

Italy: past, present....

Clemente De Lucia

In November 2011, with yields on 10-year debt securities at more than 7%, things were looking very bad for Italy. The country was trapped in a kind of bad equilibrium characterized by low output, high levels of debt ratios and rising interest rates, three elements which reinforce each other in a self-fulfilling mechanism.

Italian problems, however, find their origins well in the past. Over the 1980s and the first half of the 1990s, the public debt ratio moved from below 75% of GDP to more than 120%, while the deficit ratio was on average above 10% each year. The primary balance was constantly negative during the 1980s, signalling poor efforts or willingness from the government to control its public finances. The process towards the adoption of the euro was undoubtedly a positive shock. Since the beginning of the 1990s the primary balance turned positive, and the deficit and debt ratios started to moderate in the second half of that decade. Yet, after adopting the euro, a sense of complacency emerged. The convergence of interest rates towards German levels reduced the efforts of the government to continue on consolidating public finances and reforming the economy. This, together with the economic and financial crisis that started 5 years ago, led the debt ratio to rise again; in 2013 it was above 130%.

High levels of debt represent a drag on growth as they force governments to devote resources to pay interests on past debt rather than using resources on more productive and growth oriented investments. The debt burden and the need of refinancing it throughout the market exposes Italy to changes in market sentiments. High and rising interest rates push higher the level of debt, crowding out private investment, depressing, potentially, activity. A sluggish output pushes higher, in a vicious cycle, the debt ratio.

The huge debt stock is not the only constraint on the Italian economy. The low level of competition in several sectors combined with product and labour market rigidities have raised costs for Italian firms, undermining their competitiveness and have reduced households' purchasing power, further depressing Italian prospects.

It comes as no surprise if Italy performed poorly with respect to its European peers during past decades (see chart 1).

In the rest of the article we analyse the factors constraining Italian prospects, focusing on the state of public finances and then on the structural weakness of the economy. We then focus on the reforms that different governments put in place to address and solve these problems.

Poor performance (GDP growth, average 10 years)

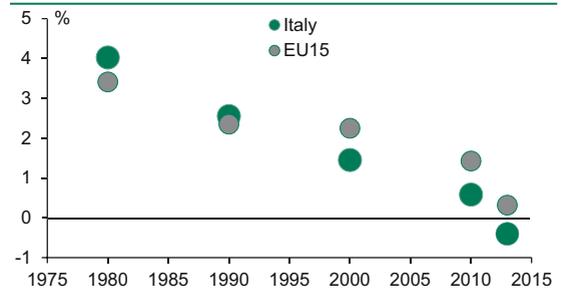


Chart 1

Source: AMECO

In just few years Italy has launched several reforms which had been delayed for years. Public finances are on a sustainable path, and there seems to be a renewed market confidence towards Italy. It is worth stressing, however, that while markets welcomed the reform agenda undertaken by Italy, it has been the ECB with its Outright Monetary Transactions (OMT) that definitely calmed markets, in eradicating the reversibility risk of the euro.

Yet, this is no time for complacency: despite other countries emerged from the recession, Italian activity was just stabilising in the third quarter of 2013 after eight consecutive quarters of contraction. The debt ratio is still uncomfortably high and its dynamics remain sensitive to changes in interest rates. Lastly, political instability risks are undermining the process of reforms which Italy desperately needs to move from a bad to a positive and long-lasting equilibrium.

The heavy legacy

The huge stock of debt (more than 130% of GDP) is undoubtedly a burden on Italy. Interest payments account for around 5% of GDP, against an average of around 3% for the eurozone. This prevents Italy from using its fiscal tools to counter adverse shocks. Since, 1992, with the only exception of 2009, Italy has been constantly forced to run primary budget surpluses in order to meet the EU targets and avoid that the debt ratio ended up on an unsustainable path. Although Italy was hardly exposed to the subprime crisis and did not experience neither the formation of a house real estate bubble nor its burst, it could not use discretionary fiscal policies in the aftermath of the Lehman's Brothers collapse, despite the fall of global activity hard hit Italian output. The necessity of managing a debt far larger than the GDP prevented Italy from offsetting the fall of private demand with fiscal stimulus. Not surprisingly, while between 2008 and 2009 public finances deteriorated by a smaller extent with respect to the other eurozone countries, Italy recorded one of largest fall in output among member countries (see chart 2).

Budget deficit and GDP growth changes (2009 with respect to 2008)

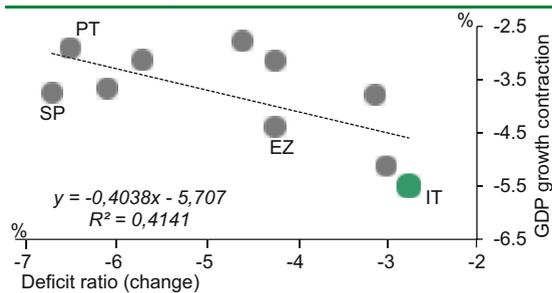


Chart 2

Sources: AMECO, BNP Paribas

Low potential output: origins have to be found in the past

In the aftermath of the financial crisis, several countries around the world experienced a decline of their potential output. In Italy, however, this process was already taking place. From around 3% during the 1980s, it decreased to 2% during the 1990s, falling into negative territory during the crisis (chart 3).

Potential output and GDP growth

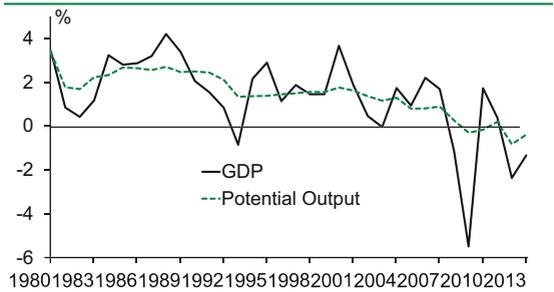


Chart 3

Source: AMECO

While the high level of debt seems to depress output, a growth accounting analysis helps detecting if other factors may lie behind the poor performance of Italy. Under certain conditions (Cobb-Dougllass production function, constant return of scale, perfect competition), the GDP growth rate might be decomposed as following (Benadal, et al., 2006):

$$\frac{\Delta Y}{Y} = \frac{\Delta A}{A} + (1 - \alpha) \frac{\Delta K}{K} + \alpha \frac{\Delta N}{N} \quad (0.1)$$

where Y is the real GDP, A is the total factor productivity (TFP), measuring the efficiency in the use of production factors, α is the elasticity of labour with respect to output, which under the above specifications is equal to the labour share in value added, and K is the level of the capital stock. Chart 4 shows that the contribution to growth of TFP has been constantly declining and even dragging down activity over the past decades. While the decline of the TFP contribution in the 1980s and 1990s might signal that Italy was investing less in those activities able to boost productivity, the negative contribution during the 2008/2009 crisis was a common factor among European countries; firms, hard hit by the collapse of demand slashed expenditures, including investment in R&D, a key driver of TFP.

The contribution of the capital stock has been rather stable over past decades and until the eruption of the crisis. After that, it drastically decreased, another common factor with respect to other eurozone countries: the fall in investment during the financial crisis, drastically reduced the stock of capital. Lastly the contribution of the labour factor has been trending downwards, becoming negative during the 1990s, recovering during the 2000s, probably benefiting from new waves of immigrants following the enlargements of the EU, and collapsing after the crisis.

Growth accounting (10-year average, contributions to growth)

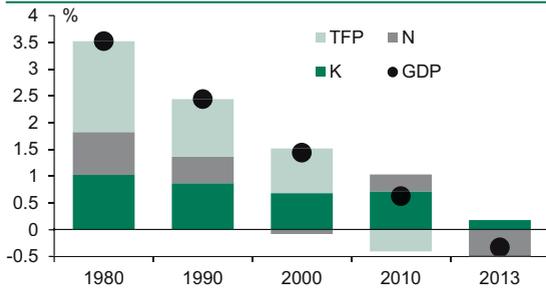


Chart 4

Sources: AMECO, BNP Paribas

To sum up, this analysis suggests that TFP and labour are the main factors behind the sluggish performance of Italy over past decades. The OECD classifies Italy extremely poorly regarding how much a country invests in new technologies and in human capital. Among the OECD countries, Italy expenditures on education amount to around 9% of total public expenditures, well below the OECD level (OECD, 2012). On the same line, the level of expenditures on R&D in all sectors as percentage of GDP remains below the eurozone levels (1.2% against an average of more than 2% according to Eurostat).

