Chemical industry in Italy: situation and outlook

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International framework

In a context of greater uncertainty, global growth continues but peak is behind

After a 2017 characterized by very favourable conditions (in terms of world growth, oil prices and euro exchange rate), current year opened under the banner of greater uncertainty dictated by a combination of economic and political factors. Risks are not expected to materialise in extreme forms and, as a consequence, should not compromise global growth that is solid and widespread (world GDP +3.9% in 2018 and +3.5% in 2019). Peak of the expansive cycle is, however, behind given physiological exhaustion of some boosting forces, after eight years of uninterrupted growth, and gradual reversal of monetary policies.

After exuberant growth in 2017, Europe returns to more normal rhythms

Slowdown experienced in the first part of the year was amplified partly by merely contingent factors, partly by the uncertainties related to the new wave of protectionism and the lack of European cohesion that hinders reforms, brings to light fears of disintegration of Euro Area (highly unlikely, but with such destructive effects that it entails a rise in the risk premium) and weakens Europe in its dialectic with other major actors of the geo-political chessboard. After a very exuberant growth phase, return to more normal rates of expansion dispels fears of marked increases in inflation and allows a very gradual reversal of monetary policy that is not expected to compromise European (and Italian) recovery (Euro Area GDP: +2.1% in 2018 and +1.8% in 2019).

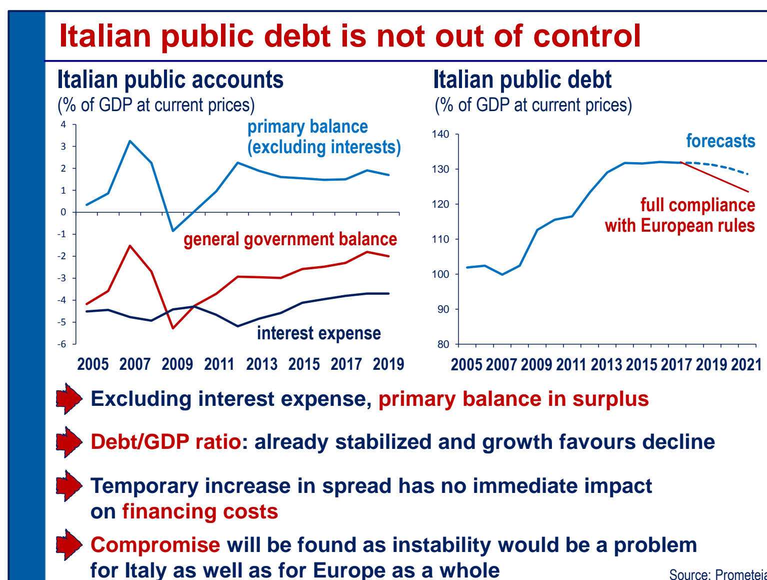
Euro coming back from recent peaks, oil price not much higher than 70 $

Interest rate increase, already started in the US, combined with more vibrant economic growth than in Europe, should avoid an excessive strengthening of euro exchange rate. On the other hand, the persistent imbalances of US economy (public and trade deficit) entail an underlying weakness of the $ which will tend to re-emerge when the European Central Bank will decide the first rate hike (not before 2019). As a consequence, forecasts for 2018-2019 place euro between 1.15 and 1.20$. However, there will not necessarily be a similar weakening against emerging countries' currencies.

The availability of Saudi Arabia to calm down quotations – mitigating the effect of sanctions on Iran – and the increase in production decided by OPEC Plus (OPEC cartel extended to Russia) should counter further price increases in oil prices. In this context, forecasts place the price of oil just over $ 70 in 2018-2019.

Italy will not be hit by a new confidence crisis on public debt

For Italy – even if the exceptionally favourable conditions of last year will not be replicated – the external context can be considered all in all still benevolent (continued global and European expansion together with accommodative monetary policy), even if weighted down by uncertainty. Domestic political situation is a further element of concern, witnessed by the increase in 10 year government bond spread.



