

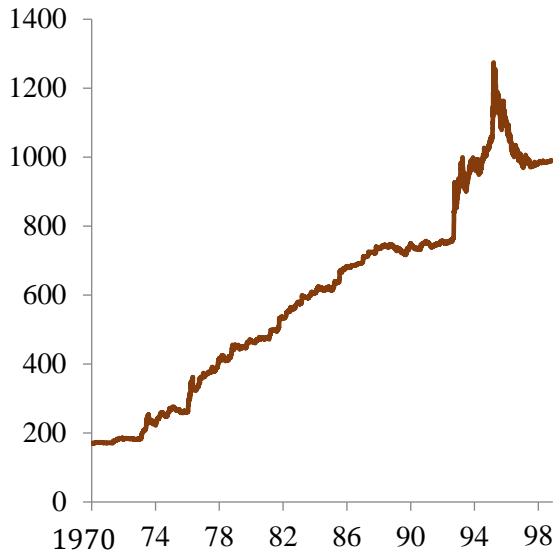
# **Italy: *Theater of EuroTragedy***

Ashoka Mody

Based on *EuroTragedy: A Drama in Nine Acts*, New York: Oxford University Press, June 2018.

## The bottom line: Italy needed—and needs—the crutch of a depreciating currency to offset its abysmal productivity growth

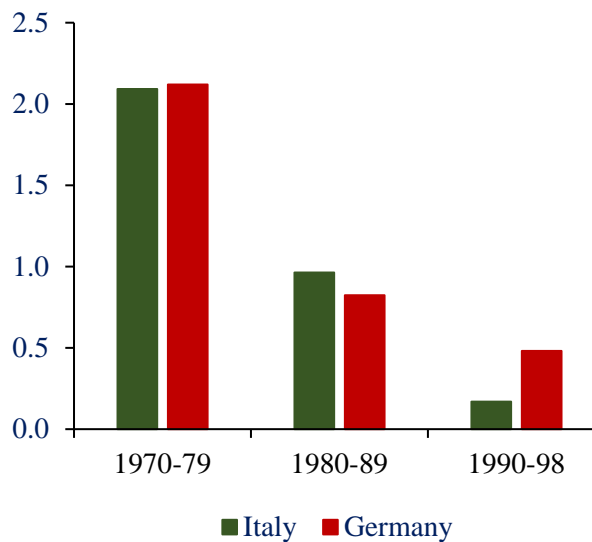
The depreciating lira, 1970-1998  
(Number of liras for one D-mark)



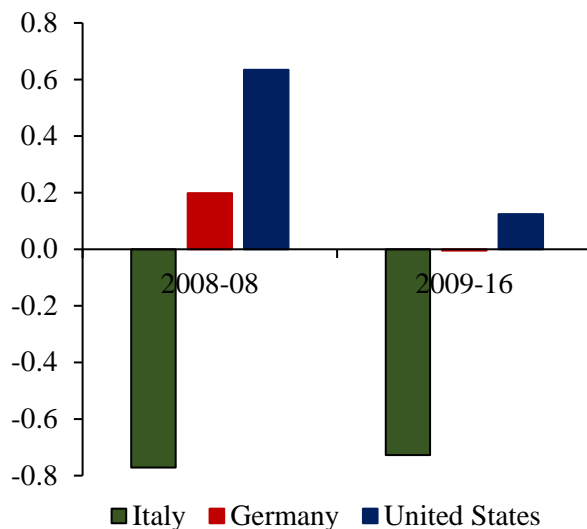
US Dollar/Euro exchange rate is back where it  
began, 1999-2018



Italian productivity fell relative to German  
(annual average total factor productivity  
growth)



Italian productivity collapsed while even  
German fell behind the U.S.  
(annual average total factor productivity  
growth)



Source: Top left panel: Banca d'Italia, <https://tassidicambio.bancaditalia.it/timeSeries>; top right panel: ECB data warehouse [https://sdw.ecb.europa.eu/quickview.do?SERIES\\_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC](https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC); bottom left and right panels: The Conference Board, <https://www.conference-board.org/data/economydatabase/index.cfm?id=27762>.

**Prologue:**

**Italy should never have been in the euro  
area.**

## The plague of political corruption

- Tony Judt: “Clientelistic system of patronage and favors put in place by Christian Democrats came to characterize Italian politics as a whole.”
- Guido Carli: Even Italy’s “miracle growth” from 1950 to 1970 occurred in a corrupt political framework where legal norms were “violated with impunity.”
  - “Shell” of the capitalist system but the “pillars of the market economy were hollowed.”
- Early and mid- 1990s, *mani pulite* (“clean hands”) judicial inquiries exposed leading Italian politicians and weakened centralized corruption.
  - Corruption spread to regional and municipal governments, continued as a plague.
- Italy settled into a “normal” of low expectations.

## **Mirage of Europe as *vincolo esterno* [external constraint]**

- Carli in his memoirs: in Italy, European strictures and appeals counted for virtually nothing
- But Carli as finance minister:
  - since Italians would no longer have the option to devalue the lira, they would collectively act to modernize their economy
- Maastricht negotiations: Draghi as Italy's chief negotiator
  - “In his soul, [he] believed in EMU [European monetary union] as a *vincolo esterno*.”

## Kohl's fateful decisions

- Italian promise: debt-to-GDP would decline from 120 of 60 percent by 2009.
- No German finance official believed this claim:
  - Horst Köhler, German negotiator at Maastricht, wrote unsolicited letter to Kohl: Italy poses “a special risk” to the euro.
- In January 1998, James Blitz, *Financial Times*, wrote, “Pinch yourself. Italy will be a founder member of Europe’s economic and monetary union.”
- Kohl pleaded Italian case; Italians would continue “structural reforms,” and overcome their handicaps “in the coming years.”
  - Kohl felt the “weight of history. Not without the Italians, please.”
  - He made that decision, single-handedly, on behalf of all Europeans.
- Also promised Bundestag: *Germans would not pay bills of other members.*
- One more time, Kohl reminded the Bundestag that they were voting for peace.

**1999-2008: “Creeping Normalcy”**

## **Central and northern Italy become pales shadow of itself**

### *[1] Unable to withstand low-wage competition*

- Production of washing machines and refrigerators plummeted, as China emerged as leading producer.
- Italian workers earned €24 an hour, while equally skilled Polish workers received only €7 an hour.
- Sweden's Electrolux, which had acquired the iconic Zanussi in the mid-1980s, cut back on number of employees and hours.
- Annarita Licci, a thirty-eight-year-old mother of two, had started working at Electrolux's Porcia factory in the year 2000 earned €1,400 a month.



## **Central and northern Italy become pales shadow of itself**

### ***[III] Unable to upgrade technologically***

- In early 1980s, Olivetti employed fifty thousand people in Ivrea, near Turin.
  - Ivrea was “a European Silicon Valley,” and Olivetti’s workers enjoyed “generous salaries and plush corporate recreational facilities.”
- In the 2000s, Olivetti was reduced to “a small machinery company:”
  - Its factories, jewels of Italy’s “industrial architecture,” converted into museums.
  - Olivetti’s workers nearly all gone, company’s tennis courts lay abandoned.
- Former employee “Gradually at first and then suddenly, everything fell apart.”
- Soon, Ivrea’s main employers: a state-run health service and two call centers, which together employed just 3,100 people.
- Town had little work for its thirty year olds; many lived on parents’ pensions.

