ifoVIEWPOINT

Munich, 18 May 2018

No. 196

Italy’s New Government: Transfer Union or Euro Exit*

The Five Star Movement and the Lega Nord promised Italian voters massive tax cuts and increases in public spending in their election campaigns. How a country with a government debt ratio of 132 percent of its economic output was going to finance these promises was unclear though. Now the first draft of a coalition agreement between the two parties has been made public, explaining where the money is supposed to come from: namely from the purses of taxpayers in other Eurozone countries. If these countries don’t go along with the plan, the coalitionists wish to take Italy out of the Eurozone.

How is the transfer of funds supposed to work? The European Central Bank (ECB) should cancel Italian government bonds worth a total of EUR 250 billion purchased as part of its “Quantitative Easing” programme. This would get rid of a good 10 percent of Italy’s debts. While it would not represent any sustainable restructuring, such a move would give Italy a couple of years of breathing space. Since making the coalition agreement public, however, Lega Nord leader Matteo Salvini, has declared that calls on the ECB to cancel bonds no longer apply. Perhaps somebody told him that the national central banks are liable for the bonds of their own country in the ECB’s government bond buying programme. So cancelling the Italian government bonds would leave a hole in the Italian central bank’s balance sheet. Given that the Italian government or Italian private banks would have to fill that hole, this would not achieve anything for Italy. It would be like robbing a bank that you own.

There will only be financial relief for Italy if the other euro member states carry the costs. Italy could try to make this happen in another way. Italy’s central bank owes the rest of the Eurosystem around EUR 440 billion – it used this credit to finance Italian government ECB would have to write off this debt. It is only conceivable that the Bank of Italy could declare insolvency if Italy were to leave the euro. But in such a scenario that would be a real possibility. By threatening to leave the euro without repaying its TARGET debts of EUR 440 billion, Italy could exert significant pressure on other countries to relent and take over a sum EUR 250 billion of Italian debt.

This leads to the second demand in the coalition agreement, namely an exit clause for the Eurozone. The agreement states that the Eurozone’s member states should be in a position to regain their monetary sovereignty if their population wishes them to do so. This sounds like the coalition parties are suggesting that their country wishes to abandon the Eurozone and its debt rules, perceived as a strait jacket, by threatening a referendum. How little Italy’s coalition parties think of the Eurozone’s current architecture is clear from passages in the agreement on the European Stability and Growth Pact and the Fiscal Pact. These pacts stipulate debt ceilings and the economic policy coordination

procedure. The agreement between Lega Nord and the Five Star Movement explicitly describes these compacts as “economically and socially unfounded and not sustainable.” The fact that Italy did sign up to these pacts of its own free will does not seem to bother them.

The message behind this coalition contract is clear: either Germany, France and the rest of the Eurozone takes on a significant share of Italy’s debt – initially EUR 250 billion and later perhaps more – or Italy leaves the Eurozone. German politicians need to start thinking seriously about which of these unattractive option represents the lesser evil for them.

It is clear that Italy’s new government will not explicitly ask its European partners to choose between paying or accepting Italy’s exit from the euro. That would be too blunt. The EU response to such blatant blackmail could only be that Italy should exit and there would undoubtedly be massive opposition to such a step in Italy. Lega leader Matteo Salvini has already asserted that this is an old version of the coalition agreement, which is no longer up-to-date. In fact, the agreement dates from 14 May and it is fairly rare for politicians to draft a provisional version of a coalition agreement and release it to the press only to subsequently move in the opposite direction. The new government in Rome can be expected to play with the possibility of a euro exit in order to win financial concessions in the Eurozone.

What can be expected in the weeks and months ahead and what can German politicians and European institutions do to protect their interests?

If Rome’s new leaders do not do a 180 degree U-turn very quickly, a horror scenario threatens to materialise. The unrest in financial markets will grow. To date investors have seemed remarkably unconcerned. The risk premia on Italy’s government bonds rose by 17 base points within one day of publication of the coalition agreement. This constitutes a warning signal, but not a panic. Many investors obviously believe that the government will opt to follow a new course, but that could change fast. If investors lose faith in Italy then this would cause major damages, and not only to Italy’s fragile public finances. The Italian banks would also come under pressure and would restrict access to credit. The economic recovery in Italy, which is weak in any case, would grind to a halt.

How should European institutions react to such developments? There will certainly be calls for the ECB to support Italy, give its banks liquidity support and buy more government bonds. But such a step would be dangerous. Private capital that flows out of Italy because Italian savers, for example, transfer their money abroad for fear of a euro exit would be replaced by liquidity from the Eurosystem. Italy’s TARGET debts would continue to rise as a result. The potential losses for Germany and the rest of the Eurozone in the case of an Italexit would grow immeasurably. That would massively strengthen the negotiating position of the Five Star Movement/Lega Nord government. It would leave the rest of the Eurozone open to blackmail.

The ECB could only prevent such a scenario by forcing the Italian government to introduce capital controls. The ECB acted in a similar manner in 2015 in the crisis triggered by the Tsipras government

in Greece, albeit very late. This scenario resembles the Greece crisis of 2015, only the focus will be on a country with a tenfold economic weight.

What is the outlook if things are not so bad and the new government in Rome unexpectedly gives up its demands? Unfortunately, the process of Eurozone reform has already been damaged significantly. The chances were already fairly slim before the publication of the coalition agreement, partly due to Germany's failure to put forward any constructive proposals. Now they look non-existent.

Closer integration within the Eurozone requires a minimum of mutual trust and shared political vision. The trust between the new leaders in Rome and the rest of the Eurozone has been eroded by the coalition agreement before cooperation has even begun. But there is also a lack of any shared vision of the single currency's future. The lack of such a vision is illustrated by another component of the Lega Nord/Five Star Movement coalition agreement. It takes up the proposal of creating synthetic European government bonds, or so-called "European Safe Bonds". The idea is to bundle government bonds from all euro states and to finance the purchase of this portfolio by issuing new bonds of which one tranche is senior and the other is junior. Instead of buying domestic government bonds, the Eurozone's banks should buy the senior tranche of the new bonds in the future. They would then be more diversified and less prone to crisis. It is crucial that there is no form of joint liability among the states involved. In their coalition agreement the Lega Nord and the Five Star Movement support the European Safe Bonds concept, but talk about "synthetic joint liability". Critics of these bonds fear that this represents joint liability by the back door. Their fears are justified. As long as Eurozone members have such different views of its future, they will struggle to keep the euro afloat; and they certainly won't make a success of it.

* Published in German under the title "Römisches Illusionstheater", *Handelsblatt*, 18 May 2018, p. 80.

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