LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

THE FRYING PAN BURNS LESS THAN THE FIRE

Why Italy should not go out of the euro

Marcello Messori

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1. *Introduction*

Leaving the euro or staying in the area is not an alternative that offers symmetrical advantages and disadvantages to Italy and to other "peripheral" Member States, as it would happen if these countries had to decide to enter or not in a new currency area from outside. First, the opting out which was used by the United Kingdom and Denmark in 1998 at the creation of the single currency, cannot be used by the peripheral countries of the European Economic and Monetary Union (EMU), except by an unlikely revision of the European Treaties. Second, the exit from the euro area requires to manage stocks accumulated in that currency; this problem, often labeled as the legacy problem, would not have risen with an initial opting out.

In the following *Policy brief*, my initial assumption may appear too academic since it refers to the ultimate abandonment of the EMU and, consequently, of the European Union (EU) by the side of a peripheral Member State.[1] In fact, the analysis of the effects of an irreversible abandonment are interesting because they foreshadow the outcome, where more realistic scenarios lead to. In particular, they apply to the case of a temporary exit of a peripheral country that aims at implementing an adjustment period. My analysis is specifically dedicated to Italy; and my conclusion is that, if this country decided to temporarily withdraw from the single currency 'frying pan', it would be condemned to the flames of the sixth circle of Dante's hell. This is not to argue that the current configuration of the EMU reflects the best of all possible worlds. However the severe criticisms that can and must be addressed to the European choices, cannot call into question the permanence of Italy (and that of other peripheral countries) in the euro zone.

[1] Despite what many commentators (see, among others: Soros and Stiglitz) suggest, here I do not consider the possibility of a permanent leaving of the EMU and the EU from a 'central' country (for instance, Germany). If this happened, the central country outgoing would drag along all the other central countries. This would create two different European Unions: the union of the central countries, and that of the peripheral countries. The latter would incorporate the same problems that are attributed, in the text, to the peripheral outgoing country.

2. Out of the EMU, out of the EU.

Given the existing legislation, the extreme assumption of the exit from the EMU would entail the exit from the EU. Therefore, for a peripheral Member State, the disadvantages of its unilateral abandonment of the euro would be massive. The resulting withdrawal from the EU would lead this member to an expulsion from the EU single market and other cooperation pacts. Moreover, the EU members would not be ready to sign with the defector State (henceforth, referred to as *D*) agreements similar to those that characterize the relationships between EU and other non-EU European countries or between EU and non-European countries (for instance, developing countries), and that go beyond the WTO duty to apply the “best conditions” clause to all. As a result, *D* would be condemned to the devaluation of its currency, and then to protectionism. In a world of integrated markets, this would mean being unable to implement an adjustment process and taking the risk to be deleted from the list of advanced economies.

Since neither its government nor most of its private companies would be able to cope with their debts in euro through the proceeds coming from the new and devalued national currency, *D* should declare itself insolvent on the international markets and should restructure its debt; this would exclude *D*, for a long period of time, from monetary international transactions not covered by an adequate flow of 'real' goods and services or by an adequate amount of collaterals. In such a situation, it is likely that the big and medium-size firms of *D* with a strong international presence and without internal rent-seeking positions would be pushed to move their headquarters abroad; many small-to-medium and other medium-size firms of this same country would be expelled from or marginalized in international value chains (see also below, section 4); the affluent households of *D* would transfer their financial wealth abroad; and the most qualified human resources would leave the country. All these factors would trigger pressures for increasing the public spending (higher transfers to firms and strengthening of social protection mechanisms) and the interest rates on various forms of debt, so that a growing share of the public and private debt would have to be 'monetized' by subordinating the central bank to the political objectives. This would cause serious financial difficulties to households with mortgages and an impoverishment of social aggregates with fixed income. Moreover, it would further compromise the international reputation of *D* in terms of economic governance.