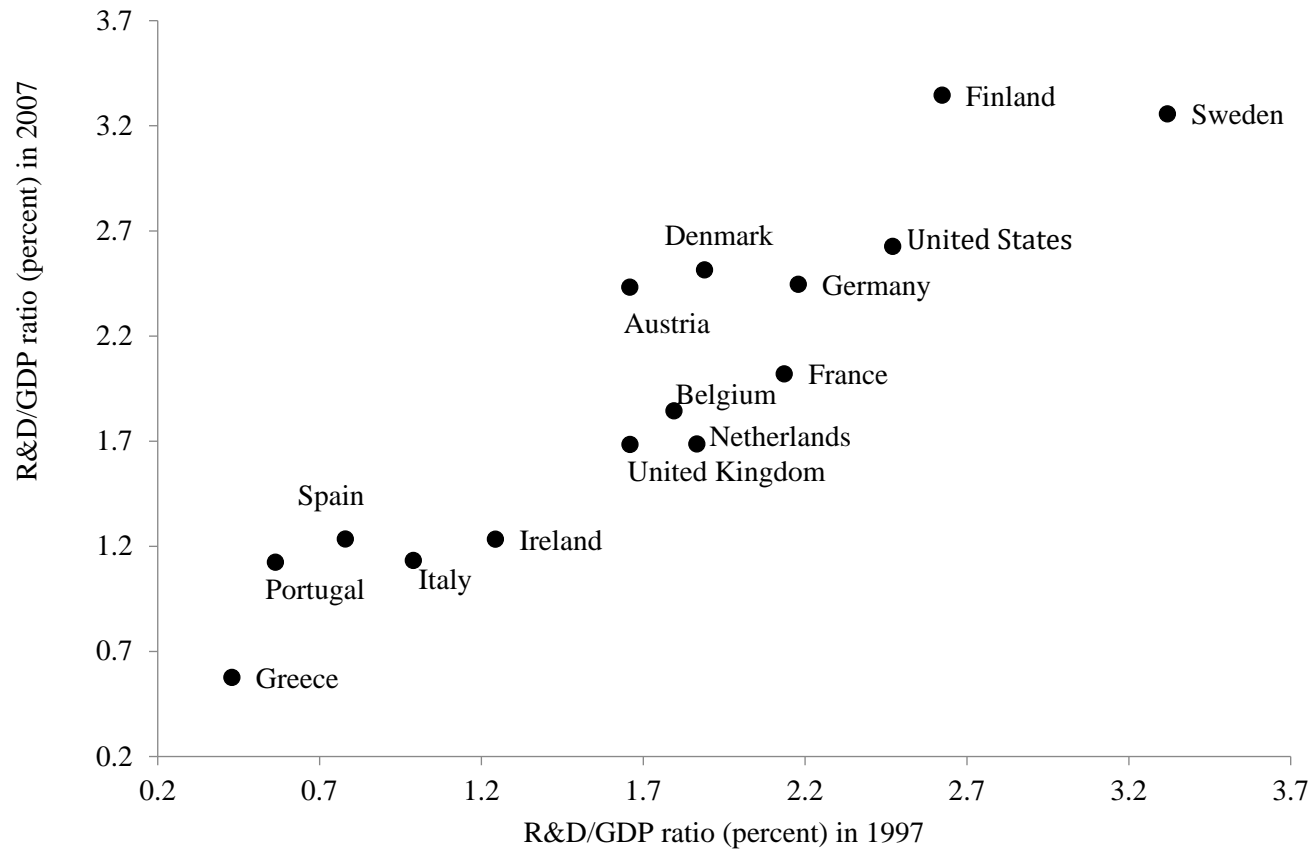
VALENTINE

OLIVETTI



# R&D rates: low in 1997, stayed low in 2007

(R&D as a percentage of GDP, 2007 versus 1997)



Source: OECD Statistical Database.

## **Italy's chaotic banks**

- More bank branches per capita than any other European country.
- As one wit remarked, more bank branches than it has pizzerias.
- Even during the years before the global financial crisis, banks struggled to return a profit in a slow- growing economy.

## **Malaise most stark in Banca Monte dei Paschi di Siena (MPS)**

- Main shareholder, Fondazione Monte dei Paschi di Siena:
- Cash machine for the city of Siena, including funding Palio horse races.
  - Siena's residents: those who received a pension from MPS, those who worked at MPS and expected to draw a pension, and those who aspired to work at MPS so that they too would draw a generous pension.
- In November 2007, making losses, MPS began to gamble
- Bought Antonveneta for €9 billion, well above market value
- Prime Minister Romano Prodi said the purchase be “considered positively.”
- In November 2008, Berlusconi government compelled to prop MPS up.
- MPS's exotic derivative deals, “Alexandria,” “Santorini,” and “Nota Italia.”
- Banca d'Italia inspectors alerted management—then under Governor Draghi—about “potentially critical” risks embedded in these transactions.

## **The happy *vincolo esterno* story failed, miserably**

- Italy in slow economic decay.
- Huge banking vulnerabilities.
- Government debt-to-GDP ratio around 100 percent in 2008, not near 60 percent, as promised.
- Official view on Italy...cautiously optimistic: IMF Staff Report, May 2010
  - Strengths: high savings, low private debt, resilient financial sector.
  - However, elevated public debt, disappointing growth performance; hence Italy vulnerable to future external shocks.

**Euro hit hardest—where it hurt the most:**

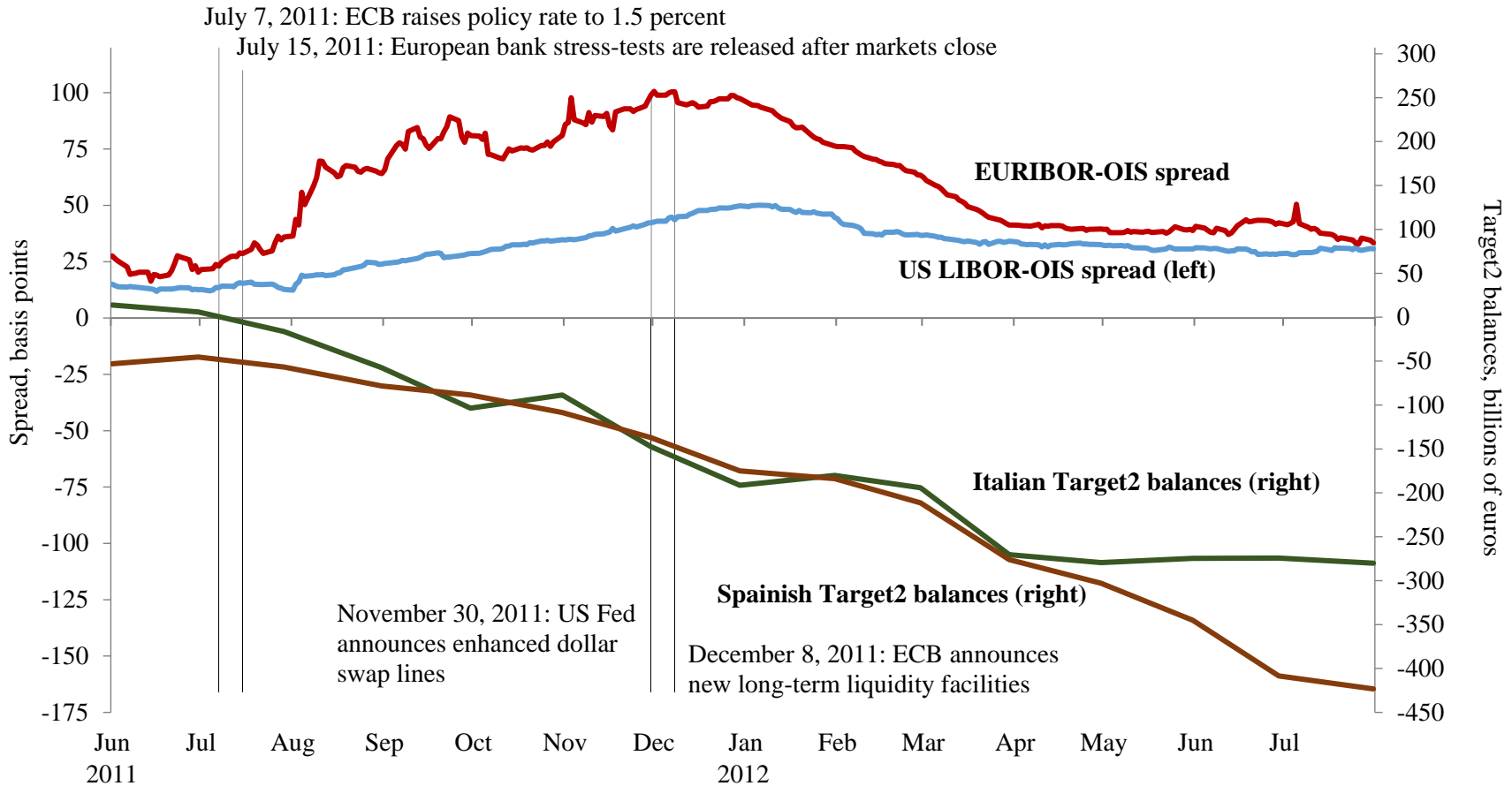
**Italian pathologies and eurozone policies interact ferociously**

## **Draghi as inflation hawk**

- European parliament, June 14, 2011
- Draghi: euro “a great success, a success.”
- Success because the ECB kept inflation rate at “just under 2 percent.”
- Time for the ECB to start planning its “exit from the still very accommodative monetary policy stance”...
  - ...if necessary, take “preemptive measures” to avoid fight inflation.
- Message: he would vote to hike the interest rate.



