ITALY

March 2018

THE ITALIAN ECONOMY: 2 YEARS TO TRANSFORM, 5 MACRON-OMICS, 12 ACTIONS

EULER HERMES

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EXECUTIVE SUMMARY

- Following the outcome of the March 4, 2018 General Elections, all eyes are on Italy's economic resilience when faced with a difficult political transition. Economically, stars are still aligned. Italy is up for two more years of growth above potential (+1.4% in 2018, and +1.2% in 2019), supported by past reforms, supportive financial conditions, and the Euroboom.

- (Economic) life is like riding a bicycle: you don't fall off unless you stop pedaling (reforms). Seeing through the fog, we identified five areas for action and 12 specific recommendations inspired by French President Macron's centrist policies, which have been quite successful in restoring business confidence.

    * Macron-omics #1: Boost Purchasing Power. Two ideas: (i) Implement a more progressive income tax; and (ii) Reduce price rigidities in several sectors.

    * Macron-omics #2: Unleash Financing and Investment. Three proposals: (i) Improve collateral rules on corporate loans to restore the credit channel; (ii) Develop financial products to tap into Italian wealth; and (iii) Expand the reduced capital gain tax.

    * Macron-omics #3: Count on SMEs - Mass Flourishing. Three suggestions: (i) Introduce a reduced corporate tax rate for SMEs; (ii) Lower employer social contributions; and (iii) Incentivize faster inter-enterprise payments and e-invoicing.

    * Macron-omics #4: Think Brand Equity. A couple of resolutions: (i) Refocus on attractiveness; and (ii) Make export a national priority.

    * Macron-omics #5: Build #ItalianTech. Two recommendations: (i) Make Italy a digital innovation champion; and (ii) Move from labor market reforms to human capital building.

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Italy GDP growth estimate 2018

+1.4%

ITALY: TWO YEARS FOR A TURNAROUND?

- **Italy is expected to grow by +1.4% in 2018 and +1.2% in 2019 i.e. two more years above potential**
- **Though uncertainties remain regarding the reforms agenda, markets see Italy as pivotal to Europe's regeneration**

On March 4, 2018, Italy's General Elections proved inconclusive. While talks for a coalition government are in the making, investors will continue to look for reassuring pro-business reforms, just like the ones implemented by Prime Ministers Monti, Letta, Renzi and Gentiloni.

Although uncertainties about the reforms lingered, the lid on Italian growth and confidence was lifted and the *economic* stars aligned for Italy.

There are two more years of above-potential growth for Italy.

In 2017, Italy grew by +1.5%, its best growth figure since 2010 and a noticeable acceleration from previous years. The broader cyclical upswing in Europe (see Figure 1), the rebound in trade, and good monetary and financial conditions explain this increase in performance.

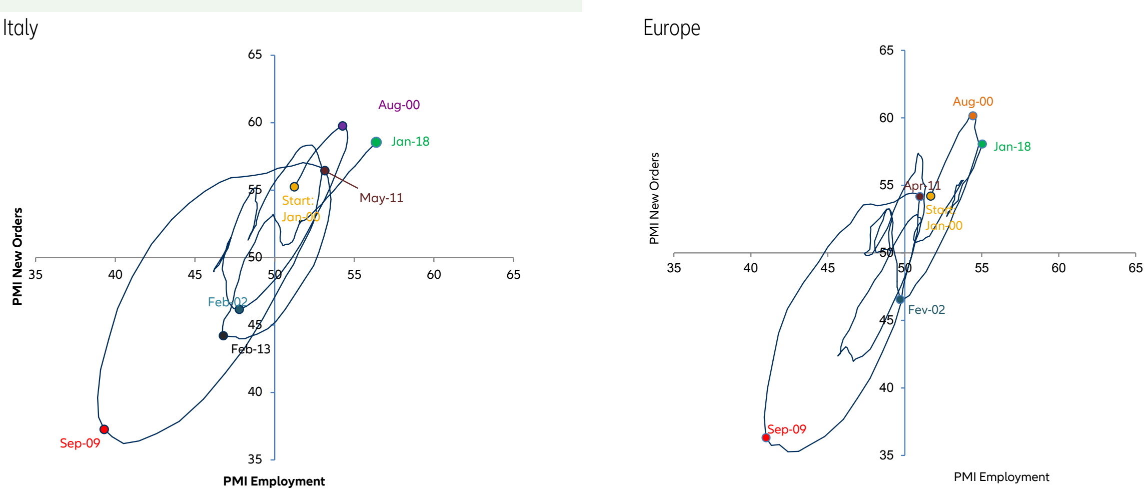
Yet, Italy also planted the seeds of success with decisive reforms brought about at the onset of the European crisis and covered many policy areas ranging from product and labor markets to taxation, public administration and civil justice (see Figure 2).

Private sector investment growth has finally started to pick up in H2 2017, boosted by the Enterprise 4.0 plan that included tax incentives for businesses investing in new technologies. Additionally, the favorable labor market trend facilitated by the Jobs Act managed to bring down the unemployment rate to its lowest level since 2012.

Going forward, we expect Italy to have two more years of positive cyclical momentum with a GDP growth expected at +1.4% in 2018 and +1.2% in 2019, mainly driven by private consumption (+1.0%) and investment (+4.4%); export growth will remain high (+4.4% in real terms).

The expected continuation of the Euroboom in 2018 (GDP in the Eurozone should expand to around +2% in 2018, for the fourth consecutive year), together with the ECB's very gradual normalization of its monetary policy, will continue to act as a safety net for investor sentiment.

