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Italy and Macroeconomic Policy

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MACROECONOMIC POLICY, ESPECIALLY MONETARY POLICY, is one of the areas most cited as providing proof that the European Union is emerging as a supranational polity that is assuming many of the powers and responsibilities that were once primarily in the hands of national states. The convergence criteria for entry into the single market, the (original) terms of the Stability and Growth Pact (SGP), and the independent European Central Bank setting monetary policy all seem to point in the direction of a diminished, if not marginal, role for member states in governing their economies. Macroeconomic policy also is the area that highlights some of the tensions, if not contradictions, of Italy's position within the EU—tensions that derive from, and contribute to, the asymmetries that exist within the framework for macroeconomic policy in the Union. On the one hand, as a founding member, Italy has played an active role in pushing forward the ambitions and instruments of a political union as well as reaping the benefits of economic integration. It has been instrumental in transferring responsibilities, such as that for monetary policy, to the European level. On the other hand, its basic macroeconomic regime has been seen as being out of step with the exigencies and requirements of economic and monetary union. It is commonly assumed to be a policy taker in this respect, in need of the "*vincolo esterno*," of "tying its hands in advance," and of the disciplinary constraints imposed by its partners and the EU to get its economic house in order.[1] It is seen as not only passive with respect to macroeconomic policy made at the European level, but also as a threat to the stability of Europe's macroeconomic regime.

Italy's position in the European Union's macroeconomic policy regime not only reflects, but also helps define, the asymmetry and ambiguity that exists within macroeconomic policy making in the EU, with monetary policy set by an independent central bank without corresponding European powers in fiscal, industrial, and labor market policy. As we will see below, this asymmetry has created both opportunities and problems for Italy and for the European Union. The establishment of policy parameters at the European level has become an important moment (perhaps the only one) at which member states can express and realize their national interests. The broad lines of European macroeconomic policy since Maastricht reflect the principles of sound money, price stability, and market mechanisms to determine the allocation of resources. These have been the cornerstones of macroeconomic policy of most EU member states since the early 1990s, if not earlier. Italy's challenge since the 1990s has been to convince its partners and international markets that it is committed to these principles of economic governance, while pushing for a more elastic interpretation, as it has failed to translate most of them into a change in policy and policy paradigm. The aim of this chapter will be to examine Italy's role in the recent debate about the SGP and to explore the extent to which it was able to define a clear policy position and to successfully achieve it within the European decision-making sites. It will focus on the discussion around the reform of the SGP in the 2001–2006 period and on the Berlusconi government as it took a decidedly ambiguous position not only with respect to Europe but also with respect to its macroeconomic policy regime.

The first part of the chapter will focus on the asymmetrical nature of Europe's macroeconomic regime. As will become apparent shortly, this makes it difficult to assess clear successes and failures for Italy in the setting of macroeconomic policy as an important area, that is, monetary policy, has been removed from the political realm and is in the hands of an independent central bank. Having said this, we will see in the second part of the chapter that Italy's entry into the single currency was a success story, given the political and social upheaval that characterized the first half of the 1990s. Much has been written about how Italy managed to put its public finances in order in the decade, curbed inflation, and demonstrated enough fiscal discipline to convince its partners that it met the convergence criteria to gain entry into the single currency.[2] The bulk of the chapter will focus on what has happened since Italy's entry into the single currency. It will concentrate on the attempts to both respect and change the terms of the SGP. It will demonstrate that the Pact was changed but not in ways favorable to Italy; and that this led to an even greater policy failure, the recommendation that Italy be cited for an excessive deficit.

Italy Caught Within an Asymmetric Policy Regime

As has been noted by Amy Verdun and others, macroeconomic policy in the European Union is defined by an asymmetry, with monetary policy set by the supranational and independent European Central Bank (ECB), while fiscal policy instruments remain primarily in the hands of member states. This structural feature of macroeconomic policy has serious implications for both the economic performance of the European economy but also the establishment of political legitimacy for the European Union.[3] It is this asymmetry that has been at the heart of two opposing trends in this policy area. On the one hand, there has been a constant demand to have mechanisms for monetary policy subject to some form of political leadership, largely guided by member states. The French government of Lionel Jospin in the last part of the 1990s, alongside the Schröder government in its early days with Oscar Lafontaine as minister of the economy, were at the forefront of the push to have a "political governance" of the economy. This was clearly a response by center-left governments to the establishment of a central bank committed to its independence and to sound money policies. On the other hand, with few instruments to set fiscal policy at the supranational level, there were fears that European monetary union would create opportunities for free riders to exploit the benefits of being within a single currency while abandoning the fiscal discipline that had been a requirement for entry. This led to the establishment of the Stability and Growth Pact, which somewhat assuaged German worries that governments that had lacked fiscal discipline in the past, especially Italy, would be subject to clear criteria and mechanisms to monitor fiscal discipline. The SGP was meant, then, to address the asymmetry of macroeconomic policy in that its provisions for multilateral surveillance of the members of the Euro-Zone could become a mechanism for some degree of coordination of macroeconomic policies.

But this attempt to provide a political impetus to policy was conditioned by the fact that the Euro-Zone was, as Kenneth Dyson argues, ECB-centric: that is, the center of gravity remained with the independent central bank, which was committed to sound money policies.[4] The Treaty, as well as the draft constitution, provided a legal and constitutional basis not only for the independence of the central bank but also to the main features of sound money policies. These include enshrining the commitment to price stability as the central responsibility of the central bank authorities. The impact of the instruments used to achieve these objectives—primarily monetary policy and interest rates—will have different consequences in different parts of the Euro-Zone. Those economies that stagnated in the first years of the new century, such as those of Germany and Italy, looked for some relief in interest rates and a lower

exchange rate for the euro; while the ECB had to keep a close watch on other economies, such as the Irish and Spanish, to keep them from overheating. The ECB also had to establish its credibility in international markets and chose to do so as a guardian of price stability and sound money in the face of political pressures for looser monetary policy. On the whole, the ECB achieved its policy objectives and established credibility in international markets; whether it has done so with member states is another matter. Indeed, the SGP was designed precisely to deal with those governments that might be tempted to temper the tight monetary policies of the ECB with a less rigorous approach to public finances.

