Managing high inflation in an uncertain world

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Ufficio Parlamentare di Bilancio

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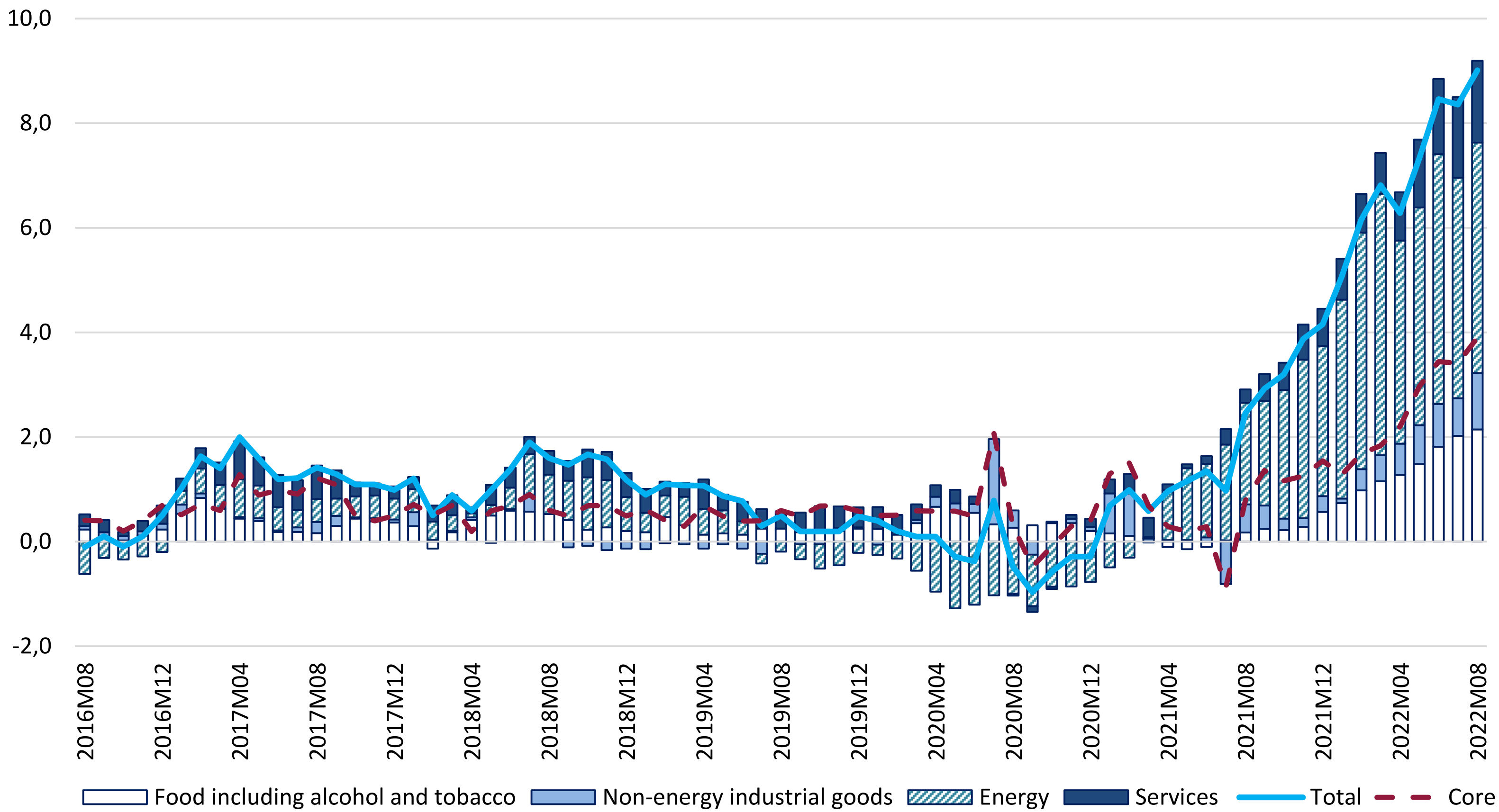
Outline

- Latest developments in inflation dynamics: core v headline inflation; persistence; dispersion across EU member states
- Impact on public finances: revenues & expenditure; debt dynamics;
- Measures to mitigate the impact of rising energy prices: households v firms; price policies v income support; general v selective
- Challenges ahead: persistent shifts in energy markets (war & green transition); redistribution: across countries, generations, income classes
- Policy implications: monetary v fiscal policy; national v EU-level

Inflation in Italy climbed to 9%

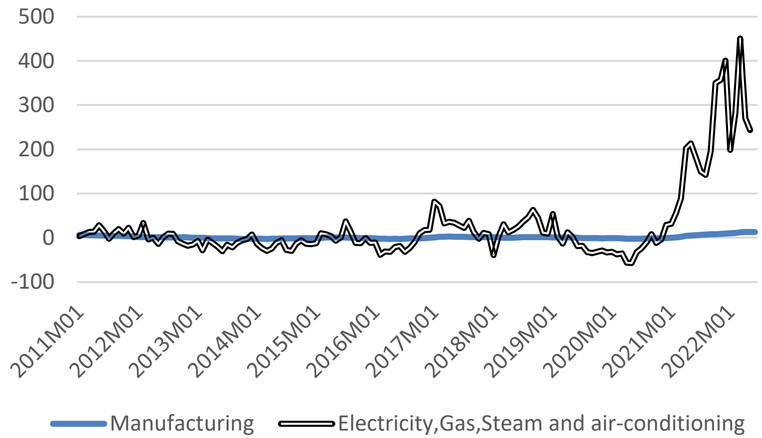


Source: Our calculation on Eurostat data. The vertical bars indicate the contribution to year-on-year HICP

