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FOCUS NOTES

Sustainability of Italy's public finances under question post budget announcement

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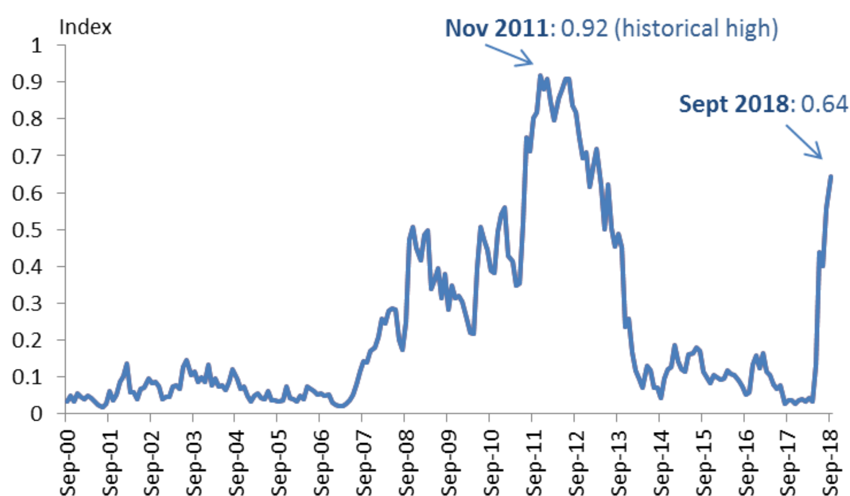
Executive Summary

The Italian government's Draft Budgetary Plan 2019, based on its earlier multi-year Economic and Financial Document, was submitted to the European Commission on 15 October as mandated by the European Semester, keeping the budget deficit target for 2019 at 2.4% of GDP. Although the planned fiscal relaxation is expected to boost overall economic activity in the short-term, fiscal expansion could lead to a lower positive contribution on real GDP growth than currently envisaged by the government, as a sizeable increase in bond yields, a tightening in financial conditions and a negative impact on confidence could potentially crowd out private investment and hurt consumption growth. Given the overly optimistic GDP growth path and the government's unwillingness to introduce large spending cuts ahead of the European Parliamentary elections in May 2019, the risk of significant fiscal slippage in the following years seems to have increased. All in all, we expect the Italian government to have a severe confrontation with the European Commission, while risks of a downgrade by rating agencies have increased significantly, putting further pressure on Italian assets. To illustrate our point, the Italian Sovereign Systemic Stress Composite Indicator -an ECB calculated index- has been on an upward trend since May 2018, and actually surged to a $5^{1/2}$ year high of 0.64 in September 2018, not too far from its historical high of 0.92 in November 2011 (Figure 1).

Figure 1

Italy, Sovereign Systemic Stress Composite Indicator



Source: ECB, Eurobank Research

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The update to the 2018 Economic and Financial Document

The Italian Ministry of Finance published the *2018 Economic and Financial Document (Documento di economia e finanza - **DEF***) on 5 October, including an update to the public finance and economic strategies for the medium term, and the Italian Parliament approved it on 11 October. According to the new budget plan, the Italian government's expansionary strategy targets fiscal stimulus worth ca. 1.0% of GDP in total over 2019-21, while the key policy measures to be implemented are the following:

- the citizenship income, worth about €9bn and likely to be supplied from April 2019 (plus €1bn for reorganizing the employment centers)
- pension reform, worth about €7bn per year: earlier retirement at a minimum retirement age of 62, foreseeing 38 years of contributions paid
- a flat tax of 15% for small businesses, worth about €2bn, and reduced tax burden for firms that reinvest profits in new hiring, R&D and new equipment
- higher public investment, worth about €4bn
- increased infrastructure spending

Nevertheless, the DEF remains highly unclear on the financing of the spending increases and tax cuts. Among mentioned financing measures are lower expenses for ministries, changes in subsidy schemes, cancellation of the VAT hike in 2019-2021, but permanent revenue measures remain basically absent from the updated DEF and need to be fully specified.

According to the announced budgetary targets (Table 1), the **government deficit-to-GDP ratio** was set at **2.4% in 2019** (from 1.8% in 2018), with a slight improvement to **2.1% in 2020** and to **1.8% in 2021** that marks the end of the forecasting horizon. Although the 2020 and 2021 figures are lower than initially reported (the first announcement by the government envisaged a budget deficit stable at 2.4% of GDP from 2019 to 2021), the **cumulative deviation** from the trajectory agreed with the European Commission (EC) in April still surged to **5.7%** of GDP (April 2018 Budget Deficit Projections: -0.8% of GDP in 2019, 0.0% in 2020 and +0.2% in 2021).

