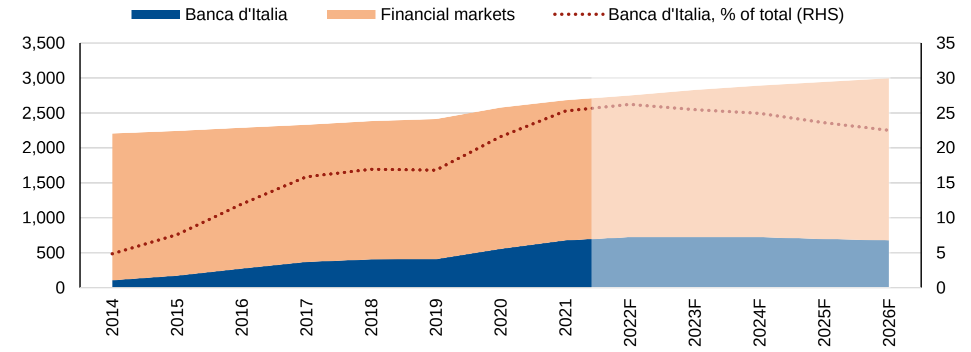
Italy: sovereign bond market's resilience and pressures from quantitative tightening

The ECB's accommodative monetary policy was instrumental in ensuring highly favourable financing conditions for Italy, especially during the Covid-19 pandemic. Now normalisation in the monetary policy stance has started, though the ECB will also have to contend with the significant economic ramifications of the Russia – Ukraine war. Our estimates of ECB asset purchases and Italy's funding needs signal that the ECB's role in the Italian bond market will remain supportive through the reinvestment phase, likely limiting the amount of annual bond issuance to be absorbed by private investors to below historical peaks. Pressures on the capacity of households and the banking sector to absorb government securities could emerge longer term in the absence of significant fiscal consolidation.

The PEPP and PSPP supported demand for Italian government bonds in the secondary market, lowered borrowing costs for the Italian Treasury and resulted in a large transfer of government debt to the central bank's balance sheet (**Figure 1**). Net asset purchases have been so significant to even reduce the amount of Italian debt held by the private sector.

We expect annual ECB asset purchases – net purchases and the reinvestment of maturing principal – of Italian government securities to decrease from about EUR 180bn in 2021 and EUR 210bn in 2020 to around EUR 90bn this year on current economic projections. This would result in the annual volume of Italy's long-term issuance that needs to be absorbed by financial markets to reach approximately EUR 215bn this year, which is significantly above our 2020-21 estimates, but still below 2019 levels (EUR 225bn). The ECB's supportive role will remain material also in the following years, thanks to the continued reinvestment of its maturing debt holdings, which should curtail the volume of annual issuances by the Italian Treasury absorbed by financial markets below or in line with 2014 levels.

Figure 1: Italy government debt, by holder sector
EUR bn (LHS) and % (RHS)



Source: MEF, Scope Ratings GmbH

Longer term, however, we see rising pressures given our expectations of continued budget deficits, increasing outstanding debt securities. For 2026, we assume a fiscal deficit of about 2.5% of GDP, which is broadly in line with our baseline of about EUR 50bn of PSPP reinvestments. The private sector would thus absorb securities corresponding to Italy's redemptions of about EUR 235bn. However, should PSPP reinvestments end around 2026, the private sector would need to absorb around EUR 280-300bn, which is above levels in 2014. Put differently, so long as PSPP reinvestment continues, debt securities corresponding to a deficit of 2.5% of GDP could be absorbed by the ECB. Without reinvestments, the private sector would need to absorb the highest annual level of Italian issuance to date, even assuming a balanced budget. Adverse economic consequences from the Russia-Ukraine crisis could affect Italy's ability to consolidate its finances over coming years, but also the pace of the ECB's reduction of its government debt holdings vis-à-vis our baseline scenario.