# Market panic after July 7 interest-rate hike and farcical bank stress tests.



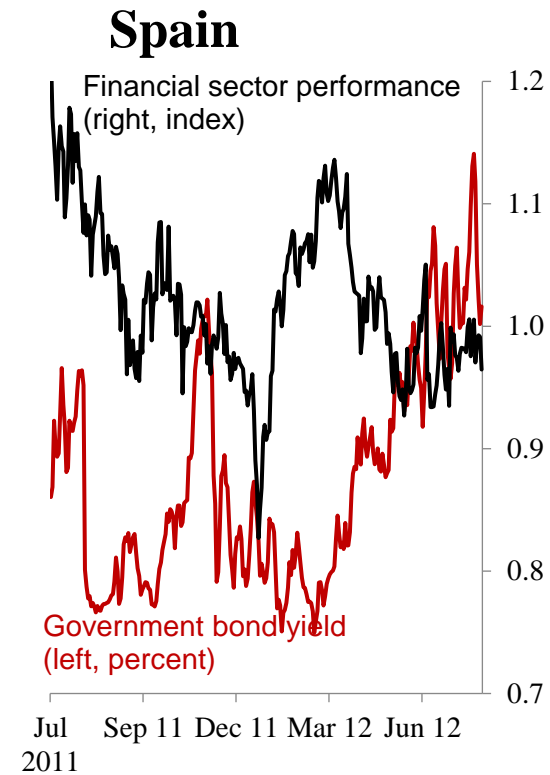
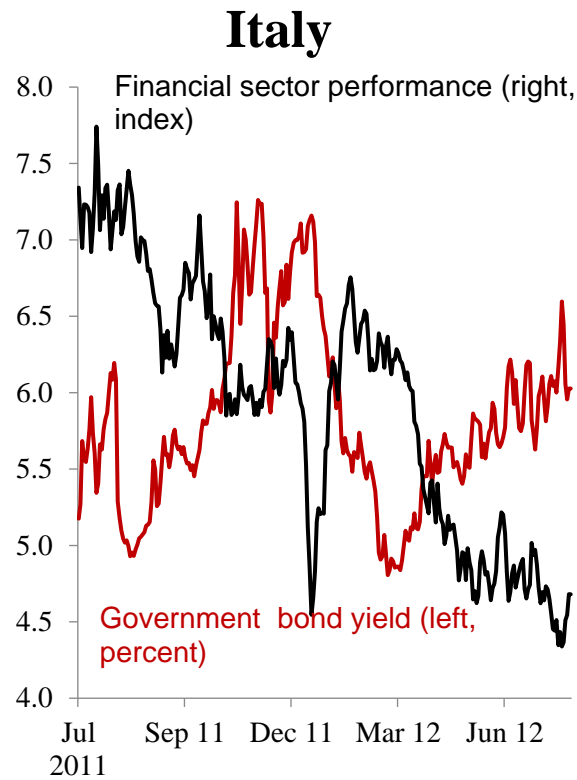
Sources: US LIBOR-OIS spread: Bloomberg, US0003M Index—USSOC Curncy; EURIBOR-OIS spread: Bloomberg, EUR003M Index—EUSWEC Curncy; Target2 balances are end-of-month position from ECB Statistical Data Warehouse.

Note: One hundred basis points equals 1 percentage point.

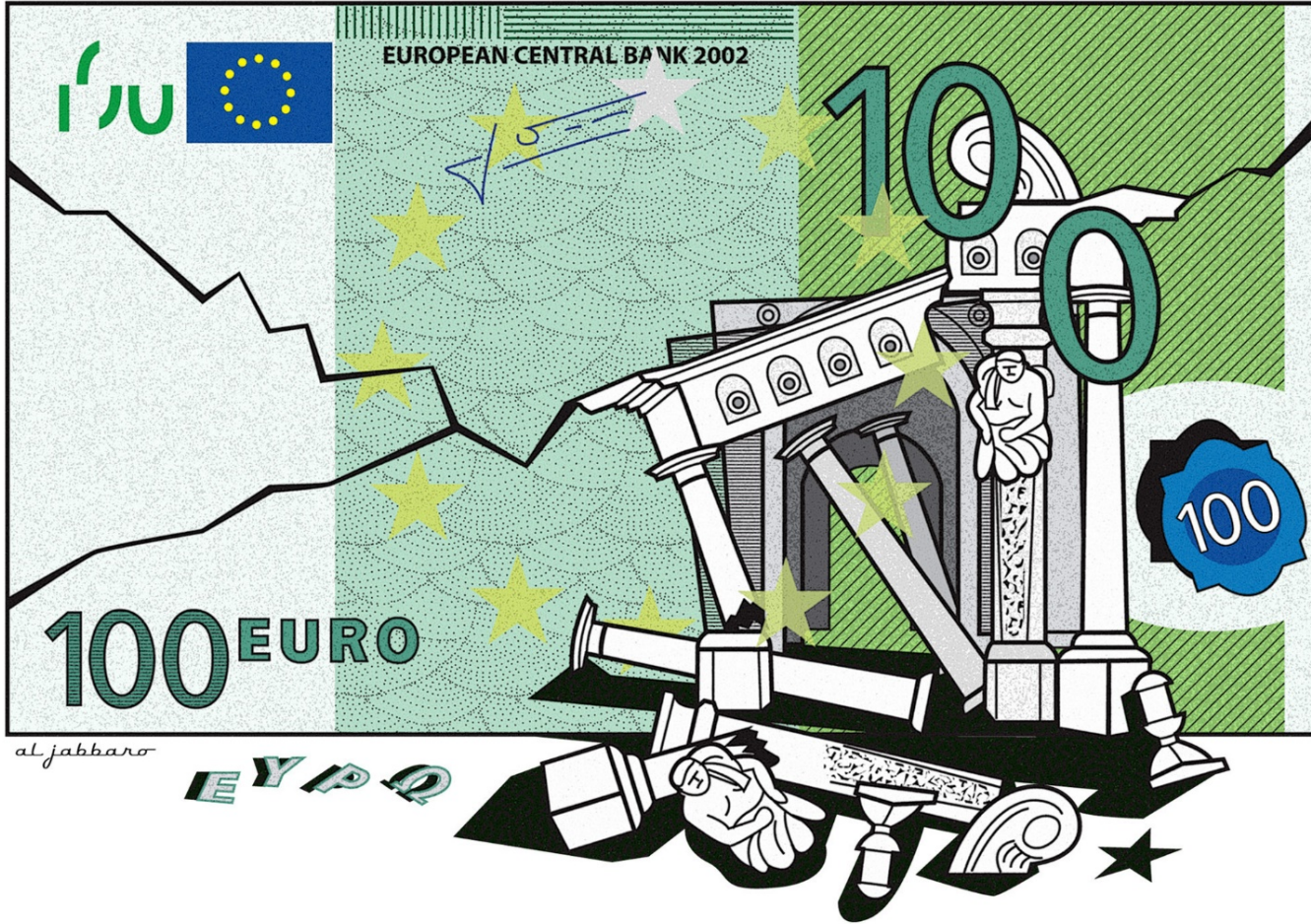
## **Draghi supports the rate hike, praises Italian banks**

- Next day, July 8: “Need to end exceptional fiscal and monetary support provided in the last three years is undisputed.”
  - Translation: “*We do things differently in Europe—our way is better.*”
- July 13: “Italian banks have shown and continue to show an ability to resist and react in time of difficulty.”

# Italy in existential crisis: vicious sovereign-bank “doom” loop



# Threat of euro break up



## **Draghi-Merkel alliance to save the euro**

Draghi's July 2012 makes "whatever it takes" announcement

Crucial assist from Merkel, who overruled her Bundesbank chief Jens Weidman



Merkel was unwilling to let the euro collapse, but did not want to burden German taxpayer.

