

Italy's public debt: new challenges brought on by the COVID-19 crisis

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- The COVID-19 crisis will weigh heavily on global public-debt dynamics. This constitutes a vulnerability, particularly for Italy. In this note, we provide an assessment of the consequences for Italy of running a higher public-debt/GDP ratio and update our debt sustainability analysis.
- Our main conclusion is as follows: **1.** a more-favorable starting point in terms of interest rates mitigates the risk related to an increase in the fiscal burden of debt; and **2.** despite its higher level, Italy's public-debt/GDP ratio is projected to decline if interest rates align with market expectations.
- We conclude by explaining how Italy could benefit from a decision to activate the European Stability Mechanism's (ESM) Pandemic Crisis Support and from a contribution from the European Commission's (EC) Next Generation EU instrument. The role Italy decides to have in Europe will contribute to shaping its debt dynamic in the long run.

1. A rising public-debt/GDP ratio

The latest fiscal forecasts for Italy made by the government and the main international organizations show that Italy's public-debt/GDP ratio is expected to breach 155%, some 20-25pp higher than its 2019 level, which was already considered high.

TABLE 1: THE LATEST FORECAST FOR ITALY

		Real GDP growth (%)	Budget balance (% of GDP)	Public debt (% of GDP)
Actual	2019	0.3	-1.6	134.8
Government (April)	2020	-8.0	-10.4	155.7
	2021	+4.7	-5.7	152.7
EC (May) ¹	2020	-9.5	-11.1	158.9
	2021	+6.5	-5.6	153.6
OECD (June)	2020	-11.3	-11.2	158.2
	2021	+7.7	-6.8	152.2
IMF (June)	2020	-12.8	-12.7	166.1
	2021	+6.3	-7.0	161.9
UniCredit (June)	2020	-14.0	-12.9	166.8
	2021	+7.0	-6.3	159.6

Source: EC, IMF, Ministry of Economy and Finance, OECD, UniCredit Research

This has revived a debate about the sustainability of Italy's public debt. In this note, we discuss different aspects of this issue and the main challenges ahead.

¹The EC's Spring 2020 Economic Forecast, published in May, was updated with the Summer 2020 (interim) Economic Forecast, published on 7 July, but the EC only provides its forecast for real GDP and inflation. The EC now expects Italy's GDP to decline by 11.2% in 2020 and to increase by 6.1% in 2021.

We acknowledge that, in an environment of low policy interest rates, the European Central Bank's (ECB) pandemic emergency purchase program (PEPP) has been playing a crucial role in keeping the BTP-Bund spread below 250bp since the beginning of the COVID-19 crisis, while the EC's recovery plan², with its role in fostering European prospects, has prompted a further leg down of the spread, currently towards 170-180bp, around 40bp higher than it was pre-crisis. Still, such improvement will continue to depend on the degree to which the Italian government uses this opportunity to put in place long-term growth-enhancing policies and to manage the higher public debt that will remain in its hands.

2. The fiscal burden of public debt

There are several measures that are important when assessing the sustainability of a country's public debt, and these can be seen as complementary. One can start by looking at how a country's interest obligations will evolve relative to the amount of fiscal revenue it generates – the fiscal burden of public debt – and its ability to serve this debt. The greater the ability to afford public debt, the less negative the implications of higher debt will be in terms of creditworthiness.

Last year, Italy allocated 7.2% of its fiscal revenue to interest payments. This was a result of a further reduction in interest rates and a favorable development in fiscal revenue³. Chart 1 shows that in 2019, Italy (together with Portugal) had one of the highest interest/revenue ratios among its main eurozone's peers. However, it was at a historically low level. Italy's interest expenditure as a percentage of total revenue was in the double digits for many years prior to its joining the eurozone. Italy's interest/revenue ratio averaged 11% in the decade from 2000 to 2009, when its public-debt/GDP ratio was 107%, on average. It then declined to 9% in the last decade, when Italy's public-debt/GDP ratio rose to 131% on average.

