Two Decades of Italian Euro-Membership: Destabilising Periphery or Destabilising the Periphery?

Ton Notermans (Antonius.notermans@ttu.ee[)](mailto:)

& Simona Piattoni (Simona.Piattoni@unitn.it)

# Introduction

The strong support an ‘ever closer union’ traditionally enjoyed in Italy was based on the hope that Europe would save the country. The inverse relation between trust in national elites and popular support for Europe (Sànchez-Cuenca, 2000), certainly held for Italy. Conversely, mounting elite suspicion of a country that seemed ungovernable fuelled support for European integration as a “vincolo esterno” that would enable the implementation of the necessary reforms. Ironically, the mutual distrust between the governed and the governing combined to create near universal support for a stronger Europe. Popular support for the EU, however, underwent a trend break around the introduction of the Euro. By 2018, what once was one of the most pro-European publics had become euro-sceptic in large segments. In November 2018, e.g. 43% of Italians thought that the country would be better off outside the EU, a figure topped only by the United Kingdom (44%), while 63% believed that Italian interests were not well taken care of in the EU. In 1992, less than 10% of respondents said they were against the common currency, by late 2018 that percentage had risen to 27%. The cross-party consensus that had reigned since the end of the war similarly started to fray. With the founding of the Lega Nord (1989) and the M5S (2009) euro-scepticism acquired a party base, while euro-critical positions now were regularly vented also in mainstream parties. Populist electoral strength ballooned during the Eurocrisis, with M5S becoming the largest party in the first national elections it contended in 2013, shortly after the escalation of the crisis in 2011-2012. In the next elections in 2018, Lega and M5S acquired a parliamentary majority making Italy the first Eurozone country with a government entirely composed of euro-sceptics, and in particular a government opposed to the EU’s rules of fiscal rectitude.

That populist discontent targets the EU in addition to national political elites is unsurprising given the central role it plays in economic governance. Many Italians now see the EU as an unwelcome constraint. As pressures for austerity and structural reforms from Brussels and Frankfurt mounted, the imperatives of EMU came to be seen as recipes for further hardship, while simultaneously relegating Italy to the status of policy-taker instead of policy-maker. Indeed, according to the current minister for European affairs, European economic governance with its emphasis on supply side measures inhibits inclusive growth (Ministro per gli Affari Europei 2018). Simultaneously, Italy appears as the main threat to the integrity of the Euro. In contrast to the programme countries, Italy did not accumulate a massive net external debt, nor has it suffered a collapse of the banking system like Spain, Ireland and Cyprus. The main bone of contention is its accumulated debt of roughly €2.26 trillion – second only to France’s in absolute terms and Greece’s in relative terms – making the country too big to fail and too big to bail out.

This paper asks how the marriage between Italy and the euro could take such an unhappy turn and what lessons this experience might hold for the future of EMU. Given the development of Italian debt and deficits during EMU’s second decade, an almost self-evident conclusion would seem that the Italian experience illustrates the unworkability of EMU’s asymmetric integration which has supranationalised monetary policy while leaving fiscal matters largely to the member states. With neither the SGP, nor its strengthened version, having been equipped with the necessary powers of enforcement, and given the externalities excessive debt creates for monetary and financial stability, a political union that locates fiscal policy authority in Brussels would seem imperative. The implication of that position is that the Euro is not compatible with national level democracy in fiscal matters, at least not for countries like Italy that seem to suffer from a southern syndrome of being unable to live within their means. Supranational authority might also need to be extended to the broader field of structural reform. Italy’s disappointing growth performance during the last decades directly compounds its debt and deficit problem, both through mechanical effects and as a consequence of increased political pressures for government spending. The long-term compatibility of Italy and the Euro thus seems to require that reforms be implemented to make the country more competitive and Euro-compatible, yet its political system apparently has proven unable to do so.

This paper seeks to advance a different interpretation. The fiscal governance of the Eurozone is based on the assumption that deficits and debts reflect discretionary decisions, hence the scepticism with respect to the economic management of South-European democracies that allegedly provoked a sovereign debt crisis. The southern periphery’s behaviour thus exposed the Eurozone to asymmetric shocks, but is sometimes also portrayed as the direct cause of such shocks. Instead the Eurozone crisis is better understood as the second leg of the North Atlantic Financial crisis that started with the US sub-prime debacle, as it was sparked by the massive macroeconomic imbalances provoked by the combination of the common currency and deregulation and integration of European financial markets. While successive Italian governments embarked on debt reduction since the early 1990s, its massive debt – a legacy problem of the 1970s and 1980s – made it extremely vulnerable to changes in market sentiments. As the panic that gripped bond markets in 2011 caused a flight out of Italian and into safe-haven bonds, especially German Bunds, a self-fulfilling spiral was set in motion as higher debt service and lower growth put the Italian debt to GDP ratio on an upward trajectory again, with the opposite effects in Germany.[[1]](#footnote-1) The problem was compounded by austerity policies that aimed to address the problem but served to increase debt to GDP ratios due to their negative effects on growth.

The remainder of the paper is structured as follows. Section two documents the mounting opposition to Europe and interprets this as a result of economic stagnation and socio-economic disparities. Section three argues that the Italian public debt is largely a legacy problem resulting from the escalating social contestation since the 1970s. Section four shows that since the early 1990s as a result of reduced social antagonism, a fundamental reform of the party system and the strategic use of EMU constraints by governments, Italy managed to place its public debt on a sustainable downward trend. Section five argues that this equilibrium was durably disrupted with the dynamics of financial flows under a common currency provoking divergence while forcing Italy and the south into a bad equilibrium of high debt service and increasing debt, while doing much the opposite for Germany. Section six concludes.

# Mounting Opposition to the EU and EMU

Since the 1990s, Italy has undergone a remarkable transformation from one of the most ardent supporters of Europe to a substantially euro-critical country. Support for European integration since 1945 had rested on three pillars. The most important pillar consisted in a perceived urgent need for modernisation. The war had served to create an acute awareness of economic backwardness while the ECSC and later the Single Market promised to assist in modernisation as well as in providing outlets for an export-oriented growth strategy. In addition, the common market opened an escape hatch for the unemployed, especially in the South. Secondly, membership in Europe was intimately connected with matters of national pride. Suffering from a latent inferiority complex with respect to the “great powers” of Northern Europe ever since unification, participation in the European project would be confirmation that the country was playing in the first league. Finally, after the Fascist period, participation in Europe promised a way towards rehabilitation.

