Bundesverband der
Deutschen Industrie e.V.

COUNTRY REPORT ITALY

Italy's reforms.

Efforts to catch up are under way

October 2015

- **Italy has instituted wide-ranging reforms in the last few years.** These include economic policy reform and restructuring public administration and political institutions. Implementation is still proving problematic.
- **Positive economic signs have been increasing since the beginning of 2015.** The Italian economy looks set to return to growth this year.
- **Further consolidation will be necessary to tackle Italy's extremely high public debt.** Reform efforts will be duly taken into account in EU monitoring procedures for 2015 and 2016. Margin for manoeuvre in fiscal policy remains very limited**.**
- **Italy's industry has endured a hard period of adjustments.** The latest export figures of many sectors are pointing up and reflect the new competitiveness of Italian enterprises. A range of product market reforms will further firm up industry. Stepping up investments in high-performance broadband coverage is a high priority to integrate Italy in the digital value chain.
- **German-Italian economic relations continue to be important.** The transformation of Italian industry in the course of the last decade towards the sectors of mechanical engineering, robotics, pharmaceuticals and food has strengthened the links between German and Italian industry.

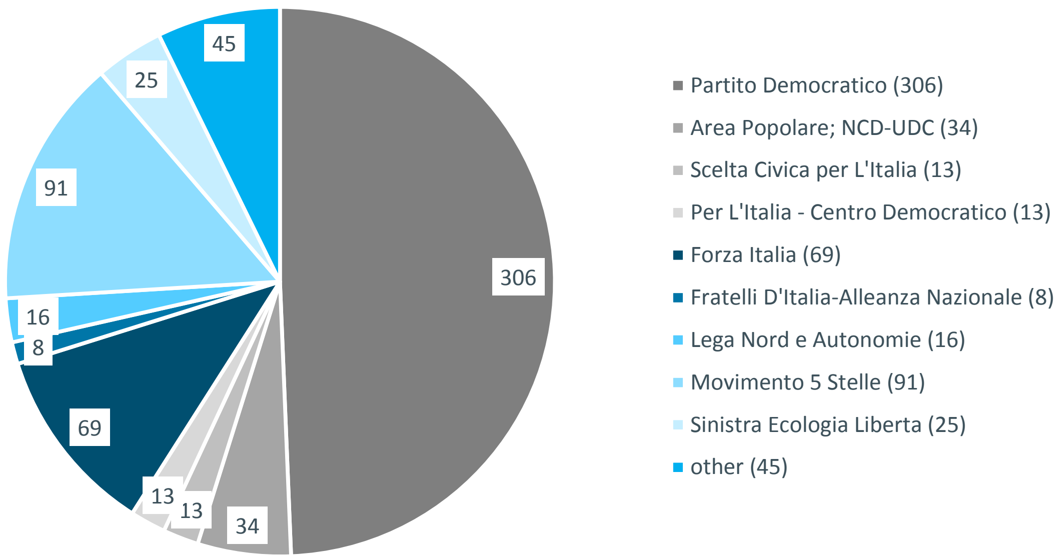
Contents

The political situation in Italy

Prime Minister Renzi and parliamentary majorities

Since February 2014, Italy has been governed by a coalition government led by Prime Minister Matteo Renzi, head of the social democratic party Partito Democratico (PD). The PD is part of the governing coalition made up of PD, Nuovo Centrodestra (NCD), Scelta Civica per l'Italia, Per l'Italia – Centro Democratico and a loose alliance of the linguistic minorities Per le Autonomie (SVP-UV-PATT-UPT)-PSI-MAIE. The parties have an absolute majority of seats (376 of 630) in the Chamber of Deputies (Camera dei Deputati) and in the Senate (Senato della Repubblica) (167 of 321 members).

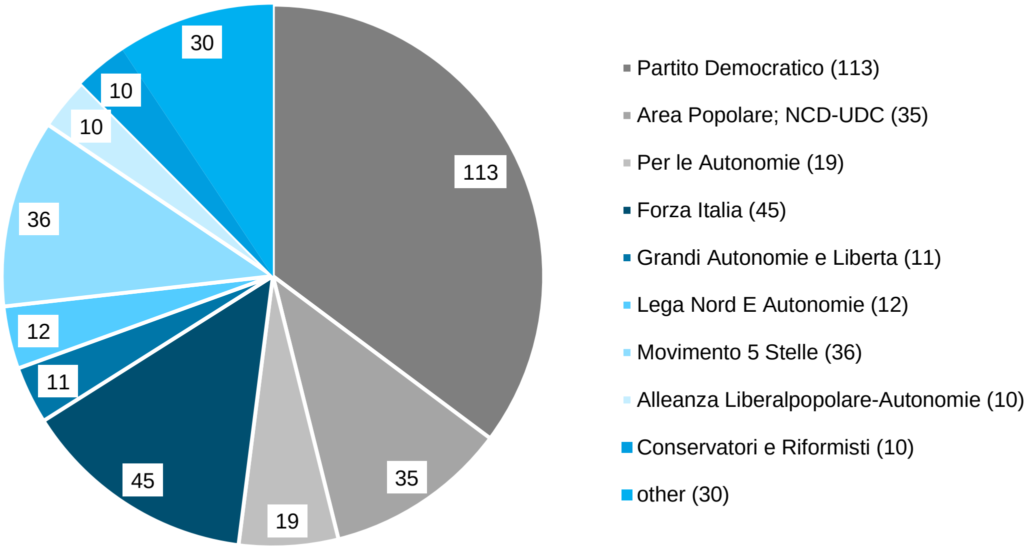
Distribution of seats in the Italian House of Representatives (total: 630 seats)



Source: Italian House of Representatives; as of September 2015

The strongest opposition party in the Chamber of Deputies is the Eurosceptic party Movimento 5 Stelle (M5S), led by Beppe Grillo. The Forza Italia (FI) of former Prime Minister Silvio Berlusconi is still the strongest opposition party in the Senate, even after a number of Senators defected to the newly founded splinter parties at mid-year (Conservatori, Riformisti italiani and Alleanza Liberalpopolare-Autonomie). FI currently has 69 seats in the Chamber of Deputies and 45 members in the Senate. M5S has 91 seats in the Chamber of Deputies and 36 senators.

Distribution of seats in the Italian Senate (total: 321 seats)



Source: Italian House of Representatives; as of September 2015

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The other political opposition parties are regional parties either from the north of the country such as Lega Nord or from the south like Grandi Autonomie e Libertà. The majority of the remaining seats in the Chamber of Deputies and the Senate are held by other regional parties.

European elections

Only a few months after Matteo Renzi took office, the Partito Democratico achieved a record result at the European elections, winning 40.8 percent of votes. The Movimento 5 Stelle got 21.1 percent, beating Forza Italia, which picked up 16.8 percent. With 6.2, 4.4 and 4.0 percent respectively, the parties Lega Nord, Nuovo Centro Destra and L'Altra Europa con Tsipras all secured some seats in the European Parliament. The L'Altra Europa con Tsipras is an alliance set up specifically for the 2014 European elections to show political support for Alexis Tsipras, the leader of Greece's far-left party Syriza.

Italy's presidential election

Giorgio Napolitanos resigned as president of Italy on 14 January 2015, setting off new elections for a successor. Matteo Renzi's candidate, Sergio Mattarella, was elected in the fourth round of voting by members of the Chamber of Deputies and the Senate. He only gained enough seats with the help of other parties in the governing coalition and some members of the Forza Italia, who ignored Berlusconi's call to cast blank votes.

Focal points of government activity

At the beginning of his term, Prime Minister Renzi promised to stimulate the economy with extensive reforms. He started off announcing one big reform every month, but has since slowed down his pace. The government's reforms are focused on the sclerotic labour market, cutting taxes on low earners, the public administration, the justice system, the electoral system and the Senate. Italy's reform efforts thus largely correspond to the recommendations of the European Commission, the Council, the IMF and the OECD. Further steps need to be taken towards strengthening anti-corruption organisations, cutting taxes overall and increasing the participation of women in the labour market.

Electoral law reform

Italy's electoral law was in urgent need of reform following the ruling of Italy's top court that it was unconstitutional. To secure the majorities Renzi needed in the Chamber of Deputies and the Senate, he made a pact with Berlusconi, the so-called Nazareno Pact. Although the pact was later dissolved, Prime Minister Renzi managed to push the bill to reform the electoral system through the Chamber of Deputies in 2014 and through the Senate in 2015. The new electoral law was finally adopted in May 2015.

The new electoral law, Italicum, stipulates that the party that gets more than 40 percent of all votes in the first round is automatically entitled to 55 percent of the seats in the Chamber of Deputies. In case no party or coalition is able to pass the 40 percent threshold, a second round takes place between the two parties that received the most votes the first round. The minimum threshold for representation in the Chamber of Deputies is 3 percent.

