“German Cage” or unsung savior? The effect of Eurozone membership on Italy’s economy and economic policymaking

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Notorious for its ever-changing governments and a seemingly spiraling debt-to-GDP ratio, Italy is undoubtedly not what one might consider an economic success story of the European Project. Indeed, in a number of economic measures it continues to be vastly outperformed by its more northerly European cousins. In this paper, Kate Devane analyses the impact that membership of the Eurozone has had on the economy of Italy, noting the binding effect that the adoption of the Euro has had on monetary and fiscal policymaking. Despite the superficial drawbacks of membership of the Eurozone and the unpopularity of austerity policies implemented in Italy over the past two decades, Devane shows that joining the Euro was certainly beneficial to the Italian economy, and that, without it, the economy would not be what it is today. What some Italians view as a “German cage” might be more of a saviour than outwardly appears.

I. Introduction

Since the introduction of the Euro, Italy has consistently underperformed economically in comparison with its peers, with its growth far exceeded by that of Germany, France and even Spain. The Italian economy has barely increased in size since the turn of the millennium and it has the third largest sovereign debt burden in the world (Giugliano & Odenhal, 2016). The Euro has oft been held accountable for Italy's economic woes in recent decades, blame which is largely unfounded. Eurozone membership has had both positive and negative effects on the Italian economy. An analysis of the effects of Eurozone membership on Italy's economy and policymaking reveals that Italy's problems lie not with the Euro but with the structural domestic flaws that have long plagued the country.

II. The Italian economy and the Euro

A brief examination of several aspects of the economy highlights the costs and benefits of Eurozone membership for Italy. Manasse et al. (2014) construct a synthetic control (simulating an Italy that had never joined the Eurozone) in order to test the counterfactual. This proves a useful tool in analyzing the effects that the Euro has had on the Italian economy.

GDP per Capita

Italian GDP per capita today, when adjusted for inflation, is less than it was in 2000 (Romei, 2008), indicating the country's underwhelming economic performance since the adoption of the Euro during 1999-2002. The popular perception of the Euro is that of a "German cage" (Paolo Savona, Minister of European Affairs, 2018-19), depriving weaker countries - including Italy - of the policy instrument of devaluation. The Euro is seen as a currency created and managed on Germany's terms to the detriment of Italy. This, the argument goes, has allowed Germany to issue cheap loans to weaker economies to increase their purchases of German goods (Bershidsky, 2018). The evidence however, in the form of the relative growths in GDP per capita of both countries as Euro members compared to their respective counterfactuals, refutes this theory. It is true that Italian GDP per capita has suffered somewhat as a consequence of the Euro, showing a cumulative loss of 3.7% during the period 1999-2011 relative to the counterfactual. Contrary to popular perception, however, Italy's loss was not to the benefit of Northern Europe: Germany's loss of potential GDP was in fact greater than Italy's, with a cumulative loss over the same period of 7.4% relative to its counterfactual control.

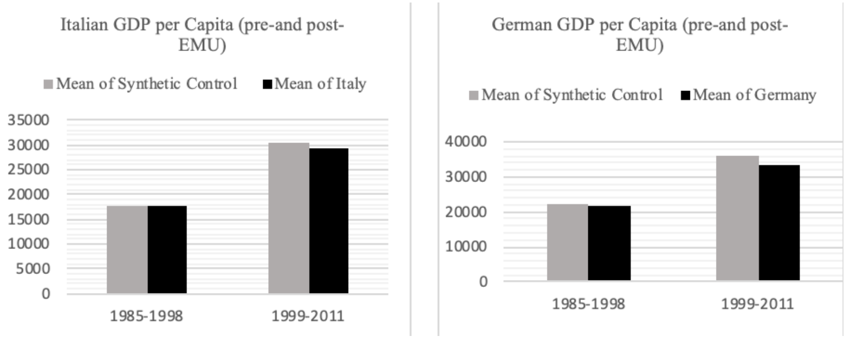

Figure 1. Change in GDP per capita relative to their controls for Italy and Germany (Manasse et al., 20140

It seems reasonable to conclude, therefore, that Italian GDP per capita has not suffered disproportionately as a result of the Euro.

Inflation

Italy's decision to join the Eurozone was partly motivated by a need to curb inflation, which had reached double digits in the preceding decade. Manasse et al. (2014) show that while rising prices are often attributed to the Euro, in its early years the common currency contributed to a cumulative reduction in inflation (compared to the counterfactual) – albeit a temporary one – of 0.7% per year (1999-2009). The Euro, therefore, had the desired effect of reigning in Italian inflation somewhat. Characterized by political instability and low levels of social peace, an Italy with complete monetary policy independence would, as the past has demonstrated, be highly inflation prone. The Euro therefore is an effective shield against the domestic policymaking process's potential for hyperinflation.

