Economics

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# Euro Economics Weekly

## Focus on Italy

- In this note, we consider the economic outlook for Italy. With current market yields Italy's fiscal position is probably on an unsustainable long-term path – in the sense that the debt/GDP ratio is set to rise for an extended period. Moreover, the situation could rapidly become critical, because the country is highly vulnerable if the sovereign debt crisis persists or intensifies. A significant further rise in yields would deepen and extend the recession and accelerate the rise in the debt/GDP ratio, triggering a worsening vicious circle. As we expect a further escalation of the crisis, we believe Italy will probably need outside help at some point.
- We believe that Italy will experience a deeper recession this year and next than most forecasters predict, reflecting headwinds from the sovereign debt crisis compounded by Italy's large planned fiscal adjustment. We expect the government to miss its deficit targets and even in the absence of any major shocks to yields, the country's debt to GDP ratio is set to increase significantly over the next few years.
- Moreover, over the medium- to longer-term, we continue to believe that the Monti Government's structural reforms, whilst a step in the right direction, will not go far enough to address the product and labour market rigidities which have plagued the Italian economy for generations and will therefore fail to significantly lift the country's potential growth rate from its present lows. We further believe that, as we approach the April 2013 election, and given the increasing popularity of new political parties in Italy, the main political forces which back the Monti Government will make the adoption of far-reaching reform ever more unlikely and protracted.
- As a result, and whilst we do acknowledge some of Italy's strengths (such as the health of its private sector balance sheets and the less damaged balance sheets of its banks, relative to those of other periphery countries), we believe that Italy will experience a deep recession and that its long-term growth prospects will remain weak for an extended period. Such weak growth prospects mean that in our view, Italy remains susceptible to large and sudden rises in yields and that in the event of an aggravation in market tension as a result of the problems in Spain and Greece, Italy too will most likely require some form of intervention from the ECB (which supported Italy already twice), the EFSF/ ESM and the IMF at some point (Jürgen Michels, Ebrahim Rahbari, Tina Fordham and Guillaume Menuet, see page 2).

**Figure 1. Citi Market Forecasts**

| | $/€ | Euro Repo | 10-yr Bunds | £/€ | U.K. Bank Rate | 10-yr Gilt-Bund | SKr/€ | SEK Policy Rate | NOK/€ | NOK Policy Rate | SFr/€ | CHF Policy Rate | CHF Spread vs Bunds |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3Q 12 | 1.23 | 0.50 | 1.40 | 0.78 | 0.50 | 40 | 9.13 | 1.25 | 7.67 | 1.50 | 1.20 | 0.00 | -79 |
| 1Q 13 | 1.25 | 0.50 | 1.25 | 0.79 | 0.50 | 45 | 8.83 | 1.00 | 7.54 | 1.75 | 1.21 | 0.00 | -69 |

Source: Citi Investment Research and Analysis

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**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

# Focus on Italy

**A further escalation of the sovereign crisis is likely to affect Italy more badly**

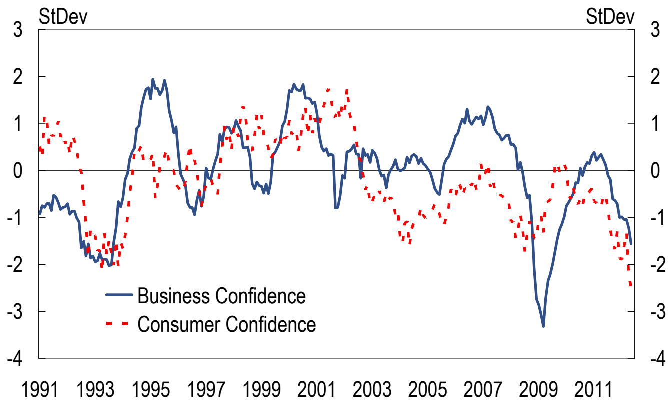
We believe the sovereign debt crisis is likely to escalate further, partly reflecting the increased risk of Greece leaving the euro area.[1] After not being at the center of markets' attention recently, we expect that disappointing economic data and delays in the approval/implementation of structural reform will raise market participants' concerns in respect to Italy. With more signs that Italy could miss its fiscal targets, markets are likely to focus on the country's huge stock of debt and poor growth performance. In such an environment the existing strengths of the country are likely to move to the backseat. As we argued in November 2011, we expect that Italy will require external support from the EFSF/ESM and IMF at some point, or through another round of bold liquidity injections from the ECB, particularly if Spain also finds itself in need of some kind of assistance from the Troika.[2]

### Italy is in a Prolonged Recession

**Sentiment indicators (some at record lows) suggest deepening recession**

Italy is in recession, with GDP having contracted for three consecutive quarters from 3Q11 to 1Q12. Sentiment indicators signal that the economic situation should continue to worsen in 2Q12. In May, consumer sentiment fell to 86.5 — a record low for the time series that exists since 1982 — and business confidence dropped to 86.2, the lowest reading since August 2009 (see Figure 2). Although the composite PMI improved somewhat in May, the April/May average of 43.1 is clearly below the 1Q average of 45.3.

**Figure 2. Italy — Consumer and Business Confidence, Standard Deviation Around Avg, 1991-May 2012**




Sources: Haver and Citi Investment Research and Analysis.

**Figure 3. Italy — Cumulative Fiscal Tightening Effect of the Various Decrees: By Level of Public Administration, 2011-2014**

| | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| Central Administration in €Bn | 3.4 | 35.7 | 51.4 | 51.7 |
| Local Administration in €Bn | -0.5 | 9.2 | 14.3 | 17.4 |
| Social Security in €Bn | -0.1 | 4.0 | 10.0 | 12.2 |
| Total Tightening in €Bn | 2.8 | 48.9 | 75.7 | 81.3 |
| Total Tightening as % of GDP | 0.2 | 3.1 | 4.7 | 4.9 |

Source: Economy and Finance Document 2012, Stability Programme Section

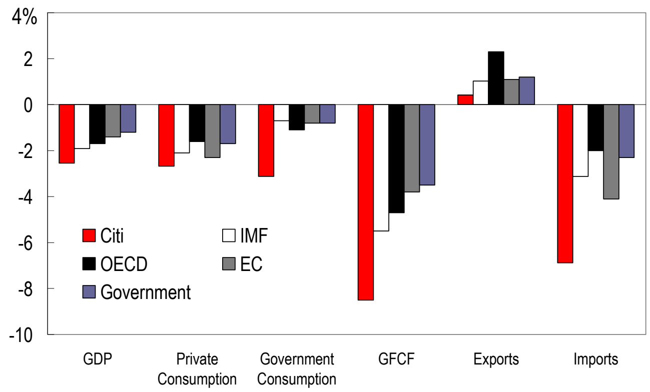
**We have a more downbeat view on Italy's short-term growth prospects than most other forecasters**

These indicators suggest that the Italian government's GDP growth estimates (of a contraction of 1.2% for 2012 and an expansion of 0.5% for 2013) are too optimistic in our view. With our forecast of a contraction in GDP of 2.5% in 2012 and a further fall of 2.0% in 2013 we are also clearly below the growth estimates of the IMF, the OECD and the European Commission. Compared to the other forecasters we are particularly more negative on the outlook on private consumption and investment activity. With a more negative outlook for the euro area economy on average — where 43% of Italian exports go — our forecasts for Italian exports are also lower than other forecasts (See Figures 4 and 5).

[1] See Hollande Takes Over; "Grexit" More Likely, Guillaume Menuet and Jürgen Michels, 7 May 2012, Citi

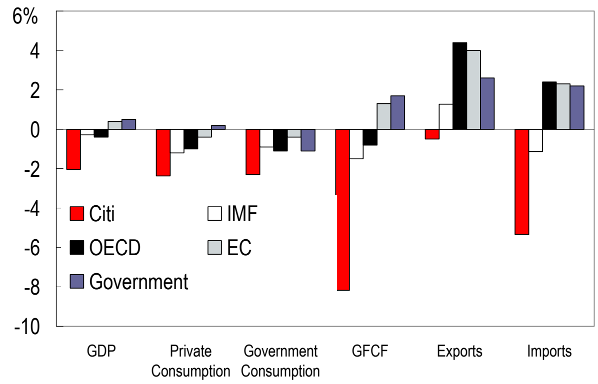
[2] See Euro Weekly - Italy — Too Big to Fail, But Difficult to Bail Out, November 11, 2011, Citi

**Figure 4. Italy — Comparison of GDP Forecasts for 2012 (%)**




Sources: Institutions and Citi Investment Research and Analysis.

**Figure 5. Italy — Comparison of GDP Forecasts for 2013 (%)**




Sources: Institutions and Citi Investment Research and Analysis.

**Our forecast reflects assumption that Grexit (or the prospects of Grexit) will undermine consumer sentiment and investor confidence**

A main reason behind the large divergence between our view and that of other forecasters lies with our outlook on the sovereign debt crisis. We assign a 50%-75% probability of Grexit over the next 12-18 months and use it as a baseline scenario in our economic forecasts.[3] In our baseline scenario, we expect that the ECB and the other European decision-makers will introduce measures (including the ECB providing more multi-year LTROs and cutting rates, the EFSF/ESM providing support and maybe the EU taking first steps towards a banking union) helping to ensure that Grexit will not force other countries to leave the euro area.[4] However, we expect that the escalation of the sovereign debt crisis will undermine sentiment of consumers, businesses and investors in the euro area periphery countries, including Italy. According to the European Commission's report which comments on Italy's latest Stability and Reform Programme, "*the macroeconomic scenario underlying the country's adjustment programme is plausible under the assumption of no further worsening in financial market conditions*". This suggests that under a possible Greek exit and a further intensification of market stress, Italy's macro outlook would worsen substantially relative to the current Government projections.

