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GLOBAL & REGIONAL FOCUS NOTES

Italy: Keeping Calm and Carrying On

Despite familiar challenges, risks to Eurozone stability remain contained

- BTP-Bund yield spreads have tightened this year as the government has set about tackling its fiscal gap without drama; France is instead the new focus of market jitters
- Finance Ministry sees budget deficit narrowing to 3.8% of GDP this year from 7.2% in 2023; expects to bring it below the EU's 3% of GDP ceiling in 2026, at 2.8%
- Government plans to raise €3.5 billion from banks and insurance companies in its 2025 budget, mostly by suspending banks' DTA deductions; measure met with calm by markets, unlike aborted attempt to impose levy on bank profits last year
- GDP growth has been sluggish, closely tracking that of the euro area as a whole since the pandemic
- Strong headwinds to growth and revision of historic series data make government's 2024 GDP growth target of 1%YoY unlikely
- GDP growth in Q2 slowed to 0.2%QoQ from 0.3%QoQ in Q1; if Italy maintains 0.2%QoQ growth rates in both Q3 and Q4, then 2024 growth would come to 0.6%YoY
- Near-term downside growth risks dominate; composite PMI fell below 50-threshold in September as manufacturing activity contracted at a faster rate
- Headline HICP in September dropped to 0.7%YoY, below euro-area average of 1.7%YoY

Introduction

Italy faces economic challenges that make it a microcosm for many of the problems that the European Union as a whole is grappling with – sluggish economic growth, high levels of public indebtedness and stagnant productivity. In the decades before and after the global financial crisis, those issues led to Italy's characterisation as the biggest of the problematic "periphery" states.

However, in the post-pandemic era, that core-periphery distinction is less potent than it once was. Prime Minister Giorgia Meloni's government has had a difficult task to produce a multi-year fiscal plan that will bring the deficit into line with EU rules, but Italy's fiscal troubles pale next to those of France, which also has a far less stable political environment to contend with. Meanwhile, GDP growth, although sluggish, has

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closely tracked that of the euro area as a whole. Instead, it is Germany that has been the Eurozone's laggard, while "periphery" state Spain has showed the most dynamism among the biggest economies.

Nevertheless, Italy retains several structural challenges that remain distinctly worse than in other large EU economies, including poor dynamics in labour productivity and participation rates. Meanwhile, disturbances in its €2.6 trillion bond market, the euro area's second deepest after France, retain the potential to pose a systemic risk to Eurozone stability. The spread of 10yr Italian BTPs over German 10yr Bunds – seen as a key gauge of Eurozone risk – reached 252bps in 2022 and, after subsiding, again spiked above 200bps in October 2023 as worries over the sustainability of Italy's public finances came into investor focus.

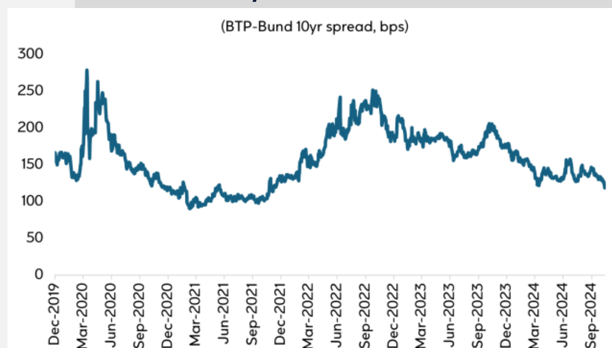
Budget Reckoning

Despite those budget problems culminating in the European Commission placing the country in an Excessive Deficit Procedure in June 2024, along with six other EU countries, bond markets no longer appear concerned about Italian fiscal risk. The yield spread over German bonds has been stable so far this year, mostly moving in a range between 130bps and 150bps. It's been falling in recent weeks, dropping to 119bps on October 17, its lowest level in more than two years. That contrasts with the volatility seen in France, where the spread of 10yr OTPs over Bunds spiked more than 30bps to a 12-year high of 82bps after President Emmanuel Macron called snap parliamentary elections in June and remained slightly above 70bps as of October 17. The spread of 10yr BTPs over OTPs stood at 46bps on October 16, its lowest since 2010, at the start of the Eurozone debt crisis.

Part of the reason why spreads haven't spiked in Italy as they have in France is that markets were confident that Meloni's government would take the measures needed to bring the country's budget deficit under control. The government submitted its new fiscal plan on September 27 which projected that the budget deficit will drop to 3.8% of GDP this year from 7.2% in 2023, before narrowing further to 3.3% in 2025 and 2.8% the year after, bringing it back into compliance with the EU's rules and out of the EDP.

