The Italian Economy –
Models, Measurements and Structural Problems

Aspects of Italian Economic Policy
from the 1992-93 Crisis to the
Crisis of 2008-09

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1. From an Endogenous to an Exogenous Crisis

Present-day economic policy in Italy is evidently the result of contemporary decisions, but it is also the culmination of a historical process that began some time ago.

How long ago? The choice of a date in the past from which to begin recounting some aspects of recent Italian economic policy is unavoidably bound by conventions. A good starting point would be 1992-93, because that is when a break occurred in the country’s political as well as economic and financial system. For the economic and financial system the most dramatic “break” was the foreign-exchange crisis and the financial quasi-crisis of September 1992; politically, it was the end of the First Republic in the spring of 1993.

Until recently, 1992 was remembered in Italy as the year of the Great Crisis. In 2008-09 the global crisis hit Italy, too, with such force as to virtually erase our memory of the events of 1992 and our perception of their macroeconomic impact.

The two crises had very different origins.

The 1992-93 crisis was “endogenous”: it was the day of reckoning of more than two decades of economic policies born of the social and political climate that had arisen at the end of the 1960s and lasted right through the 1970s – policies designed to placate the social unrest of the time with inflation and with money taken from future generations. When foreign investors began to acquire increasing shares of public debt, in the mid-1980s, the countdown began; it ended in September 1992 when those investors lost confidence, unleashing quick speculation against the lira and a sharp devaluation. The political system known as the First Republic, corroded from the core, finally imploded a few months later.

The 2008-09 crisis was certainly “exogenous”: it was of US origin, born of years of monetary mismanagement and inadequate financial regulation; it spread like wildfire to the rest of the world, paralyzing money markets everywhere and causing the financial circuits to seize up. The consequences for the real economy were inevitable and severe. That crisis affected Italy’s financial system less than other countries thanks to its greater immunity to the degeneration observed elsewhere. Yet the real economic consequences have been worse: in the two years, GDP has declined in total by around 3.5

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1 This paper, suitably extended and adapted, is based in part on chapters from my book La politica economica italiana 1968-2007 (Rossi, 2007). I wish to thank Francesca Lotti, Pietro Rizza, Paolo Sestito and Giordano Zevi for their assistance and comments on an earlier version. All errors are my own. Any opinions expressed are mine and not those of the institution for which I work.
percentage points more than the average for the OECD area. How is it that a less virulent infection has caused a higher fever?

One answer may lie in the fact that the Italian economy came to the global crisis more weakened structurally than the other advanced economies. And this leads us to reconsider the economic policies undertaken during the fifteen years between the two crises, the reasons for them and their effects.

During this period, the domestic economic policy debate in Italy saw a clear shift of emphasis from macro to micro, due to the changes in the external scenario: the creation of the single European currency and the coupling of “technology revolution” with “market globalization”.

Once Italy was part of the euro area, monetary policy – which in Italy meant predominantly exchange-rate policy – ceased to be a focus of national debate; moreover, the first ten years of the euro coincided with a period of exceptionally moderate inflation worldwide and generally low interest rates, reducing the pathos surrounding monetary policy decisions.

The debate on budget policy – in the macroeconomic sense of the overall fiscal balance – had also lost some sense (until the eve of the latest crisis), owing to the substantial constraints imposed by the need to control the increase in the large accumulated public debt and the formal constraints of the Maastricht treaty.

By contrast, attention focused more closely on structural policies, for reasons associated with our tardy and partial response to the combination of technological and market transformations in the international scenario.

I will accordingly divide my considerations into three sections. I begin with macroeconomic policies: monetary policy – which I examine together with that peculiar feature of Italy that is incomes policy – and fiscal or budget policy. I continue with the whole bundle of microeconomic, or structural, policies. I conclude with some reflections on the challenges facing us today.

I must point out, obvious though it may be, that the title of this paper covers only some aspects of Italian economic policy. It could not be otherwise, given the paper’s brevity. For instance, I do not touch on such important questions as corporate governance or financial regulation. For these and other matters I refer the reader to Rossi (2009).
2. **Inflation, incomes policy and monetary policy**

Between 1991 and 1995 the lira lost almost a third of its *external value* on the foreign exchange markets. In the same period, its *domestic value*, i.e. what Italian consumers could buy with it, decreased by just one sixth. This is unusual. During the other period of sharp devaluation of the lira, between 1972 and 1976, the relationship between the two changes in value was the opposite: against a contraction of just over a third in its external value, the lira lost nearly half its internal value.

