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ITALY AND THE EURO

Foreword

Something more than a decade has elapsed since the Euro start. The world economy is not in good health and most of the EU is in recession. Italy is experiencing its second worst year since the end of the second world war. The need for a reflection on what the Euro has meant and on its future is strongly felt. The present writing owes much to the stimulus received from Jerome L. Stein, *Stochastic Optimal Control and the U.S. Financial Debt Crisis* (New York, Springer, 2012), Chapter 8, The Diversity of Debt Crises in Europe.[1]

1 -Initial convergence and theoretical weakness of the Maastricht criteria

When planning the start of the single currency the Maastricht Treaty (1992) ruled that in order to be admitted the candidates should stay in the European Exchange Mechanism (EEM) for at least two consecutive years and reach a satisfactory economic convergence to be judged on the base of four indicators concerning: Government deficit, Government debt, Inflation and Interest rates. More precisely (1) the Government deficit as a percentage of GDP should not exceed 3%; (2) the Government debt as a percentage of GDP should not exceed 60% (the target may not be reached but the ratio has to be sufficiently diminished); (3) the consumption price inflation rate must not exceed the mean of the three best performing members by more than 1.5 %; (4) the long run interest rate must not exceed the mean rate of the three members with less inflation by more than 2%. The exam of the candidates took place on the 3 May 1998. Italy passed the exam, but it must be noted that as to the weight of the Government debt the scrutiny was generous, prizing the progress made by the Prodi's Government between 1996 and 1998 (Tab. 1).

Tab. 1 - Italy, Government Borrowing, Government Debt and Foreign Debt as GDP percentages

Years	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Borrowing	11.7	10.7	10.0	9.1	7.4	7.0	2.7	2.8	1.7	0.8
Debt	98.6	105.5	115.7	121.8	121.5	120.9	118.1	114.9	113.7	109.2
Ext. net debt	n a	n a	n a	n a	n a	n a	4.8	9.0	5.0	7.2

Source: Bank of Italy home page, Statistics, Public Finance Statistics in the European Union

The Italian debt was at that time the second largest of the EU (after the Belgian one). Nevertheless the markets showed to be confident on Italy, charging a modest risk premium on the 10 year bonds (spread) of nearly 30 basis points on the corresponding German bunds.

[1] I need to express my gratitude to Jerome Stein. Together with his friendship he offered me the opportunity of exchanging a great number of reflections and encouraged me to write. Giorgio Basevi, Karlhans Sauernheimer and Serge Rey read preliminary versions of the paper and made comments that have been precious for the final version of my writing. I wish to thank them very much. Responsibility for errors is only mine.

Surprisingly at the time of admission in the Euro the European Commission didn't pay much attention to the convergence of the real exchange rates as the variable that controls competiveness. True that there was attention to the convergence of the consumption price index of the candidate country but unit labour cost is a better measure (Tab. 2). Competitiveness is the variable that controls the evolution of exports and imports, and through accumulation of the trade balances is the ultimate determinant of the net foreign debt. Living in the single currency requires that competitiveness is preserved over the time and that the foreign debt is sustainable. Using a more rigorous language economists view competitiveness as controlled by the actual *real exchange rate* (i.e. the relative price in terms of [foreign]tradable goods foreigners have to pay to buy one unit of domestic tradable goods). The actual real exchange rate compares to the *equilibrium* real exchange rate. This one is a notional value of the real exchange rate that, if realized, guarantees the balance of exports and imports at capacity output, and capital flows such that the ratio of debt over GDP is constant (NATREX model).[2]

The long *academic* discussions preceding the introduction of the Euro had stressed the fact that the EU is not an optimal currency area, not only from the point of view of the exposure of the likely candidate countries to external shocks, but also with respect to the limited propensity to labour mobility and with respect to the different patterns of the competitiveness evolution. As a matter of fact looking at the data of the period 1995.1-1999.1 (the four years preceding the start of the Euro) we realize that Italy worsened its initial competitive position by nearly 20% relative to the Euro Area, whereas Germany (that was successfully including her East Länder) improved its own by 10.7% (Tab. 2). Fortunately no signal of special concern came at that time to Italy from the net foreign debt (Tab. 1). But in view of the admission to the Euro the message conveyed by the competitiveness data was not taken into consideration. Within the single currency the market forces, especially the labour market and the capital markets, were expected to maintain the competitiveness of each country at a level consistent with the existence of the single currency.

