DOCUMENTI

IAI

ITALY AND ECONOMIC AND MONETARY UNION

by Ciro Schioppa

Paper presented at the conference on "Italian Experience in European Integration",
European Institute
Lodz, 17-18 May 1996

ISTITUTO AFFARI INTERNAZIONALI

IAI9621

Italy and Economic and Monetary Union

Ciro Schioppa*

Introduction

It is difficult to write a paper on Italy and Economic and Monetary Union (EMU) in the very middle of Stage II. On the one hand, a description of this issue in purely historical terms would be largely redundant, as a number of very interesting articles of this type have already been written on this subject.[1] On the other hand, the EMU process has been gaining momentum since the summit of the European Council in Madrid in December 1995, so that any prescriptive evaluation of the relationship between Italy and EMU risks being obsolete well before the article goes to press.

A possible solution to the problem is to take a snap-shot of the issue and to illustrate its most critical components as they appear in the spring of 1996. In this way the task of analysing the relationship between Italy and EMU becomes more manageable and, at the same, more useful for readers not familiar with the terms of the problem.

The article is divided into four parts. The first, *What is EMU?,* describes the basics of the EMU process and sets the general framework for the ensuing analysis. In the second part, the title of the article is slightly modified and the subject *Italians and EMU* dealt with, in order to illustrate what people in Italy expect from the European Union in general and from EMU in particular. The third part of the article, *Italy and economic adjustment,* tries to determine the possible consequences for Italy of the adjustment process necessary to join EMU. The fourth part, *The technical building of EMU,* looks at the stage we have reached in preparing the transition to the single currency.

What is EMU?

There are two important facts to be kept in mind when we talk about EMU. The first is that the Maastricht Treaty regards the Economic and Monetary Union not as a goal in itself but rather as an *instrument* to achieve a number of broader aims. These aims include a harmonious and balanced development of economic activities; a high degree of convergence of economic performance; a high level of both employment and social protection; a general raising of the standard of living and quality of life; and economic and social cohesion and solidarity among member states.

---

* Banca d'Italia, Foreign Department, Rome. The author wishes to thank F. Papadia for his comments on a previous draft. The usual disclaimer apply. The opinions expressed are the author's and do not necessarily reflect those of the Banca d'Italia.

[1] See Papadia and Saccomanni (1994); Bini-Smaghi et al. (1994).

The second fact is that the acronym refers to three different components. The first is a *micro-economic component*, which means that EMU is based on the complete mobility of goods, services, labour and capital and on an integrated space among the EU member states, along the lines established in 1986 by the Single Act, which laid the foundations for the EMU process. The second is *a macro-economic component*, which means that EMU implies the adoption of an economic policy based on the close co-ordination of member states' economic policies conducted in accordance with the principle of an open market and free competition. Broadly speaking, this corresponds to the procedure indicated in the Treaty for avoiding excessive fiscal deficits. The third is a *monetary component*, which means that EMU implies the adoption of a single currency, the euro, and the creation of a new institution, the European Central Bank (ECB) within the European System of Central Banks (ESCB), to manage the new European currency. The adoption of the single currency will come at the end of a process of economic convergence to be evaluated in the light of four criteria (convergence of inflation, convergence of interest rates, stability of exchange rates, avoidance of excessive fiscal deficits). Moreover, convergence will also imply a minimum degree of harmonisation of the legal framework of the member states in order to ensure the proper working of the ESCB and the achievement of its main task, i.e. price stability.

What is important to stress is that while the term EMU is (rightly) used interchangeably to indicate these three components, most of the debate on the desirability of EMU refers not to the "E" in the acronym, which stands for economic, but to the "M", which refers to the Monetary Union project envisaged by the Maastricht Treaty. A recurrent criticism is that the way indicated by the Treaty to achieve Monetary Union makes it impossible to achieve the broader goals of EMU indicated above. In particular, the criticism regards the importance attributed to fiscal stability as a prerequisite for adopting the single currency and the fact that orthodox fiscal policies will aggravate the problem of unemployment in Europe (Buiter at al., 1993). This criticism is addressed in the third part of the paper.

Italians and EMU.

