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Daily Observations

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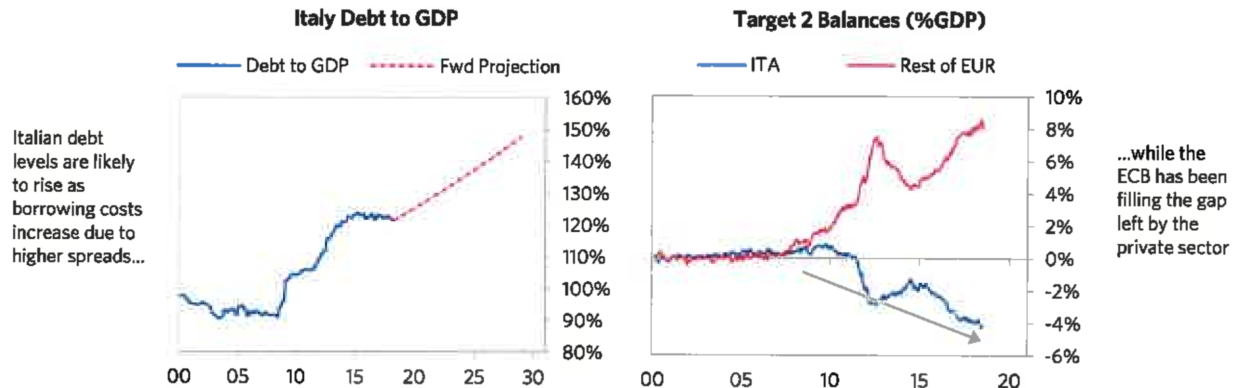
Italy as a Systemic Risk with or without a Budget Problem

The risks in Italy are economic and political, and longer-term rather than immediate.

Conditions in Italy are fragile, which makes for both economic and political (populist) risks if there is either a tightening of monetary policy or a downturn. That is because Italy made very little progress with structural reforms to deal with its larger problems (and, given the current political dynamics, is unlikely to make progress anytime soon), so it has been left in the dust relative to the rest of Europe. This leaves Italy more vulnerable to what happens when the ECB tightens policy in response to the aggregate recovery of the Euroland economy.

In this context, the potential conflict between Italy and the EU over Italy's fiscal budget is a symptom rather than the problem. The proximate cause of renewed concerns are that Italy's budget proposal came in 50bps higher than expected and puts the Italian government in conflict with EU budget rules. There is probably some wiggle room and time for Italy and the EU to work things out before the official budget submission deadline on October 15. But a compromise will only provide short-term relief. Given the structurally weak Italian growth rates and high debt levels, Italian debts will continue to compound faster than income. We think it more likely than not that Italy will eventually come under more strain before the situation gets resolved one way or another. Below, we provide our perspective on Italy's longer-term problems, as well as the details on the recent budget impasse.