3. A temporary exit from the EMU

The picture above represents an extreme 'solution' that does not seem to suit the Italian case. Therefore, let us suppose more realistically that Italy agrees with the other EMU Member States a limited period out of the euro (i.e. the temporary adoption of the euro-lira), with a commitment to re-enter into the currency area once achieved the 'real' and monetary adjustments necessary to restore its competitiveness. The biggest cost of such an option would be managing the debts in euro (legacy), as the monetary adjustment would be based on a strong and repeated devaluation of the euro-lira compared to the euro.

First, there would be the problem of managing the debt exposure towards financial intermediaries and savers who are foreign or disguised as foreign and who own Italian government bonds. Although the percentage of this type of bondholders is now lower than that achieved before the European sovereign debt crisis, its absolute value is still huge and recently rising. The Italian government would have to face its debt obligations, that is paying the interests and liquidating the debt by its maturity, by converting a deeply depreciating euro-lira in euro. The country would also have to handle an unavoidable dispute towards the Italian citizens and companies (financial and non-financial), who hold bonds of the public debt denominated in euro and not in euro-lira currency, and who require the observance of the original debt contract.

A similar problem would also apply to the Italian banking groups. It is well known that, especially since the late Nineties to 2007, but even in the last period of severe credit crunch, the Italian banking sector has had to face a structural funding gap. In other words, Italian banks have had to cover a structural difference between the amount of loans supplied and the amount of traditional funding (bank deposits). Before the crises, this funding gap was covered by issuing a large amount of banking bonds ('plain vanilla' as well as structured bonds), at low interest rates. However, after the international financial crisis and the banking and sovereign bond crises in the EMU, and also thanks to the positive developments in the regulation of the European financial markets,[2] Italian banks have encountered increasing difficulties to issue non-covered and low-yields bonds. Thus, these banks built a strong debt position in the international wholesale market and towards the European Central Bank (ECB). Moreover, in order to protect their returns, these same banks used the low-cost liquidity provided by the ECB to buy Italian government bonds which offered higher yields. It follows that, in case of a temporary and agreed exit of Italy from the euro, the country's banking sector would face the risk to get a large part of its proceeds in euro-lira and to pay back most of its debt in euro. Similar considerations should be repeated for all the non-financial firms operating in the domestic market while buying a relevant portion of their input from the international markets.

The only part of the Italian economy, which could benefit from such a situation of currency devaluation, would be that represented by the subset of non-financial firms selling the prevailing shares of their output in the international markets but that can buy (a large amount of) their inputs from domestic suppliers. This subset of firms would experience an increase in its price competitiveness at international level. However we are referring to firms which are successful even under the current euro *regime*, and whose macroeconomic impact is not large enough to prop up the growth of an economic system overburdened by the other factors mentioned above. On the other hand, it could be maintained that the devaluation process would enlarge the number of Italian firms able to sell an important share of their outputs in the international markets. However, the advantages acquired by these latter firms might be ephemeral.

4. The debt management

In order to put the last statement on firmer foundations, let's analyze in some details the debt problems of the other and more extended part of the Italian economy in the case of a temporary exit

[2] One of the best examples is offered by the recent launch of the Banking Union. Let specifically refer to the resolution mechanism of banks' crisis, which characterizes the second pillar of the Banking Union. The 'bail in' process of a given bank implies the involvement of the holders of its non-covered bonds. Hence banks' bonds, which were considered low-risk assets before the financial crisis, can become high-risk assets since they have a counterpart risk.

from euro. For this part the alternative would be: (a) to pay with the original currency (i.e., euro) all the old debts, at least those with foreign counterparts, and hence to take the heavy and growing burdens deriving from the gradual devaluation of the euro-lira; (b) to reject debts in euro in order to renegotiate them in euro-lira terms.

