Villa Mondragone International Economic Seminar,

Round table on “Risks from inflation and opportunities from fragmentation”

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Round 1 on Inflation and globalization

- The expansion in world trade has decelerated in the last decade, driven by a variety of factors. The impressive sequence of shocks that has hit the world economy since the global financial crisis appears to have taken its toll on trade dynamism. On the structural ground, the marginal benefits from trade may be close to diminishing returns, while geopolitical tensions induce a reorientation of global trade flows in the direction of “friend-shoring” and fragmentation. Yet, the debate is open on whether there is a structural break in the pace and nature of globalization. Evidence so far is not conclusive. What is instead clear is the explosion in trade restrictions in recent years.

- The reorientation of globalization presents both risks and opportunities. Economic risks concern efficiency losses, related to the shortening and geographical orientation of value chains, reduced economies of diversification, and non-negligible chances of playing a zero sum game. Protectionism and inward-looking policies may not only affect the distribution of the benefits from trade but also reduce the size of the benefits to be distributed. A decline in world trade would be detrimental for all players, especially for highly integrated economies. On the opportunity side, the reorientation of trade can induce more efficient and sustainable production modes, facilitate the green, digital and technological transitions and support inclusive and sustained growth.

- What is it needed for grasping the benefits while reducing the risks? First, zero sum games should be avoided, by strengthening multilateral cooperation and reducing the scope for inward-looking, self-defeating policies. Second, key transitions should be adequately supported. Both objectives require massive resources.

- Adequacy of resources may constitute a weakness for Europe compared to its main trade partners, a weakness in terms of both the overall amount of resources that can be mobilized and their distribution across countries. The quest for resources involves both private and public capitals, at the national as well as the supranational level. Common resources at the EU level may be required for ensuring the provision of strategic public goods (energy security, defence, technology, among others), for which national incentives are insufficient. By the same token, EU resources may be necessary for coping with extreme events and large shocks in the common area, overcoming the difficulties related with asymmetric fiscal space across Europe.

- Important common tools, like NGEU and RePower EU, have been introduced after the pandemic and the energy shock. They have deployed remarkable resources for sustaining green and digital transitions while strengthening energy security. Further steps toward the creation of a common fiscal capacity would be necessary.

Round 2 on Inflation and public debt

- In the short run, high inflation may help to reduce the debt-GDP ratio, by increasing the nominal GDP growth rate above the average debt cost (the snowball effect), and improving the primary balance with a boost in tax revenues (inflation increases the tax base in nominal terms, notably VAT in 2022). On the other hand, support measures may be very costly (around 60 billion last year). Over time, also spending would increase in nominal terms (especially, pensions), while the debt service becomes more costly (higher interest rates).

- The debt ratio at the end of 2022 was 144%, more than 5 percentage points below the value in 2021. It is expected to decline further (though at a lower pace) and reach 140% by 2026. The expected debt dynamics reflects a sharp deterioration of financing conditions (higher interest payments, around 80 billion this year and 100 billion in 2026) together with a negative contribution of the stock-flow adjustment and a positive contribution of the primary balance back to surplus since 2024.

- UPB simulations show that in the absence of further adjustment after 2024, the debt ratio would soon start to increase and reach 180% by 2040, driven essentially by age-related expenditure. The required consolidation efforts are substantial yet feasible: for the 4-year plan, a primary balance of 1.8% of GDP on average, with a peak of around 2.8%, is sufficient to keep the debt ratio on a plausible declining path for the successive 10 years.

- The policy mix for coping with high inflation is clear: monetary policy keeps expectations anchored, while fiscal policy addresses distribution issues and shields the most vulnerable. This is far from easy to realize in practice and a strict alignment of policies is required: too strong or abrupt monetary tightening can depress the economy and put pressure on fiscal accounts; too generous fiscal intervention can fuel inflation.

- A solid fiscal governance can ease the tension between inflation and output. It can strengthen debt sustainability by promoting credible and feasible adjustment plans in high-debt countries. It can sustain the quality of public budgets, promoting the components that are more favourable for growth, like investments. It can ensure a coherent fiscal stance in the common area with respect to both national policies and the supra-national monetary policy. It should also provide common resources for strategic European public goods and for coping with exceptional events. These objectives require medium-term budgetary planning for a proper account of investments and reforms; transparency in the design and assessment of fiscal plans; effective monitoring mechanisms and enforcement.