ECONOMIC POLICY IN A GLOBAL CRISIS: DID ITALY GET IT RIGHT?

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I shall approach the theme of this chapter bearing in mind two facts. The first is that the worst post–World War II crisis in the world economy has been halted, and we are slowly getting back to the surface. The second is that Italy is a small, open, slow-growing economy with little room to maneuver by itself and is part of a large, rich, open, and most probably irresolute and relatively declining area of the world. Let me clarify. The world economy has indeed been rescued. A wide range of emergency measures have been adopted throughout the world to arrest its descent along a downward spiral. Generally speaking, the measures adopted were prompt, untested, and partial, and many went against conventional wisdom. But they seem to have worked, which is even more of a tribute to those who decided to adopt them. However, rescue is not recovery. That will take more time and will be more difficult to achieve, in part because during a recovery there usually is much less pressure to act immediately.

Italy has little that it can do by itself, especially in terms of short-term policies. Its monetary and exchange rate policy is (luckily) set by the European Central Bank (ECB). Its fiscal policy is effectively blocked by its enormous debt. Its ability to reform is gravely hindered by the lack of social and policy consensus and by the deterioration of the climate for public and policy debates. The fact that many of the measures that have been adopted have pushed Italy in the right direction is indeed something to celebrate. Nonetheless, these measures are

insufficient to promote a more sustained recovery. Italy is in a relative decline, but since Italians were comparably well off before the crisis, they will not find this situation too alarming—at least for a while. Hopefully, they will take action before it becomes too late.

How the Crisis Began

The financial crisis started in 2007 in the United States and then spread to the financial systems in other countries, mostly in Europe, and to the real economy, first in the US and then to other real economies, again mostly in Europe. As is well known, the catalyst for the crisis was the end of the housing bubble in the US. From March 1998 to March 2007, there had been a double-digit rise in house prices every two years. This ended in August 2007, and by September prices began to fall. The fall in house prices caused the collapse of the sub-prime mortgage market, which spread to all of the US financial markets, leading to the remarkable failures of Northern Rock (in the United Kingdom, February 2008), Bear Sterns (March 2008), and both Lehman Brothers and AIG (September 2008). The stock market held on for a little longer, but after 8 October 2007, the US stock markets began to slide, followed by the other world indexes, and the slide became a crash after March 2008. Markets seemed to have bottomed out in early March 2009, after a fall that amounted to 57 percent for the S&P 500 (US), 60 percent for the FTSE Eurofirst 300 (Europe), and 54 percent for the S&P/ASX 200 (Asia).

The real economy began to emerge from the crisis in the second half of 2009, both in Europe and in the US. Although a recovery is under way, the course that the major economies will follow along this path is quite uncertain and is probably also conditional on the policies that will be adopted as part of the so-called exit strategies.¹

How the Crisis Spilled Over to Europe—and to Italy

The economic crisis had two dimensions, financial and real, and each had its own “channels of transmission” from one country to the others. Here we deal first with the real side of the crisis. In the euro area, GDP peaked in the second quarter of 2008, and industrial production remained strong until that quarter. Thus, although Europe held up a little longer than the US, when the crash came, it was even harder: production fell by 15 percent in the US between December 2007 and June 2009, and by 20 percent in the euro area between the first quarter of 2008 and the second quarter of 2009.

Why did not Europe decouple from the US? Let us focus on the euro area, which had already been a slow growth region at least since 1999.² With the crisis, exports from the euro area declined by 21 percent between the third quarter of 2008 and the second quarter of 2009—five times more than the contemporaneous decline of GDP. Additionally, in the same period, gross fixed capital formation decreased by 11 percent. Hence, even without a more technical analysis, it is clear that the recession was due in part to the fall in the world's—especially the US's—demand for euro area exports, which quickly fed into the domestic demand for capital goods.

In Italy, both industrial production and total exports fell faster than in the rest of Europe and the euro area, declining, respectively, by 24 percent and 25 percent between the first quarter of 2008 and the second quarter of 2009. This was presumably to be expected, given that the positioning of Italy's trade in the euro area makes it relatively more sensitive to the weakening of the business cycle and to the depreciation of the dollar.

How did the labor markets keep up as these unfavorable events were unfolding? Almost everywhere in the industrialized world, unemployment had been declining since 2006, reaching a new low toward the beginning of 2008 (the end of 2007 in the US). Unemployment rates then rose to around 9 percent (the same values held in 2003–2005), having increased by about 2 percent in the EU and the euro area as a whole and by more than twice that (4.4 percent) in the US. In Italy, unemployment has increased even less to date, by roughly 1 percent, although the 2009 World Economic Outlook of the International Monetary Fund (IMF) foresaw that unemployment would deteriorate further and that by 2010 it would reach between 10.3 percent and 10.7 percent in Italy, as well as in Germany, France, and the US.

