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Is there any hope for Italy?

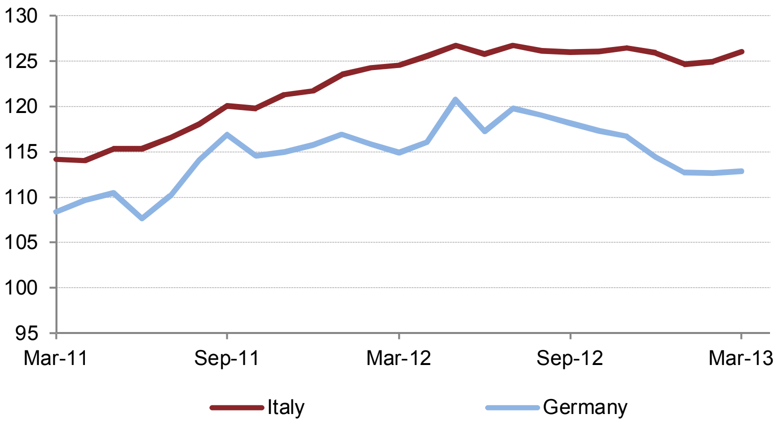
- **In spite of pessimistic outlook, there are a few bright spots in Italy**
- **Broad money growth is accelerating, banks' balance sheets are expanding**
- **Italy does not have to do well; it just has to do less badly than expected**

It is difficult to be other than pessimistic about Italy. GDP fell for a seventh consecutive quarter in Q1, and in Q4 last year nominal GDP was 0.6% *below* its pre-crisis level of Q3 2008. By comparison, French nominal GDP was up 5% since Q3 2008 and German was up 7%, testifying to not just the depth of the Italian recession, but also to the country's low trend growth rate. The latest quarterly *Economic Bulletin* (April 2013) from the Banca d'Italia (BdI) remains pessimistic. Domestic demand remains weak and the government's latest forecast is for GDP to contract by 1.4% in 2013, followed by 0.7% growth in 2014.

However, the *Economic Bulletin* also notes that "[T]he likelihood of an upturn continues to depend mainly on the evolution of business confidence and financial conditions over the next few months"; and that the deterioration in economic activity has slowed. And herein lies at least a small hope for Italian assets. Italy does not have to do well for Italian assets to become more attractive; it just has to do less badly than expected. The question then becomes, are there any signs of this occurring?

Not many – but some. The foreign trade surplus continues to widen, reaching a 15-year high in March. That was partly because of falling imports – another sign of weak domestic demand – but also because exports continue to grow on a 12-month basis.

Consolidated balance sheet of Italian and German MFIs, index September 2008=100



But a more intriguing development is that the Italian banking system balance sheet is expanding and the growth of Italian broad money (strictly speaking: the Italian contribution to euro area M3) is accelerating.

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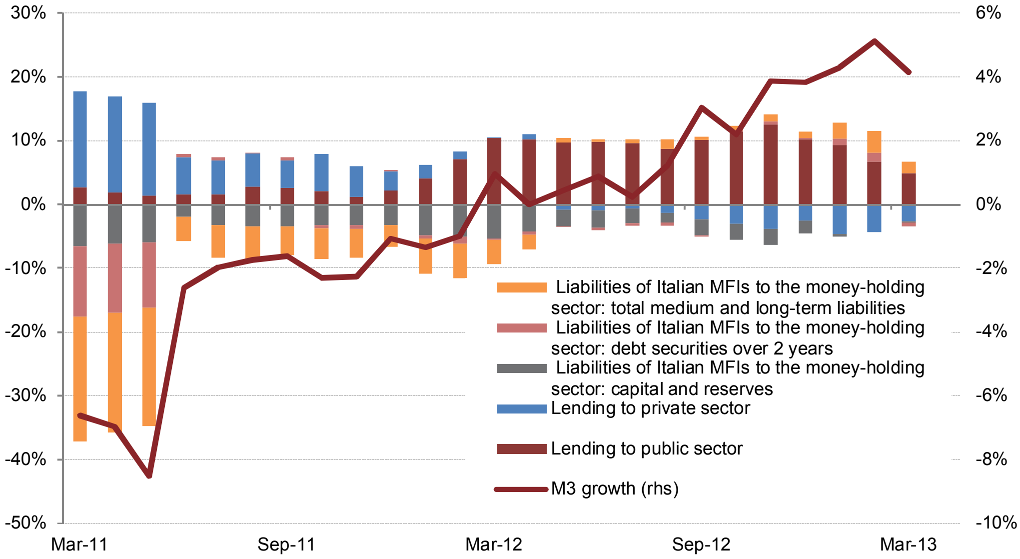
This is in sharp contrast not only with Italy's southern European partners such as Spain; but also to Germany and France.[1] Moreover, the Italian banking system balance sheet is expanding – again contrast to the German – meaning there should be scope for faster broad money (and credit) growth in the near and medium term. On the face of it, this is surprising: both the *Economic Bulletin* and the BdI's April *Financial Stability Report* highlight the weakness of the banking system. Credit – a key counterpart to broad money – is still contracting, notably corporate lending; and banks' profits remain weak. Bank risk premia and expected default frequencies rose in early 2013 (partly connected with the problems at Monte dei Paschi di Siena).

