Portugal, Spain and Italy: Fiscal Convergence or Divergence?

Italy (BBB+/Stable), Portugal (BBB/Stable) and Spain (A-/Stable) have high public debt levels which raise the need for sustained fiscal consolidation in the context of slowing economic growth to ensure their public debt sustainability and to preserve sufficient fiscal space for adverse shocks. Scope analyses the countries' fiscal trajectories from a stock, flow and contingent liabilities perspective and the associated rating implications. While there may be some upside for Portugal's ratings over the medium-term, in Scope's view, the rating risks for Italy and Spain are broadly balanced and, if anything, more tilted towards the downside.

During 2018, Scope affirmed Spain at A-/Stable and Portugal at BBB/Stable but downgraded Italy to BBB+/Stable. For 2019, as highlighted in Scope's Sovereign Outlook, a key rating-relevant question is whether, and to what extent, the governments continue to pursue the (structural) fiscal consolidation needed to ensure a gradual debt reduction, which is a positive rating trigger for the three sovereigns.

Table 1: Public finances and contingent liabilities (incl. EC forecasts)

	2009-12				2013-16				2017-20F			
Public finances	EA	ES	IT	PT	EA	ES	IT	PT	EA	ES	IT	PT
Fiscal balance	-5.1	-10.1	-4.0	-8.5	-2.3	-5.7	-2.8	-4.6	-0.8	-2.5	-2.6	-1.1
Primary balance	-2.2	-7.9	0.6	-4.7	0.2	-2.5	1.6	0.0	1.1	-0.1	1.2	2.3
Structural balance*	-3.3	-5.5	-2.7	-6.3	-1.0	-2.3	-0.9	-2.3	-0.9	-3.1	-2.6	-1.0
Public investment	3.3	4.0	2.9	3.8	2.7	2.2	2.3	2.0	2.7	2.1	1.9	2.2
Debt level (end)	91.6	85.7	123.4	126.2	91.2	99.0	131.4	129.2	82.8	95.4	131.1	116.8
Debt change (period)	12.4	33.0	10.8	42.6	-2.7	3.5	2.3	0.2	-6.1	-2.7	-0.1	-8.0
Contingent liabilities									2016-40F			
Δ Health care spending	--	--	--	--	--	--	--	--	0.7	0.8	0.7	1.8
Δ Pension spending	--	--	--	--	--	--	--	--	1.3	1.8	3.1	1.2
Long-term growth												
Potential growth (%)	0.6	0.4	-0.4	-0.5	1.0	0.1	-0.1	0.0	1.5	1.3	0.5	1.6

(*) data available from 2010 onwards

Source: EC, AMECO, Scope Ratings GmbH

- For **Portugal**, which faces a legislative election to be held no later than October 2019, the key question is whether the next government will continue implementing policies that raise the country's growth potential whilst reducing the still-too-high public debt level of around 122% of GDP. Scope notes positively the gradual and sustained turnaround of public and primary balances, which is expected to result in a significant debt reduction of around 20-25pp since 2013 by 2023. Still, long-term public challenges remain, particularly related to healthcare expenditures.
- For **Spain**, Scope notes that the country's debt-to-GDP ratio has only fallen modestly in recent years despite real growth rates markedly above potential. Absent further fiscal consolidation and pro-growth reform, Spain's ratings will remain constrained at the A-/Stable level. The regional elections in May this year, and the possibility of snap general elections are the key political developments which may provide some indication on the government's ability to address these issues over the medium term.
- For **Italy**, it is uncertain whether the government will moderate the deterioration in the fiscal balance in light of slower economic growth and expansionary budgetary goals. Despite maintaining primary surpluses since 2009, Italy's structural fiscal path will deteriorate in 2019. In Scope's view, given Italy's low medium-run growth potential, the failure to reduce debt ratios during the current global expansion raises the risk of greater debt sustainability challenges in a future downturn. Italy moreover faces the highest pension-related expenditure burden of all euro area countries.

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Portugal, Spain and Italy: Fiscal Convergence or Divergence?

Diverging fiscal adjustment: focus on flow variables

In the context of high public debt, flow variables are key for public debt sustainability

Scope's focus on the fiscal flow variables reflects its methodological emphasis around the emerging consensus that debt sustainability should be linked to both stock and flow features of public debt. As Italy (131%), Spain (97%) and Portugal (122%) all have high public debt-to-GDP levels, albeit to varying degrees, changes in their respective fiscal flow variables are key to assessing debt sustainability risks[1], and consequently their rating implications.

