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Italy's Fiscal Crisis

Italy is presently one of the most vulnerable economies in the eurozone. Over the past twenty years it has failed to adapt to increasing global competition and its public finances have deteriorated dramatically. Even with huge fiscal support from the other members of the eurozone, Italy's perspectives look rather bleak. How did this situation come about? Did Italy's EMU membership make things worse?

Italy's financial stability is being increasingly challenged by the global financial markets. Standard & Poor's (S&P) downgraded Italy's rating to A/A-1 from A+/A-1+ in September 2011 and said Italy's economic growth prospects were getting weaker. This maintains Italy's rating at the level of investment grade, but the junk bond status threshold is getting closer. The future outlook is still negative according to S&P, raising expectations that further downgrades may occur in the near future. After S&P downgraded Italy, Moody's and Fitch followed in October. Moody's lowered its Italian sovereign bond rating by three notches to A2 on 5 October 2011 for the first time since 1993. Fitch followed suit on 7 October 2011, lowering the Italian short- and long-term ratings to A+ with negative outlooks on both of them. The downgrade of Italy's sovereign rating was followed by a downgrade of major Italian financial institutions, since they are major holders of Italian government bonds. The downgrading leads to higher financing costs for both the government and the commercial banks in Italy. This creates a vicious circle which could become much more painful in the near future.

One cause for the downgrade mentioned by S&P was that the financial reforms proposed by the former Italian government of Silvio Berlusconi provided no expectation of a major adjustment to the current weaknesses. The key elements for Italy's recent S&P downgrade are:

- "Weakening real and nominal growth prospects.
- What we view as significant political impediments to growth-enhancing reforms.
- High gross and net general government debt.
- Limited commitment to expenditure cuts under the current medium term fiscal programme."[1]

The underlying factor for the current downgrade is the weakness of Italy's long-term growth perspectives, which have up to now not been addressed properly by the Italian government.[2] The Italian government under Silvio Berlusconi was quite reluctant to address these weaknesses, which are the outcome of long-term structural weaknesses of the Italian economy. Now that Mario Monti's new government has taken office we shall have to wait and see whether, and how soon, this will change. Under the current circumstances of a crisis of confidence in the fiscal stability of numerous eurozone countries, these weaknesses have become a severe liability. Structural reforms to bring government expenditures into line with the lower growth perspectives are still in their infancy. Furthermore there has been stiff resistance in the Italian population to the austerity measures taken by the Italian government. Again, we shall have to wait and see if the new government has sufficient public support. Without public support for stabilising the government budget and bringing the high public deficits down to a sustainable level, attempts to get the country's public finances under control in the face of rapidly waning trust in the Italian financial system will lead sooner or later to a debt trap. Rising market interest rates for the burgeoning public debt – about two trillion euros – will make refinancing via private capital markets less and less feasible. The deteriorating market sentiment for Italy, indicated by the country's credit default swap (CDS) rate through August 2011, is shown in Figure 1. Similar to Greece, Italy might end up in a sovereign default situation. This would ultimately put the financial stability of the entire euro area at risk.

The Core Debt Problem: Lower Growth but not Lowered Public Expenditures

However, in addition to these weaknesses, the rapid increase of the Italian state's indebtedness has rendered the country's fiscal position unsustainable since the early 1990s. Italy's public debt is currently at its highest level

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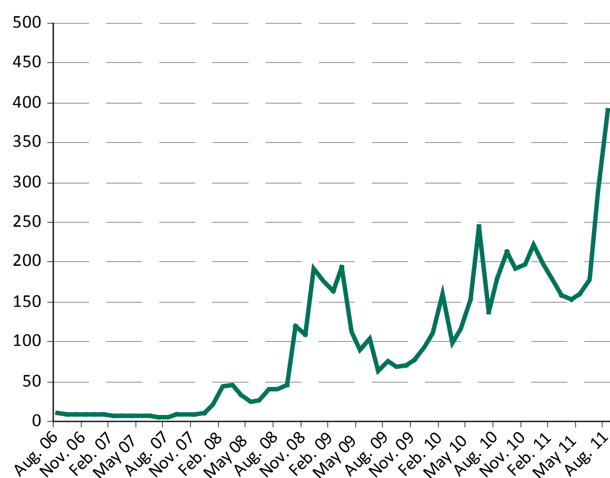
1 Standard & Poor's: Republic of Italy, Ratings Direct – Global Credit Portal, Message from 19 September 2011, London.

2 R. Sanderson: S&P downgrades seven Italian banks, in: Financial Times, Message from 21 September 2011.

Figure 1

Credit Default Swap Rates for Italy

Aug. 2006 – Aug. 2011.