Tab. 2 – Euro Area, Competitiveness Indicators (1999.1) and their changes (1995.1 - 1999.1)

Base 1995.1 = 100

Countries	France	Germany	Netherlands	Ireland	Greece	Italy	Portugal	Spain	Euro Area
Index [1]	96.0	88.3	96,2	95,8	113.3	109.9	104.7	103.5	90.4
% change [2]	4.0	11.7	3.8	4.2	- 13.3	- 9.9	- 4.7	- 3.5	9.6

Notes: [1] Real effective exchange rates based on unit labour costs; cost increase means competitiveness reduction; [2] here positive numbers mean competitiveness increase. Source: Bank of Italy home page, Statistics, Eurosystem Statistics

Even the entrance exchange rate of the Euro member national currencies was not based on an equilibrium exchange rate rigorously measured [3], but was agreed upon bilaterally by the EU Commission and each entrant, in the confidence that small over or under-valuation would be quickly corrected by the market forces .

Today we understand that for a country like Italy whose competeviness was maintained for a long period by currency depreciation the new rules of the game represented quite a challenge. But what we understand today was not perceived as an insurmountable problem on the eve of the Euro.

To conclude on the position of Italy at the time of the admission exam for the entry in the Euro, it may be remarked that the political result was assured, but the viability prospects for the future were not without reasons of concern.

[2] NATREX means *natural real exchange rate*, Cf J.L. Stein (1995) in J.L. Stein, and P.R. Allen eds.(1995).

[3] Cf Serge Rey (2001).

2 - Non-economic motivations and experience

An economic historian not familiar with the political and social history of Europe may look with surprise at the decision of 15 countries to adopt a single currency in a situation where the results of that decision were not fully investigated and foreseen. But it should be remembered that when the idea of a European union started spreading in Europe it was felt as a new page of history replacing a previous experience of crazy wars. This new page was conceived as a process of subsequent steps to a future unite Europe , the single currency being one of special symbolic meaning and grand expectations. From this point of view it may be that the birth of the Euro has not been the fruit of rational calculation, at least in the sense economists give to this expression. Human behaviour, as we know, is not explained only by rationality, but also by emotion and intuition. Now, after a decade (or something more) of disappointing or arguable results feelings are mixed. Some believe that institutional errors and/or wrong policies are to be blamed but that the basic intuition is sound. To others the query is whether a currency union among countries with different debt burdens and different economic structures may survive. Emotionally I belong in the first group, but as an economist my task is to investigate whether a big experiment, such as the Euro, is sustainable at reasonable economic cost.

3 - A decade in the Euro

The period 2000-2011 is at the same time the first decade of the Euro and the time span encompassing the world financial crisis of 2007-2008 along with the subsequent real crisis. I don't think that the double crisis subtracts significance to the meaning of the data describing the whole period: all the Euro members have been exposed to the same events, the fat cows of the first seven years and what has come after. The performance of Italy over the whole period, if compared with the one of other Euro members, cannot be presented as a success. An examination of data is in order.

3.1 - *Government debt*

The Government deficit first. As it is clear from Tab. 3 a clear trend in the Italian debt to GDP ratio is not visible. Some improvement was realized during the first four years, then we have four other years of relative stability, and finally a jump up in 2009 (the worst year of the real crisis) followed by two years of further increase. On the whole the period under exam started with a debt GDP ratio of 109.2 and finished with 120.1: a worsening of nearly 10 percentage points even if most of the increase took place in the last three years as a consequence of the real crisis, when all the Governments eased spending or reduced the stringency of their budgets.

