Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

GLOBAL ECONOMIC & MARKET OUTLOOK

Eurobank EFG

July 29, 2011

Focus Notes

Editor:

Dimitris Malliaropoulos
Research Advisor
dmalliaropoulos@eurobank.gr

Written By:

Vasilis Zarkos:
Economist Analyst
vzarkos@eurobank.gr

DISCLAIMER
This report has been issued by EFG Eurobank Ergasias S.A. (Eurobank EFG), and may not be reproduced or publicized in any manner. The information contained and the opinions expressed herein are for informative purposes only and they do not constitute a solicitation to buy or sell any securities or effect any other investment. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees may perform for their own account, for clients or third party persons, investments concurrent or opposed to the opinions expressed in the report. This report is based on information obtained from sources believed to be reliable and all due diligence has been taken for its process. However, the data have not been verified by EFG Eurobank Ergasias S.A. (Eurobank EFG), and no warranty expressed or implicit is made as to their accuracy, completeness, or timeliness. All opinions and estimates are valid as of the date of the report and remain subject to change without notice. Investment decisions must be made upon investor's individual judgement and based on own information and evaluation of undertaken risk. The investments mentioned or suggested in the report may not be suitable for certain investors depending on their investment objectives and financial condition. The aforesaid brief statements do not describe comprehensively the risks and other significant aspects relating to an investment choice. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees accept no liability for any loss or damage, direct or indirect, that may occur from the use of this report.

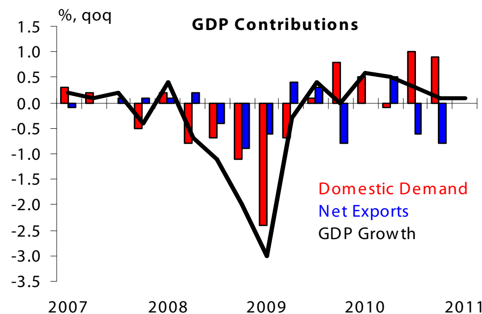
Italy: Public debt sustainability seems feasible

- Italy has come to the bond markets' spotlight due to high level of debt combined with weak growth prospects.
- Successful execution of the fiscal consolidation program is required to lower borrowing costs and put debt dynamics on a sustainable path.
- Successful implementation of structural reforms would boost the country's long term potential economic output and allow public debt to decline faster.
- On the positive side, healthy private sector balance sheets imply that there is potential to fund the public sector.
- Italian banks are vulnerable to sovereign risk due high exposure to government bonds. However, the banking sector fundamentals remain solid.

Public debt excesses and anemic recovery have put Italy on the spotlight

Italy has recently been suffering from contagion due to the Greek sovereign debt tensions. Bondholders are worried about the country's debt sustainability as general government debt has soared to about 120% of GDP, the second largest in the euro area, after Greek debt. In addition, a sharp decline of economic activity during the financial crisis (1.3% in 2008 and 5.2% in 2009) was followed by a weak recovery (Figure 1), fueling concerns about the country's ability to bring its public finances back in order.

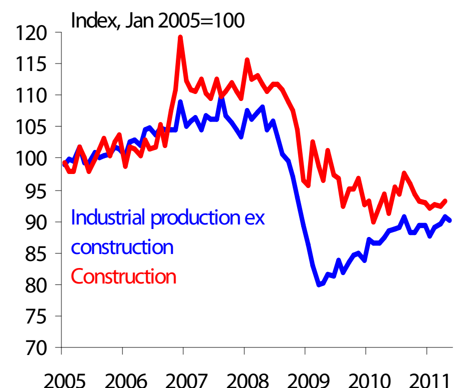
Figure 1



Source: ECB

Growth prospects of the Italian economy remain downbeat. Both industrial production and construction activity (Figure 2) has failed to recover, remaining at levels well below those recorded before the financial crisis. In addition, the rebound in exports has been rather muted so far, contributing to pressures on the debt to GDP ratio. The Bank of Italy predicts that the economy will grow by 1% and 1.1% in 2011 and 2012, slightly below the government forecasts at 1.1% and 1.3% respectively.

