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ITALY: TESTING THE LIMITS

Berenberg Macro Flash

Italy is aiming for a fiscal deficit of 2.4% of GDP for 2019 through 2021. Last night, the leaders of the radical parties backing the Italian government prevailed over their more prudent finance minister, Giovanni Tria, who had initially wanted to restrain the deficit to 1.6% and fought hard to not go beyond 2%. Although Tria had reportedly threatened to resign, his office last night denied plans that he would do so. According to some Italian media reports, President Sergio Mattarella called Tria last night, asking him not to resign.

A 2.4% deficit for 2019 is probably slightly worse than markets had expected after earlier more encouraging comments from Tria. Markets may react accordingly, also noting Tria's weakened position within the government. Still, 2.4% is probably not scary enough to trigger an immediate full-blown Italian crisis. It is close to our current forecast of a 2.5% Italian deficit for 2019 and 2020 and not far away from our original prediction of a 2.6% of GDP budget deficit (see Italy: heading for an even hotter September). With the usual fiscal slippage, the actual deficits for coming years could be slightly above the targeted 2.4%. A Lega official already opined last night that the numbers are "not written in stone".

The EU commission will likely put Italy into the "significant deviation procedure" and later in the "excessive deficit procedure" as the deficit target breaches the rules of the Stability and Growth Pact and ignores the commitment to progressively lower Italy's deficit. However, the budget deficit targets still allow for Italy's debt to GDP ratio to decline slightly over the next 3 years, fulfilling one of Tria's key demands. We do not expect that Italy will have to pay a multi-billion EU fine in the end (see Italy: a timeline for potential trouble). As long as Italy does not breach the 3% limit, the EU will likely admonish Italy without imposing a fine that could trigger an anti-European backlash in Italy. France had been in an excessive deficit procedure from 2009 to early 2018 without ever being subjected to a fine.

Since mid-2016, Italy has topped our list of home-grown risks in the Eurozone. With the fiscal plans on which the left-wing 5Stars and the right-wing Lega agreed last night, they have missed an opportunity to defuse the risk, to put it mildly. Instead, Italy is bringing itself into a precarious position. In the long run, Italy's structurally weak economy cannot afford the reversal of the 2011 pension reform and 2015 Matteo Renzi's labour market reform (see The big Italian risk: labour market reversal). Because Italy's underlying fundamentals are shaky, it may not take much to trigger a major selloff in Italian bond markets that would weaken banks, tighten financing conditions and dampen economic growth further. The increase in social spending might also lead to credit rating downgrades (Moody's and S&P will update their ratings in October) increasing pressure on the sovereign bond yields. An Italian debt crisis remains an accident waiting to happen.

Still, we maintain our call that the accident will probably not happen immediately. With a fiscal deficit below 3%, a current account surplus and an economy that is growing at least modestly, Italy is not a prime candidate for an immediate debt crisis – unless the radicals were to get even more imprudent. However, Italy may well suffer a genuine debt crisis once the next recession (due perhaps in 2021) has exposed the underlying weaknesses of Italy while reducing investor appetite for risk at the same time.

Budget details: The higher deficit allows Di Maio to spend more on his flagship citizens income and on pensions. The Italian leaders agreed (as expected) to cancel the planned 2019 VAT increase at a cost of around €12bn or 0.7% of GDP. Tria reportedly offered around €10bn for the implementation of the citizenship income, in line with Di Maio's proposal, but only €2.5bn for the reversal of the 2011 Mario Monti pension reform. This was below the €8bn demanded by Di Maio and right-wing Lega leader Matteo Salvini. Also Tria initially did not want to provide €2bn for the reform of employment centers. A further €1.5bn will be spent to compensate those who lost money in bank defaults. Salvini managed to implement the first steps of his flat tax plan which will allow 1 million Italians to pay only 15% tax according to his calculations. Additionally, a yet unspecified increase in investment for schools, roads and municipalities is included into the budget.

Having agreed on key fiscal parameters, notably the deficit target for 2019, Italy's government will present its detailed 2019 budget draft to parliament and the European Commission in mid-October.

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