

Italy Business Forecast Report Q2 2014

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Abstracts

Core Views

We view positively the urgent structural reform agenda of new Prime Minister Matteo Renzi. However, we remain sceptical that he will be able to avoid the chronic instability, political infighting and rigid vested interests that have in the past impeded reform efforts. Lack of significant structural reform in the previous years seriously jeopardises Italy's long-term growth trajectory, and raises the risks that the public sector debt burden will become unsustainable.

Even if reforms aimed at addressing Italy's decline in productivity growth and external competitiveness are passed, an ageing demographic profile will make debt consolidation efforts over the long term exceedingly difficult.

Public sector debt levels imply that Italy will eventually be forced to undergo a period of fiscal consolidation over the next decade, which will likely have negative implications for the country's social fabric, regional and global standing and governability.

Major Forecast Changes

No major forecast changes

Key Risks To Outlook

If Renzi's reform programme succeeds at rapidly pushing through key reforms in 2014 and 2015, we see upside risks to our growth forecasts over the medium and long term. Although key structural reforms would likely take several years before their full effect on the real economy is felt, immediate positive benefits could come in the form of rising investor and business confidence, lowering credit spreads while encouraging domestic

firms to expand and invest. The Italian banking sector remains a key downside risk ahead of the European Central Bank's Asset Quality Review. Any major capital shortfalls uncovered could reignite the negative feedback loop between sovereign and banking sector risk, leading to another rapid loss of investor confidence in Italian assets. This would significantly impede the government efforts to push through reform while staying within the European Union's budget deficit limits.

Contents

Executive Summary
Core Views
Major Forecast Changes
Key Risks To Outlook

CHAPTER 1: POLITICAL OUTLOOK

SWOT Analysis
BMI Political Risk Ratings
Domestic Politics
Major Hurdles Ahead For Renzi

Prime Minister Matteo Renzi's urgent structural reform agenda could go far to address endemic political instability and boost long-term growth potential. However, we see key impediments to his success, and for now remain doubtful that his government will be able to produce materially different results from its predecessors.

TABLE: Political

Long-Term Political Outlook

Fiscal Rebalancing To Weigh On Social Cohesion

Regardless of subsequent government's ideological leanings, we believe Italian policymakers will eventually be forced to push through painful austerity measures at some point over the next decade. We expect this consolidation to increase poverty and social discontent within Italy, with the north-south socio-economic divide widening. We also expect Italy's regional and global standing to decline, and finally, we see populist and xenophobic parties gaining momentum over the coming years.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis
BMI Economic Risk Ratings
Economic Activity
Tepid Recovery Highlights Need For Reform

We maintain our below- consensus real GDP growth forecasts for Italy of 0.4% and 0.7% in 2014 and 2015 respectively, as domestic demand remains severely constrained by record high unemployment, contracting corporate credit and ongoing fiscal consolidation. Meanwhile, a lack of structural reform has prevented competitiveness gains and the potential for a more robust export led recovery.

TABLE: ECONOMIC ACTIVITY

Balance Of Payments

Rebalancing Has Nearly Run Its Course

Italy's rapid current account rebalancing has now largely run its course. We forecast the current account surplus to peak at 1.1% of GDP in 2015, before narrowing gradually in the years beyond.

TABLE: BALANCE OF PAYMENTS (Euro)

Fiscal Policy

Fiscal Constraints Remain Prevalent

Deficit consolidation will not be a priority of Prime Minister Matteo Renzi's government, which will emphasise growth and employment boosting measures. However, the European Union's 3.0% of GDP deficit limit will be respected, implying that fiscal constraints will continue to impede the policy agenda. Based on our current forecasts, long-term GDP growth rates will be insufficient to achieve a significant reduction in public debt ratios, emphasising the urgent need for structural reform.

TABLE: FISCAL POLICY

Regional Exchange Rate Forecast

EUR: Monetary Policy Decoupling Will Weaken The Euro

We expect euro strength against the dollar and on a trade-weighted basis to persist in H114. However, we continue to argue that the economic and monetary policy cycles in the eurozone are lagging further behind peers in the US and UK, which will trigger a re-pricing of the euro towards the end of 2014. Indeed, we believe that weak eurozone economic growth and lingering deflationary risks will spur the European Central Bank into loosen monetary policy further.

TABLE: BMI Eurozone Currency Forecast

CHAPTER 3: 10-YEAR FORECAST

The Italian Economy To 2023

Major Macroeconomic Challenges Ahead

We believe that the Italian economy will continue to face a very modest rate of growth over the longer term, weighed down by lower credit availability, a weaker external environment, and waning global competitiveness. We also warn that major challenges, such as the government debt load, a deteriorating demographic profile, structural decline in productivity and potential political instability, pose threats to longer-term economic prosperity.

TABLE: Long-Term Macroeconomic Forecasts

CHAPTER 4: BUSINESS ENVIRONMENT

SWOT Analysis

BMI Business Environment Risk Ratings

Business Environment Outlook

Institutions

TABLE: BMI BUSINESS AND OPERATION RISK RATINGS

TABLE: BMI LEGAL FRAMEWORK RATING

Infrastructure

TABLE: LABOUR FORCE QUALITY

Market Outlook

TABLE: G20 - ANNUAL FDI INFLOWS

Operational Risk

CHAPTER 5: KEY SECTORS

Autos

TABLE: Auto Sales - Historical Data & Forecasts

TABLE: Exports By Vehicle Category

TABLE: Auto Trade - Historical Data & Forecasts

TABLE: Auto Production - Historical Data & Forecasts

Food & Drink

TABLE: Food Consumption Indicators - Historical Data & Forecasts, 2010-2017

TABLE: Soft Drink Value /Volume Sales - Historical Data & Forecasts , 2010-2017

TABLE: Mass Grocery Retail Sales By Format - Historical Data & Forecasts,
2010-2017

Other Key Sectors

Table : Oil and Gas Sector Key Indicators

Table : Pharma Sector Key Indicators

Table : Infrastructure Sector Key Indicators

Table : Telecoms Sector Key Indicators

Table : Defence and Security Sector Key Indicators

Table : Freight Key Indicators

CHAPTER 6: BMI GLOBAL ASSUMPTIONS

Global Outlook

Global Growth Optimism Turning To Disappointment

Table: Global Assumptions

Table : Developed States , Real GDP Growth, %

Table : BMI VERSUS BLOOMBERG CONSENSUS REAL GDP GROWTH

FORECASTS, %

Table : Emerging Markets , Real GDP Growth , %

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