PROMETEIA
DISCUSSION
NOTE N. 14

SEPTEMBER 2020

ITALY: POST COVID-19 RECOVERY, WILL THIS TIME BE DIFFERENT?

I. Introduction

This note assesses the likely strength of the current Italian recovery based on experience of the last two recessions (2008-09 and 2011-12) and the new European Union (EU) Next Generation EU (NGEU) Plan. The 2008-09 recession originated in the US, but spread quickly to Europe, resulting in a major slowdown in global trade, significantly tighter credit conditions and a considerable fall in output. The recovery was interrupted early by the European sovereign debt crisis, which triggered a large rise in interest rates and a further contraction of credit conditions, topped by an appreciably restrictive fiscal policy compared to the 2008-09 mildly expansive fiscal policy. The slow recovery from the sovereign debt crisis reflected the continued weakness in credit, the persistently high interest rates - at least until the introduction of Quantitative Easing (QE) by the European Central Bank (ECB) in 2015 - and the continuing need to adjust the fiscal balance.

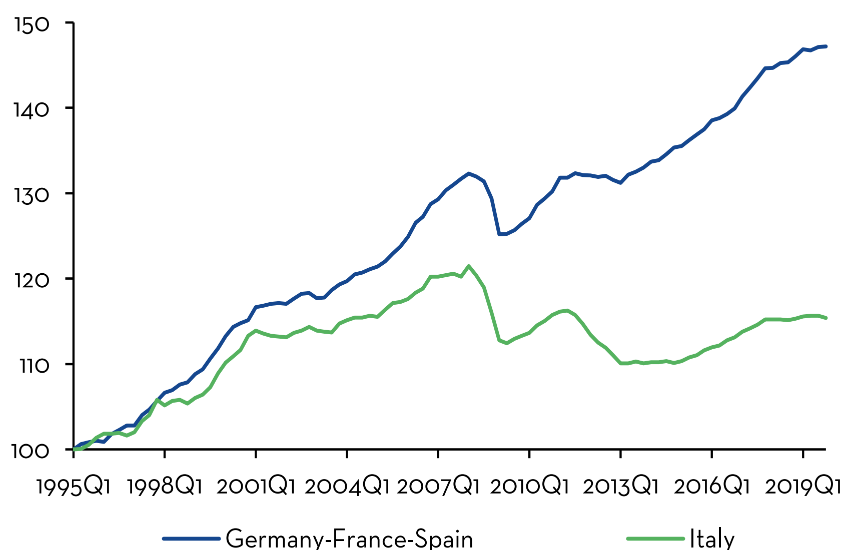
The nature of the current crisis is completely different. Economic activity has been constrained by lockdowns and fear of contagion, with an accompanying contraction in global trade. Given these circumstances, many observers argued initially that a recovery could be fast (V-shaped). Although this optimism has been dampened somewhat by the high levels of unemployment and the persistence of the constraints on supply/demand due to the virus, it is nevertheless the case that this crisis is different.

Fiscal policy and monetary policies have been accommodative, interest rates are being contained and government policy is ensuring credit flows. Although all of these factors should support a recovery, our estimates suggest that their impact will be limited compared to the magnitude of the fall in activity. We estimate the fiscal measures introduced in 2020 would provide a cumulative 4% of GDP support for the economy in 2020-2021, while low interest rates and credit flows would contribute for slighly less than 1% to GDP growth over the same period. These numbers should be set against the fall in activity which reached a low of around 18% in Q2-2020.

The NGEU plan should make a difference (see box). It is difficult to assess the likely impact of the proposed programme since details are scarce, but its extent and the level of support being provided by monetary policy, suggest that its effect will be sizeable. Overall, if properly managed, an exit from the current crisis might be different and prove more successful than the emergence from previous recessions.

II. Italy has lagged behind its peers in the last 20 years

Over the last 20 years, Italian GDP growth has been lower than that of the other large euro area countries (Figure 1). This performance reflects a combination of structural and more temporary factors. Starting from the late 1990s, the Italian economy proved less able than other advanced economies to cope with the changes deriving from globalization, the ICT revolution and the fixed exchange rate related to entry to the European Monetary Union (EMU). The reasons for this disappointing performance are well known and have been studied extensively; they are related mainly to certain structural and institutional features, which have worked to slow the restructuring that was needed. They include demographics and ageing, inefficient administrative and legal systems, the north-south divide, poor quality human capital and small size of firms. The economy suffered, also, from some temporary shocks, which were persistent and were also linked to structural weaknesses, related mainly to fiscal consolidation, disruptions to the flow of credit and interest rate dynamics. All of these factors resulted in unsatisfactory Total Factor



Source: Prometeia's calculations on Eurostat data.