**Large fiscal consolidation will add to Italy's gloomy economic outlook**

In addition to the negative impact from the likely further escalation of the sovereign debt crisis, the implementation of the earlier-approved austerity measures in Italy are likely to have a negative impact on the economy in the near-to-medium term in our view. As a result of the four fiscal packages since July 2011, which have been mainly adopted through Decree Laws, there will be a cumulative fiscal consolidation of 4.9% of annual GDP (€81.3bn) between 2011 and 2014. With the majority of the measures concentrated in 2012, we expect a large negative impact on the economy this year (see Figure 3).

**Tight lending conditions for the private sector**

Furthermore, similar to other periphery countries' banks, Italian banks have tightened their lending standards substantially since 2H 2011. While there was a large drop in the number of banks reporting a further tightening in lending conditions in the April survey, as a reaction to the ECB's 3Y LTROs, still a net-balance of 25% of Italian banks reported a further tightening in lending conditions to companies and 37.5% to households. These readings are clearly above the euro area average

[3] See Global Economic Outlook and Strategy, Willem Buiter et al, May 2012, Citi

[4] See Euro Economics Weekly - Is Europe Ready for Grexit?, Jürgen Michels, May 25, 2012, Citi

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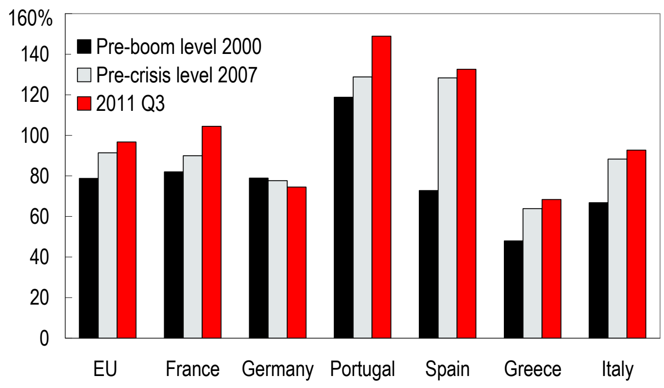
readings of 9% and 17% respectively. To us, this suggests that tight lending conditions will remain a headwind for private sector demand in Italy for the time being.

**Private sector balance sheets in better shape than those of main competitors...**

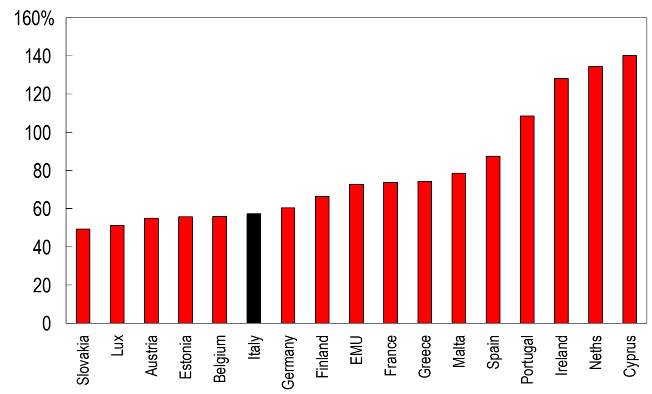
While the private sector in Italy faces headwinds from the ongoing tightening in lending conditions by banks in a similar way to other periphery countries, there seems to be less pressure on the Italian economy from private sector balance sheet problems. Although the debt of non-financial corporations as a share of GDP increased in recent years, the latest available readings for Q3 2011 shows that the debt burden of Italian non-financial companies is somewhat below the EU average and clearly lower than in other periphery countries (see Figure 6).

**Figure 6. Selected Euro Area Countries — Non Financial Corporations Gross Debt-to-GDP Ratio (%), 2000–2011 Q3**




Sources: OECD and Citi Investment Research and Analysis.

**Figure 7. Selected Euro Area Countries — Household's Gross Debt-to-GDP Ratio (%), 2011**




Sources: IMF and Citi Investment Research and Analysis

**…but their good health will not be sufficient to insulate the economy**

Household balance sheets are also in better shape than in many other countries, which probably will help to make private consumption more resilient in an environment of tightening financing conditions. According to IMF data, in 2011 Italian household debt as a share of disposable income (84.0%) and also as a share of GDP (57.3%) was the lowest among the G7 countries. The Italian household debt-to-GDP ratio is the sixth lowest in the euro area (see Figure 7). Also in terms of net financial assets, Italian households - with a share of 163.6% of GDP - are in a better position than those in the other periphery countries. Furthermore, Eurostat data for 2010 show that the homeowner ratio in Italy of 71.9% is above the euro area average of 66.7%, and that 56.4% of Italian households own a house without holding a mortgage, which is clearly above the euro area reading of 38.1% and much higher than in the other periphery countries. This suggests that, in addition to their financial wealth, Italian households also own a large amount of non-financial assets. But, to be clear, in our view Italy's relatively healthy private sector balance sheets will not offset the headwinds of the sovereign debt and financial crisis and will not be sufficient to avert the escalation of the recession which the country entered into in the third quarter of 2011.

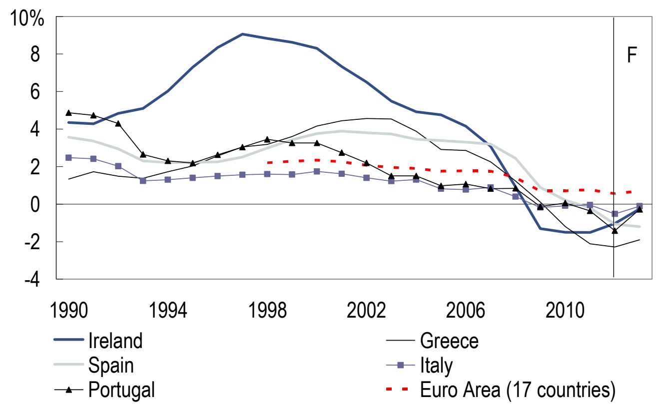
## Italy's Poor Potential Growth Performance

**Italy's low potential growth a problem even before EMU**

The deep renewed recession which we are forecasting also reflects Italy's long-lasting weakness in potential growth which we believe will persist. Potential growth estimates by the European Commission and the IMF show that the low growth potential had been a problem even before the country joined the monetary union.

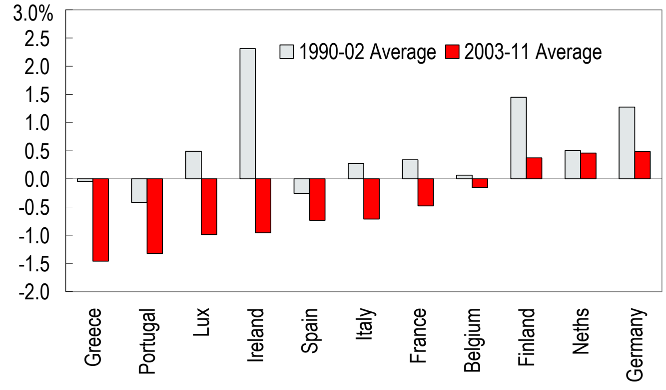
The deterioration persisted after the start of EMU, and has intensified since the beginning of the financial crisis (see Figure 8).

**Figure 8: Selected Euro Area Countries – Potential GDP Growth, (%), 1990-2013F**




Sources: EU Commission and Citi Investment Research and Analysis

**Figure 9: Selected Countries — Total Factor Productivity Growth (%), 1990-2011**




Sources: Conference Board and Citi Investment Research and Analysis

**Poor TFT and employment growth at the heart of Italy's low trend growth**

Data from the Conference Board highlight that Italy's poor growth potential can be traced to a negative contribution from Total Factor Productivity (see Figure 9). According to the latest available IMF Staff paper on Italy (Article IV), Italy's poor TFP record reflects a number of structural rigidities which include:

(i) Policy and regulatory rigidities which limited competition and business creation;

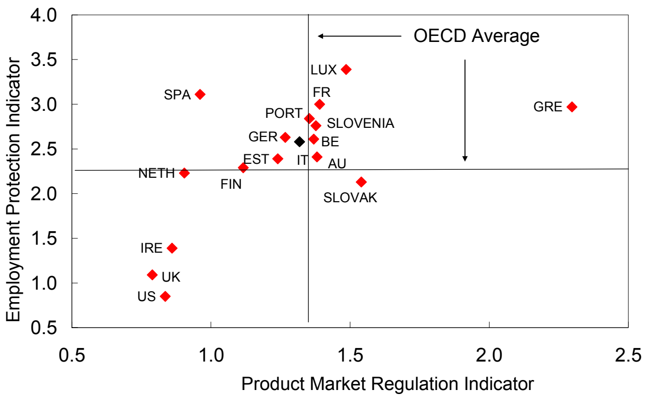
(ii) Low firm efficiency, linked to the preponderance of SMEs that are unable to fully exploit economies of scale, which tend to display low levels of R&D intensity and which have more limited access to credit;

(iii) Limited process and product innovation which have been hindered by rigidities in the country's labour market large share of low-skilled workers; and

(iv) The inefficiency of public expenditure which has also resulted in the crowding out of more productive private sector investment.

