Italian Government at Risk on Berlusconi's Future in Politics

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Economics
Western Europe
Industrialised G7 Countries

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Summary

Tensions within Italy's governing coalition have escalated over the past two days, after Mr. Berlusconi said he would pull down the government if a solution is not found to preserve his political career, following his conviction for tax fraud. A vote to oust Mr. Berlusconi from his Senate seat is scheduled for 9 September. Democrats and PM Letta claim the decision is purely juridical and the Senate should just apply the law. Comment: although a last-minute compromise between PD and PdL is still possible, positions are getting further apart. Even if the government falls, ballot boxes could be avoided in the immediate future, but we still think early elections are likely to occur in spring 2014.

However, the **Italian government seems closer to agreement on the much-debated IMU property tax**, scrapping it (as requested by the centre-right PdL), but introducing a lower *"service tax"*. This is likely to leave a revenue shortfall relative to original budget plans, which adds to an already widening fiscal deficit. In our view, a dangerous strategy, given exceptionally high, and rising, debt-to-GDP ratio.

Buba's Weidmann would welcome publication of ECB meeting minutes, saying *"more transparency would definitely contribute to better public understanding of the decisions of the ECB"*. Good news for investors, we think. Separately, Mr. Weidmann also warned of the risks of a euro area exit.

Belgium's overvalued housing market, by 49% (on a price to income ratio) and 63% (on a price to rent ratio) according to an OECD study reported by *Le Soir*. Comment: housing is one of Belgium's key vulnerabilities, but with GDP growth set to remain on a modest upward trajectory, we think the issue is less problematic than in the Netherlands.

French employers and small entrepreneurs at loggerheads with government on pension reform, recommending an increase before 2020 in the minimum retirement age from 62 to 63 and an increase in the number of years of contributions.

Greece – German politicians continue to discuss a third programme for Greece, with Merkel saying the precise sum would only be known in March 2014. Similarly, ECB's Asmussen in Athens yesterday said debt relief for Greece to be considered only in Q1 14, when final data on the government's primary budget is known (and it will be clear that Greece needs additional money only to service the debt held by the Europeans).

Flash Aug PMIs – strong reading for euro area composite PMI, up to 51.7 (50.5 in July), above expectations. French composite PMI fell to a two-month low of 47.9, while the German composite index rose by 1.3 point to 53.4, highest since January.

Euro Area Economic Outlook: we are lifting our euro-area growth forecasts and no longer expect the ECB to cut the refi rate. But with widespread austerity fatigue,

Recent Research

Global Economic Outlook and Strategy — August 2013

We cut 0.1% off our 2013 global growth forecast this month (to 2.4%), but lift our 2014 forecast by 0.1% to 3.2%. We highlight four key issues that will shape the economic and market outlook in coming months: Fed tapering, Japan's consumption tax hike choices, the EM slowdown, plus renewed focus on issues of longterm fiscal sustainability in various EMU periphery countries. We pencil in the first Fed hike for 2015, with an even longer period of ultra-low rates likely from the ECB, BoJ and BoE.

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Germany — Is the Current Coalition Heading For Four More Years?

Western Europe

The parties of the current German ruling coalition, CDU/CSU and FDP, have been gaining in recent polls of German voting intentions ahead of the general election

a series of unresolved issues needs to be tackled. See ***Global Economic Outlook and Strategy - August 2013.***

Today's News in Detail

Italy – government at risk on lack of agreement on Berlusconi's future in politics. Tensions within the governing coalition have escalated over the past two days, after Mr. Berlusconi issued an ultimatum and announced that he would withdraw his PdL party's support for the Letta administration if a solution is not found to preserve his political career. A vote to oust Mr. Berlusconi from his Senate seat is scheduled on 9 September, following his conviction for tax fraud. A law approved in December 2012 rules ineligible for public office anyone sentenced to more than two years in prison, but PdL's members claim the law could be deemed unconstitutional and should be carefully reassessed. A meeting yesterday between the Democrat PM Letta and Deputy PM, PdL's Alfano, did not bring any positive news on a possible compromise, according to several media reports. *Il Corriere* newspaper reports government officials' comments defined the meeting as *"harsh and tense"*. The newspaper says the PdL asked the government to find a *"political solution"* to prevent the leader of one of the two major coalition parties to lose his parliamentary seat, while the Democrats and PM Letta claimed the decision is purely juridical and the Senate should simply take note and apply the law. Comment: although a last-minute compromise between PD and PdL is still possible, the positions of the two main coalition partners are moving further apart. Mediation from President Napolitano could be the last resort to keep the government alive and avoid the ballot boxes. A different governing coalition – perhaps including part of Beppe Grillo's anti-establishment M5S party – is also a possibility, albeit a small one, if Berlusconi decides to pull the plug on the government. However, we still think early elections are likely to occur in spring 2014.

