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Italy's Economic Policies: In Search of a New Course

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I am delighted to be speaking at this prestigious university. While I am going to discuss the policy program of the Italian government, I would also like to look at the broader context of European economic policies and the Italian role in the European Union.

I will close with a reflection on the role of Italy in searching and promoting a new policy course, both at national and supranational level.

Background

Italy has been badly hit by the latest great recession (2007-2012), with a large drop in GDP (12%) and income per capita that is today still below pre-crisis levels (almost -5%). This has affected both the middle class and the poor, with per capita disposable incomes plunging almost 16%, absolute poverty threatening 8.4% of households, and relative poverty affecting a share almost twice as large. Unemployment has also increased from the 6% level before the crisis to an average level of about 10%, with dramatic increases for the youth and the population of Southern Italy. Public finance conditions have somewhat deteriorated in spite of the efforts toward consolidation and a continuous primary surplus for the past 10 years.

Against this backdrop of negative effects from the double dip recession and lingering structural weaknesses, the Italian economy still exhibits a number of current and potential strengths.

High competitive performance of Italian exports have strengthened the external position of the country, allowing the development of a sizable current account surplus hovering around 2.5% of GDP, in spite of persistent overvaluation of the exchange rate and the negative effects of the crisis.

The financial conditions of the households are also stronger than most other European countries, with private wealth estimated at more than twice national debt, which is itself held domestically for about 60% of its nominal value.

A positive side effect of the crisis is that productivity has been increasing in the manufacturing sector because enhanced competitiveness has pushed many inefficient firms off the market and reduced rents and monopolistic distortions.

The government program is founded on a limited set of measures that try to strike a politically acceptable balance between short and long run goals and the different priorities of the two political parties involved. These measures aim to combine emphasis on social policies with growth and stability, by addressing three major problems: first some pressing social issues on unemployment, inclusiveness and fairness; second, taking steps to improve growth prospects; third, maintaining financial stability by ensuring that social and pro-growth policy are consistent with placing the country's high public debt-to-GDP ratio on a declining path.

The 2019 Budget Law

The budget law, adopted on December 30th, ensures compliance of Italy's 2019 budget with the EU fiscal rules and entails a modest expansionary fiscal stance in the period 2019-21. The budget law sets the objective to achieve a deficit on 2.0 percent for 2019, 1.8 percent for 2020, and 1.5 percent for 2021.

The budget law seeks to achieve a balance between a modest expansionary policy, which has proven timely under the manifest threat of a cycle downturn, and social and investment programs, while ensuring that the debt-to-GDP will decline between 2018 and 2021.

The bulk of the measures focus on active labor policies, poverty reduction and social fairness; also included is a series of policies to boost private and public investment and improve institutional performance and the overall business climate.

The results expected from these measures however have to be interpreted in the framework of high uncertainty characterizing the world economy at this stage and in the context of what Edmund Phelps has recently characterized as a combination of Knightian uncertainty and imperfect information.[1]

Nevertheless, the financial markets have shown a positive reaction to the adoption of the budget law, with the spread on 10-year German government securities lowering from the November-2019 high of over 320 basis points and now hovering below 250 basis points.

I would like to underline that the Italian debt is fully sustainable for several reasons.

First, Italy's private wealth is one of the highest in the world, with asset values estimated at 9 times per capita income, in line with the richest EU countries, but private liabilities at only 62% of disposable income, much below the 100% level of the EU average. Thus, the overall net worth position of the country is solid and signals a resilient and liquid economic system.

Second, as shown also by recent theoretical and empirical analysis, in an environment of interest rates that fall below average growth, debt is only an apparent burden, over-zealous consolidation attempts have proven to be self-defeating and both roll over. Deficit spending for investment purpose may not only be possible, but could be even advisable.

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[1] See Phelps, "The Three Revolutions Economics Needs," *Project Syndicate*, January 23, 2019.

Third, in order to re-establish a climate of confidence and stability in the financial markets, Italy is determined to reduce the debt level continuously and progressively, as shown by its adherence to a continued primary surplus in the past twenty years.

