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Italy
Prometeia Brief

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Executive summary

- GDP growth forecast for 2016 revised upward to 0.9 per cent ...
- ... while 2017 forecast revised downward to 0.7 per cent
- Effects of recent downgrade of Italian sovereign debt expected to be minor
- InFocus: new government measures to provide support to Monte dei Paschi di Siena and ensure financial stability ...
- ... and the recent Constitutional Court ruling on the Jobs Act

GDP and inflation

The latest data for the second half of 2016 suggest that the recovery is strengthening. However, the increased political uncertainty following the resignation of Prime Minister Matteo Renzi in December and his replacement by former Foreign Minister Paolo Gentiloni will weigh on economic activity in 2017.

GDP growth was 0.3 per cent (q-o-q) in Q3, thanks to households and public consumption (+0.1 and +0.2 per cent q-o-q respectively), and investment in machinery and equipment (+1.7 per cent q-o-q). On the other hand, exports increased less than imports, generating a negative contribution.[1]

Monthly data for Q4 has led us to revise upward our Q4 growth forecast, from 0.1 to 0.2 per cent.

Table 1 GDP growth quarterly profile

	2016q3	2016q4	2017q1	2017q2
GDP (% change q-o-q)	**0.3**	0.2	0.1	0.2

in bold historical data.

The industrial production index increased by 0.7 per cent m-o-m in November, and by 1.3 per cent from the beginning of 2016 compared to the same period of the previous year. Manufacturing firms' production expectations also improved. Based on our estimates for the whole of 2016, domestic demand contributed 1.3 per cent to growth, while changes in inventories and net exports both contributed negatively (by -0.3 and -0.1 per cent respectively). Domestic demand has been the main engine throughout the year, sustained by an improved credit and labour market climate and a negative inflation rate (-0.1 per cent).

As far as 2017 is concerned, the improvements over the second part of last year and the effects of slightly better international economic conditions could be offset by the impact of the rejection of the constitutional reform in the December referendum and the ensuing resignation of Prime Minister Matteo Renzi. A new government with a limited scope, the possibility of early elections and of a new

1 In the last few months of 2016, the Italian National Institute of Statistics significantly revised the national accounts for the years 2013-2015. GDP growth was revised upward for 2013 and 2014 (by 0.8pp overall), while the figure for 2015 was confirmed.

referendum on labour market issues (see InFocus), coupled with the scheduled elections in important euro area countries, will increase uncertainty. This will add to the already known banking sector difficulties (see InFocus). Overall we estimate that this increase in uncertainly could negatively affect growth in 2017 by as much as 0.3 per cent.[2] ■

Public finances

General government net borrowing for 2016 should end up at 2.4 per cent, the lowest level since the start of the financial crisis and in line with expectations. For 2017, while the budget deficit at unchanged policies is estimated at 1.6 per cent of GDP (mainly due to a legislated increase in the VAT rate), the Budget Law adopts an expansive stance targeting a deficit equal to 2.3 per cent. Importantly, the planned reduction in the corporate tax (IRES) rate from 27.5 to 24 per cent is confirmed. Regarding the medium term, the government aims at a zero deficit in 2019 which we believe is optimistic.

The 2017 Budget Law, approved on December11th, contains new expansionary measures for about €25 billion (around 1.5 per cent of GDP) with new financing for only about €13 billion (0.8 per cent of GDP). The remaining 0.7 percentage points (€12 billion) will increase the deficit as compared to the deficit at unchanged policies.

Among the expansionary measures, the most relevant is the decision not to move forward with the planned increase in VAT (the so-called "clausola di salvaguardia" or safeguard clause) which is worth €15 billion. Moreover, higher investment and local spending will account for about €3 billion, including expenses related to migration and the earthquake of last summer. There is also an increase in public employees' wages and social assistance measures (about €4 billion). On the revenue side, the Law extends fiscal easing for investing firms ("super-depreciation" allowance) for innovative industries ("Industry 4.0") and for research and development which, together with other small measures, will cost about €3 billion. New financing will mainly come from extraordinary or temporary revenue measures (the fight against tax evasion, the reform of tax collection, amnesties, and the sale of broadband licences) and partly from spending measures.

