

Italy

The election issue

Stress free country monitoring

raffaella@adaeconomics.com

shubhra.singh@adaeconomics.com

Forecasts

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F	
Real GDP	-1.0	-5.5	1.6	0.7	-2.9	-1.7	0.2	0.9	1.1	1.6	1.9	2.2	
Nominal GDP, trn	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.8	1.9
HICP, avg	2.4	1.1	2.1	3.7	2.6	0.6	0.0	0.1	0.5	1.5	1.8	2.3	
Unemployment rate eop	7.0	8.5	8.6	9.5	11.6	12.6	13.3	11.9	12.2	10.8	9.5	8.5	
Budget deficit % of GDP	-2.7	-5.3	-4.2	-3.7	-2.9	-2.9	-3.0	-2.7	-2.4	-2.5	-2.2	-1.8	
Debt % of GDP	102.4	112.5	115.4	116.5	123.4	129.0	131.8	132.1	132.6	131.3	129.2	126.2	

Sources: Eurostat data, ADA Economics

Italy: A recap and projections

Real GDP growth in Italy in 2017 averaged at around 1.6%.

The last quarter saw favourable conditions, such as rising consumer sentiments, capacity utilisation and low constraints limiting production. Italy's competitiveness both in domestic and foreign markets also seems to be on a continued rise since 2016. Trade balance is sustained and is at an all-time high since the 90's.

Assuming a rising industrial production coupled, increased consumer confidence, and YoY retail trade ranging from 1.5% to 2%, we expect the real GDP growth to average 1.8% in 2018.

Government social expenditure now accounts for just less than 60% of the total, with increased focus on healthcare but somewhat less public spending on education.

Our forecast for inflation remains unchanged – a gradual rise over the next two years, ending at 2.2% in 2019 Q4.

Budget 2018

The Senate has given its final approval to the 2018 budget. Amongst other changes, budget 2018 introduces a “web tax” from 2019, that establishes a 3% tax on some internet transactions. This new tax is intended to apply to sales of intangible digital products such as online advertising and sponsored links embedded in web pages. However, those companies that make fewer than 3,000 transactions per year will be excluded from paying the tax. This provision is expected to have an annual yield of around €190m.

The budget also aims to lower next year's fiscal deficit to 1.6% of the GDP from a targeted 2.1% this year. However the European Commission says the budget may break EU rules because it raises previously agreed deficit targets and does little to control Italy's huge public debt, which at 132% of the GDP is the highest in the Eurozone after Greece.

To help curb the 35% youth unemployment rate, a new measure includes a three-year reduction in social-security contributions for companies that hire young people on long-term contracts.

Some incentives have been introduced for companies that spend on machinery or other capital improvements. There are also measures to address the country's growing poverty levels, which as a problem is fueling support for populist parties.

Factbox : Elections 2018

- President Sergio Mattarella dissolved the parliament on 28th Dec 2017, ahead of the election scheduled on 4th March 2018.

CENTER LEFT: Ruling Democratic Party, Matteo Renzi

Negotiate with Italy's partners to abolish the EU's Fiscal Compact which imposes steep budget cuts on high-debt countries. Raise the budget deficit to 3% of GDP for 5 yrs to cut taxes and increase investment. Continuity in social and foreign policy, with Italy maintaining its traditional pro-NATO stance

POLLS: Support sliding, 23%

ANTI-ESTABLISHMENT: 5-Star Movement, Luigi Di Maio

Universal income support to ensure monthly income of at least € 780.; renegotiate the Fiscal Compact; raise the budget deficit above 3% of GDP to cut taxes and increase investments; hold a referendum on euro membership if partners refuse any concessions on the Fiscal Compact; cut privileges of politicians, trade unions and well-off pensioners; repeal 2011 pension reform to allow earlier retirement; repeal 2014 labor reform to make firing harder; raise taxes on banks and oil and gas companies; toughen conflict of interest rules.

POLLS: Most popular party, support 28%

CENTER RIGHT: Forza Italia, Silvio Berlusconi

Introduce parallel currency for domestic use to boost the economy while keeping the € for international trade; "flat tax" of 23% for both individuals & companies; double monthly minimum pensions to €1,000; abolish housing tax, inheritance tax and road tax; tax breaks for pet owners; guarantee minimum income of €1,000 per month for everyone; block the arrival of immigrants.

Berlusconi cannot run at the election due to a tax fraud conviction. He has not yet said who Forza Italia's candidate for prime minister will be. He is pro-NATO but boasts of his friendship with Vladimir Putin.

POLLS: Support rising, 16%. (Most popular party in a center-right coalition expected to win most seats)

CENTRE RIGHT: Northern League, Matteo Salvini

Parallel currency for domestic use; abolition of the Fiscal Compact and Stability Pact; leave the euro as soon as politically feasible; "flat tax" for individuals and companies at 15%; repeal 2011 pension reform to allow earlier retirement; immigration crackdown and repatriating up to 100,000 illegal immigrants per year; toughen penalties for violent crime; improve relations with Russia.

POLLS: Support slipping, 13%.

CENTER RIGHT: Brothers of Italy, Giorgia Meloni

Immigration crackdown by intercepting migrant boats and repatriating illegal immigrants; toughen penalties for violent crime; improve relations with Russia. Policies similar to Northern League's but unlike the League, its support is based in central and southern Italy.

POLLS: Support stable at 5%.

LEFT: Free and Equal, Piero Grasso

Repeal 2014 labor reform to make firing harder; soften 2011 pension reform to end automatic increases in the retirement because of rising life expectancy, increase spending on education, health & public works; improve relations with Russia and fully recognize Palestine.

POLLS: Support rising gradually, 7%

Taxation in Italy

- Italy has a progressive employment income tax system, and the following rates apply since 2013:

Income range	Tax rate
€0 — €15,000	23%
€15,000 — €28,000	27%
€28,000 — €55,000	38%
€55,000 — €75,000	41%
over €75,000	43%

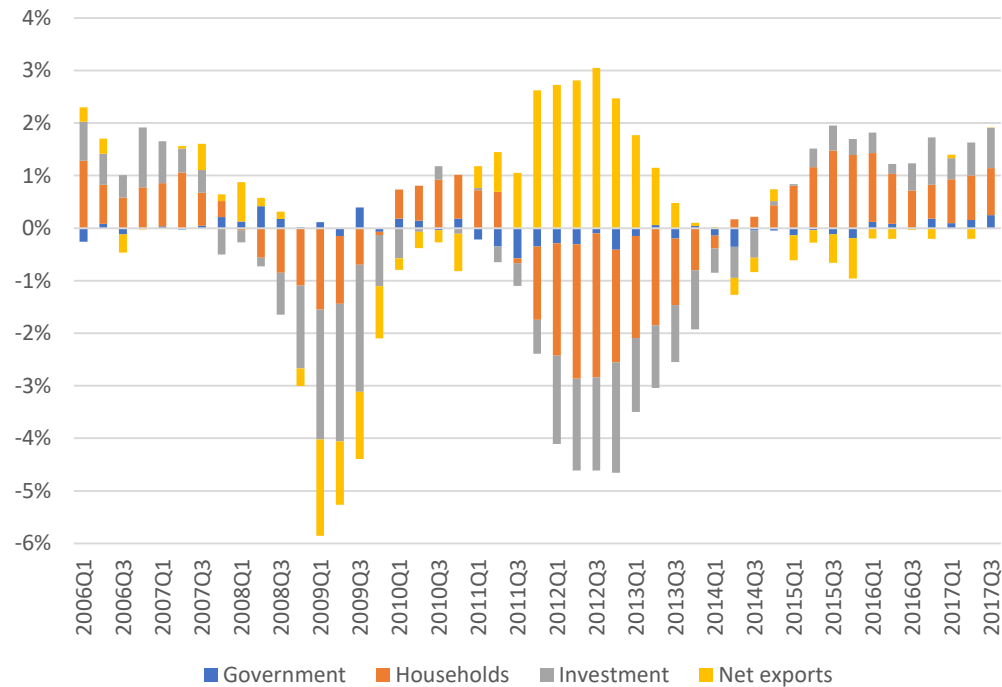
- Corporate entities are subject to a corporate income tax, known as IRES and to a regional production tax, known as IRAP. The IRES taxable bases determined according to the worldwide taxation principle, which states that irrespective the location of the generated income, if the income is legally attributed to an Italian resident, it is taxed in Italy. IRAP, on the other hand, taxes the total net income reported in the company's financial statements.
- The current rates are 24% for IRES and 3.9% for IRAP, making the corporate tax rate at 27.9%. This change came about only since Jan 2017 before which the IRES was fixed at 27.5%, making the previous corporate income tax rate higher at 31.4%.
- One of the key proposals of Forza Italia and Northern League is to switch to the “flat tax system” for both individuals as well as corporates, with the flat rate being fixed at at 23% for FI and 15% for NL.

Macroeconomic backdrop



GDP growth and projections

Contributions by key component to YoY growth



Outlook for the next two years



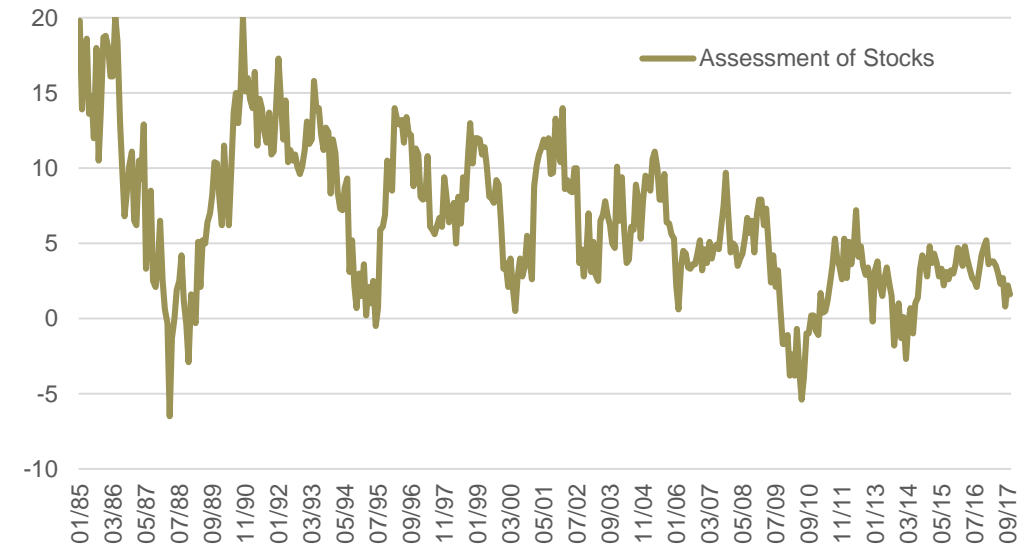
Sources: Macrobond, ADA Economics

Industrial sector

Industrial sentiment (RHS) and pricing power recovering



Inventories are relatively low



- Industrial production in coming months should be supported by improving demand, relatively low inventories and recovering pricing power (though still low in historical perspective)

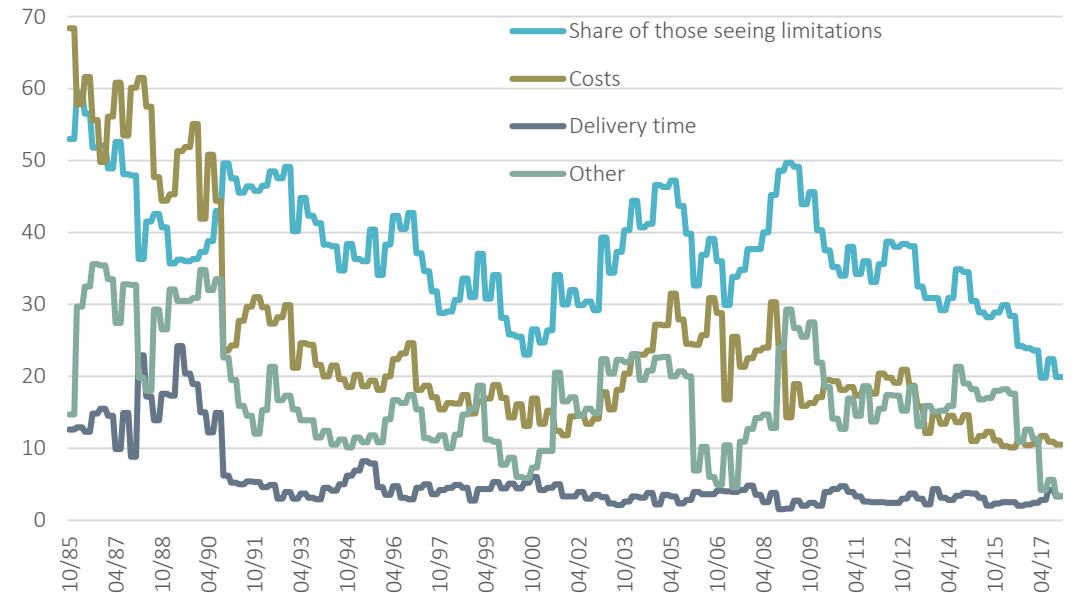
Sources: Macrobond, CEIC, ADA Economics

Industrial sector

Manufacturing sector capacity utilization



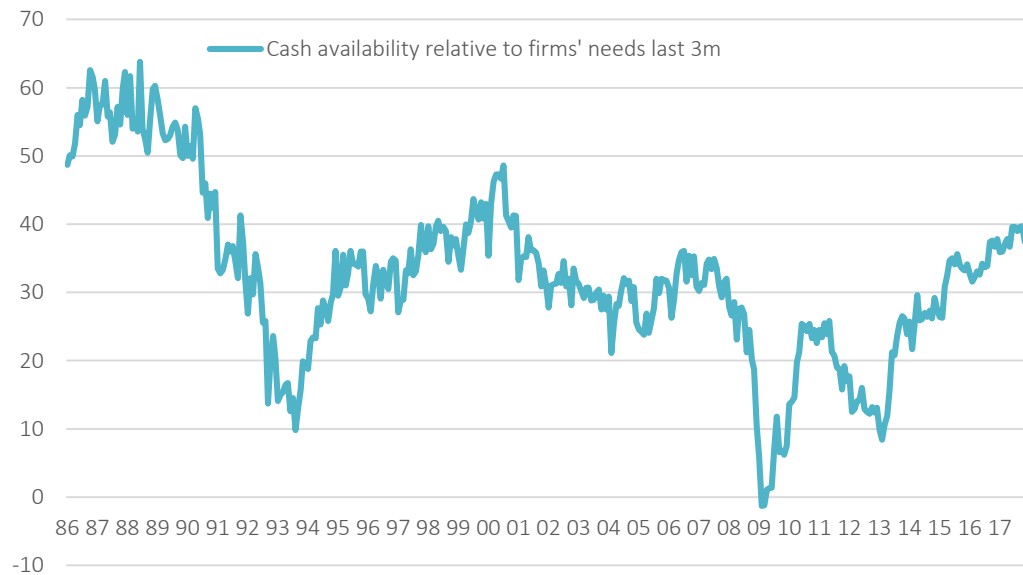
Factors limiting exports production



- Capacity constraints are rising, which should help with a modest recovery of investments. Companies that report limitations to exports are few in historical perspective and other constrains are seen at all time lows.

