A Slow Fuse: Italy and the EU Debt Crisis

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Italy is firmly in the grip of an austerity programme mandated by the European Union institutions, and executed by an unelected technocrat. This state of affairs is at once the result of the acute and unexpected crisis of the financial and economic integration of the eurozone, and an expression of the failures of the Italian political class. Although the euro crisis has been mishandled by European elites, Italy's long-term economic decline, and the inability of Italian party politicians to generate a sustainable coalition to address Italy's economic problems, hinders an exit from the crisis.

Keywords: Italy, euro crisis, austerity

In 2012, the eurozone crisis has begun to follow a predictable script. First, a member state begins to show signs of financial stress, with a growing public deficit and debt burden alarming markets. The spike in borrowing costs sparks a policy response by the member state government, raising taxes and cutting public spending, which depresses economic activity further. The resulting poor growth data leads to further increases in borrowing costs. When these costs hit an unsustainable level, the European Union institutions intervene by lending the struggling country bailout money, in return for further commitments to reduce the deficit. A further fiscal squeeze follows, sending the debtor nation into what economist Paul Krugman describes as a ''death spiral''.[1]

By July 2012, Greece, Portugal, Ireland and Spain had all reached the final stage of this process. The three smaller countries were the first to be bailed out, and although the sums involved appear staggering, the EU had little trouble raising funds to sustain public borrowing in countries whose GDP amounted to less than a tenth of the eurozone total. But the financial troubles of Italy and Spain, the third

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[1] P. Krugman, ''The Austerity Agenda'', *New York Times*, 31 May 2012, http://www.nytimes.com/2012/06/01/opinion/krugman-the-austerity-agenda.html?_r=0.

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and fourth largest economies in the eurozone, are of an entirely different order. Like the large investment banks at the centre of the financial meltdown of 2007–08, Italy and Spain are widely seen as 'too big to fail', since their national debts are so large that default would likely trigger a financial collapse of incalculable scale.[2] At the same time, they are also 'too big to bail', since covering their borrowing costs for any significant period of time would require vastly greater resources than those provided for the smaller periphery economies.

This dilemma is at the heart of the euro crisis, and explains why it is taking so long to resolve. Bailing out the periphery countries would be enormously expensive, and countries such as Germany, Netherlands and Finland fear that a bailout would create a lasting relationship of dependency of the debtor nations on their more creditworthy neighbours. Not bailing them out, however, would risk bankrupting financial institutions not only in the eurozone periphery, but also in the creditor countries of Northern Europe: after all, the debts run up by the periphery correspond to the financial surpluses built up over the past decade by the eurozone core. Faced with a choice between such unpalatable courses of action, European summits have chosen to patch together short-term measures which stave off the inevitable reckoning without providing any definitive solution, a technique observers have christened "kicking the can down the road".[3]

For Italy and the other Southern European countries, this impasse has vast economic and political costs, which cannot but have profound consequences not only for the periphery countries themselves, but for the eurozone and the European Union as a whole. This article will discuss the economic and political implications of the Southern European crisis with particular focus on Italy, the largest debtor nation. It proceeds as follows: the first section examines the roots of the crisis in the design of the euro and Italy's efforts to join it, the second section examines the way in which monetary union paved the way for the debt crisis in Italy and the rest of Southern Europe, the third assesses the response to the crisis, and the final section discusses the political sources of Italy's economic problems.

The roots of austerity: Maastricht, the euro and the convergence criteria

The global financial crisis which began in 2007 has been the subject of a vast amount of analysis and discussion, in the traditional media, in business circles, in academia and, most fascinatingly, in the emerging new social media which have provided an innovative channel for popular input into the debate. Unlike the

[2] "The Spanish Bail-Out: Going to Extra-Time", *The Economist*, 16 June 2012, http://www.economist.com/node/21556953.

