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ITALIAN EXPERIENCE WITH THE EURO

The paper has been devoted to drawing a provisional balance of the Italian experience within the Euro Zone in the 11 years elapsed from its inception. We have seen that prior to the setting up of the single currency, Italy has accepted to play the convergence game with the financial conditions prevailing in Germany, the main and the pivot country of the subsequent attempts to create in Europe an area of monetary stability, as a precondition to establish eventually a monetary union within the EU, in order to avoid competitive depreciations or devaluations putting in jeopardy the correct functioning of the single market, on a non discriminatory basis or in levelling out starting points among partners. During the convergence game Italy's monetary constitution underwent a dramatic change, giving up a traditional set of lax policies nurturing the vicious circle of inflation-devaluation-inflation. The transition towards a new stance of monetary stability and anti-inflationary reputation was not without troubles, as it was shown by the withdrawal of the national currency from the ERM in the period 1992-1996, but was made possible by the loyalist choice to accept to tie one's hand within the latter, or by the strong currency option implied in the link between the lira and the German Mark, thus importing credibility in international markets while forsaking to produce inflation by surprise. Once included in the Euro Zone, however, Italy was possibly penalised in terms of decreased growth rates by the mix of monetary and fiscal policies allowed by the Euro Zone framework, with the caveat that the virtual stagnation of the Italian economy could also be due to an outdated international specialisation, challenged by emerging countries in the new division of labour within globalisation. Even worse, also for Italy, as for the rest of the peripheral countries with a past low record of financial stability, some divergences due to high relative unit labour costs compared with the internal devaluation implemented by the policy of wage restraint followed by Germany came to the fore, possibly putting at risk in the future its permanence in the Euro Zone.

1. INTRODUCTORY REMARKS

The participation in the European Monetary System (EMS), dating back to the end of 1970s, and subsequently in the Economic and Monetary Union (EMU), when twenty years later the Euro Zone was launched, represented for Italy a dramatic change in its monetary constitution. Indeed, the country had a long record of unorthodox monetary and exchange rate policies, resorting in a systematic way to devaluation within the different fixed exchange rate regimes where the lira, the national currency, was in sequence pegged, or to its depreciation, during the periods in which it floated, under different circumstances, after the collapse of the Bretton Woods system. The intentional goal of authorities – in fact the government due to the lack of independence suffered in those times by the Bank of Italy – was

to offset the loss of competitiveness following a higher than average inflation, compared with the main partners', driven by cost factors and fostered by an accommodating monetary policy.

Thanks to two main factors, along a bumpy process extended over a time span of about two decades, such a lax monetary stance was progressively abandoned in favour of adopting a German-style monetary policy. As hinted, the change in Italy's monetary constitution did not take place in a smooth way, but was characterised by an alternation of successes and setbacks along a thorny path. On the one hand a first driver of the convergence process was due to the structural push linked to new directions taken in the framework of the European economic integration process towards monetary stability and in the long run towards monetary unification, after the setting up of the customs union and the Common Agricultural Policy (CAP). On the other hand, as shown by a convincing political economy literature, disinflation in the Italian economy was rendered possible by an increased power in the government sphere and policies of lobbies and parties defending the rentiers' interests to avoid to be damaged by the inflation tax on their financial investments and assets.

The aim of the present note consists in describing the central experiences gained by Italy in the convergence game that led the country to become part of the first wave of Euro Zone components, as well as the past consequences and perspectives of its membership in the latter. The rest of the paper is organised as follows. In the second and third sections we focus on the path followed by Italy across the EMS, from the initial period in which the European monetary device worked as a crawling peg mechanism to the subsequent time span of the loyalist choice to accept the system constraints. Section 4 describes the policies adopted by Italy in the run up to the EMU, after the lira crisis and floating from 1992 to the re-entry the system in 1996 and the final qualification for joining the Euro Zone. Sections 5 and 6 are devoted to identifying the costs and benefits deriving from the participation in the Euro Area, respectively in the short and in the long run. The following section 7 tries to put into perspective the debate on a possible withdrawal of Italy from the monetary union and the last section concludes with a number of final remarks.

2. THE EMS: THE INITIAL EXPERIENCE

During the collapse of the Bretton Woods system European countries belonging to the European Economic Community (EEC) tried to withstand monetary turbulences generated by the end of the gold exchange standard by linking their currencies within a tunnel of limited exchange rate fluctuations moving freely against the dollar. Such an agreement was in its essence a target zone device aimed at providing a degree of monetary stability deemed to be necessary for the correct functioning of the two main schemes of economic integration achieved by the EEC in that period: the customs union and the CAP. In this respect, monetary instability could put in jeopardy both achievements: the former by allowing competitive devaluations or exchange rate depreciations which were incompatible with the existence of a stable and protected towards the rest of the world internal market for manufactured goods; the latter by rendering exceedingly complicated the operation of the com-

mon price system put at the basis of public management of the market for agricultural produce. By the way, we find here two of the prerequisites for the survival of economic integration in the framework of European general institutions, in that time EEC and subsequently the European Union (EU), which are the same conditions that justify the present monetary integration within the euro area.