The Christian democratic (DC) that dominated the party system until its dissolution in 1994, consistently maintained a pro-integration attitude, frequently being the source of proposals that were considered too supranational by the other members. In Western Europe, early euro-scepticism was commonly confined to the extreme right and the social democratic and communist left. The Italian Communist Party (PCI) was no exception. It denounced European integration as a bourgeois construction and a tool for German dominance. As the PCI loosened its ties with Moscow, its views on European integration changed such that by June 1976, when it booked its largest success with 34.4% of the votes, it had become pro-European (Bell 1996). The socialists (PSI) instead were an exception, embracing federalist ideas early on (Kaiser & Schot 2014: 105). Similarly, during its existence from 1946 to 1995 the (neo) fascist MSI exhibited a more positive attitude towards Europe than its ideological brethren elsewhere, in part based on the hope of using the EU as a platform to reform Italy (Fieschi et al 1996).

This virtually united pro-European front started to show cracks roughly after the introduction of the euro. While per capita GDP growth from 1950-90 had been second only to South Korea amongst the OECD countries (De Cecco 2007: 763), preparation for EMU membership coincided with long-term stagnation. Since 1990, Italian GDP growth has been amongst the lowest in the EU, with especially the euro crisis exerting a negative impact, leading to a shrinking of manufacturing production by about a quarter. Per capita GDP has exhibited a similar trend. Although EU and EMU membership were strongly linked to the promise of income convergence, this has failed to materialise. Income convergence started to stall amongst the EU15 roughly with the adoption of the common currency, while in the wake of the North-Atlantic financial crisis, it went into reverse in southern Europe and largely stalled in the eastern periphery (Franks et al 2018). Labour productivity has been similarly stagnant for much of the last three decades.

The most common complaint about the new common currency concerned the expenditure constraints of the SGP, in particular its failure to take sufficient account of the cyclical position of the economy, as well as the inclusion of public investment spending in the SGP limits. EU Commissioner, Mario Monti already argued in 1998 that public investment should be exempt from the SGP. Finance minister Giulio Tremonti joined the call in 2002 while the M5S-Lega government has made similar arguments. Gradually an argument emerged that had traditionally been part of the arsenal of the extreme right, namely that the Euro was a tool of German dominance. In 2005, e.g. welfare minister Roberto Maroni famously called for the introduction of a dual currency referring to the UK as a positive example of how non-participation in the Euro benefited autonomy as well as economic recovery. At the height of the euro crisis, moreover, PM Berlusconi frequently argued for Germany to leave the Euro. Though more euro-critical voices emerged in all parties, the populists Lega and M5S became the most consistent anti-euro voices.

While popular support remained strong in the run-up to 1999 and was not even dented by Prodi’s Euro tax, already at that time a certain decline set in (Table 1). Trust in the benefits of the EU steadily declined until 2011, after which Eurobarometer removed this question from its survey. Growing doubts about the benefits of the EU are reflected in the by now 43% of Italians who feel their country would be better off outside the EU. Though the figures are declining, 63% of Italians still supported EMU membership in November of 2018[[2]](#footnote-2). Trust in the EU, the ECB and the Commission similarly has steadily declined. In each case Italy started from significantly above average trust to arrive at a level below the EU average. Declining enthusiasm for Europe was also reflected in voter turnout for the European Parliament elections. At 85.7%, Italian turnout for the first EP elections was the third highest in the EU. By 2014, only 57.22% of Italians decided to vote.[[3]](#footnote-3) Moreover, the declining trust in EU institutions is matched by a significant increase in trust in the national government of M5S and Lega.

Though there is a debate on whether support for populist parties is primarily rooted in nativist cultural impulses or a revolt of the socio-economically disadvantaged (Algan et al 2017; Dal Bó et al 2018; Guiso et al 2017; Inglehart & Norris 2016), in Italy the latter clearly is the case. Initially public dissatisfaction with the common currency was based on the conviction that its introduction had provoked large price hikes. A more consistent source of euro-scepticism, however, was the permanent austerity together with reforms that weakened labour market as well as social protection against the background of a stagnating economy (Rombi 2016). Already in 2007, Beppe Grillo, the founder of M5S, published a book entitled *Modern Slaves*, denouncing the rapid growth of precarious jobs.

Though the Lega at times has drifted towards a racist discourse, the M5S lacks such impulses and is eager to distinguish itself from other European parties in this respect. Instead, their main electoral appeal has rested on a call to reverse economic stagnation and reduce social disparities (Bordignon & Ceccarini 2013: 441-442) with a programme of deficit spending, a more inclusive social protection system by means of a basic income, and a partial reversal of pension reforms. In the first elections it contested in 2013 M5S managed to become the biggest party in terms of votes, largely in reaction to the previous technocratic government of Mario Monti that had resolved to fully implement the programme outlined in the letter by Trichet and Draghi. In a sense, Monti had foreseen the political results, repeatedly complaining that without support from the EU, and Germany in particular, his programme of (regressive) tax increases, spending cuts and pension reform might result in an anti-European majority.[[4]](#footnote-4) Monti’s successor, Matteo Renzi of the social democratic (PD), perfectly demonstrated this dynamic. Despite its socially friendly framing, Renzi’s main reform project, the Jobs Act (2014), continued along the lines of Monti’s programme of flexibilisation. Failing to produce noticeable improvements in job growth while easing dismissals, the reform in the end further strengthened support for the Lega and M5S. Renzi himself, in turn, came to place more blame on Europe for Italy’s performance, arguing that German-inspired austerity was driving voters into the camp of the populists.[[5]](#footnote-5)

Table 1 Public Support for European Integration

Table 2 Trust in European Institutions and the National Government

# The Origins of the Italian Debt Problem: Social Contestation, Crises and Disinflation

In a longer-term perspective, the development of the Italian debt to GDP ratio exhibits a pattern common to most OECD countries, with a declining or stably low debt level during the decades of high growth, followed by a continuous increase once the *Trente Glorieuses* ended in the 1970s. What distinguishes Italy though is the massive increase of its debt from the mid-1970s to the early 1990s. The ratio almost doubled from 57% in 1975 via 81% in 1985 to 105% in 1992.[[6]](#footnote-6)

