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COMPLETING THE ECONOMIC AND MONETARY UNION AND THE PIVOTAL ROLE OF ITALY

PART 2: A NON-PUNITIVE CONTRACT FOR INVESTMENT AND REFORM*

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Executive Summary

The Italian government needs to propose a new contractual agreement to European institutions aimed at reforming the country. The process of economic and administrative reform needs to be subjected to rigorous monitoring by the European institutions. On the other hand, Italy should obtain a medium-term plan to re-launch private and public investment through the mobilization of European resources that are, in part, already available. The agreement cannot be reduced to the financial assistance programs that some other euro-zone countries have received in recent years. In fact, it would not be centered on sanctions but it would stimulate that capital formation lost in Italy during the crises due to the radical uncertainty over the future of the euro area. It is this persistent uncertainty that, interacting with the country's own severe weaknesses, impedes the Italian economy to converge towards the rest of the euro area, and thus keeps the future integrity of the monetary union in doubt, as argued in Part 1. This analysis on the impact of radical uncertainty on investment and savings decisions, also suggests the need for a profound revision of European economic governance.

* This text draws from a longer version published for the School of European Political Economy: C. Bastasin & M. Messori: "A Joint Intervention for Italy—A Non-Punitive Plan for Investment and Reform." February 2017. http://sep.luiss.it/brief/2017/02/13/c-bastasin-m-messori-joint-intervention-italy-non-punitive-plan-investment-and-refo

Overview

For many years, and particularly following two serious economic crises, Italy started to diverge from other European economies. Many endeavors were made to remedy the situation. Italy tried to pursue demand and supply side policies aligned with the European institutions' prescriptions, even if in an inconsistent way. At the European level, more severe fiscal discipline was tried out, after which came a period of unlimited support from the European Central Bank (ECB) and budgetary flexibility. From the end of 2011, the Italian government sought to improve its economic institutions' functioning and attenuate labor market segmentation; moreover, mainly starting in 2014, it incentivized household consumption and business investment in order to increase growth in the short term and potential GDP in the long term. Despite these efforts, the Italian economy's divergence with respect to the rest of the EMU worsened: in 2015, almost all member states other than Italy exceeded their GDP peak prior to the 2007-8 crash; again, except for Italy, euro area countries are registering growth rates aligned with those prior to the international crises and aligned, on average, with those of the US. Italy's decline makes its stubbornly growing level of public debt a serious threat for the euro area's integrity.

The shocks of uncertainty on investments

In fact, errors have been made in the analyses of events and their causes. The weakness of the Italian economy, a result of not only public debt but also the country's capitalist system, was underestimated. With the euro, many of the larger firms took refuge in the services sector or in rent seeking positions, at lower productivity, for fear of competition. Credit ended up in real estate, which now accounts for 40% of all non-performing loans clogging up the banking system.

At the European level, interventions based on old handbooks were opted for, with the crises evaluated based only on falls in consumption and employment. For this reason, a divide emerged between proponents of measures to support demand and those who favored supply-side interventions. This pattern accompanied the policy divide between left and right. Additionally, the entire structure of European economic governance was based on the same framework, which left social security cushions in place to bolster consumption while pursuing structural reforms to create job opportunities through improved competitiveness.

However, during the European crises, neither consumption nor employment (at least initially) were the primary victims. In Italy, what fell was investment, which saw two 15% plunges over the course of a few years. These added up to a third of all investment, an event with no precedent among advanced economies. It was an exceptional phenomenon coinciding with shocks that, in 2009 and 2011, put the very institutional framework in which Italian economic actors operated in doubt—the longevity of the euro area and the permanency of Italy in the euro. Contrary to what is generally assumed, in a mobile and financialized Europe, savings and investment were the first to react to shocks, and they did so with extreme shifts. Even the German current account surplus, one of the big macroeconomic imbalances of the European economy, can be explained solely by observing how successive shocks generated uncertainty among German households—which, at certain stages, were also weighed down by doubt over the longevity of the euro area—leading them to take incremental steps to increase savings without, however, changing their propensity to consume. This practice persisted, widening the positive gap between exports and imports.

Europe's system of economic governance was not designed to counteract institutional shocks affecting savings and investment, but to moderate cyclical fluctuations in demand or structural divergences in supply, thus responding to conventional logic. The shock of uncertainty, such as those concerning the euro's demise, are combatted, if at all, in extremis—

for example, when the ECB provided assurance that it will do whatever is takes to save the euro—but these measures are never enough to nullify them entirely. Once uncertainty impacts savers and investors, it creates hysteresis—the behavior of greater savings and/or less investment persisted even after removal of the factors that caused them. Thus, the German current account surplus recurs year after year, even after the government in Berlin helped households to get higher income levels. Equivalently, despite the ECB supporting the euro area's integrity, nothing seemed to convince investors to take a chance on Italy once again.

