The Rimini Platform

78 – 8 February 2021

Key points

- We look into the likely agenda and the chances of success of a Draghi premiership in Italy, in particular drawing from a wide-ranging speech he gave in Rimini in August of last year.

In Rimini in August 2020, Mario Draghi gave a speech which in retrospect could well define his action if he manages to summon a parliamentary majority and becomes Italy's head of government. The main point, from a macroeconomic point of view, was on a distinction between "good" and "bad" debt. Good debt funds productive, future-oriented expenditure which will enhance potential growth and ultimately strengthen the sustainability of public finances. This is very close to Larry Summers re-jigged brand of Keynesianism with a strong focus on fiscal action, in a context of low interest rates, taking the lead in the fight against secular stagnation. This resonates particularly well in Italy given its low potential growth.

This is not the first time a respected non-political personality with strong European credentials become Prime Minister in Italy – it is actually a fairly usual pattern. These experiences deal well with emergencies but fail to tackle the long-term structural issues with the kind of ambition Mario Draghi sketched out in his speech ("taking inspiration from those who were involved in rebuilding the world, Europe and Italy after World War II").

We see two differences with the Mario Monti experience of 2011-2012. First, Draghi is not tasked with delivering fiscal austerity together with potentially unpopular structural reforms. Quite the opposite. He could draw on the EU's Recovery and Resilience Facility as well as on the ECB's insurance against market pressure. Second, Monti appointed a purely technocratic government. The latest reports suggest that representatives of the parties supporting Draghi would be in cabinet. This matters. The political personnel need to take ownership of the policies in front of public opinion. This would make it more difficult to withdraw support if and when "the going gets tough".

The Rimini speech also called for a reform of the European economic framework. This will be crucial for Italy, and hence for the fate of the whole monetary union. A structural reform platform primed by public spending will need time to prove itself to the markets. The fiscal surveillance system needs to evolve. As President of the ECB, Draghi did wonders thanks to Angela Merkel's silent support (her refusal to criticize him for his unorthodox monetary policy). As, potentially, head of government of the Euro area's third largest economy, he will have to get explicit support for a new framework.

Why would it be different this time?

Last week we expressed our concern about the relative performance of continental Europe, lagging on vaccination – and hence on the timing of economic reopening – and at risk of taking over the US role as the prime "generator of political noise". While we see little reason today to be much reassured about the first point, at least **we have seen a key improvement on the political side with the news of Mario Draghi's appointment as potential Prime Minister by President Mattarella.**

The very positive reaction in the market is understandable. In the short-run, assuming he finds a majority in both houses of parliament, this reduces the odds of early elections in Italy, with the significant risk of victory by opposition parties which – at least until recently – professed little liking for the European Union. In the medium-run, a Draghi-led government raises the odds that the EU transfers channelled through the Recovery and Resilience Facility would be directed at addressing long-term structural issues in the Italian economy which have been the root cause of investors' questions about public debt sustainability there. Finally, the arrival of Mario Draghi at the European Council would boost leadership capacity at a time when Angela Merkel's looming retirement will unavoidably create some uncertainty.

Your humble servant first learned his craft as an economist covering Italy in the run-up to qualifying to the monetary union in the mid-1990s and upon writing the paragraph above could not escape a sense of "déjà vu". **The Euro area's third economy has already been through several similar cycles**. Traditional politics fail to agree on a policy stance or come up with one which is met by massive market scepticism. Catastrophe is averted because the checks and balances within the Italian institutional system – in particular the role of the President of the Republic – make it possible to appoint at the helm of government a well-respected, extremely skilful and "Brussels compatible" Prime Minister who assembles a dream team of technocrats to turn the policy stance around. Market pressure recedes, and in due course the well-respected "technical PM" gives way to "traditional politicians" again. These "last chance" cabinets usually have just enough time and political space to deal with the emergency, but they never get to do "whatever it takes", to borrow words from Mario Draghi, to deal with Italy's structural issues.

We could use a simple yardstick to assess Italy's macro performance: potential GDP growth. In Exhibit 1 we chose to present the estimate by the OECD but using another source such as the European Commission would not change the general story. Italy's potential growth was on par with Germany and France in the early 1990s (if not higher). It has had the worst decline of the three to the point that the OECD now estimates it to be negative. This is what makes Italy's debt sustainability threshold so problematic. In short, Italy needs zero to negative real interest rates or else is sentenced to endless, and often counterproductive fiscal austerity.

