Italian Euro Exit?

Why it's not as far-fetched as you'd think.

BY WOLFGANG MÜNCHAU

Financial markets are only ever in two states of mind over Italy: one of complacency or one of panic. Right now markets are in complacent mood. Prime Minister Giorgia Meloni does not appear as dangerous as investors originally feared. The spread between Italian and German ten-year bonds has hardly shifted as the European Central Bank started to raise interest rates. It has been steady at around 200 basis points. The markets are relieved that Meloni did not challenge the European fiscal order or threaten to take Italy out of the euro. She is, it seems, a fiscal conservative, who prioritizes other political battles, like immigration, LGBTQ rights, and other social issues that enrage the right in Europe. It certainly looks that way. But looks might deceive.

It is hard to conceive of a worse financial crisis than one caused by an Italian exit from the eurozone. It would be accompanied by a default on Italy's nearly $3 trillion in debt, most of which is denominated in euros. In addition, Italy has a huge deficit in the Target2 balance sheet of the European Central Bank. Target2 is the real-time settlement system of the eurosystem. In December, Italy's had a negative balance of almost €700 billion. Germany had a surplus of nearly €1.3 trillion. The Target2 imbalances do not have significance during normal modes of operation, but not so if a country defaulted and exited the eurozone.

It is therefore a fair question to ask whether Europe's most far-right political leader is really as harmless as she appears to be. Meloni's party, the Brothers of Italy, has origins in Italian fascism. She has disassociated herself from that ideology, and refers to herself as a supporter of the nation state. So should we believe her? My answer to this question is: We would be wise not to.

The reason I worry about Meloni is not because of what she is doing now, or saying now, but what she might do in the future. Right now, she consolidates her position. She has outmaneuvered her many, mostly male, rivals in Italian politics, including political heavyweights like Silvio Berlusconi and Matteo Salvini, the leaders of her coalition partners Forza Italia and the

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Lega respectively. She will only be able to take a more aggressive position on European issues once she is firmly in the driver's seat. This is the autocrats' playbook. Vladimir Putin and Viktor Orbán, the Hungarian prime minister, started out as moderates. It took a few years until they showed their true colors.

After a decade of austerity and low investment, Italy is struggling to invest.

But her lack of focus on economics should not deceive into thinking that this will always remain the case. Exiting the euro might eventually be her best, or her only option to stay in power. If the Italian voters believe that she, too, is not solving the problem, she will need a strategy.

Since the exit of Silvio Berlusconi during the euro crisis in 2011, there have been seven prime ministers, including Meloni. What they all have in common is their failure to address the country's underlying economic problem. This is not the level of debt, but the lack of productivity growth. Italy has had virtually no significant productivity growth since it joined the euro. Data from the University of Groningen in the Netherlands show that during 2014–2019, the eurozone as a whole had productivity growth of 1 percent. The United Kingdom had 0.6 percent. Italy had 0.2 percent. But the trend was deeply negative for Italy. In 2018–2019, Italy's productivity growth became negative, at -0.2 percent.

Perhaps the most shocking statistic is that from 1995 until 2019, average annual total factor productivity growth in Italy, the part of productivity not accounted for by capital and labor, was -0.51 percent according to data from the University of Groningen. Total factor productivity is the animal spirits component of productivity that measures how we get better at doing things.

When Italy joined the euro, the big economic gap was between a wealthy and industrious north, and the *mezzogiorno* in the south. This gap no longer describes Italy' modern economic geography. Areas of poverty and desolation are now scattered throughout. Liguria is the part of Italy that borders the French Riviera. Whereas the French Riviera is one of Europe's most prosperous regions, Liguria is one of its poorest. So is Piedmont and Valle d'Aosta, both of which border France. According to a study by the European Commission, thirteen out of Italy's twenty-one regions have entered a doom loop of emigration, low educational attainment, and low investment. Germany has only four regions—in the east of the country—that fall into that category. France has three. Spain has none. The number of university graduates among 25- to 64-year-olds is only 20 percent in Italy, half the level of France. It is second-lowest level in the European Union. Italy has the worst demographic outlook of EU countries, and badly needs immigration to fill jobs.

And no prizes for guessing how Meloni stands on the issue of immigration.

What about fiscal transfers? In theory, that could help make an unsustainable situation sustainable. In practice, this is not going to happen on a permanent basis. Italy managed to secure €80 billion from the European Union's €310 billion recovery fund of investment grants. Most of those investments are targeted for special EU priorities—green technologies and digital infrastructure. Linked to those grants is an obligation to undertake economic reforms.

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How a Euro Exit Could Work

Italian Prime Minister
Giorgia Meloni

This is how it could work.

First of all, don't repeat the mistake of the coalition between the Five Star Movement and Lega in 2018. They committed the cardinal error of talking about it.

The second step would be to make secret preparations. Skip the paper money, and go straight for a digital-only currency. That facilitates the logistics. Also, modernize information technology systems in banks to give them the specific capability to handle multiple currencies and digital payments systems. This might be hardest part.

And then you wait—for an incident. That could take years. But in Europe an outrage is never far away. Less than two years after the 2018 Italian elections, during the early stage of the covid pandemic, Germany banned the sale of face masks to Italy. The popular mood in Italy suddenly flipped against Germany and the European Union. That could have been one of those moments to engineer a fracture and pull a parallel currency out of the drawer.

—W. Münchau