Macroeconomic Outlook

Green shoots of recovery in a reform-oriented environment

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"The tree of life", the symbol of Italy at Expo Milan 2015

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Italy: pulled by tailwinds past dangerous seas

4 tailwinds
- Lower energy prices
- Weaker exchange rate
- Favourable financial conditions
- Neutral fiscal policy

Improving outlook
- Rising confidence
- Real incomes are rising
- Domestic and foreign demand both growing
- GDP forecasts up

GDP 2015 +0.6% 2016 +1.2%	CPI 2015 +0.2% 2016 +1.1%
Unempl. 2015 12.8% 2016 12.3%	Deficit: 2015 -2.8% 2016 -1.9%

First achievements
- Labour market reform currently being implemented
- Steps to cut the labour tax wedge
- Cuts to local governments spending
- Reform of civil justice under way, first results visible
- Pension spending has been stabilised

A large gap to overcome
- High tax rates and government inefficiencies
- Slow civil justice
- Ageing population, resistant to change

Crisis of traditional parties
- Dissolution of Forza Italia
- Radicalisation of right-wing opposition
- PD gains at the centre, but risks losing its left wing

Government
- Renzi smart in getting the most out of a weak coalition..
- …but internal opponents are more and more vocal

Institutional reforms
- Electoral reform passed May 4
- The constitutional reform would be good for political stability and quality of governance…
- …but it is still unclear whether it can pass with this Parliament

Italy – Factors affecting the risk profile

- PSPP flows>net issuance
- Rising duration of debt
- Low impact of ageing in next 20Y
- **Low expected GDP growth**
- **Debt ratio >130%**
- Cost of debt at issuance <1%
- Cyclically Adj. primary surplus consistent with debt stabilization
- **Recovery lagging the rest of EZ**
- **Debt ratio rising in 2015**

- **Electoral law not conducive to effective governments**
- (Partial) reform approved by Parliament
- Renzi's most popular leader
- **Tense situation inside Renzi's PD**
- **Radical opposition parties (M5S, Lega Nord) >30% in total**
- No interest in early elections by PD, Forza Italia and NCD

Financial stability

- Little household debt . Net worth 7.9x disposable income
- BOP: current account surplus
- Banks: good liquidity
- Banks: worse asset quality
- **Declining house prices**
- Conservative lending practices on house loans
- Investment position: -27.7% 2014
- Banks: adequate capital
- **Business sector weakened by the long crisis, financial conditions more heterogeneous**

Agenda

A “perfect storm” is driving Italy out of recession

- A mix of important factors, mainly **exogenous**, have the potential to drive the economy out of the woods.
- Once the impact of the shocks is being absorbed, **reforms** will help to have a self-sustained recovery.

The oil price shock

- Brent Crude forecast at -42% in 2015 vs 2014 (year averages)

The exchange rate shock

- The EUR effective exchange rate down -12% in April vs 2014 average

ECB’s QE

- The amount of total purchases is 1140Bn from March 2015 to Sep 2016
- Bank of Italy’s purchases of BTP around 130Bn

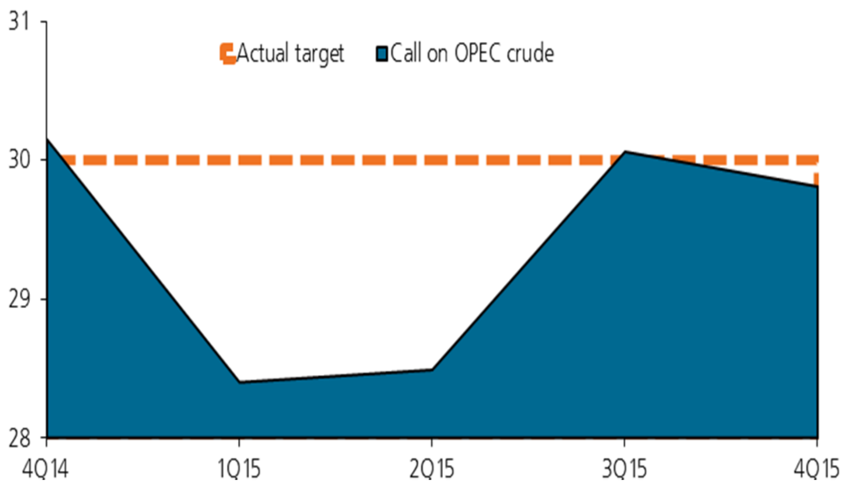
Fiscal policy is no tighter

- After budget austerity in 2011-13 (3.4% increase in cycl.adj. primary balance), fiscal policy is supporting the cycle in 2014-15 (0.7% decrease in cycl.adj. primary balance)

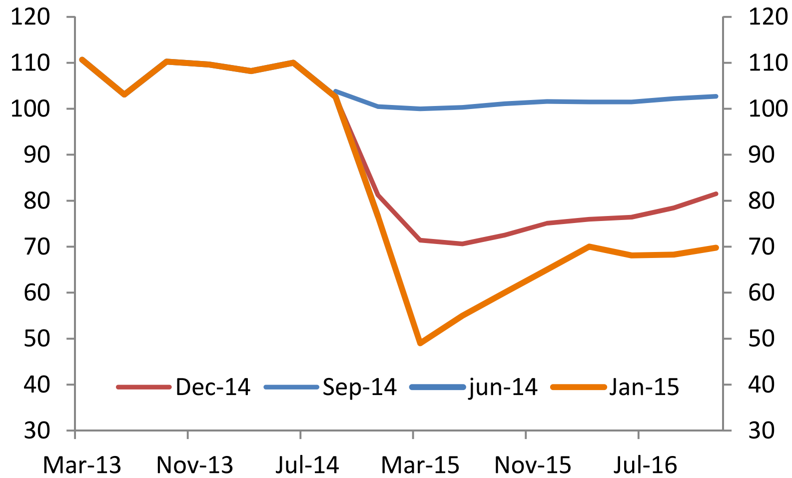
Tailwind #1: the oil shock

- November OPEC meeting a turnaround: price is now determined by the market.
- Target unchanged at 30 mb/d: OPEC's response to the sharp rise in non-OPEC production. Supply and demand balance decided by producers.
- We see the price at 68$ at end-2015 and 71$ at end-2016. Excess supply is being re-absorbed. We expect better fundamentals in 2015H2.

Call on OPEC crude & target OPEC



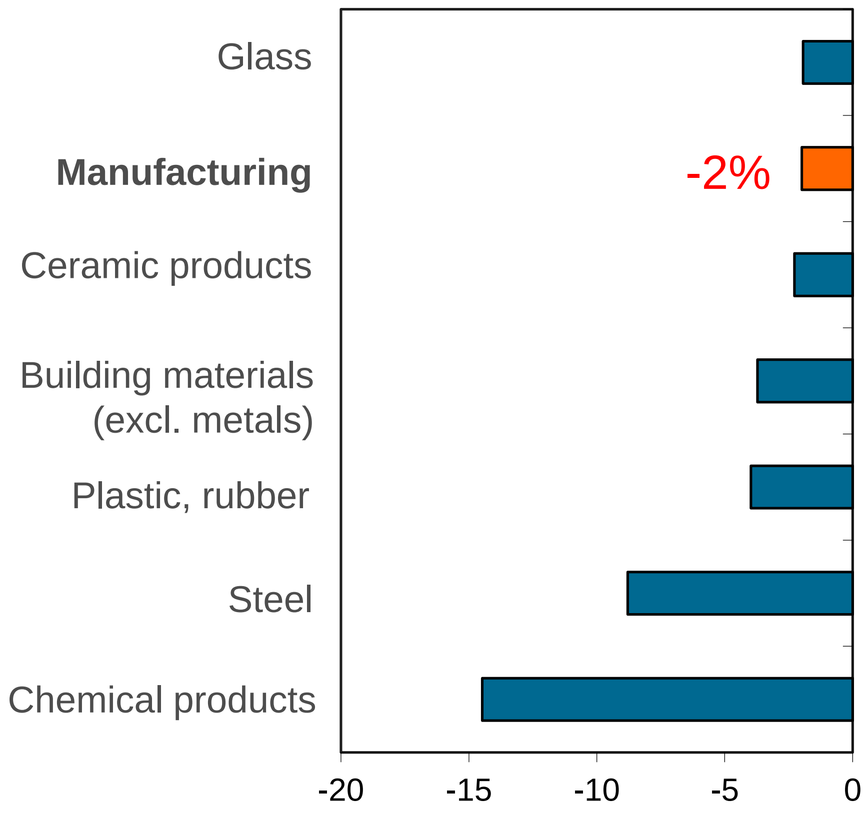
Brent Crude projected at 70$ by end 2016



Source: Datastream & ISP estimates OPEC

Cheap oil: impact on total costs, by industry

Estimated % change in total costs, 2015



Source: Intesa Sanpaolo-Prometeia, February 2015

- Cheap oil will reduce costs in manufacturing by 2% on average, with the highest impact in energy-intensive or oil-intensive industries.
- On the other hand, other industries will suffer because of the decline of exports to oil-exporting countries.
- Exports towards OPEC and Russia are more relevant for engineering (13%), oil products (20%), jewelry (14%), electric equipment (8%), furniture (8%), apparel (7%), metal products (6.4%), leather products (4.6%).

Tailwind #2: the exchange rate shock

FX: ISP forecasts vs mkt forward rates

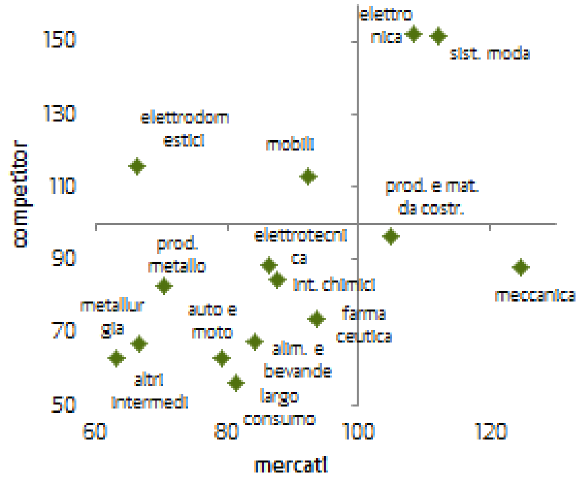
	14-05-2015	1m	3m	6m	12m	24m
EUR/USD	1.1428	1.05	1.00	0.98	1.05	1.20
USD/JPY	119.21	120	122	126	130	125
GBP/USD	1.5789	1.44	1.50	1.53	1.57	1.60
EUR/CHF	1.0394	1.07	1.08	1.09	1.10	1.15
EUR/SEK	9.3789	9.30	9.40	9.25	9.10	8.80
EUR/NOK	8.4118	8.70	8.85	8.75	8.50	8.20
EUR/DKK	7.4638	7.45	7.45	7.45	7.46	7.46
USD/CAD	1.1948	1.25	1.30	1.32	1.25	1.20
AUD/USD	0.8091	0.76	0.73	0.70	0.78	0.80
NZD/USD	0.7495	0.72	0.68	0.65	0.72	0.75
EUR/JPY	136.23	126	122	124	137	150
EUR/GBP	0.7236	0.73	0.67	0.65	0.67	0.75
EUR/CAD	1.3657	1.31	1.30	1.30	1.31	1.44
EUR/AUD	1.4115	1.38	1.37	1.41	1.35	1.50
EUR/NZD	1.5240	1.46	1.47	1.51	1.46	1.60
USD/CHF	0.9094	1.02	1.08	1.11	1.05	0.96
USD/SEK	8.2063	8.86	9.40	9.40	8.67	7.33
USD/NOK	7.3590	8.29	8.85	8.89	8.10	6.83
USD/DKK	6.5289	7.10	7.45	7.57	7.10	6.22
USD/AUD	1.24	1.32	1.37	1.43	1.28	1.25
USD/GBP	0.63	0.69	0.67	0.66	0.64	0.62

	14-05-2015	1m	3m	6m	12m	24m
EUR/USD	1.1428	1.1432	1.1441	1.1458	1.1507	1.1667
USD/JPY	119.21	119.17	119.07	118.88	118.27	116.27
GBP/USD	1.5789	1.5785	1.5779	1.5769	1.5759	1.5765
EUR/CHF	1.0394	1.0386	1.0368	1.0341	1.0291	1.0211
EUR/SEK	9.3789	9.3770	9.3721	9.3643	9.3526	9.3443
EUR/NOK	8.4118	8.4232	8.4435	8.4716	8.5200	8.6227
EUR/DKK	7.4638	7.4600	7.4536	7.4493	7.4406	7.4242
USD/CAD	1.1948	1.1953	1.1964	1.1978	1.1998	1.1978
AUD/USD	0.8091	0.8077	0.8051	0.8012	0.7944	0.7843
NZD/USD	0.7495	0.7473	0.7430	0.7371	0.7264	0.7075
EUR/JPY	136.23	136.24	136.23	136.22	136.09	135.64
EUR/GBP	0.7236	0.7240	0.7249	0.7263	0.7299	0.7397
EUR/CAD	1.3657	1.3668	1.3690	1.3728	1.3808	1.3974
EUR/AUD	1.4115	1.4144	1.4202	1.4291	1.4475	1.4868
EUR/NZD	1.5240	1.5291	1.5390	1.5536	1.5826	1.6387
USD/CHF	0.9094	0.91	0.91	0.90	0.89	0.88
USD/SEK	8.2063	8.20	8.19	8.17	8.13	8.01
USD/NOK	7.3590	7.37	7.38	7.39	7.40	7.39
USD/DKK	6.5289	6.53	6.51	6.50	6.47	6.36
USD/AUD	1.24	1.24	1.24	1.25	1.26	1.28
USD/GBP	0.63	0.63	0.63	0.63	0.63	0.63

Source: Intesa Sanpaolo Research estimates

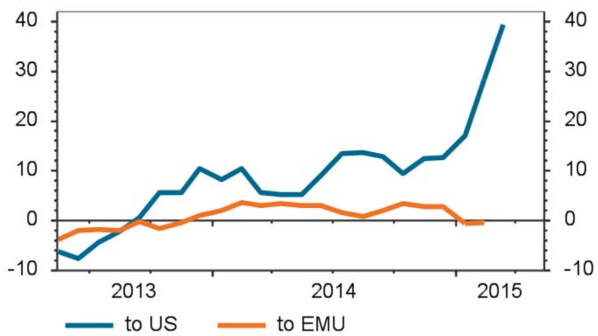
Impact of the weak euro on manufacturing industry

Sensitivity to exchange rates by market and competitors (index, total manufacturing sector =100)



Source: Prometeia - Intesa Sanpaolo, February 2015.

Italian exports to the US and to the EMU (3-m mov. avg., y/y)



- Impact of the weaker euro first on profit margins. Pricing policies then determine eventual effects on volumes.
- Strong acceleration of exports to the US is already visible in trade data.
- Around 30% of exports goes to countries with currencies that have risen vs euro.
- Some of these countries compete with Italian manufactures in other markets.
- All considered, the main beneficiaries of the weak euro will be engineering, fashion goods, furniture, electric equipment, electronics.

Tailwind #3: ECB's EAPP was the main game-changer

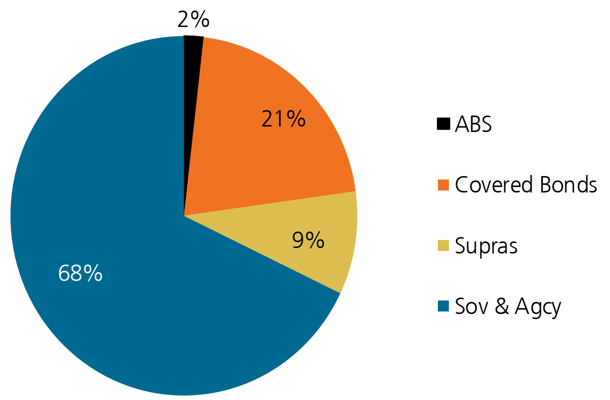
- Program expected to last until Sep 2016
- 3 sub-programmes: CBPP3, ABSPP and PSPP. PSPP large with respect to supply
- ECB not expected to be a seller of bonds
- Executions by NCBs and ECB.
- Risk mostly in NCBs balance sheets

Estimated EAPP total amount by sector

	Total target Mar15-Sep16		Purchased amount as of 08/05/2015	Residual purchase
Monthly purchase	60	Monthly Bn		
Mar15-Sep16	19	N.Months		
EAPP from Mar15 (1)	1140	EUR Bn	137.83	1002
of which:				
- ABS	21	EUR Bn	2.35	18
- Covered Bonds	240	EUR Bn	26.77	213
- Supras	106	EUR Bn	11.43	94
- Sovereigns & Agcy	774	EUR Bn	97.28	677
Previous CBP3 & ABSP (2)	55		55	
Total EAPP (1)+(2)	1195		193	1002
Sov & Agcy	41	Monthly Bn		
Supras	6	Monthly Bn		
CB & ABS	14	Monthly Bn		

Source: Bloomberg, Intesa Sanpaolo

Estimated EAPP total amount by sector



Source: Bloomberg, Intesa Sanpaolo

Large purchases as a % of issuance

Sovereign EAPP: purchase versus 2015 gross and net issuance (EUR Bn)										
	2015					2016				
	Gross issuance	Net issuance	ECB purchases	Gross issuance minus ECB purchase	Net issuance minus ECB purchase	Gross issuance	Net issuance	ECB purchases	Gross issuance minus ECB purchase	Net issuance minus ECB purchase
DE	158	3	88	70	-85	155	2	79	75	-77
BE	36	10	12	24	-2	36	10	10	25	-0
IE	17	14	6	11	9	14	6	5	9	1
GR (*)	0	-7	0	0	-7	-	-	0	-	-
ES	146	60	43	103	17	119	39	39	81	1
FR	208	94	69	140	25	230	78	62	168	16
IT	262	58	60	201	-2	223	42	54	169	-12
NL	47	6	20	26	-14	38	8	18	20	-10
AT	15	2	10	5	-8	18	7	9	10	-2
PT	19	13	9	10	4	13	5	8	5	-3
FI	10	3	7	4	-4	13	7	6	7	1
SI	4	2	2	2	-0	4	1	2	2	-0
SK	5	2	4	2	-2	5	2	3	2	-1
CY (*)	2	1	0	2	1	2	1	0	2	1
MT	1	1	0	1	0	1	1	0	1	0
LU	0	0	1	-1	-1	0	0	1	-1	-1
EE	0	0	-	-	-	0	0	-	-	-
LV	1	0	2	-1	-1	1	0	1	-1	-1
LT	1	0	2	-2	-2	1	0	2	-1	-2
TOTAL	931	260	333	598	-73	872	209	300	573	-91

(*) Country currently excluded from the SPP.

Source: Bloomberg, ECB, Intesa Sanpaolo

Distribution by country and by year

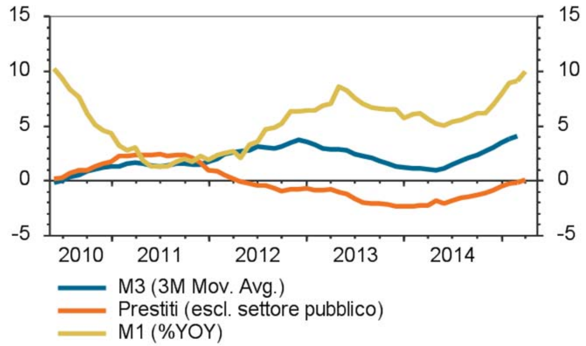
EAPP distribution by country and by year (EUR Bn)	Sov.Bonds ex -Tbill	2-30Y Bonds ex T-bill	Capital keys	Total PSPP Mar15-Sep16	PSPP Mar-Dec 15	PSPP Jan-Sep 16	Purchased amount as of 30/04/15	Residual purchase	Avg Maturity of purchased bonds	Monthly purchases
DE	1,113	830	26.4%	204	108	97	22.21	182	7.9	10.8
BE	311	263	3.6%	28	15	13	3.06	25	9.1	1.5
IE	123	115	1.7%	13	7	6	1.46	12	9.1	0.7
GR (*)	60	55	2.9%	-	0	0	na	na	na	0.0
ES	715	556	13.0%	100	53	48	10.91	89	9.7	5.3
FR	1,379	1,124	20.8%	161	85	76	17.38	144	7.8	8.5
IT	1,563	1,279	18.0%	140	74	66	15.19	125	8.4	7.4
NL	332	272	5.9%	45	24	22	5.01	40	7.0	2.4
AT	190	166	2.9%	22	12	11	2.42	20	8.0	1.2
PT	100	87	2.6%	20	10	9	2.16	18	10.8	1.0
FI	83	71	1.8%	14	8	7	1.56	13	7.2	0.8
SI	14	12	0.5%	4	2	2	0.43	3	7.9	0.2
SK	30	25	1.1%	9	5	4	1.03	8	9.3	0.5
CY (*)	3	2	0.2%	-	0	0	na	na	na	0.0
MT	5	4	0.1%	1	0	0	0.06	1	8.5	0.0
LU	6	6	0.3%	2	1	1	0.39	2	6.9	0.1
EE	0	-	0.3%	2	1	1	0.00	2	0.0	0.1
LV	1	1	0.4%	3	2	2	0.25	3	5.9	0.2
LT	2	1	0.6%	5	2	2	0.12	5	5.2	0.2
Total	6,030	4,867	103%	774	407	367	84	691	8.3	41

(*) Country currently excluded from the SPP.

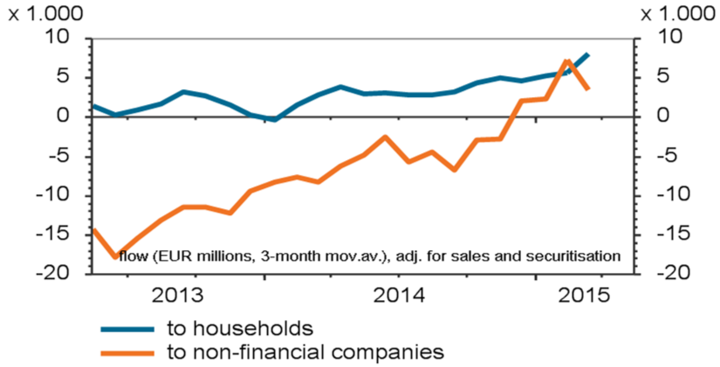
Source: Bloomberg, ECB, Intesa Sanpaolo

The EAPP will improve monetary policy transmission

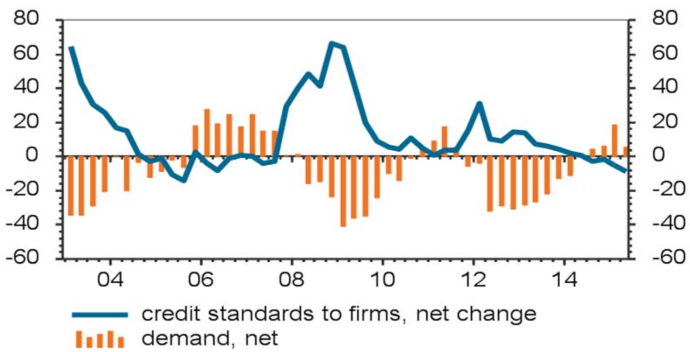
Money and credit, y/y % change



Flow of lending to NFCs is positive again

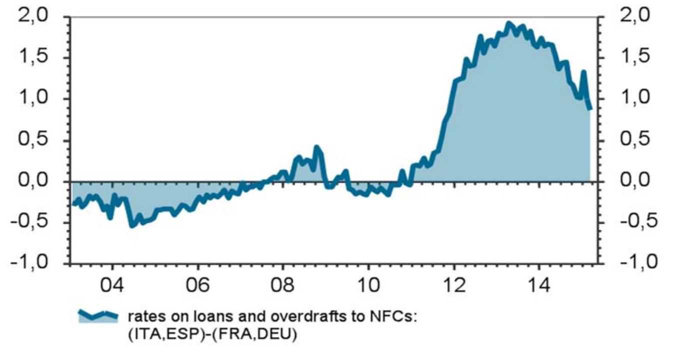


Credit standards are now being eased



Source: ECB and ISP calculations

Spread between Core and Periphery on corporate lending is narrowing



Source: ECB and ISP estimates

Tailwind #4 – A more flexible fiscal policy

- **A "modulation" of Pact rules** (on the size of the structural balance correction required by the "preventive arm" of the Pact) **over the economic cycle**;
- **The "investment clause",** which allows a temporary deviation (and of modest entity) from the budget targets for works and programmes co-financed by the EU or by the EFSI;
- **The "reform clause"**: the Commission will make an ex ante assessment of the impact of structural reforms Concession of the margins described in the previous two points is tied to this assessment.

		Required annual fiscal adjustment*	
	Condition	Debt below 60 % and no sustainability risk	Debt above 60 % or sustainability risk
Exceptionally bad times	Real growth <0 or output gap <-4	No adjustment needed	
Very bad times	$-4 \leq$ output gap <-3	0	0.25
Bad times	$-3 \leq$ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	$-1.5 \leq$ output gap < 1.5	0.5	> 0.5
Good times	output gap ≥ 1.5 %	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

* all figures are in percentage points of GDP

Source: European Commission, Making the best use of the flexibility within the existing rules of the stability and growth pact, *COM(2015) 12, January 2015.*

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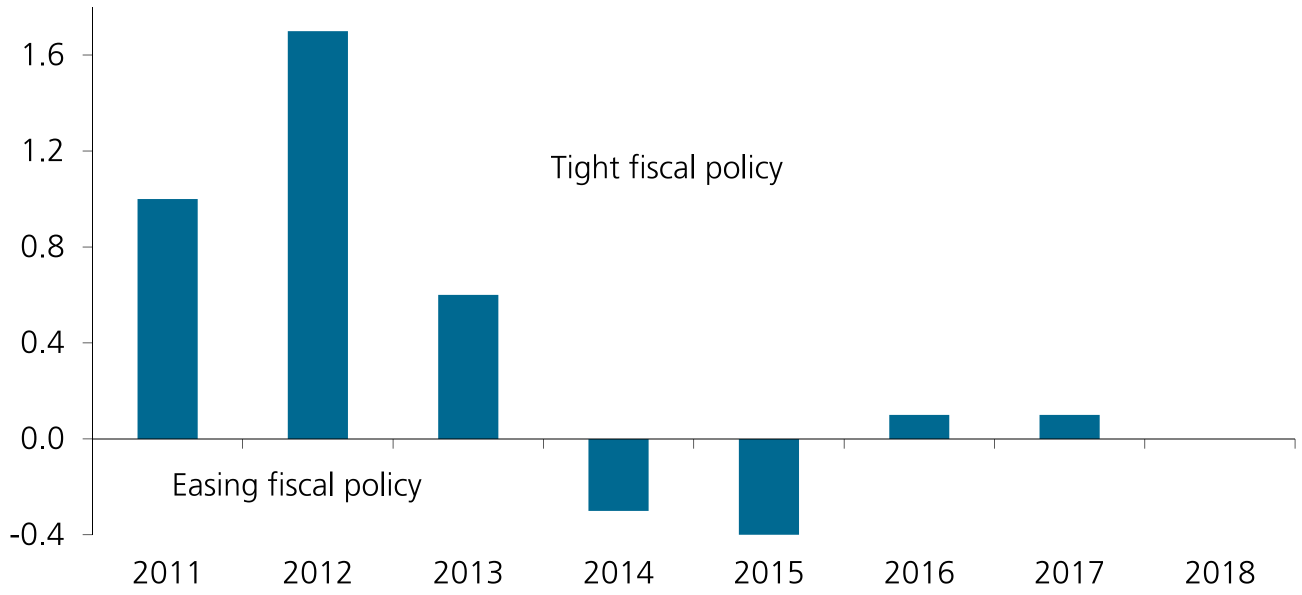
Fiscal policy stance

- Taking into account the 2015 Budget, which implies a 0.2% net easing, 2014-15 are the first years of easing fiscal policy after years of tightening.
- The need of correction in 2016-17 will be tempered by savings on interest spending.

Change in c.a. primary balance, as a % of GDP



Source: Italian Government

Growth coming mainly from exogenous factors…

- The combination of the favourable shocks (energy, exchange rate, monetary and fiscal policy) could generate a potential impact on Italian GDP, if compared to the June 2014 scenario, worth almost 1.5%.
- Yet, we are cautious especially on the impact of the exchange rate shock, so we think the real impact in 2015 will be less significant than that implied by models.
- We estimate upside risks on our current growth forecasts of around 0.2% per year in 2015-16.

