Global Economics

Why Italy Puts Up With Silvio Berlusconi

▶ **The Italian Prime Minister has a strong Finance Minister and a core of loyal followers**

▶ **"The evil of Italy is a culture that makes Berlusconi a normal politician"**

By his own reckoning, since becoming Italy's Prime Minister, Silvio Berlusconi has endured 105 judicial probes and trials and 2,500 court hearings and spent more than 300 million euros ($409 million) in legal fees defending himself against allegations of tax fraud, bribery, corruption, and more. That's 48,000 euros a day since he was first elected in 1994, when he parlayed his celebrity as a media baron and one of Italy's richest men into a political career.

No conviction of Berlusconi has survived Italy's tortuous appeals process, a fact the Prime Minister cites as evidence that his judicial tormentors are nothing more than closet communists who want to bring him down. His latest trial begins on Apr. 6. Prosecutors in Milan allege that the Prime Minister paid to have sex with a minor—a young Moroccan dancer whose stage name is Ruby Heartstealer—and that he abused the power of his office to cover his tracks. "I'm not the least bit worried," Berlusconi said on Feb. 16.

Salacious details of Berlusconi's off-duty life, like allegations of suggestive dances with young girls in the bunga-bunga room of his villa, have made Berlusconi the butt of jokes. From economist Nouriel Roubini's Twitter page: "Berlusconi's defense: I screwed all Italians for 15 years for free and no one complained; now that I screw one and pay her, they give me hell." In demonstrations on Feb. 13, hundreds of thousands of Italian women called for Berlusconi's resignation and an end to the sexism they feel he has done so much to promote. Their slogan: "If not now, when?"

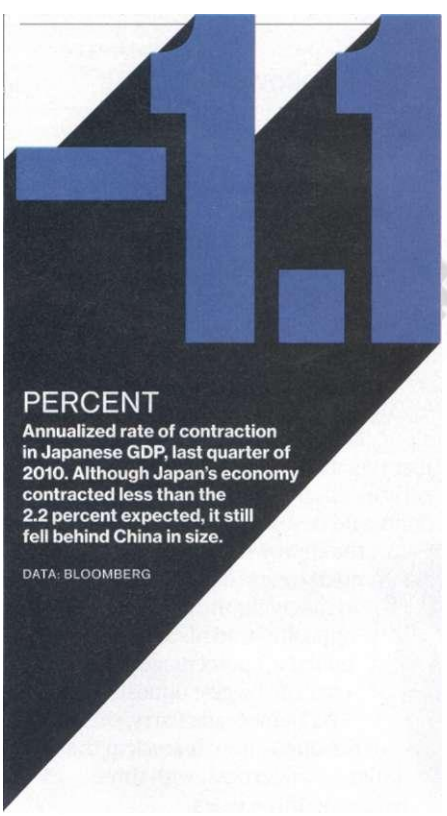
The answer may be: not just yet. Berlusconi's People of Liberty Party and its allies cling to a tiny majority in Parliament. In a Feb. 8 poll about possible early elections, 61 percent of respondents said Berlusconi should resign. Yet the survey showed that voters abandoning Berlusconi may shift to his coalition partner, not the opposition, so his alliance maintained a 3 percentage point lead over the biggest opposition bloc. The Democratic Party, the pillar of the opposition, is stuck in the political wilderness, with three leaders in three years.

CLOCKWISE FROM TOP: ANTONIO SCATTOLON/A3/CONTRASTO/REDUX; LUCA BRUNO/AP PHOTO (3); MARCO SECCHI/GETTY IMAGES

With no compelling alternative, many Italians may vote for Berlusconi again if his legal troubles lead to elections before his term expires in 2013. He has a core following among voters who share his conviction that the Democratic Party is riddled with communists, or who admire him as Italy's ultimate self-made man and model of virility.

Berlusconi also has a secret weapon: Giulio Tremonti, his Finance Minister. While Tremonti has not reversed the widening economic divide between Italy and its main European Union partners, he has averted the kind of catastrophe that dragged down Ireland and Greece. That's an achievement, given that the International Monetary Fund last May described Italy's economic performance as "dismal." Among the failings cited were low productivity, a rigid labor market, and a bloated private sector. Italy's gross domestic product grew an average of 1.5 percent a year from 1999 to 2007, compared with 2.2 percent for the EU. Last year growth was a meager 1.1 percent, following a 2009 contraction in GDP of 5 percent.

