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Financialisation and Economic and Financial Crises: The Case of Italy

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Financialisation and Economic and Financial Crises: The Case of Italy

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Abstract: This report on Italy examines the long-run changes between the financial and real economic sectors, with a focus on the effects of financialisation on the macroeconomic developments that drove to the 2007 financial crisis. Part one investigates the major GDP components and the financial balance pattern over the long term. The analysis classifies of Italian economic growth as being mainly consumer led type. Part two discusses the effects of an increasing dominance of the financial sector since the beginning of the 1990s in terms of income distribution, investment in capital stock, consumption and the current account. The third part links long-run developments with the financial and economic crisis, showing that the consumer collapse and public investment constraints explain how the recession is still influencing the Italian economy.

Key words: income inequality, consumption, financialisation, financial and economic crisis, current account, credit, Italy

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Introduction

This report on the Italian link between the financial and real sectors before and after the 2007 crisis studies the nature of the economic growth in the country, the contribution of the domestic and foreign channels, and, finally, the effects of these changes on the macroeconomic developments that have led or contributed to the financial crisis[1].

The report is structured in three parts. In the first part, we show the pattern of real GDP growth and the main demand aggregates (private consumption, public consumption, private investment, public investment, net exports) since the early 1980s. The overview summarises concisely the drivers of aggregate demand and growth. We classify the growth in Italy as an internal demand-led economy, demonstrating how it has been characterised by a large component of aggregate private consumption, a relatively low contribution of stock investments and a balanced current account. Italian growth appears to be particularly exposed to the financial crisis through the consumption channel. Consequently, manufacturing firms, due to their low competitiveness in foreign markets, have shown a low ability to tackle the collapse of domestic aggregate demand by finding alternative opportunities to stabilise their sales.

In the second part, we examine the long-run effects of financialisation on real Italian channels. Earlier literature has found that financialisation can affect income distribution, fixed investments, the pattern of consumption and the current account. Four sections explore to what extent these effects have occurred in the case of Italy. Empirical findings are mixed. On one side, income and wealth inequality have increased, whereas on the other side, corporate earnings distribution and labour market data do not show a widespread dominance of the shareholder value principle.

Moreover, we collect evidence showing that the period in which the financialisation process has accelerated has been characterized by a growth in profits, but weak investments in capital stock and wage moderation. The third channel we investigate is the link between financialisation and households' consumption. The Italian propensity to borrow has increased over the last few decades, albeit with a lower intensity of other countries. Nevertheless, mortgages and consumer credit have experienced a continuous expansion over the decade prior to the crisis. Finally, the liberalisation process introduced in the early 1990s relating to international capital markets and capital accounts, has created the potential to run and finance persistent current account deficits, especially due to sovereign bond demand in foreign countries. This has created the problems of rising foreign indebtedness of current account deficit, speculative capital flows, exchange rate volatilities, and related potential crises.

The third part focuses on the role of financial agents within the economic system and how transmission channels affected the crisis. Italy has a banking system that is based on one side by investors' who allocate their savings predominantly through the banking channel; on the other side the link between non-financial companies and bank credit remains

[1] Data used in our report, if not differently cited, are officially delivered by the Italian Statistical Institute (ISTAT) or the Bank of Italy.

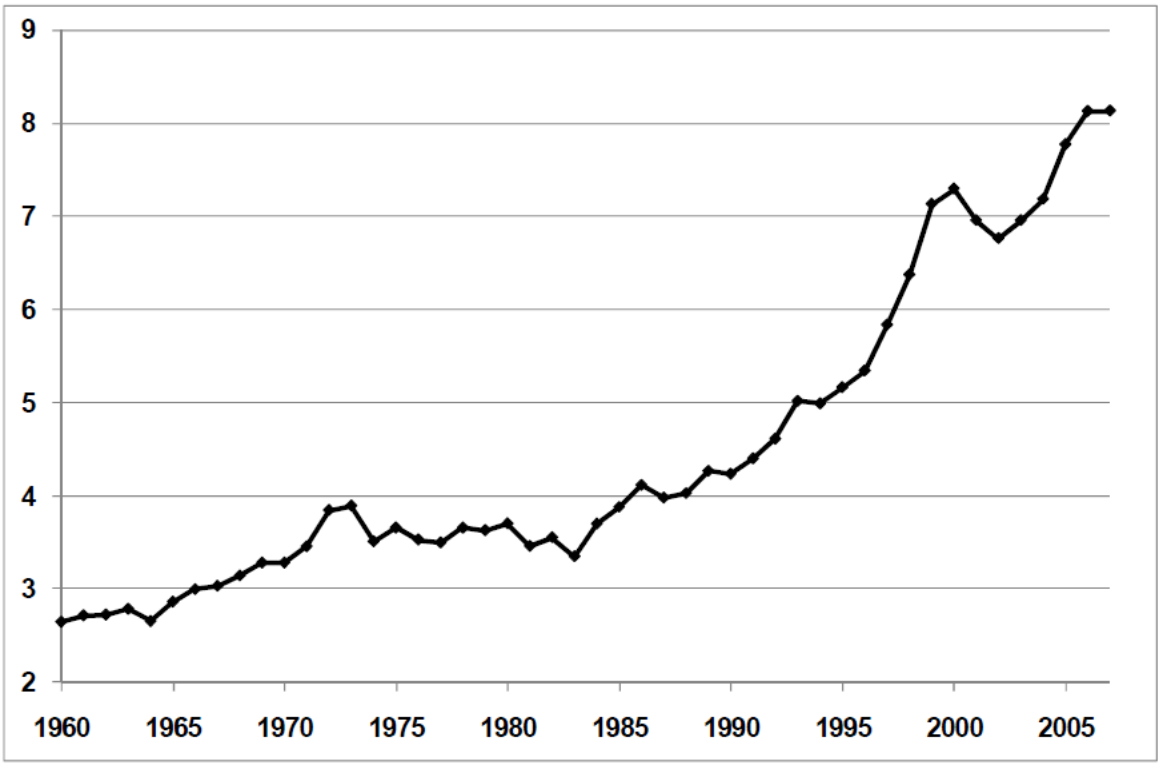
particularly strong. The impact of non-performing loans, and default rates of small and medium enterprises has depressed the economy with a vicious cycle that appears to be far from solved.
At the same time, the macroeconomic policies implemented to tackle the crisis have been mainly based on fiscal consolidation measures with no plan for public substitution of diminished private consumption and investment decisions.
The conclusion section reviews the main drivers of the link between financialisation and the different features of the Italian crisis.

I. Long-run developments in the era of financialisation since the early 1980s, and the economic and financial crises.

The level of financialisation in Italy has experienced strong acceleration since the mid-Eighties. From 1960 until 1985, the ratio of financial assets to GDP hovered consistently at around 3. This period was mainly characterised by a deep structural change in the composition of the Italian economy, with a relevant increase in the share of the industrial sector at the expense of the primary one.
At the end of this transformation, around 35% of the country's annual GDP was derived from industry with only 4% coming from agriculture. This shift from an agricultural economy to an industrial economy was accompanied by a massive rise in the Italian GDP: in 2002 the GDP was around €22.000 per person.
As shown in figure 1, in the first phase of financialisation during the mid-Eighties and mid-Nineties, the financial assets to GDP ratio rose from 3.7 to 5. This phenomenon was essentially due to the strong dependence of the public deficit on financial markets, with issuances devoted to private investors. One of the reasons behind this trend is the agreement signed in 1981, between the Bank of Italy and the Italian Government to reform the bid system of government bonds (also known as "divorce"). The new system removed the mandatory underwriting role of the Bank of Italy in sovereign bond auctions, allowing the central bank to buy bonds in secondary markets. The rationale behind this decision was to increase central bank accountability and its capability to control inflation. Even though the Italian government primary balance was one of the highest in the euro area (OECD, 2013), the Government lost the power to administrate the interest rate in the primary market and, as a consequence, the control of a deficit covered by the debt service.
The second phase of financialisation drove the financial assets to GDP ratio (figure 1) from 5 in the mid-1990s to 8 in the mid-2000s. In this period the liberalisation of capital movements, and the euro monetary union propelled private investments within global markets. Furthermore, the freedom to take exposure in foreign markets and the elimination of currency risk within the euro area, led to an increase (around 40% of total public debt) in the dependence on foreign institutional investors.
One of the policy reactions to the increasing debt was an extensive privatisation process in line with the neo-liberal model which established itself in the same period. The overall evaluation of the effects of privatisation in Italy during the last two decades alludes to how the objectives to increase managerial efficiency and to reduce the public debt have been

disregarded. From 1992 to 2009, Italy experienced 93 operations of privatisation, for a total amount of about 119 billion euros. The State lost the entire control of credit institutions in 1998. Nonetheless, public debt to GDP increased from 95 to 110%.
The strong dependence of the Treasury on the fixed income market explains the huge stock of sovereign bonds in banking and trading books, and the crowding out effect suffered by the real sector. This scenario was induced not only by the dynamics of real interest rates after the separation of the Government and Bank of Italy, but also as a result of banking regulation.
Until the end of 1980s, banking supervision was mainly structural, directly affected by the "structure, conduct and performance" paradigm (Bain, 1959), postulating barriers to entry as a determinant of industry performance. As a consequence, the Bank of Italy used to govern not only the license to enter the banking sector, but also the geographical diversification of legal entities and branches. The purpose to promote safe and sound conduct and to avoid banking system turmoil was substantially reached: Italian depositors have never experienced a bank run or losses. Since 1987, the safety net managed by the Interbank Deposit Protection Fund (after the authorisation of the Bank of Italy) intervened just 9 times, adopting one of the schemes: supporting banks, transferring assets and liabilities of the distressed bank to other banks, reimbursing depositors.

Figure 1: Financialization in Italy. Financial Assets to GDP ratio, 1960-2006

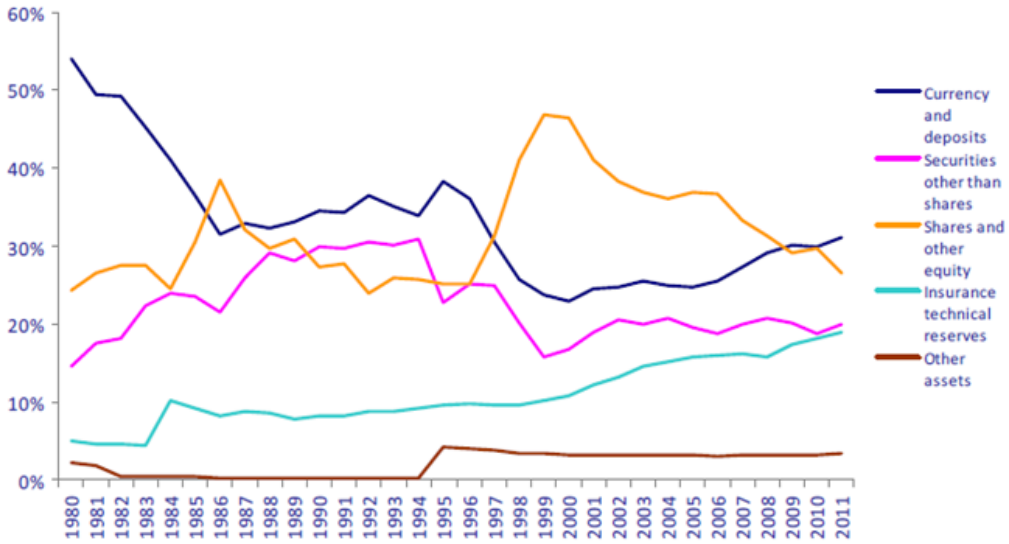


Source: Saltari and Travaglini, (2009), from Bank of Italy data

During the last two decades, the importance of stock markets and more generally of institutional investors, such as mutual funds and SICAVs, has become more relevant. At the beginning of the financial crisis in 2007, the financial wealth of households was mainly

managed by financial firms, and the role of bank deposits recorded lower levels than in comparison shares and other stocks (figure 2).

Figure 2. Households financial asset mix, Italy, 1980 – 2011.



Source: De Bonis et al. (2013).

This process was accompanied by a considerable redistribution of income at the expense of wages and of low income households in particular, as we will show in detail in Section II of this paper. At the same time, the increasing role of financial agents in the economy concurred with a severe drop in real GDP growth and its composition. Comparing the development of the two trade cycles from the early 1990s until the Great Recession with the previous trade cycles, we can observe that the average real GDP growth over the cycle slowed down considerably with the increasing dominance of finance and the associated redistribution of income (Table 1). Whereas average real GDP growth was 5.4 per cent in the cycle of the late 1960s until the mid-1970s, it fell to 2.6 per cent in the cycle of the 1980s, and 1.3 per cent in the cycle of the 1990s to early 2000s. Furthermore, the relevance of the main demand aggregates contribution to growth changed significantly. Real GDP growth in the cycles of the 1960s, 1980s and the 1990s was mainly driven by domestic demand. For all the periods before the crisis, between 1961 and 2007, the average real GDP growth was 3.07%, and the contribution of domestic demand to the increase of GDP at 2,99%, that is 97.6%, had a very small variance.

Table 1: Real GDP growth in Italy (in percent) and growth contributions of the main demand aggregates (in percentage points), 1961 – 2013, cyclical averages.

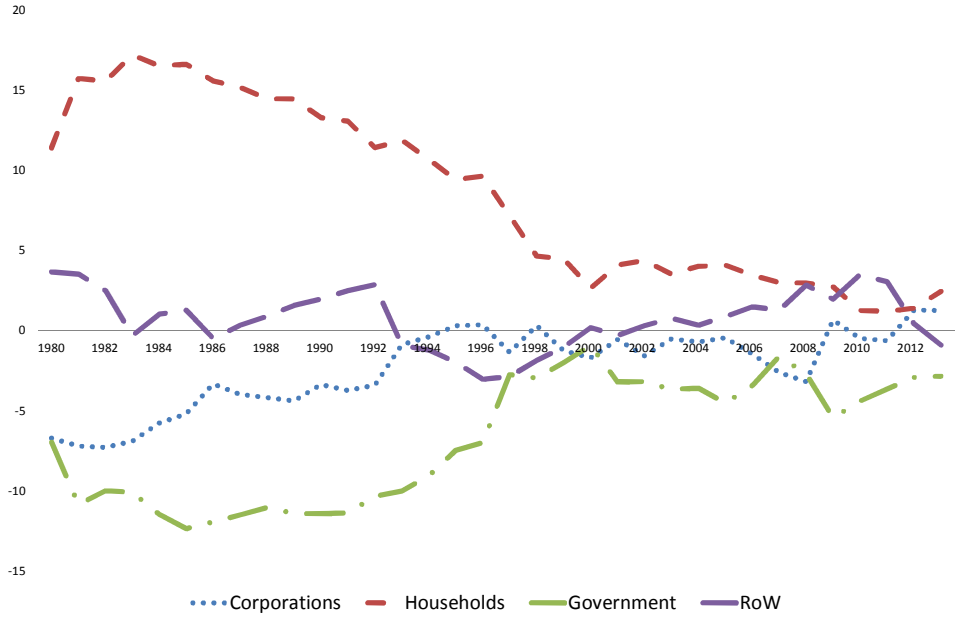
	1961-1974	1975-1992	1993-2002	2003-2007	2008	2009	2010-2011	2012	2013
Real GDP growth, cyclical averages (in percent)	5,38	2,6	1,61	1,3	-1,16	-5,49	1,09	-2,37	-1,85
Contribution to the increase of GdP of:									
domestic demand including stocks	5,28	2,62	1,34	1,32	-1,2	-4,43	0,55	-5,11	-2,7
private consumption	3,44	1,74	0,8	0,63	-0,47	-0,92	0,38	-2,45	-1,6
public consumption	0,63	0,51	0,09	0,31	0,11	0,16	-0,18	-0,53	-0,16
gross fixed capital formation	1,08	0,41	0,38	0,3	-0,8	-2,46	-0,16	-1,52	-0,85
changes in inventories and acquisitions less disposals of valuables	0,14	-0,09	0,07	0,08	-0,04	-1,2	0,51	-0,62	-0,08
the balance of goods and services	0,1	0,04	0,27	-0,02	0,04	-1,07	0,54	2,75	0,84

Notes: The beginning of a trade cycle is given by a local minimum of annual real GDP growth, 1961 – 1974 and 2008 – 2013 are incomplete cycles. 2008, 2009, 2012 and 2013 are separately considered for their peculiarity.
Source: AMECO, European Commission (2014), our calculations.

The domestic demand-led model of development is typified by a strong contribution of aggregate demand to real GDP, by a positive financial balance of domestic sectors as a whole, a neutral current account contribution, a high weight of private consumption and relatively high inflation. During the period 1961 – 2007, private consumption explained 64.3% of aggregate demand. Inflation in Italy has historically recorded higher values than the Euro-area average. Over the last two decades, Italy has experienced a marked slowdown of productivity growth and a progressive deterioration in competitiveness leading to a steady loss of export market shares and, since 2000, a significant contraction in manufacturing activity.

During the 1980s cycle, Italian financial balances dramatically changed, experiencing a loss in term of households' saving propensity and a significant reduction of deficit needs of non-financial companies and the Government (figure 3).

Figure 3. Financial balances, Italy, 1980 – 2013 (per cent of nominal GDP)



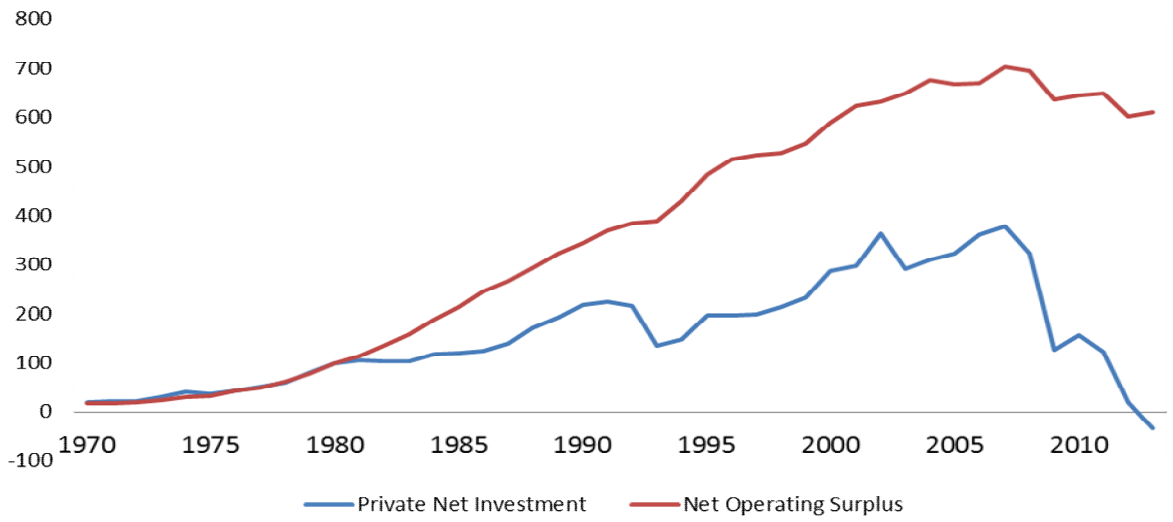
Source: AMECO, European Commission (2014), our calculations.

The financial balances of Italian private households have been for a long period one of the largest surpluses in industrialised countries, along with Japanese households. However, the reduction of households' surplus levels was associated with a weak consumption demand. In the same period, the corporate sector experienced positive and rising financial balances but weak fixed capital investments. Indeed, the collapse of households' saving was accompanied by an increase of the net operating surplus (NOS) of non-financial companies, defined as:

$$NOS = GV - [CE + (IT-SU) + CFC]$$

where:
GV is the gross value added; CFC is the consumption of fixed capital; CE is the compensation of employees; IT are the indirect taxes paid by producers; SU are the producer subsidies received.

Figure 4: Investments and profits, Italy, 1970 – 2013 (Index 1980 = 100)



Source: AMECO, European Commission (2014), our calculations.

In other words, the "domestic-demand led" model of growth which characterised Italy during the first and second financialisation phases, coupled with a strong profit increase without investments. This economic model, therefore, was as fragile as the "debt-led consumption boom" type of development in the most financialised countries such as US and the UK.

The collapse of investments was also accompanied by negative movements in real wages which explain households' inability to maintain large positive financial balances and the consequent slowdown in growth of real domestic demand (from 5.28 in the 1960s, to 1.32 in the 2000s before the crisis). This was particularly true of private consumptions (from 3.44 in the 1960s to 0.53 in the 2000s).

The constraints to public consumption and investment, along with the neutral contribution of the external sector, led to a predictable crisis of the real sector which led to a negative real GDP change, from 2008 to 2013, of -8.70%.

The role of financialisation in this process can be summed up as follows: households' saving has been mainly crowded out by the public sector, whose debt has been propelled by the cost of interests paid to investors; non-financial companies have become more prone to distribute their net operating surplus and this change in financial behaviour has contributed to depressed investments. Finally, the crisis increased the number of non-performing loans out of total banks' assets with a strong impact on their capitalisation, and the subsequent decision to deleverage and adopt a credit crunch policy.

II. Long-run effects of financialisation on the economy through different channels

1. Financialisation and distribution

Recent economic literature has shed light on the effects of financialisation on functional and personal income distribution (Dünhaupt, 2013), Stockhammer, 2009, 2013, and Kristal, 2010). According to Hein (2013), starting from the 1980s financialisation and the neo-liberalism paradigm are at the base of the increase of the capital income share and, consequently the cause in the fall of the labour income share.