Estimated impact on 2015 GDP of energy, exchange rate, and economic policies (%), Intesa Sanpaolo forecasts

	Min	Max
Energy	0.2	0.3
Exchange rate	0.4	0.6
Monetary policy	0.1	0.2
Fiscal policy	0.1	0.2
Total	0.8	1.3

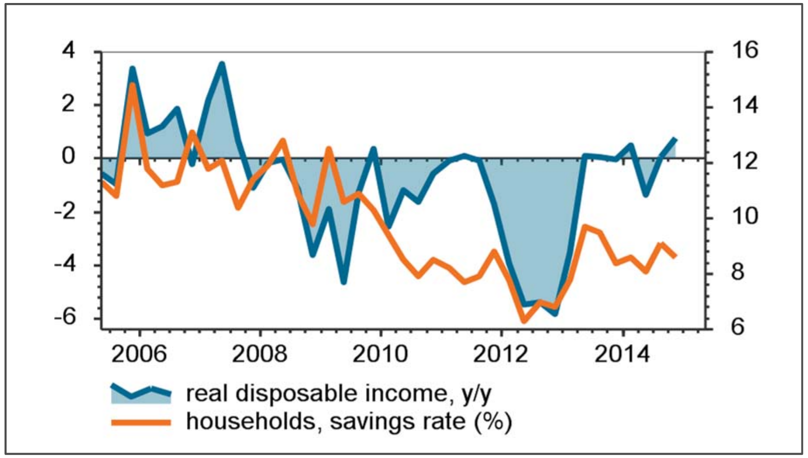
Source: Intesa Sanpaolo elaborations

…but something is moving also in fundamentals driving both consumption…

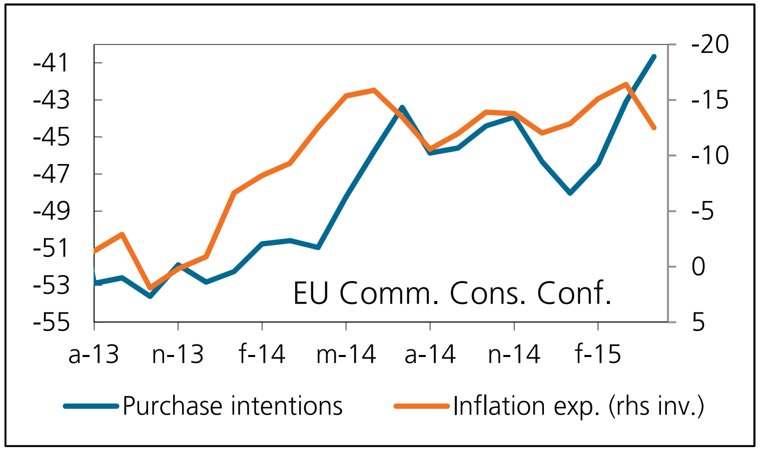
1. **Nominal disposable income** rebounded in 2014 (+0.8% yoy in 4Q), mainly due to the cut in the personal income tax;
2. **Purchasing power** is set to improve further, thanks to declining inflation (which remains a positive factor for households' confidence and spending intentions).

- The rebound in disposable income for the moment has been **saved** rather than spent, due to uncertainty both on the permanent or temporary nature of the tax cut, and on the economic outlook.
- As **uncertainty** is being reduced, propensity to consume will increase.

Income rebounding, but mostly saved



Lower inflation expectations, more spending



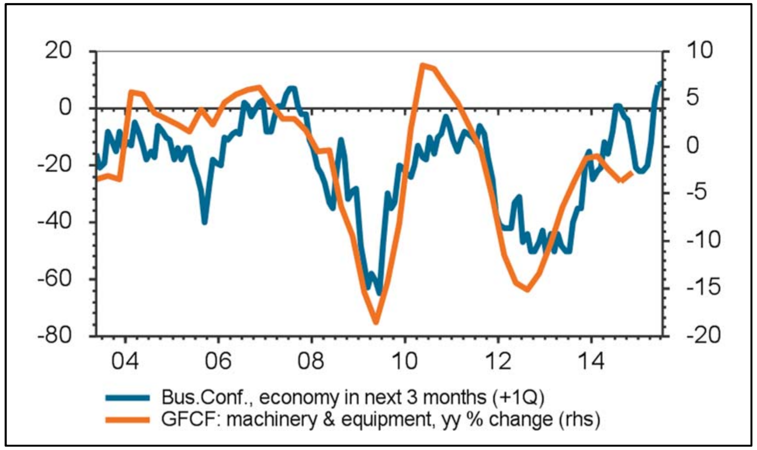
Source: Intesa Sanpaolo calculations on Istat, EU Commission data

…and investments

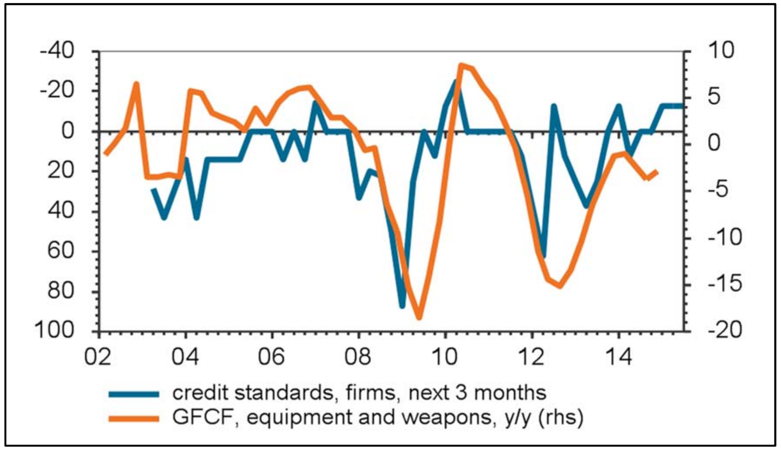
Investments have been dragged by **low profitability** and **uncertainty** over the future. Yet,

1. **Expectations on the economy** are rebounding
2. **Financial conditions** are improving: according to the last BLS, the net percentage of banks easing credit standards for businesses was the highest ever recorded in the survey's 12-year history. The ECB's QE programme (combined with the TLTROs) will strengthen this trend.

Capital spending will be supported by an improving economic outlook…



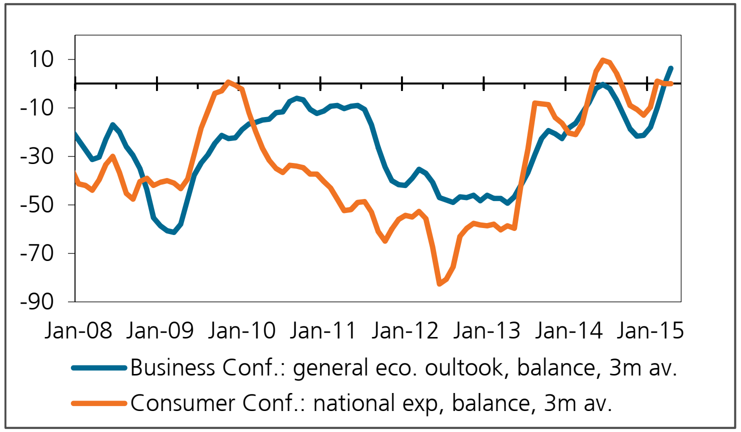
..and by an easing of credit standards



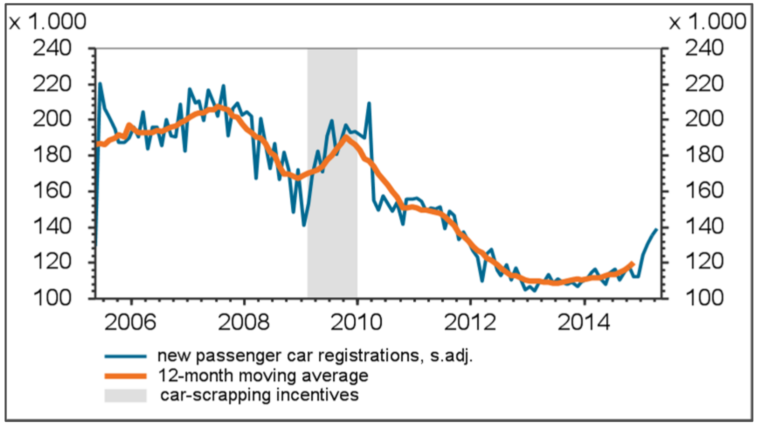
Source: Intesa Sanpaolo calculations on Istat and ECB data

Hard data starting to reflect the improvement

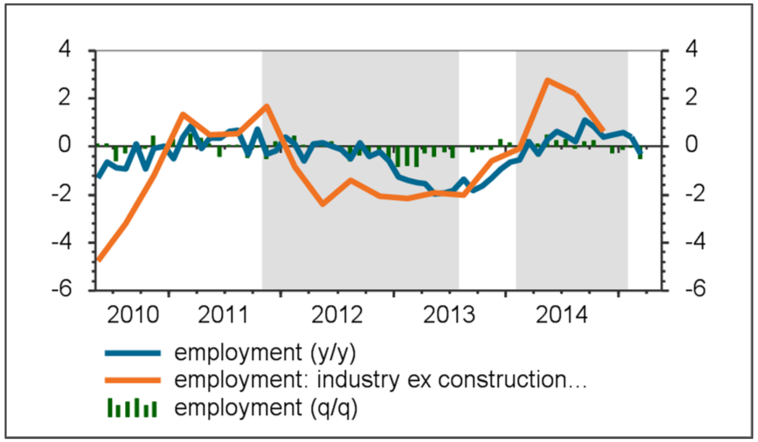
Not just confidence improves…



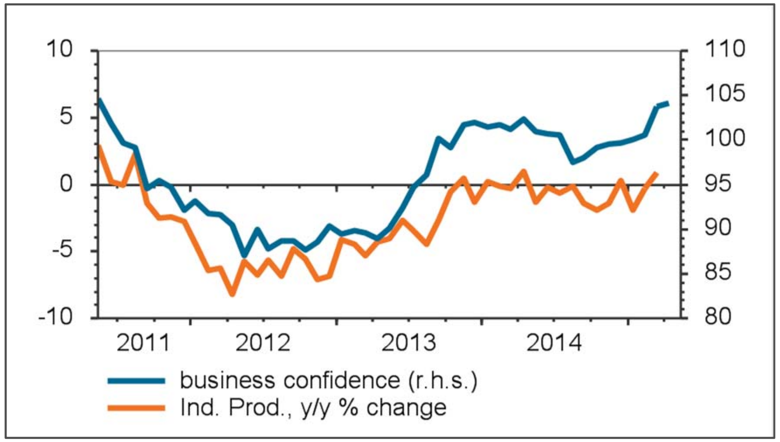
…but also household spending



Employment rebounding in 2014 and now stabilizing



Business output posed to accelerate

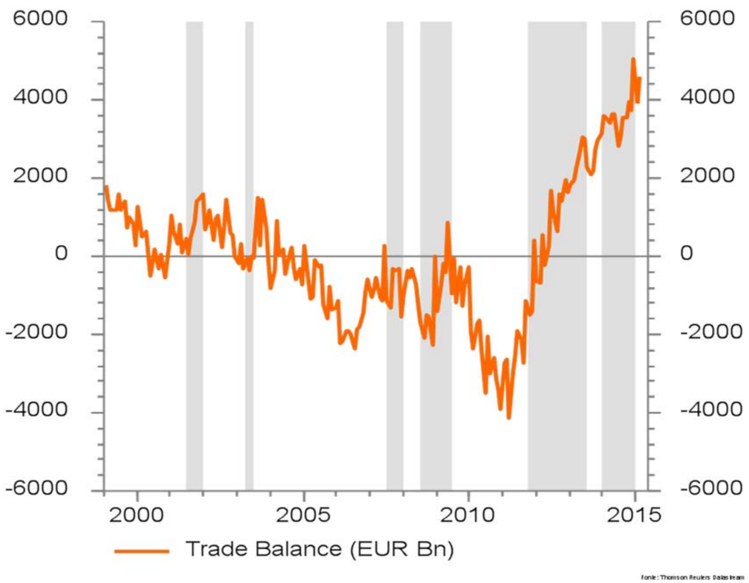


Source: Intesa Sanpaolo calculations on Istat data

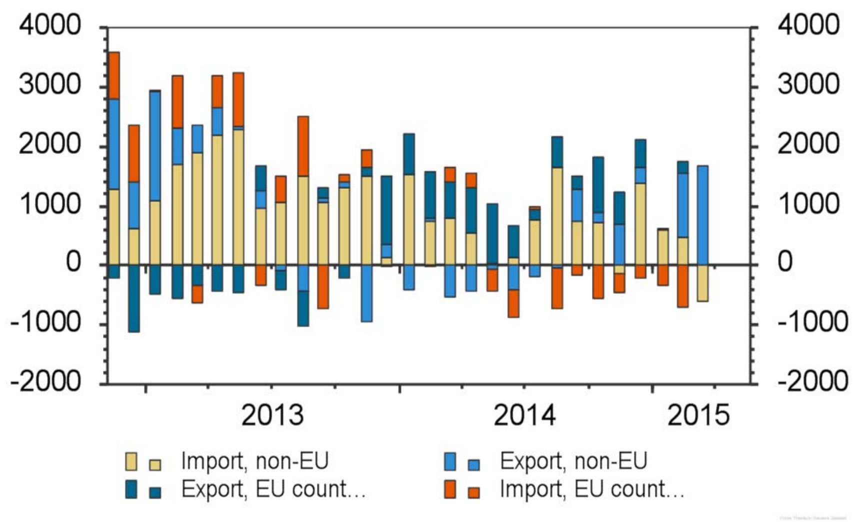
Marked improvement in the trade balance

- The marked improvement of Italy's trade balance was mostly the result of smaller imports due to weak domestic demand.
- However, exports were resilient during the recession and are now rebounding strongly towards non-Euro countries.

An impressive turnaround for the trade balance...



…due to both smaller imports and higher export to non-EU countries

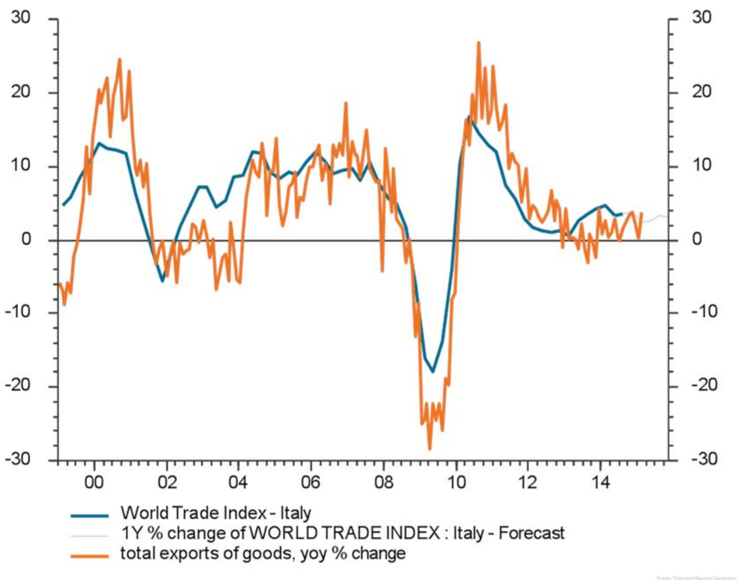


Source: Istat and Intesa Sanpaolo forecasts.
Note: left hand side graph: levels of trade balance; right graph: annual absolute changes in trade balance

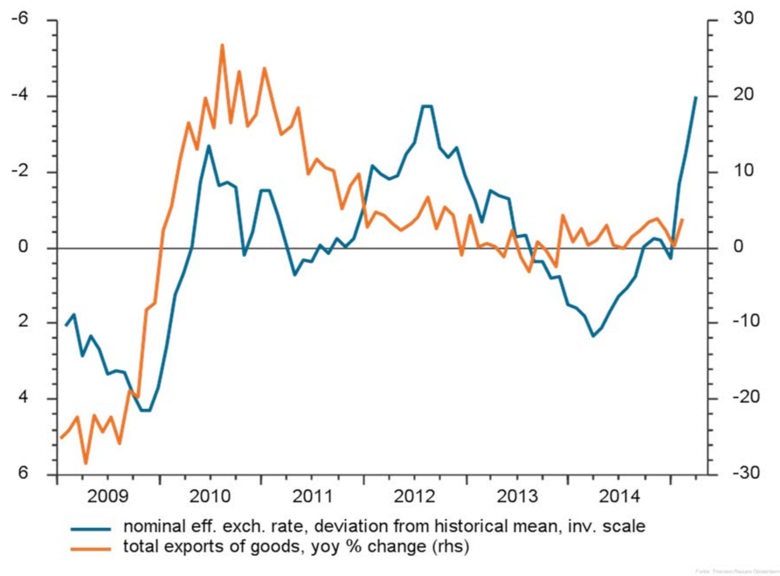
Exports, foreign demand and the exchange rate

- Foreign demand maintains a moderate rate of growth.
- The full effect of the weak exchange rate has yet to be seen on exports.
- Despite worries about competitiveness, export moves in line with potential demand.

Exports will benefit from growing global demand…



…and a weak exchange rate



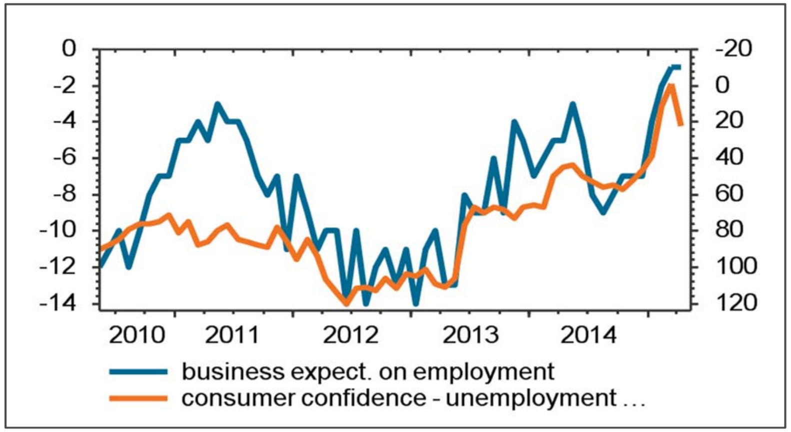
Source: Istat, Markit, BIS and Intesa Sanpaolo calculations.

INTESA SANPAOLO

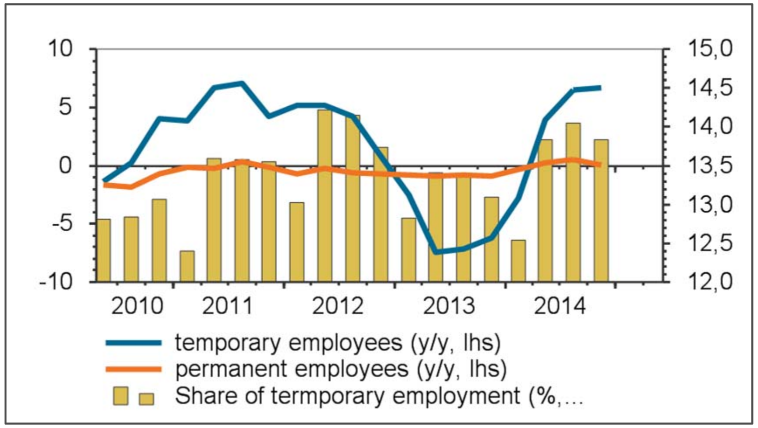
The worst should be over for the labour market

- Employment bottomed out starting from end-2013. The resilience was also due to Govt Decree increasing **entry flexibility** in the labour market: most of new hiring was on fixed-term contracts. The unemployment rate reached new records due to an expanding labour force (=increasing activity rate), but fell in the very last months.
- Employment **expectations** from consumers and business surveys rebounded strongly.
- Government **incentives** are helping to transform temporary employment into permanent one.
- The labour market reform will tackle the main problem of the Italian labour market: **duality** between overly protected older workers and highly flexible younger ones.

Improving employment expectations



Strong rebound in temporary employment



Source: Intesa Sanpaolo calculations on Istat data

Italy - baseline macroeconomic scenario 2015-16

- 2015 should mark a turning point for growth. We expect growth to accelerate significantly above potential in 2016.
- Risks on the growth outlook are on the upside.

	2014	2015	2016	2014 3	2014 4	2015 1	2015 2	2015 3	2015 4	2016 1	2016 2
GDP (constant prices)	**-0.4**	0.6	1.2	**-0.5**	**-0.5**	**0.0**	0.5	0.9	1.2	1.2	1.2
- q/q change				**-0.1**	**0.0**	**0.3**	0.3	0.3	0.3	0.3	0.3
Personal consumer spending	**0.3**	0.8	1.1	**0.2**	**0.1**	0.2	0.2	0.3	0.3	0.2	0.2
Government consumption	**-0.9**	0.0	-0.2	**0.2**	**0.4**	-0.2	-0.1	0.0	0.0	-0.1	-0.1
Fixed Investments	**-3.2**	0.3	2.1	**-1.0**	**0.2**	0.2	0.3	0.5	0.5	0.6	0.5
Imports	**1.6**	3.1	3.9	**0.7**	**0.3**	1.0	0.7	0.9	1.0	1.0	0.9
Exports	**2.4**	3.8	4.2	**0.4**	**1.6**	0.6	0.9	1.0	1.1	1.1	1.0
Net exports	**0.3**	0.3	0.2	**-0.1**	**0.4**	-0.1	0.1	0.1	0.1	0.1	0.1
Final Domestic Demand	**-0.6**	0.5	1.0	**0.0**	**0.2**	0.1	0.2	0.3	0.3	0.2	0.2
CPI (y/y)	**0.2**	0.2	1.1	**-0.1**	**0.1**	**-0.2**	0.1	0.2	0.6	1.1	1.1
Unemployment (%)	**12.7**	12.8	12.3	**12.8**	**13.0**	**12.8**	12.9	12.8	12.6	12.5	12.4
Real Disposable Income (y/y)	**0.0**	1.0	1.2								
Saving rate (%)	**8.6**	8.4	8.6								
Current Account (% GDP)	**1.8**	2.4	2.1								

Percentage change on previous period, if not otherwise stated.
Source: Intesa Sanpaolo.

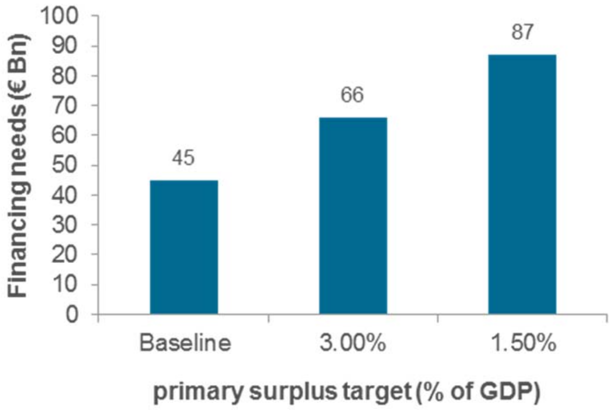
Risks

Greece: walking on the edge of a precipice in the m/t…

- The **agreement** to extend by 4 months (to end-June) the terms of the aid package was merely a way to buy time. Yet, the impasse on negotiations and the high level of uncertainty is derailing a recovery of Greek economy which was seemingly under way last year.

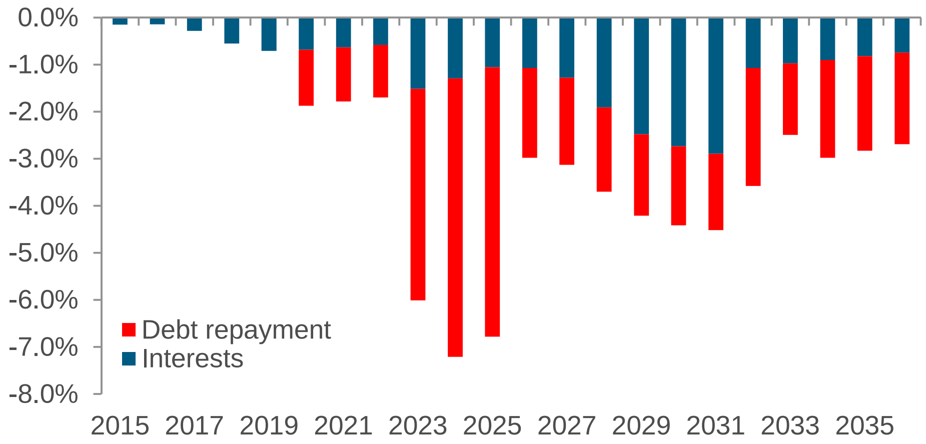
- Estimates made 3 months ago on Greece financing needs in coming years are becoming increasingly optimistic. The EU could make concessions on the **primary surplus** (but even a 1.5% target looks ambitious today), but only in exchange with **reforms** on pensions, the labour market, privatizations.

Greece: financing needs 2015-20 with different fiscal targets



Source: based on Zsolt Darvas, *The maths behind an amended Greek plan*, www.bruegel.org, 11 February 2015.

Cost of debt towards EFSF



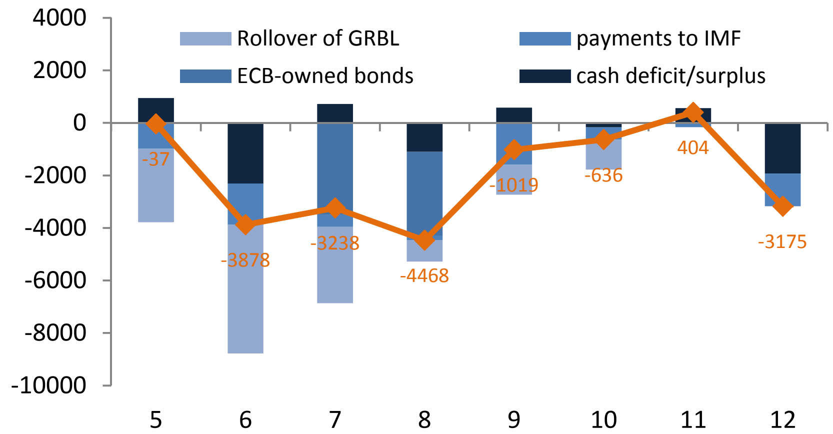
Note: 2/3 of debt expiring in 2023-25 should be extended from 11 to 38 years. Source: Intesa Sanpaolo calculations

Risks

…but also in the s/t

- Greece faces **pressing financial needs** in 2015, 16Bn from May to December as a minimum assuming full rollover of T-bills.
- Some **coverage** is being provided by a squeeze on capital spending, a centralization of the liquidity of public entities and a delay in payment of suppliers.
- Main deadlines in June:
  - 6/5: 311M (IMF)
  - 6/12: 350M (IMF)
  - 6/16: 584M (IMF)
  - 6/18: Eurogroup
  - 6/19: 350M (IMF)+ 85M (interests on bonds)
  - 6/25-26: Euro Summit
  - 6/30: deadline of the extension of European bailout programme

Greece: estimated gross financing needs in 2015



Extra Funding Sources - estimates	Min	Max
Rebate from HFSF	550	550
Additional release of FSF	650	650
Constraint on cash management of pension funds and other State entities	1000	3000
Total of unconditional measures	**2200**	**4200**
Conditional on review:		
Transfer of SMP-related profits in 2014	1800	1900
Last tranche of the Financial Assistance (EFSF)	1800	1800
IMF disbursements (Nov 2014 Tranche)	3500	3500
Higher cap on GRBL issuance	0	3000
Total of funding conditional on review	**7100**	**10200**
TOTAL	**9300**	**14400**
Additional IMF disbursements in 2015 (subject to review and possibly ESM programme)	7200	7200
Grand Total (without 3rd programme)	**16500**	**21600**

Note: in 2015 the IMF was expected to provide a total of 7.2Bn in 4 tranches, relative to the 8th-11th reviews, in 4 quarterly instalments (Feb-May-Aug-Nov). Besides, the IMF has not released the Nov 2014 tranche of 3.5Bn, which is the part that could be paid soon

Risks

Possible outcomes of the Greek "tragedy"

- **1) Agreement with European institutions**
  The Govt accepts most of the conditions to unblock the last tranche of the 2nd programme (7.2Bn) and starts negotiating a 3rd bailout programme. Eurogroup unlikely to give up on reforms. An escamotage for the Govt to preserve internal credibility would be promising a referendum.
- **2) Default inside the Monetary Union**
  The Govt decides to suspend payments to IMF and ECB, with a saving of 12Bn in 2015. Risks: 1) bank run and capital flights; 2) the ECB suspends ELA -> Need to close banks and introduce forms of capital controls.
- **3) Default and exit from the Monetary Union**
  Unchartered territory….