[3] "Kicking the Can Down the Road, Again", *The Economist*, 18 June 2012, http://www.economist.com/blogs/newsbook/2012/06/greeces-election.

previous major crisis affecting Western economies in the 1930s, today we benefit not only from decades of research in economics and the other social sciences, but also an unprecedented amount of information and analysis available to not only policymakers, but also to any interested citizen possessing a networked computer. The experience of the 1930s, the Keynesian revolution in economics that resulted from it, and the more recent examples of financial crises and their consequences in countries as diverse as Argentina, Russia, Japan and Sweden, should have made governments more prepared than ever to deal with this kind of situation.[4] Yet the advanced countries are still in the grip of a deep recession, five years on, and the policies followed in the eurozone almost seem designed to make things worse.

Although there is legitimate debate on the different remedies to the economic problems, it is difficult not to see the current mess in the eurozone as a political, rather than a policy, crisis. The policy response of delay and denial followed by conditional bailouts which obstruct economic recovery certainly corresponds to the economic thinking of influential figures in the financial community and in key institutions like the European Central Bank (ECB).[5] However, the inability of European policymakers to move beyond these policies, even when their failures become evident, is a direct consequence of the way the euro was constructed. In order to understand the policy response, we need to briefly revisit the policy dilemmas addressed at the very beginning of the process of monetary integration, over two decades ago.

The creation of the euro was the culmination of two decades of attempts to revive the kind of exchange rate stability that had underpinned the 'Golden Age' of European growth in the 1950s and 1960s, the so-called Bretton Woods system. The collapse of Bretton Woods, formalized by the United States' decision to float the dollar in 1973, left the European nations facing an increasingly unstable monetary environment, with currency parities increasingly impossible to maintain. Germany, with its independent Bundesbank tasked with the job of ensuring price stability, was able to keep inflation under control, reinforcing the Deutschmark. Italy, along with other European countries including the United Kingdom and France, found it impossible to put a lid on inflation, as oil price rises fed through into higher wages and yet further price rises. The result was a series of devaluations of the weaker currencies, disrupting trade between European nations and undermining governments' attempts to stabilise prices.[6]

The idea of monetary union was a response to this turbulent period, but the differences in the inflation rates of different European countries were a serious

[4] Krugman, *The Return of Depression Economics*.
[5] See, for example, the press conference given by ECB President Jean-Claude Trichet in September 2011 (http://www.ecb.int/press/pressconf/2011/html/is110908.en.html), or the speech given at Chatham House, London, by Bundesbank President Jens Weidmann in March 2012, entitled 'Rebalancing Europe' (http://www.chathamhouse.org/publications/papers/view/182652).
[6] For an analysis of this period, see Eichengreen, *The European Economy Since 1945*.

obstacle to a single currency. German policymakers, and in particular the Bundesbank, were reluctant to compromise the anti-inflationary credentials they had carefully built up through the postwar period. Pooling their monetary credibility with other weak currency nations would inevitably put it at risk, and Italy, as the most inflation-prone of the largest European economies, was the most obvious threat. Concerns about Italy and the other Southern European member states were a key reason for the Maastricht Treaty establishing strict convergence criteria which countries had to meet to be admitted to the euro. As well as achieving inflation rates close to those of the other participating countries, qualification for euro entry also required a fiscal deficit below 3 percent of GDP, and total government debt no higher than 60 percent of GDP. The usefulness of the criteria in preparing countries for monetary union was contested by many economists, but these tough requirements were crucial in overcoming resistance to the euro in Germany, and particularly in the Bundesbank.[7]

At the time of the Maastricht summit, Italy was a long way from meeting any of the convergence criteria. Inflation, interest rates, budget deficits and public debt were all far higher than the Maastricht limits. But in just a few short years, Italy qualified for participation in the first wave of monetary union. How was this possible? In the 1970s and 1980s, Italy had managed its economic problems through a combination of frequent currency devaluations, to maintain competitiveness when wages rose more quickly than productivity, and deficit spending, which allowed government to buy social peace. By the 1990s, the essential unsustainability of this model had become clear, and Italy experienced a deep economic crisis which brought sweeping changes to its political system, but also paved the way to its successful bid to enter the euro.[8]

