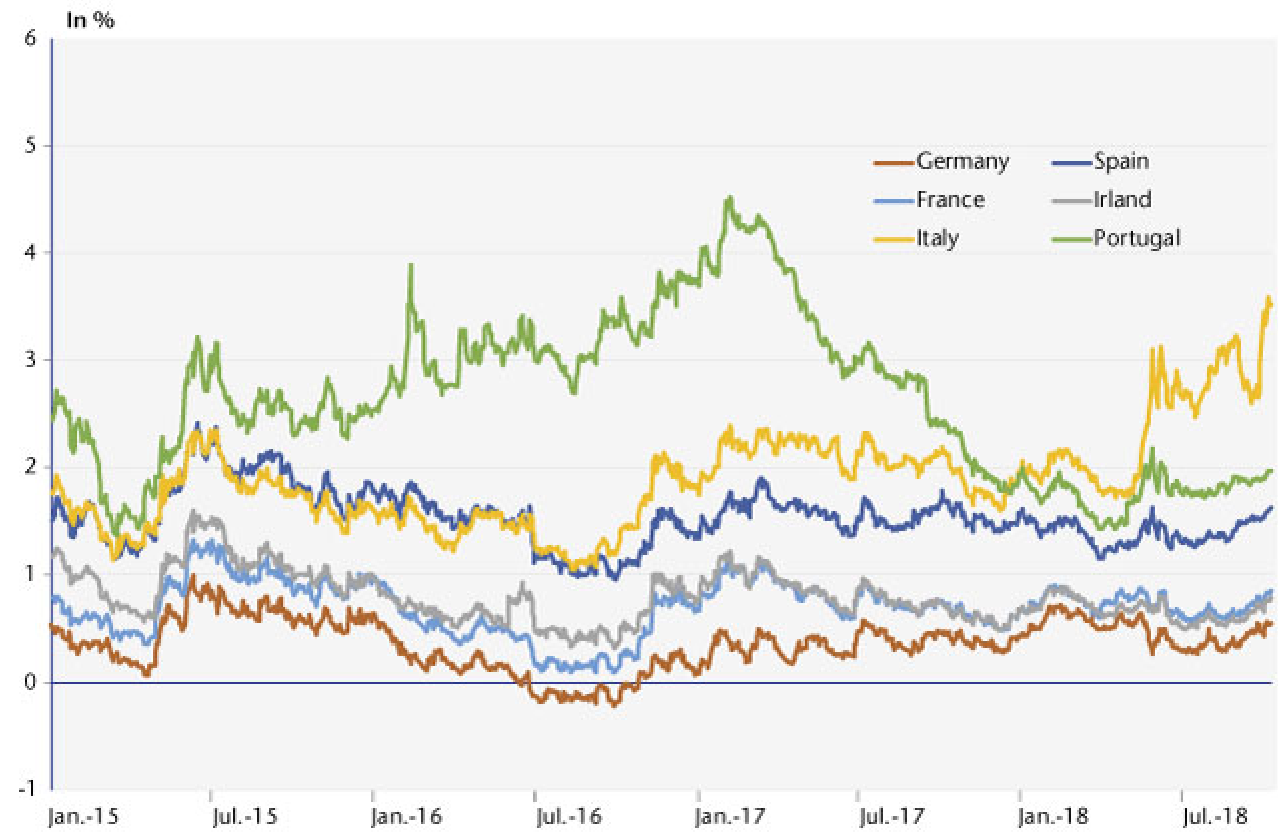
Italy’s debt: Is the bark worse than the bite?

By Céline Antonin

The spectre of a sovereign debt crisis in Italy is rattling the euro zone. Since Matteo Salvini and Luigi di Maio came to power, their headline-catching declarations on the budget have proliferated, demonstrating their desire to leave the European budgetary framework that advocates a return to an equilibrium based on precise rules[1]. Hence the announcement of a further deterioration in the budget when the update of the Economic and Financial Document was published at the end of September 2018 frayed nerves on the financial markets and triggered a further hike in bond rates. (**graphic**).

But should we really give in to panic? The crucial question is just how sustainable the Italian public debt really is. Looking up to 2020, the situation of the euro zone’s third-largest economy is less dramatic than it might appear. Stabilizing interest rates at the level of end September 2018 would leave the public debt largely sustainable. It will decline in 2019, from 131.2% to 130.3% of GDP. Given our assumptions[2], only a very sharp, long-lasting rise in bond interest rates in excess of 5.6 points would lead to an increase in the public debt ratio. In other words, the bond rate would have to exceed the level reached at the peak of the 2011 sovereign debt crisis. Should such a situation occur, it’s hard to believe that the ECB would not intervene to reassure the markets and avoid a contagion spreading through the euro area.

Figure. Interest rate on 10-year sovereign bonds



Source: Datastream.

A very strong fiscal stimulus in 2019

Changes in the public debt ratio depend heavily on the assumptions adopted. The ratio varies with the general government balance, the GDP growth rate, the deflator, and the apparent interest rate on the public debt (see calculation formula below).

In budgetary matters, despite their differing views, the two parties making up the Italian government (La Ligue and the 5 Star Movement) seem to agree on at least one point: the need to loosen budget constraints and boost demand. In any case the government contract, published in May 2018, was unequivocal. It announced a fiscal shock amounting to approximately 97 billion euros over 5 years, or 5.6% of GDP over the five-year period. But although the measures have been gradually reduced, the draft presented to the Italian Parliament plans for a public deficit of 2.4% of GDP for 2019, far from the original target of 0.8% set in the Stability and Growth Pact forwarded to the European Commission on 26 April 2018. We assume that the 2019 budget will be adopted by the Parliament, and that the deficit will indeed be 2.4% of GDP. We therefore anticipate a positive fiscal impulse of 0.7 GDP point in 2019. This stimulus breaks down as follows:

– A decrease in compulsory taxation of 5 billion, or 0.3 GDP point, linked to the gradual introduction of the “flat tax” of 15% for SMEs, a measure supported by the League. The extension of the flat tax to all businesses and households was postponed until later in the mandate, without further clarification;

– An increase in public spending, calculated roughly at 7 billion euros, or 0.4 GDP point. Let’s first mention the flagship measure of the 5 Stars Movement, the introduction of a citizens’ pension (in January 2019) and a citizens’ income (in April 2019), for an estimated total amount of 10 billion euros. The citizens’ pension will supplement the pension of all pensioners, bringing it to 780 euros per month. For the working population, the principle is similar – supplementing the salary up to 780 euros – but subject to conditions: recipients will have to take part in training and accept at least one of the first three job offers that are presented to them by the Job Centre. The revision of the pension reform, which provides for the “rule of 100”, will also allow retirement when the sum between a person’s age and the years worked reaches 100, in certain conditions. This should cost 7 billion euros in 2019. Finally, an investment fund of 50 billion euros is planned over 5 years; we are expecting an increase in public investment of 4 billion euros in 2019. To finance the spending increase without pushing the public deficit above 2.4%, the government will have to save 14 billion euros, equivalent to 0.8 GDP point. For the moment, these measures are very imprecise (further rationalization of spending and tax amnesty measures).

For 2020, the Italian government has declared that the public deficit will fall to 2.1% of GDP. However, to arrive at this figure, given our growth assumptions, would require tightening up fiscal policy somewhat, which is not very credible. We therefore assume a quasi-neutral fiscal policy in 2020, which means that the deficit would remain at 2.4% of GDP.

With a very positive fiscal stimulus in 2019, annual growth (1.1%) should be higher than in 2018. This acceleration is more visible year-on-year: growth in Q4 of 2019 will be 1.6%, compared with 0.6% in Q4 of 2018. Although low, this level is nevertheless higher than the potential growth rate (0.3%) in 2019 and 2020. The output gap is in fact still large and leads to 0.4 GDP point of catch-up per year. Spontaneous growth[3] thus amounts to 0.7 GDP point in 2019 and 2020. In addition, we anticipate a much stronger fiscal impulse in 2019 (0.7 GDP point) than in 2020 (0.1 GDP point). Other shocks, such as oil prices or price competitiveness, will be more positive or less negative in 2020 than in 2019.

Changes in the public debt ratio also depend on developments in the GDP deflator. However, prices should remain stable in 2019 and 2020, due in particular to wage moderation. Thus, nominal growth should be around 2% in 2019 and 2020.

Finally, we assume that the interest rate on the debt will stay at the level of the beginning of October 2018. Given the maturity of the public debt (seven years), the rise in rates forecast for 2019 and 2020 will be very gradual.

Reducing the public debt up to 2020

Under these assumptions, the public debt should decline continuously until 2020, falling from 131.2% of GDP in 2018 to 130.3% in 2019 and then to 129.5% in 2020 (table). In light of our assumptions, the public debt will fall in 2019 if the apparent interest rate remains below 3.5% of GDP, i.e. if the debt-service charge relative to GDP is less than 4.5%.

Table. Changes in the public debt to GDP ratio based on our hypotheses

	2017	2018	2019	2020
Public debt /GDP (d_t)	131.8%	131.2%	130.3%	129.5%
Apparent interest rate on the debt (i)	2.9%	2.7%	2.9%	3.0%
GDP growth in value (g)	2.2%	2.1%	2.3%	2.1%
GDP growth in volume	*1.6%*	*1.0%*	*1.1%*	*1.0%*
GDP deflator	*0.6%*	*1.1%*	*1.2%*	*1.1%*
Primary deficit in % of GDP (s_t)	1.5%	1.8%	1.5%	1.6%
Public deficit in % of GDP	*-2.3%*	*-1.8%*	*-2.4%*	*-2.4%*
Debt-service charge in % of GDP	*3.8%*	*3.6%*	*3.8%*	*4.0%*
Projected public debt/GDP (d_{t+1})	131.2%	130.3%	129.5%	129.1%
Apparent interest rate stabilizing the debt	*3.4%*	*3.4%*	*3.5%*	*3.3%*
Primary deficit stabilizing the debt	*0.9%*	*0.8%*	*0.8%*	*1.1%*
Public deficit stabilizing the debt	*-2.9%*	*-2.7%*	*-3.1%*	*-2.8%*

Sources: AMECO, author's calculations..