Senate reform

Renzi's government has also proposed a reform of the Italian Senate to simplify political decision-making and make it more effective. The completely equal status of the Senate and the Chamber of Deputies in the legislative process is not only unusual but also widely regarded as making the parliamentary system susceptible to long-winded and complicated institutional proceedings, which can also have a destabilising impact on the political environment. The proposed reform cuts the number of seats in the Senate from 315 to 100 in an attempt to speed up and increase the efficiency of reform initiatives and other legislative proposals. The Senate will also not be able to dismiss the government with a vote of no confidence anymore. Senators will be given a greater role as regional representatives. Bills will be reviewed within a period of ten days and amendments proposed to the Chamber of Deputies. Around four rounds of voting are needed to pass the reform of the Senate. The reform is expected to be finally passed by parliament in late 2015, although it could take until the middle of 2016 if less than three quarters of both chambers of parliament vote in favour of the reform, which would then make a referendum necessary in accordance with the Italian Constitution.

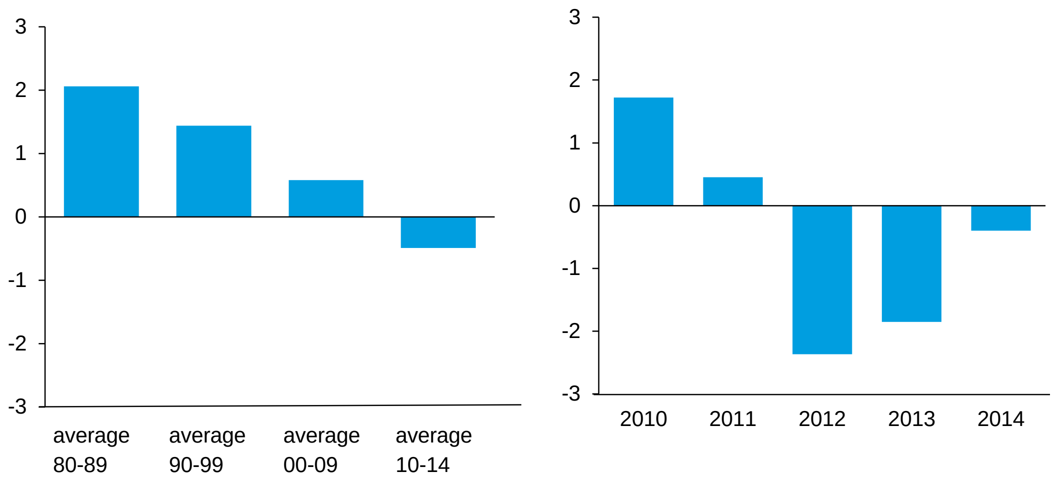
Economic situation

Structural problems are weighing heavy

The Italian economy has been troubled by large-scale structural problems for at least the past 15 years. Economic growth is still being stifled by the difficult structural parameters. For many years now, Italy has been stuck in a deep structural economic crisis, intermittently compounded by medium cyclical problems and high public debt. Italy's productive capacity has successively lost momentum in the last 30 years, culminating in a protracted stagnation since entering the euro area. In the last three decades, between 1980 and 2009, real growth dropped from 2.0 percent in the 1980s to 1.5 percent in the 1990s and down to 0.6 percent in the first decade of the 21st century. In the last five years, Italy's economic output has contracted by an average of 0.5 percent per year, dropping most in 2012 (–2.4 percent of GDP).

Italy's economic output dropped in 14 successive quarters with the exception of the third quarter in 2013 with growth of 0.1 percent. There are also sharp regional differences, with economic output dropping by 6.7 percent between 2007 and 2013 in the north, and as much as 13.6 percent in the southern part of the country.

Italy`s growth crisis 1980 – 2014, in percent of GDP



Sources: IMF, WEO

The weak performance of the Italian economy is also reflected in its extremely high public debt. In the last two decades, public debt was almost constantly at over 100 percent of GDP (the only exception was in 2007, when it dropped to 99.7 percent of GDP). Public debt in relation to economic output recently reached its highest level since the inter-war period – 132.1 percent of GDP in 2014, with estimates pointing towards 133.1 percent of GDP in 2015 (Bartoletto et al. 2013). The European Commission sees Italy's declining productivity and competitiveness as the major factors driving up public debt (European Commission 2014d).

Declining productivity and high unit labour costs

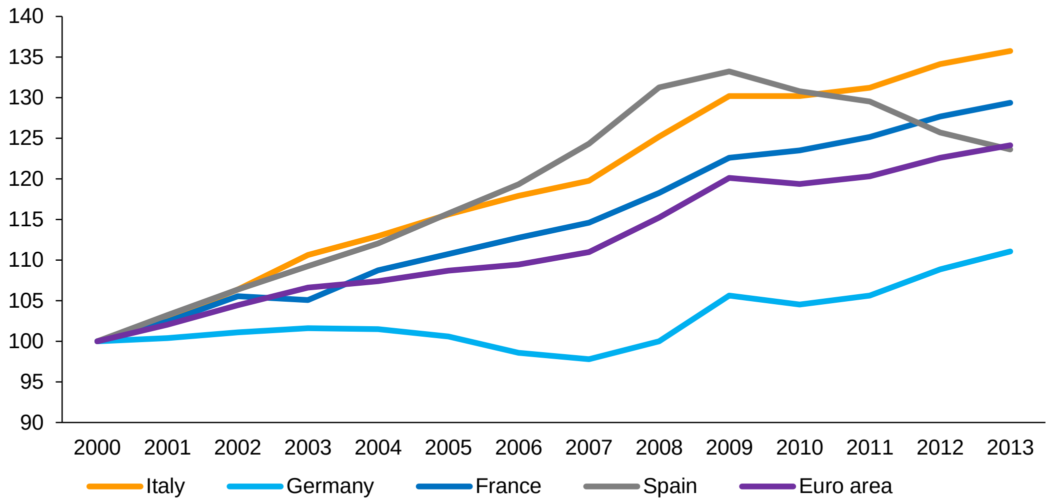
Of particular concern is the constantly declining productivity of the Italian economy. A productivity gap of 60 percent has emerged between the north and the south of the country (IMF 2014). The reasons for Italy's stagnating total factor productivity lie in several areas. According to the European Commission, Italy's present corporate demography with an extremely high proportion of enterprises with less than ten employees (95.2 percent of all enterprises) and low productivity is the main factor for the decline in exports seen over the last few decades and also has a negative impact on productivity (European Commission 2015a).

This is reflected in particular in the stagnating total factor productivity. Very high rates of corporate insolvency and very few new businesses are the main reasons behind this weak performance (European Commission 2014d).

The competitiveness of Italian companies is deteriorating as a result, a situation that is also compounded by increasing labour unit costs. Wage-setting procedures are not sufficiently oriented towards the country's overall productive capacity.

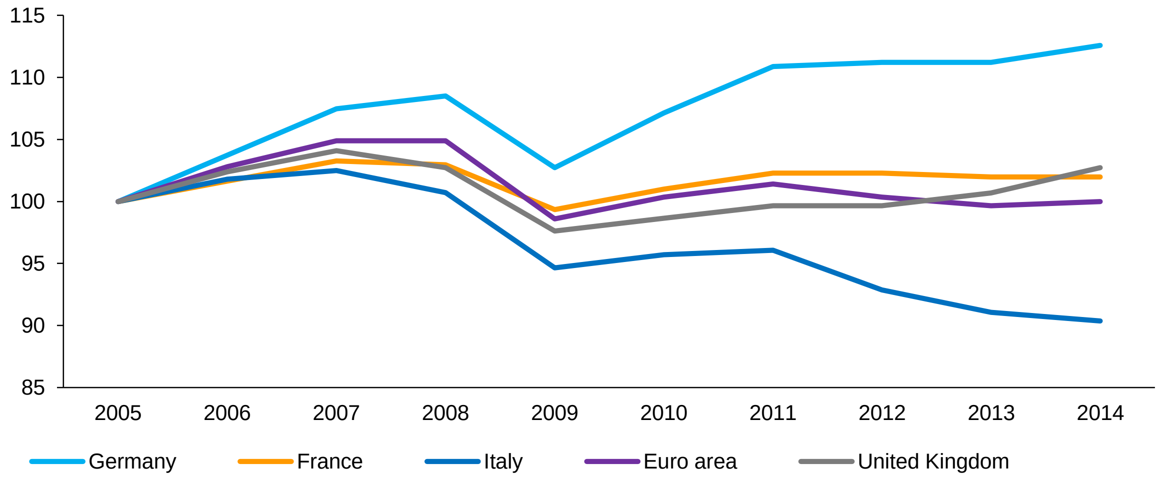
Per capita income has slumped since the global economic crisis and is still under the figures for Germany, France, the United Kingdom and the overall euro area average.

