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Italy: An unstable fiscal balancing act

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- As the 2019 Budget season approaches, the 5SM-L government will be soon wedged between the need to deliver on aggressive fiscal easing pledged in its economic programme and risks that a reversal of the prudent fiscal stance maintained by Italy for the past few years could impact market sentiment severely.
- We do not expect Italy's fiscal prospects to deteriorate dramatically in the near term; mindful that they likely lack the political capital needed to survive internal and external pressures should they decide to implement the pledged economic programme, we expect 5SM and L will take a pragmatic approach over public finance management and institutional relationships.
- In our central scenario, we forecast Italy to revise up its general government budget deficit target to 1.9% of GDP in 2018 and 1.7% of GDP in 2019 from the respective 1.6% and 0.8% previously agreed with the European Commission.
- This would represent a positive development in the near term for Italian assets as the projected fiscal easing would be significantly smaller than that pledged by 5SM and L in their economic programme.
- However, the slowing core fiscal effort will set Italy's debt equilibrium on an increasingly unstable path in the medium term. Of further concern for an economy saddled with a debt-to-GDP ratio above 130%, we expect the primary surplus to decline, for the first time since 2015, to 1.6% in 2019 from a projected 1.9% in 2018.
- The anticipated slowing primary balance consolidation will likely prevent the debt-to-GDP ratio from marking a steady declining trend. We now think the risks of debt-to-GDP increasing are non-negligible, and have possibly increased at the margin lately.
- Against this backdrop, with ECB-led financial market complacency coming to an end as the central bank progresses with its plan to normalize monetary policy conditions, downside risks to growth mounting, and preliminary signs that structural reform efforts deployed during the previous legislature have started to slow – and in some cases reverse – we expect Italian assets to remain volatile with high risk premium until the government clarifies its medium-term position on public finance management and structural reforms.

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2019 Budget preview: Precarious soft landing ahead

The 5SM-L government will be soon have to decide whether to deliver on the aggressive fiscal easing pledged in its electoral economic programme, which could cost up to EUR100bn gross per year or 5.5% of GDP (see *Italy Focus: Form and content of anti-system government talks thus far: a preliminary assessment*, 14 May 2018) and poses risks that a sudden reversal of the prudent fiscal stance held by Italy over the past few years may impact market sentiment severely.

Consistent with our baseline that 5SM and L are both incentivised to remain in a government coalition, we expect the government to take a pragmatic approach on public finance management and soften its fiscal policy stance in the near term (*Italy: The good, the bad and the middle way*, 28 June 2018).

We forecast the pace of fiscal consolidation to slow in the coming years but do not anticipate a deterioration of public finances of the magnitude that the economic programme pledged by 5SM and L would imply.

We expect the government to revise up its budget deficit target to 1.9% of GDP in 2018 and 1.7% of GDP in 2019 from the 1.6% and 0.8%, respectively, previously agreed with the European Commission. Against this backdrop we expect tensions with Brussels to increase but to remain manageable.

At the same time, while we expect the prospects for core public finances to remain sound, we forecast a deterioration in the primary surplus to 1.6% of GDP in 2019 (compared with the previously agreed target of 2.7%), following a projected 1.9% in 2018. While such revised fiscal targets are likely to represent a positive development in the near term for Italian assets – as they would imply the government does not want to take the risk of exacerbating market and political pressures by deploying unreasonable fiscal policy – we stick to the view that Italian assets will remain volatile with high risk premium.

With ECB-led financial market complacency coming to an end, as the central bank progresses with its plan to normalize monetary policy conditions, and downside risks to growth mounting, we expect the weakening core public finance conditions to prevent the debt-to-GDP ratio from embarking on a steady declining trend; consistent with this, investors are likely to remain wary of Italy's very unstable debt equilibrium, as the country is increasingly exposed to shifts in financial market sentiment.

Given signs that structural reform efforts deployed during the previous legislature have started to slow (and in some cases reverse), as the recently approved labour market reform would suggest (*Italy labour reform: more work needed*, 30 July 2018), we expect Italian assets will remain volatile until the Italian government clarifies its position on public finance management and structural reforms.