Figure 1 Manufacturing PMI sub-indices (12-month average)



Sources: Markit, Euler Hermes

The reduction in public spending through the 2014 Spending Review was responsible for the elimination of expenditure items totaling EUR29.9bn in 2017.

Italy will continue efforts to rationalize spending (e-services, targeting of social and health benefits, procurement, etc.) and improve tax collection. The primary surplus guarantees credibility as it stood at +1.7% of GDP in 2017, up from +1.5% in 2016, and is expected to be close to +2% in 2018.

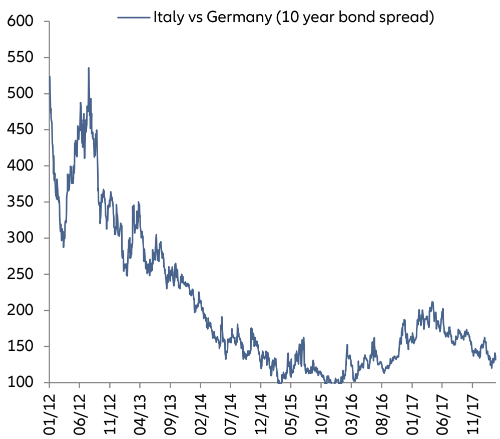
However, Italian public spending is characterized by a higher percentage of current spending, which has crowded out capital spending . Freeing up resources for investment in physical and human capital is necessary.

Figure 2 Reform scorecard for Italy

Main reforms	Approved	Implemented
Institutional reforms		
Electoral Law	√	√
Constitutional reform	Rejected in Dec 2016 referendum	
Competitiviness		
Enterprise 4.0	√	2017-2020
Strategic plan for tourism	√	2017-2022
Labour market and social policies		
Jobs Act	√	√
ANPAL (National Agency)	√	√
Jobs Act for self-employed workers to strenghten social protection	√	√
Single family code	√	√
Fiscal issues		
Reduction of public administration arrears	√	2017-2018
Combate tax evasion	√	2017-2018
Spending Review Phase II	√	2017-2020
Structural budget balance by 2019	√	2017-2020
Privatisation		2017-2020
Justice		
Rules on corporate crisis and insolvency procedures	√	2018
Reform of civil and criminal procedures	√	√
Fighting organised crime	√	√
Infrastructure		
Reform of public procurement	√	√
National Plan for public investment	√	2017-2020
Ultra-Broadband plan		2018-20
South Pacts for territorial rebalancing (Patti per il Sud)	√	2014-2020

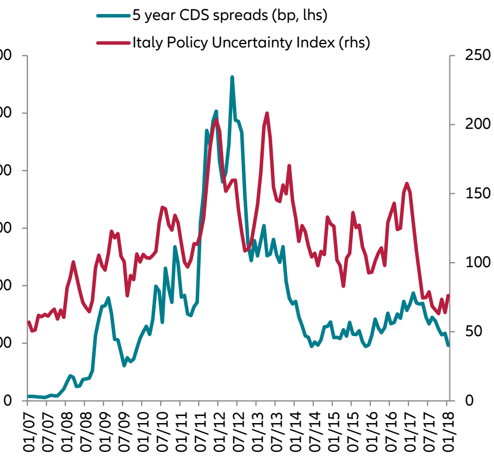
Sources: OECD, Euler Hermes, Allianz Research

Figure 3 10-year bond spreads BTP vs Bund



Sources: Bloomberg Euler Hermes

Figure 4 5-year CDS Policy Uncertainty Index



Sources: Bloomberg Euler Hermes

Furthermore, Italy is pivotal to Europe's *Rinascimento*. Even markets are aware of this.

Italians continue to trust the European project, but the recent vote calls for a stronger voice in shaping a Europe which works better for Italians citizens.

From the European Banking Union[1], a compromise on the European Deposit Insurance and a full-fledged Capital Market Union to true collective management of the refugee crisis based on the principles of solidarity and more equitable burden sharing, Italy should be part of the tripod of stability the Eurozone so longs for.

Financial markets believed Italy would leap forward. The reform of an electoral law in late 2017 helped contain political uncertainty during the run-up towards the parliamentary election. For instance, bond yields have barely budged at the turn of 2017-18 (see Figure 3).

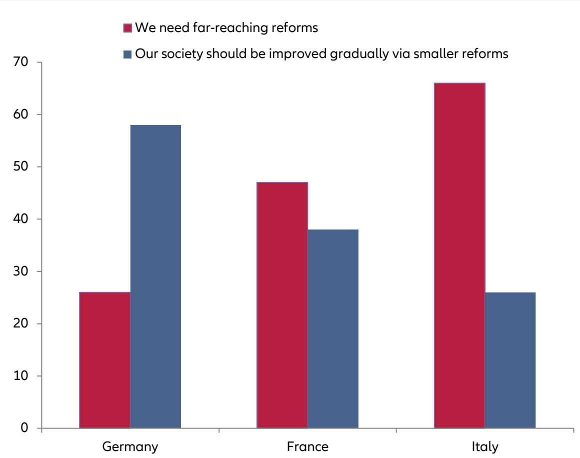
Additionally, year-to-date stock markets have outperformed their European peers and CDS spreads have fallen when Italy made decisive moves to reduce systemic risks (recapitalization and restructuring of several problem banks, consolidation agenda, etc.) – see Figure 4.

Financial markets will welcome a sustained pro-business reform agenda including lower corporate taxes and/or reduced social security contributions on wages, new investments mainly in the industrial sector (Enterprise 4.0 initiative planned to last until 2020), and further competitiveness reforms prolonging the Jobs Act.

Lastly, Italians are ready for change.