Note : Changes in the public debt depend not only on the primary deficit, but also on the apparent interest rate and the growth rate, according to the formula: $d_{t+1} = d_t \frac{(1+i)}{(1+g)} - s_t$ *whith g = growth rate of nominal GDP, I = apparent interest rate on the debt, s = primary public deficit / GDP, d = public debt / GDP.*

Reading note: the public debt/GDP ratio in 2017 was 131.8% and should fall to 131.2% in 2018.

However, for the apparent interest rate to rise from 2.7% in 2018 to 3.5% in 2019, given the 7-year maturity on the debt, the interest rate charged by markets would have to rise by about 5.6 points on average over the year, for one year. While this scenario cannot be excluded, it seems certain that the ECB would intervene to allow Italy to refinance at lower cost and avoid contagion.

Still, even if interest rates do not reach this level, any additional rise in interest rates will further limit the Italian government's fiscal manoeuvring room, or it will lead to a larger-than-expected deficit. Also, the deficit forecast by the government is based on an optimistic assumption for GDP growth of 1.5% in 2019; if growth is weaker, the deficit could widen further, unsettling nerves on the market and among investors and jeopardizing the sustainability of the debt.

[1] L. Clément-Wilz (2014), “Les mesures ‘anti-crise’ et la transformation des compétences de l’Union en matière économique” [“’Anti-crisis’ measures and the transformation of the competences of the EU in economic matters”], *Revue de l’OFCE*, 103.

[2] For more information, see the forthcoming 2018-2020 forecast for the global economy, *Revue de l’OFCE*, (October 2018).

[3] Spontaneous growth for a given year is defined as the sum of potential growth and the closing of the output gap.

Italy: The horizon seems to be clearing

By Céline Antonin

With growth in Italy of 0.4% in the third quarter of 2017 (see **table** below), the country’s economy seems to have recovered and is benefiting from the more general recovery in the euro zone as a whole. The improvement in growth is linked to several factors: first, the continued closing of the output gap, which had worsened sharply after a double recession (2008-2009 and 2012-2013). In addition, the expansionary fiscal policy in 2017 (+0.3 fiscal impulse), mainly targeted at businesses, and thriving consumption driven by expanding employment and rising wages explain this good performance. The increase in employment is the result of the reduction in social contributions that began in 2015 as well as the pick-up in growth in 2016 and 2017.

Despite all this, Italy remains the “sick man” of the euro zone: GDP in volume is still more than 6% below its pre-crisis level, and the recovery is less solid than for its euro zone partners. Furthermore, the public debt, now over 130%, has not yet begun to fall, potential growth remains sluggish (0.4% in 2017), and the banking sector is still fragile, as is evidenced by recent bank recapitalizations, in particular the rescue of the Monte dei Paschi di Sienna bank (see below).

In 2018-2019, Italy’s growth, while remaining above potential, should slow down. Indeed, fiscal policy will be neutral and growth will be driven mainly by domestic demand. Unemployment will fall only slowly, as the employment support measures implemented in 2017 wind down and productivity returns to its trend level [1] over the forecasting horizon (see OFCE, La nouvelle grande modération [in French], p. 71). Furthermore, the banking sector will continue its long and difficult restructuring, which will hold back the granting of bank loans.

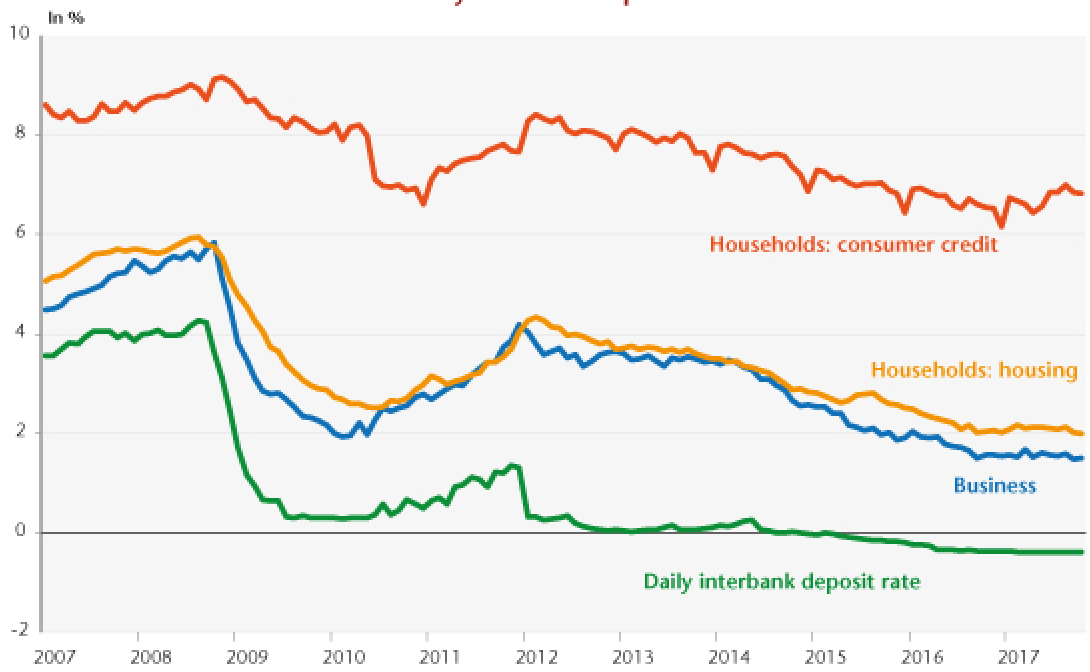
In the third quarter of 2017, the contribution of domestic demand to growth (consumption and investment) reached 0.8 point, but massive destocking attenuated the impact on growth (-0.6 point). Gross Fixed Capital Formation (GFCF) leapt 3% in the third quarter of 2017, returning to its 2012 level, thanks to a strong increase in the productive sector (machinery, equipment and transport). Private consumption, the other pillar of domestic demand, grew on average by 0.4% per quarter between the first quarter of 2015 and the third quarter of 2017, thanks to falling unemployment and a reduction in precautionary savings. Credit conditions have improved slightly due to the quantitative easing policy pursued by the ECB, even though the channel for the transmission of monetary policy is suffering from the difficulties currently hitting the banking sector.

The number of people in employment rose to 23 million in the second quarter of 2017, back to its pre-crisis level, while the unemployment rate is declining only slowly due to the steady increase in the labour force [2]. Job creation did indeed take place between 2014 and 2017 (around 700,000 jobs created, 450,000 of them permanent), mainly due to the lowering of charges on new hires in 2015 and 2016 and the resumption of growth. Moreover, according to INPS figures, the number of new hires on permanent contracts decreased (between January-September 2016 and January-September 2017) by -3.1%, as did conversions from temporary contracts to fixed-term contracts (-10.2%), while the numbers of new hires on temporary contracts exploded (+ 27.3%): in other words, it is mainly precarious contracts that are currently contributing to job growth. From 2018, the pace of job creation is expected to decline due to the winding down of the measures cutting employer social contributions (which represented a total of 3 billion euros) and the slowdown in economic growth. This underpins a forecast of a very slow decline in unemployment: employment is expected to rise more slowly in 2018 and 2019, but the labour force is also growing more slowly, due to a bending effect, a distortion linked to the slowdown in job creations and the retirement of the baby boom generation.

The productivity cycle in Italy is still in poor shape, despite the downward revision of the productivity trend (-1.0% for the period 2015-2019). The measures taken to cut social security contributions over the 2015-2016 period will have enriched employment growth by 27,000 jobs per quarter (extrapolating the estimates by Sestito and Viviano, Bank of Italy). Our hypothesis was for a closure of the productivity cycle over the forecast horizon, with productivity picking up pace in 2018 and 2019 [3].

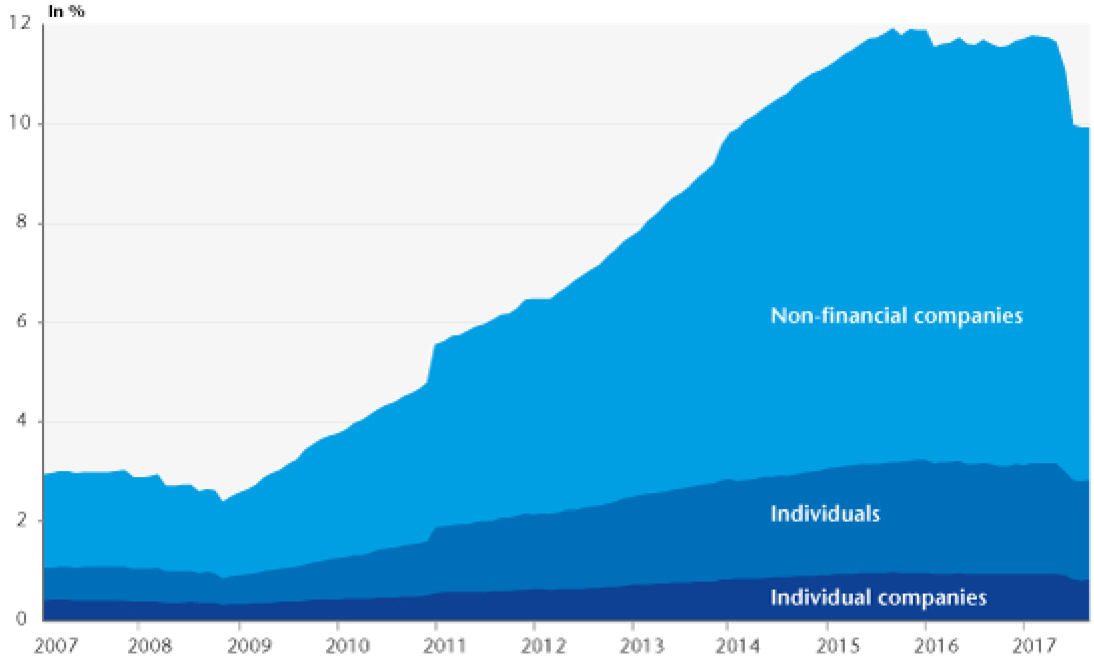
Moreover, the productive investment rate recovered strongly in the third quarter of 2017: it should continue to rise in 2018 and 2019, thanks in particular to a higher pace of extra-depreciation, to the ECB's quantitative easing programme and to clearing up the situation of the banks, which should allow a better transmission of monetary policy (**Figure 1**). In addition, the amount of bad debt (*sofferenze*) began to fall sharply (down 30 billion euros between January and October, 2 GDP points – **Figure 2**). This is linked to the gradual restructuring of bank balance sheets and the economic recovery in certain sectors, particularly construction, which accounts for 43% of business bad debt.

