Euler Hermes Economic Research

Country Report

Italy

*Mettendocela tutta, ma un po' in ritardo**

Timid recovery as reforms just started

General Information

GDP	USD2,144bn (World ranking 8, World Bank 2014)
Population	61.34mn (World ranking 23, World Bank 2014)
Form of state	Republic
Head of government	Matteo RENZI
Next elections	2018, legislative

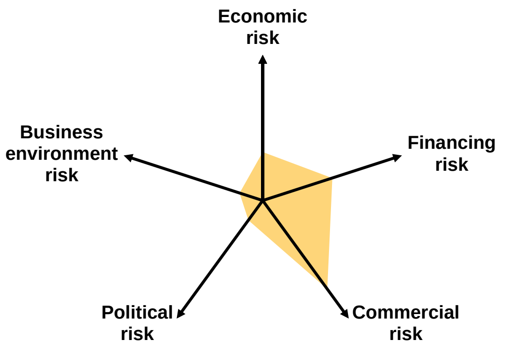
Strengths

- Geographical hub
- Very diversified export structure
- Strong manufacturing sector
- Low private debt
- Primary fiscal surplus

Weaknesses

- Excessive stock of public debt
- Weak business environment
- Low profitability of firms
- High fiscal pressure on companies
- Low R&D expenditures
- Decreasing long-term per capita income

Country Rating A2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	13%	1	14%	Germany
France	11%	2	8%	France
United States	7%	3	7%	China
Switzerland	6%	4	5%	Netherlands
United Kingdom	5%	5	5%	Russian Federation

By product (% of total)

Exports		Rank		Imports
Other industrial machinery	10%	1	14%	Petroleum products
Road vehicles	7%	2	7%	Gas, natural
Specialised machinery	6%	3	6%	Road vehicles
Petroleum products	5%	4	5%	Pharmaceutical products
Iron and steel	5%	5	4%	Electrical machinery

Source: Chelem (2013)

Economic Overview

Getting back on track takes time

Italian GDP started to recover in 2015, following four consecutive years of recession. In Q2 2015, GDP rose by +0.3% q/q, pulled up by private consumption which registered its highest increase since Q4 2010 (+0.4% q/q). This is mainly due to the positive effect of low inflation and lower oil prices on households' purchasing power. Indeed, we estimate that the lower oil prices could trigger EUR9bn savings thanks to cheaper energy imports.

After seven years of contraction, the momentum improved for investment. We forecast positive investment growth for both 2015 and 2016 (+0.5% and +1.4% respectively). The good news comes from investment in machinery that stopped decreasing and stands above the 2014 level. It is supported by the rise in goods exports (+1.2% q/q in Q2 vs. +0.6% during the previous quarter). However, the construction sector is expected to remain depressed with investment still 30% below 2007 levels, production still on the downward trend and housing prices at a record low in Q1 2015.

All in all we expect GDP growth to reach +0.7% in 2015, still half of the eurozone average (+1.4%), and to exceed +1% in 2016 (see Table 1).

Table 1: Key economic forecasts

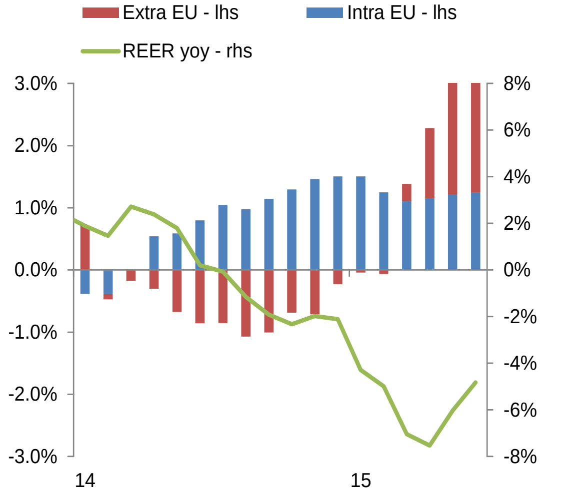
Italy		2013	2014	2015	2016
GDP		-1.7	-0.4	0.7	1.1
Consumer Spending		-2.8	0.3	0.7	1.2
Public Spending		-0.3	-1.0	-0.1	-0.2
Investment		-5.8	-3.2	0.5	1.4
Stocks	*	0.3	0.0	0.2	0.1
Exports		0.7	2.4	4.0	3.9
Imports		-2.2	1.7	4.7	3.9
Net exports	*	0.8	0.2	-0.1	0.1
Current account	**	15	26	29	37
Current account (% of GDP)		*0.9*	*1.6*	*1.8*	*2.2*
Employment		-1.5	0.3	0.7	0.6
Unemployment rate		12.2	12.7	12.5	11.7
Wages		-0.5	0.1	-1.4	0.0
Inflation		1.2	0.2	0.0	0.5
General government balance	**	-47	-51	-51	-48
General government balance (% of GDP)		*-2.9*	*-3.2*	*-3.1*	*-2.9*
Public debt (% of GDP)		*127.9*	*131.8*	*132.2*	*131.5*
Nominal GDP	**	1609	1617	1632	1657

