The Trouble with Economic Reform:

Understanding the Debt Crisis in Spain and Italy

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Introduction

The ‘great recession’ of the late 2000s began as the collapse of the ‘Anglo-Saxon’ model of highly leveraged capitalism, but the countries that have suffered most have been the Southern European democracies, often referred to as the ‘PIGS’[1]. The transformation of what started as a banking crisis into a sovereign debt crisis has ended up engulfing countries who, for the most part, were not particularly associated with the financial excesses of the boom years, and has allowed debate to move away from reform of the financial system in the Anglo-Saxon countries to the sustainability of government spending in Europe, and particularly Southern Europe, and the future of the euro currency.

A common view expressed ever since the euro crisis began has been that the euro was fatally flawed from its inception because of the presence of the EU’s Southern fringe, whose economic backwardness and fiscal recklessness was bound to place the single currency under strain unless greater convergence with the North was achieved[2]. Even before the euro began to circulate, their histories of high inflation, frequent currency devaluations, difficult labour relations and fiscal indiscipline called into question their commitment to the hard money regime of the Euro. Extensive structural reforms would be necessary if their economies were to integrate successfully with the more developed and ‘virtuous’ North, reforms which would be politically costly and which most commentators were skeptical could be achieved[3].

These fears – that the eurozone would be ‘economically and politically divided between a northern hard core and a flaky southern fringe’[4] - now appear to have been justified. The Southern European countries all face serious fiscal problems, and years of inflationary wage and price increases have made their products uncompetitive. The disciplined and productive North has to pick up the tab in order to hold the eurozone together and avoid a chaotic default or exit of one or all of the Southern member states. If this is to work, it is argued, the Southern countries must rein back their public spending and adopt economic reforms to restore competitiveness. Austerity and reform are the order of the day.

This chapter proposes to revisit and scrutinize more carefully this standard argument about national institutions and euro membership in Southern Europe. Although the failure of monetary union to induce effective convergence, the failure of eurozone institutions to police national fiscal policies effectively, and the institutional weaknesses of the periphery nations are all very real, the conventional narrative on the causes of the crisis misses the point. A more plausible view is that euro crisis is the result of the way in which the euro was designed, which inevitably generated imbalances between surplus and deficit countries, but lacked the appropriate institutions to deal with them. Laying the blame on the institutional failings of the debtor countries is misleading, and fails to take into account the extensive reforms already undertaken by these countries both before and since euro membership.

In fact, this chapter argues, economic reform in Southern Europe has not only been extensive, it is to a degree part of the problem. Some aspects of the structural reform project promoted by European institutions (summarized in the 'Lisbon process') were useful and to the extent that they were taken seriously by the Southern member states produced positive results. However the broad programme of promoting liberalization and greater openness may have been more risky than initially believed, and have made the current crisis far more acute. The Southern European political economies have distinctive institutional arrangements, and in the context of this particular regime type liberalizing reforms may well have unexpected and perverse effects.

A comparison between Spain and Italy presented in this paper suggests that a more closed economy with higher levels of state interventionism may in fact prove beneficial under the conditions of financial integration characteristic of the eurozone. Italy was long seen as the main threat to the stability of the euro, whilst Spain won plaudits for its embrace of fiscal probity and openness to trade.

Yet the crisis has proved more acute in Spain than Italy, with the latter suffering more as a result of its historical accumulation of government debt than because of recent policies. This chapter will therefore explore the hypothesis that the structural reform agenda in Southern Europe may have done more harm than good, given the absence of complementary institutions.

The Contours of the Problem: Southern Europe and the Crisis

The crisis of the euro is the result in the short-term of the financial turbulence associated with the American sub-prime crisis, but its structural component is to be found in the rapid financial integration of the eurozone without any real economic convergence. As predicted during the 'optimal currency area' debates of the 1990s, differential productivity and wage/price increases added to low levels of labour mobility created strain which was visible initially as a persistent trade deficit of the South (and Ireland) and surplus in the North (see Figure One). In the 2000s, persistent trade surpluses were run by the eurozone's continental and Northern members, most notably Germany, and persistent balance of payments deficits by the periphery (Ireland, Greece, Spain and Portugal, with Italy also moving into deficit by the end of the decade). This imbalance mirrored the imbalances in the global economy as exporting nations (such as China) recycled their surpluses in the financial markets of the deficit countries (such as the UK and US), for instance by buying government debt and real estate.

(Figure One About Here)

A related development in this period was differential productivity and wage growth. Whilst the anchor of the eurozone, Germany, squeezed labour cost growth and eeked out productivity gains (a strategy also followed by Scandinavia and the Benelux countries), unit labour costs grew more quickly in Southern Europe as well as in Ireland. The failure to prevent wage growth exceeding that of the eurozone anchor, and the appreciation of the euro in the mid-2000s, led to a sharp increase in the real exchange rate for these countries.

Southern Europe was disproportionately affected by competition from emerging economies, since its industries relied to varying extents on low value added, labour intensive production[5]. Financial flows from surplus countries such as Germany both accentuated and disguised this problem: an excess of available capital over investment opportunities maintained a buoyant labour market and allowed divergent wage growth to continue, pushing wages and prices beyond competitive levels and leaving Southern Europe exposed once the downturn arrived.

At the heart of the problem was the collapse of the 'competitive corporatism'[6] which had been successful in the 1990s as Southern Europe strived to meet the convergence criteria for eurozone membership. The Maastricht Treaty required countries aspiring to join European Monetary Union to maintain interest rates, inflation and government deficits within strict parameters. For the Southern Europeans, this meant a dramatic reduction in nominal wage growth which could only be achieved with the collaboration of the trade unions, who signed up to painful wage restraint, at least until euro membership was secure. Social pacts were agreed in Spain and Italy which kept inflation and interest rates close to the European average, whilst tax rises and government spending restraint kept deficits within range. Once the euro came into circulation, these pacts began to break down. In the absence of effective coordination in wage bargaining, costs rose more quickly than productivity, a familiar problem in the past, but for which the traditional remedy – competitive devaluation – was no longer available.

