

# **European Solidarity in the face of the Eurozone crisis**

**Club University Foundation – Brussels**

**24 January 2013**

## **Why one size doesn't fit all – Case of Italy**

**Claudio Borghi Aquilini**

Dear sirs

I would like to offer you a short journey, starting from here and ending in Italy, my country, and at the end of this journey I hope it will be clear that sometimes there are weddings that it's much better not to celebrate. A brilliant Italian economist, Professor Alberto Bagnai, even wrote a short novel: "the story of Hans Center and Maria Periphery" forecasting what will come in the future should we insist to keep this engagement for too long, and the consequences will be dire. There is nothing wrong in friendship, sometimes it could turn into a wedding but more often than not it is better to stay friends. For Europe this is the case.

Let's start in the nineties: the EMS was a proxy of the euro, with almost fixed currency rates. This situation quickly started creating a heavy trade deficit in Italy, the outflow in currency was tackled exactly with the wrong tools we are using today: a sharp tax hike (government even taxed bank deposits overnight, levying a percentage of every Italian positive balance on their banking accounts), rise in interest rates up to 18% and the very same rhetoric we are hearing today about the disaster of an EMS exit. As you maybe remember, after having depleted all the Bank of Italy's foreign currency reserves, eventually Italy was forced to abandon EMS devaluating the lira around 20%.

As you can see in this table the rebound on trade balance has been almost immediate, and paved the way for the last "Italian miracle" of the nineties, the very last growth period Italy witnessed.

### 5. Report for Selected Countries and Subjects

You will find [notes](#) on the data and options to [download](#) the table below your results.

Lira si sgancia da SME

Country	Subject Descriptor	Units	Scale	Country/Series-specific Notes	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Austria	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	1.166	0.061	-0.683	-1.433	-3.280	-6.816	-6.651	-5.030	-3.396	-3.451	-1.414
Belgium	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	3.637	4.763	6.664	11.251	12.600	15.391	13.836	13.842	13.255	20.070	9.393
Cyprus	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.154	-0.420	-0.638	0.110	0.074	-0.205	-0.468	-0.418	0.292	-0.170	-0.489
Finland	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-6.989	-6.734	-5.117	-1.126	1.099	5.356	5.148	6.856	7.292	6.971	9.499
France	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-9.869	-6.186	3.835	9.188	7.406	7.338	19.361	37.813	38.555	45.091	19.317
Germany	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	45.307	-24.253	-22.743	-19.034	-30.520	-29.587	-14.019	-10.008	-16.330	-26.858	-32.558
Greece	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-3.537	-1.574	-2.140	-0.747	-0.146	-2.864	-4.554	-4.860	-3.682	-7.295	-9.820
Ireland	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.675	-0.025	0.393	2.005	1.764	2.149	2.584	2.696	0.704	0.241	-0.350
Italy	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-21.692	-29.946	-34.125	11.908	13.907	23.182	40.185	33.769	19.791	8.208	-5.863
Luxembourg	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	n/a	n/a	n/a	n/a	n/a	2.473	2.367	1.839	1.648	2.272	2.688
Malta	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	n/a	n/a	n/a	n/a	n/a	-0.382	-0.422	-0.222	-0.229	-0.136	-0.488
Netherlands	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	8.106	7.333	6.900	13.273	17.312	25.793	21.412	25.073	12.970	15.643	7.251
Portugal	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.181	-0.716	-0.184	0.233	-2.196	-0.132	-4.917	-6.607	-8.332	-10.312	-11.502
Slovak Republic	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	n/a	n/a	n/a	-0.651	0.665	0.383	-2.098	-1.828	-1.983	-0.983	-0.707
Slovenia	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	n/a	n/a	1.087	0.282	0.700	-0.309	0.057	0.065	-0.156	-0.878	-0.631
Spain	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-18.050	-20.049	-21.421	-5.533	-6.394	-1.835	-1.418	-0.510	-7.074	-18.100	-23.054

Please note the balance of euro states trade: Italy in surplus, Germany deficit. Another world indeed.