Change over the period, unless otherwise indicated: *contribution to GDP growth **EUR bn

First positive effects from the lower EUR, but don't hope for too much

The improvement in the current account (respectively +1.8% of GDP for 2015 and +2.2% of GDP for 2016) is accounted for by the growing trade surplus, owing both to higher exports and subdued imports. The pick-up in exports is essentially due to goods while the services balance continues to deteriorate and is now close to equilibrium (vs +1.5bn EUR surplus in January 2014). Since the start of 2015, the Italian exports have been directed more outside the EU (see Chart 2) and we think this is mainly thanks to the improved price competitiveness helped by the lower euro. However, this positive trend is expected to be limited as we don't foresee the euro to reach the parity with the USD next year despite the Fed interest rate hike (and the dollar appreciation) since the eurozone remains a strong receiver of investment flows. Further, the Italian companies still suffer from the absence of unit labour costs adjustments over the past years as the labour market reform have been implemented late in comparison with countries such as Spain, Ireland and Portugal.

Chart 2 Nominal exports by destination vs REER (y/y)

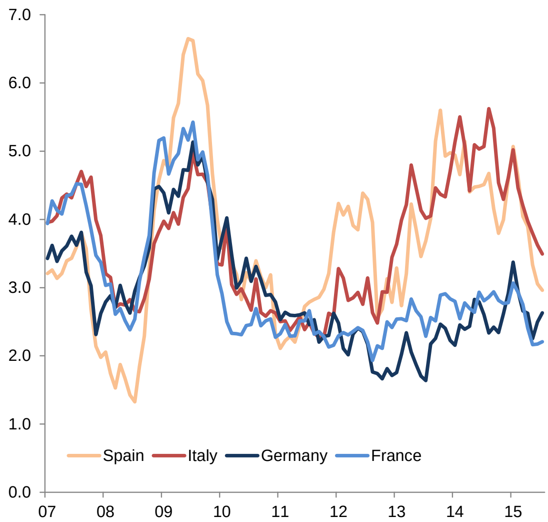


Improving financing conditions for companies thanks to the ECB QE, but demand issues prevail and turnovers are flat

Since the beginning of the year, nominal rates on 1-to-5-year loans to Italian SMEs decreased significantly (-80bp) to 3.7% - also true for real interest rates (see Chart 3). Even if it is at an early stage, the reduction in interest rates witnesses the pass-through from ECB and financial institutions to the real economy after 6 months from the start of the Quantitative Easing Programme. However, the spread compared to the core countries remains high (+0.85bp vs the eurozone average), so more needs to be done. We expect the ECB to maintain its QE program at least until mid-2017 and to increase its size by year-end.

Although recovering, domestic and external demand prevail below pre-crisis levels and this explains why lending to corporates continues to fall. Further, downside price pressures for companies remain high due to the zero-inflation environment.

Chart 3 Real interest rates on loans to SMEs (1 to 5 years)



Sources for charts: ISTAT, IHS, Bloomberg, Euler Hermes

After having lost -14% since 2008, industrial turnovers started to show a timid sign of recovery in Q2 2015 (+2.7% y/y, see Chart 4), essentially led by the manufacturing sector.

Still close monitoring for insolvencies and non-performing loans

(i) After double-digit growth in both 2013 and 2014, business insolvencies are expected to decrease by -2% in 2015 (to 15,300 cases) and by a further -5% in 2016. However, they remain 2.5 times above the 2007 level.