Labour market dysfunctions

Another decomposition of GDP growth, which also takes into account demographic trends, allows to deepen the analysis of the evolution of the labour. In particular, GDP growth can be re-written as (Benadal, et al., 2006):

$$\Gamma_Y \approx \Gamma_{WAP} + \Gamma_{ER} + \Gamma_{NP} + \Gamma_P \quad (0.2)$$

where Γ_Y is the real GDP growth rate; Γ_{WAP} is the growth rate of the ratio of working age population (15-64 years) to total population. This ratio, called also “working age population rate”, reflects the effect of changes in the demographic structure of the population on activity. Γ_{ER} is the change of the employment ratio (employment on working age population); Γ_{NP} is the growth rate of labour productivity and finally Γ_P is the growth rate of population. Chart 5 shows the results of this decomposition.

Growth accounting (demographic decomposition, contributions to growth, 10-year average)

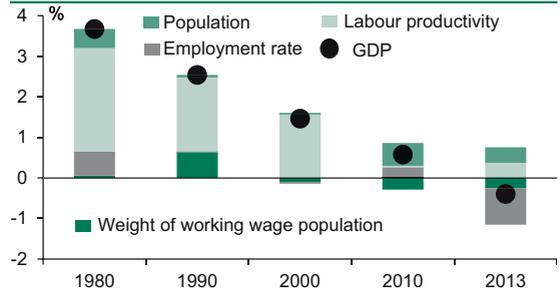


Chart 5

Sources: AMECO, BNP Paribas

It appears that the Italian population is still increasing, although at slower pace. The age structure of the population seems to weigh on growth as the working age population rate has been decreasing over past decades and even dragging down activity during the 2010s. This trend might strengthen in the future as the proportion of older persons in total population is projected to increase.

Labour productivity has been the largest growth contributor in the past, although it has been declining. It is worth stressing, however, that the relative good performance of labour productivity comes mainly from the sluggish performance of employment over past decades.

With the only exception of the 1980s, the contribution of the employment rate has always been extremely low if not negative. The Italian employment rate is, indeed, among the lowest within the eurozone. The participation rate, mainly female, is also extremely disappointing.

To sum up, the population dynamics is not supporting growth. In addition, the sluggish performance of labour over past decades is a case of concern. Labour market rigidities combined with the lack of an efficient family policy are among the factors explaining low employment growth rates and extremely poor female participation rates.

Duality in the labour market.

During the 2000s, Italy has been undertaking reforms to revitalise employment. Aiming at introducing some flexibility in the labour market, several governments introduced a set of atypical fixed-term contracts (chart 6) which normally have lower levels of protections than open-ended positions.

Large use of atypical contract since the 2000s make the labour market highly segmented

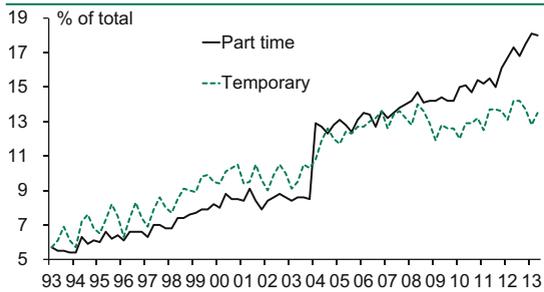


Chart 6

Source: Eurostat

Although this battery of new contracts had positive effects on employment data, they were not able to launch the virtuous cycle linking, employment, consumption and eventually growth. The high level of uncertainty surrounding their job position as “atypical workers” pushed them to increase their savings rather than to consume. Keep in mind that income support schemes for the unemployed was at that time mainly restricted to workers in permanent job positions, leaving job seekers and those in atypical jobs with little access or no access at all to public funds devoted to job search. In addition, there were no incentives for employers to invest in human capital, since they were expecting to change workers frequently. Eventually, the Italian labour market began to be highly segmented between those with a permanent job position, highly protected, and those with short-term contracts with few guarantees if any with adverse consequences on access to credit, and consumption.

The duality in the labour market has made employment less sensitive to changes in the economic outlook, decreasing the capacity of the country to adjust to adverse shocks, which is exactly the opposite of what member countries of a monetary union have to do. The cost of losing the monetary instrument to counter shocks can be minimised if the economy is flexible enough to adjust to shocks. The classical Phillips curve relationship, linking wage growth to unemployment, highlights the diseases of the Italian labour market (see chart 7). The relationship seems not to be working at all for Italy while the eurozone as a whole exhibits a regular Phillips curve. During the crisis, employees with short-term and atypical contracts were those suffering the most, while those with permanent jobs were much less exposed. Therefore the pressures on wages coming from the recession were relatively muted.

Phillips' curves (2001-2013)

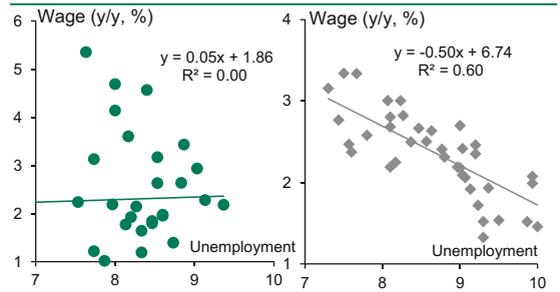


Chart 7

Sources: Eurostat, BNP Paribas

Competitiveness gap

Italian export products have been constantly losing market shares (chart 8); several factors contribute to explain this phenomenon. Among them, we can count lack of competition in several services sectors, relatively high taxes on labour combined with rigidities in the labour and product markets. This probably raises costs for firms, undermining their international competitiveness. Not surprisingly, inflation in the services sector have been constantly above the eurozone average, while the tax wedge (i.e. the difference between gross and net salary) is more than 10 percentage points above the OECD average (OECD, 2013).

Losing market shares (in % of world exports)

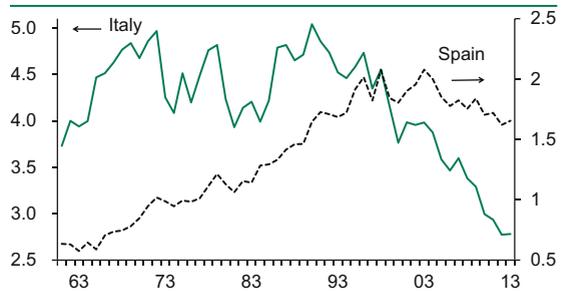


Chart 8

Source: Ameco

Unit labour costs have been rising faster than in many other eurozone countries. Compensations per employee rose by a cumulative 35% between 2000 and 2013 (see chart 9). Some countries, like Spain and Ireland recorded an even larger increase in compensation. However, their increases in productivity

compensated the wage growth. This was not the case in Italy, where unit labour costs were in Q2 2013 above their 2000 level, contrary to what happened in Greece, Portugal and Spain. In France and Germany they were almost stable. Italian price competitiveness, therefore, deteriorated with respect almost all the eurozone countries.

Price/costs competitiveness problems

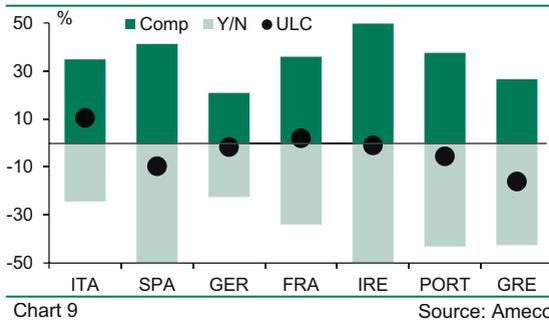


Chart 9 Source: Ameco

Adjustment during the crisis: Italy lagging behind

Cyclical factors, such as the changes of labour productivity following the crisis and the recovery, contribute to explain the decline in unit labour costs for peripheral countries. However, these countries have been adopting measures to correct their imbalances and to rebuild their competitiveness, aiming at making their labour markets more flexible. Compensation per employee started to decline in Greece, Ireland, Portugal, and it stabilised in Spain (see chart 10). By contrast, in Italy, compensation per employee kept increasing at the same rate as before the crisis. The adjustment process is in a more advanced phase in countries like Portugal and Spain than in Italy.