Figure 1: Debt to GDP Ratios; 1950-1970

Since its birth, the Italian state has suffered from weak popular legitimacy, but a veritable crisis erupted in 1969 when a wave of social unrest swept the country, lasting, with varying intensity, for over a decade and at times bringing the country close to civil war. That crisis reflected the absence of a comprehensive post-war-settlement. With the political left largely represented by the Communist party rather than by social-democracy as typical of western Europe, a social contract based on growth and redistribution in exchange for an acceptance of democracy and the market economy proved harder to achieve. For fear of strengthening the communists, no reckoning with the fascism was undertaken after 1945. Nor was a corporatist bargain struck with labour relations remaining unregulated and business threatening to move abroad at the first sign of unrest. Similarly, the notion that legitimacy, required a concern for full employment as well as a redistributive welfare state that would serve to share the fruits of economic growth more evenly was largely absent (Boltho 2013).

The political reaction to that crisis consisted in a rapid increase of expenditures primarily through social measures and the expansion of public sector employment, so as to placate mainly the left, and to mostly finance this through debt rather than taxation, so as not to antagonise the more well-off. The 1970s marked the beginning of a welfare state replaced the highly fragmented system made up of minimal services offered by the state, charitable associations and self-help societies into a “Bismarckian system” based on a mix of occupational schemes for the professions, the self-employed and the civil servants and of a public scheme for the “core industrial workers”. In terms of fiscal governance, because of its escalating tensions, Italy came to resemble what Hallerberg et al (2009: 5) have called a “fiefdom state”, characterized by independent access of competing political factions to public expenditure with weak centralised control over the budget. Moreover, the fragile political constellation mandated that the global downturn after the two oil price crises be met with deficit spending to keep up growth and employment while neglecting the escalating inflation for fear of the unemployment that a disinflation strategy produces. The negative consequences of inflation on workers’ and employees’ purchasing power were countered by introducing full and immediate indexation of wages, which further fanned inflation, triggered repeated rounds of devaluations, and became ultimately unsustainable. This suggested a reversal in monetary policy which, while having accommodated government expenditure through the creation of money in the 1970s, became gradually more restrictive in the 1980s, aided also by the eventual repeal of wage indexation. The concomitant freeing of the Banca d’Italia from the requirement to purchase public debt and high interest rate policy significantly contributed to a further rise of the debt to GDP ratio, exacerbated by the short average maturity that still characterised Italian public debt on the eve of EMU (Balassone et al 2013: 526; Graziani 1998: 176; Scobie et al 1996, ch. 4).

# Stabilising the Periphery: Political Reform and the Euro Constraint

Though much attention has focussed on the institutional structure of the budgetary process, in particular its degree of fragmentation in explaining cross national differences in the accumulation of debt (Hallerberg et al 2009), institutional arrangements themselves are the product of political decisions and hence largely endogenous to the policy process. Stabilising public debt primarily required a change in the underlying political constellation. That long-drawn out process gradually came to fruition in the early 1990s. First, belatedly compared to most West European countries Italy promoted social inclusion through the creation of a Bismarckian welfare state. Secondly, with the end of the Cold War, the country’s political system underwent a radical restructuring from a dominant but incoherent five party block with the permanent exclusion of the PCI to something resembling a competitive system of two main party coalitions based on a more majoritarian electoral system. As a result, the period since 1994 saw a regular alternation in power, with the centre-right governing in 1994 and from 2001 to 2006, and the centre-left governing from 1995 to 2001 and again between 2006 and 2008. Thirdly, the dysfunctional consequences of deficit spending, in the form of pressures on the currency, higher interest rates and inflation, served to mobilise political support for a change of course. As a result, Italian budgets have recorded primary surpluses since 1992 with the exception of the G20 reflation of 2008-9.

Figure 2: Public Deficits

Crucially, Italian politicians were able to exploit cross-party support for European integration to impose constraints on fiscal policy. While forcing a change in economic policy orientation, the explosion of social tensions since 1969, if anything, served to strengthen the commitment to Europe. Faced with increasingly dismal performance, culminating in the request for IMF assistance in 1976, political elites saw European integration as a useful external constraint that might help to break the opposition to necessary reforms (Heipertz & Verdun 2010: 23). Guido Carli, governor of the Banca d’Italia (1960-75), chairman of *Confindustria* (1976-8) and finance minister (1987-92) summarised it succinctly: “the European Union represented an alternative path for the solution of problems which we were not managing to handle through the normal channels of government and parliament”[[7]](#footnote-7). Paradoxically, the distrust of the political elites to be able to reform the country through the “normal channels” was matched by growing popular distrust in a political class, which, under the tenure of the DC, seemed to have morphed into a corrupt unaccountable caste, far removed from the concerns of ordinary people (Rizzo & Stella 2007). The deep-rooted distrust in “Rome” translated into popular support for Brussels.

Fixing the currency became the linchpin in this process. The requirements of adherence to a fixed exchange rate regime, or monetary union, had implications that went far beyond the conduct of monetary policy as it required prudent fiscal management and, in general, a set of structural reforms promoting competitiveness and thus, it was hoped, growth. For those assuming an OCA world in which asymmetric shocks appear randomly, the common currency made no economic sense (Feldstein 1997; Mody 2018). Yet, this short-term Keynesian framework was not what informed Italian policy-makers. The choice between short-term policy autonomy and a long-term oriented reform of the policy-making process was placed on the agenda by the 1992-3 Exchange Rate Mechanism (ERM) crisis.

Provoked by a ferocious tightening of policies by the Bundesbank, the Lira and several other currencies were exposed to heavy speculation based on the expectation that the country would not be willing match Germany’s severely restrictive policies. Faced with an overwhelming wave of selling, the Lira was pushed into devaluation despite desperate measure of the Banca d’Italia, followed only 3 days later by the British sterling. But while this episode cured British appetites for participation in European fixed exchange rate arrangements, let alone a common currency, in Italy it had the effect of strengthening the commitment to adopting the Euro. In part, the 1992 devaluation was a blow to national pride. More importantly, abandoning the fixed exchange rate was seen as tantamount to abandoning the long-term programme of restructuring the political economy in favour of a short-term palliative. Indeed, Italy wanted to be rescued by Europe (Sbragia 2000; Ferrera & Gualmini 2005; Scobie et al 1996).

