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Three conditions for the Italian reforms' success

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The Italian government's programs for changing the inertia of the country's economy are well founded. After thirty years that have passed mostly between recessions and stagnations, the recovery plans powered by European resources offer the possibility of modifying Italy's structure and aligning it with that of the European economies that have proven to be more solid and capable of development.

However, there are at least three sources of uncertainty that will influence the success of this endeavor. The first comes from the consequences of the exceptional monetary and fiscal impulse provided in the advanced economies. An unexpected increase in interest rates could result from an acceleration of inflation expectations or from difficulties in the financing of the public debt, which greatly increased during the recession caused by the pandemic. The second source of risk comes from the difficulty of recovering from the sharp increase in the public deficits that will be recorded between 2020 and 2022, part of which was achieved through a permanent increase in current expenditure. As a consequence, Italy's debt/GDP ratio could worsen more than is currently expected. The third source of risk is linked to the evolution of the Italian political framework. The confidence inspired by the measures taken by the Draghi government is essential to support the growth of consumption and private investments. But the duration of the government and its policies is not clear enough to ensure the continuity needed to encourage productive investment decisions in the country. Political uncertainty also affects the relationship between Italy and its European partners. A relationship in which the three sources of risk that we have described could be condensed: an abrupt interruption of policies to support the economy; a non-cooperative assessment of the risks of excessive indebtedness in Italy; tensions in the country's political stability.

In this policy brief, we analyze the relevant aspects of the macroeconomic framework, both global and Italian, that allow us to evaluate the chances of success of Italy's economic policy initiatives, highlighting in particular the strengths and weaknesses of the National Recovery and Resilience Plan. In conclusion, we present three conditions that should be met to help the government obtain the desired results. The first condition is to set long-term priorities for the structural transformation of the economy, distinguishing between growing sectors and decelerating sectors. The second condition requires the availability of tools and resources that facilitate the transition from emergency management to a phase of growth supported by reforms and investments. The third condition is that there be political, not just economic, certainty over a medium to long-term period.

1. The global macroeconomic framework

The world economy is experiencing a vigorous, albeit unequal, recovery. The main boost comes from the success of vaccination campaigns, effective in advanced countries but still lagging behind in many emerging countries. According to the World Bank's recent *Global Economic Prospect*, by the end of 2022 about 90% of the advanced economies will return to the pre-crisis per capita GDP levels. On the contrary, the recovery will be much slower in emerging and developing economies, where in 2022 the economy will return to its pre-crisis levels only in one third of the countries. The divergence is exacerbated by the reaction capacity of monetary and fiscal policies, which is much stronger in advanced countries. Purchases of central bank securities for quantitative easing in relation to GDP were multiple in advanced countries compared to those made by central banks in emerging countries. The fiscal boost was also significantly greater, amounting on average to 17% of GDP (with significant differences between the 25% in the US and the 13% in the EU) in advanced economies. Discretionary fiscal support relative to GDP was three times higher in advanced economies than in emerging or developing countries.

With regard to 2021 and the subsequent years, in the US the American Rescue Plan Act (amounting to approximately 9% of GDP) and the preparation of other extensive programs, both in favor of households and for the relaunch of investments, add to the rebound of private spending in providing a robust stimulus to the economy. In Europe, the suspension of the Stability and Growth Pact makes it possible to extend the safety net for the people and firms affected by lockdowns, and almost all the EU Member States have presented their National Recovery and Resilience Plans to the European Commission to access the resources of the NextGeneration-EU.

Outside the advanced area, China continues the strong expansion started last year, but the large emerging economies (India, Brazil, Argentina) and many of the smaller ones are still in the midst of the crisis due to the insufficient availability of vaccines, the shortcomings of their health systems and the inefficiency of virus containment measures.

Despite these divergences, world trade appears to be recovering strongly, driven above all by vigorous development in the United States, China and throughout the Asia-Pacific Region. Trade in goods has fully recovered from the fall of 2020 and in the first months of 2021 it stood at levels above the pre-crisis peaks, favoring the restart of manufacturing industries.

The recovery of the economies is being held back by the widespread phenomena of scarcity of raw materials, of components for manufacturing production - including an acute shortage of microchips that is expected to persist next year - and of strong misalignments between supply and demand in the labor market.