This general framework will allow us to evaluate the attitude and expectations of the Italian people towards the EU in general and EMU in particular. To do so, reference will be made to a survey conducted last autumn on a sample of 300 Italian opinion leaders (Pragma, 1996).[2]

Table 1 lists the issues that the EU should tackle and solve urgently according to the Italian opinion leaders. Three elements are worth noting. First, economic problems have higher priority than political problems, even if the importance of the latter is tending to increase. Secondly, a large and growing number of Italian opinion leaders believe that the Union should actively pursue the goal of the single currency. Thirdly, the importance attributed to inflation

---

[2] The survey was jointly commissioned by the Italian public broadcasting service (RAI), a leading Italian financial newspaper (il Sole-24 Ore) and the EU Commission. The sample was equally composed of people operating in five sectors (agriculture, industry, services, the civil service and politics).

and the consolidation of the fiscal situation is increasing, but the fight against unemployment nonetheless remains the top priority of Italian opinion leaders.

These aspects of the Italian attitude toward the EU confirms that Italians fundamentally agree on the necessity of achieving the goal of EMU. However, two questions remain unanswered. First, there is the problem of ascertaining whether they also agree on the instruments and timing indicated by the Maastricht Treaty for arriving at the single currency. Secondly, there is the problem of assessing whether Italian public opinion believes that the goal of the single currency will imply costs, especially in terms of higher unemployment, that Italy cannot afford to pay.

As for the attitude towards the way of achieving EMU indicated by the Maastricht Treaty, Table 2a shows that more than eighty percent of the sample believe that it is desirable to adopt the single currency within the deadline and following the path set by the Treaty. Against this positive background, there is a rather cautious evaluation of the chances that monetary will actually take place as planned. In fact, Table 2b shows that only thirty-two percent of the opinion leaders believe that monetary union has a good chance of being launched according to plan.

As for the possible costs of the single currency project, Table 3 indicates that more than seventy percent of the sample believe that the social costs associated with economic convergence are in fact acceptable, while only around twenty percent hold the contrary view.

Italy and economic adjustment

Table 4 shows the process of economic convergence for the fifteen EU member states. It can be seen that only two countries (Germany and Luxembourg) are fully convergent, whereas four countries (Greece, Italy, Portugal and Spain) do not meet any of the four quantitative criteria indicated by the Maastricht Treaty.

In Italy's case the gap between the actual and the target values set for the fiscal variables is very wide. Moreover, the country suspended its participation in the ERM in September 1992. This means that if Italy wants to be in the group of countries adopting the euro on 1 January 1999, a substantial economic adjustment, especially in the fiscal field, must be implemented in a very short period, as the decision on which countries will take part in the third stage of monetary union has to be taken in the early months of 1998.

One question immediately arises. Are the expectations of the Italian public that EMU will not require unacceptable social costs compatible with the harsh realities of the Italian economic situation? To answer this question, it is useful to refer to recent studies on the effects of fiscal adjustment in advanced countries. These studies offer two alternative policy prescriptions in the case of Italy. The first is to tackle the fiscal deficit *indirectly* by reducing the rate of inflation. The second is to address the fiscal imbalances *directly* by a mixture of (mainly) expenditure cuts and structural measures. It is beyond the scope of this article to ascertain which is the most appropriate strategy for Italy. What is worth stressing is that economic adjustment can be achieved, in both strategies, without causing excessive hardship.

On this basis, it is fair to say that Italian opinion leaders are right in believing that EMU will not (necessarily) imply unacceptably high social costs.

An *indirect* approach to fiscal adjustment has recently been proposed by Modigliani, Baldassarri and Castiglionesi (1996). The authors maintain that a forward-looking incomes policy based on a zero-inflation target would have the main advantage of bringing the rate of inflation within the range of one to two percent. In this way, it would be possible to reduce the nominal rate of interest payable on Italian public debt, an objective which is crucial for the overall fiscal balance of the country. In fact, the high Italian fiscal deficit is caused by the heavy interest burden, whereas the country shows a large primary surplus as a result of the fiscal packages implemented since 1992.

