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Euro crisis or public debt crisis? With a remedy for the latter case

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1. The Eurozone, public debt, and the crisis

On the growth prospects for the world economy little remains to be said after the summing up of the most likely global scenario pronounced by the International Monetary Fund (IMF) in the spring World Economic Outlook (WEO):

> "Improved activity in the United States during the second half of 2011 and better policies in the euro area in response to its deepening economic crisis have reduced the threat of a sharp global slowdown. Accordingly, weak recovery will likely resume in the major advanced economies, and activity is expected to remain relatively solid in most emerging and developing economies. However, the recent improvements are very fragile. Policymakers need to continue to implement the fundamental changes required to achieve healthy growth over the medium term. With large output gaps in advanced economies, they must also calibrate policies with a view to supporting still-weak growth over the near term."[1]

In autumn the IMF explicitly said that uncertainty weighs heavily on the outlook, as policies in the major advanced economies failed to rebuild confidence for the medium term. The viability of the Eurozone and the looming "fiscal cliff" in the USA are still worrying investors.

It is hardly likely that anyone would care to question the IMF succinct diagnosis, apart from possibly probing into the details of the forecast and/or the underlying modelling. As for the remedy, it is very easy to spell it out, while the strategy to implement it, at least in Italy, is economically challenging, given the difficulty of reconciling the short-term and medium-term aims and actions, and, politically speaking, it remains something of a mystery: we have a President's government supported in Parliament by a "strange majority" of parties that are gearing

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[1] International Monetary Fund (2012), p. xv.

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up for the general election subsequent to a sample of local authorities' by-elections certifying their scant hold over the electorate. It is, therefore, wiser to go no further than a few and lengthy considerations on the Eurozone.

First of all, allow me to restate my firm belief that the crisis did not originate with the Euro, but with the excessive public debt of peripheral Eurozone countries, mainly located on the Mediterranean shores. Of course, the sheer size of public debts and, in some countries, that of private debt, too, made for the exit from the Euro of many investors, which led to a weakening of its rate of exchange vis-à-vis other currencies, to much higher refinancing rates for highly indebted countries and – for some of them – to the impossibility of making recourse to financial markets.[2]

The first real crisis broke out over ten years after the birth of the single currency[3] and for reasons apparently originating in the United States, in the *modus operandi* of its financial institutions, in the propagation of that model in Europe, too, and in the contagion transmitted by globalisation. Did the great moderation that kept the euro sheltered from the storms prove a boon or a bane? A boon, certainly, because it granted the currency the status of a sound asset, although today some critics are inclined to define it ironically as a fair-weather currency, but equally certainly a bane because it had led euro holders, and indeed the markets, to believe that the euro area had implicitly reached such a degree of cohesion and pooling of risk as to make a Greek or Italian government security, for example, almost as sound as a German one.

When the Greek crisis,[4] thanks also to the lies of its government leaders and US top investment bank collusion in return for lavish outlay, came to a climax, the obvious truth became clear to all: a single central

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[2] As of late, I have seen this view shared by such German pundits as Habermas, Bofinger and Nida-Rümelin (2012).

[3] European Commission – Economic and Financial Affairs (2009). See also Sarcinelli (2009).

[4] For a concise account of the crisis, see Lossani (2012). The realisation that the euro offers no shelter from crises, be they external or, indeed, internal, has generated deep disappointment in many, fuelling a great deal of criticism and rekindling the older generation's nostalgia for the lira; see, for example, Rinaldi (2011).

bank for the euro area with the primary task of defending the purchasing power of the currency and a Maastricht Treaty entailing a ban on the bailing out of States ruled out any chance of saving a country whose public debt could only be increased or renewed at interest rates that would inevitably speed up precipitation into default.

If this awareness had dawned rather sooner, the rates of Italy's public debt, for example, would have been considerably higher[5] and government leaders might (but it's a big 'might') have woken up sooner from the dream of governing a country that could outlast any storm thanks to its ample private wealth, despite its massive public debt. Thus the euro acted as a drug, soothing pain, dispelling worries and creating a general sense of security (or, some may say, impunity).

