

Convergence towards a Single Economic Model? Italy and Germany in the Interconnected Euro-System.

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1 Introduction

Though the Euro was deemed a great success for its first ten years, the Eurozone crisis exposed a tragically overlooked weakness in the form of a set of uncompetitive models of capitalism in Europe's periphery. Greece proved unable to service its public debt in the spring of 2010, soon followed by Ireland (2010), Portugal (2011), Spain (2012) and Cyprus (2012). In all cases the crisis was preceded by high and sustained current account deficits which seemed to suggest a dramatic loss of competitiveness, in combination with the recourse to excessive (private or public) borrowing so as to maintain levels of output and consumption. In 2008, when the US sub-prime crisis broke, Greece recorded a current account deficit of 15.8 % of GDP, Spain 9.2%, Portugal, 12.6% and Cyprus 15.5%.¹

Although Italy escaped the fate of becoming a programme country, in many ways it came to be considered the biggest potential threat to the coherence of the common currency. With a gross public debt of roughly €2.3 trillion and uninterrupted budget deficits, the country was simultaneously too big and interconnected to fail and too big to bail out. Indeed, Italy had some close encounters with disaster in the second half of 2011 when escalating interest rates on sovereign debt seemed to spell an imminent default leading to strong German and French pressures to replace the government of Silvio Berlusconi with a technocratic one that would pursue "sounder" policies. Given its inability (or unwillingness) to reduce its debt, there could be no guarantee that the situation would not escalate again. The "Italian problem" was further compounded as what had seemed a banking system whose health compared favourably to its neighbours north of the Alps became increasingly vulnerable. The election in the summer of 2018 of a government made up of

¹ Source: AMECO.

the populist M5S and Lega adamantly opposed to the rules of fiscal rectitude imposed by the EU would seem to make a disaster greatly more likely (Kriwoluzky 2018).

Despite at times different readings of the causes of the crisis, a remarkable consensus reigns amongst European policymakers as to the correct remedies. That diagnosis reproduces the fundamental elements of the Washington Consensus of old in that it posits that: (1) the causes of the crisis are to be attributed to the periphery, (2) the core problem is a loss of competitiveness, (3) macro-economic problems require microeconomic solutions, i.e. “structural reforms”, and (4) the nature of the problems is the same throughout the periphery, thus warranting similar adjustment programmes (Draghi 2012; Finance Ministers 2018; Juncker 2015; Magone 2016, Magone, Laffan and Schweiger 2016). In a secret letter sent to the Italian government on August 5, 2011, e.g., ECB President Trichet and *Banca d’Italia* governor Draghi set out the conditions under which the ECB would intervene to support Italian sovereign debt: draconian budget cuts and legal debt brakes were demanded as well as large scale privatisations, immediate deregulation of the liberal professions, liberalisation of local public utilities, abolition of some administrative layers, and labour market reforms that would bring wages and working conditions in line with the requirements of firms (Wall Street Italia 2011).

That structural reforms are the key to economic success most impressively seemed to be demonstrated by the German experience. Just as every decade washes to the surface a new model country (Schmitter & Todor 2012), Germany, Europe’s sick man from the early 1990s, rose to that rank in the wake of the Eurocrisis. Structural adjustment – from flexibilisation of the labour market and growth-friendly tax reforms to a fundamental overhaul of the social security system – apparently had allowed it to rise like a phoenix from the ashes. This overhaul of the German system, and in particular the Agenda 2010 of the Red-Green coalition under Chancellor Schröder, was controversial and caused the coalition to lose the following election while setting the SPD on a seemingly unstoppable descent from a *Volkspartei* to a minor political force². Yet, this display of almost suicidal political courage in light of subsequent developments came to be considered the key to Germany’s success (Funk 2014: 308-09).

Given that the correct recipe was supposedly known, it followed that the threat to the viability of the Eurozone derived from a political deficiency in the Southern European system of interest intermediation, i.e. from the inability of those countries to manage in a coordinated fashion societal

² In July 2018, the SPD polled at around 17% in surveys,; roughly equal to the AFD: <https://www.wahlrecht.de/umfragen/emnid.htm>

demands so as to bear short-term pain in exchange for long-term gain (Ritzen 2017: 5-6). Hence the need to force them to adopt a number of measures such as the Fiscal Compact, introduce a balanced-budget clause preferably in the constitution, and empower the Commission to enforce Excessive Deficit Procedure (EDP) sanctions the hard way. Yet, not only does Italy fail to display the traits commonly associated with the “south European syndrome”, but the last two decades have seen many of the reforms in labour and product markets that are held to be the key to growth. Moreover, Italy has recorded significant primary surpluses uninterruptedly for the last three decades – that is, precisely since Italy began to “pay for Europe” (Sbragia 2000) – but “the sustained growth needed to reduce the burden of public debt” (IMF 2011: 1) has failed to materialise.

Why is it then that those reforms have not sorted the hoped-for effect (Talani 2016)? We argue that the founding assumptions of this programme of microeconomic structural reforms can be questioned. As growth is fundamentally a macroeconomic issue, the outcome of this single-minded focus on nominal stability has been secular stagnation with durably low growth rates, diminishing productivity growth, increasing socio-economic disparities and unsatisfactory labour market performance (Sandbu 2015: 197-216). The EU’s policy assignment not only locks Euro-area members (and particularly Italy) into low growth: its focus on external competitiveness essentially establishes a zero sum game among them. Rather than stabilising the Euro and the European project by the intensification of a programme of structural reforms, this strategy is turning into a threat as it has provoked the rise of Eurosceptic populism throughout the EU. Indeed, the recent victory of the Eurosceptic M5S and Lega in Italy does not reflect the unwillingness to engage in the short-term pain of structural reforms, but protest against the longer-term adverse consequences of a thorough programme of reforms that has been carried out since the 1990s.

In this paper, we aim at drawing these broader points home by discussing the case of a country that sticks out, even within the southern periphery, for all the things that it should theoretically have done, but supposedly failed to do: Italy. In addition to questioning the category of “Southern periphery”, we will argue that Italy’s reform performance casts a doubt on the validity of the macroeconomic recipe embedded in EMU. The rest of the paper is structured as follows. Section 2 reviews the reigning analysis of the reasons for the economic woes of the Southern periphery. Section 3 shows that the widespread tendency to subsume the Italian economy under a south European model is based more on prejudice than fact. Section 4 compares labour and product market reforms in Italy and Germany, showing that the alleged inability of the Italian system to reform equally has a stronger basis also in prejudice than in fact. Section 5 proposes an alternative

reading of the current predicament of the Italian and German economies in the interconnected context created by the single currency. The last section concludes.

2 Reforming the Periphery: The Analysis

The Eurozone crisis revived a much older distinction between a core North-Western Europe and a Southern and Eastern periphery. That distinction primarily referred to a pattern of late industrialisation and lower levels of per capita GDP, as well as a general gap in modernisation (Aldcroft 2006). For Southern Europe, the current version propounds a syndrome of countries living beyond their means. Uncompetitive economies, made so by excessive government intervention coupled with weak and inefficient states and an inability to contain wages and consumption within the limits of what their productive basis will allow, allegedly caused twin deficits, in turn leading to the (public or private) over-indebtedness that sparked the crisis (Crouch 2013; Hall 2012; Magone 2016; Streeck 2015).

