

European Economics

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Recovery and Reforms: A New Italian Renaissance?

- **After a long recession, Italy should finally see positive growth again this year.** Since our report of exactly one year ago: "[Italy – clearer skies](#)", the economy has leveled out and green shoots of recovery have indeed started to appear.
- **Prospects for 2015 are objectively brighter** – with the political situation stabilising, reforms proceeding at a sustained pace, and with the significant improvement in the overall macroeconomic backdrop thanks to lower interest rates, a large currency depreciation, and much lower oil prices. As a further boost to activity, it is also the case that lower interest rates and QE are providing Italy with some substantial fiscal room for the years ahead.
- **Hard data so far remain somewhat mixed, however, with clear improvements in some indicators but still negative surprises on others.** Some cyclical indicators – notably related to consumer confidence and durable goods spending have rebounded, and there is early evidence that the measures on the labour front are having a meaningful impact. The industrial and investment situation remains depressed, even if we believe that macroeconomic stimuli should start to show their impact soon.
- **On the reform front, much has been legislated already or will be legislated in the coming months.** Building on previous reforms, the current government is trying to deliver a comprehensive package, addressing most weaknesses of the Italian economy in a wide-ranging reform drive. Some initial doubts on the ability to deliver reforms have subsided, and all major international institutions are providing a broadly favourable assessment of the renewed reform ambition of the country. We provide in the main text a detailed list of the reforms voted so far and of those that still need legislative acts – mostly due to happen during 2015.
- **Visible improvement in key measures of international competitiveness are starting to appear,** but Italy still lags behind its European peers.
- **Looking ahead, Italy has to focus on the full implementation of its comprehensive reform package** – the real success of reforms doesn't stop at the legislative level, but needs the follow-through at the public administration and local level, too – and then to the broader economy.
- **... knowing that a lot still needs to be done to climb the international competitiveness ladder.** Looking beyond the short term, key efforts are still needed on education, anti-corruption, new technologies and on the overall synergy of intents between the public and the private sector – the latter being the elements of a new frontier for reforms, which would follow the "normalization" of the Italian economy that is taking place through the current set of reforms.

DISCLOSURE APPENDIX AT THE BACK OF THIS REPORT CONTAINS IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS.

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1. Cyclical update

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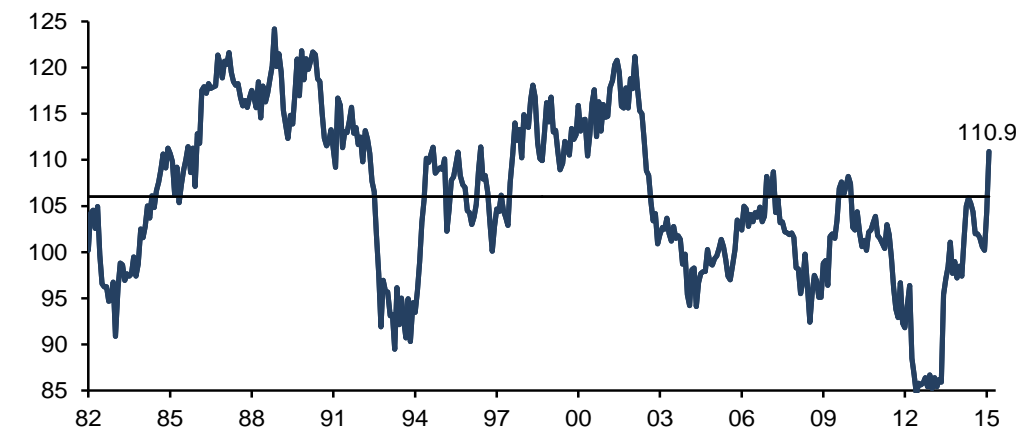
Slowly but surely. Despite some more positive signs in recent months, we still expect modest growth of just 0.7% this year, after three consecutive years of negative growth. Italy's GDP is improving only slowly. GDP was flat in Q4 2014, and overall the economy declined by just 0.4% in 2014, "improving" from a fall of 1.9% in 2013.

The year has started on the right footing. Italian consumer confidence is at its highest in almost 13 years, business confidence has improved as well, the manufacturing PMI jumped by two points in February, with new export orders at a high level and even outperforming Spain. Additionally, the employment index rose sharply and the unemployment rate ticked down. It's worth noting that the sharp increase in the unemployment rate seen over the previous two years was essentially driven by the rise in the participation rate, which reached its all-time high in Q4 2014.

The recent improvement in the data is clearly a consequence of the "common factors" we are also seeing for the euro area [as a whole](#) – the fall in oil prices, a weaker currency, easier monetary policy, and no more fiscal drag – **but we believe there are increasingly country-specific factors** – the effective implementation of structural reforms, a more stable political backdrop also seen in the recent smooth election of the President of the Republic – that are allowing us to be more optimistic on Italy's prospects. Additionally, "Expo 2015" – an international event in Milan, which should attract an estimated 20m visitors this year, might also add a couple of tenths of a percent to Italy's GDP this year.

The improvement in consumer and business sentiment indicators suggests we have now reached an inflection point in domestic demand. The acceleration in car sales, mortgages, and some improvement in retail sales point clearly to a recovery in domestic demand. The latter has been the main drag in the recession, having fallen by more than 13%, outpacing the loss recorded by overall output. Investment is timidly trying to get back on board, although the signal there remains weak and we will probably see more positive dynamics toward the end of the year.

Exhibit 1: Italian consumer confidence at its highest in almost 13 years



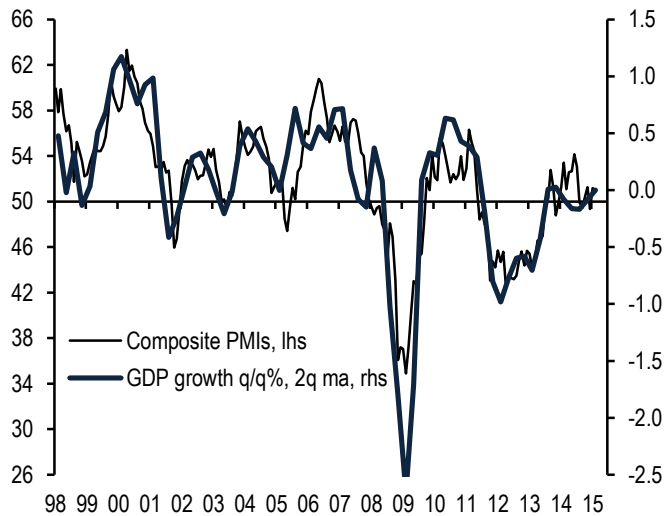
Source: Credit Suisse, Istat

Net trade should continue to contribute positively to growth, on the back of increasing (and more balanced) global demand – and thanks to the euro depreciation. As we show below, Italy has managed to maintain export market shares in recent quarters. We expect this development to continue to support activity in Italy, in particular given the meaningful depreciation of the euro. Additionally, falling oil prices should bode well for an acceleration in cyclical momentum and for a further strengthening of the current account balance – which has already turned into surplus since 2013.

Inflation is too low but deflation seems unlikely, in light of QE and its impact on the currency. A deflationary spiral would be particularly damaging for Italy's public debt dynamics, although it must be said that it would be even more damaging for most other countries when private debt is included in the equation (Exhibit 25). On our estimates, inflation is likely to be flat in 2015 largely due to the fall in oil prices, while it should recover somewhat, growing 0.7%, in 2016.

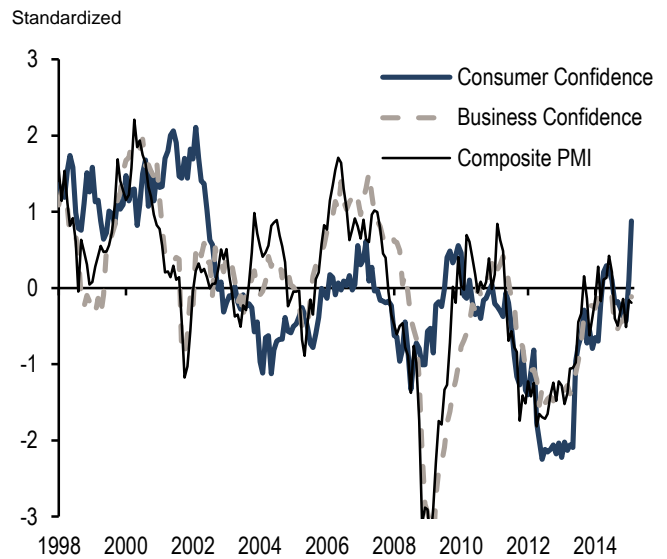
We provide below a "chartbook" on the latest economic developments in Italy.

