The Italian Economy:
Past, Present and Future

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Historical Overview: Italy Since WWII

With the end of World War II and the implementation of the Marshall Plan, significant investment in Italy began, and it experienced substantial economic growth, propelling it from the status of a developing country into the top tier of nations in terms of GDP per capita. Sustained economic growth increased Italy’s real per-capita GDP relative to other major industrialized nations.

At the same time, increasing economic and political cooperation between the nations of Western Europe integrated Italy firmly into the European economy. Italy’s membership in the General Agreement on Tariffs and Trade (GATT), the forerunner of the World Trade Organization, resulted in it reducing significantly its barriers to trade. Particularly after 1970, trade increased exponentially as Italy became more integrated into world markets.

### Italian RGDP Per Capita as a Percent of Other Nations’ RGDP Per Capita, 1950-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Italy/France</th>
<th>Italy/US</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>72.3%</td>
<td>37.8%</td>
</tr>
<tr>
<td>1960</td>
<td>83.5%</td>
<td>55.5%</td>
</tr>
<tr>
<td>1970</td>
<td>86.9%</td>
<td>67.3%</td>
</tr>
<tr>
<td>1980</td>
<td>88.6%</td>
<td>71.7%</td>
</tr>
<tr>
<td>1990</td>
<td>92.7%</td>
<td>73.6%</td>
</tr>
<tr>
<td>2000</td>
<td>89.8%</td>
<td>65.4%</td>
</tr>
</tbody>
</table>

Source: OECD

### Real Gross Domestic Product, 2000=100 (1000's of USD)

Source: Penn World Tables 6.2
Joining the Euro: 1990-1999

During the 1990’s groundwork was laid by members of the European Union to move towards a unified currency, the Euro. The reasoning behind this movement was partly political, since a consolidated European economic unit would have more impact on world affairs than each nation could have individually. However, the economic rationale was perhaps more important: a currency union eliminates (at least in theory) the restrictions on the movement of goods and services across national borders, as well as eliminating the barriers to the movement of labor and capital within the union’s jurisdiction. Additionally, it removes the complication of multiple national currencies, which should facilitate intra-union economic activity.

Joining the Euro required Italy to maintain a tighter monetary policy than it historically had. For example, Italy’s historical pattern had been to devalue its currency periodically in order to offset its higher rates of price inflation. However, under the rules for joining the Euro, nations were required to maintain stable exchange rates and maintain inflation at levels comparable to those of low-inflation European nations. Italy followed the requirements for EMU membership (namely, keeping its currency within the narrow EMS band) between 1990 and 1992. However, the "Tangentopoli crisis" in 1992 caused the government to abandon its defense of the lira, allowing it to float until 1996, when it was pegged to the German deutschmark until Italy joined the Euro in 1999. The "Tangentopoli crisis" revealed widespread corruption in the Italian political system and led to the disbanding of all of Italy's major political parties. Several
important politicians from that period, including Silvio Berlusconi, re-entered the political sphere under different affiliations. Italy has not yet fully recovered from the crisis and Italians remain disillusioned with their leaders.

![Trade-weighted Value of Lira, 1970-1999](chart)

Source: IMF International Financial Statistics

Italy in the EMU

**GDP Growth**

Since joining the European Monetary Union in 1999, Italy’s performance has been mixed. For the years 2000 through 2005, Italy’s GDP growth tracked fairly closely with Germany’s. However, beginning in 2005 Italy’s GDP growth began to lag behind, growing more than 1% less than the German economy during 2006 and 2007. Under these economic conditions, it is difficult for the European Central Bank to design policies which can deal effectively with economies, such as Italy’s which are lagging behind, without risking overheating economies, like Germany’s which are doing comparatively well.

