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Italy: outlook still hinges on fiscal reforms

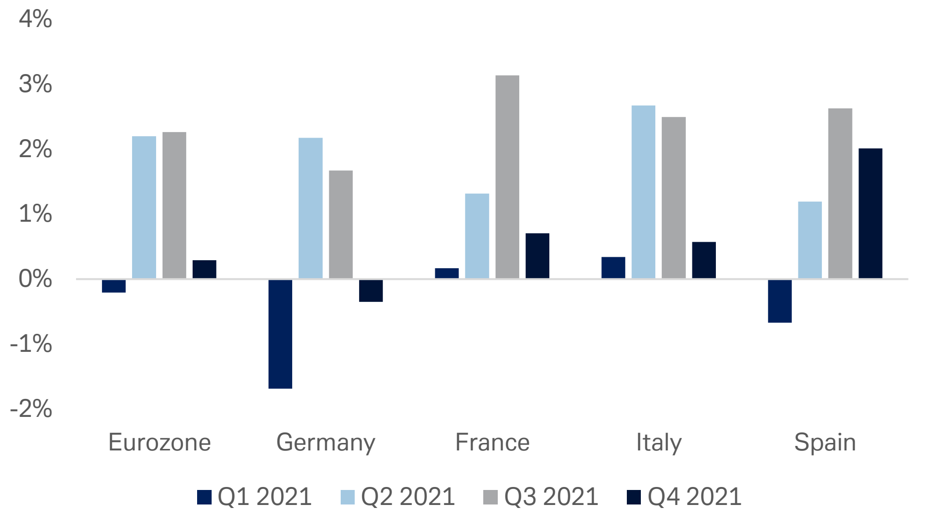
Key take aways

- Economic recovery has continued, with further progress on fiscal reforms after the agreement on the budget law.
- However, all-important NextGen EU disbursements remain dependent on the achievement of a wide range of objectives.
- The Italian economy will face a range of challenges, but output and consumption resilience and a changing debt structure are positives.

01 Macroeconomic update

The success of European vaccination campaigns, combined with favourable seasonal effects, enabled the Eurozone to reach high levels of growth in Q3 2021. However, an increase in Covid-19 cases, combined with problems related to increases in the cost of raw materials (above all the sharp rise in energy prices recorded in the last months of 2021), led to a slowdown in growth in Q4 but significant growth was posted for 2021 as a whole. According to ISTAT data, the Italian economy grew by 6.6% in 2021 (relative to a Eurozone average of 5.2%). This leaves Italian GDP -0.5% below pre-crisis levels, rather better than Germany (-1.5%) or Spain (-4.0%).

Figure 1: Eurozone GDP growth in 2021 (QoQ growth, %)



Source: Eurostat, Deutsche Bank AG. Data as of March 1, 2022.

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A positive impact on growth across Eurozone and in Italy is expected from the implementation of the NextGen EU spending package. Inflation however remains an issue, given rises in energy prices and other problems related to supply chains and production bottlenecks.

02 Budget plans

The fiscal budget law approved on December 30, 2021 should be seen in the context of the multi-year budget for the three-year period 2022-2024 and attempts to address the effects of the pandemic situation that began in 2020. The predicted deficit for 2022 is EUR201.7bn. Capital expenditure is estimated at EUR147bn.[1]

The budget law also includes the resources deriving from the NextGen EU scheme for the year.

Key measures include a reduction of the tax burden (allocated EUR8bn per year until 2024); more expenditure on healthcare (EUR2bn per year over a three-year period; and interventions in favour of families, young people, and the social sphere are also part of the law. Specific measures, for example around the protection of work. will be supported during the exit from the emergency status.[2] In the social security field, on the other hand, there are exceptions to the retirement age rules for the current year only.