What was it, in the wake of the 1992 exchange crisis, that prevented the devaluation of the currency from being passed on, in amplified form, to domestic prices? Three elements were responsible: a deep recession in domestic demand, due to the loss of consumers’ and investors’ confidence; favourable trends in international prices; and wage moderation, thanks to the rapid dismantling of index-linking mechanisms. Let us focus on this last aspect.

In the four years from 1991 to 1995 real per capita earnings fell by 3.3 per cent in the economy as a whole; they stayed constant in industry, where productivity gained almost 8 per cent. In nominal terms, unit labour costs in industry increased overall by only slightly more than 2 per cent in the four years. Twenty years earlier, from 1972 to 1976, that same variable had risen by 94 per cent!

To what can this difference of reaction be ascribed? On 23 July 1993, the social partners and the government ratified a framework agreement on the cost of labour and the collective bargaining system. The agreement marked the conclusion of a phase that had begun in 1990 with the unilateral repudiation of the *scala mobile* wage-indexation mechanism by Confindustria and continued in 1992 with the agreement on its definitive aboliton. This brought to a close a long cycle, the start of which can, ideally, be dated to the Lama-Agnelli agreement of January 1975 assigning a lump-sum value to each point increase in the cost of living index. It had taken almost twenty years to overturn, and set on its feet, a bizarre “upside-down” incomes policy that had contributed in no small way to make the 1970s so damaging to the Italian economy. It would be fifteen years before the social partners reformed, in 2009, part of that agreement, and only with the abstention of the CGIL, the largest trade union.

The agreement of July 1993 was no masterpiece either of clarity or of economic logic. However, it did establish one important point. Contractual wages were to be negotiated on the basis of the future rate of inflation officially set by the Government as the target of macroeconomic policy, and not on the basis of actual inflation. At the end of the two-year contract period, if actual inflation was higher than the target rate, there would be no automatic restitution: the parties would negotiate the amount of the redress. Moreover, this redress would only cover that part of the additional inflation not accounted for by a deterioration in the country’s “terms of trade”, that is to increases in international prices or to a depreciation of the lira (and also, by logical extension, to increases in indirect taxes): such events should be regarded as exogenous with respect to the mechanisms of domestic price formation. Firm-level
contracts could only award productivity bonuses, which firms were anyway encouraged to grant in the form of profit-sharing schemes.

The incomes policy stance of 1993 contributed significantly to averting the very serious risk to the Italian economy represented by the near-collapse of the lira in September 1992: a return to rapid inflation. Monetary policy did the rest.

In the 1980s, and up until the foreign exchange crisis of 1992, the principal objective of Italian monetary policy was to comply with the exchange-rate constraints imposed by membership of the EMS. With the transition to a free-floating exchange regime, monetary policy lost its anchor and partly in response was forced to develop a new model of operation (Visco, 1999). The Bank of Italy’s Annual Report presented on 31 May 1993 contained the first direct reference to the final goal of price stability, never before stated explicitly: “The prevention of a resurgence of inflation is the primary objective of the central bank, pursued in parallel with fiscal and incomes policies”.

From the closing months of 1992 until the middle of 1994, monetary policy grappled with the task of helping the money and financial markets get back to normal in the wake of the foreign exchange crisis. Moving from the exceptionally restrictive stance adopted at the height of the September 1992 crisis — and despite continuing international turmoil — interest rates came steadily down. Not only did short-term rates decrease in the wake of twelve successive reductions of the official discount rate in the space of twenty months, but so did long-term rates and the interest rate differentials with the other leading countries.

In the meantime, the institutional framework within which the Bank of Italy operated evolved into complete independence from the government and clear separation of the functions of monetary policy management and public finance. There were two main steps in this process, marked by the passage of specific laws. In February 1992 the Bank of Italy was formally and exclusively entrusted with the power to change the official discount rate and the rate on advances: such rates were of limited operational significance but they had become important signals of the monetary policy stance. In November 1993 monetary financing of budget deficits was prohibited, as part of the requirements for joining the Euro area: in particular, overdraft facilities on the Treasury’s account with the Bank of Italy were barred; at the same time, the Bank of Italy was assigned sole competence in matters of banks’ compulsory reserves.

The lengthy process that had begun with the “divorce” from the Treasury in 1981 was completed. The new monetary constitution invoked by the Governor of the Bank of Italy Carlo Azeglio Ciampi at the beginning of the 1980s (Ciampi. 1981) was two-thirds in place — independence
of the central bank and collective bargaining code; the “strengthening of budget procedures” was still to be achieved.