Table 1

Key Variables Projections under the Updated Stability Programme

(%)	2017	2018	2019	2020	2021
Real GDP growth (YoY)	**1.6**	**1.2**	**1.5**	**1.6**	**1.4**
Unchanged Regulation	1.6	1.2	0.9	1.1	1.1
April Stability Programme	1.5	1.5	1.4	1.3	1.2
Budget Balance (% of GDP)	**-2.4**	**-1.8**	**-2.4**	**-2.1**	**-1.8**
Unchanged Regulation	-2.4	-1.8	-1.2	-0.7	-0.5
April Stability Programme	-2.3	-1.6	-0.8	0.0	0.2
Primary Balance (% of GDP)	**1.4**	**1.8**	**1.3**	**1.7**	**2.1**
Unchanged Regulation	1.4	1.8	2.4	3.0	3.3
April Stability Programme	1.5	1.9	2.7	3.4	3.7
Structural Balance (% of GDP)	**-1.1**	**-0.9**	**-1.7**	**-1.7**	**-1.7**
Unchanged Regulation	-1.2	-1.1	-0.4	-0.1	-0.2
April Stability Programme	-1.1	-1.0	-0.4	0.1	0.1
Public Debt (% of GDP)	**131.2**	**130.9**	**130.0**	**128.1**	**126.7**
Unchanged Regulation	131.2	130.9	129.2	126.7	124.6
April Stability Programme	131.8	130.0	128.0	124.7	122.0

Source: Ministry of Economy and Finance of Italy, European Commission, Eurobank Research

Once adjusted for the cycle and having excluded one-off and other temporary measures, the government's fiscal plan projects a **significant weakening in the 2019 structural budget balance** by **0.8ppt**, from -0.9% in 2018 to -1.7% of GDP, instead of an improvement of 0.6% (largely through an increase in indirect taxes) previously agreed with the EC in the context of the Stability and Growth Pact in May. The structural budget deficit stabilizes in 2020 and 2021 at the 2019 level of -1.7% of GDP, as an increase in VAT revenue is expected to counterbalance enhanced public investment worth about 0.3% of GDP. Hence, given the stabilization in the structural budget deficit as a percentage of GDP in 2020-21, the decline in the headline budget deficit to 2.1% and 1.8% of GDP, respectively, is primarily attributed to the cyclical component of the deficit as the output gap closes.

Key budget assumptions

The three-year budget deficit forecasts are based on GDP growth projections of 1.5%, 1.6% and 1.4% in 2019-2021 (new policy scenario), compared to the updated projections of 0.9% in 2019 and 1.1% in 2020-21 under an unchanged policy scenario. Therefore, **the new projections imply a considerable boost to GDP growth** (of 1.4% of GDP cumulatively over three years, **not realistic** in our view) from a fiscal loosening of 0.8ppt relative to unchanged legislation, with a fiscal multiplier well above 1.0. In theory, multipliers depend on the type of stimulus; a fiscal multiplier around 1 is usually related to investment spending, while a much lower multiplier around 0.5 is used for the money that finances changes to pension/citizenship income/tax legislation. Indeed, according to OECD estimates[1], transfers to households for Italy incorporate a fiscal multiplier of 0.4 in the first year and cumulatively 0.8 for the second year. Thus, a fiscal stimulus of 0.8ppt could push real GDP growth by about 0.6%, lower than half of the assumed growth boost in the updated 2018 DEF. Nevertheless, **fiscal expansion could lead to an even lower positive effect on real GDP growth**, as a sizeable increase in interest rates, a **tightening in financial conditions** and a **negative impact on confidence** could potentially crowd out private investment and consumption growth leading to a further increase in precautionary savings. The current fiscal figures are based on yield levels as of the end of September, but have moved upwards since then, with the Italian 10-year bond yield trading at 3.6% at the time of writing from 2.8% a month earlier. According to the IMF a 100bps increase in Italian bond yields could lower real GDP growth by 0.4ppt, which could in turn counterbalance the fiscal boost to growth. Given the overly optimistic DEF's growth projections and the government's unwillingness to introduce large spending cuts ahead of the European Parliamentary elections in May 2019, the **risk of severe fiscal slippage** in the following years seems to have increased.

