Working Paper
Research Division EU Integration
Stiftung Wissenschaft und Politik
German Institute for International
and Security Affairs

©

Elisa Cencig[*]

Italy's economy in the euro zone crisis and Monti's reform agenda

[*]*Elisa Cencig was an intern in the Research Division EU Integration in Spring 2012*

Ludwigkirchplatz 3–4
10719 Berlin
Phone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org

Working Paper FG 1, 2012/ 05, September 2012
SWP Berlin

Table of Contents

List of figures and info boxes

Introduction

Italy's economic and political situation recently gained widespread attention in the midst of the sovereign debt crisis. Since 2011, the country, which faces substantial refinancing needs, experienced a marked increase of the BTP-Bund spreads on financial markets[1] and a substantial downgrade of its credit worthiness. Italy as the euro area's third largest economy[2] is generally seen as being too large to be supported by the current euro area rescue mechanisms. A default of Italy would meanwhile have disastrous contagion effects on the rest of the euro area. Italy is the make-it-or-break-it issue for the euro zone which can put the survival of the common currency at risk.

After former Prime Minister Silvio Berlusconi was forced to resign in November 2011, former EU-Commissioner Mario Monti took the office with a technocratic government, backed by broad political and popular support. He set out a broad reform agenda with the objective to address the country's troubled public finances and structural problems of the economy. Although the general public, most Italian political parties and international leaders[3] have welcomed the reform agenda, Italy's economic and financial recovery is no done deal and Monti's mandate is due to expire in April 2013. The labour market reform and opposition by the workers' unions and general public caused a substantial albeit temporary fall in Prime Minister Monti's approval rates, with high unemployment and falling internal demand causing serious pain to the population. Notwithstanding the high pace of the reforms, in the second quarter of 2012 the worsening of the euro area sovereign debt crisis and continuing uncertainty over the EU governments' and ECB role increased financial markets pressures[4]. Markets have welcomed the ECB's announcement of

[1] The BTP-Bund spread reached its ever highest peak of 553 basis points on 9 November 2011, short before the resignation of Berlusconi's government. Italian 10-year BTPs (*Buoni Poliennali del Tesoro* or Multiannual Treasure Bonds) correspondingly reached a peak of 7,057 percent in interest rate. The yield later went under 300 bps, but it markedly rose again over 500 basis points during July 2012. Source: Bloomberg.

[2] With a nominal GDP of 1.550,264 billion Euro Italy was in 2010 the third largest economy in the euro area, after Germany (2.462,100 bn €) and France (1.917,190 bn €). Source: Eurostat.

[3] See Michael Schuman, *The most important man in Europe*. *Mario Monti is trying to put Italy and its neighbors back from the economic brink*(Time, February 20, 2012); Christian Wulff, "Berlino e Roma partner forti per creare un'Europa competitiva" (Corriere della Sera, February 12, 2012), http://archiviostorico.corriere.it /2012/febbraio/12/Berlino_Roma_partner_forti_per_co_8_120212019.shtml (accessed September 27, 2012).

[4] Despite the substantive reform process the credit rating agency Moody's decided to downgrade Italy's government debt from A2 to A3, with a negative outlook, on 13th February 2012. The reasons adduced to motivate this decision are the "uncertainty over the prospects for institutional reform in the euro area, the challenges facing Italy's public finances and the significant risk that Italy's government may not achieve its consolidation targets". Moody's, *Rating Action: Moody's adjusts ratings of 9 European sovereigns to capture*

the Outright Market Transactions Programme, but its details and effects are still undefined. Other potential obstacles are traditional contrasts between the party leaders who are currently supporting Monti's government, as the consensus behind his parliamentary majority could turn out to be pretty fragile. Italy's inherently fragmented party system could revive political bargaining and thus put the implementation of the reforms at stake. In addition, even successfully adopted reforms take time to fully display their effects, and structural supply-side adjustments put social cohesion and economic recovery at stake in times of recession as it is the case right now[5].

This paper outlines Italy's economic situation in the midst of the current crisis and the challenges ahead and discusses the current government's reform agenda. It argues that the technocratic government led by Monti is undertaking comprehensive reforms which address a wide range of structural weaknesses, yet economic recession and political factors both at a national and European level make the outlook all but safe. In addition, a number of issues remain high on the agenda, notably the weakness of the justice system, inefficiency in PA and corruption, which hinder Italy's economic growth. Although something has been done to deal with them, more courage is needed to address these weakening factors.

The first chapter gives an overview of the evolution of the financial and economic crisis from its very inception in 2008 with the subprime crisis in the US. The second chapter deals with the current situation of Italy's economy, including a discussion of the effects of the economic and financial crisis. The third chapter investigates the structural characteristics, traditional problems and current challenges of Italy's economy. The fourth chapter turns to the political situation, providing a concise summary of the dynamics and drivers of the political crisis leading to the government change in November 2011. The following chapter depicts Monti's fiscal and economic policy, which was inaugurated by harsh austerity measures in December 2011, accompanied by a reform of the pension system and liberalization measures in January 2012. The reform of the labour market and the spending review approved in July 2012 will also be discussed. The last chapter draws conclusions and highlights the challenges ahead.

1. The current economic situation

Italy was among those euro area countries which have been particularly struck by the financial and economic crisis in 2008/9. In 2010, Italy became

downside risks, Preass release (February 13, 2012), http://www.moodys.com/research/Moodys-adjusts-ratings-of-9-European-sovereigns-to-capture-downside–PR_237716 (accessed September 27, 2012).

[5] Istat certified that the country is experiencing the fourth quarter of negative growth (-0.7 percent in the second quarter of 2011, amounting from a total of -2.5 percent from the second quarter of 2011). Stima preliminare del PIL, II trimestre 2012 (Istat, August 7, 2012), http://www.istat.it/it/archi vio/68720 (accessed September 27, 2012).

one of the Member States which are seen as candidates for a sovereign debt crisis, as it saw a marked rise in its sovereign bond yields. Financial markets pressures are intertwined with structural economic problems which have long affected the country.

1.1. Growth performance and perspectives

Italy's growth prospects are currently rather dismal, as the country officially re-entered recession in the second half of 2011. The following figure shows real GDP growth rates since the inception of the crisis, with positive figures only between the beginning of 2010 and mid-2011. Germany's relative positive record is apparent as well as the worsening of the gap between Italy and other euro area countries since mid-2011.

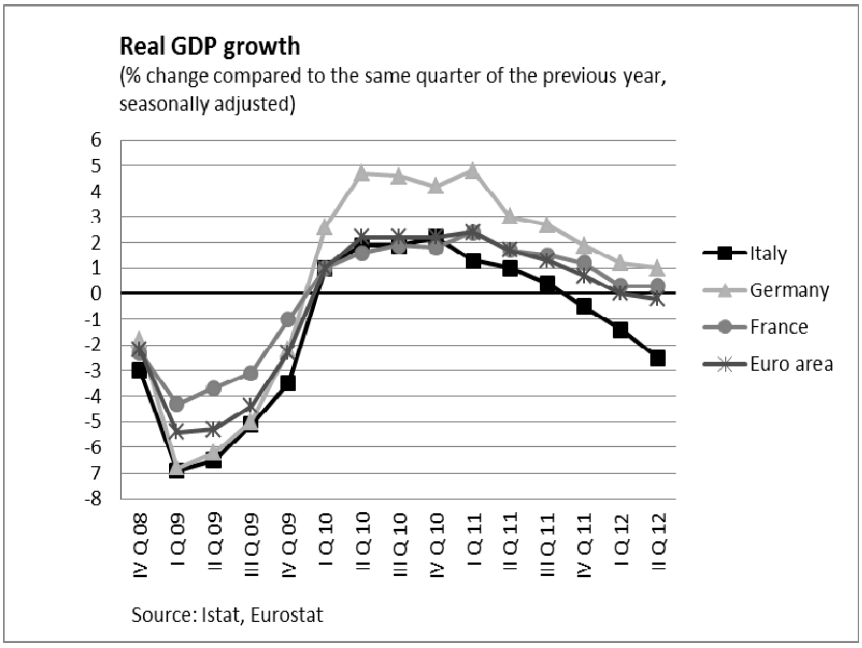


Figure 1: Real GDP growth in comparison: 2008-2012

Even before the current crisis, i.e. between 2001 and 2007, Italy's average real GDP growth was only around 1 percent per year, roughly half the euro area average. The economy was severely hit by the crisis, recording a huge collapse in exports and investment. As Figure 1 shows, Italian real GDP contracted by around 7 percent only between the second quarter of 2008 and the second quarter of 2009[6]. As a consequence, government gross debt increased to 119 percent by the end of 2010[7]. Employment deteriorated by

[6] In the midst of the global crisis, Italy's GDP fell at a rate of -1.2 percent in 2008 and -5.1 percent in 2009, then the real GDP growth rate surged to 1.5 percent in 2010. Source: Eurostat.

[7] The debt/GDP ratio had fallen to below 105 percent in 2003. See Statistiche di finanza pubblica nei Paesi dell'Unione Europea, 52 (Banca d'Italia,October 17, 2011), http://www.bancaditalia.it /statistiche /finpub/pimfpe/sb52_11/suppl_52_11.pdf (accessed September 27, 2012).

almost 2 percentage points since 2008[8] and the labour market situation remains fragile (see below, chapter 3.3.).

The economy started to recover at the beginning of 2010 thanks to the export dynamics, which have been a counterpart to the weakness of the internal demand and imports, severely affected by the recession. The weak growth experienced in 2010, as sovereign debt risk had not yet become an issue and refinancing costs were still low, distracted attention from much-needed structural reforms[9]. Even though this recovery was still half a percentage point lower than the average in the euro area, it gave way to some hope for the country's situation. Italy had indeed avoided major downfalls mainly because of the sound fiscal position of its households, traditionally showing a considerably more limited indebtedness than most EU countries. Its banking system was similarly limitedly exposed towards foreign investors and financial products, as a large percentage of deposits was made up of national households' savings and credit institutions enjoyed a relatively stable stance. Nonetheless, the need for sound and wide-ranging structural reforms was still pressing, as the country seemed set for no more than the rather sluggish growth experienced in the decade prior to the crisis.

In the third quarter of 2011, Italy's economy officially re-entered recession, as the country's GDP fell by 0.2 percent between July and September 2011. Over the last quarter of the year, GDP further decreased by 0.7 percent, with similar rates in the first and second quarters of 2012[10]. Compared with the same quarter of the previous year, seasonally adjusted GDP fell by 2.5 percent in the second quarter of 2012. Italy thus continued to lag well behind most other developed economies, as its GDP grew by only 0.4 percent over the whole year[11]. In 2011, Germany's gross domestic product grew by 3.0 percent, France grew by 1.7 percent and the euro area as a whole by 1.5 percent.

GDP shrinking in the second half of 2011 was largely due to the consequences of the sovereign debt crisis in the euro area, which first hit the country in summer. Worsening financial tensions affected banks' balance sheets, influencing loan policies to the private sector and consequently the internal demand, notably investment spending. Consumption expenditure also weakened in 2011, reflecting the falling real incomes and families' worries about the labour market situation. GDP dynamics thus reflected the shrinking internal demand, while external trade contributed to sustain GDP growth as export increased moderately

[8] The employment rate fell from 59.7 percent in 2008 to 58.4 in 2010, in line with the average decline in the euro area of 1.8 percent, although Italy's starting employment rate was already substantially lower. See below 1.3.

[9] At the beginning of July 2011, the premium risk on Italy's 10-year national bonds was still less than 200 percentage points higher than the interest rate on the German bund. Source: Bloomberg.

[10] Stima preliminare del PIL, II trimestre 201 (Istat,August 7, 2012), http://www.istat.it/it/archivio/68720 (accessed September 27, 2012).

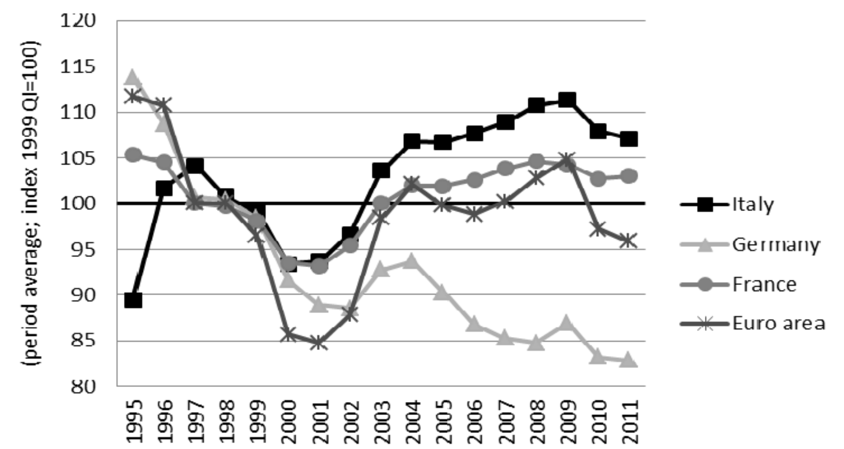
[11] Source: Istat.

(+1.6 percent in the last quarter of 2011 and +5.6 percent over the whole year) and imports further decreased[12]. Furthermore, financing for small and medium enterprises have become more costly since the last quarter of 2011, as the sluggish macroeconomic outlook led to a sharp loss of confidence and a visible credit crunch for SMEs, accompanied by a rise in interest rates[13]. The government restrained from reacting to the crisis with expansionary fiscal policies, thus avoiding a major increase in budget deficits which was recorded in other EU countries. However, GDP dynamics are dependent on growth rates and tight fiscal policies alone cannot put Italy on the growth path.

Overall, the country's GDP is predicted to fall by a further 2 percent in 2012, with other economic forecast data being similarly dismal in regard to consumption, productivity, employment figures.

1.2. Competitiveness and structural reform needs

The major problem of Italy's economy – alongside the lack of growth - is its steadily widening competitiveness gap, in particular in unit labour costs (ULCs). Figure 2 shows Italy's and France's decline in competitiveness both in comparison to Germany and to the euro area in average.



Based on ULCs indices for the total economy
Source: ECB statistics

[12] Relazione Annuale sul 2011 (Banca d'Italia, May 31, 2012): 88-95, http://www.bancaditalia.it/pubblicazioni/relann/rel11/rel11it (accessed September 29, 2012).

[13] The difficulties experienced by enterprises in accessing to bank financing were denounced by CGIA Mestre (Associazione Artigiani Piccole Imprese), an association providing trade-union style support to autonomous workers and small enterprises. See Imprese: le banche hanno chiuso i "rubinetti" del credito (CGIA Mestre, February 2012), http://www.cgiamestre.com/2012/02/imprese-le-banche-hanno-chiuso-i-rubinettidel-credito/ (accessed September 29, 2012). For more detailed data on bank financing to the industrial sector, see Bollettino Economico, Appendice statistica, tav. 2.19, No. 69 (Banca d'Italia, July 2012): 64, http://www.bancaditalia.it/pubblicazioni/econo/bollec/2012/bolleco69/bollec69/boleco_69.pdf (accessed September 29, 2012).

Figure 2: Italy's competitiveness gap: harmonised competitiveness indicators (HCIs)

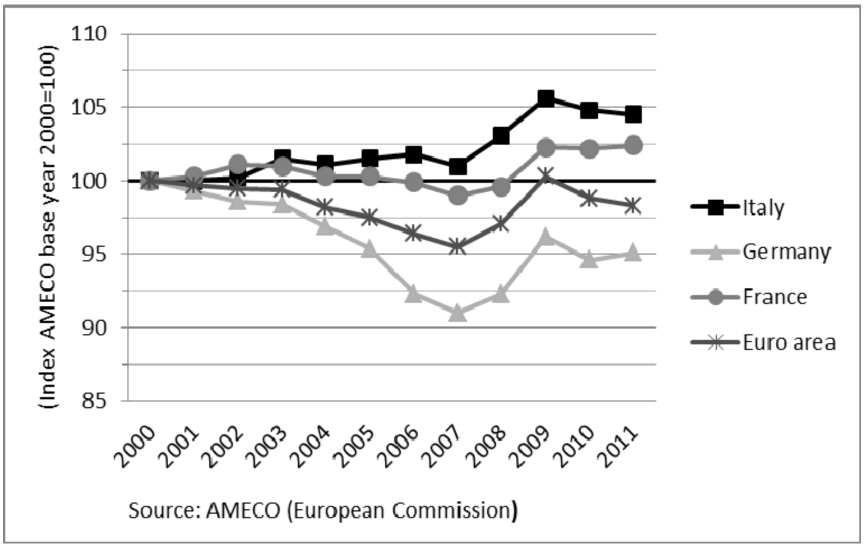


Figure 3: Real unit labour costs (total economy)

As Figure 2 and 3 show, Italy's position deteriorated steadily during the first ten years of euro area membership, after a decade of already sluggish growth and market slowdown in the dynamics of exports[14]. Stagnation in productivity since the end of the 1990s and the correlated rise in unit labour costs reduced its market shares for goods and services measured in volume terms by almost 3.5 percent per year on average over the 2000-2009 period[15]. Italy's total market share in world trade has declined significantly since the mid-1990s, and the country has not profited from increased demand in fast-growing emerging markets[16].

Italy's export mix similarly to that of emerging economies relies mainly on low-technology and labour-intensive products, e.g. textiles and clothing, leather, furniture and mechanical engineering products. Notwithstanding the high quality of Italian products, there has been no significant shift in the industrial specialization pattern over the last years and Italy's exports shares to fast-growing emerging markets are still rather

[14] See chapter 1.2.

[15] This figure sharply contrasts the export performance of Germany, which recorded a market share gain of almost 1.75 percent per year over the same period.

[16] The first Alert Mechanism Report, published by the European Commission in February 2012, highlighted Italy's main macroeconomic imbalances compared to other EU countries. In line with previous findings, Italy's scoreboard values are above the indicative thresholds in the area of competitiveness, which is clearly reflected in the loss of market shares (-19.0 percent in 5 years). Nevertheless, Germany similarly suffered a 8.3 percent decrease over the same period. Report from the Commission, Alert Mechanism Report (European Commission, February 14, 2012), http://ec.europa .eu/economy_finance/economic_governance/ documents/alert_mechanism _report_2012_en.pdf (accessed September 29, 2012).

low[17].

Italy's traditionally high levels of public ownership, regulatory barriers to competition and administrative burdens for start-ups have also made it difficult for companies to enter the world market. Italy's regulatory policy continues to lag far behind best practice in the OECD, as several professional services are highly protected from competition and often cumbered by excessively lengthy bureaucracy[18]. Another structural characteristic is the traditional predominance of small and medium size enterprises which are unable to fully exploit economies of scale. Furthermore, non-bank SME financing is limited and the equity market as a source of financing for enterprises is underutilized[19].