As long as the underlying causes behind the uncertainty are not addressed, the area's different economies will drift away from each other, because the imbalance between savings and investment in each of them will continue to diverge. Whatever the economic policies of governments, some countries will experience an increase in precautionary savings (despite negative interest rates or, even, because of them) and investors in others will continue to hold back.

The Institutional nature of the shocks

Institutional factors are the most influential in determining investment decisions. Every time Berlin brandishes the threat of a Greek default in order to impose fiscal discipline and reform, it ends up rendering both inefficacious. Paradoxically, it increases fear among German savers and investors as well. In the same vein, every time an Italian political leader theorizes about exiting the euro, it contributes to investor uncertainty. On the other hand, even a rule-based sanctioning procedure for macroeconomic imbalance due to Italy's excessive debt level—a not too remote eventuality—could further increase the level of uncertainty surrounding private investors. In other words, as long as institutional uncertainty persists, the European system of economic governance does not seem apt to dissipate the crises.

The Italian case once again provides additional proof that persistent shocks with a strong impact on investment could also, if not above all, have an "institutional" origin. In 1992, the Italian economy experienced in fact a fall in gross fixed investment of around 15%, which is thus comparable to the corresponding dips between 2008-2009 and 2010-2012. The Italian economic and institutional system was characterized by a set of peculiar factors. On the economic side, Italy played a decisive role in the "breakdown" of the fixed exchange rate system (the European Monetary System) that had been in place since 1979; this, in turn, caused strong financial instability and the national currency's uncontrollable depreciation. Furthermore, the Italian government pursued a restrictive fiscal policy that, after several years of strong deficit, brought about a primary surplus in the national public balance sheet destined to last into the future. An even stronger discontinuity occurred, however, on the politico-institutional level. The clamorous and pervasive corruption accusations, levied by a group of magistrates in the Milan prosecutor's office against the leaders of a large number of major national political parties and various key players in the Italian economy, irreversibly undermined public trust in political representatives and brought about the dissolution of the party system and the substitution of a large chunk of the ruling class. The combination of negative events of an economic but, above all, politico-institutional nature created an environment of uncertainty so radical as to cause a fall in (public and private) investment in Italy.

In 2008-09 and 2011-12, analogous negative combinations occurred in Italy, although the latter resulted from economic and politico-institutional events with an international or European origin. The international financial crisis' rapid propagation to the 'real' sector made quickly evident that the persistently high Italian public debt would have severely limited the possibility of government interventions in the economy. Hence, Italian businesses and households faced a situation of radical uncertainty that, different from almost all other advanced economies, could not have been stemmed by the state's active participation. An even more severe situation manifested between the second half of 2011 and July 2012, since economic and institutional shocks generated radical uncertainty in the euro area, starting with Italy (and Spain). With the perception of Italian isolation, Italian firms and households found themselves once again facing an environment of radical uncertainty, which spread to many other EMU countries (including, as already stated, Germany).

The policy responses—devaluation followed by the launch of EMU's 3rd phase—that allowed the 1992 shock to be absorbed are not reproducible. They indicate, however, an avenue also possible today: bridging the gap between investment and savings by stimulating the former through creating a stable long-term institutional environment.

However, it may already be too late to combat the loss of trust in a country such as Italy. In order to reverse the damage, the institutional framework in which Italy operates needs to be shored up, and the chasm of private investment that the crises provoked must be refilled.

Designing a contractual agreement

Founded on cooperative relationships between various actors and aimed at the creation of favorable conditions for relaunching investment while keeping the effects of "moral hazard" under control, non-conventional European policies require both preventive and corrective actions. The former counter the impact of economic and politico-institutional shocks while the latter reverse them. To be timely, these interventions would require a delegation of powers from national authorities to the system of European governance. The direct route for creating this kind of delegation is to pursue closer economic and institutional integration in the EMU, following the road set out by the Five Presidents' Reports and thus flowing into a progressive centralization of national fiscal policies and into a connected partial mutualization of the public debts of member states. The beginning of a process, oriented in this direction, would signal the European Monetary Union's irrevocability and the design of a new and robust economic governance.

However, in the core member states, the legacy inherited by the crises led to a distinction between fiscally responsible countries and fiscally irresponsible countries that has resulted in a reciprocal loss of trust. Together with the 'political cycle' that opened with the British referendum on Brexit and will ideally close with the upcoming elections in Germany and Italy, the euro area is condemned to a temporary but prolonged stalemate. Hence, an institutional process, aimed at further integration of responsibility, appears politically difficult to implement in the short term.

