Italy-EU: No clear short-term solution to the fiscal impasse

Latest developments point to little willingness to substantially amend the budget draft. With 2019 elections looming, the risk of a continuation of a challenging attitude by the Italian government looks elevated

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Moody's downgraded Italy to Baa3, as expected

Late on Friday, Moody's announced that it had downgraded Italy to Baa3 (from Baa2), switching to a neutral outlook. Moody's press release shows that the downgrade had two drivers: a material weakening in Italy's fiscal strength and the negative implications for medium-term growth on the stalling of plans for structural economic and fiscal reforms. According to Moody's, the planned fiscal stance of the Italian government will cause the debt/GDP ratio to stabilize around 130% rather than decline over the coming years, leaving Italy vulnerable to external shocks. On the growth front, Moody's believes that the Italian government's plans might have limited a short-term impact on GDP growth, without lifting Italy's mediocre economic growth performance on a sustainable basis.

Next Friday, S&P will release its update to the Italian sovereign rating, currently at BBB with a neutral outlook. Moody's decision to some extent has stolen the thunder from S&P, which is at least expected to change its outlook to negative.

The downgrade did not seem to affect the Italian government's approach to negotiations with the EU

Will Moody's anticipated decision substantially impact the Italian government's approach in negotiations with the EU Commission on the content of the draft budget? We suspect it will not, but do not rule out some openings to a discussion on the post-2019 plans. The quarrel between the EU Commission and the Italian government which followed the submission of the Italian draft budget is developing at a fast pace. The last move was a letter that Commissioner Moscovici handed to Finance Minister Tria last Thursday, in which the Commission deemed the fiscal expansion drafted by the Italian government as an unprecedented deviation from Stability and Growth Pact (SGP) requirements and asked for clarifications on the optimistic growth forecasts. The letter solicited a reply, which came earlier today.

No opening to deficit and growth forecast revision for 2019 from Tria's reply letter...

The content of Tria's reply letter does not legitimize the strong optimism on the government's willingness to revise the budget draft. The letter, while acknowledging the strong deviation from that foreseen by the Stability and Growth Pact, deems that as necessary for a country heavily hit by the consequences of a prolonged period of subdued growth. The validity of the economic projections of the draft budget is also re-stated, on the back of the expectation that the future combined effect of demand multipliers and of prospective reforms will eventually play out.

...but some reassurance that the target set will be met anyway

On a more conciliatory note, in the letter the government says that should the deficit overshoot planned levels, it would intervene to correct the mismatch, re-stating that "Italy's place is in Europe and the Eurozone". The tone of the letter came as no surprise, as reported openings to a deficit target revisions from the side of Tria and Prime Minister Conte filtered over the weekend had been turned down by the wrap-up statements of Deputy Prime Ministers Di Maio and Salvini, which confirmed the 2.4% target.

The EU Commission will likely ask Italy to amend the budget draft

On the back of the budget draft and of the letter which re-affirmed its validity, the EU Commission will have to formally reply by the end of the month. We expect the Commission to ask the Italian government to submit a revised draft. Barring a substantial acceleration of market pressure on Italian bonds, we would expect the Government to be willing to concede only limited amendments to the current text, possibly in the direction of a commitment to resume the structural adjustment already in 2020 and not in 2022. This would probably be not enough to stop the Commission from re-opening an excessive deficit procedure against Italy, more likely in 2019.

With the 2019 European elections looming, the risk is that the Italian government will maintain a challenging attitude towards Europe over the next few months, without pushing the relationship to the extreme. This is an environment that will tend to keep volatility in the Italian government bond market elevated.

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