The Politics of the

Premier global strategist Edward Luttwak sat down with TIE *founder and editor David Smick. The question: Given the grimy, intractable underside of Greek, Spanish, and Italian politics, are structural reforms and fiscal consolidation even possible?*

Smick: We are at a critical moment in the eurozone debt crisis. The EU summit's reforms are already being watered down. The European Central Bank has an ambiguous policy which some suggest is a backdoor means of quantitative easing, if not creating some equivalent to eurobonds. Yet the Bundesbank is resisting. The future seems murky. At the end of the day, the eurozone's enormous pile of sovereign debt is between €5 trillion and €7 trillion. What's the endgame in all of this?

Luttwak: It depends on one essential unknown: whether the ruling elites of the countries most brutally affected continue to be prisoners of a *götterdämmerung* mentality, whereby they refuse even to evaluate the costs and benefits of staying in the euro.

Smick: Please elaborate.

Luttwak: The effects of the current austerity policies are not merely extremely recessionary with no recovery expected for years—in some countries the effects include mass emigration and a collapse in fertility. If and when any of the respective governments decides to leave the euro, accepting sharp currency depreciation and the resulting need to negotiate debt relief for the sake of rapid growth and increased employment, the European debt problem could become manageable. The sheer volume of the debt could then decline to sustainable levels. The

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Eurozone Crisis

Edward Luttwak

claim that the debt is already manageable is simply false. Even in the case of Greece, that pretense was long maintained by the European Central Bank and the French and German governments, as if arithmetic did not exist. The pretense of sustainability continues still in the case of the colossal Italian debt.

For the new European Fiscal Union that the German government has almost singlehandedly created—approved by the seventeen euro countries at the European Council meeting of December 9, 2011—the debt problem is not qualitative, and cannot be resolved by more "credibility." It is a question of impossible numbers. Members are obligated to reduce their sovereign debt by 5 percent per year. The fiscal drag caused by adding that 5 percent to current interest payments would further damage economies already in recession, and totally sink the economies of Italy, Spain, and Portugal. By contrast, if they left the euro and negotiated debt relief, the remaining European Fiscal Union members would only face the bounded problem of recapitalizing banks to the extent necessary to offset the losses caused by delayed maturities, if not outright cuts. It would be in everyone's interest to minimize disruptions and the resulting damage to intra-EU trade. In any case, a multi-directional, political, social, economic, and financial problem would be drastically simplified, a matter of the German government putting some money into Deutsche Bank, the French government doing the same for Société Générale and Paribas, and so forth.

In the end, the creditor class loses.

On the other hand, the ruling elites of these countries may decide to stay in the euro regardless of the consequences, accepting more mass emigration in the case of Portugal, the catastrophic collapse of the birthrate in the case of Spain, and disastrous youth unemployment in the case of Italy. If they continue down that path—remaining with the euro that makes them structurally uncompetitive—then of course the European debt problem will continue to be unmanageable. I do recognize that the pro-euro elite is not irrational: no growth and unemployment are simply less important for them that to be accepted as full, that is, "Nordic," Europeans.

Smick: Let's use Italy as an example. In this new German-run effort at reform and consolidation, isn't reforming the Italian situation just too politically complicated? The real power is on the regional and local level. Italy is a country rich in government assets, but wouldn't privatizing those assets be difficult because so many are controlled at the regional and local levels? The same is true for cutting government sector spending, including for public pensions. The national officials lack enforcement power.

Luttwak: According to an Italian Treasury report of September 29, 2011, Italy is indeed well endowed with saleable assets: their total for real estate, infrastructures such

as the autostrade, and shares in utilities and other entities, is €571 billion, equivalent to 30 percent of the current public debt, without counting less saleable assets such as natural parks, Pompei, the Uffizi, and so forth (the report cites a highly theoretical total of €1.815 trillion).

But of that €571 billion, only €185 is controlled by the twenty-two state ministries, with the remaining €386 billion the property of some nine thousand local authorities—and that includes the valuable utility companies of the major cities. Many Italians complain that Italy is too centralized, but when it comes to implementing structural changes, it often functions as a confederation of cities and regions. It would be very difficult for Rome to privatize municipal assets.

Smick: Doesn't Chancellor Merkel have in mind the experience of assimilating East Germany, in which East German taxation was brought in line with that of West Germany? Would that model work with Italy? Can Berlin impel Italians to pay their taxes?

