Istituto Affari Internazionali

The Germany Italy Wants: A More Daring Leader of a More United Europe

by Simone Romano

ABSTRACT
The divergences between Italy and Germany span a broad spectrum of crucial issues related to the governance and future development of the Eurozone and the European Union – from the banking union to current-account imbalances, from the Union-wide fiscal stance to the size of the EU's budget. Behind these divergences lies a lack of mutual trust and shared vision for the whole EU. If the two countries fail to act together to achieve a more integrated and resilient Union, the risks for the sustainability of the European project are real. The current positive economic juncture is an occasion not to be missed for both EU members – for Italy to reform, for Germany to finally start embracing its role as a leader and acting accordingly.

European Union | Eurozone | Germany | Italy | Economic policy | Economic governance

keywords

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Introduction

Germany and Italy are two founding members of European Union, and the first and third economies of the Eurozone. They are long-standing allies, sharing common values and often similar positions on international matters. Their economic ties are strong, as bilateral trade flows demonstrate. Nevertheless, the two countries have divergent ideas on many issues – among them, Eurozone governance, economic policy and the future development of the EU.

This paper analyses the different perspectives of these two member states and outlines how Italy would like Germany to act. The two countries have adopted opposing positions, in particular, on three fundamental issues. First, the dichotomy between Eurozone fiscal rules and flexibility. Second, the proposals to reform EU and Eurozone governance, with different views on the institution of a European Minister of Finance and the reform of the EU budget. Third, the path to follow in order to complete the banking union – in particular, whether it should prioritize risk sharing or risk reduction.

Behind the divergences lies a twofold problem: lack of trust and the pursuit of national interest regardless of the needs of the Union as a whole. If both Italy and Germany fail to acknowledge that the smooth functioning of the EU currency union requires each member to act in accordance with the interests of the whole area, the EU and the European Monetary Union (EMU) will remain incomplete. It will thus be just a matter of time before the next shock shakes them to the core. As trivial as it might sound, it is of paramount importance for the future of the European project that these two key countries bridge their differences and act together, boldly and swiftly.

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1. Rules versus flexibility

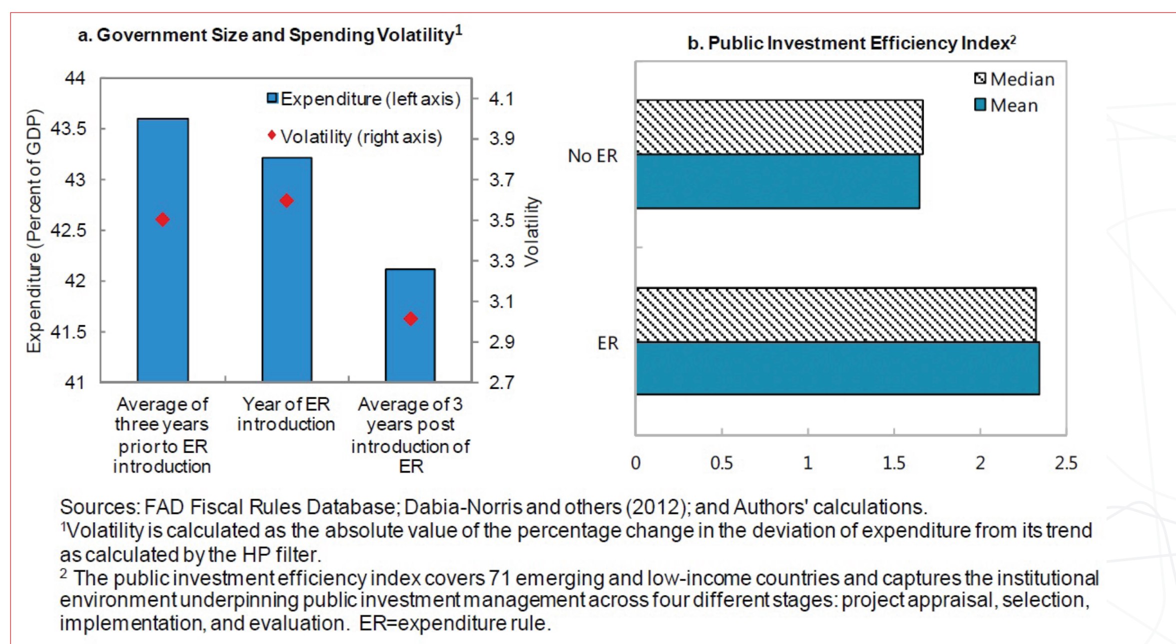
Some EU members cite the excessive rigidity of the rules imposed by Brussels as the root cause of the poor economic performance that has characterized the EU over the last ten years. Consequently, they ask for more flexibility – demanding, in particular, the implementation of expansionary fiscal policies in order to bolster aggregate demand and boost growth.

Others blame the fiscal recklessness of several members, whom they deem incapable of following the basic rules needed for the smooth functioning of the Union, and they warn about the dangers of fiscal laxity.
Behind this deadlock lies the deeper issue of whether an intergovernmental approach is enough to make a currency union thrive.

