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Italy Business Forecast Report Q4 2013

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Abstracts

Core Views

Following the February 2013 general election which resulted in a clear voter rejection of austerity, the coalition has adopted a more pro-growth stance, implying an end to further fiscal consolidation. Although this will support short-term GDP growth, it also means the pace of structural reform implemented under former Prime Minister Mario Monti will slow dramatically, and in some cases reverse.

Lack of significant reform anytime soon seriously jeopardises Italy's long-term growth trajectory, and raises the risks that the public sector debt burden will become unsustainable.

However, the very high 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

Given the change in rhetoric and direction of the new government, who have already suspended an unpopular housing tax, we do not expect further fiscal consolidation in 2013. As such, we have revised our nominal budget deficit forecast from -2.9% of GDP to -3.2% of GDP. Although political uncertainty makes policy trajectory difficult to forecast, we have revised down our expectations in 2014 as well, from -2.9% to -3.1% of GDP.

We now forecast the Italian economy to contract by 1.5% in 2013, from our previous -1.3% forecast. The recovery in 2013 remains sluggish, with consumption, investment

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and exports all remaining broadly weakened through H113. While we revised up our 2014 growth forecast modestly to 0.3% from 0.1%, this reflects primarily a higher contribution of net exports resulting from a downward revision to our expectations for import growth.

Key Risks To Outlook

Given a fragile and contentious government coalition, the main risk to our forecast stems from the potential for renewed government instability. Furthermore, there is the potential for the government to overreach in its attempts to stimulate economic growth, creating a visible deterioration of fiscal accounts. Both of these scenarios would potentially create a crisis of investor confidence that would necessitate decisive fiscal consolidation to protect debt sustainability. This would severely damage the outlook for investment and consumption, necessitating a downward revision of our growth forecast.

We see tentative signs that the shape of growth in Germany will become more oriented towards domestic consumption, which would have positive implications for Italian exports and growth. However, we caution that a lack of structural reforms will impede Italy’s longterm export competitiveness.

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Sub-Optimal Rebalancing To Continue

Italy's current account will post a surplus of 0.5% and 0.7% of GDP in 2013 and 2014 respectively, as underperforming economic growth relative to trading partners ensures external demand outpaces domestic demand. However, a long-term decline in competitiveness and weak export outlook implies the sustainability of external rebalancing remains uncertain.

TABLE: BALANCE OF PAYMENTS (EURO)

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Pro-Growth Stance To Widen Deficit

The budget deficit in Italy will widen to 3.2% of GDP in 2013 as the government's shift away from austerity policy weighs on public finances. Although political instability makes policy trajectory uncertain beyond 2013, we remain bearish on the potential for meaningful fiscal reform and significant debt consolidation in the long term.

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Beware Of Volatility Blowback

Despite efforts by the European Central Bank to quash volatility in the eurozone by eradicating left tail risk (there is now surprisingly little talk of a euro breakup) we warn of the possibility of a major blowback in 2014. We keep coming back to same fundamental constraint facing the euro area: a lack of serious structural reform of the currency union. Progress on a combined banking, fiscal and political union, as well as efforts to bolster internal and external competitiveness, has been minimal and suggests that the ECBs anaesthetic could abruptly wear off.

TABLE: ITALY – GDP BY EXPENDITURE

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The Italian Economy To 2022

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

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