Italy’s updated EFD points to mild fiscal expansion

The document seems to confirm that the new government under Prime Minister Conte is adopting a more constructive approach towards Europe. No disruptive calls, but a mild counter-cyclical loosening which will have to be qualified to assess its impact on growth

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In a cabinet meeting held on Monday evening, the Italian government approved the updating note to the Economic and Financial Document (EFD), which sets the macroeconomic framework for the upcoming budget.

A mildly expansionary fiscal stance in the EFD update

As it is often the case with the EFD update, all eyes were on the combination of the new macroeconomic outlook and the new set of fiscal targets, whose joint reading qualifies the fiscal stance. A cross reading of the relevant tables shows that the government is aiming at a mildly expansionary budget. According to the government, this should allow Italian economic growth to accelerate from 0.1% in 2019 to 0.6% in 2020 (against a trend forecast of 0.4%).

Economic growth could accelerate from 0.1% in 2019 to 0.6% in 2020.

One can forget the 0.6% of GDP adjustment requested in July by the EU Commission. The government aims for a 0.2% increase in the structural deficit, which could be qualified as a moderate fiscal push. As far as headline metrics are concerned, the EFD foresees the headline deficit stabilizing at 2.2% of GDP next year. On the back of these planned deficit developments, the debt-to-GDP ratio is expected to peak this year at 135.7% (a revision of past GDP data has inflated the debt ratio), and start a modest decline in 2020, courtesy of some privatization intakes. In the document, the government admits that such a profile would not pass current debt-rule tests.

Little funds left after the sterilization of budgeted VAT increases

When writing the EFD, the government had apparently a clear priority: the sterilization of the €23.3bn of VAT increases already budgeted as safeguard clauses. Fund scarcity restricted the list of additional measures to a timid start to the cut of the tax wedge for low-income households (to be introduced only in July 2020 to limit its cost) and to the first tranches of green investments and a family act. The budget would then amount to some €29-30bn. What about the relevant funding? The government seems to rely heavily on fiscal flexibility allowed by the European fiscal rule and on the successful fight on tax evasion stimulated by a reduced-VAT cash-back facility for those using electronic payments over cash. At €7bn, the expected intake looks ambitious.

Other funding sources cited in the document include spending cuts, the reduction of environmentally unfriendly tax incentives and the prorogation of an existing tax on land re-evaluation. While some of these funding sources might ultimately prove not fully reliable, sounder funding will likely come from the lower interest rate bill which will follow after the sharp reduction in BTP-Bund spreads. Confirmation of a non-confrontational approach towards the EU and refrains from any Itexit reference could be worth c.€4bn for each 100bp of lower rates across the curve in 2020. Details on both the measures which will be adopted and the relevant funding will likely be negotiated with the EU Commission over the next two weeks. The budget draft will have to be submitted to the Italian Parliament and to the EU Commission by 15 October.

New commission may prove tolerant due to weak Italian economy

Will the EU institutions raise strong objections to this projected fiscal profile and flag again the threat of a re-opening of a debt-driven excessive deficit procedure? We suspect they won't if the government will maintain a conciliatory attitude, prove willing to make minor adjustments and commit to some extra reforms. With zero GDP growth expected in 2019, the Italian economy is likely to be the growth laggard in the eurozone. To the eyes of a growth-conscious new commission, this could possibly justify some tolerance to a mild counter-cyclical loosening

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