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Italy
Prometeia Brief

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Executive summary

- 2017 growth forecast confirmed at 0.7 percent ...
- ... and 2016 slightly revised upward
- EC requests supplementary budget in 2017
- InFocus: the Italian TARGET2 balance...
- ...and how US protectionist policies and a stronger dollar may impact Italian exports.

GDP and inflation

The recovery is moving forward but higher political uncertainty will weigh heavily going forward. Rising inflation is mostly due to higher energy and fresh food prices, not to core inflation.

According to the first official release, GDP increased at a rate of 0.2 per cent (q-o-q) in Q4 2016, in line with our expectations. Even if high-frequency indicators point to a continuation of the recovery in Q1 2017, signs of a likely slowdown have been emerging. Household consumption continued to increase in the second part of 2016 but at a slower pace than in the previous quarters, partly reflecting a rise in households' saving propensity related to higher uncertainty. Moreover, investment in construction is still performing poorly and there are only weak signs of recovery in investment in machinery and equipment. Fiscal incentives, the gradual recovery of the credit market and the historically low interest rates do not seem enough to boost the rate of capital replacement so far. Overall, we see GDP in 2017 increasing more slowly than in 2016 (0.7 per cent compared to 1 per cent).

Table 1 **GDP growth quarterly profile**

	2016q4	2017q1	2017q2	2017q3
GDP (% change q-o-q)	**0.2**	0.2	0.1	0.1

in bold historical data.

The labour market performed strongly in 2016. Last December there were 240 thousand more people employed than a year before and the employment rate had increased by 0.7 percentage points, reaching 57.3 per cent. These favourable conditions attracted previously discouraged workers, who entered the labour market and thereby increased labour supply (+377 thousand). Consequently, the participation rate increased by 1 percentage point, reaching 65.2 per cent, and the unemployment rate increased from 11.6 per cent in December 2015 to 12 per cent a year later.

Overall inflation increased from 0.1 per cent in November 2016 to 1.0 per cent in January 2017, while core inflation remains at 0.5 per cent. A few factors have contributed to the increase in the consumer price index, notably higher oil prices, the depreciation of the euro and the bad weather conditions, which have damaged agricultural crops. ■

Public finances

The European Commission has formally requested a supplementary budget in 2017. There is some uncertainty on which measures the government will propose.

The 2016 deficit-to-GDP ratio is expected to come in at 2.3 per cent, thus meeting the authorities' headline deficit goal. Italy's public accounts are, nevertheless, under close scrutiny from the European Commission (EC), which has asked the Italian government to approve corrective budget measures for an amount equal to 0.2 per cent of GDP (about €3.4 billion). Which measures the government will put in place is still an open question. Officials have mentioned cutting spending, broadening the tax base through greater "compliance" and finally, expanding the "split payment" (this latter measure has already been announced).

The EC request adds another layer of uncertainty to Italy's situation after the decision by rating agency DBRS to downgrade it from A to BBB, the Constitutional Court decision to allow a referendum on some parts of the so-called "Jobs Act" and, last but not least, the prospect of early political elections. The widening of Italy's bond yield spread with Germany to over 200 basis points is a further sign of the country's weaknesses. This increase in yields, however, will have moderate effects on interest spending as in 2016 the average maturity of the debt reached 7.3 years and the average annual cost-at-issuance an historical low of 0.55 per cent. Moreover, the 2016 increase in public debt is mostly explained by an accumulation of a buffer of about €7 billion (compared to a decrease of around €11 billion in 2015).

Although the planned fiscal stance is mildly expansionary, for 2017 the government targets a deficit-to-GDP ratio at 2.1 per cent (0.2 per cent down from the 2.3 per cent previously stated), and a debt-to-GDP ratio at 132.6 per cent, thanks to privatisations that are expected to generate receipts equal to 0.5 per cent of GDP (around €8 billion), and to an expected higher (compared to 2016) nominal GDP growth (2 per cent). Compared to these government figures, we estimate a lower nominal GDP growth rate and higher interest rates on sovereign debt so we expect a higher deficit, at 2.5 per cent, and a further moderate increase in the debt-to-GDP ratio (to 133.3 per cent in 2017)[1]. ■

Credit and banks

In December 2016 credit growth to households and firms continued to improve (+1.1 per cent y-o-y), but still underperformed the EU average (+2.3 per cent). Non-performing loans increased as well (+0.9 per cent m-o-m).

