TCW

INSIGHT

VIEWPOINT

Italy: Rattling the Cage

MARCELA MEIRELLES | SEPTEMBER 21, 2018

The Italian sovereign debt selloff picked up momentum last May when euroskeptic economist Paolo Savona was considered for the role of Italian Finance Minister. Savona, who has referred to the fiscal discipline imposed by Eurozone membership as the "German cage", was instead appointed as the Italian Minister of European Affairs. A market friendly economist, Giovanni Tria, was selected for the top Italian Treasury job. Mr. Tria has since then tried to regain investors' confidence, and as a result, credit spreads have tightened relative to May selloff levels. We believe, however, that we are witnessing the beginning chapters of a different approach to fiscal policy and that the new political leadership in Italy feels fundamentally different about austerity imposed from Brussels.

Frustration over what is perceived as excessive austerity runs deep in the country. A recent fatal collapse of a bridge in Genoa sparked official calls for more infrastructure spending. At the heart of Italy's problems lies a dilemma between, on one hand, still strong popular support for the Euro and Eurozone membership and on the other, deep frustration caused by income stagnation. Eurozone policymakers have argued, in contrast, that growth underperformance is due to lack of structural reforms in Italy relative to peers such as Spain and Portugal, and not a result of excessive austerity.

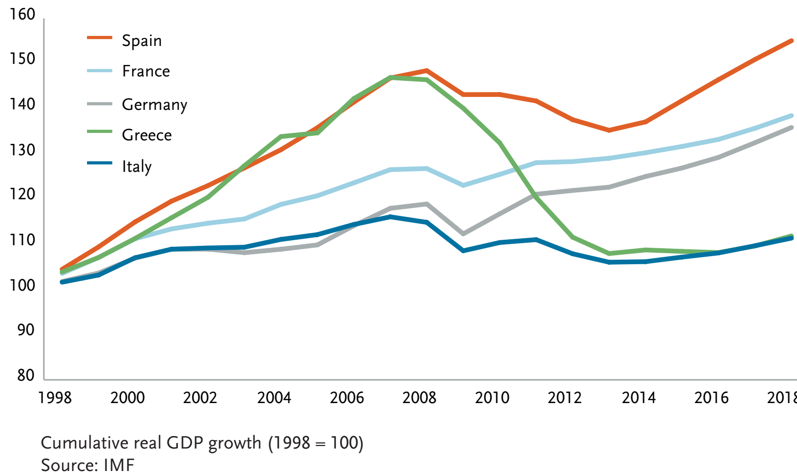
In this note, we summarize our takeaways from our Italian debt sustainability and scenario analysis. We also discuss the 2019 outlook for Italian bonds supply and demand, once the ECB stops expanding its balance sheet. Finally, we look at Target 2 balances, in particular, at Italy's widening Target 2 deficit, a measure of Bank of Italy liabilities with the ECB. This is an issue that has caught analysts' attention as

Marcela Meirelles, PhD, CFA
Managing Director
Fixed Income

Dr. Meirelles is a Senior Analyst within the Fixed Income group responsible for international nominal and inflation linked bonds; she has been with TCW for over a decade having previously served as the firm's primary Latin America Credit Analyst. She brings the firm strong experience as a former Economist with the Federal Reserve Bank of Kansas City, where she conducted research on inflation targeting and was responsible for the construction of U.S. macroeconomic scenarios. Born and raised in Brazil, Dr. Meirelles was an Economic Policy Advisor for the Brazilian Senate and the Health Ministry of Brazil. Prior to that, she was a Researcher with the Institute of Applied Economic Research (IPEA) in Brasilia. Dr. Meirelles earned her PhD in Economics from UCLA, where her dissertation focused on the optimal design of inflation and fiscal targeting regimes. She holds a Master in Economics from the University of São Paulo and a BA in Economics from the University of Campinas, Brazil. She is a CFA charterholder.

a potential source of risk. We offer our interpretation for the widening gap and how it reveals unresolved issues in the uneven economic structure of different economies bound by the single currency arrangement.