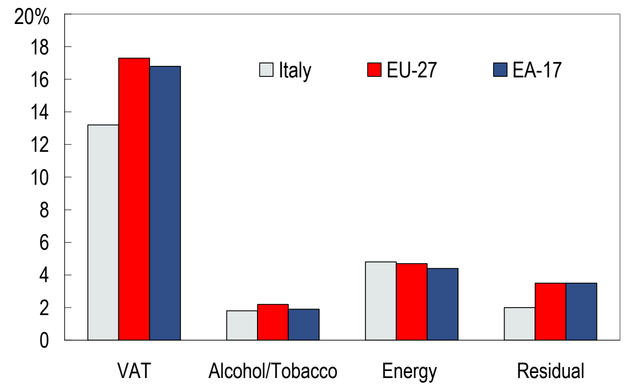
For example, whilst the latest available data from the OECD regarding Product Market Regulation and Employment Protection for 2008 show that Italy is close to the OECD average and the other euro area countries, Italy's employment protection and product market regulation are much higher than in the UK and the US (Figure 10). Furthermore, Italy has the second weakest ranking (87 out of 183 economies) of all euro area countries in the World Bank's *Doing Business* report, only Greece (rank 100) is weaker.

**Figure 10. Selected Countries -- OECD Product Market Regulation and Employment Protection Indicators, 2008**




Sources: OECD and Citi Investment Research and Analysis

**Figure 11. Selected Countries — Share of Consumption Taxes in Total Taxation (%), (2009)**




Sources: OECD and Citi Investment Research and Analysis

**Tax policy sets wrong incentives**

Another source of Italy's poor growth potential lies in its high taxes on labour and capital, which probably contribute to the country's poor employment creation. This distorting feature of the country's tax system is something which is being increasingly acknowledged, with the Governor of the Bank of Italy stating in a recent speech that Italy needs to address its over-reliance on tax policies which hamper growth[5] — a comment also echoed in the European Commission's recent report on the country's Stability Programme for 2012-15[6].

## Monti's reforms: A step in the right direction but not radical enough…

**Monti's reforms constitute an attempt to address these long-standing structural weaknesses**

The Monti Government's first wave of structural reforms has focused on measures to increase competition, reduce barriers to entry and administrative burdens on businesses as well as on measures to increase the flexibility of the country's labour market.

**Italy has room to increase participation rate**

On the labour market reforms, the government's measures aim to boost the country's low participation and employment rates and raise labour productivity with the ultimate goal of boosting potential growth. For example the European Commission assessment of Italy's Stability and Reform Program for 2012-15 argued that if Italy were to raise its employment rate of women aged 30 to 54 years and the employment rate of low-skilled workers aged between 20 and 64 years to the average EU wide employment rates for these groups, it would boost the country's employment rate of 61.1% by as much as 7.1ppts and 7.5ppts, respectively.

**Italy's high centralized wage-bargaining has hampered growth**

Moreover, the international institutions identified Italy's highly-centralized wage-bargaining system as a major source of the country's deteriorating competitiveness and poor growth performance. For example, the European Commission advised the Italian government that its new wage bargaining-framework already formalized into legislation in 2011 should *"allow for more extensive use of firm-level contracts"* to take better account of firm and sector specific needs and address the issue of high rigidities in nominal labour costs.

5 See http://www.bancaditalia.it/interventi/integov/2012/cf_11/cf_11_en/en_cf2012.pdf
6Recommendation for a Council Recommendation on Italy's 2012 national reform programme and delivering a Council opinion on Italy's stability programme for 2012-2015. A copy of the recommendations can be found at: http://ec.europa.eu/europe2020/pdf/nd/csr2012_italy_en.pdf

**EU Commission asks for swift implementation of labour market reform**

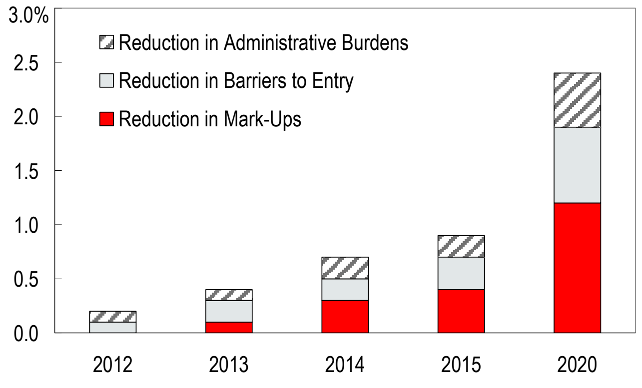
According to the European Commission, the government should move swiftly on the implementation of the labour market reform programme proposed on 4 April aimed at addressing the rigidities and asymmetries of employment protection legislation and practices in Italy whilst better regulating flexibility at entry and moving toward a more integrated social security system. In that respect the planned comprehensive insurance-based system of unemployment benefits for 2017 looks far away.[7] Although Mr. Monti recently said that he is looking for a quick approval of the proposed modifications to the country's rigid labour laws and the upper house has approved the package with a small majority, it is still unclear whether he will succeed in getting even the latest (milder) version of the reform packages through the lower house of parliament (see below for a discussion of the political environment in Italy).

**Italy's high tax burden a problem — especially as a higher share of the burden falls on labour and capital**

According to the EU Commission, the Government's tax reforms to date are welcomed, in particular the increased tax deductibility of labour costs for women and young people. This is because they are likely to boost employment amongst these two groups, whose employment rates are, at 49.5% and 47.8% in 2010, well below the EU27 area averages of 62.1% and 61.6%, respectively.[8] Moreover, the increased emphasis on property taxation, including the planned revaluation of cadastral values for the purposes of the payment of IMI, should also increase the growth-friendliness of the country's tax system.

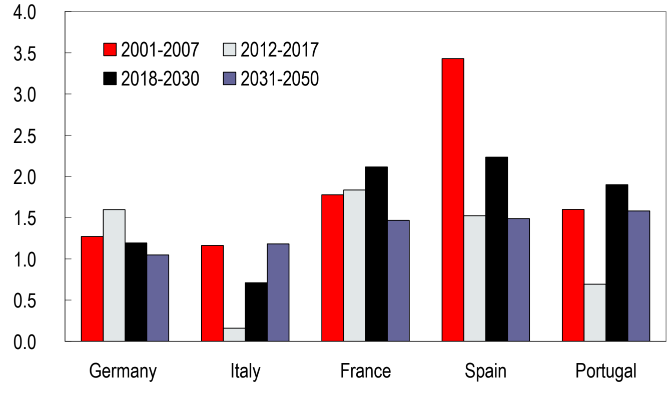
However, according to the Commission's recent assessment, there remains scope for further shifting of the tax burden away from labour and capital onto property and consumption taxes (see Figure 11).[9] This is all the more pertinent, given that as they stand, the Monti Government's fiscal consolidation plans for 2012-2015 include some 2/3 of revenue-raising measures and only 1/3 in expenditure cuts, thereby further adding to the country's already high tax burden.

**Figure 12. Cumulative Impact of Product Market Reforms on GDP (% of GDP), 2012-2020**




Sources: Ministry of Finance, Citi Investment Research and Analysis

**Figure 13. Selected Euro-Area Countries -- Long-term Prospects for Annual Growth Potential (OECD), 2001-2050**




Sources:OECD and Citi Investment Research and Analysis

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[7] European Commission Staff Working Document Assessment of the 2012 national reform programme and stability programme for Italy. 30 May 2012. The document can be found at: http://ec.europa.eu/europe2020/pdf/nd/swd2012_italy_en.pdf

[8] More recently available unemployment data paint an even worse picture, showing an increase in the unemployment rates of the young to 35.2% in April 2012 from 27.3% in April 2011. Source: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-01062012-AP/EN/3-01062012-AP-EN.PDF

[9] According to OECD figures for 2009, taxes on property accounted for around 2.6% of GDP for Italy, above the 2% average for an average of 22 EU countries but substantially below the figure for the UK (over 4.0%); France (just under 3.5%) and Belgium (around 3.75%).

**Modest positive impact from product market reforms**

On product markets, the reforms to date included the liberalization of some professional services and the simplification of administrative procedures aimed at reducing admin burdens on businesses. The government expects that those measures will have some positive impact on GDP in the longer-term. However, even according to the Government's (normally-optimistic) assumptions, the estimated effect of the product reforms implemented to date on GDP growth is relatively modest, cumulating to only 0.9% of GDP by 2015 and to 2.4% of GDP by 2020 (see Figure 12). The EC also asks for more reforms of Italy's product markets, particularly in the energy and transport sectors.

**Structural reform unlikely to spur potential growth substantially**

Overall, the potential growth estimates of the European Commission, the IMF, the OECD, and even those of the Government itself support our concerns that the Monti reforms have not gone far enough to address the country's underlying growth weakness. Although the IMF expects that currently negative potential growth of minus 0.4% will move into positive territory in 2014, potential growth will only reach 0.3% YY in 2016. Even the government's own projections — normally more optimistic — see the country's potential growth reaching only 0.4% YY by 2015. Moreover, according to the OECD's latest estimates for growth potential, it is not until after 2030 that Italy is expected to close the gap of annual potential growth with Germany which currently stands at over 1ppt (see Figure 13).