Exhibit 2: Composite PMI pointing to flat Q1 GDP



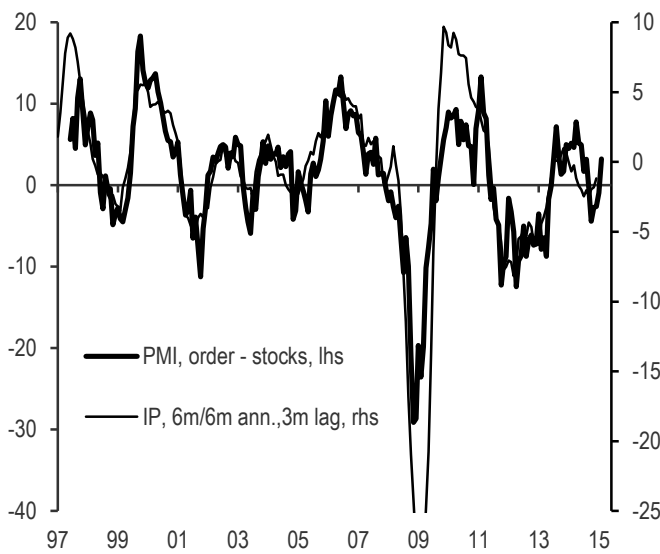
Source: Credit Suisse, Markit, Istat

Exhibit 3: Cyclical indicators: optimistic consumers



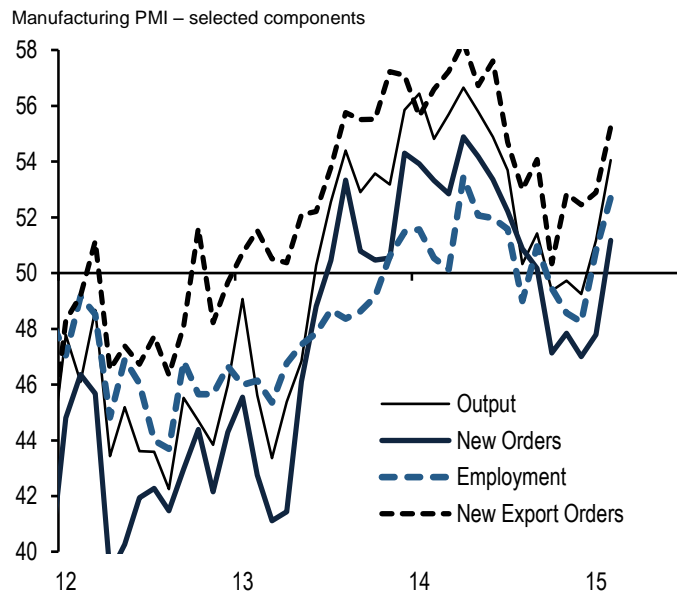
Source: Credit Suisse, Thomson Reuters DataStream, Istat, Markit

Exhibit 4: Industrial production should rebound



Source: Credit Suisse, Markit, Istat

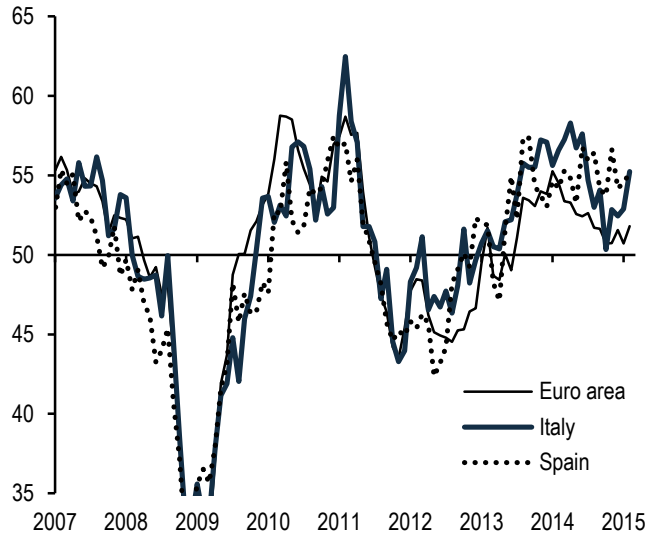
Exhibit 5: A re-acceleration in (export) orders



Source: Credit Suisse, Markit

Exhibit 6: Italy back above Spain in export orders

Manufacturing PMI – new export orders



Source: Credit Suisse, Markit,

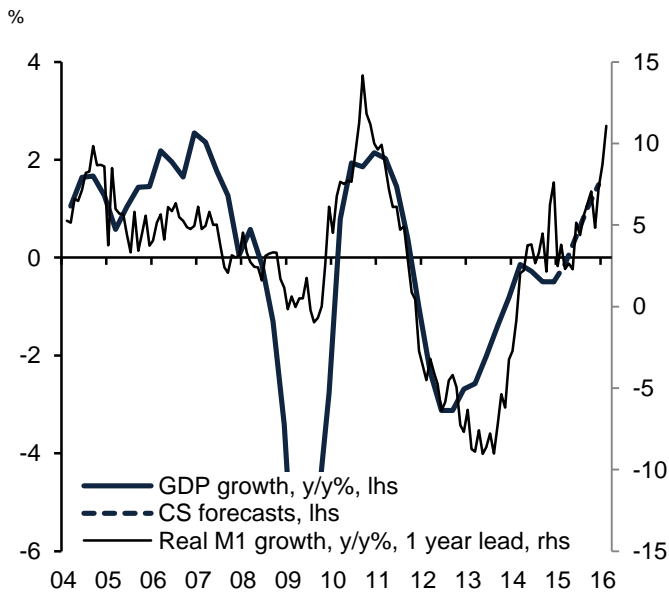
Exhibit 7: A bounce in employment expectations

European Commission Survey - employment expectations



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 8: M1 suggesting a stronger upside



Source: Credit Suisse, Markit, Thomson Reuters DataStream, Istat

Exhibit 9: Car sales bouncing from the lows

Index, Q1 2007 = 100, lhs - y/y% 2m ma, rhs



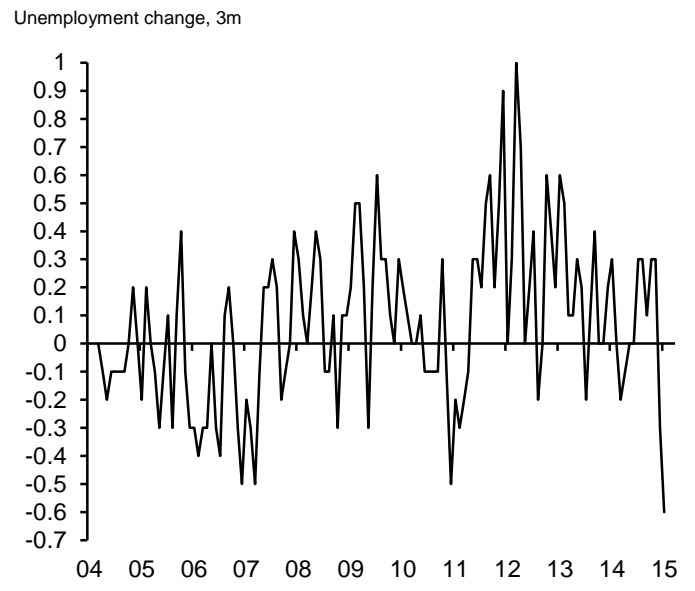
Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 10: Unemployment ticking down, finally