We predict a worse outcome than 2.3 per cent, at 2.7 per cent. This is partly due to differences in macroeconomic assumptions (the government assumes a higher GDP growth, at 1 per cent) and a lower efficacy of spending measures. The increase in government bond yields, due to both a steeper yield curve (reflecting market expectations on the policy mix of the new US administration) and a larger spread between BTP and Bund than the one assumed at the time of the budget formulation will also have some weight. Regarding the recent sovereign downgrade, we do not expect it to have additional effects on government bond yields, as it was largely expected by market participants and priced in before the announcement. On January 17th the EU informed the Italian government on a possible excess deficit of 0.2 pp of GDP in 2017. It is not yet known how the government will address the recommendation to reduce spending. ■

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

	2016	2017	2018		2016	2017	2018
GDP	0.9	0.7	0.8	Consumer prices	-0.1	1.2	1.5
Imports	1.7	2.2	2.4	Household disposable income	2.4	2.0	2.2
Household consumption	1.4	0.6	0.7	Total employment	1.2	0.4	0.3
Government expenditure	0.6	0.2	0.2				
Gross fixed capital formation:				General government fiscal balance*	-2.4	-2.7	-2.5
- machinery and equipment	2.8	1.5	1.1	Structural balance*	-1.5	-1.9	-2.0
- constructions	0.9	0.1	0.7	General government debt*	132.2	133.4	133.7
Exports	1.3	2.9	3.0	10 year government bond yield	1.48	1.90	2.35

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

2 See Prometeia, "Rapporto di previsione", December 2016.

Credit and banks

Credit growth to households and firms continued to improve in November (0.5 per cent y-o-y), but still underperformed the EU average (2.2 per cent). Bad loans growth has slowed down in recent months and decreased in November (0.2 per cent m-o-m). The recent sovereign downgrade by Canadian rating agency DBRS will weigh on Italian banks' funding costs but will be manageable.

In November credit[3] to households continued to increase, by 1.8 per cent (y-o-y), broadly in line with the euro area average (1.9 per cent). This growth was mainly supported by consumer credit and mortgages, while other credits continued to decline. Since January 2016, the overall flow of loans to households has increased consistently (by €11.2 billion) compared to the same period in the previous year (by €4.1 billion).

On the other hand, credit growth to firms in October and November (0.8 and 0.0 per cent y-o-y respectively) still underperformed the euro area average (2.1 per cent in October and 2.2 per cent in November). Nevertheless, from January to November 2016 net flows were positive (€8.2 billion) for the first time since 2012. According to the Bank Lending Survey, in Q3 credit supply conditions remained stable and firm financial conditions improved, thanks to lower leverage and debt service costs.

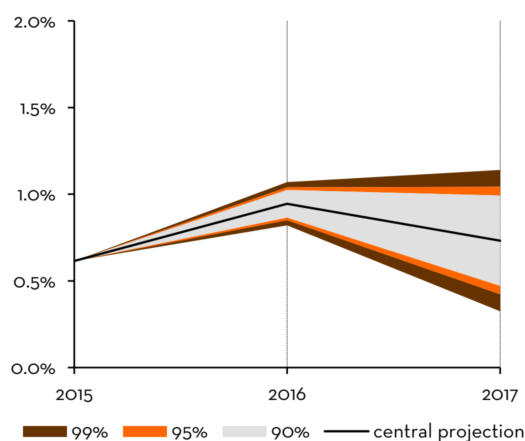
Bad loans related to firms have continued to decrease (-0.9 per cent y-o-y in November) but very slowly, so that the ratio between bad loans and loans has remained stable at 18.1 per cent. The securitisation process has started and it is estimated that the overall amount of bad loans securitised in 2016 will reach €17 billion.

The recent sovereign downgrade by Canadian rating agency DBRS will increase the haircut on Italian sovereign debt and sovereign guaranteed debt placed with the ECB as collateral. For example, the haircut on short-term (up to 1y) bonds (BOTs, CCTs) will rise from 0.5 per cent to 6 per cent, while that on BTPs with 5-7y maturity will rise from 2 per cent to 10 per cent. According to data provided by the Bank of Italy for the Italian banking system at the aggregate level, the collateral buffer currently available to the Italian banking system appears to be sufficient to cover the increased needs. ■

Risks to the projection

- 2017 will be a year full of event-related uncertainties: elections in The Nederland, France, Germany and possibly Italy (where general elections must be held by February 2018 at the latest)
- 20th January will see the inauguration of Donald Trump. There is already heated debate regarding his first moves, which are likely to focus on corporate and income tax reform, but uncertainty looms large
- The Greek situation is still unsettled, with discussions on next steps (and debt restructuring) falling apart

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



Prometeia calculations (see 2015 December Brief for methodology).

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

InFocus

Government measures to ensure financial stability

On December23rd, the Italian government issued a decree establishing the creation of a €20 billion fund to support the banking sector once it was confirmed that Monte dei Paschi's (MPS) private recapitalisation plan had not succeeded (of the €5 billion required only €2.4 had been raised from the voluntary conversion of bonds). The fund can be used: (1) to recapitalise banks, but only those with capital shortfalls arising from a stress test; and (2) to provide guarantees on new bond issues or to obtain liquidity from the central bank (emergency liquidity assistance, ELA) for banks that meet their capital requirements and have no stress test shortfalls. However, there can be exceptions to these last criteria and guarantees can be extended to weaker banks provided that their book value is positive.

