Why Italy's public debt is sustainable

by Loredana Federico (UniCredit Bank Milan)

- The sustainability of Italy's public debt has moved back into focus amid normalizing bond yields, the European Commission's demands for further budget consolidation and political uncertainty.
- However, fears surrounding the sustainability of Italy's public debt are overdone. We show that under reasonable assumptions on rising interest rates and nominal GDP growth, the primary surplus that Italy would need to achieve to see its public debt to GDP ratio gradually fall is no more burdensome than that which it has already achieved.
- The European Commission's budget consolidation demands are small but positively demonstrate that EU institutions are enforcing flexible fiscal discipline. Meanwhile the Italian government's pledge to meet these demands shows that it can deliver the necessary reforms despite political uncertainty.

Renewed fears over debt sustainability

Since the beginning of the year, Italian public debt sustainability has been back in the headlines as a result of: **1.** ECB tapering (which we do not expect to be announced before September) and inevitable yield normalization; **2.** The European Commission (EC) has demanded that Italy implement additional budgetary measures that would deliver an improvement in the structural budget balance equivalent to a modest 0.2% of GDP to become broadly compliant with the rules of the EU's Stability & Growth Pact (SGP); and **3.** Heightened political uncertainty ahead of the next general election and questions over whether the government will be able to push through reforms.

In this note, we explain why Italy's public debt sustainability will not be at risk under any reasonable forecasting assumptions. We then show that the EU fiscal framework assures that the right dose of fiscal discipline is administered – and that this will limit the room the Italian government will have to oppose the requested tightening measures. Although Italy's fiscal deficit is below the 3% of GDP threshold outlined in the Treaty of Maastricht, the requested budget adjustment is a relevant factor that serves to mitigate Italy's deviation from the EU's debt rules and, in turn, contributes towards improving the overall debt dynamic.

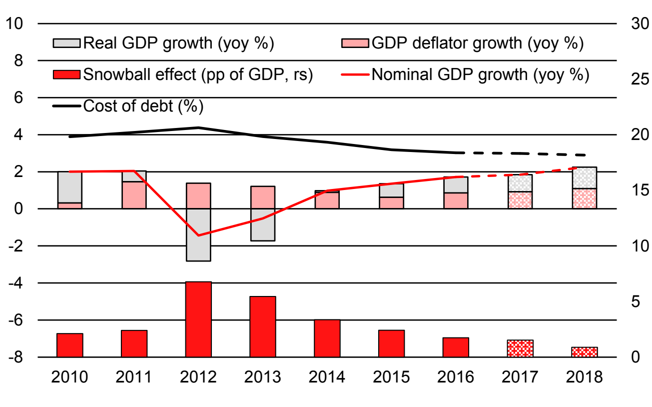
The public debt is sustainable

<u>In the short term</u>, according to the EC forecasts, Italy's public debt to GDP ratio is expected to stabilize at its present level (133% in 2016) over a two to three-year forecast horizon.

The evolution of the public debt to GDP ratio is simply a function of the primary budget balance, the difference between the nominal interest rate and nominal GDP growth, and of all those transactions that affect the debt but not the deficit (for example, privatization revenues or the impact of some of the resources put into the banks).[1] The interest-growth rate differential (otherwise known as the snowball effect), in particular, is the key driver of public debt dynamics. For the public debt to be sustainable, the public debt to GDP ratio should not be rising over the longer term.

In Italy, the average cost of debt is higher than the nominal GDP growth rate, meaning that debt interest payments are growing faster than the size of the economy. However, this gap is closing as the burgeoning European recovery is spreading to Italy and inflation (measured by the GDP deflator) picks up. As Chart 1 shows, this so-called snowball effect is projected to continue to decline amid a nominal growth forecast of around 2% and the declining impact of interest expenditures. In 2018, the snowball effect is expected to add less than 1.0pp to Italy's public debt to GDP ratio – down from 7.0pp in 2012 (in the wake of a severe recession and before the positive impact of the ECB's actions on the bond market were felt).

