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# Research Briefing | Italy

## Leaving the euro will not solve Italy's problems


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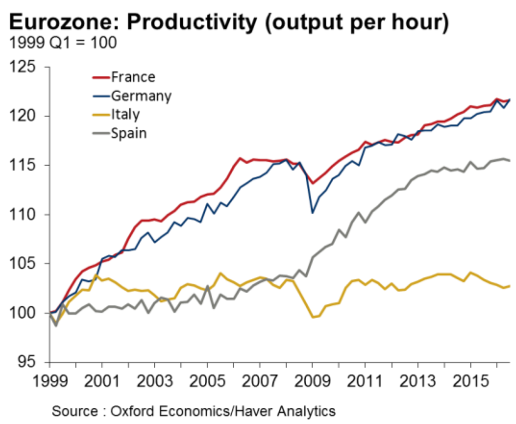
- **Leaving the euro is not going to solve Italy's economic problems, despite what the populist Five Star Movement is telling voters. We would argue that it's not a lack of price competitiveness that is weighing on growth, but a deeply entrenched confluence of structural problems: high public debt, low productivity, political clientelism and a dysfunctional banking system. While none of these are caused by the euro, leaving the single currency would exacerbate them.**
- Granted, a one-size fits all monetary policy is not ideal for a country like Italy, but we don't find any evidence that the problem has been a single currency-induced lack of price competitiveness. Many metrics, including the real exchange rate, did not deteriorate after the introduction of the euro.
- Exiting the euro would allow Italy to devalue the new currency and reduce the nominal price of exports, but it will probably tip the country back into recession and, left unattended, the real problems will only get bigger.
- Italy is the second most indebted country in the Eurozone, so leaving the single currency would likely spark a new debt crisis. The government of the day will not only face surging risk premiums on any new debt but repaying existing euro debt will be even more expensive, making Italy's debt burden unsustainable.
- Moreover, in the past, when the central bank weakened the currency, Italy failed to show any meaningful gain in the level of employment and in its export share. Any gains in competitiveness are not sustainable in the medium-to-long term as a spike in inflation will offset short term gains.

**We believe that Italy's low productivity growth is explained to a large extent by misallocation of resources. This is not going to change after a euro exit.**




Italy has become the productivity laggard of the Eurozone. Its productivity has remained stagnant since the introduction of the euro.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## Do not blame the euro for structural weakness in the economy

**Italy's economy remains beset by structural weakness which weighs on growth and will not be solved by leaving the euro**

Italy's economy just can't seem to grow its way out of its misery. Almost four years after it exited the recession, the Eurozone's third largest economy has been left behind by other former problem countries like Spain and Ireland. The economy has grown on average 0.5% since 2013, not enough to relieve the state's debt burden.

By the end of 2018 – 10 years after the onset of the crisis – Italy's per capita GDP will still be 10% below its pre-crisis level.

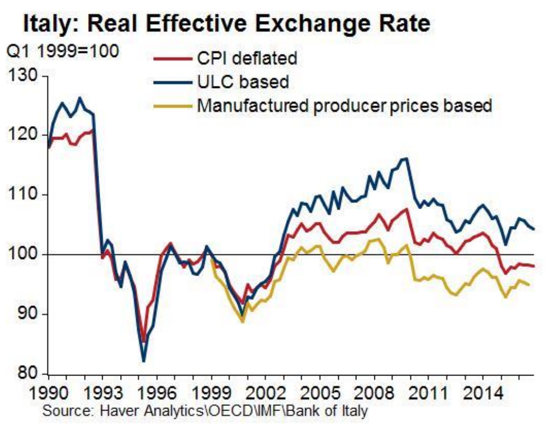
Many blame the straight jacket of the single currency for Italy's woes, including the populist Five Star Movement which would be the second strongest party if the country would hold elections now. Advocates expect that by devaluing the currency Italy will transform into an export power house, creating much needed jobs in a country with an unemployment rate of 12%. Youth unemployment stands at 40%.

In this Research Briefing we show that leaving the euro is not the answer and the likely consequences of another recession, debt crisis and a bank run will vastly outweigh any benefits a weaker currency would afford.

We would argue that high levels of public indebtedness combined with a political system that still leans towards clientelism is at the root of many of Italy's problems. It means the government lacks funds to invest in infrastructure or provide a sufficient social safety net. This encourages a highly sclerotic economic system characterised by high levels of product and labour market protection. The net effect of these regulations is a severe limit on the profitable reallocation of the factors of production (either labour or capital), which in turn partly explains Italy's poor productivity performance

None of these issues are going to be solved by the country turning its back on the single currency.

**Chart 2**




According to different measures of price competitiveness, Italy did not show a big loss in price competitiveness after joining the euro. Only one out of three indicators we analysed shows a marginal loss in price competitiveness, but all of them remain below the level in 1992, before the last depreciation of the Lira.