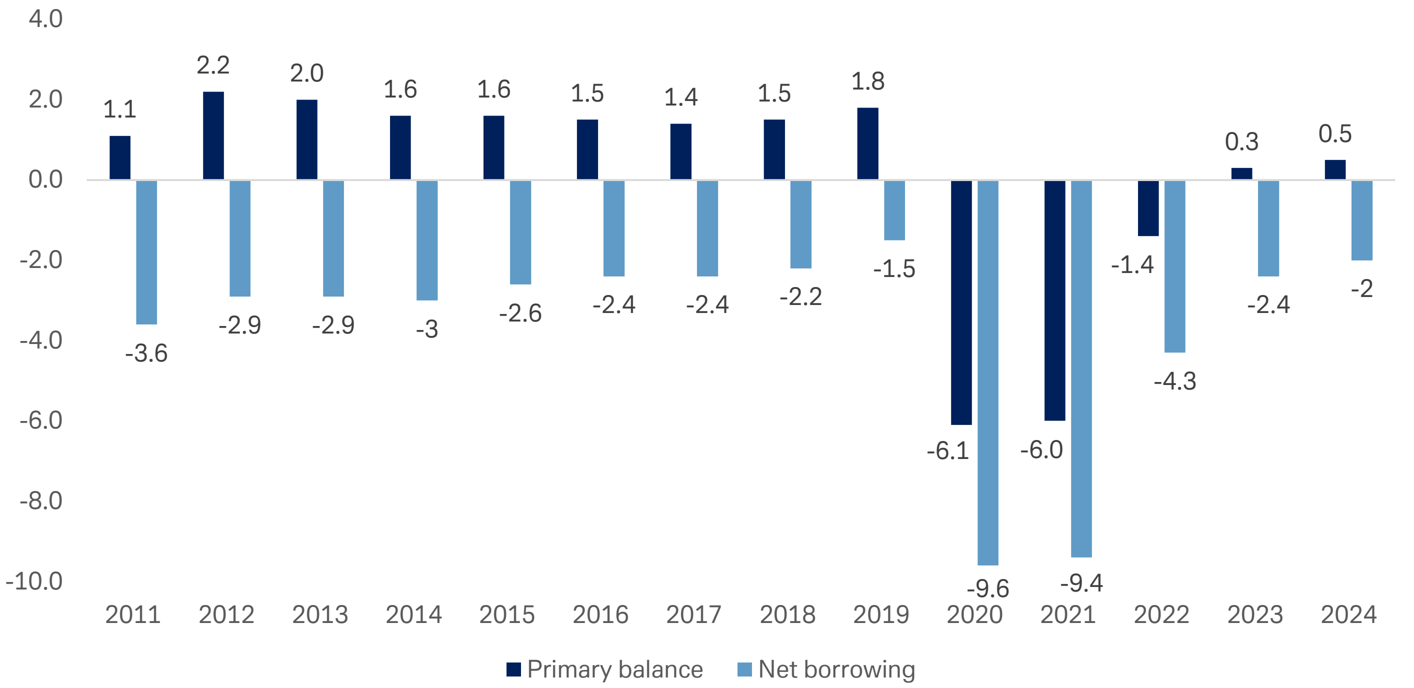
In the context of public investments, with EUR112bn of additional resources on the table from 2022 to 2036, much of the spending is related to the contract with RFI (Rete Ferroviaria Italiana/Italian railways) which totals EUR10bn, and the one with ANAS (public road and highways manager). Investments in sustainable mobility in the main cities will amount to EUR3.7bn from 2022 to 2036.

The interest component on the current year budget balance is expected to be 9.5% of total expenses.[3]

On the fiscal revenues side,[4] growth of 7% is expected in 2022 to a total of EUR625bn. EUR, with revenues reaching EUR646bn2024 (equivalent to cumulative growth of 3.4%).

These trend in revenues and GDP will have a positive effect on the debt / GDP ratio.[5] This is estimated to have reached 153.5% at end-2021 (against an original forecast of 155%) with a further decline[6] expected in 2022, to 149.4%, and with the ratio then reaching 143.3% in 2024. These forecasts show the positive influence of the expected return to a positive primary balance already in 2023 and further growth here in 2024 (as shown in Figure 2). In the overall public finances framework[7] an important role is played by the national rescue and recovery plan (RRP) as is underlined in the budget document. Approved in 2021, and with a range of action until 2026, it will help in fiscal budgeting over the next few years.