Tab. 3 - Italy, Government Borrowing, Government Debt and Net External Debt as GDP percentage

Years	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Borrowing	0.8	3.1	2.9	3.5	3.5	4.3	3.4	1.5	2.7	5.4	4.6	3.9
Debt	109.2	108.8	105.7	104.4	103.9	105.9	106.6	103.6	106.3	116.1	119.1	120.1
N.E. Debt	7.2	5.8	12.4	13.6	15.8	16.8	22.2	24.5	24.1	25.4	24.0	20.6

Source: Bank of Italy home page, Statistics, The Public Finances and IMF home page, Data and Statistics, Principal Global Indicators

At first sight (Tab. 3) it may seem that over the years Italy has not adopted a particularly rigorous debt policy; but if the Italian debt evolution is compared to the one of the other Euro members the final judgement turns out that to be very different: Table 4 focuses over the first four recession years (2007-2011) and shows how much the Euro countries added to their debt to GDP ratio. Italy added 16.5 percentage points, Germany 16.3, France (which is not considered a weak country) 23.1, Greece 57.9, Spain 34.5 (due, as in the case of Ireland, to the bad credits originated by the housing bubble that the Government had to bail out) and the Euro Area as a mean 22.1.

Tab. 4 – Euro Area, Debt to GDP Ratio: percentage points addition 2007-2011

	France	Germany	Netherlands	Ireland	Greece	Italy	Portugal	Spain	Euro Area
2007	71.5	65.2	51.5	24.9	107.4	103.6	68.3	41.4	70.1
2011	94.6	81.5	70.6	108.2	165.3	120.1	107.3	75.9	92.2
2007-2011	23.1	16.3	19.1	83.3	57.9	16.5	39.0	34.5	22.1

Source: IMF home page, Data and Statistics, Principal Global Indicators

So I think that in this period (and certainly also in the present year 2012) Italy followed a comparatively more stringent fiscal policy than the one of other Euro members. Unfortunately the consequence of this comparatively strong restriction is clearly visible in the negative growth rate of 2011 and 2012 as well as in the overall growth of the period 2000-2011 (Tab. 5) that turns out to be in the order of one third of percentage point per year, the lowest among the counties taken into account.

3.2 – *Growth, productivity, competitiveness*

In this section we come to the heart of the mechanism explaining how the economic system of Italy has worked over the period 2000-2011. Table 5 shows a disappointing record of growth of the economy as a whole and an even worse record of labour productivity growth that turned out negative.

Tab. 5 – Euro Area, Growth, labour productivity , employment 2000-2011
Index base 2000 = 100

Countries	France	Germany	Netherlands	Greece	Ireland	Italy	Portugal	Spain	Euro Area
Growth	113.7	113.0	115.9	115,0	127.5	104.3	104,8	123.6	114.2
Productivity	107.4	108.1	108.5	110.6	119.5	96.5	108.5	110.1	107.5
Employment	105.1	104.4	106.8	101.8	107.3	107.9	96.6	112.2	104.9

Notes: Labour productivity refers to output per employed person. Source: OECD, StatExtracts page, National accounts, Productivity, Labour