Under this approach, the risks of a policy-induced recession could be completely avoided and there would be no need, given the already high primary surplus, for further fiscal cuts to achieve the 3% target set by the Maastricht Treaty. On the contrary, a strict incomes policy would foster growth and employment, thus contributing to solve another serious Italian problem. Of course, the authors do not deny that wide-ranging structural policies are necessary to avoid repetition of the large fiscal imbalances recorded in the past. However, such measures could be taken once a more stable macro-economic situation had been achieved and without risking a serious recession.

More numerous are the studies which support a *direct* approach to the problem of fiscal consolidation for a country such as Italy (Giavazzi and Pagano, 1995; Pisani-Ferry and Cour, 1995; Sutherland, 1995). In this type of model, fiscal consolidation does reduce total demand in the short-term along the lines of the standard "Keynesian" models. At the same time, one or more of the following expansionary effects occurs sooner or later: i) the higher value of wealth brought about by lower interest rates, caused in turn by fiscal consolidation, increases consumption; ii) investment increases as a result of lower interest rates; iii) the real value of long-term bonds increases because of lower inflation, thus making shares more attractive; iv) the real value of both physical and human capital increases, leading to higher investment and consumption, as fiscal consolidation leads to expectations of lower taxes in the future; v) fiscal consolidation reassures investors on the sustainability of the financial position of governments.

It is clear that the magnitude of the positive effects on growth depends on the behaviour of interest rates, which in turn depends on how international markets regard the adjustment measures, not only in terms of their size but also in terms of their timing and incisiveness. In this context, the credibility effect remains crucial, especially if the existence of a large stock of public debt leads financial markets to question the sustainability of the government's financial position. In this case, the return to a sustainable fiscal path may produce such a large decrease in interest rates that the negative impact of fiscal consolidation will be more than fully compensated by the above-mentioned expansionary effects as early as the short term. This point is well illustrated by a number of episodes of fiscal retrenchment in the late 1980s (Ireland, Denmark), which suggest that fiscal adjustment, if combined with appropriate structural measures, may lead to a so-called "virtuous circle" of successive rounds of fiscal consolidation and growth. Thus, it is not unrealistic to expect that a convincing fiscal adjustment in Italy could also have expansionary effects on output and demand.

Of course, credibility depends, first and foremost, upon the strategy of fiscal consolidation chosen by each member state. However, the credibility of the process of economic convergence as a whole can be substantially increased if markets perceive that progress in the macro-economic area is achieved at the same time as the preparations necessary for the launching of the single currency are being made. In fact, work in this more technical area may help to convince markets of EU governments' determination in pursuing the goal of the single currency. This is why it is important to deal with the problems related to the technical building of EMU.

The technical building of EMU.

Seen from this angle, EMU amounts to an EU-wide monetary reform, as it implies the abandonment of the national monetary units in the signatory countries of the Maastricht Treaty and the adoption of the single currency. Of course, a number of monetary reforms have been undertaken in the past in Western Europe and numerous are those recently carried out in Latin America and Eastern Europe. However, the single currency experiment is truly unique in economic history.

Firstly because, unlike similar experiments in the past, it will involve fiat money and the establishment of a new institution, the ECB, to manage the new currency.[3] Since the Treaty requires the European Monetary Institute to specify the regulatory, organisational and logistical framework necessary for the ECB to perform its tasks, we can evaluate the technical difficulty of the single currency experiment with reference to the complexity of the preparatory work as presented in the EMI's plan of action, the so-called Master Plan.

The Master Plan is a comprehensive plan elaborated by the EMI to put the single currency into practice. It is composed of 88 fiches with detailed descriptions of medium-sized projects. Each project requires an average of 36 months/man. The main issues to be tackled include the organisation and implementation of the single monetary and exchange-rate policy and the related problem of the collection of statistics. The plan also envisages the creation of an integrated payments system at the EU level, the design of efficient information and telecommunication systems within the ESCB, the preparation of euro banknotes, the harmonisation of the accounting standards of the NCBs in order to have a workable system of accounts at the ESCB level. Seen from this angle the EMI's task appears daunting.[4]

But there is a second reason why the single-currency project is unique in history, which has to do not only with the number of countries *simultaneously* involved in the transition, up to fifteen with a population of more than 300 million people, but also with the high degree of monetary sophistication of these economies. Thus, another yardstick for measuring the

---

[3] See De Cecco (1996) for a historical illustration of the 19th century European currency unions.