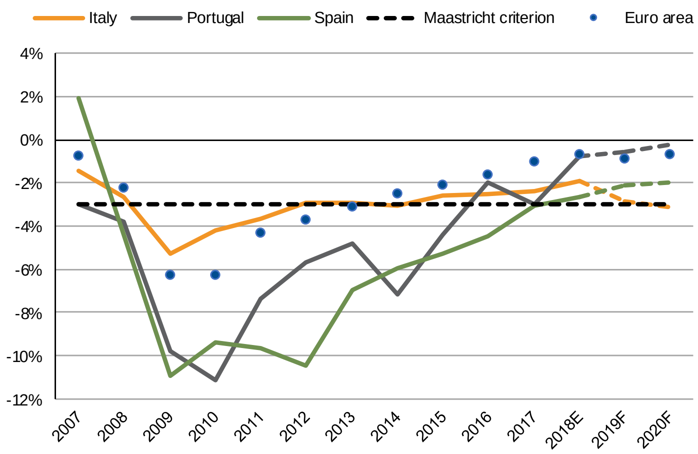
Significant fiscal adjustment in Spain, and particularly Portugal

In this context, over recent years, Spain and Portugal have undergone a significant budgetary adjustment, reducing their fiscal deficits from above 10% in 2009-10 to below the 3% Maastricht criterion in 2016[2] (Portugal) and 2018 (Spain). Scope notes that Portugal's fiscal effort has been more ambitious compared to that of Spain, achieving sustained and significant primary surpluses since 2015 whereas Spain is expected to achieve its first primary surplus since 2007 only in 2019, despite growing at around 2.8% since 2014. Still, Scope notes that Spain's gradual fiscal consolidation will allow the country to finally exit the European Commission (EC)'s Excessive Deficit Procedure (EDP) in 2019.

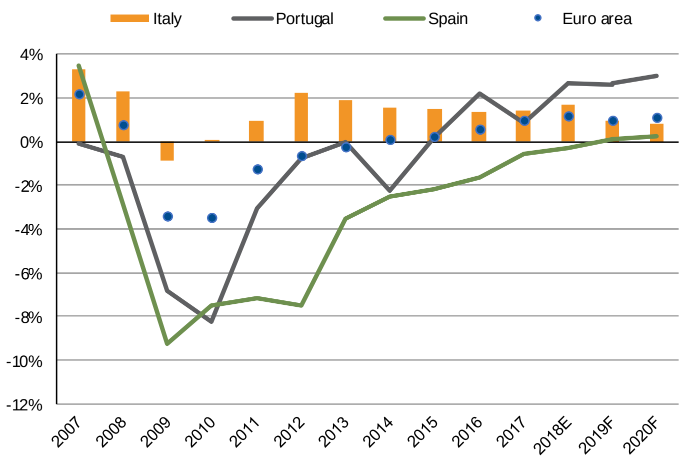
Convergence around a sustainable fiscal programme is fundamental for Italy's rating

Conversely, since 2009, Italy's budget deficit has declined more modestly to around 1.9% of GDP by 2018. Looking ahead, and in line with Scope's recent rating downgrade of Italy, one of the main rating-relevant questions is to what extent the Italian government will moderate its expansionary fiscal programme and limit the deterioration in fiscal sustainability. In Scope's opinion, the inadequate convergence around a sustainable reform programme that balances the government's core pro-growth agenda with greater fiscal discipline, or a pronounced weakening in Italy's debt sustainability, could be grounds for a further downside revision to the BBB+/Stable rating.

Fiscal balances, % of GDP



Primary balances, % of GDP



Source: AMECO, Scope Ratings GmbH

Deteriorating structural fiscal adjustment in Italy…

Adjusting for the economic cycle and changes in interest expenditures, Scope analyses the development in the structural primary balance, which measures the fiscal balance adjusted for interest payments, one-offs and automatic stabilisers as a percentage of potential GDP. On this basis, Scope notes that Italy's structural primary fiscal adjustment has deteriorated every year from a high at around 4.2% of potential GDP in 2013 to just around 0.4% by 2020.

[1] See for instance Gabriele et al. (2017) who show the existence of a significant negative effect from changes in gross financing needs when debt stocks are high.
[2] Although Portugal's deficit rose temporarily back above 3% of GDP in 2017 owing to a large capital injection in state-owned bank CGD.

… which contrasts with marked structural efforts in Portugal.

Conversely, while both Portugal and Spain returned to structural primary surpluses in 2012-13[3], reflecting their fiscal adjustments and large negative output gaps, Portugal's has since been above 2% of potential GDP since 2014 whereas Spain's has declined and in fact turned into a deficit since 2016. Thus, for Spain, the continued fiscal adjustment in recent years has been mostly cyclical, benefitting from improving labour market conditions, resulting in lower benefits, as well as reduced interest expenditure, whereas changes in the structural position suggest an expansionary fiscal stance.