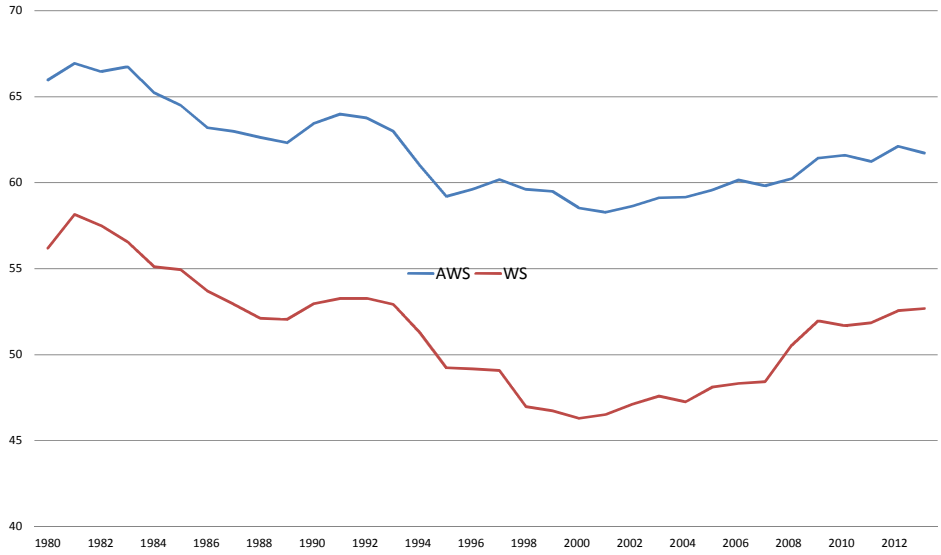
As regards functional income distribution, we try to verify this position for Italy. We first focus on the relationship between the wage share, as drawn from national account, and the interest and dividend payments of the corporate sector, generally associated with the fall of the labour income share according to the shareholders value orientation principle. Secondly, since changes in functional income distribution could be ascribed to sectorial shifts, we examine where there has been a shift from the real sector towards the financial sector of the Italian economy. Finally, we show data regarding Trade Unions in order to verify if their bargaining power has changed after the de-regulation process with an impact on the labour market during the last twenty years.

1.1. Functional distribution

1.1.1. Evolution of the wage and the rentier share

The last three decades have been characterised by a wide income re-distribution from labour to capital. As can be seen in Figure 5, between 1980 and 2012, the ordinary wage share (as a share of net national income) fell from 56.15 to 53.7 per cent following a U-shape, with a strong decline since the early eighties to 2000 (around -10 per cent) and partial recovery from the early 2000s onwards (+6 per cent). In order to give a more accurate picture of the evolution of labour income, taking into account the changes in the composition of employees, we also show the adjusted wage share in figure 5. Although they exhibit the same trend, the decline of the latter has been more pronounced (-4.5 per cent at the end of 2013) because of the lower recovery during the 2000s (about +3 per cent).

Figure 5: Wage Share (compensation of employees as a percentage of net national income) and Adjusted Wage Share (percent of GDP at current factor cost), Italy, 1980-2013.



Source: AMECO, European Commission (2014), OECD National Accounts (2014); author's calculation

Table 2 reports the changes in the adjusted wage share in most advanced economies. If we do not consider the cyclical characteristics affecting the labour income share[2], the labour share in Italy dropped less than most of the other developed economies indicating that redistribution has been more severe in countries like France, Japan, Spain or Germany.

[2] The wage and profit shares fluctuate with economic cycles: wages show a lower volatility than profits when economic downturn occurs, so the share of remaining economic pie going to wages is likely to increase with recessions and increase with expansions.

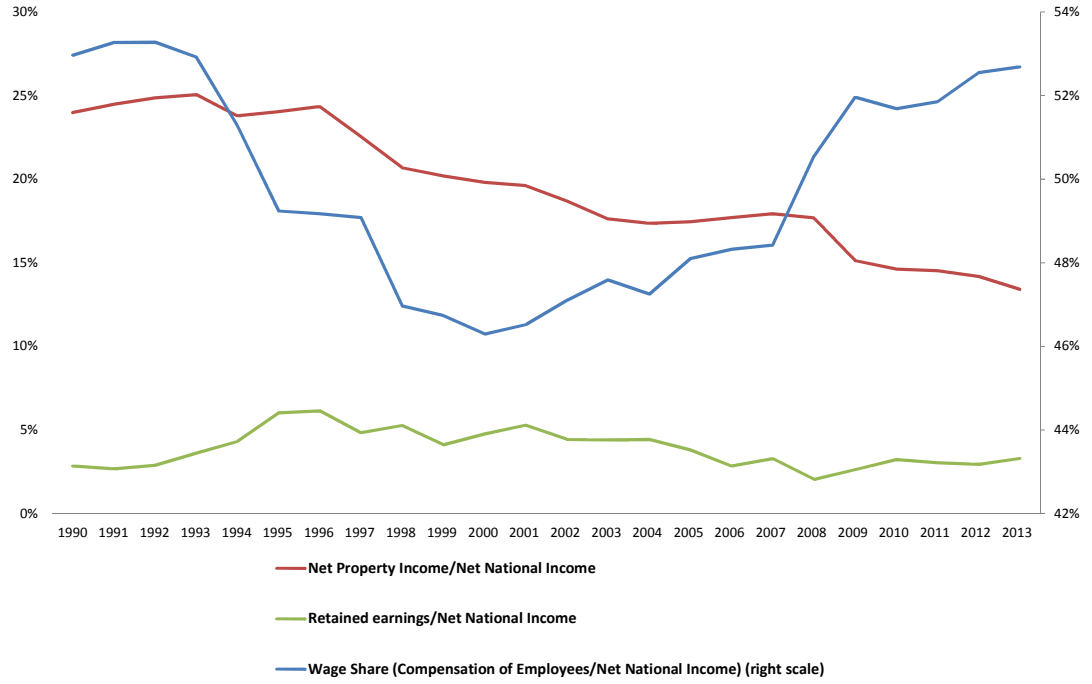
Table 2: The Adjusted wage share as percentage of GDP at current factor cost, changes over time 1980-2013.

	1980-2013	1980-2007	2007-2013
Belgium	-3,91	-6,78	1,50
Denmark	-6,09	-5,82	-0,77
Germany	-7,75	-11,26	2,60
Ireland	-19,08	-19,56	-4,21
Greece	-1,80	0,60	-2,67
Spain	-10,89	-8,92	-2,86
France	-8,25	-11,48	3,09
Italy	-4,25	-6,16	1,49
Netherlands	-7,75	-11,60	3,42
Austria	-9,04	-12,90	2,73
Portugal	-9,34	-6,18	-3,60
Finland	-4,38	-11,03	5,26
Sweden	-2,29	-5,92	2,31
United Kingdom	-3,80	-3,81	0,76
Norway	-7,26	-9,73	3,85
United States	-6,10	-3,47	-2,84
Japan	-13,33	-14,54	0,47

Source: AMECO, European Commission (2014)

In order to analyse whether in Italy there were possible redistribution effects at the expense of the labour share, following the analysis provided by Dünhaupt (2010) for Germany, we derive the rentier share and the other complementary income shares. The wage share dramatically falls between 1990 and 2000 (from 53 to 46 per cent of net national income) and since then, it has recorded a strong increasing up to reach the starting levels (Figure 6). There is no evidence that the fall of labour share in the first decade was accompanied by an increase in the rentier income share but, on the contrary, we find a constant decline of property income up to the end of the observation period. Retained earnings in the long-run have fluctuated at around 3 per cent.

Figure 6: Income shares, Italy, 1990-2013.



Source: OECD National Accounts (2014); author's calculation

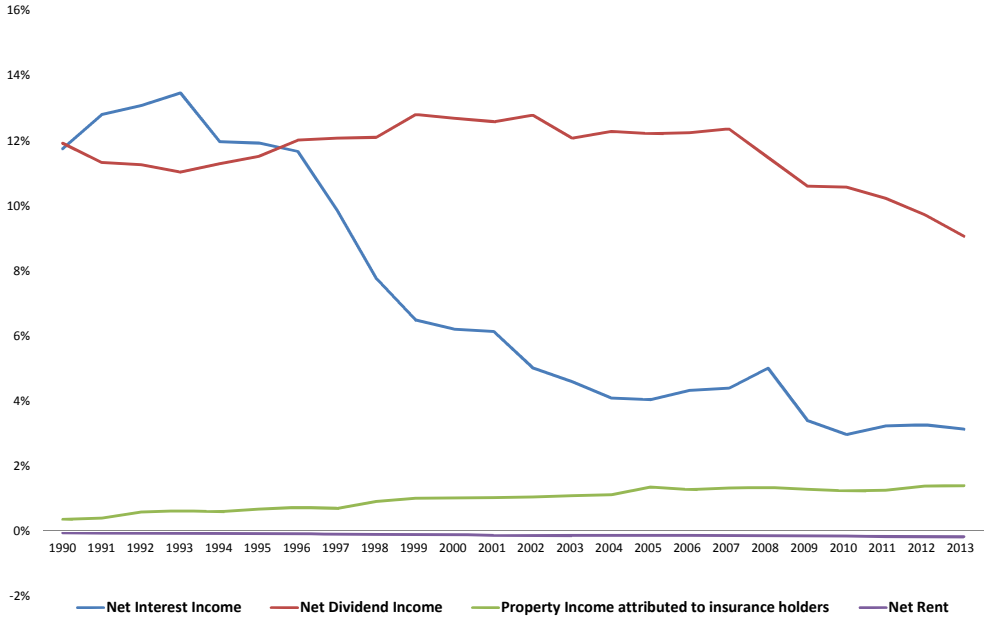
To better understand the reasons of the deep downward trend, we split the property income share into its components, namely interest, dividends and rent (Figure 7). The decrease of the property income share was mainly caused by an astonishing fall of the share of interest that dropped from 12 per cent in 1990 to 3 per cent in 2013. A plausible explanation for this dramatic fall could be the rising indebtedness of private households and, therefore, the interest payments to the rest of the world.

The dividend income share trend is less pronounced: it was substantially stable at around 12 per cent until the early 2000s, and then it fell to 9 per cent in 2013. These results for Italy do not fit with the hypothesis that financialisation, and in particular the increasing adoption of a shareholders' value orientation, leads to an increase in dividend income share[3].

Relative to the property income attributed to insurance holders, even if it exponentially increased from 1990, at the end of 2013 its share accounted for only 1 per cent of net national income. Finally, net rent income was found to not be significant.

[3] Lazonik and O'Sullivan (2000).

Figure 7: Components of rentier income as a share of net national income, Italy, 1990-2013.



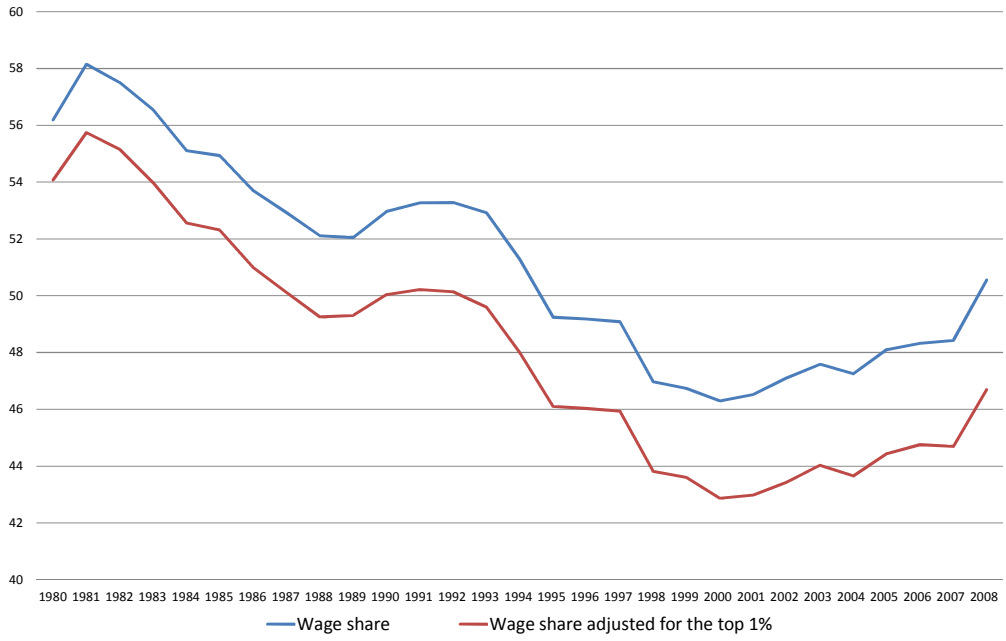
Source: OECD National Accounts (2014); author's calculation

Many studies argue that the labour income computation obtained by national accounts can give a misrepresented picture of the economy[4]. The income labour share is the sum of the different forms of income, namely wages, salary,, dividends and interest payments (Lavoie 2009, and Atkinson 2009). The most important criticism concerns the treatment of stock options and bonus payments received by corporate executives. Although this part of variable remuneration is recorded in the national accounts as employee compensation, many authors argue that, since stock options represent one form of equity compensation, they do not represent an actual cost for firms (Kuhn 2003) but a way of deferring compensation and, therefore, should be treated as capital transfers. Starting from this argument and following the method used by Dünhaupt (2011) for Germany[5], we show in Figure 8 the wage share as taken from national accounts adjusted for the labour income of the top 1 per cent. As can be seen, although they show the same trend from the early 1990s to 2000, the adjusted wage share shows a more pronounced decline (-6.5 and -7.2 respectively). On the contrary, when the upward trend began in 2000 the recovery of the adjusted wage share was less important (3.8% and 4.3%, respectively). Both these facts suggest that without the share of the top management salaries, the income labour share as taken from national accounts would be significantly lower.

[4] See Gomme and Rupert (2004), Krueger (1999), Glyn (2009).

[5] Dühhaupt follows the examples of Buchele and Christiansen (2007), Glyn (2009) and Atkinson (2009) where the top wage income shares are subtracted from the labour income share taken by national accounts.

Figure 8: The wage share and the wage share adjusted for the top 1 percent wage income (as percentage of Net National Income), Italy, 1980-2008



Source: The World Top Incomes Database (2014); Ameco (2014), European Commission, OECD National Accounts (2014); author's calculations.

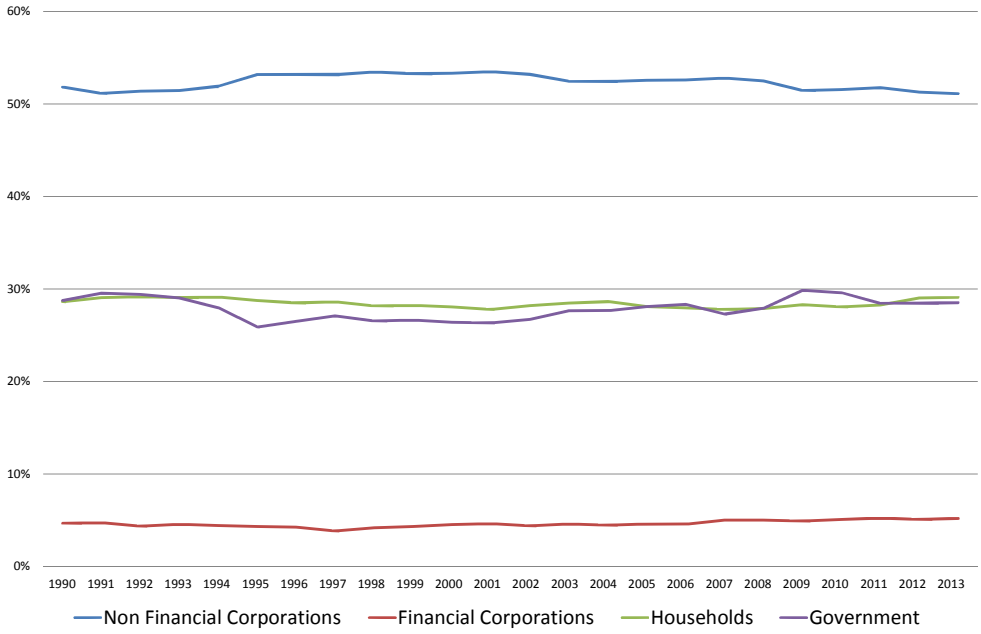
1.1.2. Functional distribution and sectorial composition

Relating to the role of sector development in the analysis on functional income distribution, figure 9 illustrates the share of gross value added by the institutional sector as a share of gross value added of total the economy. The non-financial sector share steadily fluctuates at around 52 per cent ,while the financial sector share is stable at around 4.5 per cent over time. It does not seem therefore, that Italy has experienced a sectorial shift towards the financial sector. It is worthy to note that the share of the government sector after an initial phase of decline, has shown an upward trend from the end of Nineties to reach the peak in 2009 (at around 30 per cent). This result can help explain the recovery of the aggregate wage share in the national accounts seen above.

Figure 10 shows the share of gross operating surplus of financial and non-financial corporations as a share of gross value added for the period 1990-2013. The profit share of non-financial corporations has been on average substantially higher than financial corporations. However, starting from the mid-nineties (the period of increasing weight of

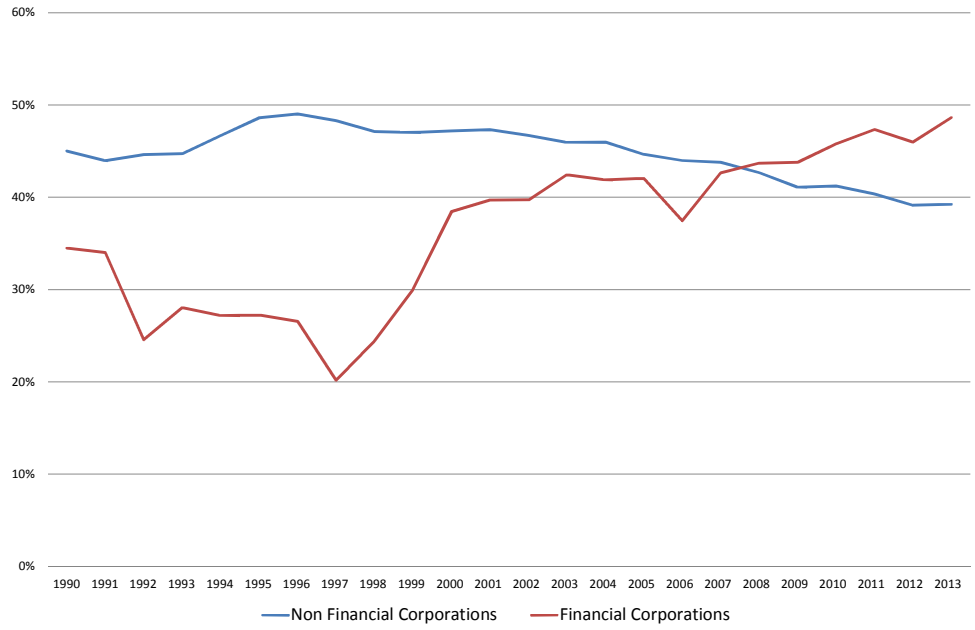
finance in the economy), we find a strong recovery in profits of the financial sector and a clear downward trend for the non-financial sector.

Figure 9: Gross value added by institutional sector in percent of total gross value added, Italy, 1990-2013



Source: OECD National Accounts (2014); author's calculation

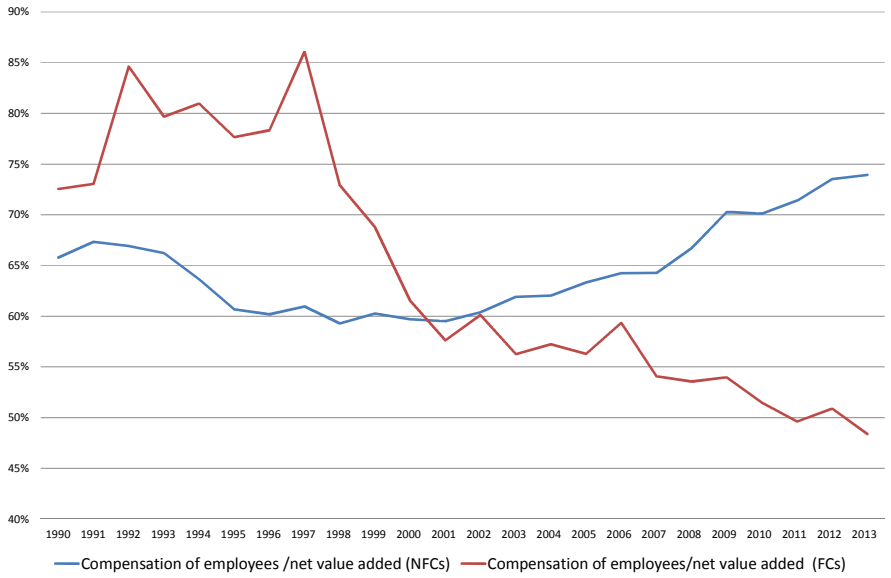
Figure 10: Sector gross operating surplus in percent of sector gross value added, Italy, 1990-2013



Source: OECD National Accounts (2014); author's calculation

Finally, in figure 11 we show the compensation of employees for non-financial and financial corporations between 1990-2013. Again, the two branches of the corporate sector are characterised by very different trends, in particular from the mid-nineties. Indeed, while the wage share in the non-financial sector had a high recovery reaching a peak at the end of 2013 (74 per cent of the net value added), in absolute contrast, the wage share of the financial sector has recorded a steep and continuous decline shifting from 86 per cent in 1997 to 48 per cent in 2013. Hence, it is plausible to sustain that the recovery of the wage share of the economy as a whole was driven by the non-financial corporate sector, and therefore, by the real economy.

