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# Understanding Inflation: The Italian Case

In 2022, the return of inflation drastically changed the economic landscape in Italy as well as the rest of Europe. The average annual growth of the Harmonised Index of Consumers Prices (HICP) in Italy reached 8.7% (compared to 1.9% in 2021), and the monthly change over the previous year reached 12.3% in November 2022. Starting in late 2021 with a major rise in imported energy prices, inflation then spread to producer prices and set in motion a process of readjustment in the economy as a whole.

We have to understand the inflationary shock as a transfer of real income from the domestic economy to energy-supplier countries, and – internally – from the economic actors operating with unchanged prices and incomes to the industries, firms and individuals in a position to increase them. This process of redistribution is shaped by power asymmetries among economic actors and by public policies regulating energy prices, the operation of markets and the redistribution of incomes.

Without public control of energy markets, the industry has obtained large excess profits; firms in oligopolistic markets and with some degree of market power have increased their prices to compensate for more costly inputs; firms unable to raise prices have experienced a squeeze in profit margins. In the longer term, firms may respond to the inflationary shock with investment in new technologies and organisations that reduce the monetary cost of energy and other expensive imported inputs, or that expand the value of exports relative to imports, leading to a recovery in efficiency and competitiveness.

Individuals are exposed in different ways to the effects of inflation. Poorer households devote a greater share of their incomes to energy and food, and are hit hardest by price increases. Moreover, individuals have little ability to respond to inflation. Self-employed workers may have some opportunity to increase the price of the services they provide, depending on their market power. Conversely, employees' real wages are seriously eroded by price increases; automatic adjustments of wages to prices have a modest relevance and a recovery of real wages can only come from demands in collective wage contracts; these, however, face a strong resistance by firms. Moreover, an increasing number of workers – including many in temporary and part-time employment – are not covered by collective contracts and have few prospects to recover their losses in real wages. Labour conflicts over the protection of real wages may result from these tensions.

Moving from income flows to the stock of assets, price increases mean that the holders of financial wealth face the erosion of the nominal value of stocks and bonds. Inflation undermines the foundation of financial expansion and is addressed by monetary authorities with restrictive measures on money supply and interest rates.

In economies with national currencies, a higher inflation tends to be reflected in exchange rate adjustments and currency devaluations that may have further wide-ranging effects on a country's competitiveness and income distribution. Monetary and exchange rate policies are centralised in the hands of the European Central Bank for countries with differing rates of price increases, leading to additional problems of potential policy mismatch.

In these ways, inflation brings about a wide-ranging redistribution of incomes, hitting mostly the weaker parts of the economy and society. Inflation becomes an issue of political contention and a challenge for governments, and public policy plays a key role in addressing the dynamics and effects of inflation and in managing the conflicts over income distribution that may emerge. These adjustments end when the external shock disappears and the resulting new set-up in terms of production, income distribution and policy actions becomes socially and politically acceptable under the new domestic and international conditions.

Following this analytical framework, we investigate the case of Italy, the dynamics of inflation, the trends in prices and wages, considering the compensatory policies that have been adopted and the broader actions that have ad-

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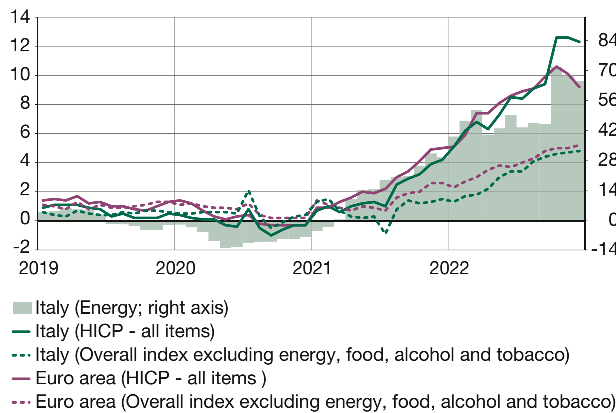
Figure 1