Compensation per employee (2000=100)

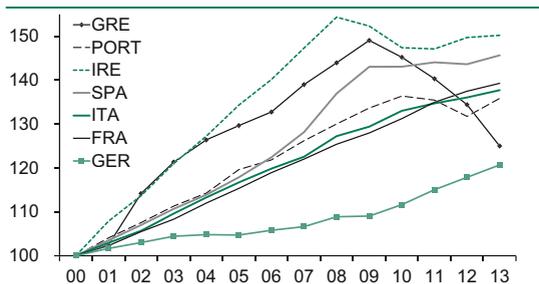


Chart 10 Source: Ameco

As illustrated in chart 10, for several years Germany has been conducting for several years a policy of wage moderation with respect to its European peers, a policy on which Germany has built large part of its price competitiveness gains.

Product market rigidities and product specialisation

Price competitiveness, however, is not the only factor undermining the performance of Italian exports. Chart 11 shows the correlation of the specialisation indicator, as computed by Unctad, for Italy with respect to other countries. Positive correlations indicate that the two countries are competitors as they are net exports of the same basket of goods. By contrast, negative correlations suggest that the two countries do not specialise in the same type of goods and are potential trading partners.

Trade specializations: correlation (indicators in 1995 and in 2012) - Italy versus partners

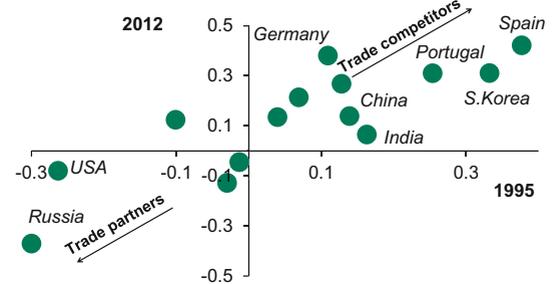


Chart 11 Sources: Unctad, BNP Paribas
Positive correlations indicate that the two countries are competitors, while negative correlations suggest that the two countries are potential trading partners.

The correlation analysis shows that fast growing Asian emerging countries, such as China and India, which built part of their price competitiveness on low labour costs, are direct competitors of Italy. Therefore, it comes out as no surprise that Italian products are losing market shares (see again chart 8). Italy should move up the value chain of its products. It is worth stressing that countries like Portugal and Spain are direct competitors of Italy as well. As these countries have been adopting much more aggressive policies to regain price competitiveness, Italian market shares risk declining further.

The adjustment process has begun

Over the past two years Italy has undertaken several measures to address its underlying problems. Those measures aim at consolidating public finances and to reduce all the constraints weighing on potential output as both factors weigh on Italian prospects.

Consolidating public finances

At the end of 2011 Italy's position was everything but enviable. Markets had partly lost confidence on the ability of the country to honour its obligations. Yields on 10-year debt sovereign debt securities climbed to more than 7%, undermining the stability of public finances. Against this backdrop, the Government adopted several measures to strengthen public finances, reducing expenditures and introducing several tax hikes (see box 1).

Box 1: Fiscal consolidation...through tax rise or expenditure cuts?

Solid public finances are a pre-condition, although not sufficient, for growth. Public finance adjustments do not come without costs as they depress activity in the short-run. The composition of the adjustment, however, matters. As whether the adjustment has to be implemented through rising revenues or reduced spending depends on the ratio of government revenues on GDP –the higher the ratio, the smallest the possibility to raise taxes-. In Italy everything was pleading for slashing spending (the ratio of total revenues with respect to GDP, a direct measure of the fiscal burden, was already relatively high in 2009 up to 46.5%, while primary expenditures amounted at 47% of GDP)¹. However, the Government introduced several tax hikes, mostly on property and consumption to correct its fiscal deficit. Consequently the revenue ratio rose by 1.2pp with respect to 2009.

The government decided to act on the expenditure side as well, freezing wage increase in the public sector, blocking price indexation on pensions, taking measure to reduce pension expenditures and conducting several waves of spending reviews in order to reduce inefficiencies in the public administration. Primary expenditures (excluding interest payments) decreased by 2.2 pp. between 2009 and 2012. Part of the improvement was,

however, offset by an increase in interest payments, up by almost 0.8 pp. (see Table 1). At first sight these figures might suggest that the fiscal effort was more based on savings than on rising taxes. Yet, an analysis based just on GDP ratios might be misleading as the behaviour of the denominator might affect results, and the evolution of the business cycle can alter the effective efforts undertaken by the government.

Fiscal adjustments:

Changes 2009-2012 (percentage points)

Ratio (% of GDP)	Nominal	Cyclically adjusted
Budget balance (total)	2.5	1.8
Primary Budget	3.4	2.7
Revenue	1.2	1.2
Total expenditures	-1.3	-0.6
<i>of which</i>		
Primary expenditures	-2.2	-1.5
Interest payments	0.8	0.9

Table 1

Sources: Ameco, Datastream

In order to bypass these shortcomings, we consider cyclically adjusted variables as computed by the European Commission (see again table 1). It emerges that the efforts in terms of higher revenues is unchanged; by contrast, the expenditure reduction seems less pronounced. The GDP ratio of primary expenditures improved by 1.5 pp between 2009 and 2012, versus 2.2 pp using non-cyclically adjusted figures. Cyclically adjusted data suggest, therefore, a more balanced approach followed by Italy to consolidate its public finances.

Going forwards, the country has to continue to strengthen its public finances. This is the best way to reduce interest payments, a real burden on Italian growth. As the revenue ratio is already extremely high, incoming adjustments would better pass through the reduction of expenditures and inefficiency in the public administration. Cutting investment to reduce expenditures should be avoided as these measures inevitably depress activity both in the short and in the medium to long-term. Note that between 2009 and 2012 almost all the spending cuts were achieved through slashing investment (down by more than EUR9bn or more than 24%). The decision of the Government to reduce expenditures by EUR 16bn between 2014-2016 throughout a new wave of spending review aiming at reducing inefficiency rather than cutting investment, is welcome news.

With these measures, Italy, was able to reduce the budget deficit to 3% in 2012 from 3.7% and 4.3% in the previous two years. This resulted in Italy exiting from the excessive deficit procedure (EDP) in 2013. The process of consolidation of public finances has given some marge of manoeuvre to the government. In the first quarter of 2013 the Government launched a plan worth of EUR 40 bn (2.5% of GDP) over two years in arrears payments to private companies². These measures are very welcome and represent a breath of oxygen for the Italian private sector hard hit by the crisis.

These results suggest that Italian public finances, at least throughout a certain angle, are in a better position than in the other eurozone countries caught into the debt crisis. Beyond running lower fiscal deficits than its member peers and primary balance surpluses, fiscal efforts that Italy needs to undertake to stabilise its debt ratio or to meet the targets set in the fiscal compact are much lower than in other eurozone countries (see table 2).

Fiscal positions (% of GDP)		NLD	FR	IT	ES
Current (2013)	Budget balance (BB)	-3.3	-4.1	-3	-6.8
	Primary balance (PB)	-1.9	-1.5	2.4	-2.7
	Debt ratio	74.8	93.5	133	94.8
PB stabilising the debt in the medium term (MT)*		0	0.7	2	1.9
Fiscal efforts (changes with respect to 2013 PB, pp)		1.9	2.2	-0.4	4.6
PB respecting the 1/20 debt reduction in the MT*		0.1	1	5.7	3.7
Fiscal efforts (change with respect to 2013 PB, pp)		2	2.5	3.3	6.4

*Medium term is built on the IMF (WEO) growth and inflation projections
This is an update of the analysis presented in Cerisier (2013)

Table 2

Sources: IMF, BNPP

The problem of Italy remains its huge stock of public debt. Fiscal efforts to meet the obligations to reduce the debt by 1/20th annually (on average over three years) if the debt ratio exceeds the 60% threshold are highly demanding (see again table 2)³.