Figure 1. Interest rates on new loans to households and business and daily interbank deposit rate



Source: Bank of Italy.

Figure 2. Bad debt (*sofferenze*) as a share of GDP



Sources: Istat, Bank of Italy.

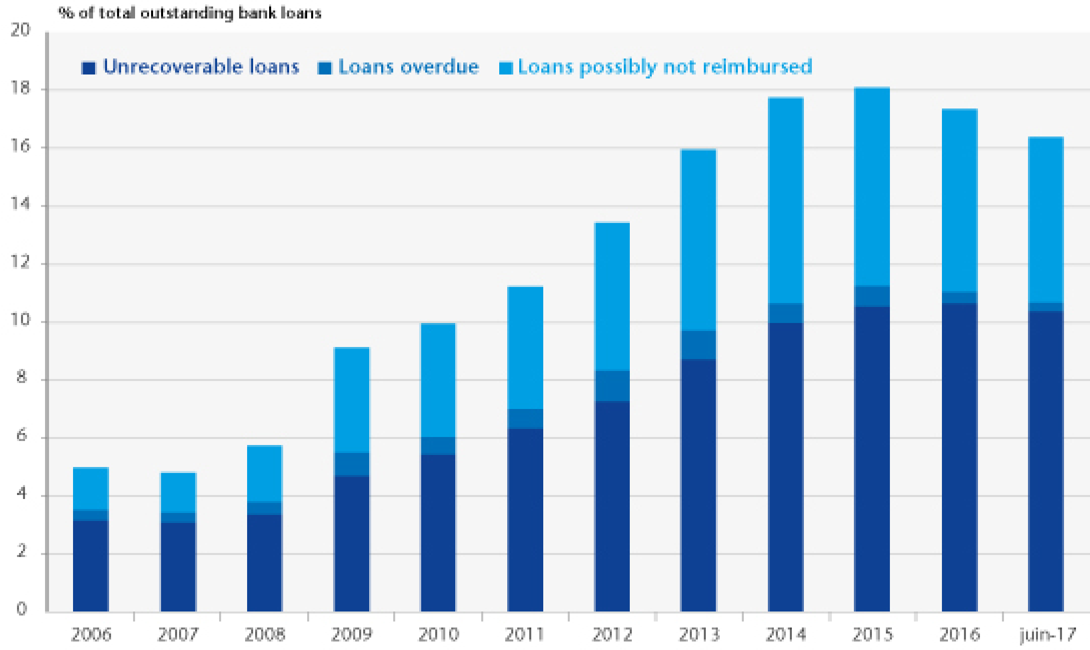
In 2017, it was domestic demand that was driving growth; the contribution of foreign trade was zero because of the dynamism of imports and the absence of any improvement in price competitiveness. We anticipate that the contribution of foreign trade will be null in 2018 and slightly positive in 2019 thanks to an improvement in competitiveness (Table).

Fiscal policy was expansionary in 2017 (+0.3 point impulse) and supported growth. This has mainly benefited business: support for the world of agriculture, extra-depreciation, the reduction of the corporate tax rate (IRES) from 27.5% to 24% in 2017, a boost in the research tax credit, etc. 2018 should not see a noticeable increase in taxation, and spending is expected to increase slightly (0.3%). The additional public expenditure should reach 3.8 billion euros, for: youth bonuses (youth employment measures), prolongation of extra-depreciation in industry, the renewal of civil service contracts and the fight against poverty. As for public revenue, the government has ruled out a VAT hike that would have brought in 15.7 billion euros; the adjustment will therefore come from a smaller reduction in the deficit and an increase in revenue (5 billion euros forecast). To boost revenue, the government is counting on the fight against tax evasion (repatriation, recovery of VAT with electronic invoicing), and the establishment of a web tax on large companies on the Net.

A banking sector in full convalescence

The deterioration in the situation of Italy’s businesses, in particular small and medium-sized enterprises, has led since 2009 to a sharp increase in non-performing loans. Since 2016, the situation of the Italian banking sector has improved somewhat, with a return on equity of 9.3% in June 2017 against 1.5% in September 2016. The ROE is higher than the European average (7% in June 2017) and puts the country ahead of Germany (3.0%) and France (7.2%). In addition, at the end of June 2017, the ratio of bad debt to total loans came to 16.4% (8.4% net of provisions), of which 10.4% was for unrecoverable loans (**Figure 3**). Banks are shedding these loans at an increasing pace with various partners (Anglo-American hedge funds, doBank, Atlante and Atlante 2 funds, etc.). Hence, between 2013 and 2016, the share of bad loans that were repaid in the year rose from 6 to 9%. Overall, the amount of bad loans was cut by 25 billion euros between 2016 and June 2017, down to 324 billion euros, of which 9 billion euros came from the liquidation of the Venetian banks (Banca Popolare di Vicenza and Veneto banca). This improvement reflects the fact that the banks are increasingly adopting active management policies for bad debts. In addition, the 2015 Asset Seizure Reform reduced the length of property seizure proceedings.

Figure 3. Share of non-performing debt by category



Note: Non-performing loans can be broken down into three mutually exclusive categories:
- Unrecoverable loans, which designates exposure to a debtor who's insolvent;
- Loans possibly not reimbursed, which designates exposure to a debtor who has little chance of reimbursing in full without some action such as the invoking of guarantees;
- Loans with overdue repayments, which designates any exposure where the delay in reimbursement exceeds 90 days.

Sources: Bank of Italy, Financial stability reports.

The Italian government has implemented various reforms to cope with the difficulties facing the country's banking sector. First, it has been working to accelerate the clearance of bad debts and to reform the law on bankruptcy. Legislative Decree 119/2016 introduced the "martial pact" (*patto marciano*), which makes it possible to transfer real estate used as collateral to creditors (other than the debtor's principal residence); the real estate can then be sold by the creditor if the default lasts more than 6 months. Other rules aim at speeding up procedures: the use of digital technologies for hearings of the parties, the establishment of a digital register of ongoing bankruptcy proceedings, the reduction of opposition periods during procedures, an obligation for judges to order provisional payments for amounts not in dispute, the simplification of the transfer of ownership, etc.

In April 2016, the government introduced a public guarantee system (*Garanzia Cartolarizzazione Sofferenze, GCS*) covering bad debts, for a period of 18 months (extendable for another 18 months). To benefit from this guarantee, the bad debt must be securitized and repurchased by a securitization vehicle; the latter then issues an asset-backed security, the senior tranche of which is guaranteed by the Italian Treasury.

The Atlante investment fund was also set up in April 2016, based on public and private capital, in order to recapitalize troubled Italian banks and redeem bad debt.

There are many lessons to be drawn from the case of the Monte dei Paschi di Sienna bank (MPS, the country's fifth-largest bank), which has been a cause of major concern. The Italian State, working in coordination with the European Commission and the ECB, had to intervene as a matter of urgency, following the failure of the private recapitalization plan at the end of 2016. A system of public financial support for banks in difficulty was introduced after a government proposal – *"Salva Risparmio"* [4] of 23 December 2016 – was enacted on 16 February 2017. The precautionary recapitalization of MPS was approved by the Commission on 4 July 2017 [5], in the amount of 8.1 billion euros. The Italian State increased its stake in the bank's capital by 3.9 billion euros on the one hand, and on the other 4.5 billion euros of the bank's subordinated bonds were converted into shares. The State is also to buy 1.5 billion euros of shares resulting from the forced conversion of bonds held by individuals (i.e. a total of 5.4 billion euros injected by the State, giving it a 70% holding in the capital of MPS). MPS will also sell 26.1 billion euros of bad debt to a special securitization vehicle, and the bank will be restructured.

Two other banks, the Venetian banks Banca Popolare di Vicenza and Veneto banca (the 15th and 16th largest banks in the country in terms of capital), were put into liquidation on 25 June 2017, in accordance with a "national" insolvency procedure, which lies outside the framework set by the European BRRD Directive [6]. The Intesa Sanpaolo bank was selected to take over, for one symbolic euro, the assets and liabilities of the two banks, with the exception of their bad debts and their subordinated liabilities. The Italian State will invest 4.8 billion euros in the capital of Intesa Sanpaolo in order to keep its prudential ratios unchanged, and it can grant up to 12 billion euros of public guarantees.

The Italian banking sector is thus in the midst of restructuring, and the process of clearing up bad debt is underway. However, this process will take time; the ECB nevertheless seems to want to tighten the rules. In early October 2017, the ECB unveiled proposals demanding that the banks fully cover the unsecured portion of their bad debt within two years at the latest, with the secured portion of the debt to be covered within at most seven years. These proposals will apply only to new bad debt. The Italian parliament and the Italian government reacted to these announcements by warning of the risk of a credit crisis. Even though these are only proposals, for now, this indicates that it is a priority to clear Italy’s bad debt rapidly, and that the government must stay the course.

Table. Italy: Summary of forecasts

Change from the preceding period (%)

	2017				2018				2016	2017	2018	2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
GDP	0.5	0.3	0.4	0.3	0.3	0.3	0.2	0.3	1.1	1.5	1.2	0.9
GDP per capita	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	1.0	1.2	0.9	0.7
Household consumption	0.7	0.2	0.3	0.3	0.3	0.3	0.3	0.3	1.5	1.5	1.2	1.0
Public consumption	0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.5	0.8	0.1	-0.2
Total GFCF, *of which:*	-2.2	1.1	3.0	0.5	0.4	0.3	0.3	0.4	3.0	3.2	3.0	1.3
Productive	-7.2	3.6	8.2	0.6	0.5	0.4	0.4	0.3	7.1	6.6	6.4	1.3
Housing	0.7	-0.3	0.4	0.2	0.2	0.2	0.2	0.2	2.8	1.8	0.7	0.6
Exports of goods and services	1.8	0.1	1.6	0.6	0.7	0.7	0.7	0.7	2.6	5.1	2.9	2.3
Imports of goods and services	0.7	1.6	1.2	0.6	0.6	0.6	0.6	0.6	3.3	5.4	2.8	2.0
Contributions:												
Domestic demand excl. stock	0.1	0.4	0.7	0.3	0.3	0.2	0.2	0.2	1.5	1.6	1.3	0.8
Change in stock	0.1	0.4	-0.5	0.0	0.0	0.0	0.0	0.0	-0.3	-0.1	-0.2	0.0
Foreign trade	0.3	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.1	0.1
Consumer prices (HICP)[1]	1.4	1.6	1.2	1.2	0.8	0.8	0.8	0.9	-0.1	1.0	0.5	1.0
Unemployment rate	11.6	11.2	11.2	11.1	11.0	10.9	10.9	10.8	11.7	11.3	10.9	10.8
Current balance as % of GDP									2.7	2.6	2.6	2.5
Current deficit as % of GDP									-2.5	-2.0	-1.5	-1.2
Public debt as % of GDP									132.8	132.3	131.1	129.9
Fiscal impulse in GDP points									0.3	0.3	0.1	0.1
GDP – euro zone	0.6	0.7	0.6	0.4	0.4	0.4	0.4	0.4	1.8	2.4	1.9	1.6

1. For the quarters, year-on-year. For the years, annual average.
Sources: ISTAT, Author's calculations, OFCE October 2017 forecast.