Source: Credit Suisse, Istat

Exhibit 11: Unemployment fall momentum: strong



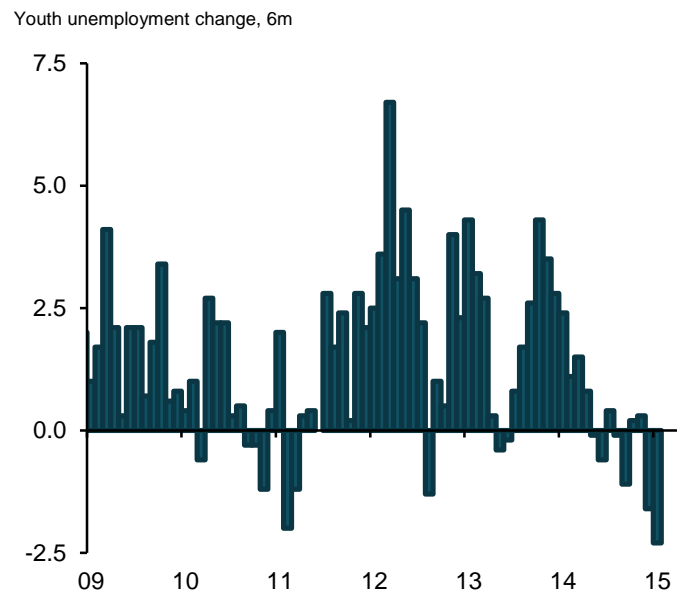
Source: Credit Suisse, Istat

Exhibit 12: Youth Unemployment – past the peak



Source: Credit Suisse, Istat

Exhibit 13: Youth unemployment falling faster



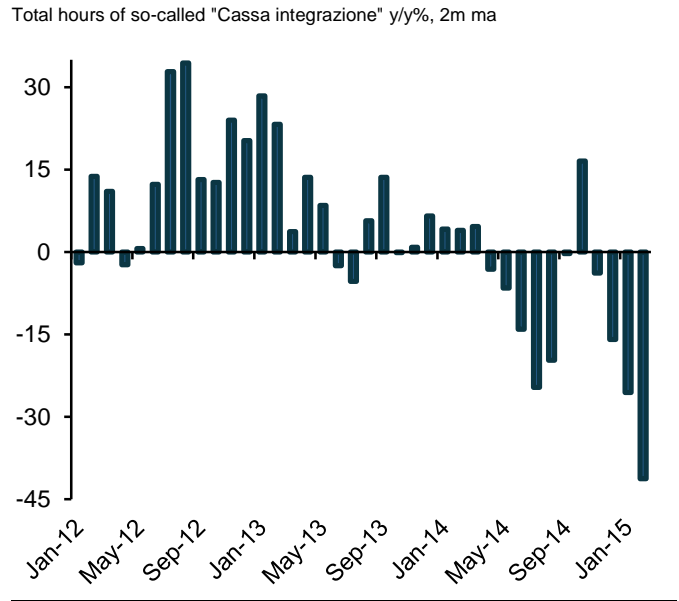
Source: Credit Suisse, Istat

Exhibit 14: Participation rate at an all-time high



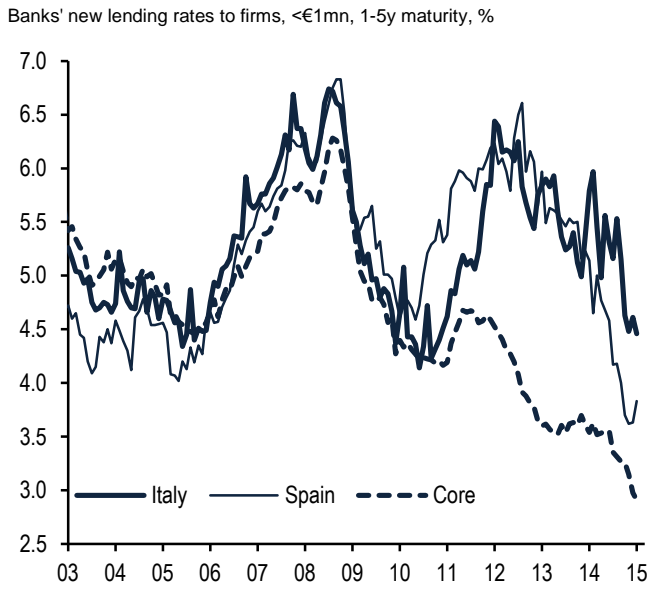
Source: Credit Suisse, Istat

Exhibit 15: Shrinking use of unemployment benefits



Source: Credit Suisse, Inps

Exhibit 16: SMEs' funding costs falling but still high



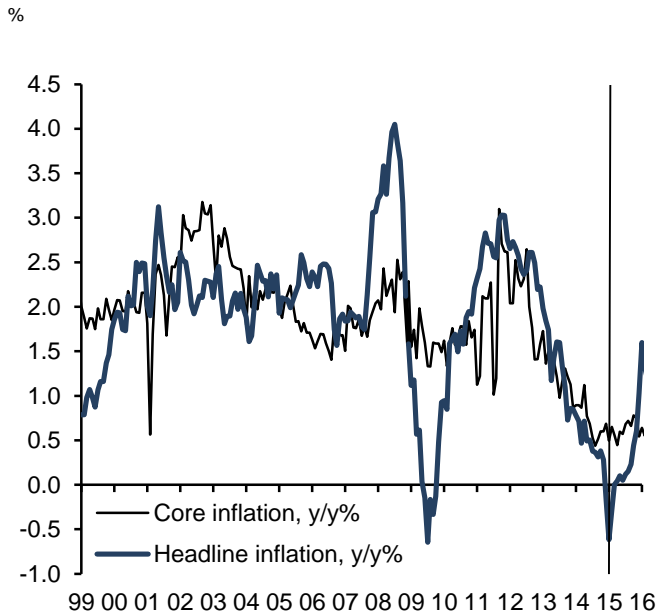
Source: Credit Suisse, ECB

Exhibit 17: Strong increase in new mortgages



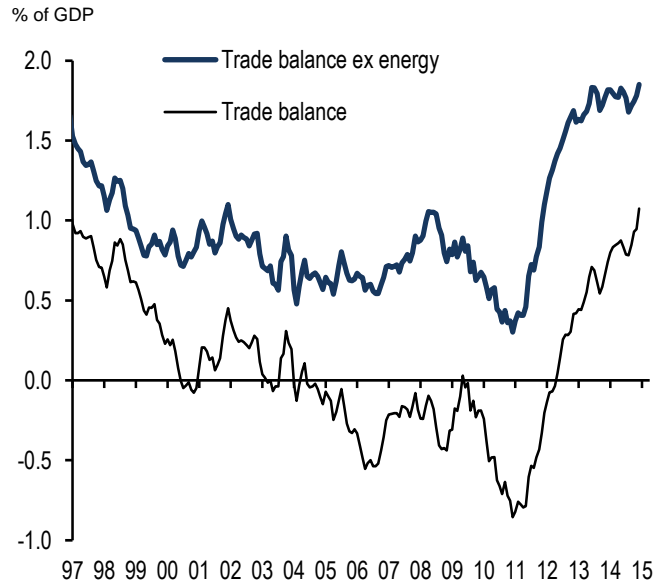
Source: Credit Suisse, ECB

Exhibit 18: Low Inflation, but no deflation expected



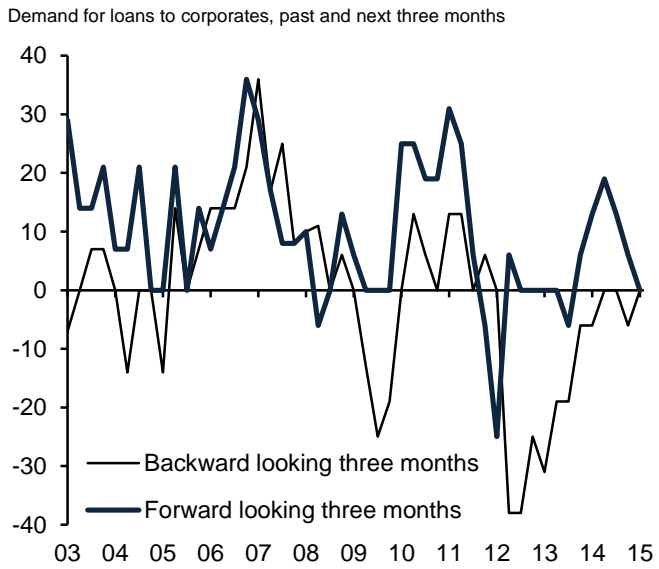
Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 19: A positive and rising trade balance



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 20: Loan demand is mixed, from corporates...



Source: Credit Suisse, Bank of Italy

Exhibit 21: ... while from households is back



Source: Credit Suisse, Bank of Italy

2. Fiscal update

As the charts above suggest, most indicators point to a recovery in the making, albeit not an extremely strong one so far. Looking ahead, positive surprises could come from the investment component – on the back of a return of confidence and also thanks to the structural reforms we highlight in the section on reforms below.

Meanwhile, in addition to the positive boost coming from the obvious stimulus from lower oil prices, the currency depreciation and from lower rates, **another channel of support could come from the "fiscal space" created by the fall in interest rates and by ECB's QE.** The contribution of the fiscal channel – especially for Italy – could be very significant, as we elaborated in our [European fiscal publication](#) earlier this year and as we do in this section.

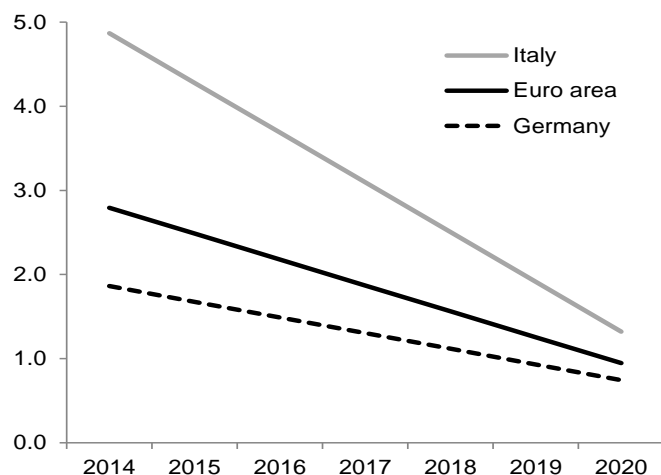
Italy's underlying fiscal position has improved significantly, even though part of the story is hidden behind the adverse cyclical developments of the past several years. Past structural efforts have already created the conditions for the debt ratio to fall in the coming years – thanks to a large structural primary surplus (close to 4% according to the European Commission, and even slightly higher in the OECD estimation). The biggest effort was undertaken in 2012 by the Monti government, but the following governments have kept it at high levels. For the near future, there is little expectation of improvement on the structural fiscal front – which should provide some breathing space for growth.

QE is adding another important layer to the story, by lowering present and prospective interest payments. Indeed, while interest payments amounted to nearly 5% of GDP last year, it is plausible to expect a c.½pp reduction of the interest burden, annually, for the next few years, just on the back of the roll-over of the debt into lower-yielding securities.

