

# Country risk assessment – Italy

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Since many years and next to the Subprime crisis of 2008, Italy was plunged into a deep debt crisis. Indeed, the public debt represents 135% of the GDP today, being one of the most important ratios for developed countries. Moreover, the recent political crisis did not fix the problems, the government of the extreme right-wing and the Movement 5 Star recently collapsed and a new one, which does not appear strong, took place. Less than one year ago, politicians promised to revive the economy, but this has not clearly been the case, contrarily Italy still presents high unemployment rate and is not able to enhance economic growth. Considering all the problem above, we thought that Italy could be an interesting country to study. This is why in a first a part the paper will examine the political situation before moving to an economic overview and finishing with a detailed analysis on the public debt.

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# **1. Political Risk assessment**

## 1.1 Political landscape:

The Italian state is a republic based on parliamentary democracy. The president (currently Sergio Mattarella) is elected for a seven-year mandate by parliament and regional representatives. The president designates the prime minister who serves as the head of government and is often the leader of the largest party in the chamber of deputies.

Giuseppe Conte, a law professor without any experience of government or administrative service became prime minister in June 2018 as part of the coalition agreement between the Five Star movement and the league. Leaders of Five Star and the League, respectively Luigi Di Maio and Matteo Salvini became both deputy prime ministers.

The last Italian legislatures led to a Parliament without a majority where we witnessed parties from extreme right and left take over on more traditional parties like PD from the left and Forza Italia from the right. The majority was held by the Five Star movement followed by the right-wing coalition formed by Matteo Salvini's League. Following a long period of negotiations, an agreement based on the most important political orientations and goals of the two parties was reached and a coalition government was presented to the president of the republic in May 2018.

Nevertheless, recently this government fell, Matteo Salvini decided to leave the government because his party and the Five Star movement had too many divergences in terms of projects. League's leader claimed new elections, but this has not been the case. As a consequence, the democratic party seized the opportunity to find an agreement with the Five Stars reaching a majority in Parliament. The results have been the creation of a new government, still led by Conte, born by a coalition between these two parties. This coalition is now more reassuring for the European Union since the old Eurosceptic government which could have led to clear tensions on the financial markets raising apprehensions about a systemic crisis does not exist anymore.

However, in spite of this new government seems more Europe-oriented, it has been created by two parties that have spent the last years fighting and clearly have different views. Therefore, it cannot be considered strong. Matteo Salvini, who strongly won the last European elections, would not lose the occasion of taking the lead whether the two parties at the power would not be able to collaborate until the end of the mandate. If this would happen, Italy and Investors would be even more exposed to new uncertainty, but for the moment this does not seem the case.

## 1.2 Political rights and civil liberties:

People have the freedom to choose any political party they want without any coercive forces intervening to bind their will. However, criminal organizations do have power over politicians some time by threatening them into acting in their interest.

Linguistic minorities are encouraged to participate in the political field by several electoral laws. Women have the same political rights as men even if in reality their interests are not always well represented.

Concerning corruption, despite a long-term effort initiated several years ago to eradicate it, it remains an issue, specially ties between mafias and public officials. As we saw during recent years, several local and regional officeholders have been sentenced to prison on charges of colluding with criminals. As of 2017 new laws regarding mafias were voted to help government fight it in a more efficient way.

The Italian government is aiming toward greater transparency of information. It wants to make the administration more compliant with requests for information from the public though the responses take long time to be given. In the matter of press freedom, journalists are free to express their opinions as they want. The only remaining problems are a strong concentration of newspapers ownership and some threats against journalists, but police protection is offered when there are serious threats.

As for trade unions and the freedom to organise strikes, the Italian constitution recognizes the right to strike but there are restrictions on important fields such as transportations, health, doctors, lawyers... Italy gives its population equal right to justice, but the country has one of the lowest numbers of judges per capita in the European Union. Discrimination based on any criteria is prohibited but we have seen detained migrants denied access to lawyers, which brought a lot of criticism to the government. Despite being in an open-minded country, LGBT community still faces societal discrimination and acts of violence.

The political context, the legal and regulatory framework encourages property rights and conducting private business but as we mentioned, the presence of corruption and organized crime unfortunately prevent normal business activity in some areas. Also, bureaucratic obstacles and delays in court proceedings hinder enforcement of protections for property rights.