On both sides of the Atlantic, this crisis was the deepest one since the 1930s, bearing little resemblance to the other recessions experienced since World War II. 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 US, but the impact it had was of the same order of magnitude. The difference was that while the fall in aggregate demand and supply had since been slightly deeper on the European side, the consequences on the labor markets were less harsh in the larger European countries than in the US.

Fiscal Stimulus

As is well known, the response to the crisis was quick. Generally speaking, it involved a fiscal stimulus, measures to sustain employment, and

specific actions to deal with financial markets and intermediaries. The financial measures were the first to be implemented, but here we continue to focus on the fiscal aspect.

Several facts ought to be noted from table 10.1, which contains IMF estimates. First, with the exception of Germany, all of the countries in the table—whether industrial or emerging—immediately and indeed “automatically” reacted to the real contraction with a fiscal expansion. For the G20, this amounted to 1.3 percent of GDP on a weighted basis. This expansion was due to strengthen to more than 5 percent in 2009 and 2010. For Italy, this amounts to 3.9 percent in 2009 and 4.4 percent in 2010.

Second, discretionary measures contributed less than half of this stimulus. Among the emerging countries, the largest discretionary spenders are China and Russia, while the US and Germany are the largest among the industrial countries (although, until October 2009, Germany was among the least vocal supporters of such measures). Italy basically abstains from discretionary spending.

The European Commission drafted the European Economic Recovery Plan (EERP) as soon as the crisis developed.³ Besides an increase of 10 billion euros in the annual package of loans from the European Investment Bank to small and medium enterprises (bringing the total amount to 30 billion euros) and a simplification package to speed up the decision-making on the issue of state aid, the main purpose of the EERP was to encourage member states to approve an immediate budgetary expansion of 70 billion euros, thus bringing the whole stimulus package to around 200 billion euros, or 1.5 percent of the EU's GDP. Although no formal process of coordination took place, most countries—Italy included—chose to present their own independently adopted fiscal maneuvers as being consistent with the Commission's plan.⁴ In all of these cases, these measures imply a breach of the 3 percent threshold for acceptable budget balances, to be maintained for a few years. Hence, and although the EERP had called for the adoption of measures “consistent with the flexibility offered by the Stability and Growth Pact,” the Commission was forced in the following months to begin for each country an “excessive deficit procedure.” Not surprisingly, the result was that, in most cases—Italy included—both the deficit and the debt criteria were found “not to be fulfilled.”⁵

On the opposite side, several commentators have criticized Italy for not doing enough,⁶ as the aggregate dimension of Italy's stimulus was essentially obtained by letting the automatic stabilizers operate. This judgment is probably unfair. The reason is in the last two columns of table 10.1. Simply by letting the stabilizers work, Italy's debt-to-GDP ratio will increase by 15 points by 2012, reaching almost 117 percent.

TABLE 10.1 *Overall fiscal expansion (% GDP)*

	2007	2008	2009	2010	2008	2009	2010	2008	2009	2010	Debt projections 2012°	
	Overall Balance				Change in Overall Balance (with respect to 2007)			Discretionary Measures (with respect to 2007)			Pre- crisis	Post- crisis
Brazil	-2.2	-1.5	-1.9	-0.8	0.0	0.0	0.0	0.0	0.6	0.8	62.7	58.3
China	0.0	-0.3	-3.6	-3.6	-1.2	-4.5	-4.5	0.4	3.1	2.7	11.2	20.2
France	-2.7	-3.4	-6.2	-6.5	-0.7	-3.5	-3.8	0.0	0.7	0.8	60.5	80.3
Germany	-0.5	-0.1	-4.7	-6.1	0.0	-4.2	-5.0	0.0	1.6	2.0	59.4	78.9
India	-5.2	-8.4	-10.2	-8.7	-3.2	-5.0	-3.5	0.6	0.6	0.6	61.6	78.2
Italy	-1.5	-2.7	-5.4	-5.9	-1.2	-3.9	-4.4	0.0	0.2	0.1	102.0	116.7
Russia	0.3	0.2	-6.2	-5.0	-2.5	-13.0	-11.7	0.0	4.1	1.3	2.3	6.5
United Kingdom	-2.6	-5.4	-9.8	-10.9	-2.7	-7.2	-8.3	0.2	1.4	-0.1	42.5	74.7
United States	-2.9	-4.7	-9.1	-8.8	-1.8	-6.2	-5.9	1.1	2.0	1.8	65.8	97.3
G20*	-1.1	-2.3	-6.6	-6.5	-1.3	-5.5	-5.4	0.5	2.0	1.5		

Notes: °Estimates from IMF, "The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis," 6 March 2009, <http://www.imf.org/external/np/pp/eng/2009/030609.pdf>. *PPP (purchasing power parity) GDP-weighted averages.

