managing risk, enabling trade

Atradius Country Report

Italy – February 2014

Overview

General information

Capital:	Rome
Government type:	Parliamentary democracy
Currency:	Euro (EUR)
Population:	61.2 million

Most important sectors (2012, % of GDP)

Services:	68 %
Industry:	28 %
Agriculture:	4 %

Main import sources (2012, % of total)

Germany:	14.6 %
France:	8.3 %
China:	6.6 %
The Netherlands:	5.4 %
Russia:	4.9 %

Main export markets (2012, % of total)

Germany:	12.6 %
France:	11.2 %
USA:	6.9 %
Switzerland:	5.9 %
United Kingdom:	4.9 %

Key indicators

	2010	2011	2012	2013*	2014**
Real GDP growth (y-on-y, % change)	1.7	0.6	-2.6	-1.8	0.5
Consumer price inflation (y-on-y, % change)	1.5	2.8	3.0	1.3	1.3
Real private consumption (y-on-y, % change)	1.5	-0.3	-4.2	-2.5	-0.1
Retail sales(y-on-y, % change)	-1.3	-3.4	-4.7	-3.4	-1.6
Industrial production (y-on-y, % change)	6.7	1.1	-6.5	-3.5	0.8
Unemployment rate (%)	8.4	8.4	10.7	12.2	12.4
Gross fixed investment (y-on-y, % change)	0.5	-1.6	-8.4	-5.4	0.8
Real net exports (EUR billion)	-30.0	-7.9	33.7	47.5	49.9
Fiscal balance (% of GDP)	-4.6	-3.9	-3.0	-3.4	-3.1
Government debt (% of GDP)	119.3	120.8	127.0	132.2	133.8

* estimate **forecast Sources: Consensus Economics; IHS Global Insight

" The expected small rebound in Italy in 2014 and the increase in exports cannot hide the fact that Italy's international competitive position continues to worsen due to a lack of reform efforts compared to some of its European peers."

Atradius Economic Unit

Political situation: More stability than in 2013

Head of state:	President Giorgio Napolitano (since May 2006)
Head of government:	Prime Minister Enrico Letta (since April 2013)

In November 2013 the governing centre-left Democratic Party (PD) allowed the expulsion of Silvio Berlusconi from Parliament after his conviction for tax fraud. Berlusconi then tried to withdraw his People of Freedom party's (Il Popolo della Libertà, PdL) support for the coalition government of the PD and the centrist Scelta Civica. However, this led to a split in the PdL, with the factions that did not support Berlusconi regrouping as the New Centre-Right (Nuovo Centrodestra, NCR). Headed by Deputy Prime Minister Angelino Alfano, the NCR continues to support the coalition government, while the pro-Berlusconi factions revived and refounded the Forza Italia party. The coalition government now has a smaller parliamentary majority (especially in the Senate) but is far more cohesive than before. This has arguably improved political stability to some extent.

Progress on badly needed structural reforms to revive the ailing economy, such as bringing wages in line with productivity, has so far been limited. But pressure on the reluctant coalition to advance these reforms may come from the newly elected PD chairman Matteo Renzi, mayor of Florence. On his agenda are deep cuts in government spending, tax cuts and deregulation to accelerate growth and privatisation and reduce debt. He is also expected to push for political reforms after the constitutional court in December 2013 ruled that the current electoral law of 2005, designed to create workable majorities in parliament, is unconstitutional. If his push fails, Renzi may force snap elections ahead of the scheduled elections of 2018.

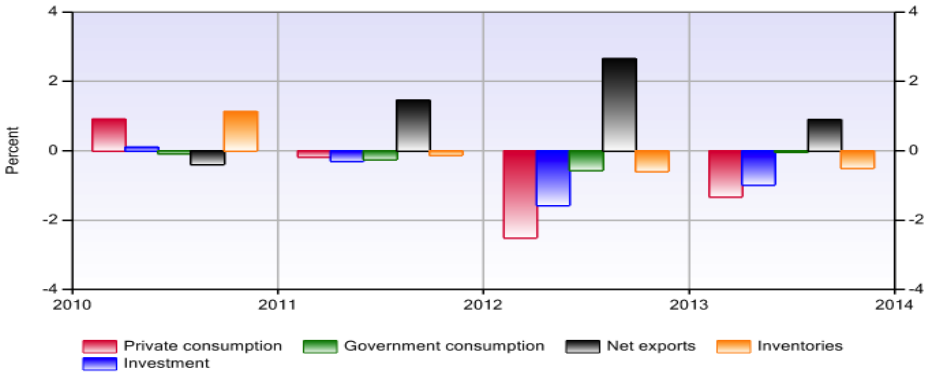
Economic situation: is there a rebound on the horizon?