(ii) The high number of non-performing loans remains a critical point as they reached a new record high of EUR197.1bn in July. However, the proposed reform of converting Italy's ten largest cooperative banks into joint-stock companies, together with the possibility of creating a "bad bank" to collect loans from insolvent borrowers, improves the outlook.

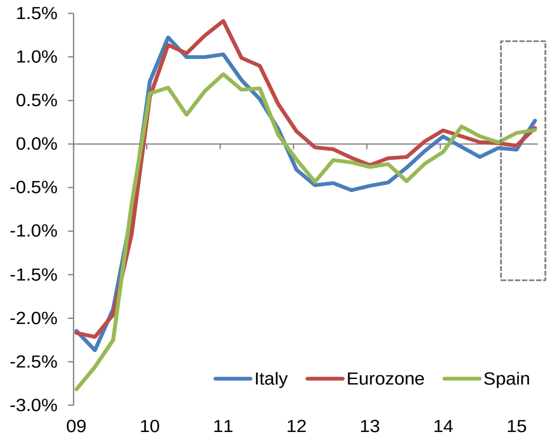
Progress in the reform agenda, although measures come late compared to peers

Although the ruling Democratic Party (PD) led by PM Matteo Renzi performed below expectations in the May 2015 regional elections, especially in Northern regions such as Veneto and Liguria, the center-left government maintained the momentum on its reform initiatives. The law decrees 22/23 2015, entered into force last March - the so-called *Jobs Act*, see Table 2 - aiming to create better incentives for firms to hire and train workers, while reducing job protection and increasing contracts' flexibility through the revision of Article 18 of workers' Statute.

The first positive effects of Renzi's *Jobs Act* on GDP growth and employment are already visible, although moderate (see Chart 5). However, the NRP (National Reform Program) will not be limited to the job market: efforts have been done both to increase product market competition and to raise public sector efficiency (e.g. the Annual Competition Law's implementation steps and "*Destinazione Italia*", a reform intended to liberalize the energy sector). Administrative and bureaucratic inefficiencies represent to date the major brake to resettle Italian productivity to its pre-crisis levels: the pace for reform implementation is slower than initially expected and especially compared to peers.

However, structural bottlenecks such as stagnant productivity, high unemployment, labor misallocation and the public debt which stands above 130% of GDP will continue to limit the Italian growth engine.

Chart 4 Industrial turnovers, y/y



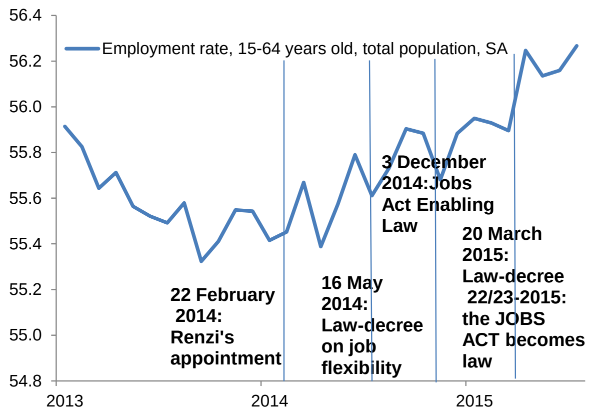
Sources: Eurostat, Euler Hermes

Table 2 Highlights from 2015- 2016 job market reform

Renzi's Jobs Act in 6 points	1. **Reorganization of contract types**, with the introduction of a **new permanent contract** which provides **increased protection** depending on work seniority
	2. **Interruption of layoff payments** if the firm's activity permanently ended
	3. **Revision of article 18** (workers' Statute) on unfair dismissal (reduction in firing costs and abolition of differentiation based on firms' size)
	4.Firms' independence in **restructuring and reorganizing workers' tasks**
	5.**Universalization of unemployment benefits** through the national social insurance agency **(ASPI)**
	6. **Establishment of a National Agency for Employment**, responsible both for Employment Services and the Social Insurance Agency (ASPI)

Sources: Official documents, Euler Hermes

Chart 5 Employment rate and job policies evolution



Sources: IHS, Euler Hermes

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