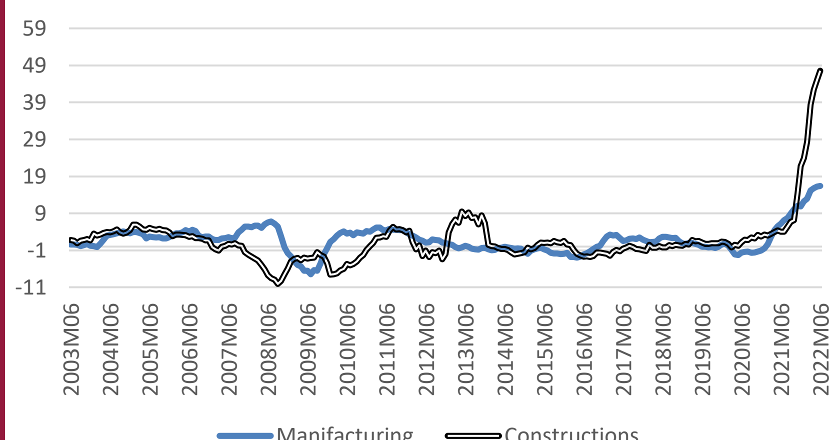
Driven mainly by energy prices but also food and services

In Italy inflation is mainly imported..

Import prices



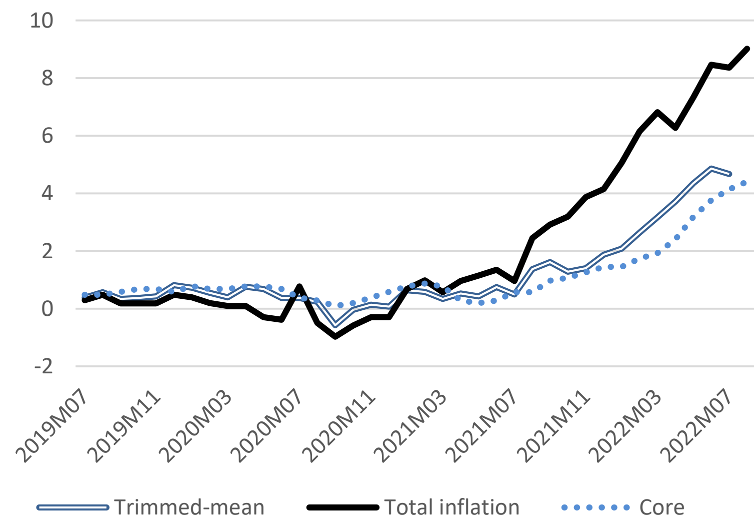
Production prices



Source: Istat

..but it is propagating along the production chain

Core and trimmed-mean inflation

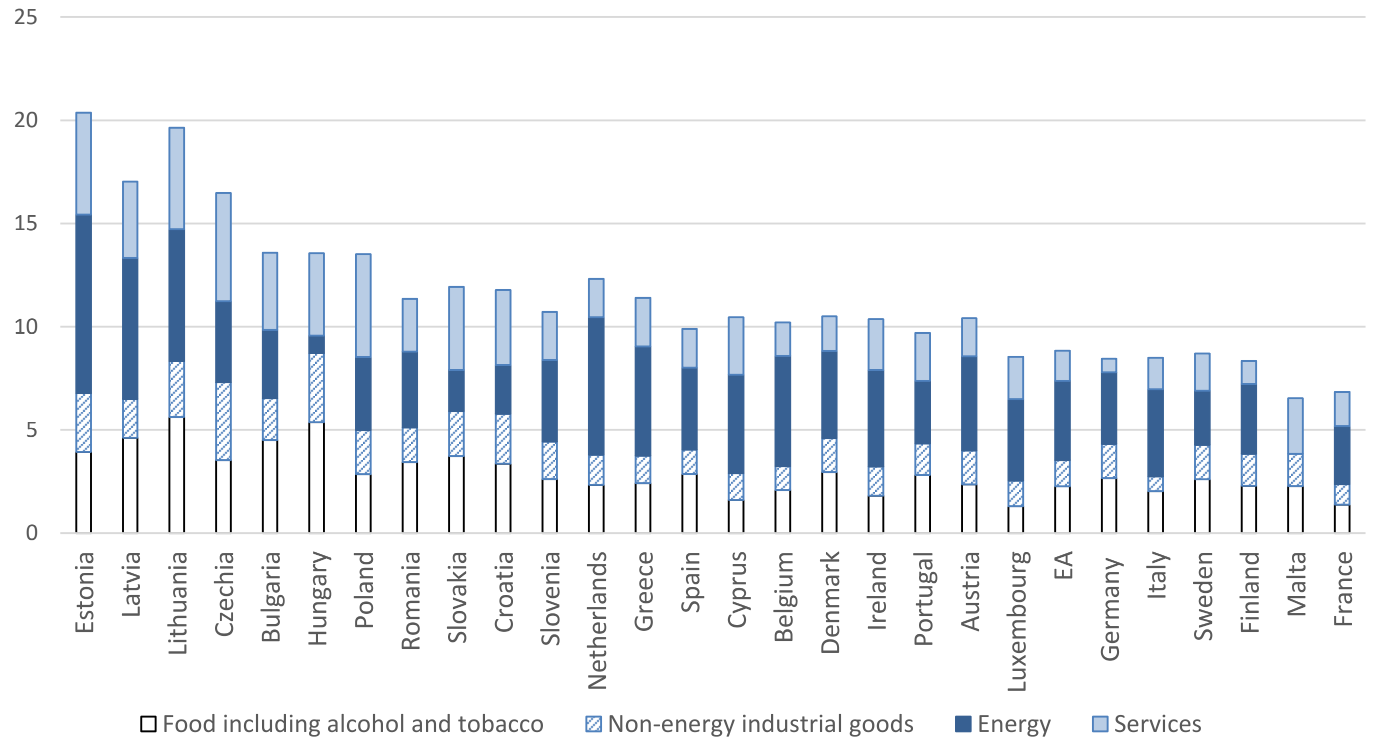


Source: Our calculation on Eurostat data.