1.1 The "house in order" approach: Necessary, but also sufficient?

The Eurozone is a peculiar currency union, with a common monetary policy but many national budgetary policies. Germany holds the principle known as "keeping your house in order" to be the fundamental requirement guaranteeing the smooth functioning of such a union. This entails each member state being called on to adopt a sound and wise fiscal policy, in accordance with the mandate of the Union's Stability and Growth Pact, keeping both its deficit and its debt under control.

Figure 1 | Expenditure rules and efficiency



Sources: FAD Fiscal Rules Database; Dabia-Norris and others (2012); and Authors' calculations.
[1]Volatility is calculated as the absolute value of the percentage change in the deviation of expenditure from its trend as calculated by the HP filter.
[2] The public investment efficiency index covers 71 emerging and low-income countries and captures the institutional environment underpinning public investment management across four different stages: project appraisal, selection, implementation, and evaluation. ER=expenditure rule.

Source: Till Cordes et al., "Expenditure Rules: Effective Tools for Sound Fiscal Policy?", in *IMF Working Papers*, No. 15/29 (February 2015), p. 16, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Expenditure-Rules-Effective-Tools-for-Sound-Fiscal-Policy-42706.

According to this vision, a rules-based fiscal policy is enough to bring stability and assure the prosperity of the Eurozone (see Figure 1). Expenditure rules reduce volatility and impart predictability to fiscal policy, making it less destabilizing.[1] Cordes et al. find that such rules are associated with counter-cyclical fiscal policy (contrary to conventional wisdom, which holds tight fiscal rules to be pro-cyclical) and improved fiscal discipline, and that fiscal performance is better in countries where expenditure rules exist.[2] Debrun at al. and Wierts have shown that the presence of expenditure rules could help to mitigate pro-cyclical bias.[3]

According to this view, it follows that fiscal policy should no longer be used as a discretionary stabilization tool. Budgetary decisions should be made on a long-term basis, with relatively little attention paid to issues of demand management.[4] These positions recently informed economic policies not only in Germany but at the European level as well, ushering in debt-consolidation policies in 2011 (commonly known as "austerity measures") and leading to the principles contained in the Fiscal Compact.[5]

Italy has often voiced its concerns about this policy course, advocating more flexibility in the design of the Union's fiscal policy. Contractionary fiscal policies aimed at stabilizing debt dynamics can be self-defeating if coupled with private deleveraging and liquidity trap, as was the case in the period 2011–15.[6] More generally, in a period characterized by persistently low interest rates, high unemployment and financially constrained agents, fiscal multipliers are found to be much higher[7] – warranting a more active role for fiscal policy in bolstering aggregate demand.

[1] On the importance of predictability for fiscal policy, see Lilia Cavallari and Simone Romano, "Fiscal Policy in Europe: The importance of Making It Predictable", in *Economic Modelling*, Vol. 60 (January 2017), p. 81-97.

[2] They analyze a sample of 29 countries which adopted different forms of fiscal rules in the years between 1985 and 2013. Germany is not part of the sample. See Till Cordes et al., "Expenditure Rules: Effective Tools for Sound Fiscal Policy?", cit.

[3] Xavier Debrun et al., "Tied to the Mast? National Fiscal Rules in the European Union", in *Economic Policy*, Vol. 23, No. 54 (April 2008), p. 297-362; Peter Wierts, "How Do Expenditure Rules Affect Fiscal Behavior?", in *DNB Working Papers*, No. 166 (February 2008), https://www.dnb.nl/en/news/dnb-publications/dnb-working-papers-series/dnb-working-papers/auto170658.jsp.

[4] Olivier Blanchard and Lawrence Summers, *Rethinking Stabilization Policy. Back to the Future*, paper presented at the Peterson Institute for International Economics' conference "Rethinking Macroeconomic Policy", Washington, 8 October 2017, https://piie.com/system/files/documents/blanchard-summers20171012paper.pdf.

[5] Fiscal compact is the common way to refer to the chapter related to fiscal policy design into the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, formally concluded on 2 March 2012, and entered into force on 1 January 2013.

[6] Philipp Engler and Mathias Klein, "Austerity Measures Amplified Crisis in Spain, Portugal, and Italy", in *DIW Economic Bulletin*, Vol. 7, No. 8 (22 February 2017), p. 89-93, https://www.diw.de/sixcms/detail.php?id=diw_01.c.553149.de.

[7] Menzie David Chinn, "Fiscal Multipliers", in *La Follette School of Public Affairs Working Papers*, No. 2013-002 (18 March 2013), http://www.lafollette.wisc.edu/research/publications/fiscal-multipliers; Giancarlo Corsetti, André Meier and Gernot J. Müller, "What Determines Government Spending Multipliers?", in *Economic Policy*, Vol. 27, No. 72 (October 2012), p. 521-565.