The economic downturn continued in 2013

After a 2.6 % contraction in 2012 the Italian economy shrank again in 2013, by 1.8 %. However, the dip in private consumption was just 2.5 % year-on-year after a sharp drop of more than 4 % in 2012, when disposable income shrank sharply and consumer confidence reached its low point. Sizeable fiscal consolidation also hampered economic performance in 2012 and 2013, as did lower investments (down 5.4 % in 2013) in an atmosphere of difficult financing conditions and poor business confidence. Foreign demand provided only limited support to growth, as Italian exports continued to lose competitiveness (see below), with vital economic reforms so far implemented in a piecemeal and half-hearted fashion. Nevertheless, with lower imports, net exports were the only positive contributor to GDP growth in 2012 and 2013 (see chart below).

Contribution to GDP growth: Italy

(Chain-weighted basis; forecast data edge 2009)



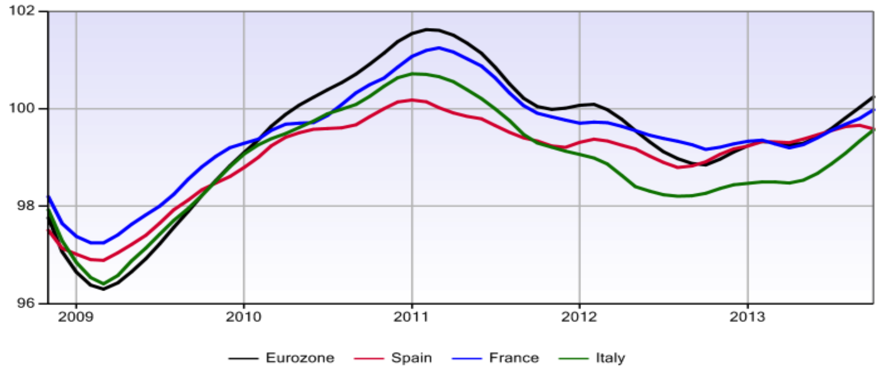
Source: DataInsight

Slight growth expected in 2014

Some sentiment indicators paint a more optimistic picture for this year. Industrial confidence had already rebounded in mid-2012 and continued upwards in 2013 (see chart below). Industrial confidence is helped by the modest rebound in the Eurozone and the improved global economic outlook for 2014.

Industrial confidence: selected countries

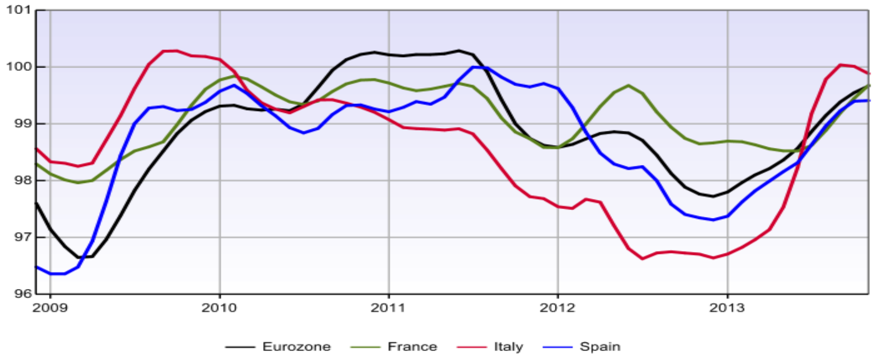
(Manufacturing confidence index, 100 = neutral)



Source: DataInsight

However, it is the surge in consumer confidence since the beginning of 2013 that is the most noteworthy (see chart below). Improved political stability and less fiscal consolidation are arguably contributing factors, while unemployment has more or less stabilised, albeit at a very high level.

Consumer confidence: selected countries



Source: DataInsight

In 2014 the economy is at last expected to rebound, by 0.3 %-0.5 %, driven by a global trade surge that will hopefully boost Italian exports, along with less fiscal consolidation (e.g. EUR 11.5 billion stimulus measures to boost growth will primarily be spent on infrastructure). Better financing conditions expected this year will spur domestic demand - notably investment -while private consumption will remain subdued. However, this positive projection may be derailed if tensions in the financial markets resurface, while higher growth is hindered by Italy's lack of competitiveness, with no comprehensive economic reform programme yet implemented.