Note: The trimmed mean cuts 10% in both tails of the distribution

Inflation rates are heterogeneous across countries in the euro area

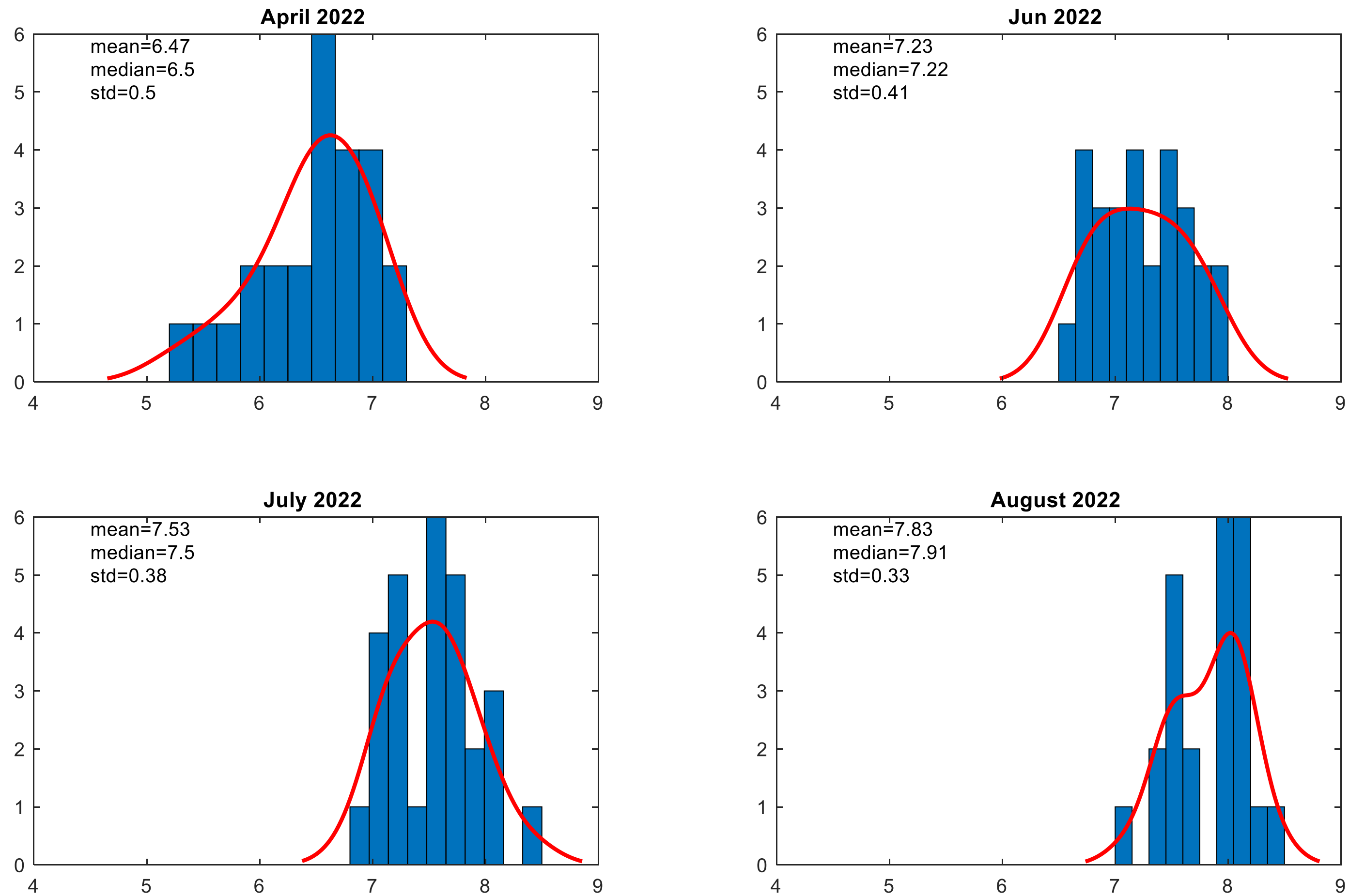
Contributions to year-on-year HICP, July 2022



Source: Our calculation on Eurostat data

Inflation expectations on the upside

Consensus forecasts for Euro zone inflation in 2022



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Some favourable fiscal risks from inflation in the short run……

- Upward inflation surprises can improve debt/GDP dynamics through a denominator effect
  - ✓ but unexpected inflation cannot last
- They can also reduce primary deficits/GDP in the short run
  - ✓ because revenues tend to improve with nominal GDP growth and not all expenditure items are indexed, at least in the short-run