1.3. Labour market and other structural weaknesses

Unemployment in Italy is steadily rising reaching 10.7 percent in July 2012, still below the euro area average of 11.3 percent (which is markedly affected by the situation in Spain and Greece)[20]. In a comparative perspective, participation in the labour market remains very low. The following figures display both indicators in comparison with France, Germany and the euro area average.

[17] Italy's exports are mainly directed to other EU countries, with only 3.8 percent of export shares to Central and South America, 1.0 percent to India and only 2.7 percent of exports going to China. Source: Istat.

[18] *OECD Economic Surveys Overview, Italy* (Organization For Economic Co-Operation And Development, May 2011), http://www.oecd .org/italy/economicsurveyofitaly2011.htm (accessed September 29, 2012).

[19] The large predominance of SMEs also explains Italy's scarce investment in R&D and innovation, as small and medium sized enterprises find it quite difficult to meet up costs of R&D. Gross domestic expenditure on R&D was only slightly higher than 1.3 percent of GDP in 2011, compared with the EU average of 1.9 percent and Germany's 2.8 percent. Nonetheless, R&D investment in university and research institutions is also comparatively rather poor. See *Relazione Annuale sul 2011* (Banca d'Italia, 31 May 2012): 118, http://www.bancaditalia.it/pubblicazioni/relann/ rel11/rel11it (accessed September 29, 2012).

[20] *Euro area unemployment rate at 11.3%, News release euro indicators* (Eurostat, August 31, 2012), http://epp.eurostat.ec.europa .eu/cache/ITY_PUBLIC/3-31082012-BP/EN/3-31082012-BP-EN.PDF (accessed September 29, 2012); *Occupati e disoccupati. Luglio 2012 (dati provvisori) e II semestre 2012* (Istat, August 31, 2012), http://www.istat.it/it/archivio/69249 (accessed September 29, 2012).

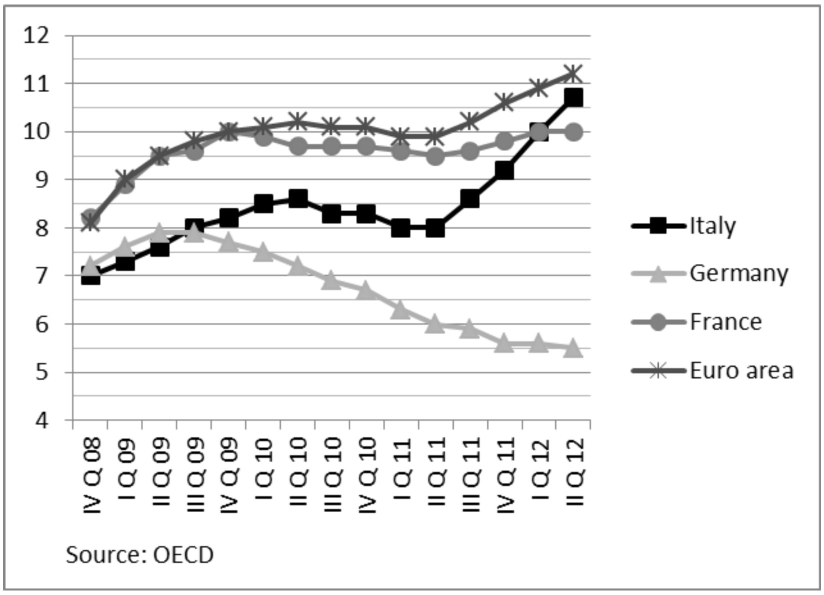


Figure 4: Italian unemployment rate in comparison: 2008-2011

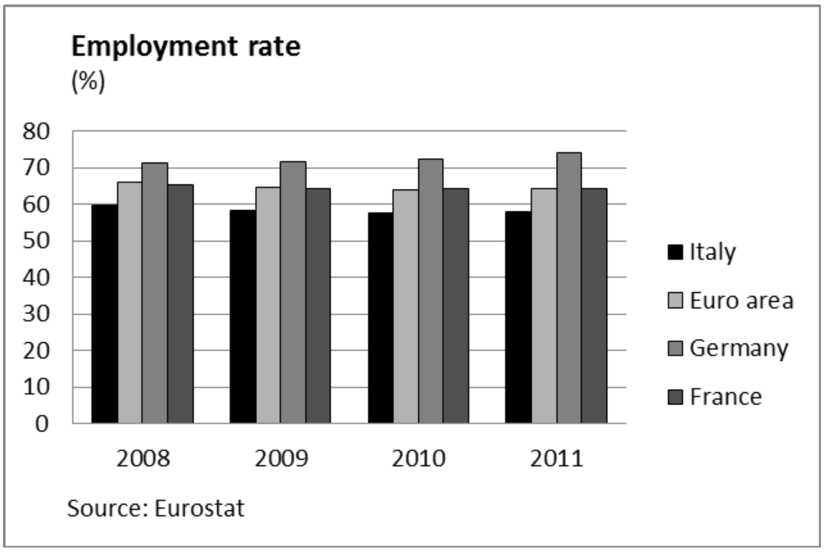


Figure 5: Italian employment rate in comparison: 2008-2011

Italy's unemployment rate rose sensibly in 2009 and in the first two quarters of 2010 (from 7 percent at end-2008 to 8.6 percent at mid-2010). Afterwards a weak decline in overall unemployment was experienced between mid-2010 and mid-2011, before the sovereign debt crisis brought along renewed distress. However, it appears to be entirely due to the creation of fixed term and atypical contracts, while the number of permanent jobs kept falling[21]. Since the second half of 2011, the

[21] OECD Employment Outlook 2012 – How does Italy compare? (Organization For Economic Co-Operation And Development, July 10, 2012), http://www.oecd.org/employment/employmentpoliciesanddata/Italy_final_ EN.pdf (accessed September 29, 2012).

unemployment rate has kept rising, with a sharp rise of about 2 percentage points over the course of a year[22]. The crisis further contributed to the segmentation of Italy's labour market, with strong employment protection possibly discouraging hiring on permanent contracts. In the meantime the general unemployment insurance system leaves most workers completely unprotected which fuels social tensions. Furthermore, the deterioration of employment rates also led to an increase in the gap of female employment rates and women's inactivity rates, thus widening the distance from most EU countries. Italy's employment rate has traditionally been rather dismal, and the crisis has had no positive effect on such worrying gap[23].

Italy's employment rates vary considerably among different socio-economic groups, with women, older workers and youth particularly disadvantaged in a comparative perspective. While the male employment rate reached about 67.5 percent, the employment rate among women was 46.1 percent in 2010, against an EU average of 58.2 percent, with countries such as Germany recording even better rates (66.1 percent in 2010)[24]. The rate slightly increased to 46.5 percent in 2011, but 44.6 percent of young women living in Southern Italy are unemployed[25]. Furthermore, employment rates among over-60s rank considerably lower than in most EU countries[26] and together with rapidly rising life expectancy put the pension system under considerable pressure.

The unemployment rate of the 15 to 24 year olds rose to a blatant 33.9 percent in early 2012, particularly affecting the Centre and Southern regions[27]. Contracts offered to young people are typically more flexible to

[22] Effective unemployment rates increase substantially considering that these data do not take into account the workers who benefit from the unemployment redundancy scheme Cassa Integrazione, which saw a 426 percent increase in the number of total authorized hours from 2008 to 2010 (jumping from 227.66 million to 1,197.82 million of hours in 2010). In 2011 the total number still reached 973.16 million. Source: INPS, Osservatori statistici, http://www.inps.it/webidentity/banchedatistatistiche/menu/cig/main1.html (accessed September 30, 2012).

[23] In 2011 Italy's employment rate in the 15-64 age range remained stable at 56.9 percent. See Relazione Annuale sul 2011 (Banca d'Italia, May 31, 2012): 104, http://www.bancaditalia.it/pubblica zioni/relann/rel11/rel11it (accessed September 29, 2012).

[24] In 2010 Italy's female employment rate ranked with 46.1 percent second-worst in the EU, with only Malta (39.3 percent) lagging behind. Source: Eurostat.

[25] See Relazione Annuale sul 2011 (Banca d'Italia, May 31, 2012): 97, http://www.bancaditalia.it/pubblicazioni/relann/rel11/rel11it (accessed September 29, 2012).

[26] The employment rate among people aged over 65 was 3.1 percent in 2010, against an EU average of 4.7 percent. Source: Eurostat.

[27] See Occupati e disoccupati. Luglio 2012 (dati provvisori) e II semestre 2012 (Istat, August 31, 2012), http://www.istat.it/it/archivio/69249 (accessed September 29, 2012). Alone in 2009, almost 500,000 workers aged between 15 and 34 lost their job (-6.8 percent), while in the first half of 2010 close to 400,000 more became unemployed (-5.9 percent). See Censis, Italy Today. Social picture and trends 2010 (Franco Angeli, 2011), http://www.censis.it/17?relational_resource_263=55&resource _386=55&resource_105=55 (accessed September 29, 2012).

allow easier lay-offs. More fundamentally, inadequate training systems are seen as a reason for high youth unemployment.

1.4. Italy in the sovereign debt crisis

1.4.1. Budgetary policies and situation of public finances

Italy's total government debt surpassed 120 percent of GDP in 2011, well above the euro area average of 87.9 percent of GDP as Figure 6 shows[28]. Both Italy's public levels and the euro area average reflect the impact of the financial crisis and the global recession starting in 2008. The increase in Italy's government debt mirrors the lack of economic growth rather than a deterioration of the country's own internal financial situation.

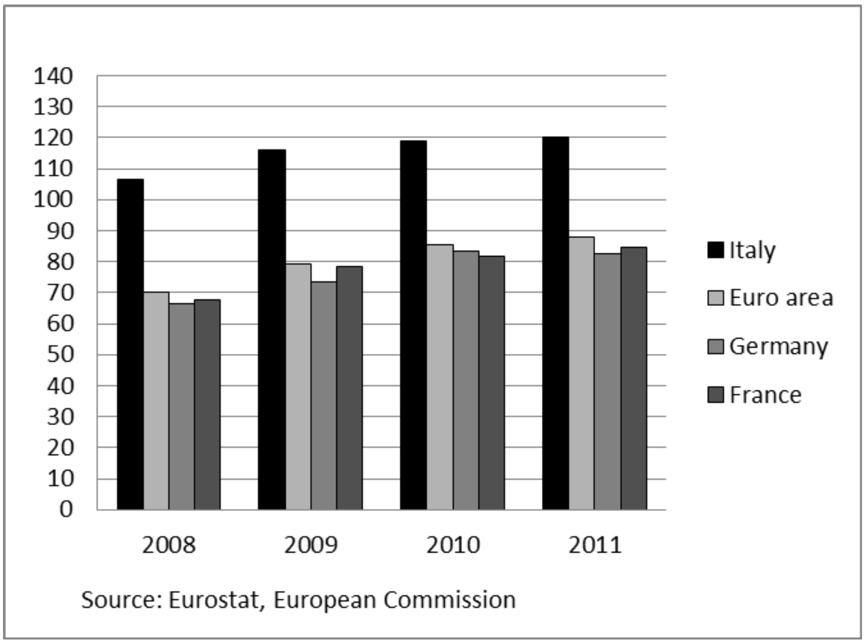


Figure 6: General government debt (in percent of GDP)

Since 2009, Italy has run a general government deficit well above the 3 percent of GDP limit of the Stability and Growth Pact, but has remained under the euro area average as Figure 7 below shows.

[28] It is however to be mentioned that a high level of public debt alone seems not to constitute a worrisome situation to financial markets, as close-to-one-percent interest rates on Japan's sovereign debt titles demonstrate. The country's public debt exceeds indeed 200 percent of GDP, and the OECD has only lately started to call for fiscal consolidation and spending cuts. Hence the real problem is rather the lack of economic growth, as the debt dynamics clearly show. See Centro Europa Ricerche, Rapporto CER, Box 1. Sustainability of debt (Rome, June 2012): 18, http://www.centro europaricerche.it/reports.asp?pg=doc&Did=549 (accessed September 29, 2012).

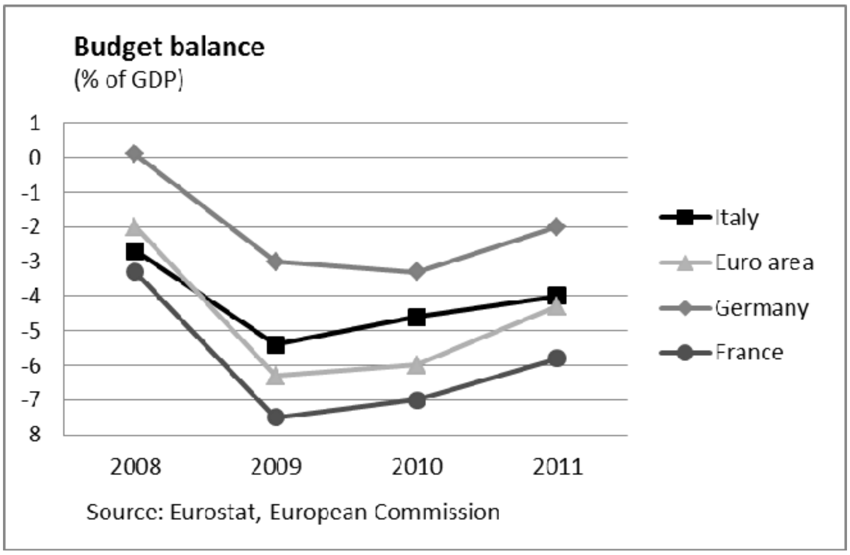


Figure 7: Budget balance (in percent of GDP)

Berlusconi's government adopted comparatively restrictive fiscal policies during Italy's recession in 2009 and 2010[29]. In response to the recession triggered by the financial crisis, it shifted expenditure towards social spending and industrial support, rather than a deficit-increasing stimulus[30]. Most measures were designed to be budget-neutral and this policy was to a certain degree successful in bolstering Italy's position in the debt markets but the starting point was already one of high deficits and outstanding public debt leaving little room for action[31]. Thus the further increase of the country's public debt since 2009 has been mainly the result of low or negative growth rates rather than of irresponsible fiscal policy[32].

[29] The government deficit was indeed higher in both France and the euro area as a whole over the same period, as Figure 7 shows. Countries such as Portugal, Greece and Ireland even recorded double-digit figures due to the large stimulus packages adopted in the midst of the crisis.

[30] The European Commission welcomed Italy's sound decision to refrain from large stimulus packages in the midst of the crisis, yet it also identifies key bottlenecks to growth potential. See European Commission, *Council Recommendation of 12 July 2011 on the National Reform Programme 2011 of Italy and delivering a Council opinion on the updated Stability Programme of Italy, 2011-2014* (Official Journal of the European Union, July 21, 2011), http://ec. europa.eu/economy_finance/economic_governance/sgp /convergence/programmes/2011_en.htm (accessed September 29, 2012). Although the National Reform Programme contained wide-ranging initiatives within the Europe 2020 strategy, the need to address persistent long-standing structural weaknesses was stressed. These had been repeatedly hinted to by the Commission itself and other international organizations (notably the OECD and IMF) and comprised: reform of the labour market, greater competition in the product markets and service sector, improvement of the business environment, a strengthening of R&D policy and a better use of EU cohesion funds.

[31] See *OECD Economic Surveys Overview, Italy* (Organization For Economic Co-Operation And Development, May 2011), http://www.oecd .org/italy/economicsurveyofitaly2011.htm (accessed September 29, 2012).

[32] Although financial markets exerted considerable pressure on Italian sovereign assets by

Italy's implicit tax rate on labour was 42.5 percent in 2011 and is expected to rise to 45.1 percent in 2012. It is thus one of the highest in Europe, as the EU average amounts to around 39.5 percent[33]. However, inefficiency in the public sector and high rates of tax evasion (roughly equivalent to one third of the country's GDP, according to ISTAT estimates) hamper a rational utilization of state revenues.

In the second half of 2011, three budget laws were passed, containing a mixture of spending cuts and tax increases. Spending cuts however played a relatively minor role, with roughly two thirds of measures building on taxation[34]. The measures amounted to an overall 3.1 percent of GDP in 2011 and 4.7 percent in 2013; they have had a negative effect on economic growth but have averted a major debit crisis[35]. The largest austerity package was approved in December 2011 by Monti's government and aims to achieve the budget balance by 2013 in order to comply with the so-called "Fiscal Compact" signed in March 2012[36].

Nevertheless, the rating agency Standard and Poor's downgraded Italy's sovereign debt from A to BBB+ on 13 January 2012[37], a move followed by Moody's on 13 February, adjusting Italy's rating from A3 to A2[38]. Both rating agencies motivated their decision with Italy's increasing vulnerabilities to external financing risks and the possible negative implications for public finances, as well as the deteriorating macroeconomic outlook and the risk that the government would not achieve its consolidation targets. Standard and Poor's had already lowered

boosting interest rates and hence higher refinancing costs, the interest payment component of the government expenditure increased only marginally from 4.5 percent of GDP in 2010 to 4.9 percent in 2011. However, the spread over Italian bonds reached record-level peaks only in the second half of the year and only estimates are available to date on 2012 interest payment expenditure. See *Bollettino Economico*, No. 69 (Banca d'Italia, July 2012), http://www.bancaditalia.it/pubblica zio-ni/econo/bollec/2012/bolleco69/bollec69/boleco_69.pdf (accessed September 29, 2012).

[33] See *Statistiche di finanza pubblica nei Paesi dell'Unione Europea*, No. 52, (Banca d'Italia, October 17, 2011), http://www.banca ditalia.it/statistiche /finpub/pimfpe/sb52_11/suppl_52_11.pdf (accessed September 29, 2012).

[34] The Italian Court of Auditors (Corte dei Conti) released a mixed evaluation of the government's fiscal efforts, stressing the high reliance on tax increases and foreseeing fiscal pressure to exceed 45 percent in 2012-2014. See *Audizione sul Documento di Economia e Finanza 2012* (Corte dei Conti, April 23, 2012), http://www.corte con-ti.it/export/sites/portalecdc/_documenti/chi_siamo /audizioni /audizione_23_aprile_2012.pdf (accessed September 29, 2012).

[35] See *Relazione Annuale sul 2011* (Banca d'Italia, May 31, 2012): 146, http://www.bancaditalia.it/pubblicazioni/relann/rel11 /rel11it (accessed September 29, 2012).

[36] See chapter 4 for Monti's budgetary and fiscal policy.

