

European Daily: Italy—Three Reasons to Be Constructive About Italian Debt in 2025 (Taddei)

- Italian sovereign spreads have been well-behaved for some time, gradually tightening since Autumn 2022. The current 10Y BTP-Bund spread is the tightest in almost-five years. Some market participants find this benign pricing unlikely to last given that the debt-to-GDP ratio is expected to increase, sovereign real rates are rising, and defence spending is set to rise by 1 % of GDP by 2027 because of the European geopolitical challenges.
- While all the above are at play, we see three ameliorating factors. First, the funding support of the European recovery fund is set to continue until 2026 providing fiscal space of about 1.5% of GDP per annum. The Italian fiscal balance is improving at the fastest pace across the EMU4, reaching the lowest gap versus the Euro area average since 2016, and the government has reiterated its commitment to preserve this trend. We expect the Italian fiscal balance to improve further.
- Second, real rates are increasing because of disinflation, US tariffs, and rising long-end yields. Still, Italian real rates are approximately 100 basis points lower than the pre-pandemic average. Moreover, the demand on the Italian fiscal space from increasing defence spending will be absorbed by EU debt supply. While it will result in higher deficit and debt, BTP issuance will likely not increase and average maturity should extend further.
- Third, with one exception, all episodes leading to wider spreads in the last 10 years have been triggered by political instability. But at present this risk seems low in Italy. According to opinion polls, the current government is the only Italian cabinet in 20 years to have gained in popularity in the 30 months following its appointment. We expect this condition to extend until next year given the lack of upcoming political catalysts.
- While the temporary tailwinds are likely to support the outlook for Italian debt this year, Italy is the only country in the EMU4 to experience negative productivity growth in the last two years despite the large fiscal support toward investment. A persistent upgrade of Italy's debt will require more structural improvement in its economy.

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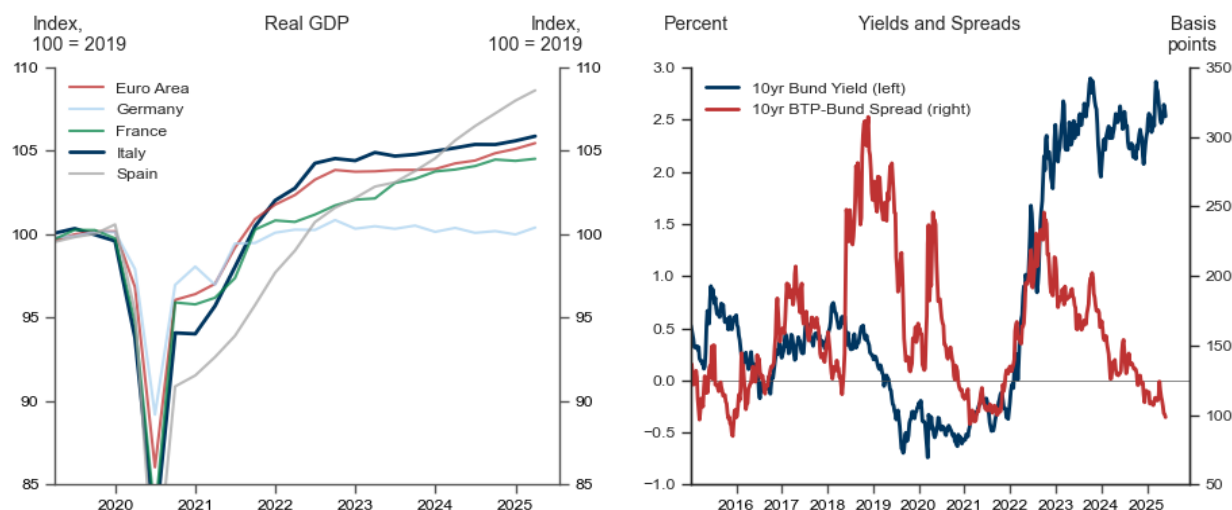
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Italy—Three Reasons to Be Constructive About Italian Debt in 2025

Italian sovereign spreads have been well-behaved for three years, gradually tightening since Autumn 2022. This is not the result of economic outperformance, as Italy has only recovered from a larger reduction in GDP experienced during the pandemic. Its GDP has only grown as much as the Euro area average or France since 2019. Nonetheless, the current 10Y BTP-Bund spread is the tightest in almost five years ([Exhibit 1](#)).