Finally, social rights are enforced by authorities to protect all workers from bad working conditions, but with the rise of informally employed workers due to migrants and asylum seekers, it's difficult to protect equally all workers from abuse since informal workers are not accounted for by the system. As surprising as it may seem, women trafficking for sexual exploitation is still a problem even if the government is actively working to eradicate this issue.



## 2. Italy economic risk assessment

### Italy GDP in USD<sup>1</sup>

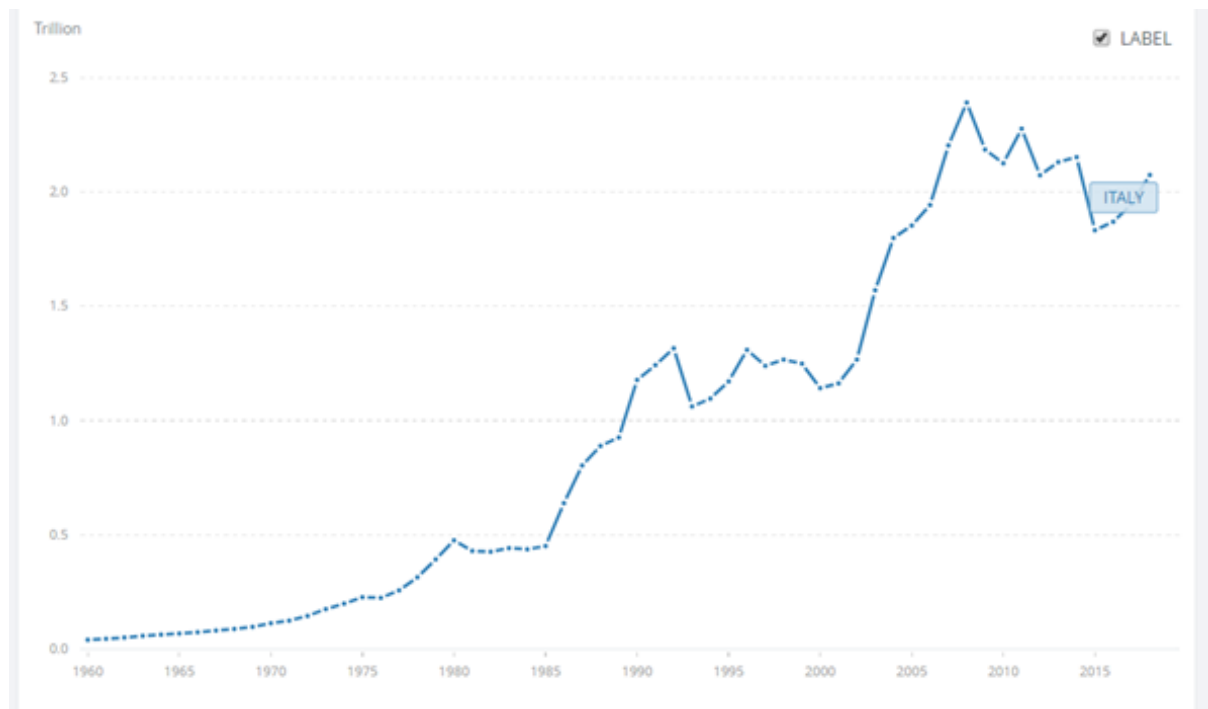


Chart Nb.1

### 2.1 GDP and public debt introduction

Italy is currently ranked as the 8th largest GDP out of 185 countries by the World Bank, with a GDP as of end of 2018 at 2,075 trillion \$. The country has recently just got its head out of four years of economic difficulties, therefore, its growth forecast for 2019 and 2020 is very low. According to the IMF (*International monetary fund*), in 2018, its GDP grew about 1%. The European commission and the IMF forecast a GDP growth of 0,6% in 2019 and 0,9% in

<sup>1</sup> Source: World Bank

2020. These projections show that Italy should face the slowest growth among all the European members. For what concerns the inflation previsions are 1,5% and 1%.

According to the Coface (*Compagnie Française d'Assurance pour le Commerce Extérieur*), Italian public debt in 2019 represents 132% of the total GDP compared to 131,2% in 2017 and 131,1% in 2018. To tackle the low levels of growth rate forecast for the next 2 years, measures have been taken in the 2019 budget such as tax increase and expenses in social area, other than that retirement programs and a universal basic income are being planned. The latter, as we saw, contributed to an increase in the debt to GDP ratio forecast for this year. (132% from 131,1% last year).