As against that, there are also some bright spots in this sector. While Italian banks have what are by EA standards high proportions of non-performing loans, this is partly because of different definitions; using standard EA definitions, NPLs fall from 12.4% of assets to 8.5%. Moreover banks have continued to strengthen their capital positions.

But this does not explain why bank balance sheets are expanding and why broad money growth is accelerating. For that, we need to look at the components of broad money and at the credit counterparts to M3. (Deposits of the non-bank private sector constitute 96% of total Italian M3, ie, liabilities of the banking system; the credit counterparts are the corresponding assets and banks' capital and reserves. Changes in the credit counterparts must be equal to and opposite changes in M3.)

Italian M3, 12-month change, and main credit counterparts, contributions to 12-month change, %-age points



[1] In last week's Comment, there was a reference to German broad money growth having fallen to "barely 1%"; this figure was wrong. German broad money growth has slowed sharply, but from 9.2% last October to 5.3% in March. It does not change the overall story. Even so, I apologise.

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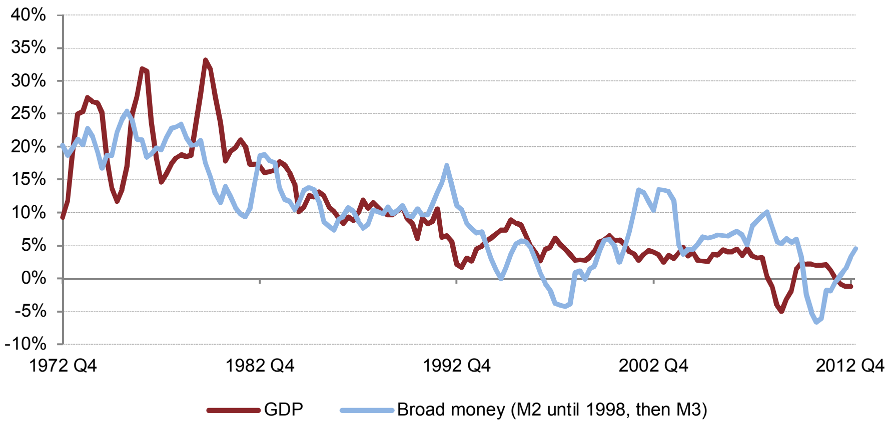
The stock of broad money has risen by a total of €52.7bn over the past twelve months. This is the result of a €79bn rise in overnight deposits and deposits with an agreed maturity of up to two years; partly off-set by smaller falls in other components. The rise in deposits could be a combination of a lower opportunity cost of holding overnight deposits with low interest rates; and a flight of from government bonds because of the default risk, leading to savings in fixed-term deposits to lock in (at least marginally) higher interest rates. On the counterparts' side, the main positive influence is lending to the public sector. Interestingly enough, there is little negative impact from capital and reserves. Given the pressure on EA banks (and banks elsewhere) to build up their capital, and the strengthening of Italian banks' capital, this could otherwise have been expected to prove a further drag on broad money growth.

This is all very technical, but it is also relevant. Italian households and – to a lesser extent – companies, are building up their deposits. This is good for the banking system, as it provides a cheaper and more reliable source of funding for banks than wholesale funding. It is also important because if households are moving out of government bonds, prevailing low interest rates means that they are unlikely to wish to hold their money as cash for long, meaning that they are likely to look for alternative assets. As it happens, Italian mortgage rates are falling and housing loans are rising; and while the Italian stock market may not be a world beater, shares are still up by 40% from a post-crisis low in July last year to late May this year, providing an attractive alternative for return-starved savers.

Italian nominal broad money and nominal GDP, 4-quarter change, %



But it is also relevant because in Italy, as elsewhere, there is a link between broad money developments and output growth. Broad money has historically grown roughly at the same speed as nominal GDP – perhaps not surprisingly, giving Italy's history as a high-inflation economy. Since EMU, which enforced lower inflation on Italy, the velocity of money in Italy has fallen, as it has in most EA countries and over the past 15 years broad money growth has been about 2% faster than nominal GDP growth. As elsewhere, the impact of broad money on activity is subject to long and variable lags. Nevertheless, a surge/slump in broad money growth will be followed by a pick-up/slowdown in output growth. Hence, the recent acceleration in Italian M3 growth, particularly compared with the slowdown in other EA countries should be seen as a positive sign, certainly so if it is prolonged and gathers strength. And, as noted above, Italy does not have to do well to provide money-making opportunities. If Italy does less badly than expected, equities should benefit. But so too should BTPs, since markets would interpret stronger than expected activity to mean less sovereign risk and reward this with a narrower spread over Bunds.

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