Taking stock of fiscal developments and agreed targets

Italy very rapidly consolidated its fiscal accounts in the aftermath of the Global Financial Crisis. The (general government budget) deficit improved from -5.2% of GDP in 2009 to 2.3% in 2017 (or 1.9% of GDP excluding liquidation cost of regional banks Banca Popolare di Vicenza and Veneto Banca). This remarkable performance was driven by strengthening core public finances and declining debt servicing costs. Over the same period, the primary balance moved from -0.8% of GDP to +1.5 % of GDP (1.9% of GDP excluding bank bailout costs), while average interest rate spending fell to 3.8% of GDP from 4.4 % of GDP.

According to the Stability and Growth pact, a country in Italy's cyclical position and with public debt higher than 60% of GDP should make a structural fiscal effort greater than 0.5pp each year over the policy horizon. The 2018 Economic and Financial Document published by the Gentiloni government (26 April 2018) projects significant improvements in the headline and structural balances over the 2018-2020 period (Figure 1).

The budgetary projections submitted by the previous outgoing government are based on a baseline trend scenario assuming unchanged legislation/policies, ie. includes already adopted/legislated fiscal measures and structural reforms. In particular, on the growth front, real GDP is expected to expand 1.5% in 2018, 1.4% in 2019, 1.3% in 2020, in line with the projections of the 2018 Draft Budgetary Plan of October 2017.

Against this backdrop, Italy is expected to deliver fiscal consolidation worth about EUR12.4bn in 2018, EUR14.6bn in 2019, EUR15bn in 2020. Consistent with the projected fiscal effort, the budget balance is expected to print -1.6% of GDP in 2018, -0.8% in 2019, 0.0% in 2020 and +0.2% in 2021. Under the assumption that debt servicing costs will remain at 3.5% of GDP through the forecast horizon, the primary surplus is expected to rise from 1.9% in 2018 to 3.4% in 2020.

The structural balance, which is cyclically-adjusted and excludes one-off and other temporary measures, is also expected to strengthen remarkably. Under the government's assumption that the output gap will remain negative in the next three years at -1.3% in 2018, -0.6% in 2019 and -0.2% in 2020, the 2018 Economic and Financial Document projects the structural balance to improve by 0.1pp to -1.0% in 2018, 0.6pp to -0.4% in 2019 and 0.5pp to +0.1% in 2020, after worsening by 0.2pp to 1.1% in 2017.

FIGURE 1

Government medium-term outlook based on trend scenario (April 2018)

	2017	2018	2019	2020
Budget Balance, % of GDP	-2.3	-1.6	-0.8	0.0
Primary Budget Balance, % of GDP	1.5	1.9	2.7	3.4
Structural Budget Balance, pp	-1.1	-1.0	-0.4	0.1
Public debt, % of GDP	131.8	130.8	128.0	124.7
Real GDP, % y/y	1.5	1.5	1.4	1.3
Nominal GDP, % y/y	2.1	2.9	3.2	3.1

Source: Ministero del Tesoro e delle Finanze, Barclays Research

Budget season agenda

Before discussing our expectations regarding structure of the next Budget and macroeconomic assumptions behind it, we want to recall the most important phases of the Budget process; we describe below the most critical ones and provide an indicative timeline.

1. **Update to the Economic and Financial Document (DEF)** – submitted to Parliament no later than 27 September of each year. It updates multi-year public finance and economic forecasts contained in the DEF (released in April) in light of more recent and reliable information on macroeconomic trends. It includes an update on programme goals, along with notes and amendments to the DEF in light of the recommendations issued by the European Council regarding Italy's Stability Programme and National Reform Programme.
2. **2019 Draft Budgetary Plan (DFP)** – submitted to the European Commission no later than 15 October. It includes details of budgetary measures to be deployed consistent with growth and public finances targets indicated in the Update to the DEF.
3. **European Commission (EC) releases its economic and fiscal forecasts** – beginning of November.
4. **European Commission opinion on DFP** – to be released usually around mid-November and no later than 30 November. It contains the EC's considerations regarding the compliance of the Draft Budgetary Plan with the provisions of the Stability and Growth Pact.
5. **Possible country reply to the European Commission opinion** – usually straight after the release of EC opinion.
6. **Parliament debate/vote on DFP** – usually from end-November/beginning of December until the end of December.