Figure 1

Real GDP

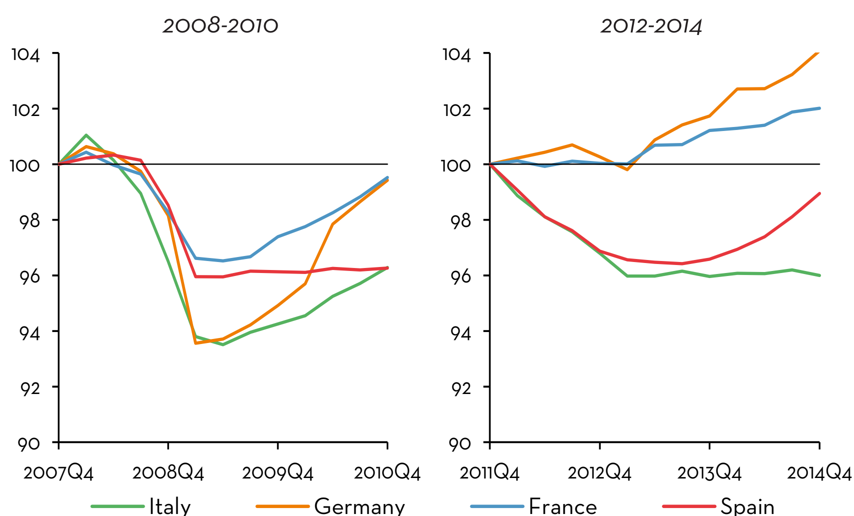
1995=100

Productivity (TFP) growth since Italy's labour and capital inputs (employment and investments) dynamics were broadly similar to those of peer countries.

This Discussion Note focuses on the two most recent recessions (2008-09 and 2012-13) and the ensuing recoveries, in order to try to assess how the current recovery might progress. Recession/recovery episodes are influenced more by temporary shocks (causing the recession or hindering the recovery) than by structural factors, although it can be difficult to disentangle these two effects. We focus on an evaluation of temporary shocks.

III. Which temporary shocks?

Focusing on the 2008-2010 and 2012-2014 cycles, it is clear that Italy experienced worse recessions and slower recoveries than the other larger European countries (Figure 2). On both counts, Italy lagged behind Germany, France and, also, Spain especially after the sovereign debt crisis. At the end of 2010, compared to 2007-Q4, Italy's GDP was 3.1pp lower than German GDP and, in the following four years, Italy lost another 5.0pp. This large fallback after 2010 was no



Source: Prometeia's calculations on Eurostat data.

Figure 2

Cycles in comparison: GDP indexes during the 2008-2010 and 2012-2014 recession/recovery episodes

2007Q4 and 2011Q4 =100 respectively

surprise since the 2008 financial crisis had equally bad effects on all European economies, but the sovereign debt crisis had a particularly severe effect on Italy (and also Spain). We consider four important temporary shocks that affected these dynamics.

Uncertainty. To proxy for uncertainty we use the BTP/Bund spread. There are other indicators that could be used, but all provide the same results. Figure 3 shows that, during the global financial crisis and the following recovery, spreads tended not to differ widely across countries although they increased more in Italy and Spain than in France for instance. Italy and Spain have been at the epicentre of the European sovereign debt crisis. The spread stabilized after the launch of QE in 2015, although, in 2018, Italy suffered a further period of uncertainty due, mainly, to domestic political reasons.

Credit. The availability of credit is another factor that might explain the different performance among euro area countries. Following the global financial crisis, the banks had to undertake a profound process of restructuring, in order to increase their resilience and comply with the more restrictive Banking Union rules. To proxy for the differential effects of these processes across countries, we use indicators for credit restrictions/easing from the Bank Lending Survey (BLS, Figure 4). Again,

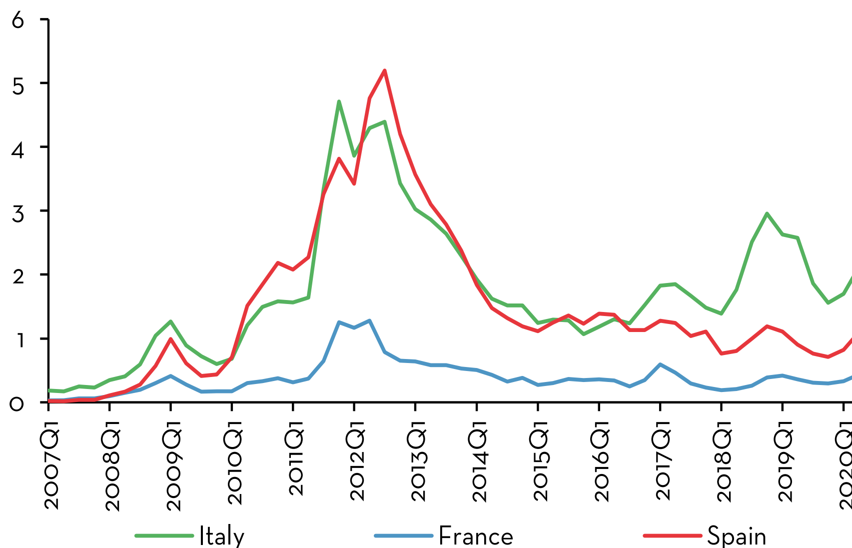


Figure 3

Spreads versus 10Y Bund

1995=100

Source: Prometeia's calculations on REFINITIV data.