Industrial sector

Manufacturing sector liquidity



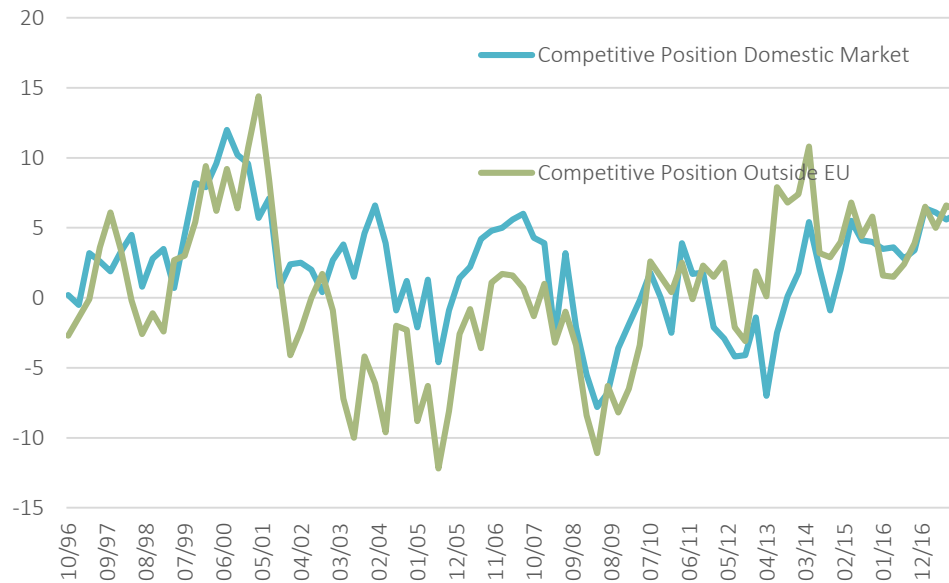
Hiring appetite



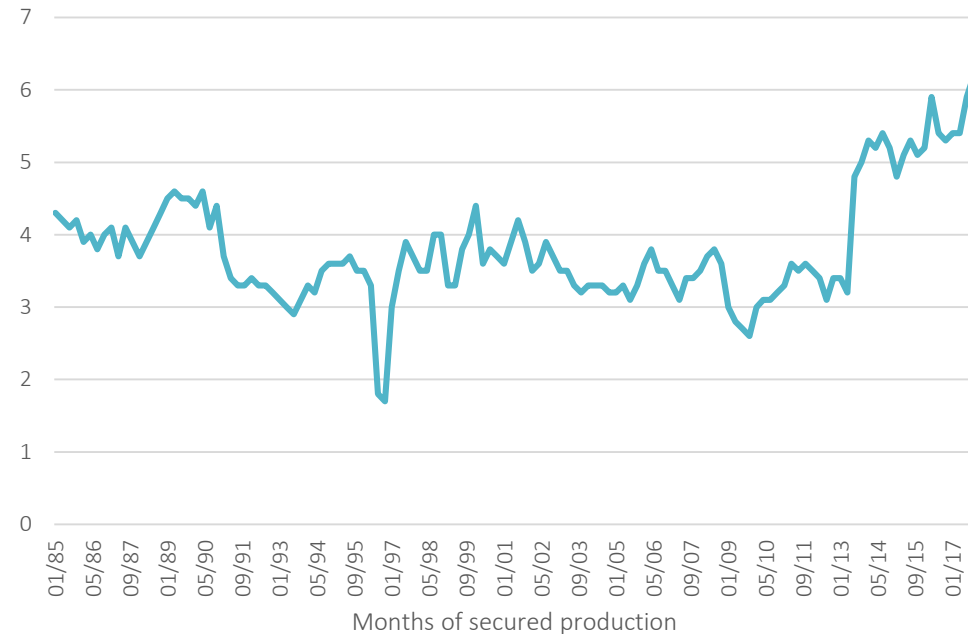
- Manufacturing sector balance sheet show a steady improvement in liquidity and a jump in hiring appetite.

Industrial sector

Competitiveness perceived domestically & abroad



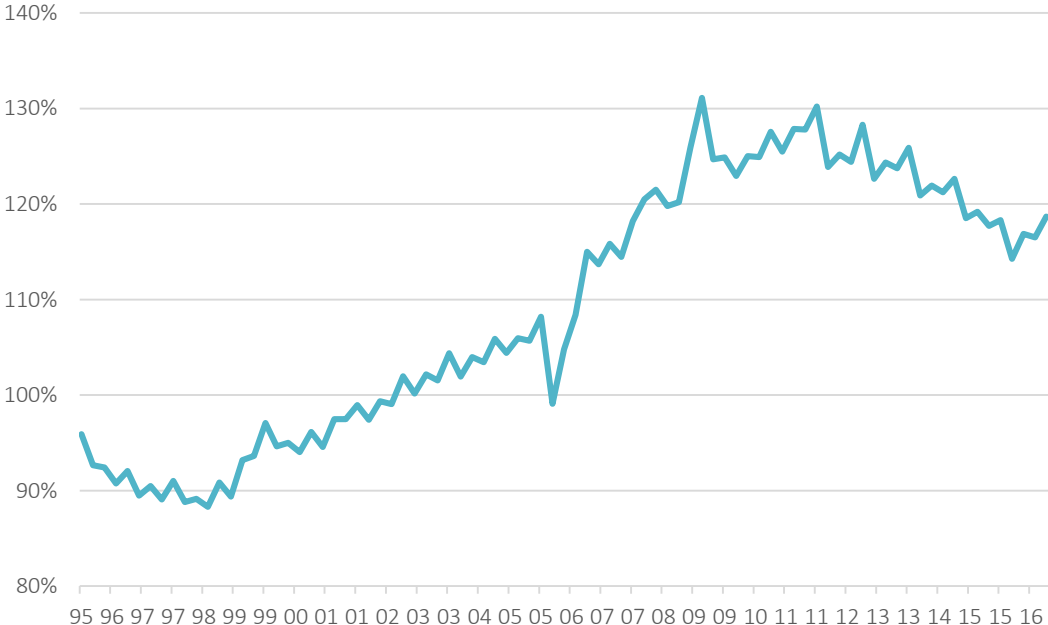
Months of secured production



- Surveys reporting companies' perceived competitive position signal a steady improvement in recent years and a jump in the number of secured months of production, which in other countries has proved to be a key leading indicator of the turnaround in the recovery

NFCs' balance sheets have improved

Debt-to-GDP ratio



Assets-to-GDP ratio

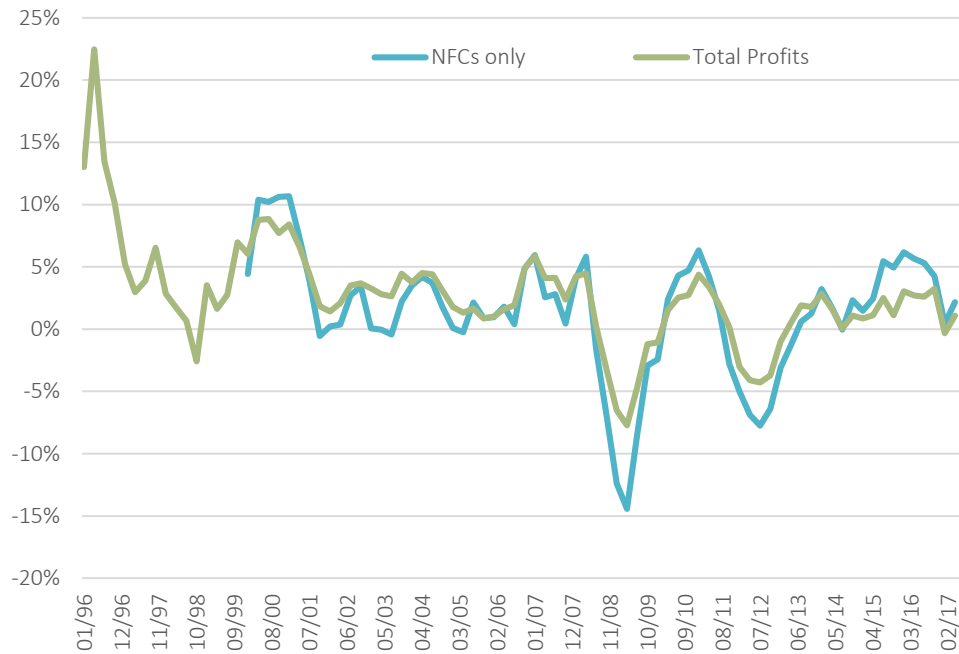


Sources: Macrobond, ADA Economics

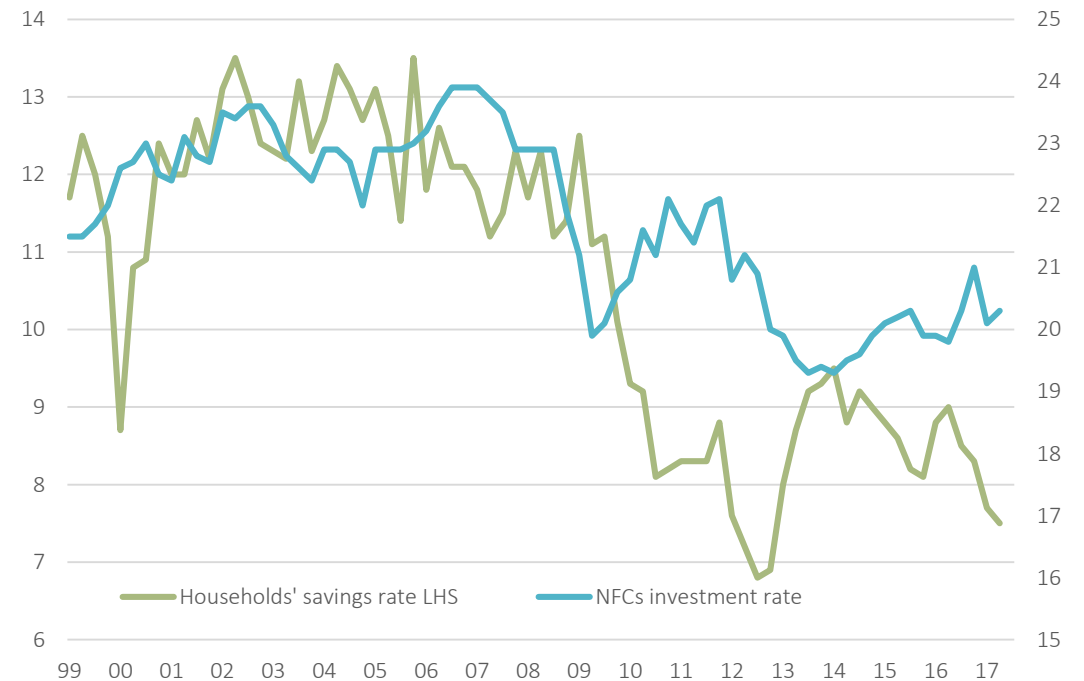


Profitability: better but not stellar

Profits are rising, but not that fast...



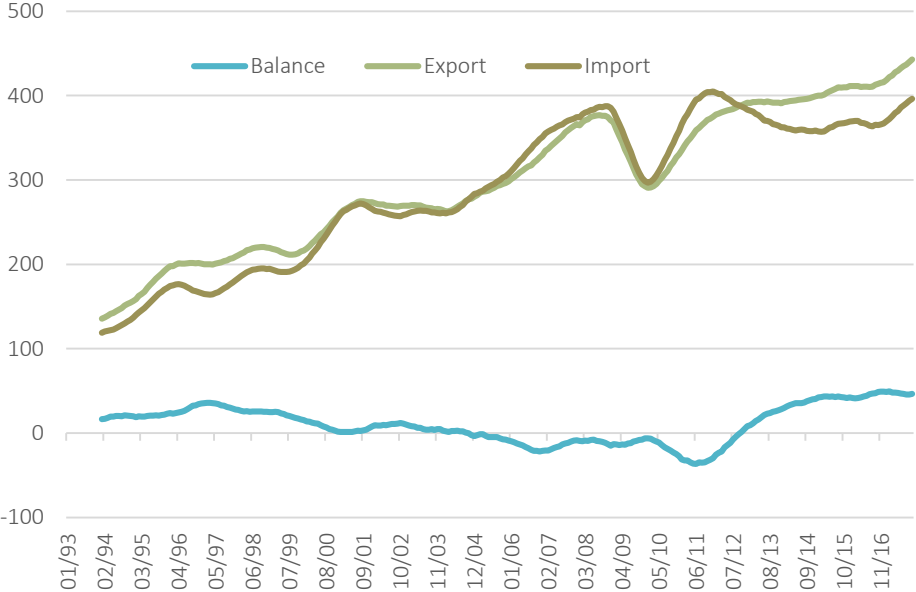
...but the investment rate is improving, while households continue to run down savings



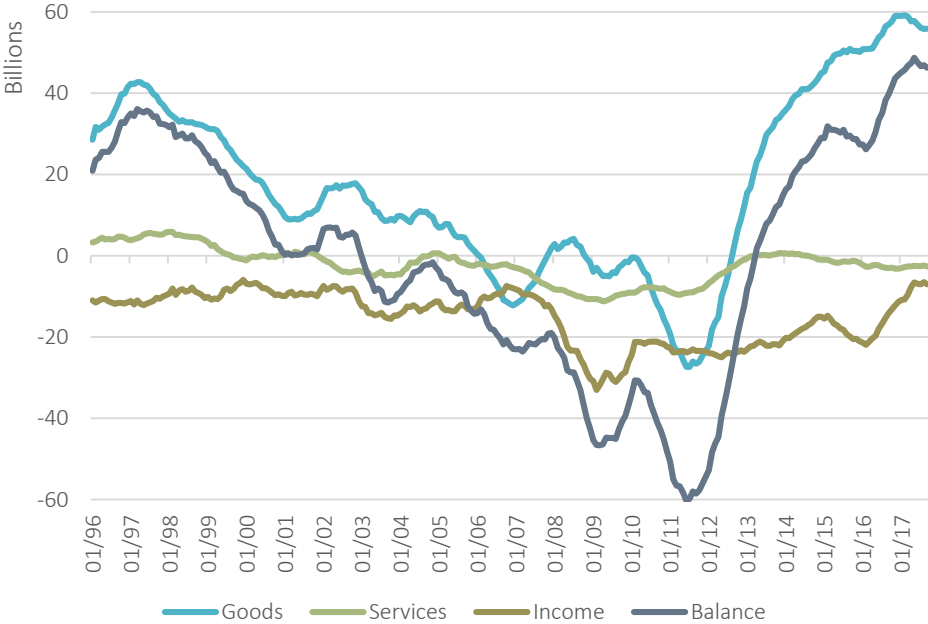
Sources: Macrobond, Eurostat, ADA Economics

External sector

Exports and imports dynamics (EURbn)



Current account breakdown dynamics (EURbn)

