Italy Outlook:
Gradual Recovery with New Uncertainties

Scope Ratings

Italian GDP increased moderately in 2016, with a yearly growth rate of 1.0% as compared to 0.7% in 2015. Recent indicators point to an ongoing but slow recovery in both 2017 and 2018. New political uncertainties may hinder the implementation of further reforms and, in turn, stronger economic growth. Italy's debt-to-GDP ratio peaked in 2016 at 133% and Scope expects it to stabilise in 2017 and 2018 at levels slightly above 130%. The interest rate-growth differential is likely to benefit from low interest rates and primary surpluses are expected to remain in place despite the government's Budget Law aimed at supporting economic recovery. In a low interest rate environment, GDP growth and primary surpluses will remain the key determining factors for Italian medium term public debt dynamics.

Real GDP grew by 0.2% in the fourth quarter of 2016, reflecting increasing business investment. Scope expects moderate economic expansion at around 1% to continue in 2017 and 2018. The lack of fiscal room, coupled with new political uncertainties, is likely to hinder the dynamics and sustainability of the recovery.

Italy's manufacturing sector output has grown by more than three percentage points since 2014. Such growth supports the country's recovery as well as underscores the country's role as the second largest manufacturer in Europe and the seventh worldwide. However, production capacity has dropped in the aftermath of the global financial crisis and subsequent euro debt crisis.

As in many eurozone countries, Italy's unemployment rate rose significantly during the crisis to over 10%, with youth unemployment peaking at over 40% in 2013. The government's Jobs Act labour market reform implemented in the spring of 2015 boosted the numbers of those in permanent employment despite unemployment and labour costs remaining high. Scope believes that further enhancement of labour market efficiency will continue to play a decisive role in improving Italy's growth prospects.

There is uncertainty surrounding the makeup of the new government following the general election scheduled for the spring of 2018. In Scope's view, this may slow down economic recovery and the implementation of reforms. Anti-establishment political forces have gained in popularity during the years of economic crisis and have benefitted from divisions in the ruling PD party, as well as in the centre-right parties. This political fragmentation is an obstacle to the formation of stable majorities.

Excluding 2009, Italy generated primary surpluses in more than 20 years, even during recessions. In Scope's view, this is credit-positive as it signals Italy's ability to service debt out of its own revenues. The government is expected to continue gradually reducing the deficit ratio. In this scenario, Italy's debt-to-GDP ratio will start a slight downward trajectory in 2017 and 2018, following its peak in 2016. The high stock of public debt remains a vulnerability, despite Italy's proven debt-servicing capacity, which continues to benefit from long maturities and a strong domestic investor base.

Banks' non-performing loans are largely a legacy of the past and are unlikely, in Scope's view, to lead to widespread bank failures or to weigh heavily on public finances. Although remaining a justified concern, asset quality trends have improved over the last several years, together with the economy. Banks have continued to work out their recapitalisation plans.

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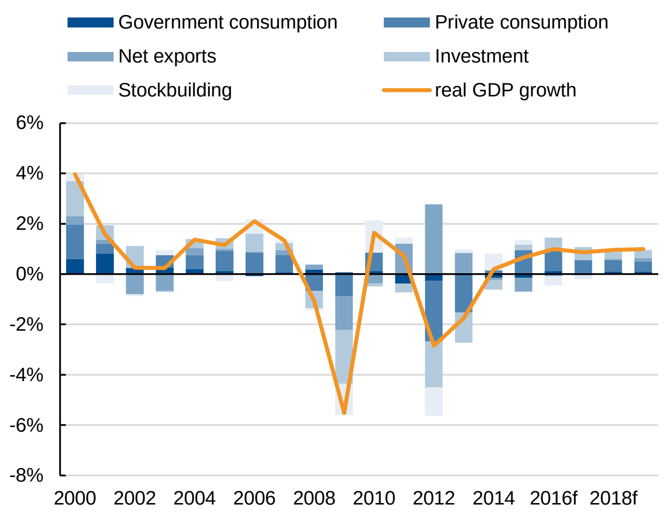
A gradual recovery is underway

Italian GDP increased moderately in 2016, with a yearly growth rate of 1% as compared to 0.7% in 2015. Recent indicators point to an ongoing, yet gradual, recovery. Real GDP grew by 0.2% in the fourth quarter, reflecting increasing business investment. In February, the composite Purchasing Manager Index (PMI) stood at its highest level since 2011, signalling a positive momentum in Q1. Scope therefore expects moderate economic expansion at around 1% to continue in 2017 and 2018.