Source: Bloomberg.

since WWI. Italy crossed the 100 per cent debt-to-GDP-ratio threshold in 1992 and has never managed since to bring the ratio below this threshold.[3]

The opening of Eastern Europe as a newly accessible low-cost labour market put those countries at the southern periphery of the future eurozone under massive cost pressure. Previously, Italy and other Mediterranean countries were regarded among European companies as low-cost destinations for European investment. This locational advantage shifted after German unification and the collapse of the Soviet Union. With the eastward enlargement of the EU, the problems became even more pronounced for Italy. Nowadays Bulgaria and Rumania are the lowest cost destinations in the EU area. To stay competitive under this global shift, Italy would have had to have adjusted its economy accordingly. This, however, never happened. Instead, hope was placed in the belief that the New Economy growth regime might offer new opportunities for higher growth without lowering the income level in Italy.

If the Maastricht Treaty's debt ceiling of 60 per cent had been taken seriously by the EU institutions, Italy would never have been admitted into the eurozone. When representatives from the German Bundesbank, such as the former president Hans Tietmeyer, started to make such statements[4], they were ignored by the German chancellor Helmut Kohl and the finance minister Theo Waigel. Instead Waigel pushed to establish the Stability and Growth Pact to prevent future eurozone states from drifting into fiscally unsustainable positions and having to be bailed out by the other member countries.[5] From the beginning, however, the Maastricht criteria were not taken seriously by most European politicians. Even Germany had to resort to tricks to match the three per cent debt criteria in 1997. So it comes as no surprise that other countries used financial engineering to hide parts of their fiscal deficits from the official statistics collected and published by Eurostat.[6]

This includes Italy, which has never been in line with the Maastricht Treaty's debt-to-GDP criterion since being admitted to the eurozone in 1997. Italy was able to reduce its debt burden only due to lower refinancing costs when the interest rates of Italian government bonds plummeted to a level which had previously only been common to Germany (see Figure 2). This huge benefit in interest rate savings was used to expand the total amount of government bonds so that the underlying debt burden increased. Instead of paying double-digit interest rates as it had before 1997, Italy could expand its debt without facing higher financing costs due to the interest rate savings which cut financing costs by more than half compared to the previous levels.

Only since the onset of the global financial crisis has the interest rate spread between German and Italian government bonds started to diverge again. The temporary decline of Italy's debt-to-GDP ratio after 1997 concealed the fact that the actual amount of outstanding debt was increasing; the reduced financing costs for becoming a member of the eurozone and the immediate interest rate convergence to the lower German interest rate levels overcompensated for this effect. Italy could simply shrink its debt-to-GDP ratio by refinancing its older debt at significantly lower financing costs.

Manipulation of the European System of National Accounts

Faced with the problem that it could not meet the Maastricht debt criterion in 1997, Italy pressed the EU Commis-

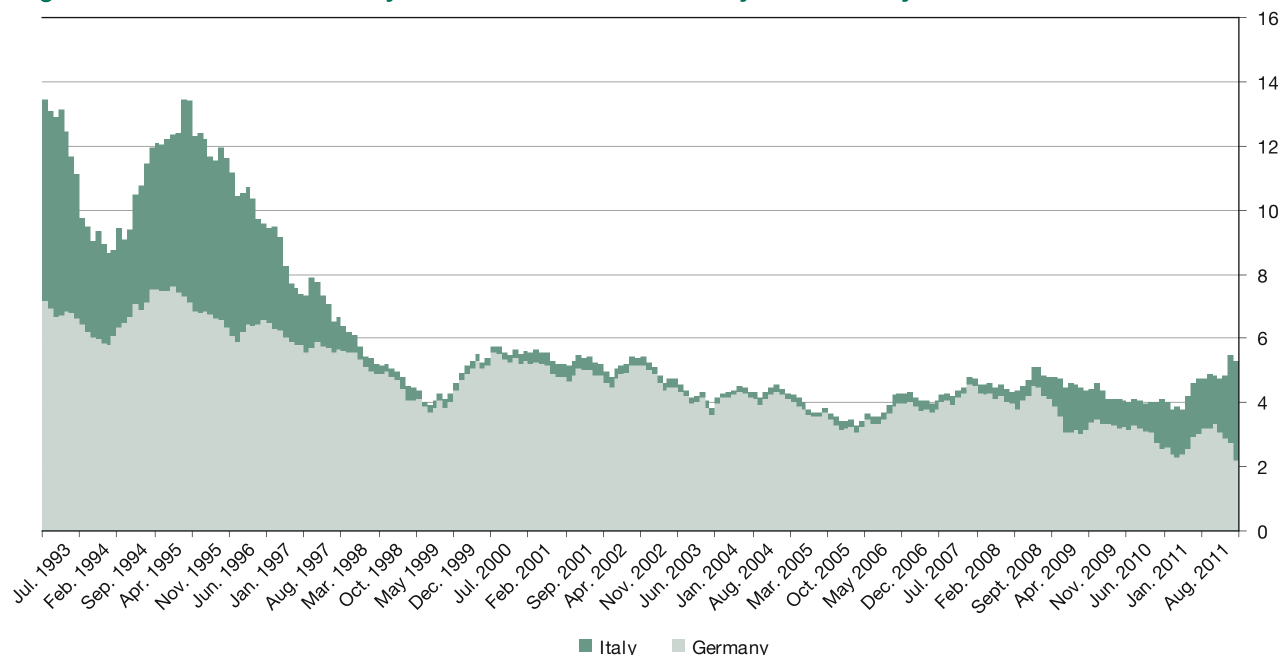
3 S.A. Abbas, N. Belhocine, A. ElGanainy, M. Horton: A Historical Public Debt Database, IMF Working Paper WP/10/245, International Monetary Fund, Washington DC, November 2010.

