Sunday Wrap

Happy Sunday,

What a week it's been!

On Wednesday, Mario Draghi was asked by Italian President Mattarella to form a new Italian government. Since the news of this "seismic shift for Italy's political scene" (in the words of Bloomberg's Ferdinando Giugliano) broke on Tuesday, markets have rewarded holders of Italian assets (i.e. mostly Italians) with more than EUR 25bn in capital gains between BTPs and bank shares. The 10-year BTP/Bund spread dropped to double-digit territory for the first time in more than five years. I think there is more to come as the government is (likely) being formed and the policy agenda laid out.

Meanwhile in the US, Congress approved the budget resolution for the fiscal year, putting us on the road towards potentially using the reconciliation process to pass President Biden's eye-watering USD1.9 trillion (9% of GDP) fiscal plan, or whatever the committees end up agreeing on, with the simple majority that the Democrats have. This triggered a fascinating economics debate if it's fiscal overkill and if so, what that'll mean.

So, here's today's agenda:

- **What to look out for as Draghi navigates the road to the Chigi Palace and forms a government, and the policy agenda he'll need to pursue as prime minister.**
- **The new US debate of what's the right amount of fiscal stimulus – and what we Europeans should learn from it.**

1. Draghi: The road from here to the Chigi Palace – and his agenda.

As you'll recall, the Conte government in Italy lost its majority three weeks ago when Matteo Renzi pulled his "Italia Viva" party out in protest over PM Conte's plans for the spending and oversight of the roughly EUR 200bn from the EU, and concerns about the government's opposition to use the cheaply available ESM lines.

On Tuesday, after Conte had failed to reach a new mandate, President Mattarella announced that he opted for the formation of an institutional government rather than calling early elections. As expected, Mattarella said he had ruled out going to the polls in light of the current global health and economic emergency and the urgency with which the Recovery and Resilience Plan must be finalized. What he didn't say, but which I suspect also played a significant role in not calling elections now, is the fact that Parliament will need to appoint a new president early next year, a process with a reasonably predictable outcome with the sitting Parliament, but an extreme uncertain outcome after elections because of the new electoral system that will severely reduce the number of parliamentary seats.

What I had not expected was that Mattarella would turn to Draghi on this occasion. Draghi was widely understood to be eyeing the presidency in 2022, but of course when called upon by the president, he accepted the mandate to form a government – which probably complicates, but does not rule out, the presidency next year.

Draghi immediately started a round of consultations with the political leader, concluding the first round last night. He'll probably have it wrapped up by mid-week and if the outcome is positive, as I expect it will be, Draghi will announce the list of new ministers of (probably) both technicians and politicians, and the new government will be sworn in before next weekend.

The Draghi government must then face a confidence vote in both chambers of parliament within ten days to confirm that it has the support of a majority. We'll then know the size of the parliamentary majority in support of the government, and we'll learn the key policy priorities for the new government.

I'll first briefly summarize the key issues involved in getting a majority, and then discuss the policy agenda – both based on the immense amount of detail and analysis by my colleague, our chief Italian economist, Loredana Federico.

The majority to support Draghi:

Draghi will need a majority in both chambers of parliament. Assuming he'll get that, the issue is how big it'll be and hence how stable.

The key will be what the Five Star Movement (M5S) and League decide to do. After yesterday's first round of talks, both sounded supportive; reportedly League leader Salvini more so than M5S leader Crimi, but both conditional upon the policy agenda. (Draghi can count on the support of the Democratic Party, Italia Viva and centrist and pro-European groups, as well as the moderate Forza Italia (the Berlusconi party) and centrist MPs. The far right will oppose him.)

The most stable solution would presumably be for both the League and M5S to support the government. In this case, Draghi would command more than 90% of the vote in the Senate and broadly comparable in the lower house. But the support of either of the two parties would still hand him a solid majority on which to govern.