Although recent experience teaches that events considered highly improbable (as Brexit) cannot be completely excluded, several reasons lead to believe that **a confidence crisis on public debt will not verify** as

- the reduction of deficit has been achieved thanks not only to ECB policy, but also to a steady positive balance between income and expenses (net of interest expense);
- debt to GDP ratio – which is the main reference for the country's ability to meet financial commitments – has already stabilized and economic growth facilitates its decrease;
- the increase in spread does not have an immediate impact on financing costs, which will continue to benefit from the very favourable rates of past years: 100 points of spread increase cost, in fact, 2 billion euros after a year and 4 after two years (but if stabilized, after seven years they would absorb as many as 22 billions);
- a frontal confrontation between Italian government and European institutions would destabilize not only Italy (with a dramatic impact) but also Europe itself, as a consequence it can be assumed that a compromise solution will be reached (only partial reduction of deficit, remaining under 3% and debt to GDP ratio going slightly down instead of significantly decline, as required by full compliance with European rules).

In this context, the choice of how to use resources "freed" from the mitigation of budgetary constraints is central, because some items of expenditure (public and private investments), unlike others, not only represent a short-term stimulus but also increase medium term capacity for growth.

Although excluding the most pessimistic scenario, the political situation – combined with gradual withdraw of monetary policy support – will certainly not be without consequences:

- **the increase in interest rates will affect not only Italian Government, but also companies and – to a more limited extent – households** (given the prevalence of fixed-rate mortgages);
- in a medium term perspective, such a high level of public debt takes resources away from the economy and limits the possibility of introducing anti-cyclical measures in the event of a recession.

The uncertainty of political situation – resulting in an increase in the risk premium and greater caution in spending and investment decisions – will generate an estimated loss of over € 5 billion in 2019.

Furthermore, requests for corrective measures that would have a negative effect on growth cannot be completely ruled out.

Manufacturing is the backbone of recovery in Italy

In a context in which public budget is a constraint on domestic demand rather than a stimulus, manufacturing industry is the main driver of recovery. Actually,

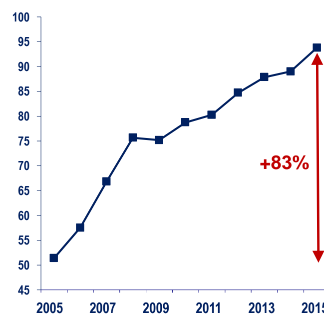
- all components of domestic demand have lost ground between 2010 and 2017
- and without the contribution of exports – which accounts for 80% of industrial products – GDP would still be 7% lower than in 2010, i.e. Italy would still be in the midst of the crisis.

Will industry continue to give its valuable contribution, despite less favourable external conditions? **Several elements testify to a structural strengthening of Italian manufacturing, which justifies some optimism**:

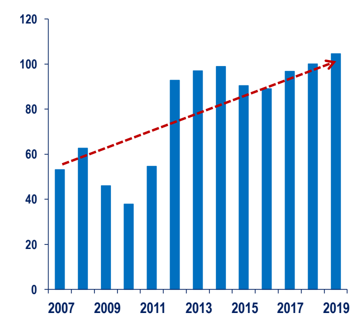
- crisis has hit mainly smaller companies, consequently the industrial structure is now more suited to competitive challenges;
- surviving companies reacted by focusing on international markets and increasingly on research-based innovation (also in traditional sectors);
- a plant renewal phase has started, also with reference to Industry 4.0 technologies, supported by tax incentives;
- results are already clearly visible in the trade surplus (almost doubled in the last decade up to almost 100 billion euros in 2017) which is expected to grow further in the coming years.

