Euler Hermes Economic Research

Economic Insight

Renzimania: Will charm survive tough reforms?

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Executive summary

- The reform package announced by the new PM Matteo Renzi is likely to boost GDP growth by 0.2pps in 2014-15 to 0.4% and +0.9% according to our forecasts with possible positive surprises.
- However, business insolvencies are expected to remain on the rise in 2014 (+4%), credit crunch is still on and payment delays will remain high (at 98 days on average).
- Going forward, Renzi reform agenda is likely to focus on the labor market (Jobs Act), the housing market, the constitutional reform and a new electoral law. Risks remain skewed on the downside given the weak governing coalition.
- Further reforms are needed to support credit, ease fiscal pressure on companies and reduce energy and transportation costs.

The 'Renzi' effect

Matteo Renzi, new Prime Minister since 22 February 2014, unveiled a package of tax cuts and other measures that are likely to support the economy in the short-term.

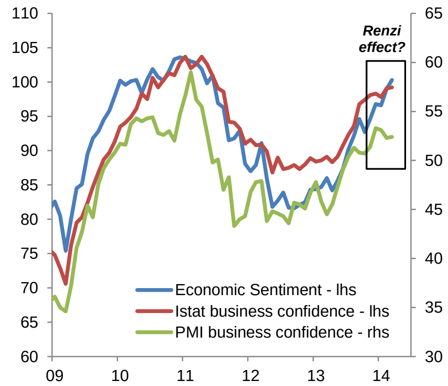
Business confidence, already recovering since several months, shows signs of acceleration since Renzi came in place (see Chart 1). The return in confidence is essential for the economy and for foreign investors and we expect a positive impact on consumer spending and private investment in 2014-2015. A return in confidence could also signal a return of foreign investors in Italy and positive effects start to emerge (see Chart 2). Indeed, Renzi is seen as a 'reformer' of Italy by his people, foreign investors and European leaders.

Renzi: Act 1

Renzi first reforms (outlined below) are likely to boost GDP growth by 0.2pps in 2014-15 (see Table 1) to 0.4% and +0.9% according to our forecasts with possible positive surprises. The return in confidence, if sustainable, could support even further private investment and foreign inflows in the coming quarters, in which case GDP growth forecasts would go to 0.6% in 2014 and to 1.1% in 2015.

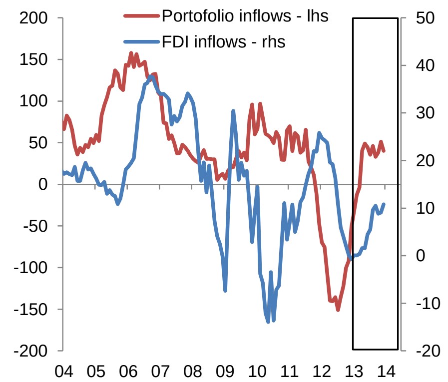
From a political point of view, these measures could strengthen Renzi's position in parliament for future more painful reforms.

Chart 1: Business confidence index



Sources: Bloomberg, Eurostat, Istat, Euler Hermes

Chart2: Foreign direct and portfolio investment flows (12M, EURbn)



Sources: Eurostat, Euler Hermes

Renzi reform package:

1/ EUR10bn of tax cuts for low income earners (up to EUR1,500 per month). Ten million people earning less than EUR25,000 per year would benefit from this measure (i.e. around 39% of the total labour force).

→ Impact in 2014-15: Support GDP growth by 0.2pp through higher consumer spending, but to weigh on fiscal deficit (+0.6% of GDP).

2/ modest reduction in the tax burden on businesses of EUR2.4bn by a 10pps cut in the regional IRAP business tax paid by employers. IRAP is generally levied at 3.9% on a tax basis which differs from the corporate income tax (IRES) basis.

→ Impact in 2014-15: Moderate positive support on GDP growth (<0.1pp) through higher private investment. Negative impact on fiscal deficit (+0.2% of GDP).

3/ EUR3.5bn of investment in schools and social housing.