2. The banks, the European Central Bank (ECB), and economic policy options

When application of the stress tests imposed on US banks entailed that government securities were to be evaluated at market price while those enjoined upon the European banks, following well-established practice, took reference from the budget values for investments to be held up to maturity, controversy ensued and the markets penalised the banks whose portfolios contained a great deal of sovereign securities, often issued by some of the most indebted countries of southern Europe and

[5] According to Marattin, Paesani and Salotti (2012), who employed a panel VAR methodology, "[…] in the pre-EMU period debt shocks positively affected real interest rates with a substantial asymmetry between high and low debt countries. A 1 % increase in the stock of government liabilities led to a 34 basis point increase on real interest rates in high-debt economies, but the impact was significantly lower (and statistically not different from zero) in more disciplined countries. The inclusion of the EMU years in the analysis weakens the link between debt and interest rates in all the member countries, particularly benefiting high debt countries. […] Moral hazard has been an evident disadvantage, making it possible for high debt countries to postpone *sine die* the structural adjustment and lessening fiscal discipline overall" (p. 19). For a graphic illustration of the Euro-Government bonds interest rate divergence before the introduction of the Euro, the strong convergence after its adoption, and the new divergence after the Lehman Brothers insolvency, see Micossi (2012, p. 1).

purchased for their high returns. Finally, on recommending to the European Council a consolidation of the capital of the major banks, the European Banking Authority (EBA), too, eventually accepted the principle that the entire portfolio of government securities should be evaluated at market prices.

As if by the book, the consequences soon emerged in various forms: i) a sharp drop in the value of the banks' public-securities portfolios; ii) difficulties in financing deficits and refinancing sovereign debts; iii) rising interest rates also for banks and private debtors, government securities no longer representing riskless assets; iv) waning confidence of the banks in their sister institutions – in particular of the American banks in their European counterparts – as well as dwindling liquidity, especially in dollars. Private borrowers were then faced with a credit crunch of alarming proportions due either to lack of liquidity or shortage of capital or both in many banks, while public borrowers faced a serious threat of default.

As I recalled earlier, even today's crisis is a matter of sovereign debts and not the euro, as demonstrated by the dollar exchange rate, which dropped from 1.4 to 1.2, eventually coming to rest for a while at 1.3. Nor is the euro in danger on the home front, where interest rates are tending to decline, while the annual rate of inflation remains within acceptable limits for the ECB; the HICP index is expected to exceed the annual 2% by half a point due to energy prices and indirect taxation in 2012, but to fall back below the limit next year.

What would have happened if the holders of the European public debts and the markets had believed from the outset that participation in the euro entailed no equalisation of the sovereign risk, nor any assurance of being saved by the stronger and more 'virtuous' countries? It would have been harder for the securities of the weaker countries to find their way into the foreign banks' portfolios, whether or not they belonged to the Eurozone, and a country facing insurmountable difficulties in refinancing its public debt would have been able to shed part of its burden through default. National holders of public debt, together with foreign countries' individual savers, single banks or financial intermediaries, might have been hard hit or ruined once and for all, but the waves

transmitted to the other financial systems in the Eurozone – and *a fortiori* outside of it – would have been little more than ripples.

To be thoroughly orthodox, there can be no denying that an ECB dedicated primarily to fighting inflation, a ban on intergovernmental bail-out and a stability pact should have convinced savers and markets that each country could only rely on its own resources to honour the sovereign debt, but the belief that has long prevailed is that belonging to the Eurozone granted the various member states a sort of insurance on their debts. It was, one might say, the danger of jeopardising the banking systems that had acquired sovereign securities with the highest returns and being exposed to the greatest risks that led member states to stray from the path of strict orthodoxy. In other words, it is the single market of public securities that has left no room for default to serve as last resort for the debtor *ultra vires*.

What, in practical terms, came about as a result of the diehard conviction that monetary union entailed insurance against the risk of default for one or more of the countries burdened with a high sovereign debt?

On 10 May 2010 the ECB decided to intervene in the public debt and private securities markets in the Eurozone (Securities Markets Programme) to restore solidity and liquidity to those market segments no longer functioning. The declared aim of the programme was to target the malfunctioning parts of the securities markets and bring back an appropriate transmission mechanism for monetary policy. The spreads between German bonds and the government securities of the other Eurozone countries widened considerably between mid-July and mid-August 2011. The tensions that had more or less been limited to Greece, Ireland and Portugal were increasingly propagated in the direction of Italy and Spain. The spreads of the sovereign securities of Belgium and, to a lesser extent, France showed significant increases. On 5 August the spreads of the ten-year securities reached record heights in most of the Eurozone countries. Stock market volatility in the euro area saw a sharp increase over the relative calm that had prevailed in November 2010, rising well above the levels seen in May 2010, when southern Europe's sovereign debt crisis first reared its head. In fact, volatility reached a level

last seen subsequent to the collapse of Lehman Brothers in September 2008. Consequently, liquidity conditions in the sovereign debt markets of the various Eurozone countries deteriorated drastically.