CHART 1: MACRO OUTLOOK IS LIKELY TO BE SUPPORTIVE



Source: EC, UniCredit Research

a) Interest rates. The average cost of debt is expected to broadly stabilize this year and the next despite gradually rising yields.[2]

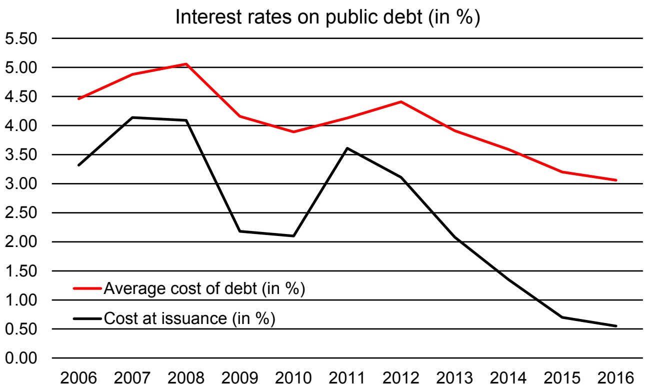
[1] More formally, $\Delta(D_t/Y_t) = -(PB_t/Y_t) + ((r_t - g_t)/(1+g_t))(D_{t-1}/Y_{t-1}) + (SF_t/Y_t)$ where D is public debt, Y is nominal GDP, PB is the primary balance, r is the average interest rate on debt, g is nominal GDP growth, and SF is the stock-flow adjustment.

[2] According to the EC Winter 2017 Forecasts, Italy's 10Y BTP yield is assumed to rise to 2.4%, on average, in 2018 (vs. 2.1% currently).

The reason is that, while Italian government bond yields are projected to rise slightly (increasing the cost of issuance slightly), they are expected to remain below the average cost of debt. The ECB has driven bond yields down in recent years, and this has indeed helped Italy's public debt to GDP ratio. The average cost of Italian sovereign debt fell from 4.4% at its peak in 2012 to about 3.1% in 2016 (see Chart 2). This decline would have been greater if it wasn't for the government's (in our view appropriate) decision to lengthen the average life of the stock of government securities to 6.8 years in 2016 (from 6.4 years in 2014). This brought it in line with the G7 average (but was longer than Germany's 6.1 years and Spain's 6.5 years).

In the near future, this will be important because it will mean that, as the cost of issuing new debt continues to rise, it may take several years for a material impact on the average cost of the debt stock to be felt. Indeed, a simple simulation shows that a permanent shock of 150bp on BTP yields (say, due to the re-pricing of credit risk in Italy), on top of a gradual normalization in Bund yields, would raise the average cost of debt by about 0.15% (and of the interest payment by 0.20pp of GDP) in the first year – while the impact would rise to around 0.80% (and the interest payment by about 1.0pp of GDP) only four years after the initial increase.

CHART 2: COST OF DEBT AND THE IMPACT OF DURATION



Source: Istat, Italy's finance ministry, UniCredit Research

b) Nominal GDP growth. Over a two-year forecast horizon, it is reasonable to expect a steady but slow recovery to continue, with real GDP continuing to expand by 1% and the GDP deflator edging up (+1.0% yoy). Indeed, the latest improvement in business surveys – the manufacturing PMI rose to a 14-month high of 55 in February – is encouraging and fully consistent with annualized GDP growth of about 1.0% in 1Q17. With respect to the GDP deflator, one should not forget that it (not headline inflation) is the price gauge that matters in determining debt sustainability.

Although the GDP deflator was more resilient than inflation during the period when energy prices hit their low, the GDP deflator is projected to increase only gradually now that the recovery in oil prices is likely to push headline inflation close to 1.5%. Over a longer period, it is generally assumed (also by the EC) that the GDP deflator and headline inflation will converge towards the 2% target.

c) Government measures. The primary balance is the key variable that is expected to offset the impact of a still-positive but declining snowball effect, allowing the public debt to GDP ratio to stabilize. Indeed, under the assumption of no policy change in the EC's forecasts, the primary surplus is likely to stabilize at 1.5% of GDP in 2017 and to decline to 1.2% of GDP in 2018. Indeed, the Italian government, in its 2017 draft budgetary plan, committed itself to implementing in 2018 and 2019 significant and challenging fiscal consolidation, which would allow the primary surplus to exceed 3% of GDP.