Labour unit costs, indexed to 2000



Source: Eurostat

Real GDP per capita since 2005*



* 2005=100

Source: Eurostat

Labour market and the shadow economy

Italy also suffers from above-average problems in its labour market. The Italian population has far too few employment prospects, and participation in the labour market is still below the European average. The rate of unemployment has doubled since 2007 (European Commission 2014).

The Italian labour market recorded slight positive growth between 1999 and 2008 with absolute employment and the employment rate rising slowly but constantly. In 2009, however, this upward trend reversed. While in 2008 some 22.7 million people were employed, this figure had dropped to 21.8 million by 2014. The employment rate also dropped in this period, from 58.6 percent in 2008 down to 55.7 percent in 2014. A look at the rates of employment according to gender and age reveals structural underemployment among young adults, older persons and women. While the Scandinavian countries and the Netherlands have the highest employment rate in the EU, Italy comes in last on a European comparison. In 2013 only 63.5 percent of the total population in Italy of working age was actively integrated in the labour market. The European average is 71.9 percent. The situation for young adults aged 15 to 24 is also cause for alarm – together with Hungary, Italy also has the lowest employment rate for young adults throughout the EU. Denmark, Malta and the Netherlands perform best in this area. Older persons are also underemployed. In 2013 only 45.3 percent of persons aged between 55 and 64 and capable of employment were in work, compared with the European average of 54.3 percent. The employment rate among women could also be better. Italy is also at the bottom of the list in this regard alongside Malta. In 2013 some 53.6 percent of women capable of employment were actually in work, compared with the European average of 66 percent. The poverty risk has increased accordingly (IMF 2014).

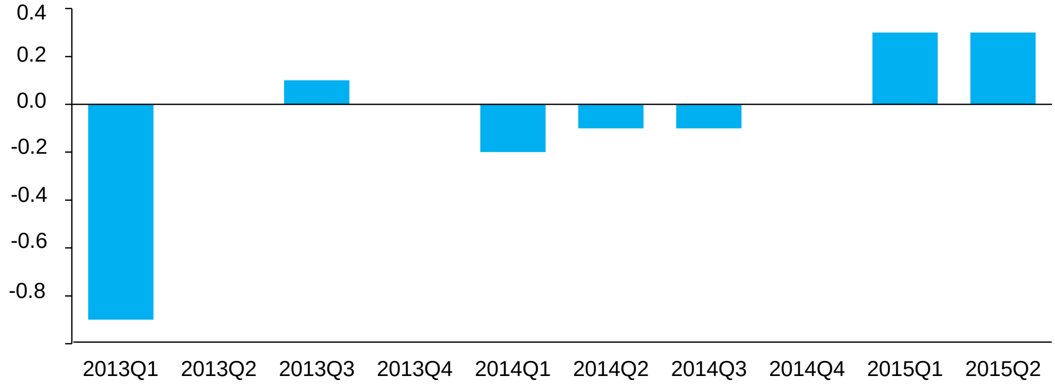
According to estimates from the national statistics office, the shadow economy accounts for around 12 percent of full employment (OECD 2015). Furthermore, the gap in employment between women and men is the second highest in Europe (Deutsche Bank Research 2015). The output gap is considerable on account of the high rate of unemployment and is only closing slowly in the medium term (OECD 2015: –5.8 percent).

Economy recovering but below European average

Economy slowly coming out of recession

The Italian economy appears to be recovering after three years of continuous recession. In the first quarter of this year GDP increased 0.3 percent over the previous quarter, followed by an estimated 0.2 percent in the second quarter. Gross investments in the first quarter rose 1.5 percent, mainly on account of an increase in investments in the transport and construction sectors. The 2.5 percent increase in investments in capital goods is also down to increased expenditure for transport facilities in preparation of Expo Milan 2015 (Banca d'Italia 2015a). Business leaders are nonetheless expecting the business climate to improve (Banca d'Italia 2015b). Private consumption stagnated.

Italian real GDP growth quarter-on-quarter in percent



Source: Eurostat

Brighter growth prospects

Estimates of GDP growth for this year and next are between 0.6 and 1.2 percent for 2015 and 1.2 and 1.7 percent for 2016, signalling that economic recovery is probable. The government is being realistic in its assessment of the chances of recovery, anticipating 0.7 percent of growth this year and 1.4 percent next year, while the Banca d'Italia is even slightly more optimistic for next year (1.5 percent).

Forecast for real GDP growth in percent

Year	Italian government	European Commission	IMF	OECD
2015	0.7	0.6	0.7	1.2
2016	1.4	1.4	1.2	1.7

Sources: Italian government (2014), European Commission (2015c), IMF (2015), OECD (2015).

It is striking that for all years, all three international organisations have corrected their forecasts upwards: in May 2015 the European Commission made a slight upward correction to its GDP forecast for 2014 from –0.5 percent to –0.4 percent. It held steady on its forecast for GDP growth in 2015 at 0.6 percent, but raised its 2016 figure from 1.3 to 1.4 percent. In July 2015, the IMF also revised its growth forecast from April 2015 upwards. It now believes that the Italian economy will grow 0.7 percent in 2015 (up 0.2 percentage points), and 1.2 percent in 2016 (up 0.1 percentage points). The OECD made the biggest upward adjustment. Back in February the OECD expected real growth of 0.4 percent for 2015; in June it raised this figure by a hefty 0.8 percentage points to 1.2 percent. For 2016 the OECD upped its predictions by 0.4 percentage points to 1.7 percent.

These in part substantial upward corrections point to an impending revival of the Italian economy, bolstered by increased foreign demand due to the weak euro and lower labour unit costs (European Commission 2015c). The favourable interest rates should also encourage investment activity.

We should nonetheless get used to seeing low economic growth in Italy as well. The OECD estimates Italy's growth potential for the period from 2014 to 2030 at 1.5 percent. For 2000 to 2013 this estimate was at zero percent (OECD 2014b).

Trade balance has turned positive

Since the slump in 2009, exports have increased steadily both in relative and in absolute terms. Demand from the US and Japan has stimulated exports. Italian net exports turned positive in 2013. The European Commission is still explicitly warning against interpreting Italy's trade balance surplus as an increase in its competitiveness as it is largely due to a low demand for imports (European Commission 2015a). In the first quarter of this year this trend came to a halt as exports stagnated. Imports caught up with exports, increasing 1.4 percent. The trade balance surplus in the months January to April 2015 was double that of the previous year, mainly on the back of falling oil prices.

Investment activity of large companies set to recuperate

Investment activity has been on the decline since 2008. For 2015, the Banca d'Italia is expecting to see a clear upward trend in companies with 500 or more employees (12.7 percent), in contrast to the persisting investment weakness of smaller companies with less than 50 employees (–4.8 percent). The profitability of Italian businesses is still at a historically low level.

Bad loans in the banking system weigh on the economy

The Italian banking sector is currently being plagued by a high ratio of defaulting loans. According to estimates, 10 percent of all loans are currently defaulting, which is making it difficult for banks to give loans to companies. Since the middle of the year, there has been a slight improvement in borrowing conditions and costs. This situation could be improved by a government initiative to offload bad loans. The so-called ABI Moratorium, which is shouldered in full by the banking system, was reinforced and turned into a permanent fixture to curb the flood of defaulting loans (ABI 2015). This moratorium allows companies, under certain conditions, to suspend the principal payments of loans and/or extend the repayment schedules. Hopes are that this will drastically cut the processing time for loan defaults (Banca d'Italia 2015a). The government is also negotiating further offloading with the European Commission through a special agency. A reform of the governance structures of cooperate banks with assets of less than €8 billion is also under way (ECB 2015).

Economic policy and structural reform

Since the end of 2011 many structural reforms have been tackled by the governments of Mario Monti, Enrico Letta and Matteo Renzi and adopted by parliament.

Monti government already reformed the pension system

One of the structural reforms implemented under the Monti government (November 2011–April 2013) was overhauling the pension system. Age was no longer made the only factor determining the point of retirement, but the number of years of contributions. The retirement age was also increased from 65 to 66 years for men and from 60 to 62 years – and to 66 years by 2018 – for women. Men need to make 42 years of contributions and women 41 years in order to claim a pension.

Crucial reform of labour law

The Monti cabinet also made amendments to the labour law with the aim of aligning the differing conditions for older and younger employees. Older employees benefited from a particularly high protection against unwarranted dismissal, while younger employees often only received temporary employment contracts with very low protection.

