Forum for Macroeconomics and Macroeconomic Policies

IMK
Macroeconomic Policy Institute

The IMK is an institute of the Hans-Böckler-Stiftung

FMM WORKING PAPER

No. 37 · October, 2018 · Hans-Böckler-Stiftung

WHAT WENT WRONG WITH ITALY, AND WHAT THE COUNTRY SHOULD NOW FIGHT FOR IN EUROPE

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ABSTRACT

In this paper we briefly review the evolution of the Italian economy in the post-war period, discussing the shift from a first period when fiscal policy was targeted – among other things – at full employment, to a later period when controlling inflation through a "foreign discipline" became the main policy target. We review critically the literature on the Italian productivity slowdown, suggesting that it neglects the role of aggregate demand, and of labor market reforms, on productivity. Finally, we discuss Eurozone imbalances, suggesting that Eurozone institutions adopt new rules to keep the interest rate low enough to make public debt sustainable, while using fiscal policy to stimulate growth.

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Sergio Cesaratto[+] and Gennaro Zezza[*°]

Abstract

In this paper we briefly review the evolution of the Italian economy in the post-war period, discussing the shift from a first period when fiscal policy was targeted – among other things – at full employment, to a later period when controlling inflation through a "foreign discipline" became the main policy target. We review critically the literature on the Italian productivity slowdown, suggesting that it neglects the role of aggregate demand, and of labor market reforms, on productivity. Finally, we discuss Eurozone imbalances, suggesting that Eurozone institutions adopt new rules to keep the interest rate low enough to make public debt sustainable, while using fiscal policy to stimulate growth.

Keywords: Italy; stagnation; Eurozone; imbalances

JEL codes: E44; E52; E62;F45

Introduction

The Italian economy has returned to a modest, positive growth rate, but it is the only large economy in the Eurozone which has not recovered yet from the Great Recession (GR from now on) of 2007 (Figure 1). In the last quarter of 2017, its real GDP per capita was 8 percent below its peak of 2008, while Spain – which suffered a similar downturn – has recovered faster. Figure 1 includes the IMF projections up to 2023, which predict that the situation is not likely to change in the coming years.

As the chart in Figure 1 shows, the slowdown of the Italian economy, relative to its major partners, seems to start earlier than 2007. After many years when the real average income was growing in line with that of France, and closing to that of Germany, in the second half of the 1990s the performance of the Italian economy worsened, and the combination of the effects of the GR, and of the policies implemented afterwards, implied a widening gap with both Germany and France.

This slowdown has been addressed by many mainstream commentators, following the hypothesis that aggregate demand matters only in the short run, but that a prolonged slowdown in the growth rate must depend from supply-side factors. In addition, the (fallacious) (Reinhart & Rogoff, 2010) argument on the relevance of the public debt level for growth has contributed to put the reduction in public debt on top of the

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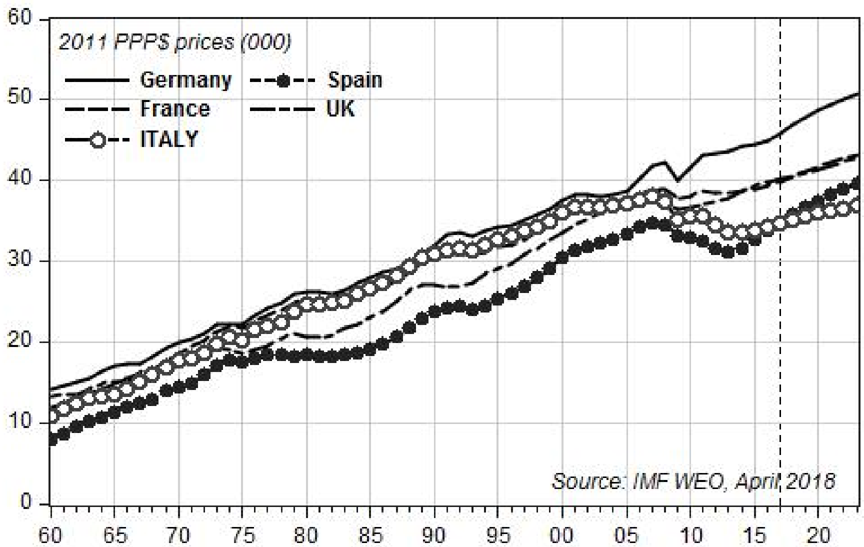
[°] We wish to thank Jan Priewe and Hansjörg Herr as well as the participants to the Workshop on Euro-reforms, Berlin, 7-8 June 2018, for helpful comments on a previous draft. Usual disclaimers apply. A slightly modified version of this paper will be published in a Social Europe e-book.