Such an arrangement of limited exchange rate fluctuations, dubbed the "Snake", was launched in April 1972 and Italy took part in it, above all for political reasons. Nevertheless the lira was not able to bear the constraint of a fixed exchange rate pegging and in early 1973 was forced to withdraw, following a deterioration of inflation and external balance conditions [Maes and Quaglia 2003]. In fact Italy in those years was still following a growth- cum- inflation path, that required a progressive depreciation of the lira. With the qualification that such a policy was subsequently exacerbated by the supply shocks in form oil price increases which took place during the 1970s [Giavazzi and Spaventa 1989].

The Snake did not succeed in bringing together the currencies of the EEC member countries, which from time to time joined, left and re-entered the European mechanism, so that in 1977 it had become the equivalent of a German Mark zone.

However, not least owing to a reduced pace of economic integration which came to the fore in that period, the quest for monetary stability in the EEC area went on, by devising a new and more structured exchange rate mechanism, the European Monetary System (EMS), that came into force in 1979. In the run up to EMS Italy expressed its preference for a symmetric monetary arrangement, in order to share the burden of adjustment between deficit and surplus countries. And indeed the EMS on paper showed such a character, but Italy's expectations were soon frustrated since in its real functioning it became an asymmetric device, dominated by the German mark and shifting the whole of adjustment on the debtor countries. Still in present time, within the eurozone such a latter issue has not yet been solved due to unwillingness of creditor countries, and namely the largest of them, Germany, to reflate thus helping debtor countries to reduce their disequilibria and hence their deflationary policies.

Under these circumstances in the first part of its participation in the EMS, covering the period 1979–1986, Italy went on following the cycle devaluation-inflation-devaluation, considering the new arrangement not as a fixed but adjustable exchange rate mechanism, but as a crawling peg device, accompanying the sliding of the exchange rate, or allowing a progressive devaluation of the national currency. *Table 1* shows the realignments of the lira during the period under scrutiny, implying a devaluation of the Italian currency by more than 20 per cent during the first half of 1980s.

Table 1. Realignments of the Lira's exchange rate between 1979 and 1986

23.03.1981	–6.00
05.10.1981	–3.00
14.06.1982	–2.75
21.03.1983	–2.50
22.07.1985	–6.00

3. THE EMS: THE LOYALIST CHOICE

By 1987 Italy decided to change its monetary stance, giving up its traditional policy to try to offset its competitive loss by decreasing the value of the lira via a realignment of the exchange rate. Whereas in the first part of its experience within the EMS Italy did not fully play the convergence game towards the financial conditions of the leader country of the monetary arrangement, Germany, behaving as a reluctant follower, by that time it entered the group of loyalist countries of the system. Such a choice was influenced probably by two distinct but interlinked factors. On the one hand by a similar shift made in 1983 by President Mitterrand in France, who launched the "franc fort" policy, after having realised that an expansionary policy based on the franc devaluation was unsustainable and that an attempt to reflate in a single country in the context of an asymmetric EMS was bound to fail [Bernard 2002]. On the other hand the Bank of Italy and Italian policymakers were in search of a new monetary constitution, not least in order to strengthen an institutionalised co-ordination among EMS monetary authorities in view of a more symmetric working of the scheme [Quaglia 2003].

As a consequence, the EMS constraint was considered by Italy as a means for importing anti-inflationary credibility. By linking the lira to the Mark, Italy could hope to share the strong currency option adopted by Germany, benefiting from a better anti-inflationary reputation in international financial markets. The mechanism by which such a reputation could accrue has been explained in terms of advantages obtained for countries accepting to "tie one's hand".

In general terms, taking part in the EMS for the leader country meant to obtain a big benefit in terms of reduced probability for the EEC partners to be allowed to follow a policy of competitive devaluation, that would translate into lessening its sales in the protected market of the customs union, putting in jeopardy the export led growth model traditionally adopted by it. But what about the follower countries? Since in a fixed exchange rate regime, with free capital mobility, the monetary policy becomes ineffective, what was their interest to give up their monetary sovereignty, by linking their policies to the EMS rules? The explanation has to do with the need to reassure international markets as to their anti-inflationary credentials.