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Italy – government close to an agreement on the IMU property tax. The Letta-Alfano meeting yesterday (see previous story) reportedly brought some positive news on another issue, the much-debated IMU property tax. This tax has been the other major point of divergence between the two coalition parties. Scrapping the tax on primary residences (as requested by centre-right PdL), but incorporating it into a lower *"service tax"* to be paid to local governments, seems to be the compromise reached. The first IMU instalment on primary residences was due in June but was suspended by the government before a revision of real estate taxation was completed. The revenue shortfall resulting from the suspension is not to be covered by the new tax, press reports suggest. Comment: the budget deficit is re-widening, after narrowing significantly in 2012, largely because of less austerity policies. This is a dangerous strategy in our view given the exceptionally high, and still rising, debt-to-GDP ratio.

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Buba's Weidmann would welcome publication of ECB meeting minutes – European Central Bank Governing Council member and Bundesbank President Jens Weidmann in an interview with German magazine *Capital* notes that *"more transparency would definitely contribute to better public understanding of the decisions of the ECB"*, adding that he would *"welcome it if we publish our discussions promptly after the monetary policy meetings"*. As to the precise format that the minutes should take, Mr. Weidmann would favour making public the *"main lines of argument and motives for our decisions"*, while noting that the publication of minutes would also have associated risks that *"grandstanding would take place and then the actual discussions are held outside the official sessions"*. Comment: this is good news for investors, as a greater degree of

on September 22. Their combined share is now at 46% according to the Citi Polling Trend, leaving them slightly ahead of the joint share of the opposition parties (the centre-left SPD and Greens and the far-left Linke party) at 45%.

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Euro Economics Weekly — Euro Area Recovery? Not Strong Enough

Western Europe

The 0.3% QQ gain in Q2 euro area GDP released this week marked the end of a six-quarter recession. We argue that the main factors behind the economic improvement have been some rebound after a particularly weak, and partly weather-related, GDP outcome in Q4 12 and Q1 13, a rebound in exports to non-eurozone countries and significantly less severe fiscal tightening than we had anticipated. Falling inflation has probably also boosted real incomes and private consumption.

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UK Economics Weekly — The Upturn and Unemployment

Western Europe

With upturns in housing, consumer spending and exports, we are again lifting our UK growth forecasts. Nevertheless, we believe the journey to a 7% jobless rate will prove quite long, probably taking until about 2017. This reflects scope for a productivity rebound, more use of under-employed labour, plus high labour supply growth. UK labour supply is likely to continue to be lifted by high inflows of foreign workers, rising participation rates among the over 50s and tightening benefit standards.

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transparency would likely help understand a little bit more of the Governing Council's thinking on certain topical issues pertaining to the medium-term outlook for the refi rate at the time when the Governing Council experiments with forward guidance. We doubt that comments would necessarily be associated with the names of central bankers to avoid putting too much pressure on Governing Council members initially.

Bundesbank president Weidmann warns of risks of euro area exit. In the same interview with *Capital*, Mr Weidmann warned of the dangers of leaving the eurozone, noting that *"what vexes me is how recklessly people invoke such a scenario"* and that such an exit would have grave consequences both for the exiting country and other countries as well. Weidmann also repeated both his skepticism of ECB bond purchases and his interpretation of forward guidance as a change in communication without commitment, even though he also noted that exit from low interest rates was *"very distant"*.

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Belgium's overvalued housing market – an OECD report on housing markets reveals that Belgian real estate could be overvalued by 49% (on a price to income ratio) and 63% (on a price to rent ratio) according to *Le Soir*. In both cases, Belgium is clearly above the average. The article goes on to highlight that this OECD study confirms similar analyses by the ECB and rating agency S&P, as well as from weekly magazine *The Economist*, with all parties having concluded that Belgium is experiencing a housing bubble, but without quantifying it precisely. *Le Soir* notes that most Belgian housing specialists suggest that prices will stabilise rather than experience a sudden correction. Comment: housing is one of Belgium's key vulnerabilities, given the extent of the overvaluation, with a possible adjustment likely to have negative consequences for the banking system. But with GDP growth set to remain on a modest upward trajectory throughout the rest of 2013, we estimate that the issue is less problematic than in the Netherlands where the phasing out of the deductibility of interest payments from income tax triggered a sharp adjustment in affordability, and subsequently prices.

