

Italy: Weaknesses and Strengths

di Franco Bassanini

President, Cassa depositi e prestiti

President, Astrid Foundation

Ladies and gentlemen,

Thank you very much for welcoming me here today. It is a great honour.

I feel a bit embarrassed to take the floor before a great economist such as Edmund Phelps. I hope he will share my diagnosis. Not sure he will share my policy solutions!

The crisis has highlighted Italy's long-standing structural weaknesses, first of all high government debt, declining total factor productivity and prolonged low growth. While some important measures have been adopted over the past two years, their full implementation remains a challenge.

The most well-known element of weakness is our high public debt. The Italian Treasury has estimated that the Debt-to-GDP ratio will reach the 130.4% at the end of 2013¹ (and even more if Parliament decides to speed up the payment of the local government overdue commercial debts). Over the past two decades, it has been a heavy burden for public finances and for the economic system as whole. It has been estimated that interests paid by the government on the part of public debt exceeding the 60% of the Debt-to-GDP ratio - in the period between 1992 and 2007 - were exceeding 1.000 billion euros at constant price. A huge amount of public resources, which could have been channelled to other needs, such as tax reduction, capital expenditure and pro-active industrial policy.

Key note speech al seminario su *Facing Current Weaknesses in the Euro Zone*, organizzato dall'Euro50 Group - Roma, 24-25 giugno 2013

¹ Source: MEF(2013), "Documento di Economia e Finanza), april.

No less crucial is our prolonged constrained growth potential. During the twenty years before the creation of the Monetary Union, Italy has grown at an average annual rate of 0.8% compared to an average rate of 1.5% of the other Member States. The gap in terms of growth was further amplified after the introduction of the Euro and more sharply during and after the 2008 crisis.

One of the main reasons of this weak growth dynamics is the fall in the general productivity level of our economic system, largely due to the higher cost of doing business. Italian firms have higher input costs than other European countries in many areas.

First, the cost of capital. Italian companies, in particular SMEs, pay higher interest rates on bank loans. This is connected to the stress on the Eurozone sovereign market of the past two years. The spread between Italy and Germany on long term loans to firms (over 5 years) is actually about 240 basis points (190 basis points compared to France)². The same figure is still higher for SMEs. At the same time, the low development of capital markets does not allow SMEs to find alternative resources to finance their activities: the access to capital market remains difficult for them.

Second, the higher cost of energy, due to the lack of a stable energy policy which is reflected, especially in the electricity market, in an inadequate stock of physical infrastructure and in a unfavourable generator mix. In 2012 the annual average wholesale electricity price in Italy was about 42% greater than Germany and France³.

Third, the higher taxation on labour and capital, mostly due to increases in tax burden required to respect our tough fiscal consolidation programme. has contributed to the poor employment performance in terms of productivity and has limited firms' propensity to invest and to innovate.

Other factors contributed to this long-standing structural weaknesses of the Italian business environment: the high size of regulatory and bureaucratic burdens,

² SourceBCE, Statistical Data- Warehouse, april.

³ Source: National energy markets.

the inefficiencies of the civil justice system, the lack of infrastructure, the higher presence of small firms, the lower development of ICT and the presence of several sectors still not entirely open to market competition. All together, these factors have negatively affected the ability/propensity of Italian firms to invest, to improve the stock of labour force in terms of human capital and organisation and to incorporate new technologies in their production function. They have also contributed to worsen the actual recession phase. As a consequence, the unemployment rate has reached 12%⁴, and the youth unemployment more than 40% with a dramatic peak of 52% in Southern Italy. Increasing unemployment tends to weaken the country social cohesion, and produces negative effects on real economy, deteriorating the stock of human capital and finally reducing the households' income and their propensity to consume and to save.

But, the Italian economy has not only weaknesses. It has – fortunately – also some strength.

First, despite the high debt, the public finances are still in a strong and safe position. Between 1992 and 2012, the average annual primary balance (as percentage of GDP) was about +2.6%. In the same period it was +0,5% for Germany and -0.5% for France⁵.