Our view

- Our baseline remains that some sort of agreement will be reached, eventually subject to a referendum (scenario #1).
- Yet, a **mix of scenarios # 1 and 2** could be possibile: the EU is not prone to concessions until Greece is facing the precipice. A default on at least one payment, and the financial crisis included in scenario #2, could force the Govt to accept an agreement.
- The 3rd scenario looks more harmful to Greece itself than to the EMU

Risks

Greece – What could happen soon

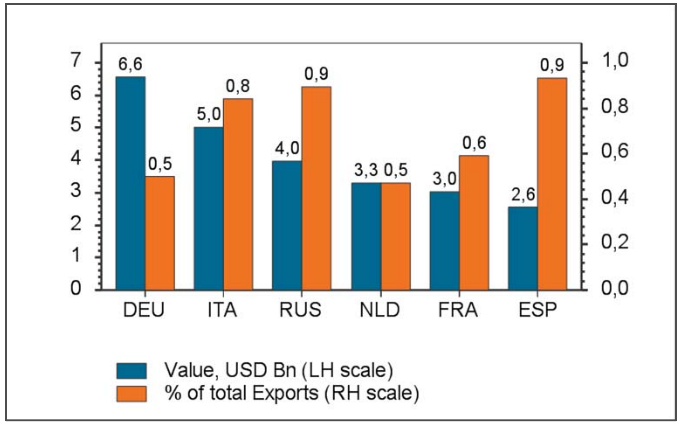
- In case of an agreement, assuming a primary surplus of 2.3% in 2016-20, we estimate gross financing needs of EUR82Bn (44.5Bn from marketable debt, 12Bn on loans and the remaining part coming from the budget deficit).
- In case of full T-bills rollover (15Bn) and a limited access to bond market (10Bn), the amount of the new programme could be around 55-60Bn. Each 0.5% of primary surplus increases this amount by 5Bn.

Risks

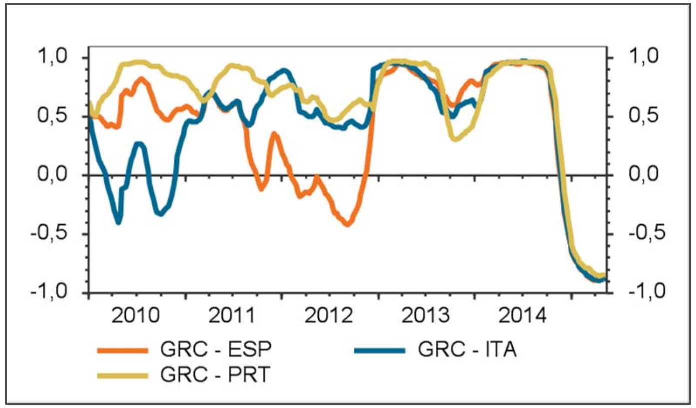
How much does Greece matter?

- **Direct economic links** with Greece are small for all EU countries (<1% of total exports, ca. 0.3% of GDP for Italy).
- Little **financial** exposure in the private sector after the 2012 restructuring.
- Damage through **official** exposure significant but not worrying.
- Due to the ECB's APP, Greek yields have been **negatively correlated** with yields of BTP, PGB and SGB for most of the crisis (not now, however).
- Risk is that Grexit may be considered by some investors as **the first in a series**; however, there is little reason for Grexit to raise the likelihood of similar events in Italy, Portugal or Spain (it could be quite the opposite…)

Exports to Greece are <1% of total exports



Greek yields negatively correlated with ESP, ITA and PRT (200-days moving correlation)



Source: Datastream, Eurostat, ISP calculations

Agenda

1	Strong tailwinds pulling the economy out of recession
2	Fiscal discipline, but with less austerity
3	Structural reforms: something to show, at last
4	Politics: Renzi storms Fort Paralysis
5	Annex - Background material

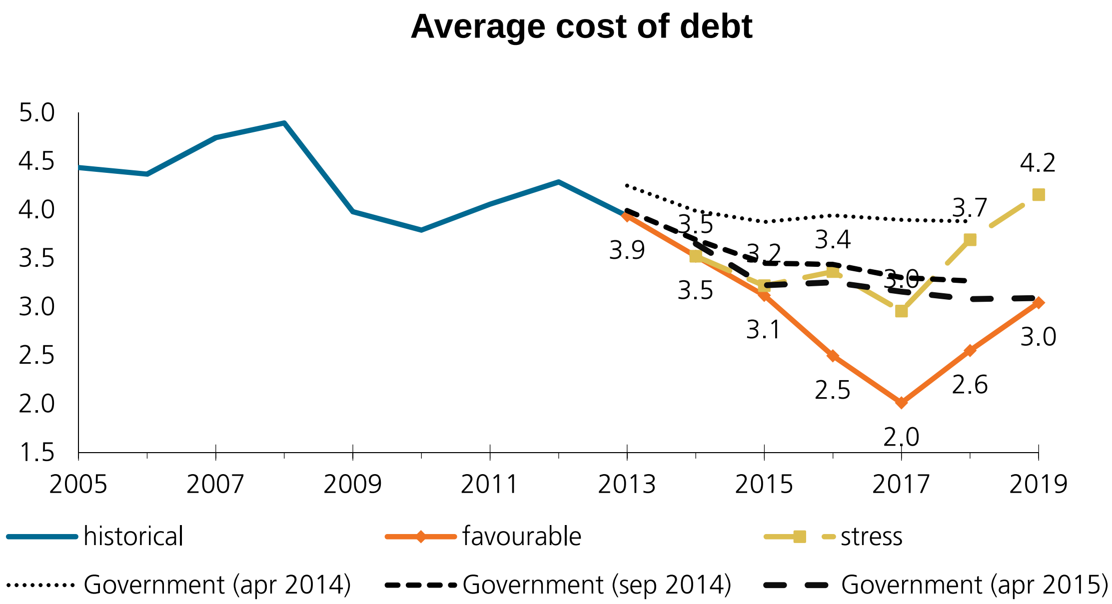
The budget and debt outlook: Italy's m/t fiscal plan

In the new DEF due out April 1st, the government revise GDP growth to 0.7% in 2015. Yet, deficit was confirmed at 2.6% in 2015.

	2012	2013	2014	2015f	2016f	2017f
Government targets (DEF, Apr 2015)						
Real GDP (y/y)	**-2.3**	**-1.9**	**-0.4** (-0.3)	0.7 (0.6)	1.4 (1.0)	1.5 (1.3)
Interest outlays, % of GDP	**5.2**	**4.8**	**4.7** (4.7)	4.2 (4.5)	4.2 (4.5)	4.0 (4.2)
Overall balance, % of GDP (1)	**-3.0**	**-2.8**	**-3.0** (-3.0)	-2.6 (-2.6)	-1.8 (-1.8)	-0.8 (-0.8)
Primary balance, % of GDP	**2.2**	**1.9**	**1.6** (1.7)	1.6 (1.9)	2.4 (2.7)	3.2 (3.4)
Structural balance (cyclically adjusted), % of GDP	**-1.4**	**-0.7**	**-0.7** (-0.9)	-0.5 (-0.6)	-0.4 (-0.4)	0.0 (0.0)
Government Debt, % of GDP	**122.2**	**127.9**	**132.1**	132.5	130.9	127.4
Intesa Sanpaolo Research (April 2015)						
Real GDP (y/y)	**-2.4**	**-1.8**	**-0.4**	0.6	1.2	1.4
Interest outlays, % of GDP	**5.2**	**4.8**	**4.6**	4.2	3.8	3.3
Overall balance, % of GDP	**-3.0**	**-2.9**	**-3.0**	-2.8	-1.9	-0.8
Primary balance, % of GDP	**2.2**	**1.9**	**1.6**	1.4	1.9	2.5
Structural balance (cyclically adjusted), % of GDP	**-1.3**	**-0.8**	**-0.9**	-0.8	-0.7	-0.3
Government Debt, % of GDP	**122.2**	**128.5**	**132.1**	133.7	132.3	129.1

Note: (1) the inertial projection for the deficit was -2.5%, -1.4% and -0.2% respectively for 2015, 2016 and 2017. The difference is related to a lower planned primary surplus than in the inertial projection.
Source: DEF, April 2015, (DEF Update of September 2014 in brackets), Istat and Intesa Sanpaolo Research forecasts.

Sizeable benefits from ECB action



The 'favourable' projection is based on ISP baseline forecasts for 6-month Euribor, 10-year Bund and the BOT-Euribor, BTP-Bund spreads. The stress scenario introduces a 100bps parallel shift of the yield curve.

Source: Intesa Sanpaolo Research and MEF

Difference between the new DEF estimate on deficit at unchanged policies and previous forecasts (as % of GDP)

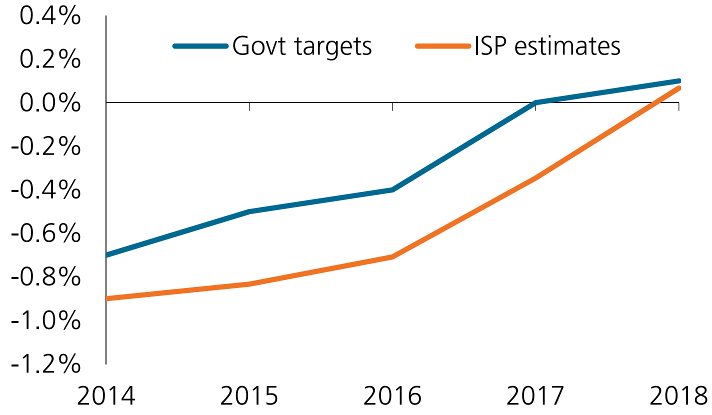
	2014	2015	2016	2017	2018
Difference on deficit at unchanged policies (= margin for easing measures), of which:	0.0	0.1	0.4	0.6	0.5
- Savings on interest expenditure	0.0	0.3	0.2	0.3	0.3
- Primary balance difference, of which:	0.0	-0.2	0.2	0.3	0.2
- due to growth effect (theoretical)	-0.1	0.1	0.3	0.2	0.1
- due to the trend net of growth effect	0.1	-0.3	-0.1	0.1	0.1

Source: Intesa Sanpaolo elaborations on MEF data

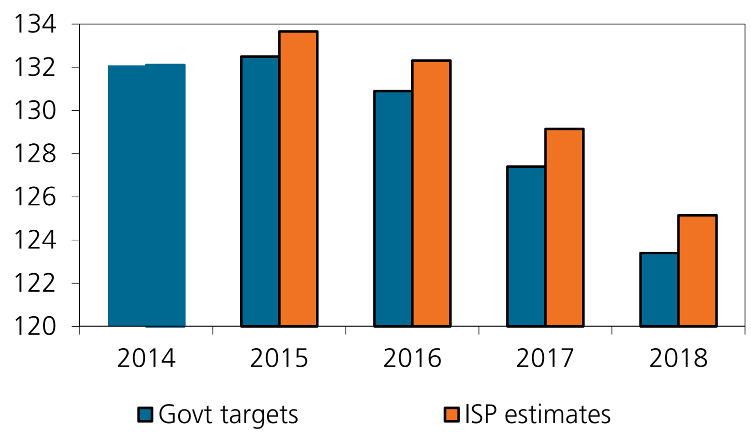
The match with the EU is on structural balance, debt

- In our estimates, the **structural deficit** will improve mainly due to savings on interest rate expenditure, although not as fast as the government estimates.
- The **debt** to GDP ratio is expected to peak this year and then start declining, albeit at a slower pace than projected by the Govt.

Structural balance as % of GDP: govt targets vs ISP estimates



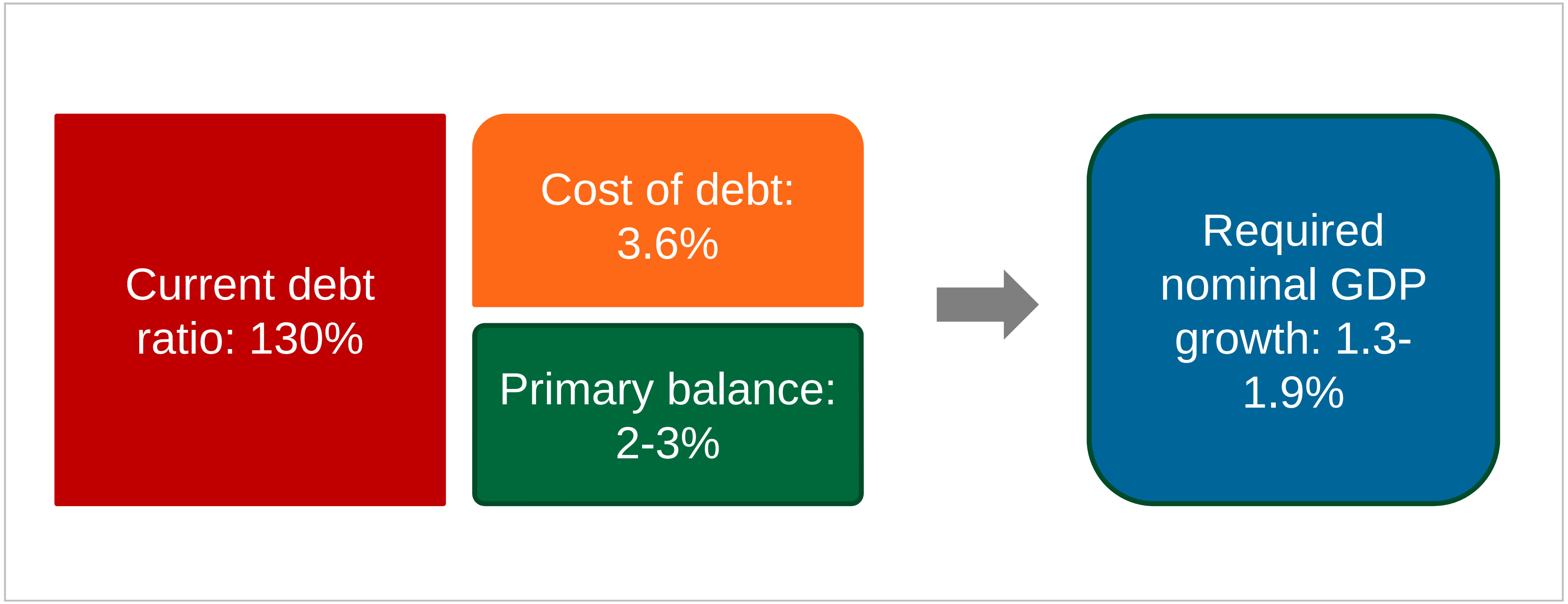
Public debt as % of GDP: government's targets versus Intesa Sanpaolo estimates



Source: MEF and Intesa Sanpaolo forecasts

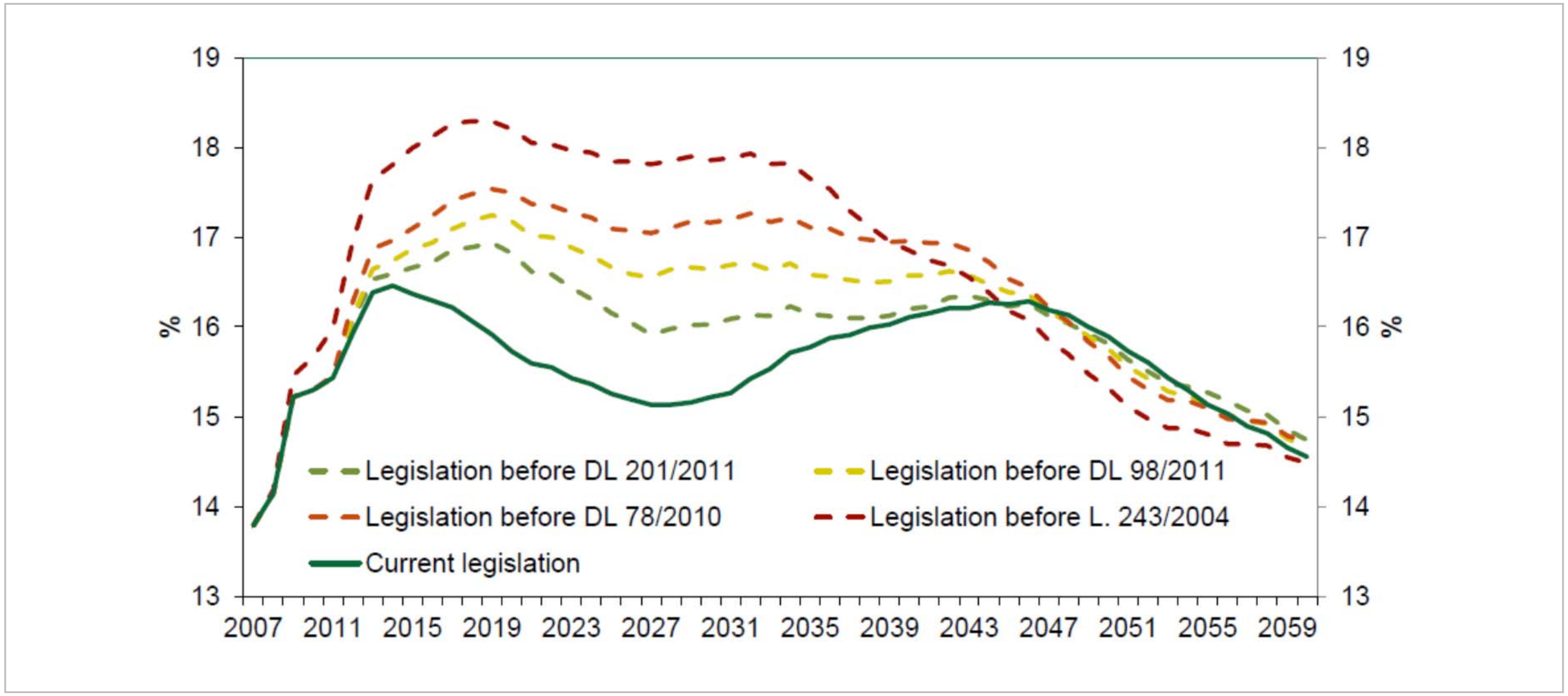
The arithmetics of debt sustainability is improving

- The **cost of debt** is set to run well below “normal levels” for years
- Thus, a **nominal growth of 1.5 %** per year will be enough to stabilize the debt ratio, with a primary surplus of 2-3% of GDP.



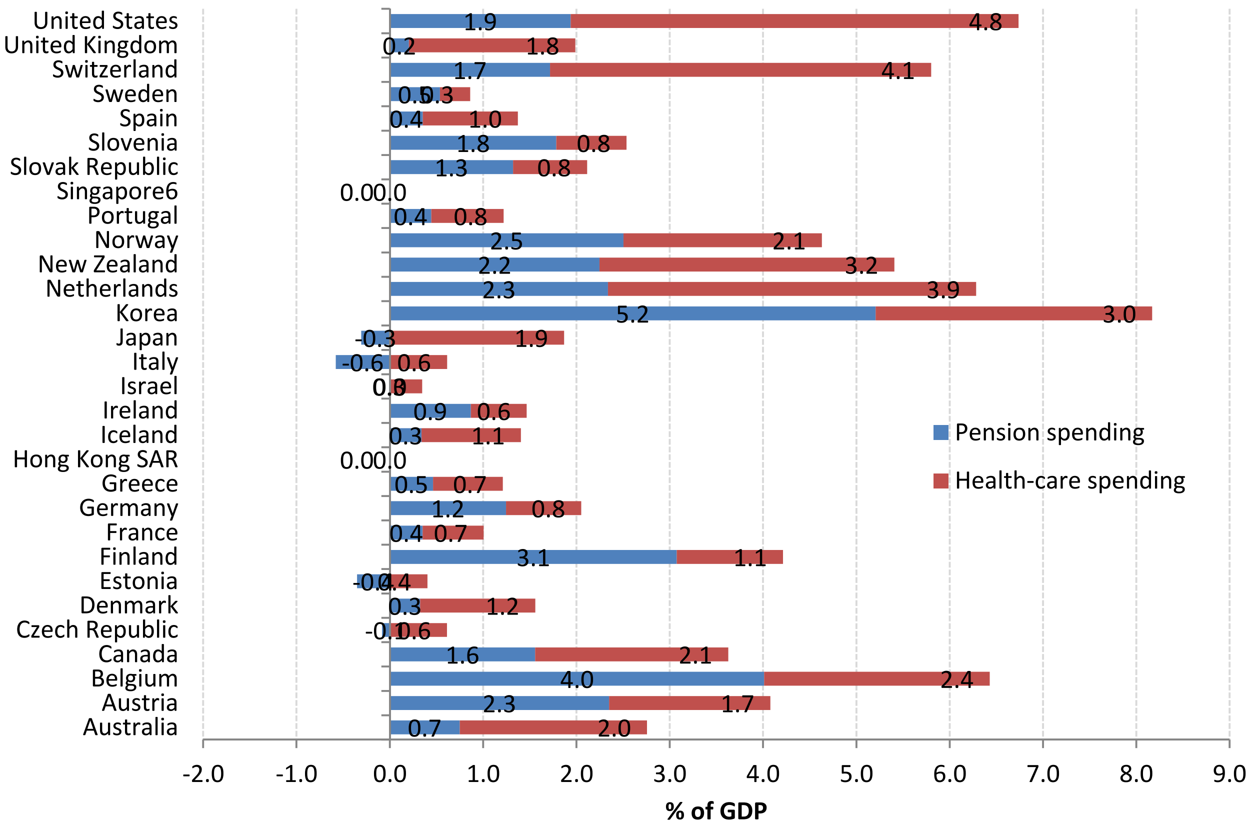
Pension spending: improving outlook

The starting level is high, but Italy is the only developed country where pension spending will <u>decline</u> between now and 2030.



Source: Update of 2013 Economic and Financial Document, *20 September 2013, as reported in Ministry of Economy and Finance, «Italy's Strategy for Growth and Fiscal Consolidation», 27 September 2013..*

Pension and Health-care spending change 2014-30



Source: IMF Fiscal Monitor

Agenda

Reforms

Renzi's reform agenda

1. Institutional reforms

Legislative power

Objective: faster and more efficient legislative function.

Main features: the Senate will be stripped of most legislative powers and be turned into a mostly consultative organ.
Issues: constitutional reform

Electoral reform ✓

Objective: ensure that elections result in a governing majority. The current system is proportional.
Main features: two ballot system, with threshold at 40%.
Issues: the bill only applies to the Camera, not to the Senate.

Local Governments

Objective: less overlapping between central and local governments; leaner structure.
Main features: re-centralisation of some functions; abolition of provinces.
Issues: constitutional reform.

2. Structural reforms

Labour market ✓

Objective: less duality, more flexibility.

Public administration

Objective: more efficiency.

Tax reform

Objective: reduce the tax burden on (labour) income

Education

Objective: quality, better connection with labour market.

Justice

Objective: more efficiency, reduce the backlog.

Competition

Objective: lower mark-ups, more efficiency

Politics and reforms

1. Institutional reforms

- After the approval of the **electoral reform**, the reform of the Senate is expected.

Reform	State of the art	Outlook	Risks/Problems
Electoral reform	Approved	Approved	The law applies only to the lower house, not to the Senate.
Constitutional reform of the Parliament	Voted by the Senate on August 8. The discussion by the lower house has resumed.	Final vote planned before end 2015. Approval by the lower house is feasible, but changes may be needed after the dis-engagement of Forza Italy. Approval by qualified majority very hard, so a confirmative referendum will probably be called.	1. This is a constitutional reform, involving special majorities and long procedures. 2. The 2nd vote by the Senate will again involve risks for the government, since Forza Italy has withdrawn its support. Changes may be needed to appease the left wing of PD.
Constitutional reform of local governments	Partial reform approved. Broader reform included in the same bill as above.	Same as above.	Same as above.

Politics and reforms

2. Structural reforms/1

- The government managed to overcome strong opposition from within PD and by the trade unions to pass a comprehensive **labour reform**.
- The reform of the **judiciary system** has already resulted in some benefits.

Reform	State of the art	Outlook	Risks/Problems
Labour reform	Enabling Law 10/12/2014 n. 183 is effective. 1st implementation decree issued on 24 dec 2014 (new long-term labour contract)	The Parliament can propose changes to the implementation decrees, which must be within the limits set by the delegating law, but there is no required parliamentary approval. The reform must be completed by mid 2015.	None, except that the government must make good use of the powers it has received.
Justice	Law 98/2013 (measures to deal with the backlog of trials) L. 9/2014 (digitalisation of judiciary procedures, mediation, commercial courts) L 114/2015 (corruption, mandatory dematerialisation of acts, proceedings office to support to judges) L 162/2014 (public procurement, arbitration, bankruptcy procedures)	Results were already visible in 2013 (average length of trials: -14%, backlog declining by 3-4% y/y on average since 2010, and by -6.7% yy in June 2014). In 2014, total backlog below 5mln for the first time since 2009. The digitalisation of acts has cut the time needed to issue legal orders by 43-60% in 2014.	

Politics and reforms

2. Structural reforms/2

- The shift of taxation from labour to financial income and real estate is well advanced.

Reform	State of art	Outlook	Risks/Problems
Taxation	• The tax deduction for wage earners (income <€25000) was increased in May 2014 • 10% cut to IRAP rates (tax paid by firms on value added), deduction of wages paid to l/t employees from tax base. • Tax incentives for long-term job contracts effective from Jan 2015. • New municipal tax (IUC) on real estate, replacing previous taxes. • Law 21/2/2014 n° 13 delegated the government to reform the tax code by decree within 12 months, now extended to end 2015. The decree on the cadastral reform is effective from 28 Jan 2015; that on the simplification of procedures from 13 Dec 2014. • A stamp duty on bank accounts and financial portfolios had already been introduced. • Cross-check of database to improve tax compliance	Between 2010 and 2014, various acts have cut the overall tax rate on wage income, while raising VAT and taxes on financial income and real estate. Further steps will have to rely more on expenditure cuts or in a decrease in tax evasion.	Most decrees relative to the reform of the tax code have yet to be issued. The complexity of the tax code has been barely dented.

2. Structural reforms/3

- Some **micro-liberalisations** have been implemented since 2011.
- The reform of the **banking system** is relevant.
- A broad reform of the **Public Administration** has been proposed, but it is still in an early stage.

Reform	State of art	Outlook	Risks/Problems
Public Administration	A bill of reform was sent to the Senate on 23 July 2014. The process is still in very preliminary stage. The debate resumed on Feb 11.	Unclear. The issue is less divisive than other reforms and should pass more easily, but it has been assigned a lower priority than other projects.	The process is very slow. The impact of the reform will depend more on the implementation than on the law itself
Simplification and competition	• Some liberalization steps were taken in 2011-12. • Transport Authority in place since Jan 2014 • Leasing of large properties has been deregulated • Streamlining of authorization processes for construction and for the extraction of hydrocarbons, and of other procedures • Cut in energy costs for SMEs • A decree forcing 'banche popolari' to change voting rules has just been issued.	Several simplification and liberalisation measures have been approved since 2011 and the process is ongoing.	The EC also asked to "remove remaining barriers to, and restrictions on, competition in the professional and local public services, insurance, fuel distribution, retail and postal services sectors". As for public procurement: rationalisation of the central purchasing bodies, e-procurement, rectification of non-compliant contracts in local public services.

The 2014-15 labour market reform

A law delegating the government to reform the labour market was approved in December 2014 (L. 183/2014). A number of implementation decrees are being issued by the government in 2015.

Labour contract	**More flexible regime for new open-ended jobs**, with wider recourse to arbitration and monetary compensation in place of re-instatement in case of unjust dismissal or faulty redundancy procedures. (DL 4/3/2015 n 23)	Easier to change the job of workers. Simplification of contractual forms for temporary work and staff leasing, but with limits on the share of total staff (<10%). Decree presented in April 2015.
Unemployment insurance	DL 4/3/2015 n 22 introduced a more comprehensive regime of unemployment benefits, providing coverage equivalent to half of the working weeks in the previous 4 years, with a max. of EUR 1300/month.	By June 2015, the government will reform the regime of *cassa integrazione guadagni*, a scheme in which wages are paid by the State in case of temporary redundancy, with the purpose of restraining i
Job replacement and training	According to DL 4/3/2015, unemployed workers should be offered support in the search for a new job. More recourse to private companies.	By June 2015, a decree will reform the system of job placement and job training.
Simplification	By May 2015, a decree will cut the red taper around labour contracts. Target 50% cut in the administrative burden.	

Estimates on the effects of reforms on growth

The government expects the reforms to raise GDP by 1.8% by 2020 and by 3.0% in 10 years. The most relevant contribution comes from the reforms of labour markets and of the public administration.

GDP, % cumulated deviation from baseline	2020	2025	Longer run
Labour market	0.6	0.9	1.3
Public Administration	0.4	0.7	1.2
Product and service markets	0.4	0.7	1.2
Education	0.3	0.6	2.4
Tax shift (net)	0.2	0.2	0.2
Justice	0.1	0.2	0.9
Total	**1.8**	**3.0**	**7.2**

Note: the impact was estimated by MEF with the QUEST III and IGEM models. The baseline is the scenario with no reforms. The estimate includes the cost of funding those reforms that raise the borrowing requirement.