In scenario (a), to cope with the growing financial burden linked to the debt service, both the Italian government and Italy's companies would have to increase their monetary takings through a growing aggregate demand. However, the long stagnation of the Italian economy from the beginning of the new millennium to 2005, the acute phases of recession that hit this same economy between 2008 and the end of 2009 and between the first half of 2011 and the third term of 2013, the consequent fall in the purchasing power of Italian households have caused a dramatic decrease in domestic demand and a risk of deflation. The new raising of the domestic demand in an Italian economy temporarily out from the euro would require substantial wage increases and public spending increases (in terms of transfers and investments). Moreover, wage increases would be justified by the high rates of non-employed in each family (in particular, the most vulnerable components such as women and youths),[3] and by the related economic and social difficulties that a growing part of the Italian households have had to suffer since 2008 until today (including dramatic increases in the relative poverty rates and a persistence of high levels of absolute poverty). Finally, increases in wages and in public spending would also be the effect of that social pressure which led to the exit from the euro and the effect of the pre-existing process of public finances consolidation.

The problem is that wage increases would push firms to raise output prices, thus determining an abrupt transition from deflation to high inflation; and the increase in government spending would force the government either to monetize a growing part of its debt or to further increase taxes and to raise interest rates on government bonds to attract domestic and international investors in spite of the increasing risks of inflation and devaluation. The consequence would be an abruptly halt in the containment of public spending. This would lead to a vicious circle between inflation and devaluation, to a trend towards out-of-control fiscal imbalances and to a strengthening of the rent seeking positions. These three outcomes, which were typical of the Italian situation during the Seventies and Eighties, generated strong macroeconomic instability. Today the consequences would be even worse.

The increase of domestic prices would require an acceleration in the depreciation of the euro-lira to reproduce the price competitiveness of Italian exporting firms. On the other hand, devaluation would increase the cost of imports for the large majority of Italian firms. Indeed, nowadays most of the Italian firms are included in international 'value chains' and, as a consequence, they import a large share of their intermediate inputs from firms which come before them in the integrated production processes of the chains, or from the enterprises which lead these same chains. Thus, the overall efficiency of the Italian firms included in the value chains crucially depends on the high-quality international suppliers, that are often an important source of innovation. A moderate

[3] Non-employed are the set of persons of working age who are unsuccessfully searching for a job (unemployed) or who are not in the labor force, that is are not working and are not looking for work even if they do not study and do not choose to be engaged in a non-wage-paying sector. This subset of persons of working age out of the labor force can be denominated discouraged workers, in the sense that they systematically tried to find a job but the lack of success pushed them to stop searching.

devaluation of the euro-lira would not prevent the Italian firms from reproducing these positive relationships on the international market. On the other hand, a strong depreciation, such as the one we are here referring to, would force the Italian firms to restructure their supply-chains, largely reducing the quantity and the quality of imported imports. The consequent shift from high-quality international partners to smaller and less efficient ones would throw out the Italian firms of their original value chain or would marginalize them.
Moreover, the high inflation would undermine the purchasing power of fixed-income households and of those individuals not protected by rent seeking privileges. This would have, at least, two consequences. First, it would drown in the macroeconomic instability the international competitiveness that a larger set of Italian firms tried to acquire through currency devaluation. Second, it would cause a further boost of the already increased government transfers to firms and households. The results would be that: the new export-led firms would obtain just ephemeral advantages; the current public spending would become out of control; and then, the imbalances in the Italian public balance sheet would be increased by the growing financial burden on government bonds and by the need to increase public investment .

5 . Is it bearable a throwback to the Seventies and Eighties?

The picture sketched in the previous section opens negative perspectives. To face the instability of the Italian economy, it would be necessary to introduce constraints which are incompatible with the functioning of the market and the pursuit of efficient institutional arrangements. For example, it may become necessary to impose distortionary and binding constraints to the management of the Italian banks, such as the compulsory obligation to use at least a minimum share of their assets to purchase domestic government bonds and to finance small and medium-sized firms. It may also become unavoidable to subordinate monetary policy choices to political decisions, forcing the Bank of Italy to buy increasing amounts of public debt, and to 'bail out' banks at the brink of insolvency. As a result, Italy would go back to a 'nationalized' banking sector which would offer an ideal channel to revive the iniquitous pact between economic actors, politicians and criminal organizations. The banking activity would thus escape the supervision of a central bank already under siege; and the network with the political power would allow banks to dump their possible losses on the community.
Given that the temporary exit of Italy from the euro area was aimed at re-adjusting its main disequilibria (the high public debt, the stagnation in productivity dynamics, the weakness of the economic institutions, the corruption, etc.), the likely outcomes described above are ruinous. To say the least, these outcomes will not allow the Italian economy to reinforce its competitiveness and to go back to the EMU with a sounder potential output. Thus the scenario (a), mentioned at the beginning of the previous section and characterized by the decision to repay all the old debts with foreign counterparts in euro, cannot be put in contraposition to the scenario (b), centered on the decision to renegotiate all the old debts in euro-lira terms. Differently from our previous assumption (see again the beginning of section 4), scenario (a) is a false alternative in the sense that it leads to scenario (b). And the latter, in its turn, would condemn Italy to the failing destiny of country *D* (see section 2).

