

## Why Italy is different

- In the first quarter of the year, Italy's GDP growth outperformed most eurozone peers, mainly thanks to stronger exports, firm capex and milder weather conditions that left the construction sector relatively unscathed. However, in the medium term, the outlook remains one of only moderate growth. The boost from trade is likely to ease in coming quarters, following a slowdown in global growth; low capacity utilization and high firms' indebtedness and the expiry of the government incentive scheme are likely to weigh on capex prospects, while the lack of a convincing recovery in the labor market might hamper the consumption outlook. GDP growth will likely average 0.9% in 2010 and 1.0% in 2011.
- External imbalances are increasingly becoming a key variable to assess the vulnerability of a country. We show that, in this respect, Italy seems better positioned than its "periphery" neighbors. However, a dismal export performance over the last decade suggests that a problem of competitiveness does exist. Therefore, it is crucial to take action on many fronts: implementing structural reforms is the way to go.
- From a public finance standpoint, Italy has weathered the storm of the financial crisis remarkably well, as the government has adopted a very cautious approach to fiscal policy. The budgetary correction recently approved by the government is a further step in the right direction, as it achieves fiscal consolidation mainly through expenditure cuts rather than higher taxes. However, the only way towards long-term public finance sustainability will be to achieve structurally higher growth. Once again, the solution can be found in structural reforms.
- Thanks to the reforms implemented in the last two decades, the Italian pension system seems to be in a better position than most of its European peers. However, as most assumptions are made on relatively optimistic growth projections and a structural increase in labor force participation, positioning on a structurally higher growth profile will be crucial also to improve the sustainability of age-related spending.
- The lower level of financial leverage in the private sector compared to the rest of the eurozone places corporates and households in a reassuring position, although some recent developments need continuous monitoring. On the one hand, weak profitability and low self-financing are likely to leave firms' financial position still in negative territory, adding uncertainty to investment decisions in the medium term. On the other hand, weak dynamics of disposable income of Italian households over the last two years put the savings rate on a declining trend, bringing it back to the level of 2000. This, together with lack of improvement in net wealth, might weigh on households' balance sheets in the near future.
- While the debt-to-GDP ratio remains the second highest in the eurozone, Italy's management of public debt features many strong points: a sizeable base of domestic investors, a relatively high average maturity and a low proportion of short-term debt. The presence of a network of specialists contributes to a smooth placement of debt.

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## Contents

3	Executive Summary
5	1. Growth outlook: The moderate recovery story still holds
7	2. External imbalances and competitiveness
10	3. Cautious management of public finances
12	4. A sustainable pension system, but not without risks
14	5. Private sector's balance sheets remain in good shape
18	6. Public debt management

## Executive Summary

**Italy is probably the “swing factor” in the current European crisis: as the largest of the vulnerable countries, and the most vulnerable of the large,** its ability to withstand current market tensions will likely determine whether and how the eurozone can weather the storm. Italy accounts for nearly one fifth of the eurozone’s economy, and over one quarter of its marketable sovereign debt: its stability is therefore essential to the eurozone’s ability to navigate the current crisis. So far, Italy has been a paradoxical success: the country had long been regarded as the weak link, with some investors periodically wondering whether it might eventually leave the eurozone; **yet when it came to the crunch, Italy proved extremely resilient compared to its “periphery” peers,** namely Greece, Ireland, Portugal and even Spain. Contagion-driven tremors have been felt in Italian fixed income markets too, however, and more recently spreads on Italian government bonds have suffered the opaque ECB’s interventions in the sovereign debt market.

It therefore seems to be an **appropriate time to take stock of Italy’s strengths and vulnerabilities,** to assess whether and to what extent Italy really is different from its periphery peers. In this paper we provide a detailed analysis of the key aspects of Italy’s macro outlook, from its growth performance to its external balance, from the state of public finances to the health of its private sector.

The main conclusion is that the tensions which have recently affected Italian bond markets are probably a blessing in disguise: **Italy is genuinely stronger than its periphery peers, but its resilience is eroding and fragile;** a decisive acceleration in structural and fiscal reforms is needed to put the country on a stronger sustainable footing.

**Improving competitiveness and boosting potential growth should be seen as the uncontested number one priority.** Italy’s chronic poor growth performance is well known: the country has consistently underperformed the eurozone average and has experienced three recessions over the last ten years. The first quarter of this year has proved to be a positive surprise, but we expect growth to fall back sub par, with real GDP expanding by a mere 1% this year and next.

In an environment where global trade is the eurozone’s main engine of growth, Italy’s poor competitiveness is a dramatic handicap. Over the past ten years, Italy’s competitiveness relative to Germany has deteriorated by 26% based on unit labor costs and 40% based on export prices, worse than most other eurozone countries. As we already have pointed out in previous analyses, **this loss of competitiveness stems mostly from a dismal performance in productivity,** which actually *declined* by a cumulative 6% over the last ten years compared to a 7% growth for the eurozone as a whole. This is exacerbated by non-price factors, including the relative labor intensity of Italy’s industry, insufficient investment in Research and Development, poor performance in education and training and rigidities in labor, products and services markets.

This lack of competitiveness poses a threat in at least two dimensions. First, poor productivity undermines wage and income growth, thereby limiting domestic demand as well as preventing the country from taking full advantage of the stronger external demand. Secondly, poor competitiveness could gradually contribute to undermining Italy’s external balance.

**Compared to other peripheral countries, Italy’s external position is strong,** with a current account deficit of just over 3% of GDP last year compared to double-digit deficits for Greece and Portugal, for example. This in turn reflects the more robust position of Italy’s household sector, which unlike its peripheral counterparts has not been running up substantial levels of debt during the credit boom period. **This is undoubtedly an important strength, signaling the country’s limited reliance on external financing**—indeed the strong household savings help to ensure that over 50% of Italian government debt is held domestically, an important element of stability. However, Italy’s C/A balance has suffered a slow but steady deterioration, from a surplus of about 2% of GDP in 1998 to a deficit of over 3% of GDP in 2009. This

deterioration reflects largely a decline in national savings, in turn driven by a marked drop in corporate savings as firms went through a significant leveraging process—something else that we have analyzed in detail in past studies.

Just as for the C/A balance, when we look at the financial leverage of Italian corporates we find that the current level is reassuring, but the trend is a source of some concern. **The debt-to-GDP ratio of Italian Non-Financial Corporations is well below the eurozone average** and much lower than in other periphery countries (just half of Portuguese and Irish levels); over the last ten years, **however, the corporate debt ratio has risen fast**, and somewhat faster than the eurozone average. The ensuing financial vulnerability is likely to provide a headwind to investment. Note that while the household sector is stronger, a somewhat similar consideration applies: **while Italian household debt-to-GDP is one-third lower than the eurozone average** and less than half the level of other peripheral countries, **the household savings rate has been declining**, and last year for the first time dropped below the eurozone average.

What does this all mean once we look at Italy's public finances and sovereign debt? Italy's public debt has been uncomfortably high for some time, and is now expected to stabilize just under 120% of GDP in the next couple of years. The government is well aware that the high debt limits the scope for discretionary fiscal policy: last year no fiscal stimulus was provided, so that the budget deficit at 5.3% of GDP settled one full percentage point lower than the eurozone average; recently the government has announced additional tightening measures worth a cumulative 1.6% of GDP over the next two years, to bring the deficit below 3% of GDP by 2012. **The commitment to fiscal sustainability is concrete and credible**, and underpinned by previously adopted rounds of pension reform. Meanwhile, years of living with high debt have been a precious learning experience for the Italian Treasury, and as a consequence **Italian government debt is well managed, with a relatively long average maturity and a smooth redemption profile**—and as we mentioned above, it benefits from a strong domestic demand. Having said all this, however, it is still simply too high. While Japan demonstrates that debt can be kept stable at even higher levels, there is **no doubt that a debt-to-GDP ratio in excess of 100% reduces the room for error, increases vulnerability to shocks, and hinders economic growth**. The commitment to fiscal discipline must be maintained.

But above all, Italy should now accelerate efforts to improve flexibility, productivity, competitiveness and growth. This is needed also to help ensure fiscal sustainability, but first and most importantly to guarantee a sustainable improvement in living standards and incomes. This in turn would help reverse the ongoing deterioration in Italy's main strengths: its strong private savings and robust external position. The European crisis provides a call to action, and the timing is fortunate: Italy's relative strengths are still clear, Italy still is different than the rest of the periphery in some important ways; but the difference is eroding, and the trend must be reversed now.

## 1. Growth outlook: The moderate recovery story still holds

1Q 2010: GDP outperformance vs. eurozone...

...likely due to milder weather conditions

A large carry-over effect for 2010 made us revise our forecast...

... but the medium-term outlook remains one of moderate growth

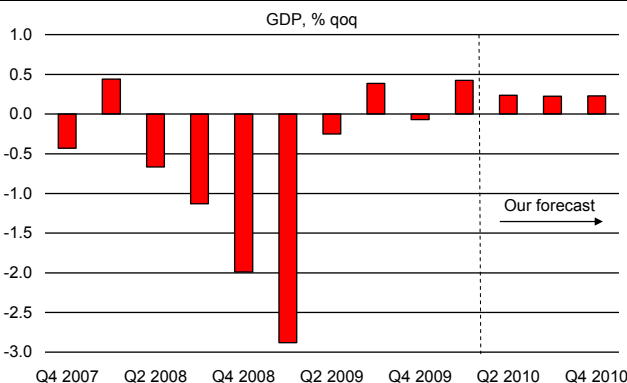
The boost from global growth is bound to ease

In 1Q 2010, Italy's GDP growth came in better than expected, printing at 0.4% qoq. The strength of this figure was underpinned by an upward revision of 4Q 2009 GDP growth, from -0.3% to -0.1% qoq. **The 0.4% qoq increase led Italy outperforming the eurozone in 1Q 2010**, given that GDP in the area was up 0.2% qoq and, among the largest countries, Germany recorded a 0.2% qoq gain, while activity in France and Spain was up 0.1% qoq. However, one should recall that GDP growth in most eurozone countries was dragged down by a sizeable contraction in activity in the construction sector, which was battered by **adverse weather conditions. Italy, on the other hand, remained rather unscathed in this regard** as the trend in construction investment was not severely affected by this one-off factor, contracting by only 0.3% qoq. With respect to the expenditure side, **net exports provided the largest positive contribution to growth**. In contrast, private consumption and fixed investment had a neutral/slightly positive impact on GDP. A positive note came from machinery&equipment investment, which posted a solid 2.2% qoq gain.

