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THE FALSE PROMISES OF THE EMU: THE CASE OF THE ITALIAN ‘DECLINE’

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The starting point of the EMU was the connection ‘*monetary stability = growth*’. However, the economic performance of the European economy in the past decade has been very unsatisfactory. Monetary stability has not produced the promised growth. Italy, in particular, is experiencing the connection ‘*monetary stability = decline*’. Its growth rate is decreasing not only in absolute terms, but also relatively to the other European countries.

The widespread interpretations of Italian ‘decline’ focus entirely on the supply-side of the economy: the scant flexibility of the labour market, the low competitiveness and flexibility of the markets for goods and services, the excessive weight and the inefficiency of the state, the increasing competition by the emerging countries.

Is it correct to entirely ignore the demand side? This is the main question addressed by the paper. On reviewing the post-World War II Italian economic development, the answer is negative. From the point of view of its timing, the Italian economic decline coincides with the restrictive U-turn of macroeconomic policies of the 1980s and 1990s. By contrast, most of the structural supply-side problems of the Italian economy were already present in the 1970s while competition by the emerging countries is a phenomenon of the 1990s. Supply-side problems have only indirectly caused Italy’s ‘decline’, i.e. by forcing a contraction of aggregate demand. This means that the proposed supply side policies will not necessarily be sufficient. In order to restart the Italian economy, they will have to be coupled with an increase in aggregate demand.

The inadequacy of a strategy based exclusively on the supply-side is confirmed by the limited effects of the increased flexibility of the Italian labour market. As a consequence of the fall in wages and of the higher uncertainty, consumption did not grow. The increase in profits did not turn into a rise in investments. Italian productivity and competitiveness have fallen. Both domestic and foreign demand are stagnant.

The Italian case may serve as a lesson for Europe as a whole.

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1. THE PROMISE OF THE EMU AND THE ITALIAN DECLINE

The promise of the EMU was

MONETARY STABILITY = GROWTH

An illuminating example is the Stability and Growth Pact, according to which sound public finances would guarantee growth.

As a matter of fact, however, Europe has been loosing ground to the USA.

In 2005, the Stability and Growth Pact had to be loosened.

Italy, the 'black sheep' of the EMU, is experiencing:

MONETARY STABILITY + 'DECLINE'

The term decline is recurring; to quote only some examples:

- Nardozzi, G. 2004, *Miracolo e Declino*.
- Toniolo, G. e Visco, I. 2004, *Il Declino Economico Italiano*
- Boeri T., Faini, R. et al. 2005, *Oltre il Declino*
- Economist, 2005, 26th Nov., *Addio dolce vita*

'DECLINE' = DECADENCE/IRREVERSIBLE DETERIORATION

While Europe is loosing ground to the USA,
Italy is loosing ground to Europe.

The main symptom of the Italian decline is a low and declining growth rate, both in absolute terms and relatively to the other European countries.

We shall focus on this symptom of the decline.

Further symptoms:

- small dimension of Italian firms;	- low expenditure in R&D
- low productivity;	- low overall employment rate (among the lowest among the EU25)
- higher inflation rate;	- high inefficiency in the market for goods and services
- low and declining competitiveness	- high, and increasing, North-South divide
- trade specialization in traditional sectors	
- the decreasing share of world exports	
- a low level of education	

2. WIDESPREAD INTERPRETATIONS OF THE ITALIAN DECLINE

THE DIAGNOSIS

At the aggregate level, the *causes of the decline* have been identified in the literature and by policy makers as follows.

- i. On the domestic front, *structural problems* such as:
 - the excessive weight and the inefficiency of the State;
 - the rigidity of the labour market;
 - the low competitiveness and flexibility in the markets for goods and services.

- ii. On the foreign front:
 - the competition from the *emerging countries*.

THE SUGGESTED THERAPIES

Structural reforms, such as:

- to reduce the weight and inefficiency of the State;
- to increase the flexibility of the labour market;
- to increase competitiveness and flexibility in the markets for good and services.

THE UNDERLYING PHILOSOPHY

Italy needs more market and more efficiency. To this purpose, it has:

- i) to strengthen the market mechanisms by stimulating competitiveness, flexibility and so on;
- ii) to move the production function upwards, by increasing efficiency, productivity and so on.

OUR DOUBT

The widespread interpretations focus entirely on the *supply-side*.

Is it correct to ignore the *demand-side*?