## Italy is likely to disappoint on the fiscal side

**Italy's already high public debt is likely to increase further**

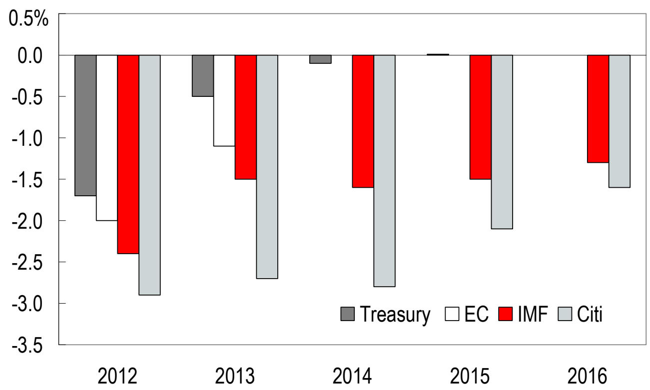
Under our base case economic scenario of a deep recession in the next couple of years and poor potential growth prospects over the medium- and longer-term, Italy's public sector balance sheet problems are likely to mount. Although Italy's deficit-to-GDP ratio was not particularly high (3.9%) compared to other periphery countries in 2011 and the country plans to enact 4.9% of GDP in terms of fiscal tightening up to 2014, we do not share the governments projection of a close-to-balanced budget in 2014 (see Figure 14 and 15). Instead, we expect that the deficit will be just slightly below 3% at that stage. As a consequence, we estimate Italy's very large and persistent stock of public debt is likely to increase further, reaching 137% of GDP by 2014 compared to 120.6% in 2011 and expected 129.3% in 2012.

**Figure 14. Italy — Government Deficit Targets by Level of General Government in % of GDP, 2010-2015**

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| Central | -4.5 | -3.8 | -1.6 | -0.5 | 0.0 | 0.1 |
| Local | -0.5 | -0.3 | -0.3 | -0.2 | -0.3 | -0.4 |
| Social Security | -0.5 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| GG | -4.6 | -3.9 | -1.7 | -0.5 | -0.1 | 0.0 |

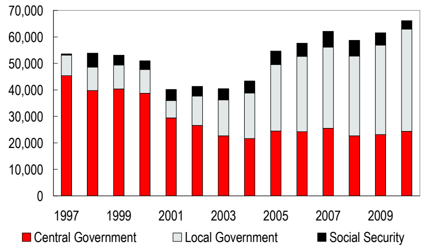
Sources: Italian Finance Ministry, Stability Programme 2012 and Citi Investment Research and Analysis

**Figure 15. Italy – General Government Deficit Projections, % of GDP, 2012-16F**




Sources: Institutions and Citi Investment Research and Analysis

**Figure 16. Accounts Payable/Receivable by Level of Public Administration, Million Euro, 1997-2010**




Sources: Bank of Italy, Citi Investment Research and Analysis

Italy has created only modest contingent liabilities to its financial sector during the financial crisis (€43.7bn, or 2.8% of GDP in 2011) and has low age-related implicit liabilities.[10] But, liabilities and contingent liabilities outside the Government perimeter (not covered under the Excessive Deficit Procedure (EDP) definition) are not immaterial. These include a sizeable stock of arrears to suppliers, potential contingent liabilities from the creation and use of Special Purpose Investment Vehicles (SPIVs) to fund investment at the local level; and contingent liabilities from the use of Public Private Partnerships (PPPs) — mostly by the local administrations to fund investment in infrastructure and services provisional the local level.

As Italy, similar to other non-programme countries, does not report data on arrears we obtain a proxy value for the stock of bills unpaid by the General Government. We take the figures reported under the Other Accounts Payable/Receivable of Financial Accounts on the liabilities side. According to these (annual) figures, Italy's Government unpaid bills amounted to approximately €64.2bn (4.1%) of GDP in 2010 (latest available data) with local governments accounting for 60% of the total (see Figure 16).Given the Government's recent announcement that it will set up a credit line for the local governments to clear their arrears to suppliers, it is possible that the country's deficit and debt figures will rise, taking into account these items.

**Italy's potential liabilities from PPPs and SPIVs**

According to the European PPP Expertise Centre (EPEC)[11], the Italian central Government made only a modest use of PPP projects compared to other developed economies. However, according to Russo and Zampico (2012), taking into account Italy's local administrations, the use of PPPs and SPIVs appears to have increased substantially over the last decade, with PPPs accounting for 14% of total public tenders for infrastructure projects in 2003, but 20% in 2009.[12] Russo and Zampico also found evidence of a significant link between the presence of budget constraints and the use of PPPs to fund investment at the local level. This suggests that with increasing fiscal constraints, the use of off-balance sheet vehicles for public investment is likely to increase.

### Can privatizations and reducing tax evasion help?

**Italian sovereign has large amount of assets…**

Privatizations could help reduce the debt stock and can have a positive — if small — impact on growth by promoting competition and in some cases increasing efficiency in key industries. After the first waves of privatizations in the 1980s and mid 1990s, Italy could therefore embark upon another round of privatizations to realize a one-off reduction in its gross debt. According to an IMF study, the general government held assets worth around 133% of GDP in 2003. Given that the country has sold virtually no assets since then (see Figure 17), the sovereign could potentially reduce its debt stock substantially through privatizations and it seems that the government considers action in that direction.[13],[14]

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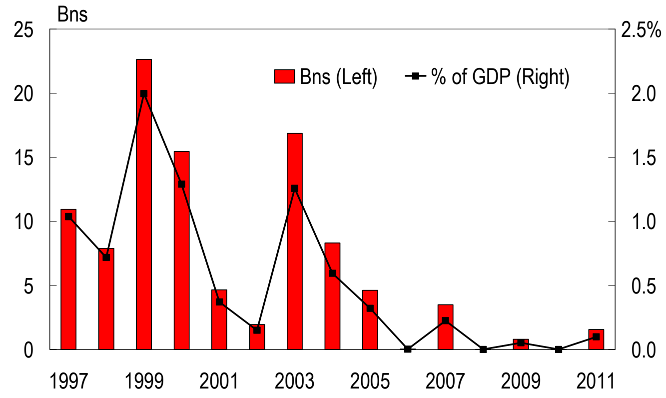
10 According to Moog and Raffelhüschen (2011), Italy's age-related implicit liabilities are, at 28% of GDP, by far the smallest of the Euro zone countries, followed by Germany (110%) and Finland (147%), and far below Greece (872%), Luxembourg (1097%) and Ireland (1405%). Moreover, a recent study by the IMF also flagged up that Italy was amongst a small group of countries that have already adjusted their pension formulas to take account of increasing life expectancy.
11State Guarantees in PPPs: A Better Guide to Evaluation, Design, Implementation and Management, May 2011 can be found at http://www.eib.org/epec/resources/epec-state-guarantees-in-ppps-public.pdf.
12 Antellini Russo, F., and Zampino, R (2012). Infrastructures, Public Accounts and Public-Private Partnerships: Evidence from the Italian Local Administrations. Review of Economics and Institutions, Vol. 3 (1), Winter 2012.
13 In particular, the Italian government continues to have large stakes in the country's largest energy and telecoms companies (for example it has a 30.3% stake in ENI; a 31% stake in Enel and a 29.9% stake in Terna (via the Cassa Depositi e Prestiti)). The central government also has a stake in a large industrial conglomerate (Finmeccanica) and owns 100% of the post office which, according to the government, had a value between €14-15bn in 2007.

**…but difficult to sell those quickly**

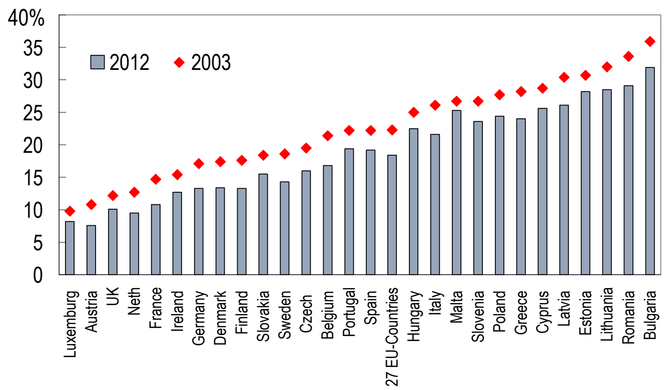
In our view, privatizations and asset sales are unlikely to be very helpful for Italy in the event of contagion from a possible Grexit, because asset valuations would be likely to fall. In addition, there will probably be large opposition to the fire-sale of such assets. However, in order to prevent fire-sales, the government might transfer its assets to a Treuhand-style off-balance sheet SPV, which would sell these assets over time. Such a transaction probably would reduce the general government debt immediately. Furthermore, the government might make use of the assets as collateral if the European Debt Redemption Fund came to pass, as proposed from the German Board of Economic advisors.[15]

**Figure 17. Italy -- Privatizations & Other Extraordinary Revenue, 1997-2011**




Sources: IMF and Citi Investment Research and Analysis

**Figure 18. EU Countries — Share of Shadow Economy (Pct of Official GDP), 2003-2012**




Sources: Schneider and Citi Investment Research and Analysis

**Fighting tax evasion could make a big difference**

Another often quoted way of reducing Italy's sovereign budget problems is through a more fierce and effective fight on tax evasion and tax arrears. Friedrich Schneider, an often cited expert in this area, estimates that, at 21.2% of official GDP, the size of Italy's shadow economy is the sixth largest in the euro area and one point above the EU 27 average (see Figure 18).[16] According to the Bank of Italy, as much as 27.4% of GDP may be created "off the books". It could be argued that by fighting tax evasion, the Government would be able to improve its budget situation without having a large impact on officially measured GDP, because the widening of the tax base would also lead to a broader GDP base. However, as Istat already includes an estimated share of shadow economy activity in the official GDP data, the GDP-enhancing part of smaller tax evasion will be probably rather small.[17]