Near-term outlook: comparing the government's and Barclays' fiscal forecasts

Potential update to government baseline for 2018 and 2019[1]

Given the caretaker nature of the Gentiloni government that approved the 2018 DEF in April this year, the medium-term baseline released at the time was based on a trend scenario that assumed unchanged legislation.

We will be watching the updated 2018 DEF and the 2019 Draft Budgetary Plan to be released by the 5SM-L government between September and October to assess the fiscal stance of the current ruling coalition.

As we discussed in *Italy: The good, the bad and the middle way* (28 June 2018), we think 5SM and L are both incentivised to remain in a government coalition.

Mindful that the government might lack the political capital needed to survive internal and external pressures should it decide to implement the pledged economic programme, which we estimate could cost up to EUR100bn gross per year unless properly backed by strong and credible offsetting measures (*Italy: Form and content of anti-system government talks thus far: a preliminary assessment*, 18 May 2018), we expect 5SM and L will take a pragmatic approach with EU authorities to public finance management and institutional relationships.

[1] For consistency our analysis will focus on 2018-2019 period corresponding to our published forecast horizon.

Growth and fiscal forecasts in greater detail

We believe government will revise down its real growth forecast for 2018 and 2019 on account of weakening global demand and rising oil prices. We expect its projections to be lowered to 1.2% or 1.1% this year and to 1.1% or 1.0% next year (from 1.5% and 1.4% previously expected) broadly in line with our baseline (1.2% and 1.1%, respectively).

Against this backdrop, we think the government will revise up its fiscal targets, with the aim of slowing the pace of fiscal consolidation compared to what was published in the 2018 DEF under the Gentiloni government.

The updated 2018 general government budget deficit target will mechanically reflect the impact of lower growth expectations and higher interest spending of around 0.2-0.3pp in total, in our view. Accordingly, we expect the government to set its fiscal target to a range of -1.8% and -2.0% of GDP this year from -1.6% previously agreed with the European Commission.

We forecast a larger target revision for 2019. In addition to the mechanical effect of lower growth and higher debt servicing costs (between 0.3pp and 0.4pp), we expect the government to commit to the following actions:

1. Deactivate fiscal safety clauses set by previous governments (worth an additional EUR12.4bn or 0.7pp of GDP).
2. Preliminary implementation of the fiscal pillars contained in the economic programme pledged (EUR7bn to EUR15bn or 0.4-0.8pp of GDP).
3. Mandatory spending (EUR3.5bn or 0.2pp of GDP).
4. Spending cuts (EU2bn to EUR11bn or 0.1-0.6pp of GDP).
5. Request fiscal flexibility related to migration, protection against seismic risks and infrastructure maintenance (EUR3bn to EUR8bn or 0.2-0.4pp of GDP).
6. Tax amnesty (EUR4bn to EUR6bn or 0.2-0.3pp o GDP).

Consistent with this, we expect the 2019 general government deficit target will be set in a range between 1.3% and 2.2% in 2019, significantly above the 0.8% agreed with the European Commission.

While a revised target of 1.7% of GDP (our central scenario) would represent a slowdown of the pace of fiscal consolidation previously agreed, it would still signal that the government is unwilling to oversee a deterioration of public finances of the magnitude that the economic programme pledged would imply.

In terms of structural balance developments, we expect the government to delay the goal to achieve a balanced structural deficit position by at least one year by keeping the 2019 structural balance in line with the 2018 level. Unfortunately it is not possible for us to be more precise than this, as the government forecast will very much depend on the methodology of estimation of the output gap that it uses.