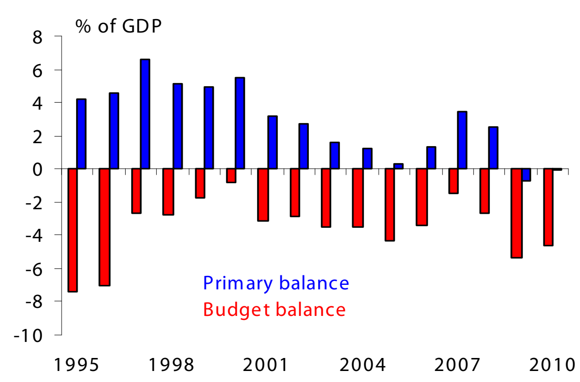
Figure 2



Source: I.Stat

Italy reduced its debt to GDP ratio and the public budget deficit during the years before the introduction of the euro. However, public debt remained at elevated levels and began expanding again during the financial crisis, climbing to 119% in 2010 from 103.6% in 2007. Italian debt standing at about €1.9tn is the largest in the euro zone and way larger than the rescue capacity of the EFSF. Such a high level of debt renders the economy vulnerable to bond market stress. Debt servicing interest expenses place a heavy burden on the economy, as they account for almost all of the budget deficit increase (Figure 3). Interest payments of the general government as percent of GDP are among the highest in Europe standing at 4.4 in 2010 (compared to 2.7% in EU-27 and to 5.3% in Greece in 2009, when the Greek crisis erupted).

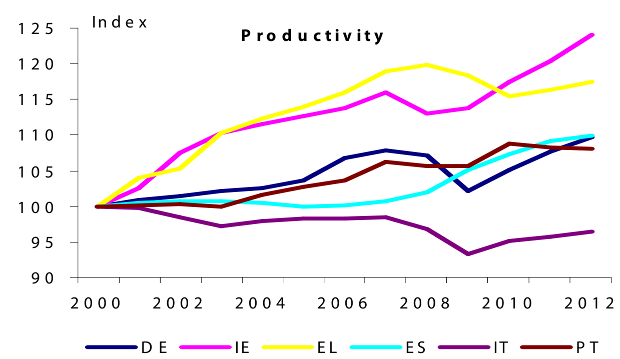
Figure 3



Source: Eurostat

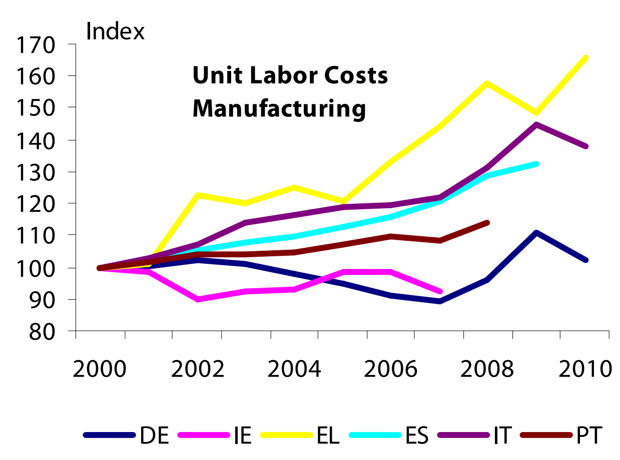
A structural weakness of the Italian economy that has caused it to underperform is low productivity (Figure 4). Whereas nominal unit labor costs (Figure 5) increased sharply since 2000, productivity declined, affecting adversely the competitiveness of Italian exports. Productivity declined even further since the onset of the financial crisis, while unit labor costs have increased sharply. Loss of competitiveness is reflected on the widening current account deficit, mainly due to a deterioration in the good and services balance. Wider current account deficits call for wider external financing at a time of increasing borrowing costs.

