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A JOINT INTERVENTION FOR ITALY: A NON-PUNITIVE PLAN FOR INVESTMENT AND REFORM*

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Abstract

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

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1. Introduction

Eight years have passed since Lehman Brothers' bankruptcy and seven since the beginning of the European sovereign debt and banking crises; however, the euro-area's sustainability still remains in doubt. With the exceptions of the last months, the area's average economic growth rate continues to remain below that of the United States; primarily, this is due to the divergent performances of certain more fragile European countries.

Italy, the third largest economy in the European Economic and Monetary Union (EMU), appears as the principal accused. Its persistent macroeconomic recession has today progressed into an overly weak recovery. The stagnation of its various forms of productivity and its financial system's feebleness represent a danger not only for its own stability, but also for that of the monetary union, complicating the making of a common monetary policy and hindering the adoption of risk sharing mechanisms. This fuels tensions between member states and hinders the initiatives of the European institutions.

The divergence between European economies is also reflected in public opinion. Opposite narratives of EMU become apparent: the more fragile countries, Italy in particular, increasingly perceive European rules as a cage and resist European pressures for risk reduction; more competitive countries, particularly Germany, interpret any form of risk sharing in the euro-area as a Trojan horse to transfer to them the costs pertaining to other countries. These tensions endanger the monetary union's sustainability.

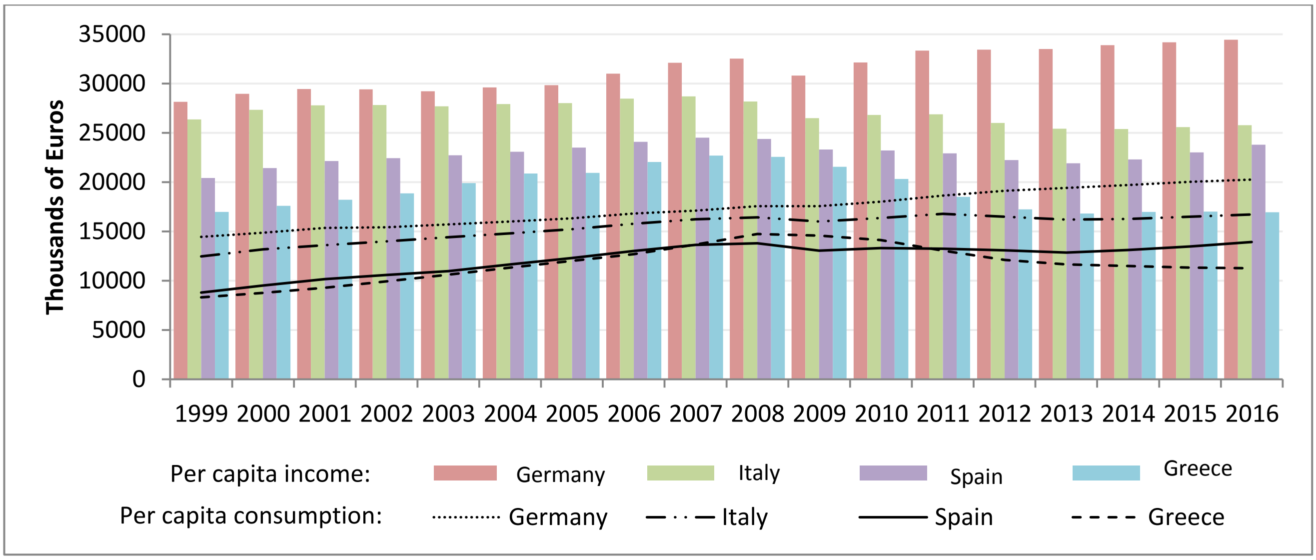
In this paper, we will present an explanation of the crisis' dynamics centered on institutional shocks which stem from uncertainty, first and foremost about the possible breakdown of the euro, that cannot be reduced to probabilistic calculations. We define this kind of uncertainty as "radical uncertainty." Our analysis maintains that this uncertainty prevalently affects investment and savings decisions. Additionally, the effects of institutional shocks are persistent: they survive the short-term absorption of their destabilizing impact, and even the removal of their causes. Euro-area member states are, in this manner, hit by a form of hysteresis—that is, by the persistence of the effects of a phenomenon even after the removal of the factors that caused it. This type of hysteresis explains the distorted investment and savings dynamics in many euro-area countries, which has suffocated capital formation processes. The centrality of institutional shocks and the connected hysteresis signals the inadequacy of the EMU's current system of economic governance, which is based on the principles of the "optimal currency area" and considers that the impacts, produced by (idiosyncratic and systemic) shocks, mainly affect consumer demand imbalances and supply inefficiencies.

While Italy will need to continue to face its peculiar weaknesses (*in primis*, the inefficient allocation of resources) and to implement a number of conventional adjustment prescriptions, it cannot correct its fragile position in the EMU without new European intervention strategies. Since the uncertainty concerns the stability of euro-area's institutional setting, the solution needs to be of an institutional nature. This means designing an Italy's reform plan that is voluntary activated but agreed with European institutions. The main feature of this agreement consists in delegating to the European institutions the control function on the national measures undertaken to implement the agreed reform plan. The actual and checked implementation of the agreement has then to be accompanied by a flow of investments, financed by European resources, which meet efficiency criteria and are themselves subject to supranational verification over a five-year period.

