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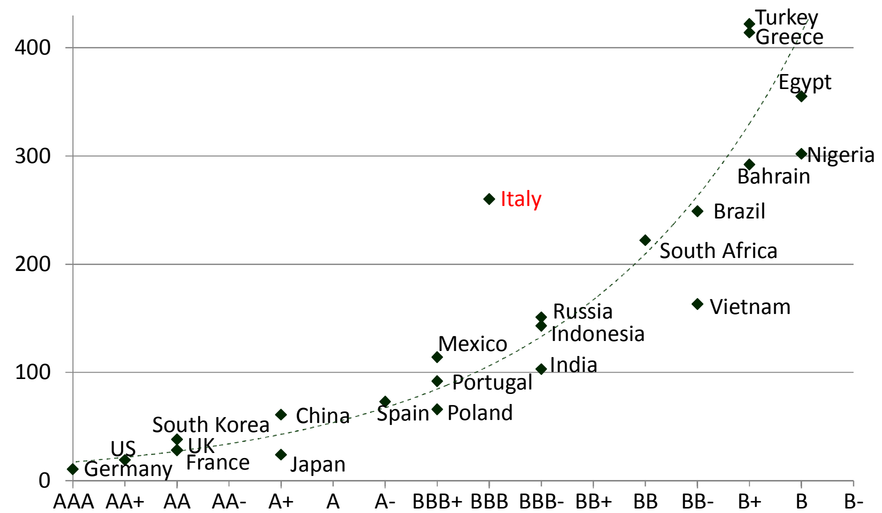
5 October 2018

"Attenzione": is Italy putting its investment grade rating at risk?

The odd one out: five-year CDS levels (bp) versus S&P credit rating



CDS = credit default swap; data as of 5 October 2018 at 13:00 UK time. Sources: Bloomberg, S&P Global, Berenberg

- **Pressure from higher-yield spreads:** Italy's radical government plans to flout EU fiscal rules in 2019 and beyond (see *The trouble in Rome*). Even if Rome manages to dodge a fine from the EU, investors are concerned. The spread of Italian 10-year bonds over German Bunds surged to a painfully high level this week, briefly surpassing 300bp.
- **The fiscal plans do not add up:** Italy's government projects that the budget deficit will rise from 2.0% in 2018 to 2.4% in 2019 before falling to 2.1% in 2020. But this is based on over-optimistic GDP growth forecasts of 1.5% for 2019 and 1.6% for 2020. We expect a deficit of 2.8% for the next two years with GDP growth close to 1% instead.
- **The odd one out:** Judging by the default risk now implied in Italy's credit default swaps, rating agencies are behind the curve (see chart). Currently, the three major rating agencies (Standard & Poor's (S&P), Moody's and Fitch) put Italy two notches above the threshold, while lesser-known DBRS is three notches above. Emerging markets, such as Vietnam, South Africa and Brazil, have lower CDS levels than Italy but are rated below investment grade (BB+ or lower).
- **Rating agencies tend to move slowly:** Rome still has time to correct its fiscal course. While S&P and Moody's could revise their Italian ratings at the end of October, a downgrade by more than one notch is unlikely. However, if Italy does not convince markets and rating agencies that its bonds remain safe and that it would rather change course than possibly ponder a euro exit if the going gets rough, it may lose its investment grade status in 2019.
- **Losing the investment grade status would hurt:** First, many institutional investors who buy only investment grade paper may be forced to sell their Italian bonds. Second, the European Central Bank (ECB) can buy only investment grade bonds under its asset purchase programme (APP). While net purchases stop at the end of 2018, Italy might lose out on ECB reinvestments of its maturing debt thereafter. Luckily for Italy, under a first-best rule, the ECB takes the best rating from just one of the four credit agencies. Third, Italy's banks would suffer from the sovereign-bank doom loop. The ECB could not accept Italian bonds as collateral any more, forcing banks to use more-expensive refinancing options. Higher borrowing costs would hurt demand and weigh on Italy's already weak GDP growth.
- **Serious risks:** Our base case remains that Italy will muddle through noisily. It will not lose its investment grade status and will not succumb to a debt crisis soon. However, the risks are far from trivial. Italy's fiscal plans are testing the limits of investor patience. Rome's fiery rhetoric exacerbates the risks. If Italy oversteps the limits and triggers a spiral of capital flight, ratings downgrades and plunging economic confidence, it may eventually face the tough choice Greece had to make in mid-2015: descend into the chaos of a euro exit or make the painful policy-U-turn back to prudence and pro-growth reforms. Any help from the European Stability Mechanism and the ECB would come with clear conditions attached (think Greece). And even if – as we expect – Italy dodges the bullet now, reform reversals could still make the country a prime candidate for a debt crisis once the next global recession (due perhaps in 2021 on current US cyclical dynamics) exposes Italy's underlying fiscal and structural weaknesses.

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