Pressure on international competiveness remains

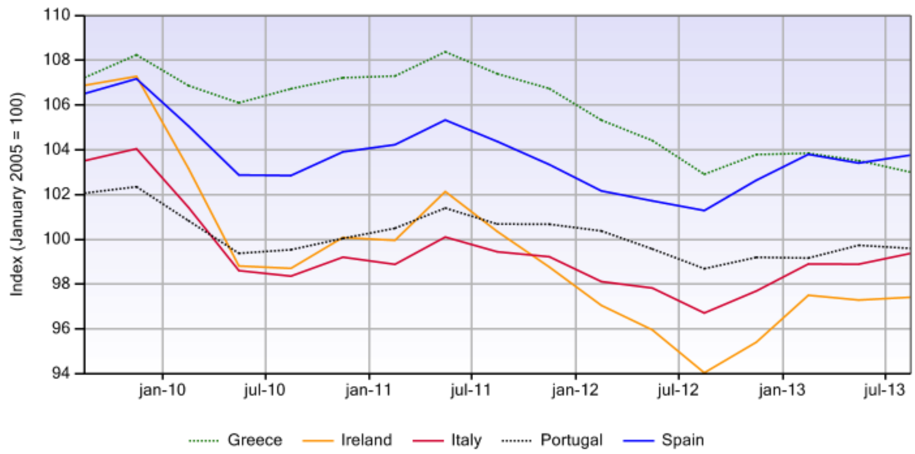
Mainly as a result of a significant decrease in imports (down 7.7 %), the current account deficit shrank to 0.4 % in 2012 from 3.1 % in 2011 and turned into a surplus in 2013 (between January and October 2013 imports decreased 5.9 % year-on-year). In 2014 a current account surplus of 0.8 % is expected, helped by a rise in exports (up 2.0 %) after their levelling off in 2013, but mainly thanks to a further drop in imports as domestic demand remains low.

Italy has lost nearly 20 % of its share of its export markets - particularly European markets - over the last couple of years, although it has retained its leading position in fashion, clothing and textiles. Its export performance remains under pressure, especially to the Eurozone, which accounts for 40 % of the value of exports. Between January and October 2013 exports to the Eurozone decreased by 2.9 % year-on-year.

This loss of market share is borne out by Italy's Real Effective Exchange Rate (REER) development. The REER measures a country's international competitiveness as costs and prices change. The higher REER since mid-2012 indicates higher export values, but also an erosion in export volumes. Italy's competitive position against some other Southern European countries further worsened in 2013, as those markets implemented more reforms to reduce their unit labour costs.

Real Effective Exchange Rate (REER) fluctuations

(Trade weighted currency baskets adjusted for relative inflation)



Source: DataInsight

Unemployment is still rising and labour market reform is of limited help

After increasing to 12.2 % in 2013, the rate of unemployment is set to rise to 12.4 % in 2014. But even this figure does not give a complete picture of the labour market's problems. Companies have frozen recruitment and terminated temporary contracts, with the greatest impact on young people. The unemployment rate of young Italians (i.e. those aged 15-24) increased to more than 41 % at the end of 2013, compared to 37 % in December 2012. At the same time, elderly people are drawing more from the state funded wage supplementation schemes. Italy's employment rate of 55.6 % is one of the worst in the EU.

The labour market reform passed by the former government under Prime Minister Mario Monti is of only limited help. While it aims to make it easier for employers to hire and fire staff, it also maintains the solid protection for those workers on permanent contracts. Because newly hired staff on a permanent contract have the same protection as those who have worked for a company for 30 years, firms are still shying away from such contracts. With many young employees on temporary contracts, productivity is decreasing, not least because companies are less willing to invest in training temporary staff.

As said before, crucial labour market reform elements, such as bringing wages in line with productivity, have yet to be introduced – and without them Italy´s international competitive position will not improve.

The banking sector remains vulnerable

When the Eurozone crisis deepened in the first half of 2012, Italian banks had to rely increasingly on the European Central Bank (ECB) for funding. While the ECB's liquidity provisioning remains considerable, it has decreased. In November 2013 it amounted to EUR 235 billion down from EUR 275 billion.

Since 2009, non-performing loans as a percentage of regulatory capital have tripled, indicating stress in the banking sector. Moreover, credit losses as a percentage of profit rose to 35 % in 2012 (20% in 2009). Credit to non-public borrowers contracted 3.7 % year-on-year in the 12 months to October 2013, due to weak demand, tight credit standards and high borrowing costs. Bank share prices have risen in response to the slightly better outlook but a discount to book value remains, especially for the larger banks.

