Italy and the Euro: Which Way to Go?

By

Volker Grossmann*

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1. The Euro Crisis: Background and Issues

For one decade by now, the Eurozone has experienced substantial economic problems in various, but related disguises. The two countries which shaped the original *Stability and Growth Pact* of the *European Union* (EU) at the end of the 1990s, Germany and France, came close to recession in the years 2002 to 2004. As a result of declining tax revenues, both countries breached the contractually binding public deficit threshold of three percent of GDP in 2002-05 without facing any sanctions. To the contrary, the rules were relaxed in 2005. These events were already clear signs of fundamental problems in the institutional design of the Euro system.

In this essay, I want to discuss the economic and institutional problems of the Eurozone and potential remedies with an emphasis on the Italian case. In fact, I will argue that Italy and Spain are the key countries to deal with in the ongoing crisis.

* University of Fribourg; CESifo, Munich; Institute for the Study of Labor (IZA), Bonn. *Address:* University of Fribourg, Department of Economics, Bd. de Pérolles 90, 1700 Fribourg, Switzerland. E-mail: volker.grossmann@unifr.ch.
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1.1. The Financial Crisis 2007-2009 and Sovereign Debt

The Stability and Growth Pact became basically meaningless when the financial crisis hit the World economy in 2007. The bursting of the housing bubble in the US residential market led to a global banking crisis. The market for securitized mortgage loans and consequently inter-banking lending was almost completely frozen. In the aftermath, the European economy was hit by a deep recession due to a drop in private investment and falling exports to the recession-stuck US. In both Europe and the US, the economic crisis was tackled by fiscal spending and far-reaching monetary easing measures.

Falling tax revenues and large-scale government spending programs led to double-digit public deficits in countries like Spain and Greece. In Italy, the fiscal deficit in Italy in 2009 increased to five percent of GDP (according to Eurostat data). Given that the stock of public debt-to-GDP ratio in Greece and Italy was already above 100 percent, the economic crisis became a sovereign debt crisis in these countries.[1] Spain, Portugal and Ireland had in comparison a significantly less pronounced stock of public debt when the financial and economic crisis came along. In Spain and Ireland, however, fiscal deficits went hand in hand with a banking crisis due to a bursting house price bubble comparable to the US case.[2] Italian banks are vulnerable as well, as they hold substantial fractions of the Southern countries' government debt. In addition, trade imbalances between Southern Europe and other EU countries have risen. This is partly due to wage increases in Southern Europe prior to 2007 which exceeded productivity increases and led to higher goods prices. By contrast, in Germany, for instance, wage increases have been fairly moderate.

1.2. A Vicious Cycle

Italy and Spain are in particular subject to a vicious cycle which is at the heart of the current sovereign debt crisis. Bailing out system-relevant banks by public borrowing further worsens public debt problems. At the same time, banking regulation (like the *Basel Accords*)

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[1] For further discussion, see Lane, Philip R. (2012), The European Sovereign Debt Crisis, in: *Journal of Economic Perspectives* 26 (3), pp. 49-68.

[2] Portugal is a different case. Being poorer than Spain and Ireland and having high private-sector debt, it is vulnerable despite having kept public sector debt in check.

traditionally does not pose significant, if any, capital requirements on government bonds. Unlike other assets, government bonds of OECD countries have (implicitly) been treated as being risk free. Financial institutes were and are thus incentivized to hold government bonds. This regulatory investment incentive for banks may have been seen as a way to keep public financing cheap. However, it can nowadays hardly be justified, as the Greek quasi-default in 2011 has painfully shown. As banks hold large amounts of government bonds as a result of such regulatory arbitrage, defaults on government bonds would make further bail-outs of banks necessary, which in turn again raises public debt, and so on. The close link between the sovereign debt crises and banking crisis even if confined to a single country like Italy and Spain is therefore a recipe of contagion in the entire Euro system and beyond. Most likely, both Italy and Spain are “too-big-to-fail” in the sense that a major default on government bonds would almost surely imply the end of the Euro under the current institutional framework. Breaking the negative feedback loop between the sovereign debt crisis and the banking crisis should therefore be at the heart of measures to stabilize the Eurozone.