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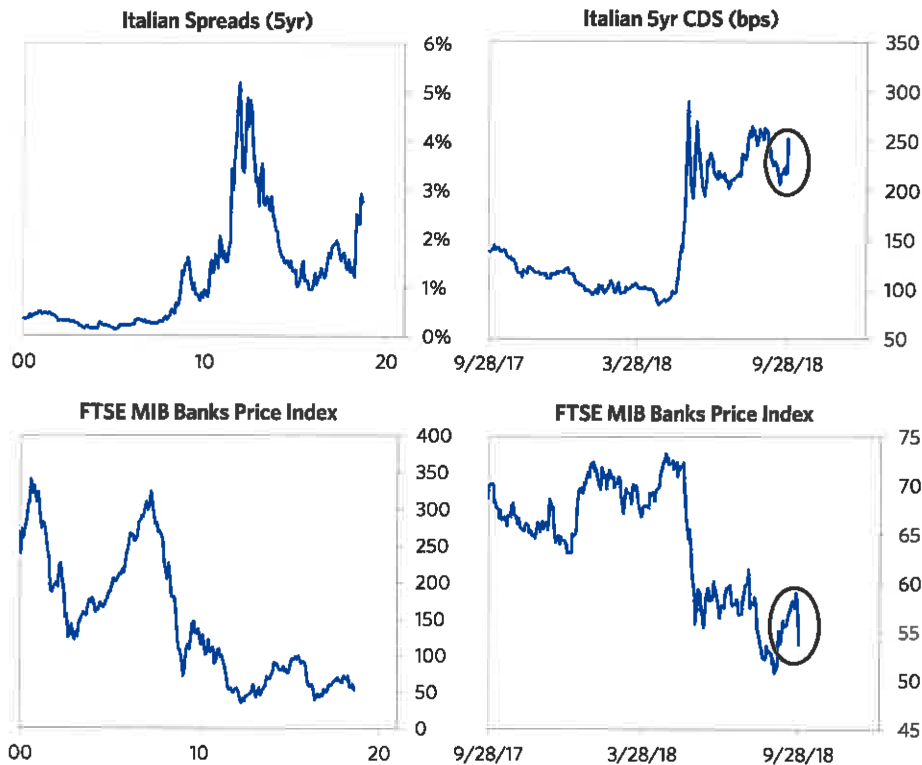
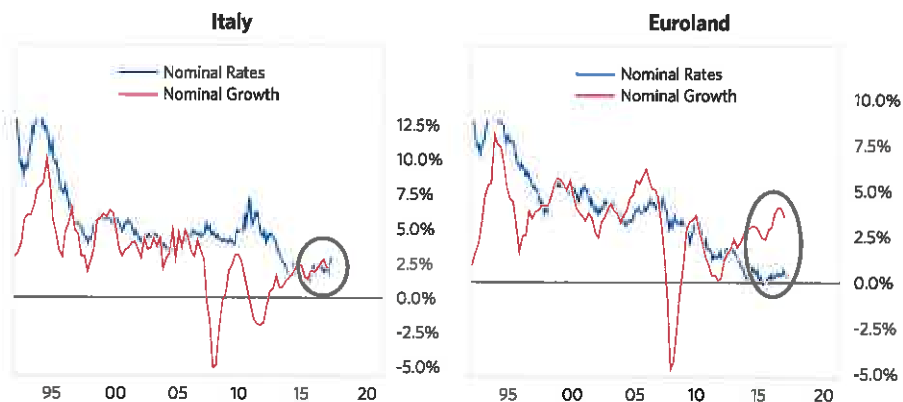
Give Feedback

Short-term market action has ebbed and flowed with political gyrations, including Thursday's larger than expected budget proposal. But spreads remain well below crisis levels and are low relative to the risks we see.



Unlike the Rest of Europe, Italy Hasn't Had Much of a Beautiful Deleveraging

Even with ultra-accommodative ECB policy, Italy merely stabilized its debt trajectory. The rest of Europe, however, has enjoyed a much more beautiful deleveraging, with nominal growth well above nominal debt rates. This situation allows for debts to come down relative to GDP while maintaining reasonable rates of growth.

