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The risk of a fallout in the absence of the government's institutional commitments

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Italian GDP growth was revised sharply upwards in 2023 by the Bank of Italy, which in June more than doubled the expected increase compared to the 0.6% expected in January. The strengthening of growth follows a trend in 2021 and 2022, which also surprised everyone with its vigor, with a final cumulative figure for the two years of 10.7%. The Italian economy has therefore recovered more quickly than expected from the dramatic fall in GDP in 2020, which occurred as a result of the pandemic crisis and at the end of decades of stagnation.

The fact that for three consecutive years the forecasts have been exceeded by the final data has led many observers to hypothesize that a structural change in the functioning of the economic system is underway in Italy. If this were the case, the level of potential growth could detach itself from the level of stagnation of the decades preceding 2020, making it easier to stabilize the debt/GDP ratio. The current forecasts for the next few years seem to contemplate a detachment of the growth path from the stationary level, but cannot be interpreted conclusively as a permanent and structural turnaround.

After the strong recovery in the first quarter of 2023 (0.6%), the Bank of Italy expects GDP to expand to a limited extent in the rest up to the forecast horizon of 2025, held back by the worsening of financing conditions. On yearly average, GDP is expected to increase by 1.3% in 2023, by 1.0% in 2024 and by 1.1% in 2025.[1] These are levels that do not differ too much from the direct contribution of the NRRP alone (the National Recovery and Resilience Plan formulated in the context of European initiatives to support European economies after the pandemic crisis). It is therefore necessary to try to distinguish the cyclical thrust factors of European fiscal aid from the structural effects which, in the short to medium term, do not seem likely to break the stationary trend of the economy in the years considered. In this policy brief, we will limit ourselves to expressing some evaluations on the interaction between European aid and private investment.

[1] https://www.bancaditalia.it/pubblicazioni/relazione-annuale/2022/rel_2022.pdf

Interpretations of the current developments as an encouraging sign of change are in fact based, above all, on the strong increase in gross fixed investments. In 2021, the increase in these investments was 18.6% (equal to a contribution to the growth of 3.3% of GDP). In 2022, the increase was 9.7% (corresponding to more than half of last year's entire GDP increase). Investment-led growth tends to justify a structural interpretation, noting the increase in stock endowment. Also in the current year there should be a significant increase in gross fixed investments equal to 3%, but already in the following years the trend would be less marked (stationary in 2024 and a slight increase of 0.9% in 2025). The slowdown in investments has justified a downward revision of GDP growth expectations for the 2024-25 two-year period.[2]

According to expectations, in the next few years the support for investments will mainly come from the public component, that is, from the direct interventions of the NRRP. Private sector investments, on the other hand, would slow down significantly because they are held back by the rise in financing costs and by stricter conditions for accessing credit. Spending on residential construction is expected to increase again in the current year, benefiting from some residual support measures for the sector, to then stagnate in the following two years.

Taking into account the fact that the tightening of credit conditions corresponds to the normalization of monetary policy, it is not possible to conclude that the slowdown in private investments – that is, the return to levels typical of the years preceding the pandemic phase - is anomalous and indeed does not correspond to the normal economic policy framework that Italian operators will have to deal with again once the inflationary pressure that justified the increase in monetary restriction in recent quarters has been overcome.

What drove private investment during the great rebound? The first factor was the recovery in household consumption demand, which was vigorous thanks to the availability of enormous savings resources set aside during the lockdown phase. Between 2018 and 2021, the financial wealth of households had increased dramatically and then decreased only partially during 2022 when the rapid increase in interest rates cut the value of both equity and bond assets. However, a substantial reservoir of savings had been accumulated in 2020 and was able to support consumption in 2022. It is a one-off factor, a temporary one, which is currently running out. Furthermore, a phenomenon of monetary illusion seems to have had an effect on private demand, which has slowed down the internalisation of the erosion of real incomes and assets in the consumption function.

A further boost came from foreign demand. In fact, Italian exports continued to expand by 9.4% in 2022. The increase was extremely high for the services component (28.4%) which, driven by tourist revenues, fully recovered the values before the pandemic. The increase in foreign sales of goods (6.1%), which in 2021 had already slightly exceeded the 2019 levels, was more significant than in the other eurozone countries. This robustness in foreign trade is the indicator that most justifies the hypothesis that the economy would have made a leap in the level of competitiveness (if not productivity), making possible a higher rate of development in the years to come.

