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After the considerable growth of the Gross Domestic Product obtained also thanks to the economic policy action of the Draghi administration, the growth of the Italian economy next year will be significantly lower, a result, also, of the uncertainty factors that we list in this policy brief[1] and that are aggravating the ongoing slowdown. It is very likely that the differential between the growth rate and the level of interest rates will significantly worsen, something that is of crucial importance for determining the sustainability of the Italian public debt. The protracted gas crisis can push the economy into recession already this winter.

The European institutions are providing Italy with double support: concerning the increase in interest rates, Italy will be able to benefit from the support of the European Central Bank against any excessive increase in interest rate differentials; regarding growth, the European Commission will be able to disburse the expected funds of the National Recovery and Resilience Plan. However, both of these benefits are conditioned by the fact that Italy in the future must maintain the economic strategy it has followed in the last two years.

Both the intervention of the ECB and that of the Commission require strict compliance with the commitments undertaken. This is what Italian citizens must demand of those who are running for the office of prime minister in the upcoming national elections.

Macroeconomic framework

The war in Ukraine has exacerbated the uncertainty in an international macroeconomic framework already weakened by widespread bottlenecks in the supply of raw materials and strong inflationary pressure. The conflict is continuing beyond the initial expectations, creating substantial tension on the raw materials markets, especially gas, with growing repercussions on price dynamics. Due to the significant increase in inflation, central banks are raising interest rates. At the same time, the volatility of the currency markets is also growing. The severe restrictions implemented in China to combat Covid, in addition to affecting the domestic economy by slowing its growth, are causing negative effects on global supply chains.

[1] We are grateful to the members of the Strategic Policy Group of the Luiss School of European Political Economy, with whom the topics of this policy brief were discussed.

This scenario, in which downside risks prevail, has led the International Monetary Fund (IMF) to revise its global growth forecasts at the end of July. This year, global output is expected to grow by 3.2%, almost half a percent less than what was expected in April. The revision is even more significant (-0.7%) for 2023 when world growth is expected to be 2.9%.

For Italy, GDP growth should be well above 3% this year, almost a percentage point higher than the April projections.

Services and industry (both manufacturing and construction) contributed to the positive trend of the second quarter. Concerning demand, it was above all the use of services that drove domestic demand. For the second half of the year, the trend of the Italian economy seems destined to be affected by negative factors in the international scenario (America's slowdown, possible German recession, Chinese difficulties), something that is difficult to escape for an open economy like the Italian one. Furthermore, the effects on the credit of the European monetary tightening will become more evident. We cannot exclude repercussions on the spread linked to the worsening of Italy's political uncertainty. The risk of the worst case scenario (total cut off of gas supplies by Russia) remains in the background, but it would probably plunge many European economies, including Italy's, into recession.

Regarding inflation, the harmonized index reached 8.4% in Italy in August, a value that has not been observed since the 1980s. The trend in consumer prices is largely driven by increases in energy prices, but also in food and some services, such as recreation and transport. Recently, the core component, which excludes food and energy, has also started to grow rapidly, up to almost 4%, doubling compared to last spring. Wage growth remains moderate for the moment, also in connection with the delays in the renewal of some important collective agreements and with the persistence of significant underutilization of labor, but it is unlikely that in the medium term there will not be a push to increase wages. The growth of inflation is producing strong redistributive effects, which are weighing mainly on low-income families.

Public finance framework

Overall, the Draghi administration has left the public budget in order: in the first part of the year there was a marked improvement in the public finance balances compared to 2021. The cumulative requirements of the Public Administrations in the first six months of 2022, measured in terms of cash, amounted to approximately 41.7 billion, 43 billion lower than in the same period of 2021. The improvement is due both to the carry-over of the positive effects on revenues that were determined starting from 2021 and to the higher than expected trend of tax revenues, in particular, of indirect taxes, especially VAT, linked to the increase in inflation.

Thanks to the good performance of the public budget, the Draghi administration has financed energy interventions in the order of 30 billion since the beginning of this year, without making budgetary shifts with respect to the 2022 debt target set in the DEF at 5.6%.

