Euler Hermes Economic Research

Economic Insight

Italy: The show must go on

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Executive summary

- Italians voted No to constitutional reform in a referendum (59.1%) and Prime Minister Renzi resigned. In 2017, political uncertainty can cause a mild confidence crisis. If there are no spillovers to banks or the bond market as the baseline scenario suggests, the downturn may shave off -0.3pp of Italian GDP. In this case, the economy should grow by a mere +0.6%.
- A knee-jerk reaction is inevitable. But a 2011-12 style financial stress, which would cost -0.7pp in GDP growth and push Italy close to zero growth (+0.2%), should be avoided. This time around Italy benefits from stopgaps, courtesy of Europe, such as the ECB's QE program and the ESM 2.0. Add to that the country's structural strengths: fiscal surplus and debt ring fencing. The Italian banking sector should feel the pinch.
- Italian companies will bear the brunt of a confidence shock, albeit mild. Slight divestment from abroad and tougher financing conditions mean that investment will stay flat. +2% growth was previously expected for 2017.

Italians said No to Constitutional reform and Renzi resigned. No panic needed, but confidence will take a hit

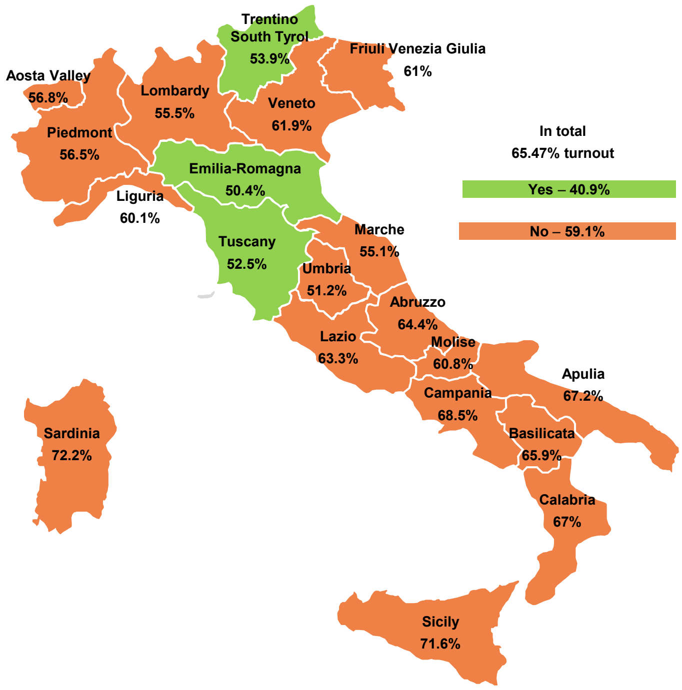
On December 4, 65% of Italian voters cast their ballots. The results – 59.1% voted to reject a proposed constitutional reform – were anticipated by pollsters. The almost 20 point gap was not. The results signified widespread defiance of Prime Minister Renzi, who was asking for the people's direct support for the first time since taking office. As a consequence, Renzi announced his resignation, opening yet another period of political uncertainty in Italy.

This year, Italian GDP performance has disappointed time and again. Growth should reach +0.9% in 2016, a lackluster performance compared to the +1.6% Eurozone average. Moreover, Italy's fragilities, and its banking sector's precarious position, have taken center stage following the Brexit vote and US election. The economy's prospects are once more linked to confidence – or lack thereof. This is evident both domestically and abroad.

The President may appoint a Grand Coalition or a Technocrat government to serve in the run-up to the next elections. These are due in the first half of 2018, or in late 2017, if most pundits are to be believed.

Latest polls show the ruling Democratic Party (social democrats) in a neck to neck race with the anti-establishment Five Star Movement (M5S). This adds to the uncertainty surrounding Italian policy-making and its safeguarding role.

Figure 1: The Italian Constitutional Reform referendum results by region



Sources: Ministero dell'Interno, Euler Hermes

Moreover, the unresolved status of the two houses of parliament will continue to hinder forward-looking reforms. As a result, markets might test the resilience of Italian banks and public debt.