In the past decade, business confidence is at its highest level ever and national sentiment towards reform is positive. Two-thirds of Italians surveyed in 2017 believe that far-reaching reforms are necessary, compared to 47% in France and 26% in Germany (see Figure 5). The broad consensus on the need for far-reaching reforms in Italy is reflected across all generations, although it is more favorable amongst the young (61% of 16-29 year olds think reforms are positive). The current economic situation is an opportune moment for advancing much-needed reforms in Italy.

Figure 5 Allianz-Allensbach Institute Survey on the sentiment for reforms



Sources: GTA, Euler Hermes

[1] Italy already showcased a notable reduction in banking sector risk where NPL stocks have been reduced by EUR104bn since 2014.

FIVE
MACRON-OMICS FOR ITALY

President Macron's *En même temps* (at the same time) doctrine, a mix of economic flexibility and security, is a success. While Italy started reforming much before, what else can be done to increase brand equity?

Macron-omics #1: Boost purchasing power

Although private consumption has been the main engine of growth, household purchasing power has held back peers over the last period.

Annual growth of household gross disposable income –stood around +2% since 2016, which in turn has been a drag on retail sales (+1% 3M y/y growth compared to +4% in France). In real terms, household purchasing power lost steam since mid-2016 as headline inflation picked up (see Chart 6).

1. Implement a more progressive income tax

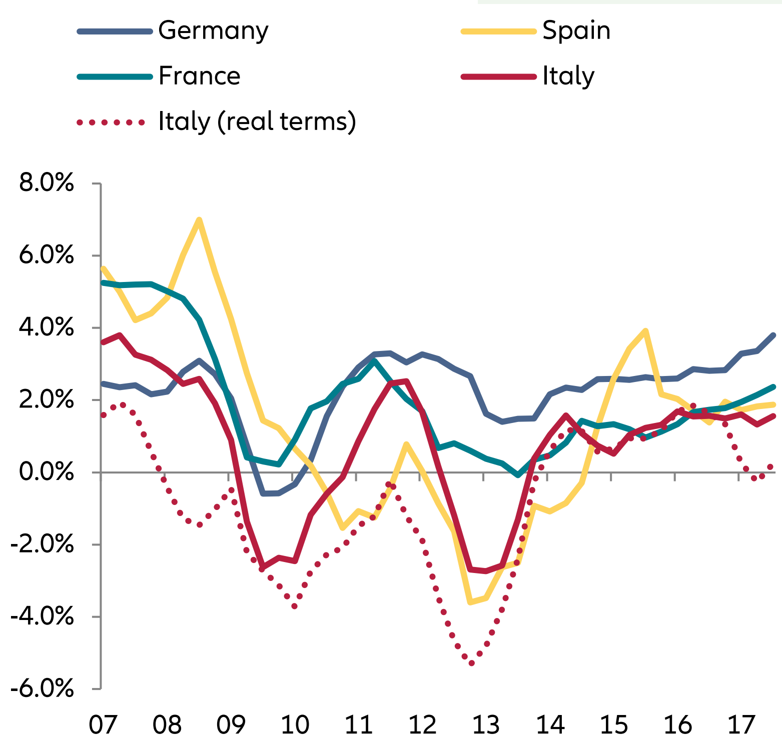
An idea for unleashing additional purchasing power would be to adopt a more progressive income tax regime compared to the current one (from 23% to 43%). For example, in France low incomes of up to 9 710EUR are exempt from income tax. Moving the current first threshold from 15,000EUR and 23% to 7,500EUR at 0% would unleash cash for higher consumer spending as low-income earners display a higher propensity to spend rather than to save. This is a costly measure since it would lower tax revenues by around EUR30bn, but would unleash 2.6pp of gross disposable income in total. The results in France and the US (with its reformed tax bill) show that most countries are adopting a lower tax position.

2. Reduce price rigidities in several sectors

Product-market reforms have been successful in recent years. However, when looking at Italy's energy consumer prices, levels remain above those in France and Spain, for example (see Figure 7).

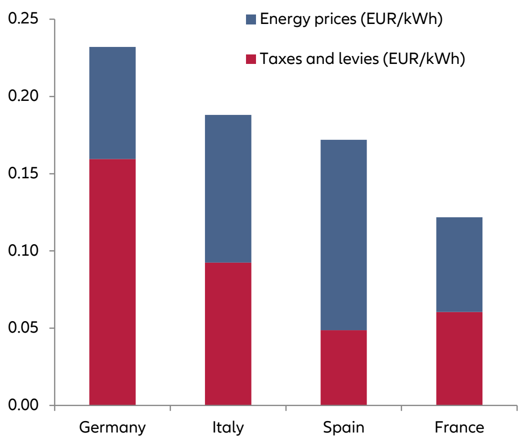
The same applies to the utilities sector where prices were not adjusted as much as in other Eurozone countries (see Figure 8). Reforming further these two sectors through increased deregulation would help reduce price rigidities and provide additional household purchasing power.