In this respect, the follower countries within the EMS, when trying to realign their currencies in case of past inflation, would be penalised since European partners did not allow to transfer the whole of past inflation on the exchange rate devaluation. It follows that some loss of competitiveness remained as a residual, and that a country generating inflation by surprise was permanently penalised, reducing its interest in adopting a lax monetary policy [Giavazzi and Pagano 1990]. International markets, anticipating such a development, came therefore to the conclusion that Italy had no interest in producing self damaging inflation, thus strengthening its anti-inflationary credentials.

In the aftermath of the loyalist choice towards the disciplining effects of the EMS, Italy follows a path of disinflation and convergence with the core EMS countries and the lira appreciates in real terms.

However, the new co-operative policy decided by Italy towards the EMS came to an abrupt stop five years later. In the meanwhile the EMS had worked with an excess of credibility, since its member countries behaved as if the stage of the monetary union had been already reached. But of course the final and irrevocable locking of the national currencies into the euro was not yet accomplished and when in 1992 the Danish referendum on the Maastricht treaty was rejected such an excess of credibility vanished suddenly. Speculation performed by a group of aggressive hedge funds attacked the weaker monies of the system and the lira was forced to withdraw from the Exchange Rate Mechanism (ERM), alongside with the pound. The Bank of Italy tried unsuccessfully to resist speculation attacks, but when its foreign exchange reserves were virtually depleted and a possible help by the financing facilities of the system proved to be unworkable, abandoning the EMS was inevitable and the Italian government put into being a heavy fiscal plan the keep the country finances afloat.

Amongst the possible culprits of the lira crisis one can quote the loss of competitiveness of Italian goods. On the basis of the "tying one's hands" mechanism just described, the subsequent realignments of the national currency in the form of devaluation by an amount of more than 20 per cent since the inception of the EMS left a significant penalty in terms of extra costs for the Italian tradables, due to the difference of past inflation over the partners' average not offset by the decline of the exchange rate parity. As a result the worsening of the competitive conditions of Italy represented a signal of weakness, which could be easily challenged by international speculators.

At the same time a second factor was at work when the increase of the German interest rates linked to the country re-unification was transmitted to the partners economy via the pegged exchange rate, and hence also to Italy. We find here an additional element of fragility blurring the perspectives of Italian economy.

However, probably the crucial factor precipitating the currency collapse was the lifting of controls on capital movements, that took place after 1989. For a country considering as a penal offence to export capitals abroad to shift to the free capital movement regime was not an easy task. Yet it was deemed to be necessary as a step on the path to monetary unification.

By getting rid of controls on capital movements Italy tied its hands also towards international speculators. And when in 1992 the lira was targeted by a massive speculation attack the Bank of Italy was found to be defenceless, after having sacrificed almost all available exchange rate reserves.

From the technical point of view the crisis of the lira was a reminder of the relevance of the Mundell's impossibility triangle: the fact that autonomy of monetary policy, fixed exchange rates and capital mobility cannot be attained simultaneously together. Or, how Padoa Schioppa [1988] put it, the triangle could became an inconsistent quartet, adding to the former also the free trade of goods and services.

Thus, for Italy, the removal of controls on capital movements, that had allowed the country to bear the constraint of the EMS, implied also the end of the pegged exchange rate regime, allowing the lira to take a leave from the ERM.

4. THE RUN UP TO EMU

The withdrawal of the lira from the ERM translated in a noteworthy depreciation of the currency, that by 1995 reached the amount of 30 per cent [Bugamelli and Tedeschi 2005]. Italian policymakers decided to take the opportunity offered by the dramatic break with the EMS for restoring the country's competitiveness previously damaged by the constraints of the latter and stopped adopting the disinflation policy followed since 1987. Hence, after a period of about five years of loyalist behaviour, Italy reverted to the traditional stance of reducing the nominal exchange rate of the lira and over a time span almost equivalent Italian authorities did not take the necessary policy measures for re-entering the European system. The return to the old strategy of competitive devaluation or depreciation was scarcely appreciated by European partners. Not only the German policymakers reinforced their doubts as to the possible admission of Italy in the final step of monetary unification that the Maastricht Treaty had put on the rails, but France too voiced to find itself damaged by the Italian currency floating.

Indeed, Germany insisted for extending two of the Maastricht criteria for joining the future eurozone to the functioning of EMU by a formal agreement stating the obligation for the member countries to fall in line with the limits concerning the public finance, both for the yearly deficit and the outstanding public debt. Later on such provisions were laid down in the Stability Pact, agreed upon in 1997 with the addition of a second name, becoming the Stability and Growth Pact (SGP), for the sake of politically correct speech. Still today it is not clear if the intent of German policymakers was really to set up a control on fiscal policies of member countries in order to ensure the viability of EMU, or to keep out from the latter countries with low fiscal credentials, such as Italy and in general the countries of the so called 'Med Club'. The latter interpretation is legitimate since the financial crisis of Greece in 2010 shows the limited availability by the German institutions (included the Constitutional Court of Karlsruhe) to pass over the no bail out clause of the Lisbon Treaty for helping a divergent Euro Zone southern member country avert a possible default.