Source: Ministry of Economy and Finance, *Documento di Economia e Finanza 2015*, April 2015, p. 48 and *Programma Nazionale di Riforma*, which details the simulations..

Agenda

1 Strong tailwinds pulling the economy out of recession

2 Fiscal discipline, but with less austerity

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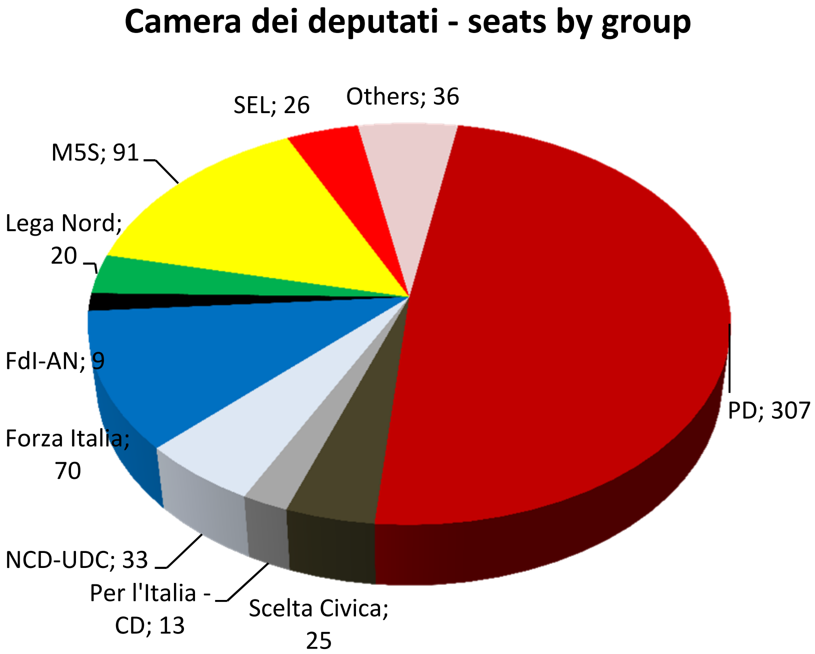
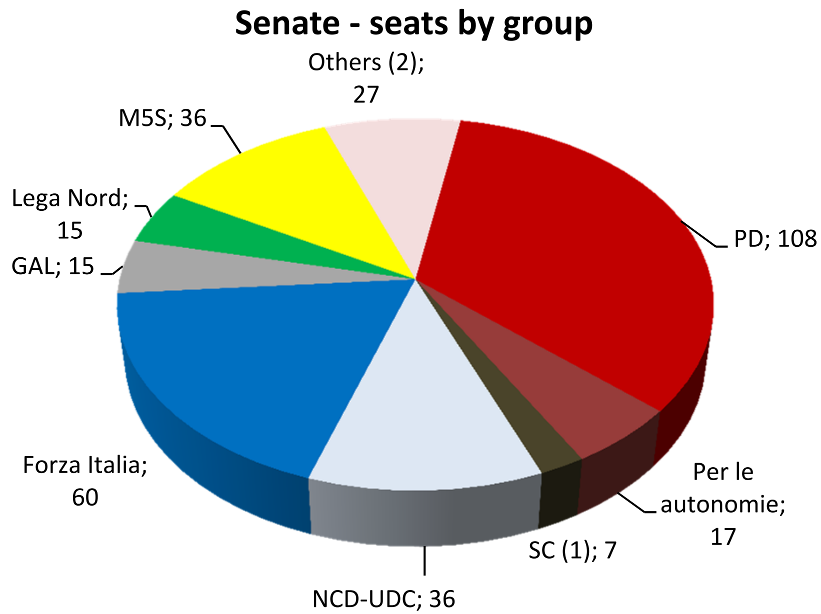
5 Annex - Background material

The parliamentary situation remains challenging

The governing coalition can count on a comfortable majority of 365 votes out of 630 in the lower house, but of just 168 out of 321 in the Senate.



Source: Camera dei Deputati.



Source: Senato.

Politics

A map of Italian politics

Note: *The size of the symbols is roughly proportional to the share of the national votes in opinion polls*.

Pro-euro

Anti-euro

Some MoP and senators disagree with PM Renzi and may leave PD

Partito Democratico

2013 election: 26.0%
Polls: 35-38%
Issues: a left-wing faction opposes the centrist shift imposed by Renzi. It gained support among moderate and older voters.

Centrists

2013 election: 8.3%
Polls: 1%

Some small centre-right parties try to find some room between PD and Forza Italia, with little success.

2013: -
Polls: 2-4%

2013 : 0.4%
Polls: -%

Support for institutional reforms has come so far from this area, including most of PD and most of Forza Italia. However, Forza Italia has recently announced a change in its stance.

2013 election: 21.6%
Polls: 10-13%
Issues: Berlusconi's leadership is challenged by Fitto. Berlusconi recently imposed a closer relationship with Lega Nord.

Hard-left

2013 : 3.2%
Polls: 4-5%

Tiny hard-left movements spring up continuously at the left of PD, but never gain much traction. SEL is the only long-time survivor. It sided with Tsipras at the last European election, but occasionally sides with PD.

2013 election: 25.6%
Polls: 19-21%
Issues: it has lost or expelled many MoP and senators; it quickly slid into irrelevance out of inability to withstand normal negotiation processes. It is competing with Lega on immigration and euro issues

Populist right

The typical anti-euro, anti-immigration populist right is dominated by Lega Nord

2013 : 2.0%
Polls: 3-5%

2013: 0.6%
Polls: -%

2013: 4.1%
Polls: 13-16%
Issues: it has become even more populist and anti-euro under its new leader Salvini.

Left-wing agenda on immigration, public order

Right-wing agenda on immigration, public order,

Politics
Outlook and risks

- **Our baseline is that the PD-NCD-SC coalition will govern until 2017 at least**, completing the reform agenda and waiting for the benefits of economic recovery to become evident to voters.
- The risk of PD splitting has receded after Forza Italia ended its cooperation on institutional reforms, but the left wing of the party is leading an attrition war against Renzi.
- However, the risk of a snap election being called in 2015-16 is slim.
- The next electoral test is the round of **local elections at end-May 2015** (1080 municipalities, but just 5 with more than 100k inhabitants, and 7 regions), but it does not pose any risk for the government.
- There is a **radicalisation of opposition parties** on European issues, with two large parties (Movimento 5 Stelle and Lega Nord) and a few tiny right-wing ones openly supporting an exit from the Eurozone. However, their popularity would probably recede with economic recovery; moreover, with the new electoral system in place, extremists would be unlikely to win an election.

Politics

Renzi strong and committed to reforms

- PD secretary Renzi forced Enrico Letta (PD) to resign from prime minister in February 2014, in order to lead the government himself. Despite the lack of a strong parliamentary majority, he launched a wide-ranging programme of institutional and economic **reforms**, including some important constitutional changes.
- Renzi's position was strengthened by the outcome of the **European vote** in May 2014, when PD rose unexpectedly to 41% (a record high).
- Renzi got new strength from the election of **Mattarella** to president of the Republic, as he rallied his party behind him, obtained a large majority for his candidate (almost 2/3 of votes) and cornered former premier Berlusconi.
- Renzi succeeded in finally approving the **labour market** reform and a new **electoral** system, despite strong resistance from the left wing of PD.
- **Other reforms in the pipeline** are about education, justice and the public administration.
- Renzi is aware that **public opinion** is behind him, supporting the reform effort. For the moment he has not an opponent on the right-wing side.

Political calendar

Year	Month	Date	Importance	Event	Notes
2015	5	31/05/2015	●	Senate vote on Constitutional reform	With this vote, the reform of the Parliament and of local governments will have completed half of the process. It was expected to take place before the administrative vote, but it may be further delayed.
2015	5	**31/05/2015**	●	1st round of municipal elections (partial)	A small round, involving 1066 municipalities, but just 5 with >100k inhabitants
2015	5	**31/05/2015**	●	Regional elections (partial)	7 regions involved out of 20: Veneto, Campania, Puglia, Toscana, Liguria, Umbria, Marche. A test for Prime Minister Renzi.
2015	6	**12/06/2015**		Moody's: rating announcement	Current: Baa2
2015	6	**14/06/2015**		2nd round of municipal elections (partial)	Only where a second ballot is required
2015	9	**25/09/2015**		DBRS: rating announcement	Current: A(low)/stable
2015	10	**09/10/2015**		Moody's: rating announcement	
2015	10	**23/10/2015**		Fitch: rating announcement	
2015	10	31/10/2015	●	Draft budgetary plan	
2015	11	**13/11/2015**		S&P: rating announcement	
2015	12	31/12/2015	●	Final parliamentary vote on the Constitutional Reform	A 2nd vote by both chambers, 3 months after the first, is required for the reform of the constitution.
2016	6	30/06/2016	●	Referendum on the Constitutional Reform	A referendum may be called on constitutional reforms, if they are not approved by the specified qualified majority.
2017	10	28/10/2017		Regional elections (partial)	Regions involved: Sicilia
2018	2	25/02/2018	●	Deadline for next general election	
2018		28/02/2018		Regional elections (partial)	Regions involved: Lombardia, Lazio, Friuli-Venezia Giulia, Basilicata, Valle d'Aosta, Molise
2018		31/12/2018		Municipal elections	
2019		31/12/2019		Regional elections (partial)	Regions involved: Piemonte, Calabria, Emilia Romagna, Abruzzo, Sardegna
2022	2	**02/02/2022**		President Mattarella's mandate ends	

Source: Intesa Sanpaolo

Agenda

1. Strong tailwinds pulling the economy out of recession
2. Fiscal discipline, but with less austerity
3. Structural reforms: something to show, at last
4. Politics: Renzi charges Fort Paralysis
5. **Annex - Background material**

Real GDP growth

GDP, yoy % change

	2012	2013	2014	2015f	2016f
USA	**2.3**	**2.2**	**2.4**	**2.5**	**2.9**
Japan	**1.7**	**1.6**	**-0.1**	**1.0**	**1.8**
Euro Area	**-0.8**	**-0.4**	**0.9**	**1.6**	**2.0**
- Germany	0.4	0.1	1.6	1.7	2.2
- France	0.2	0.7	0.2	1.0	1.3
- Italy	-2.8	-1.7	-0.4	0.6	1.2
- Spain	-2.1	-1.2	1.4	2.7	2.4
OPEC	**5.8**	**2.2**	**2.1**	**1.5**	**3.0**
Eastern Europe	**2.3**	**1.8**	**1.3**	**-1.2**	**2.3**
Latam	**1.9**	**3.0**	**0.9**	**0.6**	**2.5**
- Brazil	1.0	2.5	0.0	-0.9	1.1
- China	7.7	7.7	7.4	7.5	6.3
- India	4.4	6.4	7.2	7.8	8.0
- Russia	3.4	1.3	0.5	-5.9	0.9
World	**3.4**	**3.3**	**3.3**	***3.6***	***4.0***

Source: ISP Research estimates

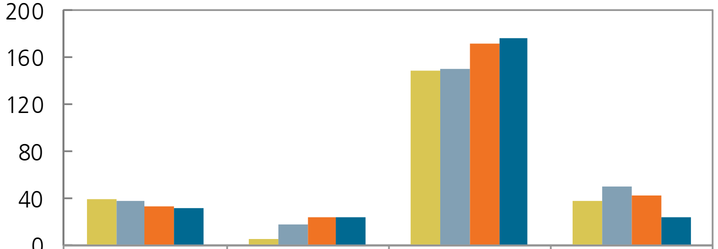
Rates markets

Our view

		Baseline	Risks
Duration	Eur	Greek crisis is adding volatility to a scarcely defined market trend. That will be a bearish factor together with a high net supply adjusted for EAPP in May that should be reversed in July when the net supply will turn highly negative in particular on the core markets. Hold long positions on German real rates and neutral duration on nominal Bund.	Bullish
	US	Fed delayed the first rate hike and the market has reacted with a fast bear steepening movement. Keep duration neutral.	Neutral
Curve	Eur	We suggest to play converge trades between core euro and US treasury curves: open 2-5Y Bund steepening against US Treasury flattening. Maintain 10-30Y Bund flattening position.	Bear steepening
	US	Keep long positions on the belly of the 2-5-10Y US Treasury fly outright or against short positions on the belly of the 2-5-10Y Bund fly.	Bear flattening
Euro Spread	Eur	Sovereign supply net of ECB purchases will shift from +50Bn in May to -80Bn euros in July. We expect this dispersion to reap a bearish short-term impact that could be an occasion to re-enter flattening position and outright long position on the long-end of BTP and SPGB curves.	Neutral
ASW	Eur	ASW spread widening positions should be played ahead of scarcity effect on Bunds: the current tightening is an opportunity to open positions with a 48bp target on 10Y Bund.	Balanced
	US	Widening bias on UST.	Balanced
Inflation	Eur	Long-end BEIs slightly retraced during the recent sell-off, prefer flattening position on 5/10Y BEI BTPei. Maintain 5-30Y steepening position on German real rates.	Widening BEIs
	US	Real rates sold-off with an high beta with respect to nominal rates: we continue to expect a long position with a 2.20% target on 10Y TIIS.	Balanced

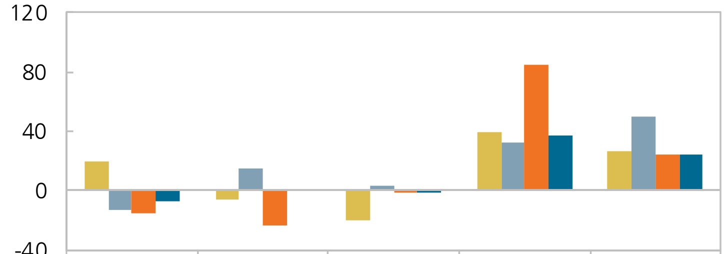
2015 issuance

Italy - Gross issuance
(2015 forecasts , EUR Bn)



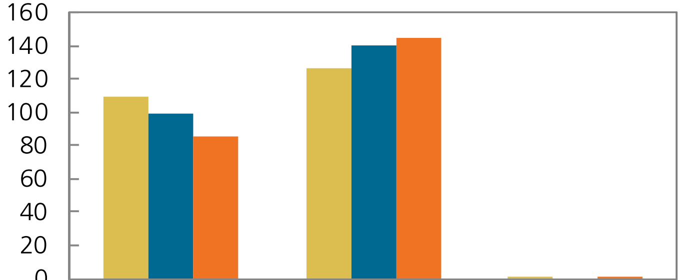
	CTZ	CCT/CCTeu	BTP	BTP infl
2012	40	5	149	37
2013	38	18	150	50
2014	33	24	171	43
2015 F	32	23	177	24

Italy - Net issuance
(2015 forecasts, EUR Bn)



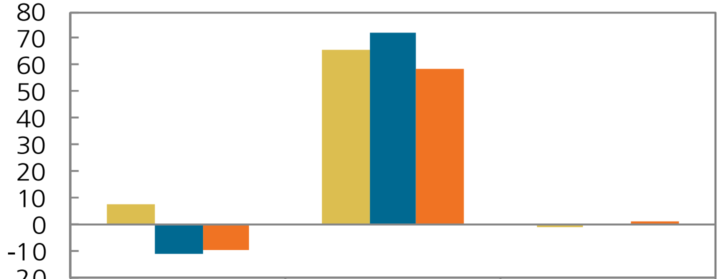
	BOT	CTZ	CCTeu	BTP	BTP infl
2012	19	-6	-21	39	26
2013	-13	15	3	33	50
2014	-16	-24	-1	85	24
2015 F	-7	1	-2	37	24

Spain - Gross issuance
(2015 forecasts, EUR Bn)



	Letras	Bonos	Eurobond
2013	109	126	2
2014	99	140	0
2015 F	86	145	1

Spain - Net issuance
(2015 forecasts, EUR Bn)



	Letras	Bonos	Eurobond
2013	7	66	0
2014	-11	72	0
2015 F	-9	59	1

Source: Bloomberg, Forecasts Intesa Sanpaolo

Italy – Forecasts 2015 issuance

Government Debt Expiration Schedule

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
BOTs (*)	16.5	15.5	15.3	14.1	13.3	14.9	14.2	15.0	16.1	14.5	12.5	13.5	175
CTZs	-	-	-	-	-	15.9	-	-	-	-	-	15.5	31
CCTs	-	-	-	-	-	-	-	-	10.0	-	-	15.0	25
BTPs	-	21.0	12.4	17.3	-	16.9	16.1	24.0	-	-	17.3	14.5	139
BTP infl	-	-	-	-	-	-	-	-	-	-	-	-	0
Eurobonds	4.8	-	1.3	0.3	-	1.1	-	-	-	-	-	-	8
TOTAL	21	36	29	32	13	49	30	39	26	15	30	59	379

(*) BOTs redemptions are based on Intesa Sanpaolo expected rollover.

Gross Issuance - Forecasts (all data are indicated on a settlement date basis)

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
BOTs		23.8	15.0	13.6	13.0	12.5	14.3	14.8	14.5	16.0	13.5	11.5	5.5	168
CTZs		5.0	3.8	2.3	2.0	2.0	2.5	3.0	2.5	2.5	4.0	2.5	-	32
CCTs		1.6	2.0	2.0	3.9	2.0	1.5	1.5	1.5	2.0	1.8	1.8	2.0	23
BTPs		22.1	18.4	25.5	22.8	15.5	13.0	15.5	5.0	19.5	18.5	17.8	7.0	201
of which	3 yr	3.5	2.9	2.5	3.5	2.0	2.5	2.5	-	3.0	3.5	3.0	-	29
	5 yr	3.3	3.5	2.9	2.3	4.5	2.5	2.5	2.5	3.5	3.5	5.0	3.0	39
	7 yr	2.9	5.2	3.0	2.5	3.0	3.0	4.5	-	4.5	2.5	3.0	-	34
	10 yr	3.4	4.0	5.9	2.9	2.5	3.0	3.0	2.5	5.0	3.0	3.5	4.0	43
	15 yr	1.5	1.7	8.0	1.5	-	2.0	-	-	2.0	-	-	-	17
	30 yr	6.5	-	1.8	-	2.0	-	1.5	-	-	2.0	1.5	-	15
	BTP infl	1.0	1.2	1.5	10.1	1.5	-	1.5	-	1.5	4.0	1.8	-	24
Eurobonds		-	1.8	1.0	-	-	1.0	-	-	-	2.0	-	-	6
TOTAL		52	41	44	42	32	32	35	24	40	40	34	15	430

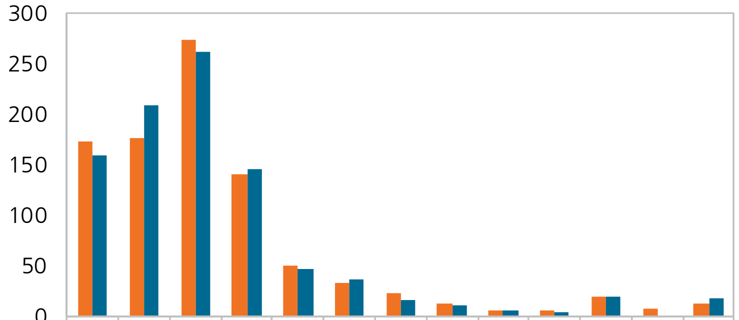
Source: Bloomberg, Forecasts Intesa Sanpaolo

Euro area - Forecasts 2015 issuance

2015 (Eur Bn)	Q1	Q2	Q3	Q4	Total
Gross issuance	303	251	192	179	925
2-3 year	55	48	42	43	188
5-7 year	67	68	59	46	240
10 year	87	63	51	45	246
15 year	46	19	12	14	91
30 year	18	17	12	5	52
50 year		2		3	4
Linkers	18	22	11	14	64
Floater	6	8	5	6	24
Eurobond	6	4	1	4	14
Redemptions	177	137	196	158	668
Net issuance	126	114	-4	21	257
Gross EFSF/ESM/EU	9	10	7	18	43
Net issues withEFSF/ESM/EU	127	119	-3	22	266

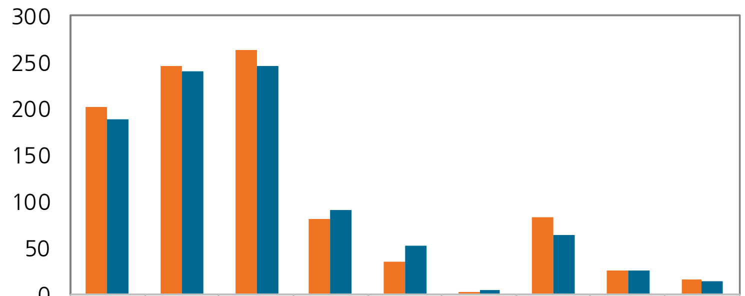
2014 (Eur Bn)	Q1	Q2	Q3	Q4	Total
Gross issuance	285	288	191	189	953
2-3 year	64	61	41	36	202
5-7 year	72	70	56	47	246
10 year	82	76	50	56	264
15 year	26	20	19	15	80
30 year	14	10	5	6	35
50 year	2				2
Linkers	15	40	9	20	84
Floater	4	8	6	8	26
Eurobond	6	3	5	1	15
Redemptions	121	136	236	116	608
Net issuance	165	152	-45	73	345
Gross EFSF/ESM/EU	23	15	8	20	65
Net issues with EFSF/E	171	161	-37	79	374

Gross issuance by country (EUR Bn)



	GE	FR	IT	SP	NE	BE	AT	FI	SK	SV	PT	GR	IRE
2014	172	175	273	140	50	33	23	12	5	6	18	7	12
2015 F	158	208	262	146	46	36	15	10	5	4	18	0	17

Gross issuance by duration (EUR Bn)



	2-3y	5 yr	10 yr	15 yr	30 yr	50 yr	Infl	Float	Euro mkt
2014	202	246	264	80	35	2	84	26	15
2015 F	188	240	246	91	52	4	64	24	14

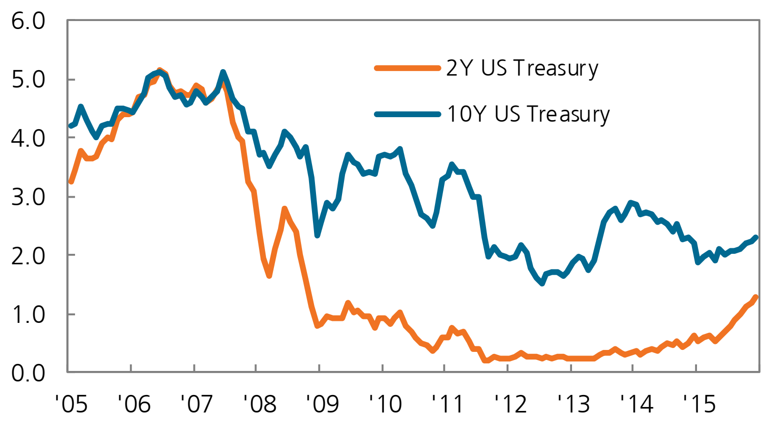
Source: Bloomberg, Forecasts Intesa Sanpaolo

Forecasts Govt yields core

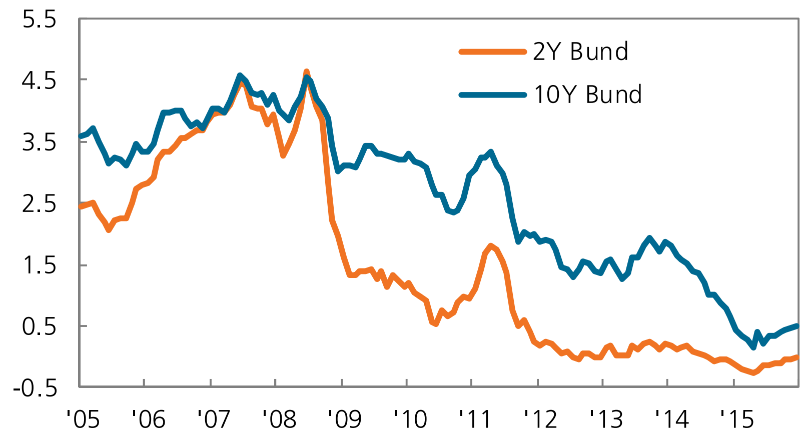
US Treasury	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	0.59	0.70	1.00	1.30	1.50
Forward		0.62	0.68	0.74	0.80
5Y	1.52	1.50	1.60	1.80	2.00
Forward		1.56	1.64	1.71	1.79
10Y	2.19	2.00	2.10	2.30	2.50
Forward		2.22	2.28	2.34	2.40
30Y	2.95	2.78	2.90	3.09	3.29
Forward		2.97	3.00	3.03	3.07
Slope (bp)					
2/10Y	160	130	110	100	100
Forward		160	160	160	160
2/5Y	93	80	60	50	50
Forward		94	96	97	99
10/30Y	76	78	80	79	79
Forward		75	72	70	67

Bund	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	-0.21	-0.15	-0.10	0.00	0.10
Forward		-0.22	-0.21	-0.19	-0.18
5Y	0.06	-0.10	0.10	0.20	0.30
Forward		0.07	0.09	0.11	0.13
10Y	0.57	0.20	0.40	0.50	0.60
Forward		0.58	0.61	0.63	0.66
30Y	1.18	0.57	0.77	0.87	1.02
Forward		1.18	1.20	1.21	1.23
Slope (bp)					
2/10Y	78	35	50	50	50
Forward		80	81	83	84
2/5Y	27	5	20	20	20
Forward		28	29	30	31
10/30Y	60	37	37	37	42
Forward		60	59	58	57

US Treasury



Bund



Source: Bloomberg, Forecasts Intesa Sanpaolo

Forecasts Govt yields peripherals

Government Bond Yield Curves (%)

BTP	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	0.15	0.25	0.20	0.30	0.30
Forward		0.17	0.22	0.28	0.38
5Y	0.69	0.60	0.65	0.75	0.75
Forward		0.72	0.77	0.83	0.89
10Y	1.73	1.20	1.20	1.30	1.30
Forward		1.79	1.85	1.90	1.96
30Y	2.78	1.97	1.92	2.02	2.02
Forward		2.79	2.83	2.87	2.91
Slope					
2/10Y	157	95	100	100	100
Forward		162	163	162	159
2/5Y	54	35	45	45	45
Forward		55	55	54	52
10/30Y	105	77	72	72	72
Forward		100	98	96	94

Bonos	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	0.06	0.30	0.20	0.30	0.30
Forward		0.06	0.09	0.16	0.27
5Y	0.67	0.60	0.65	0.75	0.68
Forward		0.69	0.74	0.79	0.85
10Y	1.72	1.20	1.20	1.30	1.15
Forward		1.74	1.80	1.85	1.91
30Y	2.75	1.97	1.92	2.02	1.87
Forward		2.77	2.81	2.85	2.89
Slope					
2/10Y	167	90	100	100	85
Forward		169	170	169	164
2/5Y	62	30	45	45	38
Forward		63	64	63	58
10/30Y	103	77	72	72	72
Forward		102	101	100	98

Note: Forward rates are computed using GC repo rates specified in the table below.
Source: Bloomberg, Intesa Sanpaolo

Forecasts spread vs Bund

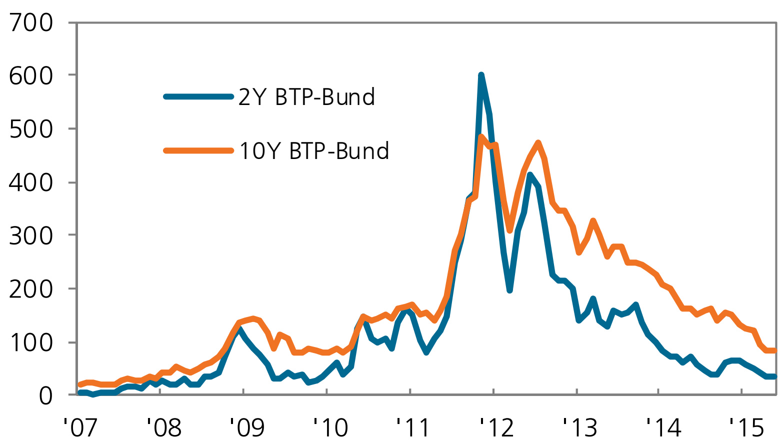
BTP-Bund	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	37	40	30	30	20
Forward		39	42	48	56
5Y	63	70	55	55	45
Forward		65	68	72	76
10Y	116	100	80	80	70
Forward		121	124	127	131
30Y	160	140	115	115	100
Forward		161	163	165	167
Slope					
2/10Y	79	60	50	50	50
10/30Y	45	40	35	35	30

Bonos-Bund	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	27	45	30	30	20
Forward		27	30	35	45
5Y	61	70	55	55	38
Forward		62	65	68	72
10Y	115	100	80	80	55
Forward		116	119	122	125
30Y	157	140	115	115	85
Forward		158	161	164	166
Slope					
2/10Y	88	55	50	50	35
10/30Y	42	40	35	35	30

