Euler Hermes Economic Research

Country Report

Italy

Pian piano… *(little by little)*

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Executive summary

- Euler Hermes expects Italy to exit a two-year recession in 2014 (+0.4% in 2014; +1.0% in 2015) thanks to export growth, ECB support and the Renzi effect on confidence.
- However, the positive pass through to companies is expected in 2015 as household consumption and credit are still subdued. As a result, payment terms will improve gradually (95 days in 2014 from 100 days in 2013) and insolvencies are expected to stabilize in H2 2014 before slightly moderating in 2015 (-2%).
- Political stability is welcome by the private sector but further action Is needed to fully support a conducive business environment.

Exports: Italy's safety net

GDP fell by -0.1% q/q in Q1 2014 but, excluding stocks, it increased by +0.1%. Private consumption increased by +0.1% q/q in Q1 and public spending by +0.4% q/q, the most rapid rate since 2011. Total investment contracted by -1.1% q/q, reflecting weakness in both construction and equipment. As a result, domestic demand continued to contribute negatively to GDP growth. The good news comes from the continued positive trend in exports (+0.8% q/q in Q1), which provided the highest contribution to GDP growth for the third consecutive quarter (see Chart 1). Wage moderation is ongoing and unit labour costs are stabilizing. Further, Italy should benefit from its comparative advantage in sectors like machinery and equipment and demand from emerging markets.

The ECB is helping

On top of the small bazooka this month, the ECB should implement further measures in the fall, once the Asset Quality Review and the stress tests are completed. A progressive private credit recovery, lower interest rates for credit to SMEs, lower pressures from the euro and moderately-rising inflation could help finance growth in 2015.

Companies continue to face challenges

For non-financial corporations, margins are at a record low due high employers' social contributions and high corporate taxes (see Chart 1). Further, micro-enterprises (with less than 10 employees)

Table 1: Key economic forecasts

Italy		Weights	2012	2013	2014	2015
GDP		100%	-2.5	-1.8	0.4	1.0
Consumer Spending		60%	-4.0	-2.6	0.1	0.6
Public Spending		21%	-2.6	-0.8	0.4	0.3
Investment		19%	-8.1	-4.6	-1.2	1.0
Stocks	*	0%	-0.5	-0.1	-0.1	0.1
Exports		29%	2.0	0.0	3.3	2.8
Imports		28%	-7.1	-2.9	1.4	2.0
Net exports	*	0%	2.6	0.8	0.6	0.3
Current account	**		-4	16	20	18
Current account (% of GDP)			*-0.3*	*1.0*	*1.2*	*1.1*
Employment			-0.3	-2.0	-1.0	-0.4
Unemployment rate			10.7	12.2	12.6	12.4
Wages			-0.1	-0.5	-0.2	-0.3
Inflation			3.0	1.2	0.5	0.9
General government balance	**		-45	-44	-44	-49
General government balance (% of GDP)			*-2.9*	*-2.8*	*-3.1*	*-2.5*
Public debt (% of GDP)			*127.0*	*132.3*	*134.7*	*133.2*
Nominal GDP	**		1567	1560	1586	1618

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

Sources: IHS Global Insight, Euler Hermes forecasts

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constitute the vast majority of the Italian companies and a much higher proportion than in the rest of the EU (94.4% of total companies, i.e. 2.3pps higher than the EU average). In addition, the average SME in Italy is half the size of the German one, and is often family owned and managed. This coupled with the strong fall in private consumption and the credit crunch (see Chart 2) explains why business insolvencies have been on the rise since 2008 and reached record levels in 2013 (14,086, more than double the 2007 levels). The past-through of the economic recovery should help business insolvencies stabilize in H2 2014 before a decrease by 2% in 2015, the first one in 7 years. Firms' payment practices are expected to improve going forward and average Days Sales Outstanding (DSO) should fall to 95 days in 2014 from 100 days on average in 2013(see Chart 3).

Finally, the country enters a period of political stability

As Matteo Renzi obtained a resounding victory in the European elections last May (the Democratic Party won more than 40% of the vote against 21% for the Eurosceptic M5S and 16.8% for Forza Italia), the risk of early elections is reduced. This success also granted him with a strong mandate to implement further structural reforms, expected in late 2014. Renzi's appointment last February has accompanied by skyrocketing business confidence and a return in capital inflows (see Chart 4).Will the *Renzimania* suffice?

Medium-term challenges remain important

Although Italian banks are in better shape after significant loan write-downs and capital increases to strengthen balance sheets, they still suffer from high levels of non-performing loans. On the public side, fiscal deficit has improved significantly since 2009, falling from 5.4% of GDP to 2.8% in 2013. In 2014, we expect fiscal deficit to increase slightly to 3.1% of GDP. Without debt repayments (above 5% of GDP), Italy would post a surplus of 2% of GDP. EUR250bn to refinance each year continues to make Italy's future extremely linked to market confidence.