For the League to support Draghi, the lifespan of the government will be a potential issue as they are widely understood to prefer elections. That said, should they end up voting against Draghi government the League leadership would risk disenfranchising their more moderate electorate, especially among entrepreneurs in northern Italy, where also the most likely future challenger to Salvini may emerge.

Meanwhile, the M5S is having its characteristic open debate within the party (or movement) to decide what to do. The initial position, announced on Tuesday evening, was that they would not support a Draghi government, but Crimi sounded more open-minded yesterday. Judged from the media, there seems to have been a shift under way in recent days, suggesting a possible warming to Draghi. We could see M5S supporting Draghi, but with a number of defections in opposition, - or we could have M5S opposing Draghi, but with defections in opposition. Either way, Draghi might find himself with a narrow majority.

So, our bottom line is this: A very high probability of a Draghi government by the end of the week – but whether it'll command a solid, or just a narrow, majority remains to be seen. In either case, given the key task of addressing the pandemic emergency and the commitment to the Next Generation EU, you'll be looking at a government life of probably a year minimum, which then coincides with the election of the President of the Republic. This election will represent a critical phase for all political parties in parliament, with the potential to damage whatever harmony there may be within the majority supporting the Draghi's government.

Assuming Draghi wins a majority, here's the policy agenda – actually, it should be the policy agenda for any Italian government:

Most urgently, the health crisis and the associated economic crisis need to be addressed, of course. But they must not lose sight of Italy's more fundamental problems which have caused the past many years of growth underperformance. In other words, in addition to critical support to the health sector and the roll-out of the vaccination, fiscal stimulus will be needed to close the output gap ASAP. But when doing so, the bigger the share of short-term stimulus which also works to boost longer-term growth, the better.

A good first benchmark would be to get GDP levels back to the pre-pandemic level – and hence discretionary fiscal measures to make that likely. The outgoing government injected close to 6.5% of GDP in stimulus measures in 2020, along with a generous guarantee scheme and other measures. Yet, it still fell short of what was needed and of that of most other countries, most noticeably Germany. On most forecasts, including ours, Italy will be one of the last OECD countries to restore its end-2019 GDP level, namely only around 2023. That should not be an acceptable prospect for the incoming government.

In our assessment, that would require at least the same amount of national fiscal resources this year as last year, or more likely, a fiscal package more similar in size to the one proposed by Germany last year, moving closer to 8%. Of GDP. Of course, this goes without saying that the measures should be well targeted and properly managed in order to remain temporary to avoid further slowing of the adjustment of the budget deficit/GDP in the next few years.

Fiscal support will be essential for households and firms. Obviously, policies should be tailored to the evolution of the pandemic and the economy, starting with further extension of the measures that are likely to be contained in the next relief package, including (i) temporary resources for the poorest part of the population (with an eye to the recovery of private consumption) and for the wage-supplement schemes; (ii) liquidity support to alleviate the tax burden for firms; (iii) support for the most exposed economic sectors (hospitality, recreational services and transportation); (iv) resources for the national health system aimed at speeding up the defeat of the pandemic and completing the vaccination campaign (Italy has administrated 3,500 COVID-19 vaccinations per 100,000 people so far, higher than Germany and France, but still only one third of the US and one fifth of the UK figure); and (v) further resources for the schools.

In addition, the 2020 policy support was also – appropriately - channelled through the banking sector, mainly in the form of government-guaranteed credit, back-stopped by the ECB. The increase in bank loans pushed up Italy's corporate debt to around 75% of GDP in Q3, interrupting a seven year long deleveraging process which had brought the corporate debt down to 68% by the end of 2019; among the lowest in the eurozone. The Draghi government needs to address the risks connected with such an increase in firms' indebtedness. Short term, the guarantees will need to be extended, but longer term, incentives should be introduced to get firms to switch from debt to equity financing. In this respect, Italy will be in good hands with Draghi: Remember the Group of Thirty's steering committee, which Draghi chaired, on "Reviving and Restructuring the Corporate Sector Post-Covid: Designing Public Policy Interventions". The report is here: Reviving and Restructuring the Corporate Sector Post-Covid: Designing Public Policy Interventions.

