



## ITALY: INCHING OUT OF THE GLOBAL CRISIS

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Despite being one of the large members of the EU, when it comes to the world scenario Italy remains just one in a group of several small advanced, open, slow-growing economies, with little room to maneuver by themselves, and no clear idea in which direction to play their limited options. This is even truer now, in the grand scenario of 2010, as the world's worst economic crisis of the last seventy years has been halted, and economies are slowly recovering, but with no clear sign of direction and many unresolved issues that only temporarily have been brushed aside.

The world economy has indeed been rescued. Generally speaking, the measures adopted were prompt, several had not been previously tested, and many went against conventional (academic) wisdom. But they seem to have worked, which is even more a tribute to those who decided to adopt them. But rescue is not recovery. That will take more time and will be more difficult to achieve, also because recovery might take pressure away from painful reforms.

In this paper I would like to highlight two aspects. First, in order to get out of the recession, there was little that Italy could do by itself, especially in terms of short-run policies. Its monetary and exchange rate policy is set by the European Central Bank (ECB). Its fiscal policy is effectively blocked by its enormous debt. Its ability to reform is hindered by the lack of social and policy consensus, and by the deterioration of the climate for public and policy debates. In this respect, the policy choice has been not to fight the recession head on, but to minimize some of its social costs. Within these limits, results have been positive.

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Second, the measures that have been adopted are going to have at best a modest influence on the causes of Italy's persistent slow growth. They are qualitatively insufficient to promote a more sustained recovery and to reactivate a growth process, the engines of which have been stalled for quite some time. One possible outcome is that Italy is likely to remain a country in relative decline. But as Italians were relatively well off before the crisis and their plight is not uncommon in Europe, they will find this situation not too alarming, at least for a while. But as limited signs of a more positive determination to resume growth are also apparent (as I will argue in the end) the final outcome might still be different.

To develop my arguments, I will briefly relate to the current state of the crisis in the first section; then discuss in the next section why the financial crisis affected only marginally the Italian financial system. In the third section I will briefly characterize the transmission of the crisis to the economies of the euro area, followed by the examination of government response to the crisis in Italy. The final section concludes.

### Legacies of the crisis

The US house price bubble began to burst in September 2007, and the US stock markets began to slide after 8 October 2007, followed by the rest of the world. The slide became a crash after March 2008. On the real side, the US economy had reached a peak in December 2007, while the euro area did not peak until the first quarter of 2008. The first signs of recovery came about a year later. Stock markets seem to have bottomed out in March 2009 and also the real economy slowly began to grow in the second half of 2009, both in Europe and in the United States.

World output declined by 0.8 percent in 2009, and is now expected to rise by 3.9 percent in 2010. In this scenario growth will be 2.7 percent in the United States, and only 1 percent in the Euro area (see

**Table 1**  
**World economic outlook projections (%)**

	2008	2009	2010	2011
<b>World output</b>	3.0	-0.8	3.9	4.3
Advanced economies	0.5	-3.2	2.1	2.4
Euro area	0.6	-3.9	1.0	1.6
Germany	1.2	-4.8	1.5	1.9
Spain	0.9	-3.6	-0.6	0.9
France	0.3	-2.3	1.4	1.7
Italy	-1.0	-4.8	1.0	1.3
UK	0.5	-4.8	1.3	2.7
USA	0.4	-2.5	2.7	2.4
Japan	-1.2	-5.3	1.7	2.2
Emerging & developing countries	6.1	2.1	6.0	6.3
<b>World trade volume (goods &amp; services)</b>	2.8	-12.3	5.8	6.3
Imports				
Advanced economies	0.5	-12.2	5.5	5.5
Emerging & developing countries	8.9	-13.5	6.5	7.7
Exports				
Advanced economies	1.8	-12.1	5.9	5.6
Emerging & developing countries	4.4	-11.7	5.4	7.8

Source: IMF (2010).

Table 1). The main emerging markets are leading the recovery, even more firmly than they were leading growth before the crisis. Not only (with the exceptions of Russia and Mexico) they have decoupled from the worst of the crisis, but they have re-asserted a yearly growth differential of about 4 percent against the advanced economies. This new balancing of the world economy does not show only in the GDP data: China, now the world's largest exporter, increased its share of exports to developing countries from 50 to 56 percent during 2009.<sup>1</sup>

Recovery in the advanced economies will probably continue to be slowed down both by the unresolved issues from before the crisis and the added difficulties of unwinding the expansionary fiscal and monetary policies that have been adopted during the crisis. And no matter how necessary such policies have been, the exit strategies they now require are not going to be a stimulus for further growth.

To discuss the situation of Italy, first in the crisis and now in the recovery, I begin in the next section with a short discussion of the impact of the crisis on the financial system.

### The financial crisis: why not in Italy?

Although the crisis originated in US financial markets, and owed a large part of its global dimension to the global connectedness between financial

institutions within and across countries, the financial aspects of the crisis came to Italy mostly as a side-show. This sets Italy apart from other European countries, where finance played a much more important role in both the local origin and the spreading of the crisis.<sup>2</sup> This is particularly true for banks, an issue which is worth examining in more detail.

#### *Banks' losses ...*

In the United States, according to a report by Credit Suisse in January 2010, banks are facing about USD 1.4 trillion of commercial real estate (CRE) loans maturing in the next four years. Almost 55 percent of the commercial mortgages that will mature until the end of 2013 are currently 'underwater', meaning the borrowers owe more than the value of the property, according to the research company Foresight Analytics.

