December 5, 2016

ITALY'S YOUNG PEOPLE VOTE AGAINST VESTED INTERESTS

The country leaves itself vulnerable to a crisis to implement change

by Francesco Giavazzi

To understand what is happening in Italy, imagine a company that has been losing money and building up debt for a very long time. At some point, to stop the bleeding, a young and energetic chief executive is appointed. He understands that simply cutting costs will not be enough: he will need to invest and reorganise as well as introduce more flexible contracts for employees. The alternative is debt restructuring under bankruptcy procedures.

Shareholders welcome him with open arms. To protect their jobs, workers accept the new contracts. But when the CEO starts cutting the private benefits shareholders enjoy at the expense of workers and creditors, they rebel and kick him out. He is replaced by an old hand in debt restructuring who puts the firm in receivership.

The parallels with what is happening in Italian politics today are easy to spot. The outgoing prime minister Matteo Renzi is the ousted CEO. The new flexible labour contracts are Mr Renzi's signature jobs act legislation that was surprisingly accepted by the trade unions. Finally, there are the vested interests, notably the ageing politicians who have campaigned against Mr Renzi, who do not want change and have for decades prevented the country from growing, while at the same time extracting private benefits at the expense of the young.

It was the young who revolted in Sunday's referendum: 80 per cent of people aged between 18 and 24 voted against the government. To understand what drove them to revolt, consider the fact that the youth unemployment rate is 37.1 per cent. How many of these young people would like to drive a car for Uber while looking for a permanent job? They cannot because Uber is prohibited in Italy so as to protect taxi drivers. How many with a law degree (still one of the more popular educational options in Italy) would like a job as a notary, an attractive and well-rewarded occupation in a country stifled by bureaucracy? Most of these graduates will fail to achieve their ambition because the profession has protected itself through strict admission limits.

Mr Renzi's proposed constitutional reforms, which were rejected on Sunday, were designed to speed up legislation and, for example, make liberalisation of closed professions possible. But if you are 20, unemployed and your future looks bleak, you could be forgiven for thinking that the prime minister was not on your side.

What comes next? To pursue our analogy, receivership can be postponed, but only as long as the European Central Bank does not start raising interest rates. But if interest rates were to rise, Italy's debt risks becoming unsustainable, and with that its membership of the euro. This could take some time to unravel but, as the late economist Rudi Dornbusch used to say: "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

What could trigger a crisis? The sorry state of Italy's banks. A few urgently need an injection of fresh capital: at least €5bn in the case of Monte dei Paschi di Siena, considerably more in the case of UniCredit. Estimates of the total amount of capital needed to secure all banks approach €40bn, 2.5 per cent of gross domestic product. With an interim government and elections due in 2018, private investors are likely to look the other way. In that case the solution would be recapitalisation by the state. The sooner that happens the less likely a financial crisis is to erupt.

But in the absence of reform of the kind the Renzi government has started, Italy is heading for receivership. The deep crisis this would entail might be the only way for Italy to free itself of the vested interests that stifle it.

The writer is professor of economics at Bocconi university in Milan