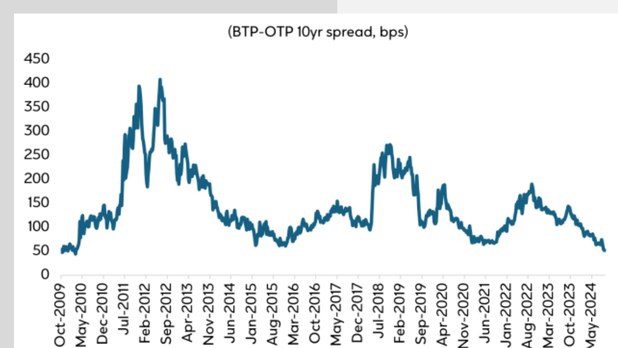
Italy's fiscal situation also received a small boost when the statistical authority, Istat, revised the country's GDP figures for 2021-2023 in September, showing that nominal GDP was €42.6 billion higher last year than

Figure 1: The 10yr Italian bond spread over Germany has been stable this year...



Source: Bloomberg, Eurobank Research

Figure 2: ...while the spread over French bonds has fallen to levels last seen 15 years ago



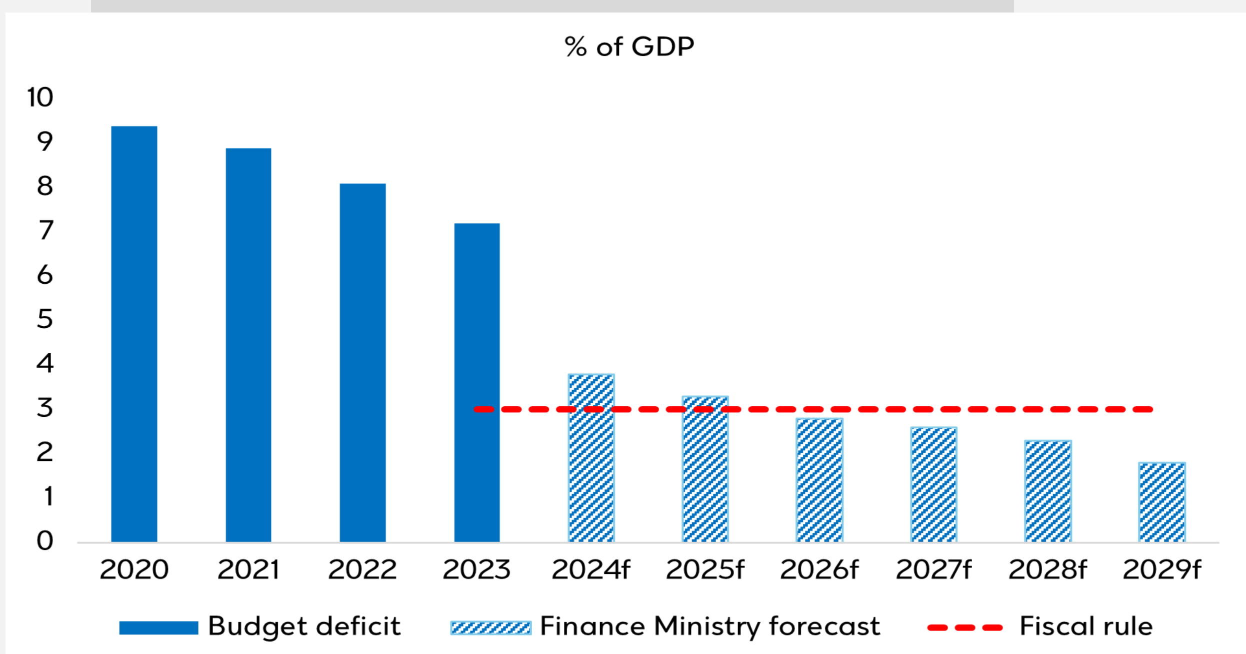
Source: Bloomberg, Eurobank Research

previously estimated. That meant last year's public-debt-to GDP ratio was revised almost 3ppts lower to 134.8%. The government forecasts that the ratio will rise though 2026, peaking at 137.8%.

To hit its fiscal projections the Italian government has spent weeks trying to come up with concrete measures to find €25 billion of budget savings, while also keeping an election promise of making €10 billion reduction in the tax wedge permanent. On October 16 it announced that it had approved a budgetary plan including that permanent reduction and raising €3.5 billion from banks and insurance companies. Most of this will come by suspending banks' deferred tax asset deductions for 2025 and 2026. The measure's announcement did not cause a drop in Italian bank shares in its immediate aftermath. That is significant, since a plan last year to raise funds through a levy on banks' profits was abandoned after causing a selloff in Italian banks. Judging the credibility of the government's fiscal projections is hard at this stage since it has still not made public the full funding details of its 2025 budget, though it also includes spending cuts across various ministries and services. The critical next stage is that the European Commission will assess the government's proposals in the coming weeks.