[2] https://www.bancaditalia.it/pubblicazioni/relazione-annuale/2022/rel_2022.pdf

A greater contribution to economic growth and to the investments themselves came instead from the public deficit, above all if the tax credits to the construction sector are taken into consideration. These are enormous incentives for the construction and real estate services sector that represent a large part of the increase in business investment. However, this contribution too is destined to run out, while the path of public finance balances indicates the restrictive impact of budgetary policy in the years to come.

In these circumstances, the economy's change of pace would seem to be linked above all to the success of the implementation plans for European aid launched with the Next Generation-EU (NGEU) program. The impact of the NRRP on the growth rate of the Italian economy comes firstly from fiscal spending through capital grants[3] and secondly through the impact, subject to considerable uncertainty, of structural reforms on the trend growth of total factor productivity . At the time of the program's presentation, it was estimated that the investment projects activated by the NRRP would have been able to raise GDP by more than 2 percentage points over a five-year period thanks to the direct stimulus and the activation effects of aggregate demand, and by more than 3 points when taking into account the complementarities between public and private investments. This "crowding-in" phenomenon is particularly difficult to predict other than, of course, depending on the effective implementation of European plans. Even more difficult is the estimate of the reforms prefigured in the Plan, whose additional positive impact on economic activity in 2021 was estimated at between 3 and 6 percentage points over ten years. Recent doubts about the effective implementation of both public investments and the reforms envisaged by the NRRP have led to greater reflection on the permanent effects that are justifiably expected.

According to the initial estimates of the ECB,[4] the cumulative effect due to the fiscal impulse of NGEU should have amounted to one point of GDP by 2022 and 1.4% by 2026. As estimated in April 2023 by the Ministry of Economy (DEF[5]), on the other hand, the boost of capital contributions in 2022 was equal to about 0.2% of GDP, while the effect of the reforms cannot yet be considered. As is well known, European capital contributions are not included in the calculation of GDP unless they are used by the public administration for the purchase of goods or services. Not surprisingly, the estimated effect on GDP becomes more significant in 2023 when the impact of the NRRP is estimated at 1% of GDP. Between 2024 and 2026, the impact rises from 1.8% to 3.4%. Paradoxically, the contribution to GDP growth therefore coincides - based on the Bank of Italy's estimates of the increase in gross fixed investments - not with an increase in private investments, but with their slowdown.

[3] https://www.corteconti.it/Download?id=e08e6013-0c35-4986-88ed-5f624e70889b
[4] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op291~18b5f6e6a4.en.pdf#page35
[5]https://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2023/DEF-2023-Programma-Nazionale-di-Riforma.pdf

Table II.2: Macroeconomic impact of the NRRP (percentage variations vis-à-vis the base scenario)

	2021	2022	2023	2024	2025	2026
GDP	0.1	0.2	1.0	1.8	2.7	3.4
Private consumption	-0.3	-0.6	-0.8	-0.6	0.0	1.0
Total investments	1.2	3.3	8.0	11.0	13.0	12.4
Import	0.0	0.2	0.9	1.8	2.8	3.7
Export	-0.1	-0.4	-0.6	-0.3	0.6	1.8

Source of data: Ministry of Economy and Finance, DEF

The role of expectations

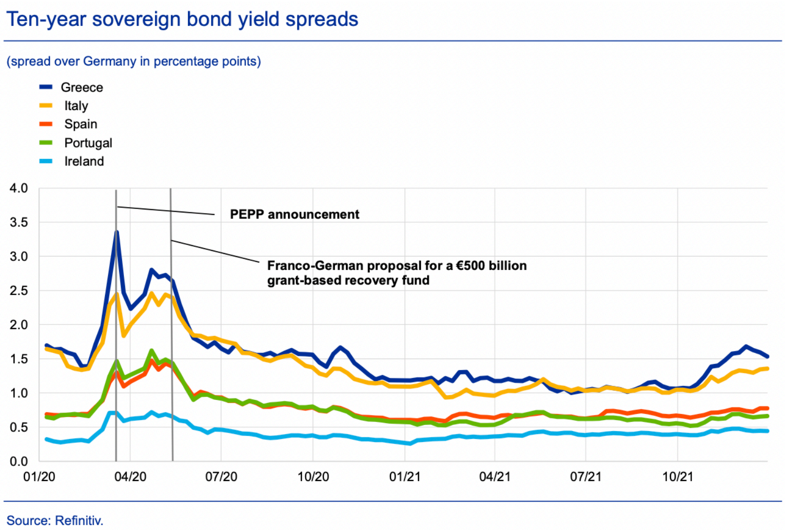
The hypothesis that we formulate here, in line with what has been said, is that the NRRP had already exercised its powerful "crowding in" effect in advance even before the effects of the plan materialized. This would have happened through a confidence effect that changed the expectations of companies in the 2021-22 two-year period above all thanks to the reduction of the credit risk premium in Italy. In this case, the fundamental confidence factor would not be that of the relaunch of investments, but that deriving from the signal of debt mutualisation through which the NRRP is financed by the European Union.

