Why Italy Will Not Make It

blogs.lse.ac.uk/eurocrisispress/2014/10/01/why-italy-will-not-make-it/

Roberto Orsi 10/1/2014

By Roberto Orsi

"Italian Landscape with Viaduct and Rainbow" by Károly Markó (1838)

Three articles by prestigious commentators (Ambrose Evans-Pritchard and Roger Bootle for *The Telegraph*, Wolfgang Münchau for *Financial Times*) have recently appeared in the financial press about the economic situation of Italy and the (in)stability of its national debt. The arguments and wording of these pieces deserve special attention, as their appearance may signal a new turn in the way in which market operators and policy makers are re-positioning themselves in relation to the Italian sovereign debt and the implications of its current trajectory, for the Eurozone and beyond.

In its essence, such turn consists in an at least partial embracing of parts of an admittedly "pessimistic" narrative already articulated by many, including by previous posts on this very blog. All three articles wonder what would happen if the Italian economy continues to stagnate or contract not only this year (which is certain), but also in 2015 and 2016.

In this respect, Bootle puts forward the view that

> *Italy is very close to the situation that economists call a 'debt trap', that is to say when the debt ratio rises exponentially. From this the only escape is through inflation or default. Italy cannot inflate while it has no separate currency. So, unless something big starts to change pretty soon, Italy is on course for the mother and father of sovereign default.*

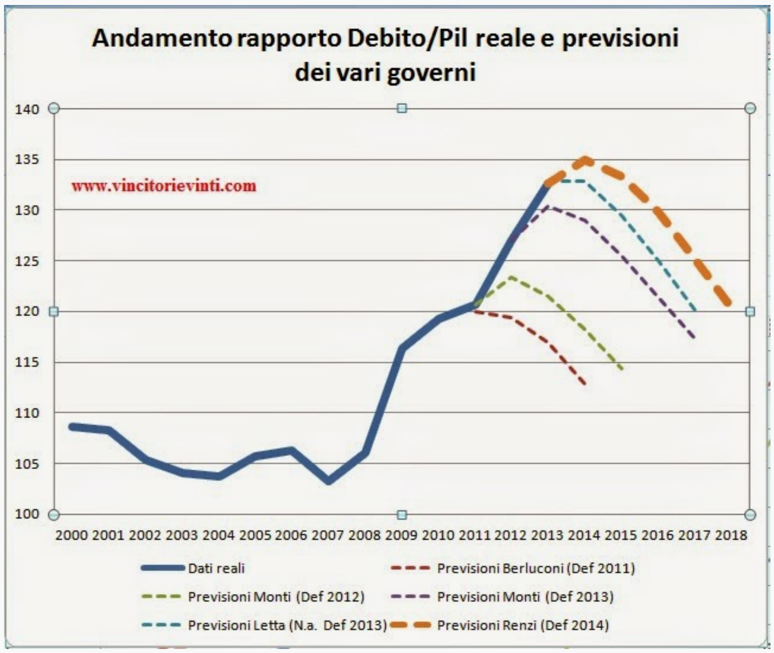
There are indeed technical discussions on the maximum sustainable level of public debt for any country, the threshold beyond which some sort of default becomes mathematically unavoidable. Japan's national debt stands currently over 230% of GDP, but Tokyo is still regarded as a solvable creditor, in essence because Japan's debt is expressed in the national currency. The case of Italy is notoriously difficult, since the Euro can effectively be considered as foreign currency. Evans is clear in stating that

> *[…] Italy's public debt will spiral to dangerous levels next year, even further beyond the point of no return for a country without its own sovereign currency and central bank.*

Münchau's article is the most explicit of the three, and adopts what the establishment may consider alarmist tones, which are however pretty much adequate to capture the situation. The associate editor and European economic columnist for the Financial Times writes:

> *Italy's economic position is unsustainable and will result in eventual debt default unless there is a sudden and durable change in economic growth. At that point, Italy's future in the Eurozone will be in doubt and – and indeed the future of the euro itself.*

These three pieces can be interpreted in several ways. At face value, they address the now very apparent question of Italy's bleak financial future, pointing at possible risk and remedies. However, they can also be seen as (the beginning of) a media offensive directed at the ECB to force the adoption of monetary policies similar to those of the American FED, the Bank of Japan, and the Bank of England, a point for action which all three authors advocate, alongside the rapid introduction of sweeping reforms in the Italian economic and political system.



