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Economic outlook, public finances and the Next Generation EU

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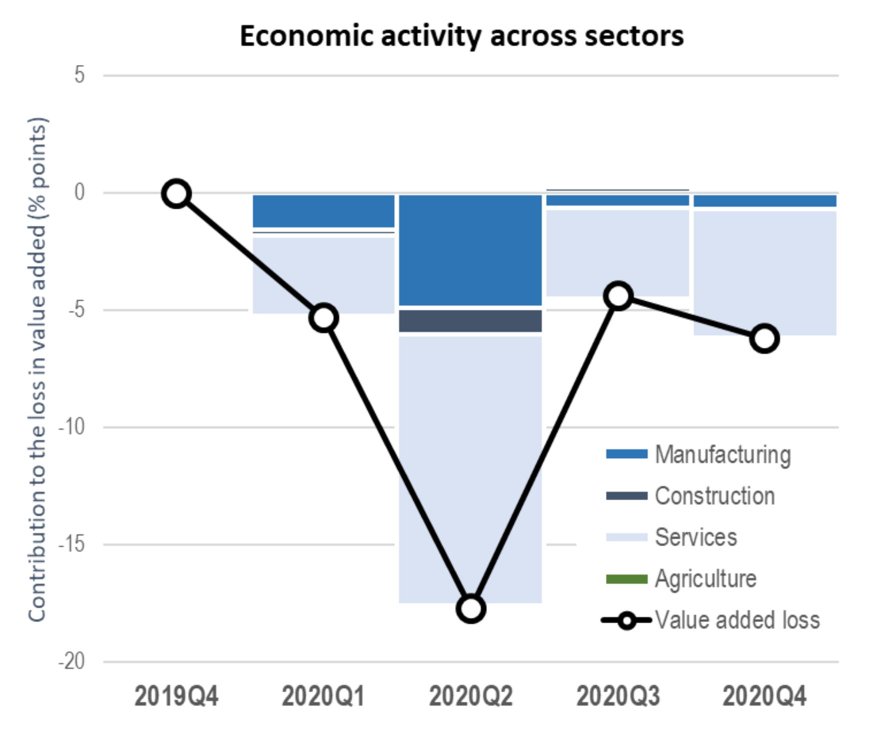
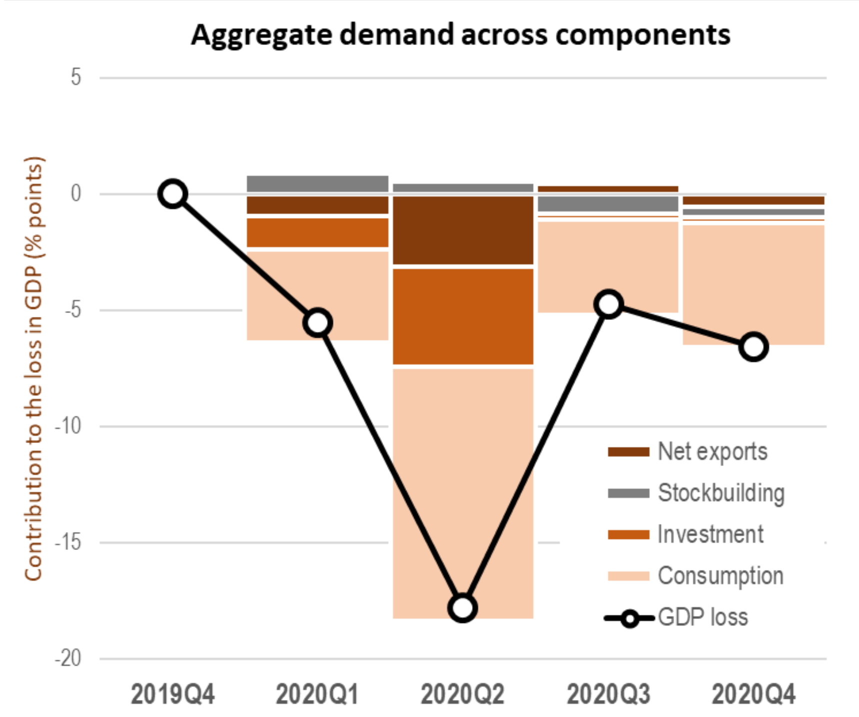
The Italian economy in 2020





- **GDP decreased by 8.9% in 2020**; at the end of the year it was 6.6 pp lower than a year earlier. All sectors and demand components were severely hit, especially services.
- **However, the production capacity of Italian businesses has proved resilient** so far: when restrictions were removed, the economy rebounded strongly.
- Unprecedented policy measures, deployed at the national and international level, contributed to containing the damages, limiting job losses and preserving smooth financing conditions.