The trigger for the crisis of the early 1990s was the reunification of Germany, which disrupted the system of adjustable exchange rate pegs adopted by most EU countries, the European Monetary System (EMS). Italy had participated in the EMS ever since 1979, but after 1990 the lira came under heavy pressure because of the Bundesbank's concerns about inflationary pressures building up in the newly reunified German economy. German interest rates were ramped up to keep prices under control, forcing other EMS member countries to either match this tough contractionary policy – which would bring an economic slump – or allow their currencies to devalue against the Deutschmark, jeopardizing their membership of the system. Italy's high inflation and budgetary weakness placed it under particular pressure and it, like Britain, left the Exchange Rate Mechanism of the EMS in September 1992.

[7] For a detailed account of this process, see Dyson and Featherstone, *The Road to Maastricht*. For a scathingly critical assessment of the Maastricht criteria, see Krugman, *Peddling Prosperity*.
[8] Guzzini, "Long Night of the First Republic", 27–61.

The Italian economic crisis of 1992 coincided with a dramatic political crisis which brought about the wholesale replacement of the political class that had governed the country for decades. The Christian Democratic-Socialist coalition, led by such historical figures as Giulio Andreotti and Bettino Craxi, collapsed in the wake of the economic slump, the rise of the populist Northern League, and a determined anti-corruption campaign waged by reformist magistrates in Milan, Palermo and elsewhere.[9] This political crisis brought to the fore a new political elite: on the right, new populist forces led by Silvio Berlusconi replaced the Christian Democrats and Socialists, whilst on the centre-left, the former Communists in the 'Left Democrat' (DS) party formed an alliance with reformist Christian Democrats and technocrats associated with prominent Italian exporters and the Bank of Italy.[10] This centre-left grouping, under figures such as Giuliano Amato, Carlo Azeglio Ciampi and Romano Prodi, spearheaded Italy's push to reform its economy in preparation for euro membership.

The changes in Italy were welcome to European policy elites, as they signalled the country's determination to adhere to the strictures of monetary union. German fears that Italy's presence would undermine the single currency were assuaged by the tough measures adopted by Prodi and others to bear down on inflation, reform budgetary practices, and stabilise the lira. Social pacts between government, business and the major trade unions secured worker wage restraint, administrative reforms and judicial pressure curbed wasteful and corrupt government spending, and revenue collection was tightened up to combat tax evasion. All of these measures contributed to improving Italy's reputation as a reliable partner in the euro enterprise, to such an extent that Italy's euro entry was approved by its European partners despite the failure to reduce public debt below the required 60 percent of GDP. By joining the euro, it was believed that Italy had secured a permanently stable exchange rate with its main trading partners, a lower inflation rate (thanks to Germany sharing its anti-inflationary credibility with the other members of the European Monetary Union) and cheaper borrowing costs. So why is Italy now suffering its worst economic crisis since the Second World War?

The euro's first decade: a disaster in the making?

The first few years of the euro's operation – beginning in 1999, with the irrevocable fixing of exchange rates, the use of the currency for financial transactions and state budgets, and the entry into circulation of euro coins in 2002 – hardly presaged the crisis to follow. For Italy, the convergence of interest rates around the core European economies continued to such an extent that the spread with German

[9] See Della Porta, "A Judges' Revolution?", 1–21.
[10] Gundle and Parker, *The New Italian Republic*.

treasury bonds (the differential between the perceived risk of Italian government debt compared to German government debt) became negligible. For Italy, a nation with the second highest national debt/GDP ratio in the advanced world (after Japan), the resulting reduction in debt servicing costs brought huge savings for the government.

