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THE GOOD OL' DAYS OF BANKING THAT OUTLIVED THE LIRA AND RESISTS THE EURO

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IN THE FINAL WEEKS OF 2016, the Italian banks' saga threatened to unsettle the euro area. The failure to implement a market recapitalization of Monte dei Paschi di Siena (MPS) led to a sizable state intervention. Public money was necessary to soften the impact of the bank's resolution for thousands of depositors who, mostly unaware of the risks, had bought—or sometimes were fraudulently sold— subordinated MPS bonds intended for professional investors. A number of other pending problems in the Italian banking sector made analysts posit a potentially hefty price tag for the Italian government if the rest of the domestic financial system needed to be shored up. Given the high level of Italy's public debt, such an extraordinary intervention would have put its sustainability at risk. Some analysts even doubted Italy's permanence in the euro.

As was the case many times over the past eight years, ever since the Lehman crisis erupted, the dreariest outlook proved to be off the mark. Nevertheless, the Italian banking saga is far from over, and it would be damning for Italy, and the Euro area as a whole, to try to shove it under the rug. For Italy, it would be particularly important to come clean on what turned many banks from profitable firms into lemons in the turn of a decade. A relatively solid Italian bank (UBI) is in the process of buying three other minor institutions (Banca Etruria, Banca Marche, and Cassa di Risparmio di Chieti) for the symbolic price of one euro, less than an espresso. The acquired banks were active in the heart of rich Italian regions. Two, in particular, were lending money in two provinces where average income remains among the highest in Europe. Part of Italy's industrial backbone, these regions made the country the

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second largest manufacturer in Europe. In 10-15 years, profitable and well positioned banks managed to become worthless.

Since the beginning of the monetary union, when Italy's interest rates converged to the lower European levels, bank credit increased at a much higher rate in Italy than the country's income. A large part of the new credit poured into real estate activities, often bloated by a number of dubious politically connected moguls (not surprisingly, more than a few of them are now in jail). Some real estate entrepreneurs heavily engaged in the media industry to gain influence over public decisions. At the local level, it was easy for them to promise jobs and investments to local administrators and use local banks, which were close to political powers, to finance their ventures.

This may sound like an ordinary story of European capitalism—a mesh of intertwined interests, with several analogies across Germany, Austria, and, of course, Italy. However, the dramatic recession that Italy suffered lowered the tide so much that many banks started posting an increasing number of non-performing loans, particularly after the real estate bubble started to deflate across Europe. Although bank loans to the real estate sector (construction and related activities) amount to one-fifth of the total, the non-performing loans to the sector is equivalent to two-fifths of the total. Loans to the real estate sector were almost four times riskier than to the rest of the economy. After the turn of the century, Bank of Italy's banking supervision spoiled part of its good reputation when its heads were advised by a former governor (who was doubtful about Italy joining the euro and dreaded a "foreign financial invasion") to tread softly and even be complacent about what was going on. In fact, we have now discovered that a little more than half the loans to real estate sector enterprises were actually backed by real guarantees. As banking guru Marco Onado recently observed, the lack of real guarantees "is the clearest indication of how much risk the banks wanted to take".

Credit misallocation in favor of real estate is probably the main, though not the only, cause of the banking troubles that are still choking off the recovery and threatening Italy's stability and permanence in the euro. On the other hand, it is also the clearest evidence of what would happen in Italy without the euro—free credit to politically connected domestic agents eager to gain from inefficient businesses sheltered from external competition who would call for a new devaluation every time they wished to start their game from scratch, just as it happened for many decades when the currency was the lira and the political class was among the most corrupt in the Western world. Coming clean on Italy's problems and its permanence in the euro means understanding the difference between an open society and a closed one.