On 29 September 2011, the ECB President and the Governor of the Bank of Italy took steps unprecedented in the annals of relations between the central bank and a sovereign state, sending an (unsolicited?) letter to President Berlusconi intimating that Italy should implement a detailed government programme to get its house in order without delay, in exchange for an implicit promise of support on the secondary government-securities market.

At the end of December and the end of February the ECB launched two Long-Term Refinancing Operations (LTROs) worth a total of a little over €1tr to relieve the conditions of illiquidity prevailing in Europe's banks, particularly those located in southern Europe obliged to repay their bonds and indeed to facilitate indirectly the placement of public securities, which, once the sovereign risk fell back along diverging paths, tended to flow back from foreign to national portfolios if the issuers were ‘weak’, and in the opposite direction if they were ‘strong’.

Various different approaches[6] have been proposed and/or pursued to tackle the crisis situation arising from sovereign debts, but most are potentially menacing or devastating for the integrity or even existence of the Eurozone, and possibly of the European Union (EU) itself: a) the first focuses on the ECB with the idea of transforming it into a central bank much like the Federal Reserve, extending its remit to the safeguarding of employment and growth; b) the second sees communising of the sovereign debts and/or the issuance of Eurobonds as the means towards various ends and with different structures; c) the third, effectively pursued, lies in the creation of mechanisms or firewalls like the EFSF, the ESM and the additional finance called for by the IMF, which can intervene in cases of acute crisis in aid of states whose sovereign debts come under attack or to recapitalise the Eurozone banks; d) the fourth, upon which focused much EU diplomatic and planning activity in 2011, has to do with budgetary discipline and was to find implementation

[6] See also Baglioni (2012).

through the 'Euro-Plus' Pact, the 'Six-Pack' and, finally, the 'Fiscal Compact', a separate intergovernmental Treaty on Stability, Coordination, and Governance (TSCG) in the Economic and Monetary Union to be incorporated in EU law within five years, signed by 25 of the 27 EU members.

Notwithstanding the stern fiscal policy implemented by Mario Monti, in accordance with the requests of the European Union, the spread between the Italian ten-year BTP and the German Bund with the same maturity continued to rise during the spring of 2012, which induced the Italian Prime Minister to call at the G20 meeting in Los Cavos for a mechanism to control the spread for the countries which had done their 'homework', a proposal that received the support of President Obama. The request was officially made in Brussels and rather grudgingly approved at the 28-29 June European Council. As doubts still lingered in the minds of some Northern members of the Union, the spread between BTP and Bund on the maturity benchmark reached the maximum of 531 basis points on July 24. The possibility of intervention on the secondary market, without ex-ante quantitative limits, through Outright Monetary Transactions (OMT) by the ECB was decided on September 6, against the will of the Bundesbank, and subject to strict conditions.

As of late, the poor shape of banks, particularly in Spain, has elicited interest in a banking union with a common deposit insurance scheme to avoid sudden runs out of 'weak' into 'strong' Eurozone countries, a centralisation of bank supervision in the ECB, as well as a unified mechanism able to manage and resolve the looming banking crises. In principle, there is wide acceptance of this project, which was already on the drawing board of the European Commission. The transfer of supervisory power to the ECB should take place during 2013, but a full banking union will take years to shape and implement…

3. Extension of ECB remit or public debt communising?

On the monetary front, the more open-minded approaches shown by Trichet and Draghi in contrast with the rigid orthodoxy preached by the

German representatives (both Weber, President of the Bundesbank, and Stark, a member of the ECB Executive Committee, resigned from their posts owing to disagreement on policy) were, however, thought insufficient by certain sectors of European public opinion, calling for the ECB to adopt behaviours similar to the Federal Reserve with its quantitative easing. Some, including Bofinger and Soros,[7] went so far as to suggest that the ECB: i) set a ceiling (for example, 5%, to be gradually reduced) for the returns on sovereign securities issued by the Eurozone countries following responsible fiscal policies and not subject to adjustment programmes; ii) state its readiness to acquire an unlimited quantity of securities.