→ Impact in 2014-15: Moderate positive support to GDP growth (+0.1pp) through higher public investment, but negative impact on fiscal deficit (+0.2% of GDP).

4/ EUR500m of cuts in salaries for high income earners in the public sector.

→ Impact in 2014-15: Very limited.

5/ repayment of around EUR68bn of government arrears owed by the state to private sector companies by September 2014. This could lead to higher VAT revenues (EUR5bn or 0.3% of GDP according to CGIA estimates). As a reminder, the Letta government already paid EUR23bn in 2013.

→ Impact in 2014-15: Limited, but if achieved this could free additional cash flow for firms.

All in all, as outlined above these measures are likely to support GDP growth by 0.2pp in 2014-15, but to increase fiscal deficit by 0.4% of GDP (see Table 1 and Table 2).

The government announced that these measures will be mainly financed through:

1/ spending cuts: additional EUR3 to 5bn are planned for this year and some leeway is available on expenditures for general public services that stand above the eurozone average. Further EUR2bn should come from lower interest expenditures thanks to the fall in bond yields.

2/ tax increases on capital gains: the tax rate on income earned from financial instruments, excluding sovereign bonds, will be raised from 20% to 26%.

We anticipate further EUR5bn of spending cuts in 2015, in line with the spending review that the Renzi government announced: spending cuts of 2% of GDP by 2016 (i.e. EUR31bn). However, the spending review as a whole seems quite ambitious.

Table 1: Estimated impact on GDP growth and fiscal deficit of Renzi reforms in 2014-15

Measure	Total amount	Cumulative impact on GDP growth in 2014-15 *(point of GDP growth)*	Cumulative impact on fiscal deficit in 2014-15 *(% of GDP)*
Lower tax on labour for low income earners (up to EUR1,500/month)	EUR10bn	0.2	0.6
Lower tax burden on businesses (10pps cut in the regional IRAP rate)	EUR2.4bn	0.1	0.2
Investment in schools and social housing	EUR3.5bn	0.1	0.2
Repayment of government arrears owed by the state to private sector companies by Sept 2014	EUR68bn	Limited	0.3
Cuts in salaries for high income earners in the public sector	EUR500m	Very limited	-0.03
Spending cuts in 2014	EUR3 to 5bn	-0.1	-0.3
Lower public interest expenditures	EUR2bn	Limited	-0.1
Increase in tax rate on income earned from financial instruments, excl. sovereign bonds (from 20% to 26%.)	EUR2.4bn	Limited	-0.2
Spending cuts in 2015	EUR3 to 5bn	-0.1	-0.3
Total		**0.2**	**0.4**

N.B.: A positive number for the impact on GDP growth suggests an increase in GDP growth; A positive number for the impact on the fiscal deficit suggests a rise in fiscal deficit.

Source: Euler Hermes

Table 2: Key economic forecasts

Italy		Weights	2012	2013	2014	2015
GDP		100%	-2.5	-1.8	0.4	0.9
Consumer Spending		60%	-4.0	-2.6	-0.1	0.8
Public Spending		21%	-2.6	-0.8	0.0	0.0
Investment		19%	-8.1	-4.6	-0.6	0.4
Stocks	*	0%	-0.5	-0.1	0.0	0.1
Exports		29%	2.0	0.0	2.3	2.6
Imports		28%	-7.1	-2.9	0.8	1.9
Net exports	*	0%	2.6	0.8	0.5	0.3
Current account	**		-6	12	15	15
Current account (% of GDP)			*-0.4*	*0.8*	*1.0*	*0.9*
Employment			-0.3	-2.0	-1.0	-0.5
Unemployment rate			10.7	12.2	12.5	12.3
Wages			-0.1	-0.4	0.2	-0.1
Inflation			3.0	1.2	1.0	1.2
General government balance	**		-45	-47	-47	-49
General government balance (% of GDP)			*-2.9*	*-3.0*	*-3.1*	*-2.5*
Public debt (% of GDP)			*127.0*	*132.5*	*134.9*	*133.6*
Nominal GDP	**		1567	1560	1584	1617

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

Source: Euler Hermes

Hence, fiscal deficit targets seem optimistic and we would not be surprised to see an upward revision for 2014 from 2.6% of GDP to 3.0% of GDP.