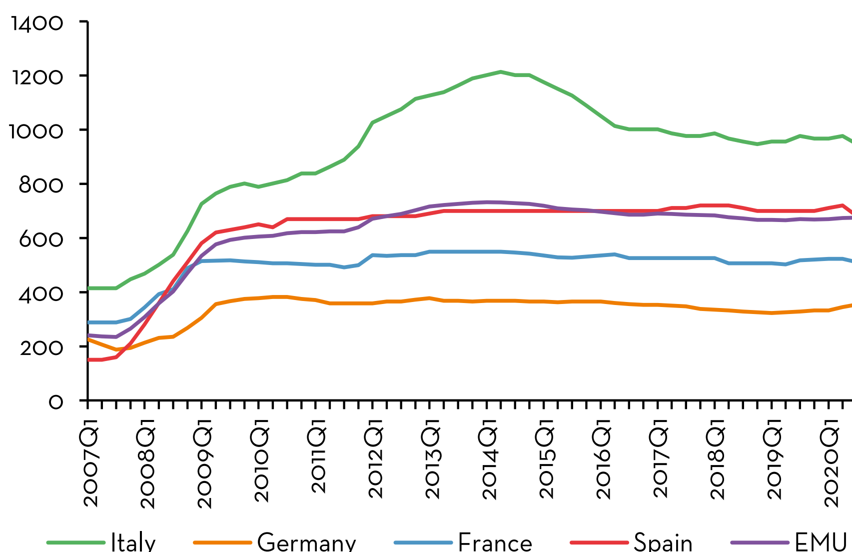


Figure 4

Bank Lending Survey

2002-Q4=100

Source: Prometeia's calculations on ECB data.

we see that the two crises were very different. In 2008-2010, credit restrictions affected all four countries, to an extent, with Spain recording the severest tightening followed by Italy. During the sovereign debt crisis, the credit crunch applied mostly to Italy.

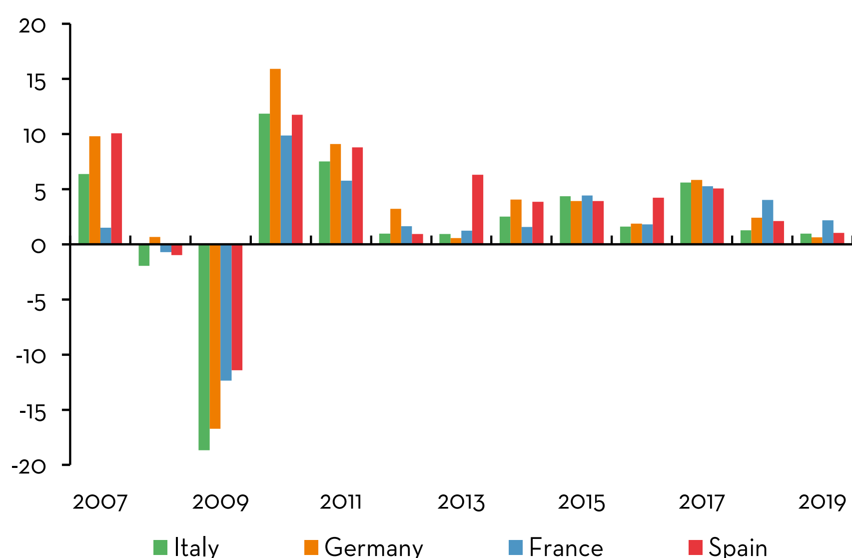
External demand. At times of global crisis, Italian exports tend to be penalized more than the exports of the other large Eurozone countries (Figure 5). The biggest gap is with France and Spain and depends, to some degree on the geographical composition of the foreign demand, and to a large degree on the sectoral specialization of Italian production which is concentrated mainly on capital goods. For example, during the global financial crisis, demand from our main trading partners for capital goods collapsed, explaining the larger fall in export than the one experienced by other member countries. In the same way, in 2012 and 2013 Italy experienced lower rates of growth of exports compared to its peers.

