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Betting on Italy

Sep 30, 2021 | MICHAEL SPENCE

Italy has endured more than two decades of slow economic growth and below-potential performance. But two factors now seem to be changing the game: the creation of a credible and effective government and a newfound willingness on the part of the EU to provide robust fiscal support.

MILAN – On September 18, I had the privilege of participating in the National Meeting of the Cavalieri del Lavoro, Italy's federation of business elites, where 25 entrepreneurs are recognized each year for their leadership, innovation, and contributions to society. The mood was strikingly upbeat.



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Optimism about Italy's economic prospects – ranging from cautious to almost giddy – is not confined to this group. Nor is it difficult to identify what is driving the upbeat sentiment. But it does come at an unusual time. After all, the global economy is struggling not only to recover from the pandemic shock, but also to adapt to a difficult new normal, characterized by climate headwinds, supply-chain congestion, and rising geopolitical tensions.

Coming after more than two decades of slow economic growth and below-potential performance, Italy's optimism is all the more surprising. But two mutually reinforcing factors now seem to be changing the game: a credible and effective government, led by Prime Minister [Mario Draghi](#), and a newfound willingness by the European Union to provide robust fiscal support for investment. These two are not unrelated.

In sustained and robust economic recoveries, private-sector investment is the proximate driver of growth and

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by acting as a credible reformer and regulator.

Faith in the ability of Italy's current government to fulfill these roles is strong. For starters, Draghi's record inspires respect. As President of the European Central Bank, he showed a firm commitment to advancing European integration and prosperity, and a willingness to take courageous action when needed.

Furthermore, Draghi has populated his government with talented and experienced ministers. The result is a government that is pragmatic and decisive, yet willing to debate contentious topics and open to experimentation. It is a winning combination.



For all its strengths, however, Italy's government still faces tight fiscal constraints. With sovereign debt spiking to 160% of GDP during the pandemic, the government would find investing adequately in future growth challenging, to say the least.



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lesson for the world, it is that no one is safe until everyone is safe. Likewise, no part of the EU can consistently reach its economic potential if other parts are struggling to finance investment and sustain growth.



So, last year, the bloc agreed to establish a €750 billion (\$870 billion) recovery fund, known as Next Generation EU, to finance investment in vital areas like human capital, research and development, the digital transformation, and the clean-energy transition. The fund could make a real difference not only because of its size, but also because financing is conditioned on credible national-level plans, and because it comes in tranches, contingent on effective implementation.



Next Generation EU marks a new direction for the bloc. After the 2008 global financial meltdown touched off a series of debt crises across Europe, proposals for fiscal transfers were fiercely resisted. Advocates of

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Not this time. The difference may be partly explained by the fact that the pandemic hit the entire global economy, whereas the debt crises that followed the 2008 crisis were blamed on individual countries' "fiscal irresponsibility." Moreover, there were serious doubts at the time about the ability of some governments to use any transferred funds wisely. Whatever its motivation, the EU suffered mightily from its post-2008 approach, which severely undermined cohesion and solidarity, especially in the troubled economies of southern Europe.



The opposite seems to be happening today. In Italy's case, confidence in the government's integrity and competence is already resulting in higher foreign and domestic investment, even though the reform agenda remains in its early stages. The same impression – undoubtedly reinforced by Draghi's impeccable European credentials – is also driving the EU to be more forthcoming with its fiscal support, further boosting investor confidence.



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reflection of the reality on the ground. But, given that expectations drive investment decisions, they can also help shape that reality. In economic terms, they are endogenous to the system: they are both outcomes and inputs.



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To be sure, if expectations diverge significantly from the underlying reality, they will eventually recalibrate. But optimism, in conjunction with effective reform, can also support the transition from low-growth to high-growth patterns. Likewise, pessimism can undermine investment and growth. Much emerging-economy experience in shifting to sustained higher growth is best understood in terms of these dynamics.



This experience has also highlighted a key determinant of the outcome: leadership. A government that advances a vision of improved economic

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gradually improves an economy's chances of exiting from a low-growth equilibrium to a pattern of sustained high growth. This may be what we are seeing in Italy now, with European fiscal support providing an additional

lit.



Whether Italy truly has reached an economic turning point remains to be seen. The government still must implement a substantial investment and reform agenda, and many stumbling blocks could appear. But, because Draghi's administration already seems to have lifted the burden of low expectations and weak confidence, Italy's economic prospects are better than they have been in a very long time.



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