That the problem was one of the periphery failing to adapt to the demands of international competition seemed to be confirmed by research on the Europeanisation of Southern Europe (Balkir, Bolukbasi & Ertugal 2013; Börzel 2005; Featherstone & Kazamias 2000; Magone, Laffan & Schweiger 2016; Magone 2016; Verney 2009). That literature documented that Europeanisation was not uniform but depended on the degree of fit between EU rules and recommendations and local institutions and practices, thus leading to varieties of Europeanisation. Southern Europe seemed to be on a sustainable reform path while trying to qualify for Euro-membership, but it apparently reverted to its old ways once having entered the common currency (Verney 2009). As Magone, Laffan & Schweiger (2015: 6) put it: “In many ways, one could characterise the cleavage or divide in terms of core efficient national governance and peripheral less efficient one. In some cases, this lack of efficiency degenerated to ‘bad’ governance”.

The Varieties of Capitalism (VoC), approach reached a similar verdict (Albert 1993; Amable 2003; Hall & Soskice 2001). It postulated the existence of two successful politico-economic models: a German coordinated market economy (CME) and an Anglo-Saxon liberal market model (LME). In Germany, the interplay of an independent central bank credibly focussed on keeping inflation low and centralised wage bargaining made for a virtuous circle of wage-restraint promoting competitiveness. Liberal countries instead were postulated to operate as a liberal textbook model in which the absence of notable market power on both sides of the labour market led to the flexibility

required to assure market-clearing wages. Echoing the analysis of Calmfors & Driffill (1988) and inspired by the work of Hall and Soskice (2001), Molina & Rhodes (2007) argued that Southern Europe suffered from its in-between status. With trade unions too powerful to allow for the system to work along liberal lines, but too fragmented to coordinate along German lines, the result was wage growth that continuously undermined competitiveness, requiring expansionary fiscal policies as well as frequent devaluations to undo some of the unemployment effects and keep the political and social peace (Höpner & Lutter 2018, Johnston & Regan 2016). With the Euro removing the latter possibility and the institutional prerequisites of the German model too demanding, the upshot of the argument was that the key to making the Euro compatible with Europe lay in structural reforms in the Southern Periphery (Amable 2003: 242; Hall 2012: 511).³

Optimum Currency Area (OCA) analysis, in turn, provided the short-term version of the structural incompatibilities thesis. OCA analysis avoided pointing the finger unilaterally at the periphery, but because of structural differences as well as insufficient integration between their economies, the incidence of asymmetric shocks would be such that the economic stability losses from giving up monetary and exchange rate policies, as well as accepting tighter constraints on fiscal policy, would outweigh the efficiency gains from a single currency (Feldstein 1997, 2012; Mody 2018).

That the benefits and drawbacks of the Euro came to be discussed in terms of an OCA framework was peculiar. After all, OCA analysis builds on a short-term model of Keynesian lineage in which the presence of rigidities, in particular sticky wages, hampers the ability of market forces to iron out shocks, thus simultaneously making short term-demand management possible and advisable. Yet, in the wake of the neo-liberal turn, the Keynesian view was largely abandoned in Europe. After the stagflation of the 1970s, European macroeconomic authorities concluded that short-term policies like fiscal expansion or devaluation could provide no durable respite for Europe's problems and, if anything, provoked inflation. Indeed the convergence towards a neo-liberal view of economic policy was a prerequisite for reaching agreement on a common currency in the first place. The single-minded orientation of the ECB to low inflation instead of a balanced commitment to nominal and real stability relies on the rejection of the type of models OCA analysis is based on. However, as the proponents of the OCA view generally do not advocate a breakup of the common currency as this allegedly would imply unacceptable costs (Feldstein 2012; Eichengreen 2007), the difference between a short versus long-term orientation in terms of policy conclusions becomes irrelevant. The

³ Crouch (2013: 58-60), while probably not considering himself a member of the VoC school, arrives at a similar conclusion on similar grounds.

upshot of the OCA argument also is that structural reforms are of the essence, in particular the flexibilisation of labour markets.

EU scholars and institutions, frequently have pointed to its missing unions, namely, economic union, financial union, fiscal union and political union as the cause of EMU's problems (Enderlein et al 2012; Juncker 2015, Legrain 2014; Matthijs & Blyth 2015; McNamara 2015; van Rompuy 2012). Yet there is agreement that completing EMU is not a substitute for structural reforms, but instead must build on this programme (Draghi 2012). In line with the short- versus long-term nature underlying the different analyses, but also reflecting the fear of Northern members of a transfer union, the Five Presidents' Report (Juncker 2015), placed those missing unions in a clear hierarchical order. Economic and financial union were to remove market rigidities by further boosting integration between the member economies. Once those unions as well as the broader structural reforms had put member states economies on a more sustainable path – i.e. once the likelihood of asymmetric shocks had been reduced and the ability of markets to absorb them had improved – a fiscal union should be contemplated that would allow for countercyclical demand management.

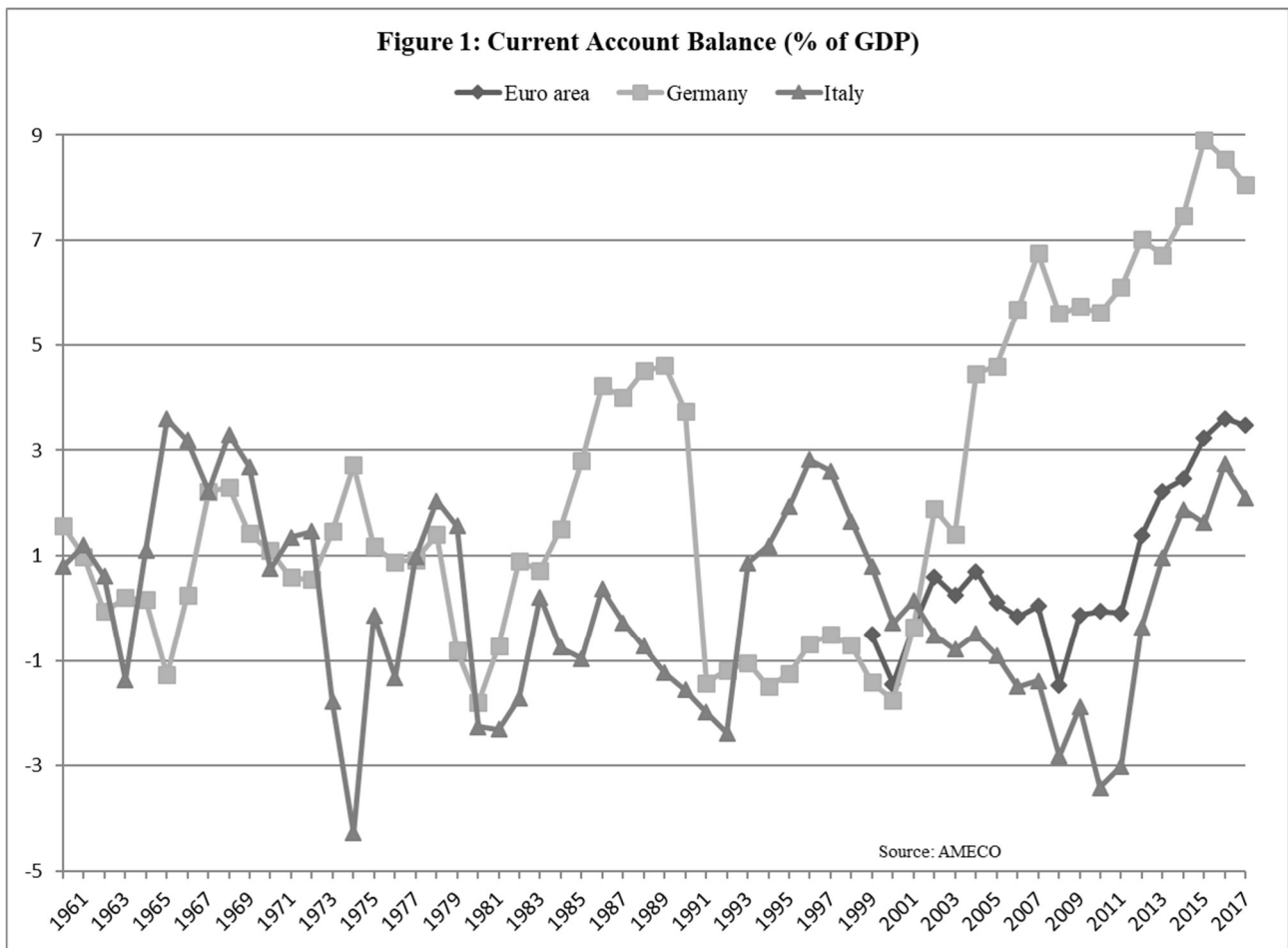
3 Is Italy part of the European Periphery?