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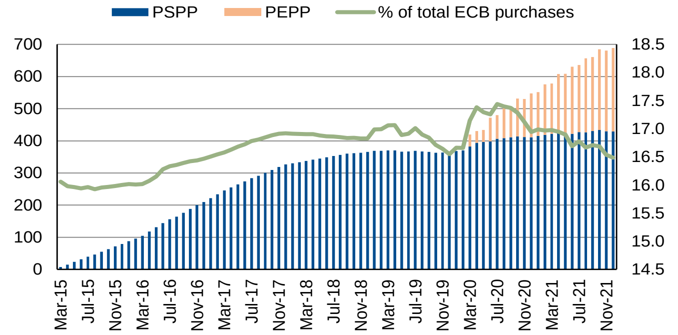
ECB asset purchases' role in Italy's favourable market conditions

ECB programs as key anchor for Italy's market access during shocks

The ECB's accommodative monetary policy stance was instrumental in ensuring highly favourable financing terms for Italy especially during the Covid-19 pandemic. The central bank's response to the shock included a significant acceleration in purchases of government securities with the introduction of the Pandemic Emergency Purchase Program (PEPP), in addition to an increase in net purchases under the Public Sector Purchase Program (PSPP), initiated back in 2015 (**Figure 2**).

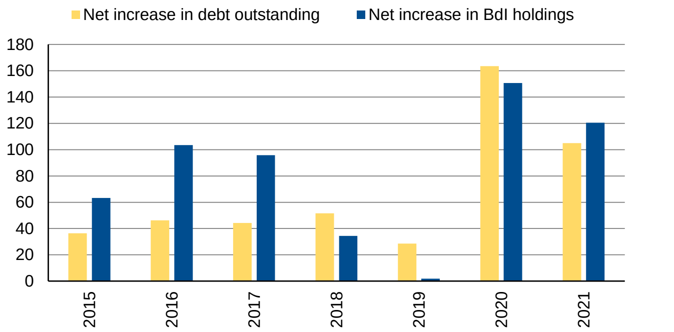
The ECB's PEPP and PSPP supported demand for Italian government bonds in the secondary market, lowered borrowing costs for the Treasury and resulted in a significant transfer of government debt to the central bank balance sheet. The Bank of Italy held over 25% of Italian debt by end-2021. ECB net asset purchases have been so significant to over-compensate for the net funding needs of Italy over time, thereby resulting in the size of Italian debt held by the private sector even decreasing in absolute terms (**Figure 3**).

Figure 2: ECB cumulative net purchases of Italian debt
EUR bn (LHS) and % (RHS)



Source: ECB, Scope Ratings GmbH

Figure 3: ECB net purchases and net funding needs
Refers to Italian debt only, EUR bn



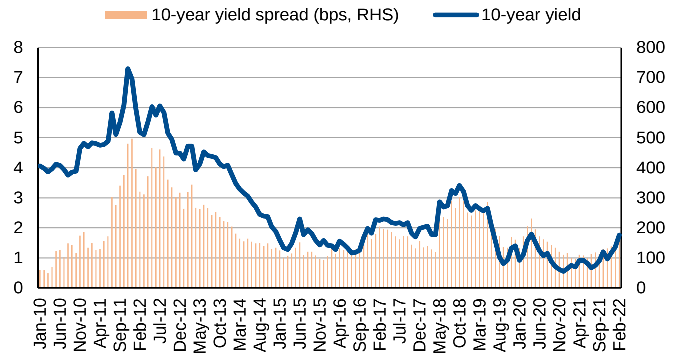
NB: We note minor measurement differences between cumulative net purchases as reported by the ECB and debt holdings reported by the Bank of Italy.

Source: Banca d'Italia, Scope Ratings GmbH

Low funding costs and reduced market fragmentation

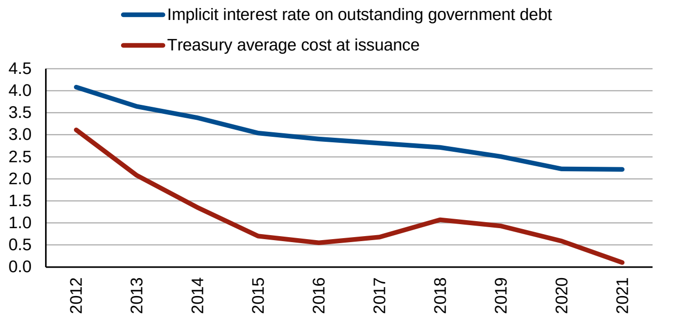
The ECB's interventions also contributed to lower Italy's funding costs, with the yield on the 10-year government bond reaching an all-time low last year, below 0.6%. Also risk premia, as measured by the yield spread to German Bunds, were markedly contained despite much higher government debt levels after Covid-19 (**Figure 4**). Yields remained below those of the period of high political uncertainty during 2018-19, with the 5 Star Movement-Lega coalition government spreading fears of an *Italexit* in the markets. Financing costs declined to well below the cost of outstanding government debt (**Figure 5**) and thus support debt sustainability. Moreover, interest on an increasing amount of debt held by the ECB is paid back to the Italian government, as distributions of Bank of Italy's profits.