Nevertheless, markets remain swayed by the relative efficiency with which Italy has set about to tackle its budget deficit, in contrast to France, where the new government projects that the budget deficit will rise to 6.1% of GDP this year from 5.5% in 2023 and will now only seek to bring it below the 3% limit in 2029 instead of 2027 initially. It is planning €60 billion of spending cuts and tax increases to get the deficit down to 5% of GDP next year. Even Spain, which was not placed in an EDP despite running a deficit of 3.6% of GDP last year, is struggling to get a budget approved through its fractured parliament. It already abandoned attempts to pass a 2024 budget, resulting in the 2023 budget rolling over, and there are fears the 2025 budget is heading towards a similar fate.

Figure 3: The government sees Italy's deficit complying with EU fiscal rules by 2026



Source: Istat, Finance Ministry, Eurobank Research

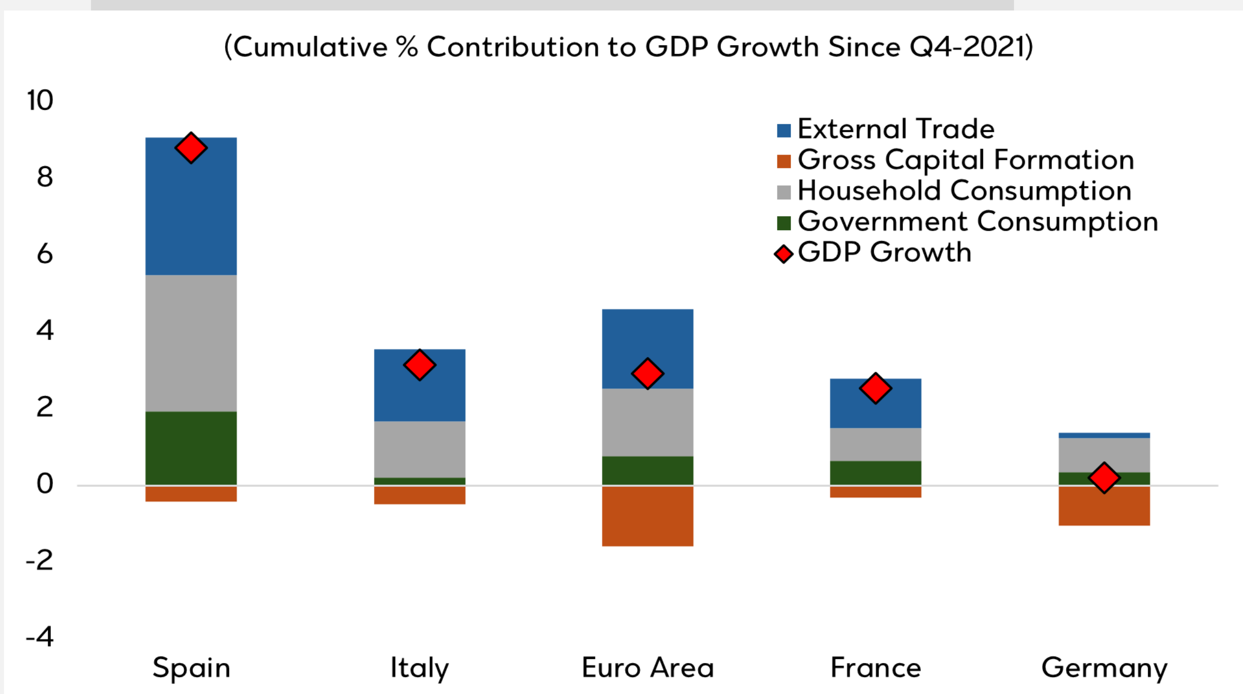
Sluggish Growth

Looking at the economic course of the euro area's four biggest economies since the pandemic, Italy is the country whose GDP has most closely tracked that of the euro area overall, growing a cumulative 3.2% since Q4 2021. That's a shade higher than the currency bloc's somewhat mediocre 2.9% expansion and far better performance than Germany's 0.2% cumulative growth during this period, but it lags far behind Spain's 8.8% expansion. The external sector has been the biggest contributor to Italian growth during this period, contributing 1.9ppts to the total, while final consumption added 1.7ppts.

