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Article

Italy Q4: So far so good

Lower political risk helped third-quarter growth but the picture might change in 2018

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Drive in domestic demand confirmed in 2Q17

The economic recovery looks set to continue at a good pace in the third quarter, with the political risk almost negated. The picture might change early next year, as a campaign mood sets in. In the second quarter of 2017, the economic recovery was still driven by domestic demand, with private consumption the main driver (with a 0.2% quarterly contribution), followed by investment (0.1%) and inventory accumulation (0.1%), with net exports growth-neutral. Somewhat puzzlingly, the machinery component of the private investment domain turned out to be weak, notwithstanding generous tax incentives and intensifying signals of fuller order books from producers.

Positive confidence signals for 3Q are spreading through sectors

Data evidence for 3Q17 has been unambiguously positive, particularly in the soft indicator domain. Business confidence has been marking further progress, initially in the manufacturing sector but lately also in the services, retail, and construction sectors. September marked a comeback in consumer confidence, where a 4-point leap came as a surprise.

Apparently, as suggested by the sharp decline in the unemployment expectation component, Italian consumers are finally more confident about the sustainability of the ongoing recovery. For the time being, both households and businesses seem scarcely concerned by looming political elections.

Temporary employment contracts fail to suppress job confidence

3Q hard data has been more closely matched with confidence data. In August, seasonally adjusted employment increased by 0.2% MoM, with a yearly growth rate of 1.6% (+375K over August 2016). Admittedly, new hiring has increasingly materialised through temporary contracts, with open-ended contracts playing a diminishing role, but which households (see consumer confidence) seem to appreciate anyway.

Industrial production data continued its steady recovery, up 4.4% YoY in July in calendar-adjusted terms. Interestingly, the sectoral breakdown shows an acceleration in the machinery and plant component. Together with the indication that order books at machinery producers are still filling

fast, this represents a good omen for GFCF (Gross Fixed Capital Formation) in 2H17.

+0.2%

August adjusted employment

1.6% yearly growth rate

Banking risks are diminishing

The investment recovery should also benefit from progress made in the consolidation of the Italian banking sector. With Banca Monte dei Paschi now under temporary state control, and the solution of compulsory administrative liquidation found for two Venetian banks, systemic risks in the banking sector have clearly abated.

The disposal of non-performing loans following bank recapitalisation looks set to continue, with the stock of bad loans net of provisioning (at €86.8bn at the end of 2016) projected to be down by a third by year end. The improved growth environment has already brought the new-non-performing loan rate back to pre-crisis levels. This is good news for prospective lending.

Back to basics, Gentiloni government focuses on the budget

Meanwhile, the government of Paolo Gentiloni (pictured) has been able to focus on the budget. In its note to the DEF Update, the economic and financial document setting the framework for the stability law (the budget), he anticipates softer fiscal consolidation than planned back on April. The budget will build on the same request of fiscal flexibility already submitted by Finance Minister Padoan in a letter to the EU Commission, targeting a structural adjustment of 0.3% of GDP for 2018 (was 0.8% in April).

When accounting for the projected full sterilisation of planned VAT increases, the budget looks set to deliver a 0.5% fiscal restriction, with two-thirds of the next manoeuvre expected to come from the revenue side and a third from spending cuts. In the note, the government sees a first decline in the debt/GDP ratio already in 2017, very much dependent on the way the public support to Italian banks will be treated by Eurostat.

Tricky political arithmetic

That said, in order to bring the debt/GDP ratio to a consistently declining trajectory, higher primary surpluses will be needed over the next few years. We believe that parliamentary approval of the budget, to be completed before year-end, will not be easy. In fact, it will happen while political parties will be trying to position themselves for the upcoming 2018 elections.

The MPS, the group which split from the PD party earlier this year while still supporting the government, might be tempted not to vote in favour. That said, we believe that the budget will be ultimately passed, eventually by resorting to the abstentions of some moderates in the Senate, as the political cost of sinking it would be huge ahead of the 2018 vote.

Electoral reform consequences

The parliamentary elections debate will likely gain more visibility over 4Q17. The consensus view is now that elections will be held in the first half of 2018, with 20 May as the latest possible date according to the Italian Constitution. A second attempt to approve a reform of the electoral law is being made on a mixed model hypothesis, assigning 65% of seats with a proportional mechanism

and 35% of seats with a first-past-the post system. With an important regional vote due on 5 November in Sicily, it is possible that the final rush to approve it will be made only after the result of the regional vote is known.

Different results could lead to different geometries in the domain of possible alliances in a national vote perspective, and this could ultimately influence the choice of new system. If no agreement is reached, Italians will have to vote with the quasi-proportional system which resulted from two separate rulings of the constitutional court. Given the current parliamentary geometry, and with three comparable contenders expected, no grouping would be in the position to win a clear majority. The formation of a new government would then call for some form of post-vote enlarged coalition.

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