The anatomy of Italy's current account

- Last year, Italy's current account deficit probably stabilized close to its highest level in more than a decade. The question is whether this might represent the lowest point and if some improvement can be expected in upcoming years, or whether this is a structural trend and Italy will continue to pile up (current account) deficits in the years to come. We argue that the first option is more likely, provided that Italy pushes ahead with the reform process.

- A retrospective analysis of the current account dynamics from a savings and an investment perspective shows that household savings was one of the main drivers of the deterioration of the external balance. Therefore, a reversal of this trend needs to play a pivotal role in the current account rebalancing. But the adjustment will likely be gradual.

- Looking at the counterparts of savings and investment, we found that the deterioration of the trade balance accounted for the lion's share, while the income balance benefited from a relatively contained, although negative, net foreign asset position. Going forward, boosting Italy's weak growth performance and lifting the export market share again will be key to drive the reduction in the current account deficit.

- In order to quantify the extent of the external imbalances Italy is facing, we derive an equilibrium value of the current account. Our analysis shows that, while not particularly demanding, an adjustment in Italy's current account position needs to be undertaken. To this extent, once again, the message is that structural reforms are of utmost importance.

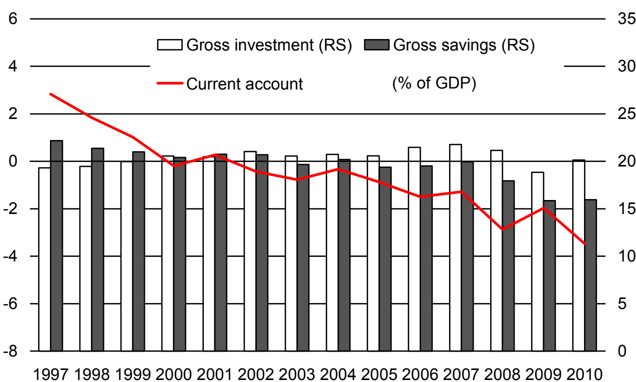
Next week, the Bank of Italy will release balance of payments data for December. Our expectations are for a broad stabilization or a marginal deterioration of the current account-to-GDP ratio in 2011 vs. the previous year: our forecast is -3.6% vs. -3.5% in 2010. Albeit remaining overall contained, at these levels Italy's current account deficit is the largest recorded since 1997 and among the highest in the eurozone when excluding Spain, Greece and Portugal. This is the result of a long and steady deteriorating trend, which brought the current account balance (in % of GDP) from a large surplus (+2.8%) in 1997 to a 3.5% deficit in 2010. In the following, we take a more detailed look at the factors that have driven this trend, both from a savings and an investment perspective and from the perspective of their counterparts – the balance of trade, income and current transfers – in order to shed some light on the dynamics we can expect in the medium term. Our analysis shows that Italy's current account deteriorated during the 10 years leading up to the onset of the crisis as households gradually lowered their savings while investment broadly stabilized – both likely as a result of excessively low interest rates around the world and the process of financial integration. With the onset of the crisis in 2007, the deficit more than doubled from less than 2% of GDP to about 3.5% as households further lowered their savings to cushion some of the blow to incomes, partly reflecting the government's reluctance to use fiscal policy to stimulate demand. At the same time, the trade balance deteriorated substantially, in the wake of a rising import share of GDP and a broadly stable share of exports – both a consequence of the process of globalization and a concurrent loss of competitiveness of Italy vis-à-vis its peers. The challenge is now to reverse this trend, with signs of this having started to happen in 2011 being evident. To bring the current account deficit back to a fully sustainable level again – an adjustment of some 3pp of GDP – it is important that recently announced structural reforms and those in the pipeline are fully implemented. The new government led by PM Monti has certainly shown a strong commitment to an ambitious reform agenda, and he enjoys enough support in the population and in Parliament to pursue his strategy. We think the odds are in favor of him succeeding. Overall, we expect the reform of the pension system and the efforts put in place to free up markets and increase competition will certainly be effective in spurring Italy's growth potential, but the reform of the labor market currently under discussion will mark another milestone.