## Italy has not shown a significant loss in price competitiveness since the advent of the euro

Problems with Italian export competitiveness have been consistently blamed for the economic stagnation over the last ten years or so. However, we don't find any firm evidence of that. We analysed several measure of export competitiveness: the real effective exchange rate deflated by unit labour costs; deflated by consumer price index and deflated by the price of manufactured goods. Chart 2 clearly shows that the only



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measure where Italy has shown a marginal loss in price competitiveness since the introduction of the euro is the real effective exchange rate deflated by unit labour cost.

Price competitiveness measured by the other two gauges (real exchange rate deflated by price of manufactured goods and consumer price) has improved slightly since the introduction of the euro in 1999. If anything, Italy has actually regained some price competitiveness in recent years – partly as a result of very depressed wage growth and low inflation and partly because of the depreciation of the euro, which depreciated by around 25% against the US dollar since the end of 2007

Furthermore, these measures of price competitiveness are not even close to the levels preceding the exchange rate crisis of 1992, when Italy decided to devalue the Lira initially by 7%, suggesting that there's no unsustainable stress in price competitiveness. This also signals that after the 1992 crisis Italy has somehow managed to live with a fixed exchange rate system.

Additionally, a study by the Bank of Spain and our own analysis have shown that non-price determinants have become more important and have more than offset the effect of price over the last six years. The size of a company, the level of investment, research and development expenditure, the ability to innovate and the firm's strategies all influence whether a company successfully exports its products and services.

This implies that while Italian price competitiveness will, at least in the short-term, improve following a depreciation of the new Lira, the effects on exports will not be that clear-cut as a host of other factors determine the success or failure of a company's export strategy.

## Public debt at the root of many of Italy's problems…

Italy's main problem is the high level of the public debt, which, at above 130% of GDP is the highest in the euro area after Greece, coupled with stagnant productivity growth (chart in the first page). The government, given its budget constraints, lacks funds to invest in human capital and in infrastructure and to provide an adequate social security system.

While state involvement in the economy is quite large (Italy spends around 30% of GDP on public social protection), only a small portion of this goes to productive factors (such as income support to the working age population), while a big chunk (around 16% of GDP) goes directly into pensions.

Educational attainment and spending on Research and Development are on average lower than in other OECD countries, with a clear negative effect on productivity and economic growth. According to OECD data, Italy scores very badly in terms of literacy and numerical skills, respectively the worst and the second-worst among the OECD countries for 16-29 years old.

Moreover, the political system has not been helping in the optimal allocation of the factors of production, capital and labour. While the labour reform of 2014 helped to reduce the cost of hiring, female labour participation for example, at just 50%, remains one of the lowest in the Eurozone. The labour tax wedge remains particularly high and the wage bargaining system is still at a national level, thereby maintaining productivity and the nominal wage dynamic disconnected.



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Additionally, Italy is not seen as business-friendly given the high level of taxation (the tax burden ratio is above 40% of GDP) and stifling bureaucracy. In the World Bank's 'Doing Business' indicator Italy ranks below the OECD average. Furthermore, public sector inefficiencies (such as lengthy judicial processes) weigh on investment and productivity.

The banking system is a clear example of this harmful relation between the clientelism of the political system and the productive sector, with a suboptimal allocation of capital. This was clear in the decade just after the creation of the euro, when credit was cheap but the banking system failed to allocate the money to the most productive sectors and companies, stifling their growth. Instead credit was continuously extended to `zombie' companies, pushing up the level of non-performing loans, at 18% or so of total Italian bank loans, that are crippling the banking system.

We believe that Italy's low productivity growth is explained to a large extent by misallocation of resources. This is not going to change after a euro exit.

## Depreciation to be offset by inflationary pressures

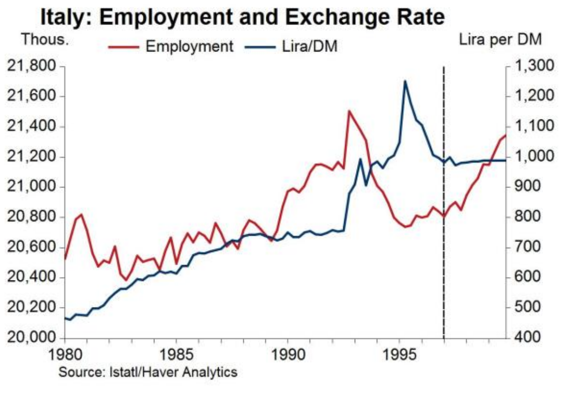
Advocates of the euro exit expect the depreciation of the new currency to start a virtuous circle: a weaker currency, coupled with a surge in confidence, will mean a better export performance and higher growth in productivity and in the economy. However, it is important to understand to what extent this progress in competitiveness is sustainable in the medium to long term and why inflation will quickly erode any gains.

**Devaluation did not work in the past: the level of employment did not show any meaningful gain**

The experience of the devaluations of the Italian Lira in the past helps us identify if a weakening currency will benefit the economy or not. A simple exercise is to look if the level of employment (as a proxy for the health of the Italian economy) has improved following the series of devaluations that started in the early 1980s. A good example is the period between 1980-1997 (1997 was the year in which the currency was pre-fixed in order to qualify for the European Monetary Union) when the Italian currency weakened against the Deutschemark.

