Euler Hermes Economic Research

Country Report

Italy

Same old challenges

General Information

GDP	USD 1,814,763 bn (World ranking 8, World Bank 2015)
Population	60,81 mn (World ranking 23, World Bank 2015)
Form of state	Republic
Head of government	Paolo Gentiloni
Next elections	H1 2018, legislative

Strengths

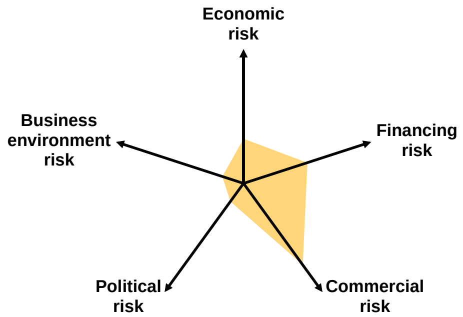
- Very diversified export structure
- Strong manufacturing sector
- Low private debt
- Primary fiscal surplus
- Domestically held public debt

Weaknesses

- Excessive stock of public debt
- Weak banking system
- Fragile political stability
- Weak business environment
- High fiscal pressure on companies
- Low R&D expenditures
- Decreasing long-term per capita income

Country Rating

A2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	12%	1	16%	Germany
France	11%	2	9%	France
United States	8%	3	6%	China
United Kingdom	5%	4	6%	Netherlands
Switzerland	5%	5	5%	Belgium

By product (% of total)

Exports		Rank		Imports
Engines	6%	1	9%	Crude Oil
Leather	5%	2	5%	Cars And Cycles
Specialized Machines	5%	3	5%	Pharmaceuticals
Pharmaceuticals	5%	4	5%	Natural Gas
Plastic Articles	4%	5	4%	Plastic Articles

Source: Chelem (2015)

Economic Overview

Weaker economic momentum

The oil dividend, albeit weaker compared to 2015, the rise in real wages, and the lower bank interest rates have supported private consumption growth in 2016. Investment – especially in equipment - has also contributed to growth.

In 2016, industry capacity utilization rates have reached the highest annual average since 2007 (76.3%). Construction investment has entered a recovery mode and constructors' confidence is at its highest since early 2008.

Export performance has been poor in 2016 (+1.2% vs. +4% in 2015, see Figure 1). This is due to the slowdown in emerging markets and weak advanced economies' growth. The stronger EUR has also played a negative role for Italian exports.

We forecast Italian GDP to grow by +0.9% in 2016, a slight acceleration from 2015. Yet growth should slow down to +0.6% in 2017, due to a still-mild confidence shock which is likely to hit banks and firms. This comes on the back of Prime Minister Renzi's decision to step down following his proposal's resounding defeat in the constitutional reform referendum held on December 4.

Figure 1: Key economic forecasts

Italy		**2015**	**2016**	**2017**	**2018**
GDP		0.6	0.9	0.6	0.8
Consumer Spending		1.5	1.4	1.2	1.6
Public Spending		-0.6	0.6	0.4	0.4
Investment		1.1	2.0	0.7	1.2
Construction		-0.8	1.1	1.0	1.8
Equipment		3.0	2.9	0.2	0.6
Stocks	*	0.0	-0.2	0.1	0.0
Exports		4.0	1.2	2.4	2.4
Imports		5.8	1.8	3.8	4.2
Net exports	*	-0.4	-0.1	-0.3	-0.5
Current account	**	27	26	25	23
Current account (% of GDP)		*1.6*	*1.6*	*1.5*	*1.3*
Employment		0.8	0.8	1.4	1.6
Unemployment rate		11.9	11.3	10.9	10.6
Wages		0.9	1.1	0.5	1.2
Inflation		-0.2	-0.1	1.0	1.2
General government balance	**	-42	-43	-41	-38
General government balance (% of GDP)		*-2.6*	*-2.6*	*-2.4*	*-2.2*
Public debt (% of GDP)		*132.3*	*132.6*	*132.1*	*133.0*
Nominal GDP	**	1639	1671	1693	1728