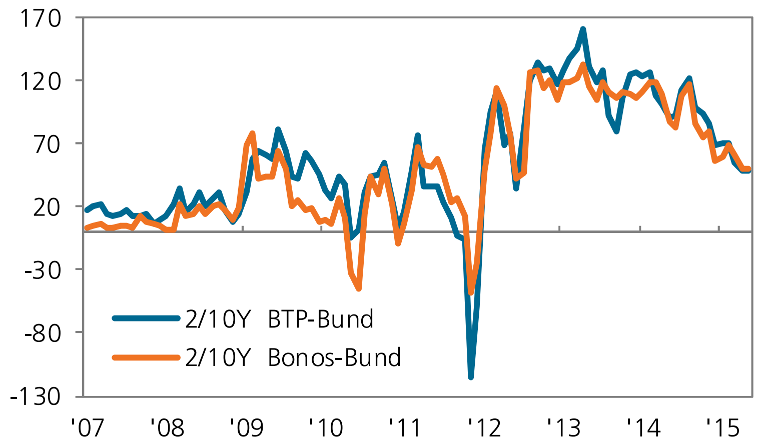
US Treasury-Bund	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	80	85	110	130	140
Forward		84	89	94	98
5Y	146	160	150	160	170
Forward		149	155	161	166
10Y	162	180	170	180	190
Forward		164	167	171	174
30Y	177	221	213	222	227
Forward		178	180	182	183

OAT-Bund	11/05	Jun-15	Sep-15	Dec-15	Mar-16
2Y	5	10	10	8	8
Forward		5	6	6	6
5Y	13	15	15	12	9
Forward		14	14	14	15
10Y	29	20	20	15	10
Forward		29	30	30	31
30Y	47	37	37	32	27
Forward		47	47	48	49

Spread BTP-Bund (bps)



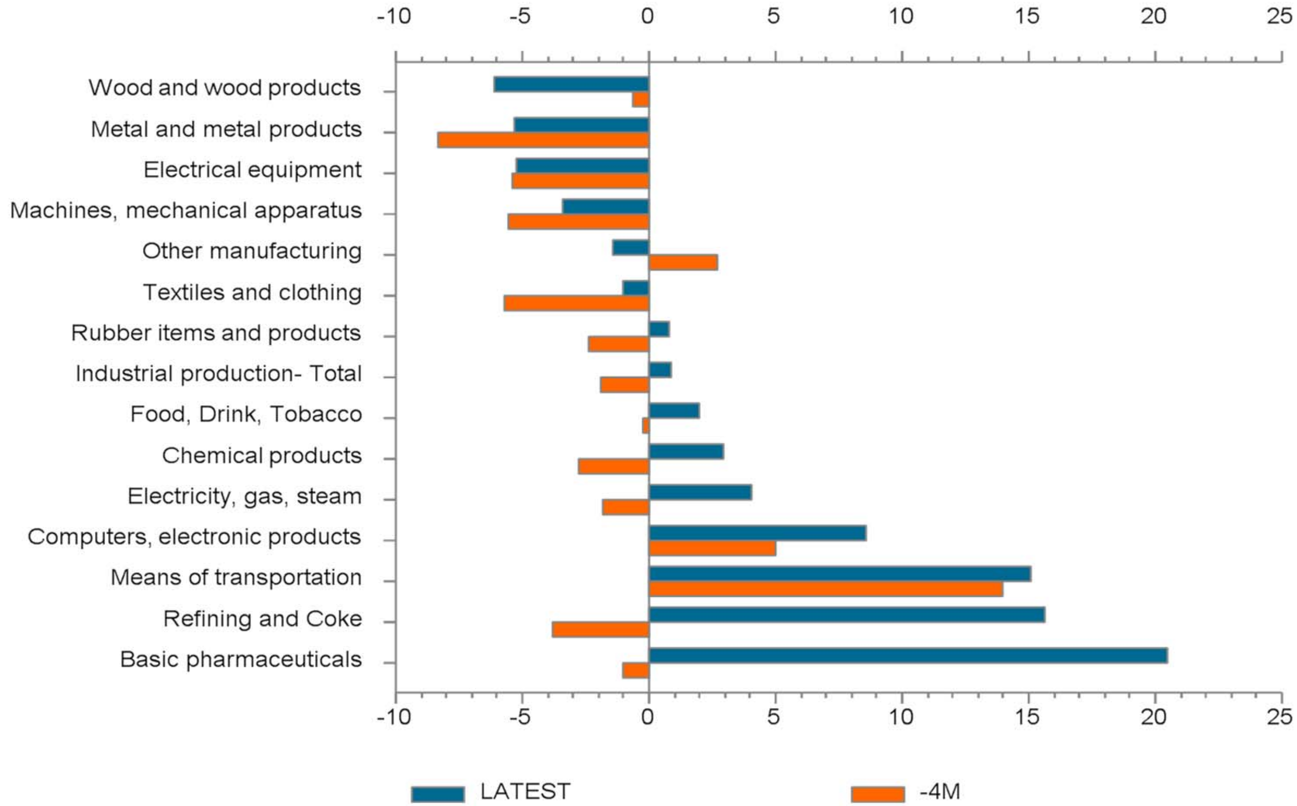
2/10Y slope of spread curves vs Bund (bps)



Source: Bloomberg, Forecasts Intesa Sanpaolo

Industrial production by sector: y/y change

- Output is already growing in some industries; few sectors are not experiencing some improvement from mid 2013.



Weights: Metals and metal products 14.0%; Machines and mechanical apparatuses 12.1%; Electricity, gas and steam 10.4%; Food, drink, tobacco 9.9%; Rubber , plastic products 8.6%; Textiles and leather goods 7.9%; other industries 7.2%: Means of Transportation 6.8%; wood and wood products 5.3%; electrical equipment 4.2%; chemical products 4.0%; pharmaceuticals 3.6%; computer and electronics 3.0%; refining and coke production 1.4%
Source: Istat

Payment of P.A. arrears to support the recovery

- The payment arrears of the public administration were estimated in at least 91Bn euros (about 6% of GDP) at end-2012. The Government started to pay them around mid-2013.
- 16.5Bn were paid in 2013 and around 18Bn in 2014. Up to end-January 2015, 36.5Bn were paid to companies and 42.8Bn were allocated to public administrations for payments. The Govt plans to reach a target of 56Bn. In short, if the target is reached in 2015, payments are worth more than 1% of GDP per year in 2013-15.
- The Renzi government introduced a new mechanism with the support of banks and of CDP. The former would discount the bills at favourable conditions; the government would guarantee the bills; CDP would step to buy the credit when it has to be restructured.
- We estimate an impact on GDP of around 0.1-0.2% per year in 2014-15.

	Targets set by D.L. 35/2013 and 102/2013	Allocated	Paid to companies
Central Govt	7,000	7,000	5,753
Regions	33,189	24,022	21,681
Local authorities	16,100	11,788	9,049
Total	*56,289*	*42,810*	*36,483*
as a % of total funds		*76%*	*65%*

Source: MEF, http://www.mef.gov.it/ufficio-stampa/comunicati/2015/comunicato_0034.html, Update of Feb 13th 2015.

A (moderately) expansionary 2015 Budget

- **Fiscal tightening delayed** to 2016-18 (but savings on interest spending will help). The balanced budget in structural terms will be achieved only in 2017.
- The 2015 Budget included **accommodative measures** worth 0.4% of GDP (less than the 0.7% originally projected). But a further 0.1% could be used.

The final version of the Stability Law: actions (net of related fiscal effects, EUR Bn)

MEASURES (net)	2015	2016	2017
Tax cuts, of which:	12.9	15.2	15.6
- for households	7.3	5.4	6.4
Re-financing of the Irpef bonus	*6.8*	*4.8*	*5.4*
Tax cuts for large households	*0.5*	*0.6*	*1.0*
- for enterprises	5.5	9.2	8.5
Irap deducibility of labour costs	*2.7*	*4.6*	*3.9*
De-contribution on unlimited contract hirings	*1.7*	*3.3*	*3.2*
Tax reductions for individual VAT positions	*0.8*	*1.0*	*0.9*
Tax credits for Research & Development	*0.2*	*0.4*	*0.5*
- Other revenue reductions	0.1	0.5	0.8
Prevention of safeguard clause	3.0	3.0	3.0
Higher expenditure, of which:	7.9	11.0	11.1
- non-deferrable spending	3.7	4.6	4.0
- "Buona scuola" school plan	0.5	1.5	1.5
- Redundancy schemes	1.5	1.5	1.5
- Easing of the domestic Stability Pact	0.9	1.0	1.0
- Other spending increases	1.2	2.4	3.1
TOTAL MEASURES (a)	23.7	29.2	29.8

Note: impact of the single measures reclassified by Intesa Sanpaolo taking into account all the related fiscal effects. Source: Intesa Sanpaolo elaborations on MEF data.

The final version of the Stability Law: funding (net of related fiscal effects, EUR Bn)

FUNDING (net)	2015	2016	2017
Spending cuts, of which:	9.8	10.5	11.6
- Ministries	2.0	2.3	2.4
- Local administrations	6.2	7.2	8.2
Regions	*4.0*	*4.0*	*4.0*
Municipalities and provinces	*2.2*	*3.2*	*4.2*
- Other cuts	1.6	1.0	1.0
Reprogramming of EU funds (Delrio plan)	1.0	1.0	1.0
Higher revenues, of which:	7.0	5.7	5.6
- from the fight against tax evasion	3.3	3.5	3.5
- from financial income tax hikes	1.1	0.8	0.8
- other, non-fiscal revenues (gaming, withholding tax on restructuring expenses)	2.6	1.4	1.2
Safeguard clause on VAT		12.1	18.5
TOTAL FUNDING (b)	17.8	29.3	36.7
EFFECT ON THE DEFICIT (=b-a)	-5.9	0.2	7.0

Note: impact of the single measures reclassified by Intesa Sanpaolo taking into account all the related fiscal effects. Source: Intesa Sanpaolo elaborations on MEF data

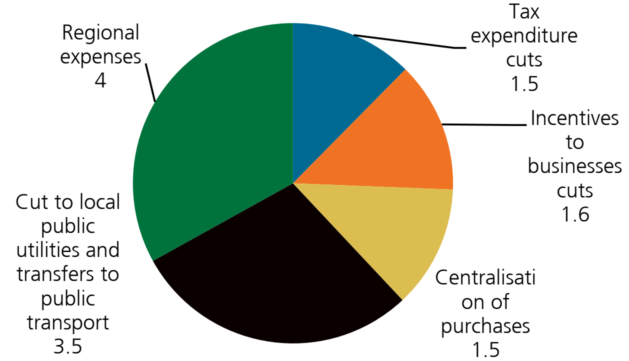
DEF 2015: problematic issues

- The aim of covering safeguard clauses principally by means of "**structural" spending cuts**, even only in 2016, remains challenging, also considering that the savings add themselves to those already provided for by previous legislation.
- The further pressure place on **local administrations** (already hit hard in past years) is only sustainable if the "linear cut" logic is abandoned, to the advantage of a sharing of sacrifices based on productivity and efficiency criteria; to date, it is still not clear whether the government is truly committed to pursuing this new path.

Estimated minimum funds required by the Stability Law for 2016-18 (Bn)

	2016	2017	2018
SL 2015 safeguard clause	12.8	19.2	22.0
SL 2014 safeguard clause	3.3	6.3	6.3
Non-deferrable spending	0.9	2.2	3.4
Use of flexibility margins	-7.2	-9.9	-9.1
TOTAL FUNDS REQUIRED	**9.8**	**17.8**	**22.6**
as % of GDP	0.6	1.0	1.3

Estimated funds achievable from spending cuts in 2016 (Bn)



Source: Intesa Sanpaolo elaborations on MEF data, press sources

The impact of Constitutional Court's ruling on pensions

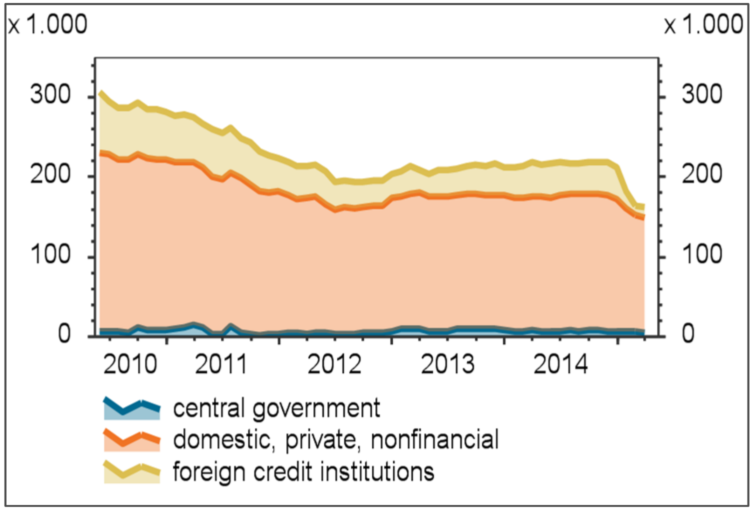
- The Constitutional Court ruled that the law that in 2011 froze inflation-adjustments for pensions above 3 times the minimum in 2012-13 was unconstitutional.
- The total cost is estimated at 10Bn (for all the period 2012-15). Yet, in all likelihood the final decision of the Govt will involve only partial refunds, reducing the impact to 2.5-3Bn. Risks of exceeding the 3% threshold remain contained.

Effects of Constitutional Court's ruling on pensions (EUR Bn) for Italy's public finance							
"Save Italy" Decree, Monti Govt (A)	2012	2013	2014	2015	2016	2017	2018
Gross of effects on PIT	2.5	4.2	4.2	4.2	4.1	4.1	4.0
Net of effects on PIT	1.8	3.1	3.1	3.1	3.0	3.0	3.0
Cumulated	1.8	4.9	8.1	11.1	14.2	17.2	20.2
as a % of GDP	0.1	0.3	0.5	0.7	0.8	1.0	1.1
Budget 2014, Letta Govt (B)			2014	2015	2016	2017	2018
Gross of effects on PIT			0.6	1.4	2.2	2.1	2.1
Net of effects on PIT			0.4	0.9	1.4	1.4	1.4
Cumulated			0.4	1.3	2.7	4.1	5.5
Net cost of Constitutional Court ruling (C=A-B)	2012	2013	2014	2015	2016	2017	2018
Gross of effects on PIT	2.5	4.2	3.6	2.8	2.0	1.9	1.9
Net of effects on PIT	1.8	3.1	2.7	2.2	1.6	1.6	1.6
cumulated	1.8	4.9	7.7	9.8	11.5	13.1	14.7
as a % of GDP	0.1	0.3	0.5	0.6	0.7	0.7	0.8
Effects on deficit (% of GDP)				2015	2016	2017	2018
No policy-change deficit (D)				-2.5	-1.4	-0.2	0.5
with full effects of Const. Court ruling (D-C)				-3.1	-2.1	-1.0	-0.3
with partial reimburses (2.5-3Bn)				-2.7	-1.5	-0.3	0.4

Note: Intesa Sanpaolo calculations on Italian Govt data

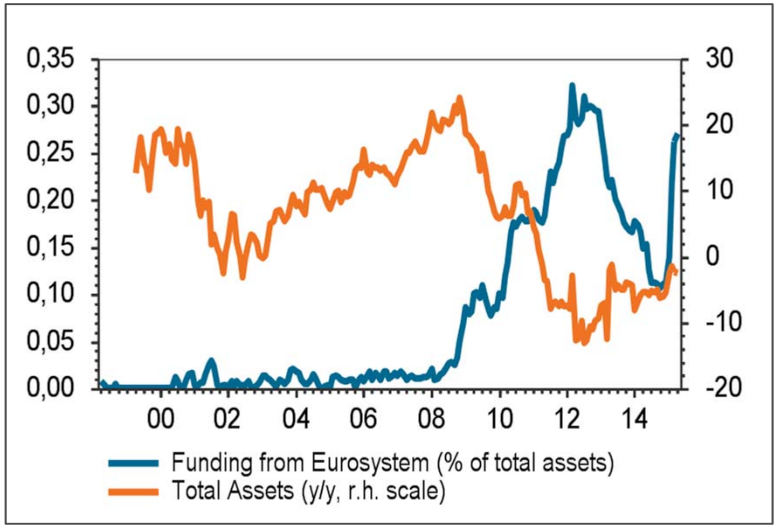
Risks of liquidity crisis for Greek banks

Greek banks' deposits



Source: Bank of Greece, Thomson Reuters Datastream Charting

Greek banks' reliance on ECB

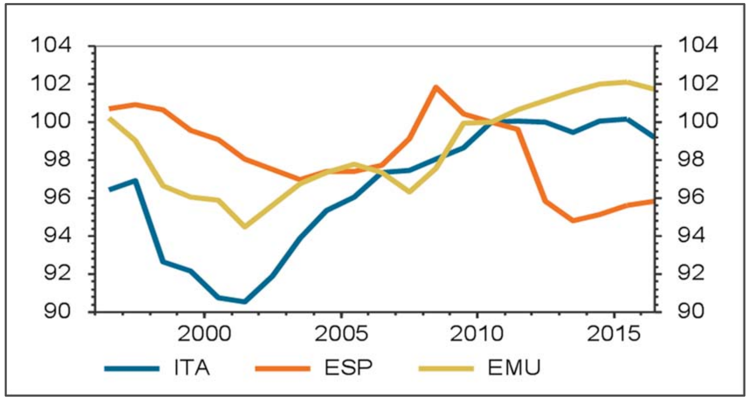


Source: Bank of Greece, Thomson Reuters Datastream Charting

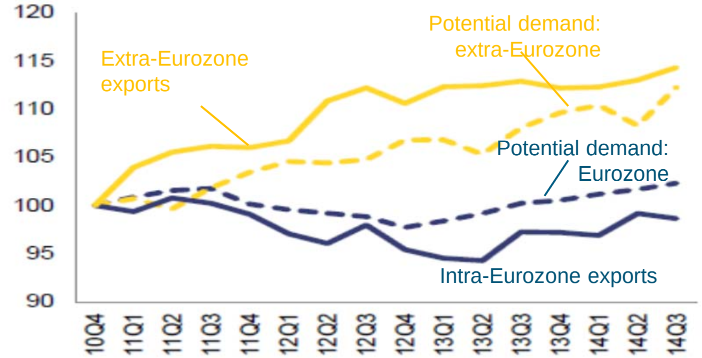
Reforms

Competitiveness monitor

Real Unit Labour Cost
(relative to average of 36 industrial countries)

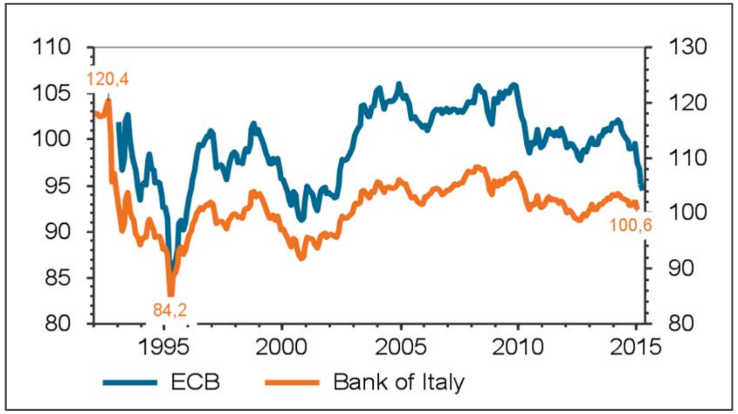


Export performance since mid 2010 to mid 2014



Source: European Commission, based on Bank of Italy analysis.

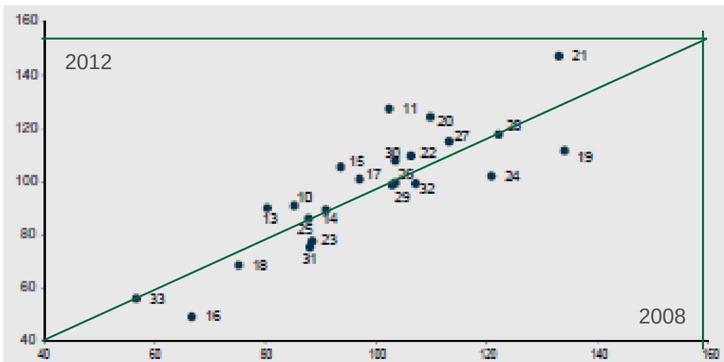
ECB and Bank of Italy competitiveness indicators



Note: the Bank of Italy index is based on production prices, the ECB one on consumer prices. Higher values represent a loss of competitiveness.

Source: Thomson Reuters – Datastream Charting.

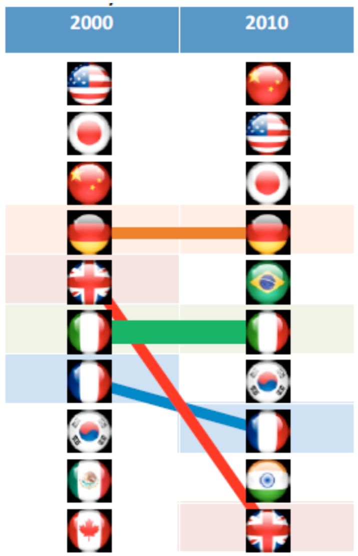
ISCO – competitiveness indicator by industry



Note: 10=food, 11=beverages , 13=textiles, 14=apparel, 15=leather goods, 19=oil products, 20=chemicals, 21= pharmaceuticals, 22=rubber and plastic goods, 24=metal goods, 26=electronics, 27=electric equipment, 28=engineering, 29=motor vehicles, 31=furniture.
Source: ISTAT, *Rapporto sulla competitività dei settori produttivi*, 2015.

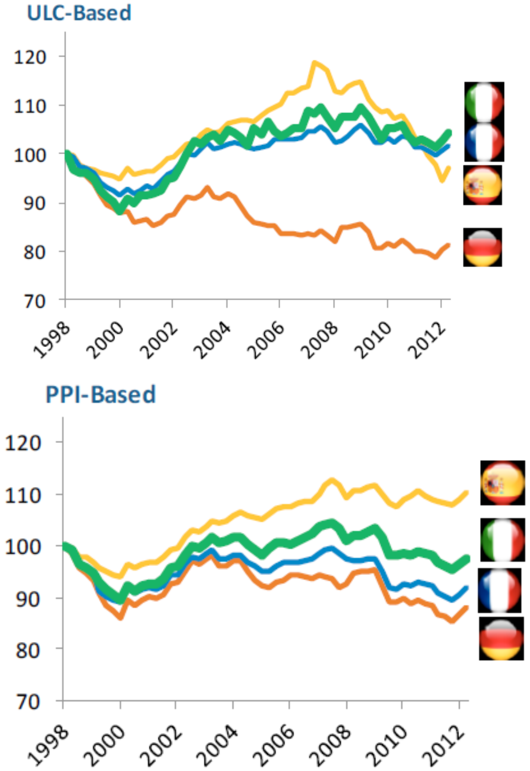
The conundrum of ULCs and competitiveness

Top 10 manufacturers by value added



Source: UN Statistics

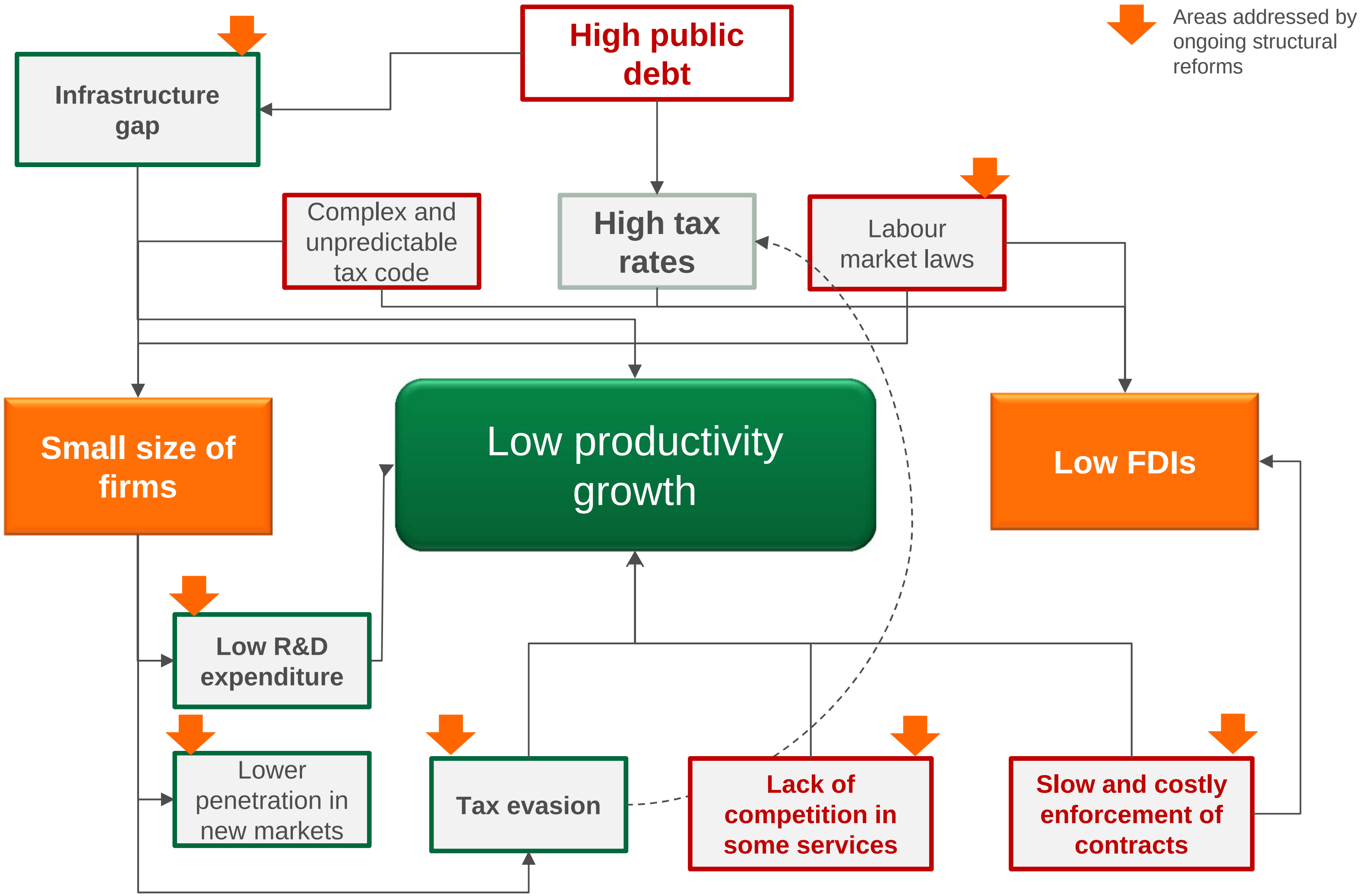
Harmonized competitiveness indicators, 1999-2013
(Index, end 1998=100)



Source: IMF, Italy – 2013 Article IV Consultation, Selected Issues.

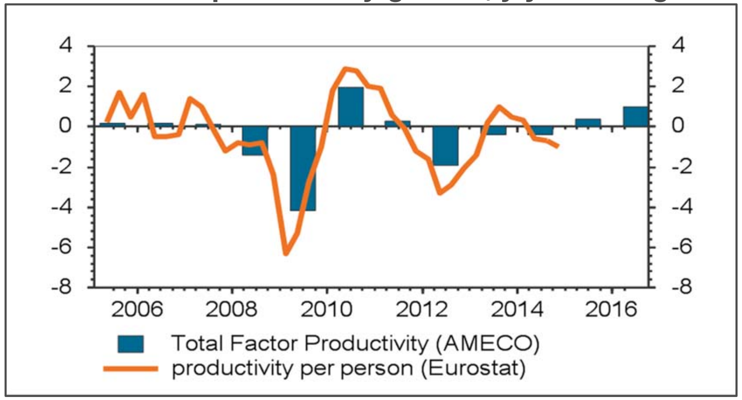
- Out of 5.517 world manufacturing products, Italy ranks 1st in 249 sectors, 2nd in 334 and 3rd in 350 according to UN Comtrade data. According to these rankings, Italy is second only to Germany (and is better positioned than China).

Why is productivity growth so low?