One criticism that can be made of this approach is that the umbrella is opened for those countries that least need it, and, above all, that even if it were to apply only to countries with orthodox fiscal policies, it would lead to monetisation of the public debt of the country or countries suspected, for example on the eve of important elections, of having no intention to tackle, or even favouring, fiscal drift. Changing the ECB statute hardly seems feasible at the moment: the cracks opening up there may be exploited for extra room to manoeuvre, but it will be difficult to go much further… unless the crisis were to begin to hit Germany, too. What was agreed on September 6 may be considered a much less radical variant of this scheme, but did extend the ECB an IMF-like role, i.e. to grant financial assistance via the sovereign bond secondary market, provided the country fulfils the agreed conditions.

Controversy has raged among opinion makers over the idea of communising the stock of Eurozone sovereign debt *in toto* or at any rate to a certain quota – for example debt in excess of the 60% of GDP as chiselled in the brittle stone of the Stability and Growth Pact. It is hard to see any reasons why the virtuous countries should take on, entirely or in part, the burden of the spendthrifts, apart, perhaps, from the advantages Germany has derived from the single currency: it has been able to export a great deal in Europe and have a positive balance of payments (in 2011 the current account surplus vis-à-vis the European Union was more than

[7] Bofinger and Soros (2011).

half and that with the Eurozone around two-fifths of the total) without the exchange rate soaring and weighing on employment and production, as would have been the case had it retained the Deutsche Mark.[8] This may be true, but one might answer that the foreign deficit of the struggling countries has at least partly been financed by the German surplus, and that if the spendthrifts had held on to their national currencies they would have imported inflation through depreciation.

The argument most often repeated rests on the spirit of solidarity between partners in the endeavour to create a currency – now viewed with growing scepticism – as a precursor of political union, or the fear that disintegration of the Eurozone will lead to fragmentation of the single market as protectionist barriers are raised. It is indeed true that the single market could not survive if the euro were to break up to be replaced by the old or new national currencies, but seeing that its own surplus derives to a large extent from outside the EU, Germany, or to be more precise, a part of its population is prepared to run such a risk.

Unification of the Eurozone public debt would certainly blunt the claws of speculation now digging into southern European debt, given their fragmentation, while from a financial point of view the United States, the United Kingdom and Japan are no better off but pay very low interest rates in comparison with Italy or Spain.

The United States, on the basis of its historical experience, suggests moving in this direction. Alexander Hamilton unified the debts of the 13 ex-colonies once independence from Great Britain had been won, but not without the objection of some states, like Virginia, that had already repaid part of their war debts. The compromise, hailed by Jefferson in the course of a historic dinner, led to unification of the debts, but cost New York its role as the capital. In Europe, saving the euro does not seem to be a sufficient reason for anyone to take on the others' debts.

A different case is that of the Eurobonds, the issuance of which is urged in order to finance the Trans-European Networks, or the project Eurobonds, which should provide resources for single projects, but in these cases German opposition is based on the need not only to prevent

[8] Fantacone (2012).

debt from ultimately falling on the solvent countries, but also to pay full tribute to the religion of austerity.

4. Mechanisms for intervention in cases of acute debt crisis

The third line of action lies in the deployment of a firewall, or in other words financial mechanisms able to intervene in cases of extreme need in aid of countries experiencing difficulty in managing their sovereign debts. The ECB made quite clear that it is up to the states themselves to provide a safety net, as its initial Securities Markets Programme (SMP) launched with the remit of getting the public securities markets back in working order, and with them transmission of monetary policy, was an exceptional, emergency measure. The European Financial Stability Facility (EFSF) is a temporary Luxembourg-registered facility instituted in the context of the European Financial Stability Mechanism (EFSM) in 2010 – and due to disappear in 2013 – with the aim of providing temporary financial assistance to Eurozone members, if necessary, with a security capacity, subsequent to extension, of 780 billion euro, and loan capacity of 440 billion euro.