In addition, in the short run, other policy decisions taken by the government can accelerate or hamper improvement in the public debt. In this respect, two factors play a role in explaining why the public debt to GDP ratio is likely to only stabilize: **1.** The resources committed to Italy's banks by the government[3] (and already imputed by the EC) will probably be added later by the government. **2.** The EC is more conservative regarding the privatization plan of the government and envisages that privatization proceeds will be lower for this year and next – this will be equivalent to about 0.3% of GDP, compared with the government's target of 0.5% of GDP.[4]

Thus, government action and policy decisions seem to represent a more responsible course of action than simply stabilizing the public debt to GDP ratio, and this might represent the beginning of a declining trend. Indeed, the EC forecasts convey the message that the government's backpedalling on some of its commitments (in terms of primary surplus and privatization) would still be consistent with stabilization of the public debt to GDP ratio.

Over the longer term, it becomes more difficult to forecast the evolution of Italy's public debt with a reasonable degree of accuracy. Consider a relatively gradual and multi-year increase in 10Y Bund yields to about 2.70% in 10 years (note this is much higher than the current 10-year, 10-year forward Bund yield of 1.1%) and an average BTP-Bund spread that is within the 150-300bp range.

[3] These resources will be used to subscribe or purchase shares of Italian banks that need to strengthen their capital, as envisaged by the bank rescue decree (containing "Urgent measures to protect savings in the banking sector") approved in December 2016 and converted into law in mid-February.

[4] These privatization proceeds should mainly come from the planned IPO of the state-owned railway company (*Ferrovie dello Stato*) and the sale of a further stake (30%) in the postal service operator *Poste italiane SPA*.

Given these assumptions, it is possible to conclude that the cost of debt is likely to stay between 3.0% and 4.0% for most of the 10-year horizon. Therefore, starting at an average service cost of Italian sovereign debt of 3.0% and a primary surplus of 2.0% – which is marginally higher than the current 1.5% but in line with the historical average – nominal GDP growth of 1.5% (rather than 2.0% currently) should be enough to achieve a stable public debt to GDP ratio. If the cost of debt were to rise to 4.0%, with the primary surplus remaining at 2.0%, it would be necessary to push nominal GDP growth to 2.5% (potentially envisaging a convergence of the GDP deflator towards 2.0%) in order to allow Italy's public debt to GDP ratio to stabilize.

Overall then, based on reasonable assumptions for rising interest rates, the Italian debt is sustainable. The right dose of fiscal discipline, and particularly Italy's ability to continue to generate a primary surplus, will surely be key. In this respect, headlines in the news highlighting the risk that the EC might decide to reopen an EDP for Italy conveys a reassuring message. The EU's pillars create a framework that serves as a constant reminder to governments (or obliges them to not forget) of the direct implications of their actions and decisions on the evolution of their countries' key fiscal indicators. And, importantly, even at a time of increased political uncertainty, the current Italian government has committed to remain compliant with the EU's fiscal set-up and pledged to implement the necessary reforms. To be sure, the fiscal adjustment demanded by the EC is modest, just 0.2% of GDP, but the Italian government will implement it. Therefore, although discussions in the coming weeks are likely to be focused on Italy's compliance with EU rules, the main takeaway should be that the cooperation and continuous dialogue with the EU will simply ensure that the overall public debt to GDP ratio will remain contained.

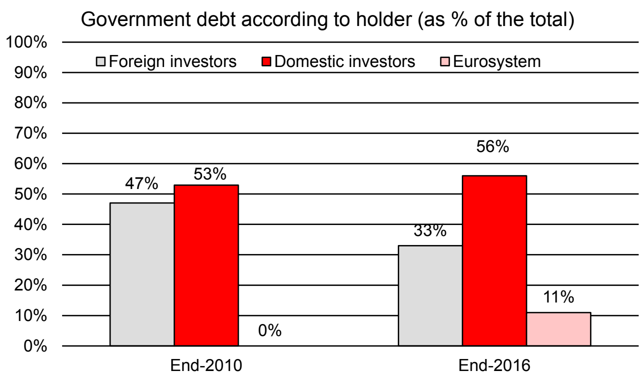
Other reasons why Italy's debt is less problematic

With a public debt to GDP ratio of about 133% at the end of 2016, Italy has the second-highest public-debt ratio in Europe, second only to Greece. Still, a public debt to GDP ratio of 133% does not tell the full story of the issues related to sovereign debt and debt sustainability.

