CHATHAM HOUSE

briefing paper

Breaking the Vicious Circle: Restoring Economic Growth and Flexibility in Italy

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Summary points

- As Europe slowly emerges from its economic crisis, Italy remains in recessionary mode. This poses a problem for EMU as a whole, given that Italy is its third largest economy and has the largest public debt.
- The current malaise of the Italian economy is a story of high economic potential that has been wasted. Over the last decade its performance has trailed behind that of France and Germany.
- Italy is trapped in a vicious circle that links sluggish growth with high public debt, fiscal tightness and difficult credit conditions. The crisis is therefore not only a matter of public finances; it has spilled from the macro level to the micro level, affecting firms and households.
- Exports are one of the main drivers of Italy's growth, but relatively low labour productivity and structural problems, such as a disproportionate number of small firms and a low level of R&D activities and investment, are affecting competitiveness.
- The government urgently needs to devise and implement policies to restore competitiveness and growth. Structural reforms should be supported by short-term measures aimed at boosting growth, creating new jobs and increasing credit provision.

Introduction

Europe is slowly emerging from the economic crisis from which it has suffered since 2009. In the last three years policies have been focused on fiscal consolidation and emergency measures to avoid the break-up of the Economic and Monetary Union (EMU). This, however, has not prevented some countries, in particular those in southern Europe, from descending into a deep and prolonged recession. Five years after the onset of the global financial crisis, prospects for growth remain sluggish, especially in the euro area.

In such a context, Italy is one of the most problematic countries, having been affected by a double-dip recession. Recent estimates reveal that prospects for economic growth remain disappointing (OECD 2013). In this paper we argue that Italy's difficulties in responding to shocks and moving swiftly out of recession result from years of inappropriate policies which have reduced fiscal space and flexibility in the whole economy. Italy's current malaise is a story of high economic potential that has been wasted. After the '*miracolo economico*' of the 1960s and years of sustained growth in the 1970s and 1980s, policies were aimed at getting short-term political consensus, with the consequence that excessive public spending was tolerated or even encouraged. While economic growth slowed, the size of the public debt expanded. Competitive devaluations through the 1980s and in the 1990s before Italy joined the European single currency masked structural problems and Italy's inability to keep up with the opening of the world economy. Loss of competitiveness thus constrained economic growth. In addition, fiscal policies were focused on nominally fulfilling the targets set by the European institutions rather than creating the required fiscal space to allow counter-cyclical policies during a crisis, especially as monetary policy was no longer an independent instrument for EMU member states.

As a result, during the years that followed the global financial crisis Italy faced both a collapse in the growth of its gross domestic product (GDP) and a deteriorating fiscal position (both deficit and debt) – even if the stimulus package implemented in February 2009 was much smaller than those of other countries. Italy let automatic stabilizers work, but their effect seemed to be reduced because of the measures implemented to lower the budget deficit without allowing any discretionary spending.[1]

Will Italy be able to break the current deadlock and respond flexibly to the adjustments necessary to remain in EMU? One way forward would be to adopt a comprehensive series of supply-side reforms, that typically have a more lagged impact, together with some short- to medium-term measures to support demand. Policy measures need to be designed within a consistent policy framework and a coherent sequence, and should be aimed at creating greater flexibility to overcome the policy constraints that are typical of EMU and to respond to exogenous shocks when they occur.

This paper starts by outlining the long-term performance of the Italian economy. Its structural rigidities are highlighted by the breakdown of the main components of its GDP and a comparison with those of France and Germany, in particular the private sector (firms and households), the external sector and the issue of productivity and labour costs. In the last section, we recommend some steps the country could take in order to break the current deadlock.

From the 1970s to the latest crisis: a long-term perspective

The long-term trend of Italian growth: a disappointing performance

Why did Italy remain stuck in a decade of sluggish growth and why has it responded poorly to the global financial crisis, with a double-dip recession? This section compares the country's long-term growth performance with those of France and Germany, as all three countries are relatively similar in size, structure and diversification of production and exports (Felipe and Kumar 2011).

1 In February 2009 the Italian government approved a €2 billion stimulus package including incentives to buy new cars and home appliances. A comparative analysis conducted on all the EU countries by Saha and von Weizsäcker (2009) showed that the overall size of expansionary measures in Italy was negative, with a €0.26 billion decrease in public spending, amounting to -0.02% of GDP. By contrast, Germany's additional fiscal spending amounted to €39.33 billion and accounted for 1.55% of GDP, while France's stimulus consisted of an extra €16.90 billion, corresponding to 0.8% of GDP.