[4] An evaluation of the work already conducted is provided by the European Monetary Institute in its Annual Report (EMI, 1996).

complexity of the single currency experiment is the co-ordination effort necessary to organise a smooth transition to the single currency of the EU economies.

In this respect, it is useful to refer to the transition timetable recently approved in Madrid by the European Council (Table 5). The whole transition process will take place over four and a half years. At the beginning of 1998, the decision will be taken on which countries will qualify to adopt the single currency, the euro. Subsequent to this decision, the ECB and the ESCB will be established. On 1 January 1999 the conversion rates among the national currencies of the participating countries and the euro will be irrevocably fixed. From that moment, the euro will be a currency in its own right and the national currencies and the euro will become different expressions of what, from an economic point of view, will be the same currency. The euro will be used to conduct monetary and foreign exchange policy operations and national banknotes will remain the only legal tender until the introduction of banknotes denominated in euro, not later than 1 January 2002, when they will start to be issued, together with the withdrawal of the old national banknotes. This final phase will last no more than six months.

Seen from this angle, the actual implementation of the single currency project will also imply considerable efforts. However, the strategy adopted in Madrid appears fully credible. It is true that a gradual approach to the transition has been chosen, in spite of the fact that markets usually prefer more clear-cut situations. However, spreading the efforts over a longer period will facilitate the transition of important parts of the social and economic fabric, for instance small banks and the public administration. Thus, a gradual approach means a realistic approach to transition.

It is also important to note that gradualism does not mean that the crucial choices have been eluded. It has been clearly stated that from the beginning of Stage III onwards the euro will be used for a number of important purposes, such as the conduct of monetary policy operations and the denomination of newly-issued public bonds. Moreover, the gradual approach has been somewhat mitigated by the fact that private agents can adopt the single currency ahead of the introduction of euro-denominated banknotes. For instance, if they wish, banks will be able to offer euro checking accounts to their customers. In turn, each private agent is left free to decide whether to accept such payments or not. Thus gradualism also means flexibility, something you desperately need when you have to co-ordinate the actions of millions of people.

Overall, the work conducted both at the EMI and at the EU Commission is designed to ensure that the transition to the euro will be performed smoothly and effectively.[5] At the same time, these efforts help reassure international markets with regard to the determination of EU national governments to achieve the goal of the single currency within the deadline indicated by the Maastricht Treaty.

Of course, member States are also doing their part in preparing the transition to the single currency. In Italy's case representatives of the Bank of Italy participate actively in the

---

[5] See Deutsche Bank (1996) for an evaluation of the transition scenario given by a market operator.

work of the EMI. Moreover, the Bank has assembled an Action Plan which broadly conforms to the EMI Master Plan and includes 70 main projects that the various Departments will have to implement to enable the Bank to adopt the euro. The Plan also indicates the timing of each action, lists the priorities and highlights the logic and practical links connecting the various projects.

At the same time, the Italian Treasury has recently formed a Working Group to study the transition to the euro of the Italian public administration. Finally, the Italian Banking Association (ABI) has established various Working Groups under a Strategic Committee formed by top Italian bankers to analyse all the possible implications for banks of their move to the single currency.

References

Buiter W., Corsetti G., and **Roubini N.** (1993), Excessive deficits: sense and nonsense in the Treaty of Maastricht, *Economic Policy,* no. 16, April, pp. 57-90.

Bini-Smaghi L., Padoa-Schioppa T. and **Papadia F**. (1994), The Transition to EMU in the Maastricht Treaty, *Essays in International Finance,* no. 194, Princeton, New Jersey.

De Cecco M. (1996), The European Monetary Union: lessons of historical experience, in *European Monetary Union: the problems of the transition to a single currency,* Banca Nazionale del Lavoro Quarterly Review, Special issue, March, pp. 55-68.

Deutsche Bank (1996), *A stable currency for Europe,* Special Report of Deutsche Bank Research, February.