Figure 1. Selected countries. Real GDP per capita



Italian economic agenda, through austerity measures which – as for Greece – have contributed to slowing down growth even further, causing an increase in the ratio of debt to GDP, rather than a fall.

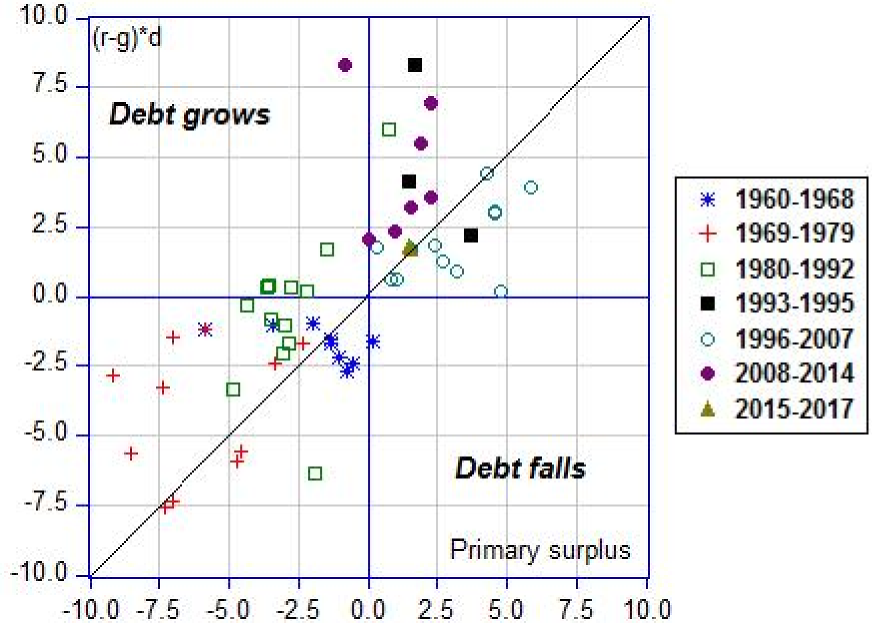
We will argue that, on the contrary, changes in aggregate demand have consequences on the growth rate, and that austerity measures are inappropriate to help the economy recover, while reducing or stabilizing public debt relative to GDP.

In the next section we will briefly discuss the determinants of Italian growth, showing that the post-war period can be broken down in different sub-periods. In the following section 3 we will review the arguments on the sources of imbalances of the Eurozone, and their implications for policy. In section 4 we will review the current proposals for reform, both of Italy and the Eurozone. Section 5 concludes discussing our own proposals.

From prosperity to austerity

As we documented in Figure 1, real income per capita in Italy has been growing in line with that of other major European countries, up to the 1990s. This does not mean that the Italian growth model remained the same over this period of time. On the contrary, as we discuss elsewhere in more detail (Cesaratto & Zezza, 2018), the post-war reconstruction period of rapid growth was based first on domestic demand (Ciocca, Filosa, & Rey, 1975), and later on exports (Graziani, 2000). In the early 1960s the country experienced a too short-lived reform season that failed, however, to introduce the social reforms necessary to sedate the potential social conflict, and the "structural reforms" aimed at modernization, to reduce the relevance of family-ownership of most businesses, and facilitate the production of domestic innovation, fully exploiting a relevant technological potential in advanced technologies (like electronics, chemistry and nuclear energy) – rather than relying on the

Figure 2. Italy. Debt sustainability



Source: authors' elaboration on data from Arcelli (1997), Bank of Italy, Istat

imitation of foreign technologies (Amatori, 2017; Graziani, 2000). At the same time, full employment in the industrialized North-West (Italy was, and still is, marked by strong regional divides) started a season of labour market turbulence which prompted the Bank of Italy to intervene through deflationary measures of credit restriction that depressed investment, putting an end, in 1964, to the years of the "economic miracle". The growth rate in the following years was lower but, again, in line with that of other countries. In the second half of the 1960s the Italian economy became even more export oriented (De Vivo & Pivetti, 1980; Salvati, 1975), with price competitiveness being achieved by an increased exploitation of the workforce, rather than by increasing capacity or by innovation. These processes led to even stronger social conflicts, peaking in 1969, and the oil shocks of the 1970s exasperated the conflict over income distribution. Later, the labour movement obtained full indexation of nominal wages to inflation, but the exchange rate flexibility avoided a loss in price competitiveness. Fiscal policy was still aiming to target full employment (De Cecco, 1997), and to subsidise the business sector, with an accommodative monetary policy which kept real interest rates low enough to help keeping public debt sustainable (Basevi & Onofri, 1997; Rossi, 1998).

