

Italy at a crossroads

- Things are moving fast in Italy! After the political shakeout that led to the formation of a technical government headed by Mario Monti, the country is at a crossroads. Faced with formidable external pressure to deliver, the new government is in the right position to gather bipartisan consensus and push ahead with the set of bold structural reforms that Italy urgently needs. For the time being, however, the markets remain unimpressed, and BTP-Bund spreads still hover around all-time highs.

- Recent developments point to a significant deterioration in the growth outlook through 2013, something which has contributed to increasing investors' worries that the Italian debt dynamics might eventually become unsustainable. Over the next few years, growth prospects will obviously be dampened by the impact of rising financing costs for the private sector, banks' need to recapitalize, and the fiscal tightening already approved and in the pipeline. However, as we face these headwinds, GDP growth in the longer term should return to about 1%. Potential surprises need not be to the downside necessarily.

- When considering flow variables, Italy's fiscal performance compares favorably not only to the periphery, but also to some of the core eurozone countries. This can be explained by the combination of a cautious handling of public finances during the crisis, a sizeable fiscal effort between 2010 and summer 2011, but also a well-established improving fiscal trend, which had brought Italy towards a relatively sound deficit position ahead of the financial crisis in 2007. The political changeover, together with a close monitoring by international financial institutions, should substantially increase the chance that the commitment to fiscal austerity will remain in place in coming years.

- Italian sovereign debt is sustainable even under very bearish assumptions for growth and interest rates. Indeed, the Italian debt/GDP trajectory does not differ materially from that of other major European countries and the US. However, in Italy this is predominantly achieved by tighter fiscal policies (combined with dismal growth), while most other countries, including the UK and the US, achieve broadly similar debt/GDP trajectories by estimating higher growth combined with much less ambitious fiscal policies. Italy needs to make a fundamental decision whether to stay on the low-growth path of previous years or whether to reform its economy to achieve higher growth rates - to the benefit of both its own population and investors in the real economy. Prime Minister Monti has committed to an ambitious reform agenda, and he enjoys very broad support in the population to pursue his strategy. The odds are that he'll succeed.

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A more challenging growth environment

Recent developments point to a significant deterioration in the growth outlook for 2011 and beyond, which has increased investors' fears that Italian debt dynamics might become unsustainable. We argue that, while growth prospects through 2013 look poor, in the longer term, Italy will resume growth rates of close to 1%. In all countries, economic growth automatically reverses to its trend once temporary drags (like fiscal tightening and financial sector deleveraging) have run their course. In this paper, we first discuss in detail the quantification of the drags on Italian growth during 2012 and 2013, then we estimate the long-term growth rate and show that even with relatively high funding costs over the long term, the sovereign debt sustainability is not at risk. Nevertheless, the Italian combination of higher primary fiscal surpluses and low growth is undesirable, and the new government - with overwhelming public support - has laid out an agenda of substantial structural reforms, which if fully implemented, will perhaps raise Italy's long-term growth rate by 0.5-0.6pp.

Short and medium-term outlook

Recent events have forced us to downgrade our growth projections for 4Q11 and for the following two years. In the very short term, **we expect GDP to have stagnated in 3Q, and to contract by -0.6% in 4Q** (vs. our previous forecast of -0.3%), **with some downside risks on both numbers**. In fact, survey indicators have dropped substantially since the summer, when growth momentum was already slowing to a standstill. Concurrently, industrial production, after a strong one-off gain in August, experienced a large correction in September, providing a very unfavorable entry into the final quarter of this year and therefore making it highly likely that GDP will shrink significantly in 4Q. In yearly average terms, we stick to our 2011 GDP forecasts of 0.6%, although this estimate is subject to some uncertainty due to a recent methodological revision¹ of past GDP numbers – note that ISTAT has only published the revised yearly figures, while the quarterly profile will be released on 21 December. **We expect a technical recession at the turn of the year**, as GDP will also likely shrink in 1Q12, although at a more moderate pace. **In yearly average terms, we see GDP contracting by 0.3% in 2012** (vs. our previous forecast of +0.6%) **and expanding by a modest +0.4% in 2013** (vs. +1.0%).

An unfavorable short-term outlook

There are several drivers behind this gloomier growth outlook, some of which have already come into play, while others will start having a material impact on growth at a later stage.

The economy is facing several headwinds

On top of a stronger-than-expected slowdown in global growth, which is partly the by-product of the uncertainty that surrounds Italy itself, the Italian economy is facing three main headwinds that will affect domestic demand prospects:

- Ongoing tensions in financial markets are already affecting – and will continue to – economic activity via a confidence channel, as firms and consumers put their investment and spending plans on hold. Both consumer and business confidence indicators are experiencing a steady downward trend;
- The negative feedback loop between the severe escalation in the sovereign debt crisis, the spike in banks' funding costs, and the banking sector's need to recapitalize and de-leverage;
- The fiscal tightening already implemented and in the pipeline.

The first factor is notoriously difficult to quantify, but it tends to be temporary and, as it comes through a further build-up in households' and corporates' savings ratio, it is typically followed by a full pay-back in terms of temporarily higher growth rates as households and corporates resume consuming and investing. In the following, we take a closer look at the latter two factors.

¹ Note in particular that 2010 GDP growth was revised up to 1.5% from the previous 1.2%.

Tighter financing costs for the private sector

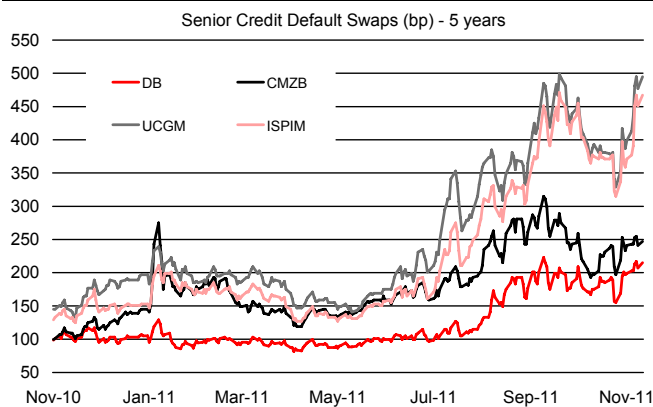
Feedback loop between the sovereign debt crisis and the banking sector

Ongoing tensions on the sovereign debt market have already had a material impact on Italian banks' ability to raise funds - Italian banks' recourse to ECB's refinancing increased to EUR 111bn at the end of October, from EUR 31bn in May - and on their funding costs - the 5Y CDS of the two largest Italian banks has increased sharply since the summer (see left chart).

