

## Italy needs reform and a euro exit is inevitable



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Matteo Renzi could lose his referendum on Italian constitutional reforms next week  
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On Sunday Italy goes to the polls to vote, not on membership of the EU, or even of the euro, but rather on an apparently arcane political matter, namely the powers of the upper house of the Italian parliament, the Senate. But there are close connections between this vote and the matters of the euro and EU membership.

For a start, [the referendum](#) was triggered by the failure of Italy's Prime Minister, Matteo Renzi, to change the constitution. He believes the extensive powers of the Senate effectively block attempts to reform the Italian economy.

Moreover, Mr Renzi has suggested that [if he loses he will resign](#), thereby plunging the country into a period of political chaos and emboldening the eurosceptic Five Star movement. As with other referendums and elections, the vote will be regarded by the populace not so much as an opportunity to express a view about the precise details of institutional reform, as a chance to give their verdict on Mr Renzi's government in particular and the state of Italy in general.



The referendum may embolden the Five Star movement, led by comedian Beppe Grillo CREDIT: STEFANO RELLANDINI/REUTERS

And it really is in quite a state. The [Italian banking system is appallingly weak](#). Almost 20pc of loans are “non-performing”, meaning that borrowers are not paying the interest due. Many will probably not be able to repay their debts. At some point or other, there is going to be a reckoning, and it is not going to be pretty.

There is also a public sector financial crisis. Over recent years, the Italian government has batted down the hatches in an attempt to reduce the burden of public sector debt. But it has failed. As a share of GDP, Italian government debt stands at about 130pc, and rising. In fact, the Italian government is no longer over-spending. Indeed, if you exclude interest payments, it is running a surplus of 1.4pc of GDP. The problem is that it cannot exclude interest payments. And they are huge, amounting to about 4pc of GDP every year.

As in just about every other notable case, the way to get on top of the Italian debt problem is through economic growth. It would help if there were a return to positive rates of inflation, rather than the stuttering deflation that currently envelops the country. In many ways, though, these financial problems are less serious than [the underlying economic weakness](#). Some readers may remember that in the 1950s, 1960s and 1970s Italy was a powerhouse of economic growth. At one point its GDP passed the UK's, an event trumpeted by the Italians as “Il Sorpasso”.

But recently it has been a very different story. It is common to compare the performance of the world's major economies since the onset of the financial crisis in the first quarter of 2008. All industrial countries suffered a loss of output in the first few years, but most then managed to recover. Since the beginning of 2008, the US and the UK are currently registering output up by about 12pc and 8pc respectively. Over the same period, Italy's GDP is down by 8pc.

If this comparison seems pretty stark, then you should reflect on Italy's performance since the euro was established in 1999. You may recall that this bold monetary construct was supposedly going to unleash a wave of prosperity across Europe, including Italy. Britain, which stood aside from the single currency, risked being left behind, mired in comparative poverty. Staying out of the euro was the Brexit of its time. The warnings of looming under-performance, accompanied by forebodings of the imminent departure of key Japanese and American firms, were its version of Project Fear.

To put it mildly, the outturn has been somewhat different. Since the beginning of 1999, the UK economy has grown by almost 40pc, against about 25pc in Germany and France. But Italy's performance is in a different league. Over the last 17 years it has managed to grow by less than 6pc. In other words, since the formation of the euro, Italy's economy has essentially stagnated. Along with this stagnation has come an employment disaster. Unemployment now stands at about 12pc of the workforce.



Italy's economy has barely grown since the country joined the euro CREDIT: MICHAEL PROBST/AP

Nor is the long-term outlook very promising. The Italian birth rate is running at about 1.4 per woman. The United Nations projects that by 2035, Italy's population will have fallen by about 2pc. Quite apart from what that would do directly to reduce the size of the Italian economy, this is not exactly an environment in which Italian businesses will be galvanised into investment.

It is pretty clear what would bring a revival of the Italian economy and ease many of its financial problems, if not solve its population crisis. Italy needs a much lower exchange rate. While it is in the euro, of course, it does not have a currency of its own to depreciate, and the exchange value of the euro is determined more by the performance of its Teutonic neighbours.

Not that a weaker currency would solve all problems. [Italy needs fundamental reform](#), and not only to the powers and practices of parliament. But if it could enjoy a boost to competitiveness of 20 to 30pc through a lower exchange rate, this would lead to a surge in net exports and higher economic growth, with corresponding gains to employment. In such an environment, it might be easier to get through some of the many reforms that Italy needs.

You may think that a referendum on the powers of the Italian Senate does not promise to be anything like as exciting as the Brexit vote or the US Presidential election. But it is well worth keeping an eye out for the result of Sunday's vote. Among other things, [it may set Italy on the path to leaving the euro](#). Whatever the outcome on Sunday, though, I have come to believe that this is not a matter of if but when.

## Q&A | Italy's constitutional reform vote

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### **What is it?**

Italians will vote in a national referendum on December 4, 2016 on whether to accept a package of constitutional reform put forward by Matteo Renzi, the centre-Left prime minister. The reform is designed to reduce the size and powers of the Senate, which currently carries as much weight as the lower house, and claw back power from Italy's 20 regional governments.

### **What are the core arguments?**

Proponents argue that it will make the passing of legislation easier and propel Italy on the path to increased stability, greater investor confidence and economic recovery. Critics say it will place too much power in the hands of the governing party, posing a threat to democracy.

### **What is likely to happen?**

Polls strongly suggest that a majority of Italians will vote against the reform. Mr Renzi has indicated that if that happens, he will resign. It is not clear what would happen then – it could be that a temporary or technocratic government is formed. It would then have to draft a new electoral system ahead of an early election in 2017, a year earlier than scheduled.