2. Conventional Interpretations and the Case of Italy

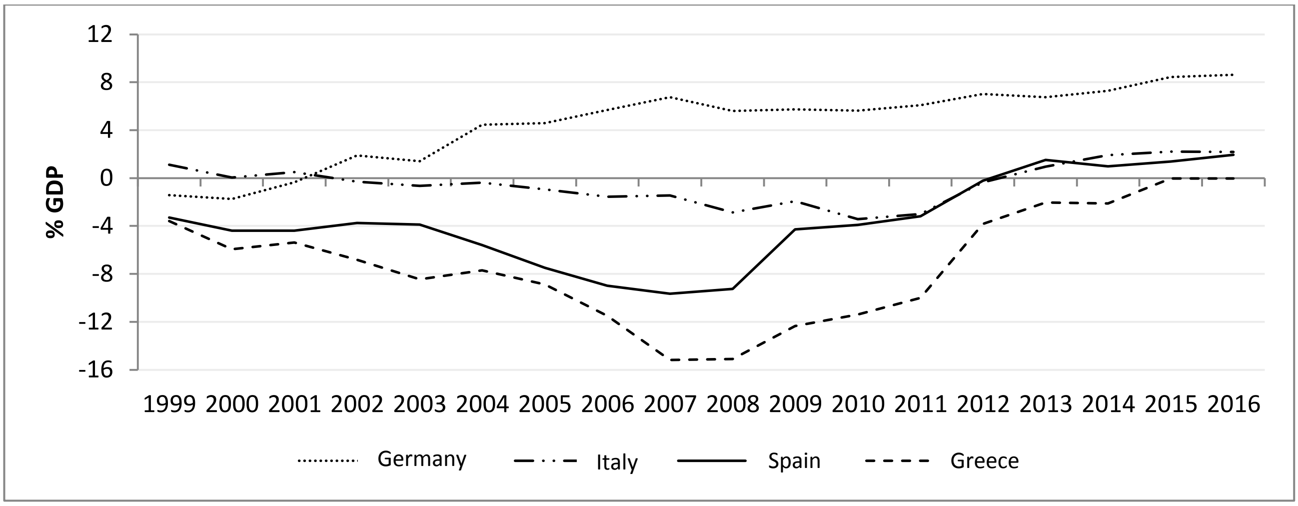
Between the monetary union's launch and the international crises' beginning, the euro-area was characterized by two phenomena: a convergence process between member states with respect to a number of 'real' variables (per capita income and per capita consumption: cf. Fig. 1), but also an improper allocation of the abundant flows fed by internal credit and financial resources moved from 'core' to 'peripheral' member states. When the double 'real' crisis hit the European monetary union (during the third quarter of 2008 – the third quarter of 2009 and the fourth quarter of 2011 - the first quarter of 2013), the consequences were relevant and asymmetric: 'core' country's wealth-holders drastically reduced their financial investments in the more fragile member states and increased their liquidity, while the majority of more fragile countries were forced into violent recessive adjustments to re-absorb their by then unbearable current accounts negative disequilibria (see also Fig. 2). These opposing reactions obstructed a shared interpretation of the recent European events.

Figure 1: Per capita income and per capita consumption.



Source: AMECO

Figure 2: Evolution of current accounts.



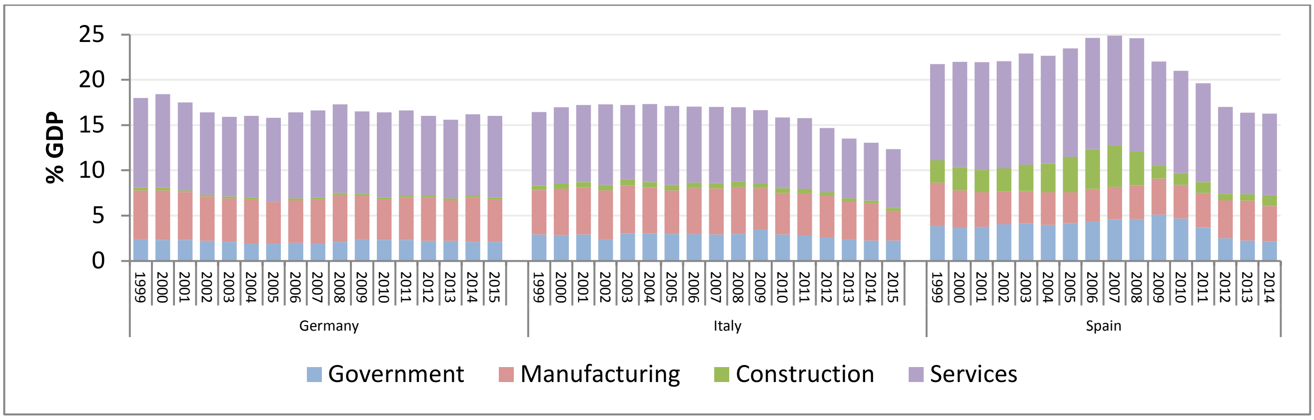
Source: IMF

A first interpretation, popular in Italy and other fragile member states, is that the international financial crisis extended its contagion to the euro-area and was transmitted to the 'real' economy, aggravating deficits in the national public balance sheets, making negative imbalances in the current accounts unsustainable and worsening competitive divergent performances between member states. The cause of the subsequent European crisis was thus attributed to the excessive risks assumed by the banks of stronger member states and the EMU's recessive fiscal policy choices that, as opposed to what happened in the United States, impeded the more gradual reabsorption of disequilibria, as well as public and private support for *per capita* income and consumption.

A second interpretation, popular in Germany and other stronger member states, identifies the European crisis' roots in the distortionary behaviors of more fragile member states during the expansive phase preceding the crisis, i.e., their failure to adjust micro and macroeconomic imbalances and the connected inefficient allocation of the large inflows of financial resources. These distortions amplified the current account imbalances of some fragile member states. Consequently, the international financial crisis and the connected investors' 'flight to quality' compelled these countries to adopt drastic income and employment compressions that had a strong recessive impact. According to this interpretation, the definitive solution of euro-area problems would require appropriate risk reduction in more fragile member states (here also labelled peripheral member states) and the implementation of so-called structural reforms. The fact that some of the euro-area member states suffer, even today, grave economic disequilibria would be due to their refusal to pursue the above-mentioned prescriptions. In this regard, the major offender among the peripheral member states is the one that had not sought recourse in a European assistance program—that is, Italy. The country is, therefore, called upon to do "its home-works" to reduce imbalances and risks that could cause instability in the rest of the EMU.