The Renzi government took up this proposal and adopted it in December 2014. This was a very positive step in countering the declining productivity that characterised the overall economy in the last 14 years (European Commission 2014d) and the very high unemployment levels. The new legislation loosens up protection against unwarranted dismissal in new employment contracts, harmonises employment contracts and further expands the unemployment insurance system. The reform also includes tools for a pro-active labour market policy (including setting up an agency for jobseekers). The new unemployment insurance system is scheduled to be introduced in full by 2017.

Following an amendment of Article 18 of Italian labour law, if the employer has more than 15 employees a claim against dismissal can no longer lead to the reinstatement of the claimant. Instead, compensation can be awarded ranging from 4 to 24 months' salaries (Unicredit 2015). Courts can now only rule for reinstatement in cases of proven discrimination. To reduce the workload on courts, tax benefits will be granted for out-of-court settlements between employers and dismissed employees for the first time in 2015 and in the two following years (Deutsche Bank Research 2015). No social security contributions will be payable for the years 2015 to 2017 in an attempt to encourage the conclusion of new employment contracts (Unicredit 2015, OECD 2015).

The simplification of employment contracts and the limitation of several service contracts are still in the process of implementation. These reforms must still be passed by the Italian parliament.

To tackle the high rate of unemployment among young persons, the EU has set up a financing framework for the Youth Guarantee to finance four-month jobs, internships or trainee positions for youths and young adults from 18 to 29 years old. In its latest review of its Country-Specific Recommendations, the European Commission reported a low take-up of these programs (European Commission 2015a).

Costs of the factor labour also cut

To reduce the high taxes on the factor labour criticised by the OECD and the European Commission, the Italian government has reduced taxes on low earners. The rate of value-added tax was increased at the same time to curtail the negative impact on government revenue.

Allowing more competition in protected markets should stimulate the economy

In early January 2012 progress was also made towards liberalising several sectors of the economy, encompassing gas and energy, transport, pharmacies, service stations, taxis, newspaper kiosks, lawyers, notaries and tax consultants (Platte 2012). The European Commission is not satisfied and is rightly calling for further reforms.

The Italian government plans to enact annually a Law on Competition. The target of this year's liberalisation measures are the insurance industry, communication and postal services, local public services, the energy and gas sector, the oil sector, airports and ports, judicial services, banking and healthcare (Ministero dell'Economia e delle Finanze 2015a).

Italy steps up privatisation of state holdings in companies

The 2015 reform agenda includes the sale of shares in state-owned energy group ENEL, Poste Italiane, the train station operators Ferrovie dello Stato and Grandi Stazioni and air traffic controller ENAV. In 2014, proceeds from privatisation only amounted to 0.2 percent of GDP, much below the 0.7 percent target. Privatisation proceeds are expected to total 0.4 percent of GDP in 2015, rising to 0.5 percent in 2016, 0.5 percent again in 2017 and 0.3 percent of GDP in 2018 (Ministero dell'Economia e delle Finanze 2015b).

Reform of the public administration and the judicial system

The implementation of adopted reforms is often hampered by the lack of a clear-cut division of responsibilities on the different levels. The Italian government put forward proposals to make the public administration system more streamlined and efficient. From 2015 the provinces are to be reorganised and merged. Some of the provinces are to be turned into special metropolitan cities, a move set to cut the workforce in provincial administration by 60 percent (Die Welt 2014a).

The government is also planning to rejuvenate Italy's public sector workforce. It wants to ban the practice of hiring pensioners as state employees. The jobs of retiring state employees will be passed on to young employees. State employees are expected to be mobile within a radius of 50 kilometres from their hometown. The government has also pledged to cap executive pay (European Commission 2014b).

The Italian government restructured the judicial system between 2011 and 2013 (European Commission 2014b). The restructuring was designed to enable economies of scale and specialisation and is starting to bear fruit. One example here is the mandatory mediation scheme for civil and commercial disputes introduced in 2013.

Under the leadership of former IMF head Carlo Cottarelli, a commission was set up to review Italy's public spending with the aim of achieving more fiscal savings. The commission concluded that an estimated €30 billion in structural cost savings would be possible by the end of 2016. The government did not work with these proposals, and Cotarelli consequently gave up his position and is currently back working at the IMF.

A National Anti-Corruption Authority (Autorità Nazionale Anticorruzione) was set up led by former Nepalese magistrate Raffaele Cantone to speed up public procedures and further reign in the shadow economy.

Measures to promote investment and capital market financing

The Italian government introduced a series of tax measures to stimulate the sluggish investment activity and make the capital market more attractive as a source of business financing:

- Tax credit of 15 percent for investments in equipment and capital goods worth over €10,000
- Tax credit of 25 percent for investments in research and development; tax credit of 50 percent if these investments are made jointly with universities, research institutes or other companies
- A new patent box regime for income from patents and brands
- Expansion and increase of the Allowance for Corporate Equity (ACE) to the amount of 40 percent for a period of up to three years; companies registering losses can benefit from a further tax credit on regional corporation tax (IRAP)

The government has also adopted further measures to facilitate access to the capital market for business financing:

- Creation of mini-bonds for SMEs (Die Welt 2014b)
- Strengthening the SME loan guarantee fund to facilitate micro-credits and the spread of mini-bonds (Ministero Dello Sviluppo Economico)
- Authorisation to issue multiple voting rights as an incentive for family businesses

- Reduction of the minimum capital requirements for listed companies
- Allowing the triggering threshold for mandatory public offers in the statutes of listed companies to be set at between 25 and 40 percent (currently at 30 percent)
- Increasing threshold at which listed companies are obliged to disclose information on equity participations from 2 to 5 percent
- Permitting non-listed companies to apply International Accounting Standards

In addition, the Sblocca Italia decree facilitates access of new infrastructure projects to private financing.

Further measures include:

- Expanding the development bank Cassa Depositi e Prestiti's funding for SMEs
- New regulation to enter into force in 2016 granting corporations that invest €30 million or more in Italy a preferential channel of communication with the tax authorities to provide swift certainty on the tax treatment of their investments (Gazzetta Ufficiale 2015)

Investment plan announced for southern Italy

In the second half of 2015, the Italian Economic Development Minister Federica Guidi announced an investment plan to support the structurally weak south of Italy (Der Spiegel 2015b), focusing on the promotion of ports, airports and intermodal transport. The strategy will be pursued in cooperation with investors and social partners in the context of a broadly based consultation and involve investments estimated at around €80 billion.

Reform assessment and proposals by the European Commission, the OECD and the IMF

Consolidating public budgets remain top priority

The IMF, the European Commission and the OECD all see public debt reduction in Italy as an urgent priority. Stagnating and shrinking competitiveness and high taxes have inflated Italy's public debt over the past few decades.

In its 2014 Country-Specific Recommendations, the Commission identified a total of eight areas in which political action needs to be taken. The Italian government has already made progress in some of these areas and has pressed on with reforms of the labour market and public administration. The Commission also sees stabilising the budget and the tax system as a high priority. The high non-performing loan ratio in the Italian banking system is also cause for alarm (European Commission 2015b).

In 2015, the European Commission urged the Italian government to tackle smaller problem areas in labour market policy, including wage supplementation schemes, the strengthening of active labour market policies, the revision of contractual arrangements and the work-life balance. It also saw further need for reform in the public administration and the judicial system.

What really matters, though, is implementation. Although much progress has been made in reforming the labour market and the tax system, Italy is still suffering from structural problems. Among them are the low participation of women, older and younger persons in the labour market and the complicated tax systems that weigh heavily on businesses. The tax system in its present form encourages tax evasion and the shadow economy. The IMF also saw a need to reform Italy's active labour market policy, particularly with policies to facilitate access to professions for jobseekers.

The OECD and the IMF are also encouraging social partners to allow the modification of national wage agreements at the company level. Both the OECD and the IMF also urge Italy to take further steps to liberalise the service sector and increase competition in insurance, banking, network industries and local public services

Fiscal policy and public budgets

Budgetary planning and public debt

Public borrowing in line with EU regulations

Italy's budget deficit climbed to 3 percent of GDP in 2014, 0.1 percentage points above the 2013 budget deficit (2.9 percent of GDP). The Commission anticipates a nominal increase in public spending for 2015 of less than 1 percent due to the tax breaks for low earners (European Commission 2015a).