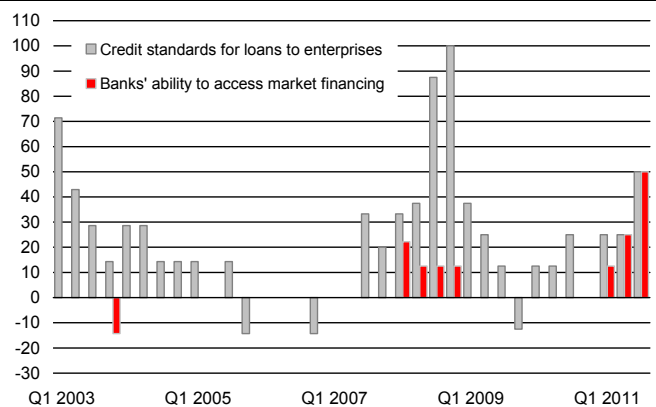
The difficulties the banking sector is facing will affect growth prospects through both: 1) stricter financing conditions for the private sector, and 2) the need for Italian banks to increase their Core Tier 1 capital ratio to 9%, in line with the request from the European Banking Authority (EBA).

1) Tighter financing conditions for the private sector. The latest Bank Lending Survey highlights that during the summer Italian banks significantly tightened their credit standards on corporate loans, with supply factors, such as their ability to access market financing, playing a major role. In the third quarter, this indicator related to market financing conditions hit its highest level since 2003, the survey's inception year, meaning that Italian banks report larger funding constraints than in the post-Lehman environment (see right chart).

ITALIAN BANKS IN THE SPOTLIGHT



TIGHTENING OF CREDIT STANDARDS RE-ACCELERATES

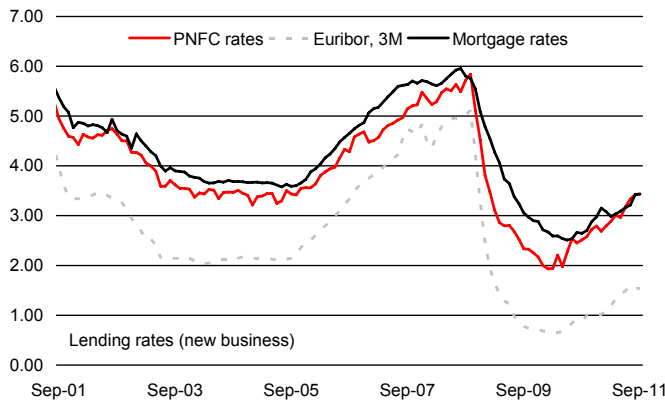


Source: Markit, Bank of Italy, UniCredit Research

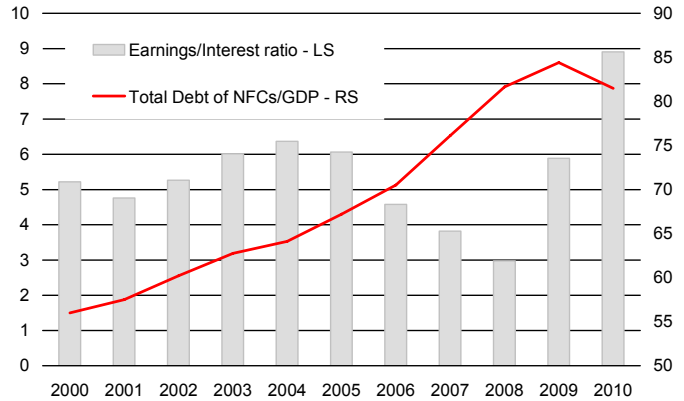
On a more positive note, first we point out that **lending to the private sector still exhibits, at least so far, a moderate pace of expansion, with no evidence of a renewed downturn.** Note, however, that this might reflect the usual time lag (12 months in the case of Italy) between the tightening of credit standards and developments in credit aggregates. Second, when we look at the debt servicing capacity of Italian non-financial corporations – which we measure as the ratio of earnings (before interest and taxes) to interest expenses – we see that the corporate sector entered 2011 in a relatively comfortable position from which to face an increase in funding costs. In particular, the **interest-coverage ratio has increased significantly since the post-Lehman crisis**, greatly benefiting from the prolonged period of very low interest rates, and now stands at its highest level since records begun (see right chart on the next page).

While the worsening of financial conditions tends to hurt non-financial corporations the most, as they are heavily dependent on bank credit to finance their investments, **a negative impact will also be felt by the household sector.** The interest rate on mortgages (new business) has already increased to 3.42% (as of September), the highest level in two years, although this still mostly reflects the increase in the Euribor rates. Moreover, a weak labor market remains unsupportive for private consumption, which is further dampened by the adverse impact on financial wealth and sentiment of the escalation of market tensions, and uncertainties surrounding the cost of fiscal austerity in forthcoming years.

BANK LENDING RATES: A CLEAR UPWARD TREND...



...BUT POSITIVE NEWS FROM NFCS' INTEREST COVERAGE



Source: Bank of Italy, ISTAT, UniCredit Research

Higher capital requirements for Italian banks will affect growth, but not dramatically

2) Higher capital requirements/deleveraging. The output loss induced by banks' additional capital requirements should be overall contained, and will probably materialize starting in 2H12. If we want to quantify this effect, it is important to point out that Italian banks have continued to improve their capital position in 2010 – the Core Tier 1 Capital ratio under Basel II rules rose to 8.3%, according to the Bank of Italy's statistics. Moreover, Italian banks have already announced further capital increases since the beginning of 2011, of around EUR 18.5bn. It is therefore reasonable to assume that complying with the new EBA capital requirements (amounting to EUR 14.77bn) would not require aggressive additional recapitalization. Against this backdrop, in our analysis we consider the impact on economic activity of a 1pp increase in capital ratios, obtained mainly via a higher capital requirement rather than deleveraging. According to the Bank of Italy's estimates², in the context of a fast shift to a new capital ratio target, for each percentage point of increase in the capital ratio, annual GDP growth would decrease by 0.02-0.14pp in each year of a three-year transition period. Moreover, under the specific assumption that a higher capital ratio is achieved with a 75% contribution of capital rising and a 25% contribution of asset shrinking, we estimate a credit contraction of around 2%. A simple analysis of the correlation between real GDP and loan growth shows that, in this case, the drag on GDP could be worth a cumulative 0.3pp by 2013. Overall, a fairly reasonable assumption is to take **0.2pp as a reference value for the GDP impact of higher capital requirements in 2013, with a somewhat smaller effect in 2012**. One final remark: If we look at the latest recession in the aftermath of the post-Lehman financial crisis, there was no strong evidence of a meaningful effect of supply-side credit constraints on economic activity (see box).