Meanwhile, the **GDP deflator** forecast at 1.6%, 1.9% and 1.7% in 2019-2021 is **overly ambitious** given the relatively flat Italian Philipps curve as opposed to other European countries, with the latest IMF WEO October 2018 forecasts projecting an Italian GDP deflator at 1.3%, 1.4% and 1.5% in the next three years. The higher GDP deflator projection used by the Italian government leads to a higher nominal GDP growth rate, improving the debt dynamics. According to the government's plan, Italy's **public debt-to-GDP ratio** is expected to decline to 130.0% in 2019 from 130.9% in 2018, while falling at a similar pace in the next two years to reach 126.7% in 2021. While the projected decline in the debt-to-GDP ratio is based on optimistic growth forecasts and the assumption of stable servicing costs, it still **does not guarantee compliance with the EC** as the target of 126.7% of GDP in 2021 still exceeds the EC's Debt-Rule[2] benchmark by 3.9ppt.

[1] OECD Economic Outlook Interim Report March 2009, The effectiveness and scope of fiscal stimulus. (https://www.oecd.org/eco/outlook/42421337.pdf)

[2] The reference value for a country's debt equals 60% of GDP. The debt criterion is fulfilled when the debt amount above 60% of GDP has been reduced by an average rate of at least 1/20 per year (based on ex-post data only).

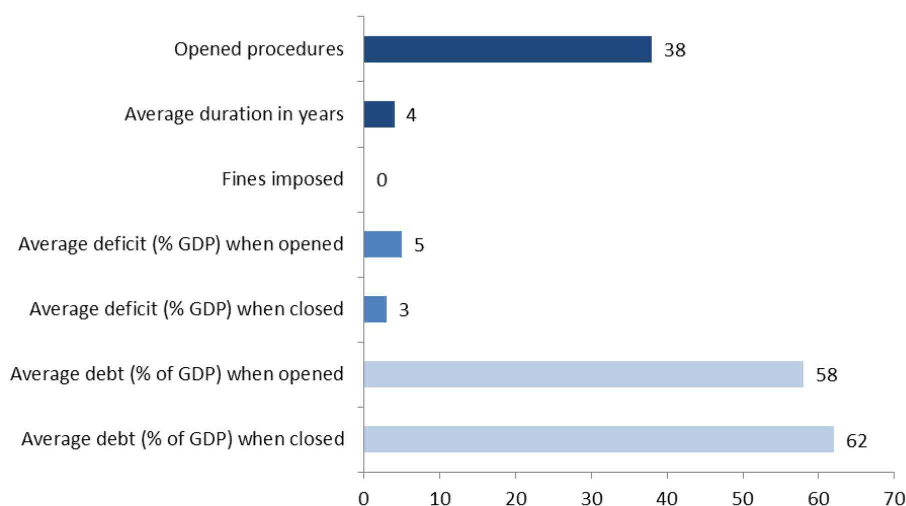
The next steps

The DEF outlined the key parameters for its Draft Budgetary Plan 2019 (DBP)[3] that was submitted to the European Commission on 15 October as mandated by the European Semester, but at this time all the available resources and their actual use need to be clarified. Meanwhile, the DBP must also be submitted to the Italian Parliament by 20 October, with the parliamentary approval in both chambers expected by the end of 2018. Within the first week post the DBP submission to the European Commission (EC) on 15 October, the EC will conclude if there is a serious non-compliance with the EU rules. In the following week it can request a revised budget plan. According to the standard procedure, the EU Commission will give its formal assessment of the 2019 budget law by 30 November, after taking into account all the approved policy measures and the underlying macro assumptions (Figure 2).