It's clear from chart 3 that there was no discernible improvement in the level of employment, despite a 50% depreciation of the lira against the German currency. This simple exercise suggests that the level of employment has not been responsive to any currency depreciation. Actually, the period which saw the biggest gain in employment was when the currency was relatively stable, from 1988 to 1992, the year in which Italy was forced to exit from the European Monetary System.

**Chart 3**




Devaluation did not work in the past: despite a depreciation of around 50% of the Italian currency with respect of the Deutschemark over the period 1980-97, the level of employment did not show any meaningful gain.



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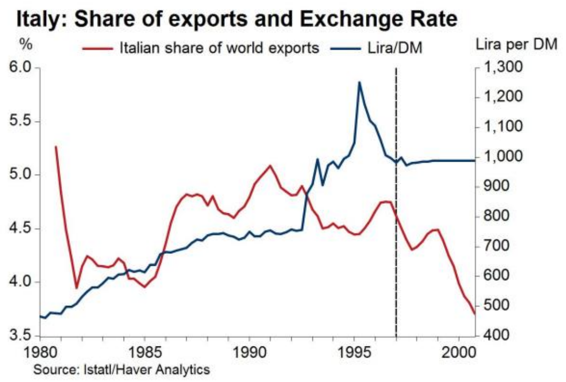
Similarly, we can have a look at what happened to the market share of Italian exports over that period. Chart 4 shows the correlation between the two series is only marginally positive and the weakening currency helped gain only modest market share.

There is a risk (and that was the case in most of the devaluations in the past) that any regained competitiveness would be quickly inflated away, even if higher inflation does offer the opportunity for Italy to reduce its debt. Workers will demand higher nominal wages, following higher import price and inflation.

However, it is true that after the depreciation of 1992, the pressures on price were quite subdued, but that was primarily owing to a huge fiscal restriction coupled with an income policy, aimed at containing inflationary pressures. It is hard to see this happening in the current environment, as the real personal disposable income is still around 8% lower than at the 2008 peak and those advocating a euro exit are also pushing for a much bigger fiscal expansion.

**Chart 4**




The experience of depreciations in the past did not help Italy gaining export market share and the correlation between the two series is only slightly positive.

## The problem of high public debt will still be there

**A euro exit would spark a massive confidence shock and huge financial turmoil**

Finally, while we showed in a recent note that some currency union exits have been less painful than others, in our view Italy leaving the Eurozone is unlikely to be a smooth process and will likely spark financial turmoil and a recession.

The Five Stars Movement is proposing a euro exit referendum, meaning there won't be a swift sharp currency reform. Therefore, households and companies will have a window to dispose of their domestic assets to avoid redenomination into lira from a strong euro. Similarly, we see Italian bond values plunging. Financial markets will likely react as soon as a referendum date is set, so interest rates could shoot up even before a decision is made to leave.

Higher nominal yields will mean a higher cost of debt and, in case of strong turbulence, the prospects of severe risk premiums and being shut out of markets altogether. The increase in bond yields will be a reflection of higher inflation expectations and higher risk premium, owing to rising credit risk. A central role of the new framework will be that of the central bank. If the central bank will lose its independence from the Ministry of Finance, it is very likely that inflation expectations will surge, with further negative effects on nominal yields.

Secondly, some of the debt would have still have to be paid in euro. Around a third of the government debt or €738 bn is owned by non-residents. Even if we assume a very mild depreciation of the lira (around 20% against the euro) this means that the cost of repaying



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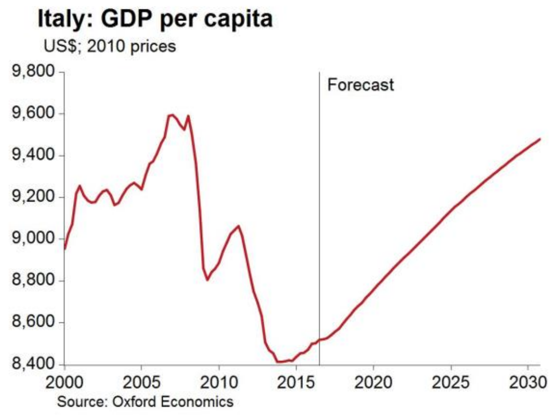
this portion of debt (without considering the cost of repaying the coupons) will be around €140 bn or 8% of GDP. Another option, according to a recent study by Mediobanca, suggests to look at the legal aspects of public debt redenomination into a new currency[1]. However, the conclusion is the same: the redenomination of debt is not financially viable given the cost of still paying a big portion of public debt in euro.

**Chart 5**




We see GDP per capita increasing only at a subdue pace, remaining below pre-crisis level up to 2025.

[1] According to the new regulations, introduced by the EU and valid for bonds issues after 2013, all bonds issued by Eurozone countries with maturity exceeding one year have a mandatory collective action clause, and thereby have a minimal probability to be redenominated from euro to lira.



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