Figure 6 Disposable income, y/y



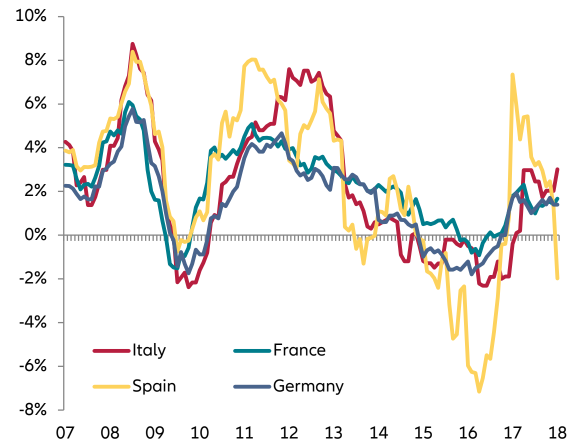
Sources::Eurostat, Allianz Research

Figure 7 Energy prices (EUR/kWh)



Sources: Eurostat, Allianz Research

Figure 8 Utilities consumer prices (housing, water, electricity, gas and others, y/y)



Sources: Eurostat, Allianz Research

Macron-omics #2: Unleash financing and investment

Total cash held by Italian corporates remains high (USD70bn in 2016, 13% of the total balance sheet) and the self-financing capacity of Italian companies has strengthened since 2016. However, its higher incidence of bank debt than in any other Eurozone country creates ever greening and bank debt covers of almost 10% of R&D spending vs. only 3% in Germany and 1% in the United Kingdom. Italian households enjoy a relatively high savings rate (9.9% of the gross disposable income). Total net financial assets of Italian households (54 533 EUR/capita) and securities represent a larger share, compared to France and Germany, for example (see Figure 9).

3. Improve collateral rules on corporate loans to restore credit channel.

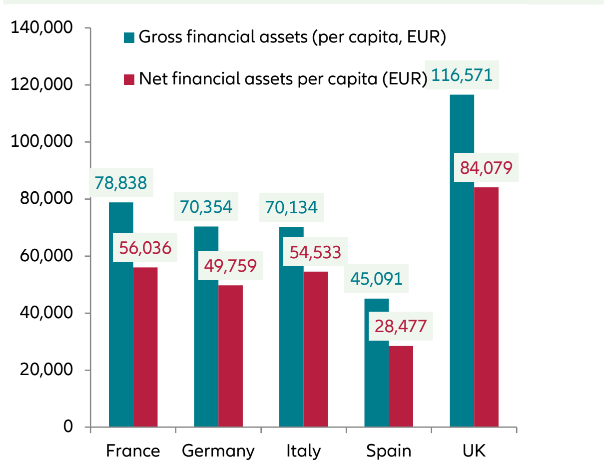
Italian banks are definitely in better shape than they were one year ago. The total stock of non-performing loans (NPL) has fallen considerably by EUR104bn to EUR274bn (see Figure 10). The IMF estimates that halving the NPL ratio from 14% today to 6% would lead to +2% higher real GDP growth and +4% higher investment growth after five years.

Currently, the bulk of NPLs continues to be corporate-related (70%) and the EUR158bn price tag for bad debt continues to be a significant drag on bank profitability and economic activity as they require significant loan-loss provisions, which in turn reduces credit availability. Improving collateral rules on corporate loans would make NPL valuation and sales much easier and could unleash additional bank financing. Currently, corporate loans are backed by anything from factories, to machinery, to shares of a firm and real estate, which make their valuation complex compared to residential mortgages, for example.

4. Develop financial products to tap into Italian wealth

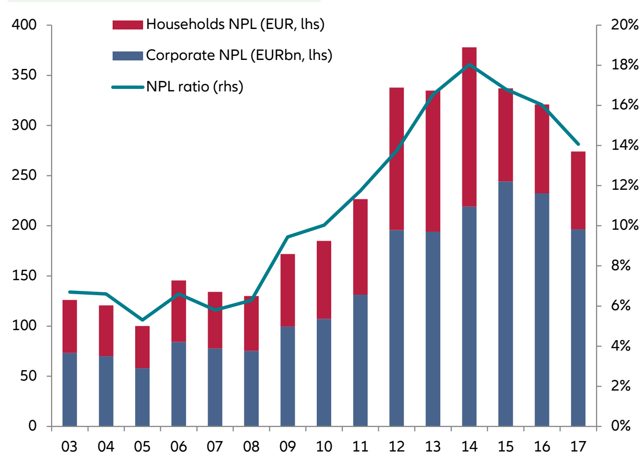
Following the example of other European countries, in 2017 Italy introduced a new investment product, the *Piani Individuali di Risparmio* (PIR), which offers favorable tax treatment and channel savings from Italian investors to productive investments. Of these funds, 70% must be invested in Italy-based firms, with at least 30% of that in SMEs.

Figure 9 Gross vs. net financial assets per capita in EUR (2016)



Sources: Eurostat, Allianz Research

Figure 10 Current stock of NPLs



Sources: Bank of Italy, Allianz Research

PIRs have generated a lot of enthusiasm in Italy (EUR20bn collected).

In the wake of the PIR, new savings products could be created.

Italian households' growing appetite for life insurance products could also support company financing (through equity or debt).

Another idea includes a stronger public-private partnership, such as, (i) a national loan scheme, with public guarantees to finance critical infrastructure with a special focus on developing Southern regions, (ii) a joint financing platform with foreign actors (e.g. Sovereign Wealth Funds) and (iii) a venture-capital fund for disruptive innovation such as the one recently announced by the French Public Investment Bank (BPI).

5. Expand reduced capital gain tax

The Italian tax on capital gains from shares, equity, and convertible bonds is at 26% if there is no qualified participation[2]. France just moved to a flat tax (30%) and other European countries such as the Netherlands, the UK, and Luxembourg are known for their attractiveness in terms of financial investments. To improve capital reallocation to a more productive use, a reduction of the capital gains tax would lower the cost of capital, boost investment, and stimulate economic growth and inward foreign capital. Italy could expand the reduced tax (12.5% on gains derived from public bonds - sovereign, local, SoEs, etc.) to bonds or equities issued by companies (listed or unlisted) in strategic sectors (e.g. machinery and equipment, textile, agri-food, etc.).