Source: IMF, "Update on Fiscal Stimulus and Financial Sector Measures," 26 April 2009, <http://www.imf.org/external/np/fad/2009/042609.pdf>.

By then, the other countries will have increased the same ratio by around 20 percent (France and Germany) or by 32–33 percent (UK and US), but none will have reached a ratio of 100 percent. Emerging countries are even more conservative: none of those included in the table are projected to increase the debt ratio by more than 10 percent of GDP. But so what? Why should not Italy maintain a more aggressive fiscal policy?

In fact, there are compelling reasons why not, and they all hinge on the high level of Italy's public sector debt-to-GDP ratio. The crisis has placed unusually strong pressures on the money and financial markets in all countries, but especially in those countries that, for one reason or another, were perceived to be somewhat "at risk." Consider, for instance, Denmark: it is one of the most "well-behaved" and disciplined countries in the EU; it has successfully pegged its currency to the euro since the start of the single European currency; its budget was in a surplus (up 3 percent of GDP); and its debt ratio was a meager 21.6 percent until 2008.⁷ Nevertheless, as soon as the crisis erupted, even such a virtuous country was forced to raise its money market rates by almost 2 percentage points relative to the euro, simply because it is not a member of the euro area. Or consider, within the euro area, the spread of long-dated government bonds against the German Bunds: between January 2008 and January 2009, the spread on Greek bonds went up from 30 basis points to 300.⁸ Even looking at the monthly spread (which averages out the daily spikes), in March 2009 this reached 285 basis points for Greece, 274 for Ireland, and 244 for Italy. For Italy, this was achieved by "doing nothing," that is, simply by virtue of the high debt that it had inherited from the late 1990s.⁹

If Italy had deliberately chosen to increase its debt beyond the projected level, moreover, the future costs of servicing the debt would have become even larger and hence also more sensitive to future oscillations in the terms structure of interest rates. The cost of servicing the debt is already enormous at above 5 percent of GDP. It is likely that, at most within the next two or three years, interest rates at the short end of the curve (and possibly also at the far end) will increase. At that time, the cost of servicing the debt will increase and become more volatile, even keeping everything else the same, and any additional fiscal imprudence now would place the Italian fiscal authorities in a much more difficult position in the near future. Italy is surely a country that must avoid these risks at all costs.

Of course, the standard response to these objections is that the debt will be paid back through faster growth. 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]."¹⁰

Nevertheless, Italy has a proven record of non-correlation between fiscal profligacy and faster growth.

Did Italy Do it Right?

Italy's room for fiscal maneuver was limited. But was this small space put to good use? Let us begin by taking a few steps back to look at two aspects that characterize fiscal policy and the budget procedure in Italy. Fiscal pressure in Italy has consistently been high (in relative EU terms) and has actually been increasing over the last three years to reach 42.8 percent 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 percent in 2008), is one cause, but clearly not the only one. A rather schizophrenic set of decision-making procedures, which provide for a considerable regionalization of decisions, but only on the expenditure side, and the coalitional nature of all Italian governments since at least the 10th Legislature (July 1987) should perhaps also be kept in mind as causes of this outcome.¹¹

When Silvio Berlusconi's government took power on 8 May 2008—and thus well before the crisis had become apparent—the government began to adopt a series of innovative measures in the field of public finance. First, the new government confirmed the commitment of the previous prime minister (Romano Prodi, 2006–2008) to reach a balanced budget (the so-called three-year stabilization of the public debt) by 2011. Even at that time, it was clear that the main route to achieve stabilization had to be the containment of the “spontaneous” growth of public expenditures (“a serious policy to contain the incremental growth in public expenditure,” as it was put by the minister of economy and finance, 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. As table 10.1 shows, this led Italy's overall budget balance for 2008 to expand by 1.2 percent in 2008 and by a further 2.7 percent in 2009. This decision limited the aggregate dimension of the maneuver to be adopted and so created tension both within the governing coalition and between the government and the opposition. Consider the remarks made before Parliament in July 2009 by Mario Draghi, governor of the Bank of Italy. Draghi observed that 2009 would be the first time in 18 years in which Italian public finances would register a primary deficit, that is, an excess of government expenditures over revenues, even before taking

into account the interest expenses. While Draghi accepted the need for a fiscal policy to accompany the exit from the crisis, he also noted that the Document for Economic and Financial Planning (DPEF) for 2010–2013 “does not include information on the levels and composition of revenues and expenditures,” which in turns “makes it difficult to evaluate some crucial aspects of the proposed budgetary policy.”¹²

