Country update **ITALY**

Summary

Italy is taking significant steps to reduce the budget deficit and reform the economy. But the former is being undermined by the return of recession while on the reform front much still needs to be done. The main risk for the austerity and reform program is the April 2013 general election. The rise in the polls of the anti-establishment Five Star Movement leads to a likely fragmented parliament which will make the formation of a stable governing coalition hard to achieve. Also, we cannot be sure that Spain will not eventually need a full rescue program, in which case the ESM funds left for Italy will not be sufficiently to be a credible backstop.

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)	61.3
Main languages	Italian
Main religions	Roman Catholic 90%
Head of State (president)	Giorgio Napolitano
Head of Government (prime-minister)	Mario Monti
Monetary unit	EUR

Social and governance indicators	rank / total
Human Development Index (rank)	24 / 187
Ease of Doing Business Index (rank)	73 / 185
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.

Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	2200	3.2
Nominal GDP at PPP	1964	2.5
Export value of goods and services	632	2.9
IMF quotum (in mln SDR)	7882	3.6
Economic structure	*2011*	*5-year av.*
Real GDP growth	0.5	-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	36190	334
Nominal GDP per head at PPP	32306	260
Real GDP per head	29202	357

Foreign trade		2011	
Main export partners (%)		*Main import partners (%)*	
Germany	13	Germany	16
France	12	France	8
US	6	Netherlands	5
UK	5	UK	3

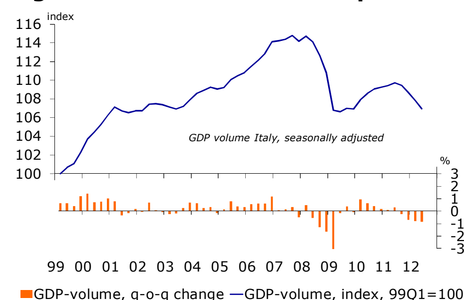
Main export products (%)	
Machinery and transport equipment	35
Chemicals and related products, n.e.s.	11
Food, drinks and tobacco	7
Mineral fuels, lubricants, and related materi	5
Main import products (%)	
Machinery and transport equipment	25
Mineral fuels, lubricants, and related materi	19
Chemicals and related products, n.e.s.	14
Food, drinks and tobacco	8
Openness of the economy	
Export value of G&S (% of GDP)	29
Import value of G&S (% of GDP)	30
Inward FDI (% of GDP)	1.5

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

Economy

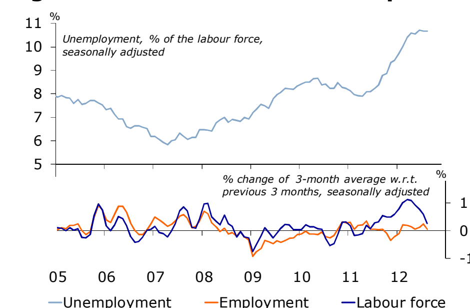
The Italian economy has been back in recession since the third quarter of 2011 (figure 1) and is likely to remain in recession at least until the end of 2012. Prior to this recession, output had only slowly recovered from the deep recession of 2008/09. In the second quarter of 2012, the GDP volume was 6.8% below the 07Q3 peak, close to the trough witnessed in 09Q2. Government austerity will keep domestic demand under downward pressure for some quarters to come, both directly due to lower government spending and indirectly through the negative impact of higher taxes on household disposable income. Export growth will only be able to offer limited

Figure 1: GDP volume development



Source: Reuters EcoWin

Figure 2: Labour market developments



Source: Reuters EcoWin

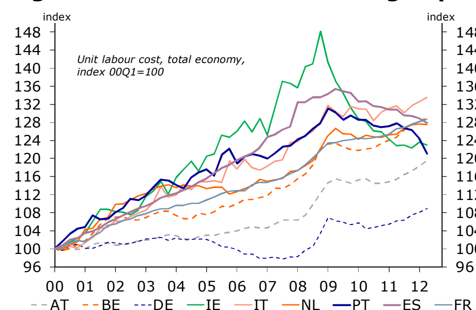
compensation for this. But with the planned fiscal consolidation becoming smaller over the next years, the negative effect of falling domestic demand should become smaller over time, which will allow for some modest economic growth to return in the course of 2013.

