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THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 28 (481), 19 March 2013 © PISM

Italy: Stuck Between the Necessity for Reform and Political Deadlock

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On March 15 the first session of the newly elected Italian Parliament was held after the elections of 24-25 February failed to produce a stable government majority capable of continuing the country's reform programme. Currently, the main task for political leaders is to find compromise on support for the new government, something that may take several weeks or even months. Yet, even if they are successful, political instability will continue. This will have an adverse effect not only upon the Italian economy, which needs urgent structural reforms, but also for the eurozone. Any further deterioration in sentiment for the eurozone may have negative implications for the Polish economy.

Until quite recently, the Italian parliamentary elections would have passed almost unnoticed, as the country's chronic political instability has largely been taken for granted. As a result of the global economic and financial crisis, however, investors have lost confidence in some of the EU-17 countries' capacity to bear high levels of public-sector debt. Italy, the world's third-largest sovereign borrower, with general government debt exceeding 120% of GDP, has become one of the main factors of uncertainty in the euro area. The readiness of Italian governments to undertake structural reform of the economy has become an object of scrutiny. Already during the euro area crises of July 2011 and November 2011, Italy's political deadlock has led to a dramatic escalation of the situation in the eurozone. Therefore, the February election date for both houses of the Italian parliament was marked in red on investors' calendars.

The election results put into question the continuation of the structural reform of the Italian economy initiated by technocratic Prime Minister Mario Monti. His reforms, including the extension of the retirement age, increased taxation and partial deregulation of the economy helped restore confidence among investors buying Italian bonds. However, they did not visibly boost the Italian economy or tackle corruption. Instead, a 13-year high record unemployment rate and new fiscal burdens caused widespread social discontent, which was reflected in the electoral results. The elections showed that more than 50% of voters rejected the reforms. Moreover, support for populist movements will likely grow, especially if these remain in opposition to the new, de facto minority government, which will have to stretch to find the compromises necessary to make up for a lack of a majority in the Senate.

Italy is thus embarking upon a longer period of intense political instability, which may last several weeks. The new parliament will last at least for the next two months, as it cannot be dissolved by the president within six months of the end of his term, which is in mid-May.

Italian Economic Reforms? The Italian economy is the 8th largest in the world and 3rd in the euro area by nominal GDP. Being "too big to fail" and "too big to be saved", it has huge systemic importance for the stability of the euro area. Yet, the domestic economic and financial situation is bleak, with a large number of risks and long list of reforms.

Italy faces the dilemma of how to further continue fiscal consolidation without affecting economic growth. Other urgent changes include raising labour productivity and flexibility, deregulation of the services sector and changes in the public sector. Italy needs to reduce red tape and ease business restrictions along with considerable efforts to enhance the efficiency of the judicial system. In the last Doing Business ranking, Italy was 160th in contract enforcement among the 185 classified countries, lower than such countries as Togo or Senegal. Italy also has one of the heaviest tax burdens among OECD countries along with a high rate of tax evasion and one of the highest levels of corruption in the EU. It seems that further pension reforms started by Monti's government seem unlikely to come to fruition due to the disapproval of Italian society.

Italy needs also to step up its efforts towards making a more dynamic and resilient banking sector, which was strongly affected by the global financial crisis. Italy alone consumed almost a quarter of the three-year loans injected into the whole eurozone financial sector by the ECB in the fall of 2011 and 2012. The last blow came in May 2012 when Moody's investors service cut ratings for 26 Italian banks, including two of the largest, Unicredit and Intesa, increasing their borrowing costs on the interbank exchange as a result. The ongoing recession and growing fears about the sustainability of government debt may result in further problems for the Italian banking sector, which owns a large portion of government bonds. The problems of the Italian banking sector may easily affect other eurozone banks, especially French and German banks due to their credit exposure in Italy.

Despite the structural problems, however, the Italian economy has considerable technology potential , as shown by the Finmeccanica group, which despite a recent corruption scandal, has maintained a strong position on the market as one of the main contractors of the Boeing 787 Dreamliner and one of the leading world exporters of weapons. Italy also has large growth potential in the chemical and car manufacturing sectors. Yet, the structural problems will continue to strangle the economy.

Implications. The election results can thus be interpreted as a voice of opposition against the government's restrictive economic policy, regarded by Italians as imposed by a German-dominated EU. Political instability in Italy may in turn lead to a further intensification of the crisis in the eurozone as reflected in increasing spread levels on Greek, Portuguese, Irish and Spanish bonds. Italians' clear "no" to budget austerity and structural reforms may bolster similar resentment in other countries, such as Greece, Spain or Portugal, resulting in greater opposition to reforms required by the International Monetary Fund and negatively affecting market sentiment. The growing momentum in Germany's parliamentary election campaign may also shatter the confidence of the markets as German politicians prove unwilling to tie themselves to any new obligations before the vote in September.

This has clear implications for efforts to bolster EU economic governance. Within the Union, discussion currently focuses on the important issue of creating incentives, such as contractual agreements, for undertaking structural reforms. The election results in Italy create the risk that there may be no partner in Italy for talks on deepening EMU reform right when a deterioration of the situation in the euro area may hasten plans for creating a banking union. Germany, increasingly at odds with the political mood in Paris, may find its capacity to show political leadership dented for fear of renewed criticism of its domination in decision-making. The resulting loss of confidence in the eurozone and a political deadlock on reform may result in instability. For now, however, the bleakest scenarios seem unlikely.

The election results for the Italian parliament may imply a certain risk for Poland, though. Although Poland is not one of the EU-17, its economy is strongly linked with the euro area and worsening market sentiment may cause further weakening of economic growth and increase unemployment. According to the National Bank of Poland, Italy was third in terms of foreign direct investment to Poland in 2010. Poland has already experienced some problems caused by the weakening of the Italian economy in the form of mass layoffs at an Italian-owned automotive company, and the reduced production also affected dozens of smaller Polish suppliers. On the other hand, weak prospects at home have prompted some Italian companies to look for opportunities abroad. They are active in the Polish construction and infrastructure sectors. The problems with the Italian banks should not affect the Polish banking sector, fortunately. The second-largest Polish bank is controlled by Unicredit and remains a fully self-funded institution.

The possible deterioration of the situation in the euro area might have a negative impact on the fledgling debate in Poland about joining the euro area, effectively reducing the pace of integration and postponing the prospects of accession and further decreasing public support for the single currency.