What Happened in Italy and What to Do Now

The overwhelming majority of Italian voters rejected the politics and economics of austerity with a resounding, "enough, already!" This is not an impudence that the Lords and Ladies of the euro zone will accept with good grace. On the contrary, already they call upon the new government to reject this insolence from the popular will and continue those anti-social policies that Signore Monti so faithfully pursued.

So what happens now? Can this new government fundamentally change economic policy without bringing down on itself the wraith of "financial markets" and sending the Italian economy into an abyss beyond recovery? The answer is "yes". The new government, whatever its composition, has a range of policy options. The dire predictions of what will happen should austerity be abandoned are nonsense.

To understand why, we must go aback a few years, into the era of Berlusconi's follies and fakery. Italians and anyone who might listen are repeatedly told that Italy's public finances are a profligate scandal and Berlusconi is to blame (and all those feckless Italians that voted for him). The austerity justifying narrative teaches us that Italy's slow growth in the 1990s and 2000s resulted from the failure of Berlusconi to bring Italy's spending "under control" and his equally serious failure to implement "reforms".

Highest on the list of reforms that the bunga-bungling Berlusconi failed to implement was the reduction of workers' rights ("labor market flexibility"). Close behind comes eliminating the protection of small businesses to let the great supermarkets and department stories achieve the monopolization in Italy that they have throughout Europe. In brief, the sin of Berlusconi was not being sufficiently neoliberal (which shows that nobody is all bad).

In my opinion the former prime minister was and is an affront to decency, a barely concealed neo-fascist and should finish his days in prison (which he will not, I regret to write). But, he cannot be accused of mismanaging the public finances in the Troika-ite sense, nor was the stagnation of the Italian economy the result of that mismanagement or lack of neoliberal "reforms".

First, I set the record straight on Italy's public finances. In 1995 Italian public expenditure stood at fifty-two percent of national income (GDP), and fell to forty-eight percent on the verge of conversion from the Lira to the euro. When the unspeakable Berlusconi became prime minister the share was still at 48 percent, where it stayed through 2007. Converting those percentages into constant prices, spending was only ten percent greater in 2007 than 1995, a real annual increase of less than one percent. This was the slowest growth of real public spending for any major euro country. After 2007 as the Great Recession unfolded, real expenditure hardly changed, one-half of one percent higher in 2012.

The accusation that Berlusconi (or any other Italian politician) sent the public finances into the red is absurd. Quite the contrary has been true. If you consult the IMF you will find what the arch-austerity hawks there offer guidelines for fiscal policy (http://www.imf.org/external/pubs/ft/pam/pam49/pam4902.htm). We read that the relevant budget balance to target for reduction is the "primary" deficit. This is the overall balance minus interest payments on the public debt. The reason to exclude interest payments should be obvious to everyone except the Bundesbank. Reducing public sector interest payments would represent *de facto* debt default.

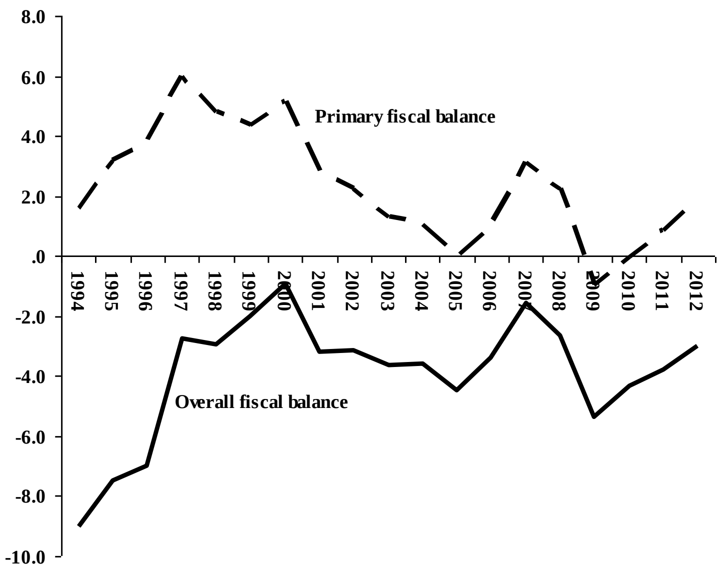
You might think that a deficit by any other name smells just as inflationary (apologies to W. Shakespeare, *Romeo and Juliet*, Act II, scene 2). Inflation results from excess demand and a deficit from any source constitutes excess demand generated by the public sector, correct? No, wrong, especially in the case of Italy. At its peak value in 2010 the Italian public debt in constant prices was only 9.4 percent greater than at the end of 2000, and at the end of last year less than eight percent greater. The public sector acquired most of that debt in the 1990s when borrowing rate reached extraordinary levels. Over ninety percent of the current debt was acquired by 1996 (again in constant prices), and the borrowing rate for the five years previous to 1997 averaged over ten percent.