[37] *Italy's unsolicited ratings lowered to 'BBB+/A-2'; Outlook negative*, Press release (Standard & Poor's, January 13, 2012), http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245327296243 (accessed September 29, 2012).

[38] *Rating Action: Moody's adjusts ratings of 9 European sovereigns to capture downside risks*, Preass release (Moody's, February 13, 2012), http://www.moodys.com/research/Moodys-adjusts-ratings-of-9-European-sovereigns-to-capture-downside–PR_237716 (accessed September 29, 2012).

Italy's credit worthiness on 19 September 2011[39], in the midst of political turmoil over Greece's situation and in perfect timing with an austerity package of €59.8 billion pushed through the Italian parliament[40].

On 18 April 2012, the *Documento di Economia e Finanza*, a three-annual framework containing both the National Reform Programme and the Stability Programme[41] was adopted[42]. The table below shows the main government finance indicators since 2008, together with government forecasts for 2012-2014. The government intends to achieve a close to balance -0.5 deficit by 2013, while the target set for 2012 is -1.7 percent. Further measures were adopted end of April 2012, when the government passed a decree law envisioning a urgent rationalization of public expenditure. The spending review was completed at the beginning of July 2012, when another decree law entered into force encompassing spending cuts for a total of €26 billion for the years 2012-2014[43].

Overall, the three budget laws and the multi-annual stability law approved between July and December 2011 envisioned a correction worth a total €48.9, 75.7 and 81.3 billion respectively in 2012, 2013 and 2014, almost 5 percent of national GDP over the last year[44].

[39] Drew Fitzgerald, Stacy Meichtry, "S&P's cuts Italy's sovereign-debt rating" (WSJ online, September 20, 2011), http://online.wsj.com/article/SB10001424053111904106704576581301721363640.html (accessed September 29, 2012). Standard and Poor's downgrade was the first in five years' time and it was mainly explained in face of weak economic growth and the fragile stance of the government coalition. Moody's adopted a similar decision on 5 October 2011, when it cut Italy's rating for the first time since 1983: see Lorenzo Totaro, *Italy rating cut three levels by Moody's on debt crisis, matching S&P's move* (Bloomberg, October 5, 2011, http://www.bloomberg.com/news/2011-10-04/italy-s-rating-cut-by-moody-s-on-concern-country-may-struggle-to-trim-debt.html (accessed September 29, 2012).
[40] Nikhil Kumar, "Italy hits back at ratings cut as Greece seeks lifeline" (The Independent, September 21, 2011), http://www.indepen dent.co.uk/news/business/news/italy-hits-back-at-ratings-cut-as-greece-seeks-lifeline-2358147.html (accessed September 29, 2012).
[41] The National Reform Programme and the Stability Programme are submitted by national governments to the European Commission within the European Semester, a framework of economic and fiscal policy coordination developed in the wake of the euro zone crisis and running for the second time in the first half of 2012.
[42] Both documents are available at http://governo.it/Governo Informa/Dossier/DEF2012/index.html (accessed September 29, 2012), as well as at http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012 _en.htm (accessed September 29, 2012) together with the Commission's and Council's recommendations.
[43] See chapter 4.6.
[44] See *Relazione Annuale sul 2011* (Banca d'Italia, May 31, 2012): 164, http://www.bancaditalia.it/pubblicazioni/relann/rel11/rel 11it (accessed September 29, 2012).

	2008	2009	2010	2011	2012	2013	2014
Budget balance	-2,7	-5,4	-4,6	-3,9	-1,7	-0,5	-0,1
Primary net lending/borrowing	2,5	-0,8	0,0	1,0	3,6	4,9	5,5
Interest payments	5,2	4,7	4,5	4,9	5,8	6,1	6,1
Gross public debt	105,7	116,0	118,6	120,1	123,4	121,5	118,2

Table 1: Main government finance indicators (in percent of GDP)

1.4.2. Financial markets' reactions

The European sovereign debt crisis has affected Italy's stance in financial markets with marked intensity, as the yield between 10-year Italian government securities and German counterparts widened to unseen levels since the inception of the common currency. Some measures adopted by the government helped reducing the spread, albeit the relief soon proved temporary in view of persisting uncertainty over the outcome of European policies and the worsening of the economic growth outlook. Contagion from Greece and domestic political uncertainty caused interest rates on Italian sovereign debt to spike starting from summer 2011. The risk spread above German bund rose from 200 basis points in early July 2011 to a range of 300 to 400 basis points, signaling a marked upheaval in financial markets regarding the country's debt sustainability[45].

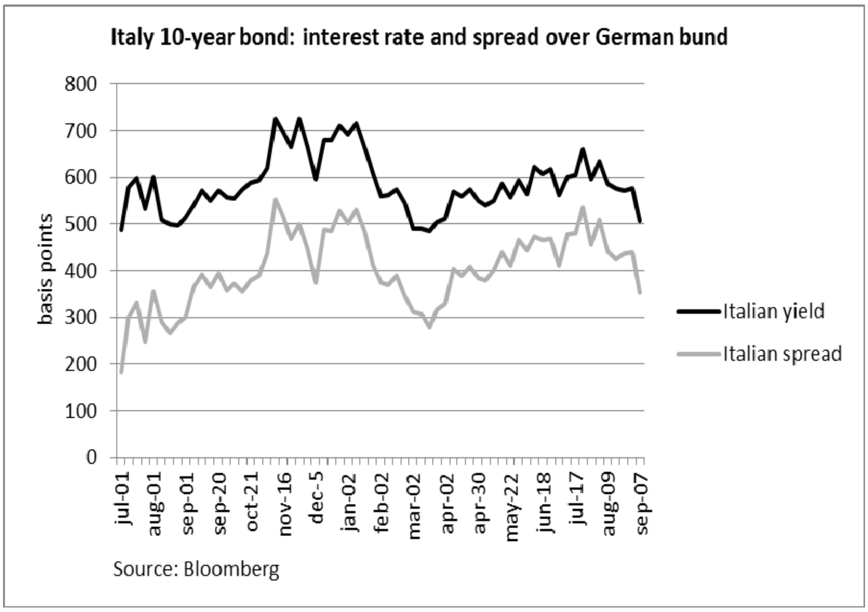


Figure 8: Italy 10-year bond: interest rate and spread over German bund

[45] William R. Cline, *Interest Rate Shock and Sustainability of Italy's Sovereign Debt*, Policy Brief No. PB12-5 (Washington: Peterson Institute for International Economics, February 2012), http://www.iie.com/publications/pb/pb12-5.pdf (accessed September 30, 2012).

The BTP-Bund spread between Italian and German assets experienced a further worrisome increase in autumn 2011, reaching its ever-highest level on 9 November 2011, a few days before Prime Minister Berlusconi resigned. The peak of 533 basis points – an unprecedented level against pre-crisis levels of around 30 percentage points – corresponded to a 7.057 percent interest rate on Italian sovereign debt, which would make the country increasingly difficult if not impossible to roll over its assets[46]. The weakening of the macroeconomic context in the euro area and the repeated downgrading of several countries' government securities were major factors in this respect.

The installation of the new government on 16 November 2011 and the announcement of new fiscal consolidation measures were followed by significant reductions of the bond spread, namely -0.5 percent and -0.9 percent in the following days[47]. By the end of January the short-term rate had fallen sharply and long-term interest rates had eased as well, sinking to 5.9 percent; at the end of February the gross yield had further fallen to 5.4 percent[48]. The decline in the short-term rate probably reflected the European Central Bank's initiative in late December, when it decided to lend €489 billion to euro zone banks for three years at 1 percent interest rate[49]. Further €529 billion were lent out at the beginning of March 2012. The move was particularly advantageous for Italian and Spanish banks and was carried out in parallel with operations on secondary markets[50].

Nevertheless, the declining trend in interest rates was stopped from a renewed upheaval in financial markets starting mid-April 2012, as contagion from Greece spread and Spanish banks started to experience further distress. Italy's sovereign bonds yields and spreads have been rising ever since, although the path has been somewhat unsteady, probably due to persisting uncertainty about the euro zone policies and Greece's possible exit from the monetary union. Temporary up and downs have been e.g. caused by Mario Draghi's firm public commitment that the ECB would do 'whatever it takes' to save the euro (26 July 2012)[51] and

[46] See *Bollettino Economico*, No. 67 (Banca d'Italia, January 2012), http://www.bancaditalia.it/pubblicazioni/econo/bollec/2012/bolleco67/bollec67/boleco_67.pdf (accessed September 30, 2012).

[47] See William R. Cline, *Interest Rate Shock and Sustainability of Italy's Sovereign Debt*: 1 (see note 45).

[48] Source: Bloomberg.

[49] See *ECB announces measures to support bank lending and money market activity*, Press release (European Central Bank, December 8, 2011), http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208 _1.en.html (accessed September 30, 2012). See also Gabi Thesing, Rainer Buergin (2011), "ECB to lend greater-than-forecast $645 billion as banks line up for funds" (Bloomberg, December 21, 2011), http://www.bloomberg. com/news/2011-12-21/ecb-will-lend-banks-more-than-forecast-645-billion-to-keep-credit-flowing.html (accessed September 30, 2012).

[50] See *Decision of the European Central Bank of 14 May 2010 establishing a securities markets programme* (European Central Bank, May 14, 2010), http://www.ecb.int/ecb/legal/pdf/l_12420100520en0008 0009.pdf (accessed September 30, 2012).

[51] See "ECB 'ready to do whatever it takes'" (Financial Times, July 26, 2012),

conversely from Germany's though stance on Greece's adjustment programme, which have stirred some panic throughout the markets.

2. Key characteristics of the Italian economy

2.1. Structural weaknesses

This chapter reviews the key characteristics of the Italian economy. While some of its structural problems – notably the persistent North/South regional divide and the negative influence played by some permanent political phenomena such as corruption – could be traced back to the origins of the Italian state in 1861, this section focuses on the last six decades starting from the well-known "miracolo economico". This expression refers to the economic boom in Italy during the post-war period, namely in the 1950s and 1960s, when the GDP growth averaged an annual rate of 6 percent[52]. Strong export-led growth turned what was then a largely agricultural country into a prosperous economy with a seat in the G8 circle. Nonetheless, the country later suffered from long periods of substantially high inflation and conspicuous budget deficits during the 1970s and 1980s which, combined with a somewhat oversized public expenditure in some sectors, led to an enormous increase of its public debt/GDP ratio[53].

The reconstruction of the Italian economy after the Second World War and 20 years of fascism was largely possible due to the Marshall Plan and the farsighted decision by the ruling coalition to abandon protectionism and open up the Italian economy to international competition and integration into the European Communities[54]. The catch-up factor was indeed decisive in the first post-war decades, as Italy was struggling to consolidate its position on the world markets. Italy' industrial system has always been mainly made up of low-technology and non capital-intensive industries, with a clear predominance of small and medium sized enterprises. Even today, the average size of Italian firms is still well below the EU standard, as it ranks (with a medium of four employees per firm) third-last in the European Union, alongside Portugal and only slightly ahead of

http://www.ft.com/cms/s/0/6ce6b2c2-d713-11e1-8e7d-00144feabdc0.html#axzz24DUAy1mA (accessed September 30, 2012).

[52] Source: Banca D'Italia, Statistiche storiche, http://www.bancaditalia.it/statistiche/storic/collana storica/tav3/tav3pdf.pdf (accessed September 30, 2012).

[53] Italy's public debt/GDP ratio had reached its highest point in 1994, when it amounted to 124.9 percent of national GDP. After a process of constant reduction which brought it down to 103.9 percent in 2004, it started rising again in 2009 due to the financial crisis. See *Statistiche di finanza pubblica nei Paesi dell'Unione Europea*, No. 52 (Banca d'Italia, October 17, 2011), http://www.bancaditalia.it/statistiche /finpub/pimfpe/sb52_11/ suppl_52_11.pdf (accessed September 30, 2012).

[54] Luigi F. Signorini, "Italy's Economy: An Introduction", in *Italy: Resilient and Vulnerable, Volume I: The European Challenge*, *DÆDALUS. Journal of the American Academy of Arts and Sciences,* (Spring 2001): 67-92.

Greece (3.3 employees/firm)[55]. Italy's specialization in small firms is a matter of growing concern in view of its competitiveness potential in a growing technology-oriented world. Already in the 1970s, economists emphasized the need to adapt Italian companies' size to an ever-growing minimum efficient production scale in the wake of the technological progress[56]. Nevertheless the prevailing size of Italian firms decreased even more during the 1970s and early 1980s, an evolution mainly explained through two different factors. Firstly, rapidly rising real labour costs, stricter labour-protection laws and a general worsening of labour relations induced many large firms to decentralize parts of the production process to smaller plants ("defensive decentralization"). The range of application of the long-needed labour laws introduced in the early 1970s (the Workers' Statute) was indeed restricted to larger firms, thus creating a strong incentive to break down production in smaller units. Secondly, the North-East and Centre regions grew most rapidly, mostly unconnected to the old industrial structure of the North-West and often specializing in different sectors. Traditional big industries were not present in these areas, where the growth was triggered by small, family-owned enterprises. They usually concentrate in "industrial districts"[57], where a single production process is distributed among a myriad of different firms, benefiting from a favourable business and civil environment[58]. Meanwhile, repeated devaluations of the *lira* induced Italian industry to increasingly concentrate on light goods, whereas originally it had been developed for strategic purposes (i.e., to create a modern armaments sector). Hence the industrial pattern changed as capital-intensive industries were somewhat neglected and the focus turned to the light goods-producing SMEs[59].

One of the main weaknesses which hampered Italy's economic growth is the substantially high inflation experienced by the country during the 1970s and 1980s. High inflation indeed contributed to rapidly rising nominal wages and labour costs, thus weakening Italy's competitiveness on world markets. Although high inflation rates were a common feature of developed countries' economies throughout the period[60], Italy's rate significantly surpassed the average, reaching almost 20 percent in 1974 and even surpassing this threshold in 1980[61]. Afterwards it started to

[55] Source: Istat.
[56] See Luigi F. Signorini (see note 54): 71.
[57] The term was firstly introduced by Alfred Marshall to describe nineteenth-century Britain.
[58] Luigi F. Signorini (see note 54): 71-73.
[59] Marcello De Cecco, "Italy' Dysfunctional Political Economy", in *West European Politics. Special Issue: Italy: A Contested Polity*, Vol. 3, No. 4 (September 2007): 767.
[60] Between 1970 and 1980 it averaged 5 percent in Germany, 10 percent in France and 8 percent in the United States. Source: Istat.
[61] The annual inflation rate index peaked 19.1 percent in 1974 and reached its maximum level in 1980, when it amounted to 21.2 percent. The average inflation rate in 1970-1985 was 13.3 percent. See *L'Italia in 150 anni. Sommario di statistiche storiche 1861-2010*, Figura 21.4 (Istat, January 18, 2012), http://www3.istat.it/dati/catalogo/20120118_00/ (accessed September 30, 2012).

decrease gradually, thanks to the combination of factors such as a tight monetary policy, the nominal anchor provided by the European Monetary System (established in 1979) and wage restraint[62]. The prospect of the monetary union and the Maastricht process provided key goals to fulfil which were reached through a severe fiscal restraint: the monetary stance became very tight from 1994 on and kept the aggregate demand in check avoiding a fearful wage-price spiral and keeping inflation rates relatively low. Nevertheless, more problematic than the inflation differential, which helped keeping down the public debt burden, was the persistent loss of productivity the country experienced over the years.

Another problem which has historically hindered Italy's economic growth is the regional divide between its Northern and Centre regions and the South. Still in 2009, the average per capita GDP in the eight Southern regions – €14,449.75 - was remarkably lower than the value registered in the Centre and the North (€22,801.00); these figures showing only a very limited improvement in terms of convergence over the last decades[63]. The South has traditionally had twice as high an unemployment rate than the North; the GDP share originating from public services and agriculture is much higher than the average while exports account for a much more limited share of GDP[64].

The roots of this economic backwardness have been widely investigated, and several factors have been called on to explain the persistent regional gap. Some invoke geographical distance from trade networks and infrastructural weaknesses, others prefer to name historical and cultural reasons, let alone the more rooted presence of organized crime. The "Southern question" (*questione meridionale*) emerged soon after the unification of the country in 1861 and Italian governments tried to tackle the issue with a mix of subsidies and investment policies. In particular, projects managed by the development agency "*Cassa per il Mezzogiorno*" significantly reduced the infrastructure gap and helped accelerate growth in the region. Nevertheless, the lack of central government funds led to a reduced contribution in recent years, and corruption affecting public works hindered the effectiveness of investments, especially in the 1980s[65].

Another sector in need of structural reform is the labour market. Despite significant reforms in the 1990s and early 2000s[66], employment

[62] Nonetheless the average inflation rate in the 1980s still remained above 10 percent. Source: Istat, Serie storiche.

[63] Source: Istat, *Noi Italia 2012*, http://noi-italia.istat.it/index.php?id=7&user_100ind_pi1[id_pagina]=96&cHash=4faca7f1032041228ef599857e056165.

[64] Nearly every economic indicator shows a substantial gap in comparison with the rest of the country and the North-South divide has overall shown very limited improvements in the last quarter of a century, although encouraging developments have been recorded in the central regions of Abruzzo and Molise.

[65] Luigi F. Signorini (see note 54): 83-84.

[66] For an overview on Italy's labour market over the two past decades, see Martin Schindler, *The Italian Labour Market: recent trends, institutions and reform options*, IMF Working Paper WP/09/47 (International Monetary Fund, March 2009),

rates in Italy lag far behind most other European countries. The extent and width of employment protection varies considerably across workers' groups and while the country's social safety net is generous for some workers' categories, it is virtually inexistent for several other groups. Main reform efforts were the Treu reform in 1997 and the Biagi reform in 2003. The so-called "Treu measures" (named after the then Labour Minister) aimed at increasing labour market flexibility and employment rates with particular attention to the South; however, the reform operated "at the margin", i.e. it introduced temporary contracts and provided incentives mainly for part-time work. Biagi reforms approved in 2003 took forward the effort to achieve further labour market flexibility by deregulating the use of atypical work arrangements (temporary agency work and part-time work) and introducing new forms of atypical contracts such as on-call jobs (*lavoro intermittente*) and occasional work (*lavoratori occasionali* and so-called *co.co.co, collaboratori coordinati continuativi*). Although both reform packages contributed to the growth in aggregate employment, they led to an increasing dualism in Italy's labour market as most employment gains since mid-1990s were in temporary and part-time employment. Italy's labour market outcomes are among the worst in the EU in spite of a regulatory framework ranking mid-field in European comparison, suggesting inefficacy of some labour market institutions. For instance, efficient labour allocation is hampered by a rigid wage bargaining system, whose two-tier nature (between national and firm level negotiation) leaves little room for many firms to engage in firm-level negotiation. Especially smaller enterprises and those located in the South are disadvantaged, with negative outcomes on regional differences in economic development. The unemployment insurance system is characterized by marked inequities, with complex eligibility rules meaning that only a small percentage of workers actually receive UI benefits. On the other hand, wage supplementation funds (*cassa integrazione guadagni*) can be quite generous, but they only apply to limited categories of workers depending on contract typology and participating firms. Employment protection legislation (EPL) reforms have substantially reduced restrictions on temporary and part-time work arrangements, while leaving restrictions on permanent employment virtually unchanged. The result has been a strong incentive for job creation towards atypical contracts and a bias towards less-productive employment.