This graph has been produced by the www.vincitorievinti.com blog. It shows the projected public debt of Italy as forecast by the various Italian governments since 2011, and the skyrocketing real trend. 2014 debt levels, now over the 135% mark, show a colossal forecast error of about 20-25% of GDP in comparison to the 2011-2012 official projections.

These considerations emerge against a background of disappointment regarding the economic growth of the country, which has been consistently missing the however modest forecasts produced by the Italian government, year after year. The recovery is always going to start from next year. This mantra has been repeated at least since 2011, but the situation has not improved. Italy will register at the end of 2014 the third consecutive year of negative GDP growth, to borrow from the economists' euphemistic language. It is very improbable that the country is going to meet the GDP targets of 2015 as well, considering the ongoing slowdown of economic activity in Europe, and the overdue correction in global financial markets.

Within this framework, economic commentators, following a thread which has been dominating Italian media for a few years, and with a great intensification since Renzi's ascent to the office of Prime Minister, have reached the conclusion (finally!) that this crisis is not caused by however contingent and transitory factors, but has a structural character, and growth can be restored only by means of "reforms".

Indeed, it is no understatement to say that "reform" has been the buzzword of Italian politics of the past three years, if not much longer, with a significant intensification since Renzi's ascent to the position of Prime Minister.

The debate may sound awkward to someone living in a better functioning European country. Proposals range from the complete re-organisation of the central and peripheral bureaucracy, of the territorial and local authorities, of the justice system, of the core constitutional organs of the state, particularly the Senate, and the electoral law. To that, a series of projects must be added in the regulation of job markets, access to credit, public school, immigration and citizenship. In sum, everything that a “normal” country has or has re-organised at least since the 1950s, if not already long before, it is still missing in Italy. More than “reforms”, the point is here almost the entire edification, rather than re-construction, of a real state of some sort.

However, all this talk about reform is an illusion at best, as it will be argued below.

Reform timing

Firstly, if it is clear that something has (had) to be changed in the architecture of Italian economy, and particularly of its public finances, despite the proclaimed urgency, only **one** structural reform has been accomplished in the **six years** following the collapse of Lehman Brothers, or in the approximately **twelve years** since Italy entered a period of stagnation, decline, and now depression: the pension reform under Monti’s government, the so called *riforma Fornero*, from the name of the minister who drafted it. That reform remains controversial for having pushed hundreds of thousand ageing workers in the regrettable position of no longer being entitled to retirement at the time in which many had lost their occupation, as a consequence of the crisis.

If the production of one single reform (however patchy) requires several years, it is unreasonable to expect that a whole set of sweeping measures will ever be adopted in the lifetime of even the youngest Italian.

This is not, however, simply the product of a notoriously slow decision-making and legislative process. The impossibility of decisively reforming the current Italian system is actually a direct consequence of its constitutional order (and the underlying political culture), one which combines an extremely weak executive with a hopelessly fragmented legislative power, the whole being surrounded and besieged by countless formal and informal veto-wielding powers and authorities. Even Berlusconi at the height of its power, with the largest parliamentary majority in the history of the Republic of Italy, could not manage to secure those laws (admittedly despicable) which would have avoided his judicial debacle, and the collapse of that very majority.

The background political context of today is one where the representatives of various social and political forces (economic, local, regional, bureaucratic, party-political) are exclusively interested in the preservation of acquired privileges and rent positions, thus embracing a substantial immobilism primarily out of lack of alternative ideas rather than fear. The few remaining productive forces are in essence not represented.

The ubiquitous fragmentation, which is to be found not only within parliamentary majority, but in each single party, however small, make sure that decisions may be taken only unanimously, therefore by degrading any initiative to the condition of a palliative measure.

The question of uncertain results

A second set of problems relates to the issue of whether the prospected reforms would actually have any positive impact on the economic and financial situation of the country quickly enough to avert collapse in the near future.

In the past, the existence of relatively self-contained economies allowed a good degree of control on the consumption-production-investment-employment cycle. Stimulating consumption with additional credit, or income, or public spending, increased domestic production, which stimulated economic expansion by means of investments (and purchase of capital goods), which stimulated employment, which stimulated consumption and so on. However inefficient and problematic, this model had the advantage of allowing some degree of steering on the economy by the government (which is the key component of the Keynesian argument).

Within the context of a globalised economy, where by definition the bulk of the economic cycle takes place outside the political control of the state, the ramifications of any decision taken by a certain country affect a system which is all too complex to allow precise, or even rough, estimates of its effects, and more importantly, of their geographical location. Renzi's recent tax break of approximately 80 euros/month for certain categories of workers may have ended up stimulating the production of manufactured goods in Guangdong (and local employment), more than any economic activity in Italy.