Labour Productivity

Italian labour productivity (expressed as GDP per hour worked) slowed from the late 1990s, stagnating after the introduction of the Euro – in sharp contrast to the continual rise of the synthetic control (Manasse et al., 2008). A plausible explanation is that with the loss of devaluation strategy, resources may have been transferred from the once-competitive productive tradable sector to the protected, less productive non-tradable sector. This provides further evidence that the Euro left structural reforms, which Italy failed to implement, as its only policy option to raise competitiveness.

The 'Euro Privilege'

Italian interest rates began to decline from the mid-1990s, most clearly illustrated using the interest yields on 10-year government bonds, as seen in Figure 2. This decline can be attributed to the impending elimination of the Lira-Deutschmark exchange rate depreciation risk, the disinflation process as Italy aimed to meet the convergence criteria for euro entry, and the new-found credibility associated with the ECB's price stability objective. The lower interest rates that accompanied the introduction of the Euro provided an opportunity for Italy to reduce its debt burden at a relatively low expense.

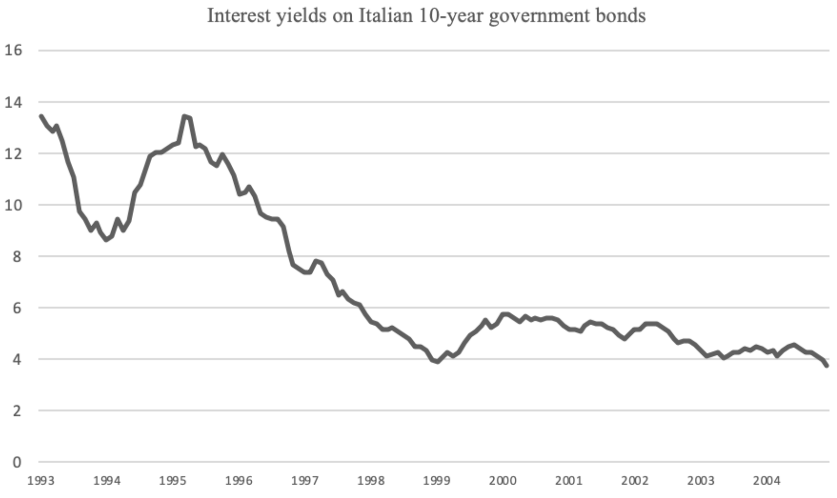

Figure 2. Interest yields on Italian 10-year government Bonds (OECD, 2020)

However, Italian authorities failed to take advantage of this cheaper debt service: debt has now risen to 131.8% (having never come close to approaching the required 60% threshold) in the wake of the crisis. Now facing high interest rates and bond yields, Italy's 2018 expenditure on debt stood at 3.7% of GDP and is forecast to rise to 3.9% in 2020. Eurozone membership can in part be blamed for these higher rates and bond yields, as discussed below, highlighting that Italy has both benefited and lost from the Euro in terms of rates on its public debt. However, failure to take advantage of the benefits shows that the fault lies with domestic policymakers, not the Euro.

III. Italy, the Euro, and shocks

The insulating role of the Euro

Fratzsher and Stracca (2009) argue that domestic policymaking not only responds to idiosyncratic shocks but is itself subject to shocks arising from political instability. The Euro, in reducing policy autonomy, then plays a role in reducing the impact of such shocks on economic policy and outcomes. Italy, characterized by a particularly unstable political sphere – having had over 60 governments in the postwar period (Fratzsher and Stracca, 2009) - benefits significantly from this aspect of EMU.

Indeed, the authors find that "political events have exerted a statistically and economically significant effect on Italy's financial markets" prior to the introduction to the Euro. Moreover, their investigation suggests that the Euro has had a significant positive role in "insulating financial markets from such adverse shocks". In general, Italian financial markets tend to exhibit "roller-coaster" behaviour around political events such as government collapses and formations. Government collapses have tended to lead to higher short-term interest rates (by an average of 40 basis points), lower equity returns (by an average of 5%) and a depreciation in the effective exchange rate of the lira, as well as raising levels of uncertainty in financial markets (Fratzsher and Stracca, 2009). Since the introduction of the Euro, however, financial markets have been shielded substantially from the effects of political turmoil. Equity returns and short-term interest rates are now influenced by events in the Euro area as a whole, causing domestic events to have a lesser impact on Italian asset prices. Exchange rate uncertainty is also reduced.