Table 1: Average real GDP growth, 1970–2011 (%)

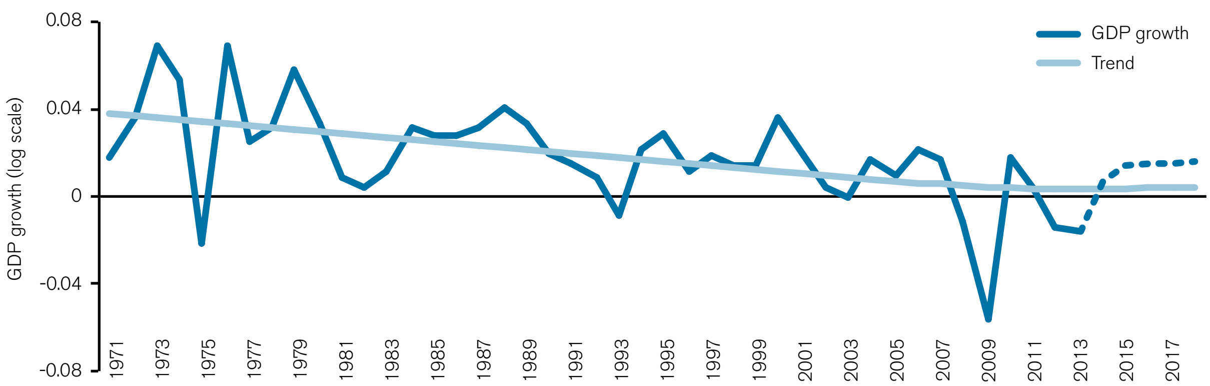
Country	1971–1980	1981–1990	1991–1995	1996–2000	2001–2005	2006–2010
Italy	3.8	2.4	1.3	1.9	0.9	-0.1
France	3.7	2.3	1.2	2.7	1.6	0.6
Germany	2.9	2.3	2.0	1.8	0.6	1.4

Source: OECD.

Despite a 2% contraction in 1976 in the aftermath of the first oil crisis, in the 1970s and 1980s the Italian economy enjoyed strong and sustained growth, in some cases higher than in the other two countries. But it began to be sluggish in the first half of the 1990s (Table 1). Italy's growth rate was again similar to that of Germany between 2001 and 2005 when the latter was dubbed 'the sick man of Europe'[2] as it underwent structural reforms (Krebs and Scheffel 2013). Between 2006 and 2010 Italy's growth rate fell sharply and even became negative, while that of France dropped to an average of 0.6%. On the other hand, Germany's growth rate picked up on the back of reforms and wage restraint.

We calculated the long-term GDP growth trend for the three countries for the period 1970–2017.[3] The econometric regressions show a downward trend which reflects the diminishing marginal returns to capital that are normally observed in the long run (Barro 1998). What is striking about Italy is that the trend approached zero in the immediate aftermath of the 2008 crisis and is expected to remain flat and close to zero in the coming years (Figure 1). France and Germany seem to have responded better to the financial crisis and present better growth prospects in the medium term (Figures 2 and 3).[4] Far from projecting growth rates, this stylization suggests

Figure 1: Italy's long-term GDP growth trend, 1970–2017*



*2013–17: projections.
Sources: OECD, IMF, authors' calculations.

2 *The Economist* called Germany 'the sick man of the Euro' in an article published in 1999 that portrayed a difficult economic situation characterized by sluggish growth, a slowdown in private consumption and high unemployment. See http://www.economist.com/node/209559.

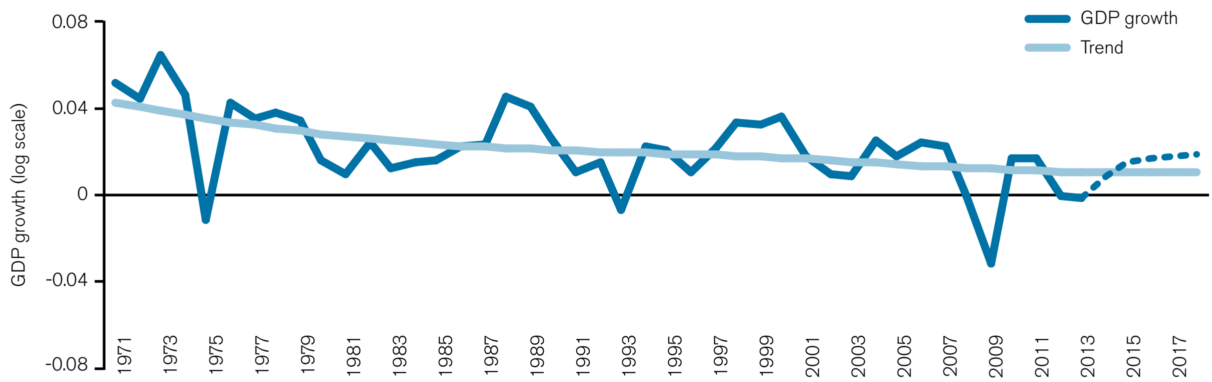
3 The long-term GDP growth trend was calculated using data measured in log scale and after including a moving-average filter of three years. The moving-average technique was adopted in order to reduce the 'noise' of the residuals in the last years of the sample, since the variability observed in these years spell is much higher than in the rest of the period covered. Projections for the period 2013–17 are taken from the latest IMF forecast.