Exhibit 1: Italian Growth Momentum in Line with Euro Area Average, But Spreads Have Tightened

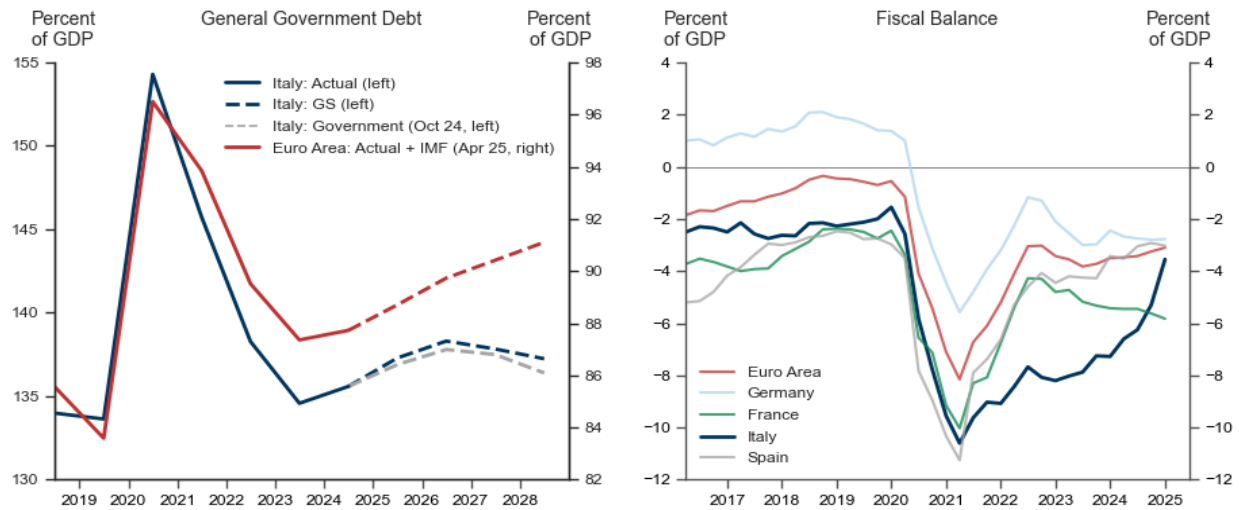


Source: Eurostat, Haver Analytics, Goldman Sachs Global Investment Research

A number of market participants find this benign pricing unlikely to last given that the debt-to-GDP ratio is expected to increase, sovereign real rates are rising, and defence spending is set to rise by 1 % of GDP by 2027 because of the European geopolitical challenges. While all the above factors are at play, there are three main temporary ameliorating factors. We discuss them in turn.

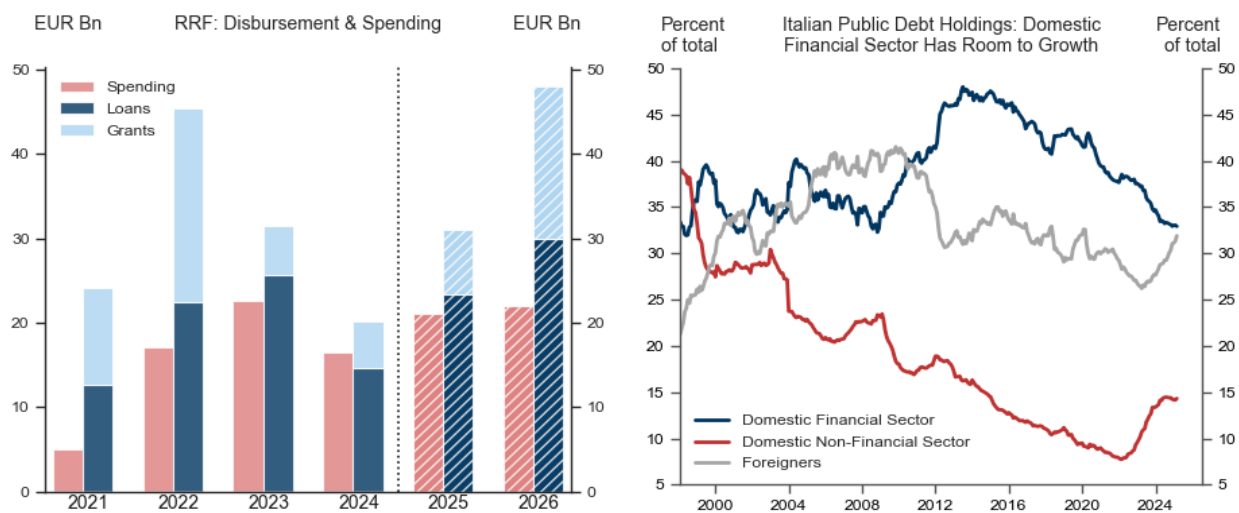
Fiscal Consolidation Despite Global Shocks

The Italian fiscal outlook is improving at the fastest pace across the EMU4. The gap between Italy and the average Euro area fiscal deficit and primary balance (in percent of GDP) almost completely closed last year, reaching the lowest level since 2016. The increase in the debt-to-GDP ratio is due to the legacy of the [construction tax credits](#) but, despite this effect, we expect the Italian debt outlook to show a flatter profile than the Euro area average ([Exhibit 2](#)).