Fiscal policy. The main indicator of budgetary performance is the evolution of the primary balance. Figure 6 shows the actual primary balance and its components: a cyclical component, which measures the impact of automatic stabilizers, and a residual component, adjusted for cyclical effects, which reflects the impact of discretionary fiscal measures. Evolution of the

Figure 5

Growth rate of goods exports

percentage points

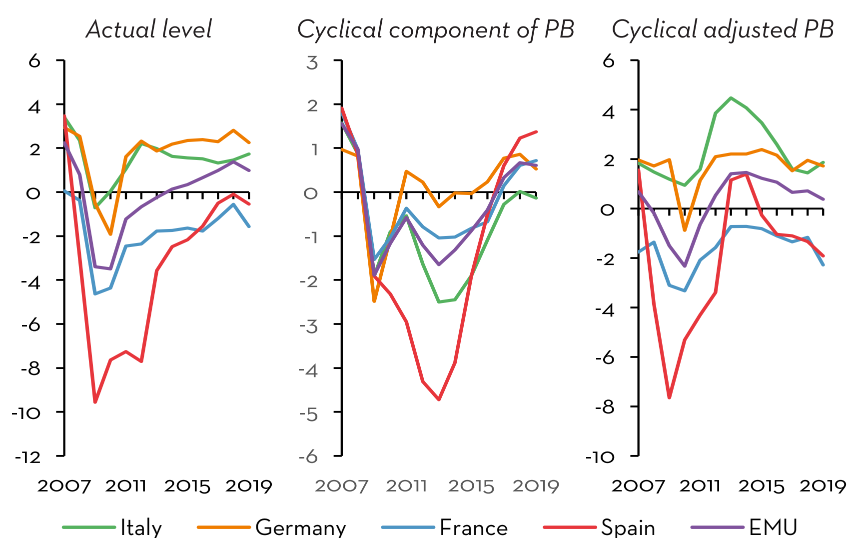


Source: Prometeia's calculations on Eurostat data.

Figure 6

Primary balance (PB), general government

as percentage of GDP



Source: Eurostat data for actual levels, European Commission Spring 2020 estimates for the breakdown of cyclical effect.

cyclical component of the balance confirms the differences referred to between the two crises. The global financial crisis affected the public finances of all European countries equally, worsening the cyclical component of the primary balance by very similar amounts in 2008 and 2009 (on average around 3.5pp of GDP, slightly higher in Spain, 3.8pp, and slightly lower in Germany, 3.3pp). However, the sovereign debt crisis had very different effects across countries, with significantly more severe negative effects on peripheral countries, such as Spain and Italy. This resulted in the primary balances in Spain and Italy suffering more than the average European zone country, while in Germany it remained almost unchanged. Policy responses also differed between the two crises. The 2008 financial crisis promoted mainly (except for Germany) counter-cyclical policies, that is, expansionary fiscal measures during the recession and restrictive measures during the recovery (see the negative – i.e. expansionary – slope of the curves in 2009 in Figure 5 right-hand panel). However, the sovereign debt crisis triggered restrictive measures during the recession (positive slopes in 2011 and 2012), which were particularly severe in those countries most affected by the crisis (Spain and Italy). In Spain and Italy, the following recovery was supported by expansionary measures, but these did not match the negative impulses in previous years.

IV. A shock decomposition exercise

The four temporary shocks considered explain a significant part of the last two recession/ recovery episodes (Table 1). To evaluate the impact of the temporary factors discussed during the periods of recession and subsequent recovery, we use the Prometeia macro econometric model for the Italian economy.[1] The uncertainty effect was contained during the global financial crisis, but was more significant during the period of the sovereign debt crisis. The credit crunch had similar effects in both recessions/recoveries, but the impact of external demand weighed more heavily during the global financial recession. With regard to fiscal policies, Table 1 shows that, during the global financial crisis, the impulse effects were small, but were much more relevant during the sovereign debt crisis, especially in the initial phase of the recession, due to the impacts of the extraordinary measures adopted since the second half of 2011. In the subsequent recovery, the small impact in 2014-2015 reflects the limited expansionary effects of policies designed to maintain market confidence. This position did not begin to reverse until 2015; from 2016, the resources available and their ability to stimulate growth, became more significant. Overall, the actual GDP recovery in 2014-2015 fell short of the impulses exerted by the determinants considered in the shock decomposition exercise, pointing to structural difficulties of the Italian economy to recovery.

Table 1 A shock decomposition exercise: the impact on GDP

	Uncertainty	Credit Crunch	External demand	Fiscal Policy	Explained change in GDP	Actual change in GDP
recession 2008-09	-0.57%	-0.18%	-4.29%	0.23%	-4.81%	-6.29%
recovery 2010-11	0.30%	0.26%	1.45%	-0.04%	1.97%	2.52%
recession 2012-13	-0.78%	-0.16%	-0.91%	-2.16%	-4.01%	-4.88%
recovery 2014-15	0.75%	0.24%	0.58%	0.41%	1.98%	0.73%

Source: Prometeia's calculations.