4 Potential GDP is defined by the OECD as the level of output that an economy can produce at a constant inflation rate. This is just an illustration, as future growth does not entirely depend on past performance.

that a bigger effort is needed to push Italy's GDP growth than is the case for Germany and France.

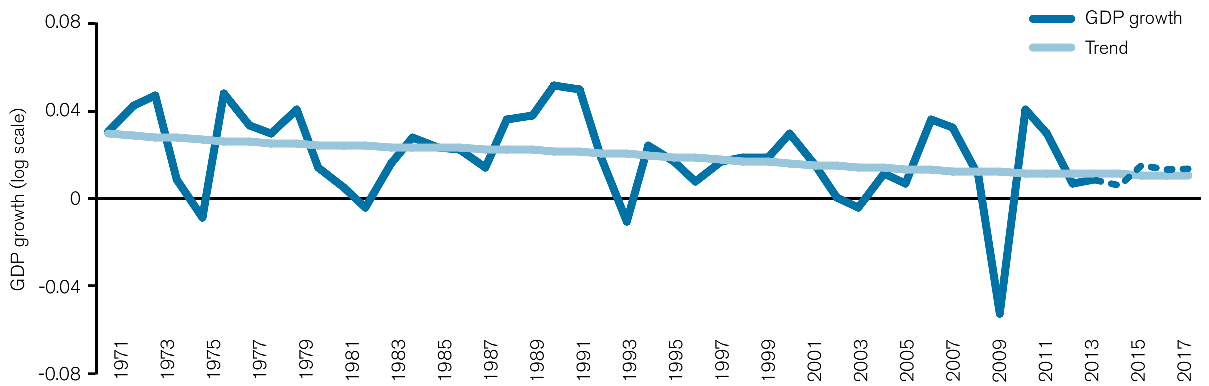
The breakdown of Italy's GDP (Table 2) shows that between 2003 and 2008 its gross fixed capital formation and private and public consumption grew at a higher rate than Germany's, but they shrank after 2008. Indeed public spending was one of the main drivers of Italy's growth in the early 2000s (+4.1% between 2003 and 2008).

Figure 2: France's long-term GDP growth trend, 1970–2017*



*2013–17: projections.
Sources: OECD, IMF, authors' calculations.

Figure 3: Germany's long-term GDP growth trend, 1970–2017*



*2013–17: projections.
Sources: OECD, IMF, authors' calculations.

Table 2: GDP nominal components, 2003–14 (average % change)*

	Gross capital formation		**Public consumption**		**Private consumption**		**Net trade (€bn)****			
	2003–08	2009–14	2003–08	2009–14	2003–08	2009–14	2003	2008	2012	2014
Italy	3.2	-3.0	4.1	-0.6	3.4	-0.5	1.6	-13.0	11.2	38.8
France	6.5	-0.8	3.7	2.1	4.0	1.2	-6.0	-68.4	-81.4	-93.6
Germany	2.7	0.6	1.6	2.6	1.9	1.8	129.9	177.5	186.5	200.6

Sources: IMF *2013–14: forecasts; **AMECO Database (2014: forecasts).

IMF calculations show that real GDP stayed above its potential from 2001 until the start of the 2008 crisis; it then suddenly reversed and it is expected to remain below its potential at least until 2017 (Table 3). After a -2.4% recession in 2012 (Bank of Italy 2013b), forecasts for real GDP growth show a 1.5% drop in 2013 and a modest 0.5% increase in 2014.[5] These rates are consistently below the average for the euro area (Table 3). Nevertheless, according to forecasts from the Italian Ministry of Economy and Finance (MEF), the recently implemented reforms[6] should bring about an additional cumulative growth of 1.6% by 2015 and 3.9% by 2020. This would mean a rate of potential growth one percentage point higher than would be the case without any reform (MEF 2013).[7]

Table 3: GDP growth, Italy, France, Germany, euro area and European Union, 2013–18 (% values)*

	2013	2014	2015	2016	2017	2018
Italy	-1.5	0.5	1.2	1.4	1.4	1.2
France	-0.1	0.9	1.5	1.7	1.8	1.9
Germany	0.6	1.5	1.3	1.3	1.3	1.2
Euro area	-0.3	1.1	1.4	1.6	1.6	1.6
European Union	0.0	1.3	1.7	1.8	1.9	2.0

Source: IMF *2013–18: forecasts.