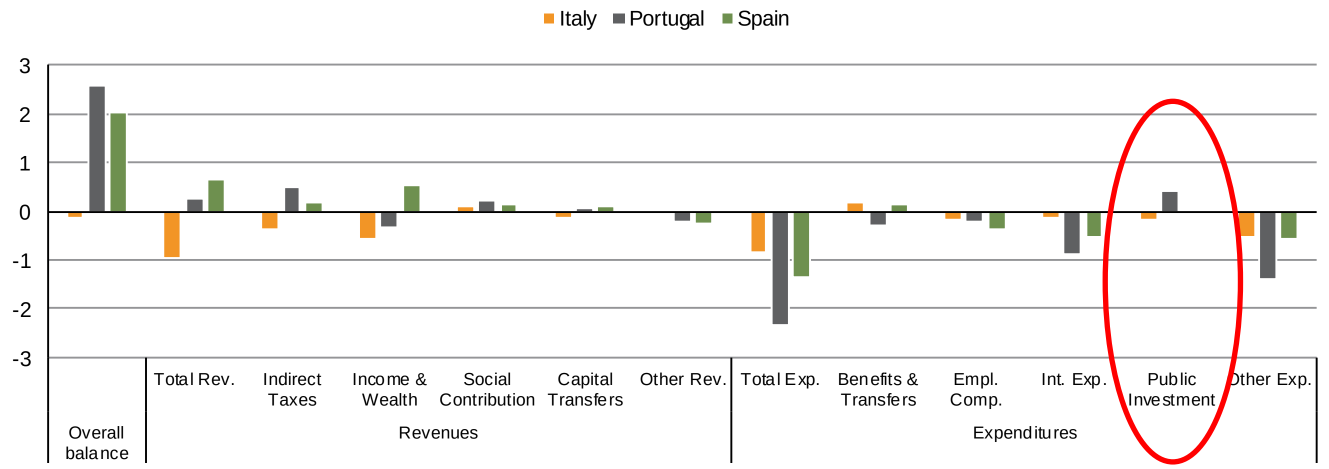
Wage restraint, efficiency savings and greater tax compliance improve Portugal's budgetary outcome

For Portugal however, Scope notes that the reduced deficits are not only due to sustained growth and lower interest payments but also continued restraint on public sector wages and employment which decreased from a high of 14% of GDP in 2009 to around 11% as of 2015 (although pressure on wages will increase with the unfreezing of career progressions) and efficiency savings from the (ongoing) spending review. In addition, improved tax compliance, as evidenced by the reduction in the VAT gap[4] from around 16% in 2012 to around 10% in 2016 – markedly below the 26% of Italy but still above the 3% of Spain, which corresponds to the second lowest value in the euro area after Luxembourg – also contributed to the positive outcome[5].

Budgetary composition shows fiscal consolidation in Portugal is not expected to curb public investments

Looking ahead, comparing the average budgetary composition from 2015-17 to that in 2018-20F, which is relevant for assessing the countries' debt sustainability given the possible implications for the countries' economic growth potentials, Scope notes that the expected budgetary adjustments of Spain and Portugal benefit mostly from cyclical components in the form of higher tax revenues and lower interest expenditures. Still, Portugal's fiscal consolidation is not expected to come at the expense of public investments, which are forecast to increase slightly in the coming years, contrary to the case for Spain, which in Scope's opinion is credit positive. While the Italian authorities have recently agreed on a 2.04% budget deficit target for 2019, it is clear that an expansionary fiscal stance may nonetheless result in some deterioration in fiscal deficit figures compared what's portrayed in the below chart.

Budget revenues and expenditures; Avg. of 2015-17 vs 2018E-20F



Source: AMECO, Scope Ratings GmbH

[3] Based on AMECO's cyclically-adjusted primary balance series (a good proxy for the structural primary balance), Portugal had a structural primary surplus in 1995-96, and Spain had a structural primary surplus in 2007.

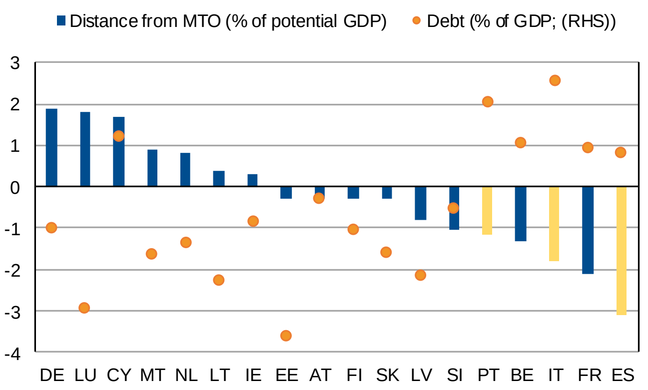
[4] The VAT gap refers to the difference between expected and actual VAT revenues and represents more than just fraud and evasion and their associated policy measures. The VAT Gap also covers VAT lost due to, for example, insolvencies, bankruptcies, administrative errors, and legal tax optimisation. It is defined as the difference between the amount of VAT collected and the VAT Total Tax Liability (VTTL)—namely, the tax liability according to tax law.