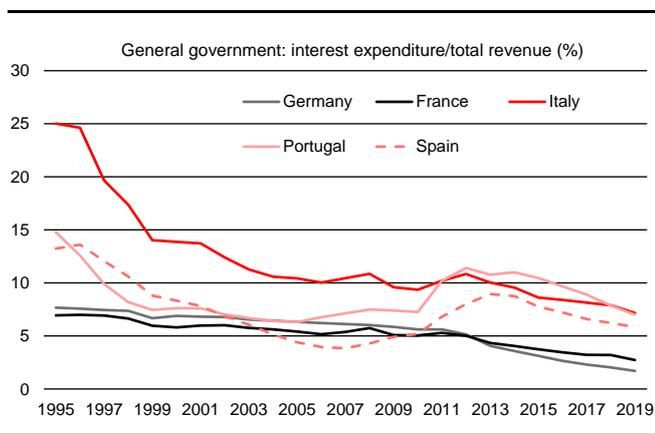
What impact could the higher public-debt/GDP ratio that Italy and the other main eurozone countries are projected to reach⁴ have on the countries' fiscal burdens of debt over the next two years?

²See European Commission (2020).

³The average cost for Italy to issue government debt fell from 1.07% in 2018 to 0.93% in 2019. In 2019, total revenue stood at 47.1% of GDP, an increase of 0.7pp compared to 2018. See Ministry of Economy and Finance (2020).

⁴We take the last full database, EC's Spring 2020 Economic Forecast, as a reference.

CHART 1: INTEREST/REVENUE RATIO OVER TIME



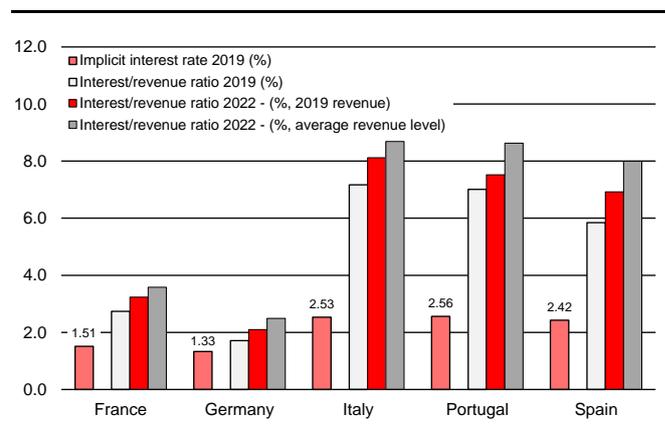
Source: EC's AMECO database, UniCredit Research

To answer this, it is necessary to make some assumptions about the evolution of interest payments. The government's implicit interest rate could serve as a starting point⁵. For Italy, this was 2.53% in 2019. Chart 2 shows that Italy's implicit interest rate for 2019 was in line with those of Spain and Portugal, while it was about 1pp higher than those of Germany and France.

Based on Italy's forward rates⁶, and when one takes into account an average residual maturity of seven years for Italian public debt⁷, Italy's implicit interest rate is projected to decline further in the period 2020-22, compared to 2019, as old high-coupon bonds are expected to be refinanced at lower rates. This applies even more to Italy's main eurozone peers, where market tensions have been more muted this year. In our exercise, we conservatively decide to stabilize countries' interest rates for 2020-22 at 2019's level, and we use that to calculate the interest/revenue ratio for 2022 for Italy and its main eurozone peers.

Chart 2 shows the main results, based on two different assumptions for the denominator (total revenue in 2022): 1. that it will return to 2019's level and 2. that it will be equal to the average level in the period 2010-19. In both cases, Italy's interest/revenue ratio would be around 8-9%. It could therefore be significantly lower than the level during the global financial crisis and the sovereign-debt crisis (it was 10.8% in 2008 and 2012, see Chart 1).

CHART 2: FISCAL BURDEN OF HIGHER PUBLIC DEBT



Source: EC's AMECO database, UniCredit Research

We acknowledge that the projected increase in public debt makes Italy more vulnerable to shocks, which might lift its interest rates and put the country in a more-stretched situation. However, in order for Italy's interest/revenue ratio to rise again towards 10.8% in 2022, the current forward curve would have to experience an interest-rate shock of 220-240bp in the period 2020-22. A shock of this kind could lift the government's implicit interest rate from 2.53% in 2019 to 3.00% in 2022.

Therefore, the fundamental message from these scenarios is that the favorable starting point in terms of interest rates all but guarantees benign interest obligations for Italy. If market stress were to resurface, the interest/revenue ratio could return to a level it reached during the previous crises, but given the interest-rate shock that would be required for this to happen, this currently seems a low-probability event.