For the euro area, the ECB had observed in its mid-year review of 2009 that euro area banks could face a total loss estimated at USD 649 billion over the period 2007–10. At the end of May 2009, "the write-downs on securities by euro area banks had amounted to USD 215 billion. At the same time, in 2007 and 2008, euro area banks provisioned and wrote-off USD 150 billion of their loan exposures. Looking ahead, therefore, there is potential for euro area banks to suffer a further USD 283 billion in losses, mainly originating from loan exposures" (ECB 2009a, 103). More recent loss estimates, published in December 2009, are bigger: "the total (i.e. already reported and yet to come) write-downs for the euro area banking system are likely to amount to around € 553 billion for the period 2007–10. Of this total, cumulative total write-downs on exposures to securities are likely to amount to around € 198 billion, while the predicted figure for total loan-losses is around € 355 billion. [...] Splitting the total loss figures into what has already been reported and what is

<sup>1</sup> See Financial Times, 10 February 2010.

<sup>2</sup> Financial aspects of the crisis were of paramount importance in Britain, Spain, Ireland and Iceland, and to a lesser extent also in Germany, Austria, Sweden and the Netherlands, as well as in many countries in the CEE.

yet to come by the end of 2010, there is a potential for euro area banks to suffer an additional € 187 billion in losses, mainly as a result of their loan exposures” (ECB 2009b, 89).

In the crisis, banks have come under increased scrutiny and pressures by shareholders, market participants and regulators over their capital adequacy and excessive leveraging. These pressures could be accommodated in three directions: (i) re-capitalization and increase in capital ratios; (ii) issuance of safer or guaranteed liabilities; (iii) reduced lending, especially to those debtors perceived to be more at risk. In general, all “EU governments implemented support measures to alleviate strains on their banking systems. These measures complement the extensive liquidity support that has been provided by the ECB” (ECB 2009a, 87).

*... and de-leveraging*

In particular, in reference to (i) above, capital ratios of banks held up well, thanks partly to government recapitalizations and especially to the quality and composition of capital. This is also true of Italian banks. The first five banking groups in Italy increased their total capital ratio by 0.6 percent to 11 percent in June 2009, while their tier 1 ratio has increased by 0.7 to 7.4 percent, compared to the increase in the core tier 1 ratio by 0.8 percent to 6.6 percent.<sup>3</sup> These ratios are still slightly below those of comparable EU banks (ECB 2009a). On the other hand, overall leverage for large Italian banks is down to 24 (from 26 at the end of 2008); this may be compared to the European average for large banking groups, which amounts to 34. Reduced leverage is probably one reason why the Italian banking system has been less and more marginally affected by the crisis, relatively to other European banking systems.

A second reason is the reliance of Italian banks on a stable deposit and funding base, with a much more limited recourse to money market liabilities: in a comparison of 27 banking groups in six European countries (Britain, Italy, France, Germany, the Netherlands and Spain) in June 2009, the average ratio of (non-interbank) deposits and own bond lia-

<sup>3</sup> See Banca d'Italia (2009). Total capital ratio is equal to the ratio between a comprehensive measure of bank capital (total regulatory capital, which includes tier 1, tier 2 and tier 3 plus supplementary capital) and risk-weighted assets. Tier 1 capital includes core tier 1 (shareholders' equity and retained reserves) plus hybrid capital instruments. Leverage is the ratio between un-weighted assets and total regulatory capital.

bilities to total liabilities was 42.6 percent for the other five countries, and 62 percent for Italy (data courtesy of the European Banking Report Observatory of ABI<sup>4</sup>).

In Europe, many governments have been supporting banks through the issuance of guaranteed bank bonds. These measures have been attractive to banks especially in Britain, Spain, Ireland, Germany and Austria, and to a lesser extent in Sweden, the Netherlands and France. In Italy, a similar initiative (called ‘*Tremonti* bonds’<sup>5</sup>) has been largely ignored, as banks have preferred to issue non-guaranteed bonds (about 50 billion euros). This has been a clear sign of the strength of the banking sector in Italy, as Italian banks could raise credit at a lower cost (or with less conditionality) than if they had accepted the support of the government.

*Credit crunch? not here, thanks*

Worldwide, several factors helped induce a contraction in the supply of bank loans: the scarcity of bank capital; the mounting of on and off-balance sheet losses; the deteriorating quality of creditors; and pressures from regulators, politicians and market participants alike, all asking banks to de-leverage. It would have been overly optimistic not to expect a worldwide credit crunch. And thus it came, despite the extreme laxity of monetary conditions almost everywhere. The IMF estimated a financing gap of about 460 billion euros for 2009 in the euro area, and one of 150 billion euros for Britain (IMF 2009a).

In Italy, the credit contraction has been less pronounced than elsewhere: outstanding loans reached a maximum around the summer of 2008, and have decreased by only 0.2 percent in the 12 months to November 2009 (Banca d'Italia 2010), although their overall quality has also deteriorated. Several specific measures have been adopted in Italy (in addition to the bank bond guarantees discussed above) to stimulate lending to private borrowers:

- State-guarantees and refinancing of the guarantee funds to insure bank loans to small and medium enterprises, and a revamped role for the “*Confidi*” (consortia promoted by local entrepre-

<sup>4</sup> ABI is the Italian Banking Association.