Unemployment has risen very quickly from the middle of 2011 to the middle of 2012, but has tapered off more recently (figure 2). The sharp increase in unemployment was primarily due to elevated labour force growth, which was the result of an increase in the effective official retirement age that kept older workers on the labour market for longer. Remarkably though, employment has hardly fallen in spite of the decline in GDP. This is reducing labour productivity, since a lower amount of output is produced by the same amount of workers.

The high and rising unemployment has been visible in wage growth, which has been subdued and been kept significantly below inflation over the past year. But modest wage growth combined with lower productivity has still pushed up unit labour costs. As a result, in marked contrast to Ireland, Portugal and Spain, Italy has not been able to regain price competitiveness over the past years (figure 3). Given that export growth has been much weaker than in those countries since the start of the recession in 2008, this is cause for concern.

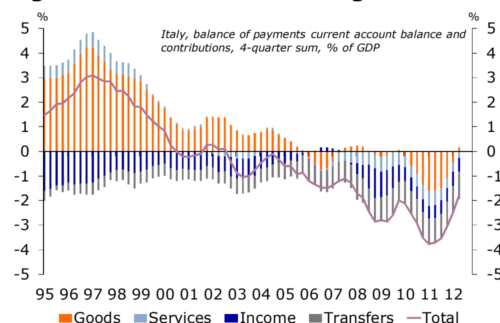
Despite the lack of increased price competitiveness, a sharp fall in import volumes on the back of lower domestic demand has resulted in a sharp fall in the current account deficit (figure 4). Dependence on foreign finance has been reduced as a result, which means that the relatively limited net foreign debtor position of Italy will be stabilized.

Figure 3: Unit labour costs still go up



Source: Reuters EcoWin

Figure 4: Trade deficit closing



Source: Reuters EcoWin

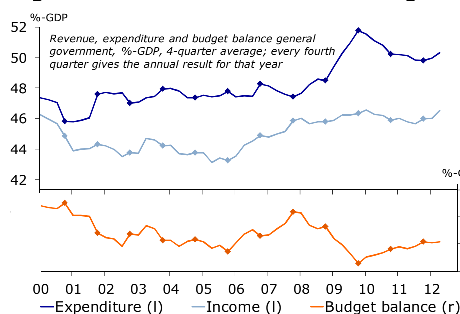
A sustainable and less economically painful change in the current account balance would be based on higher export growth and lower imports that result from changes in relative prices instead of from lower domestic spending. To achieve that, Italy needs to regain external price competitiveness. Higher productivity is the best way to achieve that. This higher productivity will also lead to higher economic growth in domestically oriented sectors. Italy is the only European country to have experienced a fall in labour productivity in the decade leading up to the crisis. The government headed by Prime Minister Mario Monti has pushed through a series of product market reforms and a labour market reform over the past year. This has the potential to boost economic growth in the medium term. But many of the reforms still have to be put into secondary legislation to become implemented. The watering down of the labour market reform in parliamentary procedures shows the limits that the technocratic government encounters in implementing reform. The labour market reform is disappointing when compared those enacted in Portugal and Spain. The latter two have

taken a broad based and deep approach tackling both firing costs, types of contracts and the system of wage negotiations. In Italy, lowering dismissal costs was restricted to abolishing compulsory reinstatement in case of layoffs for economic reasons and the system of wage negotiations was not part of the labour market reform. Much remains to be done to strengthen the Italian economy. But time is running out for Monti and it remains to be seen if the government that is formed after the April 2013 election pushes forward the reform agenda that he has initiated.

