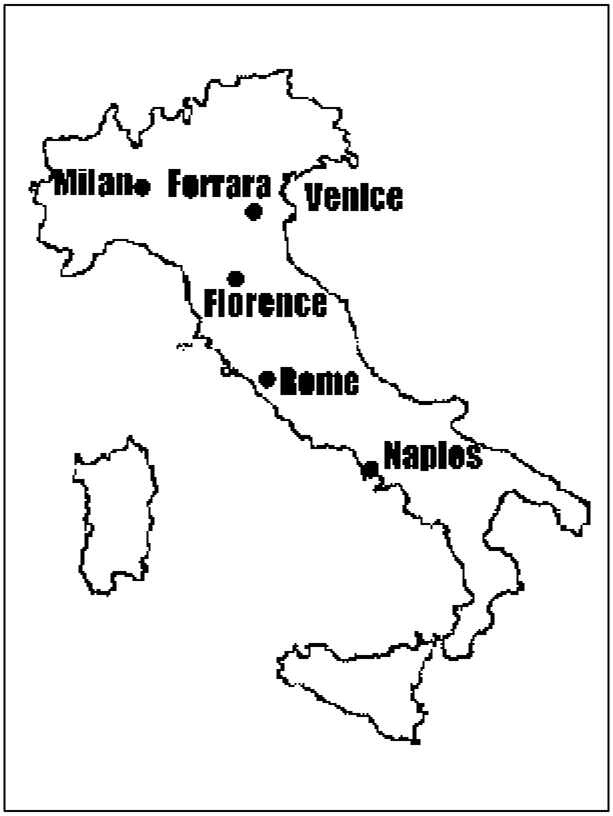
Italy

AV Vedpuriswar *



Italy, one of Europe's most important countries, is the sixth largest economy in the world after the US, Japan, Germany, Britain and France. Poor in natural resources, Italy's landscape is dominated by mountains and rugged hills, with some plains and coastal lowlands. Only 30% of the terrain is composed of arable land. But despite these handicaps, Italy has made tremendous progress over the years. The country has some top class universities. Some of its scientists have even won the Nobel Prize.

Italy is divided into two main socio-economic regions: The North-Center and the South. The North-Center is the industrial heart of the country. This region has low unemployment rates and a well-built infrastructure. The economy comprises a few large corporations and thousands of small to medium, family-owned companies. The South, also known as the *Mezzogiorno*, suffers from crime, high unemployment and a poor infrastructure. State enterprises, (including those which have recently undergone privatization), dominate the economy in this region. Most of Italy's agricultural activities are in the South.

Under electoral rules introduced in 1994, the Senate and the Chamber of Deputies are elected by a mix of first-past-the-post and proportional representation for a maximum of five years. The president, decides whether to call an election or nominate a prime minister to try to form a government in the event of a political crisis. Executive power lies with the cabinet, which is nominated by the prime minister and must be approved by parliament.

Post-war Italy has been characterized by a weak political structure. Since 1993, Italy has had nine

Table 1
Italy at a glance

Population	:	57.5m (2000)
Population growth	:	0.2% (average, 1996-2000)
Land area	:	301,300 sq km
Fiscal year	:	Calendar year
Currency Euro (E)	:	US$0.90:E1 (2001, average); US$0.938:Euro1 (June 5th 2002)
GDP	:	E1,217bn (2001); US$1,090bn (2001, at market exchange rate); US$1,464bn (2001, at PPP)
GDP growth	:	2% (average, 1997-2001); 1.8% (2001)
GDP per head	:	US$18,948 (2001, at market exchange rate); US$25,450 (2001, at PPP)
Inflation	:	2.2% (average, 1997-2001); 2.8% (2001, average)

Source: Economist Intelligence Unit.

* *AV Vedpuriswar is Consulting Editor, Global CEO and Dean, ICFAI Knowledge Center, Hyderabad. He can be contacted at ved@icfai.org.*

governments. But the country now appears to be moving towards a bipolar political system, dominated by the right-of-center Casa delle Liberta alliance, in power since June 2001, and the center-left Ulivo coalition. The May 2001, election result has reduced the influence of the smaller parties in the two coalitions. If Prime Minister Silvio Berlusconi, who is easily Italy's richest man is able to fulfill the promises he made prior to the elections, he may well become the first post war Italian leader to serve a full five year term. Berlusconi has promised to speed up privatization, reform the state pensions system, introduce labor market reforms and reduce the role of the government.

