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FISCAL OUTLOOK: EU EXPOSES ITALY'S WISHFUL THINKING

Berenberg Macro Flash

With a new set of forecasts, the EU Commission today raised the pressure on Italy to revise its spending plans. While the EU changed its economic outlook for Italy only modestly, with a downgrade for 2018 and a small upgrade for 2019, the EU now expects Italy's fiscal deficit to surge to 3.1% by 2020.

The budget plans of the Italian government are a far cry from EU fiscal rules, even if the latter are interpreted flexibly. So far, the ruling coalition in Rome has stubbornly rejected EU demands to change its budget plans. In combination with the reversal of structural reforms, Italy's fiscal planes have caused an unprecedented clash between the third largest EU27 member state and the rest of the EU. In response, rating agencies have downgraded Italian sovereign debt and spreads have widened to 300bps. On 23 October the EU commission asked Italy to submit revised plans by 13 November. If the EU commission does not give green lights on Italy's budget plans, it may start the formal procedure that could end with sanctions imposed on Italy – unlikely before next year's European Parliament elections end of May, though.

GROWTH CUTS, JUMP IN DEFICIT AND DEBT

Upon updating of its economic forecasts, the EU Commission today nudged down the growth prospects for the Italian economy in 2018 from 1.3% (May forecast) to 1.1% (November forecast). On the back of a big fiscal stimulus, the EU expects Italian growth to pick-up in 2019 to 1.2% vs. 1.1% as expected before. For 2020 it forecasts 1.3%. The slightly better outlook for GDP growth comes, however, at a high cost, namely a severe worsening of Italy's public finances. Compared to its previous forecast in May, the (simple, unadjusted) fiscal deficit will widen from 1.7% to 1.9% this year and from 1.7% to 2.9% in 2019 (see chart 1) according to the EU. For 2020, the EU expects the deficit to reach 3.1%. The structural deficit could even worsen to 3.5% in 2020, so the EU. The EU calls are far away from the Italian government's deficit forecasts of 1.8% this year, 2.4% in 2019 and 2.1% in 2020, partly owing to Italy's more optimistic growth expectations (1.5-1.6% between 2018-2020) (see chart 2). Whereas Italy claims that its public debt-to-GDP ratio would fall, the EU Commission expects the debt burden to remain roughly stable around 131% over the 2018-2020 forecast horizon.

While the EU commission always publishes a forecast in the autumn, the timing now plays very much into its hands. Of course, the EU Commission may have chosen to err on the side of caution to strengthen its hand and insist on Italy bringing its budget plans more in line with fiscal rules. But, the projections are not very different from our own ones (see chart 2) and do not, yet, include the disappointing GDP Q3 data when growth stalled. The cut-off date for taking new information into account in the EU commission's forecast was 22 October. The 2018 and 2019 forecasts for growth and the deficit could, therefore, be even worse which suggests that the risks to our outlook for growth are on the downside and the fiscal deficit could be even wider. Also, the Eu-

rogroup of Eurozone finance ministers expressed just this Monday its full support of the European Commission's assessment.

ITALY VS. FRANCE

The Italian government has accused the EU Commission of treating Italy different to France. In the Q&A after the presentation of the forecast, Commissioner Pierre Moscovici stressed that the Commission would not treat the countries differently: the EU commission has approved the French fiscal plans as France's structural balance is pointing in the right direction thanks partly to a wide array of structural reforms introduced by President Emmanuel Macron. By contrast, Italy's structural deficit is going up. In our view, the EU commission should focus its demands on preventing the reform reversals planned by the Italian government even more so than on the mere fiscal numbers.

NOISE NOW

In our view, continued pressure from the EU, further ratings downgrades and (even) higher risk spreads will force Rome to soften its policies by just enough in coming months to stave off an immediate debt crisis. Of the two radicals calling the shots in Italy, the 5Stars' Luigi di Maio and Lega's Matteo Salvini, the latter seems to be less fiscally irresponsible. Whereas the Lega stresses its anti-immigration stance, the 5Stars consider expanded welfare spending as their top priority. According to opinion polls, Salvini's Lega would gain in hypothetical new elections whereas 5Stars would not. If the going gets rough in coming weeks, as it may, Salvini could use his stronger position to force di Maio to accept some changes to the budget that would help to prevent an immediate debt crisis. In such a case, Italy would only be a minor drag on business confidence and growth in the Eurozone as a whole beyond some short-term irritation.

