Economic Update Italy

6 May 2013

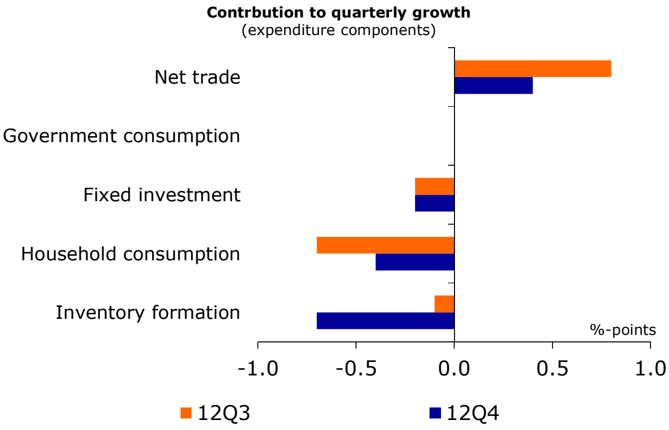
Can Letta make a difference?

Year-on-year change (%)	'12	'13	'14
Gross Domestic Product	-2.4	-1¾	½
Private consumption	-4.1	-1½	½
Government consumption	-2.9	-1	-½
Investment	-8.0	-4	3¼
Exports	2.2	2¾	4¼
Imports	-7.8	½	6¼
Inflation	3.3	1½	1¼
Unemployment (%)	10.6	12¼	13¼
Government balance (% GDP)	-3.0	-3	-2¼
Government debt (% GDP)	126.3	130	129¼

Source: Reuters EcoWin, Rabobank

The second 12Q4 GDP release showed that activity contracted by 0.9% q-o-q amid the weak domestic demand. More timely indicators point to a very weak underlying momentum. Thus, we cannot expect growth to return in the near-term. In April, inflation fell to 1.2% y-o-y. The downward trend will probably continue in the coming months if the planned VAT hike in July is postponed. The formation of a grand coalition government is viewed positively by investors. But it does not imply political instability is over. That said, Letta's pro-growth agenda could benefit domestic demand in the short-term unless extra budgetary consolidation is required to avoid fiscal slippages.

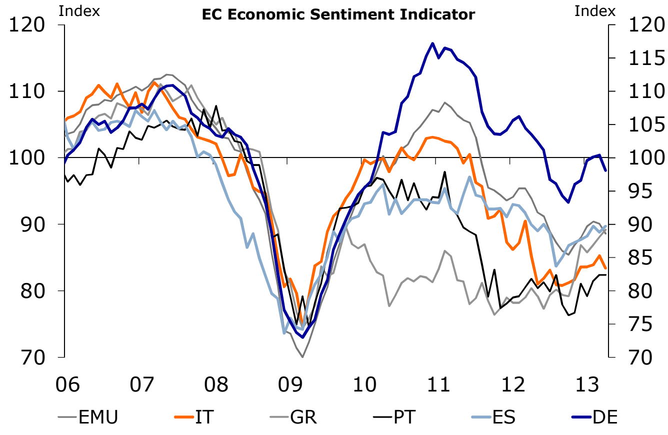
Weak domestic demand keeps GDP in the red…



Source: Reuters EcoWin

The second 12Q4 GDP release showed that activity contracted by 0.9% q-o-q. The expenditure breakdown shows that, as we suspected, both household consumption and fixed investment contributed negatively to the headline growth figure. Net exports was the single positive contributor to growth, also in line with our expectation. What was surprising, however, was that weaker inventory formation acted as the largest drag on growth. Note that inventory formation is a highly volatile series. Against this background, we do not expect output to contract in 13Q1 at the same pace seen in 12Q4. That being said, the Italian economic outlook is far from rosy amid severe headwinds.

…and sentiment is not improving



Source: European Commission

More timely indicators suggest that economic activity is still very weak. Industrial production (IP) shrank by 0.8% m-o-m in February, after growing 1% in the previous month. In level terms, IP is now around its lowest point since the trough of 2009. Looking ahead, business sentiment continues to suggest that underlying momentum is weak. The ISTAT indicator of Italian business confidence dropped from 88.6 to 87.6 in April (long-term average: 100). The Economic Sentiment Indicator (ESI) also decreased in April. In fact, amongst the eurozone countries, Italy's ESI is only higher than Portugal (see figure). Moreover, the manufacturing PMI was 45.5 in April, way below the neutral level of 50.