As with the decision to join the EMS, some differences of opinion emerged as to the merits of early versus delayed membership but in the end early membership enjoyed cross party support. Open dissent was to be found on the political fringes, with the MSI opposing Maastricht because of the loss of national sovereignty and the Lega voting against because the treaty was not European enough. On the extreme left, the PCI’s successor, the *Rifondazione Comunista*, also voted against, arguing that its neo-liberal imprint would penalize its lower-income clientele. Moreover, at crucial junctions when the dynamics of party fragmentation came to pose an obstacle to the reform deemed necessary, parliament availed itself of the solution of non-political governments to break the stalemate while avoiding to take direct responsibility for it. The Ciampi government from April 1993 to May 1994 was a temporary expedient to deal with the pressing issues in the wake of the ERM crisis, while the Dini government of 1995-96 had the task of implementing a pension reform that was considered crucial to containing the deficit but had served to split the 1994 Berlusconi government.

Efforts to reduce the debt have focussed on increasing revenues and reducing expenditures, with a bias towards the former. Revenue-boosting measures primarily focussed on direct taxes and fighting tax evasion; moreover, during the late 1990s, privatisation revenues made a significant contribution. In terms of spending cuts, policies have focussed especially on pension and health care reform, two of the biggest budget items.

The pension system was repeatedly overhauled (Dini 1995, Prodi 1997, Maroni-Tremonti 2004-5, Damiano 2006-7, Sacconi in 2009-10, Fornero 2011). The main changes were: a) equalization of treatment of men and women in response to an ECJ verdict; 2) linkage of retirement age to life expectancy 3) flexible retirement age for high-earning individuals and for particularly taxing jobs, at a cost; 4) possibility to retire earlier for women. The watershed in this long reform effort was the Fornero law of 2011, which placed the pension system on a sustainable footing, with the replacement ratio falling from 64.4% to 49.8%. Supplementary and private pension schemes have been incentivised since 1992 through tax breaks. In health care, cost containment has focussed on increasing patients’ contributions, reducing exemptions and streamlining the appropriation process with tight limits on transfers from the central budget to regional healthcare administrations as well as incentives to cut costs.

Though fiscal discipline was also relaxed in Italy after the inception of EMU (Hallerberg et al 2009: 181), the political constellation that had emerged in favour of reducing public debt held. Also after January 1, 1999, the Italian primary balance remained in surplus while the debt to GDP ratio declined from 109.7% to 99.8% between 1999 and 2007. It is noticeable that centre-left governments have been more successful than centre-right governments in reducing the deficits. While the debt to GDP ratio kept falling, the primary surplus gradually decreased during the tenure of the centre-right from 2001 to 2006. In part this was due to more depressed economic conditions at the beginning, of the millennium, leading e.g. the French and German governments to torpedo the SGP. In part it reflects the more substantial obstacles that the centre-right governments encountered in reforming pensions due to their tenser relations with the trade unions as well as their preference for reducing the tax burden on business in an attempt to boost growth.

Apart from facilitating the adoption of reforms, EMU also directly helped reduce public debt by the convergence of interest rates on a low level. EMU membership and the credible preparation for it eliminated the exchange rate risk. However, by locking in a low inflation regime, EMU removed another source of potential devaluation of the real value of government debt. Interest rate convergence was further helped along by the regulatory decision, taken with an eye to promoting financial integration, that all Eurozone public debt, irrespective of the issuer, carry a zero risk weight. From a peak of 617 points in March 1995, the interest rate differential of Italian 10 year benchmark bonds relative to their German counterpart gradually fell, dropping below 100 points in late summer of 1997 and remaining at an average of 27 points[[8]](#footnote-8) from the inception of EMU on January 1 1998 until January 2008.

Figure Interest Rates

# Destabilising the Periphery: Financial Markets and the Eurozone Crisis

Historically, the combination of fixed exchange rate arrangements and free capital flows has displayed a tendency to destabilise peripheral members, with peripheral being defined as countries with substantial negative net foreign asset positions hence being dependent on foreign financing (Gallarotti 1995; De Cecco 1996; Triffin 1997). The destabilising mechanism in each case involves a large flow of funds to peripheral countries in response to their inclusion in the arrangement followed by a sudden stop in response to difficulties in the financial system of the core countries. The much vaunted stability of the pre-war gold standard e.g. only applied to the core countries as peripheral members on several occasions were forced out of the system. Similarly, the creation of the interwar gold standard had given rise to large macroeconomic imbalances with funds flowing especially to Germany while the system started to unravel as of 1928 when financial flows reversed.

EMU was no exception as its creation gave rise to massive macroeconomic imbalances with capital flowing from the core to the periphery while; in a mirror image, current account positions polarised with southern Europe running ever higher deficits matched by surpluses in the North. Although EMU membership did seem to bestow a good housekeeping seal on its members leading to lower interest rates in the South, the definition of good housekeeping did not seem to include fiscal prudence. Toward the late 1990s the interest rate differential on 10-year benchmark bonds virtually disappeared implying that neither the large differences in debt to GDP ratio nor differences in deficits seemed to have an impact on risk assessment. In the Eurozone such imbalances were rather interpreted as evidence of the common currency promoting real convergence, with capital flows from the core boosting the development of peripheral regions. The US sub-prime crisis, which started in the summer of 2007 and severely affected also some financial institutions in core Eurozone countries such as France and Germany, followed by the revelation of similar speculative excesses in Eurozone countries such as Spain and Ireland, then set the stage for a reversal.

The onset of the crisis led to a reassessment of risk evaluation on the part of financial investors. Whereas debt to GDP and deficit ratios were largely irrelevant before the crisis, higher debt and deficits now lead to higher spreads (Klepsch & Wollmershäuser 2011). Yet, markets did not revert to simply pricing “fundamentals as expectations, based on reputation and fundamentally of a self-fulfilling nature (Ocampo et al 2008), now came to play a crucial role. Hence investors stop to rely on fundamentals, and the “government bond game” now becomes a Keynesian beauty contest in which market participants’ expectations of other markets participants’ expectations are crucial. As a result, in the wake of the crisis, interest rates spreads increased far beyond what fundamentals would justify, provoking a dramatic North-South divergence with investors fleeing potentially risky southern bonds in favour of safer northern and especially German bonds (de Grauwe & Yi 2012, 2103; De Grauwe 2017 ch. 11). Credit rating agencies adjusted their behaviour in line with the markets. While debt to GDP ratios and GDP growth rates had been until this point fairly unimportant, they now entered the equation with a vengeance further worsening market expectations (Brüha et al 2017). Similarly, reputation seemed to matter for ratings, as southern member states were consistently downgraded beyond what fundamentals could justify (Freitag 2015; Nauhaus 2015; Nauhaus & Schäfer 2015).