The SGP may not have been designed as a straitjacket for governments but it certainly established rules, procedures, norms, and institutions whose primary aim was to ensure fiscal discipline. Moreover, it was recognized that since it would be the member states that would have to assume the responsibilities for the asymmetrical shocks that were sure to emerge in the larger monetary space, they would be tempted to use fiscal instruments to deal with the consequences.[5] Italy was one of the states that had raised these concerns, especially in Germany, in the mid-1990s about how to ensure that member states in the Euro-Zone would continue their commitment to fiscal and monetary stability, which had characterized the convergence criteria phase in the run-up to the single currency.

The SGP emerged at the Amsterdam Council in 1997 and its aim was to ensure that member states would "undertake to comply with the medium-term budgetary objective of positions close to balance or in surplus."[6] It reaffirmed some of the key principles that had been part of the process for the creation of the single currency, namely multilateral surveillance of member states' public finances and procedures to deal with excessive deficits. In accordance with the third stage of economic and monetary union, member states committed themselves to enhanced coordination of economic policy through "broad economic policy guidelines" (BEPGs), which are essentially a dialogue amongst member states and between member states and the Commission on policy objectives and instruments to achieve them. The BEPGs are recognition that the economies of the member states, particularly those in the Euro-Zone, are, as stated in Article 99 of the Treaty on European Union, a matter of common concern. They highlight the fact, however, that the mechanisms for fiscal policy can be only of a consultative nature and must rely on the emergence of a common set of norms, values, and ideas about what should be the nature of economic policy. And that these should be powerful enough to override the powerful domestic political and social pressures to use public finances as a means of offsetting some of the costs of economic adjustment to the single currency, as well as broader, global economic developments. As suggested by the debates that emerged in 2005 and 2006 over the moves by certain member states, such as France, Italy, and Poland, to protect domestic firms, loss of control over monetary policy may have made the temptation to resort to the protectionist reflex too great to resist.

The question of multilateral surveillance combines both preventative measures and sanctions. The original terms of the SGP emphasized that states could not have government deficits breach 3 percent of gross domestic product (GDP), and that they were to submit regular stability and convergence programs to be monitored by the Commission. The latter had the power to issue "early warnings" if it felt that a member state's public finances were in danger of pushing beyond the 3 percent barrier. These warning signals were meant to have states face up not only to peer pressures from other members of the Euro-Zone but also from international financial markets. This was especially significant for those member states that were carrying large debt loads, as they might now be subject to higher interest rates as financial markets could interpret the early warning mechanisms as a lack of fiscal discipline and increased risk. If states did not, or could not, heed the early warnings and did indeed break through the 3 percent point, then they would be subject to the excessive deficit procedure. They would be required to implement recommendations established by the Council and could be subject to a precautionary deposit that could be converted to a fine if they did not correct the excessive deficit within two years.

Against All Odds? Italy's Entry into the Single Currency

There probably would have been few willing to bet on Italy's chances of entry into the single currency in the early 1990s, especially after its exit from the Exchange Rate Mechanism (ERM) in 1992.[7] The lira had not withstood the speculative attacks in the period leading up to the French referendum on the Maastricht treaty; nor had it been able to count on the continued support from its ERM partners. In addition to formidable challenges to correct its public finances, Italy's record in the previous two decades with price stability hardly inspired confidence that it could meet the inflationary targets of the convergence criteria. Devaluation had been a temptation that Italian governments had found hard to resist as an instrument to maintain the competitiveness of Italian exports.[8] Indeed, Italy's exit from the ERM helped spark an export boom that would characterize the better part of the decade. Lengthening the odds was the fact that the first half of the decade witnessed an unprecedented level of political upheaval that discredited the political and institutional architecture of the postwar period.

However, the convergence criteria became reference points for public policy almost right from the start. There was a broad political consensus that every effort should be made to meet all the convergence criteria, especially with respect to meeting the 3 percent of GDP for deficits and inflationary targets.[9] This consensus extended to trade unions as well, who had gained at least a consultative role in 1993 in establishing fiscal and budgetary policies in return for moderation on wages. A limited number of structural changes were introduced to curb public spending, privatization efforts were accelerated, and economic growth all helped to decrease deficit levels and bring inflation under control.[10] Many felt that although Italy might not meet all the criteria, it might still be able to negotiate its way into the single currency. However, after the then Prime Minister Romano Prodi met in Spain in 1996 with Spanish Premier Aznar, it became clear that Italy would be alone in trying to push for a political and generous interpretation of the 3 percent threshold. The Germans had made it clear that they were worried about Italy's public finances and would maintain a strict interpretation of the Maastricht criteria. The first two years of the Prodi government, then, were characterized by extraordinary measures, including a tax increase that was meant to be temporary to ensure meeting the 3 percent threshold.

It might be argued that Italy's entry into the single currency was fortuitous, the result of favorable economic conditions and a political vacuum in which it was possible for "technicians" such as Carlo Azeglio Ciampi, Lamberto Dini, and even Giuliano Amato to take control of the political process. As Claudio Radaelli argues, a combination of factors contributed to Italy's successful entry into the single currency: measures taken by the Prodi government in 1996 and 1997; increased powers of the executive through new rules and structures; and the role of the Treasury in changing the terms of political discourse.[11] Without downplaying any of the efforts that were made to bring Italy into the single currency, as well as the extent to which the terms of political discourse focused on austerity and rigor, we should not overlook the possibility that success was only partial. Italy's entry was also helped largely by the fact that the significant drop in interest rates brought large savings to the Italian Treasury in the form of reduced costs on servicing the debt.[12] Along with one-off measures such as privatization and special taxes, Italy was able to achieve the "success" of entering the euro without having to make difficult structural changes, which became an important part of the story when it tried to reform the SGP.