Household savings center stage

The decline in the current account in Italy over the last decade was accompanied by a fall in national gross savings and broad stabilization in investment. The national savings rate (defined as total savings in percent of nominal GDP) declined by about 6pp between 1997 and 2010, while the investment rate (i.e. investment/GDP) increased by about 1pp from 19.3% to 20.1%. In particular, the dynamic of the investment rate hides a relatively stable trend in 1997-2006, which was followed by a plunge in 2008-2009 and a significant, albeit short, recovery in 2010. With respect to national savings, a by-sector analysis highlights the following: The declining trend in household savings was the predominant factor behind the drop in national savings: the household savings in % of GDP fell from 14.8% to 8.2% over the period between 1997 and 2010, with the pace of decline intensifying in 2009-2010, in line with the ongoing weakness in real labor income (see left chart). This more recent dynamic went hand in hand with a significant deterioration in public savings, with the ratio to GDP turning negative in 2009 and declining by a cumulated 3.5pp in 2009-2010, well above the cumulated 2pp decline recorded during the long period of flattish GDP growth in 2002-2004, always in the context of a less restrictive fiscal stance. In contrast, corporate savings (both financial and non-financial firms) remained stable over the last decade. It worth highlighting that the corporate savings rate showed a good recovery in the last few years, and after dropping to a low of 5.5% in 2008 (dragged down by persistently high interest expenses due to corporate re-leveraging) from 8.5% in 2004, it rose again to about 8% as firms continued to benefit from the prolonged period of very low interest rates. This led to corporate net borrowing dropping to 2.6% of GDP in 2010 (compared to 5.1% in 2008), notwithstanding a recovery in the investment rate to 11.4%, in line with the average of the last decade.

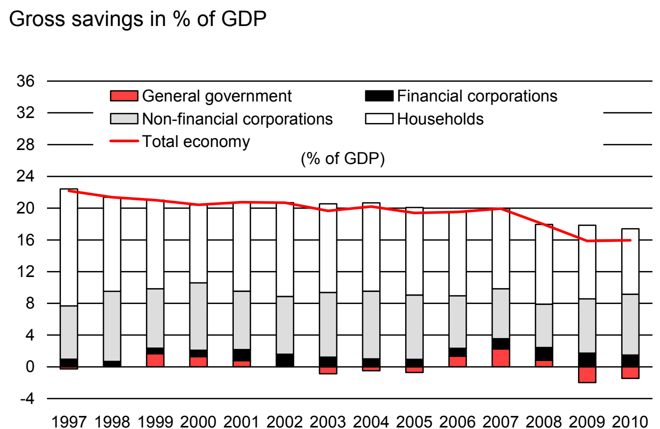
The extent to which the ongoing improvement in corporate savings is sustainable or just a temporary by-product of cyclical forces is difficult to assess. The current recession is expected to result in a renewed decline in profits and self-financing, which will go hand in hand with a decline in the corporate investment rate. This should leave firms' financial position still in negative territory, but the abrupt deterioration seen in 2008 should not be repeated. Still, the corporate sector behavior might help (or at least be "neutral") to improve the current account imbalance in upcoming years. It is highly likely, in fact, that the ongoing change in banks' risk attitude will contribute to shifting Italian firms' preference from debt towards internal financing.