The absence of a tradition of collective bargaining capable of delivering wage restraint certainly exposed Southern Europe to competitiveness problems. However what the conventional narrative tends to understate is that wage growth in the South and high savings rates in the North were two sides of the same coin. The excessive wage rises in Southern Europe were the consequence of excess capital accumulation in the North, which were recycled into net capital inflows for the South. These inflows had inflationary effects, generating increases in investment and consumption, both of which pushed up wages and prices. In a monetary union, national governments have no monetary policy instruments with which to curb such inflationary effects, and the relatively slow economic growth in Germany led the European Central Bank to set interest rates at levels which were extraordinarily loose for the faster growing Southern economies. In other words, Germany's savings and the ECB's monetary policy led to an economic boom in the South, which quickly translated into large trade deficits and a higher real exchange rate for the Southern European economies. There was no way for the Southern Europeans to counter this, save running historically unprecedented budget surpluses.

From this perspective, the Southern European crisis becomes a typical case of volatile capital movements, with an investment boom followed by a 'sudden stop', as in the Asian financial crisis of the late 1990s[7]. The speculative flow of capital into the eurozone periphery accelerated through to the mid-2000s, fed by the confidence generated by initial high returns, before stopping dead as the global financial collapse took hold. As the resulting credit crunch hammered the Southern European economies, a reverse flow was generated by the 'flight to safety' as investors tried to liquidate their positions and place their money in safe havens such as Germany. The abolition of capital controls by the Single European Act meant that national governments could do nothing to stem this outflow, whilst the ECB made its own contribution by deciding a premature tightening of monetary policy in spring 2011, and the European Commission blamed the victims and demanded recession-inducing fiscal contraction to address the explosion of government deficits resulting from the crisis.

The European institutions' focus on government borrowing as a response to the crisis is the clearest demonstration of the design faults of the eurozone. The Stability and Growth Pact established that governments should not run deficits of greater than 3% of GDP, but in the year after the financial collapse of autumn 2008 output collapsed by around 5-6% in most eurozone countries. Even without adopting any kind of stimulus measures, deficits quickly rose towards 10% of GDP in countries such as Ireland and Spain, which had been running budget surpluses prior to the crisis. This rapid reversal was the result of bubble-related tax revenues collapsing whilst social spending rose to cope with higher unemployment, and in the Irish case, an unwise national government bailout of the banking system. The effects were catastrophic in Greece, which had been running clearly excessive deficits in the boom years, but fiscal policy had not been obviously reckless in the other cases (see Figure Two). Yet European policymakers insisted that the fiscal damage caused by the crisis needed to be addressed immediately, pushing Southern Europe into a deep and sustained recession.

(Figure Two About Here)

In short, the Southern European 'problem' as such is not essentially a problem of fiscal profligacy leading to government deficits, except in the Greek case. That said, the Southern European countries' institutions have proved ineffective at managing the consequences of monetary union. Problems such as lax financial controls in the public administration, high rates of tax evasion, product and labour market rigidities and endemic corruption have all been identified as obstacles to economic recovery. For this reason bailouts and other forms of assistance are tied in the rhetoric of Northern European politicians and EU leaders to the need for 'structural reform'. But what exactly does structural reform mean, and can it contribute to saving the eurozone? The rest of this chapter discusses the politics of structural reform in Southern Europe.

Structural Reform and 'Embedded Illiberalism' in Southern Europe

The structural reform agenda in the EU, launched formally by the Lisbon summit of 2000, aimed to spur economic convergence in the European Union by establishing a common approach to supply-side policies which would encourage efficient allocation of resources and promote greater economic integration[8]. The Lisbon objectives revolved around more efficient market regulation and government intervention to improve human capital formation and innovation, with an emphasis on social cohesion as well as market liberalization. Alongside the measures to reform welfare provision and labour markets contained in the European Employment Strategy, and the fiscal and monetary convergence implied by European Monetary Union, a common European approach to economic policy was formalized around broadly market liberal principles, accompanied by a (less enthusiastic) recognition of the European traditional of social protection.

Progress in applying these principles could be assessed by consulting a variety of scorecards and league tables (some European in scope, some global) which measured the degree of consistency of national policies with the common framework[9]. Northern European, and especially Scandinavian, member states generally scored highly, the UK and Ireland also performed relatively well, whilst the large economies of continental Europe lagged somewhat. Southern Europe consistently performed poorly in these analyses, and a number of observers identified this slow progress as a potential source of strain in European economic management[10].

This slow progress was, however, entirely predictable, given the inconsistency of the aspirations of the Lisbon agenda with the entrenched institutional arrangements in Southern European countries. The Southern European countries exhibit features of 'embedded illiberalism'[11]. The distinctiveness of this model lies in its extensive use of regulation and complex (and sometimes corrupt) bureaucracy to control, distort or suppress market mechanisms. To capture this institutional pattern and place it in a comparative context, Figure Three presents aggregate scores on various measures of market regulation, which captures the bureaucratic hurdles that have to be overcome to set up a business. This is a reasonable proxy measure of the broad weight of regulatory intervention of the state in economic activity[12]. Low scores indicate lower and high scores indicate heavier regulation.

(Figure Three About Here)

This map of market regulation in the OECD yields some predictable and some less obvious findings. Whilst it is no surprise to find New Zealand, Canada, the US and the UK, which have enthusiastically adopted the deregulation agenda, at the light regulation end of the scale, it is significant that egalitarian Denmark has light regulation, and the other Nordic social democracies Sweden and Finland are also in the less intrusively regulated half of the sample. At the other end of the scale, Mexico, Turkey, Central Eastern and Southern European countries have negative scores reflecting their 'statist' tradition of heavy government intervention in the economy[13], whilst Germany, Austria and France also rank lower. In the middle we find Belgium, the Netherlands, and Norway, as well as Japan. Elsewhere, state intervention through complex bureaucracy, rules and regulations tends to be greater.

Analysis of product markets, labor markets and financial markets confirms that in many policy areas the OECD countries are divided between more 'liberal' political economies were economic activity faces lighter regulation, and more 'statist' political economies where regulation is heavier[14]. Anglo countries have the lightest labour regulation, the Southern European countries tend to have more rigid employment rules, while the other continental and Northern European countries tend to be placed in between[15]. Similarly, in financial market regulation most of the Anglo countries and Northern Europe have lower barriers to competition in the banking sector, whilst Central and Eastern Europe has higher barriers, with Southern Europe somewhere in between, and Spain below average[16].