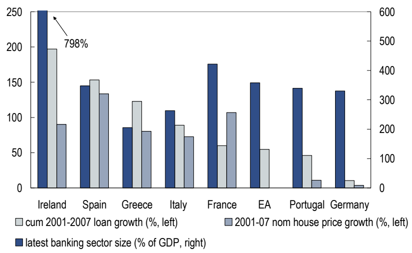
**But difficult to be implemented quickly**

While Italy has made more progress in reducing the share of shadow economic activity in official GDP than EU countries on average in recent years, Schneider expects an increase in the share of shadow economic activity in 2012 because of the tax increases. This suggests that the government's fight against tax evasion might not be very successful.[18] However, the quite stable development of tax

[14] The government announced that it will use the results of the ongoing Census of public property assets, out on 31st July, to publish its measures aimed at reducing the stock of assets.
[15] See http://www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?&L=1
[16] See "Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2012: Some New Facts", Friedrich Schneider, March 2012.
[17] According to a study by Istat, the share of non-directly observed economy was in a range between 16.3% and 17.5% of the reported GDP data for 2008.
http://www3.istat.it/salastampa/comunicati/non_calendario/20100713_00/testointegrale20100713.pdf
[18] The Italian Government's recent measures to fight tax evasion include:
•The lowering of the legal threshold for cash payments from €2,500 and €1,000;
•The imposition of less invasive controls for tax payers who are compliant with the Government's so-called sectoral studies on tax payments;

revenues in the deteriorating economic environment indicates that there might be at least some positive impact from the government's tax evasion measures. Therefore, unless the government engages in far-reaching tax amnesty measures, it is unlikely that fighting tax evasion will provide a quick fix for the fiscal problems in our view.

**Figure 19. Selected Countries — Banking Sector Size and Growth**




Note: Banking sector size is MFI total assets. Cumulative loan growth is based on nominal data on loans to EA residents.
Sources: ECB, BIS and Citi Investment Research and Analysis

## Italy's Banking System

Italy's banking system was not as affected by the 08/09 financial crisis nor by the bursting of housing bubbles, as was the case in, for example, Ireland and Spain. To us, it looks unlikely that the government will have to come up with large-scale support for the banking sector. The relatively poor quality of the domestic loan book, large exposure to other Italian banks and the government and the lack of a large buffer of 'excess' capital do give rise to solvency concerns for Italian banks in the light of a challenging economic outlook, partly reflected in the recent downgrade of 26 Italian banks by Moody's.[19] With the ongoing deteriorating in asset quality and poor access to private funding (even though domestic retail deposits have remained broadly stable), Italian banks' credit policies are also likely to be a source of drag for the Italian economy. However, the Italian banking sector is relatively small in comparison to those of other EA countries and the growth in Italian house prices and bank lending fell short of the excesses seen in Ireland or Spain after EMU entry, even though growth was faster than for the EA average (see Figure 19).

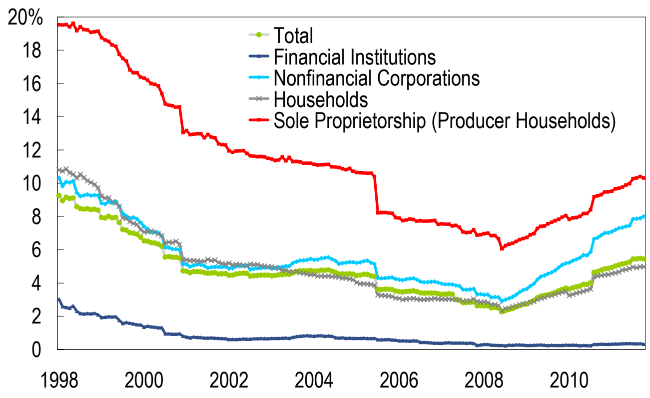
Cross-country comparisons of non-performing loan ratios (NPLs) are difficult, but according to the IMF's Financial Soundness Indicators, which aim to achieve cross-country definitional consistency, NPLs in Italy are rather high relative to other countries (see Figure 21), and rising fast.[20] It is possible, maybe even plausible, that NPL ratios eventually come close to the very high peak values observed in the mid-late 1990s (see Figure 20). While real interest rates are lower than they were then and lending standards may have improved, debt service ratios for HHs and NFCs have risen due to increases in debt levels for both sectors, while our projections for GDP growth and employment are no better than in the reference period.

•The compulsory electronic transmission of all records on financial transactions to the Tax Agency from January 2012; and
•Cheating the Tax Agency was made a criminal offence and the authorities will focus enforcement on large taxpayers and VAT fraud.

[19] Foreign exposures of Italian banks (to foreign banks, the foreign non-bank financial sector and foreign governments) have been reduced aggressively and are now likely a much less significant source of risk for Italian banks than domestic exposures. Foreign loans account for 5% of total assets of Italian banks, down from around 8.5% in mid-2007, while foreign securities holdings (fixed income and equities) account for less than 2% of total assets.

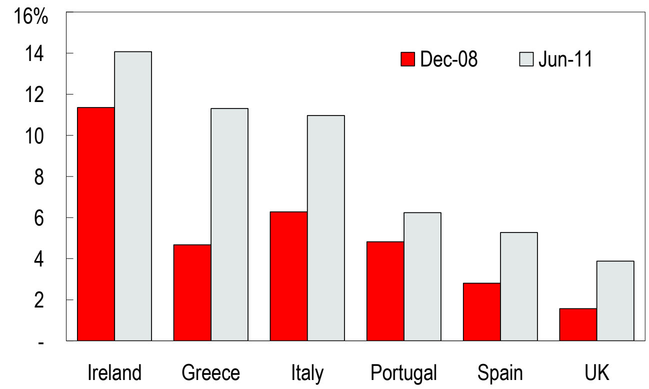
[20] According to the IMF, "a loan is nonperforming when payments of interest and/or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons—such as a debtor filing for bankruptcy—to doubt that payments will be made in full." http://www.imf.org/external/pubs/ft/bop/2005/05-29.pdf ). The values for NPLs in Spain are much lower than in data provided by the Bank of Spain, but we do not know the source of the discrepancy.

**Figure 20. Italian Banks — Non-Performing Loans (% of Loans), 1998–2012**




Sources: Bank of Italy and Citi Investment Research and Analysis

**Figure 21. Selected Countries — Banks Non-Performing Loans (% of Loans), 2008-2011**




Note: Due to data availability Dec-08 values for Portugal and Ireland correspond to Dec-2009 and Mar-2010, respectively.
Sources: IMF and Citi Investment Research and Analysis

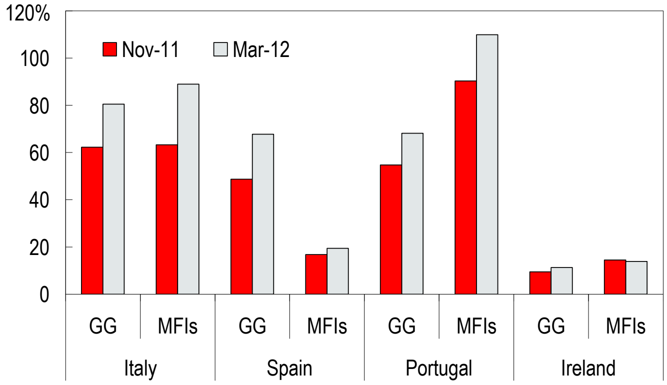
However, despite the worrying outlook for NPLs, the magnitude of any potential capital shortfall of banks and the potential exposure of the sovereign appear to be relatively limited. Figure 23 provides some illustrative calculations of different scenarios for bank loan losses. On one end of the spectrum is a static scenario where loss rates are assumed to be equal to current provisions.[21] The other end of the spectrum is given by loss rates close to those assumed under the 'adverse scenario' of the latest U.S. stress test which imply an increase of 122% relative to current provisions.[22] Deducting existing provisions and an assumed €25bn in yearly pre-provision profits, and assuming that capital would not be allowed to be depleted in any of these scenarios, leaves a residual that varies from zero in Case I to just over €50bn (3.5% of GDP) in Case IV. Even these amounts would not necessarily end up on the balance sheet of the sovereign, but if they did, they would be unlikely to materially alter the outlook for the Italian sovereign.[23]

[21] According to data from the ECB, provisions in the Italian banking system currently cover around 40% of a relatively broad measure of NPLs.

[22] While the macroeconomic environment in Italy is more challenging than in the U.S., the banking sector is not necessarily in worse shape in Italy, due to lower LTV ratios, higher lending standards and less reliance on credit card lending.

[23] These residuals also do not necessarily translate one-for-one into a need for capital injections for banks, given potential capital buffers, tax off-sets for losses and the possibility for deleveraging to reduce capital needs.