3. Debt sustainability simulations

The other way of thinking about the sustainability of public debt is to focus on the evolution of public debt as a percentage of country's GDP in the long run. Using a debt-sustainability analysis (DSA) framework over the period 2021-30, the dynamic of the public-debt/GDP ratio is subject to uncertainty surrounding the evolution of its main drivers over a longer period of time⁸. The main drivers being interest rates, nominal GDP growth and the government's primary balance.

⁵Here, the implicit interest rate is computed as interest expenditure as percent of gross public debt of preceding year.

⁶As of July 2020. We focused on the ten-year forward BTP yield.

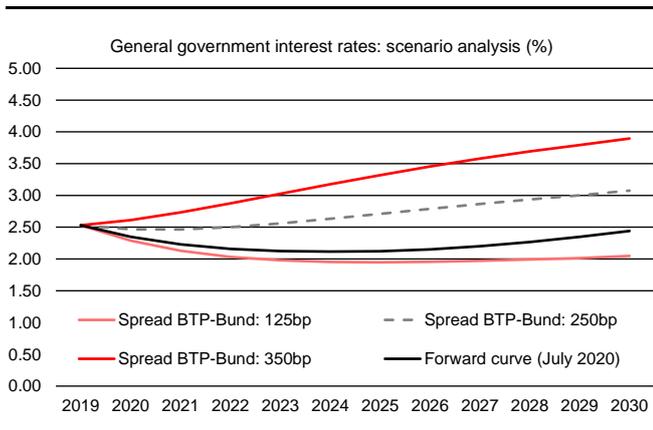
⁷See European Central Bank, Government debt securities: debt service, June 2020.

⁸The evolution of the public-debt/GDP ratio is a function of the primary balance, the difference between the nominal interest rate and nominal GDP growth and those transactions that affect debt but not the deficit (for example, privatization revenue or the impact of some of the resources put into banks or toward the payment of public administration arrears). 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 interest rate on debt, g is nominal GDP growth and SF is the stock-flow adjustment. In our analysis, we assume that the SF is equal to 0.1% of GDP in 2020 and 0.3% in 2021 and zero beyond 2021.

In our analysis, we made the following assumptions:

Interest rates. Starting from Italy's current forward curve, the data in Chart 3 show that, according to market expectations, the interest rate is projected to remain below 2.50% throughout the current decade. Chart 3 also shows projections of alternative interest-rate paths, where we project a relatively gradual, multi-year increase in 10Y Bund yields to about 1.0% in ten years' time⁹, starting from a 10Y Bund yield of -0.40%, and a BTP-Bund spread range of 125-350bp.

CHART 3: WHERE INTEREST RATES MIGHT GO



Source: Bloomberg, UniCredit Research

One interesting conclusion is that the projections of the interest rate remain between 2.0% and 4.0% for most of the ten-year horizon, and the more likely scenario is for it to be, on average, closer to 3.0% than 4.0%. More specifically, it is projected to range, on average, between 2.0% (in the scenario that involves a BTP-Bund spread of 125bp) and 3.4% (in the scenario that involves a spread of 350bp).

Nominal GDP growth. One reasonable assumption is to project real GDP growth in order to target a closure of the output gap over the ten-year period. The idea is that, starting from 2022, actual GDP growth has to converge back to potential growth. The speed of this convergence is assumed to be a function of the fiscal effort implemented by the government in order to manage a higher public-debt/GDP ratio. In the case of Italy, this is essentially determined by compliance with the EU's Stability and Growth Pact.

Bearing in mind the caveat that potential growth estimates are usually surrounded by a high degree of uncertainty, Italy's output gap hovered more or less around zero in 2019, according to the main available estimates¹⁰.

⁹ This level is much higher than the current ten-year forward Bund yield of 0.27%.

¹⁰ According to the EC's latest estimate, Italy's output gap moved from 0.0% in 2018 to -0.3% in 2019, given their estimate of potential GDP growth of 0.6%, compared to actual GDP growth of 0.3%. The government estimated potential growth at 0.2% in 2019, which led to an improvement of the estimated output gap from 0.3% in 2018 to around 0.5% in 2019.