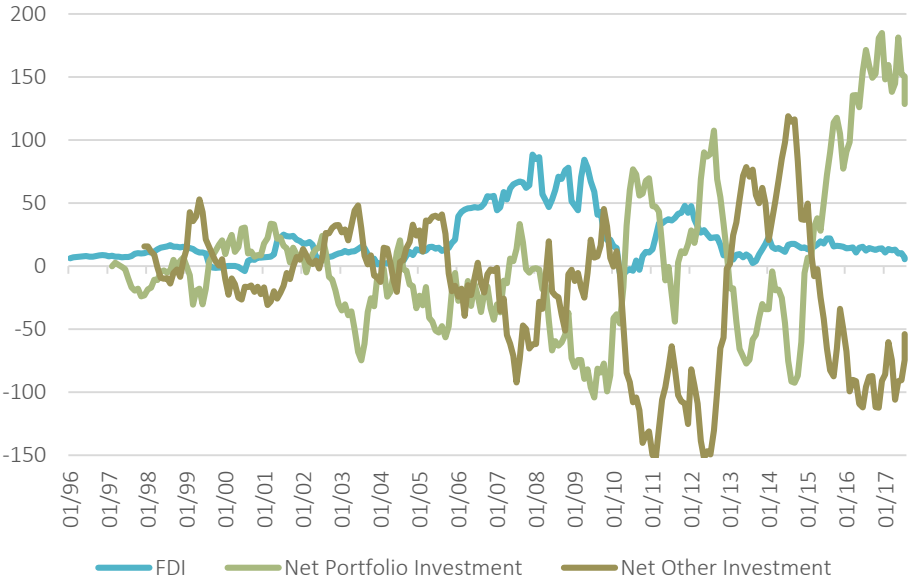


Sources: Macrobond, ADA Economics

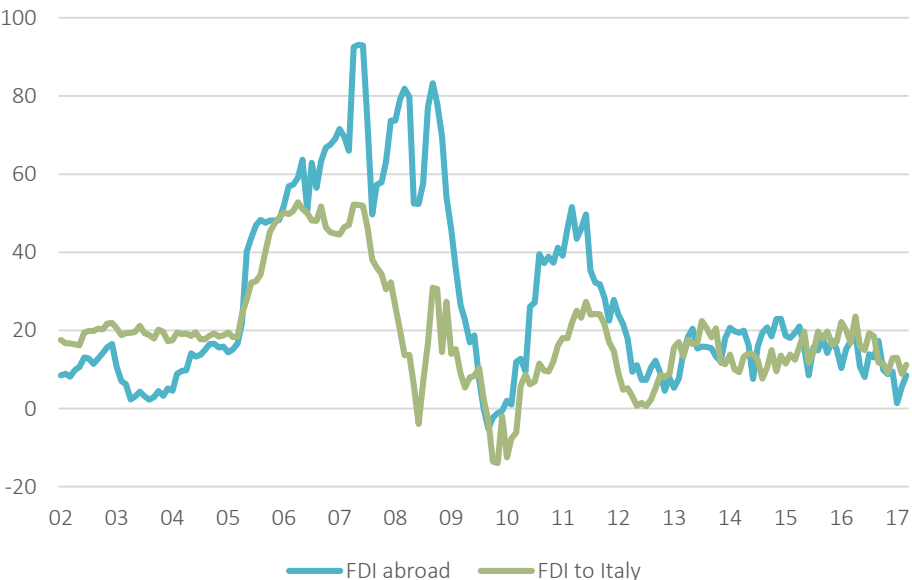


External sector

Financing for the current account: large portfolio outflows persist



Less FDI abroad, but not yet a net inflow of FDI in Italy

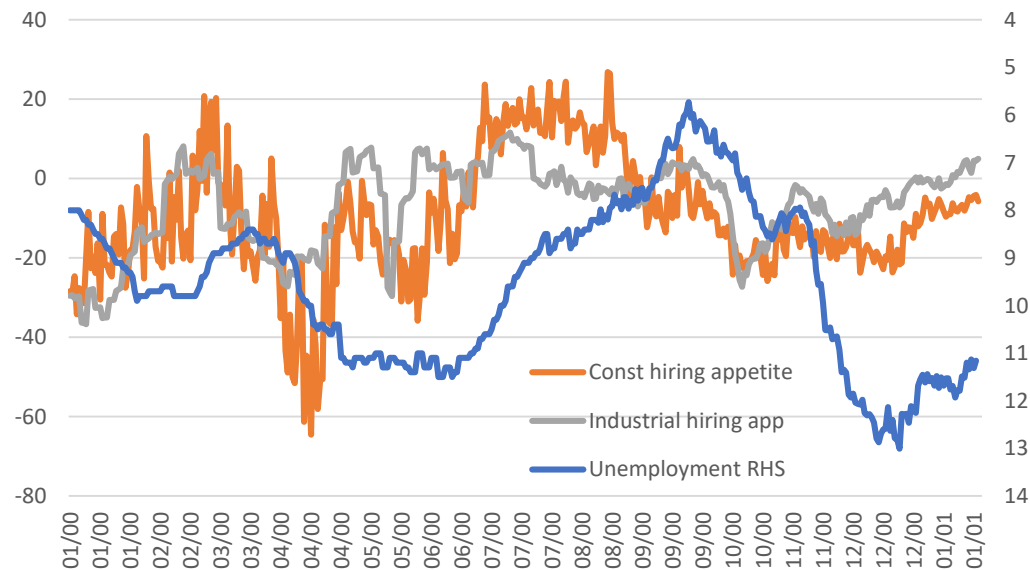


Sources: Macrobond, ADA Economics, EUR bn, 12m trailing sums

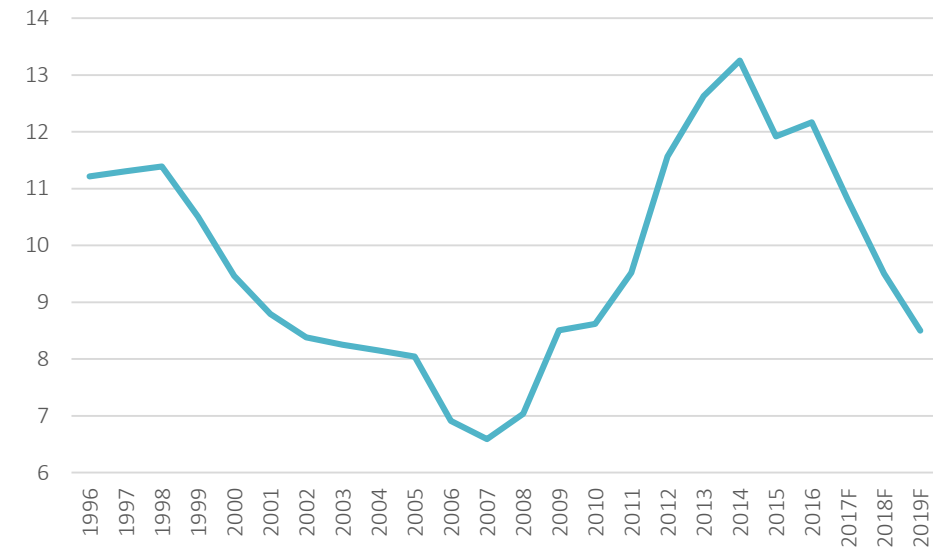


Labour market

Hiring appetite fairly high in historical perspective, but the unemployment rate is falling slowly



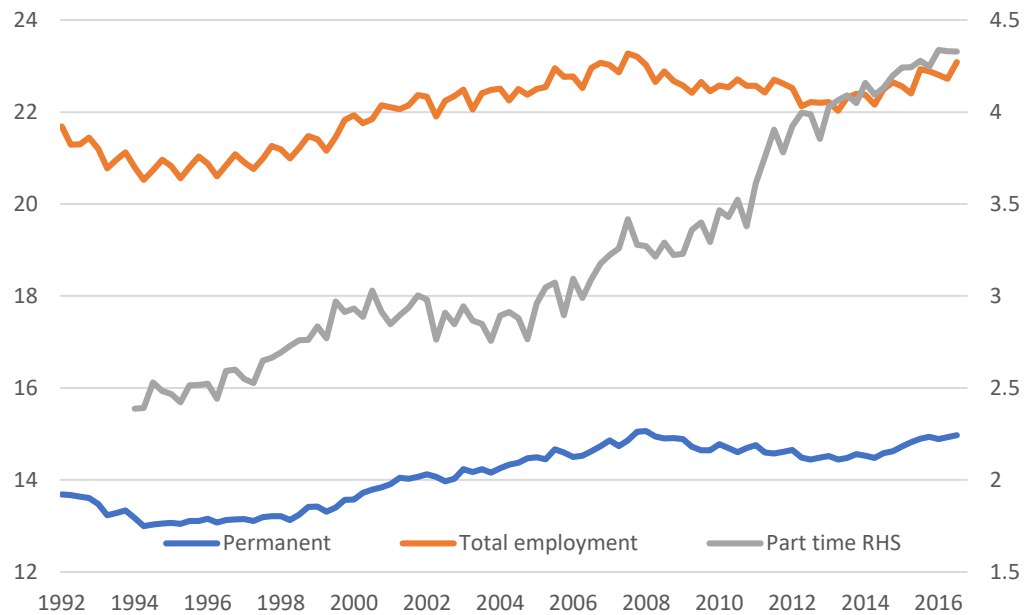
Projected change in the unemployment rate



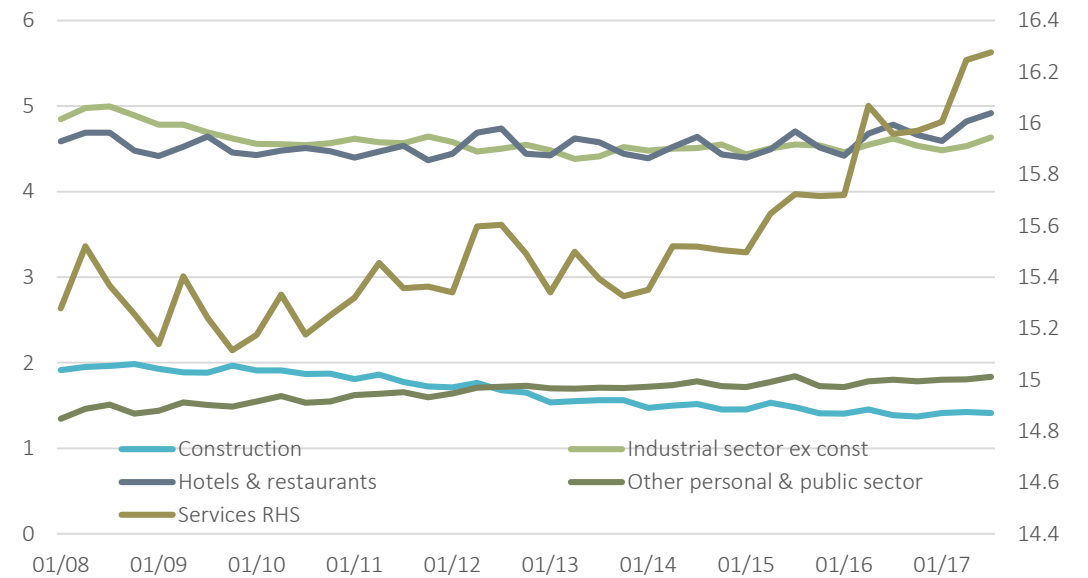
- The correlation between the unemployment rate and hiring intentions is not as close as in other countries probably because there is churning of labour (switching older/expensive with younger/cheap workforce) and the industrial sector overall is still shrinking, so the survey only picks up the optimism of the well-performing companies

Labour market: a granular view

Job creation by type of contract (mn of workers)



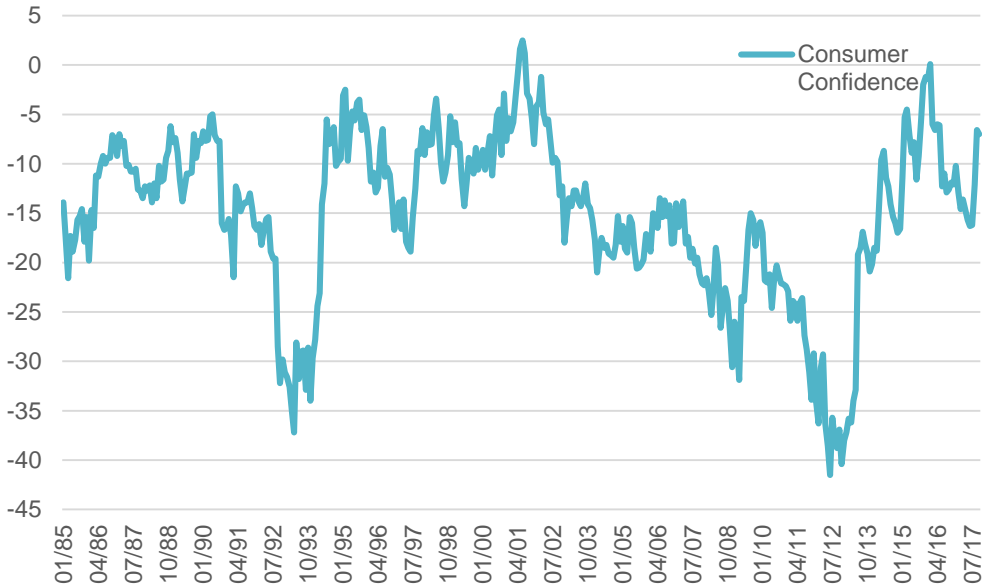
Total employment by key sector (mn)



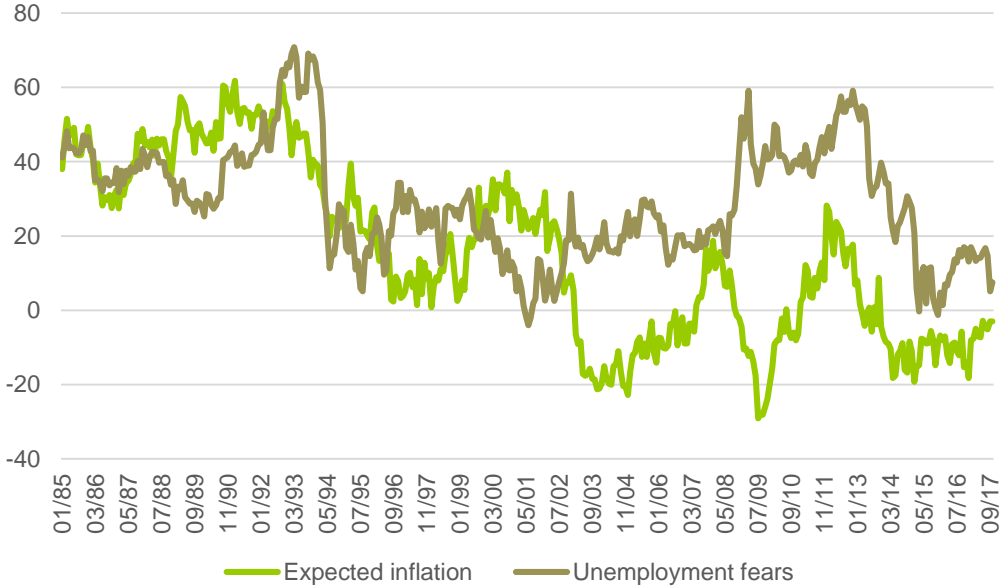
Sources: Macrobond, ADA Economics

Household sector

Consumer confidence seems to be recovering



...consumers are less worried about prices than unemployment

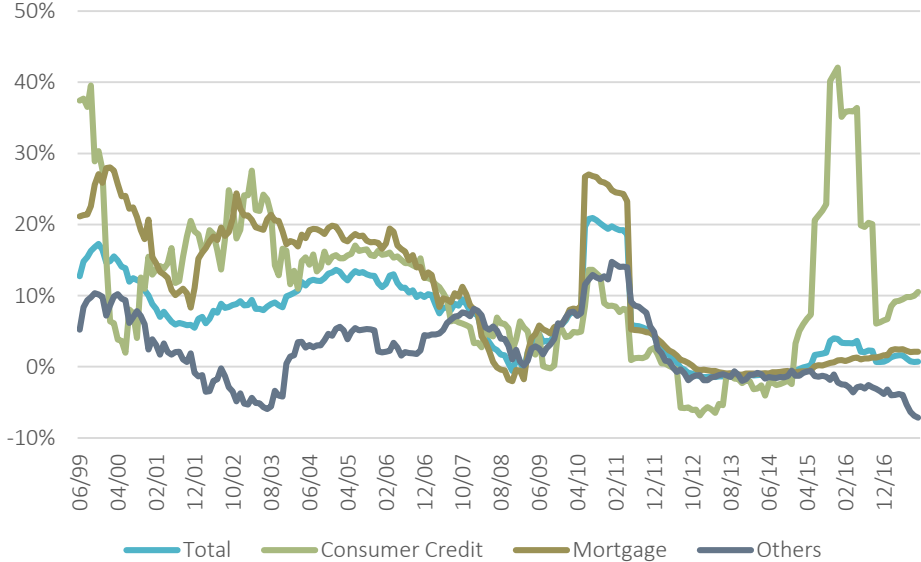


Sources: Macrobond, ADA Economics

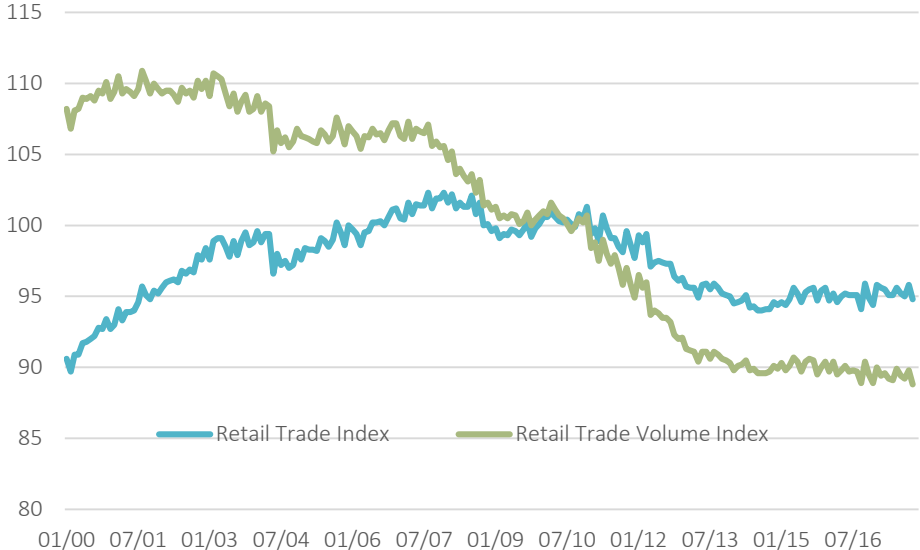


Household sector

Borrowing YoY by segment



Retail trade has stabilised in value terms, but volume is still falling)