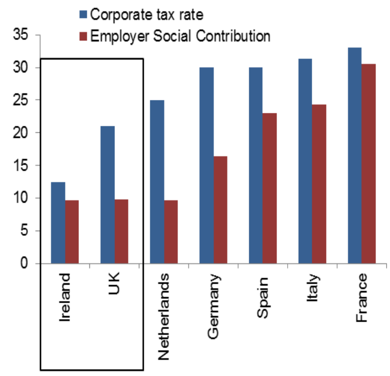
In our view, focus should remain on:

1/ Introducing as a public priority the support to investment and financing of the economy through a public investment bank (public-private partnership) and a 'bad bank' that would support deleveraging from non-performing loans and incentivize them to lend to the real economy. This would help improve firms' payment terms and investment decisions.

2/ Further reforms in public administration to simplify procedures and reduce costs and boost attractiveness. Further improvements to the degree of competition and lower entry barriers are needed.

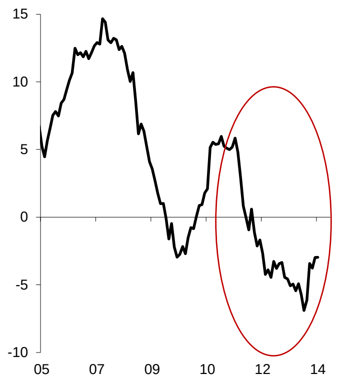
3/ Further sector liberalization to reduce energy, transportation and communication costs and support companies' profitability.

Chart 1: Fiscal pressure for companies



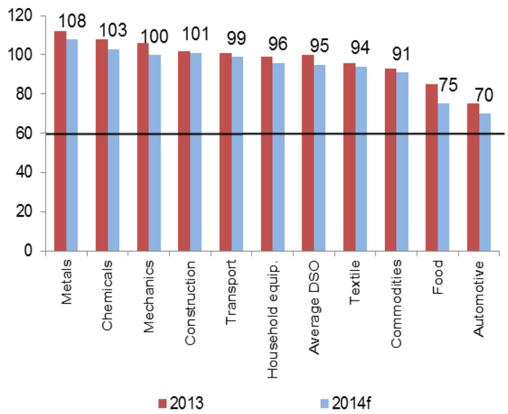
N.B.: Corporate tax in % of total profit;
Employer social contribution in % of total labour cost
Sources: OECD, European Commission, Euler Hermes

Chart 2: Credit to non-financial corporations, y/y, %



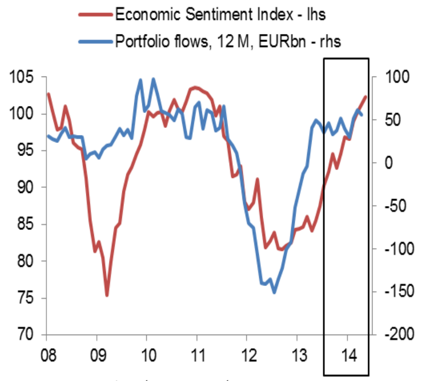
Sources: ECB, Euler Hermes

Chart 3: Average Days Sales Outstanding (DSO)



Sources: Euler Hermes forecasts

Chart 4: Economic Sentiment vs Portfolio inflows



Sources: national sources, Euler Hermes

General Information

GDP	USD2013.263bn (World ranking 9, World Bank 2012)
Population	60.92 million (World ranking 23, World Bank 2012)
Form of state	Republic
Head of government	Matteo RENZI
Next elections	2018, legislative

Strengths

- Geographical hub
- Very diversified export structure
- Strong manufacturing sector
- Developed infrastructure
- Low private debt
- Primary fiscal surplus

Weaknesses

- Excessive stock of public debt
- Weak business environment
- Record low profitability of firms
- High fiscal pressure on companies
- Low R&D expenditures
- Decreasing long-term per capita income

Trade structure

By destination / origin

Exports		Rank		Imports
Germany	13%	1	16%	Germany
France	11%	2	9%	France
United States	6%	3	7%	China
Spain	6%	4	6%	Netherlands
Switzerland	5%	5	5%	Spain

Source: Chelem

By product

Exports		Rank		Imports
Miscellaneous Hardware	7%	1	10%	Crude Oil
Engines	6%	2	6%	Cars And Cycles
Specialized Machines	5%	3	5%	Natural Gas
Leather	5%	4	4%	Pharmaceuticals
Refined Petroleum Products	4%	5	4%	Plastic Articles

Source: Chelem

Risk Dimensions

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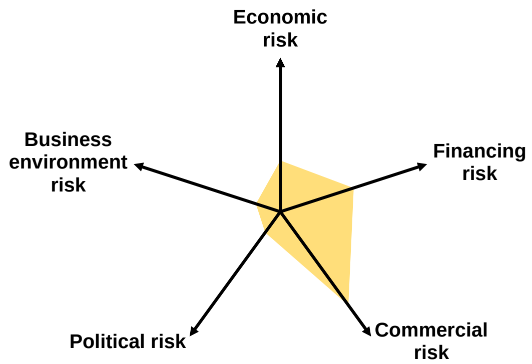

Source: Euler Hermes

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