Unfortunately, stopping regulatory arbitrage by forcing banks to fulfill capital requirements also for government bonds does not help to solve the current crises. The perceived trade-off between policies which are prudent in the long term and short run survival strategies become apparent in this respect. Although it is obvious that excessive purchases of government bonds due to regulatory arbitrage is at the heart of the current problems, currently, policy makers have any incentive not to impose capital requirements for government bond holding in order to avoid depressing demand for government bonds.

2. Problems with Current “Rescue” Measures

2.1 The European Stability Mechanism (ESM)

On September 27, 2012, the *European Stability Mechanism* (ESM) came into effect as permanent fund to lend to indebted countries below market rates. The ESM will fully replace the *European Financial Stability Facility* (EFSF), which started in June 2010 and is scheduled to run out in June 2013. The EFSF has a lending capacity of EUR 440 billion, another EUR

60 billion may be provided directly by the EU. (Further guarantees of EUR 250 billion come from the *International Monetary Fund*). The ESM keeps the lending capacity of EUR 500 billion via a total capital fund of EUR 700 billion. The biggest contributions come from Germany (27.1 percent), France (20.4 percent) and Italy (17.9 percent). Italy alone faces a total risk of EUR 125 billion.

To discuss the pros and cons of the ESM, let us remind ourselves of the theoretic reasoning behind the rescue fund. In a nutshell, it is founded in the following idea. For instance, consider countries like Italy and Spain, which have already seen their market rates gone above seven percent for medium term loans. Suppose these countries are not insolvent but may rather face liquidity problems which are the result of a speculative attack. A speculative attack may occur if multiple kinds of expectations by financial actors with respect to the fraction of debt repaid to bond holders are rational, given the fundamentals of an economy (i.e., the future growth and tax revenue potential).[3] To put it simple, multiple rational expectations equilibria are possible in the case where the debt-to-GDP ratio is not too high. In this case, optimistic expectations (of full repayment) induce a low interest rate to government bonds which makes full repayment indeed possible. However, given the same fundamentals, pessimistic expectations (of a default) drive up interest rates, in turn self-fulfilling default expectations as well.[4] In the latter case, we may speak of a speculative attack. Making the rescue fund large enough may signal commitment of Eurozone members and therefore help to coordinate the expectations towards full repayment as long as such equilibrium can be rationally expected. Therefore, in theory, the rescue fund would solve liquidity problems just by its existence and would never have to be used at large scale for solvent countries.

In other words, the idea that “putting-money-in-the-showcase” may suffice is a bet. Policy makers bet on being viewed by financial investors as credible and prudent when applying the fund. Credibility may be undermined, however. If financial investors understood that big countries like Italy and Spain would need large amounts from the rescue fund to avoid public

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[3] See Grossmann, Volker (2011), Wirkungen und Nebenwirkungen des EU/IWF-Rettungsschirms für verschuldete Euro-Länder, in: *Wirtschaftsdienst* 91 (3), pp. 179-185.

[4] Only if the debt-to-GDP ratio is sufficiently low and the economy has decent productive capacity (therefore promising sufficiently high tax revenues in the future to repay the debt), full repayment may be the only relevant rational expectation. That said, one may note that no repayment at all is theoretically always a rational expectation. In fact, interest rates would explode under such an expectation and always sustain full default as equilibrium. In a competitive financial market, however, healthy countries shall not come under such an extreme attack in practice.

default and/or banking crisis, the ESM could prove heavily underfunded.[5] At the same time as being too small to be a credible firewall, the ESM may be too large in another respect. If countries like Germany, France and Italy were forced to fulfill all promises made yet, it could trigger a Eurozone-wide sovereign debt crisis (and a related banking crisis). For instance, if Italy contributed to bailing out Spanish or Irish banks, in view of an amount of public debt of two trillion Euro, Italy could easily become a prime candidate for borrowing from the ESM itself. But at that point the fund could be pretty empty already. Enlarging it further, however, could lead to the contagion of crisis within the Eurozone, which the ESM is supposed to avoid. Due to the link of sovereign debt to the banking system discussed above, the entire European banking system could melt down. The result would be a deep recession Europe and possibly beyond. This may well lead to a backlash to democracy and the European idea as a whole. History has taught us that deep economic turmoil strengthens radical political groups. These allude to voters who feel they have not much to lose anymore. Moreover, if the population of lending countries will want their money back as their economies fall apart, indebted countries will surely resist repayment in view of their financial and economic turmoil. Thus, inappropriately using the ESM may endanger political systems within all involved countries and may destroy good international relationships, to put it mildly.

