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Europa farà da sé? Thoughts about the Debt Crisis in Italy

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ABSTRACT

Italy's predicament has just highlighted a further type of crisis in the euro zone. The Spanish and Irish crises could be blamed, more or lesser, on choice, in other words, on a real estate market that did not correspond to reality. Greek default is the punishment for having turned budgetary complacency into economic policy. The financial surveillance of Portugal logically results from a lack of response on the part of a credible government to the country's deindustrialisation. The rising cost of funding the Italian debt up to the collapse of the Berlusconi government reflected the market's exasperation at the lack of coherent policy. It also penalised management that was limited to indecision. The gap between the pace of reform adopted by most of the members of the Economic and Monetary Union and that launched on the Italian peninsula might have appeared as a real threat to the credibility of the euro zone and its currency. Barely a month after its appointment the Monti government seems to be trying to make the necessary structural reforms. The euro zone, for its part, has started revising its governance method so that it can rise to the challenges resulting from a lack of Italian credibility.

The Euro Zone Summit on 26th October has often been presented as the last attempt to save Greece from bankruptcy. It was also the chance to provide the euro zone with the means to face further liquidity crises and simultaneously to improve its governance methods. In this respect the Italian problem was the starting point for the Heads of State and government. The rising cost of Italians bonds since this summer had, in part, invalidated the decisions taken on 21st July last, notably those regarding the shape of the European Financial Stability Facility (EFSF).
The Greek debt called for specific solutions that the summit on 26th October was due to establish: the reduction of the debt held by banks or the establishment of a permanent local, committee to monitor the reforms undertaken by the government. The fear of Italy's default, the euro zone's third most important economy, led the latter to adopt measures, which might be qualified as universal, since they even affected the functioning of the Economic and Monetary Union.

1. THE ITALIAN DEBT CRISIS: A FRAGILE ECONOMIC POSITION, BUT NOT AS WEAK AS IT MIGHT FIRST APPEAR

Weaknesses...

Before addressing the European response we should look closely at the Italian debt, the fifth chapter in the sovereign debt crisis in Europe, each of which do not seem to have any points in common.
The decline of the Italian situation coincided with the publication of the country's economic results in the first half of 2011. Italy's economic lethargy is not a novelty. Since the beginning of the years 2000 the peninsula has distinguished itself by weak growth, hardly better than that of Eritrea or Haiti over the same period. It is clear that the markets and then the ratings agencies noted the constantly rising debt (1,911 billion €, 120% of the GDP), the rise in youth unemployment (29.6% of the 15-24 year olds, whilst the European average lies at 21.1%), a decrease in purchasing power (-4% over the last decade) and the stagnation of hourly productivity – they

especially insisted on the lack of any viable political response to remedying weaknesses in the Italian economy. During this time the entire euro zone was adopting measures to reduce public spending and to facilitate a return to growth via structural reform.

...that should be relativised

A rapid comparison with the main euro zone Member States brings the local economy's excessively negative into perspective however. Although the debt is great, the pace of its increase is still slower than that of its partners, who, in spite of this, enjoy better ratings: +15.3 GDP points between 2007 and 2010 against +17.4 points for France and +18.3 points for Germany. The very structure of the debt tempers any idea that the route taken is similar to that taken by Greece. Held by 56% of the inhabitants, it is relatively safe from speculative movements. In addition to this its management is diversified and its – relatively long maturity – 7.04 years on average – protects it from market mood swings. As far as public accounts are concerned, we should note that the structural primary balance, ie the state of public accounts before the payment of interest on the debt, is still positive and is one of the highest in Europe.

We should also take a closer look at the peninsula's remaining assets in order to highlight how exaggerated the prospect of economic default, similar to the Greeks or even the Portuguese, seems to be.

Indeed in Italy's north there are companies whose export results have only been slightly affected by the world crisis, notably in the textile industry. SME's – which comprise 95% of Italian companies – have succeeded in forging a "*Made in Italy*" label that has helped them penetrate markets external to Europe. Italian companies have developed a real tradition in acquiring external market shares, rallying in consortia, without ever benefiting from any real aid from the government. The successes of Italian SMEs in the building industry in Maghreb and in the Balkans no longer have to be proven.

The banking sector remains relatively healthy. Although its exposure to local public debt might be deemed a problem long term, it is important to note that all Italian financial establishments have few investments in complex financial products and have preferred helping companies and households, which, incidentally, are not greatly in debt.