[1] Estimated according to a model using trend breaks, we estimate the productivity trend at -1.0% for the period 2015-2019, due to growth that is more job-rich.

[2] This increase in the labour force is due to a higher participation rate among older workers (aged 55-64), which is linked to the lowering of the minimum retirement age. It is also due to women's increased participation in the labour market, as a result of the Jobs Act (extension of maternity leave, telecommuting, financial measures to reconcile work and family life, a budget of 100 million euros for the creation of childcare services, etc.).

[3] The increase in productivity per capita in market waged employment rose from -0.7 % in 2017 to 0.3 % in 2018 and 0.6 % in 2019.

[4] The Salva Risparmio Decree Law provides for the creation of a fund with 20 billion euros to support the banking sector. This allows the State to carry out precautionary recapitalizations of banks; it provides guarantees on new issues of bank debt; and it provides liquidity from the central bank under Emergency Liquidity Assistance (ELA). It also protects savers by providing the possibility of the State buying back subordinated bonds converted into shares prior to the public intervention.

[5] European Parliament, The precautionary precaution of Monte dei Paschi di Sienna

[6] For greater detail, see the note [in French] by Thomas Humblot, Italie : liquidation de Veneto Banca et de Banca Popolare di Vicenza, July 2017.

Italy and the labour market: improvement, with caveats

By Céline Antonin

Since early 2015, the renewal of growth in Italy, the implementation of Act II of Matteo Renzi's Jobs Act, and the reduction in business charges have undeniably contributed to the improvement on the country's jobs front. Dynamic job creation, particularly with permanent (CDI) contracts, and an increase in the labour force, could give the impression that (partial) liberalization of Italy's labour market has resolved the structural weaknesses it has been facing. Nevertheless, in the first half of 2016, the creation of permanent jobs has severely dried up, and what is driving growth in employment now is an increase in fixed-term (CDD) contracts. Moreover, stagnating labour productivity has accompanied more employment-yielding growth, particularly in the services sector. So in the absence of further action to address Italy's structural weaknesses, the upturn in the labour market may not last.

A brief review of recent labour market measures

The Jobs Act is a continuation of a series of recent measures put in place since 2012 that are intended to create a more flexible labour market (see [C. Antonin, Matteo Renzi's Jobs Act: A very guarded optimism]). In Act I, the Jobs Act led to extending the duration of fixed-term contracts from 12 to 36 months, eliminating waiting periods and allowing more renewal periods, while limiting the proportion of fixed-term contracts within a given company. Act II introduced a new type of permanent contract, with greater protection and severance pay increases in line with seniority. It also abolished the misuse of *contratti di collaborazione*, precarious work contracts often used to disguise an employment relationship. These were to be transformed into employment contracts from 1 January 2016 (1 January 2017 for the public administration).

Furthermore, Italy has opted for cutting the taxation of labour: in 2015, the wage share of the IRAP (regional tax on productive activities) for employees on permanent contracts was removed. Above all, the 2015 Finance Act abolished social security contributions for 3 years on the new form of permanent contracts with greater protection, up to a limit of 8,060 euros per year for new hires between 1 January and 31 December 2015 who had not been on permanent contracts in the six months preceding their employment. The total cost to the budget was 1.8 billion euros. The programme was partially extended in 2016: companies taking on employees on the new permanent contracts in 2016 will be exempted from 40% of their social contributions for 2 years, and the cap on the exemption from contributions was reduced to 3,250 euros per employee.

A sharp increase in the number of jobs created, but stagnation in the creation of permanent jobs in 2016 …

Since the beginning of 2015, the number of jobs grew strongly in Italy (Figure 1), but still falls far short of the pre-crisis level: between the first quarter of 2015 and the first quarter of 2016, the number of jobs grew by 304,000 (+391,000 permanent jobs).

Figure 1. Waged employment and total employment

Source: Istat.

A breakdown of these figures (Table 1) reveals a major difference between 2015 and the first half of 2016: the number of new CDI jobs exploded in 2015 (+281,000 between January and December 2015), before drying up in the first half of 2016 (-18,000 from January to June 2016). In 2015, the dramatic increase in the number of CDI contracts is partly explained by the replacement of precarious jobs by permanent jobs with progressive guarantees. Thus, of the 2.0 million CDI jobs created in 2015, there were 1.4 million new CDIs and 575,000 fixed-term (CDD) contracts converted into CDIs (source: INPS). 60.8% of these new contracts benefited from the exemption from social security contributions. However, the number of new CDI contracts dropped by 33% in the first half of 2016 compared to the first half of 2015, as a result of the reduced creation of

CDIs *ex nihilo* and a sharp fall in the conversion of CDDs into CDIs (-37%). There was nevertheless a sharp increase in the number of the self-employed in 2016, after two consecutive years of decline.

Table 1. Creation of jobs by category (flows)

1000s of jobs

	Jan-Dec 2015	Jan-Jun 2015	Jan-Jun 2016
Waged jobs	316	194	61
In CDI	281	143	-18
In CDD	35	51	79
Self-employed	-135	-80	126
Total employment	181	114	187

Source : Istat, Author's calculations.

Thus, the zeal for CDIs mainly occurred in 2015, before withering in 2016. One of the reasons is the following: **the reduction in social contributions for new hires on permanent contracts had a stronger impact than the Jobs Act itself.** In fact, the reduction in social contributions applied only to contracts concluded in 2015. These were renewed for 2016, but on a much more limited scale (two years compared with three, with the cap on the exemption from payroll taxes cut by more than half), which may well explain the decline in enthusiasm. Moreover, an anticipation effect can be seen for the month of December 2015 (Table 2), with a steep increase in the number of CDIs fully exempt (they more than quadrupled compared to the average of the preceding eleven months). In the first half of 2016, there were on average 42,000 people hired per month who benefited from the two-year exemption on contributions, or 31% of total permanent CDI contracts[1], compared with 128,000 in 2015 (taking into account December). In 2015, the exempt contracts accounted for 61% of the total.

Table 2. New CDIs by category (exempt from charges or not)

In monthly average

	Average Jan-Nov 2015	Dec. 2015	Average Jan-Jun 2016
New exempt CDIs (a)	78 324	248 919	32 802
Converted from CDD into exempt CDIs (b)	27 921	130 324	9 205
Total CDIs exempt (a+b)	106 245	379 243	42 008
Total CDIs created	186 495	450 186	133 532
% CDIs exempt of total CDIs	57 %	84 %	31 %

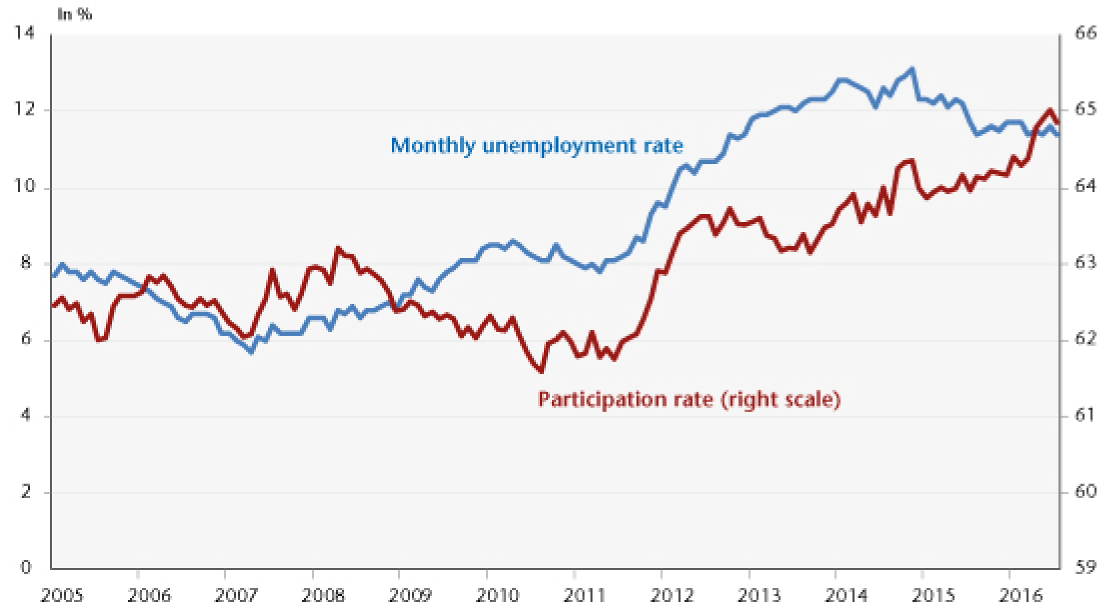
Note : The month of December was considered separately due to the sharp increase in the number of CDIs signed in that period.
Source : INPS, author's calculations.

… but stagnation in the number of jobless due to the growth in the workforce …

Despite the dynamic jobs market, unemployment has stagnated in Italy since mid-2015 at a level of 11.6% (Figure 2). This paradox is explained by the increase in the active population: between July 2015 and July 2016, the workforce expanded by 307,000 people. Several phenomena are behind this:

1. The pension reform, which has led to seniors staying in their jobs;
2. A “flexion” or bending effect: with the return of growth and the improvement in the labour market, discouraged workers have begun looking for jobs again;
3. Immigration: positive net migration has had an impact on the labour market. The share of foreigners in Italy’s labour force rose from 10.7% to 11.1% between first quarter 2014 and first quarter 2016.