[5] https://ec.europa.eu/taxation_customs/sites/taxation/files/2018_vat_gap_report_en.pdf

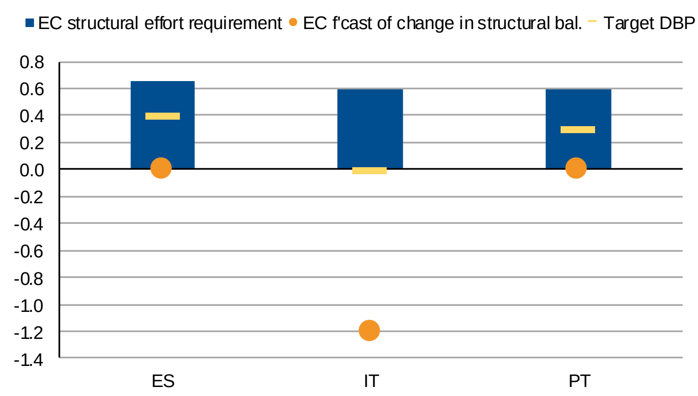
Risk of non-compliance with SGP

Despite ongoing fiscal adjustments, Scope cautions that the draft budgetary plans of both Spain and Portugal are among the five countries considered by the EC to pose a 'risk of non-compliance with the Stability and Growth Pact (SGP)', specifically the adjustment path towards the medium-term objective (MTO) and the debt reduction benchmarks. Both countries have argued that their budgets are however within the flexibility limits provided by the SGP[6]. For Italy, following interactions during Q4 2018 between the European and Italian authorities[7], the EC noted on 19 December that the fiscal measures finally proposed (and now adopted) by the Italian parliament 'allow the European Commission not to recommend the opening of an Excessive Deficit Procedure at this stage.'

Government debt and differences between structural balances and MTOs in 2018



Recommended, expected and targeted structural adjustments for 2019, % of GDP



Source: ECB, European Commission autumn 2018 economic forecasts, EC Country-specific recommendations, Draft budgetary plans. Scope Ratings GmbH

Scope assesses structural primary balances against output gap developments

Against this background, and mindful of estimation errors concerning potential GDP and output gaps, Scope assesses the change in the structural primary balance against the output gap (based on EC data) which shows whether changes in fiscal policies are either i) contractionary (positive change in the structural primary balance) or expansionary (negative change in the structural primary balance) and further, ii) pro- or counter-cyclical. Given the known problems estimating the output gap, changes in the structural primary balance may not necessarily reflect policy decision-making but could also be due to output gap revisions, which reduces the reliability of interpreting these results as 'fiscal effort'. Still, conducting the same exercise based on IMF data yields similar results (Annex I), confirming that differences are mostly in terms of degree not direction.

Mostly pro-cyclical contractionary fiscal adjustment during crisis years

On this basis, based on EC data, from 2011 until around 2014, during the height of the euro area crisis, the fiscal policy stance of the three countries was largely pro-cyclical and contractionary, that is, the fiscal adjustment amplified the economic downturn given large negative output gaps. However, since 2015, as fiscal balances improved, and output gaps were still negative – albeit also closing – the fiscal policy of governments has been slightly expansionary and counter-cyclical[8], that is, the reductions in the structural primary surpluses[9], which are expansionary, have taken place during times of continuously closing negative output gaps.

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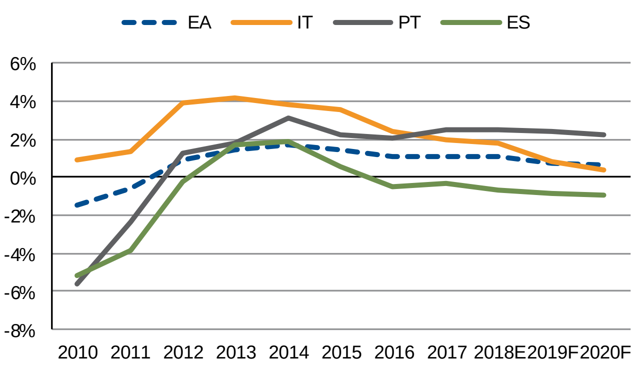
[6] Spain – Reply to Commission (DBP 2019): https://ec.europa.eu/info/sites/info/files/economy-finance/spains_draft_budgetary_plan_0.pdf
Portugal – Reply to Commission (DBP 2019): https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_pt_reply_to_commission_en.pdf

[7] This included a first-ever opinion establishing the particularly serious non-compliance of a budgetary plan with SGP requirements (18 October), a request to provide an updated budgetary plan (23 October), a confirmation that the submitted revised budgetary plan (13 November) remains in serious non-compliance (21 November), the conclusion that the debt criterion should be considered as not complied with, paving the way for opening a debt-based EDP for Italy (21 November), and the Eurogroup supporting the EC's assessment recommending Italy take the necessary measures to comply with the SGP (3 December).

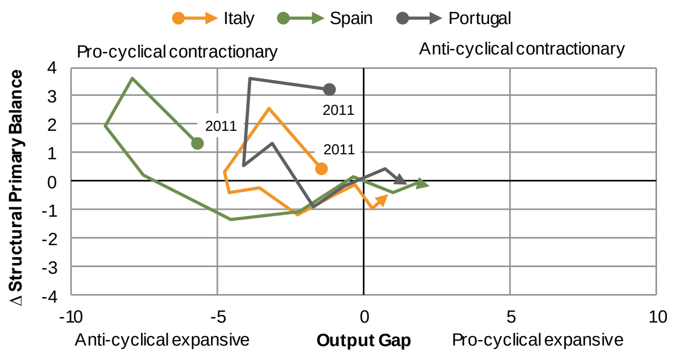
[8] Counter-cyclical when considered against negative output gaps, though fiscal expansion may not have been counter-cyclical under an alternative consideration of the growth in economies over these years.