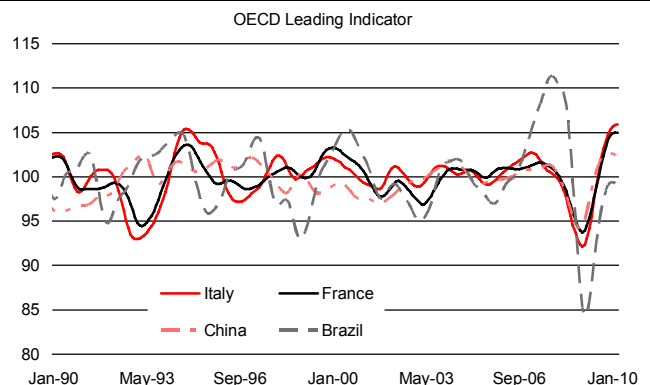
The strong 1Q and the upward revision of 4Q 2009 provide a relatively solid start into 2010 for Italy: according to ISTAT, **the carry-over effect for 2010 amounts to 0.5%**. This means that, should the other three quarters of the year come out flat, 2010 would still close with a 0.5% yearly GDP increase. We recently took stock of this by **raising our 2010 GDP forecast from 0.5% to 0.9%**, leaving basically unaltered our quarterly profile envisaging **moderate growth in the remainder of the year and for 2011, when we expect GDP to be up 1.0%**. This set of forecasts is roughly in line with numbers released by most international organizations. According to the latest World Economic Outlook, the IMF sees economic growth at 0.8% this year and 1.2% the next; the OECD is slightly more optimistic, with a forecast of 1.1% for 2010 and 1.5% for 2011. **Even the government is not too distant from this growth scenario:** in the RUEF (*Relazione Unificata sull'Economia e la Finanza Pubblica*) released one month ago, GDP growth projections were revised down slightly this year (from 1.1% to 1.0%) and more substantially in 2011 (from 2.0% to 1.5%).

**We did not change our medium-term moderate recovery story**, mainly because we have not changed our fundamental view on the structural drivers of economic growth in the coming quarters. First of all, while the strong rebound in global trade is likely to have been one of the main factors supporting the recovery not only in Italy but also in the eurozone, **we expect export momentum to weaken in the next few quarters**, mostly due to a slowdown in world growth, as the contribution from inventory rebuilding is now waning. Signs of easing momentum have indeed emerged in two leading developing economies like China and Brazil, where the OECD leading indicator has clearly turned. Moreover, PMIs are hinting at some **softening of the global manufacturing momentum**, as they remain in expansionary territory, but seemingly off this cycle's peak.

MODERATE GROWTH AHEAD



SIGNS OF PEAKING AT A GLOBAL LEVEL



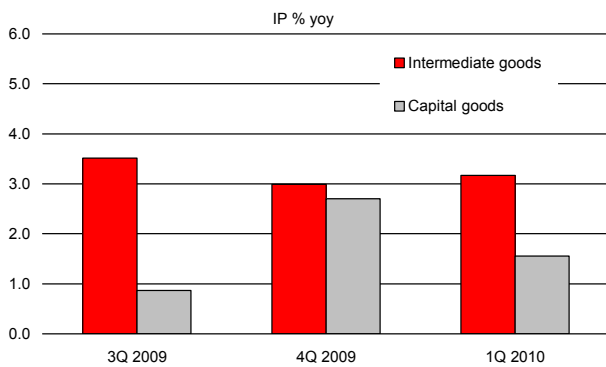
Source: ISTAT, OECD, UniCredit Research

A smaller contribution from the export recovery in the coming quarters is likely to come on top of still **relatively subdued investment and consumption dynamics**. To be sure, the trend in capital goods production so far has remained firmly upward: after the spike during 4Q 2009, when investment goods were up 2.7% qoq, in 1Q 2010 production of capital goods showed a good degree of resilience, increasing 1.6% qoq. However, as we have already noted several times, **it's likely that these positive developments largely reflect the government incentive scheme to sustain machinery investment** until mid-2010 (the so-called "Tremonti-ter"). If this interpretation is correct, the current capex resilience should be interpreted with caution. As a matter of fact, in the past, similar incentive measures had a tangible impact on the near-term investment path, but the improvement was corrected quite rapidly right after the end of the scheme. Thus, the incentive should not have altered the underlying investment trend, which remains affected by cyclical and structural headwinds.

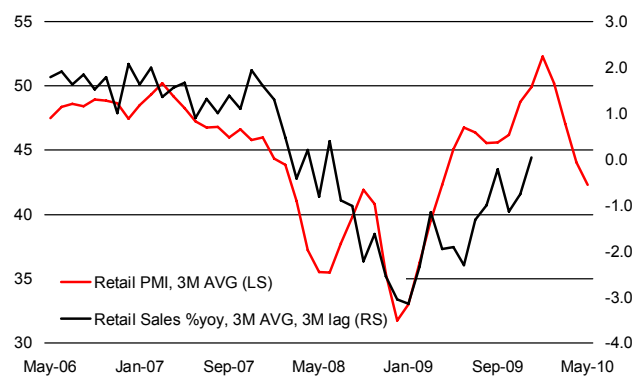
Cyclical and structural factors loom on a sustained investment recovery

In fact, from a more cyclical point of view, **capacity utilization remains extremely depressed** (68.6 in 2Q 2010, slightly up from 64.6 in 3Q 2009) **and well below its long-term average** (75.8), so that it will take some time before we see a sustainable capex recovery. From a medium-term and more structural perspective, **ongoing high corporate indebtedness in a context of still contracting profitability** (see more in the section on private sector balance sheets) is the other relevant factor that argues against a return in positive territory for investment spending already this year. For this year, we expect machinery&equipment and transport investment to flatten out, while a more convincing, albeit still moderate recovery should be expected for 2011. Signs of near-term stabilization in capital expenditure probably won't be matched by a similar development in **construction investment, which should continue to remain weak, due to persistent oversupply**. After a 7.9% drop in 2009, construction investment should decline another 2.3% in 2010; 2011 should see the beginning of a moderate recovery.

**SO FAR, SOLID DYNAMICS IN INVESTMENT GOODS**



**WEAK PROSPECTS FOR HOUSEHOLD CONSUMPTION**



Source: ISTAT, Bloomberg, UniCredit Research

Time is not ripe for a household consumption recovery...

**We expect that a genuine recovery in household consumption will materialize only in the second half of next year.** While private outlays were well supported by the car scrapping incentive during last autumn, the **expiration of the incentive scheme in the automotive sector** (not compensated for by a more contained incentive scheme for household appliances) **will negatively affect consumption dynamics** in the current year. The Retail PMI, which so far has done a decent job in tracking this aggregate, tumbled significantly during the first five months of the year, from 54.4 to 40.3, although much of the decline might be explained by the collapse in the car sub-index. Moreover, **the labor market has not yet provided any signs of a convincing pick up**: in January-April, employment was down 86k, basically the same drop experienced in the four preceding months (-87k), while the unemployment rate keeps trending up and is likely to peak at around 9.2% at the turn of the year. A more positive sign comes when looking at a fundamental standpoint, as **households' balance sheets are surely in a relatively sound position**, with a very low level of indebtedness, although the savings rate has kept declining in the past years (see section 5).

...as auto incentives expired and labor market remains weak

**Bottom-line: Signs of a more sustainable GDP upswing are unlikely to emerge before 2011**, when investment fundamentals will have improved sufficiently to allow for the beginning of a more genuine recovery in capital spending. In turn, this should have positive spillover effects on the labor market, the crucial missing link for a lasting recovery.

## 2. External imbalances and competitiveness

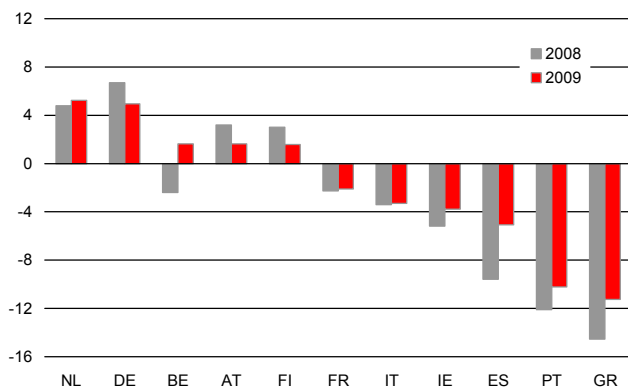
While recent tensions in the sovereign debt markets have brought the attention on public finances, in an environment where financing has rapidly become more scarce and more expensive, **the key variable to understand the vulnerability of a country is the Current Account (C/A) balance**, which measures a country's net external borrowing position. Broadly speaking, the C/A deficit can be seen as the difference, at the aggregate level (i.e. public and private) between savings and investment. If a country experiences a large C/A deficit, driven more by private saving and investment decisions rather than government borrowing, the adjustment towards a lower C/A deficit will require a painful medium-term deleveraging process both by households (via higher savings) and corporate (via lower investment), which obviously has negative implications for the potential growth rate of the economy. If the C/A deficit is driven mainly by profligate public finances, this will require a prolonged period of fiscal consolidation, which, ceteris paribus (i.e. without intervention to stimulate the economy's growth potential), will hamper growth, at least in the short term. Thus, it is key to analyze the recent **Italy's current account (C/A) dynamics and its underlying drivers** to see how vulnerable the country is, and which recipes can be adopted to strengthen its position.