**Inflation in Italy and the euro area**

Annual rate of change, monthly data, January 2019-December 2022

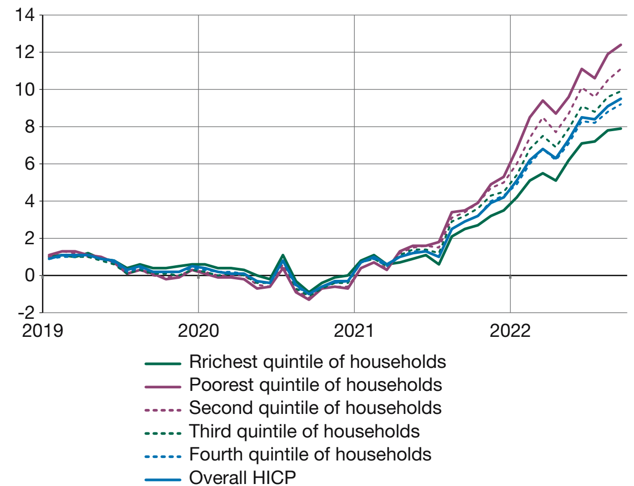



Source: Eurostat.

Figure 2

**Inflation in Italy for income classes**

HICP, annual rate of change, monthly data, January 2019-September 2022




Source: Istat (2022a).

dressed inflation through fiscal, monetary, industrial and price control policies.

## Trends in prices

Figure 1 shows the evolution of consumer prices in Italy and the euro area in 2021 and 2022. Both the overall measure and the index (excluding energy goods) shows that Italy experienced a lower price increase than the rest of the euro area, until the very end of 2022. A large part of the inflation rate is due to energy, confirming the origin of the shock in imported energy prices, rather than in domestic demand factors (Pasimeni, 2022).

The rise in international energy prices started in late 2021, in parallel with rising tensions between Russia and Ukraine. In December 2021, the increase of the HICP of energy goods was 30% in Italy and 26% in the euro area compared to the same month of the previous year. In February 2022, Russia's invasion of Ukraine led to economic sanctions and the restrictions on the import of Russian gas. The ensuing dramatic increase in energy prices peaked in Italy in December 2022 with a 70% increase over the previous year due to Italy's strong dependence on imported energy as well as to the volatility of speculation-driven international energy markets.

Inflation caused by energy goods then spread across the Italian economy; in December 2022, food prices increased by 11.6% over the previous year, and a variety of goods and services recorded substantial price hikes, pushing up core inflation.

Inflationary pressures driven by energy and food affect households unevenly, as poorer households consume a larger share of their disposable income for such goods. A study by Istat (2022a) has divided Italian households in five income groups according to their purchasing power, calculating a HICP measure for each of them on the basis of their consumption patterns. Figure 2 shows that in the third quarter of 2022, prices grew by 11.6% (year-on-year) for the poorest 20% of the population, while they grew by 7.6% for the richest quintile. The three poorer quintiles of Italian households experienced price increases higher than the 8.9% national average.

## The effects on wages

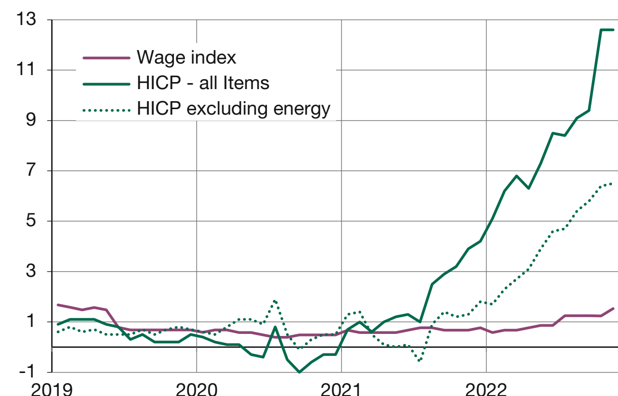
In 2021, the nominal wages of private sector employees covered by the national collective agreement increased by 0.8%, and in 2022 (January to November) the increase was 1%. The stability of contractual wages is in sharp contrast with the rise in inflation, as shown by Figure 3; according to Istat (2022c), in the first nine months of 2022, the gap between the growth of the general price level and of real wages reached 6.6 percentage points; in November 2022, the gap was around 11%.