Southern European political economies are characterized by high levels of economic regulation generally[17]. These consistent patterns have important consequences for Southern Europe's ability to meet the demands of structural reform emanating from the EU. The distance these countries were required to travel in order to reach the benchmarking standards was much greater than for the Northern countries of the EU, and not surprisingly most analyses placed the four Southern countries way down the scale in terms of structural reform performance. The World Economic Forum's 2010 'Lisbon Review' placed Italy 25th out of the 27 EU member states (ahead only of Rumania and Bulgaria), with Greece 23rd, with Spain 18th and Portugal 16th[18]. To place these results in a global context, the WEF's Global Competitiveness Index for 2012-13, which ranks 144 countries in terms of rather similar criteria[19], puts Spain 36th, Portugal 49th, Italy 42nd and Greece 96th.

In the light of this reluctance, or inability, to adopt measures recommended by a range of experts and international institutions, Southern Europe's current difficulties have been consistently interpreted as a failure to reform. In particular the failure to remove 'rigidities' in labour markets is adduced as an important source of reduced competitiveness and external imbalances[20]. The structural reform agenda of course consists of a number of measures that are obviously desirable, all else equal, such as improving the transparency and efficiency of the public administration. But the notion that structural reform, and in particular deregulatory structural reform, is unambiguously positive irrespective of broad institutional and social conditions can and should be challenged. First, liberalization in search of flexibility (for instance in labour markets) can be destabilizing, particularly in times of crisis. Moreover, the costs of structural reform in such an acute recession may end up politically undermining the whole idea of liberalization. The rest of this paper explores the dynamics of reform, and non-reform, in Southern Europe, with particular attention to Spain and Italy.

Heroes and Villains: Growth and Reform in Spain and Italy

Although a broad narrative about the problems of Southern Europe, the Euro and structural reform has developed over the last decade, important distinctions should be drawn between the various cases. First, their growth records under monetary union have differed markedly, Spain and Greece enjoying consistently high growth from the mid-1990s up until the crisis, whilst Portugal and particularly Italy stagnated. Second, the nature of the crisis differs in the four cases. In Greece a combination of growth, a large current account deficit (reaching up to 14% of GDP at its peak; see Figure One) and simultaneously a large structural budget deficit and large total volume of public debt (visible even before the crisis) has created a desperate situation in which a collapse in output has coincided with unsustainable public finances. Greece therefore faces a competitiveness and a fiscal crisis. In Portugal, growth was anemic and budget deficits generally high, but total public and private indebtedness was more contained. In Italy, growth was anemic but budget deficits remained broadly under control, despite the very high total volume of public indebtedness, and private indebtedness remained moderate. In Spain, in contrast, buoyant growth encouraged a consumer boom based on credit, and although the government finances were sound, the collapse in output has created a debt crisis in the private sector, and with a lag, in the public sector. In sum, all of these countries face high unemployment, low productivity growth and varying degrees of fiscal strain, but there are important nuances.

The Italy-Spain comparison is particularly interesting. Although both countries have performed relatively poorly in the various benchmarking exercises carried out by international organizations, Spain was considered by most observers to be on a much more positive trajectory than Italy, reflecting its much higher growth rates as the European economy recovered from the currency crises of the early 1990s (the collapse of the exchange rate mechanism)[21]. Spain was applauded for its embrace of relative economic openness, a fairly high degree of financial liberalization, and comparative fiscal rigour. Spain was also successful in attracting foreign direct investment, which transformed Madrid into a major corporate and banking centre. On the other hand, some large Spanish companies embarked on ambitious programmes of expansion making acquisitions particularly in South America. Spain still faced criticism for its dualistic labour market model, which offers some workers extraordinary degrees of job security whilst most younger workers face a succession of temporary contracts. But notwithstanding Spain's limited ambition in structural reform, it developed through the 2000s a reputation as a dynamic and forward looking economy, at least in comparison to the other Southern European countries: as the European Commission triumphantly claimed in 2005, 'the story of the Spanish economy in EMU is a dazzling one'[22].

The Italian experience was very different. In the same period, Italy's stagnant growth rates were attributed to an inward-looking and sclerotic form of crony capitalism that was incapable of addressing its chronic decline in competitiveness. The comparison occasionally surfaced in public debate in Italy, with the poor Italian growth record being set against Spain's apparently vibrant economy as an indication of Italy's decline compared to its culturally and historically similar neighbours[23]. Whilst Spain appeared open to capital inflows and willing to integrate more closely with the European and global economy, Italy shut out foreign investors and sought to protect declining domestic industries: foreign direct investment in Spain was almost twice as high in absolute volume as in Italy (see Figure Four). Aznar and Zapatero were lauded abroad for presiding over Spain's economic 'miracle' while Prodi and Berlusconi were assailed in the international press as unfit to govern the European Commission and Italy respectively[24]. The Economist magazine, ever the bell-weather of elite thinking on economic performance, stated baldly that Italy was 'the sick man of Europe' and that its 'economy was stagnant, its businesses depressed, and reforms moribund'[25].

Two brief vignettes – of the air travel and banking sectors – bear this out. In the air travel sector, both countries had national carriers under state control, which suffered from high costs and declining market share as the European market was liberalized in the 1990s. The Spanish response was to privatize Iberia and through a combination of cost-cutting and expansion (for instance the acquisition of Aerolineas Argentinas) restore its financial position. It ultimately merged with British Airways, placing it in a position to survive in a radically restructured world market.

In Italy, tentative attempts were made to follow a similar strategy, but an increasingly politicized atmosphere led these efforts to break down. Alitalia was also suffering dramatic losses as European reforms undermined its national monopoly and the political tensions between Rome and Milan prevented the emergence of any Italian airport as major hub (the botched launch of Milan Malpensa as a Northern hub being an object lesson in inept and clientelistic management, and the costs of political opportunism[26]). A decision was half-heartedly taken to privatize and encourage a merger with one of the emerging conglomerates of national carriers, with Air France-KLM being favoured. However the weakness of the centre-left government of Romano Prodi prevented this move going through – the government fell in early 2008, and the centre-right under Silvio Berlusconi launched a populist campaign to 'save' Alitalia as a national carrier, rejecting foreign acquisition and instead promoting an Italian merger with the loss-making Air One, subsidized by the government and by air travellers (with Alitalia being accorded monopoly rights on the Milan-Rome route for a period of time to help finance the deal).