The Italian government's first budget presented in mid-October 2014 put the budget deficit for 2015 at 2.9 percent of GDP. With structural deficit on a par with the previous year at 0.9 percent of GDP, and only a marginal decrease in new debt (down from 3.0 percent to 2.9 percent of GDP), Italy would have complied with the regulations of the Stability and Growth Pact and the Fiscal Stability Treaty. On 27 October 2014 the Italian government committed to further cuts of €4.5 billion in public spending, revising the projected structural deficit to 0.8 percent of BIP and new debt to 2.6 percent of GDP. The government expected to achieve the €4.5 billion cuts pledged with three items: the diversion of funds from a fund originally envisaged to finance tax breaks; the prolongation of a mechanism to collect value added tax; and the reduction of public funds for co-financing the EU Cohesion Fund (European Commission 2014a, Ministero dell'Economia e delle Finanze 2014a and 2014b).

Debt level

According to the calculations of the Ministry of Finance, public debt reached 132.1 percent of GDP in 2014 (Ministero Dell'Economia e Delle Finanze 2015c), a deviation of 0.5 percentage points of GDP from the 2014 budget. Reasons identified by the Commission for the increase in public debt are Italy's high debt servicing costs, declining GDP and low primary surplus (European Commission 2014a), which together create the so-called debt snowball effect.[1]

The Commission expects public debt to reach 133.1 percent in 2015 (European Commission 2015c). The Finance Ministry's forecast from September 2015 is slightly more positive, putting public debt at 132.8 percent of GDP. In 2016, the European Commission anticipates that public debt will drop to 131.9 percent of GDP on the back of higher nominal growth and a larger primary surplus. The Finance Ministry is also more optimistic here, forecasting that public debt will go down further to 131.4 percent of GDP (Ministero Dell'Economia e Delle Finanze 2015d), which would also halt the snowball effect.

Persisting budget risks

Italy's Constitutional Court achieved a far-reaching decision in the first half of the year, ruling that the reform which blocked inflation-adjusted increases in higher pensions for the 2012–13 period was illegitimate. Even though the ensuing repayments will not have a major impact on the budget, it is influencing further budgetary planning.

In the second half of the year, the Italian government announced tax cuts of at least €48 billion by 2018. From 2016 onwards, the tax on first homes will be scrapped. The year 2017 will see a drop in the corporation tax rate, followed by a cut in profit tax in 2018 (*Der Spiegel* 2015b, *Financial Times* 2015). According to first official statements, these tax breaks will be financed by cuts and increased efficiency in the public sector. More details

[1] The snowball effect of public debt is created when debt servicing costs are higher than nominal GDP growth. This will cause overall debt to increase irrespective of the primary surplus. The primary surplus can only counteract the negative snowball effect created by debt servicing costs and bring total debt down.

will be presented in mid-October 2015 with the annual stability law, which will include projections for public revenue and expenditure planning for the following year.

EU monitoring of Italian macroeconomic policies

The Stability and Growth Pact

Italy was in the Excessive Deficit Procedure (EDP) from 2005 to 2008 and from 2009 to 2013 under the corrective arm of the Stability and Growth Pact. Countries that successfully correct the excessive debt move into a three-year transition period to comply with the debt criterion. On account of Italy's economic contraction, it would have required an overall structural adjustment of currently 2.5 percentage points of GDP which, in turn, would have required a reduction in public debt of 1.5 percentage points of GDP in 2015. The European Commission assessed that such a high structural adjustment would risk having a large negative impact on growth and price levels.

According to the guidance issued in the Commission's Communication of January 2015 on how it will apply the existing rules of the Stability and Growth Pact, countries may under certain circumstances be allowed to deviate from the rigid annual targets in budget deficit and public debt reduction. Italy stands to benefit from these new provisions.

Under the preventive arm of the Stability and Growth Pact, a Medium-Term Budgetary Objective (MTO) is set for each euro country. The individual MTOs are set every 3 years in line with the public debt level and demographic change in each country. Italy's MTO is currently zero percent of GDP. Italy must reach a balanced budget in structural terms within the next few years. The regulations stipulate an annual structural adjustment of at least 0.5 percent of GDP towards the MTO. According to the newly announced flexibility within the Stability and Growth Pact, MTOs will be based not only on structural reform but also on the prevailing economic conditions. Italy will be classified as a state undergoing "very bad times" economically and with high public debt, so that structural adjustment set by the MTO will be lowered to 0.25 percent of GDP.

In the opinion of the Commission, Italy has complied with the adjustment to its 2014 MTO despite an increase in structural deficit of 0.1 percent of GDP. The provisions stipulate that additional medium-term public spending must be financed with equally high public revenue. Italy complies with this principle for 2014. Compliance with the required adjustment to its 2015 MTO is likely as the projected structural adjustment of 0.3 percentage points is above the set target of 0.25 percent. The flexibility provisions will probably continue to apply despite an improvement in the business climate for 2016. As the further reforms announced by Italy are set to have a positive impact on the budget, the Council can either set Italy's Economics and Finance Minister a longer period of compliance with the MTO or authorise a temporary deviation from the MTO.

Macroeconomic Imbalance Procedure

In the course of the Macroeconomic Imbalance Procedure (MIP), the European Commission established that Italy had imbalances that required decisive policy action and specific monitoring. Italy's sluggish productivity growth is the main factor behind the high public debt and the economy's low competitiveness. Both the high public debt and the low competitiveness have in turn a negative impact on the economic situation. In its latest Country Report on Italy, the Commission reports some progress in relation to the Recommendations issued in 2014 in reducing the tax wedge on labour, reforming the labour market, improving education and restructuring the banking sector.

The MIP scoreboard for Italy (2014)

Indicator	Threshold	Level of Italy
External imbalances and competitivness		
Current account balance	-4% or 6% of GDP (3-year average)	- 0.9
Net international investment position	-35% of GDP	- 30.7
Real effective exchange rate	±5% change (3-year average)	- 0.0
Export market share	-6% change (5-year average)	- 18.4
Nominal unit labour costs	9% change (3-year average)	4.1
Internal imbalances		
Deflated house prices	6% y-to-y change (inflation adjusted)	- 6.9
Private sector credit flow	15% of GDP (consolidated)	- 3.0
Private sector debt	133% of GDP (consolidated)	118.8
General government debt	60% of GDP	127.9
Unemployment rate	10% 3-year average	10.4

Source: European Commission

Excursus: A look at the EU's instruments for economic policy coordination

With the **Stability and Growth Pact**, EU member states have agreed to maintain budget discipline in a long-term and sustainable manner. The Pact lays down limits for annual budget deficits (a maximum of 3 percent of GDP) and the level of debt (a maximum of 60 percent of GDP). Higher deficits are only permitted in justified cases. With a preventative arm, the European Commission together with the Ecofin Council reviews whether the budget planning of the member states will lead to a sound budgetary position in the medium term. The corrective arm includes the Excessive Deficit Procedure (EDP) that can be initiated in cases where the 3 percent limit on new debt is exceeded or where debt is not managed appropriately to be brought down to 60 percent. If the member state in question does not adhere to the corrective measures to reduce the debt, the EU can impose sanctions.

The **European Fiscal Compact** imposes stricter budgetary rules, envisaging a limit on the structural deficit of public budgets to 0.5 percent of GDP for countries whose debt is already in excess of 60 percent. An automatic correction mechanism is triggered in the event of significant deviations (German Federal Ministry of Finance 2012, Deutsche Bundesbank 2015a).

The **Macroeconomic Imbalance Procedure** (MIP) aims to avoid and correct macroeconomic imbalances. A scoreboard composed of ten indicators to determine foreign and domestic economic imbalances is designed to identify imbalances at an early stage and take corresponding action. If the indicators exceed certain thresholds the affected EU member state is subjected to a more in-depth country analysis (in-depth review). In the event that problematic imbalances are identified, the Council gives the member states in question recommendations for corresponding corrections (the so-called preventative arm) based on proposals made by the European Commission. Sanctions (the corrective arm) are possible in the last instance if a member state does not initiate corresponding corrective measures.

The **"six-pack"** is a package of secondary legislation containing five EU regulations and one EU directive. It reinforces the rules of the Stability and Growth Pact with automatically triggered sanctions and provides a basis for applying the MIP. The **"two-pack"** comprised of two further EU regulations supplements the six-pack by expanding the preventative surveillance on budgetary planning of the Stability and Growth Pact: Every year, euro area members have to submit an overview of their budget plans for the next year to the European Commission by the middle of October.

Manufacturing

The development of industry over the last century

The general north-south divide in the Italian economy plays an important role in the regional distribution of the industrial hubs. The “industrial triangle” in the north of Italy between Milan, Turin and Genoa dates back to the beginning of the 20th century. During this period, the region experienced a remarkable upturn in the textile, steel and chemical industries (Iuzzolino 2011). The economic and social divide between north and south grew over the course of the interwar period. A major contributing factor here was Mussolini’s fascist industrial policy and restriction on internal migration.

