Economic Watch

Europe

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Economic Analysis

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Italy: Reform tasks for a new government

- **The new Italian governments of "technicians" has the task to extend reforms approved on November 12**

  Mario Monti presented its government on Nov 16. It will have the support of major Italian parties (except the Lega Nord) and will be exclusively constituted of technocrats. Mr Monti will also be finance minister, sustained by well known economists in key positions in this ministry. The tasks of the new government will be to expand the list of reforms that have been recently approved in order to prop up potential growth, and ensure that fiscal consolidation takes place.

- **Italian public sector is solvent under moderate assumptions; but not so clearly under current interest rates. This shows that action is also required at the European level**

  The deficit reduction that has to be achieved by Italy to ensure sustainability is relatively small. Even if we assume a low growth potential (1%), debt is sustainable assuming low interest rates (5%). At interest rates around 7.5% in the long term, it is not unless the primary surplus is large (+6.5%). This is not far from current targets, as the 0% deficit target in 2013 is consistent with an structural primary surplus of 6% according to our estimates, but market doubts and the large amount of maturities of debt for the first half of 2012 imply that complementary action has to be taken at Eurozone level to make confidence return on Italian bonds.

- **The two coming years of fiscal consolidation and low growth will the difficult. The task to enhance growth potential is more challenging than that to stabilize the budget**

  The total adjustment needed over the coming two years to achieve a budget balance is clearly lower than those of other periphery countries (4.4%), although under current plans the adjustment plan for 2012 is not enough, while the one for 2013 would compensate for it. Although the adjustment is smaller than in other countries, it will be hard to achieve in a context of an stagnated economy in 2012 and uncertain growth in 2013. The most urgent task will be to implement structural reforms in various areas to increase growth potential over coming years. Of those, probably the ones related to labour market reform and enhancing competition are the most urgent.

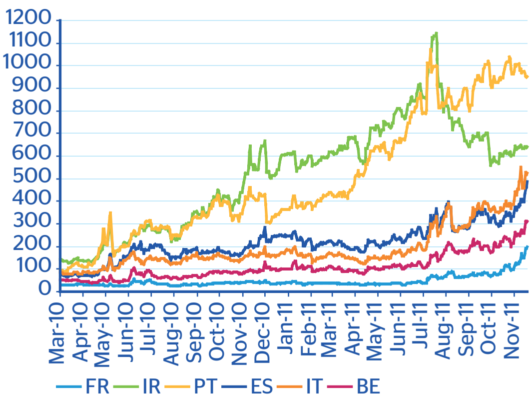
Mr Monti's new government will have to implement and extend reforms approved by Italian Parliament in mid-November

Mario Monti's new government will have the support of major Italian parties (except the Lega Nord) and will be exclusively constituted of technocrats, as the two major parties preferred to enter government directly. Mr Monti will also be finance minister, sustained by well known economists in key positions in his ministry.

The support from a wide range of parties will be a strength, in the sense that it will be easier to approve unpopular measures that are necessary to reduce Italian debt and prop up growth potential. However, it is also subject to instability, as various parties have different views on the time that such government should last (elections are due by mid-2013, but PdI –Mr. Berlusconi's party- and a smaller centre-left party want them earlier) and on policy priorities. Worryingly, the reform of the electoral system runs high in the priorities of many political parties, which could detract from efforts in other, more urgent economic reform areas.

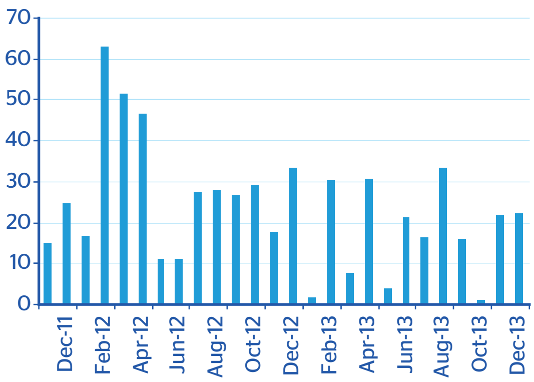
Most of the areas of reform and measures for fiscal consolidation have been already addressed in the Stability law approved on November 12 and supported by most parties. However, further action should be taken on labour market reform, competition and pensions, while the tax reform should be approved during the first half of 2012 in order to avoid the automatic withdrawal of tax exemptions projected in the legge delega –the main tool to reduce the deficit over the coming three years.

Chart 1
Sovereign Spreads: 10yr bond (bps)



Source: Bloomberg and BBVA Research

Chart 2
Italian Government:
Debt maturities (principal + interest rates) (bn €)



Source: Eurostat and BBVA Research

Budget stability rule in the Constitution needs clarification

The measures approved include a plan to introduce in the constitution a deficit rule to maintain a structural balance over the business cycle. This goes in line with similar changes approved or announced by other countries, notably Germany and Spain. The development of these changes will have to define clearly the exceptional circumstances that will allow to override the rule –which should be truly exceptional. Two key issues should also be included to make the rule effective: an independent body to determine what is a balance budget over the cycle; and how to enforce the rule on lower level administrations, including the definition of credible sanctions.