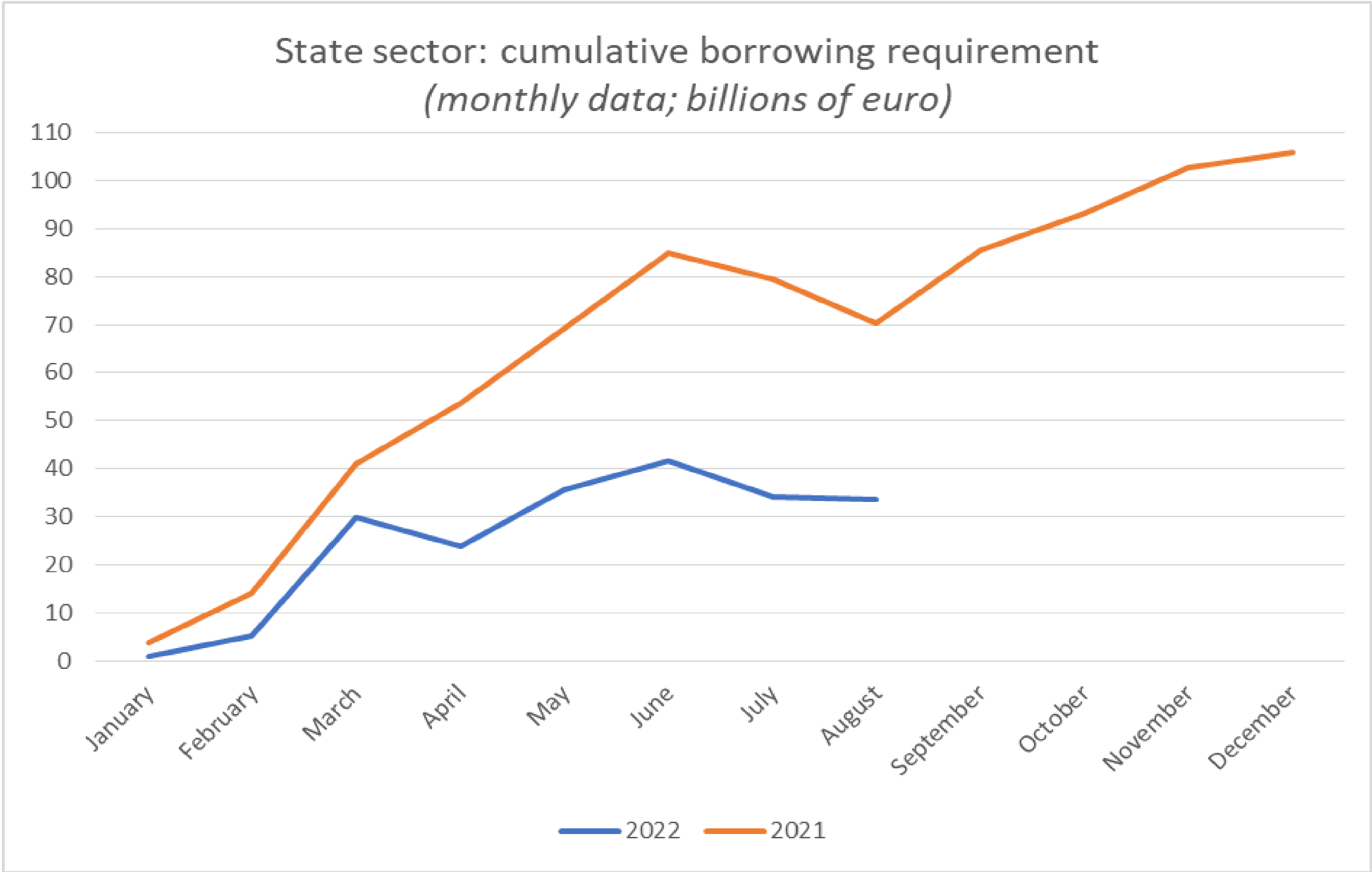
… but also <u>unfavourable ones</u>

- Discretionary measures that mitigate the impact of inflation for families and firms can have large fiscal costs
  - ✓ because by cutting taxes or granting subsidies or through generalized transfers to households, government expenses may increase and/or government revenues may fall

Fiscal risks from inflation are mostly unfavourable over time

- The rise in inflation is likely to be followed by rising interest rates and higher interest payments
  - ✓ as monetary policy tightens to curb inflation, sovereign borrowing costs will rise, increasing interest expenditure, especially in a country with high debt like Italy
- Persistently high and volatile inflation could un-anchor inflation expectations (requiring further monetary tightening) and disrupt economic activity
  - ✓ in turn, this could put further pressure on fiscal accounts
- As long as inflation expectations are revised upwards, public expenditures will be increased to higher levels

Favourable trend of the State sector borrowing requirement



Tax revenues in double-digit growth....

Monthly cumulative tax revenues

(billions of euros, percentage changes)

	Direct taxes			Indirect taxes		
	2022	2021	%ch	2022	2021	%ch
January	28.013	26.293	*6,5*	13.248	10.215	*29,7*
February	48.337	42.858	*12,8*	30.699	24.802	*23,8*
March	63.151	58.086	*8,7*	50.251	41.695	*20,5*
April	78.466	74.912	*4,7*	69.845	59.120	*18,1*
May	95.939	90.772	*5,7*	92.735	79.340	*16,9*
June	131.590	117.916	*11,6*	111.287	96.010	*15,9*
July	**157.949**	**143.964**	***9,7***	**130.474**	**114.138**	***14,3***