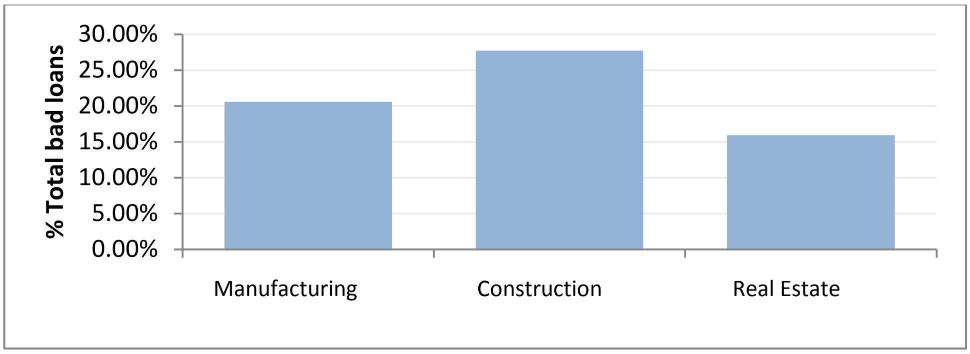
The empirical evidence seems to favor the second description over the first (see also Figures 1 and 2, above), although the responsibility for improper resource allocation is not solely the fault of debtors but also of creditors. After the euro's adoption and prior to the international financial crisis, peripheral countries massively invested, using internal and foreign financial resources, in inefficient sectors and with a meager positive impact on labor productivity dynamics (see Fig. 3). In Spain and Italy, the amount of lending registered growth rates far above those of GDP until the end of 2010 or 2011, but the financing was concentrated on investments with low efficiency. This then determined the formation of a huge amount of bad loans not only in Spain but also in Italy (see Fig. 4). To counter the crises' effects, Italy, along with almost all other EMU member states, tried to pursue demand and supply side policies aligned with the European institutions' prescriptions. Thus, from the end of 2011, the Italian government sought to improve its economic institutions' functioning, attenuate labor market segmentation, incentivize firms' investment, and support human capital formation in order to increase potential GDP in the long term. Moreover, mainly starting in 2014, it sought to counter negative short-term income fluctuations through policies supporting demand.

Figure 3: Investment by macro-sector of activity.



Source: EUROSTAT

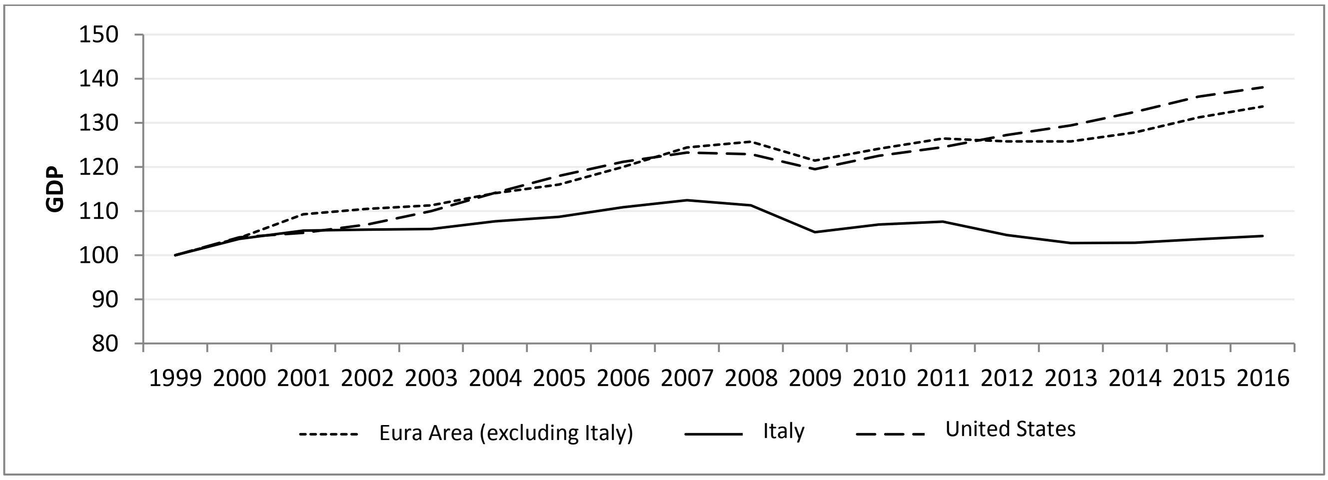
Figure 4: Distribution of bad loans in Italy by different sectors



Source: Banca d'Italia, September 2016

Despite these efforts, the Italian economy's divergence with respect to the rest of the EMU worsened: in 2015, almost all member states other than Italy exceeded their GDP peak prior to the 2007-8 crash; and, except again for Italy, euro-area countries are registering growth rates aligned with those prior to the international crises and aligned, on average, with those of the US (see Fig. 5).

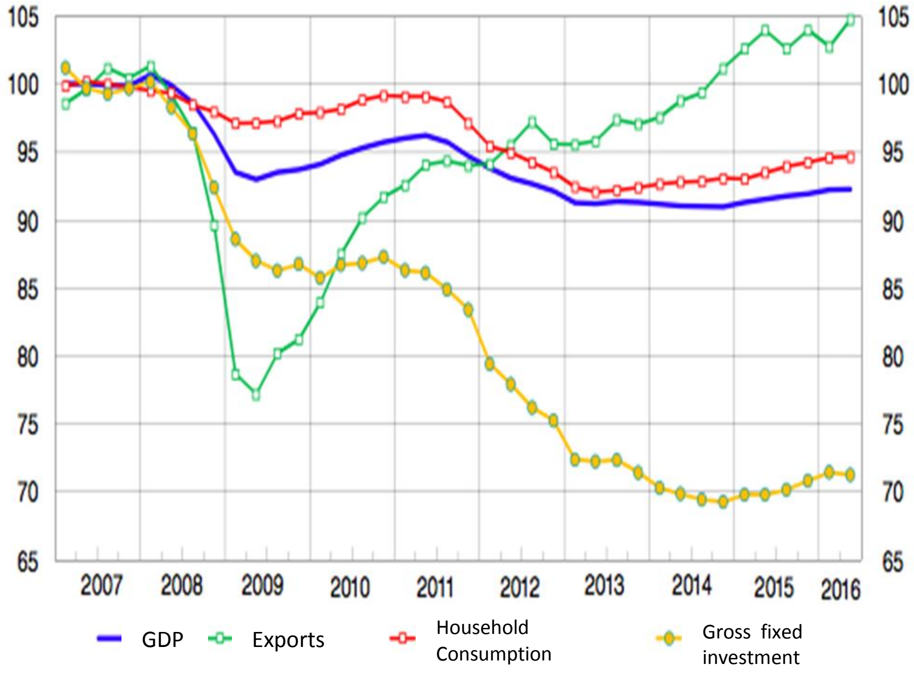
Figure 5: GDP dynamics.