And indeed, one recurring feature of the reform debate in Rome is precisely the miscomprehension of Italy's unfortunate position in the global economy. The Italian elite may well continue to state that "Italy is a great country with amazing resources", but this is unfortunately anachronistic. Today's Italy is no longer that of the early 1990s. It has changed dramatically, and not for the better. More importantly, today's world is not that of the 1990s. It has changed at least twice in quite radical terms, first in the wave of globalisation up to 2007, and in more recent years after the dramatic crisis of 2008-2009. There is little understanding of this context in Italy, where most commentators are now consuming their fighting spirit by pointlessly debating the possible abolition of an article of the labour law (*articolo 18*) from the 1970s, almost unaware that such law has been rendered substantially irrelevant by the diffusion of "flexible" contracts, or of illegal labour, or even worse by the sheer implosion of economic activity and hence of employment chances.

What reforms?

Even if observed from an international perspective, the reforms' advocates, among them the ECB, other international financial organisations, large market operators, prestigious economists and journalists, do not know in reality, what specific content should inform those measures. Advice on this point remains too vague to constitute a policy guideline, as noticeably in the (in)famous letter from the ECB to the Italian government of August 2011, listing a number of reforms (as mentioned above, so far only one has been carried out), but without giving specific indication of what is supposed to be done, and how. When Münchau in his piece writes for instance that

> *Italy needs changes in the legal system, it needs to bring taxes down to the Eurozone average, and to improve the quality and efficiency of the public sector. It needs, in other words, to change the entire political system*

he expresses an apparently reasonable advice, but on the one hand the questions of *what* new regulations would work in the context (cultural, economic, political) of today's Italy, *how* they can possibly passed, *whether* they can actually be implemented, what *resistance* they will meet, remain constantly unaddressed. Particularly "chang[ing] the entire political system" appears impossible in the continuity (legal and substantial) of any constitutional regime except enlightened despotism, as in the case of the Stein-Hardenberg reforms in early nineteenth century Prussia.

The "Washington consensus" has long passed its heyday and there is no clear indication of what policies can provide a better economic environment in a specific country, given the above mentioned complexity of a globally interconnected economy. This points to the more general problem of the inadequacy of the predominant socio-economic models, both "neo-Keynesian" and "austerity-driven", or perhaps more deeply to the limited usefulness of thinking in "positivistic" terms of economic models and paradigms, as if the government of the economy could be completely de-coupled from political questions and therefore entirely de-politicised. The anxious quest for a "scientifically right", ultimate (*endgültig*) solution of the economic question betrays in reality an implicit anti-intellectualism and inadequate leadership spirit from the part of political elites. A symptom of this conundrum is visible in the paradoxical situation whereby the question of leadership has been definitely shifted onto the shoulders of the central bankers, who were originally, at least in theory, conceived as sheer technicians in charge of the smooth, mechanical, completely de-politicised functioning of monetary policies.

To this day, reform proposals advanced by the various Italian governments remain unambitious, without a clear logic, and programmatically slow-paced, even if they were ever to be adopted and implemented. They remain chained to the sinking ship of old-fashioned neo-liberal doctrines when their time has long passed.

This is not surprising considering that any reform should stem from a vision of the future of the country, now entirely missing, and which, within the political-cultural horizon not only of Italy, but of the EU, is essentially unviable. The drift towards increasingly abstract-legalistic conceptions (again, de-politicised) of the political community have reduced the image of the country to a sheer financial and fiscal balance sheet. Working and accepting sacrifices for the betterment of a thus conceived state, accepting almost-heroic level of economic and personal sacrifice, or even being among its citizens (whatever this may still mean) is certainly undesirable.

And besides all these considerations, reforms, even if they were implemented, even if they were better that the proposals seen so far, come far too late. The country is exhausted, and is stepping on the path of irreversible demographic, economic, and social implosion. Reforms had to be done in the 1990s, in a much more favourable global environment, and in compliance with the promises made by the Italian state at the time of its accession to the Euro, promises which clearly have not been maintained.

At this juncture, reforms may instead be as dangerous as immobilism, since they can push the country off the cliff of further de-stabilisation, as it occurred in numerous historical cases of belated reforms triggering the collapse of the system they intended to save (France in 1789, the Soviet Union in the late 1980s).

