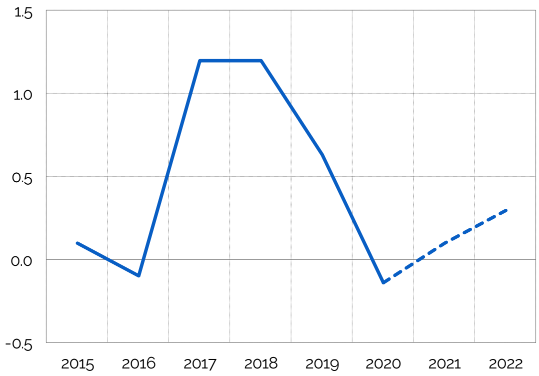
Year 2020 CPI averaged below zero (-0.1%). The drop in fuels and energy prices, emphasized by the pandemic-related fall in demand, was the major driver of the decrease of average prices. Indeed, the inflation index excluding energy products, and Core inflation (excluding energy, tobacco, and food products) remained above zero throughout the year.

Fuels consumption in the transportation sector fell by roughly 17% in 2020 compared to the previous year. Autumn new restrictive measures had a more limited effect than the spring ones, with the fourth quarter consumption having fallen 14% lower than the previous year, well-below the 46% drop recorded between Mar-20 and May-20.

The energy prices recovery and the resumption of demand led to a gradual increase of monthly inflation for the last quarter of the year, leading Jan-21 inflation to above zero (0.2%). Yearly inflation averages are above zero both in 2021 and in 2022, but below 0.5% in both years, with the subdued recovery of private consumption, discussed above, weighing.

The impact of COVID-19 on consumption behaviors, by influencing the consumption mix, is reflected in relative prices movements, potentially affecting forecasts for 2021 and 2022 inflation.

Inflation evolution in Italy (% y/y)



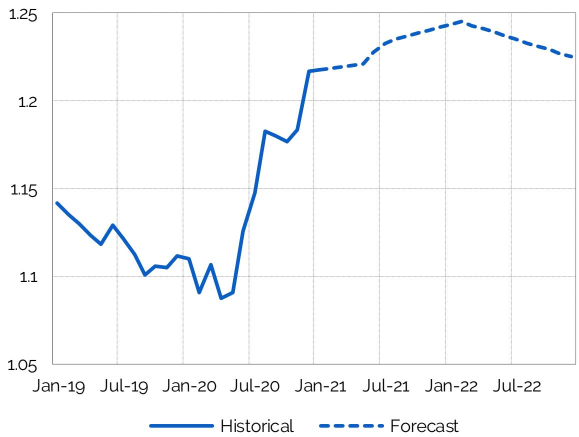
Source: ISTAT and REF-E forecasts (Feb 2021)

Central Banks and the Exchange Rate: Responses to COVID-19 and Room to Act

The latest FED statement made clear that the central bank is focused on guaranteeing the recovery is safe before they even start to consider tightening policy. Officials have signaled they will keep interest rates near zero till at least 2023 and promised to buy bonds at a monthly pace of at least $120 billion until "substantial further progress" had been made toward the targets of maximum employment and 2% inflation. Having lifted the inflation target limit frees the FED to maintain a strongly accommodative monetary policy even if inflation makes a comeback this year, as Powell recently stated saying: "We will continue to use our tools to support the economy for as long as it takes until the job is well and truly done. No one should doubt that."

In Europe, the ECB increased its emergency bond-buying program to 1.85 trillion euros ($2.3 trillion) in December and extended it through March 2022. However, the 500-billion-euro boost won the Governing Council full approval only because President Christine Lagarde conceded that not all the amount necessarily needed to be spent.

EUR/USD: historical evolution and short-term outlook



Source: REF-E elaborations on Reuters data

While the upper bound FED Funds target lies at 0.25%, the EU deposit rates are already in negative territory at -0.5%, The ECB Governing Council can continue to provide liquidity through its targeted longer-term refinancing operations at an interest rate that could be as low as -1%. However, its main weapon to support the economy is now in fact the Pandemic Emergency Purchase Program, which the Central Bank will continue buying through until the end of 2021 at a speed of about 20 billion euros per month.

Exchange rate wise, a stronger recovery in the United States than in the Euro Zone is compensated by the FED easing potential being perceived as higher than the ECB's. This offers some support to the EUR-USD and favors an overall stable exchange rate over the next couple of years. Our reference EUR-USD average rate for this year is at 1.23 and for year 2022 is at 1.24.

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