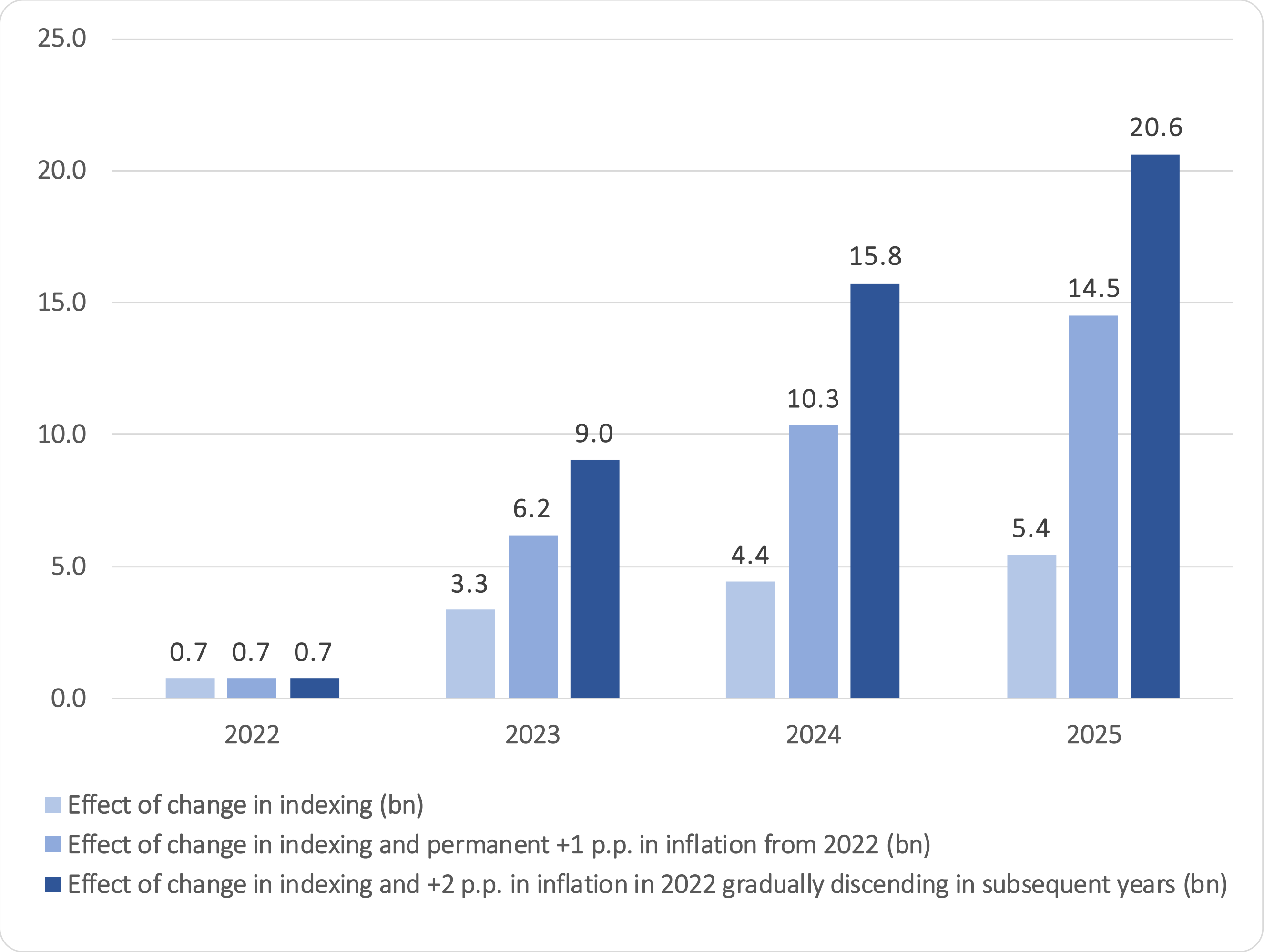
…..notably VAT revenues

Monthly cumulative VAT revenues

(billions of euros, percentage changes)

	January	February	March	April	May	June	July
VAT - Total							
2022	8.179	20.043	32.722	45.407	61.687	74.289	87.312
2021	5.841	15.542	26.636	37.362	51.488	62.174	73.537
	40,0	***29,0***	***22,8***	***21,5***	***19,8***	***19,5***	***18,7***
VAT on internal exchanges							
2022	6.725	16.976	27.792	38.717	52.952	63.378	74.286
2021	5.017	13.615	23.512	33.049	46.025	55.509	65.515
	34,0	***24,7***	***18,2***	***17,2***	***15,1***	***14,2***	***13,4***
VAT on imports							
2022	1.454	3.067	4.930	6.690	8.735	10.911	13.026
2021	824	1.927	3.124	4.313	5.463	6.665	8.022
	76,5	***59,2***	***57,8***	***55,1***	***59,9***	***63,7***	***62,4***

Impact of change in indexation and inflation rate on pension expenditure



Consumption deflator in EFD in 2022: 5.8%

Istat consumer price index in August: 8.4%

It considers disability, old-age and survivors pensions and INAIL annuities. It does not consider indexing of other recurrent social benefits in cash.

Interest expenditure: limited impact from a temporary inflationary shock

Change in interest expenditure following a temporary increase in the inflation rate in 2023

(percentage of GDP)