Deficit reduction undermined by recession

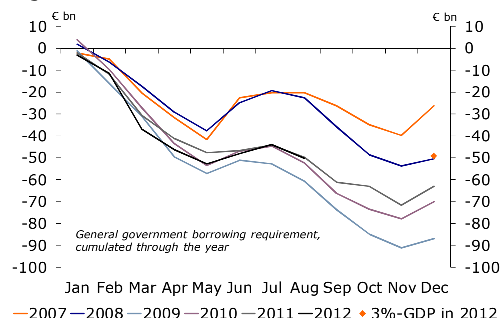
In December, the Monti government announced the third fiscal consolidation plan of 2011. The previous administration had already reduced the government budget deficit to 3.8% of GDP in 2011 from 5.4% in 2009. But the budget deficit has hardly been reduced any further since late 2011 (figure 5 and 6). The budget data for the first half of the year clearly show how the recession that is caused by government austerity is undermining the effort to reduce the budget deficit. The income and spending categories most closely related to the economic cycle have all deteriorated sharply. As such, it is not so much the budgetary effort but the economic developments that lead to disappointing results. The original government target of a 1.7% of GDP deficit in 2012 has already been relaxed to 2.6%. But monthly budgetary data up to August (figure 6) show that this may be hard to achieve as well. In fact, meeting the 3% of GDP target that Italy has to abide by this year according to the recommendations issued to it in the Excessive Deficit Procedure will also prove hard. The Stability and Growth Pact allows room to give Italy an extra year to get to below 3%, because the provision from regulation 1467/97 that "*If effective action has been taken … and unexpected adverse economic events with major unfavourable consequences for government finances occur … the Council may decide … to … extend the deadline for the correction of the excessive deficit by one year as a rule*" is clearly relevant. But slippage relative to their own targets or discussion on whether or not to give Italy an additional year will not be good for investor confidence.

Figure 5: Deficit reduction stalling…



Source: Reuters EcoWin

Figure 6: … 5 months left for EUR 14bn



Source: Reuters EcoWin

The Monti government made some further changes to the pension system on top of what the Berlusconi government had previously done. Those earlier changes have already resulted in a very positive result in the European Commission's assessment for the prospective rise in age related expenditure for Italy. The Commission sees Italian government spending on pensions falling relative to GDP over the next decades. This stands in marked contrast to most other European economies, which do not have ageing-proof budgets yet.

Of course, even with the relatively good medium term budget outlook related to ageing, and even if the current deficit is successfully reduced, the high level of gross government debt, which has risen from 106% of GDP in 2008 to an expected 126% in 2012, will continue to make the Italian

government finances very vulnerable to investor sentiment. Increases in government bond yields will quickly make the debt load look unsustainable, especially with a weak outlook for economic growth. Seeing the current and future government take measures that increase growth and reduce the debt load then, will remain very important.

Elections are due to take place no later than April 2013. The latest polls show that it will be very hard to form a stable governing coalition. The rise of the anti-establishment Five Star Movement, which according to the polls may take away up to 20% of the votes and took a large share of the votes in a recent election in Sicily, is further increasing the fragmentation of parliament. The biggest party in the most recent polls would gain about 30% of the votes, against 37.4% and 33.2% for the numbers 1 and 2 in the 2008 election. A winning coalition is granted a bonus to ensure a governing majority in the lower house of parliament. But a similar outcome in the upper house cannot be ensured. Complicating the outlook is the fact that a new electoral law is under discussion. But it is unclear if that law will be enacted before the election and what the impact would be on political stability. Although he is not running in the elections, Mario Monti has indicated that he would consider another term as Prime Minister if the election result would lead to political instability. But even with Monti hanging on as Prime Minister, his policies would still have to be accepted by a fragmented parliament. Unless an intensification of the crisis keeps pressure on parliament to do so, this will prove not to be a very stable situation.

Banks under pressure

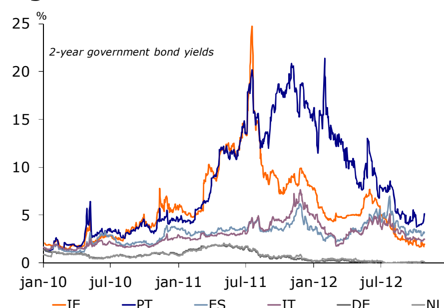
Unlike in Ireland and Spain, where the government is materially weakened by the financial problems of the banks, in Italy the banks have been weakened by the financial problems of the government. The absence of significant losses during the global financial crisis in 2008, the lack of severe macro-economic imbalances, historically high household savings and relatively modest private debt loads make for comparatively strong and stable balance sheets. Recapitalization by the government has remained limited to one institution and will likely stay below 1% of GDP. But the onset of recession has pushed non-performing loan ratios higher while higher funding costs and the weak economy make for lower profits to start with. Large holdings of Italian government debt combined with uncertainty about the creditworthiness of the state and doubts about the future of the euro area have made wholesale funding and interbank liquidity hard to come by for the banks. If not eased, these problems in the banking sector will make it hard for Italian banks to support economic growth going forward.

