ITALIAN UPDATE: HEADING FOR AN EVEN HOTTER SEPTEMBER?

Berenberg Macro Flash

Beyond the tail risk of US-led trade wars, Italy poses the biggest threat to our call that positive fundamentals will propel the Eurozone back to growth around 2% annualised in late 2018. As the radicals now ruling Italy have promised their voters to raise spending, cut taxes, reduce the retirement age and reverse some pro-growth reforms, an Italian debt crisis could become an accident waiting to happen. Following the start of serious budget discussions between the comparatively prudent finance minister Giuseppe Tria and the government’s key political leaders last Friday, the issues could come to a head in the next ten weeks as Italy prepares its draft budget for 2019. The government wants to agree key fiscal parameters by 30 September before it has to submit the budget draft to parliament and the European Commission on 15 October. In political terms, September could be an even hotter month in Italy than August.

Our base case remains that the Italian government will rein in its most pricey fiscal plans and muddle through somewhat noisily without a dramatic crisis for the time being. For the next ten weeks, we project significant noise with occasional bouts of market anxiety. To some extent, wider yield spreads may force the radicals to tone down their plans. Still, the risk that careless behaviour in Rome could soon trigger an Italian crisis is not negligible.

FISCAL STARTING POSITION

Italy’s 2018 budget still passed by the previous Gentiloni government foresees a decline in the headline deficit from 2.3% in 2017 to 1.6% of GDP due to real GDP growth of 1.5% and a drop in the underlying structural deficit from 1.7% in 2017 to 1.5%. However, Italy’s growth has slowed down in the first half of 2018 and is now more likely on track for a 1.1% gain in real GDP in 2018. The country will thus likely miss its fiscal targets this year already even if the new government refrains from any additional fiscal stimulus. Data on the “central government budget” for the first seven months of 2018 suggest that, on unchanged policies, Italy’s headline fiscal deficit could come in at around 1.9% of GDP. Back in May, the EU expressed concerns about Italy’s projections and asked Italy to tighten fiscal policy relative to the medium-term plans which the old government had submitted for 2019. The new government looks set to do the opposite.

EXPENSIVE PROMISES

In their coalition agreement of 1 June 2018, Five Stars and Lega made four expensive promises:

- **Dual rate income tax with two bands of 15% and 20%**: this two-tier “flat” tax could lower tax revenues by €30bn (1.7% of GDP) in 2019 if applied to companies and large families (or even €50bn if implemented for everybody).
- **Citizen’s Income of €780 per month**: if applied to all, such a guaranteed minimum income could cost €17bn per year (1% of GDP).
- **Pension reform reversal** with potential costs of at least €5bn in 2019 (0.3% of GDP), and possibly significantly more.
- **Cancelling the scheduled increase in the VAT from 22% to 24.2% in 2019**: this would cause a loss in revenues of €12.5bn next year (0.7% of GDP).

Upon forming their coalition, 5Stars and Lega agreed to introduce the two most expensive promises, the two-tier flat tax and the minimum income, only in stages. Lega leader Matteo Salvini has emphasised that the government has five years to implement its plans. 5Stars want to pay the minimum income initially to those who actively search for a job. For 2019, finance minister Tria reportedly wants to prevent a rise in the
structural deficit and keep the debt-to-GDP ratio on a gently declining path. Keeping the structural deficit unchanged would leave him with hardly any fiscal space, though.

A FISCAL SCENARIO FOR 2019
The political debate about Italy’s 2019 budget still seems to be in its early stages. Various ideas as to which promises should be kept to which extent are floating around in the press. Although 5Stars and Lega both want to prevent the scheduled rise in the VAT, some reports suggest that Tria may allow the rise to go ahead but use a third of the proceeds to partly compensate the losers, possibly through lower petrol and other excise taxes.

It is too early to predict the outcome of the negotiations with any confidence. For a stylised scenario, let us make some simple assumptions: First, on unchanged policies and without the hike in the VAT, the structural 2019 deficit would remain close to the likely outcome of 1.7% of GDP which the EU Commission has projected for 2018 despite slightly higher bond yields. Second, the VAT hike will be cancelled or – if it goes ahead – will be largely offset by cuts in some other indirect taxes. Third, the pension reform will be partly reversed with a 2019 cost of 0.3% of GDP. Fourth, the flat tax for companies and families and the citizens income will be introduced in stages so that, in 2019, only one fifth of the potential annual costs (0.55ppt out of a potential 2.7% of GDP) will hit the budget.

