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Italy's Belt and Road conundrum

Stay or go? A decision by year's end looms for Italy

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Executive Summary

Italy is thinking about leaving China's Belt and Road Initiative (BRI), which raises questions about the risks and opportunities such a move could bring. Rome is trying to find a way to extricate itself without antagonizing China. It must decide what to do by end-2023. The BRI has brought no major increase in Italian exports or Chinese FDI in Italy, which is trying to pull out of a low economic equilibrium. More important are EU grants to help Italy boost its economy. Withdrawing from the BRI could bring Italy closer to its Western allies. An Italian decision to quit the BRI would represent a big setback for the initiative but we would not expect a Chinese backlash. Beijing needs stable ties with Europe.

OUT OF ROAD?

Italy is considering leaving China's Belt and Road (BRI) initiative, which Washington and Brussels criticized Rome for joining in 2019. Italian Prime Minister Giorgia Meloni made clear she disapproved of the deal in comments before she won power last year. Since taking office in October 2022, she has presented herself as a pro-NATO, Atlanticist leader, while taking care not to offend China. But the war in Ukraine and China's close ties with Russia – they committed to a "no limits" partnership in 2022 – have served only to steel her resolve to steer Italy away from Beijing. In May, discussions took place with allies from the Group of Seven (G7) economic powers about the possibility of Italy withdrawing from the initiative.

> "Tensions between the United States and China have compounded Italy's caution."

No decision on the BRI has been taken yet. Under the agreement, either party can end the deal after five years, otherwise the partnership is extended for another five-year term. Italy has until the end of the 2023 to inform China on whether it wants to end the deal. Italy's conundrum is whether to abandon the BRI and move closer to Washington or allow the agreement to renew automatically to avoid the risk of antagonizing China. It is worth noting that the EU is divided on how closely to align with the US hard line on China.

ITALY'S SHIFTING POSITION

Italy's position towards China has evolved. When then-Prime Minister Giuseppe Conte signed the BRI memorandum of understanding with China in 2019, his government wanted to attract foreign investment in Italy's ageing infrastructure, to increase exports and to improve access in China for Italian companies.

A shifting domestic and foreign political landscape has since shaped Italy's position. At home, successive Italian governments have grown more sceptical of China. Abroad, growing tensions between the United States and China have compounded Italy's caution towards Beijing. Moreover, the Covid pandemic impeded economic activity and little has come from the pact, such that it has not delivered the boost to trade that it promised.

Italy's stance hardened under Conte's successor as prime minister, Mario Draghi, who used anti-takeover legislation, or so-called "golden powers", to block several Chinese acquisitions, including of an Italian microchip company. Meloni's government is also using those powers to restrict the influence over tyre maker Pirelli of its top shareholder, Chinese chemical group Sinochem. More broadly, the G7 pledged in May to "de-risk" without "decoupling" from China. In that context, the Italian government is trying to find a way to extricate itself from the BRI, without angering China. Meloni said recently "it is possible to have good relations with Beijing, also in important domains, without them necessarily being part of an overall strategic plan".