<table>
<thead>
<tr>
<th>Year</th>
<th>Italy</th>
<th>Germany</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>0.038748</td>
<td>0.034555</td>
<td>0.036598</td>
</tr>
<tr>
<td>2001</td>
<td>0.01746</td>
<td>0.013825</td>
<td>0.007507</td>
</tr>
<tr>
<td>2002</td>
<td>0.004542</td>
<td>9.86E-05</td>
<td>0.015995</td>
</tr>
<tr>
<td>2003</td>
<td>0.000535</td>
<td>-0.00234</td>
<td>0.025102</td>
</tr>
<tr>
<td>2004</td>
<td>0.013538</td>
<td>0.007217</td>
<td>0.036367</td>
</tr>
<tr>
<td>2005</td>
<td>0.007957</td>
<td>0.009472</td>
<td>0.029391</td>
</tr>
<tr>
<td>2006</td>
<td>0.020993</td>
<td>0.031697</td>
<td>0.027788</td>
</tr>
<tr>
<td>2007</td>
<td>0.014645</td>
<td>0.02587</td>
<td>0.020277</td>
</tr>
<tr>
<td>2008</td>
<td>-0.01043</td>
<td>0.00983</td>
<td>0.011114</td>
</tr>
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</table>

Average 0.011999 0.014469 0.023349

Source: OECD
One reason for Italy’s relatively mediocre economic performance since 2005 is likely its higher rates of inflation earlier in the decade. From 2000 to 2005, inflation in Italy averaged about 1% higher than in Germany. Likewise, unit labor costs increased in Italy at a significantly faster rate than they did in other Euro area nations. For example, Italy’s unit labor costs increased an average of 1.4% faster than Germany’s during the period of 2000-2007. With prices rising steadily, Italy would not have been as competitive as its European neighbors, since it no longer had the ability to devalue its currency in order to increase its competitiveness on world markets. Rising consumer prices would have decreased domestic demand for goods, while rising labor costs would have driven down the demands for Italian goods abroad.
**Consumer Price Inflation, % change per year, 1988-2008**

Sources: OECD and Bureau of Labor Statistics

**Exchange Rate**

Before it joined the Euro, Italy traditionally responded to inflationary pressures by devaluing its currency. However, Italy’s membership in the European Monetary Union precludes it from manipulating the value of the Euro. In fact, since its inception, the Euro has strengthened considerably, in part reflecting the rapid growth of other European economies since 1999. This has put considerable pressure on Italy; instead of seeing its exchange rate depreciate and its goods become more competitive on world markets, the reverse has happened. This situation led in 2005 to some Italian politicians, notably then-Welfare Minister Roberto Maroni and Prime Minister Silvio Berlusconi to openly criticize the strength of the Euro and its effect on the

**Euro/USD Exchange Rate, 1999-2008**

Source: IMF IFS Statistics
Italian economy.\textsuperscript{1} Although such statements were largely seen as political rhetoric and not reflective of a real risk of Italy leaving the Euro, they illustrated the serious consequences which rising prices posed for Italian economic growth in the face of an EU-wide monetary policy.\textsuperscript{2}

For example, if Italy was located on this graph at point a, ordinarily an increase in the money supply would shift out the AA curve and Italy would locate at point b, with a slightly lower output (Y') and a deteriorated currency (S'). However, as a member of the Eurozone, Italy has no ability to affect exchange rates or the money supply. Furthermore, any fiscal expansion would be subject to criticism by other EMU members if it drove the Italian government into significant deficit; therefore, pushing out the DD curve may not be a valid policy tool either. Under these circumstances, the Italian government would be forced to allow the economy to contract to Y'', where the asset markets are again in equilibrium and the exchange rate remains unchanged at S. The implied reduction in Y is much larger under this scenario than it is under the one in which Italy has control of its monetary policy and can devalue its currency to regain competitiveness.