Note: 1999=100
Source: AMECO

These divergences do not appear at all to be caused by more restrictive demand-side policies in Italy compared to other peripheral countries. Proof of this is the fact that the decrease in Italian household consumption was delayed and attenuated with respect to the decline in per capita income during the recessions, and it was a positive component during the recent fragile recovery (see Fig. 1 above). The most marked fall was in investment, and in particular in gross fixed investment (see Fig. 6).

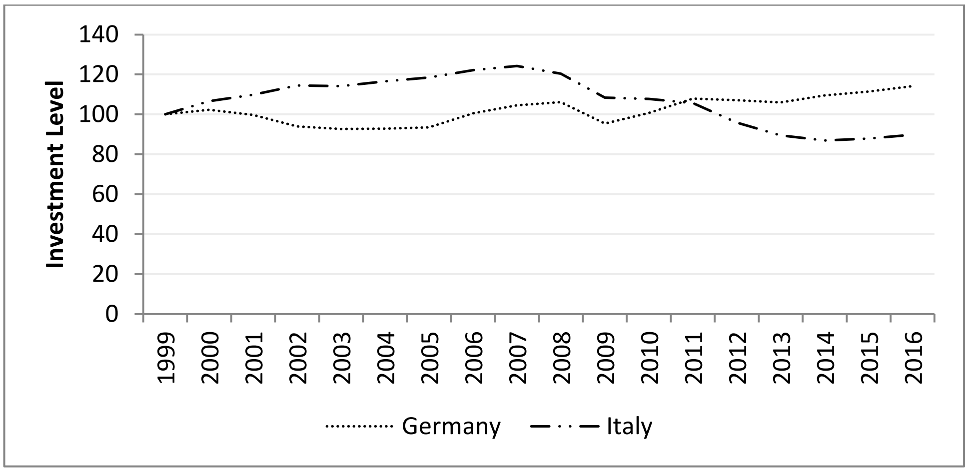
Fig. 6: Evolution of gross fixed investment and other components of aggregate demand in Italy.



Source: Banca d'Italia

As Figure 7 shows, in Italy (and other peripheral countries), this fall also refers to aggregate investment (public and private), whereas it does not apply to Germany (and other central countries). In 2016, euro-area investments level was 8% less than that of 2008; around 6 percentage points of this gap can be attributed to the decline in private and public Italian investments.

Figure 7: Dynamics of aggregate investment.

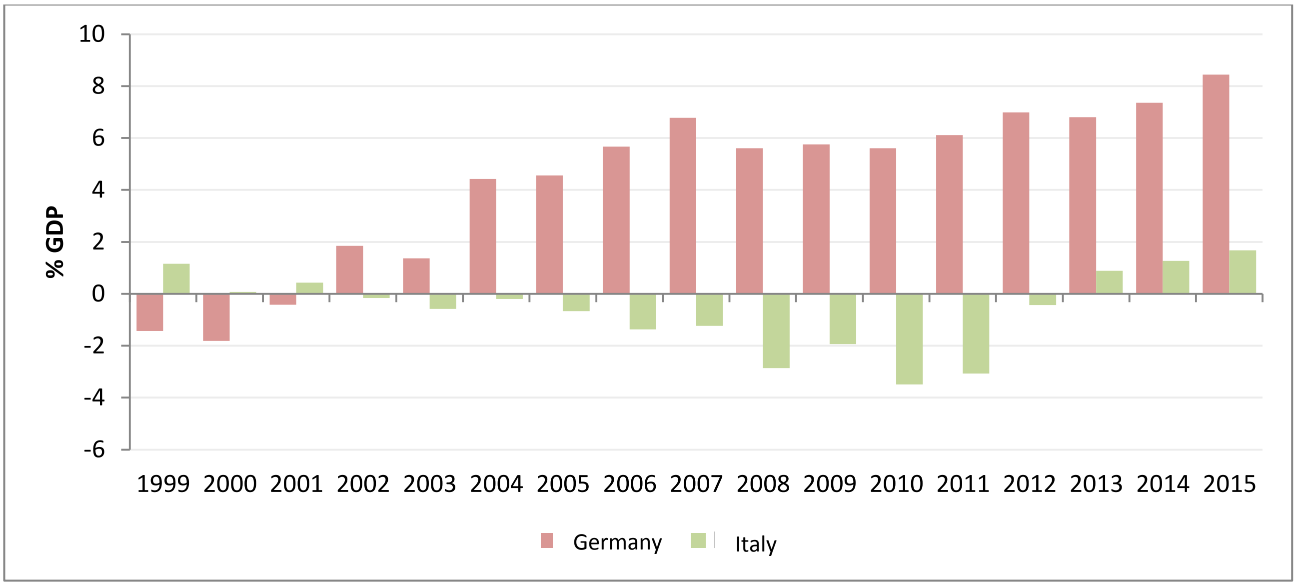


Note: 1999=100
Source: AMECO

3. Radical Uncertainty and Specific Shocks

The current account surplus of a given country or area is mirrored by a corresponding positive gap between (private and public) aggregate savings and (private and public) aggregate investment. Among the larger EMU countries, the two most significant cases are Germany and Italy (see Fig. 8). In these two countries, the reaction to the international and European crises that occurred between 2008 and 2013 were, however, different: Germany experienced a strong increase in savings while Italy registered a fall in investment.

Figure 8: Net aggregate savings.