Recent current account developments do not raise big concerns...

**In 2009, Italy experienced a C/A deficit (as a % of GDP) of 3.3%**, which puts the country in a relatively comfortable position when compared with Greece or Portugal, both in the neighborhood of a 10% imbalance. It should be noted that, among the countries which were already experiencing a C/A deficit in 2008, Italy (together with France) was the one where **the balance remained substantially stable vs. 2008**, in contrast with large reductions of the C/A deficit of 4.5pp in Spain, 3.4pp in Greece and 2.1pp in Portugal. This may be the consequence, especially for Italy, of a less compelling need to adjust for past excesses (e.g. residential investment in Ireland and Spain and public dis-saving in Greece and Portugal). Moreover, differently from Greece, Portugal and Spain, **Italy has not always experienced a C/A deficit**: the balance was in surplus in 1997-99, hovered around zero in 2000-02 and then worsened steadily over the most recent years. Admittedly, at 3.3% of GDP, **the C/A deficit raises fewer concerns than the huge numbers in the other three countries**.

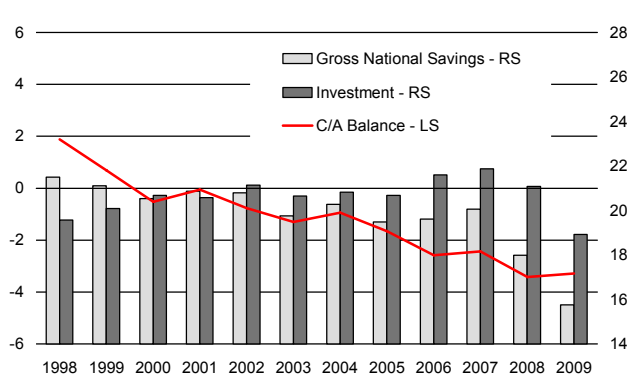
DIVERGENT C/A PERFORMANCE IN THE EUROZONE

Current account balances in % of GDP



SAVINGS AND INVESTMENT BEHIND THE C/A BALANCE

In % of GDP



Source: National Central Banks, Eurostat, UniCredit Research

...but the savings deterioration sounds an alarm bell

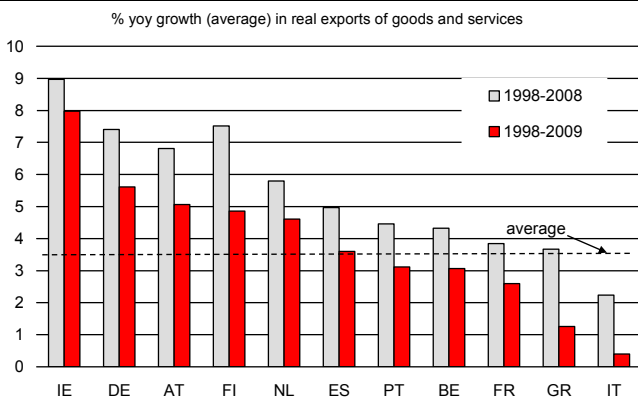
However, over the last decade, **Italy's C/A deficit has increased steadily**. This raises the need to monitor whether Italy is following the route of Greece, Portugal and Spain and is just lagging behind, or whether it is in a structurally different position. In the first case, it would be helpful to explore which actions need to be implemented to reverse such a trend. This can be done in the first place by adopting a **savings and investment perspective**. From 1998 to 2009, **the deterioration of the external position was due mostly to a drop in gross national savings (as a % of GDP)**, which were down 5.7pp, thus outpacing the small decline in gross investment (-0.6pp). Keep in mind, however, that the latter hides a relatively stable trend in 1998-2006, which was followed by a plunge in investment activity in the last couple of years. In contrast, **the decline in gross savings was due to a deterioration in both public and private savings**. In particular, over the last five years, public deficit as a percentage of GDP averaged 3%, while in the private sector a relatively sound position of households was offset by a marked decline of corporate savings (3pp from 2005 to 2008), on the back of increasing firms' indebtedness and higher interest expenses.

Therefore, **the deterioration in Italy's C/A position seems to stem more from a lower capacity to save** (and retain internally-generated funds) rather than from an increase in productive investment spending. In turn, this might hamper the long-term outlook, as this provides little support to a sustained increase of the economy's growth potential.

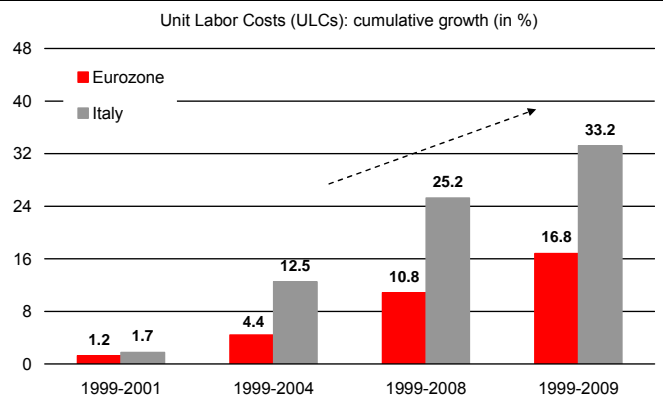
Moreover, the current account balance tends to be related to **export performance and to price and cost competitiveness**: countries with a large C/A deficit usually exhibit a worsening external position reflecting a loss in price competitiveness. **Italy's export performance over the last decade is dismal**: in 1998-2009, export growth in real terms averaged 0.4% per annum and even when we exclude the 2009 plunge, the average increase remains at 2.2%. In both cases, this is well below the eurozone average (3.8% and 5.5% respectively). More worryingly, looking at the last decade, we note that the Italian export performance is structurally lagging well behind not only the "export champions" (Germany, Austria and Finland) but also Greece, Spain and Portugal. These numbers show that the export performance remains an area of concern that calls for decisive **action to improve Italian firms' competitiveness**, and needs further investigation.

The poor export performance...

ITALY'S EXPORT PERFORMANCE IS DISMAL



ITALY: GROWING LOSSES IN COST COMPETITIVENESS



Source: ISTAT, Eurostat, UniCredit Research

...goes hand in hand with loss of competitiveness

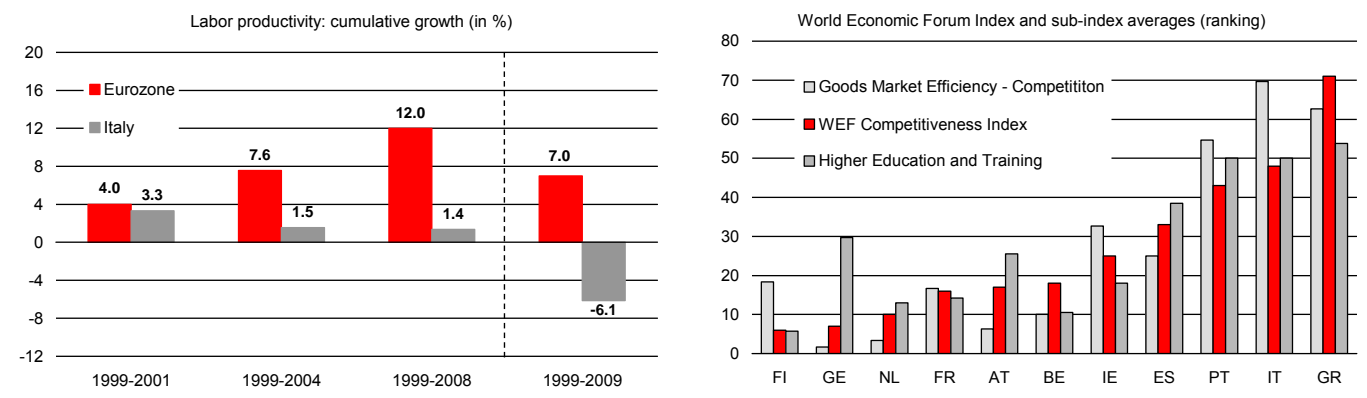
We analyze Italy's competitiveness using measures of Real Effective Exchange Rate (REER) based on the GDP deflator, export prices and unit labor costs (ULC). Unsurprisingly, **the largest appreciation (i.e. loss of competitiveness) occurred in terms of export prices**: the REER based on this metric appreciated 23.2% between 4Q 1998 and 3Q 2009, worse than Spain and Greece (15.1% and 18.1%, respectively). As the export prices-based REER depreciated 12.5% in Germany and 16.7% in Finland, Italy's loss of competitiveness with respect to these two countries was around 40%. Similar figures can be obtained when looking at the REER based on unit labor costs, which in Italy appreciated by 10.5%, one of the largest

Once again, the under-performance of labor productivity is center-stage

increases in the eurozone; in this regard, as German REER depreciated 15.5%, the loss of competitiveness was still an impressive 26%. As the appreciation in terms of GDP deflator and CPI was significantly tamer (7.3% and 2.6%, respectively), it is clear that, beyond export prices (which nonetheless remain high compared with other eurozone countries), **the other area of concern is given by ULC developments.**

Here, the story is well-known but still provides some interesting insights. The increase in ULCs over the last decade (+33.2% vs. 16.8% in the eurozone) stems more from a decline in labor productivity than from an increase in compensation, which indeed was much lower than in high-wage countries like Ireland, Greece, Spain and Portugal, and in line with increases recorded in France and Belgium, for example. We confirm that in Italy the cumulated productivity growth rate was always outstandingly low, and for the last ten years it was negative by around 6% (which compares with a positive growth rate of 7.0% in the euro area). This would mean that **Italy does not have a significant wage problem** and, as we have stressed several times, in order to regain competitiveness, **the issue of raising productivity growth seems the most compelling one.**

**THE LEGACY OF LASTING PRODUCTIVITY UNDERPERFORMANCE COMPETITIVENESS IS MADE OF MANY THINGS<sup>1</sup>**



Source: ISTAT, Eurostat, WEF, UniCredit Research

Non price competitiveness plays a key role, too

Still, we cannot forget that problems in Italy's competitiveness stem also from **non-price factors showing how business-friendly an economy is** (e.g. production and technology structure, goods market efficiency and institutional quality). We took a brief look at some of them. First, as the production structure determines how and to what extent rising wage costs can be passed on to international markets, Italy's **prevalence of labor-intensive production may be a drag for competitiveness**, especially when compared with countries with higher capital intensity (France, Austria and Germany)<sup>2</sup>. Second, a further element of non-price competitiveness is the innovative capacity of the economy. In this respect, **at 1.2% of GDP, the level of expenditure in Research and Development (R&D) remains well below the eurozone average (2%)**, far from the most innovative economies (Finland: 3.7%, Germany: 2.6%) and closer to Spain (1.4%) and Portugal (1.5%). Finally, when looking at the rankings for composite indicators of Higher Education/Training and Goods Markets Efficiency (i.e. competition) from the WEF Global Competitiveness Index, Italy is called on to make the same effort as the most vulnerable countries such as Greece, Portugal and Spain. A ranking of 70 (while Germany and France rank in the first 15) implies that there is **large and urgent need to improve market competition**, clearly a crucial step on the road to gain competitiveness.