\textit{Balance of Payments}

Before Italy’s accession to the Eurozone, its current account generally alternated between deficit and surplus. This was due to the fact that Italy was able to devalue its currency when necessary in order to regain international competitiveness when rising costs at home would have otherwise driven it into sustained current account deficits. However, after joining the Euro, Italy’s central bank no longer had this ability. As expected we can observe a steady depreciation

\textsuperscript{1} Eichengreen (2007).
\textsuperscript{2} Hale (2005).
in Italy’s current account, with deficits beginning in 2000 and continuing up to the present time. Since the Euro has generally strengthened over this time period, the Italian economy has found itself becoming more and more uncompetitive relative to foreign economies.

![Italy's Current Account as a % of GDP, 1988-2008](chart)

Source: OECD

**Government Debt**

Government debt declined significantly, both in absolute terms and as a percentage of GDP, after the Italian financial crisis of 1995. However, since the mid-point of this decade, government debt has begun to rise once again. Italy’s debt load in comparison with other industrialized countries remains large at over 100% of GDP, and contributed in the years before Italy’s adoption of the Euro to the yield spread on government securities between Italian sovereign debt and that of countries like Germany, which reflected the different risk premiums attached to each government’s debt obligations.

![Government Debt as a % of GDP, 1990-2010](chart)
Sources: OECD and Federal Reserve Board

Since the adoption of the Euro, these yield differences have been reduced dramatically, mainly on the strength of the belief that Italy would not be willing to abandon the Euro and that the other members of the European Monetary Union would not allow Italy to default on its debt, since that would represent a huge blow to the credibility of the union as a whole. For this reason, Italy has been able to borrow at rates much lower than it otherwise might have, which has been a significant fiscal advantage for the country.

Unemployment

Unemployment in Italy has historically been higher than in many other EU nations. This is due in large part to structural issues involving the strength of organized labor and guilds and Italy’s traditionally high labor costs and relatively low productivity. However, the early part of the decade saw a significant reversal of this trend with unemployment dropping steadily from over 10% in 1999 to a low of around 6% before the beginning of the worldwide financial crisis. It remains to be seen whether the Italian economy will lose much of its job gains during this economic slowdown, but unemployment did turn upward in Italy much earlier than it did in other EMU nations (see chart).
How has Italy responded to the Financial Crisis?

Even though Italy is broadly perceived to be in a structurally unsound fiscal situation, the reaction to the crisis has been remarkably calm. Part of this can be explained by the fact that Italy's debt issues preceded the crisis by several years and Italians have become used to living with high levels of government debt. Another part can be explained by the high level of personal household savings in Italy and the relative health of Italy's banks, which were not as exposed to toxic financial instruments and Eastern European debt as the rest of Europe. No one expects to be bailed out by the government--the Italian banks didn't ask for a rescue until very recently. The Economist reports that some other European banks that have already received government funds have used that advantage to start competing for business in Italy. Realizing that the recession may be prolonged, the Italian banks capitulated and asked for their own bailout funds to maintain their competitive edge.

The government could be forced to take on even more debt by the fiscal programs of its neighbors. In fact government sales of debt obligations have been the rise for the last year. The Economist states, "When Germany introduced price discounts of up to EURO 2,500 to entice motorists to scrap their old cars and replace them with new "greener" versions, the Italian government was all but forced to follow suit. Otherwise, a Fiat car on sale in Germany could be
bought for less than in Italy and imported for sale on the secondary market, threatening

Italy's official car-dealer system.3 These fiscal stimulus measures are still relatively small in size but could grow substantially if Italy is forced to take more action by its neighbors.

It seems extremely unlikely that Italy would leave the Euro and revert back to the lira. In the current credit environment, doing so would restrict Italy's ability to finance its debt even more. Italy could attempt to monetize its debt, but the impacts of the public debt on the rest of the economy do not seem dire enough at this point to justify doing so.

However, markets have begun recently to recognize the additional risk posed to the financial stability of Italy by the economic crisis: the spread on Italian government bonds over German ones jumped from an average of

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around .25 percentage points before the worldwide economic crisis to over 1.5 percent after the crisis hit in earnest in Fall 2008. Since these bonds are denominated in the same currency and are therefore not subject to exchange rate risk, the increase in the spread can be read as an indication of the increased risk of default by the Italian government on its sovereign debt.