Fourth, the Italian debt presents a time profile, duration structure and average cost that are particularly favorable, concentrated for 72% in long term bonds and an average substitution rate of 6.7 years. Furthermore, the debt is owned 70% by Italian residents.

Finally, in spite of the impending end of the quantitative easing, the average cost of servicing the debt has been decreasing (in 2018, Italy issued 390 billion euros of government securities at an average issuance cost of 1.07 percent) and the credit default swaps and spreads have remained well below the levels prior to Mario Draghi "whatever it takes" policy move.

The Policy Challenges

The key problems of the Italian economy are low growth and weak social outcomes in a business climate dominated by loss of confidence and increasing social and political distress. The latest data available also indicate weaker-than-expected growth as a consequence of the slowdown of the euro area.

The challenge for the present government is to demonstrate both its willingness and ability to perform three crucial tasks: (1) re-launch public investment, (2) design new and effective social inclusion and labor-market policies and (3) reinvigorate market confidence and the business climate.

Re-launching public investment is a key element of the government agenda, but also the greater long run challenge for the entire economy. Public investment as a ratio to GDP has fallen by more than one percentage point of

GDP since 2009, and spending for maintaining existing public infrastructures has also declined.

Many signs indicate that public capital is deteriorating alongside an even more worrisome fall of both the level and the quality of human capital.

Because of the vertical fall in the quantity and quality of public investments, furthermore, intentions to undertake private investment increasingly face the prospect of settlements in backward areas with scarce human capital and insufficient physical and civil infrastructure.

The crucial component of the fall in public investment, on the other hand, is the deterioration of the ability of public administrations to manage investment projects, in their increasing complexity, from the technical-economic planning of works to selection processes, evaluation and monitoring. Beyond the financial resources, and in spite of potential and high returns, public capital tends to decrease because the ability to move from intentions to facts finds a prohibitive limit in the human and social resources necessary for the realization of quality investments.

The institutional weakness and the declining of the planning abilities of the Public Administration are therefore a vicious circle that involves a continuous sabotage of the realization of plans and projects. In addition to this, the constant reference to the emergency on public budgets generates a form of economic myopia that considers investment irrelevant to boost growth in the short term because their long implementation time. This also fuels the idea that since Italy needs to grow immediately, the immobilization of resources awaiting distant benefits in the future must have lower priority than current spending measures that provide immediate results.

Although volatile and apparently attentive to the short term, financial markets are the place where assessments of future benefits are discounted and transformed into present expectations and values. Contrary to what some short-term balance sheet supervisors argue, increasing spreads are above all a reflection of negative investor sentiment with respect to our country's growth prospects and its ability to nurture them by making long-term allocative choices.

These expectations reflect on an increasing lack of human capital and result in a loss of dynamism that reverberates through lower investment, innovation and creativity of both public and private sectors. To counter these expectations, economic policy has the responsibility to reverse the process of the deterioration of public capital that has serious consequences on productivity and on the long-term credibility of the Italian system. This can only be achieved with wide-ranging action to boost public investment that persuades the markets of the future sustainability of the country's economy.

The Challenge of Investment and Innovation in EU

While suffering from some specific and acute lack of dynamism, Italy shares the main characteristics of a more general crisis affecting investment and innovation in Europe.

Conflicts of interest between credit and the choice of investment projects is a crucial element in the relationship between banks and enterprises in the "bank-centered" system prevailing today within the European Union and, under the current circumstances, take on a particular relevance.

The intensity of the conflicts of interest and the relative magnitude of the related costs, however, are not the same for all sectors and / or types of business. The most innovative firms with the highest growth rates are penalized more often because both the fear of failure and accelerated Schumpeterian creative destruction can be stronger among the banks and the other debtholders. Firms in mature industries, with more stable production and with fewer opportunities to innovate tend thus to be preferred by creditors. They tend to obtain credit on better terms and to have higher debt.