The absence of this information is critical, since in order to achieve the desired targets for deficits and debts in 2013 (by which time the debt is forecast to be 114 percent of GDP), it will be necessary to cut current expenditures by 1 percent in real terms each year in the period 2010–2013 (under the assumption that the GDP will grow by 2 percent in real terms each year after 2011). Of course, the projected cuts go against the practice of the recent past (in which primary expenditures have been increasing by more than 2 percent per year in real terms between 1999 and 2008). Draghi’s remarks thus point to two observations: first, that the proclaimed fiscal virtue may be more apparent than real, since the government has not made clear how it will engineer the (relative) stabilization of public finances to be achieved by 2013; second, that the specific content of the required cuts has to be stated clearly, as the budget will put under strain in the near future. Two challenges stand out in particular, one coming from the aging population (with a 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.

Adopting this perspective, how then should we evaluate the measures intended to stimulate growth that were put into place immediately after the government had been sworn into power? The first step is to summarize briefly the main economic measures enacted since the beginning of the crisis. The following are the first economic measures to be adopted.¹³

Decree No. 93, 27 May 2008; turned into Law No. 126, 24 July 2008:

- Abolition of the ICI (local property tax) for owner-occupied houses
- Partial tax exemption for overtime work.

Decree No. 112, 25 June 2008; turned into Law No. 133, 6 August 2008:

- Adoption of a three-year growth plan, aimed at concentrating the Fund for Underdeveloped Areas (FAS) on selected projects
- Adoption of a program for “strategic” infrastructures
- Remodulation of the tax base for banks, insurances, and energy companies (the so-called Robin Hood tax)

- Introduction of a “social card” to subsidize basic consumption of low-income earners
- Introduction of an “industrial plan” to increase labor productivity within the public sector

Decree No. 185, 29 November; turned into Law No. 2, 28 January 2009:

- Bonus for low-income households
- Reduction of 3 percentage points of the corporate and IRAP tax rates
- Confirmation and strengthening of tax exemptions in favor of “productivity wages” and a refinancing of social shock absorbers
- Financing and “speeding up” of procedures for several large-scale or strategic infrastructures

In the first months of 2009, under heavy pressure from the crisis, some new measures were adopted that substantially confirmed and reinforced those that had been adopted previously.

Law No. 15, 4 March 2009:

- Incentives to improve labor productivity in the public sector

Law No. 42, 5 May 2009:

- Fiscal federalism

In the long run, fiscal federalism will possibly be the most pervasive reform of all those adopted since the crisis began. However, its effects on the current situation are nil and hence will not be discussed here.

Another relevant action at the beginning of 2009 was the signing of an agreement (sponsored by the government) between the employers’ federation Confindustria and the trade unions (with the exclusion of the more left-oriented CGIL) to reform wage bargaining in the private sector. The agreement introduces two-level bargaining (national and “second level”), adopts a new reference European price index, sets a three-year length for all contracts, and confirms the tax exemptions on overtime work.

During the summer of 2009, the government issued Decree No. 78 of 1 July 2009 and Decree No. 103 of 3 August 2009, which were respectively turned, with several changes and additions, into Law No. 102 of 3 August 2009 and Law No. 141 of 3 October 2009. These laws contain several new measures:

- Tax exemptions for new capital investments
- An “employment prize” for workers receiving income subsidies (such as the so-called *cassa integrazione*), which will be used in

training projects with the same employer who put them under benefits

- The refinancing of the system of social shock absorbers
- Incentives for new self-entrepreneurs
- A limited increase of the retirement age
- The regularization of certain types of illegal immigrants (if employed in home services)
- A “moratorium” on mortgage payments owed by firms to banks
- The introduction of a new “fiscal shield” (immunity from prosecution, in return for the payment of a flat 5 percent tax) for previously undeclared foreign investments

A somewhat confused debate took place following the presentation of the government’s proposal for the financial law, which took place in September. The discussion between the two parliamentary chambers began in November 2009 and ended on 22 December, after a confidence vote was called by the government to cut the debate short. In the end, the government proposed (and received Parliament’s approval) to use the revenue from the fiscal shield (or tax amnesty)—probably on the order of 5 billion euros and only for 2010—to finance a number of measures: large infrastructures, tax credits for R&D expenditures, the refinancing of social shock absorbers for 2010, the compensation of local authorities for loss of revenue from property taxes, and also the institution of a new Bank of Southern Italy to provide financing for the development of the southern regions. These measures do not alter the macro-economic picture, with a net indebtedness (or deficit) of the public sector of 5.3 percent of GDP in 2009 and 5.0 percent in 2010 (while the change in GDP is estimated finally as a decline of 4.8 percent in 2009 and a rise of 0.7 in 2010).