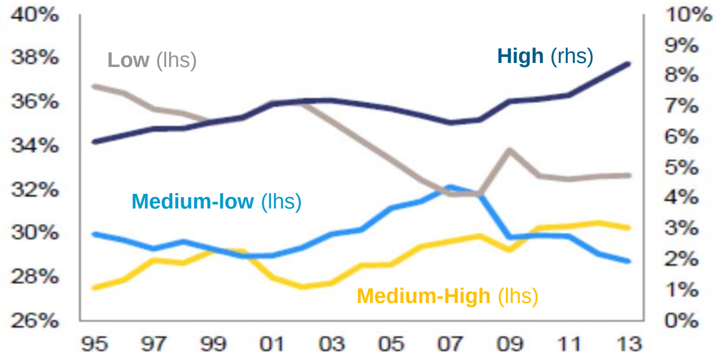
Reforms
The productivity gap

Estimates of productivity growth, y/y % change



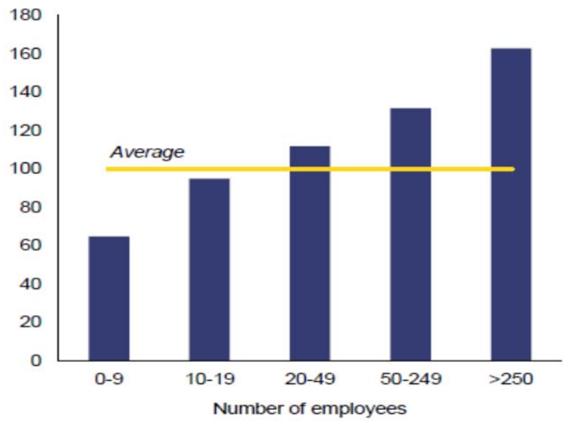
Source: Thomson Reuters Datastream Charting

Shares of gross value added in manufacturing by technological intensity



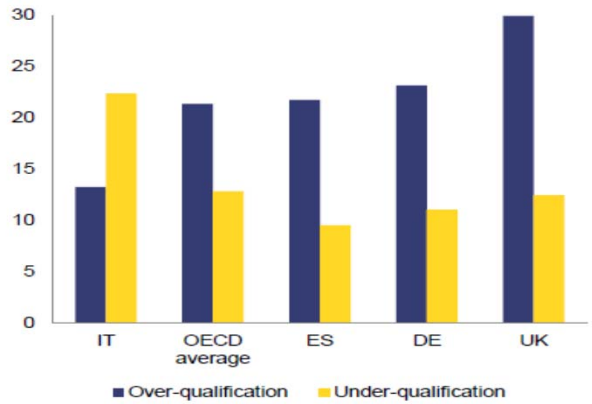
Source: European Commission (Country Report Italy 2015)

Labour productivity by firm size
(100=average over total firm population)



Gross value added per employee, at factor cost.
Source: European Commission (Country Report Italy 2015), Istat.

Incidence of under- and over-qualification
(% of workers, 2012)

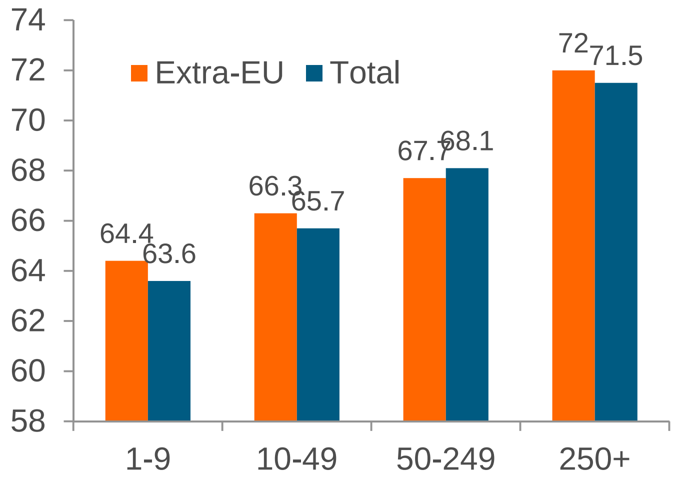


Source: European Commission (Country Report Italy 2015), OECD, PIAAC

A small size is less of a strength than in the past

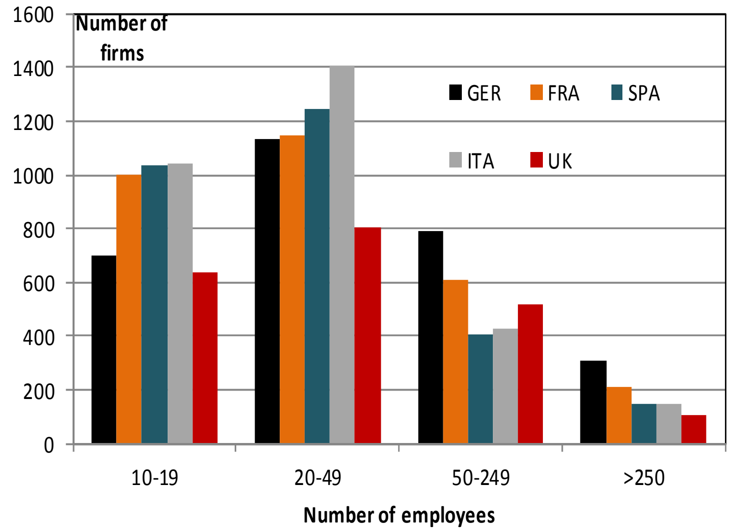
- **Some factors favoring a small size**: more flexible management of labor force, fiscal incentives for debt financing vs equity financing, easier to hide sales and profits.
- **Recent actions**: "Contratto di rete" (L. 30,7/2010 n. 122), to favour cooperation agreements among SMEs; >300 contracts signed. / L. 26/12/2011 n 214 "Salva Italy": tax allowance for reinvested profits, deducibility of the regional tax on employment / Several further measures taken by Renzi Govt

Percentage of firms growing in foreign markets, by size, 2009H1-2011H2



Source: Istat, Rapporto Annuale 2012, Table 3.1.

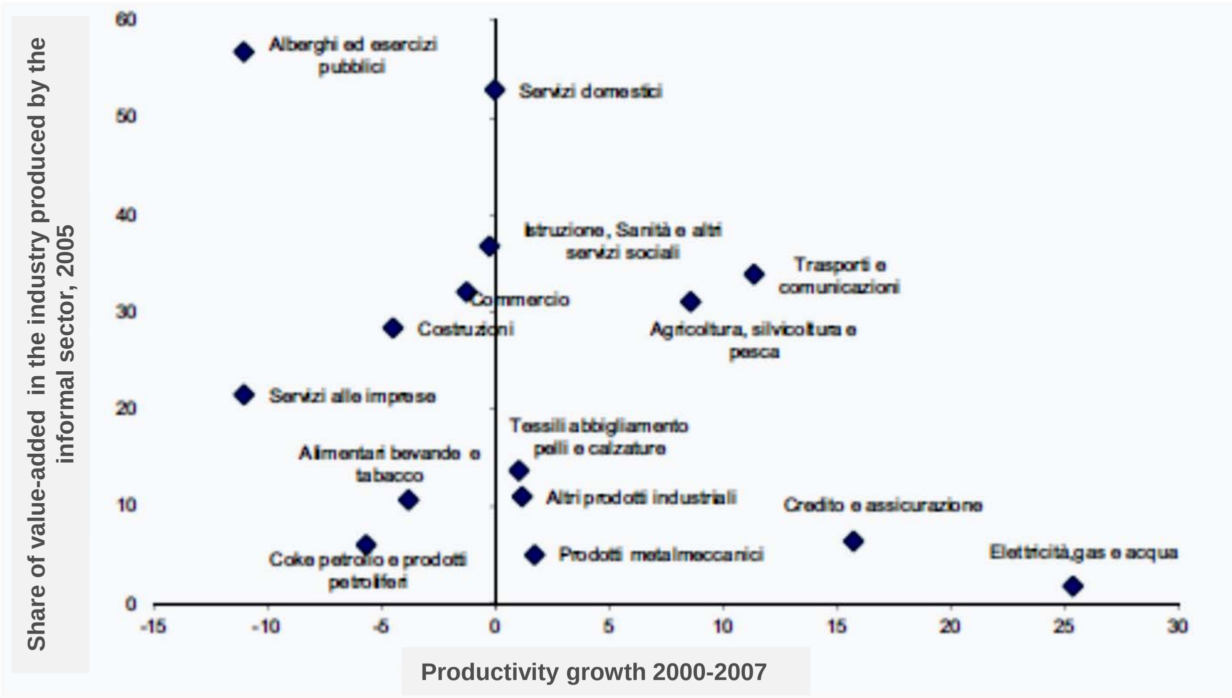
Italy has numerous small and medium size firms and only few large ones



Source: EFIGIE cross country report

Productivity growth is negatively correlated with tax evasion

- Productivity growth is lower in industries where the informal area is larger.
- Causes: under measurement of output and sales, less pressure to innovate and invest, more incentives to stay small.



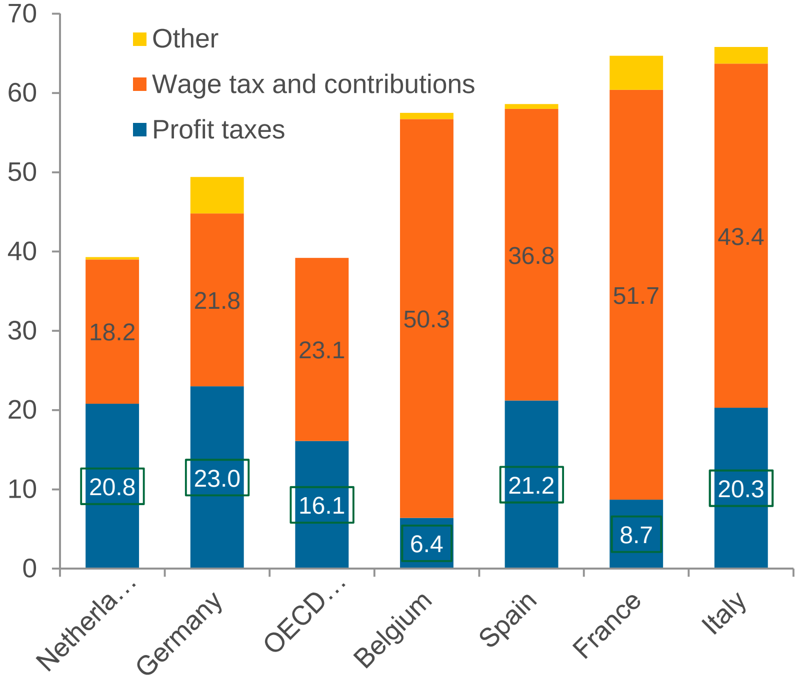
Source: Istat, Rapporto Annuale 2012, Figure 3.34.

Reforms

The tax regime needs a fix

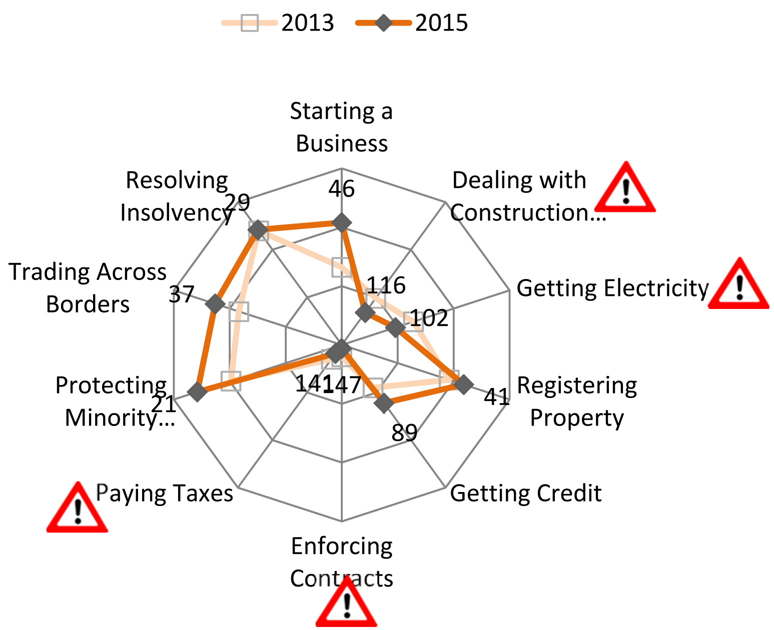
The total tax rate business firms face is among the highest in the Eurozone. Another issue is the complexity and the instability of the tax code.

Doing-Business 2015 – total tax rate faced by a representative firm



Source: IFC and World Bank, Doing Business 2014.

Doing-Business 2015 rankings vs. 2013

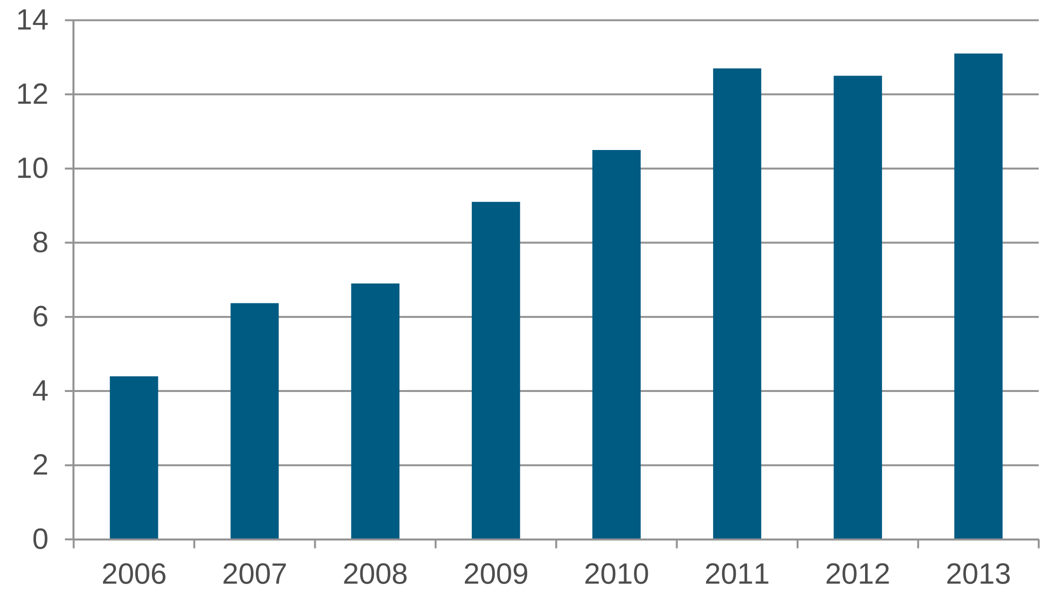


Source: IFC and World Bank, Doing Business 2015.

Dealing with tax evasion: a work in progress

- New tools to identify potential tax evaders will become operational in coming months (a screening of financial transactions and a check on individual expenditures)
- Limit of EUR 1000 for cash payments
- More cooperation with Social Security to target and investigate firms employing illegal workers

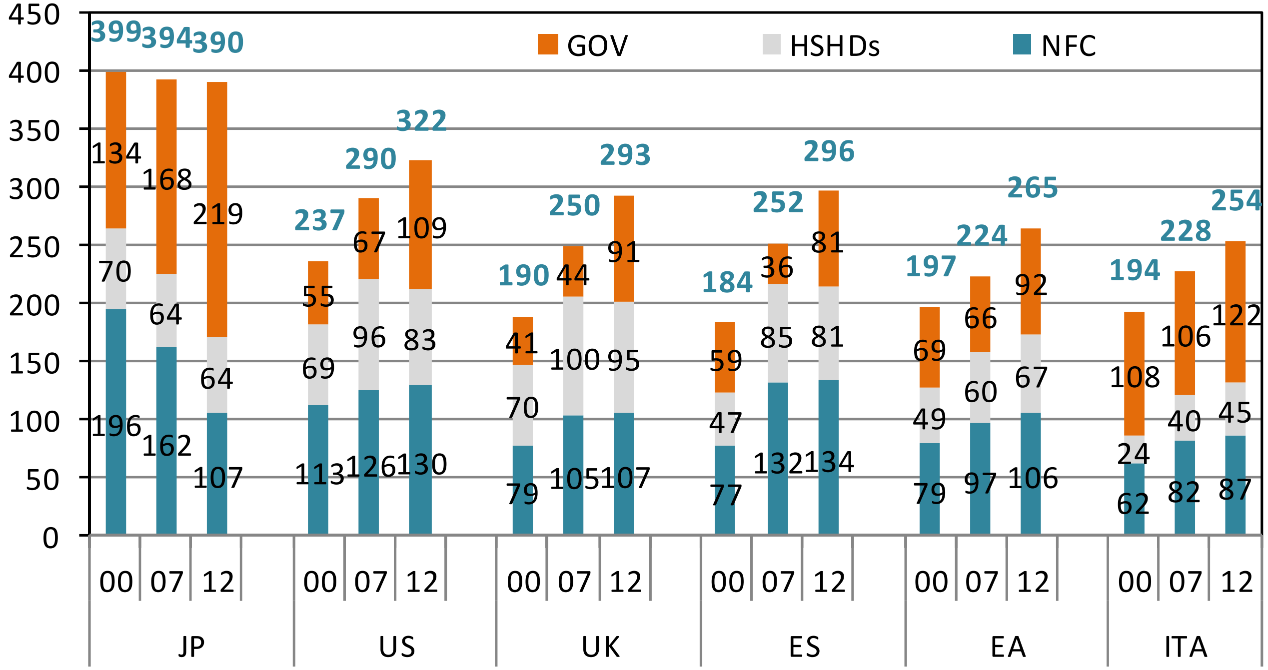
Recovered revenues



Source: Ministry of Economy and Finance – Revenue Agency.

Not only public, but also private…
(lesson from the crisis #1)

- Italy's large public debt is balanced by low private debt.



Source: Intesa Sanpaolo Research based on various sources (Eurostat, national central banks, European Commission etc.)

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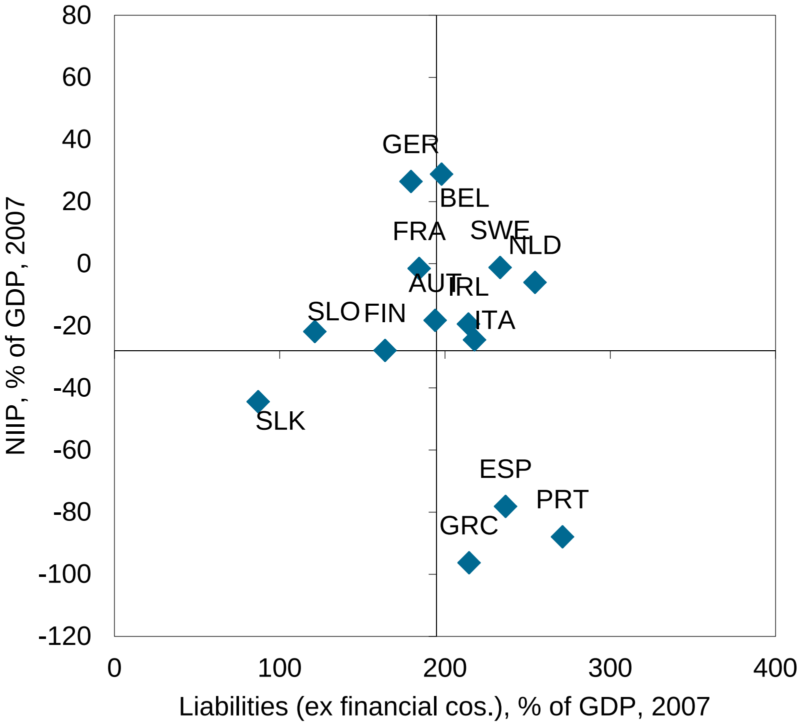
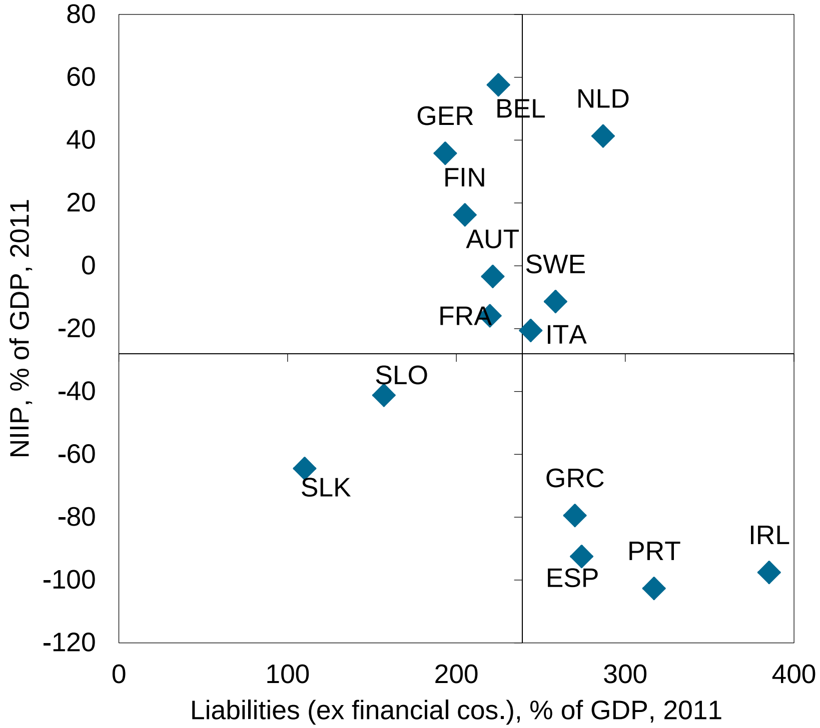
…& foreign debt matter (lesson from the crisis #2)

Net International Investment Position and Financial liabilities (% of GDP)

2007



2011



Notes: Liabilities sum private debt and government debt (as in the macroeconomic imbalances database). Axes are set equal to unweighted sample averages.

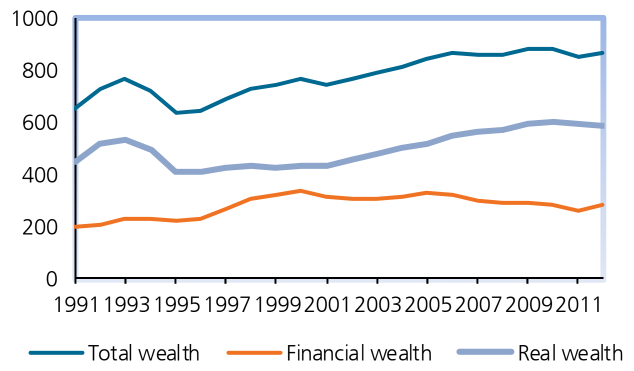
Source: Eurostat, Macroeconomic Imbalances Database

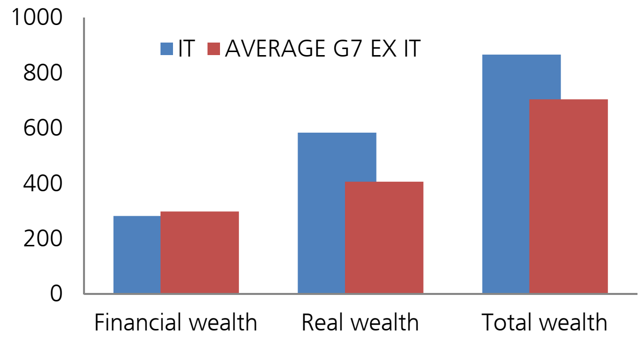
Not only financial but also real wealth matters

- The ratio of Italian households' net wealth to disposable income is 8.7, the highest among G7.

- The financial liabilities of Italian households represent 88.5% of disposable income, the lowest among G7.

- Italy's share on world net wealth is around 5.7% (Italy's share on world GDP is less than 3%, Italy's share on population less than 1%).

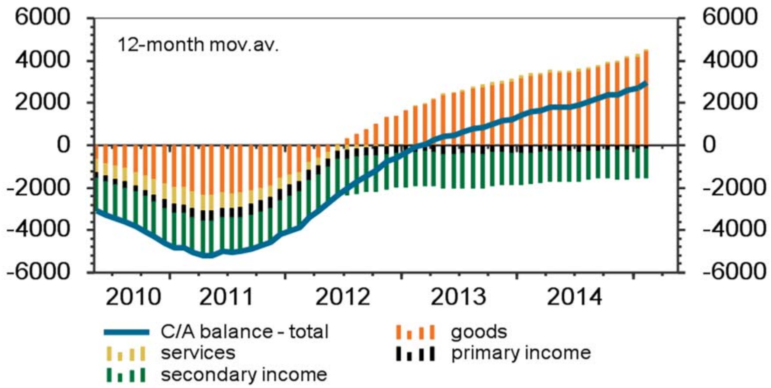




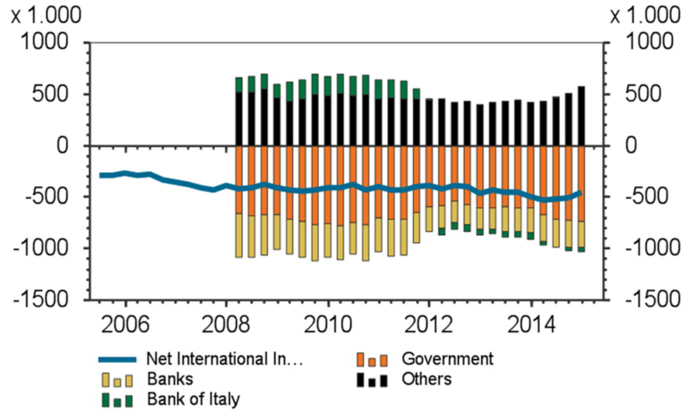
Source: OECD

The C/A surplus will improve the investment position

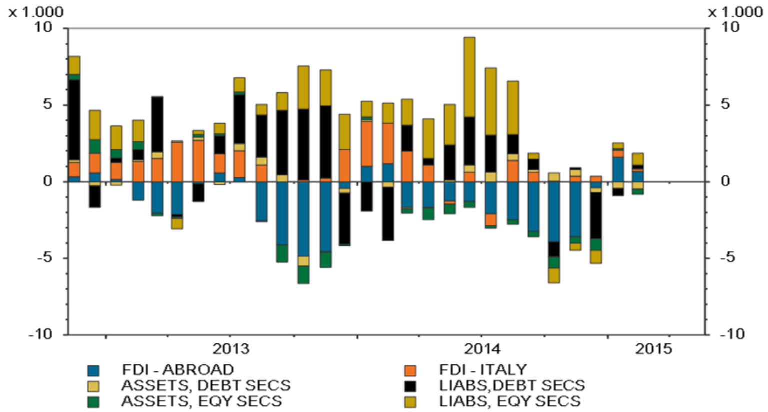
Current account balance (EUR Bn)



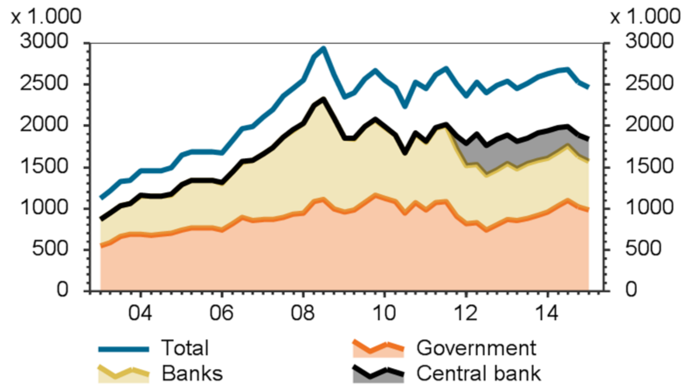
Net International Investment position (EUR Bn)



FDIs and portfolio flows



Gross External Debt (USD Bn)



