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Europe's Italy Problem

And, as a result, are monetary union and the euro in serious trouble?

BY BERNARD CONNOLLY

In April 2000, *Foreign Affairs* published an article by the then-recently deceased Federico Mancini, Italian judge on the so-called European Court of Justice. Mancini applauded the 1990 decision of Mitterrand and Kohl to ordain "the immolation of the deutsche mark on the altar of a common European currency." Mancini gloated that while the Germans thought the Maastricht bar for entering the euro—in particular the budgetary criteria—had been set high enough to exclude Italy, "The effort made by Italy was not just extraordinary; it was superhuman … The Italians won their bet and stunned Europe." Mancini was clearly just as credulous about Italy's budgetary "achievements" as anyone who naively thinks the revolutionary tribunal on which he sat, the ECJ, has any respect for the principles of law. Five years later, Italy is in recession and its budget deficit next year is likely to be close to 6 percent of GDP. There is even talk of Italian withdrawal from monetary union. What has gone wrong? The answer is obvious to anyone less credulous than Mancini: Italy got into monetary union in the first place.

The French referendum debate on the so-called EU "constitution"—a blueprint for an anti-democratic superstate with no *demos,* an imperialist and specifically anti-American *telos,* and an effectively totalitarian *ethos* in which the European state is deified—was full of envious reference to Britain's long period of economic prosperity (admittedly now facing a challenging time). While the composition of

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The Italian Problem

The Italian deficit has shot up again, from an apparently respectable 0.6 percent of GDP in 2000 to a likely 6 percent next year. Worse is yet to come: Italy is still losing competitiveness within the euro area and its production base is particularly vulnerable to the exports that China will need to take up the supply created by the massive investment of recent years.

It is now whispered in every corridor that Italian officials think they need a 20 percent improvement in competitiveness. But in monetary union the only way to get that is through competitive disinflation. That disinflation is achievable only through recession. If one factors recession and disinflation into a budgetary equation that already has a probable 6 percent deficit and a debt ratio above 100 percent among its terms, then one needs neither a spreadsheet nor even the back of an envelope to calculate that Italy's debt ratio is going to explode upwards.

—B. Connolly

demand has been less than ideal, Britain's growth, inflation, and employment record—its stability—puts the Continent to shame.

French angst about British success has largely focused on the implications of Britain's Thatcherite inheritance. Yet thirteen years ago, with Margaret Thatcher already shamefully cut down by treacherous Tory Europhiles and their co-conspirators in Brussels, Paris, Bonn, and Rome, Britain appeared to be in the same boat as Italy; or rather, the two countries shared the same pond as sitting ducks for speculators.

Does that mean that the alternative is Italian withdrawal from monetary union—and almost certainly intense speculation that Greece and Portugal, whose underlying economic situation is if anything even worse than Italy's, would have to follow?

The parting of the ways came in September 1992. While it is true that France—like Italy—has lacked a Thatcher, that is only part of the story. Italy in particular lacked a Chancellor of the Exchequer like Norman Lamont and suffered the presence of too many such as Home Secretary Kenneth Clarke (even one would have been too many). At the crucial moment when Italy too could have seized the chance of economic success after the sterling and the lira had withdrawn from the Doomsday Machine of the ERM, Lamont fought off the outrageous attempt of his europhile cabinet colleague Clarke to prevent a cut in British interest rates below German rates. Both men knew that such a cut would make it politically impossible for Britain to rejoin the ERM. But while Lamont famously declared that he "sang in the bath" when ERM exit gave Britain the hope of freedom and prosperity, Clarke's most notorious comment was that he had never bothered to read the Maastricht treaty and its nightmare vision of monetary union but knew it was right!

Lamont's patriotic triumph was the key to subsequent British success: Lamont gave Britain a policy framework that was wholly domestically oriented. In the dreadful Major government dominated by such as Clarke and Heseltine, this of course condemned him to the political wilderness. Reduced interest rates and a depreciation of the sterling allowed Lamont to begin the work of genuinely repairing public finances that had been ravaged by ERM membership—and, just as important, created conditions that have made it impossible even for someone as contemptuous of his country's interests as Blair to force Britain into monetary union. Britain owes Lamont a great deal.

Europe's Coming Debt Explosion?

But if the market continues to behave as if Italy will be bailed out, then a paradox arises: the higher Italy's debt ratio gets and the nearer Italy's situation comes to despair without a bailout, then the greater becomes the incentive for other countries to increase their debt ratios, since if there is an EU takeover of national debts, then countries with below-average debt ratios will lose out to those with above-average debt ratios. In other words, the whole euro area is likely to see skyrocketing debt. If it begins to look as though euro area governments will not tolerate such a development, and attempt instead to convince the market that Italy will *not* be bailed out, then Italy's bond spreads will rise sharply and a government default becomes a real possibility. It goes without saying that the deflation and recession involved in any attempt to rectify Italy's debt position within monetary union will bring widespread private-sector default.