Unemployment ticked up two-tenths of a percent in the most recent quarter and stands currently at 6.9%. Inflation is at 3.6%. Trade and asset prices are down but not to the extent seen in Southeast Asia or even Spain. Italy's recently released Economic Stability Program through 2011 received good marks from the Corriere della Sera and the EU Commission and Italy appears to be on a course towards gradually unwinding its debt rather than shocking the European system.\(^4\)

Does Italy Belong in the EU?

One question that researchers and politicians have grappled with since the inception of the EMU is whether or not the Euro zone delivers more costs or benefits to its members. At its heart, this question is whether or not greater Europe represents an optimal currency zone. This is the case when the economic performance of an entire area is relatively constant, so that economic growth in one part of the region is likely to mean economic growth throughout the rest of the region. In this circumstance, a unified currency can have tremendous benefits in terms of trade and global economic influence. However, if a currency zone’s members have significantly different economic conditions, pursuing a unified monetary (and to some degree fiscal) policy can be severely damaging. For example, if one country is fighting high inflation but another is suffering from low inflation.


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**Pairwise Correlations, CPI % annual change, 1999-2008**

<table>
<thead>
<tr>
<th></th>
<th>EMU</th>
<th>Italy</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMU</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>0.832125</td>
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<td></td>
</tr>
<tr>
<td>Germany</td>
<td>0.851287</td>
<td>0.510267</td>
<td>1</td>
</tr>
</tbody>
</table>

**Pairwise Correlations, Unit Labor Costs, % change, 1999-2008**

<table>
<thead>
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<th>EMU</th>
<th>Italy</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMU</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>0.169847</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>0.345641</td>
<td>0.867273</td>
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</table>

**Pairwise Correlations, Unemployment Rate, 1999-2008**

<table>
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<th></th>
<th>EMU</th>
<th>Italy</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMU</td>
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<td></td>
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<tr>
<td>Italy</td>
<td>0.623266</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>0.534062</td>
<td>-0.2864</td>
<td>1</td>
</tr>
</tbody>
</table>

**Pairwise Correlations, CA Balance as % of GDP, 1999-2008**

<table>
<thead>
<tr>
<th></th>
<th>EMU</th>
<th>Italy</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMU</td>
<td>1</td>
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<td></td>
</tr>
<tr>
<td>Italy</td>
<td>-0.30865</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>0.355923</td>
<td>-0.87979</td>
<td>1</td>
</tr>
</tbody>
</table>

Sources: OECD, EMU, BLS
growth, should the central bank increase or decrease the money supply? Either way, it is likely
to be detrimental to one of the nations’ economic circumstances. If we examine the pairwise
correlations between Italy and Germany and between Italy and the EMU as a whole, it becomes
apparent that being in the Euro is not all good news for Italy. For example, the correlation
between Italy’s and Germany’s inflation rates is only .51, meaning that it is likely that inflation
in one may not be equal to the other. Under such circumstances, getting policy right to deal with
inflation in the high-inflation country while not stifling the growth of the low-inflation country
will be difficult. The correlation between unit labor costs is even less strong, indicating that
what might have been good for Italy prior to the financial crisis (reducing the money supply to
slow the upward pressure on labor cost increases) might be very bad for the rest of the EMU.

Finally, we notice that the correlation between Germany and Italy regarding the rate of
unemployment is actually negative, meaning that policies which were designed to help one deal
with its joblessness might hurt the other. The weakness of some of these correlations indicates
that, from a strictly economic standpoint, Italy’s choice to join the EMU should be expected to
have mixed results.