It is qualified to intervene in the primary and secondary public debt markets of countries ‘subject to a precautionary programme’ and to recapitalise banks with loans to states, including countries under no programme. Financial resources are obtained with bonds issued on the stock markets or other debt instruments guaranteed *pro quota* by the euro-states. So far the countries that have benefited, at the cost of Draconian austerity programmes, are Ireland, Portugal and Greece, which are therefore no longer among the EFSF guarantors.

For the sake of brevity here we will confine our attention to Greece, which has been saved with difficulty after a great deal of shilly-shallying: first with bilateral aid from the other Eurozone states, and then with EFSF resources after approval by the ECB-EU-IMF troika, and a ‘voluntary’ haircut on the part of the private creditors of up to 70%, insisted upon by Germany despite the contraindications – without ruling out, in my view, a third rescue operation to prevent the patience of the

population reaching breaking point. The results of the general election and consequent incapacity of the political parties to form a government were ample evidence of the political stalemate. A new general election was called in June; its results were favourable to the right, with Mr. Samaras heading the new government. Requests for more time to implement a programme of tough reforms have met German (and Finnish) opposition; as of late the troika has agreed to a two-year delay.

The European Stability Mechanism (ESM) showed the first signs of life when France succeeded in persuading Germany to introduce an amendment to the contentious Treaty of Lisbon,[9] which took shape in two versions, the first approved in July 2011 and a second more cogent one, launched in February 2012. It is an intergovernmental organisation established on a permanent basis with capital of 80 billion euro to be paid out within five years, callable capital of 620 billion euro and a loan capacity of 500 billion euro. In Germany both the ESM Treaty and the 'Fiscal Compact' Treaty were challenged in front of the Constitutional Court which as promised issued its verdict on September 12: all complaints were rejected, but Bundestag approval is required for any future increase of the German contribution to the EMS above 190 billion euro. Unfortunately, other challenges have been filed with the European Court of Justice in Luxembourg, which is expected to come to its decision by Christmas. The very frequent recourse to the judiciary is making the tortuous path followed in dealing with the European problems even slower and more complex. The ESM came into force in October.

Berlin has agreed that the EFSF can continue operating up to its scheduled dissolution alongside the ESM, which initially was supposed to come into force in July 2013. The IMF has also sought further resources in aid of the Eurozone, but the request made by its Managing Director Christine Lagarde for 600 billion dollars has so far met with commitments for 456 billion (200 billion of which from Europe itself), the polite but firm refusal of the United States to join in this effort and the 'contractual' attitude shown by many emerging economies ready to provide financial resources on condition that they play a larger part in

[9] For a brief outline of the history of monetary Europe, see Lossani (2012).

managing the Fund. Brazil, Russia, India, China and South Africa said explicitly in a statement that their contribution was based on the expectation that IMF members follow through ‘in a timely manner’ on a 2010 pledge to give them a bigger say in how the IMF is run.

The Outright Monetary Transactions (OMT), which took the place of the SMP kept dormant for many weeks, will operate in the secondary sovereign bond markets only, with the aim of safeguarding the transmission of appropriate monetary policy and the singleness of the monetary policy itself. However, a necessary condition for the activation and continuation of these operations is both the definition of a strict and effective conditionality deriving from an appropriate EFSF/ESM programme, either full or precautionary, and total compliance with it over time.

5. Austerity and strictness in Eurozone public finance

Budgetary discipline and commitment to economic coordination characterised the activity of the EU governing bodies in 2011 and the early months of 2012. March 2011 saw the launch of the ‘Euro-Plus Pact’ by heads of state or government of Eurozone, with the addition of a further six countries, including Denmark and Poland, to reinforce the economic pillar of the monetary union, enhance coordination in terms of economic policy, heighten competitiveness and with it the degree of convergence. The objectives are stated in the pact as being competitiveness, employment, public finance sustainability and financial stability, to be pursued through actions that remain the responsibility of each country but subject to monitoring by the European Commission and an annual review on the part of the European Council on the basis of a series of indicators. With the aim of reinforcing the Stability and Growth Pact (SGP), December 2011 saw a new set of rules for economic and fiscal surveillance coming into force. They were grouped under the name ‘Sixpack’, and consist of five regulations and one directive proposed by the European Commission and approved by the European Council and Parliament. The new measures provide for the imposition of

semiautomatic sanctions on euro-states for breach of the rules regulating budget deficit and public debt (application of the reverse qualified majority), introduction of the budgetary medium-term objective (MTO) to ensure sustainability for public finance and effective application of the rules, as well as detection and correction of macroeconomic imbalances both with preventive and remedial action and with the application of financial sanctions. To make the coordination of national economic policies more effective, the 'Sixpack' introduced as of 2011 the 'European Semester' to analyse and assess together all national policies (fiscal, macroeconomic, structural) while keeping procedures legally and procedurally separate.