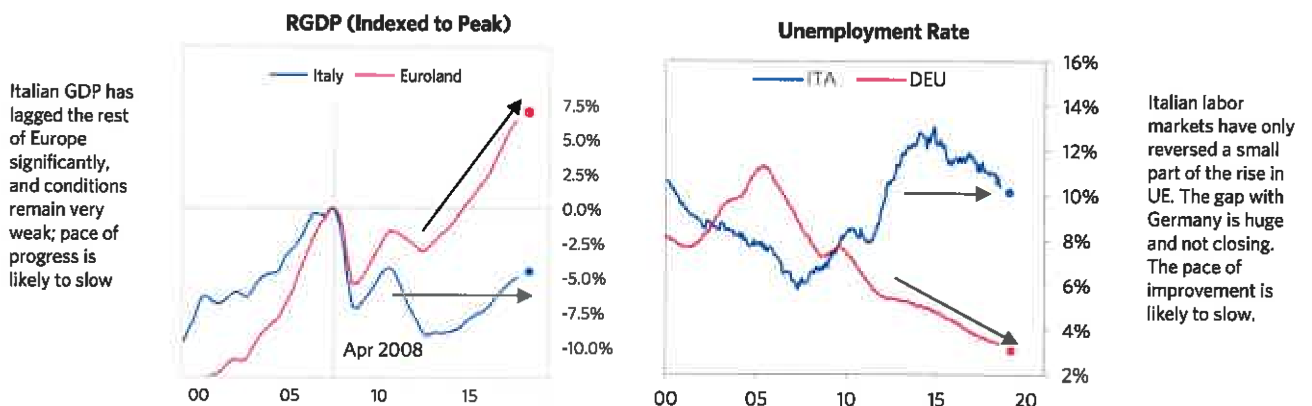


Give Feedback

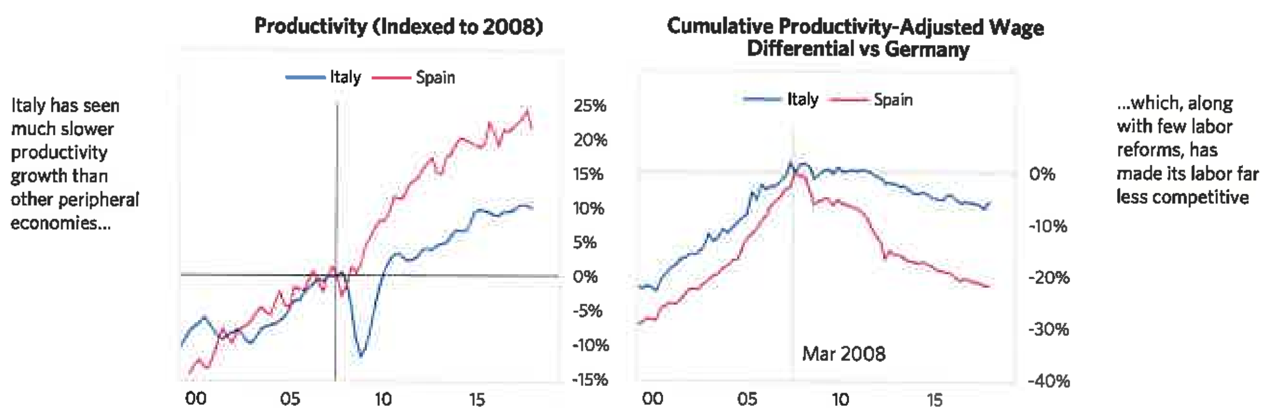
Italy Is Structurally Uncompetitive, and This Is Unlikely to Get Better Given the Politics

Italy is stuck, as its economy is secularly depressed and it can't meaningfully ease to increase growth, both because of EU restrictions and the fact that it doesn't control its currency. This is leading to difficult politics, which has made structural reforms to improve competitiveness a non-starter. So Italy is stuck, without a clear path out. The dilemma is illustrated in the charts below: as you can see, Italy's economy is secularly depressed.

The pace of progress has been very slow and is likely to slow further as a result of widening spreads (which unless reversed will gradually flow through to domestic borrowers) and less supportive global conditions. One potential support is fiscal expansion, but that would be in violation of EU rules and could be impossible due to either EU or market resistance (which would likely be related). And the gap between the level of Italian conditions and the rest of Europe is an issue for the ECB, as the policy that makes sense for Europe could push Italy into a more unsustainable situation. This can be seen clearly in the different labor markets of Italy and Germany, where the difference in recovery has been stark.



Italy's competitiveness problem is stark when compared to Spain, which has seen a meaningfully different recovery after undertaking difficult reforms, which have put its debt trajectory on a far more sustainable path. Without the ability to devalue its currency, Italy has to make its workers more competitive through either productivity gains or wage cuts, neither of which has contributed much to competitiveness, as shown below.



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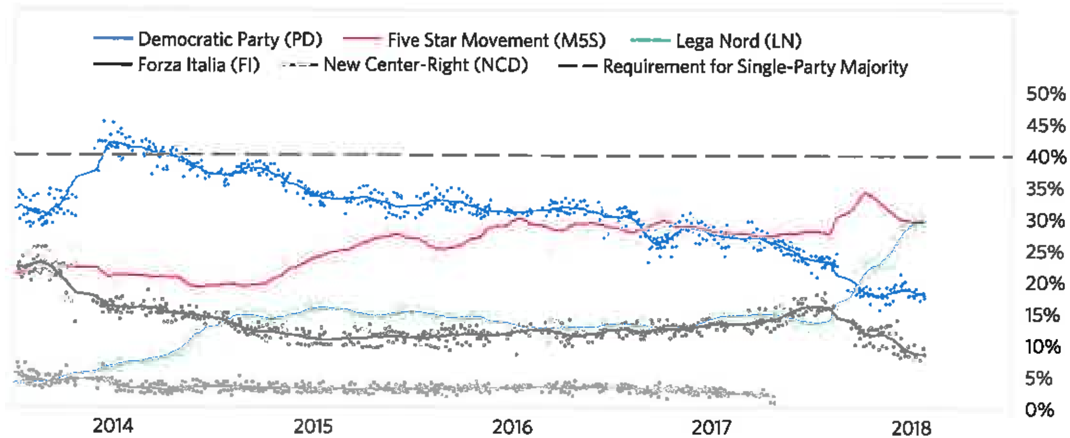
These circumstances are unlikely to change, as the Italian electorate has been and remains very fragmented, making it extremely challenging for any party or coalition of parties to push through the tough reform measures necessary to address Italy's long-term structural issues. So, there has been little progress. The rise of the populist coalition simply reflects these pressures, and without economic recovery, the political turmoil is likely to increase rather than decrease. Populist parties now have a commanding majority of support.