<sup>5</sup> See Ministero dell'Economia e delle Finanze-Dipartimento del Tesoro (2009) and Panetta et al. (2009) for a documentation and analysis of measures of bank support adopted worldwide.

neurial associations to co-insure access of firms to bank loans),

- Monitoring activity of credit conditions to be enacted by the provincial government offices (*prefettura*),
- The proposal of a new “*Banca del Mezzogiorno*”.

Of these, probably only state guarantees and the role of the *Confidi* have been of great importance in ensuring continued access to credit for small and medium enterprises. This has helped to avoid an overall contraction of credit flows in Italy. On the other hand, the monitoring measures are likely to have been irrelevant at best, while the proposal for a new bank ‘for the South’ has not become operative yet and it is probably wise to be sceptical about its design.<sup>6</sup>

### The crisis and how it came to Italy

Thus, the way the crisis came to Italy (and to a large part of Europe as well) was essentially through the ‘real’ dimension. How did that happen? Why didn’t Europe decouple from the United States? Let us focus on the euro area which had already been a slow growth region at least since 1999.<sup>7</sup> In 2009, exports and imports of the euro area declined by 18 and 22 percent, respectively, relative to those of 2008 – almost five and six times more than the contemporaneous decline in GDP. This was also a much larger fall relative to the other advanced economies and to the emerging and developing countries. And Italy’s exports and imports (including those with the rest of the EU) declined even more, by 22 and 23 percent, respectively (see Table 2). This was presumably to be expected, given the weak positioning of Italy’s trade and its high sensitivity to the depreciation of the dollar. Hence, while still waiting for a more precise quantitative assessment, it appears that the euro area’s recession was due in large part to the fall in world – especially US – demand for euro area exports, which quickly fed into the demand for capital goods (the decline in gross fixed capital formation in the euro area was probably more than 11 percent in 2009).

<sup>6</sup> There is actually little or no evidence that banks with headquarters in the North have penalized borrowers in the South. In the twelve months to November 2009 loans to the South have actually been increasing by 2.5 percent (implying that the crunch, to the extent that there was one, was only felt in the Centre-North).

<sup>7</sup> Average real GDP growth in the euro area was 2.2 percent from 1999 and 2007, compared with 2.9 percent in the United States.

**Table 2**

**External trade growth (change 2009 over 2008 in %)**

	Exports	Imports
EU27	-16	-23
Euro area	-18	-22
Germany*	-20	-18
Spain*	-20	-29
France*	-18	-19
Italy*	-22	-23
UK*	-21	-22

\* Only January to November.

Source: Eurostat.

And although Europe’s economy held up a little longer than in the United States, when the crash did come the damage was even larger: in the euro area, industrial production fell by 21 percent between April 2008 (the peak of the previous expansion) and April 2009 (the worst month of the crisis); in the United States the fall was only 14 percent in the same period. Italy took an even greater blow, minus 25 percent. Recovery has since been very slow and even slower in the euro area than in the United States (Table 3). Everywhere, the fall of production is greater for capital goods industries.

How did the labor markets keep up as these unfavorable events were unfolding? In the industrialized world unemployment rates had been declining almost everywhere since 2006, reaching a low of 4.3 percent in the United States in December 2006, and of 7.2 percent in the euro area in May 2008. In the second half of 2008 the trend turned upwards almost everywhere, and by the end of 2009 unemployment had reached 10 percent in the euro area, 8.8 in Italy, and 9.7 percent in the United States, and the IMF is forecasting further deterioration in the course of 2010 (see Table 4).

On both sides of the Atlantic, this crisis has been the deepest one since the 1930s and bears little resemblance to other recessions experienced since the

**Table 3**

**Industrial production growth  
(change in %, m/m-12, NSA)**

	April 2009	December 2009
EU27	-19.4	-4.7
Euro area	-21.4	-4.8
Germany	-24.1	-7.4
Spain	-19.4	-1.4
France	-19.9	-2.9
Italy	-24.6	-5.6
UK	-11.9	-5.7
USA	-13.7	-4.9*
Japan	-29.9	-3.8*

\* Data for November 2009.

Source: Eurostat.

Table 4

## Unemployment rate (harmonized monthly rate in %, NSA)

	Dec. 2006	Jun. 2007	Dec. 2007	Jun. 2008	Dec. 2008	Jun. 2009	Dec. 2009
EU27	7.7	6.9	6.9	6.8	7.6	8.7	9.5
Euro area	7.9	7.1	7.4	7.3	8.2	9.1	10.0
Germany		8.1	8.1	7.6	7.3	7.5	7.2
Spain	8.3	7.9	8.8	10.7	14.9	17.6	19.6
France	8.9	7.8	7.9	7.2	8.5	8.9	10.0
Italy	6.2	5.4	6.7	6.6	6.8	7.3	8.8
UK	5.3	5.3	4.9	5.5	6.2	7.9	
USA	4.3	4.7	4.8	5.7	7.1	9.7	9.7
Japan	3.7	3.6	3.5	4.0	4.1	5.2	4.8

Source: Eurostat.

Second World War. On the whole, the crisis in the real economy came to the EU and the euro area just a few months later than in the United States, but the final impact is of a similar magnitude, although the fall in aggregate demand and supply has been deeper on the European side, while the consequences on the labor markets have been less harsh in the larger European countries (with the exception of Spain) than in the United States.