The deterioration of Italy's fiscal position: a stumbling block during crises

At the heart of the current situation are policy choices that were made many years ago and proved to be unsustainable in the long run. Policies were driven more by short-term political pressures than by forward-looking considerations. In 1986, for instance, the central government public expenditure-to-GDP ratio rose to over 50% (at the beginning of the 1970s it was 32.7% – MEF 2010) and between 1980 and 1994, the public debt-to-GDP ratio more than doubled, from 60% to 121% (Bank of Italy 2013b). This triggered a progressive deterioration of macroeconomic indicators, which resulted in the narrowing of fiscal space and of Italy's ability to respond to shocks.

‘At the heart of the current situation are policy choices that were made many years ago and proved to be unsustainable in the long run’

The outcome of two crises, in 1992–93 and 2008–09, illustrates this point (Figure 4). In the first case, the response was strong and fast, partly because of the different nature of the crisis which implied a strong devaluation of the Italian lira,[8] but mainly because both policy instruments, monetary and fiscal, were available to domestic policymakers and offered a way out of recession in the short run.[9] In 2008–09 the domestic authorities had less room for manoeuvre. Monetary policy was by then in the hands of the European Central Bank (ECB) and the use of fiscal policy was limited. Inappropriate and often reckless policies in the previous two decades had contributed to the narrowing of the fiscal space, which was further constrained by the parameters imposed by EMU membership.

5 The IMF forecasts released in July 2013 after the Article IV Consultation showed the Italian economy would shrink by 1.7% in 2013 and grow by 0.7% in 2014.

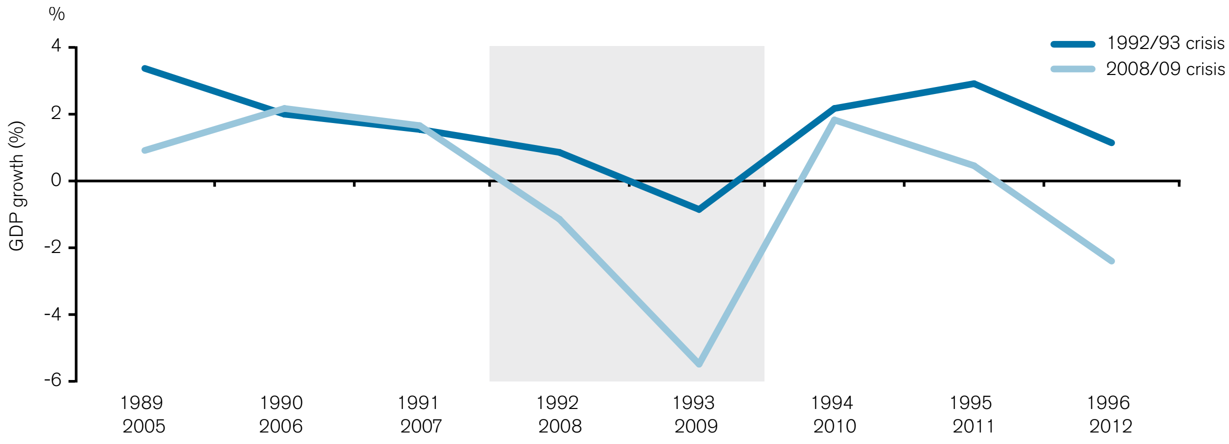
6 In January and July 2012 the ‘technocratic’ Monti government implemented a series of product market and labour market reforms that should help increase competitiveness and growth in the medium term. These include a liberalization package in the services and public sector, and measures aimed at encouraging more stable employment relationships and youth participation in the labour market, while also lowering the costs of dismissal.

7 We also calculated potential Italian GDP using OECD data until 2012 and IMF projections until 2017, to be consistent with the previous estimates. This methodology, although correct, is not as accurate as that used by the Italian Ministry of Economics and Finance owing to limited data availability. The figures we obtained seem consistent with estimates for the output gap contained in the IMF's latest *World Economic Outlook* (IMF 2013).

8 The 1992–93 crisis followed a decade characterized by high public spending and soaring inflation. The 2008–09 crisis was triggered by the global financial crisis (Rossi 2010).

9 In September 1992 Italy was forced to abandon the European Monetary System after a speculative attack was launched against the lira. Tensions in European financial markets, in the wake of the rejection of the Treaty of Maastricht in a Danish referendum, made a devaluation of the Italian currency inevitable. The loss of value of the lira against the German mark peaked at 50%, before a stable exchange rate was restored by 1995.

Figure 4: Italy's GDP growth performance during the economic crises of 1992–03 and 2008–09 (%)



Source OECD, authors' calculations.