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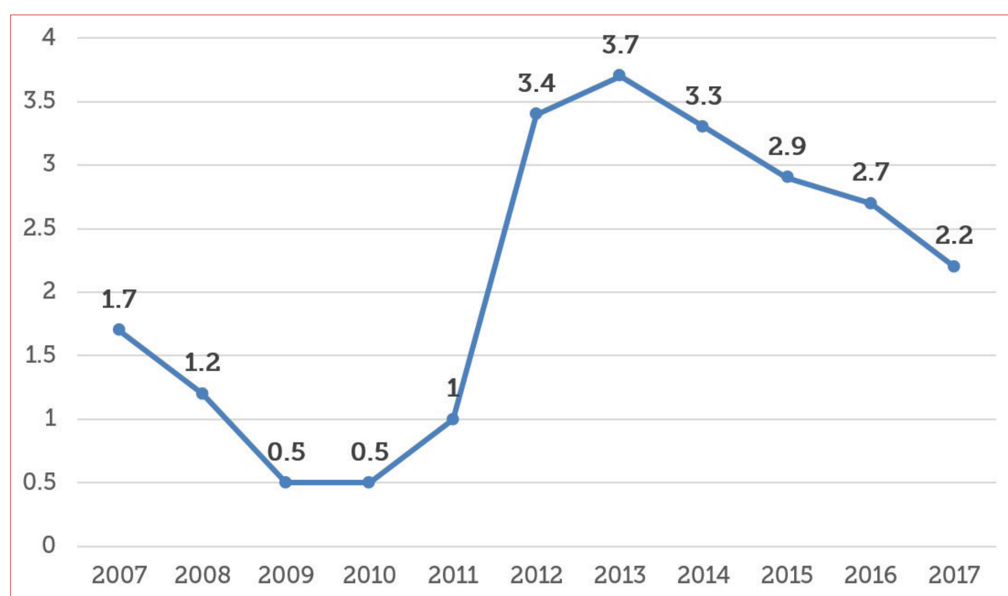
With regard to the Eurozone, the truth lies somewhere in the middle. Italy's level of debt is not only a burden on its national growth perspectives but also poses a risk to the financial stability of the whole Eurozone. Consequently, Italy should refrain from engaging in more expansionary policies and take advantage of the current positive juncture to finally set its debt dynamics on a more sustainable path. At the same time, Italy wants Germany and the EU institutions to recognize its efforts on this matter, so as to gain greater fiscal-policy latitude. Figure 2 shows that Italy has had a structural primary surplus for several years. In other words, since 2011, Italy has striven to "put its house in order".[8]

Figure 2 | Italy's structural primary balance



Note: Vertical axis: Structural primary balance / GDP in percentage terms.
Source: Author's elaboration on IMF data: *Fiscal Monitor October 2016. Debt: Use it Wisely*, 5 October 2016, p. 66, http://www.imf.org/en/Publications/FM/Issues/2016/12/31/Debt-Use-it-Wisely; and *Fiscal Monitor October 2017. Tackling Inequality*, 11 October 2017, p. 80, http://www.imf.org/en/Publications/FM/Issues/2017/10/05/fiscal-monitor-october-2017.

It is also true, however, that in the years between 2011 and 2016, the ratio of total government spending to the GDP has grown.[9] Italy has indeed been through austerity, but to nowhere near the extent of other European counties such as Ireland or Spain. Moreover, Italy has applied what some authors describe as "bad" austerity: raising taxes and cutting public investment instead of public current spending.[10] This, together with a poor growth performance, has caused the country's debt-to-

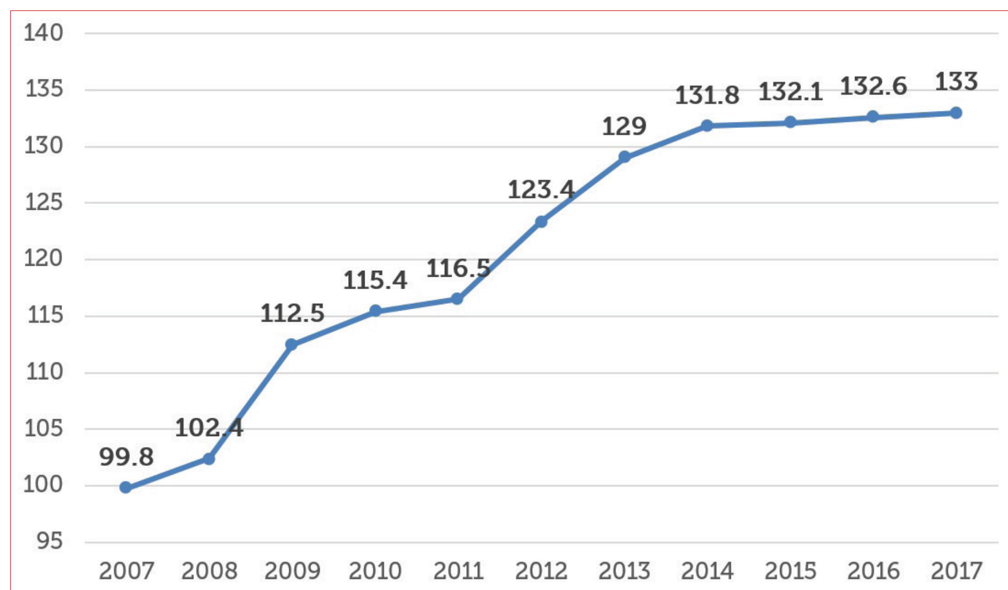
[8] In the twenty years' period spanning from 1995 to 2014, Italy registered an annual primary surplus for 19 times while the public balance of other major European economies registered a deficit at least seven times.