Change over the period, unless otherwise indicated:
*contribution to GDP growth
**EUR bn

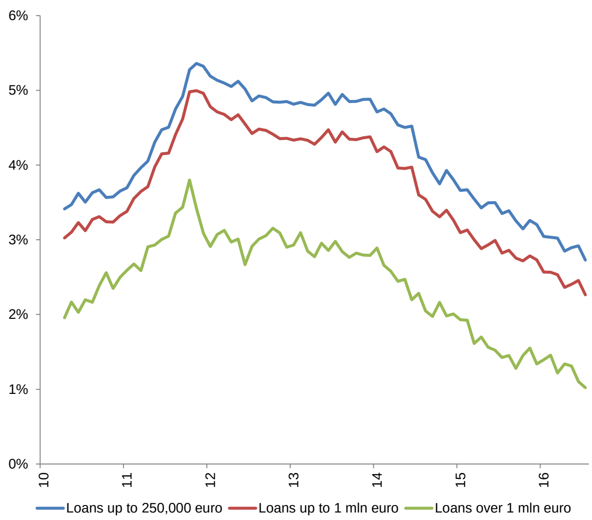
Sources: IHS, Euler Hermes

Italian firms are on a recovery mood, but political instability may be a drag

In Q2 2016, corporate profit margins have risen to 41.2% of the value added, sustained by lower energy prices and favorable financing conditions. Accommodative monetary policy by the ECB has significantly pushed down interest rates on corporate loans, although SMEs continue to face tighter conditions (see Figure 2). In turn, stronger profitability is boosting firms' investment (+2% in 2016) and pushing insolvencies down (-5% in 2016 and -6% in 2017).

Yet, political instability may impact Italian businesses through several channels. In particular, foreign investments may take a hit if the political turmoil intensifies while increasing pressures on banks could lead to a deterioration in financing conditions.

Figure 2: Bank interes rates on new corporate loans



Sources: Bank of Italy, IHS, Euler Hermes

Banks on the spot, confidence will be key

Although the stress tests conducted by the European Banking Authority last summer have confirmed the relative resilience of major Italian banks, the banking sector remains fragile. A number of small-medium sized banks, such as *Monte dei Paschi di Siena*, suffer from undercapitalization and high non-performing loans ratios. Importantly, Italian banks hold nearly EUR200bn of non-recoverable loans (*sofferenze*), equivalent to 12% of Italian GDP. This happens at a time when banks, especially smaller ones, are suffering from squeezed margins that leave little room for maneuvering.

With a number of M&A deals pending – *Banco Popolare* and *Banco Popolare di Milano* are prominent examples - further restructuring and consolidation efforts could follow. Privately-funded and government-sponsored solutions, such as the Atlas Fund which is supported by the Italian Treasury's guarantee schemes (GACS), are already in place. But investors' confidence, which depends on political stability and economic prospects, will play the pivotal role.

Still, Italy can count on stopgaps which should ward off the risk of a new sovereign-banking crisis:

(i) The **ECB** will continue to purchase Italian bonds through its QE program at least until the end of 2017. The current rate of purchases would be enough to compensate for a sell-off reminiscent of 2011-12. Still, punctual shocks are possible (see Figure 3).

(ii) **Stronger European institutions**. The Banking Union and bail-in rules provide a clearer framework for bank resolution excluding public intervention. Moreover, the European Stability Mechanism (ESM) would allow the ECB to purchase even more Italian sovereign bonds in the secondary market through the Outright Monetary Transactions program (OMT) if a Memorandum of Understanding is signed.

(iii) The **primary balance** surplus stood at +1.4% in 2015. It should reach +2% in 2018. Thus there could be some room for manoeuver in the face of higher interest expenditures for a year or so. The average interest rate on debt currently stands at around 3%. This allowed the Italian government to save EUR20bn over the past years

Reform momentum to slowdown in 2017

Notwithstanding spending review efforts, the stock of Italian public debt has peaked to EUR2255bn in July 2016. It is expected to reach 133% of GDP in 2016. As both primary surplus and low interest rates are still in place, the main problem remains sluggish GDP growth. The expected return of inflation should help. Yet Italy still needs to tackle its structural weakness: low productivity, linked to the well-known drags of high labor costs, dysfunctional training system, and limited innovation.

