Economic Update Italy

5 June 2012

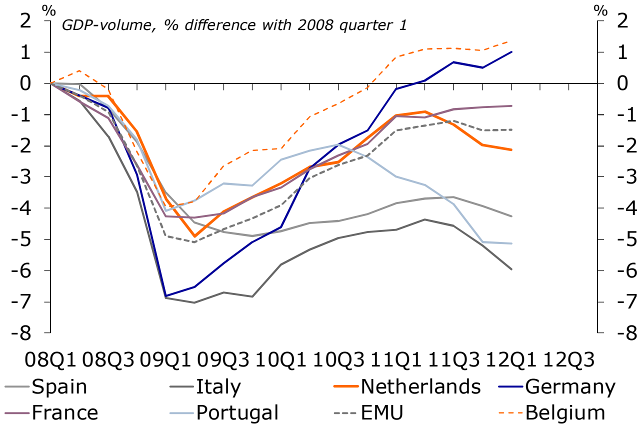
Recession continues…

Year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0.5	-2	¼
Private consumption	0.4	-3	-¼
Government consumption	-0.9	0	½
Investment	-1.2	-9¾	-1
Exports	6.3	¼	3
Imports	1.0	-9¼	3¼
Inflation	2.9	2¼	1½
Unemployment (%)	8.5	10¼	10¼
Government balance (% GDP)	-3.9	-3	-2
Government debt (% GDP)	120.1	124	125

Source: Reuters EcoWin, Rabobank

In the first quarter of 2012, Italian GDP fell back for the third quarter in a row. The contraction accelerated to 0.8% q-o-q in 12Q1 after 0.7% in 11Q4. The quickly rising unemployment rate has kept wage growth in check, leaving it significantly below the rate of inflation. Consumer and producer confidence has deteriorated over the past months. As a result, domestic demand is set to continue on its declining path. With most of the European trading partners in recession as well, export growth will not be able to compensate for that. This makes it very likely that the recession stretches out into the third quarter of 2012, making deficit reduction by the government very challenging.

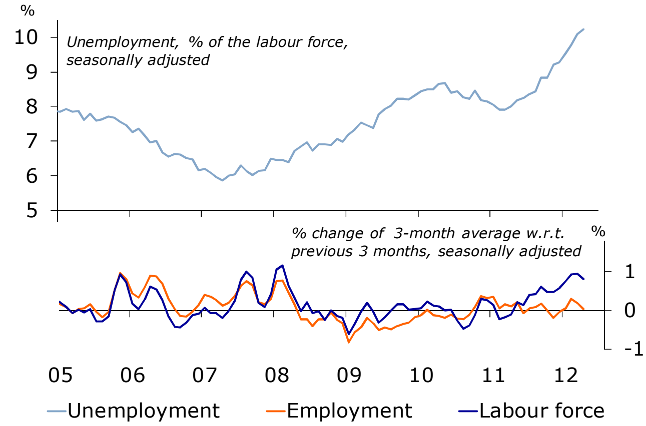
GDP falls back further



Source: Reuters EcoWin

After falling GDP of 0.2% q-o-q in 11Q3 and 0.7% in 11Q4, Italy's economic contraction accelerated further, to 0.8%, in 12Q1. The deepening recession stands in contrast to the aggregate eurozone, which managed to avoid a widely expected second quarterly drop in output. In Spain, the pace of contraction was the same as in the previous quarter while in Portugal it moderated substantially. The expenditure breakdown is not published yet, but available information points to a simultaneous fall in domestic and external demand. A further contraction in 12Q2 and beyond is likely, pushing the GDP level back towards previous recession lows.

Unemployment rises quickly…



Source: Reuters EcoWin

The renewed recession since 11Q3 has been accompanied by a quickly rising unemployment rate. Remarkably though, the rise in unemployment can hardly be explained by falling employment. In fact, it is almost completely due to the sharp increase in the labour force, which comes on the back of a rising participation rate. Given the broad-based economic weakness we would have expected discouraged workers to drop out of the labour force, leading to a lower participation rate as we have observed in the previous period of recession. The rise in the participation rate has been concentrated in the 55-65 age range, which seems to be the result of the rise in the effective statutory retirement age keeping older workers in the labour force.