4 Welt-Online: Tietmeyer wünscht Rom in der EWU – Bekräftigung zur Einhaltung der Euro-Kriterien – Duisenberg zum "Banker of the Year" gewählt, Online-Message of 4 March 1997.

5 Article 125 of the Treaties of the European Union, the so-called no-bailout clause.

6 G. Erber: Staatsverschuldung und Financial Engineering, in: DIW-Wochenbericht 36/2011, 7 September 2011, German Institute for Economic Research, Berlin, pp. 11-19.

Figure 2
Long-term Interest Rates for Ten-year Government Bonds of Italy and Germany



Source: ECB.

sion and the other member states to focus on the three per cent deficit-to-GDP criterion as the key indicator and the *tendency* in 1997 to reduce the debt-to-GDP ratio. The Italian government of Silvio Berlusconi also took major steps to hide its fiscal deficits from the public.

Italy pushed through national accounting standards for Eurostat's debt and deficit measurement in 1995, which offered a way to reduce the official debt and deficit numbers through financial engineering.[7] Eurostat initially resisted these changes, and if this resistance had been successful then moving debt from one year to another would not have changed the overall debt calculations, which would have made the window-dressing operations employed by Italy and Greece ineffective. Ultimately, however, Eurostat was forced by the European Commission and the EcoFin Council to accept the changes in the accounting framework.

The means of Italy's financial trickery were currency swaps between Italian lira and Japanese yen arranged by Morgan Stanley.

> "In May 1995, Italy had issued a 200 billion yen bond ($1.6 billion). By December 1996, the yen had depreciated significantly, giving Italy a large currency profit on its borrowing. Italy did a currency swap to lock in its profits. The swap was off-market. In a normal swap, you set the exchange rate at the time the swap is done (i.e. December 1996 – G.E.); Italy set the exchange rate at May 1995; this meant it gave up its currency gain. Not quite. Under the swap, Italy paid a rate of the dollar minus 16.77%! Given that LIBOR rates were around 5.00%, this meant that Italy had accepted a bad exchange rate and received cash in return. The payments were used to reduce the deficit."[8]

If this statement is correct, a look at the lira-yen exchange rate development at this time (see Figure 3) shows that it was an ideal time for this kind of carry trade and currency swap operation. Quite unusually, the lira-yen exchange rate dropped from about 16 lira per yen in November 1994 to reach its low at the end of April 1995. This was when Italy issued the 200 billion yen bonds. Over the following months, the lira depreciated significantly to reach a temporary peak of 13.4 lira per yen in December 1996, an appreciation of 31% in just a few months. This was locked in by the currency swap of the Italian government with the deferred purchase price arrangement. The question arises: did the Italian central bank engage in major currency interventions to make this highly profitable deal feasible?

7 G. Piga: Derivatives and Public Debt Management, Research Report delivered to the International Securities Market Association, Zurich 2001.

8 F. Partnow: Infectious Disease, Owl Books, New York 2004, p. 567.

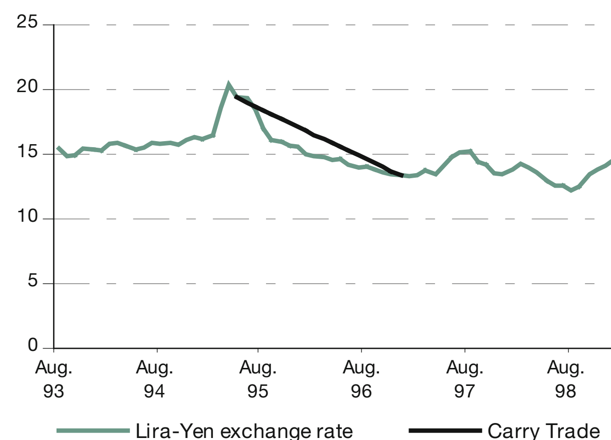
We also have to keep in mind that before the euro was introduced, the ECU system limited the bilateral exchange rate fluctuations of ECU member state currencies. If the 200 billion yen were issued in May 1995, then the profit the Italian government made from the carry trade combined with the currency swap in December 1995 was a little more than 791 million US dollars (using the yen-lira and lira-dollar exchange rates of December 1996). Even shifting this amount to 1997 as pure revenue for the Italian government to lower the deficit and debt ratios could not by itself explain the decline reported in the official Eurostat statistics.

