

Italy: Much to play for

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In an attempt to put Europe's most acute sovereign debt crisis into perspective, Giulio Tremonti likes to argue that Greece's economy is only as big as the northern Italian province of Verona.

Verona might be flattered by the exaggeration, but the conservative Italian finance minister's point is that the bailout of Greece by its eurozone partners and the International Monetary Fund involves a relatively small sum – several times less than that set aside by Germany in 2008 to prop up its banks.

“If your neighbour's house is burning it is in everyone's interests to bring water, not just for humanitarian motives but to stop the flames spreading to surrounding homes,” said Paolo Bonaiuti, Italy's government spokesman, frustrated by European prevarication ahead of the bail-out.

As the bushfire of market contagion spreads, it is clear that Italy's nerves are being tested. While, for now at least, Portugal, Spain and Ireland are next in the markets' line of fire in terms of risk attached to their debt financing needs, analysts fear the fate of the euro could be tested in Italy, the world's seventh-largest economy and more than six times bigger than Greece.

“Greece is small. Spain could be handled. But if there was a problem with Italy it would really be worrying. No one has the means to bail out such a large country,” says Natacha Valla of Goldman Sachs.

On the face of it, Italy does indeed offer cause for concern. In the past decade, its labour productivity and share of world trade have declined; economic growth has stagnated well below the European Union average. Investment is low, employment growth meagre. What is rising is public debt, forecast to grow from 115 per cent of gross domestic product last year to about 118 per cent by the end of 2010, second in Europe only to that of Greece.

Italy also suffers from structural problems, ranging from an inefficient public sector to restrictive practices in trade and the professions. Widespread corruption, an inefficient bureaucracy and a ponderous judicial system make it one of the least attractive countries in which to do business, according to the World Bank.

A succession of weak governments, often preoccupied with internal politicking rather than painful structural reforms, have failed to address these problems. The flexible small and medium-sized enterprises that form the backbone of Italy's economy like to say they survive despite, not because of, government policies.

Nonetheless over the past four years, under Mr Tremonti and Tommaso Padoa-Schioppa, his centre-left predecessor and a former European Central Bank board member, Italy has put its finances on a better footing. Pilloried a year ago by cabinet colleagues for refusing to give into their spending demands, Mr Tremonti is now hailed as a saviour.

“He was right with his *cassaforte* [strongbox] policy. Otherwise it would have been a disaster for us,” says Alessandro Castellano of the Sace export credit agency. Italy's 2009 budget deficit of 5.3 per cent of GDP may exceed eurozone rules but looks positively sober compared to those of France and the UK, let alone Greece.

Ms Valla agrees. “A changed mentality cannot be taken for granted but with the benefit of hindsight their performance has been really quite good.” She identifies as a “very positive moment” Silvio Berlusconi's return two years ago to serve a third term as prime minister,

with no marked increase of debt. “They seem to be very conscious of trying to behave in a way to keep the markets off their backs.”

Still, the crisis has taken its toll, with Italy entering recession in 2008 ahead of its peers and GDP falling 5.1 per cent last year. The fact that Mr Berlusconi’s main claim to economic success is that Rome has avoided the fate of Athens in seeking external rescue is a measure of its plight.

Also in its favour is the high level of savings held by Italians, the relatively low level of household debt – 57 per cent of disposable income in 2008, compared to a eurozone average of 93 per cent – and the high percentage of government bonds in Italian hands.

The country’s banks have weathered the crisis relatively well thanks to a combination of regulation and a less adventurous approach than some peers to the “sophisticated” products that have caused trouble elsewhere in Europe’s financial sector. Italy has also avoided a housing bubble on the scale of Spain and Ireland.

“Italy has fundamental differences from Greece,” says Marco Elser, a Rome-based banker with AdviCorp. “We have solid industries and services. Italy is a country with a culture of business.” Asked what would happen to Italy if Greece decided to default, as he thinks it ought to this month, he delivers a terse response. “Nothing.”

Not all economists are so sanguine. Massimiliano Marcellino of the European University Institute in Florence, says there is a “very low” likelihood of Italy defaulting – as long as certain conditions are met. “The only hope is high GDP growth,” he says. “If instead in the next years, the debt to GDP ratio goes out of control because the deficit deteriorates, interest rates increase and growth remains subdued, default could quickly become a less remote option.”