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By contrast, in Italy there was no equivalent of Lamont to take on the Europhile big battalions of the political and financial elites, notably Carlo Ciampi, governor of the Banca d'Italia. Desperate to get the lira back into the ERM so as to preserve Italy's self-destructive desire for euro entry, the Banca d'Italia kept interest rates high, depressing investment and deterring a restructuring of an often-antiquated industrial base in Italy. Not surprisingly, while the British budget deficit quickly shrank, Italy's remained enormous right up until 1996.

In that year, then-Prime Minister Romano Prodi was rebuffed by Spanish Prime Minister José María Aznar when he tried to get an agreement with Spain that would commit the European Union to an assured, though delayed, euro entry for Italy and Spain. Alarmed that there might be no "second wave" of entrants, Prodi hurriedly switched tactics. The EU Commission's approval of France's budgetary sleight-of-hand concerning France Télécom's pension obligations gave the Italian authorities the green light: an Italian official was quoted in the *Financial Times* as saying that whatever feats of legerdemain France could perform, Italy could do better. The Italian budget deficit, which had been 7.1 percent of GDP in 1996, was recoded as having fallen to 2.7 percent in 1997, the reference year for the Maastricht convergence criteria. Mancini chose to call this a "superhuman" effort.

But for those inclined to view budgetary outcomes as being determined by human agency, it was clearly an unsustainable effort. One-off measures are expiring and initially favorable financial stratagems for adjusting the time-profile of the deficit (stratagems for which the Maastricht rules were an open invitation) are now becoming a burden on the finances. The strong Italian growth of 1999–2000, driven by the low interest rates and weak euro imposed by European Central Bank boss Hans Tietmeyer to ease the pain of Germany's own adjustment process and by the high-tech bubble in the United States and elsewhere, has been suc-

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ceeded by recession. The Italian deficit has shot up again, from an apparently respectable 0.6 percent of GDP in 2000 to a likely 6 percent next year.

The failure of Italy's economic structure to adapt, combined with a significant loss of competitiveness in recent years (the growth of 1999–2000, in an economy with an inadequate productive base and a truly abysmal productivity performance since 1996 soon sparked above-average inflation in Italy), has devastated Italy's share of world trade—down by around 30 percent since monetary union began. Worse is yet to come: Italy is still losing competitiveness within the euro area and its production base is particularly vulnerable to the exports that China will need to take up the supply created by the massive investment of recent years.

It is now whispered in every corridor that Italian officials think they need a 20 percent improvement in competitiveness. But in monetary union the only way to get that is through competitive disinflation. That disinflation is achievable only through recession. If one factors recession and disinflation into a budgetary equation that already has a probable 6 percent deficit and a debt ratio above 100 percent among its terms, then one needs neither a spreadsheet nor even the back of an envelope to calculate that Italy's debt ratio is going to explode upwards.

In Argentina a few years ago, a prospective finance minister argued that domestic wages and prices had to be cut by 20 percent to restore competitiveness and allow Argentina to reassure foreign investors. What he did not bother to mention was that achieving a 20 percent deflation would have required Argentina to bear the unbearable, involving not only mass unemployment but almost certainly widespread bankruptcy and default. Not surprisingly (at least to those who did not swallow the "research" coming from the Wall Street sell-side), Argentina was not prepared to bear the unbearable. Economic Minister Domingo Cavallo's zero-deficit plan was always unviable: the introduction of parallel currencies by several provinces and—the straw that broke the camel's back—food riots pushed the government into accepting the inevitable: the abandonment of convertibility. Analysts sometimes debate whether Italy's present position is worse than that of Argentina in 2000. There should be no debate: not only is Italy's budgetary and debt situation far worse than was Argentina's, Argentina had merely tied itself to the mast of convertibility, while always keeping a pair of cutters in its hands. Mancini spoke of the immolation of the deutsche mark, but it is Italy that now faces immolation at the stake of monetary union to which it is chained.

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The markets treat the Maastricht treaty, with its "no bail-out" clauses, as the collection of tricks, deceits, outright lies, and false promises that it really is.

Mancini had crowed that, on Christmas Eve, 1998, "When prime minister d'Alema, an imperturbable former Communist, announced that the Italian ten-year government bond yield had dropped below that of its German counterpart for the first time in history, his voice rang with delight." Germany's fiscal situation in 1998 was not good, and it is hardly good today. But is enormously less bad than Italy's. Why have bond spreads, although moving against Italy recently, not yet caused the "imperturbable former Communist" and others to scream as financial market flames begin to singe them? The answer seems to be that the markets treat the Maastricht treaty, with its "no bail-out" clauses, as the collection of tricks,

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deceits, outright lies, and false promises that it really is. The market has preferred to believe the explicit statement of former EU Commission President Jacques Delors that "Monetary union means that the Union [the EU] acknowledges the debts of the member states of the monetary union." The syntax was tortured but the meaning clear: there would be a bailout of any country that got into budgetary deep water.