[9] The average growth on the fivr years' period was 0.2%. See Veronica De Romanis, *L'austerità fa crescere*, cit.

[10] Veronica De Romanis, *L'austerità fa crescere*, presentation at the IAI conference "Un'Europa a vele spiegate. Dove è finita l'austerità?", Rome, 23 October 2017, http://www.iai.it/en/node/8372.

GDP ratio to grow in the last ten years regardless of the aforementioned efforts, rising from around 100 per cent in 2007 to 133 per cent today (as shown in Figure 3).

Figure 3 | Italy's debt/GDP ratio



Note: Vertical axis: Public debt / GDP in percentage terms.
Source: Author's elaboration on IMF data: *Fiscal Monitor October 2016*, cit., p. 69; and *Fiscal Monitor October 2017*, cit., p. 83.

Empirical evidence demonstrates that Italy has shown goodwill and has started moving in the right direction, but this is not enough. Italy must remain on the path of debt-stabilization, for its own sake and for the benefit of the whole Eurozone. This, according to the International Monetary Fund,[11] should be coupled with the implementation of structural reforms that can alleviate some historical problems, such as low productivity growth and youth unemployment,[12] allowing for better growth perspectives. In this sense, it can be concluded that Italy needs to follow Germany's advice.

It is also true, however, that if Italy should continue to follow wise budgetary policies in order for the Eurozone to thrive, then Germany should engage in more expansionary fiscal policies. As the European Commission has reported,[13] in the

[11] International Monetary Fund (IMF), "Italy: Reforms Needed for Stronger Growth and Stability", in *IMF Country Focus*, 27 July 2017, https://www.imf.org/en/News/Articles/2017/07/24/na072717-italy-reforms-needed-for-stronger-growth-and-stability.

[12] In order to regain competitiveness, Italy should decentralize wage bargaining at firms' level. To encourage employment, Italy should develop a more effective package of active labour policies and lower taxes on productive factors, above all labour. The resources to finance these measures should be found by combating tax evasion, bringing more persons and enterprises into the tax net. Ibid.

[13] European Political Strategy Centre (EPSC), "Towards a Positive Euro Area Fiscal Stance. Supporting Public Investments That Increase Economic Growth", in *EPSC Strategic Notes*, No. 20 (23 November 2016), https://ec.europa.eu/epsc/publications/strategic-notes/towards-positive-euro-area-fiscal-stance_en.

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aftermath of the sovereign debt crises (that is, between 2011 and 2013), the Eurozone as a whole adopted a contractionary fiscal stance, deepening and prolonging the pain of the recession that followed the European double dip. This shows the short-sightedness of the intergovernmental approach, which regards the currency union merely as the sum of its members (and their policies).

The sovereign-debt crisis in 2011 demonstrated that the "house in order" approach is necessary for the smooth functioning of the Union. The slow and painful recovery that followed, however, showed that it is not sufficient to guarantee economic growth and prosperity, which can be achieved only by overcoming the intergovernmental approach in favour of a Union-wide policy design. Countries with limited fiscal space, like Italy, should refrain from implementing expansionary policies. Countries with sufficient fiscal space, such as Germany, must use it when that is required from a Eurozone perspective. Italy wants Germany to do exactly this.

Germany, for its part, holds steady to its position, stating that its economy is in no need of a fiscal boost. Even though investing in public infrastructure would be beneficial first and foremost for Germany itself,[14] the point here is not to advise Germany on its own needs. The point is to make Germany acknowledge its role as leader of both the EU and the Eurozone and start acting accordingly, taking the interest of the Union as a whole into account. In this sense, Germany's sizeable current account surplus provides a perfect example.

1.2 A concrete example: The German current-account surplus

Since Germany joined the Euro, it has had a current-account surplus.[15] In 2015, it peaked at 8.6 percent (Figure 4). Germany sees this as a reason for pride[16] and as a model for other Eurozone members.

The sizeable growth of German exports played a key role in the success story that brought the country from being the "sick man of Europe" in the early 2000s to being its engine of growth.[17] The reasons behind the current-account surplus are manifold, and some of them are indeed to be envied – from the corporate renewal of many key companies to the early positioning in markets that in the last 15 years

[14] Matteo Pignatti, "Raising Consumption in Germany Would Benefit German Savers As Well", in *CSC Position Papers*, No. 17-07 (10 June 2017), http://www.confindustria.it/wps/wcm/connect/www.confindustria.it5266/e243d355-5f36-4a8a-8c12-fdd6458a690e/CSC+Position+paper+n.+7.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=e243d355-5f36-4a8a-8c12-fdd6458a690e.