[9] A deterioration of the structural primary deficit in the case of Spain.

Structural primary balance, % of GDP



Change in structural primary balance vs output gap, 2011-20, % of GDP



NB. The comparison of the change of the structural primary balance vs the output gap is taken from an illustration of the Austrian Fiscal Council.

Source: AMECO, Scope Ratings GmbH

Anti-cyclical contractionary fiscal policy would be credit positive as it builds fiscal buffers

Looking ahead, as the economic cycle moves into a late stage and output gaps become positive – implying that the slack of the economies from the crisis has been recovered – Scope notes that the key question is to what extent the governments will adjust their current fiscal stance, as shown in the change in the structural primary balance. From a rating perspective, an anti-cyclical contractionary fiscal policy would be credit positive, as continued failure to build fiscal buffers raises the risk of being forced to tighten fiscal policies in a future downturn. This reflects one of the major lessons from the last crisis, specifically, that sound fiscal positions provide countries with the fiscal space they may need to counter unforeseen shocks[10]. As highlighted by the Eurogroup, 'a slow pace of debt reduction from high levels in a number of Member States remains a matter for concern and should be decisively addressed.'

Debt sustainability assessments differ

Taking the lessons from the sovereign debt crisis into account, Scope notes that the structural budgetary developments matter significantly for Italy, Spain and Portugal given that all three countries have high public debt levels, significantly above the 60% Maastricht criterion.

Portugal's debt burden expected to fall significantly over next 5 years while Spain's and Italy's likely to remain almost flat

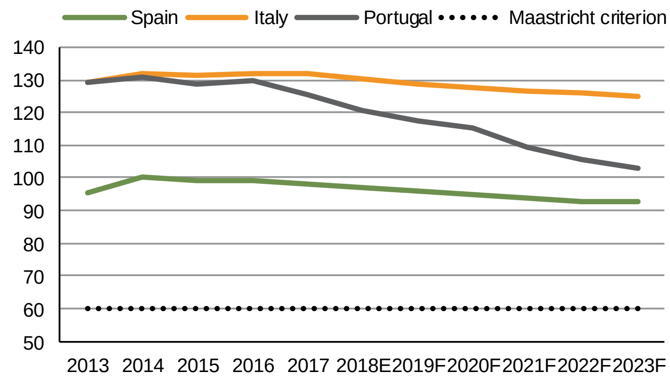
In this context, Scope's debt sustainability analysis, based on IMF forecasts and a combination of growth, interest-rate and primary-balance shocks, confirms that slower growth and lower primary balances remain key risks to the debt sustainability of the three countries. The baseline results reflect their high public debt levels and slowing growth rates but diverging primary balances, with Portugal being the positive outlier. By 2023, the IMF's baseline scenario is for the debt-to-GDP ratio to have fallen significantly to around 103% for Portugal, moderately to 93% for Spain and to around 125% for Italy. These figures are however subject to some downside risks given the expected 2019 economic slowdown as highlighted in Scope's sovereign outlook 2019.

Conversely, a more adverse scenario assuming a permanent country-specific shock of one-half standard deviations (based on 2008-18 outcomes) to real GDP growth (lower) and the primary balance (lower) for each year over the forecast horizon would lead to a debt-to-GDP level of around 120% for Portugal, 106% for Spain and 135% for Italy (see Annex II for the detailed assumptions). However, there are even worse outcomes conceivable. For example, in Scope's stressed scenario for Italy, under conditions of a global economic shock with the effect of two years of recession (and a hypothetical 5.9%

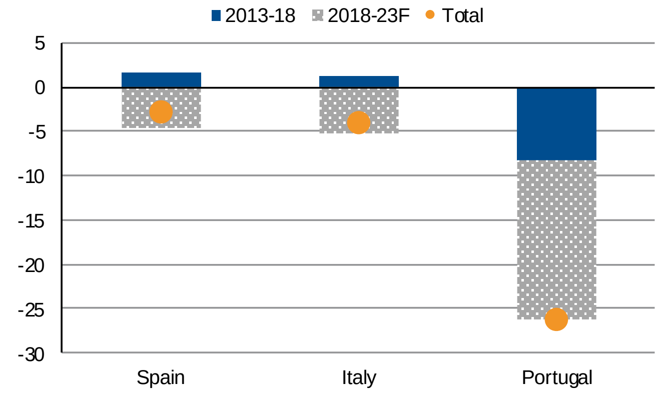
[10] https://www.ecb.europa.eu/pub/economic-bulletin/focus/2018/html/ecb.ebbox201808_06.en.html

cumulative contraction in output) and associated deterioration in the fiscal balance (with the primary surplus reaching a deficit of 1.5% of GDP at a trough), alongside a simultaneous spike in market financing rates, the debt ratio would climb to above 145% of GDP by 2021. These results highlight the importance of achieving and sustaining primary surpluses over the medium-term, particularly in the context of slowing economies with large debt stocks.