2.2. The origins of Italy's high public debt and the inception of the common currency

Another well-known structural problem is the country's high level of public debt which can be traced back to the 1970s. In the early 70s, public expenditure only amounted to roughly one-third of GDP. Afterwards Italy's public debt/GDP ratio reached 57.7 percent in 1980 and 98.0 in 1990. The

http://www.imf.org/external/pubs/ft/wp/2009/wp0947.pdf (accessed September 30, 2012).

highest ever level – 124.9 percent - was reached in 1994[67]. This large increase resulted partly from increased public education and health spending, partly from generous industrial policies intended to help the reconstruction of manufacturing firms[68]. Tax revenues failed to keep pace with this steady expenditure increase.

The Maastricht Treaty signed in 1991 set strict fiscal convergence criteria. As the political elite was firmly determined to join the EMU as soon as possible, budgetary policies became more restrictive[69], in particular under the Amato government in 1992-93, following the currency crisis that forced Italy out of the EMS in September 1992[70]. The primary factor of deficit reduction was however the decline in interest rates on the public debt, thanks to the abatement of inflation and the prospect of achieving the standards on schedule. A relevant role was thus played by the so-called "*vincolo esterno*" (the external constraint)[71]. In fact, the Prodi government (1996-1998) initially aimed at reducing the budget deficit to within the requested 3 percent limit only by end-1998, thus allowing the country to enter stage III only in 2000. Nonetheless, as Spain committed to be part of the first group of states, Italy decided – mainly in view of political reasons - to review the deadline and hence join the other Member States from the very starting point[72].

Nonetheless, the high level of already accumulated public debt meant that high shares of public expenditure were needed yearly to pay the interest rates on debt servicing, thus weakening the positive effect of current account surpluses on the balance of payments.

2.3. The 1990s: a lost decade for growth

Thanks to devaluation, Italy managed to regain some competitiveness in the first half of the 1990s. However, from 1997 onwards the rate of growth declined and became significantly lower than in other industrial economies[73]; the Italian share of world exports also contracted indicating

[67] That year the average public debt/GDP ratio in the EU-15 was 67.9 percent and the only country with a higher debt/GDP ratio than Italy within the European Union was Belgium (133.2 percent). See *Statistiche di finanza pubblica nei Paesi dell'Unione Europea*, No. 8 (Banca d'Italia, 1999), http://www.bancaditalia.it/ statistiche/finpub/pimfpe/sb0899/sb0899 .pdf (accessed September 30, 2012).
[68] Luigi F. Signorini (see note 54): 76.
[69] In 1991 a primary surplus was recorded for the first time and it reached the unusually high value of 7 percent in 1997; the overall deficit shrunk from 11.8 percent in 1990 to 1.5 percent by the end of the decade. See *Statistiche di finanza pubblica nei Paesi dell'Unione Europea*, No. 62 (Banca d'Italia, 2001), http://www.ban cadita-lia.it/statistiche/finpub/pimfpe/sb62_01/suppl _62_01.pdf (accessed September 30, 2012).
[70] Ugo La Malfa, "The Italian Economy and European Monetary Union", in *Review of economic conditions in Italy,* Banca di Roma, No. 2/3 (Rome, 2000): 309-11.
[71] In fact, the external constraint appears to have played a substantial role also in the framework of the establishment of the European Monetary System in 1978-9.
[72] Ugo La Malfa (see note 70): 312.
[73] Particularly telling is the comparison between the Italian figures in 1998-99 (respectively 1.4 percent and 1.5 percent annual growth rate) and the corresponding average figures

an apparent loss of competitiveness. Real GDP grew by an annual average of only 1.2 percent in 1990-2000, down from 2.2 percent in the 1980s. The decline in Italy's trend growth rate was much greater than in other EMU countries, as GDP increased on average at an annual rate of 1.8 percent in the euro area, down from 2.4 percent in the 1980s. This marked slowdown was partly due to temporary factors, namely the exceptional macroeconomic adjustment undertaken before the introduction of the euro in 1999. However, the deep causes behind such poor growth performance are of a structural nature and some of them are still negatively affecting Italy's economy.

Italy entered the decade with rising macroeconomic imbalances which were the legacy of previously conducted policies. Italian governments tackled such imbalances under the narrow time conditions provided by the convergence criteria set by the Maastricht Treaty, an action undertaken through an exceptionally incisive budget consolidation. Indeed, the budget deficit – still at double-digit levels at the beginning of the decade – was reduced to below 3 percent of GDP by 1997. Monetary policy was hence restrictive for most of the decade, but unlike most EU countries, which mainly pursued an expenditure-based deficit reduction, Italy' fiscal consolidation was largely based on tax increases. Fiscal adjustments efforts were nonetheless accompanied by the launch of several ambitious structural reforms, ranging from pension reform, a privatization and liberalization programme and a reform of the public administration.

Domestic demand was negatively affected by the fiscal adjustment policies and uncertainties regarding the implementation of the reforms, but a positive role in boosting consumption expenditure was played by the confidence in a future more stable monetary policy. Investment expenditure also declined, particularly investment in construction rather than its machinery and equipment component, which kept rising. The main factor behind the growth gap vis-à-vis Italy's EU partners was however the evolution of real net exports[74], partly connected to the appreciation of the *lira* in 1995 and 1996 which put an end to the marked competitiveness gains of previous years. The dismal export performance was linked to Italy's pattern of trade specialization, which remained relatively static during the 1990s and persistently weak in more dynamic, skilled labour-intensive sectors.

The steady deterioration of the GDP growth differential relative to other EU members was matched by a decrease of the employment rate and the further widening of North-South regional imbalances from the second half of the 1980s. Another matter of concern was the inconsistency of the reform agenda, as the uncertainties regarding effects, timing and implementation negatively affected the evolution of domestic demand,

in the EU-15, which amount to 3.0 percent. Source: Eurostat.

[74] Over the 1987-98 period, the external contribution to growth was sharply negative, and it took away on average more than 1 percentage point from real GDP growth. See Luigi F. Signorini (see note 54).

already depressed by the strong tax bias of the fiscal adjustment process[75].

In the last decade, the country's stance on international export markets have further worsened, as the inception of the single European currency put an end to the practice of devaluating the *lira* vis-à-vis other main currencies, which had been a short-sighted medium to regain competitiveness over the previous 30 years[76]. Productivity also remained low and labour costs rose much more than in other large European countries[77]. On the other hand, the euro succeeded in preventing the repetition of speculative attacks which had previously been experienced by the *lira,* depressing the prices of Italian securities and pulling up interest rates to unsustainable levels. The inception of the common currency implied that all participating Member States could afford refinancing their debt at a similarly low interest rate, eliminating previously existing differences between sovereign yields. Thus refinancing costs for the Italian government were very favourable throughout the whole decade and low interest rates made debt roll-over costs easily affordable. Yet financial crises can still severely hit the country, since the spread between Italian and other members' public debt is easily affected by worsening public accounts, as the current situation clearly demonstrates.

2.4. Major bottlenecks to growth

The lack of economic growth over the whole decade prior to the inception of the crisis has long been recognized as Italy's main structural problem. Incautious fiscal policies would not have been a great issue if the rate of GDP growth in the country had been substantially higher, since this would have helped lowering both the debt/GDP and the deficit/GDP ratios. Several structural weaknesses have been pointed to as explaining factors, but these alone cannot explain Italy's growth problems during the boom years preceding the crisis. The poor growth performance of Italy since it joined the euro zone thus must be examined when searching for those growth factors that have clearly deteriorated since 1990-2000. As a matter of fact,

[75] Back in 1999, the European Commission already identified as key areas of desired intervention the reform of labour market regulations, a reorganization of the welfare system (particularly the pension system), a reduction of the tax burden and specifically tailored economic policies for the South of the country. See European Commission, Directorate-General for Economic and Financial Affairs, *Italy's slow growth in the 1990s*, European Economy Reports and Studies, No. 5 (1999), http://ec.europa.eu/economy_finance/publications/publication8097_en.pdf (accessed September 30, 2012).

[76] Devaluation had often been used by Italian policy makers as an easy tool to win export market shares without needing to impose economic policies which could be quite unpopular and hence very difficult to promote. See Luca Paolazzi, Mauro Sylos Labini, "L'Italia alla sfida del cambiamento: le lezioni per le riforme e i benefici di un cammino appena iniziato", in Luca Paolazzi, Mauro Sylos Labini, *Cambia Italia. Come fare le riforme e tornare a crescere* (Milano: Centro Studi Confindustria, March 16-18, 2012): 8-9, http://www.confindustria.it/studiric.nsf/f597a6d3a5f4264fc125 6fc00052ef64/373a7cef34fc32cac12579c3004ab1ca/$FILE/Biennale%20CSC%202012.pdf (accessed September 30, 2012).

[77] Marcello De Cecco (see note 59): 764.

three important factors such as investment in R&D, investment in physical and human capital and indicators in product and labour market regulation have all improved during the period, both in relative and absolute terms. Italy's performance has however clearly declined in the area of governance, which can be surveyed through the World Governance Indicators from the World Bank. The three most important indicators for the economic performance are corruption, the rule of law and government effectiveness in general: Italy's performance deteriorated dramatically on all the three over the last decade, leaving the country at the bottom of the euro zone ranking[78]. The country ranked 57th for the control of corruption, 68th for government effectiveness and 63rd for the rule of law worldwide in 2010[79].

Inefficiency in the public administration also appears to be strictly linked to the rate of fiscal evasion in the country, as many studies suggest[80]. The quality of the institutional setting and the shadow economy, which in Italy is estimated to amount to more than one third of GDP (i.e. €700-800 billion), are in a trend relation of inversed proportionality, with inefficiency and corruption intertwining in a feedback loop with high tax evasion. At a closer look, all peripheral countries currently affected by the sovereign debt crisis are seemingly characterized by fragile bureaucracies and a high tax-to-GDP ratio, suggesting weak public governance and a bad utilization of state revenues.

The weakness of the justice system is another well-known bottleneck to growth. Lengthy justice mechanisms hinder economic growth substantially as they render access to bank credit difficult and very time-consuming, with a depressionary effect on investment. Hence the economic system as a whole and enterprises tend to adopt a risk-minimizing behaviour, automatically turning into a loss of the country's competitiveness[81]. Inefficient territorial distribution, disorganization of the judiciary and distrust in the mutual respect of rules have direct effects on a country's economic performance by destroying citizens' and investors' confidence in contract-enforcing mechanisms and hindering firms' size expansion[82].

[78] See Daniel Gros, *What is holding Italy back?*, CEPS Commentary, (Centre for European Policy Studies, November 8, 2011): 1-3, http://www.ceps.eu/book/what-holding-italy-back (accessed September 30, 2012).
[79] All data are taken from World Bank, *2011 World Governance Indicators (WGI)*, available at http://databank.worldbank.org/ddp/ home.do?Step=3&id=4 (accessed September 30, 2012).
[80] See Maurizio Bovi, "Il Club Med della pubblica amministrazione" (La Voce, January 17, 2012), http://www.lavoce.info/articoli/-fisco/pagina1002795.html (accessed September 30, 2012).
[81] See Daniela Marchesi, "Il costo salato della giustizia civile lenta" (La Voce, June 21, 2011), http://www.lavoce.info/articoli /pagina1002372.html (accessed September 30, 2012).
[82] Mauro Sylos Labini, "La giustizia più veloce accelera l'economia", in Luca Paolazzi (eds), *Ripresa globale: dallo slancio al consolidamento. Italia in ritardo,* Scenari economici, No. 11 (Milano: Centro Studi Confindustria, June 17, 2011): 81-83, http://www.unindustria.na.it/Unindustria/resources/cms/documents/Ripresa_globale-

Such dismal institutional framework does not apparently provide adequate incentives for economic growth and structural reforms, which have long been ineffective, partial and highly contested. The necessary setting for reform undertakings, with the broadest possible sharing of the objectives and a coherent design meant to provide for consistent implementation, has always been weak, with external constraints and crisis momentums often providing the stimulus to tackle the debated issues[83].

3. The political crisis in 2011

In parallel to the worsening sovereign debt crisis, Italy slipped into a political crisis in the second half of 2011. Berlusconi's government increasingly showed signs of instability, affecting the confidence of financial markets and European leaders. Bad results for the governing party in local elections in the second half of May 2011 and successful referenda on 12-13 June 2011 were significant setbacks for the government[84]. While popular demonstrations called for earlier elections and wide-ranging reforms, Berlusconi's main coalition partner Lega Nord signalled increasing impatience with the slow implementation of federal fiscal reform and Italy's high level of taxation.

3.1. A hectic semester: Italy on the verge of disaster

The tension in the ruling alliance escalated in early July 2011, when the Prime Minister and some coalition partners blamed the electoral defeats on Tremonti's prudent fiscal policy and reluctance to cut taxes. Attempting to resist such pressures, Tremonti warned his partners that any sign of fiscal indiscipline would mean dragging Italy into the euro zone sovereign debt crisis. This happened on 11 July 2011, as interest rates on 10-year government bonds soared to about 300 basis points above benchmark German equivalents. On the following day, the spread rose to a peak of 350 basis points, enabling the Economy minister to push his

__dallo_slancio_al_consolidamento.pdf (accessed September 30, 2012).

[83] For an introduction to the country's change potential and related obstacles, see Luca Paolazzi, Mauro Sylos Labini (see note 76).

[84] Local elections held in May, in particular the second-round required to elect mayors, highlighted the coalition's lack of cohesion and a rapidly deteriorating support for the government even in traditional northern strongholds. Indeed, the centre-right Berlusconi's candidates were defeated in all the four main cities where the second ballot was held: Milan, Naples, Cagliari and Trieste. Letizia Moratti's defeat by the far-left candidate Giuliano Pisapia in Milan was perceived almost as a symbolic event as the city had always elected a mayor from the centre-right before. The government defeat in the four referendums held in June was equally appalling since they aimed to abrogate government-sponsored laws and the Prime Minister had publicly discouraged people from voting. Nonetheless, over 57 percent of the electorate went to the polls and 95 percent of them voted in favour of abrogation. Abstention from vote did hence not prevent the success of the referendum, which had not achieved the necessary 50 percent participation quote to obtain validity since 1995.

budget plan through parliament, backed by President Napolitano's appeal for national unity to all political parties. Investors grew more and more sceptical about the ability of Italy's uncompetitive economy to meet its future obligations, hence throwing the country in a vicious circle of spiralling interest rates. Such pressure, together with Lega Nord's demands for ministries relocation to northern cities, further compromised Berlusconi's ability to tackle the economic and financial crisis. The budget programme for 2011-2014, which envisaged a total fiscal correction of €40 billion, offloaded almost all of new adjustment to 2013-14 and left one-third of the measures unspecified[85]. Mr Tremonti's announcement that he would introduce additional austerity measures and liberalization provisions did little for appeasing the markets.

As financial market pressure increased in August 2011, the ECB demanded additional deficit-reduction plans in exchange for its support to Italian bonds within the Securities Markets Programme[86]. The external call for consolidation measures exacerbated internal divisions within Berlusconi's coalition and the weakness of the centre-left opposition parties. On 13 August 2011, the government adopted another emergency budget decree to eliminate the general government deficit by 2013 instead of 2014 as previously envisaged[87]. However, its exact content was still unspecified when the budget was presented to parliament; the amendments mainly consisted of revenue-raising measures rather than spending cuts, thus proving insufficient to calm investors' nerves[88].

The definitive approval of the emergency budget on 14 September 2011 and the on-going purchase of Italian bonds by the ECB proved ineffective to reduce the spread, reflecting investors' concerns about Italy's poor growth prospects and the weakness of the country's economic governance. Standards & Poor's downgraded Italy's sovereign debt by one notch from A+ to A on 19 September, keeping the country' rating outlook on negative similar to Moody's. In an effort to tackle the situation, Tremonti suggested

[85] *D.L. 6 luglio 2011, n. 98, Disposizioni urgenti per la stabilizzazione finanziaria, convertito in legge 15 luglio 2011, n. 111*, available at http://www.altalex.com/index.php?idnot=53051 (accessed September 30, 2012). See also *Bollettino economico*, No. 66, Info box: Le manovre di finanza pubblica approvate nell'estate 2011, (Banca d'Italia, October 2011): 41-43, http://www.bancadita lia.it/pubblicazioni/econo/bollec/2011/bolleco66/bollec66/boleco_66.pdf (accessed September 30, 2012).

[86] The ECB had begun to intervene on the secondary markets in order to help bring down interest rates on Italy's and Spain's sovereign assets, establishing the Securities Markets Programme (SMP) in May 2010.

[87] *D.L. 13 agosto 2011, n. 138, Ulteriori misure urgenti per la stabilizzazione finanziaria e lo sviluppo, convertito in legge 14 settembre 2011, n. 148*, available at http://www.altalex.com /index.php?idnot=53435 (accessed September 30, 2012).

[88] The confusion over the 2011-2014 emergency budget, combined with renewed uncertainty regarding the resolution of Greece's sovereign debt crisis, resulted in higher interest rates on government borrowing. As a matter of fact, the spread between Italian bonds and the equivalent German benchmarks peaked to 400 basis points at the beginning of August 2011, narrowing to 330 basis points on 7 September, the day the budget plan was approved by the Senate. Source: Bloomberg.

to sell off a large share of state-owned assets and thus bring the public debt down to 100 percent of GDP by raising about €400 billion. However, the plan soon proved unviable due to fierce political opposition and adverse conditions in the markets. Meanwhile, Berlusconi faced increased pressure to resign as his on-going judicial proceedings further hampered his government's credibility, involving several other members of his party Il Popolo della Libertà (PDL). Polls carried out in September 2011 showed that the trust in the government had fallen by 30 percentage points since 2008: 80 percent of Italians appeared to have lost confidence in Berlusconi's ability to rule the country[89].