One possible explanation is that this might not have been the only transaction engaged in by the Italian government to bring down its deficit ratio. It is possible that the currency swap deal was combined with an interest rate swap, betting on the expected lower interest rates in 1999 after Italy had been admitted into the eurozone (see Figure 2).

Another possibility is that the size of Italy's GDP reported to Eurostat was heavily distorted upwards. It is well-known that Italy includes an estimate of its shadow economy to significantly mark up its official GDP numbers, producing an upward bias which lowers the Italian debt and deficit ratios.[9] Dell'Anno and Schneider estimate the size of the Italian shadow economy as 26% of GDP in 1994/95, which increased to 27.3% in 1997/98. If similarly high values were used to increase the official GDP statistics, this could have lowered the debt- and deficit-to-GDP ratios significantly. More recent research challenges the high estimates presented by Dell'Anno and Schneider. If the Italian shadow economy were indeed much smaller, Italy's debt and deficit ratios would be much higher than reported in the official statistics.[10] Increasing the size of the shadow economy and raising the GDP numbers would have had a major impact on the calculations for entering the eurozone. Questions regarding the huge 4-5% drop in Italy's deficit-to-GDP ratio in the years 1997 and 1998 remain unanswered.[11]

An A.T. Kearney[12] study on the shadow economy in Europe estimates the size of the Italian shadow economy at

Figure 3
Lira-Yen Exchange Rate
Aug. 1993 – Dec. 1998



Source: Oanda.

22% of the national GDP. In 2009, this would have been more than 334 billion euros. This is a huge amount with which one could manipulate the national accounts data. Since the relationship between the formal and informal economies varies over time, it would have been possible to generate any number needed by the Italian Statistical Office in order to conform with the debt und deficit criteria. Combined with financial engineering, there is likely no reliable measure of fiscal debt control by an outside institution. Thus there is essentially no reliable database against which the current measures undertaken by the Italian government can be checked.

By taking huge deficits of -7.4% in 1995 and -7.0% in 1996, the Italian government probably obtained huge upfront payments in 1997 and 1998 to reduce its deficits to -2.7% and -2.8%, respectively. This made the debt and deficit reduction trends look quite impressive to an uninformed outsider. The Italian government could claim that it had taken major steps to reduce its deficit and debt to be able to enter the eurozone. But alas, this was just an outcome of window dressing via financial engineering. Once Italy had been admitted into the eurozone, it was rewarded with the huge interest rate reductions shown in Figure 2. This presented Italy with the opportunity to further reduce its debt through lower interest rate payments while at the same time expanding the debt volume.

When the cheating to fulfil the Maastricht criteria was revealed to the public in 2001, Eurostat changed the accounting rules to block such methods of artificially reduc-

9 R. Dell'Anno, F. Schneider: The Shadow Economy of Italy and other OECD Countries: What do we know?, in: European Journal of Political Economy, Vol. 21, No. 3, September 2005, pp. 598-642.

10 H.-G. Petersen, U. Thiessen, P. Wohlleben: Shadow Economy, Tax Evasion, and Transfer Fraud – Definition, Measurement, and Data Problems, in: International Economic Journal, Vol. 24, No. 4, 2010, pp. 421-441.

11 R. Basile, B. Chiarini, E. Marzano: Can we Rely upon Fiscal Policy Estimates in Countries with Unreported Production of 15 Per Cent (or more) of GDP?, CESIfo Working Paper No. 3521, Munich, July 2011.

12 A.T. Kearney: The Shadow Economy in Europe, 2010 – Using electronic payment systems to combat the shadow economy, A.T. Kearney, in Cooperation with F. Schneider and VISA Corp, 2010.

ing the debt and deficit burden.[13] However, neither the EU Commission nor the European Council took any steps to remove Italy and Greece – which had also managed to enter the eurozone via financial engineering[14] – from the eurozone.

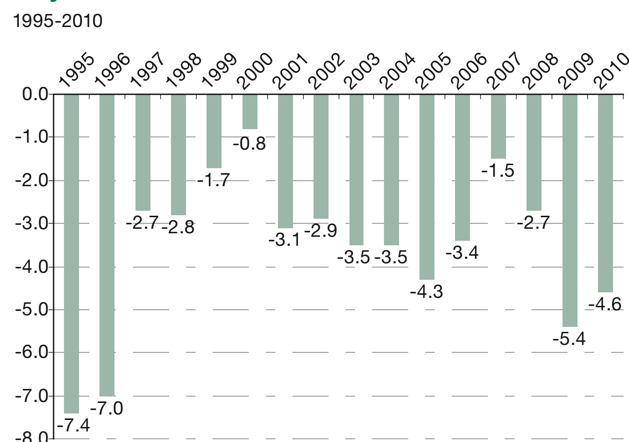
According to Goodhart's law[15], once a social or economic indicator or other surrogate measure is made a target for the purpose of conducting social or economic policy, then it will lose the information content that would qualify it to play such a role. The Maastricht criteria represent a case study for this observation. This raises scepticism about the possibility of creating a stricter version of the Maastricht criteria in the future.