The first bank to take advantage of these measures will be MPS, starting with the issuance of state-guaranteed bonds that could amount to €15 billion. To obtain both the bond issuance guarantees and the capital injection, MPS needs to apply for state aid and submit a restructuring plan to the ECB. In accordance with BRRD (the European directive on bank recovery and resolution) rules on "precautionary recapitalizations", capital injection by the state requires burden-sharing, i.e. the conversion of Additional Tier 1 and subordinated bonds into equity. The government decree establishes that Tier 1 debt will be converted at 75 per cent of par value and other subordinated debt at 100 per cent of par value. Moreover, in order to protect retail holders, the decree stipulates that they will be allowed to exchange the shares received from the conversion of their subordinated bonds with senior debt of the bank. The state will then buy these additional shares from MPS.

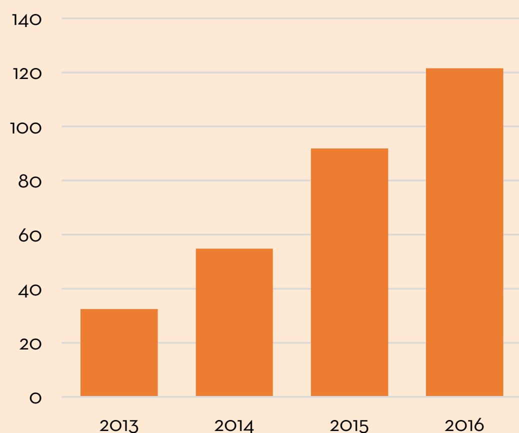
The capital need identified by the ECB for MPS is €8.8 billion, more than the €5 billion that the bank intended to raise from private investors. The difference is due to the fact that the private recapitalisation plan was designed to cover the losses stemming from the disposal of bad loans, about €3 billion, and the increase in the coverage ratio of other deteriorated credits (unlikely to pay), €2 billion. The capital need identified by the ECB is based on the result of the stress test conducted in 2016, as envisaged for precautionary recapitalisations. In the adverse scenario, the common equity tier 1 ratio of MPS was down to -2.44 per cent. To bring this ratio to 8 per cent, as the ECB requires, common equity needs to increase by €6.3 billion (€4.2 billion coming from burden-sharing and €2.1 billion from the state). Moreover, since all additional tier 1 and tier 2 (i.e. subordinated) bonds will be converted, an extra €2.5 billion of capital will be needed to reach a total capital ratio of 11.5 per cent, again an ECB requirement. This brings the total capital need to €8.8 billion and the state contribution to €4.6 billion plus any additional purchase of shares that retail investors involved in the burden-sharing can sell back to MPS (about €2 billion).

Italy's political agenda

After the Constitutional Referendum held on December 4th, a new government was sworn in, led by Paolo Gentiloni but with most of the ministers of the former government. The government's mandate is limited, with the main aim of approving a new electoral law, at least for the Senate (which remains unreformed following the referendum), and dealing with some bank problems. The natural conclusion of the parliamentary term (February 2018) is unlikely to be reached and a general election is expected any time from next June. The outcome of the election seems very uncertain.

On 11th January the Supreme Court ruled on the labour unions' request to (partly) abolish by referendum three laws contained in the Renzi government's labour market reform (Jobs Act). The first of these, a key piece of the labour reform legislation, is the weakening of dismissal rights.

Figure 2 Vouchers *(number/million)*



Source: INPS.

The referendum, deemed non-admissible by the Constitutional Court, aimed at reinstating workers' rights to return to a job in the case of unfair dismissal and extending this to all companies with more than five employees. The second item relates to "vouchers" used to pay workers for occasional work. The voucher, which is worth €10 gross per hour (€7.50 net after social security and insurance coverage), gives workers no rights to sick pay, holidays or leave. They were introduced in 2003 and extended in 2012, mainly as an instrument to bring illegal work out into the open. Over the last few years, they have become much more popular and widely used (Fig. 2), with increasing concerns regarding possible abuse. The referendum (deemed admissible by the Court) aims to eliminate them. The third law refers to contractual responsibilities and intends to exclude the possibility for a collective labour agreement (an agreement with the union at national level) to waive the joint companies' liability. Specifically, both a company that wins a contract and outsources it or part of it, and the subcontractor company (which is generally financially weaker), should be equally responsible towards the workers. The aim is to extend the rights of employees of subcontractor companies in case of adverse situations.

The most contentious and politically charged issue was certainly that of workers' rights to be reinstated, so most of the uncertainty was eliminated by the Court ruling. In addition, the government has indicated that it wants to pre-empt and avoid a referendum through legislative changes. The Court will need to assess the possible legislative changes to be sufficient to address the requests of the Referendum proponents, otherwise the two referendums will have to be held by next June.

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