Nevertheless, the prime minister won a vote of confidence in the Chamber of Deputies on 14 October 2011[90], thus managing to secure an absolute majority, although some members of Berlusconi's coalition started to call for his resignation. Sources of uncertainty over Berlusconi's tenure also came from outside, namely from Emma Marcegaglia, who repeatedly demanded incisive growth enhancing actions, and from Luca Cordero di Montezemolo, who blamed the government's ineffectiveness and internal paralysis and called for a "national health government" to address anti-crisis reforms[91]. Moreover, Berlusconi came under pressure from EU leaders[92]. Growing attention was paid to the country's President Giorgio Napolitano, who was in favour of a technocratic government, especially since the centre-left parties did not appear to provide any credible alternative nor was it assured that they would gain an absolute majority in the eventuality of an early election. Furthermore, rising popular discontent became evident through several protests taking place in Rome and other major cities, reflecting rising social tensions, dissatisfaction over the government's handling of the crisis and increasing

[89] *Crolla la fiducia nel premier e nel governo. Intenzioni di voto: il centrosinistra a +6,5 percento. Ipotesi di governo istituzionale: il 44 percento favorevole* (IPR Marketing, September 15, 2011), http://www.iprmarketing.it/dettaglio_news.asp?ID=284; see also http://www.sondaggipoliticoelettorali.it/asp/ visualizza_sondaggio.asp?idsondaggio=4851 (accessed September 30, 2012).

[90] "Fiducia per Berlusconi, 316 voti a favore e 301 contrari. Pd all'attacco dei radicali" (Il Fatto Quotidiano, October 14, 2011), http://www.ilfattoquotidiano.it/2011/10/14/fiducia-al-governo-comincia-il-dibattito-il-voto-previsto-alle-1230/163820/ (accessed September 30, 2012).

[91] Luca Cordero di Montezemolo, "Il tempo è scaduto, Berlusconi lo capisca" (La Repubblica, October 31, 2011), http://www.repubblica .it/economia/2011/10/31/news/il_tempo_scaduto_berlusconi_lo_capisca-24175497/?ref=HREC1-1 (accessed September 30, 2012).

[92] During a press conference on 23 October 2011, the German chancellor Angela Merkel and the French president Nicolas Sarkozy smirked at a journalist's question on whether they had confidence in Italy's prime minister's promises to undertake decisive action. Mr Sarkozy singled out Greece and Italy as the two euro zone countries in need of taking incisive steps in order to halt the spread of the sovereign debt crisis and Ms Merkel also called on the government to take concrete steps to reduce its debt burden and speed up its economic growth. See "Das "solideste Land Europas" verbittet sich Lektionen" (Welt online, October 25, 2011), http://www.welt.de/politik/article13679027/Das-solideste-Land-Europas-verbittet-sich-Lektionen.html (accessed September 30, 2012).

concern over the country's record-high youth unemployment. Meanwhile, government borrowing costs continued to rise steadily, as shown at an auction on 28 October when the interest rate rose to 6.1 percent. Alongside the evidence of an impending double-dip recession, another factor driving up the risk premium were the investors' doubts about EU plans agreed on 26 October 2011 to contain the Greek sovereign debt crisis and boost the European Financial Stability Facility (EFSF).

3.2. The establishment of Mario Monti's government

Financial market pressure on Italy worsened dramatically at the end of October and early November 2011. On 9 November LCH Clearnet, a clearing house for buying and settling debt, started to request larger deposits for trading Italian bonds[93]. Yields on ten-year bonds thus sprung to a euro era record of 7.5 percent, corresponding to 575 basis points over German benchmarks. Under sustained pressure from President Napolitano, Berlusconi pledged to resign soon after the parliament's approval of a package of reforms which he had promised to EU partners on 26 October at a European Council meeting[94]. Another factor behind his resignation was the sharp decrease in the value of Mediaset actions, experiencing a consistent downfall over the following weeks[95]. The stability and budgetary decree was eventually approved on 12 November 2011, thus paving the way for Berlusconi's stepping down and formal opening of the government crisis.

Such eventuality having long been discussed, a technocratic administration was soon installed led by former EU Commissioner Mario Monti, whom Napolitano quickly appointed a senator for life[96]. As no political party wanted to get involved in the new government, the cabinet was entirely composed of experts and unelected politicians, with Monti in charge of the Ministry of the Economy[97]. Monti formally took office on 16

[93] "LCH.Clearnet raises margin call on Italian debt" (Reuters, November 9, 2011), http://www.reuters.com/article/2011/11/09/us-markets-bonds-clearnet-idUSTRE7A82BK20111109 (accessed September 30, 2012).

[94] The letter sent by Berlusconi to the President of the European Council Van Rompuy and the Commission President Barroso referred to a substantive package of reforms the government intended to undertake to boost growth and reduce Italy's public debt, including labour market and pension system reform. The document is available at http://www.repubblica.it/economia/2011/10/26/news/ il_testo_della_lettera_alla_ue-23930250/.

[95] "Borsa: Mediaset paga il lungo addio del Cavaliere, -13,5% da lunedì" (Il Sole 24 ore, November 9, 2011), http://archivio-radiocor.ilsole24ore.com/articolo-996648/borsa-mediaset-paga-lungo-addio/ (accessed September 30, 2012).

[96] As European Commissioner, Mr Monti had been in charge of the internal market and services from 1995 to 1999 and later for competition (until 2004), under Romano Prodi's presidency of the Commission. He has also been the president of the Bocconi University in Milan since 1994, co-founder of the Brussels-based Bruegel think-thank and former international advisor for Goldman Sachs.

[97] Vittorio Grilli took office as Minister for the Economy (he was previously Vice-Minister) on 11 July 2012, thus putting an end to Monti's temporary holding of the office.

November 2011[98] and confidence votes were held in both the Chamber of Deputies and the Senate on 17 and 18 November respectively, with large majorities (556 to 61 in the lower house and 281 to 25 in the upper one) voting in favour of the new government composition. These were the largest majorities ever gained in a confidence vote in the whole history of post-war Italian democracy, with the Lega Nord as only party not backing the government. During his speech at the Senate, Mr Monti unveiled the main contents of his intended reform agenda and set out three guidelines, namely “austerity, growth, equity”, ruling out as his main priorities the pension system, labour market regulation and tax evasion. The government also enjoyed widespread popular support since its very inception, as polls by IPR Marketing soon pointed out[99].

Info Box 1 – Italy’s political parties

From 1945 to 1994, Italy’s political landscape was dominated by two parties: the Christian Democracy (*Democrazia Cristiana*, DC), which was constantly part of the government coalitions and always enjoyed the broadest support, and the Italian Communist Party (*Partito Comunista Italiano*, PCI), which never managed to become a government party. Other major parties were the Italian Socialist Party, which succeeded in forming a coalition cabinet with DC in the late 60s, the Italian Democratic Socialist Party, the Italian Republican Party and the Italian Liberal Party. The political life was characterized by unstable governmental coalitions and a fragmented party system, a characteristic largely due to the proportional electoral system.

In 1992, a series of scandals known as Tangentopoli unveiled the widespread corruption at the basis of the party system, leading to the Mani Pulite investigations and hence the collapse of traditional parties. Following the entering of Silvio Berlusconi and its Forza Italia party on the political scene in 1994, the system reorganized around a centre-right and a center-left coalition, with a visible reduction in the number of parties. New entities gained strength such as the regionalist Lega Nord (founded in 1991) and the post-fascist National Alliance (*Alleanza Nazionale*) led by former lower house-speaker Gianfranco Fini. The 2008 general election led to a further simplification of the parties’ landscape: the parliament majority is made up of the People of Freedom (Berlusconi’s party), the main centre-right party whose secretary is the former minister for justice Angelino Alfano, and the Lega Nord, which stands at about 8 percent of popular support at national level but is markedly stronger in Northern

[98] Presidenza della Repubblica, Giuramento del Governo Monti, Comunicato (Roma, November 16, 2011), http://www.quirinale.it/elementi/Continua.aspx?tipo=Comunicato&key=12582 (accessed September 30, 2012).
[99] Fiducia: Monti al 58 per cento nel gradimento degli italiani e tiene nonostante la manovra. Per gli italiani la responsabilità delle nuove tasse è del precedente governo (IPR Marketing, December 13, 2011), http://www.iprmarketing.it/dettaglio_ news.asp?ID=294 (accessed September 30, 2012).

Italy. These formed the bulk of Berlusconi's ruling coalition until November 2011. On the left-center side, the main party is the Democratic Party (Partito Democratico, PD) led by Pierluigi Bersani, which was founded in 2007 but still suffers from internal divisions due to the coexistence of ex-communists and socio-democratic tendencies. It was the second biggest party at the 2008 elections and it is likely to gain the broadest support at next elections in spring 2013, according to the polls. Other minor parties are the Left Ecology Freedom party (SEL) and the Italy of Values (IdV), which is a centrist, populist and anti-corruption party who has always focused its discourse on anti-Berlusconism. Furthermore, a third pole (called Nuovo Polo per l'Italia) has emerged comprising the Union of the Centre (UdC), a Christian democratic coalition of parties led by Pierferdinando Casini, and the Future and Freedom (FLI), formed by Gianfranco Fini in summer 2010 as a split from Berlusconi's People of Freedom party.

Info Box 2 – Technocratic governments in Italy

The practice of technocratic governments is well-known in Italy's political history. The term "governo tecnico" refers to a non-elected administration mainly or totally made up of experts in their fields, academics and professionals, whose task is to implement non-partisan and usually controversial measures within a short time period. Technocratic governments are traditionally appointed in times of political crises, when parties are not able to provide a viable alternative and often prefer to pass on responsibility for taking pervasive and long-needed reforms. As a matter of fact, they tend to enjoy broad political support from the public opinion. Technocratic governments hence tend to be regarded as valuable solutions in view of consistent party belligerence and failure to form a stable, trustworthy coalition. Notable examples in Italy's constitutional history are the Dini government, which ruled the country in 1995-1996 short after the Tangentopoli political crisis, and the Ciampi government in 1993-1994. In this latter case, the Prime Minister had been governor of Italy's central bank but the coalition itself mainly comprised career politicians.

The current government led by Mario Monti was indeed established against this background, with the ambitious aim to overcome the country's economic and financial problems within a time limit set by the next general elections due in April 2013. Political parties have voluntarily resigned their responsibility and the "animal spirits" of the financial markets discouraged a possibly destabilizing recourse to the ballot boxes. As policy choices to implement were highly unpopular, no political leader was eager to tackle the task. On the other hand, this confidence in technocratic governments helps eroding democratic accountability and risks to further undermine the likelihood of effective party-run politics in the future.

4. Mario Monti's reform agenda

4.1. An overview

When Mario Monti became Prime Minister on 16 November 2011, he was confronted with an undoubtedly harsh task to fulfil[100]. He was expected to consolidate the country's unsustainable public finances and simultaneously restore the economy's growth potential. Short-term austerity measures were an imperative to meet EU targets and abate the ever-increasing spread in the bond markets, while long-term structural reforms also had to be launched in order to avoid a lasting recession. Monti has been highly dependent on both investors' confidence, reflected in the level of interest rates on Italy's government bonds, and European policy makers, since a lack of support from EU institutions could bring about growing scepticism among the country's parliamentarians and voters.

The first government measures were contained in a harsh austerity package informally called "Salva Italia" ("Save Italy") approved as a decree law in early December 2011 (see chapter 4.2.). The decree aimed at balancing the budget by 2013 and comprised a long-needed revision of the pension system as well as further revenue-side measures. Furthermore, a long-term fiscal reform was announced at the beginning of March, as Monti revealed his intention to shift the tax burden from labour income to consumer spending in order to replace Italy on a level-playing field with most EU countries[101].

At the end of January 2012, the government adopted a series of measures opening-up some highly protected service sectors. Although the measures will take some years to display their effects, Mr Monti's hope was to restore investors' confidence by meeting objectives which had long been pointed out by EU institutions and several international organizations.

[100] For instance, Deutsche Bank's chief economist Thomas Mayer stated that 2012 would be "Italy's year", as the fate of the common currency as a whole was seen as dependent on the country's consolidation and reform efforts. Thomas Meyer, "Das Jahr 2012 wird das Schicksaljahr für den Euro" (Frankfurter Allgemeine Zeitung, November 26, 2011), http://www.faz.net/aktuell/wirtschaft /deutsche-bank-chefvolkswirt -mayer-das-jahr-2012-wird-das-schicksalsjahr-fuer-den-euro-11579985.html (accessed September 30, 2012). See also DB Research, Italien 2020: Schuldenabbau ist das Gebot der Stunde!, Aktueller Kommentar (Deutsche Dank AG, October 12, 2011), http://www.db re-search.de/PROD/DBR_INTERNET_DE-PROD/PROD0000000 000279502.PDF (accessed September 30, 2012).

[101] Referring to several studies and simulations, the IMF finds that a reduction of the labour tax wedge could lift Italy's growth potential in a considerable way and deliver substantial long-time employment gains. See IMF Country Report No. 11/176 (International Monetary Fund, July 2011), http://www.imf.org/external/pubs/ft/scr /2011/cr11176.pdf (accessed September 30, 2012). For an overview of the links between taxation and employment gap in Italy, see also Laura Bardone, Italy's employment gap: the role of taxation, European Commission, Directorate-General for Economic and Financial Affairs, ECFIN Country Focus, Vol. 7, Issue 1 (February 2010), http://ec.europa.eu/economy_finance/publications/country _focus/2010/pdf/cf-7-01_en.pdf (accessed September 30, 2012).

However, lobby interests managed to water down some of the most controversial measures in parliament, namely the liberalization of closed-up professions such as pharmacists and taxi drivers[102].

The major political hurdle faced by the new Prime Minister was the contested labour market reform, as talks between government representatives and the workers' unions proved all but easy. Monti firmly intended to address the dualism of the country's labour market, characterized by strong protection for so-called "insiders" and low security for temporary workers and "outsiders" (mainly young people and women). He clearly stated that the much-debated Article 18 of the Workers' Statute (the labour code) would not constitute a taboo in negotiations, hence provoking strong criticism by Italy's largest trade union, the General Confederation of Italian Workers (CGIL). In spite of some social unrest over the cost of the foreseen flexibilization, the labour market reform was finally approved in June 2012.

The last major accomplishment by Monti's government were the spending cuts adopted in July 2012, the result of a comprehensive spending review encompassing all sectors of public administration and aiming to provide public services at same quality and lower prices.

4.2. "Salva Italia": fiscal policy and pension system reform

On 4 December 2011 the Italian Council of Ministers approved a decree law comprising a series of fiscal consolidation and growth-enhancing measures[103]. Its main content was a €34 billion worth budget revision aimed at balancing the budget by 2013, a task already encompassed in the September medium-term budget plan. The decree law was thus meant to ensure a concrete delivery of the objectives already set out by the previous government[104]. Fiscal consolidation measures are mainly of a structural nature, while growth enhancing measures contained in the decree encompass improvement in the business environment, liberalization and deregulation measures and consumers' protection, underpinned by the

[102] For an overview of Monti's first reform undertakings, see for instance Katja Christina Plate, *Italien: Die Reformen der Regierung Mario Monti*, Länderbericht, Konrad-Adenauer-Stiftung (January 31, 2012), http://www.kas.de/wf/doc/kas_30074 -1522-1-30.pdf?120201124752 (accessed September 30, 2012), Sergio Grassi, *100 Tage Regierung Monti: eine erste Bilanz*, Perspektive, Friedrich Ebert Stiftung (March 2012), http://library.fes.de/ pdf-files/id/08958.pdf (accessed September 30, 2012).

[103] Governo Italiano, *Consiglio dei Ministri n. 5 del 4/12/2011*, Comunicati stampa del Consiglio dei Ministri (Roma, December 4, 2011), http://governo.it/Governo/ConsiglioMinistri/dettaglio.asp?d= 65675 (accessed September 30, 2012). The full text of the decree is available at http://www.altalex.com/index.php? idnot=16537 (accessed September 30, 2012).

[104] As a matter of fact, the anticipation of the budgetary target from 2014 to 2013 had been already pledged by Berlusconi's government and welcomed by EU leaders at the European Council on 26 October 2011. Nonetheless, the fiscal measures still lacked clear cut specifications on the single provisions, thus failing to restore investors' confidence and reduce the spread on Italy's state assets.

three key pillars of "fiscal consolidation, economic growth and social equity"[105].

As the global financial outlook had significantly deteriorated right prior to the decree's approval and Italy's macroeconomic scenario had just been revised downwards, higher-than-expected interest payments made additional fiscal measures of the utmost importance in order to confirm the balanced budget target by 2013. The package amounts to structural €20 billion savings for the 2012-2014 period, while the gross correction is worth €34 billion, as incisive intervention is foreseen to enhance growth and improve the product and labour market for over €10 billion.

On the expenditure side, focal points are a reduction of pension expenditure, combined with a comprehensive pension system reform[106], and cuts to local government transfers. Savings worth €8.5 billion by 2014 are alone a result of the modification of the pension system and are expected to increase further in the following years. On the revenue side, the main measure is a reintroduction of a property tax under the newly created form of a municipal real estate levy (IMU – *imposta municipale unica*). Berlusconi's government had eliminated the first home tax (previously called ICI – *imposta comunale immobile*) back in 2008, achieving widespread popular consent yet creating a *unicum* in the spectrum of OECD countries. Further measures comprise higher exercise taxes on fuels, tax surcharges on luxury items such as sports cars and boats, taxation on financial assets and dismissal of some state-owned real estate[107]. Several measures are aimed at strengthening the fight against tax evasion, including the compulsivity of electronic means for payments worth above €1000[108]. The government indeed set out a wide-ranging strategy to effectively tackle tax evasion. The main measures have been a premium-based regime for tax-complying actors and the complete availability for fiscal authorities of banks' and financial operators' data on financial transactions. This way, the revenues' agency (*Agenzia delle Entrate*) will be able to identify strikingly incoherent disparities[109].

[105] See info sheet *A strategy for fiscal consolidation, growth and social fairness,* http://governo.it/GovernoInforma/ Dossier/salva_italia/doc/stampa_estera_20111204.pdf (accessed September 30, 2012).

[106] See Info Box 1.

[107] A *una tantum* tax on so-called "tax shielded" assets was also included in the package, with a 1 percent taxation rate foreseen for 2012 alone. Italy's share of indirect taxes on the total (33.5 percent) lied well below the EU average of 38.6 percent in 2010, reflecting Italy's heavy bias towards direct taxation. See European Commission *Taxation and Customs Union, Taxation trends in the European Union* (2012): 109, http://ec.europa.eu/taxation _customs/taxation /gen_info/economic_analysis/tax_ structures/index_en.htm (accessed September 30, 2012).