The fiscal response to the pandemic

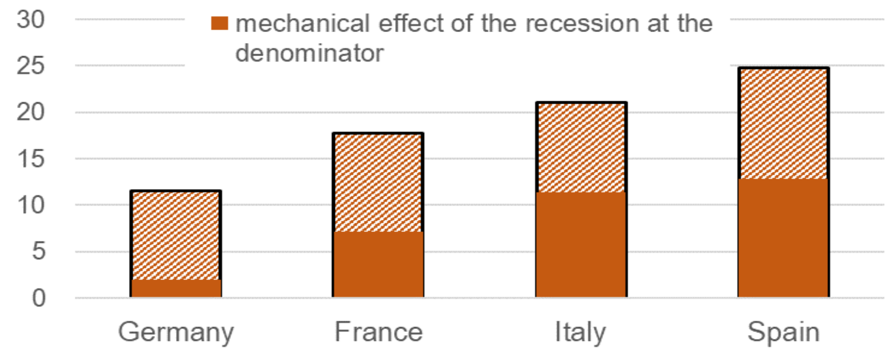
- **Sharp deterioration in general government accounts** (joint effect of GDP contraction, automatic stabilizers and discretionary measures): debt-to-GDP ratio increased by 21 percentage points; net borrowing by almost 8 pp.

Selected public finance indicators (% GDP)

	2018	2019	2020
Net borrowing	*2.2*	*1.6*	*9.5*
Primary balance	*1.5*	*1.8*	*-6.0*
Interest expenditure	*3.6*	*3.4*	*3.5*
Debt	*134.4*	*134.6*	*155.6*

Sources: Istat and Banca d'Italia

Increase in debt-to-GDP ratios in 2020
(percentage points)



Sources: European Commission, Winter forecasts; for Italy, Istat and Banca d'Italia.

- Discretionary measures aimed at supporting: 1) income of workers and households; 2) liquidity needs of companies, mostly in the form of state guarantees on bank loans; and 3) the healthcare system. From the revenue side, postponed deadlines for payment of some taxes and social security contributions.
- The **fiscal response** was targeted to the households and firms most severely hit by restrictions; it was timely and mostly temporary.