1 *"The Prometeia Italian Quarterly Model, Past, Present and Future", Prometeia, Nota di lavoro, 2018-03.*

V. The 2020 crisis and recovery: this time is different

The EU NGEU programme is short on detail. To assess the potential impact of the NGEU programme on the current recovery requires several assumptions, especially about the amount of resources that Italy will be able to access and how they will be spent over time. It is clear, also, that obtaining and allocating the funds according to European Commission rules, will not be straightforward. To pass the Commission's scrutiny process requires precise spending plans which define milestones, targets and implementation arrangements.

The resources potentially available to the Italian government are significant and include:

- €36 billion in loans from the ESM pandemic credit line;
- €27.4 billion in loans from SURE to support the labour market, as proposed by the European Commission on 24 August and adopted by European Council Decision on 17 September;
- around €207 billion under the NGEU, broken down into around €81 billion in grants and €126 billion in loans.

Overall, the amount of public expenditure enabled by these programmes totals some €270 billion, 15% of 2019 GDP. On this basis, cumulative debt would amount to €189 billion, lower than the total expenditure due to the grant component of the NGEU, which would not lead to higher government indebtedness.

How could these funds be spent over time? Figures 7 and 8 assume that all potential funds are used and depict realistic scenarios of the distribution of expenditure flows and debt obligations over the next few years. The two profiles are different since the loan disbursement terms may differ from the pattern of expenditure. The repayment of funds will begin in 2028.

Timing of funds availability. Disbursement of SURE funding should begin in the last quarter of 2020 for 15% of the total, with the remainder payable in 2021. Since the funding proposed by the Commission refers to expenditure related to measures already adopted by the government under the Cura Italia and Rilancio decrees, a large part of the SURE funding is related to expenses done in 2020. For the ESM funding, it is assumed that the credit line will be activated starting from early 2021, to support the health care system mainly in 2021 and 2022, with some additional funding in

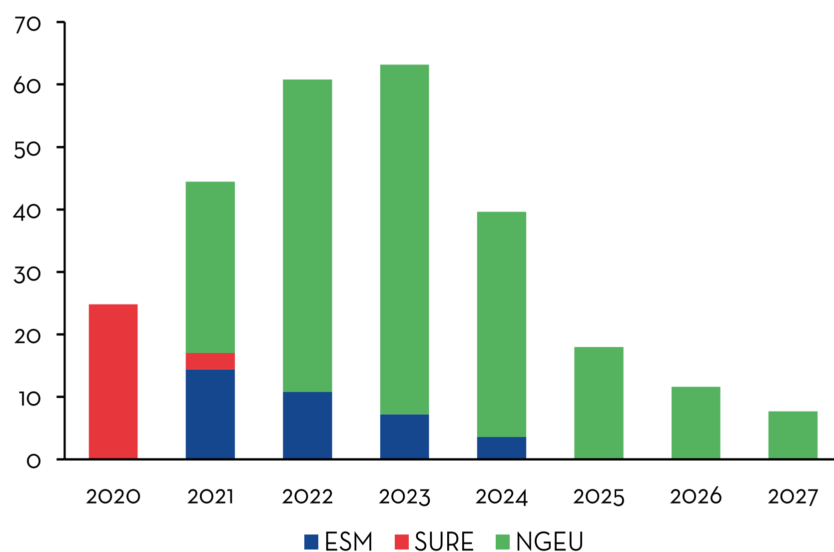


Figure 7

Public expenditure flows linked to European funds

billions of euros

Source: Prometeia's calculations.