The concept of a southern syndrome obfuscates more than it clarifies. The countries of the European South do not have much in common other than being the object of the scathing criticisms of politicians, the media and the scholarly literature from “core” member states (Matthijs & McNamara 2015). Italy, displays hardly any of the characteristics of the “Southern model”.⁴ The hypothesis of a domestic demand-led model conflicts with a primary balance that has been in surplus since three decades; unlike the rest of the “periphery” its current account hovered around balance before 2012 while recording surpluses afterwards, nor has it witnessed the foreign-financed boom-bust cycle that characterised Spain, Portugal and Greece in the 2000s (Perez, this volume).

Given that the current account is (erroneously) interpreted as an indicator of external competitiveness, deficits are said to provide evidence that the south is unable to live up to the requirements of international competition. Like Germany, the Italian growth model was export-led from the early 1950s to the 1970s (Rangone & Scolari 2012; Rossi & Toniolo 1996; Holtfrerich

⁴ Whether Italy is part of Europe's periphery has traditionally been a contentious issue (see e.g. Aldcroft 2006 for pre-war Italy). Magone, Laffan & Schweiger (2015) place Italy somewhere between the core and periphery.

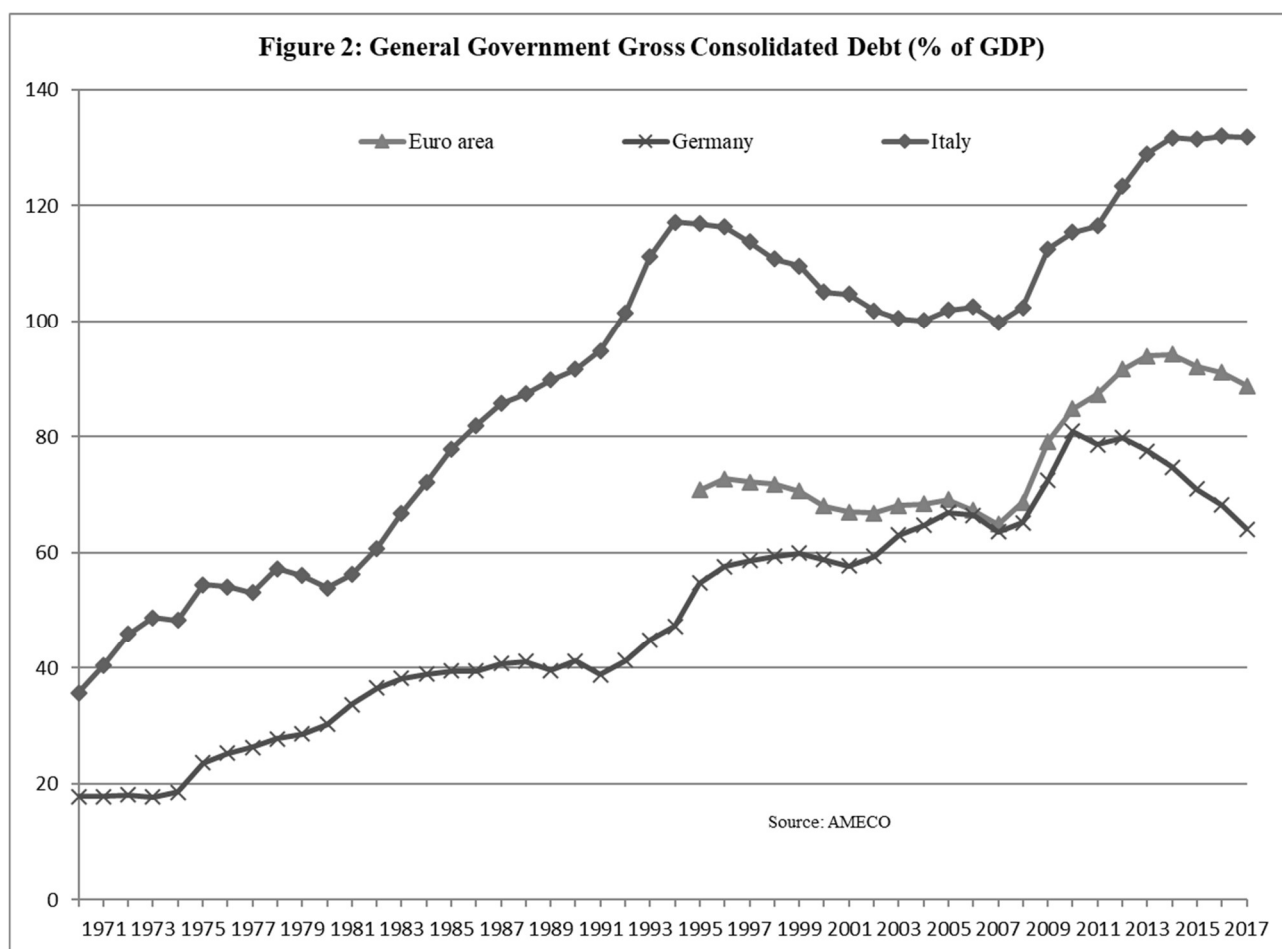
2008). Since then, Italy's current account has switched between modest deficits and surpluses until the Eurozone crisis. The current account thus exhibits no clear trend, exception made for a weak lagged correlation between German and Italian current accounts until 2010.⁵