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French employers and small entrepreneurs at loggerheads with government – Pierre Gattaz, head of Medef, France's employers group, wrote in an op-ed in *Le Monde* that the government should be bolder with its upcoming pension reform, recommending an increase before 2020 in the minimum retirement age from 62 to 63, as well as an increase in the number of years of contributions to obtain a full pension from 41.5 to 43. The Medef also called on the government to review urgently more than 30 special pension systems allowing much earlier retirement to their beneficiaries, and which are running sizeable deficits. On Wednesday, the government also announced that it was postponing a parliamentary debate on a draft law that would lower the revenue threshold at which small-scale entrepreneurs must exit the scheme and pay social charges, prompting some criticism that the delay was creating legal confusion. Comment: the adversarial position that employers' organisation and small entrepreneurs are adopting illustrates the high degree of fiscal pressure that the French system puts on businesses, dampening their profitability and restricting employment.

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German politicians continue to discuss third programme for Greece: Chancellor Merkel said to TV station Sat1 that the precise sum would only be known in March 2014, as *Frankfurter Allgemeine Zeitung* reports. The newspaper also notes that the route of using structural EU funds to fill any funding gaps for Greece may not work, as these were always tied to specific projects rather than general budget expenditures, and Greece already struggled to use its current

quotas fully. Comment: The debate in coming weeks – in Germany and elsewhere – is unlikely to yield many insights. In one sense, however, it may yet be significant: As German pollster Güllner (who heads the Forsa polling institute) notes in *Handelsblatt*, the continued debate about Greek rescue measures and eurozone bailouts could give the euro-sceptic AfD party a much-needed boost, after it has failed to generate any momentum with the German public in recent months. The pollster also warned that in polls of voting intentions uncertainties were particularly large for the AfD compared to other parties.

Greece – ECB's Asmussen says debt relief for Greece to be considered only in Q1 14, when final data on the government's primary budget will be available. During his visit to Athens, Mr. Asmussen mentioned that debt relief for Greece could take the form of further reductions of the interest rate on the Greek loan facility and the co-financing of the EU structural funds, but he fell short of suggesting that outright haircut on official loans are under discussion. Mr. Asmussen highlighted that any discussion on additional measures can only start when it is certain (only in Q1 14) that Greece has managed to achieve a budget primary surplus. Asmussen also said he did not discuss a third bailout programme for Greece but reaffirmed the Eurogroup's pledge made in December 2012 to stand by Greece. Comment: the achievement of a primary surplus is clearly a key milestone for additional help to be considered. This is because any financing need would only arise to service the existing debt, which is held almost entirely by official lenders (and primarily by the Europeans). We think additional debt relief measures will be granted in 2014, but they would probably fall short of haircuts on the outstanding loans.

Greece – government mulls changes to foreclosure law, scrapping the moratorium. *Ekathimerini* reports that a government meeting today has to decide on the new foreclosure law and on suspending the moratorium on foreclosures, in place since 2009. The newspaper reports that the government may consider at first allowing banks to focus on business properties and holiday homes, thereby avoiding the politically-sensitive problem of home-owners losing their primary residences. The recent IMF report on Greece said that cleaning up banks' balance sheets is a key next step in the adjustment programme, with the NPL ratio on mortgages at a substantial 27% in Q1 13 (as a reference, in Spain after the housing bubble, the same ratio stands at 4%).

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Flash Aug manufacturing PMIs: mixed readings – there was a **strong reading for the euro area composite PMI**, up to 51.7 (50.5 in July), above expectations, with manufacturing at 51.3 (50.1) and services at 51.0 (49.6). The **French composite PMI** fell to a two-month low of 47.9 in August, recording a 1.2-point fall. The services PMI printed a 0.9-point drop to 47.7 while the manufacturing PMI was unchanged at 49.7. Both readings were much weaker than expected, as the consensus was looking for upticks of 0.6pp for both the manufacturing and services measures. Reuters indicated that the new orders manufacturing index rose slightly for the first time in over two years. The **German flash composite PMI** rose by 1.3 point to 53.4, printing its fastest rate of expansion since January. Both the manufacturing (+1.3pt to 52.0) and the services (+1.1pt to 52.4) PMI rose in August, highlighting the likelihood of greater divergence in performance with France in the third quarter. Comment: while there could be some seasonal factors at play in the month of August, the main message from the French PMIs is that the third quarter GDP performance is unlikely to even come close to the 0.5% QQ uptick recorded in 2Q. We continue to expect the economy to expand modestly in the second half, averaging 0.6% in seasonally annualised terms.