Even in the advanced countries, significant inequalities persist, both between countries and within countries between people and different social groups. The European economies have restarted more slowly, due to the difficulties in launching vaccinations, compared to the United States, the United

Kingdom and the Asia-Pacific Region. Across sectors, service activities lag behind manufacturing. The impoverishment of the population groups most exposed to the crisis has resulted in the growth of inequalities among individuals, coinciding with those already structurally weaker, in the face of the increase in wealth of those who were able to set aside large savings and at the same time benefited from the increase in the prices of real and financial assets. While the first two differentiations are destined to gradually diminish, the widening of inequalities in advanced countries is a more persistent phenomenon, only partly dependent on the intensity of the recovery and the improvements in the labor market. It will have to be addressed with appropriate redistributive measures and with the adaptation of welfare systems to their inclusion in the post-pandemic development processes aimed at technological innovation and environmental sustainability.

2. The recovery in Italy

In the context of the gradual spread of the recovery, signs of improvement prevail in Italy as well. Revised data for the first quarter (+ 0.1%) show that a new recession has been avoided thanks to the easing of the decline in services and the recovery of industry and construction. In the latter sector, activity has rebounded significantly and is now well above pre-crisis levels, thanks also to the measures enacted in favor of building renovations.

As in the other advanced countries, even in Italy the pandemic has been accompanied by the accumulation of household savings, largely set aside in low-paying jobs. It can be expected that overcoming the anti-pandemic restrictions and the easing of precautionary behaviors will put at least part of last year's unspent income back into circulation. The intensity of Italy's recovery will also depend on the speed with which consumption and investments will grow and therefore on the speed with which the propensity to save (16% of disposable income in 2020) will return to nearing pre-crisis levels (8%). The DEF (Economic and Financial Document) forecast of a 4.5% increase in GDP in 2021, based on prudential estimates of the normalization of savings, seems to have been overtaken by more favorable economic developments. Greater rebounds, following growth in consumption greater than that estimated in government forecasts, would induce increases in economic activity even higher than 5%, making it possible to return to pre-health crisis GDP levels at the end of 2021 or early 2022.

3. The dilemmas of economic policy

The economic scenario and the speed of recovery of the private economy remain closely linked to the economic policy choices that will be made in the major countries. The objective for the next few months is to continue supporting the recovery underway with both monetary and fiscal instruments. However, there are signs of an increase in inflation, which the authorities tend to see as temporary, but which could prove to be even more sustained. If this second possibility proves to be well founded, monetary and fiscal policies may have to reverse direction, thus jeopardizing economic recovery and financial stability.

This tension is particularly evident in the United States, where inflation has climbed in recent months well beyond the 2% reference point and where long-term interest rates have risen albeit remaining below 2%. The current analysis of the nature of inflationary pressures sees two dangers. The first is inherent in the announced strategy of the US Federal Reserve, which indicates the intention to react later, rather than preventively, to the occurrence of any acceleration of inflation, abandoning the reference to expectations. In this method, the risk of acting late (falling back "behind the curve") with respect to the resumption of inflation expectations is evident. Given the time in which monetary policy produces its effects, a late decision to tighten monetary conditions could favor a sharp acceleration of inflationary expectations, which in turn could then require a drastic increase in interest rates, with undesirable effects on the real economy and the financial markets.

Secondly, both the supply bottlenecks and the size of the stimulus measures launched by the American government can weigh on the evolution of inflation in the medium term. Their impact on wage dynamics could make permanent the price tensions that at the moment appear temporary, also in view of the increase in food prices.

On the other hand, if the increase in inflation were instead temporary and ended within a couple of years, a premature tightening of monetary conditions would risk undermining the recovery underway and prolong the depressive phase of the crisis.

The dilemma between excessive or insufficient stimulus concerns not only monetary policy but also budgetary policy. If the financial support is extended even when the economy is in a recovery phase, there is a risk of causing an increase in interest rates and jeopardizing the sustainability of debts. A premature reduction in support, on the other hand, could slow growth and plunge the economy back into stagnation.

European economic policy faces the same dilemmas, albeit in the presence of a less robust recovery. Discussions on the adequacy of the expansive approach to monetary policy will tend to intensify with the gradual strengthening of the European economy. Also in this case a balance will have to be found between the risk of a premature tightening of monetary conditions, which would produce an appreciation of the euro, with negative effects on economic activity, and the risk of excessively prolonging very favorable monetary conditions that produce distorting effects on economic activity and the financial system. The European dilemma is aggravated by the fact that countries with different economic recovery conditions must coexist in the same area.