Can labour productivity grow without growth of the economy as a whole? In principle yes. We may certainly conceive of firms with positive productivity growth (tradables sector) replacing firms without productivity growth (non-tradable sector), diminishing total employment and GDP remaining constant. But as a matter of fact it is likely that with zero growth of the economy, unused capacity and depressed expectations, there is no incentive to reallocate resources and open new enterprises to replace the non-efficient ones. A minimum growth of the economy is required. But if reaching zero Government deficit (except minor corrections allowed for by taking into account the structural, rather than actual, deficit) is the almost exclusive policy objective it is possible that the growth of the economy is totally lacking and that also the growth of labour productivity is not realized. In my view this is the interpretation of what has happened in Italy. If this interpretation is correct it is necessary to indicate which fiscal policy measures can contribute to start a virtuous mechanism and re-activate growth of both labour productivity and GDP. As an example one can think of well selected, productivity enhancing investment projects that deserve to be deduced from the Government debt. *Well selected* may mean that the productivity enhancing character of these projects must be recognized by EU supervision. At the same time a re-composition of both public expenditure and revenues must be envisaged. On the expenditure side items capable to promote productivity increasing firms and productive investment projects must be favoured and items that address inefficient firms must be cut. We can briefly say that expenditure with rate of return higher than the rate of interest must replace unproductive expenditure, even knowing that many expenditure items reflecting outlays for wages of the public services are not easy to be changed. On the revenue side taxation should favour rather than dis-favour[4] medium size, highly efficient and highly exporting firm; and should also hit consumption rather than labour income. Clarity is required: simple reduction of the fiscal stringency not joint with expenditure and revenue re-composition could not produce the desired effects on the productivity growth of the system, increase the foreign deficit and cause foreign debt accumulation. So the problem is not the one of applying a standard Keynesian policy (expenditure increase and/or taxation cut), but to specify such a policy so to ensure favourable effects on productivity growth.

Table 5 shows also that over the period under examination Italy enjoyed a non-negligible increase in employment. Unfortunately the new jobs are not in the productivity increasing compartments. We know that manufacturing as a whole lost employment; consequently the new jobs are mainly in the service sector where most compartments belong in non-tradables, typically characterized by no productivity growth. The picture is completed by the dynamics of real wages. In the years 2000-2011 the proportion of temporary workers, immigrants and other irregular workers in total employment increased and the average real wages remained almost constant (OECD average annual wages). In other words the distribution of value added to wages basically reflects the disappointing dynamics of labour productivity.

As expected the negative developments in labour productivity shown in Tab. 5 are reflected in the evolution of competitiveness. Tab. 6 suggests that between 2000 and 2011 Italy lost something like 23 index points of competitiveness with respect to Germany and 13 points with respect to the Euro Area.

Tab. 6 – Euro Area, Competitiveness Indicators (1999.1-2012.1)
Base 1999.1 = 100

France	Germany	Netherlands	Ireland	Greece	Italy	Portugal	Spain	Euro Area
101.8	81.5	103.1	107.9	104.1	104.8	103.8	99.2	91.6

Notes: Competitiveness indicators are real effective exchange rates based on unit labour costs; note that cost increase means competitiveness reduction. Source: Bank of Italy home page, Statistics, Eurosystem statistics.

Remark that under this point of view Italy is not alone: France, the Netherlands, Ireland, Greece and Portugal suffered similar losses. Looking at the whole Euro Area one gets the impression that during the first decade of the single currency (actually 1999.1-2012.1) only Germany and Austria (this one not recorded in Tab. 6) experienced an increase in their competitiveness index whereas all the other Euro members experienced competitiveness loss. Probably the reason for two different stories about the evolution of competitiveness (Germany and Austria versus all the others) has been the success of Germany in addressing a larger part of its aggregate expenditure toward productivity enhancing compartments. In a

[4] Cf Mediobanca (2011), p. XXII. In the group of companies taken into account by Mediobanca for the year 2010 the average taxation rate of medium size firms income turns out to be 34.6% versus 25,6 of the company sample as a whole. The difference is mainly attributed to tax exemptions granted to large firms.

more sophisticated language one could say that over the period under examination the actual real exchange rate of Germany has gone under its equilibrium value setting the conditions for a positive trade balance. In principle such a situation of divide in the Euro Area could lead to an inflation pressure in the domestic production system. Due to the specific conditions of both the domestic and foreign demand such risk has not materialized so far. But in case the world demand revives, a period of inflation pressure is likely until the actual real exchange rate has sufficiently increased. Not surprisingly in any case Germany has become the largely surplus country of the Euro Area that lends foreign currency to the deficit members. The increasing competitive gap between Germany and not only the weakest countries, but also countries like France and the Netherlands, jeopardizes the viability of the Euro area. A two economic speed Euro Area is not the kind of monetary union envisaged by the founders.