First, the crisis years marked an important shift in the composition of holders of Italian sovereign debt. There was a switch from foreign investors to domestic ones and then to the ECB (see Chart 3). Hence, foreign creditors now hold less than 35% of Italy's total public debt. Just before the onset of the sovereign debt crisis in early 2011, foreign creditors held 47%. This sharp reduction in holdings by foreign private creditors has three benefits for Italy:

1. Italy is much less exposed to sudden changes in international market moods than before – for the sake of comparison, for example, foreign creditors hold 44% of Spanish debt, 53% of German debt and 56% of French debt. **2.** The drag on Italian growth from "debt overhang" is much smaller because interest payments to domestic investors simply imply a redistribution of income from taxpayers to domestic savers and banks, as opposed to foreign creditors. **3.** The political incentive to restructure the debt may be lower.

CHART 3: WHO HOLDS ITALIAN DEBT



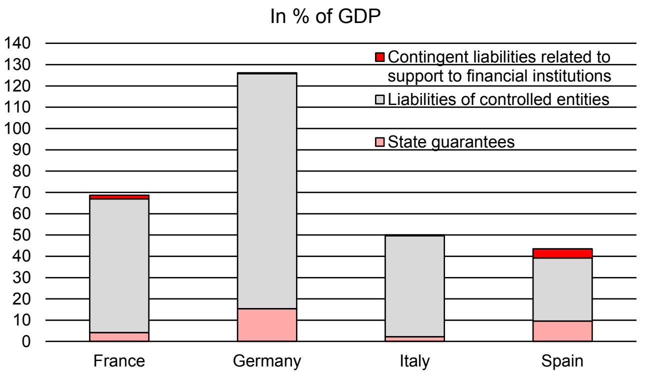
Source: Bank of Italy, UniCredit Research

Second, a sizable share of Italy's public debt is held by the Eurosystem under its quantitative easing (QE) program. This is important because interest paid on this share of the debt contributes to the profit of Italy's central bank. This is, in turn, transferred to the government's budget. Thus, the public debt dynamic is less of a concern for the share of debt that is held by the central bank – and, just like in the US and the UK, there is little prospect of QE-generated claims being sold back to the market.

Third, the overall burden for the Italian government is essentially represented by its high public debt. The relevance of contingent liabilities, in the form of state guarantees, liabilities of government-controlled entities[5] and liabilities related to the support of financial institutions is relatively limited in Italy. These liabilities are contingent in the sense that they are potential liabilities that could become actual liabilities only if certain specific conditions are met. As Chart 4 shows, the total amount of these contingent liabilities is equivalent to 50% of GDP in Italy – similar to that of Spain (44%) but much lower, for example, than that of France (69%) and Germany (126%). The lower value of such liabilities may increase the flexibility of Italy's budget to generate primary surpluses.

[5] Classified outside the perimeter of the general government.

CHART 4: THE RELEVANCE OF THE STATE GUARANTEES



Source: EC, Eurostat, UniCredit Research

Why the structural effort cannot be avoided

Lastly, we delve into the current discussion between the EC and the Italian government. Our main goal is to show how the requested adjustment by the EC already embodies a flexible implementation of the SGP rules, which ensures the right dose of fiscal discipline is administered and serves to limit the room the government has to deviate from the SGP. In particular, the requested budget adjustment represents a relevant factor which mitigates Italy's deviation from the EU's debt rule, and contributes towards containing the overall debt dynamic.