Consider that Italian public debt was not different than today, but it was not a matter of concern, the shock did reflect on the exchange rate, no one was thinking about selling government bonds under par. Note also that most of the terrible consequences envisaged for an EMS exit by the very same names (one of the most vocal was Mr Mario Monti himself) that warn about the doom of an eur exit (banking crashes, hyperinflation, impossibility to buy oil and basic materials) never happened in the slightest. Inflation even dropped 0,5% compared with previous year.

Then come the Euro and Italy was successfully lured in the same trap. After having blocked again the natural balancing tool represented by floating exchange rates, the ghost of the trade deficit come back with multiplied power and this time euro-wide

### 5. Report for Selected Countries and Subjects

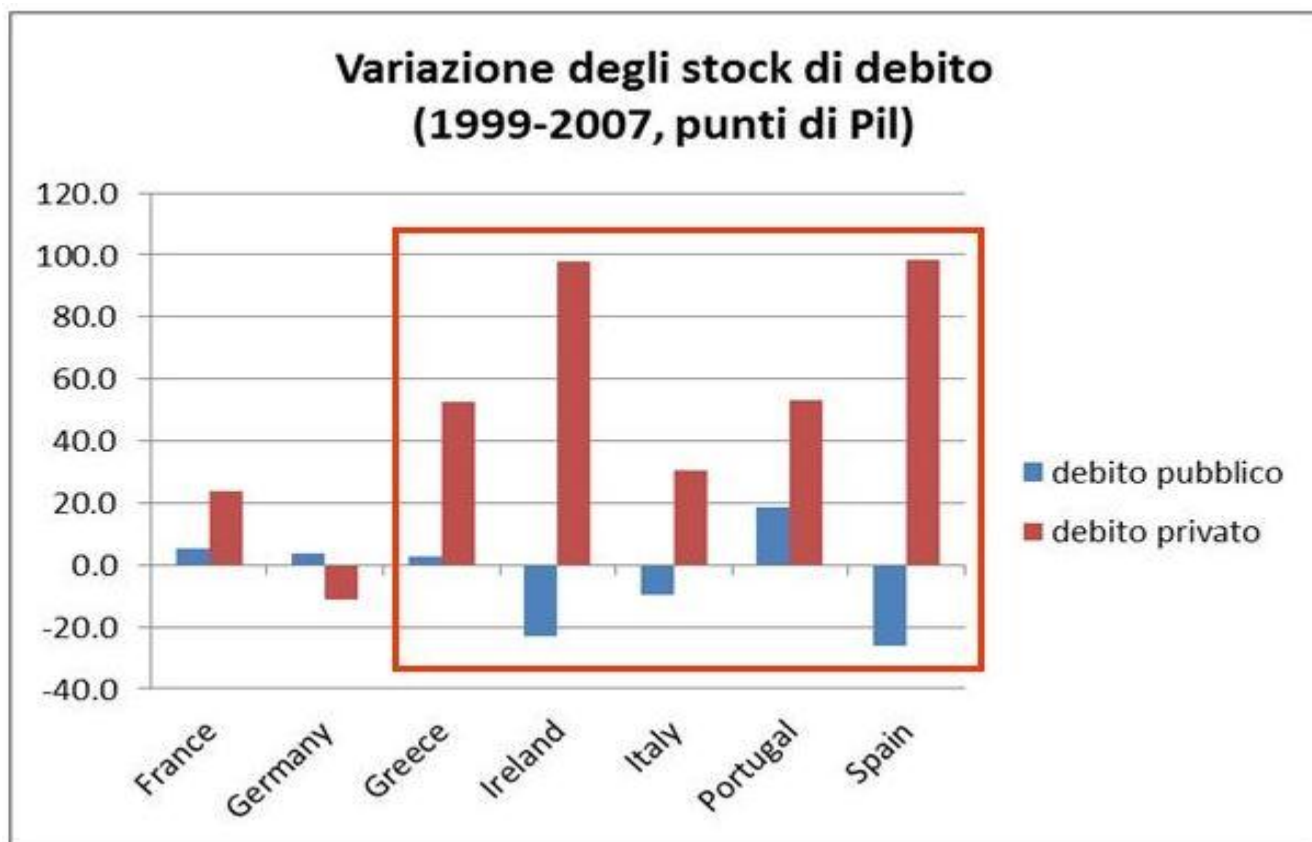
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Euro Start