Note finally that, contrary to what one would expect, the loss of competitiveness in Italy, at least in the second part of the period 2000-2011, has not been followed by external debt accumulation. Most likely the reason has nothing to do with the evolution of competitiveness, but is the consequence of the incentives offered by the past Government to the repatriate financial assets illegally held abroad.

At the end of this section I would like to call the attention on the question of labour productivity once more to look into its sectorial aspects. Productivity increase is the ultimate source of economic progress and without it there is no future. So understanding why there is lack of productivity growth is crucial. Banking inquiries concerning 2030 Italian companies, their compartment structure and their exports suggest that the Italian productive machine is not immobile; the mechanical and electronic compartments, as well as the chemical compartment, those which export more, are doing very well and their labour productivity is continuously improving[5]. At the same time other firms, mainly belonging in compartments that serve the domestic demand (including non-tradable goods) are experiencing productivity loss. In order to justify the official macro data one must presume that the weight of the poorly performing compartments is still prevailing and affecting the poor labour productivity performance of the economy as a whole (unless one doubts of the reliability of the official data).

If there is a conclusion for this whole section (3.1-3.2) it is that the disappointing performance of Italy in the period under examination (2000-2011) as regards GDP growth and labour productivity growth is largely due to what happened in the second part of the whole period, the years 2007-2011, that include the double crisis and the following recession. Starting in 2008 the fall in labour productivity (negative growth rate) is so sudden and sizeable to influence the average growth of the whole period 2000-2011. And looking for the reasons it appears that in those four years the Italian fiscal policy was much more stringent than the other countries' (Tab. 4). Most probably if the degree of stringency of fiscal policy had been comparable to the average of the Euro countries under examination the overall performance of Italy would not have been distant from the average performance. This leads me to think that some more flexibility of the Euro fiscal discipline during recessions is necessary.

One should have a clear understanding of the main balancing mechanisms operating in the economy: a current account deficit can be reduced either by a real depreciation of the domestic currency (i.e. lower domestic over foreign prices or nominal depreciation of the domestic currency, impossible within the Euro Area) or by a decline in income below capacity output. But fiscal repression or austerity that just leads to a decline in income is not sustainable and counterproductive. The troika that leads the Euro economic policy seems to ignore this choice of equilibrating mechanisms and has not led to the best of all possible worlds.

[5] Cf Mediobanca, op. cit., p. XIX.

4 - *The years 2011-2012 and the Monti Government*

The year 2011 has not been a good one for Italy. The consequences of the real crisis were far from being over. Industrial production was much under its 2007 level and the EU showed concern about the size of the Government deficit that didn't promise to comply with the Maastricht rules.

During the summer the interest rate spread of Italian 10 year Government bonds with respect to the corresponding German bonds started to grow: from about 150 b.p. to 400 b.p. at the end of August and to almost 600 at the end of October. The public opinion was deeply disturbed by this development. Given the size of the Italian debt people understood that the increase of a single percentage point of interest spread, if applied to the whole amount of outstanding debt, meant something more than one percentage point of higher fiscal pressure, to let alone the consequence on the cost of capital on private investments. Since then the "spread" has become the problem number one of the Italian economy. In this climate the Italian prime minister promised solemnly to the EU Commission that Italy will have zero government deficit in 2013. The objective clearly required national cohesion. This is why Mr Berlusconi stepped down as prime minister saying that his move was dictated by the country's interest.

Mr Monti, the new premier leading a so called *technical cabinet*, was well received due to his personal reputation as a past EU Commission President and past Rector of the Bocconi University. As a matter of fact he is a premier without "full powers" and must take into account the positions of the two main parties supporting his government. Monti's almost immediate measures have been (1) severe cuts in the government budget (pensions, expenditure of local administrations and start of a full spending review); (2) consistently heavier taxation of the real property; (3) a program of profession liberalizations and government property adjustments. At the same time explicit programs to sustain growth were not articulated. But it must be understood that Monti is confident that in an environment of true competition and just laws resources are naturally attracted towards the productivity enhancing sectors, so that growth of national product and employment come consequently.