Indeed, probably more than in any other country, when designing the short term relief measures in Italy, a view of how they'll impact longer term growth will need to be considered. As I have argued ad nauseum, Italy key problem is not the public debt level, but the years of insufficient growth – and no, the debt stock itself has not been a break on growth.

In the so-called economic recovery period between 2015 and 2019, Italy's GDP grew at an average pace of just 1.0% per year. The main driving force was labor input, with the employment growth rate being 0.9% on average per year, meaning that labor productivity growth was an almost non-existing 0.1%, on average. Those two issues – labor input and productivity – need to be top of the structural agenda for the incoming government.

Loredana has done more work on these issues than anyone else I know of, and these are a few of her key numbers to illustrate the issues from where one can relatively easily identify the policy priorities:

First, the issue of the growth in labor input: The Italian unemployment rate declined from slightly above 12% at the end of 2014 to 10% in 2019, when it was still 2.5pp above the eurozone average. In contrast, the trend in the labor force did not improve, with average growth of 0.3% in 2015-19, and seemingly stuck at the same pace of growth observed in the previous decade. This is not surprising because Italy has been facing a contraction in its working-age population, but this was barely offset by an increase in the participation rate (by about 1.8pp) to around 66% in 2019. This is unusually low for a modern economy. At the end of 2019, the male participation rate was 75% compared to 79% in the eurozone as a whole, while the female participation rate in Italy was just 57%, a whopping 12pp less than the eurozone average, and the lowest in the OECD area. To put it simply: If such a small share of the working age population is available to work, you won't grow – or have income levels – as well as others. And to complicate matters, the lockdown has led to a further decline in the participation rate, especially among women.

So, policy prescription number one is clear: Italy urgently needs to put in place measures to raise the participation rate, particularly for women. This includes access to quality childcare and measures to improve work-life balance, as well as tax incentives. (And yes, by boosting the labor supply, you'll also automatically boost demand as well because "supply creates demand", also in the labor market.)

Second, the meager labor productivity growth needs to be addressed. It is primarily the result of continued weakness in the capital stock - and of an increase in total factor productivity (TFP) of only slightly above zero. The ongoing decline (or, at best, stabilization) in the net capital stock urgently calls for a boost in private and public investment. In this respect, the resources allocated to Italy from the Next Generation EU represent a great opportunity. Italy's public investment was only 2.1% of GDP in

2018 (2.3% in 2019), as the obsession with the deficit and public debt continues to dominate the policy debate – and, like in any other country, when pressed for resources, investments are the politically "easy" ones to chop.

Hence, policy prescription number two is equally clear: Public investment must be boosted (and please stop obsessing about the fear that some part of it may be inefficient.) Not investing when interest rates are negative in real terms (let along zero or negative in nominal!) leaves a terrible legacy for the next generation – one many times worse than the (cheap) debt that would have financed the investment in better infrastructure, schools, healthcare etc. (Of course, this is not only a matter of resources, boosting public investment will also require measures aimed, for example, to accelerate administrative procedures and to continue to simplify the most complex aspects of the public procurement code, etc.) In addition, tax incentives should be considered to encourage private sector investments.

The roots of Italy's poor performance in terms of TFP growth are multiple and much harder to pinpoint, let alone prescribe the most effective policy adjustments, but a simple "best practices" in a number of areas from around Europe (or OECD) would be a good way of starting.

Our list would starts with: (i) reform of the public administration by increasing digitalization, and the opening-up of some local public services to competition, (ii) make it easier to start (and close down) business; (iii) judicial reforms to reduce the length of civil trials at all instances by enforcing and streamlining procedural rules; (iv) Italy needs to improve the quality of its human capital which requires a significant improvement in the Italian educational system; in this respect, among other things, there is the need to scale up the post-secondary vocational education and training system, to design bachelor degrees more in line with what the labor market needs.

