Italy: Politics trumps fiscal discipline

The Italian government's choice to mark a break in the fiscal adjustment path was partly expected, but the scope and, more importantly, the persistence of the deviation is a reason for concern. The possibility of a downgrade and risks of medium-term debt sustainability have just gone up

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After days of noises, leaked numbers and what not, the Italian government approved but hasn't published, the framework for the next budget. This was the first official opportunity for the new Five Star Movement and Northern League's government to put their actual stance on budgetary policy and attitude towards Brussels.

No fiscal splurge but confirmation of piecemeal approach

The debate over the last month had already made clear that Italy wouldn't be in for a massive fiscal splurge. Top officials from both the League and 5SM had accepted the introduction of the three strongholds of the government programme, i.e. the introduction of a flat tax, the loosening of the Fornero pension reform and the introduction of a form of minimum universal income and pension would necessarily follow a piecemeal approach.

Still, uncertainty remains as to how challenging the proposal would be for the EU.

The planned 2.4% target confirms politics wins over fiscal discipline

Inevitably, all eyes were focused on the headline deficit target.

During the debate, the finance minister Giovanni Tria consistently played a reassuring role for markets, reiterating his drive to prioritise fiscal discipline, and particularly the need for a steady decline in the debt to GDP ratio. He quantified his view pointing to a possible 1.6% deficit/GDP target for 2019, which would allow the government to start implementing electoral promises while remaining consistent with a small decline in the structural deficit, deemed as the minimum acceptable outcome for the EU Commission.

However, the prominence of fiscal rigour wasn't shared by the two main stakeholders of the government alliance. Both Matteo Salvini and Luigi Di Maio converged on the idea that more fiscal leeway should be left to implement their electoral promises - and reportedly setting a 2.4% deficit/GDP target for the next three years.

A weakened Tria is likely to stay

Minister Tria, who was seen by the markets as an effective counterbalance to the deficit-inclined duo is now in a weakened position and was forced to bow yesterday.

However, we expect him to stay and play an important role in the making of the next budget, whose draft will be submitted to the EU Commission by 15 October and will enter its parliamentary passage on 20 October.

What will the EU Commission and rating agencies say?

Lacking projected fiscal and growth details, it's impossible to assess the extent to which the EU fiscal requirements will be missed under the planned deficit profile. In case of a big mismatch and continuous clash, we won't rule out the future re-opening of an excessive deficit procedure against Italy.

Also, the way the budget will be crafted can still have a say in the pending credit rating decisions expected from Moody's and S&P at the end of October. To be sure, after yesterday's deficit target announcement, the risk of a resurrection of medium-term debt sustainability concerns has now gone up, as has that of a possible downgrade. Markets are already showing their concern.

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