Debt sustainability

The debt ratio, at more than 130% of GDP, is projected to start easing next year and to keep on moderating over the forecast horizon (see box 2). Fiscal efforts, however, remain non-negligible. To meet its target of structural deficit as fixed in the Treaty on Stability, Coordination and Governance⁴, Italy has no other alternative but to run primary surpluses. In our baseline case, Italy has to run primary budget surpluses

in the range of 3-4% of GDP, which is feasible, although painful. Between 1996 and 2000, that is in the years preceding the final stage of the Economic and Monetary Union, Italy run primary surpluses in the range of 4-6% of GDP.

The debt dynamics remain on a favourable path even under adverse scenarios, such a drastic deterioration in market sentiment which pushes significantly higher interest rates. In this case the fiscal effort the country has to undertake is 1pp above the baseline case.

To sum up, the analysis of debt sustainability is rather reassuring. However, it remains highly sensitive to changes in interest rates. Protracted period of stress might require greater primary budget surpluses which might prove to be unfeasible. Our model shows that one big threat might come from deflation, a case we are confident the ECB will prevent by any mean. As shown by the Japanese experience, through depressing GDP in nominal terms, while leaving unchanged the nominal outstanding amount of debt, deflation leads to rapidly growing debt ratios, increasing interest payments as a share of GDP and in turn driving budget balances into deficits, which is the recipe of the snow-ball effect.

Box 2: debt dynamics

In order to assess the debt dynamics of Italy, we resort to a short model where GDP, inflation, the implicit interest rate and deficit ratio are linked each other. In particular a decision by the government to tighten its fiscal stance, reducing its structural budget deficit, would have a negative impact on output. The negative impact on output, however, might be mitigated, at least to some extent, by lower interest rates. Markets indeed might appreciate the government effort in reducing fiscal imbalances. In addition, lower inflation (the output gap widens following the reduction of GDP) adds further downward pressures on interest rates. Despite all the shortcomings that a model might have (misspecification, problems of omitted variables during the simulation, potential structural breaks), this is a more flexible approach with respect to a standard debt sustainability analysis which determines the debt ratio for a given profile of real GDP growth rates, inflation, interest rates and primary surpluses. The model is, based on 7 equations (3 stochastic equations and 4 identities); there are four exogenous variables: the fiscal effort, proxied by the structural budget balance, the growth rate of potential output, the 3-month Euribor to take into account the evolution of the monetary policy stance and unit labour costs (ULC), a key determinant of inflation. While ULC is clearly affected by the evolution of

activity, we resort to leave it as exogenous for simplicity otherwise we had to model the labour market as well. A more general model is left for further researches.

The model is specified as following:

$$y = f(y_{-1}; \overline{bb}, i_t) + \varepsilon_y$$

$$\pi = f(\pi_{-1}; \overline{gap}, \overline{ulc}) + \varepsilon_\pi$$

$$i = f(i_{-1}; \pi; \overline{bb}, \overline{Eurib}) + \varepsilon_i$$

$$\overline{bb} = \overline{cab} + \eta \overline{gap}$$

$$pd = pd_{-1} - \overline{bb}$$

$$pb = \overline{bb} + i \frac{PD(-1)}{YP}$$

$$\overline{gap} = \frac{y - y^{pot}}{y^{pot}}$$

where, y is real GDP, π is inflation (GDP deflator), \overline{bb} is the budget balance in % of GDP, i is the implicit interest rate; \overline{ulc} are unit labour costs, \overline{Eurib} is the 3 month Euribor, \overline{cab} is the cyclically adjusted budget balance, $\overline{pb}; \overline{pd}; \overline{gap}$ are respectively the primary balance in % of GDP, the public debt in % of GDP and the output gap (% of potential output). $PD; YP$ are respectively the stock of public debt in euros and the nominal GDP in euros. ε_i are the error terms. Lastly, the elasticity η was set equal to 0.5% in line with what done by several international organisations. Over-lined variables are the exogenous variables considered. Data come from the AMECO database from Eurostat with the only exception of the Euribor (from Datastream). After estimating the first three equations and assessing their forecast capacity to replicate data in the past, we solve the model dynamically over the future. The model present a long-run stable solution: simulating the model up to 2060, activity converges towards its potential, the output gap closes, so that the budget balance coincides with the structural budget balance and the implied interest rate converges to the nominal growth rate of the economy. Fixing then a shorter horizon, until 2020, we compute different simulations under different assumptions on the exogenous variables. In the base scenario we set the fiscal effort at -0.72% over the forecast horizon, that is we leave it unchanged at the same level as the one that the European Commission forecasts for 2014 (spring 2013 forecasts). The potential output is projected to progressively recover from around 0.5% to around 1% in line with the government and other international organisation assumptions. The Euribor progressively increases towards a "neutral" refi rate for the eurozone which can be approximated by the sum of the eurozone

potential output plus the ECB inflation ceiling target (inflation rate close but below 2%). Under this scenario (scenario 1) the debt ratio starts to moderate from the peak of 133%-134% of GDP in 2013-2014 (see chart 12) to around 126% in 2020. The deficit ratio decreases over the forecast horizon, while the primary balance moderately increases, approaching 3.7% in 2018 and moderating thereafter. In the first alternative scenario, we assume the Government consolidates its public finances at a faster pace, balancing its budget by 2015. In this case, the debt ratio declines at a higher speed, falling below 123% in 2020. Major fiscal consolidations favour a slightly more rapid decline in interest rates, while growth slows down a little bit. Clearly to obtain this relatively rapid reduction of the debt ratio, the fiscal efforts will be larger, passing above the threshold of 4% in 2018 (see chart 13). The Government currently forecasts a debt reduction at an even faster pace. However, the fiscal efforts, with primary surpluses by far larger than 5%, seem very demanding.

Finally in the scenario 2 we consider a shock on interest rates generated, for instances, by new waves of panic in financial markets. The shock is produced by a sharp increase in the Euribor. Under this scenario the implied interest rate is around 100bp above the base scenario. Higher interest rates cause the deficit ratio to increase (interest payments rise), which reinforces the effect on interest rates. Clearly higher interest rates weigh on activity as well. As we assume that the government will keep its fiscal objective in structural terms unchanged with respect to the baseline, primary balance rises as well. In particular, with unchanged fiscal efforts, 100bp interest rate increase causes a fiscal tightening of 1pp in terms of higher primary balance surpluses in each year of the forecast horizon. Under this scenario the primary balance will peak at 5%, admittedly a significant fiscal effort, which might create political and economic tensions. In this scenario (2) debt ratio will decline a slower pace (higher deficits and lower growth rates), falling shortly below 130% of GDP in 2020, that is almost 4pp above the base line scenario..

Public debt ratios under different scenarios

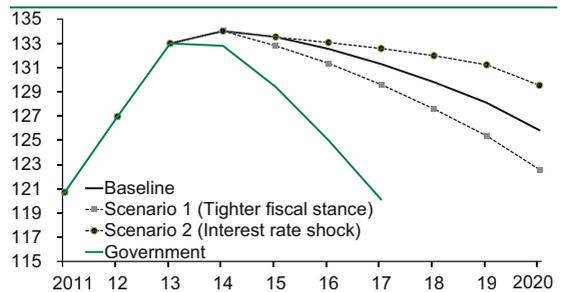


Chart 12

Sources: Ameco, Datastream, BNP Paribas

Primary balances under different scenarios

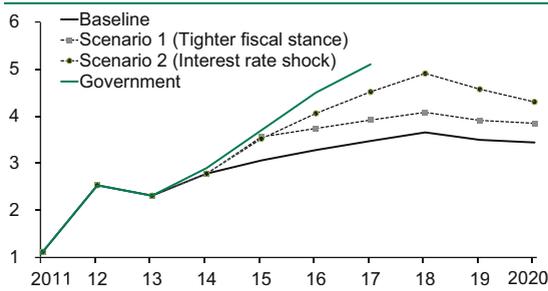


Chart 13 Sources: Ameco, Datasteam, BNP Paribas

The model shows that the Italian debt dynamics is particularly sensitive to change in interest rates, given the huge stock of debt. The relatively long duration of the public debt is still a buffer against volatility in the market and its impact on the debt. Yet, since the outbreak of the debt crisis, the Italian Government is issuing sovereign debt securities at shorter maturity (see chart 14). The average life of the debt passed from almost 8 years at the end of 2010 to below 7 during summer 2013. In a period of stress, shorter-term securities find more demand than longer maturities. The launch of the Outright Monetary Transactions from the ECB under which the Bank could buy debt securities with maturity up to 3 years, is another factor favouring this trend.