A tax lawyer by training, Tremonti has kept the public accounts in order.



He has tempered Berlusconi's populist instincts by playing bad cop to his boss's good cop. That meant blocking the kind of stimulus spending that helped turn Spain's 2007 budget surplus into a deficit of 9.3 percent of GDP by last year. "He is seen as the guarantor of fiscal discipline during a period when other governments were much more relaxed on the fiscal front," says Chiara Corsa, an economist at UniCredit Bank in Milan. As a result, Italy's budget shortfall was a manageable 5 percent of GDP last year.

Overall debt, though, remains almost 120 percent of GDP, vs. 76 percent for Germany. The yield premium that investors demand to hold Italian 10-year bonds over German debt has roughly doubled since early 2010. That is still less than half the gap between yields on German debt and the sky-high yields on Portuguese, Irish, and Greek bonds.

Tremonti, a northern Italian who first ran for Parliament as a Socialist and who regularly rails against the ills of globalization, is known for using creative methods to keep Italy's deficit in check. He has fashioned a series of amnesties for tax dodgers that pardoned their transgressions for a fee that was lower than the maximum penalties. In the most recent amnesty, Italians paid the government 5 billion euros to have 100 billion euros of undeclared funds regularized.

Both Berlusconi and Tremonti have gotten an assist from high household savings, which helped ordinary Italians weather the depths of the recent recession fairly intact, despite an 8.6 percent jobless rate. Private debt in Italy is only 42 percent of GDP, vs. 118 percent for Ireland. Tremonti has told EU authorities they should take this low private debt level into account when figuring out how to improve Europe's finances. EU authorities want mandatory debt reduction targets for the union's most leveraged states. Tremonti argues that Europe's debt crisis was caused by reckless banks and hedge funds, not public spending. "Public debt isn't the cause of the crisis. It's the medicine," he says.

Tremonti, 63, could end up succeeding the 74-year-old Berlusconi if his boss's position weakens dramatically and his party starts to disintegrate. For now, Berlusconi's supporters are defending their man and accusing the judiciary of trying to override the will of voters, who re-elected Berlusconi by a landslide in 2008.

Berlusconi's opponents, meanwhile, wonder if Italy can ever move beyond its fascination with the man. "We think the evil of Italy is Berlusconi," says Luigi Zingales, professor of finance at the University of Chicago Booth School of Business and a graduate of Milan's Bocconi University. "I think the evil of Italy is a culture that makes Berlusconi a normal politician. That is much more difficult to change." —*Andrew Davis*

The bottom line *While Berlusconi's reputation has been battered, he has no strong rivals and a respected Finance Minister.*

State Enterprise

Egypt's Army Marches, Fights, Sells Chickens

- The country's generals run a network of businesses
- The military is "becoming a 'quasi-commercial' enterprise"

The Egyptian military played a crucial role in the ouster of President Hosni Mubarak and has promised to steer the nation toward democracy. What's little known outside *Egypt* is that the army plays a crucial role in the economy as well. That raises the question: Will the military back reformers if they threaten to dismantle its business interests?

The armed forces have a substantial stake in Egypt's civilian economy through a host of government-owned service and manufacturing companies, at least 14 of them under the auspices of the Military Production Ministry. Military-run companies are in such businesses as janitorial services, household appliances, pest control, and catering. El Nasr Co. for Services and Maintenance, for instance, has 7,750 employees in such sectors as child care, automobile repair, and hotel administration, according to its website. Other military companies produce small arms, tank shells, and explosives-as well as exercise equipment and fire engines.

These companies add up to "a very large, unaccountable, nontransparent Military Inc.," says Robert Springborg, a professor in the department of national

security affairs at the Naval Postgraduate School in Monterey, Calif., and author of *Mubarak's Egypt: Fragmentation of the Political Order.* The generals "will try to massage the new order so that it does not seek to impose civilian control on the armed forces," he says. "It's not just a question of preserving the institution of the army. It's a question of preserving the financial base of its members."

As much as one-third of Egypt's economy is under military control, says Joshua Stacher, an Egyptian-military expert and assistant professor at Kent State University in Ohio. Revenues from military companies are a state secret, along with the armed forces budget, he says.

It isn't uncommon for governments and militaries to own or run their own defense-related industries and arms makers. In Singapore and Israel, for example, nationalized production of fighting hardware is seen as a way to protect national security by avoiding dependence on foreign arms contractors. What sets apart the Egyptian military, the Arab world's largest, is that its companies also offer an array of products or services in the domestic consumer economy-and without any civilian oversight.