Exhibit 2: Growing Debt But Faster Fiscal Consolidation

Source: European Commission, IMF, Istat, Haver Analytics, Goldman Sachs Global Investment Research

The government is committed to preserve this trend and we expect the fiscal balance to improve further thanks to the sizeable funding support of the European recovery fund. Started in 2021, the European programme is set to continue in 2025 and 2026 providing fiscal space at about 1.5% of GDP per annum. Moreover, while retail demand already peaked last year and foreign investors have sizeably increased their exposure, the domestic financial sector currently owns the lowest share of BTP holding in 25 years. This suggests that the domestic buyers have room to absorb upcoming BTP supply (Exhibit 3).

Exhibit 3: Recovery Fund Still Provides Fiscal Space per Year and Domestic Financial Sector BTP Holding Remain Subdued

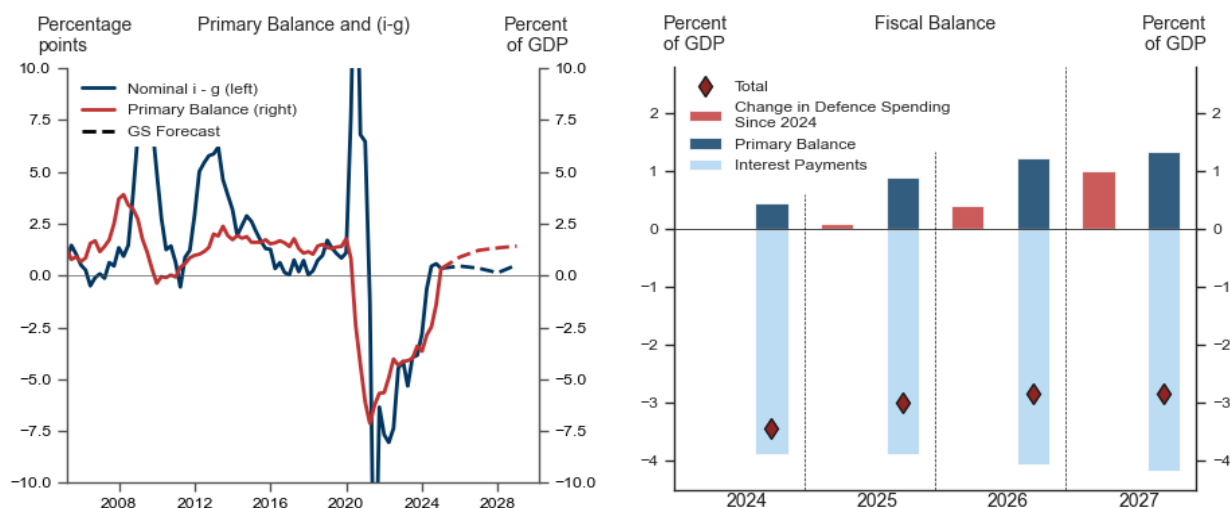
Source: Eurostat, Banca d'Italia, European Commission, Haver Analytics, Goldman Sachs Global Investment Research

Real Rates Remain Below Pre-Pandemic Level, But EU Policy is Now More Supportive

Sovereign real rates, i.e. the difference between nominal growth and the effective cost

of debt, have been rising across the board in Europe. This is the consequence of the joint effect of disinflation, slow real growth with the risk of US tariffs, combined with rising long end yields because of the building global bond supply. However, Italian rates remain almost 100bp lower than the pre-pandemic average providing a less challenging landscape than before. Moreover, the demand for additional defence spending due to the shared European geopolitical challenges are now likely to be absorbed by EU debt supply (European Defence Facility). While this extra spending will result in higher deficit and debt, national issuance is unlikely to increase and average maturity should extend thanks to the EU funding strategy (Exhibit 4).

Exhibit 4: The Snowball Effect is Almost Melting, While Defence Spending Builds Up Slowly