What will all of these measures achieve? First, they will have a minimal impact on the aggregate amount of the public sector’s receipts or outlays. 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. This increase is mostly, but not entirely, due to automatic stabilizers.¹⁴ Second, these measures are supposed to be effective in two directions: some (which could be termed “demand side”) are meant to address the gravest aspects of the economic uneasiness caused by the crisis, while others (termed “supply side”) are intended to address the long-run (and long-overdue) problem of low productivity growth.

On the demand side, the relevant provisions are the introduction of the “social card” and the bonus for low-income households. Also the

refinancing and extension of income subsidies for redundant workers (*cassa integrazione*) goes in this direction. However, the overall impact of these measures appears to be limited. Some of them essentially remodulate previous commitments: for instance, the refinancing and extension of the *cassa integrazione* has taken the place of expenditures for active labor market policies.¹⁵

As regards the supply side or pro-growth measures, the negative trend of labor productivity growth in Italy vis-à-vis 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 increase the age of retirement and to remodel 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 to improve infrastructures, it is doubtful whether the scale of the policies adopted is proportional to the effort that is required to restore productivity growth.

Unsurprisingly, the measures proposed by the government have met with criticism, both from within the government coalition (with some ministers explicitly criticizing the strict budget limits enforced by the minister of economy and finance) and from the opposition (which, however, seems more keen on taking part in parliamentary debates than on proposing well-structured alternatives). Among criticisms, those that advocate more deficit spending or a drastic reduction of the overall tax pressure appear quite unreasonable, for the reasons outlined above. The same goes for those requests “to put people before firms,” as if a sustainable recovery could ever be engineered (given the protracted relative decline in Italian productivity) by a more generous or more populist income redistribution. Other criticisms that look more clearly into the detailed functioning of each measure appear to be more justified, as analyzed below.

Fiscal Shield

The three main criticisms of this measure are (1) that the tax rate (5 percent) appears complacent toward tax evaders; (2) that there will be no request to recapture foregone tax revenue; and (3) that there will be no controls on how the capital to be “shielded” was obtained, so that in fact the shield may encourage money laundering.¹⁶ 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 relegitimize illegally earned

income. On the other hand, as 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 to take a stand against illegal capital exports). This effort should clearly be appreciated and supported.

Retirement Age

The measures adopted (under pressure from the European Court of Justice) 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 sector and those in the private sector, and it fails to address the main issue with respect to the retirement age, which is to render the whole procedure more flexible, with appropriate incentives for those who want to retire early or late. While it is clear that the government did not want to confront the opposition of left-wing unions and possibly also of the Northern League, this has been a missed opportunity. This is particularly true given the resources that would become available with a more radical (and immediate) reform of the retirement age.

Regional Tax on Productive Activities (IRAP)

As mentioned previously, there has been some debate, within the government and within its parliamentary majority, as to whether it would be appropriate to reduce, remodulate, or substitute this unpopular tax with a new regional tax, more in the spirit of fiscal federalism. This opportunity has not been taken.

Social Shock Absorbers

The debate about social shock absorbers is more complicated. The government has essentially refinanced shock absorbers without introducing any new measures or reforms, possibly at the expense of funding alternative labor market policies. This position has encountered two main criticisms: (1) that this was a lost opportunity to reform the whole system by adopting a more modern system of shock absorbers, which would focus on stimulating re-employment opportunities; and (2) that 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” is surprising.¹⁷ According to a survey conducted by ISTAT for the second

quarter of 2009, the number of unemployed people has increased from 1,704,000 in the second quarter of 2008 to 1,841,000 in the second quarter of 2009. At the same time, the number of workers covered by the three forms of *cassa integrazione (ordinaria, straordinaria, in deroga)* reached a record level for the first nine months of 2009, probably above 600,000. Still, many temporary workers (especially project workers) have received no benefit after having lost their jobs. It might be tempting to sympathize with the rationality and universality that would be ensured by some of the reform proposals that have been advanced.¹⁸ Nevertheless, it is fair to say that a proper reform of the unemployment benefits system, with an emphasis on re-employment, is a fairly complex mechanism of incentives that can 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, there is a question as to why this crisis has not been used as an opportunity to change the law by adopting a single universal labor contract as a possible first step before adopting universal unemployment benefits. The recent remarks of Minister Tremonti on the desirability of “permanent” job positions could perhaps be interpreted as an overture to this option.¹⁹ Even so, it is unfortunate that no serious debate is apparently taking place on these issues, either within the government or with the parliamentary opposition. Berlusconi and other ministers have taken the opportunity to emphasize once more the socially stabilizing role of the traditional Italian family—hardly a promising starting point for a debate on how to restore dynamism to Italian productivity.