For now, the suspension of the Stability and Growth Pact allows for the implementation of policies supporting economic activity that lead to an increase in public debt. However, if the gradual strengthening of the economic recovery does not translate into a reduction in the deficit in the coming years, such as to ensure the gradual decrease of the debt over time, the tendency to introduce rigid rules for disciplining public budgets in Member States will re-emerge.

4. The Italian Recovery and Resilience Plan (NRRP)

The National Recovery and Resilience Plan (NRRP), which the Draghi government sent to the European Commission at the end of April 2021, pursues the difficult task of returning the Italian economy to a path of sustained growth in income and productivity. The plan should succeed in changing the country's inertia, which over the years has been made stronger by the stratification of the very extensive organized interests in its defense.

After more than twenty years of stagnation and recessions, interrupted only by two or three years of growth (2015-2017) at rates that are still lower than in the rest of the EU, converging towards the 'core' EU countries requires significant changes. It is necessary to overcome the widespread bureaucratic inefficiencies, the institutional context which is unfavorable for innovation and change, the pervasive rent-seeking positions especially - but not only - in the service sector, the widespread confusion between ownership and management in family businesses, and the production sector's excessive dependence on self-financing and bank credit, which results in the inability to reorganize production processes. It is also essential to commit to the European ability to become an innovative area, while safeguarding leadership in terms of low environmental impact and strong social inclusion. Italy's NRRP makes this commitment by focusing on the activation of a robust and prolonged growth of national GDP based on the implementation of reforms, but above all on the increase in public spending in relation to which, however, it will be necessary to keep alive a clear distinction between current expenditure and investments.

From a purely quantitative point of view, the bet to change Italy's inertia through the NRRP is founded. The Recovery and Resilience Facility (RRF), which consists of about 90% of the total resources disbursed by NextGeneration-EU, reserves 191.5 billion euro for Italy, divided into almost 69 billion euro in the form of grants and a little more than 122 billion euro in the form of loans. For its part, the government has decided to set up an additional fund of 30 billion euro financed with national debt and has indicated its intention to commit additional resources to the implementation of the NRRP for 35 billion euro in the coming years. Furthermore, the suspension of European fiscal constraints and the convergence between an ultra-expansionary monetary policy and new equally expansionary fiscal policies offer a favorable framework that is probably unrepeatable.

At the same time, it is appropriate to be aware of the risks involved in the challenge taken on by the government. First, it is assumed that Italy's public debt will not get out of hand. The stable return of real growth and inflation towards 2% would make a significant contribution to reducing the debt/GDP ratio. However, the Italian public deficit forecast for the current year is 11.8% of GDP (with a negative primary balance of 8.5%); this same deficit is expected to touch 6% in 2022 and still be above 4% in 2023, with negative primary surpluses.

The DEF assumes that in the current year the real growth rate will rise to 4.5%; in fact, an even better result, above 5%, cannot be ruled out. But for the following years, the policy framework points to a real GDP growth rate of 4.8% in 2022, and still higher than 2.5% in 2023. Furthermore, the Italian NRRP states that, thanks to additional spending, the potential rate of GDP growth will more than double (to 1.4%) and that GDP itself will be 3.6% higher at the end of the RRF (that is, at the end of 2026).

Such policy forecasts are difficult to assess because they are not adequately justified in detailed macroeconomic scenarios. For similar reasons, it is also difficult to calculate the multiplicative impact of public spending: the multiplier outlined in the DEF, required to ensure a stable increase in Italian GDP equal to 3.6% in 2026, remains uncertain. The data underlying the NRRP presuppose that the design of the Plan is so effective as to guarantee the realization of the projects it contains in the period and in the manner provided.

5. The conditions for success

The high decision-making capacity shown so far by the Italian government and the reliability of the ministers most involved in the NRRP increase the probability of winning the bet. However, we cannot overlook the fact that the time horizon of the Draghi government is indeterminate but not very long, while the initiatives financed by the NRRP and - even more so - by the National Fund cover at least seven years. This problem of 'temporal inconsistency' would be mitigated if the NRRP traced a path so detailed and compelling as to bind future commitments and if its implementation could involve various social components and - first of all - the social partners. Instead, also due to the short time available for the new government to modify the draft inherited from the Conte government, the Italian NRRP was not the result of prior discussion and commonality. Furthermore, the Plan is not so stringent as to impose severe constraints on those who will assume governmental responsibilities after Draghi.

