SURVIVAL OR SIESTA?

Italy

Italy exemplifies everything that is wrong with Europe – poor government finances, stultifying bureaucracy and rising labour costs. Can it sort itself out? Silvia Pavoni, an Italian national who lives in the UK, takes a long, hard look.

As the world tries to rebalance itself after having been hit by a fast-spreading and wide-reaching financial crisis and economic recession, is Italy on the side of the countries emerging as winners or losers? Views differ according to who is asked, with foreign observers inevitably the gloomiest about Italy's future.

Earlier this year, Charles Calomiris, who is the Henry Kaufman professor of financial institutions at the Columbia University Graduate School of Business, and was one of the first people to predict Argentina's debt crisis a decade ago, said that Europe's biggest concern after Greece is Italy, given that it has the continent's second highest debt-to-gross domestic product (GDP) ratio, not to mention the perceived level of corruption within the country.

The statistics do not make pleasant reading for Italy. Its GDP growth had been swinging between 0.45% and 1.56% in the five years before the global economic crisis hit in 2008, the country's public debt is a staggering 117% of GDP, and its unemployment rate is 7.8%. In addition to this, Italy has one of the lowest transfers of academic innovation into the business world in Europe, what reforms do get passed lose any momentum as governments change, and foreign investors have been reluctant to locate in the country. In additional to all of this, the widespread negative perception of business and politics in the country is not helped by the various scandals surrounding current prime minister Silvio Berlusconi.

On the other hand, however, Italy has a primary deficit (public deficit before interest payments) of zero, a conservative and solid financial system that withstood the credit crunch and a long tradition of entrepreneurialism, which has softened some of the most cynical observers. Mr Calomiris himself concedes that, thanks to the country's limited deficits, relatively small changes can solve the Italian problem.

SHAKING ITALY OUT OF ITS LIMBO

Italy is a country that only 50 years ago went through a *miracolo economico*, a surge in manufacturing that transformed the country from a relatively backward agricultural region into one of the world's most powerful modern economies. Between the mid-1950s and mid-1960s, GDP grew at more than 6% a year and industrial

production doubled – growing at a faster rate than anywhere in the world apart from Japan and Germany. Most of this growth took place in the industrial triangle of Italy's north-west, the area between Turin, Milan and Genoa. It was led by car manufacturer Fiat, which by 1976 was selling more cars in Europe than any other company, including Volkswagen.

Fast-forward to 2010 and after years of losses and state funding, Fiat seems only now to have put itself back on track. It acquired 20% of car-maker Chrysler when the North American company was close to bankruptcy, and both businesses are expected to close in profit this year. Much of the credit has to go to CEO Sergio Marchionne and chairman Luca Cordero di Montezemolo, who also helped turn around the Ferrari racing team and was instrumental in pushing its Formula 1 successes.

SMALLER COMPANIES, BIGGER PICTURE

Italy's entrepreneurial talent in both multinational and small and medium-sized companies has helped banish negative perceptions over both the country's image and its economy. But a look at the bigger picture shows that such entrepreneurs flourish in spite of the country's business environment, not because of it.

Unit labour costs, which indicate how competitive and expensive countries are in terms of labour productivity, grew in Italy by more than 20% between 2000 and 2007, against a eurozone average of 12%. Spain, Greece and Portugal increased their labour costs by 24%, 22% and 19%, respectively, while Germany's fell by 0.3%. The divergence in labour costs increased further in 2009, according to rating agency Standard & Poor's.

High labour costs and limited productivity per worker are a serious problem for developed countries such as Italy, which seem stuck in an environment characterised by low GDP growth and a lack of investment. Since real salary levels cannot easily be reduced, it makes little sense for Italy to compete on a cost basis. This means that its focus must shift from becoming more competitive in terms of quality and productivity. To put it simply, Italy's workers must be more productive.

This is not simply a microeconomic factor and it requires some structural reforms, such as a slimmer, more efficient public administration machine. However, public sector workers in Italy are in the habit of considering their employment as a lifelong right, and this is supported by a tradition That makes it almost impossible for employers to terminate contracts. In an attempt to tackle this, tougher controls on levels of *assenteismo* (absenteeism), introduced by current public administration minister Renato Brunetta, have helped to expose the practices of many state employees used to taking time out of their working day to carry out personal chores. Italy's government has highlighted poor labour practices along with an excess of red tape and lack of liberalisation in some public administration's services as its chief concerns.