The reduction in interest rates was a key benefit to Italy of euro membership. Outside the single currency, Italy's history of high inflation, its volatile exchange rate and the poor international credibility of its governing elites would have kept interest rates high, damaging business investment and significantly increasing the risk of default on Italian treasury bonds. With public debt peaking at 121 percent of GDP in 1994, markets would have been ultra-sensitive towards any signs of fiscal laxity, compelling Italian governments to run a tight fiscal policy which would dampen economic growth. The benefits of convergence for debt management were clear; the debt/GDP ratio fell consistently until 2004, dropping to 103 percent, still high but on a trajectory towards sustainability.

Nevertheless, subsequent events have shown that the benign effects of euro membership were more questionable. There is evidence that major problems were brewing, despite the apparently favourable economic climate. The European single market in general, and euro membership in particular, made Southern European countries financially far more integrated with the other EU member states than had been the case in the past. Capital controls were abolished as a requirement of the Single European Act of 1986, totally freeing up capital movements between EU member states. But European Monetary Union also significantly enhanced the effects of the removal of capital controls, by reducing the transaction costs involved in transferring funds across borders, and changing the perception of country risk. In the early years of the euro, markets began to see euro membership as an irrevocable step, implying that exchange rate risk had all but disappeared. The perceived safety of euro-denominated assets sparked massive capital flows, from which Italy and the other Southern European countries initially benefited. But these capital flows set the stage for the subsequent crisis by encouraging the accumulation of greater external debt.

As a wave of capital headed South from the exporting economies of Northern Europe, economic growth rapidly picked up in peripheral economies such as Ireland, Greece and Spain. These capital inflows had different effects on different countries: in Ireland and Spain, the money was to a significant extent recycled into property speculation and construction, and through that into consumer spending. The result was rapid growth and an explosion of private household debt. In Greece, on the other hand, much of the inflow went into government debt, and the government exploited its sharply improved risk profile to increase spending, in part investing in public infrastructure (notably, the 2004 OIympics), in part by fuelling a clientelistic expansion of public sector employment. By the time of the financial crisis of 2007–08, these three countries had accumulated significant external liabilities and trade deficits, leaving them dangerously exposed should the flow of capital reverse.[11]

The picture in Italy was different. As a more mature industrial economy, it was less prone to capital flows attracted by the prospect of rapid 'catch-up' economic growth. Italy in fact had suffered from very low growth ever since the onset of the crisis of the early 1990s. Moreover, the Italian authorities appeared reluctant to encourage such capital inflows: the opacity of the Italian financial system, the close relationships between financial actors and industrial companies, and the notorious complexity of Italy's administrative and judicial systems, all acted to discourage inward investment. However, Italian public debt had become more attractive to international investors. As in the other Southern European countries, the apparent elimination of currency risk meant that Italian bonds seemed a good investment, offering higher rates than German *bunds*, but almost the same default risk. As a result, the profile of holders of Italian debt internationalised, to the point that less than half was owned by domestic investors.[12]

The Italian economy benefited initially from these benign conditions, and growth picked up from the stagnant levels of the 1990s, albeit remaining well below the EU average. Italian exporters enjoyed a more stable exchange rate with their main trading partners, a key gain for the Northern manufacturing industries which were closely integrated into core eurozone production processes. But the euro also exposed some of the weaknesses of Italy's economic institutions. Although inflation had dropped markedly through the 1990s, converging close to the eurozone average, the introduction of euro coins and notes in 2002 was widely perceived by the Italian population as sparking inflation, as opportunistic businesses converted their prices into euros at the rate of 1000 lire to the new currency, rather than the official rate of almost 2000 lire.[13] Although official statistics did not confirm any significant increase in prices, the public perception of a squeeze on living standards was strong. Certainly in some sectors where market competition was ineffective and cartel-like behaviour entrenched, there were opportunities for price hikes.

It is not clear whether the phenomenon of euro inflation impacted on wage bargaining, but it became evident over the subsequent decade that Italy, like the other Southern European countries, saw a substantial increase in its relative labour costs as a result of euro entry. The formal requirements of the Maastricht Treaty and the Stability and Growth Pact, which focused on fiscal policy levers controlled

[11] Eichengreen, "Imbalances in the Euro Area", http://emlab.berkeley.edu/~eichengr/Imbalances_Euro_Area_5-23-11.pdf.