Note: Difference between (public and private) savings and (public and private) investment.
Source: World Bank

The data in Figure 6 show that, in each of the two periods 2008-2009 and 2010-2012, gross fixed investment in Italy fell by 15%, thus accumulating a decrease of 30% over four years. These are extremely rare events for an advanced economy, which cannot be plausibly explained by standard demand functions for private investment, where the independent variables are (i) investor's expectations regarding net actualized total future proceeds from the potential investment, and (ii) the medium-to-long-term interest rate. Given that nominal and 'real' interest rates are at their historical minimum, a 30% fall in gross fixed investment is only justified if investors are experiencing a negative discontinuity with respect to their trust in the future and their attitude towards risk. A discontinuity of this magnitude refers, however, to a situation which is characterized by radical uncertainty rather than by a measurable stochastic risk.

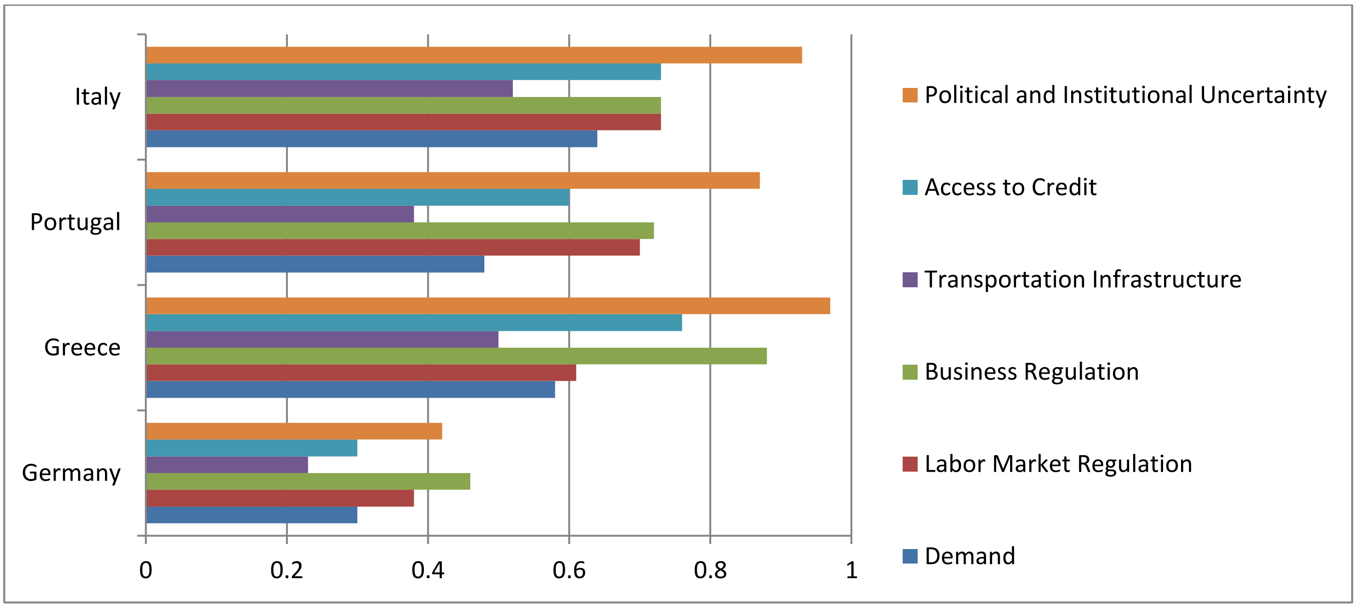
A comparison with the data for Spain allows us to add that, in Italy, the radical uncertainty generated hysteresis. In the Spanish case too, the 2008-09 international crisis and the two country-specific crisis in the summer-fall of 2011 determined a dramatic fall in aggregate investment that, in conjunction with doubts about the permanence of Italy and Spain in the euro-area, worsened their subsequent recession. After the Spanish government's decision to resort to a new form of European assistance for its banking sector (in July 2012), the economic evolution of Italy and Spain started to diverge. The Italian banking sector experienced an exponential increase in non-performing loans (NPL); non-financial Italian companies continued to compress their investment and failed to introduce productive and organizational innovations; the Italian government tried to counter the fall in employment but, in doing so, also obstructed the market exit of firms with inefficient capital allocations.

Consequently, the shocks which created radical uncertainty and depressed investment, have been so persistent in Italy that their impact was not overcome by the European Central Bank (ECB) initiative (the Outright Monetary Transactions program in July-September 2012), which greatly reduced the euro-area's risk of breakdown.

The exogenous shocks under examination created radical uncertainty in Germany as well. However, the structural divergences between Germany and Italy implied that this uncertainty produced partially different effects. The data in Figures 1, 7, and 8 show, in fact, that Germany experienced a strong increase in household and aggregate savings. This phenomenon underlines that, when faced with radical uncertainty, the perseverance of German macroeconomic growth and employment was not enough to prevent an increase in risk aversion and a consequent precautionary behavior of German households which increased their propensity to save. Other incentives for the German propensity to save were bolstered by greater uncertainty about future personal and family's incomes, due to the repeated changes in the pension system and the increasing precariousness of various jobs, as well as a fall in financial portfolio returns. Moreover, Germany implemented a gradual re-equilibration of its public balance sheet.

Even though the German aggregate savings increase was more accentuated than the fall in aggregate investment (in particular, among non-financial German firms), between the beginning of the international financial crisis and the end of the euro-area recession, aggregate investment evolved in a worse manner in Germany (and France) than in the US or UK. The European Commission observed that the disappointing overall evolution of European investment could not be directly attributed to traditional demand and supply factors but, rather, to less conventional factors. The latter are represented by financial frictions and increases in risk aversion that tend to have a protracted temporal impact since, affecting in any case capital formation, they limit potential aggregate production dynamics of various EMU countries. The surveys conducted by the European Investment Bank (EIB) show that institutional and political shocks played an essential role in slowing down European investment (see Fig. 9). In particular, these shocks seem to have had a relevant impact on German investment.

Fig. 9: Institutional factors with negative impacts on investment



Source: Elaboration of EIB data – Investment and Investment Finance in Europe – 2016.