According to the Report to Parliament presented by the Government on July 26, 2022, the net debt of public administrations for 2022 would be 0.8 percentage points of GDP lower than the policy framework indicated

in the DEF (-5.6%). In absolute value, the debt would be approximately 14.3 billion euros lower. Thanks to these resources, plus others for a total of 17 billion, the Government has launched a measure intended to counter the effects of the increase in the prices of energy products and more generally of inflation, as well as those caused by the water emergency.

It is important to emphasize that the intervention mainly consists of one-off measures. This is in order not to jeopardize the public accounts of the next few years and taking into account the limited scope of action consented to a resigning government that remains in office just to manage the ordinary administrative affairs.

New support measures for households and businesses have been announced in response to the recent dramatic increases in the price of gas. The government seems willing to find the necessary resources without new budgetary changes, while it is now clear that the budget law for 2023 will be prepared by the government that emerges from the elections on September 25.

Inflation and the cost of money

The surge in energy prices and the increase price pressure pushed inflation to 8.4 per cent in August 2022. Core inflation also accelerated, reaching 4.4 percent. The producer price index registered a change of about 35%, mainly due to the energy component, followed by intermediate goods. Businesses are transferring the rise in prices, even as profit margins have fallen and labor cost increases have so far been moderate. For households, energy price inflation rose to over 50% in March and the government had to step in to contain it with tax cuts. Poorer households are exposed to a higher impact of inflation due to the higher shares of energy and food in their total budget expenditure. Households in the lowest spending decile face an inflation rate of 8.5 percent, about one and a half times higher than the inflation rate of those in the top quintile. Also, in consideration of this, the state budget will be burdened by new interventions necessary to reduce the impact of the increase in prices on citizens in greater difficulty.

Financial market conditions have tightened as a result of the global decline in the degree of monetary accommodation. The increasing geopolitical tensions have also raised the degree of risk felt by investors. As a result, nominal yields on Italian government bonds began to rise in the course of 2022 and the differential with German Bunds stabilized above 200 basis points. Given the high level of inflation, the impact on the economy of negative real rates is still benign.

Expected inflation at the end of 2022 is over 6% in Italy and two points higher in the euro area. This could imply a relatively worse effect of the increase in real rates in Italy than in the other economies of the euro area. The sharp increases in the price of gas and the drop of the euro below par against the dollar will probably force the ECB to accentuate the tightening already at the next Governing Council meeting.

Banks tightened their credit standards in the first quarter of 2022, amid a 30% drop in bank stock prices since mid-February and the rollback of numerous regulatory and financial measures, according to the ECB's Bank Lending Survey of the pandemic era. After a rapid expansion over the past two years, the growth of bank

lending to the corporate sector has slowed, while lending to households remains positive. Interest rates for new mortgages are rising in response to rising market rates. We will return to the prospects of the credit market in the coming years later.

Additional factors relevant to the growth of the economy in 2023

Several factors are weighing on the forecast scenario, with growth that in 2023 is estimated to be much lower than in 2022: energy prices will remain high, even without assuming supply disruption scenarios; further increases in interest rates; the persistence of bottlenecks in global supply chains; and finally, a more stubborn inflation than has been considered so far.

In such a scenario, the erosion of real incomes will inevitably be felt and one of the probable consequences will be the reduction of aggregate household savings. Rising interest rates, lowering profit margins and the effects on confidence will weigh on private investment. In this context it is possible that there will be a reduction in net exports.

In this scenario, the implementation of the National Recovery and Resilience Plan (NRRP) will play a fundamental role. According to an IMF analysis, the cumulative increase in GDP deriving from public investments linked to the NRRP and from capital transfers can be estimated at around 13% in the 2021-2031 period, with a peak increase in the level of production of almost 5% in 2025 and 2026. To achieve more favorable results in terms of growth, several factors must be taken into account: the time horizon within which to place the impact of the Plan, the interaction between public investments and structural reforms, the spillover impact on Italy caused by public investments and the reforms of other European countries, and the role of private investments. The simulation exercises show that in the first years of the Plan (2021-22), demand-driven production gains are mainly supported by tax incentives for private investments, while the subsequent effects reflect the rotation of expenditure towards public investment. The realization of public investments at the best possible conditions will be essential for the Italian economy to overcome the uncertainty of the coming years.