Italian manufacturing more and more competitive thanks to structural changes

R & D personnel in Italian manufacturing (thousands)



Trade balance of Italian manufacturing (billion euros)



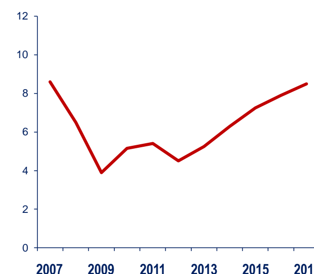
Source: Istat, Prometeia

This competitive repositioning, coupled with the overcoming of the most critical economic phase, has also led to significant progresses on the financial side:

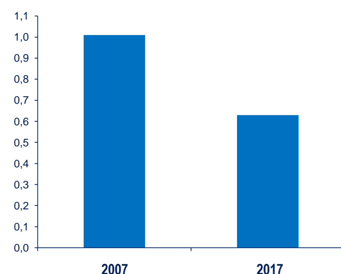
- in 2017, profitability returned to pre-crisis levels and the improvement has also involved SMEs;
- at the same time, such improvement made it possible to reduce dependence on bank credit.

Improved profitability and lower financial debt

Profitability of invested capital of manufacturing companies (ROI)



Leverage of manufacturing companies (debt to capital ratio)



Source: Prometeia-Intesa Sanpaolo

Ultimately, Italian manufacturing has come out of the crisis downsized, but also strengthened in its competitive capacity, indeed

- it firmly holds second place at European level
- and confirms its distinctive features, in particular a significant presence of excellent supply chains and products not only in traditional Made in Italy and in machinery, but also in the so-called "new specializations" (food, packaging, specialty chemicals, cosmetics, pharmaceuticals).

As a consequence, **manufacturing will continue to give a decisive contribution to growth of the Italian economy, allowing to further increase the weight of exports on GDP** (passed from 36% in 2008 to 48% this year and expected to reach 51% in 2022).

Recovery in Italy holds, but loses some momentum

In a scenario characterized by less favourable but not strongly adverse external conditions, **recovery in Italy will be confirmed, because it is self-sustaining and driven, not only by exports, but also by all components of domestic demand**:

- investment cycle is picking up (+3.6% in 2018 followed by +3.9% in 2019), driven by the need to renew plants – after years of standstill – and by tax incentives;
- after ten years of recession, also constructions investment should recover (+1.3% in 2018 and +1.8% in 2019), thanks to the restart of both public works (given resources already allocated since 2016) and new housing;
- increase in employment, even if at a more moderate pace, combined with improvement in real disposable income, will allow private consumption to grow (+1.0% in 2018 followed by +1.3% in 2019);
- public consumption will remain conditioned by expenditure control needs (+0.1% and +0.5%).

Recovery in Italy continues, but slows down

Macroeconomic forecasts for Italy

(real% change, unless otherwise indicated)	2017	2018	2019
GDP	**1.6**	**1.2**	**1.2**
Private consumption	1.4	1.0	1.3
Government consumption	0.1	0.1	0.5
Gross fixed investment			
- machinery, equipment and transport means	6.0	3.6	3.9
- constructions (*)	0.1	1.3	1.8
Exports of goods and services	6.0	2.3	3.9
Imports of goods and services	5.7	2.9	4.7
Inflation (%)	1.2	1.4	1.5
Total employment	0.9	0.4	0.3
Households' disposable income	0.6	0.9	1.2

Note: (*) excluding property transfer costs
Source: Prometeia, Ance

Uncertainty and gradual markets slowdown, especially in 2019, will not allow, however, to confirm good results of the recent past, by constraining economic growth at a more modest pace (GDP +1.2% in both years 2018 and 2019).

In light of a more challenging framework, growth will be less generalized and homogeneous among sectors and companies. In fact, selectivity is a characteristic that will accompany markets also in the future, in presence of companies able to exploit opportunities of change and significantly over-perform in the face of others that will suffer more.

Chemical industry in Italy continues to grow, but in a less supportive environment

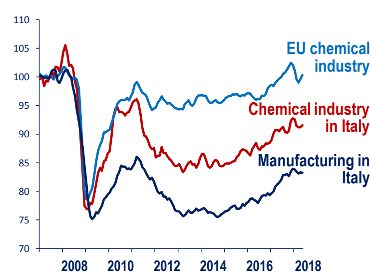
After robust and generalized growth in 2017, chemical production in Italy faced a significant slowdown in the first part of the year as in the rest of Europe. Despite such a correction, levels of activity remain higher than in the previous year, which was a very positive one (+1.4% in the first five months, in line with European average).