www.rabobank.com/economics

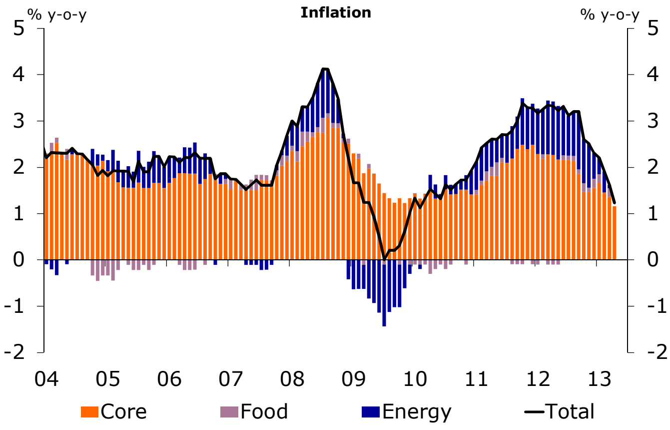
Shahin Kamalodin
Tel. +31 (0)30-2131106
S.A.Kamalodin@rn.rabobank.nl

Maartje Wijffelaars
Tel. +31 (0)30-2168740
M.Wijffelaars@rn.rabobank.nl

Economic Update Italy

6 May 2013

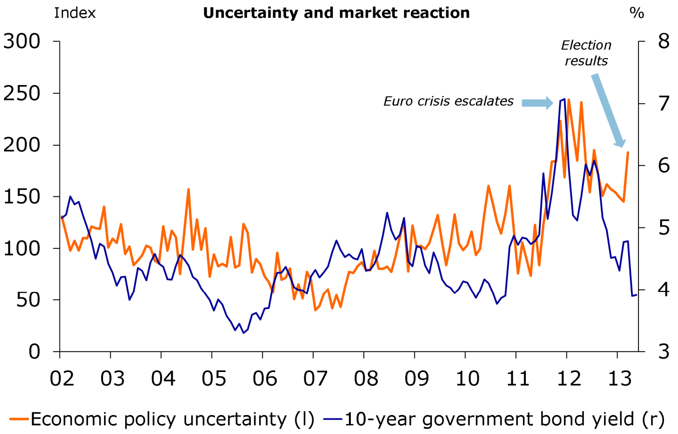
Inflation trending down



Source: Reuters EcoWin

In April, inflation fell to 1.2%, reaching its lowest level in more than three years. Inflation has been on a downward path since September last year, partly because the VAT-hike and rise in petrol tax at the end of 2011 dropped out of the equation. Inflation is expected to fall further in the coming months amid the weak domestic demand. This should benefit consumer spending. High unemployment, weak sentiment, and low growth of global demand will continue to act as significant drags, however. Note that another VAT-hike scheduled to be implemented in July would considerably increase inflation again. But the new government may possibly delay it to give households a bit of breathing space.

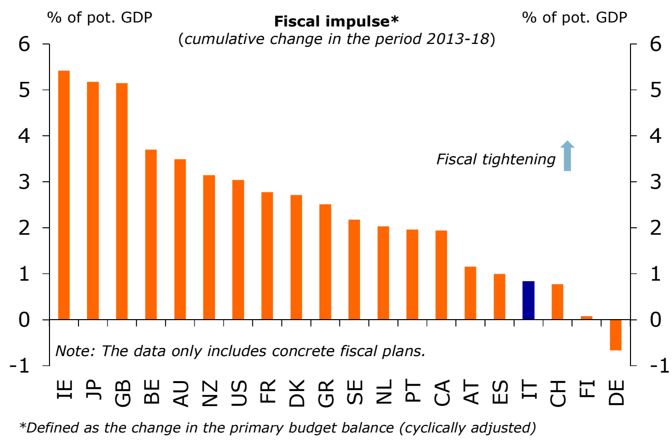
Financial markets reward political breakthrough…



Source: Reuters EcoWin, policyuncertainty.com

Contrary to expectations, government bond yields have not spiked after the inconclusive election results in February. As a matter of fact, the formation of a grand coalition government headed by Enrico Letta (center-left) even pushed 10-year bond rates below 4%. This supports fiscal sustainability as it reduces the refinancing costs of the massive stock of public debt. The question is whether the positive market reaction will last for long. The government formation does not imply political instability is over. The broad spectrum of parties makes the coalition unstable because any party moving up in the polls has an incentive to pull the plug and call for early elections.

…but does the new PM have what it takes



Source: IMF

Letta wants to revisit the austerity agenda in favour of growth-oriented policies. A delay of the upcoming VAT-hike and the cancellation of the June property tax payment, alongside other measures, might indeed benefit domestic demand in the short-term. But it is unclear how the resulting EUR 10bn (0.7% of GDP) budget shortfall in 2013 will be financed. Note that weaker growth prospects already led to the relaxation of Italy's fiscal target to 2.9% of GDP in 2013. In order to avoid further fiscal slippages, maintain market calm and comply with EU's budget rules, extra budgetary consolidation might be necessary. Needless to say that this would jeopardize Mr. Letta's pro-growth agenda.

www.rabobank.com/economics

Shahin Kamalodin
Tel. +31(0)30-2131106
S.A.Kamalodin@rn.rabobank.nl

Maartje Wijffelaars
Tel. +31 (0)30-2168740
M.Wijffelaars@rn.rabobank.nl