Italy's economic problems are not caused by the euro, but by the country's chaotic political system

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Despite some signs of economic recovery in the Eurozone, the Italian economy has continued to struggle. **Salvatore Perri** *assesses the argument that Italy's economic problems are largely a result of its membership of the euro. He argues that most of the problems identified with Italy's use of the single currency would likely be exacerbated with an independent currency and that the real issues facing Italy are a consequence of the decisions made by Italian politicians.*

In Italy, the debate about the euro is becoming increasingly complex. Many analysts, politicians, and also some economists have openly suggested that exit from the euro could be a good solution for the Italian economy. Nevertheless, there are some aspects which are not given sufficient attention in this analysis. What would the impact of leaving the euro actually be on the Italian economy?

The most important argument which has been made against the euro in Italy is that the productivity of Italian workers has declined since monetary union. This may well be true, but it is difficult to assert that the euro was the biggest cause of this development. In all developed countries, the so called 'financialisation' of the economy has generated a reduction in the weight of work for modern societies due to the financial sector absorbing a greater chunk of a nation's financial resources.

Historically, Italy was a country which was capable of transforming raw materials into products which could be sold to other countries. Independently of which currency is used, globalisation has reduced the opportunity for Italian goods to be successful in world markets as developing countries have gained a larger stake in exporting goods to areas such as Europe.

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Competition over goods will always be determined by two factors: cost and quality. Italian goods are now in a situation where they will only be in an advantageous position if they are of greater quality than alternatives, with a high level of technological skill in terms of production. Reducing wages is therefore not the solution to making Italian goods competitive again and the productivity of workers is not the problem facing Italian industries.

Exit scenarios

Leaving this issue to one side, let's imagine that Italy did leave the euro and opted to take a 'new lira' as its legal currency. Under this scenario what would happen to wages? The new lira would be weaker than the euro and, as such, Italian firms which export goods would be at an advantage. Unfortunately, however, Italy is not blessed with oil or other raw materials and would therefore have to pay a premium to produce these goods, which could also potentially lead to high levels of inflation.

Far from obtaining an advantage by leaving the euro, this course of action would probably achieve the opposite of what is intended. Workers would have to pay higher prices to sustain themselves and, as a consequence, would demand higher wages. Firms, in turn, would have to increase prices further to compensate for the higher staff costs, potentially leading to requests for government support to help production.

The result would likely be similar to the situation in the late 1970s, with high inflation and high levels of social instability. Under these conditions Italian exporters would certainly not be in a position to compete more effectively in world markets. Moreover, it should also be remembered that in southern Italy criminal organisations remain strong: if inflation is growing and the state becomes weak, the main beneficiaries may end up being Italian Mafias.

The real problem with Italy's use of the euro

Clearly, the euro has more than one problem, but these issues have been presented incorrectly in the Italian debate. In reality the solution is not 'less Europe', but more Europe. Monetary policy has become integrated, but local governments still compete over fiscal policy. The result is that countries across the Eurozone possess different kinds of policies, from social security to commercial laws. The fact that the European market is not complete is what disadvantages Italian firms.

High levels of corruption, criminality, and inefficiencies in the country's bureaucratic and banking systems are additional problems in Italy. None of these problems will be solved by exiting the euro and in many ways leaving the single currency could achieve the opposite result. If Italian politicians again have the capacity to determine both fiscal and monetary policy why should we expect a different situation from that which occurred in the 1980s, where policies were regularly set with the aim of securing votes rather than solving existing problems?

Contrary to public opinion, Italy is not respecting important European legislation in the areas of competition and anti-corruption, among others. The reasons for this are clear: the Italian system is not competitive internally, with banks and firms closely connected to each other, and politics having to take into account the opinion of the strongest voting blocks. The sale of the 'old' Alitalia airline in 2008 is a prominent example, where the Italian government split the company into two parts and sold the profitable section to a group of Italian investors, at great cost to taxpayers, under the guise of preventing it becoming French property.

Earlier this year, in the last period of Enrico Letta's government, banks were also granted support through a highly unusual operation which involved hiking the value of the Italian central bank's share capital from 156,000 euros to 7.5 billion euros (something which had not previously been done since the 1930s). The decree simultaneously set a ceiling of three per cent on the amount of the bank's shares that could be owned by any individual stakeholder.

This ensured that other banks such as Intesa and UniCredit were 'forced' to sell most of their existing stakes in the Italian central bank (42 per cent and 22 per cent respectively) back to the central bank itself at the now greatly increased rate. Contrary to the way it was presented, the legislation thereby sought to provide substantial financial support to these banks directly from the central bank.

Normally, if a government helps banks it is required to implement a change of governance strategy at the banks being granted support (as happened, for instance, in the United States), but in this case this did not happen. In Italy, the rule appears to be 'help without control' and this is the real problem. Italian politicians and bureaucracy evidently do not like to lose power with respect to the European institutions.

A vicious circle

To avoid problems, Italian politicians accept some European Commission indications related to austerity measures and cuts of public expenditure. However these are precisely the policies which are harming the Italian economy as the reduction of workers' incomes (through labour reforms) reduces consumption and the level of production.

At the same time, these policies increase unemployment and thereby raise the amount of public debt. Considering the structural problems within the Italian economy, the fall in GDP experienced since the start of the crisis has virtually no limits as firms that close will not be replaced by others. Moreover, some of the measures within the fiscal compact and balanced budget requirements have fuelled Euroscepticism.

It is still possible to halt this trajectory with the right reforms. First, structural funds should be managed by international actors and not by an Italian bureaucracy which is largely unfit for purpose. Second, the European institutions should take a tougher line on the application of EU legislation in Italy, particularly with respect to anti-corruption laws, public agencies, private firms that work for the public sector, and the timing of judgements.

Finally, the European Commission should recognise that the economic conditions in Italy are close to a disaster and remove (temporarily) some hurdles in terms of public investment to sustain aggregate demand. This can be done in two ways: by helping firms to change production processes and by considering universal forms of protection for people that lose their jobs (such as a basic income). These measures have costs and may entail being flexible on the current deficit/GDP limit of three per cent. It may also be necessary to adapt the strategy of the European Central Bank and move resources directly to these projects without the intermediation of Italian banks.

Ultimately, the issues surrounding Italian public opinion and the European Union are generated by the contrast between Italian politicians and the European institutions. The Italian system is blocked by the inability of policy-makers to arrive at the correct solutions because they are scared of disrupting the political consensus.

In this context, the European institutions have to help Italy to implement reforms – not with absurd economic parameters, but through anti-corruption laws, social protection, a reduction in inequality and strict control of European funds to reduce the gap between the South and the North. The Eurozone may have real problems, but the current exit strategies being put forward for leaving the single currency are little more than a smokescreen used by Italian politicians to obscure their own responsibility for the crisis.

About the author

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