Rabobank

Country report

ITALY

Summary

The Italian economy has many structural weaknesses, leading to low economic growth before recession and now to a very sluggish recovery. The government deficit is estimated to have been better than expected in 2010, and compares favourably to a number of other European countries. The high debt level and the future rise of age-related spending are a concern. Fortunately, the weak financial position of the government is compensated by high saving and sizeable net financial wealth of the Italian households. High savings coupled with the lack of a housing market boom-bust pattern enabled the banks to weather the global financial crisis and the recession relatively well.

Things to watch:

- Political stability
- Government deficit reduction
- High government debt
- Economic growth, competitiveness

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Italian Republic

National facts	
Type of government	Republic
Capital	Rome
Surface area (thousand sq km)	301.34
Population (millions)	59.9
Main languages	Italian
Main religions	Roman Catholic (90%)
Head of State (president)	Giorgio Napolitano
Head of Government (prime-minister)	Silvio Berlusconi
Monetary unit	EUR

Social and governance indicators	rank / total
Human Development Index (rank)	23 / 169
Ease of doing business (rank)	80 / 183
Economic freedom index (rank)	87 / 179
Corruption perceptions index (rank)	67 / 178
Press freedom index (rank)	49 / 178
Gini index (income distribution)	36.0

Economy	2010	
Economic size	*bn USD*	*% world total*
Nominal GDP	2052	3.29
Nominal GDP at PPP	1834	2.48
Export value of goods and services	560	3.02
IMF quotum (in mln SDR)	7056	3.25
Economic structure	*2010*	*5-year av.*
Real GDP growth	1.2	-0.5
Agriculture (% of GDP)	2	2
Industry (% of GDP)	25	27
Services (% of GDP)	73	71
Standards of living	*USD*	*% world av.*
Nominal GDP per head	34140	347
Nominal GDP per head at PPP	30517	261
Real GDP per head	29047	363

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Germany	13	Germany	17
France	12	France	9
US	6	Netherlands	6
UK	5	UK	3

Main export products (%)	
Machinery and transport equipment	36
Chemicals and related products, n.e.s.	11
Food, drinks and tobacco	7
Mineral fuels, lubricants, and related materials	4
Main import products (%)	
Machinery and transport equipment	27
Mineral fuels, lubricants, and related materials	17
Chemicals and related products, n.e.s.	14
Food, drinks and tobacco	9
Openness of the economy	
Export value of G&S (% of GDP)	24
Import value of G&S (% of GDP)	25
Inward FDI (% of GDP)	1.4

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

Struggling to recover

After experiencing one of the biggest falls in output of all euro zone economies during the global recession, the Italian economic recovery has been one of the slowest in the euro zone as well. From a 7% peak-to-trough fall in GDP from 2008Q1 to 2009Q2, only 1.8%-points had been regained by the last quarter of 2010. We expect economic growth of 1¼% this year and 1½% in 2012 (more optimistic than the Economist Intelligence Unit forecasts in the table below). This implies a GDP level at the end of 2012 that is still 2½% below the early 2008 pre-recession level. The steep recession and the limited recovery were mainly due to a sharp fall in exports and investment. Although exports are recovering, demand from the main trading partners remains weak. Given the further economic recovery we expect in Germany and France (the number 1 and 2 trading partner), export growth should continue to recovery. But at the same time export growth to the southern European countries of Greece, Portugal and Spain, who jointly make up about 11% of Italian exports (a share that has been growing since the early 1990s), will not recover for years to come given the sizeable demand adjustments going on in those countries. Also, the export package of Italy is not geared enough to emerging markets. So even though Italian exports to India, Turkey, Brazil and China more than recovered from the slump in world trade, this has not been enough to compensate for continued weakness of exports in the European and US market.

Apart from the steep recession and sluggish recovery, the Italian economy has been under-performing its European peers in the decade before recession as well, mainly because of falling productivity. Income per capita was above the EU-15 average up until 2001. After that, Italy fell behind and did not regain its previous standing. With wages having grown faster than productivity, unit labour costs have been rising faster than for many of its competitors, leading to a steady reduction in the Italian share of world trade.

Structural weakness

Underlying the weak productivity growth are deep rooted structural problems. In November 2010, the IMF produced a 'structural reform heatmap' indicating necessary structural reforms in a number of areas like labour market flexibility, business regulation, the legal system, education and innovation. With the maximum number of 18 structural problems to deal with by Greece, Italy came next in line with a score of 14 and being closely followed by Portugal with 13. Greece and Portugal (will) have a financial rescue package with conditions imposed by the European Commission and the IMF, forcing them to deal not only with current government finances, but also specifically with the identified structural weaknesses. For Italy, the only external mechanism in place to deal with its structural issues is the pressure from financial markets and pressure from the European partners. For now, the markets have been relatively easy on Italy while the European arrangements do not have enough enforcement mechanism to force the desired changes. As such, structural weaknesses and the subdued economic growth that results from them are expected to persist.