Figure 4



Source: OECD

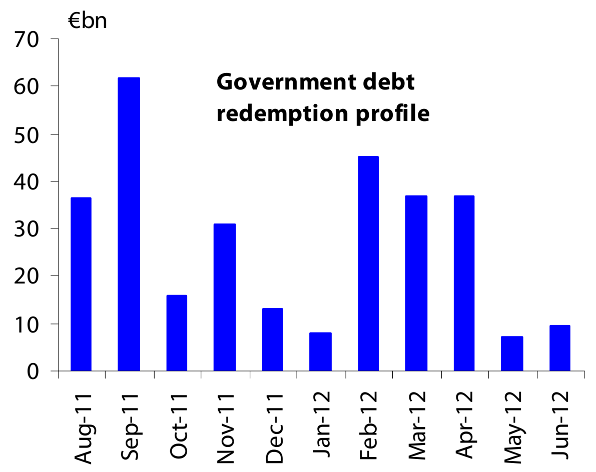
Figure 5



Source: Ameco

In light of the aforementioned weaknesses, Standard & Poor's downgraded their outlook for the Italian economy to negative in May. Moody's has also revised its outlook to negative in June. While agreement on a second Greek bail-out package is expected to tame bondholders' concerns, tensions on Italian debt may linger as no permanent solution to the sovereign debt crisis is in place, yet. In addition, the Italian government is facing a wall of debt redemptions in the third quarter (Figure 6) which is likely to exert pressures on spreads as it will test markets appetite for Italian debt. In our view, upsizing of the EFSF along with enhancing its flexibility to intervene on a precautionary basis would increase its anti-contagion firing power, assisting Italy to face tensions in its borrowing costs.

Figure 6



Source: Dipartimento del Tesoro

Austerity is indispensable to keep debt on a sustainable path.

In view of mounting pressures on public borrowing costs, Italian policymakers responded very fast (within one week while the maximum response time was 60 days) by passing additional measures of austerity worth about €48bn in an attempt to eliminate the budget deficit by 2014. Such a rapid response signals Italy's decisiveness to tackle market concerns. The government plans for debt reduction in the next three years broadly follow the 1/20 rule. On the negative side, the package is back-loaded, as more than €40bn of the additional measures is planned for 2013 and 2014.

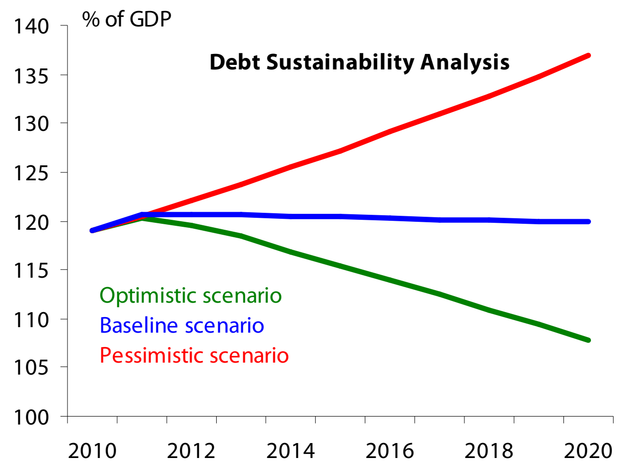
Our debt sustainability analysis (Figure 7) shows that under our baseline scenario in which borrowing costs remain at the current levels, the debt as percent of GDP stabilizes at the current level (119%). In this scenario, we have assumed real GDP growth at 1.2% per annum, which is the average growth between 1995 and 2007 (with the exception of 2000, which is an outlier). We have also assumed that the government succeeds in achieving primary surpluses of 2.5% each year, which is the 2000-2008 average value. In a more optimistic scenario, the borrowing cost falls to 4.5%, which is the 2000-2008 average value, the economy grows at 1.2%, while primary surpluses are sustained at 3%. In our pessimistic scenario, bondholders' concerns intensify, leading to nominal borrowing costs at about 6%, 50bps higher than the recently observed interest rates on 10 year government bonds. We assume that the economy grows by an anemic 1% per year, while primary surpluses are 2%. We find that the debt rises to 136% by 2020. In all cases we take headline inflation equal to 2%, the ECB's target. One should keep in mind that these results are heavily dependent on the assumption made, thus they should be treated with caution.

Overall, our assessment is that debt sustainability seems feasible. Given the weak growth prospects, markets will most likely continue testing Italy, which needs to adhere strictly to its austerity plan in order to tame bondholders' fears, achieve primary surpluses and sustain pressures on debt servicing interest rates. Despite past reforms, Italy remains a rapidly aging, heavily regulated economy, burdened with low productivity, red tape and corruption. Pension spending is the highest in Europe, (at about 15% of 2008 GDP), while Italy has the second smallest old-age support ratio after Japan among the OECD countries. Italian policy makers should move fast with structural reforms, such as liberalization of labor and product markets, privatizations and higher expenses on R&D, in order to increase long term potential growth that would allow the country to grow faster out of its debt woes.