Default Trajectories

Münchau's article explicitly mentions the "D word" (default). Anticipating what is likely or inevitably going to take place in the future is an old heresthetic technique: the truth will hurt less when it will become manifest and inescapable, because it has somehow been anticipated and its psychological ground at least partially prepared.

It must be clear that Italy will not grow itself of out its debt. It must be clear that no amount of very belated reforms can save Italy at this juncture. The loss of industrial capacity is irreversible. The national debt will continue to growth and indeed some sort of default will become inevitable.

However, there may be a variety of default options. Just like a star can end its days with the dramatic explosion of a *nova*, or quietly fade away over a long period of time, the collapse of Italy's financial situation can take different forms. The blogger Stefano Bassi, in his usual colourful language, has prospected several scenarios, articulating the view that Italy will undergo a progressive *démontage* aimed at tapping the considerable private wealth of its ageing population, before being allowed to implode completely. Bassi calls this process "the Greek way" and he is probably correct. However, there are risks with this operation, as events of such complexity rarely exhibit a totally linear trajectory. As Bootle has argued, markets can rapidly detect the risks of the Italian situation, especially if the political agreement still enabling life-support measures to Rome will start to falter, shifting "from insouciance to panic in a jiffy".

This prospected long-term smooth implosion of Italy (and indeed, of many other EU countries in the long run, including Germany) can only be made viable by a parallel strategy of monetary manipulation by the ECB, which is the real Gordian knot of whether the Euro will survive and how.

There are notorious limits to the further expansion of ECB operations in the direction prospected by the financial press, both legal and political. The ECB mandate is enshrined in international treaties whereby the signatory parties accepted a certain conception of the European common currency and its management in the framework of a comprehensive political agreement. However right or wrong that conception may be in the eyes of economists, the legal obligation is currently standing, and it can only be altered by means of another, admittedly very difficult to achieve, political agreement and treaty.

The German constitutional court has been rather explicit in arguing that the *Bundesrepublik* may not be legally able to accept ECB measures which can be deemed to be *ultra vires*. This may sound as the *nemesis* of Germany's and EU's post-war obsession with the rule of law and *Ordnungspolitik*, and probably it is, though there is certainly no guarantee that what "works" for the US or the UK may actually have the same effect on the economy of the Eurozone.

A new political agreement might be reached at European level to replace Maastricht, but that may take years, and it appears very unlikely. Exactly as in the case of Maastricht, there is no guarantee that reforms are going to take place in the countries which need them. Exactly as with Maastricht, it is unlikely that effective enforcement mechanisms can be established, and even if that were case, actual enforcement may not be brought about without meeting resistance which EU authorities may not be able to overcome. As an historical lesson, if informal control methods could always suffice in asserting one's political line over a certain territory or nation, nobody would have probably ever ventured in attempts at establishing formal control. But this is not the case. And besides, as mentioned above, it is somewhat illusionary to think that the EU authorities, and even the German government, have any better idea on what ought to be done.

Conclusions

As already argued in previous posts, there is little doubt about the future trajectory of Italy and the unsustainability of its debt. The country can be kept artificially afloat for a rather long period of time, but certainly not indefinitely, while its real economy continues to deteriorate, and its debt/GDP ratio grows exponentially.

There is also little doubt that the whole Euro-project, notwithstanding Draghi's famous awe-inspiring statement about its survival, continues to experience inherent contradictions which are well capable of tearing it apart, reflecting in-built design defects which have been proven impossible to remove without dismantling the whole structure. The euro cannot however collapse overnight, and the EU political and financial leadership is as likely to publicly announce the end of the common currency as much as a pilot is likely to inform his passengers that he has no control of the aircraft: it will never happen. But gradually there may be a transition towards a new monetary system, which may be presented as an "improvement" and/or "completion" of the euro, while being instead the first step of its abandonment, for instance by means of introducing a dual currency regime in certain Eurozone members, or even in all of them, the redenomination of national debts, and so on. An extremely bumpy road, admittedly, both politically and financially, albeit preferable to the prevalence of chaotic centrifugal forces.

But for the reasons exposed above, Italy will certainly not make it.

Note: This article gives the views of the author, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.

Roberto Orsi is a co-investigator on the Euro Crisis in the Press project. He holds a PhD International Relations and is currently member of the Security Studies Unit at the Policy Alternatives Research Institute (東京大学政策ビジョン研究センター), and lecturer at the Graduate School of Public Policy (GraSPP – 東京大学公共政策大学院) of the University of Tokyo (Japan).
View all posts by Roberto or visit his personal website.