Chemical industry is a very sensitive thermometer of the conjunctural situation: as it produces predominantly intermediate goods, it is affected in an amplified way by the slowdown in downstream sectors and by uncertainty, which makes customers more cautious in their purchase decisions.

If signs of general economic slowdown won't get worse, we can expect that destocking by customers (also stimulated by the increase in prices of oil and basic chemical intermediates) will only be temporary.

Weakening of chemical industry in the first part of 2018

Production
(indices 2007=100, in volume)



Production
(% y-o-y change, in volume)

	2017	Jan-May 2018
Chemical industry in Italy	+3.5%	+1.4%
EU chemical industry	+3.5%	+1.0%
Manufacturing in Italy	+3.8%	+3.4%

Source: Istat, Eurostat and Federchimica estimation

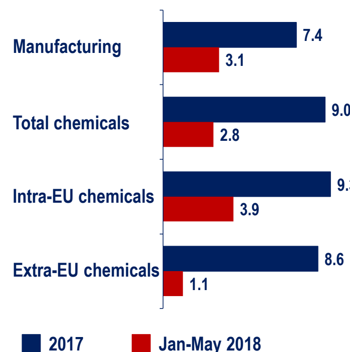
Part of the slowdown, however, is also determined by the fact that important customer sectors are gradually extinguishing their push (this is the case of car industry) or they do not see a decisive cyclical inversion (construction), while the most dynamic industrial sectors (such as machinery) have a more limited content of chemicals.

After the strong progress registered in 2017 (+9% in value), Italian chemical exports confirm expansion even if at a slower pace (+2.8% in the first 5 months). Sales to European market slow down and, even more, those to emerging markets. Exports to US, on the other hand, are buoyant (+10.8%) despite the strengthening of euro.

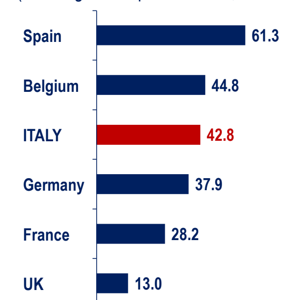
Since 2010 export performance of Italian chemical industry has been among the best in comparison with other major European producers, thanks to strong orientation to international markets of both Italian companies – in many cases endowed with production sites abroad – and Italian plants of foreign-owned groups, which show export shares on turnover often exceeding 75% as result of a specialization process.

After a brilliant 2017, chemical exports continue to grow

Italian exports
(% y-o-y change, in value)



Chemical exports of main European producers
(% change Jan-Apr 2010-2018, in value)



Source: Istat, Eurostat

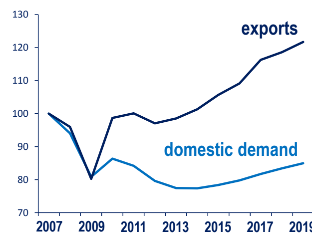
If uncertainty of national and international political framework will not deteriorate further, chemical production in Italy can be expected to increase by 1.5% in 2018.

However, there are many factors of risk that could dampen sector performance in 2018 and, especially, in 2019: turbulence related to the reversal of European monetary policy, changes in exchange rates and oil price, protectionism, geo-political tensions.