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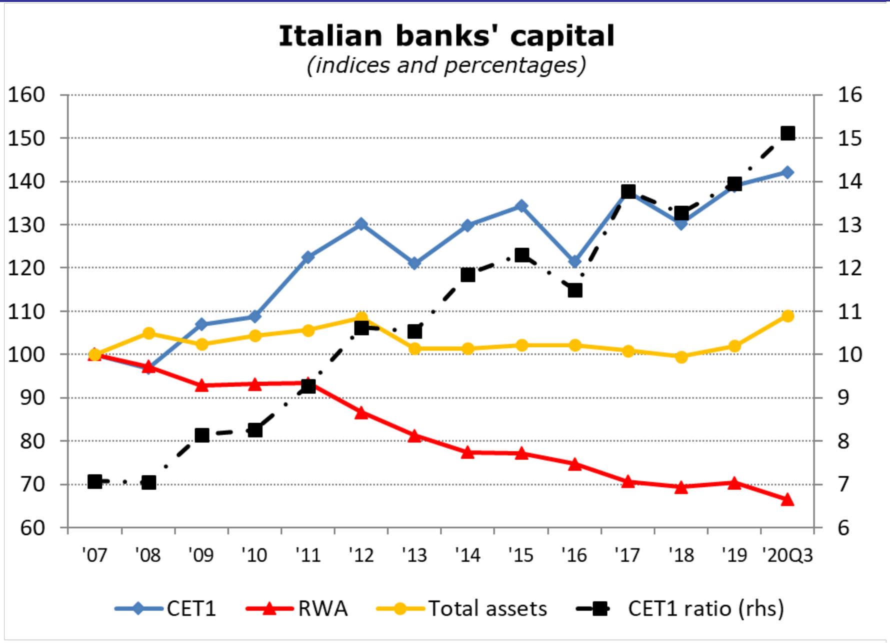
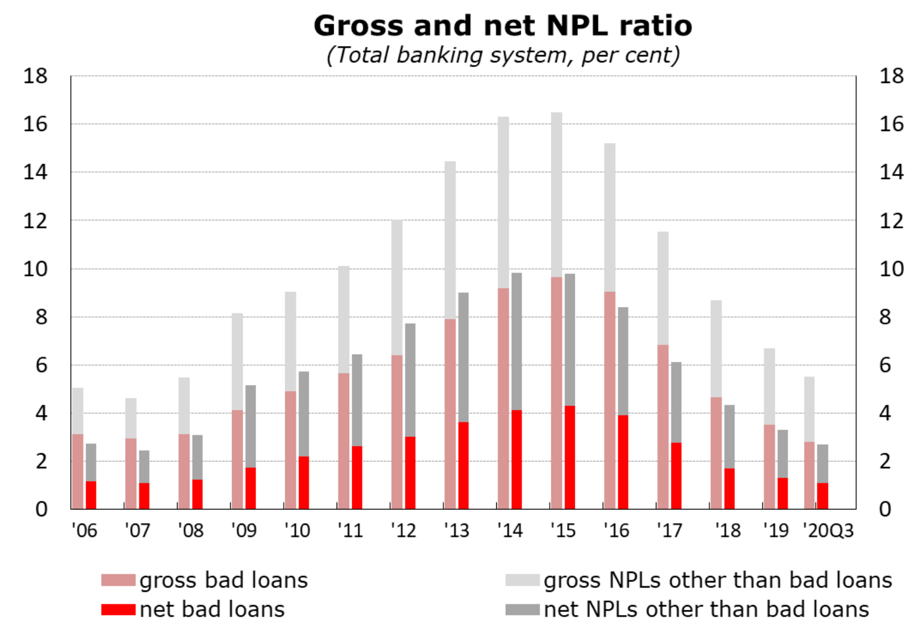
The banking system





- Thanks to reforms and supervisory actions undertaken before 2020, Italian banks have faced the economic impact of the pandemic from a **strong capital and liquidity position**.
- In **2020, banks further strengthened their balance sheets** to withstand the expected deterioration in credit quality, while keeping credit supply standards relaxed:
  - ❑ The CET-1 ratio continued to increase (to 15.1 per cent) mainly thanks to the capitalization of profits from the 2019 financial year onward (dividend distribution restrictions);
  - ❑ The disposal of NPLs was almost €30 billion in 2020, surpassing initial projections;
  - ❑ Banks’ profitability fell significantly, mainly due to the considerable increase (+52 per cent) in loan loss provisions for performing loans, for which the probability of default rose.

Prospects in the near term heavily dependent on pandemic developments

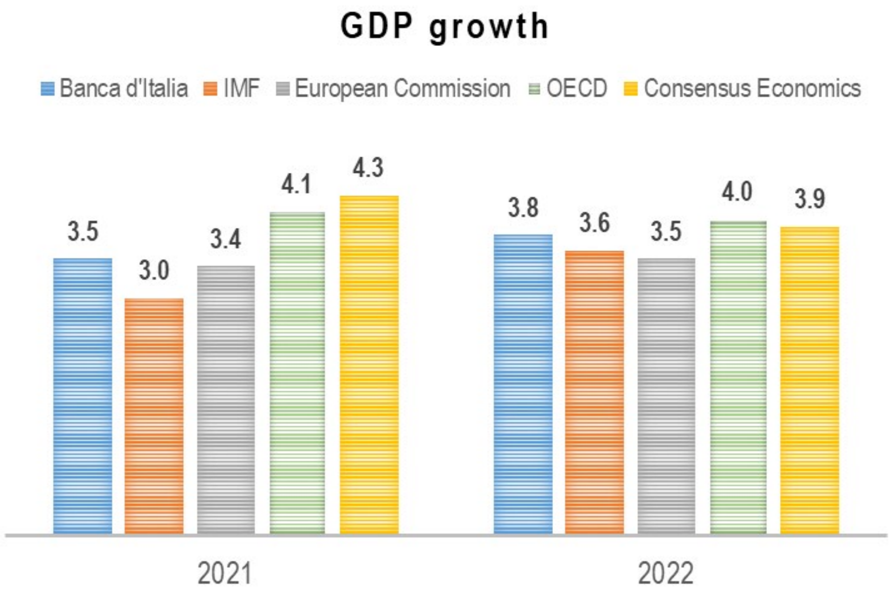
Macroeconomic scenario in Italy

(% change over previous year, unless otherwise indicated)