### Fiscal stimulus

The reaction to the crisis has been quite fast everywhere. Generally speaking, it involved fiscal stimulus, specific measures to sustain employment and specific measures to deal with financial markets and intermediaries. Here I look at the fiscal stimulus from an aggregate viewpoint. In this perspective, several facts ought to be noted from Table 5, based on IMF estimates of October 2009. With the exception of Germany, which delayed its response until 2009, all countries in the table immediately and indeed 'automatically' reacted to the real contraction with a fiscal expansion that amounted to 1.2 percent of GDP for the euro area. This expansion further strengthened to more than 5.6 and 6.0 percent in 2009 and 2010. For Italy, it amounted to 3.9 percent

in 2009 and 4.4 percent in 2010. It must be noted that expansionary policies were also adopted, and with a similar intensity, by all the major emerging economies. In a related paper, the IMF also suggest that in the advanced G20 economies discretionary measures contributed less than one third to the stimulus of 2009, and in particular that Italy basically abstained from any discretionary stimulus, whereas in Germany discretionary measures amounted to more than 40 percent of the stimulus.<sup>8</sup>

Hence, the aggregate dimension of Italy' stimulus was essentially obtained by letting the automatic sta-

<sup>8</sup> See IMF (2009b). It is also useful to recall that, as soon as the crisis developed, the European Commission drafted a plan for European economic recovery (see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008DC0800:EN:NOT,26November2008>). The main purpose of the plan was to recommend to Member States an immediate budgetary expansion of 170 billion euros, adding into an overall stimulus of about 200 billion euros, or 1.5 percent of the EU's GDP. Although no formal process of coordination took place, most countries – Italy included – presented their own, independently adopted fiscal maneuvers as consistent with the European Commission's (see Stability and Convergence Programmes Submitted by Member States, [http://ec.europa.eu/economy\\_finance/thematic\\_articles/article10982\\_en.htm](http://ec.europa.eu/economy_finance/thematic_articles/article10982_en.htm)). Overall progress is documented in [http://ec.europa.eu/economy\\_finance/publications/publication15048\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication15048_en.pdf). In all of these cases, these measures imply a breach of the 3 percent threshold of budget balances, to be maintained for a few years. Hence, the European Commission was forced in the following months to begin for each country an 'excessive deficit procedure', finding that in most cases – Italy included – both the deficit and the debt criteria were 'not to be fulfilled'. The procedures initiated by the European Commission are listed at [http://ec.europa.eu/economy\\_finance/sg\\_pact\\_fiscal\\_policy/excessive\\_deficit9109\\_en.htm](http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm).

Table 5

## General government fiscal balances and debt (in % of GDP)

	2007	2008	2009	2010	2008	2009	2010	2007	2010	2014
	Actual balance				Balance change from 2007			Gross debt		
Euro area	-0.6	-1.8	-6.2	-6.6	-1.2	-5.6	-6.0	65.7	86.3	95.6
Germany	-0.5	-0.1	-4.2	-4.6	0.4	-3.7	-4.1	63.4	84.5	89.3
Spain	2.2	-3.8	-12.3	-12.5	-6.0	-14.5	-14.7	36.1	69.6	
France	-2.7	-3.4	-7.1	-7.1	-0.7	-4.3	-4.4	63.8	82.6	92.6
Italy	-1.5	-2.7	-5.6	-5.6	-1.2	-4.1	-4.1	103.5	120.1	128.5
UK	-2.6	-5.1	-11.6	-13.2	-2.5	-9.0	-10.6	44.1	81.7	98.3
USA	-2.8	-5.9	-12.5	-10.0	-3.1	-9.7	-7.2	61.9	93.6	108.2
Japan	-2.5	-5.8	-10.5	-10.2	-3.3	-8.0	-7.7	187.7	227.0	245.6

Source: IMF (2009c).

bilizers operate. This has been a sound choice and the reason is apparent from the last two columns of Table 5: simply by letting the stabilizers work, Italy's debt-to-GDP ratio, the highest in the EU, will increase by 17 percentage points by the current year, and by 25 percentage points by 2014, reaching almost 130 percent (by then, debt in the euro area will have increased by 30 percentage points, in Britain and the United States by approximately 45 percentage points, but still, the US debt-to-GDP ratio of the United States will be about 20 percentage points lower than that of Italy). Note that in this perspective the debt positions of the main emerging countries are going to be even more conservative. Hence, my point is quite simply that, if Italy had chosen to conduct a more aggressive fiscal expansion, it would now be hitting the headlines at a faster pace than the news from Greece or Spain, and only thanks to the conservativeness of the government in this respect it is not.<sup>9</sup>

Of course, a standard response to these objections is that debt will be paid back through faster growth or, as Germany's chancellor Angela Merkel put it recently: "we must pursue a growth path, otherwise we cannot generate the needed savings [to pay for the debt]".<sup>10</sup> Nevertheless, Italy has a proven record of no-correlation between fiscal profligacy and faster growth.

### Did Italy do it right?

Italy's room for (fiscal) maneuver was thus quite limited. But was this small space put to a good use? Let us take a few steps back and look at two aspects that characterize fiscal policy and the budget procedure in Italy.