Figure 2. Unemployment rate and participation rate, 2005-June 2016



Source: Istat.

In conclusion, although it is not reflected in the unemployment figures, there has been an undeniable improvement in Italy’s labour market, with a great deal of job creation and marked growth in the workforce. This improvement is attributable not just to the Jobs Act, but to three combined factors: 1) the return of growth since 2015, driven by the ultra-accommodative policy of the European Central Bank, less fiscal austerity and falling oil prices; 2) the reduction in labour taxes introduced in 2015 and extended in part in 2016; and 3) the implementation of the Jobs Act. In the light of Table 2, it can also be assumed that the reduction of business social charges had a stronger impact than the Jobs Act per se.

After the upturn in 2015, the figures for the first half of 2016 call for caution. The drying up of the creation of permanent jobs in 2016 shows that the Renzi reform did not resolve the underlying problem, namely the structural weaknesses of Italy’s labour market, in particular labour productivity. To restore growth and employment, Italy really needs to address the issue of structural reform, including the poor level of innovation, research and development, the low level of competitiveness and the undercapitalization of its SMEs.

[1] including the conversion of CDD contracts into CDIs.

Matteo Renzi's Jobs Act: A very guarded optimism

By Céline Antonin

At a time when the subject of labour market reform has aroused passionate debate in France, Italy is drawing some initial lessons from the reform it introduced a year ago. It should be noted that the labour market reform, dubbed the Jobs Act, had been one of Matteo Renzi's campaign promises. The Italian labour market has indeed been suffering from chronic weaknesses, including segmentation, a duality between employees with and without social protection, high youth unemployment, and a mismatch between costs and labour productivity. Renzi's reform takes a social-liberal approach, advocating flexicurity, with the introduction of a new permanent employment contract with graduated protection, lower social charges on companies, and better compensation and support for the unemployed. Although the initial assessment is surely positive in terms of both unemployment and job creation, there's no cause for hasty triumphalism: the reform has been implemented in especially favourable circumstances, marked by a return of growth, an accommodative policy mix, and a stagnating work force.

***Jobs Act* Italian-style: The key points**

The Jobs Act is actually the latest in a series of measures adopted since the Fornero Act of 2012 that are aimed at a more flexible labour market. Act I of the Jobs Act, the Poletti Decree (DL 34/2014), was adopted on 12 May 2014, but went relatively unnoticed because it targeted fixed-term contracts and apprenticeships. It allowed in particular extending the duration of fixed-term contracts from 12 to 36 months, suppressing gap periods, and allowing for more fixed-term contracts to be renewed, all while limiting the proportion of fixed-term contracts within a single company[1].

The real change came with Act II of the Jobs Act, for which the Italian Senate passed enabling legislation on 10 December 2014. The eight implementing decrees adopted in the first half 2015 have four key points:

– The elimination of Article 18 of the Labour Code, which allowed reinstatement in cases of manifestly unfair dismissal: the reinstatement requirement was replaced by a requirement for indemnification that is capped[2], with reinstatement still being required in case of a dismissal involving discrimination;

– The creation of a new form of permanent (open-ended) contract and graduated protection, lying between permanent contracts and fixed-term contracts: dismissal was facilitated during the first three years on the job, with severance pay that increases with employee seniority;

– The suppression of the abuse of what are called "collaboration contracts", [3]precarious contracts that are often used to disguise an actual employment relationship, affecting about 200,000 people. These contracts will be transformed into wage labour contracts from 1 January 2016 (1 January 2017 for public administrations), except for a few limited cases;

– The reform of unemployment insurance, with an extension of compensation schemes. The benefit period, for instance, is extended to two years (from 12 months previously). As for compensation for short-time working ("technical unemployment"), this is extended to cover apprentices and companies with 5-15 employees[4]. A National Employment Agency (ANPAL), which introduces a one-stop system that helps to link training and employment, was also established.

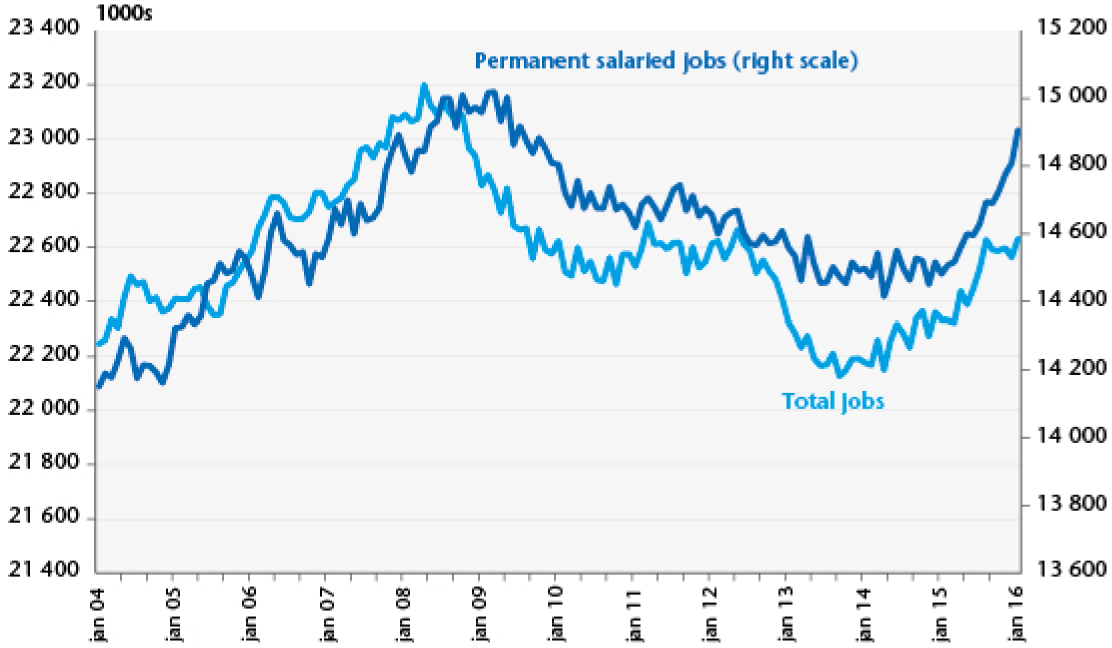
Note that only measures related to experimentation with a national minimum wage[5], which are contained in the enabling law in December 2014, were not addressed.

Alongside the Jobs Act, Italy opted to lower taxes on labour: in 2015, the wage part of the IRAP (equivalent to a business tax) for those employed on permanent contracts was eliminated, reducing the amount of the IRAP by about one-third. Above all, Italy's 2015 Budget Act eliminates social security contributions for 3 years on the new open-ended contracts with graduated protection, up to a limit of 8,060 euros per year for new hires taken on between January 1 and December 31, 2015 who did not have permanent job contracts in the six months preceding their hiring. This measure is expected to cost 3.5 billion euros between now and 2018. It was extended in 2016: companies that hire employees on the new permanent contracts in 2016 will be exempt from 40% of social security contributions for 2 years.

Strong jobs growth and a lower unemployment rate

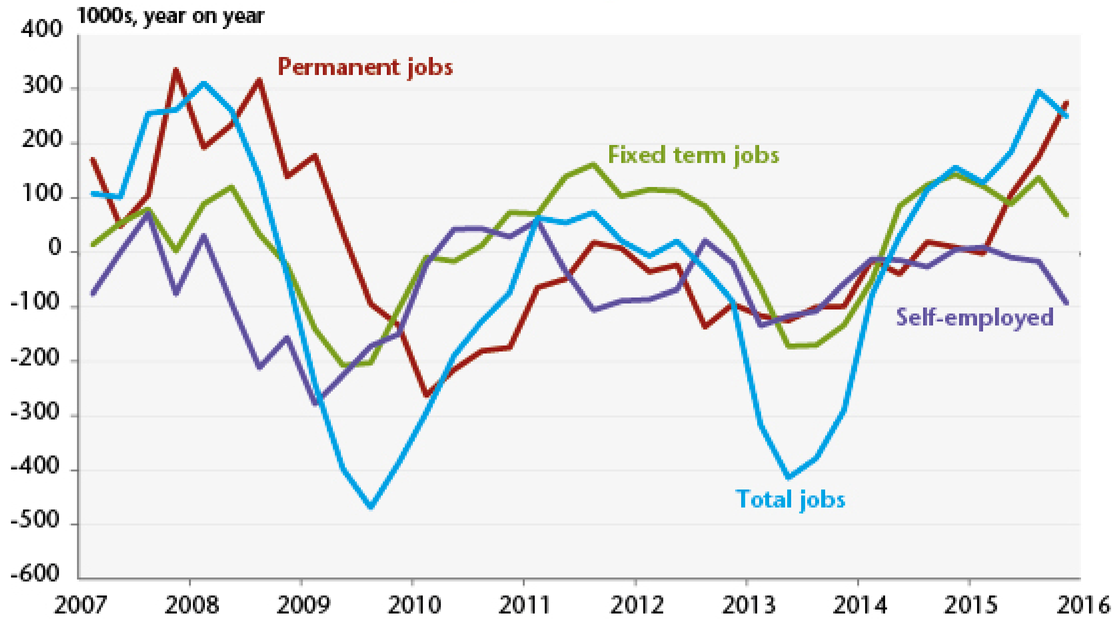
There has been strong growth in employment, in particular permanent jobs, since the start of 2015: between January 2015 and January 2016, the number of employed increased by 229,000, with strong growth in the number of salaried employees (+377,000) and a decline in the number of self-employed (-148,000). Among employees, there was a sharp increase in the number of permanent positions (+328,000). The number of permanent employees has now returned to the 2009 level of 22.6 million (Figure 1); as for total employment, even if it has not yet reached its pre-crisis level, the decline in the 2012-2014 period has been overcome. At the same time, the annual rate of job creation has returned to its pre-crisis level, with growth of about 250,000 per year (Figure 2).

Figure 1. Number of jobs (total and permanent), 2004-January 2016



Sources : Istat, author's calculations.