**Figure 22. Selected Countries – Bank Holdings of Securities Issued by Domestic MFIs and GG (% capital and reserves), Nov 2011–Mar 2012**




Note: GG is General Government; MFIs are credit institutions for Spain and Ireland, Monetary-Financial Institutions excl the NCB for Italy and Portugal.
Source: Citi Investment Research and Analysis

**Figure 23. Italian Banks — Loan Loss Scenarios**

| | Case I | Case II | Case III | Case IV |
|---|---|---|---|---|
| Loans | 1805 | 1805 | 1805 | 1805 |
| Assumed Loss Rate | 3.6% | 5.0% | 6.5% | 8.0% |
| Implied Loss | 65 | 90 | 117 | 144 |
| Current Provisions | 65 | 65 | 65 | 65 |
| Assumed Pre-provision profit | 25 | 25 | 25 | 25 |
| Residual | 0 | 0.3 | 27.3 | 54.4 |
| % of 2012 GDP | 0.0 | 0.0 | 1.7 | 3.5 |

Sources: ECB, Bank of Italy and Citi Investment Research and Analysis

The fate of Italian banks is also closely intertwined with that of other Italian banks and the Italian state, a link which has been tightened by large recent purchases of securities of other Italian banks and the Italian government. In March 2012, Italian bank holdings of Italian MFI and government securities were €351bn (8.4% of total assets) and €318bn (7.6%), respectively, record levels in nominal terms since 1997 (when these data series began). In the four months between November and March 2012, these holdings rose by €107bn (44%) and €77.4bn (32%), respectively, and were closely associated with the large uptake of cheap funding through the ECB's 3Y LTROs (see Figure 22). Hence, Italian banks may not be at risk of bringing down the Italian sovereign, but if the Italian sovereign is in trouble, we believe the banks would have difficulty standing firm or of rescuing the sovereign

## How long can Monti's political capital last?

**Political consensus could become ever-more elusive, as parties position themselves for 2013 elections amid eroding public support for austerity measures**

When Mario Monti stepped in to lead a technocratic government in November 2011 in the midst of a rapidly escalating sovereign debt crisis, commentators raised the risk that an unelected government would not enjoy sufficient legitimacy with the Italian public to pass unpopular reforms. Instead, the former EU official, together with his technocratic cabinet, has presided over a period of relative political stability, reflected in approval ratings that until recently exceeded 50%, enhanced credibility in both relations with the EU/ECB and with financial markets.

We expect Monti's technocratic government to continue to preside into 2013, when new elections are expected, and for reforms to continue, albeit at a slower pace. By extension, the continuation of political stability in Italy is critical to the stability of the wider eurozone in our view.

More broadly, in the wake of former PM Silvio Berlusconi's departure from the political scene, a wave of corruption investigations opening into political party operations across the country has led to a fall in public support for Italy's political party establishment to historic, single-digit lows. The dramatic decline in support for Italy's mainstream political parties was evident in May's local elections, which saw a surprise strong performance by a new party, the 5-Star Movement, led by comedian Beppe Grillo. Entirely new to the political scene and without a developed political

platform, the party took several prominent posts, including the mayoralty of Parma, and has risen to third place in the polls.

While we caution that the local elections should not serve as a proxy for 2013 elections, they point to a phenomenon we have been tracking in the mature democracies in the wake of the global financial crisis — the decline of mainstream political parties and rising appeal of NEAPs - New, Extreme and Alternative Political Parties (see Global Political Insights - The New Eurozone Political Geometry: What Economic and Market Implications?, May 2012). The recently announced spending review and an effort to address the generous mechanisms for funding political parties are steps to restore the faith in institutions and the political establishment. As Monti has helped restore Italy's reputation externally at least partly, we believe his next efforts must include measures to restore public confidence in the political system for the next phase of the country's political transition—and return to growth—is to take place.

As mentioned above, in its first months in office, the Monti government pushed through several reform measures. The most recent proposals for a labour market reform, which is historically highly controversial and long-resisted by Italy's powerful labour unions, has disappointed the private sector. But the fact that they have been subjected to the full parliamentary process underscores Monti's concern for getting wide political buy-in for the measures.

**Figure 24. Polls Conducted Between 28 May 2012 and 31 May 2012**

| | |
|---|---|
| **Government Coalition** | **51.7** |
| Democratic Party | 24 |
| The People of Freedom | 16 |
| Union of the Centre | 5.9 |
| Panella List | 1.4 |
| Future and Freedom | 4 |
| Other | 0.2 |
| Opposition | 11.2 |
| Northern League | 5.7 |
| Italy of Values | 5.5 |
| Parties with no representation in the Parliament | 37.1 |
| Five Star Movement | 17 |
| Left Ecology Freedom | 6 |
| Communist Refoundation Party | 3 |
| The Right | 3.5 |
| The Greens | 0.8 |
| Other | 6.8 |

Source: Osservatorio politico SWG

Six months after taking office, Monti's political capital is undoubtedly diminishing, as witnessed by the sharp decline in his government's approval ratings to 37% at the end of May after the introduction of the labour market reform measures. As politicians gear up for new elections, attention may turn toward political survival, a matter heightened by a series of high-profile corruption scandals. The election of Socialist leader Francois Hollande to the French presidency could also provide a template for Italy's chastened opposition, which could start to push back on austerity, capitalizing on public opposition. The formation of further new political parties is also a possibility.

These forces do not bode well for forging a post-Monti political consensus, raising the possibility that Monti could be asked to stay on in a new government in some capacity. Monti has rejected this possibility in his public statements, but we think

that if a viable coalition cannot be formed the possibility of his continued participation in government should not be excluded.

## Conclusion

**Monti government made steps in the right direction, but is unlikely to meet near-term growth and deficit targets**

By putting in place a range of structural reforms and austerity measures, Mario Monti and his cabinet have managed to ease market concerns regarding the country's debt sustainability. While we welcome the initiatives as important steps to improve Italy's growth outlook and fiscal position over the long-term, we believe the measures are unlikely to solve Italy's massive public debt problem any time soon. Furthermore, the austerity measures are likely to deepen the recession in Italy in the near-term, which probably will lead to a clear failure of the government deficit targets.

**Limited room for near-term action**

As the government might also run into difficulties to approve the watered-down labour market reform and to enact the earlier approved measures, bond market participants probably get increasingly worried. While the government might use privatization and the reduction of tax evasion to reduce the large pool of debt over time, such measures are not immediately available. We also regard limited room of the domestic banks to increase their holdings of domestic government securities significantly.

**Increase in yields probably will trigger vicious cycle**

A significant further rise in yields, probably caused by an escalation of the sovereign debt crisis, would deepen and extend the recession and accelerate the rise in the debt/GDP ratio, triggering a worsening vicious circle that probably would leave Italy needing outside help at some point. This process would probably be accompanied by further downgrades of Italy's sovereign ratings: we expect Moody's to reduce its current from A3 to Baa3 in the longer term and S&P from BBB+ to BBB-.

**Italy is likely to need external help at some point**

We expect that after already getting support from the ECB twice (through the SMP and the 3Y LTROs) in an environment of increasing funding costs Italy will again require external help from the ECB, the IMF and the EFSF/ESM at some point. Given the huge financing need of the Italian sovereign of €125bn in the remainder of 2012 and €139bn for 2013, it is unlikely that Italy would get a fully fledged programme, because the means of the EFSF/ESM appear too small. Note that this year the combined firepower of the EFSF/ESM is only €640bn which will increase to €700bn in 2012 (after additional capital payments into the ESM have been made). Even before a likely use of the facilities for a Spanish package in order to support the banks, a possible programme for Cyprus and second bailout packages for Portugal and Ireland, around €200bn have been disbursed or earmarked to the existing programmes for Ireland, Portugal and Greece. As a consequence, we expect that Italy will have to request help from the EFSF/ESM through the primary and secondary market bond purchase facilities.