FIGURE 2

Government[1] versus Barclays near-term fiscal outlook

	Italian Treasury						Barclays	
	2018			2019			2018	2019
EURbn*	Lower bound	Central case	Upper bound	Lower bound	Central case	Upper bound	Baseline	Baseline
Growth impact	1.8	2.6	3.5	1.8	2.7	3.6	4.2	4.4
Additional interest spending	1.0	2.0	2.0	3.5	4.0	4.5	2.0	4.0
Deactivation fiscal clauses				12.4	12.4	12.4		12.4
Government policies**				7.0	12.0	15.0		15.0
Mandatory spending				3.5	3.5	3.5		3.5
Budget legacy			1.5				1.5	
Spending review				-6.0	-4.0	-2.0		
Tax expenditure cuts				-5.0	-3.5	0.0		
Fiscal flexibility				-3.0	-5.0	-8.0		-2.0
Tax amnesty				-6.0	-5.0	-4.0		-3.5
Total	2.8	4.6	7.0	8.2	17.1	25.0	7.7	33.8
Total, pp of GDP	0.2	0.3	0.4	0.5	0.9	1.4	0.4	1.9
Revised deficit target, % of GDP	1.8	1.9	2.0	1.3	1.7	2.2	2.0	2.7

Note: [1] Barclays' expectations for Treasury forecasts; *Unless stated otherwise; **Flat tax, pension reform, universal income. Source: Barclays Research

Barclays growth and fiscal forecasts for 2018 and 2019

We expect the pace of fiscal consolidation to slow compared with fiscal targets planned in the 2018 Draft Budgetary Plan and reiterated in the 2018 DEF. We project the general government budget deficit to decline to 2.0% of GDP in 2018, from 2.3% in 2017 (Figure 2).

For 2018, our forecast is only marginally higher (+0.1pp) than the one we expect the Treasury will publish in the 2018 DEF update in September, owing to a slightly larger impact on public finances from weaker growth and assuming that Italy will not be fully compliant with the 2018 debt reduction benchmark due to unaddressed budget legacy worth about EUR1.5bn. In this regard, the European Commission will reassess compliance on the basis of the ex-post data for 2018, notification of which is expected in spring 2019; we do not rule out potential re-opening of an excessive deficit procedure, from which Italy exited in 2013.

We expect the primary surplus to increase to 1.9% of GDP in 2018, after printing 1.5% in 2017 (1.9% net of banks' bailout costs), while public debt should decline only marginally to 130.8% of GDP in 2018 from 131.8% of GDP in 2017. Compared to our forecast for the government baseline, we are much more pessimistic on the final outturn for 2019's general government deficit, forecasting deterioration to 2.7% versus an expected government revised target of 1.7% of GDP (Figure 2).

Compared to the 0.8% of GDP target included in the 2018 DEF, we expect net additional spending of EUR33.8bn (worth 1.9% of GDP), split as follows:

1. Growth impact: EUR4.4bn (or 0.2pp of GDP).
2. Additional interest spending: EUR4.0bn (or 0.2pp of GDP).
3. Deactivation of fiscal safety clauses: EUR12.4bn (or 0.7pp of GDP).
4. Government policies (Flat tax, universal income, pension reform): EUR15bn (or 0.8pp of GDP).

5. Mandatory spending (EUR3.5bn or 0.2pp of GDP).

6. Fiscal flexibility (related to migration, protection against seismic risks and infrastructure maintenance (EUR2bn or 0.1pp of GDP).

7. Tax amnesty (EUR3.5bn or 0.2pp of GDP).

Medium-term outlook: Risks of unintended consequences

With public debt at 131% of GDP this year, and support from ultra-accommodative monetary policy likely to soon come to an end, the sustainability of sovereign debt dynamics continues to deserve close scrutiny.

To a large extent, whether Italy manages to set public debt-to-GDP on a clear downward sloping path will depend on enhanced and sustained fiscal and structural reform policy efforts, the prospects of which are still extremely uncertain, if not marginally worse than during the previous legislature.

While the potential softening of the fiscal policy stance for the 2019 Budget in line with our expectations would represent a positive development in the near term for Italian assets – as it implies the government doesn't want to take the risk of exacerbating financial market and (external and internal) political pressures by deploying unreasonable fiscal policy – we believe that the slowing core fiscal effort combined with a weakening pro-growth attitude will put Italy's debt equilibrium on an increasingly unstable path in the medium term.

Following the recent implementation of the growth-unfriendly labour market reform and likely deterioration of primary surplus prospects, we believe that risks of the debt-to-GDP ratio moving along an upward sloping path are non-negligible.