Italy and the Reform of the Stability and Growth Pact

There are many paradoxes that have characterized the short life of the SGP. It was supposedly an agreement that had as much widespread consensus as the

convergence criteria. Yet, despite countless statements of allegiance to the terms of the SGP, it had few ardent supporters outside of the ECB and the small "virtuous" member states such as the Netherlands and Austria. Romano Prodi called the asymmetry of the pact "stupid" at one point during his presidency of the European Commission, while governments such as those in France and Germany chafed under its restrictions on deficit financing. A second paradox was that it was largely inspired by a desire to convince German business and public opinion that the surrendering of the German currency to the vagaries of a European currency would be countered by constraints on spendthrift governments, especially those in Italy. Yet, while Italy would eventually run afoul of the SGP rules in 2005, it was the public finance problems of Germany and France that led to a crisis for the Pact in 2004.

Political leaders could rely on the political capital afforded by the ambitious objective of creating a single currency to help legitimize unpopular budgetary choices in the 1990s. However, their task became much more arduous when trying to gain support for continued fiscal discipline after entry, especially once growth levels began to stagnate at the start of the new century. The SGP was introduced partly to provide member states with an external pressure that could be used to help them overcome domestic political and institutional obstacles to sound money policies. The center-left governments of Romano Prodi ran into problems both in 1997 and especially in 1998 precisely because they had to contend with political forces within their coalition that were expressing fatigue with continued budgetary discipline.[13] The major parties of the center-left, however, never wavered in their commitment to the terms of the SGP, partly because the reformist forces in the coalition saw them as the minimum conditions to help introduce needed structural reforms to the Italian economy. Few of those reforms were introduced, but at least the principle of fiscal discipline seemed to hold sway in the second half of the 1990s. Moreover, the center-left leader in the 1996 national elections, Romano Prodi, was named president of the European Commission in 1999, thereby creating an indirect link between the center-left parties of the Ulivo and the EU policies that Prodi was institutionally charged to defend and promote.

It was with the election of the center-right government of Silvio Berlusconi in 2001 that questions began to emerge about Italy's position with respect to the SGP. There were three primary reasons to think that the new government might raise questions about the terms if not the very basis of the SGP. First, despite the free-market rhetoric of the House of Freedoms and of its leader, its election promises of opening up construction sites across the peninsula to public works projects, such as a bridge across the Strait of Messina to connect Sicily to the mainland, were certain to raise problems in terms of public finances. This was especially the case as the prime minister was committed to

introducing significant cuts to income tax rates.[14] The second, and related, factor was that the center-right coalition was hardly cohesive in its views on macroeconomic policy, as well as on Europe. The minister of the economy from 2001–2004, Giulio Tremonti, sent out ambiguous signals about Italy's economic objectives and interests. He was careful to always express Italy's commitment to the Pact and to maintaining fiscal discipline. At the same, he was seen as a modern day Colbert—not entirely convinced of the power of markets and not entirely opposed to forms of state intervention.

Tremonti was also the architect of the alliance between Forza Italia and the Lega Nord. It is easy to dismiss as political posturing the Lega's positions on Europe, which bordered on the hysterical at times. But its positions on important economic questions could not be dismissed so easily—for instance, its oft-repeated claim that the introduction of the euro as the source of inflation and lack of growth would become a common government refrain after 2002. It is easy to understand the political motives for the Lega's anti-euro and anti-SGP positions. Its base of support in the provincial towns and cities of northern Italy benefited from the devaluation of the lira in the 1990s and was exposed to competitive pressures exacerbated by European enlargement and Asian producers. The Lega also mixed free-market rhetoric with mercantilist positions, as seen in its defense of medium-sized banks, again in the northern provincial cities, from European and international competition.

The position of the third major party, the Alleanza Nazionale (AN), in the governing coalition also was ambiguous with respect to the SGP. On the one hand, its base of support in southern Italy, as well as a more interventionist wing of the party, tended to see the SGP as a constraint that weakened both the state and the political position of the party. On the other hand, the leader, Gianfranco Fini, had embarked on a strategy to bring the party into the mainstream of European conservative parties.[15] This included taking a much more conciliatory position on Europe and becoming one of the strongest advocates in Italy for the draft constitution. The AN leadership supported fiscal discipline, but its membership was less convinced, as were leaders of the "social" wing, such as agriculture minister Gianni Alemanno.

Third, the policy and political tensions within the center-right government were exacerbated by the state of the country's public finances and economic fundamentals at the start of the new century. While the Berlusconi government tried to shift the entire blame for the country's economic challenges to previous governments, it did inherit a number of problems that were to make the job of reaching the SGP thresholds difficult. Even with the stability of interest rates brought about by entry into the euro in 1999, debt levels remained exceedingly high. They were expected to remain so in the absence of high rates of growth (something that not even the most optimistic forecasts called for),

or unless governments sought austerity measures that went beyond what was called for in the SGP. Moreover, the fact that devaluation was no longer available as a policy instrument brought into relief the microeconomic challenges that Italy faced, and which had not been addressed in the 1990s: low productivity levels, high labor costs, lack of research and development (R&D) investment, costly and fragmented capital markets, and so on.[16] Having missed the opportunity to bring about these basic reforms, which many thought of as an essential part of the single currency during the economic growth of the 1990s, it was even more difficult that they would be addressed during a downturn in the economic cycle.

