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Italy and Next Generation EU: Economic and Political Unknowns

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Key Points

- Italy's ambitious Recovery and Resilience Plan is on track. Having met the objectives and milestones it was supposed to by mid-2022, the Italian government has requested another €21 billion instalment from the European Commission under Next Generation EU.
- Despite the risk of a recession-induced sovereign debt crisis at the beginning of the pandemic, Italy quickly returned to strong growth. This trend continued until the beginning of 2022, before the war in Ukraine and supply-chain problems led to a worsening economic outlook.
- The monetary policy tightening expected from the European Central Bank (ECB) in July and September to counter eurozone inflation has added to concerns over Italian growth and hence the sustainability of the country's public debt. Given the size of its economy, Italy's fiscal problems could have devastating consequences for the eurozone.
- There is uncertainty too as to whether Prime Minister Mario Draghi will be able to deliver further reforms envisaged under its Recovery and Resilience Programme before the next general election due in spring 2023, the outcome of which will be very consequential for Italy's long-term growth.

So far so good for Italy's Recovery and Resilience Plan

Intended to support economic recovery following the COVID-19 pandemic, Next Generation EU (NGEU) is now in its full deployment phase. The EU is currently projected to use €504 billion out of the maximum allocation available (€723.8 billion) under the Recovery and Resilience Facility (RRF) (European Parliament 2022). On 24 June 2022, the European Commission (2022a) announced its plans to issue a further €50 billion of EU-Bonds between July and December, to be complemented by short-term funding (EU-Bills) (European Parliament 2022).

Italy's Recovery and Resilience Plan is the most ambitious under Next Generation EU (Tesche 2022). Totalling €191.5 billion, the loans and grants provided by the EU to Rome amount to 26.5 per cent of the entire RRF, equal to 10.7 per cent of the country's gross domestic product (GDP) in 2019 (European Parliament 2022). Italy received €24.9 billion in pre-financing from the EU in August 2021 (European Parliament 2022), with the disbursement of further payments dependent on progress in implementing the plan.[1] In December 2021, Rome submitted a first payment request worth €21 billion in grant and loan instalments, which on 28 February 2022 was positively endorsed by the European Commission (2022b). By 29 June 2022, Italy had completed 45 objectives and milestones to be achieved by the first semester of 2022 under the country's Recovery and Resilience Plan (Ministry of Economy and Finance 2022). A second payment request worth €21 billion was therefore disbursed to the European Commission by the Italian government.[2]

[1] For a detailed overview of Italy's Recovery and Resilience Plan, its missions and resources see the dedicated website ItaliaDomani.

[2] For a detailed overview see the dedicated press release available on the website ItaliaDomani.

From a robust recovery in 2021 to lower growth, inflation and rising spreads

Italy looked to be on the cusp of a sovereign debt crisis at the beginning of the pandemic as unforeseen expenditure on healthcare and social security added to the country's already high debt levels. But Italy quickly returned to strong growth thanks to negative interest rates and the promise of nearly €200 billion in EU recovery funds. This trend continued until the beginning of this year, before being abruptly interrupted. Unprecedented factors – such as the spike in energy prices due to the war in Ukraine and squeezed supply chains since the pandemic – changed that outlook drastically (Tamma 2022a).

After a fall of nearly 9 per cent during 2020, Italy's output rebounded by 6.6 per cent in 2021. GDP growth is now expected to moderate to 2.4 per cent this year and to slow to 1.9 per cent in 2023 (European Commission 2022c).[3] Although the Recovery and Resilience Plan will likely mitigate some of the negative impact of supply disruptions and uncertainty on investment, Italy remains the second biggest European gas importer after Germany. With gas constituting 40 per cent of Italy's total energy consumption (Reuters 2022), the main risks to its economic outlook are higher energy prices and uncertain supplies (OECD 2022). Italian inflation rose to nearly 7 per cent in May (Tamma 2022a), the highest level in over two decades, largely driven by energy prices. Despite Rome's willingness to introduce a price cap on Russian gas imports, the idea was met with resistance by other EU capitals for fear that it could trigger further retaliation by Moscow (Tamma 2022b).

Faced with inflationary pressure, the ECB is expected to tighten monetary policy in July and then again in September to counter eurozone inflation which is four times higher than the ECB's 2 per cent target.[4] The bank is also ending government bond purchases, which started in 2015 and were ramped up during the pandemic to keep interest rates low and borrowing cheap.

A tighter monetary policy would drive output down in all eurozone members. But Italy is especially vulnerable because a return to lower growth could reignite concerns over the sustainability of the country's government debt. On 14 June, the spread between Italian and German 10-year government bonds reached 237 basis points, its highest level since the pandemic began and an indicator of growing financial market concern over Italy. Although the spread fell to 184 points by 1 July, fears that it might spike once again remained.[5]

Given the size of its economy, an Italian sovereign debt crisis could have devastating consequences for the eurozone as a whole. For this reason, the ECB's announcement that it is developing an anti-fragmentation instrument to limit the divergence in eurozone borrowing is welcome, even if further details are required on how and whether this new tool will work (Lagarde 2022).

What's next: Italy's 2023 general election

At a meeting in Brussels on 24 June 2022, EU leaders disagreed on whether to contain skyrocketing energy prices and their inflationary effects through government handouts, joint borrowing, or energy price caps. Those divisions left open the question of whether the EU can maintain unity in the face of growing economic difficulties, especially because Russia's invasion of Ukraine is turning into a war without a quick resolution. Within this context, scepticism is growing as to whether Prime Minister Mario Draghi will be able to deliver the reforms envisaged under Italy's Recovery and Resilience Programme

[3] According to the OECD (2022), Italy's GDP growth is expected to be 2.5 per cent in 2022 and 1.2 per cent in 2023.

[4] According to the most recent forecasts of the European Commission (2022b), Italy's inflation rate is expected to reach a peak close to 6 per cent in 2022 and reach an average of 2.3 per cent in 2023. Data are available here.

[5] Data on the bond spread between Italy and Germany are retrieved from Borsa Italiana and are available here.

before the next general election due in spring 2023.

Amid expectations of further political stalemate, there is the possibility that any political coalition winning next year's elections may lack a sufficient parliamentary majority to form a stable government (Tamma 2022b). The main reason why Draghi was appointed Prime Minister was to ensure that Italy would fulfil the commitments it undertook under Next Generation EU. However, now that political parties are preparing for next year's elections, frictions within the government and its majority are widening, thereby making Draghi's task increasingly challenging. Last week, the Five Star Movement (currently, the largest party in parliament) split over providing weapons to Ukraine. Although the Movement confirmed its support for the government, it is far from clear how long such commitment will last (Breda 2022).

As elections approach, the greater the likelihood of further political infighting taking place, making it increasingly difficult for Draghi to keep his majority focused on the reform agenda under the auspices of Next Generation EU. The outcome of next year's legislative elections will be very consequential for Italy's long-term growth prospects, as the willingness of the future Italian government to steer the country's finances to healthier territory is by no means guaranteed. Right-wing eurosceptic parties, Brothers of Italy and the League, are polling at nearly 40 per cent, ahead of any left-wing alliance between the social democratic PD and the Five Star Movement (2022b).

Despite such developments, the local elections of late June were won by the centre-left coalition rather than right-wing parties. There is thus considerable uncertainty over the outcome of next year's Italian elections and with it the impact of Next Generation EU on the Italian economy.

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Further Information

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