In the banking sector, a similar contrast can be observed. The Spanish financial sector had long been consolidated into a small number of large, national banks which had ambitions of overseas expansion. However, the Spanish market was also opened to foreign acquisitions relatively early, with British mortgage lender Abbey National opening in Spain in the early 1990s, and Deutsche Bank acquiring the Banco Zaragozano. Liberalization measures in the 1990s encouraged a substantial growth of mortgage lending and consumer credit, facilitating a housing boom that began in the late 1990s and ended only in 2007 with property prices in Madrid reaching levels to rival the most expensive cities in the world. The boom in prices also fed a construction boom, with huge house-building projects along the length of Spain's Mediterranean coastline (often fuelled by local-level political corruption, as building permits were exchanged for money or political favours; the scandals surrounding Valencia regional president Camps being an eloquent example). Properties were bought by many foreign buyers, often retirees or small investors from Northern Europe (financing a substantial part of the emerging trade deficit). Although the Bank of Spain regulated the banks relatively tightly (enforcing counter-cyclical reserve requirements) the small regional savings and loans (*cajas de ahorros*) were able to build up unsustainable exposures to the housing market, which was very clearly in an Anglo-Saxon style bubble.

The Italian banking sector has a different history; until the 1990s it was highly fragmented, with few large national-scale banks and many small regional and local institutions with close ties to local politics (many of them state-owned to some degree). The period since has seen rapid consolidation, with regional savings banks absorbed into emerging conglomerates, such as Unicredit and Intesa-San Paolo. However, the sector remains relatively inward-looking and politicized, as one recent episode illustrates clearly. When Dutch bank ABN-

Amro sought to expand into Italy by buying the Venetian Banca Antonveneta in 2005, Bank of Italy governor Antonio Fazio pulled out the stops to block the deal. He first used regulatory powers inappropriately, and then mobilized contacts in the Italian financial world to generate an unsuccessful counter-bid, which allegedly used insider-trading to raise the capital for an alternative deal (the banker leading the consortium, Fiorani, was jailed). The affair seemed symptomatic of everything that was dragging the Italian economy down: regulatory inefficiency, inflexibility, corruption, and cronyism. Yet when the financial crisis hit, ABN-Amro, now owned by the Royal Bank of Scotland in a deal involving the Spanish Banco Santander, found itself forced into the arms of the British taxpayer by insolvency. In an ironic twist, Antonveneta was sold off by Santander back to another Italian bank, Monte dei Paschi di Siena[27]. Again, the national model of capitalism was protected by political interventionism, in contrast to the relative openness of the Spanish political elite to international economic and financial integration.

These two examples serve to make the point that, within the broad pattern of 'embedded illiberalism' we can observe in Southern Europe, Spain appears much more open to integration than Italy, and received plaudits (at least until 2008) from international organizations and the financial press as a result. The catastrophic collapse of the Spanish economy in the last two years is therefore a remarkable outcome. Spain's impressive growth performance was, it turned out, a mirage resulting from an unsustainable property bubble. The resulting building boom spilled over into the rest of the economy, bringing unemployment down to unprecedented levels, whilst speculative property investments from Northern Europeans helped generate a trade deficit which reached around 10 per cent of GDP at its peak. Just as we saw in the other bubble economies, investors over-reached themselves, leaving deserted building sites, at least a million unsold homes, and a 4 per cent drop in output in 2009. Despite running fiscal surpluses and provisioning for future losses in the banking sector in the good years, Spain very quickly found itself running fiscal deficits of around 10 per cent of GDP.

In contrast, Italy, which has not run a budget surplus for over quarter of a century, is surprisingly in a better (or less disastrous) position. The current government deficit is, at just over 5 per cent of GDP, within touching distance of the Eurozone's much maligned Stability Pact, and although the overall levels of government debt remain high (over 120% of GDP) Italy is still running primary fiscal surpluses even in the midst of the recession. Output has certainly shrunk sharply and unemployment is rising, but not on a scale comparable to Spain, and although Italy has not embarked on anything approaching a recovery, it is not suffering the freefall facing its Mediterranean neighbour. The next section will draw out some of the political implications of the comparative trajectories of these two countries.

The Dark Side of Structural Reform

This chapter has argued that the liberalizing structural reform agenda is no panacea for the imbalances within the eurozone, and may even have brought more damage than benefit to Southern European countries. Although all of the Southern European countries have been condemned at various points as structural reform 'laggards', there are grounds for dismissing the widely held view that this failure to reform is an important cause of the crisis. Moreover, if this is the case, by extension the widely touted remedy for the crisis – financial aid coupled with a commitment to structural reform on the part of the debtor countries – is unlikely to bear the expected fruit. This section examines why is structural reform so difficult to achieve, and why its results are so often disappointing.

The first point to be made is that liberalization measures interact with other economic and social institutions, sometimes with perverse effects. This suggests a 'dark side' to structural reform, with its emphasis on flexibility in the labour market and openness in product and financial marktes. Although the big Spanish banks adopted a conservative approach to capital requirements, Spain's openness to foreign capital flows allowed the over-confidence and excessive risk-taking in the international financial system to stoke a housing boom to match those in the US, the UK and Ireland. On a macro-level the supposedly sound budgetary position of the Spanish government also masked the accumulation of household debt, while the euro hid the symptoms of an unsustainable trade deficit. The partial liberalization of the labour market – Spain has the highest proportion of temporary workers of any EU country – allowed the effects of recession to feed into the labour market rapidly and acutely. Spain's embrace of some of the key features of the economic policy orthodoxy of the early 21st century – financial innovation, balanced government budgets, labour market flexibility (at least for part of the workforce), openness to trade and foreign investment - did not avert a disastrous crisis. The high levels of indebtedness of Spanish households, a major break with tradition, are particularly problematic given the limits of the Spanish welfare state and the importance of the family as a social shock absorber.

While Spain was prospering, Italy was supposedly doing everything wrong. Outside capital – whether industrial or financial - was shunned[28]. The stories of Antonveneta and Alitalia are evocative of broader trends in the Italian economy. This protectionist and mercantilist style has clear efficiency costs. But rejection of open markets, long criticized by outsiders as a drag on growth, proved an asset when the global financial system imploded. Hostility towards foreign investment protected Italy from the direct effects of the crisis, as there were limited flows of hot money to dry up. Italian output suffered as a result of the collapse of its export markets, as much as from a fall in domestic demand. In sum, despite the apparently dysfunctional nature of Italian economic institutions, it can be argued that these institutions proved helpful in protecting Italy from international financial turbulence[29].

Not only did (partial) structural reforms fail to produce clear benefits on economic performance, the political implications of the crisis undermine the reform agenda still further. The crisis has discredited the 'Anglo-Saxon' model of capitalism which inspired at least in part the Lisbon process and the push for reform from institutions such as the IMF and OECD. To the extent that structural reforms are associated in the public debate with the excesses of financialization, the case for these reforms is weakened. The severe imbalances of the Spanish economy were ignored because Spain ticked the correct boxes according to the orthodoxy of the boom years: fiscal probity, openness to financial flows, a booming real estate market and an acquisitive and outward looking corporate sector. The collapse of this model can only discredit these policies.