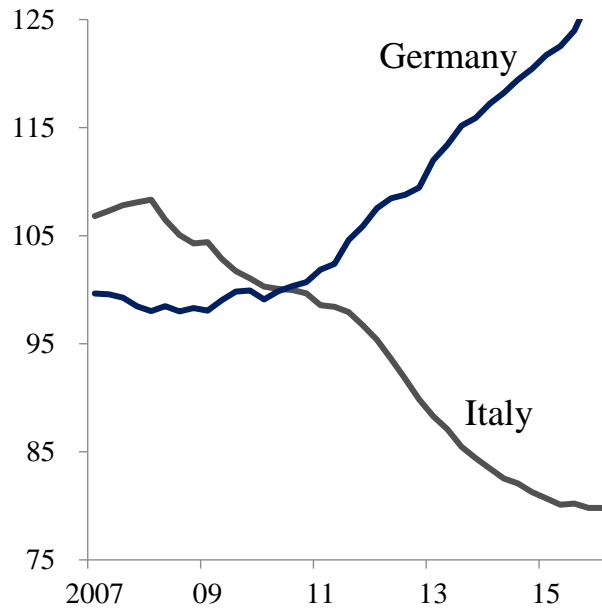
Outright Monetary Transactions (OMTs) approved in September 2012.

## **OMTs provided only partial help**

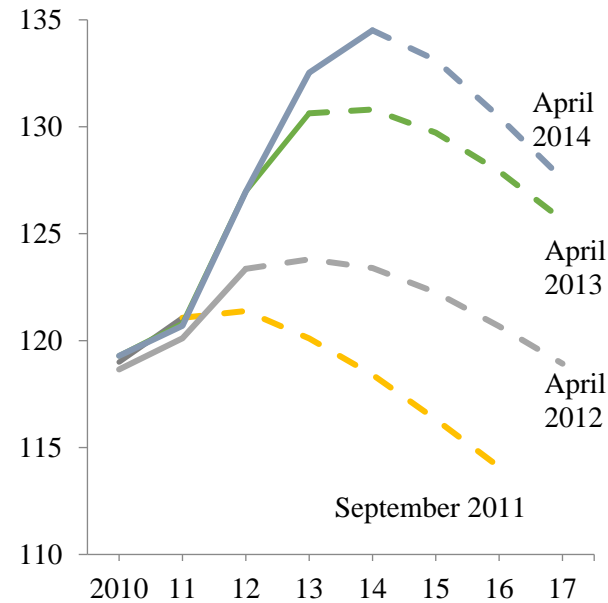
- OMTs only partially undid the ECB's July 2011 error.
- German and other “northern” Governing Council members held ECB back from aggressive monetary stimulus through end-2014:
  - Italian real interest rates remained high, between 2 and 3 percent.
- Long-Term Refinancing Operations (LTROs) do not count: passive monetary policy, ease credit supply; do not put money in people's pockets (do not create demand);
  - Hence, funds used by banks to buy sovereign debt, aggravating the sovereign-bank “doom loop.”

# Italy began slide into debt-deflation cycle.

**Property price deflation in Italy  
(Price Index in 2010=100)**



**Government debt rises much faster  
than expected  
(Debt-to-GDP ratio, percent)**



Sources: Left panel: OECD, Real House Price Index (2010 = 100). Right panel: International Monetary Fund, World Economic Outlook Database, various editions, <http://www.imf.org/external/ns/cs.aspx?id=28>.

Note: Dashed lines refer to projections at the time.

**Matteo Renzi:  
The search for a savior**



## **Renzi promises to transform Italy**

- Became prime minister through old-fashioned Italian political infighting.
- But portrayed himself to the world as a modernizer.
- Ran marathons, rode his bicycle around Florence, wore black leather jackets
- Denounced the Democratic Party's national leaders as "dinosaurs."
- On Twitter, used the hashtag #rottamare:
  - A boast that he would consign to the scrap-heap Italy's aging and corrupt.
- "Tonight we are young, so let us set the world on fire," he often exclaimed, using the words of the American pop group Fun.

### **International admirers**

- “Projects **hope** of wrenching Italy out of its long decline.”
- His “radical reform agenda” was the Italy’s **best hope.**”
- “A **rare moment of hope** for Italy—and indeed for Europe.”
- *Financial Times*, **so much hope is invested** in Matteo Renzi.” Few days later added, he had “**rekindled fresh hope for reform.**”

### **Domestic critics**

- Accused him of being “all style and no substance.”
- He focused on “communication rather than content.”
- “Makes a nice show at first and then wilts.”
- As Florence mayor, “allotted much more time for his Facebook updates than he did for serious discussion on the city’s budget.”

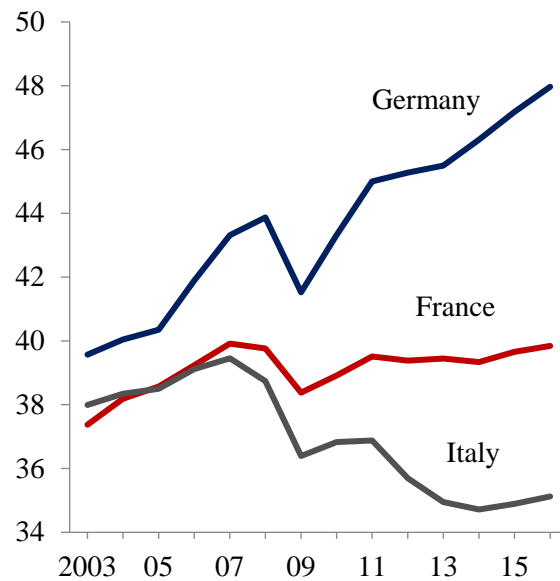
In late 2014, a disappointed FT wrote, “That didn’t last long.”

Flamed out in December 2016 referendum, joining the anti-European mood

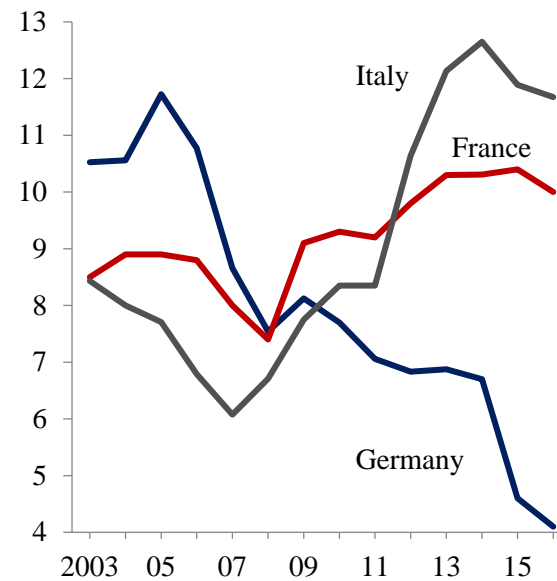
**The single monetary policy—as predicted  
by Nicholas Kaldor (1971) and Alan  
Walters (1986)—causes divergence**

# The great divergence in euro-area incomes and employment.

Per capita incomes  
(In thousands of US dollars, corrected  
for purchasing power parity)



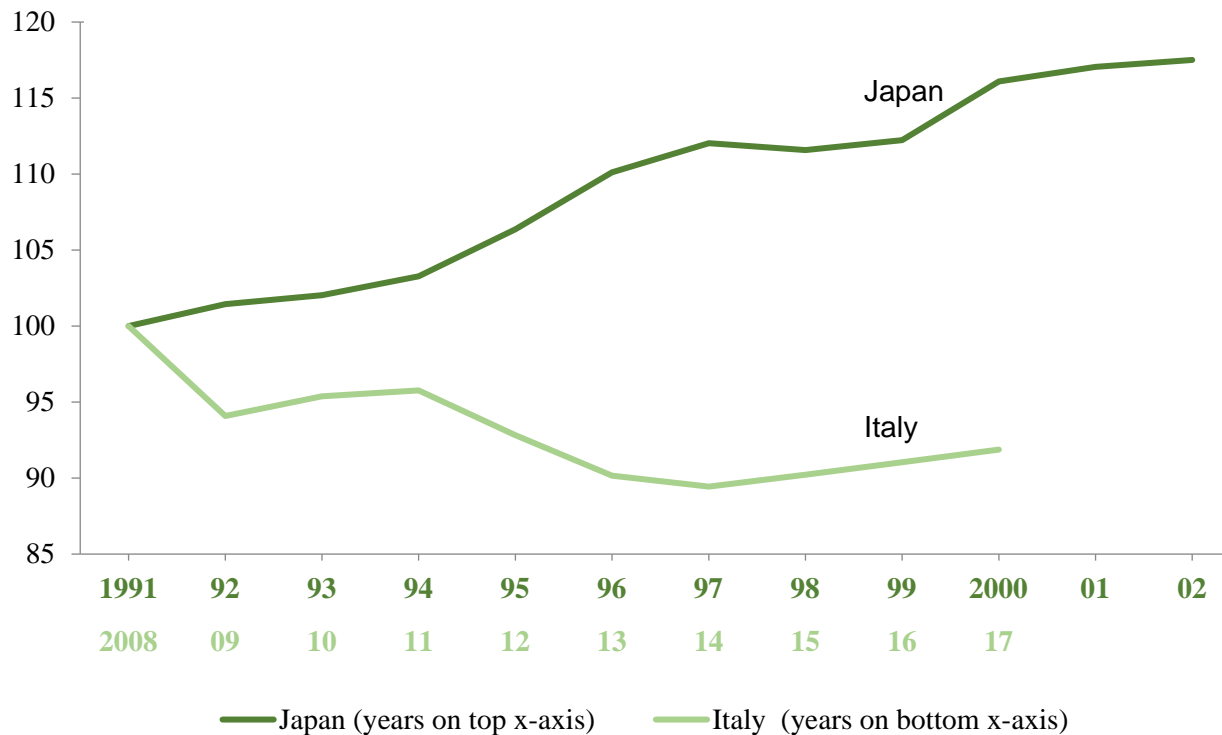
Unemployment rates  
(Percent)



Sources: Conference Board, "Total Economy Database (Adjusted Version)," <http://www.conference-board.org/data/economydatabase/>; IMF, World Economic Outlook Database, <https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>.