Focus on Growth and Productivity

Finally, a critique related to the previous one is that the set of measures adopted up to and including the financial law of December 2009 lacks an overall focus on growth. While some proposals do address infrastructural improvements, the number and type of measures adopted to stimulate productivity and competitiveness are quite limited. On this point, the government has stated its intention to propose a new, more specific law on January 2010.

Banks

Although the economic crisis originated in US financial markets and owed a large part of its global extent to the interconnectedness between financial institutions within and across nations, the financial

aspects of the crisis came to Italy mostly as a sideshow. This sets Italy apart from other European countries, where finance played a much more important role in both the local origin and spread of the crisis.²⁰ Nevertheless, there are at least three points on the financial crisis that need to be mentioned with reference to Italy.

To begin with, the Italian financial system has been (and hopefully will continue to be) affected only marginally by the crisis (and mostly through subsidiaries operating in other European countries). The reason is probably twofold: the first is the reduced leverage of the large Italian banking groups, when compared with those of other EU countries, and the second is the importance of a stable deposit and funding base, with a much more limited recourse to money market liabilities.

For Europe as a whole, we do not yet know the full dimensions and locations of the crisis. Where are the remaining losses? When will they come due? Unfortunately, when it all becomes clear, it will not be a pleasant moment. As observed by the European Central Bank, "[E]uro area banks could face cumulative total losses of \$218 billion on their exposures to securities, and an additional \$431 billion of losses on their loan book. This comes down to a total loss estimate of \$649 billion over the period 2007–2010." At the end of May 2009, "the write-downs on securities by euro area banks had amounted to \$215 billion. At the same time, in 2007 and 2008 euro area banks provisioned and wrote off \$150 billion of their loan exposures. Looking ahead, therefore, there is potential for euro area banks to suffer a further \$283 billion in losses, mainly originating from loan exposures."²¹

The second point has to do with bank recapitalization. In this crisis, "banks have come under increased scrutiny by shareholders and market participants over capital adequacy and some face intense pressure to deleverage." These pressures could be accommodated in three directions: (1) recapitalization and increase in capital ratios; (2) issuance of safer or guaranteed liabilities; and (3) 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." In particular, in reference to the first of these directions, capital ratios of banks "held up well, thanks partly to government recapitalizations and especially to the quality and composition of capital."²² This is also true of Italian banks. The first five banking groups in Italy have 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 percent to 7.4 percent, and their core tier 1 ratio has increased by 0.8 percent to 6.6 percent.²³ These ratios are still slightly below those of comparable EU banks.²⁴ 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 is 34.

Many governments have also been supporting banks through the issuance of guaranteed bank bonds. In Italy, this initiative took the name of “Tremonti bonds.”²⁵ Nevertheless, while this measure has been attractive in countries like the UK, Spain, Ireland, Germany, and Austria (and to a lesser extent in Sweden, the Netherlands, and France), Italian banks have essentially issued only non-guaranteed bonds, albeit to a large extent—almost 50 billion euros. This has been a clear sign of the strength of the banking sector in Italy, as it has demonstrated that Italian banks could raise credit at a lower cost (or with less conditionality) than if they had accepted the support of the government.

A final concern is the possibility of a credit crunch. Given the scarcity of bank capital and mounting on-and-off balance sheet losses, deteriorating credit quality, and the efforts of regulators, politicians, and market participants to pressure banks to deleverage, it would have been overly optimistic not to expect a worldwide credit crunch. And so it came about, despite the extreme laxity of monetary conditions almost everywhere. The IMF estimates a financing gap of about 460 billion euros for 2009 in the euro area and of 150 billion euros for the UK.²⁶ In Italy, the credit contraction is less pronounced than elsewhere. Outstanding loans reached a maximum around the summer of 2008 and have essentially remained constant since then, growing by only 1 percent in the 12 months up to August 2009.²⁷

In addition to the bank bond guarantees discussed above, several specific measures have been adopted or proposed in Italy to stimulate lending to private borrowers:

- State guarantees and refinancing for the guarantee funds to insure bank loans to small and medium enterprises, and a revamped role for the *confidi*—consortia promoted by local entrepreneurial 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 Bank of Southern Italy

State guarantees and the role of the *confidi* have been of paramount importance in ensuring continued access to credit for small and medium enterprises. This probably has helped to avoid an overall contraction of credit flows in Italy.

