CREDIT COMMENTS

ITALY'S ECONOMY SLOWLY IMPROVING

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A little more than a half year since the repudiation of Italy's old political order was begun with the election of Silvio Berlusconi as prime minister, the Italian economy is slowly beginning to improve. Italy's gross domestic product, which began to expand in the final quarter of 1993, registered a healthy 2.3% gain in the second quarter of this year. Overall, the economy is expected to grow between 1.5%-2.0% this year and 2.5% in 1995.

So far it has been an export-driven recovery; Italy's share of world trade has increased markedly since the lira was devalued in 1992. In 1993, exports grew 8.5% in volume terms and the trend continues in 1994 as the world's economy begins to pull out of recession. Asia and the U.S. have been particularly good markets for Italian products, with sales to Asia up 53% in the first quarter of the year. Italians have been increasing their export orders not only because of the weak lira, however. Many companies have reduced production costs and raised productivity by trimming their work forces and investing in new plant. In addition, real wages have declined since 1992, with wages among the large industrial groups rising less than 2% in 1993, half the rate of inflation.

Domestic demand, on the other-hand, which has been weak, is expected to grow only 0.3% in 1994 after declining 5% last year. Construction, heavy industry and the automotive sectors have been hit particularly hard, with Fiat SpA, the country's largest industrial concern laying off tens-of-thousands of workers. The decline in domestic demand was due in part to a freeze on public works projects imposed in 1992 due to the ongoing bribery scandal. The freeze has been lifted, so the construction and heavy industry sectors should begin to pick up by the end of the year.

In addition, Italy's political situation remains unstable depite the fact that the current government was elected with a clear mandate in March, crushing a divided opposition. The coalition partners in the right-of-center government, Forza Italia, the National Alliance, and the Northern League, have been quarreling the last several months over, among other things, Mr. Berlusconi's packing the management of the state-owned television network RAI with his supporters, and his attempt to restrict the powers of the magistrates investigating political and corporate corruption. Also, concerns about conflicts of interest have surfaced; the prime minister's substantial business interests, through his media group Finivest, include television stations and newspapers.

BUDGET DEFICIT REDUCTION

While the Italian economy is finally recovering from the deepest recession since the 1940s, its medium- and long-term prospects will depend in large part on the government's ability to tackle the country's budget deficit and reduce its huge debt of $1.16 trillion, now equal to 124% of GDP, according to Guido Cipriani, a director and sovereign analyst in S&P's International Finance Department. "The government's recently unveiled budget, which contains substantial spending cuts, including health and pension benefits, is a step in the right direction," Mr. Cipriani said. The government's proposed budget would, among other things, freeze pension cost-of-living adjustments, raise the minimum retirement age, and reduce retirement benefits, now at 80% of earnings for most employees.

The passage by the parliament of a budget with significant spending cuts is not a certainty, however, as public dissatisfaction with the plan brought on a one-day general strike in October involving 13 million workers and another is planned for this month. As a result, the Berlusconi cabinet agreed to soften the proposal on early retirement and over 500 amendments to the budget were tabled by members of the governing coalition. Given the fact that the cost of state pensions is the largest item in the budget besides servicing the national debt ($115 billion this year), the credibility of a deficit reduction plan requires the government to follow-through on reforming the country's pension system, according to Mr. Cipriani. Particularly in view of the fact that the problem will only grow worse given Italy's rapidly aging population.

The government will also try to hold down public sector wages as part of its effort to control the deficit. This will probably face less opposition as the country's high unemployment rate (12%) has forced unions to place employment security above wage demands.

PRIVATIZATION

The government also hopes to lower the deficit by continuing to sell-off state-owned companies. Privatizations help reduce the deficit in two ways, Mr. Cipriani indicated. First, the proceeds of the sell-offs are used directly to pay-down outstanding public debt. Secondly, the government no longer is obliged to subsidize what are often loss-making enterprises. In the longer run, ▶

and most importantly, the privatization program will make the Italian economy more efficient, Mr. Cipriani added.

In addition to the strategic oil and gas, electricity, and telecommunications sectors, the government's business empire, through its two large holding companies ENI and IRI, includes hotels, supermarkets, steel-makers, ship builders, machine tool manufacturers, banks, and insurers.

Political abuse, which has been rampant in the state-run part of the economy, would also be reduced as a result of privitizations, according to Mr. Cipriani. State-owned companies were used by politicians to reward their supporters and enrich themselves. Consequently, these companies were poorly managed and rarely made a profit.

By encouraging wider shareholding among savers and institutional investors, the government hopes that privatization of public sector companies will also strengthen Italy's financial markets, which are the least developed of Western Europe's major economies.

Several large privatizations have been postponed this year due to disputes within the coalition. The privatization process is complex and politically delicate for a variety of reasons, but most particularly because the state has been a source of patronage and jobs, especially in the poorer South. The Berlusconi government is committed to moving forward with the selling of state assets, however, it will clearly be a drawn out and contentious process.

To date, the most prominent privatizations, including the large insurer INA, have been in the financial sector, and two of the country's largest banks, Credito Italiano and Banca Commerciale Italiana SpA (BCI) were sold off in late 1993 and early 1994, respectively. The government pushed the banks to be among the first of the state assets to be shed in part to shake-up Italy's antiquated and inefficient banking sector.

For years state-owned banks, like most public sector companies, were used to provide patronage and jobs and consequently were over-staffed and technologically backward. "The Italian banking system also tended to be very fragmented," according to Donald Gabbai an associate in S&P's Financial Institutions Group, "in part because tradition and in certain cases regulatory restrictions prevented them from expanding into each other's territory. New rules governing banking should encourage consolidation among the more than 1,000 Italian banks," Mr. Gabbai continued. Over the past several years the government has lifted restrictions on branching and encourage mergers through tax break. "Even Italy's big banks are small compared to the competition in France, Germany, and the United Kingdom. Consolidation should help banks like BCI and Credito Italiano compete globally and in Europe, although it may place some stress on their asset quality in the short run," Mr. Gabbai concluded.

The two have made moves to purchase medium-sized banks. Credito Italiano proposed a $1.3 billion takeover of $20 billion asset Credito Romangolo of Bologna. And BCI announced plans to acquire control of Banco Ambrosiano Veneto SpA ($27 billion in assets) for $1.13 billion. The BCI-Banco Ambrosiano Veneto combination would create Italy's largest private bank. Both moves are being opposed by the management's of the take-over targets. "The trend toward consolidation will move ahead irrespective of what happens with these two cases," Mr. Gabbai says. "Other large Italian banks, specifically Banca di Roma and Instituto Bancario San Paulo of Turin, are looking to grow through acquisitions." And the large savings bank, Cassa di Risparmio delle Province Lombarde SpA, has been buying stakes in smaller savings banks recently.

In addition to consolidation, Italian banks need to update their technology, revamp their management structures, and shed staff to be able to compete internationally, according to Mr. Gabbai.

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