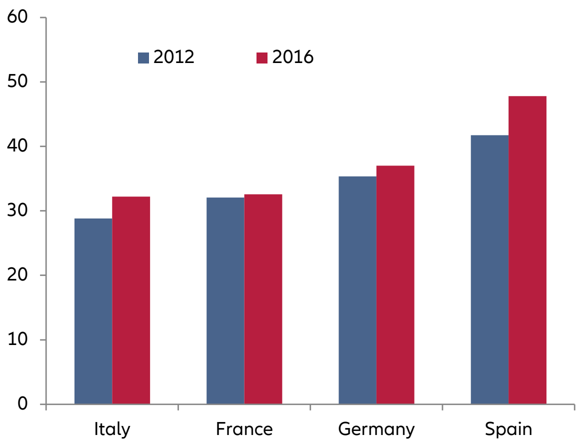
Macron-omics #3: Mass flourishing: Bank on SMEs!

Italy is known for its vibrant and daring Small and Medium Enterprises (SME) segment.

Companies have managed to restore comfortable margins (41.9% of value added in Q3 2017), but the manufacturing sector is still confronted with high, yet stabilized, labor costs (27.3 EUR/hour in 2016, the fifth highest after Belgium, Germany, France and the Netherlands).

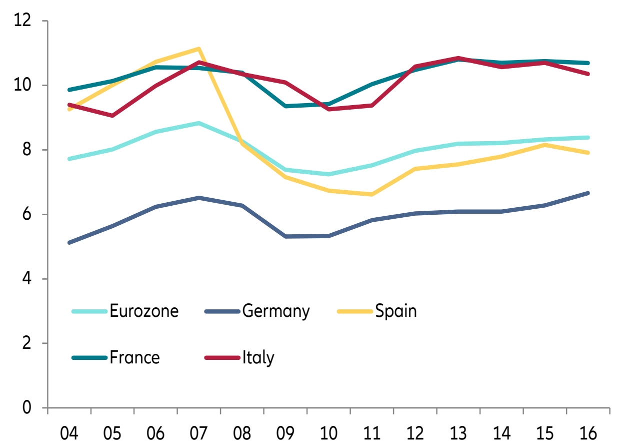
SMEs, which have been Italy's safety net and competitiveness champions, could be Italy's springboard, however, decisive actions to support the segment need to be taken to make their lives simpler.

Figure 11 Equity to total liabilities, %



Sources: Bank of Italy, Allianz Research

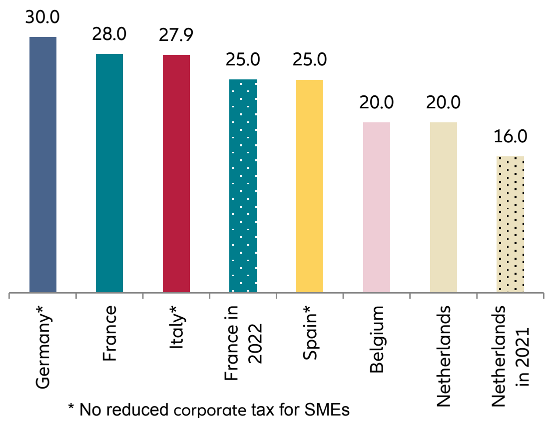
Figure 12 Taxes on capital, % of GDP



Sources: Eurostat, Allianz Research

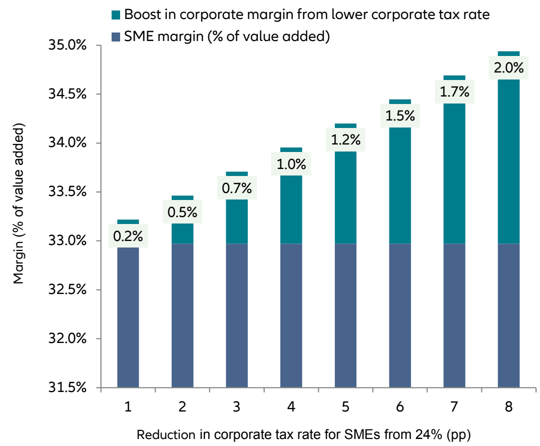
[2] Less than 2% of the voting rights or less than 5% participation in the capital of a listed company. In case of unlisted shares, the qualifying holding thresholds are, respectively, 20% of the voting rights or 25% participation in the capital.

Figure 13 Corporate tax rates (national and local)



Sources: European Commission, Allianz Research

Figure 14 Margins for SMEs (% of value added)



Sources::Eurostat, Allianz Research

6. Introduce a reduced corporate tax rate for SMEs

Since 2007, Italy has reduced its main corporate tax rate by -13.25pp to 24%, a pioneering move when compared to Germany (-8.36pp) and Spain (-7.5pp).

At 24%, the Italian corporate tax rate remains above the EU average of 21%, yet still in line with the OECD and global average.. Without endangering its public finances, Italy could implement a progressive tax rate for companies. A reduced tax rate for SMEs to 21% (-3pp in line with France, see Figure 13), lost revenues would amount to EUR2bn, but the positive impact on margins would be +0.7pp[3] (see Figure 14).

Higher margins would translate into higher cash-flow and potentially higher investments. Note that such a measure could be critical for the ICT, chemicals, agri-food, construction and manufacturing sectors.