As to France, which went on following the 'franc fort' strategy in that period, its reaction to the Italian exchange rate policy was bluntly tough. During a meeting with Italian government members the president in charge Chirac maintained that the free floating of Italian lira gave Italy an unfair competitive advantage, warning that the EU partners could decide as a response to re-introduce customs duties on Italian exports to the single market. Unmistakably an over-reaction since other partners such as the UK did not link their currency either to the ERM, without any precise complaint by the rest of the EU.

In the meanwhile, during the move from the EMS to the project of EMU Italy had changed its mind as to the best method to reach the monetary union. Its positions went back to the early period in which the reflections on monetary integration started, prior to 1970s. Whereas initially Italy shared with Germany the views of the "economist" approach, in the course of time its policymakers accepted the "monetarist" mind-set. The use of the two adjectives surrounded by quotation marks is made here in a particular sense concerning the order of stages leading to monetary

integration. In the debate launched after the setting up of the EEC customs union on how to create the monetary union, considered as the subsequent chief objective to be achieved by the end of 1970s, two schools of thought emerged. According to the “economist” school, headed by German scholars and policymakers, the birth of a single currency had to be the final stage of full economic integration and could be obtained only in so far as all markets and policies, except of course that regarding the monetary regime, had been previously integrated at the European level. So the German-born theory of coronation (Kroenungstheorie) maintained that monetary union, in order to be achieved and remain sustainable, had to be based on the building of economic union, like a roof crowning the latter.

On the other front stood the “monetarist” approach, following to which a common monetary device leading to a single currency could represent a constraint strong enough to push member countries to make progress on the road to economic union. France supported this second stance, confirming the influence exerted in the past by an adviser to General De Gaulle for monetary affairs, the economist Jacques Rueff, who used to argue: “L’Europe se fera par la monnaie ou elle ne se fera pas”.

The choice between these two conflicting views was decided by the need for the EEC to build up, in any case, a monetary agreement with which to fight the currency instability that the imminent break-up of the Bretton Woods was going to generate, as Robert Triffin had famously anticipated, with his dilemma between the need for the US to provide the world economy with dollars via a persistent current account deficit and the commitment to exchange the latter for gold. In 1970, just one year before the declaration of dollar inconvertibility by President Nixon, the EEC countries approved the Werner plan, which foresaw the setting up of a monetary union through a three stages process, following the "monetarist” inspiration.

The choices made at the time of the first attempt to set up the European single currency extended their influence in the run up to EMU. Thus, during the discussions preceding the approval of EMU design Italy was considered to be in the group of “economist” countries, alongside with Germany and the Netherlands, that were opposed to the creation of the European Fund for Monetary Cooperation. But starting in the early 1980s Italian policymakers joined France, Belgium and the Commission in the “monetarist” grouping, under the leadership of Governor Ciampi and his aide Padoa Schioppa [Maes and Quaglia 2003].

Against this background, Italy took an active part in the decisions that led to the setting up of the Maastricht Treaty, which laid the foundations of EMU, displaying a pro-European initiative in a number of crucial choices instrumental in overcoming the resistance of eurosceptic countries such as the UK, which expressed at the start a preference for a system of parallel currencies in competition among them, up to the moment when the market would have selected the preferred one. In particular, Italian policymakers played an outstanding role during the Strasbourg summit in 1989, when the objections of Mrs Thatcher were put aside and the fundamental decision was taken to create not a simple common money, but a single currency.

In such a way Italy reverted to its traditional function of a country that could exploit initiative by the EEC political engine, the French-German couple, in order to make the European integration process move on.

It is clear that in such a framework Italy could not afford to pass over the next grand appointment of the EU: the launch of the single currency. And in fact, after a period of strong depreciation following the withdrawal from the ERM, the lira rejoined the latter in 1996, just in time to qualify Italy to enter the first EMU wave country group. To have one's currency within the ERM for at least two year, respecting the normal margins of fluctuation and without having carried out devaluations represented indeed one of the Maastricht convergence criteria. It goes without saying that the come back to the full set of EMS rules meant for Italy the resumption of the previously followed disinflationary and convergence policy.

To be honest, in that period the Italian government planned to enter the Euro Zone with some delay since the convergence criteria were not fully attained, despite the lax interpretation of the rule regarding the public debt, whose level of 110 per cent was about the double of the 60 per cent ceiling established by the Maastricht Treaty. A political reading of such a criterion stated namely that it could be considered as respected, when the divergent country reduced the debt proportion at a satisfactory pace. However the public deficit was still too high, and for this measure no escape clause existed.