If the average cost of funding were to stabilise at around 1% in the coming years (the marginal funding cost is currently lower, close to 0.5%), Italy would have an interest burden of just 1%-2% of GDP by 2020 vs. close to 5% currently, meaning that around 3pp of GDP would be available to either accelerate greatly the speed of debt reduction or to boost activity via public spending or lower taxation.

Exhibit 22: A decreasing cost of funding

Interest payments, % of GDP



Source: Credit Suisse, Eurostat

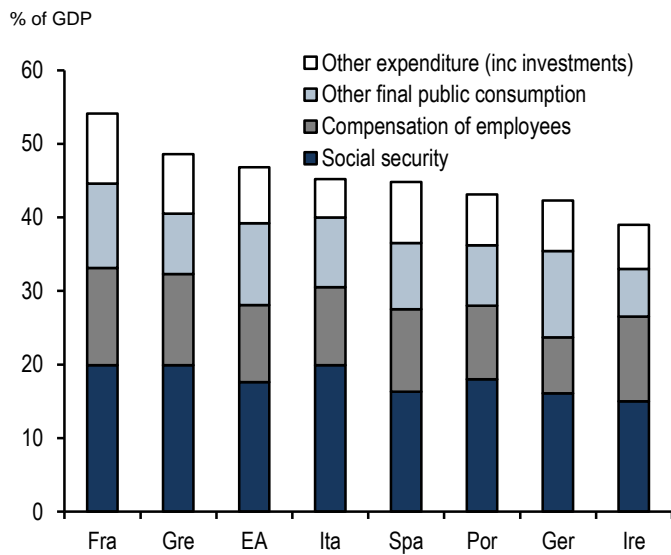
Exhibit 23: ... with primary surpluses in line

General government balance excluding interest payments, nominal and adjusted for the cycle (structural), % of GDP, 2015 estimates

	Primary balance	Structural prim. bal.
Euro area	0.3	1.6
Belgium	0.1	0.6
Germany	1.8	2.4
Ireland	0.9	0.5
Greece	4.1	5.8
Spain	-1.2	1.0
France	-2.2	-0.7
Italy	1.8	3.7
Cyprus	0.2	1.9
Netherlands	-0.7	0.6
Austria	0.7	1.5
Portugal	1.6	3.3
United Kingdom	-1.8	-1.9

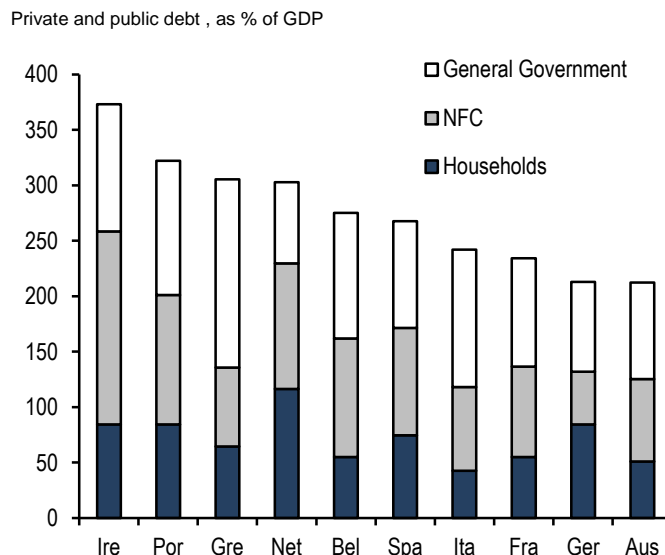
Source: Credit Suisse, Eurostat

Exhibit 24: Government expenditure ex interests



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 25: Italy's private debt still relatively small



Source: Credit Suisse, Eurostat

3. Competitiveness – where does Italy stand?

Italy's low growth is only partially related to its external or price competitiveness, in our view. As we have already explained in detail our thoughts on this topic (see [here](#)), we only summarise and update some indicators here.

Size matters. Among European countries, Italy is one in which the size of companies is smallest. The average number of employees per enterprise is 3.9, just above Portugal with 3.7 employees. This translates into companies having difficulty financing themselves and retaining talent; more broadly it relates to skill mismatch, in which low-skilled people occupy jobs which require high skills, or the other way round. Productivity correlates well with firm size.

Unit labour cost dynamics have been unfavourable – even if things are changing this year. Competitiveness is commonly measured by relative price and costs indicators, i.e., a trade-weighted currency index deflated by different relative price or cost deflators. Looking at the effective exchange rate deflated by unit labour costs in the manufacturing sector, which is one of the most commonly used measures of price competitiveness, Italy seems to be one of the worst performers in the euro area in the past decade. Looking at ULC in the whole economy, the picture is less daunting, but still severe. On this front, Italy is likely to improve its competitiveness this year, thanks to a combination of the permanent reduction in the tax wedge and fiscal incentives for firms who hire workers, and the depreciation of the euro since last May.

Focusing only on ULC would, however, bias the assessment. Indeed, other measures of price competitiveness do not paint a similarly bleak picture. Looking at effective exchange rates deflated by price deflators such as the CPI, the PPI, or the GDP deflator, the loss in competitiveness between 2000 and today is small – barely significant statistically.

In fact, using the producer price index (PPI) as a deflator, Italy even appears to have improved the level of price competitiveness since the start of the EMU era. With the wage share in gross output falling globally, a broader indicator of prices such as the PPI is arguably more relevant than more narrow measures based on (only) labour costs. If we look at competitiveness basing our views on the relative prices of producers, Italy's position has not deteriorated vis-à-vis its main trading partners over the past 15 years.

If labour costs have increased more than elsewhere, other elements of producers' prices have been more subdued, in fact intermediate goods' costs have increased less relative to other euro area economies and non-financial corporates have significantly reduced their profit share in the last decade. Conversely, we believe that the reduced tax wedge, implemented by the current government as we discuss in section 5, will only partially feed through into export prices due to recovering [profit margins](#).

Moreover, non-price competitiveness indicators, such as export market shares, support the view that Italy's external competitiveness remains resilient. In fact, export market shares have not deteriorated as much as some price-competitiveness indicators would have warranted. Over the last four years, Italian exports have grown broadly in line with demand in the export destination markets, and since mid-2012 they even have slightly outperformed world exports, resulting in a mild increase in export shares in the past couple of years, for the first time in many years. And looking ahead, the collapse in the euro, and the "tax cut" coming from a lower oil price, would bode well for an improvement in export shares this year and the next. Additionally, Italy has lost less market shares – in value terms – than most other direct competitors since 2000. Only Spain and Germany, to some extent, have done better, in a context of increasing export shares being taken by China.

Additionally, the loss of turnover in the manufacturing sector is exclusively due to its domestic economy, while on the external front Italian firms have done as well, or even better than, their direct competitors – including Germany.

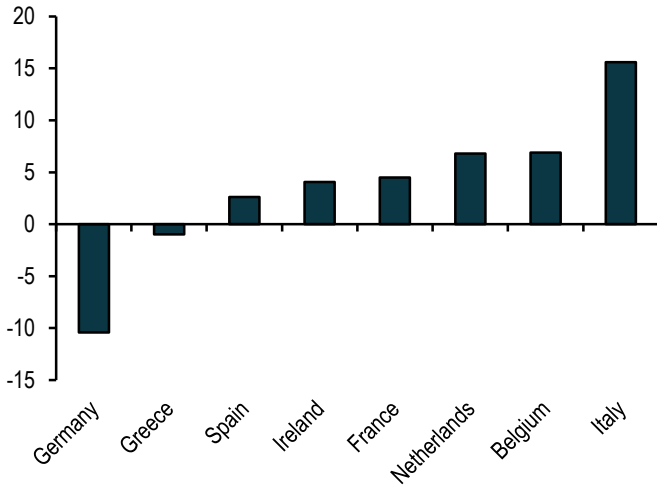
That price competitiveness may not be the real problem for Italy can also be seen by looking at the trade balance ex-energy. When energy is excluded, the country has consistently recorded a trade surplus, even during the years of supposed loss of (price) competitiveness. And the trade surplus ex-energy recorded an all-time high in December 2014, at 2% of GDP, while including energy, it approached a solid 1.3% of GDP.

According to The World Trade Organization (WTO)'s "Trade Performance Index" rankings Italy is seen as the best performing exporter after Germany (and before China).

Even if from our analysis external competitiveness does not seem to be the major issue for the country, it appears clear to us that Italy could strengthen its position in terms of exports and productivity growth. Lack of competition in product markets, weaknesses in public administration, corruption, and a slow and inefficient justice system are key reasons for the low productivity of the system. However, a draft law on economic competition has been adopted by the government in February, but it is not yet on the Parliament's agenda. Elsewhere, as we detail in the section on reforms, steps have been taken to address the main weakness of the economic system – with some first but still initial successes. Despite some signs of improvement, international indicators on the "ease to do business", as well as productivity dynamics of the country as a whole, suggest that reforms are required.