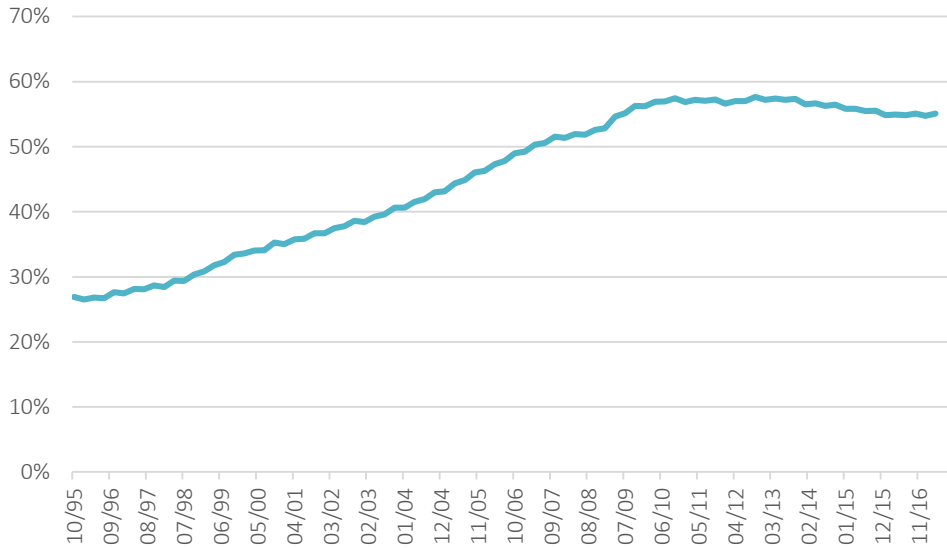


Sources: CEIC, Macrobond, ADA Economics

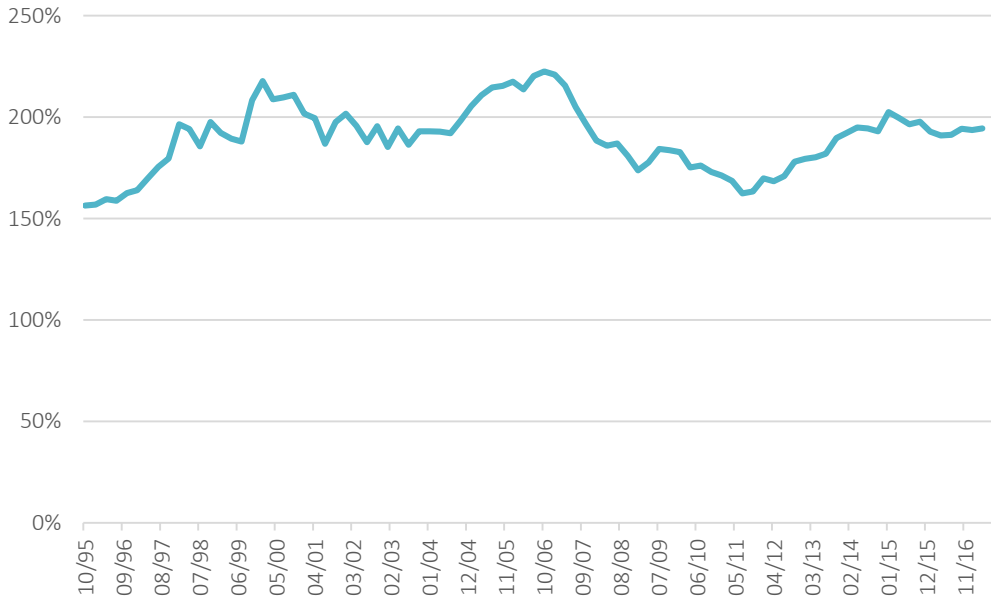


Household sector balance sheet

Debt to GDP



Net financial assets % of GDP

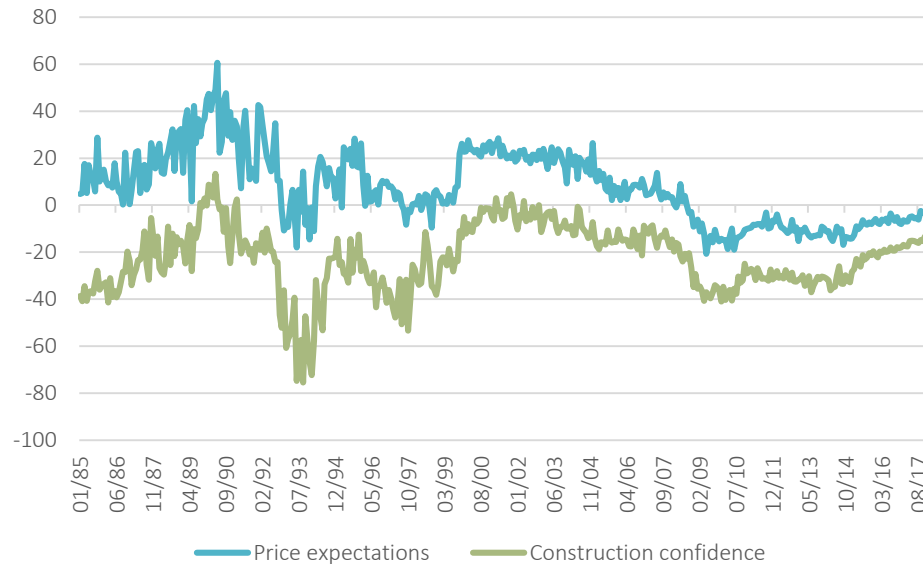


Sources: Macrobond, ADA Economics

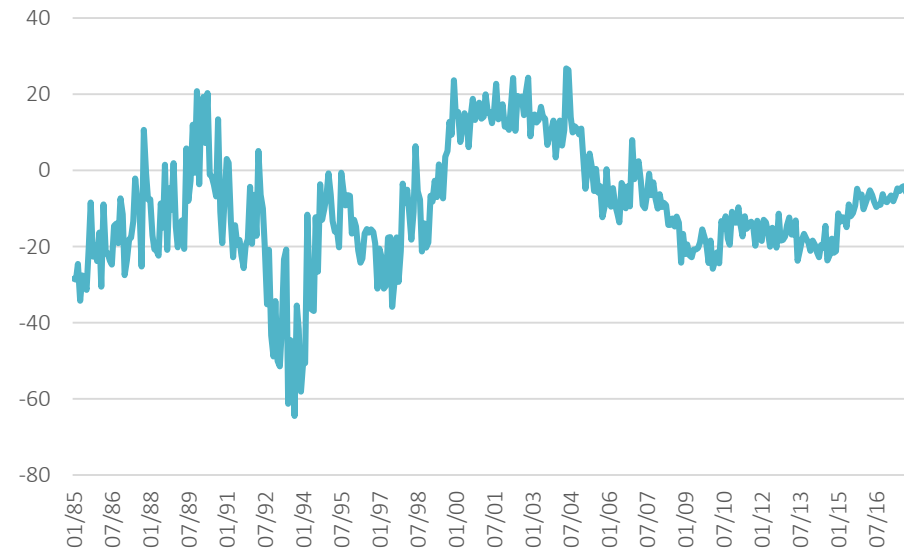


Construction sector

Confidence and pricing power are coming back



...as well as hiring appetite

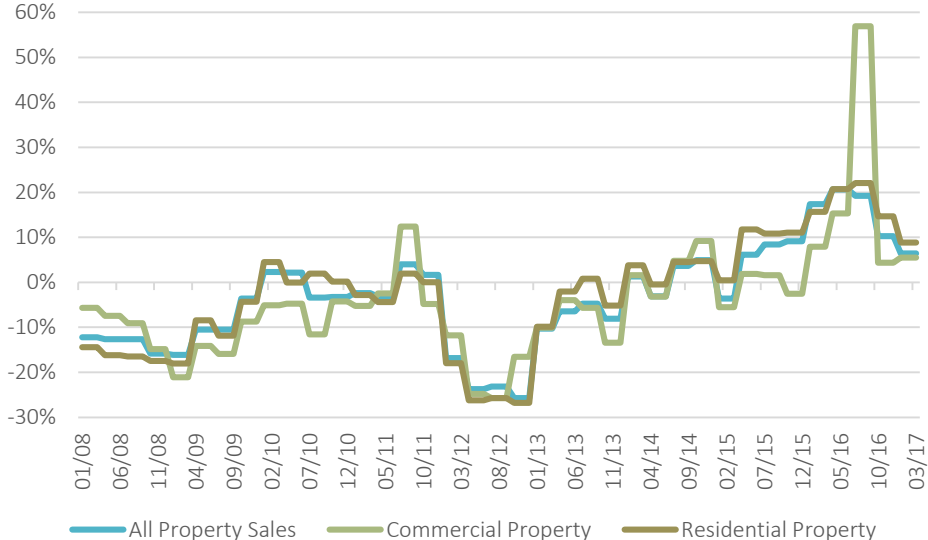


- A sustained recovery of the constructing sector would greatly speed up the drop in the unemployment rate