Luttwak: The *Wiedervereinigung* that united East Germany with West Germany suggests a synthesis, but what actually happened was that the Easterners had to accept *in toto* the structures, norms, and rules of West Germany, including personal behavior in the workplace, with no synthesis whatever. Easterners accepted it all because the benefits were immediate and very large, though there were still endless complaints that it was an imposed *Gleichschaltung,* a "bringing into line," a Nazi term.

It is the same with the new European Fiscal Union: what the southern Europeans agreed to accept on December 9, 2011, and British Prime Minister Cameron rejected, was the adoption of current German norms, not any kind of synthesis. As the Union is formed, this must necessarily include tax collection, for without it there would be the most politically conspicuous kind of free-riding—the Southerners would in effect get their pensions from Frankfurt, from the common European Treasury, without paying commensurate taxes to Frankfurt.

Hence, one issue is how to implement common standards of tax collection. Plenty of Italians, especially in the North, long to pay their taxes under fair and equal rules, but especially in the South there is a deep anti-state culture. In some cases, adequate levels of tax collection would probably require forcible police action. As it is, the Guardia di Finanza, the Italian tax police, is routinely armed with automatic weapons. In Spain also, by the way, tax evasion is deeply rooted in anarchical traditions, and its substantive reduction would require cultural change. The ruling elites of both countries are thus imposing nation-destroying economic sacrifices to remain in the euro, but the required *Wiedervereinigung* may turn out to be culturally and politically unfeasible in any case.

Smick: What about the politics of austerity? To what extent is economic sacrifice going to be a problem given that the elites in these weaker countries have been benefiting the most? For example, are government elites going to willingly give up incredibly generous pensions?

Luttwak: This differs, of course, from country to country. Spain and Italy have very similar legal systems but while tax evasion is rampant in both countries, corruption in Spain has been a marginal phenomenon, and the Spanish governing elite is not especially privileged. Even the

The Italian presidency costs much more than the British monarchy. Buckingham Palace is an outhouse compared to the Quirinale, and Balmoral a mere cottage as compared to the summer residence of **Castel Porziano,** *both full of highly paid staff, in line with Italy's uniquely high political salaries.*

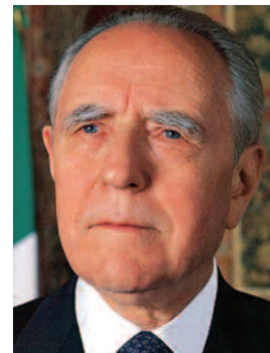
Spanish king lives relatively modestly. The Italian presidency, by contrast, costs much more than the British monarchy. Buckingham Palace is an outhouse compared to the Quirinale, and Balmoral a mere cottage as compared to the summer residence of Castel Porziano, both full of highly paid staff, in line with Italy's uniquely high political salaries.

For example, the president of the province of Bolzano (160,000 inhabitants) is paid €25,000 a month, some 40 percent more than Chancellor Merkel, and a tad less than President Obama. He has lots of colleagues in Italy's nine thousand-odd local authorities: the 300,000 inhabitants of the region of Molise are served by a full-fledged regional government, a regional council, two provincial governments with their own councils, and 105 municipalities. Their governor, various presidents, and 105 mayors are paid from €3,000 to €20,000 per month.

Italy's central government also pays top officials very high salaries: the director-general of the Treasury receives some €500,000 a year, with many judges receiving more than €250,000. That reflects the indirect effect of a law that links the salaries of deputies and senators to the salary of senior judges: by ensuring that top judges are paid far more than the EU average, Italy's 945 parliamentarians (Germany has 691) themselves outdo all their European colleagues with salaries of roughly €150,000, in addition to lots of fringe benefits, including free travel.

But the privileges of Italy's ruling elite really come out in their exceptionally generous pensions. Mario Draghi, who made many speeches calling for reductions in ordinary worker pensions (rarely more than €1,400 a month), continued to collect his own €14,843 a month from his former Treasury job, while also being paid €450,000 a year as head of Italy's central bank (he has taken a huge cut at the European Central Bank, though he will still do much better than Bernanke). Because there is no limit on the concurrency of parliamentary salaries with state and Bank of Italy pensions, former President Carlo Azeglio Ciampi collects a combined €53,000 a month, with a slew of former ministers and prime ministers including Amato (€31,000), Dini (€44,000), and Andreotti (€29,000) all receiving more than the salary of U.S. presidents or German chancellors.

