# THE BLACK SHEEP?
# ITALY AND THE PUZZLE OF EUROPEAN FISCAL SOLIDARITY

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# Abstract

Over the past decade, two crises have scarred the European Economic and Monetary Union (EMU): the sovereign debt crisis of 2010 and the COVID-19 crisis of 2020. From an economic standpoint, these events could not be more different The Eurozone debt crisis was an *asymmetric* shock with origins *endogenous* to domestic economic policymaking. It was born out of ten years of economic divergence but became a trigger for massive convergence of the Eurozone *South* towards the growth model of the Eurozone *North*. Politically, that crisis cracked open a cleavage on the issue of intra-EMU fiscal solidarity, underpinned by a discourse that saw the EMU split between Northern fiscal 'saints' and Southern 'sinners'. The COVID-19 pandemic was a *symmetric* shock – a virus spreading globally – whose origins were *exogenous* to domestic economic policymaking. Yet, it risked having a diversified economic impact across countries due to potentially sizeable asymmetries in the economic recovery. The diversified debt legacy left by the Eurozone crisis on Member States' balance sheets limited the fiscal space of some countries and their ability to spend to tackle the impact of an otherwise symmetric shock. Given the non-economic origins of the crisis and its potential to revive the risk of a two-speed Eurozone, the COVID-19 shock would appear to be a politically uncontroversial case for cross-border fiscal solidarity within the EMU. Yet, the early phase of crisis management featured a reminiscence of the familiar north-south tensions and a manifested unwillingness to engage in fiscal solidarity. The Next Generation EU package agreed in July 2020 constituted a major step forward, by allowing for large size EU issuance to finance unprecedented cross-border fiscal transfers. Yet, the political process underpinning

the agreement was acrimonious and the resulting solidarity is clearly framed as a one-off event. Why was an unprecedented, symmetric, and exogenous shock like COVID-19 not enough to overcome the *North-South* cleavage on fiscal solidarity in the EMU? This is the puzzle central to this work, which uses a range of quantitative and qualitative analyses to explore the political economy of the EU fiscal solidarity discussion both before and during the COVID-19 crisis.

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# Dedication

This thesis is dedicated to my parents, Rita and Silvano, for their immense love, trust and support, and to my husband Fabrizio, for being always there for me through this journey.

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# Introduction

Over the last decade, two crises have marked the life of the Economic and Monetary Union (EMU): the sovereign debt crisis of 2010 and the COVID-19 crisis of 2020. From an economic standpoint, they constitute two diametrically opposed events. The Eurozone sovereign debt crisis was an *asymmetric* shock with origins deeply *endogenous* to domestic economic policymaking. It was the product of a decade of economic divergence – a fact that weighed heavily on the narrative of it, particularly in some parts of the Union – but ended up being a trigger for massive convergence of the Eurozone *South* towards the growth model of the Eurozone *North*. Politically, that crisis cracked open a cleavage on the issue of intra-EMU fiscal solidarity, underpinned by a discourse that saw the EMU split between Northern fiscal 'saints' and Southern profligate 'sinners'. 'North' and 'South', 'saints' and 'sinners', 'Core' and 'Periphery', might appear as inconsequential labels, but they are in reality very powerful identifiers that – by shaping the narrative of a crisis – can alter the understanding of it from the public opinion and influence the response that policymakers are willing to offer, for a long time to come. So engrained was this narrative that, even after the Euro-*South* had undergone a decade of painful macroeconomic adjustment and drastically restructured their economic growth model, it still was impossible to resolve the political stalemate on the topic of EMU macroeconomic governance reform. In 2018, an agreement on a Eurozone-level countercyclical stabilisation instrument seemed to be forthcoming, only to be blocked by an apparently irreconcilable fracture on whether the reform should be predicated on the principle of 'risk reduction' (disengagement) or on that of 'risk sharing' (solidarity). That was the state of the discussion on EMU macroeconomic governance reform, when the COVID-19

pandemic hit Europe in early 2020. The COVID-19 crisis is at the antipodes of the Eurozone crisis, in both its origins and its implications for Europe's economic and political balance. The pandemic is a *symmetric* shock – a virus that spared none among the EU Members States – whose origin is completely *exogenous* to domestic economic policymaking, but that risked having a diversified economic impact across countries through the asymmetry of the ensuing recovery. When the shock hit, countries' ability to spend varied significantly across the EMU due to different macroeconomic pre-existing conditions. In particular, the legacy of debt accumulated as a result of the Eurozone sovereign-debt crisis significantly limited the fiscal space of some Member States and their ability to spend to counter the impact of an otherwise symmetric shock. It soon became clear that the unevenness in countries' recovery capabilities could severely jeopardise the economic convergence achieved since 2010 and revive the risk of a two-tier EMU. Given the non-economic origins of the crisis on one hand, and its potential to trigger sizable macroeconomic risk on the other, the COVID-19 shock would appear to be a politically uncontroversial case for Eurozone-level fiscal solidarity. Yet, this has not been fully the case. The initial reaction to the COVID-19 outbreaks in Italy and Spain in March 2020 was eerily reminiscent of the reaction to the outburst of the Greek crisis at the end of 2009, and to a large extent it featured the same *North*-vs-*South* tensions. Early on, the Italian, Spanish and French governments called for the mutualisation of 'COVID debt' – i.e. the portion of public debt that could be seen as the direct result of the response to the pandemic – through the issuance of a EU 'Corona-bond' or a similar instrument. This call was predicated on the view that the existing EU crisis resolution toolkit – most notably the European Stability Mechanism (ESM), whose lending operations feature strict macroeconomic conditionality – were ill-suited to address a crisis whose origins could not be traced back to domestic economic policy choices. These calls were met with explicit scepticism from interlocutors in

the Euro-*North*. During the EU summit convened at the end of March 2020, Chancellor Merkel stated[1] that she did not envision Corona-bonds or any other debt mutualisation initiative as part of a European response to the COVID-19 crisis, and that Germany's preference remained for fiscally constrained countries to resort to the ESM. At the same summit, Dutch Finance Minister Hoekstra reportedly called for Brussels to investigate why some countries did not have enough individual fiscal space to weather the economic impact of the crisis on their own, a comment that Portuguese Prime Minister Costa called outright 'repugnant'[2]. So, while the topic of European solidarity was thrusted very early on into the spotlight of the policy discussion about how to respond to the COVID-19 crisis, the first two months saw little progress and views on supra-national solidarity appeared to be as far apart as before the pandemic. A breakthrough came in May 2020, when French President Macron and German Chancellor Merkel published a joined proposal for a EUR 500 bn Recovery Fund to be set up as part of the EU Multiannual Financial Framework (MFF). The Fund was to be financed entirely by borrowing of the European Commission, and disbursements were to be skewed towards the "most affected sectors and regions"[3]. The Franco-German proposal foresaw common EU issuance to an amount that was unprecedented: over the 10 years prior to the COVID-19 crisis, the EU had borrowed around one tenth of what it would be allowed to issue in the context of the recovery fund initiative. More importantly, the language of the Franco-German agreement implicitly catered for the possibility of temporary but explicit fiscal transfers across *countries* – something unprecedented in the history of EU Cohesion Policy, which is designed to focus strictly on the sub-national regional level. The political negotiations

[1] See: https://www.politico.eu/article/virtual-summit-real-acrimony-eu-leaders-clash-over-corona-bonds/
[2] See: https://www.politico.eu/article/netherlands-try-to-calm-storm-over-repugnant-finance-ministers-comments/
[3] See: https://www.algebris.com/policy-research-forum/blog/eu-recovery-fund-a-franco-german-revolution/

that followed, stretching well into the summer of 2020, made clear that even the one-off temporary transfers foreseen in the Franco-German agreement were far from uncontroversial for the rest of the Eurozone *North*. As the countries most opposed to the initiative (Austria, Denmark, the Netherlands and Sweden) decided to label themselves 'Frugal Four', it also became evident that the 'sinners versus saints' narrative of the Eurozone crisis casted a long ideological shadow. The agreement reached by the EU Council in July 2020 was the outcome of a long and hard-fought bargaining on the governance structure that should apply to the tool, and on the conditions that should govern the allocation of funds. The compromise inflicted harsh cuts to programmes that would have funded EU-level public goods and hence could have helped bridging the temporary recovery fund (formally 'Next Generation EU') initiative onto some form of structured permanent federal spending. The Next Generation EU agreement had the merit to overcome two historically strong German ideological red lines on the issue of European fiscal solidarity, ie. common EU issuance and fiscal transfers. Yet, it fell short of the 'Hamiltonian moment' that many observers had auspicated – with reference to the constitutional compromise forged by Alexander Hamilton, James Madison, and Thomas Jefferson in 1790. The European agreement did not include any commitment to debt mutualisation at the 'federal' level – not even for the increase in debt that could be linked directly to the COVID-19 crisis. This is a key difference with respect to US history: what enabled the 1790 American compromise was an understanding that the States' debt had been incurred in fighting a 'common enemy', a narrative that applies equally well to the portion of public debt incurred by EU members as a direct consequence of COVID-19. Yet, the European solidarity that emerged from this shock was still largely predicated on (debt-augmenting) loans and, at least in some quarters of the Union, it was seen as a strictly one-off event. Why was an unprecedented, symmetric and exogenous shock like COVID-19 not

enough to fully overcome the *North*/*South* political cleavage on fiscal solidarity in the EMU? This is the puzzle that is central to this work, where I will explore the political economy of the EU fiscal solidarity discussion both before and during the COVID-19 crisis. I will frame the puzzle by examining the Eurozone crisis and the COVID-19 crisis as part of a single intertwined model of change, where integration and dis-integration are two possible outcomes of self-reinforcing economic and political cycles. This model will be used to discuss how the political compromise adopted at Maastricht to solve the economics of Mundell's Trilemma set the basis for the divergence that would lead to the Eurozone crisis, and how the approach adopted to respond to the Eurozone crisis affects the degree of solidarity achievable in response to the COVID-19 crisis. I will also discuss whether and how the criteria underpinning the theory of Optimum Currency Area (OCA) can help explain the puzzle laid out in the introduction, and how the isolation (or inequality of opportunity) of one or more Member States may feed into disintegrative tendencies. I will show how the moral hazard argument that granting fiscal solidarity in a context of persisting economic misalignments would lead to permanent transfers is significantly weaker in today's Eurozone, following the sizeable macroeconomic and structural adjustment of the Euro-*South,* and I will also evaluate the issue of whether ideologies and macroeconomic policy preferences across countries differ enough to provide a convincing explanation to the puzzle of European solidarity. Ultimately, I will argue that the key to solving the puzzle is to be found in the idiosyncratic position of Italy within today's EMU. With public debt expected to 160% of GDP at the end of 2020, a stagnant growth dynamic (of both income and productivity) over two decades, an incomplete external competitiveness adjustment, and an exceptionally widespread political and popular Euroscepticism, it is beyond doubt that Italy will face an especially challenging economic and social outlook both during the COVID-19 crisis and in its aftermath. At the same time, no

country more than Italy embodies the issue of 'legacy debt' – a ghost that has haunted any post-2010 discussion about closer EU integration, most notably in the context of the Banking Union and on the topic of EMU macroeconomic governance reform. The fact that it represents a case of missed economic adjustment and interrupted convergence within the Eurozone, makes Italy's political position extremely weak. Unlike Spain and the other former Programme countries, Italy lacks the political capital to demand EU-level fiscal solidarity as a mean to avoid that the economic convergence achieved since 2010 be reversed, voiding the painful macroeconomic adjustment that made that convergence possible. As such, Italy has become the fulcrum of an economic and political conundrum that may make or break the EMU going forward. Its continued permanence in the euro is going to be increasingly difficult, absent a more significant acceptance of fiscal solidarity through either debt mutualisation, long-term transfers, or more implicitly through major changes to the rules of the Stability and Growth Pact (SGP). At the same time, any agreement on such level of fiscal solidarity within the EMU is and will be especially difficult, precisely because the country that needs it most is Italy. As such, it is hard to overstate the responsibility and the centrality of the role that Italy will have in setting the direction of travel for future EU integration (or dis-integration).

# 1. A Tale of Two Crises

## 1.1 An Intertwined Model of Change

The two crises that have marked the life of the EMU over the past 20 years are diametrically opposite events – one born out of an asymmetric shock endogenous to the economy, the other from a *symmetric* shock that had nothing to do with economic policymaking. Yet, the experience of a 'common catastrophe' of the proportions of COVID-19 was not enough for Europeans to reach an agreement on debt mutualisation comparable to the 'Hamiltonian moment' that set the stage for the federalisation of US fiscal policy. In this chapter, I will frame the puzzle that is central to this work by examining the Eurozone crisis and the COVID-19 crisis as part of a single intertwined model of change, where integration and dis-integration are two possible outcomes of self-reinforcing economic and political cycles. The foundation of the model presented here is the cumulative causal theory of integration developed in (Jones, 2018) after the work of (Myrdal, 1956) – a feedback-loop model where an economic integration cycle is accompanied and reinforced by a political cycle that goes in the same direction. As discussed in (Jones, 2018), this model can easily be made to go in reverse: breaking one of the self-reinforcing legs of the virtuous circle can turn the dynamic into a vicious one, where the compounded effects work towards dis-integration. It also lends itself well to analyse the influence of exogenous shocks (like COVID-19) as well as at the role of ideas – especially in explaining the switch from integration to disintegration and vice versa. This model will be used to discuss how the political compromise adopted at Maastricht to solve the economics of Mundell's Trilemma set the basis for the divergence that would lead to the Eurozone crisis, and how the approach adopted to respond to the Eurozone crisis

affects the degree of solidarity achievable in response to the COVID-19 crisis. I will also discuss whether and how the criteria underpinning the theory of Optimum Currency Area (OCA) can help explain the puzzle laid out in the introduction, and how the isolation (or inequality of opportunity) of one or more Member States may feed into disintegrative tendencies.