Between the 1950s and about 1972, the economy in southern Italy managed to catch up. Productivity increased both within and across sectors (Iuzzolino 2011). Enterprises based in the north made the necessary investments, motivated by fiscal incentives, the modernisation of the local infrastructure and lower labour costs. The government’s instrument of choice was the Southern Italy Development Fund that provided funding for aqueducts, hydroelectric projects, roads, railways and other infrastructure projects.

The southern industrial structure changed in the wake of the 1973 oil price crisis, shaping the divergence between the two regions for decades to come. The energy-intensive industries located in the south of the country (oil refineries, steel production and petrochemicals) lost momentum and ground to a halt. Repeated depreciations of the lira were unable to bring back the competitiveness lost in the south. The divide grew.

The trend in Italian exports reflects the transformation of its economy over the decades. After the First World War, Italian enterprises started exporting more manufactured products to European periphery countries and emerging countries for the first time. Between the 1950s and the 1970s, Italy became a major exporter of textiles and medium-level technology. This began to change in 1980, with Italy reverting back to exporting a similar range of products that it had at the start of the century – goods with a low level of technology for non-European trade partners and a few specialised engineering products (Federico, Wolf 2011).

Special features of Italy’s economic structure

In the last 20 years, many Italian enterprises have encountered serious problems in bringing about the necessary internationalisation of their operations and in making the necessary investments in research and development. A major obstacle in this regard was the regulatory framework that produced a great number of smaller enterprises: in 2007 the average size of enterprises in Italy was four employees, compared to 13.3 in Germany and 11.1 in the United Kingdom (Amatori, Bugamelli, Colli 2011). In 2009, 95 percent of Italy’s 4.5 million enterprises had fewer than ten employees and accounted for 47 percent of all jobs. Only one-third of Italy’s industrial enterprises counted more than 250 employees. The business landscape in Italy is thus extremely fragmented.

Many of these enterprises are nonetheless so-called pocket multinationals, meaning that they are competitive on the global market in niche areas (Amatori, Bugamelli, Colli 2011). These enterprises are often family-run and specialised in consumer and domestic household products that are only innovative to a limited extent and tend to be of a rather manual nature such as white goods (Lino Zanussi, Giovanni Borghi) and textiles. There is an interesting link between these traditional Italian industry clusters in that they all put a strong focus on design, fashion and style. This is Italy’s clear competitive advantage over other producing countries (Porter 1991).

Another special feature of Italy’s economic structure is the high number of family-owned and family-run businesses, especially compared to Germany, France and the United Kingdom. According to EFIGE figures (“European Firms in a Global Economy: internal policies for external competitiveness” [EU-EFIGE/Bruegel-UniCredit 2012]), the majority of Italian enterprises are family-owned. This figure is quite similar to the figures for other major European economies (Italy 86 percent, France 80 percent, United Kingdom 81 percent, Spain 83 percent and Germany 90 percent). In contrast to the other countries, though, two-thirds of the family-owned businesses in Italy are also family-run, compared to one-quarter in France and Germany and only one-tenth in the United Kingdom. According to the research on this topic, enterprises that are family-owned and family-run tend to be less productive, less profitable, less innovative and make lower investments in research and development (Amatori, Bugamelli, Colli 2011).

Italian enterprises are also lagging far behind in digitalisation (Italy is at the tail end in the European Commission's Digital Economy and Society Index for 2015, ranking 25th out of 28 countries). The largest manufacturing enterprises have not managed to move forward from their business areas in the 1980s. Information and communications technology (ICT) still plays a subsidiary role (Amatori, Bugamelli, Colli 2011).

Post-2008 slump in industrial output

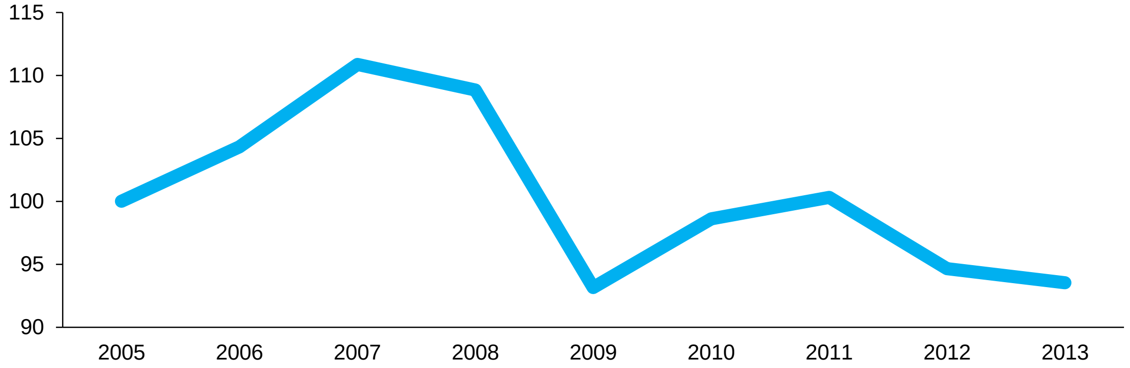
Output in the industrial sector has plummeted since the crisis in 2008. Italy has not experienced such a wide-scale and protracted drop in industrial output since the Second World War (Conti, Scoccianti 2014). As in many other European economies, industrial production already declined in 2008 before collapsing in 2009 (2008: 3.5 percent in Italy; EU average – 1.9 percent; 2009: 19.4 percent in Italy; EU average – 15.2 percent). Italian industrial output then recorded growth of 7.1 percent in 2010 and 1.6 percent in 2011, only to contract again in 2012 and 2013, down 6.8 percent in 2012 (EU average: 2.2 percent) and 3.0 percent in 2013 (EU average: –0,5 percent). The year 2014 saw another slump in industrial production, while output across the EU grew at an average rate of 2.1 percent.

Since 2007, every fifth industrial enterprise has disappeared from the market. The production volume of manufacturing in 2014 was 25 percent below pre-crisis levels. The chemical and pharmaceutical industries have had a softer landing, dropping a mere 7 and 8 percent respectively (Conti, Scoccianti 2014). The Italian automotive industry has suffered the biggest decrease, tumbling a hefty 40 percent (OECD 2015). Capacity utilisation also dropped by 8 percent. Overall, Italian industry has lost more than 500,000 jobs since 2007.

Gross value added and jobs shift to new sectors

The make-up of Italy's industry gross value added has also changed since the beginning of the economic crisis. In 2013, value added was still 6.5 percent below the 2005 level.

Development of manufacturing gross value added, indexed to 2005 (2005=100)



Source: Eurostat

Some industries in Italy are nonetheless doing very well, particularly consumer products in the so-called 4 Fs (food, fashion, furniture and Ferrari). The traditionally Italian production of food products, textiles, clothing and shoes, furniture and high-end motor vehicles is still highly valued abroad.

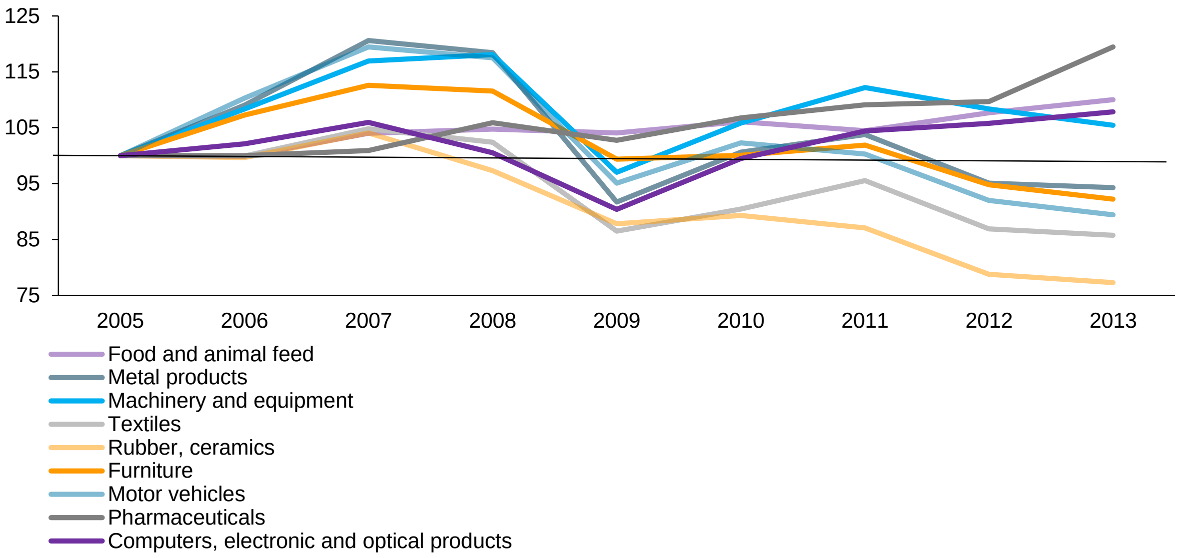
The data from the last ten years reveals a strongly divergent trend in the gross value added within the 4F industries. In 2005, textiles and clothing was the biggest generator of gross value added in Italian manufacturing, but the latest data (2013) records a substantial drop of 15 percent in absolute terms since then. Furniture production also declined during the crisis years and, in 2013, was still 8 percent under the absolute level of 2005. The automotive industry has suffered a similar fate, sliding 11 percent until 2013. The food products industry is the only traditional Italian industry trending positively in terms of gross value added, making a recovery that achieved 10 percent growth.