[15] Economist, "Why Germany's Current-Account Surplus Is Bad for the World Economy", in *The Economist*, 8 July 2017, https://www.economist.com/news/leaders/21724810-country-saves-too-much-and-spends-too-little-why-germanys-current-account-surplus-bad.

[16] International Monetary Fund (IMF), "Germany: Spend More At Home", in *IMF Country Focus*, 7 July 2017, https://www.imf.org/en/News/Articles/2017/07/05/na070717-germany-spend-more-at-home.

[17] Valentina Romei, "Germany: From 'Sick Man' of Europe to Engine of Growth", in *Financial Times*, 14 August 2017.

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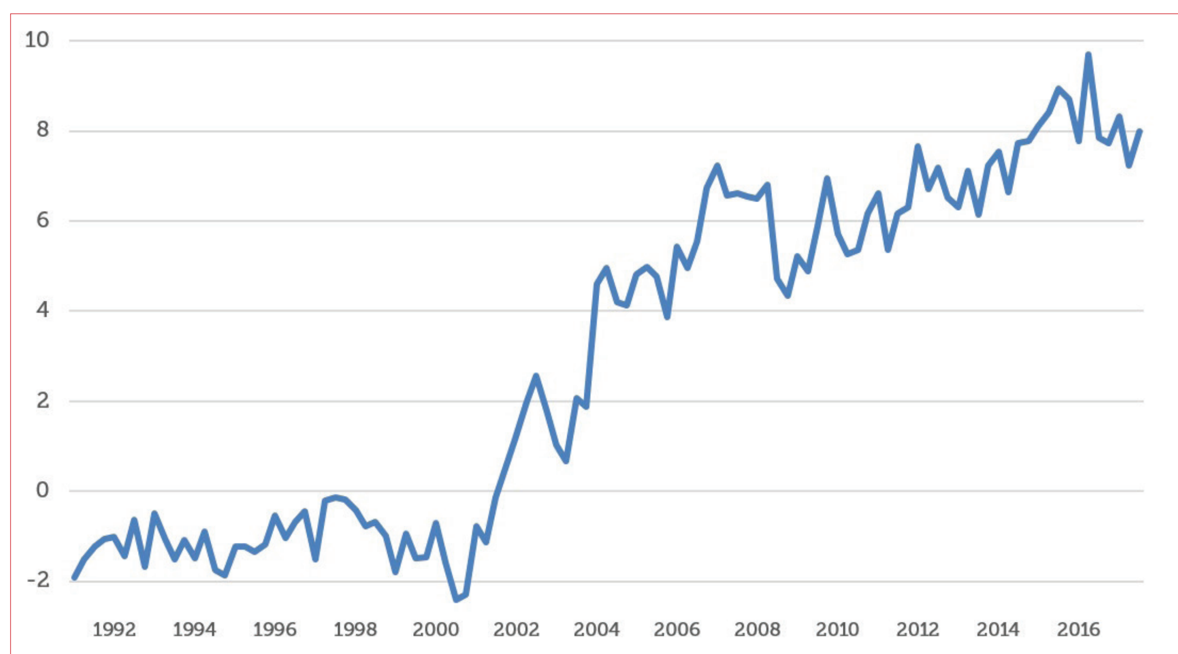
have grown exponentially, from the agreement between unions and employers to favour employment over salary growth to incisive labour and structural reforms.[18] All this has made German products very competitive, but that is just part of the story. Being a member of the Eurozone has greatly helped Germany to develop and maintain its current-account surplus.[19] It has done this firstly by delivering "captive markets" – namely, the markets of the other Eurozone member states, which have been increasingly attracting German goods (accounting for two-fifths of German exports) – and secondly by helping Germany to maintain a competitive exchange rate. If Germany had still had the Deutschmark instead of the common currency, these sizeable surpluses would have pushed its value upwards, eroding German competitiveness.[20] However, the point here goes beyond the importance of Eurozone membership for Germany. The point is how dangerous intra- Eurozone imbalances are – for countries in financial distress as well as for Germany itself.

Figure 4 | Germany's current-account surplus



Note: Vertical axis: Current-account balance / GDP in percentage terms.
Source: Author's elaboration on OECD data.

Systems of fixed exchange rates have historically suffered from the fact that countries with balance-of-payments deficits come under severe pressure to adjust, while countries with surpluses do not face the same pressure. To understand the

[18] Christian Odendahl, "The Hartz Myth: Drawing Lessons from Germany", in *CER Bulletin*, No. 115 (August/September 2017), p. 4-5, http://www.cer.eu/node/6160.

[19] Simon Tilford, "Germany's Euro Advantage", in *The New York Times* and *The International Herald Tribune*, 13 July 2010, http://www.nytimes.com/2010/07/14/opinion/14iht-edtilford.html.

[20] Martin Wolf, "Germans are Wrong: The Eurozone Is Good for Them", in *Financial Times*, 8 September 2010.