SAVINGS AND INVESTMENT BEHIND THE C/A BALANCE



HOUSEHOLD SAVINGS NEED TO BE MONITORED CLOSELY

Gross savings in % of GDP



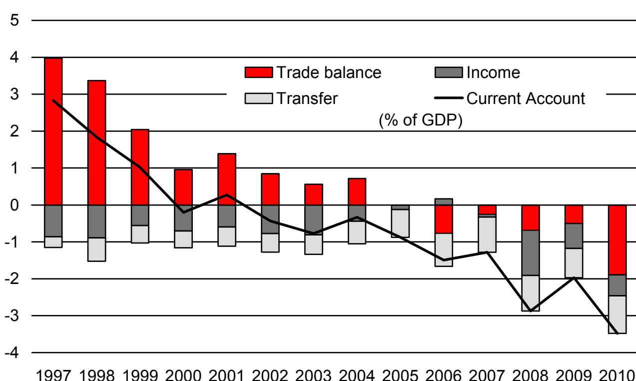
Source: Eurostat, UniCredit Research

There is a greater degree of uncertainly whether the declining trend in the household savings rate can be reverted in the short and medium term. But we are confident that this will happen in the longer term. On the cyclical front, the negative impact of fiscal tightening will continue to weigh on households' disposable income dynamic, and the savings in % of GDP will stabilize at the current low level (with slight improvements) over the next few years, if household spending declines at the same pace (or slightly more) than disposable income. In this respect, job shedding and slowing wages are likely to represent an important drag. Moreover, budgetary consolidation in Italy might induce a confidence-driven decline in household precautionary savings. In contrast, on the structural side, Italy is expected to face an ongoing decline in the working age population in this decade (on average -0.2% growth per annum) and a higher future dependency ratio (which is expected to hit 60% in 2020 vs. 52% currently). This dynamic will likely have a positive impact on the household savings rate, and hence on longer-term current account prospects. Moreover, the potential boost for employment and hence labor income as a result of the reform of the labor market – which is on the government's agenda – will be another factor supporting the improvement in the household savings rate. In addition to these developments – and as far as the public sector is concerned – the strong fiscal consolidation measures already implemented and those in the pipeline, will likely facilitate a clear increasing trend in public savings, supporting a reduction in the current account deficit in the medium and long term.

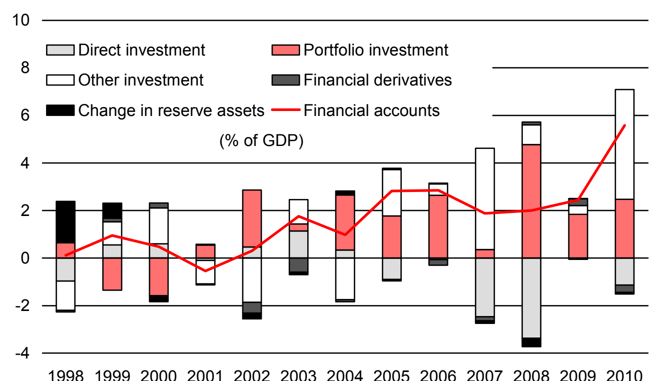
Export growth needs to be enhanced

Looking at the counterparts of the savings/investment dynamics – i.e. the balance of trade, income and current transfers – a retrospective analysis shows that in the period between 1997 and 2010, the 6.3pp deterioration in the C/A was almost entirely driven by a sharp deterioration of the trade balance, while the transfer balance contributed slightly less than 1pp. In contrast, the income balance had an offsetting, although limited effect, improving by 0.3pp. In the following, we will first focus on the income account and then move on to the trade balance. As depicted in the left chart, while the C/A was in deficit for almost the whole period, the income balance never exceeded -1%, with the exception of 2008, being only a minor drag on the C/A balances. This benign dynamics of the income balance reflects Italy's relatively healthy net foreign asset (NFA) position (see box for accounting identities): while having been negative, Italy's NFA always remained relatively contained, ranging between -4.8% and -24% in the period between 1997 and 2010. At these levels, Italy's NFA position does not diverge too much from that of France, which stood at -10.0% at the end of 2010, and that of the UK (-13.5%), and compares more favorably to that of Spain (-87.1%), Portugal (-107.6%), Ireland (-90.9%), and Greece (-99.5%).

TRADE BALANCE DROVE THE CURRENT ACCOUNT DECLINE



C/A FINANCING: PORTFOLIO FLOWS TAKE LION'S SHARE



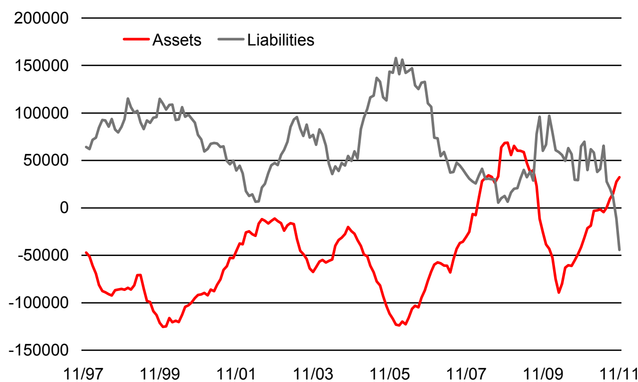
Source: Bank of Italy, UniCredit Research