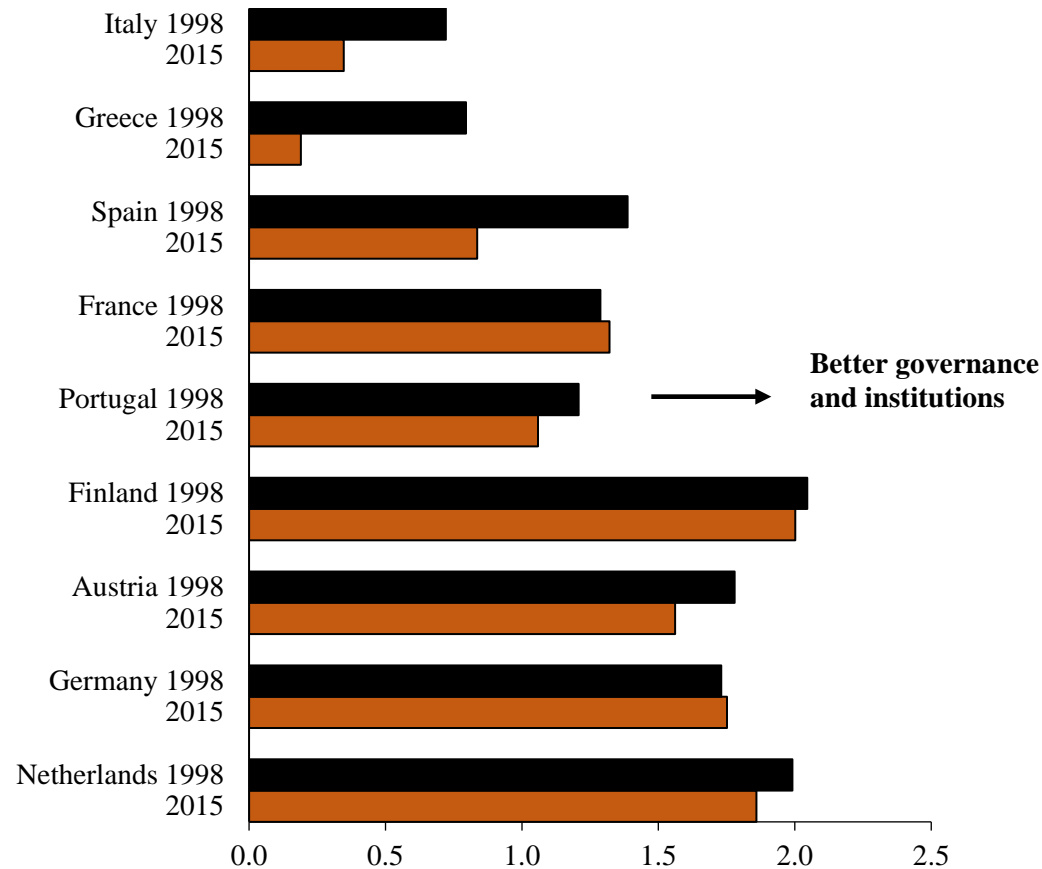
# Another perspective: Italy in the mirror of Japan's lost decade.

(Per capita GDP, corrected for purchasing power parity, Japan 1991=100, Italy 2008=100)



Source: Conference Board, "Total Economy Database (Adjusted Version)," <http://www.conference-board.org/data/economydatabase/>.

The crisis hit Italy hard because, with the exception of Greece, Italy area suffers from the weakest governance and institutions.

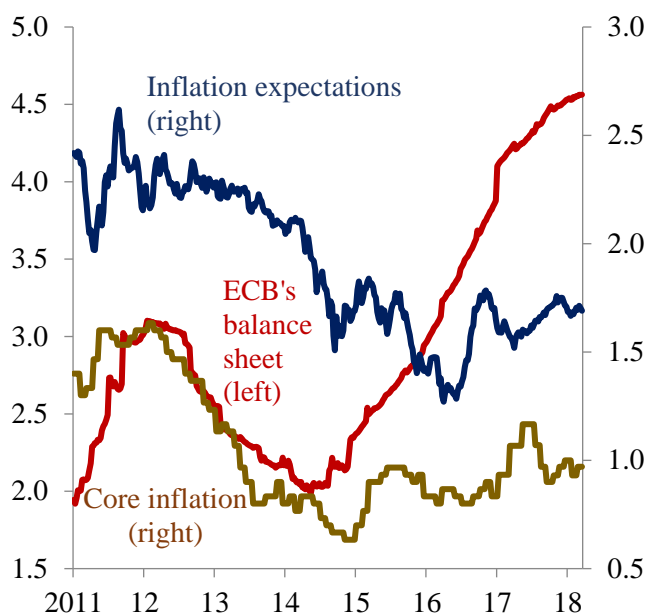


Source: World Bank, Worldwide Governance Indicator. Note: The overall index presented is an average of measures of government effectiveness, regulatory quality, rule of law, and control of corruption. Each individual measure is normally distributed, with a mean of zero, a standard deviation of 1, and an approximate range of -2.5 to 2.5. Larger values indicate better governance.

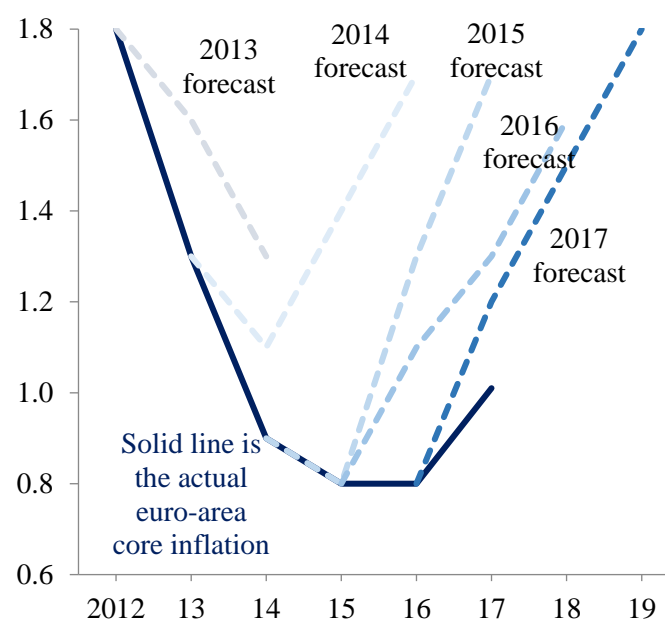
# **ECB's lowflation wound**

## ECB's delayed quantitative easing failed to raise inflation in the manner the ECB anticipated.

The ECB's balance sheet (left-hand scale, trillion euros) increased rapidly, but the annual inflation rate (right-hand scale) remained low