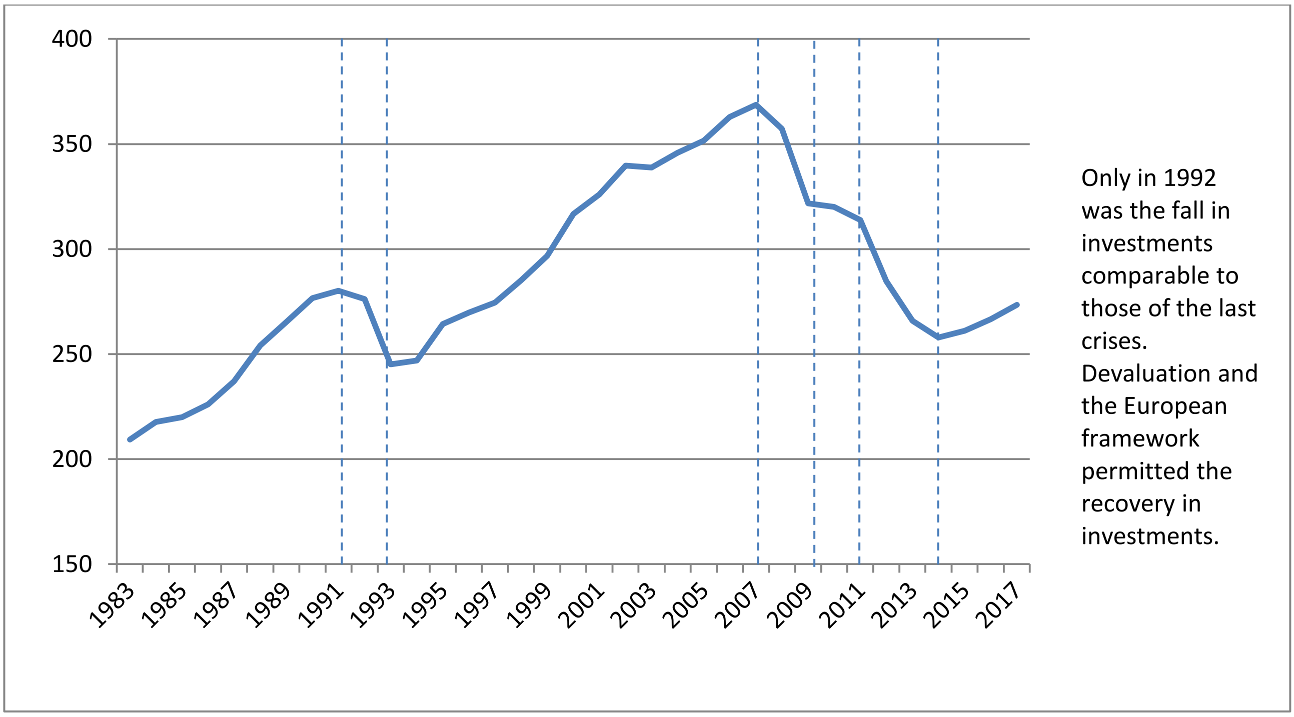
The evidence provided by Fig. 9 indicates that institutional shocks could be linked to economic shocks through a complex interaction; in fact, the former's impact could be augmented by the strengthening of expectations about the euro-area crisis that, in its turn, could be plausibly based on negative economic shocks. Even if this eventuality was considered convincing, institutional shocks would continue to have a relevant weight.

4. The Role of Institutional Shocks

The data provided in the previous section indicate that, at least in the euro-area, the divergent evolution of aggregate savings and aggregate investment played the most relevant role in determining the variations in demand and supply that caused macroeconomic imbalances and the prolonged recession or stagnation in almost all EMU member states. Further examination of these data suggests that aggregate savings and aggregate investment dynamics were also, if not above all, determined by institutional shocks. If this was confirmed by further analysis, it would put into question the effectiveness of various more or less conventional adjustment interventions recommended by European institutions or its more radical critics. If one insists on reinforcing the supply apparatus through the so-called structural reforms or instead on relaunching aggregate demand through supporting medium-to-low incomes and consumption, one would end up neglecting the underlying cause behind the different macroeconomic imbalances of European countries—the gap between aggregate investment and aggregate savings driven by radical uncertainty. The latter had and continues to have (at least in part) its roots in institutional shocks. It is worth offering, therefore, additional springboards for confirming this interpretation key.

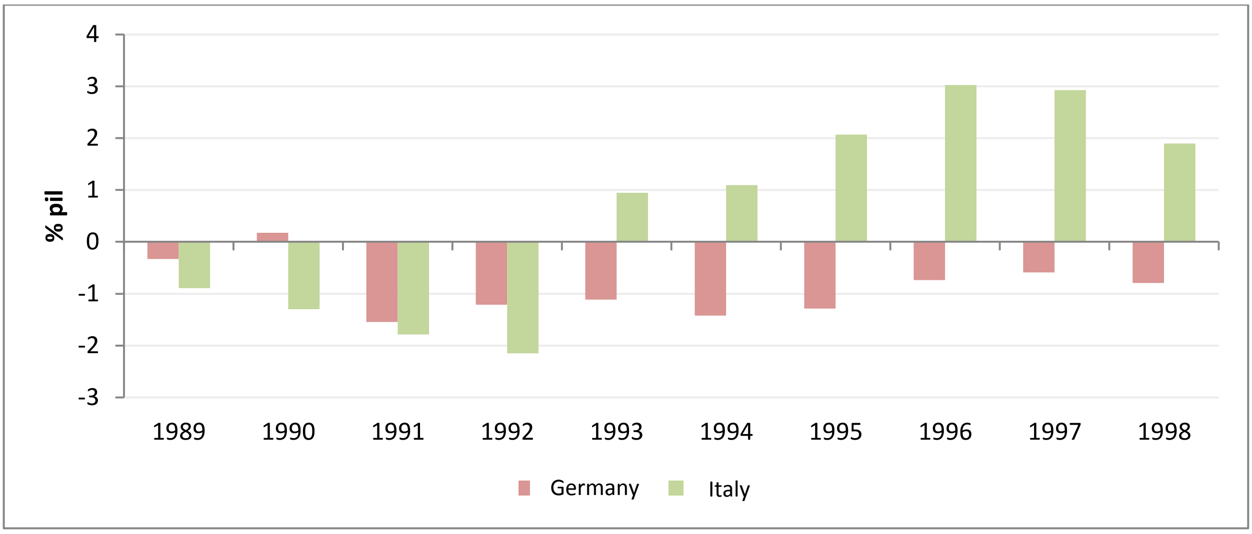
The Italian case once again provides additional proof that persistent shocks with a strong impact on investment could also, if not above all, have an "institutional" origin. In 1992, the Italian economy experienced in fact a fall in gross fixed investment of around 15%, which is thus comparable to the corresponding dips between 2008-2009 and 2010-2012. Moreover, capital formation in Italy experienced a dramatic decrease due to institutional factors (see Fig. 10).