In my opinion all this may not be so automatic, especially in a situation of depressed expectations and international recession. In any way the initial effect of the new government has been a spread reduction to nearly 400 b.p.; but in the course of spring 2012 the contraction of production in most manufacturing sectors and increasing unemployment have made the recession worse and fostered distrust of the financial markets. So the spread moved down and up several times without showing a clear trend. Understandably a persistent high spread in addition to other weaknesses menaces to make the redressing policy almost unbearable.

At the end of June after interminable discussions the leaders of the Euro area make some decisions on the future of monetary and financial institutions of the single currency: paving the way towards a banking union along with a single banking monitoring and giving the ESM (European Stability Mechanism) the possibility of acting to contain the spreads *on request of the interested countries, t*he ECB (European Central Bank) being the operating agent. All this to be realized in few months. As a consequence of the news the spread is volatile: the financial markets want certainty but the Euro institutions are unable to produce certainty. The next move (July 2012) comes from Mario Draghi, the governor of ECB. In his view the correct working of monetary policy requires that the ECB operates on the short government bonds (up to the maturity of three years) of the weak Euro members to contain the spreads. Long term bonds are vice versa the concern of the ESM. When in September Chancellor Merkel declares her support to the words of

Governor Draghi, even if with some caution, the markets react promptly and in few days the spreads on the long bonds of Italy and Spain shrink by two full percentage points. This gives considerable relief to both countries. At the end of September the ESM is established, and by the beginning of October its ratification process is complete. So the ESM is in function and another step towards the completion of the EU monetary and financial institutions is taken. Yet reservations on the ECB interest rate interventions are probably still there.

5 – *The macroeconomic policy of the Euro and recent measures of the EU and BCE*

Over the years the rules of the Maastricht Treaty have been finalized by introducing regular monitoring of the member counties fiscal behaviour (Stability and Growth Pact, 1997), and by strengthening the fiscal discipline in view of the fact that the Maastricht targets had been repeatedly violated without consequences (Fiscal Compact, 2012). The Fiscal Compact requires zero *structural* deficit (i.e. [almost] zero difference between Government expenditure and *trend* Government revenues). In addition if the debt to GDP ratio exceeds 60% it must be reduced by 1/20 per year. Italy has ratified.

Doubtless a monetary union cannot do without fiscal discipline and responsible behaviour of its members. But clearly the choice of the EU has been one of rules versus discretion: with advantages and disadvantages of this choice. Unfortunately the real world is complex and living with rules in recessions may be very hard. Increasing unemployment, falling wages, lack of opportunities cannot exceed certain limits without causing harsh reactions from societies. Must such problems be of concern to the EU? Aren't they member countries' business? True that the Euro is a monetary union, not a transfer union; but in order to enter the monetary union the member countries had to give up not only their monetary sovereignty (which is trivial to recall) but also a considerable portion of their fiscal sovereignty with the consequence that within the present rules of the monetary union virtually no tool is available for a countercyclical economic policy. In this situation it is not obvious that the Euro institutions have no responsibility and no policy instruments to help manage the downturn and/or the member countries have no instrument as well.

This is why in section 3.2 of this paper I expressed the opinion that productivity enhancing investment projects, verified by Euro authorities to make sure that they don't represent breaks of the fiscal discipline, should be allowed and not computed in the Government debt (being assets and not liabilities). I know the objections to this proposal. There are many instances in which pretended capital expenditure concealed de facto consumption or even wasteful expenditures. This is to be absolutely avoided. One could also conceive that the investment projects I refer are financed on the capital market or that they are EIB (European Investment Bank) projects, provided Governments are allowed to buy their financing bonds without computing them in the public debt. Details cannot be discussed here, but some instrument (distinct from generic expenditure) to sustain sound growth in an open economy context during recessions and/or when market forces are not effective enough is strongly needed.

