Confidence must be earned

Amundi ASSET MANAGEMENT

Thematic paper | CROSS ASSET Investment Strategy

October 2019

Italy: few ambitions from the new budget framework

Research & Macro Strategy

Italy: few ambitions from the new budget framework

ANNALISA USARDI, CFA
Senior Economist,
Macroeconomic Research

Finalised on 10/10/2019

The essential

On 30 September the newly formed Italian government released an update to April's Economic and Finance Document, with new fiscal plans for the years 2019 to 2022 and changes to the underlying economic assumptions.

The Update Note to the budget shows little ambition in strengthening growth or shoring up public finances for now and can be seen as a transitional budget, aimed at restoring confidence in Italy's commitment to comply as much as possible with the EU framework.

In fact, the deficit target for 2020 is set at 2.2%, in line with expectations and within the maximum flexibility Italy could ask from the EU Commission. In trying to remain in line with the goals stated in its program released few weeks ago (i.e., to try to deliver a mildly expansionary budget) without putting public finances at risk, the fiscal projections rely on a few assumptions still uncertain to materialise and highlight the clear weakness of a heavily indebted country.

On 30 September the newly formed Italian government published an update to April's Economic and Finance Document, with new fiscal plans for the years 2019 to 2022 and changes to the underlying economic assumptions**. In a nutshell, the Update Note to the budget shows little ambition in strengthening growth or shoring up public finances, while relying on a few assumptions still uncertain to materialise and highlighting the clear weakness of a highly indebted country.**

> "The Update Note to the budget shows little ambition in strengthening growth or shoring up public finances."

The Update Note generated little surprise, as the deficit target proposed (2.2%) was broadly in line with the expectations and plans announced by government officials. The Update Note, as of now, sets the framework broadly in terms of economic projections and deficit targets. The actual ways to achieve the goals will be elaborated in more detail by 15 October (when the document must be submitted to the EC) and further by 31 December, when the budget law must be finally approved by the Italian Parliament.

Although 2.2% seems little different from the 2.4% targeted earlier, it is in reality different in terms of its composition. Underlying growth assumptions have been scaled down significantly, and there is no increased deficit projection (2019 and 2020 remain at 2.2%), while proceeds from privatisations have been scaled back to easier-to-achieve targets.

Yet, some critical points and questionable assumptions remain:

- **For achieving the deficit target, the government projects higher tax revenues by fighting tax evasion** (approximately EUR 7bn); this is one of the major sources of additional financing for the budget this year and will depend on the success of not yet disclosed measures to fight tax evasion;
- **For achieving the convergence of the debt/GDP ratio at lower levels, the projections rely on lower interest spending (market-related) and on a quite significant increase in the GDP deflator**, which helps the projected nominal growth to remain above the average interest rate on

debt and is therefore a key driver in the declining debt/GDP path projected by the government for the 2020-2022 period;

- The government itself points out that the projections do not comply with the debt rule, although the projected reduction in 2020 debt is meaningful; so **the government is implicitly relying on some level of flexibility by the EU Commission** to avoid incurring another "significant deviation", leading to a potential Excessive Deficit Procedure (EDP).

It can be seen, broadly speaking, as a transitional budget, where the government has tried to remain in line with the goals stated in its program released few weeks ago, i.e., to try to deliver a mildly expansionary budget without putting public finances at risk, and to remain within the spirit of the Stability and Growth Pact (SGP). As we argued, it is equivalent to walking on a tightrope with high risks of losing one's balance.

Was the budget able to connect all dots the government wanted to tick?

- **Mildly expansionary fiscal policy.** The proposed budget looks mildly expansionary compared to the previous one. While the deficit remains unchanged at 2.2% from 2019 to 2020, the implied structural correction of 0.7% of GDP embedded in the unchanged legislation projection (with an increase in VAT) is avoided and becomes an expansion of 0.1% of GDP in 2020 in the new policy framework (where VAT does not increase). Indeed, the difference amounts to approximately EU 14.4 bn of additional deficit, with the cost of avoiding the VAT hike left partly unfunded.

"The government is implicitly relying on some level of flexibility by the EU Commission."