Fig. 10 Institutional shocks and capital formation in Italy.



This fall determined important positive aggregate net savings, contrary to the corresponding trend in Germany (see Fig. 11). On the other hand, in this same year, the Italian economic and institutional system was characterized by a set of peculiar factors. On the economic side, Italy played a decisive role in the "breakdown" of the fixed exchange rate system (the European Monetary System) that had been in place since 1979; this, in turn, caused strong financial instability and the national currency's uncontrollable devaluation. Furthermore, the Italian government (Amato government) pursued a restrictive fiscal policy that, after several years of strong deficit, brought about a primary surplus in the national public balance sheet destined to last into the future. An even stronger discontinuity occurred, however, on the politico-institutional level. The clamorous and pervasive corruption accusations, levied by a group of magistrates in the Milan prosecutor's office against the leaders of a large number of major national political parties and various key players in the Italian economy, irreversibly undermined public trust in political representatives and brought about the dissolution of the party system and the substitution of a large chunk of the ruling class.

Fig. 11: Net aggregate savings.



Note: Difference between (public and private) savings and (public and private) investment.
Source: World Bank

It is evident that this combination of negative events of an economic but, above all, politico-institutional nature created an environment of uncertainty so radical as to cause a fall in (public and private) investment in Italy.

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

The similarities between the developments in 1992 and the more recent ones encourage the examination of factors that, after 1992, allowed Italian investment to recover. If they were reproducible, these factors could in fact offer an indication as to how the problems facing Italy after 2012 may be overcome. In fact, despite exiting recession in 2014 and timid signals of recovery in 2015-16, the Italian economy does not seem to have yet overcome the radical uncertainty and connected stagnation in public and private investment. The short-term response back in 1992 had been a strong currency devaluation that, putting aside any judgement on efficacy, is impractical today given our participation in a monetary union. The medium-term response to the radical uncertainty and its consequences was, instead, a result of a peculiar exogenous opportunity: the non-negotiable date for the final phase of the EMU's construction (the so-called Phase 3). Both opportunities are not reproducible. They indicate, however, an avenue also possible today: bridging the gap between investment and savings by stimulating the former through creating a stable long-term institutional environment.

5. Hysteresis and the Insufficiency of Conventional Policies

The combination of institutional and economic shocks has a persistent impact on the economy that must be taken into account. In this regard, an Italian and a German example should suffice (see also Figures 6, 7, and 8). Italy's macroeconomic environment has certainly changed since the OMT's launch by the European Central Bank (ECB), which has guaranteed the euro-area's medium-term integrity; however, after more than four years, the propensity of private Italian firms to invest has not significantly changed. On its end, the German government has recently pursued an expansive fiscal stance vis-à-vis households, including the return to less severe conditions for accessing pensions; however, this has had a marginal impact on reducing the average propensity for precautionary savings. Moreover, in 2015 and 2016, the real income of German households had growth rates higher than the European average.

These examples show that, even if one removes the most obvious shock determinants, the connected effects persist thus generating hysteresis. If the negative gap between investment and savings is subject to hysteresis, the entirety of European economic governance will have to be put under discussion. The guiding idea behind this current governance is that the divergences between various euro-area countries can only be countered through so-called structural reforms in more fragile countries and the relaunching of aggregate demand in stronger countries. Vice versa, these conventional supply and demand policies are not, in themselves, effective; they need to be redefined and enriched. In this regard, one can refer once again to the Italian case. The Monti, Letta, and Renzi governments introduced several reforms targeted at strengthening the supply-side structure and the Italian economy's competitiveness; additionally, in the final stage, the Renzi government above all tried to pursue expansive policies to support demand. In both cases, the results were not encouraging in terms of investment and, therefore, failed in stimulating medium-term growth for the country.

This conclusion is not surprising considering the radical uncertainty and hysteresis. To overcome the financial and fiscal instability that has framed the reforms introduced by preceding Italian governments, it would have been necessary to eliminate not only the economic and politico-institutional shocks but also the persistence of radical uncertainty. Vice versa, although the approval of Italian reforms was facilitated by the state of emergency brought upon by an environment of radical uncertainty, these reforms' contents were not adequate for overcoming this environment; at the opposite, being often perceived as incomplete and/or revocable, these reforms increased uncertainty. This is mainly applicable to the Renzi government's recent attempts to support medium-to-low incomes and relaunch internal demand by slackening fiscal policy. Given the presence of persistent radical uncertainty and the ambiguity of certain government choices, these initiatives' recipients were never convinced that the measures were permanent rather than temporary; as a result, they perceived increasing uncertainty and reacted accordingly.

The Italian government initiatives' perverse effects were aggravated by the European institutions' sanctionary behavior. The EMU's message to Italy and other fragile countries too often assumed the following tone: if you do not pursue reforms, you will be abandoned to cope on your own. This sanctionary stance certainly did not help disperse uncertainty. At the opposite, as German Finance Minister Wolfgang Schäuble explicitly theorized, stronger EMU countries found in this uncertainty not an enemy to fight, but an instrument for enforcing the implementation of reforms and the application of fiscal discipline that would otherwise be resisted by national governments due to excessive short-term political and social costs. If, however, the widening negative gap between aggregate investment and savings is a result of excess uncertainty about the future of the involved countries and the euro-area, and if the goal is to reduce this gap, recourse to uncertainty itself as a policy instrument will condemn every supply-side reform and demand-side stimulus to failure. Thus, the adoption of policies under the threat of European sanctions that tend to increase "institutional uncertainty" indeed risks being counterproductive.