In Italy, the crisis is also likely to reinforce economic policy conservatism. The Italian elites' determination to retain control of their economy by curbing markets was theorized by Giulio Tremonti, Berlusconi's Treasury Minister, in a book, *La Paura e la Speranza*, published in early 2008[30]. For Tremonti and his allies on the Italian right, globalization was always seen as a threat rather than an opportunity. The Italian left, ironically, has increasingly embraced a 'third way' style of politics that accepts many features of market liberalism, such as flexible labour markets[31]. But after the experience of the Monti government, which combined attempted structural reforms with tax increases and restrictions on spending, the Italian electorate's suspicion of liberalization remains strong.

In sum, structural reform has failed in Southern Europe. It has failed in that most of the agenda remains unfulfilled, but it has also failed because to the extent that liberalization measures were taken, they cannot be defended politically as unqualified successes. Given the political difficulties of pushing through reforms which in many respects would be inconsistent with entrenched social and economic institutions, this suggests an increasing rejection of reform. The association of reforms with austerity policies imposed by supranational institutions, under the threat of punishment by the bond markets, seems almost designed to mobilize electoral support for protectionist policies. The Southern European countries and Ireland have seen the biggest drops in popularity of the European project over the years since the crisis[32]. For the European Union to blame the crisis on these countries' reluctance to reform, and impose strict pro-cyclical fiscal policies, is courting further popular hostility to European integration.

Conclusion: Reform or Revolt?

This chapter has drawn on the experiences of the two largest Southern European democracies – Italy and Spain – to argue that the sovereign debt crisis in the eurozone has been misinterpreted. Northern European politicians and European Union leaders have focused on the alleged fiscal irresponsibility and inflationary wage rises in Southern Europe as causes of the crisis, neglecting to take seriously the role of financial flows within the eurozone as the real cause of the problem. Although Southern Europe's characteristic institutional arrangements have many flaws, they are not the sole cause of the crisis, and in some respects, may have helped mitigate its effects. The comparative analysis of Italy and Spain illustrates that the rush to open peripheral economies to capital flows from surplus economies in the North was the real threat to the integrity of the eurozone. The protectionist instincts exhibited by Italian political and business elites may have contributed to containing the effects of global instability for Italy, whilst Spain's more enthusiastic embrace of financial integration exposed it to the bubble dynamics generated by unrestrained and unregulated capital movements.

There are at least two possible explanations for this misinterpretation of the nature of the crisis on the part of European elites. The first is that it is politically easier to blame the victims of the crisis, and helps avert the risk that the response to the crisis would threaten the interests of the creditor nations within the eurozone. After all, blaming the failings of the debtor nations deflects attention away from the reckless and inept management of the North's financial surplus by its financial institutions. A focus on the failings of the financial sector would increase the pressure on Northern European creditors to consider debt restructuring, and would also build momentum behind the push for stronger regulation of the European financial system, a thorny political issue that European leaders seem reluctant to address.

The second interpretation emphasizes the ideological blinkers afflicting European policymakers in the current context. The design of European Monetary Union reflected the dominant thinking in elite circles about economic governance in the 1990s, and in particular, the dominant view on how the economy works amongst German political and financial elites. These dominant views emphasized the efficiency of financial markets (which justified unrestricted capital flows, allowing money to be invested in ways which would supposedly maximize returns), the undesirability of exchange rate flexibility and inflation, the importance of fiscal probity, and a preference for 'light touch' regulation in the financial, product and labour markets. These views reflected in part the broad 'Washington consensus' centred around US elite thinking, and in part the preferences of the dominant actors within the European Union. The response to the crisis was naturally conditioned by the assumptions made by the designers of the monetary union.

Given these assumptions, the crisis in Southern Europe could not possibly be the consequence of financial markets' inherent instability or the dangers of excessive monetary rigidity. Instead, the problems lay in the reckless behaviour of Southern European politicians who spent too much public money, and the greed of Southern European trade unions who bid wages way beyond competitive levels. Given this interpretation of the crisis, it is only natural that European policymakers should identify greater restraints on national fiscal autonomy and structural reforms of labour markets as the way forward. Moreover, it follows from these assumption that counter-cyclical macroeconomic policy is out of the question, since it would only worsen the problem of government indebtedness whilst likely sparking inflation. Hence, the only response to the crisis, save last minute bailouts when the eurozone appears close to collapse, is to impose austerity and demand structural reforms. But if the analysis presented here is correct, these policies are entirely misplaced, and fail to address the real problems of the institutional framework of the eurozone. Not only will these policies most likely fail, they may well prove politically self-defeating, encouraging a populist, anti-European backlash in the periphery countries.