Privatization plans are not enough to achieve a meaningful reduction of public debt

The privatization targets announced so far amount to € 5 bn for three consecutive years, which in total do not reach 1% cent of GDP. The list of goods to be privatized include real estate assets and land, but not the participation in key utility companies which are under control of the state, which in our view should be included, not only to improve revenues but also to increase competition in sectors concerned.

There is a wide potential for consolidation and privatization from local public firms. So far the government has requested local authorities to identify a list of sellable assets. But this is only a first step, and the task to pus it further falls into the new government. It is not clear how such privatization process, that has also large potential efficiency gains, could be imposed to local authorities.

Pensions: bringing forward expected reforms and extending them to other workers

Pension age is expected to be raised to age 67 by 2026, and equalized for men and women (currently it is lower for women than men, especially in the private sector). However, those who have worked for 40 years or even 35 can retire much earlier. This aspect of pension reform failed to be included in the law approved on November 12th because of lack of support from Lega Nord and is likely to be added in the new reform agenda, as well as bringing forward the introduction of the new pension age.

Labour market: Not enough with measures approved so far

The letter addressed by Italian PM to the EU Council summit in October 26 included reform plans for the labour market to reduce duality and foster labour market participation of women and employment of the young. The latter has been approved through tax incentives for employment of targeted groups. However, the reduction of duality through a reform of dismissal costs was only been introduced through a very vague statement among the measures approved in the Stability law and does not seem to be widely supported by some parties. This is a key task for the new government, as the experience on other countries –notably Spain- shows that tax incentives to employment of targeted groups (women, young) are not enough to break labour market duality. The reform of unemployment benefits seems have been postponed due to budgetary constraints.

Other measures to increase productivity…

The full introduction of the Services Directive is in the agenda, and the way it will be done will be key for improving the very low productivity performance of the Italian economy. The new measure passed in the Stability law (that had failed to be passed during the summer because of strong opposition in the parliament from within the government coalition) is the reform of professional services. In particular, in one year minimum fees for professions will not be compulsory and will have only and indicative value. However, more comprehensive measures are needed, in particular those which allow professionals to associate within corporate companies.

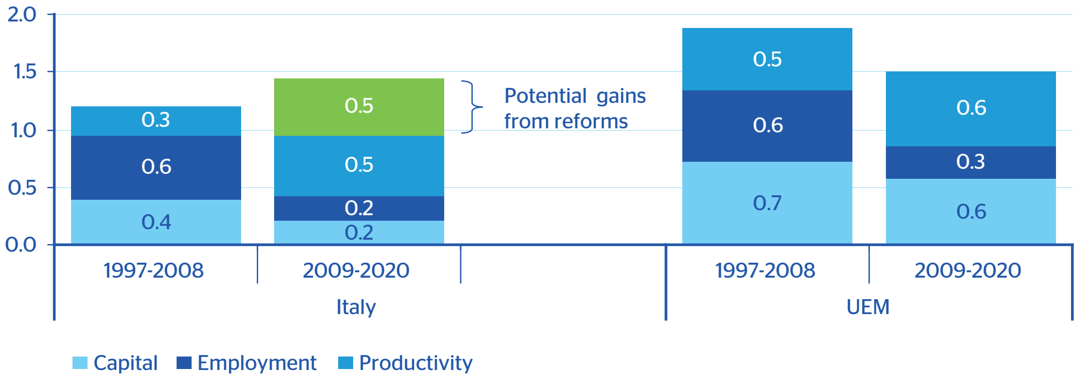
… in order to enhance the potential growth

Growth potential is difficult to gauge in general, particularly in a period of considerable crisis when there are structural changes in the economy, and old certainties tend to vanish. Italy grew by an average of 1.5% in the ten year prior to the crisis, and our last estimate for its potential growth is of around 1%. The reasons for the lower growth potential are weaker demographics (including a less open attitude towards immigration), together with very low productivity growth. Our estimate for growth potential for the Eurozone as a whole is around 1.5%. In our view, a broad programme of structural reforms could lift Italian potential growth by about 0.5% of GDP, to match Eurozone levels.

One of the reasons for the low productivity record lies in the lack of continuity in the process of reform. By the mid 2000s there were successful reforms in the labour markets that spurred the employment of young and low-skilled workers, but that also increased labour-market duality, which is also damaging for productivity performance. Attempts by the Prodi government early in the decade to reform services were short-lived.