European Monetary Institute (1996), Annual Report for 1995, Frankfurt am Main.

Giavazzi F. and **Pagano M.** (1995), Non-Keynesian effects of fiscal policy changes: International evidence and the Swedish experience, *NBER Working Paper,* 5332M, November.

Modigliani F., Baldassarri M., and **Castiglionesi F.** (1996), *Il miracolo possibile,* Laterza, Bari.

Papadia F., and **Saccomanni F.** (1994), From the Werner Plan to the Maastricht Treaty: Europe's stubborn quest for monetary union, in Steinherr A. (ed.), *Thirty years European Monetary Integration,* Longman, London.

Pisani-Ferry J., and **Cour P.** (1995), The costs of fiscal retrenchment revisited, *Problèmes Economiques,* 2448, November.

Pragma (1996), *L'Europa degli Italiani,* a survey commissioned by Il Sole-24 Ore, RAI and the European Commission.

Sutherland A. (1995), Fiscal crises and aggregate demand: can high public debt reverse the effects of fiscal policy?, *Centre for Economic Policy Research Discussion Paper,* no. 1246.

Table 1

Which problem should the EU tackle and solve urgently?

(percentages)

	1993	1995:	Agriculture	Industry	Services	Civil Service	Politics
Reduce unemployment	83	71	70	61	63	73	88
Oblige Member States to consolidate fiscal deficits	50	46	47	52	56	42	35
Reduce interest rates	34	25	28	29	26	19	23
Reinforce the EMS	21	19	12	30	18	23	15
Reduce inflation	24	26	32	30	23	24	20
Favour the introduction of the single currency	25	38	38	41	39	47	23
Limit immigration from non EU-countries	22	23	28	29	15	13	32
Help Eastern European and ex-USSR countries	19	16	12	12	8	14	37
Intervene actively in international crises	26	29	23	24	28	27	45
Reinforce a common defence policy	not available	21	22	24	11	23	25

Source: Pragma

Table 2a

How *desirable* is the launching of the single currency according to the modalities and the deadlines set by the Maastricht Treaty?
(percentages)

	1994	1995:	Agriculture	Industry	Services	Civil Service	Politics
Highly desirable	42	43	45	51	45	35	37
Moderately desirable	40	38	35	34	35	40	47
Little desirable	13	16	15	15	16	24	12
Undesirable	4	3	5	0	3	0	5

Table 2b

How *likely* is the launching of the single currency according to the modalities and the deadlines set by the Maastricht Treaty?
(percentages)

	1994	1995:	Agriculture	Industry	Services	Civil Service	Politics
Highly likely	3	4	7	7	2	2	5
Moderately likely	22	28	37	37	26	24	18
Little likely	63	58	47	49	65	58	72
Unlikely	11	9	10	7	8	16	5

Source: Pragma

Table 3

The compliance of Italy with the convergence criteria will imply
(percentages)

1995	Total	Agriculture	Industry	Services	Civil Service	Politics
Socially acceptable costs	70	53	61	74	79	83
Socially unacceptable costs	19	30	24	19	8	15
No costs	6	7	14	3	8	0
No answer	4	10	2	3	5	2

Source: Pragma

Table 4

Convergence parameters: EU-15 (1994-96)