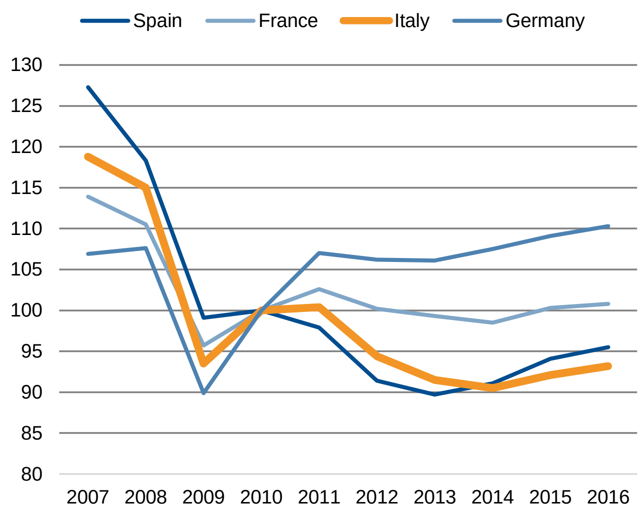
Subdued energy and interest rate costs, as well as the rise in real wages, are likely to continue to support private consumption and business investment. This trend began in 2014 as the Italian economy emerged from the recession. From 2011 until 2013 the negative impact of the euro crisis, followed by frontloaded fiscal consolidation, largely outbalanced international trade surpluses.

Figure 1: Percentage point contribution to real GDP growth



Source: National statistical accounts, calculations Scope Rating AG

Figure 2: Industrial Production, Index (2010=100)



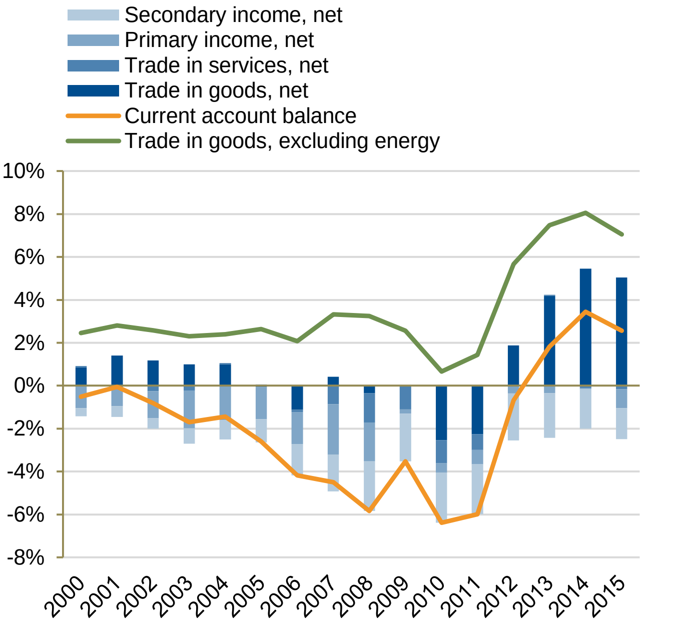
Source: Eurostat

Italy's production capacity fell in the aftermath of the global financial crisis and subsequent euro debt crisis. At the beginning of 2017, industrial production volumes stood at around 93% of 2010 levels. This is in sharp contrast to the strong rise in German industrial production and the stagnation of industrial production in France over the past six years.

The drop in industrial production capacity is a reflection of the vulnerabilities within Italy's production infrastructure. More than 90% of manufacturing output is generated by micro firms concentrated in industrial districts. Even though international trade statistics show that they are competitive within their niche markets (luxury clothing, household goods, food processing, mechanical, goods, motor vehicles), they are also susceptible to market shocks. Their financing capacities are limited and have been hit hard during the euro crisis as the Italian banking sector suffered a loss of confidence in a fragmented European capital market.