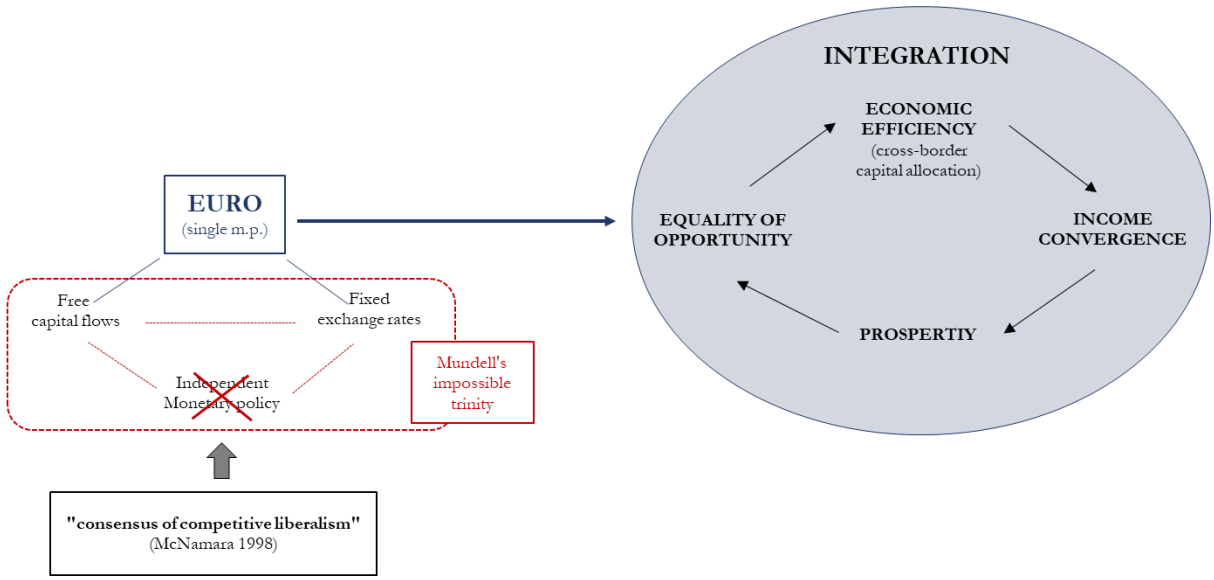
## 1.2 A Virtuous Cycle

In his 1956 work, Myrdal describes European economic integration as the "realisation of the old Western ideal of *equality of opportunity*[4]", occurring not as an isolated economic event but rather as the result of "interactions within a dynamic social process of cumulative causation" driven by interdependent factors and characterised by self-reinforcing dynamics. In the cumulative causal model of integration, the realisation of equality of opportunity leads to greater efficiency in the allocation of resources, resulting in economic prosperity, which in turn fosters income convergence and spurs a self-reinforcing virtuous cycle of economic (and political) integration[5]. Extending Myrdal's framework, *monetary* integration (and currency unification) can be thought of as the realisation of one specific form of equality of opportunity, namely *equal conditions in access to capital* for the countries belonging to what Myrdal calls the "underdeveloped rural South" and the "industrialised North" of Europe. This conceptualisation of monetary integration is aligned with the economic premises of monetary unification in Europe. Economic theory suggests that, in the absence of frictions, savings should naturally flow 'downhill' from capital-rich countries towards countries where capital

[4] Page 11, 12, 13 (Myrdal, 1956), emphasis is mine
[5] See (Jones, 2018) for a discussion.

is relatively scarcer and its remuneration relatively higher (such was the Eurozone *South* at the end of the 1990s)[6]. A central economic question in the run up towards EMU had been precisely how to ensure that the perfect capital mobility needed for countries to be able to access financing on equal terms ('equality of opportunity') were compatible with fixed exchange rates in the persistence of separate monetary policy regimes. This conundrum – identified by Robert Mundell in his 1961 seminal paper as an 'Impossible Trinity'[7] – was solved politically by the decision to abandon independent monetary policy and form a European currency union (Figure 1).

**Figure 1 The Virtuous Circle**




Source: own elaboration, based on the work of (Jones, 2018) and (Myrdal, 1956)

[6] The fact that after World War I capital was not, in fact, flowing downhill was described as a "paradox" by Robert Lucas in a famous 1990 paper.
[7] See (Mundell, 1961)

By eliminating the exchange rate risk, the single currency allowed capital to flow seamlessly from the capital-rich *North* to the capital-poor *South*, yielding what economic theory would describe as a more efficient resource allocation[8]. This in turn spurred nominal income growth ('prosperity') in the recipient countries and led to a convergence of standards of living in the EMU – both across and within countries – very much along the lines of the cumulative virtuous circle of economic integration described in (Jones, 2018). The magnitude of this positive feedback loop during the decade preceding the Global Financial Crisis (GFC) is easily quantifiable: a simple absolute beta convergence analysis suggests that real per capita income converged across EU regions at a rate of 2.7% between 2000 and 2007 and converged across Eurozone regions at a rate of 1.5% (Merler, 2016). The policy choice to pursue the free circulation of capital was aligned with the political objective to complete the transformation of the Common Market into a Single Market, where 'equality of opportunity' would be realised in "southern countries [having] at their disposal some of the capital which the richer countries of the region kept for themselves"[9].Monetary integration is thus a choice replete with potential solidarity implications – which are laid out quite clearly in the theory of Optimum Currency Areas (OCA), the intellectual reference framework for the EMU process. OCA theory originated with the seminal contributions of Mundell (1961), Mc Kinnon (1963), and Kenen (1969). The theory aims at establishing criteria to be fulfilled by countries that aspire to share a single currency, to ensure the sustainability of the resulting monetary union vis-à-vis asymmetric shocks, which raise the cost of abdicating monetary sovereignty in the trade-off for exchange rate stability and free capital flows. Monetary policy is less efficient in

[8] Efficient in the sense that capital would flow 'downhill', to where the relative remuneration rate of capital was higher. This was the prevalent interpretation of EMU macroeconomic imbalances before the crisis (see (Blanchard & Giavazzi, 2002)) but it is not unproblematic, as acknowledged later in e.g. (Giavazzi & Spaventa, 2010).
[9] Page 64 (Myrdal, 1956)

managing a negative economic shock affecting only some of the members in a monetary union, because by targeting the average economic cycle, the single monetary authority can only compensate for part of the fallout. To be fully functional, a monetary union therefore requires countries to either be 'similar' enough in their economic structures to minimize the risk of experiencing asymmetric shocks – a feature that the original members of the EMU lacked. Absent that, an OCA would require countries to share homogeneous preferences as to how asymmetric shocks should be dealt with, coupled with strong reaction mechanisms that the literature identifies in factor mobility or the willingness to set up transfer payments to support the recovery of the hardest-hit countries.

The choice to share the same currency then logically implies a change in the understanding of the creditor and debtor positions stemming from balance of payment relations internal to the currency union. This issue – which the intellectual consensus leading up to currency unification expected to be made irrelevant by the very introduction of the single currency – would turn into an existential threat to the continued existence of the euro, during the Eurozone crisis. In one of the earliest papers on EMU, (Ingram, 1973) noted that in a monetary union "payments imbalances among member nations can be financed in the short run through the financial markets, without need for interventions by a monetary authority" and therefore "intracommunity payments become analogous to interregional payments within a single country". This 'benign' view of intra-EMU balance payments relations quickly became conventional wisdom. The European Commission *One Market, One Money* landmark report published in 1990 posited that "a major effect of EMU [would be] that balance-of-payments constraints will disappear [..]. Private markets will finance all viable borrowers, and savings

and investment balances will no longer be constrained at the national level"[10]. It was a very powerful notion, implying that currency unification would render country-specific intertemporal budget constraints irrelevant from an economic standpoint, like we observe across regions within countries[11]. This view was so widespread, in the early 1990s, that the Maastricht negotiators decided to exclude members of the EMU from access to the EU Balance of Payment (BoP) Assistance facility established under Article 143 of the Treaty. It was believed that they would never need it. A lone challenger to the 'benign' view was (Garber, 1998), who argued that the federal structure of the Eurosystem and the continued existence of national central banks with separate individual balance sheets made it possible to imagine a speculative attack even within a monetary union. According to Garber, "as long as some doubt remain[ed] about the permanence of Stage III exchange rates, the existence of the currently proposed structure of the ECB and TARGET [would] not create additional security against the possibility of an attack". Garber expected the trigger of such an attack to be an asymmetric economic shock, where financial markets would bet that "finance ministers and central bank officials might be unable to reconcile excessive unemployment in one region – particularly in the absence of major new inter-EMU redistributive mechanisms". This crucial observation pointed to a major inconsistency: the benign view of balance of payment irrelevance rested on the disregard of a key difference between regions within a country, and countries within a supra-national monetary union: the existence, within countries, of explicit fiscal solidarity mechanisms the like of which did not exist across countries within the EMU. The European Commission's *One Market, One Money* report was prescient of this

[10] Page 24, (European Commission, 1990)

[11] A sizeable body of research has looked at cross-regional capital mobility within countries, finding the Feldstein-Horioka correlation coefficient to be insignificant (Bayoumi and Rose 1993; Dekle 1996; Bayoumi 1999). A similar result holds for countries within the euro area, from the introduction of the euro till the crisis (Merler 2016).

inconsistency, which is mentioned when discussing the effect of currency unification on fiscal discipline. “On one hand”, the Commission wrote, “participation in EMU is indeed disciplinary since it implies the acceptance of monetary discipline and therefore the renunciation of debt monetization”. But “on the other hand, markets cannot be expected to behave as if solidarity across Community Member States was completely ruled out, since concerns for solidarity are integral to the philosophy of the Community”[12]. In addressing the issue of distributive implications, it was noted that “financial difficulties in one Member State would raise the issue of financial solidarity across the Community. At the extreme, this would take the form of pressures to bail out an insolvent government. But milder forms of solidarity [could] exist, e.g. through the purchase by [the Central Bank] of a disproportionate share of public bonds from a specific country (which would be equivalent to a Community loan) or in the form of explicit transfers”[13]. The Commission hence seemed to assume that the enterprise of currency unification ought to be based on a common understanding that solidarity may ultimately be needed to counteract asymmetric shocks – be it through an explicit acceptance of transfers or through a geographical targeting of monetary policy, which interestingly the Commission sees as indistinguishable from a community loan. This is what financial markets seemed to be thinking as well. (Arghyrou & Kontonikas, 2011) clearly show that in the decade leading up to the Eurozone crisis, markets were discounting only a scenario of full convergence to German fundamentals – including for those countries that at the time were accumulating large macroeconomic imbalances. Market participants seemed to be operating under the assumption that the ‘no-bail out’ clause in the Maastricht Treaty was not fully credible, and that *de facto* an implicit guarantee existed that would minimize the default risk

[12] Page 100, (European Commission, 1990)
[13] Page 107, (European Commission, 1990)

associated with investment in EMU sovereign debt. The near-zero spread values on EMU members' debt observed between January 1999 and July 2007 can be interpreted as evidence that markets expected a fully credible EMU commitment under the perception of fiscal guarantees, which resulted in a complete de-linking of macro fundamentals from the interest rates charged on debt.

Yet, this implicit solidarity assumption was hardly a premise on which participating Member States in the Euro-*North* had based their decision to join the EMU. As concisely but effectively synthetised by Martin Sandbu in his 2014 book: "deficit countries were offered prosperity and equality with Germany […]. The Germans, and their fellow surplus countries, were promised they would never need to subsidize others, and even secured a Treaty article that they thought outlawed such subsidies[14]". Solidarity was not a stated principle in the ideational convergence that ultimately made the EMU possible. As Kathleen McNamara argues in her constructivist analysis of European monetary cooperation, the key to explain the choice for currency unification lies "in the historic policy convergence that occurred across the majority of European governments beginning in the mid-1970s and solidifying in the 1980s. A neoliberal policy consensus that elevated the pursuit of low inflation over growth, or employment[15]". This consensus constituted a break with the prevailing divergence of economic policy paths and priorities of European countries during the Bretton Woods era, and a major ideational shift in the way to perceive and operate the key policy levers in the economy. It was this ideational shift that ultimately led countries to agree on resolving Mundell's trilemma by abandoning independent monetary policy in favour of a single

[14] Page 8 (Sandbu, 2014)
[15] Page 3 (McNamara, 1998)

currency (see Figure 1). Yet, the solidarity implications of that political choice did not find much space in the newly found ideational consensus. In McNamara's account, three interacting factors were driving this intellectual convergence. First, changing economic conditions – especially the raise of capital mobility – led to the failure of the then-dominant economic policymaking paradigm (Keynesianism). Second, this disruption created the space for the emergence of an alternative economic idea (Monetarism), which became increasingly relevant in the definition of policymakers' macroeconomic policy preferences. And last, the existence of a successful example of 'pragmatic monetarism' – embodied in Germany – solidified and legitimised the paradigm reversal. Years later, Paul De Grauwe[16] would speak of a 'Brussels-Frankfurt consensus', grounded in the economic prescriptions of monetarism on the theoretical side and relying on real business cycle theory on the operational one. At its core, however, the ideational consensus from which the euro was born was a 'consensus of competitive liberalism'[17], which left little or no space to the idea of *solidarity*[18] - at least as a 'cooperative effort from a shared political perspective to promote growth and competitiveness in the euro zone as a whole' (Habermas, 2013).