Figure 11: Compensation of employees by corporate sector as a share of net value added, Italy, 1990-2013.



Source: OECD National Accounts (2014); author's calculation

1.2. The main features of the Italian labour market and their implications for distribution

The Italian labour markets are characterized by high rates of long-term youth and women unemployment, and by low employment rates compared to other industrialized countries. Other distinguishing features of the Italian labour markets are the diffusion of undeclared work in the black economy and deep regional disparities of the overall conditions of the labour market.

Among the factors to explain these negative records, we can underline some institutional factors, such as union power, the fiscal assistance system, employment safeguard legal mechanisms, low growth in labour productivity, low investments in human capital formation and technology. The case of Italy is particularly interesting in terms of the extension and enlargement of collective agreements, as the Constitution (Art. 39) declares collective agreements signed by trade unions generally binding on all employee categories covered by the agreement. On this basis, the minimum wage level set by collective bargaining in a particular sector is often taken as a reference by courts when determining whether specific wages conform to constitutional requirements.

There are different methods through which the union power may influence salary levels along with macroeconomic results. Iversen and Soskice (1998) show that Italy can be classified as a borderline country, between decentralisation and centralisation. Maastricht criteria and the introduction of the Monetary Union inspired the coordination approach through the implementation of "Social Pacts", agreements establishing norms of (moderate) wage policy. The Euro anti-inflationary framework has affected the Pact signed in Italy in 1993 (Accordo sul costo del lavoro – Cost of Labour Agreement) which can be

seen a co-operation between unions and companies trusts aimed at reducing the income effect on inflation and the public deficit.

Another feature affecting the labour market is the tax wedge, which could discourage labour supply and increase labour costs. Many observers and labour market agents sustain that the mix of fiscal norms could be considered as one of the rationales behind the high unemployment rates. The Italian income tax rate, out of the average wage level is currently 14.2%, only 0.1% more than the EU average. Social contributions are 32.2%, which is 1.2% higher than the EU average level. More significantly, Italian financial resources spent on unemployed to GDP is about 0.6%, while according to Eurostat, in EU countries as a whole this value is 1.7%.

Italian labour market institutions are an interesting case where job protection is coupled, with central regulation over salaries and working requirements. The combination of this income policy structure gives a significant power to insiders and appears to be less effective in helping to reach the employment target. An important feature of this system is that the protection of insiders is not evenly distributed throughout the economy. In particular, workers in large manufacturing firms tend to be much more protected.

Among the most significant changes observed during the last few decades, we underline the "Accordo sul costo del lavoro" (Cost of Labour Agreement) signed in 1993 which is a cornerstone of Italian labour market reforms. Salaries have been linked to a target inflation rate both in the private and the public sectors. Some deviations from the centralised rule can be accepted, particularly to introduce incentives for companies located in disadvantaged areas. Unfortunately, the impact was "positive" only for the inflation target, much less so for the employment rate and the real value of wages.

In 1997, the new Labor Act (no. 196/1997) introduced some structural reforms to ease the flexibility through full-time and part-time temporary contracts, and internship contracts for young workers and private job-placement agencies.

After the crisis, the Jobs-Act designed by the Government to be approved in 2015 enforces the purpose to increase the employment rate through flexibility with the following measures:

a) Reduction of job protection for large companies;
b) Liberalisation of the time-contracts;
c) Tax benefits for permanent contracts;
d) Elimination of project contracts, to avoid their diffusion even in cases where there was no real project to be delivered;
e) Introduction of increasing job and social protection.

In table 3 we present data on trade union development, and its bargaining power between 1980 and 2013. Looking at employment protection, the development of the dual labour market started from the end of the nineties. Indeed, while employment protection for regular contracts has been stable between 1990 and 2013 with only a slight decrease over the last three years, temporary contracts have recorded a deep fall in employment protection, especially due to the strong de-regulation process suffered following the adoption of Law n.30 of February 5th 2003 (so called Legge Biagi).

Although the membership trend seems to point out a weakening of trade unions (with an union density equal to 47 at the beginning of the 1980s and 36 at the end of 2011), data on

bargaining coverage is high and constant over the entire period suggesting that there still is a high degree of wage bargaining coordination.
Finally, the indicators of unemployment benefits, both gross and net replacement rates, underline a heavy increase.
In summation, from the joint interpretation of data in table 3 and figure 7, it does seem that the two channels through which an increase in shareholder value orientation might influence the income labour share does not fit well with the Italian case. Indeed, on average, in Italy there has neither been rising overhead costs in the corporate sector such as interest and dividend payments, nor the weakening of trade unions, especially if we examine the bargaining coverage data.

Table 3: Labour market regulation and trade unions bargaining power, Italy, 1980-2013

	1980-1984	1985-1989	1990-1994	1995-1999	2000-2004	2005-2009	2010-2013
Trade Unions							
Union density rate	47,0	40,4	38,9	36,5	34,1	33,7	35,5
Union coverage of workplaces or establishments (per cent	NA	NA	NA	NA	NA	NA	NA
Bargaining (or union) coverage, adjusted for occupations and sector without right for bargaining (per cent)	85,0	85,0	85,0	85,0	85,0	85,0	85,0
Employment protection							
Strictness of employment protection- individual dismissals (regular contract) (index)			2,8	2,8	2,8	2,8	2,7
Strictness of employment protection- collective dismissals (additional restrictions) (index)				4,1	4,1	4,1	4,0
Strictness of employment protection- temporary contracts (index)			4,8	4,3	2,6	2,0	2,0
Unemployment benefits							
Gross replacement rate (per cent of average production worker wage)[1]	0,6	1,1	9,6	23,9	33,9	32,5	
Gross replacement rate (per cent of average wage)[2]					6,7	10,0	11,0
Net replacement rate summary measure of benefits entitlements(excl. Social assistance and housing benefits) (per cent)					20,8	23,0	23,3
Net replacement rate summary measure of benefits entitlements(incl. Social assistance and housing benefits) (per cent)					21,3	22,6	24,0

Notes: Even if the result refers to the average calculated for the five year period indicated, the time series of each indicators are different and sometimes data are available for all years; [1] refers to an adult full-time employee in sector D of revision 3 or the Internation Standard Classification of All Economic Activities; [2] refers to the sectors B to N of Revision 4 of the International Standard Classification of All Economic Activities.

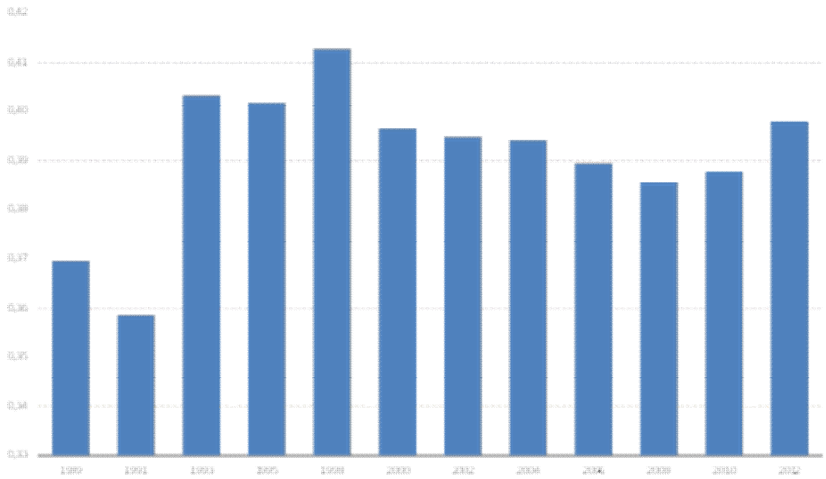
Source: OECD (2014); Vissier (2013); author's calculation

1.3. The evolution of income inequality

Consistently with the economic literature about great increases in inequality income distributions within each developed country over the last twenty years (Cornia, 2003; Berg and Ostry, 2011; Bergh and Nilsson, 2010; Bollè, 2008; Jaumotte et al., 2008; Ulubasoglu, 2004), the analysis of personal income distribution in Italy shows an

increase in inequality over the last two decades. In our study, we use data from Survey of Households Income and Wealth from the Bank of Italy. Italy recorded a strong growth in the Gini coefficient of disposable income during the nineties when, in 1988, it reached a peak of 0.413 (figure 12). Between 2000 and 2008 the Gini index decreased by 0.8 and we have observed a significant convergence process. This trend was interrupted by the financial crisis; at the end of 2012 inequality reached levels higher than the early 2000s (with a Gini coefficient at 0.398).

Figure 12: Gini coefficient for Households average disposable income, Italy, 1989-2012



Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Since the Gini index could be associated with different underlying income distributions, we also show inequality data at the extremes of the income distribution. The information given by distribution ratios such as P90/P10, P50/P10, and P90/P50 may help us to better understand the drivers of the upward and downward movements in inequality. As shown in Table 4, there has been an income re-distribution at the expense of very low income households. At the end of 2012 the average income of the richest 10 per cent of households was more than 12 times that of the poorest 10 percent, while in 1989 it was 9 times. The increasing inequality is also confirmed by the growth in the P90/P50 ratio that indicates a growing income concentration in the hands of relatively few people at the expense of the middle class[6]. Data referring to the distribution tails do seem to confirm that "the rich get richer and poor get poorer" also in Italy.

[6] Italy is characterised by wide differences between geographical areas both in terms of households income distribution and households wealth distribution. For a more detailed analysis see Acciari, P. and Mosetti S. (2013) and Consolandi C. et al (2013).

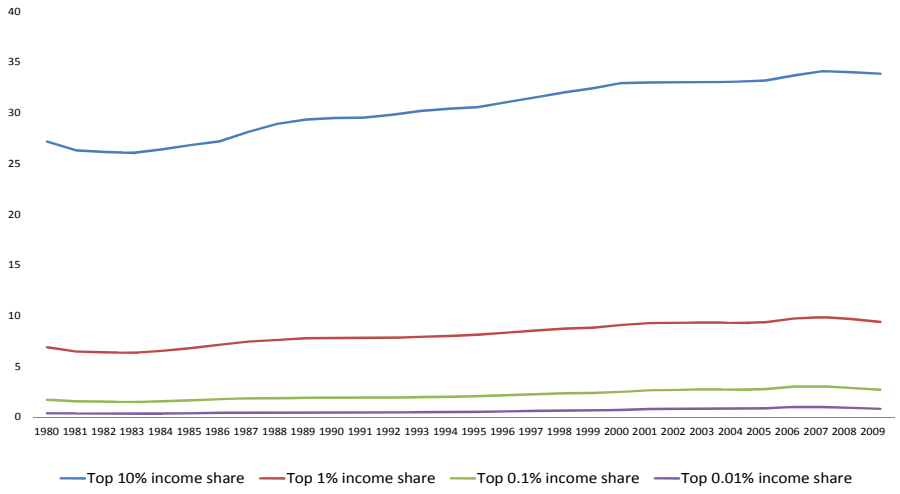
Table.4 Percentile ratios for Households average disposable income in Italy, 1989-2012

	1989	1991	1993	1995	1998	2000	2002	2004	2006	2008	2010	2012
P90/P10	9,3	8,9	12,6	12,8	14,2	12,2	11,6	11	10,8	10,4	11,2	12,3
P90/P50	0,9	0,9	1,1	1,1	1,2	1,1	1,1	1,1	1,1	1	1	1,1
P50/P10	9,8	10	11,5	11,7	12,3	11,3	10,9	10,1	10,1	10,1	10,8	11,4

Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

In order to verify results on increasing inequality seen above, in figure 13 based on data provided by Top World Incomes Database (Alvaredo et al., 2014), we show the income share held by top incomes. Starting from the early eighties, the share of very top incomes rapidly increased: the top 0.01 and 0.1 income shares practically doubled, while the top 1 and 10 per cent of income share account grew, from 6.9 and 27.2 in 1980 to 9.4 and 33.9 at the end of 2009 respectively.

Figure 13: Top income shares in Italy, 1980-2009 (per cent of national income)

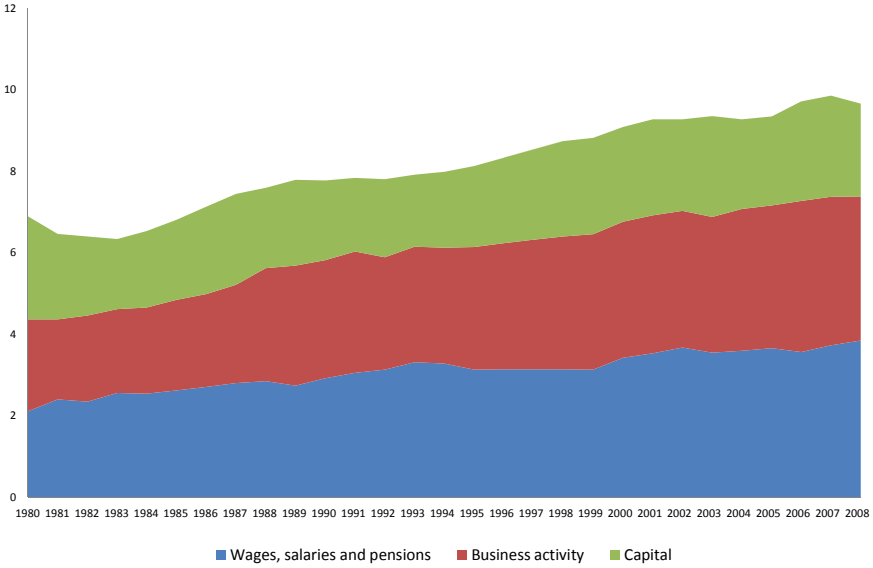


Source: The World Top Incomes Database (2014), OECD National Accounts (2014); author's calculation

Looking at the composition of the top 1 per cent income share (figure 114), we find that the main driver of this increase is represented by wage, salaries, and pensions (its contribution increased from 30 per cent in 1980 to 40 per cent in 2008) followed by business income, defined as the sum of self-employment and entrepreneurial income. The capital income share suffered a heavy fall over the last three decades from 37 per cent in 1980 to 27 per cent in 2008. As there are top corporate executives within the top 1 per cent and if we consider that bonus and stock options are included as wage items, then it is plausible to

think that the remuneration of top management has also contributed to making income distribution more unequal.

Figure 14: The top 1 per cent income share as a share of national income and its composition, Italy, 1980-2008



Source: The World Top Incomes Database (2014), OECD National Accounts (2014); author's calculation

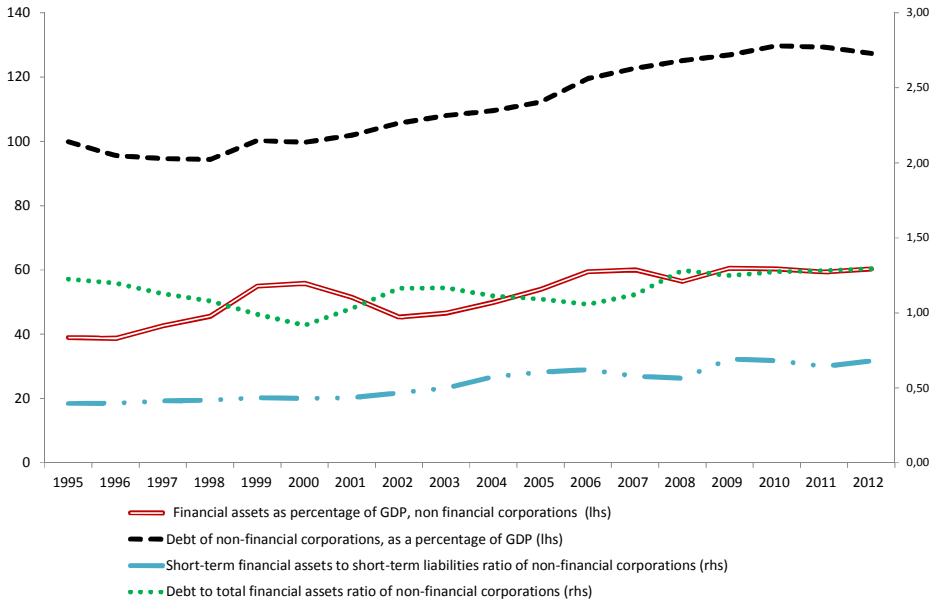
2. Financialisation and investments in capital stock

Financial systems are deemed as providers of services to serve production and commercial activities, namely real economy. One of the main functions of financial systems is to facilitate real investments by promoting an efficient transferring and channeling of resources from providers and users of funds. In other words, theoretically an expansion of finance should enhance the provision of liquidity for cost-effective projects and investments with a positive impact on the performance of the real economy. Recent theoretical and empirical studies (for a literature review see Gabbi and Ticci, 2014), however, increasingly suggest that the recent acceleration of financialisation in several advanced economies might instead have crowded out and depressed real investments in capital stock. Most of this literature does not include any analysis on Italy. This section contributes to fill this knowledge gap by comparing the main trends and dynamics in investment financing and allocation strategies of Italian NFCs during three separate periods: in the 1990s, at the beginning of financialisation era; in the pre-crisis period when the Italian financial and banking systems had already integrated the majority of deregulation and liberalisation reforms which are preconditions and foundations of financialisation; finally, in the recent years of the Great Recession.

In Italy the financialisation process, from its early phase to its consolidation, was accompanied by a deceleration of private investments in capital stock. The annual growth rate of investments in gross fixed capital stock of NFCs was, on average, 7.7, 4.4 and -2.2

percent in the 1995-2000, 2001-2006 and 2007-2013 periods respectively[7]. In other words, the growing interactions between NFCs and financial markets have not been particularly effective in boosting real investments. During the last two decades in fact, Italian NFCs have been increasingly active in financial markets, they have started to invest more in financial assets, and they have become more exposed to financial markets. As shown in fig.15, the ratio of financial assets held by NFCs to GDP grew by 20 percentage points from 1995 to 2006 (from 39 to 59 percent) and it remained stable at around 60 percent until 2012 (with the exception of a drop during the 2008 financial crisis). At the same time, corporate indebtedness and the financial leverage of NFCs, represented in fig. 15 by the debt to financial assets ratio, shows a positive trend overall which is more evident at the end of the 2000s. A similar evolution is followed by the proportion of short-term financial assets available to cover short-term liabilities. In the era of financialisation therefore, Italian NFCs have become more able to finance capital investment even in periods of stagnant or weak sales, and they have experienced an improvement in liquidity. Despite this potential strengthening in investment capacity, their propensity to finance real investments has actually weakened.

Figure 15: Financial stocks of NFCs, selected indicators on structure, financial leverage, maturity profile, Italy, 1995-2012.



Source: authors' elaboration based on OECD statistics (2014).

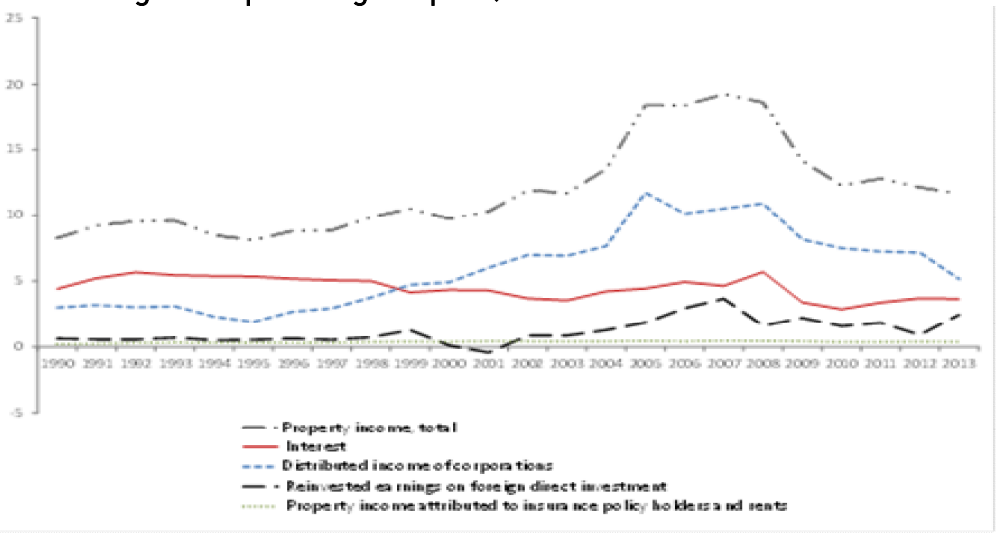
At the same time, an excessive debt burden can also represent a constraint on investment expenditure, and can make NFCs more vulnerable to interest rate risk and to perturbations in financial markets. Indeed, there are signs that the debt sustainability of NFCs has

[7] Authors' elaborations based on OECD (2014)

deteriorated since the beginning of the 2000s, namely in the second and mature phase of financialisation, and especially during the ongoing economic crisis. For instance, the ratio of debt to operating surplus, which indicates to what extent income generated will be able to service debt repayments, has almost doubled from the second half of the 1990s to recent years. While in 1995 it was 2.7, in 2012 the debt outstanding of NFCs was more than 5 times larger than the annual flow of gross operating surplus[8].

