Economic Update Italy

2 August 2011

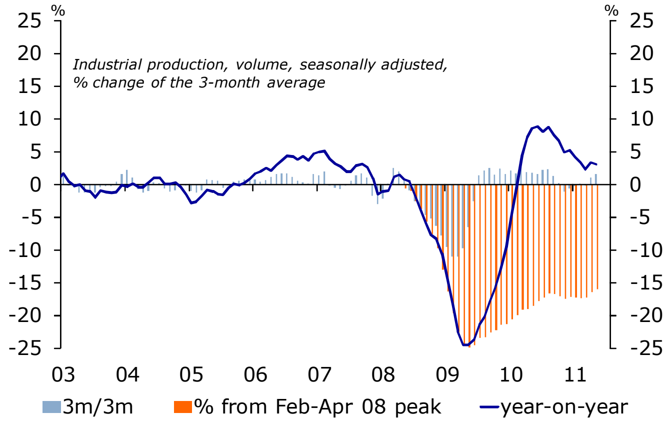
Growth revival is over before it really started

Year-on-year change (%)	'10	'11	'12
Gross Domestic Product	1.2	1	1½
Private consumption	1.0	¾	1
Government consumption	-0.6	-1	0
Investment	2.3	2	3
Exports	8.9	6¼	4½
Imports	10.3	4	3
Inflation	1.6	2½	1½
Unemployment (%)	8.5	8¼	8
Government balance (% GDP)	-4.6	-4	-3¼
Government debt (% GDP)	119.0	120½	120

Source: Reuters EcoWin, Rabobank

After two quarters of contraction and stagnation, industrial production grew again in the second quarter of this year. But sentiment indicators suggest that this growth revival may be short-lived. Both the manufacturing and the services indices point to stagnation at the start of the third quarter. Like in the rest of the eurozone, Italian exports will suffer from the slowdown in world trade growth. Apart from that, the economic recovery has until now been very sluggish. As a result, the capacity utilisation rate in the manufacturing sector is still low while unemployment remains high. This will hold back the growth of private consumption and investment.

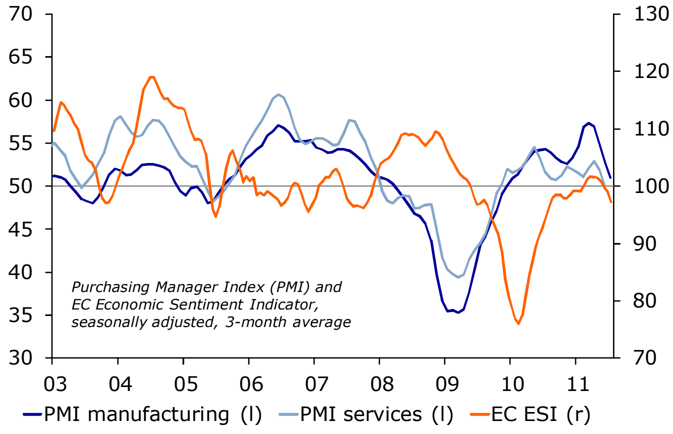
Industrial production is growing again…



Source: Reuters EcoWin

After a pause for two quarters, industrial production (IP) resumed its q-o-q growth in 11Q2. Production in May was down 0.6% on the month, but this was preceded by an average monthly growth of over 1% in the three months before it. As a result, production reached a level that is high enough to ensure that IP in 11Q2 as a whole will have grown compared to the quarter before, even if June shows a sizeable further fall. Industrial dynamics have played an important part in the recession and subsequent recovery. So the positive developments in 11Q2 bode well for the Italian economy, which hardly grew in the two previous quarters.

… but the upturn may be short-lived



Source: Reuters EcoWin, Rabobank

The positive developments in the second quarter may, however, prove to be short-lived. Sentiment indicators such as the PMI and the ESI have deteriorated sharply over the past months. The PMI for both the services and the manufacturing sector dipped below 50 in June, the level indicative of the difference between growth and contraction. The three month average of all three indicators is getting close to levels last seen during the recession. The deterioration of sentiment is in line with developments in the rest of the eurozone. Like elsewhere, the slowdown in world trade growth will lead to lower export growth for Italy. Domestic demand will not be strong enough to compensate for that.