Unlike other southern members, Italy had steered clear of macroeconomic imbalances. Its current account remained roughly in balance. Italian banks, moreover, were still engaged in a much more prudential management style and prevented by law to over-leverage (Billotta 2017). Moreover, their exposure to (foreign) toxic assets was essentially zero (Bologna et al. 2014). Accordingly, when the crisis set in, it was originally viewed by the Berlusconi government as having its causes outside of Italy. As in all Eurozone countries, its immediate effect was to increase debts and deficits, as automatic stabilisers boosted deficits. In addition, the government supported the fiscal stimulus agreed at the three G20 summits between November 2008 and April 2009, and advocated simultaneously by the European Commission (2008: 7). As a result, the debt to GDP ratio increased marginally in 2008 and more substantially the next year so that in 2009 Italy recorded its first primary deficit since 1991. Although its GDP decreased substantially more than the European average, the deficit increased modestly between 2008 and 2011 from 2.6% to 3.7%, with only Germany and Latvia recording lower values.[[9]](#footnote-9) Though increasing slightly, the spread proved largely insensitive towards the turnaround in debts and deficits. Matters came to a head, however, in June of 2011 when it became clear that debt restructuring was on the books in Greece. Suffering from a clear case of contagion, interest spreads started to increase rapidly, manifesting what De Grauwe & Yi (2012: 866-867) have termed a “bond price bubble”, and creating not only financial but political panic.

The Berlusconi government reacted with an austerity package envisaging a balanced budget by 2015, which however failed to calm markets. Fearing a panic that might seriously affect the banking system, the ECB stepped in with an unprecedented move as its outgoing and incoming presidents sent an urgent letter on August 5, 2011 which de facto set out the conditions under which it would be willing to support Italian government debt through purchases in the secondary market (Sacchi 2014). ECB intervention prompted an additional austerity package in September 2011. Simultaneously, the Council stepped up its pressure deciding to “invite the Commission to provide a detailed assessment of the measures and to monitor their implementation, and the Italian authorities to provide in a timely way all the information necessary for such an assessment” (Eurosummit Statement: 2). Those measures were then spelled out in more detail than even the Trichet-Draghi letter by Commissioner Rehn in 39 separate points included in a letter of November 4.

As the spread crisis developed, the Berlusconi government suffered a radical drop in popularity, a split within his coalition and yet another scandal, this time involving an under-age prostitute. He stepped back on November 12. President Giorgio Napolitano then decided to nominate a former EU Commissioner, Mario Monti, to head a technical government supported by all parties in parliament except the Lega, and which eventually fell in 2013 when Berlusconi withdrew the support of his party, Forza Italia. In short, in the face a financial panic and being considered too big to fail, the EU effectively stepped in to push through the reforms deemed necessary. While this appeared a way to bypass the dysfunctionality of the Italian system that now seemed to have evolved into an acute threat to the Euro, the rescue policies failed to restore what was considered the all-important investor confidence while doing lasting damage to the support for the integration project and setting in motion a fundamental restructuring of the party landscape.

The recipe urged by the ECB and the EU, and implemented by PM Monti followed the usual two-pronged approach of radical budget austerity together with liberalization of the economy, in particular the labour market. Structural reforms were intended to favour growth, hence boosting the denominator of the debt to GDP ratio, while austerity would reduce the numerator. In line with what had been requested by the Eurosummit, Monti promised a balanced budget by 2013 and a structural surplus by 2014. Pension reform, introduced on December 4, 2011 was expected to lead to savings of about €30 billion within the next 20 years. An additional €26 billion in austerity measures were introduced in the summer of 2012 followed by more measures in the stability law in October. In an effort to boost growth through labour market deregulation, the Monti government also succeeded in what had proven elusive to previous governments, namely watering down the dismissal protection enshrined in article 18 of the *Statuto dei lavoratori*.

In practice, this programme set in motion a potentially vicious circle, as the IMF had already warned in early 2012 when it talked of the overarching risk “of an intensified global ‘paradox of thrift’ as households, firms, and governments around the world reduce demand” (IMF 2012). As had been already experienced in the programme countries, austerity under the reigning crisis conditions in fact served to curtail growth to such an extent that the debt to GDP ratio increased (De Grauwe & Yi 2013: 36). In addition, the microeconomic recipe of structural reform, could do little to solve what was a macroeconomic crisis. As Monti implemented a ferocious austerity programmes in Europe, GDP sagged accordingly. Between 2011 and 2014, Italian real GDP dropped by roughly 4.55%, roughly comparable to the contraction experienced by Portugal and Spain and only exceeded by the two other programme countries, Greece and Cyprus.

Balancing the budget hence turned out to be impossible, with Italy recording a 3% deficit in 2014 while the debt GDP ratio jumped from 116.5% to 131.8%. Declining growth prospects and a rising debt to GDP ratio, in turn, served as reasons for downgrading the ratings on the Italian public debt. By mid-February 2012 the three main credit rating agencies had issued a negative watch and downgraded Italian sovereigns.[[10]](#footnote-10) Commercial banks, while hardly affected by the sub-prime crisis, now suffered an escalating number of non-performing loans due to the recession just as the downgrading of their asset base curtailed their lending capacity thus exposing Italy to a different kind of potential “doom loop”. In short Italy had moved into a debt trap. In that constellation, Monti’s austerity programme obviously failed to reach its primary goal, i.e., re-establish the confidence of financial markets in Italian sovereigns. The spread did decline after Berlusconi’s resignation but peaked again in December 2011 and was only stabilised after the ECB’s announcement in September 2012 to flout the spirit of the no bail-out clause and assume a role of lender of last resort by supporting government debt through purchases in the secondary markets.