All this indicates that the Italian banking sector is still very vulnerable – especially medium-sized and smaller banks.

Loans to the private sector

(Annual percentage change in total amount outstanding)

Source: Statistical Office of the European Communities (Eurostat)

A lower budget deficit, but government debt remains high

Down to 3 % of GDP in 2012, the Italian budget deficit has reached healthier territory and, as a consequence, Italy has exited the EU's Excessive Deficit Procedure. The primary budget (i.e. excluding interest payment on outstanding debt) recorded an increased surplus of 2.5 % of GDP. Primary expenditure was down due to savings in public employee remuneration, lower investment and subsidies while pension reforms helped to constrain social transfers. At the same time, revenue increased as a result of higher property taxes, although VAT revenue shrank due to the lower consumption.

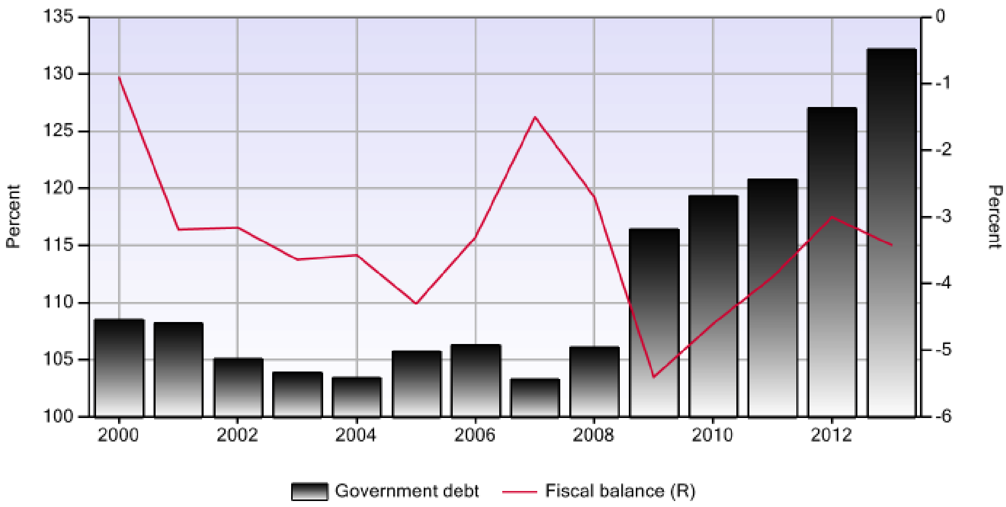
In 2014 a budget deficit of around 3 % of GDP is expected. Italy is now carefully weighing up growth supporting measures (EUR 11.5 billion in 2014, or 0.7 % of GDP) against the new EU target of a structural balance.

However, the subdued economic growth is clearly a constraint, and also impacts on another EU target: a sustainable decrease in the high government debt/GDP ratio. Despite successful fiscal consolidation, this ratio increased to 132.2 % in 2013 from 127 % in 2012, due mainly to the economic contraction, and is expected to rise again in 2014: to 133.8 % of GDP. At this rate, annual reductions of 3.7 % would be needed to reach the 60 % government debt-to-GDP target within 20 years. This would be a challenge, requiring a nominal annual growth rate of 3.6 % (inflation is currently at 1.3 %) and an improvement in the primary fiscal surplus from 2.4 % (2013) to 4.5 %, with annual privatisation receipts of 0.5 % of GDP. The challenge is not only that of achieving the required high level of real growth, above 2 %, but also in combining growth and fiscal consolidation in a low inflation environment.

While reducing debt may be problematic, the ability to maintain debt sustainability is not - as long as the ECB continues to provide support if needed by way of bond purchases. Currently 34 % of government debt (EUR 700 billion) is held by non-residents.