Cost of borrowing in Italy has been quite high in the past years, reaching last year, nearly the 3,5%, despite that, in July 2019, thanks a deal reached between Italy and European Union, the yield has seen a significant decrease, leading as of today the 10 years bond yield yielding about 1,00%. The objective of the agreement was to protect the country from further increases in growing debt. Nevertheless, compared to Europe countries such as Germany, France and Spain, the cost of borrowing still presents high levels, affecting negatively the country's accounts.

## 2.2 Current Balance and Investments

Italy's current account balance was at +2,5% last year increasing to +3,3% as of end of last semester. This has been mostly up especially thanks to an important domestic demand during the past years. The FDI (*Foreign direct investments*) have improved by 3,2 billion USD in 2019, while the Budget balance slightly went down to -2,9%. For what concerns the deficit we can observe that it is widening.

Private investments have been increasing in the past years since the implementation of the tax strategy in 2016 defined as "Industry 4.0". Those tax policies, in addition to more favourable credit rates, have helped the private investments, which plummeted by more than 14% since 2016. The tax incentives launched by the project "Industry 4.0" was supposed to reward companies keen to invest and innovate, without restrictions in the sector they would have done it. Even though, in 2019 doubts about the sustainability and continuity of these policies brought investments to a decrease during the first semester.

## 2.3 Nonperforming loans

The NPL (*nonperforming loan*) ratio has been growing since 2007, even though, as shown in chart 2, it has been sharply fell in the past years, from nearly 18% in 2015 to 8,67% in April 2019 according to the CIEC data. If compared to the majority of European countries, the financial crisis had a bigger impact in Italy, as a matter of fact its economy took time to restore the issues that arrived with it, nevertheless, the improvement in the NPL ratio can be considered as an indicator of hope.

## Italy Non Performing loans 2008-2019<sup>2</sup>

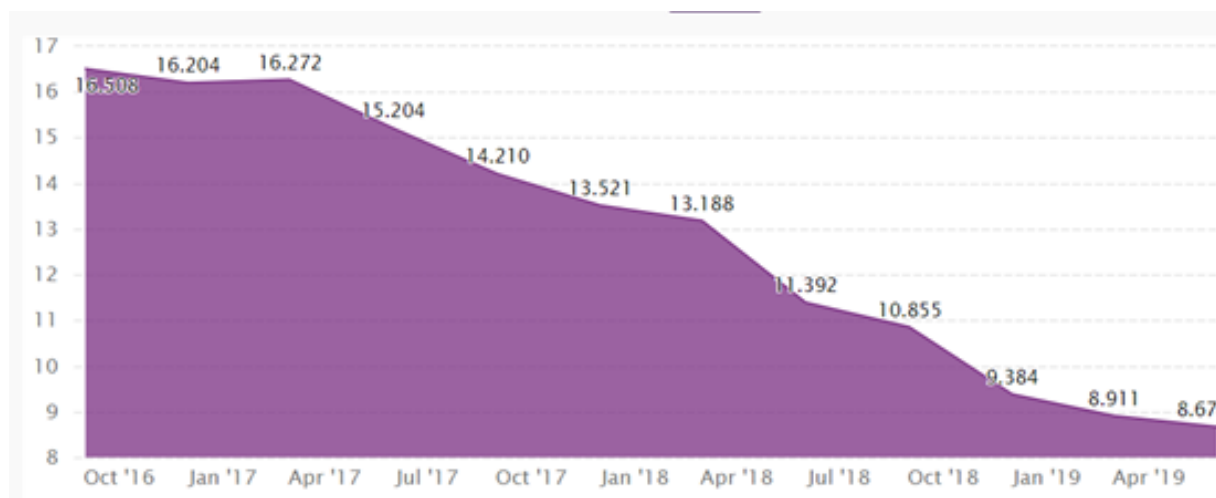


Chart Nb. 2

### 2.4 Taxes, Corruption, Doing Business

Taxes in Italy are extremely high, the world bank shows in its *“Paying taxes 2019”* that this country has suffered from the largest tax increase in the recent years, evolution that is shown by the TTCR (*“Total Tax And Contribution Rate”*) seeing this ratio increasing from 48% in 2016 to 53,1% in 2017. Other than a high public debt, the main triggers of the increase in taxes seem to be corruption and tax evasion, which are particularly high in Italy. In fact, Italy is ranked 53th out of 180 for its CPI transparency Index. The tax evasion amounts at roughly 90bn euros per year.