In Ireland, Portugal, and Spain, austerity decisions were made by governments that no longer had popular support, and which had no hope of winning in imminent elections.



Former President of Italy **Carlo Azeglio Ciampi** *collects a combined pension of €53,000 a month.*

A second unique feature of the Italian state pension system is that while most pensions are very low, there are no upper limits at all. Hence the pensions of former state-owned company managers often exceed €240,000 a year, with quite a few collecting more than €400,000, including the lucky recipient of what must be the world's highest state pension, at €1,173,205.

Finally, the Italian state pension system also differs from Social Security and most of its European counterparts in having no minimum age limits. Draghi himself has collected his own ample "baby pensione" from age 53, but the ex-teacher wife of the head of the Northern League started receiving her modest €766 a month from age 38, while a great number of former politicians started on their much higher pensions of €100,000–200,000 a year well before reaching 50. Some were parliamentarians who resigned very soon after being appointed, with a certain Luca Boneschi being the record-holder: he served only one day (May 12, 1982) before resigning, but from next year at age 44 he started receiving €3,108 a month. Two other recipients of parliamentary pensions served only eight days, and hundreds for only one term.

Certainly, a *Wiedervereinigung* with German norms would mean a drastic loss of income for Italy's political elite. Yet many of them are willing to accept that, some because of patriotism, others because they are confident in their ability to circumvent salary and pension cuts—politics is a highly profitable business in Italy in other ways as well.

Smick: So financial markets can never know if the Italians are serious? The likely scenario is that the elites announce cuts to their generous pensions as an example to the rest of the world. Then they circumvent the cuts.

Luttwak: That has been the case so far. Prime Minister Mario Monti, who renounced his own salary (he receives both Italian state pension system and European

The Guardia di Finanza, the Italian tax police.

Commission pensions) wanted to cut Parliamentary salaries to the European average, by roughly half. So far, he has been circumvented.

Smick: What's their ability to sell assets?

Luttwak: There are certainly lots of assets—the Greek state, by contrast, is very poor, so that the site of the former Athens airport loomed large in what could be sold (nothing happened, of course—Greek politicians do not believe in transparent auctions, and in present circumstances they would be lynched if they gave it to friends).

The Italian case is entirely different, as we saw. There are lots of assets, but as currently managed their returns on equity—including municipal utilities that have monopoly power—average only 0.9 percent according to the Treasury report already cited. Obviously that could be multiplied if the real estate (estimated at €421 billion), operating companies (€80 billion), and infrastructure concessions (€70 billion) were managed professionally—the report itself estimates a potential return on investment of 5.7 percent. It would mean €32.5 billion a year for the Treasury for debt reduction.

But as we saw, the central government only controls €185 billion out of €571 billion in those assets, and I have seen no realistic proposals even for that part. Past experience is not reassuring: instead of open international auctions, past privatizations were negotiated, supposedly to keep things in Italian hands, but only a few well-connected Italians actually benefitted.

Smick: Let's say the Italian elite finally reaches the conclusion that Germany is not going to allow the eurozone to reflate—that is, monetize the debt. Will it choose this new German-run financial unification entity, which sooner or later will hit the Italian elite with a loss of power and income? To what extent will the Italian elite have any choice in the matter with either the strong core countries, the bond market, or both dictating the policy direction?

Luttwak: The loss of power has already reached the point of dictating the composition of the Italian government. Berlusconi was not voted out by the Italian Parliament. Instead he resigned under overwhelming pressure from Berlin, Paris, and the bond market. But now his unelected successor Mario Monti—who was not even a member of Parliament—is already asking for a relaxation of the European Fiscal Union debt-cutting rule which Italy accepted last December. The Germans cannot live with that, any more than Italy can live with the rule, which would add €95 billion in debt reduction to at least €95 billion in interest payments. You cannot take that much out of a €1.6 trillion GDP without starting a disastrous downward spiral in incomes, consumption, and tax revenues.

Smick: At that point countries such as Italy have to decide whether they are in or out. How do you see the calculus?

Luttwak: Different regions would offer different answers. The Neapolitans and the Sicilians would never want to leave the euro, because they value the stability of the money they receive from the center, while they do not fear that they will actually have to pay the high taxes imposed to stay in the euro. As for the Milano elite whose highest exemplar is Mario Monti himself, they desperately want to stay in the euro because it embodies their claim to a central European identity—in leaving the euro, they think that they would be redefined as "Mediterranean," not a compliment for them. But the head of the now openly separatist Northern League, Umberto Bossi, says that he would leave the euro immediately if he could. For the League, the financial model is independent Switzerland, not the German-led European Union, and it is true enough that if Piedmont, Lombardy, and the Veneto provinces were on their own, they could do very well with their own currency. Italian exporters everywhere would certainly benefit very greatly from a devalued national currency that would offset the years of relative cost growth that they have suffered.