Italy's Growth Underperformance: A Close Race with Greece



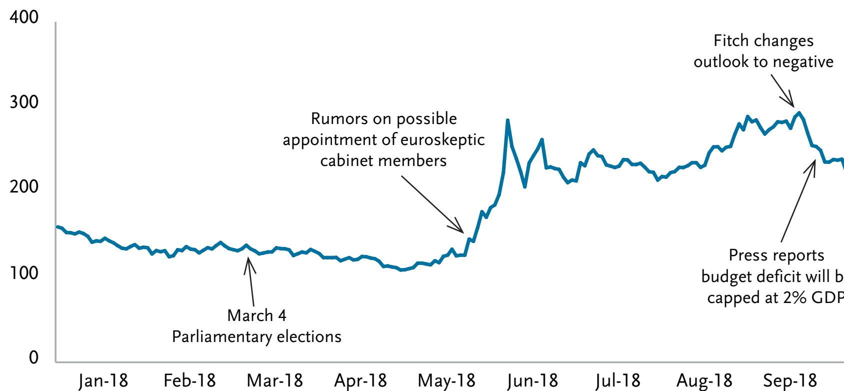
Cumulative real GDP growth (1998 = 100)
Source: IMF

Key risk events ahead: updated government assessment on the economy, 2019 budget draft, sovereign ratings announcements, European Commission annual review

Italian credit spreads have tightened somewhat since May, but the country is still making headlines, as we approach four key events:

1. The updated report by the Italian Treasury on Italy Stability Program (due on the last week of September); this report will provide important clues regarding the government's assessment of the state of the economy and fiscal projections;
2. The presentation of the 2019 budget draft to Parliament (October 15);
3. S&P (October 26) and Moody's (mid to late October) ratings announcements (consensus expectation: one notch downgrade, still maintaining investment grade (IG) status, stable outlook).
4. European Commission annual review of Italy's 2019 budget (and those of other EU member countries) in the first week of November.

Italy: 10 Year Government Bond Spread to Bunds (bps)



Source: Bloomberg

TCW

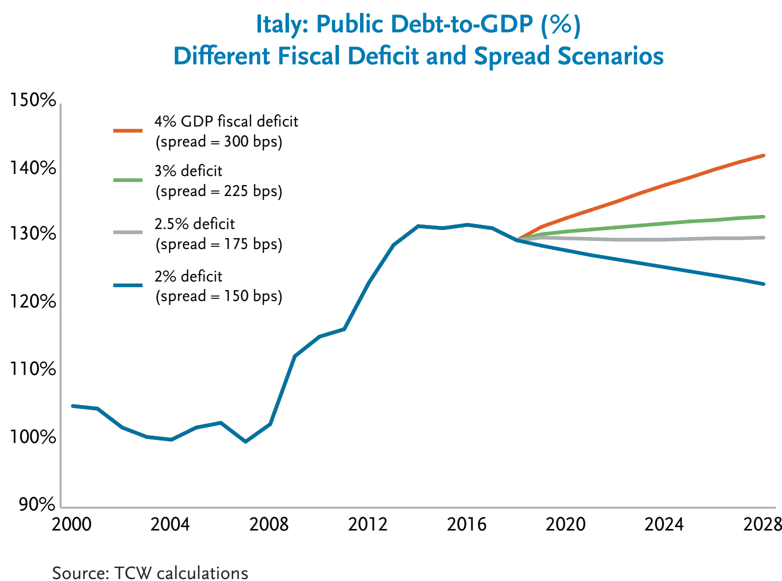
Italy's debt sustainability: Scenarios and key variables to watch

Headlines on the likely contours of the 2019 budget conveyed mixed signals about the government's plans. Finance Minister Giovanni Tria has emphasized the importance of fiscal discipline. Italy's two deputy prime ministers, Matteo Salvini (Lega Party) and Luigi di Maio (5 Star Party) – the two political forces that overtook the political establishment in the March 4, 2018 Parliamentary elections and were able to form a left-right populist coalition – have frequently reiterated the importance of fulfilling campaign promises, such as rolling back pension reform, universal minimum income, postponing VAT tax increases and personal and corporate tax reform. Immediate implementation of the complete package would cost an estimated 7% GDP.

How much room for additional fiscal spending does Italy have, without compromising the already fragile debt sustainability? The answer is not much. Italy has persistent low growth, so there has to be a systematic fiscal effort to keep the debt-to-GDP ratio stable. Since the country already spends 3.5% GDP on interest payments, keeping the overall budget deficit at acceptable levels requires steady savings, before debt service (a primary surplus), of at least 1.5% GDP.