**Bottom-line:** While Italy seems better placed than its "periphery" neighbors from an external imbalance perspective, the deterioration observed over the past years stems from a series of structural weaknesses, ranging from scarce export attractiveness, to low labor productivity, to insufficient non-price competitiveness. Thus, actions should be taken on these fronts, in order to raise Italy's growth potential.

<sup>1</sup> For a more detailed analysis of indicators of competitiveness, see the full report of the World Economic Forum, available at <http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm>

<sup>2</sup> See "From External Imbalances to Competitiveness. And Return", UniCredit Euro Compass, March 2010.

### 3. Cautious management of public finances

A cautious fiscal stance left Italy relatively unscathed in the sovereign debt crisis...

...but the high level of public debt may be a concern

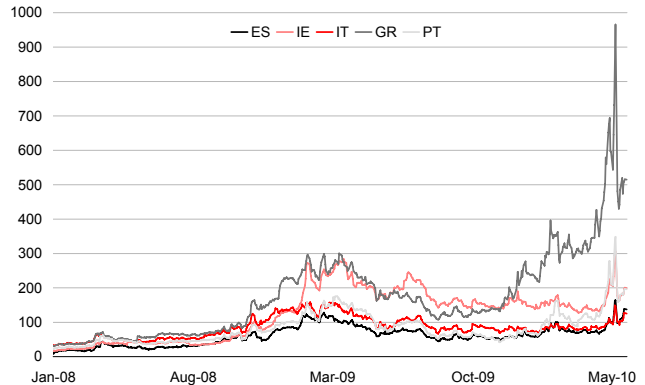
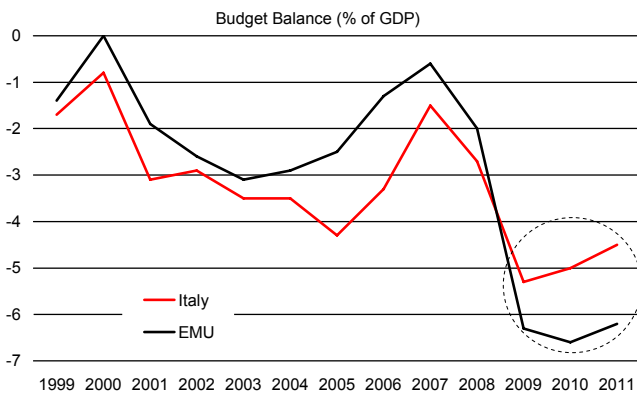
The RUEF 2010: a more prudent stance on economic growth

We have already stressed several times that, **from a public finance standpoint, Italy has weathered the storm of the financial crisis remarkably well**, as the government has adopted a very cautious approach to fiscal policy, with discretionary expansionary measures amounting only to a few tenths of a percent of GDP. This prudent approach led to Italy closing 2009 with a deficit-to-GDP ratio of 5.3% vs. 6.3% for the eurozone as a whole, thus marking the first outperformance since inception of the euro. However, the relatively good performance on the deficit side did not prevent the ratio of debt-to-GDP from surging almost 10pp, from 106.1% to 115.8%. This is **a sober reminder that Italy's position cannot be considered completely safe**, given the country's low growth potential and, possibly, its not-too-distant past of fiscal profligacy. Therefore, while Italy remained very resilient as long as market focus was on the weakest countries (Greece and to a lesser extent Portugal and Ireland), as soon as contagion across eurozone peripheral countries began to spread in a less discriminating way, **we were not surprised to see Italy in the spotlight again. Therefore, we provide here a thorough assessment of fiscal policy through 2012.**

**Assuming unchanged policies:** According to the RUEF (*Relazione Unificata sull'Economia e la Finanza Pubblica*) published on 6 May by the Ministry of Economy and Finance, **the deficit-to-GDP ratio should decline moderately 5.0% in 2010**. However, with respect to the Update of the Stability Program published in January, the budget deficit forecast was **hiked to 4.7% and 4.3% in 2011 and 2012** (from 4.3% and 3.9%, respectively), mainly on the back of lower tax receipts (mostly direct taxes). As far as the debt burden is concerned, **the debt-to-GDP ratio is seen at 118.4% in 2010, 119.5% in 2011 and 119.6% in 2012.**

ITALY'S FISCAL OUTPERFORMANCE VS. EUROZONE...

... HAS BEEN ACKNOWLEDGED BY FINANCIAL MARKETS



Source: Eurostat, ISTAT, Bloomberg, UniCredit Research

The commitment on expenditures is encouraging

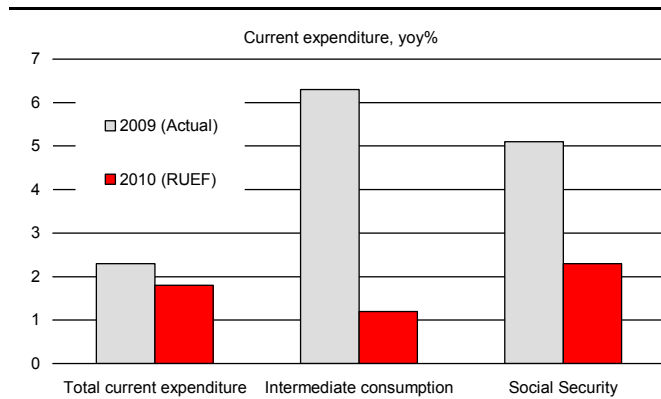
After having contracted 0.9% in 2008 and plunged 3.2% in 2009, with no policy changes, tax receipts are expected to resume positive growth: +1.2% in 2010, 2.0% in 2011 and 3.9% in 2012. With respect to the expenditure side, total current expenditure was up a relatively tame 2.3% in 2009, mainly thanks to the plunge in interest expenditure (-12.2%). For the current year, under the assumption of no policy changes, **the RUEF envisages a 1.8% increase in total current expenditure**, with 2011 estimated at 2.3% and 2012 at 3%. Net of interest payments, current spending is forecasted at 2% in 2010, 1.4% in 2011 and 2.2% in 2012. Moreover, while in 2010 the benefit from lower interest rates will no longer apply (the RUEF assumes that interest payments will be in line with 2009), **the government has committed to containing those expenditures that increased significantly in 2009**. In particular, after the sizeable 6.3% marked last year, intermediate consumption should be up only 1.2% in 2010. This year, the growth rate of social security spending (pensions plus other social spending) is expected to slow down as well, from 5.1% in 2009 to 2.3%. Within this category, while pension expenditure is anticipated to slow from 4.2% in 2009 to 2.7% (more on that in the

next section), **stable or even lower recourse to temporary layoff schemes to support employment should contribute to a decisive curb of “other social spending”**, which is expected to be up only 0.6% after the 8.5% surge in 2009.

The SSBR hints that Italy is on track to reach the 2010 deficit target

In order to monitor in a timely manner the risks to the government deficit and debt forecasts for 2010, **the best measure is the state sector borrowing requirement (SSBR or *Fabbisogno di cassa*)**. The last data available show that in January-May the SSBR amounted to EUR 50.1bn, a meaningful improvement (-12%) if compared to the same period of 2009, when the deficit stood at EUR 56.2bn. As the government estimates that SSBR will reach EUR 82.3bn at end-2010, which is about 5% lower than the 2009 figure, **in the first five months of the year Italy seems to be on track to reach the government objective**. And this despite not-so-encouraging signs from the revenue side: the latest data from the Ministry of Economy and Finance for the first three months of 2010 show a contraction in tax revenues of 1.3%

**A PROMISING COMMITMENT ON EXPENDITURES**



**PUBLIC FINANCE: THE GOVERNMENT PROJECTIONS**

(in % of GDP)		2009	2010	2011	2012
<b>Budget deficit</b>	with correction	-5.3	-5.0	-3.9	-2.7
	unchanged policies	-5.3	-5.0	-4.7	-4.3
<b>Primary balance</b>	with correction	-0.6	-0.4	1.0	2.5
	unchanged policies	-0.6	-0.4	0.2	0.9
<b>Structural Deficit</b>	with correction	-3.8	-3.3	-2.5	-2
	unchanged policies	-3.8	-3.3	-3.3	-3.6
<b>Public debt</b>	with correction	115.8	118.4	118.7	117.2
	unchanged policies	115.8	118.4	119.5	119.6

Source: Ministry of Finance, UniCredit Research

The budgetary correction envisaged in the RUEF for 2011-12...

