LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

THE POLITICAL ECONOMY OF LETTA AND RENZI

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The dynamics of the Euro-crisis can help explain the sudden changes of language and protagonists in Italian politics. On the eve of the Italian presidency of the European Union, Italy's new course bears potential consequences for the relation with Europe

Unexpectedly, Italian politics has undergone a significant breakthrough over the last months. New protagonists, new languages, and new projects have markedly enlivened the usually swampy political landscape. In fact, if one adopts concepts and tools that are common to the analysis of political economy in the euro area, one would discover that what happened was far from unexpected. The unprecedented depth of the economic crisis of the last years paved the way to policy responses that were different from those common in the past. How different they should be, is however another question. This analysis shows why change was unavoidable, but some pillars of the "old politics" need to be carefully preserved if the new course is to succeed.

The consequences of the financial crisis on the Italian economy have produced a loss of output of around 9% of Italy's GDP. There had never been a similar loss of income in post-war Italian economy. The protracted recession has caused permanent effects on the output capacity of Italian firms affecting the level of investments that fell by almost 30%. Households have considerably shifted downwards their consumption patterns. This breakthrough in economic behaviors has been mirrored by a sense of deep disappointment among the population vis-à-vis the political class. The dramatic loss of income represented a rupture of the former political-economic model of the Italian economy based on cyclical developments.

Until the recent past, policy-makers could rely on the cyclical nature of the economy. Cycles used to bring the economy back into equilibrium in a fairly regular succession of recessions and recoveries. Often, heads of government considered reasonable to just assume a wait and see modality: when the economy was weaker, it was politically convenient or even advisable not to get too excited and simply wait for the automatic stabilizers gaining traction, or for the decline in interest rates and in the prices of goods and services generating the context for a resumption of consumption and investments.

Before the crisis, the European Central Bank, published a report on output growth differentials since 1990 in euro area countries and found that they were small (comparable with those of US states), but persistent. Surprisingly, the loss of flexibility in exchange rate and monetary policy did not increase significantly the output co-movements across countries in the euro-area. This happened despite the fact that EMU members states have differed from one another for what concerns the degree of competitiveness, real interest rates and for their institutional characters.

Cycles remained alive and national, but changed in their political significance. Since the mid-1970s economists and political scientists formalized a common idea according to which incumbent politicians, willing to be re-elected, try to manipulate the economy prior to elections in order to secure favorable outcomes. Exploitation of the "political business cycle" became harder once the traditional policy instruments – both monetary and fiscal - were severely constrained by the new tight policy provisions engraved in the European Treaties. In fact, political and reputational benefits were reaped when governments were acknowledged to be complying by the fiscal rules, rather than violating them. A more concrete benefit was granted by the lower interest rates accompanying fiscal stability. Consequently, endogenous cycles became less pronounced. In fact, in the years before the crisis, the increasing integration of the economy in the global markets exerted a larger influence on national cycles. In more open countries, recoveries were facilitated by the impact of external demand. The closer the economic ties with other foreign trade partners were, the likelier it was that the external demand would step in and absorb the domestic production, as the recession dampened prices at home.

In this perspective, *stability* and the *international credibility* of the government leaders, represented qualities that were functional to take advantage of the cyclical nature of an economy well integrated into global markets for goods and capital. Stability basically assumed the meaning of waiting for the cycle to gain traction, while credibility was instrumental to closer financial ties with the other economies. The characters of the leaders who preceded Matteo Renzi were generally in line with the prescribed qualities. With the notable exception of Silvio Berlusconi, all others were harbingers of European integration or greatly influenced by the belief in future integration and in what the "theory of endogenous optimal currency area" defines as natural structural convergence through the stability of economic cycles.

