Analysis

Italy – On a Collision Course?

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Fabrizio Pagani offers his unique insights into the current political situation surrounding Italy's budgetary challenges and its relationship with the European Union.

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Fabrizio joined Muzinich in June 2018. Prior to that he was in the public sector where he has held a number of roles including most recently Head of the Office of Italy's Minister of Finance, responsible for developing policies targeting macroeconomics, tax, finance and banking. Before that he served as G20 Sherpa and Senior Economic Counsellor to the Italian prime minister. Previously, during his time at the OECD in Paris, he also held the role of Chief of the Sherpa Office and Special Counsellor to the Secretary General in Paris, responsible for coordinating the OECD's contributions to the G20 and G8 during and after the financial crisis. He holds a degree in International Affairs from the Scuola S. Anna in Pisa and a Masters in International and European Law from the European University Institute.

What is the significance of the current situation in Italy?

The government has been in place since June and is a coalition of two parties – the Five Star and the League. They have come to power with an agenda that is very different from previous administrations and we believe are being more expansionary in their fiscal stance.

The proposed budget numbers were published at the end of September. Fiscal expansion was wider than expected and the government settled on a 2.4% deficit for 2019, 2.1% in 2020 and 1.8% for 2021.[1]

This was a surprise for the market and European institutions alike due to the magnitude of the deficit. As a result, we saw the widening of Italian government BTP spreads over German Bunds.[2]

In addition, over the last month the ratings agencies have reviewed the country's credit rating. All had Italy under review; Fitch and S&P changed their outlook from 'stable' to 'negative' and Moody's downgraded the country one notch, but kept the outlook on 'stable'.[3]

1. Source: Financial Times "Italy's government agrees sharply higher public spending plan" 27 September 2018.
The Wall Street Journal "Italy Sets Lower Budget-Deficit Targets" 3 October 2018
2.Source: Bloomberg, ICE BofA Merrill Lynch 10+ year Italy Government Index (G9I0), 10+year German Government Index (G9D0)
3. Source: Fitch, S&P's, Moody's.

Why is Italy's budget so important?

Italy is part of the European Monetary Union and has a large amount of debt. In our view, the situation is important in terms of how it relates to the previous European sovereign debt crisis, and everyone is keen to avoid a repeat.

As a result, markets are closely following the situation – not only the country's public finances but also Italy's real economy and GDP and the health of Italian corporates.

In 2017, GDP grew at a healthy 1.6%. While 2018 started off fairly well, we have since seen GDP stall in the third quarter. The latest unemployment data reported no positive results.[4] Nevertheless, medium and large Italian corporates continue to appear well positioned, with strong exports and healthy balance sheets.[5]

How are Italian banks faring in this new environment? Do you see any risks?

The Italian banking sector has been in the spotlight for some time. There was a particularly difficult time around two years ago when some banks were recapitalised by the government while others were bought by larger banks.

Further complicating the situation were the number of non-performing loans (NPLs). The issue has since been addressed and NPLs have been declining quite rapidly - falling in net terms from 84bn to 40bn over the last 18 months.[6]

There is a negative correlation between sovereign and bank spreads. Italian banks have significant exposure to BTPs and therefore this has had an impact on the Common Equity Tier 1 (CET1) of Italian banks.[7] Therefore there has been some weakening, but we do not believe there to be any immediate risk.

What do you believe are the main strengths of the Italian government's programme?

We still do not know all the details of the budget measures – the draft law will be presented to Parliament shortly. A number of measures have been announced to provide tax breaks for private investment, help simplify the tax system and assist small companies, all of which are being welcomed by the business community.

What are the implications for Italy if a budgetary agreement does not meet the recent demands of the European Commission?

As the most recent budget submission deviated significantly from the European Union's (EU) fiscal framework, it was rejected by the European Commission (EC) which gave Italy three weeks to come up with an amended version.

Therefore, at the moment Brussels and Rome are at loggerheads and in our view it is vitally important that this situation is resolved. Italy is the eurozone's third-largest economy and therefore an agreement has to be reached.

4. Bloomberg "Italy Unemployment Rises as More People Seek Jobs, Workers Cut" 31 October 2018
5 OECD Data - https://data.oecd.org/gdp/real-gdp-forecast.htm

What are the risks of contagion to other peripheral countries?

We believe the risk of contagion is fairly limited. We have seen some contagion into Greece, but it does not seem to be spreading. Italy has created this situation and Italy can solve it.

Brexit has already rocked the European Union. Do you believe Italy could be next?

There are many moving pieces. Brexit is one; it is the first time a country will leave the EU. Next year is an important election year for the EU and all key positions will be up for renewal in the Commission, the Parliament and at the Central Bank.

We believe that, for the first time since the creation of the European Parliament, the European public will have a chance to have a proper debate on the future of the EU.

So far, European elections have acted as a poll for the popularity of national governments and the focus has been on domestic policy and politics.

Next year there will be a healthy debate on the future of the EU and Europe. We see this as good news for the EU's future as the electorate will decide.

Do you think the rise in populism is likely to gain further momentum?

It is an ambition of the new populist movement to gain a major role in the European Parliament. If this happens, we will be in unchartered territory and many different outcomes are possible.

What are your main expectations for your outlook on Italy over the next 6-12 months?

Firstly, we believe there will be some form of arrangement between Brussels and Rome. Everyone has an interest in working together. The two parties need to look at the Italian budget and fiscal position in a less politicised way. Some of the measures put forward by the Italian government need to be analysed more closely by the EC, while Rome should also be mindful of the EU rules and of its debt burden.

Secondly, we do not believe there is any immediate danger for the banking sector, even at current spread levels, as the capitalisation of Italian banks is quite substantial. A further major widening of spreads could impact some of the medium-sized banks, and an intervention by the government may become necessary. However, in our view, we will not get there.

Overall however we believe waves of volatility and turbulence can continue to be expected from now until the European elections in May next year.

6. Banca D'Italia Monthly Publication "Banche e moneta: serie nazionali" 10 October 2018
https://www.bancaditalia.it/pubblicazioni/moneta-banche/2018-moneta/statistiche_BAM_20181010.pdf
7. Financial Times "Italian banks feel the strain from bond market sell-off" 11 October 2018

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