Table 2 **Italy: macroeconomic scenario** *(% change)*

	2016	2017	2018		2016	2017	2018
GDP	1.0	0.7	0.8	Consumer prices	-0.1	1.3	1.5
Imports	2.0	3.3	2.5	Household disposable income	2.4	1.9	2.2
Household consumption	1.4	0.6	0.8	Total employment	1.2	0.3	0.3
Government expenditure	0.6	0.2	0.2				
Gross fixed capital formation:				General government fiscal balance*	-2.3	-2.5	-2.4
- machinery and equipment	3.1	2.1	1.0	Structural balance*	-1.5	-1.8	-2.0
- constructions	0.9	0.1	0.6	General government debt*	132.6	133.3	133.3
Exports	1.4	3.4	3.2	10 year government bond yield	1.48	2.30	2.44

** % of GDP*
National Accounts Aggregates based on ESA 2010.

1 Debt figures are net of funds to support the banking sector.

In December credit[2] to households continued to increase (by 1.9 per cent y-o-y), broadly in line with the euro area average (2 per cent). This growth was mainly supported by consumer credit and mortgage. In 2016, the overall flow of loans to households increased by €12 billion, compared to €4.7 billion in the previous year.

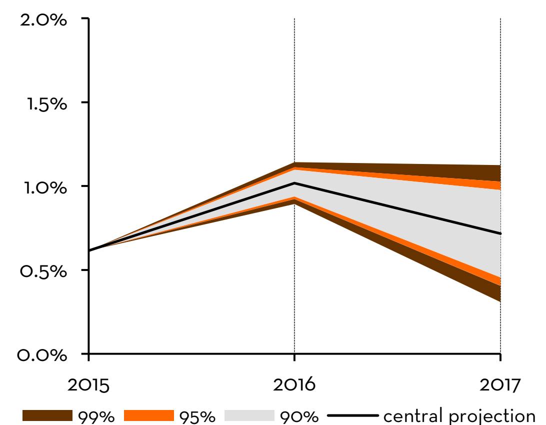
Credit growth to firms, at 0.2 per cent y-o-y in December, still underperformed the euro area average (2.3 per cent). Nevertheless, in 2016 net flows were positive (€2.2 billion) for the first time since 2012 (in 2015 net flows were negative and equal to -€4.2 billion). According to the Bank Lending Survey, in Q4 credit supply conditions remained stable, as well as firm credit demand. Bad loans related to firms increased (by 0.2 per cent y-o-y in December), raising the ratio between bad loans and loans to 18.5 per cent (from 18.1 per cent in November).

On 16th February Parliament approved a law (the "salva-risparmio") to create a €20 billion fund to support the banking sector. The law implements the decree of 23rd December (see our January 2017 Brief). Although the fund has been put in place to recapitalise problem banks, provide guarantees on new bond issues and obtain liquidity from the central bank (emergency liquidity assistance, ELA), about €9 billion has already been committed to sustain Monte dei Paschi's private recapitalisation plan and up to €5 billion to two other banks, Banca Popolare di Vicenza and Veneto Banca. ■

Risks to the projection

- In his first month in office, President Trump has focused on protectionist and immigration policies, but was less active on expansionary fiscal policy. This is the worst combination for the European economy.
- Political uncertainty is growing ahead of important European elections. Anti-euro parties remain strong.
- Italy's political situation looks even more fragile with the possibility of a split in its larger party, the Democrats.

Figure 1 **Prometeia forecast of annual GDP growth** *(central projection and confidence levels)*



Prometeia calculations (see 2015 December Brief for methodology).

2 ECB statistics; credit growth to both households and firms has been adjusted for statistical discontinuities and securitisations.

InFocus

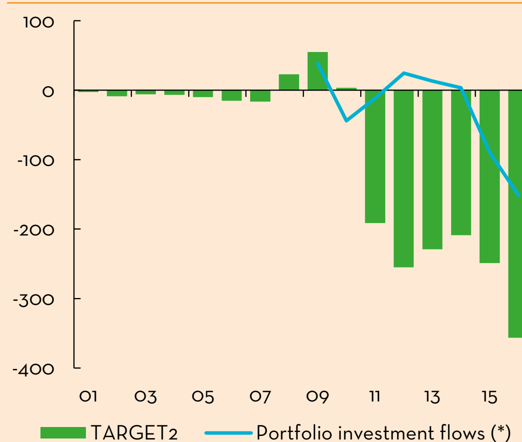
Are capital outflows behind the worsening TARGET2 balance?

In December 2016, Italy's debt position in the TARGET2 payments system[1] reached its highest ever value of €357 billion, €107 billion more than in 2015. This deterioration has mainly reflected a worsening of the balance of portfolio investment.

The TARGET2 balance reflects the difference between transactions that give rise to an outflow of funds towards non-residents and those that give rise to an inflow of funds from non-residents. This difference, when negative, corresponds to the Bank of Italy's debit balance vis-à-vis the ECB, and therefore the TARGET2 balance represents a debt position of the country vis-à-vis the rest of the Eurosystem.

In 2011, during the sovereign debt crisis, TARGET2 positions became negative after having been balanced since the start of EMU and reached €191 billion, reflecting the refinancing of national banks by the ECB through the LTRO (Long-Term Refinancing Operation) programme.