In the era of financialisation therefore, NFCs have increased their ability to use financial instruments and to raise financial capital for their investment decisions. However, this change has not translated into particularly positive performance in real investments even in the pre-crisis period. Moreover, it has occurred at the cost of increasing vulnerability to fluctuations in the business cycle, interest rates, and credit risk assessments by market participants as demonstrated by the persistent impact of the Great Recession on real investments.

Figure 16: Sources of non-financial corporations' operating surplus, Italy (1990-2013) (per cent of sector gross operating surplus)



Source: authors' elaboration based on OECD statistics (2014).

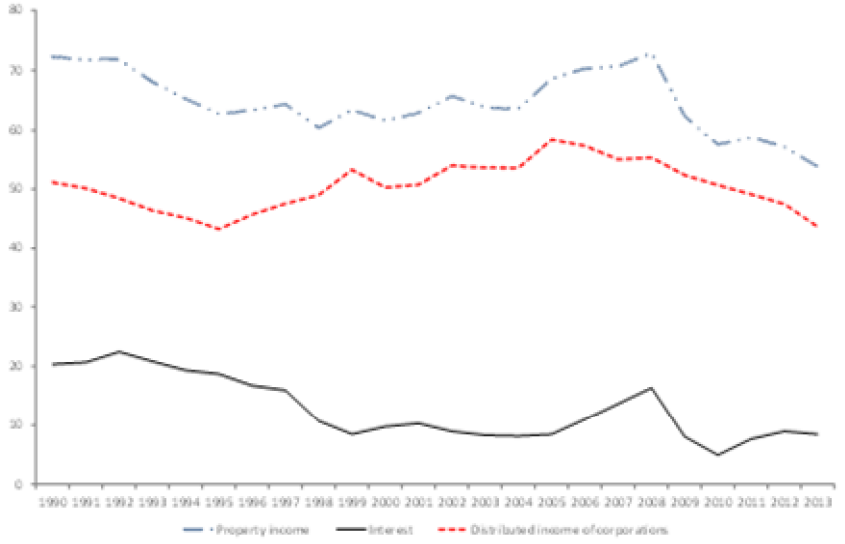
Among others factors, a possible explanation of these dynamics is the introduction of a set of trade-offs to the detriment of real and long term investments compared to financial investments. For instance, the adoption of performance-related pay schemes for CEOs, which is a recurrent feature of the financialisation process, can generate a tighter relationship between shareholders' and managers' interests. Managers might have incentives to drain resource from "internal means of finance" and redirect them from real and productive, to more reversible and short term financial investments. In other words, financialisation and the diffusion of the shareholder value orientation might have promoted a shift from 'retain and invest' to 'downsize and distribute' in the investment behaviour as observed by Lazonick and O'Sullivan (2000) in the case of US NFCs.

[8] Authors' elaboration based on OECD statistics (2014).

The evolution of sources of non-financial corporations' operating surplus over the last twenty years also reveals in the Italian case that financial investment has become an increasingly remunerative and profitable alternative vis-à-vis real investment especially in the pre-crisis period of credit expansion and low interest rates (figure 16). Not only do financial assets of the NFCs account for an increasing GDP share over time, but the share of the resources from property income over the total operating surplus increased from less than 10 percent in the nineties to 18-19 percent in the 2005-2008 period. It has then since stabilised to around 12 percent. The overall trend has been driven by distributed income of corporations whose share of the total operating surplus constantly grew from around 3 percent in the early nineties to almost 11 percent in 2007 (it then declined to about 7 percent in the years 2010-2012). Reinvested earnings on FDI, has followed a similar evolution but at much lower levels (from 0.6 to 3.7 in the same period of reference), have also contributed to this trend.

The impact of financialisation on the use of funds is less marked but still evident up until the years prior to the crisis (figure 17). In the late 1990s, the share of distributed property income in the gross operating surplus started to increase, suggesting a growing propensity in NFCs management decisions to meet shareholders' preferences to distribute their profits. However, this trend reversed in 2008 due to the effects of the crisis. Moreover, in the entire period under study, the share of resources used by NFCs to pay interests shows a declining trend overall, interrupted by a partial recovery only in the years immediately before the crisis. The dynamics of interest payments tends, therefore, to reflect those of the interest rates rather than to indicate a change in portfolio allocation decisions towards financial operations.

Figure 17: Uses of operating surplus of non financial-corporations, Italy, 1990-2013 (per cent of sector gross operating surplus)



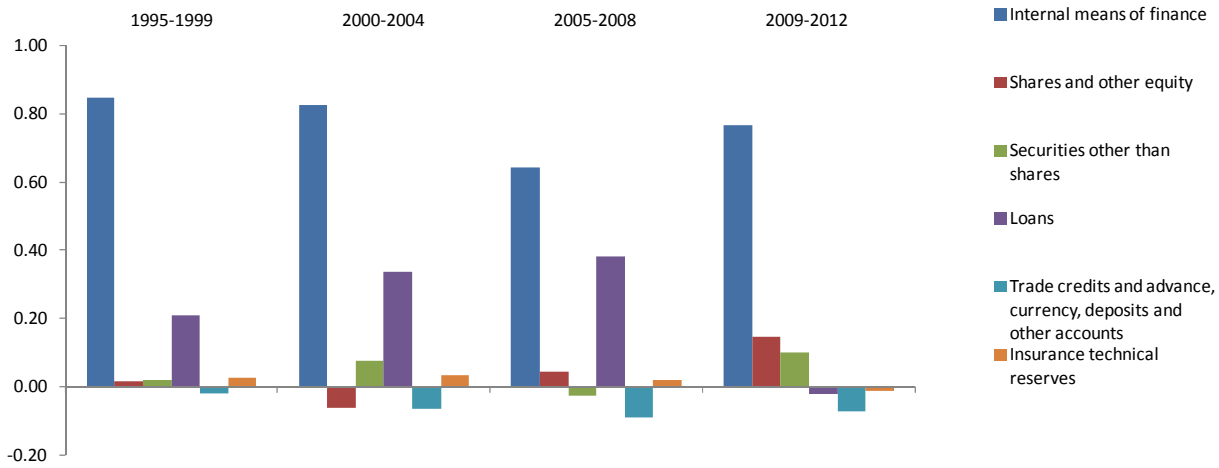
Source: authors' elaboration based on OECD statistics (2014).

Financialisation processes are also reflected in the structure of investment finance of the non-financial corporate sector. Figure 18 shows the composition of internal means of

finance and net financial transactions as a share of investment in gross capital stock of NFCs. Interestingly, the evolution of the means of finance composition in the pre-crisis period are consistent with the notion that financialisation creates incentives for NFCs to increase debt exposure, invest in equities, and reduce internal means of finance for real investments, though there is no evidence of the use share buybacks to stimulate share prices. At the same time, data confirms that investment finance of Italian firms mainly relies on a bank-based system rather than a capital-market based one. Internal means of finance, calculated as corporate savings plus capital consumption allowances, have substantially declined since 2005. They still represented the main source of investment finance for Italian NFCs, but while during the 1990s and the first half of the 2000s they provided more than 80 percent of resource for gross capital stock formation, in the years immediately prior to the crisis, their contribution dropped to about 64 percent. As regards external finance, bank loans represent the main source of funds. In the period under consideration, loans rapidly increased, showing a growth in the financial leverage of NFCs. At the same time, the contribution of equity transactions between the 1990s and the first half of the 2000s became negative indicating that share acquisition overcame their share sales.

Data referring to the post-crisis period is emblematic of the severity of the Great Recession for Italian productive investments. The credit crunch has resulted in the collapse of loans to NFCs, while NFCs have tried to tackle this tightening of bank credit by enhancing their recourse in self-financing and by increasing bond issuance. At the same time, the crisis which has reduced access to bank debt and induced firms (especially SMEs) to grant extended payment deferrals, has also led to a marked increase in net transactions of other accounts, such as trading credits and advances.

Figure 18: Finance of investment in gross capital stock of non-financial corporations, Italy, 1995–2009 (4/5-year averages)



Notes: "Internal means of finance" are calculated according to the method proposed in van Treeck (2009) as corporate savings plus capital consumption allowances. Items in external finance are calculated as net incurrence of liabilities minus net acquisition of financial assets.
Source: authors' elaboration based on OECD statistics (2014).

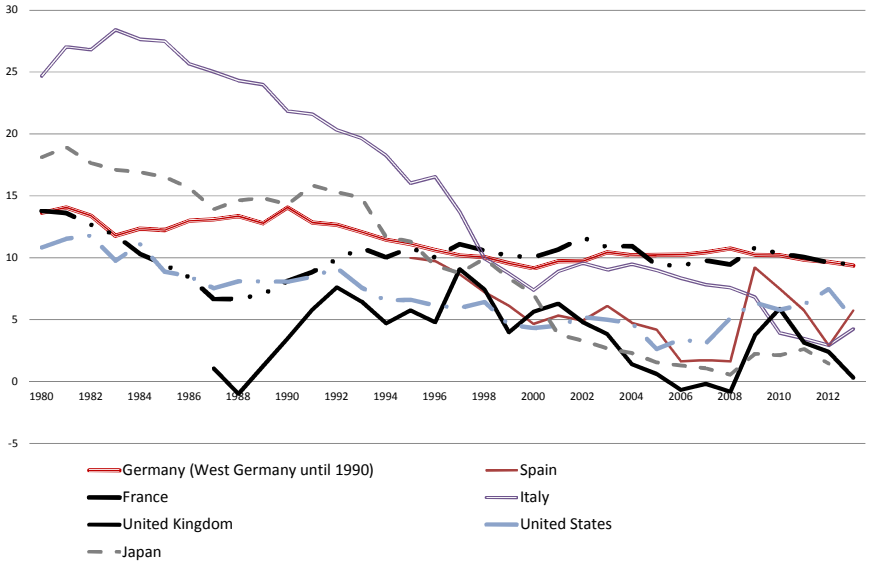
3. Financialisation and consumption

As the result of the financialisation process that affected the Italian economy during the last two decades, we have seen an increase in wealth-based and debt-financed consumption (Hein, 2013). The sharp increase in stock market and housing prices, along with easier access to credit markets and the loosening of the borrower constraints (in particular for low-income households), has allowed credit (and therefore consumption) to expand relative to income.

In this section we analyse Italian households' consumption behaviour and we attempt to verify the presence or not of the wealth effects on consumption through our interpretation of data extracted from the Surveys of Household Income and Wealth (SHIW) conducted by Bank of Italy.

In 1980, the households' net saving rate in Italy was around 25 per cent and, even though it showed a steep decline up until 2000, it has remained substantially higher than that of other European countries as well as Japan and United States (figure 19). However, after 2000 it felt below the saving rate of both German and French households. The trend saw a partial recovery in the early 2000s when the tendency reversed again reaching the floor in 2012 (around 3 per cent). Several empirical studies have identified different factors to explain this decline. Campiglio (2013) finds that the fall of the saving rate was due to the decrease of consumer household real incomes. Modigliani and Jappelli (1990) argue that the fall in Italy's saving rate results from the drop in productivity growth, while other studies have attributed this decrease to the stronger social insurance schemes and to the financial liberalisation process that affected Italy in the early nineties (Jappelli and Pagano 2000, Casolaro, Gambacorta and Guiso, 2005).

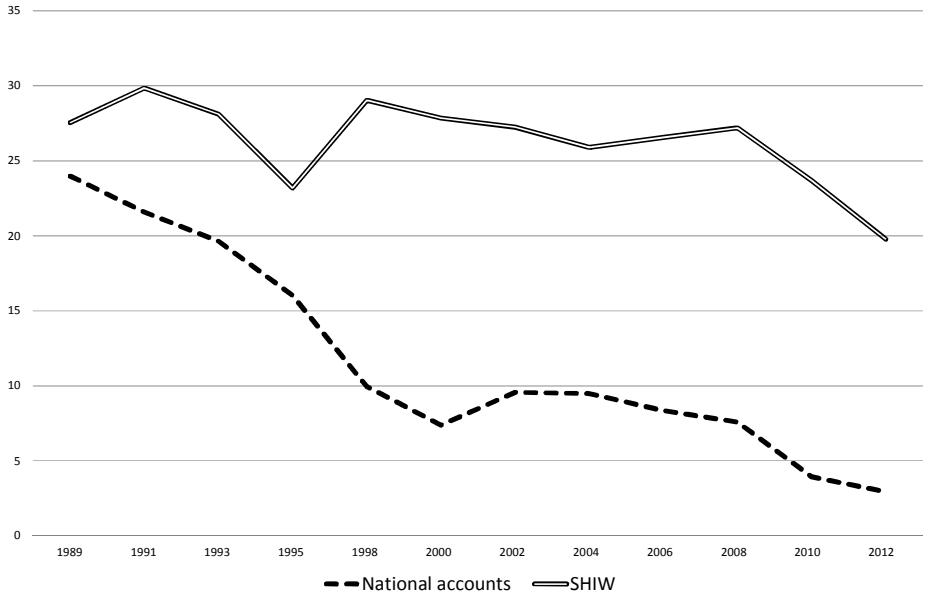
Figure 19: Net saving of the Household sector as a percentage of net disposable income, 1980-2013



Source: Ameco, European Commission (2014)

In order to better understand the downward tendency of the aggregate saving rate and the main drivers of its drop, we also use microeconomic data drawn from the Survey on Households Income and Wealth from the Bank of Italy. These datasets allow us to compute the average propensity to save from disposable income of households and its differences between different income groups. As can be seen in figure 20, even if the data does not completely match, the drop of the saving rate as calculated in the national accounts is confirmed when micro-data are used[9].

Figure 20: Households propensity to save out of disposable income as in national accounts and in microeconomic data, Italy, 1989-2012 (percentage values)



Source: Ameco, European Commission (2014); Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

In the economic literature on this issue, most of the empirical evidence finds a positive correlation between propensity to save and income levels. As table 5 shows, our results confirm this relationship also for Italy. On average over the observation period the saving rate falls by 8 percentage points, and the decrease is higher for lower income levels. Households' saving rate in the bottom half of the income distribution steeply decreases, and becomes negative from the early nineties onward. On the contrary, households saving rate at the top of distribution has increased up until the onset of the Great Recession. It has been mostly driven by the top and bottom decile of the income distribution (figure 21).

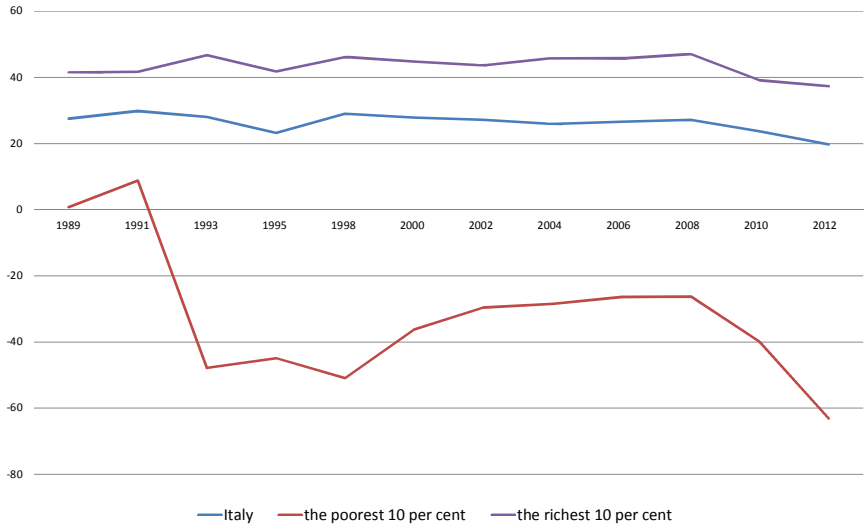
[9] The saving rate as drawn by the Survey on Households Income and Wealth by the Bank of Italy is substantially higher than that based on national accounts. The difference is due to the fact that the former is computed residually and as the Surveys tend to underestimated consumption, in particular for the wealthiest households.

Table 5: Propensity to save out of income by quintiles of disposable income: Italy, 1989-2012

Income category	1989	1991	1993	1995	1998	2000	2002	2004	2006	2008	2010	2012
Total	0,28	0,30	0,28	0,23	0,29	0,28	0,27	0,26	0,27	0,27	0,24	0,20
I°	0,08	0,13	0,19	0,19	0,17	0,08	0,12	0,10	0,11	0,10	0,14	0,27
II°	0,15	0,17	0,08	0,05	0,12	0,12	0,10	0,08	0,08	0,09	0,10	0,04
III°	0,19	0,25	0,19	0,12	0,19	0,20	0,21	0,16	0,18	0,18	0,17	0,12
IV°	0,28	0,30	0,30	0,23	0,30	0,27	0,27	0,24	0,25	0,27	0,25	0,21
V°	0,38	0,39	0,42	0,38	0,43	0,41	0,40	0,41	0,41	0,42	0,36	0,33

Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Figure 21: Propensity to save out of net disposable income by income percentiles, Italy, 1989-2012 (in per cent)



Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Before analysing wealth effects on consumption, it is useful to provide an overview on the composition, level and distribution of net worth. Cannari and D'Alessio (2006) calculate that in the mid-2000s the ten richest individuals held an amount of wealth equal to that as held by three millions poorest Italians. Based on data drawn by the Survey on Households Income and Wealth from the Bank of Italy, we find that households' medium net wealth value was 59,909 € in 1991, 95,545 € in 2000, 158,275 € in 2008 and 149,500 € at the end of 2012.

Wealth is much more concentrated then income. The Gini coefficient computed on households' average net wealth fluctuated on average at around 67 per cent (table 6)[10]. As

[10] See note 6 .

can be seen, there is a high increase in inequality during the 1990s and a slight slowdown up to the mid-end of the 2000s when the financial crisis caused it to trend upwards again. The richest ten per cent of households held 47 per cent of total wealth in 2012 (44% in 2008 and 41% in 1991). Net wealth of the poorest ten per cent was negative. Interestingly, the ratio between the poorest 10 percent and the bottom 50 percent, after a downward trend during the 2000s, grew again during the crisis and reached its peak in 2012 (5.7%).

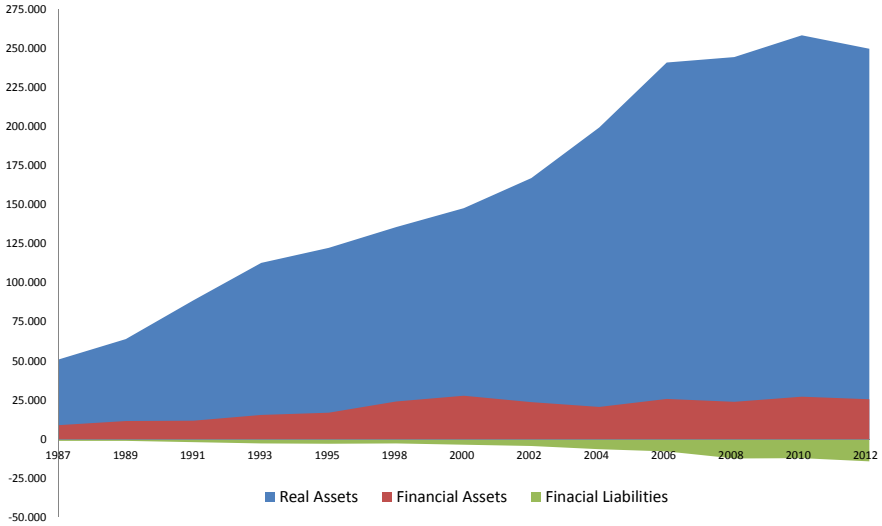
Table 6: Inequality in Italy, 1987-2012

	1987	1989	1991	1993	1995	1998	2000	2002	2004	2006	2008	2010	2012
Gini coefficient	0,68	0,64	0,64	0,68	0,66	0,68	0,68	0,67	0,65	0,67	0,66	0,67	0,69
The richest 10 percent	0,45	0,43	0,41	0,45	0,44	0,48	0,48	0,46	0,44	0,46	0,44	0,46	0,47
The poorest 10 percent	-0,0015	-0,0002	0,0007	-0,0006	-0,0001	-0,0002	-0,0001	-0,0003	-0,0003	-0,0003	-0,0007	-0,0008	-0,0023
The richest 10 percent to least well-off 50 percent ratio	5,04	3,97	3,99	5,40	4,69	5,27	5,03	4,79	4,30	4,73	4,35	4,86	5,70

Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Figure 22 shows how most of the net wealth of Italian households is represented by real assets. At the end of 2012 real assets accounted more than 90 per cent of net wealth, of which around 85 per cent was represented by real estate (buildings and land).