The Egyptian Military's Odd Jobs

- Janitorial Services
- Pest Control
- Child Care
- Manufacturing
- Crane and Generator Rentals
- Agricultural Waste Management
- Lodging and Transportation
- Maritime Services

DATA: QUEEN SERVICE WEBSITE

The latest assessment of defense production and military companies in Egypt from defense information firm IHS Jane's in London, and a 1998 report produced by the American Embassy's commercial affairs section in Cairo, list three military-owned businesses that sell to both the armed forces and the public. One is El Nasr, which operates under the brand Queen Service. It has at least 18 service businesses, according to its website.

General Ahmed El-Banna, general manager of El Nasr, says the military owns 75 percent of the company while the rest is held by retired officers. Two other consumer companies were named by the reports: El Nasr Co. for Intermediate Chemicals, whose website says it produces chemicals, fertilizers, industrial and medical gases, and household pesticides; and Arab International Optronics, a maker of lenses and advanced optical equipment. No one answered the phone at Arab International Optronics, which doesn't have a website, and the number given by telephone information for El Nasr Co. for Intermediate Chemicals didn't answer.

Foreign Accounts

How the Swiss Freeze Crooks-in-Chief

Switzerland's decision on Feb. 11 to freeze the assets of former Egyptian President Hosni Mubarak is the latest action taken by the famously neutral country against a fallen strongman. The Swiss claim to have returned $1.8 billion in assets from dictators to their countries of origin in the last 15 years. Clawing back the spoils of corrupt regimes is no simple matter. —*Ira Boudway*

The Swiss Constitution allows the country's ruling Federal Council to freeze assets temporarily in anticipation of criminal charges being filed abroad to recapture the funds on deposit in Switzerland.

Under a 1981 law, Switzerland may cooperate in cases against "politically exposed persons." The demand for forfeiture must come from the country of origin. Failing that, the assets are returned to the original depositor or his heirs.

Last fall Switzerland passed the Restitution of Illicit Assets Act (RIAA). It allows the Federal Council to seize frozen assets in cases where the judicial system in the country of origin is inadequate.

1 Mobutu Sese Seko
Democratic Republic of the Congo

Assets frozen: **$6.7 million**

In 1997 the Swiss froze the assets of longtime dictator Mobutu at the request of the newly formed Democratic Republic of the Congo. After four extensions over 12 years and repeated attempts to help the DRC bring a case, Switzerland released Mobutu's assets in July 2009, effectively returning the money to his heirs.

2 Sani Abacha
Nigeria

Assets frozen: **$700 million**

In 1999, a year after the Nigerian military leader and de facto ruler died, the Swiss froze Abacha's accounts at Nigeria's request. In accordance with a 2005 agreement with the country, they have returned the money to Nigeria in installments for health and education projects.

3 Jean-Claude "Baby Doc" Duvalier
Haiti

Assets frozen: **$5.7 million**

When the Haitian President fled in 1986, the Swiss froze his assets at Haiti's request. Over the next 25 years Haiti failed to bring a formal case against the former dictator. The Swiss enacted RIAA and seized Duvalier's funds. Baby Doc's representatives will have a chance to prove the legitimacy of his wealth during forfeiture proceedings.

DATA: SWISS FOREIGN AFFAIRS DEPT., WORLD BANK

ILLUSTRATION BY LEIF PARSONS

The money behind the nominees page 24 ▶

The Ministry for Military Production lists on its website more than a dozen "military production companies," including Abu Zaabal Co. for Engineering Industries, Benha Co. for Electronic Industries, and Maadi Co. for Engineering Industries. Abu Zaabal was established to secure the armed forces' artillery needs, according to the website. It also produces water and fuel tanks.

Maadi makes parts for medical and agricultural equipment as well as home appliances, radiators, and exercise equipment. Benha owns factories and produces telecommunication equipment, microwaves, and personal computers. The Egyptian Tank Plant makes red firefighting vehicles.

In a secret cable signed by U.S. Ambassador to Egypt Margaret Scobey, the embassy in Cairo told Washington that the Egyptian military was "becoming a 'quasi-commercial' enterprise itself." The secret cable was dated September 2008 and was released last December by WikiLeaks. Although the cable didn't detail individual firms, it said the embassy's sources "told us that military-owned companies, often run by retired generals, are particularly active in the water, olive oil, cement, construction, hotel and gasoline industries." It also offered this view from embassy staff: "We see the military's role in the economy as a force that generally stifles free market reform by increasing direct government involvement in the markets."