2. THE IMPORTANCE OF THE POLITICAL FACTOR: FROM SILVIO BERLUSCONI TO MARIO MONTI

From political uncertainty...

The downgrading of Italy's sovereign rating by the three credit ratings agencies does however temper these observations, which are positive in part. The analysts' position is a subtle one, but reveals the reality of the country's political situation quite accurately. Since 2010, Berlusconi's government pushed through three austerity plans including the last two, approved in July and September, which were to help the State to save nearly 140 billion € by 2014. The effort required appears similar to that adopted in Greece, Ireland, Portugal and Spain. The agencies, like the markets, conveyed their concern with regard to the effective implementation of these austerity measures, and at the same time, to the lack of any really far-reaching reform.

Italy has been suffering a real problem regarding credibility, which until recently the government's media hype only made worse. What, in this respect, can be said of the suggested reforms of the land map or the structure of the administration, with the leading measure being the reduction in the number of provinces and MPs? Indeed projects like this lead to constitutional revision and therefore long parliamentary processes, the outcome of which is uncertain. In addition to this the issue of growth did not appear to be crucial in the eyes of Berlusconi's government.

Moreover, the political situation seemed to accentuate the risk of budgetary slippage. The dissension observed within the parliamentary majority over the magnitude of the reforms to be taken and the latent conflict between Silvio Berlusconi and his Finance Minister, Giulio Tremonti, a firm supporter of austerity, were perceived as even more negative signs by investors.

The euro zone summit of 23rd October notably ended with the French and Germans asking the Italian government to present a viable road-map to reduce debt, together with a real programme for economic revival. For the most part the letter addressed to the euro zone Member States by the Berlusconi government on 26th October comprised a simple repetition of the summer *manovre*, such as the progressive increase in the retirement age to 67 by 2026 that had been promoted by the European authorities in the summit's conclusions. Most of the measures announced in support of economic revival had had to be removed from the previous *manovre* given the political dissension that they had caused. In addition to this, the package of measures, adopted on 12th November by the Italian Parliament, did not include sensitive issues associated with the reform of the employment market or the revision of the early retirement regime.

...to the return of credibility

With Silvio Berlusconi's resignation Italy now seems decided to respond to the requests of both the EU and the IMF. Silvio Berlusconi's resignation cannot be considered as the only answer to the crisis. Although the appointment of Mario Monti and the formation of a so-called "technical" government team have already reassured the markets in part, acts must now follow the rhetoric. The new government now has to work quickly, even though its final composition has still not been decided.
The announcements made by the new President of the Council on 17th November seem to be moving in this direction. The introduction of an effective property tax that was abolished in 2008 by the previous government, the adoption of a true reform of the employment market in support of young people and women, are the real political challenges facing the new government. The deregulation of the economy, that was barely started by the previous government, is also due to continue. This notably implies several sectors (such as energy and transport), which have been managed to date by the local governments, opening up to competition. Political consensus on these issues will necessarily have to be found, rising beyond the reticence that still held sway in the summer. We should also note that the abolition of the early retirement regime already seems to have been dismissed.
It is also up to the European Commission to establish true partnership with the Italian authorities in view of making an optimum use of the European funds, notably in the South, which is a significant impediment to the country's dynamism.
It remains however that Italy seems to have won a first wager, and that is of restoring its political credibility. Its inclusion in the Franco-German discussions via the tripartite summit on 24th November last in Strasbourg, just days after Mario Monti's appointment, bore witness to this.
It also remains that the Italian rates now seem dependent on the European Union's ability to provide real strength to euro zone governance and also to create instruments that can help surmount any risk of serious liquidity crises. The fact that nothing was said after the Franco-Italian-German tripartite summit was not without effect on the bond auction that took place the next day, when six month to two year rates rose to record levels.