Investors' confidence will be weaker, to the detriment of companies and banks. Economic reforms could come to a standstill, exposing more of Italy's structural weak points.

Our baseline scenario suggests that Italy will avoid a 2011-12 style confidence crisis with significant economic spillovers. Sovereign bonds are backed by ECB's QE purchases and the European institutional framework has been reinforced. If the political transition is carried out in a swift and transparent manner, negative shocks should remain contained. In this scenario, we expect GDP growth to reach +0.6% in 2017. That is -0.3pp lower compared to our previous forecast.

Yet, if a confidence crisis were to hit banks and/or the bond market with spillovers similar to 2011-12, the impact could be significant. -0.7pp could be shaved off growth in 2017, pushing GDP to +0.2% (Figure 2).

Fearing the spread? Do not expect a 2011-12 rerun

Compared to political transitions in the past, Italy benefits from a number of stopgaps.

(i) **The ECB.** It will remain the savior as it will continue to purchase Italian bonds through its QE program, perhaps until late 2017. Since March 2015, the net monthly purchases of Italian public debt securities by the ECB reached EUR10bn on average. The scheme amounts to EUR188.5bn in total, 10% of the total Italian bond market. This rate of purchase, constrained by the capital key rules of the ECB, would be enough to compensate for a sell-off reminiscent of 2011-12. Still, punctual shocks are possible (Figure 3);

(ii) **Stronger European institutions**. The Banking Union and bail-in rules provide a clearer framework for bank resolution excluding public intervention. The European Stability Mechanism (ESM) is also a source of stability and would allow the ECB to purchase even more Italian sovereign bonds in the secondary market if a Memorandum of Understanding is signed;

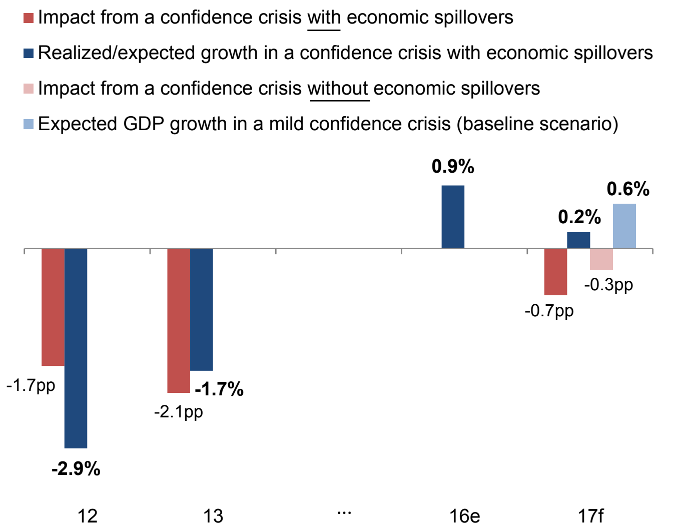
(iii) **The primary balance surplus** stood at +1.4% in 2015. It should strengthen going further and reach +2% in 2018. Thus there should be some room for manoeuver to face higher interest expenditures for 1-year or so. The average interest rate on the debt currently stands at around 3% and allowed the Italian government to save EUR20bn over the past years; and

(iv) **The ring fencing of Italian debt**: 65% remains held by Italian residents which will mean that contagion effect to the other eurozone countries should remain limited.