Debt sustainability IMF baseline scenarios, % GDP



Reduction in debt-to-GDP ratio 2013-2023F



Source: IMF baseline forecasts, Scope Ratings GmbH

Contingent liabilities increase fiscal risks

Pension and healthcare liabilities affect a sovereign's creditworthiness

In addition to fiscal consolidation efforts aimed at reducing government debt levels, future liabilities linked to pension and healthcare expenditures play a crucial role for the long-term sustainability of public finances. In particular, ageing societies reduce the working-age population, adversely affecting a country's economic growth potential and increasing ageing-related expenditures. While Scope acknowledges that pension and healthcare obligations are sensitive to assumptions, and in addition, subject to unilateral changes on the part of governments via targeted structural reforms, they do constitute commitments that involve a moral obligation and the expectation of government responsibility. Consequently, these liabilities have the potential to become public debt and thus affect a government's creditworthiness if and when they materialise.

Italy, Spain and Portugal among countries whose expenditures likely to be most affected by ageing populations

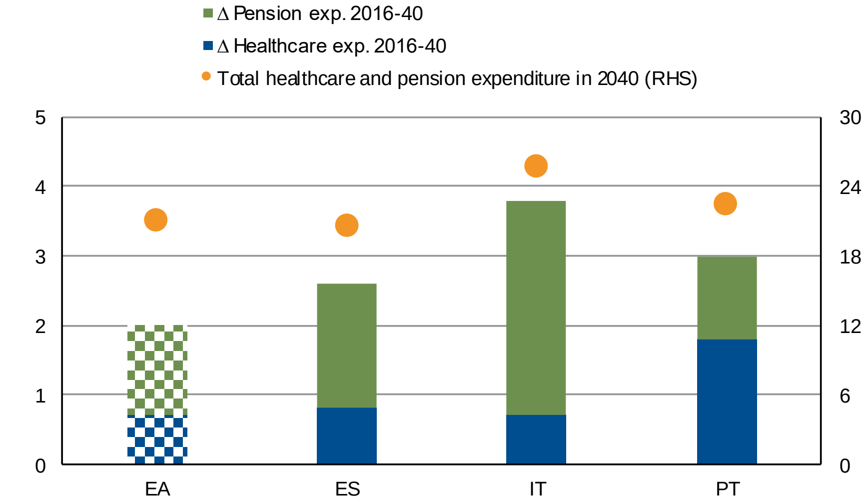
In this context, Scope notes that these developments affect all advanced economies, albeit to varying degrees. In the euro area, the ageing population is set to increase fiscal pressures across most[11] countries; however, sovereigns with limited fiscal space, such as Italy, Spain and Portugal, are also among those countries whose public expenditures will be most affected by ageing populations.

Italy's and Spain's healthcare expenditure contained but a significant burden for Portugal

The latest EC Ageing Report shows that the three countries will see their healthcare and pension related expenditure increase more than the euro area average. However, Scope notes that over the forecast horizon until 2040, Spain will face the smallest cumulative expenditure increase of the three countries, mostly driven by pension expenditures, at around 2.6pp, compared to the euro area average of 2pp. Conversely, Portugal's ageing-related expenditure increase of 3pp is mostly driven by healthcare, which is set to increase 1.8pp, more than twice the euro area average of 0.7pp. Both countries, however, face an overall ageing-expenditure burden of around 21% of GDP by 2040, in line with the euro area average.

[11] While healthcare expenditure will increase in all euro area countries by 2040, pension expenditure will decrease in Estonia, Greece and Latvia to an extent that more than compensates for the increase in their respective healthcare expenditure (EC Ageing Report 2018).