Thus, it is necessary that the ESM is used in a prudent manner. Unfortunately, there is the risk that money is lent out even in the case of insolvency.[6] This is because political processes are prone to mistakes. The hectic meetings of European leaders we have frequently witnessed in the last years did not contribute to gain confidence in their handling of the crises. Particularly, it is hard to decide whether or not a country is solvent. One has to check if future government budget surpluses are potentially large enough to repay government debt, at least in the case where interest rates are low. There are obvious limits to estimate the per capita income growth potential of a country and the feasibility of public sector reforms accurately.

In sum, I consider the ESM idea as good and safe as nuclear power. It is an appealing idea in theory and with some luck may work in practice, but if things go wrong they go wrong indeed. The ESM may trigger an economic and political meltdown, like nuclear power may trigger a nuclear meltdown. Thus, in my view, the ESM is the most dangerous instrument policy makers created in the modern history of Europe.

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[5] One suggested possibility of enlargement would be to hold private investors liable only above a threshold fraction of debt default. Below this threshold, the ESM creditors would bear the full burden. This could incentivize private investors to buy government bonds along with the ESM.

[6] Greece comes to mind. Of course, one may argue that one can afford to bail out Greece completely, even if there is never repayment, whereas such a possibility is infeasible in the case of Italy and Spain.

Needless to say, the ESM is an also instrument which runs fundamentally counter to the "no-bail out clause" in the *Treaty on the Functioning of the European Union* (Art. 125). Rightly or wrongly, given the situation at hand, policy makers (and even the constitutional court in Germany which recently approved the ESM) do not seem to be particularly interested in enforcing legally binding contracts. For instance, someone who considered the European Stability and Growth pact as backbone of the architecture of the European house must be very disappointed and disillusioned by now. Thus, the ESM undermines credibility of any future institutional architecture in a potentially dangerous way.

2.2 Bond-buying Program of the European Central Bank (ECB)

Not surprisingly, as a major contributor to the ESM and given its still comfortable economic situation, Germany is rather unwilling to enlarge the ESM in any way. For this reason, the *European Central Bank* (ECB) has stepped in and announced another "putting-money-in-the-showcase policy". On September 6, 2012, the ECB indicated the possibility to purchase government bonds on secondary markets if a country receives funds from the ESM (therefore also being subject to further austerity measures). Like the ESM itself, it may work by coordinating financial markets to optimistic expectations and may never be used for truly insolvent countries. But even if the ESM is applied at the wrong time for the wrong country, the ECB may feel obliged to join forces and buy government bonds nevertheless. The result could be self-fulfilling inflation expectations and asset price bubbles, which could possibly destroy the credibility of the ECB for a very long time. This would materialize in declining living standards through inflation and misallocation of private capital.

Moreover, it should not be forgotten that taking money out of the showcase one way or the other basically buys out accumulated risks of banks with public money. Strikingly, all policy measures since 2007 seem to ensure that equity holders and bank managers do not lose considerably, no matter how risky the decisions they take were and are. This spreads public discontent in addition to economic crisis. It also creates moral hazard problems in the financial sector. Banks may already have included the possibility of public intervention to prevent banking crisis in their pre-crisis risk-taking behavior. Now, after frequent rescue measures, they can be almost certain that taxpayers will always bail out banks under the current regulatory regime. The current route of European leaders could therefore spread the seed for coming financial crises.

3. Alternative Policy Proposals

So what are alternative policy measures, which may be less dangerous for the economy, democracy and peace in Europe?