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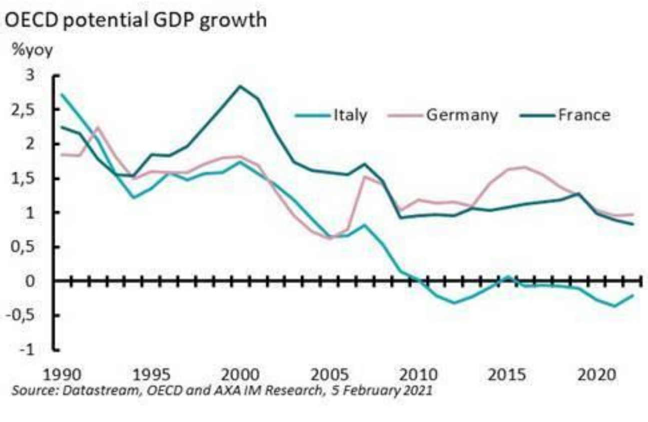
Exhibit 1 – why Italy needs negative real interest rates



There are however reasons to think "this time may be different". What has plagued most technical governments in the past has been the obligation to deliver fiscal austerity at the same time as structural reforms triggering thorny distributional issues. The last example of this was Mario Monti's experience from November 2011 to December 2012 (he remained PM until April 2013 but in care-taker position). While Italy could not count on the Euro area emergency support (the European Stability Mechanism backed by potential ECB intervention on the bond market was not ready when he took office) and under severe market pressure, Monti was brought in to deliver a tough fiscal package, which he did in December 2011. According to the EC, the structural balance of Italian public finances tightened by 2 % of GDP between 2011 and 2012, adding to the ongoing recession, which lasted until Q1 2013. In this already challenging environment, Monti embarked on a series of ambitious reforms, focusing on i) liberalizing the labour market (Fornero reform) and ii) opening more professions and services sectors to competition.

It is therefore not surprising that in such environment Monti found it increasingly difficult to compose with parliament. For instance, half of nominally free-market PdL parliamentarians – Berlusconi's movement at the time – abstained on the Fornero reform. After having formally lost PdL support, Monti chose to form his own party to fight the February 2013 elections but secured only 10% of the votes. In hindsight**, Monti's experience can be credited with generating goodwill from core Euro area countries at the height of the sovereign crisis**, which was crucial in making it possible for the ECB under Draghi to design the Outright Monetary Transactions (OMT) framework which ultimately dealt with the peripheral crisis**. But the long-term impact on Italy's economy was limited.**

Unlike Mario Monti, Mario Draghi would be under no short-term pressure to deliver any significant fiscal consolidation. He is getting help from the fiscal and monetary arms of the EU. Grants worth c.4% of Italian GDP will come from the Recovery and Resilience Facility, of which 2 thirds in 2021 and 2022. Of course, this may look rather small in comparison with the size of the current fiscal deficit, but the latter is inflated by one-off stimulus measures while post-pandemic normalization should trigger a mechanical improvement of the cyclical component of the government's balance. The ECB's Pandemic Emergency Purchase Programme will help contain any market-led tightening in financial conditions in Italy – and anywhere else in the Euro area - until March 2022 at least. The recent political crisis in Rome which broke the coalition came from a dispute on allocating more spending, not on arguing where cuts should be made. Draghi has the time and policy space to focus on how the RRF grants should go to underpin an acceleration in Italy's trend GDP growth, which would reassure investors about medium-term debt sustainability.

In a speech in Rimini on August 18th, 2020, Mario Draghi set out in very general terms a programme which in retrospect may well have been the founding stone of his current endeavour: *"this rise in debt will be sustainable – that is, it will continue to be funded in the future by European institutions, by savers, by markets – only if it is used for productive purposes: investment in human capital, in crucial infrastructure for production, in research. In that case, it will be seen as "good" debt. If, however, debt is used for unproductive purposes, it will be seen as "bad" debt and its sustainability will be eroded".* In his time at the ECB Mario Draghi loved to draw on apparent paradoxes to express his strategy. For instance, he loved to explain that ultra-low interest rates today were a condition for positive interest rates in the future, as they would contribute to re-start the economy and inflation expectations. His "Rimini platform" follows a similar pattern. More leveraging today is key to debt sustainability tomorrow – as long as this additional debt goes towards lifting growth and hence future capacity to repay.