The armed forces' business interests would be at risk if demands for opening up the economy ran too deep, said Samer Shehata, an assistant professor at the Edmund A. Walsh School of Foreign Service at Georgetown University in Washington, before Mubarak stepped down. "If the military was completely removed from politics, then there is no question that these interests would be put in jeopardy."

Military companies also play a significant role in consumer food production, says Springborg, the Naval Postgraduate School professor. The military runs "chicken farms, dairy farms, horticultural operations. And it of course has its own bakeries," he says.

The military's "business interests are very large," says Bassma Kodmani, executive director of the Paris-based Arab Reform Initiative and a senior adviser at the French National Research Council. Those businesses, though, help build the nation and keep capital within its borders. "The army is not seen as corrupt," she told a group of reporters in Paris last week. "It might seem strange to people in the West, but in Egypt it's not considered shocking that the army builds highways or new housing projects."

—Cam Simpson and Mariam Fam

The bottom line *The Egyptian military, which runs a large network of businesses, will defend those interests if they are threatened by reformers.*

Quoted

"Imagine if housing prices stabilize where we are, and then we slowly crawl back just based on the underlying level of inflation. That could take a decade to get back to where we were in 2006 in terms of home prices. So it's a shock."

—Christopher Whalen, Managing Director, Institutional Risk Analytics

Regulation

The Fed's A-Team Hunts for Signs of Risk

▶ A new group of analysts and economists probes the banks

▶ "What do these guys really bring to the table?"

Some of the biggest banks in America, such as **JPMorgan Chase** and **PNC Financial Services,** want to increase dividends over the next few quarters. When those dividends do go up, it will look like a vote of confidence by bank boards on the sustainability of economic growth and profits. The payouts will also be one of the most carefully screened moves by regulators in modern financial history.

The behind-the-scenes guiding hand of these bank board actions is a little-noticed team of economists, payment systems experts, bank examiners, and quantitative analysts at the Federal Reserve. The group was formed in early 2010 by Chairman Ben Bernanke and Governor Daniel Tarullo to hunt down risks in the financial system before they trigger another crisis.

Almost a year ago, the new Fed team, known as the Large Institution Supervision Coordinating Committee (LISCC)-which staffers pronounce "Iis-sick"-helped Bernanke identify and respond to an emerging threat to the global banking system when U.S. money market funds began dumping European bank debt out of fear of a Greek default.

Now, the unit has given the directors of 19 banks, including JPMorgan Chase, PNC, **Citigroup,** and **Goldman Sachs,** a challenge: Before you hand out cash to shareholders, think about what might happen to you over the next nine quarters if unemployment rises and the economy falters. "The current review of firms' capital plans is another step forward in our approach to supervision of the largest banking organizations," says Tarullo.

If the bankers don't come up with a plan to have enough capital to withstand economic, regulatory, and lending risks, then the regulator is likely to challenge the dividend increases and ask for revisions, according to a set of guidelines issued by the Fed in November. "We came about as close as you can to the Great Depression. Regulators are going to err on the side of caution," says Joel Conn, president of money managers Lakeshore Capital in Birmingham, Ala. The pressure from the Fed may be working. At a Feb. 15 presentation, JPMorgan Chief Financial Officer Douglas Braunstein revealed that the bank's stress scenario for the economy was more severe than the Fed's.

LISCC also wants banks to plan for an array of new regulations that could lower profits. Another LISCC focus is the likelihood that investors in faulty mortgages may force the banks to take them back. Standard & Poor's estimates such a maneuver could cost the industry $60 billion.

Before LISCC's creation, the Fed's 12 reserve banks handled much of the day-to-day supervision of big banks and reported back to the Board of Governors in Washington, which sets the rules for bank holding companies. With LISCC, the Fed can tap its deep bench of more than 200 PhDs to figure out how a particular risk might

➔

FROM TOP: ALBERTO E. RODRIGUEZ/GETTY IMAGES; SVEIN ERIK DAHL/JOHN WILEY & SONS/BLOOMBERG

affect the entire financial system or just a single bank.