BOX: GROWTH IMPLICATION OF CREDIT RATIONING

In order to assess the adverse impact of credit constraints on domestic demand during the 2008-2009 cyclical downturn, we estimated a long-run model linking machinery and equipment investment to its main macroeconomic determinants (GDP, the degree of economic slack, the real long-run interest rate and the real gross operating surplus). The residuals tend to be stationary throughout the whole sample, so we can consider their size as a proxy for investment strength/weakness relative to macroeconomic determinants. In particular, the residuals during the period ranging from 3Q08 to 2Q09 are very close to zero, suggesting that after the Lehman collapse, investment performed roughly in line with its fundamental drivers. We see this outcome as evidence that **credit supply did not play a major role in explaining the investment collapse in the previous financial crisis**. This is not to say, however, that there was no credit rationing in 2008-2009. Rather, the results seem to suggest that the shock to credit supply most probably did not exceed a threshold that can be considered physiological given the intensity of the past recession.

As a matter of fact, **recent literature is not conclusive on the assessment of the impact of credit rationing on economic activity**. The main obstacles are the difficulty of separating the role of credit supply and demand in explaining the behavior of corporate lending, and the fact that the effects on the economy of credit quantity restrictions are variable over time and depend on the phase of the economic cycle.

² Locarno, A., "The Macroeconomic Impact of Basel III on the Italian Economy", Bank of Italy, February 2011.

A recent study by the Bank of Italy³ tries to overcome these problems in the estimate of the link between credit quantities and investment by: 1) Introducing in an investment equation qualitative, company-level information on whether credit applications have been turned down, together with other macroeconomic variables; and 2) allowing these qualitative indicators of credit rationing to interact with dummies indicating the position of the economy in the business cycle. The main finding of this analysis is that credit restrictions do have a negative and statistically significant effect on investment, and that the elasticity becomes larger and more significant during contraction periods.

Source: UniCredit Research

Fiscal tightening

A genuine and ongoing fiscal consolidation effort...

...and a cautious handling of public finance during the crisis

2010 and 2011 fiscal adjustments account for about 5% of GDP

1) **A sizeable fiscal adjustment already on the book.** Markets remain skeptical, but **when we consider flow variables, Italy's fiscal performance looks ok** and compares favorably not only to the periphery, but also to some of the core eurozone countries. This can be explained by the combination of a cautious handling of public finances during the crisis and a sizeable fiscal effort between 2010 and summer 2011. Belt-tightening measures over the last eighteen months came on top of a well-established improving fiscal trend, which had brought Italy towards a relatively sound deficit position ahead of the financial crisis in 2007. The table on the left shows a **significant increase in Italy's structural primary surplus**⁴ between 2003 and 2007 and quite a favorable number in 2010, indicating that **fiscal consolidation is indeed genuine and ongoing**. Note that Italy's fiscal stance in response to the 2008-2009 recession was fairly conservative, and helped to contain the increase in the deficit and debt/GDP ratio.

Against this backdrop, **since last year, Berlusconi's government has implemented a substantial fiscal consolidation effort**: combining the austerity measures passed in 2010 and 2011, fiscal tightening amounts to around 5% of GDP – 1.6% in 2010 and 3.5% in 2011. Admittedly, when looking at the austerity package for the years 2011-2014 that was passed this summer (worth EUR 59.8bn in cumulative terms), one can rightly argue that the mix of measures is suboptimal as 1) the bulk of the consolidation is on the revenue side, and 2) a large part of the adjustment (a cumulative EUR 20bn by 2014) stems from fiscal and welfare reform, the details of which have not yet been specified. This raises some downside risks to the government's fiscal projections. Moreover, we think that, although the size of the **fiscal tightening is considerable**, there will be some slippage – assuming no additional consolidation measures, we see the fiscal deficit still hovering around 1% in 2013-2014 vs. the government's target of a balanced budget in 2013 (see table on the right). Our less optimistic fiscal projections stem mostly from a less benign revenue performance, due to the significant deterioration in the growth outlook and a more conservative estimate of extra receipts from the fight against tax evasion compared to those envisaged by Berlusconi's government in the 2008-2010 fiscal packages. For more details on this latter point, see the box "Estimates of revenues from tax evasion and new provisions" on the next page.

A PRUDENT FISCAL STANCE

GOVERNMENT'S FISCAL TARGETS VS. OUR PROJECTIONS

	Change in the ratios (in pp)								Ratios			
	2003-2007				2007-2009				2010			
In % of GDP	GE	SP	FR	IT	GE	SP	FR	IT	GE	SP	FR	IT
Budget balance*	4.3	2.1	1.4	2.0	-3.3	-13.0	-4.8	-3.9	-3.3	-9.2	-7.0	-4.6
Structural primary balance*	1.8	-0.9	0.6	2.4	0.0	-7.8	-2.2	-1.7	0.1	-5.3	-2.1	1.4
Gross debt	1.0	-12.6	1.0	-0.8	8.6	17.2	14.4	12.5	83.2	60.1	81.7	119.0

(* a positive sign shows an improvement (that is either a reduction in the deficit or an increase in the surplus), while a negative sign shows a deterioration.

In % of GDP	UniCredit projections				Government projections			
	2011	2012	2013	2014	2011	2012	2013	2014
Budget balance*	-3.9	-2.1	-1.2	-0.7	-3.9	-1.6	-0.1	0.2
Primary Balance	1.0	3.0	4.2	4.7	0.9	3.7	5.4	5.7
Expenditures ex-interest	45.6	45.0	44.1	43.4	45.7	44.4	43.6	43.3
Revenues	46.6	48.1	48.3	48.1	46.6	48.1	48.9	48.9
Gross debt**	120.1	120.2	118.8	115.8	120.6	119.5	116.4	112.6

(* UniCredit projections in the table above do not include the additional fiscal adjustment which is needed, according to our calculation, to meet the balanced budget in 2013. (** Government's projections take into account the second aid package for Greece and EFSF issuance until August 2011, while ours do not.

Source: Eurostat, IMF, MEF, UniCredit Research

³ Gaiotti, E., "Credit Availability and Investment in Italy: Lessons from the "Great Recession", Bank of Italy, February 2011.