Draghi can play on a complete change in the Zeitgeist. 10 years ago, the exponents of Ricardian equivalence under various sophisticated guises – quite often Italian economists by the way – were holding sway on the profession and profoundly influencing policymakers, arguing against the efficiency of fiscal policy under almost any circumstances. This was the "intellectual atmosphere" in which Monti had to operate. Today, Draghi can draw on the narrative put together by Lawrence Summers for instance – a keynote speaker of the ECB's annual conference in Sintra under Draghi's mandate - on the need for productive fiscal expenditure to take precedence over monetary policy to deal with "secular stagnation".

Looking for the right mix

The key to Draghi success may well lie in the right dosage of "traditional politicking" and technocratic style in the government he is about to assemble. Monti chose not to compromise much with the usual Italian political personnel and opted for a 100% technocratic cabinet. This probably did not help his reformist agenda, for two reasons. First, politicians may be more skilful in packaging and delivering unpopular measures. Second, parties nominally supporting Monti in parliament felt little ownership of the package since none of their figureheads were associated in public opinion with any of the flagship measures. This made it easier for them to distance themselves from the executive when resistance to austerity and reforms flared up. **It is actually a very political government which brought about some of the most visible changes in Italy's macro management**. We look at two simple indicators: the OECD's index of strictness of employment protection and the World Bank's "ease of doing business".

Exhibit 2 – More a Renzi than a Monti effect…

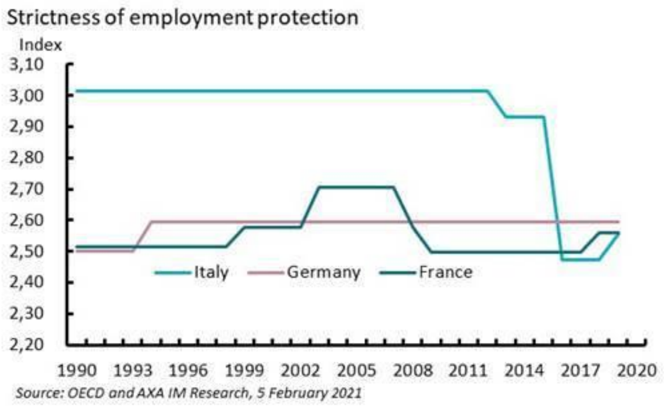
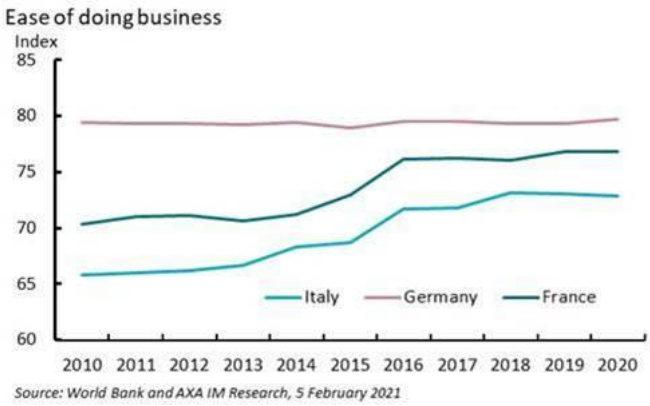


Exhibit 3 - …but still some gap to fill



The diluted Fornero reform triggered some liberalization of the Italian labour market but Exhibit 2 plainly shows that Italy converged towards the French and German levels on this metric only later, as a consequence of Matteo Renzi's "Jobs Act". The action of his government (February 2014-December 2016) is also quite visible in the World Bank index (see Exhibit 3). Renzi ultimately had to leave office not because he had failed on the economic agenda on account of unpopular reforms, but essentially on an institutional issue – his attempt to strengthen the executive branch in Italy in a referendum which backfired.