Debt according to different maturities The average life is decreasing after the crisis

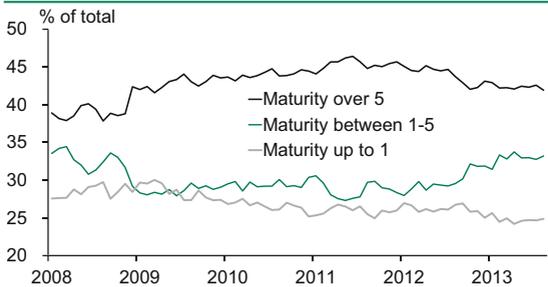


Chart 14 Source: Bank of Italy

Lastly, we analysed how the debt ratio evolves in the case Italy tilts towards deflation. Inflation indeed is particularly low, well below 1%. Despite the recent VAT increase in October 2013, it did not increase neither in October 2013 nor in November 2013. Using measures which exclude the impact on final prices of increases in indirect taxes, the inflation is even lower and close to zero. Against a backdrop of sluggish demand, firms have to offer significant discounts to stimulate it. Under this alternative scenario we assume that confidence decreased significantly; lack of confidence reduces investment and overall expenditures. A sluggish activity moderates wage inflation and finally, as the economy operates

well below its potential, the outputgap widens. Notice that we are not considering a kind of "genuine deflation" caused by moderating wages aiming at rebalancing the economy and improving cost competitiveness with respect to the other eurozone countries, a process indeed which eventually has positive effects on growth. This is exactly that what crisis-hit countries are doing. The fall in prices considered here comes from lack of demand. Under these assumptions the output and the GDP deflator growth rates are close to zero for several years (up to 2018). In this scenario the debt ratio ends up on an unsustainable path, approaching 150% by 2020. While this simulation shows that the risks for the country leaning towards the deflation are almost devastating, this scenario is highly unlikely. Policy makers, and notably the ECB, will adopt all instruments to avoid deflation within the eurozone.

Since November 2011, markets have regained some confidence on Italy, as suggested by the decline of yields on debt securities. However, market participants are still cautious as for holding significant amounts of Italian public debt securities. This is the picture emerging from the breakdown of public debt by holding sectors. Until the end of 2011, 57% of total public debt was held by residents and 43% by non-resident. Since then foreigners have reduced their exposure to Italy. Currently, non-residents hold just 35% of outstanding debt (see chart 15).

Debt holding

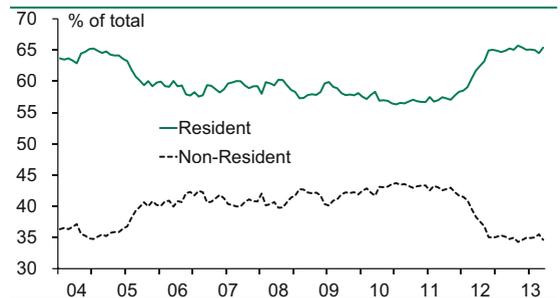


Chart 15 Source: Bank of Italy

Sovereign exposure of the banking sector

Since the launch of the two special 3-year Longer Term Refinancing Operations (LTROs) in early 2012, resident monetary and financial institutions have considerably increased their holding of Italian sovereign debt securities (chart 16).

Debt holding by sector

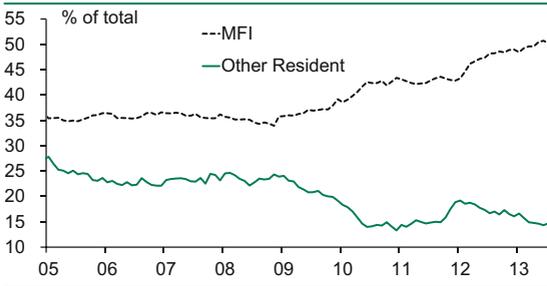


Chart 16

Source: Bank of Italy

A solid demand from financial institutions, might undoubtedly favour the task of managing the debt. Yet, a strong demand from the banking sector does not come without cost; the vicious cycle between banks and sovereign becomes even tighter. Given their exposure to the sovereign sector, the Italian banking sector was hard hit, as it has been the case in other stressed countries, by the financial and debt crisis. The perceived risk on the banking sector, as measured by the CDS rose sharply; markets judged riskier to hold Italian banks' securities than the corresponding securities of banks of core countries (see chart 17). Italian banks were forced to rely on the liquidity provided by the ECB, as they could not easily raise funds in the money markets (see chart 18).

While before the crisis, the stock of liquidity borrowed from the ECB stood at around 2% of GDP, since early 2011 it climbed to 18% in 2012. Italian banks have been among the main bidders at the special 3-year LTRO and despite the ECB gave the opportunity for early repayments, Italian banks are largely keeping liquidity in their balance sheets. The stock of liquidity has eased by around 3pp to 15% of GDP, still disproportionately high with respect to pre-crisis levels.

CDS banking sector

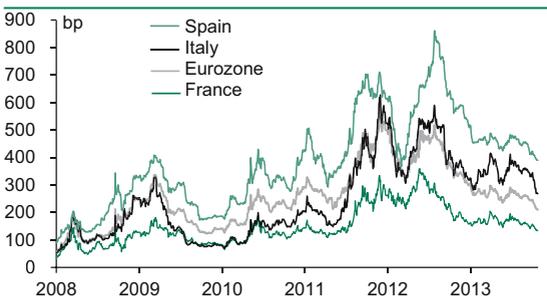


Chart 17

Sources: Datastream, BNP Paribas

Stock of liquidity

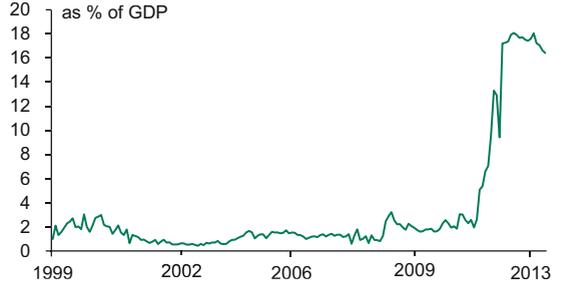


Chart 18

Sources: Bank of Italy, Istat

Credit risks

While sovereign exposure remains a case of concern, other elements added tensions on the Italian banks. The rise of Performing Loans (NPLs) following the crisis has further weakened Italian banks' balance sheets. Since the outbreak of the crisis NPLs have been sharply increasing, from 2.7% of total loans at the end of 2008 to 8.5% in summer 2013, (see chart 19). Credit risks are mainly concentrated in the corporate sector, where the NPL ratio was up as 26% in May 2013. The corporate sector is highly leveraged (the debt in % of total assets was higher than 30% at the end of 2012 against an average of around 25% for the eurozone (IMF, 2013), and interest payments are weighing on firms profitability. Interest expenditures, indeed, account for around half of gross operating surplus (IMF, 2013).

Counterpart risks

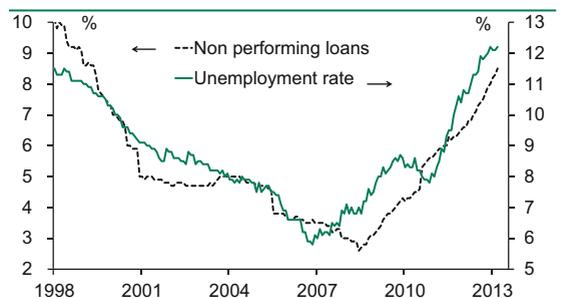


Chart 19

Sources: Bank of Italy, Istat

Undoubtedly the rise of NPLs has dented the coverage ratio of Italian banks, making them more vulnerable to adverse shocks. Yet, on this point Italian authorities have started to take actions. Between 2012 and 2013, the Bank of Italy conducted an Asset Quality

Review (Banca d'Italia, 2013) aiming at assessing the level of NPLs and the coverage ratio characterizing Italian banks⁵. After detecting the need of additional provisions, private institutions have taken actions to consolidate their balance sheets. According to the IMF (IMF, 2013), under a severely adverse scenario bank losses, due mainly to credit losses and mark to market losses from Italian sovereign securities, would lead to a shortfall of capital of between EUR 6-14bn, (0.4-0.9% of GDP). A recapitalisation of this magnitude seems, at first sight, manageable. Assuming, in the worst case, that the recapitalisation would come entirely from the Government, an additional 1pp of GDP on the deficit in one single year would not alter the debt dynamics.