In the Annual Report presented in May 1994 the operational link between the trend of inflation and the reaction of monetary policy was rendered even more explicit: “…the central bank is taking care to prevent cost and price pressures from developing. If the behaviour of the economy were incompatible with a non-inflationary recovery, monetary policy would necessarily address the objective of slowing down the rise in prices through a return to higher interest rates”. The control panel of Italian monetary policy was effectively enriched by a set of indicators of costs and prices to flank the traditional gauges of monetary base, money supply, credit, financial assets and “spot” interest rates. Careful scrutiny was applied to the month-on-month rise in the prices of industrial goods and in the cost of living, both suitably seasonally adjusted; the findings of surveys of households’, firms’ and opinion-makers’ inflation expectations; and “forward” interest rates, which reflect the inflation expectations of the financial markets. The monetary policy toolkit was also expanded, adapting to the models most common in the rest of Europe.

The moment of truth for the new approach being developed came in the summer of 1994. The US monetary policy stance had been gradually tightening since February in order to avert a rise in inflation induced by the expansion of economic activity. This time the policy move was made earlier than in comparable moments in the past. The increase in short-term interest rates was transmitted to long-term rates, owing to the American financial market’s uncertainty over the Fed’s ability to curb inflation in the long run. The high degree of cross-border integration, already characterizing the main financial markets and the importance of the dollar, meant that the rise in longer-term rates spread immediately to the other currencies, despite the lag with which their economies were regaining momentum and the still accommodating stance of monetary policy in those countries.

These international developments caught Italian monetary policy in the midst of a gradual easing. The last reduction of official interest rates was in early May. The twelve-month inflation rate fell below 4 per cent in June, its lowest level in a quarter-century, and stayed there in July and August. However, June also brought early warning signs of an impending pick-up in consumer price inflation, perceptible in current producer price developments and above all in the expectations of economic agents. These signs were little noticed by public opinion and were totally ignored in the political debate.

Registering the insufficient effect of fiscal policy in curbing domestic demand, the Bank of Italy reversed its policy stance, first rationing monetary base and then, in August, raising its official interest rates. This move caught the markets by surprise. At first operators misunderstood the move and became even more sceptical of the Italian central bank’s determination and ability to hold the anti-
inflation line in the face of the country’s still severe structural fiscal imbalance. As a consequence, long-
term rates and spreads increased at least as much as short-term rates, and the lira continued to
depreciate. It took months for these doubts to be attenuated. The incident taught monetary
policymakers an invaluable lesson – the need for a well-designed communication strategy to prepare the
markets to understand policy decisions.

In February 1995, in response to the Mexican crisis, the lira again plummeted, with a
depreciation only slightly less sharp than in September 1992, foreshadowing another serious threat of
inflation, which in some simulated scenarios was seen as rising as high as 9 or 10 per cent. The
monetary policy stance was made much more restrictive.

The Annual Report of the Bank of Italy in May 1995 marked a decisive passage. An explicit
target for lowering the average annual consumer inflation rate was set for that year and the next.
Though no precise quantitative details were given, a month-by-month course was set out that could
realistically and rapidly bring inflation down into line with the annual target. The future course of
monetary policy would depend on verification that the economy did not deviate from that path. The
average annual targets set by the Bank of Italy were very close to those of the government but not
exactly the same; for the sake of realism, they were put slightly higher.

This was not a formal inflation-targeting plan, which presupposes the ability of monetary policy,
by its own instruments alone, to affect the target variable to the extent and in the timeframe desired. The
Bank of Italy did not consider that this was the case for Italy with its formidable public debt, which,
through financial market expectations concerning sustainability, influenced the exchange rate of the lira,
which in turn was decisive to price developments. Nevertheless, the Bank acknowledged that monetary
policy could be effective in taming inflation in the longer term by imposing the necessary costs on real
economic activity. It recognized the importance of expectations in determining the behaviour of
economic agents, not just expectations concerning budget adjustment but also those regarding
monetary policy action. The latter are affected by the central bank’s success over the years in
establishing a reputation for setting clear objectives and for resolution and independence in pursuing
them.

Once the Mexican crisis had passed, inflation in Italy began to decline again, in line with the
targets the Bank had set in May 1995 and extended, in May 1996, through 1997. A contributing factor
was the containment of aggregate demand by fiscal policy, which as we shall see was being steadily
tightened. In the closing years of the decade, consumer price inflation fell to about 2 per cent, bringing
the inflationary period to an end after nearly three decades. This was a boon to the incomes policy
agreement of 1993, whose survival would have been jeopardized by the resurgence of inflation.

Price dynamics formed one of the five convergence parameters (inflation, long-term interest
rates, exchange rate, government deficit and public debt) established by the Treaty of Maastricht to
qualify for the nascent single European currency. At last, on this particular front Italy had made the grade. Now the effort was to bring the other variables within the limits. (In the next section we examine the difficulties and uncertainties involved in this political decision and discuss the two public finance parameters.)