Country	Subject Descriptor	Units	Scale	Country/Series-specific Notes	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Austria	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-1.569	5.545	4.278	6.408	6.614	9.111	13.184	13.602	8.804	8.474
Belgium	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	7.896	11.729	12.837	12.625	9.790	7.934	7.299	-14.891	1.333	2.321
Cyprus	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.316	-0.402	-0.301	-0.794	-1.010	-1.284	-2.565	-4.445	-1.949	-1.802
Finland	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	10.421	11.476	7.945	11.734	6.568	8.787	10.483	8.465	3.153	3.315
France	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	23.522	18.164	12.984	11.141	-10.375	-12.995	-25.931	-54.629	-51.287	-45.743
Germany	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	0.380	40.584	46.270	127.852	142.801	188.481	253.756	245.722	163.256	200.188
Greece	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-9.400	-9.582	-12.804	-13.476	-17.874	-29.832	-44.686	-51.212	-37.092	-33.053
Ireland	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.678	-1.223	-0.002	-1.078	-7.088	-7.916	-13.876	-13.886	-6.705	-5.582
Italy	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.639	-9.483	-19.605	-16.208	-29.448	-48.137	-51.691	-78.874	-67.151	-58.272
Luxembourg	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	1.770	2.386	2.378	4.046	4.141	4.415	4.985	3.091	2.967	3.625
Malta	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-0.148	0.104	-0.156	-0.335	-0.523	-0.595	-0.466	-0.475	-0.486	-0.421
Netherlands	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	9.770	10.939	29.568	45.898	46.433	63.331	67.589	41.978	42.702	44.024
Portugal	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-11.384	-10.246	-9.423	-13.410	-17.428	-19.372	-20.902	-29.374	-23.461	-22.330
Slovak Republic	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-1.747	-1.930	-1.976	-3.302	-4.072	-4.388	-3.962	-6.282	-2.818	-1.171
Slovenia	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	0.038	0.247	-0.227	-0.897	-0.620	-0.968	-2.256	-3.663	-0.732	-0.338
Spain	Current account balance	U.S. dollars	Billions	<a href="#">i</a>	-24.023	-22.443	-31.071	-54.909	-83.291	-110.890	-144.281	-155.962	-81.198	-71.920

I think that this table does not need any comment. One could dig deep in the reasons of Germany's boom. Evidence is that it's the outcome of an aggressive salary control that widened the competitive gap with euro periphery, whose deficits were filled with an huge flow of capital invested by core Europe in the now "currency risk free" countries. Capital flow drove inflation up, widening even more the competitive gap, and fueling an out-of-control private debt rise that crushed most of Euro periphery countries. Please check

the following graph: red is gdp% shift in private debt and blue public debt from 1999 to 2007, so much for another of the myths of this crisis, the one that says that “the fault is of the public debt”



What went wrong? Nothing strange, in fact another outcome was very unlikely because Eurozone violated openly the basic requirements for an Optimal Currency Area and eventually Euro turned out to be nothing more than the usual currency peg trap for the weak countries leading to a classic Frenkel's cycle. The tax hike imposed to an already tax plagued economy like Italy's one crushed the economy and the higher take went to northern Europe creditors via Esfs and loans to Greece and other periphery countries. Italy had almost zero exposure to peripheric Europe debt.

It is possible to understand the dangerousness of the situation if only we think that in a normal situation a shock in a country determines a drop of its currency, thus an help for its economy. In Eurozone we were able to build the monster of a system that worsen the condition of an area under shock, driving its borrowing cost higher.

Let's now move to solutions and why the “more Europe” option is negated by Italy's example.