In general, the effects of the NRRP on potential growth are expected to materialize mainly beyond the usual forecast horizons, but will significantly depend on the quality of new infrastructure and the successful implementation of structural reforms. In the medium term, income growth will in fact be driven by productivity growth which will be impacted by structural reforms. It should be remembered that structural priorities differ from country to country and that in the Italian case the priorities include civil and criminal justice reform, the insolvency framework and competition reform, as well as increasing the public sector's capacity to administer the Plan and strengthen public procurement.

In the long term, potential growth will increase only marginally (according to IMF estimates,[2] growth could settle just above 0.75%), something that is also held back by the country's demographic impoverishment.

[2] https://www.imf.org/en/Publications/CR/Issues/2022/07/28/Italy-2022-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-521484

This is a level that does not solve the country's financial stability problem in the absence of continuous attention to public finance balances and the maintenance of the cost of money at levels close to the euro-area average.

The economy in the face of monetary tightening

The uncertainty generated by the risk of recession and aggravated by the phase of political instability has affected the differential of Italian interest rates compared to those of other countries. To prevent the phenomenon from feeding on itself, the European Central Bank has announced the preparation of a specific stabilization instrument, the Transmission Protection Instrument (TPI), commonly referred to as the "anti-spread shield."

It is important to understand the innovative quality of the TPI, which differs from the Outright Monetary Transactions (OMT) launched in 2012 following the famous reassurance given by Mario Draghi to save the euro "whatever it takes."

The two tools share some aspects: in particular the absence of quantitative limits, implicit or explicit, to the action of the central bank. The goal is to create a strong deterrent for market participants to take positions contrary to that of the central bank. Furthermore, albeit in different ways, both instruments sterilize the effect of their use on the monetary base in order to avoid undesirable effects on the overall approach of monetary policy. Finally, in both cases, the decision to activate the shield falls, ultimately, within the prerogatives of the European Central Bank, in a discretionary manner, without any automatism, based on its assessments of market conditions.

Instead, the declared objectives of the two shields are different. The OMT, which was launched in 2012 in the face of strong tensions on the financial markets that were leading to the possible exit of some countries from the euro area, intended to ensure the integrity of monetary policy and its transmission to the real economy. The most recent TPI, adopted in a less dramatic phase, focuses mainly on the transmission of monetary policy in a phase of generalized increase in interest rates.

However, the main difference between the two instruments is related to cross compliance. It should be made clear from the outset that there are two types of requirements that must be met for the ECB to take action, those that are necessary and those that are sufficient.

Let's start with the necessary conditions. In the case of the MTO, a country must first negotiate with the ESM (European Stability Mechanism) an adjustment program or obtain a precautionary line. The ESM can grant financial assistance if this is considered necessary for safeguarding the financial stability of the entire euro area and of the member states. In the case of the adjustment program, assistance is provided in exchange for specific commitments to adopt fiscal and structural policies consistent with macroeconomic consolidation. In the case of the precautionary line, the ESM must certify that the country's situation and policies are sustainable. The decisions are taken unanimously by the ESM Board of Directors and subsequently ratified by the member countries.

The TPI does not require the use of the ESM. The new shield can be put in place for all countries that comply with the European procedures for coordinating economic policies. Four are mentioned. The first concerns the Stability and Growth Pact. In order to benefit from the new shield, a country must not have an excessive government deficit, or not diverge significantly from the planned path to exit from this situation. The second precondition concerns the absence of serious macroeconomic imbalances or policies to correct them. The third concerns the sustainability of the public debt. The fourth is compatibility with the implementation of the NRRP.

In summary, unlike the OMT, the TPI does not require a country to enter into negotiations with the ESM to obtain a precautionary line or to define an adjustment program, but rather to comply with existing recommendations relating to the coordination of economic policies. This represents an undoubted advantage, especially from a political point of view. First of all, the stigma of having to resort to external help is avoided, which often discourages and delays the request because this act is interpreted as the recognition of the failure of the government's action. Furthermore, it is not necessary to submit its adjustment program to the scrutiny of other countries, each of which could block it if it does not consider it appropriate. Finally, the ECB can intervene before a country's access to the financial market is jeopardized, which sometimes precedes the request for ESM support and which can lead to debt restructuring.