Thus, when after a meeting with Spain's government Italian policymakers realised that the Iberian country had a firm intention to qualify for an early entry and was not available to form with Italy a group of loyalist but laggard countries, former prime minister Prodi decided to speed up the transition to EMU. As a consequence, the Italian government asked for a one-off sacrifice by tax payers, whom were charged by an extra "Europe tax" in view of lessening the public deficit. Later on such an extraordinary contribution was largely paid back thank to savings produced by the reduction of the debt service burden, following a fall in interest rates.

The occurrence of the "Europe tax" deserves some attention because it could be a clue of the possible validity of the endogenous currency area theory.

One of the fresher shoots of the theory of Optimum Currency Area (OCA) states that a number of optimality features that are absent among a group of countries whishing to set up a monetary union, can be generated by the monetary zone itself, once the latter has come into being. In other words optimality characters that did not exist ex ante, can be produced ex post. Hence, the stress on endogeneity of some elements of economic integration founding the viability of a monetary union such as a high degree of trade integration put recently by a new strand of literature [Frankel and Rose 1998]. In our case, also some components of financial integration can be taken into account in the same way. So, the "Europe tax" was instrumental in inducing international financial markets to anticipate the admission of Italy into the eurozone, reducing in a short time span its interest rates at levels converging towards the German ones. And when such a fulfilling expectation became true Italy recovered the resources to pay largely back the amount disbursed by tax payers.

5. BENEFITS AND COST OF EMU FOR ITALY: THE SHORT RUN

After more than ten years of the Euro Zone's working it is possible to draw a provisional balance of the specific cost and benefits that accrued to Italy following

its participation in the monetary union. Here we focus on the specific impact that the launch of euro had on Italian economy, over and above the general costs and benefits of a single currency, that in principle are the same for all partner countries.

In this respect on the microeconomic advantages attached to the presence of a single money for a group of countries, such as reduction of transaction costs, removal of exchange rate risks, increased transparency of prices and the like Italy's experience was not such different from what happened in other eurozone countries. As to the main macroeconomic cost, traditionally identified in the loss of the monetary and exchange rate policies (the so called Corden's, 1972, argument on the main cost of monetary integration), possibly in case of Italy the contra argument that the exchange rate tool can have sometimes destabilising effects [Mundell 1973] could be made and expanded on, but not in this note.

The idiomatic advantages and drawbacks of the use of the single currency for Italy concerned two sets of developments. On the one hand a possible euro inflationary effect and a significant decrease of interest rates in the short run; on the other a potential reduction of growth rates and the appearance of divergences towards the EMU core countries in the longer term.

The claim that the euro has been an inflation factor has been levelled in Italy soon after the changeover from the lira to the single currency. In January 2002 the euro was introduced into circulation and after a short period of double pricing the lira ceased to be legal tender. From that time on and for a couple of year a popular sentiment arose, according to which many prices had been changed on the basis of an exchange rate not of 2000 liras per euro (the people's mental reference for the official rate of 1936.27) but of a much lower rate for the old national currency of around 1000 liras. In such a way in many cases one had the feeling that prices had been doubled. A widespread say in that period was that the introduction of the euro had had a negative impact on people living from their salary or pension since the latter, as to their value, continued to be paid in liras, whereas prices were charged in euros.

A possible, immediate explanation of such a development, that translated into a negative popular judgment on the new currency, has to do with the circumstances that in a large number of markets, above all in those regarding the consumer goods, conditions of imperfect competition prevailed. Thus, in the presence of an information asymmetry in imperfect markets the changeover had been the pretext for price setters to charge new prices well above the level justified by the official rate of exchange between the old and the new currency. As a result, the higher prices generated a major loss of purchase power for consumers to the benefit of sellers, whose initial income and wealth conditions improved. However in the longer term the subsequent fall in aggregate consumption was one of the driver of the stagnation of growth in Italy, with a negative impact also on consumer prices.

Also in other member countries similar effects came to the fore. In Germany, for instance, popular press spoke of “Teuro”, an acronym composed by “euro” and the adjective “teuer”, meaning “expensive”.

Yet, oddly enough, such a one-off surge in inflation was absent from the official statistics, whose figures did not record price spikes.

The difference between the official rate of changes in the price levels and what has been dubbed the "perceived inflation" has been explained in different ways and is still a focus of economic research, with mixed results. For instance, whereas some authors use indirect measures of prices behaviour and do not find evidence of the alleged inflationary effects of the euro [Angelini and Lippi 2007], for others the rise in perceived inflation did materialise and was due in its essence to the existence of large, upward and regularly watched price movements in frequently purchased consumer goods [Del Giovane and Sabbatini 2005].