[12] J. Doukas, "Germany has Benefitted the Most from the Adoption of the Euro", LSE EUROPP Blog, http://blogs.lse.ac.uk/europpblog/2012/05/23/germany-current-account-euro-benefit/.

[13] De Cecco, *Gli anni dell'incertezza*, 281.

by governments, perhaps distracted European policymakers from the other potential sources of instability which lay outside government control. As well as financial flows, labour market institutions were also fundamental to economic management within the constraints of the euro. By tying eurozone countries to an irrevocable fixed exchange rate with other member countries, monetary union removed forever the strategic tool of competitive devaluation, a tool deployed frequently by Italy over the postwar period. Since relative inflation could no longer be addressed by allowing the currency to slide, eurozone member states needed to ensure wage costs did not increase at a constantly higher rate than their neighbours.

This proved difficult because the Southern European countries lacked the tradition of stable corporatist bargaining entrenched in the successful Northern European states. In Germany in particular, trade unions had accepted in their negotiations with employers significant constraints on real wage growth, in exchange for job security. Italy and Spain both achieved high levels of industrial coordination in the 1990s, with trade unions accepting wage restraint in order to facilitate euro entry, but once monetary union had been achieved, bargaining reverted to the more inflationary patterns of the past. The perceived pressures on prices, the low rate of productivity growth, and the more tense political climate after Berlusconi's victory in 2001, all contributed to the breakdown of industrial peace. Although wage rises were not dramatic by historical standards, in a context of a fixed exchange rate and tough wage restraint in the eurozone core, Italian unit labour costs quickly rose relative to Germany, threatening competitiveness.[14]

Along with the decline in competitiveness, the government's fiscal health began to deteriorate soon after monetary union. The austere policies followed by the technocratic and centre-left governments of the mid- to late 1990s were significantly relaxed once euro entry was achieved. The election victory of Silvio Berlusconi's centre-right coalition in 2001, won with promises to cut taxes (but no real commitments to cut spending), marked a shift in emphasis. Italian public debt maintained its downward trajectory until 2004, when it reverted to an upward trend. Although this trend was briefly halted by Romano Prodi's short-lived government elected in 2006, by 2008 the effects of the financial crisis had blown a hole in the Italian government's finances, and by 2011 public debt was back up to 120 percent of GDP, the level reached in 1994. After little more than a decade, Italy's fiscal progress had been wiped out.[15]

This left Italy particularly vulnerable when the global financial crisis began to impact on the eurozone. Although Italy and Spain had a fairly stable and manageable fiscal situation in 2007, once the crisis hit, their budgets quickly took a turn

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[14] OECD, *Italy: Reviving Growth and Productivity*, http://www.oecd.org/about/publishing/2012.09ItalyBrochureEN.pdf.

[15] Hopkin, "How Italy's Democracy Leads to Financial Crisis", http://www.foreignaffairs.com/articles/136688/jonathan-hopkin/how-italys-democracy-leads-to-financial-crisis#.

for the worse. Tragically, the reaction of Germany and the ECB to the unwinding of the commercial and financial imbalances between Northern and Southern Europe was to attack the symptom, not the illness. Spain had low levels of overall government debt and a budget surplus before the crisis, Italy had been running a large primary surplus ever since the early 1990s. Although Germany's ability to exploit its newly fixed exchange rate with the rest of the eurozone to run large current account surpluses implied substantial capital flows towards Southern Europe, which produced corresponding current account deficits, the institutions governing the single currency were not equipped to deal with such imbalances, and the attention of policymakers – and investors – focused instead on budget deficits, and the purported 'profligacy' of the recipients of German capital.