Moreover, another issue is represented by the black market, which represents approximately 12,4% of the total GDP. For what concerns the indicator of economic freedom, which considers variables such as rule of law or government size, sees Italy reaching 62,2 out of 100 in 2019, ranking the country 80th out of 180.

Italy ranks only 51th out of 190 economies in the World Bank *“Doing Business Report”* of 2019. Making its position one of the lowest when compared to the OECD countries. Another major issue is the unemployment rate, which is pretty high, in 2018 it was up to 10,8%, even though this level was lower than the previous ones, the youth rate of unemployment is still at 37% this year.

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<sup>2</sup> Source : CIEC Data

### 3. Focus on Public Debt

#### 3.1 The history of the Italian public debt

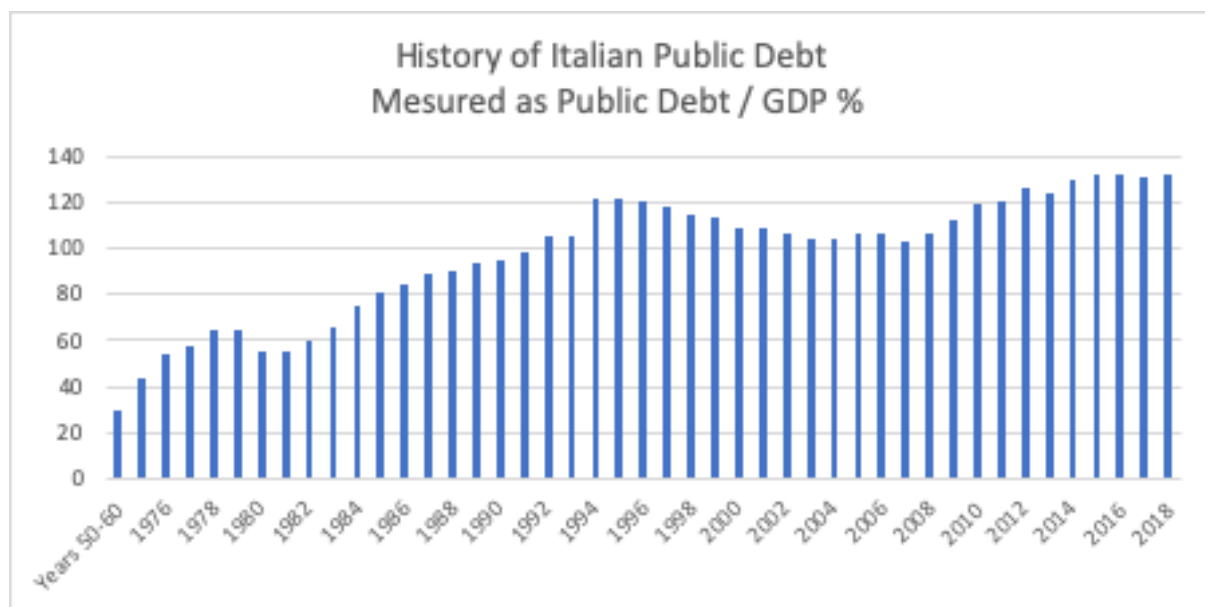


Chart Nb. 3.

Italy's public debt first increase is dated 1887 (during the crisis at the end of the XIX century). Public debt surged to 117% of GDP. The other two main jumps that followed have been reached mainly during the world wars. In fact, during the period going from 1913 to 1918 the debt/GDP ratio plummeted from 71% to 99%, reaching the highest historical level of 160%. In 1920 this ratio would finally decrease later, thanks to the debt cancellation for war debts and a remarkable decrease in internal debt.

The great depression in 1929 led to a new increase in Italy's public debt, it has reached a level of 88% of GDP in 1934. The same happened when Italy decided to take part at the second world war, when the ratio Debt/GDP surged in 1943 to a level of 108%.

It is worth to mention that in presence of significant inflation, the GDP tends to increase rapidly in nominal terms and then, if debt is nominal, the ratio to GDP will decrease rapidly. That's what happened during the last years of the conflict, when the hyperinflation reduced the debt, leading in 1946 to a Debt/GDP ratio of 40%.

Later on, in 1964, period characterised by a 0 inflation and an average speed's growth, the debt to GDP ratio was at 33%. The ratio did not increase mainly because the interest on the debt were lower than the growth rate, hence Italy had enough to pay the debt back.