#### *Rising pressure*

Fiscal pressure in Italy has constantly been high (in relative EU terms), and has actually been increasing in the last three years (to reach 42.8 percent of GDP in 2008). The huge bill for servicing the debt (which had decreased from 11.5 percent in 1996 to 6.4 percent in 2000, and then more slowly to 5.1 percent in 2008), is one cause, but clearly not the only one. A rather schizophrenic set of decision making procedures (which provides for a considerable regionalization of decisions, but only on the expenditure

side) and the coalitional nature of all Italian governments since at least the X legislature (July 1987)<sup>11</sup> should perhaps also be kept in mind as causes of this outcome.

#### *Lengthening the horizon*

Since the Berlusconi government took power (on 8 May 2008), and thus well before the crisis had become apparent, the government has begun to adopt a series of innovative measures in the field of public finance. First, the new government confirmed the commitment of the previous one (Prime Minister Prodi, 2006–2008) to reach a balanced budget by 2011 (the so-called '*stabilizzazione triennale del debito pubblico*'). And even at that time, it was clear that the main route to achieve a stabilization had to be the containment of the 'spontaneous' growth of public expenditures ('*Una politica di serio contenimento delle dinamiche incrementalì della spesa pubblica*'), as it was defined by the Economics Minister Giulio Tremonti in a parliamentary speech on 25 June 2008).

Thus, the government confirmed the decision not to adopt an expansionary stance even once the crisis became apparent, although it did leave the automatic stabilizers free to operate. This limited the aggregate dimension of the fiscal stimulus, and created some tensions both within the governing coalition and between government and opposition.

#### *A summary ...*

Since the inception of the crisis the Italian government has adopted numerous policy measures. A list of the more important ones is contained in the appendix. Here I assess them synthetically, comparing their intended and likely achievements. First, the overall impact on the public sector's aggregate receipts or outlays is likely to be small. In fact, fiscal pressure is expected to rise from 42.8 percent of GDP in 2008 to 43.0 percent in 2009 and then to decrease only to 42.5 percent in 2010, while expenditures (net of interest costs) are expected to rise from 40.4 percent in 2008 to 43.1 percent in 2009 and 42.7 percent in 2010. As we saw earlier on, this increase is mostly due to automatic stabilizers.<sup>12</sup>

<sup>11</sup> On the relevance of coalitions in this context – see Hallerberg (2004) and also Hallerberg et al. (2007).

<sup>12</sup> It must be noted, however, that tax revenue on a cash basis decreased by 2.6 percent or 10.6 billion euros, against increases of 9.6, 4.8 and 0.7 percent in the three previous years. Revenue in 2009 was boosted by the extraordinary receipts from the one-off withholding taxes introduced by the first anti-crisis decree (Decree Law 185/2008) and the foreign assets disclosure scheme (Banca d'Italia 2010).

<sup>9</sup> Also note that the cost of servicing Italy's debt is already enormous, above 5 percent of GDP (See Banca d'Italia 2010).

<sup>10</sup> Quoted in the Financial Times, 26 October 2009.

A question arises, however, on their aggregate impact over the longer run. In this respect, a sharp criticism has been voiced by Mario Draghi, the Governor of the *Banca d'Italia*, in his remarks before the parliament in July 2009. He observed that 2009 is the first after 18 years in which Italian public finances would register a primary deficit (that is, an excess of government expenditures over revenues, even before accounting for interest expenses). While he accepted the need for fiscal policy to accompany the exit from the crisis, he also noted that the “*Documento di Programmazione Economica e Finanziaria*” (DPEF: Document for Economic and Financial Planning) for 2010–2013 “does not include information on the levels and composition of revenues and expenditures”, which in turn “makes it difficult to evaluate some crucial aspects of the proposed budgetary policy”.

The absence of this information is critical, since in order to achieve the desired targets for deficits and debts in 2013 it would have been necessary to cut current expenditures in real terms during each year until then, and any such cuts would go against the recent experience (current primary expenditures have been increasing by more than 2 percent per year in real terms between 1999 and 2008). In this context two challenges stand out in particular: one coming from the ageing population (and the corresponding increase in pension expenditures); the other from the need to adopt a series of reforms to strengthen the enterprise sector and restore conditions for growth.

Second, the policy measures may be distinguished into those (which could be termed ‘demand-side’) meant to address the gravest aspects of the economic uncertainty caused by the crisis, and those (‘supply-side’) meant to address the long run, long overdue problems of low productivity growth.

On the demand side, the relevant provisions are the introduction of a ‘social card’ and a bonus for low-income households. Also, the refinancing and extension of income subsidies for redundant workers (*‘Cassa Integrazione Guadagni’*) goes in this direction. However, it must be noted that some of these measures essentially re-invent previous commitments: for instance, the re-financing and extension of the *Cassa Integrazione* has taken the place of expenditures for active labor market policies.

As regards the supply side or pro-growth measures, the negative trend of labor productivity growth in

Italy, compared to the euro area, explains the need for urgent action. Such action includes policies to encourage labor productivity and to retrain temporarily unemployed workers; to stimulate new investments and to incentivize new entrepreneurs; to raise the retirement age and to re-model the tax pressure; to boost productivity in the public sector and to provide a substantial improvement in public (infrastructure) capital. However, with the possible exception of measures to enhance productivity in the public sector and infrastructures, it is doubtful whether the scale of the policies adopted is proportionate to the effort which is required to restore productivity growth.