Despite the internal differences and the economic constraints on the Berlusconi government, its position in the summer of 2001 was that it was firmly committed to maintaining the terms of the SGP. Tremonti and Berlusconi stated repeatedly that budgetary decisions would be guided by the SGP reference points. The government's first update of the Stability Programme, presented to the Commission in November 2001, was cautious about the future. It pointed out that the global economy had slowed down in the previous year and that the political instability at the international level after the terrorist attacks on September 11 would mean a lowering of growth forecasts. However, this would not divert government policy, and a balanced budget would be achieved by 2003. The report stated:

> For the years after 2002, budgetary policy will continue to be compliant with the financial adjustment path agreed at the European level. One of the benefits of a rigorous fiscal policy is the lowering of interest payments, which is of special importance for a country like Italy burdened with the legacy of a large public debt. Starting in 2003 the Government intends to achieve a substantial reduction in the tax burden, so as to foster both economic growth and greater social equity.[17]

This statement reveals a number of important points with respect to how the government saw the SGP in relation to Italy's interests and the government's policy objectives. First, it is clear that Italy's economic interests were seen not simply as complementary to its European commitments but indistinguishable from them. Fiscal discipline was to be pursued not simply because it was dictated by Europe but because it was necessary to deal with basic features, such as a large public debt, of the Italian economy. Second, the government's political objectives of lowering taxes could only be sustained if interest payments could remain at the lowest levels possible. With over 5 percent of GDP going to service Italy's debt, a government intent on lowering taxes and pursuing massive public works could ill afford to give off any signal that it was wavering in its support for fiscal discipline. The center-right government, like its center-left predecessor, understood that it needed to maintain

credibility as fiscally responsible amongst international markets in order to lessen the impact of debt payments on budgetary politics. There seemed to be little option but to adhere to the principles of the SGP if it wanted to achieve this objective.

These initial positive signals were difficult to sustain, as they were based on GDP growth projections—2.3 percent in 2002, 3.0 percent in 2003 and 2004—that were never realized, as European economies, and Italy's, were slow to respond to the positive global trends. Growth in 2002 was registered at only 0.4 percent, 0.3 percent in 2003, and 1.2 percent in 2004, significantly lower than the government's revised projection of 1.9 percent.[18] Although in November 2003, the government did not foresee any problems in meeting the Pact's reference points, the stagnant economy would prove to be a test of the government's commitment to the SGP and to fiscal discipline. It continued to stand by the Pact, but signals were being sent out that some of its terms needed to be revisited.[19] For instance, in December 2001, Berlusconi had mentioned that some of the deadlines in the Pact needed to be reexamined. Tremonti quickly intervened to confirm that the prime minister was talking about merely tinkering with minor details of the Pact and not its basic features. At the Madrid Council of Economic and Finance Ministers (ECOFIN) meeting in June 2002, Italy would back the French proposal that the aim of reaching a balanced budget by 2004 be replaced by the objective of budgets that were "close to balance" for the 2004–2007 period. Italy did not feel that it was in any danger of running excessive deficits, but by 2002 it was clear that slower than expected economic growth would make it unlikely that Italy, along with Portugal, France, and Germany, would have a balanced or surplus budget in 2004. It was glad to have an ally, in this case France, take the lead in leading the discussion to change the wording. The Commission, on the other hand, took the position that any changes to the wording or the interpretation of the Pact would open the door to future attempts to change it when states ran into budgetary problems.

Sluggish growth rates were not confined to Italy, and by 2002 and 2003, the French and Germans were facing problems in trying to meet their SGP commitments. When Italy assumed the presidency of the Council in July 2003, it was apparent that it would have to deal with a major confrontation between the Commission and two of the largest economies in the EU over their repeated breaching of the 3 percent debt barrier. The Commission had recommended that the excessive deficit procedure be applied to the French and the Germans so that they take immediate action to respect the terms of the SGP. Italy's position was rather delicate in the looming confrontation between the Commission and the large member states. On the one hand, the SGP was not a straitjacket but it did limit the room to maneuver in terms of the objectives

of decreasing taxes or in being able to use public spending to stimulate the economy. So, the government was happy to have the Pact thrown into question in the hope that a looser Pact would provide it with a little more fiscal room. It also did not displease the Berlusconi government to have Romano Prodi engaged in a political battle with powerful member states such as France and Germany.

On the other hand, the government could not pursue a visible and aggressive campaign to change the terms of the Pact. Its large debt load meant that it had to continue to send signals to international financial markets that it remained wedded to fiscal discipline, even if lower growth targets would mean less revenue for tax cuts or spending. As president of the Council, it could not ignore the "virtuous" member states who were adamant that the terms of the Pact be respected and the excessive deficit procedure applied. Many of the "virtuous" states, such as the Netherlands, were also smaller member states in the EU that had reservations about agreeing to the draft constitution because it was seen as too favorable to the larger members. Italy, which was trying to get their support for the draft constitution, did not want to have the conflict over the SGP also be labeled as one between small and large member states.

In the end, Italy sided with the November 2003 ECOFIN decision to suspend the application of the SGP to Germany and France. Italy was reported to have supported Germany in its battle to suspend the Pact in return for German support for the establishment of the Euro-Mediterranean Bank.[20] While all the members of the Euro-Zone went to great lengths to claim that the Stability Pact was still the foundation of fiscal policy, its legitimacy was seriously undermined. The central precept that basic macroeconomic objectives and instruments were to be insulated from political calculations had been challenged. Moreover, that the two largest economies were able to use their weight to be exempted from sanctions created a split between the "virtuous" and the laggards; a split that corresponded roughly not only to a division between small and large states, but also between those states that had introduced structural reforms to their economies and those that had not. Italy found itself in the second group and could only count as potential allies other states that had trouble meeting the SGP criteria and were having problems liberalizing important parts of their economies. In addition, Italy had clearly sided with the member states in the challenge to the Commission's role as guardian of fiscal discipline in the Euro-Zone.

Two, perhaps conflicting, objectives of government policy were now clear after the controversy over France and Germany. First, there was no doubt now that Italy wanted the terms of the Pact changed, but it sent out ambiguous signals. On the one hand, it was happy to have France and Germany push for a change. On the other hand, it was worried about an emerging "big three" axis

of Germany, France, and Britain.[21] Along with Spain, the Netherlands, Poland, and others, it sent a letter to the Council presidency and to Prodi asking that the SGP be applied in the same way to all states. But it did side with the Germans and French in the Constitutional Convention and successfully weakened the powers of the Commission in the draft constitution to issue sanctions for excessive deficits.