What about the private sector?

Competitiveness has eroded progressively since 1999 because of the euro appreciation but also continuous wage increases. Unit labour costs remain above the 2000 level. As a result, non-financial corporations margins are at a record low (at 38% of value added). Labour taxes are very high in Italy while the corporate tax remains one of the highest in the eurozone (see Chart 3).

In addition, since mid-2012 Italian corporates suffer from the absence of credit more than its European peers (see Chart 4) given the need for banks to restore their balance sheets on the back of still very high levels of non-performing loans (20% of total loans in 2013).

Thus, businesses tend to increasingly use payment delays to limit the damage caused by the credit crunch. The average Days Sales Outstanding (DSO) increased from 97 days in 2012 to 100 days in 2013 (compared with a regulatory DSO of 60 days) and they are expected to moderate only slightly in 2014 (to 98 days on average) – see Chart 5.

Business insolvencies are expected to continue to increase, by 4% in 2014 after 12% in 2013 (currently at a record level of around 14,086, more than double the 2007 level – see Chart 6).

Renzi: Act 2

Much still needs to be done. Future tax cuts need to focus more on corporates. Indeed, private investment continues to be hurt by the weak business environment due to the credit crunch, high corporate taxes and high employers' social contributions as explained above.

All eyes will be on future structural reforms that Renzi committed to announce in late 2014 (see Chart 7).

The focus will be on:

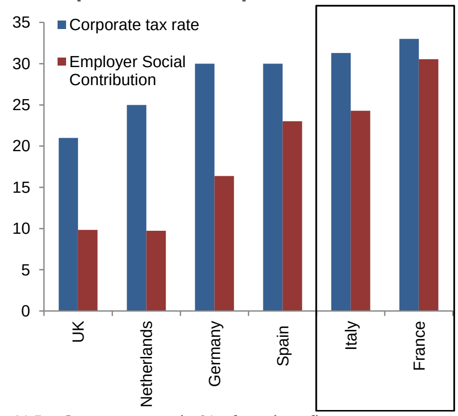
1/ The labor market (Jobs Act) with the introduction of an universal unemployment benefit, cut in employment taxes, introduction of tax incentives for companies that create jobs and ease employment protection (one of the highest in the eurozone).

2/ The housing market through the reduction of taxes on rental housing and provision young couples with affordable home loans.

3/ A constitutional reform;

4/ A new electoral law aiming to simplify the electoral system and to facilitate coalition formation by changing the powers of The Chamber of Deputies and the Senate, currently perfectly balanced, and the electoral thresholds.

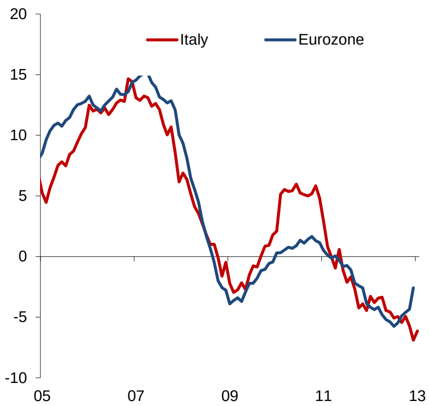
Chart 3: Fiscal pressure for companies



N.B.: Corporate tax in % of total profit;
Employer social contribution in % of total labour cost