To evaluate the sustainability of the Italian public debt in different periods, we used the standard accounting for the evolution of debt relative to GDP. Standard textbook accounting shows that, when $(r - g) \cdot d > s$ (where *r* is the nominal interest rate, *g* the growth rate of GDP at current prices, *d* the starting debt to GDP ratio, and s the primary surplus relative to GDP), the debt to GDP ratio increases. In Figure 2 this accounting relation is used to split the diagram in two parts: in the upper left portion public debt is increasing because the interest rate is higher than the growth rate, and/or the primary surplus is too small, or negative. In the lower right part of the diagram, debt is falling relative to GDP. Using data from (Arcelli, 1997) for earlier years, and from Bank of Italy and Istat, we have plotted the evolution of the Italian public debt over the years, showing that in the earliest periods a large growth rate coexisted with reasonable primary deficits, implying a fall in the debt to GDP ratio. The 1970s are characterized by large primary deficits, but interest rates low enough, relative to the growth rate, to allow for a fall – or a moderate increase – in public debt.

In 1979 the government decided to join the European Monetary System (EMS), without being fully aware of the consequences (Arcelli & Micossi, 1997; De Cecco, 1997; Rossi, 1998), even though the governor of the Bank of Italy of the time was sceptical, being fully aware of the perils of a fixed exchange regime without substantial assistance to weaker countries (Baffi, 1979). In 1980, trade unions were defeated, putting an end to a long period of social conflict. The political defeat of trade unions allowed the monetary authorities to switch to a new, restrictive monetary regime (Simonazzi & Vianello, 1998), with the political support of the Treasury. In 1981 the Bank of Italy stopped its intervention on the primary market of Government Treasuries, so that the cost of borrowing for the government was no longer under control. In the early 1980s, therefore, monetary policy started to target monetary stability. Fiscal policy, however, did not change its target of sustaining employment: the outcome was a rapid increase in interest rates, and in the public debt ratio to GDP, as documented in our chart in Figure 2 (Arcelli & Micossi, 1997; Longobardi & Pedone, 1994; Rossi, 1998). In addition, the attempt at stabilizing the exchange rate and reduce inflation was particularly difficult, since inflation expectations adapted slowly, and nominal wages were still fully indexed. The result was a deterioration of the foreign balance, which added pressure to the choice of using fiscal policy to sustain employment levels. Our econometric exercise – not reported for space consideration – shows that the data support the hypothesis of the current account balance helping predict the government net borrowing position, rather than the other way round.

While the temporary Italian exit from the EMS in 1992 let the economy to take some breath and adjust the foreign unbalances, the choice to import foreign discipline was completed with the participation to the European Monetary Union. Some commentators (Daveri, 2017; Piluso, 2017) interpret the choice of adopting a common currency issued by an independent Central Bank – the Maastricht Treaty – as a way of putting, once and for all, a rigid discipline on the Italian labour market and on fiscal policy, with the political bonus of putting the blame of real wage compression and of fiscal austerity on foreign institutions, rather than the domestic government.