[108] See info sheet *Manovra dicembre 2011* http://governo.it/Go vernoInfor-ma/Dossier/salva_italia /doc/manovra_scheda.pdf (accessed September 30, 2012).

[109] Furthermore, Italy's fiscal police (*Guardia di Finanza*) launched an impressive series of targeted inspections in several touristic localities and big cities. Inspections have so far involved renowned localities like Cortina and Courmayeur alongside cities such as Roma, Napoli, Milano, Trento, finding an average non-compliance rate of around 20 percent and obtaining large media coverage on national newspapers.

Several growth enhancing measures were also included in the decree comprising different areas. The first were initiatives in the business environment, which is comparatively cumbersome and requires lengthy procedures. To improve the situation, the government granted tax benefits for company recapitalization and refunded the guarantee fund for SMEs; reductions of the tax wedge on labour trough tax deduction from IRAP[110] and simplification of administrative procedures were also envisaged. In particular, tax deductions are intended to foster employment of women and young workers through an intervention worth a total €5.5 billion. The decree law also included some measures to foster greater competition in the product and services market and to support infrastructure investment. A streamlining of the institutional structure was also achieved by revising one layer of administration (the "province").

The law was approved with some amendments in the Chamber of Deputies by a large majority of 402 in favour, while 75 voted against; it was passed with a similarly large majority of 257 on 315 in the Senate on 21 December 2011. However, the parliament had no possibility of amending the decree as a "confidence motion" (*questione di fiducia*) was put by the government on the text. The Lega Nord and the Italia dei Valori, led by former prosecutor Antonio Di Pietro, both voted against the budget law, thus displaying the lack of a completely unified support for Monti's temporary administration. In particular, Mr Bossi strongly criticized the recessionary and pro-cyclical nature of the decree, deploring the larger burden on lower socioeconomic strata and the bias towards revenue-rising measures. The EU Commissioner for Economic and Monetary Affairs Olli Rehn welcomed the package as a long-awaited turn in economic policy setting ambitious yet timely measures, but he simultaneously stressed the need for incentives to job creation and growth enhancement[111]. Notwithstanding the tough fiscal measures included in the budget, the package enjoyed similar support from the population, as the necessity of the austerity policy was broadly acknowledged.

Nevertheless, a general strike was organized by the trade unions on 12 December 2011 to protest against "inequitable" budget revisions, while the spread on Italy's government assets continued to float over 450 percentage points. The package indeed failed to implement tax risings on upper classes or the called-for "*tassa patrimoniale*" (capital levy) which would have more equitably distributed the burden of the budget law, while the effect of spending cuts have mainly affected retirees, consumers and weaker

[110] IRAP (*imposta regionale sulle attività produttive*) is a regional tax on productive activities paid to local administrations by enterprises; the IRAP tax rate currently stands at 3.9 percent of company gains. It will now be possible to deduct the payroll tax against this regional taxation.

[111] See European Commission, Directorate-General for Economic and Financial Affairs, *Statement of Vice President Olli Rehn on adoption by the Italian Government of extraordinary fiscal and economic measures* (December 4, 2011), http://ec.europa.eu/economy_finance/articles/governance/2011-12-04-rehn-speech-italy_en.htm (accessed September 30, 2012).

social strata[112]. In addition, a complete blockade of motorway and road junctions almost paralyzed Sicily in the week starting from 16 January 2012. Truck drivers and auto carriers, together with farmers, unemployed and fishers, gathered in the so-called "*Movimento dei Forconi*" (Pitchforks Movement) and inaugurated a hefty strike to protest against the rise in fuel taxes, "the EU dictate", the inequity of the budget law and Monti's government as such. The 5-days-long blockade of roads and seaports brought Sicily's economy to a standstill and expanded to several other Southern regions, but it received very limited media coverage from the national broadcasting service[113].

Info Box 3 – Pension system reform

Italy is characterized by one of the lowest support ratios among industrialized countries, a rapidly ageing demographic context being the main factor behind high spending on old-age benefits[114]. The country records a very low fertility rate (about 1.4 against an EU average of 1.6) and one of the highest life expectancies in Europe (currently about 82 years). In 2010 the percentage of GDP devoted to pension spending amounted to 14.1, while the OECD average stands at 7.0 percent. Although some measures comprising benefit reductions and higher eligibility age had been taken by previous governments to reduce growth in public pension expenditure, it was clear that improving the participation rates of workers over the age of 60 was a crucial necessity[115].

In the early 1990s, Italy's authorities began to take action to prevent the pension expenditure to further jeopardize the already fragile financial situation. The system has been substantially modified as a result, starting

[112] The Italian Court of Auditors (Corte dei Conti) showed some concern regarding the possible depressionary effects of the measures and the high level of fiscal pressure Italy would achieve (above 45 percent in 2012-2014). See Corte dei Conti, *Audizione sul Documento di Economia e Finanza 2012* (Roma, April 23, 2012), http://www.corteconti.it/export/sites/portalecdc/_documenti/chi_siamo /audizioni/audizione_23_aprile_2012.pdf (accessed September 30, 2012).

[113] "The Pitchforks Movement in Sicily" (Struggles in Italy, January 18, 2012), http://strugglesinitaly.wordpress.com/2012/01/18 /the-pitchforks-movement-in-sicily/#more-868 (accessed September 30, 2012).

[114] In 2010, Italy was the second oldest OECD country after Japan, with only 2.6 people of working age (20-64) relative to the number of retirement age (65+) (the so-called support ratio). See *Highlights from OECD Pensions at a Glance 2011, Italy* (Organization For Economic Co-Operation And Development, March 2011), http://www.oecd.org/dataoecd/17/43/47365777.pdf (accessed September 30, 2012).

[115] 62 percent of people aged 55-69 participate in the labour market, compared to an average 78 percent in the OECD. See Organization For Economic Co-operation And Development (see note 114). The working potential of older people was seen as a possible key solution also by financial institutions: see for instance DG Research, *Italienisches Frührentensystem bremst Wachstum aus*, Aktueller Kommentar (Deutsche Bank AG, November 4, 2011), http://www.dbresearch .com/PROD/DBR_INTERNET_DE-PROD/PROD00000 00000280352.pdf;jsessio nid=4BEBC3C2DBA800FACA014D5B8324C8FA.srv-net-dbr-com (accessed September 30, 2012).

from a previously fragmented and purely earning-related benefit system. This means pensions were paid as a percentage of the average wage received by the worker during his/her last years. Seniority pensions were also very easily accessible from the age of about 50 onwards[116]. The first Amato reform in 1992 was aimed at securing immediate financial sustainability and started by indexing the benefits to consumer prices rather than contractual wages. In 1995 the Dini reform delivered a substantial change by switching from the defined-benefit (DB) system to a notional defined contribution (NDC) system, where benefits are linked to the worker's contributions on a lifetime basis. These contributions are accumulated on an "account" where the employee puts roughly one third of his/her gross monthly earnings and are converted into the proper pension by a "transformation coefficient"[117]. The Dini reform was later amended in 1997 and inaugurated a decades-long transition period, as a mixed and fragmented system was in place before the new NDC rule could be fully implemented towards 2035. The latest reform, approved in July 2010 (Law 122/2010), strengthened the so-called "exit window" mechanism (postponing access to pension entitlements) and equalized the statutory retirement age of women and men in the public sector[118].

Measures contained in the decree "Salva Italia" completed such slow-paced, steps-based pension reform by extending to all the NDC method for future entitlements. A flexible system for minimum retirement age was introduced, envisaging an incentivized retirement window from 62 to 70 years for women and a 66-70 years window for men. This provision is aimed at encouraging a larger old workers' participation in the labour market. Rules for private sector women shall be equalled to that for public sector workers by 2018, meaning both women and men will be entitled to retirement starting from 66 years onwards. Several privileges have been eliminated and the recourse to anticipated retirement has also been discouraged through pension penalization, although it will remain possible to retire with a 42 years and a month' working life irrespective of contributions paid. As a temporary, austerity-driven measure, pensions will not be indexed to inflation in 2012 and 2013, only minimum pensions under 936 euro being exempted from this provision. The revised system shall be fully implemented by 2035, with a minimum retirement age of 67 for all and 20 years' contribution, thus bringing Italy's pension system in line with most other EU countries.

[116] Extremely advantageous loopholes actually made this phenomenon quite widespread in the public sector and people benefiting from anticipated retirement were known as "*baby pensionati*" (baby retirees).

[117] *OECD Ageing and Employment Policies, Italy* (Organization For Economic Co-Operation And Development, 2004), http://www.oecd.org/ dataoecd/31/35/3505 0433.pdf (accessed September 30, 2012).

[118] See European Commission, Directorate-General for Economic and Financial Affairs, *Joint Report on Pensions. Progress and key challenges in the delivery of adequate and sustainable pensions in Europe, European Economy Occasional Papers*, No. 71 (November 2010), http://ec.europa.eu/economy_finance/publications/ occa-sional_paper/2010/pdf/ocp71_en.pdf (accessed September 30, 2012).

4.3. "Cresci Italia": liberalization and service sector reform

Italy has an established tradition of state ownership in several sectors of its economy. This pattern of a "mixed economy" has recently been challenged as the outcomes of several studies have put forward the need to address some widespread inefficiencies and adopt liberalization/deregulation measures. It is indeed undisputable that several sectors are characterized by lengthy administrative procedures and a burdening regulatory framework. The newest Index of Economic Freedom compiled by the Heritage Foundation placed Italy as 92nd freest economy in the world, with an economic freedom score of 58.8 classifying the country as "mostly unfree" (50 – 59.9 score range)[119]. Italy is ranked 36th out of 43 countries in the European region and its score remains slightly below the world average. What is worse, its economic freedom score declined from 2010 to 2011, thus placing the country among "moderately free" economies. The discouraging improvement is largely due to declines in freedom from corruption and control of government spending, which undercut confidence in the government and negatively affect some economic scoreboards. One of the main issues is the absence of an efficient judicial framework able to provide a timely resolution of cases: although property and business law provisions are deemed adequate, problems arise when it comes to the time needed for paying taxes and enforcing contracts[120]. Court procedures are extremely slow and many companies choose to settle out of court, thus weakening respect for the judiciary and breeding a culture of lawlessness and tax evasion. In spite of repeated reform attempts, the regulatory framework remains complex and the cost of conducting business is high, while labour market rigidities constrain dynamic job growth and the informal sector still accounts for a large part of the country's economy. Against the backdrop of such dismal findings, the OECD repeatedly recommended reforms such as reducing regulatory barriers to competition (particularly in professional and local services), reducing the tax wedge on labour, improving the overall efficiency of the tax structure and decentralizing wage bargaining[121].

The government adopted a decree law informally named "Cresci Italia" (Grow Italy) on 20 January 2012, comprising a series of liberalization and growth-enhancing measures intended to restore Italy's competitiveness

[119] Heritage Foundation, *Index of Economic Freedom 2012*, http://www.heritage.org/index/ (accessed September 30, 2012).

[120] See *Doing Business 2012. Doing Business in a More Transparent World* (World Bank, 2012), http://www.doingbusiness.org/ reports/global-reports/doing-business-2012 (accessed September 30, 2012). In the World Bank's Doing Business report, Italy ranks 87th out of 183 countries and is after Greece the second-worst in this regard among OECD countries. In addition, a 5-year measure of cumulative change comprised in the report highlights that the business regulatory environment further worsened between 2006 and 2011, in sharp contrast to the tendency in most higher-income countries.

[121] See *OECD Economic Policy Reform 2012: Going for Growth, Country Notes. Italy* (Organization For Economic Co-Operation And Development, February 24,2012), http://www.oecd.org/dataoecd/33/40/ 49655443.pdf (accessed September 30, 2012).

over the long run[122]. The package was approved by the Senate with some modifications and gained the final vote in the Chamber of Deputies on 22 March 2012. Aim of the government was to tackle two key bottlenecks to Italy's growth, namely insufficient market competitiveness and inadequacy of infrastructure, in order to achieve a level of services regulation broadly in line with its main EU partners. The width of the measures is hoped to bring about a rise in GDP of about 10 percentage points in the long term, according to OECD and government studies[123].

The bulk of the reform was built around a series of liberalization measures to foster economic initiative and reduce the administrative burden for enterprises. In particular, the abrogation of a number of numerical limits such as authorizations and licenses required to start a business was envisaged. Youth entrepreneurship has been encouraged by radically simplified procedures for setting up a company: for instance, a symbolical minimum capital of only one euro is now needed by under-35s. Several provisions were intended to reinforce consumers' protection (*inter alia* the newly introduced class action is simplified) and strengthen the mandate of the Guarantor Authority for Competition and Market, a quasi-governmental organization established in 1990 to enforce Italian and European consumer protection law. In the service sector, professionals – notably lawyers and notaries - are required to agree the terms of the fee before the assignment is given, and minimum tariffs have been abolished in order to promote competition. To facilitate young workers' entry into the labour market, it will be possible to perform the necessary traineeship for entering professional orders during graduate studies. The government facilitated the creation of around 5,000 new pharmacies by lowering to 3,000 inhabitants the population quorum needed to open up a new pharmacy, while a similar provision is intended to increase the number of notaries through new national competitions.

In the energy sector, the government wants to re-launch the procedure of separation of the natural gas distribution network SNAM from Italy's main oil and gas company ENI, of which Italy's government still controls the golden share. In the field of rail transportation, the possibility of opting-out from the national wage agreement applying to *Trenitalia*, the main train operator, should introduce some competition by helping its recently established competitor *Nuovo Trasporto Viaggiatori* (NTV). Competition in local public services is also promoted alongside an increase in number of taxi licenses, the exact number of which shall be set by a

[122] *D.L. 24 gennaio 2012 n. 1, Disposizioni urgenti per la concorrenza, lo sviluppo delle infrastrutture e la competitività*, available at http://www.normattiva.it/urires/N2Ls?urn:nir: stato:decreto-legge:2012-01-24;1 (accessed September 30, 2012).

[123] Governo italiano, *Consiglio dei Ministri n. 11 del 20/01/2012*, Comunicati stampa del Consiglio dei Ministri (January 20, 2012), http://governo.it/GovernoInforma/Dossier/cresci_italia/Consiglio_comunicato11.pdf (accessed September 30, 2012). Italy's Finance Ministry has calculated that a reduction of profits in the service sector, bringing the country in line with the average EU level, could boost a medium-term GDP rise of 11 percent, an 8 percent rise in employment and consumption, 18 percent more investment and a 12 percent rise in real salaries.

newly created transport authority. Furthermore, "project bonds" are introduced as a means to foster private capital involvement in infrastructure building, and additional provisions aim at enhancing competition in the banking and insurance sector.

Before the definitive approval of the decree, lobby groups strongly pushed for several amendments to be introduced which watered down the original government proposals to some extent. Widespread strikes by taxi drivers and considerable reform resilience by lobby interests forced the government to leave the decision regarding the number of new licenses to communal authorities, with the Guarantor Authority enjoying only the power to advice rather than the final decision, as originally proposed. Similarly, pharmacists were successful in obtaining the rise of the population quorum for opening a new pharmacy from 3000 to 3300; lawyers and other professionals succeeded in making the foreseen compulsory cost estimate optional. Substantial tensions arose in the banking sector, as the whole executive committee of the Italian Banking Association (ABI – Associazione Bancaria Italiana) resigned as a sign of protest in view of the lowered profit margins for bank charges and the obligation to set up basis current accounts free of charge for retirees.

To sum up, the second reform package soon proved more problematic than the "Salva Italia" budget plan, clearly demonstrating that large sectors of Italy's society are still characterized by a high level of resilience to reform. Besides, provisions in the pharmacy and taxi service sector may have allowed an increase in the number of businesses/licenses, yet they failed to completely liberalize these sectors and introduce an extensive modification in the field.

4.4. "Semplifica Italia": simplification and fiscal reform

At the end of January 2012, the government adopted its third reform package, known informally as "Semplifica Italia" (Simplify Italy)[124]. Recognizing the need for radical de-bureaucratization, the measures introduced are intended to modernize the relationship between public administration, citizens and enterprises, building on the digital agenda and innovation as underpinning principles. The reform is in line with recommendations from the European Commission and aims to tackle this bottleneck to long-term growth by implementing new technologies and thus helping stimulate productivity, while eliminating a series of largely excessive regulatory provisions and burdens.

The decree contains first and foremost simplifications for citizens, i.e. faster and simpler procedures for administrative tasks, namely online residence change and rapid registry office procedures. Further provisions targeted for enterprises aim at achieving a timely fulfilment of administ-

[124] Governo italiano, *Consiglio dei Ministri n. 12 del 27/01/2012*, Comunicati stampa del Consiglio dei Ministri (January 27, 2012), http://governo.it/Governo/ConsiglioMinistri/dettaglio.asp?d=66448 (accessed September 30, 2012).

rative duties, creating a comprehensive national databank for public contracts and allowing a quick starting-up of businesses. Simplification for the public administration involves the possibility for customers to turn to another official in case the competent person fails to provide a timely conclusion of the procedure. In addition, state administration offices are requested to compile an annual report for the government regarding the state of the art in improving administrative burdens. Further measures are intended to set up a national "unified portal" for universities which will allow students to manage exam procedures directly online, while the national assessment system for study and research institutions (ANVUR) will be strengthened. Moreover, the package launched the so-called "Digital Agenda" and defined a road map in accordance with EU Commission initiatives: main objectives concern the realization of broadband networks to bridge Italy's widespread digital divide, open-data management of public institutions' files and initiatives for creating online smart communities among citizens.

Another decree adopted by the government on 24 February 2012 intends to achieve fiscal simplification by further amending taxation law and reinforcing fight against tax evasion; some unjustified tax deductions are eliminated and procedures are to be accelerated. In a multiannual policy document, the government also stated its commitment to a further reform of the fiscal system, which shall be characterized by the much called-for shift from direct, labour-based to indirect taxation[125]. A signal of dissatisfaction came nonetheless from Italy's Court of Auditors, whose President Luigi Giampaolino criticized the latest fiscal measures for further rising the overall tax burden.

4.5. The labour market reform

The objective of the government's labour market reform was to shift Italy's rigid, two-tier labour market towards a "flexicurity" model typical of Northern European countries. In particular, Monti clearly stated his intention to reduce the persistent dualism by rising protection for temporary and young workers and somewhat softening or restructuring the safety net for permanent should workers. While improving youngsters' chances to enter the labour market was welcomed as a much-needed priority by all, the debate involving the Article 18 proved considerably difficult. Talks between Labour and Social Minister Elsa Fornero, the employers' union Confindustria and Italy's three major trade unions[126]

[125] Ministero dell'Economia e delle Finanze, *Atto d'indirizzo per il conseguimento degli obiettivi di politica fiscale per gli anni 2012/2014* (2011), http://www.tesoro.it/documenti/open.asp?idd=29217 (accessed September 30, 2012).

