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ITALY: 2019 BUDGET

ARE FISCAL ISSUES OFF THE TABLE?

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SUMMARY

- After battling for more than two months over a 2019 budget plan defiantly non-compliant with the EU fiscal rules, Rome and Brussels struck a last-minute agreement in December which avoided opening an Excessive Deficit Procedure (EDP).
- We remain of the view that 2019 will be a challenging year for Italy. The economic slowdown, the tensions within the governing coalition and the potential for a fresh confrontation with Europe could rapidly push sovereign yields higher again.

A deal in December after weeks of battle

After intensive negotiations lasting more than two months over Italy's 2019 budget plan, Rome and Brussels struck a last-minute deal in December. The deal avoided Italy being subject to an Excessive Deficit Procedure (EDP) (see our Flash Note for further details here).

To avoid the EDP, **Italy had to backtrack on some elements of its initial plans for fiscal expansion. Rome reduced its fiscal deficit target for 2019 to 2.04% of GDP instead of the 2.4% originally planned**. To arrive at this new figure, the Italian government coalition had to agree to cut proposed spending on its two flagship proposals—namely, welfare benefits (a key pledge of the Five Star Movement) and pension reform (key for the League, the other governing party). Rome also lowered its GDP outlook for 2019 to 1.0% (from 1.5% previously). In addition, the government committed to fully reinsert the so-called "safety clauses" for 2020 and 2021 budget consisting of VAT rate hikes to ensure that the deficit hits a target of 1.8% in 2020 and 1.5% in 2021. Finally, the government agreed to freeze EUR2bn (0.1% of GDP) in expenditure until July 2019 as a buffer in case a mid-year review reveals deviations from the deficit target.

For its part, the European Commission was once again forced to bend the EU fiscal framework. The new budget presented by the Italians now plans a zero change in the structural deficit (the previous document expected a deterioration of 0.8pp), far from the original requirement for Italy to improve the structural deficit in 2019 by 0.6pp of GDP.

Market focus will quickly return to fundamentals and politics

The deal between Rome and Brussels was largely a political compromise, probably helped as much by France's moves to increase its own fiscal deficit (see our Flash Note here), as by fears of a destabilizing Italian crisis and by the cyclical deterioration in Italy's economic performance. But while the Italian 2019 budget saga has quietened down for now, risks remain.

First, on the political front, the concessions made by the Italians on some key parts of their budgetary plans have the potential to feed tensions within the government coalition. Both the Five Star Movement and the League will do all they can to stay in office, at least until the European parliamentary elections in May. **But talk of a snap general election may gain momentum thereafter**.

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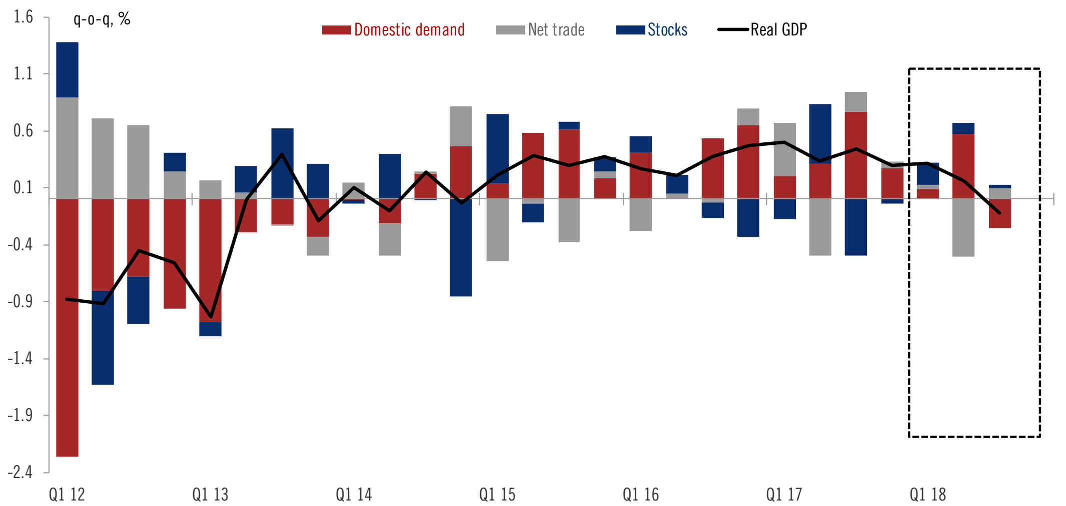
It will also be important to monitor the debate on pension reform and the government's hallmark minimum income scheme. The two measures are not contained in the budget bill approved in December but are due to be addressed in a separate decree. Finally, **the recent issues with lender Banca Carige could well strain the ruling parties**. The government this week approved urgent measures which include government guarantees and a potential public "precautionary recapitalisation" to prop up Banca Carige. This move could set up Italy for a new clash with the European Commission but could also increase tensions within the governing coalition, as voters from the Five Start Movement have come out strongly against public bailouts of banks in the past.

Second, fundamental **concerns remain over Italy's economic outlook**. As such, the preliminary Q4 GDP report, to be released on January 31, will be very important. After negative Q3 GDP growth (see our Flash Note here), the ghost of a technical recession has resurfaced. Business and consumer confidence has eroded significantly. While the budget climbdown has helped to soften market concerns, a marked cyclical deterioration could hurt investment sentiment further and put even more pressure on the government.

CHART 1: ITALIAN REAL GDP GROWTH AND SURVEYS



Source: PWM - AA&MR, Istat.

2020 budget will not be easy

The risk of overshooting the 2.04% deficit target in 2019 is significant, as the government's growth and fiscal baselines remain optimistic. To achieve 1% GDP growth this year, Italy will need to record average quarter-on-quarter growth of 0.4%, which seems ambitious. Our own forecast is for 0.8% growth in 2019, but with risks tilted to the downside.

Along with Brexit, Italy will remain at the top of the European agenda in the coming months. The European Commission will continue to closely monitor budgetary developments there and the government's execution of its 2019 budget. The approval of the Stability Programme in April, just ahead of the European Parliament elections, could be the next flashpoint in EU-Italy relations. The relationship could also deteriorate in H2 2019, when the country will need to present its 2020 budget. Indeed, the government's

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budget strategy for 2020 relies heavily on using the planned VAT hike to meet budget targets, yet the governing coalition has little appetite for this measure.

All in all, **we remain of the view that 2019 will be a challenging year for Italy**. The economic slowdown, the tensions within the governing coalition and the potential for a fresh confrontation with Europe could rapidly push sovereign yields higher again. Budget difficulties with Brussels are not entirely off the table. A large deficit without a significant rise in GDP growth will increase the vulnerability of Italy's public finances to negative shocks.

TABLE: POLITICAL AND ECONOMIC CALENDAR FOR ITALY (H1 2019)

2019	
21 Jan	Eurogroup
31 Jan	**First GDP estimate (Q4)**
01 Feb	Manufacturing PMI (Jan)
10 Feb	Abruzzo regional election
11 Feb	Eurogroup
24 Feb	Sardinian regional election
01 Mar	Manufacturing PMI (Feb)
05 Mar	Final GDP (Q4)
11 Mar	Eurogroup
21 Mar	European Council Meeting
01 April	Manufacturing PMI (Mar)
30 April	First GDP estimate (Q1)
02 May	Manufacturing PMI (Apr)
16 May	Eurogroup
31 May	Final GDP (Q1)
23-26 May	**European Parliament election**
26 May	Basilicata and Piedmont regional elections
13 June	Eurogroup
03 June	Manufacturing PMI (May)
20 June	European Council Meeting

Source: PWM - AA&MR

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