3.1 Eurobonds and Target2 Liabilities

There is an ongoing discussion on *Eurobonds* and other forms of shared liability. These measures would imply common interest rates for newly issued government bonds of all countries. However, shared liability within the Eurozone would distort the important role of interest rates in a market economy to signal risk differences between bonds. Without that role, excessive risk taking results on behalf of both financial institutes and governments alike. In fact, one may argue that the bond yield convergence which occurred in the Eurozone at the end of the 1990s was due to the expectation of bailing-out indebted countries despite the "no-bail-out-clause" in the EU treaty. Declining interest rate in today's indebted countries may have led to the house price bubbles in Spain and Ireland in the first place, which are now threatening the banking sector. They may also be responsible for private investment booms in Greece and Portugal. Being welcome at first, they led to internal appreciation (i.e., wage and price increases), which harmed the competitiveness of export sectors. Some scholars convincingly argue that the economic weakness of Germany and France in 2002-2004 was the other side of the coin of massive capital inflows in Southern Europe and Ireland. These inflows, in fact, may have been financed by capital flight from Germany and France. The relative strength of Germany at present may therefore be due to the reversal of capital flows after the bursting house price bubble in Spain and Ireland and after widespread sovereign debt problems in other countries became apparent.

As a result of internal appreciation, a country like Greece is nowadays net importer even of agricultural products, like olive oil, although it should have a comparative-advantage in agricultural production. Trade imbalances within the Eurozone are also the result of wage moderation in exporting countries like Germany. In fact, trade imbalances per se may not be a problem per se. However, unfortunately, the sovereign debt crisis and banking crisis are accompanied by a balance of payment crisis in Southern Europe. The ECB system has made it possible that, despite the lack of major capital inflows in the last three years or so, current account deficits have lasted in a clearly unsustainable and potentially dangerous way. The extent of the balance of payment crisis may be measured by the so-called *Target2 balances*. Put simply, Target2 balances are equivalent to the liabilities and claims of national central banks to the ECB, which result from cross-border money transfers. For instance, if an Italian importer pays a German exporter, then the German Bundesbank receives a claim and the Banca d'Italia has incurred a liability. Now suppose the importer has borrowed from its commercial bank in Italy and this money has come from the Banca d'Italia via an open market operation, secured by Italian government bonds. If both the importer and Italian state defaulted, the Bundesbank would have to write off its claim. Such a loss would reduce public revenues in Germany. According to the ifo, a research institute based in Munich, the Bundesbank alone currently holds so-called Target2 claims of more than EUR 750 billion mostly vis-à-vis Southern European central banks. The Banca d'Italia has a Target2 liability of EUR 289 billion. In per-person terms, this is still considerably lower than that of Greece and Spain. It puts into question, however, that the Italian economy is sufficiently competitive internationally. If Southern countries default on this kind of debt, countries like Germany, Netherlands and Luxembourg would bear the burden. The "rescue package" is thus by far greater the ESM and ECB bond purchases would suggest, putting countries with Target2 claims at additional risk. On the whole, this situation is closely connected to wrong investment incentives created by shared liability of borrowing. Thus, any kind of route in this direction should not be followed for the sake of avoiding future problems, however tempting it may be to mitigate current crises.

3.2 The European Commission's Banking Union Proposal

Another proposal made by the *European Commission* is a *banking union*, which would allow lending of ESM funds directly to banks. As a result, national government debt would not increase when national banks receive public money. This could help particularly Spain and Ireland by breaking the link between the sovereign debt crisis and a potential banking crisis. However, again, the basic principle that risk-taking activity and liability should coincide would be heavily violated. Like the other measures in place (i.e. the ESM and ECB bond purchases), banks would be bailed out with public money, giving them further incentives for excessive risk-taking. One may hope that creating a common “banking supervision agency” in Europe, which is discussed in the context of banking union, may avoid socially irresponsible behavior in the future. However, given the recent failures of European institutions, some doubts are in order. There are plenty of challenges for supervising banks. To date, for instance, the European Commission has not revealed the basic principles of insolvency procedures or banking regulation (like capital requirements) in a banking union. Consensus on these questions should be achieved before deciding upon a banking union. If the decision for such a union is taken in the first place, strict rules will never be accepted later on.