[126] Italian trade unions are strong, counting more than 12 million members, more than in any other EU country. However, about half of the membership is made up of retirees, so overall trade union density among workers stands at about one third. Data are taken from the European Trade Union Institute http://www.etui.org/ (accessed September 30, 2012). See also European Commission, Directorate-General for Employment, Social

indeed concentrated on the reform of the aforementioned article from the Workers' Statute, which was approved in the midst of high social tensions in 1970. Article 18 protects workers from redundancy, regulating the case of workers dismissed singularly "without just cause" (*senza giusto motivo*) and the eventual trial following the worker's layoff. The burden of proof demonstrating the just nature of the measure falls on the firm, which additionally has to reinstate the worker in case the dismissal is declared illegitimate or unjustified at the end of the proceeding[127]. Besides, the firm has to pay substantial compensation benefits throughout the entire duration of the process, rendering the trial quite expensive for companies: no maximum limit was set for compensation and dismissal trials are usually very long in line with Italy's juridical processes. Over time, this measure led to considerable dissatisfaction on employers' side, as firms complained that firing a single unproductive worker has become virtually impossible, also in view of a presumably worker-friendly juridical culture among competent judges. Furthermore, this article only applies to firms employing a minimum of 15 workers and has been correspondingly pointed to as a possible explanation for Italy's strong SME pattern, as it would hinder firms' enlargement due to higher dismissal costs. Trade unions have always defended the measure, highlighting that article 18 is of the utmost importance in defending workers from dismissal out of ideological or other private reasons, especially in a situation where the general social scheme provides no adequate protection. Nonetheless, some claim that the life-long job perspective is no longer viable in an era of increasing globalization and flexibility, while other stress the fact that trade unions as such always tend to represent insiders' interests rather than improve outsiders' employment prospects.

After weeks of controversial talks between social partners, Monti's cabinet approved a disputed draft of the reform on 23 March 2012. Initially the government sought to approve the reform under the form of a decree law, but opposition from trade unions effectively put pressure on parties to have the reform democratically shaped in parliament, when it was finally passed end of June 2012[128]. The government had indeed come very close to reach a tripartite agreement with both Italy's employers' confederation *Confindustria* and the labour unions, but easing dismissal rules through a reform of Article 18 was consistently opposed by workers and their representatives, hence causing a partial failure of the

Affairs and Equal Opportunities, *Employee representatives in an enlarged Europe*. Volume 1 (April 2008): 302-304, http://europa.eu/rapid/pressReleasesAction .do?reference=MEMO /09/45&format=HTML&ag (accessed September 30, 2012).

[127] However, if the dismissal is declared void the worker can always opt for an indemnity equal to 15 months' pay as a replacement to reinstatement.

[128] Il Governo Informa, *La riforma del mercato del lavoro è legge,* http://governo.it/Presidenza/Comunicati/dettaglio.asp?d=68561 (accessed September 30, 2012). The full text of the decree law is available at http://governo.it/GovernoInforma/Dossier/lavoro_ri forma/index_cdm.html (accessed September 30, 2012).

concertazione effort[129]. Soon after it was approved by the Council of Ministers, European Commissioner for Employment, Social Affairs and Inclusion László Andor welcomed the reform and called on the Italian parliament's responsibility in supporting the government's efforts[130]; similar encouragement came from the OECD Secretary-General Angel Gurría[131].

The key points of the reform are a reorganization of unemployment protection, changes in the individual dismissal discipline, a reshaping of social safety nets and some measures devoted to encourage flexibility in the labour market[132]. Firstly, job contract typologies have been reformed with a view to simplifying the existing pattern and discouraging the improper use of several temporary/atypical categories as a means to abate labour costs. In particular, apprenticeship is seen as the standard starting point for establishing a lasting, permanent contract-oriented job relationship. Recourse to temporary workers is also discouraged through an increase in the contributions' quota paid by the employer to finance social safety schemes, as well as a maximum duration of 36 months. The latter are to be reorganized through the 2013 introduction of the "social insurance for employment" (*assicurazione sociale per l'impiego*, ASpI) which should grant eligibility also to artists and apprentices and be fully implemented in 2017. However, foreseen modifications do not radically reinforce the existing compensation scheme, as the eligibility criteria have not undergone substantial revision. The overall unemployment protection scheme has been reformed and unified, while specific redundancy funds such as *Cassa Integrazione*, which are directly run by companies and have so

[129] The Prime Minister greeted the result of the talks declaring that no social party has the right to veto any reform proposal and stated that the government does not appreciate "the culture of *consociativismo*", meaning the practice to involve opposition in government by yielding to compromise, which has long been a key characteristic of Italian industrial relations.

[130] "The reform adopted by the government has the ambition to address comprehensively the rigidities and asymmetries of employment protection legislation while moving towards a more integrated unemployment benefit scheme. This should allow finding a better balance between flexibility of entry and exit from the labour market. The momentum of reform must be maintained. The responsibility for a quick adoption of an effective reform now rests with the parliament. It is important that the objective and degree of ambition of the final text of the reform remain commensurate to the challenges of the Italian labour market, in line with the Council country specific recommendation. It is key that the final text of the reform package gives rise to a more dynamic and inclusive labour market, including during the transition phase to the new regime." Statement by László Andor, EU Commissioner for Employment, Social Affairs and Inclusion (March 27, 2012).

[131] He described the reform as "a decisive step to tackle the main problems of the Italian labour market in a coherent manner". See *Italy: OECD's Gurría welcomes labour market reforms,* Press release (Organization For Economic Co-Operation And Development, March 27, 2012) http://www.oecd.org/document/54/0,3746,en_21571361_44315115_49989430_1_1_1_1,00.html (accessed September 30, 2012).

[132] The full text of the reform is available at http://governo.it/Governo/ConsiglioMinistri/testo_int._asp?d=67285 (accessed September 30, 2012).

far helped limiting the impact of the crisis, have been given less scope[133]. The reform included additional measures to guarantee gender equality in the work place, specifically outlawing the practice of having women sign open-ended resignation letters, commonly applied in the case of pregnancy. Paternity parental leave was also rendered compulsory, but the minimum duration was set at only three days.

The most delicate provision concerned Article 18 of the Workers' Statute and the sanction regime for unfounded individual dismissals, which has been divided in three categories. Dismissals with an unjust discriminatory purpose will remain subject to the dispositions which were already in force, i.e. companies are forced to rehire the worker if the employer's case is ruled unfounded. In case of an allegedly disciplinary-driven dismissal, the reinstatement obligation is to be maintained in some cases, while the judge will be able to arrange for compensation benefits in others. More tricky is the option when dismissal is explained out of economic reasons, an eventuality where legislation was substantially modified. In the initial governmental proposal, if the dismissal was proven to be unjustified, the firm would have been only forced to pay compensation benefits to the worker (15 to 27 monthly salaries), unless the worker was able to demonstrate that the employer's decision could be traced back to a discriminatory or disciplinary reason. After substantial opposition to this provision rose from both parties and public opinion, the government decided to reintegrate the possibility of reinstatement in case the economic reason is "patently unfounded", albeit assuring companies that such eventuality would be remote. The move was welcomed by trade unions as a sign of compromise, yet it was harshly criticized by the employers' leader Emma Marcegaglia and some international observers, who claim it substantially watered down the reform proposal[134]. On the other hand, the workers' unions underlined that economic reasons will be easily pretended to conceal discriminatory or disciplinary purposes. A special judicial fast-track was introduced to help bring down the duration of judicial proceedings involving dismissal cases, and the indemnity replacing reinstatement in some cases was set a maximum of 24 months' value of the worker's salary[135].

Softening workers' protection against unjust unemployment was seen from the government as a priority and a means to foster firms'

[133] As a matter of fact, the *Cassa Integrazione Ordinaria* was subject to no modifications, while *Cassa Integrazione Straordinaria* (the mostly used redundancy fund during the crisis) has been modified and ruled out in some cases. See "La riforma del lavoro è legge" (Il Sole 24 Ore, June 28, 2012), www.ilsole24ore.com/art /norme-e-tributi/2012-06-27/riforma-lavoro-legge-tutte232524_PRN.html(accessed September 30, 2012).
[134] Richard Barley, "Italian Labour Market Reforms fall short of Full Monti" (WSJ online, April 10, 2012), http://online.wsj.com/article/SB10001424052702303815404577335131896025126.html (accessed September 30, 2012).
[135] For a review of the labour market reform, see *Relazione Annuale sul 2011* (Banca d'Italia, May 31, 2012): 108-109, http://www.bancaditalia.it/pubblicazioni/relann/rel11/rel11it (accessed September 30, 2012).

competitiveness, but it is debatable whether this aim can be reached by mainly increasing exit flexibility. Several voices have also underlined the absence of a far-reaching action to improve young people' and women' perspectives and the weakness of provisions regarding entrance flexibility[136]. The very rigidity of Italy's labour market has been debated, as there is certain evidence that the "fixed place" is not as widely spread as it is commonly believed[137]. Political tensions also emerged as centre-left parties consistently fought to amend the regulation of individual dismissals, hence acknowledging claims from both CGIL and its working class base. Moreover, a poll published in the national newspaper *Corriere della Sera* on 25 March 2012 found that government approval rates were seriously affected by Mr Monti's handling of the talks and the reform process as a whole. Nonetheless, the effectiveness of the reform is still to be proved, as several studies question the supposed link between labour market flexibility, particularly on the exit side, and much needed-for rises in the total productivity of the economic system[138].

Info Box 4 – The role of trade unions in Italy

Italian trade unions are strong, counting more than 12 million members, more than in any other EU country139. However, about half of the membership is made up of pensioners, so overall trade union density among workers stands at about one third. There are three main trade unions, whose divisions were initially based on clear political affiliations.

CGIL, General Confederation of Italian Workers (Confederazione Generale Italiana del Lavoro), nowadays led by Susanna Camusso, was initially linked with Italy's communist party PCI and still has the most radical views, leaning towards socialist and communist positions. It was set up in 1906 and currently has almost 6 million members, half of them being retirees.

CISL, Italian Confederation of Workers' Unions (Confederazione Italiana

[136] Gros and Maselli show that youth unemployment rates have not improved since the coming into force of the labour market reforms; in particular, the youth (15-24) to prime age (25-49) unemployment ratio has remained constant at about 4:1, Daniel Gros, Ilaria Maselli, "Giovani disoccupati italiani tra mito e realtà" (La Voce, June 21, 2012), http://www.lavoce.info/articoli/pagina1003129.html (accessed September 30, 2012).

[137] Some studies found that exit flexibility is already higher than it may appear, and that the mobility rate of workers is substantially higher than in a labour market characterized by real rigidity. See e.g. Maurizio Franzini, Michele Raitano, "Rigido, flessibile o "liquido"? Il mercato del lavoro e il rischio di riforme inutili" (Nel Merito, February 24, 2012), http://www.nelmerito .com/index.php?option=com_content&task=view&id=1624&Itemid=1 (accessed September 30, 2012).

[138] See e.g. Pasquale Tridico, "Flessibilità e istituzioni nel mercato del lavoro: dagli economisti classici agli istituzionalisti", in *Economia & Lavoro*, no. 1 (Bologna: Carocci Editore, 2009).

[139] Data are taken from the European Trade Union Institute http://www.etui.org/ (accesses September 30, 2012).

Sindacati Lavoratori), was affiliated with the strong christian-democratic party Democrazia Cristiana and still holds a centrist, moderate perspective. It is led by Raffaele Bonanni and has about 4.5 million members.

UIL, Union of Italian Workers (Unione Italiana del Lavoro), distanced itself from CGIL over time to adopt social-democrat views in line with Italy's Socialist Party. Its current leader is Luigi Angeletti and it has slightly over 2 million members. The three trade unions are all organized in a similar way on an industry basis; CGIL is the strongest one in the manufacturing industry, while CISL and UIL have their strongholds in the public services. When the Tangentopoli scandal and subsequent political turmoil led to the collapse of Italy's political system in the early 1990s, Italian trade unions lost their traditionally established links with political parties, but their leanings have remained quite stable over time.

4.6. Spending review and "Decreto Sviluppo"

A ministers' committee presided by the Minister Piero Giarda was built at the end of April 2012 with the task to perform a comprehensive process of spending review[140]. The aim was a rationalization of public spending for goods and services, and a definition of spending levels for single items of public expenditure at unchanged quality. A decree law named "Riduzione della spesa a servizi invariati" (d.l. 95/2012) was approved by the Council of Ministers on 5 July 2012 and gained parliament approval the following week[141]. It encompassed spending cuts for a total of €25.9 billion over the range of three years (4.4 in 2012, 10.3 in 2013 and 11.2 in 2014). The cuts aim at reducing the primary deficit and postponing the awaited 2 percentage points increase of VAT rates to the third quarter of 2013, initially foreseen for October 2012. A first group of public spending containment measures is intended to reduce inefficiencies in the purchasing of goods and services by the public administration, and the central PA will be subject to 10-20 percent offices and personnel cuts. State property is to be more efficiently utilized and state-owned services-supplying enterprises will be either alienated or dismissed. In addition, both ministries and territorial administration bodies have undergone substantial cuts, and the number of provinces will be halved by the end of 2012 in accordance to territory and population criteria[142].

[140] See info sheet *Le decisioni sulla spesa* http://governo.it/GovernoInforma/spending_review/decisioni _spesa.html (accessed September 30, 2012).

[141] See *Spending review. Riduzione della spesa a servizi invariati (DL n. 95/2012),* http://governo.it/GovernoInforma/spending_review/decreto_legge95_2012.html (accessed September 30, 2012). The full text of the decree is available at the same page.

[142] See *Bollettino Economico*, No. 69 (Banca d'Italia, July 2012): 37-39, http://www.bancaditalia.it/pubblicazioni/econo/bollec /2012/bolleco69/bollec69/boleco_69.pdf (accessed September 30, 2012).

The government later promoted another emergency decree (Legge Monti-Passera "Misure per la crescita e lo sviluppo sostenibile") which was finally approved on 3 August 2012. The decree law aims at fostering development growth, envisioning a number of provisions in fields ranging from tax relief for hiring highly qualified workers to VAT reductions on energy requalification and building renovation spending. It also foresees tax facilitations for enterprises, project bonds to finance infrastructure spending and several other measures to support SMEs and innovation[143]. The Council of Ministers then set forth a wider growth-oriented agenda at the end of August 2012, stating it will address a number of still unresolved issues which have long hindered Italy's economic growth restoral. The government's announced path will pursue *inter alia* red tape reduction, a catching-up of the country's infrastructural gap and investment in human capital in an attempt to promote sustainable productivity[144].

5. Final remarks

5.1. Achievements and outlook for implementation

During its first year of office, Italy's new government launched an impressive reform agenda, trying to address a wide range of structural problems hindering the country's economic potential. The very breadth of the reforms yet raises concerns about their effectiveness and coherence, especially because they have been adopted under consistent pressure from the outside of the country. A first, welcomed achievement of the new government is undoubtedly Italy's full re-entrance onto Europe's negotiation tables. Thanks to his solid European curriculum, his academic expertise and personal qualities, Mario Monti managed to restore the country's diplomatic stance, which had been substantially weakened by Berlusconi's debatable handlings and personal scandals. Widespread appraisals do not help abating Italy's enormous public debt, but they have contributed to restore the Italian government's trustworthiness at the EU and international level[145].

Approval rates for the technocratic government have been impressively high ever since its inception on 16 November 2011. Polls have found an average approval rate of 55 percent having enough or great confidence in the government as a whole, and similar rates have been recorded for the

[143] See info sheet http://governo.it/GovernoInforma/Dossier/decreto_sviluppo_passera/leggemonti passera.pdf (accessed September 30, 2012).

[144] See info sheet *Obiettivo Crescita. L'agenda del governo,* http://www.governo.it/GovernoInforma/ documenti/agenda_governo_20120824.pdf (accessed September 30, 2012).

[145] The latest recognition in this regard was Merkel's welcoming of the 'impressive reforms' Italy has undergone recently, a statement made during a meeting end of August 2012. For a full record of the Berlin meeting, see http://www.bundesregierung.de/Content/DE/Artikel/2012/08/2012-08-29-Merkel-Monti.html (accessed September 30, 2012).

Prime Minister alone[146]. On the other side, several voices have outlined the need for democratic accountability and a properly elected government, stressing that the present coalition is and must remain only an exceptional eventuality in crisis times.

At the European and international level, satisfaction with the new Prime Minister was already expressed at the very inception of his mandate. Mario Monti was well-known as a capable Eurocrat and economist and most ministers from his coalition also enjoyed experts' recognition. Praises have been almost uncountable for the Prime Minister and his reform agenda, ranging from Germany's Chancellor Angela Merkel to U.S. President Obama[147].

Considering its decisive role in the handling of the sovereign debt crisis, Germany's attention to Italy's new Prime Minister has been particularly noteworthy, with a thick series of bilateral meetings marking the two countries' reinforced collaboration. Merkel welcomed Italy's budget consolidation and substantial reform package, emphasizing the will to cooperate even more closely towards the final overcoming of the crisis. In the meanwhile, several EU officials and European Commissioner for Economic and Financial Affairs Olli Rehn have kept appraising Monti's reforms, which are in line with EU and other organizations' long-standing economic policy recommendations.

As part of this restored agility on the diplomatic scene, on 20 February 2012 Monti signed a letter to the President of the European Council Herman Van Rompuy asking for growth policies at a European level. The initiative was envisaged together with British Prime Minister David Cameron and Dutch Prime Minister Mark Rutte and was backed by nine

[146] A survey published in the national newspaper *La Repubblica* at the beginning of March highlighted Italian people' trust in " technicians", as it found that 22 percent would vote for a "party of technicians" in case it ran for the next general elections. This result shows a deeply rooted dissatisfaction with Italian politics and party system, a result of years of weak trustworthiness and failure in delivering promised results. See http://www.repubblica.it/politica/sondaggi/2012/03/06/news/il_partito_dei_tecnici_al_22_-31020253/ (accessed September 30, 2012). See also Ilvo Diamanti, "Il Paese è sempre più indeciso. Promosso Monti ma non i tecnici" (La Repubblica, September 10, 2012), http://www.repubblica.it/politica/2012/09/10/news/il_paese_sempre_pi_indeciso_promosso_monti_ma_non_i_tecnici-42253792/?ref=HREC1-3 (accessed September 30, 2012).