A Beautiful Lie: The Lisbon Agenda

The Lisbon Agenda has two possible origins. One is that European governments and the EU Commission believed that Europe would follow the New Economy growth miracle of the USA, which seemed to have achieved a new high-growth regime. The other is that European officials realised that without significantly higher long-term economic growth, the eurozone – with its highly indebted member countries – was standing on shaky ground. Public debt reduction is always much easier to accomplish with higher economic growth than without. Governments need only to stabilise their expenditures and let the economy grow, and this reduces the relative degree of indebtedness. Even if public debt stays nominally at the same level or increases less rapidly, the public debt-to-GDP ratio declines.

Therefore it came as no surprise when the European Council unveiled the Lisbon Agenda in 2000 as an economic target for the next decade. The key goal was for member states to attain an average annual growth rate of three per cent by 2010. Based on most of the countries' past performances, this was a heroic assumption and soon proved unattainable. But as long as the Lisbon Agenda had some credibility, it gave the respective governments time to base their fiscal planning on this overly optimistic growth assumption. This definitely delayed the necessary fiscal consolidation of public debt towards fiscal sustainability, i.e. cutting back spending and raising taxes to bring public finances in line with the true lower growth perspectives of the European economies.

Figure 4
Italy's Deficit-to-GDP Ratio
1995-2010



Source: Eurostat.

It became obvious after the bursting of the New Economy bubble that the three per cent target growth rate for the eurozone GDP was unfeasible.[16] However, only very few countries undertook major structural reforms of their pension systems to bring public deficits under somewhat better control, as Germany did as part of its Agenda 2010.[17] German public disapproval of these reforms contributed to the Schröder government's being voted out of power in 2005.

While Germany made major progress in reversing its 3.3% deficit in 2005 to a tiny 0.1% surplus in 2008, Italy's budget deficit dropped from 3.7% in 2005 to 1.5% in 2006 but then began rapidly rising again with the outbreak of the global financial and economic crisis (see Table 1 for a summary of the development of debt and deficit ratios in selected European countries). With a current debt-to-GDP ratio of more than 120% this year, Italy's finances have become highly vulnerable to interest rate increases. From May 2011 onwards, Italy has had to refinance €204.2 billion. This figure will rise to €231.9 billion next year before dropping off. Depending on the time structure of the refinancing, the amount outstanding will have to be adjusted accordingly. What was highly beneficial in the initial years after entering the eurozone is now becoming a severe liability for Italy as interest rates are rising. No wonder that Eurobonds are at the top of the Italian gov-

13 Eurostat: Decision of Eurostat on deficit and debt – Securitisation operations undertaken by general government Decision, Luxembourg, 2002. European Parliament: Regulation No 2558/2001 of the European parliament and the Council of 3 December 2001, in: Official Journal of the European Communities, 28 December 2001, L344/1-4.

14 G. Erber, op. cit.

15 C.A.E. Goodhart: Monetary Relationships: A View from Threadneedle Street, Papers in Monetary Economics (Reserve Bank of Australia), 1975.

16 European Communities: Facing the challenge – The Lisbon strategy for growth and employment, Report from the High Level Group chaired by Wim Kok, Brussels, November 2004.

17 The Agenda 2010 is a series of reforms planned and executed by the German government which are aimed at reforming the German social system and labour market.