This implies that the size of the deterioration of the output gap this year is broadly in line with the slump expected to be seen in Italy's real GDP growth. When the output gap is closed – in our assumptions this happens in 2026-27 – actual GDP growth becomes equal to Italy's potential GDP growth. In order to reflect the severe economic impact of the country's lockdown in 1H20, and assuming that a vaccine against the COVID-19 will be made available within the next 12-18 months, we project that Italy's potential GDP growth may decline by about 30% to 0.6-0.7%, compared to our estimate before the pandemic¹¹. With respect to the GDP deflator, it is assumed that it will converge towards 1.0%, showing a gap of about 1pp compared to the eurozone's 2.0% inflation target at least until the output gap is closed.

Overall, in terms of growth assumptions, this implies that average nominal GDP growth will be 1.8% in 2022-30, compared to 1.3% on average in the previous decade.

Primary balance (as a percentage of GDP). This is determined by the impact of the economic cycle and compliance with EU fiscal rules, which, in the case of Italy, broadly imply an annual improvement of 0.5-0.6pp¹².

Within this framework, Chart 4 shows the evolution of Italy's public-debt/GDP ratio over a ten-year horizon (2021-30). We plot the outcome of a market-based scenario (black line), in which, as mentioned before, interest rates move in line with market expectations. We then added two alternative scenarios. The first (red line) is based on the path of the interest rate implied by assuming a 350bp BTP-Bund spread shown in Chart 3. The second (pink line) is based on interest rates implied by the more-benign 125bp spread shown in Chart 3. Such a level would be lower than the average of the BTP-Bund spread over the last decade (200bp in the period 2010-19), however it may be consistent with further steps taken by member states towards implementing European integration in the current decade. The progress made towards agreeing the EU recovery plan looks to be an important, initial sign of this.

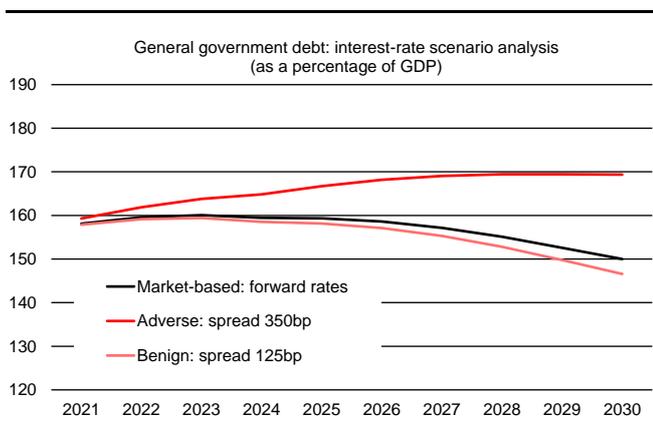
Together with Chart 4, Table 2 summarizes the key statistics of the DSA analysis conducted for each scenario. Both show the following:

1. Italy's public-debt/GDP ratio for 2030 ranges between 147% of GDP in the benign scenario, in which the interest rate averages 2.0%, and 170% in the adverse scenario, in which the interest rate averages 3.4%, which is slightly higher than it was in the last decade. In the adverse scenario, Italy's public-debt/GDP ratio broadly stabilizes at a higher level rather than shooting up. This is supported by the improvement in the primary balance.

¹¹ See *UniCredit Economics Thinking* – "Italy: potential growth on the rise, but could be boosted further", 6 April 2018.

¹² See European Commission (2015).

CHART 4: SCENARIO ANALYSIS: PUBLIC-DEBT/GDP TREND



Source: EC's AMECO database, Bloomberg, UniCredit Research

TABLE 2: SCENARIO ANALYSIS: MAIN OUTCOMES¹³

	Nominal GDP growth (%)	Average interest rate (%)	Average interest payment (% of GDP)	Cumulative interest payments (EUR, bn), 2021-30	Average primary balance (% of GDP)	Average primary balance* (% of GDP)
Historical data 2000-09	3.0	4.8	5.0	727	1.8	-
Historical data 2010-19	1.3	3.3	4.2	707	1.5	-
Market-based scenario	1.8	2.2	3.4	630	1.5	0.6
Adverse scenario	1.8	3.4	5.6	1006	1.5	2.5
Benign scenario	1.8	2.0	3.1	563	1.5	0.2

Source: EC's AMECO database, Bloomberg, UniCredit Research

2. Cumulative interest payments range between EUR 563bn in the benign scenario to above EUR 1000bn in the more adverse one. In terms of GDP, the values range from 3.1% to 5.6% per year, on average (see Table 2). The cumulative interest payment is estimated to be EUR 630bn in the market-based scenario. Therefore, this could be considered to be broadly in line with interest paid in the last decade.