Loose fiscal policies and considerably slower GDP growth in the pre-EMU years contributed to the increase in public debt – to well above the threshold indicated by the Maastricht Treaty (Table 4). In only four of the years since the Maastricht Treaty came into force in 1994 was the debt-to-GDP ratio on a downturn trend – towards the target of 60% – before rising again (AMECO 2013). Despite historically low interest rates, the high cost of servicing public debt coupled with recession are currently seriously hindering attempts to reduce Italy's debt-to-GDP ratio below 120%.

Table 4: Italy's economic performance before the economic crises of 1992–93 and 2008–09 (%)

Period	Annual GDP growth*	Average debt/ GDP ratio*	Average deficit/ GDP ratio**	Average government bond yields – 10 years maturity**	Annual inflation rate**
1987–1992	2.5	92.5	-11.2	12.4	5.6
2003–08	0.9	96.9	-3.1	4.1	2.5

Sources: *OECD; **Eurostat.

Analysing the crisis

Uncertain times for households

Italian households have reduced their consumption since the beginning of the crisis. In 2008 and 2009 the drop in their total expenditure was respectively 0.8% and 1.6%, and in 2012 private consumption fell even more sharply – by 4.3%, according to the latest data released by ISTAT (2013).[10] This has been amplified by a constant erosion of purchasing power. On average this has contracted annually by 1.9% since 2008, falling to a record negative of -4.8% (ISTAT 2012) because of rising inflation (3.5% in 2012, according to the Bank of Italy 2013d) and a concomitant drop in real salaries by -4.4% in 2012 (ISTAT 2012). This has constrained consumption and has increased the economic vulnerability of Italian households. Also the level of net savings has been steadily eroded during the last decade; they are now below the average of the euro area (OECD 2013).[11] The household savings rate dropped from 23.8% of disposable gross income in 1991 to a meagre 9.7% in 2010 (Bank of Italy 2013b).

10 The average annual change in private consumption was -1.02% between 2008 and 2012 (ISTAT 2013).

11 Dissaving is also due to changes in the demographic structure. The increase in the number of elderly people raises the likelihood of a reduction in the savings rate. Italy's old-age index (measured as the ratio between the number of people above the age of 65 and those below the age of 15) increased from 96.6 in 1991 to 148.7 in 2011 (ISTAT 2012).

A disaggregated analysis shows that the highest reductions in the level of savings have been observed in young households (under 35) living in rented accommodation. Financial fragility has been amplified by the doubling in the proportion of indebted households, from 11% in 2005 (ECB) to 22% in 2010 (Bank of Italy 2013b). Moreover, the decline in disposable income and the credit crunch, which negatively affected both households and firms (Bank of Italy 2013b), are further signals of the weakening financial conditions. The intergenerational sustainability of the financial system is called into question by the fact that the young cohorts and the lower-income households seem to be the most heavily affected. However, despite the overall decline in households' wealth, in general terms their financial position is still sound. This is one reason why the economic system has been able to absorb some of the worst consequences of the crisis so far.

Too many micro and small enterprises?

Italy's manufacturing sector is also going through a deep crisis. Industrial production declined constantly for 20 months from September 2011. In April 2013 it dropped by 0.3% relative to March 2013 and by 4.6% on a year-on-year basis (ISTAT 2013). The performance of industrial production completely offset the partial recovery in 2010 and in the first part of 2011 (by +6.7% and +0.1% respectively).

The Italian manufacturing system is affected by structural problems, particularly with regard to the average size of its firms. In the manufacturing sector 66% of Italian firms are classified as micro or small,[12] as opposed to only 31% in Germany (and 49% in the euro area), while in the services sector the percentage goes up to 70%, versus 48% in Germany (and 53% in the euro area). Micro firms contribute to around 50% of total value added, and more than 50% of employees in the service and construction sectors (De Mitri et al. 2013).

While micro, small and medium-sized enterprises (SMEs) are more dynamic, flexible and able to specialize and organize in so-called industrial clusters than bigger firms, their size also hinders their ability to respond to the challenges posed by economic globalization. Indeed many Italian firms are undercapitalized, often because of their size (Guerrieri and Esposito 2012) and are thus unable to invest on a regular basis, for example in R&D activities; in 2010 almost 40% of micro enterprises did not invest at all, according to the Bank of Italy (2013c). Data from the Bank of Italy (2013c) also show that the 30% differential in R&D investments between Italian and German firms is due to the much lower percentage of German SMEs in terms of the total. Moreover, globally competitive firms tend to be bigger and concentrated in specific sectors, while an excessive level of fragmentation among firms in other sectors prevents them from achieving a sufficient degree of competitiveness. In addition, since the global financial crisis many SMEs have found it difficult to obtain credit. This is reflected in a 5.3% contraction of loans to firms, especially to the smaller ones, between February 2012 and February 2013 (Bank of Italy 2013c). The lack of capital available to firms is also reflected in the low level of foreign direct investments (FDI) flowing into the country, which fell dramatically in 2012 as a result of the increased political and economic uncertainty (UNCTAD 2013).[13]

The size of Italian firms also affects the performance of exports. Despite the overall positive performance in external trade – the country is currently running a trade surplus that accounts for an additional 1.3% of GDP, although this reflects a significant drop in imports (MEF 2013) – global market shares held by Italy in its main export sectors are generally lower than those of France, Germany and in some cases even Spain. Italy's top five sectors include textiles, chemicals, metal products, machinery and equipment, and means of transport (ICE

12 The European Commission defines the size of enterprises according to the number of employees: a firm with fewer than 10 employees is defined as micro; one with between 10 and 49 employees as small; and one with between 50 and 249 employees as medium-sized.