As policy coordination and the prevention of contagion was still thought insufficient in the Eurozone, the Commission proposed in November 2011 two further regulations, or 'Two-Pack', the first aimed at making ex ante assessments and in-year checks of national budgetary plans by the Commission possible, the second designed to implement enhanced surveillance of Eurozone countries threatened by financial instability. These regulations should become operational in the autumn of 2012.

March 2012 saw 25 EU countries – the exceptions being the United Kingdom and the Czech Republic – signing the European Fiscal Compact, formally known as the 'Treaty on Stability, Coordination and Governance in the Economic and Monetary Union' (TSCG), which will come into force on 1st January 2013 if ratified by at least 12 euro-states. As of the beginning of August, seven states – five belonging to the Eurozone – had ratified the treaty. The Fiscal Compact entails a rule to be incorporated at constitutional or equivalent level to the effect that the national budget must be in balance or in surplus (the annual structural deficit cannot exceed 0.5% of the GDP) and should include an automatic correction mechanism; for want of meeting such a requirement the European Court of Justice will apply a fine of up to 0.1% of the GDP. States subjected to the excessive deficit procedure will submit to the Commission and the Council an economic partnership programme detailing the structural reforms necessary to ensure an effective and durable correction of excessive deficits. Countries with debts in excess of

60% of GDP will have to reduce as a rule their distance from the target level at a rate of one twentieth per year. The Treaty covers economic policy coordination and convergence, as well as improvements of Eurozone governance, too.[10]

Unfortunately, European law is becoming more and more convoluted, since the overall fiscal framework, which is supposed to become tighter through better surveillance by the Commission, more automaticity, and less political discretion by the Council, has not been streamlined. In fact, the Fiscal Compact has been added on top of the SGP, which in turn was already supplemented by the 'Sixpack'. According to the ECB, the key elements for an enhanced framework of economic governance of the Eurozone are numerous, rather exacting and strongly limiting national discretion with regard to choosing the path of adjustment.[11]

6. The negative consequences for growth with no centralised fiscal system

After the repeated failures of the Stability and Growth Pact to regulate the euro-states' budgetary behaviour, we could only expect from the 'guardian of stability', Germany, pressure to reinforce the communal systems for the control of public finance, but this came about in the midst of a financial crisis that all too soon had repercussions on the real economy with recessionary effects. The advocates of fiscal rigour at all costs still hold that only when the public accounts have been put in order will the markets come round to renewing their confidence in the countries now in deficit and/or over-indebted, expectations waxing positive anew and the growth process getting under way once again. As I see it, their reasoning is flawed if all or almost all European countries, and in particular the Eurozone countries, have to pursue austerity policies since, in this case, the drop in income has repercussions on demand which, in

[10] For a thorough analysis of this Treaty, see European Central Bank (2012).
[11] European Central Bank (2011). See also Visco (2011).

turn, will affect supply negatively, unleashing a recession or even a depression spiral.

For austerity in one or more countries to be able to adjust imbalances in public finance it is necessary for those countries with balanced or at any rate less unbalanced budgets and the European Union as an institution to be ready to step up internal demand, giving the countries obliged to apply restrictive policies the possibility to rely on increased exportation within the area. Without a differentiated macroeconomic policy – restrictive for countries with seriously unbalanced budgets and expansive for the others – a monetary union with the primary objective of fighting inflation will inevitably drive more and more countries towards recession and instability (take the case of the Netherlands, for example, where anti-European sentiment is now rather rife), prolonging the recession cycle and fomenting increasing doubts about the role and benefits of the single currency. Moreover, in any co-operative system, and *a fortiori* in a currency union, the adjustment burden cannot fall on debtor countries only, whatever their 'sins' in managing their economies and public finances, but must be shared with the creditors, on an automatic or pre-agreed basis, to avoid squabbles, reciprocal recriminations, and finally distrust.