Second, it was essential for the government that it continue to be seen as adhering to the terms of the SGP. The loosening of the Pact meant that international financial markets would be paying even closer attention to the balance sheets of member states with public finances in fragile health. While Italy had not run afoul of the SGP rules, its policies had caused concern amongst the Commission and some of the other member states. What had drawn particular attention were the series of tax amnesties and ad hoc measures that were designed to raise additional revenues so that the 3 percent reference point would be respected—measures that went back to the 1996–2001 period, as well. This helped fuel a growing suspicion that Italian authorities were engaging in creative accounting, which meant Italy respected the letter of the Pact but not the spirit. Clearly, Tremonti and the government hoped that the ad hoc measures would tide Italy over until growth returned in 2003, or certainly in 2004.

The Italian government continued to insist that it would abide by the terms of the SGP but this did not seem enough to convince the Commission. By April 2004, it was ready to issue an early warning to Italy that it was in danger of running excessive deficits for 2004 and 2005. The Italian government's response was to attack on all fronts. Tremonti pointed out that member states representing 85 percent of the Euro-Zone economy were in danger of violating the terms of the Pact. He went on to state that the early warning mechanism was to be used in extraordinary situations but that could hardly be applied when so many member states seemed to be having trouble with public finances.[22] Tremonti emphasized that the Pact was not just about stability but also growth, and if so many member states were in trouble, it was because the SGP was becoming a straitjacket for stagnating economies. Berlusconi went after the Commission, and in particular Prodi. He claimed that reports of the early warning were the start of the "anti-Italian campaign," and that Brussels was full of "inadequate people" who moved like "big snails."[23] He also argued that breaching the 3 percent barrier was not a major problem if it meant stimulating growth, and he remained confident that the Pact would not be applied to Italy in the same way as it was not in the case of France and Germany a few months earlier.

There were signs that the Italian case might be different. First, the Italian case combined a possible violation of the Pact in 2004 with exceptionally high public debt levels. As much as the government may have felt that it was the target of a political campaign, it had to be careful not to be seen as wanting to upset the basis of the SGP and abandoning fiscal discipline. Italy's high level of debt meant that any sign of wavering would be interpreted as a return to the old ways of reckless public finances. It simply did not have the credibility in international markets that Germany, and even France, had; borrowing could become more expensive for Italy if there was an early warning and if it was ignored. The bond rating agencies such as Standard & Poor's and Moody's had made it clear that they were paying close attention to whether an early warning had been issued when assessing Italy's bond ratings.[24]

A second and related sign was that Italy seemed to be going in a different direction from that required by the Pact. For instance, the Netherlands, which also had been subject to an early warning, had quickly taken measures to remain safely under the 3 percent marker through a combination of tax increases and cuts to spending. The Italian government, on the other hand, in April was presenting plans to stimulate growth with cuts to income tax without any drastic and structural reforms of spending. Tremonti was fairly confident that Italy would find allies in Germany and France in its campaign to put the emphasis on growth rather than stability. His argument was that if there was a violation of the 3 percent point in 2004, it would be temporary and quickly reversed in 2005 as the economy returned to growth. There was no danger of excessive deficits because 2004 would prove to be an exception.

Tremonti never got to make his case to the July ECOFIN that was to take action on Italy. At a meeting on May 11, he had promised that he would present a plan for the next ECOFIN on July 5 that would outline the measures Italy would take to avoid the early warning. However, a government crisis, precipitated in part by divisions in the coalition over economic policy, in late June and early July led to his resignation and to the eventual appointment of the most senior official in the ministry of the economy, Domenico Siniscalco. It was Berlusconi himself who attended the July 5 ECOFIN to present the government's corrective measures. It was not an easy job, as the government was committed to introducing tax cuts that amounted to 6 billion euro. Corrective measures totalling 7.5 billion euro were taken in July, and along with the economic plan for 2005–2008, were enough to satisfy Italy's European partners so that no early warning was issued.[25] Moreover, there was even more reason to think that Italian interests were gaining ground as the Commission issued a communication on September 3, 2004, that suggested ways in which the SGP could be interpreted with greater flexibility, and clarified with respect to stating medium-term objectives. The fact that the Commission was stating that the SGP needed to be improved may have suggested that, as Siniscalco argued, "the reform of the Pact is no longer taboo."[26]

In November 2004, Berlusconi wrote to the Dutch prime minister, who had the chair of the Council, to outline the case for a changing of the SGP rules. Without some sort of flexibility or modification of the budgetary provisions, Italy was sure to run into problems. The government, despite its neoliberal rhetoric, argued that deficit spending was justified if it was countercyclical. The government also had some very specific reforms it wanted to introduce, which would exclude spending on infrastructure and military technology from the SGP calculations. Berlusconi shared German Chancellor Schröder's point of view that the Pact could not be left entirely in the hands of the Commission and the economic ministers, but could also be a matter for the Council; that is, it could become a matter that was open to wider political negotiations.[27] Italy clearly wanted to ride the coattails of French-German campaign to change the rules, despite the fact that the three shared only the objective of having an agreement that would place as much emphasis on growth as it did on stability. Moreover, the Dutch presidency had indicated that there was little hope that the Italian request for excluding infrastructure and capital investments would be approved in the ECOFIN, as there was little consensus around a single set of proposals.

The immediate Italian objective, then, at the end of 2004 was to change the terms of the SGP, and the government was looking to have the French and the Germans once again take the lead. The danger was that the terms of the Pact would be changed but not in the ways wanted by the Italian government, as the different member states were looking to solve different problems without undermining the credibility of the SGP and the stability of the euro. At the March 22–23, 2005, European Council, Berlusconi presented a fairly optimistic picture of Italy's relationship with the Commission and the state of Italy's public finances, promising more tax cuts in 2005, while staying under the 3 percent barrier. The Council did introduce changes to the SGP, but not those that the Italian government had hoped for. The most important modifications were those found in Section 2 ("Strengthening the Preventative Arm") of the ECOFIN report that was adopted by the Council. The new regime recognized the heterogeneity of the twenty-five economies and how they were not always at the same point in the economic cycle. The report also stated that there could be exceptional circumstances and relevant factors that could account for member states violating the 3 percent rule. These other relevant factors could include funds dedicated for international aid and development, and policies that aimed to meet the Lisbon Agenda and to promote R&D.

