Italy: Beyond the point of no return or surprisingly resilient?

Public Finances and the Economic and Financial Document

Rome, 11 March 2017
A comeback of Europe?

Composite PMI
Eurozone, Developed markets, Emerging markets

Index

Jan-11  Jan-12  Jan-13  Jan-14  Jan-15  Jan-16  Jan-17

Developed markets
Emerging markets
Eurozone

Source: Thomson Reuters Datastream, Markit, LC-MA calculations
It is German manufacturing at the forefront again

Source: Thomson Reuters Datastream, Markit, LC-MA calculations
Synchronised upswing, but huge differences in output gaps

Eurozone output gaps

% gap between actual and potential GDP

Source: Thomson Reuters Datastream, OECD, LC-MA calculations
Expectations are gradually improving

Italy - Consensus forecasts for GDP and CPI

Source: LC-MA calculations based on Consensus Forecasts data.
The puzzle of productivity and potential growth

◆ **Demographics:** Unfavourable unless immigration of skilled-workers increases sharply. Fertility rate at 1.35% (2015). Cohort effect of women entering the labour market to help increase participation over the next 10-15 years. However, the labour force is ageing rapidly.

◆ **Productivity:** Moderate cyclical upswing likely, although there are no convincing signs of structural improvement, at least not yet. TFP growth has been negative in several of the past 15-20 years.

◆ **Supply side damage:** Squeeze in aggregate demand has produced damage on the supply side which is difficult to assess but is sizeable.

◆ **Education attainment:** Weak results in PISA and other surveys. The number of students at universities declined during the crisis. Low return on education.
Loans to the private sector slowly improving

Source: Bank of Italy.
NPLs need to be reduced more forcefully
Turning point in house prices to help NPL collateral value

Source: Thomson Reuters Datastream, ISTAT, LC-MA calculations.
Lower changes to have taxpayers’ money back

Government intervention on banking sector: liabilities (debt) and assets

Source: own calculations based on the Eurostat and Ameco data; weighted by countries' GDP.
A turn in interest rates favours profitability, hurts portfolios

Source: Thomson Reuters Datastream, ECB, LC-MA calculations.
ITALY - PUBLIC FINANCE

A primary surplus steadily above 2-3% of GDP is key

Source: Thomson Reuters Datastream, Italy’s Ministry of Economy and Finance, LC-MA calculations.
Read my lips: what is the actual composition of fiscal efforts?

◆ **Stated objectives:** Structural reduction in current expenditure, increase capital expenditure, reduce tax burden, economic growth through a proper mix of structural reforms and demand support.

◆ **Non-stated (implicit) objectives:** Support aggregate demand by implementing an expansionary fiscal policy and maximising budget flexibility. Balanced budget to be achieved as slowly as possible. Debt/GDP ratio not a priority.

◆ **What has been achieved?** Modest decline in current expenditure, capital expenditure and the tax burden. Since 2013 consolidation only through lower interest rates. Continuing rises in the debt/GDP ratio.

◆ **The new environment:** Fiscal rules become no longer binding as the key overreaching factor has become debt sustainability.
A few 2016 outcomes

◆ Primary current expenditure: +1.7%.
◆ Non-monetary social benefits: +1.7%.
◆ Monetary social benefits: +1.4%.
◆ Compensation of employees: +1.3%.
◆ Capital expenditure: -16.0%.
◆ Government gross fixed investment: -4.5%.
◆ Expenditure on EU investment programmes: 0.2% of GDP against 0.25% authorised (0.7bn less than authorized).
◆ Non compliance with investment requirements: attempt to include other types of expenditures (soft infrastructure).
## Italy – Public Finance

### Flexibility Agreed in Compliance with Stability Pact (Page 56)

<table>
<thead>
<tr>
<th>% change yoy</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<tbody>
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<td>Output gap (DEF 2017) % Potential GDP</td>
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<td>Investment</td>
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<td>Unusual events</td>
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<td>Revised required adjustment</td>
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<td>-0.36</td>
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</table>

ITALY - PUBLIC FINANCE

government expenditures: modest decline as % of GDP

Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculations; four-term moving average of quarterly data.
Social benefits have edged above 20% of GDP

Source: Thomson Reuters Datastream, Italy’s Ministry of Economy and Finance, LC-MA calculations; four-term moving average of quarterly data.
Compensation of employees declining as share of GDP

Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculations; four-term moving average of quarterly data.
The tax burden started to decline gradually only in 2013.

Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculations; four-term moving average of quarterly data.
ITALY - PUBLIC FINANCE

Interest payment as % of GDP twice as high as Eurozone’s

Eurozone and Italy
Implicit cost of debt financing and interest payments as % of GDP

Source: Thomson Reuters Datastream, European Commission Forecasts, LC-MA calculations.
Austerity was over already in 2013

Source: Thomson Reuters Datastream, Italy’s Ministry of Economy and Finance, LC-MA calculations.
Fiscal stance depends on output gap estimates (and changes)

Source: Thomson Reuters Datastream, Italian Ministry of Economy and Finance, IMF, OECD and
ITALY - PUBLIC FINANCE

Composition of debt: net of ECB and LX/IR, 1/3 is abroad

By type of security (billion euro)
Total debt: 2,223.8
Total debt securities: 1,881.3
Total short-term securities (initial maturity < 1y): 114.8
Total long-term securities (initial maturity > 1y): 1,776.5
Total CAC debt securities: 845.0 (48% of debt securities)
Target 2 balances deteriorating with gradual outflows

Source: Bank of Italy.
2017 Budget: a difficult proposition

◆ **Mini-budget:** It should have broadly closed the gap between trend and target scenarios.

◆ **Safeguard clauses:** They are worth 1.1% of GDP (0.8% net of measures already approved). How can the government replace them with new measures?

◆ **Flexibility:** In 2016 the flexibility asked for capital expenditure has not been matched by an increase in capital expenditure or gross fixed capital formation, partly due to the introduction of the new procurement code. Can extra flexibility be granted in 2017/2018?

◆ **The tradeoff between growth and fiscal consolidation:** Fears of self-defeating fiscal consolidation? Reduction of current expenditures harts in the near-term but it is highly beneficial in the medium term.
Some issues

- Are there enough assets to justify 0.3% of GDP of privatisation each year?

- Year-end liquidity (0.4% of GDP): are we sure it will go away next year?

- Precautionary recap: are we sure that 10bn is enough? (8bn MPS + VB BPV)?

- Why is cash borrowing requirement consistently bigger than the deficit? (MEF)

- No respect of the debt rule in 2018 on projections up to 2020? (MEF)

- Does it make sense to reduce ACE?
**ITALY - ECONOMY**

**GOVERNMENT’S PROJECTIONS FOR ITALY (APRIL 2017)**

<table>
<thead>
<tr>
<th>% change yoy</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
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<td>Real GDP</td>
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<td>1.1</td>
<td>1.0</td>
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<td>1.1</td>
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<td>c. Domestic demand net of inventories</td>
<td>1.4</td>
<td>1.2</td>
<td>0.9</td>
<td>1.0</td>
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<td>c. Inventories</td>
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<td>0.0</td>
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<td>c. Net export</td>
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<td>-0.1</td>
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<td>Nominal GDP</td>
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<td>1.7</td>
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<td>Labour cost</td>
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<td>Employment</td>
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<td>Unemployment rate</td>
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<td>Current account balance*</td>
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<table>
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<th>% of GDP</th>
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<td>General government balance</td>
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<td>Structural balance (1)</td>
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<td>Output gap</td>
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<td>-1.7</td>
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<td>Primary balance</td>
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<td>Interest expenditure</td>
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<td>Public debt (2)</td>
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<td>133.1</td>
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- Chief economist of the Italian Treasury, in charge of the economic analysis and planning directorate, from April 2006 to February 2015.
- Head of the Italian delegation at the EPC of the EU, which he chaired in 2010/2011, thus attending Ecofin/Eurogroup meetings with ministers. At the OECD, he headed the Italian delegation at the EPC, the EDRC and the WP1, which he chaired in 2013/2015.
- Bank of America as Managing Director, senior economist and co-head of European Economics in 1995/2006. Before that, he worked in the research department of Unicredit.
- Padua University and Master Degree from Syracuse University, NY, USA. He published numerous journal articles/policy papers. He is a regular commentator on financial media.

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