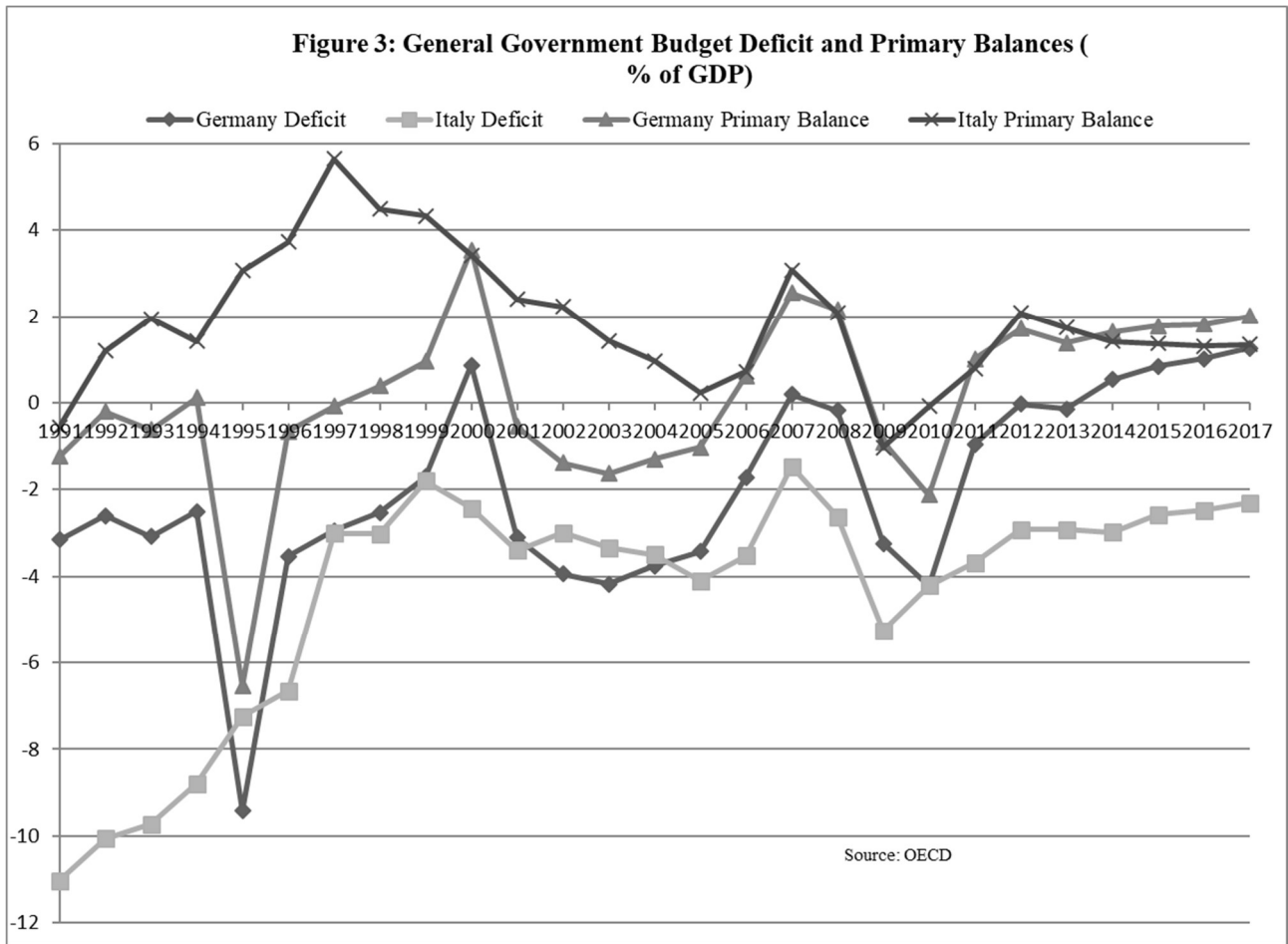
With 132%, the Italian gross public debt to GDP ratio currently is the second highest in the EU, after Greece and closely followed by Portugal, yet this primarily constitutes a legacy problem rather than reflecting a socio-economic model characterised by an inability to live within its means. Like all West European countries, during the first two post-war decades Italy recorded falling ratios and (Balasone et al 2013). Also like other West European countries, the late 1960s saw a durable revision of this trend.

⁵ Coefficient -0.35, R²: 0.19, Significant at 0.005

Figure 2: General Government Gross Consolidated Debt (% of GDP)



Since the late 1960s, Italian public debt expanded at a higher rate due to a severe political crisis that tested the legitimacy of the post-war system and led governments to buy social peace through spending, not unlike the constellation in Germany after 1918. While high deficits characterised all of the 1970s, public debt acquired a cumulative character in the 1980s after the divorce of the *Banca d'Italia* from the Treasury and the monetary disinflation leading to escalating debt service (Bourgeot 2013). Debt and deficit reduction has constantly reigned high on the list of priorities since the 1980s. With the exception of the G20 reflation, the Italian primary balance has continuously recorded surpluses, while the German primary balance switched between deficit and surplus until 2011. Overall deficits came down to German levels since the late 1990s and have not been significantly larger until 2010 when the Eurozone crisis provoked increasing divergence. Moreover, the attainment of primary surpluses in Germany since 2011 is primarily a result of the Euro crisis. Germany's net interest receipts on Greek sovereign debt e.g. amounted to about €2.5 billion (Süddeutsche Zeitung, 21 June 2018). When taking into account the lower yield on public debt because of the Eurocrisis, the gain for the German budget amounts to over €100 billion (Dany et al 2015).



What distinguishes Italy, constituting the more acute threat to the Euro, are its anaemic GDP and productivity growth and an unsatisfactory labour market performance (Tables 1 & 2). While outperforming Germany in terms of GDP growth and being slightly below the south European average during the first four post-war decades, convergence gave way to divergence from the 1990s. The early 1990 marks the start of exceptionally low growth. Compared to the other South European countries, Italy was spared the boom and subsequent bust of the 2000s largely due to the structure of its financial industry as well as stricter financial regulation. Similar to Japan, post-war catch-up relied on a tightly controlled banking system with extensive cross shareholdings and interlocking board membership, with the effect of limiting competition and making the industry impenetrable to foreign takeovers. Though also Italian banks underwent a wave of mergers after the Second Banking Directive of 1992, this further accentuated the closed nature of the system. In addition, Italian regulatory authorities kept a tighter rein on credit growth outlawing e.g. off-balance sheets vehicles and maintaining a cap on loan to value (LTV) ratios for mortgages at 80%. Despite the absence of a boom-bust cycle, alongside Greece, Italy is the only Eurozone country to have experienced a drop in per capita GDP since the new millennium. Germany, instead, while

experiencing similar stagnation since the 1990s managed to recover by the middle of the following decade. Italy's stagnating growth is reflected in its labour market performance. While having been spared the extreme unemployment of Greece and Spain, it records the lowest employment rate in Southern Europe. Also here divergence with Germany set in around 2006. While Italy is stuck at an unemployment rate of slightly over 10% since the early 1990s, German unemployment has consistently dropped since the mid-2000s currently reaching levels that come close to full employment. Lower German unemployment was achieved despite a substantial increase in the employment rate. Though the Italian employment rate has also increased, it remains at a substantially lower level than in Germany.

Table 1: Growth Performance

Per Capita GDP in 2017 US\$				
	1950	1980	2010	2017
Germany	8,530	31,023	45,005	49,580
Italy	7,243	27,198	39,223	38,130
Greece	4,497	21,067	32,661	28,184
Spain	4,636	19,490	35,683	37,671
Portugal	4,219	16,266	29,871	30,635
Other OECD ^a	10.331	25.863	45.424	50.506
Per Capita GDP, Average Annual Growth Rate				
	1950-1969	1970-1989	1990-2009	2010-2017
Germany	5.38	2.34	0.89	1.77
Italy	5.44	2.61	0.81	0.04
Greece	6.02	2.90	1.93	-2.45
Spain	5.55	3.34	1.94	0.65
Portugal	4.72	3.82	1.71	0.57
Other OECD	3.47	2.62	1.53	1.35
Average Annual GDP Growth Rate				
	1950-1969	1970-1989	1990-2009	2010-2017
Germany	6.05	2.44	1.09	2.12
Italy	6.13	2.93	1.02	0.31
Greece	6.84	3.60	2.42	-2.88
Spain	6.55	4.15	2.86	0.69
Portugal	5.13	4.25	2.00	0.24
Other OECD ^a	4.75	3.48	2.29	1.91

Notes: Other OECD = EU15 - Italy and Germany, plus, Canada, USA, Japan, S. Korea, Australia, New Zealand.