For this reason, a European plan to help Italy through the creation of a contractual agreement with Europe is now needed. For the government, it would mean creating an ambitious administrative and economic reform proposal and presenting it to the European partners, delegating severe oversight over the implementation of the reforms to European institutions. In this context, Italy could obtain a medium-term plan to relaunch private and public investment, amounting to 1% of GDP annually, through the mobilization of European resources that are, for the most part, already available.

Such an agreement is not comparable to financial assistance by the Troika. It would not, in fact, have the punitive characteristics of those programs, where suspension implies the country's default, thus perpetuating the uncertainty that the attempt is trying to defuse. The exchange between reform and investment is instead targeted at ensuring the flow of capital to Italy that was interrupted by extreme uncertainty over the survival of the euro. This persistent uncertainty is impeding the Italian economy's convergence. It also threatens the integrity of the euro area and hinders every shared policy.

A few details of the new contract

At its core, the incentive design of public and private Italian investment would have to be a form of European transfer or financing. In this regard, it is possible to have recourse to programs already in existence. The first and most obvious reference is to the Juncker Plan and, more specifically, to the functions performed by the EIB's fund (the EFSI) for financing and implementing the selected investment projects. The second reference is to the funds for cohesion and solidarity that are periodically transferred to Italy for various interventions to support the country's southern regions. Combined, the financial resources from these two programs are already relevant. A third source could then come from a portion of the significant financial resources of the European Stability Mechanism (ESM), which have thus far been destined to financing traditional European assistance plans for member states on the verge of bankruptcy or the financing of solvent European banking sectors facing severe difficulties. As far as European norms and rules are concerned, nothing prohibits the ESM's use for financing investment projects in a member state with the goal of guaranteeing the euro area's stability ex ante instead of ex post.

The terms for the realization of the agreement would need to satisfy the following procedures. The Italian government and the European Commission would jointly identify quantitative medium-term growth objectives for the Italian economy and the areas of non-conformity with European rules as well as the principal weaknesses this same economy would have to overcome. The criteria, adopted in this regard, would aim at gradually overcoming structural divergences between Italy and core EMU countries which feed the euro area's instability. The agreement would be aimed at increasing the Italian economy's growth rate and its stabilization over time. On the other hand, it is highly likely that the European Commission would ask the Italian government to adjust its public balance, incentivize the various forms of productivity, improve its education system, strengthen its banking sector, streamline its bankruptcy procedures, introduce reforms to the judiciary and public administration, and adapt the welfare system to new exigencies brought by unemployment and poverty, as well as reduce both tax evasion and fiscal pressure.

The Italian government's successive move would be to design a public investment plan focused on the requalification of human capital, and a consistent incentive scheme for private investment, adequate for reaching the predefined growth objectives, as well as a set of reforms and economic policies which it considers adequate to meet the European rules and to overcome country's structural weaknesses. The European Commission would evaluate the various components of the Italian government's proposal and could request changes. If the adjustments led to a final proposal by the Italian government which receives European Commission approval, the initiative would move into the hands of European institutions.

The European Commission, with the agreement of other European institutions (the European Council, Euro-summit, EU Council, and Euro-group), would be called upon to provide financing and transfers to Italy, which would allow the implementation of the agreed upon plan for public investment and incentives for expected private investment. Additionally, the European Commission, with the agreement of possible lenders (such as the ESM and EFSI), would have to create a formal and rigorous monitoring system to verify that the results in terms of investment and reform meet the plan and the obligations, and that the financial flows are adequate. The process of external verification is the cornerstone of the contract and would have to result in quarterly reports to be also submitted to the European Parliament in order to reinforce the accountability of EMU governance. The positive evaluation by European institutions would be necessary for the continuance and completion of the contractual agreement.

Delegating oversight instead of sovereignty

The main idea underlying the contractual agreement is, therefore, simple. In view of a reform agenda, Italy would obtain European financial resources consistent with the restructuring program of "Standort Italia," i.e., Italy as a venue for the production of goods and services. A reasonable and concrete growth objective could be based on a 1% additional annual growth rate for total investments. Support for the implementation of the measures required in Italy can be found in active EIB and ESM financing programs. Thus, the Italian economy would cease to be a divergent factor in the EMU, and the other member states would no longer have to fear that the third largest euro area country would act as a hot bed of instability.

Italy's contract would not surrender sovereignty over the reforms' design, which would remain the country's mandate and reflect its political preferences, while entrusting European institutions with fundamental oversight over the implementation of both the reforms and investment. The lack of oversight, legality, and efficiency, at every level, is behind Italy's lagging performance and low productivity. It has made even Italians wary of each other, as well as exaggeratedly distrustful of the future of their country.