GENERALI INVESTMENTS

Focal Point

Italy: Escape velocity not achieved yet

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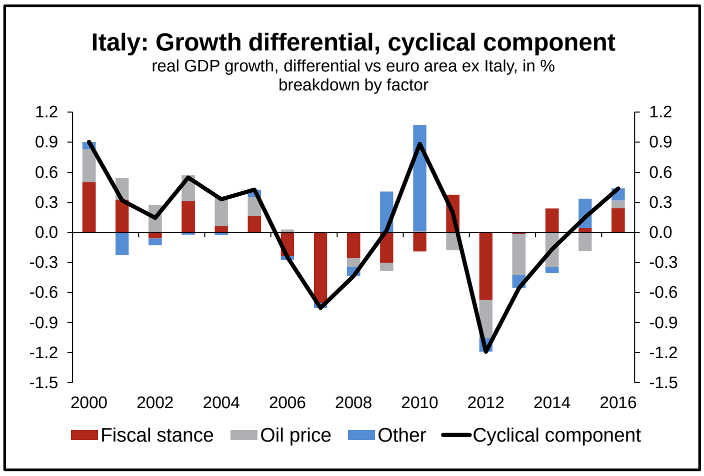
- The recovery in Italy has so far proved to be much weaker than in other crisis-hit euro area countries like Ireland or Spain. Moreover, concerns over the solidity of the banking system have harmed market sentiment in early 2016.
- This came despite the government's efforts in terms of structural reforms and substantial external tailwinds, including ECB-induced easier financial conditions and lower oil prices.
- Long-lasting hurdles to growth remain in place, namely low competitiveness, poor corporate profitability, a still unfavorable environment for businesses, high public debt (at 132.7% of GDP) and a banking system plagued with nearly €350 bn of non-performing loans.
- We do not anticipate any major progress on the reform side in the short-term. A large victory in the referendum over the new constitution in October is a pre-condition for PM Renzi's government to revamp the reform momentum.

The weakening in the global growth momentum has not left Italy unaffected. The IMF has recently cut the 2016 growth estimates for the euro area's third largest economy to a mere 1%. The slowdown in external demand adds to a sluggish domestic recovery, with fixed investments still 29.5% below the 2008's peak. Moreover, the renewed concerns over the stability of the banking system, plagued by high non-performing loans (NPLs) and by the impossibility of a clean-up via public means, have weighed on financial market sentiment, depressing stock prices after an exceptionally strong 2015. While we do not see major risks in the short-term, we believe it is worth investigating the ultimate causes of the growth underperformance, with an eye on the outlook for reforms.

A weak cyclical upswing

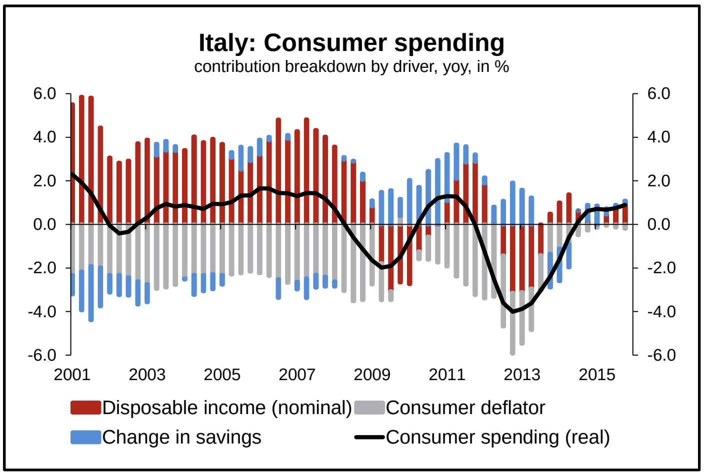
The Italian economy reemerged from a 3.5-year long recession in early 2015, posting a full-year 0.6% expansion in real GDP. This compares to a 1.5% expansion at the euro area (EA) level. The market consensus points to a further reduction of this gap in 2016, from 0.9 percentage points (pp) to 0.5 pp (EA: +1.5%; Italy: +1.0%). We share this view, albeit we remain more cautious on the absolute growth levels (EA: +1.1%; Italy: +0.8%).

The nature of the upswing is largely cyclical in nature though. A key factor contributing to the recovery in Italy is the gradual relaxation of the fiscal stance. In the first two years of PM Renzi's government, the structural primary surplus declined by 0.7 pp in GDP terms to 3.2% at the end of 2015. Moreover, in the Stability Law for 2016, PM Renzi continued to pursue this strategy, stretching the flexibility clauses (structural reforms, investments, exceptional events amid the costs to deal with the refugee crisis) to the limit. The European Commission calculated that the fiscal stimulus would amount to 0.85 pp, the largest since the one seen in response to the great financial crisis in 2009. This should increase the absolute level of real GDP growth by up to 0.45 pp and contribute by nearly 0.25 pp to the relative performance against other EA countries.