The following chart shows different paths of debt to GDP over time, with varying assumptions about the size of the budget deficit and corresponding credit spreads (see footnotes for all underlying assumptions and methodology).

Italy: Public Debt-to-GDP (%)
Different Fiscal Deficit and Spread Scenarios



Source: TCW calculations

Investors will likely scrutinize the September 2018 update of the Stability Program and its underlying parameters. For example, excessively optimistic growth assumptions (and therefore likely overstated revenues) would be counter-productive. Growth forecasts for 2018 and 2019 should be revised down by 0.2-0.3% GDP (to a 1-1.2% real GDP growth range in 2018/19) to take into account the loss of momentum in economic activity since 2018 Q1. Higher borrowing costs should also be acknowledged, especially given that the ECB plans to end balance sheet expansion by the end of the year.

When lower growth and higher interest rates are factored in, then some fiscal deterioration is to be expected, bringing the overall budget deficit to about 1.8%-2% GDP. In fact, the recent rally in Italian yields came as the market consolidated a view that the proposed budget would show some fiscal deterioration – a modest fiscal easing of EUR 10 bn - but not signal the intention to breach a 2% deficit.

A budget deficit capped at 2% GDP would be cheered by the market but would leave little to no room for the ambitious stimulus promised during the election campaign period. The EUR 10 bn of fiscal easing would afford the government a gradual phasing in of their proposed policies, for example using previously budgeted funds to fight poverty as the basis for a "pilot" universal income program that can be expanded later. Corporate tax reform can also start with a subset of small enterprises.

Gradual adoption of a targeted fiscal stimulus, focused on poverty alleviation and job creation is a palatable approach that will probably be enough to prevent Italy from losing IG status over the next year or so. More concerning is the loss of economic reform momentum, including the risk of unwinding of previous efforts such as the labor market reform. This could have a big impact on ratings agencies assessment of whether Italy belongs to the IG universe.

ECB balance sheet expansion ends in December 2018: Implications for Italy

By the time the ECB ends its balance sheet expansion in December 2018, the institution will have purchased, under its asset purchase program, an estimated EUR 366 bn Italian government bonds, equivalent to 17% of the total stock of public debt.

Reinvestments of maturing bonds will still be sizable. Given the country and maturity profile of ECB holdings, reinvestments in Italian bonds worth EUR 30 bn are expected in 2019. The end of net asset purchases means, however, that the private sector will have to absorb a larger share of Italy's gross funding needs, to the tune of an extra EUR 4.5bn/month. This is manageable, as long as Italy's indebtedness level is seen as sustainable.

Italy: Estimated Funding Needs (EUR bn) (Assuming 2% GDP deficit and 150 bps spread)

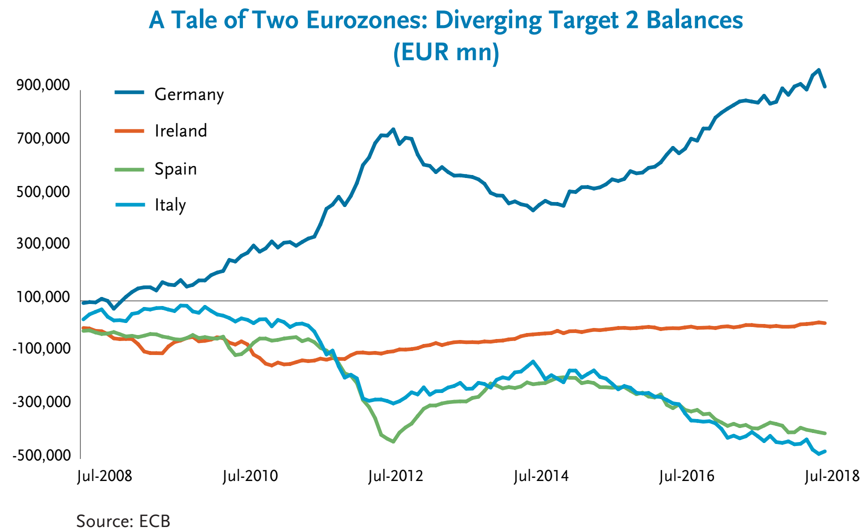
	Gross Funding Needs	Bond Redemptions	Net ECB Purchases	ECB Reinvestments	*Gross Funding Needs Minus ECB*
2018	258	180	43	26	189
2019	273	238	0	30	243

Source: TCW and JPM

Italy's widening Target 2 deficit: Where does it come from and what does it tell us?