Figure 2
Timeline for the period ahead

Source: European Commission, Eurobank Research

Figure 3
The excessive deficit procedure in numbers



Source: European Commission, Jaques Delors Institut, Eurobank Research

[3] https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_it_en_0.pdf

The Italian authorities will have three weeks to submit a compliant budget plan and, and in case of non-compliance, a **Significant Deviation Procedure** could start against Italy, usually used as a warning that could lead to the imposition of sanctions (0.2% of GDP non-interest bearing deposit is the default). However, enforcement could be a rather cumbersome and lengthy process[4] as non-compliance must be based on actual economic and public finances data rather than projected budget figures. The Significant Deviation Procedure[5] aims to give a member state the opportunity to correct a deviation from its medium-term objective (MTO) or the adjustment path towards their MTO in order to avoid the opening of an **Excessive Deficit Procedure** (EDP).[6] Should an EDP is finally opened against Italy by the end of the year, the Italian government would be given three to six months to implement recommendations. Following that period, the EC would assess if there has been "effective action" by the non-compliant government, and, if not, sanctions of up to 0.5% of GDP could be imposed along with suspension of EU structural funds (no EU country has ever paid a fine for breaching EU fiscal rules in the past).[7]

Given that the structural deficit projection has turned from a 0.6% of GDP consolidation in 2019 (in the April Stability Programme) to a 0.8% of GDP fiscal easing, and the government's 1.5% growth target for 2019 seems overly optimistic, non-compliance seems a fairly reasonable outcome and we expect the **Italian government to have a severe confrontation with the EC**. On the same page, the European Commission Budget Commissioner Gunther Oettinger noted on 17 October (two days after the 2019 DBP submission to the EC) that "Italy's draft budget for 2019 is not consistent with existing EU obligations," probably giving an early indication that the EC is likely to reject the Italian fiscal plan. Nevertheless, we do not expect the EC to prepare a recommendation to take Italy into an EDP right away, at least not until Italy responds to some amendments and clarifications asked, possibly stalling corrective action until the spring of 2019, when the 2018 deficit and debt data as well as the preliminary assessment of the 2019 fiscal outlook will be published. In any case, whether the EC takes tough action against Italy or adopts a more moderate stance will be evident around the end of October, which is the deadline for the EC to reject the budget or raise any concerns.

Although the EC can recommend an EDP, ECOFIN/Eurogroup has actually the final word, with the right to overrule the EC and overturn the process. The double majority system, under which the Eurogroup operates, requires at least 55% of euro area countries representing a minimum of 65% of GDP (excluding the country in question) in order to overturn an EC decision, meaning that such a move should have the vote of Germany and France. According to the latest data published by the EC, Germany and France together comprised half of the euro area GDP as of 2017, with the respective shares coming in at 29.2% and 20.5% of euro area's GDP, respectively.[8]

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[4]https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/legal-basis-and-related-stages_en

[5]https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/preventive-arm/significant-deviation-procedure_en

[6]A procedure through which the EC exerts more control over a government's fiscal policy and fines the country that does not comply with the EU rules.

[7]Until today, the European Commission has opened 38 EDPs, with all EU countries (except for Estonia and Sweden) having been subject to an EDP at some point since 1999. Currently only Spain is still under EDP, but no country has ever paid a fine. The average duration of the closed procedures was 4 years. When the procedure was opened, the annual deficit-to-GDP ratio and the annual debt-to-GDP ratio were on average 5% and 58%, respectively. When the procedure was closed, almost all countries were below the 3% debt-to-GDP threshold again, while the average debt-to-GDP ratio was higher and stood around 62%. All past EDPs were launched based on ex-post deficit outcomes, while no EDP has ever started based on the debt criterion (Source: European Commission, Jaques Delors Institut – see Figure 3).

[8]https://ec.europa.eu/eurostat/web/products-eurostat-news/-/DDN-20180511-1?inheritRedirect=true