Figure 22: **Households' average net wealth and its composition, Italy, 1987-2012 (in euro).**

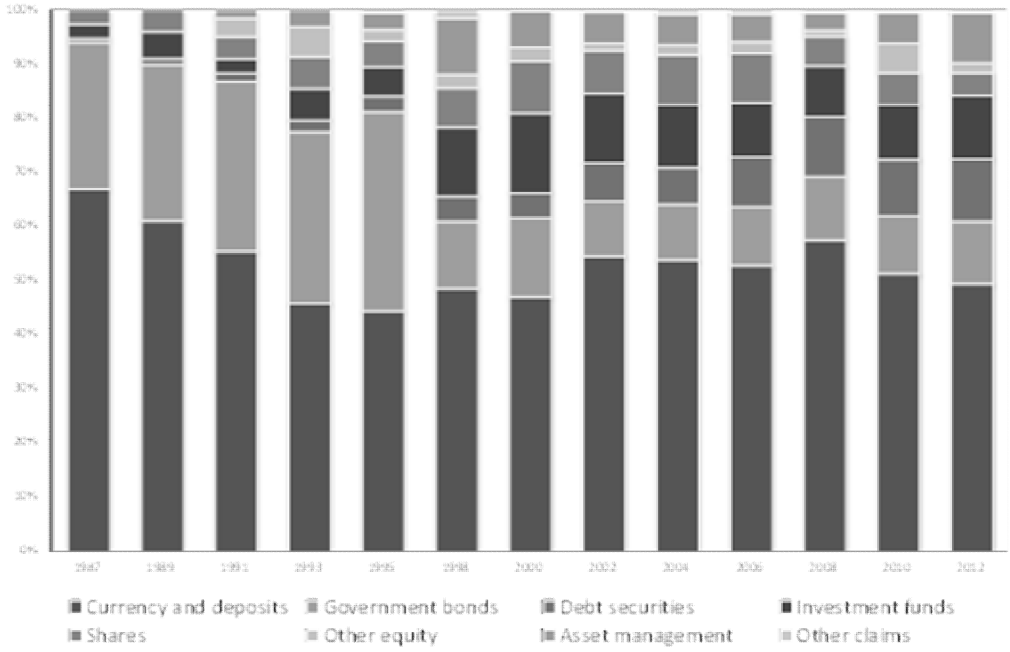


Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Figure 23 shows the composition of financial assets of Italian households and its changes over the period 1987-2012. The share held in currency and deposits, though the most

important form of wealth, sharply decreased during the nineties and reached the a bottom in 2000 (47%). It displayed a strong recovery up to 2008 (57%) in conjunction with the financial crisis, and then it decreased again thereafter. Government bonds were the second most important form of financial wealth up to the mid-nineties, form which we observe a sudden reverse tendency. At the end of 2012, government bonds accounted for 11 per cent of total financial wealth, 26 percentage points fewer than the peak reached in 1995. On the contrary, debt securities increased greatly shifting from 1 per cent in 1987, to 12 per cent in 2012. The share held in investment funds significantly increased up to 2000 when the dot-com bubble burst, and it decreased up to the beginning of the last financial crisis when its trend reversed again. The weight of wealth in shares rose during the 1990s reaching the peak in 2000; since then it has shown a constant decreasing trend. Asset management data indicates an astonishing growth up to 1998 and a strong decrease until the end of 2010. In 2012, the proportion of financial assets under management shows almost the same level as seen in the late nineties.

Figure 23: Breakdown of Households financial assets, Italy, 1987-2012.



Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

In table 7, we provide evidence on wealth concentration at the top of the income distribution. Households in the top income quintile (Panel 1) hold a very large share of both assets and liabilities; concentration has increased over the observation period and it has affected assets mostly. At the end of 2012, households in the top income quintile held 50 percent of real assets and 60 percent of financial assets, of which almost 80 percent were risky assets, such as equity. This picture highlights that, although during the last twenty years the propensity of Italian households to invest in financial assets has substantially

increased, most of the financial assets are still concentrated at the top of the income distribution.

Table 7: Share of assets and liabilities held by households in the top (Panel 1) and bottom quintile (Panel 2) on the income distribution, Italy 1987-2012.

	PANEL 1												
	1987	1989	1991	1993	1995	1998	2000	2002	2004	2006	2008	2010	2012
Real Assets	0,49	0,44	0,44	0,48	0,46	0,48	0,50	0,47	0,48	0,48	0,49	0,51	0,50
Financial Assets	0,49	0,45	0,46	0,49	0,50	0,52	0,50	0,48	0,48	0,52	0,56	0,58	0,60
Deposits cashable assets	0,45	0,37	0,39	0,38	0,38	0,35	0,34	0,39	0,36	0,44	0,48	0,44	0,46
Governments bonds and bills	0,53	0,49	0,47	0,51	0,54	0,50	0,54	0,55	0,51	0,50	0,48	0,57	0,67
Other securities (corporate bonds, stocks, mutual funds, foreign stocks and bonds,etc..)	0,69	0,75	0,74	0,70	0,71	0,74	0,69	0,60	0,65	0,63	0,73	0,78	0,77
Total liabilities	0,42	0,42	0,47	0,48	0,46	0,49	0,57	0,44	0,45	0,47	0,47	0,49	0,46
	PANEL 2												
	1987	1989	1991	1993	1995	1998	2000	2002	2004	2006	2008	2010	2012
Real Assets	0,07	0,07	0,05	0,05	0,07	0,06	0,06	0,06	0,05	0,05	0,04	0,04	0,06
Financial Assets	0,06	0,06	0,06	0,06	0,04	0,06	0,07	0,08	0,06	0,04	0,03	0,03	0,03
Deposits cashable assets	0,05	0,07	0,08	0,11	0,06	0,09	0,12	0,12	0,09	0,06	0,04	0,06	0,05
Governments bonds and bills	0,10	0,04	0,03	0,03	0,03	0,06	0,03	0,02	0,04	0,02	0,02	0,01	0,02
Other securities (corporate bonds, stocks,	0,01	0,02	0,03	0,01	0,01	0,02	0,02	0,02	0,01	0,01	0,00	0,01	0,01
Total liabilities	0,03	0,02	0,02	0,04	0,03	0,03	0,02	0,03	0,03	0,03	0,03	0,03	0,06

Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Looking at the growth of households' net wealth, table 8 shows the ratio of wealth to disposable income. For the sample as a whole, the ratio increased from 4.41 in 1989 to 8.37 in 2012. The growth has affected every income group with the most pronounced impact falling upon the households at the income distribution tails. As regards the bottom of the income distribution (first quintile), the net wealth rose from 3.85 in 1989 to more than 9 times income in 2012, whereas the top quintile increased from 4.75 in 1989 to 9.2 times income over the same period.

Table 8: Net worth-income ratio by quintiles of disposable income, Italy, 1989-2012

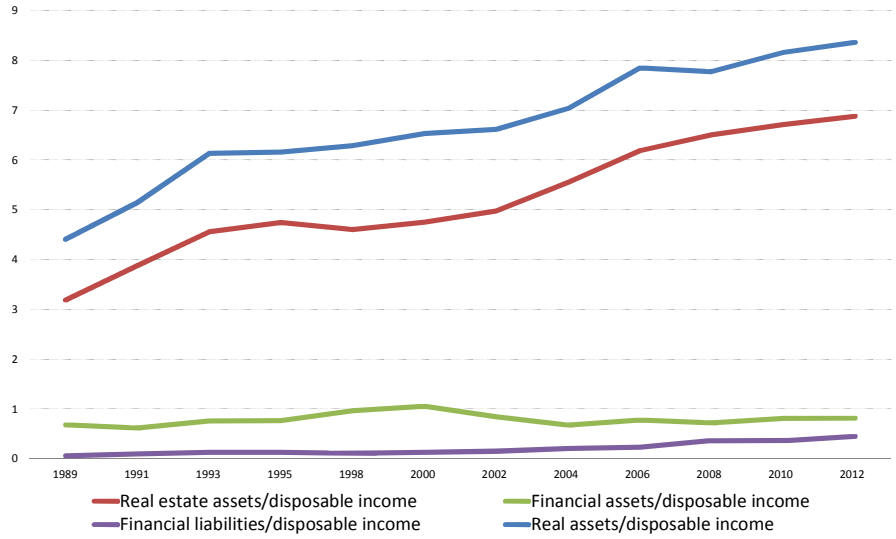
Income category	1989	1991	1993	1995	1998	2000	2002	2004	2006	2008	2010	2012
Total	**4,41**	**5,15**	**6,13**	**6,16**	**6,29**	**6,53**	**6,62**	**7,04**	**7,85**	**7,77**	**8,16**	**8,37**
I°	3,85	3,86	5,91	5,98	7,09	6,39	8,38	5,74	6,16	4,67	5,08	9,19
II°	3,62	4,44	5,07	5,12	5,12	5,17	5,47	5,75	6,12	6,28	6,09	6,04
III°	4,20	4,81	5,42	5,63	5,59	5,43	5,99	6,47	7,19	7,06	6,99	7,28
IV°	4,07	4,83	5,09	5,53	5,47	5,65	6,08	6,94	7,07	7,06	7,31	7,35
V°	4,75	5,64	6,86	6,73	6,77	7,36	7,28	7,69	9,33	9,02	9,44	9,17

Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

As can be seen in figure 24, the growth in the household worth to income ratio was mainly driven by the sharp increase of real assets, particularly by real estate assets which as is evident above, account for about 85 per cent of total assets. In contrast, households financial assets, after the peak reached in 2000 (1.1), recorded a heavy decline during the dot-com crisis in line with the fall of stock market prices. The financial assets to disposable

income ratio shows an upward trend starting from 2004 and then a slight increase after the onset of the financial crisis.

Figure 24: Households worth to disposable income ratio by different types of wealth, Italy, 1989-2012

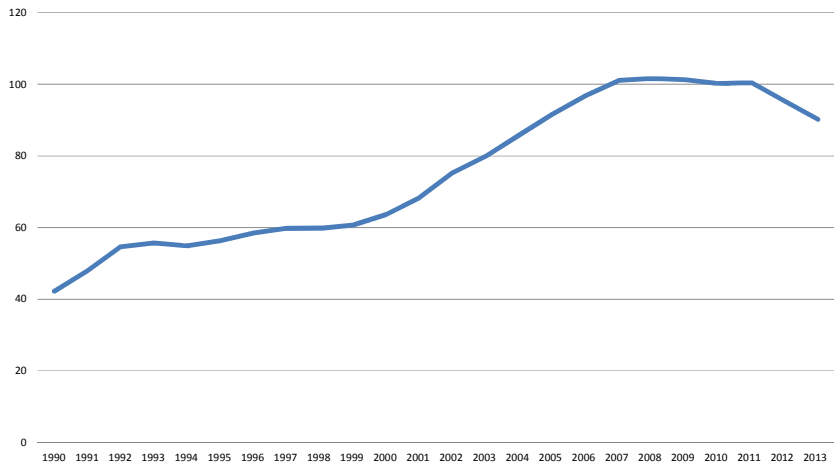


Source: Survey on Households Income and Wealth, Historical Database, Bank of Italy (2014); author's calculation

Two driving factors that explain the rise in the ratio between real wealth and disposable income, especially for households at the bottom of the income distribution, are the increase in the rates of homeownership[11] and the appreciation of the housing stock (figure 25). However, for households at the top of the income distribution increases in stock market prices also contributed significantly.

[11] Between 1980 and 2010 the share of households that owned their homes grew by about 10 per cent (Bank of Italy, Supplements to the Statistical Bulletin, 2011)

Figure 25: Residential property prices, Italy 1990-2013 (Index 2010=100) (values end of the year)



Source: National sources, BIS Residential Property Price database (2014)

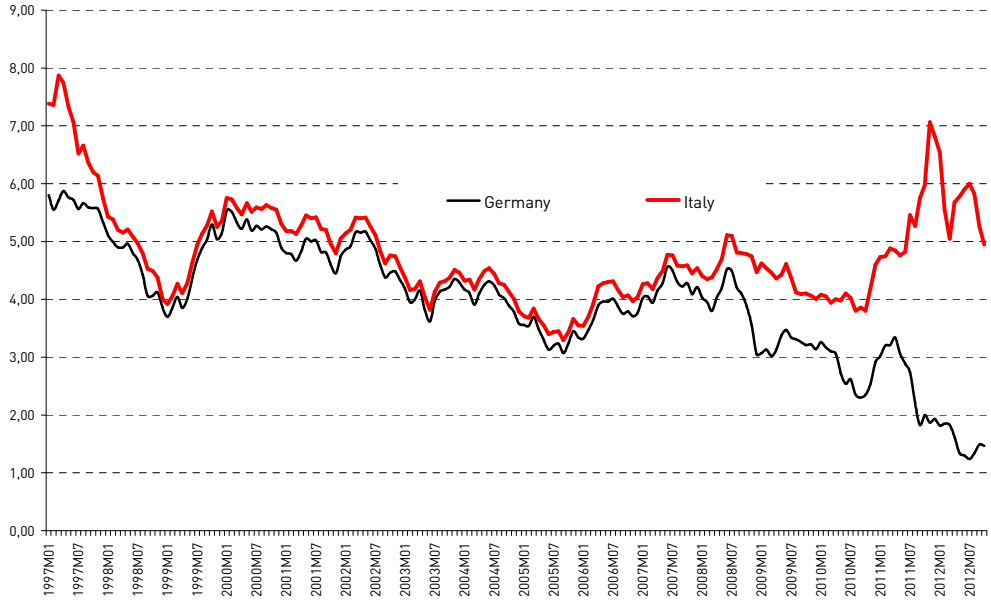
The issue of wealth effects on consumer behavior has been widely analysed in the economic literature since the late 1980s. The relationship between wealth and consumer spending appears to be strong although its magnitude differs a lot across countries (Paiella, 2009, Boone and Giraud, 2002). Many empirical studies have investigated whether there are differences when financial and housing wealth effects are separately estimated. Case et al. (2005) found a larger effect of housing wealth upon household spending than changes in stock market prices in the U.S. and other developed countries. In their analysis on Canada, Finland, and Italy, Sierminska and Takhtamanova (2007) found that the overall wealth effect from housing is stronger than the effect from financial wealth. Contrastingly, the results concerning eleven OECD countries (De Bonis-Silvestrini , 2011) confirm that both financial and real wealth have a positive effect on consumption but the magnitude of the former is larger than that of real wealth. Several recent studies on Italy have focused on differences between propensities to consume out relating to both real and financial wealth. Paiella (2004) finds that financial wealth effects are small, although close to those compared to the U.S. and other developed countries, and that the marginal propensity to consume out of real wealth is very low also. Guiso, Paiella, and Visco (2005) estimate that on average, an increase of one euro in housing wealth translates to an increase of consumption of around 2 cents, while the substitution effect rules over the income effect when capital gains on financial assets occur. According to the analysis by Grant and Peltonen (2008), the marginal propensity to consume out of real wealth is 8 per cent and statistically significant, while wealth effects are much lower. In their empirical analysis on the effect of a change in real estate wealth on household spending, Calcagno et al. (2009) find that, consumption rises with increases in houses prices for both homeowners and renters.

According to a study by Bottazzi et al. (2013) that focuses on the last financial crisis, one of the most important drivers explaining the drop in consumption was the decrease in financial wealth. Moreover, they estimated that the impact of one euro change in housing wealth fluctuated between 0.2 and 0.4 in non-durable spending.
As suggested by Paiella (2004), one way to look at the possible influence of wealth accumulation on consumption is by a joined interpretation of the wealth to disposable income ratio along with the saving rate. As we have seen above (table 8), the net worth to disposable income ratio shifted from 4.4 in 1989 to 8.4 in 2012, and the increase affected all income groups. Over the same time period the saving rate dropped by 8 percentage points (table 5). However, in contrast with the results of Maki and Palumbo (2001) for the U.S., according to which the entire decline observed in the aggregate saving rate could be attributed to a change in the propensity to save among households in the top of income distribution, in Italy the wealthiest share of the population continued to both save at a high rate and to heavily invest in stocks. In addition, data on assets and liabilities concentration (table 5) confirm what we have said about the main drivers of the increase in the worth to income ratio, i.e. real assets for households in the bottom of the income distribution, financial assets, as well as real assets, for households in the top of distribution.
The available data do not confirm the hypothesis of relevant wealth effects, even though the average propensity to save declined before the crisis. The low wealth effects most likely depend on the increased unequal distribution of real and financial wealth, on the one hand, and on the high diffusion of real estate ownership in term of first home on the other.

4. Financialisation and the current account

The current account balance provides an indication about the level of international trade and competitiveness of a country. Usually, countries recording a strong current account surplus have an economy that is heavily dependent on export revenues, with high saving rates and weak domestic demand. On the other hand, countries recording a current account deficit have strong imports, a low saving rate, and high personal consumption rates as a percentage of disposable incomes. Historically from 1980 until 2011, the Italian Current Account to GDP averaged -0.6 percent. Partly as a consequence of the liberalisation of financial movements, in the early 1990s, and the consequent devaluation within the European Exchange Rate Mechanism, the current account balance became positive between 1993 and 2002, reaching a peak of 3.1 percent in 1996. After the introduction of the euro, the financial markets assessed sovereign risk and the risk of bank failures as extremely low, as they did not believe that the no-bail out clause would be enforced. As a consequence of this, interest rates on government securities of euro countries initially converged to the level of Germany (Figure 26) and increasing current account deficits were financed by massive capital inflows, especially from Germany, leading to a strong external debt burden.

Figure 26: Euro Convergence Bond Yields (nominal rates; 1997-2012).



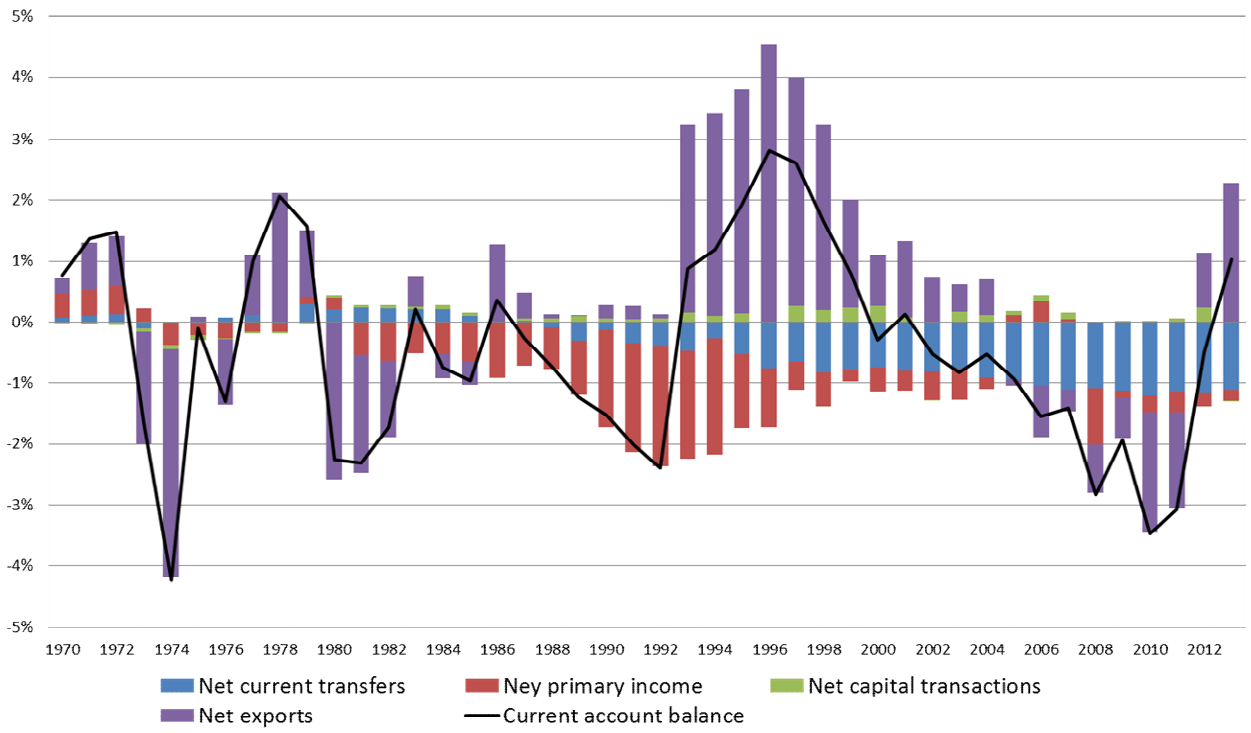
Source: Eurostat (2012), Statistics Database

The relative neutral contribution to growth played by the current account in the long run allows us to categorise Italy as a consumer led country. Nevertheless, the pattern of external balances has been affected by financialisation during the last three decades before the crisis.

In the period from the 1960s up until the mid-1980s, Italy's current account balance fluctuated within a range of -4 to +2 basis points (bps) of GDP, giving rise to 9 cycles over 25 years (figure 27). This is consistent with the analysis by Ahearne, Schmitz, and Von Hagen (2007) who categorise three groups of European countries: those who are structurally in surplus (Germany, Finland, Netherlands, Luxembourg), those which have consistently run current account deficits (Greece, Portugal, Spain and Ireland) and, finally, a third group which basically experienced a balanced current account, at least during the last decade before the crisis (Austria, Belgium, France and Italy). For France and Italy, Ahearne, Schmitz, and Von Hagen (2007) also find that the persistence of the trade balance is significantly weaker after the start of EMU.

The role of the current account in a fixed currency zone is a matter of debate among economists. This aspect has rarely been considered in both the Maastricht convergence criteria and in the Commission's assessments of individual members performance; the European Central Bank has worried less about current account imbalances and net foreign positions than about the deterioration of some countries' competitiveness. The literature provides sound explanation for this attitude. According to Ingram (1973, p.13) *"the traditional concept of a deficit or a surplus in a member nation's balance of payments becomes blurred"*.

Figure 27: Current account, Italy, 1960 – 2013 (per cent of GDP).