Italy is a member of the Euro zone. Unlike many other Europeans, Italians have not been paranoid about losing their national identity after the launch of the Euro. This is probably because after 140 years or so reunification, the country has still not developed a strong national identity. Many people also feel that Italy has been so badly managed that any alternative will be preferable. Moreover, many of the recent positive developments including increased competition, reduced red tape and growing privatization have been prompted by the Euro. The general thinking seems to be that European institutions will impose necessary checks and balances on Italian politicians.

Background note

Early history

Rome was founded on the banks of the Tiber in the middle of the 8th century BC. The formation of the Republic during the 6th century BC marked an important social transformation. Plebeians gained political power and the first written laws were recorded. In the 5th and 4th centuries BC, the Roman Republic expanded its empire to southern Italy. The expansion inevitably led to a series of battles between Rome and Carthage. In 146 BC, Rome defeated Carthage and became the leading military power in the Mediterranean.

In 5th century AD, the Western Roman Empire, weakened by political instability and poor economic conditions, collapsed after a series of foreign invasions. Political unity was lost. In the centuries that followed, Italy became a frequently changing succession of small states, principalities and kingdoms which fought among themselves. Foreign powers called the shots.

The Renaissance of the 14th century brought Italy out of the Middle Ages. Economic prosperity in Italy's north and central regions fueled the advancement of classical art, literature and science. The textile industry began to flourish in Florence and Milan. Venice and Genoa became leading centers for spice trade.

France and Spain competed for territorial control of Italy during the 16th century. Spain controlled most of southern Italy, while France held onto some northern pockets. Only the Papal States and Venice remained independent during this time. With campaigns in 1796 and 1800, Napoleon conquered the entire Italian peninsula and established a republic.

After Napoleon's fall, the Austrians assumed control of Italy. But the intellectuals and the middle class began to press for more democratic institutions. In 1848, Giuseppe Mazzinni and Giuseppe Garibaldi, inspired by the dream of unification, led a revolution against the Austrians and established the Roman Republic and the Republic of San Marco. Unification was not achieved until 1860, when the Bourbons and the Papal States, who had been opposed to unification, were conquered.

Though Italy was united under a constitutional monarchy in 1861, it remained deeply fragmented. Class distinctions, especially in the South, continued to divide Italy, as the demands of the peasants and working class clashed with those of big landowners and industrialists. To complicate matters, the Church viewed the new State as a challenge to the Vatican's authority.

In the first World War, Italy fought the War on the side of the Allies. Although the victory expanded Italy's north-eastern borders, it left the Italian economy in ruins. After a series of liberal governments failing to restore order in the struggling economy, the King invited Benito Mussolini, the leader of the National Fascist Party (Partito Nazionale Fascista), to form a government. Mussolini abolished all other political parties and established a fascist dictatorship in 1926.

In 1940, Mussolini's ties with Hitler brought Italy into the Second World War on the side of Germany. On July 10, 1943, the Allies invaded Sicily and triggered

Table 2 Economic data	1997	1998	1999	2000
GDP per head (USD)	20,300	20,800	20,400	18,600
GDP (% real change pa)	2.03	1.81	1.61	2.92
Government consumption (% of GDP)	18.61	18.40	18.58	18.46
Budget balance (% of GDP)	-2.70	-2.80	-1.90	-1.54
Consumer prices (% change pa; av)	1.79	1.72	1.63	2.51
Public debt (% of GDP)	119.80	117.70	116.60	110.23
Labour costs per hour (USD)	17.57	17.11	16.60	14.71
Recorded unemployment (%)	11.74	11.83	11.36	10.50
Current-account balance/GDP	2.78	1.67	0.53	-0.60
Foreign-exchange reserves (bn$)	55	29	22	25

Source: Economist Intelligence Unit.

an anti-fascist movement. Following the invasion, the King replaced Mussolini with Marshal Pietro Badoglio, who signed an armistice with the Allies on September 2, 1943. In 1945, the Germans surrendered. Mussolini was shot and killed.