Source: World Bank, Quarterly External Debt Statistics

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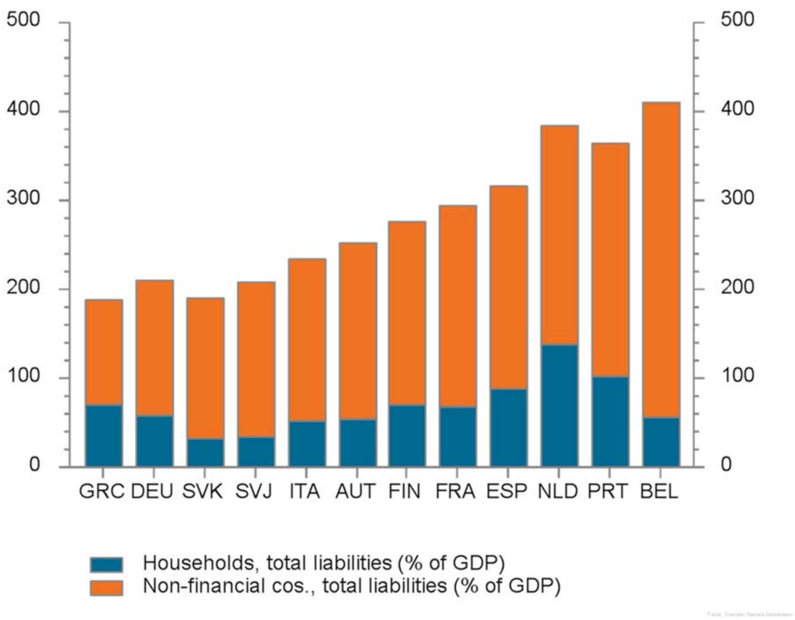
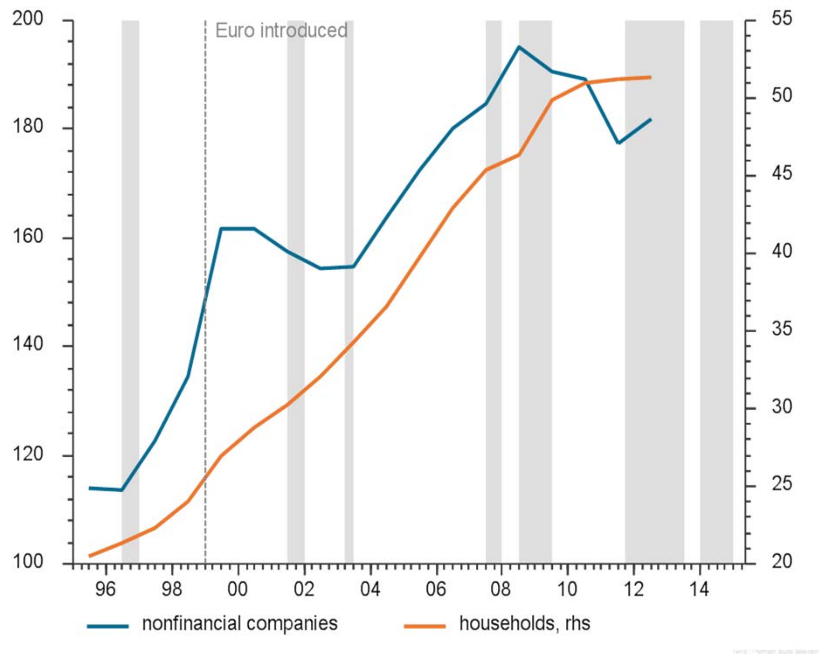
Low financial leverage in the household sector

Financial Liabilities (% of GDP), **2012**



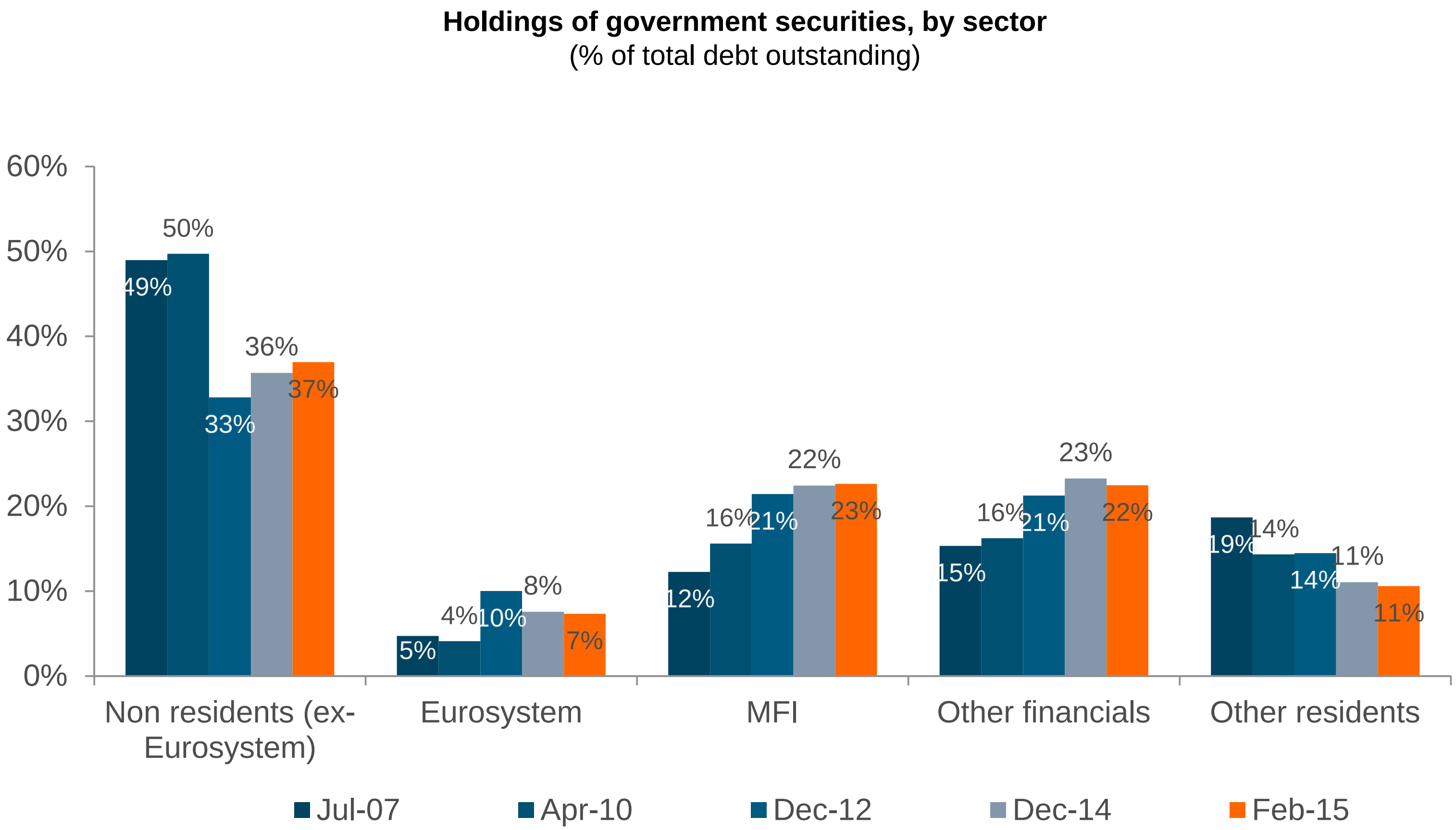
Italy – Financial Liabilities (% of GDP)



Total consolidated liabilities as a % of GDP.

Source: Eurostat, financial accounts.

Government debt by holding sector



Source: Intesa Sanpaolo estimates, based on Bank of Italy's data on government debt.

The split between Eurosystem and non-resident holdings is ISP's estimate, based on official data for BdI holdings and the official figures for the SMP programme.

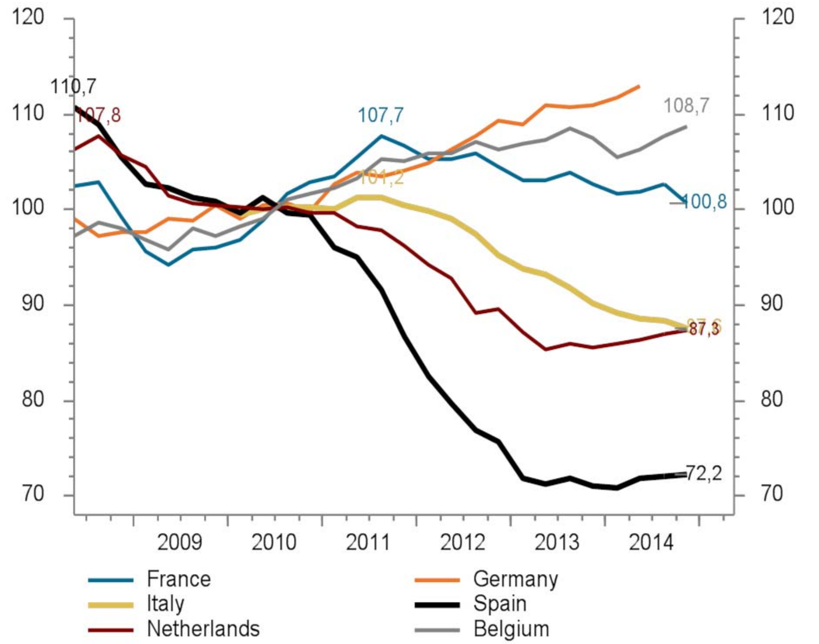
Rating of Govt debt (LT)

Scheduled publication dates for the reports relating to Italy’s sovereign rating in 2015		
	Current rating (outlook)	Next announcement date
Moody's	Baa2 (stable)	12 June
DBRS	A low (stable)	25 September
Moody's	Baa2 (stable)	9 October
Fitch	BBB+ (stable)	23 October
Standard & Poor's	BBB- (stable)	13 November

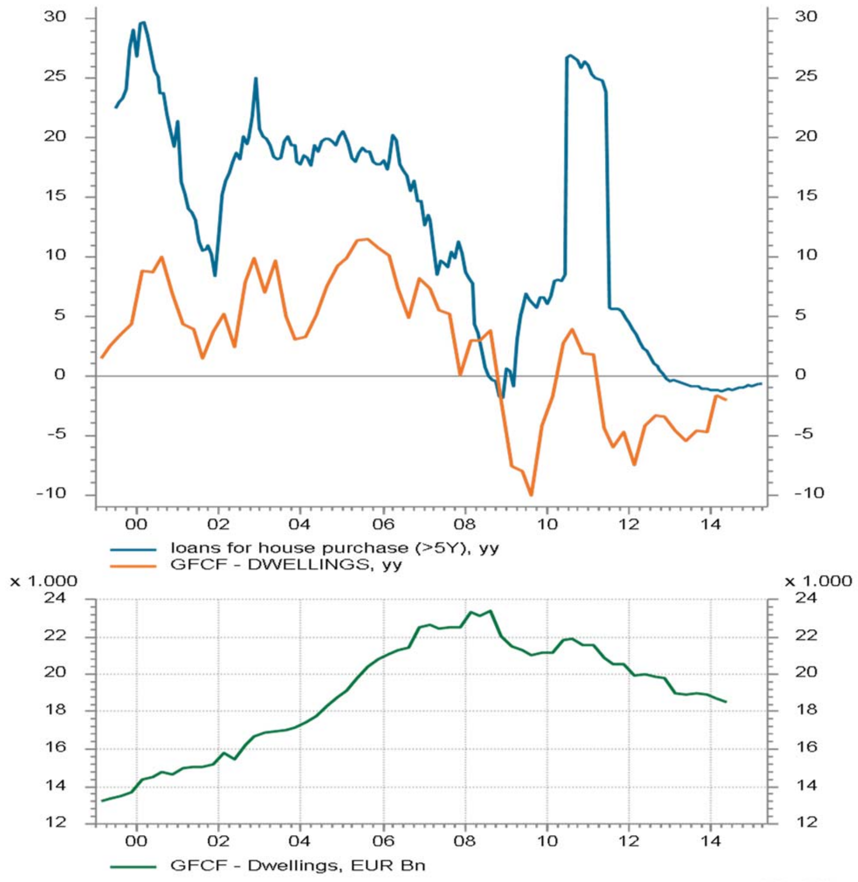
Source: rating agencies. Updated: May 14, 2015

Residential house prices

House price indexes

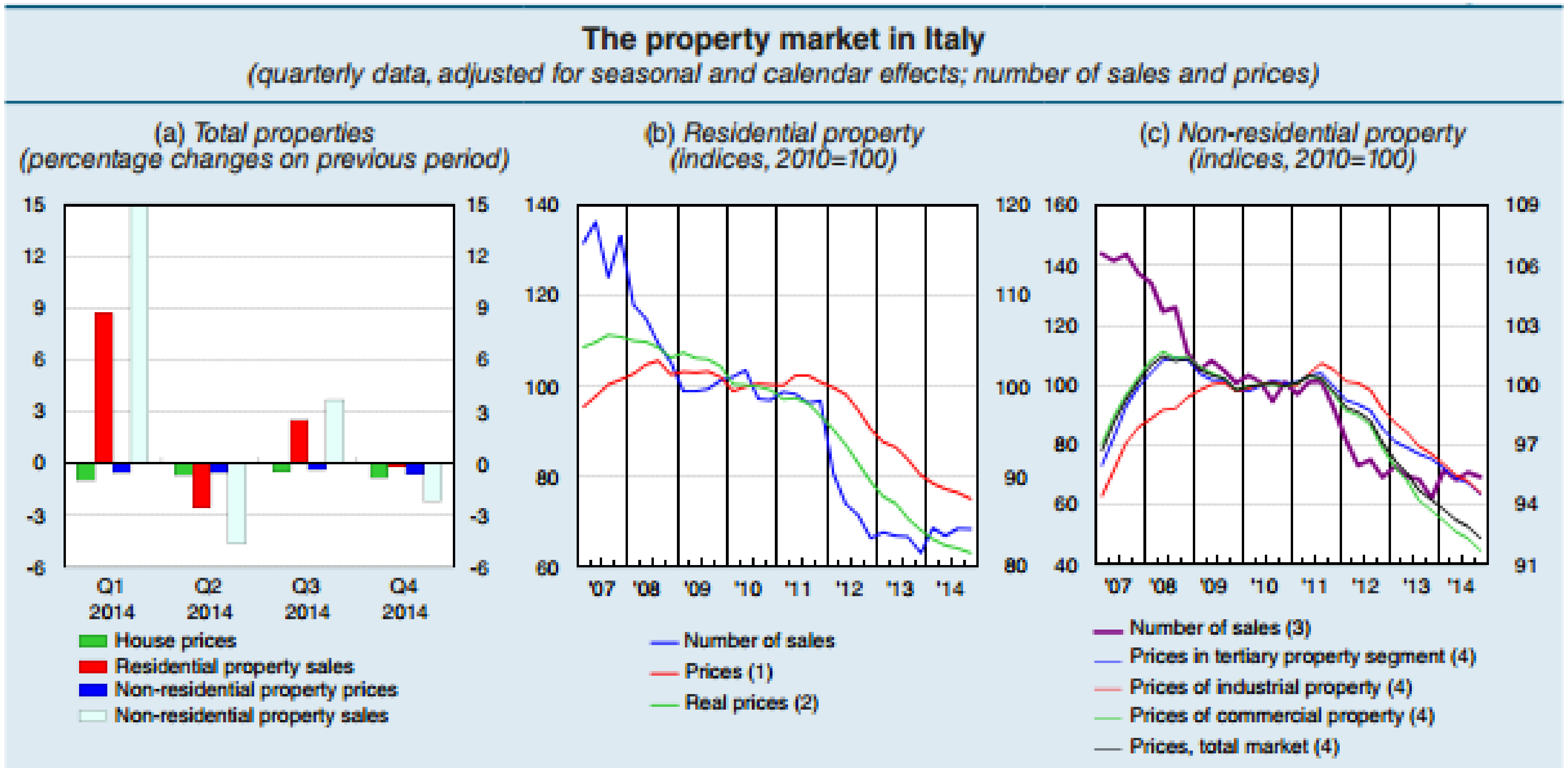


Spending in new dwellings and loans for house purchase



Rebased, 2010=100
Source: Eurostat

The property market in Italy

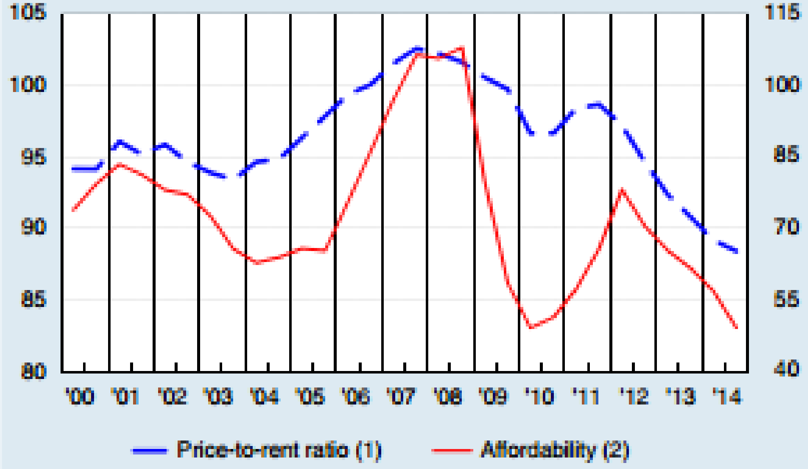


Sources: Based on data from the Bank of Italy, Istat, Osservatorio del Mercato Immobiliare (OMI), Nomisma and Scenari Immobiliari.
(1) Right-hand scale. – (2) Deflated using the change in consumer prices; right-hand scale. – (3) Total market. – (4) Right-hand scale. This experimental price indicator uses data drawn from transactions actually concluded on the market. The tertiary segment comprises office buildings and banks; commercial property comprises shops, shopping centres, and hotels; industrial property consists of buildings for industrial use.

Source: Bank of Italy

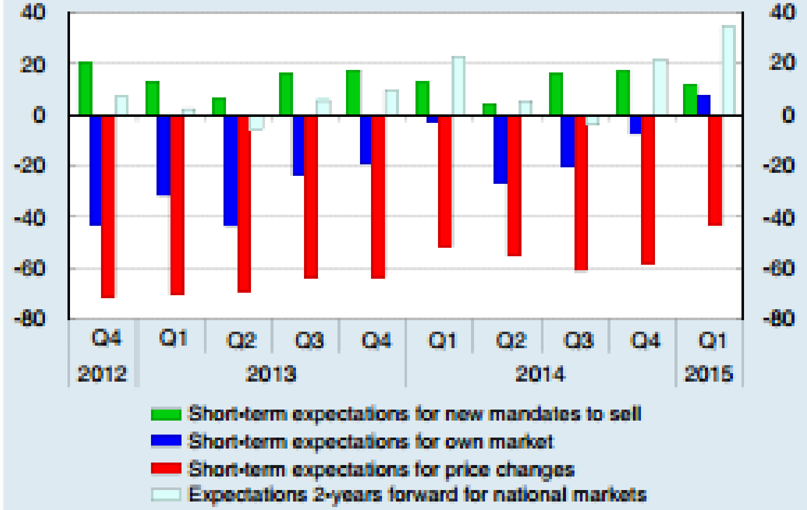
The property market in Italy (2)

Affordability of housing and ratio of house prices to rents in Italy
(semi-annual data; indices, 1992-2013 average=100)



Sources: Based on data from the Bank of Italy, Istat, Osservatorio Immobiliare Italiano (OMI) and Consulente immobiliare.
(1) Ratio of house prices to rents for new rental contracts. – (2) Right-hand scale. Ratio of debt service on new mortgage loans – proxied by the product of house prices and interest rates – to household disposable income; a decrease indicates that housing is more affordable.

Estate agents' expectations in Italy (1)
(quarterly data; balance of responses)



Sources: Based on data from the Bank of Italy, Osservatorio Mercato Immobiliare (OMI) and Tecnoborsa.
(1) Data from the survey conducted by the Bank of Italy, OMI and Tecnoborsa. Balances between the percentages of replies indicating a situation that is improving or worsening. Short-term expectations refer to the quarter following that indicated; medium-term expectations refer to a 2-year horizon.

Source: Bank of Italy

Italian banks and non-bank intermediaries

	31.12.03			31.12.13		
	Number of intermediaries			Number of intermediaries		
	Group members[1]	Non-group[2]	Total	Group members[1]	Non-group[2]	Total
Banking groups	-	-	82	-	-	77
Investment firm groups	-	-	-	-	-	18
Banks	225	563	788	160	524	684
of which:						
limited company banks	197	47	244	131	51	182
cooperative banks(banche popolari)	18	20	38	18	19	37
mutual banks (banche di credito cooperativo	10	435	445	10	375	385
branches of foreign banks	-	61	61	1	79	80
Investment firms	35	97	132	10	84	94
Asset management companies	66	87	153	21	131	152
Financial Companies[3]	304	1549	1,853	80	645	725
Electronic money institutions	-	-	-	1	3	4
Payment institutions	-	-	-	7	36	43
Other supervised intermediaries[4]	-	-	-	-	2	2

Source: Supervisory registers and lists. Notes: 1) Includes parent banks. The limited company banks include those belonging to groups headed by a cooperative bank (41 in 2012 and 34 in 2013); 2) Includes investment firms (23 in 2013), seven asset management companies and one financial company entered in the register under Article 106 of the Consolidated Law on Banking belonging to investment firm groups; 3) Financial Companies entered in the register related to article 106 and 107 of the Consolidated Law on Banking; 4) Bancoposta and Cassa Depositi e Prestiti

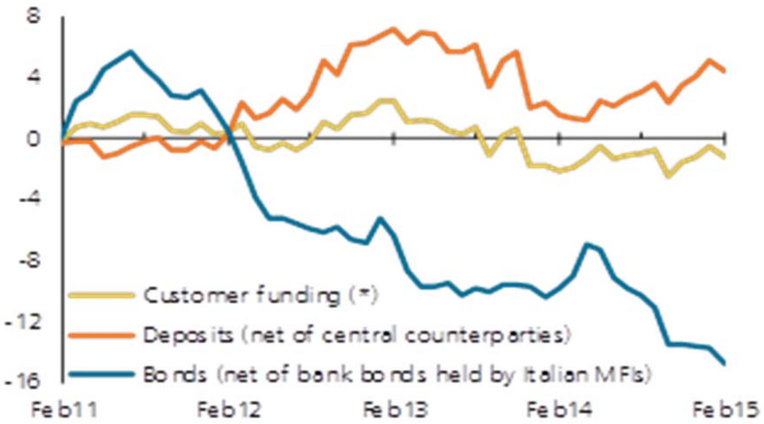
The Italian banking industry at a glance

- 952 ABI members*
- **159 independent banks and 77 banking groups***
- **22 listed independent banks and banking groups****
- **306,313 employees***
- **32,881 branches***
- **37M current accounts***
- 17.3M current accounts online
- 19.8M pre-paid cards*
- 27.6M credit cards*
- 45.7M debit cards*
- 42,908 ATMs*

- **EUR 3,441Bn total banks' assets***
- **252% total banks' assets/GDP***
- **EUR 1,717Bn of total funding (deposits, bonds[1])*****
- **EUR 1,847Bn of total loans to the economy*****
- **EUR 834Bn of total loans to enterprises*****
- **…of which 54% granted to SMEs (%)*****
- **0.4% of GDP of State aid to the banking sector during the crisis****

Notes: 1) excluding MFIs and Gen. Gov. *2013 figures; ** 2014 figures; *** February 2014. Source: ABI

Banks - Funding

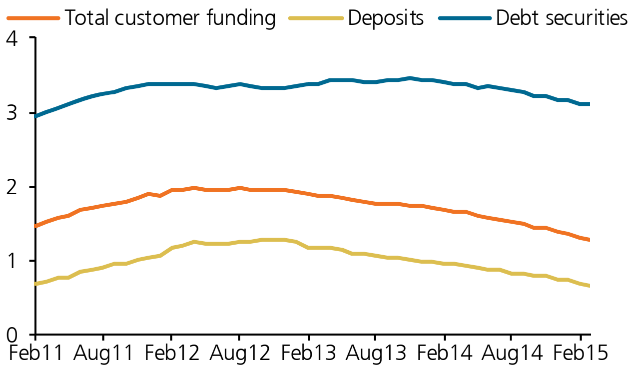


Banks' total customer funding fell 1.2% yoy in February (vs. -0.6% in January):

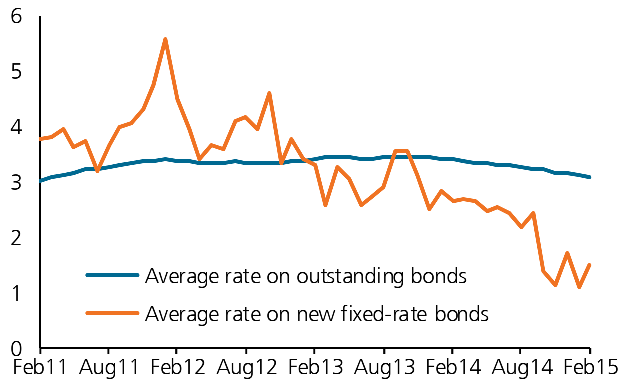
- Bank deposits increased 4.3%, slightly less than in January (+5%)
- Bank bonds recorded a double digit decrease at -14.7% yoy in February (vs. -13.8% in January), as yields are unattractive and banks do not compete for funding.

The cost of funding is declining.

Rates on outstanding bank funding (%)

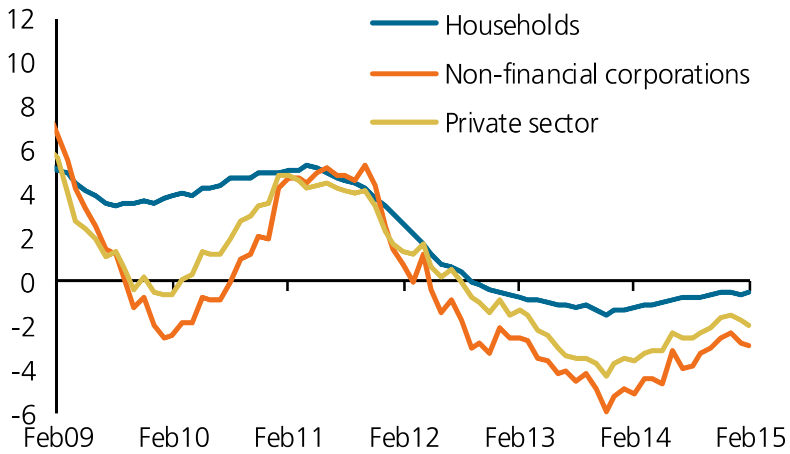


Rates on bank bonds: outstanding and new issues (%)

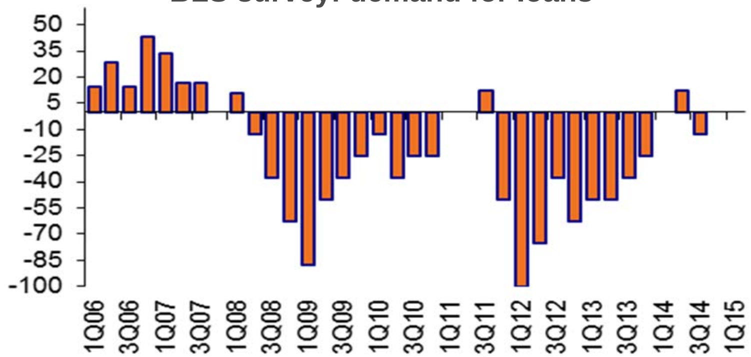


Banks - Loan volumes

Loans – y/y % change



BLS survey: demand for loans



- Loans to the private sector in February 2015 fell by -2.0% yoy (vs. -1.8% in January 2015):
  - Loans to businesses fell by -3.0% yoy (vs. -2.7% in January)
  - Lending to households dropped -0.4% yoy (vs. -0.5% in January)

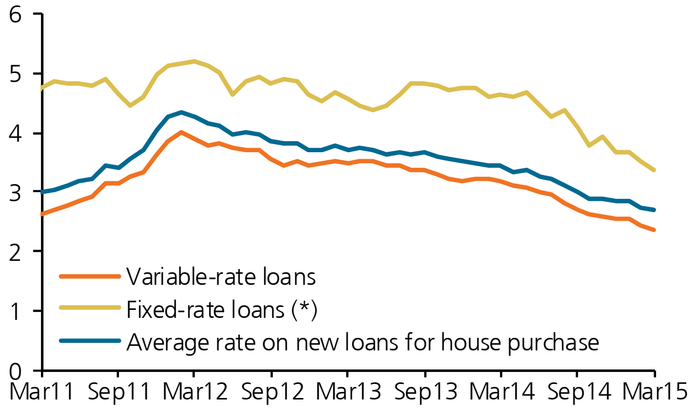
Demand for loans to enterprises:

- Euro Area: net loan demand positive in 1Q15 (+6% vs. 18.1% in 4Q14); expected strong increase in 2Q15
- Italy: loan demand assessment still unchanged at nil in 1Q15; strong increase expected in 2Q15 (+75%)

Loan demand supported by working capital, debt restructuring and interest rates, but financing needs due to fixed investments and M&A deals still muted

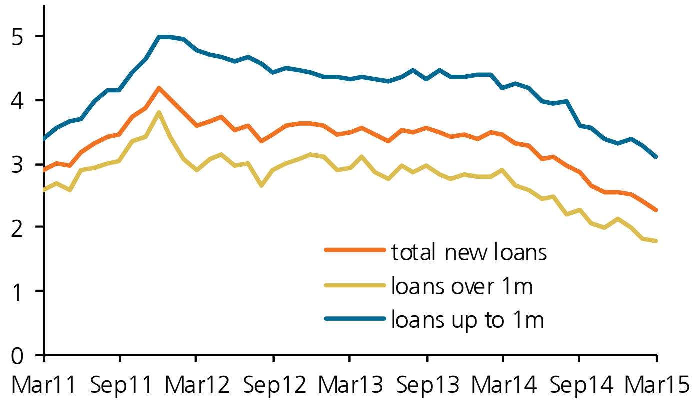
Rates on new loans

Rates on new household loans for house purchase (%)