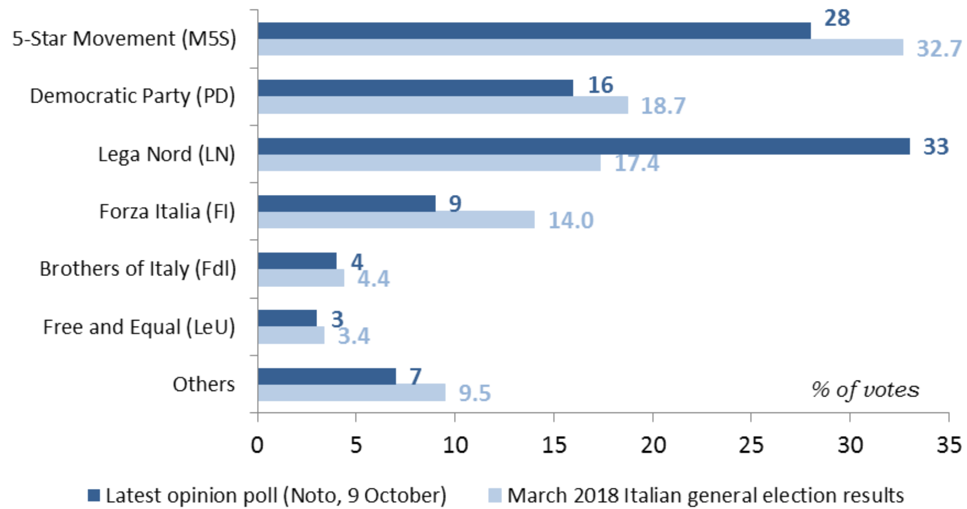
Potential of rating downgrades

The EC's budgetary surveillance process coincides with the rating agencies assessment of Italy's rating and outlook. While Fitch (BBB with negative outlook), Moody's (Baa2 with negative credit watch) and S&P (BBB with stable outlook) currently rate Italian sovereign debt two notches above sub-investment grade and DBRS (BBB high) three notches above with a stable outlook, Italy will be under their surveillance in the coming days. Fitch kept the BBB credit assessment of Italian sovereign debt unchanged on 31 August and revised the outlook from 'stable' to 'negative' (a decision largely based on a projected deficit of -2.2% of GDP in 2019), both S&P (26 October) and Moody's (no precise date) are expected to complete reviews regarding Italy's creditworthiness by the end of October. **Risks of a downgrade** by one notch - especially by Moody's - have **increased significantly** following the publication of the updated deficit targets, and S&P will most likely change Italy's outlook from 'stable' to 'negative' while keeping its BBB rating (although a downgrade cannot be ruled out), **putting further pressure on Italian assets**. The worst case scenario (albeit a low probability one) would be a one notch downgrade by both rating agencies with a negative outlook, raising the risk of a sub-investment grade rating, potentially leading to negative self-fulfilling debt dynamics and a sovereign bond index exclusion for BTPs.

Apart from the ongoing negotiations between the EC and Italy on the country's fiscal consolidation outlook, the **rating agencies** are highly likely to **take into consideration** the government's **headline budget fiscal targets**, which surpass their own budget deficit projections (by about 0.3ppt in 2019), as well as **potential political risks** during the months ahead. As long as financial markets pressures remain relatively contained, the Italian government is not expected to soften its fiscal policy stance and make any significant changes proposed by the EC. Besides, the Italian government's confrontation with the EU seems to be a major part of its platform ahead of the European Parliamentary elections in May 2019. However, should financial markets tensions intensify further, the 5SM and League would have to reconsider making amendments on their structural consolidation outlook in order to ensure political stability.

In case the Italian government is not able to approve the budget by year-end taking into account its thin majority in the Senate (not our base case), this could lead to a prolonged period of heightened uncertainty and potentially trigger a political crisis. An alternative government could then be formed (potentially comprised of the 5SM and PD, although former PD Party Secretary Matteo Renzi currently opposes such a possibility) or else Italy could even return to snap elections in the first half of 2019. In such a case, the latest opinion polls (Noto poll, 9 October, see Figure 4) reveal that the League currently surpasses the 5SM with 33.0% (up from 17.7% in March elections), with the latter having lost roughly 4ppt since March elections to reach 28.0% (down from 32.2%).

Figure 4
League's popularity has surpassed 5SM since the March election



Source: Ministry of the Interior of Italy, Noto, Eurobank Research

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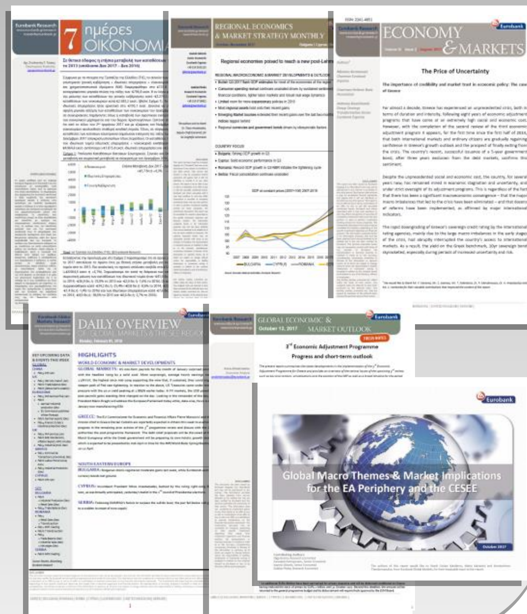

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