The restructuring of Italian banks is a matter of confidence

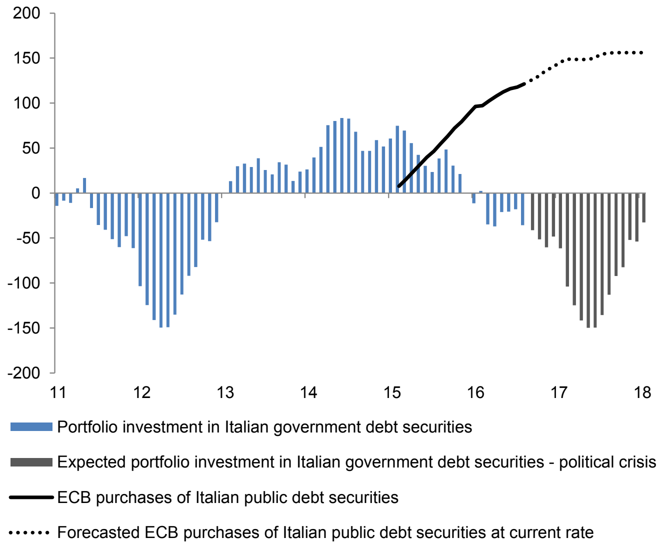
The stress tests conducted by the European Banking Authority this summer have reassured investors fretting about the resilience of major Italian banks. The local banking system remains fragile for three main reasons: (i) the high stock of non-performing loans, notably *sofferenze,* i.e. non-recoverable loans, equal to 12% of GDP (Figure 4); (ii) low profitability; and (iii) undercapitalization, especially of small-medium sized banks.

Figure 2: The impact of confidence crisis on Italian GDP growth



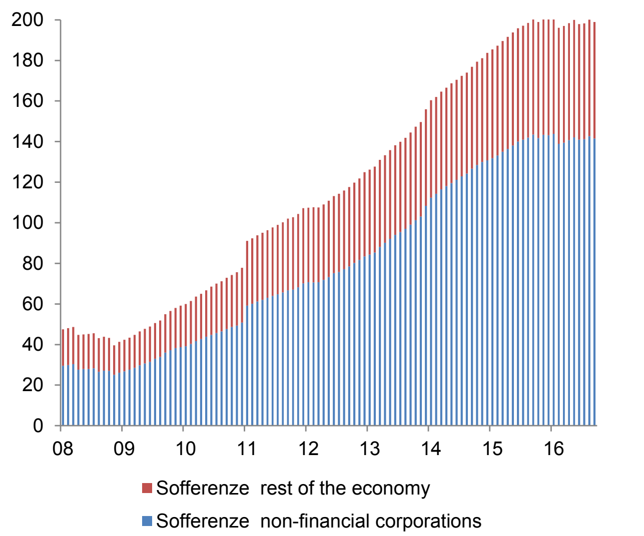
Sources: IHS, policyuncertainty .com, Euler Hermes estimates

Figure 3: Portfolio investments in Italian government bonds vs. ECB's purchases of public debt securities
EUR bn, cumulative 12M



Sources: Bloomberg, Bank of Italy, Euler Hermes estimates

Figure 4: Gross bad debts (*sofferenze*) held by Italian banks (EUR bn)



Sources: Bank of Italy, Euler Hermes

This is the case of *Monte Paschi di Siena*, which is going through an arduous EUR5bn recapitalization process. Other regional banks, such as *Banca Popolare di Vicenza* and *Veneto Banca* are also bearing the brunt. This affects many local enterprises.

With a number of M&A deals pending - *Banco Popolare* and *Banco Popolare di Milano* are prominent examples - further restructuring and consolidation efforts are to follow in the upcoming months. Privately-funded and government-sponsored solutions, such as the Atlas Fund which is supported by the Italian Treasury's guarantee schemes (GACS), are already in place. But investors' confidence, which depends on political stability and economic prospects, will play the pivotal role.

Italian companies could stray from recovery

Italy's firms are in a recovery mood: turnovers increase and profits are up. At the same time, companies are moderately indebted and hold high amounts of cash.

Yet business confidence remains fragile and might be impacted by a period of political transition through several channels.

(i) **Investments from abroad** will likely take a hit if political turmoil intensifies. In 2012, foreign acquisitions of Italian companies have dropped by more than 30% compared to 2011 (Figure 5).

(ii) Increasing pressure on banks would lead to **deterioration in financing conditions** for Italian firms. These rely on banks to cover 60% of their financing needs. This will make Italian companies, particularly SMEs, even less competitive than their European counterparts and could hurt profitability.