Figure 2. Annual change in number of jobs by contract type, Q1 2007 – Q4 2015

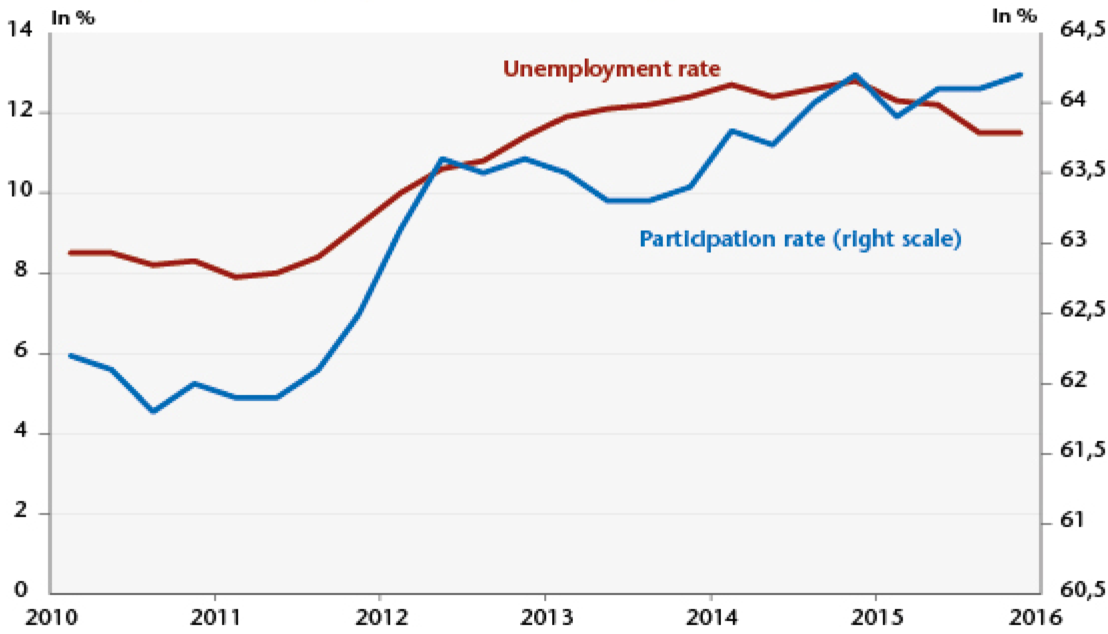


Sources : Istat, author's calculations.

In addition to new hires on permanent contracts, the Jobs Act has led to replacing precarious jobs with permanent jobs with increasing guarantees. Thus, 5.4 million new jobs were created in 2015 (+11% compared to 2014)[6], mainly permanent jobs. Of the 2.4 million permanent jobs created, there were 1.9 million new open-ended contracts and 500,000 fixed-term contracts that were converted into open-ended contracts (including 85,000 apprenticeship contracts), up sharply from 2014. There were also fewer collaboration contracts (a 45% decrease from Q3 2014 to Q3 2015) and apprenticeship contracts (-24.6%). Note also the 4.3% increase in the number of resignations and the 6.9% decrease in layoffs.

The corollary to this jobs growth is a marked fall in the unemployment rate (Figure 3), which fell to 11.4% in the last quarter of 2015 (from 12.8% one year earlier). However, the decline in unemployment was also due to stagnation in the labour force in 2015, unlike previous years that were marked by the pension reform.

Figure 3. Unemployment rate and participation rates, 2010-2015



Sources : Istat, author's calculations.

Uncertainties remain

Matteo Renzi seems to have won his bet. Yet this fall in unemployment should not be over-interpreted, as a number of positive factors have undoubtedly contributed to strengthening this trend.

First, there was a windfall effect related to the announcement of the exemptions on social contributions for hiring new permanent employees, which led some companies to put off new hiring planned for 2014 until 2015 (which led to a rise in unemployment in late 2014). Moreover, part of the fall in unemployment is related to the impact of replacing precarious short-term contracts with the new permanent contracts with graduated protection (see above). The question is whether the new flexibilities allowed by these new contracts will be used over the next three years, and consequently whether there will be an increase in contract terminations.

In addition, the stagnation of the work force (Figure 3) has significantly amplified the downward trend in unemployment. With the improvement observed in the labour market, we expect in the future that the growth in the workforce that began in the last quarter of 2015 will continue due to what is called in French an “effet de flexion”, or “bending effect”, [7] which would absorb some of the impact of the job creation in 2016 and 2017.

Furthermore, the Jobs Act was adopted when the economy was emerging from a recession, with a recovery that, while soft (+0.6% growth in 2015), still exceeded the growth potential [8]. The easing of fiscal constraints had a stimulus effect in 2015, which may partially explain the fall in unemployment. As for monetary conditions, they are particularly favourable, as Italy is one of the main beneficiaries of the quantitative easing measures taken by the ECB.

Notwithstanding these qualifications, it is undeniable that the cut in the social contributions level has had a positive impact. The February 2016 report of the National Social Security Institute (INPS) showed that, of the 2.4 million new permanent jobs created in 2015, 1.4 million benefited from exemptions on employer contributions, or almost two-thirds of these new jobs. Moreover, the reduction of precarious job contracts and their replacement by permanent contracts, even if they offer less protection than before, is a rather encouraging sign for access to long-term employment by groups that have traditionally been more marginal (self-employed, collaboration contracts).

Perhaps the main regret about this reform is the absence of a component aimed explicitly at vocational training, which is one of the main weaknesses of Italy's labour market. The country holds a dismal EU record for the number of young people (15-24) who are neither in employment nor in school or training. Moreover, the workforce has insufficient training, and investment in research and development is low, which results in low productivity. It is legitimate to want to take action on labour costs and the duality of the labour market, but this will not be enough to solve the problem of productivity and the inadequacy of the workforce. Matteo Renzi would therefore do well to foresee an Act III in his labour reforms to finally pull the country out of its stagnation.

[1] See C. Antonin, Réforme du marché du travail en Italie : Matteo Renzi au pied du mur, [Labour market reform in Italy: Matteo Renzi with his back to the wall], *Note de l'OFCE no. 48.*

[2] The monetary payment is determined by a scale based on the employee's seniority. It is equivalent to two months of the final salary per year of service, for a total that cannot be less than 4 months of salary and is capped at 24 months.

[3] "Intermediate status between salaried employment and self-employment, for workers not subject to a hierarchical subordination but 'coordinated' with the company and creator of certain social rights. These are self-employed workers who are, in fact, dependent on a single client company (which exercises limited management powers, for example in terms of the organization of work and the working time)." E. Prouet,

Contrat de travail, les réformes italiennes [The job contract, the Italian reforms], France Stratégie, *La Note d'Analyse*, no. 30, May 2015.

[4] Other measures concerning short-time work ("chomage technique") are also planned, including that an employee on short-time work may not have their hours cut by more than 80% of their total work hours. Furthermore, the period during which a company may resort to this procedure is a maximum of 24 months over five rolling years.

[5] There is no national minimum wage in Italy, with minimum wages instead set at the industry level, as was the case in Germany before 2015.

[6] This figure of 5.4 million represents gross job creation, including all forms of employment (including very short-term contracts), and without taking into account job destruction. In terms of net job creation between January 2015 and January 2016, we accept the figure of 229,000.

[7] When unemployment rises, working-age people are discouraged from reporting for the labour market. Conversely, when employment picks up again, some people are encouraged to return to the labour market, slowing the decline in unemployment; this phenomenon is called the "effet de flexion" in French, or the bending effect.

[8] Labour productivity tends to grow relatively slowly in Italy; consequently, an increase in production tends to create more jobs in Italy than in France for example, where labour productivity is higher.

Investment behaviour during the crisis: a comparative analysis of the main advanced economies

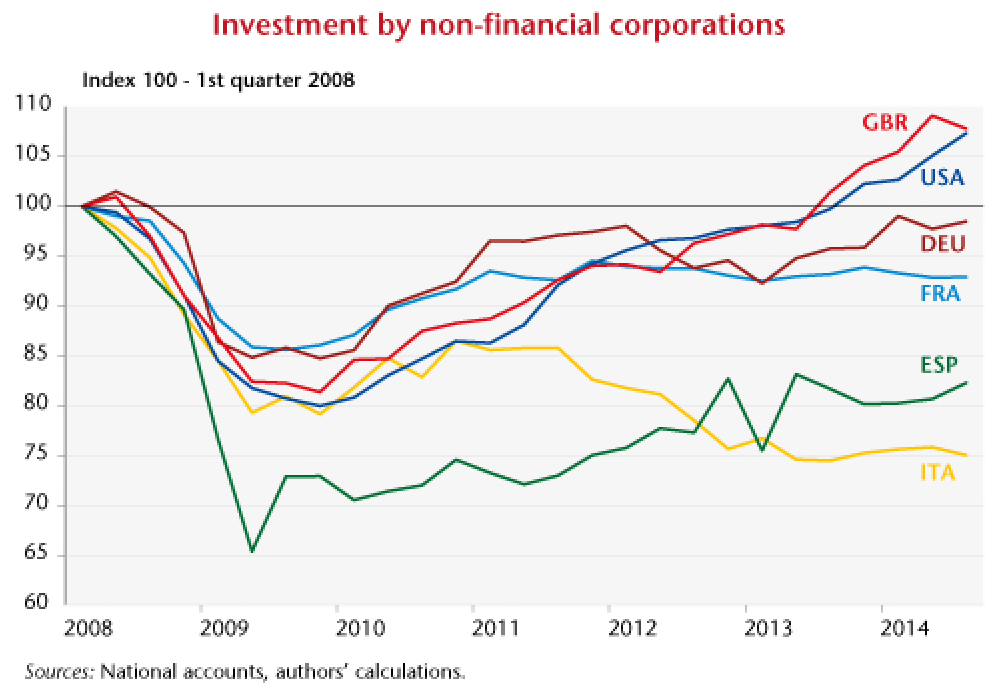
By Bruno Ducoudré, Mathieu Plane and Sébastien Villemot

This text draws on the special study, Équations d'investissement : une comparaison internationale dans la crise [Investment equations : an international comparison during the crisis], which accompanies the 2015-2016 Forecast for the euro zone and the rest of the world.