However, Italy's manufacturing sector output grew by more than three percentage points from 2014 to 2017, supporting economic recovery and underscoring the country's role as the second largest manufacturing power in Europe and the seventh worldwide. Over the last several years, increases in export values have tended to outbalance volume growth, leading to an ongoing rise in value added to Italian exports. The government launched a three-year, EUR 13 bn industrial plan in the autumn of 2016, providing a range of incentives designed to promote R&D investment, largely through tax credits. Government consumption is likely to remain subdued due to a lack of fiscal spending room. At the same time, new political uncertainties, as well as ongoing challenges for the banking sector will weaken the sustainability of the recovery. Nonetheless, Italy's competitive manufacturing sector is likely to continue to benefit from the improving growth outlook for the euro area and Italy's main trading partners, thus stabilizing growth contribution from foreign trade.

Figure 3: Current account balance % of GDP



Source: IMF, Eurostat, calculations Scope Rating AG

Figure 4: GDP, productivity and employment growth

Source: OECD

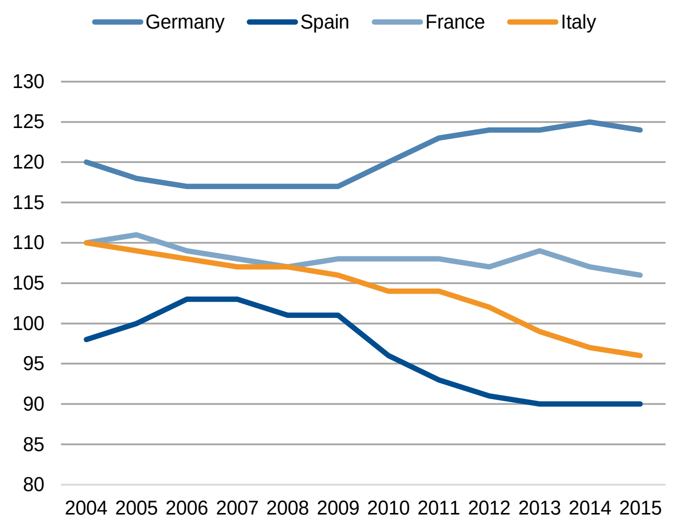
Current account surplus expands further

Italy's current account position has improved considerably moving into a surplus since 2013. This expansion was initially driven by the sharp contraction in imports as a result of the prolonged recession, followed, more recently, by the depreciation of the euro and lower interest costs. The current account is estimated to have reached 2.8% of GDP in November 2016, almost double the surplus for the same period in 2015. This outcome was the result of improvements in the balance on investment income due to increased revenue from portfolio assets (predominantly foreign investment funds) and the growing merchandise surplus, which benefited from a further decrease in energy prices.

Reforms, especially the Jobs Act, have begun to reverse the damage caused by the recession

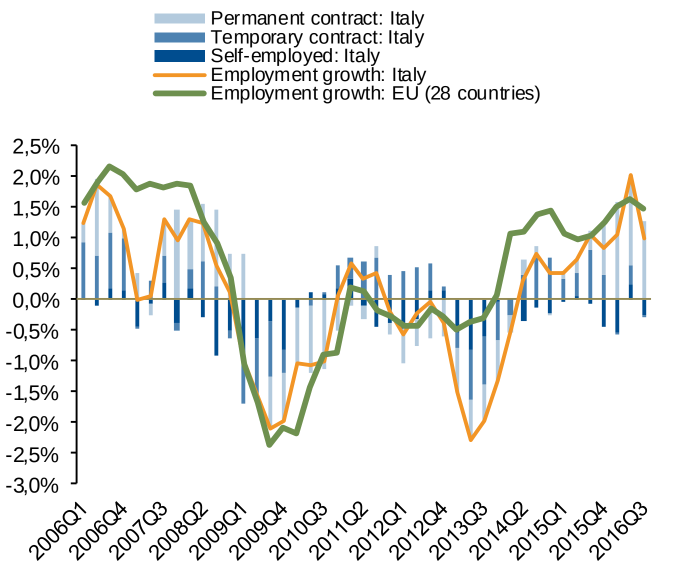
Years of recession took Italy's GDP per capita below the EU28 average. Furthermore, as was the case in many eurozone countries, unemployment rates rose significantly during the crisis to over 10% of the work force, with youth unemployment peaking at over 40% in 2013. In the years before the global downturn, Italy's unemployment rate was among the lowest in Europe. The Renzi government's labour market reform led to the creation of over 800,000 jobs – proof that the Jobs Act, implemented in the spring of 2015, has started to deliver, even if unemployment and labour costs (tax wedge) remain high. Labour market reforms will continue to play a decisive role in improving Italy's growth prospects. There is substantial capacity for increasing the labour market participation rate, which at 65% is among the lowest of the developed countries.