A 2009 agreement between employers and unions regulates the renewal of collective wage agreements. Italian nominal wages follow a price adjustment based on the three-year forecast of an inflation index estimated by Istat excluding imported energy goods (HICP-NEI). The 2022 estimate of the HICP-NEI is equal to 4.7%, a value below the 8.7% of the average annual inflation of 2022, but also below the 6.5% price increase of the index net of energy.

Figure 3

**Changes in prices and wages**

Annual rate of change, monthly data, January 2019-November 2022




Source: Istat (2022b).

Italy's current mechanism of adjustment of nominal wages is inadequate to protect real earnings, especially those of the lower income employees, who are more exposed to losses in real wages. Moreover, the renewal of collective contracts is extremely lagging, and Italy's CNEL (2022) documented that 591 out of a total of 955 contracts had expired in December 2022; out of 12.8 million employees in the private sector, 6.8 million had expired contracts, with negotiations – including agreements on the recovery of real wages – being postponed by the resistance of employers.

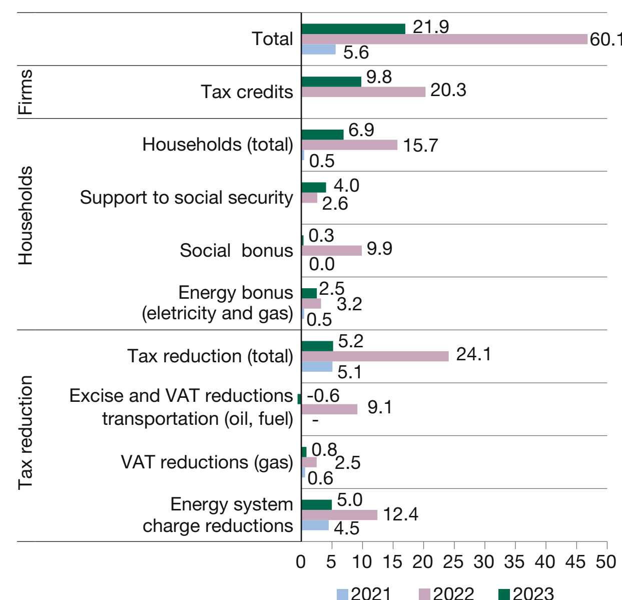
Losses in real wages are particularly serious for employees not covered by collective agreements and for those with low-wage temporary and part-time jobs. The post-pandemic recovery has been associated in Italy with a proliferation of precarious employment, with about two-thirds of all new jobs created in 2022 that are temporary in nature (Cirillo et al., 2022).

In order to reduce inequalities in the face of inflation, the general instrument for protecting real wages has been the indexation of wages to prices, a sensitive issue in Italy. After decades of trade union struggles over the automatic adjustment of wages to prices in the 1970s and 1980s, a referendum in 1985 confirmed the government decision to abolish the "sliding scale" mechanism which had ensured indexation and protected workers' real wages. What is left now in wage agreements is completely inadequate to prevent income losses, and there is a clear need for new national bargaining arrangements. However, the resistance by employers' organisations is combined with the refusal by the right-wing government of Giorgia Meloni to open tripartite negotiations on wage adjustments.

Figure 4

**Government compensatory measures on the effects of inflation**

Estimates of government selected measures to counter inflation in 2021-2023, in billion euros




Source: Authors' own elaboration on UPB (2022).

The fall in Italy's real wages, however, did not start with energy price inflation. The International Labour Organization (2022) Global Wage Report 2022-23 documented that among the G20 countries in the period 2008-22, Italy had the worst dynamics of real wages, with a *fall* of 12%. In the same period, real wages increased by 12% in Germany and by 6% in France. This long-term decline in real wages in Italy is at the root of increasing income inequalities, the rise in poverty and widespread social distress.