At a much technical level I would like to remind that debt sustainability simply requires that the debt percentage accumulation does not exceed the growth rate of GDP:

$$\text{Deficit} / \text{Debt} \leq g$$

where g represents the growth rate of GDP. This condition may also be written as

$$\text{Deficit} \leq g \text{ Debt}$$

Controlling the deficit would be perfect if this move were to leave g unchanged. But unfortunately the short term growth rate g is to some extent affected by the deficit. So, for instance, reducing the deficit has the effect of reducing g as well. In other words it may cause recession and unemployment, which may be detrimental to productivity growth and competitiveness[6]. Something should be done to avoid similar consequences. As a rule of the thumb one might conceive that deficit cuts should never increase the output gap for any but a short period of time, but obviously much better criteria may be used.

Furthermore it must be observed that two of the requirements put forward in the Maastricht Treaty (deficit not exceeding 3% and debt to GDP ratio not exceeding 60%) demand more than simple sustainability. Any debt ratio is sustainable (Japan teaches) as long as the deficit over debt ratio is equal to the economy growth rate. So why a target ratio of 60%? Target debt to GDP ratios in addition to simple sustainability may imply unnecessary restrictive fiscal policies that may come in the wrong time over the business cycle.

The remarks above highlight that the Euro rules focus entirely on to the long run equilibrium without offering adequate instruments to sustain the level of activity during downturns. Isn't the fact that the Euro rules have been so frequently broken a consequence of the fact that a viable institutional setup should have, but has not, tools for the short run?

Monetary policy is to be discussed apart. In one sense this is the area where the EU has gone farthest: the Euro as such is its major result. But monetary policy so far has been conceived as exclusively aimed at guaranteeing the purchasing power of money over the time, whereas the experience of managing a world currency has shown that the mission of the ECB cannot be restricted to this one only. Experience has shown that in order to be successful the monetary authority of a currency union must be in charge for the stabilization of both the money and financial markets, like other central banks. Furthermore the function of lender of last resort cannot be removed from the stage simply through a number of reiterated pacts for fiscal discipline that should have the virtue of making the governments immune from the occurrence of sudden liquidity needs.

As already mentioned in the previous section during the Euro crisis of 2011-2012 significant changes have been introduced in the monetary mechanisms and institutions. The ECB has been authorized to buy Government bonds of the weak countries to contain excessive spreads and a permanent stabilisation fund (ESM) has been established and allowed to lend to countries in difficulty (provided formal requests are made by the interested countries). These innovations have not been introduced without harsh discussions. Highly indebted countries that face high (excessive?) spreads are afraid that the service of their debt becomes unsustainable. As it has already been remarked in a country with a debt to GDP ratio of 100% an interest rate spread of 1% requires (at full regime) tax revenues equal to 1% of GDP for the debt service. In addition interest rate spreads on long Government bonds become spreads on the cost of capital for private investments. But what is an excessive spread and who judges? In principle market spreads should reflect risk premiums for likely defaults of the borrowers. In a world of powerful rating agencies and managers of large portfolios likely to imitate each other non-genuine risk evaluation and excessive spreads cannot be excluded in principle. Decisions to support countries in difficulty involve judgements on the correct level of interest rates (ECB for short bonds) and judgements about reliability of the submitted consolidation programs (ESM for long bonds). But critiques have been raised to these kinds of policies. In case an assisted

[6]The dependence of external debt on its fundamental determinants, given by the behaviour of both the public and private sectors, is masterly shown in J.L. Stein (2006); cf. also Stein (2012), Introduction and Ch. 8.

country defaults the acquisition of short and long bonds by ECB and ESM comes to be equivalent to a transfer in favour of the country supported by all the other Euro countries according to their weight in the single currency, and this is against the nature of the monetary union which is not a transfer union.

My opinion is that this critique is not without ground, but also that it disregards stabilization instruments that a monetary union needs. Every monetary union implies the existence of a central bank (and a stabilisation fund); every central bank must assume risks, as well as an ordinary bank. Obviously risks up to a point: the ECB cannot change its nature becoming a permanent supporter of highly indebted countries. Its interventions look reasonable if temporary. The ESM must not be required of pouring money into desperate enterprises. But all this has to do with the way ECB and ESM are run. This is why in my view the innovations under examination *as such* deserve a favourable judgement.