**Budgetary correction 2011-12:** While so far we have described the government projections assuming unchanged policies, it should be also noted that the government committed to a **budgetary correction in 2011-2012 worth a cumulative 1.6% of GDP and equally split between the two years**, which should lower the deficit to 3.9% in 2011 and 2.7% in 2012. With respect to the latest set of forecasts, the government raised the cumulative size of the correction by 0.4% of GDP. Details on deficit-cutting measures have not been published in the RUEF, but the improvement in the budget deficit seems genuine, as it translates one-to-one to the structural budget deficit, which excludes one-off and cyclical components. **The correction should lead to a more favorable trajectory of the debt-to-GDP ratio**, which is seen at 118.4 in 2010, up to 118.7% in 2011 and declining to 117.2% in 2012.

...was unveiled at the end of May

On May 26, **the Government announced the details of the EUR 25bn correction** aimed at meeting the deficit and debt targets outlined in the RUEF. The main measures include:

- a. A four-year wage freeze for civil servants for 2010-13, plus a cut in the pay of civil servants and public sector retirees earning more than EUR 90,000 per annum (from EUR 90,000 to EUR 130,000, the cut will amount to 5% of the portion exceeding EUR 90,000, above EUR 130,000 the cut will be 10% of the amount exceeding that threshold)
- b. A significant block of the turnover rate in the public sector for the next two years (only 1/5 replacement rate). According to first drafts, the combined measures in the public sector (wage and hiring) would imply EUR 0.5bn of savings.

- c. A substantial cut in transfers to local governments (regions and municipalities). From this measures, the government plans to achieve roughly half of the total adjustment, as they should be worth EUR 8.5bn
- d. Block on retirement for a few months for those approaching retirement age. The bill accelerates the transition towards 65 years as retirement age for female workers in the public sector. This will allow bringing forward by two years the savings stemming from a higher pension age. This measure could deliver savings of EUR 2.8bn
- e. A crackdown on tax evasion and fake invalids claiming benefits, and a partial amnesty for homeowners whose house has not been declared to the fiscal authorities. From these two measures, the government plans to raise EUR 8bn.
- f. A linear cut of 10% for the budget of all ministries and a reduction in the pay of cabinet members. Savings from this measure would amount to EUR 2bn
- g. Rationalization in health expenditure (both intermediate and personnel costs), worth EUR 1bn of savings.

Expenditure cuts rather than tax hikes

It is encouraging that **two thirds of the correction is taking place through expenditure cuts, rather than higher taxes**. To this extent, there is extensive empirical evidence that, in the past, budgetary corrections taking place through expenditure cuts have been i) more successful in correcting fiscal imbalances; ii) more credible, thus improving markets' confidence; iii) more successful in enhancing economic growth in the medium-to-long term. In contrast, tax-driven budgetary corrections typically failed to correct fiscal imbalances in a permanent way and did little to stimulate growth.

While we welcome the decisiveness of the Italian government in taking action on the expenditure side, **attention should be paid to implementation**. In fact, roughly half of the savings are obtained cutting transfers to regions and municipalities so that part of the task is somehow delegated to local governments. Secondly, the government should aim at making savings on the expenditure side more structural in order to achieve a long-lasting consolidation that would help freeing resources towards more productive uses.

Next step: structural reforms to raise potential growth

Finally, the next step will need to focus on the **introduction of "zero-cost measures" to boost potential growth**. In particular, a far-reaching liberalization of the several protected sectors of the economy could result in more efficient resource utilization, higher productivity and employment, and lower costs for consumers. While typically structural reforms take a long time to bear fruit, we suspect that the positive impact on growth stemming from these measures could take relatively little time to show up. **Focusing on growth-enhancing policies is crucial, especially in a de-leveraging environment**, when fiscal policy is also turning on the restrictive side. Raising the country's growth potential in the medium to longer term, when combined with a prudent fiscal stance (as Italy has correctly taken), would help improve the sustainability of public finances going forward.

#### 4. A sustainable pension system, but not without risks

Italy is in a comparably better position than most of its eurozone peers

Over the past years, most advanced economies have undertaken reforms to stabilize pension and age-related spending. These reforms often include a combination of measures to increase revenues, raise statutory retirement ages and reduce benefits. According to the IMF<sup>3</sup>, even taking into account these reforms, pension spending in the G-20 space is projected to rise from 7% of GDP in 2010 to 8.5% in 2050. Against this backdrop, a close look to the **sustainability of the Italian pension system is a crucial step to understand the sustainability of public finances of the country in the very long term**. To this extent, thanks to the reforms implemented in 1992, 1995 and 2004, **Italy seems in a comparably better position than most of its European peers, though this doesn't mean that the outlook is totally reassuring**.

<sup>3</sup> See "From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies", Fiscal Affairs Department, IMF, April 2010.

**Long-run sustainability is not a compelling issue**

Good news first. Long-run estimates by the EC in the table below show that Italy belongs to the “restricted club” of countries for which, under the assumption of no policy change, public pension expenditure as a share of GDP will decline (marginally) by 2060. This compares to a 2.7pp increase for the eurozone as a whole, though one should consider that here the starting point is lower than in Italy. It’s worth noting that, in the EC forecasts, the relative trend in Italy is much more favorable than in the peripheral countries currently under market pressure: the ratio is seen increasing 6.2pp in Spain, a whopping 12.5pp in Greece, 1.5pp in Portugal and 5.9pp in Ireland. Similar figures were provided recently by the IMF, which sees pension expenditure from 2010 to 2050 increasing a tiny 0.7 pp in Italy, well below the 6.6 pp envisaged for Spain, 12.4pp for Greece and 3.9pp for Ireland. Moreover, it is worth noting that in this regard, Italy seems more in line with traditionally more virtuous countries like France (IMF expects pension expenditure to increase 0.7pp from 13.5% to 14.2%) and Germany (1.9pp). Accordingly, **the sustainability of the Italian pension system currently does not seem a compelling issue.**

**Pension spending as a percentage of GDP up strongly due to the recession**

However, the near-term outlook is going to show a marked deterioration in the pension spending-to-GDP ratio, and **longer-term prospects are subject to a number of risks.** The last report published by the NVSP (*Nucleo di Valutazione della Spesa Pensionistica*, a government body in charge of monitoring trends in pension and welfare outlays) dated November 2009 shows that Italy’s public pension spending as a share of GDP in 2008 increased by 0.3pp to 13.8%. According to NVSP, in 2010 the ratio probably will increase further, following the depth of the 2009 recession, approaching 15%.

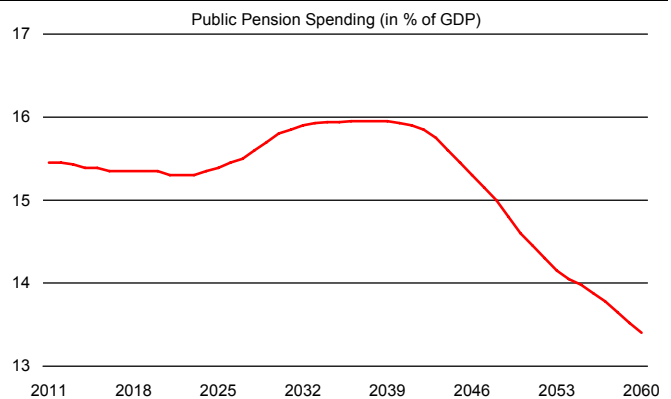
**Assumptions for the long run**

The NVSP also provides long-term projections<sup>4</sup> that run through 2060 and are based on the following assumptions:

- Average GDP and productivity growth at around 1.5%.
- Employment rate climbing 8pp from the 2007 level of 58.7%.
- An increase in life expectancy of 6.4 years for men and 5.8 years for women vs. the 2005 levels.
- A net migration flow of almost 200K a year.
- The fertility rate (births per woman) converging towards 1.58.

**ITALY’S PENSION SYSTEM IS SUSTAINABLE IN THE LONG RUN THE PENSION CURVE THROUGH 2060 ACCORDING TO THE NVSP**

	Demographics and age-related expenditure									
	Fertility rate (births per woman)		Life expectancy at birth				Net annual migration flow (as % of population)		Pension expenditure, % of GDP	
			Females		Males					
	2008	2060	2008	2060	2008	2060	2008	2060	2010	Change 2010-2060
Italy	1.4	1.6	84.2	90.0	78.5	85.5	0.4	0.3	14.0	-0.4
Spain	1.4	1.6	83.9	89.6	77.4	84.9	1.4	0.3	8.9	6.2
Portugal	1.4	1.5	82.4	88.8	75.8	84.1	0.5	0.3	11.9	1.5
Greece	1.4	1.6	82.6	88.7	77.4	84.8	0.4	0.2	11.6	12.5
Ireland	1.9	1.9	81.9	89.2	77.5	85.2	1.4	0.1	5.5	5.9
EMU	1.5	1.7	82.3	89.0	76.6	84.6	0.3	0.2	11.2	2.7



Source: EC, NVSP, UniCredit Research

<sup>4</sup> The NVSP’s projections don’t include the automatic increase in the pension age to reflect higher life expectancy due to become effective in 2015, and the hike in the pension age from 60 to 65 for female civil servants. If these measures are included, the “hump” in the ratio curve plotted in the right chart becomes smoother and the system looks in a better shape.

**Long-run trends**

As shown in the right chart on the previous page, the projections envisage a broad stabilization of the public pension spending-to-GDP ratio in 2011-2023, and a renewed rising trend in 2024-2038 – due to an increased number of pension payouts (on higher life expectancy and the retirement of the so-called baby boomers) and lower employment. **The curve peaks at 15.9% in 2038** and falls to 14.6% in 2050, and to 13.4% in 2060. The decline from the peak stems from the switch to a fully contribution-based system and the death of the baby boomers.

In general, the NVSP acknowledges that the various reforms implemented in the years 1992-2007 contributed to the stabilization of the pension spending-to-GDP ratio in the period 1997-2007, and should guarantee the sustainability of the system in the long run – as also flagged by the EC projections. Accordingly, the NSVP thinks that the bulk of the reform effort on pensions is behind us, and that future action should come mainly in the form of “fine-tuning” measures. However, the NVSP points out **two critical variables** that pose non-negligible risks to developments in public pension spending as a share of GDP over the forecast horizon.

