Italy: No request (yet) for Excessive Deficit Procedure from the EU Commission

The agreement between the Italian government and the EU Commission was made possible by more realistic growth forecasts from the Italian side and a sharp cut in the planned structural balance increase from 0.8% of GDP to zero

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The Italian government and the EU Commission reached an eleventh-hour agreement on the budget for 2019, which will allow Italy to avoid an Excessive Deficit Procedure (EDP), at least for the time being.

A more conciliatory approach by Italy

Having twice submitted a draft budget targeting a headline 2.4% deficit/GDP ratio, the Italian government had to come to terms with reality when the EU Commission finally rejected the Italian proposal and added a credible threat to start soon a debt-driven EDP against Italy. The market reaction to the increased risk of the procedure and the deteriorating economic environment induced the two main stakeholders of the Italian government, Luigi DI Maio, the leader of the 5SM, and Matteo Salvini, the leader of the League, to seriously look for a compromise with Brussels. Evidence from opinion polls that Italians were increasingly in favour of a compromise and the latest Eurobarometer's indication that support for the euro among Italians jumped by 12 percentage points in 2018 also had a say in the process, in our view. On the Commission front, French fiscal developments as a result of the “yellow vests” protest likely helped Commissioner Moscovici and German Chancellor Merkel to smooth the stance of the northern hardliners.

A more prominent role for PM Conte, with support from President Mattarella

Another factor which helped in the negotiation process was a more orderly approach on the Italian side, with PM Conte playing a more prominent role in the process in close cooperation with President Mattarella, who acted as a quiet warden of the Italian Constitution. The negotiating process reportedly ended yesterday and the positive outcome was announced earlier today in a press conference by the Commission’s Vice President Dombrovskis and by Commissioner Moscovici. The former deemed the solution as not ideal, as it does not solve long-standing Italian economic problems, but for the time being is enough to prevent the opening of a debt-driven EDP, provided that agreed measures will be fully implemented. The Commission will thus be closely monitoring relevant developments and will stand ready to reconsider the opportunity to open the procedure in January 2019 should Italy fail to keep its promises.

What are the terms of the agreement?

The agreement between the Italian government and the Commission builds on two strongholds: the downward revision by the Italian government of 2019 GDP growth forecasts from 1.5% to a more reasonable (but still very ambitious) 1% and a sharp downsizing of the projected fiscal push. In the new plan, the government foresees no change in the structural deficit/GDP ratio (from a 0.8% increase in the previous draft). As pre-announced over the past week, the new headline deficit/GDP ratio will be an unconventional 2.04% (from 2.4%), an optical illusion to distract voters from the underlying financial sacrifice.

According to PM Conte’s address to the Senate, the projected deficit decline was obtained by a combination of measures. Firstly, through a re-worked (downward) estimation of the actual financial impact of both the citizenship income and the so-called level 100 pension rule, done while maintaining unaltered the pool of eligible citizens and the planned implementation timeline. In addition, the government will reduce indexation on pensions above a certain threshold and will trim so-called “golden pensions” via a temporary solidarity contribution scaled by income brackets. Referring to the revenue side, PM Conte announced the reduction of some tax credits and a set of measures increasing taxation on gaming and betting. As a sort of safeguard clause meant to ensure Italy’s compliance with the new fiscal targets, the Government will also submit to the Italian Parliament a norm foreseeing the temporary ring-fencing of some €2bn of budgeted expenditures, which will be freed up over 2019 if it is not needed.

In his address, PM Conte also confirmed that Italy requested and obtained fiscal flexibility for an amount of 0.2% of GDP for a plan of investment targeted at the consolidation of road infrastructure and for risk management of hydro-geologic risks.

Short-term positive as EDP risk reduced...

The agreement is clearly a short-term positive and should allow the Italian government to speed up the so far delayed approval of the budget law within the end-of-year deadline. Barring extreme developments, the perspective of an (unlikely, but still possible) excessive deficit procedure now seems more likely in correspondence with the Spring publication of realized 2018 fiscal data. This should in principle help reduce the risk of an overlap with the looming European Parliament election.

...but likely ineffective in propelling growth perspectives

What the agreement does not do, in our view, is create conditions for higher potential growth, the key factor needed to secure debt sustainability. Doubts about the actual expansionary potential of the budget are confirmed now that the fiscal thrust is brought to zero. If the ongoing market re-pricing of the risk of a clash with Europe continues this would eventually filter through banks' balance sheets and, ultimately, on lending rates to the private sector and credit availability and, possibly, on confidence, with potential beneficial effects on private demand. Based on little available information, we suspect that private consumption might benefit most, while businesses, would need more visibility on political developments before revising upwards their investment plans. We thus believe that our current Italian 0.8% GDP growth forecast for 2019 remains exposed to non-negligible downside risks.

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