[147] Merkel welcomed Mr Monti in Berlin on 11 January 2012 and acknowledged the "extraordinarily important and remarkable reforms Italy has introduced, concerning both fiscal consolidation and structural reforms", *Pressestatements von Bundeskanzlerin Angela Merkel und dem Ministerpräsidenten der Italienischen Republik, Mario Monti*, Mitschrift Pressekonferenz (January 11, 2012), http://www.bundesregierung.de/Content/DE/Mitschrift/Pressekonferenzen/2012/01/2012-01-11-merkel-monti.html (accessed September 30, 2012). Obama congratulated him in February 2012 for the "very effective measures", as well as his ability to "generate confidence through-out Europe and in the marketplace that Italy has a plan that takes seriously its fiscal responsibilities and the need for structural reforms", *Remarks by President Obama and Prime Minister Monti of Italy after Bilateral Meeting*, The White House, Office of the Press Secretary (February 9, 2012), http://www.whitehouse.gov/the-press-office/2012/02/09/remarks-president-obama-and-prime-minister-monti-italy-after-bilateral-m.

more leaders from the EU. The letter simultaneously called for the completion of the single market in the services sector, the creation of a single energy and digital market, R&D enhancing policies and job creation for women and young people. It signalized that the need for growth-creating policies is supported by several EU leaders, and it also demonstrated a reinforced cooperation between Italy and Great Britain on competition-related measures. These demands fall in line with Monti's European politics, a domain where he intends to push for a strengthening of the economic union and reinforced integration of financial markets. The single market is to be fully implemented and Italy's government is determined to play a decisive role in shaping future EU intergovernmental policies, thus seeking to counterbalance the perceived Franco-Germany axis in handling crisis management structures[148].

5.2. The challenges ahead

Notwithstanding the uncountable praises and high approval rates, Monti's government has not yet fully overcome the crisis. On the one hand, pressure from EU institutions and European leaders is likely to remain high, as the full implementation of the reform agenda is seen as the only way to calm down investors' nerves and appease Northern surplus countries. On the other hand, the European sovereign debt crisis is all but overcome as Greece's exit from the monetary union is no longer off the table and the country still lies in disastrous economic conditions[149]. Hence the risk of a renewed worsening of the crisis cannot be excluded, even after the European Central Bank's announcement of the OMT-programme, and any deterioration would put at stake Italy's new fragile economic and financial policy[150]. The substantial reduction in spreads over Italy's bonds

[148] See info sheet *Governo Monti: Attività dei primi 100 giorni*, http://www.governo.it/GovernoInforma/Appoggio/RAPPORTOpercent20100percent20GIORNI.pdf (accessed September 30, 2012).

[149] The report from the "troika" (European Commission, ECB and IMF) on Greek reforms' implementation is expected to appear in late September or early October 2012, potentially putting long- and short-term crisis mechanisms at stake. See Ulrike Guerot, *The euro debate in Germany: Towards political union?*, ECFR Reinvention of Europe Project (European Council on Foreign Relations, September 2012), http://ecfr.eu/content/entry/commentary_the_euro_debate_in_germany_towards_political_union (accessed September 230, 2012).

[150] The Outright Monetary Transactions Programme, announced by the ECB in September 2012, is meant to help lowering the sovereign spreads of crisis countries, notably Italy and Spain, and ensure an effective transmission of the ECB's monetary policy. It will require strict conditionality attached to an appropriate EFSF/ESM programme, taking either the form of a full macroeconomic adjustment programme or a precautionary programme. Focusing on sovereign bonds with a maturity of between one and three years, the ECB intervention in secondary markets will be set no *ex ante* quantitative limits in order to safeguard an appropriate monetary policy transmission in the currency union. See *Technical features of Outright Monetary Transactions*, Press release (European Central Bank, September 6, 2012), http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html (accessed September 30, 2012).

in the first months of 2012 appears strongly linked with the European Central Bank's intervention on secondary markets and long term refinancing operations (LTROs). Italy's situation currently seems closely intertwined with Spain's one, as the two countries have undergone similar reforms (e.g. in the labour market) and the trend of the spread between their sovereign assets and German benchmarks follows a largely parallel path. Should yields keep increasing as from late April 2012 onwards, a range of possible options would come in question: bank recapitalization, secondary market intervention from the ECB or EFSF credit lines may be needed to restore stability on financial markets[151].

Concerns for the government's stance are similarly rooted in the political situation, as the crisis momentum providing for parliamentary cohesion is seen as already vanishing and tensions between and within political parties are once again on the upward trend[152]. Politicians increasingly call for more democratic accountability and the parliament to be fully involved in the legislation procedure, while the debated reform of the electoral system is all but agreed upon. Fight against tax evasion has delivered some results but more needs to be done in order to lower the traditionally high compliance gap. An efficient and effective tax collection would hence limit the unequal effects of tax rises and help fighting the shadow economy[153].

Moreover, tbe next general elections are due for April 2013 and political campaigning has already started. Whereas Monti has denied any intention to run for office, several voices in the business sector and on the European level would clearly cherish such eventuality. For the moment being, there is no certainty that Italy's current technocratic Prime Minister will not turn into an elected one, but the most probable scenario would see centre-left parties taking over, according to the latest polls. Still, there is no unified view on the candidate position within the coalition (primary

[151] For an overview of available options in such eventuality, see *Euro Area Macro Viewpoint: Thinking through options for Italy and Spain*, Economic Analysis (Bank of America Merrill Lynch, April 11, 2012), http://rcr.ml.com/Archive/11155174.pdf?w=laurence.boonepe rcent40baml.com&q=DpJZxB!fGc1e0aqQy2H1g&__gda__=1334312055_8d2a1b5d0c971ced 18657 ddfee6ee094 (accessed September 30, 2012). CEPS Director Daniel Gros rather sees a possible viable way out of the current high yields on Italy's bonds in persuading the country's savers to invest in domestic assets, given the limited foreign indebtedness. See Daniel Gros, *Can Italy and Spain survive rates of 6-7%?*, CEPS Policy Brief, No. 279 (Centre for European Policy Studies, July 27, 2012), http://www.ceps.eu/book/can-italy-and-spain-survive-rates-6-7 (accessed September 30, 2012).

[152] Umberto Bossi resigned as leader of the populist Lega Nord on 5 April 2012 after the party's treasurer was placed under investigation for alleged fraud and money-laundering. In the wake of the corruption scandal, public and political debate on the issue of party financing gained new momentum.

[153] The European Commission recently put forward some proposals to improve tax governance systems in EU Member States: see European Commission, Directorate-General for Economic and Financial Affairs, *Improving tax governance in EU Member States: criteria for successful policies*, European Economy. Occasional Papers, No. 114 (August 2012), http://ec.europa.eu/economy_finance/publications /occasional_paper/2012/op114_en.htm (accessed September 30, 2012).

elections are likely to be held) and alliances are being constantly discussed.

An early collapse of the government would leave no alternative for tackling Italy's economic and financial problems, as investors would restart fleeing the country's sovereign debt and political fragmentation could increase once again, leaving almost no room for a return of confidence and a restoral of the economic growth potential. The latter however cannot happen without seriously tackling systemic problems such as the dismal R&D spending, the length of civil justice proceedings and administration inefficiency, the main burdens long hampering Italy's growth. His chances simultaneously depend on keeping his good stance on the European level and succeed in promoting EU-based growth policies. Overcoming recession is indeed a priority if the country's conspicuous public debt is to be brought down to a sustainable level, particularly as Italy's GDP is forecast to fall by 2.0 percentage points in 2012[154] and economic growth is expected to be zero for the EU and -0.3 percent for euro area countries over the same period[155].

5.3. Euro zone governance

Alongside the reform process going on in Italy, EU-wide policies are pivotal to a successful overcoming of the sovereign debt crisis. Macroeconomic imbalances in the euro area have recently become a central issue of debate, being pointed to as one of the major causes of the crisis[156]. Mundell's research on "optimum currency areas" has been often referred to in order to underline the initial shortcomings of a monetary union encompassing countries with highly divergent competitiveness[157]. Massive capital flows from Northern surplus to Southern deficit countries over the course of a decade have made existing divergences worse, and peripheral Member States have seen their competitiveness steadily deteriorate[158]. The new

[154] The IMF foresees a -1.9 percent fall (July 2012 Update to the World Economic Outlook, http://www.imf.org/external/pubs/ft/weo/ 2012/update/02/index.htm accessed September 30, 2012) similar to Istat, while Banca d'Italia has a slightly worse scenario forecasting a GDP fall by -2.0 percent in 2012. See Bollettino Economico, No. 69 (Banca d'Italia, July 2012): 35, 39, http://www.bancaditalia.it/pubblicazioni/econo/bollec/2012/bolleco69/bollec69/boleco_69.pdf (accessed September 30, 2012).

[155] European Commission, Directorate-General for Economic and Financial Affairs, *European Economic Forecast,* Spring 2012, http://ec.europa.eu/economy_finance/publications/ european_economy/2012/ee1upd_en.htm (accessed September 30, 2012).

[156] See e.g. Silvia Merler, Jean Pisani-Ferry, *The simple macro-economics of North and South in the EMU*, Bruegel working paper 2012/12 (Bruegel, July 2012), http://www.bruegel.org/ publications/publication-detail/publication/740-the-simple-macroeconomics-of-north-and-south-in-emu/ (accessed September 30, 2012).

[157] Francesco Farina, ""Le stesse cose ritornano": quello che non va nell'approccio all'euro" (Nel Merito, May 30, 2012), http://www.nelmerito.com/index.php ?option=com_content&task=view& id=1697&Itemid=69 (accessed September 30, 2012).

[158] As most of the excess savings is intermediated by the banking system and other intermediaries (such as pension funds) which have a strong 'home bias' (i.e. a bias in

Macroeconomic Imbalances Procedure introduced by the European Commission foresees two competitiveness indicators (relative unit labour costs and consumer prices) playing a key role in the economic governance of the euro area. Nevertheless, it is to be reminded that competitiveness is a relative concept, and the gain of a country implies deterioration for others. That was the case for Germany's (among others) strong external surpluses accumulated before the crisis, in face of persistent current account deficits in Southern countries. The situation might therefore become one of competitive deflation, where wage increases in lower labour cost countries or cuts in those with a higher cost (lower productivity and ULCs) lead to different real exchange rates[159]. In a regime of fixed nominal exchange rate like a currency union, this is the only way a deficit country could regain export shares and improve its current account position. It is however clear that such structural adjustment is not feasible in Southern countries with higher relative ULCs, where austerity measures have already cut down consumers' purchasing power[160].

The link between government finance indicators (and distress) and external imbalances has also been subject to research. Some studies have indeed underlined the strong relationship between the spread on sovereign debt titles and current account imbalances, suggesting not focusing solely on fiscal ones. This link could easily explain why Belgium, a net creditor towards the rest of the world, is not experimenting a crisis despite its poor fiscal position[161]. A purely intra-euro rebalancing requiring

investing in the euro area), there was a strong propensity for the excess savings in the North to be invested somewhere else in the euro area itself. However, since 2009 a massive withdrawal of foreign private resources has taken place in the South, exposing these countries to rapidly worsening financial conditions. The overexpansion of domestic demand financed by capital inflows is hence seen as the main reason behind the loss of competitiveness. According to this interpretation, the focus of the correction should lie on individual countries, which should bear the main effort, rather than on European institutions. See Daniel Gros, *Macroeconomic Imbalances in the Euro Area: Symptom or cause of the crisis?*, CEPS Policy Brief, No. 266 (Centre for European Policy Studies, April 2012), http://www.ceps.eu/book/macroeconomic-imbalances-euro-area-symptom-or-cause-crisis (accessed September 30, 2012).

[159] Intra-euro real effective exchange rates (REERs) diverged significantly already before the crisis, with Germany able to engineer the greatest real depreciation and Italy the biggest real appreciation. See Zsolt Darvas, *Intra-euro rebalancing is inevitable, but insufficient*, Bruegel Policy Contribution, Issue 2012/15 (Bruegel, August 2012): 5, http://www.bruegel.org/publications /publication-detail/publication/747-intra-euro-rebalancing-is-inevitable-but-insufficient/ (accessed September 30, 2012).

[160] In spite of such feasibility concerns, several proposals have been put forward emphasizing the need for deflation policies in problem countries. Among these, see Crafts, who argues that a structural adjustment programme resembling the Marshall Plan should be envisioned to faster productivity growth in the euro area periphery; supply-side reforms and strong conditionality loans would be the pillars of the programme. Nicholas Crafts, *Saving the Eurozone: is a 'Real' Marshall Plan the answer*?, The CAGE-Chatham House Series, No. 1 (London: Chatham House, June 2012), http://www.chatham house.org/publications/papers/view/184277 (accessed September 30, 2012).

[161] See e.g. Daniel Gros, *External versus Domestic Debt in the Euro Crisis*, CEPS Policy Brief, No. 243 (Centre for European Policy Studies, May 25, 2011), http://www.ceps.eu

too-significant wage adjustments, others have focused on the external value of the euro. As the common currency was substantially overvalued in the period preceding the crisis, a process of depreciation for the common currency has been suggested. A weaker euro would boost exports for the monetary union as a whole; inflation and wage increases would follow in surplus countries and the tradable sectors of deficit countries would benefit[162].

Common euro area sovereign securities have also been high on the agenda, in spite of Germany's longstanding opposition and several differences in strategy and approach among Member States. Given the purposeful nature of the EMU as a monetary union without a fiscal union, ad-hoc additional arrangements have been required for inter-governmental support to help crisis countries. Nevertheless, the common issuance of debt instruments has been evoked which could potentially serve two main functions. "Eurobonds" would indeed stabilize financial markets in the short-term and improve the euro area economic governance framework in the medium-term, thanks to enhanced fiscal discipline and risk-sharing. The creation of a large safe asset could reduce flight to safety from one sovereign to another and weaken the currently destabilizing links between banks and their respective sovereigns[163].

Another reason for the euro area's shortcomings now widely debated is the already mentioned absence of a fiscal union with corresponding authority over fiscal, structural and banking policies. Some studies have put forward the creation of a euro zone finance minister, enjoying veto-rights over national budgets and the power to assess the liquidity and solvency of governments facing difficulties. As it should obviously rely on federal tax resources, a finance ministry would require substantial sovereignty transfers and hence a new political treaty to be signed among euro zone leaders[164]. The most recent step forward has occurred in relation to the banking union, with Eurozone Council ministers agreeing upon the ECB becoming the future supervisor of euro zone banks at a meeting end of June 2012[165].

/book/external-versus-domestic-debt-euro-crisis (accessed September 30, 2012). Gros implies that it could be vital for peripheral countries to focus on an external (surplus) objective rather than on fiscal (primary) surpluses.

[162] See Zsolt Darvas (see note 159). Such policy is however one of great consequences for exchange rates and trade balances at a global level, and would best come along with a relative appreciation of foreign currencies such as the Chinese yen (implying a strengthening of China's internal demand).

[163] For a comprehensive review of the main "eurobonds" proposals (including the Bruegel Blue-Red Bond and the European Commission "project bonds") see Stijn Claessens, Ashoka Mody, Shahin Vallee, *Paths to Eurobonds*, Bruegel Working Paper 2012/20 (Bruegel, July 2012), http://www.bruegel.org/publications/publication-detail/publication/733-paths-to-eurobonds/ (accessed September 30, 2012).

[164] Benedicta Marzinotto, André Sapir, Guntram B. Wolff, *What kind of Fiscal Union?*, Bruegel Policy Brief, Issue 2011/06 (Bruegel, November 2011), http://www.bruegel.org/publications/publication-detail/publication/646-what-kind-of-fiscal-union/ (accessed September 30, 2012).

[165] Lannoo discusses the outcomes of the meeting and underlines a need for more con-

Finally, the implementation of the aforementioned proposals cannot come without the strengthening of Europe's weak institutional framework. The well-known "democratic deficit" literature has also been considering the "executive deficit" issue, originating from the absence of a democratically accountable and effective decision-making framework. Thus deepening economic and fiscal integration among euro zone countries must be followed by political initiatives and held accountable to European citizens[166].

On the other hand, the much-called for regulation of financial markets, encompassing a financial transaction tax (following a proposal made by the European Commission in late 2011), seems far from being implemented. "Animal spirits" have occupied centre stage in the talks on markets' behaviour, but a clear pattern of relatively few investors emerges at a closer look, suggesting more could be done to limit speculation[167]. In the meanwhile, the lack of economic growth needs to be addressed and the feedback loop between austerity and recession cut. Although fiscal stimulus is no longer a viable option due to the recently adopted rules, governments could resort to the balanced budget multiplier, which allows to achieve a rise in aggregate demand (and GDP) by increasing expenditure and taxes by equal amounts and simultaneously keeping a balanced budget.

sistency in delineating the ECB's future tasks, as well as the role of the European Banking Authority (EBA) created in 2010. See Karel Lannoo, *The Roadmap to Banking Union: a call for consistency*, CEPS Commentary (Centre for European Policy Studies, August 30, 2012), http://www.ceps.eu/book/roadmap-banking-union-call-consistency (accessed September 30, 2012). Calls for supervisory and resolution authority to be centralized at a supranational level had already been pressing as an instrument to break the negative feedback loop among sovereigns and banking systems: see e.g. Jean Pisani-Ferry, André Sapir, Nicolas Veron and Guntram B. Wolff, *What kind of European Banking Union?*, Bruegel Policy Contribution, Issue 2012/12 (Bruegel, June 2012), http://www.bruegel.org/publications/publication-detail/publication/731-what-kind-of-european-banking-union/ (accessed September 30, 2012). The authors analyse in detail the possible settings of a banking union, such as the number of EU participating countries, supervision and resolution tasks and the characteristics of a centralized deposit insurance system.

166 See e.g. N. Veron, who advocates the creation of a "fourfold union" agenda for Europe encompassing banking union, fiscal union, competitiveness union and political union. Nicolas Veron, *The challenges of Europe's fourfold union*, Bruegel Policy Contribution, Issue 2012/13 (Bruegel, August 2012), http://www.bruegel.org /publications /publication-detail/publication/741-the-challenges-of-europes-fourfold-union/ (accessed September 30, 2012).

167 Andrea Fumagalli, "Il diritto al default come contropotere finanziario", in Rossana Rossanda, Mario Pianta (eds), *La rotta d'Europa. L'economia* (Roma: Sbilanciamoci/Il Manifesto, 2012): 111-112, http://www.sbilanciamoci.info/ebook/La-rotta-d-Europa-in-due-volumi-13138 (accessed September 30, 2012).