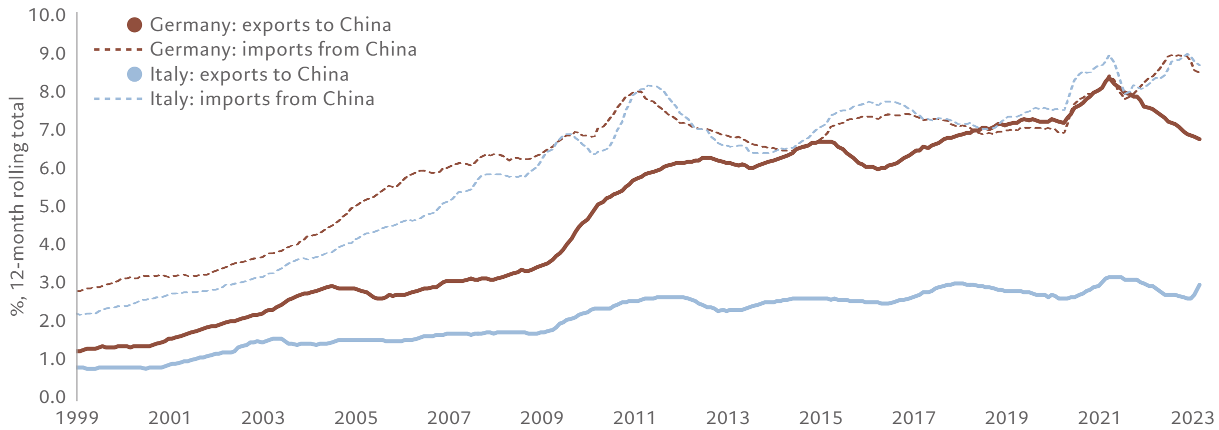
POTENTIAL BRI CONSEQUENCES

The BRI conundrum is foremost a political issue, though Italy's consideration to withdraw from the initiative also has a strong economic dimension: Meloni's government needs to prove itself as a reliable ally in order for Italian companies to win a slice of the bumper US economic recovery plan. Withdrawing from the BRI could help Italy win such a 'responsibility premium' in Washington, and also in Brussels, which it needs to keep onside.

From a trade perspective, Italy is not as dependent on the Chinese export market as other major EU economies such as Germany for example (*see chart 1*).

CHART 1

Exports and imports from China, as a share of total exports and imports

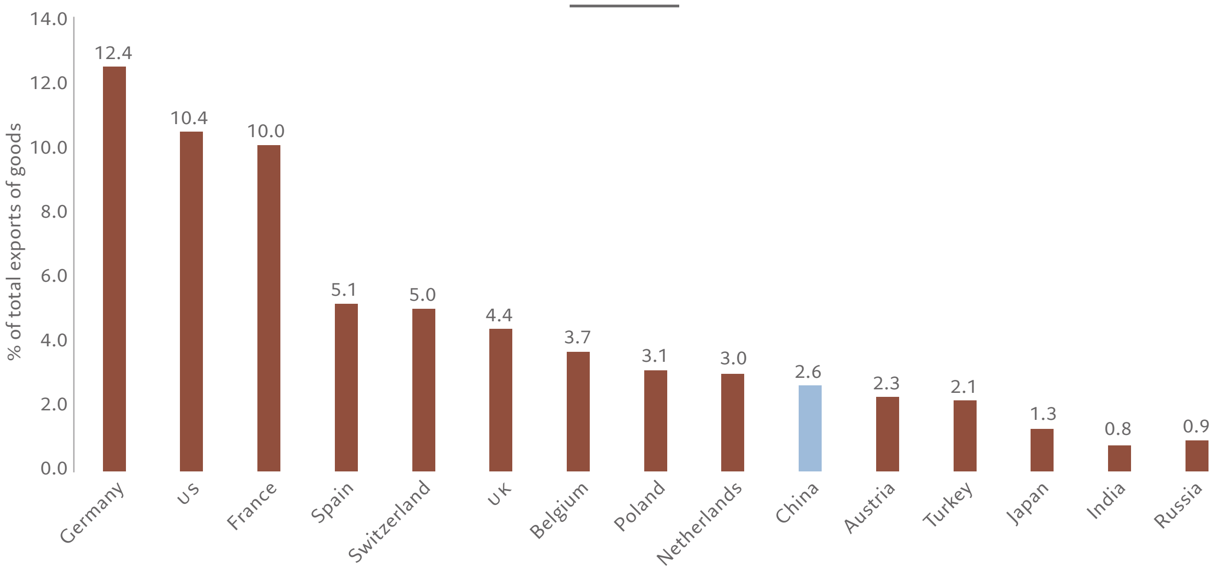


Source: Pictet Wealth Management, IMF, FT, as of 14 June 2023

For illustrative purposes only. There can be no assurance that these projections, forecasts or expected returns will be achieved.

In 2022, the top 5 importers of products exported from Italy were Germany, the US, France, Spain and Switzerland. China accounted for 2.6%of total exports of goods (or 0.9% in GDP). In comparison, China accounted for 6.8% and 4.0% for Germany and France respectively.

