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ISSUER COMMENT

Italy's Recession Adds Headwinds to Country's Fiscal and Structural Reform

From Credit Outlook

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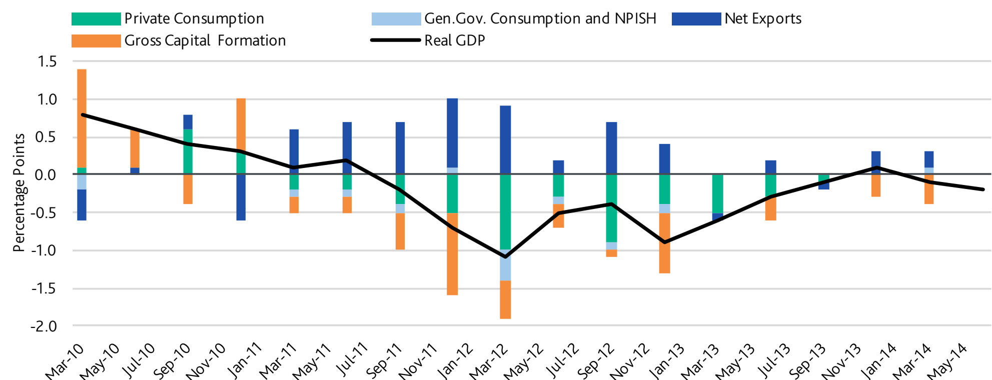
On Wednesday, Italy's (Baa2 stable) GDP figures revealed that the country's economy contracted by 0.2% in the second quarter of 2014 from the previous quarter. In light of this new data, we now forecast that the Italian economy will contract by 0.1% in 2014, versus our previous forecast of 0.5% growth, which makes deficit and debt reduction more difficult and implementing structural economic measures more politically challenging.

The government is currently targeting a 2014 deficit of 2.6% of GDP, and its stability programme targets a 1.8% deficit in 2015. We think that Italy will miss both of these targets (we currently forecast a deficit of 2.7% of GDP in both years, with significant risk of further upward revisions), and that the country's debt burden will peak at 136.4% of GDP in 2014 before falling to 135.8% the following year.

The second-quarter economic data show fairly uniform weakness in the economy. By sector, services, manufacturing and agriculture negatively contributed to growth, while net exports on a demand basis were a drag on growth. Domestic demand was neutral. Italy has been using fiscal policy to stimulate the economy, a strategy that thus far has not kept Italy out of recession. However, we note that an important measure, an €80 monthly transfer to low-paid workers, only came into effect in June and this is only reflected in one month of the second quarter.

EXHIBIT 1
Contribution to Italy's Real Quarterly Growth



Source: Haver Analytics, Istituto Nazionale di Statistica and Moody's Investors Service

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Published every Monday and Thursday morning, Moody's Credit Outlook informs our research clients of the credit implications of current events.

Italy's recession will have negative effects on fiscal policy and on the overall political climate, both at the domestic and European level. Because the government budget assumes real GDP growth of 0.8% this year, the contraction of the economy threatens the government's fiscal strength.

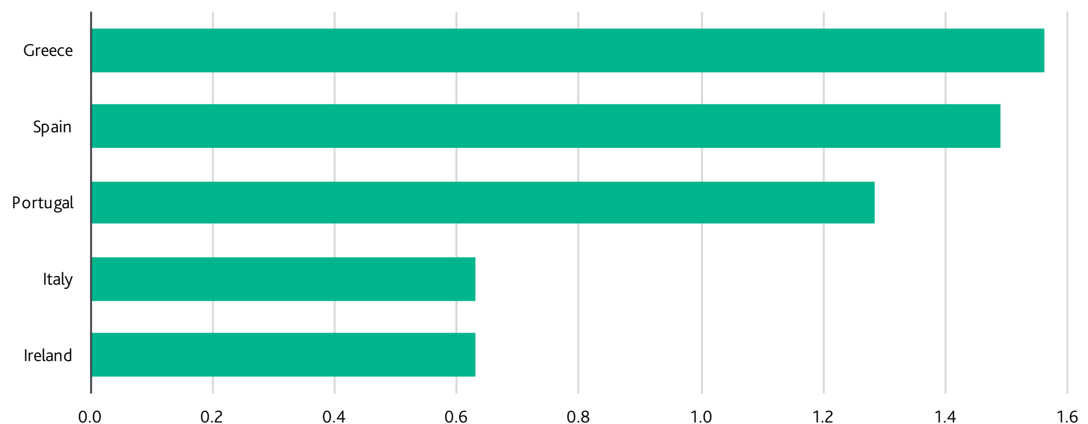
Compounding this challenge is the statement of Carlo Cottarelli, head of the government's spending review programme, that parliament now plans to use some spending cuts resulting from a spending review to finance new expenditures totalling €1.6 billion in 2015, rather than finance deficit reduction through permanent savings. Although the overall effect of this change is relatively small (less than 0.1% of GDP) in nominal terms, it points to the headwinds that Italy faces in making permanent expenditure reductions owing to domestic political pressures.

Weaker macroeconomic conditions also complicate the passage and implementation of the Renzi government's structural reform agenda. Italy has lagged other countries in the euro area periphery on structural reform (see Exhibit 2), and while the Renzi government's broad-based reform agenda is ambitious, the slow speed of action on reform suggests that the government's popularity (as reflected in the European parliament results) has not yet translated into political momentum to legislate and implement a more broad-based set of reforms.

EXHIBIT 2

Organisation for Economic Co-operation and Development Index of Responsiveness to Reform

Italy lags other euro area periphery countries in implementing reforms. A higher number points to a higher level of responsiveness.



Source: Organisation for Economic Co-operation and Development

The slow pace of reform and shortfalls in fiscal performance is likely to further increase tensions between Italy and some of its European partners, most notably Germany. In June 2014, the European Commission asked Italy to find additional savings this year when it issued its assessment of the country's stability programme; this challenge will increase owing to the growth shortfall.

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