Figure 4: Italian government bonds yields and spreads
% (LHS) and bps (RHS); NB: spread to German Bunds



Source: Macrobond, Scope Ratings GmbH

Figure 5: Financing conditions for the Italian government
%



Source: MEF, AMECO, Scope Ratings GmbH

Implications of tightening for Italy' sovereign bond market

Normalisation in monetary policy on track, with optionality to cope with heightened uncertainty

Given the relevance and materiality of the ECB purchase programs, the main question relates to whether sufficient private investor demand exists to absorb higher volumes of Italian government securities as the ECB gradually unwinds its bond-buying programmes.

Inflation has accelerated in the past year with monthly rates well above the ECB's 2% target since August 2021 (**Figure 6**). Inflation is likely to remain higher than initially expected now that the Russia-Ukraine crisis has sparked a surge in energy and commodity prices. In its March meeting, the ECB outlined a step-wise and data-driven approach that adds optionality and flexibility in light of the currently highly uncertain environment. The ECB confirmed its decision to halt net asset purchases under the PEPP program by March of this year and communicated its readiness to halt also net asset purchases under the PSPP in the third quarter if the medium-term inflation outlook does not weaken but stays ready to revise its schedule for net asset purchases in terms of size and duration if financing conditions become inconsistent with progress towards the 2% inflation target.

ECB role in debt markets will decrease, but remains material until reinvestments end

On this basis, we expect combined net asset purchases of Italian government securities under the PSPP and PEPP for this year at around EUR 45bn, down from EUR 150bn in 2021 and EUR 175bn in 2020 (see Annex). At the same time, the ECB will continue reinvesting in full the maturing principal of its holdings under the PEPP program at least until 2024. A possible end for PSPP reinvestments has not been indicated yet. This means that the amount of Italian debt currently held by the ECB will remain on its balance sheet, with the central bank continuing to cover its roll-over, thereby supporting the absorption of annual issuance by the Italian Treasury over the next years.

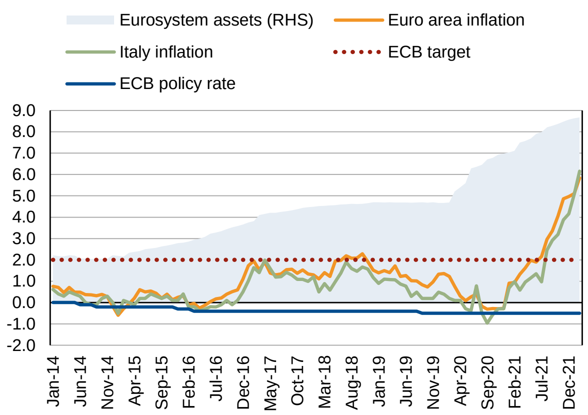
After 2024, if the ECB stops reinvestments under the PEPP – our conservative baseline – the annual roll-over related to these holdings will need to be absorbed by financial markets. The resulting negative net purchases from the ECB will gradually reduce the amount of Italian debt on its balance sheet. We expect, however, reinvestments under the PSPP to remain active in full over our forecasting horizon (2022-26).

Fiscal recovery to reduce supply of government bonds as demand from the ECB slows

Importantly, the reduction in net asset purchases from the ECB – reducing the demand for bonds – would come together with a decrease in Italy's net funding needs – reducing at the same time the supply of bonds. This reflects our expectation of a gradual reduction in the government fiscal balance from 7.2% of GDP in 2021 to 2.5% by 2026.