^a: population-weighted.

Source: Total Economy Database; Own Calculations

Table 2: Employment and Unemployment

	Unemployment Rate					
	1995	2000	2005	2010	2015	2017
Germany	8.2	7.9	11.2	7.0	4.6	3.8
Italy	11.2	10.0	7.7	8.4	11.9	11.2
Greece	9.2	11.2	10.0	12.7	24.9	21.5
Portugal	20.7	11.9	9.2	19.9	22.1	17.2
Spain	7.9	5.1	8.8	12.0	12.6	9.0

	Employment Rate					
	1995	2000	2005	2010	2015	2017
Germany	70.6	71.1	73.8	76.7	77.6	78.2
Italy	57.7	60.1	62.5	62.0	64.0	65.4
Greece	60.2	63.8	66.4	67.8	67.8	68.3
Portugal	60.9	65.4	70.0	73.5	74.3	73.9
Spain	67.5	71.4	73.2	73.7	73.4	74.7

Source: Eurostat.

4 A Failure to Reform?

This weak performance is commonly attributed to the lack of structural reforms. In a sufficiently liberalised economy, so the argument goes, competitiveness will improve and with it growth, the current account balance and employment, thus allowing for a reduction of public debt. Accordingly, the key lies in labour and product market reforms. However, it is hard to attribute Italy's anaemic performance to the absence of reforms that have proven so successful in Germany. The Italy of the 1970s corresponds fairly well to the current description of the South European syndrome. Plagued by pervasive distributional struggles, wages and public spending escalated leading to rampant inflation, with the repeated devaluations only providing temporary respite as higher import prices provoked compensating wage demands. During the second half of the 1970s, when the country submitted to an IMF programme while starting to experience difficulties borrowing in its own currency, the unviability of this model became incontrovertible. Reform of the Italian political economy started in earnest in the early 1980s, frequently being implemented through a European external constraint, in particular EMS and Euro membership. The Maastricht decision with its timetable inspired an acceleration of reforms leading many commentators to attest that a critical turn had been made and predicting a bright future (Sbragia 2000; Ferrera & Gualmini 2005; Scobie et al 1996). On the microeconomic side, reforms focussed primarily on more flexible wage bargaining, reducing employment protection – a lynchpin of the Southern European welfare model – and making product markets more flexible.

In terms of labour market reforms, the debate has focussed on price and wage dynamics undermining competitiveness. Yet the data yield mixed results: Italy’s consumer price increases since the introduction of the Euro were below the EU average and roughly on a par with those of core countries such as Austria and the Netherlands, while real effective exchange rates based on either consumer or producer prices show no loss of competitiveness since the introduction of the Euro (Kangur 2018). Therefore, attention has focussed on nominal unit labour costs (NULC), and here Italy heads the list after Luxembourg (Table 3). However, a large body of empirical literature by now has established that NULC do not provide an accurate measure of wage cost pressures and that they do not correlate with export performance.

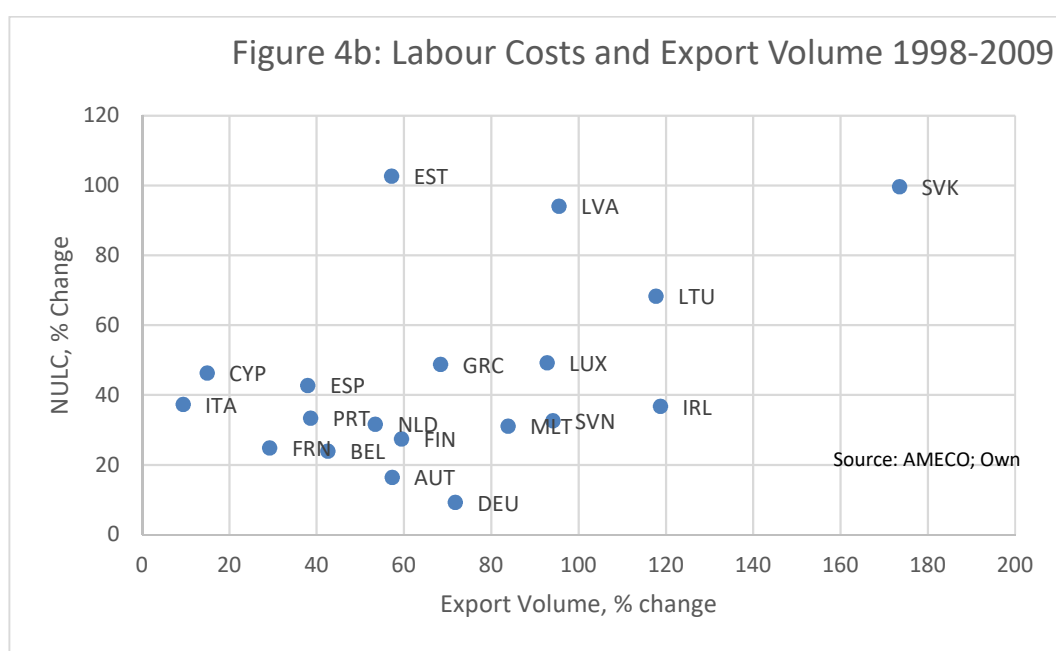
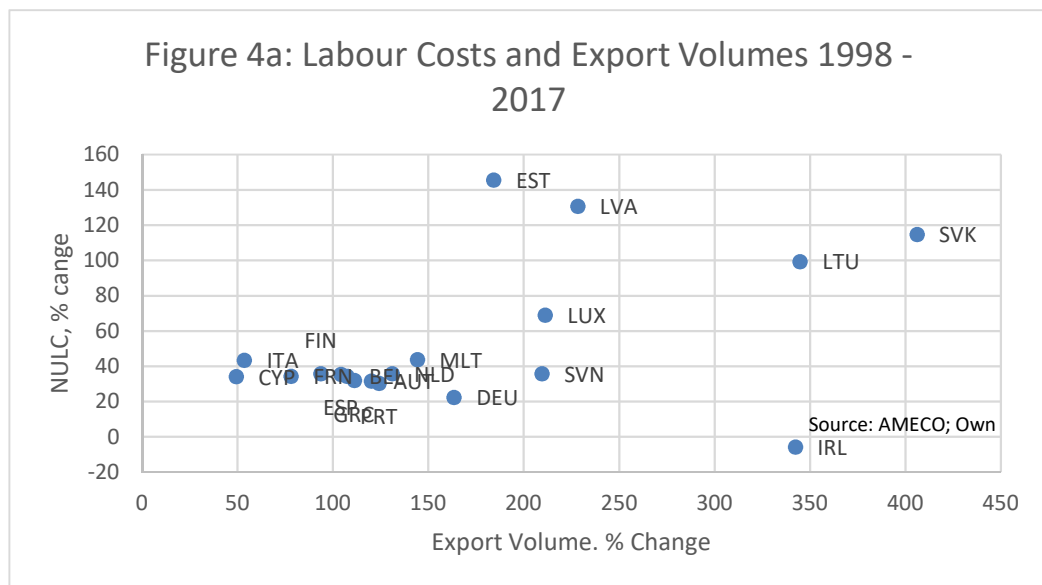
Table 3: Inflation and Wages Costs
1998-2017