... and some critiques

The measures adopted by the government have been subject to several criticisms, both within the government coalition (where some ministers have explicitly criticized the strict budget limits enforced by the Economics Minister Giulio Tremonti), and by the opposition (which, however, seemed keener on asking for more ‘debates’ in the parliament than on proposing well structured alternatives).

Among the criticisms, those that advocate more deficit spending, or a drastic reduction of the overall tax levels, appear quite unreasonable, for the reasons outlined above. Let us examine instead in more detail some individual measures:

- **Fiscal shield.** The main purpose of this measure was to induce tax evaders, who had illegally exported funds, to repatriate them. This aroused three main criticisms: (1) the tax rate (a flat 5 percent) is too compliant towards tax evaders; (2) there will be no request to recapture foregone tax revenue; and (3) there will be no controls on how the capital to be ‘shielded’ had been obtained in the first instance, so that in fact the shield may encourage money laundering (see Giannini and Guerra 2009). To some extent, these criticisms appear justified. In particular, in a country where social capital and civic duty have been downgraded, it is fair to question whether it is appropriate to indulge in efforts to re-legitimize illegally-earned capital. On the other hand, as the recent arguments with neighboring states (Switzerland and San Marino) show, the adoption of the fiscal shield is part of a wider strategy to get tough on tax evaders (or at least against illegal

capital exports): this effort is to be appreciated and supported.

- **Retirement age.** Under pressure from the European Court of Justice, the government adopted measures that require public sector workers of both genders to have the same retirement age by 2018. This actually introduces a disparity between women in the public vs. private sector, and does not address the main issue with respect to the retirement age, which is to render the whole question more flexible, with appropriate incentives for those who want to retire at a later date. While it is clear that the government did not want to confront the opposition of left-wing unions and (within its own coalition) also of the *Lega Nord* party, this has been in fact a missed opportunity. This is particularly true given that a more radical (and immediate) reform of the retirement age would generally improve the long-run outlook of public finances.
- **Regional taxes.** Although the government introduced a new law on fiscal federalism (rather vague, in fact, on empowering regions with fiscal powers), it did not take the opportunity of the crisis to redefine or rationalize the existing “regional” taxes, and especially IRAP.<sup>13</sup> In fact, the crisis could have been the appropriate time to rationalize this tax, but (despite some debates, even within the government majority) the opportunity has been missed.
- **Shock absorbers.** The government has essentially refinanced shock absorbers, without introducing radically new measures or reforms, and possibly at the expense of funding alternative labor market policies. This position has encountered two main criticisms: (i) this was a lost opportunity to reform the whole system, in order to adopt a more modern system of shock absorbers, which should be focused on stimulating re-employment opportunities; and (ii) many unemployed persons do not receive any compensation for lost jobs.

On the first point, the position expressed by a government minister, that Italy has ‘a good system of social shock absorbers’<sup>14</sup> is surprising. While the rate of unemployment has increased from a low of 5.7 percent (August 2008) to

8.8 percent in December 2009, the number of workers covered by the three forms of ‘*Cassa Integrazione*’ (*ordinaria, straordinaria, in deroga*), and as such not included in the unemployed, has reached a record level in the first nine months of 2009, probably above 600.000. Still, many temporary workers receive no benefits upon losing their jobs (especially the so-called ‘*Lavoratori coordinati e continuativi a progetto*’).

Some of the reform proposals in the spirit of introducing a system of homogenous universal benefits, should undoubtedly be explored with more determination (Boeri and Garibaldi 2009). On the other hand, it is also fair to say that a more comprehensive system of unemployment benefits, with an emphasis on re-employment, is a fairly complex mechanism of incentives, and if improperly designed, it could easily yield perverse results. Hence, it would be wiser to introduce such a new system after adequate experimentation, and not in the rush of a crisis.

On the second but related point, the question arises why this crisis has not been used as an opportunity to modify the law on labor contracts, aiming at reducing the existing segmentation between fully protected insiders and unprotected outsiders. While the recent remarks of Economics Minister Giulio Tremonti on the desirability of ‘permanent’ job positions could perhaps be interpreted as an *ouverture* to this option, it is unfortunate that no serious debate on these issues is apparently taking place, either within the government or with the parliamentary opposition. Silvio Berlusconi and other ministers have instead re-emphasized the socially stabilizing role of the traditional Italian family; hardly a promising starting point for a debate on how to restore dynamism into the Italian productive sectors.

- **Focus on growth and productivity.** A criticism related to the previous one is that the set of measures adopted, up to the Financial Law passed in December 2009, lacks an overall focus on growth. In the medium and long run, Italy’s problem is not only to fight recession but to resume growth. As Table 6 shows, Italy’s sluggishness in the last decade (which has brought its GDP per capita from 117.5 percent of the EU27 average in 1999 to 102 in 2008, and well below the euro area average) can be summarized by the abysmal performance of labor productivity (on a hourly basis the comparison would be even less flattering). In this respect, while some of the adopted measures do focus on infrastructure improvements and on tax

<sup>13</sup> IRAP is a peculiar version of a corporate tax, as it includes also the labor and interest costs in the tax base, and in many cases it must be paid even after reporting a loss in the statement of profits. On the other hand, this tax generates a large part of the resources that fund the regional health services, thus it is rather difficult to dispense with it.