Table 1

Gross Public Debt and Deficit Ratios to GDP of EU Member Countries

1995-2010

	Deficit/Surplus as per cent of the national GDP[1]															
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
European Union (27 countries)	:	:	-2.6	-1.9	-1.0	0.6	-1.4	-2.5	*-3.1*	-2.9	-2.5	-1.5	-0.9	-2.4	*-6.8*	*-6.4*
Eurozone (17 countries)	*-5.0*	*-4.2*	-2.7	-2.3	-1.4	0.0	-1.9	-2.6	*-3.1*	-2.9	-2.5	-1.4	-0.7	-2.0	*-6.3*	*-6.0*
Belgium	*-4.5*	*-4.0*	-2.3	-0.9	-0.6	0.0	0.4	-0.1	-0.1	-0.3	-2.7	0.1	-0.3	-1.3	*-5.9*	*-4.1*
Germany	:	*-3.3*	-2.6	-2.2	-1.5	1.3	-2.8	*-3.7*	*-4.0*	*-3.8*	*-3.3*	-1.6	0.3	0.1	-3.0	*-3.3*
Ireland	-2.1	-0.1	1.1	2.4	2.7	4.7	0.9	-0.4	0.4	1.4	1.6	2.9	0.1	*-7.3*	*-14.3*	*-32.4*
Greece	:	:	:	:	:	*-3.7*	*-4.5*	*-4.8*	*-5.6*	*-7.5*	*-5.2*	*-5.7*	*-6.4*	*-9.8*	*-15.4*	*-10.5*
Spain	*-6.5*	*-4.8*	*-3.4*	*-3.2*	-1.4	-1.0	-0.6	-0.5	-0.2	-0.3	1.0	2.0	1.9	*-4.2*	*-11.1*	*-9.2*
France	*-5.5*	*-4.0*	*-3.3*	-2.6	-1.8	-1.5	-1.5	*-3.1*	*-4.1*	*-3.6*	-2.9	-2.3	-2.7	*-3.3*	*-7.5*	*-7.0*
Italy	*-7.4*	*-7.0*	-2.7	-2.8	-1.7	-0.8	*-3.1*	-2.9	*-3.5*	*-3.5*	*-4.3*	*-3.4*	-1.5	-2.7	*-5.4*	*-4.6*
Cyprus	-0.8	*-3.2*	*-5.0*	*-4.1*	*-4.3*	-2.3	-2.2	*-4.4*	*-6.5*	*-4.1*	-2.4	-1.2	3.4	0.9	*-6.0*	*-5.3*
Portugal	*-5.0*	*-4.5*	*-3.4*	*-3.5*	-2.7	-2.9	*-4.3*	-2.9	-3.0	*-3.4*	*-5.9*	*-4.1*	*-3.1*	*-3.5*	*-10.1*	*-9.1*
United Kingdom	*-5.9*	*-4.3*	-2.2	-0.1	0.9	3.6	0.5	-2.1	*-3.4*	*-3.4*	*-3.4*	-2.7	-2.7	*-5.0*	*-11.4*	*-10.4*
	Gross national debt in per cent of GDP[2]															
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
European Union (27 countries)	:	:	:	:	*65.7*	*61.9*	*61.0*	*60.4*	*61.8*	*62.2*	*62.8*	*61.5*	59.0	*62.3*	*74.4*	*80.0*
Eurozone (17 countries)	:	:	:	:	*71.6*	*69.1*	*68.1*	*67.9*	*69.0*	*69.5*	*70.0*	*68.4*	*66.2*	*69.9*	*79.3*	*85.1*
Belgium	*130.4*	*127.3*	*122.7*	*117.4*	*113.7*	*107.9*	*106.6*	*103.5*	*98.5*	*94.2*	*92.1*	*88.1*	*84.2*	*89.6*	*96.2*	*96.8*
Germany	55.6	58.4	59.7	*60.3*	*60.9*	59.7	58.8	*60.4*	*63.9*	*65.8*	*68.0*	*67.6*	*64.9*	*66.3*	*73.5*	*83.2*
Ireland	*82.0*	*73.4*	*64.3*	53.6	48.5	37.8	35.5	32.1	30.9	29.6	27.4	24.8	25.0	44.4	*65.6*	*96.2*
Greece	*97.0*	*99.4*	*96.6*	*94.5*	*94.0*	*103.4*	*103.7*	*101.7*	*97.4*	*98.6*	*100.0*	*106.1*	*105.4*	*110.7*	*127.1*	*142.8*
Spain	*63.3*	*67.4*	*66.1*	*64.1*	*62.3*	59.3	55.5	52.5	48.7	46.2	43.0	39.6	36.1	39.8	53.3	*60.1*
France	55.5	58.0	59.2	59.4	58.9	57.3	56.9	58.8	*62.9*	*64.9*	*66.4*	*63.7*	*63.9*	*67.7*	*78.3*	*81.7*
Italy	*121.5*	*120.9*	*118.1*	*114.9*	*113.7*	*109.2*	*108.8*	*105.7*	*104.4*	*103.9*	*105.9*	*106.6*	*103.6*	*106.3*	*116.1*	*119.0*
Cyprus	51.4	52.6	56.9	58.6	58.9	58.8	*60.7*	*64.6*	*68.9*	*70.2*	*69.1*	*64.6*	58.3	48.3	58.0	*60.8*
Portugal	59.2	58.3	54.4	50.4	49.6	48.5	51.2	53.8	55.9	57.6	*62.8*	*63.9*	*68.3*	*71.6*	*83.0*	*93.0*
United Kingdom	51.2	51.3	49.8	46.7	43.7	41.0	37.7	37.5	39.0	40.9	42.5	43.4	44.5	54.4	*69.6*	*80.0*

[1] Values in italics are above the 3 per cent threshold. [2] Values in italics are above the 60 per cent threshold.

Source: Eurostat.

ernment's wish list, so that lower interest rates could be locked in again. This would, however, be at the expense of other eurozone members, Germany in particular, which has become the safe haven of the eurozone. While the interest rate for German ten-year government bonds fell to an all-time low of 1.5% in September 2011, Italy had to pay more than 5%.