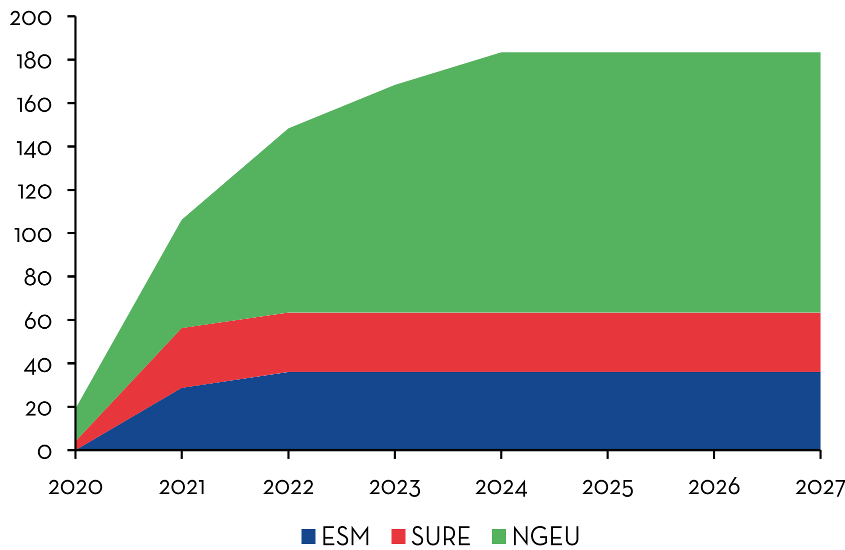


Figure 8

Public debt linked to European funds

billions of euros

Source: Prometeia's calculations.

the following two years. The NGEU spending profile assumes pre-financing starting in 2021 and loan disbursement ending in 2026, with 70% of the total funds available by end 2023.

Timing and composition of spending. Figure 9 provides a possible breakdown of how the EU funds could be allocated to different government spending items. With the exception of the social benefits associated to SURE funding, most entail direct public investments and capital transfers. We assume that, in line with the provisional guidelines, the NGEU funding will all be used to finance public investments and measures to boost private investments.

While the resources involved and their potential effect on GDP are substantial, there are several factors that could limit their actual impact. First, not all the expenses included in the programmes are additional. For example, the support provided by SURE will finance already approved measures and, therefore, the main effect is the saving on interest payments related to the more favourable financing conditions compared to market conditions. Similarly, the ESM Pandemic Support funds would mainly affect financing costs since they are associated, mostly, to expenditure which would be anyway implemented. In the case of the NGEU, while the grant component can be expected to

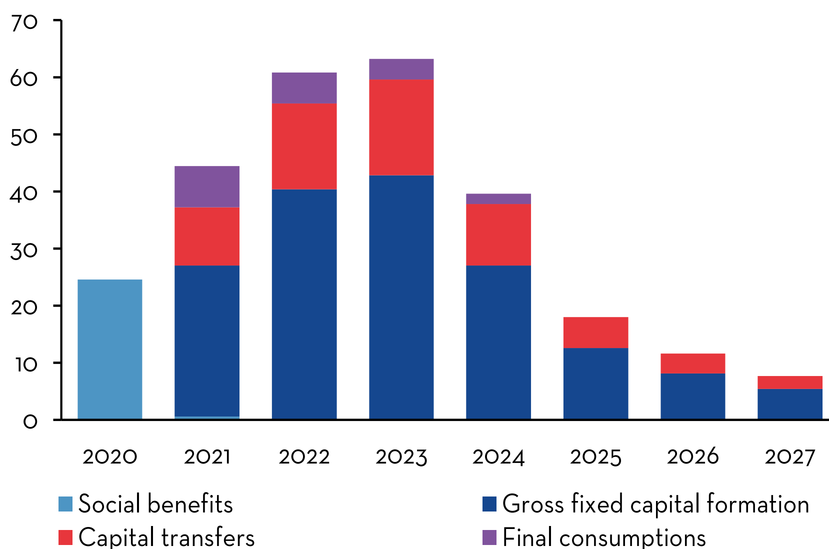


Figure 9

Public expenditure aggregates

billions of euros

Source: Prometeia's calculations.

finance additional expenses (especially investments), it is more difficult to assess how the loans will be used. The amounts involved are very large compared to historical spending and, if the new public investments and capital transfers indicated in Figure 9 were totally additional, average expenditure in terms of GDP over the next seven years would be almost 50% higher than the average over the last seven years. In some years, expenditure flows might even double (Figure 10). This casts doubt on the feasibility of using all potential NGEU resources.

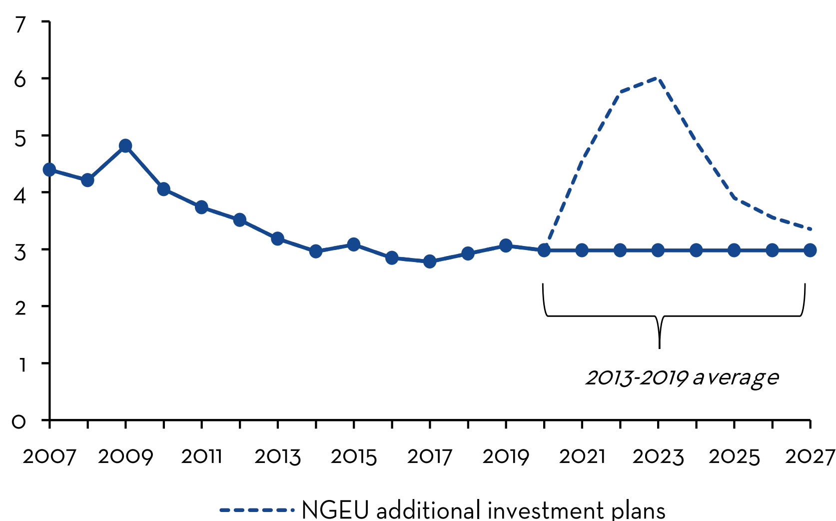


Figure 10

Public expenditure in investments and capital transfers

percentage of GDP

Source: Prometeia's calculations.