## 1.3 The Switch

The cognitive dissonance between markets and political leaders on the issue of Eurozone solidarity came to a head in November 2009, when Greece fell under heightened funding pressure following the revelation of extensive fiscal misreporting over the previous years.

[16] (De Grauwe, 2006)
[17] Page 63 (McNamara, 1998)
[18] See (Jones, 2012) and (Jones & Matthijs, M, 2017) for a discussion

Presented with the choice of whether to live up to the implicit guarantee of solidarity that the financial markets believed existed, EMU heads of state and government balked. As a result, in the eyes of investors Greece switched from "a regime of fully credible commitment to future EMU participation under the perception of fully guaranteed […] fiscal liabilities, to a regime of non-fully credible EMU commitment without fiscal guarantees"[19]. The first shift occurred in November 2009, with the Greek spread increasing from 130 basis points to 240 basis points by the end of the year. As compellingly discussed in (Arhgyrou & Tsoukalas, 2010), the unambitious nature of the 2010 budget submitted by the Greek authorities at the end of 2009 disappointed EU officials and markets alike. Things then precipitated in early 2010 – when the spread on Greek government debt skyrocketed from 240 basis points to nearly 700 basis points. The key reason behind the harsh re-pricing of Greek risk was the emergence of a clear disagreements among European leaders regarding the need and feasibility of a Greek bail-out, including the insistence by some that the no-bail-out clause in the Treaty would render any lending to a Eurozone member illegal. This disagreement shattered completely the perceived implicit fiscal guarantees that markets had assumed existed, resulting into a repricing of default risk across the board for all the countries having weak macroeconomic fundamentals (Portugal, Ireland, Spain and Italy). In the absence of clear political commitment, the yield on debt issued by these countries started to incorporate a premium for what had become a positive probability of Eurozone break-up risk. While an agreement was eventually found on a bail-out for Greece, and in May 2010 EMU leaders also agreed to create the European Stability Mechanism (ESM) to help bailing out other Eurozone countries in need, expectations had shifted irreparably due to the choices undertaken in the early

[19] See (Arghyrou & Kontonikas, 2011)

phases of a crisis that had brought the issue of solidarity front and centre. In the context of the cumulative model of integration described in the previous section, we can think of the Eurozone sovereign debt crisis as a regime-change that precipitated the EMU from the *virtuous* circle of integration described in Figure 1 into an equally self-reinforcing *vicious* circle of disintegration (Figure 2 and 3). As country-specific default risk resurfaced in the divergence of sovereign bond yields, the equality of opportunity in access to international capital spurred by monetary unification waned. Access to capital went back to being significantly more expensive for countries in the Euro-*South* than for countries in the *North*, both for sovereigns and for corporates. The widening of spreads was the mirror image of a capital flight, which was redirecting (inefficiently) resources from the Euro-*South* to the (perceived to be safer) Euro-*North*. In the attempt to stave off the skyrocketing of sovereign yields – and the associated freefall in the price of government bonds – banks in the Euro-*South* purchased massive amount of government debt issued by their domestic governments, acting as a shock absorbing sponge. The increased exposure of banks to domestic sovereign risk, however, resulted into a 'sovereign-banking vicious circle'[20] that would emerge as the characteristic feature of the Eurozone crisis. As the price of government bonds in the Euro-*South* plunged, so did the value of the assets of those banks that were more heavily exposed to their domestic sovereign, increasing the risk of bank losses and creating the need for capital injections. In the absence of private investors willing to step up at such a difficult time, banks were largely recapitalised by national governments. These operations of recapitalisation had the effect to shift large amounts of private debt onto public books, casting doubts on the sustainability of public finances in the weakest countries – which in turn translated into a further repricing of

[20] See (Merler & Pisani-Ferry, 2012) for a more detailed and extensive discussion.

default risk and pushed up the yield on public debt even further. Higher government bond yields – and hence lower prices – in turn resulted into a further deterioration of banks' asset quality, in a self-reinforcing negative feedback loop. Meanwhile, pressured by the need to raise capital, banks cut back on their lending to the real economy, thus worsening the economy's prospects. Economic hardship ensued in the countries came under market pressure, and with it came the unravelling of the nominal income convergence achieved during the first decade of monetary unification in a self-reinforcing cycle of dis-integration (Figure 3, left). Again, the magnitude of these negative effects on income convergence is easily measurable: while per capita income in the EU non-euro regions continued to converge during the 2007-14 period, in the Eurozone we observe divergence at a rate of 1.5% per year (Merler, 2016).

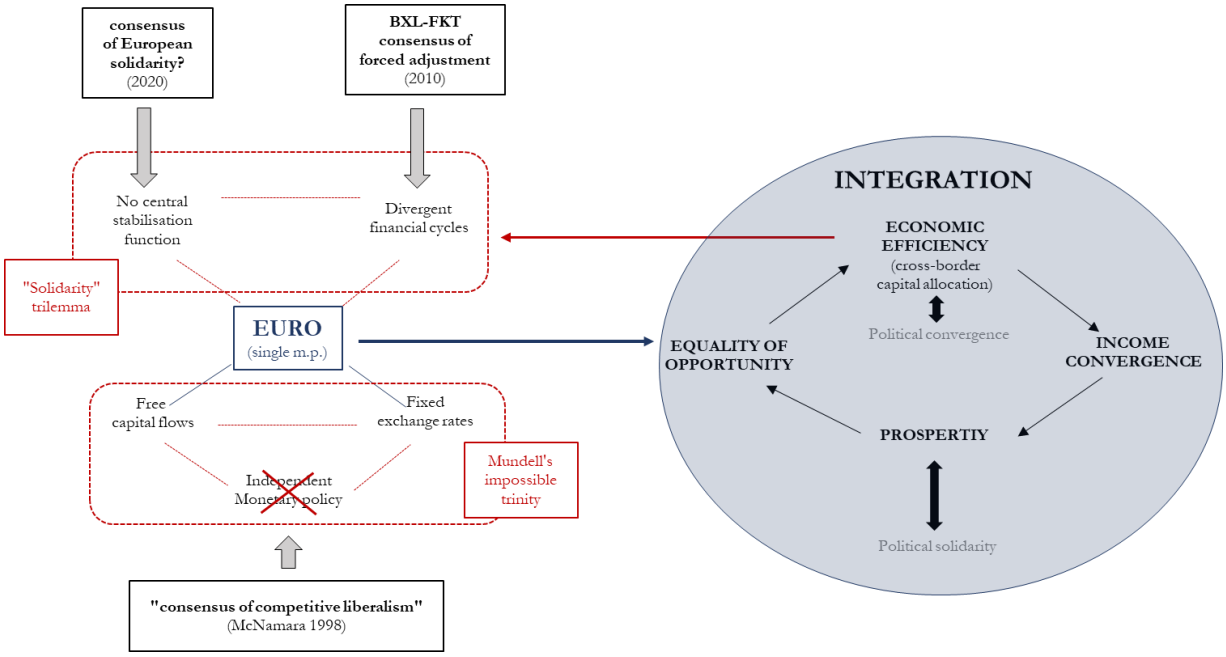
When framing the Eurozone crisis in the context of the cumulative causal model described in Section 1.1, a key question is how to conceptualise 'the switch', i.e. the mechanism that triggered the inversion of the cycle from virtuous cumulative integration to vicious cumulative disintegration. To some extent, the roots of the disintegration cycle can be traced back to an exogenous shock: the US-born Global Financial Crisis spilled over to Europe – through the exposure of part of the European banking system to the US market for securitised mortgage products – and created the negative market conditions that were the pre-requisite for the issue of solidarity to become salient. Yet, this would be only part of the story. A satisfactory explanation of 'the switch' requires looking also at contribution of path dependency and role played by ideas at times of structural break. In large part, the origin of the reversal can in fact be traced back to the nature of the virtuous integration cycle that was abruptly stopped in 2009. In a heterogeneous economic union with free capital flows and fixed exchange rates,

monetary policy unification and the ensuing nominal convergence of interest rates had triggered massive capital flows and a significant divergence in local financial cycles, which had led to the accumulation of sizeable macroeconomic imbalances in the Euro-*South*. The choice to solve Mundell's trilemma by abandoning independent monetary policy had indeed set in motion a virtuous economic and political integrative dynamic, but it had also created latent vulnerabilities which would later become a challenge to the ideational consensus that had made the EMU possible in the first place. The consensus of competitive liberalism rested on assumed that countries had 'homogeneous preferences' regarding the management of asymmetric shocks, resting on three convictions. First, that asymmetric shocks should be dealt with by increasing flexibility. Second, that the rules of the Stability and Growth Pact (SGP) would allow countries to use national fiscal policies efficiently enough to deal independently with cyclical asymmetric shocks. And third, that the SGP rules and the ECB's policy of inflation targeting would make a system-wide budgetary policy to stabilise the business cycle unnecessary. While sufficient to guarantee exchange rate stability, this structure however turned out to be not robust enough to guarantee financial stability. By fitting a fictional Eurozone average on very diverse countries that had not undergone a process of real economic convergence, the single monetary policy could not prevent – to some extent it fuelled – the divergence of financial cycles within the EMU[21]. The Eurozone crisis hence laid bare a new trilemma which, as discussed also in (Nicoli, 2019), logically descended from the choice taken to solve Mundell's original conundrum: absent the central stabilization function that markets had long erroneously assumed existed, the combination of single monetary policy and divergent financial cycles was bound to produce the very type

[21] See (Darvas & Merler, 2013)

of balance of payment crises that the single currency was supposed to render impossible. This is what happened between 2010 and 2012, when the asymmetric shock of the Eurozone crisis hit: absent the will to engage in transfers to compensate the shock, several EMU members experienced sudden stops in international capital flows of the kind and magnitude typically observed in emerging markets under fixed exchange regimes[22]. Capital flows, which Eichengreen had in 1997 identified as a stabilisation tool against asymmetric shocks in a monetary union, proved to be a dangerous double-edged sword.

**Figure 2 At the Tipping Point**




Source: own elaboration, based on the work of (Jones, 2018) and (Myrdal, 1956)

[22] See (Merler & Pisani-Ferry, 2012) for a discussion.

If path-dependency is key in explaining the build-up of the macroeconomic vulnerabilities that led to the Eurozone crisis, to explain the switch from integration to disintegration one also needs to account for the role of ideas. Even considering the pre-existing macroeconomic vulnerabilities stemmed from the choices made in the run-up to monetary unification, the outcome of the GFC exogenous shock could in principle have been either negative or positive for integration. While the choice to abandon independent monetary policy had *implicit* solidarity implications – through the change that currency unification implied for the conceptualization of balance of payment relationships in the EMU – the solidarity implications inherent to the 'new' trilemma that emerged during the Eurozone crisis were much more explicit (Figure 2). If renouncing to the single currency was not an option, then the policy choice was between forcing a re-convergence of financial and economic cycles and creating a central stabilisation function to compensate for financial divergence while easing the macroeconomic adjustment. The conceptual difference between the two options is paramount: option 1 constitutes an attempt to reconcile a new trilemma *within* the boundaries set by the old consensus of competitive liberalism, while option 2 amounts to an ideational shift towards a *new* consensus featuring an explicit acceptance of intra-EMU solidarity. In 2010, political leaders chose to go for what could be described as a 'Brussels-Frankfurt consensus of forced adjustment', predicated on the view that asymmetric shocks had to be dealt with through domestic price adjustment to deliver internal devaluation (Figure 2).

## 1.4 Cementing the Brussels-Frankfurt Consensus

That the choice taken to reconcile the 'solidarity trilemma' was a first order change within the original ideational framework of competitive liberalism is evident in the institutional structure put in place to operationalise that choice. The Macroeconomic Imbalance Procedure (MIP) and the creation of a European Banking Union both aim at preventing internal balance of payment crises of the type seen between 2010 and 2012. The MIP is based on the idea to keep countries 'out of trouble' by monitoring and curbing *ex ante* those imbalances that can arise naturally in a heterogeneous union subject to a single monetary policy, effectively forcing a degree of alignment across different countries' macroeconomic models The idea underpinning the Banking Union – at least in the 2012 Council statement that first mentioned the term – was to break the vicious circle between banking crises and sovereign crises, by taking the banks' destiny largely out of the hands of governments. This was to be achieved through a single rulebook (including limitations for state aid in banks' recapitalisation), a single supervisory function, and a single resolution mechanism – all outsourced to European institutions. Neither the MIP nor the BU however included any explicit mention of, or commitment to, solidarity. The MIP is by deliberate construction asymmetric, penalising excessive current accounts deficits more than excessive current account surplus – despite these being two faces of the same underlying problem. The BU on the other hand remains incomplete, as no agreement has yet been found on a common deposit insurance – the only block in the construction that would require acceptance of explicit solidarity. The creation of the European Stability Mechanism (ESM) aimed at remedying the decision to exclude Eurozone members from the EU balance of payment assistance facilities. The ESM is conceptually in line with the set up of the EU and IMF balance

of payment assistance: it is a lender that enjoys preferred creditor status and that lends only under strict macroeconomic conditionality for the recipient countries, without creating any joint and several liabilities for the countries that back it with capital and guarantees. Much like the IMF balance of payment assistance for emerging markets, ESM lending has come to be seen as a 'last resort' option for European countries at risk of losing market access and be unable to independently refinance their debt. The stigma associated to ESM assistance has become so powerful that governments would go to great length to avoid sending the 'signal' that they may need an ESM loan, even when assistance would be free of macroeconomic conditionality – as is the case with the *ad hoc* ESM Pandemic credit line that no country has resorted to (see Chapter 5).