With the EU and ECB now de facto determining the content of Italy’s adjustment programme and its consequence being a rapid intensification of the crisis, the stage was set for a reversal of the traditionally pro-European attitude of Italy. The rise of M5S which combined its criticism of the Italian political caste with the promise to pursue policies in the interest of Italians instead of the EU started in earnest during the 2012 local elections (Bordignon & Ceccarini 2013). By the 2013 elections, it had become the largest party in parliament with 108 out of 617 seats in the house of deputies and 54 / 302 seats in the senate. The newly formed *Scelta Civica* party of Mario Monti, promising a continuation of his policies instead only polled 8.3% in 2013, and was no longer in existence by the time of the next election.

As M5S was unwilling to govern in a coalition, the PD for a while became the main force in Italian politics, taking over the government after Monti’s resignation, first in a grand coalition with Berlusconi's Forza Italia under the premiership of Enrico Letta (February 2013 – April 2014), followed by two governments under Matteo Renzi (February 2014 – December 2016) and Paolo Gentiloni (December 2016 – June 2018). A pro-European attitude had been at the core of the political convictions of the centre-left, at least since the beginning of the second republic, but now Renzi in particular came to express a much more critical attitude, hence making Euroscepticism acceptable in the last remaining mainstream party. Renzi, in principle shared Monti’s conviction that structural reforms, alongside austerity, were the key to reviving the economy, with the greatest obstacle being the weak position of the executive in the Italian system that did not allow for decisive and coherent action. Yet, when the core of his reform programme, the Jobs Act entailing a further flexibilisation the labour market, failed to register any noticeable result, Renzi turned his attention to the macroeconomic governance of the EU, placing more blame on Europe for Italy’s disappointing performance and arguing that German-inspired austerity was driving voters into the camp of the populists.

# Conclusions

Since its inception EMU came equipped with a bail-out clause (art. 125 TFEU), ruling out that a member state would assume responsibility for the public debt of another member. The implication was that in case a member should encounter problems honouring its debt, restructuring or default would remain the only option. While Greek debt restructuring was initially considered a possibility, between February and March 2010 the EU decided against that option for fear of the consequences it might have for European financial stability. Unlike what was suggested by the ECB and the Commission, what needed saving in the Eurozone crisis was the financial system and not the Euro as such – a constellation that had not been foreseen by the creators of EMU who had considered excessive debts and deficits uniquely as a threat to price stability. With financial panic developing in European bond markets, and after the commitment for the EFSF was in place, the ECB finally decided to engage in what is common practice among central banks, namely to seek and stabilise bond markets through its Securities Markets Programme.

Yet, the way Europe decided to restore financial stability did much to aggravate the crisis. Greece was not only illiquid in the spring of 2010 but insolvent. One lesson the IMF had learned from its involvement in the Latin American financial crises of the 1980s and 1990s was that throwing good money after bad money was not an effective crisis resolution mechanism, and it accordingly came to insist on restructuring in case of unsustainable debt. Under pressure from EU members the IMF, however, decided to flout its own rules (Independent Evaluation Office 2016) and agreed to participate in the first Greek rescue package as part of the Troika. The outcome of the EU’s initial resistance to restructuring was to add to the Greek, Portuguese and Irish debt burden and to deepen the crisis.[[11]](#footnote-11)

Another lesson the IMF had learned was that to effectively solve a debt crisis, fiscal austerity should be modest whilst the programme needed to include growth impulses so as not end up increasing the debt, as it had argued, insisting against effective EU resistance, for the need for a devaluation in the Latvian crisis of 2008. With debt restructuring and devaluation ruled out, the EU’s recipe to restore confidence in financial markets rested on ferocious austerity coupled with structural reforms to boost the economy. The outcome was a serious aggravation of the crisis creating the unique double dip recession that distinguished the EU from the US, and setting Italy again on a course of increasing debt. That lack of growth in Italy is commonly attributed to its failure to actually implement the needed structural reforms thus lacking any growth impulses that might compensate for the depressive effects of austerity. The almost consensual interpretation amongst policy-makers and most academic observers is that Italian reforms were largely smoke and mirrors, were piecemeal or were reversed halfway through the process (Agostini & Natali 2016; Brunazzo & Della Sala 2016; Culpepper 2014; De Cecco 2007; Eichengreen 2007: 372; Franks et al 2018: 5; Jessoula & Alti 2010; Magone 2016: 94; Rangone & Solari 2012; Sacchi & Bastagli 2005).

However, it is hard to attribute Italy’s anaemic performance to the absence of reforms. The Maastricht decision inspired an acceleration of reforms in product and labour markets that were perceived as critical (Table 3). Though successive governments have varied in their reform zeal, no significant let-up can be observed after the decision about participation in the common currency was made. As a result, the regulatory structure of the Italian economy has moved considerably closer to what is considered the key to good economic performance as well as sustainable Euro membership.

Table 3: Labour and Product Market Reforms, OECD Indices

However, the microeconomic recipe of structural reforms was inappropriate to solve what was a macroeconomic crisis (Vines 2015: 867-868). At best, the attempt to improve external competitiveness through labour market reforms aimed at reducing wages costs engages member states in competitive internal devaluations that per definition cannot succeed in the aggregate. The implication is not that there is no need for productivity-enhancing structural reforms. Indeed, it is easy to identify a host of structural inefficiencies in the Italian system from an inefficient and wasteful bureaucracy to an underdeveloped southern economy, from an underfunded education system to a dysfunctional legal system. But Italy pays for its lower productivity with a lower per capita GDP, which as such is neither a threat to its competitiveness nor growth-reducing.