3.3 Debt-equity Swaps, Capitalization, and Financial Market Regulation

As some scholars forcefully argue, a much better way would be to transfer the debt of banks into equity via so-called *debt-equity swaps*. Banks would be rescued, but current shareholders would not, as they would have to provide equity to creditors. In this way, not governments (and therefore taxpayers) would rescue banks but the owners of banks themselves. After all, shareholders and managers would be held responsible for bad investments. This is not only in line with the “costs-by-cause” principle, but also might no other group in society be capable to bear the losses, in view of the huge sums at stake. In the longer run, such a solution to the current crisis would also mitigate moral hazard. Once those who decide on investment strategies finally start to understand that they would be liable for large losses, they are incentivized to take less risk in the future.

Another possibility to deal with a banking crisis is to force banks to capitalize by issuing new equity. If private investors are unwilling to buy new shares, the government could buy them at (presumably low) market prices. New equity means that share prices would fall, including those of old creditors who received shares via debt-equity swaps. Thus, again, shareholders and managers would bear the bulk of the losses while banks continue to operate. There are potential losses for taxpayers but to a smaller degree than under a banking union. At the same time, governments may guarantee deposits to mitigate the risk of a bank run. This could lead, however, to speculative attacks if investors believe that those guarantees are activated. Moreover, such guarantees may lead to moral hazard problems in the banking sector. It is thus important that capitalization of banks with public money gives the government control rights and supervision power in banks.

Both debt-equity swaps and capitalization measures could be accompanied by three further regulatory measures. All of them are heavily discussed at the moment and seem to be appealing indeed to prevent future banking crisis. First, big banks shall be obliged to create a sufficiently large fund among banks themselves to help each other out in the case of potential failure of single, but system-relevant banks. Second, to make banks less system-relevant even though they are big, banks should not be allowed to use saving deposits to make risky investments. The most radical version of achieving this goal would be to split any large universal bank into a commercial bank and an investment bank. Finally, financial market regulation should push for even higher capital requirements of banks than recently proposed, including for government bond holding. By these measures, banks could be enabled to bear losses themselves rather than allowing them to socialize losses.

3.4 European Safe Bonds

An innovative additional proposal comes from a group of macroeconomists and financial economists like Markus Brunnermeier (Princeton University) and Luis Garicano (London School of Economics). The so-called Euro-nomics Group (www.euro-nomics.com) suggests *European Safe Bonds* (ESBies) which are[7]

> "*securities issued by a European Debt Agency (EDA) composed of the senior tranche on a portfolio of sovereign bonds of the different European states held by that agency*".

The idea is that the EDA buys government bonds in proportion to country size or GDP of member states (rather than selectively bailing-out some countries). These bonds are then used

[7] See www.euro-nomics.com/wp-content/uploads/2011/09/ESBiesWEBsept262011.pdf, p.4.

as collateral to issue two kinds of securities, a safe “senior” tranche which is served first in case of default[8] and a more risky “junior” tranche[9].

The idea may have several advantages. First, under the regulatory design that the ECB accepts ESBies as collateral for open market operations and only holdings of ESBies by banks are treated as risk free with respect to capital requirements, banks are incentivized to hold ESBies. Moreover, other financial institutes like pension insurers, which presently abstain to buy poorly rated government bonds, would turn to ESBies. Thus, some demand for government bonds could be ensured, in turn giving some relief from possible speculative attacks for a country like Italy. Second, if a single country defaults, due to bundling and securitization from different countries by the EDA, banking crisis may be less likely than currently. Third, in contrast to Eurobonds, the price of new government bonds would still reflect differences of countries with respect to the default risk of bonds, since only part of the issued bonds would be bought by the EDA. This would leave incentives to governments to manage public finances in a socially desirable way.[10]

One caveat remains. In the case of truly insolvent countries whose worryingly high interest rates are not a result of speculative attack, there will still be the question of who bears the losses in case of default which could result in a banking crisis: the general public or shareholders of banks. Thus, the creation of ESBies could be complementary to rather than substitute debt-to-equity swaps or bank capitalization policies. It is foremost a way to secure some fraction of sovereign debt and thereby satisfy the demand for a safe asset.

4. The Case of Italy

Given my analysis of problems and policy-options in the Eurozone, what kind of policies should Italy undertake and support?

[8] “*If the tranching cut-‐off is X%, then the first X% lost in the pool of bonds because of potential European sovereign defaults would have no effect on the payment of the ESBies*.” (ibidem, p.4).