The Jobs Act is delivering but unemployment and labor costs remain high

The Jobs Act, implemented in March 2015, has contributed to the creation of more than 3.5 million jobs over the last 12 months (+56%, 12m/12m). Yet, unemployment is stuck around 11.5% and youth unemployment stands at a staggering 37.1%.

Labor costs are not helping. With a tax wedge of 47.9%, Italy remains well above the OECD average of 35.9%. Although the fiscal incentives included in the two last Budgetary Laws have pushed down labor costs by 4% y/y in Q2 2016 (excluding wages and salaries), these remain one-off solutions.

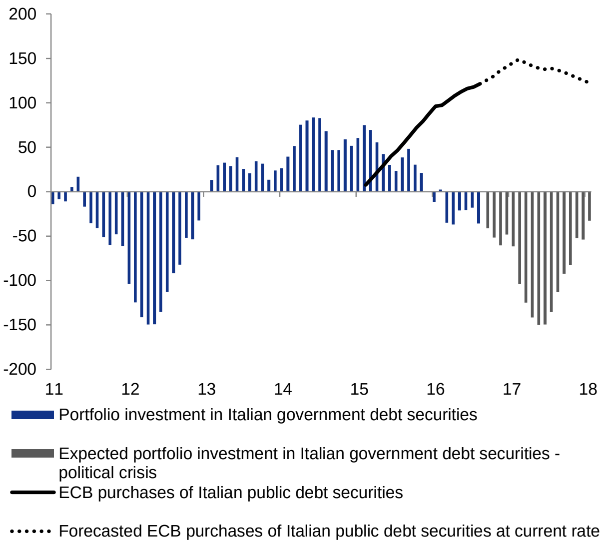
The new industrial plan (*Industria 4.0*) for revitalizing R&D investments is a positive step, but implementation risks remain

In order to boost innovation, the government has launched a 3-year industrial plan in September 2016. *Industria 4.0* designed to boost research and development expenditures. These represent only 1.3% of Italian GDP while the eurozone average is 2.1%. The plan aims at increasing private investments in R&D by EUR24bn by 2020.

The government has already committed EUR13bn to cover tax cuts on investments that will be realized in 2017. It also announced its intention to allocate additional EUR6.7bn for maximizing firms' access to ultra-broadband and strengthen its support to soft-loan schemes meant to boost machinery upgrades.

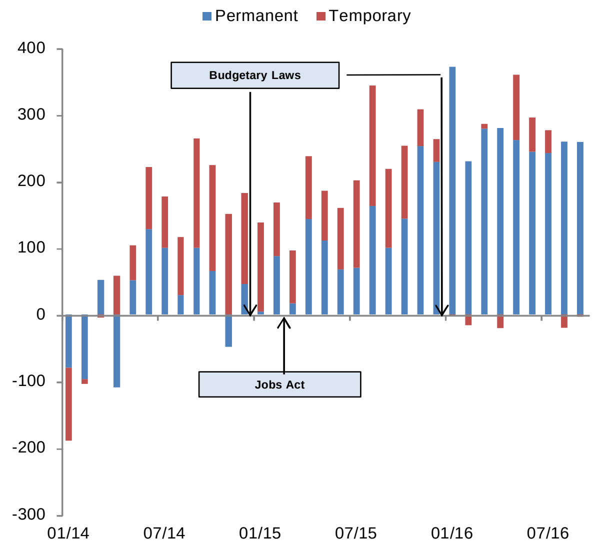
Figure 3: Portfolio investments in Italian government bonds vs. ECB's purchases of public debt securities

EUR bn, cumulative 12M



Sources: Bank of Italy, Bloomberg, Euler Hermes

Figure 4: Creation of new contracts



Sources: Istat, Euler Hermes

Last review: 2016-12-12
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