Figure 6: Inflation and monetary policy

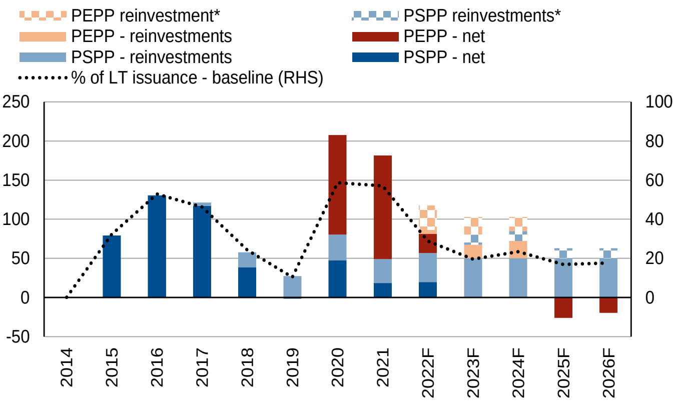
% LHS and EUR bn RHS



Source: ECB, Macrobond, Scope Ratings GmbH

Figure 7: ECB gross purchases of Italian government bonds

EUR bn (LHS) and % (RHS)



*refer to upper-end scenarios, based on the total holdings of Italian government securities under the PSPP/PEPP divided by their weighted average maturity
NB: Own estimates on redemptions since 2015 and net purchases after 2021

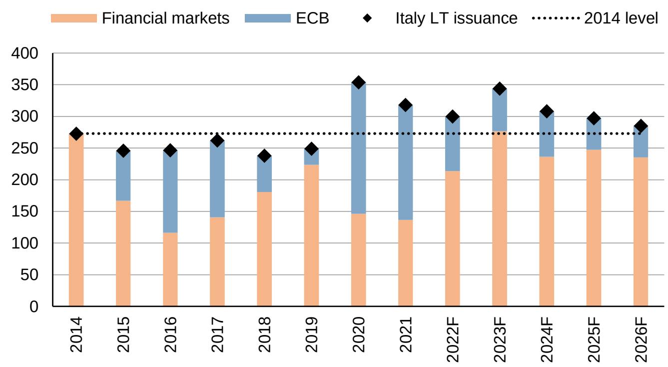
Source: ECB, MEF, Scope Ratings GmbH

Higher annual absorption of private markets as of next year, but still below historic peaks

We expect annual gross purchases by the ECB – including net purchases and the reinvestment of maturing principal – to decrease from about EUR 180bn in 2021 and EUR 210bn in 2020 to around EUR 90bn this year (**Figure 7**). For the detailed calculations, please see the annex. This would compare with long term issuance from the Italian Treasury of an estimated amount of EUR 300bn this year, down from EUR 354bn in 2020 and EUR 318bn last year. Thus, the annual volume of issuance that needs to be absorbed by financial markets would reach approximately EUR 215bn this year, which is significantly above our estimates in 2020-21 (EUR 140bn), but below levels in 2019 (EUR 225bn). Thus, ECB purchases are set to continue providing a significant shield to Italy's sovereign bond markets also this year (**Figure 8**).

This supportive role will remain material also in the following years: thanks to the continued reinvestments of its maturing debt holdings by the ECB, the volume of annual issuance by the Italian Treasury absorbed by financial markets will continue to rise but remain below or in line with 2014 levels over our forecasting horizon. This should, all else equal, contribute to limit pressures on financing costs for Italy in the short-to-medium term.

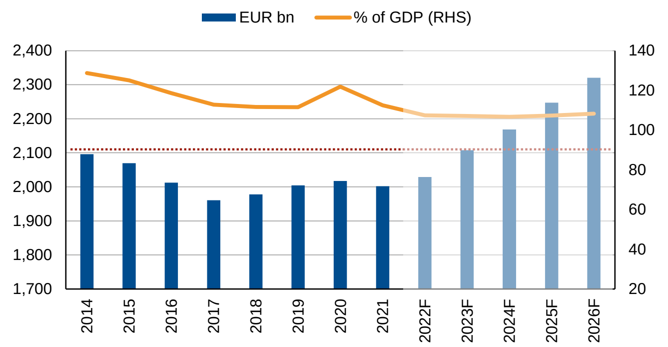
Figure 8: ECB and markets absorption of Italy' LT issuance*
% LHS and EUR bn RHS



*The ECB purchases government securities under the PSPP and PEPP only in the secondary market

Source: ECB, Banca d'Italia, MEF, Scope Ratings GmbH

Figure 9: Italian debt in the financial markets
EUR bn (LHS) and % of GDP (RHS)



Source: ECB, Banca d'Italia, MEF, Scope Ratings GmbH

Italy's solid domestic investor base supports absorption of rising debt holdings by the private sector

Still, such annual volumes of issuance would need to be absorbed in the context of a rising outstanding stock of debt held by the private sector. As net purchases from the ECB end, and net funding needs remain sizeable for Italy, given continued government deficits, the amount of Italian debt in the financial markets is set to increase as of this year (**Figure 9**). When we look at this amount relative to the size of the Italian economy, we however expect the ratio to remain below 2014 levels by the end of our forecasting horizon.