CHART 2
Italy's main trading partners – exports of goods



Source: Pictet Wealth Management, Eurostat, as of 14 June 2023

Italy exported EUR16.4bn to China in 2022. The highest value of Italian exports to China was recorded for machinery and transport equipment (EUR6bn) and other manufactured goods (EUR4.5bn).

Since Italy signed the BRI memorandum in 2019, there has been no substantial increase in exports. The recent brief spike in Italian exports to China was linked to a Pfizer Inc plant producing an anti-Covid drug (*see chart 3*).

"Being in the BRI is not a guarantee of more investment."

Moreover, there has not been any substantial increase in Chinese direct investment in Italy in recent years (*see chart 4*) even if the pandemic may have played a role in the slowdown in investments in Italy given the country was one of the most impacted countries in Europe.

Thus, being in the BRI is not a guarantee of more investment. Membership might offer some advantages, but it does not solve Italy's structural problems.

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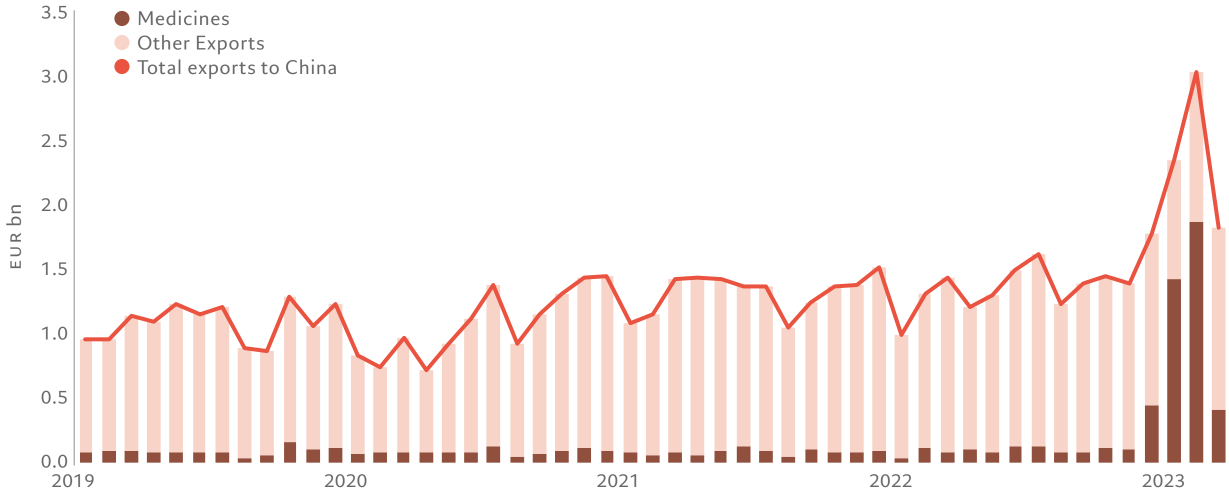
CHART 3