Almost everyone agrees that there are only three ways out for this situation: Euro breakup; sharp deflation via wage cut in periphery (possibly twinned by a rise in prices in Germany)@ and the “more Europe” mantra. From Krugman downwards there is a qualified consensus that deep deflation is not realistic, socially but also economically, due to the worsening of the debt burden should gdp fall more. So let's take a look of what Italy example can tell about the forced full integration of different economic areas.

Italy is an extremely interesting case study on integration, because it encompasses areas very different as per their economic strength. We can say that the common currency “lira” unified a German North Italy, A France Center and a Greek South, with the advantage of a common language. How the equilibrium has been obtained? In the only possible way for a non Optimal Currency Area, via deep internal fiscal transferts. This means that in order to replicate “Italian model” Germany should pay for the others like north Italy does for the rest of the country, but even should this situation be politically manageable (and I suspect it’s not) this is not desirable at all, exactly following what went wrong in Italy.

To make the point simple: imagine that economic and industrial strength of North Italy is “10” and the same level should be given of a theoretical “northern” currency, while the one of the south is “2”. The currency “lira” will trade as an average of the two area, let’s say “6”. The result is that the North gets a weaker currency compared with its strength, and the south a stronger one. Industries in the north so become very competitive and export their success in world markets and also in the internal one while in the south factories closes by the day, keeping alive only sectors out of competition (Tourism, quality food) not nearly enough to be self sufficient. Very soon it appears evident that the South situation was unsustainable and programs to “relaunch” South economy started to drain money from the North, taking back most of its trade surplus. Tax rate started to rise, in a sharply progressive way, in order to hit the successful Northern industry and to make up resources to fund the needs of a starving south and the equilibrium was set.

You see the cycle? The North is competitive thanks to a weaker currency, it piles up extra profits and these profits are drained to pay the South who have its growth made impossible by the too strong currency. I can imagine that many German industries saw only the competition side of north Italy industries, not knowing that on the other hand they were burdened by the weight of taxes and limits, without any aid from the State, without decent infrastructure, because most of the money were drained away to settle the imbalance.

What happened of the money sent South? Many attempts has been made to create industries with heavy incentives to set up business, but if there is no “real” economic interest in keeping a plant open and the only reason to do so is the state financing, the result is that no serious investment is made, because the flow of money from the state could end in any moment, as it is set every year with the budget law.

In most cases the answer has been to simply create jobs out of thin air, with a disproportionate number of civil servants. Many analyst point out funny situation, like the fact that it seems that in the small region of Calabria there are more Forest guardians than in the whole Canada. The state quickly become the main employer of the South. The unintended consequence of having a steady flow of money (around 50 billion per year as an average, but the number is higher if we consider services) intermediated by the state from North to South is the creation of a corrupt net of politics and state managers who aim to profit from the huge decisional power of allocating resources. The trade “jobs for votes” become quickly rooted in southern Italy culture when it become clear that there were no realistic chances to compete with “normal” economic activities.

Needles to say that even this flawed equilibrium was shattered by the euro. Once the country got the very same “10” currency of the rest of the Europe, Northern Italian industries competitiveness fell sharply but their strength would have been enough to stay in the market, sadly the burden for the internal money transfers was still firmly in place, so even if it has been masked for a while by cheap capital inflows the weakness eventually made them snap. Of course if the hurdle for the “2” southern economy to reach the

“6” lira strength standard was almost impossible, the next hurdle of the “10” strong Euro erased even the slightest chance of success.

It should be clear that becoming a big economic Italy it is not desirable for Europe, neither from the side of the ones that will have to pay nor from the point of view of the ones who will be forced to seek aid. A “southernization” of Europe is the last thing we need, it’s inefficient, paves the way to corruption and fuels hate between people, who will see only their money taken away but failing to grasp the whole picture. The only realistic way out is to set up currency areas better shaped, where economies are free to rise and fall for their own strength, not for a dirigistic system of internal money transfers. Splitting the euro area in two it could well be a first step towards a future of deep friendship between Europeans, without getting into the abyss of hate often created by an ill-conceived wedding.

Claudio Borghi Aquilini