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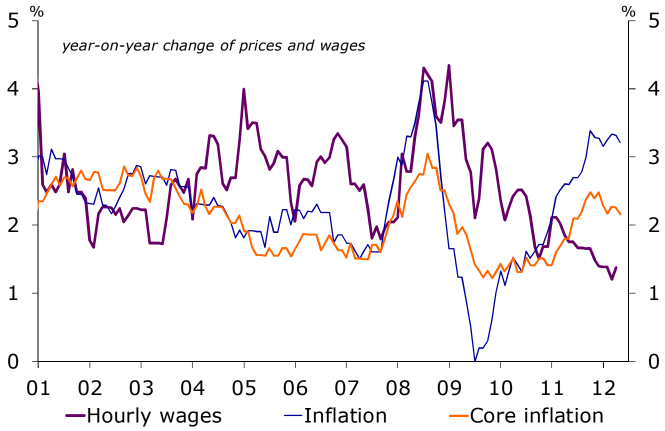
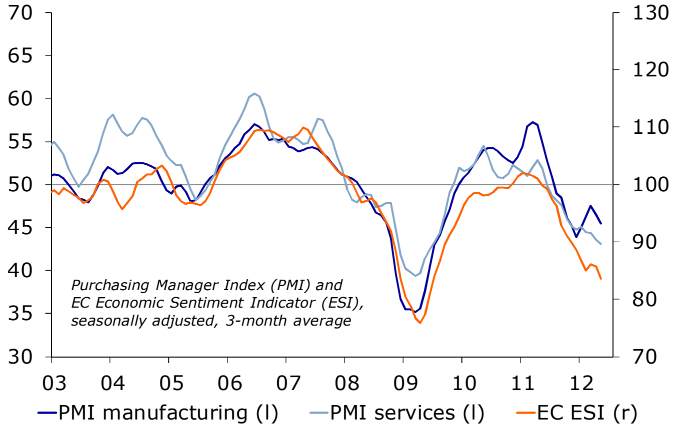
…which keeps real wage growth in check



Source: Reuters EcoWin

The pension reforms that have been enacted are good for the long run sustainability of the government finances and for raising economic potential. The short term impact of rising unemployment has been conducive in pushing wage growth to the lowest level in the past ten years, despite elevated inflation. With nominal wage growth far below inflation, households' purchasing power is being eroded. That is bad news for consumer spending. But low real wage growth is a necessary condition for Italy to regain the price competitiveness lost during the past decade. The planned labour market reforms should further support this much-needed rebalancing process.

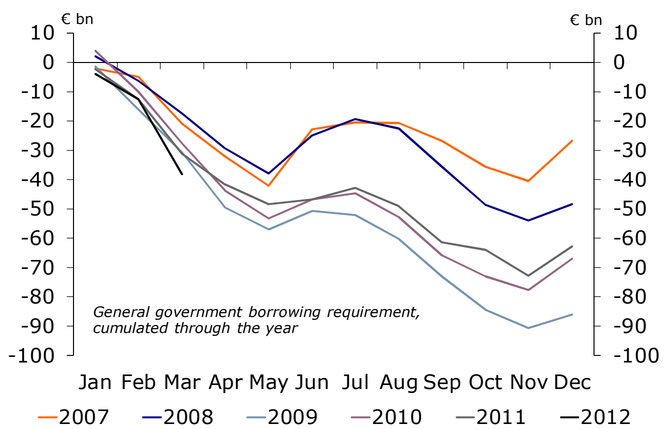
Sentiment indicators point to further contraction



Source: Reuters EcoWin

The Economic Sentiment Indicator fell sharply in May and reached its lowest level since April 2009. Consumer confidence even fell to a record low since the start of the series in 1980. In contrast, the Purchasing Manager Indices stabilised in May. But this was after having fallen sharply in the previous month. Given the continued uncertainty created by upcoming Greek elections and the trouble in the Spanish banking sector, a quick recovery in sentiment is unlikely. As such, there is a distinct possibility that the recession will be extended to the third quarter of this year. We do still hold on to our view that some modest quarterly growth can return next year.

Recession is hampering government deficit reduction



Source: Reuters EcoWin, Rabobank

In 2010 and 2011, the Italian government was able to achieve its budgetary targets. This year, the budget deficit should be lowered to below 3% of GDP, in line with the agreement with the European Commission. Yet the recession is making it harder to further reduce the deficit and nominal GDP will hardly grow. The general government borrowing requirement for the first three months of the year was bigger than in previous years. To get the deficit reduction back on track, the government has a VAT rise planned for later in the year. But in any case, the economic headwinds mean that the Monti government will have to pull out all the stops if they want to avoid a budgetary disappointment.

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