As we shall see, if we think back to the Post-World War II Italian economic development, *demand factors* seem to have performed a crucial role.

3. A 'FRESCO' OF THE ITALIAN POST-WORLD WAR II ECONOMIC DEVELOPMENT

The fresco we are going to present seems to be widely consistent with the literature. It identifies two phases of the Italian economic development, each of them composed by two periods.

1ST PHASE: THE EMERGENCE OF THE 'SUPPLY-SIDE PROBLEMS'

This phase includes two periods: the Italian 'economic miracle' (1959-1962) and the period of the supply-side shocks (1963-1979).

1.1. THE PERIOD OF THE ITALIAN ECONOMIC MIRACLE (1959-62)

This period ends the 'post war catching-up'.

Italy becomes one of the major industrialized countries.

Table 1. 1961: a 'symbolic' year of the miracle

Real L-T Int. Rate (%)	Gov. Budget (%GDP)	Real GDP (%Δ)	Gdp Deflator (% Δ)
+2.4 (EU +2.4)	-1.3	+8.2 (EU +6.2)	+2.8 (EU +3.3)

Premises

- Expansion of the world economy
- Low absolute and relative wages

Macroeconomic Policies

They are 'prudent', performing a secondary role

Monetary Policy

- is oriented towards price and exchange rate stability
- the real interest rate is +2.4%, in line with the European one

Fiscal Policy

- The government deficit is contained, 1.3% of GDP

Results

- A spontaneous '*virtuous circle*' based on:
"competitiveness/exports/income/investments/competitiveness"
- High export-led growth; the growth rate is 8% in 1961, much higher than the European one.
- A consistent current-account surplus in the BoP
- Inflation is at 2.8%, slightly lower than the European one.

1.2. THE PERIOD OF THE SUPPLY-SIDE SHOCKS (1963-79)

Table 2. Main economic indicators (1963-79)

	1961	1963-1979 (ann. aver.)	1980
Real L-T Interest Rates (%)	+2.4 (EU +2.4)	-0.6 (EU +1.1)	
Cumul. Real Depreciation (% Δ of REER; 1973-1979)		1.9	
Government Budget (% of GDP)	-1.3	-6	
Growth Rate (% Δ)	8.2 (EU 6.2)	4.4 (EU 4.2)	
GDP Deflator (% Δ)	2.8 (EU 3.3)	9.8 (EU 7.4)	20.9 (EU 6.7)

Premises

- The cost of labour increases (1962/3, 1969/70, 1975).
- The cost of oil increases (1973, 1979).
- Strong inflationary impulses.
- The current account of the BoP goes into deficit.
- The export-led growth comes to an end; miracles do not last.

Macroeconomic policies

They become expansionary in order to sustain growth.

Monetary policy:

- the real interest rate becomes negative, -0.6% on average;
- the exchange rate depreciates both in nominal and in real terms, thus supporting Italian competitiveness.

Fiscal policy:

- the government deficit increases to 6% of GDP.

Results

- Real Income: the growth rate decreases to 4.4%, remaining slightly higher than the European one.
- Prices: The '*vicious circle*' of costs/prices/depreciation/costs emerges. As a consequence, the inflation rate reaches double digits, becoming consistently higher than the European one (20% in 1980).

Conclusions

- The Italian economy stops growing spontaneously.
- Thanks to the support of macroeconomic policies, however, it maintains a growth rate slightly higher than the European one
- The wage increases and the oil crises bring to the surface a chronic inflation differential with respect to the rest of Europe.

2ND PHASE: THE EMERGENCE OF THE 'DEMAND-SIDE PROBLEMS'

This second phase includes two periods: the restrictive monetary U-turn (1980-91) and the restrictive fiscal U-turn (1992-98).

2.1. THE PERIOD OF THE RESTRICTIVE MONETARY U-TURN (1980-91)

Table 3. Main economic indicators (1980-91)

	1980	1980-91 <i>(annual average)</i>	1992
Real L-T Int. Rates (%)		+3.6 <i>(EU 4.3)</i>	
REER Appreciation <i>(% Δ, 1973-79)</i>		+3.9	
Gov. Budget (% of GDP)	-8.3	-10.9 <i>(EU 4.6)</i>	-10.7%
Prim. Gov. Budget (% of GDP)	-3.2	-2.8	+2
Int. payments (% of GDP)	5.1	8.1	12.7
Gov. Debt (% of GDP)	57.7	81.4	107.7
Growth Rate (% Δ)		2.3 <i>(EU 2.4)</i>	
GDP Deflator (% Δ)	20.9 <i>(EU 11.2)</i>	11.3 <i>(EU 6.7)</i>	4.5 <i>(EU 4.3)</i>

Premises

- The Exchange Rate Mechanism of 1979;
- The consequent need to stabilize the exchange rate, despite the high inflation differential.