As already said, in the short run Italy, as all Euro Zone member countries with a low record of fiscal credibility, was benefited by a considerable fall in short and long term interest rates. The long convergence game towards the German rates of interest that took over ten years to be accomplished ceased in the very moment where markets became convinced that Italy was going to be qualified for adopting the euro. For a country with an outstanding debt of 110 per cent of GDP in 1997 benefits in terms of reduction of the debt service happened to be remarkable.

Thus, the experience of Italy in this field confirmed that one of the main advantage to take part in EMU consists of gaining an enhanced access to international liquidity at a low risk premium [Jones 2009].

6. BENEFITS AND COST OF EMU FOR ITALY: THE LONG RUN

Let us turn now to the longer term consequences of the euro adoption. According to some scholars the stagnation of growth that Italy has been recording for a long time can be attributed to the very working of the Euro Zone, where a mix of monetary and fiscal policies followed respectively by the European Central Bank (ECB) and the German policymakers do not create a framework favourable to economic expansion.

As a matter of fact, in the period 1999–2008 the Italian average annual growth rate of income was 0.8 per cent, with a range going from 3.2 to –3.5, the latter figure being recorded in the last year of the time span. In 2009 the global crisis, after the negative result of the previous year, took a heavier toll, with a fall in GDP exceeding 5 per cent. Over the longer term the Italian rate of growth fell from 5 in the 1960s to less than 1 per cent in the last decade.

Among the authors identifying EMU as the culprit of this state of affairs we can quote Canale and Napolitano [2009] on the one hand, and De Cecco [2007] on the other hand. Canale and Napolitano [2009] challenge the theoretical foundations upon which the Maastricht Treaty and the SGP have been built, since the denial of an active role in affecting equilibrium income by central banks and national governments that they take for granted has no sound theoretical and empirical bases. Indeed in their exercise on Italy, which covers the period 1998–2008, they find that government spending has displayed a positive effect and inflation targeting by the ECB has shown to have a negative impact on growth. Hence their conclusion that the two pillars of the EMU, with a monetary policy only finalised to produce stable low inflation and rigid fiscal rules hampering government spending seem to have

reduced Italy's economic growth, namely in the last five years of the time span under investigation.

As to De Cecco [2007], he maintains that the euro has had a negative impact for Italian industrial companies, whose exports have been penalised in relative terms, and in fact the Italian share of world exports has been reduced from 4.5 per cent in 1995 to less than 3 per cent ten years later.

On the latter point, however, Faini and Sapir [2005] offer a different interpretation. According to them, the decline in the economic performance of Italy cannot be attributed to the choice to enter the Euro Zone, but depends on more structural factors. In particular they argue that the loss of export shares suffered by the Italian economy is a consequence of a traditional model of specialisation adopted by it, which is currently challenged by the less developed and emerging countries' competition in the framework of globalisation. A factor that is worsened by the growing gap recorded by Italy in the field of human capital formation, compared with other industrialised countries.

Whereas it is debatable that the decline of Italy's rate of growth is really due to EMU policies, a second negative development involving the Italian economy regards for sure the divergences recorded towards the eurozone core countries, whose origin seems to be the very functioning of the monetary union.

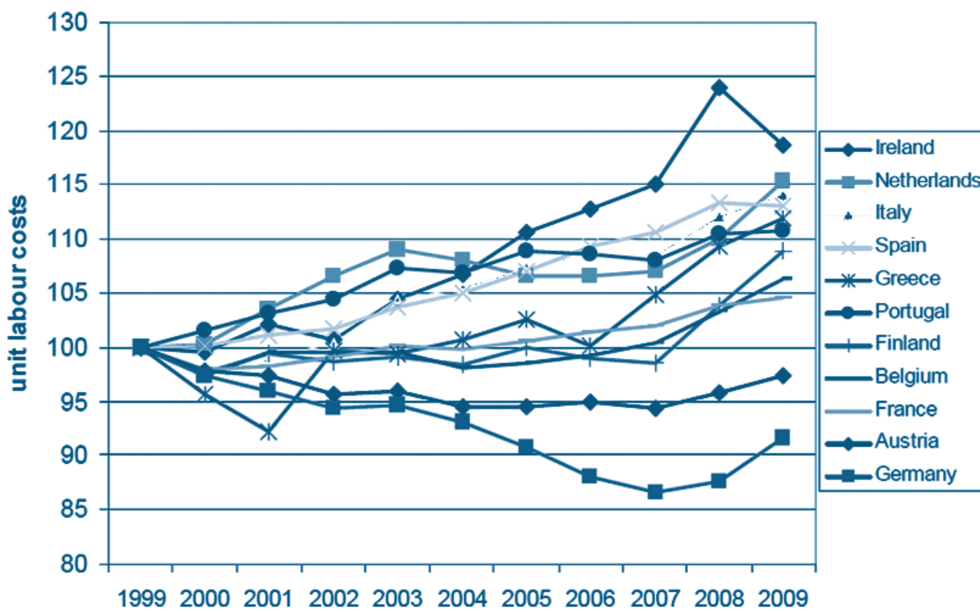
In order to put the argument into perspective we have to remember that in the aftermath of EMU regional cycles within the Euro Zone diverged. In a nutshell, within the latter a number of clusters of countries emerged. On the one hand we had a first group of countries that were characterised by high rates both of growth and inflation, whilst a second one experienced economic stagnation and a low price dynamics. A typical country belonging to the former group of growth-cum-inflation economies was Spain, but in the cluster were also present countries such as France, that experienced an above the average inflation rate. The latter group was led by Germany but included also the Netherlands. Italy and Portugal were in the middle ground, forming a third cluster with slow growth and a rate of inflation just above the ECB's target [Dullien and Schwarzer 2008].

