Italy and the euro

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Anyone who has followed the Italian crisis closely will appreciate that closing an article on an Italian government that is still being formed three days before publication is a high-risk exercise in view of the twists and turns involved. Even so, we can try to understand what has brought us to this situation.

The trigger leading to the sharp market reaction was on the one hand the manifesto of the coalition between the Five Star Movement (M5S) and the League, which included disproportionate fiscal expansion. All Italian parties had made extravagant fiscal promises, but had not envisaged sticking to them when forming a government. If there is one thing that Italian governments have always been careful about, it is keeping public deficits more or less contained, in the knowledge that for decades the country's debt ratio has been close to the point of no return. The most worrying of the fiscal proposals are the plans for immediate tax cuts, involving three more percentage points of deficit unless one believes in Laffer curves à la méditerranéenne (tax cuts financing themselves through increased growth).

On the other hand, the potential government coalition has been showing increasing signs of lack of commitment to the euro, suggesting that the ECB should forgive part of Italy’s debt, proposing something akin to a parallel currency to cover the government’s delayed payments, and making the candidacy of Paolo Savona for the ministry of the economy the symbol of the political battle with President Mattarella.

The coalition’s arguments to explain Italy’s economic problems centre on the European fiscal rules and (sometimes) the costs of belonging to the euro. But the stagnation of Italian per capita income and productivity over more than twenty years cannot be explained by restrictions on short-term instruments, which is what fiscal policy is. And several countries on the European periphery provide counterexamples showing that it is possible to belong to the euro and prosper. Italy’s problems lie in more structural factors.

The key to the solution of Italy’s current crisis is the time it takes the leaders of both parties - who will very likely play a significant role in future governments, now or after the summer - to internalise the basic budgetary restrictions and the European rules. Le Pen did so during her electoral campaign, withdrawing her proposal for a referendum on the euro. And so did Prime Minister Tsipras, albeit late, in acknowledging that leaving the euro would be more costly than the adjustments imposed by the Troika.