Another important driver supporting the current cyclical upswing is the sharp decline in oil prices experienced since mid-2014. This has depressed headline inflation, which has been hovering around the zero line for the past two years, helping households' real purchasing power in a context of subdued employment and nominal wage growth. As a result, consumer spending accelerated to

+1.3% yoy (in real terms) in the last quarter of 2015, the fastest pace since mid-2010.

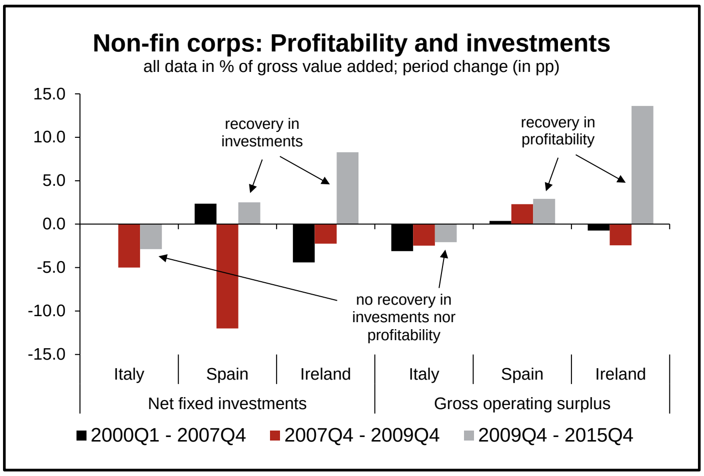


The strength in private consumption contrasts with the very subdued performance of fixed investments (0.1 pp contribution to real GDP growth in 2015) and net exports (-0.3 pp), which have historically been the main driver during the recovery phase of the business cycle. Moreover, the improvement in financial conditions induced by the ECB's comprehensive stimulus package and the structural reforms approved by the Italian government (in particular the reduced labor market regulation included in the Jobs Act) have so far failed to revive growth.

This evidence suggests that several hurdles to higher potential growth remain in place. We will focus on two areas (corporate profitability and the clean-up of the banking system) in which Italy has failed to make significant progress, falling well short compared to the achievements of other crisis-hit EA countries like Ireland and Spain.

Poor firms' profitability leads to lower investment

The contraction in investments in Italy went through two distinct phases. The first leg of the decline (nearly 14% from the peak) happened in the aftermath of the Great Financial crisis in 2008/09, while the second one (further 16 pp of decline) occurred because of the sovereign debt crisis started in the second half of 2011. While the first phase of the decline in investments affected all EA countries, only a subset of crisis-hit countries experienced the second one.



We focused on non-financial corporations, which account for nearly half of total investments in Italy. Firms have two main sources to finance their investments. Strong profitability leads to better cash generation that can be used to expand production capacity. In addition, external financing (either via banks or via corporate bond issuance) can be deployed for the same purpose.

When comparing Italy to Ireland and Spain, we found out that the latter two have experienced a significant rebound in investments activity and this happened despite a far more severe reduction in banks' credit. Indeed, the cumulative contraction in loans to non-financial corporations between 2010 and 2015 amounted to 20.9% of GDP in Spain, 14.5 in Ireland and only 3.3% in Italy. We found evidence that the divergence in investment activity can be attributed to the strong improvement in firms' profitability in Spain and Ireland opposed to the ongoing deterioration seen in Italian corporates. Over the same period, the ratio between the gross operating surplus and the gross value added declined by 2.1 pp in Italy, while it improved by 2.9 pp in Spain and by a whopping 13.6 pp in Ireland. This reflects a large reduction in nominal unit labor costs in the latter two countries (Ireland: -17.5% since end-2008, Spain: -4.8%) compared to an ongoing increase in Italy (+9.1%). The ultimate causes are Italy's more rigid labor market legislation and the higher tax wedge. On the latter topic, PM Renzi's government has started to intervene, but more radical steps on the tax system and on government expenditure are needed to close the gap with the most competitive countries.