Monetary union without a parallel or preceding political union was always going to be a perilous venture. The United States had a political union—and an initial debt union, in which the federal government assumed the existing debts of the thirteen new states—a century and a quarter before it had a full monetary union. Assumption was always feared by the German public as well as by the German Finance Ministry and by the Bundesbank—though one wonders to what extent the unmistakable opposition to Italian membership of the devoutly Catholic Tietmeyer was a function not just of his worries about Italy's debt but also of his antipathy to the anticlerical faction in the Banca d'Italia led by Ciampi and the "Ciampi boys," notably Tommaso Padoa-Schioppa. In the absence of assumption, the European monetary union should have insisted that aspiring single-currency countries, which would abandon monetary sovereignty, must first pay down their debt almost entirely and eschew *any* future deficits. But the laxity of the Maastricht convergence criteria and, more recently, the demise of the Stability Pact means that there is no source of fiscal discipline other than the market.

But if the market continues to behave as if Italy will be bailed out, then a paradox arises: the higher Italy's debt ratio gets and the nearer Italy's situation comes to despair without a bailout, then the greater becomes the incentive for other countries to increase their debt ratios, since if there is an EU takeover of national debts (and that, to repeat, has always been an objective monetary union, so clearly stated by Delors), then countries with below-average debt ratios will lose out to those with above-average debt ratios. (There is no sign whatsoever of the "degree of solidarity characteristic of a nation" sagely, if perhaps hypocritically, identified by Tietmeyer as a precondition of a successful monetary union.) In other words, the whole euro area is likely to see skyrocketing debt. If it begins to look as though euro area governments will not tolerate such a development, and attempt instead to convince the market that Italy will *not* be bailed out, then Italy's bond spreads will rise sharply and a government default becomes a real possibility. It goes without saying that the deflation and recession involved in any attempt to rectify Italy's debt position within monetary union will bring widespread private-sector default.

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This is where the fracturing of political purpose in the European Union becomes important. The political cost to the key EU countries, essentially France and Germany, of throwing a country like Italy to the wolves has always been that such a decision would make a political union—a superstate—covering the whole of the European Union virtually impossible. This consideration has, at least in part, underlain the market's conviction that there would always be a bailout in case of need. But over the past couple of years there has been an erosion of the French elites' belief in their ability to run a wide European Union as they want. That was, unsurprisingly, the essential issue in the French referendum campaign: would the "constitution" make it easier or harder for France to get what it wanted out of the European Union? One can see the referendum result as virtually a 100 percent vote against the possibility of continued erosion of French influence.

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Given that, it seems likely that France will push for closer integration among a relatively small group of like-minded countries who want to defend the "Rhenish" model. And it is quite possible that this integration will occur largely outside the existing EU framework. It is almost certain that any such grouping will want to downgrade the European Union (just as de Gaulle downgraded the European Union from 1963 to 1966 once he had tied down the Franco-German relationship with the Elysée treaty) to avoid any risk that it might, as was feared however implausibly by "no" voters in the French referendum, attempt to force countries away from the "Rhenish" model. That was not what the European Union was formed to do, and there is no chance whatsoever that France would ever let it do it. But if all that is so, then what is the purpose of the existing monetary union? It is hard to find an answer to that question. But what is clear is that the perceived political cost of throwing Italy to the wolves would be much reduced if the key countries no longer wished to enforce a political union on the whole of the European Union and perhaps not even the whole of the monetary union.

As Mancini said, Germany—or at least its voters—accepted monetary union only on the assumption that Italy would not be in it. Why would those voters now, with France less eager to press their leaders than in 1990 or 1997, accept the debt union corollary of Italy's monetary union membership? Does that mean that the alternative is Italian withdrawal from monetary union—and almost certainly intense speculation that Greece and Portugal, whose underlying economic situations are if anything even worse than Italy's, would have to follow?

That is where comparisons with Argentina may fall down. Even three years on, the legal uncertainty created by Argentina's abandonment of convertibility has not yet been fully resolved. But that most hackneyed of clichés seems appropriate: the legal and financial consequences of a withdrawal from monetary union would make *Oh! Calcutta!* look like a vicarage tea-party. There seems little doubt, however, that at some stage the European Central Bank is going to act, *in extremis,* as though it were Italy's central bank while the political conflicts about whether to bail out are being decided. That implies a period of extreme euro weakness. Unfortunately, euro weakness could be the least of the ills visited on Europe and the world by the irresponsible decision to create a monetary union. ◆