Credit risk and sovereign exposures have undoubtedly undermined the Italian banking sector and its capacity to lend. During the summer 2013, credit to the private sector was still contracting. Among the supply factors constraining lending we can list: *i)* liquidity problems, *ii)* risk aversion and *iii)* capital shortfalls. The ECB, acting as lender of last resort (for the banking sector, at least) and launching the Outright Monetary Transaction has drastically reduced liquidity issues and risk aversion. The ECB will continue to provide liquidity under the current framework of full allotment-fixed rate for as long as needed and at least until the end of Q2 2015. As for capital shortfalls, as stressed above, banks have already undertaken a process for consolidating their balance sheets, well in advance of the ECB's Asset Quality Review (AQR) that will be conducted in the first half of 2014. In addition, the arrears paying program should bring some relief on banks and non-financial corporations. Better firms' profitability might moderate the increase of NPLs.

Structural reforms to cope with Italian bottlenecks

Healthy public finances and a solid banking sector are necessary conditions for a long and sustained growth. However, they are not sufficient. On this line the Monti Cabinet first and then the Letta administration have embarked on a series of structural reforms aiming at solving all those impediments which are blocking growth. These measures aim at addressing: (see the annex for a detailed list of measures):

Labour market disfunction. These reforms aim at:

- 1) Encouraging a stable employment. Promoting apprenticeships, creating disincentive for fixed-term contract, reducing the duality in the labour market.

- 2) Adding some degree of flexibility. High levels of job protection and high levels of taxes on labour are factors limiting firms' hiring. The reform reduced the cost of worker dismissal by limiting the compulsory reinstatement in the case of dismissal for economic reasons. According to the reform, the labour judge has now the possibility to graduate the sanctions in the case of unfair dismissal depending on the severity of the case rather than requiring, as before, an automatic reinstatement. Secondly, as these procedures might last for a long period (another element limiting firms from hiring and investing in Italy), the labour reforms introduced a compulsory pre-conciliation process which may reduce the number of court actions. Other measures aim at reforming the unemployment benefit system. The new scheme would introduce a homogenous and universal unemployment benefit system, replacing the unfair and uneven current one.

- 3) Reducing labour costs. Recently, the Government has introduced measures to reduce the tax wedge (De Lucia, 2013). While this is a step in the right direction, the reduction of labour costs is marginal and spanned over several years. It is worth stressing, however, that rooms of manoeuvre of the Government are limited as it has to respect the target agreed on with the EU institutions for keeping the deficit ratio below 3% and progressively reducing the debt ratio.

A first attempt by the IMF to estimate the impact of the labour reforms shows that their correct implementation would raise real GDP by more than 1% with respect to the baseline case. (Lusinyan & Muir, 2013).

Increasing the competition in the product market.

Liberalisations. Since December 2011, the government has introduced a wide range of measures which should boost competition in several servicing-producing sectors. These measures intend to strengthen the power of the Competition Authority, raise competition in the public transportation sector, separate network ownerships (between production and supply) in the energy sector, increase the deregulation in some professional services and retail sectors (see charts 3 and 4 for details).

All these measures should have effects on activity throughout several channels. First of all, the generated cost reductions would improve competitiveness and promote a better use of resources. In addition, the higher level of competition in several sectors might push firms to invest more in innovation, with positive effects on both productivity and growth.

According to an IMF study, all those measures might raise GDP by more than 4% within 5 years (Lusinyan & Muir, 2013).

All these measures are welcome. Yet, Italy probably needs stronger doses of medicine. Labour reforms could be strengthened throughout several angles. In particular, the reform was not intended to affect the wage bargaining process which remains highly centralised. A more decentralised system would allow wages to be more in line with productivity. The low labour participation rate, due mainly to the low female participation, remains a case of concern. This is largely due to the role of women for providing care functions for children, while in other countries the public sector provides a much larger range of services in this area. Public spending on family with children is well below the eurozone average (OECD, 2013). In addition more actions aiming at reducing the tax wedge are probably needed. However, this policy would be better if part of a broader reform of the tax system, reducing taxes on labour and income and raising those on consumption.

More incisive actions on product market deregulations would be very welcome. Several factors continue to limit activity and investment. In particular competition in different retail and other service-providing sectors continue to be rather low. In addition, Italy scores rather poorly on the World Bank "Doing Business" ranking. Note that this indicator takes into account the speed of civil justice where Italy performs extremely badly. The number of days to solve commercial disputes is more than 1200 days in Italy against less than 400 in Germany and an average of slightly above 500 for the average of OECD countries. The government adopted in 2012 measures on this field including, geographical rationalisation and increasing specialisation of judges. Further steps, such as incentives to use other mechanisms to solve disputes, like mediation would be clearly welcomed.

Italy has to improve its institutional system. Constitutional reforms aiming at making more fluid and efficient the public administration would be welcome. The current perfect bicameralism system has proved to

be too complex at several occasions, limiting the speed at which laws are adopted. Measures aiming at reducing the number of members of the Parliament would be welcome. Corruption and waste of public money is by far the main factor behind the large abstention during the latest general elections and the strong support for the anti-establishment 5-Star Movement.

Last but not least, Italy has to take serious efforts to improve the stability of its political system. The current electoral law does not help as it might prove unable to detect a clear winner after a general election. The current system creates everything but stability, which is what is needed to undertake and implement important but painful reforms. It is worth stressing that the electoral law is not a constitutional law: it does not deserve a special procedure to be amended or changed. It is just a matter of political willingness.

Conclusion

At the end of 2011 Italy was caught in a bad equilibrium characterised by high levels of debt, high levels of interest rates and low growth. Since then the country has undertaken measures to strengthen its public finances and to solve the bottlenecks which constrain its prospects. The deficit ratio has been reduced below the 3% threshold in line with the EU targets and the debt ratio, although it has reached new highs should start to decrease next year. In addition some macroeconomic imbalances have started to narrow: the current account balance turned positive recently after being in negative territory for a while, and the Target 2 debt position is moderating.

Yet, this is no time for complacency. High levels of debt are still a burden for the country, constraining the government's actions. The current institutional system is a case of concern. Political instability could pose a risk to the reform agenda and its implementation. Structural reforms, highly needed, produce larger and long-lasting effects in the medium-to-longer term while they might weigh on activity in the short-run. The lack of fast results might create a sense of reform fatigue undermining what has been done so far. Progress on institutional reforms, such a new electoral law, able to reduce political uncertainty would be very welcome news.

10 December 2013

clemente.delucia@bnpparibas.com

Bibliography

Alesina, A. & Ardagna, S., 2012. The design of fiscal adjustments. *NBER Working Paper N. 18423*, September.

Banca d'Italia, 2013. *The recent Asset Quality Review on non-performing loans conducted by the Bank of Italy: Main Features and results*

Rome:http://www.bancaditalia.it/media/chiarimenti/prestiti_deteriorati/Asset_quality_review.pdf

Benadal, N., Diaz del Hoyo, J. L., Pierluigi, B. & Vidalis, N., 2006. Output growth differentials across the Euro Area Countries: some stylised facts. *ECB Occasional Paper Series*, May, Volume 45

Cerisier, F., 2013. Eurozone: Fiscal Consolidation under Review. *Conjoncture BNPParibas*, March

De Lucia, C., 2010. Financial crisis and potential output. *Conjoncture, BNPParibas*, March

De Lucia, C., 2013. A small "constrained" step in the right direction. *EcoWeek BNPParibas*, 18 October

IMF, 2013. *Global Financial Stability Report: Transition Challenges to Stability*, Washington: IMF

IMF, 2013. Italy: Financial System Stability Assessment. *IMF Country report*, N.300/13 September

Lusinyan, L. & Muir, D., 2013. Assessing the Macroeconomic Impact of Structural Reforms: The Case of Italy.