	2020	2021	2022	2023
GDP	-8.9	3.5	3.8	2.3
Households' consumption	-10.7	3.2	3.1	1.9
Gross fixed capital formation	-9.2	10.1	11.2	5.2
Exports	-14.5	9.8	4.5	3.3
Imports	-13.1	9.0	6.6	3.6
Employment	-1.9	-0.9	1.7	1.3
HICP inflation	-0.1	0.7	0.8	1.1
Current account balance	3.6	3.5	3.0	2.7

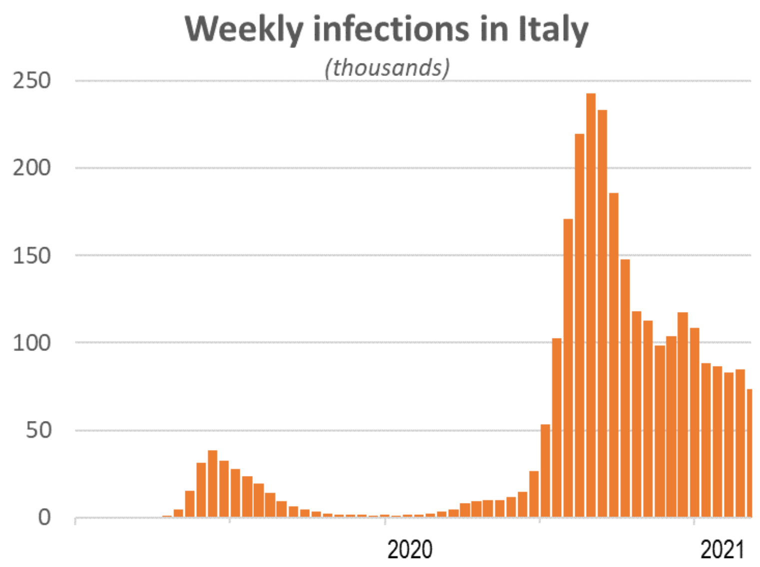
Sources: Istat and Banca d'Italia.

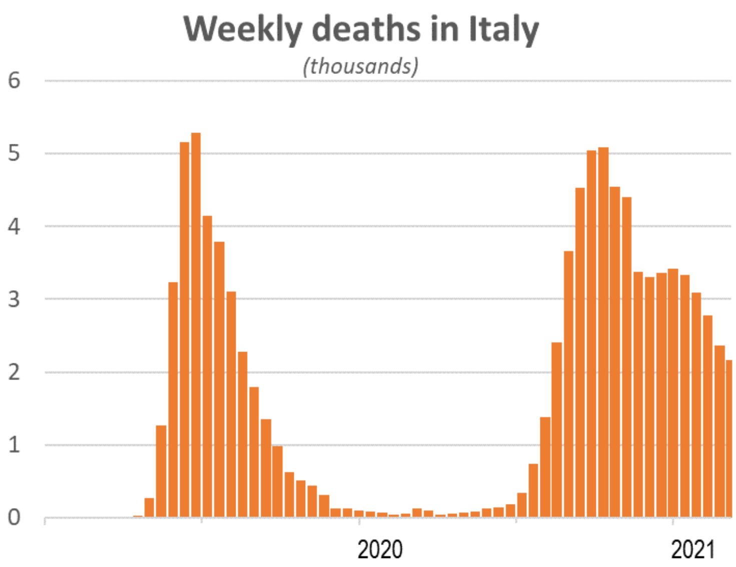
(1) Levels; in percentage of nominal GDP.