From here to austerity: Italy responds to the crisis

The global financial crisis, sparked off by the collapse of the sub-prime mortgage market in the United States, had dramatic effects in the eurozone. Initially, however, the periphery countries did not seem to be affected any more than the stronger core economies: output dropped in 2008–09 (Q1 2008-Q2 2009) by 6.5 percent in Italy, and 6.3 percent in Germany.[16] But as governments across the advanced world allowed budget deficits to grow as unemployment rose and tax revenues fell, the vulnerability of the Southern European countries quickly became evident. The rapid increases in public debt that resulted from high and sustained deficits reminded markets that government bonds did carry an element of default risk, and investors quickly concluded that this risk was much higher for the periphery countries than for the eurozone core.

Initially, Italy appeared better placed to address the crisis than its Southern European neighbours. The focus on Greece, whose chaotic finances and history of unreliable accounting made Italy's fiscal policy appear comparatively robust, and Ireland, whose crisis was at first a banking rather than a fiscal crisis, gave Italy valuable breathing space. The third Berlusconi government, unlike many other eurozone governments, shunned expansionary fiscal policy as a route out of the crisis, and maintained a primary budget surplus even as the collapse in output tore through revenues. According to OECD figures, Italy had the smallest deterioration in its fiscal balance between 2009 and 2011 of any eurozone country, in stark contrast to Northern European countries such as Germany, the Netherlands and Finland, which rolled out stimulus packages adding between 5 and 15 percent of GDP to their public debt.[17] Due to the limited nature of Italian unemployment support, even the 'automatic stabilisers' allowed to function by the Berlusconi

[16] OECD Stat, September 2012, http://www.stat.oecd.org.
[17] OECD Factbook 2010, http://www.oecd-ilibrary.org/content/data/data-00499-en.

government had a much smaller effect than in countries with more generous welfare provisions.

This early resort to austerity helped stave off the pressure on Italian public debt. As the crisis of confidence in eurozone government paper spread to Portugal and Spain, which had much smaller debt levels, Italy maintained a strict fiscal stance, aware that any sign of fiscal weakness could lead to a rapid increase in the spread between Italian and German bonds. The eventual breach of Italy's defences had a number of causes. First, as more countries struggled to contain the interest rates on new issues of debt, markets developed an increasing fear of contagion, exacerbated by the limited response of the European Central Bank and the clear signs of divisions between eurozone governments on how to deal with the crisis. Italy, with its exceptionally large stock of debt, began to be identified as the next weak link in the eurozone, and investors in the bond markets factored this fear into their trading behaviour. To that extent, Italy's slide into debt crisis was in part the result of a self-fulfilling prophecy triggered by broader fears about the future of the euro.[18]

But Italy had specific problems of its own that enhanced its vulnerability. Its economic weakness over the preceding two decades, with economic growth the lowest of any of the eurozone countries over the 1990–2012 period, suggested that even if the global crisis were to resolve, Italy would still struggle to return to healthy rates of growth. With a debt burden larger than GDP, economic growth would have to be higher than the cost of debt service if debt were to be reduced, and any spike in borrowing costs would destroy any hope of this. In the absence of recovery, markets would have to believe that the Italian government would deliver harsh austerity measures in order to protect its budget position. Here the poor credibility of Italy's political leadership became a major burden. After the brief interlude of centre-left government under Prodi ended in 2008, the Italian government was once again in the hands of Silvio Berlusconi, whose chequered business career and tax-cutting rhetoric proved less than reassuring. Berlusconi's success in engineering a return to power did not ensure a strong government, since his increasingly difficult relations with his coalition allies meant the government would have an unstable parliamentary support base.

The 'political risk' associated with Berlusconi brought about a dramatic change in leadership at the end of 2011. Weakened by scandals, Berlusconi could not deliver any coherent response to the rise in the bond spread through the second half of the year, and an ebbing of support in the parliament led to his resignation.[19] His replacement by Mario Monti, a former European commissioner but not a member of any political party, appeared to mirror the imposition by EU leaders

[18] M. Pagano, "Fiscal Crisis, Contagion and the Future of the Euro". *Vox*, 15 May 2010, http://www.voxeu.org/article/understanding-eurozone-crisis.