To evaluate solvency over the medium term, we use the following fiscal formula,

$$\Delta\left(\frac{D}{Y}\right)_t = \left(\frac{r_t - g_t}{1+g_t}\right)\left(\frac{D}{Y}\right)_{t-1} - \left(\frac{PB}{Y}\right)_t$$

where *d* denotes public debt-to-GDP ratio, *r* is the average interest rate on sovereign debt, *g* is the nominal GDP growth rate, and *pb* is the primary balance-to-GDP ratio.

We also assume that by 2020, Italy reaches the following steady state equilibrium:

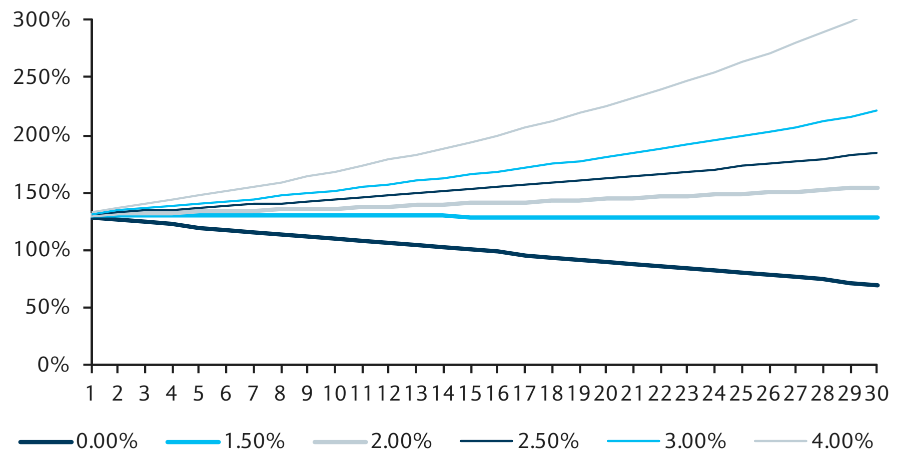
- Real growth of 1.0%.
- GDP deflator of 1.5%.
- Average funding cost of outstanding debt of 4.5%.
- Primary surplus position of 2.0%.

Under these assumptions (r-g of 2%), Italy's public debt would barely stabilise around 130% over the forecast horizon, while it also remains extremely sensitive to increasingly likely potential growth, interest rate and primary surplus shocks as alternative r-g scenarios indicate (Figure 3).

With ECB-led financial market complacency coming to an end, as the central bank progresses with its plan to normalize monetary policy conditions, downside risks to growth mounting, and weakening prospects for core public finances conditions, we expect the debt-to-GDP ratio to remain on a very unstable path, increasingly exposed to shifts in financial market sentiment.

FIGURE 3

A debt sustainability simulation for various (r-g) levels for Italy



Source: Barclays Research

A word of warning

As we argued in *Italy labour reform: more work needed* (30 July 2018), the recently approved labour market reform (Dignity Decree) carries meaningful medium-term risks for Italy's growth outlook, introducing downside risks (of up to 0.3pp) to our steady state assumption for real potential growth of 1.0%.

The Dignity Decree could affect potential growth by hampering the already weak productivity outlook. A likely return to high-turnover short-term contracts to avoid risks of litigation (stemming from the reintroduction of mandatory business reasons to activate/extend short-term contracts), combined with a 50% increase in severance payment for illegitimate dismissal for economic reasons, will likely reduce incentives for firms to hire on a permanent contract basis.

A deterioration in employment creation quality (ie. decline in the number of permanent versus short-term contracts) would likely affect the outlook for long-term labour productivity, including on-the-job training and investment in education.

Therefore, given signs that structural reform efforts deployed during the previous legislature have started to slow (and in some cases reverse), as the Dignity Decree would suggest, we expect Italian assets will remain volatile until the Italian government clarifies its position on public finance management and structural reforms.

With investors wary of Italy's unstable debt dynamics, which remain highly sensitive to shifts in financial market sentiment and potential deterioration of steady state assumptions on potential growth and the fiscal outlook, we would expect Italian assets to remain volatile with high risk premium.

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