At the time of writing negotiations towards granting a Draghi government a majority look promising. The populist parties are facing a difficult choice. On paper, Mario Draghi should be anathema to 5 Star given their misgivings about technocrats and their "complicated" approach to Europe, but the likely alternative – accepting early elections – is profoundly unpalatable to them given their current slide in the polls. The movement's founding father Beppe Grillo gave his blessing to the "Draghi experience", which should tilt the party towards participating, although a split of the parliamentary group is a significant risk. On the other side of the fence, it would probably be in Lega's tactical interest to "sit it out" and stay in opposition to a Draghi government tilted to the left, especially given the growing competition from Fratelli d'Italia on their right, but the party is divided. Salvini had taken the party further towards a Eurosceptic and dirigiste direction, but he has been struggling in the polls these last few months, leaving space to the "old" Lega close to the business community in the North, which is probably more than ready to support a Draghi government.

Still, if Draghi secures a majority, key for us will be the balance between technocrats and politicians in his cabinet. On Sunday night, according to Corriere della Sera the discussions were pointing to a "mixed government", with technocrats and politicians sitting together, with a numerical dominance of the former. Of course, the counterargument to our point on Monti's mistake in choosing a purely technocratic cabinet is that accepting too many political appointees could dilute the reform agenda and "smother Draghi under too much support", with his platform becoming less visible, weighed down by too many potentially contradicting compromises with the different parties. However, **press reports from Rome this weekend would suggest that Draghi's offer to the various parties can broadly be seen as defining a sort of "broad tent" neo-Keynesian synthesis**: to 5Star Draghi has seemingly promised to keep the principle of their flagship "citizen income", together with a digital and environmental transition plan (the latter would help get centre-left PD on board as well). We note by the way that dedicating a large share of the RRF transfers to such transition is actually a condition for their disbursement, so Draghi here would be leveraging the European deal to ease his political position domestically. To Lega he would promise an unspecified tax reform. In short, **the absence of immediate fiscal pressure is showing**. It is possible that Draghi would use these elements to placate the parties and get some peace and quiet on the parliamentary front, while focusing himself on the definition of Italy's national "recovery and resilience programme" to allocate the RRF transfers and press on with the structural reforms.

Keeping the parties "in" for as long as possible is crucial as Italy's ride will probably get tough at some point. **Before engaging in any structural effort, any new Italian government will have to deal with the immediate pressure of the pandemic** even if the very latest dataflow for Italy is encouraging. As can be seen in Exhibit 4, Italy had to deal with the second wave earlier than many other countries but has also brought it back under some sort of control faster. Because of the stringency of the restrictive measures at the end of last year, Italy's economy underperformed the rest of the Euro area: GDP fell by 2% there in Q4 against 1.3% in France while Germany and Spain had positive readings. However, the drop in new infections and lower pressure on healthcare are currently prompting the Italian government to relax mobility restrictions on a regional basis, with museums reopening and restaurants in daytime. This should boost Q1 2021 GDP but Italy just like the rest of Europe may still have to deal with more contagious variants of the virus which could force a relapse. Italy is ahead of the other big European countries with its vaccination programme, but it still very slow compared to the UK and the US (see Exhibit 5) and the country is very far from collective immunity.

Exhibit 4 – Italy had an early but better controlled "wave 2"

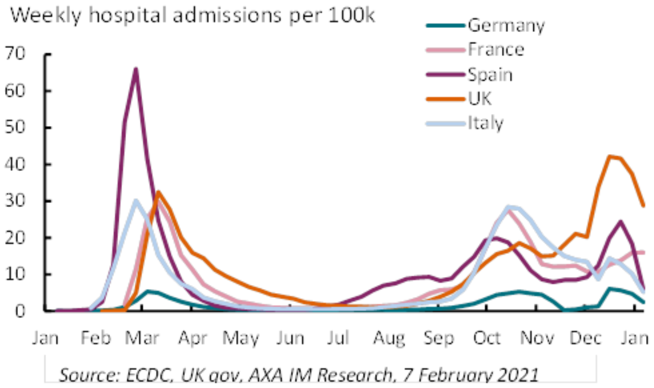
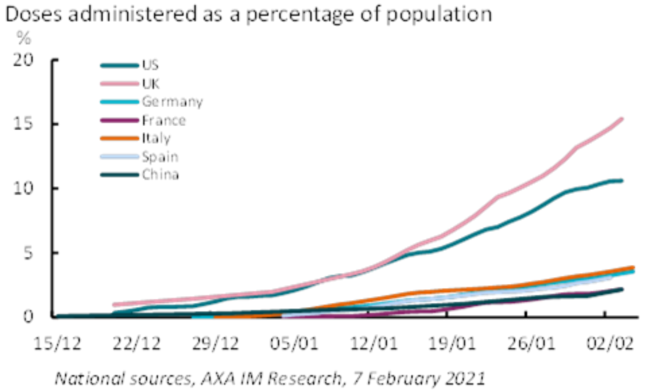


