Italy

Country note, January 2019

Key messages:

- **The PBO did not endorse the 2019 DBP macroeconomic policy scenario, while it gauged plausible the revised 2019 estimates.**
- **The 2019 DBP revised significantly upward the general and structural deficit set out in the 2018 SP for 2019 and 2020-2021.**
- **The PBO flagged an inadequate fiscal adjustment for 2018 and a risk of significant deviation for 2019.**
- **The Commission prepared an Article 126(3) Report in November, concluding that a debt-based EDP was warranted.**
- **The Government revised its fiscal plans in December, reducing the forecast deficit and the risk of significant deviation in 2019, thus allowing the European Commission not to recommend the opening of an EDP at this stage.**

Macroeconomic outlook

The Government in December, after interacting with the Commission, revised the 2019 DBP macroeconomic policy scenario estimates for real GDP growth from 1.2 to 1 percent in 2018 and from 1.5 to 1 percent in 2019 (Chart 1). The PBO did not endorse the initial 2019 DBP macroeconomic policy scenario, while it gauged plausible the revised estimates for 2019.

Short-term fiscal outlook

The 2019 DBP had increased significantly the general government deficit target for 2019, previously set in the 2018 SP, from 0.8 to 2.4 percent of GDP, while the structural deficit target was expected to deteriorate from 0.9 to 1.7 percent of GDP. In December, the Government revised the general government deficit target for 2019 downwards at 2 percent of GDP, while the revised structural deficit is now expected to deteriorate from 1.1 percent of GDP in 2018 to 1.3 percent of GDP in 2019. The main deficit-increasing measures for 2019 include: the abrogation of the increase in VAT rates previously legislated as a "safeguard clause"; the introduction of a minimum income scheme for poor households; the allocation of a fund to introduce higher flexibility in the pension system for early retirement.

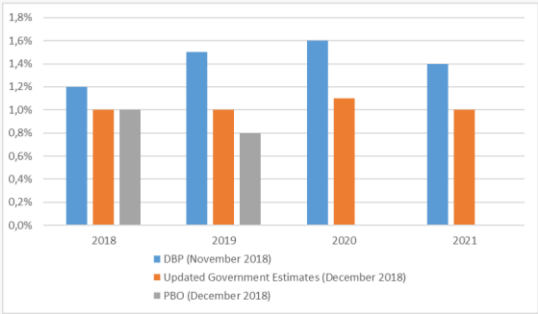
Medium-term fiscal outlook

The 2019 DBP had also increased fiscal targets set out for 2020-2021 compared to the 2018 SP, envisaging a higher headline deficit in 2020 (2.1 percent compared to a balanced budget), and in 2021 (1.8 percent compared to a surplus of 0.2 percent). In 2020 and 2021 the structural deficit was set at 1.7 percent of GDP, with no structural improvement. In the revised policy scenario in December, headline deficit targets were finally set at 1.8 percent in 2020 and 1.5 percent in 2021, while the revised structural deficit is now expected to improve from 1.3 to 1.2 percent of GDP in 2020 and from 1.2 to 1 percent of GDP in 2021. A breakdown of the change in the general government balance and its determinants for the years 2018-2021 is shown in Chart 2.

Fiscal framework and national fiscal rules

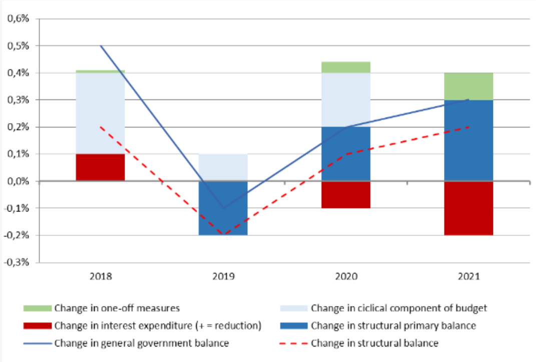
The revision of the adjustment path to the MTO published in the 2019 DBP was authorized by Parliament, as required by national law. Since the PBO did not endorse the macroeconomic forecast in the 2019 DBP, the "Comply or Explain" principle was applied, and the Minister of Economy and Finance explained before the Budget Committees the reasons of the divergence of the Government's forecasts with those of the PBO. However, since the 2019 DBP implied a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13th July 2018, the Commission requested a revised DBP, which was submitted with limited changes. The MTO was not expected to be achieved over the planning horizon, while in 2019 there was a risk of significant deviation of 1.2 percent of GDP, even considering as granted the flexibility of 0.2 percent of GDP requested by the Government. According to the Commission, Italy's fiscal plans for 2019 represented a material change in the relevant factors analysed by the Commission's Article 126(3) Report last May, prompting a new Article 126(3) Report in November, which concluded that the 2017 debt criterion should be considered as not complied with, and that a debt-based EDP was thus warranted. In late December, political dialogue with the Commission led the Government to revise the 2019-2021 policy scenario, reducing the planned structural deterioration for 2019 from 0.8 to 0.2 percent of GDP and planning a structural improvement of 0.1 and 0.2 percent of GDP respectively in 2020 and 2021, through significant VAT hikes. The Commission thus stated that the adoption of the agreed corrective measures would allow it not to recommend the opening of an EDP. According to the PBO, Italy's structural adjustment of 0.2 percent of GDP in 2018 appears inadequate, as it is not in line with the required reduced adjustment of 0.3 percent of GDP, while in 2019 there is still a risk of significant deviation, although reduced from 1.2 to 0.6. Moreover, the numerical debt rule is not respected over the forecast horizon. Chart 3 shows the official government debt dynamics, as also those without the VAT hike in 2020-2021, which the Government intends to deactivate.

Chart 1: Real GDP Growth [% GDP]



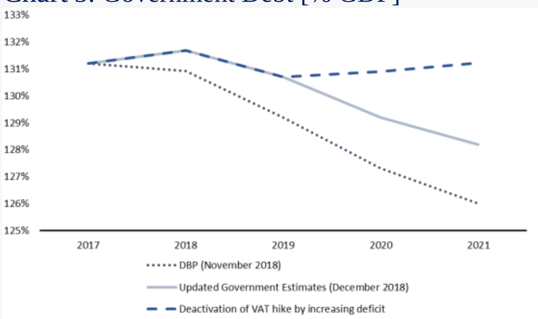
Source: PBO calculations and estimates.

Chart 2: General Government Balance [% GDP]



Source: Updated Government Estimates (December 2018)

Chart 3: Government Debt [% GDP]



Source: PBO calculations and estimates.

Key indicators

		2017	2018f	2019f	2020f	2021f
Real GDP growth	[% change]	1,6	1,0	1,0	1,1	1,0
GDP Deflator	[% change]	0,5	1,1	1,4	1,8	1,6
Output Gap	[% Pot-GDP]	N/A	-1,7	-1,4	-1,2	-1,1
GG balance	[% GDP]	-2,4	-1,9	-2,0	-1,8	-1,5
Primary balance	[% GDP]	1,4	1,8	1,7	2,0	2,5
Structural balance	[% GDP]	-1,3	-1,1	-1,3	-1,2	-1,0
GG debt	[% GDP]	131,2	131,7	130,7	129,2	128,2

Source: Updated Government Estimates, Aggiornamento del quadro macroeconomico e di finanza pubblica, December 2018, Ministry of Economy and Finance:

http://www.mef.gov.it/inevidenza/documenti/AggiornamentoQM-economico_e_di_FP.pdf

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