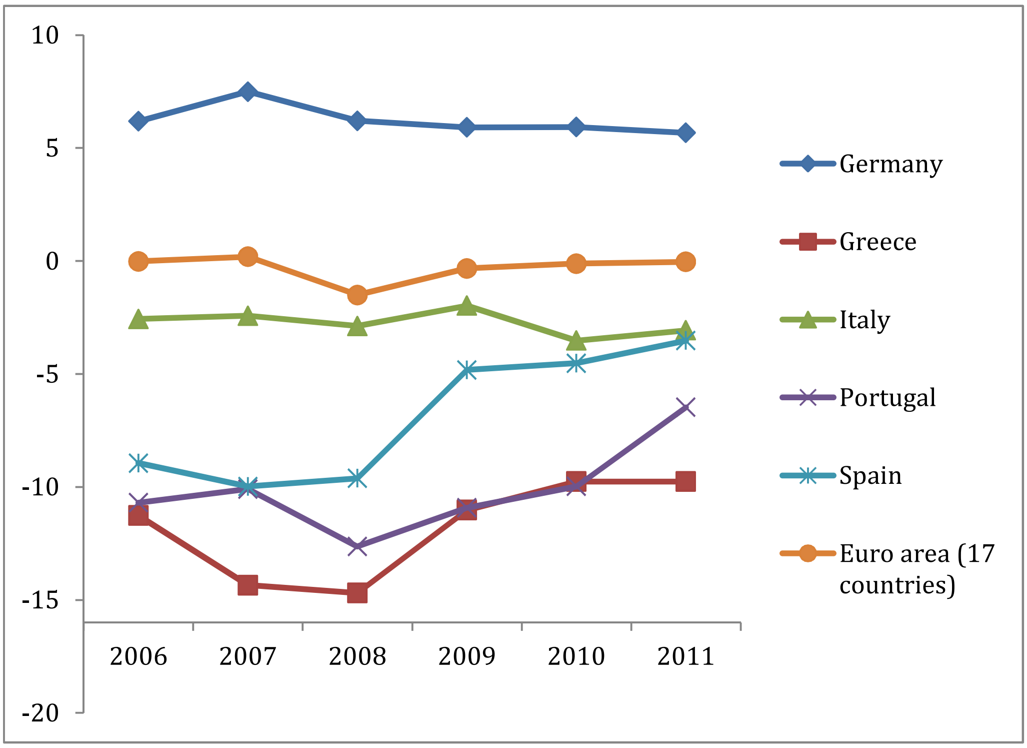
The threats to political stability in Southern Europe are clear, and they are closely related to the structural reform agenda. Economic reforms face a classic political dilemma: the costs are concentrated and immediate, whereas the benefits are diffuse and delayed. For this reason, opponents of reform are more likely to mobilized than the potential beneficiaries, leaving reformist governments exposed to high political risks with very uncertain rewards[33]. In the midst of a severe economic crisis, structural reforms will likely face even greater opposition than in normal conditions, since losers from reform stand to lose more, given the scarcity of economic opportunity. In the first three to four years of the crisis, protests against austerity policies were not of the order of magnitude necessary to threaten political stability. As the recession continues and even deepens, the potential for disorder increases, and government proposals for structural reforms which would deprive some social groups of their livelihoods can be expected to provoke a response.

At the time of writing, political upheavals in Spain and Italy have been relatively contained, but each country currently faces destabilizing threats. In Spain, one clear effect of the crisis is the sharpening of the territorial cleavage, with a strong rise in pro-independence sentiment in Catalonia, and the strategic shift of the mainstream nationalist party, Convergence and Union, in favour of a referendum on Catalan statehood[34]. In the presence of a conservative Spanish nationalist party – the Popular Party (PP) - in the central government, this development has the potential to disrupt inter-territorial solidarity at a moment when the Spanish state is demanding spending cuts of its regional governments. In Italy, where elections were held in February 2013, the backlash has taken the form of the dramatic rise of an 'anti-politics' party, the Five Stars Movement led by comedian Beppe Grillo, which has enjoyed close to 20% support in some recent opinion polls. Grillo's movement has few policy ideas, and most of its programme consisted of cuts in the salaries of elected politicians and experiments with direct democracy. Moreover, the centre-right alliance of Berlusconi's Party of Freedom with the separatist Northern League campaigned on an anti-austerity theme, blaming the European Union for Italy's fiscal problems.

Imposing further austerity and structural reform in these circumstances is fraught with risk. The euro crisis and the troubles of Southern Europe are developing into a kind of political economy experiment, testing the resilience of the social order and the political institutions of some of Europe's youngest democracies. The austerity programme places all of the burden of adjustment on the eurozone's debtor nations, whilst the recommendations of the European institutions for structural reforms require key elements of the social settlement of Southern European countries to be dismantled in the midst of the worst economic crisis for decades. The slow-motion collapse of the Greek political system provides a stark warning of the possible consequences of this experiment.

Figure One

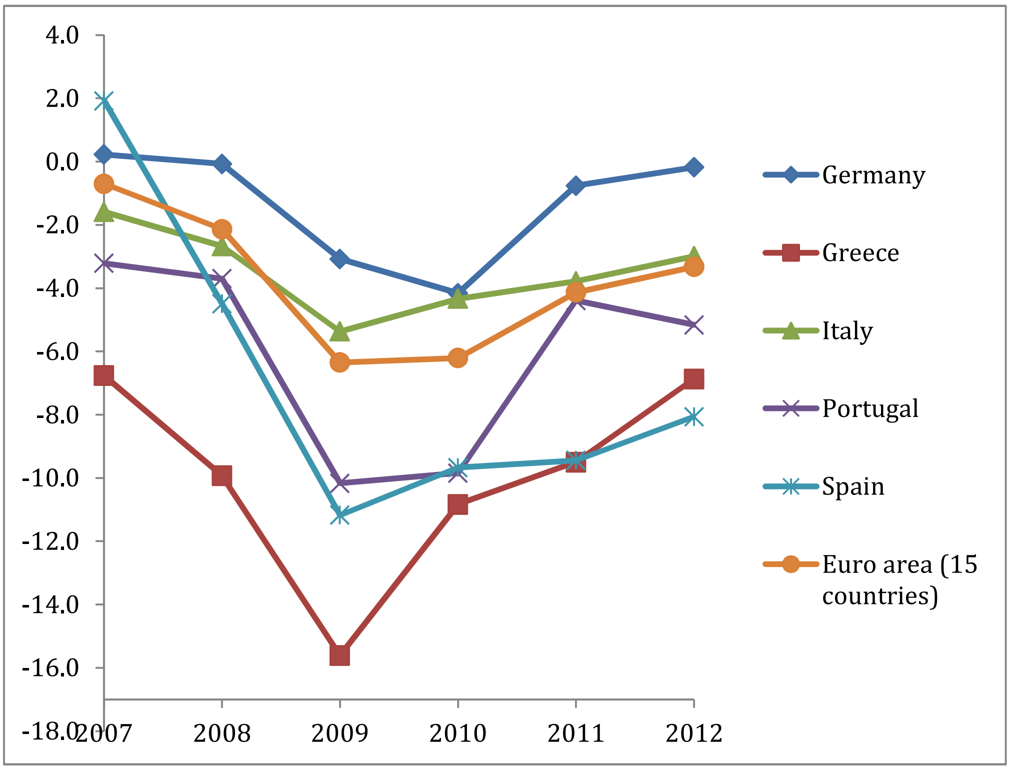
Selected Current Account Balances 2006-2011 (percentage of GDP)