The intense scrutiny of everything from compensation to stock buybacks shows the depth of the regulatory incursion into tasks normally handled by bank directors. E-mails revealed by the Financial Crisis Inquiry Commission showed the Fed even considered ousting Lehman Brothers Chief Executive Officer Richard Fuld and exercising "influence" over his successor. It's too much, says Wayne Abernathy, executive vice-president of the American Bankers Assn. and former staff director of the Senate Banking Committee under former Senator Phil Gramm (R-Tex.). "What do these guys really bring to the table that the leaders of businesses don't already know or have?" he says. "The answer is: the wrong set of incentives. Their incentive is to take no risk."

On the other side, financial regulators don't have high confidence in bank boards after the crisis revealed they didn't fully plan for events such as the fall in housing prices, says Alan Blinder, a Princeton University professor and former Fed vice-chairman. Regulators "would have loved to have left these issues, especially compensation, to boards if they exercised their responsibility," he says. Bank boards "blew it, big, big-time" during the financial meltdown.

$60 BILLION

Possible cost to banks if they have to take back faulty mortgages

To figure out if banks have enough capital, the Fed has asked the 19 largest banks to come up with at least two scenarios: a "baseline" on how the economy will probably perform and an adverse scenario. The LISCC has deployed Fed economists to come up with its own adverse scenario, laying down an official standard for what could go wrong. The Fed's worst case calls for a 1.5 percent decline in gross domestic product through the end of 2011, according to people familiar with the central bank's thinking.

The unit has also made one of the largest data requests in Fed history outside of normal regulatory reporting, asking for information in a range of areas, including loans and securities portfolios. This will allow the Fed to test any one bank's assumptions about the soundness of its portfolio against analysis of its own. Says Kevin Petrasic, an attorney at the law firm of Paul Hastings in Washington and a former special counsel at the Office of Thrift Supervision: "You have an entire industry that is now on parole." —*Craig Torres*

The bottom line *The Federal Reserve's specially assembled team of risk detectives will pressure the nation's largest banks to raise capital if needed.*

Gambling

For Hong Kong's Jockey Club, the Race is Online

▸ As websites woo bettors, the club is seeking new ways to compete

▸ The Internet "has eroded racing's capacity to ... achieve a fair return"

Over its 126 years, the **Hong Kong Jockey Club** has survived equine flu, the Japanese occupation, bribery scandals, and the end of British colonial rule. Now the club is looking to cope with its biggest challenge yet: the Internet. Though members still flock to the club's two tracks to sip Chateau Margaux and take in the races, a growing share of the money wagered is bypassing the club in favor of unauthorized betting websites. "Competition is just a mouse click away," says Winfried Engelbrecht-Bresges, 56, the club's chief executive officer. "Our competitiveness is at risk."

Unauthorized bookmakers-both online and offline-take bets on Hong Kong horse races equal to somewhere between 33 percent and 100 percent of the Jockey Club's receipts, the club estimates. Given that the club last year accounted for some 7 percent of Hong Kong's tax revenue, making it the city's biggest taxpayer, that would mean the government lost out on at least HK$2.6 billion ($334 million), based on the

19

Tom Keene's EconoChat

Tom talks with **Robert Albertson,** chief strategist for investment bank Sandler O'Neill, on disposable income in the U.S.

You say in your report: Disposable personal income is "highly artificial." You call it a "dangerous aneurysm." That's strong language.
I don't know a better metaphor. An aneurysm is something you know is there. You just don't know when it will cause trouble. If you look at the consumer side of it, over the last 20 years you have had savings drained. Over the last 10, over half of consumer spending came from home equity withdrawals. Now we are out of the recession and consumer spending was up another $159 billion annually in the fourth quarter over the third. Forty-four percent of it came from lower savings and new debt. That is not sustainable.

That's not all you're worried about.
We need to ask what it would mean if we had a 100, 200 basis point increase in interest rates. What would it mean to housing? Here's a disturbing fact: A 30 basis point increase in interest rates for the government would completely wipe out everything Obama said in the last three months in terms of deficit and debt reduction.

Are you optimistic that we are setting up policies that will clear markets, particularly in housing?
The government is still focused on, I think, the wrong thing, which is to keep the cost of financing housing low. They need to focus on establishing sensible down-payment minimums and they must deal with the damage that already happened. Ⓑ

Keene hosts Bloomberg Surveillance *7-10 a.m., 1130AM in New York, XM 129, Sirius 130.*

FROM TOP: DALE DE LA REY/BLOOMBERG; ANDREW HARRER/BLOOMBERG

Fonte: Bloomberg Businessweek, New York, p. 11-14, 21 e 27 February 2011.