HCPI (1998=100)		NULC (1998 = 100)	
Luxembourg	152.0	Luxembourg	169.1
Spain	151.1	Italy	143.5
Greece	149.7	Denmark	143.5
EU	147.1	Finland	135.8
Portugal	146.7	Netherlands	135.8
UK	145.3	Spain	135.6
Belgium	144.1	Belgium	134.3
Italy	142.3	France	134.3
Netherlands	142.1	Sweden	133.4
Austria	141.0	Euro area	132.7
Ireland	139.9	EU15	132.0
EU(15)	139.7	Greece	132.0
Euro area	138.6	Austria	131.6
Finland	137.5	Portugal	130.4
Denmark	136.8	EU15	130.2
France	132.8	Germany	122.5
Sweden	131.5	UK	119.1
Germany	131.3	Ireland	94.3

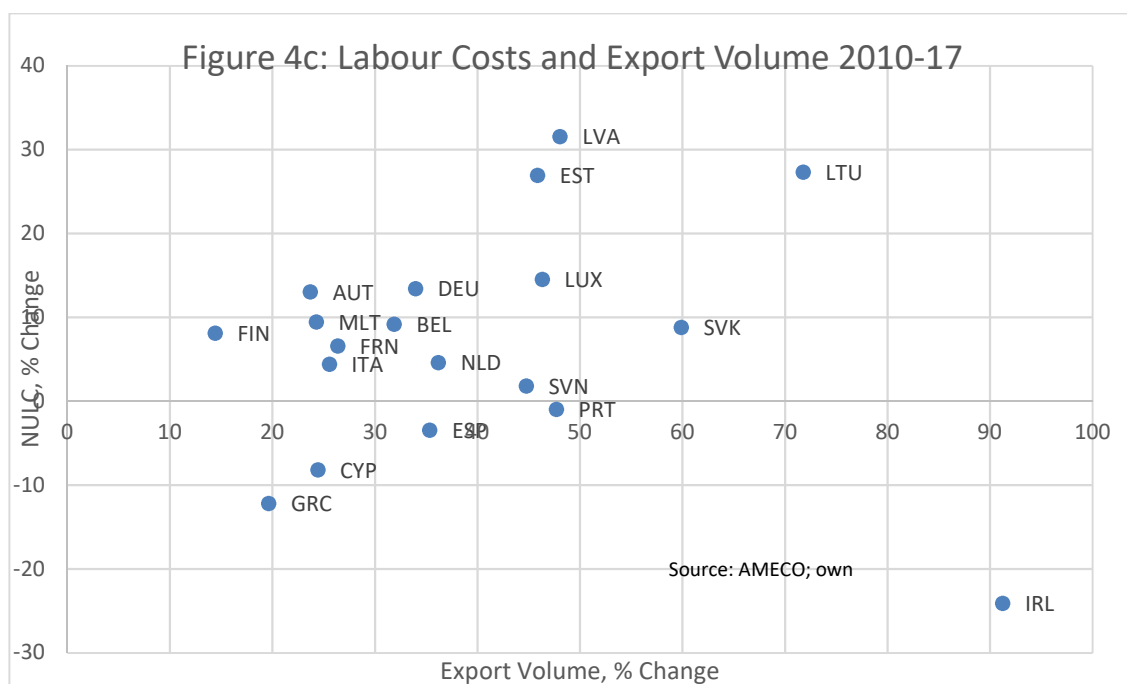
Source: AMECO, Own Calculations

As an aggregate indicator, NULC are sensitive to composition effects (Perez this volume), such that e.g., a switch from self-employment to dependent employment would result in higher NULC while a shrinkage in the low productivity sectors such as construction would imply lower unit labour costs (Knibbe 2015; Felipe & Kumar 2015). Since 1999, the share of self-employed in total employment has declined slightly in Germany while substantially so in Italy and similarly the share of the (higher productivity) manufacturing sector has declined much more steeply in Italy than in Germany. Both developments had adverse effects on the measurement of Italian NULC. Moreover, the trajectory of NULC in Italy primarily is the effect of larger price increases, in particular in the sheltered sector, and does not reflect excessive wage pressures (Hopkin 2015, Molina & Rhodes

2007). Given these measurement issues, it is not too surprising that research has failed to detect a clear relation between export performance and the development of NULC (Gaulier & Vicard 2013; Staehr & Vermeulen 2018). Figure 4 plots the change in export volumes against the change in NULC for 1998-2017 and the sub-periods 1998-2009 and 2010-2017. Except for the last period, the correlation has the wrong sign. Moreover, only the 1998-2009 period yields a significant result at the 0.05 level while the R^2 varies between 0.0 (2010-17) and 0.23 (1998-2009).⁶ For the first decade of the Euro, moreover, Italian export growth outperformed Germany's, although the country has dropped to the bottom of the league since 2010.



⁶ Regression calculations available upon request.



Nor is it possible to attribute Germany's superior employment performance to its more contained growth in NULC. First, employment and unemployment figures exaggerate the difference between Germany and Italy. Employment, measured in terms of total hours worked, has grown by 4.5% since the introduction of the Euro in Germany as compared to 3.3% in Italy. Due to a stronger reduction in average hours worked per person in Germany, this translates into lower unemployment and higher employment figures. Indeed, applying the average hours worked per person in German to Italy, employment would increase by over 27%⁷ Moreover, in contrast to the common interpretation (Carlin & Soskice 2007), the more favourable German unemployment rate derives not from its superior export competitiveness but from a strong expansion of part-time (female) jobs in quasi-public sectors such as health, education and social care (Jaehrling 2017).

Finally, despite what the NULC data suggest, Italian wage bargaining has undergone a constant process of flexibilisation since the late 1980s. The first major step concerned the progressive dismantling of the automatic wage indexation system, which had proven an engine of both inflation and wage compression. This was gradually weakened after 1984 when Prime Minister Bettino Craxi called a referendum on the issue and was abolished in 1993 by the technocratic government of Giuliano Amato. That same reform provided for greater regional and firm level flexibility in collective agreements Tripartite agreements at times have been successfully concluded but negotiation took increasingly place under the shadow of hierarchy with a decreasing ability on the part of trade unions to veto agreements and with governments willing to bypass the tripartite

⁷ Source of employment figures: Total Economy Database.

channel if so required, as e.g. in the decision to liberalise temporary contracts and allow private employment agencies. Despite its high coverage rate of collective contracts, the inclusion of flexibility clauses has led to decisive de-centralisation to sectoral and company bargaining (Visser 2013) with the result of allowing much greater variance in wage agreements, often leaving the sectoral or national agreements as little more than an empty shell. Indeed, Devicienti et al (2016) find a similar extent of wage decompression in Italy and Germany despite the differences in coverage.