Exhibit 26: A loss of price-competitiveness in the economy as a whole since 2000

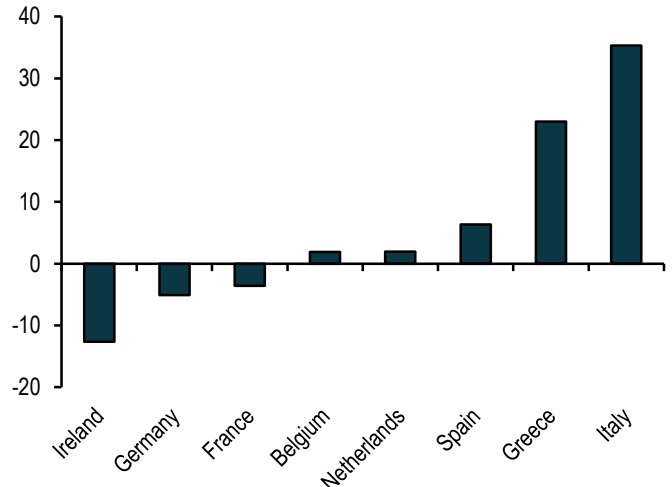
REER ULC for the total economy. Difference from 2000 average



Source: Credit Suisse, European Commission

Exhibit 27: ... even more marked when looking at the manufacturing sector in isolation

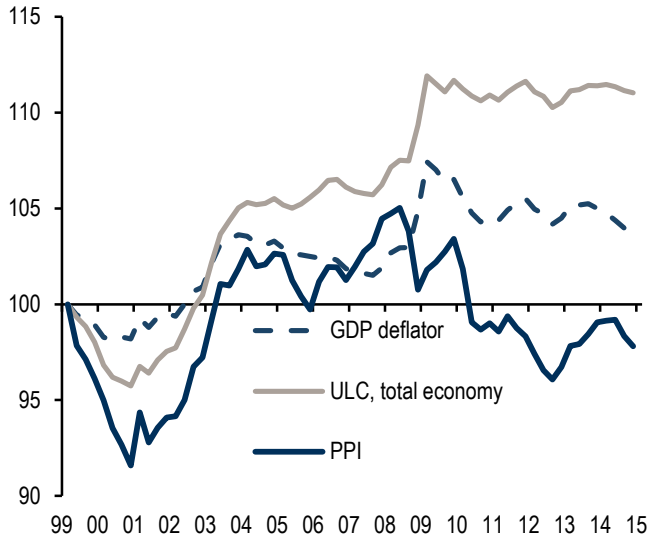
REER ULC for the manufacturing sector. Difference from 2000 average



Source: Credit Suisse, European Commission

Exhibit 28: Price-competitiveness measures show extreme divergence in Italy

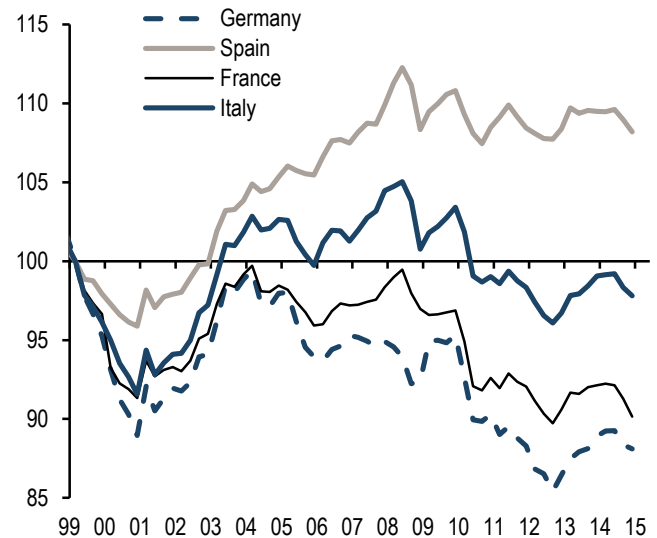
Trade-weighted exchange rate deflated by...



Source: Credit Suisse, European Commission, ECB

Exhibit 29: ... but there is a less negative assessment when looking at producer prices

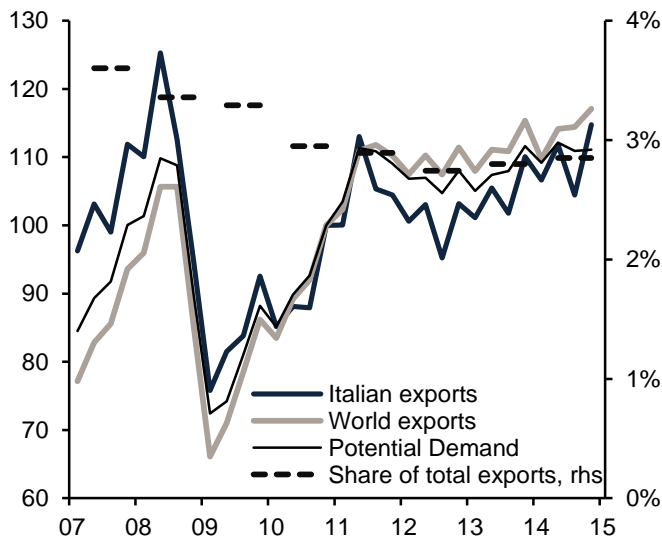
REER deflated by PPI



Source: Credit Suisse, ECB

Exhibit 30: Italian export developments in a global context

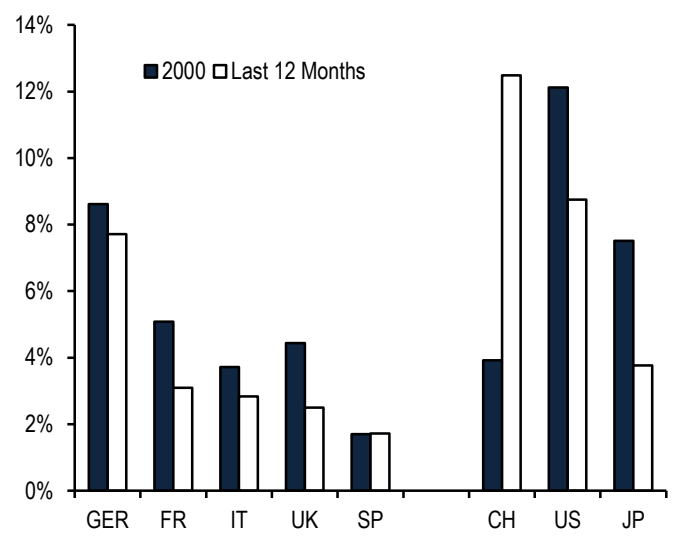
Q4 2010=100



Source: Credit Suisse, Bank of Italy, IMF

Exhibit 31: A relatively contained loss in export market shares

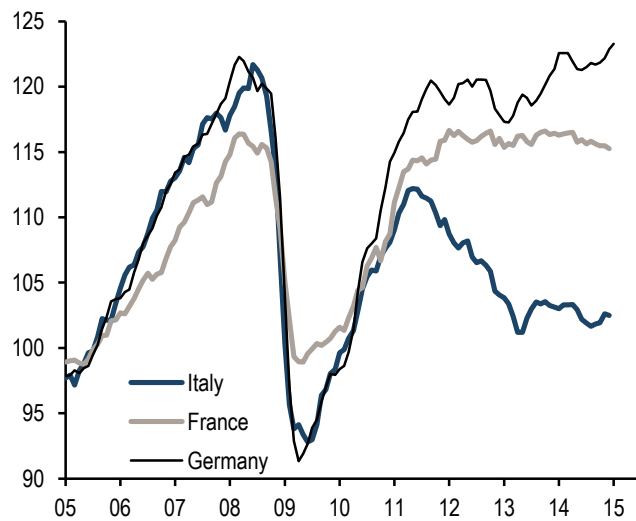
Share of world exports (%)



Credit Suisse, Thomson Reuters DataStream, IMF

Exhibit 32: Manufacturing turnover index

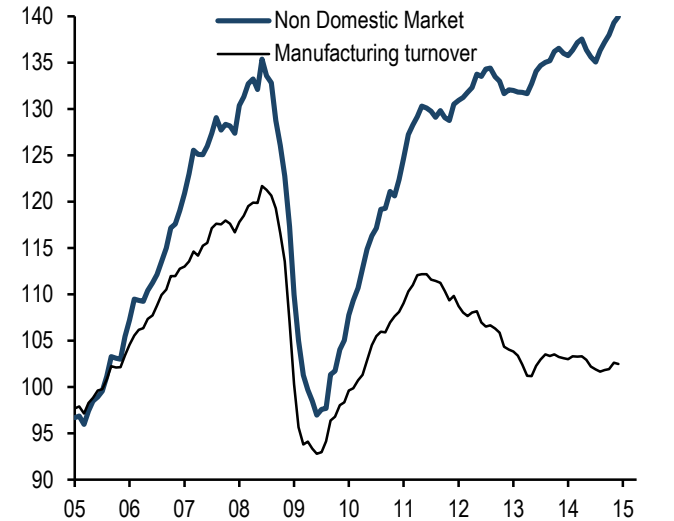
2005=100



Source: Credit Suisse, Eurostat

Exhibit 33: Italy's strength comes from abroad

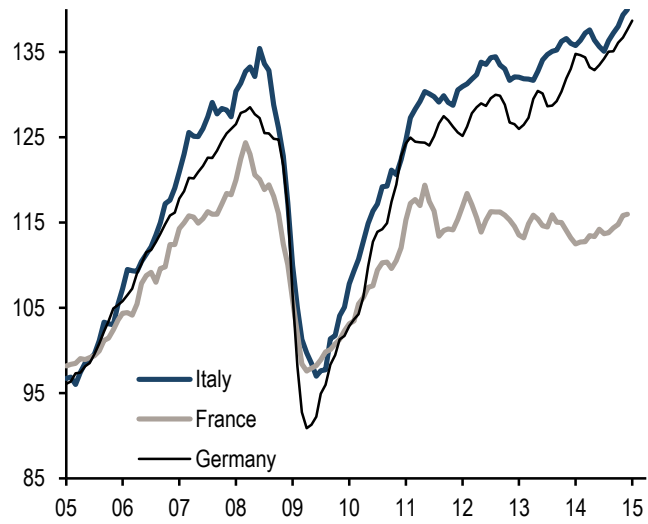
Italy's manufacturing turnover, 2005=100