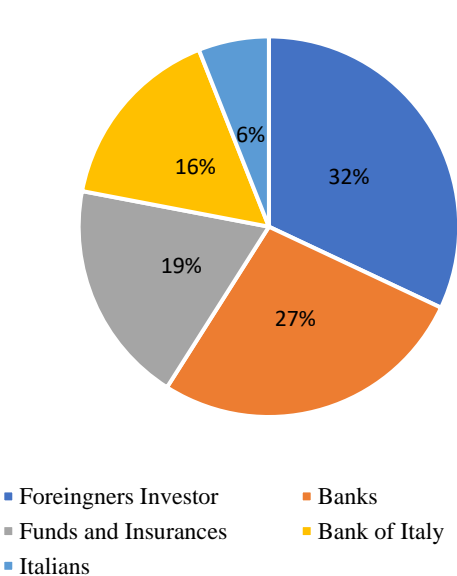
From the year 1974 it started a phase which led the Italian public debt to levels that right now have never come back. During the first years of '70s, even though the oil's crisis combined with a growth in inflation, the public debt just increases slightly, in 1980 the level was at 60%. This because from 1975 the Bank of Italy ("*Banca d'Italia*") guaranteed to buy the not sold sovereign bonds, this by printing money: The result of this operation led on one hand in a disappear of the cost of debt but, on the other hand, this policy devaluated the Lira (the old Italian currency) of 40% against the American dollar.

What made surging the Italian public debt is what happened in 1981. The USA’s new president at the time, Ronald Reagan and the Federal Governor of the Federal Reserve, Paul Volcker, wanted to tackle the high inflation by increasing interest rates, which sow an history of Italian Public Debt since XIX. As a consequence, Italy in 1982 faced a a difficult economic situation: the inflation was at 17%, interest rates were at 25% and the spread 10 year against the German securities reached the highest level ever recorded of 1175 basis points. The following governments continued to face difficulties, with the deficit reaching levels close to 15% during 1983 and 190 and an inflation rate unable to decrease under the soil of 10%.

The biggest problem for the nation has continued to be an extreme high level in the debt interest rates, which were at around 5% of GDP but even recording a 12% of the GDP in 1994. From that year, when the ratio Debt/GDP reached the 124%, the new governments have not been able to reduce, as it was done in the past, the public debt. (See chart number 3).

At this stage is important to understand who is holding the Italian public debt, see how is composed and try to understand which are the implications for the country. In the following paragraphs we will illustrate who is holding the public debt and in which amount. This will give an overview of the main actors in the subject and for the most important holders we will develop a further analysis.

3.2 Who is holding the Italian Public Debt 3



The total debt as of end of 2018 was at € 2.286 billion (today it is at a level of € 2.462). As we can see in chart 4, the main holders of the Italian debt are “*Foreigners Investors*” and “*Banks*”, which have on their hands 32% and 19% respectively. After them, with a share of 19%, there are the Italian “*Funds and Insurances*”; which are followed by the “*Bank of Italy*”, which holds the 16% of the total debt. The remaining 6%, in then hold by the Italian private investors (“*Italians*”) with the 6%.

Chart Nb. 4.

Thanks to IMF data and Eurosystem Securities holding statistics, we can breakdown the sector “*Foreigners investors*”. During the second quarter of 2018 the Italian public debt has been held by:

- 53%: foreigners not-bank
- 19%: foreign bank investor
- 28%: ECB (European central Bank)

3 Source: IMF data and Eurosystem Securities holding statistics

If we want to go deeper in this analysis, we can affirm that 78% holders of BTP (The sovereign Italian securities) were from the Eurozone. Therefore, just 7% of the 32% (see chart 5), is held by foreign investors who are not from the Eurozone. Between the most evident holdings we find<sup>4</sup>

- France €130-135 billion
- Germany: €85-90 billion
- Luxemburg: €90 billion
- Spain: €75-80 billion
- Ireland: €45 billion

For what concerns the sectors “Banks” and “Fund and Insurances” the main holders of the debt are “Poste Italiane”, a company that manages the postal service in Italy, operating in the financial, insurance and mobile telephony sectors as well, Assicurazioni Generali (Insurance) and UniCredit SpA (one of the biggest credit group in Italy and in Europe). The first one holds the 28% of the entire sector, the second one the 14% and the third one the 11%. For the rest, chart 5 illustrates which are the main other companies with a part of the Italian debt on their hands.