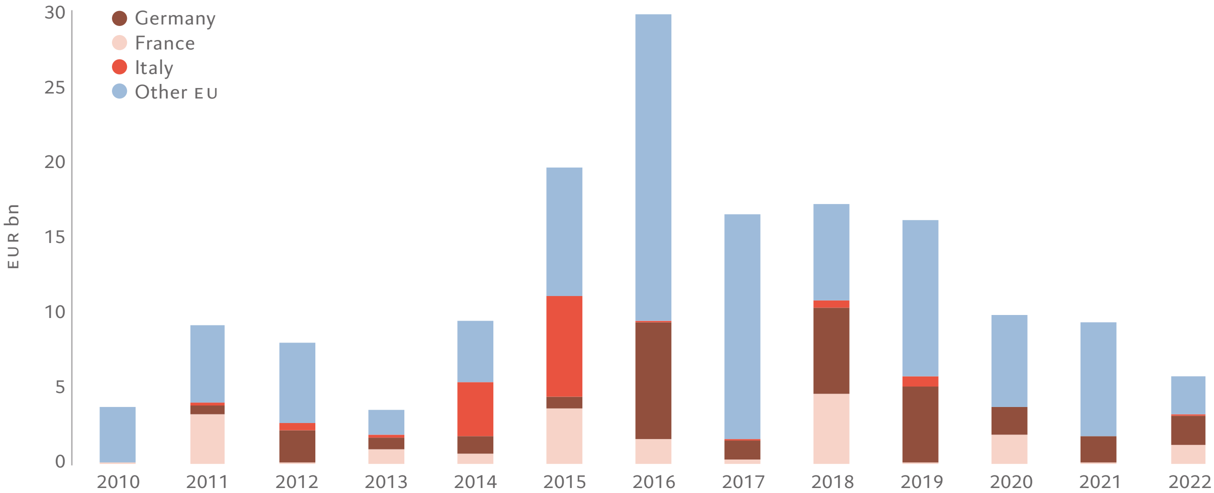
Italy exports to China



Source: Pictet Wealth Management, Eurostat, as of 14 June 2023

CHART 4

China direct investment in EU



Source: Pictet Wealth Management, FT, Rhodium Group, as of 14 June 2023

ITALY'S QUEST FOR ECONOMIC EQUILIBRIUM

Recent economic data have painted a positive short-term picture for the Italian economy. Detailed Q1 GDP data confirmed that the economy avoided recession at the start of the year. Real GDP advanced by 0.6% q-o-q in Q1, entirely driven by domestic demand. Investment, excluding inventories, is now 23% above its pre-Covid level, thanks to the popular 110% "superbonus" refurbishment scheme aimed at energy efficiency. The country is now above its pre-pandemic level, doing better than some neighbouring countries such as France or Germany.

For illustrative purposes only. There can be no assurance that these projections, forecasts or expected returns will be achieved.

Looking ahead, some slowdown is in the pipeline, but the key question is how Italy can pull out of its low potential equilibrium. There is hope that the Next Generation EU recovery plan, established to help countries to deal with the after effects of the pandemic, will also help to pull Italy out of its weak equilibrium and close the gap with the rest of the European Union.

Italy has asked for the full amount of RRF grants (EUR 68.9bn) and for the full amount of RRF loans (EUR 122.6bn) allocated to Italy – a total volume of resources of EUR 191.5bn or 10.8% of GDP. According to official estimates, the plan is expected to lift Italy's GDP by between 1.5% and 2.5% by 2026. Delays to the implementation of projects funded by the programme have prompted the European Commission to express concern, urging Italy to act swiftly.

"China needs to maintain a relatively stable relationship with Europe."