Some defects that discouraged the activation of the OMT had been partially overcome with the reform of the ESM launched last year, which in particular provided for a quicker procedure for obtaining precautionary credit lines. However, the reform of the ESM has not yet been ratified by Italy.

In summary, the TPI can also be activated in relation to countries that are in economic difficulties, such as a deficit of more than 3% of GDP or significant macroeconomic imbalances, if the policies are in any case in line with the recommendations and commitments already made with the European institutions. In fact, all European countries - including Italy - currently meet the TPI requirements. Italy currently meets the criteria of consistency with fiscal rules (absence of excessive deficits) and macroeconomic imbalances (it has excessive macroeconomic imbalances, but the European Commission has not activated the next stage of the procedure that requires the presentation of a Corrective Action Plan). In both cases, a new assessment will be made in May 2023, as part of the European Semester. The Commission's debt sustainability assessment procedure indicates a high medium- and long-term sustainability risk. Compliance with the fiscal recommendations criterion will be verified when the new government presents the new draft budget and the Commission issues its opinion. A fundamental aspect in this regard is that current expenditure grows at a rate lower than the potential growth rate of Gross Product. The Commission is also verifying the conditions of the NRRP to disburse the first tranche of 2022.

In the event that a country no longer fulfills one of the conditions envisaged - following a drastic change in economic policy regarding the consolidation of public finances, or reforms to reduce macroeconomic imbalances, or the measures agreed under the NRRP - the ECB would no longer be able implement the TPI. Once this is made public, it would expose the country to severe instability. Then there would be only the possibility of resorting to the OMT through the support of the ESM. The TPI therefore creates a strong

incentive for member countries to conduct economic policies consistent with the coordination framework of European economic policies.

Complying with the conditions necessary for the activation of the TPI does not, however, entail any obligation for the ECB. As with the OMT, the ECB reserves full discretion to decide whether the intervention is justified, based on the objectives indicated above.

The OMT has never been used, although several countries, such as Spain, Portugal or Ireland, already had a support program in place in 2012 agreed with the ESM. As mentioned above, the announcement of the OMT itself immediately produced significant effects. However, the spreads of various countries remained high, above 200 points for over a year, without prompting the ECB to intervene. Evidently the ECB considered that the rate dynamics triggered by mid-2012 no longer posed any danger to the integrity of the euro area and to the transmission of monetary policy.

Similarly, even if the criteria for activating the TPI are met, the ECB reserves the right to intervene at any time, without indicating target thresholds or making specific commitments regarding the level of the spread that should spark the transaction. The intent of the Central Bank is not in fact to replace the market in determining the prices of financial assets, but rather to prevent the development of destabilizing dynamics generated by self-sustaining expectations. The intervention aims to favor the proper functioning of the market rather than replacing the market itself. Therefore, it should not be surprising that the new instrument gives the ECB wide margins of operational discretion, while respecting the ex post reporting criteria envisaged for monetary policy operations.

The role of banks will be crucial, including in monetary policy

As already noted, the new TPI monetary instrument was introduced by the ECB with the aim of preserving the integrity of the monetary policy transmission mechanism (MTM), that is, the set of cause-and-effect relationships that, starting from the action of the central bank, spread throughout the economy, influencing, in particular, aggregate demand and through it, inflation and economic growth.

First of all, it must be said that in the last decade the MTM has operated in a completely different way than in the past, not only in the eurozone, but in all the main monetary areas, starting with the United States. While in the past this mechanism ran along a sequence of relationships between interest rates (from those controlled by the central bank, to varying degrees and with lags, onto the other rates, and from the latter to the demand for goods and services by households and businesses), in the last ten years or so, with interest rates squeezed to zero or relatively small negative values, the mechanism has not been able to operate through interest rates. Various studies have analyzed the way in which transmission took place under the Quantitative Easing (QE) regime, with results that were not universally shared. However, what matters most now is that, since interest rates have returned positive and are growing further, it is possible to refer to the extensive previous literature on the mechanism of transmission through interest rates, on which the consensus reached in the pre-QE years was much greater.