Some measures aimed at reducing government expenditure, such as increasing the country's retirement age, restricting funds for municipalities, and implementing further analysis of the fiscal federalism process, were incorporated into Italy's budget report for 2011 to 2013.

THE PEOPLE OF THIS COUNTRY KNOW HOW TO INNOVATE AND HOW TO DO THINGS, YET WE CAN'T STOP THE BRAIN DRAIN

Giancarlo Giorgetti

Italy kept its budget deficit down to 5.3% of GDP in 2009, well below the EU average, and the aim is to cut the deficit to 2.7% by 2012. The goals of the government for the next three years are ambitious: a €62bn reduction of net borrowing, thanks to an almost €40bn cut in public spending, and more than €22bn in new inflows from the fight against tax evasion.

SCEPTICISM ABOUNDS

The markets seem to have welcomed this. But are Italy's aims realistic in the longer term? Many remain sceptical, especially about the country's ability to achieve significant changes and reforms.

"There is a need to liberalise some service sectors and to reduce the weight of the public administration," says Giada Giani, an economist at Citi. "I can't see any significant policies being enacted to change this. Freeing up capital spent on the public sector would help finance liberalisations and infrastructure. Since there is no money to finance these, liberalisations don't get made."

This may be a clear, simple diagnosis for economists to make, but such statements can raise the blood pressure of members of Italy's almighty unions, which in the past flexed their muscles for much less and stopped a number of basic reforms in their infancy.

Emblematic was the taxi drivers' strike a few years ago during the administration of Romano Prodi, which was ignited by the proposed liberalisation of taxi drivers' licences, which would have allowed the start-up of small companies (similar to the situation in the UK) and would have reduced the purchase value of the licences. Drivers who had paid the price of a studio flat for their licence to previous owners were furious at the potential loss of value of that asset. Milan and Rome, whose ancient ruins mean that the city cannot house an »

BALANCE REQUIRED TO STABILISE PUBLIC DEBT/GDP RATIO AT 2007 LEVEL[1]

	More than five years	More than 10 years	More than 20 years	Forecasted balance in 2011
Austria	5.1	3	2	-2.9
France	7.3	4.3	2.8	-5.1
Germany	5.5	3.5	2.4	-2
Greece	5.4	2.8	1.5	-5.3
Ireland	11.8	5.4	2.2	-9.2
Italy	5.1	3.4	2.5	0
Japan	10.1	6.4	4.5	-8
Netherlands	6.7	3.7	2.3	-3.4
Portugal	5.7	3.1	1.8	-4.4
Spain	6.1	2.9	1.3	-6.6
UK	10.6	5.8	3.5	-9
US	8.1	4.3	2.4	-7.1

[1] As a percentage of GDP

Source: OECD; BCM and Partners

underground rail system, making it heavily reliant on car transport, were brought to a halt by such strikes, which eventually forced the government to backtrack and put forward weaker reform.

MISSED OPPORTUNITIES

Italy is a country of missed opportunities. As finance minister Giulio Tremonti said a few months ago, the country is not able to spend resources even when they are available. When it comes to EU funds on offer to support poorer Italian regions, of the €38bn available between 2007 and 2013, only €4m or €5m has been allocated, according to the government. "Funds have been lost in the past," says Giancarlo Giorgetti, president of the treasury commission of the Italian parliament's lower house. "They are not used or badly used. If you look at Spain, Portugal or Poland, they have used those resources in a clever way." He continues: "Initially, resources were given to regional administrations but lack of good management channelled them back to the government. This continual shift of responsibilities and lack of [a] strategic view means less than 15% of the resources were used to promote the poorer regions."

The 'brain drain' is another phenomenon the country responsible for the likes of Galileo Galilei and Leonardo da Vinci has not been able to stop. From the academic world to that of business and finance, talented young people leave Italy to pursue better career prospects abroad. Lack of vision and insufficient investment in research are widely blamed for this exodus, as are the costs associated with hiring a full-time employee, which have caused many small companies to impose various forms of freelance contracts on what are effectively full-time staff, moving part of the cost on to workers, such as annual leave, pension contributions and, in some cases, professional insurance. The growth and misuse of these types of contracts have created a sense of uncertainty that is new to Italians.

"The people of this country know how to innovate and how to do things," says Mr Giorgetti. "Yet we can't stop the brain drain. There are legal proposals with fiscal and financial incentives for this and we need to promote research done in university, and reward universities that do research, rather than the ones that only protect academic barons." Meritocracy in the business world and even more so in universities is a distant target. This, coupled with the fact that only two universities have nurtured a close relationship with the business world, is a poor starting point for any economy that desperately needs young talent to restore its chances of growth.