Figure 2: Impact of the primary balance on indebtedness



Source: ISTAT up until 2020, MEF (Ministry of Economy and Finance) projections from 2021 onwards, Deutsche Bank AG. Data as of January 2022.

03 Update on RRP implementation

The main interventions provided for by the RRP are in infrastructure, 75% of which are related to public initiatives in the space of energy transition with a particular focus during the year on the circular economy, waste management and hydrogen development. In the healthcare space the main target for H1 2022 is to implement a new territorial healthcare model. Education is another pivot of the RRP and includes objectives such as securing infrastructure, reform of school system organization as well as funding research activities and the evaluation of research centers focused on technological innovation. A digital transition will include implementation of cybersecurity agreements in 2022 and digitalization of country's cultural heritage. Reducing undeclared work (for tax purposes) is also center stage with a plan due to be launched by the end of 2022.

Looking at 2022, a total of 112 objectives or results must be achieved to obtain the funds provided by the EU through the NextGen EU scheme, equivalent to over EUR40bn.

Reaching the targets will depend on administrative reforms: in particular, regarding the justice system on civil and criminal trials. Another pivot will be the reform of the public administration through simplification and standardization of processes and internal procedures, focusing on digitalization and on procurement rules (including public contracts) currently under discussion in the Senate.

On the expenditure side, the Ministry of Finance (MEF) expects to conduct a spending review by the end of H1 2022 to define an annual saving plan.

The RRP will be financed during the year 2022 in two tranches as agreed with the EU. Approximately EUR24bn is due in Q2 and EUR21.8bn in Q4.[8]

To access the first tranche of resources, 45 objectives must be achieved, ranging from public administration reform to upgrading the spending review framework and procurement rules.

Some of these goals are close to being met, as last year's legislative action has already laid the foundations for the approval of reforms and integrated urban plans to counter illegal activities. Other objectives are in line with existing timelines such as the reform of tax administration, the spending review, strategy relating to the circular economy, procedures around energy efficiency and research on hydrogen, the spread of telemedicine and technological modernization and digital parks for hospitals.

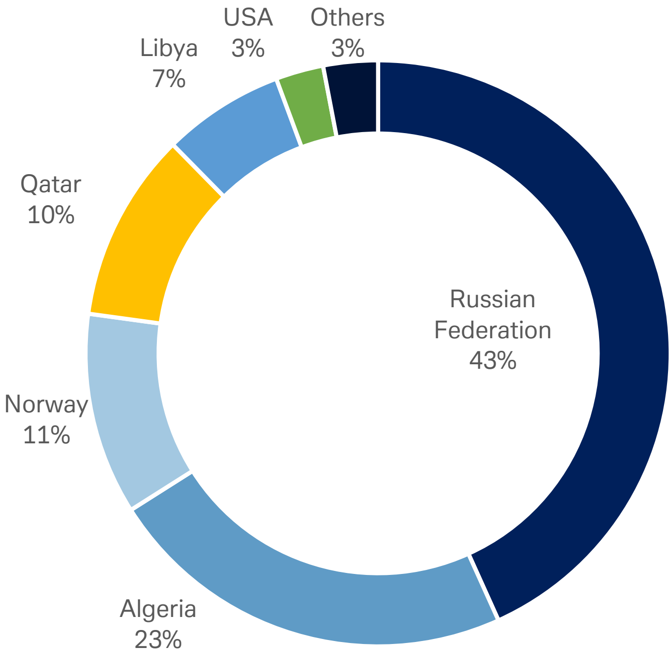
Some objectives, on the other hand, are more distant, including the new organizational model for the territorial healthcare network and the reform of contracts and concessions.[9]

The RRP represents an important support for fiscal policy. Provided that the reforms and other objectives are achieved within the set deadlines, the support for economic activity from the plan would amount to a cumulative 5 percentage points of GDP over the four-year period 2021 – 2024, with beneficial effects on investments that could expand at a rate of 5% per year in the three-year period 2022 – 2024.