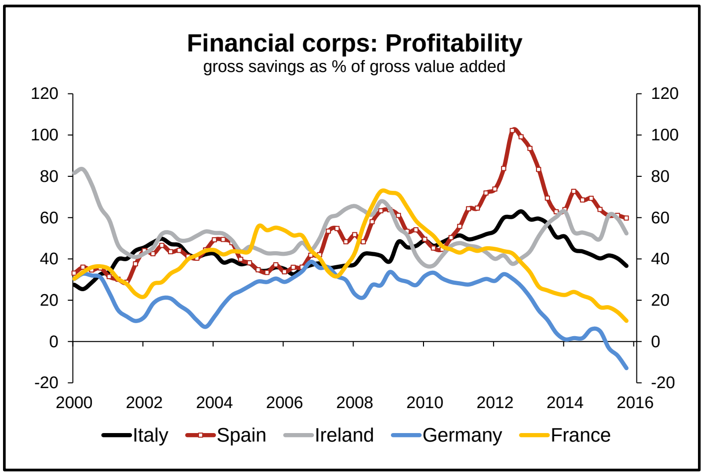
Banks: Intense work in progress

As the first source of investment financing remains clearly under pressure, Italian firms find no major support from bank credit either. Indeed, Italian banks have been in the limelight in recent months as investors turned increasingly nervous due to the large bulk of NPLs and the concerns over the capital position of several mid-cap institutes. Differently from Ireland and Spain, which set up their public bad banks respectively in 2009 and 2012, Italy refrained from adopting this solution due to the already large stock of government debt. The prolonged economic recession contributed to exacerbate the problem, leading to an accumulation of nearly €350 bn of NPLs.

The government understood the seriousness of the problem and approved several bills intended to foster the fragmented and fragile Italian banking system. With the reform of "popolari" banks (March 2015), several mid-cap institutes streamlined their governance in order to be ready for the listing on the stock exchange, which makes merger and acquisition activity simpler and more transparent. The increased market scrutiny, however, also revealed weaker than expected capital positions in some mid-cap banks.

The adverse conditions in financial markets at the start of 2016 put this process at risk. The prospect of a failure of the IPOs of two institutes (Popolare di Vicenza and Veneto Banca, whose combined total assets amount to nearly €75 bn) raised the specter of a large-scale bail-in. This would have led to a confidence crisis in the system, with an immediate shock on growth. Given the impossibility to create a public bad bank amid the new European banking regulation, the Italian government sponsored the creation of privately funded vehicles to address this imminent issue. The set-up of Atlante, a €5 bn fund participated by the major Italian banks, banking foundations, insurance companies and the Cassa Depositi e Prestiti, exactly responds to this purpose. The backstop nature of this initiative represents a clear positive factor for the short-term outlook.

Following the participation to the abovementioned IPOs, the fund Atlante will invest the remaining resources in the purchase of the junior tranches of banks' securitized NPLs. By purchasing the most risky tranche, the fund should induce other investors to put money at work in the senior tranches, helping banks to reduce the bulk of NPLs on their balance sheet. We are more cautious on the success of this second goal, as high uncertainty remains on Atlante's ability to exploit leverage and on the effectiveness of the upcoming government legislation to speed up bankruptcy proceedings and reduce time for debt recovery. Moreover, restoring profitability is a key step to address long-term issues like balance sheets' deleveraging and NPLs disposal. Unfortunately, the low yield environment will pose more and more severe challenges to the industry.



Do-or-die constitutional referendum in October

While we maintain a relatively benign stance for the short-term thanks to the ECB's action and the relative more stable political landscape compared to other EA peripheral countries, our analysis highlights the need for more incisive structural reforms in Italy as potential growth remains barely above the zero line at present.

The shift to a more business friendly tax system is of paramount importance. The latest PWC report on the ease of paying taxes shows that Italy ranked 137th out of 189 countries in 2014, due to the extremely high total tax rate paid by corporates: 64.8% of profits. This compared with a rate of 50.0% in Spain, 48.8% in Germany and only 25.9% in Ireland. In the meanwhile, Spain has reduced the marginal corporate rate tax to 25% in 2016 from 30% in 2014, while in Italy the planned cut (from 27.5% to 24%) will only become effective in 2017. In addition, Italy scores poorly with regard to the share of expenditure dedicated to R&D, family policies and labor market security. Given the high level of public debt (132.7% at the end of 2015), Italy has no alternative but to reduce government expenditure to finance structural cuts in taxation. The success of the spending review has been mixed. While primary expenditure ex social security has been reduced by 1.0 pp in GDP terms since the end of 2010, the ongoing increase in pension expenditure (up to 15.8% in 2015) has fully offset these savings. The failure to deal with such a large spending item (nearly 34% of total primary expenditure) inevitably limits the scope for a broader tax reform.

We do not anticipate any improvement in the near future. Cuts to pension expenditure would be very unpopular and the debate is rather pointing to a partial reversal of the pension reforms approved by the Monti's government in late 2011. Moreover, PM Renzi will not put his political capital at risk ahead of the challenging local elections in the major Italian cities (June 5) and the constitutional referendum in October. The latter represents a milestone for Italy. PM Renzi has repeatedly affirmed that he would resign in case of defeat. A large victory of the "Yes" front is consequently a pre-condition for the reform momentum to regain traction and to address the long-lasting impediments for a better long-term growth outlook for Italy.

Imprint

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