Economic Update Italy

4 October 2011

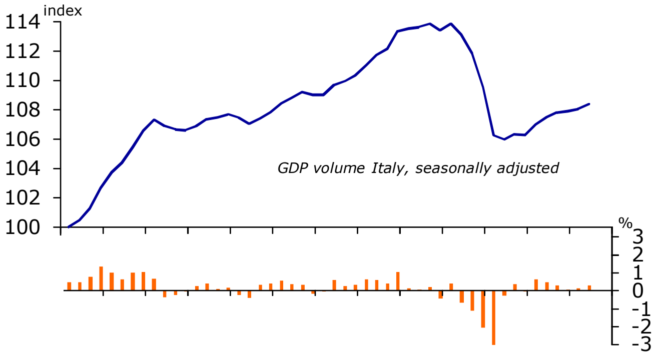
Back in recession

Year-on-year change (%)	'10	'11	'12
Gross Domestic Product	1.2	½	½
Private consumption	1.0	¾	½
Government consumption	-0.6	-1	-1
Investment	2.3	1	2
Exports	8.9	5¼	3½
Imports	10.3	3	2
Inflation	1.6	2¾	2
Unemployment (%)	8.5	8	8½
Government balance (% GDP)	-4.6	-4	-3¼
Government debt (% GDP)	119.0	120½	121

Source: Reuters EcoWin, Rabobank

In the second quarter, the Italian economy managed to realise a modest acceleration in growth. After two years of economic recovery, only 30% of the drop in output during recession has been regained. But both industrial production and sentiment indicators point to a new recession in the second half of the year. A global slowdown of growth is accompanied by European debt crisis, which forces accelerated government budget cuts and pushes consumer confidence down. Oddly enough, Italian firms are not making any headway in restoring the international price competitiveness they lost over the last decade. Likewise, the government is showing no willingness to engage in necessary structural reforms.

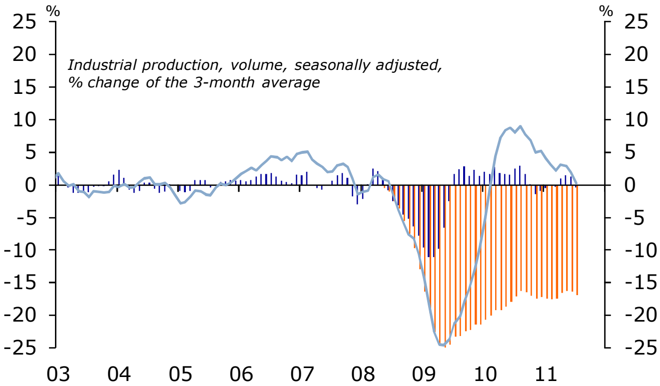
GDP growth accelerated in 11Q2…



Source: Reuters EcoWin

Real GDP grew by 0.3% q-o-q in the second quarter, accelerating relative to the previous two quarters. But compared to the pace of contraction during the recession in 2008/09 this is a very disappointing figure. Two years after the recession, only 30% of the drop in output has been recouped. The slow pace of economic growth has mainly been driven by the limited recovery in exports and investment. The slowdown of world trade growth will further deter recovery in these areas. On top of that, the escalation of the European debt crisis is leading to accelerated budget cuts and is undermining consumer confidence.

… but the positive impulse from industry has faded…



Source: Reuters EcoWin

Because of strong production growth in the three months to April, the manufacturing sector managed to contribute considerably to GDP growth in the second quarter. But industrial production (IP) has kicked off the third quarter as weak as it ended the second. The production volume fell by 0.7% m-o-m in July, after contracting by 0.6% and 0.8% in May and June, respectively. Even with modest growth in the remaining months, IP is set to contract sharply on a quarterly basis. If growth is absent, contraction in the sector will even be as big as the quarterly gain in the quarter before. As a result, IP is turning from boosting to restraining overall economic growth.