OECD Stat Extracts: http://stats.oecd.org/

Figure Two

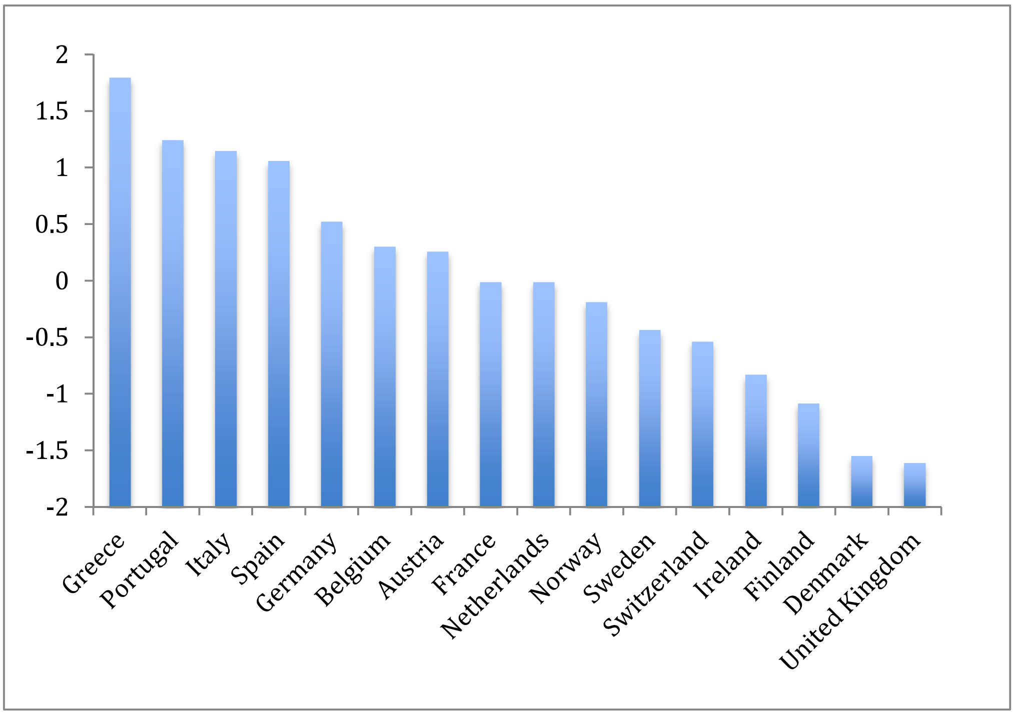
Selected Government Deficits 2007-12 (percentage of GDP)



OECD iLibrary: Key Tables: http://www.oecd-ilibrary.org/

Figure Three

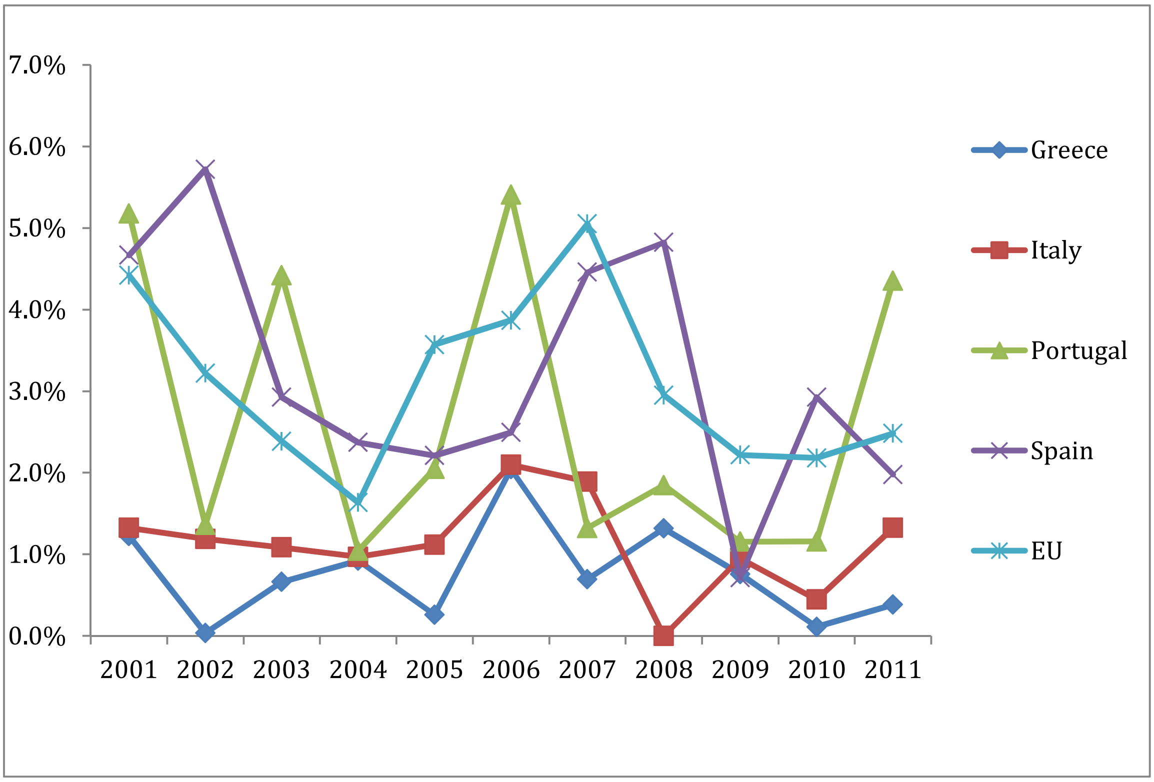
Market Regulation, Selected European Countries early 2000s



Market Regulation: Factor regression scores for 18 regulatory variables (higher scores imply more restrictive regulation). Source: Jonathan Hopkin and Mark Blyth, 'What Can Okun Teach Polanyi? Efficiency, Regulation and Equality in the OECD', *Review of International Political Economy* 19/1 (2012): 1-33.