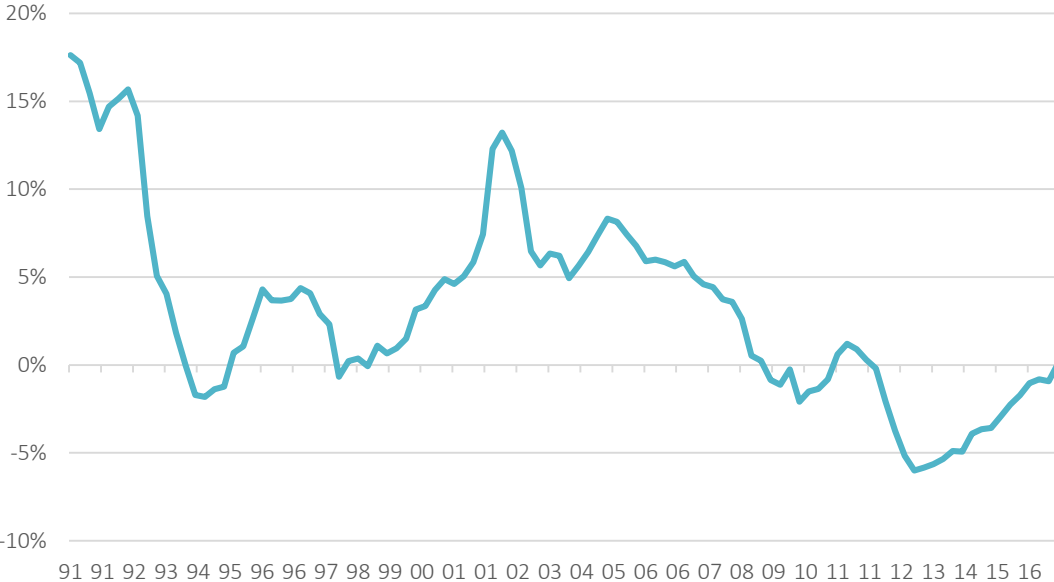
Sources: Macrobond, ADA Economics

Real estate

Residential and commercial transactions, YOY



YoY changes in Real Estate Prices Index

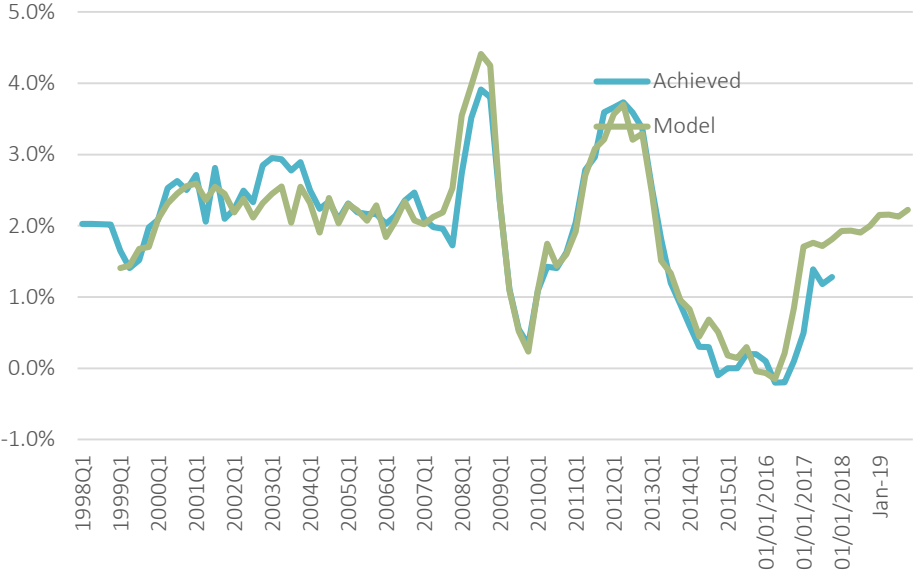


Sources: Macrobond, ADA Economics

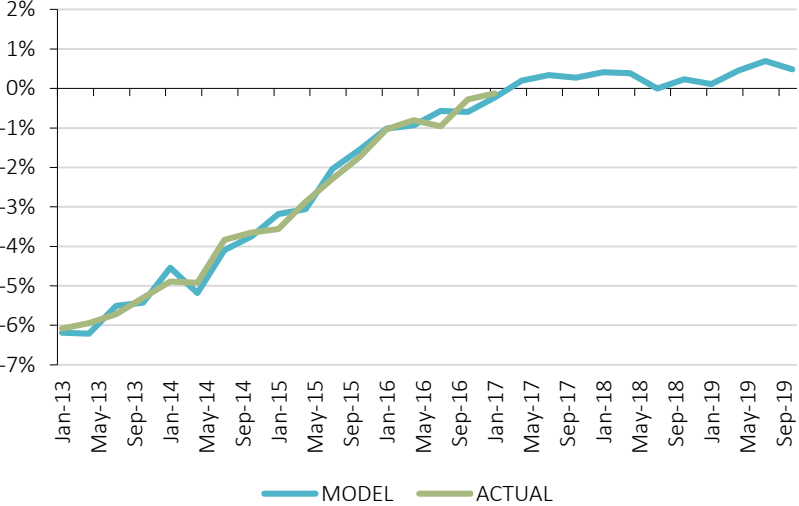


Inflation

Inflation recovering in coming years



Projected YoY changes in residential prices

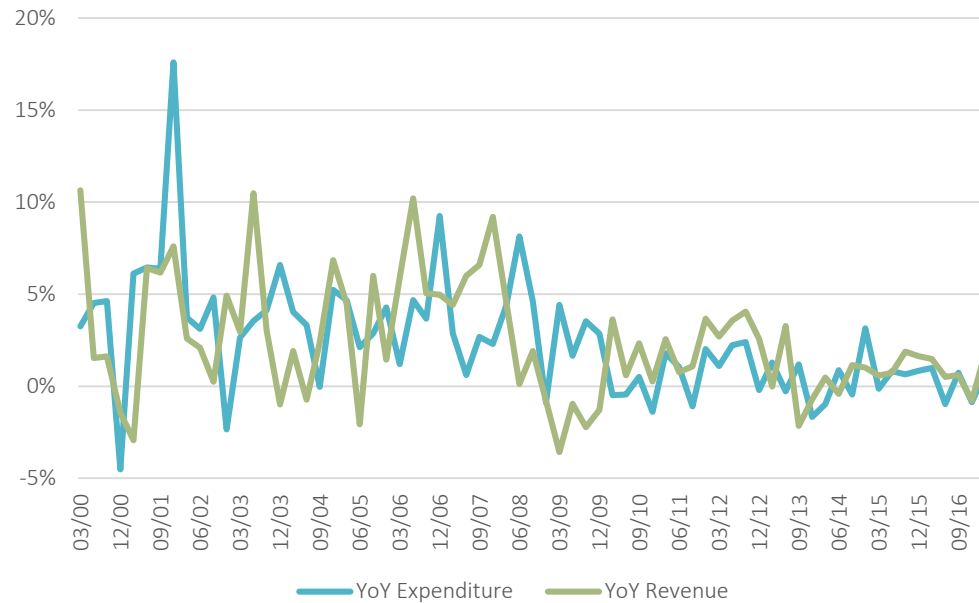


Sources: Macrobond, ADA Economics

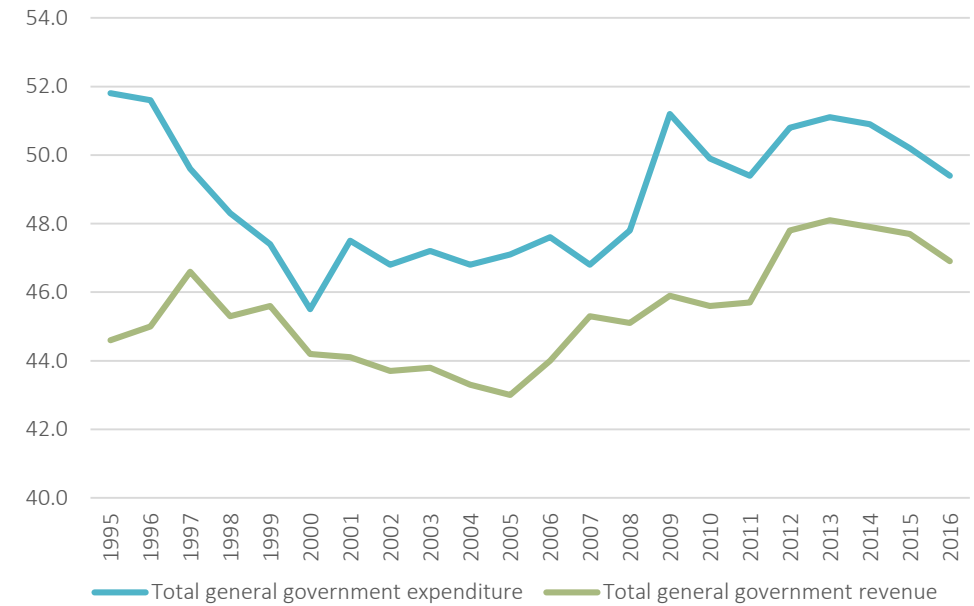


General government

Revenue and expenditure YoY



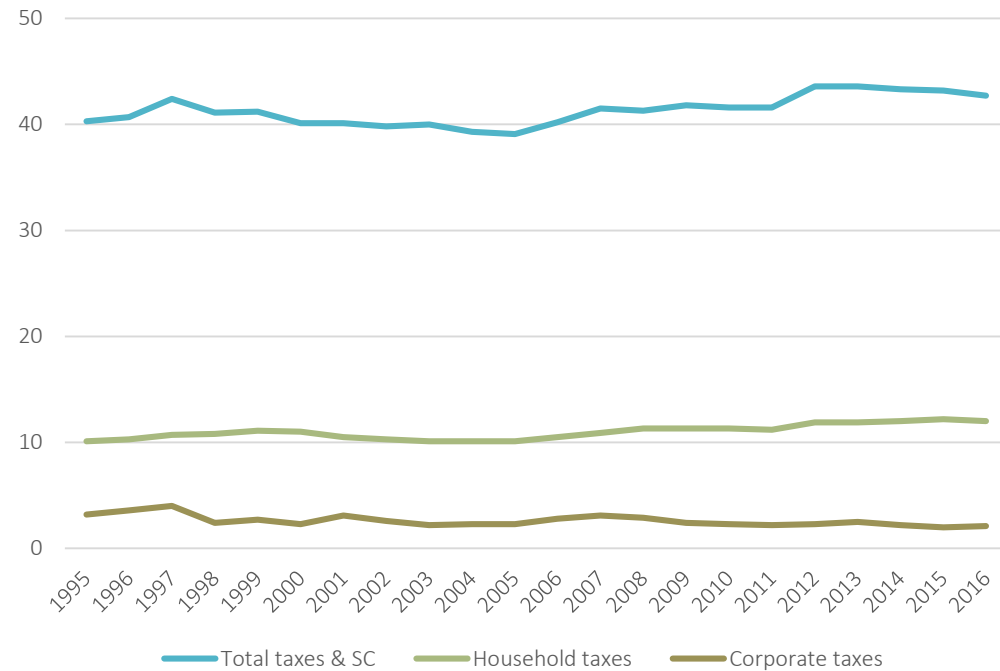
Revenue and expenditure as a % of GDP



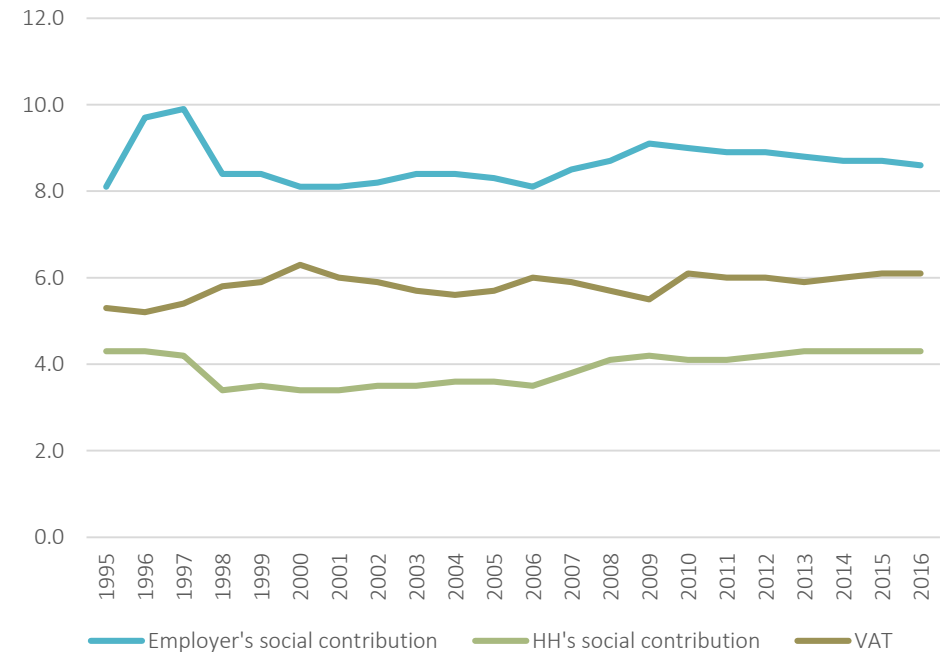
Sources: Macrobond, ADA Economics

General government revenues

Taxes as a % of GDP



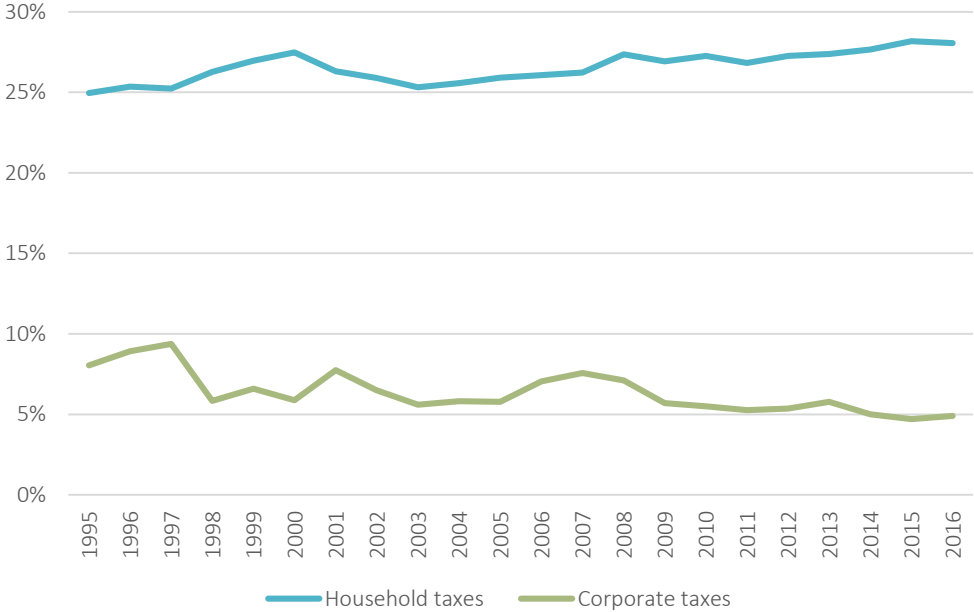
Social contributions and VAT as a % of GDP



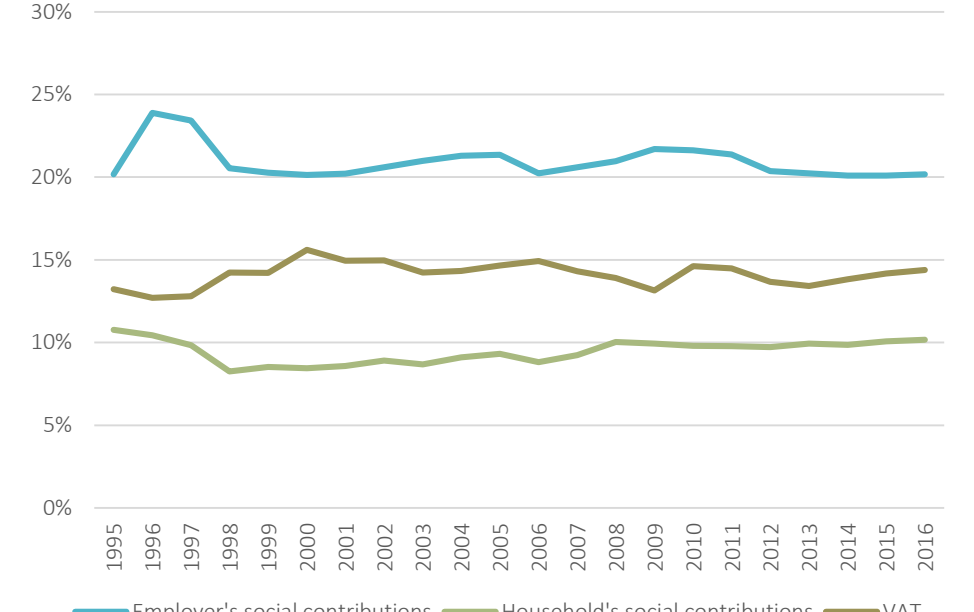
Sources: Macrobond, ADA Economics. Note: chart of the left shows total taxes and social contributions as a % of GDP