Second, despite the crisis, the main economic sectors – households, firms and banks - are quite healthy. The traditional high saving rate of households is decreasing, but their wealth is sizeable, equal to 8 times their disposable income⁶, almost in line with the figure for UK and France, but higher than US and Germany. The level of indebtedness of Italian households is about 59% of national GDP, against the 71% of the Euro Area. Firms' indebtedness is relatively moderate, too, about 53% of GDP, lower than Euro Area figure of 71%.

⁴ Source: Istat (2013), "Occupati e disoccupati mensili", may.

⁵ Source: Elaborations on European Commission – AMECO dataset.

⁶ Source: Bank of Italy (2012), "La ricchezza delle Famiglie Italiane"

Compared to some other Eurozone Member States, Italian financial sector proved to be relatively resilient during the global financial crisis, requiring only marginal public support. Contributing factors include a traditional intermediation-based business model, a sound regulatory and supervisory regime, absence of a real estate bubble and the low level of household and firms debt. Since 2011, however, the vulnerability of Italian banks has increased, owing to the negative feedback loop between fiscal sustainability concerns, banks' exposure to the Italian sovereign and weakening of real economic activity. The double-dip recession has burdened the Italian banks balance sheets with a rather large stock of non-performing loans.

Despite the crisis, the Italian manufacturing sector is alive and is showing positive growth perspectives, at least if we look to the segments competing on the international markets. Italy has the second manufacturing industry in Europe and is the third exporter of goods and services of our Continent. About 17% of total EU manufacturing value added is produced in Italy, with a relative weight surprisingly stable during the last crisis years⁷. The share of Italian export of total EU export is about 8.2%, not far from France, the second European player (9,9%).

A significant and quite impressive result, if we consider that we are talking about firms that are facing higher capital, energy, regulatory, bureaucratic and logistics costs than their German or French competitors, as well as higher tax burdens and a less friendly business environment.

Therefore I do believe that public policies focused on reducing some of these obstacles, to established a level playing field between Italian firms and their competitors, as well as policies of market liberalization in sectors still protected could significantly enhance the productivity and the competitiveness of the Italian economy . The new grand coalition government – notwithstanding political uncertainties – should be in full capacity to pursue the structural reforms needed to

⁷ Source: Eurostat (2012)

boost productivity and reduce unemployment. I hope this does not prove to be just a wishful thinking....

In the meantime, while we are waiting for structural reforms to become effective and deliver positive results (but still counting their effects in terms of expectations), the new Government should immediately inject liquidity into the system by paying the overdue commercial debts of the Public Administrations, by providing tax incentive for infrastructure investment and by extending and strengthening government guarantees on credit to SME's and export credit. These actions, partially undertaken just few days ago, will enhance growth and produce positive effects on both the denominator and the numerator of the public finance indicators, thus assuring the respect of the fiscal compact discipline.

Ladies and Gentlemen,

As you know very well, we are facing one of the most impressive convergence processes in the history of world economy. Europe - and Italy within and with Europe - will need to find its place. Major adjustments will be needed. Our Continent's history, wisdom, creativity and dynamism are still second to no other areas in the world. Thus, I believe we are going to make it. Much depends, however, on the next political steps that the European Union will be able to take. Risks are great. But rewards are even greater if we manage to take brave steps towards European political union. The pressure of the global crisis and the challenges raised by emerging economies can help to overcome political resistance, which is still quite powerful.

In the meanwhile we need to build the right framework for growth and stability in the EU. Europe will not be able to achieve its goals of financial stability and fiscal consolidation without taking steps to boost growth and to reduce the macroeconomic and productivity imbalances between Northern and Southern Europe. At present, the financial crisis and the measures taken to foster stability and fiscal consolidation have helped generate recession (particularly in the

peripheral countries), de-industrialization (France and Spain) and growing imbalances (between the North and the South), constraining economic growth to a greater extent than experts and market operators had expected.

It is well known in economic theory that investments in infrastructure innovation, R & D, technology and human capital have a positive (and significant) effect on potential GDP growth. Any debate essentially regards the measurement and size of this effect. In addition to the Keynesian multiplier effect on growth, investment is also one of the key factors for the productivity and the competitiveness of the entire European economy.