The last statement implies a straightforward conclusion. The case of the ultimate abandonment of the EMU, which appeared to be just an academic achievement, highlights instead the implications of a temporary exit from the EMU. Hence the content of section 2 illustrates the most likely outcome led to by a temporary discharge of Italy by the single currency. This is not so surprising. The idea to suspend the euro membership of Italy is, in fact, equivalent to propose a temporary exclusion of the Italian economy from the competitive discipline of the international markets, that is to have recourse to a kind of protectionism. However, in an era of integrated markets, protectionism isolates from the innovations and severs the links between domestic firms and the rest of the world economy. How is it possible to think that such a move will induce virtuous adjustments and reductions in competitive gaps rather than backwardness and decay? An Italy out of the euro would be in even worse conditions than those of the Seventies and Eighties. Italy would end up falling into that situation of bankruptcy, that it tried to avoid; and it would stretch the spectrum of the Argentinian syndrome with populist drifts at the institutional level and with a heavy progressive impoverishment of the population at an economic and social level.

6. The euro area is not a paradise

The previous conclusion does not imply that the EU and EMU represented the best place to live in the last seven years. The economic and social life in the EMU, or at least in its peripheral Members States, dramatically worsened during the international financial and ‘real’ crises and mainly during the following European crises of the banking system and sovereign bonds. For instance, Greek population experienced a rough dismantlement of those economic and social institutions that were distorted but that accompanied the rapid growth in the domestic aggregate demand and in the GDP during the first phase of Greece’s participation to the euro area; hence Greeks had to suffer a falling off of their daily life which is beyond comparison in Europe after the Second World War. Portuguese population had to face a severe compression in real wages and hence in households’ purchasing power, which were accompanied by a deep economic recession; moreover, the current initial recovery of the country does not promise a loosening of the new economic and social constraints since the dynamics of various forms of productivity did not reduce the gap towards the EMU’s central countries. On the other hand, Spanish economy carried out one of the highest European increases in labor productivity; however, this positive result was achieved by means of a radical retrenchment of its productive system and the consequent firing of a large number of workers. It follows that these three countries are today characterized by dramatic rates of unemployment, growing rates of poverty, and a stunted rate of macroeconomic growth which is insufficient to weaken the first two problems.

A similar conclusion applies to Italy. The inadequate growth of the Italian economy comes before the creation of the euro area, and the stagnation of its productivity and GDP largely precedes the international crisis. However, this economy also experienced one of the worst performance since 2008 to today. It has been one of the last Member States of the EMU to be able to break off the long recession of 2011-’13; and the negative gap between its current GDP and its 2007’s GDP is one of the highest in the EU. The result is that, during the European crises, Italy suffered a dramatic increase in the rate of non-employed persons and in poverty indexes, recorded the longest and deeper decrease of households' purchasing power after 1946, did not adjust its delay in competitiveness by increasing its different forms of productivity.

This negative picture of the EMU is not just due to the financial and European crises and to the management of the latter by the European institutions. The roots of the current difficulties must be traced to the market and policy failures which prevented the process of convergence between peripheral and central countries since 1999 to 2007. In that period, European central countries exported goods and services and transferred financial flows to the European peripheral countries with the aim of maximizing their short term profits and without worrying about the medium-term robustness and stability of this process. On the other hand, peripheral countries exploited the related loosening of their current accounts' constraints to develop speculative activities and to increase consumption without worrying about their structural imbalances and their lack of competitiveness. When the crises arrived and the direction of the European financial flows was reversed (that is, from peripheries to the center) due to the "flight to quality", the fragile attempt to pursue a "free lunch" for all the EMU's countries collapsed.