However, it is appropriate to recognize the strengths of the Italian NRRP. The long chapter on reforms represents a qualitative leap with respect to the Plan’s previous versions. Above all, it was opportunely chosen to focus efforts on 'horizontal' reforms (Public Administration and Justice) and on 'enabling' reforms (simplifications and competition). In this way, the Italian NRRP aims to address some of the crucial 'bottlenecks' that have prevented the growth of the Italian economy in the last twenty years and more. In addition, by demonstrating awareness of the long time required by these reforms and the related difficulty of bringing them to completion by 2026, it appropriately focuses on 'enabling' simplifications, which, though limited, are needed to carry out other important projects included in the Italian NRRP.

The recent Simplifications Decree has given a concrete signal of the government's determination to proceed rapidly in the implementation of investment projects; among them, the important projects for mobility, the reorganization of the territory and the construction of the 5G network stand out.

The projects that concern the three main lines of the European NRRPs (ecological transition, digital innovation and social sustainability) also make significant progress compared to the previous versions of the Italian Plan, also in the attention paid to the inevitable links with reforms (especially the 'enabling' ones).

A source of uncertainty is the lack, at least so far, of preliminary agreements in Parliament, between the social partners, and in the local administrations. Furthermore, although the choices regarding the governance of the Plan are very appreciable - above all in the basic choice of leveraging on the existing administrations, strengthening their means and competences - the success of the Plan presupposes an efficacy in the Public Administration 's action that has no record in the past. Success will depend on the government's ability to apply with determination, even ferocity, the rules just adopted on the timing of the projects and reforms, as well as those on the derogation powers in case of undue delays brought about by the responsible administrations.

6. Conclusion

The transition from an emergency management phase to a growth phase supported by reforms and investments is one of the most complex moments of the current political scenario, in Italy and elsewhere. Restoring the economy's ability to grow does not simply consist in restarting aggregate demand in the face of a supply structure that has remained unchanged. The crisis that followed the health emergency has in fact profoundly changed the supply structure, highlighting an excess of production capacity in some sectors and scarcity in other sectors. This misalignment (made more acute by the impact of new technologies) has so far been largely hidden by government action, which, with temporary support measures (freezing of layoffs, credit moratoriums, etc.) has prevented resources from being reallocated, among companies and among sectors, so as to reduce if not eliminate the different impacts of the crisis in the short term.

The choice to freeze the reallocation is understandable, above all in terms of the defense of social stability. Allowing a reallocation only on the basis of market signals in the midst of a very severe recession would have produced employment costs far greater than those that have occurred in any case. In this sense, the trade unions' strong resistance to the removal of temporary support measures, starting with the suspension of layoffs, is understandable. However, privileging the defense of the status quo without addressing the problem of overcoming the emergency risks entails much higher costs in terms of growth and employment in the medium and long term. There is therefore a need for a balance between the short and long term that must be chosen and addressed in a transparent way. In our opinion, it is possible to get over this impasse and direct the economy towards sustainable medium-term growth under three conditions.

The first condition requires that the priorities that define the long-term reference framework of economic policy be clear. This is, moreover, the task of the NRRP. The priorities that inspire it, even more than its size, must provide indications on sectoral recomposition, on the expanding and slowing sectors, on the transition to a digital and at the same time sustainable economy.

The second condition is that there be tools for managing the transition from an emergency to sustained growth that minimize the costs of the transition itself. Tools and resources are needed that allow for the gradual exit from the freezing phase of the effects of the crisis and an entrance into a phase of reallocation of resources towards priority sectors in terms of development. To this end, it is necessary to prepare active labor market policies and tools to encourage the recapitalization of firms.

The third condition, which largely derives from the first two, is that there be certainty over a medium-long-term time horizon in politics, economics and beyond. It is therefore necessary to find broad agreement among the main political and social stakeholders. Ensuring greater certainty of the political framework would be important in order to have a solid and reliable relationship with Italy's European partners in the context of the revision of the governance rules of the euro-area economy. Furthermore, it would have the effect of strengthening confidence among Italians and thus reducing the precautionary savings that businesses and households have been accumulating since the beginning of the crisis. Those resources need to be allocated to investments, without which the success of the transition from emergency to growth would be impossible.

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