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magnitude of the problem, it is useful to remember that the Gold standard was brought down by the failure of "surplus" countries to participate equally in the adjustment process.[21] Countries like Italy and Spain are going through a painful devaluation process in order to regain competitiveness, experiencing high levels of unemployment and social divisions. This process would be much quicker if Germany relinquished its contractionary policies, which are aimed at bolstering its own productivity,[22] and engaged in a public-investment strategy, which would benefit first and foremost its own firms and savers.[23]

Germany is not only acting in a way that is detrimental to the currency union but it is also doing so in breach of the rules (the new Macroeconomic Imbalance Procedure imposes a limit of 6 per cent for current-account surpluses). Italy is asking Germany to understand that the issue is not a matter of doing "lazier" countries a favour, it is about acknowledging that national policies impact on currency-union dynamics – understanding that the Union is not just the mere sum of its parts. Germany is rightly asking Italy to respect the rules and to wisely manage its public finances without harming other members with its misconduct. Italy is asking Germany to do the very same thing with regard to its current-account imbalance.

2. The EU budget and the EU Minister of Finance: Towards a fiscal union?

European Commission President Jean-Claude Juncker mentioned in his latest State of the Union speech (2017) the need for the EU to make progress in reforming its economic governance.[24] To this end, as stated in the Roadmap for deepening Europe's Economic and Monetary Union,[25] the European Commission supports the transformation of the European stability mechanism (ESM) into a European monetary fund (EMF). The Commission also favours the creation of a dedicated Eurozone budget line within a renovated EU budget, which can perform a stabilization function as well. Finally, the Commission pushes for the creation of a "double-hatted" European Minister of Economy and Finance.

German officials have long rejected calls for additional Eurozone stabilization and risk-sharing instruments, preferring tougher enforcement of existing fiscal rules

[21] Bern S. Bernanke, "Germany's Trade Surplus Is a Problem", in *Brookings Ben Bernanke's Blog*, 3 April 2015, http://brook.gs/2bjmSUT.

[22] Paul Krugman, "Germany's Drag", in *The New York Times*, 26 August 2016, https://krugman.blogs.nytimes.com/2016/08/26/germanys-drag.

[23] Bern S. Bernanke, "German Wage Hikes: A Small Step in the Right Direction", in *Brookings Ben Bernanke's Blog*, 13 April 2015, http://brook.gs/2bOvJ2V.

[24] Jean-Claude Juncker, *State of the Union Address*, 13 September 2017, http://europa.eu/rapid/press-release_SPEECH-17-3165_en.htm.

[25] European Commission, *Commission Sets Out Roadmap for Deepening Europe's Economic and Monetary Union*, 6 December 2017, http://europa.eu/rapid/press-release_IP-17-5005_en.htm.

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and more market discipline.[26] Italy, instead, has pushed for the creation, at the European level, of fiscal-stabilization tools that may supplement the action of the European Central Bank (ECB) in promoting stability and growth throughout the EU.[27]

Regarding reform of the EU budget, the Italian position is akin to that of French President Emmanuel Macron. In their view, the European budget ought to be based on a dedicated revenue stream, overcoming the juste retour logic that funding granted to project participants from a given country/region be in proportion to the budget contributed by that country/region. It should be designed to provide automatic and discretionary stabilization, allowing for the expansion or tightening of fiscal stances according to the economic cycle. To this end, the EU budget should be substantially enlarged. By contrast, Germany is not comfortable with an expansion of the EU budget. Berlin could at most welcome the creation of a small additional fund with the single goal of supporting structural reform in Eurozone member countries.

Germany and Italy also hold quite different opinions on the transformation of the ESM into the EMF. Italy would like the new ESM to be able to provide a backstop for the banking union and the European deposit-insurance scheme (EDIS). Germany would strengthen the ESM only to enable it to engage in tough surveillance of member states' fiscal policies (proposing to entrust the renewed ESM with this task rather than the European Commission).

Finally, Germany regards the position of a European Minister of Economy and Finance as an additional authority entrusted with the task of surveilling the fiscal conduct of Eurozone members. Italy associates the creation of this new institution with the establishment of a European "Treasury", to be achieved through the reform and expansion of the EU budget. If a European Treasury Secretary were not allowed to discretionally handle a treasury, the post's creation would be pointless since it could not implement a counter-cyclical action if needed.

The Italian position is based on the understanding that, as it stands, the EMU is incomplete.[28] With a single monetary policy and many national fiscal policies, the EMU lacks an aggregate redistribution mechanism and Union-wide fiscal stabilization tools. Moreover, the mobility of capital and workforces inside the Union is still limited. This leaves the EU open to idiosyncratic shocks.[29] The

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[26] Agnès Bénassy-Quéré et al., "A Resilient Euro Needs Franco-German Compromise", in *Le Monde* and *Frankfurter Allgemeine Zeitung*, 27 September 2017, http://bruegel.org/?p=22126.

