Italy’s struggle with the euro straitjacket

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Paolo Gentiloni took over from Matteo Renzi as Italian Prime Minister in December, but the country’s politics remain volatile amid infighting within Renzi’s Democratic Party and calls from the Five Star Movement for a referendum on Italy leaving the euro. **Miguel Otero-Iglesias** *highlights the widespread anger some voters feel toward the EU and Germany, but suggests that even if Grillo were to win the next election an ‘Italexit’ would be unlikely.*

There is no doubt that Italy is in a euro-funk. This is a country that has barely grown since joining the single currency. Today´s GDP is still 7% below its 2008 level. Private investment has plunged 25%, public investment 22%, and its productive capacity has shrunk 20%. Overall registered unemployment is at 12% and the percentage of youth that are not in employment, education or training (NEET) is at a staggering 27% – only Turkey performs worse among OECD countries. No wonder many young and bright Italians leave the country.

Those that remain are angry. One need only visit Italy to find out why. They are fed up of their corrupt mainstream politicians, the so-called *partitocrazia*. But this is old news. The peoples of the *Belpaese* have always felt that they don’t deserve the incompetence, nepotism and robbery of their elites. But there is something new. Now a lot of the anger is directed towards Europe, the euro and, of course, Germany. The widespread feeling is that the single currency has become a straitjacket controlled by the Germans, and that there is no way to loosen it up.

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The old social contract of Italy seems to be broken. When one asks why there is so much public outrage against the corrupt elites, when there was so little of it previously with Silvio Berlusconi (a corrupt-in-chief himself), the answer is that before, those at the top filled their pockets, but they let ordinary people dodge taxes here and there too. Italy was based on the principle of: *vivi e lascia vivere* (live and let others live). This has changed. With the crisis and the necessity to control the public budget (Italy has a public debt to GDP of 130% and is under constant market watch) fiscal control at the micro level is now more stringent.

Cash payments were limited to 1,000 euros in 2011. The screws started to be tightened. Perhaps a notch too much. The limit was raised this year to 3,000 euros. The popular outcry was just too strong. This is a clear indication that the average Italian does not feel that the adjustment is being shared evenly. For decades, the majority of Italians were pro-European because they thought the EU would act as a *vincolo esterno*, a constraining and even stabilising factor, for a country that has had 64 governments since 1945, each lasting a bit more than a year on average. The problem is that now they feel that the *vincolo esterno* constrains them, not the elites.

This is one of the reasons why Beppe Grillo's Five Star Movement (5SM) – and its critique of the euro, the EU, and Germany – is so popular. Brussels is seen as the ultimate capital of the establishment. The capital of a liberal, distant, arrogant and well-off elite that has 'imposed' no fewer than four un-elected prime ministers since 2011: Mario Monti, Enrico Letta, Matteo Renzi and now Paolo Gentiloni. Even Matteo Renzi, who arrived to power as a fresh, unstained and reformist leader, is seen as part of the euro-establishment, despite his desperate efforts to present himself as the Italian rebel who even dared to take away the EU flags from official buildings in order to win the 4 December referendum, which he eventually lost.

Renzi's critical and sometimes even hostile attitude towards Brussels and Berlin has helped to fuel anti-euro sentiment in Italy. In a similar fashion to Greece a few years ago, there are now people both on the left and the right who think life would be better outside the single currency. The former because they believe that they could introduce reflationary and redistributive neo-Keynesian policies outside the German straitjacket, and the latter because they hold the romantic view that Italy was once an industrial powerhouse – which joined the exclusive club of the G-7/8 – and hence it will go back to this position once it has regained monetary and fiscal sovereignty. These new nationalists even have geopolitical ambitions. They say that outside the EU, Italy could finally establish friendly diplomatic relations and trade agreements with the Arab world and Russia, with whom the country has historic ties. Indeed, there is a bit of Brexit, "I-want-to-go-it alone" contagion here.

However, the truth is that the euro, the EU and Germany function mostly as scapegoats. It is undeniable that the policies adopted by the Eurozone to overcome the crisis were suboptimal. There was a lack of coordination and the fiscal adjustment in some countries (especially in Greece) was too steep. Spain shows that a more gradual approach would have been better. But the predicament of Italy is not due to the euro straitjacket. If that were the case, why is Spain growing at over 3% while Italy is stagnant? Even considering Spain as an outlier, why did the Eurozone as a whole grow 1.7% in 2016, while Italy only 0.8%? The answers may be found in Italy itself, not in Brussels and Berlin.

As Bini-Smaghi, Padoa-Schioppa, Saccomanni and others warn, leaving the euro and reintroducing the lira would not solve Italy's perennial structural problems: the rigidity of its product markets, the low level of education of its human capital, the low investment in research and development, the excessive red tape, the poor infrastructure, the very slow judiciary, the lack of competition in local services, and widespread corruption.

If one looks at OECD data, Italy is one of the worst performers in increasing productivity since 2010, when the Greek crisis started. Spain, by contrast, performs better. It has also a degree of labour participation that is much higher than its Mediterranean neighbour. Ultimately, the Italian workers will not be able to go back to the cosy world before the euro. Now their competitors are not only in Europe, Japan and the US, but also in South Korea, China, Brazil and India.

The good news is that most Italians understand this. Despite the frustration, and nostalgia for the past, when asked whether they want to go back to the lira most of them reject the idea. At most there are now around 30% of Italians that want to go back to their national currency. This is not the majority, but it is a large figure. It is also likely that these are the angriest people in the country and that they will vote for the Eurosceptic 5SM and Lega Nord in the next elections. Does this mean, though, that Italy will exit the euro? This remains unlikely.

The reasons are threefold: First of all, the Italian constitution does not permit it. The 5SM and Lega Nord would need to first change the Constitution and then win a referendum. Second, Italy has a lot of public debt, but a lot of private wealth too. Italy's net international investment position is much better than that of Spain, for instance. Few Italians would want to see their savings transformed from strong euros to weak liras. Three, many Italians don't like the euro, the EU and Germany, but their trust in their national politicians and institutions is even lower. They reckon: "since the crisis started we were not able to produce a stable government, how will we be able to produce a stable currency?" So, deep down they don´t want to leave because they do not know where to go.

This does not mean, however, that talk of *Italexit* will disappear. On the contrary, as long as there is anger then the likelihood of Grillo winning the next election will remain. And anger is likely to increase because Renzi´s Jobs Act, his biggest reform effort, has generated mostly work for the elderly but not for the young, while Italy still needs to massively reduce its unit labour costs and clean up its banking system. If Grillo does win, he will use the exit card to blackmail Berlin and Brussels to change policies. If this is the case, we might see another damaging game of chicken, like Grexit with a similar outcome. It is very difficult to threaten to leave when the majority of your population wants to stay – and staying means undertaking the structural reforms Italy has been delaying for far too long.

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