In Italy, weakening of employment protection legislation (EPL) has mainly taken the form of opening up a space for atypical contracts, while only making modest changes until recently in the protection of open-ended contracts. The weakening of EPL went through 4 main stages: the Treu reforms of 1997, the Biagi laws of 2004, the 2012 Fornero reform and, lastly, the 2014 Jobs Acts. The weakening of EPL has been able to count on a cross-party coalition with the Treu reforms and the Jobs Act implemented by leftist governments, the Biagi laws by the rightist Berlusconi government and the Fornero reforms by the technocratic Monti government.

Product market liberalisation involved privatisation of state-owned enterprises and the relaxation of regulations. Although Italy had acquired the largest state-owned sector because of massive bank failures in the 1930s and the industrial rescues of the 1970s, the privatisation programme started in the late eighties and picked up steam after the Maastricht Treaty. State holdings were mainly concentrated in four public holding companies: Enel (electricity), INA (insurance), ENI (petrochemical) and IRI (industry and banking). Most of the companies controlled by the state were sold between 1992 and 1998. In particular, this implied a full-scale privatisation of the large state controlled financial sector with BNL, San Paolo, Banca di Roma and Cariplo divested in rapid succession. Apart from privatisation, reform efforts have focussed on liberalising the so-called “liberal” professions, easing the start-up of new firms, cutting red tape in general and simplified insolvency regulation.

Table 4 reviews the OECD’s indicators for labour market and product market reform since the mid-1980s in Italy and Germany. In terms of EPL, Italy has converged on the German model with similar and relatively strong protection for permanent contracts and only slightly stronger protection for temporary contracts in Germany, thus confirming the finding of the absence of a clear correlation between EPL and economic performance (Piasna & Myant 2017). However, as a result, both countries now are characterised by an increasing polarisation of the labour market with a growing share of irregular contracts with shorter working hours and more economic insecurity as

well as a growing low-wage sector. In terms of product market reform there is no good evidence either of an Italian reluctance to reform or of a radical difference from German practice. Starting from a higher level on the late 1990s, product market regulations currently are equally loose in both countries.

Table 4: Labour and Product Market Reforms

	Strictness of Employment Protection Regulation				Restrictiveness of Economy Wide Product Market Regulation	
	Germany		Italy		Germany	Italy
	Regular Contracts	Temporary Employment	Regular Contracts	Temporary Employment		
1985	2.58	5.00	2.76	5.25		
1990	2.58	3.25	2.76	4.88		
1998	2.68	2.00	2.76	3.63	2.23	2.36
2003	2.68	1.50	2.76	2.00	1.80	1.80
2008	2.68	1.00	2.76	2.00	1.40	1.51
2010	2.68	1.00	2.76	2.00		
2013	2.68	1.13	2.68	2.00	1.28	1.29

Note: 0 very loose, 5 = very strict

Source: OECD

5 European Mercantilism: Why Structural Reforms are Insufficient

The lack of success structural reforms has not diminished its advocacy. For the EU Commission, structural reforms have become an article of faith such that if, as in the Italian case structural reforms do not coincide with improved economic performance it must follow that such reforms remained only on paper. An additional device for making policy advice immune to empirical outcomes is the distinction between short- and long-term effects. By arguing that, while very beneficial in the long run, structural reforms may at times have adverse effects in the short run (Eggertson et al 2014), the coincidence of reforms and worsening performance can be ignored. But that approach loses credibility as the long run must be postponed into an ever more distant future for the model to fit the figures. As Duccio Basosi (2015) wryly remarked “after thirty years such answers remind us of the self-reassuring attitude once displayed by the true believers in “really existing socialism”: the idea is right, but the implementation was wrong”.

Structural reforms are expected to work their magic through five distinct channels. 1) By lowering wages and prices, they bring about a deterioration of the competitiveness of the core countries in favour of the periphery. 2) Real wage flexibility will allow labour markets to clear increasing employment and output. 3) Perfect competition in product markets will remove monopolistic / oligopolistic firms thus increasing output. 4) Structural reforms will improve productivity, e.g. by removing much of the red tape involved in doing business thus also increasing output. (5) To the extent that market participants hold the model underlying the drive for structural reforms correct they know that they will bring about a rise in output and income such that the credible announcement of structural reforms will immediately increase aggregate demand through the consumption smoothing of households.

The strategy of boosting demand by improving external competitiveness might at best bring about a rebalancing in Europe, as the periphery would run current account surpluses matched by a deterioration of competitiveness and current account deficits in the core countries. Yet, the actual practice in the EU looks different. The generalised mercantilism to which the EU has turned as a result of the Eurozone crisis with the current account of almost all member states and the EU as a whole now turning to consistent surpluses, has made EMU acquire many of the traits of the interwar gold standard that drove the western world into the Great Depression. The scramble for gold reserves now finds its complement in a scramble for current account surpluses that has the effect of reducing the overall growth rate of the system. Moreover, the EU's quest for current account surpluses requires matching deficits elsewhere but the prime candidate, the USA no longer seems willing to do so and instead is turning to protectionism, leading the IMF to downgrade its forecasts of what seemed a modest European upswing in its July 2018 WEO update.

To expect higher growth rates from productivity increases brought about by structural reforms, moreover also has proven erroneous. First, higher productivity is the key to potentially higher per capita incomes, but to try and boost export competitiveness by productivity growth that outpaces wage growth merely is a different road of engaging in a beggar-your-neighbour strategy that cannot succeed in the aggregate. Secondly, higher productivity will boost output only conditional on the amount of capital and labour employed. Private investment thus is the key to growth in Europe, but investment is a macro and not a microeconomic category. A company's desired capacity depends on its expected market share, which is a function of its gain/losses over its competitors and the overall growth rates. To the extent that structural reforms improve the competitiveness/productivity of individual companies/countries, they have a mirror image in the loss of competitiveness on the other side of the market. Accordingly, at macro level investment becomes a function of the expected

growth rate⁸, but since the latter is a result of investment activity undertaken, the issue is one of expectations (Bloom 2014; Bloom, Bond & van Reenen 2007; Farmer 2010).

Low growth in Europe thus has deeper roots than EMU: the growth performance of the EU during the last four decades shows clear signs of hysteresis, i.e. shocks that give rise to permanently lower levels of GDP compared to the previous trend. These longer term shifts to lower growth were marked by three major crisis: the disinflation of the 1970 and 1980s, the crisis of the early 1990s, and the Great Recession caused by the North Atlantic financial crisis (Ball 1999, 2014; Blanchard & Summers 1986, Blanchard et al 2015). Secular stagnation emerged as an issue in the 1980s concomitant with the shift to a policy regime of monetary disinflation. As the policy priority became to depress activity to eliminate inflation, a new focal point was created, as expected growth could only occur to the extent that it did not conflict with this goal, which under the rule of the ECB was set at a growth rate of more or less two percent. While still having separate currencies, the ERM bound the members to such priorities, requiring all other to follow the *Bundesbank* stance in response to unification. This implied that, for countries unwilling to run large current account deficit, the German policy orientation set the limit to growth. EMU subsequently served to institutionalise this system in a way that is much less vulnerable to political contestation than ever before. With the ECB focussed on the consumer price index and impervious to asset inflation, the EU's Financial Services Action Plan, in addition, contrary to its intention, rather than promoting growth, ended up mainly stimulating speculative finance. The institutionalisation of permanent austerity in a mercantilist framework in the wake of the Eurozone crisis, moreover, further helped undermine growth expectations.