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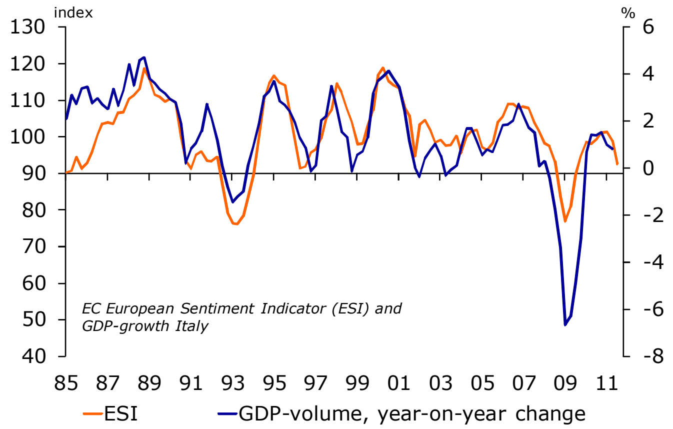
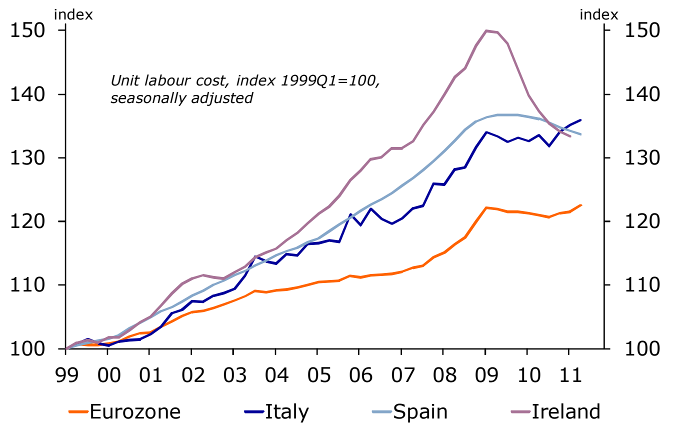
… and sentiment indicators point to recession



Source: Reuters EcoWin

The recent economic weakness is not restricted to manufacturing. The Economic Sentiment Indicator (ESI) points to recession in the second half of the year. After a number of modest falls, the ESI fell back sharply in September. The fallback was broad based and visible in manufacturing, services, retail and consumer confidence. Based on the historic relationship between the ESI and GDP, we expect a large fall in the year-on-year growth rate. This in turn points to outright contraction of GDP on a quarterly basis in 11Q3. If, as is likely, sentiment fails to improve over the next months, the economy will also contract in the last quarter of the year.

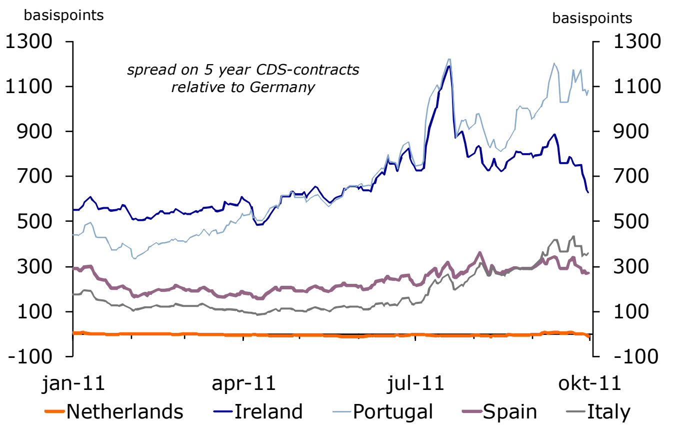
Wages outgrow productivity again



Source: Reuters EcoWin

A new recession is not yet visible in the labour market. The rise in employment, which started a year ago, continued in both July and August. Over the past year, employment grew in tandem with production, leading to constant production per worker. But despite the lack of productivity growth, wages did rise, leading to a rise in unit labour costs. Since this rise was higher than that of the eurozone average, Italy has been losing price competitiveness in the international marketplace. This is in stark contrast to developments in both Ireland and Spain, where a fall in unit labour costs is helping to correct the loss of competitiveness experienced in the first decade in the eurozone.

Government refuses to grasp the gravity of the crisis



Source: Reuters EcoWin

The behaviour of the Italian government shows very little testimony that they realise the gravity of the European debt crisis. Being shielded from market forces by ECB purchases of its government debt, the authorities are taking as little measures as possible to reduce the budget deficit. Announced austerity and reform measures that looked impressive at first have been watered down to a disappointing extent to make the proposals pass parliament. Too much emphasis is now on raising taxes, too little on spending cuts. More worrying still is the lack of serious structural reforms that could eventually lead to much-needed higher economic growth. Investors recognise this as well, and now regard Italian public debt riskier than Spanish public debt.

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