The collapse in growth following the subprime crisis in late 2008 resulted in a decline in corporate investment, the largest since World War II in the advanced economies. The stimulus packages and accommodative monetary policies implemented in 2009-2010 nevertheless managed to halt the collapse in demand, and corporate investment rebounded significantly in every country up to the end of 2011. But since 2011 investment has followed varied trajectories in the different countries, as can be seen in the differences between, on the one hand, the United States and the United Kingdom, and on the other the euro zone countries, Italy and Spain in particular. At end 2014, business investment was still 27% below its pre-crisis peak in Italy, 23% down in Spain, 7% in France and 3% in Germany. In the US and the UK, business investment was 7% and 5% higher than the pre-crisis peaks (Figure).

Our study estimates investment equations for six major countries (Germany, France, Italy, Spain, the UK and USA) in an effort to explain trends in investment over the long term, while paying particular attention to the crisis. The results show that using the traditional determinants of corporate investment – the cost of capital, the rate of profit, the rate of utilization of production capacity and business expectations – it is possible to capture the main developments in investment for each country in recent decades, including since 2008.

Thus, since the onset of the crisis, differences in decisions on taxation and on how tight to make fiscal policy and how expansive to make monetary policy have led to differences between countries in terms of the dynamics of the economy and real capital costs and profit rates, which account for the current disparities in corporate investment.



Labour market reform in

Italy: Matteo Renzi up against the wall

By Céline Antonin

While Matteo Renzi had enjoyed a relative "state of grace" since his election in February 2014, the Senate vote in early December on the hotly disputed reform of the labour market (the Jobs Act) has led to a general strike, a first since he took office. Is this the end of Matteo Renzi's honeymoon with the Italian people? Although his ascension to power had sparked a wave of hope, the initial results have been disappointing. The reforms are going down poorly as Italy experiences its third consecutive year of recession (-0.2% growth forecast in 2014), and the country is facing criticism from the European Commission for its inability to reduce its structural deficit. This reform is inspired by a free market approach and aims to introduce a flexi-security system. The measure that is the particular focus of passion would remove Article 18 of the Labour Code, which allows reinstatement in the case of unfair dismissal.

In the latest *Note de l'OFCE* (no. 48, 16 December 2014), we study the reform of the labour market being undertaken in Italy, which is a major challenge due to the segmentation of the labour market, high youth unemployment and inappropriate costs relative to labour productivity. However legitimate the Jobs Act may be, it seems too partial to have any real impact. In the short term, Italy's priority should be on investment. The only way the country can re-establish normal access to bank financing and return to growth is through the combination of an expansionary monetary policy, the continued pursuit of a banking union, and an ambitious public investment policy. Once these conditions have been met, then the question of a structural reform of the labour market will arise; this reform must be coupled with reform of the goods market in order to allow Italy to restore productivity and achieve a sustainable improvement in its growth potential.

Austerity without end – or, how Italy found itself trapped by European rules

By Raul Sampognaro

If the budget submitted by France is out of step with the rules on fiscal governance in the euro area (see the recent posts on this subject by Henri Sterdyniak and Xavier Timbeau), Italy is also in the hot seat. The situations of France and Italy are, however, not directly comparable: the case of Italy could be far more restrictive than that of France, once again reflecting the perverse effects of Europe's new governance. While, unlike France, Italy is no longer subject to an Excessive Deficit Procedure (EDP), with its budget deficit at the 3% threshold since 2012, it is still covered by the Stability and Growth Pact's preventive arm and thus enhanced surveillance with respect to the debt criterion. The country's debt of 127% of GDP is well above the 60% level set by EU rules and, according to its medium-term budgetary objective (MTO), Italy must come close to balancing government spending.

While the French budget deficit for 2015 will be the highest in the entire euro area (excluding countries subject to a programme [1]), since the latest announcements on October 28, Italy has a deficit of 2.6%, which should not trigger a new EDP. However, the Pact's preventive arm puts constraints on changes in the country's structural balance:

– (i) in the name of convergence towards its MTO, Italy must make a structural adjustment of 0.5 percentage point per year for 3 years (i.e. cut its structural deficit by 0.5 point per year),

– (ii) if the structural deficit defined in the MTO is not sufficient to reach a debt level of 60% within 20 years, the country must make an extra effort under the *debt criterion*. According to the latest forecast by the Commission, Italy must provide an average annual structural effort of 0.7 point in 2014 and 2015.

Yet the government is counting on a *deterioration* in the structural balance of 0.3 point in 2014, followed by an *improvement* of 0.4 point in 2015.

Thus, while according to the Commission the treaties require Italy to make a cumulative effort of 1.4 point in 2014 and 2015 (for its part the Italian Government considers that this effort should instead be 0.9 point), Italy is announcing an *improvement* in its structural balance of 0.1 point during the period, a difference of 1.3 points from that demanded by the Commission. From this perspective, Italy is further from European requirements than France, and will have to justify its lack of a structural adjustment. In addition, Italy is not expected to reach its MTO in 2015, even though at the end of the European Semester in July 2014 the Council had recommended it stick to the 2015 target.

Italy is the first country to be constrained by the *debt criterion* and is serving as a laboratory for the application of the rules by showing some of their adverse effects. Indeed, the adjustment required under the *debt criterion* is changing in line with several parameters, some of which were not really anticipated by the legislator. For example, the amount of the adjustment depends on a forecast of the ratio of nominal debt

/ nominal GDP at the end of the transition phase. However, the fall in prices currently underway in Italy is lowering the nominal GDP forecast for the next three years, without any change in fiscal policy. Thus, the debt criterion is tightening mechanically without any government action, endlessly increasing the need for structural adjustment as the new adjustments induce more deflation. In addition, the procedures used to find deviations from the debt criterion are slower because the controls are carried out essentially *ex post*, based on the accumulated deviations observed over two years. However, the magnitude of the deviation announced by the Italian government could spark procedures based on *ex ante* control. Recall, however, that unlike France, Italy is not currently in a procedure. This would have to be opened before any sanctions could be envisaged against Italy. This preliminary and necessary step gives the Italian government time to take suitable measures or to justify its deviation from the MTO.

Furthermore, the EDP's preventive arm provides more opportunities for deviation than the corrective arm. In addition to the clause on exceptional economic circumstances, Italy can argue major structural reforms that will improve the future sustainability of the debt. This argument, which is also raised by the French government, is not set out in the EDP text (the Commission could accept some flexibility). Here, however, the Renzi government is drawing on its reputation as more of a reformer than the French government.

Both governments have requested the application of the exceptional economic circumstances clause in order to break their commitments. The Commission could be more sensitive to the Italian request because its economic situation has deteriorated: Italy has seen 3 years of falling GDP, which is continuing in the first half of 2014. The country's GDP is 9 points below its pre-crisis peak, while in France it is one point higher. The latest survey indicators, for example on industrial production, do not augur well for recovery in the short term. Finally, Italy is suffering deflation.

In summary, while the Italian gap seems larger than that of France, it could benefit from greater indulgence. The procedures applied to each country differ and give Italy more time before any sanctions can be applied. The country's willingness to reform could win it higher marks than France from the Commission. Finally, the most important point in the discussion is that Italy's economic situation is much more serious, with an uninterrupted recession since the summer of 2011 and with prices falling.

But in both cases the reinforced pact, whether it is corrective or preventive, implies endless structural adjustment. Italy demonstrates that getting out of the excessive deficit procedure will demand continuing efforts to meet the debt criterion. If France leaves the EDP in 2017, its debt will be, according to government forecasts, around 100% of GDP. It must then continue with adjustments of more than 0.5%. Confirmation of deflation will make the Pact's rules even more recessive and absurd. Ultimately, the fiscal pact meant to preserve the euro by chasing free-riders or stowaways could lead to blowing it apart through an endless recession.

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[1] Greece, Ireland and Portugal have received European aid and thus have been subject to joint monitoring by the ECB, the IMF and the European Union. Ireland and Portugal are now out of their bailout programme.

And what if Italy's elections turned out to be an opportunity for Europe ?

By Franscesco Saraceno

The whole of Europe is currently fretting about the election results in Italy. The Centre-Left coalition won a narrow majority – because of an electoral law that everyone denounces, but no one seems to have the knowledge or ability to change – which gives it an absolute majority only in the Chamber of Deputies. Due to the way bonuses are attributed for majorities won on a regional basis, no coalition in the Senate has a majority. With its system of "perfect bicameralism", Italy now finds itself in a situation where there is no possibility of forming a government with a political majority. This note explores one possible scenario for the coming few weeks and its economic consequences for Italy and Europe.

Aside from the spectacular political resurrection of Silvio Berlusconi, whose stated goal from the beginning was to prevent the victory of the Left rather than to secure a majority, the two startling results of this poll are on the one hand the defeat of the incumbent Prime Minister, Mario Monti, and on the other the progress of the Five Star (*Cinque Stelle*) movement of the former comedian Beppe Grillo, who now heads the leading party in the Chamber of Deputies.

The defeat of Mario Monti is a stinging repudiation of austerity policies that Italy's citizens view as imposed by Europe and Germany. In Monday's *New York Times*, Paul Krugman called Monti a "proconsul installed by Germany to enforce fiscal austerity on an already ailing economy". Called in November 2011 to the bedside of a country left prostrate by the Berlusconi government, Monti has failed to offer anything other than austerity policies which, unsurprisingly, did not deliver the growth promised. The support the former European Commissioner initially enjoyed slowly eroded as the memory of the problems marking the end of the Berlusconi era faded, and especially as Italy sank deeper and deeper into economic crisis. Mario Monti undoubtedly expected to play a decisive role in the formation of a majority in the Senate, and thus to be able to negotiate his reappointment as Prime Minister. But his gamble failed, and he is now condemned to numerical insignificance.

Beppe Grillo, in contrast, rode to a remarkable success on a tidal wave that now makes him key to the formation of a new government. Thanks to a masterful campaign conducted in the media as well as the street, his movement is the leading party in the Chamber and in the Senate in several regions. He managed to capture the exasperation of the Italians against the "political caste", and he brought almost nine million voters into a campaign that tapped into right-wing populism (*e.g.* on several occasions he made remarks on immigration and the euro that are not reflected in his programme). He has also played on key concerns of the traditional Left, such as the rejection of austerity, environmental issues, the reduction of working hours, a national minimum income scheme, the regulation of conflicts of interest, limited terms for elected officials with no cumulation of mandates, and the ineligibility of those sentenced by the courts.