Revenue: *Breakdown of taxes*

% of total tax generated from households & corporates



% of total tax generated from social contributions & VAT

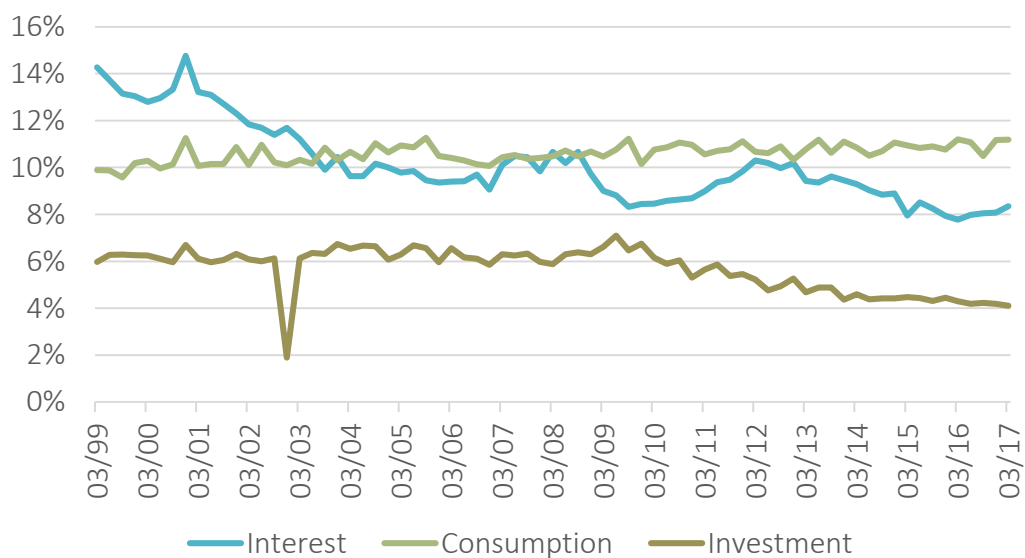


Sources: Macrobond, ADA Economics

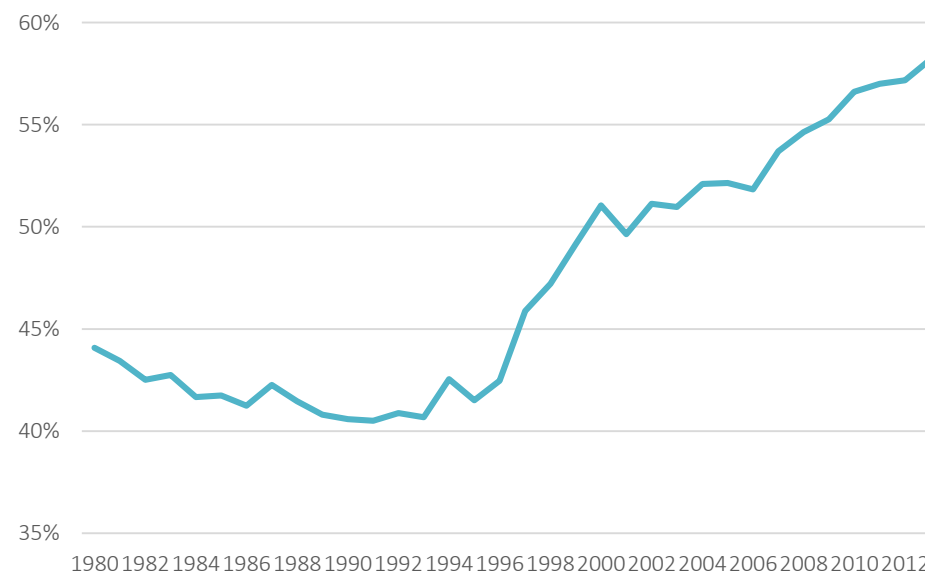


Gen gov expenditures: *Main aggregates in % of total*

Consumption, investment and debt servicing costs



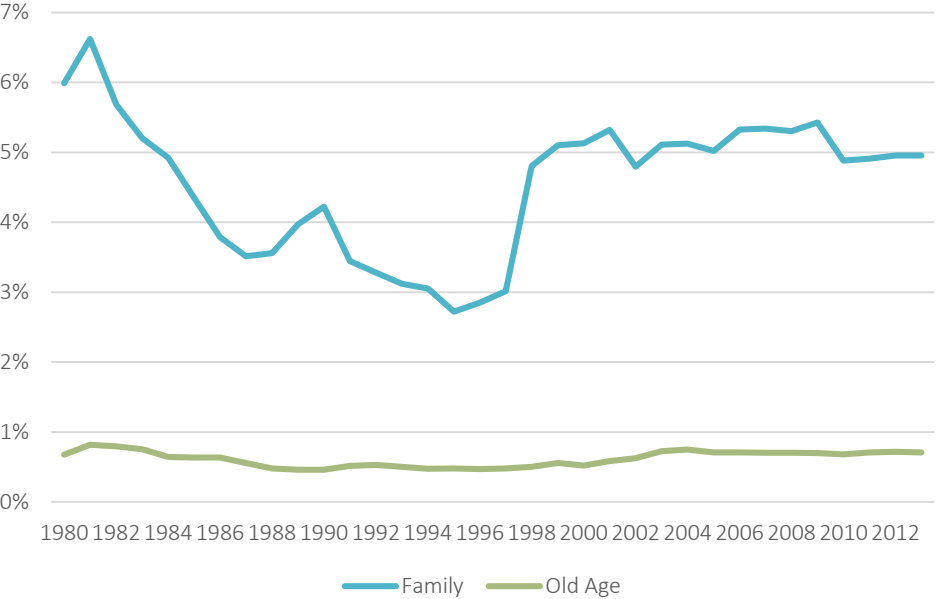
Public social expenditure



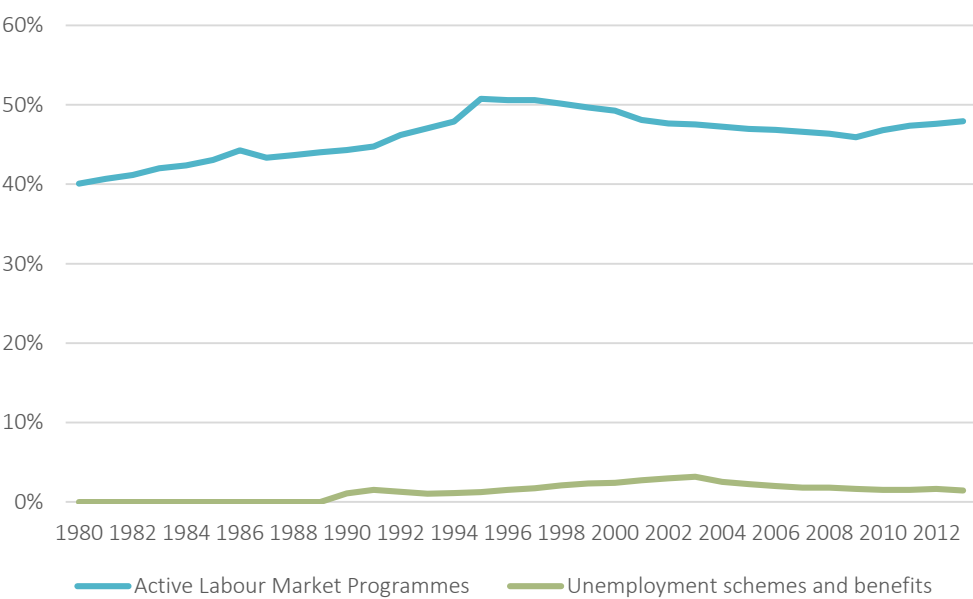
Sources: Macrobond, ADA Economics

Expenditure: *Breakdown of public social expenditure*

Expenditure on families and old-age



Expenditure on the labour market and unemployed



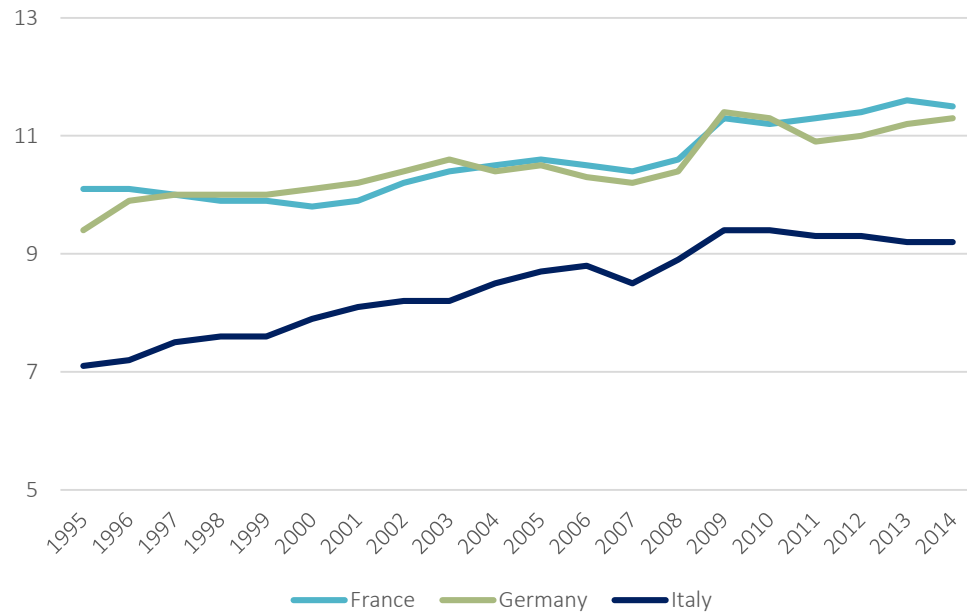
Active labour market programmes account for over 40% of the total public social expenditure, while the share of expenditure on family benefits and schemes have fluctuated considerably before stabilising at 5%.

Sources: Macrobond, ADA Economics

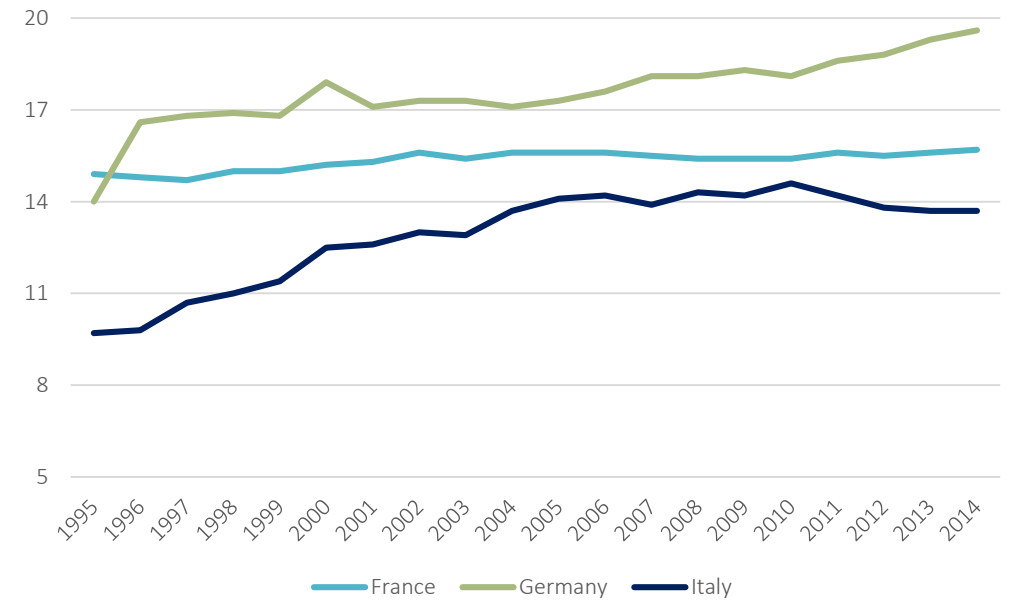


Expenditure: *Health*

Health expenditures in FR, DE, IT as a % of GDP



Health expenditures in FR, DE, IT as a % of govt expenditure

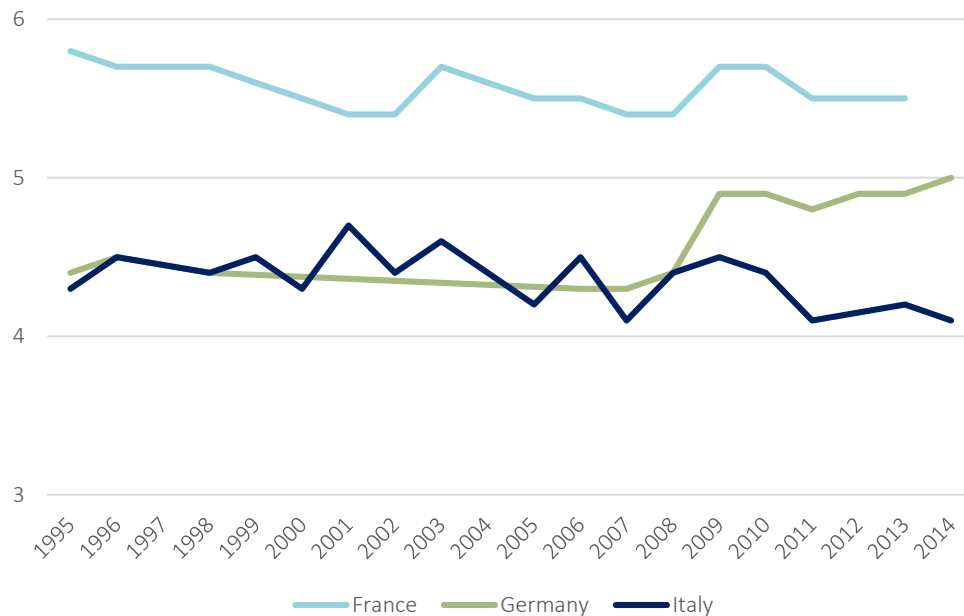


Italy's expenditure on health care has risen substantially, and has stabilised at 9.2% of the GDP since the last decade.

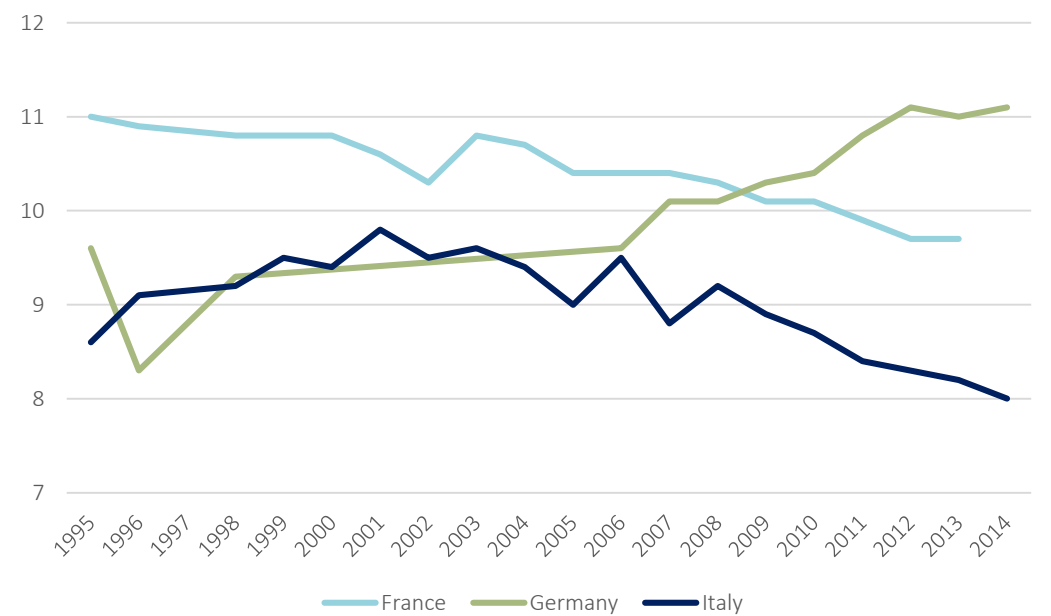
Sources: Macrobond, ADA Economics

Expenditure: *Education*

Education expenditures in FR, DE, IT as a % of GDP



Education expenditures in FR, DE, IT as a % of govt expenditure



Unlike France and Germany, though Italy's public expenditure on education has fluctuated substantially in recent decades, it has been on a steady decline since 2008, ending at 8% of the total GG expenditure in 2014.

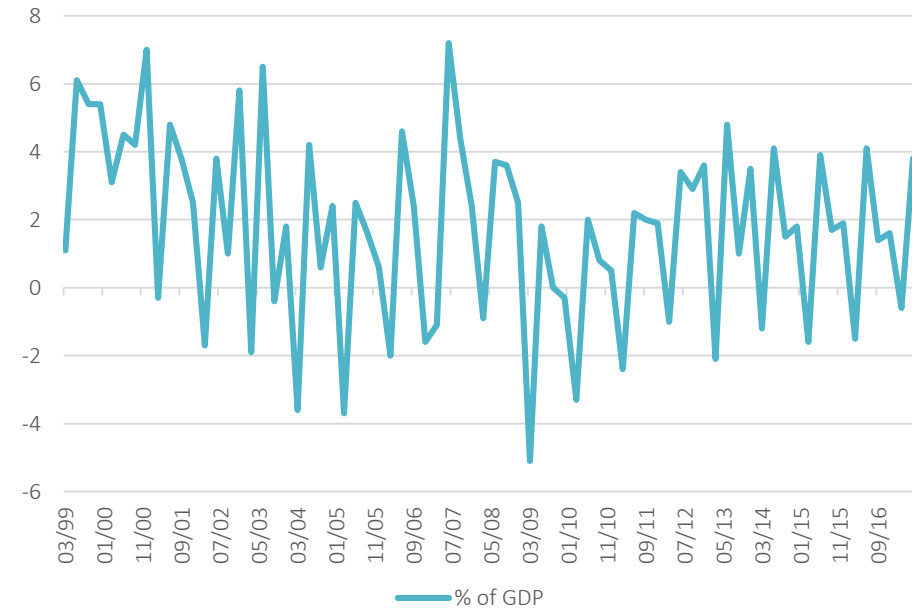
Sources: Macrobond, ADA Economics

Budget deficit and debt

In % of GDP, debt (primary) and deficit (secondary)



Primary balance (as % of GDP on secondary axis)



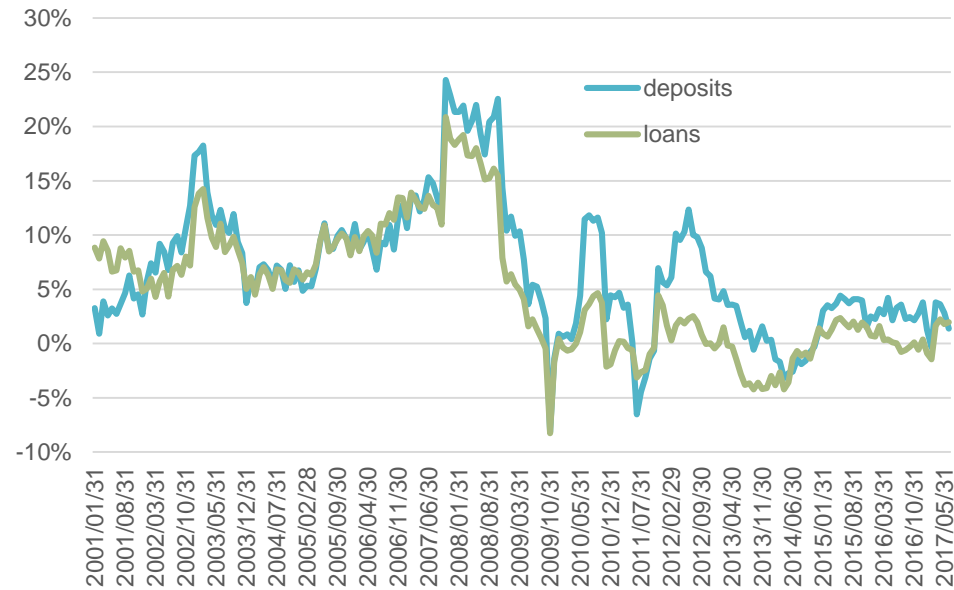
Italy aims to trim its budget deficit in 2018 to 2.1% of the GDP, which stood at 2.5% in 2017, thereby remaining inside the European Union's 3 percent ceiling. The public debt at 132% is the second-highest in Eurozone after Greece.