3. In terms of the primary balance to GDP, in the market-based scenario, an average primary balance of +0.6% of GDP, or of +0.2% of GDP in the benign one, could be enough to stabilize Italy's public-debt/GDP ratio in the period 2022-30 at close to its projected 2021 level (see the average debt-stabilizing primary balance, labelled Average primary balance*, in Table 2). Given the fact that Italy will probably maintain a primary deficit in the years just after the COVID-19 crisis, the gap compared to the debt-stabilizing primary surplus might indicate that stabilizing the public debt/GDP ratio in the short-term could be a challenge.

Closing this gap in one or two years might not be feasible and the metric is mainly defined for a long-term analysis. If the government were to run a higher primary surplus, for example of close to 1.5% of GDP, on average, as currently implied by the assumption that Italy will make an effort to comply with EU fiscal rules, the country's public-debt/GDP ratio would be on a visibly descending trend (Chart 4). In the adverse scenario, to stabilize Italy's public-debt/GDP ratio at close to 160% – as opposed to increasing it by 10pp to 170% – the government would have to run an average primary surplus of around 2.5% of GDP.

We acknowledge that momentum in the fiscal-adjustment path has not improved in recent years. This follows repeated use of the flexibility within the Stability and Growth Pact that, in the case of Italy, led to a change in the structural budget balance¹⁴ that was slightly negative, on average, in the period 2015-19 (around -0.15pp), hinting at overall, slightly expansionary fiscal policy in that period. This inevitably raises the question of the willingness of governments in the future to implement fiscal consolidation, and represents a risk factor. Still, we think that a trend of improving primary balances will be the most likely way forward, given the higher level of public debt.

As a final exercise, we assume that the government is able to turn the primary balance from a deficit to surplus position in 2022, and nominal GDP growth is stable at 1.3% in 2022-30, in line with the average of the previous decade. If the cost of debt were to stabilize at about 3.0% (the midpoint between the market-based and the adverse scenario), an average primary surplus of at least 2.5% of GDP would need to be targeted to put the public debt to GDP ratio on a downward trend.

We conclude that, even if Italy's public-debt/GDP ratio remains higher than its pre-crisis level, a scenario based on the interest rate path currently implicit in market expectations indicates that Italy's public debt dynamic is sustainable. A pace of growth that is slower than that assumed in our analysis would slow the descending trend but not derail it. A similar conclusion holds true if we assume that the government will implement only half of the annual fiscal consolidation embedded by the EU fiscal rules (of 0.25% of GDP) for the next few years. Therefore, while a deterministic calculation of the evolution of the public debt/GDP ratio cannot capture all the uncertainty related to its main determinants in the long run, current market expectations that interest rates on public debt could be, on average, lower than those in the last decade is supportive and should play a relevant role in the general debate about public debt sustainability.

¹³ In the table, the reference period is 2022-30, with the only exception being the column listing cumulative interest payments, which refers to the sum of all interest payment over a ten-year period. Average primary balance* refers to the average debt-stabilizing primary balance over the 2022-30 period, assuming that the ratio of the stock-flow adjustment to GDP is equal to zero.

¹⁴ As a percentage of potential GDP at current prices.

The path of the public debt/GDP ratio is exposed to shocks. If market stress were to resurface, as we assume it will in the adverse scenario, the likely-resulting surge in funding conditions would make it more difficult for Italy to reduce the country's public debt/GDP ratio over the next decade without implementing fiscal consolidation that is larger than that envisaged in the market-based scenario. This is particularly the case if the economic growth is slow in the coming years, more in line with what it was during the last decade. Still, it is worth highlighting that our adverse scenario envisages a permanent interest-rate shock, which implies that the projected ten-year BTP yield remains around 200bp above the current forward curve until 2026, and slightly lower (to 170bp, on average) until 2030.