[9] “*Any risk that a sovereign state may fail to honor in full its debts would be reflected in the expected return on this security. Any realized losses would be absorbed by the holders of this junior security, and not by the EDA nor the European Union nor its member States.*” (ibidem, p.5).

[10] For further discussion, see Tirole, Jean (2012), The Euro Crisis: Some Reflections on Institutional Reform, in: *Banque de France - Financial Stability Review* 16 (April), 225-242.

Fortunately, with its relatively strong industrial base, the Italian economy is in a better state and has better growth prospects than other indebted countries. Net foreign direct investment flows are negative but not dramatically (-1.2 percent of GDP in 2010, according to UNCTAD). Moreover, currently, Italy has a trade deficit of about two percent of GDP, which is considerably lower than in Greece, Spain and Portugal. The economic crisis has enhanced the unemployment rate more modestly. Between 2007 and 2011, it increased by 2.3 percentage points to 8.4 percent, according to OECD. This is not negligible but also not alarming. By contrast in Greece and Spain the unemployment rate exploded from 8.3 percent in 2007 to 17.7 percent (Greece) and 21.7 percent (Spain) in 2011, respectively. However, the Italian youth unemployment rate (age group 15-24) was in 2011 at a worryingly high level of 29 percent, up from 22 percent in 2006. There are also signs that unemployment rates further increase.

Nevertheless, in my view, Italy could stay in the Eurozone and be successful economically. Continuing the path of recent reforms could lead to higher expected tax revenues through productivity growth and higher employment. This route is necessary to ease the default prospects on sovereign debt. Contrary to repeated statements of EU politicians, however, I do not believe that large spending programs are required at the moment. The economic problems of Italy are largely structural. Labor productivity is stagnating for more than one decade and outgrown by increases of the wage rate, according to OECD.[11] Moving towards firm level wage bargaining could take into account regional productivity differences in a better way than at present and keep wage growth in check. This serves two goals. First, it should raise employment particularly in the South of Italy which suffers from a larger gap between wages and productivity than the North when wages are negotiated at the national level within sectors. Second, by reducing unit labor costs and prices, it improves competitiveness of the export sector.

Even more importantly, further reducing red tape could spur firm entry and growth. The OECD recently recommended the following:[12]

> "*Increase powers of competition agency. Reduce public ownership, especially in TV media, transport and energy utilities, local public services. Privatise and liberalise in energy and transport sectors. Remove unnecessary licensing in professional*

[11] See OECD (2012), Italy: Reviving Growth and Productivity, September 2012.
[12] Ibidem, p.6.

services. Remove quantitative restrictions on supply in services. Introduce national oversight of regional regulatory competences (e.g. retailing, land-use planning)."

Moreover, settling business and labor disputes in court takes much longer in Italy than on average in OECD countries and public administration often is inefficient in issuing business permits. All this contributes to perceived risk of entrepreneurs and discourages entry and investment.

Scope for future productivity improvement could also lie in education reform. For instance, in the past, recruitment of professors and other professional staff at universities has mostly come from in-house promotions and was not based primarily on academic achievements. Generally, incentives which reward performance of academic personnel and other public administration staff are welcome. Such measures could contribute to reverse the Italian brain drain.

As a final example for a potential reform which could solve the Italian sovereign debt problem, Italy should consider moving to a tax system which gives higher weight to property and estate taxes. These taxes are relatively difficult to evade and have little distortionary effects compared to labor income taxation. It may harm residential investment though. However, in view of the recent house price bubbles which were the underlying cause of economic problems in many countries, this may not be a disadvantage for Italy.

How about the transnational route to tackle the Euro crisis? It may be tempting for Italian politicians and voters to opt for continuation of the current "put-money-in-the-showcase" policies or even Eurobonds. However, such strategy could prove very short-sighted. As outlined above, the introduction of Eurobonds could mitigate the reform process in many countries and contribute to future asset price bubbles. The ESM could lead to contagion if indebted countries like Italy (or even Germany and France) had to fulfill their large scale promises. The ECB announcement to buy government bonds of indebted countries under certain circumstances may destroy the monetary stability of the Euro. In fact, under the current route, the Euro could become the most expensive and regrettable transnational project in the history of human mankind. Italy should have any incentive to suggest alternative measures to deal with the Euro crisis.