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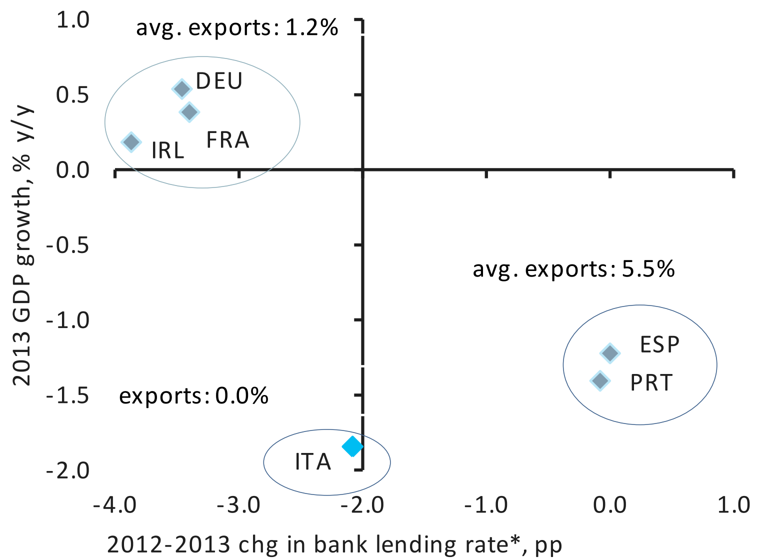
Italy: Time to walk the walk

Alessandra Perrazzelli, *Country Manager* Barclays Italy

Macroeconomic Outlook - Fragile we stand (1)

- We expect Italy's triple-dip recession to last until year-end; a fragile and uneven cyclical recovery is likely to unfold next year, but downside risks prevail. GDP is expected to contract for the 3rd consecutive year in 2014 (-0.3%) before expanding +0.4% in 2015.
- Credit conditions remain tight amid signs of improvement in Italy, but GDP contracted more than in Spain and Portugal last year, where financial conditions have been worse and declines in investment largely similar.
- To a large extent then, weak exports explain the difference in the pace of growth between Italy and peers. The government should continue to focus on supply-side reforms to improve external competitiveness and the business outlook overall.

Poor exports explains most of weakness last year



Source: *New businesses and across maturities; Haver Analytics, Barclays Research

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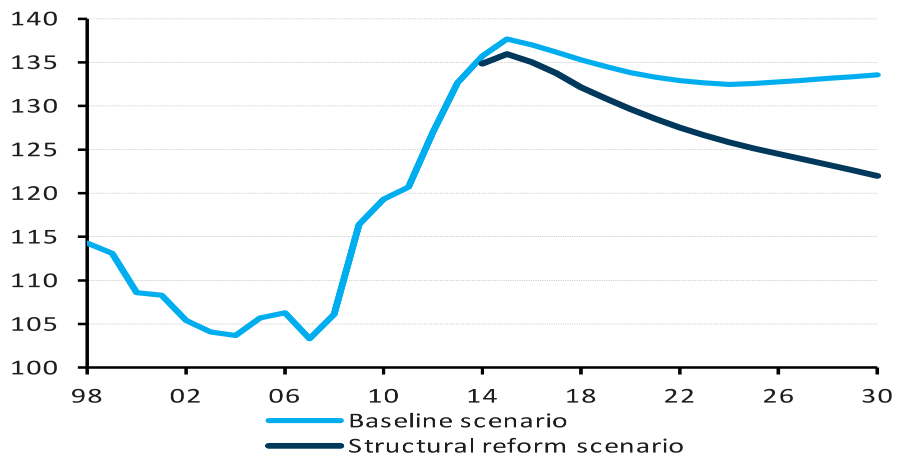
Macroeconomic Outlook - Fragile we stand (2)

- Along with a renewed focus on structural reforms, the government seems inclined to slow fiscal consolidation to the minimum in order to limit downside risks on growth. We expect Italy to keep the general government budget deficit close to 3.0% of GDP this year and next.
- The government should be mindful of the potential risks attached to discretionary fiscal easing. Growth-friendly fiscal adjustment is credible only if part of a medium-term fiscal consolidation strategy which includes cuts of equivalent size to unproductive spending
- Strong growth-enhancing measures remain essential to improving growth potential in the medium term and permanently reducing the debt ratio
- Risks ahead: Monetary policy conditions will not last indefinitely and, with that, the financial market's forgiveness for an economy saddled with large public debt and anaemic growth prospects.

Structural reforms key to improving debt-to-GDP prospects



Source: Haver Analytics, Barclays Research

Institutional reforms - Key steps towards political stability Italy

- We regard the **voting system** and the **Senate** reforms as critical steps towards improving the efficiency of the Parliament billing process. Both reforms are receiving a second Parliament reading, and we expect them to be approved by H1 and H2 next year respectively.
- *Electoral law reform: Two round voting system should eliminate post election political stability risk*
- The reform aims to introduce an electoral system similar to the one used in Spain (proportional representation), with the addition of elements from the French system (two round system).
- Parliament seats won by a party or group of candidates would be proportional to the number of votes received, while the block voting system would be nationwide and divided into small constituencies. The system would also include specific features to minimise risks of post-election paralysis, including the introduction of minimum electoral thresholds and a majority premium.
- *Senate reform: Upper house will no longer appoint the government*
- This reform aims at overcoming perfect bicameralism by limiting Senate's legislative power to a minimum. After the reform, only the lower chamber of parliament will be responsible for appointing the government through a confidence vote.
- The new system would facilitate the appointment of a more cohesive parliament, while also supporting the smooth approval/implementation of legislation, ultimately enhancing medium-term political stability.