Post War Italy

On June 2, 1946, in Italy's first popular referendum, people voted to replace the monarchy with a democratic republic. The 1948 constitution established a democratic system consisting of the executive, the judiciary and a bicameral parliament. Having had a bitter experience of authoritarianism, the Italians endorsed a constitution that limited the powers of the executive.

Despite massive destruction of its infrastructure, Italy rebounded from World War II and moved quickly through the restoration period. The 1950s gave rise to an industrial boom that brought prosperity to the northern and central regions and shifted the focus from agriculture to manufacturing. Family-owned businesses became the mainstay of the economy. They focused on industries like textiles, machinery and food processing and took advantage of Italy's proximity to the water to export goods around the world.

In an attempt to bridge the economic gap between the North and South, the State pumped funds to improve the South's infrastructure and accelerate its economic and agricultural development. The success of this program was spoiled by a great migration of southern workers, who fled to the North where jobs waited for them. The labor flight left the Southern economy in poor shape and widened the gap between the two regions.

But the State continued its interventionist role in the South. Large plants were constructed in the transportation, telecommunications, utilities, steel, coal and petrochemical industries. The system created ENI, ENEL, SIP (Telecom Italia) and other state-owned monopolies. State-owned enterprises built up high-tech know-how and improved the South's infrastructure. But they encouraged an unprofessional management culture characterized by excessive staffing.

Meanwhile, Italy continued to make progress toward its goal of European integration. In 1979, it became one of eight European states to join the European Monetary System (EMS). The new system of "snake within the tunnel" exchange rates aimed at insulating intra-European trade from the volatility of floating exchange rates.

The collapse of the Berlin Wall in 1989 had a significant impact on the Italian political system. For years, the Soviet Union had been an important trading partner, especially in Emilia-Romagna and Italy's other communist "regions." Moreover, once the threat to democracy had gone, the need for a strong anticommunist government slipped away.

In the early 1990s, Italy seemed to be doing well with increased productivity and surging exports. But the country was plagued by high unemployment, high interest rates, high labor costs, high inflation, huge public expenditures and a staggering public deficit. Serious fiscal imbalances had resulted due to inefficient economic policies, the high cost of the welfare system, and years of political corruption. In 1985, the budget deficit rose to 12% of GDP before reducing to about 10% of GDP for the remainder of the decade.

Although his government lasted for less than a year (June 1992—April 1993), Prime Minister, Giulano Amato introduced major economic and institutional reforms which put Italy on course to meet the Maastricht deadlines. Amato's budget included large tax and excise increases as well as a levy on money held in bank deposits and on residential real estate. The retirement age of male and female workers covered by pension plans was increased to 65. Amato launched an aggressive privatization program. In September 1992, Italy suffered a setback when it had to withdraw from the Exchange Rate Mechanism and sharply devalue its currency. Shortly thereafter, Amato resigned in the wake of labor unrest.

Carlo Azeglio Campi, the central bank governor led the next government. He persisted with reforms. Important labor agreements which incorporated profit-and-performance related pay were struck. Two major commercial banks were privatized.

In May 1994, Silvio Berlusconi, a powerful businessman became the prime minister. His short-lived government reduced public sector spending. In 1996, after general elections, a new government led by Romano Prodi took over.

During his three year tenure, Prodi passed tight budgetary measures in order to prepare Italy for its entrance into the EMU. His government continued to open Italy to competition by further reducing state holdings in ENI and privatizing Telecom Italia in1997. As a result of budget cuts and increased tax revenues, Italy's budget deficit fell to 3.7% of GDP in 1997.

In October 1998, the Prodi government fell after losing a vote of confidence. Massimo D'Alema formed a new center-left government. Italy continued to streamline its public finance system. The 2000 budget introduced some measures to cut the budget deficit to 1.5% of GDP. A moderate income tax cut was announced. Following a defeat in the April 2000 regional elections, D'Alema resigned. Giulano Amato was asked to lead Italy's 58th post war government.

In 2001, Silvio Berlusconi's *Forza Italia* (Go Italy) party won the elections with a handsome margin. The unusually large majority of Berlusconi's coalition created the appearance of a two-party system. Berlusconi's attempts to reform Italy's labor laws led to a day-long general strike by the country's three main trade union groups. This was the first of its kind in 20 years. The strike put Berlusconi under pressure, his earlier government having fallen in 1994 after mass demonstrations.