Macroeconomic Policies

Monetary Restrictive U-Turn:

The strategy of the Bank of Italy is to increase the interest rate in order to determine capital inflows able to sustain the exchange rate inside the ERM.

- In terms of real interest rate, we go from a negative value to an average of +3.6%
- The real exchange rate this time appreciates

Expansionary Fiscal Policy

The increase in the rate of interest provokes the explosion of government interest payments and deficit, despite the slight reduction in the primary deficit.

Incomes Policy

From 1980 onwards, tripartite agreements (1982, 1984, 1986) produced a dramatic reversal in income distribution (labour share started to fall, in favour of gross profit share).

Results

- Real Income. The growth rate falls to 2.3%, for the first time it becomes lower than the European one.
- Prices. The *vicious circle* inflation-devaluation slows down. As a consequence, inflation falls from 20% in 1980 to 7.6% in 1991 and to 4.5% in 1992, keeping slightly above the European one.
- Public Finance. The *vicious circle* of debt-interest payments-debt appears, leading to the explosion of government debt from 58% in 1980 to 108% in 1992.

Conclusions on the restrictive monetary U-turn

- The Italian growth rate falls *for the first time* below the European one.
- Inflation falls (thanks also to the union's attitude and to the fall in the \$ price of petrol), but keeps above the European one.
- Public finance worsens dramatically: the problem of the Italian government debt arises now.

2.2. THE PERIOD OF THE RESTRICTIVE FISCAL U-TURN (1992-98)

Table 4. Main economic indicators (1992-98)

	1992	1992-98 (annual average)	1998
Real L-T Int. Rates (%)		5.8 (EU 4.7)	
REER Appreciation (% Δ, 1973-79)		-2.7	
Gov. Budget (% of GDP)	-10.7	-6.9 (EU 4.2)	-2.8
Prim. Gov. Budget (% of GDP)	+2	+4.2	+5.2
Int. payments (% of GDP)	12.7	11.1	8
Gov. Debt (% of GDP)	107.7	119	116.4
Growth Rate (% Δ)		1.3 (EU 1.7)	
GDP Deflator (% Δ)	4.5 (EU 4.3)	3.9 (EU 2.7)	2.7 (EU 1.7)

Premises

- The Maastricht Treaty of February 1992
- Italy does not fulfill the Maastricht criteria, particularly with respect to the government deficit and debt.
- In September 1992 (and then in 1995) there is a strong speculative attack against the lira. The fear is that inflation will rise again.
- The admission to the EMU is strongly in doubt.

Macroeconomic Policies.

Monetary Policy

- becomes even more restrictive.
- the real rate of interest increases to 5.8%, above the European one.

Fiscal policy

- becomes highly restrictive (1992-93 e 1997).

- a high primary surplus (4.2%) partially compensates the interest payments (11.1%), thus reducing the government deficit (6.9%).

Labour market policy

Several structural changes are approved (either by law or by agreement with social partners) to increase both wage and employment flexibility:

- income policy agreement (2nd July 1993): abolition of the wage indexation mechanism and introduction of the two-tier wage bargaining system
- labour market reforms (1996, 2003) to allow for more flexibility through the expansion of atypical employment contracts

Results

- Real Income. Despite the devaluations, the growth rate falls to 1.3, keeping below the European one.

- Prices. Inflation falls to 3.9%, keeping above the European one.

- Government Deficit. It falls consistently, from 10.7% in 1992 to 2.8% in 1998.

- Employment. After the fall in the early 1990s, employment records positive increases since 1995 (but with a dramatic slow down in productivity)

Institutional achievements

Fulfillment of the Maastricht Criteria (1997)

Drawing up of the Growth and Stability Pact (1997)

Admission to the EMU (May 1998)

Birth of the EMU (1st January 1999)

Adoption of the Euro (2002)

This, however, also implies

the loss of fiscal, monetary, exchange rate policies!

