Italy: Debt-driven excessive deficit procedure recommendation: take two

The move from the EU Commission, which did not come as a big surprise, will now force a clarification between the Italian government stakeholders on the future attitude towards Europe. Should a compromise not be reached, chances of a September political election would likely shoot up

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EU Commission recommends debt-driven excessive deficit procedure against Italy

After the exchange of letters between the Italian government and the EU Commission, the latter decided earlier today to recommend the opening of a debt-driven excessive deficit procedure against Italy for the 2018 divergence.

Commission report provided details, casting doubts on 2019/2010 developments

This was circumstantiated in the preannounced EU Commission Report prepared ex Art 126(3) of the Treaty. While acknowledging that Italy complied with the deficit criterion, the Report highlights that this was not the case for the debt criterion. According to the Commission, the ample 7.8% gap recorded in 2018 will not be filled in 2019 and 2020, based on both the Italian Stability Programme, and, by a wider margin, on the Commission's own projections.

The Commission imputes the projected increase in the debt/GDP ratio to the combined effect of lower-than-projected primary surpluses and on the projected shortfall in privatization proceeds. The Commission does not see big risks to short-term debt sustainability, but its assessment of medium- and long-term sustainability has them deteriorating. According to the report, primary surpluses in the area of 3.2% of GDP will be needed to stabilize the debt/GDP ratio in the long run. The recent "quota 100" initiative, meant to temporary allow for earlier age retirement access is also seen as a problem, accentuating already high age-related expenditure.

Relevant factors assessment overall failed

When delving with so-called relevant factors, ie, factors deemed relevant from countries under scrutiny for a comprehensive assessment of compliance with the deficit and debt criteria, the Commission report is relatively negative.

Using notified data, the Commission deems the 0.1% of GDP deterioration in the Italian structural adjustment in 2018 as falling short of the 0.3% adequate structural effort. Furthermore, the Commission sees a high risk of deviation from the adjustment path towards the medium-term budgetary objective also in 2019 and in 2020.

While acknowledging that the economic slowdown recorded by Italy over 2H18 can be argued as a mitigating factor together with the negative impact of low productivity on potential output, the limited progress (or even some backtracking) on the reform front are seen as only partially addressing the 2018 Country-specific recommendations.

What next?

Article 126 of the Treaty indicates that the Commission proposal will now be examined by the Economic and Financial Committee (EFC), which will have two weeks to decide whether to back or not back the Commission's assessment. Should the EFC agree on the assessment, the Commission could then address an opinion to Italy and inform the EU Council. The next EU Council meeting of 20-21 July might then offer PM Conte the opportunity to discuss the issue. The final decision on a formal opening might be taken by the Ecofin on 9 July.

Different openness to a constructive approach to the EU Commission, for the time being...

As it has often been the case since the start of the recent European elections campaign, today the leaders of the government parties, also vice-PMs, failed to speak with one voice. Di Maio, the leader of 5SM, complained that Italy had been treated unfairly by the Commission, but added that Italy wanted constructive talks with the EU Commission over its budget. Salvini, the leader of the

League, seemed less open to a compromise. In a Facebook post he wrote that the only solution to reduce the debt was by cutting taxes via a flat tax and allowing Italians to work more, adding that cuts, sanctions and austerity had pushed up debt, poverty and unemployment.

...but a tight calendar might soon impose full disclosure

Apparently, PM Conte's Monday televised appeal for the two government stakeholders to reconcile and focus on the implementation of the government contract has not played out, as yet. In his speech, he had clearly said that he was not willing to break European rules so long as these existed and had sounded cold on the flat tax proposal, preferring instead the idea of a comprehensive reform of the tax system. Today, after the EU Commission's decision, PM Conte re-stated he is aiming to have constructive talks with the Commission on the realization of 2019 budget objectives, and might yet manage to avoid the formal opening of an excessive deficit procedure against Italy. The big question mark is whether Salvini will accept a negotiating strategy or not. If not, he might be forced to take the initiative and pull the plug from the current government. A decision in this sense after the 9 July Ecofin might be compatible with fresh political elections in the second half of September.

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