In mid-January, the EC requested that Italy implement additional budgetary measures aimed at delivering an improvement in the structural budget balance worth at least 0.2% of GDP. In response, Mr. Padoan committed the government to implementing the requested budget adjustment by April, with the approval of the 2017 Stability Program (some measures could potentially be adopted even earlier). This commitment pushed back the EC's decision on the EDP to spring; the EU is to start discussing the budget adjustment at the next Eurogroup meeting, which is scheduled for 20 March.

A more detailed look at the current European framework of fiscal surveillance reveals that Italy is subject to the preventive arm of the SGP, which should ensure that Italy makes timely progress towards achieving its medium-term objective (MTO), a balanced structural budget (from -1.6% of GDP in 2016). In particular, with general government debt above 60% of GDP, and economic growth now above its potential growth (which the EC estimates to be marginally above zero) and experiencing "normal times"[6], Italy should be called upon to deliver an improvement in its structural budget balance of 0.6% of GDP or more in 2017.[7]

However, Italy has requested (and obtained) for this year some budget flexibility according to the terms of a clause in the SGP that defines exceptional circumstances. In November of last year, the EC approved a potential allowance for Italy of 0.32% of GDP. This was related to the budgetary impact of the exceptional inflow of refugees (estimated at 0.14% of GDP) and of the investment plan for the protection of the national territory against seismic risks (0.18% of GDP) – several earthquakes have occurred in Italy since last summer. In theory, this should lower the required adjustment: it has been corrected for this year, from 0.60% to 0.28% of GDP.

Following the presentation of Italy's 2017 draft budgetary plan, the EC projected in its Autumn 2016 Forecasts (AF-16) that Italy's structural balance would deteriorate by 0.5pp of GDP and reach -2.2% of GDP in 2017. This would follow a similar deterioration in 2016 (0.6% of GDP). As a consequence, the EC pointed out the risk of significant deviation over one year from the adjustment path towards the MTO in 2017 (see table 1).

TABLE 1: REQUIREMENTS IN STRUCTURAL BALANCE CHANGES

(% of GDP)		AF-16			WF-17	
	2015	2016	2017	2015	2016	2017
Structural budget balance	-1.1	-1.6	-2.2	-1.0	-1.6	-2.0
Change in structural budget balance	0.2	-0.6	-0.5	0.2	-0.6	-0.4
Required change corrected	0.2	-0.3	0.3	0.2	-0.3	0.3
One-year deviation[8] (no more than -0.5pp)	0	-0.3	**-0.8**	0	-0.4	**-0.7**
Structural budget balance with additional effort worth 0.2pp	-1.1	-1.6	-2.0	-1.0	-1.6	-1.8
One-year deviation (no more than -0.5pp)	-	-	**-0.6**	-	-	**-0.5**

Source: EC; UniCredit Research

In February, the EC published its updated Winter 2017 Forecasts (WF-17), which showed a better estimate of Italy's structural budget balance in 2017 (revised up from -2.2% to -2.0%).[9] However, such an improvement is still not sufficient to mitigate the risk that Italy will deviate from its path towards achieving the goals set out for it by the EC.

[6] According to the EC's preventive arm matrix, which sets out the appropriate fiscal stance for each eurozone country by taking into account the cyclical situation, normal times can be interpreted as an estimated output gap of between -1.5% and 1.5% of potential GDP. According to EC estimates, Italy's output gap is expected to be close to -0.8% in 2017 (it was -4.2% in 2012).

[7] The SGP focuses on improving public finances in structural terms, i.e. ironing out the effect of the economic cycle and one-off measures.

[8] The significant deviation is also confirmed by looking at the two year deviation (computed as the average deviation of the last two years). For simplicity's sake, we have not presented them here.

[9] This is mostly due to a more-positive reassessment (compared to that of November) of some one-off revenues envisaged in the government's plan to finance expansionary measures.