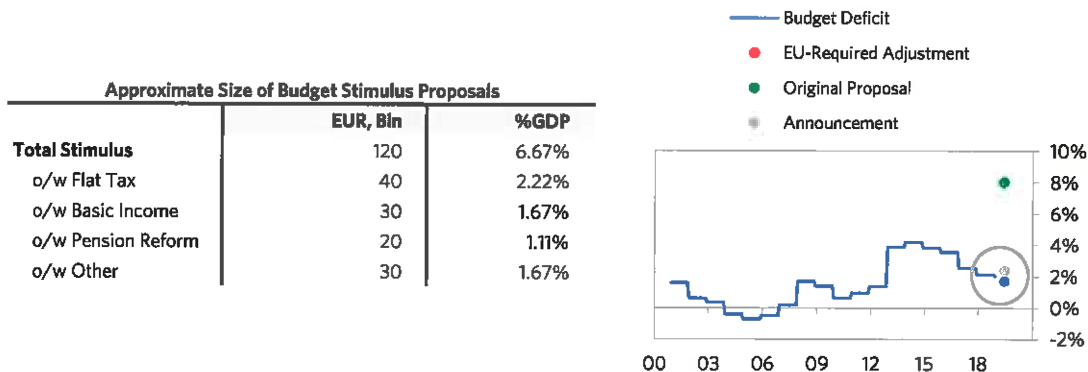
Italy Polling



What Happened Thursday and How It Fits into the Budget Story

Thursday was the deadline for Italy to issue a planning document (DEF). This is largely seen as a signaling mechanism for how they will manage their budget. After rumors that the budget deficit would be 1.9% of GDP, the budget that they announced on Thursday was a much larger 2.4%. If not changed by the October 15 EU submission deadline, this puts Italy on a collision course with the EU.

Highlighting the possibility for conflict within the coalition as well as with the EU, while the 2.4% budget deficit is larger than the EU wants (we won't go into the complex EU budget math), it's also much smaller than the campaign promises of Lega and Five Star. Additionally, it's not likely to change the debt trajectory through additional growth, and depending on the spreads at which they have to raise money, it might actually harm Italy's ability to meet its obligations.



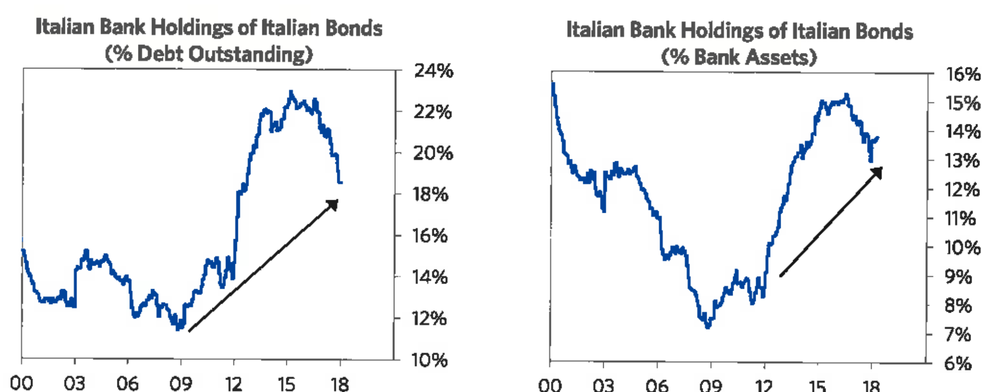
Approximate Size of Budget Stimulus Proposals

	EUR, Bln	%GDP
Total Stimulus	120	6.67%
o/w Flat Tax	40	2.22%
o/w Basic Income	30	1.67%
o/w Pension Reform	20	1.11%
o/w Other	30	1.67%