Government finances on the mend, but challenges remain

The government budget deficit for 2010 is estimated at 4.6% of GDP, much lower than the planned deficit of 5%. Despite the political turmoil and the weak economic recovery, the government is ahead of its own schedule for reducing the budget deficit to below 3% of GDP in 2012. The deficit reduction is due to successful expenditure cutbacks, while the planned increase in revenue has not been forthcoming. Higher revenue is dependent on the economic recovery. Moreover, the government plans on raising the tax intake by fighting tax evasion. This is easier said than done. While definitely positive, the good budget outcome for 2010 hardly changes the fact that the road to healthy Italian government finances will be very long. At 120% of GDP, the government debt level is twice the EMU maximum. A reform of the Stability and Growth Pact will make sure that Italy will be more closely monitored by the European Commission not only to keep the deficit below 3% of GDP but also in progressing toward a 60% of GDP debt level at a minimum pace. In principle, the government is in a good position to make some headway in getting the public finances in order and reforming the economy because there are no elections scheduled for the next three years. But given the scandals and litigation surrounding the prime minister and the history of political turmoil, there is a fair chance that this opportunity is missed.

National finances stronger than public finances

Against the worryingly high government debt level, the Italian households hold very sizeable amounts of net financial wealth. Looking at the total economy, net household financial assets are almost big enough to compensate for the net public and corporate liabilities. Compared to other Southern European countries, that makes Italy much less dependent on foreign funding, which is also visible in the relatively contained current account deficit of on average -2.1% in 2002-2010 after an average 1.6% surplus in 1993-2001. Sizeable domestic savings have also resulted in relatively low dependence on wholesale finance by the banks. This, coupled with the lack of a housing market boom gone bad, has helped the Italian banks weather both the global financial crisis and the recession that followed relatively well. In turn this means that the potential costs to the government of financial help to the banking sector are very limited.

Italy

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	2.1	1.4	-1.3	-5.2	1.2	0.7	0.8
Consumer prices (average % change pa)	2.2	2.1	3.5	0.8	1.6	2.4	2.3
Current account balance (% of GDP)	-2.6	-2.4	-3.4	-3.1	-3.1	-3.4	-3.2
Economic growth							
GDP (% real change pa)	2.1	1.4	-1.3	-5.2	1.2	0.7	0.8
Gross fixed investment (% real change pa)	3.2	1.4	-3.8	-12.0	2.3	2.2	2.3
Private consumption (real % change pa)	1.2	1.1	-0.8	-1.8	1.0	0.5	0.8
Government consumption (% real change pa)	0.5	0.9	0.5	1.0	-0.6	-0.3	0.0
Exports of G&S (% real change pa)	6.6	4.0	-4.4	-18.4	8.9	4.0	3.9
Imports of G&S (% real change pa)	6.2	3.3	-4.4	-13.8	10.3	3.6	3.9
Economic policy							
Budget balance (% of GDP)	-3.3	-1.5	-2.7	-5.4	-4.6	-4.0	-3.9
Public debt (% of GDP)	106	103	106	116	119	120	119
Money market interest rate (%)	3.1	4.3	4.6	1.2	0.8	1.3	1.9
M2 growth (% change pa)	8	21	9	7	17	8	4
Consumer prices (average % change pa)	2.2	2.1	3.5	0.8	1.6	2.4	2.3
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Recorded unemployment (%)	6.8	6.2	6.8	7.8	8.5	8.3	7.9
Balance of payments (mln USD)							
Current account balance	-47828	-51574	-78144	-66199	-63600	-69600	-66000
Trade balance	-12511	4581	-1046	3259	-18300	-27000	-25800
Export value of goods	418073	501281	546302	407161	453500	488900	486300
Import value of goods	430590	496700	547350	403900	471800	515900	512100
Services balance	-1526	-9662	-10358	-14026	-8000	-4200	-2500
Income balance	-17076	-26799	-43547	-38480	-22900	-23400	-22800
Transfer balance	-16713	-19696	-23195	-16952	-14400	-15000	-14900
Net direct investment flows	-3471	-52076	-27476	-14747	-841	-5760	-5110
Net portfolio investment flows	43900	15400	161700	17800	100	12000	13200
External position (mln USD)							
Total foreign exchange reserves	25662	28385	37088	45770	n.a.	n.a.	n.a.
International investment position	-402480	-488720	-468150	-434240	n.a.	n.a.	n.a.
Total assets	2397610	2827060	2579320	2850230	n.a.	n.a.	n.a.
Total liabilities	2800090	3315780	3047470	3284470	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-0.7	0.2	0.0	0.2	-0.9	-1.3	-1.3
Current account balance (% of GDP)	-2.6	-2.4	-3.4	-3.1	-3.1	-3.4	-3.2
Inward FDI (% of GDP)	2.1	1.9	0.7	1.4	0.9	0.9	1.0
International investment position (% of GDP)	-21.6	-23.1	-20.3	-20.5	n.a.	n.a.	n.a.

Source: EIU

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