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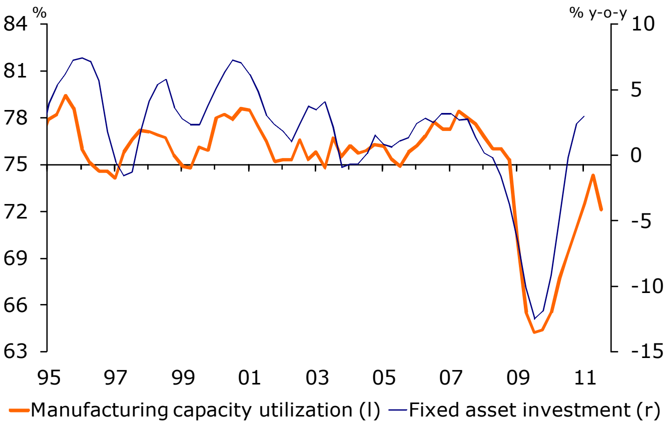
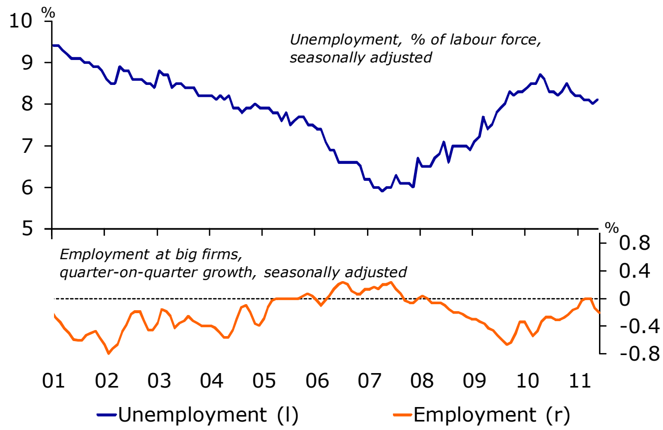
Low capacity utilisation holds back investment growth



Source: Reuters EcoWin

Since reaching a trough over two years ago, industrial production has been very slow to recover. As a result, the level of production remains more than 15% below the early 2008 peak. This in turn has held back the recovery of the capacity utilisation rate. Even worse, manufacturing firms indicate a renewed fall in the utilisation rate in the third quarter of this year. As such, investment for the expansion of capacity is on average not necessary for servicing higher demand. Replacement investment will also be subdued, since replacing broken machinery or outdated buildings is not an attractive option if they are idle or standing empty.

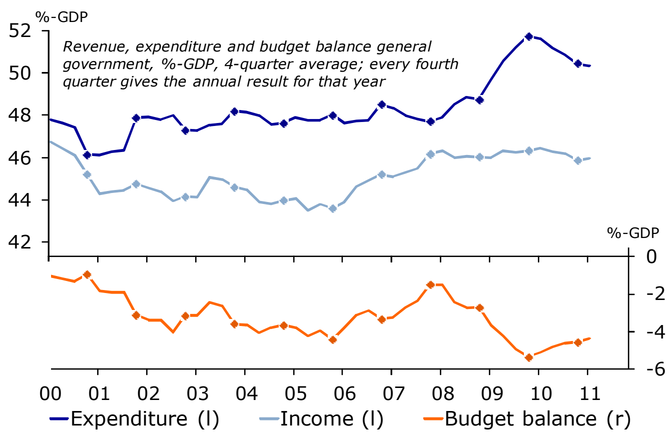
Employment is falling again



Source: Reuters EcoWin

In June, the unemployment rate rose for the first time since October 2010. Up to now, unemployment had been falling due to a gradual decline in the employment contraction and the labour force shrinking faster than employment itself. Unfortunately, after two months of stagnation, employment at big firms fell back in both May and June. Poor economic prospects make it unlikely that employment growth will resume this year. So the jobless rate will remain at a high level for some time. This is already having an impact on wage growth, which was almost 1%-point below inflation in June. Coupled with government austerity measures this leads to a reduction in purchasing power and lower expected consumption growth.

Government finances show further improvement



Source: Reuters EcoWin

Due to a sharp rise in government bond yields, Italy made headlines in the past month as being next in line to follow Greece, Ireland and Portugal. The interest rate is pushed up on the back of a general lack of trust in European leaders to prevent default by its member states. It is difficult to find serious new financial developments in Italy itself as an explanation for the rising bond yields. New austerity measures have been approved by parliament. And the budget deficit, which ended up smaller than planned last year, was successfully reduced further in 11Q1. But fear is King right now, so the high yields itself can further reduce investor confidence, with rising yields eventually undermining the sustainability of the Italian government finances.

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