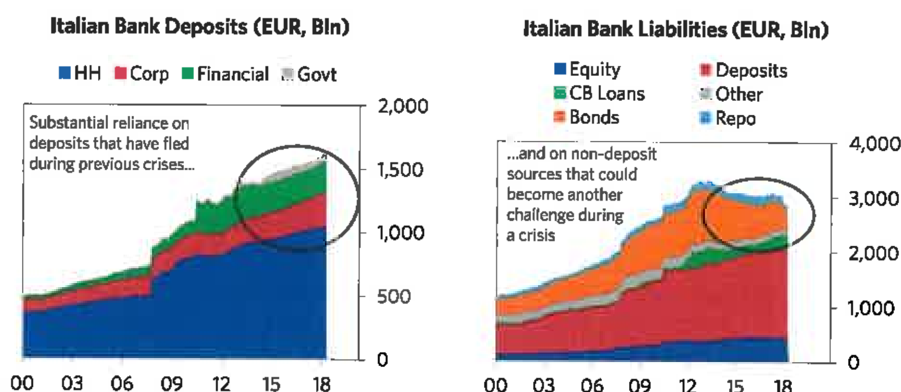
As we have laid out in prior *Observations*, we are watching a number of specific dates. The Italian government faces another major deadline over the next month that will provide more insight into how accommodative the EU will be and how the fragile coalition government will fare. This is October 15, when the Italian government needs to submit its draft budgetary plan to the commission and the Eurogroup. This could be another flash point, and the commission will also likely watch to see the budget enacted in November and December. Given the number of back and forth negotiations required, there is likely more drama ahead.

Financial Strains for the Italian Sovereign Could Quickly Escalate into Acute Pressure on Italy's Banks

If the crisis intensifies and the ECB doesn't step in, bad things will happen—e.g., the banking system and the Italian economy will suffer, and this will have repercussions on Euroland, too. Despite attempts by EU central bankers and politicians to push through reforms, banking integration in the EU has made scant progress. So, the Italian banks and the Italian sovereign remain closely interlinked. Almost 20% of Italy's sovereign debt is owned by Italian banks, and these holdings make up almost 15% of the banks' aggregate assets. As a result, pressure on either the sovereign or the banks quickly becomes an acute problem for the other and could push a sell-off to become self-reinforcing if no other buyer of the bonds (like the ECB) is ready to step in.



Given the ease of moving capital and the historical cases of Greece and Ireland, a situation like this could quickly cause sensitive deposits to move out of Italy. In the extreme case of Greece (not our base case), most large corporate deposits and foreign deposits were pulled out, requiring the ECB to fill a funding gap equal to 25% of their total deposits. In the charts below, you can see that Italy is similarly exposed today: roughly 35% of Italian bank deposits are from corporations and other financial institutions, both of which tend to be quick to flee during times of stress.



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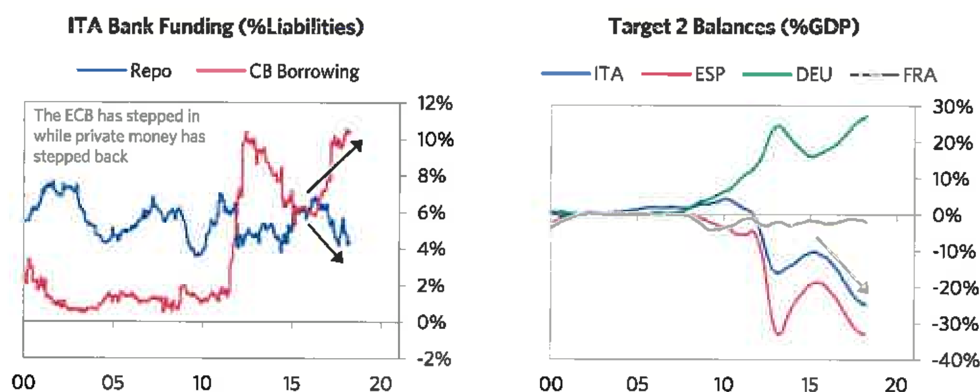
The ECB already funds 10% of all Italian bank liabilities, and Target 2 balances continue to build. In other words, it has taken a lot of ECB money to offset the lack of private-sector demand for Italian assets at current prices. Reduced attractiveness of Italian assets could quickly necessitate an acceleration of ECB support and likely a political and economic crisis.



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