Country report **ITALY**

Summary

The Italian economy fell back into recession in the second half of 2011. We expect the recession to continue in the first half of 2012 and for unemployment to rise further. The government budget deficit of 3.9% of GDP for 2011 was in line with the target. The technocratic government of Mario Monti has been proactive in pushing through further budget cuts and structural reform. Given financial markets nervousness to anything that looks like fiscal slippage or less ambitious budget targets, an important question is to what extent the Monti government will be able to guarantee medium term budget balance beyond the April 2013 elections.

Things to watch:

- Government deficit reduction
- Success or failure in deciding on and implementing structural reforms
- Monti's legacy for beyond 2013
- Financial market pressure, European support mechanisms

Author: **Tim Legierse**
International Macro Economic Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62677
T.Legierse@rn.rabobank.nl

Italy

National facts	
Type of government	Republic
Capital	Rome
Surface area (thousand sq km)	301
Population (millions)	60.6
Main languages	Italian
Main religions	Roman Catholic 90%
Head of State (president)	Giorgio Napolitano
Head of Government (prime-minister)	Mario Monti
Monetary unit	EUR

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	2203	3.19
Nominal GDP at PPP	1952	2.47
Export value of goods and services	630	2.88
IMF quotum (in mln SDR)	7882	3.63
Economic structure	*2011*	*5-year av.*
Real GDP growth	0.4	-0.2
Agriculture (% of GDP)	2	2
Industry (% of GDP)	25	26
Services (% of GDP)	73	72
Standards of living	*USD*	*% world av.*
Nominal GDP per head	36240	336
Nominal GDP per head at PPP	32111	260
Real GDP per head	29201	359

Social and governance indicators	rank / total
Human Development Index (rank)	24 / 187
Ease of Doing Business Index (rank)	87 / 183
Index of Economic Freedom (rank)	92 / 179
Corruption Perceptions Index (rank)	69 / 183
Press Freedom Index (rank)	61 / 178
Gini index (income distribution)	36.0
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	13	Germany	16
France	12	France	8
US	6	Netherlands	5
UK	5	UK	3

Main export products (%)	
Machinery and transport equipment	35
Chemicals and related products, n.e.s.	11
Food, drinks and tobacco	7
Mineral fuels, lubricants, and related materi‹	5
Main import products (%)	
Machinery and transport equipment	27
Mineral fuels, lubricants, and related materi‹	19
Chemicals and related products, n.e.s.	13
Food, drinks and tobacco	8
Openness of the economy	
Export value of G&S (% of GDP)	27
Import value of G&S (% of GDP)	28
Inward FDI (% of GDP)	0.5

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Back in recession

The Italian economy fell back into recession in the second half of 2011, with output contracting by 0.2% and 0.7% in the third and fourth quarter respectively. The renewed recession follows on six quarters of consecutive growth in the modest recovery that followed on the deep recession of 2008/09. In the last quarter of 2011, real GDP was 5.2% smaller than the pre-recession level of the first quarter of 2008. The escalation of the European debt crisis and a series of government budget adjustments resulted in a sharp deterioration of consumer confidence. Producer confidence also fell sharply. With the government in austerity mode, this has resulted in a decline of domestic demand in the second half of the year, which was only partially compensated for by lower imports. And while exports contributed to economic growth up until the third quarter, it stagnated in the final quarter of the year. We expect the recession to continue in the first half of 2012. But given the relatively modest drag of fiscal policy when compared to other Southern European countries and some more firming of the recent improvement in consumer sentiment, renewed export growth might be sufficient to pull the economy back out of recession in the second half of the year. Of course, this is partly dependent on the relative stability in financial markets not giving way again to the stress levels seen last year. With the onset of the recovery, the unemployment rate fell slightly in the second half of 2010. But in the second half of 2011, the rise in unemployment resumed, rising from 8.3% of the labor force in July 2011 to 9.3% in February 2012. This compares to a previous high of 8.7% in May 2010 and a pre-recession low of 6%. We expect unemployment to rise further with the onset of recession and given our expectation of only limited economic growth in 2013 we see only limited room for a fall in unemployment in 2013.

Monti to the rescue

For all the commentary on former Prime Minister Silvio Berlusconi and all the praise of his technocratic successor Mario Monti, the plain fact is that under Berlusconi and his finance minister Giulio Tremonti Italy posted a better than planned budget deficit in 2010 and met a revised stricter budget deficit target of 3.9% of GDP in 2011. Pressure arising from rising government bond yields resulted in sharp changes to the planned deficit reduction schedule, from aiming to bring the deficit back under 3% in 2013 as agreed with the European Commission to achieving budget balance in that year. Given the limited size of the budget deficit and the relatively modest sustainability deficit in light of the ageing of the population, to us the market reaction toward Italy was as much due to uncertainty about European rescue facilities as it was about worries concerning Italy's fiscal outlook. The net effect of it all is that Italy has been forced to accelerate its fiscal consolidation, which together with the negative impact of uncertainty created by financial market pressure is undermining the already sluggish economic recovery. This will actually make it somewhat harder to achieve the balanced budget in 2013. Even so, we expect to see a further gradual reduction in the budget deficit. This will most probably be good enough for the European Commission as the deficit will perhaps already fall below 3% this year. But slippage relative to targets may be conductive in fanning renewed market pressure.