Accordingly, the main threat to the coherence of EMU does not reside in the ability to reform but in an economic governance regime that promotes secular stagnation and increasing socio-economic disparities throughout the EU. If anything the "German Model" only survives in parts of its export-oriented metal working industry while having long been abandoned in the remainder of the economy in favour of labour market segmentation, widespread under-employment, and by tearing down the barriers between impatient and patient capital (Menz 2005) – a move that Italy has resisted until it was forced upon it by structural reforms. The imposition of this model makes Germany and Italy converge on a number of unappealing indicators, such as secular stagnation, increasing socio-economic disparities and growing populism and Euroscepticism. As a result, both countries share the political consequences. The momentous electoral gains of right-wing and left-wing populist parties

⁸The underlying growth model we use is of the Harrod type. See e.g. Fazzari et al 2013.

in Italy and Germany share a common dissatisfaction with the sacrifices that European economic governance has imposed.

In both countries. Euroscepticism finds its electoral stronghold primarily in groups with a similar socio-economic profile, in terms of having lower-education, being exposed to more economic insecurity and living in less urbanised areas. In the 2017 Bundestag elections, the AfD enjoyed above average support in areas located in former East Germany, from voters with lower education, with vocational training only and employed in blue collar professions. It is the strongest party amongst blue-collar workers and the unemployed. Though in contrast to other German parties the AfD is markedly more popular amongst men than women, the party performs above average amongst younger male workers (Goerres, Spies & Staffan 2017; Rose 2017; Roth & Wolff 2017 Tomik 2016). The 2018 Italian elections, on the one hand showed a clear north-south divide with MS5 the strongest party in Southern regions and the rightist block taking all the northern regions with the exception of Tuscany and Trentino-Alto Adige/Südtirol. However, the Lega became the strongest party of the right-wing block in the North. Apart from its predominance in the South, MS5 has become a Volkspartei, able to attract votes from most social strata. It is equally strong amongst men and women and under-represented only in the above 65+ age groups. Its support is skewed towards groups with lower education but it remains the strongest part also amongst those with a university degree. It is overrepresented amongst blue-collar workers, the unemployed and housewives but also is the biggest party amongst managers. Somewhat similar, the Lega has equal support amongst men and women, is weakest in the 65+ age group, its voters are skewed towards those with lower education and is strongly represented amongst blue collar workers as well as shopkeepers and craftsmen (Formigoni & Forni 2018).

6 Conclusions

That Italy underperforms relative to even the anaemic Eurozone is primarily due to its stronger adherence to the constraints of the common currency. The onset of Italy's now almost three decade long secular stagnation coincides with the emergence of permanent structural budget surpluses (Balassone 2013). Italian fiscal policy has practised permanent austerity since the early 1990s in order to comply with the Maastricht criteria. As of 1992 the Amato government (June 1992 - April 1993) adopted a highly restrictive policy mix made of privatizations, deregulation of the labour market and increased taxes. As the experience of the Eurocrisis suggest, such policies are not growth conducive. In response to recent experiences, some doubt has arisen also at the IMF as to the merits of forced deficit reduction, suggesting that the optimal way to reduce public debt may be

to try and grow out of it (Ostry et al 2015). In a sense, Italy hence is weighed down by its public debt burden, though in a sense quite opposite to the dead weight loss assumed by Reinhart and Rogoff (2010), but as a result of permanent austerity. Secondly, by being the only south European country that did decide to respect the balance of payments constraint, it did avoid the danger of becoming a programme country but it also tied its growth rate to a low growth deflationary regime (Bagnai 2016; Micossi 2016). Its abysmally low productivity rate, in turn, is more related to its low growth and structural reform policies than the deep structures of coordination between firms and employers. Low growth in itself has a depressing effect on productivity as innovations are embedded in investment (Carlin & Soskice 2018) and, as low growth reduces the productivity effects of scale economies. Moreover, the structural reform programme of wage decompression through labour market flexibilisation opens up space for low productivity sectors. Having experienced one of the most rapid increase in labour income inequality in the OECD area (Targetti-Lenti 2014), employment performance improved under low growth as capital was increasingly substituted for labour since the 1990s (Codogno 2009). In that sense Italy's low productivity growth rather testifies to the “success” of its structural reforms.

Our analysis suggests various reforms to European economic governance that might help Italy exit from its conundrum. First, a symmetric interpretation and implementation of the macro-economic imbalances procedure in which current account surpluses are considered as much, if not more of a problem might help soften the deflationary bias of the system. Second, a change in the ECB mandate that would prioritise the goal of real growth rather than nominal stability may be conducive to changing longer-term growth expectations. Third, fragmentation of financial markets and well-specified circuit breakers can serve to prevent “panic driven austerity” (De Grauwe & Ji 2013) and the massive imbalances that emerged in the wake of the creation of a single market in financial services. Fourth, while EU economic governance generally considered the “financial repression” that characterised management of monetary policies in most European countries in the post-war decades simultaneously an obstacle to an integrated economy and an obstacle to growth, financial crises have engendered a partial return to such selective policies under the heading of “macro-prudential policies”. While the modest turn to macroprudential policies operates primarily in a financial stability perspective, measures such as credit ceilings, administrative guidance of the sectoral composition and growth of the loan portfolios of banks may, as they did in the post-war decades, not only help prevent the speculative excesses of financial markets but can be simultaneously employed to stimulate “real” as opposed to speculative investment (Notermans 2017). Finally, in analogy to the legal framework of the WTO, the single-market rulebook could be

extended with a balance of payments clause that will allow members to invoke temporary derogations so as to defend a more expansionary policy orientation.

Most such proposals, however, would probably flounder on dogged resistance from surplus countries like Germany and the Netherlands. Within the existing regime, however, the leeway enjoyed by Italian policymakers is exceedingly small. The Keynesian spending spree on which the M5S-Lega government plans to embark is unlikely to solve the problem as it may not ignite an investment dynamic and hence will result in an acceleration of indebtedness. There are few examples of pure Keynesian deficit spending actually proving effective, but the government may not be given the time to await its results. Despite a strengthened SGP, the Commission in fact has few means to force compliance with its rules and has itself proven reluctant to impose sanctions for the fear of further fanning anti-EU sentiments. Yet, the Italian spending programme is most likely to increase interest rate spreads in the short term. Much will depend on whether and under what conditions the ECB will be willing to acquire Italian sovereign debt. Paolo Savona⁹ - who was vetoed by president Mattarella as Finance minister because of his Euro-critical views - is quite right to point out that Italy may end up like Greece if the EU were to proceed with the current reforms and that to prevent such an outcome a Plan B for exiting the common currency might be necessary.

While considered an undesirable solution by both, doing so would free Italy from its Euro constraints and would make possible a Japanese-like solution to its legacy problem of high public debt – with Japanese gross public debt standing at around 240% of GDP while its net public debt being around 75% as the majority is held by the Bank of Japan. However, an Italian exit from the Euro would raise the question of whether the populist government would be able to prevent the fiscal and inflationary excesses of the 1970s that prompted Italy to place so much weight on joining the common currency in the first place. The path remains narrow, no matter what.

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⁹ The existence of a "plan B" to exit the Euro was made suddenly famous by the clamour that surrounded the nomination of Prof. Paolo Savona to Economics minister of the recently forming M5S-Lega government. s Eventually Prof. Savona entered the new government as Minister for Europe. .

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