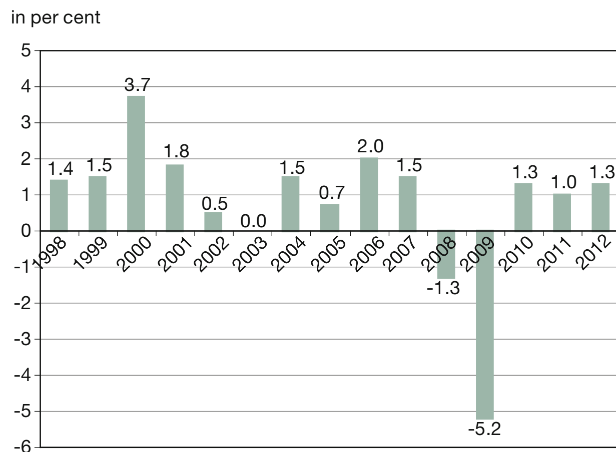
Missed Opportunity for Consolidation

Italy put little effort into pursuing the necessary structural reforms. It reaped the benefits of lower interest rates from becoming a eurozone member, which diminished the fiscal pressure it faced for some time but did not contribute to higher economic growth. Indeed, Italian GDP growth (see Figure 5) has averaged just 0.8% annually since 1998. Italian policymakers never took the Maastricht Treaty's no-bailout clause seriously, which contributed to the moral hazard of adopting a wait-and-see attitude. Furthermore, the reform of the Stability and Growth Pact in 2006, which softened the strict requirement of adherence to the debt and deficit criteria, gave the country additional room for manoeuvre. This made the whole agenda of deficit control in the eurozone meaningless. Policymak-

Figure 5

Italian Gross Domestic Product – Annual Growth Rates[1]

in per cent



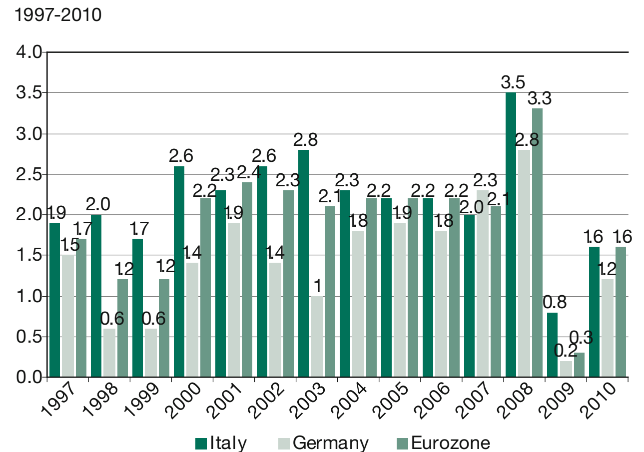
[1] 2011 and 2012 are forecasts.

Source: Eurostat.

Figure 6

Harmonised Consumer Price Index of Italy, Germany and the Eurozone

1997-2010



Source: Eurostat.

ers had managed to evade the rules of the Maastricht Treaty.[18]

In the first half-decade of the new millennium, Italy could at least benefit from the low nominal euro-US dollar exchange rate. At the time, this helped to conceal the country's competitiveness problems. When the euro was introduced in January 1999, one euro was equivalent to 1.18 dollars. Two years later, as the New Economy bubble burst, it had fallen to 0.82 dollars, giving the eurozone a price competitiveness advantage over the USA and those countries which linked their currencies to the dollar. Only after the euro had started to appreciate modestly and had reached purchasing power parity (PPP) with the dollar at the end of 2003 did problems start to surface for eurozone countries. From then on, the euro-dollar exchange rate rose above PPP, with the euro worth about 1.20 dollars in 2005 and reaching its peak of 1.60 dollars in the second half of 2008. This was the year that the Lehman Brothers default led to significant capital flight from the USA. Over the next three years, the exchange rate stabilised around 1.45, well above PPP. The euro finally started to depreciate versus the dollar in late August 2011, when it dropped to around 1.35 as the sovereign debt problems in countries like Spain and Italy became obvious.

Countries whose economies were designed for export-led growth, such as Germany, could handle this challenge much better than countries such as Italy, which had historically resorted to the devaluation of the lira when it had lost too much competitiveness versus other countries. Social adjustment mechanisms are often deeply rooted in the social fabric of societies as internal institutions[19] which cannot easily be changed by external institutions like the eurozone governed by the ECB and the Stability and Growth Pact. It was a misconception of policymakers that these external institutions, which stood in contradiction to the longstanding internal institutions in countries like Italy, would function smoothly. Now, under severe fiscal stress, this traditional adjustment path is blocked.