13 FDI inflows fell dramatically from US$34.3bn in 2011 to US$9.6bn in 2012. Moreover, the stock of FDI flowing into Italy is equivalent to US$357bn, a much lower level than for the UK (US$1,321bn), France (US$1,095bn), Germany (US$716bn) and even Spain (US$666bn) (UNCTAD 2013).

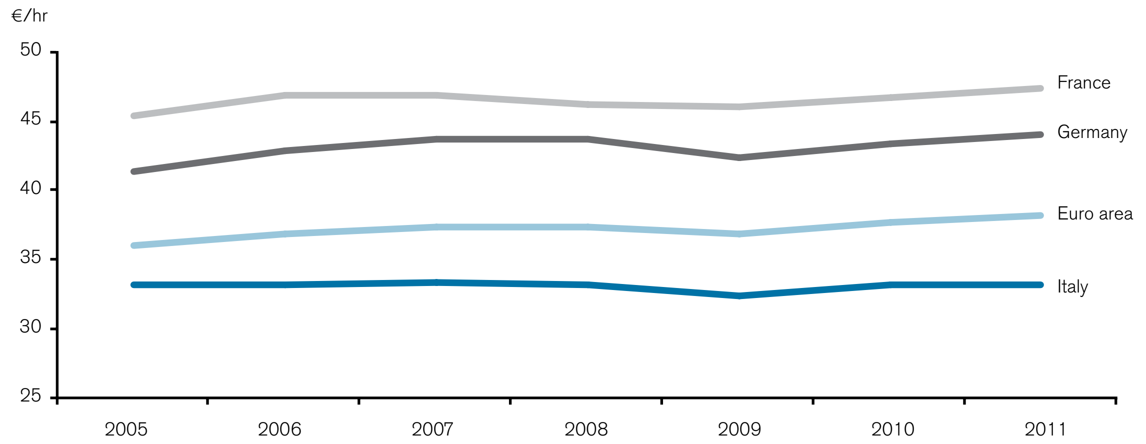
and OECD 2013). Exports in these sectors are also underweighted by comparison with domestic GDP in Italy and the other three countries, apart from in the machinery and equipment sector.[14]

Italy and Germany share a similar production structure, having respectively the first and second most diversified industrial economies in the world (Felipe and Kumar 2011).[15] Yet Italian firms lag behind German ones in terms of competitiveness. As a result Italy's share of global exports is much smaller than Germany's. A 'dimensional threshold' seems to prevent Italian SMEs from being fully competitive at the international level. Moreover, comparison with German firms suggests that the latter managed to internationalize more effectively. Indeed in the past 15 years the degree of openness in the German economy has almost doubled, from 19% to 38%. Germany has also deepened its integration with countries producing intermediate products and components, so as to increase international diversification and outsourcing of production, taking full advantage of the globalization process (Guerrieri 2012).

Raising productivity and the labour market: lessons from Germany?

Low productivity is another major cause of Italy's low competitiveness. In the pre-EMU years competitive devaluations helped avoid the implementation of politically difficult structural reforms to improve the productivity of the domestic labour market. As a result labour productivity growth has been low for the past 20 years, averaging an annual rate of 0.9% (Cipollone 2012). In particular, between 2005 and 2011 Italy's real labour productivity was the weakest among the main European countries, below the euro area average (Figure 5). During the same period labour market rigidities also constrained adjustments and resulted in unit labour costs that are approximately 10% higher than the euro area average, and as much as 25% higher than in Germany (OECD 2013). Multi-factor productivity, calculated as the difference between the rate of change of total output and the rate of change of total inputs (also taking into account the stock of capital), recorded negative growth overall in the period 2005–10 (-0.45%, according to the OECD).

Figure 5: Real labour productivity per hour worked, 2005–11 (€)



Source: Eurostat.

14 To calculate the weight of each of these sectors on GDP we derived the absolute values of exports for each of the four countries in 2011 (latest data available, UN Nations Comtrade Statistics Division) and divided them by GDP values at constant prices (AMECO 2011 Database). Our findings show that only in machinery products does Italy's GDP have a higher proportion of exports than the other three countries – at 4.81% (for France it is 4.48%, for Germany 3.43%).