Franklin Allen of The Wharton School of the University of Pennsylvania, worries that if long-term interest rates rise, as is likely, Italy will be hard pressed to raise taxes or cut expenditure to offset the increased costs. “This means they may well start down the Greek route. This is why, if Greece does default, I think there is a significant possibility of contagion to Italy.”

Mr Marcellino says Italy appears doomed to suffer low growth rates: “The main causes are the usual suspects: market imperfections combined with the political inability to remove them,” he comments.

Mr Tremonti counters that Italy’s GDP figures are seriously understated. The statistics, officials say, do not reflect the output generated by industries whose holding companies are registered abroad for tax reasons. With a manufacturing base second only to Germany’s in Europe, this makes a considerable difference.

Sace’s Mr Castellano points out that the bulk of his export credit insurance business enters into the data as transactions with Luxembourg, though the clients are effectively Italian companies with production based in Italy.

On top of that, economists reckon the famously flourishing grey economy is equal to as much as 30 per cent of GDP. Unemployment is relatively low compared to much of Europe.

These debates aside, one major barrier to growth – which would take dramatic social and economic changes to resolve – boils down to simple demographics. Italy is vying with Japan to become the world’s oldest country as fertility rates tumble. One in five Italians is a pensioner and by 2024 the country is projected to have 1m over the age of 90. The birth rate is the third lowest in the world.

By 2030 Italy’s workforce will be nearly 16 per cent smaller than it was in 2005, according to estimates by The Lisbon Council, a think-tank. If it were not for the 3m immigrants who have arrived over the past decade, the population – now just over 60m – would be in decline.

Yet the centre-right coalition government, under the influence of the overtly xenophobic Northern League, is hostile to immigration, portraying foreigners as the scourge of globalisation, costing Italians their jobs.

The impact of tougher legislation on residence permits, under which immigrants who lose their jobs have to leave the country within six months, is already having an impact. Turin, feted by the UN as the Italian city with the most progressive immigration policies, is

experiencing a decline in the number of resident Moroccans, its largest non-EU foreign community.

A recent IMF annual report predicted Italy's recovery from its worst postwar recession would be "modest and fragile". It also cast doubts on Mr Tremonti's forecasts of 1.1 per cent GDP growth this year and 2 per cent in 2011. Unicredit, a bank, forecasts growth of just 0.5 per cent in 2010.

Unlike after previous downturns, the world's second-largest exporter of capital goods after Germany has not experienced a decisive export-led recovery, though there was a pick-up in exports to emerging markets following the first quarter. Total exports plunged nearly 20 per cent last year.

Italy remains "vulnerable to external shocks" because of high public debt and disappointing growth performance, the IMF said, urging structural reforms to unlock growth potential: enhancing public sector efficiency, scrapping minimum tariffs for professional services, and overhauling and strengthening the judicial system.

Mr Berlusconi's centre-right coalition government is moving slowly on some of these issues but has been seriously distracted by passing laws to shield him from prosecution in the courts where he faces two trials on charges of corruption and fraud.

High on the list of proposed economic reforms is fiscal federalism, a process that would make Italy's powerful regions, some seriously indebted, more accountable for their budgets. But the issue has exposed north-south fault lines in the coalition, fuelling deep-rooted ideological differences over whether the country should be a strongly centralised state or move further in the direction of federalism.

The IMF says fiscal federalism "provides an opportunity to strengthen fiscal responsibility and discipline at all levels of government". But it is concerned that "many important features remain to be defined", in particular the right balance between regional autonomy and transfers across regions with large income disparities.

The issue was one of several raised by Gianfranco Fini, co-founder of Mr Berlusconi's People of Liberty party, in a speech to party leaders that degenerated into a shouting match with the prime minister on April 22.

Meanwhile Umberto Bossi, leader of the Northern League, has made clear that his vision of fiscal federalism is the price of his loyalty.

With its export-oriented, economically dynamic north and its backward, state-dependant south, Italy offers something of a microcosm of the eurozone. Just as Germany has struggled to come to terms with rescuing Greece, Mr Berlusconi will need all his political wizardry to transcend the tensions and harsh rhetoric within his divided coalition to achieve a similar grudging solidarity.

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