GENERALI INVESTMENTS

GIAM Macro & Market Research - Market Commentary

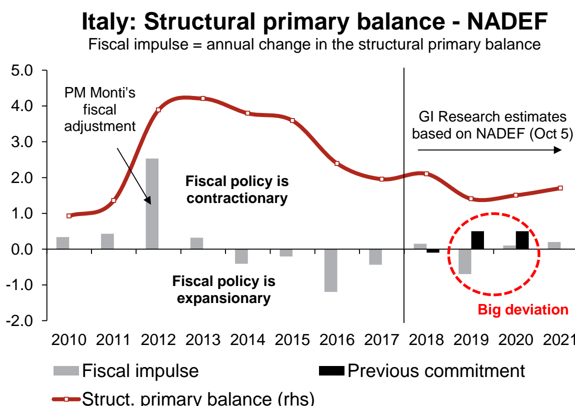
Italian government sticks to budget plan, Excessive Deficit Procedure looming

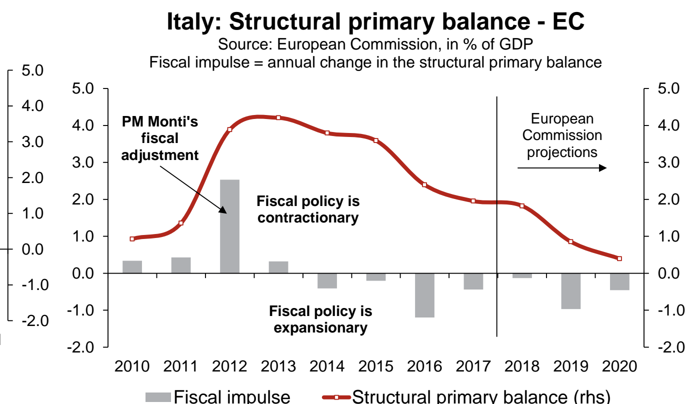
- **Yesterday, the Italian government replied to the European Commission's (EC) remarks on the 2019-21 budget plan. No material concession was offered, as both deficit targets and growth assumptions remained unchanged.**
- **The EC is expected to release on November 21 a report underlying that Italy is no longer compliant with the requirements of the Stability and Growth Pact due to the lack of a credible plan to reduce the high debt burden.**
- **That would be the first step towards the triggering of the Excessive Deficit Procedure (EDP). A decision by the ECOFIN would, however, likely take place only early next year. The EDP would lead to a stricter monitoring of Italian budget metrics and could lead also to fines and the suspension of EU structural funds.**
- **The decision did not come as a surprise to markets, as investors seem to have priced in already a number of negative news on Italy. That said, the confrontational attitude towards the EC, the weakening in the growth outlook and, further down the road, downside risks to Italy's rating will remain a drag to market sentiment and reduce the scope for a relief rally.**

Yesterday evening, the Italian government replied to the remarks the European Commission (EC) made three weeks ago on the budget draft law sent on October 15. In the letter signed by Finance Minister Tria, **the government confirmed its deficit-to-GDP targets and its above-consensus growth assumptions**, stressing the need of expansionary fiscal policies to reduce the growth gap with euro area peers and counteract the slowdown.

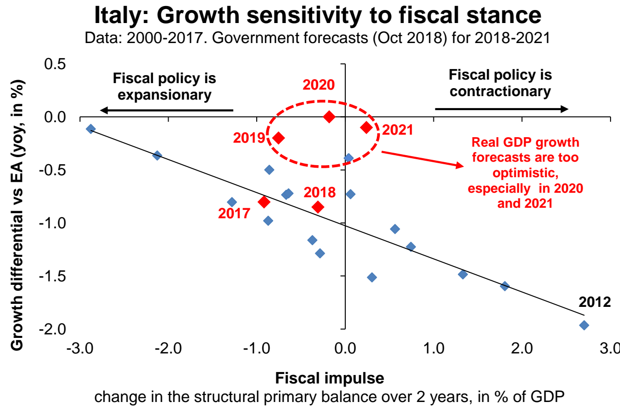
In order to mitigate the concerns over the debt trajectory, the Italian government pledged to increase privatization proceeds in 2019 from 0.3 pp of GDP to 1.0 pp. According to government's projections, this should favor a faster decline in the debt-to-GDP ratio (to 126.0% in 2021 vs 126.7% as shown in the *Nota di Aggiornamento del Documento di Economia e Finanza*, NADEF, released in early October). The government also reiterated that budget implementation would be monitored closely to detect deviations from the budget plan and that adequate measures (to be disclosed) to reduce spending would be taken in case of an overshooting in the deficit.