This insulating effect is not strictly positive: as Fratzsher and Stracca note, reduced responsiveness of asset prices to domestic events in particular may reduce the disciplining role that financial markets have traditionally held over domestic policymakers. Thus the insulating effect of the euro has had mixed results for Italy.

Business Cycle Synchronization

Italy has long had a high level of business cycle synchronization with the Euro average: in comparing Italy before and after the introduction of the Euro, Amisano et al. (2009) find no significant difference in the impulse responses in the two regimes to idiosyncratic supply and demand shocks.

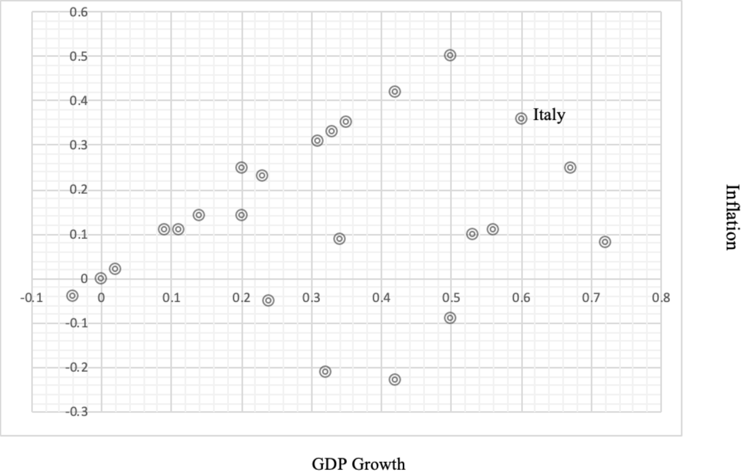

Figure 3. Correlation of cyclical components of GDP growth and inflation between the Euro area and selected countries (Broz, 2008)

The Euro has nonetheless had an effect in reducing the "variability of the divergence in real economic performance" between Italy and the rest of the Eurozone. This is due to the eradication of idiosyncratic monetary shocks as a result of integrated monetary policy.

IV. A new policymaking toolbox

Monetary Policy

Upon adoption of the Euro Italy relinquished control of its monetary policy to the European Central Bank. In adopting the common currency Italy gave up the strategy of devaluations that it had previously relied upon as a way of keeping Italian industry competitive. The relatively good performance of the Italian economy during the 1980s and 1990s was debt-driven, resulting in sizeable expenditure with relatively poor growth in total factor productivity. For almost two decades the devaluation strategy had been a key policy instrument: this "quick fix" allowed it to offset the structural inefficiencies of the economic system and compensate for relatively high inflation and wage growth. This system of devaluations benefited the large number of small to medium-sized enterprises that have long characterized the Italian economy, but it did not address the economy's long-term growth issues.

Italy has failed to modernize its industry: businesses remain small and costs are high. Without the ability to restore competitiveness through devaluations of the lira, it has suffered "the biggest drop in export market share of any developed country" (Elliot, 2016). In the absence of structural reforms exports have continued to flounder. Structural reform options are often politically unpopular – labour market reforms proposed by Matteo Renzi in 2016 were heavily defeated (59.1% voted against the proposals) by referendum, for example (Elliot, 2016). Devaluations had the advantage of meeting little public resistance. With the absence of devaluations as a viable policy option, Italy's need to address structural problems has been exposed.

Italy is likely to have struggled economically with or without the Euro: its inflexible markets, inefficient bureaucracy, and failure to modernize its industry resulted in slow true growth even before the introduction of the single currency. However, it is true that the Euro has exposed Italy's structural weaknesses and robbed it of its main compensatory strategy.

Fiscal Policy

Eurozone membership has constrained Italy's use of fiscal policy somewhat, although not to the extent that might have been expected upon entry. The desire to qualify for Euro membership provided Italy with the motivation necessary to reduce its substantial level of public debt, which peaked at almost 127% of GDP in 1994 (Sapir, 2018). Effort to meet the Maastricht Treaty's debt requirement were initially considerable, with debt-to-GDP dropping to 111% by 1998. However, Italy's fiscal efforts declined upon entry to the Eurozone, reaching only around 100% in 2002 and remaining relatively constant until 2007, at which point the crisis worsened affairs (Sapir, 2018).