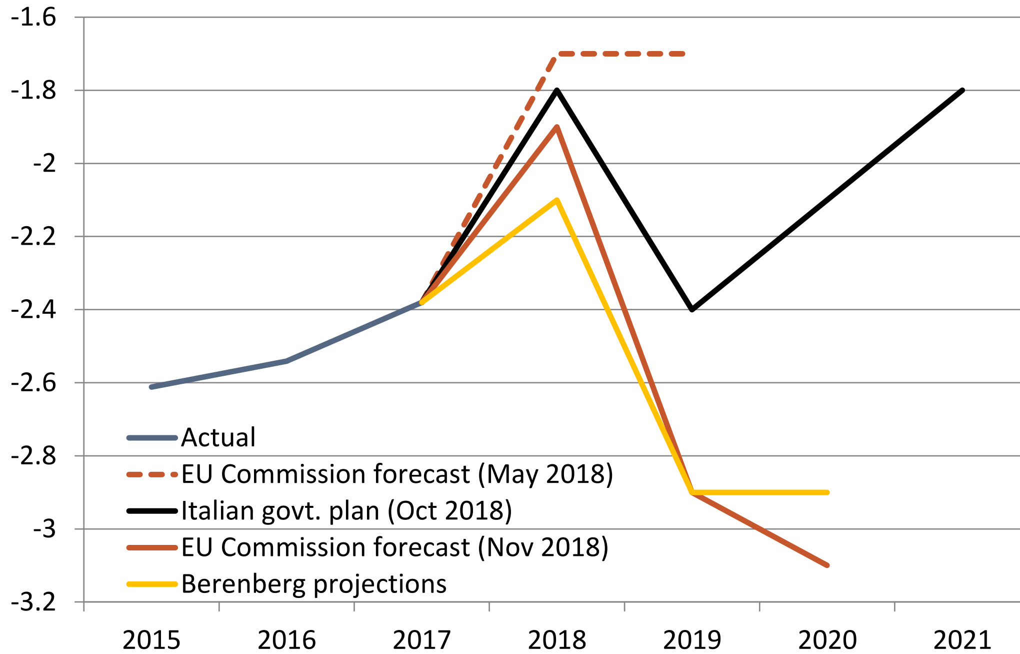
A POSSIBLE CATALYST

A credit crunch with a refusal of banks to lend and higher borrowing costs for Italian businesses could turn into a catalyst for change. If Matteo Salvini's business owners in the North, which make up a significant part of the Lega's base, face credit constraints and higher lending rates, they could lean on Salvini to drop out of the coalition with the 5Stars and try a coalition with Silvio Berlusconi's centre-right party and the right-wing Fratelli d'Italia instead. So far, however, lending rates have remained flat and actually below rates paid by German businesses, though (see chart 3).

MORE TROUBLE LATER

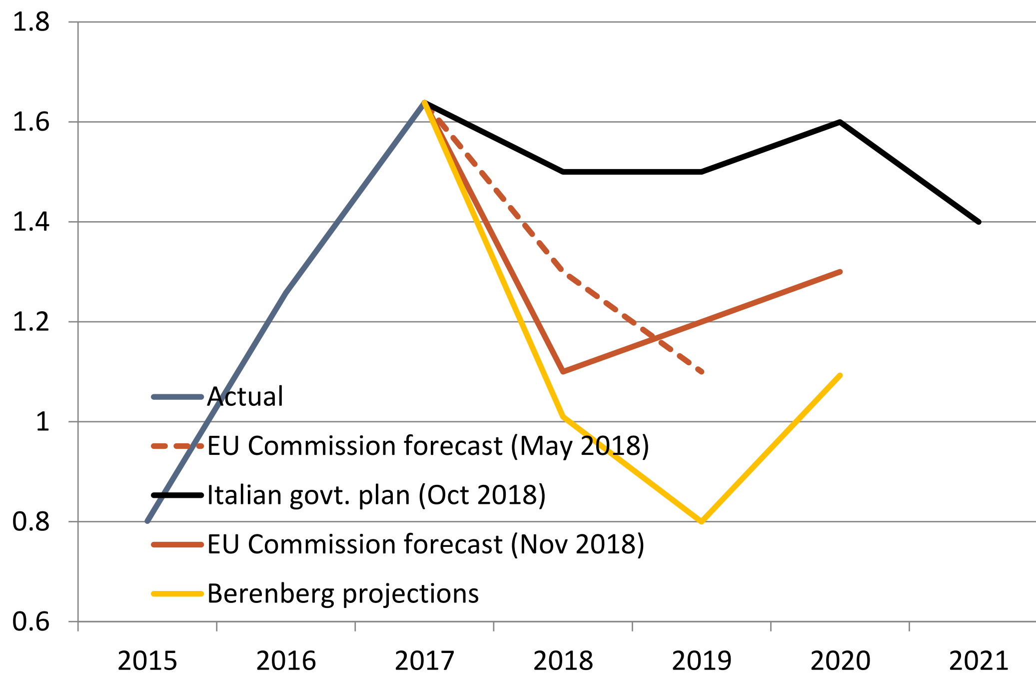
Our base case remains that Italy will muddle through for a few more years after a mini-crisis in the next few months that will force the government to soften its fiscal plans somewhat. For a discussion of the "what if" scenarios, see Notes on the Italian risk. We need to consider two top risks: First, the tail risk of an immediate debt crisis is not quite zero. Second, once the next global recession reveals the underlying weaknesses of the Italian economy in, say, 2021, a massive sell-off in Italian debt may finally force Rome to choose between serious pro-growth reforms coupled with an end to spending excesses – and leaving the euro. We do not expect an Italexit to happen, but we cannot rule it out completely.