(iii) Higher financing costs and negative confidence effects could hamper SMEs' growth in 2017. As confidence remains brittle we estimate that if political turmoil resembles 2011-12 **investment growth could stall** instead of growth by close to +2%.

Keeping the eye on the ball as far as reforms are concerned will reassure

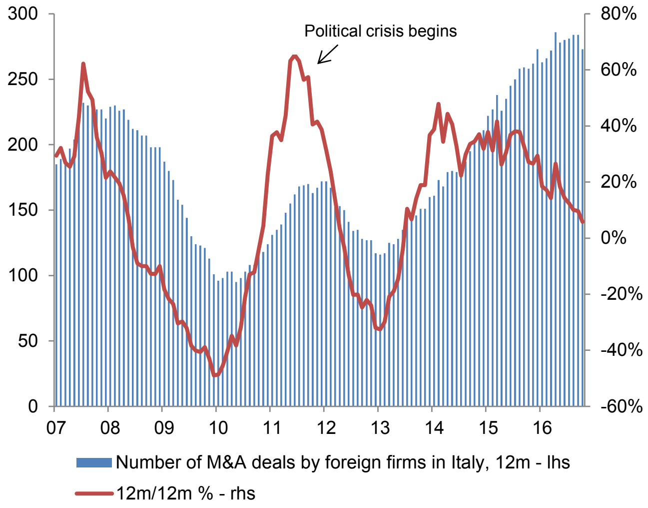
Productivity is critical to restore growth and make public debt sustainable

Notwithstanding spending review efforts, the stock of Italian public debt has peaked to EUR2,255bn in July 2016. It is expected to reach 133% of GDP in 2016. As both primary surplus and low interest rates are still in place, the main problem remains sluggish GDP growth. It stood at +0.6% on average over the past 3 years and negative on average since 2008 (Figure 6). Although the expected return of inflation should help, Italy still needs to tackle the structural weakness, i.e. low productivity.

Reforms to boost Italian firms' competitiveness are even more urgent given the sluggish growth of global trade and adjustment efforts made by European countries such as Spain and Ireland. This limits the potential of the mighty Italian exports machine.

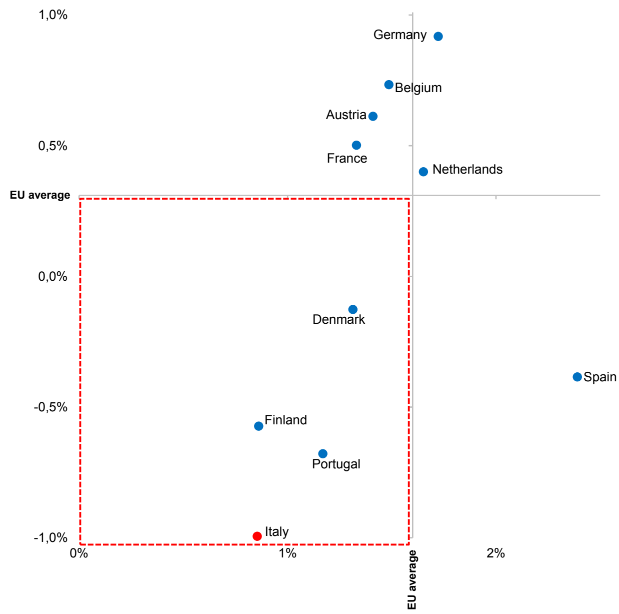
Worse still, Italian labor productivity has barely increased in the last fifteen years (Figure 7). It grew at an average rate of +0.3% far below the eurozone average of +1.1%. The gap is explained only in part by Italy's specialization in low to medium value-added sectors.