The interest rate on new government bond issues was brought below the ceiling for qualification in February 1997. At the end of that year it was less than 0.3 percentage points higher than the comparable German and French rates, and in line with the convergence criteria.

The exchange rate of the lira with the other currencies in the European exchange rate mechanism (ERM) fluctuated within what were considered “normal” margins, which is to say within the “narrow band” of the old EMS (± 2.25 per cent) starting in June or July 1996, even before the lira’s formal re-entry into the ERM. True, it was still below the floor level in May-June 1996, but it was appreciating rapidly, and over the next two years the stability of the exchange rate was not undermined by tensions and did not require market interventions by the Bank of Italy. So this parameter too was in line.

Once Italian participation in the single currency from its launch in 1999 had become highly probable and then (on 3 May 1998) certain, it was easy to foresee that at least very short-term rates would have to coincide exactly in all the euro-area countries from then on. For what determines short-term yield differences between countries is chiefly uncertainty over future exchange rates. If these are fixed irrevocably, then there is no reason for significant yield spreads (differences between long-term financial asset yields remain possible, because they also depend on debtor risk. Accordingly, the Italian government reasoned that short-term rates in lira would necessarily fall by the end of the year. The sooner they did, the greater the public saving on interest account.

At the end of 1997, notwithstanding the 75-basis-point reduction in official interest rates decided by the Bank of Italy in the fourth quarter, the overall level of short-term rates remained considerably higher than in Germany. For instance, the three-month interbank rate was 5.2 per cent on lira deposits against 3.7 per cent on deposits in marks. The rate on ten-year government bonds was 5.7 per cent for Italian BTPs and 5.3 per cent for Bunds. The Bank of Italy had the task of managing the speed with which short-term rates declined. In doing so, it had to make sure that the international financial markets’ expectation of Italian entry into the euro area was firmly established. And even after the governments’ favourable decision was taken in May, the transition from the old to the new regime was a highly delicate matter for the markets. On one front in particular – exchange rates – things would remain uncertain right up to the last day, with not insignificant risks for Italy. In May the governments and central banks of the countries that would institute the euro announced the values at which the exchange rates of the participating currencies would be locked, but in the meantime the exchange rates were determined day-by-day by the market. In order for market exchange rates to converge on the
predetermined values by 31 December 1998, it was necessary that private agents “believe” in the inevitability of the march to the euro, with no uncertainty. This was the reason for the caution shown by the Bank of Italy in guiding the reduction in short-term interest rates towards the common level; this caution was attacked in some quarters as a symptom of fundamental skepticism on the Bank’s part over the construction of the single currency.

In 1999, with the launch of the euro, monetary policy and interest and exchange rates ceased to be a domestic affair and became part of a shared responsibility.

In 2002, with the cash changeover, euro banknotes and coins began to circulate, definitively supplanting the national currencies of the participating countries. By coincidence, in the first few months of that year the dollar depreciated and, as a consequence, the euro appreciated, nearly regaining the exchange rate vis-à-vis the dollar that it had had at its launch in 1999. It is easy enough to see that, if the lira had stayed out of the euro, there would have been intense downward pressures on it, as always when the dollar was weak, by reason of Italy’s still large public debt. The strains would have fueled inflation and forced monetary authorities to raise interest rates, with severe repercussions on economic growth.

From our vantage point today, we can say that under the common monetary policy both the euro area and Italy have enjoyed lower interest rates than at any time since the 1950s, both short- and long-term, both real and nominal. After thirty years in which inflation was a dramatic problem for Italy, the strength and stability of the common currency have defused the issue.

3. Budget policy

In the 1970s and 1980s Italians elected to live beyond their means, building up debt with future generations (Franco et al., 1994) and with the rest of the world. The political class had found the way to satisfy this yen, mortgaging the income of the years to come. In the meantime, the source of the means to cover the public sector’s financing requirement – massive household saving, at low cost and with little competition from other borrowers – was drying up. The household saving rate was falling, and at the same time savers were growing bolder, attracted by investment opportunities abroad to which they had legal access after the liberalization of capital movements.

With the crisis of September 1992, there was an effort to translate into government practice the idea that, for the budget, the day of reckoning had come. The necessity now was to stop the enormous public debt that had been built up over the years from increasing in proportion to national income. As the existing debt would continue to be honoured at market interest rates, this meant that a primary budget surplus had to be achieved. And the greater the interest burden, the larger the surplus would have to be.
The first fairly substantial primary surplus (nearly 2 per cent of GDP) was recorded in 1992. This achievement was consolidated in 1993 (2.6 per cent) and 1994 (2.3 per cent). But these surpluses were still too small, and the public debt continued to rise rapidly in relation to GDP: from just under 100 per cent at the end of 1991 to 105 per cent, 116 per cent and over 120 per cent in the next three years. The main reason was the enormous interest payments, which amounted to more than 12 per cent of GDP in 1993, owing in part to soaring interest rates in connection with the tribulations of the lira.