Therefore, as table 1 shows, the EC's requirement that Italy undergo a structural adjustment equivalent to at least 0.2% of GDP, while apparently modest and not significant in size, is key to making Italy broadly compliant with the SGP in 2017.[10,11] In addition, it is clear that, even when this additional effort is taken into account, the flexibility granted within the SGP allows Italy to still adopt an expansionary fiscal policy stance also this year, albeit somewhat less so than initially planned by the government. This is expected to continue to support aggregate demand and in turn to spur economic growth.[12]

BOX 1: THE ROLE OF THE OUTPUT GAP

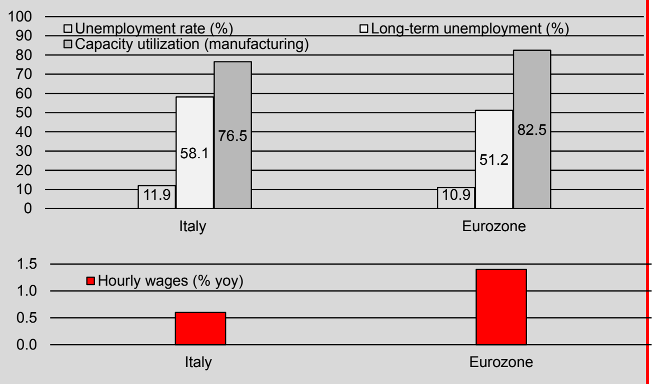
Indeed, any decision to implement outright fiscal consolidation would need to be carefully evaluated at any time while pursuing fiscal discipline, particularly in the case of Italy. This is because fiscal policies that are too restrictive could prove to be self-defeating. EU fiscal rules rely critically on the estimate of a member country's potential output and, in turn, on its output gap. As the latter improves, the required fiscal adjustment increases.

The EC expects Italy's output gap to be -0.8% of potential GDP this year and to close quickly next year, even given modest projected real GDP growth of about 1.0%. This is essentially due to persistent very low potential growth. This may appear puzzling and counterintuitive, especially when comparing Italy to the eurozone, where the output gap is estimated to be broadly similar to Italy's (-0.6% of potential GDP) this year.

Steps have been taken by the EC to increase transparency and mitigate the scope for discretion in the application of the rules. One of these steps is the introduction of a plausibility tool that provides an alternative estimate of the level of the output gap[13], based on a series of indicators that correlate with the business cycle. These indicators tentatively suggest that there may be a difference between Italy's and the eurozone's output gaps (see chart 5).

According to the EC's plausibility tool, Italy is one of the eurozone countries indicated to have an output gap that is more negative (by at least 0.5pp of potential GDP) than the current EC estimate, pointing to a plausible estimate of the output gap of -1.3% of potential GDP for 2017 (rather than the official EC forecast of -0.8%). This alternative estimate of the output gap still implies that Italy is experiencing (by a whisker) "normal times" – it is slightly higher than the lower bound of the output gap interval in the EC's preventive arm matrix (see footnote 6).

CHART 5: ITALY VS. THE EUROZONE



Source: Istat, Eurostat, Ameco, UniCredit Research

Therefore, it does not materially affect the required structural effort for this year. However, the progress in this debate is an important reminder of the high degree of uncertainty that still surrounds the EC's estimate of output gaps and a country's potential – which leaves the use of a right dose of flexibility in the application of the rules and a continuous dialogue between the EC and eurozone countries (as it is indeed) as the high road to be pursued.

The budget adjustment and the public-debt rule

The other important element to consider is the dynamic of public debt, as Italy is also subject to the debt rule. The structural adjustment path is one of the key, relevant factors taken into account by the EC in assessing overall compliance with the debt rule and in determining whether an EDP should be opened regarding the level of Italy's public debt. Thus, this is the other key element that makes the requested budget adjustment even more binding for the government.

Table 2 shows public-debt projections and the computation of public debt benchmarks according to government and EC forecasts[14].

[10] In the preventive arm, the SGP requires that, even in the presence of an annual deviation from the required change in the structural budget balance, as could still be the case for Italy, it does not result in more than -0.5pp of GDP.

[11] We add that achieving of broad compliance with the preventive arm in 2017 is also one of the conditions required by the EC to grant to Italy the maximum possible allowance in 2016 under the structural reform clause and the investment clause, and in turn to make Italy broadly compliant in 2016. Any unwillingness to move down the suggested path could cause the EC to re-assess the 0.75% of GDP flexibility it granted Italy in 2016 and to conclude that there may be a risk of significant deviation by Italy in 2016 as well.