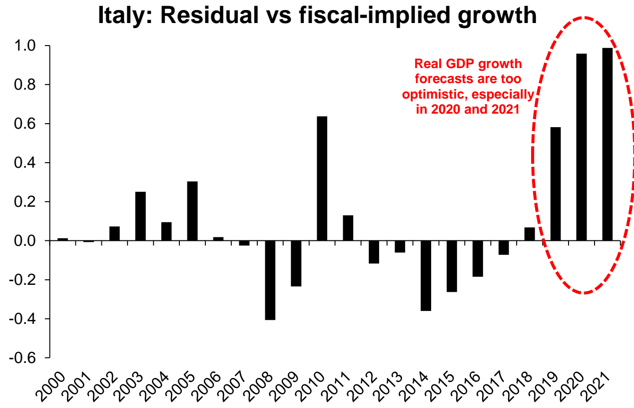
Clearly, **the government's response does not satisfy the requests by the EC**. In its Autumn forecasts released last week, the EC pointed out that the overall deficit will increase to 2.9% of GDP in 2019 and 3.1% in 2020, while the debt-to-GDP ratio will remain broadly stable at 131% in both 2019 and 2020. The EC expects the structural primary surplus to decline to only 0.4% of GDP in 2020, nearly 1 pp below the levels seen in 2011.

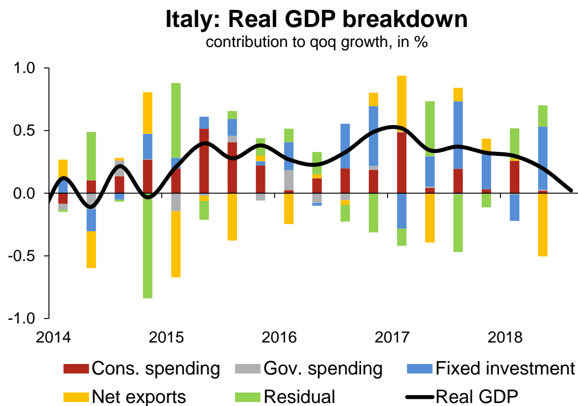


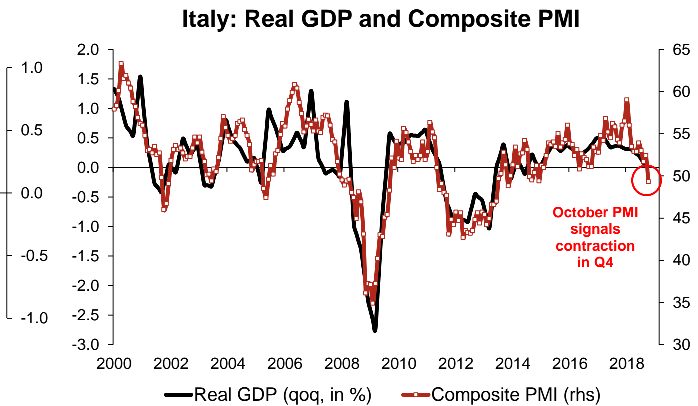


In addition, **growth forecasts remain too optimistic**. According to our calculations, given the government's fiscal assumptions and the consensus growth forecasts for the euro area, real GDP growth in Italy should be 0.6 pp lower in 2019 (0.9% vs 1.5%) and nearly 1 pp lower in both 2020 and 2021 (0.6% and 0.4% respectively vs 1.6% and 1.4% assumed by the government). Moreover, it should be noted that recent macro data point to rising downside risks to Italy's growth outlook (flat growth in Q3, Composite PMI down to 49.3 in October, i.e. in recessionary territory).