**Table 1:
Key fiscal projections, % of GDP**

	2017	2018	2019	2020	2021	2022
Deficit	-2.4	-2.2	-2.2	-2.2	-1.8	-1.4
Primary Balance	1.3	1.5	1.3	1.1	1.3	1.5
Interest Expenditure	-3.8	-3.7	-3.4	-3.3	-3.1	-2.9
Structural Deficit	-1.4	-1.5	-1.2	-1.4	-1.2	-1
Structural variation	-0.6	-0.1	0.3	-0.1	0.2	0.2
Debt /GDP (gross)	134.1	134.8	135.7	135.2	133.4	131.4
Debt / GDP (net)	130.7	131.5	132.5	132	130.3	128.4
State Asset Sales	0	0	0	0.2	0.2	0.2

- **SGP compliance? Hoping for flexibility.** Remember that EU rules do not target the headline deficit, but the structural balance. If the deficit exceeds 3% and or debt/GDP is above 60% and not decreasing at a sufficient pace (the case of Italy), the member-state must undertake fiscal consolidation to correct the deviation.

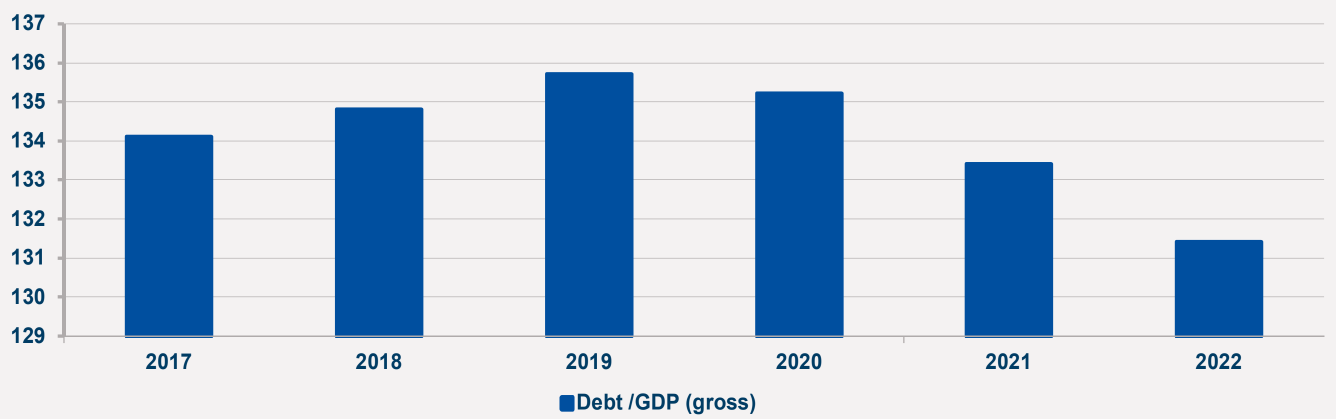
  In "normal times" (with an output gap between 1.5% and -1.5%) the consolidation is *at least* 0.5% of GDP. According to the Spring Forecast projections (output gaps of -0.3% in 2019 and -0.1% in 2020), Italy falls under this case.

  Instead of the consolidation required by the EU commission, the government is proposing a structural change of -0.1% of GDP for 2020, postponing consolidation to the following years. Also, the Note itself acknowledges there is a significant deviation in public expenditure for the 2018-2019 period; and for 2020 public spending is expected to rise instead of contracting, as prescribed by the rules. **Italy is therefore under the pressure to try and avoid the case for an EDP by escaping the "significant deviation" level**, which would be the case for the 0.6% gap above (+0.5% correction by the rules, -0.1% deviation in the budget).

  It will be crucial to see how negotiations evolve with the EU Commission, as the Government is implicitly betting on additional flexibility to be allowed. The autumn forecasts (out in early November) could be key; it's no accident that they were cited by Economic Affairs Commissioner Gentiloni in his hearings at the EU parliament as particularly relevant.

The size of the output gap and the phase of the economic cycle are one of the grounds under which Italy could try to ask for additional flexibility. The first step is to position the economy in "bad times" (instead of "normal times"), arguing that the output gap is larger than -1.5% (and, indeed, it is estimated to be at 1.8% and 1.7%, respectively, in 2019 and 2020 in the Note), whereas the correction requested is would be 0.5% and not above (with GDP growth rate at potential). **Italian newspapers reported rumours that the EU Commission would be inclined to admit some, albeit limited, flexibility (0.2%)**, which is the size of the request the Government expects to ask for in its Draft Budgetary Plan in October. **This would bring the deviation to 0.4% (from 0.6%), enough to ensure a degree of compliance with the "preventive arm" of the SGP.**