Figure 5: The number of M&A deals by foreign investors in Italy (cumulative 12m)



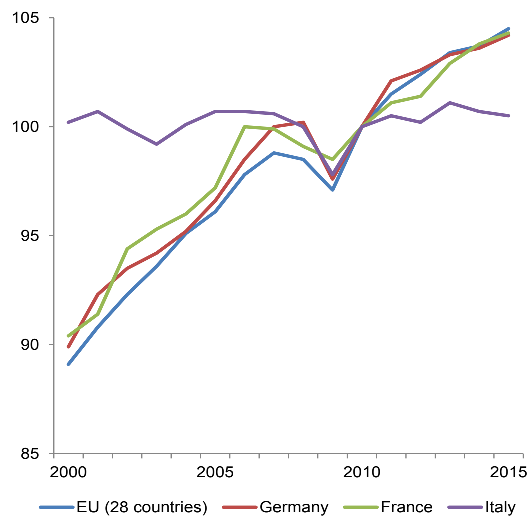
Sources: Bloomberg, Euler Hermes

Figure 6: Average GDP growth 2016-2017 (x-axis) vs Average GDP growth 2008-2015 (y-axis)



Sources: IHS, Euler Hermes estimates

Figure 7: Labour Productivity Index
(Real GDP per hour worked)



Sources: Eurostat, Euler Hermes

In fact, the country continues to suffer, *inter alia,* from high labor costs, a dysfunctional training system, and low innovation. The shrinking labor force and a historically low fertility rate of 1.37 are additional important structural drags.

R&D investments are needed to revitalize firms' competitiveness: *Industria 4.0* is a positive step but implementation risks remain

In order to boost innovation, the government has launched a 3-year industrial plan in September 2016. *Industria 4.0,* inspired by a German initiative, designed to boost research and development expenditures. These represent only 1.3% of Italian GDP while the average euro area is 2.1%.

The plan aims at increasing private investments in R&D by EUR24bn by 2020, and the government has already committed EUR13bn to cover tax cuts on investments that will be realized in 2017. It also announced its intention to allocate additional EUR6.7bn for maximizing firms' access to ultra-broadband and strengthen its support to soft-loan schemes meant to boost machinery upgrades.

Public efforts are in place. Yet as in the case of banks' restructuring the key success factor will be investors' confidence.

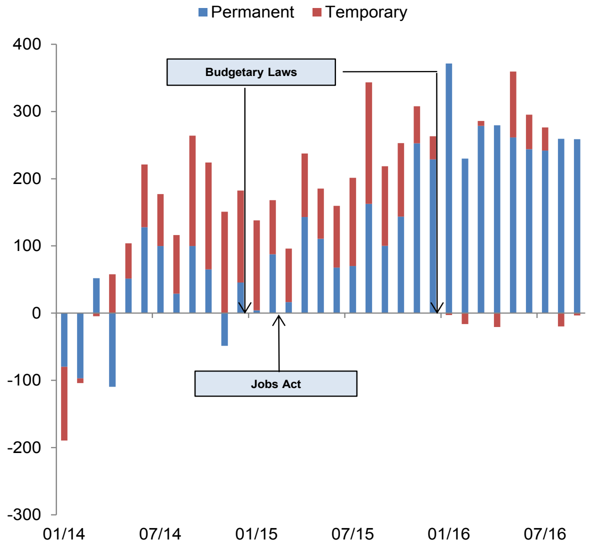
The Jobs Act is delivering, but labor costs are still to be reduced

The Jobs Act which entered into force in March 2015 has introduced some flexibility into a relatively rigid labor market. It contributed to the creation of more than 3.5 million jobs over the last 12 months or +56%, 12m/12m (Figure 8).

The effort has been accompanied by the education system reform. *La Buona Scuola* should help academic institutions become more responsive to labour market demands, through the strengthening of on-the-job training programs. According to the Italian Treasury, it will contribute mostly to long-run growth, adding +2.4% to baseline GDP.

Yet, reforms are still needed to tackle the high cost of labor. With a tax wedge of 47.9%, Italy remains well above the OECD average of 35.9%. Although the fiscal incentives included in the two last Budgetary Laws (the so-called *decontribuzioni*) have pushed down labor costs by 4% y/y in Q2 2016 (excluding wages and salaries), these remain one-off solutions.

Figure 8: Net creation of new contracts



Sources: ISTAT, Euler Hermes

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