⁴ We recall that the structural primary balance is calculated stripping out cyclical components and one-off measures. This is the best indicator when it comes to assess the government's fiscal stance.

BOX: ESTIMATES OF REVENUES FROM TAX EVASION AND NEW PROVISIONS

Regarding our assumptions on extra receipts from the fight against tax evasion, there are a few points worth exploring. If we consider the fiscal packages passed by the center-right coalition between 2008 and 2011, **Berlusconi's government projected that the fight against tax evasion would bring in extra revenues worth around EUR 11bn (or 0.7% GDP) per year between 2011 and 2013.** The bulk of this comes from the packages approved between 2008 and 2010, while the measures passed in July-August are forecast to add only EUR 2bn. In our baseline scenario, we prefer to err on the side of caution, yet do acknowledge that the new measures adopted this summer (see below) and the commitment of the newly-appointed PM Monti to enhance the fight against tax evasion, may provide some positive surprises.

Berlusconi's government's targets in terms of extra revenues coming from the fight against tax evasion are indeed ambitious, but not out of reach, if we consider that **the latest ISTAT estimate of the black economy (as of 2008) ranges between 16.6% and 17.7% of GDP.** This implies that more than EUR 100bn of additional revenues per year might be potentially raised, assuming a 100% efficacy of the fight against tax evasion. Obviously, this is just a theoretical exercise, but if we look at the recent past, we discover that in 2006-2007, when Prodi's government set up credible measures to counter tax evasion, the estimate of the revenue windfall was EUR 23bn in two years⁵. Overall, this shows that the assumptions made by the Berlusconi's government (around EUR 11bn of extra revenues per year in the next three years) are optimistic, but not unrealistic.

Concerning **new provisions to enhance the fight against tax evasion** adopted in both the July and August fiscal packages, key measures include:

- Limiting cash transactions to amounts below EUR 2,500; note that the newly-appointed PM has already said he will probably lower this limit;
- An overhaul of regulations governing shell companies as well as their extension to companies repeatedly reporting losses;
- Tax evaders now face harsher penalties, including jail;
- Enhanced involvement of municipalities in tax inspections;
- The reduction in bank secrecy through selective lists drawn up on the basis of information provided to the tax register by financial operators;
- Strengthening of the statistics-based tax assessment (the so called *studi di settore*) and the requirement to include the social security number of the party and of his/her lawyers in judicial records;
- The requirement to inform the Italian Revenue Agency (Agenzia delle Entrate) about transactions that may be subject to VAT;
- Measures to streamline and strengthen financial investigations that can be widened to include insurance companies and bodies that may be required to respond to requests.

Source: UniCredit Research

Drag from the fiscal tightening

2) The impact of the fiscal tightening. The political changeover, together with the close monitoring by international financial institutions, will most likely bring an additional fiscal effort (on top of that announced in the summer). According to our estimates, further belt-tightening measures should be worth around EUR 15-18bn (around 1% of GDP). When he presented the government's agenda, the newly-appointed PM stressed that commitment to fiscal austerity remains a priority. There is also little doubt that the new government will immediately address the issue of welfare and fiscal reform, something which increases upside risk to our estimate of the additional fiscal effort. Assuming fiscal multipliers of 0.5 (see box on next page), the GDP drag of **the fiscal consolidation in the pipeline will be worth a cumulative 0.5pp over the next two years**, which comes on top of the negative impact of the austerity package approved in the summer – i.e. 0.4pp in 2012 and 0.3pp in 2013.

⁵ See "I Risultati della Lotta all'Evasione", Tommaso Padoa Schioppa, October 2007.

BOX: ESTIMATE OF THE FISCAL MULTIPLIER

Estimates of fiscal multipliers in the literature range **between 0.5 and 0.7**. In the case of Italy, several factors should help soften the growth impact of fiscal consolidation and thus **argue for a relatively low multiplier**. In general, empirical studies show that the output cost of fiscal consolidation tends to be smaller when 1) the composition of the **consolidation is skewed towards higher taxes** rather than lower government expenditures, and 2) the country faces a **higher perceived sovereign default risk**, because budgetary consolidation helps to regain market confidence and thus reduces the cost of servicing the debt. According to IMF estimates, in this case, the growth impact of the fiscal tightening could, ceteris paribus, be halved. Currently, Italy enjoys both. However, there are also a few factors which point to **some upside risks to our estimate of the fiscal multiplier**. First, when interest rates are very low and cannot be reduced much further, the effects of fiscal tightening cannot be mitigated by a looser monetary policy. Second, the output cost of fiscal consolidation in open economies like Italy tends to be larger when fiscal tightening is implemented simultaneously across trading partners. Last but not least, in contrast to what the economic theory suggests, budgetary consolidation in Italy is unlikely to induce a confidence-driven decline in household precautionary savings. In fact, while during the crisis in 2008-2010 the saving ratio edged lower as household spending dropped less than disposable income – in what resembles a sort of “consumption smoothing” – going forward we are actually assuming a moderate increase in the saving ratio. Moreover, the confidence channel tends to be stronger when fiscal adjustment is carried out mostly via lower spending - a strategy that is usually more sustainable and signals a strong political will to tackle budgetary inefficiencies, but unfortunately not currently in the case of Italy.

Source: UniCredit Research

The longer-term growth outlook

The longer-term outlook remains one of moderate growth as...

As we come through the poor growth performance of the next two years the pace of economic expansion should stabilize at its trend-growth of about 1%. From a domestic perspective, our longer-term view is based on the assumption that **Italy’s economic fundamentals remain sound**, and thus we do not expect the crisis to have caused a significant decline in potential growth. Of particular note:

...current turbulences will unlikely entail a deterioration in economic fundamentals

1. Italy has one of the largest manufacturing sectors in the eurozone, the second largest when we consider nominal valued added (18% of the total), and the third in real terms (16%, which compares with a 17% share in France), with some excellences, mainly among the quoted and large firms, which are characterized by healthy profits and a positive financial position. If the external environment is favorable, Italy should enjoy a positive net trade contribution in the years ahead;
2. Italy has a highly favorable private sector position in terms of low indebtedness and very high household net wealth. Italian households’ share of global net wealth was at 5.7% in 2009, much larger than the country’s share of world GDP (3%);
3. A still contained C/A deficit, at 3.5% in 2010. Although a moderate widening is expected this year, we assume a narrowing trend in the medium term – with the C/A deficit below 3% – in the wake of a more restrictive fiscal stance and a moderate recovery in household savings due to an improving labor market situation.