As I see it, there is no other adjustment mechanism under way in the Eurozone, as recommended in the literature on optimal monetary areas. Robert Mundell,[12] the first exponent, placed the emphasis on price and factor mobility, but the mobility and price of capital are guaranteed by the single market and ECB policy, at least under normal conditions, while the labour factor mobility is severely limited not only by the general fall in demand, but also by language barriers, portability of pension rights, etc., leaving scant or even no room for the price/supply of labour to play a role within the Eurozone. Therefore, appalling rates of unemployment in Spain (25%) can coexist with perfectly acceptable ones in Germany (7%). In fact, the Portuguese are now emigrating towards the ex-colonies and the Irish towards Canada and other English-speaking countries. A few

[12] Mundell (1961).

years after Mundell, Peter Kenen[13] argued that a monetary union had to be matched by some form of fiscal union since a federal tax based on income can absorb the shock effects which he classified as expenditure switching (i.e. exogenous shifts in demand between commodities produced internally and those of foreign origin), and that this way of softening the impact is better than stabilisation, whether discretionary or automatic, enforced at the regional level. Later he went on to point out that fiscal union is not essential for the efficient functioning of a monetary union, but helps offset an imperfect matching of the single monetary policy to the needs of each member state. Exploring the issue of optimal monetary areas De Grauwe dealt with it in various publications and with Mongelli brought to light the endogenous mechanisms, for example through intra-area trade, that progressively enhance integration between countries sharing a currency.[14] However, they are mechanisms that function over the long and very long term; after all, it took the United States 150 years to become an optimal monetary area.[15]

I have always held that a single monetary policy cannot survive without a certain degree of centralisation of fiscal policy helping endogenously on the road to an optimal monetary area, while devising a system of automatic compensation lest productive specialisation increase vulnerability to asymmetric shocks. As long ago as 1989, in fact, I pointed out the need for 'automatic' transfer mechanisms that do not entail long and laborious negotiations between the regions involved.[16] In other words, of the many levels of public finance, a centralised echelon is indispensable for an area that wishes to advance in regional equilibrium. The issue, touched upon in other texts, was addressed in further depth in a publication that appeared almost fifteen years[17] later and looms large in the studies and concerns of many authors.[18]

It would therefore have been worth making efforts to bring in once and for all a budget of some kind for the European Union or at least the

[13] Kenen (1969); Kenen (2002).
[14] De Grauwe and Mongelli (2005).
[15] Rockoff (2000).
[16] Sarcinelli (1989).
[17] Sarcinelli (2003).
[18] E.g., Boitani (2012); Bordignon (2012).

Eurozone in 2011. Instead, on top of a strengthened SGP we got the Fiscal Compact, which is mainly a matter of balancing public accounts and the associated reduction of the public debt to 60% of GDP, a recipe for greater austerity, but not one that redistributes the burdens – for example, in terms of current account deficits – deriving dynamically from a common monetary policy.[19] At long last, on September 7, at Bruges, the French Finance Minister, Pierre Moscovici, started talking about a Eurozone unemployment insurance and on October 29, in the meeting conclusions, the European Council mentioned for the Eurozone as a whole "an appropriate fiscal capacity."

7. What are the alternatives to reduce excessive public debt and thereby escape the blackmail of the markets?

What is the way out of the situation where austerity brings very short-lived relief that risks aggravating matters in the short- and medium-term, eventually leading to social unrest? The answer is growth, and on this point it suffices to say that growth has seen a progressive waning in Italy since the 1970s and over the following decades, and that in the last 12-15 years it has on the whole abandoned the Italian scene. Invoking growth, like invoking rain, repeatedly, obsessively, will not bring it any nearer unless conditions are right for it. It will, of course, come back, but we do not know when or whether it will be lasting, nor whether it will be high and constant enough to allow for reduction of the debt/GDP ratio in accordance with the dictates of the Fiscal Compact. In the meantime, every day, every minute, the markets are watchful and at every adverse puff of wind they drive up refinance rates, so that the efforts required of us begin to look like the labour of Sisyphus. Moreover, by increasing the spread with Germany, they harm Italy's prospects of competitiveness while enhancing those of Germany. Excessive expectations placed upon the OMT to be undertaken by the ECB should be avoided, not only for the strict conditionality that it will entail, but also for the opposition

[19] Guiso and Herrera (2012); Hamaui (2012).

expressed by the Bundesbank and the German public opinion to such a scheme.