The construction sector played an important role in supporting Italy's post-pandemic recovery, driven by a controversial subsidy for home energy renovations, which was responsible for blowing last year's budget deficit way off target. With that phased out, future growth is likely to be driven by a recovery in household consumption as disinflation means that households see an improvement in real incomes. Real wages are starting to tick up after being squeezed by rapid price rise after the pandemic. However, poor demographics, workforce participation and productivity continue to constrain growth in the long term. Labour productivity in Italy has grown just 4.3% in total since the start of the euro's inception, compared with 21.3% for the euro area in total and 47.2% for the United States. Since 2019, Italian labour productivity has actually decreased 0.3%, while for the euro area and the US it has grown 1.2% and 7.6% respectively.

The slowdown in inflation is more advanced in Italy than most of the rest of the euro area, with headline HICP growth slowing to 0.7%YoY in September from 1.2%YoY the month before, compared with Eurozone figures of 1.7%YoY and 2.2%YoY respectively. Italy's core HICP also fell below the European Central Bank's 2% target in September, decreasing 0.5ppts to 1.8%YoY, compared with 2.7%YoY for the Eurozone.

Figure 4: Italian growth since the pandemic has closely tracked the euro area as a whole



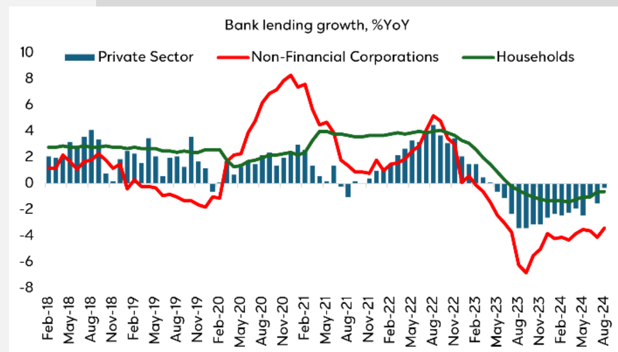
Source: Eurostat, Istat, Eurobank Research

This makes Italy a compelling exhibit for why the ECB was able to step up its pace of monetary easing from the expectation of one 25bp interest rate cut per quarter at the start of the easing cycle in June. On October 17 the central bank stepped up the pace of easing with a 25bps back-to-back cut, taking the deposit rate to 3.25%, while markets are fully pricing in another 25bps cut at the ECB's next and final meeting of the year on December 12. Tight monetary conditions have squeezed the Italian economy as bank lending to the private sector has been contracting on an annual basis since May 2023. In August, the rate of contraction fell to 0.3%YoY from 1.5%YoY in July – a sign that ECB monetary easing may be starting to have an effect. However, the credit contraction is deeper for lending to non-financial corporations, which fell 3.4%YoY in August.

This most affects Italy's manufacturing sector, which accounts for 15.4% of Italian GDP and is currently stuck in a rut. Industrial production fell 3.2%YoY in August, slightly more than the consensus estimate of 3.1%YoY, marking 27 straight months of contraction. Meanwhile, a 1.1pt drop in the manufacturing PMI to 48.3 in September unexpectedly dragged Italy's composite PMI below the 50-threshold separating expansion from contraction, to 49.7 from 50.2. The services PMI fell by a higher than expected 0.9pts to 50.5.

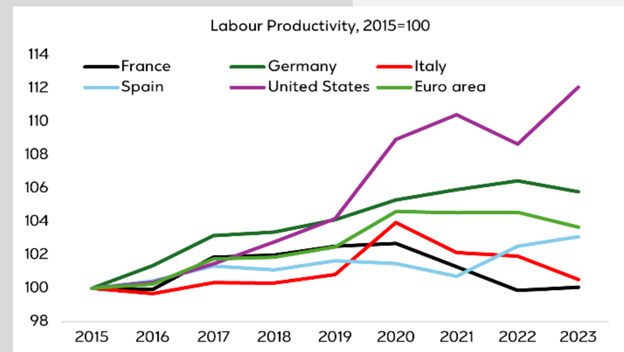
This means the government faces strong headwinds in meeting its growth target for 2024 of 1%, after last year's 0.7% expansion, which has been retained in its new fiscal plan. The government sees Italy's GDP expanding 0.9%YoY in 2025 and 1.1%YoY in 2026. However, the Bank of Italy has already cast doubt on the 2024 growth forecast since Istat's GDP revisions mechanically lowers the carry-over effect for this year's annual growth by 0.2ppts to 0.4ppts – and that's before considering the weakening recent data. GDP growth in Q2 slowed to 0.2%QoQ from 0.3%QoQ in the first three months of the year. If it maintains a 0.2%QoQ growth rate in each of Q3 and Q4 – which would be in line with consensus expectations – then growth this year would come to 0.6%.

Figure 5: Bank credit to Italy's private sector has been contracting since May 2023



Source: ECB, Eurobank Research

Figure 6: The Italian economy has been dogged for years by stagnant labour productivity



Source: OECD, Eurobank Research

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