By studying the effects of several currency unions that occurred in the past, Rose and Frankel showed that monetary integration leads to a very significant deepening of reciprocal trade. Their implication for EMU was that the euro area may turn into an optimum currency area after the launch of monetary integration even if it wasn't at its beginning. In the process of integration, there are diverse market-based forces at play. A currency union signals a political commitment toward even more harmonization in areas of regulations and social policies. A common currency among partner countries precludes future competitive devaluation, facilitates foreign direct investment and the building of long-term relationships. And it is likely to encourage forms of political integration. This will promote reciprocal trade, economic and financial integration and even foster business cycle synchronization among the countries sharing a single currency.

The reliance on the positive effects of EMU was so strong that, in some cases, the steady-hand approach, waiting for the cycle to bring convergence among different countries, became an alibi for the dominance of political inertia in the process of structural reforms. Unfortunately, the so called effect of trade deepening did not prove as large as expected, probably because of the parallel expansion of global trade that superseded the effects on internal integration in the euro area and privileged extra-euro trade.

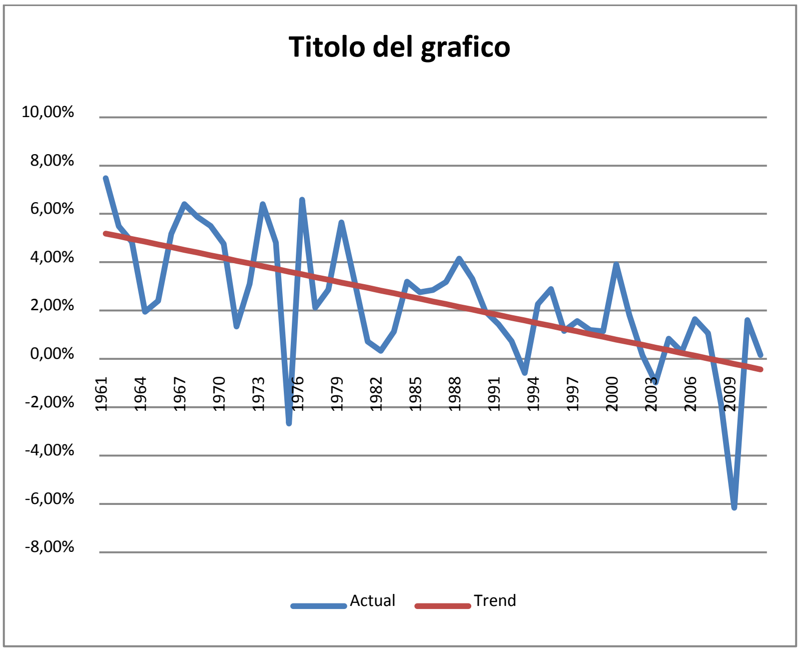
The "stability and credibility" model represented a higher level of modernity in the political management of the country relative to the pre-euro period. Before mid-Nineties, Italian political economy was characterized by cyclical spending policies that often became unsustainable and needed to be rebalanced through the devaluation of the currency. The flexibility of the exchange rate allowed preserving the rigidity in all other market prices and primarily in the nominal wages fixed through a system of rigid labor markets granting a large and collusive consensus among firms and trade unions. In the nineties, however, the flexibility of the exchange rate became a source of dangerous financial instability causing severe recessions. For this reason, it was decided to fix the exchange rates and adopt a single currency in an area, such as the European one, that is financially highly integrated.

Once the exchange rate was fixed, it could no longer accommodate either the excesses in government spending or increases in salaries that were too high compared to the levels of productivity. It became necessary to create a context of institutional and fiscal stability that would allow markets to allocate resources as best as possible through a system of more flexible prices. Unfortunately, Italy is one of those countries that have failed to adapt to this new set of economic policy either in terms of political stability and of market flexibility.

The crisis has completely changed the framework that justified the steady-hand reliance on the coming cyclical recovery. During the recent crisis, the political modernity of the “stability and credibility” model seemed to run out. In the course of a few years, the entire European economy lost a significant portion of its production capacity. Italy, in particular, lost a quarter of its potential.