Lower interest rates due to OMT

The European Central Bank's (ECB) announcement of Outright Monetary Transactions (OMT), in which it will purchase government paper with a maturity of up to three years from countries that receive financial assistance from the European Stability Mechanism (ESM) and abide by the conditions for such assistance, has had a very positive impact on Italian government bond yields, which have been falling in line with other Southern-European countries (figure 7). Yields had been rising since March 2012, when the positive impact of two 3-year Longer Term Refinancing Operations (LTRO) by the ECB started to wane and financial stress rose due to uncertainty about Greece and Spain. With the two year yield close to 2.5% and the ten year rate close to 5%, yields in early November 2012 were close to or below the levels seen in the first months of 2011, before the pressure in Italian bond markets went up severely. As a result, the government has been able to issue debt in the market at reasonable interest rates. To diversify their funding sources, the government this year issued a significant amount of inflation linked retail bonds to tap into the

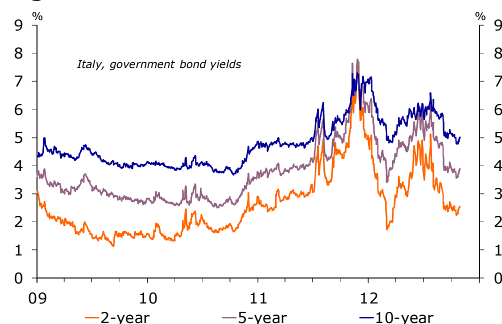
large stock of domestic savings. This shows the practical use of the theoretical advantage that Italy has compared to the other Southern-European countries and Ireland given its history of limited current account deficits and a limited net external debt because high government debt is compensated for by high household wealth.

Figure 7: Interest rates



Source: Reuters EcoWin

Figure 8: Term structure



Source: Reuters EcoWin

But the current situation is far from stable. With the economy still in recession, the necessity of further austerity and reform and elections coming up in April 2013, there is a significant probability that interest rates move back up in response to doubts about the sustainability of the government finances. Outside of Italy, adverse developments in Greece, Portugal or Spain and the lack of progress in euro zone institution building in Brussels also have the potential to lead to renewed pressure in the Italian government bond market. Much will depend on developments in Spain. That country is widely expected to ask for additional financial assistance on top of the rescue package that has been set up to recapitalize its banks. A Spanish request for aid will test the effectiveness of combining such aid with Outright Monetary Transactions by the ECB. If Spain can keep financing itself in the market with the assistance of a precautionary credit line from the ESM and supported by OMT, the amount of ESM funds necessary to do so will be limited to perhaps some EUR 100bn. Such a setup would leave sufficient funds available to do the same for Italy. But if Spanish interest rates rise to unsustainable levels nonetheless and more money would be needed from official lenders to substitute for market finance, the current setup of the European rescue fund will be shown to be insufficient to support Italy. A loss of that backstop coupled with renewed worries about the creditworthiness of other states and the viability of the euro zone will no doubt lead to a sharp rise in Italian government bond yields.

Conclusion

The temporary political stability offered by the technocratic government of Mario Monti and the ECB's announcement of OMT has helped to lower Italian government bond yields significantly. But deficit reduction is proving hard in the face of recession and the high debt ratio means the financial situation of the government will remain very vulnerable to adverse shocks. Although the government has started with economic reform, much needs to be done. With elections coming up in April 2013, both doubts about the effectiveness of the remaining time for the Monti administration as well as doubts about political stability after the elections are likely to rise. Apart from that, Italy remains very vulnerable to developments in other euro area countries as well as to general market sentiment that is driven by euro area institution building.