Exhibit 5 – Ahead of the EU pack on vaccination, but still slow



Looking ahead, once the immediate impact of the pandemic is dealt with, Draghi would have a lot on his plate on structural issues. In this speech in Rimini, he insisted on the impact of the crisis on the younger generation and the loss of human capital. This is a specific challenge in Italy where the quality of the education system is lower than in France and Germany (see Exhibit 6), when taking the average of the PISA scores in the three dimensions.

Exhibit 6 – Italy's education system needs a boost

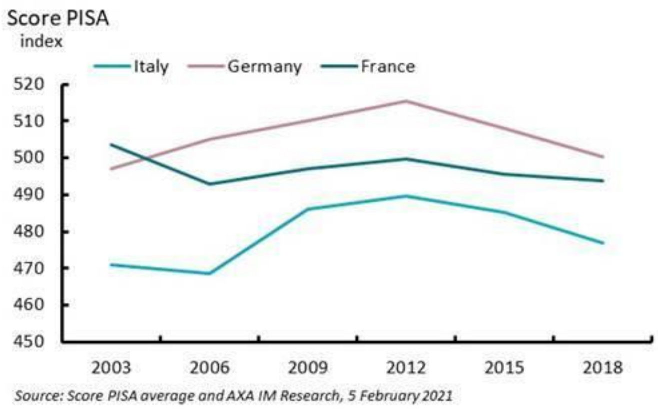
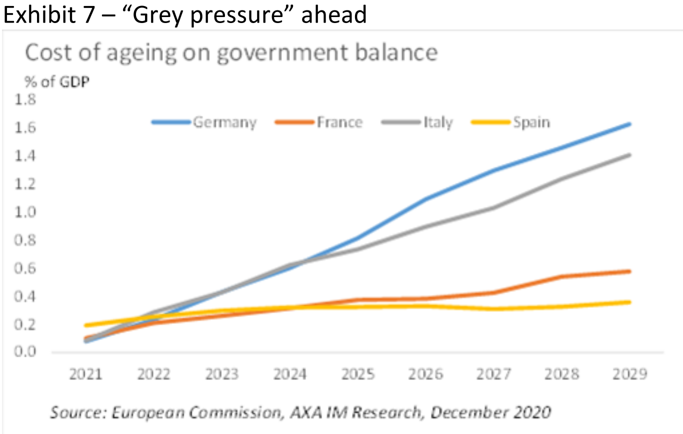


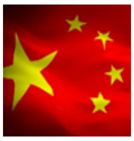
Exhibit 7 – "Grey pressure" ahead



More spending into education is a necessity in Italy, but even with support from the RRF, competition for scarce government resources will be rife. Indeed, the country's challenging demographic situation will add specific pressure on public expenditure in the coming decade, via pension and healthcare spending (see Exhibit 7).

The success of a "Draghi experience" in Italy - may largely depend on further reforms of the overall macroeconomic arrangements of the Euro area. Draghi in his Rimini speech made it clear he thinks the current framework, organized around the Stability and Growth Pact, although necessary in its principle, is obsolete: "it is likely that our European rules will not be reactivated for a long time and certainly not in their current form. So, our search for a new sense of direction must, in the same way, entail immediate reflection on their future shape”.

On the European policy side, 2021 is already sealed: the ECB has defined its stance for the whole year and a bit beyond, and the usual fiscal surveillance system has been suspended and great leeway has been provided to member states on how they tackle the current crisis**. 2022 will be more complicated.** The German position is going to be crucial, as usual. On the domestic fiscal front, CDU, after toying briefly with prolonging the suspension of the constitutional debt brake, reverted to orthodoxy and seems to pledge a quick return to balance. However, the party is likely to be forced into another coalition after the next elections which casts a doubt on this stance. How Berlin would opine on the European side of the fiscal equation is even less clear. Again, the new “zeitgeist” seems to have taken hold in Germany as well, and the new CDU leader – Armin Laschet - seems to be following Angela Merkel ‘s approach to European matters. Still, as President of the ECB, Mario Draghi mainly needed Merkel’s silence – i.e., a tacit acceptation of the distance the central bank was taking from the received understanding of its policy framework. Now, as potentially Prime Minister, he will need the German government to explicitly agree on a new setup for fiscal surveillance, allowing him enough time to push his reformist agenda through. Draghi did wonders in Frankfurt. He can repeat this in Rome. But he is taking on a gruelling challenge.