The convergence towards the Maastricht criteria first, and the adoption of the Euro later, were indeed successful in lowering the inflation rate in Italy, albeit not as much as in Germany, so that a small inflation differential persisted, implying a slow but growing deterioration in price competitiveness. Lower interest rates helped the convergence towards Maastricht fiscal criteria, but the price of the restrictive fiscal stance and the loss of external competitiveness led to a substantial stagnation of aggregate demand and productivity growth.
In the 2000s, up to the GR, Italy grew less than its major partners (Figure 1). The reasons were the deterioration of price competitiveness, which implied a decline in net exports, combined with a restrictive fiscal stance. In addition, other countries (the U.S., Spain, Greece, etc.) experienced faster growth in this period because of a boom in the real estate market, going hand in hand with the explosion of mortgages, and private sector indebtedness. Italian households already had a relatively large share of wealth in housing, and the Italian financial sector was at the time less open to international markets. The implications were that Italy did not experience a dramatic increase in its financial fragility in the pre-GR period, and was relatively less exposed to the financial crash of 2007, but did not enjoy the rapid finance-led growth of other countries. Stagnating domestic demand, along with the shrinking of the manufacturing sector, were the main contributors – in our view – to the relative decline in Italian productivity. Another determinant of low productivity growth, which probably became more important later on, was the deterioration in labour market conditions, with a number of reforms which allowed firms to increase the share of temporary, and/or part-time jobs. Workers on temporary contracts are not likely to contribute to productivity growth arising from learning-by-doing, and have little incentives to increase their efforts.
If the Italian financial sector suffered less than other countries from the 2007 shock, the combination of late response of the ECB to the crisis, climbing interest rates after the Greek crisis in 2010, and the adoption of a restrictive fiscal stance with the Monti government in 2011 implied a strong and long recession, with a considerable fall in private sector investment, a credit crunch which created liquidity problems to small business first, and insolvency problems later (leading the banking sector into troubled waters), and a dramatic increase in poverty. The combination of rising interest rates and low growth implied an increase in the public debt to GDP ratio (Figure 2) which called for further austerity, putting the economy in a deflationary spiral.
The feeble recovery, which started around 2014, is mainly due to exports: part of the business sector diversified their foreign markets, and were able to increase sales abroad, mainly to extra-euro countries (Bugamelli et al., 2017). Since most of these firms are located in the North, the recovery is widening regional disparities.
Summing up, the decline in Italian productivity, which started in the 1990s, is mainly analysed from the supply side (Bugamelli et al., 2018). However, supply-side determinants internal to firms (small size, family ownership, etc.) were already there in previous decades, and did not preclude the ability of the country to grow. On the

other hand, the external determinants of productivity (rule of law, efficiency of the public sector, etc.) would require public investment, rather than austerity-driven cuts. Finally, more attention should be paid, as discussed above, to the determinants of productivity from the demand side, as well as to the vicious circle between labour market "flexibility", human capital and productivity.

Eurozone imbalances

The idea that the design of Eurozone institutions inevitably implies imbalances, and the inability of single Eurozone government to address asymmetric shocks without starting a recessionary spiral was diagnosed early – see (Godley, 1992) among others – but still the 2007 shock took Eurozone institutions unprepared. The imbalances are mainly visible in the polarization between northern countries – notably Germany – running a large current account surplus – and "southern" countries with a corresponding deficit. In a closed system, of course, it would be impossible for some countries to run a trade surplus without some other countries running a deficit, with the implication that the former group is financing the net balance position of the latter.

Some contributions focus on price competitiveness, given by differentials in labour costs, as the main source of trade imbalances (Flassbeck & Lapavitsas, 2016), achieved by stronger wage moderation in Germany (Baccaro & Tober, 2017; Nocella, 2015). Further evidence on the relevance of price competitiveness is in (Paternesi Meloni, 2018), while (Algieri, 2015) finds that for Italy non-price factors played a more relevant role. Others (Horn, Lindner, & Stephan, 2017; Storm, 2016) point to the quality of German exports and the reshuffling of the European production network in a direction unfavourable to southern countries. (Cesaratto & Stirati, 2010) point to the role of faster growth in domestic demand in southern countries. Another crucial role was the progressive integration of the German economy with that of Eastern European countries (Celi, Ginzburg, & Guarascio, 2018). On the structural determinants of the German surplus see also (Priewe, 2018).

Current account imbalances are obviously mirrored in imbalances on the capital account or, to put it differently, current account deficits must be financed. Before the Greek crisis, the private financial sector of surplus countries was willing to meet the demand for funds from deficit countries. After the crisis, current account imbalances were reflected in Target2 balances, giving rise to a debate on whether the crisis is similar to a standard balance of payments crisis, a debate that we do not address here for space consideration (Cesaratto, 2013, 2018a; Febrero, Uxó, & Bermejo, 2018; Lavoie, 2015).

In any case, after the Greek crisis it became clear to financial markets that the ECB would not act as a lender of last resort for governments in trouble, and the spread between the cost of borrowing for the Italian government and that of the German government increased markedly (Figure 2), and the Italian debate started to gravitate even more on how to reduce the size of public debt, instead than focusing on how to increase aggregate demand and reduce unemployment and poverty.