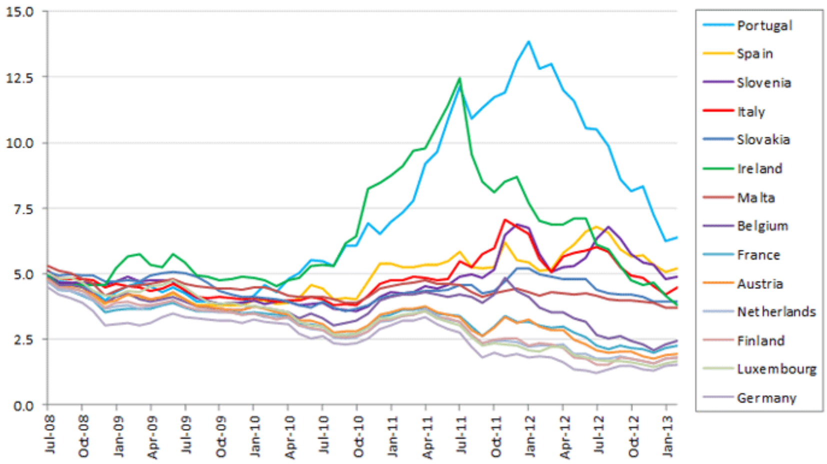
In graph 1, one may observe how the cyclical development of the Italian economy has come to a halt after 2009. In addition, exactly at the beginning of the crisis, the trend of the cycle has bottomed to the level of zero growth. This level has a significant impact on political dynamics: under that level, even the expectation of cyclical recoveries entails a prospective loss of income. Inadvertently, policymakers defending and representing the cyclical interpretation of the political economy – and purporting the messages of stability and credibility – were promising only further decline.

Real GDP per capita growth rate



Graph 1: At the beginning of the crisis the median GDP per capita growth rate plunges below zero

After the Lehman crisis, and with the notable exception of Italy, the primary policy response to the economic crisis has been entrusted to fiscal policy. Fiscal stimulus in late 2008 and early 2009 helped contain the first impact of the crisis. After the Toronto G-20 Summit, on June 26, 2010, fiscal policy was reined in, and the main policy instrument for supporting the economy was monetary policy. Both in the United States and in Europe, interest rates have fallen to historically low levels. Policymakers have tried to reconstruct the relative profitability of investments through lower financial costs. The monetary stimulus was intended to counter the cyclical decline at least on the short term. However the financial nature of the crisis – as Reinhart and Rogoff appropriately pointed out – implied that the cyclical stimulus was by far not enough. The fragility of the financial systems had different impact in different countries. Consequently the monetary impulse could not work everywhere. In countries like Italy where the sovereign crisis had spilled over - damaging the banking system, breaking the transmission mechanism of monetary policy and jeopardizing the sustainability of public and private debt - monetary stimulus did not reach the economy. Interest rates had lost their power of leading the economic cycle in highly indebted countries.



Graph 2: The level of Interest rates differentials in the euro-area 10ys gov bonds loses relation with GDP growth

In those countries where the damage of the protracted crisis has become structural, the depression has represented a breakdown of the cyclic model of the previous decades. Furthermore new structural problems have developed, beginning with the accumulation of new debts. In this context, steady-handed government leaders who privileged policies typical of the cyclical economy – the stability and credibility model – got disappointing economic outlets.

In a recessive scenario even attempts to introduce structural reforms have not produced the outlet that more reactive government leaders – first of all, Mario Monti's initial drive for massive reform programs - had been hoping for. The macroeconomic framework is important for the efficacy of reform policies and Monti became Prime Minister in November 2011, the very month that inaugurated a new recession. The recovery is a condition for fostering trust and significantly facilitates the effects of reforms. Unfortunately, the recession became so deep that the cycle was abruptly interrupted and the expected recovery never arrived. The hope for a *light at the end of the tunnel* has been raised regularly ever since, but just as regularly it turned out to be a blunder. There was not, or it was not easy politically to accept, the awareness of an economic framework no longer determined by cyclical behaviors.