All that translated into cyclical imbalances among eurozone member countries, which could not be offset owing to the absence of fiscal union, a precondition linked to the existence of a centralised common budget strong enough for exerting significant stabilising effects via inter-regional transfers

Under these circumstances the eurozone economic fabric came under strain, as it is currently shown by the impact of the global crisis, which displayed the fragility of peripheral EMU countries, dubbed by the popular press with the unflattering acronym PIGS or PIIGS (Portugal, Ireland, Italy, Greece, Spain).

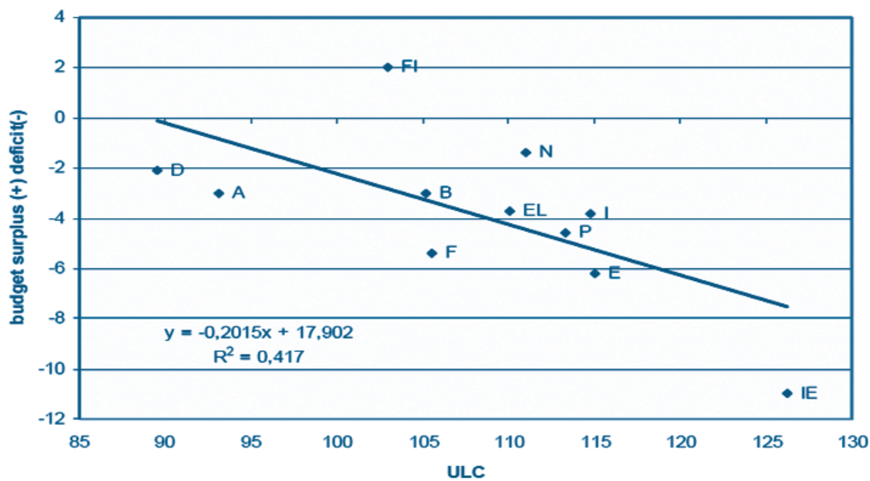
One of the most satisfactory explanations of divergence by peripheral countries towards the core ones has been offered by Blanchard [2006] with his theory of revolving slumps. For countries with low inflationary credentials entering EMU produces a reduction in interest rates, with a subsequent boom often linked to the residential sector development. However, when the capital stock reaches a new equilibrium, the economic expansion comes to a stop. At this point, provided that labour productivity improvements have not been in the meanwhile materialised, a loss of competitiveness comes into view, which cannot be offset through the depreciation

of the exchange rate. In *Figure 1* we find a picture of divergences among member countries' relative unit labour costs dynamics. It appears that whereas labour costs in countries such as Netherlands and the group of peripheral countries including Ireland, Italy, Spain, Greece and Portugal, have increased by 10–15 per cent from the start of the euro area, in Germany and Austria a fall of 5–10 per cent of them has been recorded. All this means that, compared with the situation in Germany, labour costs for peripheral countries moved up by 20–25 per cent. At the same time, as shown in *Figure 2,* the higher relative unit labour costs were associated with higher public deficits [De Grauwe 2010].



Source: De Grauwe [2010]

Figure 1. Relative unit labor costs in the Euro Zone



Source: De Grauwe [2010]

Figure 2. Relative unit labor costs in (1999–2008) and budget balance

7. ITALY'S PERMANENCE IN THE EURO ZONE AT RISK?

Blanchard's [2006] model partially applies also to Italy, with the caveat that both rates of growth and property market boom were quite moderate in its case. Yet, for Italy too the absence of labour costs relative reductions compared with the euro-zone core countries involved a deterioration of its competitive position.

When the lira joined the eurozone, its depreciation that had generated a robust expansion cycle was largely wiped out. After 1999 Italy suffered from the wage deflation systematically carried out by Germany, in order to recover its competitive edge. Such a restrictive stance was quite similar in its economic consequences to a currency depreciation (the so called "internal devaluation") and this added to Italy's economic woes: by 2006 the loss of competitiveness of the latter towards Germany reached a level of 15–20 per cent, with a possible worsening in recent times [De Grauwe 2010].