The main error of European governance and its policies consists of nurturing radical uncertainty instead of eliminating it. This error is relevant and harmful because uncertainty, once it manifests, tends to take root in investment and savings decisions of economic agents, carving itself into the medium-term dynamics of capital accumulation and altering, in this manner, the impacted country's entire economic structure.

This underlines the importance of moving beyond traditional policies through the creation of cooperative relationships between EU and EMU institutions, national governments of strong member states, and national governments of more fragile member states. This cooperation's objective would be to irreversibly overcome radical uncertainty and the forms of hysteresis that have suffocated EMU economies and continue to suffocate a portion of its more fragile member states. One of the binding constraints, which goes hand in hand with this objective, is ensuring control over the effects of "moral hazard," i.e., impeding the opportunistic violation of agreements by member states faced with inadequate sanctions. Once the objective, subject to this constraint, was fulfilled, it would become possible to increase aggregate EMU investment bridging the gap with aggregate savings, and thus eliminate the more impactful macroeconomic disequilibria.

6. A Shared Responsibility

Founded on cooperative relationships between various actors and aimed at the creation of favorable conditions for relaunching investment while keeping the effects of "moral hazard" under control, non-conventional European policies require both preventive and corrective actions. The former counter the impact of economic and politico-institutional shocks while the latter reverse them. To be timely, these interventions would require a delegation of powers from national authorities to the system of European governance.

The direct route for creating this kind of delegation is to pursue closer economic and institutional integration in the EMU, following the road set out by the Four or Five Presidents' Reports (see, respectively, 2012 and 2015), and thus flowing into a progressive centralization of national fiscal policies and into a connected partial mutualization of the public debts of member states. In this regard, an adequate instrument would be the creation of an EMU Minister of Finance endowed with a significant amount of own resources, with the attached capacity for European public spending as well as the power to enforce member states to meet fiscal discipline based on strengthened European rules. The beginning of a process, oriented in this direction, would signal the European Monetary Union's irrevocability and the design of a new and robust economic governance. However, in the core member states, the legacy inherited by the crises led to a distinction between fiscally responsible countries and fiscally irresponsible countries that has resulted in a reciprocal loss of trust. Together with the 'political cycle' that opened with the British referendum on Brexit and will ideally close with the upcoming elections in Germany and Italy, the euro-area is condemned to a temporary but prolonged stalemate. Hence, an institutional process, aimed at further integration of responsibility, appears politically difficult to implement in the short term.

On the other hand, if European institutions passively adapt to the stalemate just looking for medium-to-long-term solutions, the impact of radical uncertainty and hysteresis would be strengthened, with negative and increasingly irreversible consequences on the potential growth and stability of more fragile countries. Therefore, it is necessary to contain the consequences of economic and institutional shocks and radical uncertainty, through initiatives to correct the deficit in investment impacting more fragile EMU countries, and to overcome the stalemate in the integration process. For reasons already stated, the more relevant of all these countries is Italy. Consequently, a plan for Italy that would relaunch capital formation and help overcome crucial problems in its economy and society needs to be defined. The realization of this plan would also be in the interest of other European partners because it would reduce divergences between member states, the related uncertainty, and thus the euro-area's instability.

The plan's salient points would need to consist of a binding contractual agreement between European institutions and Italy, which would nullify the negative impacts of radical uncertainty and last for five years. In particular, the agreement would incentivize public and private investment and protect investors from the following risks: the risk of forced currency redenomination, the risk of 'bad' equilibria in the sovereign bond market, and the risk of exogenous restrictions on the flow of credit. To be effective, this agreement would have to have a multi-year term, so it could offer adequate certainty and justify engagements by new investors. On the flipside, the Italian government and the other national policymakers would need to guarantee the public balance's sustainability and the financial and economic positions of the country's various economic sectors through the implementation of appropriate fiscal initiatives, necessary reforms, incentive designs and regulations compatible with the markets' functioning. After fulfilling each of these tasks, the Italian government would need to reach an agreement with European institutions in order to combine its performance with the setting and realization of a plan for public investment and incentives for private investment. The predefined steps for implementing the reform engagements, on the one hand, and the public investment and the utilization of incentives for private investment, on the other, would then need to be subject to monitoring and verification by European institutions.

It is important to underline that the binding agreement described above is not comparable to traditional European assistance programs, offered between 2010-2015 to Greece, Ireland, Portugal, and Cyprus. One of the most problematic aspects of these financial assistance programs was the risk of increasing rather than reducing uncertainty, since European and international institutions (the so-called Troika) imposed the policies on national governments, disregarding their socio-economical acceptability. In the case under examination, there are instead two closely related and complementary elements at play: on the one hand, European institutions would engage themselves to creating a plan to incentivize investment in Italy and eliminating the principal factors of radical uncertainty for economic institutions and investors; on the flipside, the Italian government engages itself to implement public policy decisions and reforms. To prevent public and private Italian actors from opportunistic behavior and European partners from reacting arbitrarily, the Italian government would have to agree to subject the implementation of various stages of the multi-year agreement to the scrutiny of European institutions. The latter are *de facto* delegated to take the responsibility of the administrative control.

Even in the case of the contractual agreement, the European institutions' negative evaluation of the Italian government's reform implementation, or an Italian accusation of ineffectual investment incentives from European institutions, could lead to the reversal of obligations. However, the possible reversal of its obligations by the European institutions could not involve those investment processes that have already been—fully or partially—incentivized. In any case, the difference vis-à-vis traditional European assistance programs is that the default of a member state is not at stake.

7. Conclusions: Some Details on the Agreement

An adequate analysis of the contractual agreement between European institutions and Italy would require a number of details. An appropriate start for this analysis could be offered by the different and unsuccessful attempt to build bilateral contractual arrangements between the European Commission and each of the EMU's member states (see European Council, December 2013). Another important point could refer to the extent of the power transfer from the national government to the European institutions. Here we cannot enter in this kind of crucial but specific problems. We will limit ourselves to providing a partial depiction of just one aspect of the possible contractual agreement between the European institutions and Italy: the European plan to incentivize public and private Italian investment.

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

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

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

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

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