A look at the supply side of the economy

One helpful way to look at potential growth in the long term is to decompose **GDP dynamics in terms of labor input and productivity trends**. Our bottom line is as follows: compared to what happened in the seven years preceding the Lehman collapse, when Italy’s GDP grew at an average pace of 1.1% per year, we expect: 1) a **softer**, but still fair, **pace of labor input expansion**; and 2) some **improvement in labor productivity growth**, which should compensate for the lower contribution from labor input. **We think** that the recently approved **growth-enhancing measures will have some positive impact on longer-term GDP prospects**. Following the political changeover, pleasant growth surprises now seem more likely than not: if the reform agenda of the new government will be fully implemented, this will perhaps raise Italy’s long-term growth rate by 0.5-0.6pp.

In the following we summarize the rationale behind our GDP expectations for the current decade (annual average growth of 1.0%). For the more analytical aspects of our growth accounting exercise, please see the box “Growth Accounting”.

We expect softer labor input growth...

A softer labor input growth:

We do not think that the healthy pace of labor input growth recorded in 2001-2007 (1.5% on average) will be repeated. This performance was largely due to the combination of a wave of labor market reforms undertaken during the 90s, which significantly lowered the unemployment rate and lifted the participation rate, as well as a strong acceleration in the growth rate of the working-age population due to several rounds of immigrant regularization.

Coming to our **longer-term projections**, we assume that:

- The average **unemployment rate will stabilize** at around the same level recorded in the last decade (around 8%, vs. 10.4% in 1991-2000), as two offsetting forces will be at play. On the one hand, we expect the recently approved labor market reforms (in particular, the introduction of the so called “contratti di prossimità”) to bear down on the unemployment rate. On the other hand, we think that some of the unemployment increase seen in the last recession, is likely to turn into structural unemployment.
- Regarding **labor-force dynamics**, we project a moderation in 2011-2020, as the **working-age population is forecast to decline by 0.2%** per annum, in a context of still increasing total population⁶ (on average 0.2% growth per annum). Meanwhile, **the participation rate should rise** at roughly the same pace as in 2001-2007, benefiting from measures already implemented - aimed at increasing labor market flexibility and boosting the female participation rate. Moreover, revisions to the pension system implemented so far in order to increase the retirement age will also bear their fruits.

Against this backdrop, we think that **the commitment of the new government** under PM Monti 1) to address in full the duality of the labor market; 2) to **reform the tax system** in order to reduce the tax burden on labor, and 3) to further intervene on the pension side and boost female participation, **is likely to lift employment growth** in this decade with respect to our estimate.

DECOMPOSITION OF ITALY'S REAL GDP GROWTH INTO ITS MAIN DETERMINANTS

Average annual growth rate	Real GDP	Employment	Labor productivity	Total Factor Productivity	Capital intensity	Main employment components			Demographic perspective		
						Employment growth	Unemployment rate	Labor force growth	Participate rate growth	Working age population growth	
	$a=b+c$	b	$c=d+e$	d	e			$a=b+c$	b	c	
1971-1980	3.8	1.0	2.8	1.8	1.0	1971-1980	1.0	6.1	1.2	0.7	0.5
1981-1990	2.4	0.6	1.8	1.1	0.7	1981-1990	0.6	8.6	0.8	0.2	0.6
1991-2000	1.6	0.1	1.5	0.9	0.6	1991-2000	0.1	10.4	0.2	0.4	-0.2
2001-2007	1.1	1.5	-0.4	-0.5	0.1	2001-2007	1.5	7.8	0.9	0.5	0.4
2001-2010	0.3	0.8	-0.5	-0.8	0.3	2001-2010	0.8	7.8	0.7	0.3	0.4
2011-2020	1.0	0.5	0.5	0.3	0.2	2011-2020	0.5	7.7	0.5	0.7	-0.2

Source: ISTAT, Eurostat, AMECO, UniCredit Research

...but a moderate improvement in labor productivity

Improving trend in labor productivity:

Between 2001 and 2007, labor productivity declined at an unprecedented pace (see above table on the left). This was the result of a poor contribution from capital intensity⁷ – the rate of growth of the stock of capital was not strong enough to offset the sustained increase in employment - and a dismal performance in terms of total factor productivity – the legacy of insufficient market competition, virtually zero investments in R&D and human capital and the low level of FDI flows. However, going forward, we expect some recovery in labor productivity stemming from improving total factor productivity, which should come on top of supportive dynamics from the capital-intensity ratio.

⁶ Long-term demographic projections, ISTAT, 2007.

⁷ This is the ratio between the stock of capital and the labor input (in terms of total employment).

In detail:

- The financial crisis took a severe toll on the stock of capital: the annual growth rate, at constant prices, was only 0.8% between 2009 and 2010 (it had been stable at around 2% since 1998), as investments contracted on average by around 3%. We are aware that the financial crisis will probably have a long-lasting effect on the dynamics of fixed investments and we do not expect a return to the pre-crisis pace of growth: long-term interest rates are likely to remain structurally higher than in the previous decade, as investors re-assess risk premium in the aftermath of the debt crisis. This will inevitably affect firms' financing costs, reducing their demand for capital. However, we think that the pace of growth of the capital stock will settle in a reasonable range between 0.8% (the average growth recorded during the crisis) and 2% (recorded in the pre-crisis period), most probably closer to the lower bound of the range. This will likely be sufficient to outweigh the modest labor input dynamics and underpin a **still positive contribution from the capital intensity ratio**.
- Moreover, **total factor productivity should return to positive** (but still modest) **growth** (see left table on the previous page). On the one hand, the financial crisis and higher borrowing costs will probably reduce firms' willingness to invest in R&D, leading to a lasting negative impact on productivity – although the financial crisis may have pushed the least productive firms out of the market. On the other hand, however, we see some positive spillover on TFP from the measures implemented so far to increase the internal competition and to address the weakness of the business environment in Italy (see the last section for more details).

Needless to say, **the more the new government pushes ahead with growth-enhancing measures, the larger the upside surprise in terms of total factor productivity and potential output growth**. In particular, we expect an upside potential coming from a further commitment 1) to promote internal competition; 2) to endorse the increase in firms' size; 3) to promote human capital and to push ahead on institutional reform (e.g. reform of the judicial system). This could support a further increase in the total factory productivity over the current decade. Overall, as mentioned above, if the ambitious reform agenda of the newly-appointed PM Monti should be implemented to the full extent in the longer term, Italy will resume growth rates of about 1.6% rather than 1.0%.

