Daily Note

ITALY DIS-CREDITED

Davide Oneglia

- **The slow-motion confrontation with the EU Commission will drag on well into next year**
- **Higher cost of funding and higher taxes for banks next year will hurt credit**
- **Lack of contagion means Italy is the only major EA "peripheral" country left**

Yesterday, for the first time in its history, the EU Commission (EC) formally rejected the budget plan of a member state and asked for a revision. Italy now has until 13 November to make changes to its 2019 budget if it wants to avoid an Excess Deficit Procedure next spring.

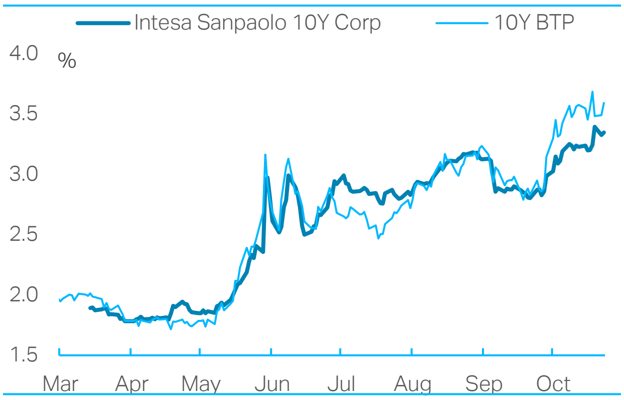
Deficit? What deficit? The EC rejection comes as no surprise after Italy's finance minister, Giovanni Tria, confirmed on Monday that the government was unwilling to change the draft budget. However, Rome reiterated its promise to "intervene" in case the debt/GDP and deficit/GDP ratios fail to evolve in line with the plan. Procyclical fiscal tightening is implicit. So, if the projected GDP multiplier boosts growth, the deficit shrinks; but, if the multiplier is null and growth disappoints, *it also shrinks*. Effectively, we're back to square one with the usual Italian-style empty promise of a "safeguard clause".

Moodiness. There's a lot to dislike about sovereign ratings. Most importantly: (i) they reflect market changes rather than anticipating them; and (ii) since the EA debt crisis they have overestimated the importance of fiscal balances, which, in general, are not good indicators of a government's actual ability to service its debt. Perhaps it was to correct the latter flaw that Moody's justified the "stable" outlook accompanying its downgrade of Italy (from Baa2 to Baa3 [BBB-], one notch above junk) by citing the country's large stock of private wealth: another, more explicit, hint that the government could rely on a wealth tax or a levy on bank deposits (like the one imposed overnight at the peak of the 1992 lira crisis) in case it misses its targets. Not a great consolation for the economy.

In another bizarre passage, Moody's says the government's proposed pension reform changes are "ostensibly intended to be one-off measures". In fact, the budget plan is adamant about the permanent cost of the measure, worth about €7bn per year and cumulatively 1.2% of GDP by 2021. If any item is one-off, it's likely to be on the revenue side of the budget (e.g. a tax amnesty).

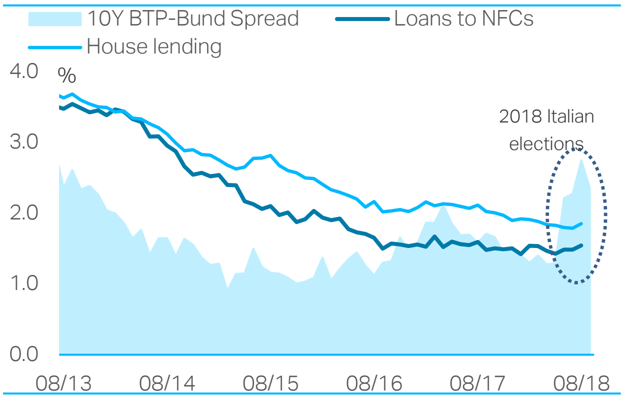
More debt and no growth. A wealth tax on property, levies on bank deposits and a serious spending review are political non-starters. So, we expect S&P to change Italy's outlook to negative on

Banks' funding cost rises



Source: Bloomberg, TS Lombard

Lending rates on new loans rise



Source: Bank of Italy, Datastream, TS Lombard

Friday in anticipation of a downgrade (together with Fitch) in Q1 next year, which is already priced in. We also stick to our view that the fiscal multipliers for Italy are very small, if not zero. Any stimulus from the budget (estimated at around 0.2% of GDP) will be offset by deteriorating credit conditions for households and firms.