Economic and social policies

In recent times, Italy has embarked on a journey of wide ranging economic reforms. It has focused on cutting taxes, tackling unemployment, enhancing competitiveness and reducing the budget deficit. But Italy's large bureaucratic government has sometimes made it difficult to implement market-oriented reforms. Economic and cultural differences between Italy's North and South regions have also hindered the development of a market economy.

Some of Berlusconi's recent actions have also not impressed observers. He has frozen the prices of an array of public services, blocked a hike in electricity tariff and reduced the independence of the country's

Table 3
Comparative economic indicators, 2001

	Italy	Germany	France	Spain	UK
GDP (% real change)	1.8	0.6	1.9	2.8	2.2
GDP (US$ bn)	1,090	1,848	1,312	582	1,511
GDP per head (US$)	18,950	22,500	21,960	14,463	23,750
Consumer price inflation (av; %)	2.3	2.5	1.6	3.6	1.2
Unemployment	9.4	9.5	9.0	13.1	5.0
Current-account balance (US$ bn)	2	4	26	-15	-23
Current-account balance (% of GDP)	0.1	0.2	2.0	-2.6	-1.6
Exports of goods fob (US$ bn)	242	571	289	118	275
Imports of goods fob (US$ bn)	-224	-488	-283	-149	-323

Source: Economist Intelligence Unit.

energy regulator. During the period 1992-2001, Italy sold off assets worth €113 bn. But since March 2001, Berlusconi's privatization initiatives have generated only €235 mn. The government which is having stakes in various businesses is finding difficult to let go. The Treasury still owns one-third of ENI, the energy group over two-thirds of Enel, the electricity group and 4% of Telecom Italia. The government has not been able to make much headway in the area of pensions which account for 15% of the GDP and 40% of the public sector spending. Berlusconi seems to have upset both workers and employers.

Italy has the second-highest unemployment rate among the EU countries. Unemployment in the southern part of the country is as high as 22%. In 1998, Italy's unemployment rate was 2.2% more than the average unemployment rate for the EU-15. Among EU countries, Italy has the lowest proportion of working-age people, 54% in jobs. Italians are also not very mobile. Many youngsters who are unemployed prefer to stay put in their parents' house instead of relocating to the thriving business centers. They also do not want to do menial jobs. Ironically enough, immigrant workers from central Europe and the Balkans are flowing in to make up for the labour shortages in the north.

Labor market reform has been high on the agenda but difficult to implement because of stiff resistance not only from the trade unions but also from some politicians.

The financing of Italy's pension system, particularly its generous provisions for early retirement, continues to be subject of controversy.

Like in many other developed countries today, Italy's greying population is a major concern. About 60% of Italy's welfare spending is on account of pensions, compared with the EU average of 45%. The low birth rate is pushing up the number of pensioners. By 2030, some 42% of Italians may be pensioners. The use of private pension schemes and a higher retirement age are some of the measures being contemplated to deal with the problem. Other highly sensitive domestic issues are education, health, immigration controls and judicial reforms.

Italy has a large underground economy, which accounts for 15.4% of GDP (although the IMF, in its most recent estimate, puts it at 27% of GDP). Underground businesses are widespread in agriculture, construction and services.

Italy is one of the more corrupt countries in Europe. Berlusconi's own less-than-perfect record when it comes to business ethics is a major cause for concern in this regard. Italy is considered the least transparent among the G-7 countries in its business practices. Transparency International has put Italy along with Greece at the bottom among the countries of Western Europe. Corruption and the opaque legal system are probably the main reasons for Italy's inability to attract enough foreign investment for an economy of its size and sophistication.

Industry

Like most other advanced OECD economies, Italy has a small primary sector. Services contribute close to two-thirds of gross value added. However, apart from tourism and design, Italy is not internationally competitive in most services sectors. Italy is strong in manufacturing, which accounts for about 25% of GDP and about 90% of Italy's total merchandize exports.