On the whole, however, the debate on these issues has sometimes been confused, especially with regard to two specific sets of questions:

- Is the contraction of credit coming from the demand or supply side? How much has the overall riskiness of borrowers increased?
- What are the specific reasons why banks would want to reduce the supply of loans to firms? In particular, how are they using the enormous liquidity that has been supplied to them via the money markets?

Although we cannot deal here with a complete analysis of these issues, it should be clear that in a crisis with a strong real dimension, the creditworthiness of many borrowers has deteriorated. Thus, it is natural that lending standards will be tightened. In other words, to the extent that part of the story is the reduced creditworthiness on the demand side of the loan market, the remedy is not to pump liquidity into loan suppliers. The proper way to avoid banks' attraction toward more speculative financial activities is to redefine the measures and criteria for bank capital in order to render certain activities more capital costly (and possibly to "separate" them from the more "regular" banking activities). Of course, such rules would have to be decided at the supranational level, and solutions at this level are still far away.

One specific debate in Italy has focused on the availability of credit in the South. Aggregate data do not show a localized contraction. Bank credit in the South has increased by 2.8 percent in the 12 months up to August 2009 (and by only 0.7 percent in the Center-North). This is due to a larger growth of loans to the local public administrations (up 10.4 percent), which has more than compensated for small reductions of overall supply to other borrower types.²⁸ Nevertheless, the debate has focused on the desirability of having a large new bank based in the South: the Bank of Southern Italy. However, it is unclear whether banks with headquarters in the North have actually penalized borrowers in the South, even relative to the traditional South-based banks, while it is clear that South-based banks were led to virtual or *de facto* bankruptcy by their poor models of corporate governance.²⁹ Overall, a little reflection on the negative roles that public sector-owned (or -participated) large banks have had in the recent experience of the southern regions should induce some skepticism about the desirability of new state-sponsored initiatives of this sort. My impression is that the debate on the Bank of Southern Italy is distracting attention away from two much more fundamental issues: (1) the need to reform bank capital requirements; and (2) the deterioration of social capital and civil society in the South. The latter is probably a better explanation of the lack of success of many local entrepreneurial initiatives than the absence of a locally based, public sector-sponsored bank.

Dangers Ahead and a Glimmer of Local Hope

Several indicators worldwide suggest that the crisis is coming to an end: the US economy returned to positive growth in the third quarter of 2009, and the EU Commission has announced that the “recession is over but major challenges persist.”³⁰ A first challenge comes again from finance. The financial crisis is not ended yet. According to the IMF, write-downs on UK bank assets are going to be \$604 billion, \$814 billion for the euro zone, and \$1,025 billion for the US. This is enormous. It is especially enormous for the UK, given its small size, but we have learned by now that it would be hard to constrain any new financial crisis to a local dimension. Despite all this, the path of structural and regulatory reforms seems to have run out of steam. One reason is that the world as a whole, and Europe in particular, is awash with liquidity. Of course, this cannot be avoided, and it is part of the rescue. Yet liquidity and easy money created the scenario in which the economic crisis took place, and since nothing fundamental has changed, the risk is still there: too much liquidity is already fueling new bubbles. So we sit on a razor’s edge, and whichever way we move, we risk a new crash.

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 US vis-à-vis the rest of the world. Hence, we should—and we will—live with a weaker dollar. 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. These changes will cause pain, but it could be lessened by proper measures to help firms reorganize and consolidate. This will require more labor mobility and more organizational flexibility, and these, in turn, 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. Global challenges and local reforms—they all fit together. And we should realize this sooner rather than later.

But at least a reasonable division of labor is emerging. On the financial challenge, which is inherently global, Italy has some voice but no exit option. We can speak, wait, and hope. On the real challenge, we have both voice and options. The political economy is not great, but it is affordable. A few opportunities have been missed, some appropriate measures have been put into effect, and many and more resolute actions remain to be taken or improved upon.