Other manufacturing sectors that have performed well in Italy over the last few years are mechanical engineering (up 5 percent); electronic and optical products and data processing devices, including products for robotics (up 8 percent); and the manufacture of pharmaceutical products, which recorded a particularly high growth of 19 percent.

Metals production has not yet completely recovered from the two periods of recession in 2009 and 2012–13, with value added still 6 percent below the pre-crisis level. Worst hit are rubber and plastic goods, and glass and ceramics, all of which have nosedived more than 20 percent since 2005.

The new value added structures are also reflected in Italy's absolute export volumes. The trade surplus brought about by exporting enterprises from traditional areas of production crumbled from 74 to 30 percent between 1994 and 2013. In 2013, Italy exported more machinery and equipment than fashion goods, and more drugs than furniture. Almost two-thirds of Italy's trade surplus with third-party countries in manufacturing is attributable to machinery and equipment or to transport equipment (Fortis 2014).

Devolopment of gross value added in different areas, indexed to 2005 (2005=100)



Source: Eurostat

Key industrial sectors in Italy (2012)

NACE code	Sector	Share of industry gross value added (%)	Number of employees
10	Food	9.4	394,042
11	Beverages	1.7	35,768
13	Textiles	2.7	136,464
14	Clothing	3.4	218,032
15	Leather, leather products and footwear	3.2	136,665
17	Paper	2.3	73,423
20	Chemicals	4.6	111,264
21	Pharmaceuticals	3.9	61,601
22	Rubber and plastics	5.0	181,696
23	Non-metallic mineral products	4.4	191,799
24	Basic metals	3.7	124,667
25	Metal products	12.2	534,042
26	Computers	3.4	108,692
27	Electrical equipment	5.0	164,365
28	Machinery and equipment	15.2	452,440
29	Motor vehicles	4.2	162,865
30	Other transport equipment	2.7	84,764
31	Furniture	2.5	147,163

Source: Eurostat

The 18 sectors listed in the table account for almost 90 percent of Italy's industry gross value added. Although the most important sector is machinery and equipment with a 15.2 percent share of industry gross value added, an upstream sector – the metal products industry – employs the most people.

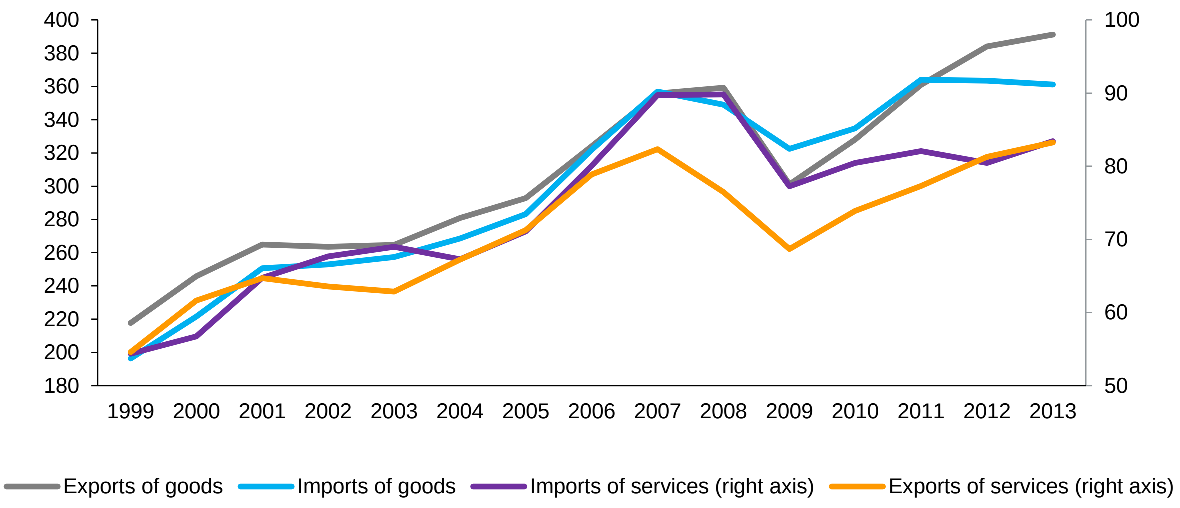
The largest enterprises according to number of employees are in tobacco processing (133 employees per enterprise), closely followed by the pharmaceutical industry at 132.7. However, the Italian tobacco industry is of only very minor significance to Italy's industrial landscape. Ranked third is the manufacture of motorised vehicles and components (70 employees). Enterprises operating in metals production and processing are in the middle of the range with an average of 33 employees. The smallest industrial enterprises in Italy are in the textiles (nine employees) and the clothing sectors (seven employees), furniture and metals production (both eight employees), and producers of non-metallic mineral products (nine employees).

Trade and investment

Foreign trade: record highs for Italian exports

The trend in Italian foreign trade over the last decade has been largely positive even though the share of Italian exports on the world market has lost ground (Brandolini and Bugamelli 2009). As in many other countries, the imports and exports of both goods and services plummeted during the worst periods of the global economic crisis. By 2011 the impact of the slump had been fully digested. From 2012, Italy exported more goods and services than it imported. Between 2008 and 2009, Italian exports dropped from 27 to 22.5 percent of GDP, but have since climbed steadily, reaching 29.4 percent of GDP in 2014. Imports as a percentage of GDP moved in the opposite direction, falling from 28.6 percent in 2011 to 26.2 percent in 2014. Since 2011 the imported volume of goods has decreased twice as fast as imported services.

Development of exports and imports of goods and services, in million Euro

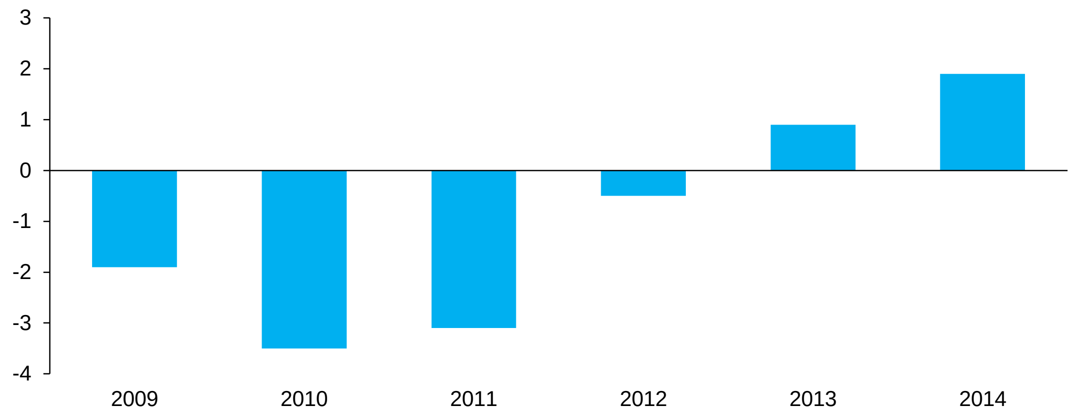


Source: Eurostat

Italy's current account balance

The European Commission has emphasised that the current account surplus seen recently is based not on expanding exports but on declining imports (European Commission2014d). Reduced domestic demand can also be interpreted as an indicator of recession (Cline 2014). The Italian economy is not showing any signs of enhanced competitiveness through increased total factor productivity (European Commission 2015a). The rise of four percentage points of GDP in Italy's current account surplus between 2011 and 2013 is nonetheless a considerable achievement and signals a continuation of the upward trend.

Current account surpluse, in percent of GDP



Source: Eurostat

Direct investment at home and abroad

Direct investment flows and stock, both investment in Italy and Italian investment abroad, have been very volatile in the last five years. All major European economies were hit by a major drop-off in foreign direct investment flows in 2012, largely caused by the extremely high volatility of intercompany loans. Foreign direct investment in Italy has displayed moderate fluctuation during the last five years, ranging from the low in 2011 of zero percent of GDP to the peak in 2011 of 1.6 percent of GDP. Italian direct investment flows abroad have fluctuated on a similar level to foreign direct investment in Italy. The highest rate was registered in 2011 with 2.4 percent of GDP, while one year later foreign direct investment to Italy had sunk to 0.4 percent of GDP.