Despite ECB forecasts of rise in inflation, inflation remained at a low level

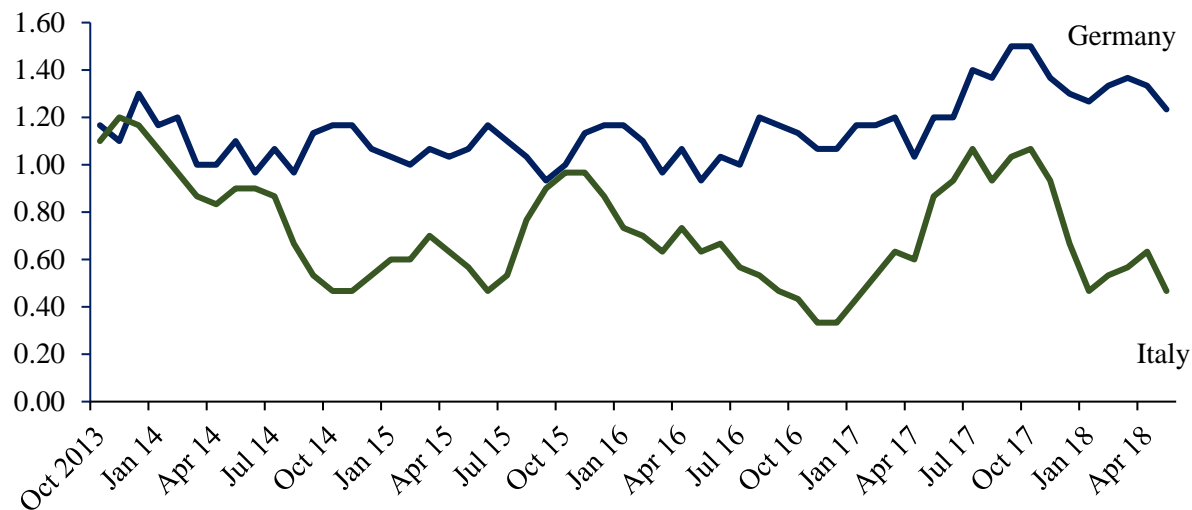


Sources: Left panel: ECB Balance Sheet, Bloomberg's weekly "EBBSTOTA Index" at weekly frequency; inflation expectations are measured by Bloomberg's daily FWISEU55 index (five-year, five-year inflation swaps); core inflation is the three-month moving average of Eurostat's annual change in the monthly "HICP—All-items excluding energy, food, alcohol and tobacco" index. Right panel: ECB's Macroeconomic Projections made in March of the year, <https://www.ecb.europa.eu/pub/projections/html/index.en.html>. Note: The ECB's balance sheet and inflation expectations are plotted at weekly frequency; the core inflation rate for the week is the same as the year-on-year monthly inflation during the month in which the week falls.



# The eurozone problem: single monetary policy causes inflation divergence: Italy's lowflation problem.

(Annual core inflation, three-month moving average, percent)

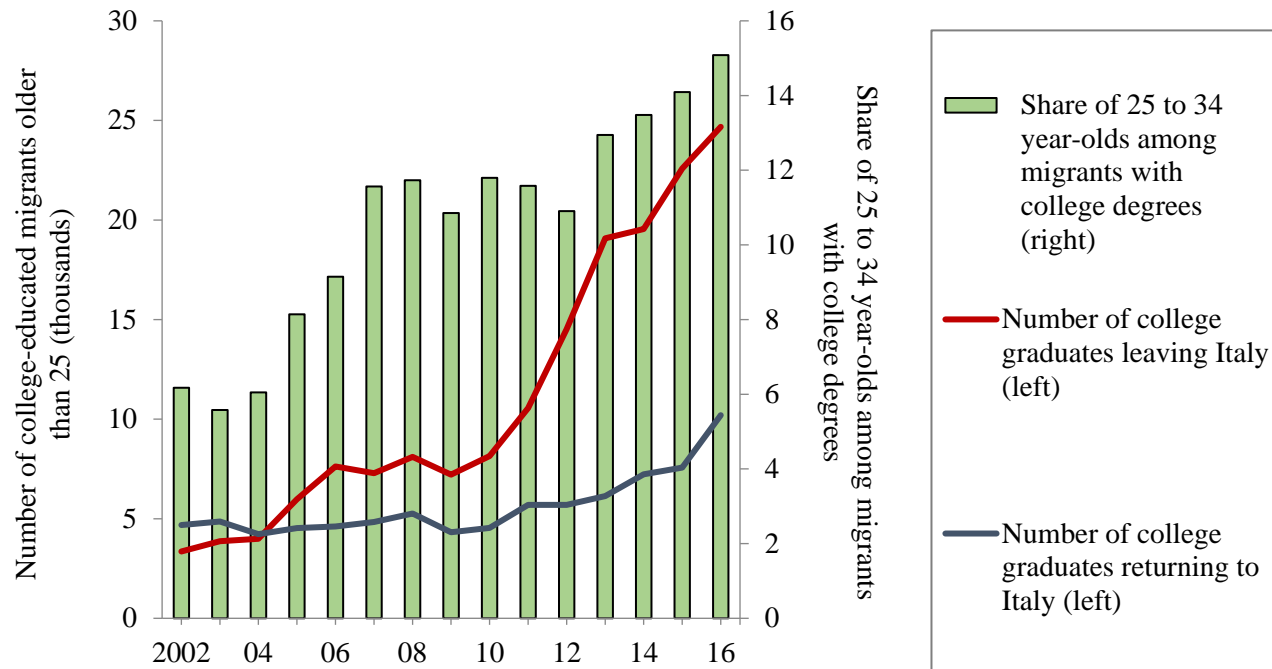


Source: Eurostat. Note: Core inflation is the annual percentage change in the Harmonized Index of Consumer Prices excluding energy, food, alcohol and tobacco.

*Hence, with current 10-year government bond yields near just below 3 percent, Italian real interest rate is over 2 percent, with negative productivity growth and potential growth rate below 1 percent.*

- By early 2014, Annarita Licci's bosses told her that they would reduce her €1,000-a-month salary by €130.
- Once the wage cut went through, Licci said she would not be able to afford her monthly €600 mortgage payment.
- "It's a matter of survival," she said.
- "Why doesn't Electrolux do more R&D and product development here and give us better jobs," she asked.
- Because Italy is in a low growth trap.

## Young college-educated Italians leave Italy in growing numbers.

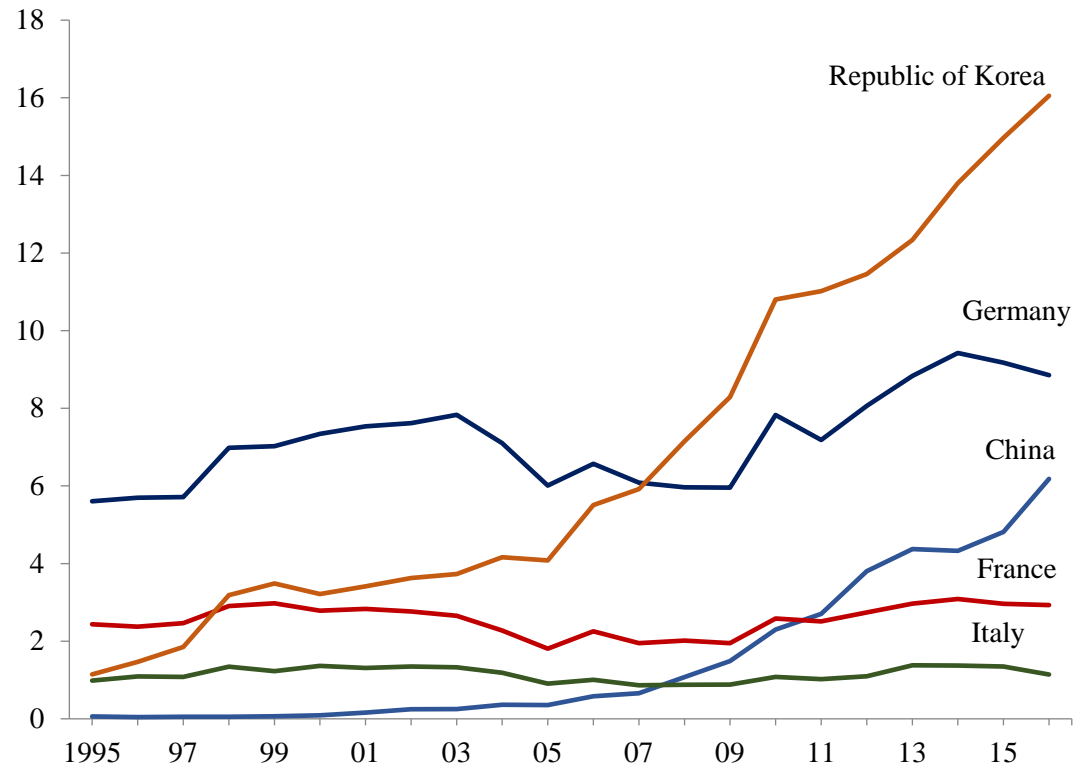


Source: Italian National Institute of Statistics.

