Italy in 2021: In search of a safe path

The forthcoming soft patch for Italy will likely call for extra funding. To avoid debt sustainability concerns resurfacing down the road, effective use of the EU's recovery fund and an increase in the pace of reforms will be necessary

Growth still hostage to the mechanics of lockdowns and re-openings

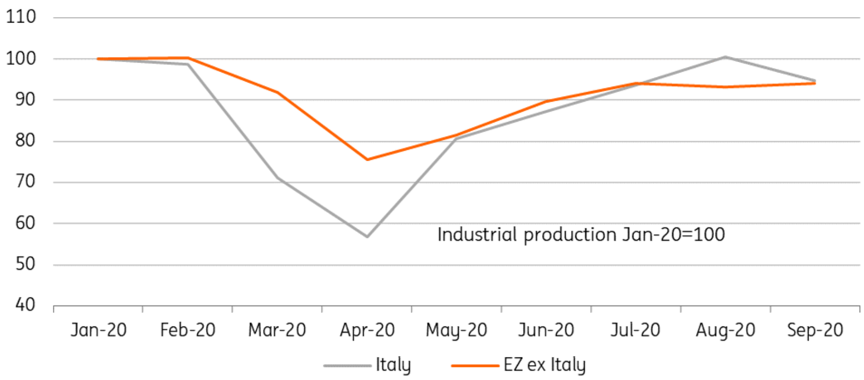
Italy's 2020 growth profile is being dramatically affected by the sequence of lockdowns and reopenings, which will extend at least until the end of the year. After contracting a cumulative 17.6% over the first half of 2020, the Italian economy rebounded by 16.1% in the third quarter, clearly beating expectations. In principle, this could have been a good starting point for 2021, but the dynamics of the Covid-19 pandemic are again changing the external environment. Since early October the number of new infections has again been growing at an accelerated pace, putting increasing pressure on medical services and prompting a response from the Italian government.

Locally differentiated measures, but W seems inevitable

The new measures, which will apply until 3 December, are differentiated regionally based on a set of parameters monitoring both the epidemic and the resilience of hospitals. They range from mild restrictions to soft lockdowns in the most critical cases. As industrial and construction activity is not affected, the current measures are clearly less severe than those imposed nationally during the first wave in the spring, but more severity cannot be ruled out should the curve fail to flatten.

As risks are tilted towards the lengthening of restrictions into December, a GDP fall in 4Q20 looks almost inevitable. On the assumption that most regions will eventually shift into soft lockdown mode, we tentatively anticipate a 3% quarter-on-quarter fall for Italian GDP over the last quarter of 2020, with downside risks.

Deeper early fall in production fully compensated over 3Q



Source: Refinitiv Datastream, ING

Unfavourable statistical carry-over calls for 2021 budget draft revision

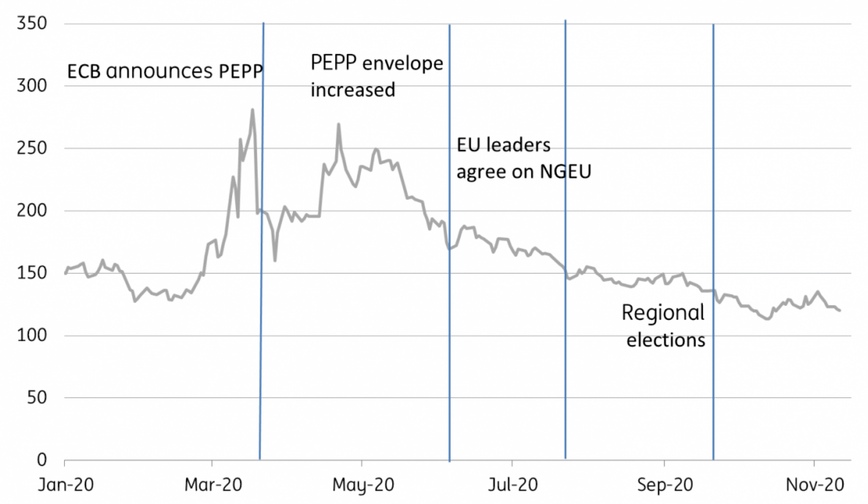
The upshot of this is that 2021 looks set to start with a poor statistical carry-over, which will likely translate into a softer average yearly growth number than previously anticipated, notwithstanding the recent good news on the vaccine front. To be sure, early availability of the vaccine would likely spur a solid rebound thereafter, but this is, to some extent, already incorporated into our forecast profile. The Italian government based its draft budget for 2021 on the assumption that growth would reach 6% in 2021. In the current circumstances, with another soft patch in the making, this seems out of reach, and a substantial revision to the draft plan looks inevitable.

Higher deficit will call for new funding decisions, with an eye on sustainability

Lower growth, lower tax revenues and possible extraordinary outlays in the absence of a spending review will likely translate into a higher budget deficit than previously planned for 2021. In an environment of rising funding needs, it will be increasingly difficult for the Italian government to ignore the existence of potentially available cheap funds (some €36bn for Italy) from the European Stability Mechanism Covid facility. While fear of a 'stigma effect' remains within the 5SM party, the other parties in the government alliance have already stated their willingness to tap the fund.

The alternative would be tapping the market. Provided the ECB remains fully in the reinforced QE game for the whole of 2021, as seems likely, this should be doable without raising immediate debt sustainability concerns, as has been the case in 2020. The issue could eventually resurface towards the end of next year should the debt to GDP ratio inch up again, as we believe. From this perspective, it will be extremely important for Italy to prove it is able to effectively use the opportunity offered by the EU Recovery fund to spur potential growth. This will call for a careful selection of projects and, in parallel, an unambiguous willingness to step up the pace of reforms.

ECB safety net crucial in containing BTP-Bund spread at bay



Source: Refinitiv Datastream, ING

The Italian economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	0.3	-8.7	3.6	2.8
Private consumption	0.4	-8.7	3.9	2.1
Investment	1.4	-11.5	6.5	4.8
Government consumption	-0.4	-0.7	1.8	1.3
Net trade contribution	0.5	-1.7	-0.1	0.3
Headline CPI	0.6	-0.2	0.5	1.2
Unemployment rate (%)	9.6	9.3	11	10.8
Budget balance as a % of GDP	-1.7	-10.7	-8.2	-4.6
Government debt as a % of GDP	134.8	158.0	159.8	158.6

Source: Refinitiv Datastream, all forecasts ING estimates

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