15 On average, between 2001 and 2007, Italy exported 2,241 products with revealed comparative advantage (Felipe and Kumar 2011).

There are many ways to boost productivity. A flexible labour market in terms of adjustment in real wages is a lever for economies with fixed exchange rates, including those in the euro area. In the 2000s in Germany, effective labour market reforms helped turn the 'sick man of Europe' into a success story featuring a reduction in unemployment and increased productivity (Krebs and Scheffel 2013). The policies implemented between 2003 and 2005 through the creation of 'short-time contracts' (Roxburgh and Mischke 2011) had the advantage of maintaining skills in the labour market and reducing the unemployment rate from 11.3% in 2005 to 5.5% in 2012 (AMECO). Between 2005 and 2010 unit labour costs in real terms were capped, thereby creating internal deflation that resulted in a more competitive real exchange rate.

Wage moderation has recently been introduced in Italy with the 'freezing' of collective bargaining. It remains unclear whether this strategy would be effective in enhancing global competitiveness, especially if it is mainly implemented in non-tradable sectors such as public administration, where nominal wages fell by 1.3% (Bank of Italy 2013b). In addition, the labour market reforms adopted by the government of Mario Monti in 2012 introduced an adjustment mechanism that aims to establish a link between wages and productivity. It is not yet certain, however, how this will work in practice (OECD 2013). The Monti reform also aims at increasing flexibility in terms of entry into and exit from the job market while reducing the cost of individual dismissals and promoting apprenticeships, training and more permanent contracts for young workers through tax incentives. As the German case shows, a higher degree of flexibility would also help retain experienced workers and therefore skills (Schindler 2013). However, the impact of this reform on GDP growth is relatively modest[16] since it seems to mainly address labour supply; further measures to boost labour demand and job creation are needed (Lusinyian and Muir 2013).

What's next?

As recently stated by Ignazio Visco, Governor of the Bank of Italy, the country is caught in an economic vicious circle of reduced purchasing power, sluggish domestic demand and low productivity growth, where public debt, credit conditions and the outlook for the real economy are intertwined (Bank of Italy 2013a). The crisis was first manifest at the macro level and was then felt at the micro level, in terms of the declining competitiveness of businesses and contraction of private consumption, but also of challenges for the financial stability of young and lower-income households.

This situation is the outcome of the 2008–09 crisis, but has been exacerbated by almost two 'lost decades' of economic growth. Choosing the right policies at the right time would have helped Italy maintain fiscal space, boost potential growth and live with and within the euro. It would have also allowed more flexibility to respond to crises.

Fortunately, Italy's public finances have recently improved, and it was able to exit the European Commission's Excessive Deficit Procedure (EDP) in May 2013. In principle this would allow Italy to spend an additional €12 billion without the risk of going above the deficit-to-GDP threshold of 3% and to implement measures that could support growth in the short to medium term. Moreover, in July 2013 the European Commission allowed countries released from the EDP to deviate temporarily from their pattern of fiscal adjustment in order to increase growth-enhancing investments. These circumstances open a small window of opportunity that Italy must not waste. It is therefore critical that policy-makers implement a road map of policy measures to sequence them according to their intensity and impact in the short, medium and long term.

Policies to support growth in the near future should be aimed at restoring confidence in households and should therefore help private consumption. A short-term stimulus for domestic consumption would be needed, such as a temporary reduction of VAT on durable consumer goods, which are more price-elastic than non-durables. The current government[17] was

16 IMF estimates forecast a positive but relatively small impact on output from labour market reforms. In the long run, real GDP is expected to increase by an additional 1.8%, with most of the increase driven by the reforms that boost labour supply, particularly through higher female participation (Lusinyian and Muir 2013).

17 At the end of April 2013, two months after the parliamentary elections, the two main parties, the Democratic Party (PD) and the People of Freedom Party (PDL), formed a coalition government, with Enrico Letta (PD) as the prime minister.

supposed to increase VAT from 21% to 22%[18] on many categories of consumer goods, as previously planned by the Monti government, but then decided to freeze the increase until September.[19] We suggest it should go in the opposite direction, on the assumption that the loss of VAT revenues should be limited given the collapse of private consumption (Table 2). The trade association Confcommercio estimated an annual loss of fiscal revenue of about €135 per household if the planned increase in VAT eventually goes ahead (Confcommercio 2013).[20]

> ‘According to the Global Competitiveness Index, Italy currently ranks 42nd out of 144 countries, well behind Germany (6th) and France (21st)’

Coordinated measures with the ECB should be implemented in order to ease the constraints on credit provision. As suggested by the OECD, the ECB should act more boldly and complement the cutting of the interest rate in May 2013 (down to a historic low of 0.5%) by reducing the deposit rate to below zero. This could ease the credit squeeze and encourage banks in crisis countries to lend more, offering an important relief to firms constrained by tight financial conditions.