Foreign direct investment stock in Italy was similarly volatile, bottoming out at 16 percent of Italian GDP in 2010 and peaking in 2013 at 19.5 percent of GDP.

A worrying trend is the comparably low volume of foreign direct investment in Italy compared to the other major European economies such as France, the United Kingdom, Germany and Spain (Deutsche Bank Research 2014). Barriers to foreign investors in Italy could be a factor driving this disparity.

By contrast, Italian foreign direct investment stock abroad grew steadily from 23 percent of GDP in 2009 to 28.8 percent in 2013.

Foreign direct investment (FDI) to and from Italy				
By FDI flows	**2010**	**2011**	**2012**	**2013**
Inward to Italy				
in billion USD	65.6	59.3	13.2	26.7
Share of EU in %	17.1	12.1	6.1	10.8
Outward from Italy				
in billion USD	32.7	53.6	8.0	31.7
Share of EU in %	6.8	9.2	3.4	12.7
By FDI stocks	**2010**	**2011**	**2012**	**2013**
Inward in Italy				
in billion USD	328.1	355.1	363.6	403.7
Share of EU in %	4.5	4.7	4.5	4.7
Outward from Italy				
in billion USD	489.7	519.7	535	598.4
Share of EU in %	5.3	5.5	5.4	5.6

Source: United Nations Conference on Trade and Development

Bilateral economic relations between Germany and Italy

In 2013, indirect and direct Italian direct investment in Germany was in excess of €35 billion. That corresponds to almost 8 percent of all foreign direct investment in Germany. The indirect and direct German direct investment stock in Italy in 2013 totalled €32 billion and was thus lower than the volume of Italian investment in Germany.

More than 15 percent of German investments in Italy are in manufacturing, which is larger than the proportion of Italian investments in Germany's manufacturing sector. German investments in manufacturing in Italy are particularly high in the automotive industry, chemicals and mechanical engineering, which together account for more than 75 percent of total German investments. The automotive industry is the clear favourite with a share of 41 percent.

More than twice as many German enterprises are based in Italy than there are Italian companies based in Germany. Although German enterprises in Italy also have almost twice as many employees as Italian enterprises in Germany in absolute terms, the German enterprises based in Italy are around 25 percent smaller than the Italian counterparts in Germany.

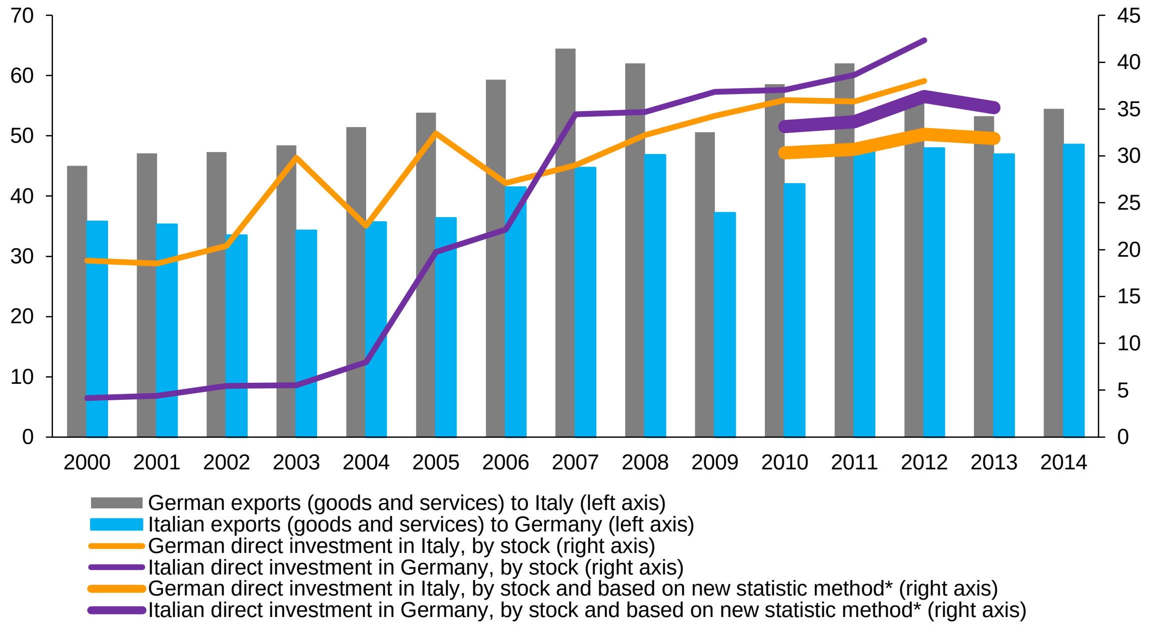
In 2014, exports from Germany to Italy were still under their peak levels in 2011. Italy has a trade balance and current account deficit in its trade relations with Germany, but the deficit is gradually declining on both accounts. Italian exports to Germany have increased most in the area of consumer goods, rising more than 25 percent in the last five years. German exports to Italy have decreased, particularly in the area of capital goods, where they have fallen 14 percent in the last five years.

Company activities in the partner country (2013)

	Italian companies in Germany	German companies in Italy
Indirect an direct investment (in billion Euro)	35.2	31.9
in manufacturing (in billion Euro)	4.0	5.1
Number of countries in the partner country	610	1,365
Number of workers employed by these companies	99,000	176,000
Annual revenues of these companies (in billion Euro)	60.4	93

Source: German Bundesbank

Trade and direct investment between Italy and Germany since 2000 (in billion Euro)



*based on new statistic method from 2010 consolidated to include financial ties

Sources: Federal Statistical Office; German Bundesbank

German enterprises in Italy

According to the German Chamber of Commerce in Italy, the approximately 2,300 German enterprises operating in Italy represent the second largest group of foreign enterprises in the country following US enterprises. In 2005, German enterprises generated around €9.7 billion of revenue, corresponding to 1.6 percent of Italy's GDP.

In 2008, German enterprises in Italy particularly praised location factors such as standard of living for foreign executives, availability of skilled suppliers and availability of skilled enterprises in their sector. But the surveyed enterprises also rated nine out of the 13 location factors for business as problematic, revealing a high level of dissatisfaction with the tax and social contribution levels. The efficiency of the public administration and energy costs also received criticism as did the payment terms and payment behaviour, and the funding available to businesses in the country.

Conclusion

In the last few years, Italy has proved its determination and willingness to undertake reforms. The initiatives of the technocratic Monti government, the former *Partito Democratico* leader Enrico Letta and the current party leader Matteo Renzi together constitute an impressive range of far-reaching reform efforts to restructure the relations between the Italian state and the private sector. In particular, amendments to labour market regulations, the reform of public administration and the liberalisation of service sectors will create new incentives for growth in the medium term while at the same time increasing Italy's appeal to foreign investors.

In the long run, the country's economic strength must be founded on political stability. This is why the reforms of the electoral law and the Senate – which fortify and facilitate political decision-making processes – are such a welcome and crucial step. However, a worrying trend here is that Eurosceptic parties enjoy a high degree of support at the local level.

The Italian economy has continued its recovery this year, boosted by a positive macroeconomic environment. The government now needs to press on with reforms and not rest on the laurels of its achievements so far. On the labour market front, important steps to take now are defining the legal spectrum of competence of the new employment office or agency and further increasing the participation of women and young persons. The government must make further progress towards consolidation, also in its budgetary policy, if it is to maintain its established credibility.

Reforms of the financial and banking sector are also going in the right direction. Both the packages to improve corporate financing on the capital market and the government's initiative to offload non-performing loans can contribute towards reducing the costs and improving the conditions of borrowing.

The Italian economy needs a good infrastructure in order to retain its competitiveness in the face of digitalisation. Industries that have emerged as clear winners despite the economic crisis are mechanical engineering, pharmaceuticals and chemicals, new robotic sectors, and the food and animal feed industries. Other manufacturing sectors such as textile, furniture and automotive production have suffered significant losses. The shift towards highly specialised production with a high level of automated processes should be carried forward given the high productivity and growth potential of these sectors. Extending broadband coverage is of central importance for both the highly developed and the structurally weak regions of Italy. The regulatory framework needed to stimulate dynamic SME growth has also improved. The growing interest shown by Chinese enterprises in Italian enterprises operating in both high-end consumer product industries and traditional mechanical engineering is a clear sign that Italy still offers attractive investment opportunities.

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