Italy's Future:

Italy’s GDP growth will probably continue to lag developed country averages for some
time. Much like Japan, an aging population and low fertility rates will exert a drag on the
economy, although this may be partially mitigated if the age of retirement is increased. Official
GDP growth may tick higher if Italy successfully integrates its shadow economy, a perennial
suggestion in the Italian dailies that may also decrease the public debt through tax recapture.
Some strides have been made in this area recently although much remains to be done. Several
chronic problems have contributed to low participation in the business tax system. First and
foremost, government is perceived to be dysfunctional and corrupt. Italy’s leaders demonstrate
poor ethics in their personal finances and business dealings, which contributes to the perception
that playing by the rules is for suckers who will never get ahead. Reducing corruption in
government and in public contracts would likely increase rates of participation in the tax system.
Second, employment rules, much like in France, are extremely rigid. This encourages business
owners to keep employees off the books by dealing in cash. Loosening employer obligations
would encourage greater reporting rates.
Inflation should stay at recent levels barring an exchange rate crisis. Continued EU subsidies for food staples and relatively low per capita energy usage should reduce Italy's exposure to upward trends in commodity prices. The debt crisis will continue to loom until Italy addresses its chronic structural deficit.

Projections of the Italian Economy

Italy has certainly not been immune to the current financial crisis. GDP is forecast to contract by approximately 2% from during 2009, and although recovery is projected for 2010, much depends on the overall global economic situation. The financial crisis is having a significant impact on Italian government debt levels, which are forecast to rise above the 3% of GDP limit for EMU nations. However, in the current economic climate it is unlikely that any sanctions will result, since government debt loads are increasing across the board. On the bright side, the worldwide slowdown has eased the upward pressure on prices; Italian inflation is forecast to drop to between 1 and 1.2% during 2009-2010.5

<table>
<thead>
<tr>
<th>Key indicators</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (%)</td>
<td>-0.5</td>
<td>-2.0</td>
<td>0.2</td>
<td>0.8</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Consumer price inflation (av; %)</td>
<td>3.3</td>
<td>0.8</td>
<td>1.0</td>
<td>1.8</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Consumer price inflation (av; %; EU harmonised measure)</td>
<td>3.5</td>
<td>1.0</td>
<td>1.2</td>
<td>2.0</td>
<td>2.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Budget balance (% of GDP)</td>
<td>-2.8</td>
<td>-3.6</td>
<td>-3.5</td>
<td>-2.9</td>
<td>-2.7</td>
<td>-2.9</td>
</tr>
<tr>
<td>Current-account balance (% of GDP)</td>
<td>-3.0</td>
<td>-1.7</td>
<td>-1.9</td>
<td>-2.2</td>
<td>-2.1</td>
<td>-1.6</td>
</tr>
<tr>
<td>Short-term interest rate (av; %)</td>
<td>4.8</td>
<td>2.1</td>
<td>2.0</td>
<td>2.6</td>
<td>3.6</td>
<td>3.9</td>
</tr>
<tr>
<td>Exchange rate US$:€ (av)</td>
<td>1.46</td>
<td>1.29</td>
<td>1.30</td>
<td>1.33</td>
<td>1.35</td>
<td>1.37</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit

One key policy prescription identified by the conservative daily Corriere della Sera involves loosening some of Italy's governmental obligations under the European Stability and Growth Agreement to fund infrastructure projects and technology research to reduce global warming. The editorial board believes that individual Italians could be persuaded to use their personal savings to fund the projects instead. Regardless, relaxing the goals for Italy in the short term

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5 “Italy: Country Outlook.”
would create some breathing room for the government to pursue other cuts.  

It may turn out that the crisis is exactly what Italy needs to address its structural deficit. If the government is simply unable to get credit from illiquid debt markets, it will be forced to make some of the tough choices on issues like pension reform that it has been putting off for years. Berlusconi's center-right coalition has been looking for an excuse to slash Italy's extremely generous pension system for some time and this crisis might provide the grease it needs to get that ball rolling.

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References