On the monetary policy front, the ECB's long-term repurchase operations (LTROs), introduced during the GFC and extended during the Eurozone crisis, were subject to heavy criticism in some quarters of the Union. Prominent representatives of the German economic establishment asked for the collateralisation of the asymmetric credit and liability positions emerging in the TARGET2 payment system as a consequence of the central bank's liquidity provision – a request conceptually equivalent to revoking the full fungibility of the euro across national borders. If the functioning of TARGET2 has been described by some as a form of 'solidarity by stealth'[23], other features of the ECB's unconventional monetary policy operations are even less ambiguous in ruling out solidarity. The risk associated to the Emergency Liquidity Assistance (ELA) – a facility that provides liquidity to banks still solvent but facing heightened liquidity problems – remains on the books of the national central bank

[23] See (Schelkle, 2017)

individually providing the liquidity, rather than being consolidating at the central level. Even the Asset Purchase Programme (APP) – the Eurosystem's flagship Quantitative Easing programme – is structured so that that the risk of losses is only be shared on 20% of the purchases, of which 12% is constituted of securities issued by EU institutions and only 8% by national securities held at the ECB. Even the ECB's Outright Monetary Transactions (OMT) – the result of Mario Draghi's famous 'whatever it takes' statement that succeeded in restoring markets' trust in the irrevocability of the single currency – is constructed as a sort of 'monetary policy with conditionality', whereby the ECB effectively subjects part of its action to an exogenous political decision on ESM-like conditionality (Darvas & Merler, 2013). Moving into the remit of the European Commission, the Eurozone crisis triggered a tightening and increase in complexity of the EU fiscal framework. While the introduction of flexibility clauses in the application of this framework has resulted into a strict enforcement, in essence that flexibility it did not alter the ideological framework underpinning those rules, which are still solidly anchored on the Brussels-Frankfurt macroeconomic governance consensus.

## 1.5 A New Crisis

The institutional choices made in response to the Eurozone crisis and described in section 1.3 found their ultimate ideological justification in the fact that the Eurozone crisis was an *asymmetric* event, very much in line with the risk highlighted in the OCA theory, and whose causes were endogenous to economic policy choices. This provided plausible deniability to a successful narrative of the crisis that counterposed 'sinners' and 'saints', having as its logical corollary the decision to resolve the crisis through a punishing asymmetric adjustment rather than through solidarity. The asymmetric adjustment under irrevocably fixed exchange rates

proved to be very painful. As anticipated in (McNamara, 1998), it became evident that "the consensus of competitive liberalism [could] create exchange rate stability despite rising capital mobility, but [could not] assure politically acceptable levels of employment and growth"[24]. The ten years following the outbreak of the Eurozone crisis were marked by an impressive degree of real economic convergence within the Eurozone – which happened unilaterally through a massive re-alignment of financial cycles in those countries that had previously accumulated the largest imbalances. This dynamic played into the dispute the in the run up to currency unification had split the economic profession into 'economists' – who called for real economic convergence as a pre-condition for monetary unification – and 'monetarists' – who argued that nominal convergence would endogenously produce real convergence. At the time, the monetarist approach prevailed, only to be proven wrong by the macroeconomic developments the first decade of the EMU, when nominal convergence went hand in hand with real divergence. The macroeconomic adjustment programmes enacted in response to the Eurozone crisis forced the kind of real convergence that the 'economists' had advocated, through a unilateral restructuring of the Southern growth models. Real convergence is most strikingly visible through the lens of monetary policy: in 2018, contrary to what had been the case for the first 10 years of EMU, the interest rate prescription from a simple Taylor Rule would have been remarkably homogeneous across Eurozone countries and, differently from 2010, financial and credit cycles were aligned across the Euro-*North* and the Euro-*South* (Focella & Merler, 2020). Through the macroeconomic adjustment of the South, the EMU had moved from a world where one-size monetary policy fit none, to a world where one-size monetary policy would fit most. Importantly, this structural change implied

[24] Page 11 (McNamara, 1998)

that the ground for moral hazard arguments against centralised fiscal stabilisation was shrinking. Yet, the question of how to reconcile the 'trilemma of solidarity' to make perfect capital mobility compatible with the pursuit of employment, growth and democracy, remained unresolved[25].

An answer seemed to be forthcoming in 2018, when the Eurogroup of EMU finance ministers started discussing the idea of countercyclical stabilization for the Eurozone in the form of a Budget for Investment, Competitiveness and Convergence (BICC). Soon enough, however, it became clear that the BICC risked being quite far from a genuine countercyclical stabilization instrument and closer to a hybrid between a mild macroeconomic adjustment programme and a duplicate of the existing cohesion funds framework. As a result of this stalemate, when the COVID-19 pandemic hit, the Eurozone had no instrument that could prevent a symmetric health shock from triggering very asymmetric economic effects across countries with diverse pre-existing conditions. During spring and summer 2020, real-time data on Member States' use of state aid measures provided clear evidence of how the ability to spend in order to mitigate the economic impact of COVID-19 varied considerably across countries and how different the impact on the available fiscal space was going to be for the coming years. In its Spring 2020 forecast, the European Commission was expecting the German debt to GDP ratio to remain below 80% at year-end – despite Germany's unprecedentedly massive resort to fiscal spending. On the other end of the spectrum, Italian debt was forecasted to reach almost 160% of GDP, and France and Spain were both expected to close the year with a debt load worth over 100% of their national income. If left unaddressed, this asymmetry would lead to

[25] See (Matthijs, 2017) for a discussion of the EU democratic deficit in the context of the Eurozone adjustment.

divergence in the speed of the economic recovery and narrow considerably the path to debt sustainability in the Euro-*South*. While not an immediate threat to financial stability, the risk of disintegration into a two-speed Eurozone was sizeable. Ensuring the long-term survival of the single currency hinged once again on resolving the unsolved solidarity trilemma. However, views about how the trilemma should be resolved proved still quite diverse across Europe. Italy and Spain, with the support of France, immediately called for explicit fiscal solidarity through some form of mutualisation of the 'COVID debt' – i.e. the portion of domestic debt issued in response to the pandemic shock. On the other hand, Chancellor Merkel stated during the end of March EU summit that she did not envision debt mutualisation as part of a European response to the COVID-19 crisis, suggesting instead that fiscally constrained countries resort to the ESM. On the same occasion, Dutch Finance Minister Hoekstra reportedly called for Brussels to investigate why some countries did not have enough fiscal room for manoeuvre to weather the economic impact of the crisis on their own and demanded that any help came with macroeconomic conditionality. The initial political reactions from Northern European politicians were overall indicative of a preference for continuing in the tradition of the 'Brussels-Frankfurt consensus of forced adjustment', an attempt at reconciling the solidarity trilemma once again within the boundaries set by the old consensus of competitive liberalism. Nowhere was this approach more evident than in the work of the Eurogroup – which was tasked to discuss an ESM-based instrument to address the pandemic-related spending constraints in the hardest-hit countries. Meeting on March 4th 2020, the Eurogroup recognised[26] that the virus had "hit some areas particularly hard"

[26] See the Eurogroup statement released on 4th March 2020: https://www.consilium.europa.eu/en/press/press-releases/2020/03/04/remarks-by-mario-centeno-following-the-eurogroup-conference-call-of-4-march-2020/?utm_source=dsms-

and that "the response [had] been differentiated" but still framed the rationale for further policy action clearly within the flexibility for "unusual events outside the control of government" embedded in the Stability and Growth Pact (SGP). The underlying view seemed to be that the crisis was once again asymmetric, and hence that it did not warrant a deviation from the playbook used during the Eurozone crisis.

Even ECB's President Christine Lagarde initially fell for this misconception. During a press conference in early March, after announcing a new round of EUR 120 billion of the ECB's Asset Purchase Programme (APP)[27], Lagarde was asked what the ECB would do if sovereign spreads were to increase for the hardest-hit countries and she replied infamously that the ECB was not there "to close the spreads". The comment spurred a negative market reaction and a political outcry from the Euro-*South*, eventually leading the ECB to announce on March 19th a new EUR 750bn Pandemic Emergency Purchase Programme (PEPP), which would later be increased to EUR 900bn and extended throughout 2021. PEPP constituted a radical change from the previous approach to QE: while the **s**overeign purchases under the new programme were still formally allocated according to the capital key rule, the ECB stated explicitly that it would apply more flexibility to the self-imposed limits (see Chapter 5). The programme constituted the first serious recognition at European level that the crisis required a forceful and centralised response to stave off the risk of an asymmetric recovery. PEPP was good to manage the immediate emergency, because it provided states with a safety valve for the debt that they needed to issue in a short span of time to fund the health response and provide a

auto&utm_medium=email&utm_campaign=Remarks+by+M%C3%A1rio+Centeno+following+the+Eurogroup+conference+call+of+4+March+2020

[27] See the press release at https://www.ecb.europa.eu/press/pressconf/2020/html/ecb.is200312~f857a21b6c.en.html#qa

safety net for the economic activities that would need to be 'frozen' for months. While helpful to reduce funding pressure in the short-term, however, the ECB's action could not address the long-term imbalance in the economies of Member States from the asymmetric debt legacy that COVID-19 would leave behind.

## 1.6 Testing the Limits

On March 20th, the European Commission proposed activating the general escape clause that suspended the application of all fiscal rules in the Stability and Growth Pact (SGP). The proposal was endorsed by the European Council shortly after, but the thorniest topic of discussion was whether the additional debt that countries would incur to finance the post-COVID recovery should stay on national books or be mutualised. The Italian Prime Minister's proposal of issuing 'Coronabonds' to finance the recovery was discussed by EU ministers on March 17th, with no agreement – despite the idea gaining some traction in part of the German academic establishment, as seven prominent German economists published an op-ed in the conservative daily FAZ where they advocated for EUR 1 trillion in common bonds (Südekum, et al., 2020). Former ECB President Mario Draghi also weighed in early on the debate, with an op-ed in the Financial Times where he argued that the speed of the deterioration of private balance sheets "must be met by equal speed in deploying government balance sheets, mobilising banks and, as Europeans, supporting each other in the pursuit of what is evidently a common cause" (Draghi, 2020). Meeting on March 24th, however, the Eurogroup was so divided on the issue that it did not even release a conclusive statement – leaving it to

President Centeno to summarize the state of affairs in his remarks to the press[28]. Centeno said that the Eurogroup had discussed "a Pandemic crisis support safeguard based on an existing ESM precautionary instrument, such as the Enhanced Conditions Credit Line (ECCL)", which "would need to be consistent with the external, symmetric nature of the COVID-19 shock" including for any attached conditionality. In the short term it would be "targeted to coronavirus response and in the longer term, countries [would be] expected to return to stability". These remarks suggested that Eurogroup was warming to the idea that a global exogenous shock did not warrant the kind of macroeconomic conditionality that ESM lending would normally be subject to but was not in agreement on what the alternative would be. After an inconclusive summit of European leaders at the end of March, on April 9th the Eurogroup delivered what appeared to be a first breakthrough on addressing the economic fallout from COVID-19, articulated in three components. First, the Eurogroup endorsed the Commission's proposal to create a centralised unemployment support instrument (SURE), which would provide EUR 100 billion in loans granted on favourable terms from the EU to Member States. Second, the ministers agreed to establish a Pandemic Crisis Support tool for the ESM, based on the existing ECCL precautionary credit line. The details would be published one month later[29]: the special credit line would be available to all Eurozone Member States until 2022, with a maximum average maturity of 10 years and extremely low interest cost. Each member would be allowed to draw up to 20% of its GDP, for a total Eurozone capacity

[28] See https://www.consilium.europa.eu/en/press/press-releases/2020/03/24/remarks-by-mario-centeno-following-the-eurogroup-meeting-of-24-march-2020/ and also the letter sent by the President of the Eurogroup to the President of the European Council https://www.consilium.europa.eu/en/press/press-releases/2020/03/25/letter-of-eurogroup-president-mario-centeno-to-the-president-of-the-european-council-following-the-eurogroup-of-24-march-2020/

[29] See https://www.consilium.europa.eu/en/press/press-releases/2020/05/08/eurogroup-statement-on-the-pandemic-crisis-support/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Eurogroup+Statement+on+the+Pandemic+Crisis+Support

EUR 240 billion. The only requirement to access the credit line would for the requesting Member States to use the funds solely to finance the cost of direct and indirect healthcare, cure and prevention measures related to the COVID 19 pandemic. There would be no programme-style macroeconomic conditionality, nor the enhanced surveillance that would typically apply to Member States using an ECCL. Eligibility would be determined based on an upfront debt sustainability analysis run on all countries at the same time. Third, the ministers also agreed to work on an EU 'Recovery Fund' to provide funding through the EU budget to programmes in line with European priorities and ensuring EU solidarity with the most affected Member States. Importantly, the Eurogroup statement mentioned that the discussion would focus on the fund's "relation to the EU budget" and potentially "on innovative financial instruments", which many took as codeword for the exploration of joint debt issuance. While no country seemed eager to apply for help from the new ESM Pandemic Support tool – which would end up not being used – the Recovery Fund quickly became the focus of attention[30].