Figure 5: GDP per capita in PPP$ (EU 28 = 100)



Source: Eurostat

Figure 6: Contribution (in % points) to Italy's employment growth



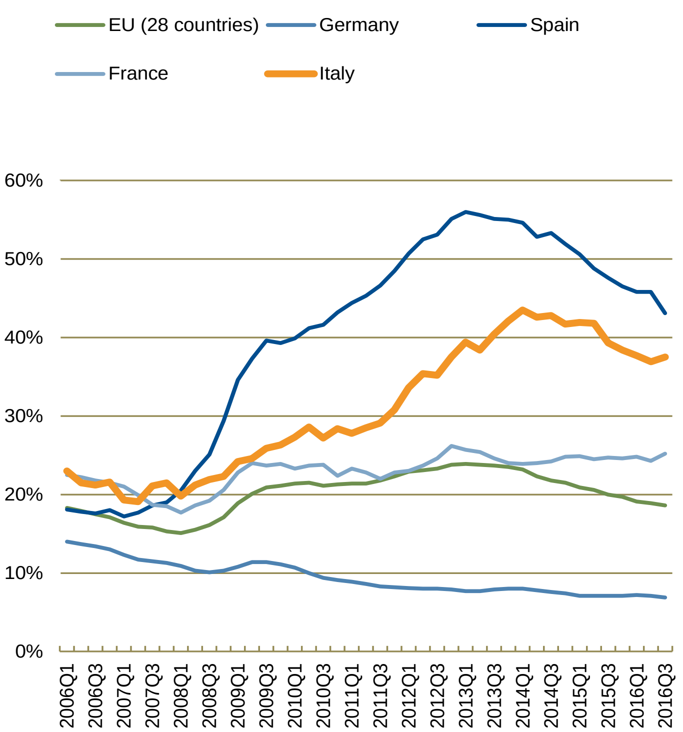
Source: Eurostat, calculations Scope Rating AG

Recent reform efforts followed by new political uncertainty

Some of the structural challenges to Italian society have become particularly pressing since the outbreak of the financial and economic crisis in 2008. Very high youth unemployment is not the only major social challenge. According to Eurostat, nearly one third of the total population is either at risk of poverty or social exclusion. As a consequence, the prolonged recession, together with fiscal austerity measures, appears to have sparked rising euro scepticism and political radicalisation in a traditionally pro-European country.

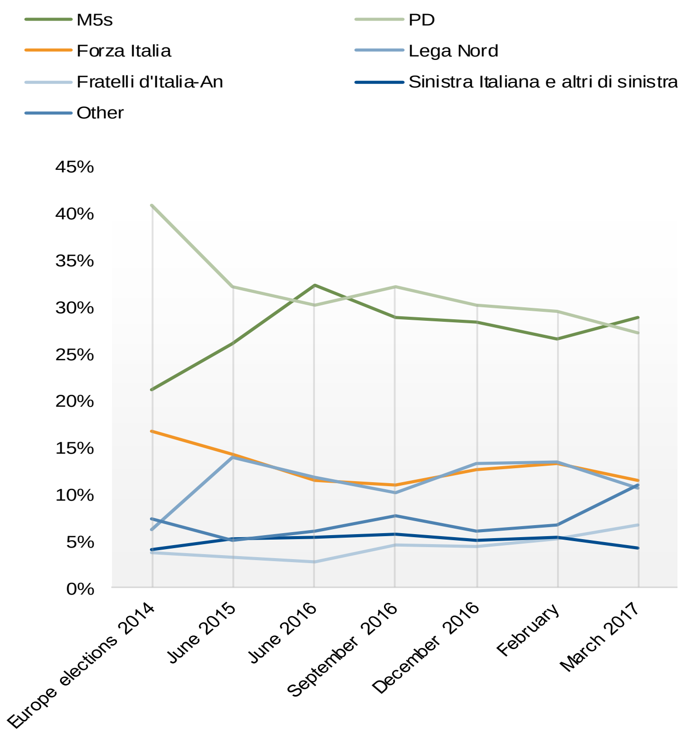
In 2014, Matteo Renzi committed to political and constitutional reforms in an attempt to speed up the country's ability to react to the challenges posed by the crisis. In a bid to gain more room to manoeuvre politically and implement political and economic changes, he planned to streamline and rationalize the structure and work of the senate upper house. These plans were soundly rejected in a referendum in December 2016, prompting Renzi's resignation. Paolo Gentiloni, of the ruling Democratic Party (PD), was then asked by President Mattarella to lead the government until the end of the current legislative period, with a general election planned for the spring of 2018. Until then, one of the government's major tasks will be the harmonization of the electoral laws applying to the lower house and the senate as well as to reach an agreement on an electoral system that will foster political stability. Scope expects parliament to agree on a form of proportional representation with a majority bonus for those political parties that achieve a clear lead of at least 40% of the votes. This will prove a challenge, given the fragmentation of the political landscape.