One may counter that there are the firewalls in place, but these can only suffice for the small countries like Ireland, Portugal and Greece, while Spain's economy is twice the sum of these three countries', not to mention Italy, which is 50% larger than Spain. According to President Obama, Europe must save itself on its own. Not only does any assistance from the EFSF/EMS, the ECB and/or the IMF come for free, but it is a stopgap, not a solution to our heavy public indebtedness. It is my belief that Italy must rely on itself. But how? Certainly, for one thing, by selling its public real estate, but recently this has not proved very successful and takes a long time to implement given the great number and scattered distribution of assets, as demonstrated, *mutatis mutandis*, by the sale of public real estate in the 19th century, which took many decades.[20] More or less the same happened to confiscated Church properties. So which of the three options cited by Keynes (1924) might one choose to address excessive public debt – inflation, default, or capital levy? Inflation is not only anathema to the European monetary constitution, but is also less effective than it used to be given the variously indexed securities that make the destructive work of inflation more difficult or even impossible. If we rule out default, total or partial through unilateral redefinition of repayments, rates, maturities and/or conditions, the one choice left to save the country's face is the third – in the form of an extraordinary wealth tax.[21] David Ricardo proposed such a levy to the British House of

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[20] For an overview see: Ministero del Tesoro (1988).

[21] Much debate was dedicated to this issue in conferences promoted by: a) AIAF on 31 January 2012, in a contribution entitled "E' sufficiente una cura omeopatica per il debito pubblico?" ("Can a homoeopathic cure suffice for the public debt?"), summarised in Sarcinelli (2012a); b) SIEP in the intermediate meeting dedicated to the issue: "La gestione di elevati debiti sovrani in contesti di crisi finanziaria: quali insegnamenti dalla storia?" ("Managing high sovereign debts in the context of financial crisis: what can history tell us?"), held at Villa Hüffer (Bank of Italy) on 2 March 2012, as discussant of reports by Antonio Pedone and Gianni Toniolo, see Sarcinelli (2012b); c) CNEL – Commissione istruttoria per la politica economica on 5 June 2012 in a meeting devoted to the subject "Lo stock del debito pubblico si può abbattere con misure straordinarie?" ("Can the public debt stock be slashed through extraordinary measures?"), held at Villa Lubin, see Sarcinelli (2012c).

Commons in 1819, after the Napoleonic wars,[22] but it was first implemented in Japan in the aftermath of the Second World War.[23]

A decision in this direction would have a rebalancing effect for Italy in terms of: a) the financial structure, because it would reduce the public debt and most likely increase the private debt in order to pay the tax, as long as the liquidity conditions of the banks allow for it (Ricardo had envisaged a complicated system to facilitate payment of the tax); b) the proportion of family estates, over eight-fold the corresponding income (in 2009 the net wealth stood at 8.3 times the disposable gross income of Italian families, followed close behind by the United Kingdom and France with 8.0 and 7.5 respectively, while for the United States and Canada it came to around 5 times)[24]; c) the rate of growth, which, on the evidence of research by various authors[25] with some confirmation for Italy, too,[26] shows a downward trend when the debt/GDP ratio exceeds the critical level of 85-90%; for Italy, return to such a level, one which France and Germany now stand at, would not in itself suffice in order to get growth underway once again, for it would continue to need the support of restructuring in many supply sectors, and in particular in the public sector; however, the Monti Government is attending to this at the normative level. And this, I believe, is the only way to induce markets to change their attitude and expectations vis-à-vis Italy.

That such a remedy does not go down well is hardly surprising, but there is no realistic and honourable alternative. After all, as a British politician and philosopher of the 18th century, Edmund Burke, acknowledged:

"*To tax and to please, no more than to love and to be wise, is not given to men*"

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[22] On this topic and for additional references to the British public debt and David Ricardo see: Asso and Barucci (1988).
[23] Eichengreen (1989).
[24] Banca d'Italia (2011), pp. 15-16.
[25] Reinhart and Rogoff (2010; 2009); Kumar and Woo (2010); Cecchetti, Mohanty and Zampolli (2011).
[26] See Balassone, Francese and Pace (2011).

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