First Italy, now France sees fiscal issues surface

REIKO SHINOHARA
ECONOMIC RESEARCH OFFICE

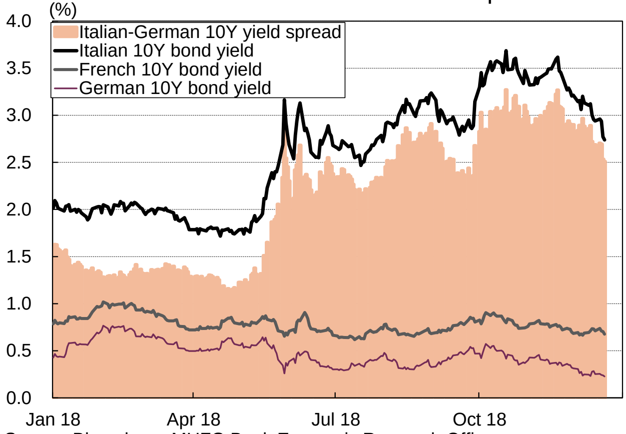
MUFG Bank, Ltd.
A member of MUFG, a global financial group

7 JANUARY 2019
(ORIGINAL JAPANESE VERSION RELEASED ON 26 DECEMBER 2018)

At last, the conflict between Italy and the European Union over the Italian draft budgetary plan (DBP) is close to being resolved. The DBP that the Italian government submitted to the European Commission (EC) in October represented a major retreat from the fiscal reconstruction planned by the previous Italian government. Because of this the EC demanded revisions to the DBP, but the current Italian government initially refused to change its budget deficit target from 2.4% of GDP, using their election manifestos as a justification. In response to this, the EC concluded that the Italian DBP was in breach of EU fiscal rules, advising that it required correction. At one point, there were fears that the EC might impose sanctions under an "excessive deficit procedure", but the Italian government eventually agreed to reduce its budget deficit target to 2.04% of GDP (19 December). This compromise can be attributed to Italian concerns over the negative influence of rising interest rates on the economy and government finance. Italian bond yields have now returned to pre-DBP levels (Chart 1) and the fears of the financial markets seem to have been assuaged for the time being.

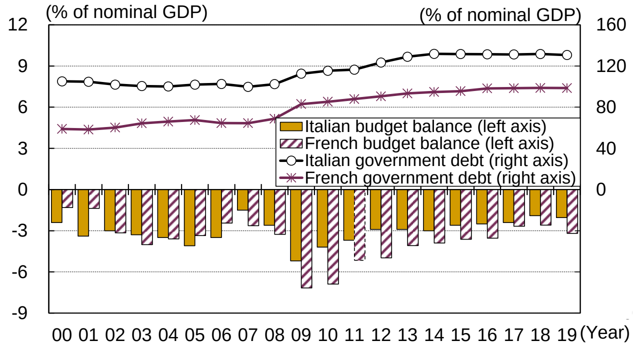
From the EU's point of view, it has become increasingly difficult to demand fiscal compliance from Italy amid currently growing speculation over fiscal deterioration in France. This has forced the EU to soften its initial hard-line stance on Italy. Since mid-November, protests against Macron's reforms have sprung up across France. In response, Macron has announced measures such as a fuel tax freeze and government-funded rise in the minimum wage. The protests seem to be settling down, but the measures announced are forecast to increase France's 2019 budget deficit from 2.8% of GDP to 3-3.5% of GDP, bringing it above the EU's budget deficit ceiling of 3% of GDP (Chart 2). We are yet to see a notable jump in French bond yields (Chart 1). However, once it is confirmed that its revised DBP doesn't comply with EU rules, there are fears that the Macron administration’s reform agenda will stall. This engenders the possibility of a major sell-off in French bonds. Despite the looming deadline, there is no end in sight for the UK's exit from the EU. These new problems in the area’s third largest economy can only heighten the risk of a downturn in Europe, and future developments should be monitored closely.

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



Source: Bloomberg, MUFG Bank Economic Research Office

Chart 2: Italian and French Budget Balances and Government Debt



Note: Italian figures for 2018 and 2019 are based on 2019 DBP.
French figures for 2019 based on statements by French prime minister Edouard Phillippe, with other figures based on France's 2019 DBP.
Source: Istat, INSEE, European Commission, MUFG Bank Economic Research Office

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Yasuhiro Ishimaru Tel: +81-(0)3-3240-3204

Written by Reiko Shinohara <reiko_shinohara@mufg.jp>