1/ Debt/GDP (in %)



Source: Nota di aggiornamento del documento di economia e finanza 2019, Ministero dell'Economia e delle Finanze Italia, as of 30 September 2019, Amundi Research

- **Putting public finances at risk? No, but under a few substantial conditions.** According to the estimates, the deviation of the primary balance in 2020 (1.1%) from its long-term average (1.4%) would be temporary and limited to 2020. Interest expenditures are projected, according to current market expectations, to remain significantly below the April estimates, over the forecast horizon. The deficit is expected to decline over the horizon (from 2.2% in 2020 to 1.8% in 2021 and 1.4% in 2022). From 134.8 in 2018, debt to GDP would move higher, to 135.7 in 2019 and then come back to a slightly declining path (131.4 in 2022). The increase in 2019 debt results mainly from eliminating from the budget the proceeds from privatisations that are no longer expected to materialise and that amounted to 1% of GDP in 2019.

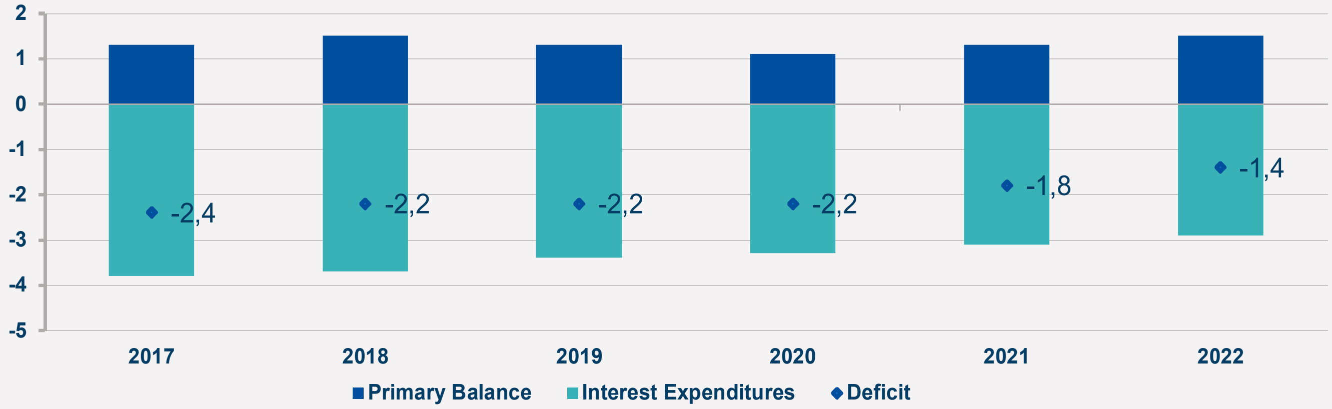
Everything would seem to be in the spirit of the SGP, yet the projections rely on important *caveats*: market projections on rates should hold and economic projections should materialise.

In particular, the downward path of debt/GDP is based on an assumption of nominal GDP growth turning in 2020 above the average interest rate on debt. Yet, the former depends on real growth projections (reasonably in line with the consensus and ours) and on the GDP deflator, which picks up and lifts nominal GDP growth above 2% from 2020 onward; this is clearly the key variable to the debt/GDP path, and here is where we see most risk.

And we see another question here: as per recent declarations of the Minister of Finance, in 2021 deflator is embedded a partial deactivation of the VAT automatic increase (half of the total, EUR 14bn). Knowing how much a VAT hike is embedded in the 2021 projections would be key to evaluating possible friction points with the EU Commission, as the Commission has not included the VAT hike in its projections (as they are usually deactivated) for several years.

> "The size of the output gap and the phase of the economic cycle are one of the grounds under which Italy could try to ask for additional flexibility."

2/Deficit, Primary Balance and Interest Expenditure projections as % of GDP



Source: Nota di aggiornamento del documento di economia e finanza 2019, Ministero dell'Economia e delle Finanze Italia, as of 30 September 2019, Amundi Research.