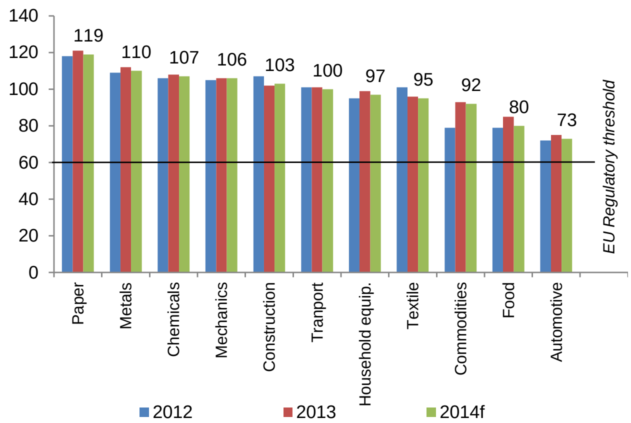
Sources: OECD, European Commission, Euler Hermes

Chart 4: Credit to non-financial corporations, y/y, %



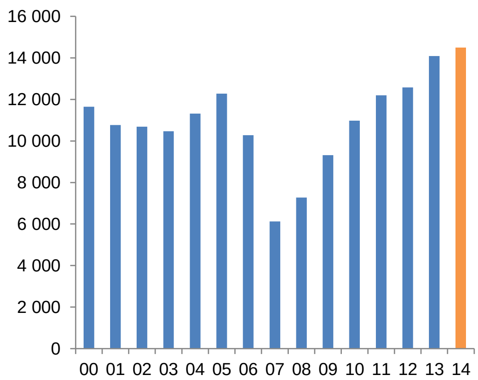
Sources: ECB, Euler Hermes

Chart 5: Average Days Sales Outstanding (DSO)



Source: Euler Hermes forecasts

Chart 6: Business insolvencies, number



Source: Euler Hermes forecasts

However, there are downside risks to Renzi reform agenda. This is notably due to the fragile political environment given the weak governing coalition. Early elections by mid-2015 (vs. 2018 as currently scheduled) are not excluded as soon as the electoral law would be adopted by the Senate.

In our view, remaining unresolved issues that are not yet on Renzi reform agenda focus on:

1/ Introducing a public credit policy through a public investment bank (public-private partnerships) and a 'bad bank' that would support banks deleverage from non-performing loans and therefore incentivize them to lend to the real economy. This would help improve firms' payment terms.

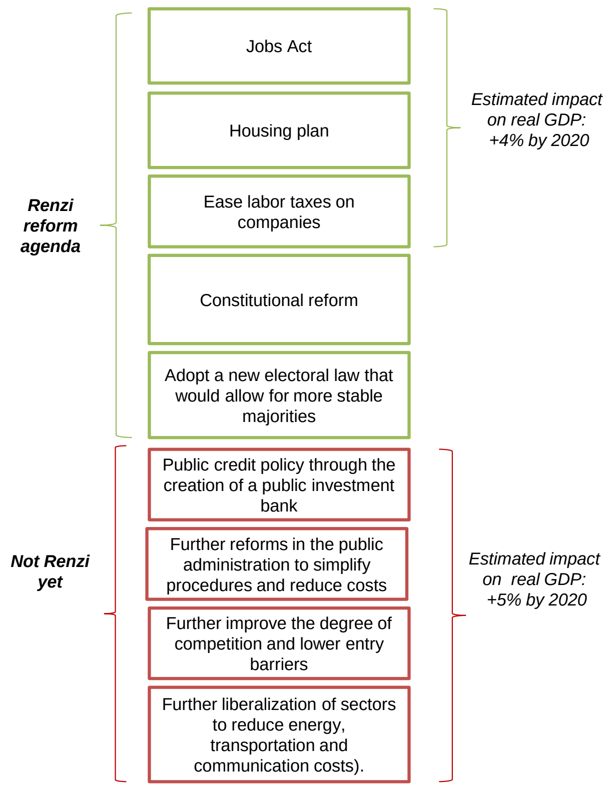
2/ Further reforms in the public administration to simply procedures and reduce costs.

3/ Further improve the degree of competition and lower entry barriers.

4/ Further liberalize sector to reduce energy, transportation and communication costs.

External pressure to implement these measures could come from the European Commission that has recently put Italy on a 'watch list' due to its high public debt and weak competitiveness and expects the government to show commitment in terms of further structural reforms.

Chart 7: Roadmap for reforms



Source: Euler Hermes

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