## Key Economic Indicators (11 June – 15 June 2012)

| Monday 11 June | | Forecast | Last |
|---|---|---|---|
| 07:45 | France: Industrial Production, Apr | -1.0% MM, -1.2% YY | -0.9% MM, -0.9% YY |
| | Manufacturing Output, Apr | -2.0% MM, -2.2% YY | 1.4% MM, -0.3% YY |
| 09:00 | Norway: Consumer Prices, May | 0.0% MM, 0.5% YY | 0.1% MM, 0.3% YY |
| | CPI-ATE, May | 0.1% MM, 1.1% YY | 0.1% MM, 0.7 % YY |
| 09:00 | Italy: GDP Details, 1Q | -0.8% QQ, -1.3% YY | -0.7% QQ, -0.4% YY |
| **Tuesday 12 June** | | **Forecast** | **Last** |
| 00:01 | UK: RICS House Price Survey, May | | |
| 06:30 | France: Non-Farm Payrolls, 1Q Final | 0.1% QQ, 0.0% YY | -0.1% QQ, 0.4% YY |
| 06:45 | Switzerland: SECO Economic Forecasts, June | | |
| 07:00 | Germany: Insolvencies, Mar | | |
| 08:30 | Sweden: Consumer Prices, May | 0.0% MM, 1.1% YY | 0.2% MM, 1.3% YY |
| | CPIF, May | 0.0% MM, 0.9% YY | 0.3% MM, 1.0% YY |
| 09:30 | UK: Industrial Production, Apr | -0.1% MM, -1.0% YY | -0.3% MM, -2.6% YY |
| | Manufacturing Output, Apr | -0.4% MM, 0.0% YY | 0.9% MM, -0.9% YY |
| **Wednesday 13 June** | | **Forecast** | **Last** |
| 06:30 | France: CPI – EU Harmonized, May | -0.1% MM, 2.3% YY | 0.2% MM, 2.4% YY |
| | Consumer Price Index, May | -0.1% MM, 2.0% YY | 0.1% MM, 2.1% YY |
| 07:00 | Germany: National CPI, May Final | -0.2% MM, 1.9% YY | 0.2% MM, 2.1% YY |
| | HICP, May Final | -0.3% MM, 2.1% YY | 0.1% MM, 2.2% YY |
| 07:45 | France: Balance of Payments, Apr | | |
| 08:00 | Spain: HICP, May Final | 1.9% | 2.0% |
| 08:15 | Switzerland: Producer and Import Prices, May | | |
| 09:00 | Italy: Consumer Prices, May Final | | |
| 10:00 | Euro Area: Industrial Production, Apr | -1.0% MM, -2.4% YY | -0.3% MM, -2.0% YY |
| **Thursday 14 June** | | **Forecast** | **Last** |
| 08:30 | Switzerland: Swiss National Bank Monetary Policy Assessment & Press Conference | | |
| 08:30 | Netherlands: Trade Balance, Apr | | |
| 08:30 | Netherlands: Retail Sales, Apr | | |
| 09:00 | Euro Area: ECB Monthly Bulletin | 52.5 | 53.3 |
| 09:30 | Italy: General Government Debt, Apr | | |
| 10:00 | Euro Area: HICP, May Final | -0.1% MM, 2.4% YY | 0.5% MM, 2.6% YY |
| 10:00 | Euro Area: Labour Costs, 1Q | 1.5% YY | 2.8% YY |
| | Greece: Quarterly Unemployment, 1Q | | |
| **Friday 15 June** | | **Forecast** | **Last** |
| 07:00 | EU-25: New Car Registrations, May | | |
| 07:00 | Sweden: Registered Unemployment Rate, May | 4.1% | 4.3% |
| 08:00 | Spain: Labor Costs, 1Q | | |
| 09:00 | Norway: Trade Balance, May | | |
| 09:00 | Italy: Trade Balance, Apr | | |
| 09:30 | UK: Trade Balance – Goods & Services, Apr | £-3.0 Billion | £-2.7 Billion |
| 09:30 | UK: Construction Output, Apr | | |
| 10:00 | Euro Area: Employment, 1Q | -0.2% QQ | -0.2% QQ |
| 10:00 | Euro Area: Trade Balance, Apr | €4.8 Billion Surplus | €4.3 Billion Surplus |
| 11:00 | Ireland: Trade Balance, Mar | | |

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

## Economic Indicators

| | | | |
|---|---|---|---|
| **Euro Area** | | | |
| Jun 13<br>10:00<br>London Time | ***Industrial Production, Apr*** | **Forecast: -1.0% MM, -2.4% YY** | **Prior: -0.3% MM, -2.0% YY** |
| | Available member state data suggest a substantial fall in industrial production in April. If our forecast is correct, the April reading will be 0.9% below the 1Q average. | | |
| Jun 14<br>10:00<br>London Time | ***HICP, May Final*** | **Forecast: -0.1% MM, 2.4% YY** | **Prior: 0.5% MM, 2.6% YY** |
| | We expect a confirmation of the flash estimate showing a 0.2 point decline in the inflation rate to the lowest reading since February 2011. The split, available for the first time, probably will show that falling prices for energy contributed to the small MM decline in consumer prices. We also expect a fall in core consumer prices (ex. food and energy) of 0.2% MM, contributing to a moderation in the core inflation rate from 1.6% YY in April to 1.4% YY in May. | | |
| Jun 14<br>10:00<br>London Time | ***Labour Costs, 1Q*** | **Forecast: 1.5% YY** | **Prior: 2.8% YY** |
| | After increasing again in 4Q 2011, we expect a substantial slowdown in labour costs in 1Q, as downward pressure on periphery wages fed through, while the recently approved wage deals in Germany were not yet in place. | | |
| Jun 15<br>10:00<br>London Time | ***Employment, 1Q*** | **Forecast: -0.2% QQ** | **Prior: -0.2% QQ** |
| | We expect the contraction in employment to continue in 1Q. Taking into account the reduction in companies' employment plans, the weak economy and downside pressure on corporate profitability, we expect a third consecutive quarter with a fall in employment of 0.2% QQ. | | |
| Jun 15<br>10:00<br>London Time | ***Trade Balance, Apr*** | **Forecast: €4.8 Billion Surplus** | **Prior: €4.3 Billion Surplus** |
| | A further fall in imports of around 1.0% (partly due to a fall in prices for energy) is likely to contribute to a further increase in the nominal trade surplus. However, the expected second consecutive fall in exports (-0.6% MM) probably will cap the increase in the trade surplus. | | |
| **Germany** | | | |
| Jun 13<br>07:00<br>London Time | ***National CPI, May Final***<br>***HICP, May Final*** | **Forecast: -0.2% MM, 1.9% YY**<br>**Forecast: -0.3% MM, 2.1% YY** | **Prior: +0.2% MM, 2.1% YY**<br>**Prior: +0.1% MM, 2.2% YY** |
| | We expect a confirmation of the flash estimates. The details probably will show a substantial fall in prices for fuel and heating oil. We expect the core CPI (excluding seasonal food an energy) to remain unchanged at 1.6% YY. | | |
| **France** | | | |
| Jun 11<br>07:45<br>London Tim | ***Industrial Production, Apr***<br>***Manufacturing Production, Apr*** | **Forecast: -1.0% MM, -1.2% YY**<br>**Forecast: -2.0% MM, -2.2% YY** | **Prior: -0.9% MM, -0.9% YY**<br>**Prior: 1.4% MM, -0.3% YY** |
| | Industrial production is expected to have declined for the second successive month in April. Manufacturing production is forecast to record a sizeable drop after a strong gain in March. All anecdotal evidence points to a correction: Banque de France reported that capacity utilisation had fallen to an 18-month low while INSEE indicated that the industrial business climate had lost three points. Factors limiting the downside are an unchanged manufacturing PMI (albeit in contractionary territory) and the turning point indicator returning to neutral after a large gain in March. | | |
| Jun 12<br>07:45<br>London Time | ***Non-Farm Payrolls, 1Q Final*** | **Forecast: 0.1% QQ, 0.0% YY** | **Prior: -0.1% QQ, 0.4% YY** |
| | We do not anticipate any significant revision to the second estimate, although the 0.06% gain suggests that a downward adjustment remains possible. Both the industry and the construction sectors shed jobs for the fourth consecutive quarter, but job creation turned positive in services for the first time after six months in the red. We expect renewed job losses in the next few quarters as the economy falls back into recession. | | |
| Jun 13<br>06:30<br>London Time | ***CPI – EU Harmonised, May***<br>***Consumer Price Index, May*** | **Forecast: -0.1% MM, 2.3% YY**<br>**Forecast: -0.1% MM, 2.0% YY** | **Prior: 0.2% MM, 2.4% YY**<br>**Prior: 0.1% MM, 2.1% YY** |
| | We expect headline inflation to have eased by a decimal point in May, with prices also declining by 0.1% MM for both the harmonised and national indices. Energy prices likely fell in May, but the base effects are not favourable. The opposite holds true for unprocessed food prices. Core inflation probably eased a little in May, and should continue to trend lower in the coming quarters given the weakness of the labour market. Our forecast for the ex-tobacco CPI index is 124.72 down from 124.80 in April. | | |
| **Italy** | | | |
| Jun 11<br>09:00<br>London Time | ***GDP Details, 1Q*** | **Forecast: -0.8% QQ, -1.3% YY** | **Prior: -0.7% QQ, -0.4% YY** |
| | According to the 1Q flash estimate, Italy's GDP contracted by 0.8% relative to 4Q11 and by 1.3% relative to the same period a year ago. Given the sharp fall in consumer confidence in 1Q to near historic lows in March, we expect household consumption to have contracted substantially. We also expect public consumption to have fallen, albeit not by as much as household consumption, because Italy's fiscal consolidation strategy is dominated by revenue-raising measures. We expect investment to have continued the decline of the previous three quarters but do not expect it to fall by as much as in 4Q. We expect exports to fall slightly after posting no growth in 4Q and imports to continue to contract. | | |
| **Spain** | | | |
| Jun 13<br>08:00<br>London Time | ***HICP, May Final*** | **Forecast: 1.9% YY** | **Prior: 2.0% YY** |
| | We expect the final estimate of the HICP to come in line with the flash estimate for an annual change in May of 1.9%. This would be 0.1ppts down from the 2.0% YY change in April and would be the lowest annual increase since August 2010. | | |