VI. Conclusion

Significant tailwinds will support Italian recovery in the next few years. The support from the various European programmes will allow a smoother than otherwise fiscal normalization during the recovery. The new European direction will also help to reduce uncertainties regarding the European project. Monetary policy will remain accommodative and interest rates will stay close to zero (negative in real terms). The political risks are likely to be contained since it is difficult to envisage an alternative to the current course, which implies working closely with the European partners to support the recovery.

These tailwinds could significantly push annual growth upward in the next few years. Potentially, the NGEU could contribute a great deal to growth in the immediate next few years. The lack of tensions in the sovereign market and the recent rapid expansion of credit due to supportive monetary and fiscal policies and absence of other relevant shocks, should allow the economy to achieve a sustained recovery.

The next few years should be used to get the Italian recovery on solid ground. Although the European funds should promote growth in the next few years, they may not be sufficient to sustain continuing economic growth. This will require a series of structural reforms to reduce some of the structural factors that have constrained Italian growth during the last 20 years. A return to the recent trend growth will not be sufficient to address the challenges that Italy faces and which are well known. For instance, it will not be enough to reduce public debt, invest in education to upgrade Italy's human capital, increase the ability of the health system to meet the requirements of an ageing population or support the transition to a low emissions economy. The funding and efforts over the next few years must be expended wisely to avoid the long-term public debt sustainability and the country's macroeconomic stability being jeopardized.

The European Funds supporting post COVID-19 recovery

EU institutions have reacted to the pandemic shock in timely and vigorous ways. In March, some European rules were relaxed according to the general escape clause (which temporarily suspends the Stability and Growth Pact) and through approval of a State Aid Temporary Framework and the decision to make non-utilized EU funds available to Member States. In April, the European Commission proposed an emergency package that was approved by the European Council, which mobilizes up to €540 billion for exceptional and immediate expenditure by Member States. In May, the Commission proposed a new €750 billion recovery instrument which was discussed and reviewed by the European Council in July.

The approved emergency package aims to make €540 billion available to member states and businesses as early as the second half of 2020. It consists of three measures:

- **The new ESM credit line (€240 billion at EU level), known as Pandemic Crisis Support, can be used to finance direct and indirect health care expenditure related to COVID-19.** It is already operational and will be available to all member states up to a limit of 2% of Gross National Income, up to December 2022. Countries may withdraw a maximum of 15% of the credit line each month, which is in line with the timeframe for the ESM to collect resources.
- **SURE (Support to mitigate Unemployment Risks in an Emergency) includes a total of €100 billion in loans, with favourable (but yet unspecified) conditions which Member States can request to finance short-time work schemes**, protect self-employed individuals and finance health measures (particularly in the workplace). These loans will be financed by the international capital markets and guaranteed by the member states' contributions - representing at least 25% of the total loans - to the EU budget. The guarantee payments will be based on relative shares in EU total Gross National Income. No allocation threshold has been defined, though a prudential rule states that the three largest beneficiaries should not receive more than 60% of the total. All Member States have already finalized their national approval procedures and signatures to provide guarantees and the European Council has adopted the EC proposals to grant financial support of €87.3 billion to 16 Member States (Italy would be the first beneficiary, receiving €27.4 billion).
- **The European Investment Bank (EIB) will provide up to €200 billion, mainly for small and medium-sized enterprises** (65% of total loans) up to (so far) the end of 2021. This will require member states to contribute pro-rata to the establishment at the EIB of a €25 billion Pan-European Guarantee Fund. The EIB will work in collaboration with national promotional institutions (Cassa Depositi e Prestiti for Italy) and local financial intermediaries.

The ESM-SURE-EIB aid package could be operational from this autumn and high-debt countries, which face higher financing costs, might find it convenient, especially if hit hard by the crisis. Among the main EU countries, Italy (followed by Spain and Portugal) is likely to benefit the most from the lower cost of debt.

On the other hand, **the NGEU should fulfil three main objectives over the next few years: support the recovery of member states, boost private investment, and learn from the crisis**. In May, alongside the Multiannual Financial Framework 2021-2027 proposal, the EC

proposed this temporary instrument worth €750 billion, to be split between grants (€500 billion, including €66.8 billion of guarantees) and loans (€250 billion).