That the handling of the Eurozone crisis provoked a surge in Eurosceptic sentiments in Italy hence does not lack grounds. ECB presidents Trichet and Draghi did exploit Italy’s vulnerability to impose a largely counterproductive programme of structural reforms and austerity. Though a wholehearted supporter of such a programme, PM Monti towards the end of his brief tenure came to realise its problematic economic and political aspects. With the help of significant pressures from US policy-makers, who feared another financial meltdown, and with the support of Spanish PM Rajoy, Monti managed to convince the EU summit of late June 2012 that what was needed to calm markets was a more aggressive intervention by the EFSF and less austerity. Simultaneously he identified the need for Germany to provide a growth impulse by reducing its massive current account surplus, indicating his waning trust that structural reforms alone might show a way out. His prediction that without such growth impulses the programme imposed on Italy would serve to strengthen Euro-critical populism was becoming reality.[[12]](#footnote-12)

Form an Italian perspective, the major design flaw that manifested itself during EMU’s second decade was not its institutional incompleteness but its tendency to promote financial instability and its inability to handle such crises effectively. Based in part on the disinflationary dogma that had gripped EU circles since the 1980s, according to which governments are the only possible source of economic instability and in part on the belief that any advance in integration, irrespective in what field, would constitute a welfare gain, the EU pressed ahead to accompany its single currency with a liberalised and integrated single market in financial services while promoting trade in toxic assets, notwithstanding the many examples, not only from emerging economies, of the dangers of such policies. When the crisis hit, the EU’s recipe then primarily consisted in removing the alleged source of instability through reducing the size of government spending as well as excessive regulation of labour and product markets.

The Italian populist government that was formed in June 2018 set out to supersede the European constraints, though its policies have proven much more moderate than its rhetoric. Discussions of a Euro exit have been discretely shelved after president Mattarella vetoed Paolo Savona as Finance minister. The remaining element of the programme then pivots on boosting demand though a “citizens income” and a partial reversion of pension reforms, both designed in such a way as to simultaneously increase employment. Even though a citizens’ income fits well with the EU Commission’s new emphasis on inclusiveness, in an unprecedented move the budget, which envisaged a deficit well within the 3% limit, was rejected on the grounds of excessive debt levels. The Commission questioned the validity of the 2019 Medium Term budgetary Objective (MTO),[[13]](#footnote-13) which the Italian government apparently set too high by hypothesizing a GDP growth forecast of 1.5% and by simultaneously opening up a window for early retirement for a particular cohort of prospective retirees in the context of a growing spread between Italian and German ten-year bonds. In response to these criticisms, the new budget law was based on revised expectations and envisaged a 2.04% deficit. The attempt still was to try and revert expectations by betting on the fact that these measures would boost consumption, and hence investment and employment, and that they would therefore fulfil ex-post the rather heroic expectations on which they are based. However, it is doubtful that this modest spending programme can rekindle growth, as it focusses primarily on consumption instead of investment – downsizing particularly public investment, some of it co-financed directly from the EU budget – and has been confronted with an increasing interest rate spread (Figure 3). Though the government seems unwilling to challenge the EMU rules head on, its presence is bound to contribute to policy making paralysis in the EU as it is creating a coalition of Euro-sceptic members that might greatly increase in strength after the next EP elections.

# References

Agostini, Chiara & Davide Natali (2016) “Italian Welfare Reforms: Missed Opportunities for a Paradigmatic Change?”, In: Klaus Schubert, Paloma de Villota & Johanna Kuhlmann, eds., *Challenges to European Welfare Systems*. Cham: Springer.

Balassone, Fabrizio, Maura Francese & Angelo Pace (2013), “Public Debt and Economic Growth: Italy’s First 150 Years”, In: Gianni Toniolo, ed., *The Oxford Handbook of the Italian Economy Since Unification*. Oxford: Oxford University Press.

Bell, David (1996), Western Communist Parties and the European Union”, In: John Gaffney ed., *Political Parties and the European Union*. London: Routledge.

Billotta, Nicola (2017), “The Italian Banking System”, *Moral Cents: The Journal of Ethics in Finance*, 6 (2), 2-13, accessible at: <https://sevenpillarsinstitute.org/wp-content/uploads/2017/11/Italian-banking-system-final-EDITED.pdf>

Bologna, Pierluigi, Arianna Miglietta & Marianna Caccavaio (2014), “EU bank deleveraging”, *VOX: CEPR Policy Portal*, accessible at: <https://voxeu.org/article/eu-bank-deleveraging>

Bordignon, Fabio & Ceccarini, Luigi (2013), "Five Stars and a Cricket. Beppe Grillo Shakes Italian Politics". *South European Society and Politics, 18*(4): 427-449.

Brunazzo, Marco & Vincent Della Sala (2016), “Italy between Transformismo and Transformation”, In: J. M. Magone, B. Laffan & C. Schweiger, eds., *Core-Periphery Relations in the European Union Power and Conflict in a Dualist Political Economy.* London: Routledge.

Culpepper, Pepper D. (2014), “The Political Economy of Unmediated Democracy: Italian Austerity under Mario Monti”, *West European Politics*, 37(6):1264 – 1281.

Dany, Geraldine, Reint E. Gropp, Helge Littke & Gregor von Schweinitz (2015), “Germany‘s Benefit from the Greek Crisis”, *IWH Online 7/2015*. Halle: Leibnitz Institut für Wirtschaftsforschung.

De Cecco, Marcello (1996), “Short Term Capital Movements under the Gold Standard.” In: Jorge Braga de Macedo, Barry Eichengreen & Jaime Reis, eds., *Currency Convertibility: The Gold Standard and Beyond.* London: Routledge.

De Cecco, Marcello (2007), “Italy's Dysfunctional Political Economy”, *West European Politics*, 30(4): 763 - 783.

De Grauwe, Paul & Yuemei Ji (2012), Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone, JCMS 2012 50(6): 866 – 880.

De Grauwe, Paul & Yuemei Ji (2013), “From Panic-Driven Austerity to Symmetric Macroeconomic Policies in the Eurozone” *Journal of Common Market Studies* 51: 31–41.

De Grauwe, Paul (2017), *The Limits of the Market.* Oxford: Oxford University Press.

EU Commission (2008), *COM(2008) 800 final, Communication from the Commission to the European Council: A European Economic Recovery Plan*.

Eichengreen, Barry (2007), *The European Economy Since 1945.* Princeton NJ: Princeton University Press.

European Commission (2008) A European Economic Recovery Plan, COM(2008) 800 final, 11 November.

Fieschi, Catherine, James Shields & Roger Woods (1996), “Extreme Right-wing Parties and the European Union: France, Germany and Italy”, In: John Gaffney, ed., *Political Parties and the European Union*. London: Routledge.

Franks, Jeffrey, Bergljot Barkbu, Rodolphe Blavy, William Oman & Hanni Schoelermann (2018), “Economic Convergence in the Euro Area: Coming Together or Drifting Apart?” *IMF Working Paper WP/18/10*. Washington DC: IMF.