The studies conducted by the ECB on the MTM have led, in a nutshell, to four main results:

1. In all euro area countries, the intonation of monetary policy is best approximated by the level of the short-term money market rate: typically, an interest rate on interbank funds maturing around three months. This rate is influenced both by the actions of the central bank and by expectations of how the market, and the central bank itself, will move in the following three months.

2. In all euro-area countries, a key role in the transmission of monetary policy impulses is played by the banking system; in particular, by the supply of bank credit (both through prices and through quantities), which is in turn influenced by short-term interest rates. The eurozone differs in this respect from the United States, where the crucial role is played by the term structure of financial market returns, from the short to long term (up to 10 years and beyond).

3. In the euro area, the monetary transmission may differ from country to country because the market-driven component of the short-term rate varies in different jurisdictions. In particular, in countries experiencing a crisis of confidence, large short-term interest spreads can arise with respect to more stable countries, as occurred for example during the sovereign debt crisis in 2010-12. This is how the euro-area MTM may not work well and the single monetary policy may be jeopardized. Here the TPI can play its role as "defender" of the transmission mechanism, with interventions aimed at containing the spread in the short term.

4. To some extent, the MTM may also differ due to differences in national financial structures (for example, competition from strong banks, institutional characteristics of the mortgage market, greater or lesser presence of cross-border banking transactions, size of the stock market, and so on) or the sectoral composition of GDP (since different components of demand have different sensitivities with respect to interest rates). These differences are inherent in the economic structure and the central bank cannot eliminate them, nor should it attempt to do so. In conclusion, therefore, not all spreads are harmful, some are physiological and must be preserved.

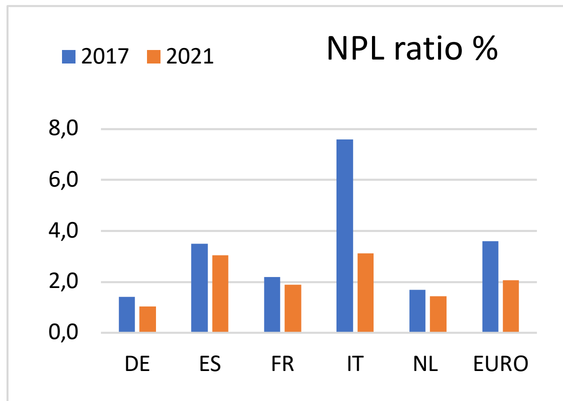
To be effective against the MTM, therefore, the TPI interventions should focus on the short segment of the market yield curve and pay particular attention to how these yields are transmitted to the banks' credit supply - cost and quantity.[3]

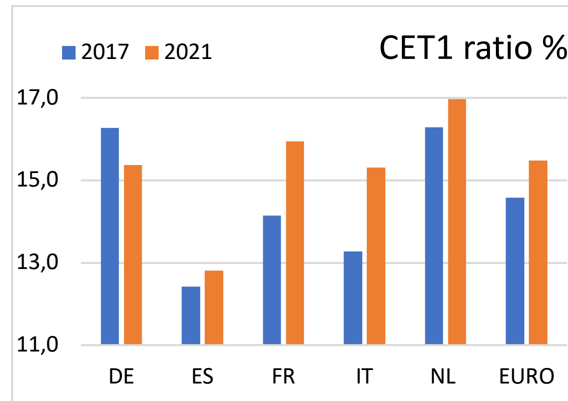
In light of all this, it is useful to take stock of the state of health of the Italian credit system. As known, Italian banks found themselves in serious difficulty in the years following the sovereign debt crisis, due to the high level of non-performing loans and their exposure to the national sovereign debtor, also subject to a crisis of confidence. The balance sheet restructuring called for by ECB supervision has led to a significant strengthening of Italian banks, measured both by the levels of capitalization and by the quality of assets. The strengthening, it is important to note, has continued in recent years mainly on the initiative of the banks themselves: the capital endowments of the so-called "significant" banks (the medium-large ones directly supervised by the ECB) have increased further and non-performing loans have reduced. The following charts