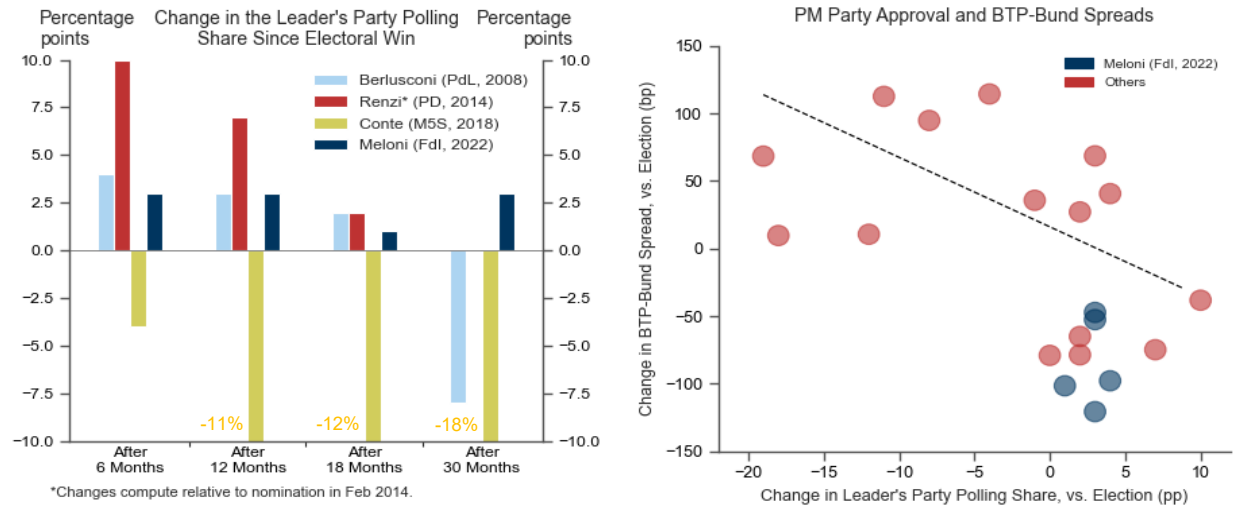


Source: Eurostat, Istat, Haver Analytics, Goldman Sachs Global Investment Research

Reduced Political Risk

With the exception of the pandemic, all episodes leading to wider spreads in the last 10 years have been triggered by political instability. Political instability is usually initiated when the incumbent government experiences a drop in approval ratings that ends up exposing the vulnerability of the Italian economy. At present the risk of political instability seems low in Italy. Using the Prime Minister's party as a proxy for the government's stability, the current government enjoys remarkably stable support. According to opinion polls, the current cabinet is the only one in 20 years to have gained in popularity in the 30 months following its appointment. We expect this condition to extend at least until the end of the year given the lack of upcoming political catalysts (Exhibit 5).

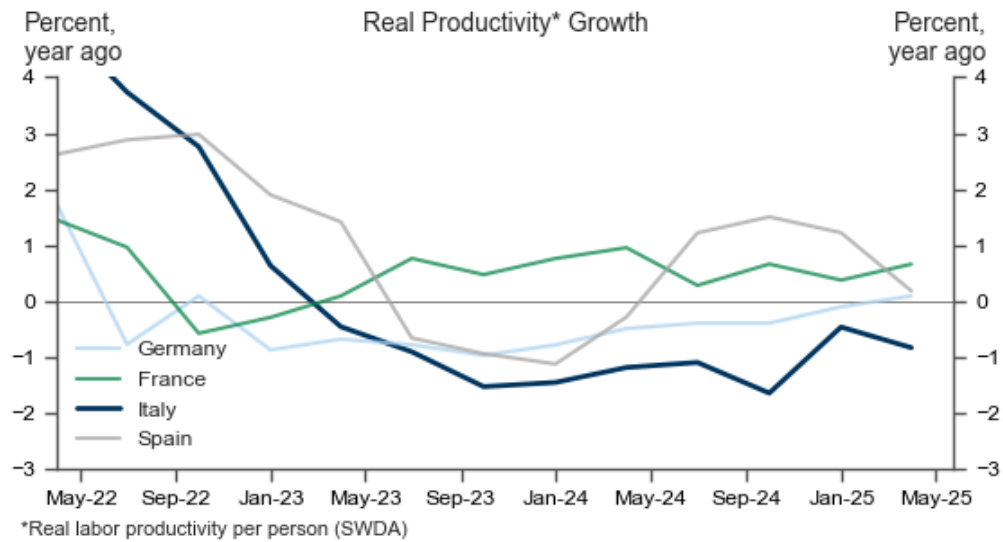
Exhibit 5: Unprecedented Political Goodwill Keeps Political Risk at Bay



Source: POLITICO, Haver Analytics, Goldman Sachs Global Investment Research

That said, an improvement in the long run outlook of Italian debt will require more than a few temporary factors. Italy is the only country in the EMU4 to have experienced negative productivity growth in the last two years, despite the large fiscal support toward investment coming from the European Recovery Fund. A persistent upgrade of Italy's debt will likely require the structural improvement of its economy. Such productivity improvement seems some way off (Exhibit 6).

Exhibit 6: Structural Change Still Distant: Productivity Growth Has Been Negative for 2 Years



Source: Eurostat, Haver Analytics, Goldman Sachs Global Investment Research

Filippo Taddei

Disclosure Appendix

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We, Sven Jari Stehn, Filippo Taddei, Alexandre Stott, James Moberly, Niklas Garnadt, Katya Vashkinskaya and Giovanni Pierdomenico, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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