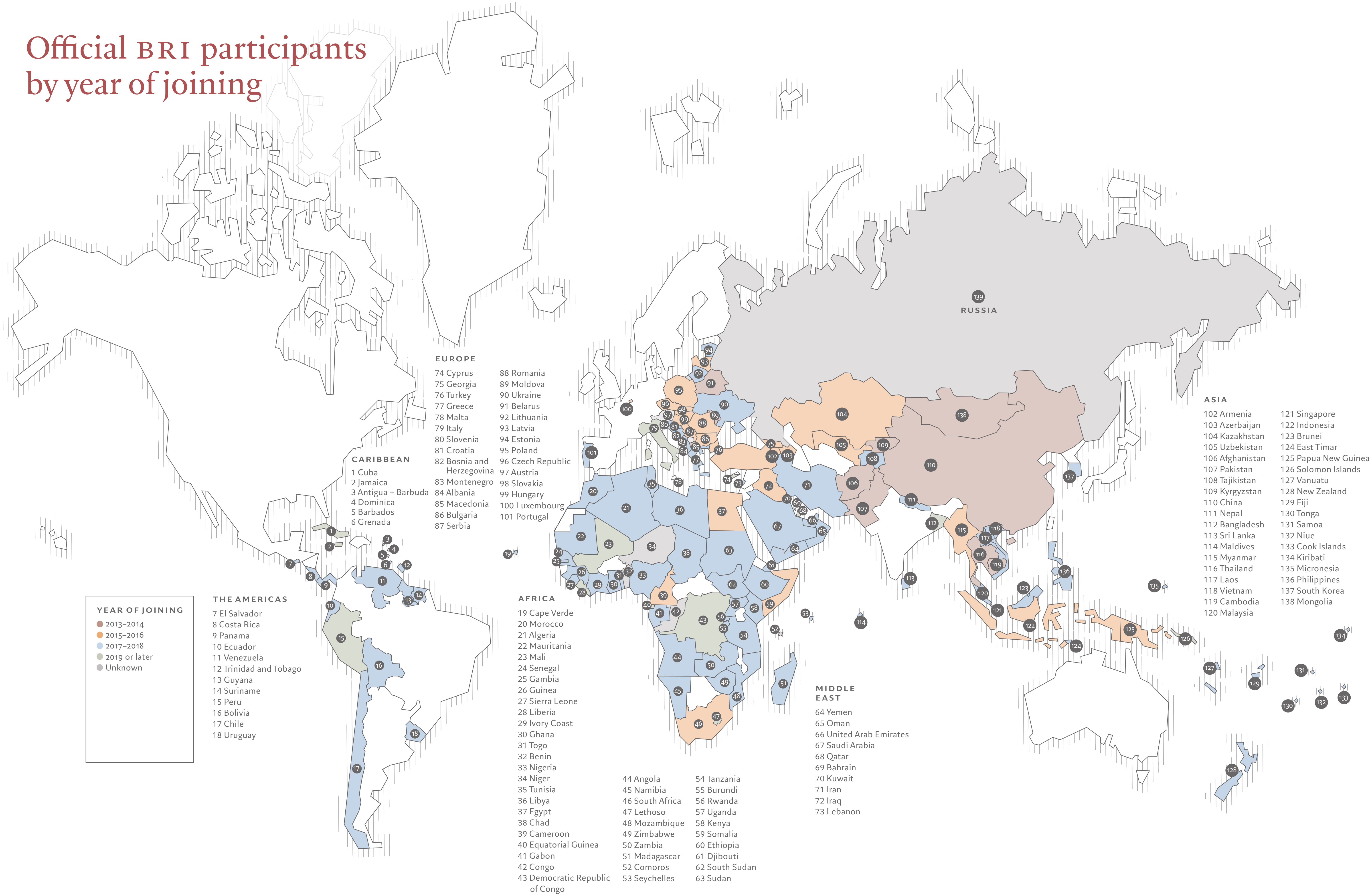
RISK, REWARD....

Withdrawing from the BRI could bring Italy closer to its Western allies, and the US in particular. The disadvantage would be the risk of damage to Italian companies from distancing Rome definitively from China. There are precedents: Western brands that shunned Xinjiang cotton over human rights concerns suffered a consumer backlash in recent years. However, with the global geopolitical situation in flux, that does not mean Italian businesses would necessarily suffer a similar reaction now.

CHINA'S PERSPECTIVE

For China, an Italian decision not to renew its membership of the BRI would represent a major setback for the initiative, which has had mixed results with other signatories too. However, this should not come as a surprise to Beijing, given the decoupling of US-China relations. We would not expect a strongly negative Chinese reaction should Italy withdraw. China needs to maintain a relatively stable relationship with Europe given the cooling in its ties with the US. Retaliating against Italy would not help with that.

Official BRI participants by year of joining



Sources: Green Belt and Road Initiative Center, Belt and Road Portal.

APPENDIX: CHINA'S BELT AND ROAD INITIATIVE: WHAT IS IT?

- Launched in 2013, the Belt and Road Initiative (BRI) is an infrastructure project led by the Chinese government aimed at expanding China's trade footprint
- The programme was initially devised to link East Asia and Europe through physical infrastructure, in the spirit of the original Silk Road Eurasian trade routes
- The project has since expanded into Africa, Oceania and Latin America
- To date, close to 150 countries, accounting for two-thirds of the world's population and 40% of global GDP, have signed onto projects or indicated an interest in doing so
- Italy is the only G7 country to be a member of the initiative, which Rome joined in 2019, hoping the deal would give its economy a lift
- China has described the initiative as "project of the century". The United States and other Western nations are wary, concerned about Beijing's expanding influence.

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