Italy: Temporary fiscal push next year but what then?

The stated unwillingness to resume the structural adjustment path and very optimistic growth assumptions raise doubts about debt/GDP developments. A more conciliatory post-2019 and a constructive debate on the contents of the budget might yet limit the market concerns

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NADEF marks a break with the past

The update to the Economic and Financial Document (NADEF), published last Friday, with a one-week delay, has shed some light on the policy stance of the 5SM/League government. For obvious political reasons the new 5SM/League government had to mark a break with the past, and the NADEF was the first available official vehicle. As we know, it had a complicated formation, which left observers hostage to volatile and not always reliable sources of information.

A temporarily expansionary budget for 2019, with no plan to adjust afterwards

After pre-announcing a projected deficit of 2.4% all across the 2019-2021 period, the government was confronted with the market reaction and with warnings from senior officials from the EU Commission. It then decided to amend the proposal, trimming deficit projections for 2020 to 2.1% and for 2021 to 1.8%. The NADEF shows that the government concentrated its projected fiscal expansion in 2019, when the structural deficit is meant to widen from an estimated 0.9% of GDP in 2018 to 1.7%, with an ex-ante fiscal push of 0.8% of GDP. In the two following years, the projected structural deficit is stable at 1.7%, implying fiscal neutrality. As explicitly stated in an ancillary document, the government sounds unwilling to resume convergence towards the MTO path before economic growth has consolidated. This challenging attitude to the EU solicited an unconventionally quick reaction from Commissioner Pierre Moscovici who, in a letter, expressed his concern for the deliberate deviation from the adjustment path.

Focus on programme strongholds, but flat tax dwarfed

Unsurprisingly, the NADEF shows that, concerning 2019, the government focused very much on the strongholds of their programme: the so-called citizenship income for the 5SM and the loosening of existing pension rules for the League. Together they should absorb about €17 billion from the 2019 budget. The much-hyped introduction of a flat tax system will boil down to a diminished intervention devoted to a limited business audience, which is expected to cost some €2 billion. Approximately €4 billion of fresh public investment is included and other planned measures are expected to cost cumulatively some €2.5 billion.

Very optimistic on growth

The NADEF sounds clearly optimistic on growth perspectives. On the back of the fiscal push, the government projects growth to accelerate to 1.5% in 2019, to 1.6% in 2020 and to slow down to 1.4% in 2021. Given the nature of deficit-generating expenditure, mostly in the form of higher pension expenditure and transfers and, in part by public investment, the implicit multipliers look exceedingly high. At this stage, there is little evidence of measures meant to increase potential output. Additionally, the positive potential impact of the fiscal push on demand could be partially compensated by the negative impact of the transmission of higher interest rates on public debt to the private sector. In a hearing at the Italian parliament earlier today, Finance Minister Giovanni Tria deemed the growth projections included in the NADEF as prudent. We tend to disagree, also on the back of our forecast of softer growth in the US and the eurozone, which will limit the scope for any positive contribution of net exports to Italian GDP growth in 2019.

Debt-to-GDP decline also at risk in 2019

Should growth turn out slower than the NADEF projects, the risk would be that the ex-post deficit-to-GDP ratio might turn out higher than the planned 2.4%, with almost inevitable consequences on the expected declining path of the debt/GDP ratio. Should the net effect of the fiscal push in 2019 turn out only marginally positive, as we suspect, the debt-to-GDP ratio would more likely stabilise at around 131% in 2019 rather than falling by 0.9% as the NADEF foresees.

With May 2019 European elections in sight, little willingness to compromise, but there are faint signs of a more constructive approach

The neutral fiscal stance planned by the NADEF for 2010 and 2021 is likely a reason of concern for both the Commission and eurozone peer members. Over the weekend, in an interview, minister Luigi Di Maio reaffirmed his determination not to amend his plan, but it is not clear whether he referred only to 2019 or also to the following years. We believe that the government will sternly defend its 2019 plans, but might eventually prove willing to tweak those for 2020 and 2021 to allow for a minor structural adjustment then. We do not expect substantial U-turns, but a stronger effort from the Italian government side to better qualify and improve the content of the next budget, whose draft will have to be submitted to the EU Commission by 15 October. With a conciliatory move, Di Maio met the German labour minister yesterday, reportedly announcing that his citizenship income plan would be inspired, with some amendments, by the Hartz IV German plan. Re-opening a constructive communication channel with eurozone partners might help, but something will likely have to be done on the EU Commission front as well. Delegitimizing the current Commission as irrelevant in anticipation of a possible May 2019 European election earthquake, as done by both Matteo Salvini and Di Maio over the past weekend, does not seem the best way to prepare the ground for the Commission's budget evaluation period.

A full agenda ahead

The agenda for the next few weeks is particularly full. The draft budget will be examined by the Commission starting 15 October, and the Commission might issue a first negative opinion on it within two weeks. The Italian government would then have three weeks to submit a reworked version. If it decided not to amend it the commission could recommend the opening of an excessive deficit procedure. The second half of October will also see S&P and Moody's reassessing the Italian Republic credit rating: after the publication of the NADEF, the risk of a downgrade from Moody's has increased substantially, in our view.

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