[27] Fabrizio Saccomanni, "Rules vs Discretion in the European Fiscal Framework", in *Beyond the Austerity Dispute: New Priorities for Fiscal Policy, Bank of Italy Conference Proceedings, Perugia, 9-11 April 2015*, https://www.bancaditalia.it/pubblicazioni/altri-atti-convegni/2015-beyond-austerity.

[28] Mario Draghi, *Stability and Prosperity in Monetary Union*, speech at the University of Helsinki, 27 November 2014, https://www.ecb.europa.eu/press/key/date/2014/html/sp141127_1.en.html.

[29] Paul Krugman, "Revenge of the Optimum Currency Area", in *NBER Macroeconomics Annual 2012*, Vol. 27 (2013), p. 439-448, https://doi.org/10.1086/669188.

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proposal of a European unemployment-benefit scheme, put forward by the Italian Government, represents a concrete step in the direction of EMU "completion": it aims to provide the Euro area with an instrument that mitigates the impact of severe asymmetric shocks, which would otherwise be reflected directly on its labour market in the absence of flexible exchange rates. Such a mechanism would help in building a consistent aggregate fiscal stance at European level, ensuring that countries under fiscal constraints do not have to cut automatic stabilizers during such a crisis reducing consequently negative spillovers in the case of future crises. Obviously, the scheme would include an appropriate incentive structure in order to limit moral hazard and avoid permanent transfers from some countries to others, but it is important to understand that it would be beneficial for all member states: it will contribute, in the medium term, to the creation of a more stable macroeconomic environment with strengthened demand and, in the long run, better growth prospects in all currency-union members.[30]

Recent history has demonstrated the incompleteness of the European project and the damage that this can cause. If standing still is not an option, neither is dismantling the common currency – due to the incalculable costs that this would have on the economies of EU member states and for the whole idea of European integration.[31] For the European project to thrive, the only solution is a profound reformation of its architecture.[32] What is needed is to go beyond the "Europe of sovereign nation states" and make some significant progress towards political union.[33] Italy is concerned that Germany's reluctance to embrace the responsibilities that its leading role in Europe implies might leave the Union unprepared to cope with the next adverse shock.

3. Completing the banking union: Risk reduction and risk sharing

The crises that have recently shaken Europe had financial origins. Their deep repercussions shed light on the fragility of the European financial framework and the inappropriateness of its financial institutions.

In response to these crises, European authorities embarked on a thorough process of reform. Progress has been made, above all, towards the creation of a European banking union.[34] Further effort is nonetheless needed to complete this. The

[30] Italian Ministry of Economy and Finance, *European Unemployment Insurance Scheme*, October 2015, http://www.mef.gov.it/documenti-allegati/2015/note_unemployment/note_unemployment_insurance_2015_5OCT.pdf.

[31] Mario Draghi, *Speech at the Global Investment Conference*, London, 26 July 2012, https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.

[32] Jean-Claude Juncker et al., *Completing Europe's Economic and Monetary Union* (Five president's report), 22 June 2015, http://europa.eu/!cY66kX.

[33] Fabrizio Saccomanni, "The Report of the Five Presidents: A Missed Opportunity", in *Documenti IAI*, No. 15|14 (July 2015), http://www.iai.it/en/node/4421.

[34] The debt crisis that hit Europe in 2011 highlighted the necessity for the banking systems of the

banking union's "third pillar", the EDIS, must be agreed upon if the new system is to work properly. Again, Italy and Germany sit on opposite banks on this issue, with divergent ideas on prioritizing risk reduction over risk sharing or vice versa.

One of the main amplifying factors of financial distress during these recent crises was the nexus between banks and sovereign debts. The difficulties encountered by many banks in the aftermath of the global financial crisis affected the state of public finances in many countries, both directly and indirectly – directly, through the bailout of troubled intermediaries; indirectly, because of the impact of reduced lending, which transmitted the financial distress to the real economy, lowering public revenues and increasing public expenditure.[35] The opposite linkage also worked, as the 2011 sovereign-debt crisis affected the balance sheets of banks as well. The high exposure of the banking systems of several countries to the debts of their own governments implied that the difficulties in the sovereign-debt market translated promptly into difficulties for financial intermediaries and the financial system in general.

In order to break the "diabolic loop" between sovereign debt and financial institutions, the Germans want to assign a non-zero risk weight to the exposure of banks to sovereign bonds. This measure would prompt banks to further increase their capital and thus the resilience of the banking system as a whole. The non-zero risk weight would also discourage high concentrations of sovereign exposure, thereby increasing banks' chances of surviving a sovereign default and preventing them from playing a "shock amplifier" role.[36]

Italian officials believe that German proposals may bring about the opposite result, making the monetary union more fragile rather than more resilient. By raising fears that sovereign debts might not be honoured, the introduction of ex ante automatic mechanisms for sovereign-debt restructuring would make it more difficult for markets to distinguish liquidity from insolvency risk. Rather than strengthening market discipline, these mechanisms would open the door to the possibility of an investor run, leading to self-fulfilling financial crises. Furthermore, introducing positive risk weights on sovereign bonds issued by Eurozone members in the calculation of banks' capital requirements would probably exacerbate financial

Eurozone countries to be more integrated, leading to the creation of the Baking Union. Its first pillar, the single supervisory mechanism, is in place and it has helped to improve the macroprudential supervision at the European level. The European Central Bank (ECB) has become the central prudential supervisor, fostering a better evaluation of the systemic risk. The second pillar, the creation of a single resolution mechanism, has contributed to reduce the probability of a bank run or of a crisis of confidence, creating clearer procedure for financial institution in financial distress.