It was only in 1995, with an insidious new exchange-rate crisis, that the primary surplus became large enough (4.2 per cent of GDP) to begin lowering the debt/GDP ratio. In 1996 the budget adjustment effort was maintained, with a primary surplus of 4.6 per cent. By now the debt ratio had been set definitively on a downward path.

How did Italy go from a primary balance of practically zero in 1991 to a surplus of over 4.5 per cent of GDP in 1996? By raising tax and social contributions by 2.2 points of GDP, increasing other revenues (some via one-off measures) by 0.5 points, and reducing primary expenditure by 1.9 points.

Primary expenditure is dominated by social spending. Italian social spending is not out of line with the rest of Europe, but its composition is anomalous. Nearly two thirds is taken up by old people, compared with less than half in the rest of Europe, while a much smaller share of the total goes to unemployment benefits and employment subsidies and to family, housing and poverty programmes. And the composition of expenditure is anomalous in another way as well – much more than in other European countries it is in favour of self-employed workers and present or past workers in the “formal” job market, especially workers in large companies and the public sector. Thanks to their income level or relative youth, these people may be in less social distress than other, unprotected categories – poor people of all ages and especially children, the long-term unemployed and those who have never worked, the employees of small or “underground” firms exposed to international competition, and workers with precarious employment contracts.

All in all, this expenditure structure is socially iniquitous. It is counter to the requirements of competitiveness and of the development of the productive system. It is financially pernicious, because it clashes with the demographics of an aging society. The extremely difficult task that the new Italian political course faced was to educate the citizenry to these three truths and to derive from them, without unneeded drama, the urgent corrections needed. This fragile exercise did succeed in fostering awareness for a few years, but as the currency emergencies receded in time, that awareness faded. The crisis of 2008-2009 has brought the problem back to the forefront.

The year 1996 ended with discouraging results for Italy’s realistic chances of meeting the Maastricht criteria for the public finances on time.

The two aggregates indicating the financial condition of general government – the annual balance between revenue and expenditure and the stock of accumulated debt – were still far above the
Maastricht limits, in fact more than twice as high. The budget deficit amounted to 7 per cent of GDP, against the Treaty ceiling of 3 per cent; to be sure, it had been diminishing “substantially and continuously” for seven years now (as the Treaty prescribed), but it remained well above the limit. At the end of the year the debt stood at 120.9 per cent of GDP, compared with a ceiling of 60 per cent; the ratio was indeed declining, but had been doing so for only two years. In the European race, Italy was visibly behind the pack.

During 1996 the Government made an abrupt change of course on the prospect of entry into European Monetary Union. As late as June, in the three-year planning document, the official objectives of budgetary policy for 1997 were explicitly incompatible with satisfying the Maastricht criteria. This signaled the Italian government’s belief that, barring a postponement of the entire operation, only a few countries, with Germany at the core, would make up the first wave into EMU, with the corollary that planning for Italy to join a year or two later – provided it was accompanied by other important countries such as Spain – represented a balanced strategy. This belief betrayed inadequate information or assessment of what was afoot in the other European countries, and it was soon shown to be unfounded.

Thereupon the Government found the will to decide that the Italian economy had to make a mad dash for the finish line, lest Italy be isolated in Europe. The Finance Bill for 1997, presented in October, called for a much sharper budget tightening than had been planned in June, in order to strive immediately for a 3 per cent deficit/GDP ratio and a significant reduction in the debt ratio. The implied budget adjustment was to come mainly from tax increases, although one percentage point of the revenue-side impact was temporary. On the spending side, substantial savings were expected from the systematic rationing of the Treasury’s cash disbursements to local authorities.

This policy of convergence on the double succeeded. In 1998 Italy presented itself for the examination of its credentials for immediate entry into the euro with results that surpassed the most optimistic forecasts and gave it solid arguments with which to defend its candidacy.