Source: Credit Suisse, Eurostat

Exhibit 34: Non-domestic turnover comparison

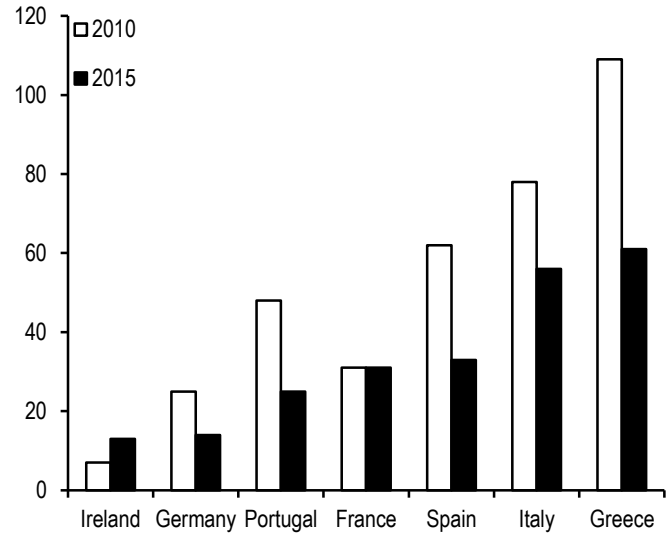
2005=100



Source: Credit Suisse, Eurostat

Exhibit 35: The “doing business” index

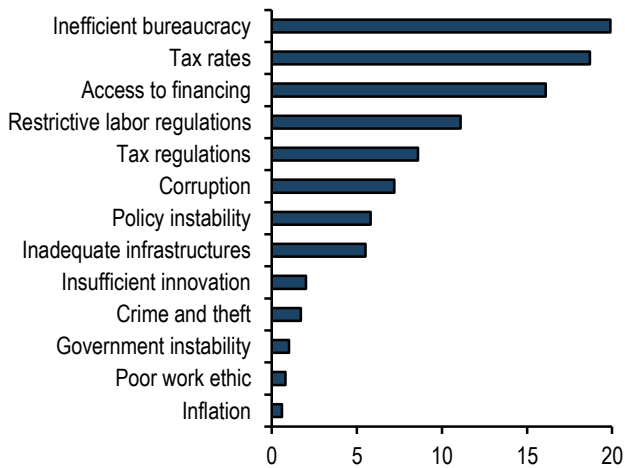
Economies are ranked on their ease of doing business, from 1–189 (1=most business-friendly regulations).



Source: Credit Suisse, World Bank

Exhibit 36: Italy's main problems, according to WEF

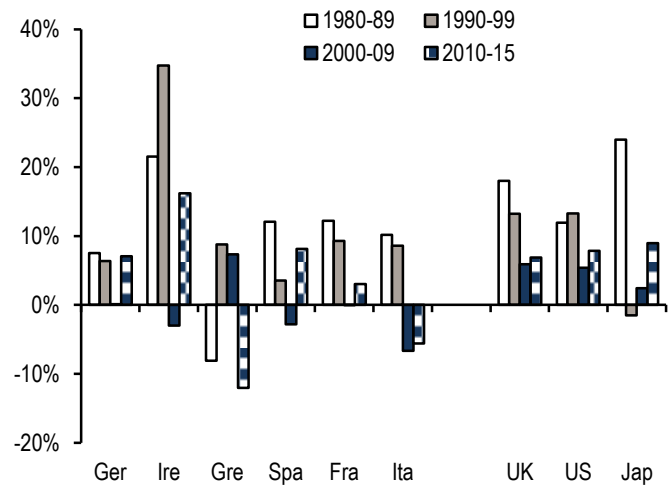
The most problematic factors for doing business, % of responses



Source: Credit Suisse, WEF

Exhibit 37: Italy could strengthen its position in terms of productivity growth

Total factor productivity growth y/y%, average of the period



Source: Credit Suisse, AMECO

4. Political situation stable, and likely more stable soon

Italy has long been known for its inherent political instability. Ironically, it is today in a situation of relative stability, especially in light of political uncertainties surfacing in most other countries in Europe. Moreover, a new set of institutional reforms are in the process of being approved by the Parliament, which should improve the political landscape further.

Reforms of the State and a new electoral law should stabilize things further. As we discuss more in detail below (in the reforms section), there has been a first vote in the Senate and in the Lower House on a set of constitutional reforms. A second vote is required later this year and a final referendum expected for year-end. We believe the process will end with a final acceptance of the constitutional changes. The electoral law has also already been voted, and needs a final confirmation passage in Parliament, expected by the government in the coming weeks.

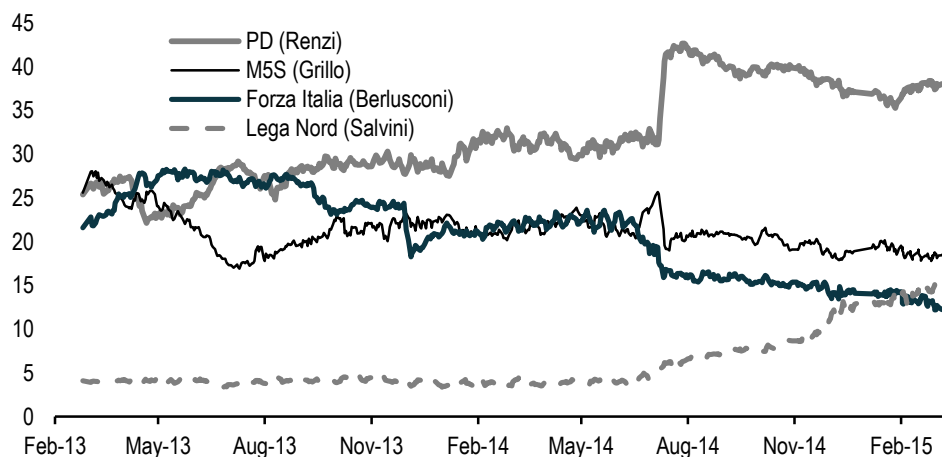
In addition to these key expected changes, it is interesting how the political situation has stabilised even in the current context (i.e., "pre-reform"), with PM Renzi's party, the center-left Partito Democratico, obtaining a large share of the political consensus in Italy (with Renzi also gaining support from MPs outside of the official existing majority), with all the other parties at a much lower level of support and, in addition, with the center-right forces increasingly fragmented. This is, to some extent, in contrast with the increase in uncertainty and in support for extremist parties seen in several other European countries – and also in salient contrast with the recent history of political instability in the country. Even if there has been an increase in the support for the anti-system Northern League, the numbers of that party remain contained and appear to be cannibalizing other anti-system votes, rather than denting the support for the government.

The relative stability is likely a factor behind the recent narrowing of the Spain-Italy bond spread, with Spain seeing some rising uncertainty in the political sphere since mid-2014.

Italy's political stability will be "tested" soon, with local elections on May 31 (likely to be postponed to June 7), although the consequences for the government are likely to be negligible in our view. We believe that the next general elections will take place in 2018. By then, the new rules should be in place, providing the country with a clear and stable elected majority and government.

Exhibit 38: Polls suggest strong support for PM Renzi's party

5 poll-moving average



Source: Credit Suisse, various polls

5. Structural reforms

We focus on the more recent measures taken by the current government¹. These include in particular labour market reforms as well as, more generally, measures aiming at improving the overall efficiency of the economic system – institutional reforms, judicial and public administration changes, as well as measures to fight corruption and foster domestic and foreign investments.