Contingent pension and healthcare liabilities; 2016-40F; % of GDP

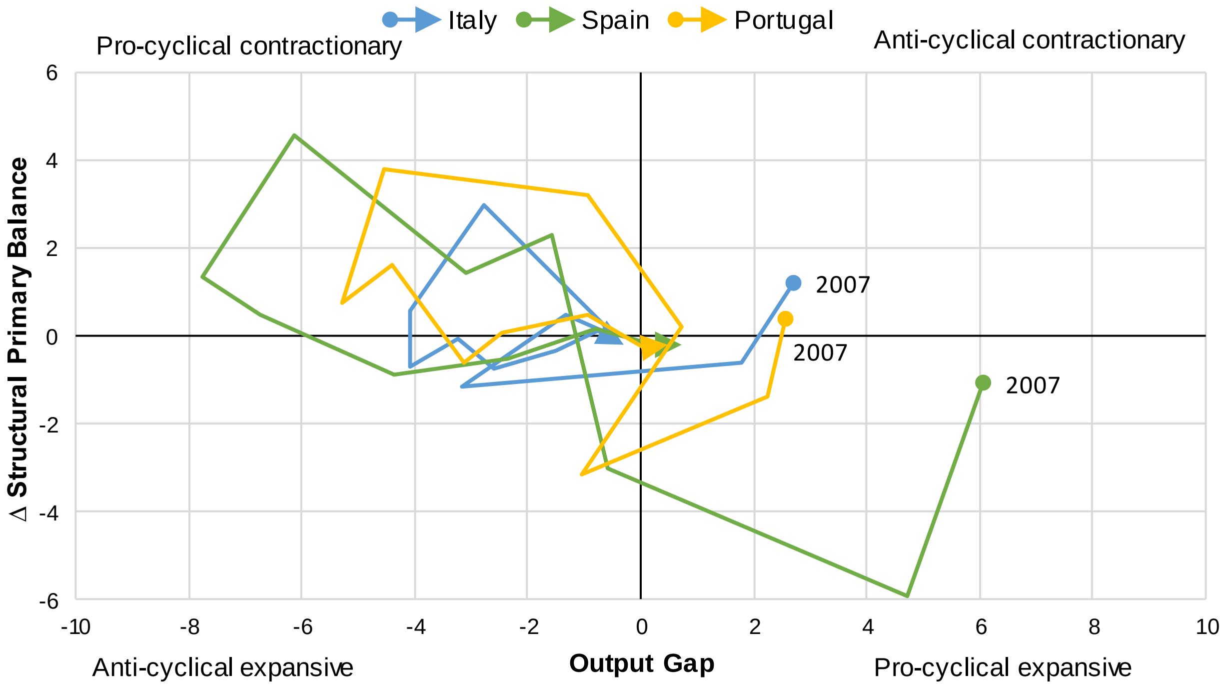


Source: EC Ageing Report 2018, Scope Ratings GmbH

Italy's pension expenditure expected to be highest among all euro area countries by 2040

Finally, Italy's contingent liabilities are set to increase by 3.8pp, driven mostly by pension expenditures, which are set to increase 3.1pp, compared to the euro area average of 1.3pp, resulting in the highest pension-related expenditure among euro area countries at 18.7% of GDP in 2040. Together with a modest increase in healthcare expenditures, Italy's ageing-related expenditures will exceed 25% of GDP, the highest value among all EU countries, highlighting the need to implement reforms to address long-term public finance challenges.

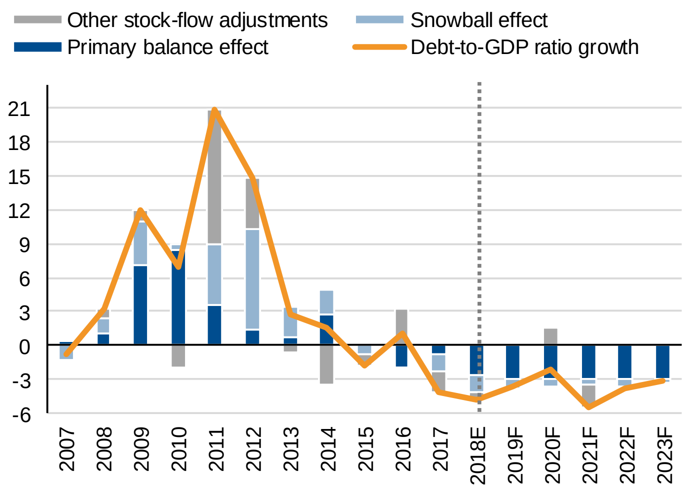
Annex I: Change in structural primary balance vs output gap (IMF)