## Economic Indicators

| | | | |
|---|---|---|---|
| **Sweden** | | | |
| Jun 12<br>08:30<br>London Time | ***Consumer Prices, May***<br>***CPIF, May*** | **Forecast: 0.0% MM, 1.1% YY**<br>**Forecast: 0.0% MM, 0.9% YY** | **Prior: 0.2% MM, 1.3% YY**<br>**Prior: 0.3% MM, 1.0% YY** |
| | Both headline and core inflation are expected to moderate in April on an annual basis. The Riksbank's preferred measure of inflation; CPIF – which adjusts for changes in the cost of mortgages – is seen trending lower, hence widening the gap versus the Central Bank's 2% inflation target. Our forecasts for both headline and underlying inflation are in line with the Riksbank's projections. | | |
| Jun 15<br>08:15<br>London Time | ***Registered Unemployment Rate, May*** | **Forecast: 4.1%** | **Prior: 4.3%** |
| | The weekly data from the Swedish Public Employment Service suggest that the number of unemployed declined further in May, at the same time as the number of persons on Labour Market Programmes fell somewhat. In seasonally-adjusted-terms, the jobless rate is expected to remain unchanged at 4.5%. There is still some uncertainty regarding the seasonal pattern following the new definition of registered unemployment. | | |
| **Norway** | | | |
| Jun 11<br>09:00<br>London Time | ***Consumer Prices, May***<br>***CPI-ATE, May*** | **Forecast: 0.0% MM, 0.5% YY**<br>**Forecast: 0.1% MM, 1.1% YY** | **Prior: 0.1% MM, 0.3% YY**<br>**Prior: 0.1% MM, 0.7% YY** |
| | Following a temporary drop in core inflation in April, we expect underlying inflation to continue to trend higher in May. Base effects from very weak airfares in May 2011, are also likely to add to the overall annual rise. Our forecasts are broadly in line with those of the Norges Bank (CPI: 0.5% YY, CPI-ATE: 1.2% YY). | | |
| **United Kingdom** | | | |
| Jun 12<br>09:30<br>London Time | ***Industrial Production, Apr***<br>***Manufacturing Output, Apr*** | **Forecast: -0.1% MM, -1.0% YY**<br>**Forecast: -0.4% MM, 0.0% YY** | **Prior: -0.3% MM, -2.6% YY**<br>**Prior: 0.9% MM, -0.9% YY** |
| | In March, industrial production was depressed by weakness in output of utilities and the energy sector, despite a gain in manufacturing output. For the April data, we expect output of the utilities and energy sectors to rebound a bit, but expect manufacturing to fall back – hence producing another small decline in industrial production. Such a figure would leave industrial production in April a little below the 1Q average. | | |
| Jun 15<br>09:30<br>London Time | ***Trade Balance – Goods & Services, Apr*** | **Forecast: £-3.0 Billion** | **Prior: £-2.7 Billion** |
| | Export growth slowed in 1Q, with volumes (goods ex oil and erratics) up just 0.3% YY, after growth of 5.8% YY in 4Q. Exports to euro area countries fell outright, reflecting the weakness of activity in that region, although exports to non-EU countries continue to grow steadily. We expect the trade deficit will continue to drift wider in coming months as the euro area crisis takes its toll on UK exports. | | |

Sources: National Statistical Offices, National Central Banks, Bloomberg, CIRA forecasts

**Key Economic Indicators (18 June – 22 June 2012)**

| | | Forecast | Last |
|---|---|---|---|
| **Monday 18 June** | | **Forecast** | **Last** |
| | G-20 Summit Meeting, Los Cabos, Mexico (Jun 18-19) | | |
| 09:00 | Norway: Registered Unemployment, May | | |
| 14:00 | Belgium: Consumer Confidence, Jun | | |
| **Tuesday 19 June** | | **Forecast** | **Last** |
| 07:45 | France: Industrial Confidence, Jun | | |
| 08:30 | Sweden: Unemployment, May | | |
| 09:30 | UK: Consumer Prices, May | 0.1% MM, 2.9% YY | 0.6% MM, 3.0% YY |
| | CPI Ex Food, Drink, Tobacco, Energy, May | 0.1% MM, 2.3% YY | 0.6% MM, 2.1% YY |
| | Retail Prices, May | 0.3% MM, 3.4% YY | 0.7% MM, 3.5% YY |
| | RPIX – Excludes Mortgages, May | 0.3% MM, 3.4% YY | 0.7% MM, 3.5% YY |
| 10:00 | Euro Area: Construction Output, Apr | | |
| 10:00 | Germany: ZEW Economic Expectations, Jun | | |
| **Wednesday 20 June** | | **Forecast** | **Last** |
| 07:00 | Germany: Producer Prices, May | | |
| 08:00 | Sweden: Business and Consumer Surveys, Jun | | |
| 08:00 | Spain: Trade Balance, Apr | | |
| 08:30 | Netherlands: Consumer Confidence, Jun | | |
| 09:00 | Italy: Industrial Orders, Apr | | |
| 09:30 | UK: Claimant Count Unemployment, May | +5,000 MM, 4.9% Rate | -13,700 MM, 4.9% Rate |
| | LFS Unemployment, Feb-Apr | -26,000 QQ, 8.3% Rate | -45,000 QQ, 8.2% Rate |
| 09:30 | UK: MPC Minutes (Jun 7) | | |
| 10:00 | Italy: Current Account, Apr | | |
| 13:00 | Norway: Norges Bank Monetary Policy Outcome | | |
| 17:30 | US: FOMC Outcome | | |
| **Thursday 21 June** | | **Forecast** | **Last** |
| 07:00 | Switzerland: Trade Balance, May | | |
| 08:15 | Switzerland: Industrial Production, 1Q | | |
| 08:30 | Netherlands: Unemployment, May | | |
| 09:00 | Euro Area: Flash PMIs, Jun | | |
| 09:00 | Euro Area: Balance of Payments, Apr | | |
| 09:30 | UK: Retail Sales Volumes, May | 1.2% MM, 2.1% YY | -2.3% MM, -1.1% YY |
| 11:00 | UK: CBI Industrial Trends: Output Expectations, Jun | -5% | -3% |
| | CBI Order Books, Jun | -20% | -17% |
| | CBI Selling Prices, Jun | +8% | +12% |
| 15:00 | Euro Area: Consumer Confidence, Jun | | |
| | Euro Area: Eurogroup Meeting of EA Finance Ministers (Luxembourg) | | |
| **Friday 22 June** | | | |
| | EU: EcoFin Meeting of EU-27 Finance Ministers (Luxembourg) | | |
| 08:30 | Netherlands: Household Consumption, Apr | | |
| 09:00 | Italy: Consumer Confidence, Jun | | |
| 09:00 | Germany: ifo Business Climate, Jun | | |
| | Greece: Current Account, Apr | | |

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

| Recent Research Publications | Author | Date of Publication |
| --- | --- | --- |
| **Euro Area** | | |
| Euro Area: Sovereign Debt Crisis Update | Jürgen Michels | Jun 8, 2012 |
| ECB - Weaker Data Likely to Spur ECB Action in July | Jürgen Michels | Jun 6, 2012 |
| European Economic Forecast Highlights - May 2012 | Ann O'Kelly | May 24, 2012 |
| Hollande Takes Over; "Grexit" More Likely | Guillaume Menuet/Jürgen Michels | May 7, 2012 |
| ECB - Things Have to Get Worse Before the ECB Acts Again | Jürgen Michels | May 3, 2012 |
| **Euro Economics Weekly** | | |
| ECB — Getting Closer To Action | Jürgen Michels | Jun 1, 2012 |
| Is Europe Ready for Grexit? | Guillaume Menuet/Jürgen Michels | May 25, 2012 |
| Ireland — Recession Casts Doubt On Fiscal Sustainability | Michael Saunders | May 18, 2012 |
| More on Grexit | Jürgen Michels/Guillaume Menuet | May 11, 2012 |
| ECB Not Yet Ready To Act | Jürgen Michels | May 4, 2012 |
| **Chief Economist Publications** | | |
| Global Economic Outlook and Strategy - May 2012 | Willem Buiter | May 23, 2012 |
| Global Economics Flash - 'Grexit' Back In The Spotlight | Willem Buiter | May 10, 2012 |
| What More Can Central Banks Do To Stimulate the Economy? | Willem Buiter | May 9, 2012 |
| **Spain** | | |
| Focus on Spain | Guillaume Menuet | Apr 3, 2011 |
| **Ireland** | | |
| Ireland - Interesting Honohan Speech | Michael Saunders | Apr 27, 2012 |
| **Switzerland** | | |
| Switzerland – PMI Falls Sharply - | Michael Saunders | May 2, 2012 |
| **Norway** | | |
| Scandi/Swiss Economics Update | Tina Mortensen | Jun 1, 2012 |
| Norway - Strong Momentum In Private Consumption | Tina Mortensen | May 31, 2012 |
| **Sweden** | | |
| PMIs and Swedish Stability Report | Tina Mortensen | Jun 1, 2012 |
| Sweden - Strong Recovery in GDP Growth in 1Q 2012 | Tina Mortensen | May 30, 2012 |
| **Denmark** | | |
| Denmark - Danish Central Bank Cuts Rates Again | Tina Mortensen | May 31, 2012 |
| Denmark - Out of Recession | Tina Mortensen | May 31, 2012 |
| **UK** | | |
| UK – MPC Leaves Policy On Hold - | Michael Saunders | Jun 7, 2012 |
| UK – PMI Plunges- | Michael Saunders | Jun 1, 2012 |
| UK - Is Monetary Policy Really "Very Stimulatory"? | Michael Saunders | May 29, 2012 |
| UK – YouGov Reports Lower Inflation Expectations - | Michael Saunders | May 25, 2012 |
| **UK Economics Weekly** | | |
| MPC Likely to Resume QE, Other Easing Also May Follow | Michael Saunders | Jun 1, 2012 |
| Heading for Extra Stimulus | Michael Saunders | May 25, 2012 |
| MPC Pave Way For Extra Stimulus | Michael Saunders | May 18, 2012 |
| Options for Extra Stimulus | Michael Saunders | May 11, 2012 |

Source: Citi Investment Research And Analysis

# Appendix A-1

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