Public debt and budget balance: Italy

(Government debt and budget balance in percent of GDP)



Source: DataInsight, Italian Ministry of Finance

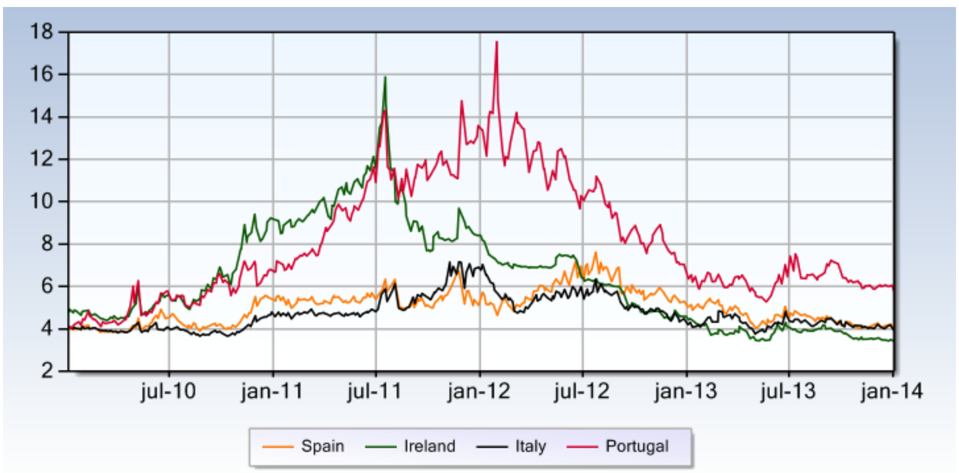
Bond yields have decreased significantly

Following fears of a Greek exit from the Eurozone in May 2012, Italian government bond spreads leapt quickly to levels considered unsustainable, as financial markets feared that Italy would be part of a Eurozone breakup. However, the June 2012 summit of Eurozone leaders confirmed a number of measures to reinforce the Eurozone. Crucially, the European Central Bank gave its backing by announcing that it would do ‘everything it takes’ to prevent a breakup, including a government bond purchase programme. Consequently, bond yield spreads over the German bunds have decreased significantly since then (see chart below).

However, the relative situation of Italy seems to have worsened in 2013. Firstly, Italian yields are no longer below Spanish ones, and secondly, Irish yields (Ireland has left the IMF programme) are now below the Italian ones after an absence of any differential since mid-2012.

Long bond yield divergence within the Eurozone

(10-year government bond yield spreads over the German Bund)



Source: DataInsight

Downside risks to the expected scenario

The combination of fragile political stability, limited progress on structural reforms, still weak economic performance, banking sector woes and high government debt makes Italy susceptible to any potential return of the Eurozone crisis. Currently the situation seems to be under control as a result of the ECB pledge to prevent a Eurozone breakup, including a government bond purchase programme if necessary. But any further deterioration in the banking sector may jeopardise the relative calmness in the financial markets and, with a very high sovereign debt level of more than 130 % of GDP, Italy is vulnerable to adverse financial markets sentiment, as higher funding cost would entail further fiscal consolidation. In such a worst-case scenario, a request for Eurozone partner support may become inevitable. Whatever happens, any additional structural reforms that are introduced will need some time before they contribute to Italy's economic growth, which will probably remain low in the coming years.

Business situation

For Italian companies, the short and limited economic recovery of 2010 and the first half of 2011 - following the sharp GDP deterioration of 5.5 % in 2009 – has not been enough to rebuild sufficient cash and capital reserves to cushion the double-dip crisis. The traditionally geared financial structure of Italian businesses has also contributed to this situation. We have noted that many Italian businesses´ days sales outstanding (DSO) and days payable outstanding (DPO) did not improve in 2010-2012 – a sign that the funding of working capital remains an issue.

Liquidity problems are exacerbated by continuing poor payment behaviour, especially by the public sector. Moreover Italian companies, compared to their Western European counterparts, show a higher average gearing - especially short-term gearing. Many businesses suffer from the banks´ current restrictive loan policy, and this will continue into 2014.
The structurally high dependence of Italian businesses on bank financing is proving to be a major structural weakness.

The insolvency environment

Corporate insolvencies rose in 2013

Corporate insolvencies have increased sharply since 2008 and we expect business failures to have increased further in 2013. In view of the subdued economic environment, we have revised our 2013 insolvency forecast upwards, from a 5 % to a 10 % increase at least, i.e. to around 15,000 insolvencies (see chart below).