**Risks to the scenario**

1) **The first critical area of risk is poor GDP growth prospects in the medium to longer term.** For what concerns the medium term, the NVSP expects that pension spending, net of indexation, will grow at an average rate of 1.8% in 2011-2013. Accordingly, real GDP in these years must expand at a similar pace to stabilize the pension spending-to-GDP ratio. This is not easy to accomplish: Italy expanded by just above 1% a year on average in 2001-2007, and it's likely that the financial crisis depressed the already low potential growth rate of the economy to no more than 1%. Coming to the longer term, our view is that, unless we see fairly aggressive structural reforms on the supply side of the economy in the next few years, 1.5% real GDP growth per annum risks being an overly optimistic assumption.

2) **The second critical area is the employment rate**, which has fallen considerably during the crisis to just 57.1% in 4Q 2009, and seems unlikely to post a significant recovery soon.

**Once again, the key to sustainability is implementing structural reforms**

**Bottom line:** The main take-away is that, while the Italian pension system enjoys relatively good health compared to several European peers, its expected sustainability in the long run by no means implies no need for reforms. Actually, the opposite is true. Given that long-term public pension spending projections are based on GDP growth and employment rate assumptions that currently seem overly optimistic, **it is essential that productivity and the labor market soon move to the top of the government's reform agenda.**

## 5. Private sector's balance sheets remain in good shape

**From public to private debt**

Since the beginning of the financial and (above all) the sovereign debt crisis, concerns regarding the sustainability of public finances were accompanied by an **increasing attention towards the indebtedness of the private sector**. The latter gained in importance especially after a decade of buoyant credit growth at a global level. In this section, we focus on the financial situation of Non-Financial Corporations (NFCs) and Households (HH)<sup>5</sup>. We show that while **Italy compares very favorably with respect to the eurozone as a whole** and in particular with respect to periphery countries, which recently came under market pressure, **the situation is not without risks and needs to be carefully monitored.**

Based on national account data, **Italian firms' profitability kept contracting in the last quarter of 2009:** after having troughed at -11% yoy, corporate profits in 4Q 2009 were still down 9.5% yoy. Accordingly, profit margins (operating profits over nominal value added) still remained at around 40%, the lowest level of the last decade, well below the long-term average of 45%. However, after having contracted markedly for four consecutive quarters, in the last part of 2009 profitability recovered slightly and profit margins stabilized somewhat, as the marked yearly decline in value added was matched by a fall in labor costs (thanks to the ongoing weakness in the labor market). In particular, compensation of employees contracted

**NFCs: Weak profitability dynamics...**

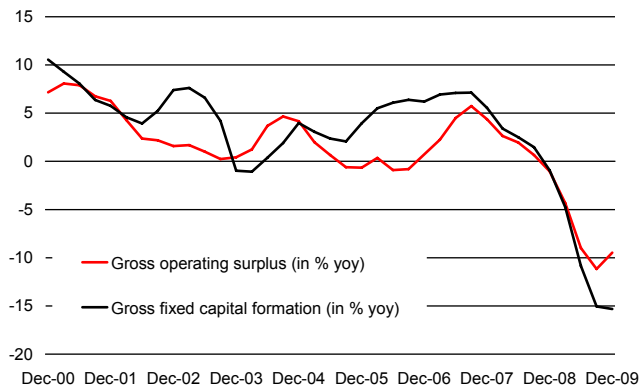
<sup>5</sup> In this framework, the household sector is considered as households and non-profit institutions serving households.

by 0.7% and 2.3% yoy, in 3Q and 4Q 2009 respectively. Therefore, at this juncture, it seems that **profitability has stopped its plunge mainly thanks to the adjustment taking its toll on the labor market**, rather than due to a genuine recovery in value added.

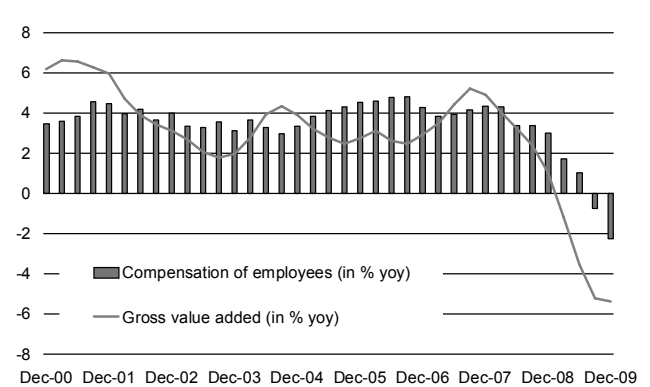
**PROFIT STABILIZATION OCCURRED ONLY AT END-2009 ...**

**...AS LABOR COSTS STARTED TO DECLINE**

Cumulated 4-quarter transactions



Cumulated 4-quarter transactions



Source: ISTAT, UniCredit Research

**...and a still stretched financial position**

**Such weak profitability still weighs on the financial position of Italian firms.** In Italy more than in the eurozone, **the corporate financing gap** – a proxy for the need for external finance to fund investment plans – **widened sizably at end-2008**, reaching -11.3% of nominal value added (see left chart on the next page). Different from the eurozone, where data on annual non-financial sector accounts were released at the end of April, in Italy these data will be released only in July, hence a measure of financing gap for the full 2009 is not yet available. However, we can provide a rough idea of its dynamics in 2009 through a proxy computed directly using the difference between firms’ acquisition of financial assets and the incurrence of financial liabilities<sup>6</sup>. What we discover is a reduction of firms’ financial deficit for 2009, mainly as a consequence of the continued investment slowdown. In fact, given that the visible reduction in financing costs and, hence, in interest payments, has not yet been matched by a significant improvement in profitability, a sound recovery of self-financing has not occurred yet. This has left Italian **corporates’ financing gap well in negative territory last year and is likely to keep it negative at least in the first part of this year.**

**Italian vs. eurozone corporates**

Thus, **at first glance, Italian firms seem to be more vulnerable than those in the eurozone.** In fact, while the financial deficit of Italian firms remains high on the back of very weak internal funds, the financing gap in the eurozone showed a substantial improvement, dropping to -0.5% of nominal value added in 4Q 2009 from -6.2% at the end of 2008. Thus, although corporate profitability hasn’t fully recovered yet, eurozone firms are again in a situation similar to the one experienced at the beginning of 2005, when the financing gap was hovering around zero. In turn, this would create fertile ground to catch the recovery phase. In contrast, **a still negative financial position is likely to add some uncertainty to Italian firms’ investment plans for quite some time.**

**Firms’ indebtedness remains lower than in the eurozone...**

To be sure, **the financial leverage of Italian firms remains lower than that of the eurozone:** the ratio of Non-Financial Corporations’ debt (loans and securities) to GDP approached 83% in 4Q 2009, compared to the average of 102% in the euro area (see right chart on the next page). Moreover, when looking at the periphery countries, the differences appear to be more pronounced than with the eurozone average, with firms’ financial leverage

<sup>6</sup> In particular, the difference between the financing gap and the “Net Financial Transactions” is simply a statistical discrepancy

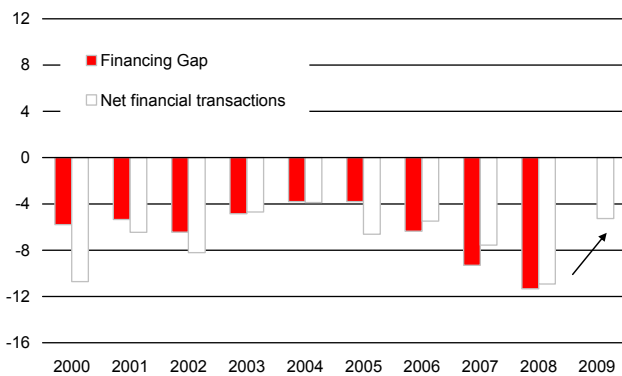
... but the debt burden will keep weighing on balance sheets

reaching 140% of GDP in Spain and 157% in Portugal and 166% in Ireland.<sup>7</sup> So, **when compared with most eurozone peers, Italian firms do not appear overly stretched**; more importantly, their financial situation looks **more comfortable than that of firms in other periphery countries. However, corporate debt-to-GDP ratio in Italy has been increasing steadily since 2001, progressively narrowing the gap with the eurozone.** Thus, the high level of debt and of interest-related payments might leave Italian firms vulnerable in the near term, above all in a context of weak internal funds, due to the difficulty to generate significant profitability growth. Structurally low levels of productivity are clearly not supportive in this respect.

