Concern mounts over Italian fiscal policy

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Fiscal uncertainty has been simmering in Italy since the formation of the coalition government in June, which has expansive fiscal policies. On 15 October, the government submitted its much anticipated draft budgetary plan (DBP) to the European Commission (EC). The DBP sets the budget deficit at 2.4% of GDP for next year. Though this complies with the European Union (EU) deficit limit of "less than 3.0% of GDP", the plan incorporates policies such as the ‘citizen's income’ and the cancellation of a planned rise in VAT. This would be a considerable retreat from the fiscal consolidation planned under Italy's previous administration. According to EU budget rules, there is a process whereby if the EC deems that a country's DBP for the following year is in "serious non-compliance" of the rules (for example, when there are insufficient efforts to cut the deficit), they have two weeks from the submission of the draft to demand revisions. The country then has three weeks to submit its revised plan. The EC expressed concern to the Italian government about the expansion in its annual expenditure and insufficient efforts to cut the deficit as early as 18 October. It made clear that the DBP deviated significantly from fiscal rules. Looking forward, the focus will be on the EU's demand for a revised plan and the Italian government's reaction to it. Concern is mounting in the financial markets over these issues. Italian 10-year government bond yields have been high since the formation of the current coalition government, but have recently jumped to heights last seen in February 2014 (Chart 1). Given Italy's colossal level of government debt, the burden of interest expenditure is already high (Chart 2). If confrontation between the Italian government and the EU leads to further increases in government bond yields, there are fears that this could lead to a "doom loop" of increasing interest expenditure and fiscal deterioration. We should also monitor the possibility of the re-emergence of voices in favour of Italy leaving the Eurozone. The Five Star Movement and League have both openly discussed leaving the Eurozone in the past. Whilst both parties dropped the subject before the general election, concern over the possibility of Italy leaving the Eurozone has by no means disappeared from financial markets. In early October, Italian bond yields rose after a senior member of the League alluded to possibility Italy leaving the single currency. It would be wrong to say that Italy is likely to drop out of the Eurozone, but it is important to keep an eye on this topic due its potential to cause major fluctuations in the financial markets.

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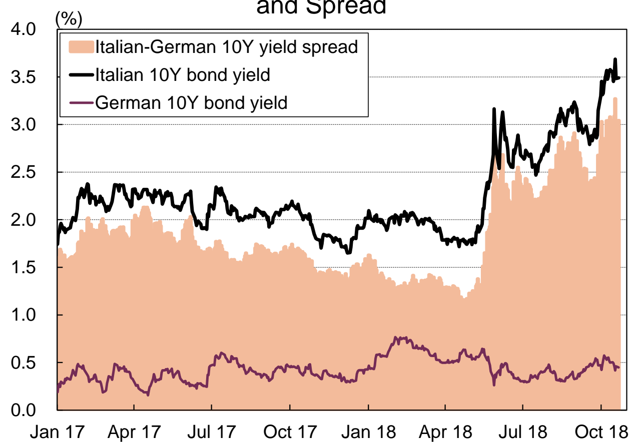
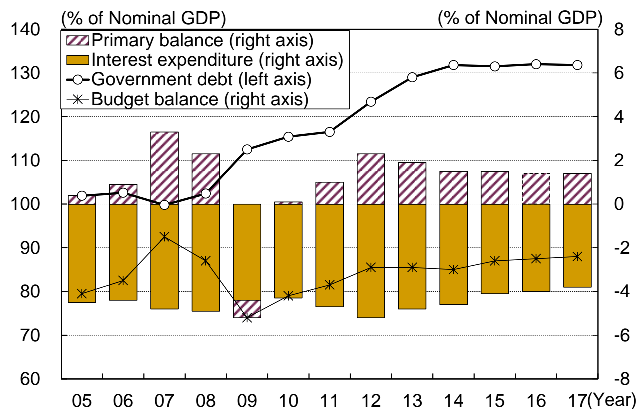
Chart 1: Italian/German 10Y Government Bond Yields and Spread



Source: Bloomberg, MUFG Bank Economic Research Office

Chart 2: Italian Budget Balance and Government Debt



Note: The axis for "Interest expenditure" has been inverted.
Source: Istat, MUFG Bank Economic Research Office

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