In achieving the goal of participating in the euro from the start, the Italian economy took an important step towards macroeconomic adjustment. In the years since then it has taken a half-step back. The public debt is still among the highest in the world in relation to GDP and it constrains budgetary policy, given the continual need to reassure the holders of Italian government securities, half of which are in foreign hands, that Italy is a sound and reliable debtor. The high road to debt reduction necessarily lies in cutting current public expenditure – including pension expenditure, even after the significant reform measures of the 1990s (Franco, 2002). But this course is fraught with political difficulties that have stayed the hand of all the following governments ever since.
4. Structural policies

During the past decade the attention of observers of the Italian economy gradually shifted from the traditional focus on macroeconomic policies to structural policies, as the idea gained ground that the economy suffered from defects that were in fact structural. These are held responsible for the near stagnation into which the economy fell during the decade, the outcome of a combination of adverse demographics, a labour market offering insufficient stimulus to the employment (in the formal economy) of unused resources, and increasingly sluggish productivity. The picture is aggravated by a North-South gap which, far from shrinking, is tending to widen.

Economic policy can attack these issues in various ways, which fall under two broad headings: normative action and active resource management. The former, limited to setting the rules of the economic game, does not imply an impact on the government budget, at least not directly. The latter implies an increase in public spending or a reduction in revenue, with an impact ceteris paribus on the budget balance that must be made consistent with the macro objectives of budgetary policy.

At the turn of the new century, Italy’s productive system displayed a structural deficiency of competitiveness compared with the other advanced countries. The problem was not new, but it attracted general attention only after the great cloud of dust raised by the macroeconomic emergency of the 1990s had settled, making it possible to look more closely at how the productive apparatus functioned.

In the first half of the past decade, Italy’s annual rate of economic growth fell far below the European average, itself lower than the American rate. In the more dynamic economies, growth was driven by increases in both employment and productivity.

Over the decade as a whole, Italy’s employment rate as a proportion of the working-age population rose by more than four percentage points but still remained below 60 per cent, one of the lowest among the advanced countries. The gain in employment, in part a statistical effect of the regularization of the status of immigrant workers, was due mainly to the entry into the labour market of new workers hired on fixed-term contracts under legislation (the “Treu package”, the “Biagi Law”) explicitly aimed at making the labour market more flexible. But flexibility was introduced only on the hiring side, while the rules on firing, and especially the legal disputes procedures, were not touched. Consequently, dismissing an individual worker who is no longer useful or fit remains a high-cost operation for firms, particularly in light of the length and uncertain outcome of judicial proceedings. Given the possibility of hiring workers who can be dismissed automatically when their contract expires after even a very short term, employers, starting with the public sector, take ample advantage of it. Not least because of the multiple abuses permitted by inadequate enforcement, this situation has produced two grave problems: on the one hand, an army of young people in chronically precarious employment,
kept at the fringes of the labour market and society; on the other, employers trapped in the myth of unfettered power to exploit and dismiss precarious workers, blind to the harm done to their own companies by the impossibility of instilling staff loyalty and giving their personnel thorough training.

But the crucial issue is productivity. In the United States, output per hour of labour grew by an average of 3 per cent a year in the 1990s, thanks to the use of new tools that made work faster and easier to perform (ICT) and to American companies’ superior ability to organize the activity of many people effectively in complex productive structures.

In Italy, instead, productivity growth slowed and then ground to a halt. What were the causes? They date back in time and can be analyzed from three angles: who produces, what is produced, and how it is produced.

Italy’s industrial structure is highly fragmented. Unlike those of the other major European countries, it continues to consist of a host of small and tiny firms, a handful of large companies and a still insufficient number of medium-sized enterprises. Italy’s small firms, are agile and flexible, but reluctant to grow, and this conditions both the Italian productive system’s ability to conduct research and to innovate and its presence abroad, which remain weak and underdeveloped.

This fragmented, undynamic productive structure weighs down the efficiency of the system. The stagnation of average labour productivity in Italy is due more to the deterioration of the so-called total factor productivity – the ability to combine the total endowment of productive factors efficiently – than to insufficient investment or low capital intensity. This deterioration is linked to the notable lag with which new technologies are taking root in the Italian productive economy.

If average firm size remains small, product specialization backward and productivity stagnant, this is not explained entirely by the conduct of businessmen seeking to preserve family ownership and control. It is also the outcome of several fundamental defects of the Italian system. These include an archaic juridical and administrative culture that is hostile to the claims of efficiency and the market; an inadequate national system of innovation, in which public research falls short in quality (with commendable exceptions), private research in quantity, and both in their capacity for dialogue and coordination; a legislative, tax and financial environment that does not encourage small and medium-sized businessmen to scale up by opening their family firms to the market for equity investment; a dearth of competition in the markets for goods and especially services, public utilities first and foremost.

In the past years some analysts suggested that Italy’s society and economy was in the throes of an irreversible “decline”, a phenomenon for which there are actual precedents in the history of peoples and territories, while others disputed this view (Visco, 2002). The economic recovery of 2006-07 and some harbingers of a restructuring under way in some parts of the system that are most exposed to international competition have relaunched the hypothesis that the Italian productive system is capable
of regrouping and adapting, albeit tardily, to the two great changes of context, that is to say globalization and the technological revolution.