"Brains go where the money is," says Roberto Siagri, founder of international hardware manufacturer Eurotech. "If you want to stop the brain drain, you need to bring back investment into the country."

Given the size of many Italian companies, capturing their investment in research and development (R&D) is difficult. While in a larger corporation it is simple to see how many resources are allocated to the R&D department, in a small family-run business it is often the owner who studies how to improve the firm's machinery in his spare time. While difficult to measure, this phenomenon at least leaves the hope that some innovation is created under the radar, which would also help explain the success of so many small and medium-sized enterprises (SMEs). Others, however, take a more cynical view and point towards all the wealth generated by SMEs that is immediately channelled to Swiss private bank accounts, rather then reinvested in ways to improve the company.

PERCEPTION PROBLEM

Many Italians say that the country's biggest problem is the one of perception, and that the perceptions of foreign observers paint a much bleaker picture than actually exists. While there may be some truth in this, such denial of Italy's all-too-evident problems does not help to find a solution to its ills.

The Italian corporate governance system presents a fitting example. Despite a sophisticated corporate governance structure that gives minority shareholders representation on the board of listed companies, thanks to the *voto di lista* (vote of the minority shareholders' list), foreigners often feel cut out of the unofficial knowl- »

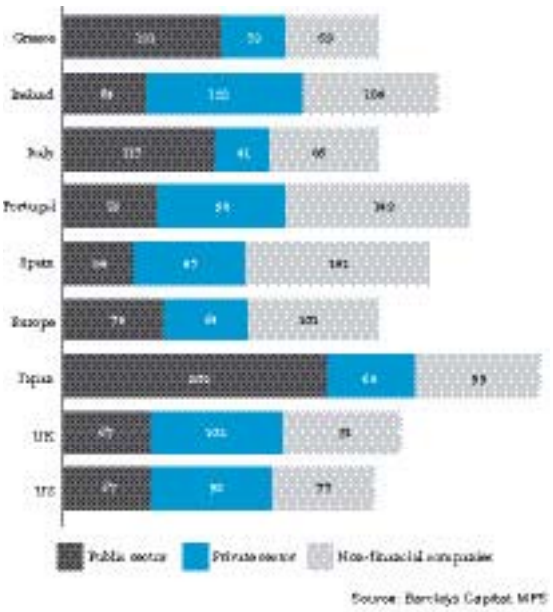
edge network needed to understand who to elect as their representative on the board.

"No other country has a rule like that," says John Wilcox, chairman of advisory firm Sodali. "The problem is that institutional investors do not really understand how the *voto di lista* process works. In general terms, the more political nature of a board of directors of a large Italian company is something that is unfamiliar to most investors outside of Italy. They don't really understand the different lists of candidates and the relationships between certain shareholder groups."

These relationships go back to the *fondazioni*, the holdings created at the time those companies became privatised. This leaves foreign investors unaware of the *voto di lista*'s benefits. "This process is made even more difficult because of the tendency of shareholders to vote only part of their shares because of stock lending and other practises," says Mr Wilcox. "Investors are still convinced that there is a share blocking system in Italy. It has been outlawed but has been perpetrated in practice by the activities of intermediaries and custodians of shares held by foreign investors."

Some of the reluctance of foreign companies to invest in Italy is the result of bad publicity surrounding the country, about economic problems and failures of the political establishment to organise its economy effectively. This is not a new story, and it has presented a conundrum to foreign observers for decades. "The marketplace is extremely strong when you look at small companies," says Mr Wilcox. "The country is very entrepreneurial. It has many very successful companies and new start-ups. But the real economy and the economy run by the government are in contrast. The political dimension doesn't help and creates a perception problem."

Debt/GDP ratio in 2009



Antonio Vigni, chief executive of Monte dei Paschi di Siena (MPS), the oldest bank in Italy and the country's third largest lender, agrees: "We did a tour to place our €1bn corporate bond, and investors were saying ours is a solid bank, an historic bank, but what about Italy? What about the sovereign risk? I think there is a wrong perception of the country."

Carlo Michienzi, co-CEO of asset manager BCM and one of many highly qualified Italians working abroad, agrees. He remembers how, in the late-1970s, when he was a high school student in Switzerland, the geography book had represented Italy with an unpaved country road, a donkey and a woman wearing a black headscarf. "When I was at Morgan Stanley, the management considered the Italians geniuses because they saw our results in asset management or sales or other departments, and thought we got there from that country road," he says.