Freitag, Lennart (2015), "Procyclicality and Path Dependence of Sovereign Credit Ratings: The Example of Europe". *Economic Notes, 44*(2): 309-332.

Gallarotti, Giulio (1995), *The Anatomy of an International Monetary Regime.* Oxford: Oxford University Press.

Graziani, Augusto (1998*), Lo sviluppo dell’economia italiana*, Torino: Bollati-Boringhieri.

Hallerberg, Mark, Rolf Rainer Strauch, Jürgen von Hagen (2009), *Fiscal Governance in Europe*, Cambridge: Cambridge University Press.

IMF (2012), *Global Economic Prospects and Policy Changes*. Meeting of G-20 Finance Ministers and Central Bank Governors, February 25-26, 2012, Mexico City.

Independent Evaluation Office (2016), *The IMF and the Crises in Greece, Ireland, and Portugal: An Evaluation by the Independent Evaluation Office*, Washington DC: IMF.

Jessoula, Matteo & Tiziana Alti (2010) “Italy: An Uncompleted Departure from Bismarck”, In: Bruno Palier, ed., *A Long Goodbye to Bismarck? The Politics of Welfare Reforms in Continental Europe*. Amsterdam: Amsterdam University Press.

Kaiser, Wolfram, & Johan Schot (2014), *Writing the Rules for Europe.* Basingstoke: Palgrave Macmillan.

Klepsch, Catharina, & Wollmershäuser, Timo. (2011), “Yield Spreads on EMU Government Bonds — How the Financial Crisis Has Helped Investors to Rediscover Risk. *Intereconomics, 46*(3): 169-176.

Lagarde, Christine (2018), “Ten Years After Lehman – Lessons Learned and Challenges Ahead”. *IMF Blog*, September 4, https://blogs.imf.org/2018/09/05/ten-years-after-lehman-lessons-learned…

Magone, José M. (2016), “From ‘Superficial’ to ‘Coercive’ Europeanization in Southern Europe: The Lack of Ownership of National Reforms”, In: José M. Magone, Brigid Laffan & Christian Schweiger, eds., *Core-Periphery Relations in the European Union Power and Conflict in a Dualist Political Economy.* London: Routledge.

Ministro per gli Affari Europei (2018), *Una Politeia per un’Europa diversa, più forte e più equa.* Roma: Presidenza Del Consiglio Dei Ministri Dipartimento per le Politiche Europee.

Nauhaus, Steffen (2015), “The Power of Opinion: More Evidence of a GIPS-Markup in Sovereign Ratings During the Euro Crisis” *DIW Discussion paper 1501*. Berlin: Deutsches Institut für Wirtschaftsforschung.

Nauhaus, Steffen, & Dorothea Schäfer (2015), “Nur Beschränkt Nachvollziehbar: Länderratings Während Der Krise Im Euroraum”. *Wirtschaftsdienst, 95*(10): 678-683

Ocampo, José Antonio, Shari Spiegel & Joseph E. Stiglitz (2008), “Capital Market Liberalization and Development.” In: José Antonio Ocampo & Joseph E. Stiglitz, eds., *Capital Market Liberalization and Development*. Oxford: Oxford University Press.

Rangone, Marco & Stefano Solari (2012), “From the Southern-European Model to Nowhere: The Evolution of Italian Capitalism, 1976–2011”, *Journal of European Public Policy* 19(8): 1188 – 1206.

Rombi, Stefano (2016), “European Voters in the Face of Crisis: The Prominence of Unemployment” *Italian Political Science Review/Rivista Italiana di Scienza Politica* 46(2): 151 – 173.

Sacchi, Stefano & Francesca Bastagli (2005), “Italy—striving uphill but stopping halfway: The troubled journey of the experimental minimum insertion income”, In: Maurizio Ferrera, eds*., Welfare State Reform in Southern Europe: Fighting poverty and Social Exclusion in Italy, Spain, Portugal and Greece*. London: Routledge.

Sacchi, Stefano (2014), “Conditionality by Other Means: EU Involvement in Italy’s Structural Reforms in the Sovereign Debt Crisis”. *Comparative European Politics, 13*(1), 77-92.

Sànchez-Cuenca, Ignacio (2000), “The Political Bases of Support for the European Integration”, *European Union Politics* 1(2): 147 – 171.

Triffin, Robert (1997) [1964], “The Myth and Realities of the So-called Gold Standard”, In: Barry Eichengreen & Marc Flandreau, eds., *The Gold Standard in Theory and History*, 2nd ed. London: Routledge.

Vines, David (2015), “Impossible Macroeconomic Trinity: The Challenge to Economic Governance in the Eurozone”, *Journal of European Integration*, 37(7): 861-874.

1. The lower yield on German public debt as a result of the Eurocrisis has saved the German budget over €100 billion (Dany et al 2015). [↑](#footnote-ref-1)
2. Source: Standard Eurobarometer 90. [↑](#footnote-ref-2)
3. Source: http://www.europarl.europa.eu/elections2014-results/en/turnout.html [↑](#footnote-ref-3)
4. “Monti warnt vor anti-europäischen Protesten in Italien”, Die Zeit, 11, January 2012. [↑](#footnote-ref-4)
5. “Eurozone Austerity Fanning Populist Flames, says Renzi,” *Financial Times*, December 21, 2015. [↑](#footnote-ref-5)
6. Source: IMF Historical Public Debt Database. [↑](#footnote-ref-6)
7. Quoted in Heartfield 2007: 141. [↑](#footnote-ref-7)
8. Average of monthly data. [↑](#footnote-ref-8)
9. As well as Greece, which however, already was a programme country by 2011. [↑](#footnote-ref-9)
10. Fitch on January 27 from A+ to A-, S&P on January 13 from A to BBB+ and Moody’s on February 13 from A2 to A3. [↑](#footnote-ref-10)
11. ECB president Trichet, in particular, was adamantly opposed to private sector involvement. [↑](#footnote-ref-11)
12. See: “Monti warnt vor anti-europäischen Protesten in Italien”, *Die Zeit*, 11. Januar 2012. [↑](#footnote-ref-12)
13. MTO is the deficit level which countries have to set so as to bring the structural debt progressively in line with the SGP provisions, and as such is sensitive to GDP growth forecasts, to the cost of government debt and to future age-related costs. [↑](#footnote-ref-13)