Figure 7: Youth unemployment (% of active population aged 15-24)



Source: Eurostat

Figure 8: Election voting intentions



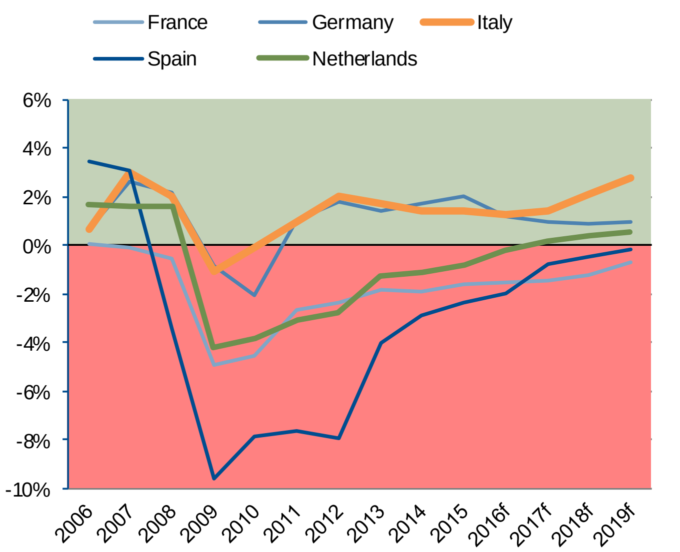
Source: Opinion Polls Repubblica Demos & Pi, March 2017

There is uncertainty surrounding the future authority and leadership of ex-premier Matteo Renzi and the potential makeup of any ruling coalition after the general election scheduled for the spring of 2018. This uncertainty may slow down economic recovery and the implementation of reforms. Anti-establishment political forces, such as the Five Star movement of Beppe Grillo, were strengthened by the economic crisis and have benefitted from divisions in the ruling PD party, as well as on the centre-right. The PD suffered a split in February 2017, reflecting internal battles around its former leader Renzi and future political strategies. Recent developments are likely to complicate future coalition building and may consequently hinder the formulation and further implementation of economic and fiscal reform policies.