The Council, however, did not adopt the Italian proposals for taking capital and infrastructure investments into account. Indeed, it emphasized that "Clearly no redefinition of the Maastricht reference value for the deficit via the exclusion of particular budgetary items should be pursued."[28] Perhaps more worrying for the government was that the report, while trying to provide greater flexibility for the SGP and to signal that growth was just as important as stability, went to great lengths to highlight the overall health of public finances, especially debt levels. Member states that introduced structural reforms to their economies that improved the long-term health of public finances through cost-savings, and that brought down debt levels, would be given more room to maneuver with respect to meeting the medium-term objectives of close-to-balanced budget and the 3 percent reference point. The Council report charged the Commission with examining compliance with the Treaty not only with respect to deficits but also to increase the focus on debt and sustainability. This did not augur well for Italy, whose high debt level was stuck at about 106 percent of GDP. It seemed that the reforms to the SGP met the demands of other member states, such as Germany and France, but not Italy.

The changes to the Pact also had an effect on Italy's primary interest, that is, assuring international financial markets and its partners that Italy was dedicated to, and successful in, maintaining fiscal discipline. Italy was immediately under the spotlight after the March Council for two reasons. First, although the discussion about changing the Pact had been going on for at least three years, and the Pact had suffered a serious blow with its suspension in the cases of France and Germany in November 2003, there was speculation that the latest modifications had undermined it. The Commission and some of the "virtuous" member states were determined to be especially vigilant and to send out signals that the changing of the rules did not mean any less of a commitment to fiscal discipline. Second, the Council report had also included a section on "Statistical Governance," which called for reliable, timely, and credible fiscal statistics. This was partly a result of problems with Greek data prior to its entry into the euro. But it also implicated Italy, as Eurostat was reviewing Italy's fiscal statistics for 2003 and 2004 with respect to reporting practices.[29]

There was a string of bad news on the financial and fiscal front in the first half of 2005, culminating in the Commission recommending that the excessive deficit procedure be applied to Italy. The Eurostat ruling did find that Italy's accounts for 2003 and 2004 had to be adjusted. The rulings meant that the deficit figure was revised upward to 3.1 percent for both years, from 2.9 percent in 2003 and 3 percent in 2004. This minor adjustment meant that the projected deficit figures for 2005 (3.6 percent) and 2006 (4.6 percent) would result in violating the terms of the SGP for four consecutive years. It became hard for the government to counter the Commission claim that Italy's deficit problems were not due to exceptional circumstances and other

relevant factors. The Commission report that recommended the excessive deficit procedure emphasized that Italy's slow rate of growth was not cyclical but structural, as it had lagged behind the rest of Europe since the beginning of the 1990s.[30] The Commission also pointed out that despite the structural weaknesses in the economy, Italian governments had consistently presented SGP updates with projected rates of growth in the 2.5–3 percent range. The Commission essentially traced the roots of the problem to declining revenues because of tax cuts added to increasing primary expenditures.[31] It argued, "The projected worsening of fiscal imbalances mainly reflects the fact that a structural budgetary correction necessary to replace the diminishing budgetary impact of temporary measures is not in place."[32] Even under the terms of the reformed SGP, Italy was in excessive deficit and measures would have to be taken, according to the Commission.

Italy was going to be the test as to whether the new terms of the pact had enough teeth to compel states to reimpose fiscal discipline. Berlusconi and Economy Minister Siniscalco were able to negotiate a two-year grace period in which Italy would have to bring deficit levels below the 3 percent mark. Making a silk purse out of a sow's ear, the government heralded the deal with its European partners as a confirmation of its policies of seeking to have finances corrected by promoting growth and not simply through cuts in taxes. Siniscalco said the plan was "a diet, not starvation" because no corrective measures were requested for 2005, even though the deficit was projected at the time at 3.6 percent of GDP.[33] The plan called for Italy to reduce its budget deficit by 0.8 percent in each of the 2006 and 2007 budgets, which would bring the deficit down to 3.0 percent (the projected deficit without corrective measures was 4.6 percent) of GDP and much closer to the SGP objectives. Even with the gradual adjustments, meeting the terms of the deal would require major fiscal measures involving tax cuts and revenue increases that would total around €20 billion for the successive budgets. Italy had gained an extra year that had been normally used in excessive deficit procedures, as well as the possibility of getting an extension in 2007 if the 3.0 percent target was not reached because of lower than expected growth. This would be conceded only if the Commission and ECOFIN were confident that the government had done everything possible to meet the terms of the deal.

What was becoming apparent, but was not absorbed by Italian policy makers, was that the point of contention was not just the 3 percent reference point but a fundamental divergence on the question of growth and the means to stimulate it. What Italian governments had fixated on since the Maastricht treaty was fiscal discipline and meeting the 3 percent reference points, preferably by avoiding difficult policy choices that were sure to cause social and political tensions for governments that leaned either to the left or the right. When it came time to reform the Stability Pact, Italy's push for an emphasis on growth focused primarily on using public spending to stimulate demand, while the SGP was predicated on supply side measures. This is why the reformed SGP, rather than being an opportunity for the Italian government, was, possibly, an even tighter constraint.

It can be concluded that Italy failed to achieve its primary policy objectives with respect to the SGP. It wanted a reform of the Pact that would prevent it from being singled out for budgetary deficits. On this front, it was not able to secure a rewording that it wanted. A second and related objective was to avoid the excessive deficit procedure. It was not able to convince the Commission that its problems were temporary and did not require new and extraordinary budgetary measures. Moreover, the government's economic policies, which included further tax cuts in an election year, were a source of concern for the Commission. Essentially, the Commission rejected the foundation of the government's economic policies: that the Pact was the reason for the lack of growth and that tax cuts would generate sufficient levels of growth to ensure that Italy met the terms of the SGP.