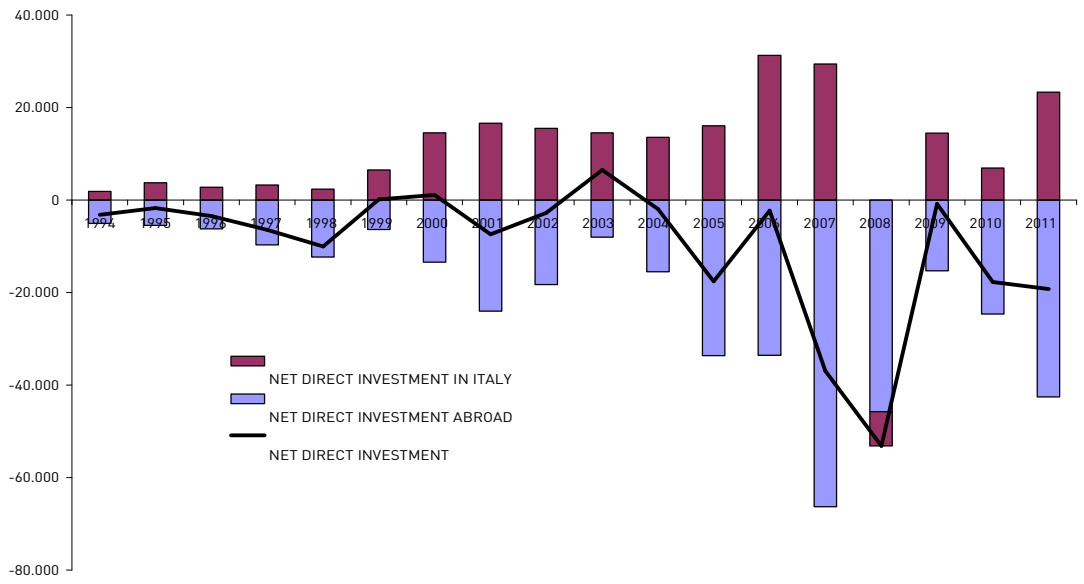
Source: Bank of Italy (2012, 2014); Istat (2014)

After the liberalisation of financial movements, net assets became more and more negative, with an increasing component of liabilities and other sectors' assets, along with the central bank. This process was accompanied through the period 1985-2000 with an increasing current account deficit.

During the last two decades net direct investments (FDIs) recorded a stable increase until 2006 when they reached the peak (figure 28). In 2008 FDIs were affected by the financial crisis, with a strong impact on their contribution to economic growth and reducing access to credit. The net inflows of direct investments (new investments net of dis-investments) towards Italy dramatically fell from 29.4 billion in 2007 to a negative value in 2008. The impact of banking M&As completed after the beginning of the crisis (above all, the acquisition of Banca Antonveneta from Banco Santander by Monte dei Paschi di Siena for about 10 bn €) and with the negative trend of banking branches due to technological innovation, noticeably affected the FDIs balance and, more importantly, bank resilience after the liquidity and capital collapse.

Inversely, net Italian investment abroad was basically stable until 2006. After a peak in 2007, it recorded a decreasing path until 2009. Between 2010 and 2011 it grew again but it was still significantly low with respect to the 45.8 billion of euros seen in 2008.

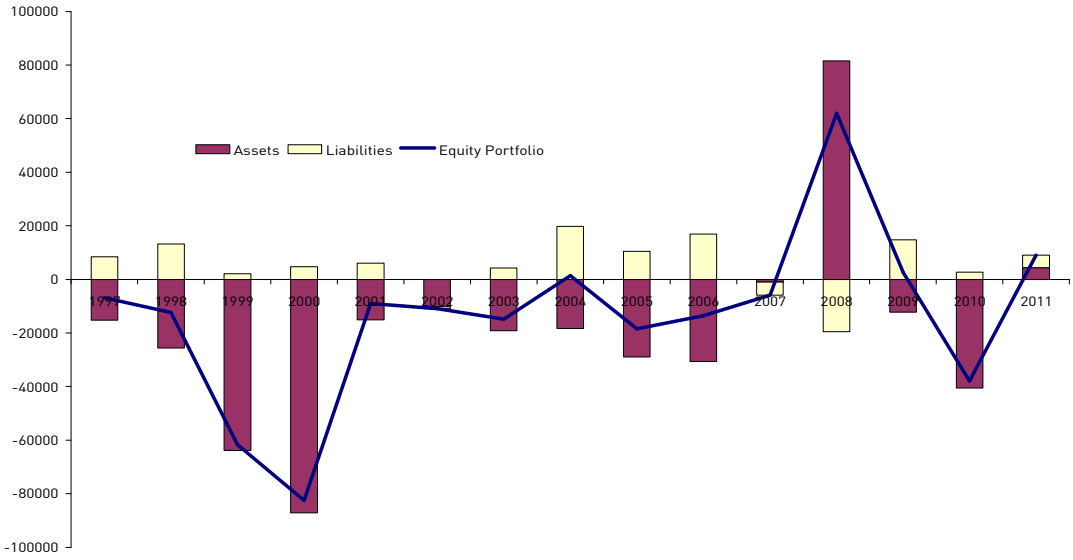
Figure 28 – Net Foreign Direct Investment (millions of euros) (1994-2011)



Source: Eurostat (2012), Statistics Database

When looking at equity investments (figure 29) we observe that at the end of the 1990s purchases of foreign equities grew strongly; residents bought an extremely large volume of foreign equities in 1999 reaching a peak in 2000. This was essentially affected by the hi-tech bubble which was driven by institutional investors advisory and mutual funds investment decisions. When international equity market capitalisations started to decline (in the second part of 2000), equity investments began to scale down, and growing uncertainty about the timing of the world economic recovery caused them to suffer further reductions in the following years. A first "flight to quality" process was observed during the period 2001 – 2003, with a significant switch to liquidity and real estate assets. The financial crisis in 2008 set off a second category of "flight to quality", boosting investors' demand for the government securities of the major countries and leading to the repatriation of capital invested abroad in riskier assets. This last factor led to an exceptionally large capital inflow of about 81 billion of Euros in 2008 relative to the equity portfolio. The preference for relatively low-risk securities that had characterised capital movements in 2008 and the first half of 2009, gave way to a renewed appetite for risk on the part of Italian investors. The worsening of the sovereign debt crisis in the middle of 2011 had a major effect on developments in the second half of the year. Italian households and firms restarted to sell foreign equities. For the first time since the 2008 financial crisis, Italians made net disposals of foreign portfolio assets; these amounted to €35.8 billion, of which equity portfolios accounted for about 4 billion euros.

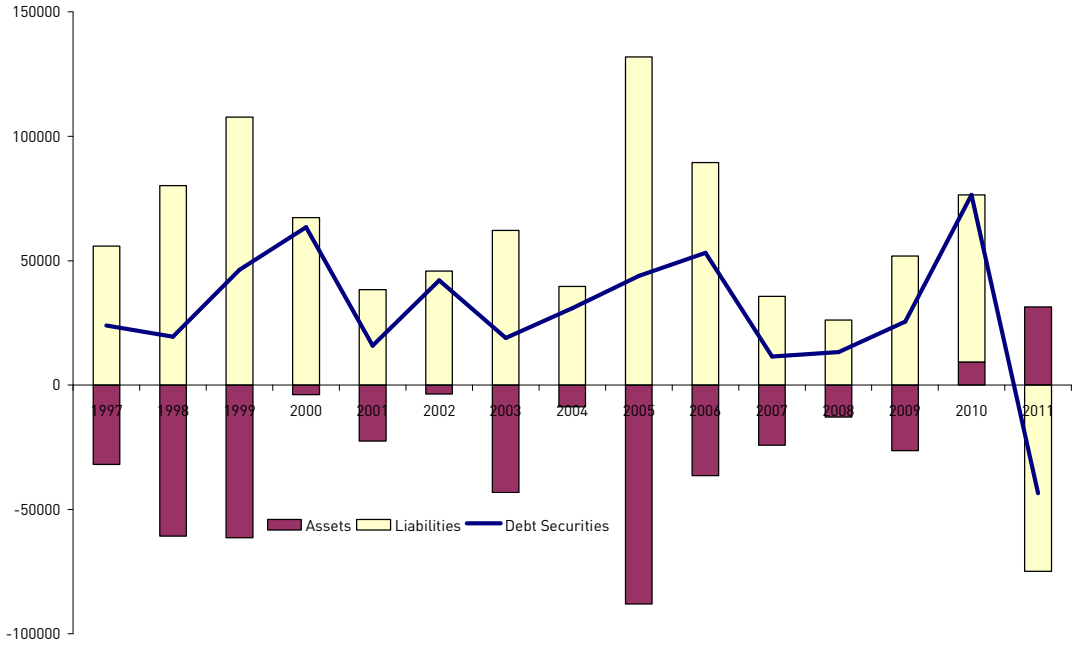
Figure 29: Equity Portfolio Investment (millions of euros) Italy, 1997-2011.



Source: Bank of Italy (2012), Statistical Database (*BDS*)

The dynamics of debt securities within the current account have always recorded positive values, with foreign investors attracted by Italian government bonds for their relatively higher return (much less than after the credit spread experienced after 2010) than sovereign bonds issued by other euro partners. After a significant reduction in the amount of new Italian debt securities bought by foreigners recorded between 2006 and 2008, a massive net purchase of medium- and long-term debt securities (almost all of them consisting of other types of public securities) totalling 67 billion in 2010 can be seen from 2009, a sign of the firming up of confidence in Italian government securities after the lows of 2008 (figure 30). However, the strength of the sovereign debt crisis has affected foreign confidence towards Italy; in the second half of 2011, when the credit spread paid by 10-year government bonds reached 575 bps, non-residents significantly reduced their holdings, especially of medium and long-term public debt securities. In the year as a whole non-residents made net sales of 74.8 billion Euros of debt securities issued in Italy.

Figure 30: Debt Securities Investment (millions of euros) Italy, 1997-2011.

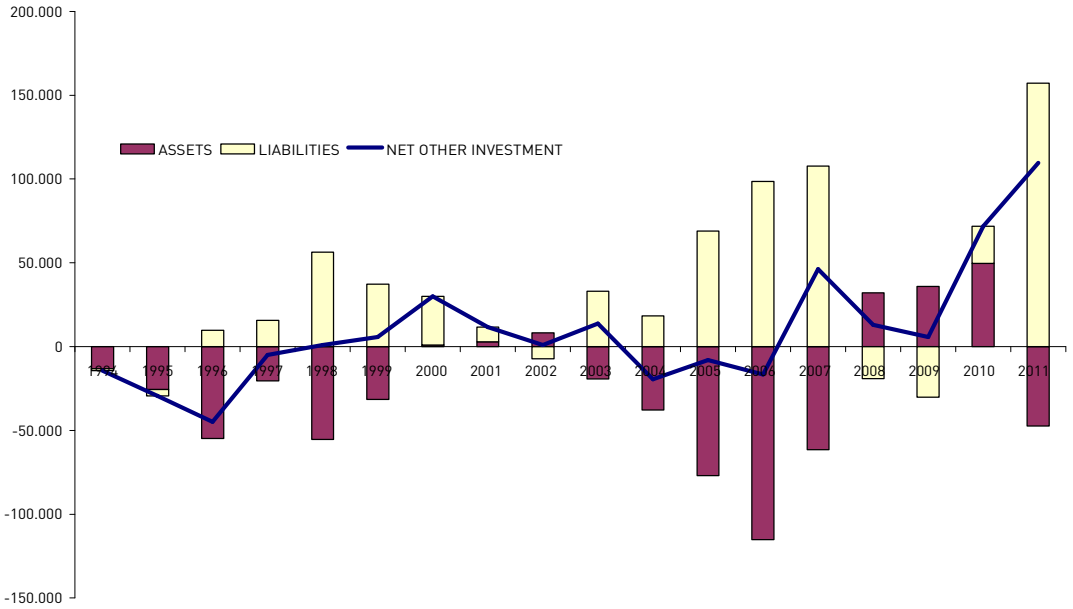


Source: Bank of Italy (2012), Statistical Database (*BDS*)

On the opposite side, the other investment component of the current account (which covers trade credits, loans, deposits and other accounts receivable and payable), experienced positive changes after the crisis, essentially due to the European Central Bank decision to underwrite countries' liabilities and sustain the liquidity crisis as a lender of last resort (figure 31).

This item recorded a net inflow of 46 billion Euros in 2007; the result is very meaningful if compared with the three previous years in which Italy was a net borrower abroad. After the sharp decline recorded in 2008 and 2009, there were signs of a return to higher levels in 2010 with a net inflow of 71 billion euro. In 2011, in contrast to the net outflows concerning debt securities, "other investments" recorded net inflows of about 109 billion euros, most of which was due to the Bank of Italy in relation to the TARGET2 balance.

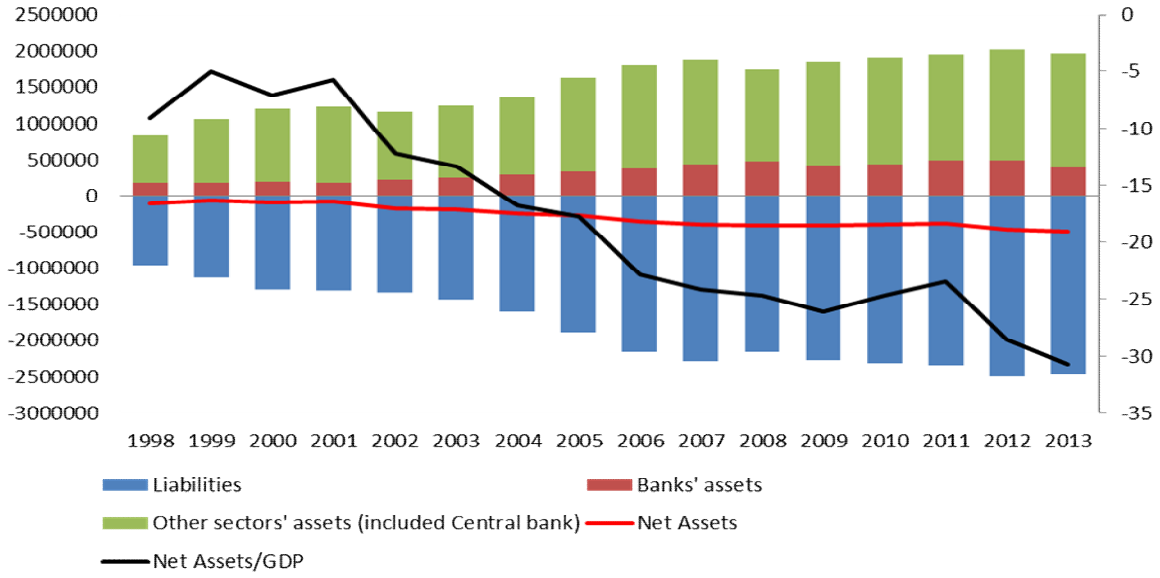
Figure 31: Net Other Investment (millions of euros) Italy, 1994-2011.



Source: Eurostat (2012), Statistics Database

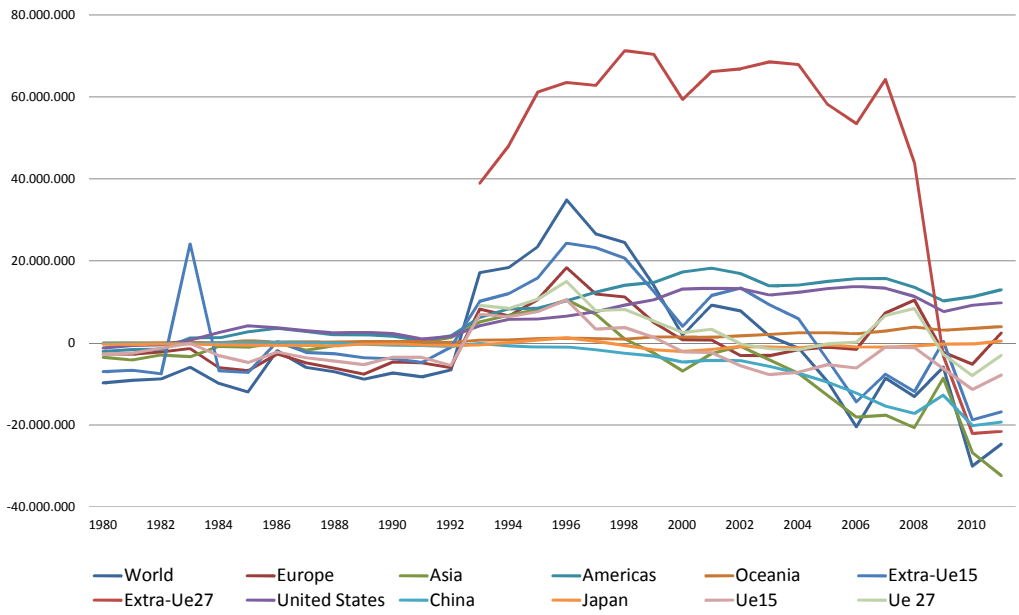
On balance, the net investment position declined from a surplus observed up until 2003 to a deficit which has been confirmed during the crisis (figure 32).

Figure 32: International investment position, Italy, 1998 – 2013 (billion euro, per cent of GDP)



Source: Bank of Italy (2014), Statistical Database (*BDS*)

Figure 33: Trade balance with other regions and countries, Italy, 1980 – 2011 (thousand euro)



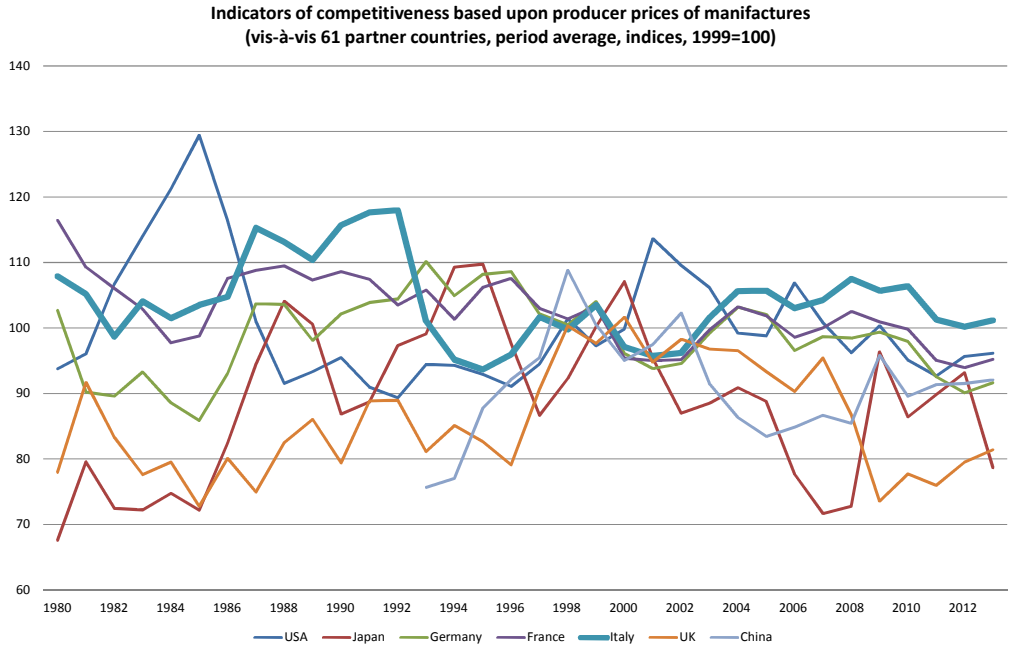
Source: Istat (2014), Serie Storiche, Archivio della Statistica Italiana

Up to the onset of the financial crisis, Italy experienced a significant trade balance surplus within European markets. This dramatically declined in 2008 to become a negative component of the current account (figure 33). Only exports to American partners have increased over the long run, and this was even seen during the crisis. The weakening of consumption has affected foreign aggregate demand, decoupling the impact on real Italian growth.

During the 1980s price competitiveness (figure 34) increased significantly mainly thanks to the currency policy which was aimed at devaluating the Italian lira against trade partners.

With the exchange rate fixed, Italy constantly gained in price competitiveness against other Euro area countries until 2008. Price competitiveness has remained at that level since then, even though the country did not benefit with a relevant increase of the current account.

Figure 34: Indicator of price competitiveness of the Italian economy against selected countries, based on the deflators of total sales, 1980 – 2013 (Index, March 1999 = 100)



Source: Bank of Italy (2014), Statistical Database (*BDS*)

On balance, our analysis shows that the liberalisation of financial movements affected the current account more than real trade. With the openness of financial opportunities, particularly government issuances, investors suddenly realised that the pattern followed by some countries in the last decade, with growth driven by domestic demand and financed with foreign borrowing like Italy was unsustainable, and that the heavy imbalances which had accumulated were not the unavoidable outcome of healthy convergence processes but signaled the existence of solvency problems. To quote Ingram (1973) once more, under a single currency "the nation's entire stock of financial assets becomes a kind of external reserve asset" pledged against the foreign debt..

III. Financialisation and the economic and financial crises, as the crisis of finance-dominated capitalism

1. The transmission of the crisis to Italy

The impact of the financial crisis on Italian growth has been the most strong among all the Euro Area countries, apart from Greece (Table 9). Averaging the GDP rates from 2008 to 2014 (with the OECD expected value), the Italian decline can be estimated at -1.2% yearly, while Spain, Portugal and Ireland recorded a GDP decay of about -0.7 - 0.8% per year, and the Euro Area -0,1%.

