

Italy Business Forecast Report Q3 2014

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Abstracts

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Core Views

Italy will return to modest growth in 2014 and 2015, although a weak labour market and ongoing contraction in credit growth will continue to impede a more robust recovery.

We view the urgent structural reform agenda of new Prime Minister Matteo Renzi as positive. However, we remain sceptical as to whether Renzi will be able to avoid the chronic instability, political infighting and rigid vested interests that have impeded reform efforts in the past.

A lack of significant structural reform for a number of years seriously jeopardises Italy's long-term growth trajectory, and raises the risk of the public sector debt burden becoming unsustainable. Even if reforms aimed at addressing Italy's decline in productivity growth and external competitiveness are passed, an ageing demographic profile will make long-term debt consolidation efforts exceedingly difficult.

Major Forecast Changes No Major Forecast Changes.

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CHAPTER 1: POLITICAL OUTLOOK

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BMI Political Risk Ratings

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EP Elections Strengthen Mandate For Reform

Italian Prime Minister Matteo Renzi gained much-needed legitimacy following a resounding win for his Democratic Party at European Parliamentary elections in May, bolstering his mandate to continue pursuing an ambitious structural reform agenda. However, powerful vested interests and marginalised political opposition will attempt to water down reforms, and we cannot rule out a return to the ballot box in the coming quarters should Renzi's progress falter.

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Long-Term Political Outlook

Fiscal Rebalancing To Weigh On Social Cohesion

Regardless of subsequent governments' ideological leanings, Italian policymakers will be constrained by Italy's massive public debt load, and will be forced to enact unpopular austerity measures over the next decade. This will limit the government's ability to tackle poverty and social discontent, 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

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More Reform Needed To Boost Growth Potential

We remain below consensus in our forecast for Italian real GDP growth in 2014 and 2015. Despite an increasingly positive outlook for

political stability and structural reform, measures taken thus far have not gone far enough to significantly boost growth potential in the coming years.

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EU Deficit Limits Complicated Reform Efforts

Italy's budget deficit will remain relatively stable in the coming years as the government prioritises growth over further fiscal consolidation and does just enough to stay within EU deficit targets. The need to maintain fiscal discipline will prevent a faster pace of structural economic reform, while public debt reduction will remain a slow process even in an optimistic scenario of accelerating growth and a prolonged period of low interest rates.

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Economic Recovery To Slow External Rebalancing

As Italy's economic recovery gathers pace, a narrowing gap between export and import growth will slow the pace of external account rebalancing. We forecast the current account surplus to peak at 1.4% of GDP in 2015, from 1.0% in 2013, before narrowing gradually over the medium- to long-term.

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The European Central Bank (ECB) has delivered on nearly all of the policy options that we were expecting for the June 5 meeting. This is a step in the right direction towards warding off the risk of deflation and will be positive for European equities and sovereign bonds. However, we warn - as we have done countless times during previous easing rounds - that the efficacy of ECB policy action will be limited absent structural reforms in the eurozone at the national and federal levels.

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The Italian Economy To 2023

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We believe that the Italian economy will continue to face a very modest growth rate 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.

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