Summing up, economists disagree on the roots of Eurozone imbalances, and therefore on the appropriate policies to address them. Mainstream economists who stress the role of price competitiveness call for "internal devaluation", to be obtained through labour market reforms. These have been implemented in Italy, so much so that the vast majority of new jobs is with temporary contracts, and the country has the largest share in Europe of part-time workers who would like a full time job. As we have argued, labour market flexibility may have an ephemeral impact on price competitiveness, but also a negative impact on domestic demand and productivity, which more than offset the gains, as the Greek and Italian experiences have shown.

Heterodox economists who stress the role of price competitiveness would rather underline the necessity of a German dismissal of her mercantilist, low-wage policy. This is in line with those who stress the role of aggregate demand on imbalances call for a German reflation: expansionary fiscal policy coupled with an increase in nominal wages. While this would be beneficial, the literature shows that the impact might be insufficient to rebalance the Eurozone, and avoid the building up of imbalances (Angelini, Ca' Zorzi, & Forster van Aerssen, 2016; Garbellini, Marelli, & Wirkierman, 2014; Gaulier & Vicard, 2018; Horn et al., 2017; Landmann, 2017; Portella-Carbó & Dejuán, 2018).

Reforming the Eurozone

That the euro is dysfunctional is presently consensual. How to fix is not. There are two fundamental positions, leaving apart the most radical one that suggests that one or all members should abandon the monetary union. The mildly Keynesian French position maintains that there is a problem of completing the EMU institutions complementing the common monetary pillar with a common fiscal one. An old inspiration of this position is the MacDougall report (Commission of the European Communities, 1977). This position was abandoned in the eighties under the influence of New Classical Macroeconomics, and the shift towards neo-liberalism.

The second, monetarist German stance finds the origin of the euro troubles in the negligent application of the existing rules, particularly of the fiscal rules.

The first position was revived by Macron's speech at La Sorbonne in September 2017 where he proposed a wider macroeconomic coordination and of a more robust European budget, given that "no state can tackle an economic crisis alone when it no longer controls its monetary policy". This budget should be financed by "European taxes in the digital or environmental fields" and by "partly allocating at least one tax to this budget, such as corporation tax once it has been harmonized" (Macron, 2017).

The German response was given in (Schäuble, 2017), where a European budget is rejected, and it is suggested to transform the European Stability Mechanism (ESM) into a European Monetary Fund (EMF) responsible of monitoring the members' compliance to the fiscal rules and, eventually to implement the necessary restructuring processes. In addition, emphasis is given on the respect of the debt rule, which would compel

Italy to comply to the Fiscal Compact prescription of a reduction of the public debt/GDP ratio to 60 percent in 20 years: an impossible target.

An attempt at finding a common ground was made by a group of French and German economists (Bénassy-Quéré et al., 2018): the document aims to strengthen fiscal discipline in exchange for some "risk sharing" among partners. In order not to be misunderstood, countries with high debt will have to accept more discipline and receive less risk sharing than others. The document is made up of three parts: the first is devoted to the completion of the banking union; the second to budgetary rules; and the third to the institutional framework. In essence, the latter endorses the German proposal of a reinforced monitoring and crises-management role of the EMS. France seems to have abandoned the idea of turning the Euro group (the Council of Finance Ministers) into a place where countercyclical budget policies are coordinated, and has now surrendered completely to the German reduction of economic policy management to a strict observance of rigid rules.

The German consented to a common European deposit insurance scheme (EDIS), but with guarantees concerning the financial sustainability of banks. They therefore subordinated EDIS to the disposal by national banks of domestic Treasury bonds, in order to avoid the 'doom loop' between banks' and State troubles, and of the non-performing loans (NPL) in their possession beneath a certain threshold (sanctioned by penalties). This would be penalizing for countries like Italy that should hastily sell the large amount of government bonds they own, with destabilizing effects on the Italian treasuries market. The reduction of NPL – due to the austerian policy stance so far – obviously requires a reversal of this policy. German economists also forget the huge participation of the German large banks – almost speculative institutions – to the preparation of the American financial crisis, and the huge financial help they received from the German government. The involvement of the private sector in public debts restructuring is also a proposal likely to destabilize markets by increasing the financial risk as soon as it is implemented (Bastasin, 2017; Cesaratto, 2018b).

Opposite proposals have recently been advanced by Paolo Savona, the current Minister of the European affairs (Savona, 2018), proposing, inter alia, a selected action by the ECB as a lender of last resort to eliminate the spread differentials on peripheral debt, in order to restore uniform credit conditions for States, banks and firms in the Eurozone.