Solid private and banking sector fundamentals

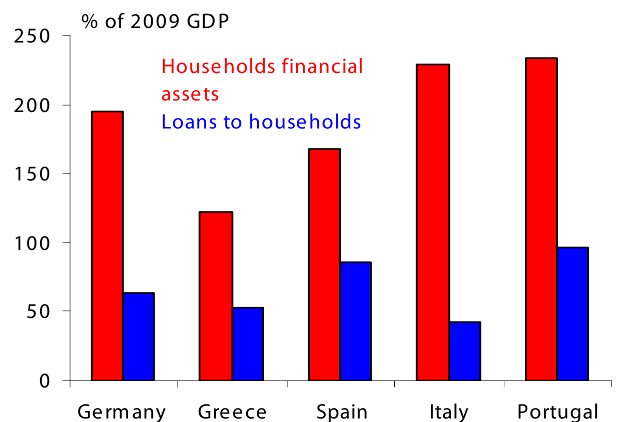
Healthy financial stance of the households (Figure 8) is one of the strengths of the Italian economy. Financial assets as percent of GDP held by households are high, implying that households have a large ability to finance public debt. In addition, the leverage of the household sector is among the lowest in the euro area, suggesting that households could partially accommodate austerity measures. Debt of non-financial corporations does not generate any concerns either, as it stands at a manageable 77.3% of GDP (2009 data).

Figure 7



Source: Eurobank EFG estimates

Figure 8

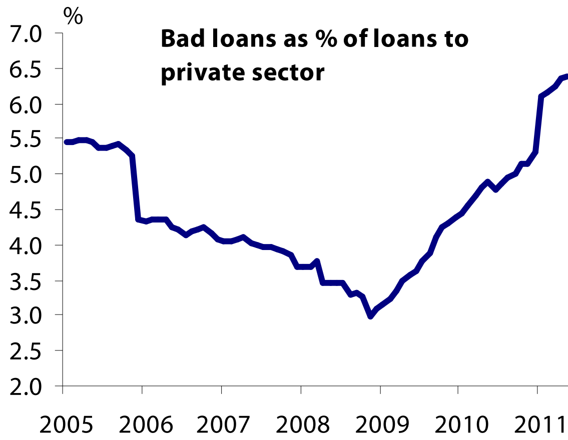


Source: Eurostat

Italian banks are prone to sovereign debt jitters as they hold about 30% of government bonds. However, the banking sector has weathered well the financial crisis. Rich households in terms of financial assets and the lack of excesses in the real estate sector are beneficial for banks' portfolios. Total loans to total deposits ratio stands at 114%, providing evidence that the banking sector is largely self-funded. Bad loans (loans of which the collection is considered highly questionable and improbable) to the private sector have been rising (Figure 9), but at reasonable levels (the jump in early 2011 is due to a series break and it does not represent a sharp increase in non performing loans). Five Italian banks took part in the European stress tests, representing more

than 60% of the whole national banking system assets. They all passed the stress scenario, with the post-stress Core tier 1 ratio weighted average for the five intermediaries at 7.3%.

Figure 9



Source: Central Bank of Italy

Research Team

Editor, Professor **Gikas Hardouvelis**
Ch ief Economist & Director of Research Eurobank EFG Group

Financial Markets Research Division
Platon Monokroussos, *Head of Financial Markets Research Division*
Paraskevi Petropoulou, *G10 Markets Analyst*
Galatia Phoka, *Emerging Markets Analyst*

Sales Team
Nikos Laios, *Head of Sales*
Vassilis Gioulbaxiotis, *Head of International Sales*
Yiannis Seimenis, Ioannis Maggel, *Corporate Sales*
Stogioglou Achilleas, *Private Banking Sales*
Alexandra Papathanasiou, *Institutional Sales*

Economic Research & Forecasting Division
Dimitris Malliaropulos, *Economic Research Advisor*
Tasos Anastasatos, *Senior Economist*
Ioannis Gkionis, *Research Economist*
Vasilis Zarkos, *Economic Analyst*
Stella Kanellopoulou, *Research Economist*
Olga Kosma, *Economic Analyst*
Maria Prandeka, *Economic Analyst*
Theodosios Sampaniotis, *Senior Economic Analyst*
Theodoros Stamatiou, *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobnak.gr

Eurobank EFG Economic Research

More research editions available at http://www.eurobank.gr/research

- **New Europe**: Economics & Strategy Monthly edition on the economies and the markets of New Europe
- **Economy & Markets**: Monthly economic research edition
- **Global Economic & Market Outlook**: Quarterly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research