The highly anticipated summit of EU leaders on April 23rd however failed to provide political guidance to the ministers on the thorniest points in the Recovery Fund discussion, and instead tasked the European Commission to make a proposal on the matter[31]. Meanwhile, on May 5th, the German Constitutional Court delivered a shocking verdict on the ECB's Public Sector Purchase Programme – the QE programme targeted to sovereign bonds – that risked inflicting a serious blow to the post-COVID recovery and challenging monetary integration more generally. In a judgement on PSPP issued in July 2017, Karlsruhe had dismissed a plaintiffs'

[30] See (Creel, et al., 2020)
[31] See https://www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/

claim that PSPP was illegal monetary financing. At the same time, however, the Court had argued that PSPP was an economic policy measure potentially exceeding the ECB's mandate and that secondary market purchases under PSPP would not be clearly distinguishable from primary purchases – hence potentially affecting the Bundestag's right to decide on the budget (*Budgetrecht*)). The European Court of Justice (ECJ) had subsequently dismissed the German Constitutional Court's view and stated that PSPP could not be held in violation of the prohibition of monetary financing nor exceeded the ECB's mandate. The argument used by the ECJ was that "as regards the procedures for implementing the PSPP, the way that programme is set up also helps to guarantee that its effects are limited to what is necessary to achieve the objective concerned, in particular because, since the PSPP is not selective, the ESCB's action will have an impact on financial conditions across the whole of the euro area and will not meet the specific financing needs of certain Member States of that area." The same argument was used by the ECJ to dismiss the risk of monetary financing from PSPP, by recalling the safeguards in the form of the self-imposed limits in the PSPP's design. In its May 2020 landmark judgement, the German Constitutional Court argued that the ECJ had exceeded its authority in its 2018 ruling and it intimated to the ECB to provide additional evidence to support the proportionality of PSPP. This ruling effectively superseded the ECJ's jurisprudence and opened a constitutional struggle[32] that would eventually lead the European Commission to threaten the opening of infringement proceedings against Germany[33]. What was most shocking in Karlsruhe's decision were the potentially disruptive implications for the future of EMU. While having no jurisdiction on the ECB, the German Constitutional Court did

[32] For an analysis of the constitutional and political implications of the German Constitutional Court judgement, see (Bobic & Dawson, 2020) and (Jones, 2020)
[33] See https://twitter.com/sven_giegold/status/1259141585595437056

theoretically have jurisdiction to order the German 'branch' of the ECB – the Bundesbank – to suspend its participation in the Eurosystem's QE. If order to do so, the Bundesbank would have needed to choose between its legal obligations as a German institution (hence subject to the authority highest court in the land) and its obligation as a member of the Eurosystem (hence required to be independent from any local political interest). In any case, any such order from Karlsruhe would have been enough to cast again very serious doubts on the future of the EMU, the continued German participation in it, and hence the irrevocability of the single currency. Eventually, well into 2021, the German Constitutional Court declared itself satisfied with the evidence provided in support of the proportionality of PSPP. But by demonstrating the risk that local courts could force the hand on ECB's monetary policy, Karlsruhe highlighted the importance of reaching an agreement on an EU fiscal initiative to back the action of the monetary authority.

## 1.7 A New Consensus?

The breakthrough in the management of the COVID-19 crisis came on May 18th 2020, when the German and French governments issued a joint proposal for a EUR 500bn in EU budget spending, skewed towards the most affected countries, inherently re-distributive, and financed by EU issuance integrated in the Multi-annual Financial Framework[34]. On the side of Germany, this seemed to be in part a reaction to the bind in which the government had been put by Karlsruhe's attempt at forcing the ECB's hand, but it also entailed considerations of broader convenience having to do with the nature of the German economic comparative

[34] See https://www.bundesregierung.de/breg-de/aktuelles/deutsch-franzoesische-initiative-zur-wirtschaftlichen-erholung-europas-nach-der-coronakrise-1753760

advantage. Chancellor Merkel hinted at this line of reasoning during a CDU meeting five days earlier, when she lined up with the position of the leader of the CDU/CSU parliamentary bloc, Ralph Brinkhaus, that Germany would have to transfer considerably more money to Brussels if the COVID-19 crisis was to be resolved[35]. In making her case, Merkel remarked that it was "essential for Germany, *as an export nation*, that its EU partners *also* do well[36]". Compared to previous Franco-German proposals – most notably the unambitious Meseberg compromise (discussed in Chapter 2) – this agreement amounted to an intellectual revolution. The Franco-German position was onboarded by the European Commission in its "Next Generation EU[37]": a proposal for an economic package published at the end of May[38], which was pathbreaking in two ways. First, while not being the first instance of EU debt issuance, Next Generation was to increase common issuance from a total of EUR 70 bn over the 2010-19 decade to EUR 750 bn over the next budget cycle. Second, the proposal included a grants component that was neutral on the recipient countries' debt and produced explicit net fiscal transfers across countries, a long-lived taboo in the history of European fiscal integration. In the negotiation phase, however, the 'new consensus' proved far from consensual, and the politics rather poisonous. Just as Germany was coming to terms with the idea that temporary fiscal transfers within the EMU might be needed to respond to a shock of historic proportions, the self-named 'Frugal Four'– led by the Netherlands – appeared much less open to embrace EU fiscal spending and demanded that EU money come only in the form of loans (hence adding to the receiving countries' debt burden) rather than grants. These ideological tensions came to a

[35] See the reporting at: https://www.euractiv.com/section/economy-jobs/news/merkel-germany-must-help-other-eu-states-get-back-on-their-feet/
[36] Emphasis is my own
[37] See https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940
[38] See https://ec.europa.eu/info/sites/info/files/economy-finance/assessment_of_economic_and_investment_needs.pdf

head during the EU summit of July 2020 – during which Council President Charles Michel tabled a compromise that would entail a significant reduction in the size of the grant component within the Next Generation EU package and important changes to the governance of disbursements. The European Commission's original proposal envisioned a system where countries would need to present national spending plans, and the plans would be approved by leaders through a Reverse Qualified Majority Voting (RQMV) system –making for a fast and smoother approval process. The Dutch government staunchly opposed this mechanism, requesting instead that spending plans be voted under unanimity rule at the EU Council level. The compromise put forward by Michel featured a switch to Qualified Majority Voting (QMV) – where a majority of members would be required to approve, rather than block, disbursements – with the addition of an 'emergency brake' allowing even few countries to stall the process if they deemed a certain national spending plan to be unsatisfactory. This change in the governance of Next Generation EU would make the process much more prone to politicization – with the risk of reproducing a useless and ineffective instrument like the Budget Instrument for Convergence and Competitiveness that had been the outcome of a 2018 Franco-German Meseberg accord. After 4 days of discussion, the Council finally reached agreement on a spending envelope worth EUR 750 billion and a Multiannual Financial Framework (MFF) worth EUR 1,074 billion for the period 2021-2027. The total amount available in the context of Next Generation EU remained unchanged compared to the original Commission proposal, but the composition had shifted significantly. The grant component was reduced to EUR 390 billion, while loans were increased to EUR 360 billion. Most importantly, while the grants allocated to the Recovery and Resilience Facility (RRF) remained broadly unchanged at EUR 312,5 billion, funding for the Horizon EU programme (financing EU research) were cut by 62%; funds for InvestEU (targeting investments in EU internal policies)

was cut by over 80%; the allocation for the Just Transition Fund (supporting communities in the effort of energy transition) was slashed by two thirds, and three programmes were scrapped altogether – including the Solvency Instrument, which would have provided EU-level solvency funds for firms in the hardest-hit countries. Overall, it was evident that the political compromise underpinning the largest EU-level fiscal effort in history entailed slashing the funds that had been allocated to programmes administered at the central level and potentially instrumental in the creation of genuine EU-level common goods. This decision – which was accompanied by an explicit statement in the Council's conclusion as to the temporary nature of the initiative –reduced the probability that at least part of Next Generation could morph into some form of permanent federal spending. The outcome suggested with very little doubt that – in the eyes of at least some EU members, largely coinciding with the Euro-*North* – this unprecedented exercise at European solidarity was to remain a one-off.

## 1.8 The Puzzle of European Solidarity

In this chapter, I have discussed how the Eurozone crisis and the COVID-19 crisis can be framed using a single model, whose outcome (integration or dis-integration) largely depends on policy choices made in resolving the trade-offs associated to the original decision of sharing a single currency. When that decision was taken, the EMU lacked the attributes identified in the literature for Optimum Currency Areas (OCA). While EMU members are (and were already back then) all very open to international trade, the trade effect of the single currency proved to be smaller than anticipated. Rose and van Wincoop (2001) expected the euro to increase intra-EU trade by over 50%, but *ex-post* studies generally estimate the euro-

related increase in bilateral intra-EMU trade to be between 5 and 10 percent only[39]. Regarding Kenen's criteria of industrial specialisation, there is some evidence pointing to the fact that European countries experienced a moderate increase in specialisation after currency unification, thus increasing the EMU's vulnerability to asymmetric shocks[40]. The hope that currency unification would endogenously lead the EMU to morph into an OCA proved misplaced, as the single monetary policy fuelled – rather than tamed – the divergence in the economic and financial cycles of countries within the Eurozone[41]. When the Eurozone crisis erupted, capital flows – which the OCA literature expected to play a stabilising function – worsened the crisis by triggering a fully-fledged sudden stop and a balance of payment crisis in the hardest-hit countries[42]. Despite free movement of people being one of the fundamental tenets of the EU construction, cross-country labour mobility within the EU was minimal before the crisis (limited to 0.1% of working age population against 2-2.5% annual interstate mobility observed in the United States)[43]. While emigration from countries in the Euro-*South* increased massively during the Eurozone crisis, significant frictions and obstacles remained, limiting the effectiveness of this stabilisation mechanism. Lastly, the most political of the OCA criteria – the will to engage in transfers to compensate for asymmetric shocks – was assumed by financial markets to be fulfilled but turned out to be unattainable at the time of need.

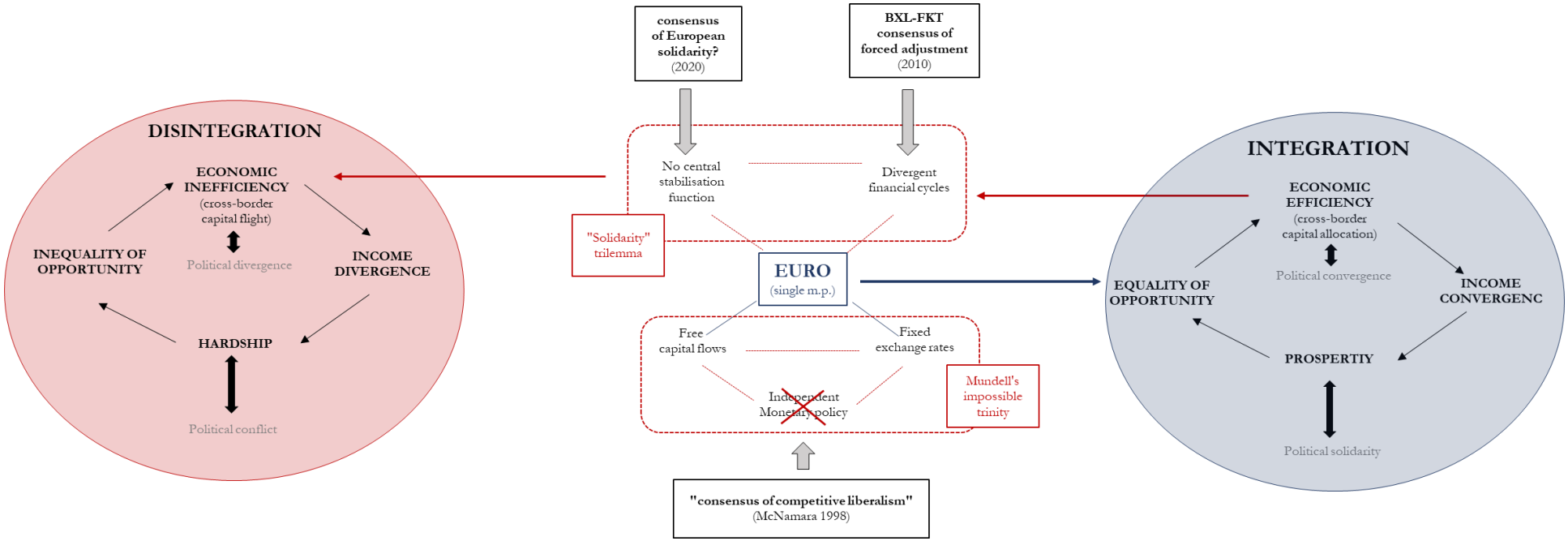
The crisis was instead managed through a massive unilateral macroeconomic adjustment of the countries in the Euro-*South* – thus forcing that process of real convergence that