In this respect, Italy can rely on a deep investor base, including a large domestic market, supported by the very large amount of financial wealth among Italian households, with somewhat higher yields possibly making Italian bonds more appealing to private investors.

Flexibility in the ECB's toolkit provides further buffers in the short term

Other supportive elements in the short-to-medium term include the ECB's additional policy flexibility following its response to the pandemic. For example, the ECB communicated its readiness to be flexible in adjusting reinvestment related to the PEPP in case of renewed market fragmentation, which could further increase its supportive role in Italian debt markets vis-à-vis our baseline scenario.

Overall, the combination of a still material role of the ECB during the reinvestment phase, its policy flexibility in more adverse scenarios as well as Italy's large investor base are important elements supporting private market absorption of higher volumes of Italian debt.

Fiscal consolidation needed to balance ECB holdings reduction

Pressures if the ECB unwind its holdings longer term

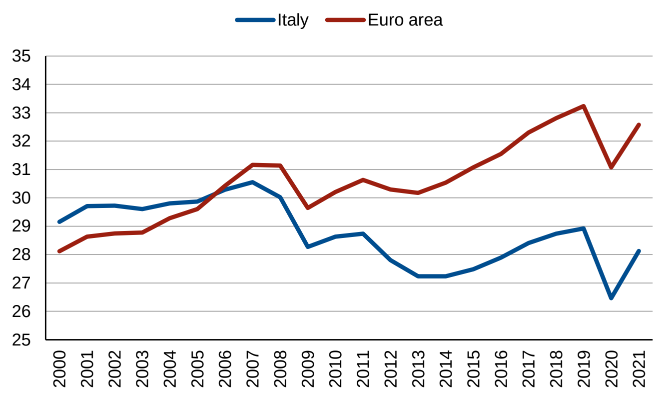
Despite Italy's resilience, we see rising pressures towards the end of the forecasting horizon. If we assume that also reinvestments under the PSPP will end, the private sector will need to absorb these additional Italian government bonds eventually. In addition, given our expectation of continued budget deficits, and thus net funding needs increasing debt longer term, reliance on the private sector will rise regardless of ECB reinvestments.

Limits to the financial market absorption capacity could emerge

Despite deep capital markets and investor demand for Italian bonds, we see certain long-term pressure points in the case of Italy: First, the country's below-average GDP per capita for the euro area and lack of economic dynamism since the financial crisis (**Figure 10**), with adverse consequences for savings, could limit the wealth of Italian households in the long term and thus their capacity to absorb ever rising amounts of government debt. Secondly, domestic banks retain high exposure to domestic government securities compared with other euro area lenders, indicating greater risks associated with the sovereign-bank nexus (**Figure 11**) in Italy than in the rest of the euro area.

Figure 10: GDP per capita

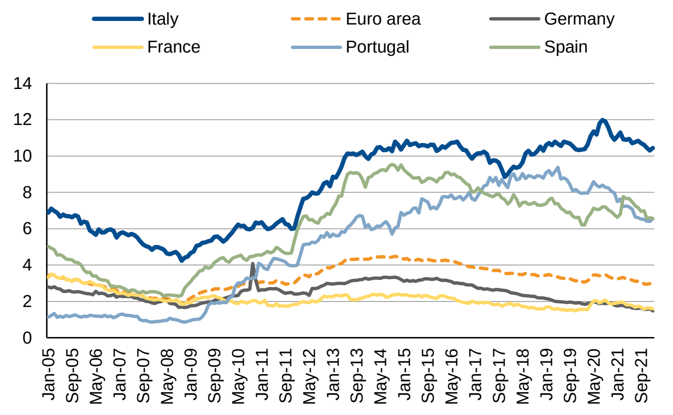
EUR thousands



Source: AMECO, Scope Ratings GmbH

Figure 11: Sovereign-bank nexus

Banks' exposure to domestic sovereign debt in total assets, %



Source: ECB, Scope Ratings GmbH

A "EUR 50bn consolidation gap" to stabilize private market absorption at 2014 levels

