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ITALY'S BUDGET: THE TROUBLE IN ROME

Berenberg Macro Flash

The radicals ruling Rome are turning into their own worst enemies. Having presented fiscal plans for 2019 through 2021 that are testing the limits of investor patience, logic would suggest that they should be trying their very best to soothe nerves. Instead, 5Star leader Luigi Di Maio and, to a lesser extent, Lega leader Matteo Salvini are carelessly spooking investors and raising eyebrows across Europe. With their borderline fiscal plans, Italy's radical leaders have put themselves at the mercy of bond vigilantes, rating agencies and their European peers. Italy‘s budget plans are seriously misguided but probably not scary enough to trigger a genuine debt crisis now. Noisy muddling through remains our base case. Still, careless talk by top leaders in Rome keeps a tail risk alive that Italy could cross the border and fall into a serious crisis soon.

According to Corriere della Sera, the populists may make a small concession to market pressure and the EU, reducing their deficit targets to 2.2% for 2020 and 2.0% for 2021 from their original plan of 2.4% for each of the next three years. Even with that small concession, the plans would still clearly breach EU rules. If Italy's leaders watch their rhetoric carefully, such small steps should raise the chances that Italy could get away with fiscal slippage without triggering a major crisis. But the more the leaders rail against the EU, the greater the tail risk that nervous bond markets react accordingly.

STIMULUS - WHAT STIMULUS?

Italy‘s fiscal plans and the behaviour of its key political leaders are probably self-defeating. Yes, Italy has underutilised resources. The economy may well respond for a while to a fiscal stimulus such as the one Italy‘s radical coalition is planning against the advice if its own finance minister. However, picking a noisy fight with Italy's European partners could stoke euro exit fears and depress economic sentiment by more than the fiscal stimulus could lift investment intentions and consumer spending. Also, the resulting rise in yields constrains the fiscal leeway, raises financing costs, retards credit growth and weakens banks. All of this hurts the economic outlook. The net result of the planned fiscal stimulus for 2019, which on paper could be worth up to 0.8% of GDP, could be a higher fiscal deficit and a bigger debt burden without even any temporary boost to demand growth to show for it. Even worse, partial reversals of pension and labour market reforms and the fiscal focus on additional social transfers instead of pro-growth investment and tax cuts will further weaken Italy's meagre rate of trend growth.

5Star leader Di Maio has reportedly opined that French President Emmanuel Macron and German Chancellor Angela Merkel would like to bring down the current Italian government. Such comments may go down well with parts of his domestic base during an election campaign. But they can backfire for a senior politician in office.

First, they lack substance. For example, Merkel has forged a reasonable working relationship with a very diverse bunch of leaders in Europe including erstwhile left-wing firebrand Alexis Tsipras. Europe is always ready to let new leaders prove their mettle.

Second, stoking market concerns about a potential confrontation between Rome and the EU raises yields for Italian but not for French and German bonds. It thus weakens Italy's fiscal situation and its bargaining position in the coming discussions about the Italian budget.

Rating agencies may also take the conflict risk into account upon pondering potential downgrades. If - god forbid - EU leaders were to react in kind with equally careless comments about Italy's fiscal plans, the market damage could be substantial.

As explained before, Italy has made some serious progress under prime ministers Mario Monti, Matteo Renzi and Paolo Gentiloni. Even though an Italian debt crisis is an accident waiting to happen, with economic growth of c1% in 2018, a sizeable current account surplus of 2.8% of GDP, a bearable fiscal deficit of just 2% of GDP in 2018, Italy should not be a candidate for an immediate debt crisis. Instead, its government should be able to get away with some modest fiscal slippage. However, if the radicals now ruling Rome really want to mimic the antics of Greece's disastrous Yanis Varoufakis, all bets could be off. If handled badly, the mix of a slowdown in growth, a noisy conflict with Brussels (and possibly Italy's own constitutional court) and some likely ratings downgrades could turn toxic.

HOW SHOULD EUROPE REACT?
Overly harsh words from other European capitals could potentially trigger a chain reaction in Italy's bond market. Hopefully, other European leaders will restrain themselves, letting the Eurogroup's Portuguese boss Mario Ceteno calmly and politely remind Italy of the rules and apply the rules in due course. The tone matters, especially for senior policy makers. There is no point in ratcheting up the rhetoric. That European Commission President Jean-Claude Juncker pointed to a potential parallel between Italy and Greece yesterday was not completely wrong on substance but not exactly helpful either in this respect.

Ideally, Italy's president Sergio Mattarella and its constitutional court would turn this more into an internal Italian debate rather than a conflict between Rome and Brussels/Paris/Berlin. Of course, Italy's parliament could outvote a presidential veto with a simple majority and the constitutional court may only rule whether or not the budget breaches the constitutional "balanced budget" rule when it is too late, that is at some time in 2019. Still, their interventions may impact the debate, helping Italy to avoid a debt crisis now.

NEXT STEPS

- 15 October: Italy submits draft budget to EU
- 20 October: deadline for publishing full budget
- 22 October: European Commission likely to ask Italy to clarify its fiscal plans
- 26 October: S&P updates its credit rating
- Late October: after some back-and-forth, European Commission will likely reject the Italian budget
- Late November: Eurozone finance ministers likely to approve European Commission's verdict and ask Italy to change budget
- Early December: EU summit likely to discuss Italian budget.

EU leaders may start in December the formal procedure that could result in fines on Italy eventually, perhaps by mid-2019. More likely, EU leaders will play for time and give Italy another chance to rethink its fiscal policies in early 2019. The EU may try to not bring the conflict to a head before the elections to the European Parliament in May 2019. If Italy were to go wrong, which we continue to see as a tail risk far from our base case, European leaders would not want to have been the trigger for that.

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