Italy is dominated by two tiers of private companies. The first tier consists of a few large family-owned companies. The second tier is made up of clusters of family-owned Small and Medium-Sized Companies (SMEs). These firms specialize in products that require high-quality design and engineering. Ninety-eight percent of manufacturing firms have fewer than 50 workers and 83% have less than 10 employees. SMEs account for more than a third of Italy's export revenues and are an important source of employment. They provide roughly two million jobs in the manufacturing sector. Italy has the highest percentage of SMEs among the EU countries.

Italy has few large private companies, but those that exist play a pivotal role in the economy. They include Fiat, which is controlled by the Agnelli family; Pirelli, controlled by the Pirelli family; and Fininvest, controlled by Silvio Berlusconi. The promoter families have generally exercised tight control, with a relatively small shareholding, through holding companies and cross-shareholdings with industrial and financial allies. In recent times, this practice has begun to change (albeit only slowly), with the introduction of legislation that requires greater transparency by listed companies and improved minority shareholder rights.

Table 4

Major exports (2001)	% of total
Engineering products	29.9
Textiles, clothing & leather	15.9
Transport equipment	10.9
Chemicals	9.5
Major imports (2001)	**% of total**
Engineering products	21.9
Transport equipment	14.3
Chemicals	12.9
Refined petroleum products	1.8
Leading markets (2001)	**% of total**
Germany	14.5
France	12.2
US	9.7
UK	6.7
EU	53.8
Leading suppliers (2001)	**% of total**
Germany	17.7
France	11.1
Netherlands	6.2
UK	5.1
EU	56.5

Source: Economist Intelligence Unit.

With the exception of firms in the machine tool industry, most SMEs produce high-quality consumer goods, including clothing, furniture, kitchen equipment and white goods. Despite their export-orientation, the SMEs face a serious challenge due to globalization and increased competition. Their unwillingness to go public to finance expansion has hindered growth and left them vulnerable to acquisition by larger foreign firms. The "Made in Italy" stamp is synonymous with quality and style. Italy is also the sixth largest market in the world. So, there are always foreign buyers on the prowl for these companies.

The extent of the state's direct involvement in the economy has significantly reduced in recent times, due to the privatization program carried out by successive governments since 1993. This process has been facilitated by EU restrictions on state aid to industry and the need to reduce public sector debt. Besides reducing its stake in ENI and Enel, the state has gradually sold off the assets of Italy's largest state holding company, Istituto per la Ricostruzione Industriale (IRI), and others since the early 1990s. In mid-2000, IRI was liquidated in line with an agreement made with the European Commission in 1997.

Foreign trade

In 2000, Italy exported goods worth to US$ 238.7 bn (fob) while its imports were valued at US$ 228 bn (fob). In 2000, the current-account balance swung into deficit (US$ 5.7 bn, or 0.5% of GDP) for the first time since 1992.

Thanks to its dynamic SMEs, Italy is a major global player is food-processing machines, washing machines, fridges, shoes, shoe-making machines, ski-bolts, ceramic tiles, jewels, woolen and silk clothes, boilers, optical frames and neck-ties.

Future outlook

In recent times, consensus seems to have emerged among most of Italy's politicians about the need for market oriented reforms. Privatization, pension reforms, lower taxes and flexible labor markets are being supported by parties both on the left and the right. But despite this consensus, a lot remains to be done if Italy does not want to be left behind by other G-7 countries. In the past decade, the Italian economy has grown at a smaller pace compared to all other countries in the European Union (EU). In 2002, the Italian economy may grow only by about 1.5%. The global downturn has aggravated to Italy's poor economic performance in recent times.

Berlusconi is an admirer of Margaret Thatcher, who won a famous victory over the labor unions in the UK in the 1980s. But the pace of labor reforms continue to be slow. Berlusconi does not seem to have gone far enough in cutting taxes, reforming the pensions system and restructuring the education and health care system.

The budget deficit is expected to be 2.0% of GDP well outside the target of 0.5%. The ratio of public sector debt to GDP looks set to rise to about 110%. Another problem for Berlusconi is that the National Alliance, an important party in the coalition favors government control. Many of Italy's politicians in fact, still favor paternalistic government intervention. Berlusconi's personal legal problems have also been a major distraction. Himself a businessman, Berlusconi understands what Italy needs to improve its global competitiveness. But only time will tell whether he can successfully take on Italy's well-entrenched interest groups. ■

Reference # 15-02-12-07