Figure 2 **TARGET2 balance and portfolio investment –** *€ billion*



(*) Outflows have negative values.
Sources: Prometeia calculations on Bank of Italy and ECB data

In 2016, for the first time since 2012, non-residents have reduced their investments in Italian securities, while at the same time residents have increased their investment in foreign assets as part of a portfolio diversification process in search of higher returns.[2] This reallocation mirrors, and has probably been favoured by, the ECB Asset Purchase Programme, since as part of the programme the Bank of Italy has been buying Italian government bonds, a relevant share of which are from non-residents.

How US protectionism and a strong dollar may change the scenario for Italian exports[3]

The United States is the third biggest market (and the first outside Europe) for Italy's exports, and of growing importance, as the share of exports to the US increased from 6.2 per cent to 9.2 per cent between 2010 and 2015.

The possibility of a trade policy with a pre-WTO 1980s flavour (Trump's "Make America great again" slogan dates back to Ronald Reagan) does not seem compatible with the current system of multilateral regulations. Moreover, it would undoubtedly raise costs for foreign companies selling to the US. For example, setting customs tariffs at 1989 levels would cost Italian companies an estimated €756 million (Fig. 3), or 2 per cent of the current value of their US exports, with a particularly heavy cost for the "Made in Italy" sector (i.e. fashion and textiles, food, and vehicles, as duties on these sectors were relatively high back in the 1980s), and for mechanics (Italy's largest export sector to the US; Fig. 4). However, this is a scenario that – although technically possible – would amount to a complete rejection of existing institutions and multilateral relations, which seems quite unlikely.

1 TARGET2 is the real-time gross settlement (RTGS) system owned and operated by the Eurosystem.

2 According to the Bank of Italy, this diversification involved only marginally assets of core euro area countries (France and Germany) suggesting that the flight to quality does not represent the main driver of portfolio diversification.

3 For more details, "*The Trump effect on Made in Italy: What, where, if and when...*"

Figure 3 **Increase in duties for Italian companies in the event of a return to pre-1990s tariffs**
€ thousand

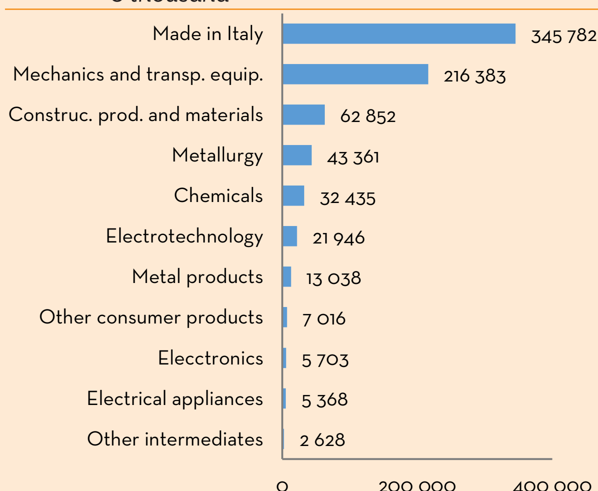
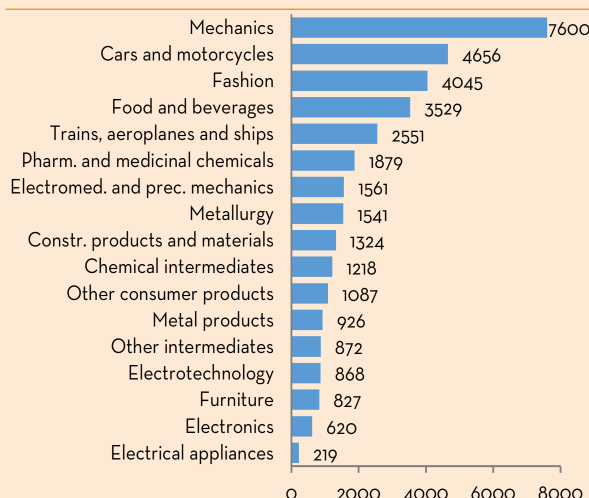


Figure 4 **Italian exports to the United States**
€ million, 2015



Source: Prometeia calculations based on NBER, WTO and FIPICE data

The new US administration has already had a significant effect on the dollar. It appreciated substantially right after the elections, although it has since partly corrected. Prometeia estimates that if the dollar were close to par to the euro throughout 2017, this would amount, ceteris paribus, to an increase of around 2 per cent for Italy's worldwide exports.

The potential gain here comes first and foremost from the US market, but gains would also be obtained in all the international markets where Italian companies compete with US ones or with firms from countries with a fixed dollar exchange rate. Looking at the over 6,000 product/market combinations Prometeia uses to analyse global trade, it emerges that Italy and the US are among the top five competitors in 15 per cent of their external markets. From the point of view of individual sectors, those that would gain the most are mechanics, food and beverages, and fashion, all of which are extremely important components of the Italian export system.

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