Weaker than expected Italian GDP may help disinflation process

The surprising contraction in GDP in the second quarter was driven by domestic demand. This could well have affected services, as July inflation data shows. Based on business confidence and labour market data, we believe that another contraction in GDP should be avoided in the third quarter

After posting a surprisingly strong 0.6% quarterly expansion in the first quarter, Italian GDP contracted by 0.3% in the second, doing worse than expected.

The succinct press release by Istat indicates that the quarterly decline was driven by domestic demand (gross of inventories), while net exports were growth neutral. From the supply side, Istat notes that value added contracted in both industry and agriculture and expanded marginally in services.

We anticipated that the very positive first quarter would be difficult to replicate in the second, but thought that resilience in services could manage to marginally compensate for the contraction in industry. Apparently, this was not the case. On the demand front, we suspect that soft private investment and inventories might have been at the heart of the negative surprise, while private consumption could have managed to remain in positive territory courtesy of a still resilient labour market and decelerating inflation. After the preliminary estimate for the second quarter, the statistical carryover for full-year GDP growth stands at 0.8%. Our base case forecast for average GDP growth is currently 1.2%, but today's disappointing release adds downside risks. Still, we believe that a technical recession could still be avoided in 3Q23. July business confidence data were a mixed bag, with another decline in manufacturing and improvements in services (tourism and transport) and construction (specialised works). We believe such a pattern is still compatible with a return to modest positive growth in the third quarter.

The weakening economy possibly helped to cool inflation in July. Preliminary inflation data, also released today, confirms that the disinflationary path is still in place, both for the headline and core measures.

Headline inflation was down to 6% (from 6.4% in June), mostly driven by the deceleration in transport services and non-regulated energy goods. The deceleration of core inflation to 5.2% (from 5.6% in June) is a comforting factor on its own, helped by a decline in services, but a similar rate of decline over the second half of the year cannot be taken for granted. Indeed, the recent acceleration in hourly wages (at 3.1% in June from 2.4% in May) will filter through the price pipeline, possibly showing up in services inflation over the next few months.

Today's inflation release still fits with our current projected profile, which points to an average headline reading of 6.5% for 2023.

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