<sup>14</sup> See an interview with Renato Brunetta by Aldo Cazzullo, *Corriere della Sera*, 7 March 2009, [http://www.corriere.it/politica/09\\_marzo\\_07/intervista\\_brunetta\\_ammortizzatori\\_sociali\\_aldo\\_cazzullo\\_382e8f6a-0ae2-11de-a3df-00144f02aabc.shtml](http://www.corriere.it/politica/09_marzo_07/intervista_brunetta_ammortizzatori_sociali_aldo_cazzullo_382e8f6a-0ae2-11de-a3df-00144f02aabc.shtml).

Table 6

**Labor productivity per person employed**  
(GDP in PPS per person employed relative to EU27, EU27 = 100)

	2000	2005	2006	2007	2008	2009	2010
EU27	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Euro area	112.8	109.8	109.6	109.6	109.3		
Germany	108.0	109.4	109.2	108.3	107.0	101.3	102.8
Spain	103.7	101.3	102.7	103.3	103.6	106.4	106.4
France	125.1	122.2	121.2	121.6	121.6	120.6	121.3
Italy	126.0	111.0	110.1	110.2	109.7	105.3	105.3
UK	110.8	112.5	112.0	110.0	110.0	106.6	106.9
USA	141.8	144.1	143.8	143.2	144.9	146.0	147.8
Japan	98.8	99.5	100.0		99.7	95.5	96.3

Source: Eurostat.

exemptions for new capital investments (the so-called ‘*Tremonti-ter*’ law), as well as on boosting labor productivity within the public sector, the amount and type of the measures adopted to stimulate productivity and competitiveness are quite limited. And the way the shock absorbers operate, by essentially ‘freezing’ employees in their pre-existing jobs, might even reduce the ability of firms to adapt to the opportunities and challenges posed by the scenario post-crisis.<sup>15</sup>

On this point, however, the government has stated its intention to propose new, specific laws in the beginning of 2010 – although these are still in the waiting room. Perhaps more important, however, is that some crucial debates on growth-related issues are now hitting the headlines. One is the question of criminality and corruption, and of their negative impact not only on the ‘quality’ of life but also on economic performance: on these issues, a new determination and political consensus might be slowly emerging. The second is related to the refusal of car-maker Fiat to accept an ‘exchange’ of government subsidies for a commitment to keep an obsolete plant going that is located in Sicily. Both sets of issues might be conducive to more productive ‘soul-searching’ exercises about the causes of slow growth in Italy.

#### Dangers ahead and glimmers of local hope

Several international indicators are suggesting that the crisis is coming to an end: the US economy returned to positive growth in the third quarter of 2009, and in November the European Commission

announced that the “recession is over but major challenges persist”.<sup>16</sup>

A first challenge comes again from finances. The financial crisis has not ended yet. According to the IMF, write-downs on British bank assets are going to be USD 604 billion, USD 814 billion for the euro area and USD 1,025 billion for the United States. These are enormous sums. They are especially enormous for Britain, given its small size, but we have learned by now that it would be hard to contain any new financial crisis on a local dimension. In this respect, it is worrisome that the engine of structural and regulatory reforms seems to have run out of steam.

The other main challenge stems from the fall of the US dollar. A lower dollar is desirable, as it is the only way to rebalance the United States current account deficit *vis-à-vis* the rest of the world. Hence we should and probably will live with a weaker dollar relative to the euro. This is bad news for Italy, however. Given its weak export base, a lot of industrial restructuring will be needed before Italy can adjust to a stronger euro. This adjustment will cause pain but it could be helped by proper measures to help firms restructure and consolidate. And this will require more labor mobility and more organizational flexibility – which in turn will call for new social shock absorbers and new labor contracts, as well as a reform of the retirement age and an improvement of educational standards, as well as an enforcement of the ‘rule of law’ adequate to that of an advanced economy.

In the end it all fits together: global challenges require (also) local reforms, and we should realize

<sup>15</sup> An interesting (albeit negative) observation is that, based on data from the Innobarometer, Italy is one of the EU countries where firms have been induced to cut more from their innovation investments after the current recession (see Archibugi and Filippetti 2010).

<sup>16</sup> See [http://ec.europa.eu/news/economy/091103\\_en.htm](http://ec.europa.eu/news/economy/091103_en.htm).

this sooner rather than later. At least a reasonable division of labor is emerging. On the financial challenge, which is inherently global, Italy has some voice, but no real options. On the real economy challenge, Italy has a voice but could also exercise some options. The internal political economy for these options is not great, but affordable. And although a few opportunities have been missed, some appropriate measures have been taken. But many and more resolute ones should still be taken, and serious discussions are hopefully about to begin.

### Appendix: main policy measures adopted by the Italian government during the crisis 2008–2009

#### *Economic measures adopted during 2008*

- Decree No. 93, 27 May 2008; turned into Law No. 126, 24 July 2008:
  - Abolition of ICI (local property tax) for owner-occupied houses, and
  - Partial tax exemption of overtime work.
- Decree No. 112, 25 June 2008; turned into Law No. 133, 6 August 2008:
  - Adoption of a 3-year growth plan, aiming at concentrating the resources for underdeveloped areas ('FAS') on selected projects,<sup>17</sup>
  - Adoption of a program for 'strategic' infrastructures,<sup>18</sup>
  - Re-modulation of the tax base for banks, insurances, and energy companies (so-called 'Robin Hood tax'),<sup>19</sup>
  - Introduction of a 'social card' to subsidize basic consumption of the low income earners, and
  - Introduction of an 'industrial plan' to increase labor productivity within the public sector.
- Decree No. 185, 29 November 2008; turned into Law No. 2, 28 January 2009:
  - Bonus for low-income households,
  - 3 percentage points reduction of the corporate and regional (IRAP) tax,
  - Confirmation and strengthening of tax exemptions in favor of 'productivity wages', a refinancing of social shock absorbers, and
  - Financing and 'speeding up' of procedures for several large-scale or strategic infrastructures.