Sources: Macrobond, ADA Economics



Banking sector

Deposit and loan YoY growth



Loan to deposit ratio

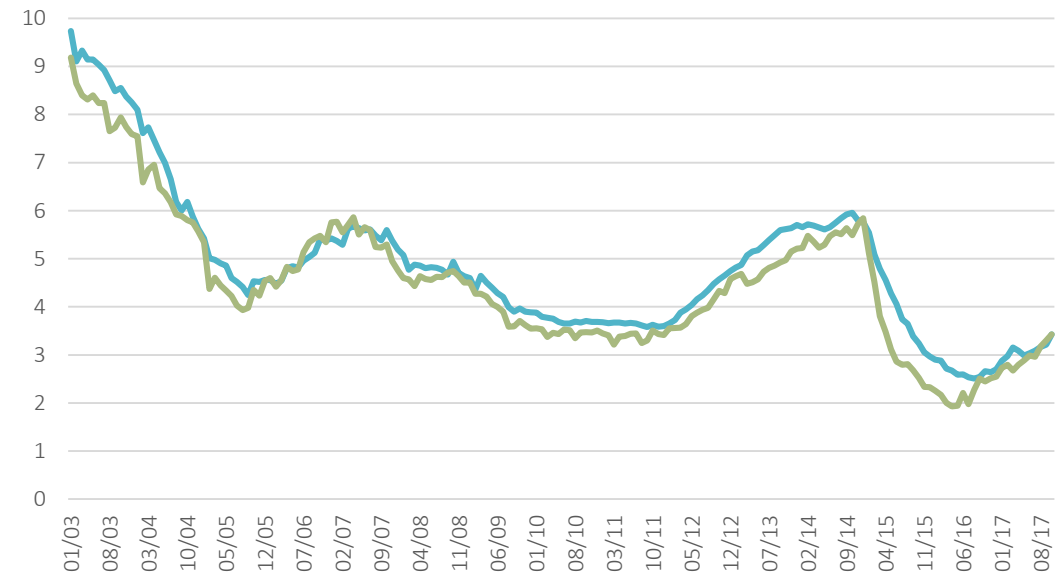


Banking sector

Retail deposit rates, new business

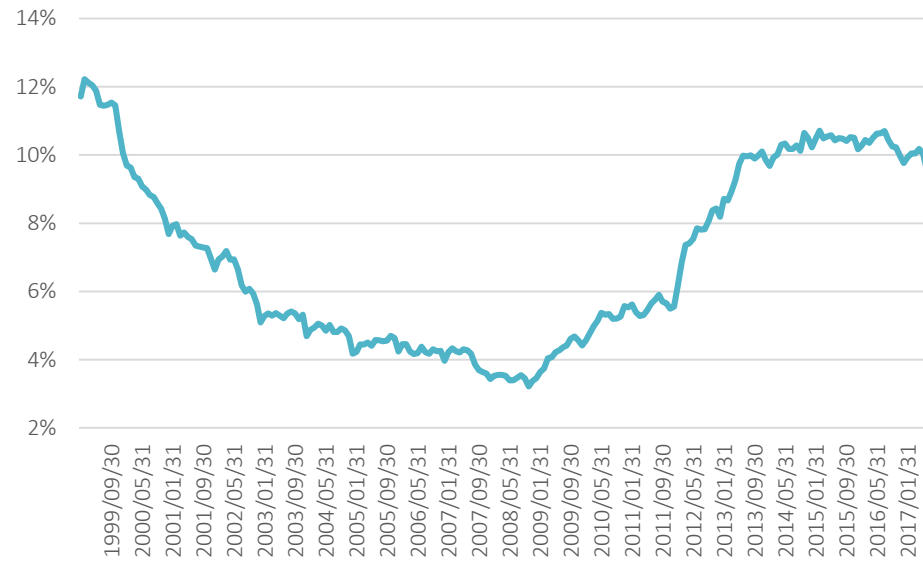


Retail lending rates, new business

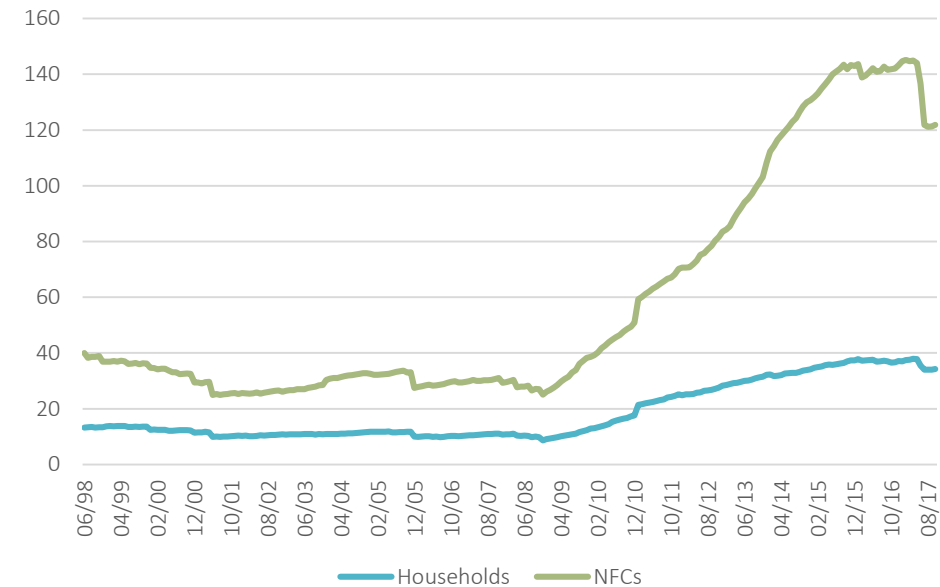


Banking sector

Bonds as a share of total assets

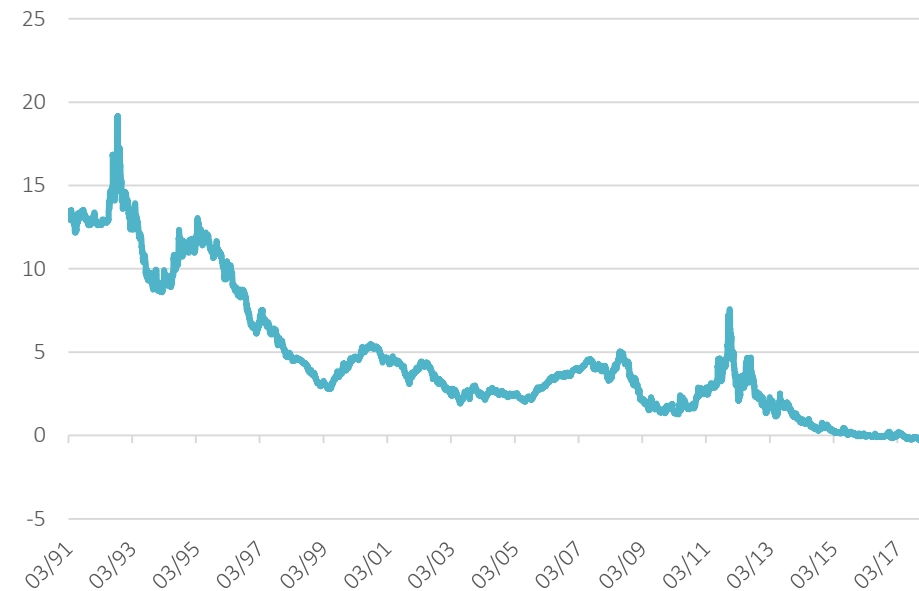


Non-performing loans (EUR bn)

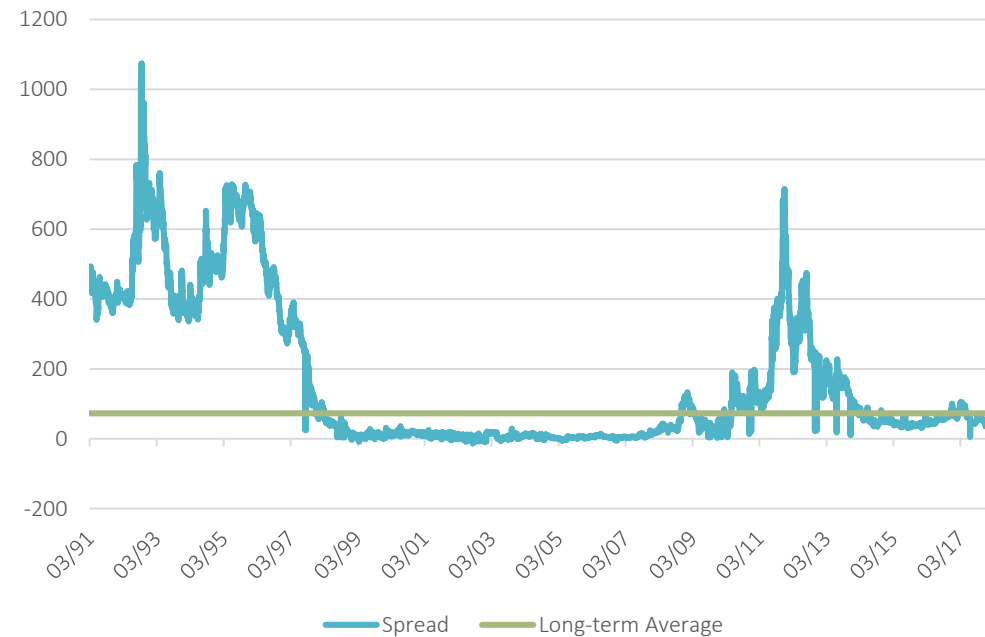


Public sector

2-year sovereign bond yield



Spread over bund & 15 yr average of the spread



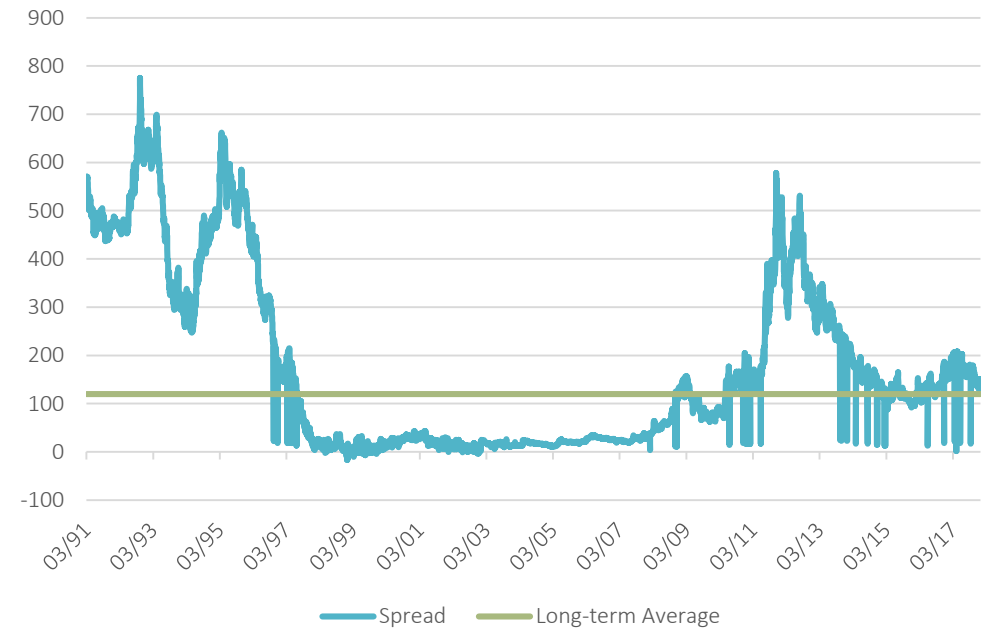
Sources: Macrobond, ADA Economics

Public sector

10 yr sovereign bond yields



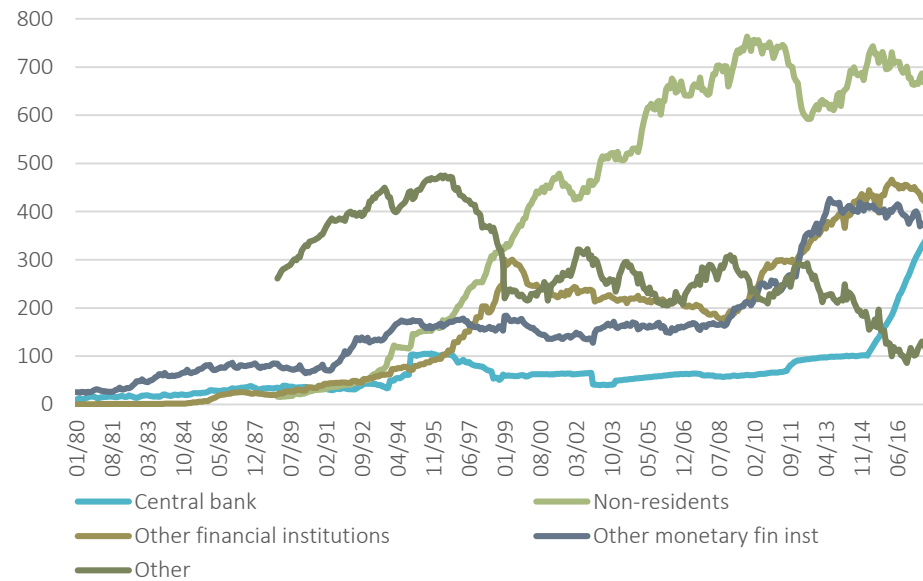
Spread over bunds and 15yr average spread level



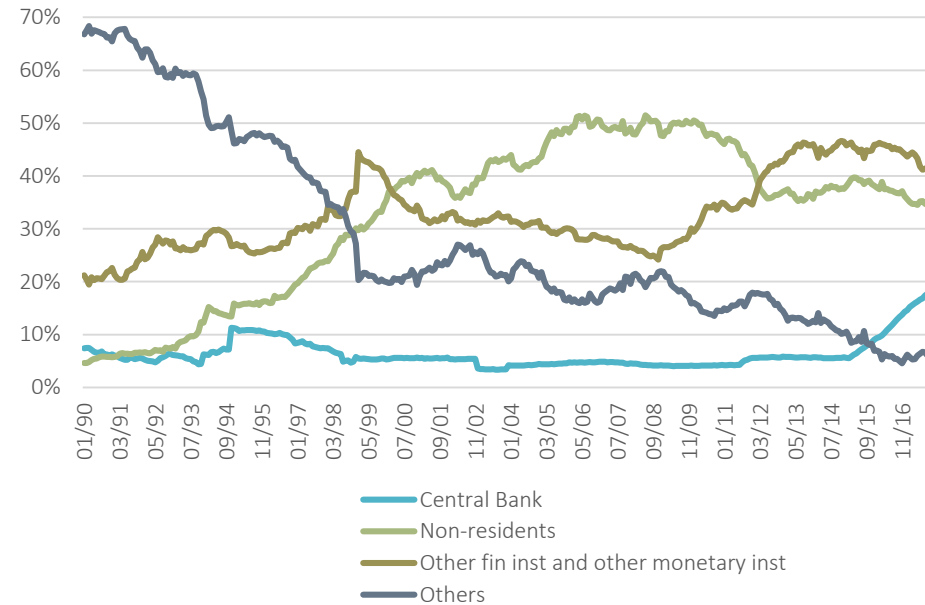
Sources: Macrobond, ADA Economics

Holdings of bonds

Levels, in billions of euros

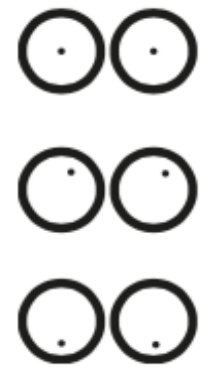


% of total securities



Sources: Macrobond, ADA Economics

Politics



Electoral scenarios – key macro variables

	Current scenario			Centre right victory M5 led government			
	2017E	2018F	2019F	2018F	2019F	2018F	2019F
Real GDP	1.6	1.9	2.2	1.9	3.0	1.6	1.6
HICP, avg	1.5	1.8	2.3	1.9	2.5	1.8	2.1
Unemployment rate eop	10.8	9.5	8.5	9.5	8.2	9.7	9.0
Budget deficit % of GDP	-2.5	-2.2	-1.8	-2.2	-3.0	-2.4	-2.3
Debt % of GDP	131.3	129.0	126.0	129.2	125.0	129.1	126.4

What we priced in:

For the centre-right coalition scenario we assume that a flat tax rate for the corporate sector and a meaningful fiscal income boost are both approved for 2019 with a cumulative impact on the budget of EUR30bn. The full impact on the actual budget deficit and debt are offset by the positive effect on GDP and inflation. We assume that households do save a large share of the additional stimulus, but that the bulk of the tax reduction for corporates results into new investment

For the coalition government led by M5, we assume that in 2019 a sizeable boost to household income comes from a more widely available minimum income policy, worth EUR15bn, but no other fiscal measure is taken. We expect the government to focus on regulatory changes, which weighs on consumption and investment plans in the first two years of their term.

Our estimates should PD lead the next government do not differ from our current central scenario, as the amount of fiscal stimulus promised is too small to matter and the bulk of their proposals were included in the budget already.

Estimates of the cost of election promises

Centre right coalition	PD	M5
<ul style="list-style-type: none"> • Flat tax for corporates & households. <u>EUR40bn+</u> • Min income. <u>EUR17bn</u> • Min pension. <u>EUR18bn</u> • Remove IRAP. <u>EUR10-13bn</u> • Repeal pension (Fornero law). <u>EUR140bn</u> by 2020. 	<ul style="list-style-type: none"> • Maintain & extend EUR80 to all families. Eur7.5bn • Cleaning up tax deductions EUR12 - 15bn budget savings • Tax breaks for companies that reinvest profits • Further tax cuts for companies • Reduction of TV license fee 	<ul style="list-style-type: none"> • Minimum income EUR15-17bn • Cleaning up tax deductions EUR 12-15bn budget savings • Replace the Fornero law with a system that allows greater flexibility on the retirement age • Push the budget deficit above 3% of GDP to fund investment and tax cuts • Greater focus on domestic economy of publicly owned companies • Emphasis on circular-green economy, to boost industrial base • Labour code: facilitate a reduction of the avg working week under 40hrs, boost flexible work arrangements to increase productivity and well being

Sources: ADA Economics estimates on the basis of party comments released to the press, estimates available publicly and our judgement

Italy: A recap and projections

Real GDP growth in Italy in 2017 averaged at around 1.6%.