Italy one of few countries generating primary surpluses even during recessions

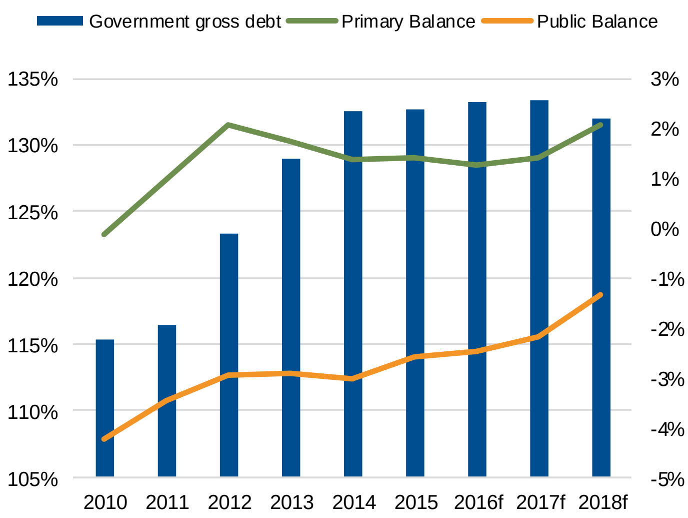
In stark contrast to many government balance sheets in the eurozone (which was severely hit by the global financial crisis, precipitating the eurozone debt crisis), the volatility of Italian public deficits and debts has been relatively weak over the past eight years. Furthermore, with the exception of 2009, Italy has generated primary surpluses averaging 1-2% of GDP every year. This is credit-positive, as it demonstrates the Italian government's ability to pay international creditors in part out of its own revenues, unlike most other eurozone governments, which were forced to generate new debt in order to pay interest on their public debt stocks. It also indicates that Italian public finances remained under control during the global financial and economic crisis whilst, simultaneously, reflecting a lack of fiscal room to support the economy. Despite a traditional primary surplus generation, Italy regularly struggles to meet the Maastricht criteria 3% budget deficit level, largely due to high interest payments (11%-13% of government revenues) on the large stock of public debt.

Figure 9: General government primary balances (% GDP)



Source: IMF

Figure 10: Fiscal developments (% GDP)



Source: IMF

Fiscal policy to tread fine line between consolidation and support for the recovery

The Gentiloni government is committed to fiscal sustainability and is expected to continue to reduce the deficit ratio gradually. Scope expects that lower interest payments and moderate economic expansion will keep the government budget deficit at 2.4% of GDP in 2017 and 2.3% in 2018. The 2017 Budget Law provides a number of fiscal measures, amounting to approximately EUR 11bn (0.7% of GDP). These include incentives to boost investment, the reversal of a VAT hike scheduled for January 2017 and the two-year extension of social security contribution exemptions for new permanent contracts. The government's emphasis on investment, in combination with the corporate income tax rate cut from 27.5% to 24% should support economic activity over the medium term.

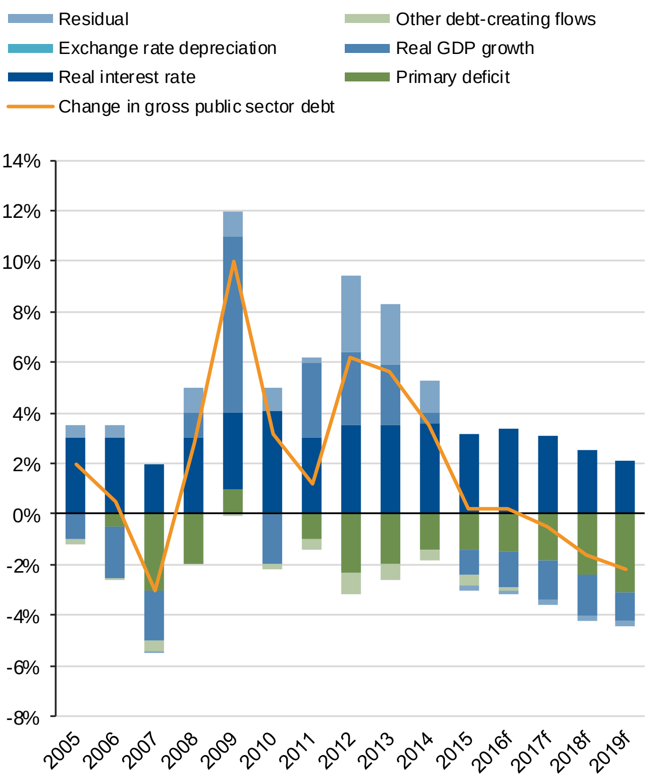
Low interest rates and growth are key drivers of debt stabilisation

Scope expects Italy's debt-to-GDP ratio to have peaked in 2016 at 133% and to stabilise in both 2017 and 2018 at levels slightly above 130%. The growth-interest rate differential is likely to benefit from low interest rates, and primary surpluses are expected to remain in place despite the budget providing tax credits to boost the recovery and promote business investment. In this case scenario, the level of GDP growth and primary surpluses will remain the key determinants of Italy's medium-term public debt trajectory.