In this context, for 2026, we assume a fiscal deficit of about 2.5% of GDP which is broadly in line with our baseline of about EUR 50bn of PSPP reinvestments. The private sector would thus rollover Italy's redemptions of about EUR 235bn. However, should also PSPP reinvestments end around 2026, the private sector would need to absorb around EUR 280-300bn, which is above the levels of 2014 (EUR 272bn). Put differently, so long as PSPP reinvestments continue, debt securities corresponding to a government deficit of around 2.5% of GDP could be 'absorbed' by the ECB. Without reinvestments, the private sector will need to absorb the highest annual levels of Italian issuance to date, even assuming a balanced budget which is not Scope's baseline.

Growth-friendly consolidation remains paramount to ensure long-term market stability

Reducing spending will certainly not be easy given long term structural challenges, including the very adverse demographic developments, necessarily weighing on healthcare and pension expenditure. More realistically, consolidation could be achieved through higher economic growth, for example, by raising the comparatively low employment rate, which is below 60% (vs. 64% for Spain, and 69% for the euro area) and boosting productivity which has stagnated in the past two decades. Finally, adverse economic consequences from the war in Ukraine could significantly affect Italy's economic growth outlook, and thus Italy's ability to consolidate its public finances over coming years. At the same time, the pace of the ECB's plans to wind down its holdings of government debt could also be altered in scenarios of a more pro-longed adverse impact on Europe's economic outlook.

Annex: Our estimates

Economic and fiscal variables

	2021	2022F	2023F	2024F	2025F	2026F
Real GDP growth, %	6.6	3.0	1.7	1.3	1.0	0.8
GDP deflator, %	0.9	3.0	2.5	2.0	2.0	1.5
Government fiscal balance, % of GDP	-7.2	-5.5	-4.0	-3.0	-2.5	-2.5
Government debt, % of GDP	150.5	148.0	146.0	145.0	144.0	144.0

These estimates are subject to high uncertainty, given rapid developments of the Russia-Ukraine conflict and their impact on Italy's economic and fiscal outlook.

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ECB asset purchases of Italian government securities

NB: EUR bn

	2015	2016	2017	2018	2019	2020
PSPP – net purchases	79.2	130.4	117.1	38.6	-1.6	47.4
PSPP – reinvestments of maturing principal	0	0	4.1	19.0	27.3	32.9
PEPP – net purchases	0	0	0	0	0	127.2
PEPP – reinvestments of maturing principal	0	0	0	0	0	0
Total net purchases	79.2	130.4	117.1	38.6	-1.6	174.6
Maturing principal	0	0	4.1	19.0	27.3	32.9
Total reinvestments	0	0	4.1	19.0	25.7	32.9
Total gross purchases	79.2	130.4	121.2	57.7	25.7	207.5

	2021	2022F	2023F	2024F	2025F	2026F
PSPP – net purchases	18.2	19.5	0	0	0	0
PSPP – reinvestments of maturing principal	30.8	37.3	50.1	50.1	50.1	50.1
PEPP – net purchases	132.4	24.4	0	0	-26.0	-19.7
PEPP – reinvestments of maturing principal	0	5.1	17.2	21.9	0	0
Total net purchases	150.6	44.0	0	0	-26.0	-19.7
Maturing principal	30.8	42.5	67.3	72.0	76.1	69.9
Total reinvestments	30.8	42.5	67.3	72.0	50.1	50.1
Total gross purchases	181.4	86.4	67.3	72.0	50.1	50.1

ECB, Scope Ratings GmbH

Key assumptions and calculation steps

- **PSPP - net purchases**:
  - 2015-2021: data available on the ECB website.
  - 2022F:

    Step i) total estimate of annual net purchases under the APP program based on assumed volumes of EUR 20bn per month on average in Q1, EUR 30bn in Q2, and zero afterwards, based on the ECB's March communications;

    Step ii) multiplication by the share ("Italian Share" in following sentences) of cumulative net purchases of Italian government securities under the PSPP until January 2022 to the cumulative net purchases of the ECB under the APP.
- **PSPP - reinvestments of maturing principal**:
  - 2015-22F:

    Step i) total amount of redemptions and expected redemptions under the PSPP program available on the ECB website;

    Step ii) multiplication by the Italian Share.