Poor efforts to continue to strive to meet the criteria highlights the failure of EMU rules to have a binding effect on Italy's policymaking – often to the country's own detriment. Public debt now stands at close to 132% of GDP and, left to their own devices, the Five Star and Lega coalition government would implement an expansionary budget worth close to 1% of GDP. In the face of sanctions of up to 0.5% of GDP (Euractiv, 2019), Italy conceded to the European Commission's demands that it revise its 2019 budget so as to reduce the initial planned deficit of 2.4% (ibid.). This recent development shows that the Stability and Growth Pact continues to exercise at least some constraining power on domestic policymakers.

Italy is legally committed to the Stability and Growth Pact through EU membership. Given its extensive flouting of the rules however (the 2019 budget issue is only the latest in a series of clashes between Rome and Brussels), it can reasonably be assumed that without the stricter enforcement mechanisms Italy is subject to by virtue of being a Eurozone member, the Pact would have been unlikely to bring any significant level of fiscal discipline to the country. It can be concluded that Euro Area membership has limited domestic Italian fiscal policymaking somewhat, although not to the extent it would have were Italy to be more cooperative with the fiscal rules it has nominally agreed to.

Impact of the crisis

Euro Area membership has indisputably affected the extent and manner in which Italy has been affected by the Eurozone crisis. In May 2010 fears that Greek sovereign debt would spread to other "Club Med" countries (including Italy) caused markets to demand higher yields on Italian government bonds. Italian public debt, being the largest in the Euro Area (in value terms) was a source of concern for markets. The failure of Euro rules to constrain Italian public debt in previous years became particularly salient. The ensuing austerity measures introduced by the Berlusconi government in efforts to reassure markets depressed both private consumption and growth (Sapir, 2018), as seen in Figure 4.

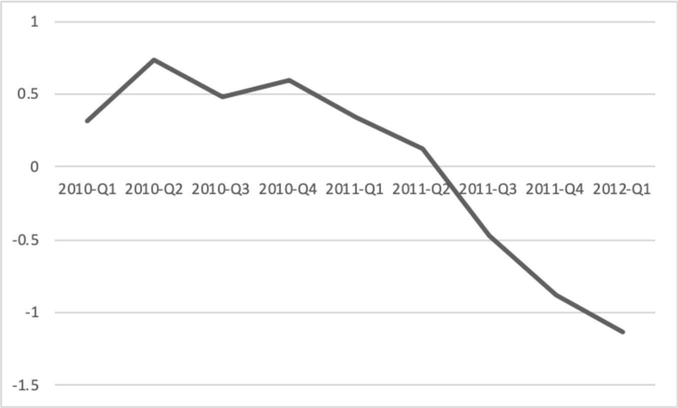

Figure 4. Italian GDP growth 2010-2012 (OECD, 2020)

Contrary to Mody's (2018) claim that the ECB's "big focus was on more fiscal austerity", the austerity-only measures implemented by Italy 2010 and 2011 were not part of an agenda set by the ECB – in fact, Jean-Claude Trichet called for "significant measures to enhance potential growth".

The most significant effect of the Eurozone in causing Italian recession was therefore through the "perceptions of vulnerability to contagion" (Sapir, 2018) from debt crises of fellow Euro Area members such as Greece. As the crisis worsened, the potential redenomination risk of Greek exit from the Eurozone spread quickly to Italy, whose credit rating dropped accordingly. The "panic-driven austerity" imposed by domestic policymakers that led to recession was a consequence of this market perception of potential contagion within the Eurozone (De Grauwe, 2011).

V. Conclusion: Italy and the Eurozone – a neglected opportunity

Membership of the Eurozone has greatly altered Italy's economic policymaking through the elimination of its independent monetary policy. Fiscal policy has also been altered, although to a much lesser extent. These changes have not, contrary to popular opinion, caused the dismal economic state Italy finds itself in – they have simply served to reveal the underlying problems in Italy's economic system. The case of Belgium demonstrates the potential that the Euro held for Italy. At the time of the Maastricht Treaty, Belgian public debt was even higher than that of Italy; Belgian interest rates following entry were lower (Sapir, 2018). Belgian authorities, in contrast to their Italian counterparts, showed absolute commitment to the fiscal goals of the EMU, and thus reaped the benefits of the Euro, reducing debt and gaining stability, enabling Belgium to withstand the crisis while Italy floundered. Italy has no doubt suffered due to contagion effects in the Eurozone crisis. However, Eurozone membership has offered a wealth of benefits, many of which Italian policymakers have simply failed to utilize.

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