The effect of expectations is difficult to measure. According to the Bank of Italy research on the indicators revealed by direct surveys with companies, a non-linear phenomenon occurred: at the end of last year. The balance between assessments of improvement and worsening of the conditions for investing in the fourth quarter remained largely negative, albeit been halved compared to previous research. However, despite the unfavorable assessments of investment conditions, the balance between forecast increases and decreases in spending on capital goods remained positive in all sectors, signaling the continuation of accumulation (13.8 percentage points).

On this basis, it is possible to resort to another indicator of expectation revealed by the performance of the shares of the major companies. The stock market index (MIB 30) marks a clear increase which coincides with the approval of the European aid program. Between May 2020 (when the Franco-German agreement of the program was announced, giving rise to the decision of the EU Council on NGEU in the following month) and the end of 2022, the Italian stock index grew by about 50%, an increase greater than that of the analogous indices of the major European countries.

MIB-30 Index

This phenomenon is also linked to the reduction in the country's credit risk, measured by the differential between Italian and German interest rates.



In the graph on ten-year bond yields in various European countries, it is possible to observe how it was precisely the announcement of the Franco-German plan - even more than the previous intervention by the ECB on the securities market (PEPP) - that determined the reduction of the "spreads".

In general terms, the most important characteristic of the investment demand curve in relation to the level of interest rates is not so much its downward slope, but rather the fact that the curve is subject to "shifts" due to expectations. In Italy, however, expectations linked to various factors of the economy also regularly influence the country's credit risk and therefore the interest rates, making the negative relationship of the investment curve even more significant.

A variation in the capital stock changes future productive capacity. If expectations change such that the expected return on investment increases, the investment demand curve shifts to the right. This appears to have happened in Italy starting in May 2020 and would explain the unexpected increase in private investment. However, what happened does not mean that the curve shift represents a structural factor. It would only be so if the reason for the reduction of the spread (the mutualization of European debt) became a permanent factor of the European political-economic and financial system.

Economic policy implications

In this sense, it is understandable why the current government has adhered to a line of "fiscal credibility" aligned with the control of the national public debt. In doing so, it took a position in stark contrast to the Eurosceptic rhetoric that had characterized its agitprop prior to the elections of 27 September 2022. The change of course was communicated immediately after the appointment of the government, last October, and aroused a positive reaction by investors in public debt securities, leading to a further reduction in the differential between Italian and German interest rates.

While the impact of the NRRP is linked, upstream, to the confidence effect induced in the most indebted countries by debt mutualization, the successful implementation of the plan represents a decisive factor not so much in the structural conversion of the Italian economy (subject, as mentioned, to the uncertainty on the real effects of the NRRP and on the level of the fiscal multiplier of public investments and reforms), but in the possibility of replicating other mutualization exercises that would have positive effects on the spread and, as an immediate consequence, on the confidence of Italian firms in the country's financial stability, which is a precondition for investment decisions. Making European countries' investment financing mutualization exercises permanent would be a decisive turning point for the economies of indebted countries.

For this reason, in addition to the conversion of the government in terms of fiscal discipline and the implementation of the plan in agreement with the European Commission, a further step is essential: the adhesion of the Italian government to the project of closer financial and economic integration of the European Union, such as to strengthen the political-institutional platform on which an intensification of joint support initiatives for the European economy and funding sharing can be based. In this context, the initiatives of adherence to the rules of governance of the European economy are important, while the adhesion to the reform of the Treaty Establishing the European Stability Mechanism would at least have a signaling nature. In view of the European parliamentary elections, a political pronouncement in opposition to Eurosceptic rhetoric would represent a significant commitment of the governing parties to the partner countries. Steps in this direction would strengthen the consensus among European countries on shared responsibilities in policies of common interest.

In conclusion, the good performance of the Italian economy seems to be linked to the country's financial stability expectations justified by the NGEU program and by the mutualization of the relative debt. These expectations were reflected in the interest rate differential that directly influenced the cost-return ratio of private investments even before the material effects of the NRRP investments and reforms became clear. The experience of recent years shows that the level of the differential is determined not only by fiscal discipline but also by common European initiatives for the mutualization of economic policies. Making the common European investment and debt initiatives permanent would represent a decisive breakthrough for the Italian economy. This breakthrough requires consensus on the process of greater European integration and a political commitment to recognizing shared responsibilities.