*Italy's low growth trap: poor opportunities, the educated leave, R&D remains weak, and opportunities remain poor.*

## The future does not look any better: Asia surges ahead of Europe in the technology race.

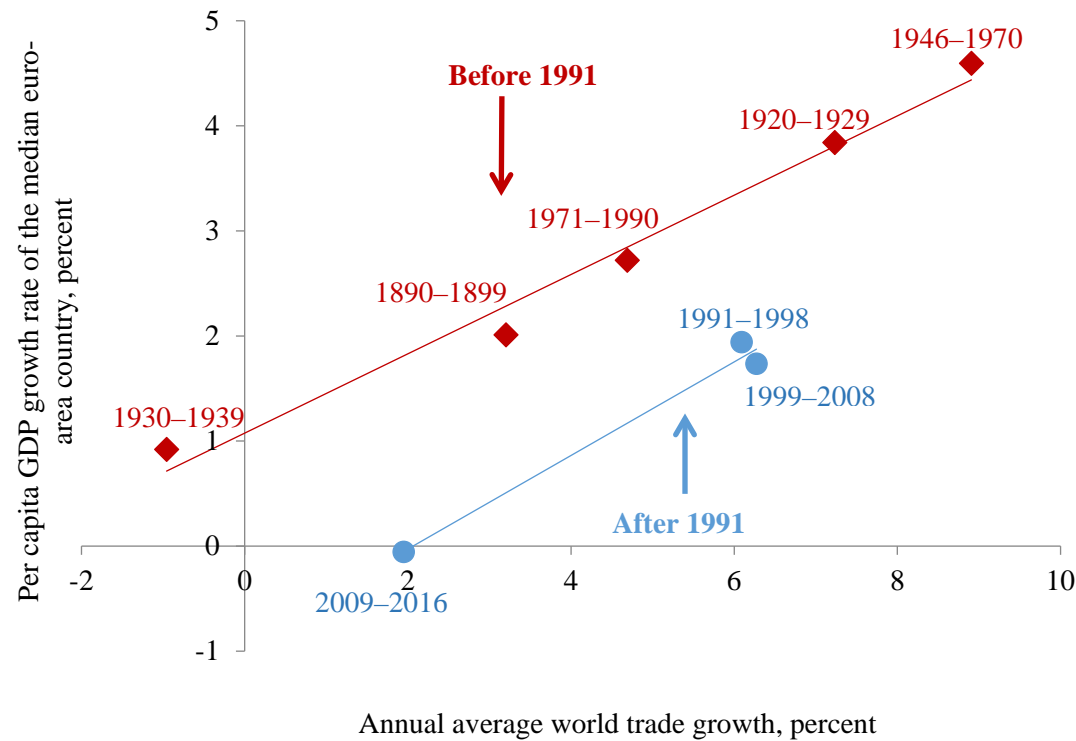
(US patents granted annually to companies in different countries, numbers in thousands)



Source: World Intellectual Property Statistics Database, <https://www3.wipo.int/ipstats/index.htm>.

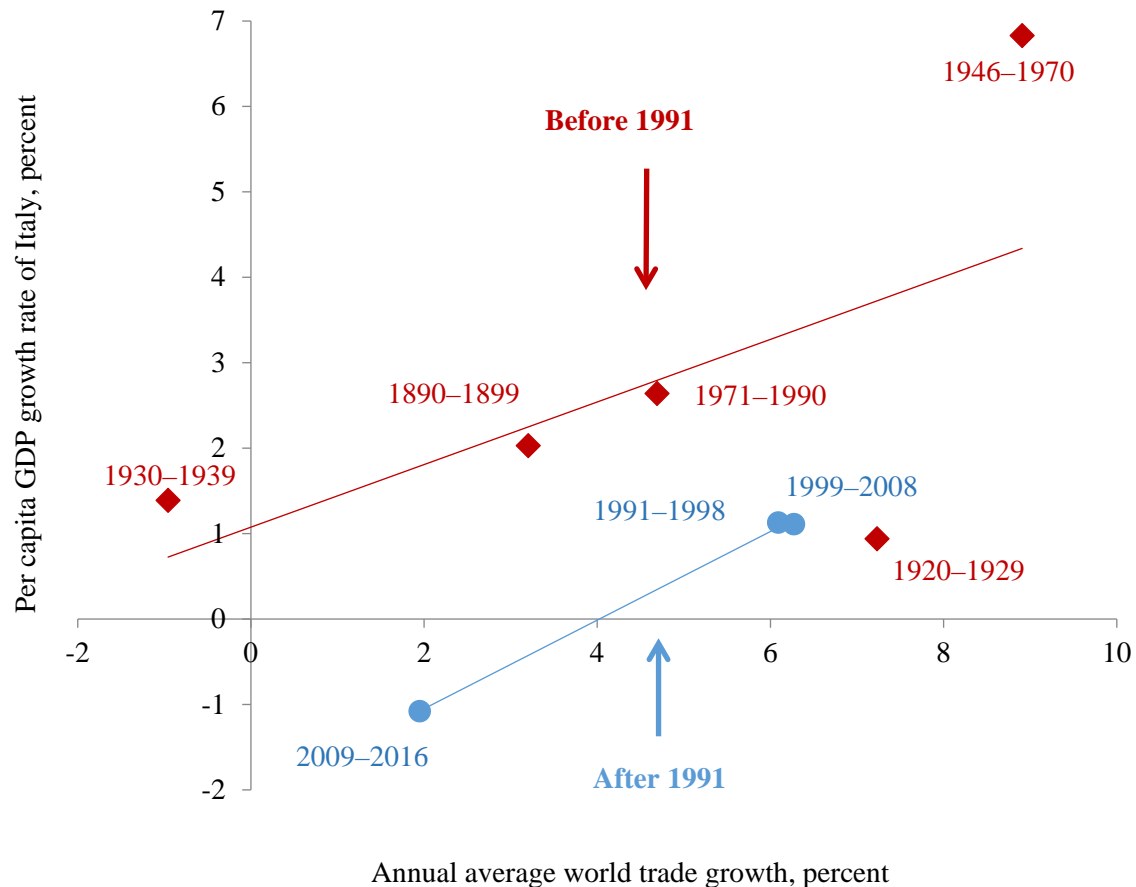
**Short-term growth prospects also looking  
shaky**

## Euro-area growth marches to the drum of world trade growth, which is slowing.



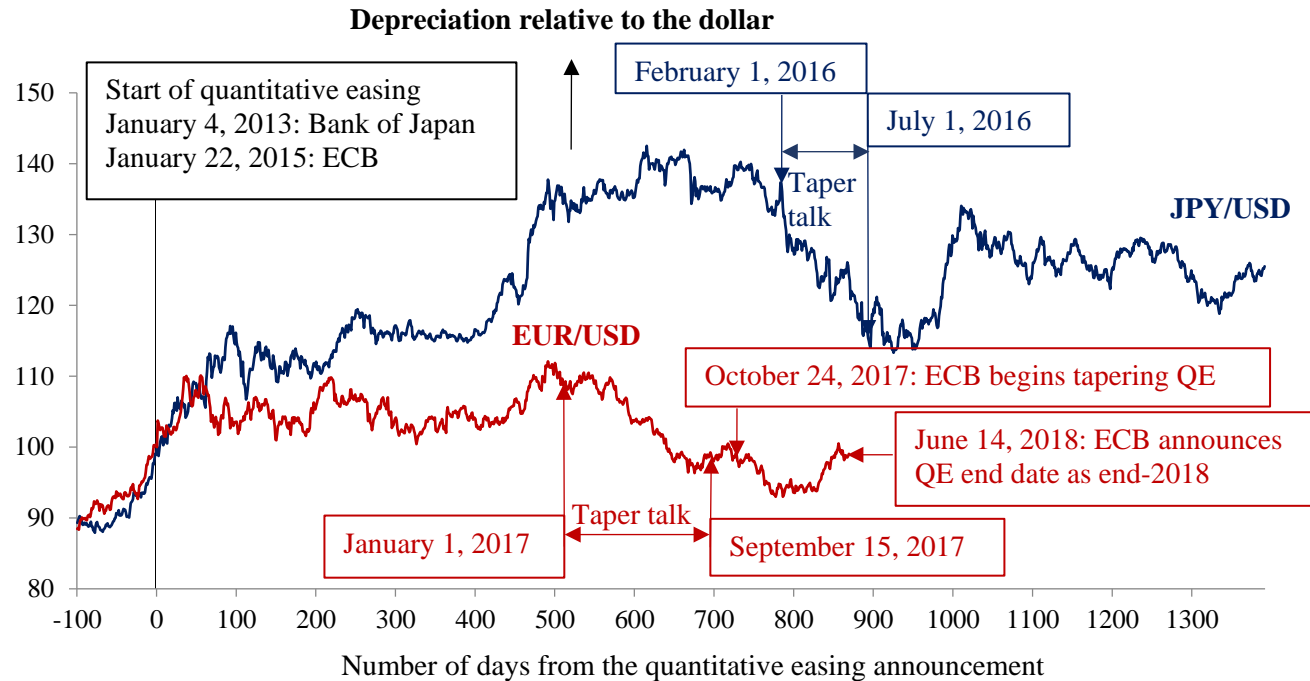
Sources: Real per capita GDP growth rates: Angus Maddison, “Historical Statistics of the World Economy: 1–2008 AD,” <http://www.ggdc.net/maddison/oriindex.htm>; Penn World Tables 8.0, <http://www.rug.nl/ggdc/>; International Monetary Fund, World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx>. World trade: League of Nations, Monthly Bulletin of Statistics; CPB Netherlands Bureau for Economic Analysis, World Trade Monitor, <https://www.cpb.nl/en/data>. Note: Eurozone countries in this chart include Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, and Spain. The periods 1914–1919 and 1940–1945 are missing due to a lack of wartime trade data.