Will Draghi be able to do it all? Of course not. But this is a crisis very different from the one Mario Monti faced when he became PM in 2011. For one, Monti was faced with virtually unanimous demands for fiscal tightening, while Draghi is facing a (almost as unanimous) demand for fiscal stimulus, along with some EUR200bn from the EU for structural reforms. And this in the middle of the greatest health crisis in anyone's memory. I'm giving Draghi good odds when it comes to putting Italy on a sustainable path to better growth.

2. The new US debate of what's the right amount of fiscal stimulus – and what we Europeans should learn from it.

So, also this past week, while we Europeans spent our time wondering what a Draghi government might mean for Italy and Europe, and – at least for some of us – raising hope of some additional sizable fiscal stimulus (while we keep wondering why the roll-out of the vaccination is going so slowly), the Americans didn't mess around.

On Friday, the US Senate and House passed the budget resolution, which is a blueprint for tax and spending bills this fiscal year, which opens the door to approve Biden's USD1.9 trillion (9% of GDP) mega plan – or whatever part of it ends up being agreed in the congressional committees – by reconciliation; i.e. with a simple majority and hence in the hands of the Democratic majority. However, given the razor thin majority, and the number of conservative democrats, it still does not seem realistic to think Biden gets his USD 1.9 trillion through.

As my colleague, Daniel Vernazza, discussed in our Friday Macro & Markets publication, we still think the US package will be scaled back to USD1.0-1.2 trillion. In addition to that discussion, you'll also find all our revised forecasts (relatively minor for Europe, but substantial for the US) in Friday's Macro & Markets. It's here, in case you missed it: UniCredit Macro & Markets Weekly - Transatlantic growth gap set to widen

Maybe triggered by the approval of the budget resolution, former Treasury Secretary Larry Summers triggered a fascinating economics debate in the US about whether the package may actually be too large. Summers points out that while the 2009 Obama stimulus (which he was a key architect of) was roughly half the size of the output gap at the time, this one (along with the December package) would be some three times greater than the present output gap. This makes him worry about inflation overshooting the Fed target by such a margin that it could trigger (usually recession driving) rate hikes. Summers also worries that such a big (mostly cash) stimulus will leave no spare capacity for the much-needed longer-term infrastructure investments.

Former IMF chief economist, now at the PIIE, Olivier Blanchard, tweeted that he agrees with Summers that “the 1.9 trillion program could overheat the economy so badly as to be counterproductive”, and when questioned, he doubled down this morning with a very illustrative tweet thread: In a nutshell, Blanchard points out that the US may have an output gap of up to USD 900bn (that’s the gap from present GDP up to where it would have been, had we continued along the pre-pandemic trend line.) Between the USD 900bn December fiscal package and the proposed USD 1.9 trillion, you’ll get USD 2.8 trillion in fiscal stimulus. He then adds an assumed “release” of half the population’s present USD 1.6 trillion of excess savings due to the pandemic, and you have USD 3.6 trillion in potential extra spending – or a whopping four times the upper bound estimate of the output gap. (He assumes a multiplier of 1, which he calls conservative.) This, he suggests, would lead not to “overheating” but to “a fire”, driving unemployment to zero and inflation to “potentially much more than” 2.5%. (If you believe like we do, that Biden will only get some USD 1.0-1.2 trillion through, then the “excess” stimulus, on Blanchard’s assumptions, would be roughly three times the output gap, which I’m sure would lead him to the same conclusion of the administration risking to start a fire.)

Former Obama economic advisor, Jason Furman, also stepped into the debate, sharing some of the same concerns as Summers and Blanchard, but not all, including about inflation moving too much higher. Furman argues that 3% would be okay (and a good opportunity to reset the target to 3%), while he sees 4% as excessive.

And Paul Krugman came in with two thought-provoking pieces. First, in a tweet thread Krugman wonders why anyone worries about output gaps in the middle of a major health crisis. He argues that just like in a war, in a national crisis you spend what it takes to win the battle as fast as possible, and you deal with the aftermath later on Second, while not directly reacting to this new specific debate, Krugman re-vitalized his economics blog on Friday with a great discussion of the Phillips curve, suggesting that its recent flatness may be a more structural and hence a longer-lasting issue. If so, as he points out, overdoing the stimulus relative to the output gap would eliminate unemployment, but it would hardly drive inflation higher. His very read-worthy discussion is here: Stagflation revisited.

