**GIAM Macro & Market Research- Market Commentary**

## Italy: downside risks to growth increase, but there is room for fiscal stimulus

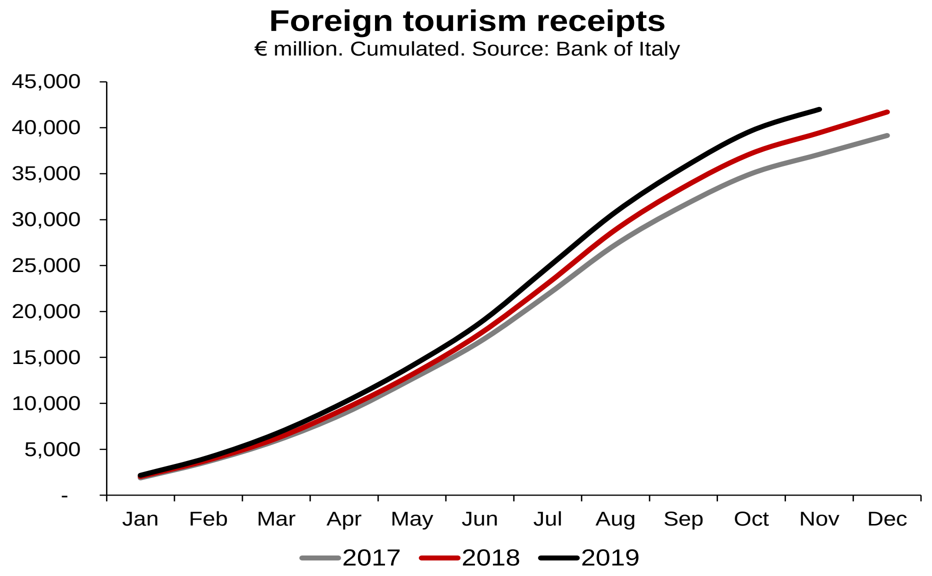
- **The number of COVID-19 cases is increasing but remains concentrated in some parts of Northern Italy. The government has decided further containment measures: schools have been closed nationwide and attendance to public events has been restricted.**
- **The government has already set up a €7.6 bn package, with emergency measures for healthcare and the sectors affected so far. More will follow as the European Commission will not object against a much higher deficit than the 2.2% of GDP planned for this year.**
- **We project a 0.4% GDP contraction this year, assuming that activity recovers from Q3. Risks are titled to the downside and increasing.**
- **The large fiscal stimulus that will be required is made somehow easier by good fiscal results posted in 2019. The primary surplus has increased beyond expectations and a large part of the improvement is structural.**

Coronavirus cases in Italy remain on the rise (they were 3296 as of March 5), but most of them remain concentrated in the two areas (south of Milan and near Padua) where the outbreak originated; importantly there is no evidence of other local clusters of infections, a first tentative indication that the harsh containment measures are proving effective. In order to stem the contagion, the government has decided to extend to the whole country the suspension of school activities (until March 15) and to limit the number of people attending public events, cinemas and theaters. Large gatherings have been postponed, and football matches will be played behind closed doors. Talks of extending lockdown to other areas have not yet led to concrete measures.

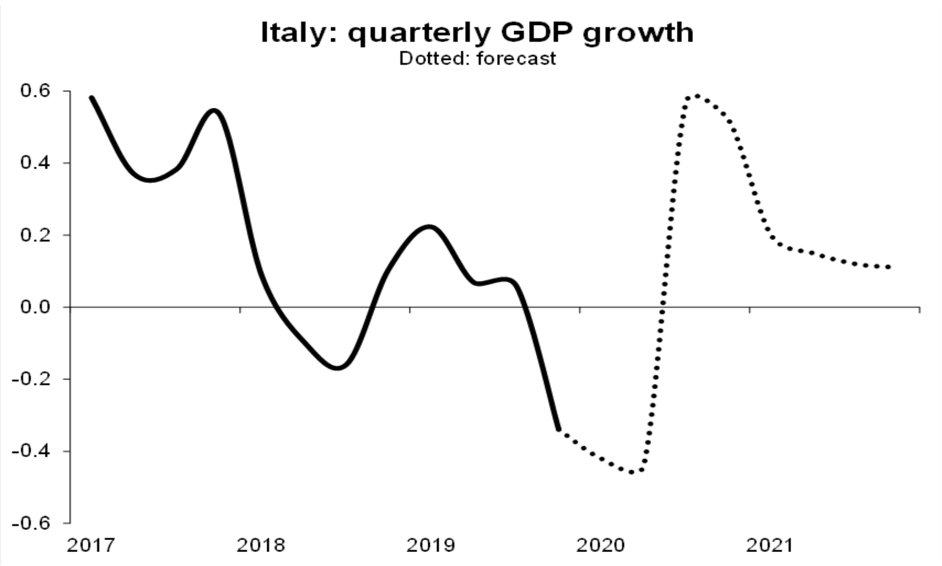
**Detected cases as of March 5**

Source: Ministry of Health

The evidence on the impact on these measures on economic activity is still anecdotal and does not point to a significant activity slowdown outside the most affected regions (Lombardy and Veneto), which however account for around 30% of Italian GDP. A much bigger worry is, at present, tourism, as evidence of booking cancellations mounts. The industry accounts for around 5% of GDP and 6% of employment. Unlike manufacturing, most losses in travel and tourism cannot be recovered later in the year.