But for now, most leading politicians simply refuse any discussion of the option of leaving the euro. Instead they habitually obfuscate by asserting the impossibility of leaving "Europe," as if there were no EU members beyond the seventeen in the euro, including such successful examples as Denmark, Sweden, and the United Kingdom.

Smick: What happens to the sovereign debt under a new currency?

Luttwak: As of now Italy's sovereign debt is 20 percent bigger than its GDP, far too much to be successfully managed. With a new and inevitably devalued currency, the debt would become totally unmanageable, and debt reduction in some form entirely unavoidable. The only question is whether it would be negotiated or not, with the former altogether more likely given the importance of Italy's economy, for Germany first of all. The Greek haircut, not yet enacted, was first proposed at 40 percent, then 50 percent,

With their euro prices suddenly very low, everybody and his brother in northern Europe would drive down to Spain to buy houses and apartments in the sun.

and then 60 percent. In Italy's case, a 30 percent debt reduction, whether achieved by negotiations or by the asset disposals that are theoretically possible, could keep Italy in the euro while reducing its debt to sustainable levels. (It is interesting to note that Italy's 4 percent bond with a 2037 maturity is selling at €69 today). But if Italy stays in the euro, it would still have to confront its fundamental competitiveness problem: its relative production costs were too high even before the recent tax increases.

The Spanish case is different in basic ways. As of now unemployment is over 25 percent, youth unemployment runs at 40 percent, and with fertility already the lowest in Europe pre-crisis, Spanish women have now stopped making babies. It's not just the Spanish economy that is in trouble, but even the biological survival of the Spanish nation itself. If Spain leaves the euro, its debt that was only 60 percent of GDP pre-crisis would become unmanageably large in devalued pesetas.

But think of the other consequences. With their euro prices suddenly very low, everybody and his brother in northern Europe would drive down to Spain to buy houses and apartments in the sun. The huge real estate overhang that condemned Spanish savings banks and immobilized the economy would rapidly disappear. The new owners would hire people to clean the apartments, and do a bit of repainting and renovation no doubt. They would buy furniture, and eat a few meals before returning home. Spain's unemployment rate would go down very fast. People would be working again, and making babies. As against that renaissance of lives and hopes, there would be a banking problem to be solved.

The issue now is whether, in what are still ostensibly democratic systems, the material needs of much of the population still count. In Ireland, Portugal, and Spain, austerity decisions were made by governments that no longer had popular support, and which had no hope of winning in imminent elections. In Italy and Greece, under foreign and market pressures, elected governments had to hand over power to completely non-representative governments, as it happens headed by leaders who had fervently argued for entering the euro back in 1994. In both cases, calls for new elections were silenced by the dire warnings of unelected EU officials.

But debts that became unsustainable in economies that had become uncompetitive remain just as unsustainable as they were.

Smick: So you're saying that in the end, unavoidably, the creditor class loses, even though today they think they're going to end up the winners?

Luttwak: Yes, absolutely. Given the German refusal to monetize the debt—they have their good reasons, given the composition of their savings—the theoretical alternative is for everything to be rolled back in the now uncompetitive south. If everyone accepts lower wages, salaries, and fees, and every business cuts prices, the benefits of devaluation could be achieved without any of its costs. While theoretically entirely possible, this method has never before been implemented in human history. For decades, the Italians successfully managed their progress from poverty to affluence with successive devaluations of the lira to maintain their competitiveness. They preserved social harmony by allowing wage increases, which they then recouped through devaluations. By contrast, the stability of the euro has only protected Italy's pensioners and savers (unless they made the mistake of investing in state bonds), while penalizing its active population of entrepreneurs, employees, and unemployed would-be employees. Even before the greater stringency of the new Fiscal Union, taxes have now been further increased and social spending has been cut to stay in that same euro system that makes Italy uncompetitive. Perhaps for all his vulgarity—he has lately insulted the venerable president, the flag, and Italy's national anthem—Bossi is right after all, as the economic and social costs of the euro *status quo* keep rising. ◆