[19] "Berlusconi Resigns After Reform Vote", *Financial Times*, 12 November 2011, http://www.ft.com/cms/s/0/b4217efa-0d52-11e1-a47c-00144feabdc0.html#axzz27V1jQ8l0.

of a technocratic government in Greece earlier the same year. Berlusconi's tenuous grip on the political situation had generated uncertainty about Italy's resolve to keep control of its finances, and the European Central Bank's letter to the prime minister in July 2011 demanding a series of measures in exchange for central bank support confirmed that the Italian government was increasingly subject to outside supervision in the main areas of economic policy.

Yet, although Monti's ascent to the prime minister's office was certainly a result in part of direct pressure from the ECB and other European leaders, it was far from unprecedented. The crisis of the early 1990s ushered in a period in which a series of partially or fully technocratic governments were charged with managing Italy's financial and economic problems. In 1993, as the leaderships of the major governing parties were decimated by a wave of corruption investigations, Carlo Azeglio Ciampi, a central banker, replaced Socialist Giuliano Amato until new elections could be held. After the first Berlusconi government collapsed after only eight months, Lamberto Dini, another central banker, replaced him until the election of a centre-left government under Romano Prodi in 1996. Although Prodi's first government was formally a partisan administration, with the prime minister having stood for election at the head of a coalition of parties, he assigned key roles to technocrats in his cabinet, with Ciampi taking over the Treasury and Dini acting as foreign minister.

These dynamics suggest a broader interpretation of the ways in which Italian politics has shaped the nature of the current economic crisis. The tensions between political forces – a powerful Communist Party and trade union movement in the postwar period, pitted against a fragmented coalition of Socialists, Christian Democrats and a variety of minor parties – have hindered the formation of stable governments capable of adopting coherent and far-sighted policies. The accumulation of public debt over the period from the 1970s through to the early 1990s was in part an expression of the difficulties involved in holding together heterogeneous governing coalitions whilst keeping the industrial peace: deficit spending appeared as an early, national manifestation of the current European strategy of 'kicking the can down the road'. When Italy's economic problems reached crisis point in 1992, the existing array of political parties proved incapable of generating any serious response and, instead, collapsed under the weight of their history of systematic corruption. But instead of paving the way for a more effective party system, the changes of the early 1990s did little to provide Italy with stable and sustainable government. The final section examines why.

From First to Second Republic: the leopard changes its spots

The adoption of a new electoral law, based in part on the 'first past the post' system used in most English-speaking countries, did succeed in addressing one of Italy's secular problems: its high government turnover.[20] The new electoral system forced parties to form pre-electoral, rather than post-electoral, coalitions, and to stand for election under a *de facto* prime ministerial candidate. So after the rapid collapse of the first Berlusconi government in 1995, the Prodi government lasted from 1996–99, and the same broad coalition sustained two further centre-left governments in 1999–2001. The Berlusconi government elected in 2001 lasted, with few changes, until 2006, and his third government from 2008 to late 2011. But despite this increase in the duration of Italian governments (which before 1994 averaged around one per year), the ability of these governments to deal with Italy's most pressing structural problems has not shown the same improvement.

One reason for the failure of the reformed political system – sometimes referred to as the 'Second Republic' – to address Italy's economic decline, is that the new political parties that emerged from the crisis of the early 1990s have proved incapable of building coalitions for economic reform. The complexities of winning over the myriad interests and lobby groups needed for success in the new, more presidentialist pattern of political competition hinder the construction of broad programmes of reform. This has meant that narrow interest groups opposed to reform have achieved a degree of veto power over the political process. On the right, representatives of the sheltered part of the economy – small retail interests, taxi drivers, construction firms – have enjoyed a sympathetic hearing from centre-right governments, making a mockery of Berlusconi's early stated ambitions to spearhead a liberalising, pro-market revolution in Italy.[21] On the left, trade unions representing largely older, stably employed production workers have been able to resist calls for greater labour market flexibility, whilst public sector employees and pensioners have sufficient weight in the centre-left parties to block radical reforms and spending cuts.[22]