- Assumption of continued reinvestments in full of the principal payments of maturing securities purchased under the APP over the forecasting horizon.
- 2023-26F:

  Step i) calculation of a *lower-end reinvestment scenario,* based on the multiplication of the *Italian Share* and the expected reinvestments for the entire PSPP, as kept constant to 2022 data over the forecasting horizon;

  Step ii) calculation of an *upper-end reinvestment scenario*, based on the total holdings of Italian government securities under the PSPP divided by their weighted average maturity;

  Step iii) average of the two becomes our *baseline reinvestment scenario*.

- **PEPP – net purchases:**
  - 2020-21: data available on the ECB website.
  - Assumption of a halt in net asset purchases under the PEPP after Q1-2022.
  - 2022F: Step i) total amount under the program calculated as the 80% of total net purchases in Q4 2021, following ECB's communication of net purchases in Q1 2020 being conducted at a lower pace than in the previous quarter;

    Step ii) multiplication by the Italian Share (based on cumulative net purchases under the PEPP).
  - 2025-26F: net purchases turn negative, reflecting the gradual maturing of securities holdings in the ECB balance sheet in the context of zero gross purchases by the ECB.
- **PEPP – reinvestments of maturing principal**:
  - 2022-26F: redemptions are approximated by applying same proportions of redemptions in the PSPP in the period 2017-2021, i.e. T+2 to T+6 vis-à-vis the start of the program, and applied to the holdings of the PEPP.
  - Assumption of continued reinvestments in full of the principal payments from maturing securities purchased under the PEPP until end-2024. Afterwards, we assume zero gross purchases from the ECB, with negative net purchases in 2025-26F reflecting the maturing amount of debt holdings in the ECB balance sheet.

Italian government debt and funding needs

NB: EUR bn

	2015	2016	2017	2018	2019	2020
LT issuance	245.9	246.8	262.1	238.2	249.2	353.9
Redemptions	203.5	184.5	216.3	184.4	201.4	201.5
Net LT issuance	42.4	62.2	45.7	53.8	47.8	152.3
Total debt	2,239.4	2,285.6	2,329.8	2,381.5	2,410.0	2,573.5
Held by Banca d'Italia	170.1	273.5	369.3	403.6	405.5	556.2
Held by financial markets	2,069.3	2,012.1	1,960.5	1,977.9	2,004.5	2,017.3
LT absorbed by financial markets	166.7	116.4	140.8	180.5	223.5	146.3

	2021	2022F	2023F	2024F	2025F	2026F
LT issuance	318.0	300.0	343.8	308.3	297.3	285.3
Redemptions	216.6	228.7	265.1	247.3	245.0	231.7
Net LT issuance	101.4	71.3	78.7	61.0	52.4	53.6
Total debt*	2,678.4	2,749.7	2,828.4	2,889.4	2,941.7	2,995.3
Held by Banca d'Italia	676.7	720.7	720.7	720.7	694.6	674.9
Held by financial markets	2,001.7	2029.0	2,107.8	2,168.7	2,247.1	2,320.4
LT absorbed by financial markets	136.6	213.6	276.5	236.3	247.2	235.2

MEF, Scope Ratings GmbH

Key assumptions and calculation steps

- 2022F:

  We use data from the Italian Treasury' funding plan. We acknowledge that these might, however, be subject to changes given the adverse impact of the Russia-Ukraine crisis on the economic outlook and the government's fiscal policy response.

- 2023-25F:
  - Net long-term (LT) issuance based on our fiscal deficit and nominal GDP forecasts; historically there is a good correlation, implying rather stable shorter-term securities outstanding[1];
  - Redemptions for 2022-26F based on MEF data; for 2023-26F adjusted by the expected amount of redemptions related to 3-year BTPs that will be issued in 2022 and 2023, based on historical data.

*Debt here reported is approximated based on the annual estimated net LT issuance only and does not include other elements.

[1] Short-term issuance has ranged between EUR 150bn and 160bn between 2014 and 2021, except EUR 182bn in 2014 and 2020.

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