4. THE IMPLICATIONS OF OUR 'FRESCO' FOR THE ITALIAN DECLINE

Our fresco confirms the widespread diagnosis. The 'decline' can be really traced back to the Italian *supply-side problems* that emerged in the 1960s and 1970s.

These supply-side problems, however, seem to have acted indirectly, i.e. by forcing a contraction of *aggregate demand*.

It is only in the 1980s and 1990s, when macroeconomic policies become restrictive, that the Italian growth rate falls below the European one.

The following figures might improve our understanding of what has happened. Let us start with inflation.

Figure 1. Italian and European inflation; gap between the two

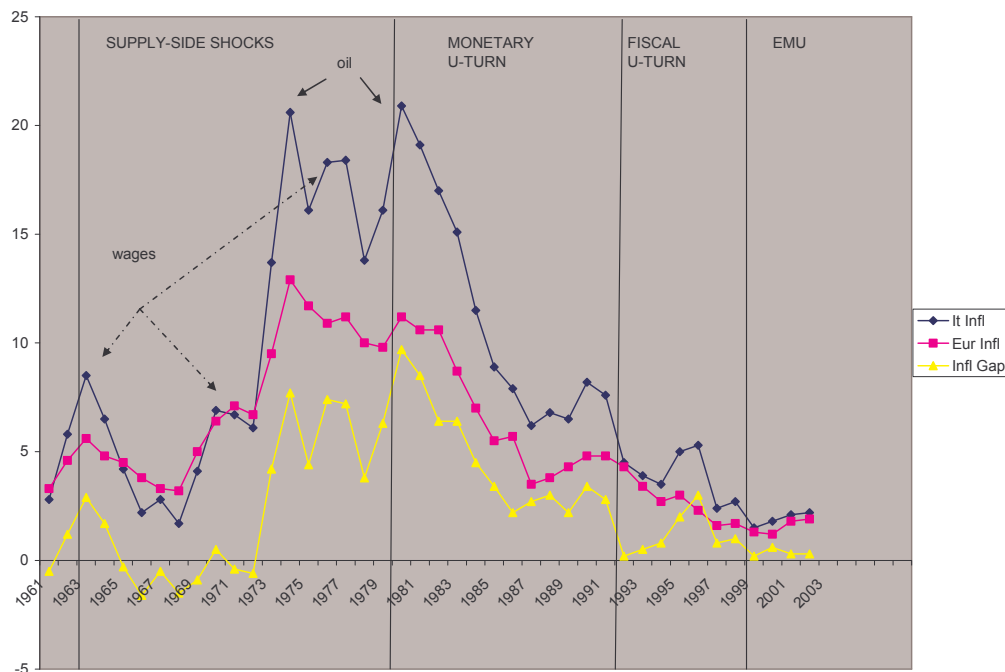


Figure 1 shows:

- the remarkable inflationary repercussions of the supply-side shocks of the 1960s and 1970s
- the sharp decrease in inflation of the 1980s and 1990s connected to the restrictive U-Turn in macroeconomic policies.
- despite its fall, the Italian inflation rate tends to remain higher than the European one.

Let us now consider the U-turns in macroeconomic policies, starting from the monetary one.

Figure 2. Real Long-Term Interest Rates in Italy and in Europe. Nominal Effective Exchange Rate (divided by its last value).



In the 1960s and even more in the 1970s, the Italian monetary policy was more expansionary than the European one. On average, the real interest rate tends to be lower. To this, we can add the exchange rate devaluation of the 1970s.