IMF Working Paper, January

OECD, 2012. *Education at glance*, Paris: OECD

OECD, 2013. *Economic Survey: Italy*, Paris: OECD

OECD, 2013. *Taxing wages 2011-2012*, Paris: OECD

Product Market reforms: Main problems and actions taken so far

Area	Sub sector	Main Problems	Actions Taken
Energy	Gas industry	High wholesale prices as a result of insufficient facilities for gas importation; insufficient investment in transport/ storage capacity by incumbent ENI; multi-level veto powers and co-ordination failure; long-term import contracts	Ownership separation of ENI from the gas distribution company; lower tariffs for vulnerable customers; promoting strategic investments
	Electricity	High tariffs as a result of costly gas-based generation; insufficient investment in distribution infrastructure; information asymmetries between integrated distributors and final sellers	Promoting investment in the distribution network; increasing information transparency
	Petroleum Products	Outdated and oversised distribution network; regulatory barriers; contractual constraints	Eliminating restrictions on contractual arrangements and activities; replacing outdated systems; improving information transparency
Transports	Regulatory framework	Fragmented regulation, involving conflict of interest between regulators and service providers	Establishing independent Transport Authority
	Railways	Lack of vertical separation and competition; low quality of passenger (regional) and freight services; incumbent protected by government subsidies and entry barriers	Measures to be defined by the Transport Authority; competitive tender process for local railway services introduced
	Higways	Inadequate tariff system (not translating into investments to extend the network); very long duration of concessions	Measures to be defined by the Transport Authority; tariffs systems for new concessions to be reviewed
	Taxi services	Supply restrictions	Guidelines to limit the restrictions are provided but yet to be implemented; however, Transport Authority's role in decisions on licenses will be limited
Professional services	General	Excessive regulation; limited competition protecting incumbent rents; conflict of interest in the governance of professional orders	Abolishing tariffs for regulated professions; reforming professional orders to ease entry and activity restrictions; separating administrative, education, and disciplinary functions within orders
	Pharmacies	Quantitative restrictions; constraints on ownership; partial liberalisation of the sale of drugs	Increasing the number of pharmacies; abolishing some restrictions; drug prescriptions should indicate generic alternative
	Notaries	Quantitative restrictions; inadequate supply; shortcomings in entry exams	Increasing the number of notaries; more regular assessment of needs
Local public services	General	Non-competitive contract awards in favor of incumbents; "in-house" contracting; conflict of interest between regulators and service providers; low service quality	Requiring competitive tendering and territorial consolidation in service provision to increase efficiency/reduce costs; strengthening enforcement and sanctions for non-compliance; monitoring by the Presidency of the Council of Ministers

Table 3

Sources: IMF, BNP Paribas

Labour Market reforms: Main problems and actions taken so far

Area	Sub sector	Main Problems	Actions Taken
Contracts and labor market entry	General	Dualism; large number of atypical contracts; precariousness and difficulties to enter the market, especially for the youth	Encouraging stable employment relationships
	Apprenticeship	Insufficient training contents; ineffective in translating into an open-ended contract	Promoting apprenticeship via tax incentives; increasing training; conditioning new contracts on past conversion into open-ended positions; increasing minimum duration and share of apprentices
	Temporary contracts	Disincentives for investing in skills and human capital; subject to abuse	Tax disincentives for fixed-term contracts ; controlling abuse of atypical contracts
Employment protection legislation	Open-ended contracts	Prohibitively high costs for dismissal; mandatory reinstatement and compensation for unfair dismissal	Reducing costs of individual dismissal by limiting the compulsory reinstatement in case of dismissal for economic reasons
	Collective dismissal	Highest costs among OECD countries	Harmonizing with the modifications proposed for individual dismissal
	Legal process	Long and costly; only country in the OECD where legal representation is mandatory; limited use of out-of-court settlements	Establishing special accelerated process for dismissal litigations; incentives for out-of-court settlement
Social safety net	General	Fragmented, complex, and uneven system; inefficient workers' reallocation, regionally and in terms of skill mismatches	Reorganizing social safety net to make the coverage more uniform (within the overall fiscal constraints) by 2017; instruments for employer-financed early retirement schemes
	Wage guarantee funds	May hinder efficient workers' reallocation and create adverse incentives for non-viable firms	Extend wage guarantee funds, as in part already in place during the crisis years
Labour Participation	Female participation	Very low participation	Vouchers for baby-sitting services; tax incentives to hire
	Youth employment	Very low participation	Tax incentives to hire; establishing a special type of company (with simplified requirements) for young entrepreneurs ; apprenticeship contracts (see above)
	Active labour market policies	Regional fragmentation and differences in efficiency; low spending on activation policies	Some liberalisation of employment placement services ; strengthening the system by introducing minimum levels of employment services
Internal flexibility	Firm-level contracts	Disconnect between wage and productivity developments; insufficient use of firm-level contracts	Agreement between social partners and legislation to promote wage bargaining decentralisation; tax incentives for productivity-based contracts
Public sector employment	General	Large regional differences in the relative size; high public-private wage ratio; differences in regional cost of living not reflected in wages; insufficient mobility	Not yet covered in the reform proposal but remains under discussion; earlier public administration modernization reform stalled because of fiscal constraints

Table 4

Sources: IMF, BNP Paribas

NOTES

¹ In addition there is a large literature showing that adjustments made by raising revenues rather than reducing taxes might decrease activity by a greater amount (see among others (Alesina & Ardagna, 2012)).

² While the impact on the debt was of around 2.5 pp, the impact on the deficit was limited. Current expenditures had already been added to the deficit (under accrual-based rules). However, around EUR 8bn out of EUR 40bn are considered capital expenditures, which are accounted for at the time cash payments are actually made. The deficit target for 2013 was, therefore, raised from 2.5% early forecast to 2.9%.

³ While Italy is not respecting this new debt rule, set in the Six-Pack, a procedure will be not open over the coming years. The European Commission decided to leave the countries exiting from excessive deficit procedure a window of three years before an action might be considered regarding its debt. This transitional period should avoid abrupt changes in the path of policy consolidation after that the countries have undertaken (in many case for several years) measures to correct excessive budget deficits. However, in its recent assessment on the Italian 2014 national budget proposal, the European Commission has raised some concern that the country is not taking enough measures to reduce its debt in line with the new rules. In other words, the Commission believes that if the country does not strengthen its actions towards consolidating public finances, it might be forced to re-open a procedure against Italy for excess debt in three-year times.

⁴ The fiscal part of the Treaty on Stability, Coordination and Governance, called "Fiscal Compact", sets that all eurozone countries have to respect or converge towards a balanced budget in structural terms (-0.5% of GDP). For more details see "Six-pack? Two-pack? Fiscal Compact? A short guide to the new EU fiscal governance, available at:

http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

⁵ The analysis shows that at least 20 medium and large bank groups had coverage ratio below the average or which have decreased sharply recently. The analysis indicates the need of additional provisions for EUR 7.5bn (between September and December 2012). The coverage ratio thus rose to 43% at the end of 2012 from 41% in September. Admittedly, this is a small increase. It is worth stressing, however, that over the same period NPLs, the denominator, rose sharply.