This was mainly due to the fact that within a private consumer-led economy, Italy suffered with a collapse of real incomes with the worsening of their distribution among the weakest components of the social structure (see Section II.2).

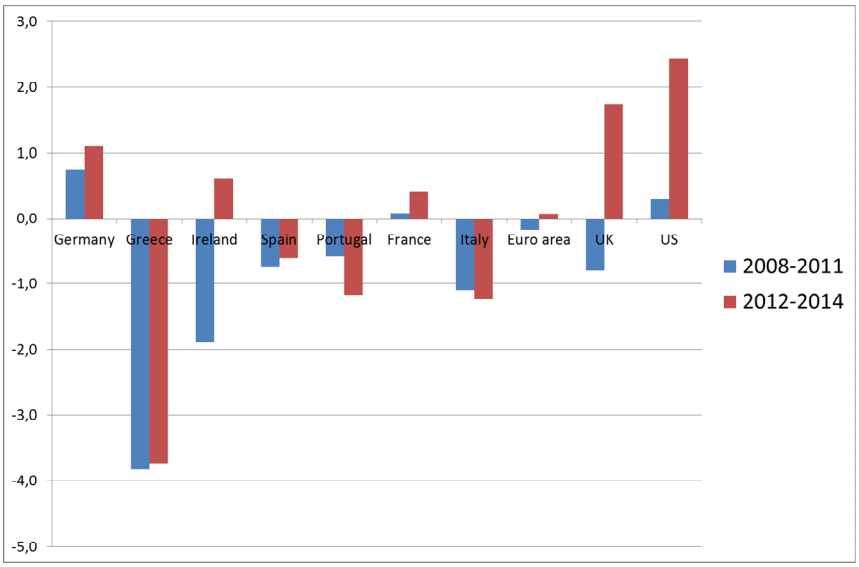
Table 9: Real GDP growth, 2008 – 2014 (per cent)

Country	2008	2009	2010	2011	2012	2013	2014	Average
Germany	0.8	-5.1	3.9	3.4	0.9	0.5	1.9	0.9
Greece	-0.2	-3.1	-4.9	-7.1	-7	-3.9	-0.3	-3.8
Ireland	-2.2	-6.4	-1.1	2.2	0.2	-0.3	1.9	-0.8
Spain	0.9	-3.8	-0.2	0.1	-1.6	-1.2	1	-0.7
Portugal	0	-2.9	1.9	-1.3	-3.2	-1.4	1.1	-0.8
France	-0.2	-3.1	1.6	2	0	0.3	0.9	0.2
Italy	**-1.2**	**-5.5**	**1.7**	**0.6**	**-2.4**	**-1.8**	**0.5**	**-1.2**
Euro area	0.2	-4.4	1.9	1.6	-0.6	-0.4	1.2	-0.1
UK	-0.8	-5.2	1.7	1.1	0.3	1.7	3.2	0.3
US	-0.3	-2.8	2.5	1.8	2.8	1.9	2.6	1.2

Note: * Forecast by the OECD
Source: OECD (2014)

If we split the crisis period into two sub-phases, from 2008 to 2011 to catch the impact of the international financial crisis on the real growth, and from 2012 to 2014 to estimate the reaction to the Euro crisis (figure 35) we observe that only Italy (and Portugal) experienced a decline more significant in the second period than in the first phase of the crisis.

Figure 36: GDP yearly change in two sub-periods (2008-2011 and 2012-2014)



Note: * Forecast by the OECD
Source: OECD (2014) and our elaborations

Along with the consumer collapse, Italy recorded a drop of private and public investments, due to the credit crunch that originated in the banking sector for non-financial companies and in the capital markets for the government respectively. Moreover, the first phase was exacerbated by the collapse of exports partly compensated with social interventions to ease the labour cost for firms, while the 2011-2012 recession appears to be more explained by domestic factors and a lack of injection of resources in the public sector according to Italian Government policy,. The consumption collapse was accompanied by the significant increase of the unemployment rate (table 10).

Table 10: Unemployment rate, 2008 – 2014 (per cent of labour force)

Country	2008	2009	2010	2011	2012	2013	2014*	Average
Germany	7.5	7.8	7.1	6	5.5	5.3	5	6.3
Greece	7.7	9.5	12.5	17.7	24.2	27.3	27.1	18
Ireland	6	12	13.9	14.6	14.7	13	11.4	12.2
Spain	11.3	18	20.1	21.6	25	26.4	25.4	21.1
Portugal	7.6	9.5	10.8	12.7	15.6	16.3	15.1	12.5
France	7.1	8.8	8.9	8.8	9.4	9.9	9.9	9
Italy	**6.8**	**7.8**	**8.4**	**8.4**	**10.7**	**12.2**	**12.8**	**9.6**
Euro Area	7.5	9.4	10	10	11.2	11.9	11.7	10.2
UK	5.7	7.6	7.9	8.1	7.9	7.6	6.9	7.4
US	5.8	9.3	9.6	8.9	8.1	7.4	6.5	7.9

Note: * Forecast by the OECD
Source: OECD (2014)

The weakness of domestic demand has fostered a significant improvement in the external accounts (figure 36). Notwithstanding the worsening economic picture, budgetary policy

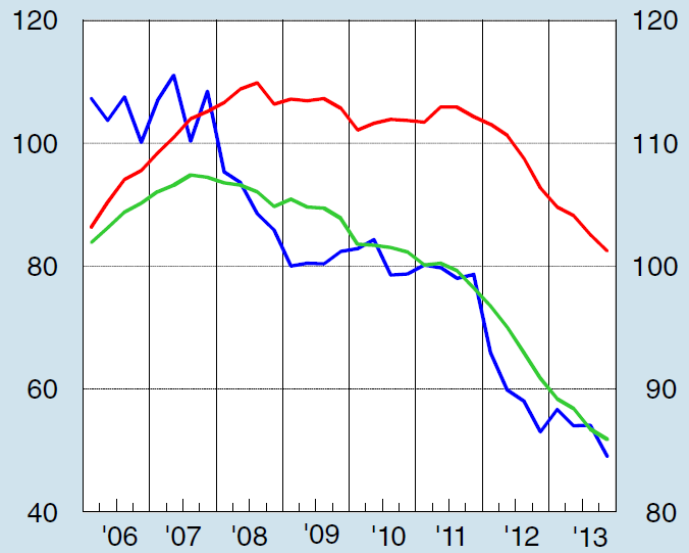
remains oriented towards fiscal discipline.

Figure 36: Consumption, disposable income and consumer confidence in Italy, 2006-2012 (percentage changes and indices).

Source: ISTAT (2013) and Bank of Italy (2013)
Notes (1) Chain-linked volumes; percentage changes in relation to the previous year. Annual data up to 2011; for 2012, percentage changes in the first half on the same period in 2011. (2) Obtained using the consumption deflator for resident households. (3) Monthly data, seasonally adjusted. Indices, 2005=100. (4) Monthly data; moving averages for the 3 months ending in the reference month

Real estate market prices have consequently experienced a decline in terms of nominal prices, real prices, and the number of sales (figure 37).

Figure 37: House prices and sales in Italy (nominal prices, in red, rhs; real prices, in green, rhs; number of sales, in blue, lhs; 2005 = 100)



Source: Bank of Italy (2014)

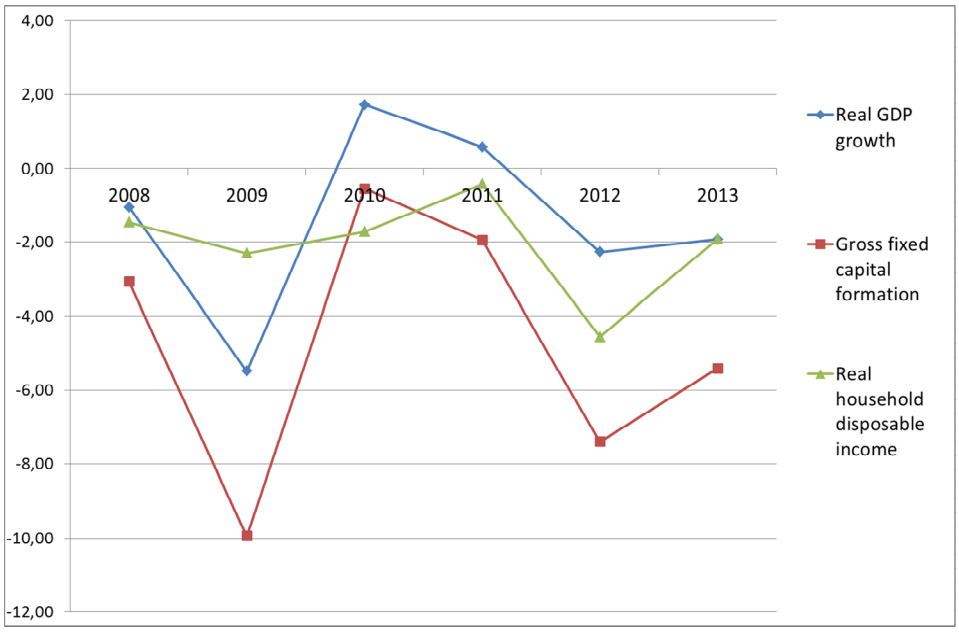
On balance, the pattern of real household disposable income (table 11) has dissolved during the post crisis period (-2.06% each year) with an inflation rate which has increased by 1.66% per year, confirming the high correlation between the real GDP dynamic and disposable income along with gross fixed capital formation (figure 38).

Table 11: Key macroeconomic variables, Italy, 2008 – 2013 (percentage change if not indicated otherwise)

	2008	2009	2010	2011	2012	2013
Real GDP growth	-1.15	-5.48	1.71	0.59	-2.37	-1.83
Gross fixed capital formation	-3.08	-9.94	-0.55	-1.94	-7.4	-5.41
Unit labour costs, total economy	3.89	4.39	-0.09	0.64	2.05	n.d.
Labour compensation per unit labour input, total economy	3.2	1.98	2.33	0.99	1.19	n.d.
Gross national income per capita (USD)	34614.15	33984.41	34311.3	35393.01	35027.1	35058.61
Real household disposable income	-1.46	-2.31	-1.72	-0.42	-4.55	-1.92
Household net saving rates	7.71	6.98	4.15	3.68	3.15	3.92
Unemployment rates: total	6.73	7.8	8.43	8.38	10.7	12.19
CPI: all items non-food non energy	2.21	1.51	1.64	1.96	1.55	1.08

Source: OECD (2014)

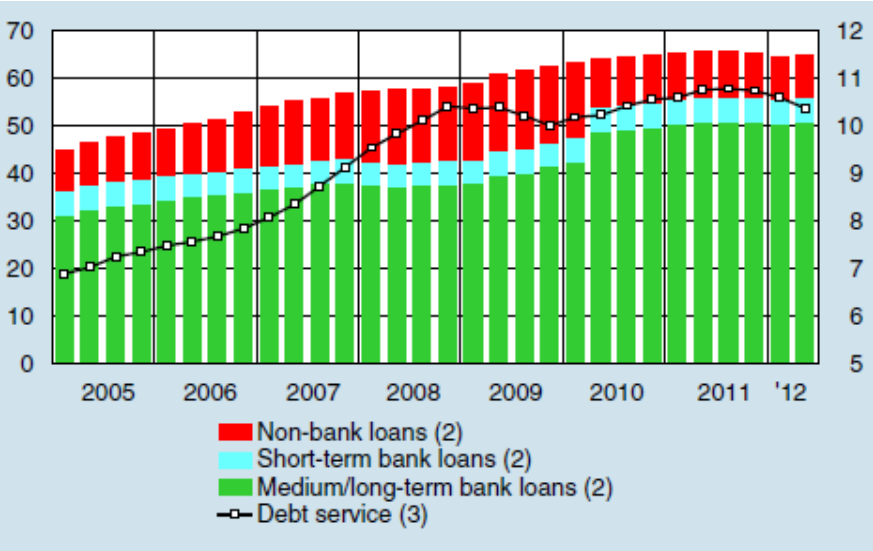
Figure 38: Real GDP, household disposable income, and gross fixed capital formation, Italy, 2008 - 2013 (yearly data)



Source: OECD (2014)

Diminished disposable income has affected the leverage of households, which has increased from 45% to 63% out of gross disposable income (figure 39).

Figure 39: Household debt (as a percentage of gross disposable income; End-of-quarter stocks and flows in the 12 months to the end of the quarter), Italy, 2005-2012



Source: Bank of Italy (2013)
Notes: (2) There is a break in statistics on the distribution between bank and non-bank loans for the second quarter of 2010. (3) Right-hand scale. Estimated cost of debt service (payment of interest and repayment of principal) for consumer households only.

The credit quality of banks' portfolios has worsened over the last few years and the asset quality review managed by the European supervisors has even increased the unexpected loss measure for most large Italian banks

2. The financial sector after the onset of the crisis

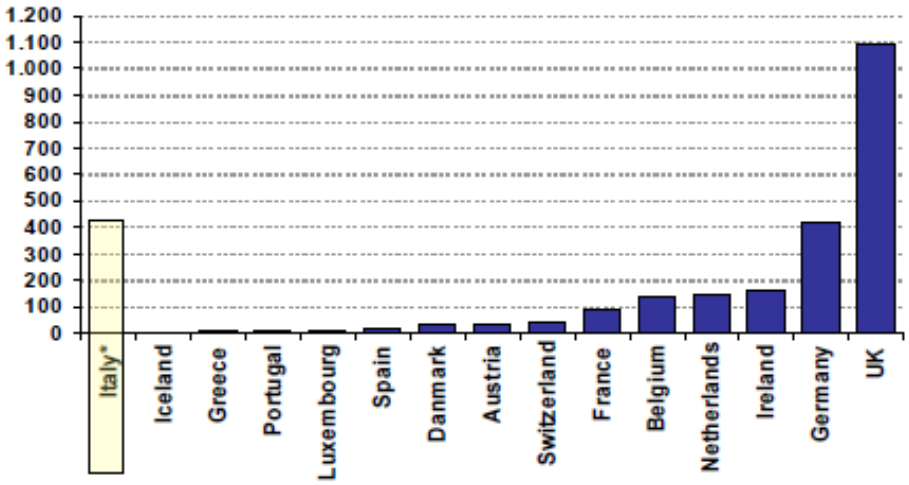
The causes of the crisis are many, and several observers have tried to rationalize them. We should seek to answer three separate questions: what started it?; what prolonged it?; and what made it so severe? Among the answers to the first question, we might list the following: 1) monetary excesses, particularly in the US, where the interest rates, during the early 2000s, were lower than expected if one applies the Taylor rules (Coibion and Gorodnichenko, 2012); 2) financial engineering, which created sophisticated and hard-to-track contracts (Pezzuto, 2008); 3) mispriced concentrated portfolios, which facilitated the risk assumption of financial intermediaries who were confident they could manage (or transfer) it; 4) rating procedures and model risk, particularly for securitisation tranches, driving underestimation of the probability of default (White, 2010).

In response to the second question (why did the crisis last so long?), the answers most frequently quoted are central bank policy-making, which treated the crisis as an illiquid situation and the interconnection of banking institutions, which led to a systemic crisis.

The intensity of the crisis was most likely strengthened by the uncertainty among bailout schemes, where in some cases both equity and bond holders were protected (Bear Sterns and, to some extent, AIG), in other cases only bond holders were protected (Fannie Mae and Freddie Mac), and where sometimes no-one was protected (Washington Mutual and

Lehman Brothers).
Italian banks were characterised by the absence of formal public interventions of bail outs after the crisis (figure 40). The only intervention (in convertible bonds and not equity) was in terms of Tier1 bond underwriting (called Tremonti bonds), that acted to re-capitalise banks.

Figure 40: State support to financial institutions (June 2007- June 2011; bln €)



Source: ECB annual report (2012)

The remedies to the crisis can be grouped into three different categories: natural response or self-regulation; market pressure; public regulation. The regulatory issue and the debate on what might be an optimal regulatory framework, is based on the idea that self and market regulations are scarcely effective - at least in reducing the likelihood of creating a new systemic risk within the financial system - and that behind all the causes explaining the crisis, a lack of effective regulation must be recognised.
In December 2009, the Basel Committee published a consultative document ("Strengthening the resilience of the banking sector") aimed at defining the guidelines of the new framework for a macro-prudential regulation, after the lessons learnt from the crisis.
According to most of the commentators, the regulatory regime before the crisis was focused on idiosyncratic risks - in other terms it was a micro-prudential regulation. In particular, the Committee stated that:

"one of the main reasons the economic and financial crisis became so severe was that the banking sectors of many countries had built up excessive on- and off-balance sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the re-intermediation of large off-balance sheet exposures that had built up in the shadow banking system. The crisis was further amplified by a procyclical

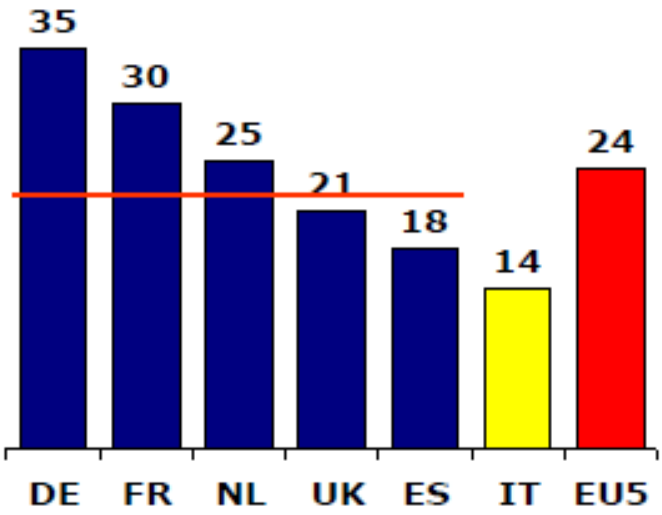
This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability." (Basel Committee, 2009, p.1, no. 4).

The impact for European banks appears to be impressive: according to the Quantitative Impact Study run by the Basel Committee, for the largest 45 European banks the impact of new capital regulation should require approximately 1.1. trillion euros; for the liquidity measures the cost can be estimated at 3.6 trillion euros.

The need to increase capital quality in Italy affected large banks particularly. The two largest banks (UniCredit Group and Intesa San Paolo) raised new Tier1 capital for 5 and 7.5 billion euros respectively. In terms of leverage risk, Italian banks appear to be less exposed than other European banks (figure 41).

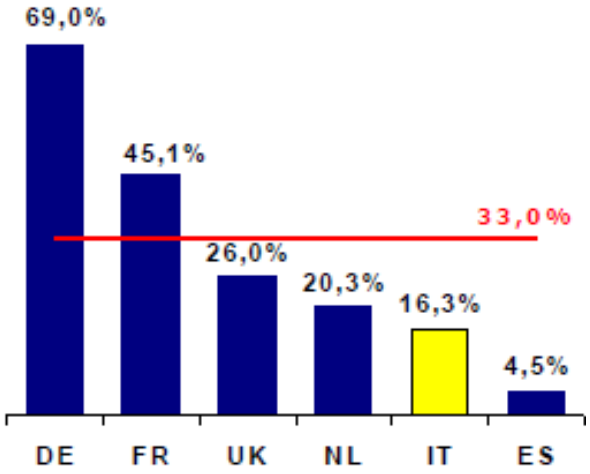
Figure 41: Leverage ratio of Italian banks compared with some European countries (assets to equity ratio, 2010)



Source: ECB annual report (2012)

Italian banks' propensity to trade in securities markets appears to be lower than other banking systems (figure 42).

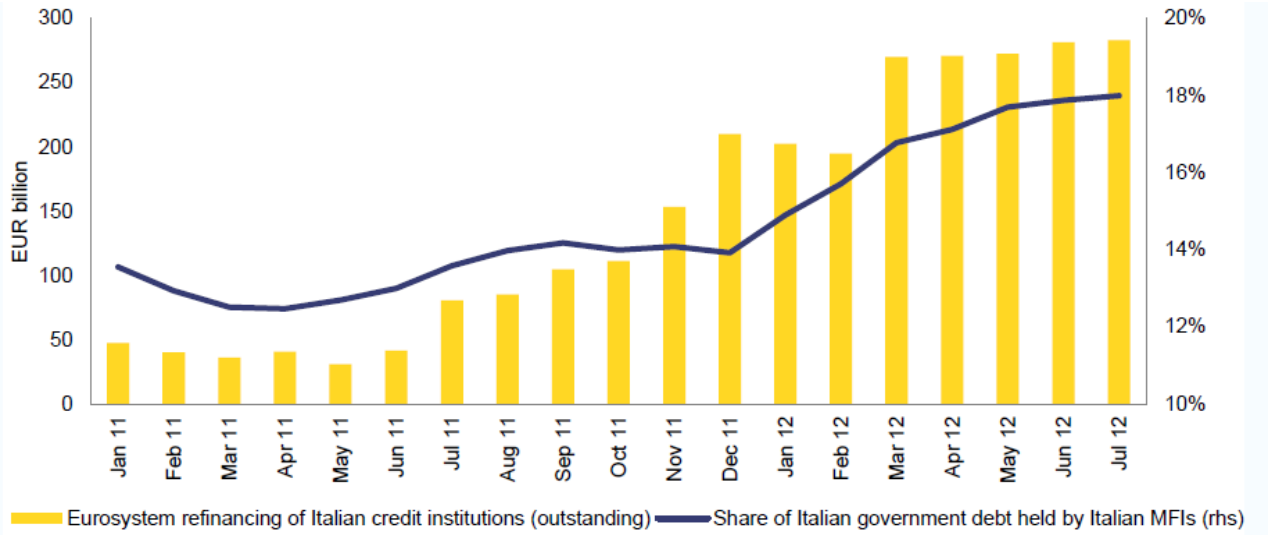
Figure 42: Trading propensity of Italian banks compared with some European countries (financial instruments to Tier 1 capital ratio, 2010)



Source: ECB annual report (2012)

Our analysis shows that Italian banks did not require any public bail-out, at least until the asset quality review and the stress test run by the European Central Bank. Nevertheless, banks suffered a liquidity crunch, supported by long-term funding through the two 3-year long-term refinancing operations (LTROs) in December 2011 and February 2012 (figure 43).