[39] See for example (Baldwin , et al., 2008) for a review of the literature and estimates.
[40] See (Persson, 2011)
[41] See (Merler, 2015) for a discussion.
[42] See (Merler & Pisani-Ferry, 2012)
[43] See (Bonin , et al., 2008)

endogenous OCA theory had expected to occur naturally. This choice found its intellectual and political justification in the fact that the Eurozone crisis was an asymmetric shock, endogenous to local economic policy, and thus providing plausible deniability to a narrative that saw a risk of moral hazard from granting fiscal solidarity in a context of persisting economic misalignments. Born out of economic divergence, the Eurozone crisis ended up producing a convergence through the massive process of macroeconomic adjustment underwent by the Euro-*South* in the context of the EU/IMF bailouts. As a result, when the COVID-19 crisis hit Europe, the economies of EMU members had become more similar than they had possibly ever been in the past. Yet, Next Generation EU represents a partial solution to the solidarity trilemma unveiled by the Eurozone crisis and revived by COVID-19. It is a step away from the 'Brussels-Frankfurt consensus of forced adjustment' and represents an acknowledgement that existing EU instruments – most notably the ESM – are not suited to address a crisis whose origins could not be traced back to asymmetries in local economic policy. But at the same time, the agreement falls short of any form of debt mutualisation and the political compromise underpinning it is clear about the unwillingness to turn it into permanent federal fiscal policy. Hence, the compromise falls short of being a genuine ideational shift towards a new consensus with full acceptance for the need of explicit intra-EMU solidarity – for example as a formal central stabilization function. As such, while succeeding in preventing a new disintegration cycle, Next Generation EU does not take that risk fully away. Absent a political agreement on how the debt legacy of COVID-19 will be dealt with as part of a more solid solution to the solidarity trilemma, Europe may remain locked in a state of stagnation at risk of precipitating in a new dis-integration phase when the next crisis will hit. The question of how Europe should move forward after this unprecedented shock will likely dominate EU and national political discourses in the coming years. Central to that

discussion is a question that needs answering: why was it so difficult to reconcile political positions on the issue of intra-EMU solidarity, even in the face of an exogenous shock of historic proportion and even after a decade-long unilateral macroeconomic adjustment that had produced unprecedented convergence in the EMU members' economic growth models? This is the puzzle that will be addressed in the rest of this work.

**Figure 3 A cumulative causation model of integration and dis-integration, applied to the Eurozone and COVID-19 crises**




Source: own elaboration, based on the work of (Jones, 2018) and (Myrdal, 1956)

# 2. An Ideological Oddity

## 2.1 A matter of preferences?

In Chapter 1 I have discussed how the Eurozone crisis and the COVID-19 crisis, while being two completely different events, can be framed within a single model whose outcome (integration or disintegration) depends on the choices made to resolve certain macroeconomic trade-offs. The core of the argument in Chapter 1 is that the policy choices taken in response to the Eurozone crisis derived directly from the ideological consensus underpinning the decision to create the EMU as a solution to Mundell's trilemma. I have also highlighted how the Brussels-Frankfurt consensus of forced adjustment and the sinners-versus-saints narrative guiding the Eurozone crisis management could be rationalised intellectually in light of the features of that crisis – particularly its asymmetry and its origins in the macroeconomic divergence prevailing during the first decade of currency unification. The consensus of forced adjustment ultimately was grounded on the Euro-*North*'s fear that granting fiscal solidarity in a context of persisting economic misalignments would lead to moral hazard. This argument is significantly weaker today, following the sizeable macroeconomic adjustment of the Euro-*South.* Hence, one would have expected the COVID-19 crisis –a symmetric event, with origins exogenous to economic policy and occurring after a decade of unprecedented macroeconomic convergence – to trigger a new consensus and a broader acceptance of EMU fiscal solidarity. The fact that this did not happen, or happened only partially, is a puzzle. One possible explanation could be found in the least clear-cut among the OCA criteria – i.e. that of homogeneous preferences. Could the continued Euro-

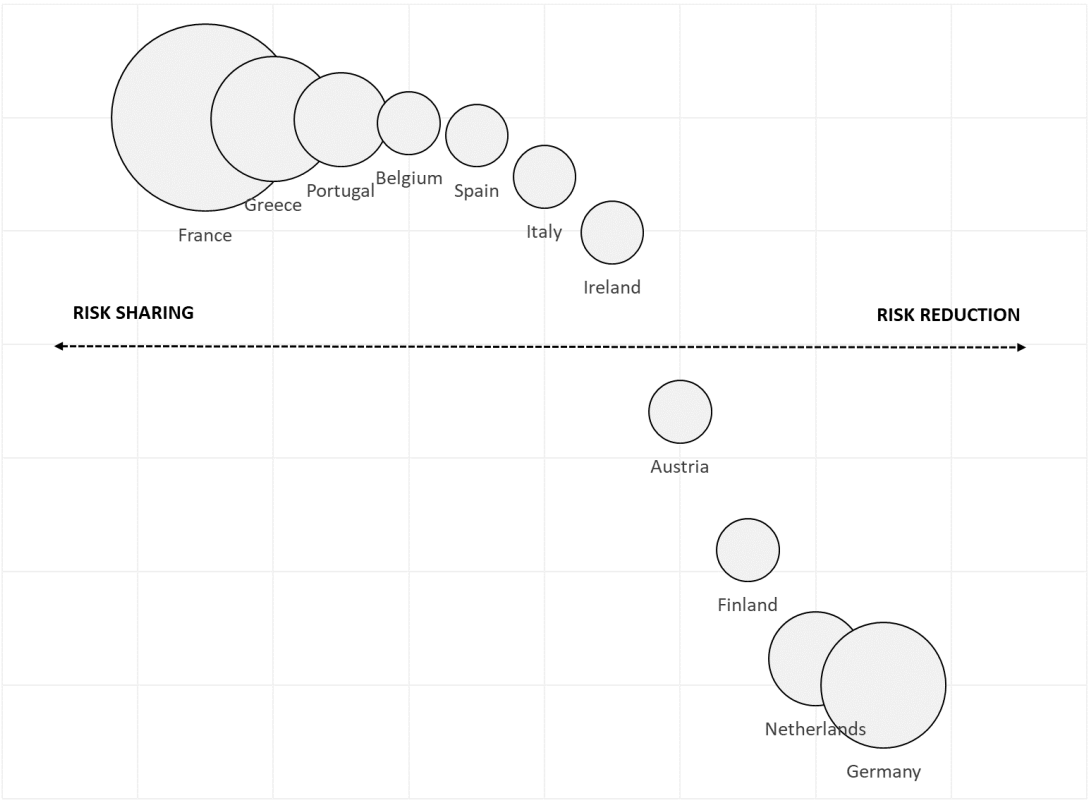
*North* scepticism about EMU fiscal solidarity be due to concerns that, although countries have converged in macroeconomic terms, their preferences on macroeconomic governance are still too dis-homogeneous to completely eliminate the risk of moral hazard from risk-sharing? This is the question that will be addressed in this chapter, looking first at the most recent history of the policy debate on EMU macroeconomic governance reform and then using opinion survey data to investigate how dis-homogeneous preferences about macroeconomic governance really are across the EMU.

## 2.2 Risk Sharing versus Risk Reduction

The ideological polarization about EU solidarity observed in the context of the COVID-19 crisis is deeply rooted into a decade-long debate on the reform of the EMU macroeconomic governance framework, that started on the back of the Eurozone crisis. Today, widespread agreement exists on the fact that the original EMU was not an OCA and that hopes it would endogenously morph into one were misplaced. It is also generally acknowledged that the EMU architecture was not equipped to guarantee financial stability in the face of asymmetric shocks, but agreement on how the macroeconomic governance framework of the monetary union should be reformed has so far been elusive. At the core of this disagreement lies a different perception of the need for, and the modalities of, intra-EMU solidarity. Countries in the Euro-*South*, which have been hit hard by the Eurozone sovereign debt crisis and have gone through a decade of painful and politically challenging economic adjustment, have called for the EMU macroeconomic governance reform to be predicated on more risk sharing and solidarity. Countries in the Euro-*North*, whose economic models emerged unchallenged from the Eurozone crisis but whose political goodwill was eroded by domestic sentiments of

'bailout fatigue', have been in favour of a reform predicated on risk reduction and disengagement.

**Figure 4 Relative positioning on risk sharing / risk reduction**




Source: authors based on the dataset by (Wasserfallen & Lehner, 2017)
Note: based on 40 issues that directly relate to countries' views on risk sharing vs. risk reduction. Positioning has been obtained through a basic factor analysis (with 1 factor) to achieve a unidimensional ranking of countries. The result is similar to what (Wasserfallen & Lehner, 2017) find using 47 issues and W-Nominate methodology.

In a research work published in 2017, Fabio Wasserfallen and Thomas Lehner at the University of Salzburg combined the analysis of documents[44] and interviews[45] to identify 47 contested policy issues discussed between 2010 and 2015 at the EU level and code the positions held by EU members on those issues[46]. From this dataset, I selected 40 issues that are indicative

[44] Positions of member states from 5000 primary and secondary documents (Wasserfallen & Lehner, 2017)
[45] The interviewees are officials who had been present in the negotiations of the contested issues.
[46] Data was made available by the researchers within the context of the "EMU Choices" Horizon 2020 project, and it can be downloaded at this link (accessed on February 15th 2019): https://emuchoices.eu/data/emup/

of countries' underlying views about risk sharing *versus* risk reduction, and by running a simple factor analysis I mapped countries' aggregate views on a unidimensional scale that can be interpreted as ranging from strongest support to strongest opposition to risk sharing[47] (Figure 4). On one end of the spectrum, Germany, the Netherlands, and Finland stand out as the least inclined to risk sharing and most opposed to initiatives with the potential to create closer fiscal or financial integration. On the opposite end, Belgium, France, Greece, Italy, Portugal and Spain systematically supported more risk sharing. Wasserfallen and Lehner collected this data a few years prior to COVID-19, so this picture represents the spectrum of views as they were at the onset of the pandemic. While some of these red lines have been blurred in 2020 with the agreement on Next Generation EU, that agreement so far is designed as a one-off exceptional measure and does not entail any commitment to continue fiscal risk sharing in the longer term. So, the question of how the macroeconomic governance of the EMU should be revised for the longer term remains unanswered – particularly regarding the topic of countercyclical stabilization, which has so far been at the core of the split on risk sharing versus risk reduction.

## 2.3 Fiscal Risk Sharing

One obvious instrument for macroeconomic risk sharing is fiscal policy, which can naturally have important redistributive effects. Unsurprisingly, views on the opportunity to engage in

[47] Positioning has been obtained by running a very simple factor analysis, which yields the "loading" for each country onto a unidimensional scale. The 7 issues that I have dropped speak less directly of Member States' underlying views about risk sharing vs. risk reduction within the Eurozone. The issues that I have excluded are: (1) the IMF involvement in the 1st Greek Programme; (2) IMF involvement in rescue programmes; (3) the participation of non-euro members at the Euro summit; (4) EU cap on bank bonuses; (5) capital buffers (centralization or flexibility for higher buffers); (6) double majority for decisions of EBA (for non-EZ countries); (7) SRM decision-making powers (Council vs Commission).

fiscal risk sharing have been quite polarised across the Euro-*North* and the Euro-*South*. One topic of discord concerns the need for the EMU to be endowed with a common budget or common fiscal capacity, and whether this budget should play a function of countercyclical stabilization against asymmetric shocks. By allowing for resources to flow from resilient countries towards countries negatively hit by a shock, central stabilization establishes a risk-sharing element that is present in all federations. In the US, the federal budget is responsible for about 13% of the country's shock-absorption capacity[48]. In Germany, the federal budget smooths at least 10% of shocks[49]. The Eurozone is peculiar in its lack of a dedicated central budget, and as discussed in Chapter 1, the other traditional adjustment mechanisms (labour mobility and capital flows) have played a limited or even counterproductive role during the Eurozone crisis, exposing the fragility of the EMU construction. The closest substitute to an EMU budget – the EU budget – is normally worth only 2% of GDP and a third of those resources is earmarked for the EU Cohesion Policy which, while playing an indirect stabilization role during the Eurozone crisis, does not have an explicit countercyclical mandate[50]. Over the past 5 years, France has been a champion of the demand for more fiscal risk sharing at the EMU level. President Macron has argued in favour of a "Europe turned towards growth" (Destais, 2018), with a common finance ministry in the EU Council and a separate Eurozone budget that would establish "a minimum level of solidarity to […] be able to raise money in common, invest, and absorb economic shocks" (Rettman, 2017). The Spanish official position laid out in a joint statement by Macron and Spanish Prime Minister Sánchez[51], included a call for a Eurozone central budget "to promote competitiveness,

[48] See (Asdrubali, et al., 1996).
[49] See (Furceri & Zdzienicka, 2013)
[50] See (Merler, 2016)
[51] See (Moncloa, 2018)

convergence and stabilization […] with full democratic accountability". In the Euro-*North*, however, the concept of an EMU budget has been traditionally associated to the politically toxic topic of permanent transfers. German Chancellor Angela Merkel, while open to the idea of turning the existing European Stability Mechanism (ESM) into a European Monetary Fund (EMF)[52], kept very cold feet on the subject of a Eurozone budget well into 2019 and despite the recent shift in the German stance on EU-level fiscal as a response to COVID-19, there is no indication that the ideological shift will extend to the topic of a permanent EMU macroeconomic stabilization function. The German position is traditionally in favour of *ad hoc* lending in exchange for structural reform[53]. Former German finance minister Schäuble expressed this position very clearly in 2017, when he wrote that "a macroeconomic stabilization function […] is economically not necessary for a stable monetary union" and that "we have to much better use the national automatic stabilizers to absorb shocks"[54]. A 2018 report by the German Council of Economic Experts similarly rejected the idea, and warned that "any insurance function performed by a fiscal capacity can, in practice, hardly be distinguished from quasi-permanent transfers"[55]. The position of the Dutch government before COVID-19 was that "solidarity demands responsibility"[56] and that the single currency should "bring […] more prosperity and not a redistribution of existing prosperity". Some of the members of the self-labelled 'New Hanseatic League' – comprising Denmark, Finland, Ireland, Latvia, Lithuania, the Netherlands, and Sweden – argued in 2018 that a stronger EMU would start "with implementing structural reforms and respecting the Stability and Growth

[52] See (Schwarzer, 2018)
[53] See (Valero, 2018)
[54] See (Schauble, 2017)
[55] (Sachverstaendigenrat, 2018) page 210
[56] See (Rutte, 2018)

Pact, thereby building up fiscal buffers in national budgets to allow room for national fiscal policies [...] to smoothen economic downturns"[57]. Dutch finance minister Hoekstra echoed this view when, in March 2020, he called for Brussels to investigate why some countries lacked the fiscal room for manoeuvre to individually counteract the economic impact of the COVID-19 pandemic and the German position in the early days of the crisis was also that the hardest hit countries should apply for ESM conditional lending.