BOX: GROWTH ACCOUNTING

Growth accounting provides a useful framework for analyzing long-term developments in real GDP and supply-side factors. In its basic form, it assumes that the factors of growth can be combined in terms of an aggregate (Cobb-Douglas) production function, with the output Y_t produced by technological efficiency or TFP (A_t), labor (L_t) and capital (K_t):

$$(1) Y_t = A_t L_t^\alpha K_t^{(1-\alpha)}$$

$$(2) L_t = N_t - U_t = N_t(1 - u_t)$$

$$(3) N_t = pr_t P_t^{WA}$$

In our exercise, we measure labor input in terms of total employment and capital input in terms of the stock of physical capital. In the text, we refer to a simplified version of the production function that appears in (1), where output depends on labor, total factor productivity and capital intensity (K_t/L_t).

In order to add more detail to our growth framework, we decompose labor input in other economically meaningful components. In particular, employment (L_t) is defined as the difference between the labor force (N_t) and total unemployment (U_t), expressed as a function of the unemployment rate (u_t). Moreover, we also capture a demographic perspective, by further decomposing the labor force (N_t) in the product of the participation rate (pr_t) and the working-age population P_t^{WA} (the latter defined as the number of people aged 15 to 64).

Source: UniCredit Research

Scenario analysis for debt sustainability

The legacy of high public sector indebtedness

Although Italy's prudent fiscal policy in recent years has prevented a sharp acceleration in **the public debt/GDP**, this ratio **remains uncomfortably high at around 120%⁸**, especially in a context of **structurally low GDP growth and rising sovereign yields**. Following the dramatic escalation of the sovereign debt crisis in the last few months, the yield premium required by investors to purchase debt issued by highly indebted countries, like Italy, is becoming significantly elevated, with negative consequences for debt-servicing costs. In this uncertain environment, **financial markets continue to price in the risk that Italy's medium-term fiscal consolidation plan will not be successful** in reducing public debt at a satisfactory pace. This seems to be the message coming from Italy's CDS spreads (see left chart), which rose again to around 560bp in the last few days, vs. a level of around 490bp in Spain, 240bp in France and 102bp in Germany.

A debt-sustainability exercise

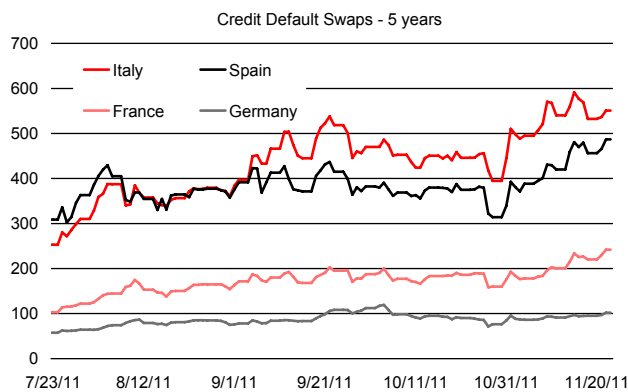
In this section, we carry out a debt-sustainability analysis over the forecast horizon 2012-2030 and, by stressing our baseline assumptions in a more pessimistic direction, we assess the market's perception on Italian debt. Under our baseline scenario, which envisages 1.0% real GDP growth, 2.0% inflation and an effective interest rate paid on the debt of 4.4%, the Italian government would need to run a primary surplus of 2.7% of GDP (average since euro inception: 2.4%) to achieve a decline in the debt-to-GDP ratio to 97% in 2030 (see right chart).

Cost of debt in the spotlight

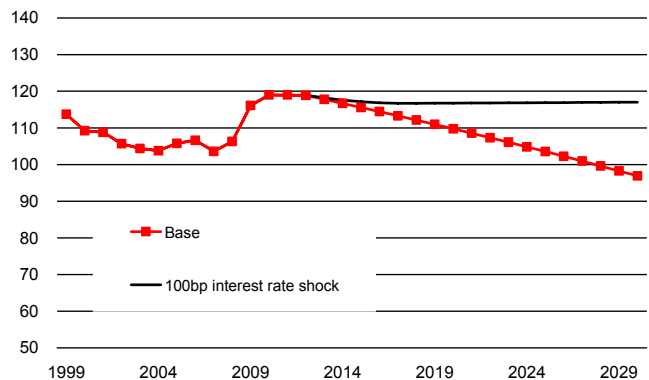
Interest rates: To gauge the implications on debt sustainability of investors' re-assessment of Italy's creditworthiness, **we look at the impact of a permanent 100bp increase** in the effective interest rate starting in 2012, which gradually feeds through to interest spending over the following seven years, i.e. the comfortable average maturity of Italian debt. In this scenario, the debt-to-GDP ratio eases only marginally from the peak and stabilizes around 117% throughout the forecast horizon. We emphasize two points:

1. This simulation reveals **the break-even interest rate which tends to stabilize the debt trajectory (4.4% + 100bp = 5.4%)**, given our base-case assumptions for economic and fiscal fundamentals. As a reference, in the last few weeks the yield of BTPs on the secondary market weighted by their relevant share in Treasury issuance rose well above our break-even level.
2. As higher interest rates are expected to feed through only slowly due to the comfortable average maturity of Italian debt, **we do not anticipate market tensions to have a significant impact on the debt trajectory before 2015** (see right chart). Furthermore, in this stress scenario, we assume that 5.4% will be the new interest rate level consistent with the sovereign risk of Italy for all forecast horizon - regardless of any action by the new government and/or a resolution of the eurozone crisis.

MARKET-IMPLIED PROBABILITY OF A DEFAULT



DEBT DYNAMICS: AN INTEREST RATE SHOCK



Source: Bloomberg, ISTAT, Eurostat, MEF, UniCredit Research

⁸ These numbers are subject to revision due to the methodological changes to past annual GDP figures by ISTAT.

While we stress that the largest risk to Italy's debt sustainability is a permanent interest rate shock, we attribute a small probability to this happening, and we continue to see our baseline scenario - characterized by a descending public debt trajectory - as more realistic. Moreover, when **assessing the impact of a more severe, but temporary, interest rate shock** (a 300bp increase in the next three years) - in a context of weak growth - Italian debt doesn't blow up.