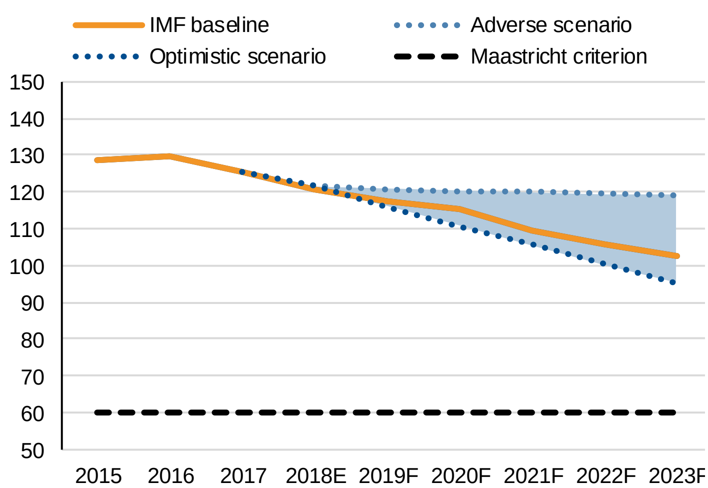


Source: IMF, Scope Ratings GmbH

Annex II: Debt sustainability assumptions and results

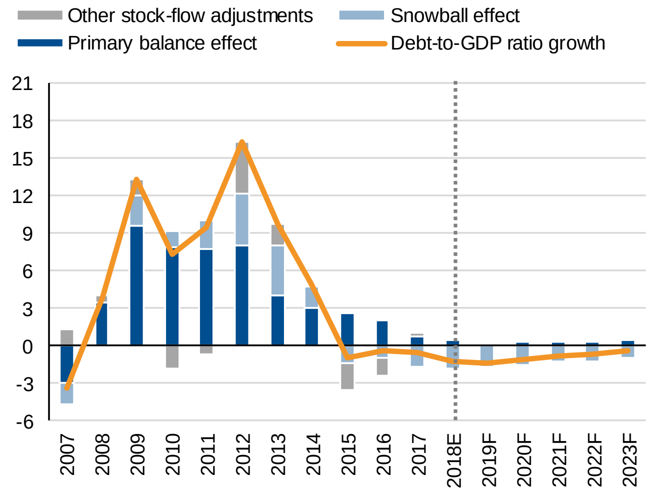
DSA Portugal

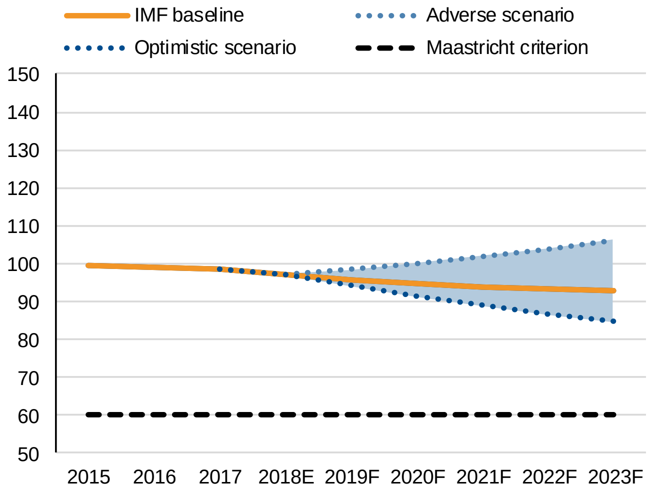




Scenario	Time Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2013-2018	1.4	0.3	1.5	120.8
IMF Baseline	2019-2023	1.5	2.9	0.9	102.8
Optimistic Scenario		2.1	3.8	0.8	95.3
Adverse Scenario		0.3	1.2	0.9	119.1

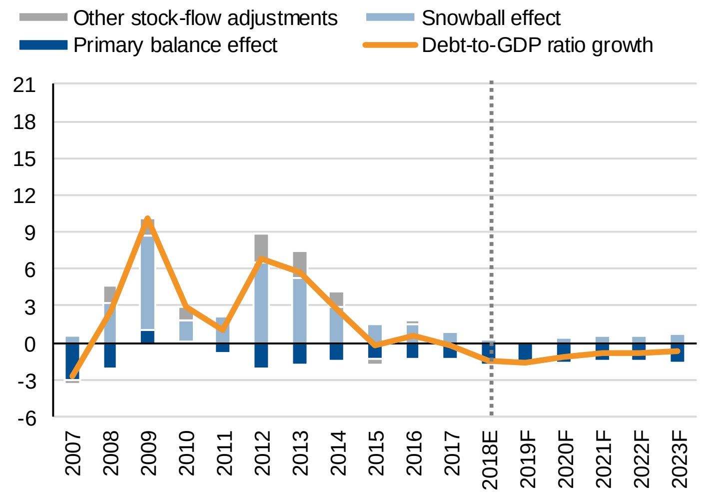
DSA Spain

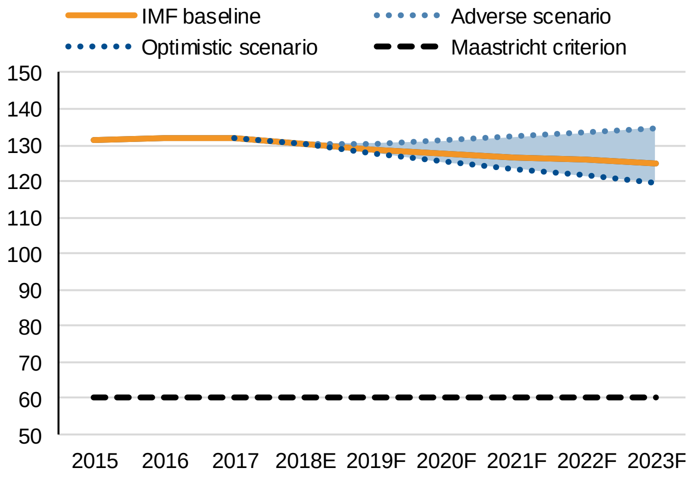




Scenario	Time Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2013-2018	2.0	-2.1	2.1	97.2
IMF Baseline		1.8	-0.3	0.4	92.6
Optimistic Scenario	2019-2023	2.4	0.5	0.4	84.6
Adverse Scenario		0.5	-1.9	0.5	106.2

DSA Italy





Scenario	Time Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2013-2018	0.5	1.5	2.1	130.3
IMF Baseline		0.8	1.6	1.2	125.1
Optimistic Scenario	2019-2023	1.4	1.8	1.1	119.7
Adverse Scenario		-0.3	1.1	1.2	134.6

Source: IMF, Scope Ratings GmbH.

NB. Adverse (optimistic) scenarios are with a ½ (¼) standard deviation downside (upside) shock to growth and primary balances.

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