While in Europe these investments were once financed directly or indirectly by the public budgets, now increasing recourse must be made, given the constraints of the Fiscal Compact, to private capital and financing. In Europe, the banks have always played a central role in the medium/long-term financing of infrastructures and corporate investments (while in the US this role is played by the capital market). But the European banking system has dramatically slowed down medium and long term lending, at least in Southern Europe. If governments and European banks do not finance enterprises and infrastructure, the economy cannot grow. If the economy does not grow, the public finances will not improve, and Europe risks slipping into a dangerous, vicious circle. While it is true that financial stability and fiscal discipline are the sine qua non for enduring and sustainable growth, it is also true that recession and stagnation undermine financial stability in the long run and make fiscal consolidation efforts unsustainable over time.

Only recently has Europe taken steps on a number of fronts where it should have taken action earlier, such as harmonizing prudential supervision criteria and speeding up the cleaning up of bank balance sheets (EBA rules, banking union and the Liikanen Report). But the new banking and financial regulations, while useful for preventing new crises and ensuring financial stability, threaten at the same time to discourage investment in the real economy and infrastructure and, more generally, to generate pro-cyclical effects.

The European Council of June 2012 established the pillars of a Compact for Growth and Jobs, acknowledging the need to harmonise fiscal rules and support growth. Alongside the renewed commitment to achieve the goals set out in the Europe 2020 agenda, to complete the Single Market for goods, services and energy, to create the Digital Single Market and to reduce bureaucratic and regulatory burdens, a commitment emerged to direct the new Multiannual Financial Framework towards promoting investment for growth, employment, innovation, research, competitiveness and convergence.

But very few concrete measures have been defined thus far. The recapitalization of the EIB could be partially absorbed in strengthening its own capital ratios. The reallocation of the structural funds has run up against significant limits and restrictions. The resources for the Connecting Europe Facility (CEF) have been drastically cut by the European Council. The EU project bonds initiative encounter difficulties and struggling to take off. The emphasis on innovative financial instruments designed to attract private investors and on risk mitigation instruments that create a multiplier effect for financial resources can be appreciated, but is still waiting for effective policies and measures for its implementation.

The time to deliver is now! Moreover, I believe that a European policy for promoting investment for the EU's growth and competitiveness must also act on other fronts, such as for instance:

- 1) the establishment, at least at the European level, of a regulatory framework more favourable for the LTI and more attractive to private investors (CRD IV, Solvency II and so on);
- 2) the development of new sources of public funds for investments in infrastructures (Eurobonds?);
- 3) the creation of other innovative financial instruments and risk mitigation instruments for LTI;

4) the introduction of tax incentives and EU or national guarantees schemes for LTI, and, finally,

5) an extraordinary unconventional intervention by the ECB to counter the liquidity crunch affecting LTI (VLTROs): a kind of new LTRO, but with three significant differences: a longer term, a lower amount and a clear earmarking of the funds for financing LTI (infrastructure and productive investments), accepting the investment projects themselves as collateral, if receiving co-financing from the EIB and if backed by government guarantees (or by a system of guarantees developed jointly by the national development banks and the EIB).

To conclude.

Europe finds itself in the typical Keynesian situation of the so-called “liquidity trap”. It is continuing to focus on supply-side policies (which many countries, Italy included, should have been undertaken decades ago) when the problem is now one of demand. The ECB is aware of this, but it also knows that monetary policy is not enough, especially when interest rates are close to zero and the external constraints of the euro are very strong.

The upcoming European Councils must tackle the issue of effective policies for supporting growth, employment and investment. Sooner or later, it will also be impossible to avoid some basic questions that today appear provocative: does it make economic sense to increase national debts by more than 500 billion euros to finance the European Stability Mechanism (ESM) and to fight a financial speculation which is aimed primarily against the peripheral states because, above all, they are not growing, when one reason they are not growing is too restrictive fiscal policies? Would it not be better to use these resources – may be by issuing Eurobonds - to stimulate the economy or to lower the tax burden? Would it not be more logical to give the ECB the powers of the FED or the Bank of England, allowing it to print money (or threaten to do so) when speculation rears its head too high?

Anyway, we need to increase rapidly the speed of the process of political and fiscal union. Time is running out. We must start to move now.

Thank you for your attention.