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MARIO DRAGHI AND THE TWELVE LABOURS OF HERCULES

Berenberg Macro View

The members of the Five Star Movement, the largest group in parliament, are holding an online vote today (from 9h to 17h GMT) on whether to back a government under the premiership Mario Draghi. We are confident that Draghi will be able to form a mixed government composed of both technocrats and politicians, probably this week, before facing confidence vote in both houses of parliament shortly thereafter. We believe that Draghi is Italy's best chance to implement pro-growth reforms that would end years of economic underperformance. This will be anything but an easy task, though. At home, Draghi will face many difficulties to keep his parliamentary majority unified and conflicts with the Five Star Movement over the policy agenda are likely to emerge. Abroad, Draghi will need to win support from countries North of the Alps for a new framework for fiscal surveillance in the eurozone. In this piece, we focus on what reforms Italy needs to do to catch up with the rest of the euro area.

Domestic agenda: First and foremost, the Italian government will have to deal with the health crisis and its economic consequences. On the pandemic front, the number of new daily infections is currently standing around 8,000-12,000 – a level not seen since mid-October. Since early February, the Italian government has relaxed restrictions in low-impact regions, with the reopening of restaurants, museums and stores. Due to a more forceful tightening in restrictions in Q4 2020, the Italian economy underperformed the rest of the euro area: Italy's GDP contracted by 2% qoq in Q4 2020 against 0.7% in the eurozone. We currently project a decline in GDP of 2.1% qoq for Q1. But the Italian economy could surprise positively this quarter if the second wave of the pandemic remains under control, thus allowing for a further reopening of the economy in coming weeks. Apart from dealing with the pandemic and the roll-out of the vaccination, the new Italian government should address the country's deeper economic problems which have resulted in years of growth underperformance. We identify three urgent labour market specific issues: 1) labour market rigidity; 2) the decline in the labour force participation rate, which is the proportion of the working-age population that is either working or actively looking for work; and 3) low labour productivity.

1) The Jobs Act of 2014-2015, initiated by then Prime Minister Matteo Renzi, constituted a major step in order to bring the country's labour market institutions more closely into line with international benchmarks and with the principles of flexisecurity. It introduced a unified labour contract for new hires, reduced the judicial risks of layoffs for companies and offered temporary subsidies for permanent jobs too. However, there is still a lot to do. In particular work needs to be done so as to improve business regulatory areas (such as starting a business), reform the public sector, strengthen the collective bargaining framework and adapt to the new challenges resulting from innovation and new technologies (i.e. the emergence of the gig economy, technological layoffs and the need for reskilling).

2) Italy's labour force participation rate is low compared to the eurozone, standing before Covid-19 at 49% against 57%. As it is the case for other developed economies, the ageing of the baby boom generation, which is reaching retirement age, explains the decline in the overall participation rate. Added to this is also the low level of the female participation rate in Italy, at 57% - twelve percentage points lower than the euro area average. One often

mentioned reason for Italy's low female participation rate is the lack of access to affordable childcare. A survey from mUp Research and Norstat released in February 2020 concluded that less than one in three families had access to a public childcare facility. Those with no free access to childcare are left with only two options: either they resort to expensive paid solutions (on average, private nurseries cost €530 per month according to the survey) or they don't go back to work. Providing families with accessible and affordable childcare is essential to boost maternal employment and economic growth. The government has made efforts, especially through the opening of more childcare facilities, but regional disparities persist between Northern and Southern Italy.

3) Since the early 1990s, the slowdown in productivity has been more marked in Italy than in other European countries. OECD data show Italian companies with fewer than 10 employees, which constitute a large chunk of Italy's business model, have lower levels of labour productivity than their peers (on average, the value added per employee in Italian companies vs German companies is 35% lower in Italy than in Germany). Some possible causes of Italy's poor productivity are the low level of spending in research (1.4% of GDP in 2018 against 2.4% in the average of the OECD countries according to the latest available data) coupled with insufficient investment in education and the accumulated delay in the adoption of new technologies. In this respect, the resources allocated to Italy from the European recovery fund (€209bn of grants and loans) and the investments identified by the Italian government in Autumn 2020 (see below table) could represent a great opportunity to increase labour productivity growth.

European agenda: Though it might not be his first priority, Draghi is likely to bring a breath of fresh air in the debate about the future of the European Union and the eurozone. He will likely advocate for a common eurozone budget, for the completion of the banking union, with the introduction of the European deposit insurance scheme, and for a more integrated single European capital market which would make the financial system in Europe more resilient. But more importantly, he will probably try to convince its European counterparts of the urgent need to modify the European fiscal surveillance system and to introduce a distinction between "good" and "bad" debt (Draghi's Rimini speech of 18 August 2020). Draghi can count on the support of other Southern European countries and France, but bringing the German and Dutch governments and parliaments on board is the key to success. While his good relations with German chancellor Angela Merkel could be of some help, Merkel's final term in office ends in late 2021.

What if? If Draghi fails to form a government, which seems unlikely in our view, President Sergio Mattarella will have no other choice but to call snap elections. Opinion polls suggest that this option could hand the victory to far-right parties, with Matteo Salvini's anti-immigration and eurosceptic League and Giorgia Meloni's Brothers of Italy gathering more than one third of the voting intentions.

Table: Main investments to increase growth and productivity identified by the Italian government in Autumn 2020

Energy transition	€74.3bn to invest in renewable energy generation and energy efficiency in line with the European Green Deal's objectives
Digitalization and Innovation	€48.7bn for the digitalization of the public administration and to support firms' vertical integration so as to increase competitiveness
Health	€9bn for first-line medical assistance and general practitioner services
Infrastructures	€27.7bn for sustainable urban mobility and infrastructure investments. It includes investments in the high-speed rail network and highways (through a revision of the current procurements) with attention to smart districts
R&D funding	€19.2bn for education and research

Source: Italy's Ministry of Economy and Finance, Berenberg.

Also see our 2019 Euro Progress Monitor.