## Italy does even worse when world trade slows



Sources: Real per capita GDP growth rates: Angus Maddison, “Historical Statistics of the World Economy: 1–2008 AD,” <http://www.ggdc.net/maddison/oriindex.htm>; Penn World Tables 8.0, <http://www.rug.nl/ggdc/>; International Monetary Fund, World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx>. World trade: League of Nations, Monthly Bulletin of Statistics; CPB Netherlands Bureau for Economic Analysis, World Trade Monitor, <https://www.cpb.nl/en/data>. Note: The periods 1914–1919 and 1940–1945 are missing due to a lack of wartime trade data.

# Cumulative effect of tight money: ECB credibility even lower than BOJ's in maintaining sustained monetary policy easing.



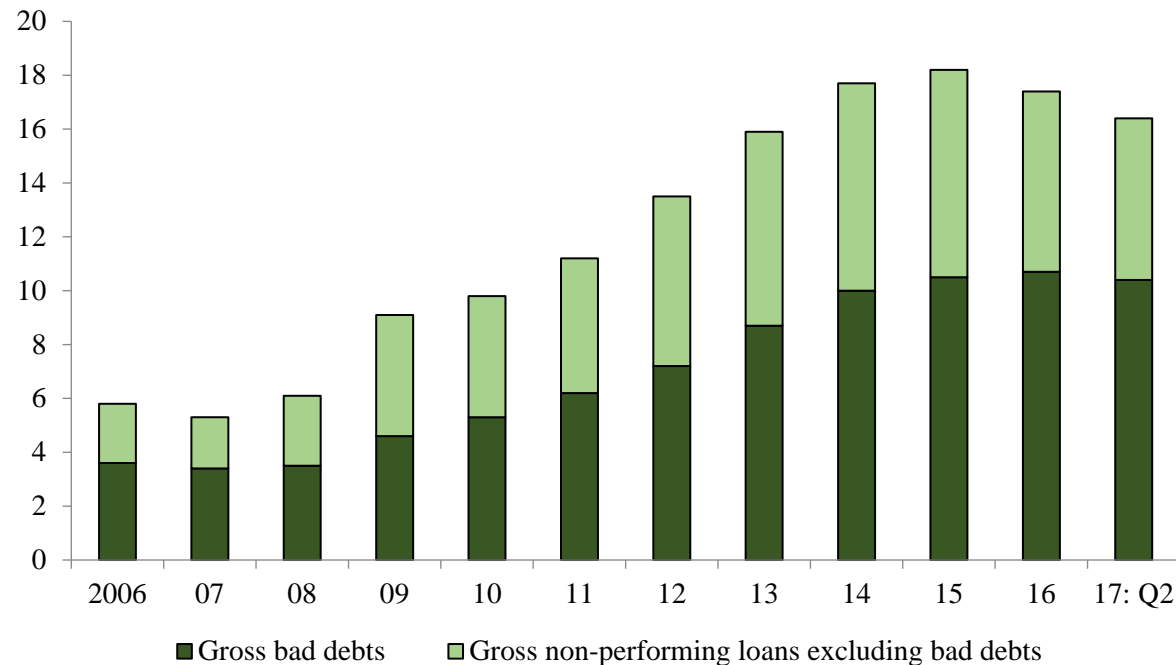
Note: Exchange rate for JPY/USD equals 100 on January 4, 2013 (date of the announcement of quantitative easing by the Bank of Japan) and exchange rate for EUR/USD equals 100 on January 22, 2015 (date of the announcement of quantitative easing by the ECB).

Source: For USD and Japanese Yen, <https://www.investing.com/currencies>, for USD and Euro rates ECB, [https://sdw.ecb.europa.eu/quickview.do?SERIES\\_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC](https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC)



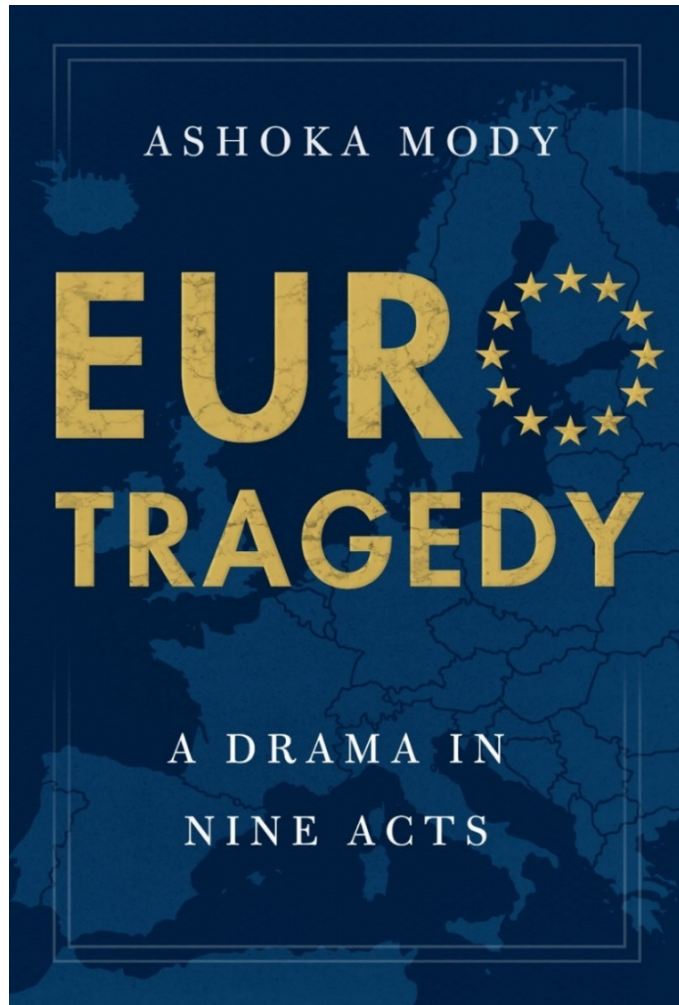
## Italian banks still struggle to collect debts.

(Non-performing loans as a percentage of all loans)



Source: Banca d'Italia, "Financial Stability Report," November 2017, <https://www.bancaditalia.it/pubblicazioni/rapporto-stabilita/2017-2/index.html>. The complete data series is in: "Data for charts," Section 2. Financial system risks, Figure 2.11. Non-performing loan ratios, per cent. Note: "Nonperforming loans" are the loans on which scheduled payments are late by more than 90 days. "Bad debts" is a category of nonperforming loans whose full repayment is highly uncertain because the debtors are either legally insolvent or in an essentially similar situation.

**“It is true, Italy breaks your heart.” Enrico Letta.**



- Italy has not invested in its future for two generations.
- Today, macro conditions are grim:
  - High real interest rates, strong euro, slowing world economy.
- As the Italian economy slows—possibly goes into a recession—non-performing loans and government’s debt burden will rise rapidly.
- These macro conditions will determine budget discussions and performance.
- For sure, Italy will continue to break our hearts.