The European Council reached a historic agreement based on a proposal from the European Commission.[1] The total resources remain unchanged at €750 billion, but, following requests from more 'frugal' countries, the breakdown between grants and loans has been revised so as to provide more loans (€110 billion to a total of €360 billion) and a lower amount for grants (from €500 billion to €390 billion). The European Commission is authorized to finance a total amount of EUR 750 billion (2018 prices) on behalf of the EU by the end of 2026 through bond issues with maturity between 3 and 30 years.[2] All these funds are to be used only in relation to the COVID emergency.

The Recovery and Resilience Facility (RRF) represents the main package in the NGEU programme, and amounts to €672.5 billion, accounting for 90% of the total amount of the instrument. It is divided between grants (€312.5 billion) and loans (€360 billion), with the remaindering earmarked mainly for Cohesion Policy (REACT-EU, €47 billion), the new Just Transition Fund (JTF, €10 billion) and the European Agricultural Fund for Rural Development (EAFRD, €7.5 billion). Compared to the European Commission proposal, the RRF funds represent a substantial increase and are comprised almost entirely of loans. In contrast, other programmes have suffered substantial cuts or been scrapped (Table A).

The RRF funds are to be used for investment or reforms related to national priorities, as indicated by EU country-specific recommendations, and/or for EU priorities such as the green and digital transitions, to which at least 37% and 20% of total resources should be allocated respectively. Countries will receive 70% of these grants between 2021 and 2022, according to the allocation criteria already defined in the Commission's proposal (data on population and GDP per capita in 2019 and unemployment between 2015 and 2019), and 30% in 2023, when the unemployment criterion will be replaced by GDP losses between 2020 and 2021. These allocation criteria have been criticized by some countries for making allocation dependent more on initial conditions than the depth of the national recession.

To access RRF funds, member states must submit national recovery and resilience plans setting out reform and investment programmes consistent with EU country-specific recommendations. The European Commission will assess these plans within two months of submission, based on the country-specific recommendations and the contribution of planned reforms for strengthening growth potential, job creation and social and economic resilience. The reforms must be oriented to green and digital transitions. Within four weeks of the Commission's proposal, the plans must be approved by the European Council by a qualified majority: member states in favour must represent at least 65% of the EU population and must be at least 55% of the total number of states (15 out of 27 countries). Member States may submit their national plans from 1 January 2021 and no later than

1 The amount funded by the NGEU might still increase since approval of the European Parliament (EP) is required before end 2020. The EP can approve or reject the European Council's proposal, but does not have the power to amend it. However, a recent EP resolution stated that the current agreement could not be approved because it lacks some relevant requirements, so the European Council may have to modify it.

2 In the coming years, the EU will work to reform the own resources system. A tax on non-recycled plastic waste will be applied from 1 January 2021, while in the first half of 2021, the Commission will propose a carbon border tax and a levy on digital giants with a view to their introduction by 1 January 2023 at the latest. In addition, the European Commission will present a proposal to extend the emissions trading scheme to the aviation and maritime sectors.

the end of April 2021, although the EC recommends submitting a first draft in October together with the national Draft Budgetary Plan.

Currently, Italy should receive €207 billion from the NGEU, €81 billion in grants and €126 billion in loans, equal to 11.6% of 2019 GDP. According to preliminary calculations Italy would be the main beneficiary of the NGEU funding and would receive around 28% of the total amount. The cross-country allocation key is known only for RRF grants , while for the other NGEU programmes it depends on the specific objectives of each programme. Finally, neither the methodology nor the cross-country allocation key is available for the RRF loans component (except that the maximum volume of the loans for each Member State will not exceed 6.8% of its GNI).

Table A Next Generation EU: European Council agreement vs EC proposal

	European Council conclusions (July 2020) - A	European Commission proposal (May 2020) - B	A-B
• Recovery and Resilience Facility (RRF)	672.5	560.0	112.5
of which: loans	360.0	250.0	110.0
of which: grants	312.5	310.0	2.5
• ReactEU	47.5	50.0	-2.5
• Horizon Europe	5.0	13.5	-8.5
• InvestEU*	5.6	15.3	-9.7
• Rural Development	7.5	15.0	-7.5
• Just Transition Fund (JTF)	10.0	30.0	-20.0
• RescEU	1.9	2.0	-0.1
• Solvency Support Instrument*	-	26.0	-26.0
• Strategic Investment Facility*	-	15.0	-15.0
• Neighbourhood, development and int. cooperation*	-	10.5	-10.5
• Humanitarian aid	-	5.0	-5.0
• Health programme	-	7.7	-7.7
• Total	750.0	750.0	0.0

**guarantees*
Source: Prometeia's calculations.

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