In the face of a structural crisis, the policy response should also have been structural. In fact new categories of radical policy change forced their way into the public discourse: the abandonment of the euro, the breaking of the EU fiscal agreements, the request of financial assistance from foreign institutions, and the involvement of non-political and non-national authority (the Troika) in the government of the country.

The structural breakdown of the economic policy framework became immediately clear to many citizens who were feeling it directly under their skin. The political and electoral responses were in fact very vigorous: protest movements and anti-political or anti-European formations upstaged the traditional parties in several countries. In such a heated environment, the conventional and tranquilizing messages of stability and credibility suddenly sounded hypocrite or conservative. The powerful metaphor of the "scrapping", wielded by Matteo Renzi, captured the widespread popular feelings reckoning with an old guard that was held responsible for the decline of the Italian society. Renzi's scrapping exemplified the end of the (re)cycle, intercepted a widespread feeling of "waste" well-grounded in the difficulties of a large part of the citizenship.

Renzi has become the emblem of *the end of the cycle,* both the political and the economic one. Not incidentally, however, the structural renewal called for by the new Prime Minister hit its first stumbling block exactly when confronted with the European stability policies typically designed on the old cyclical politics. Fiscal criteria – as the 3% threshold – were meant to ensure both stability and credibility in fiscal policy. Since its first days as Prime Minister Renzi has collided head on with the prescriptions of fiscal discipline agreed by his predecessors with the European institutions. In the following weeks, the language of the Prime Minister has become more muted. But still does not leave room for wait-and-see attitudes. His political experience shows neither patience nor confidence in the natural virtues of the system to spontaneously regenerate itself. Cyclical behaviors do not seem to be his playground. This means that in his mind-frame, per se stability may be a priority of second order.

In his political economy, Renzi placed more emphasis on economic recovery than on stability. His strategy centered on stimulus to the demand (either through tax reductions or through the release of liquidity of receivables by the Public Administration). Reforms are also high in the agenda, with more attention than in the past for letting reform fall on the ground of a recovery. Trying to put a gloss on this strategy, one could say that Renzi seeks to reverse the sequence between the traditional "phase one" of Italian economic policy, that is the phase of fiscal stabilization, and the "phase two" dedicated to boosting the demand and completing the reforms.

This reverted policy response is perfectly in line with the feelings of the citizens, but it is not without risks. The new political language hides the fact that today's problems are no different from those identified in the past, in particular by Monti and Letta. The severity of the recession in fact certainly implies a demand vacuum, but it is mainly caused by structural problems that have different nature. First of all, the impact of the sovereign risk on the balance sheets of Italian banks has caused a severe credit crunch. This kind of problems has become structural and it is very difficult now to solve them only through national policies.

The European fiscal rules aimed at stability, are meant to reduce the perception of sovereign risks in the euro area. In turn, the reduction of sovereign risk would reactivate the circulation of credit in highly indebted countries in the context of a better designed banking union. For this reason stability prescriptions are even more important for those policymakers who want to invert the inertial decline of the country. The reduction of sovereign risks and the reactivation of credit through the euro area are based on a prerequisite: that European partners trust each other, or in other words that each of them proves to be credible. Lack of reciprocal trust has become the main problem in the design of solutions for the euro area. But Italy has a special role in respect to trust enhancement in the euro area. Due to its dismal track-record in GDP growth and in implementing reforms, Italy is still watched with fear because of a public debt that makes of Italy a country too large to be saved by others, but too large too not to bring down the whole European house. So, stability and credibility cannot simply be dismissed out of hand, but must become an integral part of the new policy of structural change. Building a new trust in the euro area – and cooperative solutions for the crisis - lies on Italy’s threshold. In particular because, starting in July 2014, Italy will hold the presidency of the European Union.