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Euro Area Economic Outlook: With Q2 GDP up 0.3% QQ, the Euro economy has exited recession and we again lift our growth forecasts. We no longer expect

the ECB to cut the refi rate in our base case. However, with a varied mix of sizeable fiscal deficits, falling nominal GDP and (in some cases) sizeable bank recapitalisation needs, the general government debt/GDP ratio in Q1 hit new record highs across periphery countries, up by 6.6 percentage points from a year ago in Italy, 12.6pp in Cyprus, 14.9pp in Portugal, 15.2pp in Spain, 18.3pp in Ireland and 24.0pp in Greece. Moreover, austerity fatigue is widespread amidst very high unemployment, and a s**eries of unresolved issues needs to be tackled:** Will Greece need a new debt restructuring? Will Portugal need a second rescue package and will this include some restructuring of liabilities? Will Ireland be able to secure an adequate backstop once its current IMF/ESM programme is completed around year-end? Will Spain seek to extend the ESM bank recap facility into 2014? Will Italy's fragile government survive? And what does the German election on September 22 mean for these issues? See ***Global Economic Outlook and Strategy, August 2012,*** just out.

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Latest Issues of Sovereign Debt Crisis Update

Greek Debt Back at the Centre of Political Debate

"There will have to be another programme in Greece", German FinMin Schäuble admits for first time. Merkel calls for EU unity, saying it's "worth fighting for Europe". Oberhausen is German Detroit, says study. France's 2014 budget to be growth friendly, says FinMin. French pension reform to be financed by higher taxes. Strong gains in Belgian and Dutch consumer confidence. Irish property prices see second consecutive annual rise. Slovenia's central govt deficit improves slightly in July.

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Political Uncertainty: Germany and Italy in the Spotlight

Polls show rising likelihood of current German coalition continuing after election. In Italy, crucial Senate vote on 9 Sep could bring down government. Bundesbank clarifies its view of forward guidance, discusses effect of Japanese policy mix on other countries' economies. Spanish NPL ratio hits new high. Greece's current account deficit continues to shrink. French government finalises pension reform and 2014 budget drafts. Dutch budget deficit to exceed 3% EU limit in 2014 says Dijsselbloem.

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Moody's Sees Risks of Rating Downgrade for Netherlands

While Moody's still rates Netherlands as Aaa, the outlook has been negative since July 2012. Merkel does not rule out Grand Coalition in Germany after the election. Merkel and SPD's Steinbrueck reject another face-value haircut for Greece. SPD politicians call for solidarity, reduce focus on tax increases. Poll shows that only a minority of French households support more austerity. Greece achieves primary budget surplus in July. Head of Greek privatisation agency sacked on ethical grounds.

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A Busy September for the French Government

French PM to unveil politically charged pension reform plans in first weeks of September, trade unions organising day of protest on Sep 10. FAZ estimates Germany's eurozone bailout exposure at €122bn, higher than quoted by FinMin Schaeuble in parliament last week. Greek privatisation fund to decide on real estate securitisations by Nov. Netherlands: lower inflation ahead. Global business leaders want Merkel to stay - FT poll. Germany losing export market share. Slovakia's 2Q GDP at 0.3% QQ.

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Rebound in 2Q GDP Spurs Optimism among Politicians

German Economy Minister Roesler (FDP) optimistic about Germany's economic prospects, as the FDP gains momentum in the polls. German parties argue over energy subsidies - likely a major post-election topic. French government joy over solid 2Q GDP growth. Netherlands' weaker-than-expected growth likely to widen 2014 budget deficit says CPB. German industrial association's proposal on Greek debt. Portugal's very strong 2Q GDP figures. Cyprus sees eighth consecutive quarterly GDP contraction.

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Macroeconomic Research

Global Economic Outlook and Strategy — August 2013

We cut 0.1% off our 2013 global growth forecast this month (to 2.4%), but lift our 2014 forecast by 0.1% to 3.2%. We highlight four key issues that will shape the economic and market outlook in coming months: Fed tapering, Japan’s consumption tax hike choices, the EM slowdown, plus renewed focus on issues of longterm fiscal sustainability in various EMU periphery countries. We pencil in the first Fed hike for 2015, with an even longer period of ultra-low rates likely from the ECB, BoJ and BoE.

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Appendix A-1

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