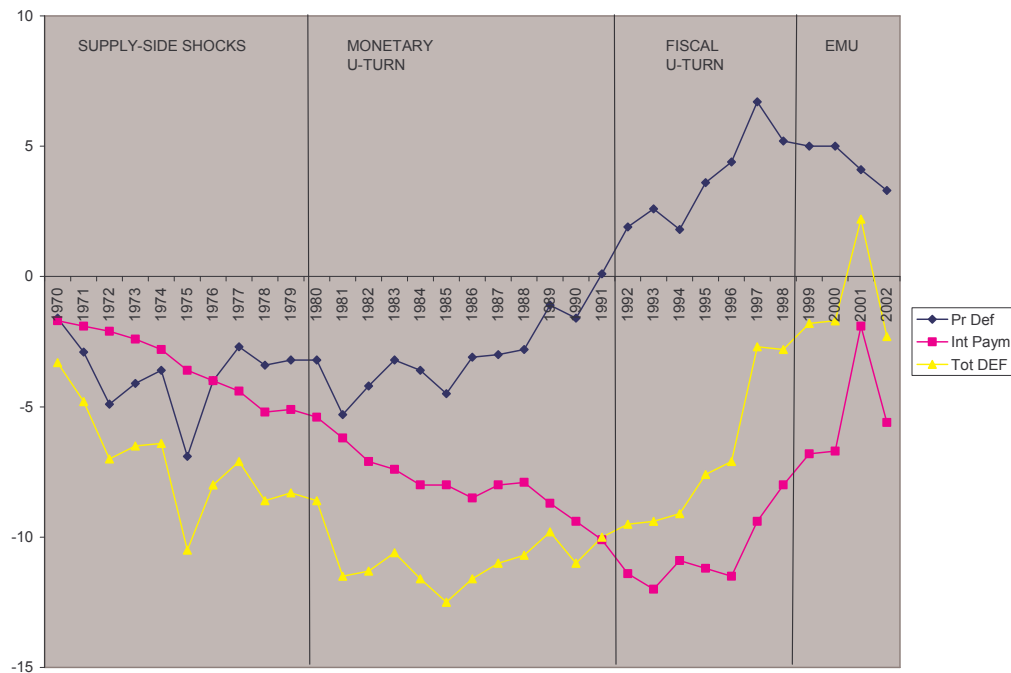
From 1980, on the contrary, the Italian monetary policy tends to become not only restrictive but also more restrictive than the European one.

The real interest rate becomes positive and, on average, higher than the European one.

In the 1980s, the exchange rate interrupts its fall and start rising. The exchange rate devaluations of 1992 and 1996 took place 'despite' the Bank of Italy, out of speculative attacks against the lira.

Let us now turn to the fiscal U-turn of the 1990s.

Figure 3. Primary deficit, interest payments, government deficit



In the period of the supply-side shocks, fiscal policy is expansionary. The primary deficit is high, interest payments increase, the government deficit increases.

In the period of the monetary U-turn, the decrease in the primary deficit is overwhelmed by the increase in interest payments. As a result, the government deficit grows.

In the period of the fiscal U-Turn, the primary deficit turns into a remarkable surplus, interest payments fall, the government deficit falls.

Finally, let us look at the Italian growth rate.

Figure 4. Italian and European growth rate, gap between the two



In the period of the supply-side shocks, when macroeconomic policies were expansionary, the Italian growth rate is not only high, but also higher than the European one.

It is when macroeconomic policies become restrictive that the Italian growth rate tends to be lower than the European one.

In other words, the Italian ‘decline’ of the 1980s and 1990s seems to be a consequence of the *fall in aggregate demand* due to the monetary and fiscal U-turns.

On the opposite:

- The *domestic structural problems* were present also in the 1960s and 1970s.
- The competition from the *emerging countries* is a phenomenon of the 1990s.

As we have seen, the Italian decline of the 1980s and 1990s coincides with the inflation slowing down. If there were aggregate supply contractions, the aggregate demand contractions would thus have prevailed.

5. CONCLUSIONS

New Classical and Real Business Cycle Theories do not seem to apply to the Italian experience. Italian business fluctuations do not look like random shocks. They seem to be perfectly understandable in terms of domestic and international income redistributions on the one hand and of macroeconomic policies on the other hand. Furthermore, according to the Italian experience, aggregate demand seems to perform a crucial role.

The illness of the Italian society and the structural weaknesses of the Italian economy are under everybody's eyes.

Nevertheless, the supply-side problems seem to have caused the Italian decline only indirectly, i.e. by forcing a contraction of aggregate demand.

It was a probably a mistake to try to solve the Italian supply-side problems with demand contractions. Now we have problems on both the sides.

If this is true, the proposed structural reforms, alone, will not necessarily be able to restart the Italian economy. They will have to be coupled by an increase in aggregate demand.

Given the worrying level of the Italian government debt, a solution might be the golden rule. If properly used, government expenditure might be the best instrument to solve our supply and demand-side problems at the same time.

In the last decade, the Italian labour market has become much more flexible. Firms' profits have increased by a considerable amount. This, however, has not led to the hoped increase in investments, productivity and competitiveness. Domestic and foreign demand keeps being stagnant. The productive capacity keeps being underutilized. This should be a lesson for the whole Europe.

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