Italy

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	1.5	-1.2	-5.5	1.8	0.5	-2.4	-0.8
Consumer prices (average % change pa)	2.0	3.5	0.8	1.6	2.9	3.2	2.0
Current account balance (% of GDP)	-2.4	-2.9	-1.9	-3.5	-3.3	-1.5	-0.6
Economic growth							
GDP (% real change pa)	1.5	-1.2	-5.5	1.8	0.5	-2.4	-0.8
Gross fixed investment (% real change pa)	1.3	-3.8	-11.7	2.0	-1.3	-8.5	-2.0
Private consumption (real % change pa)	1.1	-0.8	-1.6	1.2	0.2	-3.6	-1.5
Government consumption (% real change pa)	1.0	0.6	0.8	-0.6	-0.9	-1.0	-1.5
Exports of G&S (% real change pa)	5.6	-2.8	-17.7	11.4	6.3	0.5	0.6
Imports of G&S (% real change pa)	4.6	-2.9	-13.6	12.4	1.0	-6.9	-0.8
Economic policy							
Budget balance (% of GDP)	-1.5	-2.7	-5.4	-4.6	-3.9	-2.8	-2.0
Public debt (% of GDP)	103	106	116	119	120	126	127
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	0.6	0.2
M2 growth (% change pa)	21	9	6	18	-3	1	1
Consumer prices (average % change pa)	2.0	3.5	0.8	1.6	2.9	3.2	2.0
Exchange rate LCU to USD (average)	3.7	3.7	3.7	3.7	3.7	#N/B	#N/B
Recorded unemployment (%)	6.1	6.8	7.8	8.4	8.4	10.9	11.1
Balance of payments (m USD)							
Current account balance	-51574	-66252	-41003	-72015	-71873	-30100	-11700
Trade balance	4581	-2841	1458	-27278	-24725	13600	28100
Export value of goods	501281	545080	407457	448375	524864	484600	493800
Import value of goods	496700	547920	406000	475650	549590	471000	465600
Services balance	-9662	-12564	-11477	-12183	-9656	-6300	-3900
Income balance	-26799	-28640	-14254	-11410	-16299	-17900	-16600
Transfer balance	-19696	-22207	-16731	-21144	-21194	-19600	-19400
Net direct investment flows	-52076	-79008	-3189	-23009	-27209	-13880	-14580
External position (m USD)							
International investment position	-560920	-528360	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	2637450	2345900	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	3198370	2874260	n.a.	n.a.	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	-1.1	0.7	1.4
Current account balance (% of GDP)	-2.4	-2.9	-1.9	-3.5	-3.3	-1.5	-0.6
Inward FDI (% of GDP)	1.9	-0.4	0.8	0.5	1.5	1.5	1.6
International investment position (% of GDP)	-26.3	-22.8	n.a.	n.a.	n.a.	n.a.	n.a.

Source: EIU, IMF via Reuters EcoWin; the Economist Intelligence Unit estimates and forecasts for 2012 and 2013 do not necessarily represent Rabobank views and hence may deviate from the text

Disclaimer
This document is issued by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. incorporated in the Netherlands, trading as Rabobank Nederland, and regulated by the FSA. The information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness. It is for information purposes only and should not be construed as an offer for sale or subscription of, or solicitation of an offer to buy or subscribe for any securities or derivatives. The information contained herein is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. All opinions expressed herein are subject to change without notice. Neither Rabobank Nederland, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith, and their directors, officers and/or employees may have had a long or short position and may have traded or acted as principal in the securities described within this report, or related securities. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities are described in this report, or any related investment. This document is for distribution in or from the Netherlands and the United Kingdom, and is directed only at authorised or exempted persons within the meaning of the Financial Services and Markets Act 2000 or to persons described in Part IV Article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001, or to persons categorised as a "market counterparty or intermediate customer" in accordance with COBS 3.2.5. The document is not intended to be distributed, or passed on, directly or indirectly, to those who may not have professional experience in matters relating to investments, nor should it be relied upon by such persons. The distribution of this document in other jurisdictions may be restricted by law and recipients into whose possession this document comes from should inform themselves about, and observe any such restrictions. Neither this document nor any copy of it may be taken or transmitted, or distributed directly or indirectly into the United States, Canada, and Japan or to any US-person. This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of Rabobank Nederland. By accepting this document you agree to be bound by the foregoing restrictions.