- **GDP expected to rebound as the pandemic comes under control**; pre-crisis levels would be attained by 2023. Underlying assumptions: the pandemic comes to a gradual resolution by 2022; financial conditions remain favourable; steady recovery in world trade; positive impact of NGEU.
- The recovery is expected to be driven by investment, also thanks to NGEU, while consumption increases more gradually with the propensity to save slowly decreasing from the high levels touched in 2020.
- Labour market conditions will recover in line with GDP.
- BI scenario broadly similar to other recent forecasts.

Risks are related to the evolution of the epidemic

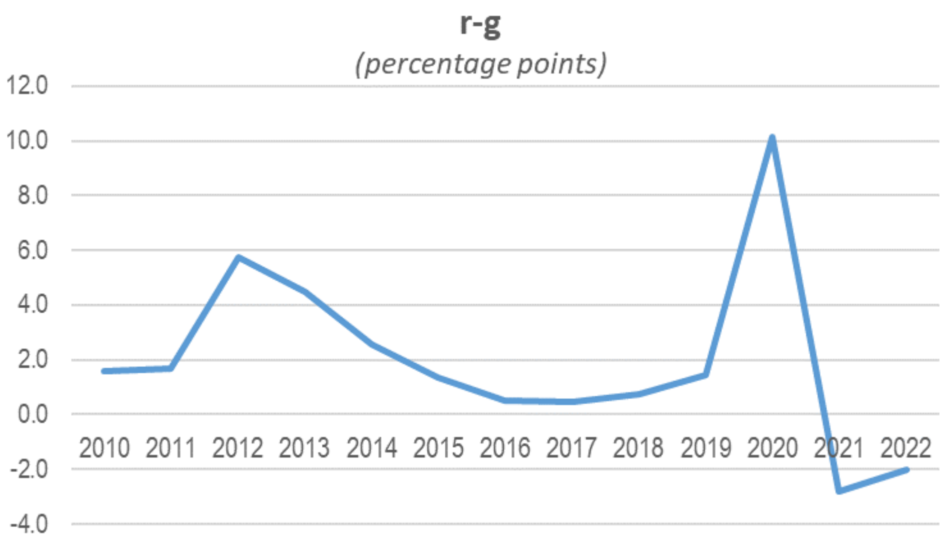




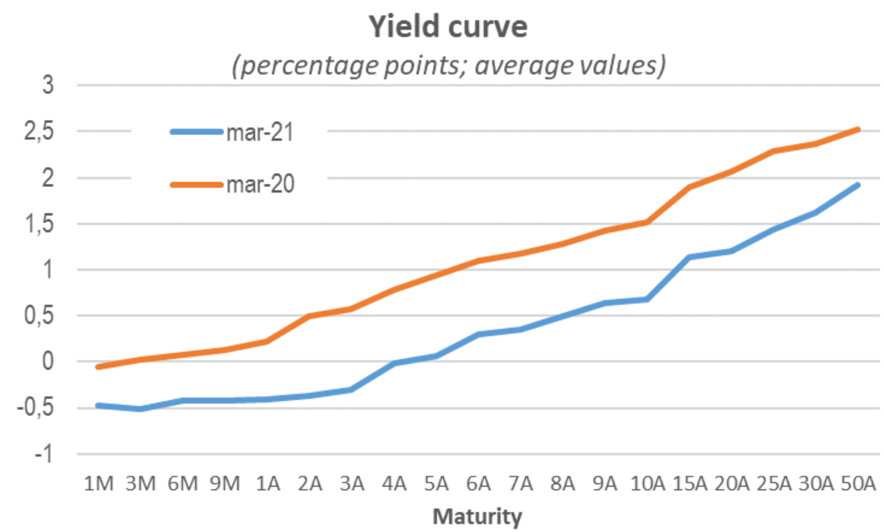
- **The second pandemic wave had a milder economic impact**, thanks to more targeted measures and possibly to the productive system having learnt how to cope with restrictions.
- **The recovery could be delayed by a strong increase in infection rates** due to new variants, with negative consequences on confidence, trade and financial conditions of firms and households.
- **A faster vaccine rollout could help contain infections**, but a substantial reduction of containment measures seems unlikely before the late 2020Q2.