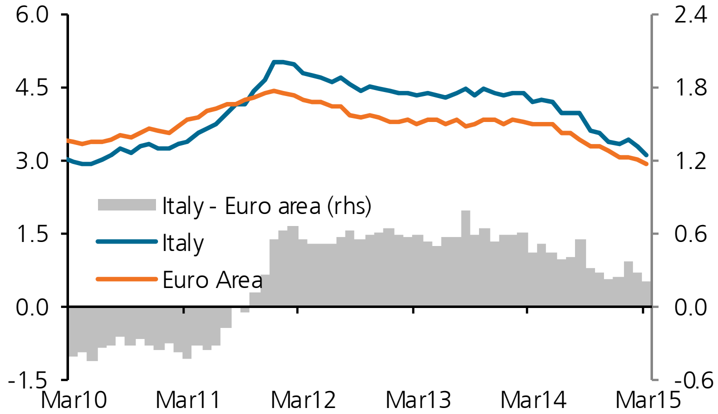
Note: (*) Initial rate fixation period over 10 years
Source: Bank of Italy

Rates on new loans to non-financial businesses in Italy (%)



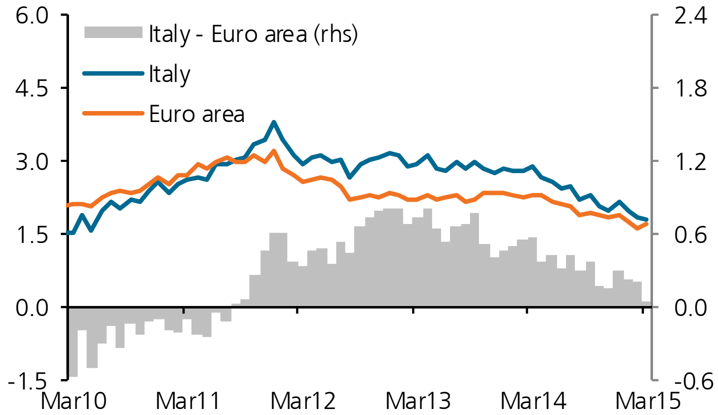
Source: Bank of Italy

Average rate on new loans of up to EUR 1M to non-financial businesses, Italy – Euro area comparison (%)



Source: Bank of Italy, ECB and Intesa Sanpaolo calculations

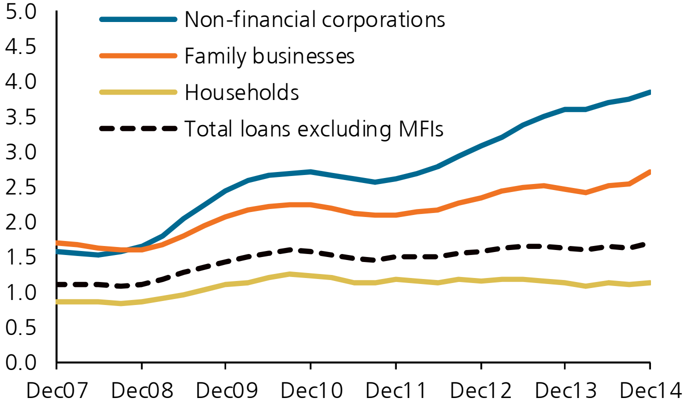
Average rate on new loans of over EUR 1M to non-financial businesses, Italy – Euro area comparison (%)



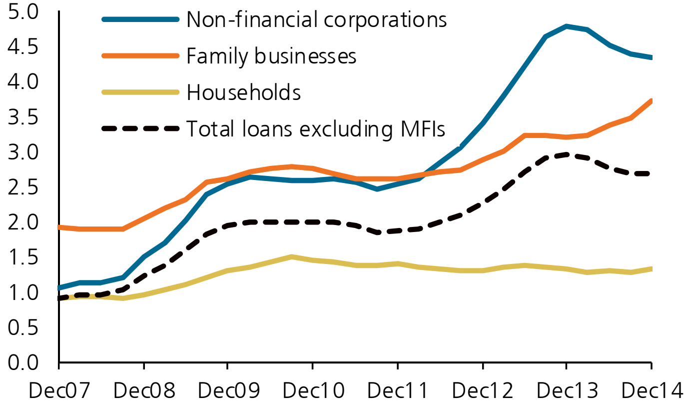
Source: Bank of Italy, ECB and Intesa Sanpaolo calculations

The loan default rate is still on the rise

Annual loan default rate, by number of counterparties (*) (%)



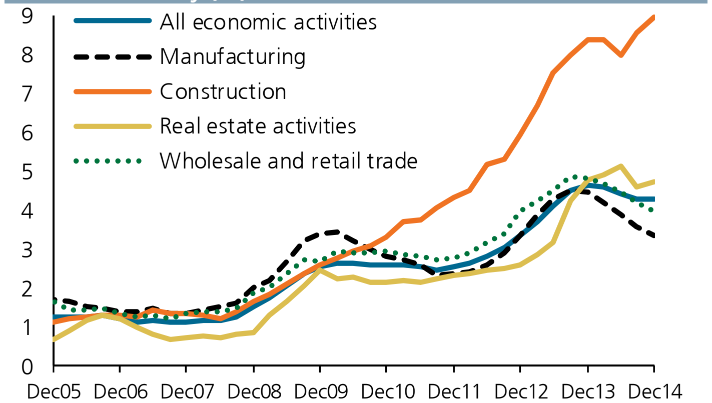
Annual loan default rate, by amounts (*) (%)



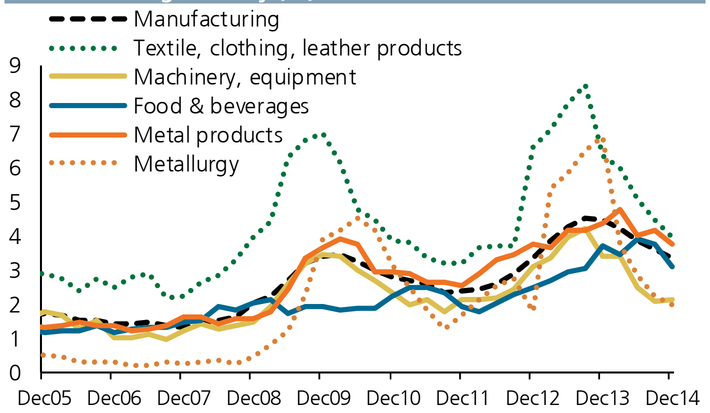
Note: (*) default rate for loan facilities calculated on the number of counterparties. Ratio of counterparties with performing loans that became "adjusted bad debts" ("*sofferenze rettificate*") in the quarter (flow) and outstanding amounts of counterparties with performing loans at the start of the period. Annual figures are calculated as the sum of the four quarters ending with the quarter under review. Figures refer to banks, financial businesses and other entities reporting to the Central Credit Register.

Source: Bank of Italy and Intesa Sanpaolo Research Department calculations.

Annual default rate (*) of loans to the production sector by economic activity (%)



Annual default rate (*) of loans to the main sectors of the manufacturing industry (%)



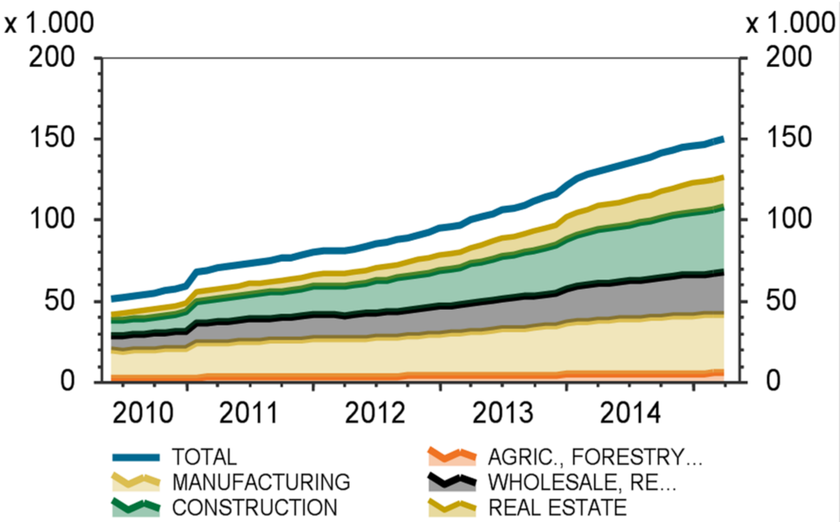
Note: (*) default rate for loan facilities. Ratio of "adjusted bad debts" ("*sofferenze rettificate*") in the quarter to the volume of loans not included in the "adjusted bad debts" category. Annual figures are calculated as the sum of the four quarters ending with the quarter under review. Figures refer to banks, financial corporations and other entities reporting to the Central Credit Register.

Source: Bank of Italy and Intesa Sanpaolo Research Department calculations.

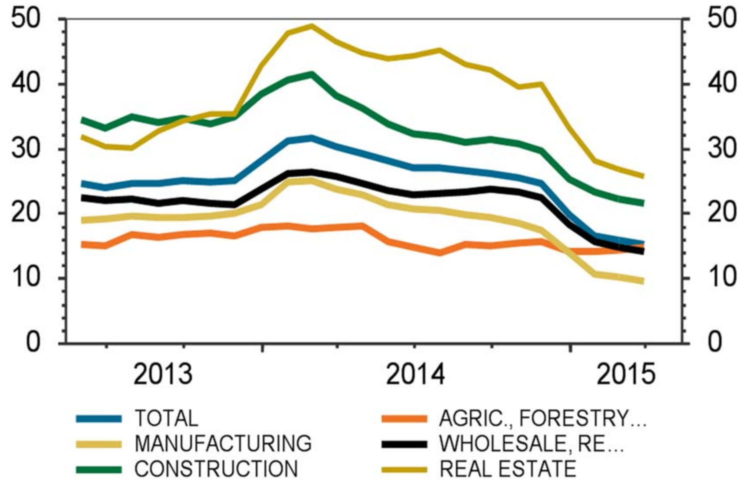
Banks: bad debts are still rising, but at a slower pace

The trend for credit quality still negative, with gross bad debts rising 15.3% yoy in February (+15.4% in January)

Bad debt, by sector (EUR mln)



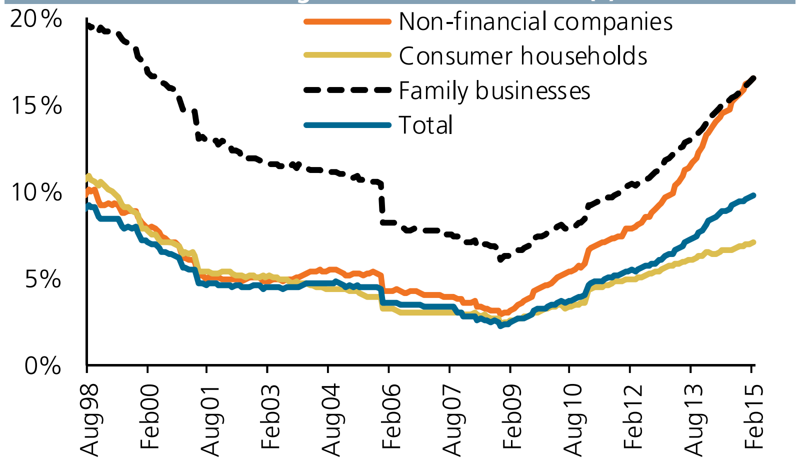
Bad debt, by sector (y/y % change)



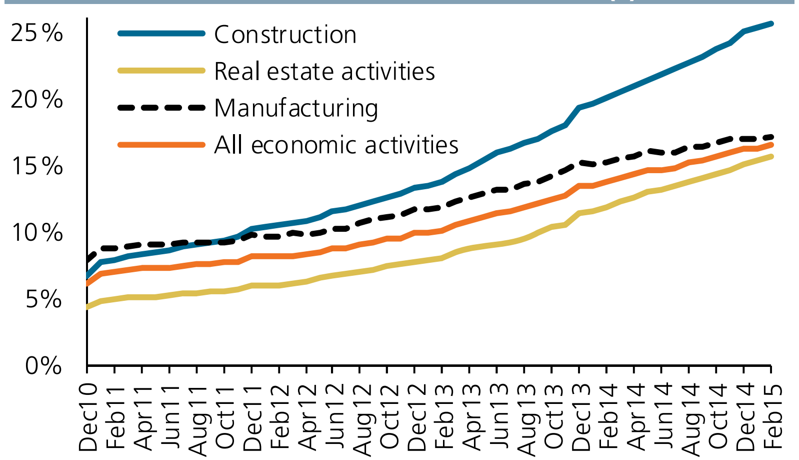
Source: Bank of Italy, Thomson Reuters Datastream Charting

Gross non-performing loans still high

Bad loans in the banking sector as a % of loans (*)



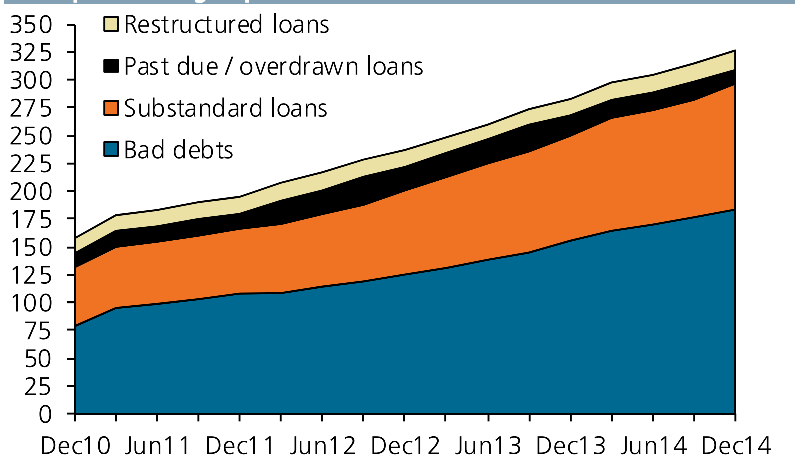
Bad loans in the business sector as a % of loans (*)



(*) The change over time was the result of several events that broke the continuity of the time series. Among these, in January 2011 bad loans were affected by corporate transactions carried out by some banking groups.

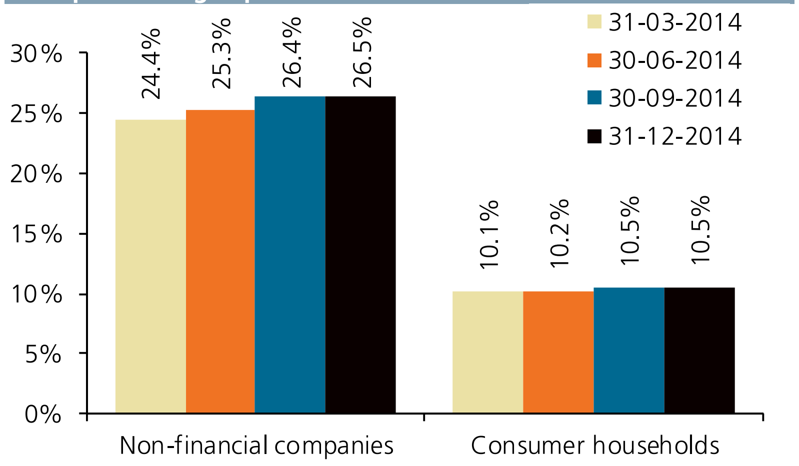
Source: Bank of Italy and Intesa Sanpaolo Research Department calculations.

Non-performing exposures in EUR Bn



Source: Bank of Italy and Intesa Sanpaolo Research Department calculations

Non-performing exposures as a % of loans



Source: Bank of Italy and Intesa Sanpaolo Research Department calculations

2104 ECB/EBA AQR and Stress Test - Italian Banks

A total of 15 Italian banks participated in the ECB's stress test. For Italy, the overall findings were:

- Nine Italian banks out of 15 assessed showed they had a potential capital shortfall of a total of EUR 9.7Bn. When taking into account the capital increases undertaken in 2014 up to end-September, the potential capital shortfall actually now relates to only four banks, for a lower amount of EUR 3.3Bn

- Moreover, we note that in all cases the shortfall derived from the stress test; in fact, no Italian banks recorded a capital shortfall stemming from the AQR

- In addition, other capital-strengthening actions beyond rights issues were carried out by Italian banks in the January-September 2014 period, mainly assets disposal, finalisation of internal model authorisation by Regulators and elimination of specific capital requirements (“capital add-ons in the case of BPM)

- Taking into account these other capital enhancements, the potential capital shortfall related to only two Italian banks, for the further lower amount of EUR 2.9Bn (MPS, EUR 2.1Bn and Carige, EUR 814M)

Source: Intesa Sanpaolo Research elaboration, ECB/EBA

2104 ECB/EBA AQR and Stress Test - Italian Banks

Italian Banks: Results of ECB Comprehensive Assessment 2014 - Capital Surplus / Shortfall									
	Results disclosed by the ECB							Results including other capital strengthening measures	
	Exc./Short. AQR[1]	Exc./Short. ST Bas.[2]	Exc./Short. ST Adv.[3]	Min Exc./Max Short.[4]	Main capital actions[5]	Exc./Short.	Exc. AQR, incl. Main capital actions	Other capital action[6]	Final Exc./Short. incl. all capital actions
EUR M	A	B	C	D = min(A,B,C)	E	F = D+E	G = A+E	H	I = D+E+H
UCG	6,451	6,167	5,580	5,580	1,235	6,815	7,686	1,932	8,747
ISP	10,548	9,419	8,724	8,724	1,756	10,480	12,304	417	10,897
MPS	-845	-1,516	-4,250	-4,250	2,139	-2,111	1,294	0	-2,111
BP	-34	-693	-427	-693	1,756	1,063	1,722	120	1,183
UBI	2,432	1,848	1,743	1,743	18	1,761	2,450	0	1,761
BPER	162	149	-128	-128	759	631	921	0	631
Mediobanca	205	600	445	205	0	205	205	560	765
BPM	-482	-647	-684	-684	518	-166	36	879	713
ICCREA H.	356	385	256	256	0	256	356	0	256
BP Vicenza	-119	-158	-682	-682	459	-223	340	253	30
CARIGE	-952	-1,321	-1,835	-1,835	1,021	-814	69	0	-814
Veneto B.	-583	-574	-714	-714	738	24	155	0	24
BP Sondrio	-148	-183	-318	-318	343	26	195	0	26
CREDEM	463	480	599	463	0	463	463	0	463
CREVAL	-88	-197	-377	-377	415	38	327	12	50
Total									
Shortfall (EUR M)	-3,251	-5,289	-9,415	-9,679	8,148	-3,313	0	1,132	-2,924
Excess (EUR M)	20,617	19,048	17,347	16,971	3,009	21,762	28,523	3,041	25,546
Italian banks in shortfall				9		4	0		2

Exc./Short. = Capital Excess/Shortfall; ST Bas. = Stress test baseline; ST Adv. = Stress test adverse. 1) Capital surplus/ shortfall vs 8% CET1 ratio threshold at 31.12.2013 (item B8 of

Exc./Short. = Capital Excess/Shortfall; ST Bas. = Stress test baseline; ST Adv. = Stress test adverse. 1) Capital surplus/ shortfall vs AQR 8% CET1 ratio threshold at 31.12.2013; 2) Capital surplus/ shortfall vsST Baseline 8% CET1 ratio threshold at 31.12.2013; 3) Capital surplus/ shortfall vs ST Adverse 5.5% CET1 ratio threshold at 31.12.2013; 4) Minimum surplus or maximum shortfall registered at 31.12.2013; 5) Major capital strengthening measures carried out in the period January-September 2014, mainly capital increases (as per ECB CA templates); and 6) Other capital strengthening measures carried out in the period January-September 2014, in addition to Main capital actions of note 5 (Bank of Italy templates). Source: Intesa Sanpaolo Research elaboration on ECB, EBA and Bank of Italy

2014 ECB/EBA AQR and Stress Test - Italian Banks with capital shortfall

2014 AQR/Stress tests: Italian banks with capital shortfalls

	CET1 Ratio				AQR/ST Impact			Shortfall	Strengthening Capital Actions			Final Shortfall
	YE13	AQR	ST Bas.	ST Adv.	AQR	ST Bas.	ST Adv.		Main	Other	Total	
	%	%	%	%	bps	bps	bps	EUR M	EUR M	EUR M	EUR M	EUR M
MPS	10.2	7.0	6.0	-0.1	-320	-97	-708	-4,250	2,139	0	2,139	-2,111
CARIGE	5.2	3.9	2.3	-2.4	-129	-154	-624	-1,835	1,021	-	1,021	-814
BP	10.1	7.9	6.7	4.7	-212	-124	-320	-693	1,756	120	1,876	-
BPER	9.2	8.4	8.3	5.2	-78	-4	-316	-128	759	0	759	-
BPM	7.3	6.9	6.5	4.0	-40	-35	-293	-684	518	879	1,397	-
BP Vicenza	9.4	7.6	7.5	3.2	-179	-13	-441	-682	459	253	712	-
Veneto B.	7.3	5.7	5.8	2.7	-163	8	-296	-714	738	-	738	-
Bp Sondrio	8.2	7.4	7.2	4.2	-78	-13	-317	-318	343	-	343	-
CREVAL	8.8	7.5	7.0	3.5	-127	-57	-401	-377	415	12	427	-
N. of Banks with shortfalls								**9**				**2**

ST Bas. = Stress test baseline; ST Adv. = Stress test adverse. Source: Intesa Sanpaolo elaboration on ECB/EBA and Bank of Italy

EU-AQR and Stress Test: Our View on Italy

In our view, overall the ECB's CA outcome on Italian banks has confirmed their vulnerability to the weak economic cycle, as most of the capital shortfall was driven by a combination of the stress test adverse scenario and higher provisioning on non-performing exposures

As we expected, the significant fresh capital raised in 2014 (mainly by already distressed banks and medium-sized banks) was the key factor to reduce the number of failing banks and, was positive in general, in our opinion, to build up a buffer in light of the sluggish domestic economy

Going forward, we believe the health check should also represent a driver to find a solution to the reduction of the huge amount of NPEs, and to call for further consolidation in the domestic system

Source: Intesa Sanpaolo Research elaboration

2104 Stress Test: Italian adverse scenario

EBA EU-wide stress test includes the following main assumptions for Italy in the adverse scenario:

- (i) A prolonged mild recession, with a 2014-16 cumulative deviation of GDP growth from the baseline scenario of -6.3% (vs. -7.3% for the European Union adverse scenario)
- (ii) A sell-off in stock and equities, with a 2014-16 cumulative deviation from baseline levels of -58% (vs. -54% for EU)
- (iii) A destabilisation of the real estate market, with a 2014-16 cumulative deviation in residential property prices of -14% and of -9.9% in the commercial component (vs. -23% and -16% for the EU, respectively)
- (iv) A sharp increase in government bond yields, with a 2014-16 cumulative deviation of + 503bps (vs. +370bps for the EU)
- (v) Direct sovereign exposures (loans and bonds) will be subject to valuation haircuts, which look harsh at the longer maturities ranging from 0.2% to 28%

Source: Intesa Sanpaolo Research elaboration, EBA

The Italian banking system: rating

Italian banking industry ratings

S&P		Moody's		Fitch	
Last action	21.01.2015	Last action	15.07.2014	Last action[5]	03.12.2014
Sector outlook	-	Sector outlook[2]	Negative	Sector outlook	Negative
BICRA [1]	Group 6	Macro Profile[3] (17.03.2015)	Moderate +	BSI[4]	bbb
Italy rating	BBB- /S*/ A-3	Italy rating	Baa2 /S*/ P-2	Italy rating	BBB+ / S/ F2
Action	1n Downgrade	Action	Confirmed	Action	Confirmed
Last action	05.12.2014	Last action	14.02.2014	Last action	24.10.2014

NG = negative outlook. Notes: *) Moody's Outlook upgraded from Negative to Stable; 1) BICRA = Banking Industry Country Risk Assessment, includes 10 groups of which Group 1 is the least risky; 2) Industry outlook represents Moody's outlook for credit conditions in the sector over 12-18 months; 3) Banking System Macro Profile = five level from Very Strong down to Very Weak. It is the rating input to determine each bank's Baseline Credit Assessment, capturing the system-wyde factors that are predictive of the propensity of banks to fail; 4) BSI = Bank System Indicator, ranging from levels aa, bbb, bb and ccc/cc/c; and 5) Last action refers to Sector outlook confirmed at Negative. Source: rating agencies

- S&P, on 9 March 2015 confirmed that Italian bank prospects remained weak in 2015; on 21 January the agency downgraded Italy's banking sector BICRA to group 6 with a stable trend (from 5, negative)
- Moody's, on 15 July 2014 confirmed a negative outlook for the Italian banking system for the fifth consecutive year. On March 17 it assigned Italy's banking system a Macro Profile of Moderate + within its revised bank rating policy
- Fitch, on 3 Dec 2014, amid a scenario of lower downside risks, confirmed its negative outlook on Italian banks, due to the ongoing asset quality deterioration and expected weak profitability

Reform of Cooperative banks

- On 20 January 2015, Italy' 's cabinet approved a reform of the cooperative bank sector (*banche popolari*), then ratified by Parliament on 24 March (Law 24 n. 33)
- It could be enacted potentially by the end of 2016 (within 18 months from the issue of the implementing regulation by the Bank of Italy)
- The Bank of Italy, on 9 April, published for consultation the implementing regulation. Consultation will last on 24 April
- The reform will apply to 10 larger cooperative banks with more than EUR 8Bn in assets, representing some 14% of total asset system-wise.
- The reforms envisages:
  - Demutualisation (i.e. transformation into joint stock companies) of b*anche popolari* and removal of the one-shareholder-one-vote governance rule
  - For a two year transitional period since the approval of the Decree, banks can introduce a 5% shareholding limit, as an anti-hostile take-over measure; and
  - The set up of a minimum and maximum limit to the number of proxy votes in general meetings to improve participation

Banche Popolari under the reform

Italian Banche Popolare with total asset > EUR 8Bn (at YE14)

	Listed	Total Assets (EUR M)	Net Profit (EUR M)	Net Bad Debt ratio (%)	CET1 Phase-in ratio (%)	Employees	Branches
Banco Popolare	Yes	123,082	-1,946	7.5	11.9	17,179	1,858
UBI Banca	Yes	121,787	-726	4.7	12.3	18,132	1,670
Banca Popolare dell'Emilia Romagna	Yes	60,653	15	6.4	11.3	11,593	1,274
Banca Popolare di Milano	Yes	48,272	232	4.2	11.6	7,759	654
Banca Popolare di Vicenza	No	46,148*	-497	6.0	10.0	5,515	654
Veneto Banca	No	36500	-650	5.9	9.7	5,678*	555*
Banca Popolare di Sondrio	Yes	35,618	115	2.3	9.8	3,077*	343
Credito Valtellinese	Yes	28,814	-325	5.8	11.0	4,275	539
Banca Popolare dell'Etruria e del Lazio[1]	Yes	12,308**	-126**	15.2**	5.9**	1,915**	186**
Banca Popolare di Bari	No	9,337***	17***	3.7***	14.2[2,***]	1,894***	192***
Total		**476,371**				**68,262**	**7,370**

Notes: 1) BP dell'Etruria e del Lazio under Extraordinary Administration; 2) BP di Bari: core Tier 1 capital ratio under Basel 2; (*) as at June 2014; (**) as at September 2014; and (***) as at YE13. Source: companies' data

Our view is overall positive

- The reform would be positive for governance because cooperative bank structures are more vulnerable to interference from local politics, current and retired employees and other local connections

- However, we do not expect that the mandatory conversion into joint-stock companies (broader access to capital markets) and improved governance rules (removal of one-vote-per shareholder structure) would necessarily translate into a material improvement of cooperative bank credit profiles

- The transformation into a limited company combined with the cooperative banks' widespread ownership may facilitate a change of corporate control, thus paving the way to further consolidation within the banking system

- We regard the consolidation process as positive especially for medium-sized banks and expect friendly mergers as more in line with the Italian "norm", but the timing is uncertain and could be long

Appendix (1/2)

Analyst Certification

The financial analysts who prepared this report, and whose names and roles appear on the next page, certify that:

(1) The views expressed on companies mentioned herein accurately reflect independent, fair and balanced personal views;

(2) No direct or indirect compensation has been or will be received in exchange for any views expressed.

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Appendix (2/2)

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Trading Ideas are based on the market's expectations, investors' positioning and technical, quantitative or qualitative aspects. They take into account the key macro and market events and to what extent they have already been discounted in yields and/or market spreads. They are also based on events which are expected to affect the market trend in terms of yields and/or spreads in the short-medium term. The Trading Ideas may refer to both cash and derivative instruments and indicate a precise target or yield range or a yield spread between different market curves or different maturities on the same curve. The relative valuations may be in terms of yield, asset swap spreads or benchmark spreads.

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