[12] The composition of the budget adjustment the government had initially planned, and which is still the official one so far envisages revenue increases equivalent to 0.15% of Italy's GDP, with the rest represented by selective expenditures cuts within the spending review process and a cut in tax benefits. By referencing first-year multipliers from a permanent fiscal consolidation (via cuts to intermediate consumption and tax benefits, and increases in indirect taxes), we estimate that the overall budget adjustment will have a total negative impact on GDP growth less than 0.1% of GDP, relative to the government baseline scenario, which envisages 1.0% GDP growth in 2017. Therefore, it is expected to be easily manageable.

[13] We refer to the implementation of the "Constrained Judgment approach", presented in the Communication from the Commission – 2017 Draft Budgetary plans: Overall Assessment, EC, 16 November 2016. An Economic Brief, explaining the methodology of the Plausibility Tool on the Output Gap Calculation is forthcoming.

[14] Compliance with the debt rule in 2017 requires one of the following criteria to be met: **1.** In the three years preceding 2017, the gap between the debt-to-GDP ratio and the 60% of GDP threshold must fall by an average of 1/20 (backward-looking benchmark). **2.** In the three years preceding 2019, the gap between the debt-to-GDP ratio and the 60% of GDP threshold must fall by an

It shows that Italy will not comply with the debt rule in 2017, as the difference between the projected public-debt-to-GDP ratios and any of the three debt benchmarks is always positive.

Italy's deviation from its path towards achieving debt-reduction benchmark results has been shown by EC forecasts to be even greater – given the fact that these forecasts show public debt only stabilizing.

TABLE 2: COMPLIANCE WITH THE DEBT RULES IN 2017[15]

Public debt (as a % of GDP)	Backward-looking benchmark (in 2017)	Forward-looking benchmark (in 2019)	Cyclically adjusted public debt (in 2017)
	2017	2019	
Italy's government forecasts			
Public debt projections (A)	132.6	126.7	-
Benchmark level (B)	122.6	124.8	132.4
Gap to the debt benchmark (A-B)	10.0	**1.9**	9.8
EC's AF-16	-		-
Public debt projections (A)	133.1	132.8	-
Benchmark level (B)	122.6	126.0	134.4
Gap to the debt benchmark (A-B)	10.4	**6.9**	11.8
EC's WF-17			
Public debt projections (A)	133.3	133.0	
Benchmark level (B)	122.6	126.0	134.5
Gap to the debt benchmark (A-B)	10.6	**7.0**	11.9

Source: Italy's finance ministry, EC, UniCredit Research

Still, when the more benign forward-looking configuration is considered – the aim of which is to evaluate whether the debt benchmark would be met over a two-year horizon (i.e. in 2019) – the size of the gap to the debt benchmark is significantly lower according to government forecasts, and the gap is likely to become even lower if the requested budget adjustment of at least 0.2% of GDP is implemented. In other words, compliance with EU debt rules leaves limited scope for Italy to get around EC requirements and to avoid resuming a path towards improvement in its fiscal indicators. The risk is that Italy will be forced to implement hard fiscal consolidation in the near future under the more rigid constraints imposed by an EDP. Indeed, these would require Italy to exercise even more, rather than less, fiscal discipline.

average of 1/20 (forward-looking benchmark). **3.** Net of economic cycle, the debt-to-GDP ratio for 2017 must be below the backward-looking benchmark.

[15] Any difference is due to rounding.

Concluding remarks

The expected rise in the cost of issuance amid rising bond yields will take a long while before it causes a meaningful rise in Italy's average cost of debt. Moreover, with the right dose of fiscal discipline – and particularly Italy's ability to continue to generate a primary surplus – we have shown that Italy's public debt remains sustainable under reasonable assumptions. This is why the current discussion between the EU and the Italian government is important – notwithstanding the fact that the fiscal tightening requested is indeed very modest. Despite political uncertainty, the EU's fiscal framework is expected to guarantee that Italy's public debt to GDP ratio remains overall contained.

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