This extraordinary public sector borrowing rate, far above the current "crisis" level, resulted in equally extraordinary interest payments, over ten percent of national income in the mid-to-late 1990s. As the chart below shows, the IMF "gold standard" for fiscal prudence, the primary deficit, shows a positive value for every year except 2009, the deepest point of the global crisis (when it was barely minus one percent of GDP). Not even the

Teutonic Puritans of fiscal rectitude in the German government could claim a primary deficit as great as the feckless Italians.

Most of the interest payments went abroad, especially to German banks (which might give a hint as to why the Merkel government is so pro-austerity). Far from generating domestic demand pressure, the interest payments represented *de facto* saving, flowing out of the country not into consumption or investment at home.

The Italian public sector overall and primary fiscal balance, 1994-2012



Statistics are from www.oecd.org, *Economic Outlook 91*, Annex Tables.

Italians bitterly complain that for at least twenty years the economy has stagnated, and right they are. For the fifteen years, 1993-2007, economic growth averaged 1.7 percent a year, and fell to one percent during the inglorious government of Berlusconi (2001-2006). Many people inside and outside Italy, including some on the soft and hard Left, argue that this moderately dismal growth performance shows that the Italian economy and Italian society require radical reform. The neoliberal Right is especially enthusiastic for "reform", bitterly disappointed that their putative champion Silvio proved more interested in the pleasures of the flesh than busting unions and down-sizing the public sector (though he did not ignore those reactionary pursuits).

It would be difficult for even the most uncritical to come up with an advanced capitalist country not requiring fundamental change. It is not clear that Italy is the worst, or even worse than average. For example, I doubt that the Italians can seriously challenge the UK privatizations, the criminality of US financial sector, or the LIBOR scam in the world corruption sweepstakes.

The stagnation of the Italian economy over the last twenty years has a simple, straight-forward cause, which is the mirror opposite of the neoliberal narrative. Insufficient public spending caused a drag on the economy. During 1991-2001 Italian national income grew at 2.1 percent per year, and real public spending increased at 1.8 percent annually. During 2003-2012 annual economic growth averaged slightly less than zero, while the annual growth in real public expenditure fell to one percent.

The election in Italy demonstrated that the country's voters have a considerably better grasp of economics than their government. The Democratic Party that holds a majority in the Chamber of Deputies and a plurality in the Senate. The minority government should propose an expansionary fiscal policy combining recovery with enhancing growth potential.

Current expenditure to raise public sector salaries, pensions and unemployment benefits would inject the short-term stimulus. Public investment to improve the country's woefully neglected infrastructure would lower private sector transport and production costs. The government has several alternatives to fund the increased expenditure. It could follow the orthodox route and borrow in private financial markets, where public bonds this week were sold at an interest rate less than six percent. This rate is far below the level of the 1990s when no one obsessed over a looming crisis.

Better would be a proposal I made here previously (see "A Centre-left Government and the Eurozone's constraint"). The government should borrow from publicly owned banks, which it could do at an extremely low interest rate. This would have the added advantage of not resulting in an interest outflow to banks in other countries. And if the Troika does not like it, let Silvio do something positive for a change and tell the Troikistas what they can do with their advice.