"A much more delicate issue to be addressed in terms of monetary policy concerns the development of the lender of last resort function […]The constraints related to quantity and proportionality between Member Countries (the "capital key" that introduces a monetary base even whereby it is not necessary e.g., buying Dutch and German government bonds), as well as quality of financial assets, result from the required compatibility with the Statute underlying the ECB action. Hence, rationalization of the related institutional powers would be required to face future speculative attacks in a more timely and efficient manner."(Savona, 2018, p.27)

Conclusions

What should be the priorities for reforms in Italy? Much discussion takes place in Italy about supply side-reforms (Bugamelli et al., 2018; Cottarelli, 2018). The list of inefficiencies is long, ranging from the inefficiencies of justice to the worsening quality of education; from the (perhaps exaggerated) diffusion of corruption to (the more worrying) organised crime; from the poorly managed small size firms to commercial law. At the bottom of these inefficiencies there are poor social institution, especially in Mezzogiorno, characterised by a limit sense of civic participation and commitment (with, of course, laudable exceptions), at all social levels and hierarchical positions. The perception is that merit is not awarded and that family or political connection matter much more. The absence of advanced, cooperative institutions to regulate the social conflict over income distribution has already been pointed out as the main origin of the Italian troubles. The quality of the political class has become poorer. After the surrender to the EMU of any independent policy freedom, the space for alternative, serious policy proposals has been drastically reduced, so that political parties resemble one another and new leaders will be rapidly be burned once their promises reveal unfeasible in the Eurozone context. Trust in the democratic process cannot but be badly affected.

The quoted studies (and other similar) attribute the stagnation of productivity in Italy to the listed supply-side inefficiencies. They forget, however, to explain why productivity growth precisely started to fall in the mid-Nineties when, as we have seen, Italy resolutely pursued an early membership of the EMU. We may concede that the most enlightened of the Italian bourgeois was scared that Italy outside the EMU would have been a lost country (and the entering of Berlusconi in politics seemed to prove these fears). The majority of the population was led to consider an early membership as a matter of pride. The challenge by a part of the Italian bourgeois to modernise institutions by importing them from abroad through an exchange rate discipline has largely been lost, actually making things worse. A matter of pride would have been to stay outside, taking the challenge of an endogenous institutional change seriously.

What should Italy expect from Eurozone institutions?

The news coming from Berlin are not encouraging. The new Finance minister Olaf Scholz has made it clear that the position of his country in the Eurogroup will not change. Nothing will be done to change the path of the German current account surplus, which is one of the causes of the imbalances. If a coalition of Northern Eurozone countries backs the proposal of implementing more stringent fiscal rules, the outcome will be either a financial crisis and/or the breakdown of the Euro area, given the growing support to populists movement supporting – at least in theory! – a *Italexit*.

One of the authors still believes that, in principle, Eurozone institutions can be reformed following the suggestions given by Keynes at Bretton Woods (Amato, Fantacci, Papadimitriou, & Zezza, 2016). The ECB mandate should be changed so to introduce mechanisms to have creditor countries contribute to the elimination of imbalances, as with negative interest rates on positive Target2 balances, used to finance investment targeted at the convergence of income per capita and productive capacity. At the same time, the introduction of domestic fiscal currencies could provide fiscal space for increasing aggregate demand where needed, while at the same time increasing the sustainability of the existing debt commitments in Euro-denominated liabilities. By "domestic fiscal currencies" we mean very liquid financial instruments issued by the Treasury which would not be a new legal currency, but would be accepted for tax payments by the government (Amato et al., 2016). We do recognize, however, that this is for now an academic exercise lacking a sufficient political support at the European level.

What Italy needs, if a Eurozone break-out is to be avoided, are rules of the game which allow for increasing domestic demand without destabilizing public debt. As we recalled earlier, this can be achieved by keeping the interest rate below the growth rate of the economy: any of the different proposals which require the ECB to act to eliminate any spread between the rates of return of Treasuries of different Eurozone countries would serve to the purpose. If this can be achieved, Italy could expand aggregate demand, within the limits given by the external constraint, which is currently not binding.

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Impressum

Publisher: Hans-Böckler-Stiftung, Hans-Böckler-Straße 39, 40476 Düsseldorf, Germany
Contact: fmm@boeckler.de, www.fmm-macro.net

FMM Working Paper is an online publication series available at:
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ISSN: 2512-8655