Last week we revised down our 2020 growth forecast from 0.2% to -0.4%. Our assumption is that contagion peaks over the next month and activity troughs in Q2. After then, the recovery in global activity and the planned fiscal stimulus bring back positive growth. Of course a lot of things have to go well, and therefore risks are clearly tilted to the downside. More pervasive and longer lasting containment measures would definitely increase risk, on top of the damages related to the uncertainty on how supply chains are holding.

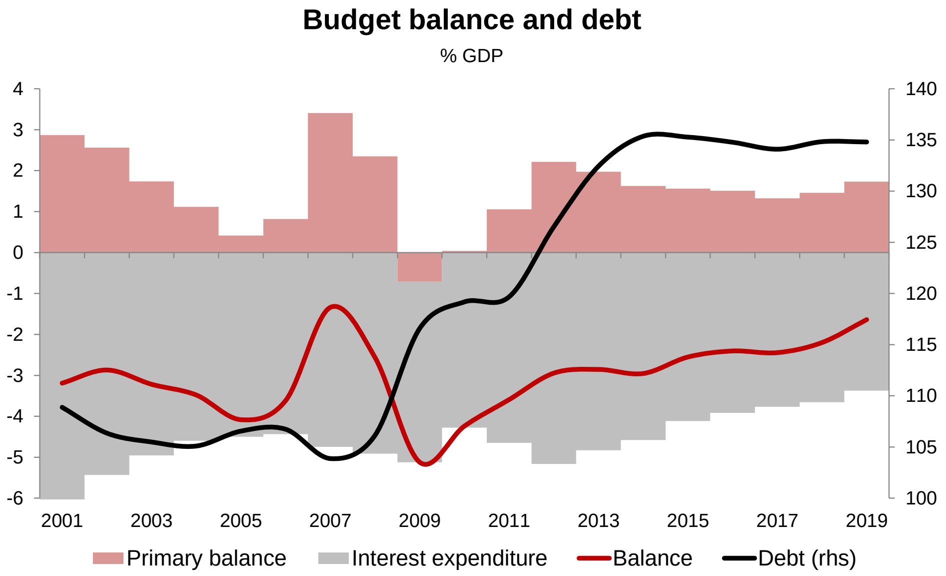



Next Wednesday, the Parliament will vote on set of measures worth €7.5bn (0.6% of GDP) aimed at strengthening the healthcare system, providing income support to workers and tax relief for the firms in affected areas. There are also talks of a much more ambitious plan involving fresh public investment.

Particular attention will be devoted to the banking sector. A prolonged activity slowdown can trigger liquidity problems among firms (especially SME, which account for over 70% of employment and whose only source of external financing is banks). On March 12 we expect the ECB to unveil support measures, which could include a new LTRO targeted at supporting bank lending. On top of that, the government can resort to the measures enacted during the 2011 crisis, and which prove effective in easing liquidity constraints. In such a scheme, banks, backed by a state guarantee, can extend the terms of payments for loans' interests and principal and allow financing for working capital. The technical facilities are already in place and the system (which has already been approved by the Commission) could be operational within a few weeks.

The size of the financial stimulus the government has planned is more than three times bigger than what had been agreed with the Commission at the beginning of the outbreak. In conjunction with the GDP contraction, it may well led budget deficit near or above 3% of GDP. EU Treaties allow for a sharp deviation from the target amid exceptional circumstances. The virus outbreak is clearly one of those, so we expect a sizeable package to be approved. However, there are still safeguard clauses worth around 1.0% of GDP which have to be financed in order not to trigger the VAT increase and this will inevitably weigh on the final size of the fiscal stimulus.

The data on 2019 public finances published early this week show that the government has more fiscal space than expected. The budget deficit shrank to €29.3 bn, or 1.6% of GDP, against the 2.2% targeted, the lowest since 2007. Interest payments dropped by €1bn, more than anticipated, but what matters is that the primary surplus increased from 1.5% to 1.7% of GDP. This is in part due to factors that may not be repeated in 2020, like higher dividends from the Bank of Italy and Cassa Depositi e Prestiti, or the jump in social contributions due to employment growth. However, there was also a noticeable increase in tax revenues as measures legislated in 2017 to increase VAT compliance start bearing fruit. We estimate that a large part of it (worth around 0.3% of GDP) will be structural.




Public debt has stabilized at 134.8% of GDP, still high but better than expected. The almost unavoidable recession and the worsening in public finances represent a clear risk to debt sustainability. But in our view they should not lead to a rating downgrade, as growth should resume and the fiscal measures taken will be temporary. At the end of last month, Moody's expressed concern for the growth outlook, but the shock will not lead to a reassessment of neither the rating nor the outlook.

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