The government's consolidation plan is credible and will ensure a steady decline in public debt

Primary balance: When considering historical trends, the fiscal consolidation path implemented in recent years and that in the pipeline (we expect the primary surplus to rise above 4% in 2014), we see broadly balanced risks to our 2.7% primary balance forecast in a context of 1.0% real GDP growth. However, even when taking into account a less favorable fiscal environment and cutting the primary balance by around 40% to 1.7%, we end up with a scenario of debt/GDP still stabilizing/gradually declining (to around 117% in 2030).

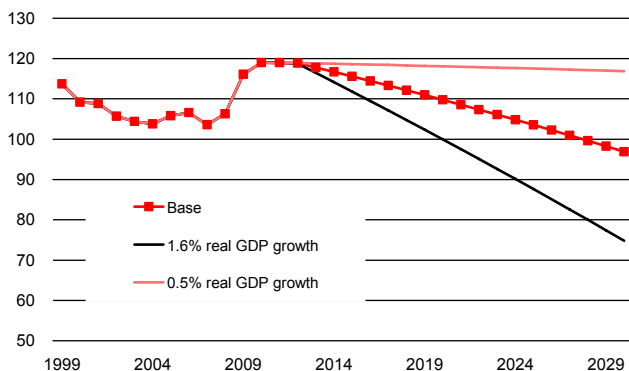
Debt/GDP stabilizes at 117% with only 0.5% GDP growth...

GDP growth: In our baseline scenario, we envisage 1.0% real GDP growth, which is consistent with our long-term estimates. Although we feel comfortable with our GDP assumption, it is important to stress that **structurally lower growth can go hand in hand with debt sustainability**. In particular, we find that public debt as a percentage of GDP should still stabilize at around 117%, even when assuming real GDP growth of just 0.5% and a primary surplus around 2%. This means that, even in a scenario in which investors' concerns regarding weak potential growth are realized, and Italy proves unable to resume decent growth in the next 20 years, public debt may avoid spiraling out of control. While in the near-term risks are skewed toward GDP growth below 0.5%, in the medium-to-longer-term pleasant growth surprises are more likely than a scenario of protracted weakness.

...while it eases to around 70% with 1.6% growth

Needless to say, a much more benign debt pattern would emerge if the new government successfully boosts the country's growth potential via far-reaching reforms on the supply side of the economy. Our analysis confirms that 1.6% real GDP growth (with a primary surplus of just above 3%) would guarantee a fast decline in the debt/GDP ratio close to 70% in 2030.

EVEN WITH SLOW GROWTH, DEBT REMAINS MANAGEABLE



SENSITIVITY ANALYSIS: A SUMMARY OF THE RESULTS

	Baseline	100bp interest rate rise	1.7% primary balance	0.5% real GDP growth	1.6% real GDP growth
Real GDP (% yoy)	1.0	1.0	1.0	0.5	1.6
Primary balance (% of GDP)	2.7	2.7	1.7	2.3	3.2
Effective interest rate (%)	4.4	5.4	4.4	4.4	4.4
Debt-to-GDP (%) in 2015	115.6	117.1	118.6	118.6	111.8
Debt-to-GDP (%) in 2030	96.9	116.9	117.2	116.9	74.8

Source: ISTAT, Eurostat, MEF, UniCredit Research

Structural reforms: where we are and where we need to go

Italy urgently needs structural reforms

Our debt sustainability analysis shows that, as we are passing through the most acute phase of the sovereign debt crisis, **Italy's main challenge remains improving the lackluster growth performance.** The country's very low growth potential is, as argued above, the legacy of the structural decline in productivity over the last decade that has widened the growth differential with respect to the euro area. Against this backdrop, serious reform measures are urgently needed.

Creating structural conditions favorable to growth: the main areas of intervention

These are the **main areas of intervention**:

- Improving the flexibility of markets, via 1) reforming the labor market and 2) measures to increase the level of internal competition;
- Improving the business environment, via 1) supporting firms in achieving a higher degree of international competitiveness, and 2) modernization of public administration;
- Increasing the participation rate in the economy, via 1) reforming the pension system and 2) measures to encourage female and young participation;
- Providing incentives to privatize publicly owned companies, which suffer from several inefficiencies, leading to large income and productivity losses.

Overall, although some initial steps had been already taken by the previous government under PM Berlusconi, a lot of hard work lies ahead for the new government. In the following, we take a look at the main structural measures that have already been implemented (Berlusconi's reform agenda), what is in the pipeline (the "Letter of Intent" presented by Berlusconi to the European leaders, on 26 October) and what is left to do (newly-appointed PM Monti's reform agenda), particularly with respect to the first three areas of intervention mentioned above.

Labor market reform: still hard work ahead

Labor market

- What has been implemented so far: With the reform package approved this summer and the Stability Law passed on 12 November, Berlusconi's government implemented some measures to increase labor market flexibility. In particular, with the emergency package approved in August, the government introduced:

1. The so-called "contratti di prossimità", i.e. company-level or regional contracts with the possibility to regulate every aspect of the organization of labor and production, even departing from national collective bargaining (i.e. rules shared by firms and trade unions at national level);
2. A new national level of discipline for training/internship, aimed at avoiding firms abusing of temporary contracts.

Furthermore, with the Stability Law, Berlusconi's government introduced:

3. Exemptions from social contributions for apprenticeship contracts in the first three years and for entry contracts for women who have been unemployed for at least six months, in order to reduce the large employment gap for youth and women workers.

- What is currently in the pipeline: A crucial step in this area is resolving the persistent labor market duality, which is a result of the coexistence of flexible temporary contracts and overly guaranteed permanent ones. One way of resolving this duality might be to replace fixed-term contracts with **open-ended contracts without fixed limits but rescindable under appropriate economic conditions**, while at the same time **broadening the unemployment benefit system**. In the Letter of Intent, Berlusconi's government set a deadline (May 2012) for approving a reform of the labor market aimed at achieving these goals.

■ What is left to do: When presenting the government's agenda, the newly-appointed PM Monti has pledged to:

1. Address the duality in the labor market, along the lines mentioned above (especially, with respect to a comprehensive reform of the unemployment benefit system), searching for a broad consensus among all social parties;
2. Continue to work to strengthen company level bargaining;
3. **Proceed with the reform of the tax system** in order to reduce the tax burden where it is most distortionary, lowering taxation on labor and output, while increasing it where it is least distortionary, i.e., consumption and property. Cutting the tax wedge via a general reduction of employers' social contributions (not only younger and unemployed female workers) might also be an option.