Debt-servicing flexibility and strong domestic investor base mitigate risks

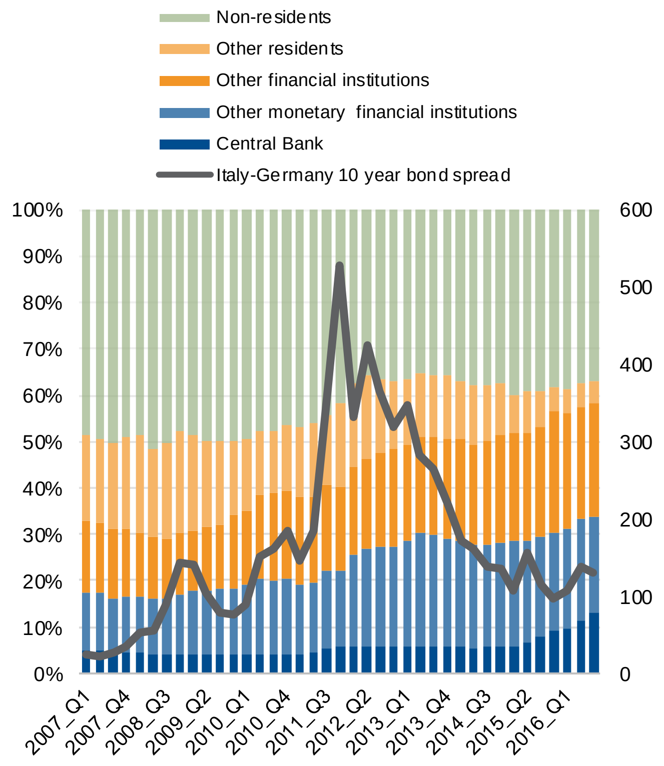
The large stock of public debt remains a key vulnerability for Italy, even though financing risks are mitigated by a relatively long average seven-year maturity of debt stock, nearly 70% of which is held by residents (compared to 56.7% in 2010). The Italian sovereign is therefore less exposed to sudden shifts in international investor confidence. Moreover, rising interest rates, beyond the current average of 3%, take time to feed through the relatively long government bond maturity structure. Another important mitigating factor is the improvement in funding conditions since the end of 2012, supported by the ECB's quantitative easing programme, with ongoing substantial Italian government bond purchases continuing until the end of 2017 at the least. Yields on ten-year Italian government bonds remain below 2.5%, despite an increase over the past months.

Figure 11: Debt-creating flows (% GDP)



Source: IMF

Figure 12: Spread with Bund and investor base evolution



Source: Banca d'Italia, Bruegel, Bloomberg

Banking sector challenges limit lending potential

In contrast to many eurozone banking systems, Italian banks did not receive government support during the first two waves of the global and European banking crisis as the subprime crisis and subsequently the eurozone crisis hit bank balance sheets worldwide. However, the third wave was characterised by the impact of the five-year Italian economic recession finally reaching bank loan portfolios. This led to public intervention and fears of a possible bail-in. Indeed, since the introduction of the Bank Resolution and Restructuring Directive (BRRD) in January 2015, policymakers in Italy have underestimated the build-up of non-performing loans on bank balance sheets and the negative impact on lending to the economy.

According to the EBA (the European Banking Authority), Italian banks' non-performing loans (NPL) stood at around 16% of gross loans in 2016. At the same time, the fiscal room for public intervention has become limited. EBA figures indicate that the NPL portfolio is a challenge for Italian banks, but at the same time they are not an outlier among the countries that suffered from years of recession. In our view, bad debts and other non-performing exposures (NPEs) are largely a legacy of the past and, contrary to certain claims, are not expected to lead to widespread bank failures or to weigh heavily on public finances. Although NPE levels remain a justified concern, asset quality trends have been improving for several years. As Scope has already stated in its comment 'Italian Banks' Asset Quality: Still a Problem but on an Improving Path', Scope considers asset quality to be less of a problem today than in recent years. The Italian economy is picking up and Italian banks have continued to work out recapitalization plans. Privately-funded and government-sponsored solutions, such as the Atlas Fund, which is supported by the Italian Treasury's guarantee schemes (GACS) are in place.

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