Against this backdrop, **we expect Italian enterprises to remain cautious on their investment decisions, as still compelling financing constraints will add to low capacity utilization.**

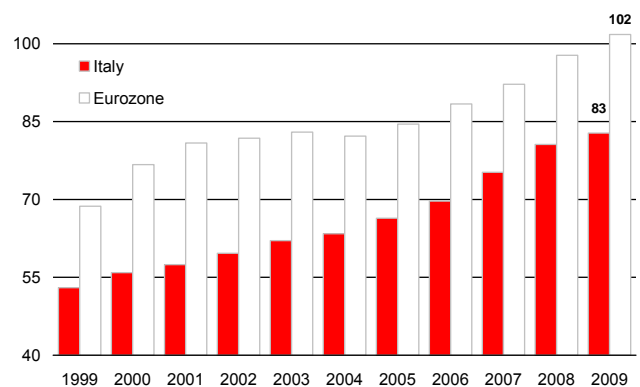
**NFCs: FINANCING GAP STILL NEGATIVE...**

In % of nominal Gross Value Added



**...WITH LOW BUT INCREASING LEVERAGE**

Total debt (loans and securities), in % of nominal GDP



Source: ISTAT, Bol, ECB, UniCredit Research

**Households: falling disposable income...**

For what concerns Italian households, we have observed a significant decline in real disposable income (-2.6% yoy in 4Q 2009); given that only a slight reduction in the consumption deflator occurred, this contraction is solely due to a decline in nominal income. We note that such a large decline actually comes after two years in which **household disposable income kept contracting on a yearly basis** (see chart on the left on the next page). Notably, these were the first yoy negative numbers ever recorded in the last decade. Moreover, as a consequence of this unfavorable income dynamics, households' consumption expenditure in real terms dropped nearly 2% yoy in 2009. Thus, as the drop in income was larger than the drop in consumption, **the savings rate continued to decline, reaching 14% at end-2009, falling back to the level of 2000.**

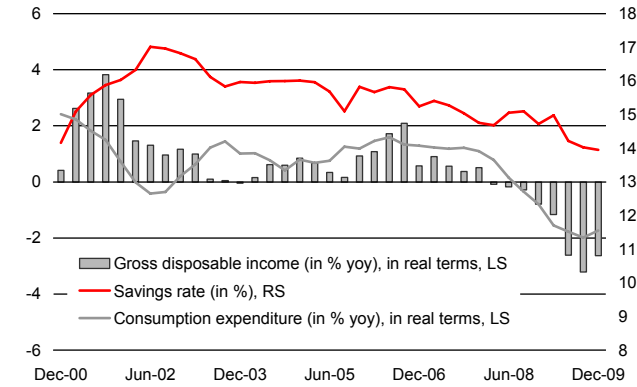
...pushed down the savings rate

**2009 was also the first year in which the Italian household savings rate was lower than that in the eurozone**, which reached its highest level at 15.4%. In fact, in the eurozone, a fall in personal consumption (in real terms) occurred in a context of resilience of disposable income, which led to households increasing their savings. Although the increase in the savings rate in the eurozone last year should not be regarded as the beginning of a new trend (as it was pushed higher mainly by precautionary motives) and it is likely to ease somewhat from the peak, there is little doubt that over the recent years the gap between Italy and the eurozone has actually closed.

<sup>7</sup> See "Current Account Rebalancing in Peripheral Countries – What to Expect Going Forward", UniCredit Euro Compass, April 2010. Data for Spain are end-2009, for Portugal and Ireland are end-2008 (latest data available).

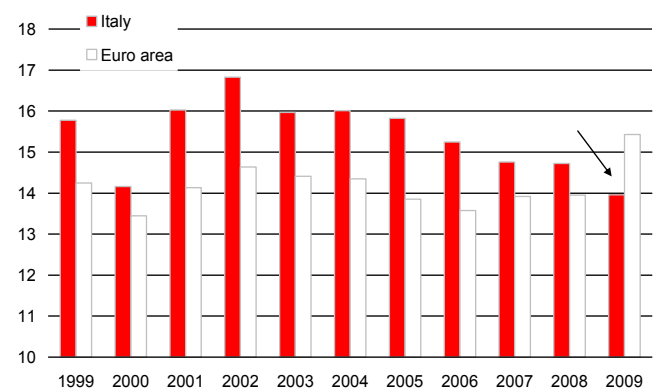
**PRIVATE CONSUMPTION FALLING LESS THAN INCOME**

Cumulated 4-quarter transactions



**HOUSEHOLDS' SAVINGS RATE ON A DOWNWARD TREND**

Savings rate as % of Gross Disposable Income



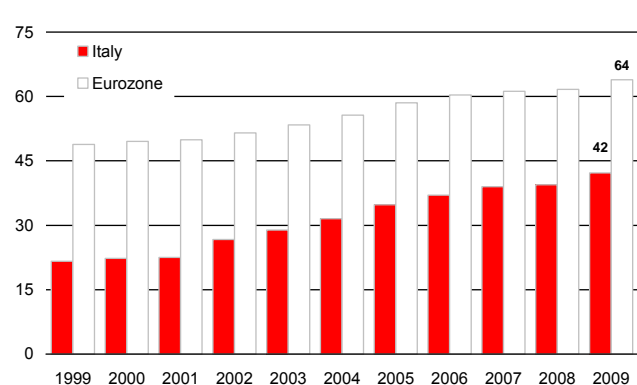
Source: ISTAT, Eurostat, UniCredit Research

**Debt: a favorable comparison with eurozone households**

Even if we have observed an ongoing decline in the propensity to save over the last years, **Italy is characterized by a more favorable environment for households, which remain among the least leveraged in the eurozone.** In particular, the ratio of Italian households' debt (mainly loans) to GDP was 42% at end-2009, and this was still well below the eurozone, (at 64% in 2009). Once again, Italian households' indebtedness compares positively with most peripheral countries: around 86% in Spain at end-2009, and at 96% and 110% in Portugal and Ireland respectively in 2008. This supports the idea that **households' balance sheets are relatively sounder in Italy.** Moreover, around 77% of these debt loans (32% of GDP) are represented by bank loans, and are essentially mortgage debt, hence guaranteed. Most of the remainder (21% of total households' debt) are given by loans from other financial corporations (not banks), whose share in percentage of GDP has increased progressively over the last few years, in line with the ongoing increase in households' leverage, edging up from 2% of GDP in 2002 to 9% of GDP in 2009. This also indicates that the process of increasing indebtedness of Italian households is accompanied by a consolidation of the credit market for this sector.

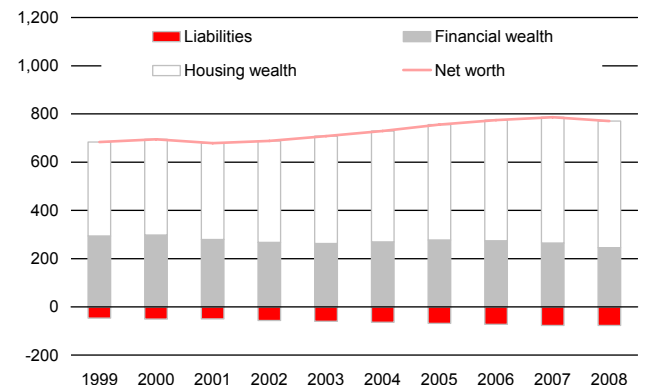
**A VERY LOW LEVEL OF HOUSEHOLDS' INDEBTEDNESS...**

Debt (loans), in % of nominal GDP



**...BUT DECLINING NET WEALTH**

% of nominal Gross Disposable Income



Source: Eurostat, Bol, ECB, UniCredit Research

**Weak housing market likely to weigh on households' net wealth**

When looking at assets owned by households, which provide a further indication of the ability to repay debt (see chart above on the right) households' financial assets in percentage of disposable income declined in 2008 following the collapse of financial markets. Given a broad

stabilization in financial liabilities, at around 77% of disposable income, this led to a decline in households' financial wealth (always as a share of disposable income). In 2008, the reduction in financial wealth was not compensated for by housing wealth, which increased only slightly. As a result, households' net wealth declined from 786% to 771% of disposable income, returning to 2005 levels. **We expect housing wealth to have declined in 2009** (the latest data available for this component is 2008) as a result of a steep contraction of residential investment and a moderate decline in house prices. **This, even when taking into account the improvement in financial wealth** (from 246% to 258% of disposable income), **will likely result only in a stabilization in households' net wealth in 2009** (and probably beyond).

Thus, although **the level of households' indebtedness remains low compared to eurozone peers, lack of improvement in net wealth and less favorable dynamics of disposable income might weigh on households' balance sheets in the near future.**

## 6. Public debt management

In this section, we briefly analyze the composition of Italian public debt, its structure along with the redemption profile. This latter aspect is of particular interest as in the last few months, as investors have focused on those factors that may create financial tensions for an issuer. We will also provide a comparison of the Italian debt structure with that of other EMU countries.

Italy is the EMU country with the biggest marketable debt (EUR 1500bn, corresponding to about 27% of EMU marketable debt). Italy has a history of being a highly indebted country and, over time, has developed a deep knowledge on how to manage it. There is a **well functioning mechanism that ensures smooth access to capital markets**, with a group of about 20 market specialists participating in the auctions.

During the last few years, Italy has reduced its stock of floating rate notes, thus reducing its interest rate risk and increasing its debt duration. Italy has followed a strategy of diversifying its investor base, issuing inflation linked bonds as well as non-euro denominated debt. With respect to fixed-coupon bonds, Italy issues at the 3Y, 5Y, 10Y, 15Y and 30Y. Since the beginning of the crisis, Italy has increased flexibility in its funding strategy, both offering off-the-run bonds as well as announcing ranges rather than specific targets for the issued amount.

**Italy carries out between four and five auctions per month** (two around mid-month, two at the end of the month and one, optional, at the end of the month offering inflation-linked bonds), selling, on average, EUR 20/25bn in bonds and EUR 20bn of T-Bills per month.

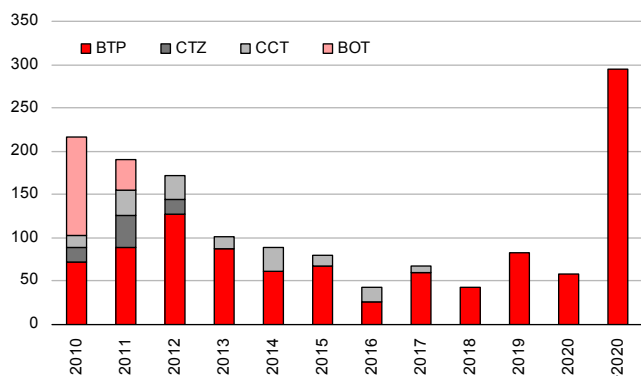
**Italy will have to refinance bonds for a total of EUR 103bn in the remaining six months of this year** (EUR 73bn of BTPs, EUR 16.5bn of CTZ and EUR 14bn of CCTs). In addition, EUR 105bn of BOTs will mature and have to be refinanced. While, as we have pointed out, there is a solid mechanism to convey supply to the market, should a serious confidence crisis on EMU debt emerge, Italy, with such extensive recourse to the market, would face difficulties

**Next year, redemptions will be EUR 20bn lower than this year** (EUR 156bn vs. EUR 174, excluding T-Bill refinancing), thus creating a relatively easier environment for BTPs. The reduction in redemptions, coupled with an improvement in the deficit, should lead to a decrease in gross supply compared to this year. **However, redemptions in 2012 will increase again to the EUR 170/175bn range** (possibly more depending on CTZ issuance in coming months), and in this respect it will be important to reduce the deficit in a structural way (see left chart on next page). Going forward, redemptions will decrease but as Italy will keep issuing 2Y and 3Y bonds in the coming months, the redemption profile might change substantially. **As the right chart on next page shows, the monthly redemption profile of Italian BOTs is rather regular.** The sharp decrease in BOT redemptions from December onwards is simply due to the fact that there are no 6M BOTs maturing in those months (yet).