The last quarter saw favourable conditions, such as rising consumer sentiments, capacity utilisation and low constraints limiting production. Italy's competitiveness both in domestic and foreign markets also seems to be on a continued rise since 2016. Trade balance is sustained and is at an all-time high since the 90's.

Assuming a rising industrial production coupled, increased consumer confidence, and YoY retail trade ranging from 1.5% to 2%, we expect the real GDP growth to average 1.8% in 2018.

Government social expenditure now accounts for just less than 60% of the total, with increased focus on healthcare but somewhat less public spending on education.

Our forecast for inflation remains unchanged – a gradual rise over the next two years, ending at 2.2% in 2019 Q4.

Budget 2018

The Senate has given its final approval to the 2018 budget. Amongst other changes, budget 2018 introduces a “web tax” from 2019, that establishes a 3% tax on some internet transactions. This new tax is intended to apply to sales of intangible digital products such as online advertising and sponsored links embedded in web pages. However, those companies that make fewer than 3,000 transactions per year will be excluded from paying the tax. This provision is expected to have an annual yield of around €190m.

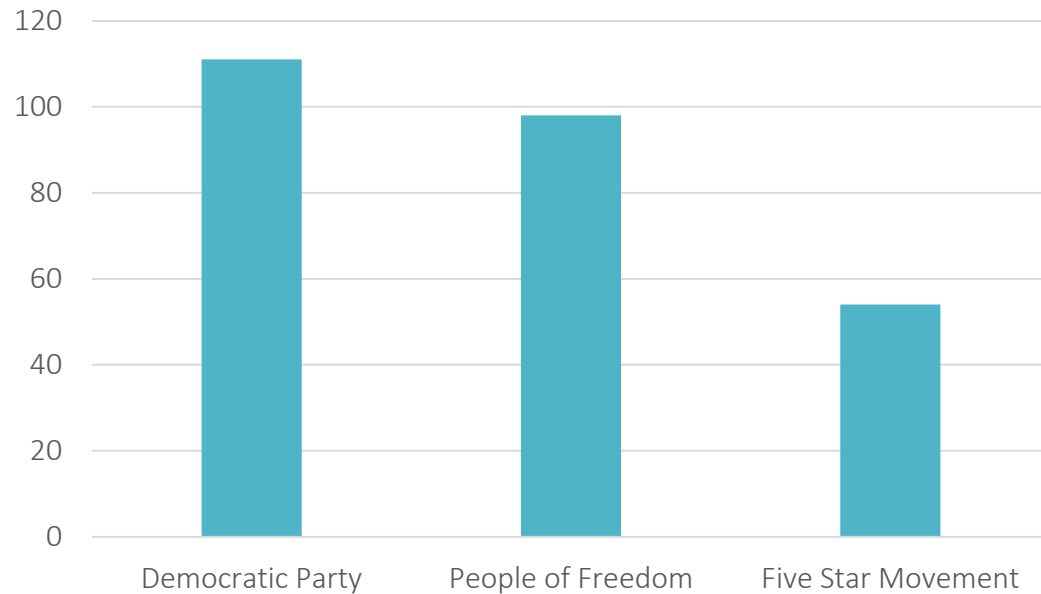
The budget also aims to lower next year's fiscal deficit to 1.6% of the GDP from a targeted 2.1% this year. However the European Commission says the budget may break EU rules because it raises previously agreed deficit targets and does little to control Italy's huge public debt, which at 132% of the GDP is the highest in the Eurozone after Greece.

To help curb the 35% youth unemployment rate, a new measure includes a three-year reduction in social-security contributions for companies that hire young people on long-term contracts.

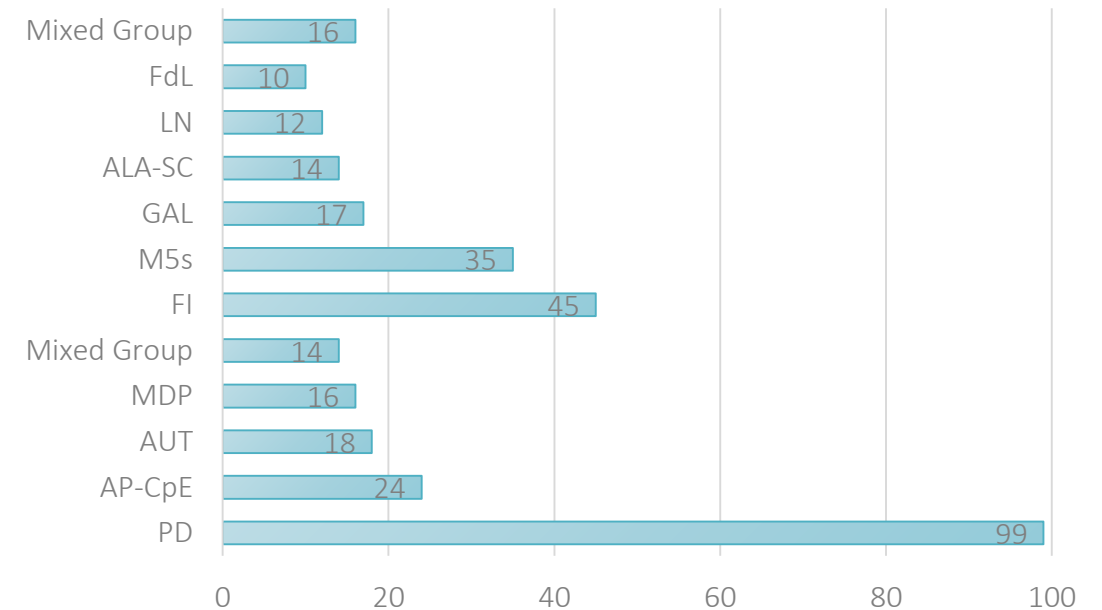
Some incentives have been introduced for companies that spend on machinery or other capital improvements. There are also measures to address the country's growing poverty levels, which as a problem is fueling support for populist parties.

Parliament structure

Senate of the Republic political groups



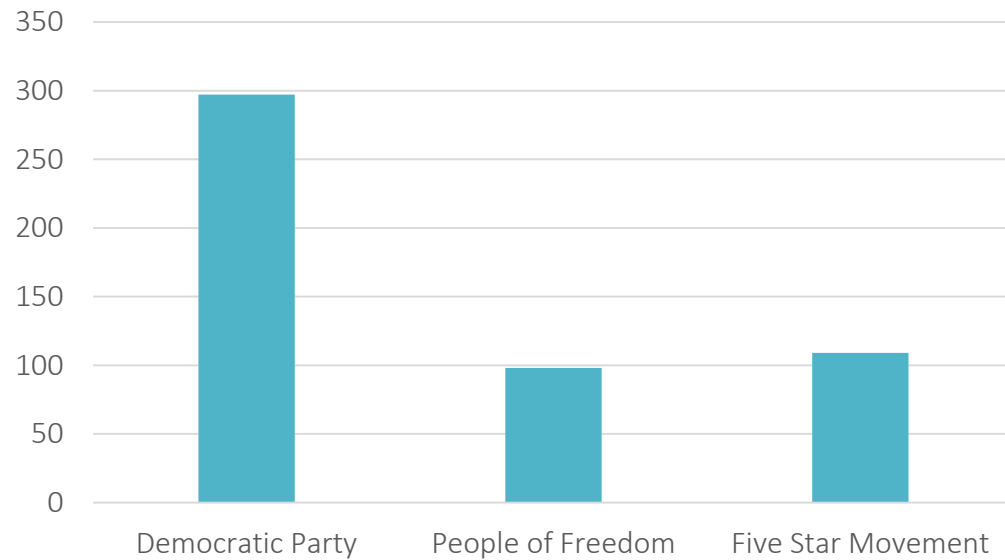
Government as well as Opposition



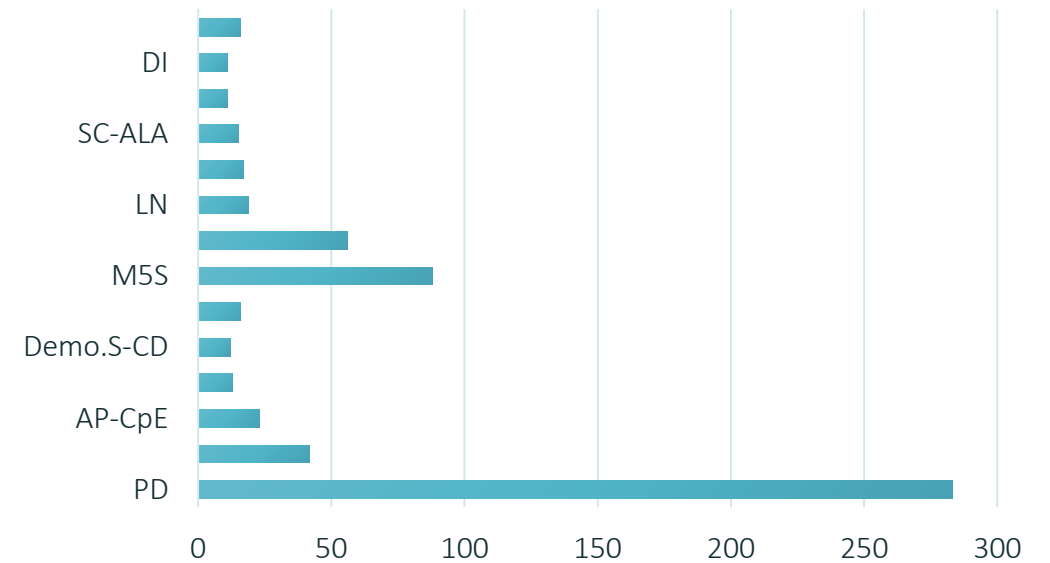
Sources: Macrobond, ADA Economics

Parliament structure

Chamber of Deputies political groups

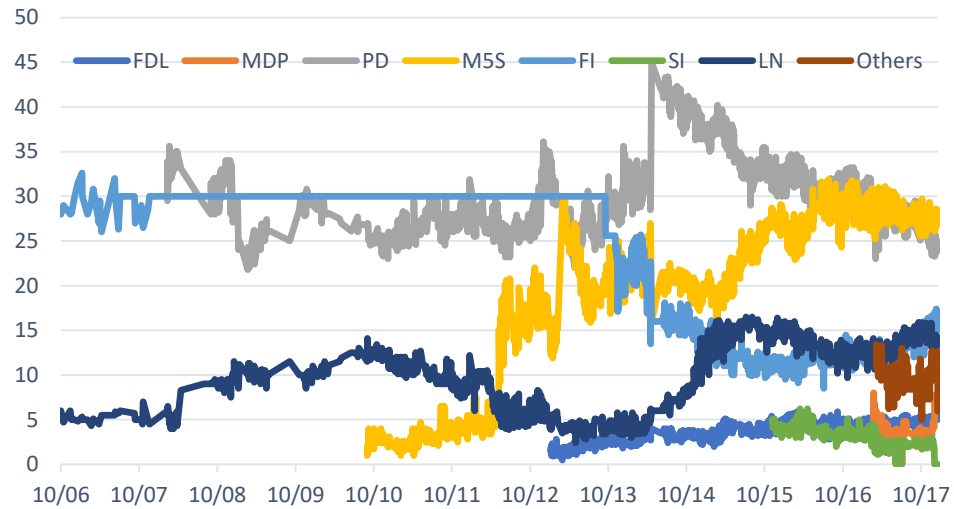


Government as well as Opposition



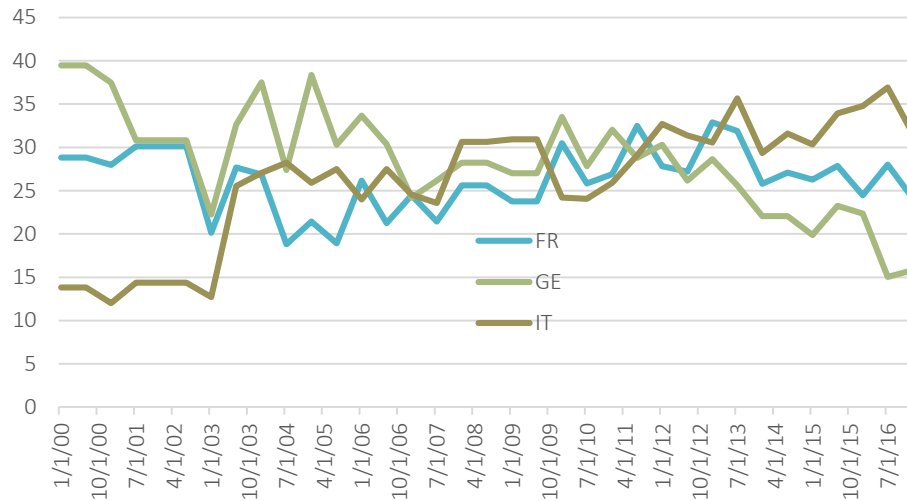
Sources: Macrobond, ADA Economics

Opinion polls



Support for the EU and the euro

Eurobarometer: against the euro, %

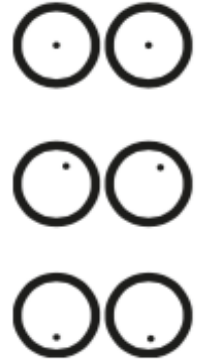


- Our surveys show high disappointment of Italians and French in the EU, but a very small fraction *actually against the euro to the point of voting in favour of a currency change in a hypothetical referendum* – in fact we polled only 12% in France and 2%* in Italy ready/eager to do so. In Germany support for the EU is more widespread: 40% saying it is definitely a positive influence on their lives and 40% torn between positive and negative. However, there is also a high share of those that regret the DM: 30%!

Analyse. Debate. Act.

Helping you plan for a changing global world

www.adaeconomics.com



Disclaimer

I/ Copyright 2017 ADA. All rights reserved.

This report may provide information, commentary and discussion of issues relating to the state of the economy and the capital markets. All opinions, projections and estimates constitute the judgment of the author as of the date of the report and are subject to change without notice. ADA is under no obligation to update this report and readers should therefore assume that AD will not update any fact, circumstance or opinion contained in this report.

The content of this report is provided for discussion purposes only. Any forward looking statements or forecasts included in the content are based on assumptions derived from historical results and trends. Actual results may vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision, and no investment decisions should be made based on the content of this report.

This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and particular needs of any specific person. Under no circumstances does any information represent a recommendation to buy or sell securities or any other asset, or otherwise constitute investment advice. Investors should seek financial advice regarding the appropriateness of investing in specific securities or financial instruments and implementing investment strategies discussed or recommended in this report.

This report should not be regarded by recipients as a substitute for the exercise of their own judgment and readers are encouraged to seek independent, third-party research on any companies discussed or impacted by this report.

In accordance with rules established by the U.K. Financial Services Authority, macroeconomic analysis is NOT considered investment research.

Materials prepared by ADA research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of ADA.

To the extent this report discusses any legal proceeding or issues, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Investors should consult their own legal advisers as to issues of law relating to the subject matter of this report. ADA research personnel's knowledge of legal proceedings in which any ADA entity and/or its directors, officers and employees may be plaintiffs, defendants, co—defendants or co—plaintiffs with or involving companies mentioned in this report is based on public information. Facts and views presented in this material that relate to any such proceedings have not been reviewed by, discussed with, and may not reflect information known to, professionals in other business areas of ADA in connection with the legal proceedings or matters relevant to such proceedings.

The information herein (other than disclosure information relating to ADA and its affiliates) was obtained from various sources and while all effort has been made to provide accurate information, ADA does not guarantee its accuracy. This report may contain links to third—party websites. ADA is not responsible for the content of any third—party website or any linked content contained in a third—party website. Content contained on such third—party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with ADA.

Any unauthorised use or disclosure is prohibited.

Date: 23 November 2017