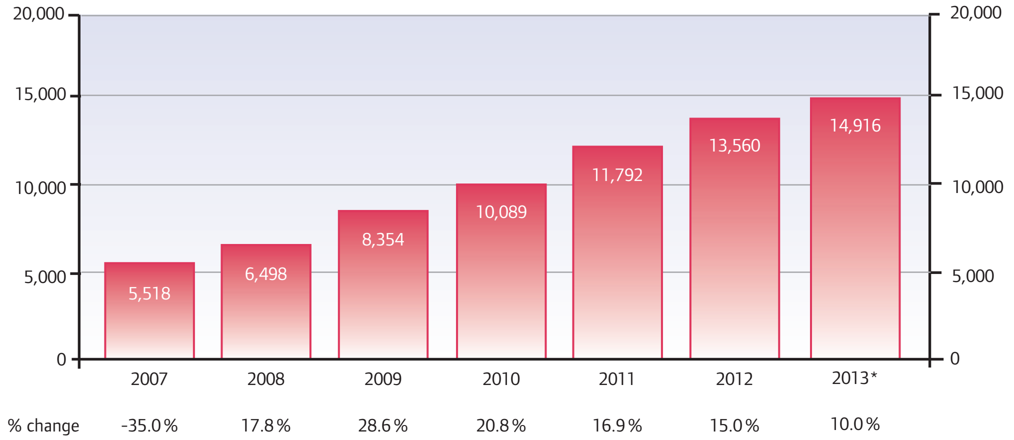
In September 2012 the Italian Bankruptcy law was amended to focus on the reorganisation, rather than liquidation, of distressed and failing businesses. However, so far, this so-called 'concordato in bianco/in continuitä' proceeding (inspired by Chapter 11 in the US) has achieved only minor success. According to Cerved, about 70 %-75 % of businesses filing for this procedure have eventually gone into the traditional concordato preventivo (settlement with creditors), bankruptcy or have been liquidated between September 2012 and September 2013, resulting in even more insolvencies in 2013.

The main problem is that the new procedure permits a blank filing (e.g. the entrepreneur has to file just a very basic document and sketchy rationales to present to the court (rather than a full memo) asking for payment to creditors to be frozen for a maximum of six months. Only after that period does the management have to present a comprehensive plan for the recovery and continuity of the business. During the six months relief period no administrator is appointed by the court and so the business's management remains in charge. In many cases there is no real turnaround: the mistakes that have caused the company to run into trouble are repeated, leading to bankruptcy/liquidation.

In 2014 we expect Italian business insolvencies to level off but to remain at a very high level, with construction, wholesale/retail (mainly furniture, household appliances, automotive equipment and textiles), manufacturing and metals still the worst affected sectors. The problem at the heart of the Italian business world is that many companies have yet to make the strategic and structural changes necessary to address the challenges of today's less benign domestic and international business environment.

Italian business insolvencies

(year-on-year change)

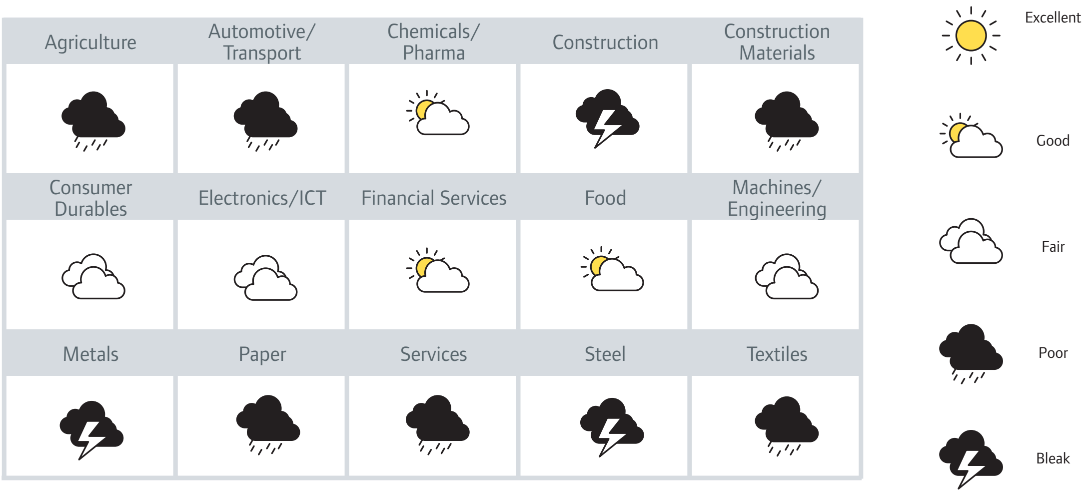


Sources: National Statistics Office, Atradius Economic Research

Note: Forecasts are based on the outcome of statistical models and expert opinion. The history of growth rates in the table represents estimates based on official insolvency statistics and model-based calculations. As such these rates should be treated as indicative. All views expressed here are those of Atradius Economic Research (date of final forecast: 10 October 2013)

Italy industries performance forecast

January 2014



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