The risk of a potential interest-rate shock remains, which could significantly increase Italy's debt-servicing cost. In the adverse scenario, interest payments in 2030 could be double that Italy is expected to have to make this year. Therefore, Italy needs to put effort into keeping its interest payments under control. In this respect, we think that the EU's rescue package might represent a valuable opportunity.

4. Potential savings related to the EU's rescue package

In the following, we focus on the potential savings in terms of interest expenditure offered by the two most relevant support mechanisms included in the EU's rescue package: the ESM Pandemic Crisis Support and the Next Generation EU recovery instrument.

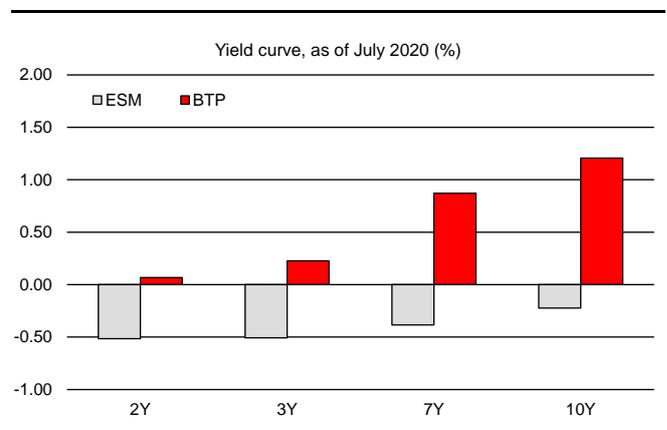
The **ESM Pandemic Crisis Support** is a credit line that is equivalent to 2% of the applying member state's GDP (as of end-2019)¹⁵. In Italy's case, the loan could amount to about EUR 36bn. Considering that, in general, a country can draw up to 15% of its total allocation in each month, Italy would be able to draw almost the entire amount this year if it were to start using such funds now. While it appears difficult to envisage today, in our exercise, we assume that this will be the case.

The pricing structure of the credit line comprises a margin of 10bp, charged annually, an annual service fee of 0.5bp and an up-front service fee of 25bp. As yet, the ESM has not made a clear commitment regarding its funding strategy. Chart 5 shows a comparison of the ESM yield and BTP yield for the main curve tenors. To maximize member states' potential savings, ESM could implement a strategy that is more skewed towards short-term instruments.

¹⁵The following are the other main features of this credit line: the initial availability period for each facility granted under the Pandemic Crisis Support is 12 months, which can be extended twice for six months, in accordance with the standard ESM framework for precautionary instruments. The maximum average maturity of the loan will be ten years. Each country has the option of borrowing funds with minimal conditions attached – that is countries will only need to demonstrate that the funds will be used to cover direct or indirect health-care costs related to fighting the pandemic. See ESM (2020).

To calculate annual interest savings, one must consider that the credit line would add 10.5bp (the margin and the annual fee) to the borrowing costs shown in Chart 5. In this scenario, if one assumes, for example, that the average maturity of bonds is seven years, Italy's benefit would amount to about EUR 400mn of direct interest savings per year and EUR 4bn over a potential ten-year horizon¹⁶. Italy's savings could be larger if any potential uncertainty causes yields on Italian government debt to rise in the near future. Moreover, as indirect savings, the credit line is designed to function as a form of insurance, which is positive in itself. For example, a country could decide to apply for the credit line but not draw on its funds¹⁷.

CHART 5: THE COST OF THE PANDEMIC CRISIS SUPPORT



Source: Bloomberg, UniCredit Research

European heads of state and government are making an attempt to strike a deal on the EC's proposal for the **Next Generation EU** instrument, which is intended to be exceptional and temporary and worth EUR 750bn¹⁸. According to the EC's proposal, about EUR 500bn of this is to be distributed to member countries as grants and guarantees, and EUR 250bn is to be distributed as loans, to be used for investment and reforms, including in green and digital transformation. Each member state is expected to define its Recovery and Resilience Plan in line with the objective of the European Semester¹⁹.

¹⁶This does not take into account costs related to the up-front service fee.

¹⁷Importantly, an additional benefit of the ESM Pandemic Crisis Support is related to the option for Italy to trigger the ECB's outright monetary transactions, even if ECB President Christine Lagarde reiterated that, while these remain an important instrument in the ECB's toolbox, for the systemic shock the EU faces today, the PEPP seems to be the most appropriate tool. The decision to boost the PEPP by EUR 600bn to EUR 1.35tn and to extend it until at least the end of June 2021 represents another step in this direction.