Not only is this strategy a recipe for a long run disastrous loss in the (many) technological races, it also makes the European countries more vulnerable to the downturns of the economic cycle. In a recession, in fact, companies operating in mature industries are more subject to the effects of demand contraction. Car manufacturing companies, for example, are the first to suffer in times of slowdown or reversal of growth and the vulnerability is high with respect to reductions or delays in strategic purchases by consumers.

Where Europe is Going and the Role that Italy Should Play

The European Dream, interpreted as the vision of federal Europe united and integrated in all its diverse and conflicting components, goes back to Charles the Great and has never abandoned the collective unconscious since then. The treaty of Rome and the alternate sorts of European integration in the past 60 years seem to many a slow, but progressive realization of a workable model of the European vision.

More recently, however, Brexit, other setbacks and a general disillusionment on the great and progressive fate of an integrated Europe have seemed to prevail.

In order to define the Italian role in the EU we must consider three main elements of the surge and the possible demise of the European Dream: (1) the perceived importance of globalization for growth, and the fear of the new vulnerabilities induced by global interdependence; (2) the need for something broader than national efforts to achieve the goals of economic development, but also the reshaping of regional and national priorities within a more flexible and dynamic European model; (3) the growing importance of multilateralism to achieve national and mutually compatible targets, but also the disappointment and ineffectiveness of multilateral and supranational institutions and the surge of a new bilateralism.

Within the EU, the Euro area countries are also the primary targets of new policy opportunities where Italy can play an important role as promoter and mediator across interests that may converge only in the long term and only if the policies are the right ones.

As a yet (rather) imperfect currency union, lack of flexibility and coordination across economic policies is the main cause of the economic divergence of member countries, and the primary reason why Europe at the same time is negatively affected and, at the same time, fuels global imbalances. The model of export led growth, which has seen several revivals and is affected by some of the same fallacies of composition of the old mercantilist illusions, is still being pursued by several countries, both within and outside Europe.

As a growth model, while external surpluses can lead the growth of a country's economy for a limited period of time, the export led model is clearly not tenable in the long run unless it is balanced by a sufficient increase, both cyclical and structural, of domestic demand. This message is being spread by multilateral institutions, including the WTO, and is being gradually absorbed even by economies like China, that have founded their development fortunes on an explosive foreign exchange account.

In the current economic landscape, a development model based on managing short term surpluses in merchandise trade also risks to lose the more important competitive challenge of the production and exchange of intangibles, especially in disembodied technologies and more generally in the capability to produce and trade innovation.

In Europe, a major policy challenge is to re-balance the response to external demand with measures to fuel both domestic supply and demand, by encouraging dynamism and promoting endogenous technological progress.

The model pursued by the German export led growth therefore appears to be at the root of the lack of convergence and the loss of dynamism across the European regions.

In the case of Italy, it exacerbates the distance between the Northern and the Southern part of the country and tends to fuel public debt in support of the dependent regions. It may also condemn the country to follow a declining model of growth based on mature products with little market prospects in terms of competitiveness and innovation.

A new course of economic policy across Europe and European institutions is thus necessary to escape the failing export led mechanism based on mature products and the neglect of innovation and services. This mechanism should be recognized as a form of a high income trap, which fuels global imbalances within and outside the EU and stifles innovation and dynamism.

Addressing this challenge requires institutional imagination, coordination across member countries, but also new policy powers for the European institutions. Here, again, by virtue of its intermediate position in power, dual growth model (export led in the North and lagging behind in the South), and political stance, Italy should play a key role of innovator and, at the same time of mediator to find new, more sustainable and equitable solutions.

Searching for the New Policy Course

As in the broader case of globalization, the European Union has embarked in an internally contradictory course, which proposes a way to organize society, where economic rules are increasingly beyond the control of national governments, while political and social policies remain national.

The main consequence of this approach is that the effects of the single market and the hard and soft budget rules on income distribution and social security are not balanced by adequate integration of welfare and fiscal policies.

