PIB PROFESSIONISTI ITALIANI a BOSTON

Goodwin Procter, Boston

Europe, the Banks, and Italy:
Make It or Break It?

GOODWIN PROCTER

Consulate General of Italy in Boston

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"Good questions outrank easy answers." -- **Paul Samuelson**, Nobel laureate in Economic Sciences.
"Think what a revolution it will be if we manage to get everyone to pay their taxes." -- **Romano Prodi**

The comments above by Paul Samuelson and Romano Prodi provide a timely subtext for a compelling presentation entitled "Europe, the Banks, and Italy: Make It or Break it?" by Prof. Dante Roscini, Senior Lecturer and L.E. Simmons Faculty Fellow at Harvard Business School, at the December 15, 2011 meeting of Professionisti Italiani a Boston. An expert in global capital markets, Prof. Roscini highlighted the factors that led to the financial conundrum facing Italy, as well as the obstacles that need to be overcome to resolve the crisis that has enveloped the country.

Prof. Roscini's insights were informed by a distinguished career that has included leadership positions as Head of European Capital Markets for Goldman Sachs, Head of Global Equity Capital Markets and Head of the European Capital Markets and Financing Group for Merrill Lynch, and Country Head of
Italy and Chairman of European Capital Markets for Morgan Stanley.

The PIB meeting took place at the Boston offices of Goodwin/Proctor through the sponsorship of Ettore Santucci, PIB member of the advisory board and a partner in the firm's Business Law Department. The Boston audience of more than 100 individuals was joined by additional Professionisti Italiani chapters in Chicago, New York, Philadelphia and San Francisco, linked audio-visually to Prof. Roscini's presentation.

Financial instability in a country with the economic scope of an Italy is of no small consequence beyond its borders, emphasized Prof. Roscini. The Italian economy was the seventh largest economy in the world and the third largest in Europe in terms of GDP in 2010. The country's labor force is estimated to exceed 25 million people.

According to *The Economist*, the country enjoys the 8th highest quality of life in the world.
After decades of strong GDP growth beginning after World War II and ending around 1990, however, annual growth rates in Italy have lagged well below the EU average. Political efforts to stimulate growth since 1980s have fueled a rise in public debt that has served to destabilize the economy. Similar economic destabilization has affected other countries in Europe, leading some

international companies to go so far as to contemplate contingency plans for a possible breakup of the Eurozone.

Prof. Roscini underscored the inability of countries, including Italy, to borrow, based on their increased debt-to-GDP ratio. Italy's debt, now standing at 1.9 trillion Euros and roughly 120 percent of its gross domestic product, has created a significant need for short-term refinancing. Further, it has eroded confidence in the ability of the State to service its debut and has exacerbated to volatility in equity trading for companies large and small in both European and U.S. markets.

Although Italy has borne debt-to-GDP ratios above 100 percent for about 20 years thanks to growth rates that have enabled significant government spending, a major change this century has been the marked decline in real growth, which plunged below zero during the recent global recession. In autumn 2011, Standard & Poor's and Moody's downgraded the Italian sovereign debt rating because of "Italy's weakening economic growth prospects." By early November 2011 the Italian bond yield was 6.74 percent for 10-year bonds, nearing a 7 percent level where Italy is thought to lose access to financial markets.

The reversal of this trend is a key to the country's ability to cover its interest payments without incurring ever-higher levels of debt. Prof. Roscini pointed to the spring of 2012 as "crunch time" for refinancing of current debt. The open question is: will Italian banks be able to sell enough new debt to enable such refinancing?

Beyond containing the spread of debt default and thereby avoiding the choking of credit to its economy, Italy will have to take additional steps, said Prof. Roscini. These include improving its productivity and thereby its global competitiveness. In fact, the World Economic forum Global Competitiveness Report for 2010/2011 ranked Italy 43rd out of 139 countries in terms of competitiveness, a ranking influenced by structural weaknesses in the labor market and weak public finances.

Compared to other Euro-zone countries, Italy suffers from excessive regulation (for example, in the services, energy and labor sectors) and a dearth of R&D spending. The venture capital model that has reached its apogee in the U.S. is virtually non-existent in Italy, where the economy is driven to a significant degree by the manufacture of high-quality, "made in Italy" consumer goods. These products are typically crafted by small and medium-sized enterprises, many of which are family-owned.

Additionally, a business-unfriendly bureaucracy, corruption, byzantine legal processes and infrastructure issues (limited broadband, for example) have contributed to the current state of economic affairs in Italy, observed Prof. Roscini. Aggravating cultural factors include aggressive individualism, low levels of interpersonal trust, suspicion of the State, a delegitimized political class, corruption, tax evasion, the presence of a black (underground) economy and an entitlement mentality.

When Prof. Roscini asked for a show of hands by those who believe the magnitude of the current crisis will be sufficient to change Italians whose mentalities are shaped by these factors, less than ten were counted. At the same time, there was general agreement that highly focused, steeled political may be the key to breaking the influence of what Prof. Roscini termed the country's politico-economic oligopoly. He emphasized the need for growth, citing

the need to harness the talents of women and the energy of a youth saddled by 30 percent unemployment.

What's next then for Italy? Leaving the Eurozone is not an option, as it would result in currency devaluation and inflation, beyond which the same structural issues and need for reforms will remain. But the situation is not without its bright spots, Prof. Roscini noted.

For example, Italy has not experienced the bursting of a massive housing bubble like Ireland. Although public debt remains high, recent spending has been more controlled than that of Greece. The Italian government owns sizeable disposable assets, as reflected in its direct stakes in a number of significant companies. Household net worth is relatively high, while non-financial leverage is low as measured by the percentage of GDP represented by household and corporate debt. The intellectual capital of Italians is yet another asset that continues to pay returns in a broad range of industries and endeavors, many of which have unfortunately flowered outside the country.

That Italy will have to embark upon a period of austerity is a given. That it will need to stimulate growth is another given. That it will have the political will to accomplish both objectives in a timely, equitable and effective fashion over a long terms remains to be seen, although there is hope and perhaps more.

In the wake of the resignation of Silvio Berlusconi, the new "technocrat" government headed by Prime Minister Mario Monti put forth an aggressive austerity package that includes tax hikes and pension reforms in a bid to address the financial crisis. "We have had to share the sacrifices, but we have made great efforts to share them fairly," said Mr. Monti, who said he had renounced his own salary as part of the package. Proposed measures include both budget cuts and pro-growth initiatives.

On December 22, 2011, Italy's Senate gave the country what may turn out to be its best Christmas present this year: a vote of confidence in the Monti government, thus sealing the new Prime Minister's budget and hopefully paving the way toward restoration of market confidence in the continent's third largest economy. The speed with which the budget was passed reflects a new sense of urgency within the country and a commitment to stimulate growth as well as to cut debt. Its longer term impact remains to be seen, but as Prof. Roscini suggested, given the size and impact of the Italian economy, failure is not an option.

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Reports and pictures from PIB's past events are at http://www.PIBoston.org. The organization's goals for 2012 include expanding partnerships with existing groups of Italian professionals in several cities of the world, and creating new ones where needed. The calendar of PIB's events and contact information are at www.PIBoston.org. Text by Bill Boni. Pictures by Dawei Ye.

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