Table 2: Economic Projections

Growth rates (%)	2019	2020	2021	2022
GDP baseline real	0.1	0.4	0.8	1
GDP projected real	0.1	0.6	1	1
GDP deflator baseline	0.9	1.9	1.5	1.5
GDP deflator projected	0.9	1.3	1.7	1.7
GDP baseline nominal	1	2.3	2.3	2.5
GDP projected nominal	1	2	2.7	2.6

- **Will we be changing our expectations? Not likely, not yet and not for the budget.** Any revision to our expectations will likely follow developments on the external front more than embedding the implications from the new budget. The most significant "domestic" development that could impact our forecasts would be a pickup in investments that may benefit from the lower yield curve, in addition to continued fiscal support for the Industry 4.0 incentives, which could pose an upside risk to our projections. Other measures, such as the avoided VAT hike, may not have such a large impact, as economic operators may have already been discounting what the government finally did, as broadly announced. We currently expect growth to be 0.1% in 2019 and 0.4% in 2020, which is exactly the baseline scenario in the Update Note.

> "The government estimates that the new policies could add 0.2% to GDP growth in 2020 and 2021."

Table 3: Italian government – estimated impact of main policies (in %)

	2020	2021	2022
VAT hike avoidance	0.3	0.2	-0.2
Reducing labour costs taxation	0.1	0.1	0.1
Extension of policy measures expiring	0.1	0.2	0.1
Higher revenues	-0.1	-0.2	-0.1
Lower spending	-0.1	0	0
Total effect of new policies	0.2	0.2	0
Baseline GDP projection	0.4	0.8	1
Expected GDP projection (new policies)	0.6	1	1

Economic impact estimated by the Government. On top of these estimates, the government estimates that the new policies could add 0.2% to GDP growth in 2020 and 2021, as the table above shows. The introduction of the measure to reduce labour costs may have a positive impact (estimated at 0.1% of GDP by the government), similar to the extension of existing policies, in particular Industry 4.0 (0.1% of GDP). The avoidance of VAT hike should boost GDP by 0.3% in 2020. The funding measures, which are expected to have a low multiplier and are limited in size, should subtract 0.2% from GDP. In total, this should have an economic impact of 0.2% of GDP, lifting the economic projections from the baseline 0.4% to 0.6%.

Last publications

THEMATIC PAPERS

Italy: few ambitions from the new budget framework
Annalisa USARDI — Senior Economist, Macroeconomic Research (2019-10)

French pension reform (an update)
Valérie LETORT — Fixed Income Strategy (2019-09)

France: the reform momentum stays alive after the Yellow Vest crisis
Tristan PERRIER — Economist, Macroeconomic Research (2019-07)

Turkey: inflation, exchange rate's pass-through and monetary policy
Karine HERVÉ — Senior Economist, Macroeconomic Research (2019-06)

Is Turkey really out of the woods?
Karine HERVÉ — Senior Economist, Macroeconomic Research (2019-01)

Global Macro: Outlook to 2020
Macroeconomic Research — Amundi (2018-12)

Morocco: moderate economic risks
Karine HERVÉ — Senior Economist, Macroeconomic Research (2018-11)

Central European countries: Outlook to 2020
Karine HERVÉ — Senior Economist, Macroeconomic Research (2018-11)

Corporate earnings in 2019:
A fading momentum is in store!
Ibra WANE — Equity Strategy (2018-10)

French pension reform: a Trojan horse for a better control of the State budget?
Valérie LETORT — Macroeconomic Research (2018-09)

Pacte Law: what changes lie ahead for savings in France?
Marie BRIERE — Head of the Investor Research Centre,
Xavier COLLOT — Director of Employee Savings & Retirement (2018-06)

France: significant promises kept, but the most crucial reforms will take time
Tristan PERRIER — Macroeconomic Research (2018-05)

Profit trend and cycle analysis: a long-medium-short term sanity check
Federico CESARINI, Lorenzo PORTELLI — Multi-Asset Strategy (2018-05)

Cross road the landscape of the fixed-income market
Valentine AINOUZ, Sergio BERTONCINI — Credit Strategy
Silvia DI SILVIO — Fixed Income and FX Strategy (2018-05)

CROSS ASSET
INVESTMENT STRATEGY

October 2019 | Thematic paper

DISCLAIMER

Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

Photos credit: iStock by Getty Images - Kagenmi

Editors

DEFEND Monica, Global Head of Research
BOROWSKI Didier, Head of Macroeconomic Research

Conception & production

BERGER Pia, Research and Macro Strategy
PONCET Benoit, Research and Macro Strategy

Find out more about
Amundi research team
research-center.amundi.com

Amundi
ASSET MANAGEMENT