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Notes

1. The term “exit strategies” indicates the decisions that will be required to withdraw the extraordinary measures that have been introduced since late 2008 in order to increase the amount of liquidity available to the financial markets.
2. Average real GDP growth in the euro area was 2.2 percent from 1999 and 2007, compared with 2.9 percent in the US.
3. See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1771>.
4. The process by which member states coordinated their fiscal programs with that of the EERP is discussed in “Stability and Convergence Programmes,” at http://ec.europa.eu/economy_finance/een/002/article_4070_en.htm. Overall progress on this front is registered in the EU’s “Economic Forecast Spring 2009,” published in May 2009. See http://ec.europa.eu/economy_finance/publications/publication15048_en.pdf.
5. For the Commission Report on Italy of October 2009, see http://ec.europa.eu/economy_finance/publications/publication15937_en.pdf. For other countries, the specific procedures initiated by the Commission are listed at http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm.
6. See, for example, T. Boeri and P. Garibaldi, “Aspettando la prima decisione di finanza pubblica,” 17 July 2009, <http://www.lavoce.info/articoli/pagina1001210-351.html>.
7. ECB, “Annual Report 2008,” May 2009, 88, <http://www.ecb.int/pub/pdf/annrep/ar2008en.pdf>.
8. *Ibid.*, 73.
9. At the end of 2008, the debt ratio for Italy was 105.8 percent, for Greece it was 99.2 percent, and for Ireland it had increased from 25.1 percent in 2007 to 44.1 percent in 2008. A similar picture to that of bond spreads emerges from the spreads on sovereign credit-default swaps.
10. Quoted in the *Financial Times*, 26 October 2009.
11. On the relevance of coalitions in this context, see M. Hallerberg, *Domestic Budgets in a United Europe: Fiscal Governance from the End of Bretton Woods to EMU* (Ithaca, NY: Cornell University Press, 2004), and also M. Hallerberg, R. Strauch, and J. von Hagen, “The Design of Fiscal Rules and Forms of Governance in European Union Countries,” *European Journal of Political Economy* 23, no. 2 (2007): 338–359.

12. M. Draghi, "Testimonianza: Commissioni riunite 5a del Senato della Repubblica e V della Camera dei Deputati," 21 July 2009, <http://www.bancaditalia.it/interventi/integov/2009;internal&action=navpage.action&Parameter=2>.
13. These policy measures and others referred to in this section can be found on the government's Web site at <http://www.governo.it>.
14. Cf. "Nota di aggiornamento al DPEF 2010–2013," 22 September 2009.
15. See also the chapter by Matteo Jessoula in this volume.
16. S. Giannini and M. C. Guerra, "Un'amnistia di fatto dietro lo scudo fiscale," 29 September 2009, <http://www.lavoce.info/articoli/pagina1001302.html>.
17. See A. Cazzullo, "Brunetta: 'Basta lamenti, in Italia i migliori ammortizzatori sociali,'" *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.
18. See T. Boeri and P. Garibaldi, "Ma quanto costa il sussidio unico di disoccupazione?" 10 March 2009, <http://www.lavoce.info/articoli/pagina1000994-351.html>.
19. "Io sono per il lavoro fisso, perché la stabilità del lavoro favorisce la stabilità dei rapporti umani e della famiglia, però è chiaro che non si può abrogare il lavoro precario, una necessità imposta dalla globalizzazione" (I am for [or support] permanent employment, because the stability of employment favors the stability of other human relationships and of families. Nevertheless, it is clear that you cannot do without fixed-term contracts, which are a necessity imposed upon us by the forces of globalization). *Corriere della Sera*, 21 October 2009.
20. The financial aspects of the crisis were of paramount importance in the UK, Spain, Ireland, and Iceland, and, to a lesser extent, in Germany, Austria, Sweden, and the Netherlands. Many countries in Central and Eastern Europe were also affected.
21. ECB, "Financial Stability Review," June 2009, 103.
22. *Ibid.*, 87, 90.
23. Bank of Italy, *Bollettino Economico*, no. 58, October 2009, 39. 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 non-weighted assets and total regulatory capital.
24. ECB, "Financial Stability Review," June 2009, 91.
25. See Ministry of Economy and Finance, Department of the Treasury, "Imprese, lavoro, banche," 5 March 2009, http://www.dt.tesoro.it/modules/documenti_it/documentiHp/1x_incontro_Impresex_lavorox_banchex_5_marzo_2009.pdf. See also F. Panetta, T. Faeh, G. Grande, C. Ho, M. King, A. Levy, F. M. Signoretto, M. Taboga, and A. Zaghini, "An Assessment of Financial Sector Rescue Programs," Bank of Italy Occasional Paper No. 47, July 2009, for a documentation and analysis of measures of bank support adopted worldwide.
26. IMF, *Global Financial Stability Report: Navigating the Financial Challenges Ahead*, October 2009.
27. Bank of Italy, *Bollettino economico*, no. 58: 62, table A9.
28. *Ibid.*
29. See, for example, F. Pelos, "Alla ricerca di un credito meridionalista," *Nuovi Lavori* 2, no. 32, October 2009, <http://www.nuovi-lavori.it/newsletter>.
30. See http://ec.europa.eu/news/economy/091103_en.htm.