3. WHAT EUROPEAN ANSWERS ARE THERE TO THE CHALLENGES RAISED BY ITALY?

The role of the European Central Bank and the rise of the Italian rates

The euro zone has been watching the Italian situation with concern over the last few months. The letter addressed by the President of the European Central Bank to the President of the Council at the beginning of August comprised the first real sign of this sustained interest. This document conditioned the purchase of Italian bonds on the secondary market by the government's introduction of structural reform. This notably targeted the retirement regimes, the deregulation of certain economic sectors and the employment market. *The manovre bis*, presented by the government in mid-August and finally adopted a month later, was partly in response to this pressure.
The European Central Bank's intervention in the Italian debate confirms this institution's change in role, a development that started with the sovereign debt crisis. Given the underlying confusion within the euro zone, the ECB has tended to provide a clear, conciliating message that encourages reform and the introduction of a financial response to market pressure via the *Securities markets programme* launched in May 2010. The rise of the Italian rates – and that of the Spanish ones to a lesser degree – also enhanced its role on the markets, since the Central Bank has purchased nearly 120 billion € in Italian and Spanish bonds since August, thereby increasing its exposure to the European sovereign debt from 74 to 194 billion €. By doing this it highlighted the threat that the liquidity crisis sets for the entire euro zone and appealed for the revision of the solutions that had been put forward to date. In any case it seemed to have been a vital instrument in view of slowing the speculative attacks launched against Italy and it also compensated for Rome's lack of credibility on the part of the investors.

Facing the challenge of the liquidity crisis: the increase in the size of the European Financial Stability Facility

Whilst the euro zone summit on 21st July led to the upkeep of the European Financial Stability Facility's capacity to act to a total of 440 billion €, the tension seen with regard to the Spanish, but above the Italian rates in August, revived debate over the Facility's ability to respond to a major liquidity crisis. The search for optimal leverage, reconciling both efficiency and the upkeep of the guarantees initially set by the Member States, led to the EFSF being able to guarantee new bonds issued by countries in difficulty. Italy is obviously affected by this type of development in the EFSF's role.
Finally we should note that this solution is not the best one for Rome. Like France, Italy supported linking the EFSF to the European Central Bank, since the multiplier effect expected of an operation like this – 2000 billion € – was better adapted to the risks weighing over Italy and Spain than the benefits expected from turning the EFSF into a credit enhancement mechanism: between 750 and 1000 billion €. Worse still, this guarantee is indeed dangerous for existing Italian bonds. Although new bonds issued by Rome enjoy the benefit of this guarantee, the old ones will become much less attractive in time. Developments like this will have a direct affect on banks, notably the Italian establishments.

Stepping up budgetary discipline

The institutional measures adopted by euro zone Heads of State and government on 26th October, whilst they enhance the governance of the Economic and Monetary Union, are in fact an attempted response to the lack of credibility on the part of Italian budgetary policy. The same applies to the invitation addressed to the National Parliaments, so that they take on board the recommendations adopted by the European Union with regard to undertaking economic and budgetary policies or the consultation of the Commission and other Member States of the euro zone before the adoption of any major programme involving budgetary reform. The euro zone goes even further, stressing that Member States, which are the focus of an excessive debt procedure, will have to subject their national budgets to the scrutiny of the Commission and the Council, which will then provide an opinion. The Commission will monitor the execution of the budget and put forward changes during the year. In this respect Italy will comprise a first test, since the country has been under the joint surveillance of the EU and the IMF since 3rd November.

CONCLUSION

In view of the conclusions of the summit on 26th October, notably with regard to the governance of the Economic and Monetary Union, it seems that Italy's situation has led to initial progress towards true budgetary federalism, without it being really named as such.
The Greek crisis has helped the euro zone define new relations with the financial world, notably via the successive reductions of the Hellenic debt. In addition to this the European Financial Stability Facility has set the foundation for true financial solidarity and - although it is not met with unanimous agreement –the European Central Bank's action on the bonds market has done the same. The Italian crisis has pushed the Economic and Monetary Union into defining a path in view of adopting real government long term. Although to date most measures have been economic, the euro zone is now providing the start to a political response, which in turn raises other questions. How will forced integration affect the functioning of the European Union itself? In this new context, in which the intergovernmental method has contributed to the emergence of true federalism, what place remains for the Commission, reduced, on the face of it, to the role of providing technical support?
The answers given on 26th October to the Italian liquidity crisis are not so extensive since the European Central Bank was not given the role of lender of last resort, demanded by this type of crisis. The revision of the shape of the European Financial Stabilisation Facility does not seem to be equal to the financial challenge. Possible help from emerging countries, and notably from China, is a source of some concern in terms of the economic independence of the euro zone. Given the obstacles that lay in the way of the unification of Italy, the King of Sardinia, Charles-Albert, said in 1848 that the country did not need foreign intervention to complete its project: "Italia farà da sé", Italy will create itself ... What do we say today?

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