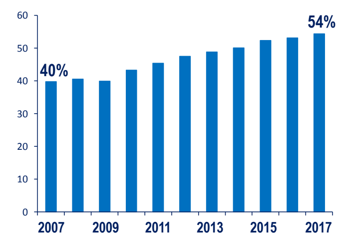
Outlook for the chemical industry in Italy

	2017 billions of €	% change in volume 2017	2018	2019
Domestic demand	62,4	2.5	2.1	1.8
Imports	37,1	4.2	2.9	3.0
Exports	30,0	6.5	2.0	2.6
Production	55,3	3.5	1.5	1.4

Domestic demand and exports
(indices in volume, 2007=100)



Exports share on turnover
(%)



Source: Istat, Federchimica

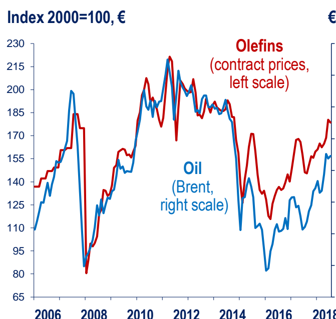
Rising raw materials costs from already high levels

In the past years the effects of the crisis and the competitiveness gap associated with high cost of energy and raw materials (ethane versus virgin naphta) have strongly affected margins and, consequently, investments in European basic chemicals, so that – following the recovery of demand – **companies have been operating with very high capacity utilization rates**, also in the first part of 2018.

Supply constraints have recently been exacerbated by the introduction in China of more restrictive environmental regulations, which have led to the closure of some productions in order to carry out necessary investments.

Tensions along the chemical supply chain

Price of oil and olefins in Europe



Current level of EU capacity utilization
(%, quarterly)

Source: EIA, ICIS, EU Commission

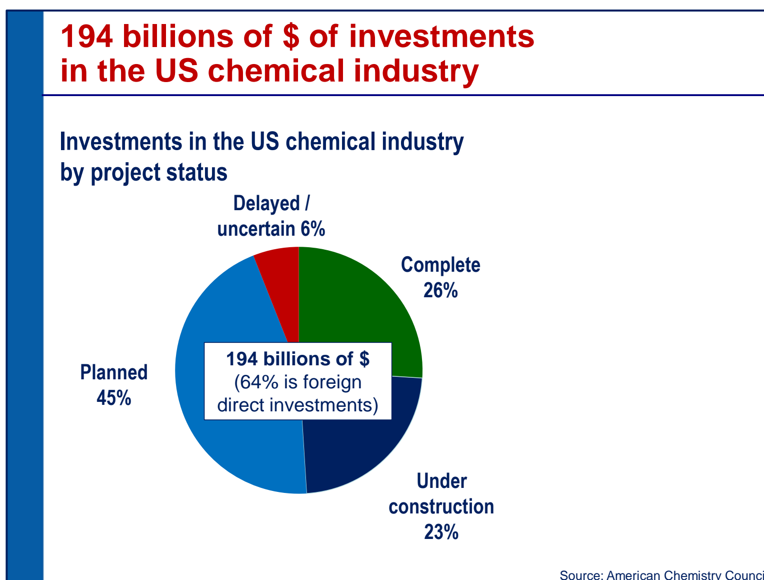
In this context and **in presence of a significant increase in oil prices compared to 2017 (Brent is expected around 70$ in the average of 2018), costs of raw materials in various chemical chains are above high levels of last year** and remain exposed to possible tensions in case of force majeur.

While EU slows down, US chemical industry is strengthening

While European chemical industry slows down, US production is strengthening (+3.4% expected this year and + 3.6% in 2019).

This reflects, first of all, the good performance of local economy, supported by solid fundamentals and by fiscal reform. Oil & gas has once again become one of the leading sectors, thanks to the significant rise in oil prices.

Furthermore, **effects of the extra-ordinary expansionary cycle of US chemicals supply (investments amount to 194 billions of $), made possible by shale oil & gas, are starting to materialize**. 26% of the expansion of production capacity has been completed and a further 23% is under construction.



According to some projections, US trade surplus could almost double in the next five years, even to the detriment of European chemicals.