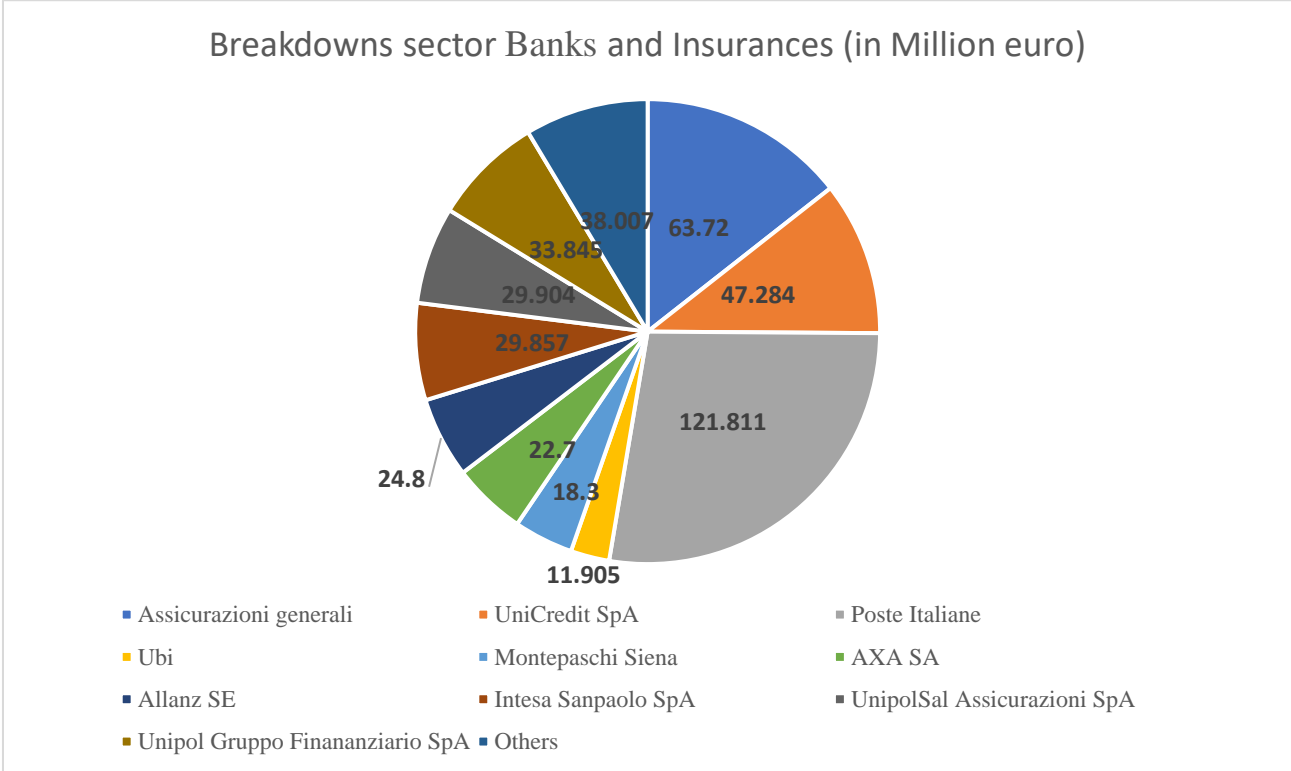


Chart Nb.5

<sup>4</sup> To note that Luxemburg and Ireland take into consideration even foreigners’ funds of companies managed by Italians.

<sup>5</sup> Source: IMF data and Eurosystem Securities holding statistics

### 3.3 Consequences of a high public debt

As illustrated in the precedent lines we realised that Italy have been facing since more than 20 years a high level of public debt, but which are the implications?

First of all, an effect correlated at the growth of the debt is that the Country in order to pay back the debt is forced to subtract resources which could be used for financing investing and productivity, the latter two main factors for the economic growth. Moreover, this creates a vicious circulus between the country and the companies. As a matter of fact, the country imposes policies that reduce the flow of resources from savers to the private sector. At the same time, the emission of sovereign bonds pushes the private companies to invest in them, the result is a flow of money from the private sector, which reduces investments and consequently growth, towards the country's accounts.

Another typical effect related to an increase in public debt are fiscal policies. In fact, in order to avoid extreme increases in public debt and hungry of financial resources, governments are forced to increase the taxation. This impact revenues, reducing individual's consumption and company's investments.

As we have seen Italy has not found the solution to decrease the public debt and therefore to generate a more stable growth. It appears clear that one of the main focus should be trying to find solutions to interrupt the vicious circle over illustrated and finally reduce the public debt.

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