¹⁸The recovery plan is expected to be negotiated by the European Council this month and be agreed on before the end of 3Q20. There are still contentious issues, including, for example, the size of the overall package, the mix between grants and loans and the criteria for allocation of resources across member countries.

¹⁹See EU country recommendations here:

https://ec.europa.eu/info/publications/2020-european-semester-country-specific-recommendations-commission-recommendations_en.

As it is one of the countries that have been most affected by the COVID-19 crisis, initial estimates indicate that Italy's grants would amount to around EUR 82bn, EUR 65-70bn of which strictly related to the Recovery and Resilience Facility, while its loans would amount to EUR 91bn. Unless the size is scaled down, these would be worth about 9% of Italy's 2019 GDP. Such resources would become available starting from 2021, while the funds raised by the EC in the market will need to be repaid through future EU budgets.

Given the temporary nature of the support, according to the EC's proposal, the availability period of these resources is limited to the end of 2024 at the latest. The Italian government is expected to present its proposal for the Recovery and Resilience Plan after the summer, together with an update of its 2020 stability program²⁰. Given the difficulty involved in planning a program to invest all of these resources, it is reasonable to assume that the government will initially target the aforementioned EUR 82bn of grants²¹.

The opportunity to receive grants would be equivalent to reduce the public-debt/GDP ratio by about 5pp in total. In our market-based scenario, this could translate into direct cumulative interest savings of around EUR 8bn over the period 2021-27. In theory, such savings could allow Italy to cover 10-15% of each year's fiscal consolidation required by EU fiscal rules, starting from 2023.

If one considers the new challenges Italy has to face in the form of higher interest expenditure both in the short term and, more importantly, over the next decade, both the ESM Pandemic Crisis Support and the Next Generation EU instrument are unlikely to be game changers. However, they have the potential to bring Italy two valuable benefits for the future. They could help it **1.** increase the incentives to accelerate investment and structural reforms and **2.** definitively consolidate market perceptions of Italy's willingness to build on a pro-European approach (based on more-integrated EU supervision of member countries' future recovery plans). Therefore, the government's decision to move in this direction could reduce volatility in market expectations and increase the probability of an outcome more similar to that envisaged in our benign scenario, in which the BTP-Bund spread moves closer to its average since the inception of the euro. This could allow for cumulative interest savings of around EUR 65bn over 2022-30 (compared to the market-based scenario in Table 2), which could increase by a factor of seven (around 450bn) compared to a scenario in which a resurgence of uncertainty causes Italian yields to rise (as, for example, envisaged in our adverse scenario).

²⁰The government has to present the *Nota di Aggiornamento al Documento di Economia e Finanza 2020* by the end of September.

²¹According to the EC's proposal, loans will complement grants and will be proposed in exchange of additional reforms and investments.

5. Concluding remarks

The COVID-19 pandemic, with its negative effects on growth and the strong fiscal response to it, will imply a much higher level of public indebtedness for all impacted countries, particularly Italy, which is already starting from an uncomfortably high level. The ECB has been stepping in with its PEPP and this policy has helped to avoid a significant increase in BTP-Bund spreads, a tightening of the financial conditions and a deterioration in financial-market expectations. Indeed, the PEPP has implied (and will probably imply) a transfer of Italy's public debt from foreign investors to the central bank. Moreover, the progress made on the EU recovery plan has improved European prospects.

Our analysis shows that Italy's sovereign debt is sustainable over the medium-to-longer term under almost all plausible scenarios. One of the main concerns is the risk related to a significant increase in interest expenditure. However, because of the increasing debt and rollover needs anticipated in the coming years, the government must be able to continue to attract market investors. There are no shortcuts here and, based on our analysis, the outcome will largely depend on: **1.** the degree to which the government uses the opportunity available in response to this crisis to put in place long-term growth-enhancing policies, which will lift nominal GDP growth above what it was during the previous decade; **2.** an announcement of a credible strategy to move from the current, sizeable primary deficit to a substantial primary surplus, and **3.** whether Italy has the will to be a key player in the implementation of a more effectively coordinated fiscal policy in Europe and an expansion in the EU's fiscal role. The potential savings in terms of interest payments should be more than sufficient to spur immediate action.

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