This problem is not limited to the 'partisan' governments of the left and right – Mario Monti too has faced similar pressures, with an attempted labour market reform being watered down after union protests, whilst parliamentarians from Berlusconi's PdL (Freedom) party threatened to block Monti's ratification of the EU Fiscal Compact. Any government, whether technocratic or party political, is subject to the constraints imposed by the composition of parliament, and the Italian electoral process has yet to deliver a parliament which could bring about a coherent programme of reform. One reason for this is the low esteem in which politicians are held in Italy: in the context of declining loyalty towards party labels and ideologies, many politicians win election through the exercise of classically

[20] Verzichelli and Cotta, "From 'Constrained' Coalitions", 433–97.
[21] M. Yglesias, "Southern Europe's Small Business Problem", *Slate*, 6 July 2012, http://www.slate.com/articles/business/small_business/2012/07/the_small_business_problem_why_greece_italy_and_spain_have_too_many_small_firms_.html.
[22] Hopkin, "How Italy's Democracy Leads to Financial Crisis".

clientelistic or corrupt methods, offering to defend the interests of narrow but well organised and financed groups, rather than those of more diffuse social constituencies. The lack of faith in the political class as a whole, not surprisingly, undermines appeals to support reforms which may be initially costly and would only bear fruit in the long run.

The lack of confidence in politicians is a long-standing problem in Italy, but has taken a curious turn in recent years. First, the emergence of Silvio Berlusconi onto the political scene in 1993 was a quite dramatic and innovative phenomenon, with a business leader exploiting a gap in the 'political market' to win power himself, building a political party in the space of just a few short months. It became apparent, once Berlusconi had won a strong mandate to govern the country, that his main preoccupations lay in the passage of legislation which directly affected his own industrial interests or, most frequently, the management and reform of the judicial processes to which he was subject through his many indictments for corruption, fraud and tax evasion. Of course, Berlusconi could not ignore his electorate and simply focus on his own affairs, and he developed a secure support base of small business people, the self-employed, pensioners and housewives, through astute use of his media resources and the trading of favours.

More recently, the Beppe Grillo phenomenon has confirmed Italy's disgruntled attitude towards its political establishment and its willingness to support non-traditional politicians. Grillo, a successful comedian with a specialisation in populist rants and conspiracy theories, has promoted a grassroots political movement – the *Movimento Cinque Stelle* (Five Stars Movement) – which has few clear policies, but a very clear anti-establishment and anti-party theme.[23] Grillo's political activity was initially greeted as another quirky addition to Italian politics, but the success of the Five Stars Movement in the 2012 municipal elections – winning around 15 percent of the vote, and electing the mayor of the city of Parma – suggests that, like Berlusconi, Grillo could be in a position to influence policy after the next election.

Conclusions

The success of figures like Berlusconi and Grillo reflect the increasingly beleaguered status of conventional political parties in Italy. This raises the degree of uncertainty around Italy's future as part of the eurozone. As suggested at the beginning of this article, the main obstacles to a resolution of the euro crisis are political, rather than technical, and uncertainty about future government policies is at the heart of this political impasse. The way out of the euro crisis requires a substantial economic adjustment in both Northern and Southern Europe, which will put electorates

[23] "Fiddling While Rome Burns", *Time Magazine*, 14 May 2012, http://www.time.com/time/magazine/article/0,9171,2113836,00.html.

under some strain. There is therefore a pressing need in all eurozone countries for authoritative governments capable of mediating between popular impulses and the harsh realities of repairing the European economy. If Germany and the other Northern European countries are to accept a more integrated fiscal and monetary union, in which they are to pool sovereign risk with less credible governments, then they will demand guarantees about the future conduct of these governments. The lack of a stable party system in Italy, the reputation for corruption and opportunism of much of its political class, and the strength of populist forces which, from Berlusconi through to Grillo, are increasingly questioning the euro project, are a long way from the kind of reassurance that European policymakers and global investors crave.

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