ITALIAN-STYLE GROWTH

Looking at recent events in the financial markets, the conservatism of the Italian financial system has isolated its lenders from the catastrophes of the global financial crisis and the collapse of some types of financial engineering. No Italian lender was significantly exposed to the subprime market or structured products that lost their value, and no bank had to be bailed out by the government. It must also be said, however, that the financing needs of the Italian banks were comfortably met by high-yielding government bonds, something that German banks, for example, did not have with the bunds on offer. Also lenders more exposed to foreign markets are not yet out of the woods.

A relatively smaller crisis helped Italy's government to contain public debt growth and delay fiscal consolidation measures until 2011. The measure that the government introduced to support credit to smaller businesses took the shape of the so-called Tremonti bonds, which were structured to be eligible as banks' Tier 1 capital. Four banks, including MPS, issued them for a total of about €4bn.

Italy did not have any single growth engine for its economy – such as the real estate sector in Spain – and this meant there were no economic shocks either.

"The growth model in Italy has not been significantly touched by the crisis and recession," says Ms Giani. "Contrary to Spain, Italy does not need to deleverage its economy because it wasn't too leveraged before and was not too reliant on real estate. The growth potential was low and remains low, but it is stable; I don't expect Italy to grow at 2% but I don't expect it to be negative either."

Italy has a vast savings pool that is still not properly served by its banks. MPS estimates that there is €1.5bn-worth of potential revenues from the consumer credit market. The figures back up this claim. Italy's number of debit and credit cards per capita in 2008 was 1.5, against the European average of 1.9. Furthermore, Italy's average debit and credit card transaction per capita from the same year was €2875, compared to the European average of €4878.

No mention of Italy's political or economic landscape is complete without mention of the country's colourful and controversial prime minister, Silvio Berlusconi.

And now the good news: businesses such as Armani show that large Italian companies can thrive on the world stage

Blamed by some commentators for being partially responsible for Italy's poor image abroad, Mr Berlusconi is rarely far from the headlines, often for the wrong reasons. However, away from the scandal he has recently started to carry out some important reforms, such as the introduction of measures to speed up settlements of civil law judicial processes, which currently can last up to 10 years. It is hoped that this measure will reassure the many foreign investors who steer clear of Italy because of the uncertainty within the country's legal system.

SUCCESS STORIES

There are some areas of growth in Italy. Fashion, for example, a sector synonymous with Italy, offers high value-added products. Only a few years ago middle-market brand Benetton stood alone in producing and exporting 'Italian-style' T-shirts. Now, luxury names such as Armani produce the same style of T-shirt but with a retail price that is 10 times higher.

In the luxury sector, the maritime market continues to perform well. In the 10 years to 2009 its turnover doubled and so did the number of employees working in the sector, as Anton Francesco Albertoni, president of Ucina, the maritime business association, proudly points out. This is an anomaly compared to other Italian industries that had been forced to move manufacturing production to cheaper labour markets. Boat manufacturing and related businesses are Italy's fifth largest source of exports, with international sales accounting for about 70% of the sector's turnover.

TOO IMPORTANT, TOO SMART...

There is much to consider when trying to understand Italy's problems. "Italy is too important and too smart to fail," says Ingo Walter, a professor at the Stern School of Business, New York University, INSEAD and a director of research institution SimCorp StrategyLab. "It is chaotic. But New York is chaotic, too. New York used to be considered ungovernable in the early 1970s and people say Italy is considered ungovernable now. But I take a less pessimistic view and when push comes to shove, people figure out a way."

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Mr Walter admits, however, that the analysis and solutions he often presents at seminars are not always welcomed by Italian audiences. "If I look at the data from last year, Italy has probably between five to six years before things might get too bad to be fixed. That's enough time politically to adjust. If no adjustments are made, I doubt you can extend much beyond that."

Where Italy will be in five to six years depends on the vision of its political leaders and their willingness to put forward the necessary and tough measures. Meritocracy must be encouraged over closed corporations aimed at preserving privileges to existing members in the business, academic and political worlds. These areas must cultivate an environment where opportunities are deserved rather than inherited.

"We probably need a change of leaders; it will be inevitable that we'll have this change," says Mr Siagri. "And it will happen very quickly. We live in a world where things happen in much shorter times. You wait longer than what you think you should wait – but when change comes, it comes [quickly]." TB