The crisis of 2008-09, with the collapse of exports and investment and the financial strains that beset many firms, has cast renewed doubt on that scenario. But the future of our economy hinges on the restructuring of the system, so analysis and proposal of reforms that can foster it are more important than ever.

The structural defects of the Italian economy pose difficult challenges for an economic policy aimed at reviving productivity, competitiveness and long-term growth. It is in this vast and variegated field of so-called structural policies, a field fraught with difficulties because it is technically complex and strewn with interests defended by aggressive lobbies, that the political system’s decision-making capacity is truly put to the test.

5. The two chases

In the period of time under consideration here, from the “endogenous” crisis of 1992-93 to the “exogenous” crisis of 2007-08, the Italian economy had to try to come from behind in two races: one to be part of the leading group founding the euro and the other to adapt to the twin technology/market revolution that transformed the world at the end of the last century. The first effort, although laborious, was successful. On the second front, not yet, or not entirely: the drive started late and involved only part of the system, and has seen Italy at a severe handicap.

The race to join the euro was undertaken with precise acts of political will that could have been deemed rash given the enormous distance to be made up in such a short time. This was undoubtedly an economic policy success, and one that yielded incalculable benefits in terms of the eradication of inflation, low interest rates, lower transaction costs, thanks above all to lesser uncertainty, and the rehabilitation of firms from dependence on competitive devaluations. But this success was obscured by two shadows. First, the distance to be made up in order to meet the Maastricht parameters, a real abyss, was the result of the culpable economic policy choices made in the previous twenty years. And second, the cursory methods adopted (basically, increasing taxes and making ample use of temporary measures) eventually themselves became one of Italy’s handicaps in the second catch-up drive.

Adapting to the technological revolution of ICT and globalization – the second catch-up race – was and is no easy task, especially because the technological paradigm keeps changing. It has not been easy for any of the advanced countries, including America, where the new technologies originated and were first widely introduced into the production process. It is necessary to change the internal organization of each production unit and retrain the workforce in order to accelerate “creative destruction” within the system and redraw the specialization map.
The Italian economy has lagged behind, it has had to work harder than others and has in the end paid the price in terms of stagnating productivity, loss of international competitiveness, low GDP growth, and social disharmony in a labour market that had become dualistic.

While the first chase was driven by economic policy, the second was basically the task of entrepreneurial forces, which had to shoulder one responsibility in particular: not to forgo concrete growth opportunities – in terms of scale of production, technological intensity of output, and internationalization – simply because of concerns about corporate control, i.e. in the name of “familyism”. There is no lack of cases in which this sense of responsibility was absent. However, entrepreneurs and their firms do not live in a vacuum, they are immersed in a social and administrative context that strongly conditions their choices. This context is in turn determined by policy choices, especially in the economic and social spheres.

And so economic policy has come to the fore once again as the protagonist of the second chase, which is still in course and whose outcome is by no means certain. Its success has been jeopardized above all by the global crisis of 2008-09 (Draghi, 2009). Many firms that are crucial to the Italian economy (especially those of medium size and of average technological standard) had actually begun to restructure, with difficulty, before the crisis began. This is documented by numerous surveys, including those conducted by the Bank of Italy (Brandolini and Bugamelli, 2009). These firms have gone into debt in order to make the necessary investments, are now having trouble reorganizing and at the same time have to address new markets. The crisis, transmitted through the credit market, first threatened them with “financial asphyxia”, then led to the collapse of investment and international trade, with even stronger repercussions on the numerous Italian firms producing and exporting instrumental goods.

Following the damage inflicted by the crisis, in the face of the concrete risk that the restructuring of the productive system might abort, the role of economic policy in driving the second chase has become absolutely crucial.

The necessary reforms all belong to the general area of structural economic policy. Some will not affect the state budget, but others will and must therefore be accompanied by offsetting measures. They can be divided as follows:

1) **Competition policies.** In Italy, there is little awareness of the extent to which lack of competition in many markets lowers general welfare by restricting consumers’ choices and increasing prices. The problem is mainly rooted in the prices of public utilities, which affect not only consumers and citizens in general but also the firms exposed to international competition.

2) **Social security policies.** The welfare system needs to be redesigned systematically in order to adjust its composition, which today is still tilted towards pensions, to improve the
3) **Education policies.** The education system is the “factory” of human capital and thus the locus of a nation’s investment in its own future (Visco, 2009). A reform effort is under way along lines that are broadly acceptable. However the need remains for a re-examination of the legal value of educational qualifications, the single state-employee status of university teachers, and the almost total absence of highly specialized education institutions comparable to the prestigious graduate schools found in the rest of the world.

