Euler Hermes Economic Research

Country Report

Italy

Moving in the right direction – albeit at a snail's pace

General Information

GDP	USD 1,821,497bn (World ranking 8, World Bank 2015)
Population	60.73mn (World ranking 23, World Bank 2015)
Form of state	Republic
Head of government	Paolo Gentiloni
Next elections	H1 2018, legislative

Strengths

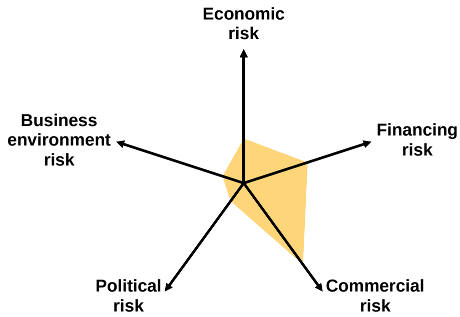
- Well-diversified export sector
- Strong manufacturing base
- Low private debt burden
- Primary fiscal surplus
- Strong domestic investor base for public debt

Weaknesses

- High public debt
- Fragile banking sector
- Growing political fragmentation
- Rigid business environment
- High fiscal pressure on corporates
- Low R&D expenditure

Country Rating

A2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	12%	1	16%	Germany
France	10%	2	9%	France
United States	9%	3	7%	China
United Kingdom	5%	4	6%	Belgium
Spain	5%	5	6%	Netherlands

By product (% of total)

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

Source: Chelem (2015)

Economic Overview

Economic momentum accelerating at last

In 2016 Italian GDP grew by 0.9%. Domestic demand – supported by favorable financing conditions, tax incentives aimed at boosting business investment and solid employment growth – was the main driver of economic growth. Meanwhile the growth contribution from net exports was negative with exports decelerating more than imports in the context of subdued global trade dynamics. The Italian economy has yet to recover to pre-crisis levels with 2016 GDP still 7% below the 2007 level.

For 2017 the outlook seems more promising: We forecast Italian GDP growth to accelerate to 1.2% – surpassing the 1% mark for the first time since the weak economic recovery started in mid-2013. In that context, the growth reading for the first quarter of 2017 is encouraging with economic activity expanding by 0.4% q/q – the highest quarterly growth rate in six years. In the coming months private consumption will not accelerate further in light of rising inflation (forecast: 1.4% in both 2017 and 2018) mitigated only to some extent by the positive – albeit weak – labor market trend. Investment meanwhile should expand further given improving growth prospects and still favorable financing conditions. Meanwhile Italian exports are set to benefit from the brighter growth outlook for key export markets, particularly in the eurozone, and a slightly lower EUR. In March 2017, the value of Italian goods exported rose more than 12% y/y, the highest rate since 2011. In 2018 Italian GDP growth will moderate to 1.0% in line with slowing economic momentum in the eurozone following the peak of the cyclical recovery.

Despite declining for the second consecutive year to 11.6% in 2016, Italy's unemployment rate still stood 5.6 ppts above the 2007 pre-crisis low. Going forward unemployment will continue to decline gradually remaining firmly above 11% over the forecast horizon. Following two years of strong gains driven by temporary reductions in social contributions employment growth will continue to accelerate but at a more gradual pace.

Slightly improving prospects for corporates

In Q4 2016, the profit share of non-financial corporations rose to 42% – the highest level since Q1 2012 – propped up by low energy prices and favorable financing conditions. However while the ECB's ultra-loose monetary policy has seen interest rates on corporate loans decline markedly, SMEs continue to face tighter financing conditions. Rising turnover and higher profitability are also key drivers behind the favorable insolvency trend (forecast: -11% in 2017 and -6% in 2018).

Italian banks: Some progress but still a long road ahead

In recent months some progress has been made in tackling the banking sector's woes. Overall systemic risk has been reduced by recapitalizing and/or restructuring several problem banks. In particular the prospects of a deal struck between the EU and Italy to rescue *Monte dei Paschi* with the bank agreeing to a deep restructuring including branch closures, executive pay cuts and forced losses on some investors in exchange for the injection of state funds is a sign of progress. An integral part of the deal is the EU agreeing to compensate retail junior bondholders that were not "adequately informed" about investment risks. With one problem likely resolved, several more troubled institutions remain for which a solution could be far harder to reach given that they are currently under-capitalized and hence not qualified for a precautionary

Figure 1: Key economic forecasts

Italy		2015	2016	2017	2018
GDP		0.7	1.0	1.2	1.0
Consumer Spending		1.6	1.3	1.2	1.2
Public Spending		-0.7	0.6	0.9	1.2
Investment		1.4	3.1	2.0	2.0
Stocks	*	0.2	-0.4	0.2	-0.1
Exports		4.1	2.6	4.0	2.7
Imports		6.7	3.1	5.1	3.4
Net exports	*	-0.5	-0.1	-0.2	-0.2
Current account	**	24	34	30	28
Current account (% of GDP)		*1.4*	*2.0*	*1.8*	*1.7*
Employment		0.8	1.3	1.3	1.6
Unemployment rate		11.9	11.7	11.5	11.3
Inflation		0.0	-0.1	1.4	1.4
General government balance	**	-44	-40	-37	-38
General government balance (% of GDP)		*-2.7*	*-2.4*	*-2.2*	*-2.2*
Public debt (% of GDP)		*132.1*	*132.6*	*133.0*	*132.3*
Nominal GDP	**	1642	1673	1693	1718