In spite of the large gains from trade and scale economies, in fact, the re-distributive effects of the single market are huge. Even though in principle winners may compensate the losers, the sheer size of the gains and the losses, in addition to the practical difficulties and costs entailed by redistributive measures, have caused divergence across member states and regions.

A major new round of EU deepening is thus necessary, aimed at re-launching convergence and mutualism across member countries, by pursuing sustainability, inclusion and shared prosperity. These public goods appear to be challenged, and in many cases threatened by globalized trends. Their provision can only be addressed at the EU level by a joint fiscal and welfare policy with sufficient resources and authority.

An integrated welfare system and social protection network should be the object of a major effort at the EU level. This effort should address the race to the bottom in labor standards and other forms of international arbitrage aimed to gain competitive advantages by avoiding social responsibilities through global networks.

Promoting investments in human capital of a scale and scope adequate to correspond to these needs is thus a crucial European policy. This should be done by offering opportunities for education and upgrading labor skills in the framework of an enlarged and enhanced European budget—a framework capable of providing an alternative to the invoking of fragmented national interests.

Overcoming the insidious divergence across member countries and income groups requires that EU launches an investment program of a sufficient scale to be transformative, rather than marginal, as most attempts have been so far, including the partially successful Juncker plan. This program would require adequate financing, which cannot be done without the introduction of effective mutualistic principles of risk as well as benefit sharing across member countries, and the backing of ECB.

Last, but not least, the EU needs to respond to the demand for a reversal of the uncertainty, lack of information and security, in a society dominated by systemic risk and destabilizing trends, where most certainties of the past, from job security to social nets have been waning or disappearing altogether and risks can only be confronted with actions coordinated and deployed on the same global scale. A clear example of areas where an integrated response is needed is the treatment of the immigration emergency, but other areas, such as defense and terrorism, that also concern security are also crucial to be able to deal with global threats.

More generally, higher risks imply a fall in the worldwide investment rate, which reverberates negatively on economic growth and employment, further exacerbating the feeling of insecurity and the loss of confidence in the future. This calls for the need to find resources and finance investment projects at the global level, by using not only enhanced EU institutions, but also existing multinationals, private financial investors, and through new global institutions. A major task of a strengthened EU investment policy is to govern globalization by using a series of fiscal and financial instruments, including global taxes.

In sum, the Italian role to find and promote a new political course as an active EU member is based on the important idea that citizens' and market trust needs to be re-established, in Italy, in Europe and globally, not only by tackling the causes of its decline, but also by providing new reasons for confidence in the world and in its future. This again calls for institutional building at the transnational scale and underlines the interdependence of structure and agency for the success of modern society. In the words of Edmund Phelps, "I personally hold that the classical spirit of challenge and self-discovery is a fundamental human trait. By showing how the risk-taking activity of individuals contributes to social benefits, economics helps societies to accommodate what Augustine called our 'restlessness of heart.' This is the better part of our human nature. Societies that suppress this restlessness stagnate and die. The issue of morality in economics is neither the fairness of income distribution nor the stability of financial systems. It is how human institutions can be shaped to correspond to human nature—to man's nature as an innovator." [2]

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[2] See Phelps, "Economic Justice and the Spirit of Innovation," *First Things,* October 2009.

* Giovanni Tria, Italy's Minister of Economy and Finance since June of 2018, has had a long career. He received his degree in Law from University of Rome "La Sapienza," in 1971, then took a series of academic posts ending up a professor in the Faculty of Economics, University of Rome "Tor Vergata" and Dean of the Faculty in 2017. He has held many positions in the course of his more than 40 years as an expert on economic development, business cycles and growth, public investment assessment and project evaluation, and the role of the governance of institutions in the growth process. He has also contributed over many years to the newspaper *Il Foglio* and recently he edited with Giovanni Valotti the 2012 volume *Reforming the Public Sector.*

As every observer of economic developments in Europe knows, Minister Tria is a central figure in the discussion of the social and economic ills in Europe and the debate over improvements in economic policy.