Figure Four

Foreign Direct Investment Inflows, Southern European Countries 2000s (percentage of GDP)



OECD iLibrary: http://www.oecd-ilibrary.org/

Notes

[1] The infelicitous acronym 'PIGS' refers to Portugal, Italy, Greece and Spain, the four Southernmost democracies in the pre-enlargement EU, which had often been grouped together patronizingly, although less pejoratively, as the 'Club Med' countries in the 1990s by commentators hostile to or skeptical of their participation in European Monetary Union.
[2] For example, Roger Cohen, 'Greece, Europe and Alexander Hamilton', *New York Times*, 1 March 2010.
[3] See for instance 'Rising deficits in Portugal, Italy rattle Eurozone', *Financial Times*, 17 May 2005.
[4] Gideon Rachman, 'When Europe starts to melt around the edges', *Financial Times*, 26 January 2009 (cited in Susannah Verney, 'Flaky Fringe? Southern Europe Faces the Financial Crisis', *South European Society and Politics* 14/1 (2009): 1-6 (p. 1). An excellent analysis along these lines can be found in Peter Hall, 'The Economics and Politics of the Euro Crisis', *German Politics* 21/4 (2012): 355-71.
[5] Nouriel Roubini and Stephen Mihm, *Crisis Economics. A Crash Course in the Future of Finance* (New York: Penguin, 2010), p.32.
[6] Martin Rhodes, 'The Political Economy of Social Pacts: "Competitive Corporatism" and European Welfare Reform', in Paul Pierson (ed.), *The New Politics of the Welfare State* (Oxford: Oxford University Press, 2001), pp.165-94.
[7] Robert Wade, 'Wheels Within Wheels: Rethinking the Asian Crisis and the Asian Model', *Annual Review of Political Science* 3 (2000): 85-115.
[8] JonathanHopkin and Daniel Wincott, 'New Labour, Economic Reform and the European Social Model', *British Journal of Politics and International Relations*, 8/1 (2006): 50-68.
[9] For example, the Centre for European Reform's annual 'Lisbon Scorecard': http://www.cer.org.uk/publications/archive/report/2010/lisbon-scorecard-x-road-2020
[10] André Sapir, 'Globalization and the Reform of the European Social Model', *Journal of Common Market Studies* 44/2 (2006): 369-90; Guido Tabellini and Charles Wyplosz 'Supply-side Reforms in Europe: Can the Lisbon Strategy be Repaired?', *Swedish Economic Policy Review* 13 (2006): 101-56.
[11] Jonathan Hopkin and Mark Blyth, 'What Can Okun Teach Polanyi? Efficiency, Regulation and Equality in the OECD', *Review of International Political Economy* 19/1 (2012): 1-33.
[12] For a more thorough analysis of the data, see Hopkin and Blyth, 'What Can Okun Teach Polanyi'. Much of this data is drawn from the World Bank Institute's 'Doing Business' data collection project; see Simeon Djankov, Rafael LaPorta, Florencio Lopez-de-Silanes and Andrei Schleifer, 'The Regulation of Entry', *Quarterly Journal of Economics* 117/1 (2002): 1-37.
[13] On statism see Vivien Schmidt, *The Futures of European Capitalism* (Oxford: Oxford University Press: 2002).
[14] Hopkin and Blyth, 'What Can Okun Teach Polanyi?'.

[15] Juan C. Botero, Simeon Djankov, Rafael LaPorta, Florencio Lopez-de-Silanes and Andrei Schleifer, 'The Regulation of Labour', *Quarterly Journal of Economics* 119/4 (2004): 1339-82.
[16] Alain de Serres, Shuji Kobayakawa, Torsten Sløk and Laura Vartia, 'Regulation of Financial Systems and Economic Growth', *OECD Economics Department Working Papers*, No.506 (2006).
[17] In this analysis, for reasons of simplicity of exposition we neglect the important observation of authors such as Vogel that market liberalization generates the need for new regulation, so that talk of 'more' or 'less' regulation can be misleading; Stephen Vogel, *Freer Markets, More Rules. Regulatory Reform in Advanced Industrial Countries* (Ithaca, NY: Cornell University Press, 1998).
[18] Klaus Schwab (ed.), *The Lisbon Review 2010* (Geneva: World Economic Forum, 2010).
[19] Klaus Schwab (ed.), *Global Competitiveness Report 2012/13* (Geneva: World Economic Forum, 2012).
[20] For example Holger Zemanek, 'Competitiveness Within the Euro Area: The Problem that Still Needs to be Solved', *Economic Affairs* 30/3 (2010): 42-47.
[21] OECD, 'Policy Brief: Economic Survey of Spain. 2005' (Paris: OECD, 2005).
[22] European Commission, 'Country Study: Spain in EMU: A Virtuous Long-Lasting Cycle?', *Occasional Papers*, No.14 (Brussels: European Commission Directorate Generale of Economic and Financial Affairs, 2005).
[23] For example, Michele Salvati, 'Italia-Spagna: Un confronto' in Víctor Pérez-Díaz, *La lezione spagnola* (Bologna: Il Mulino, 2003); also Anna Bosco, *Da Franco a Zapatero. La Spagna dalla periferia al cuore d'Europa* (Bologna: Il Mulino, 2005).
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[25] 'Italy: The Real Sick Man of Europe', *The Economist,* 19 May 2005. http://www.economist.com/node/3987219
[26] David Hine , 'Malpensa 2000', in David Hine and Salvatore Vassallo (eds.), *Italian Politics: The Return of Politics* (Oxford: Berghahn, 1999), pp.209-26.
[27] See Marcello Messori, 'The Bank Takeover Bids and the Role of the Bank of Italy', in Grant Amyot and Luca Verzichelli (eds.), *Italian Politics: The End of the Berlusconi Era?* (Oxford: Berghahn, 2006), pp.139-63.
[28] Another example is the disastrous investment made by BG Group (British Gas) in Brindisi, in the Apulia region. A planned €500 million liquefied natural gas terminal was ultimately shelved after environmental approvals were withdrawn and local managers charged with corruption. 'Italy Halts BG Group Plan for Brindisi', *Financial Times* 8 October 2007. http://www.ft.com/cms/s/0/b5f1e6ac-75da-11dc-b7cb-0000779fd2ac.html#axzz2I4lsvava
[29] Lucia Quaglia, 'The Response to the Global Financial Turmoil in Italy: "A Financial System that Does Not Speak English"', *South European Society and Politics* 14/1 (2009): 7-18.
[30] Giulio Tremonti, *La paura e la speranza. Europa: La crisi globale che si avvicina e la via per superarla* (Milan: Mondadori, 2008).

[31] Alberto Alesina and Francesco Giavazzi, *Il liberismo e di sinistra* (Rome: Il Saggiatore, 2007).
[32] Fabio Serricchio, Myrto Tsakatika and Lucia Quaglia, 'Euroskepticism and the Global Financial Crisis', *Journal of Common Market Studies* 51/1 (2012): 51-64.
[33] Susan Stokes, *Public Support for Market Reforms in New Democracies* (Cambridge: Cambridge University Press, 2002).
[34] Jonathan Hopkin, 'Catalonia's Election Result Reflects the Fragmented and Divided Nature of the Pro-Independence Majority', LSE EUROPP blog, 27 November 2012. http://blogs.lse.ac.uk/europpblog/2012/11/27/catalonia-election/