Exhibit 39: Progress on structural reforms taken by the current government

Fully legislated	Further measures foreseen
New labour contract	
Revised unemployment benefit	
Income tax cut	
Corporate tax: extended allowance for corporate equity	Ministerial decree requirement for confirmation
Courts: expansion of access to alternative dispute procedures	
Administrative justice	
Anticorruption measures; public procurement and infrastructure investment	
Expanded SME access to non-bank finance. Easier SME listing requirements	
Partially legislated	
Active labour market policy	Decree by June 2015
Minimum wage	Decree by June 2015
Administrative simplification for citizens and business	
Electoral law	Further confirmation votes in parliament
Senate reform	Constitutional referendum
Central – sub-national relations	Further votes in both chambers and constitutional referendum
Further tax reform	Decree pending
Strengthening sanctions against financial fraud and mafia	Further confirmation votes in parliament
Education reform	
Yet to be approved	
Strengthening business courts	Decree pending
Liberalisation and deregulation in local services, regulated professions, network industries, etc.	Draft Competition Law planned for June 2015
Enhance strategic energy infrastructure	
Public administration reform	
Criminal justice reform	

Source: Credit Suisse, MEF, OECD

5.1 – Labour market reforms

With unemployment high (although less so than in other peripheral countries) and the participation rate still very low (despite some trend improvement also due to previous labour market and pension reforms, see Exhibit 14), **the government has launched several initiatives to boost hiring.**

The first move – last year – was to increase the flexibility of temporary contracts, while more recent policies have targeted labour costs and the flexibility of the overall labour market, in particular by changing the characteristics of the main open-ended contract for new hires.

The tax wedge has been cut considerably. The tax burden on labour has been reduced considerably, and a significant shift away from labour taxation has taken place. The Stability Law 2015 introduced a permanent reduction in the tax wedge on labour and fiscal

¹ We discussed in [previous documents](#) Italy's key reforms of the past 20 years.

incentives for firms who hire workers with open-ended contracts. Indeed, firms will get full exemption from social security contributions for up to 36 months for new permanent hires. Meanwhile, a cut in the corporate tax rate is also taking place, via a deduction of the labour component (related to permanent workers) from the tax base of the Italian regional production tax. A tax-bonus of €80 per month on labour income (for permanent employees earning less than €26K), worth overall €10bn in tax cuts, was also approved last year and was made permanent with the 2015 Stability Law.

The Jobs act – Italy's comprehensive labour market reform – has been voted by Parliament and is currently being implemented. Inefficient labour market institutions contribute to low labour utilization. Italy's labour legislation is— or has been, until recently – well known for strongly protecting employees with open-ended contracts in firms with more than 15 employees – with the rest of the labour force enjoying significantly less protection.

The Jobs Act, adopted in December 2014 in the context of an enabling law – the latter allows the government to produce a number of bills according to that law without another vote in Parliament – is a comprehensive reform of the labour market that contains measures to rationalise employment protection, expand active and passive labour market policies and make social protection more effective. Significant parts of the Act are already in place, with the overall package of reforms expected to be finalised by June.

The Jobs Act introduces a new standard open-ended contract with employment protection increasing with tenure. The new contract provides a basic level of protection for the first two years, after which the level of compensation for unfair dismissal increases up to a maximum of 24 months' wages.

The decree on unfair dismissals, abolishing the (in)famous art.18 of Italian labour law for new hires, also recently approved, makes reinstatement following unfair dismissal extremely unlikely. Under the previous regime, dismissed workers could file a case claiming that their dismissal was unfair and claim, not only monetary compensation, but also reinstatement in their previous job. A reform in 2012, by the Monti government, restricted the possibility of reinstatement to cases in which the alleged justification was unfounded. The new decree clearly goes further. Specifically, firms with more than 15 employees will now be able to fire workers for business reasons, without the risk of having to reinstate them, even if the dismissal is ruled as unlawful. The abolishment of article 18 entails a revision of the dismissal rules both on an individual and on a collective basis. The employer doesn't run the risk of having to reinstate employees unless the dismissals are discriminatory or null. If the dismissal is judged as unfair, the employer must pay an indemnity equivalent to between 4 and 24 months of salary.

The reform reduces significantly the normal cost of firing, as well as reducing the uncertainty related to the risk of reinstatement and also in most cases the length of the possible controversy between the employer and the employee. The acceptance of the indemnity prevents any further dispute by the worker. Both parties have a strong incentive to settle the dispute through this procedure, since the sum paid is not subject to social contributions or taxation.

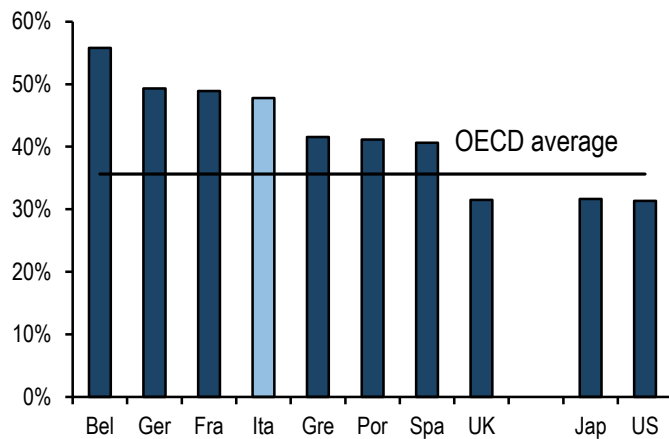
A new unemployment benefit has also been introduced (the so-called NASPI), which strengthens the conditionality to receive the benefit in terms of active labour market search.

These new arrangements imply quite radical changes for Italy – and in most cases go beyond what was asked by the European Commission on labour market reform. If fully implemented, these changes will transform the Italian labour market profoundly and enhance productivity in the broader economy, facilitating skill matching as well as reducing cost and uncertainty for companies and hopefully reinforcing workers' skills, via the predominance of open-ended contracts.

Some potential drawbacks. The few potential negatives include the usual risk of imperfect implementation of the reforms; the fact that the new rules apply only to new hires, risking a (different kind of) labour market segmentation, for a number of years; the fact that there is for now a strong tax incentive to hire with the new scheme, as we mentioned in the paragraph on the tax wedge above, means that the real interest from employers for this new form of contract might not appear clearly, initially. Finally, issues of wage supplemental schemes, job placement, and the governance and functioning of labour market policies still require more reform. **But overall, our assessment is that this is a clear improvement for Italy.**

Exhibit 40: Tax wedge

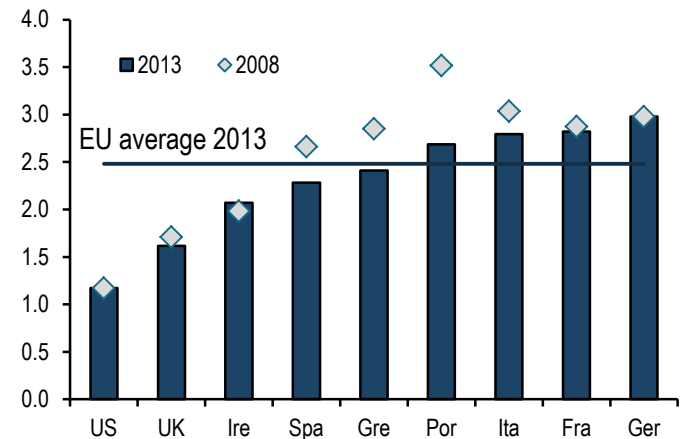
Average compulsory payment wedge as % of total labour costs, 2013



Source: Credit Suisse, OECD

Exhibit 41: EPL index

A lower number implies a more liberalised labour market



Source: Credit Suisse, OECD

5.2 – Constitutional reforms

Maybe more ambitiously still than with labour market reform, the government has launched a reform programme to overcome deep issues likely behind the poor productivity performance of the country since the early 1990s. The existing institutional setting has hindered system-wide efficiency, due to endemic political instability, institutional inefficiency and weak administrative capacity. As a consequence, reforms initiated were not complemented, not adequately implemented – or even reversed by subsequent governments.

Some of the reforms of the new administration have thus focused on streamlining the parliament, reducing the duplications and competencies of local governments, as well as changing the electoral law to make governments more stable between general elections. These important changes are expected to be completed by the end of 2015, and we believe there is a good chance that this will indeed happen.

Reducing the Senate's and streamlining regions' powers, and a new electoral law.

The new architecture of the Parliament will see the Senate losing its veto power in the legislative process. This should reduce political instability as well as streamline the law-making process. Meanwhile, the reform of the so-called "Titolo V" of the Constitution will limit the powers of local governments, also providing some more coherent and faster implementation of the measures decided by the central government. These constitutional reforms have already been voted once in Parliament – but need a second round later this year given their Constitutional nature, with the Prime Minister having also promised a referendum to confirm the new setting by the end of the year. We believe it is highly likely that the changes will go through.

Meanwhile, the new electoral law has also already been approved by the Lower House and by the Senate, and needs a final Parliamentary vote next month. It includes a "majority premium" to the party that achieves at least 40% of the votes (in that case the party would get a 55% of seats), or a second voting round if that 40% threshold isn't reached by any political party in the first round.

The new electoral law, together with the Constitutional changes, should make the political and legislative process both more stable and more efficient, reducing ambiguities about who is responsible for what, and avoid implementation delays due to sub-national government not following through on national legislation.

5.3 – Judicial system reforms

Important steps have also been taken to improve the efficiency in the judicial system. The reform of the justice system is another key piece of the puzzle to make the economic system more efficient and more similar to one of Italy's peers (as we discussed in our 2014 report as well). Some measures were taken last year, focusing mainly on out-of-court procedures, resulting in a significant reduction of the pending backlog of civil cases. Mediation is increasingly incentivised, cutting dramatically the length of proceedings; increased fees are also acting as a disincentive to starting court cases.