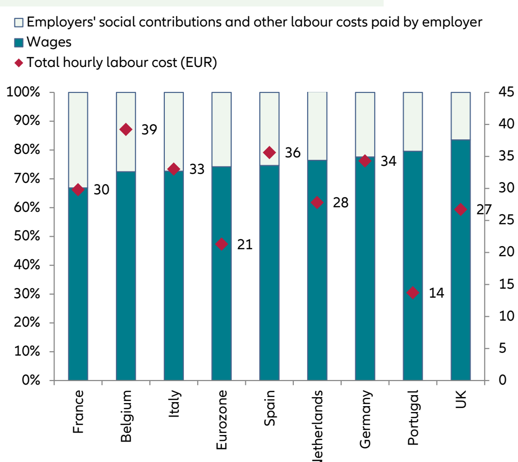
7. Lower employer social contributions

High employer-paid social contributions (27.3% of total labor cost in the total economy vs. 25.8% in the Eurozone) remain a burden on Italy's corporate segment. Hence, the total labor cost in Italy stands almost 12 EUR/hour above the Eurozone average (see Figure 15). We estimate that by lowering the social contributions paid by employers by -6pp to 24% (from 30% of gross compensation), similar to what France does, Italian corporate margins would be boosted by +1pp after one year [4] (see Figure 16). Even if Italy has an overall low pass-through of domestic costs to export prices, the cost elasticity has increased since the crisis. Lowering labor costs could boost Italy's goods exports by making them more competitive and strengthening their integration in global value chains, which is currently the lowest among the EU countries. Only 14% of total value added is dependent on foreign input.

8. Incentivize faster inter-enterprise payments and e-invoicing

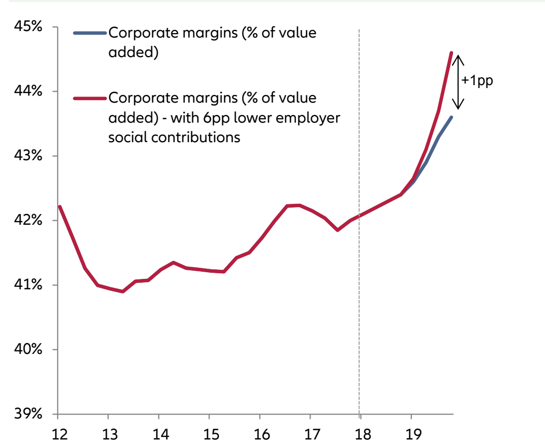
For SMEs, suppliers are a lifeline and sometimes an invisible bank. Domestic payment behavior has been improving for the past five years and insolvencies have decreased in Italy as a result (-12% in 2017, -10% expected in 2018).

Figure 15 Labor cost



Sources: Eurostat, Allianz Research

Figure 16 6pp lower social contributions impact on corporate margins



Sources: Eurostat, Allianz Research

[3] The positive impact could go up to +2pp should Italy introduce a similar corporate tax rate on SMEs as the Netherlands will in 2021 (i.e. 16%).

[4] This measure is costly: EUR30.8bn.

The average domestic non-payment has declined by -38% to 13,946 EUR since 2013[5] (see Figure 17).

All in all, since 2014, the total working capital requirement has decreased by EUR17bn (of which EUR1.2bn can be attributed to SMEs) – see Figure 18, freeing up additional cash for new investments and compensating, to some extent, for the reduction in total bank financing of EUR102bn over the same period.

Nevertheless, payment discipline must continue to improve as the average Days Sales Outstanding (DSO) is 85 days, when the national threshold stands at 30 days[6].

One idea would be to use the carrot (since the stick is not working) for those companies who manage to reduce their payment delays to acceptable standards. A tax credit or even a tax reduction could be conditioned to virtuous payment behaviors.

In parallel, bringing forward the mandatory electronic invoicing from January 2019 would also be a positive step forward for company payment behavior. Improved payment discipline in a context of restricted access to financing could see business survival rates rise from 38%, after five years of activity, to more than 50%.

Macron-omics #4: Think Brand Equity

Over the past six years, Italy has climbed up the ranks in the World Bank's Ease of Doing Business survey from 87th to 46th place, for notable improvements in the areas of paying taxes, enforcing contracts and starting a business, albeit, at times, at low levels for a developed country.

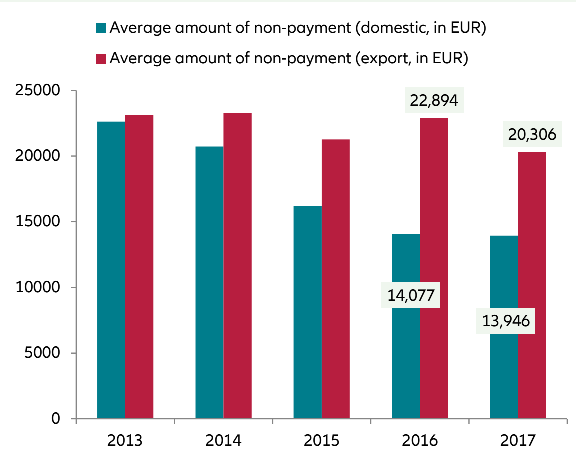
Positive story-telling is crucial for attracting foreign investors.

9. Refocus on attractiveness

Reform momentum and targeted initiatives were successful in improving Italy's attractiveness.

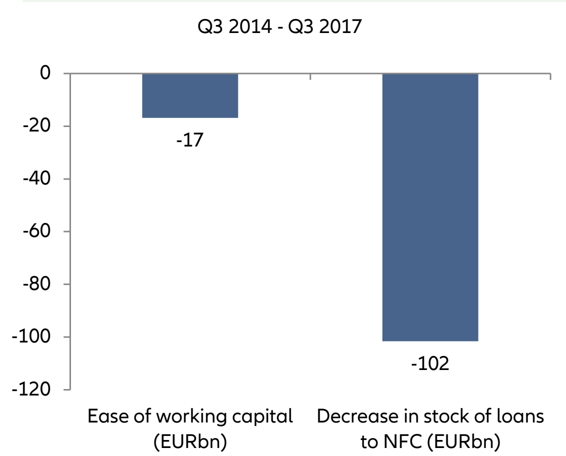
However, Italy's stock of FDI remains low compared to its neighbors (20% of GDP in 2016 vs. 50% on average in the EU). Italy needs a plan and a set of structural reforms to address its neutral (or negative) image on red tape, court proceedings and protected sectors.