The progressive move to a true banking union is the other innovation decided in 2012. This implies that the monitoring of banks has to pass from the country central banks to the ECB. As a matter of fact during the crisis of 2011-2012 the money market has more or less ceased to work in the Euro countries, replaced by individual bank relationships with the central banks. This is a clear symptom of malfunctioning of the money market, explained by lack of transparency and uncertainty about the counterpart risk evaluation. Aiming at the progress and consolidation of the banking system and money market is consequently another step towards a more homogeneous economic space.

In this section we have mainly addressed the Euro policy and its institutional context. In order to preserve viability of the Euro over the time (i.e. competitiveness and debt sustainability) appropriate fundamentals and appropriate institutional context are both needed. To conclude a look to the future of the institutional development of the Euro. Will higher political integration help the Euro approach an optimal currency area? My answer is instinctively yes, in the sense that more political integration means an environment where societies are expected to reach a higher degree of cohesion. But political union is an issue that goes beyond the short horizon. Today many people in Germany and the other strong countries are concerned about the risk that profligacy of the weak countries may jeopardise a living standard they have reached with commitment and hard work. Many others in the weak countries have a tendency to think that Governments have such a power that even inconsistencies may be disregarded. Going along the way of more political integration is not only an intellectual challenge, but a process of learning to discern what is right and what is wrong in the views of the partners. Inevitably a long process.

6 – *Conclusion*

Even the most Euro enthusiast cannot but recognize that for Italy the economic performance of the period 2000-2011, approximately the first Euro decade, has not been a success. Production (in terms of GDP) has been languishing, the productivity of labour lost percentage points, real wages reflected what happened to labour productivity. Where is the jump ahead that we all expected? True that the period considered has deeply reflected the consequences of a double world crisis, financial and real, and that consequently not all the evils may be attributed to the Euro. But the double crisis has been for all and if we compare Italy and Germany the difference is striking. To some extent what we observe for Italy may apply to other weak countries of the Euro. Germany (with Austria) has become the surplus country of the Euro Area, and some observers in Germany depict the situation as one in which the better offs must sustain the worst offs, not being happy of doing this.

I think that even the most Euro enthusiasts must recognizing that Italy, and possibly other weak countries, cannot quietly be prepared to repeat the past experience. Another decade without growth would be disruptive. It should not be ignored that society can react angrily and that anti-European feelings may surge. People know that countries like Argentina that have abandoned the pegging to a too strong currency have got a great benefit from this move. Opposition parties willing to replace the Government are ready to exploit the Euro crisis. What should Italy do? Leave the Euro?

Careful examination of the data in section 3 suggests that an excess of fiscal restriction in the years 2007-2011 is largely responsible for the disappointing performance of Italy in the whole period 2010-2012. This leads me to think that some rethinking of the Euro policy is strongly required. The business cycle is part of the world and in case of recession relying exclusively on long run rules for fiscal discipline is insufficient. Some instrument to give national Governments and/or the UE Commission the possibility of contrasting economic downturns is necessary. As described in the section on the economic policy of the Euro my belief is that this objective may be reached without giving up fiscal discipline and without forgetting the constraint of foreign equilibrium. But must be the objective number one of the Euro.

Changing views is always a hard challenge. To convince our interlocutors, rational arguments are not enough. Politicians are concerned about what people think independently from their personal views. Yet the only sensible alternative to the challenge of improving the EU economic policy is exiting from the Euro, a move that for Italy contradicts years of hopes and efforts to construct the single currency on the way of political integration in Europe. One point is clear: delaying the decision without maturing a firm view simply makes the present disagreeable situation likely to worsen over the time. “The fault, dear Brutus, is not in the stars but in ourselves, that we are underlings”.

University of Bologna, Italy, October 30, 2012

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