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

Sources: IHS, Allianz Research

Figure 2: Real GDP growth (%, y/y)

Sources: Eurostat, Datastrem, Allianz Research

Figure 3: Employment (rhs) & unemployment rate (lhs)

Sources: Eurostat, Allianz Research

recapitalization according to EU rules while the Italian government is set on avoiding a bail-in. Next to putting out fires e.g. shoring up the remaining struggling banks and tackling the high share of NPLs (18% of total loans), more action aimed at structurally strengthening the sector is needed. Key objectives include improving governance as well as raising banks' profitability and capitalization with the latter two requiring not only cost-cutting measures but also consolidation of Italy's fragmented banking sector.

Bleak reform prospects

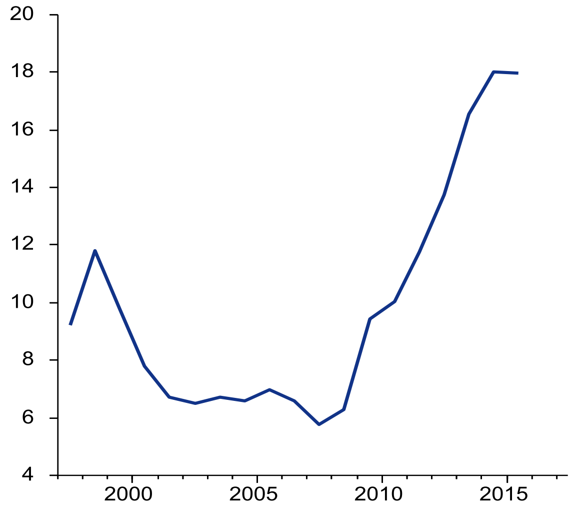
Italy's current growth potential registers close to zero – one of the lowest rates in the developed world. Italy sorely needs higher growth to address its many fundamental problems, from stifling public debt (133% of GDP in 2017) to a fast aging population and an undercapitalized banking sector.

Boosting economic growth prospects for Italy will require far-reaching reforms and hence hinges to a large degree on political developments. Hopes for political and economic reform in the near term were dashed in December when the "No" outcome of the constitutional referendum triggered Matteo Renzi's resignation. The Gentiloni government is too weak to enact any reforms before the next general election, which has to take place no later than May 20 2018. Moreover the government will be busy tackling the following three issues: reforming the electoral law, ensuring passage of the 2018 budget law and pushing ahead with measures to at least stabilize if not reform the banking sector. In addition there will be little appetite to implement unpopular structural reforms or additional fiscal consolidation measures ahead of a general election.

Yet it also remains far from certain that reform momentum will pick up markedly with a newly elected government. Currently, Renzi's Democratic Party (PD) and the anti-establishment Movimento 5 Stelle (M5S) are polling neck-on-neck at around 30%. In recent weeks the threat of a populist win has receded, but Italy remains significantly exposed to the risk of a hung parliament with a centrist coalition government headed by the PD likely to struggle to cobble together a majority. The lack of a stable, pro-reform government coupled with an expected announcement by the ECB to move towards a normalization of monetary policy, could trigger a sell-off in Italian debt markets.

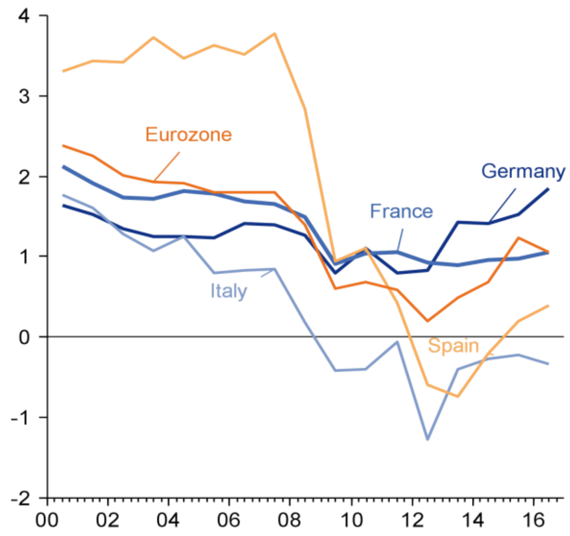
In the short-run, however, Italy's refinancing risk remains limited even in the event of a sharp deterioration in sovereign financing conditions. Mitigating factors include the ECB's active (quantitative easing) as well as ready-to-deploy policy tools (Outright Monetary Transactions program), a long average debt maturity profile coupled with a low average interest rate, a moderate budget deficit (-2.2% on average in 2017-18) and limited external imbalances including a current account surplus.

Figure 4: Non-performing loans (% of total gross loans)



Sources: World Bank, Allianz Research

Figure 5: Potential GDP growth (%, y/y)



Sources: EU Commission, Allianz Research

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