Needless to say that the outperformance of Germany, which boasted a positive NFA position of 42.4% at the end of 2010, is striking. Note that the composition of liabilities is skewed mostly towards debt instruments, with non-equity liabilities representing around 83% of the total. This results from the predominant role of portfolio investment flows in the current account financing over the last decade. The low absolute NFA position, together with its composition, was probably one of the factors behind the favorable dynamics of the income balance, with Italy benefiting from the process of interest rate convergence related to the euro adoption and later by central banks' ultra-loose monetary policy. Looking ahead, one might argue that the income balance will be negatively affected in upcoming years by the re-assessment of Italy's country risks, which might lead to significantly higher cost of servicing external debt. In this respect, however, it is important to note that since last summer non-residents disposed of a consistent share of their debt-security holdings, mostly government securities (see left chart), while there has been a significant reduction in banking sector foreign liabilities given the difficulties Italian banks recently faced in raising funds on international markets. While it is quite difficult to predict which effect will prevail – that of higher cost of servicing external debt or the decline in external debt stock – we do not see strong indications of the income balance deteriorating substantially and becoming a major drag on the overall current account balance.

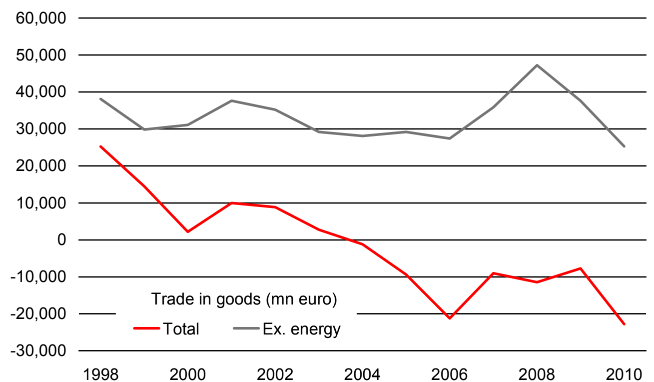
With respect to the trade balance, the 6pp decline from the 4% surplus recorded in 1997 to the -1.9% deficit in 2010, reflects a significant increase in the import-to-GDP ratio from 21.3% to 28.5%, against the backdrop of an only marginal increase in the share of exports of GDP, which rose from 25.3% to 26.6%. The right chart, which shows a strong divergence between the total trade balance and the trade balance excluding the energy components, suggests that rising commodity prices certainly played a role in the sizeable increase of the import share.

DECLINING FOREIGN HOLDINGS OF ITALIAN SECURITIES

Portfolio investment (12M cumulated flows, EUR mn)



RISING COMMODITY PRICES UNDERPINNED IMPORTS



Source: Bank of Italy, ISTAT, UniCredit Research

Having said that, when looking at the relative performance of imports and exports expressed in real terms, the former exceeded the latter, suggesting that the relative performance of the volumes of imports and exports also helps to explain the deterioration of the trade balance. As far as exports are concerned, Italy's performance has been notoriously dismal over the last twelve years (see left table on the next page). This is particularly striking when looking at Italy's exports in comparison with other eurozone countries. While not being the only one among its peers to lose export market share, the decline in Italy has been particularly pronounced. One factor commonly cited as a driver of the weak export performance is the loss of competitiveness of Italy vis-à-vis the main trading partners, which we assess by measuring the degree of REER (real effective exchange rate) appreciation. In particular, we look at the dynamics of Italy's intra-EMU REER, expressed in terms of unit labor costs and export prices. Both indicators

suggest quite clearly that between 1998 and 2010, Italy was one of the countries to have lost the most in terms of competitiveness compared to its eurozone peers, with only Greece being a worse performer. The appreciation of the REER in terms of unit labor costs mirrors a loss of productivity, which has been particularly pronounced over the last decade. The larger appreciation of the REER expressed in terms of relative export prices, however, can be subjected to different interpretations. For example, it might be read as an indication that export-oriented firms managed to pass on the increase in their production costs to the final price of their exports, signaling a gain in market power, but also that there might have been a move up on the product quality ladder.