The current situation in Ukraine, though, poses a threat to the momentum seen in the GDP growth in Europe. Speaking about energy sources, the recent events regarding the conflict between Russia and Ukraine pose a threat to Italian energy provisioning: according to IEA data[10], Europe (in 2019) relies on gas for 25.66% of the total energy sources, while Italy is more dependent on natural gas, partially because of the absence of nuclear power, with the share of energy produced by gas being 43.35% in 2020. Of this, according to Eurostat data[11] more than 43% comes from Russia (Figure 3).

If the energy prices will remain at the elevated levels currently seen, all else being equal, the damage to GDP growth will be 0.7% for 2022, according to the latest ISTAT estimates. Also, new projections from the ECB underline the negative impact on the whole European economy stemming from the Ukraine conflict: estimates for GDP growth have been revised down to 3.7% in 2022, versus an estimate of 4.2% made in December 2021.[12]

Figure 3: Italy natural gas imports by country



Source: IEA Italy Energy Statistics, Deutsche Bank AG. Data from 2020.

04 Conclusion

The Italian economy will face many challenges during the coming year. In addition to exogenous factors such as increases in energy costs and price of intermediate goods, an equally important factor is linked to the evolution of the pandemic and international situation and the consequent limitations with effects on business confidence.

Recovery signs should be assessed carefully. For example, the labour market recovery appeared to have been very strong: between Q3 2020 and Q3 2021, employment levels increased by 2.2% and inactive share of people between 15 and 64 years old decreased by -3.3%. However, breaking the numbers down, the recovery has seen a substantial increase in temporary employees (+13.3% vs. Q3 2020) with a much less pronounced increase in permanent employees (+1.5% vs. Q3 2020).[10]

The overall unemployment rate remains elevated at 9% vs. a Eurozone average of 7%[11]. Good news comes from the recovery in household consumption (despite it still being below pre-Covid levels), a savings rate that still remains at high levels and an overall private household debt / GDP ratio that is lower than the Eurozone overall (43.8% vs. 60.8%).

In terms of public finance, the MEF (Ministry of Economy and Finance) expects a reduction in the primary deficit over the three-year period and a reduction in the debt / GDP ratio from over 153% in 2021 to 146% in 2024. The average residual life of the country's debt increased again in 2021, to 7.11 years and the average cost was around 2.3%. On February 28, 2022 the yield on a BTP with 7 years maturity was 1.353%, significantly lower than this current average cost of 2.3%, so some benefits from public debt refinancing are still possible.

Figure 4 indicates the falling cost of debt on issuance over the last two decades. The average maturity of the debt instruments issued has been combined with a constant decrease in the share of floating rate instruments, which means that Italian debt has different characteristics compared to the past: fixed rate issues now account for more than 70%[13] of the outstanding debt.

Italy's economic challenges will have an impact on growth and on the path of economic recovery and employment over coming years. But existing signs of resilience (for example, on industrial production and consumer confidence) suggest economic slowdowns will be manageable and give us confidence for the future.

Figure 4: Average cost (interest paid) of debt issuance

Source: MEF, Deutsche Bank AG. Data as of March 7, 2022.

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The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

EUR is the currency code for the euro, the currency of the Eurozone.

The International Monetary Fund (IMF) was founded in 1944, includes 189 countries and works to promote international monetary cooperation, exchange rate stability and economic development more broadly.

The Italian National Institute of Statistics (ISTAT) is specialized agency for official statistics in Italy.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Next Generation EU (NGEU) fund is a European Union recovery package to support member states hit by the COVID-19 pandemic.

Recovery and Resilience Plan (RRP or in Italian PNRR) is Italy's investment and reform plan for recovery from the Covid-19 emergency approved by the EU.

Ministry of Economy and Finances (MEF – Ministero economia e finanza) is the Italian ministry who manage the public finances in the Country

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