As you’ll see in our Macro & Markets, when it comes to the effect on inflation of overdoing the fiscal stimulus we are closer to Krugman (and maybe Furman) than to Summers and Blanchard. We think that the structural disinflationary forces at work these past decades will persist at least for the next few years. As Daniel Vernazza points out, the Trump tax cuts basically closed the output gap, but didn’t lead to much higher inflation. Longer term, as I have discussed before, I think there is a lot to be said about the demographic forces as the key driver of inflation, as argued by Goodhart and Pradhan in their book from August last year (The Great Demographic Reversal.)

Here are the four key lessons I think we Europeans should take away from this latest US fiscal debate:

First, note that in the US, everyone agrees that the outlook is very uncertain and that policymakers should err in doing “too much”, rather than “too little”. And while US economists are now having this interesting discussion about the effects of fiscal stimulus on the order of 3-4 times the output gap, I – and other European “fiscal activists” – are getting push-backs for suggesting that European policymakers beef up their fiscal stimulus at just to match the output gap one-to-one. It’s in times like these I miss my years in the US… (a feeling, incidentally, which had seemed less pronounced these past four years.)

Second, note that nobody on the US side worries about public debt as an argument against doing too much. You can argue that is because of the US’ “exorbitant privilege” of being the issuer of the world’s reserve currency, but if so, I can only conclude that if that privilege comes with such a degree of fiscal policy room, then there can be no arguments left against the development of the international role of the euro, including via common debt and a risk-free yield curve, with a view to gain some of that same privilege for European policy makers. Or you can conclude that the lack of concern about public debt is all because they know that in the US fiscal and monetary policies, including the use of the Fed’s balance sheet, are playing in sync. (They do so too in Europe these days, and that will surely have to continue.)

Third, and meanwhile, on the issue of public debt, one has to accept the following two key facts: At zero – or negative – rates, it really doesn’t take much to make new debt productive for future growth, and that at such low rates there is a fundamental difference between “good debt” and “questionable” debt. As OECD chief economist, Laurence Boone, explained on l’eco this past week, “good debt” includes debt that finances a host of issues, including for health and education.

Fourth, if Summers and Blanchard are right and this US fiscal drive leads to higher inflation, it would indeed raise the risk of monetary tightening down the road, and that would, in turn, risk a recession then. But as Furman notes, 8% nominal growth made up of 5% real growth and 3% inflation doesn't feel like a particularly troublesome outcome. And to all you who always argue that markets can be trusted to send the right signals to policy makers (I disagree), you may have noticed that the US 5Y/5Y hasn't gone crazy.

Alas, it all leaves me increasingly convinced that we are heading into another 3-5 years of European growth under-performance relative to the US, something that was not the case in per capita terms prior to the European policy mistakes after the Great Financing Crisis.

During the last few speeches of his ECB presidency, Draghi spoke quite a bit about policymaking and how it should be based on "knowledge" (including of the knowns versus unknowns), "courage" (to act in the face of uncertainty), and "humility" (to recognize when those calculated risks don't play out as expected, and then adjust policies.) After showing a lot of courage in 2020, it now feels like the European fiscal response has frozen with fear of the unknown - or with excessive confidence in a stronger recovery from the pandemic than any main forecaster predicts.

At critical moments in his ECB years I'm led to believe that Draghi turned to the analysis and experience from the US to drive what ultimately turned out to be the right policies. I hope the Italian political establishment will back him in coming weeks and that he then proceeds to show the same type of analysis and courage he displayed in Frankfurt, hopefully dragging other European leaders with him in the process. After all, as Draghi himself said in January 2016: "We don't give up".

And with that, I'll leave you to enjoy the rest of your afternoon.

Best

Erik

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