Growth projections for 2012 are weaker (0.3%), with high uncertain since they depend on the management of the crisis by European authorities as a whole and on the contagion of financial stress. The deterioration in the second half of the year seems to have been rapid, which implies a weaker base effect for 2012.

Chart 3
Potential GDP Italy vs. Eurozone

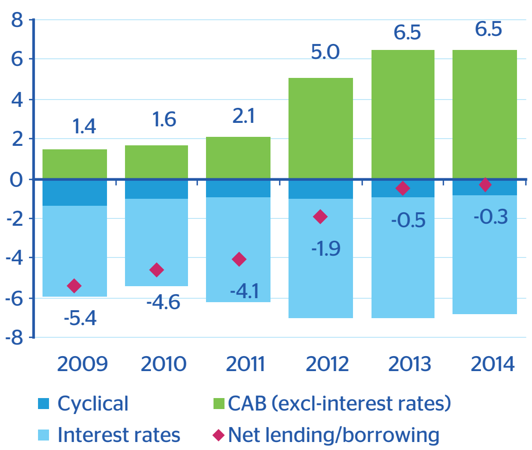


Source: BBVA Research

Fiscal consolidation: more needs to be approved in 2012

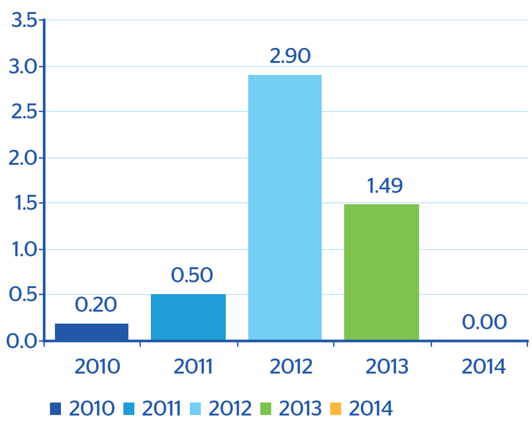
The rise in Italian public deficit during the crisis was much slower than in other periphery countries due mostly to two factors: the lack of fiscal stimulus in 2009, when many countries in the Eurozone and outside Europe embarked in a countercyclical fiscal expansion; and the fact that growth in consumption and asset prices during the expansion years was well below that of other countries, and hence the sharp reduction is structural revenues linked to the boom was much lower.

Chart 4
General government deficit decomposition (as % of GDP)



Source: Eurostat and BBVA Research

Chart 5
Required structural effort (as % of GDP)



Source: Eurostat and BBVA Research

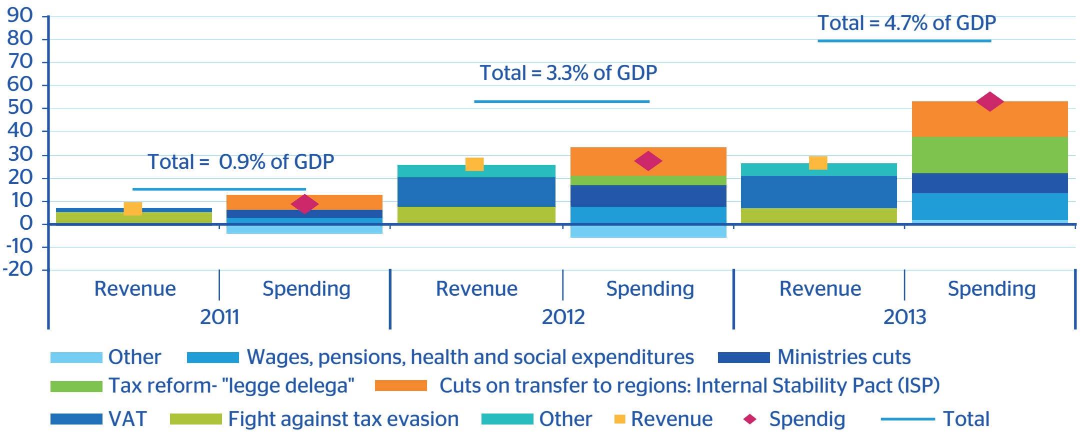
The commitment of the government to lower the deficit has been brought forward very recently, and the current target is a budget balance by 2013, with an intermediate deficit of -1.5% in 2012, after 4.1% which will be achieved in 2011. To do so, the government announced new measures in August that joined those already included in the Stability programme presented earlier in the year. In September, the fiscal plan was rescheduled and brought forward to 2012-13, as the August measures concentrated most of the adjustment to after the general elections of mid-2013, therefore failing to gain credibility. On our calculations, the measures approved should be enough, but not the timing (more needs to be done in 2012, given the low projected growth, and probably less in 2013, to meet current targets).