Country/Region	What we focused on last week	What we will focus on this week
	• Virus cases continue to retreat, disrupted some vaccinations • Payrolls rose in Jan, but up only 49k from a downward revised 227k in Dec. But unemployment fell back to 6.3% from 6.7% • Democrats make plans to pass $1.9trn stimulus through reconciliation • Vehicle sales hit pre-Covid high of 16.6m in Jan • Weekly consumer conf softens again in latest • ISM indices remain broadly at robust levels	• Beginning of Trump impeachment trial in the Senate • Ongoing falls in virus cases and smooth vaccine rollout • CPI inflation (Jan) expected to inch higher to 1.5%yoy • Consumer sentiment Feb (p)
	• Statistical or temporary effects pushed EA HICP to 0.9%yoy, with core jumping 1.2pp in January • EA Q4 GDP shrank less than expected by 0.7%qoq, confirming that economies are coping better with restrictions • ECB PEPP details showed no significant deviations from capital keys • Draghi tasked to form a technocratic government	• December Industrial production data to show continued growth momentum • The European Commission will release its Winter Forecasts • Catalonia region going to polls next weekend
	• BoE left policy unchanged. It instructed to banks to make negative rates feasible from 6 months but stressed this was not a signal of intent. We continue to expect further QE, +£75bn in May • >10m people vaccinated, virus cases continue to fall. Quarantine from int Covid hotspots 15 Feb. • January PMIs revised higher from initial estimates	• UK Q4 GDP growth estimate, we expect +0.4% q/q after stronger November • RICS housing survey to guide ongoing demand strength post Stamp Duty return • BRC retail sales monitor gauges impact of January lockdown on spending
	• The number of new cases halved but PM Suga extended the state of emergency until 7 March • Both PMIs remain in contraction territory. Manufacturing PMI is flat at 49.8 vs 49.7 in December while services PMI slightly declined to 46.1 from 47.7	• Bank loans is expected to remain flat, close to 6%yoy • The IPSOS-Thomson Reuters IPSOS-Thomson Reuters household confidence survey in February is expected to decline due to tightening restrictions
	• Weaker PMIs suggest the economy lost some momentum as social restrictions tightened against the virus resurgence • PBoC injected liquidity to ease fears over monetary policy tightening	• Inflation readings should improve due to rising food prices ahead of lunar new year
	• Preliminary Q4 GDP yoy fell 2.2% for Indonesia, 5.1% for Czech Rep. Russia 2020 GDP at -3.1% • EM central banks on hold across the board (India, Thailand, Poland, Czech, Ghana, Egypt) • Jan PMI throughout EM edged slightly lower • Indian central government budget retains growth focus, pursuing an expansionary	• CB meetings: Philippines, Russia, Mexico, Peru – expected on hold • Jan CPI in India, Brazil, Mexico, Argentina, Hungary, Ghana, Egypt, Ukraine • Q4 preliminary GDP: Malaysia, Poland • Ecuador presidential elections –1st round as front runners likely lack majority

Upcoming events	**US :**	Tue: NFIB small busi. optimism (Jan); Wed: CPI (Jan), Wholesale inventories (final, Dec), Fed Chair Powell speaks; Fri: Michigan consumer sentiment (prel., Feb)
	Euro Area:	Mon: Ge, Sp IP (Dec); Tue: Ge CA, TB (Dec), It IP (Dec); Wed: Ge HICP (final, Jan), Fr IP (Dec); Fri: EA IP (Dec), Sp HICP (final, Jan)
	UK:	Tue: BRC Retail Sales Monitor (Jan); Thu: RICS Housing Survey (Jan); Fri: GDP (prel., Q4), Monthly GDP (Nov)
	Japan:	Mon: Economy Watchers Survey (Jan)
	China:	Wed: CPI, PPI (Jan)

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