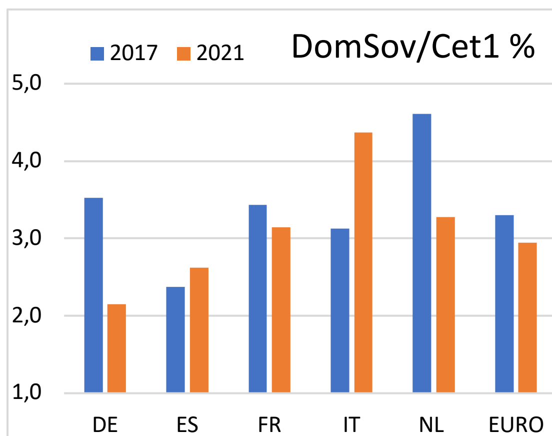
[3] The Bank Lending Survey and the supervisory findings collected by the ECB contain the necessary information for this monitoring.

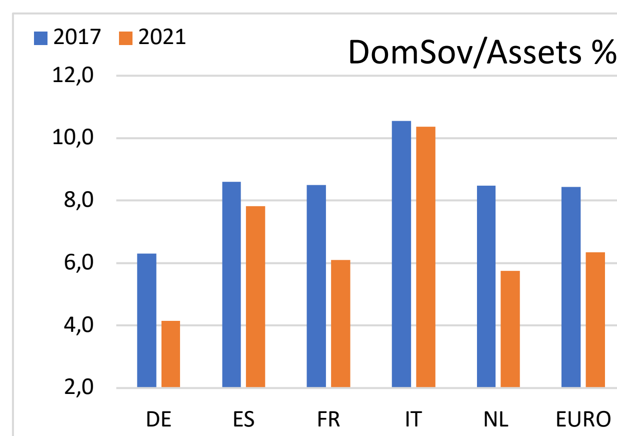
show that Italy's progress in the period from 2017 to 2021 was higher than that of the other main eurozone countries.

Bank indicators: 2017 and 2021









Source: ECB. NPL: Non-Performing Loans. CET1: Common Equity Tier 1 capital. DomSov: exposure towards the domestic sovereign.

At the same time, however, the exposure of Italian banks to the national public sector has increased more than in other countries. Banks in particular underwrote Italian government bonds during the pandemic period, cushioning the impact of the health crisis on the cost of servicing the public issuer's debt. It should also be noted that in Italy, contrary to what happens in other eurozone countries, the exposure to the state is higher for small and medium-sized banks (those not directly supervised by the ECB) than it is for larger ones.

The condition of Italian banks has therefore improved considerably over the last ten years, in terms of balance sheet strength and quality. The good results of the balance sheet achieved by the main banks in

the most recent quarters confirm and reinforce the positive opinion. All this bodes well for the future, meaning that the transmission mechanism of the ECB's policy on the Italian economy will not be significantly distorted by the precarious condition of the banks, as has probably happened in past years. A further strengthening must go through a reduction of the exposure in sovereign debt securities by both the major banks and especially the medium-small ones, and through the further reorganization of some banks, mainly medium-small, which remain weak.

Conclusion

The Italian economy in general has thus far appeared 'resilient' in an economic climate disrupted by the increases in the price of gas. The boom in services, in particular in tourism, has supported the growth in demand beyond expectations. The banking system is on the whole well capitalized, while households and businesses have limited debt and no major financial imbalances can be discerned. The public budget is on the whole under control, despite the significant increase in current expenditures, in particular due to the support offered to households and businesses to cope with increases in energy prices.

On the financial front, the main source of potential instability lies in the high public debt, which will expose Italy to the reaction of investors if the orientation of the new government deviates from the commitments made so far. The next budget law will have to move on a narrow path, bound by the need to finally start reducing the debt/GDP ratio.

In the near future, containing the imbalances will largely depend on the ability to deliver the NRRP, boosting productivity growth.