[35] Fabrizio Balassone et al., "Economic Governance in the Euro Area: Balancing Risk Reduction and Risk Sharing", in *Questioni di economia e finanza*, No. 344 (July 2016), https://www.bancaditalia.it/pubblicazioni/qef/2016-0344.

[36] Ignazio Visco, *Banks' Sovereign Exposures and the Feedback Loop between Banks and Their Sovereigns*, speech at the conference "Euro50 Group: The Future of European Government Bonds Markets", Rome, 2 May 2016, p. 3, https://www.bancaditalia.it/media/notizia/banks-sovereign-exposures-and-the-feedback-loop-between-banks-and-their-sovereigns-speech-by-ignazio-visco.

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fragmentation. In the absence of an Eurozone fiscal backstop against massive liquidity runs, and of a safe asset of common reference for the management of banks' liquidity, banks' borrowing costs would inevitably be linked to those of their sovereign. Thus, a risk weight on national treasury bonds held by banks may aggravate fragmentation by reinforcing that perverse link between government debt and banks' balance sheets that should be broken, thus depriving banks of the instrument needed to manage their liquidity.[37]

In order not to squander the important progress made thus far on making European financial institutions more solid and resilient, the impasse on risk sharing versus risk reduction must be overcome.[38] Italy maintains that, for the benefit of the whole Union, risk sharing should not follow risk reduction but that the two should go hand in hand, generating a mutually reinforcing dynamic. In fact, a measure of risk sharing, such as the creation of a European deposit-insurance scheme, would certainly help Italian banks to continue to reduce their risk levels.[39]

Conclusion

This paper has reviewed the different positions held by Italy and Germany on some key issues regarding the economic governance of the Eurozone and the future of the EU, outlining what Italy would prefer Germany to do on these matters.

With regard to fiscal and budgetary policy design, Italy asks for more flexibility while Germany insists on strict fiscal discipline. For the benefit of the Eurozone, Italy should avoid engaging in expansionary fiscal policies and continue to improve its public finances. Germany, on the other hand, should avoid damaging the EU and Eurozone with policies that are in conflict with Union-wide interests. In this sense, Italy wants Germany to adopt a more expansive fiscal position in order to reduce its (Germany's) current-account surplus and loosen the EU's current fiscal stance.

Italy pushes for a more centralized approach within the Eurozone governance structure, proposing a redesign of the ESM and the EU budget so as to provide the EU with Union-wide stabilization tools, while Germany rejects calls for additional

[37] Carlo Bastasin et al., "On Banks and Debt in Europe, To Err Is Human, But to Persist Is Diabolical", An appeal by the professors of the LUISS SEP, in *LUISS Open*, 12 October 2017, http://open.luiss.it/en/?p=2943.

[38] Peter Praet, *We Need to Complete the Banking Union*, speaking points for Eurofi panel on "Priorities for Relaunching the Eurozone", Malta, 6 April 2017, https://www.ecb.europa.eu/press/key/date/2017/html/sp170406_3.en.html.

[39] Cross-border deposit insurance is necessary to protect the Euro area from idiosyncratic shocks hitting one national banking system and resulting in depositors running away from most or all of the banks in that country. Such an event would be the result of a liquidity drain generated by a confidence crisis. If EDIS was there, the likelihood of a destabilizing event generated by fickle financial investors would be much diminished, if not entirely eliminated. The availability of an adequate public backstop, for the eventuality that the deposit insurance fund proved insufficient to halt the rout, would stabilize expectations of wary investors.

Euro-area stabilization and risk-sharing instruments. Italy asks Germany to acknowledge that the Union as it stands is incomplete and that the "house in order" approach, although necessary, is not sufficient to guarantee stability and growth.

Regarding the dispute between risk reduction and risk sharing, which holds back the completion of the banking union, Italy has a key role to play in breaking the deadlock. In continuing the ongoing reduction of the risk carried by its financial sector, Italy should eventually be in a position to request that Germany allows for risk-sharing measures (like the creation of the EDIS) that would make the risk-reduction process much smoother and quicker. Preventing any form of risk sharing could raise fears about the soundness of the European financial sector, and thus result in a self-fulfilling crisis that would affect all European Union members.

Finally, both Italy and Germany should recognize their pivotal roles in pushing forward the necessary reforms to complete the EMU and improve its functioning and resilience. If both countries fail to bridge their differences and act in accordance with Union-wide interests, the consequences could be extremely severe for the entire EU – even jeopardizing its own survival. The current positive economic juncture is an opportunity that should not be missed: the Eurozone and the EU have survived previous severe crises; they might not survive the next.

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