Italy has a wide Target 2 deficit that went deeper in the red after the May 2018 selloff. This sparked commentary on the warning signs coming from Target 2 balances. We view Target 2 balances as a normal aspect of the functioning of the single currency system, but they are still worth monitoring as a by-product of underlying Eurozone economic issues.

The Target 2 system processes the settlement of cross border flows of Euros. An outflow from the Italian banking sector to somewhere else in the Eurozone creates a negative entry in the Target 2 system for Bank of Italy and a positive one for the central bank of the recipient country. There is a clear diverging trend in select country balances, as illustrated in the following chart:



Source: ECB

Target 2 balances became larger as a consequence of the 2011 European sovereign debt crisis, which accelerated a bank deleveraging process that unwound previous cross border flows. For example, when German banks reduced credit exposure to Italian banks, there were corresponding financial outflows from the Italian banking system. That outflow triggered a negative accounting entry at the Target 2 balance of Bank of Italy with the ECB.

More recently, the increase of Bank of Italy Target 2 deficit has been linked to ECB asset purchase program. The ECB has proposed this connection in a recent report[1]: the liquidity created by bond purchases facilitates a portfolio rebalance process that is closely correlated with recent changes in Target balances. For example, when Bank of Italy buys an Italian government bond from foreign investors – let's say, from a Dutch pension fund – and the proceeds are not reinvested in Italian securities, this creates an outflow from Italy to a foreign financial market.

Market participants have wondered if there is more at play than just the sale of Italian government bonds by foreigners, expected to take place anyway while the ECB buys these assets. For instance, balance of payments data shows that Italian investors have also rebalanced their portfolios in favor of foreign assets.

Putting all these arguments together, we believe the ECB offers a correct description of one of the recent mechanisms that have influenced Target 2 balances, but we would take one extra step while analyzing recent developments. When foreign investors sell Italian government bonds to the Monetary Authorities, they could use the proceeds to buy Italian corporate bonds, or to make an equity investment in a local business. The fact that there are actually net outflows from Italy to somewhere else in the Eurozone signals that foreign investors' appetitive for Italian risk exposure remains subdued, relative to pre-2011 levels.

[1]Eisenschmidt, Kedan, Schmitz, Adalid, Papsdorf, "The Eurosystem asset purchase program and TARGET balances", Occasional Paper Series, number 196, September 2017.

TCW

Summing up

Investors' concerns about Italian debt sustainability and increased scrutiny of Target 2 deficit reveal doubts about Italian assets performance in an environment where the ECB is gradually withdrawing policy stimulus.

We find it unlikely that current political leadership in Italy will completely walk away from its campaign promises and related fiscal expansion. For the time being, we do not rule out a gradual and targeted adoption of fiscal stimulus that could even be positive for growth. More concerning are the populist pledges to unwind reforms, for example reducing minimum retirement age and adding to the already costly pension system.

We don't see Italy losing its investment grade status over the next year or so. But the message from the March 2018 general elections was clear and will linger in the back of investors' minds: a group skeptical of reforms and of Eurozone rules is in charge. Lega and 5 Star parties share a populist approach, but they have very little in common when it comes to choosing policy priorities. Perhaps the market finds some comfort in the fact that disagreements about the best course of action will lead to inaction (hence fiscal policy status quo). The downside is that this is a fragile alliance that could fall apart and send Italians to the polls again – further delaying much needed focus on economic reforms.

Methodology notes

We estimate alternative debt scenarios by taking the risk free rate path (priced in Bunds forward curve) as an exogenous factor and then adding a risk premium that varies according to the size of the deficit.

The interest cost on the stock of debt changes over time, being a function of:

1. The evolution of the risk free rate (from forward rates);
2. Different average spread assumptions;
3. The current cost of debt (based on coupons of previously issued bonds);
4. The cost of newly issued bonds. We assume that debt issuance is distributed in a way such that the current average maturity of debt is stable.

We assume that the government sets an overall budget deficit target, then the primary surplus/deficit adjusts in order to be consistent with the overall deficit and interest payments of debt. ■

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2018 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup