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The Italian Patient in 2016: Weak but not poor

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1. Introduction

Italy has been struggling with weak economic performance for the better part of a decade. Since 2007, the economy has not returned to a path of robust growth. The Italian economy is suffering from a triple-dip recession, and a solution seems far away. Despite this lasting stagnation, there have been only limited economic reforms. For some outside observers, Italian society seems to be longing for a return to the 1970s, the days of television personality Ugo Fantozzi: a cosy life without major turbulence. But to expect that Italy, or the European Union, will be able to return to the sheltered life of the past is wishful thinking. Italy is facing a choice: it will either embrace globalisation – with all its disadvantages, job losses in uncompetitive industries for instance – or it will have to opt for a more sheltered, but probably poorer path of economic development. If Italian society chooses the former, it will require a radical overhaul of the Italian economy.

Currently, however, Italian policy makers have not presented these options to Italian society. Prime Minister Matteo Renzi, greeted with great fanfare in both Brussels and Berlin, is scaling back his ambitions for reform. Instead of analysing the root causes of the Italian economic malaise, Renzi blames the Germans, the euro and the European Union for the country's problems. The promotion of domestic growth is considered essential, or the "euro is finished".[1] Growth, of course, requires more debt. Renzi is following an old logic: debt is better than stagnation, and over time the debt problem will be solved. If that were the case, Italy should have been thriving: between 2007 and 2015, Italy's gross debt grew from 116.5 percent of GDP to 160.7 percent, but there has not been a corresponding economic boom.[2]

2. The easy option: Blaming the Germans

Throughout the past decade, Italian observers continue to blame Germany for the lasting recession in Italy. The position that the German government is considered to be responsible for Italy's misery has been used by Prime Minister Renzi to maintain his support with domestic audiences. In Brussels and elsewhere, observers are surprised by the lack of willingness to address the internal mistakes in economic policy made in Italy. The former President of the European Commission, José Manuel Barroso, criticised Italian politicians in an interview with "Corriere della Sera". Barroso, himself from a country that has been forced to restructure its economy, has underlined that the rules of the monetary union have been established by member governments. Neither Brussels nor Berlin has forced Italy into the monetary union, and "Italy's debt was not accumulated by Angela Merkel".[3]

But there is a deeper, irritating asymmetry in the debate. Some member countries accept responsibility for their success, but blame the rest of the EU for any difficulties. José Manuel Barroso describes this as "the Europeanization of failures and the nationalization of success".[4] Regrettably, this assessment characterises the current situation of the European Union.

In 2016, the Italian government has beefed up its campaign for reform of European institutions and has been criticising Germany explicitly. In the years before, Prime Minister Renzi had been implementing an astonishing number of reforms – from the labour market to downsizing Parliament. But lately, the tone from Rome has become angrier and often explicitly anti-German.

Of course, Chancellor Merkel currently is easy prey. Her unilateral actions taken on immigration in September 2015 have weakened her political weight – both at home and abroad. Germany is isolating itself and contributes to a weakening of the EU. In the past, Germany insisted on the observation of European treaties. By acting unilaterally and ignoring the concerns of other European countries, Germany is contributing to a further deterioration of the prospects for the EU.

The resulting isolation of Germany in the refugee crisis is a grave and dangerous development. Berlin argues that it had to break the rules because of humanitarian emergencies, but that has been an avenue other European countries have tried to use when they attempted to legitimise violations of the European treaties. Of course, in the past Germany had always denied the appropriateness of such attempts.

The result of these developments is a weak Germany, and Prime Minister Renzi has spotted the opportunity to get his message heard. He is advocating reform in the European Union and has been suggesting that Germany is the main stumbling block for a more benign and enlightened economic policy. Whilst Renzi's political instincts have worked well in sensing an opportunity to lash out against Germany, his reform agenda is flawed. The changes he proposes will not make the Italian economy more competitive and will result in a weaker, not stronger, European Union. But in order to understand why Renzi is so confident in 2016, a closer look at Germany's policy failures is essential.

Within less than 12 months, Germany's position in Europe has deteriorated dramatically. Gone are the golden days when Germany was considered to be an example of efficiency and successful policy making. 2014 will probably be remembered as the high-water mark for German success. In that year, the country excelled at many levels: from the Soccer World Cup to Angela Merkel's position in international affairs. 2015, by contrast, was an "annus horribilis" for Germany. The Volkswagen scandal exposed some structural weaknesses in corporate Germany. German engineering was no longer praised by many. Above all, however, Chancellor Merkel alienated friends and foes in September 2015 with her unilateral decision to open Germany's border for refugees. Since then, Germany has been deprived of allies: Paris is explicitly rejecting German proposals for burden sharing, and Eastern European countries are openly hostile to Berlin.

A somewhat diverging experience was the debate on Greek exit from the Eurozone in July 2015. Most finance ministers of the Eurozone supported the German position, which considered Grexit to be the preferred option. Only France, Italy and Cyprus rejected Finance Minister Schäuble's proposal.[5]

Of course, close observers of Angela Merkel's chancellorship should not have been surprised. On previous occasions, Merkel had shown a propensity for unilateral action. On 5 October 2008, three weeks after the collapse of Lehman Brothers, she single-handedly declared that deposits in German banks were guaranteed. No other head of government had been consulted before she made that statement on German television. Of course, that activity had negative repercussions for other European economies as well as developing countries: capital was eagerly flowing to

Germany. Then, as in 2015, it would have been appropriate to at least inform other European governments first, and subsequently address the public.

From a German perspective, some of Prime Minister Renzi's aggression is understandable. Northern Europeans, including Germany, ignored the plight of Italy and Greece with refugees prior to 2015. Italy, for instance, had to finance the rescue operation "Mare Nostrum" without support from other European countries. Berlin preferred to insist that border protection is a national, rather than a European, affair. Against that background, it is not surprising that Italy refused to contribute to the payments to Turkey that shall solve a problem that Germany created without consultation of other players.

The fear of further German unilateralism is thus rising rapidly: a fatal collateral damage resulting in the strengthening of forces that want to terminate European integration in France, Italy and the United Kingdom. The French government has often raised concerns about the large number of refugees that have been permitted into the Schengen area. In September 2015, former French President Sarkozy had argued that many of the refugees that Germany had accepted will eventually reside in France – due to the high level of social benefits there. Sarkozy complained that France had not been informed let alone consulted about the German decision to open its borders.[6] Italian politicians have been critical of the negative effects of monetary integration, including Prime Minister Renzi himself. In British society, which has its own polarisation regarding migration, the defenders of a continuation of membership in the EU may have been decisively weakened. The referendum on 23 June 2016 may end British membership in the European Union. Historians would have to find out whether Chancellor Merkel's policies played a role in that decision. Recent anti-German statements by prominent members of the Brexit camp, for instance former London Mayor Boris Johnson, suggest that German policies are closely monitored and considered in the British debate.

From a German perspective, the obsession of some Italian commentators with Germany and its role in Europe is irritating. Put simply, previous Italian governments showed a great interest in joining the monetary union, and chose to sign the Treaty of Maastricht consistent with their own aims and ambitions. The criteria of Maastricht are not as irrational as some opponents suggest: in a group of sovereign states that forms a monetary union, fiscal policy remains under the control of the individual member states. The criteria of Maastricht *inter alia* had the intention of preventing negative spillover effects from one fiscally incautious country to the rest of the monetary union. The violation of the criteria has resulted in havoc – for the entire group. Since the collapse of Greek public finance in 2010, the entire Eurozone is negatively affected by unsustainable fiscal policy in some countries. Negative sentiment is both preventing consumers from spending and companies from investing.

Of course, one can spend a lot of time debating whether the European Monetary Union has been a good idea. While quite a few countries continue to consider membership in the Eurozone as positive, Italian policy makers and society appear to perceive the project negatively. Apparently, Silvio Berlusconi was contemplating taking Italy out of the Eurozone in autumn 2011.[7] In essence, that policy option was a reaction to the decline of competitiveness of Italian companies. Effectively, there are two options: either staying in the Eurozone and grudgingly accepting the long process of raising competitiveness, or leaving the monetary union and devaluing the new lira.

3. Debt addiction as a global phenomenon and the decline of Italian manufacturing

Of course, Italy's addiction to (public) debt is part of a global phenomenon. Despite all the talk about deleveraging, debt levels have been rising all over the world. Between 2007 and 2013, world total debt (excluding the financial sector) has been rising from about 180 percent of global GDP to about 210 percent.[8] In Europe, most economies, including Italy, continue to accumulate new debt and are not reducing debt levels.

Martin Wolf, columnist at the *Financial Times* has noted that the world is trapped in a cycle of credit booms. Without a credit boom somewhere, the global economy seems unable to generate growth in demand sufficient to absorb potential supply. Currently, the most dramatic rise of debt has been occurring in China: Since 2007, the ratio of total debt to GDP has risen by 72 percent to 220 percent of GDP. China has been paying for all its new cities and its sparkling infrastructure with debt. Eventually, China will either have to digest a dramatic decline of growth or will be confronted with an (internal) financial crisis.

In addition, in a world that is drowning in debt, Italian calls for more "fiscal space" appear dated. There is no evidence that more debt is fuelling economic growth. In Europe, the fastest growing economies in 2015 were Ireland and Spain, growing at 5.6 and 3.2 percent respectively. The USA recorded a growth rate of 2.4 percent, and Germany's and Italy's growth rates were well behind, with 1.5 and 0.8 percent. Public debt in Ireland shrank between 2014 and 2015 from

126.5 percent of GDP to 120.0 percent. Germany showed a moderate reduction of public debt – from 82.1 percent to 78.5 percent of GDP. The USA reduced its debt a little bit – from 111.6 percent to 110.6 percent. Spanish public debt grew a bit more than one percentage point, from 117.1 percent to 118.9 percent.

However, there were two countries in the OECD that recorded significant increases of already high debt levels: Italy and Japan. Japanese public debt rose by more than 3 percent, from 226.1 to 229.2 percent of GDP. Italian debt grew from 158.7 to 160.7 percent.[9] Neither Italy nor Japan has demonstrated that higher public spending results in higher economic growth. The equation has not worked in Japan since 1990 – in 1998 Japanese public debt was half its current level – nor in Italy. Considering the above mentioned psychological effect of deficit spending, today's calls from Rome for more fiscal space simply do not seem to match empirical evidence.

Of course, one may ask what relevance this discussion has for Italy. The answer is: for many observers in Germany, Italian policy-makers surprisingly have not yet identified debt as a serious problem. They continue to suggest that debt-financed growth is the answer to the economic slump, and given the serious problems the global economy already faces, further debt clearly will not solve the problems. Such an approach simply is not sustainable. Over time, debt will have to be paid back – or part of it has to be written off. Failing to address the issue of ever-increasing debt levels will result in more muddling-through. Of course, in Europe we have seen enough of that in the last five years.

The key to understanding the problems of the Italian economy is the decline of manufacturing. Italy's postwar boom was based on the rise of manufacturing, and the decline since 2000 has been "unparalleled", according to the industry association "Confindustria". While industrial output has grown across the world in the past decade, it declined significantly in Italy. Since 2000, global industrial output has risen by 36 percent, while in Italy it shrank by 25.5 percent. More than 120,000 Italian companies have closed their doors since 2000, and 1.2 million Italian workers have lost their jobs.[10] Manufacturing in Italy is – so it seems – in a sectoral decline.

The sector which demonstrates that depression is the car industry. In the past, Italian manufacturers were competitive, and Italy was a key player in car manufacturing. This has changed dramatically. In 1990, Italy produced 2.1 million vehicles (cars and light commercial vehicles). In 2014, that figure shrank to less than a third of the 1990 numbers. Today, Slovakia, Argentina and Iran produce more vehicles than Italy. Admittedly, no Ferraris and Maseratis are produced in any of these countries.

Policy makers, but also trade unions ought to ask themselves a simple question: why should Fiats be produced in Italy? Wages are not extremely high, but there must be a reason why its industry is so depressed. Without a revitalisation of industry, a return to sustainable economic growth will be difficult – as it would be in any other OECD country.

4. Who benefits from the common currency?

In Italian society, one often hears the claim that Germany is the main beneficiary of the European Monetary Union. That, however, is not correct. Yes, Germany is the largest economy and is a significant exporter within Europe. But only about 39 percent of Germany's exports go to Eurozone countries, and that share is declining. Furthermore, many observers fail to appreciate the complexities of the current account. Germany exports goods – and the surplus corresponds with exports of capital. Put differently: Germany has been financing investment and consumption – abroad. The car industry, for instance, has been opening many new factories, but none of them in Germany. In 2010, the German car manufacturers for the first time produced more cars abroad than at home. In 2014, figures were amazing: 5.6 million vehicles were produced in Germany, but 9.3 million abroad. Thus, countries like Hungary, Mexico or China have been benefiting from the German current account surplus and its associated export of capital.

Currently, however, Italian policy makers are criticising what they see as the structural weaknesses of the European economies. The main point is perceived weak domestic demand. In addition, in a White Paper published in February 2016 the Italian government has argued that "national interests are prevailing over the common good".[11] Of course, the implicit assumption is that in particular the Germans have been selfish and uninterested in advancing the EU. The well-rehearsed story in the economic domain is probably incorrect. In contrast to a widely held view, Germany is not the major beneficiary of European integration and the introduction of the common currency. For instance, German trade with the rest of the world is growing faster than trade with other member countries of the monetary union. In fact, in 2015 the USA replaced France as Germany's biggest trading partner. Only two of Germany's five largest trading partners are members of EMU (France and the Netherlands). The other three are the USA (1), China (4) and the United Kingdom (5). In 2015, German trade with the United Kingdom and

Poland was larger (€ 224.1 billion) than the sum of exports and imports to Italy, Spain, Portugal, Greece and Ireland (€ 208.1).[12]

Why is it necessary to consider these figures? In Southern European societies, there appears to be a populist nationalist claim that Germany has been prospering at their expense. Of course, without trading partners an exporting economy cannot flourish. But the equation is a bit more complex. Germany has been exporting goods and capital, and the results have not been all that positive. German exporting firms have benefited from successful exports, but losses incurred from unwise investment had to be paid for by taxpayers and bank customers. Indeed, it is astonishing that those groups within German society that benefited from the introduction of the euro have been successfully portraying their interests as the interests of the whole German society.[13] Large manufacturing companies, first and foremost the car industry, have successfully argued that the creation of the euro is beneficial to the *entire* society. While there is no doubt that some parts of German society have benefited, people outside the manufacturing sector probably have not enjoyed the same level of economic benefits. One example: before the euro, the currency was regularly revalued, which increased the purchasing power of citizens, both at home and abroad. That effect vanished after the euro was created.

Nevertheless, one country does have ample reason to reconsider its foreign economic relations within the EU: Germany itself. Apart from foreign direct investment, which often was beneficial, Germany has wasted billions of euros in portfolio investment abroad. In simple terms: the Germans have sold Porsches and BMWs and have received Greek government bonds and American real estate paper in return. That model has been expensive: between 2000 and 2012, the sum of the current account surpluses was 1 300 billion euros, and that should have resulted in (at least) claims on the rest of the world of the same magnitude. Regrettably, due to unwise investment decisions by German bankers, 300 billion euros had to be written off. Germany has been financing unsustainable debt abroad.

Thus, the very country that should question the utility of Eurozone membership is Germany. The economist Karlhans Sauernheimer has even suggested that the combined effects of exporting goods and losing money in the export of capital – a necessary consequence of a current account surplus – have not made Germany more affluent, but have led to welfare losses through exports.[14]

Unsurprisingly, the Renzi government has not been considering both sides of the balance of payments, but instead has chosen to lament the effects of German surpluses. It argues that "very large current account surpluses have a negative effect on the overall functioning of the Eurozone …"[15] As suggested, Germany should reduce its current account surpluses, but primarily for purely egoistic motives. Rather than selling Porsches and giving away the money to buy them, Germans should raise their own level of consumption. The mathematics of this process are simple: Germany can reduce exports, increase imports, reduce savings or increase domestic investment – all four changes reduce the current account surplus. If, however, German companies reduce investment abroad, the losers would be workers in other countries, for instance in Eastern Europe. Above all, it would not help Italy or other currently weak economies all that much. The beneficiaries would be those economies that already export quite a bit to Germany – China for example.