Fiscal consolidation should be continued, especially in view of a change in the current monetary policy stance, as the US Federal Reserve recently indicated.[21] For instance, a follow-up of the spending review carried out in 2012 by the Monti government would entail further cuts in unproductive public expenditure.

As the debt-to-GDP ratio needs to fall at least below 120% to be considered sustainable, it is crucial that GDP starts growing again, while the debt stock contracts.[22] Nevertheless, this process is not going to be straightforward. According to the MEF, Italy’s debt-to-GDP ratio would stabilize in 2013 at 126.5% and is expected to start decreasing to 125.2% in 2014, but estimates by the European Commission have been revised to 132.2% of GDP in 2014 (AMECO 2013).

This policy mix needs to be complemented with comprehensive and effective structural reforms, mainly in product and labour markets, which are typically expected to have an impact in the long run. The Monti government started this process, but the measures adopted need full implementation for the reforms to fulfil their potential, which would result in estimated additional GDP growth of 5.8% after five years and 10.5% in the long run (Lusinyian and Muir 2013). Such reforms should also be aimed at increasing Italy’s attractiveness to FDI, providing foreign investors with a more favourable business environment, especially in terms of bureaucratic efficiency and reduced labour costs. According to the Global Competitiveness Index (Schwaub 2013) published by the World Economic Forum, Italy currently ranks 42nd out of 144 countries, well behind Germany (6th) and France (21st). Increased inflows into the country therefore appear to be a necessary part of the solution to the lack of credit available to domestic firms.

Most measures in the Monti reforms consist of supply-side policies aimed at enhancing productivity. These policies can be extremely effective and have a structural impact

18 The standard rate of VAT in Italy is currently 21%. In Germany and France it is respectively 19% and 19.6%. The average rate at the EU level is at 21.2% (European Commission 2013).

19 The government also stopped payment of the first annual instalment of the property tax on primary residences, which the Monti government had reintroduced at the end of 2011. This decision was criticized in the IMF’s recent Article IV Consultation, which claimed that the tax should be maintained for equity and efficiency reasons and that the tax base should be broadened.

20 Several studies tried to assess the existence of a negative relationship between indirect taxation and economic growth (Emran and Stiglitz 2005; Greenidge and Drakes 2009), while others (Acosta-Ormaechea and Yoo 2012) showed that, especially in high-income countries, increasing income and property taxation has on average a stronger negative impact on growth. On the other hand, increasing taxation on consumption might help unlock resources to reduce taxes on labour, thus having a potentially stronger impact in terms of growth in the long run.

21 On 19 June 2013, Ben Bernanke, Chairman of the US Federal Reserve, announced the end of the third round of Quantitative Easing (QE3) for 2014 (Federal Reserve 2013). This could represent the conclusion of a period of unconventional expansionary monetary policy and a potential rise in interest rates.

22 The most recent forecasts show that economic recovery, expected to start in 2013, has been delayed and recession will continue in 2013, with GDP expected to show negative growth of -1.3%. MEF (2013) predicts that GDP should start growing again in 2014 (+1.3%).

on the economy in the long run, but what Italy currently needs is also an expansion in labour demand. In June 2013 the government approved a measure aimed at promoting the employment of young workers through a system of tax incentives for firms. This could be the first step towards a progressive reduction of the labour tax, which is one of the highest among the OECD countries (OECD 2013). Concluded at the beginning of July 2013, the Article IV Consultation between the IMF and Italy urges the government to undertake measures aimed at creating new jobs, especially for young people (IMF 2013a). Policy measures also need to be targeted at improving investment in R&D, higher and continuing education and skills enhancement, as well as fostering policies to help firms overcome their limited size and become more competitive through 'networks of enterprises'.[23]

In conclusion, lessons from a not too distant past show which mistakes should not be repeated. The Italian economy has a high potential in terms of exports, as highlighted by their increasing contribution to the GDP. The restoration of global demand might help Italy regain some growth, but structural problems that have resulted in underperformance for many years and a double-dip recession since the global financial crisis also need to be addressed. The future outlook for the Italian economy depends on improving competitiveness and restoring growth with a comprehensive set of policies and reforms that can be effective in the short, medium and long run. The achievement of these targets will require the rapid identification, development and implementation of appropriate policies within a consistent, well-sequenced and forward-looking framework.

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23 The 'networks of enterprises' were created by Decree of 10 February 2009, No. 5 and consist of flexible aggregations of SMEs around specific purposes, e.g. the sharing of core inputs or of activities such as R&D and internationalization. Some financing schemes were launched in several Italian regions in order to support the establishment and consolidation of these networks.

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