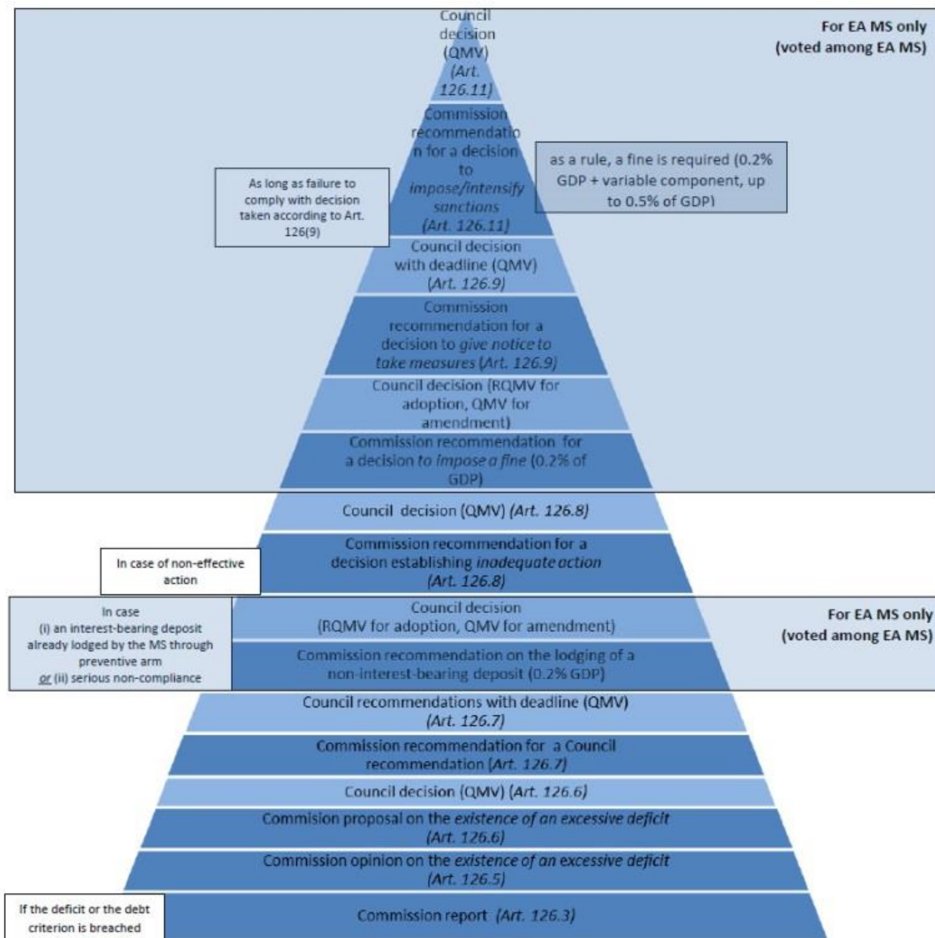






The EC is expected to update its assessment of Italy's fiscal metrics soon. On November 21, the EC should publish a report based on **Article 126(3)** of the Lisbon Treaty stating that the Italian budget does not comply with the requirements of the Stability and Growth Pact. While the overall deficit ratio is projected to remain below 3%, Italy's debt is no longer expected to converge downward due to the increase in the structural deficit.

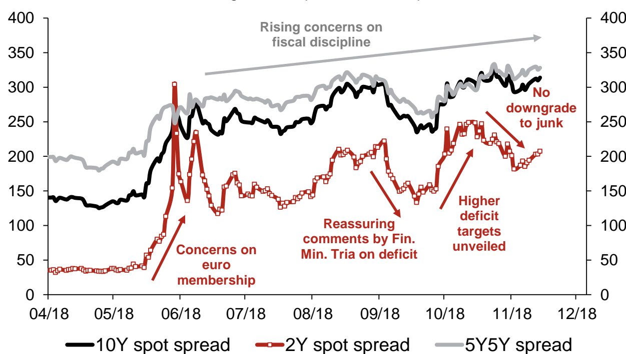
That would be the first step towards the triggering of the **Excessive Deficit Procedure** (EDP). The opening of the EDP is a rather long and formal process, requiring several rounds of assessment by both the EC and the Council. The adequacy of the fiscal measures with respect to the reduction of debt towards the target of 60% of GDP will be subject to an **evaluation by the ECOFIN in January 2019 at the earliest**. The EDP would lead to a stricter monitoring of Italian budget metrics and could lead also to fines and the suspension of European Structural and Investment Funds. The chart below provides a summary of the numerous steps leading to the opening the EDP and subsequent escalation (Source: EC website).



The government's decision did not come as a surprise to markets. The 10-year BTP-Bund spread rose by up to 13 bps to 317 bps earlier this morning, but then has tightened back to 307 bps. **Investors seem to have priced in already a number of negative news on Italy**. **However**, **the confrontational attitude towards the EC** (likely to persist until at least the next European parliamentary election in late May 2019), **the weakening in the growth outlook** and, further down the road, downside risks to Italy's rating **will likely remain a drag on market sentiment**, limiting the scope for a relief rally.

BTP-Bund spread curve

using zero-coupon curves, in bps



Author:

Luca Colussa

luca.colussa@generali-invest.com

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio periodically updating the contents of this document, relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible changes or losses related to the improper use of the information herein provided. Opinions expressed in this document represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio.

Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..