ECONOMIC RESEARCH DEPARTMENT

• Jean-Philippe COTIS Chief Economist	+33.(0)1.55.77.47.31	jean-philippe.cotis@bnpparibas.com
---	----------------------	------------------------------------

OECD COUNTRIES

• Jean-Luc PROUTAT Head	+33.(0)1.58.16.73.32	jean-luc.proutat@bnpparibas.com
• Alexandra ESTIOT Deputy Head – Globalisation, United States, Canada	+33.(0)1.58.16.81.69	alexandra.estiot@bnpparibas.com
• Hélène BAUDCHON France, Belgium, Luxembourg	+33.(0)1.58.16.03.63	helene.baudchon@bnpparibas.com
• Frédérique CERISIER Public finance – European institutions	+33.(0)1.43.16.95.52	frederique.cerisier@bnpparibas.com
• Clemente De LUCIA Euro zone, Italy - Monetary issues - Economic modeling	+33.(0)1.42.98.27.62	clemente.delucia@bnpparibas.com
• Thibault MERCIER Spain, Portugal, Greece, Ireland	+33.(0)1.57.43.02.91	thibault.mercier@bnpparibas.com
• Caroline NEWHOUSE Germany, Austria -Supervision of publications	+33.(0)1.43.16.95.50	caroline.newhouse@bnpparibas.com
• Catherine STEPHAN United Kingdom, Switzerland, Nordic Countries – Labour market	+33.(0)1.55.77.71.89	catherine.stephan@bnpparibas.com
• Raymond VAN DER PUTTEN Japan, Australia, Netherlands - Environment - Pensions	+33.(0)1.42.98.53.99	raymond.vanderputten@bnpparibas.com

• Tarik RHARRAB Statistics	+33.(0)1.43.16.95.56	tarik.rharrab@bnpparibas.com
--------------------------------------	----------------------	------------------------------

BANKING ECONOMICS

• Laurent QUIGNON Head	+33.(0)1.42.98.56.54	laurent.quignon@bnpparibas.com
• Delphine CAVALIER	+33.(0)1.43.16.95.41	delphine.cavalier@bnpparibas.com
• Céline CHOLET	+33.(0)1.43.16.95.54	celine.cholet@bnpparibas.com
• Laurent NAHMIA	+33.(0)1.42.98.44.24	laurent.nahmias@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

• François FAURE Head	+33.(0)1 42 98 79 82	francois.faure@bnpparibas.com
• Christine PELTIER Deputy Head - Methodology, China, Vietnam	+33.(0)1.42.98.56.27	christine.peltier@bnpparibas.com
• Stéphane ALBY Africa, French-speaking countries	+33.(0)1.42.98.02.04	stephane.alby@bnpparibas.com
• Sylvain BELLEFONTAINE Latin America - Methodology, Turkey	+33.(0)1.42.98.26.77	sylvain.bellefontaine@bnpparibas.com
• Pascal DEVAUX Middle East – Scoring	+33.(0)1.43.16.95.51	pascal.devaux@bnpparibas.com
• Hélène DROUOT Asia	+33.(0)1.42.98.33.00	helene.drouot@bnpparibas.com
• Jean-Loïc GUIEZE Africa, English and Portuguese speaking countries	+33.(0)1.42.98.43.86	jeanloic.guizee@bnpparibas.com
• Valentin LETHIELLEUX Latin America	+33 (0)1.42.98.48.45	valentin.lethielleux@bnpparibas.com
• Johanna MELKA Asia – Capital Flows	+33.(0)1.58.16.05.84	johanna.melka@bnpparibas.com
• Alexandre VINCENT Central and Eastern Europe	+33.(0)1.43.16.95.44	alexandre.vincent@bnpparibas.com
• Alexandra WENTZINGER Brazil	+33 (0)1 55 77 80 60	alexandra.wentzinger@bnpparibas.com

• Michel BERNARDINI Public Relations Officer	+33.(0)1.42.98.05.71	michel.bernardini@bnpparibas.com
--	----------------------	----------------------------------





OUR PUBLICATIONS

**CONJONCTURE**

Structural or in the news flow, two issues analysed in depth

**EMERGING**

Analyses and forecasts for a selection of emerging economies

**PERSPECTIVES**

Analyses and forecasts for the main countries, emerging or developed

**ECOWEEK**

Weekly economic news and much more...

**ECOFASH**

Data releases, major economic events. Our detailed views...

**ECOTV**

In this monthly webTV, our economists make sense of economic news

**ECOTV WEEK**

What is the main event this week? The answer is in your two minutes of economy

To receive our publications, please subscribe on our website. You can read and watch our analyses on EcoNews, our iPad and Android application.



<http://economic-research.bnpparibas.com>

The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. This report does not constitute an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein. Any reference to past performance should not be taken as an indication of future performance. To the fullest extent permitted by law, no BNP Paribas group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report. BNP Paribas SA and its affiliates (collectively "BNP Paribas") may make a market in, or may, as principal or agent, buy or sell securities of any issuer or person mentioned in this report or derivatives thereon. BNP Paribas may have a financial interest in any issuer or person mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon. Prices, yields and other similar information included in this report are included for information purposes. Numerous factors will affect market pricing and there is no certainty that transactions could be executed at these prices. BNP Paribas, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any person mentioned in this report. BNP Paribas may, from time to time, solicit, perform or have performed investment banking, underwriting or other services (including acting as adviser, manager, underwriter or lender) within the last 12 months for any person referred to in this report. BNP Paribas may be a party to an agreement with any person relating to the production of this report. BNP Paribas, may to the extent permitted by law, have acted upon or used the information contained herein, or the research or analysis on which it was based, before its publication. BNP Paribas may receive or intend to seek compensation for investment banking services in the next three months from or in relation to any person mentioned in this report. Any person mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

BNP Paribas is incorporated in France with limited liability. Registered Office 16 Boulevard des Italiens, 75009 Paris. This report was produced by a BNP Paribas group company. This report is for the use of intended recipients and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of BNP Paribas. By accepting this document you agree to be bound by the foregoing limitations.

Certain countries within the European Economic Area:

This report is solely prepared for professional clients. It is not intended for retail clients and should not be passed on to any such persons. This report has been approved for publication in the United Kingdom by BNP Paribas London Branch. BNP Paribas London Branch is authorised and supervised by the Autorité de Contrôle Prudentiel and authorised and subject to limited regulation by the Financial Services Authority. Details of the extent of our authorisation and regulation by the Financial Services Authority are available from us on request.

This report has been approved for publication in France by BNP Paribas SA, incorporated in France with Limited Liability and is authorised by the Autorité de Contrôle Prudentiel (ACP) and regulated by the Autorité des Marchés Financiers (AMF) whose head office is 16, boulevard des Italiens 75009 Paris, France.

This report is being distributed in Germany either by BNP Paribas London Branch or by BNP Paribas Niederlassung Frankfurt am Main, a branch of BNP Paribas S.A. whose head office is in Paris, France. BNP Paribas S.A. – Niederlassung Frankfurt am Main, Europa Allee 12, 60327 Frankfurt is authorised and supervised by the Autorité de Contrôle Prudentiel and it is authorised and subject to limited regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

United States: This report is being distributed to US persons by BNP Paribas Securities Corp., or by a subsidiary or affiliate of BNP Paribas that is not registered as a US broker-dealer to US major institutional investors only. BNP Paribas Securities Corp., a subsidiary of BNP Paribas, is a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority and other principal exchanges. BNP Paribas Securities Corp. accepts responsibility for the content of a report prepared by another non-U.S. affiliate only when distributed to U.S. persons by BNP Paribas Securities Corp.

Japan: This report is being distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited or by a subsidiary or affiliate of BNP Paribas not registered as a financial instruments firm in Japan, to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. BNP Paribas Securities (Japan) Limited is a financial instruments firm registered according to the Financial Instruments and Exchange Law of Japan and a member of the Japan Securities Dealers Association and the Financial Futures Association of Japan. BNP Paribas Securities (Japan) Limited accepts responsibility for the content of a report prepared by another non-Japan affiliate only when distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited. Some of the foreign securities stated in this report are not disclosed according to the Financial Instruments and Exchange Law of Japan.

Hong Kong: This report is being distributed in Hong Kong by BNP Paribas Hong Kong Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Hong Kong Branch is registered as a Licensed Bank under the Banking Ordinance and regulated by the Hong Kong Monetary Authority. BNP Paribas Hong Kong Branch is also a Registered Institution regulated by the Securities and Futures Commission for the conduct of Regulated Activity Types 1, 4 and 6 under the Securities and Futures Ordinance.

Some or all the information reported in this document may already have been published on <https://globalmarkets.bnpparibas.com>

© BNP Paribas (2014). All rights reserved.

Prepared by Economic Research – BNP PARIBAS

Registered Office: 16 boulevard des Italiens – 75009 PARIS

Tél : +33 (0) 1 42 98 12 34 – Internet : www.bnpparibas.com

Publisher: Baudouin Prot

Printed in France by: Ateliers J. Hiver SA – January 2014

ISSN 0224-3288 – Copyright BNP Paribas