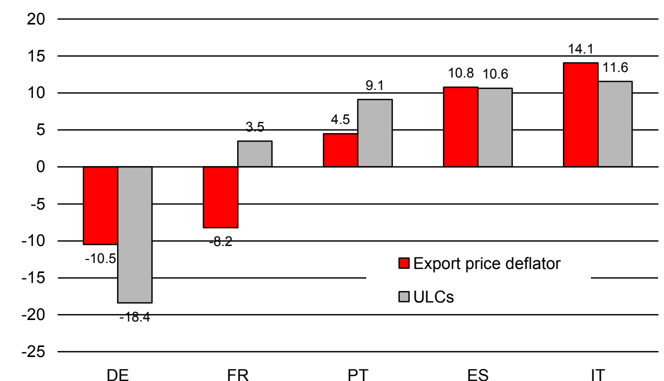
What can we expect in terms of trade balance going forward? On a short-term perspective, we forecast some cyclical pick-up in exports, in line with the recovery in global demand, while weakening domestic demand should dampen import growth. There is, however, one caveat: A simple regression analysis shows that Italian imports are not only driven by some components of domestic demand, namely household consumption, inventories and machinery investment, but also by exports that have become increasingly important in explaining import growth – which is related to the ongoing process of internationalization at Italian firms. This implies that the recovery of exports will to some extent feed through to import growth, capping the improvement in the trade balance. Our bottom line is that in order to achieve a more structural and sustainable improvement in the trade balance, it is of utmost importance that Italy pushes ahead with the process of structural reforms, which should help improve productivity growth and contribute to the country regaining some degree of competitiveness. Some of the reforms already undertaken – in particular the measures implemented to improve the flexibility of markets and the business environment – will certainly bear fruit, but this will be a long process.

ITALY'S EXPORT PERFORMANCE IS DISMAL

World export market share (in %)	*Goods*			*Goods and services*		
	1998	*2010*	*Change in % of initial value*	*1998*	*2010*	*Change in % of initial value*
Germany	9.9	8.6	-13.1	9.1	8.2	-9.9
France	5.5	3.4	-38.2	5.7	3.5	-38.6
Italy	**4.5**	**3.0**	**-33.3**	**4.5**	**2.9**	**-35.6**
Spain	2.1	1.7	-19.0	2.4	2.0	-16.7
Portugal	0.5	0.3	-40.0	0.5	0.4	-20.0

A SIGNIFICANT LOSS OF COMPETITIVENESS

% changes in REER (intra euro area),1998-2010



Source: Eurostat, EC, UniCredit Research

Computing an equilibrium level for the current account

Now we take a longer-term perspective and, following the "External Sustainability" approach, derive an equilibrium value of the current account (or its "norm"), using accounting identities. To put it simply, the "norm" is the value which stabilizes Italy's net foreign asset position – in other words, the current account then can be deemed sustainable in the longer term. Our analysis shows that an adjustment in Italy's external position needs to be undertaken in order to prevent a continuing deterioration of external indebtedness. Once again, the main message is that the reform process is key to speeding up this adjustment.

For this analysis, the standard accounting identities (see box) show that the key variables affecting the "norm" are: **1.** the potential GDP growth and an average inflation rate; **2.** the net foreign asset (NFA) position; **3.** the capital account and capital gains. In our baseline scenario, we envisage long-term real GDP growth of 1.0%[6], an inflation rate of 2%, the ratio of NFA to GDP at -24% – the level prevailing in 2010 – while we assume no capital transfers and no capital gains on the NFA. The outcome is that the value of the equilibrium current account balance in Italy is -0.7% of GDP, which points to a clear gap to the current value. This gap is mitigated only slightly by considering a current account balance adjusted for the economic cycle ("Adjusted C/A", see table next page). Our analysis shows that, while not particularly demanding, crucial adjustments need to be made. In other words, delaying this adjustment would lead to a substantial increase in external liabilities and/or a decrease in foreign assets.