Additional steps are required and expected, which will involve further amalgamation of small courts, measures strengthening special courts for companies so that commercial cases can be dealt with more swiftly, with a goal to limit the length of proceedings, to increase the use of mediation, and to enhance monitoring of court performance.

Reducing corruption is another priority, more linked to the field of criminal justice. The anti-corruption agency ANAC has been given some additional powers and has used them in recent cases of corruption, with some success. ANAC can request that firms, or specific projects that are suspected of being involved in corrupt behaviour, are put under compulsory administration. New measures are being prepared as we write, which include increasing penalties for corruption crimes.

The importance of systemic reforms for economic efficiency. More broadly, as the recent [OECD report on Italy](#) highlights quite clearly, the above changes are key to have a more efficient economic system, but more needs to be done in terms of effective implementation of reforms, which require well-designed laws (i.e., in clear and unambiguous language), an effective public sector (e.g., promptly implementing new regulations via a skilled, transparent public administration) and of course an efficient legal system to back up enforcement and prevent corruption.

Past reforms have tackled many of these areas, though progress has been slow. The OECD suggests that the government needs to continue its efforts to pursue more performance-oriented management and improve skill levels. The revision to public employment regulations that allows them to be reassigned more easily should improve both flexibility and skill-matching, if used by a management system that focuses on performance. Transparency has improved and is an important tool in the fight to avoid waste and corruption, but more could be done

5.4 – Financial sector reforms

Tentative attempts to deal with NPLs. The deterioration in the quality of loans has led to a sharp increase in NPLs. Part of the increase in the ratio is denominator-driven (due to the contraction in overall loans), and there are signs that the pace of increase in NPLs is subsiding. Still, this represents a key weakness of the Italian banking sector, which the government is now trying to address with some still unspecified regulatory and fiscal measures, after it failed to find a suitable "bad bank" structure that was also in agreement with the European state aid rules. Meanwhile, the largest banks have taken the initiative with their own structures to start dealing with the problem.

Meanwhile, the other change in the banking sector concerns the reform of the cooperative banks, via a significant change in their governance structure: 10 cooperative banks in Italy will have to transform themselves into join-stock companies in 18 months and remove their “one share one vote” governance rule. This could accelerate a process of consolidation that would likely also help in dealing with the NPL question.

Finally, the government has tried to provide funding alternatives for companies, and SMEs in particular, via a deregulation of credit and an improved access to capital markets. These are summarised in a box from the recent [OECD report on Italy, which we](#) provide below.

Recent government measures to increase “Finance for Growth”

The government has taken a number of measures to make it easier or cheaper for finance to flow to small companies or infrastructure projects and investment in general, as well as encouraging wider stock market listing to improve access to equity finance.

Easier access to credit. Some institutions previously prohibited from lending directly to companies, such as credit funds, securitisation companies and insurance companies, may now lend directly to firms. The withholding tax for EU investors on medium-long term financing, unlisted bonds and certain other securities is removed. The endowment of the Central Guarantee Fund has been increased and the scope of the Fund widened by including guarantees for mini-bonds issued by SMEs.

Fiscal and other incentives for investment. Measures recently enacted include a temporary tax credit for companies increasing their level of investment and a subsidy targeting loans to small and medium-sized enterprises for the purchase of machinery, equipment, capital goods and for investment in IT. A tax credit for incremental investments in R&D in the 2015-19 period has been introduced. A favourable “patent box” taxation on income deriving from direct/indirect use of intellectual property, patents and trademarks has been also introduced (see also Criscuolo and Appelt, 2015). Project bonds for infrastructure investment have been made cheaper and simpler to issue. Regulations governing the involvement of institutional investors in real estate have been relaxed.

Encouraging the supply of equity finance. The allowance for corporate equity has been increased and can also now be set off against regional corporate taxes (IRAP). Measures to simplify public listings by SMEs and by family companies include the possibility of multiple-voting shares, reduced minimum capital requirements, variable thresholds for compulsory takeover and an increased threshold for compulsory communication of holdings or admissible cross-shareholdings. The allowance for corporate equity is to be increased by 40% for newly-listed companies (Super ACE).

Early results are encouraging. Within the first few months additional lending SMEs from the “Sabatini law” fund was EUR 2 billion, and 26 new companies raised EUR 1 bn in bond issues.

Source: OECD

Summary forecast table

	2008	2009	2010	2011	2012	2013	2014	2015E	2016E
National accounts									
Real GDP growth (%)	-1.1	-5.5	1.7	0.7	-2.3	-1.9	-0.4	0.7	1.6
Real private consumption growth (%)	-1.1	-1.5	1.2	0.0	-4.1	-2.7	0.3	0.8	1.0
Real fixed investment growth (%)	-3.2	-10.0	-0.6	-1.7	-7.5	-5.4	-3.2	0.5	2.9
Fixed investment (% of GDP)	21.2	20.0	19.9	19.7	18.6	17.8	17.3	17.3	17.5
Nominal GDP €bn	1632	1573	1604	1639	1628	1619	1617	1635	1674
Nominal GDP %	1.4	-3.7	2.0	2.2	-0.7	-0.6	-0.1	1.2	2.4
GDP per capita (€)	27830	26653	27099	27617	27407	27121	26595	26814	27366
Industrial production growth (%)	-3.8	-18.6	6.9	1.3	-6.3	-3.0	-0.7	0.6	1.8
Household savings rate (%)	13.7	13.4	10.9	10.6	10.4	11.7	12.2	13.1	13.1
Labour market									
Unemployment rate (%)	6.8	7.8	8.4	8.4	10.7	12.2	12.8	12.6	12.2
Employment growth (%)	0.2	-1.9	0.1	-0.1	-0.8	-1.7	0.0	0.4	0.7
Participation rate (%)	49.0	48.4	48.2	48.1	48.9	48.5	48.3	48.3	48.3
Population (mln)	58.7	59.0	59.2	59.4	59.4	59.7	60.8	61.0	61.2
Prices and exchange rate									
CPI inflation (% change in annual average)	3.5	0.8	1.6	2.9	3.3	1.3	0.2	0.5	0.8
CPI inflation (% change in December to December)	2.4	1.1	2.1	3.7	2.6	0.7	-0.1	0.8	0.9
Core CPI inflation (% change in annual average)	2.2	1.6	1.7	2.0	2.0	1.2	0.7	0.6	0.8
Core CPI inflation (% change in December to December)	2.3	1.5	1.7	2.6	1.6	0.9	0.7	0.5	1.0
REER (% change in December to December)	1.3	0.7	-5.7	0.8	-0.8	2.8	-1.9		
Fiscal data									
General government balance (% of GDP)	-2.7	-5.3	-4.2	-3.5	-3.0	-2.8	-3.0	-2.7	-2.3
General government balance (€bn +ve deficit)	-44	-83	-68	-57	-49	-46	-48	-45	-39
Government bond redemptions (€bn)	158	172	175	161	199	155	193	201	175
General government primary balance (% of GDP)	2.2	-0.9	0.0	1.2	2.2	2.0	1.7	1.5	2.0
General government expenditure (% of GDP)	47.8	51.1	49.9	49.1	50.4	50.5	50.7	50.3	50.0
General government revenue (% of GDP)	45.1	45.9	45.6	45.6	47.4	47.7	47.7	47.6	47.7
General gross government debt (% of GDP, end year)	102	112	115	116	122	128	132	133	132
Money supply and credit									
Broad money supply (M3, end period, €bn)	1293	1363	1281	1267	1315	1322	1352		
Broad money supply growth (M3, % change Dec to Dec)	6.9	5.5	-6.1	-1.1	3.8	0.5	2.3		
Domestic credit outstanding to non-fin private (% GDP)	83.7	85.7	90.6	92.8	91.3	87.7	88.5		
Domestic credit growth to households (%)	3.8	3.9	7.8	5.6	0.8	-1.2	-1.1		
Domestic credit growth to households (% of GDP)	29.1	31.3	36.5	37.7	37.5	37.1	37.0		
Domestic credit growth to non-financial business (%)	11.1	2.4	-0.1	4.6	-1.3	-4.4	-4.1		
Domestic credit growth non-financial business (% GDP)	54.6	54.3	54.1	55.1	53.8	50.6	51.5		
Balance of payments									
Exports (national accounts concept, % of GDP)	26.9	22.4	25.1	27.1	28.3	28.6	29.4	30.3	31.0
Imports (national accounts concept, % of GDP)	27.7	23.1	27.1	28.6	27.4	26.3	26.8	27.3	27.7
Real export growth (national accounts concept, %)	-3.2	-17.9	11.3	6.1	1.6	0.9	2.4	3.9	3.8
Current account (% of GDP)	-2.8	-1.9	-3.5	-3.1	-0.5	1.0	1.8	2.6	2.6

Source: Credit Suisse

Notes: National accounts data sourced from Eurostat. Population, labour market, government revenues/expenditures, saving rate and debt data and forecasts are based on European Commission projections. Participation rate data and forecasts and current account forecasts are from the OECD. REER sourced from European Commission using 41 partners and deflated by CPI. All other forecasts are Credit Suisse

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