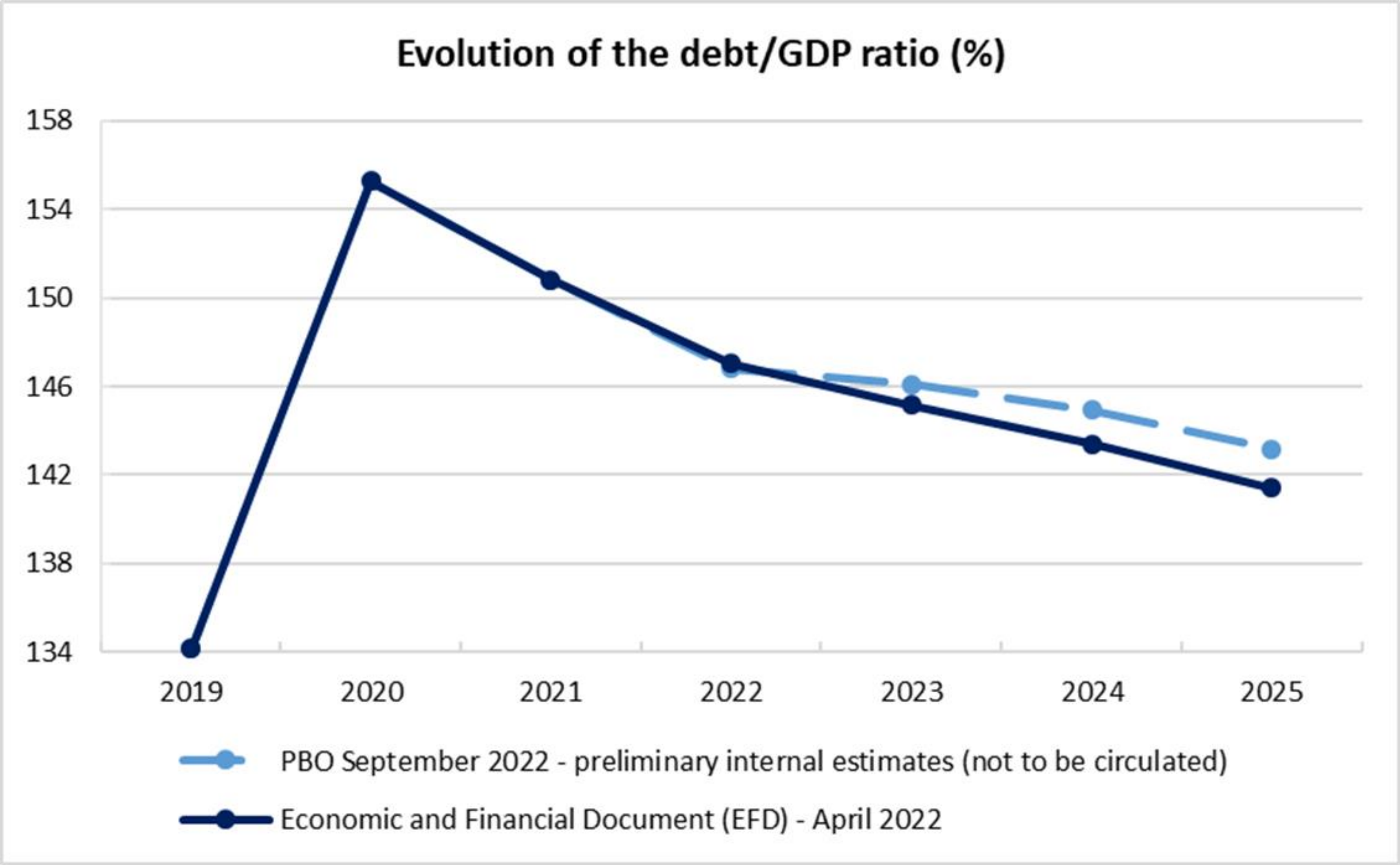
	2023	2024	2025
Temporary +1% shock to Italian and European inflation rate	0.09	0.00	0.00
Temporary +1% shock to Italian and European inflation rate with differentiated maturity-decreasing impact on fixed interest rates (average of +50 basis points)	0.17	0.10	0.07

Interest expenditure: gradual impact over time from a permanent interest rate shock

Change in interest expenditure following 100-basis-point permanent increase in yield curve as from 2023

	2023	2024	2025
Millions of euro	2.489	6.734	10.100
Percentage of GDP	0.13	0.33	0.48

Debt to GDP ratio still likely on a downward path



Measures to mitigate rising energy prices

- Total resources mobilized for 2021-2024 amount to around **€54 billions** (main part in 2022). €13 billion are targeted at households, €11 billion at businesses, and 24.4 at both.