4) **“Legal certainty” policies.** I use this term, rather than the more usual “administration of justice” because, economically speaking, legal certainty is the most important goal and is precisely what is lacking in Italy: a *reasonable* degree of certainty as to the length of trials (which should, besides being certain, also be as short as possible), and a *reasonable* degree of certainty about the stability over time of the legislation and judicial interpretation.

5) **Territorial equalization policies.** Recent research by the Bank of Italy (Cannari, Magnani and Pellegrini, 2010) has demonstrated that the apparatus of ad hoc policies for the development of Southern Italy has often failed to meet its goals. A change of view is needed: no more direct incentives but rather territorially differentiated procedures for the application of broad national policies in order to equalize the results, which at present are worse in the South even for equal resources.

6) **Major infrastructure policies.** In this area Italy is far behind the other advanced countries.

None of these reforms can be totally successful without a solution to the basic problem, a sort of methodological precondition. This is shown by the pointlessness of various reforms attempted over the entire period of the Republic, the work of governments of all political persuasions. The precondition is to renew the foundations of the judicial order, placing at its centre the concept of efficiency, i.e. costs and benefits, both to be evaluated in terms of the administration of justice and, more generally, the *res publica*, a “service” to the community (Rossi, 2009). Following a cultural operation of this sort, Italy’s other phoenix – streamlining and increasing the efficiency and productivity of public institutions and public administration – can rise more easily from the ashes.

Many of these reforms, as noted, cost nothing to the public purse; the only thing blocking them is the resistance of the vested interests that will be affected (they are often influential with lawmakers) and the objective hurdle posed by the regulation and functioning of the judicial and administrative apparatus. But at times, as in the case of large infrastructural works, the cost is not nil. Furthermore, the pressure of taxes and contributions on law-abiding citizens has been intolerably high for years. Besides
the problem of the average level of taxation, there are also those of the distribution of the fiscal burden and of adverse selection: tax evaders and avoiders typically belong to professional categories that could be considered less “useful” in terms of contribution to the country’s economic development, but de facto they enjoy fiscal incentives compared with the medium-sized and large firms exposed to international competition, the honest firms and self-employed persons who therefore augment the nation’s social capital, and salaried workers, the backbone of the productive system. This situation has to be rectified, as it acts as a brake on economic growth.

The unavoidable conclusion is that, if we want to pursue the objectives set out here simultaneously, the composition of the state budget must be radically re-thought. Substantial areas of public spending that are unproductive or no longer justifiable under today’s new demographic and social circumstances will have to be downsized. I see no other way to succeed in Italy’s second chase and to keep its place among the advanced and modern economies.

References


Figures
Gross domestic product

(percentage change on previous year)

Sources: OECD and Istat.

Consumer price inflation

(per cent)
Sources: OECD, Istat, Eurostat. The harmonized index of consumer prices (HICP) for Italy and Germany, the consumer price index (CPI) for the OECD.
Labour productivity in the manufacturing sector
(three-term moving average of percentage changes on the previous period)

Sources: Bank of Italy and Deutsche Bundesbank.
Source: Based on European Commission data.
Three-month interest rates

Source: Based on Istat data.
Sources: Bank of Italy; from 1999, ECB (Euribor panel banks).
Ten-year interest rates
(yields on benchmark securities)

Sources: Bank of Italy for Italy, Bloomberg for Germany.

Real effective exchange rate based on the
producer prices of manufactured goods
(indices, 1989=100)

Source: Bank of Italy.

Italy’s public debt
(as a percentage of GDP)
Italian government budget: primary surplus

(as a percentage of GDP)

(*) Transactions that leave general government net worth unchanged (e.g. privatizations and changes in assets with the Bank of Italy).

Source: Bank of Italy.
Source: Bank of Italy.

Italian government budget: current primary expenditure and tax and contributions burden
(as a percentage of GDP)
Share of the working-age population (15-64) as a percentage of the total population

Source: Bank of Italy.
Employment rate
(employed persons as a percentage of the population aged 15-64)

Source: Eurostat.
Employment rate in 2008
(employed persons as a percentage of the population aged 15-64)

Sources: Based on Istat data and the Labour Force Survey.
Source: Eurostat.

Female employment rate in 2008
(employed persons as a percentage of the population aged 15-64)
Source: Eurostat.

Share of the population at risk of poverty in 2008
(Percentages)
Business demographics and the economic cycle

(Percentages)
R&D expenditure in 1990 and 2008
(as a percentage of GDP)