Italian redemptions in the remainder of the year ...

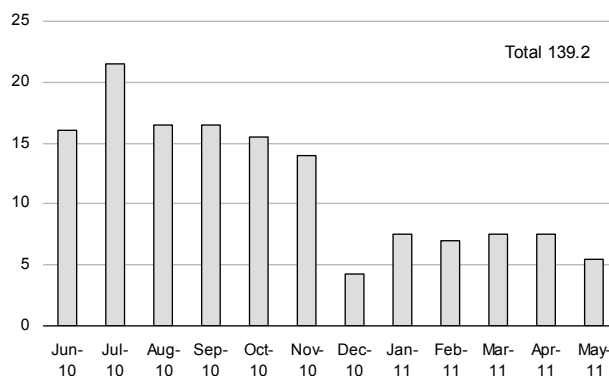
... and in 2011

**BTP REDEMPTIONS PROFILE**



2010 indicates the amount of redemptions still due

**MONEY MARKET REDEMPTIONS IN THE NEXT 12M (EUR BN)**



Source: Bloomberg, UniCredit Research

**Long-run trends**

**In terms of debt composition and structure, Italy features some important point of strength:**

- **First**, the portion of Money Market debt on total marketable debt is 10%, in line with Germany and well smaller than France, Spain, the Netherlands, Portugal and Belgium, where this ratio is between 13% and 16%. Italian debt also looks better than that of many other EMU countries when it comes to the ratio that needs to be refinanced in the coming 12M: 21.5% compared to 25% in the Netherlands and France and 26% in Germany (see table below for a comparison with other EMU countries).
- **Second**, Italian debt has a high average maturity (6.8-years, including T-Bills, as shown in the right chart on next page), and this is another factor that should reduce refinancing risk, at least compared to other EMU countries.
- **Third**, Italy issues a well diversified range of instruments. As the table below shows, Italy is the country with the broadest range of debt instruments. It issues, along with plain vanilla bonds, inflation linked bonds, floaters and also 2Y zero coupons
- **Fourth**, a good portion of Italian debt is held domestically (54%), so that demand for BPTs is less subject to changes in market mood and to a deterioration of market sentiment.

**DEBT STATISTICS – EMU COUNTRIES**

Country	Rating		Debt composition					Debt indicators		Market indicators	
	Grade	Outlook	MM	ZC	FIX	FLOAT	IL	Maturing in 12M (%)	Avg life (yrs)	ASW (10Y)	Yield (10Y)
IT	A+	stable	10.3%	4.9%	66.5%	10.5%	7.8%	21.5%	6.8	132.9	4.271
GR	BB+	negative	3.2%	1.9%	82.0%	6.8%	6.1%	8.6%	7.7	518.2	8.124
PT	A-	negative	15.5%	-	84.5%	-	-	23.5%	6.7	225.1	5.193
BE	AA+	stable	13.9%	-	85.1%	1.0%	-	23.8%	5.9	61.6	3.558
SP	AA	negative	16.7%	-	81.9%	1.4%	-	23.1%	6.9	160.9	4.551
IE	AA	negative	4.4%	-	95.6%	-	-	4.4%	6.9	219	5.132
NL	AAA	stable	16.3%	-	83.7%	-	-	25.9%	5.8	-0.1	2.941
AT	AAA	stable	4.9%	-	95.1%	-	-	9.1%	7.6	30	3.242
FI	AAA	stable	13.2%	-	86.8%	-	-	28.1%	4.9	-6.8	2.874
FR	AAA	stable	14.1%	-	74.1%	-	11.7%	24.4%	7.1	10.5	3.047
GE	AAA	stable	8.7%	-	88.1%	-	3.2%	26.1%	6.2	-36.5	2.577

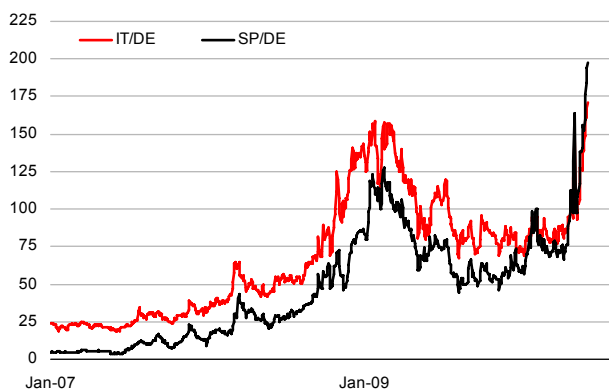
Source: Bloomberg, UniCredit Research

**In line with the points of strength outlined above, markets have recognized during the fiscal crisis that Italy is not as fragile as other peripheral countries: bond yields and CDS spreads have widened, but to a lesser extent than for Greece, Portugal, Ireland and Spain.**

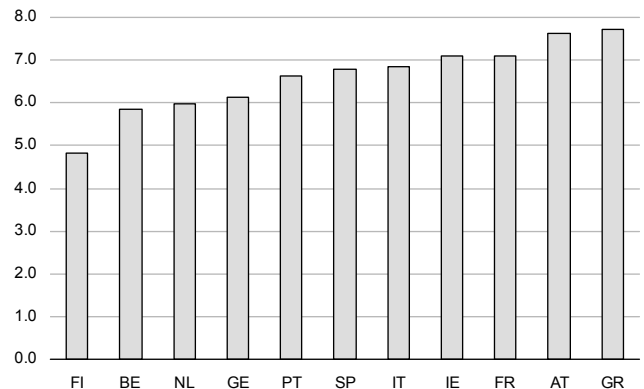
For instance, Italy's 10Y bond yield spread against the German Bund hovered around 90bp in the second half of last year, widening in a more pronounced way only in recent weeks. **Also, it should be noted that much of the spread widening occurred because the yield on the 10Y German Bunds declined substantially**, as lower risk appetite and higher volatility drove investors towards safer assets. To get a rough idea, since the outbreak of the financial crisis in August 2007 until 7 May 2010, the yield on the 10Y Bund in Germany declined by 175bp to 2.65%, while it decreased by 80bp to 3.90% in Italy.

At present, German 10Y yields trade in the 2.50/2.60% area while 10Y BTPs are in the 4.20/4.40% area, a level still well within the sustainability range.

ITALY AND SPAIN VS. GERMANY (10Y SPREAD, BP)



AVERAGE LIFE (YEARS)



Source: Bloomberg, UniCredit Research

## UniCredit Forecasts for Italy

	2009				2010				2011				Annual average		
	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11	Q2-11	Q3-11	Q4-11	2009	2010	2011
GDP	-2.9	-0.3	0.4	-0.1	0.4	0.2	0.2	0.2	0.3	0.3	0.4	0.4			
GDP (% yoy)	-6.5	-6.1	-4.7	-2.8	0.5	1.0	0.8	1.1	0.9	1.0	1.1	1.2	-5.1	0.9	1.0
Private Consumption	-0.9	0.2	0.5	-0.1	0.0	-0.2	0.1	0.2	0.2	0.3	0.3	0.4	-1.8	0.2	0.8
Government Consumption	-0.1	0.8	-0.3	-0.2	-0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.6	-0.5	0.4
Gross Fixed Capital Formation	-5.2	-1.8	-0.4	0.4	0.6	0.0	-1.3	-0.3	0.4	0.6	0.9	1.0	-12.2	-0.4	0.6
Change in Inventories*	-0.6	-0.5	-0.1	0.9	0.0	0.2	0.1	0.0	0.0	0.0	0.0	0.0	-0.4	0.7	0.7
Exports	-11.6	-2.3	2.5	-0.4	5.3	1.2	0.8	0.7	1.0	1.0	1.1	1.2	-19.1	7.2	3.8
Imports	-8.8	-3.3	1.2	3.4	3.3	0.7	-0.2	0.2	0.8	1.1	1.2	1.6	-14.6	6.1	2.8
Net Exports*	-0.6	0.3	0.3	-0.9	0.4	0.1	0.3	0.1	0.0	0.0	0.0	-0.1	-1.2	0.2	0.2
CPI Inflation (% yoy)	1.5	0.9	0.1	0.7	1.3	1.4	1.6	1.9	1.8	1.7	1.9	1.9	0.8	1.5	1.8
Unemployment rate (%)	7.4	7.5	7.8	8.2	8.6	8.8	9.0	9.1	9.0	8.9	8.7	8.5	7.7	8.9	8.8
Budget Balance (% GDP)													-5.3	-5.0	-4.5
Public Debt (% GDP)													115.8	118.5	119.1
ECB Refi rate	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	--	--	--
3M Euribor rate	1.51	1.10	0.75	0.70	0.66	0.72	0.85	0.85	0.90	5.00	1.20	1.60	--	--	--
10Y swap	3.37	3.73	3.50	3.60	3.37	2.89	3.35	3.50	3.60	3.60	3.65	3.80	--	--	--
10Y Bund	2.99	3.39	3.22	3.40	3.15	2.55	3.10	3.25	3.35	3.40	3.50	3.65	--	--	--
10Y BTP	4.39	4.59	4.06	4.15	4.06	4.10	4.50	4.25	4.15	4.20	4.20	4.35	--	--	--

All data are % q-o-q unless otherwise specified; GDP data are working-day adjusted. Interest and exchange rates are end of period.

\* Contribution to growth

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