5. Italian talent leaving the country

Today, the group that pays the biggest bill for the narrow policies of the Italian political elite of many Italian citizens, including the trade unions, are young Italians. From 2007, unemployment has risen, but most dramatically in the age-group under 25. The result is a brain drain: young Italians are leaving, and in Italy's ageing society these people will be difficult to replace. Since 2011, every year more than 70,000 young Italians leave the country in order to find work elsewhere. Of these, 70 percent have a university degree and many are multilingual. In short: exactly the type of employee that is sought elsewhere. Most young Italians go to the United Kingdom, but Switzerland, Germany, France, the USA and Brazil are also accepting young talent from Italy.

Of course, Italy has seen waves of emigration before. But this time is different: first, the population is declining. Second, and more important: those leaving are not primarily from the Italian South, nor are they badly qualified. The main regions of emigration are Lombardy, Veneto, and Latium. Sicily comes fourth.[16] This brain-drain results in a negative perspective for the Italian economy, also because very few Italians attend universities anyway: only one in five young Italians completes university, compared to a European average of one in three.

Adding to the malaise is the fact that the departure of young people is not matched by the arrival of young talent from other OECD countries. Italy's universities do not attract foreigners: only

2.3 percent of university graduates are foreigners, compared to an OECD average of 10.5 percent. In the Economist Intelligence Unit's Global Talent Index, Italy ranked 23rd in "ability to attract talent" – the same as Greece but lower than Spain or Taiwan.[17] In short: life in Italy is no longer attractive to young people – neither young Italians nor those from abroad.

6. The hidden wealth of Italian households

Contrary to a commonly shared view of Italy, Italians are in fact richer than Germans. Recent research has added a new dimension to this picture: Italian households have the lowest level of debt in the developed world.

The Italian Central Bank has regularly evaluated the wealth levels in Italy. Despite a decline in recent years, at the end of 2012 Italian households' net wealth amounted to € 8.542 billion, corresponding to about € 140.000 per person or € 360.000 per household.[18] 80 percent of Italian households own property.

Even more surprising is an international comparison of debt levels. Of course, it is well-known that Italy occupies the third rank among developed countries with regard to public debt – after Japan and Greece. But the overall level of debt – including the private sector – is relatively low. In 2013, the total level of debt – public and private excluding the financial sector – was 258 percent of GDP, almost exactly the average of the Eurozone (257 percent). Some countries have a significantly higher debt level: Swedish public and private debt stood at 293 percent of GDP, the Netherlands at 295 percent of GDP. Germany's debt level in 2013 was 192 percent of GDP, and the USA's level (265 percent) was marginally higher than the Italian one.[19]

But the key to understanding the Italian case is the low level of household debt. Whereas the average level of household debt in that group was 74 percent of GDP, Italian households had a mere 45 percent, lower than Austria (53 percent of GDP), Germany (57 percent), not to mention the Netherlands (126 percent) or Australia (110 percent).[20]

In essence, Italy has a poor state but affluent citizens. Neither is the overall level of debt extremely high nor the public debt problem an issue for other countries: the poverty of the public sector is the result of Italian fiscal policy, and it will have to be solved by Italian fiscal policy. This is a simple question of political economy: who has benefited from Italy's fiscal policy in the past? While there are certainly many people in Italy who do not live in affluence, compared with other countries in the Eurozone, Italians do have the means to reduce the debt of the Italian state. To suggest that Brussels or Berlin is responsible, or should accept responsibility, for the Italian public debt is courageous. Should Italian society fail to successfully address this problem, the consequences for the European Union and the Eurozone will be severe. Italy, a founding member of the EU, could be the trigger to Europe's deepest crisis since 1945 – with an unknown outcome.

7. How to strengthen domestic demand?

The Italian government has correctly identified weak domestic demand as a key factor in the sluggish performance of European economies. But priming the pump and increasing public borrowing and spending will only provide temporary relief. In fact, citizens are well aware of the long-term consequences of borrowing by governments. They know that today's borrowing represents tomorrow's taxes. Italy is the perfect example: the country has both the second highest level of public debt in the EU and simultaneously the lowest level of household indebtedness. Italians know that whatever governments spend today will result in the taxman's bill tomorrow. They do not borrow to consume – knowing how deep their government is in debt.

The only solution to that dilemma is to have a third party coming to the rescue. If Italian deficit spending is covered by someone else, then the negative effect on households might be avoided. Thus, the calls for eurobonds and other forms of sharing liabilities make sense – for those who would see a reduction of their debt as a consequence. Of course, the effect for Germany would be the opposite: the current high level of confidence of consumers would be eroded by higher future obligations.

Italy today seems to face the prospect of becoming Europe's Japan: ageing, with declining industrial capacity and rising levels of debt. But like in Japan, there is no magic solution. There cannot be a rapid return of growth without making private investment more attractive. Italy has made substantial progress in that field, but the increasing nervousness of the Italian government, combined with an Anti-European hysteria in the opposition, makes further turbulence more rather than less likely.

Of course, the Italian government's White Paper has more to offer than just calls for more lenient fiscal policy. It suggests the creation of a European Deposit Insurance Scheme (EDIS).[21] But from a German perspective, this is a proposal that would serve Italian savers more than others. Essentially, the Italian government makes proposals that primarily serve its citizens – and there is no plan to advance the "common good" across the Eurozone.

Earlier phases of European integration have benefited from a convincing narrative: joining forces is beneficial to all countries. In fiscal policy, this approach no longer works. Fiscal policy is a zero-sum game: whatever Italy would gain from shared fiscal responsibility, Germany would lose. It is difficult to see how German policy makers could convince their voters that another act of burden sharing, this time for Italy, is a good option for Germany.

Of course, if the Italian approach were not so blatantly self-interested it might be more convincing. The Italian government, blaming Germany for its selfishness, is acting in exactly the same way. The White Paper does not name any area in which Italy would be willing to make a contribution to European integration, it merely blames others.

A key element in the 2016 White Paper of the Renzi government is the proposal of a fund to stabilise labour markets in the EU. There should, in other words, be transfer payments from those economies in the EU that have successfully implemented reforms and have created improved employment opportunities to those that have not been able to do that.[22] In effect, such a fund would be a step towards the creation of an EMU-wide welfare state. But who would fund it?

The Renzi proposal is not specific on that question. It simply argues that all countries – both paying and receiving – would benefit from "a more stable and prosperous macroeconomic environment".[23] But one could argue that this is a distributional issue: the affluent should be paying the bill, regardless of where they reside. Given that property owners in many European countries have been experiencing a significant increase of their net wealth position, why not tax them moderately? A small tax on residential property would surely be sufficient to finance that fund, and Europe would avoid a division between nations and instead have a classical redistributional issue. Of course, such a tax would attract widespread criticism, but there would not be the bias that characterises the current Italian proposal.

8. Conclusion: The situation is difficult, but not hopeless

The key to a return to a sustainable economic development is the revitalisation of manufacturing in Italy. Without successful manufacturing, Italy has very few options. Put simply, tourism and other services will not be sufficient to fund Italy’s current standard of living. However, the time for a revival of Italian manufacturing is good. After a rise of real wages in China by 300 percent between 2000 and 2012, today transnational companies are much less inclined to manufacture in China. A combination of labor market reform – including a further weakening of the infamous Article 18 – and a push for higher productivity are of course essential. The old dichotomy – either a job for life or precarious jobs – ought to be a feature of the past.

In order to reform the public budget, Italy should contemplate raising the taxes. Even a one-off tax might be an option. Of course, such measures would be extremely unpopular. But in fiscal policy, Italy is confronted with two ugly options: either a process of long stagnation – not unlike that of Japan – or a short, tough but eventually beneficial cure. Of course, this is a choice for Italian citizens, and a foreign observer cannot recommend either option. But given the sharply decreasing confidence of Italians themselves in the future of their country – demonstrated by the emigration of young people as well as by the rising export of capital – marginal changes may not suffice to reboot the Italian economy.

In 2016, the European Union faces several crises. Germany has many reasons to reconsider its unilateral approach – and will be forced to do so. Nevertheless, in fiscal policy the conservative Northern European approach continues to be convincing. Europe should not follow the Japanese model – keeping zombie banks alive, having one stimulus package after the other and financing those policies with ever greater levels of public debt.

The European project still has many positive dimensions. In the near future, policy makers have to find ways that enable European societies to diverge from the mainstream without sacrificing their participation in the integration process. There is no future for the European Union if that issue is not answered successfully. Whether in the regulation of migration, in fiscal policy, or in welfare policy, Europe continues to be characterised by diversity, and successfully managing diverging preferences will strengthen, not weaken, the European idea.

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