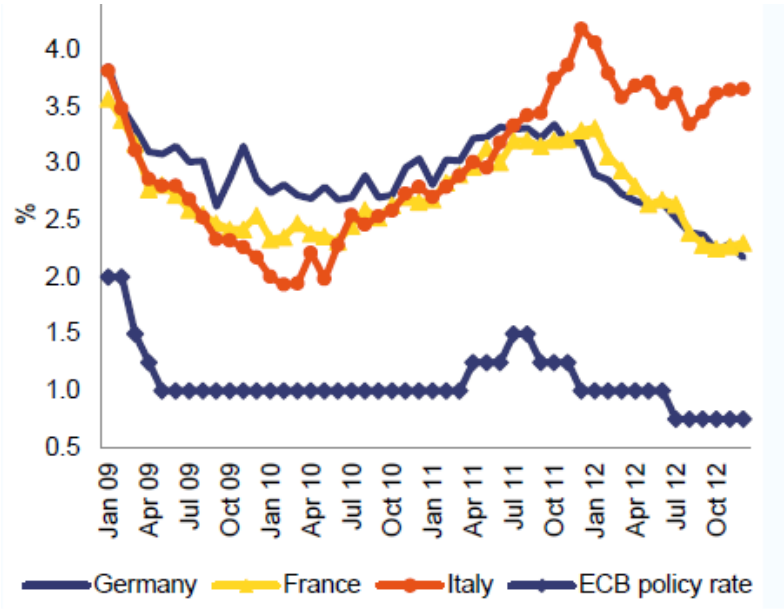
Figure 43: Share of Italian government debt held by Italian MFIs and Eurosystem refinancing of Italian credit institutions.



Source: Bank of Italy (2012)

Despite the relaxation of liquidity constraints, the average cost of new credit to firms in Italy remained significantly higher than in Germany or France, indicating continued impairment of the monetary policy transmission mechanism (figure 44).

Figure 44: Interest rates on new bank loans to non-financial corporations in selected countries



Source: Commission Services (2012)

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It is not surprising that the resilience of Italian banks appears to be very weak, especially after the stress test managed by the European Central Bank to introduce the Bank Union in 2014 (table 12).

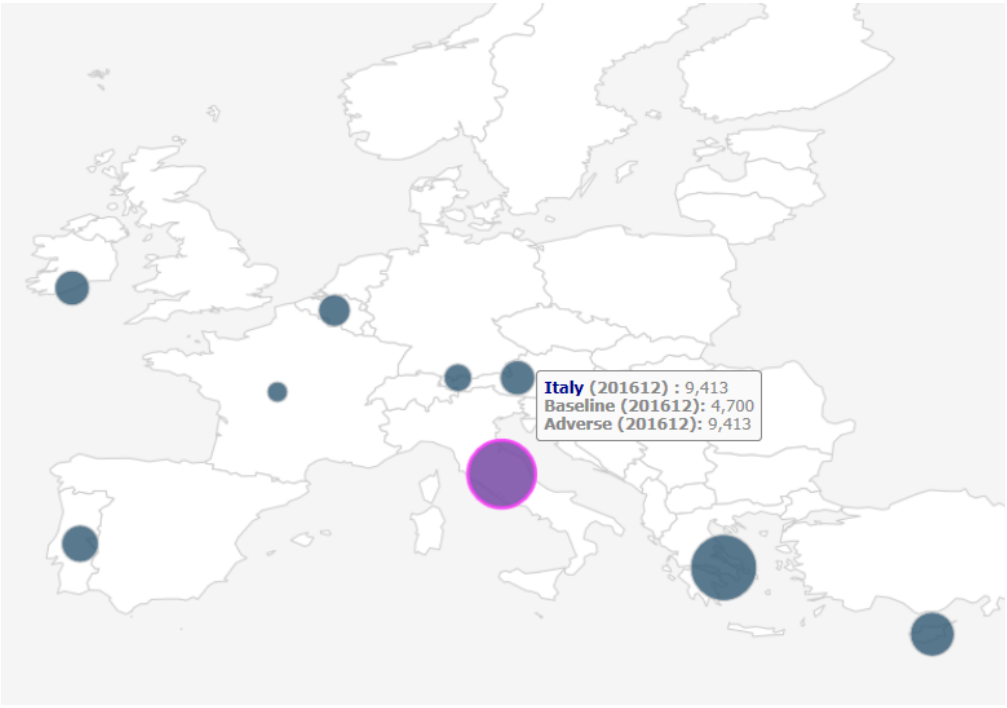
Table 12: Shortfall for individual banks 2016 under the adverse scenario, capital raised or converted in 2014 and net shortfall (EUR BN)

	Bank	Shortfall adverse 2016[31]	Net CET1 raised or converted[32]	Shortfall adverse 2016 after capital raised
AT	Österreichische Volksbanken-AG with credit institutions affiliated according to Article 10 of the CR	0.86	-	0.86
BE	AXA Bank Europe SA	0.20	0.14	0.07
BE	Dexia NV[33]	0.34	-	0.34
CY	Bank of Cyprus Public Company Ltd	0.92	1.00	-
CY	Co-operative Central Bank Ltd	1.17	1.50	-
CY	Hellenic Bank Public Company Ltd	0.28	0.10	0.18
DE	Münchener Hypothekenbank eG	0.23	0.41	-
FR	C.R.H. - Caisse de Refinancement de l'Habitat	0.00	0.25	-
GR	Eurobank Ergasias	4.63	2.86	1.76
GR	National Bank of Greece	3.43	2.50	0.93
GR	Piraeus Bank	0.66	1.00	-
IE	Permanent tsb plc.	0.85	-	0.85
IT	Banca Carige S.P.A. - Cassa di Risparmio di Genova e Imperia	1.83	1.02	0.81
IT	Banca Monte dei Paschi di Siena S.p.A.	4.25	2.14	2.11
IT	Banca Piccolo Credito Valtellinese	0.38	0.42	-
IT	Banca Popolare Dell'Emilia Romagna - Società Cooperativa	0.13	0.76	-
IT	Banca Popolare Di Milano - Società Cooperativa A Responsabilità Limitata	0.68	0.52	0.17
IT	Banca Popolare di Sondrio	0.32	0.34	-
IT	Banca Popolare di Vicenza - Società Cooperativa per Azioni	0.68	0.46	0.22
IT	Banco Popolare - Società Cooperativa	0.43	1.76	-
IT	Veneto Banca S.C.P.A.	0.71	0.74	-
PT	Banco Comercial Português	1.14	-0.01	1.15
SI	Nova Kreditna Banka Maribor d.d.[34]	0.03	-	0.03
SI	Nova Ljubljanska banka d. d.[34]	0.03	-	0.03
	Sum	24.19	17.90	9.52

Source: European Banking Authority (2014)

According to the stress test results, the expected shortfall in 2016 in case of a dramatic recession, 35% of the total depends on Italian banks (3.31bn out of 9.52bn for all the area), with 9 banks involved out of 24 European banks. Compared to the other European countries (figure 45), Italy shows the greatest banking system weakness with the largest capital loss in the adverse scenario.

Figure 45: Shortfall comparison by European countries



Source: European Banking Authority (2014)

Italian banking appears to be suffering more than any other large European country in the case of stress, due to the large sovereign bond and non-performing loans exposure (table 13).

Table 13: Baseline and Adverse scenarios for banks' core tier 1 by country after the ECB stress test

Countries	CET 1 Ratio (%) 2013	2016 Bas.	2016 Adv.
All EU banks	**11.1**	**11.7**	**8.4**
Austria	10.5	10.6	7.4
Belgium	14.0	11.9	7.2
Cyprus	4.4	9.5	-1,00
Denmark	14.2	15.4	11.7
Finland	16.4	17.6	12.0
France	11.3	11.8	9.0
Germany	12.8	12.8	9.1
Greece	9.9	8.0	2.0
Hungary	15.9	17.0	11.9
Ireland	13.2	12.2	7.0
Italy	9.5	9.3	6.1
Latvia	9.8	10.5	7.7
Luxembourg	15.9	15.1	11.2
Malta	10.7	13.2	8.9
Netherlands	11.6	12.2	8.9
Norway	11.3	14.4	11.3
Poland	13.3	15.4	12.3
Portugal	11.1	10.1	5.9
Slovenia	15.9	14.4	6.1
Spain	10.4	11.6	9.0
Sweden	15.3	16.9	13.7
United Kingdom	9.8	11.2	7.6

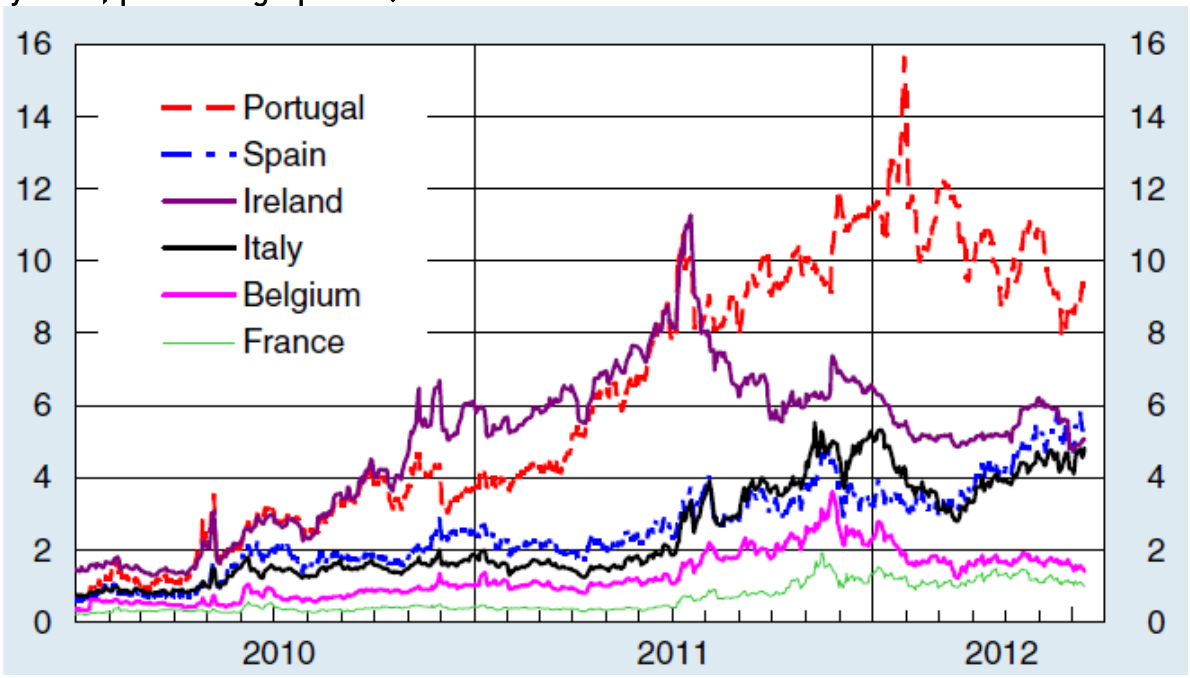
Source: European Banking Authority (2014)

Both banks and the Government have resorted to wholesale and retail capital markets to leverage their financial structures, even though during the last few years banks have been asked to increase core Tier 1 capital, which has risen to 10.2 per cent. Nevertheless, the weakness of the banking system was not solved by these efforts which also changed the corporate governance for most institutions.

The Greek crisis was the first signal that the financial crisis changed into a Sovereign debt crisis, at least within the euro area. Figure 46 shows the pattern of credit spreads with respect to German Bund yields of some of the most indebted countries (but Greece) Government bonds, with the same maturity (10 years).

Soon after the Greek shocks (April 2010) the Italian spread remained at around 170 basis points until mid-2011. In the second semester of 2011 the risk perception, associated with political conditions, caused a rally of the spreads, with a maximum level of 575 bps reached in November 2011.

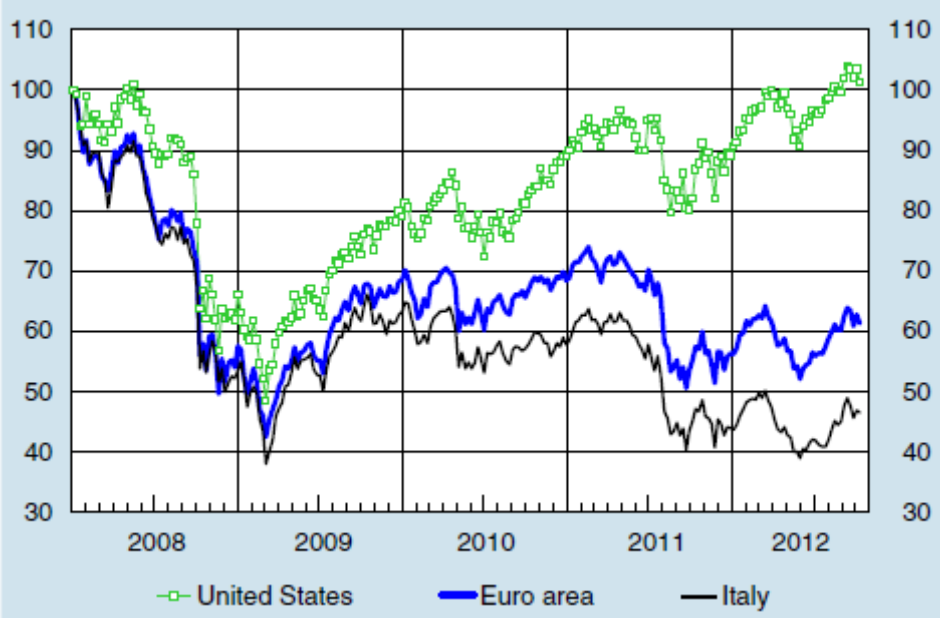
Figure 46: Yield spreads between ten-year government bonds and the German Bund (daily data; percentage points)



Source: Bloomberg (2013)

The impact of the equity markets crisis can be evaluated in figure 47. Until the end of 2009 the Italian equity index was perfectly correlated with European ones. After the Greek crisis a negative gap materialised, associated with the country's risk perception.

Figure 47: Share prices (end-of-week data; indices, 4 January 2008=100; Indices: for Italy, FTSE Italia MIB; for the euro area, Dow Jones Euro Stoxx; for the United States, Standard & Poor's 500.



Source: Bloomberg (2013)

3. Macroeconomic policies and recovery from the crisis

The primary intervention after the crisis was based on fiscal consolidation measures, such as property taxation, raise in the standard VAT rate, taxation on luxury durable goods, and higher duties on transport fuels. Along with these tax measures, a more powerful set of tools to improve tax compliance were introduced (inspections and an 'income-meter' to detect potential tax evaders)

Italian reforms are still based on public budget constraint according to the "austerity" EU policy. According to the Economic and Financial Affairs (2013, p. 29)

> "while increasing the overall tax burden, the recently adopted fiscal measures have some desirable properties in terms of efficiency. Due to the budget constraints, the shift of taxation away from labour and capital was relatively modest and, despite some rebalancing of the fiscal adjustment towards expenditure cuts, the overall tax burden increased. Against the background of Italy's persistently low growth combined with the pressing need to bring the public debt on a declining path, higher taxation of immovable property is preferable to other taxes: it is less harmful to long-term growth, while appearing broadly consistent with equity objectives if properly designed"

Most of the EU proposals (in some cases, constraints) to ease the Italian convergence to other more "virtuous" countries are still based on labour market flexibility and production competitiveness.

Conclusions

This report analyses the long-run changes between the financial and the non-financial sectors in Italy, and in particular the effects of these changes on the macroeconomic developments that have led or contributed to the financial crisis that started in August 2007.

In the first part we classified the development in Italy as an internal demand-led economy. This type of development is featured by the relevant components of the aggregate private consumption and a relatively balanced current account. During the first and second financialisation periods, Italy followed a "domestic-demand led" model of growth which was coupled with a strong profit increase without investments. This model was as fragile as the "debt-led consumption boom" type of development in the most financialised countries such as US and the UK. The collapse of investments associated with the negative movement of real wage values that explain the inability for households to maintain the large positive financial balances, led to the fall of domestic demand and particularly of private consumption. We have not found evidence that the fall of labour share in the first decade was accompanied by an increase of the rentier income share but, on the contrary, our estimates indicate a constant decline of property income up to the end of the observation period. Retained earnings, in the long-run, have fluctuated slightly at around 3 per cent. In terms of the labour market, Italy is characterised by high rates of long-term, youth and women unemployment, and by one of the lowest employment rates among European countries, strong disparities by region, gender and age, and a relevant diffusion of undeclared work. Another finding of our study is that Italy experienced neither rising overhead costs in the corporate sector such as interest and dividend payments, nor the weakening of trade unions, especially if we consider bargaining coverage. However, the labour Italian market has been growingly characterised by a strong segmentation between protected and permanent contracts, and atypical and flexible jobs.

The role of financialisation in this process can be summed up as follows: households' saving has been mainly crowded out by the public sector, whose debt is in fact dragged by the cost of interests paid to the investors; non-financial companies depend essentially on bank credit and suffer from a lack of investments, for their decision to distribute the net operating surplus; the crisis increased non-performing loans out of the total of banks' assets, which had a strong impact on their capitalisation and the subsequent decision to deleverage and adopt a credit crunch policy.

In the second part, we then examined the long-run effects of financialisation on real Italian channels. The increasing inequality of incomes, the marginal contribution of fixed investments, particularly depressed by the public budget constraints, and the collapse of consumption for households' with the lowest disposable incomes led to a bigger suffering than other European countries in the Great Recession since 2008-2009.

In particular, we analysed four channels through which financialisation is expected to have affected economic development: income distribution, fixed investments, consumption and current account. First, during the consolidation of the financialisation process and before the financial crisis, Italy recorded a deep decline of the wage share and a clear income redistribution at the expense of very low income households. Data on employee compensation and on the sectorial distribution of added value do not come out in favour of a

shift from the real to the financial sector. The analysis of functional income distribution highlights that without the share of top management salaries, the income labour share would be significantly lower. Finally, although financialisation and liberalisation processes in the labour market were accompanied by an increase in wage inequality and by stronger segmentation of the labour market between protected and a non-protected workers, financialisation has not affected any Trade Unions' coverage change. The second issue that we studied was the impact of financialisation on investment in capital stock. In the era of financialisation, though Italian NFCs have become more able to use financial instruments for their investment decisions, their real investments have shown an overall process of deceleration even in the pre-crisis period. As concerns the link between financialisation and households' consumption, we have found that the Italian propensity to borrow has increased over the few last decades even though with a lower intensity of other countries. Nevertheless, mortgages and consumer credit have experienced a continuous expansion over the last decade prior to the crisis. Thus, the credit crunch heavily constrained the behaviour of households. Finally, the liberalisation process introduced in the early 1990s for international capital markets and capital accounts has created the potential to run and finance persistent current account deficits, especially due to the demand of sovereign bonds in foreign countries. This created the problems of rising foreign indebtedness of the current account deficit, speculative capital flows, exchange rate volatilities and related potentials for crises.

The third part focused on the role of the financial system. The role of the financial system can be described as a banking system based one, with investors' behaviour that is still highly dependent on the banking channel to invest their savings, and non-financial companies whose bank credit link remains particularly strong. The impact on non-performing loans and the default rates of small and medium enterprises is depressing the economy with a vicious cycle that appears to be far from solved. Macroeconomic policies are mainly based on fiscal consolidation measures and do not allow any planning of public substitution of diminished private consumption and investment decisions.

Neo-liberal policies introduced in the 1980s, based on liberalisations, privatisations, and mark-to-market prices, stimulated the increasing of the public deficit essentially due to unsustainable interest rates. Reducing income inequality through adopting a fiscal policy was ineffective. Italy is far from reaching the EU Commission's goal to reduce poverty by 2020. Actually, the number of people living in poor conditions was 14.6 million in 2010. After two years it increased to 18.1 million.

Revising the policy model should be the starting point to interrupt the vicious cycle affecting the reduction of income inequality and depressing economic growth: changing the mix of the public deficit, introducing the control of common service tariffs and orienting the fiscal policy to fill the income and wealth gaps and, finally, inducing the financial sector to sustain the lending relationship and finance for growth, could help to reduce inequalities that have been prevalent in Italy.

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

THE PARTNERS IN THE CONSORTIUM ARE:

Partecipant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
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11	National and Kapodistrian University of Athens	Greece
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13	Lund University	Sweden
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