Fiscal outlook and public debt sustainability

- European Commission winter forecasts: **debt ratio should broadly stabilize** over 2021-22, despite the increase in primary borrowing (primary surplus 1.5 per cent of GDP in 2010-19).
- Importantly, the **expected differential between the implicit interest rate on public debt (r) and the nominal GDP growth rate (g) is negative**; quite new, and very favourable, for Italy! Interest rates are lower compared with one year ago.



Sources: for 2010-2020, Istat and Bank of Italy; for 2021-22, European Commission, Winter forecasts



Source: Refinitiv

- Debt Sustainability Monitor 2020 prepared by European Commission: **the long-term sustainability indicator for Italy more favourable than for the EU and the EA.**

The January draft of the Italian Recovery and Resilience Plan and its macroeconomic effects

- Draft presented last January by the former Government to Parliament.
- Aim: making "Italy a more sustainable and inclusive country, with a more advanced and dynamic economy". Three **strategic axes** (digitalization and innovation, ecological transition and social inclusion) and three **horizontal priorities** (gender equality; youth; the South).
- **NGEU funds: around €210 billion** (almost **83 billion transfers** which do not increase public debt).
- **«Additional» interventions should amount to €124 billion** (all transfers + part of the loans from the RRF), more than **70 per cent of which for public investments and other capital expenditure**. Not much detail about the time profile, but supposedly concentrated around middle of implementation period.
- Our estimates of the short-run (demand-side) impact of these interventions: **GDP level could increase by almost 2 percentage points by 2023-24**.
- **In the long run, supply side effects could be more important than the short run impact** of the programme. Efficiency in the implementation of projects will be key.

The new Government’s strategy for the Italian Plan

- ‘Strategic axes’ and ‘horizontal priorities’ of the Draft Plan broadly confirmed by the new Government *(President Draghi’s speech, 17 February; parliamentary hearing of the Minister of Economy and Finance, 8 March)*.
- New government’s plans require projects to be **feasible** over a six-year horizon**,** with **well-designed responsibilities for oversight,** and easily **monitored** at any point in time.
- **Comprehensive approach** for accompanying **reforms**. Focus on:
  - effectiveness of the **public administration**
  - efficiency of the **civil justice** system**.**
- Impact of planned reforms larger if accompanied **simplification in legal rules**. Timely implementation requires **good planning.**
- Improved **governance structure.** Overarching responsibility attributed to the Ministry of Economy and Finance. MEF will act in cooperation with the relevant ministries responsible for specific projects.

Way forward

- **NGEU**: **Great opportunity**, laying down the foundations for greater economic integration, but **considerable challenges** in terms of planning, implementation and monitoring of projects.
  - Efficient choice and implementation will be paramount. Funds need to be repaid eventually! (including transfers in part, through contributions to the EU budget).
- Continue to **provide relief** (necessary in current circumstances), but **start thinking about the phase-out**. Neither too quick (to avoid disruption and waste), nor too slow (to forestall misallocation and control public expenditure). *“Fiscal policies must have the clear medium-term objective of guiding the debt ratio back to a downward slope” (Governor Visco, 6 February).*
- **Government spending alone not sufficient** for a sustained increase in GDP growth potential. We agree with Government that structural action is needed. E.g.:
  - Improving quality of public administration (investment in technology and human capital)
  - Providing incentives for innovation in firms
  - Speeding up civil justice.
- Noticeable progress in past years, but not enough. **Effect of structural reforms estimated as significant**: service sector liberalizations, incentives for innovation and civil justice reforms could increase Italy's potential output by 4-8 per cent in long run.

To sum up

- The **economic impact of the pandemic has been unprecedented,** but when restrictions were lifted the Italian economy showed a remarkable ability to recover. The economic impact of the second pandemic wave has been milder, thanks to more targeted measures.
- **Policy support measures essential** to avert catastrophic developments; all in all, fiscal response well targeted, timely and temporary; **long-run sustainability of public finances preserved**.
- **Risks remain**; the phase-out must be carefully planned.
- NGEU offers a unique chance to combine a sustained impulse to economic growth with beneficial effects on public finances; to this, end, a **properly designed and effective Recovery and Resilience Plan** as well as an **ambitious programme of long-due reforms** are both needed. The Government's commitment to justice and public administration reforms goes in this direction.
- If successful, NGEU could provide a **blueprint for permanent fiscal capacity for the EU**.