Dis-credited: higher funding costs and lower capital ratios. Since the EA debt crisis, banks have improved their capital buffers and gained access to cheap central bank liquidity via repos and TLTRO programmes to lend to the public. However, home bias in banks' sovereign holdings, especially in Italy, has grown. So, since spreads widened in May, Italian banks have increased their ECB repo borrowing by 30% in annualised terms. But, at the same time, they have faced higher issuance costs (+1%), as their bonds have followed BTPs on a rollercoaster ride (see left-hand chart on the previous page). As a result, the Bank of Italy reports that the average funding cost for Italian banks between May and August increased by 10bps. The clue, of course, is in the word "average".

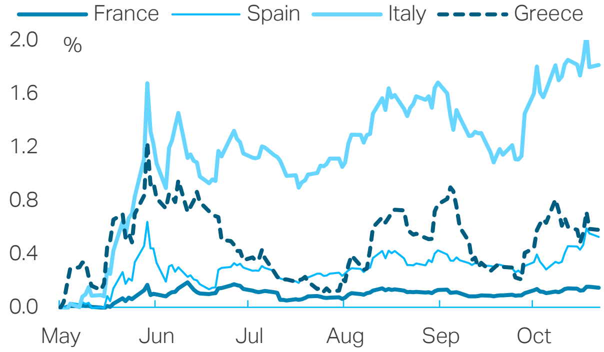
Similarly, over the same period, the CET1 ratio of the five largest Italian banks fell more than 50bps – from above 13% to around 12.5%. This is still far from the regulatory minimum of 10.5%, but, given the differences between large nationwide or international banks and small regional ones, we cannot rule out that some lenders may be already close to the threshold. In case of a breach, unfavourable conditions make it hard for fragile banks to recapitalise in the market, so the only alternative is to reduce risk assets, i.e. cut back credit supply.

Dis-credited: higher tax bill for banks. As they gradually pass on the above costs of the "spread tax" to borrowers via higher lending rates starting this quarter, banks also face a higher tax bill. The budget includes higher unspecified "fiscal measures" (€1.3bn in 2019), higher tax advances, and unfavourable changes in the fiscal treatment of write-downs and credit losses and of devaluation following the adoption of IFRS9. Total: €4.2bn or 0.23% of GDP in 2019, adding insult to injury.

Contagion is a losing game. At any rate, if the government's strategy to extract concessions on the budget plan from the EC was based on using the risk of bond market contagion to the EA periphery as a bargaining chip, it will need to reconsider (see left-hand chart below). The TLTRO, OMT and ESM programmes can confine country risk within national borders by acting as a shield for sovereigns affected by redenomination risk triggered elsewhere.

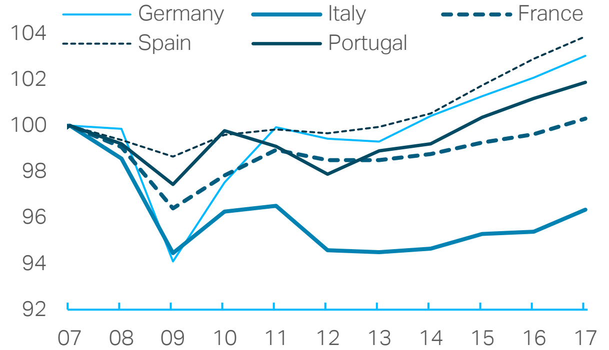
More importantly, however, the definition of the EA periphery seems to have changed. Spain and Portugal have come a long way since the EA debt crisis. Not only have they addressed their pressing structural problems, but they have also caught up on growth. With the exception of Greece, a special case, Italy remains the only true EA laggard. We don't think the ECB will do anything in the short run that could be seen as a favour to Rome, but in the long term the continued divergence of Italy (especially vis-à-vis Germany) will be the greatest challenge facing the EA and its central bank. This is a theme we explore in our latest View.

Contagion is a losing game
Change in spread over Bunds since 1 May



Source: Bloomberg, TS Lombard

Redefining the EA periphery?
Total factor productivity, indices: 2007 = 100



Source: EC (AMECO), Datastream, TS Lombard