## Government compensatory measures

In Italy, government policies have mainly focused on compensatory measures to support firms and households facing sharp increases in energy and food prices. In early 2022, the government of Mario Draghi introduced a range of policies reducing taxation on energy goods, and granting subsidies to firms and one-off payments (bonus) to poorer households. The Parliamentary Accounting Office (UPB, 2022) estimated that the governments of Draghi and Meloni allocated more than €116 billion to compensatory measures for the price hikes over the period 2021-2025; expenditures amounted to about €70 billion for 2022 and €32 billion for 2023. In 2022, the resources spent amounted to 3% of GDP, while in 2023, they are expected to be equal to 1.4% of GDP. Figure 4 shows the main measures introduced for 2021, 2022 and, in some cases, 2023.

Overall, more than one-fifth of the resources were allocated to households, one-third to firms and one-third to tax reductions, cutting excise duties and VAT on energy goods. Figure 4 shows the breakdown of the main types of measures. An additional €2.2 billion was directed to support cost increases for local authorities, €13.9 billion for Public Administration investments and only €3 billion to help the National Health System cope with the rise in energy costs (UPB, 2022). During 2022, the measures introduced were mainly financed by the increase in tax revenues, including those resulting from greater energy-related VAT and excise revenues.

General tax reductions included lowering the VAT to 5% on gas for civil and industrial use (at a cost of about €4 billion) and reducing general system charges for electricity and gas – costs for supporting renewable energy, the elimination of nuclear power, etc. – in 2021, 2022 and the first three months of 2023 (€21 billion in total). Cuts in excise duties on petrol, diesel, and gas and a reduction in VAT on gas for transportation were introduced from March to December 2022 (at a cost of €9 billion). The Meloni government prolonged several measures introduced by Draghi, but the cut in petrol excise duties was discontinued in January 2023, which resulted in major increases in consumer prices for car fuel, as well as social discontent, political quarrels and a strike by fuel pumps in late January 2023.

Government measures supporting firms included tax credits to offset the increasing cost of production inputs and specific policies for gas-intensive and electricity-intensive industrial sectors, along with fishing, transport and agriculture (Simone and Pianta, 2022). In order to compensate vulnerable households, the government introduced measures targeting the poorest population groups. An energy "bonus" reducing household bills was financed with €500 million in 2021, €3.2 billion in 2022, and €2.5 billion in 2023 for families with a total annual equivalent income below a certain threshold (€20,000 in 2022, reduced to €15,000 for 2023) and with at least four members. The energy bonus was also provided to people receiving basic income, social pensions and those with precarious health conditions.

A one-off social "bonus" of €200 was granted in June 2022 to low- and middle-income workers with a monthly wage of less than €2,700 or with an annual personal income of less than €35,000, as well as to those receiving unemployment benefits, minimum wages and social pensions. In November 2022, an additional transfer of €150 was granted to employees with an annual income below €20,000. In total the cost of social "bonuses" amounted to €9.9 billion in 2022.

Further measures included the reduction of social security contributions for low-wage employees and a 2% cost-of-living adjustment for pensions anticipated in the last quarter of 2022 at the cost of €1 billion. For 2023, the Meloni government's budgetary law extended the increase of the lowest pensions for a total of €4 billion. In total, the reduction of social security contributions and pension adjustments cost about €7 billion.

The transition from the Draghi to the Meloni government maintained the overall approach to compensatory policies. Limited changes included the controversial elimination of tax reductions on fuel, and a more specific targeting of measures favouring the social base of the centre-right, including low-income pensioners. However, the burden for public expenditure is increasing, and in 2023 the government envisages a higher budget deficit of about €21 billion. This follows from the prospects of an economic slowdown in 2023, from the higher interest payments on public debt – both resulting from the European Central Bank shift to a more restrictive monetary policy – and from the limited revenue of Draghi's government tax on the extra-profits of the energy sector (UPB, 2022).