According to De Grauwe [2006a], so large a deterioration of a competitive position could be contrasted only by a decade of inflation at less than 1 per cent, i. e. by a long period of deflation with income losses and high unemployment. The doubt that in such a condition Italy could reconsider the benefits of its participation in the EMU surfaced just by the middle of the present decade. In this respect by 2005–2006 prime minister Berlusconi and the populist party Northern League seemed to call for the reintroduction of the lira. The Italian minister Maroni who belongs to that party in 2005 advocated the secession from the euro area and the reintroduction of the lira, being supported in that by Mr. Berlusconi, who defined the single currency as a disaster.

In the following poll campaign in 2006 the centre-right coalition argued that the one-off perceived inflation surge that accompanied the introduction of the euro was due to a mistake made by centre-left parties led by Mr. Prodi in accepting an undervalued rate of changeover from the lira to the euro, not taking into account that the final rate of entry depended not by the sole will of the Italian government but by the consensus of other partners.

By that time, on the other hand, Roubini [2006], the economist that later on acquired a world reputation for having correctly forecast the imminent global financial crisis, described for Italy an Argentina scenario, with a withdrawal from the euro area and a subsequent default on public debt, launching a debate on a possible secession by Italy from the monetary union [Praussello 2010], that fostered a large number of mixed opinions. Among them some argues that the danger of a withdrawal by Italy was not immediate, but could materialise, should it prove unable to introduce the necessary reforms for complying with the criteria of an OCA.

In recent times such an occurrence has reappeared, but in a completely different context. The Greek crisis has shown that the debate on the withdrawal of a country and a possible break-up of the eurozone concerns a real danger, not an abstract study case. The latter with two schools of thoughts defending opposite views: the optimistic one led by Eichengreen [2007], who maintains that the cost of withdrawal would be so high as to deter any country wishing to secede, and the pessimistic one, inspired by De Grauwe [2006b], believing that without a fiscal union and a European government the euro in the long run is doomed to fail. And among the

possible candidates that could be affected by the lack of a European solution of the Greek crisis, Italy too is in jeopardy. Considering evaluations of Credit Default Swaps, not at once, but in a time span of 4–5 years.

In any case a subject of anxiety is the last comment by Mundell on the eurozone difficulties, stating that in his opinion the real sick man of EMU is not Greece but Italy. In this respect, whilst for Greece a concerted help by the member countries is feasible at a low cost, since its economy has a weight not exceeding 3 per cent of the euro area, for Italy a bail out could prove impossible.

8. CONCLUDING REMARKS

The present note has been devoted to drawing a provisional balance of the Italian experience within the Euro Zone in the 11 years elapsed from its inception. We have seen that prior to the setting up of the single currency, Italy has accepted to play the convergence game with the financial conditions prevailing in Germany, the main and the pivot country of the subsequent attempts to create in Europe an area of monetary stability, as a precondition to establish eventually a monetary union within the EU, in order to avoid competitive depreciations or devaluations putting in jeopardy the correct functioning of the single market, on a non discriminatory basis or in levelling out starting points among partners.

During the convergence game Italy's monetary constitution underwent a dramatic change, giving up a traditional set of lax policies nurturing the vicious circle inflation-devaluation-inflation. The transition towards a new stance of monetary stability and anti inflationary reputation was not without troubles, as it was shown by the withdrawal of the national currency from the ERM in the period 1992–1996, but was made possible by the loyalist choice to accept to tie one's hand within the latter, or by the strong currency option implied in the link between the lira and the German Mark, thus importing credibility in international markets while forsaking to produce inflation by surprise.

By the end of the transition path the convergence game provided the country with a improved access to international liquidity at a low risk premium, a major advantage for a country burdened by a high public debt exceeding the yearly GDP. Compared with such a significant benefit the one-off surge in perceived inflation following the changeover to the euro looks like a minor drawback, even though such a development contributed to level popular criticism against the single currency.

Once included in the Euro Zone, however, Italy was possibly penalised in terms of decreased growth rates by the mix of monetary and fiscal policies allowed by the euro area framework, with the caveat that the virtual stagnation of the Italian economy could also be due to an outdated international specialisation, challenged by emerging countries in the new division of labour within globalisation. Even worse, both for Italy and the other peripheral countries with a past low record of financial stability, some divergences due to high relative unit labour costs compared with the internal devaluation implemented by the policy of wage restraint followed by Germany came to the fore, possibly putting at risk in the future its permanence in the eurozone.

However if the present financial difficulties experienced by Greece will be contrasted by a European solidarity effort and Italy will be able to go back to a path of decent growth, the nightmare of an Italian economy leaving the euro area in a not too distant future could not materialise.

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