Additionally, the eurozone had to deal with diverging inflation rates among its members. Italy has traditionally been a high inflation country, as wage conflicts have led to higher than average inflation rates. Germany, in particular, has had a long tradition of maintaining greater price discipline through social consensus and a partnership between trade unions and businesses. More than ten years of diverging inflation rates in the eurozone led to a severe internal price competitiveness problem. Germany and Italy are not an optimal currency area under the current conditions of price divergence. Even worse, the negative impact of the euro crisis has accelerated this divergence process. Germany enjoys improved competitiveness both abroad, thanks to the weaker euro, as well as inside the eurozone, due to its lower long-term inflation rate com-

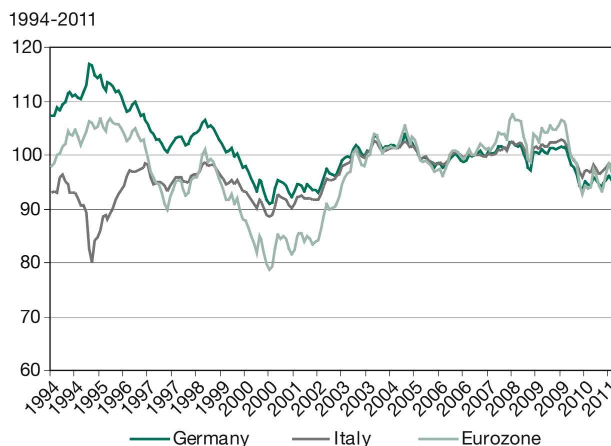
18 W.H. Buiter: The "Sense and Nonsense of Maastricht" revisited: What have we learnt about stabilization in EMU?, in: Journal of Common Market Studies, Vol. 44, No. 4, November 2006, pp. 687-710.

19 S. Voigt, H. Engerer: Institutions and Transition – Possible Policy Implications of the New Institutional Economics, in: K.F. Zimmermann (ed.): Frontiers of Economics, Berlin 2002, Springer Verlag, pp. 127- 184.

pared to the rest of the eurozone. Germany is currently easily outperforming most of its eurozone peers.

The real effective exchange rates in Figure 7 show a similar picture: Italy is falling behind. Under huge pressure from the financial markets to stabilise its fiscal position, the country's structural adjustment is becoming more painful than it was for Germany. It is an open question if the measures taken by the former Berlusconi government to cut its deficit by €79 billion will materialise under the conditions of a potential recession in 2012. Public acceptance of this austerity programme is still lacking, and disruptions similar to those we have already seen in Greece could follow, even under the new government. In Greece the consolidation process has been derailed by stiff public resistance to the policy measures, driving the country even deeper into recession.

Figure 7
Real Effective Exchange Rates of Italy, Germany and the Eurozone
1994-2011



Source: BIS.

Conclusions

Summing up this brief analysis of the Italian public debt problem, it is obvious that Italy is not suffering primarily from speculative attacks. Like many other developed economies in Europe, as well as the USA and Japan, Italy was faced with the challenge of globalisation as the Soviet Empire collapsed and China began to successfully integrate into the global economy. However, while other countries – including Germany, despite having to carry the heavy public financial burden of unification – were struggling with outsourcing parts of their value chains offshore, restructuring into global sourcing networks and right-sizing their domestic companies to maintain their competitiveness, Italy remained in a state of complacency (with the exception of a few multinational companies of Italian origin). Through the use of financial engineering and improper accounting tricks, Italy was successful in misleading the public about the rapidly deteriorating state of its economy and public finances for some time, but it could not face the reality shock when the global financial crisis hit. The crisis set an unforeseen process in motion of a rapid divergence among the eurozone member countries. The decline in international competitiveness over the past two decades has become a major structural impediment which cannot be overcome easily. Italy must now restructure in a highly unfavourable global economic environment. While the global economy is currently entering a phase of slower growth or even recession, Italy has to implement fairly radical economic and social reforms. This has to be done under the new government.

Admittedly, the privatisation of public assets is expected to bring in revenues of €40 billion to diminish the debt and interest burden of the Italian government, but under the current circumstances Italy faces the same problem as Greece, namely that fire sales will significantly diminish the revenues to be expected.[20] Such emergency measures, however, document that Italy is close to a sovereign default. The consolidation programme to save the Italian economy and public finances has to address their structural deficits by a similar consolidation programme to that put forward by the IMF/EU/ECB troika for saving Greece.[21] Based on the experience in Greece, there is little cause for optimism that this will work out smoothly.

The creation of an ever larger financial fund to socialise the Italian debt burden to the eurozone member states via the EFSF and its likely successor, the ESM, will endanger the financial stability of the entire eurozone. As Carmen Reinhart and Kenneth Rogoff found via an extensive historical analysis, a public debt-to-GDP ratio beyond 90 per cent is unsustainable.[22] Italy is already well beyond this marker, and its economy is approaching a state of free fall. Despite the eurozone members' best efforts, it is possible that, as in the famous nursery rhyme, all the eurozone countries may not be able to "put Humpty together again".

20 T. Bayer: Italien bewertet Tafelsilber – Notverkäufe könnten 40 Mrd. Euro bringen//Staatsvermögen offenbar so hoch wie Schulden, in: Financial Times Deutschland, Message of 30 September 2011.

21 EU Commission, Economic and Financial Affairs: The Economic Adjustment Programme for Greece, Fourth Review – Spring 2111, European Economy, Occasional Papers 82, Brussels, July 2011.

22 C. Reinhart, K. Rogoff: This Time Is Different: Eight Centuries of Financial Folly, Princeton, New Jersey 2009, Princeton University Press.