Figure 17 Average non-payment amounts, domestic vs export



Source: Euler Hermes Italy

Figure 18 Working capital requirements vs bank financing

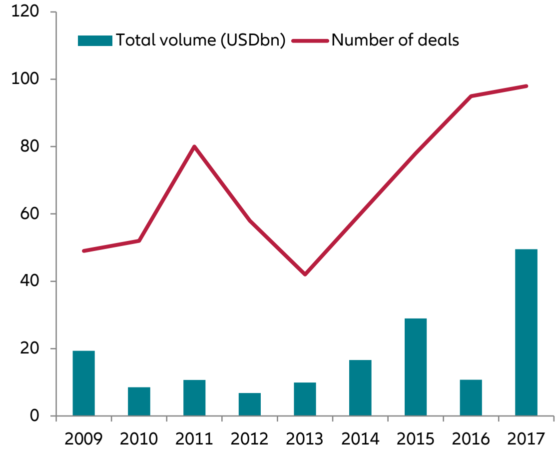


Sources: Eurostat, Allianz Research

[5] The export average non-payment has fallen by -12% from its 2013 highs to 20 306 EUR.

[6] Also, the new bankruptcy law must be finalized within the next 12 months to speed up bankruptcy proceedings from 5-7 years today.

Figure 19 Total M&A (volume and number of deals)



Sources: Bloomberg, Allianz Research

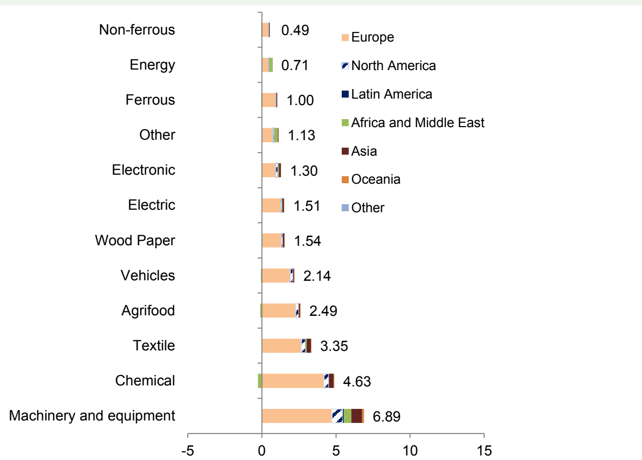
The Italian market has become increasingly attractive to foreign companies and remains promising for 2018 and later. Momentum around deal activity has picked up notably in 2017— cross-border mergers and acquisition deals amounted to USD50bn in Italy (see Figure 19), with the overwhelming majority of buyers based in Western Europe. Italy's knowhow, resilience and innovative manufacturing sector is in demand. Higher profit margins, declining debt and high quality products form a strong base. Continuing to build the brand is essential as competition intensifies.

10. Make export a national priority

Italy enjoys a flourishing export sector and ranks second in the EU after Germany regarding the total number of exporting firms (220 000- 6% of total companies against 13% in Germany and 4% in France). Design, branding and customer experience, in sectors such as luxury or agri-food are renown. The adoption of digital capabilities and the knowhow of retail and industrial sectors will boost firms already high pricing power compared to their peers, notably in France. In 2018, the machinery and equipment sector will export an additional EUR6.9bn, compared to 2017, followed by the chemical (+EUR4.6bn) and textile (+EUR3.4bn) sectors – see Figure 20.

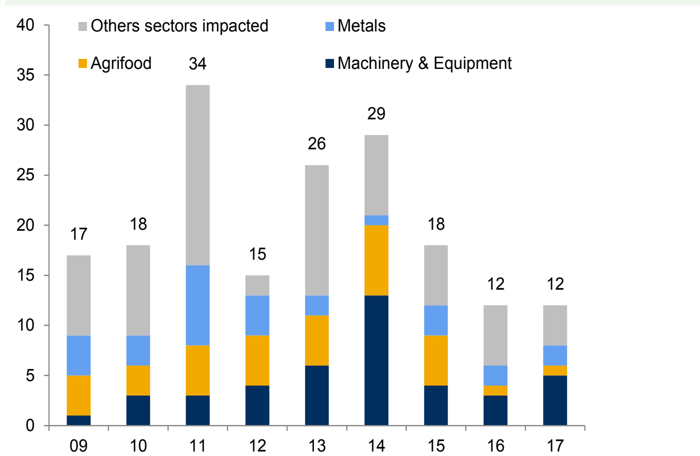
The Italian government has taken a series of measures in 2017 in the context of the 3-year Enterprise 4.0 plan worth a total of EUR18bn to stimulate investment and build export capacity. On top of much-needed measures (assembling and expanding export finance tools such as the Guarantee Fund for SMEs[7] and the Italian Strategic Fund[8]), Italy should structure the export apparatus for the long-run. Today, exporters are mainly small companies (57%) or medium ones (24%), making exports transactional and fragile. Moreover, strengthening the industrial sector in Southern regions through extended incentives (e.g. innovation, employment, etc.) could help close the gap with the rest of Italy and thus increase potential growth in the medium-term. Consolidation is needed to address bigger and more complex markets, in a protectionist environment. Mega challenges (e.g. Corporate Sector Responsibility, Climate Change and Technological disruption) call for a sector-wide approach, framed by the public sector, to avoid the Peter Pan syndrome.