	Inflation			**Long-term rates**			**Public deficit** (% GDP)			**Public debt** (% GDP)			memo: **Growth**			**Unemployment**		
	94	**95**	**96**	**94**	**95**	**96**	**94**	**95**	**96**	**94**	**95**	**96**	**94**	**95**	**96**	**94**	**95**	**96**
Belgium	3,0	*1,5*	2,4	7,8	*7,6*	7,0	5,3	4,5	3,1	135,0	134,4	132,3	2,2	2,3	2,2	10,0	10,2	10,1
Denmark	*1,0*	2,0	2,4	*8,5*	8,4	7,8	3,8	2,0	1,3	75,6	73,6	72,7	4,4	3,4	2,6	8,2	6,9	6,2
Germany	2,7	1,8	*2,1*	6,7	6,6	*6,3*	2,6	2,9	2,8	50,2	58,8	59,5	2,9	2,1	2,4	8,4	8,3	8,1
Greece	10,8	9,2	7,9	n.d.	n.d.	n.d.	11,4	9,3	8,3	113,0	114,4	114,0	1,5	1,7	1,9	8,9	8,9	8,9
Spain	5,1	4,9	3,9	9,7	11,1	10,4	6,6	5,9	4,7	63,0	64,8	65,8	2,0	3,0	2,9	24,1	22,5	21,7
France	*1,8*	1,9	*2,1*	*7,4*	7,5	*7,1*	6,0	5,0	3,9	48,4	51,5	53,4	2,7	2,8	2,4	12,3	11,5	11,0
Irlanda	2,7	2,5	2,3	8,1	8,3	7,9	2,1	2,7	2,0	91,1	85,9	81,3	6,7	6,7	5,6	15,1	14,9	14,5
Italy	4,8	5,6	4,3	10,6	11,7	10,6	9,0	7,4	6,0	125,4	124,9	123,9	2,2	3,2	3,0	11,4	11,7	11,3
Luxembourg	2,6	1,9	2,2	n.d.	n.d.	n.d.	-2,2	-0,4	-0,6	5,9	6,3	6,7	4,4	3,1	3,3	3,5	3,8	3,7
Netherlands	2,4	*1,6*	*1,8*	7,2	*7,2*	*6,7*	3,2	3,1	2, 7	78,0	78,4	78,2	2,7	3,0	2,5	7,0	6,7	6,4
Austria	3,0	2,4	2,3	6,7	6,5	6,3	4,4	5,5	5,0	65,2	68,0	69,9	3,0	2,4	2,5	4,4	4,5	4,5
Portugal	5,5	4,2	3,6	10,8	11,4	10,4	5,8	5,4	4,7	69,4	70,5	71,0	1,1	2,7	3,1	7,0	7,2	6,8
Finland	*1,3*	*1,2*	*2,0*	*8,4*	*8,0*	*7,2*	5,8	5,4	1,5	59,8	63,2	64,6	4,0	4,8	4,4	18,4	17,2	15,6
Sweden	3,0	2,8	2,6	9,5	10,1	8,8	10,4	7,0	4,5	79,7	81,4	80,8	2,2	3,7	2,6	9,8	9,1	8,4
U. K.	2,4	2,9	3,0	8,1	8,3	7,9	6,8	5,1	3,7	50,1	52,5	53,3	3,8	2,6	2,7	9,6	8,5	8,2
target-15	**2,9**	**2,9**	**3,5**	**10,1**	**9,6**	**8,8**	**3**	**3**	**3**	**60**	**60**	**60**						

Source: EU Commission, November 1995 economic forecasts

Table 5

The transition to the euro

Delineation of periods	Main action points within each period
early 1998	
Decision of the Head of States or of Government on the Member States participating in the euro area	Establish the ECB and the ESCB and make them operational
	Adopt secondary legislation with respect to the establishment of the ESCB
	Decide on, and undertake final test of, the framework for the ESCB to operate entirely in euro from day one of Stage III
	Start the production of euro banknotes and coins and announce their date of introduction
	Launch a wide-ranging public information campaign
Start of Stage III: 1st January 1999	
Irrevocable fixing of conversion rates among the currencies of participating Member states and the euro	Conduct of the single monetary and foreign exchange policy in euro by the ESCB as from day one
Entry into force of legislation relating to the introduction of the euro	Start of operation of the TARGET system
Euro introduced in non-cash form	Provide conversion facilities to counterparties which have not been able to equip themselves to translate amounts from euro into national units and vice versa
	Exchange banknotes at par value
	Monitor progress in the changeover of the private sector and give guidance where appropriate
	Prepare the changeover of the public administration
	New tradable public debt issued in euro
1st January 2002 at the latest	
Euro banknotes and coins introduced	
1st July 2002 at the latest	
National banknotes and coins lose legal tender status	Implement the complete changeover of the public administration
	Withdraw national banknotes and coins
	Monitor the complete changeover of the private sector

Source: European Monetary Institute (1996).

ISTITUTO AFFARI
INTERNAZIONALI - ROMA

n° Inv. 16408
17 GIU. 1996

BIBLIOTECA