It has to be emphasized that, in this new and difficult situation, the reaction of the European institutions was inadequate. It is true that the governance of the EU and EMU was revolutionized in few years (2010-2014) by launching aid programs to support Member States on the brink of bankruptcy, by designing a new and crucial role for the European Central Banking, by introducing new and more effective mechanisms (*ex ante* and *ex post*) to monitor and to adjust fiscal and macroeconomic imbalances, by implementing a centralized system to supervise the European banking system and to manage its possible local crises (i.e., the two pillars of the banking union). Nevertheless these radical innovations were implemented at the "last minute" or too late (with a consequent strong increase in economic and social costs), they were often conceived to solve specific cases on a temporary basis, they always implied too severe and asymmetrical adjustment conditions which condemned peripheral countries under aid program to implement Draconian policy interventions. These limits implied the prolongation and worsening of the recession in the EMU and, in particular, in the peripheral Member States.

7. Conclusions

The previous analysis showed that there are good reasons to criticize the European institutions and to maintain that the EMU's policies increased the economic and social costs of the crises in Italy and in the other peripheral countries. However, this same analysis also showed that the deep European recession had its root in two other factors. First, Italy and the other peripheral Member States did not implement the required reforms at home; second, the central Member States did not help the former to carry out these reforms. It follows that we have to make up for lost time and to reform the functioning of the euro area by means of the required reforms in each of the EMU's peripheral Member States and thanks to a more efficient cooperative behavior on the side of the central Member States.[4] In this perspective, a temporary exit of Italy (as well as Spain, Portugal, or Greece) from the euro area would have ruinous effects. Let just refer to the previous results reached

[4] I do not enter here into the different problem of the reforms to be implemented by the central countries. For instance, it is well known that German services would ask for a radical reorganization.

for the Italian case. This possible exit move would hinder any reform in Italy and any cooperation between this country and the EMU's central countries. Therefore the limited short-term advantages, which could follow from Italy's exit and which would relate to the possible increase in price competition for the subset of export-based firms, would be overwhelmed by the medium-long term disadvantages. As we saw, the latter are so important to threaten the same social and institutional cohesion of Italy.

Does this last conclusion mean that we have to accept the euro area such as it stands today? This question is ill formulated. It would be useless to list the advantages and disadvantages that Italy and the other peripheral Member States get from remaining in the euro area at the current conditions. The bet is to analyze how the current situation can be improved, given the recent evolution in the European economic mechanisms and institutions.

It is obvious that Italy as well as the other peripheral countries have a priority: the re-launching of economic growth and the consequent reduction of the unemployment and non-employed rates. And it is even more obvious that this priority can be met, in the short term, just by re-launching the aggregate demand at the national as well as at the European level due to the need to reverse the negative inertia deriving from the long recession. The German recovery, the increase of the domestic demand in some of the central Member States, and the initiatives undertaken by a number of governments in the peripheral Member States are opening new opportunities in this direction. These still fragile possibilities of short-term economic growth can be transformed into a more robust medium-term growth in the euro area, if Italy and the other peripheral countries were able to gradually close their negative gaps of competitiveness towards the central Member States. To obtain this result, the former countries have to implement a positive dynamics in their labor and total factor productivities instead of having recourse to real wage compression and deflation. They have to carry out reforms aimed at improving their institutional setting and at designing incentives for an innovative re-organization of their firms in the manufacture and services. These reforms could be eased by a European investment plan, centered on private-public partnerships and on a partial public financing backed by the issuance of European project bonds, and focused on asymmetrical adjustments[5] of potential imbalances inside the euro area.

[5] This asymmetry would have to compensate the asymmetry of the existing European mechanisms, which saddle the peripheral countries with the adjustments burden of macroeconomic imbalances. Hence, in the case under discussion, the European investment plan would have to favor the peripheral Member States.