Structural reform for the Italian economy was long overdue, so the measures taken by Mario Monti to liberalize sheltered services since taking office are very welcome. The current proposal to liberalize the labor market is also a positive development, although it remains to be seen how potent the law approved by parliament will be. In any case, structural reforms will not alter the near term outlook for recession and weak growth. But they may well prove beneficial in the medium term.

Given financial markets nervousness to anything that looks like fiscal slippage or less ambitious budget targets, an important question is to what extent the Monti government will be able to guarantee medium term budget balance beyond the April 2013 elections. These elections may well lead to the return of political instability and renewed financial market pressure. We cannot exclude that a sharp and persistent rise in interest rates will necessitate further secondary market purchases by the ECB or the EFSF. Progress on a more potent European rescue mechanism might also be instrumental in calming markets. But if this all fails to keep government bond yields from rising sharply and remaining high for an extended period of time, we cannot exclude the need for some other form of official assistance. Apart from the possibility of self-fulfilling market expectations leading to unsustainably high interest rates, we regard Italian government debt to be sustainable, especially if already enacted spending reform is flanked by successfully implemented growth enhancing economic reform. We also would assume that if some form of official financial assistance is necessary, a sustainability analysis by the IMF/EC that looks at the possibility of stabilizing and lowering the debt ratio with a reasonable macro-economic adjustment package would lead to a positive assessment and that restructuring of private sector government bonds would not be part of such assistance.

Italy

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	1.6	-1.2	-5.1	1.4	0.4	-1.5	0.0
Consumer prices (average % change pa)	2.0	3.5	0.8	1.6	2.9	2.8	1.5
Current account balance (% of GDP)	-2.4	-2.9	-1.9	-3.5	-3.2	-2.7	-2.0
Economic growth							
GDP (% real change pa)	1.6	-1.2	-5.1	1.4	0.4	-1.5	0.0
Gross fixed investment (% real change pa)	1.3	-3.8	-11.7	2.3	-1.9	0.0	0.0
Private consumption (real % change pa)	1.1	-0.8	-1.6	1.1	0.2	-3.1	-1.0
Government consumption (% real change pa)	1.0	0.6	1.0	-0.5	-0.3	-1.0	-1.0
Exports of G&S (% real change pa)	5.6	-2.8	-17.7	12.0	5.6	-0.1	1.0
Imports of G&S (% real change pa)	4.6	-2.9	-13.6	12.4	0.4	-1.2	-1.6
Economic policy							
Budget balance (% of GDP)	-1.5	-2.7	-5.4	-4.6	-3.9	-2.2	-1.1
Public debt (% of GDP)	103	106	115	119	120	120	120
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	1.0	0.8
M2 growth (% change pa)	21	9	6	17	6	4	2
Consumer prices (average % change pa)	2.0	3.5	0.8	1.6	2.9	2.8	1.5
Exchange rate LCU to USD (average)	0.7	0.7	0.7	0.8	0.7	0.8	0.8
Recorded unemployment (%)	6.1	6.8	7.8	8.4	8.4	9.5	9.4
Balance of payments (mln USD)							
Current account balance	-51574	-66252	-41003	-72015	-70400	-54000	-40300
Trade balance	4581	-2841	1458	-27278	-21100	-17000	-3900
Export value of goods	501281	545080	407457	448375	516000	474100	471900
Import value of goods	496700	547920	406000	475650	537200	491000	475800
Services balance	-9662	-12564	-11477	-12183	-5600	-2600	-1700
Income balance	-26799	-28640	-14254	-11410	-22200	-14600	-15400
Transfer balance	-19696	-22207	-16731	-21144	-21500	-19800	-19300
Net direct investment flows	-52076	-79008	-3189	-23009	-31160	-32240	-34060
External position (mln USD)							
International investment position	-560920	-528360	-565210	-507920	n.a.	n.a.	n.a.
Total assets	2637450	2345900	2544790	2452520	n.a.	n.a.	n.a.
Total liabilities	3198370	2874260	3110000	2960440	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	0.2	-0.1	0.1	-1.3	-1.0	-0.8	-0.2
Current account balance (% of GDP)	-2.4	-2.9	-1.9	-3.5	-3.2	-2.7	-2.0
Inward FDI (% of GDP)	1.9	-0.4	0.8	0.5	0.4	0.5	0.5
International investment position (% of GDP)	-26.3	-22.8	-26.6	-24.6	n.a.	n.a.	n.a.

Source: EIU