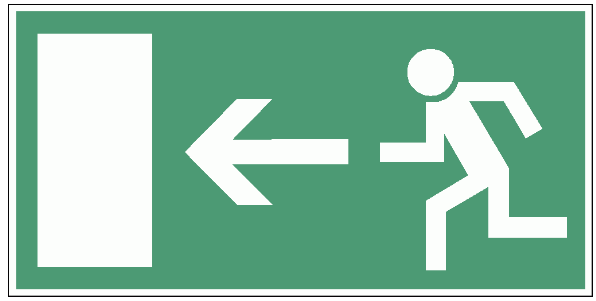
Should Italy Quit the Euro?

blogs.lse.ac.uk/eurocrisispress/2013/06/18/should-italy-quit-the-euro/

Roberto Orsi 6/18/2013

by Roberto Orsi



This question is certainly worth exploring, not so much perhaps in sheer terms of policy options, as it will be argued, but especially because of the challenge that it represents against the background of the substantial immobilism displayed by European decision makers, at all levels, during the crisis.

After years of persistent deterioration of Italy's economy, it is no surprise that, as in other countries of the Eurozone, the search for possible solutions to the on-going crisis has led to the emergence of a debate about the prospect of leaving the Eurozone and re-introducing a national currency. The debate mirrors the polarisation of the sentiments expressed by Italians towards the common currency, which have never been entirely positive. Still, today, eleven years after its introduction as physical currency (1st January 2002), the memory of the perceived sudden rise in many consumer goods prices has made the euro appear as the culprit of the steady decline in the purchasing power of Italian consumers.

Recent opinion surveys show that, as in other countries of the Eurozone, there is a sizable sector of the population, currently about 20%, that endorses leaving the euro as the way forward in order to re-start the economy. A more thorough articulation of this policy option has been envisaged by a relatively small group of economists and economic journalists, mainly Alberto Bagnai, Alberto Bisin and the controversial Paolo Barnard. Others, such as Loretta Napoleoni, have been advocating the break-up of the euro into two currencies, with a euro-2 for the southern economies. These positions are related to the critical views often expressed by leading economists, such as Joseph Stiglitz and Paul Krugman, and by the strategic analyst Edward Luttwak, about the damaging consequences of austerity policies and the opportunity of either re-thinking the whole system, or proceeding with some consensual divorce, perhaps with a German exit. Luttwak has recently articulated the view that, despite a high price to be paid in terms of domestic restructuring, Italy would be better off, in the long run, outside the Eurozone.

Those who argue for exiting the Euro base their stance on a bleak reading of Italy's position within the Eurozone and of its future. Essentially, Italy has been penalised by a combination of excessively high exchange rates against the rest of the world (thus depressing exports), the original exchange rate of 1,936.27 lire for one euro represented an over-valued lira, and the German socio-economic dumping (Hartz IV reforms and German industrial restructuring in the mid 2000s). The Euro-system is also constraining the capability of the Italian state to finance itself as austerity policies ban higher deficits and the rapid expansion of the monetary base (quantitative easing), as current enacted of the Federal Reserve, the Bank of Japan and the Bank of England. Exiting the euro and adopting a new national currency would allow a 20% devaluation, boosting exports and re-establishing the competitiveness of manufacturing. It would also allow quantitative easing and a more aggressive policy of public spending, partially by means of monetisation. Of course, the Italian public debt (currently among the largest in the world at €2,000 billion) would have to be immediately re-denominated in the new currency.

However, these positions have encountered a barrage of criticisms. Firstly, it appears that they underestimate the legal and political implications of exiting the euro. The prevalent interpretation of the EU treaties affirms that the euro is an irreversible monetary union, as also stated by Mario Draghi, and that the only way to leave would be to leave the EU entirely. But that in itself would require a couple of years. Secondly, even ignoring the legal procedures for a euro-exit, the timing of a currency switch may not be as short as it seems: if it took years of preparation to introduce the euro, it would take years to introduce a new national currency, from printing the notes and minting the coins, to updating the whole financial infrastructure. Feasibility aside, it seems very unlikely that Italian political leaders, who have not managed to introduce any substantial reform for decades, would be suddenly capable of a such bold step.

But the most important point of critique is centred on the economic consequences of the exit. As excellently summarised by Stefano Bassi, author of one of the most widely read economic blogs in Italy, the supporters of this policy option are severely misreading the context in which the country has to operate and compete. While it is true that periodical devaluations of the lira helped Italian exports in the past, today's world is radically different from that of even the last wave of devaluations in 1992-1994. Italy's international position has severely degraded in terms of export competitiveness, financial outlook, and demographics. Within a globalised economic environment, the problem is not so much about compressing the cost of labour, but the organisation of efficient production chains, which are indeed mostly globalised. This means that even goods manufactured in Italy are no longer entirely produced in the country, but are more often assembled with components coming from different parts of the world, components which need to be imported, especially if the country intends to specialise in high-tech goods (other manufacturing has already left for Asia and various developing countries). Devaluing the currency will therefore make imports more expensive, further degrading Italy's competitiveness as a place for industrial business. It is also questionable whether Italy needs any currency devaluation, at a time in which the average Italian wage (after tax) is already among the lowest in Western Europe. Indeed, looking at the historical experiences of Russia in 1998 and Argentina in 2001, massive currency devaluations have a dramatic impact on the standard of living of the population, with severe social and political consequences, which may last for decades. Besides, the proponents of exiting the euro underestimate the power of financial markets, which is far more pervasive than in 1992-1994. And even then, despite the monetary sovereignty of the nation, the Bank of Italy did not manage to defend the lira against speculative attacks.

With a debt-to-GDP ratio of 130%, it would be unimaginable to keep it denominated in euros, while switching to a devalued currency as interest payments would push Italy to default at once. On the other hand, re-denominating the debt in a different currency would be a *de facto* default, with very severe consequences for Italy and the whole financial structure of Europe and beyond.

These positions seem to be based on the illusion that today's Italy is still the same as in 1992, while unfortunately Italy is in much worse shape than twenty years ago, when not only the country, but the whole world around it was completely different. In the *Bel Paese* there is a severe underestimation of how much the world has changed during a long period (1995-2007), when the global economy has been completely transformed, new industrial powers have emerged, consumer patterns have shifted, while Italy has found itself in a long stagnation, with no socio-economic reforms, and political leaders quarrelling exclusively about their own personal and/or party interests.

There is however a legitimacy in the position of those who advocate an exit. The euro does indeed work as a straightjacket for many economies in Europe. The common perception is, quite correctly, that something has to be done about it. Exiting the euro is, however, not the right response. But expecting that the problems will solve themselves, as is the case in the on-going Euro crisis, is not the right response either. The euro and its member states – Italy in the first place – need profound reforms. The question is therefore not "should Italy quit the euro?" but "how can we restructure Italy, and Europe?", by addressing urgent issues in industrial development, demography, geostrategic positioning, global financial market regulations, without which we are all (including the Northern Europeans) on a path to nowhere. This may demand a quite dramatic shift in the political culture of the EU leadership, which unfortunately is unlikely to emerge soon.

Note: This article gives the views of the author, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.