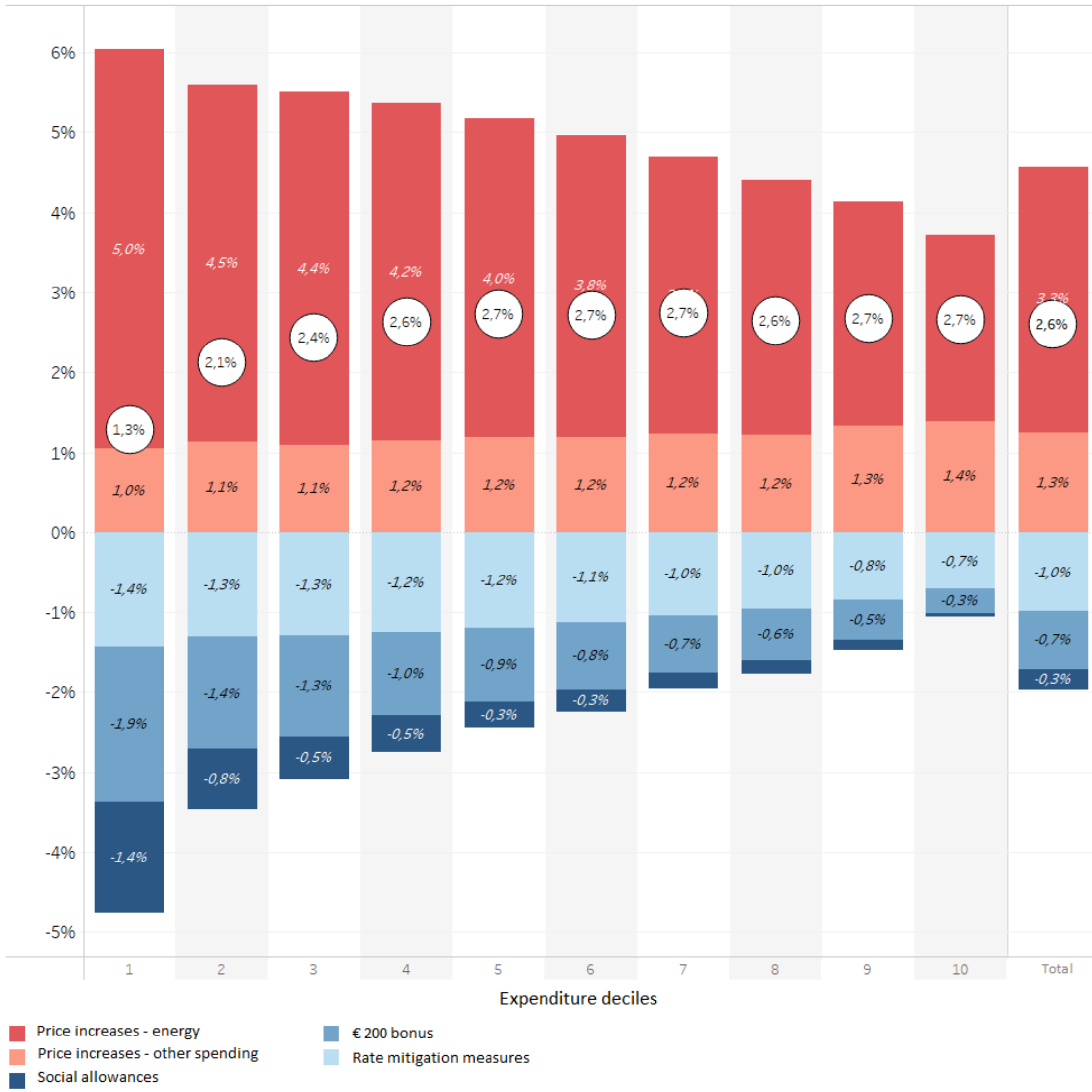
(Millions of euros)	2021	2022	2023	2024	**Total amount**
Households	450	12.659	-355	-1	**12.754**
Enterprises	800	10.229	1	0	**11.030**
Households and enterprises	4.288	20.473	-553	185	**24.394**
Other (local authorities, investments, etc.)	100	3.350	1.718	628	**5.795**
Total amount	**5.638**	**46.711**	**811**	**812**	**53.972**

Source: Technical reports annexed to various Decree Laws and PBO estimates for DM 31 August and DM 13 September.

Measures in favour of households

- ✓ Measures targeted at specific categories of beneficiary and expressly intended to contain the impact of the increase in energy costs (i.e. social energy allowances);
- ✓ Measures aimed at certain beneficiaries not expressly intended to contain the effects of the increase in energy prices but which mitigate the effect of energy price inflation on income (i.e. one-off allowance to individuals in financial distress and increase in contribution exemption);
- ✓ Measures to limit energy price increases for all users, including households and firms (i.e. offsetting of general system charges for electricity and gas; reduction of VAT on gas for civil and industrial uses and of excise duties on petrol, diesel and LPG used as fuels).
- ✓ Other minor measures (i.e. public transport subsidy)

Impact on households' purchasing power



Source: PBO micro-simulation model

Change in nominal spending (by expenditure deciles) due to the rise in prices and impact of support measures (June 2021 – July 2022).

The impact of inflation is larger for poor households.

The support measures partially offset the loss of purchasing power and the more so for relatively poor families.

Overall, the change in net expenditure was smaller or equal to average (2.6 per cent) for the first four deciles.

Measures in favour of enterprises

- Generalised measures:
  - ✓ to limit energy price increases (i.e. offsetting of general system charges for both electricity and gas; reduction of VAT on gas for industrial uses and of excise duties on fuels);
  - ✓ to reduce system charges for low-voltage non-domestic users and provide tax credits for the purchase of gas and electricity
  - ✓ to support liquidity.
- Sector-specific measures:
  - ✓ Tax credits for energy-intensive industries and those with a high consumption of natural gas;
  - ✓ Measures for road transport, agriculture & fishing and the sports sector.

Mitigating measures by category

	2021	2022	2023	2024	Total
Total amount	**5.638**	**46.711**	**811**	**812**	**53.972**
% of GDP	0,32	2,47	0,04	0,04	2,86
1) **Reduction of system charges**	**4.930**	**14.805**	**0**	**0**	**19.735**
Electricity	4.000	9.015	0	0	13.015
Gas	480	3.082	0	0	3.562
Electricity and gas	450	2.708	0	0	3.158
2) **Reduction of VAT on gas for civil and industrial use**	**608**	**2.489**	**0**	**0**	**3.097**
3) **Tax credits**	**0**	**7.635**	**0**	**0**	**7.635**
Electricity	-	4.577	0	0	4.577
Gas	-	3.058	0	0	3.058
4) **Reduction of excise duties on petrol, diesel and LPG used as motorvehicle fuel**	**0**	**7.032**	**-553**	**185**	**6.665**
5) **Additional measures**	**100**	**14.750**	**1.364**	**627**	**16.841**
of which: One-off allowance	0	6.960	0	0	6.960
Increase in exemption from contributions and measures concerning pensions	0	2.613	-362	0	2.251
Local authorities		1.100	100	130	1.330
Investments	100	**2.250**	1.618	498	4.465

Extraordinarary tax on excess profits

- levied on companies in the energy industry;
- applied to the increase in the balance between output and input invoices over a specific period of time;
- So far revenues of €3,5 billion