What will happen in the coming weeks? All Europe is wondering, and the initial reactions of the markets seem to betray nervousness about future developments. For institutional reasons, a new election in the very near term is not an option. President Giorgio Napolitano, who is at the end of his term, cannot dissolve Parliament; invoking this option would mean waiting until May for his successor (who is chosen by the MPs elected yesterday). Moreover, it is not certain that the Parliament chosen in any new elections would lead to a political majority.

The majority electoral law gives the Democratic Party an absolute majority of the seats in the Chamber of Deputies, which makes it indispensable to the formation of a new government. This means there are only two possible scenarios: firstly, a broad coalition between Left and Right (with or without Mario Monti's party). This seems unlikely, firstly, because of the ideological divide between the two parties, which has been aggravated by the return of Silvio Berlusconi; and secondly, because it would be perceived by the voters as ignoring the outcome of the election, which saw the two major parties lose over 11 million votes since the 2008 election.

The second solution would be a minority government of the Centre-Left, which could seek out votes from Beppe Grillo's MPs on a programme that was limited in scope and duration. In this case it would be worth considering what possibilities might exist for a convergence between the Five Star movement (whose programme can be downloaded here [in Italian]) and the Pierluigi Bersani coalition. There would certainly be a consensus on some very popular measures for dealing with the ongoing political crisis (abolition of the provinces, limits on the terms and multiple mandates of parliamentarians, ineligibility, reducing the cost of the political machinery, etc.), and for fixing some of the most vexing problems from the two decades of Berlusconi (reforms on conflicts of interest and corruption, judicial reform).

The environmentalist wing of the Centre-Left could also find convergences on incentives for energy efficiency and on investment in renewable energy.

In economics, some of Beppe Grillo's key measures could also see a convergence with the Centre-Left, for example on the adoption of a national minimum income scheme or minimum wage, themes which, as has been shown in the French debate, are not necessarily populist or unrealistic.

It would be difficult to agree on any convergence between the Centre-Left and Beppe Grillo within the framework of the current fiscal consolidation, so it’s worth repeating that a prerequisite for this would be calling into question the austerity policy repudiated by the voters. This would inevitably pose problems for the Democratic Party which, like the Socialist Party in France, has gone in for austerity. Negotiations with the Five Star movement would imply abandoning the ambiguous position that the Democratic Party has long held on austerity. This would in turn have an impact throughout Europe. In the coming few weeks, Europe’s leaders may be faced either with the lack of a government in the third-largest economy in the euro zone or with a government that is likely to turn its back on austerity. Europe could then be forced to rethink its own economic strategies, and some countries that have been tightening up only reluctantly (like France?) could seize the opportunity to call into question the model of growth through austerity.

Who will pay the bill in Sicily?

by Augusto Hasman and Maurizio Iacopetta

Rumors of a Sicily’s possible default are in the air again. The employees of the Sicilian parliament did not receive their checks at the end of September. Another possible default of Sicily made already the international headlines in July (see the New York Times 22/07/12) due to the contagion effects it could have had on other regions. But in that occasion, the central Italian government prevented Sicily's default by providing an immediate injection of liquidity in the order of 400 million euros.

Other Italian regions are in trouble*.* In recent months the provision of basic health care services has deteriorated; regions are renegotiating contracts with their creditors to obtain deadline extensions. The figures reported by Pierre de Gasquet in *Les Echos* of 02/10/2012, give a good idea of the deterioration of the Italian regional public finance over the last decade.

It will take a good deal of imagination for regional governments to come out of the impending budget crisis, not only in Italy but also in other European countries that have difficulties in managing their public debts, such as Spain, Ireland and Greece.

In recent weeks we learned that some local politicians are endowed with a good deal of creativeness, but they hardly use it to find a solution to the budget crises. The governor of the region Lazio –where Rome is located – resigned a few days ago in the midst of a political scandal due to revelations that members of the regional parliament funneled electoral funds to pay extravagant personal expenses, including car upgrades and luxury vacations.

Why don't regional governments issue their own money to finance public expenditures? It may seem absurd that now that European countries have finally accepted a common currency, regional and possibly local governments might be tempted to create some sort of fiat money. But historically it would not be the first time that local monies emerge when the central government has its hands tight.

Argentina in the early 1990s (convertibility law n° 23.928, 27/03/1991) pegged the currency on a one-to-one basis with the

U.S. dollar (See Anne-Laure Delatte's article on this blog for a parallel between the Argentinean events and hypothetical scenarios for Greece.). For most of the decade, things seemed to be working well; the economy was growing at the impressive annual rate of almost 5.7%, notwithstanding (or perhaps thanks to) the fact that Argentina, in practice, gave up the monetary policy instrument. But by 1998, the load of public debt started to become unbearable. Financing it by printing money was out of question. The IMF was called for help to prevent the panic of Argentinean savers. It granted a loan of 40 thousands million dollars but it also asked the government to impose a severe austerity plan, which had, among many effects, that of depriving provinces under financial difficulties from the prospect of being rescued by the central government.

It was at this point, in 2001, that a number of provinces began to print their own money in order to pay wages and current expenses. (Krugman's open editorial of ten years ago at the New York Times – Crying with Argentina, 01.01. 2002 – gives a fresh reading on the unfolding of the events). Fifteen out of twenty-two provinces ended up using newly issued interest-bearing notes, which earned the name of 'quasi-money'. At the beginning, thanks to an agreement between provinces and large stores, quasi-money had a high level of acceptability. Indeed, competition led more and more stores to accept the quasi-money. Local trade seemed to resuscitate. In August 2002, 5 thousands million pesos of quasi-money circulated side-by-side with 12 thousands million of (real) Argentinean pesos.

Interesting, although the case of Argentina seems very surprising, the academic literature has always been puzzled of why it does not happen more often. The question is why government non-interest bearing banknotes circulate side-by-side with government bonds that promise an interest. In principle the phenomenon defies an elementary no-arbitrage principle.

One of the first to pose the puzzle was Hicks in 1935 in a famous article by the title of ‘A suggestion for simplifying the theory of money’. An answer to Hicks’ puzzle was offered by [Bryant and Wallace](#) (1980). Their argument is based on observation that private banks are not allowed to slice large denomination government bonds in small denomination banknotes. If banks could issue their own small denomination notes that are fully backed by large denomination government bonds, then, competition among banks would presumably drive the return on private banknotes in line with the return on bonds. If interest rates on bonds are positive, the argument goes, the demand for non-interest bearing money should then fall to zero. For Bryant and Wallace only the legal restriction on intermediation would prevent this from happening.

But Makinen and Woodward (1986) report that, during the period from 1915 to 1927, French government treasury bonds circulated at a relatively small denomination of 100 Francs (roughly 50-60 euros of today). The bonds were issued with terms of 1 month, 3 months, 6 months, and 1 year. These bonds were continuously available to all banks (including branches of the Bank of France), post offices, and numerous local offices of the Finance Ministry. This historical episode casts some doubts on the legal hypothesis, for the Bank of France kept issuing Francs.

Why then in Argentina bonds emerged as money – albeit for a limited period? It seems to us that the key was the promise offered by the issuer to accept the regional bonds in settling a debt – typically a tax obligation. The rules on what the regions can and cannot do in Europe are different from country to country. In Italy for instance regions, provinces, and municipalities have been authorized to issue bonds by the law of ‘rationalization of public finance’, introduced in the first half of the 1990s (art. 32 of the law of 8.6.1990 n.142, for municipalities and provinces, and art.35, law 23.12.1994 n. 724). The law set several conditions for an administration to qualify to issue bonds. First, bonds can be issued only to finance investment projects. The law explicitly forbids the issue of bonds to finance current expenditures. Second, the issuer has to demonstrate a good history of balanced budgets. Third, the maturity of the bonds cannot be shorter than five years. Fourth, the bonds cannot go in direct competition with the central government bonds, namely cannot be offered a real return above the one offered by the central government for bonds with similar maturities. Fifth, the central government is not allowed to back-up bonds of the regions who, in turn, cannot take responsibility for the bonds issued by provinces or municipalities

Is it desirable to relax these conditions? Perhaps it is useful to see the end of the story in Argentina –not particularly that of a Hollywood movie. The acceptability of quasi-money outside the region that issued it was very low. More importantly, the central government did not allow tax payers to use quasi-money for their federal taxes. Consequently, in a few months the de-facto exchange rate between the quasi-money and the national currency dropped from 1 to around 0.7 – it was somewhat higher for Buenos Aires quasi-money, for this was accepted in many other provinces.

At the beginning of 2002, a new government, presided by Eduardo Duhalde, decided to abandon the convertibility law. As a result, the exchange rate of the pesos vis-à-vis the U.S. dollar dropped from one to four. During that year, the GDP declined 10.9%.

Having gained the power of printing money again, the central government allowed quasi-monies holders to convert them into the devalued national peso. The short run benefits evaporated soon. The recession along with the depreciation slashed the purchasing power of the working class. At the end of the crisis, the national product was about a quarter lower than its 1998 level, and the rate of unemployment shot up to 24%. It appears that issuing of local money delayed the collapse of the financial system, but it is unclear whether the temporary breath gained by local administrators that issued bonds made the subsequent recession less severe. The case of Argentina suggests, nevertheless, that a major relaxation of the current constraints of regional and municipal entities is not going to help solve how to guarantee the provision of health care service in the long run. Nonetheless, the current policy of cutting basic public services indiscriminately is the least imaginative of the solutions. Alesina and Giavazzi in an open editorial published on Corriere della Sera on Sept 27, suggested that hospitals could charge health care users directly instead of being reimbursed by the regional authorities. By doing so, they argued, not only the quality of the service would improve, but regions would need fewer resources. Although this is food for thought, in the U.S. such a system generated a colossal profit making machine that contributed to the explosion of the health care costs. Similarly, Fitoussi and Saraceno (2008) argue that the spectacular gain in income of the last three decades in China did not go hand-in-hand with similar gains in life expectancy and quality of health care, because the government opted for a health care system based on out-of-pocket expenses.

The Argentinean experience tells us that local administrators in distressed regions of Europe are going to lobby the government to give more freedom in managing their budget intertemporally – something that is already happening in Spain, and is summarized in the London School of Economics blog by K. Basta . They are also probably going to make more intensive use of 'creative accounting', so as to prolong their serving time in office. But this will not be the solution. A major reassessment of the national government's priorities in combination with a sensible monetary policy at the European level is the only way out. We badly need to free up resources to revitalize the public educational system and to maintain the overall good standard of public health care services.

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