Taking together the stability programme and the various fiscal packages, plans of fiscal consolidation are based mostly on the following measures (see Chart 6): 1) Restraint in wages and pension expenditures in the short term; 2) cuts in ministries expenditures and especially regions; 3) a tax reform that needs to be approved before September 2012, since otherwise there will be a horizontal cut in tax exemptions and preferential regimes (legge delega); 4) a raise in VAT taxes; 5) fight against tax evasion.

Overall, it can be said that the targets are achievable (Italy has shown in the past that it can attain and sustain large primary surpluses, if only because its high debt ratio forced it to do so). However, apart from filling the gap of 2012, the implementation of the measures envisaged requires a special effort, as the bulk of it comes from regions, a tax reform to be implemented, and fight tax evasion (of dubious results at best).

Chart 6

Structural consolidation: Detailed measures (bn eur)



Source: BBVA Research

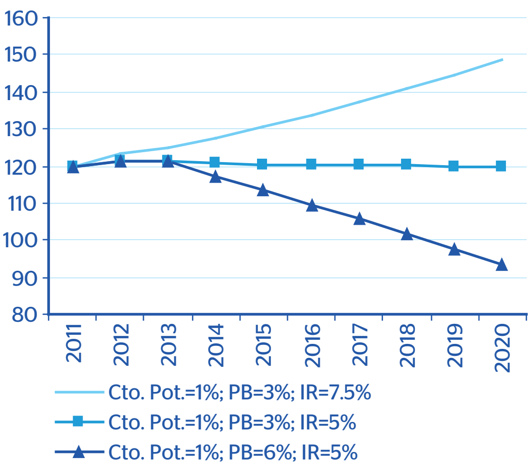
Debt is sustainable under moderate deficit and growth assumptions, provided that interest rates remain low

Provided that the deficit adjustment is carried out, Italian debt is clearly sustainable. Our analysis shows that with moderate assumptions (i.e. real growth converging to a low potential of 1%, inflation at 1.7%, the primary balance converging to +3% (it stands now at +1.3% in structural terms) and interest rates of 5%), a debt ratio of 143% of GDP or below that level would be sustainable (i.e. not falling).

With interest rates at 7.5% in the long term, the debt would clearly be unsustainable. Italy would require in that case a primary balance of 6.5% to make debt sustainable at those interest rates (i.e. an adjustment of 5.5 pp of GDP).

Chart 7

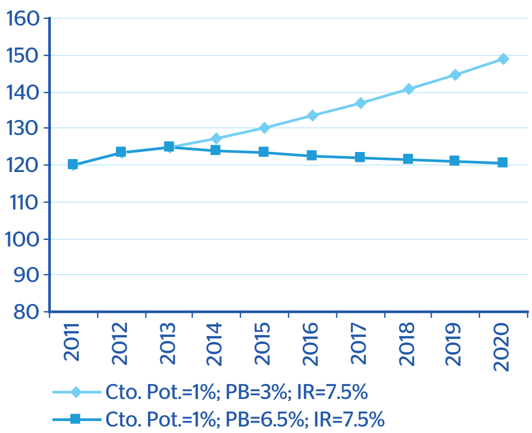
Public Debt (as % of GDP)



Source: BBVA Research

Chart 8

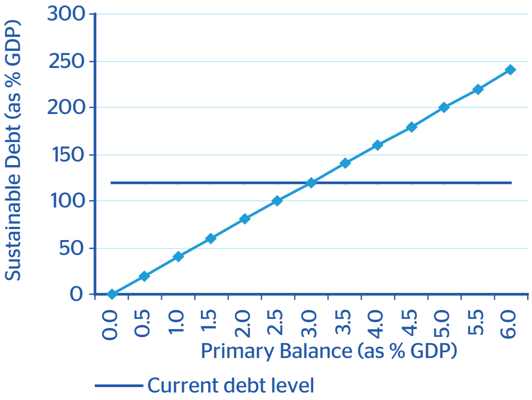
Public Debt (as % of GDP)



Source: BBVA Research

Chart 9

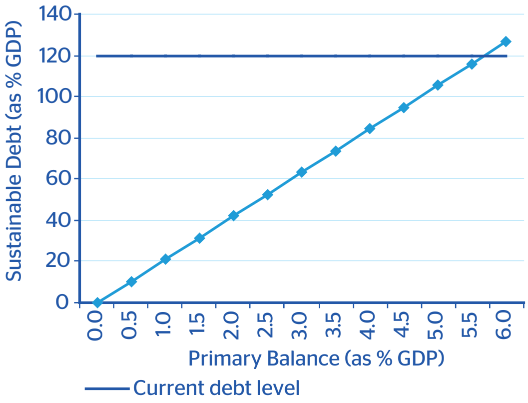
Sustainable debt for different primary balances (Interest=5.0%; Growth=1.0%; Deflator=1.7%)



Source: BBVA Research

Chart 10

Sustainable debt for different primary balances (Interest= 7.5%; Growth=1.0%; Deflator=1.7%)



Source: BBVA Research

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