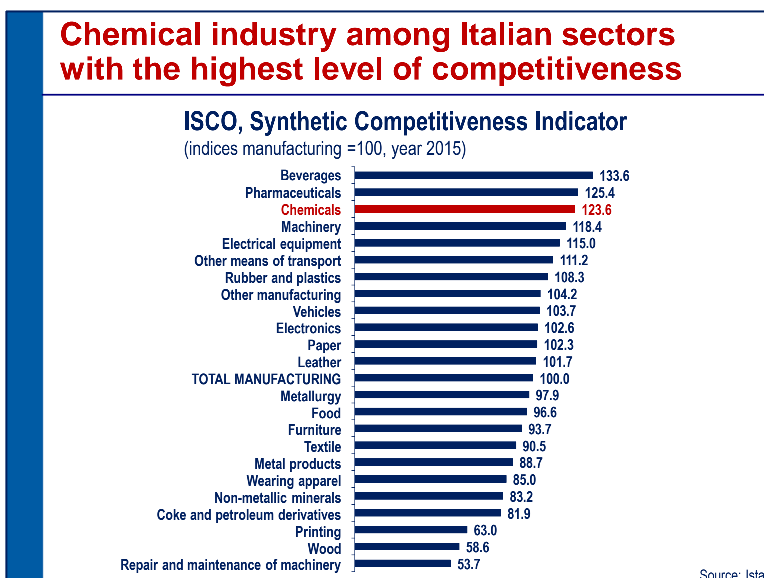
Also specialty chemicals are dynamic, both for the demand triggered by shale oil & gas and the development of other user sectors.

Chemical industry among the most competitive and productive sectors in Italy

In 2017 production value of chemical industry in Italy has amounted to approximately 55 billion euros and Italy remains the third largest chemical producer in Europe after Germany and France.

Its role derives especially from qualitative aspects – in particular its technological content and upstream positioning in the supply chains – which make chemical industry a "technological infrastructure" virtually for the entire Italian economic and industrial system.

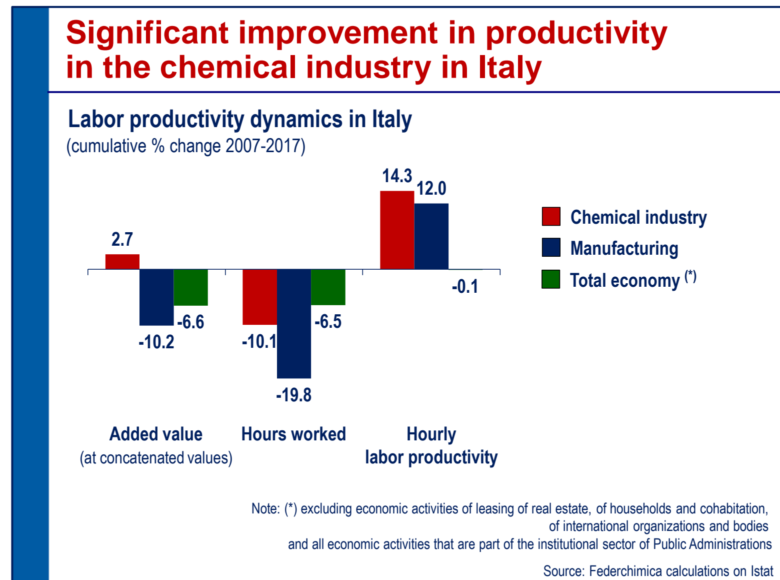
More and more indicators place chemical industry among the Italian sectors with the highest competitiveness, understood as the capability to continue to grow also in the medium to long term.



As a matter of fact, **according to ISTAT (Italian National Institute of Statistics), chemical industry is among the first three Italian sectors in the ranking based on the Synthetic Competitiveness Indicator (ISCO)**, which captures structural factors of competitiveness: internationalization, diffusion of innovation, productivity and profitability.

Productivity is a key factor in determining competitiveness and, consequently, the ability to grow and generate well-paid jobs.

Faced with a stagnant trend at national level, chemical industry has been able to increase its productivity by 14% since 2007 (measured as added value per hour worked) **reaching levels above Italian average of nearly 60%.**



This result has been achieved in a more virtuous way compared to Italian manufacturing average, through the growth of added value – confirming the increase in technological content of Italian chemical production – and with a more limited decline in worked hours.