Figure 20 Export gains in 2018 by sector and destination (EURbn)



Sources: Chelem, Allianz Research

Figure 21 Protectionist measures against Italy, top 3 most impacted sectors



Sources: GTA, Allianz Research

[7] EUR0.9bn in Italy vs. EUR12bn in France

[8] EUR 4bn in Italy vs. EUR20bn in France

Macron-omics #5: Build up the #ItalianTech

11. Make Italy a digital innovation champion

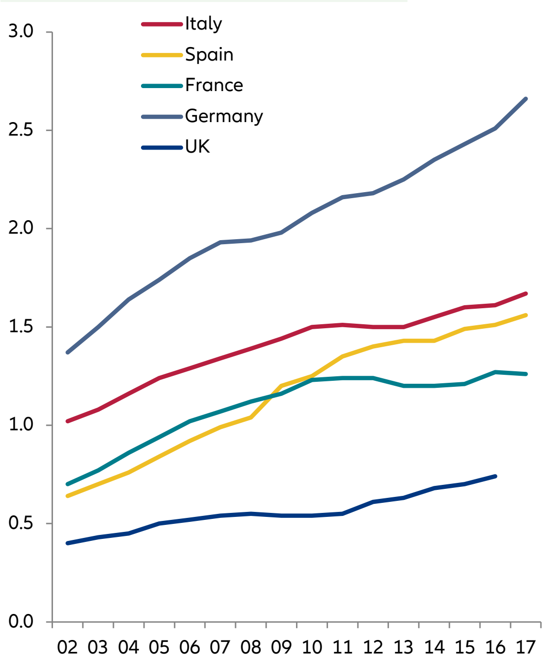
Italy ranks 29th (out of 115 countries) in the Euler Hermes Enabling Digitalization Index (EDI). Logistics performance and business environment are improving, but connectivity quality is still lagging behind. However, innovation (incl. R&D, quality of scientific research) and labor skills (incl. secondary and tertiary education, training) represent relatively strong assets. According to the European Commission, Italy is a moderate innovator. The sub-scores are strongly improving when it comes to the quality of the education (new doctorate graduates, population with tertiary education and lifelong learning), employment in knowledge-intensive activities, medium and high-tech product exports, firm investments, intellectual assets (patent and trademark applications) and SME innovation .

The Enterprise 4.0 plan has provided the necessary boost, especially in the Internet of Things (IoT) space, where Italy has a comparative advantage thanks to its industrial sector legacy. New digital investments in terms of machines and equipment are also on the rise and Enterprise 4.0 incentives through extra-amortization of new assets, notably high-tech tangible assets, by end of 2018, should favor increasing investment by Italian corporates. Robotization is strong but challengers, such as Spain, catch up fast (see Figure 22). The Innovation all'Italiana is a trade mark, which needs to be reinforced through stronger R&D tax credit, tax incentives for start-ups and innovative SMEs, digital innovation hubs and competitiveness centers (scale effect) and strong national infrastructures for digital evolution.

12. Move from labor market reforms to human capital building

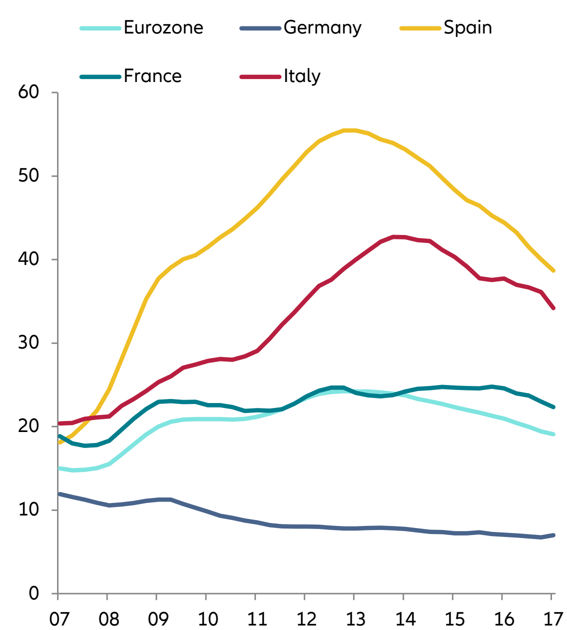
The Jobs Act (2014-2015) has improved flex-security in the Italian jobs market. The implementation of significant policy measures (less restrictive dismissal rules for open-ended workers, limitations on the use of atypical contracts and strengthening active labor market policies) has helped put Italian labor market institutions more in line with international benchmarks. The three-year exemption from employer-paid social security benefits on all new permanent contracts signed in 2015 has been instrumental to the take-up of new permanent contracts. Since February 2014, more than 1 million jobs have been added, of which slightly more than 50% were open-ended contracts. At 11.1% unemployment is still high and three-times as high for 15-24 year olds (see Figure 23). Human capital must be prioritized (quality and returns of education) to boost employability for outsiders. Ideas for reforms include a stronger firm-level collective bargaining system, incentivized women employability, an overhaul of the apprenticeship system, and standardized continuous learning opportunities to equip workers with the necessary skills needed for the future of jobs.

Figure 22 Stock of industrial robots (per 100 jobs in the manufacturing sector)



Sources: IFR International Federation of Robotics, Allianz Research

Figure 23 Youth (15 to 24 years old) unemployment rate, 4Q average, %



Sources: Eurostat, Allianz Research

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