In June 2018, in what looked like an attempt to move past these divisions, the French and German government published a joint position known since then as the *Meseberg Declaration*[58]. The text outlined what ought to be a compromise between the French and German extreme positions, and it included a call for the ESM to play the role of backstop to the Single Resolution Fund (SRF), although subject to a preliminary and vaguely defined "sufficient progress in all relevant fields of risk reduction". France and Germany also proposed the creation of a Eurozone's budget, but the tool was to be limited in scope to "competitiveness and convergence" with the more controversial stabilization function to be addressed separately. The Meseberg Declaration lacked ambition on the subject of EMU macroeconomic governance reform, but also fell short of any tangible step forward in the long-lived discussion on the European Deposit Insurance Scheme (EDIS), a key missing piece of the EU Banking Union with substantial risk-sharing implications[59]. The Euro Summit held in December 2018, while endorsing the proposed terms of ESM reform, did not mention EDIS nor the word stabilization anywhere in the final statement[60]. The initially ambitious French

[57] See (Aa., 2018)
[58] See the text at (Bundesregierung, 2018)
[59] See e.g. (Véron, 2017; Schoenmaker, 2018)
[60] See the statement at: https://www.consilium.europa.eu/media/37563/20181214-euro-summit-statement.pdf

stance seemed to be weakening in the face of political pressure to stave off the domestic Eurosceptic constituency ahead of the EU elections in 2019. In a cross-border appeal to European voters – published in several high-profile national newspapers across the EU in March 2019 – President Macron dropped any reference to the controversial issue of Eurozone macroeconomic governance reform (Macron, 2019). A joint Franco-German paper on a "Eurozone Budgetary Instrument", released in February 2019[61], framed this budget mostly as a tool to help Member States pursue structural reforms, very much in line with the previously discussed German view. The paper failed to acknowledge even in theoretical terms any merits of a Eurozone stabilization function. In June 2019, the Eurogroup published a term sheet[62] for a Budgetary Instrument for Convergence and Competitiveness (BICC), very much aligned to the same logic. Access to any funds under the BICC would depend on the "respect of applicable macro-economic conditionality" – something at odds with the idea of using the BICC to set up a functional stabilization function at the EMU level. From an intellectual standpoint, the BICC seemed to be rooted in the idea that the Eurozone budget should focus on promoting convergence, and that convergence in turn would deliver stabilization. The meaning of 'convergence' and 'stabilization' was largely unspecified in the relevant documents, but the emphasis on structural reforms suggested the objective may be the broad convergence of economic growth models towards those identified as the best performers. Hardly a novel view, this was remindful of the debate that pitted 'economists' against 'monetarists' at the time of the Werner report. The economists' view – of which Germany was a supporter – posited that real convergence towards a similar economic model ought to

[61] See the text at: https://sven-giegold.de/wp-content/uploads/2019/02/French-German-Contribution-on-a-Eurozone-Budgetary-Instrument.pdf
[62] See: https://www.consilium.europa.eu/en/press/press-releases/2019/06/14/term-sheet-on-the-budgetary-instrument-for-convergence-and-competitiveness/

be a pre-requisite for monetary unification, to ensure that asymmetric shocks would not be de-stabilizing. In a similar vein, the 2019 BICC discussion implicitly elevated risk-reduction to an overarching principle guiding Eurozone reform. Yet, this emphasis on risk reduction appeared misplaced in light of the sizeable macroeconomic convergence achieved since the crisis, as a result of which macroeconomic structures in the Euro-*South* had aligned with those in the Euro-*North*. Despite the convergence fostered by the Brussels-Frankfurt consensus of forced adjustment, some seemed to think that EMU member states were still 'too different' for temporary stabilization not to risk crystallizing into permanent transfers.

## 2.4 Monetary Risk Sharing

If the solidarity implications of centralised fiscal stabilisation are self-evident, monetary policy can also have important risk sharing effects. (Merler & Pisani-Ferry, 2012) for example, show that within a Eurozone consisting of a competitive, moderately leveraged *North* and an uncompetitive, over-indebted *South*, the differential fiscal stance between the two regions determines the real exchange rate changes, but common monetary policy could significantly ease the process of internal devaluation in one of the regions. In the context of the Eurozone crisis, if monetary policy had targeted average inflation – allowing for relatively higher inflation in the Euro-*North* – the risk to debt sustainability in the Euro-*South* would have been lowered and the real adjustment would have been easier to achieve. Accepting higher inflation at home, through tolerance of a more expansionary common monetary policy, can thus be qualified as an act of solidarity, by which the Euro-*North* could have eased the Southern burden of adjustment to the asymmetric shock of the Eurozone crisis. Unconventional monetary policy – Quantitative Easing and extraordinary liquidity support –

may also entail solidarity, in a supranational context, because asset purchases can allow for pooling risk across borders[63]. Within the EMU, however, disagreement on solidarity is no less evident in the monetary than in the fiscal remit. The shift of gears from the ECB towards a more 'interventionist' approach during the Eurozone crisis generated tensions within the ECB's Governing Council. Central bankers from Germany, the Netherlands, Austria and Finland, tended to be more hawkish than their Southern colleagues[64]. Outside the Governing Council, German policymakers argued repeatedly that ECB policy was too expansionary[65]. German academic and commentator Hans-Werner Sinn built a conservative reputation with his repeated calls for the collateralization of the Eurosystem TARGET2 balances – a previously obscure accounting concept indicative of domestic central banks' net debt or credit position vis-à-vis the ECB. By imposing a limit or a collateralisation requirement on TARGET2 balances, the ECB would have effectively limited the fungibility of euros across countries, implicitly creating what would amount to different denominations within the Eurozone. The TARGET2 system would have immediately become a target for anyone willing to speculate on the resilience of the EMU which, at that point, would be much closer to a fixed exchange regime than to a fully-fledged currency union. Despite its dangerous implications, Sinn's suggestion was endorsed by the president of the German Bundesbank, Jens Weidmann, in a letter that Weidmann sent to the ECB. Former finance minister Schäuble, on the other hand, went as far as drawing a causal link between the rise of the right-wing populist Alternative für Deutschland (AfD) party in Germany, and the ECB's expansionary monetary policy[66].

[63] See (Schelkle, 2017). In the EMU, this risk sharing element is however limited by the technical features of QE
[64] See the data analyzed in (Colman, et al., 2019)
[65] See the discussion in (Sachverstaendigenrat, 2018)
[66] "I said to Mario Draghi [...] be very proud: you can attribute 50 per cent of the results of a party that seems to be new and successful in Germany to the design of this policy" reported by (Wagstyl & Jones, 2016)

Policymakers in Spain, Italy and France held very different views. Since the early days of the Eurozone sovereign debt crisis, France clashed with Germany on the role that ECB's monetary policy ought to play in the crisis management and resolution[67]. In 2012, Italian Prime Minister Monti and French President Hollande jointly called for bolder ECB action to curb the skyrocketing yields on the government bonds issued by the Eurozone countries that were under the highest market pressure[68]. In 2013, Spanish Prime Minister Rajoy said that Europe should look at expanding the powers of the ECB to allow for further easing[69]. Speaking in 2015, Italian Prime Minister Renzi said that he welcomed the decline in the euro exchange rate and that he wished the currency could drop to parity with the U.S. dollar[70].

Over the past ten years, the ECB has also been at the centre of a broader reform of financial regulatory and oversight apparatus, in the context of which Frankfurt has been given new important power and competences. Few sectors have undergone as broad and deep a regulatory change as the European financial sector since the Global Financial Crisis. The EU regulatory response to the GFC initially focused on harmonising existing rules and strengthening cooperation among national supervisory authorities. The 2009 de Larosière report led to the creation of the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB), to ensure closer cooperation and a more systematic exchange of information among national supervisors, prepare uniform standards, and ensure supervisory convergence and coordination. In a second phase, triggered by the Eurozone crisis, the

[67] See (Vinocour & Mackenzie, 2011)
[68] See (Elliot & Smith, 2012)
[69] "I believe that in Europe among all of us, we should look at whether the ECB should have the same powers as the rest of the world's central banks. [...] We should give ourselves the instruments that other countries have", Rajoy reportedly said while answering a question about the Bank of Japan's Quantitative easing (Toyer, 2013)
[70] "My dream is parity", Renzi is reported to have said in that occasion (Baker & Safdar, 2015)

response shifted towards centralization. In a major breakthrough, in 2012 EU leaders endorsed the creation of a EU Banking Union, featuring an EU-wide single rulebook, centralized banking supervision delegated to a Single Supervisory Mechanism (SSM), centralized resolution delegated to a Single Resolution Mechanism (SRM), as well as the attribution of active macroprudential competences to the ECB. The purpose of the single rulebook is to ensure common benchmarks, while common supervision should guarantee cross-country consistency and reduce *ex ante* the likelihood of banking crisis. Common resolution, on the other hand, should provide clarity on how any crises that were to occur should be managed *ex post*.

These changes obviously took important competences away from Member States, and hence were far from uncontroversial. After making ample use of public funds to recapitalise the weakest German banks in the early days of the GFC, the German government became a staunch supporter of bail-in, a process whereby the private sector would be called to contribute to bank rescue operations through the write-off or reduction in the values of private creditors' claims against a bank in resolution. Bundesbank's President Weidmann called for bail-in rules to enter into force even earlier than initially planned[71]. Dutch Eurogroup president Jeroen Dijsselbloem caused an uproar in 2013 when he reportedly[72] praised the messy handling of the banking crisis in Cyprus – which featured a deposit run on the second-largest Cypriot bank and the first ever case of capital controls within the EMU – as a "template" for bank resolution. Italian authorities, on the other hand, made no mystery of their scepticism about the new EU bank resolution rules. The former governor of the Bank

[71] See (Reuters, 2013)
[72] See (Baker, 2013)

of Italy Visco repeatedly argued that bail-in requirements created financial stability risk and should have been revised[73]. The president of the Italian Banking Association Patuelli went as far as arguing that bail-in was incompatible with the Italian constitution[74]. Giovanni Tria – Finance Minister during the short-lived League-M5S government – claimed during a parliamentary hearing that in 2013 the then-Finance Minister Saccomanni had been "blackmailed" by Wolfgang Schäuble into accepting the early introduction of bail-in rules[75]. Meanwhile, the discussion on EDIS, remained locked into seemingly irreconcilable disagreements on how the setup of a meaningful insurance function should be reconciled with the thorny issue of 'legacy debt' from the previous crisis.