Under these assumptions, the 2019 structural deficit would rise by almost 0.9ppt of GDP, lifting it to 2.6% of GDP from 1.7% this year. With real GDP growth of 1.2% and thus above potential, the headline deficit unadjusted for cyclical and one-off effects may increase by only 0.7ppt to 2.6% in 2019 after 1.9% in 2018 in this scenario.

THREE POTENTIAL PROBLEMS
This scenario would raise three problems for Italy:

- First, it would weaken the position of finance minister Tria who opposes an increase in the structural deficit. However, a 2.6% headline deficit in 2019 could still suffice to bring the debt ratio down slightly (abstracting from other factors, a deficit of 3.3% of GDP would keep the debt ratio constant at 131% of GDP if nominal GDP rises by 2.5%). Tria may thus decide to remain in office.
- Second, it would fall foul of Italy’s constitutional requirement to run a balanced budget in normal times. Of course, that would not be new for Italy. On balance, we would not expect President Sergio Mattarella to trigger a political crisis by vetoing the budget (or challenge it at the constitutional court) as long as the projected headline deficit remains well below the 3% Maastricht benchmark.
- Third, it would ignore Italy’s commitment under the EU’s Stability and Growth Pact to reduce the structural deficit at a sufficient speed. Upon passing judgement on the medium-term fiscal plan of the Gentiloni government in May, Brussels had demanded that Italy bring down its structural deficit to 0.8% of GDP in 2019.

NOISE NOW – MORE SERIOUS TROUBLE LATER?
Brussels often lets countries get away with some fiscal overshoot. Italian fiscal plans roughly in line with the scenario presented above would severely test the patience of Brussels. Within limits, the EU may accept the argument that Italy needs some additional fiscal space to cope with the impact of the migrant crisis. Our best guess is that the EU, upon evaluating Italy’s 2019 draft budget in late 2018, will raise objections and ask Italy to correct its plans over the coming six months. The EU may formally place Italy in a “significant deviation procedure”. However, we would not expect the EU to impose a (non-zero) fine on Italy – which would technically be possible from mid-2019 onwards if Italy refuses to amend its fiscal plans – as
long as Italy does not on its own escalate any conflict with the EU further. In this respect, Italy’s fiscal plans for 2020 to be discussed in early 2019 could be interesting. If these plans were to foresee an additional stimulus for 2020 (another step towards the two-tier flat tax and a minimum income), the threat of a potential fine on Italy – and an Italian political counter-reaction to that – would loom larger. For a more detailed discussion of the Italian starting situation and a potential timeline, see Italy: a timeline for potential trouble.

The fiscal plans of the radical government in Rome present a grave risk to the country’s financial stability and the long-term sustainability of Italian debt. The discussions about the 2019 budget can bring issues to a head over the next ten weeks. The risks that finance minister Tria may resign, that the government may fall apart as 5Stars and Lega fail to agree on their priorities or that a blatant breach of Italy’s fiscal commitments to the EU could trigger a bond market rout are not negligible. Still, these risks are not our base case. Of course, it may well take an occasional further rise in Italian bond yields to remind the novice political leaders in Rome that their fiscal space is very limited.

On balance, we look for the Italian government to agree on a budget proposal for 2019 that will not be too far from the scenario outlined above. The projected deficits may even be slightly narrower than in our scenario, possibly with the help of some unrealistic estimates about unspecified savings. Such a budget would probably not be scary enough to cause an immediate Italian debt crisis. For now, noisy muddling through remains likely. Rising European and global demand also help to support the Italian economy. However, we maintain our long-term call that Italy may well suffer a genuine debt crisis once the next recession (due perhaps in 2021 on current US cyclical dynamics) has exposed the underlying weaknesses of Italy while denting investor appetite for risk at the same time. See Italian basics: noise now, trouble later,
Chart: Italy’s structural fiscal balance, in % of GDP

Cyclically adjusted balance excluding one-offs and other temporary measures. The European Commission forecasts were based on the fiscal plans submitted by the old Italian government and do not include potential policy changes beyond a cancellation of the 2019 VAT hike. Source: Tesoro, European Commission, Berenberg.

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