The External Sustainability (ES) approach

The ES approach is an accounting framework in which a current account benchmark is calculated to ensure a stable external indebtedness position. We start with the accumulation equation for the net foreign assets (denoted by B_t), which states that changes in net foreign assets are due either to net financial flows or to changes in the valuation of stocks (capital gains, KG_t). Following the balance of payment identity, net financial flows at time t can be written in terms of the current account balance (Ca_t), capital account (K_t) and errors and omissions (Z_t). We get:

1) $B_t - B_{t-1} = Ca_t + K_t + Z_t + KG_t$;

Dividing equation (1) by nominal GDP (we deflate it) yields:

2) $b_t - b_{t-1} = Ca_t + k_t + z_t + kg_t - \frac{n_t}{1+n_t} b_{t-1}$;

where $n_t = GDP_t/GDP_{t-1} - 1$ defines nominal GDP growth. Let us denote as Ca^s the current account "norm" that would be compatible with a stable NFA position as a share of GDP, b^s, then we get:

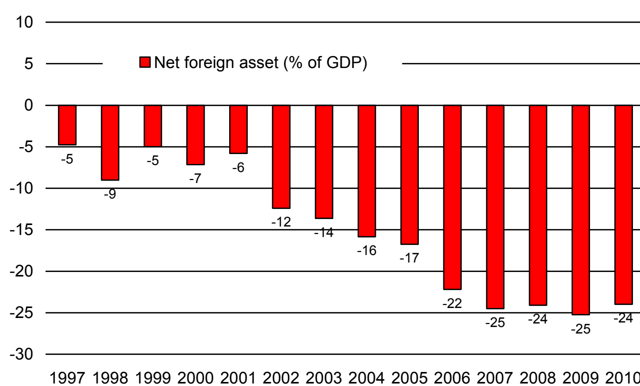
3) $ca^s = \frac{n}{1+n} b^s - k^s - z^s - kg^s$.

We are adopting a basic approach, in which the composition of aggregate assets and liabilities as well as the return on each asset class is implicitly assumed to be irrelevant. This conclusion comes from the fact that **1.** Italy is still characterized by a low level of external indebtedness and a broadly balanced path of assets and liabilities; and **2.** investment income does not represent the main component of the balance of payments. Finally, we make the assumption that on average the errors and omissions component, z^s, is equal to zero.

[6] See our growth accounting exercise in "Italy at a Crossroads", UniCredit Research, 23 November 2011.

To corroborate this outcome, we conduct a sensitivity analysis to verify how the current account benchmark would change. In the first scenario, assuming that capital transfers and capital gains are in line with their 2001-2010 average, we show that the results do not change substantially, meaning that our simplifying assumption is not so binding. Moreover, we consider two alternative GDP growth scenarios – low and high – which tell us that: **1.** the further drag, in terms of competitiveness gap, coming from anemic economic growth in the long term, should be limited; **2.** the size of the equilibrium value of the current account becomes roughly -1.0% of GDP, if the ambitious reform agenda of Monti's government (mostly liberalization, pension and labor market reforms) is implemented to the full extent in the longer term, boosting real GDP growth. This means that a higher level of growth would allow a larger C/A deficit to be run. Finally, we consider two additional scenarios in which the NFA position falls back: **1.** to the average level prevailing over the past ten years, **2.** to the level prevailing in 2001. As expected, the choice of a different NFA position feeds through into different current account norms. While the first assumption does not alter much the level of our baseline C/A norm, the second scenario, implying a current account norm that is broadly balanced, clearly suggests that a sizeable adjustment process is needed to close a gap greater than 3pp.

NFA POSITION: FALLING BUT STILL CONTAINED



A SENSITIVITY ANALYSIS OF THE EQUILIBRIUM VALUE OF C/A

	Baseline	*Last 10 yrs average Capital Account*	*0.5% real GDP growth*	*2.0% real GDP growth*	*Last 10 yrs average NFA*	*NFA in 2001*
Real GDP (% yoy)	1.0	1.0	0.5	2.0	1.0	1.0
Capital Account (% of GDP)	0.0	0.06	0.0	0.0	0.0	0.0
Net Financial Assets (% of GDP)	-24.0	-24.0	-24.0	-24.0	-18.4	-5.8
Current Account Norm (% of GDP)	**-0.7**	**-0.7**	**-0.6**	**-0.9**	**-0.5**	**-0.2**
Current Account (% of GDP) in 2010	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5
Adjusted CA (% of GDP) in 2010 (*)	-3.1	-3.1	-3.1	-3.1	-3.1	-3.1

(*) In the adjusted CA, we isolate the current account dynamic from its cyclical component, through a Hodrick-Prescott Filter method.

Source: Bank of Italy, Eurostat, IMF, UniCredit Research

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