Conclusion

The technical report annexed to the Commission's recommendation for the application of excessive deficit procedure against Italy stated, "Italy undertook remarkable fiscal consolidation efforts during the 1990s, attaining achievements in terms of deficit reduction up until the year 1999."[34] It was this fiscal performance that partly explains how and why Italy was able to successfully enter the single currency in 1999. Its performance since then, with respect to the Stability and Growth Pact and European macroeconomic policy, has been less brilliant, and by 2005 was raising critical questions about Italy's role within economic and monetary union.

There are several reasons that help to explain Italy's difficulties in recent years. First, unlike the single-mindedness that characterized economic policy in the 1990s, the center-right governments sent mixed and often confusing messages. They never wavered in their rhetoric in support of fiscal discipline and the reference values of the SGP, but they often pursued policies that seemed to fly in the face of discipline and seemed to respond to domestic political concerns. This was clearly the case with respect to pushing ahead with tax cuts even when Italy was perilously close to breaching the 3 percent barrier. These confusing messages contributed to a second factor—that is, Italy faces a credibility problem when it comes to convincing its partners about its commitment to fiscal discipline. Its use of one-off measures (even before

1999) and creative financing rather than structural reforms did little to inspire
confidence amongst the members of the Euro-Zone, the ECB, the Commis-
sion, and international financial markets.[35] Italian policy makers seemed to be
stuck in 1998, assuming that the same political ingenuity that allowed Italy to
enter into the euro with only the minimal amount of structural reforms of its
economy and public finances would continue to convince its European part-
ners. However, entry into the single currency and the SGP were just the initial
steps of a broader process that required certain macroeconomic fundamen-
tals, the absence of which made it harder to convince partners of the commit-
ment to the spirit and the terms of the Pact.

Also hurting Italy's credibility was the tendency to have domestic politics per-
colate to the European level. This included a long-standing dispute with the
Commission that often seemed inspired by the political battle with Romano
Prodi. The government did not help its case in claiming that the Commission's
concerns with Italy's public finances were part of a political campaign whose
aim was to undermine the center-right government in anticipation of Prodi's
return to domestic politics. Problems within the center-right government also
corroded the credibility of Italy's commitment to the SGP. Even taking into ac-
count that they were meant to establish political and partisan points, statements
made by the Lega ministers about pulling Italy out of the single currency did not
help to create allies for Italy within ECOFIN and the Euro-Zone. Berlusconi ac-
cusations that it was the euro that was responsible for Italy's loss of competi-
tiveness only confirmed the view that the Italian government was not address-
ing its fundamental economic weaknesses. Italy entered into the single currency
because its partners were convinced that it was committed to its basic economic
principles. But successive governments seemed to have succumbed to "Maas-
tricht fatigue" and did not have the political will or capital to continue on the
path of reform.

A third reason for the lack of success was that Italy's debt problem, and the
lack of progress in reducing it, was an albatross that limited governments'
room to maneuver on a number of fronts. It could not come out and criticize
the constraints imposed by the SGP for fear of alarming international finan-
cial markets and bond rating agencies. Unlike France and Germany, which
had to negotiate their way out of problems related to deficit levels, Italy had to
deal with two separate fronts. It could not push too much on changing the
definition of the conditions for excessive deficit without risking more strin-
gent conditions with respect to managing debt levels. In addition, there was
the simple fact that servicing the debt continued to take up a sizeable per-
centage of spending, thus crowding out other fiscal options.

Finally, the nature of the policy questions made it difficult for Italy to find
allies. Italy could not play the role it does best, that of mediator, because Italy

was the problem that needed mediation. Italy was one of the primary reasons
why the Stability and Growth Pact was created. It was the test case to see if
monetary union could sustain asymmetric shocks and different economic cy-
cles, especially in a period of stagnant growth throughout Europe. And Italy
would be under the spotlight to assess whether the changes to the SGP in 2005
had undermined the Pact or not. Italy did not have the economic weight to
pursue its interests on its own, nor a record of fiscal discipline to convince
partners and international markets of its commitment to the SGP. It was left
isolated, hoping for a political solution in an area of policy where the room for
politics is shrinking.

Italy had a fundamental interest in economic and monetary union as a way
in which to secure credibility in international financial markets in an attempt
to shield domestic interests from a more global economy. In this sense, we can
say that, by 2006, it had achieved only partial success. By entering into the sin-
gle currency, it was partly shielded from the vagaries of international markets.
For instance, one could imagine the pressure on the lira if it was still around
in April 2006, when, in the weeks that followed the election, it was first not
clear: who won the election; then if there would be a majority for the govern-
ment in the Senate; and then if the majority would stay together to push
through the drastic fiscal measures that were necessary to meet the SGP com-
mitments. On the other hand, it could be said that Italy could not secure what
it wanted and needed in Europe—that is, a macroeconomic policy regime that
would not highlight its structural weaknesses and would not put pressure on
governments to take drastic measures that were sure to cause political and so-
cial tensions.

Notes

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2. Tommaso Padoa-Schioppa, *La lunga via per l'euro* (Bologna: Il Mulino, 2004);
Francesca Fauri, *L'Italia e l'integrazione economica europea, 1947–2000* (Bologna: Il
Mulino, 2001); Luigi Spaventa and Vincenzo Chiorazzo, *Astuzia o virtù: come accadde
che l'Italia fu ammessa all'Unione monetaria* (Roma: Donizelli, 2000); Franco Reviglio,
Come siamo entrati in Europa (Milano: UTET, 1998).

3. Amy Verdun, "An 'Asymmetrical' Economic and Monetary Union in the EU:
Perceptions of Monetary Authorities and Social Partners," *Journal of European Integra-
tion* 20, no. 1 (1996): 59–81; Amy Verdun and Thomas Christiansen, "Policies, Institu-
tions, and the Euro: Dilemmas of Legitimacy," in *After the Euro: Shaping Institutions for*

Governance in the Wake of European Monetary Union, ed. Colin Crouch, 162–79 (Oxford: Oxford University Press, 2000).