<sup>17</sup> [http://www.governo.it/GovernoInforma/Dossier/piano\\_trienale\\_sviluppo/](http://www.governo.it/GovernoInforma/Dossier/piano_trienale_sviluppo/).

<sup>18</sup> [http://www.governo.it/GovernoInforma/Dossier/manovra2009/allegato\\_infrastrutture.pdf](http://www.governo.it/GovernoInforma/Dossier/manovra2009/allegato_infrastrutture.pdf).

<sup>19</sup> [http://www.governo.it/GovernoAzione/politiche\\_economiche/manovra\\_2009/dpefopen.pdf](http://www.governo.it/GovernoAzione/politiche_economiche/manovra_2009/dpefopen.pdf).

#### *The first months of 2009*

Under the heavy pressure of the crisis, some new measures were adopted, which substantially confirmed and reinforced those previously adopted:<sup>20</sup>

- Law No. 15, 4 March 2009:
  - Incentives to improve labor productivity in the public sector.<sup>21</sup>
- Law No. 42, 5 May 2009:
  - Fiscal federalism.<sup>22</sup>

Regarding fiscal federalism it must be remarked that, although it will possibly become – in the long run – the most pervasive reform of all those adopted in the year, its effects on the current situation are in fact nil.

Another relevant act at the beginning of 2009 was the signing of an agreement (sponsored by the government) between the *Confindustria* (Employers Association) and the Trade Unions (with the exclusion of the more left-oriented CGIL) to reform wage bargaining in the private sector. The agreement introduces a two-level bargaining (national and 'second level') system, adopts a new reference European price index, sets a three-year length for all contracts, and confirms the tax exemptions on overtime.

#### *Measures adopted during the summer of 2009*

The government Decrees No. 78 of 1 July 2009 and No. 103 of 3 August 2009, which were respectively turned, with several changes and additions, into the Law No. 102 of 3 August 2009 and the Law No. 141 of 3 October 2009, contain several new measures:<sup>23</sup>

- Tax exemptions for new capital investments (the *Tremonti-ter*),
- An 'Employment Prize' for workers receiving income subsidies (such as the *Cassa Integrazione*) that will be employed in training projects with the same employer who put them under benefits,
- Re-funding of the system of 'social shock absorbers',
- Incentives for new self-entrepreneurs,
- A limited increase of retirement age,

<sup>20</sup> A detailed list of the most relevant laws and decisions adopted in the context of the 'Manovra per il 2009' – see [http://www.governo.it/GovernoAzione/politiche\\_economiche/manovra\\_2009/index.html](http://www.governo.it/GovernoAzione/politiche_economiche/manovra_2009/index.html).

<sup>21</sup> [http://www.governo.it/GovernoInforma/Dossier/lavoro\\_pubblico\\_riforma/legge\\_4marzo2009.pdf](http://www.governo.it/GovernoInforma/Dossier/lavoro_pubblico_riforma/legge_4marzo2009.pdf).

<sup>22</sup> [http://www.governo.it/GovernoInforma/Dossier/federalismo\\_fiscale/legge42\\_2009.pdf](http://www.governo.it/GovernoInforma/Dossier/federalismo_fiscale/legge42_2009.pdf).

<sup>23</sup> [http://www.governo.it/GovernoInforma/Dossier/decreto\\_antiscrisi260609/index.html](http://www.governo.it/GovernoInforma/Dossier/decreto_antiscrisi260609/index.html).

- Regularization of certain types of illegal immigrants (if employed in home services),
- A ‘moratorium’ on mortgage payments due by firms to banks, and
- Introduction of a new ‘fiscal shield’ (immunity from prosecution, in return for the payment of a flat 5-percent tax) for foreign investments previously undeclared to the fiscal authorities.

### *The Financial Law of 2010*

A somewhat confused debate has taken place since the presentation of the government proposal of the Financial Law, which took place in September 2009.<sup>24</sup> The discussion between the two parliamentary chambers ended on 22 December 2009, after a ‘confidence vote’ required by the government to cut short the debate. In the end, the government proposed, and the parliament approved, to use the revenue from the fiscal shield – probably in the order of 5 billion euros, and only for 2010 – to finance a number of measures (in areas like large infrastructure investments, tax credit for R&D expenditures, refinancing of shock absorbers, compensating local authorities for the loss of revenue from property taxes, and the institution of a new *Banca del Mezzogiorno* aimed at providing financial means for the development of the Southern Regions). These measures do not alter the macroeconomic picture, with a net indebtedness of the public sector of 5.3 percent of GDP in 2009, and 5.0 percent in 2010 (while the change in GDP is finally estimated at – 4.8 percent in 2009, and + 0.7 in 2010).

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