Chart 1: Italy's fiscal balance, in % of GDP



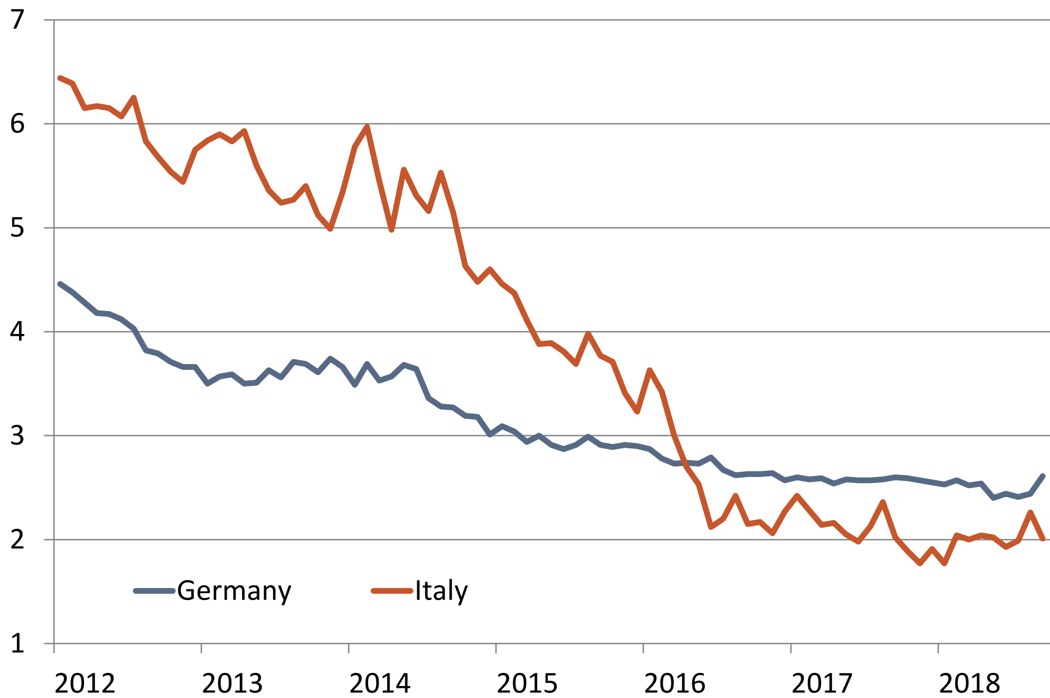
Sources: Eurostat, Tesoro, European Commission, Berenberg.

Chart 2: Italian growth in real GDP, yoy in %



Sources: Eurostat, Tesoro, European Commission, Berenberg.

Chart 3: Interest rate on bank loans to businesses, in %



Interest rate on (new business) bank loans to non-financial corporations, 1-5 years maturity, up to1 million euros. Sources: Eurostat, Tesoro, European Commission, Berenberg.

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