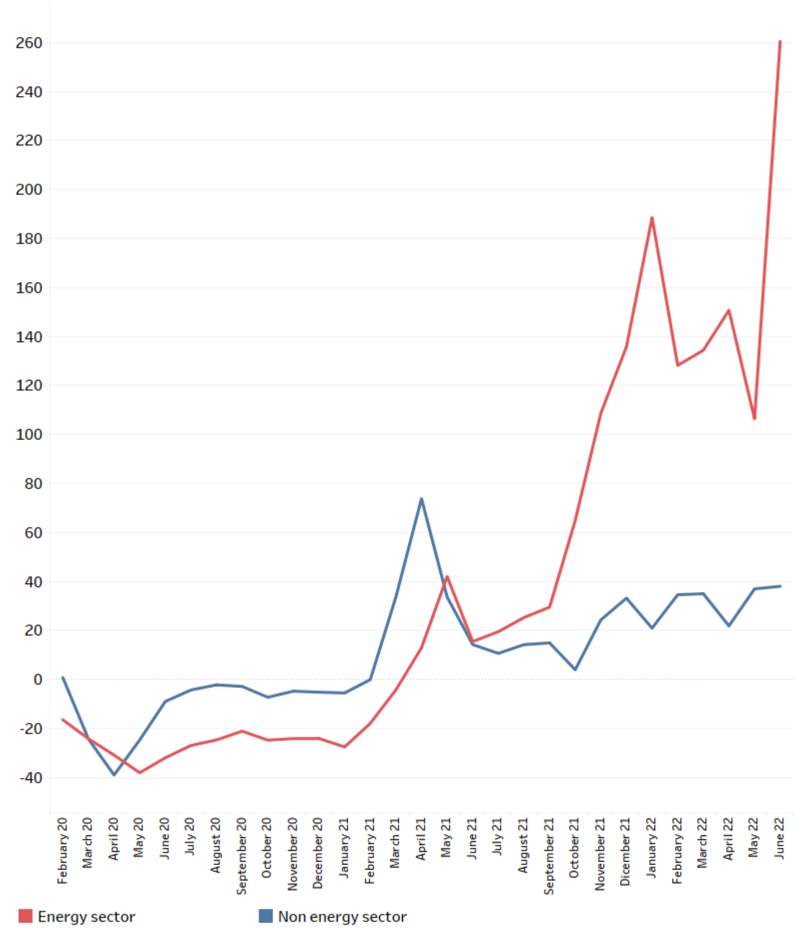
Extraordinary tax on excess profits - design

- Conceived as an extraordinary financing instrument with **redistributive purposes**:
  - ✓ in force only in 2022 and justified by the exceptional increase in energy prices and by the necessity to compensate asymmetric effects on households and businesses.
- Disegned to **respond to specific needs**:
  - ✓ **collection within the year of relatively certain amounts** (tax base given by the change in the balance between output and input invoices over a specific period of time) → proxy of the increase in value added instead of profit;
  - ✓ **warranting non-negligible revenue to finance measures to mitigate the impact of rising energy prices on households and businesses** (a tax rate set at 25% was expected to yield €10,5 billion);
  - ✓ **avoid some constitutionality issues** raised with regard to the “Robin” tax, which was an IRES surtax levied on larger companies of the energy sector in 2008-2014, in a period of similar price increases;
  - ✓ compatibility with the measures considered eligible in the European Commission’s RePowerEU Communication of 8 March 2022.

Extraordinary tax on excess profits - issues

- The current structure of the tax could raise equity and efficiency issues:
  - ✓ **adequacy of the tax base** in approximating the excess profits of energy companies generated by price increases:
    - the increase in value added represents a good proxy for excess profit only to the extent that this is not also attributable to an increase in the remuneration of the other factors;
    - discrepancies could emerge with respect to the increase in profit measured in accordance with financial reporting or tax rules governing IRES → the use of the IRES tax base would probably have made it possible to make the tax on excess profits more commensurate with corporate accounts, but would have required the calculation to be performed for an annual period and the use of a mechanism for payments on account involving forecasts that would have introduced additional complexity and uncertainty to the estimation of the revenue;
  - ✓ **choice of the "normal period"** to be taken as the baseline for measuring the increase in profit:
    - the choice of the period October 2020 - April 2021 still impacted by COVID may lead to an overestimation of the contingent increase in profits. The risk could be reduced by opting for a baseline period less affected by the health emergency, such as the same months of 2019/2020 or an average of the two periods;
  - ✓ the tax base could be influenced by tax components that do not fall within the definition of profit in an economic or statutory sense (i.e. excise duties which form part of the basis of output transactions).

Monthly changes in electronic invoicing for energy and non-energy sectors



- ✓ The performance of the energy sector has improved remarkably since the rise in energy prices;
- ✓ The baseline period was characterized by a relatively poor performance of the energy sector → overestimation of the increase in profits.

Source: PBO, Parliamentary hearing on Decree Law 50/2022.

Challenges ahead

- Persistent pressures on energy prices?

- Geo-political factors
- ✓ diversification of energy suppliers may be costly (in the SR, high demand v supply rigidity);
- ✓ Gas rationing?
- ✓ Selective globalization;

- Green transition
- ✓ may imply a permanent rise in the price of fossil fuels (to discourage use)
- ✓ and a transitory rise in the price of renewable energy (demand effect)

- We are going to see higher energy prices for quite a long time ….

Policy implications of (persistently) high energy prices

- Monetary policy should keep expectations anchored while fiscal policy should cope with redistribution (to shield the most vulnerables)

How to engineer the most appropriate mix?

- A solid fiscal governance helps ease the tension between inflation and output stabilization.
  - ✓ ensure the sustainability of public finances
  - ✓ preserve the quality of public intervention
  - ✓ ensure coherence in the common fiscal stance
  - ✓ provide EU public goods (energy security; green transition; defense …)

- National fiscal policies address distributional issues within countries (rich v poor; young v old …) in accordance with own fiscal space

- Common fiscal space may address asymmetry across countries and provide EU public goods

- Counter-supply shock?