4. Kenneth Dyson, *The Politics of the Euro-Zone: Stability or Breakdown?* (Oxford: Oxford University Press, 2000).

5. Martin Heipertz and Amy Verdun, "The Dog that Would Never Bite? What We Can Learn from the Origins of the Stability and Growth Pact," *Journal of European Public Policy* 11, no. 5 (October 2004): 766–67.

6. European Council, "Resolution of the European Council on the Stability and Growth Pact" (Amsterdam, June 17, 1997), Official Journal C 236, August 2, 1997.

7. Alberta Sbragia, "Italy Pays for Europe: Political Leadership, Political Choice, and Institutional Adaptation," in *Transforming Europe: Europeanization and Domestic Change*, ed. Maria Green Cowles et al., 79–96 (Ithaca, NY: Cornell University Press, 2001).

8. Francesca Fauri, *L'Italia e l'integrazione economica europea, 1947–2000* (Bologna: Il Mulino, 2001).

9. There was consensus but not unanimity on the question of economic and monetary union (EMU). See: Claudio Radaelli, "The Italian State and the Euro: Institutions, Discourse, and Policy Regimes," in *European States and the Euro: Europeanization, Variation, and Convergence*, ed. Kenneth Dyson, 212–36 (Oxford: Oxford University Press, 2002).

10. Vincent Della Sala, "From Maastricht to Modernization: EMU and the Italian Social State," in *Euros and Europeans: Monetary Integration and the European Model of Society*, ed. George Ross and Andrew Martin, 126–49 (Cambridge: Cambridge University Press, 2004).

11. Claudio Radaelli, "The Italian State and the Euro," 224.

12. Mark Hallerberg, *Domestic Budgets in a United Europe: Fiscal Governance from the End of Bretton Woods to EMU* (Ithaca, NY: Cornell University Press, 2004), 182–95.

13. Spaventa and Chiorazzo, *Astuzia o virtù.*

14. *Il Sole 24 Ore*, "Il Dpef conferma gli impegni europei" (July 17, 2001), 3.

15. Mark Donovan, "The Governance of the Center-Right Coalition," in *Italian Politics, A Review: Italy between Domestic Politics and Europeanization*, ed. Sergio Fabbrini and Vincent Della Sala (New York: Berghahn, 2004).

16. OECD [Organisation for Economic Co-operation and Development], *Policy Brief—Economic Survey of Italy, 2001* (Paris: OECD, 2002).

17. Ministero dell'Economia e delle Finanze, *Italy's Stability Programme—November 2001* Update (Rome, 2001): 10–11.

18. Ministero dell'Economia e delle Finanze, *Programma di Stabilità dell'Italia—Aggiornamento Novembre 2003* (Rome, 2003), 4; Commission of the European Community, *Commission Staff Working Document—Technical Document Accompanying the Report on Italy Prepared in Accordance with Article 104(3) of the Treaty* (June 7, 2005) SEC (2005)755.

19. *Il Sole 24 Ore*, "Accordi da rispettare" (December 7, 2001), 6.

20. The Commission had recommended an investment bank to help foster development in Mediterranean countries. The Germans had been able to convince the Seville Council (2002) to adopt the Commission recommendation that the Mediterranean bank be a subsidiary of the European Investment Bank. Italy and Spain had wanted a separate institution to be created and had apparently requested that the Germans change their position in return for their votes against the Commission recommendations for excessive deficit procedures. The future of the bank has yet to be determined. See: *La Stampa*, "Il negoziato dietro le quinte" (November 25, 2003), 7.

21. Mark Gilbert, "Playing the Wrong Tunes? Italy and the European Union in 2004," in *Politica in Italia, 2005*, ed. James Newell and Carlo Guarnieri (Bologna: Il Mulino, 2005).

22. *La Stampa*, "L'Europa e I conti pubblici" (April 4, 2004), 7.

23. *Il Sole 24 Ore*, "Lo scontro sui conti: A Bruxelles lumaconi e inadeguati" (April 8, 2004), 4.

24. *La Stampa*, "Alla vigilia della riunione dei 25 ministri" (July 3, 2004), 3.

25. Ministero dell'Economia e delle Finanze, *Documento di Programmazione Economico-Finanziaria, 2005–2008* (Roma, July 29, 2004).

26. *La Stampa*, "Il Ministro Tedesco: 'Il dialogo non è così avanti'" (November 22, 2004), 2.

27. *Financial Times*, "Berlusconi Criticises EU Fiscal Rules," (November 23, 2004).

28. Council of the European Union, *European Council Brussels, 22 and 23 March 2005—Presidency Conclusions, 7619/05*, "Annex II—Improving the Implementation of the Stability and Growth Pact" (March 2005), 34.

29. Eurostat was asked to review how Italy had reported receipts from securitization and from taxes raised on behalf of the state by mainly banks, as well as debt for the financing of high-speed rail. See Eurostat, "Euro-indicators," press release dated May 23, 2005 (STAT/05/65).

30. Commission of the European Community, *Report from the Commission—Italy, Report Prepared in Accordance with Article 104(3) of the Treaty* (June 7, 2005), SEC (2005)750 final, 3–4.

31. The Commission's conclusions were in line with those of other international institutions' assessment of Italy. For instance, see: International Monetary Fund, "Italy—2004 Article IV Consultation Conclusions of the Mission" (November 10, 2004).

32. Commission of the EC, *Commission Staff Working Document*, 9.

33. Adrian Michaels, "Italians Hail Budget Deal with Brussels," *Financial Times* (June 30, 2005).

34. Michaels, "Italians Hail Budget Deal," 3.

35. Italian bond prices remained very close to those for Germany, roughly only twenty basis points higher. Berlusconi commented on this when news broke that the Commission was going to implement the excessive deficit procedure. There were signs that Berlusconi was more worried than he let on. He was the first Italian prime minister to meet with representatives of bond rating agencies. *Corriere della Sera*, "E Siniscalco gioca con il premier la carta di Moody's" (May 20, 2005), 9.