Internal competition: something has been already done

Internal competition

■ What has been implemented so far: With the emergency package approved this summer and the Stability Law, Berlusconi's government took some initial steps in this area of intervention. In the August fiscal package, it introduced the following:

1. Measures to increase the level of market competition in service sectors, mainly closed professions, by: 1) deciding that no geographic restrictions are admissible, granting full freedom of choice for citizens, 2) eliminating barriers to advertising professional activities, and 3) imposing a compulsory continued training and remunerated internship for young workers;
4. Measures to boost competition in local public services, by limiting direct ownership of public utilities by local authorities.

In the Stability Law, Berlusconi's government further strengthened efforts in this direction:

5. Proceeding with the liberalization of closed professions, mostly via the abolition of minimum tariffs;
6. **Promoting a higher degree of competition in local public services**, limiting the assignment of exclusive rights only to those services where market competition is not conceivable. In addition, the Stability Law states that providers of local public services are required to make public the information concerning their investment, the average cost of service per user, as well as the quality of the services provided. If the local authorities are not compliant, the national government can intervene to implement all necessary measures to increase market competition.
7. Incentivizing the privatization of publicly owned companies.

■ What is currently in the pipeline: In the Letter of Intent, Berlusconi's government pledged to put in place new instruments to increase the degree of competition in specific sectors, such as fuel distribution and vehicle insurance.

■ What is left to do: In his reform agenda, the PM Monti pledged to push ahead the reform effort in this direction:

1. Promoting a more comprehensive reform of Professional Orders in professional activities;
2. Strengthening the role of the Antitrust Authority, in order to prevent any inconsistency between the promotion of market competition at national level and regulations at national and local level;
3. Improving the quality of the public services, with further actions to reduce the competition gap at local level.

Business environment: some measures on the book

Business environment: Entrepreneurship, Innovation and Public administration:

■ What has been implemented so far: This is one of the areas where Berlusconi's government was particularly proactive. In the July and August fiscal packages, it introduced:

1. Tax exemptions for investors in venture capital funds as well as a flat tax rate of 5% (for the first five years) for all new businesses created by young entrepreneurs;
2. A tax credit scheme on investment in research conducted by universities and research centers, amounting to 90% of the new investment;
3. A tax credit scheme for the hiring of temporary workers in Southern of Italy (subject to EU approval);
4. Measures to make the administrative (justice) system more efficient and thus reduce the high cost of doing business.

Prior to Mr. Berlusconi's resignation, in the Stability Law the government approved a general **reorganization of the system of fiscal incentives for the corporate sector**.

■ What is currently in the pipeline: In the Letter of Intent, Berlusconi's government pledged to:

1. Introduce experimental "low red-tape" areas in 2013;
2. Present a special program (called, Eurosud) for the development of southern Italian regions, mostly focused on a more efficient use of resources available from EU Structural Funds;
3. Introduce tax relief to increase companies' market capitalization, through mechanisms of deductibility of the return on equity.

■ What is left to do: In his agenda, PM Monti confirmed the commitment to proceed along these lines, pushing ahead with **further measures aimed to increase firms' size**, mainly through fiscal and welfare reform. Education and human capital development will be another key area of intervention. The new government will take further steps to reform the judicial system, surely via a reorganization of the structure of judicial offices.

Increase in the participation rate

Measures to increase the participation rate in the economy

■ What has been implemented so far: **With the Stability Law, Berlusconi's government increased the retirement age to 67** (to be implemented by 2026). This measure came on top of similar interventions introduced in the July and August austerity packages.

■ What is left to do: These are additional areas of intervention for the new government:

1. PM Monti seems inclined to further push ahead the reform of the pensions system, which might involve **more stringent requirements for accessing seniority pensions**, or even their abolishment (as requested by the ECB);
2. PM Monti pledged to take **measures to boost the low participation rate of female workers**, favoring the reconciliation of work and family life, and possibly introducing a preferential taxation regime.

Overall, **a sound reform agenda is off to a good start in Italy**, although a large amount of hard work lies ahead. Italy needs to convince markets that it can generate sufficient growth to put the debt-to-GDP ratio on a stable downward trajectory. The challenges look manageable, and this is a unique opportunity to deliver.

UniCredit Forecasts for Italy

	2011				2012				2013				Annual average		
	1Q-11	2Q-11	3Q-11	4Q-11	1Q-12	2Q-12	3Q-12	4Q-12	1Q-13	2Q-13	3Q-13	4Q-13	2011	2012	2013
GDP	0.1	0.3	0.0	-0.6	-0.1	0.1	0.0	0.1	0.2	0.2	0.1	0.1	-	-	-
GDP (% yoy)	1.0	0.8	0.5	-0.1	-0.4	-0.6	-0.5	0.1	0.4	0.5	0.5	0.5	0.6	-0.3	0.4
Private Consumption	0.1	0.2	0.1	-0.3	-0.2	-0.2	-0.2	-0.1	0.0	0.1	0.1	0.1	0.7	-0.5	0.0
Government Consumption	0.5	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.1	-0.1	-0.3
Gross Fixed Capital Formation	0.5	0.2	0.1	-0.5	0.2	0.1	0.1	0.3	0.4	0.5	0.5	0.5	0.7	0.1	1.5
Inventories*	-0.5	-0.8	0.2	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	-0.3	-0.1	-0.1
Exports	1.1	0.9	0.0	-0.7	0.1	0.5	0.7	0.7	1.1	1.2	0.9	0.8	3.9	0.7	3.6
Imports	-0.1	-2.3	0.6	0.2	0.2	0.0	0.2	0.5	0.6	0.8	0.9	0.9	2.7	0.2	2.2
Net Exports*	0.3	0.9	-0.2	-0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.3	0.1	0.3
CPI Inflation (% yoy)	2.4	2.6	2.8	3.3	2.7	2.4	2.2	1.6	1.7	1.6	1.7	1.7	2.7	2.2	1.7
Unemployment rate (%)	8.2	8.1	8.0	8.1	8.1	8.3	8.4	8.4	8.3	8.3	8.2	8.2	8.1	8.3	8.3
Current Account (%GDP)	-	-	-	-	-	-	-	-	-	-	-	-	-3.7	-3.5	-2.9
Budget Balance (% GDP)	-	-	-	-	-	-	-	-	-	-	-	-	-3.9	-2.1	-1.2
Public Debt (% GDP)	-	-	-	-	-	-	-	-	-	-	-	-	120.1	120.2	118.8

All data are % qoq unless otherwise specified; GDP data are working-day adjusted.

* Contribution to growth;

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