### The impact on inequalities

What has been the impact of inflation, and of the compensatory policy measures, on income inequality in Italy? This question has been addressed by a study of the Parliamentary Accounting Office (UPB, 2022), which examined the redistributive impact of government policies introduced between June 2021 and December 2022 across Italian households divided in ten groups based on their level of expenditure. Without government policies, the average cost of living hike would have been 9%; the actual average increase has been 5.4%. For the poorest decile of the population, the change in expenditure due to inflation would have been 15.1%; the actual impact was limited to 4.8%, suggesting that policies considerably reduced the regressive effect of inflation. Social and energy "bonuses" and the cost-of-living adjustment of pensions were found to have the highest redistributive effects. Conversely, tax reductions on energy goods offered greater benefits to the richer groups in the population. However, the redistributive effectiveness of policies has declined over time. For the poorest decile of the population, initial price hikes from June 2021 to May 2022 were fully compensated, but in the period May-September 2022, a 1.3% increase in their cost of living was found.

Similar results are presented by a study by the Bank of Italy (2022), showing that social "bonuses" were the most effective measure to mitigate the regressive effect of inflation and limit inequalities; the other measures tended instead

to allocate most resources to medium-high income households. According to this analysis, government actions were able to offset about 70% of the increase in inequality of purchasing power (measured by the Gini index) that was produced by the effects of inflation (Bank of Italy, 2022).

This evidence shows that the current inflation is indeed increasing income inequality and that the mitigation offered by compensatory measures has been partial, and with declining coverage.

### Corporate excess profits, energy markets and monetary policy

The policy mix adopted in Italy has focused on compensatory measures, while much less attention has gone to the possibility of containing prices in the international and domestic markets for energy goods.

In January 2022, Draghi's government tried to tax firms gaining from energy price increases with an additional 10% tax rate – later increased to 25%. The tax targeted profit increases greater than 10% or above €5 million obtained from October 2021 to March 2022; however, the revenues obtained were much below initial expectations.

At the European level, Draghi's government pursued the introduction of an EU-wide cap on gas prices in order to limit energy price speculation in the Amsterdam market. Greater EU-wide control over the setting of gas and electricity prices is an essential instrument to bring inflation under control. But the policies that have been introduced so far have not changed the structure and functioning of the energy and electricity markets in Europe.

In Italy, the energy market is the result of the privatisation policies of the 1990s, with some public companies – ENI and ENEL being the major ones – operating alongside private firms in a market regulated by a weak public authority. Even companies in which the Italian state is the controlling shareholder adopted a strategy of maximising speculative profits in the same way private firms did. Discussion has not yet emerged on the introduction of a price cap for consumers or companies in the Italian energy market, nor are stricter regulations being proposed to limit the market power of dominant firms, or the inefficiency and instability of market outcomes.

Even less attention has been paid so far to the long-term challenges. In the Italian debate, there is no mention of the need for an industrial policy for the energy sector and there is no consideration of the need to move the Italian and European economies towards a development model that is environmentally sustainable, less energy-intensive, more reliant on renewable energy sources – solar, wind, hydroelectric – and less dependent on energy imports from Russia and the Middle East.

Europe's strongest policy response to inflation has come from the European Central Bank and its turn to a restrictive monetary policy. Interest rates have been raised several times; after the expansion of quantitative easing, efforts to reabsorb liquidity are under way. The resulting prospects include a slowdown in economic growth, lower investments and aggregate demand, the risk of insolvency for highly indebted firms and banks, and heavier costs of servicing the high public debt. None of these developments is able to reduce the rate of inflation, nor can they address its roots in energy price hikes; on the contrary, they make the transition to an economy with lower energy vulnerability more difficult and costly. In crisis after crisis, Europe's response shows a recurrent lack of understanding of the nature of the challenge, and the adoption of policies that are highly inappropriate to address it.

The inflationary crisis that Europe is facing, and the policy responses that are implemented by governments, may turn out to be a missed opportunity for addressing the structural problems of our economic model. The monetary restrictions, the focus on compensatory measures, the failure to prevent predatory pricing and protect real wages are likely to lead to a regressive redistribution, where the burden of adjustment to higher prices is mainly put on workers' wages and low-income groups, resulting in greater inequalities, widespread poverty and social tensions.

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