## 2.5 A Battle of Ideas?

In light of the theory discussed in Chapter 1, can this polarization in the views on risk sharing versus risk reduction be attributed to dis-homogeneous preferences about the way asymmetric shocks and macroeconomic (fiscal and monetary) policy should be dealt with, in a monetary union? In their famous book "The Euro and the Battle of Ideas", Markus Brunnermeier, Harold James and Jean-Pierre Landau[76] argue along these lines. They suggest that differences in the German and French conception of appropriate economic policy explain why it was so difficult to find a commensurate response to the Eurozone crisis and they define an ideological "Rhine-divide", rooted into long-term historical, intellectual, and cultural

[73] See (Reuters, 2016), (Visco, 2018), (Bocciarelli, 2017)
[74] See (ANSA, 2019)
[75] See reporting in Il Corriere della Sera at: https://www.corriere.it/economia/19_febbraio_27/banche-tria-accusa-germania-sul-bail-in-saccomanni-fu-ricattato-36aa2560-3aa1-11e9-a94b-7b2b39079b0a.shtml and video of the hearing at: https://video.corriere.it/tria-saccomanni-fu-praticamente-ricattato-ministro-finanze-tedesco-bail-in/eb820b66-3aaa-11e9-a94b-7b2b39079b0a
[76] See (Brunnermeier, et al., 2016)

differences among the German and French economic philosophies. In their narrative, Italy is a hybrid case – split between a German-leaning north and a French-leaning south. We will see in the next chapters that the view of Italy as an 'outlier' – difficult to univocally categorise as Euro-*North* or Euro-*South* – fits well with the prevailing economic and political position that the country occupies in today's Eurozone. The recent academic debate on the Eurozone macroeconomic governance reform, however, suggests a less Manichean picture than the one drawn in (Brunnermeier, et al., 2016)[77]. In 2018, a group of seven French and seven German economists (the "7+7", as they have since become known)[78] published a paper with the objective to offer a bridge over the Rhine divide, mixing elements of risk-sharing and risk reduction in six areas for reform to the European financial, fiscal, and institutional architecture. The first pillar in the proposal was the elimination of the sovereign-bank vicious circle through the coordinated introduction of sovereign concentration charges for banks and of a common deposit insurance, together with strengthened mechanisms to bail in the creditors of failing banks, increased supervisory pressure to reduce existing non-performing loans, and tightened bank regulatory standards, all while giving the European Securities and Markets Authority (ESMA) wider authority over an increasing range of market segments. The second pillar was a replacement of the current system of fiscal rules focused on the 'structural deficit' by a simple expenditure rule guided by a long-term debt reduction target, with compliance to be monitored by independent national fiscal councils supervised in turn by an independent Eurozone-level institution, and with violations to be sanctioned by requesting that government finance excess spending using junior ('accountability') bonds that would make market discipline more biting. The third pillar was the proposal to create economic,

[77] See the impressive debate at VoXEU.org: https://voxeu.org/debates/euro-area-reform
[78] See (Bénassy-Quéré, et al., 2018)

legal and institutional underpinnings for orderly sovereign-debt restructuring of any Eurozone countries whose solvency could not be restored through conditional crisis lending. Some of these policies raised the risk of financial instability, which the 7+7 paper dismissed by advocating that the measures would be phased in gradually, and "announced at a time when the debts of all euro area countries that depend on market access are widely expected to be sustainable". A fourth pillar of this reform effort was going to be the creation of a Eurozone fund, financed by national contributions, to help member states absorb large economic disruptions, but with national contributions set at a higher for countries more likely to draw on the fund (with the aim to avoid any permanent transfers). Fifth, the paper proposed to create a synthetic EMU safe asset that would offer investors an alternative to national sovereign bonds, and for which the additional 'safety' would come through a combination of diversification and seniority. Lastly, the group of 7+7 also called for a reform of the Eurozone institutional architecture by creating an independent fiscal watchdog within the European Commission, assigning the Eurogroup presidency role to the Commission and the policy responsibility for conditional crisis lending fully assigned to a reformed ESM. These proposals were envisaged as a package largely requiring joint implementation, but both the individual elements and the overall vision were widely debated in the academic sphere. The general view underlying the paper was fiercely criticized by (Messori & Micossi, S, 2018) who argued that the proposal would increase the risk of financial instability and weaken the defences against financial shocks. (Bini Smaghi, 2018) argued that redenomination risk, although playing a major role in the Eurozone crisis in 2010-2012, was not properly addressed in the 7+7 proposal. (Dullien, 2018) objected that the 7+7 were not convincing in dealing with the issue of boom-and-bust cycles in the Eurozone, put excessive trust in the ability of financial markets to stabilise national economies in a desirable way, and proposed a structure for EU

fiscal rules that risked reducing governments' policy space. (Buti, et al., 2018) objected that the diagnosis overlooked some key features of the EMU, and that the focus of the proposals on reducing fiscal risks could lead to financial distress ultimately requiring more, rather than fewer, rescues. According to (Wolff, 2018), the 7+7 paper neglected three key issues: European public goods, a proper fiscal stance, and major national reforms. (Bofinger, 2018) rejected the proposal completely, and posited that the only way to stabilise the EMU would be to go ahead with political integration, allowing for a comprehensive debt mutualisation to remove the specific insolvency risk of euro area membership. From a Spanish perspective, (Doménech, et al., 2018) argued that deepening the EMU could not wait for all countries carry out all their domestic reforms, and that risk sharing and risk reduction needed to proceed simultaneously, with common instruments and policies at the European level. (Vallée & Cohen-Setton, 2018) added that the architecture of monetary policy and the conduct of monetary policy operations should also be reformed towards further centralisation and mutualisation. (Tabellini, 2018) argued that risk-sharing mechanisms financed by rainy day funds and the ex-ante ESM lending facility – as suggested in the 7+7 paper – might destabilise the entire Eurozone, by increasing the vulnerabilities of countries with high legacy debts that would be deprived of shock absorbers and exposed to potentially higher risk of debt runs. (Feld, 2018) on the other hand, argued that the 7+7 failed to deal convincingly with the moral hazard inherent in the legacy debt problems, and that the introduction of a fiscal capacity would amount to repeating the mistakes made at the introduction of EMU, with later steps towards European integration being attempted before the necessary first steps had been taken. He proposed to redesign the fiscal framework through the adoption of a modified expenditure benchmark, together with a drastic reduction in exception and escape clauses. For (Bofinger, 2018), however, (Feld, et al., 2018) were in practice proposing a 'black zero' –

reminiscent of the German fiscal policy constraint – in disguise. (Beynet, 2018)argued that ownership of an expenditure rule could be increased through *more* flexibility and built-in positive incentives, e.g. allowing deviations when financed with GDP-linked bonds. While (Strasky & Claveres, G, 2019) argue that a European fiscal capacity can avoid permanent transfers and improve stabilisation, (Heijdra, et al., 2018) think the potential stability benefits can simply be achieved through stronger financial market risk sharing and more effective use of fiscal stabilisers.

## 2.6 An Ideological Oddity

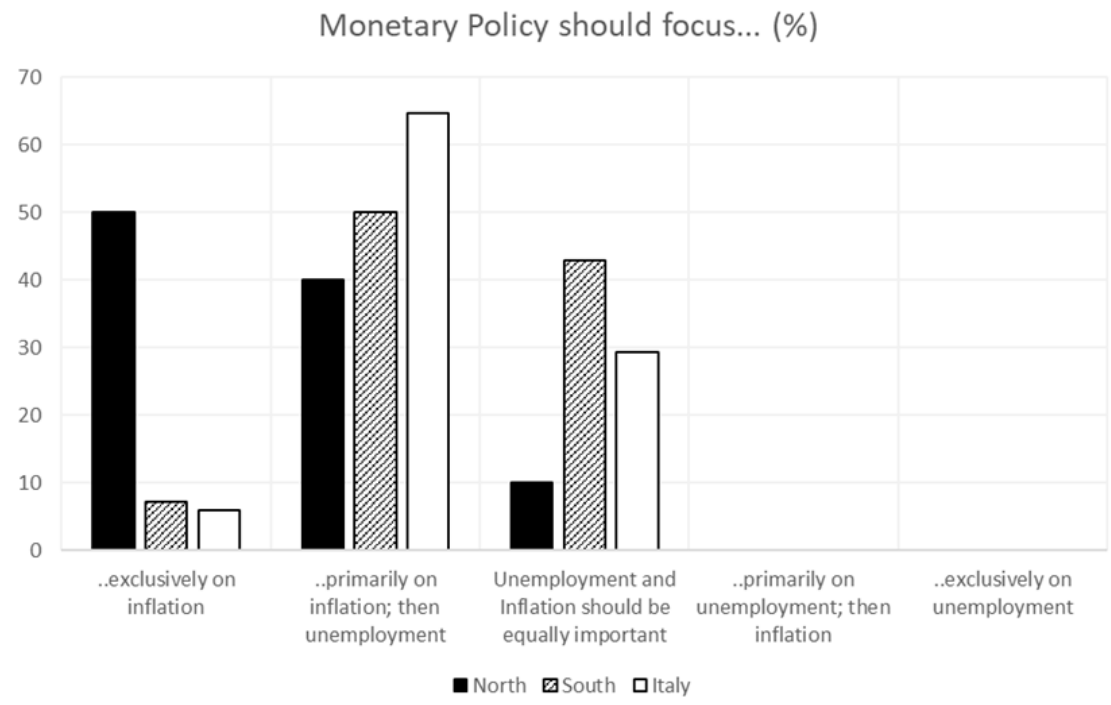
Those presented in the previous section are just some of many contributions to a very florid academic debate, which is still ongoing and whose saliency has been heightened by the COVID-19 pandemic. They suffice to show the extent to which academic positions diverge on major theoretical issues, such as the role that fiscal and monetary policy should play in a monetary union. But is this academic 'battle of ideas' reflective of dis-homogeneous macroeconomic preferences, along a *North–South* ideological cleavage? To try and answer this question, in 2018 Francesco Nicoli (at the University of Gent) and I ran an anonymous survey polling a sample of scholars and practitioners in the field of European economic policy and EU integration, from both the academic and the policy world. These experts were requested to answer questions on various aspects of monetary and fiscal policymaking, which were intended to allow us to map preferences on key aspects of macroeconomic

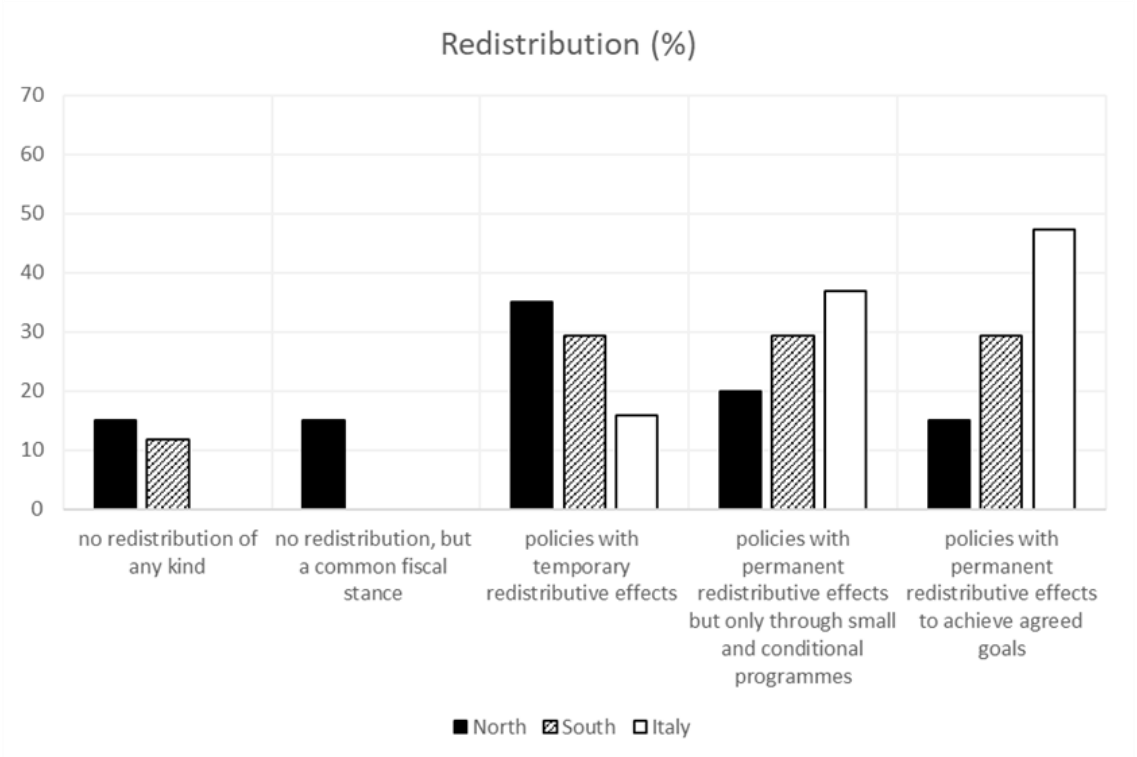
policymaking in a monetary union[79]. Here, I am aggregating answers into groups using the same *North*/*South* definition emerging from ***Figure 4*** and isolating Italy, both because it constitutes a special case of interest for this book and because the Italian sample is large compared to the samples collected for other countries, so it would bias the results if we were to include it as part of any group. Two general considerations stand out. First, in contradiction to the view of national economic philosophies as 'monolithic', significant differences seem to exist *within* the two polar groups. Second, in contradiction to the view of a 'Rhine-divide' constituting a major ideological rift, the differences found *across* groups are less marked than one might expect. Regarding views on monetary policy, it is probably unsurprising that experts belonging to the Euro-*North* group express views that are consistently more in favour of a strict inflation-targeting principle (***Figure 5***, top). As much as 50% of Northern respondent argue that the ECB should focus *exclusively* on inflation, whereas Southern and Italian respondents are clearly more dovish on average, with a non-negligible share even favouring a shift to an explicit double mandate. More interestingly, the views on how intra-Eurozone redistribution should be conceived are quite diverse among Northern experts – and only a minority appears to be completely opposed to *any* kind of redistributive policies (***Figure 5***, bottom). The most frequently stated position among Northern respondent (garnering the support of more than 30% of the sample) is actually in favour of policies with temporary redistributive effects. However, another 30% among Northern respondents appear open to permanent redistribution – either through small and conditional programmes or to achieve common goals. On the other hand – and again contradicting prevalent stereotypes – Southern

[79] We have about 180 responses from 2 survey waves. The North and South groups are defined according to the scale identified in Figure 4. The North includes Austria, Finland, Germany, and the Netherlands; the South includes Belgium, France, Greece, Portugal and Spain.

respondents do not stand out as overwhelmingly in favour of permanent redistribution, but rather equally split among the different options ranging from no redistribution to permanent redistribution. Italian experts, however, are much more clearly skewed towards permanent redistribution – which appears to be the preferred option for almost 50% of the Italian sample.

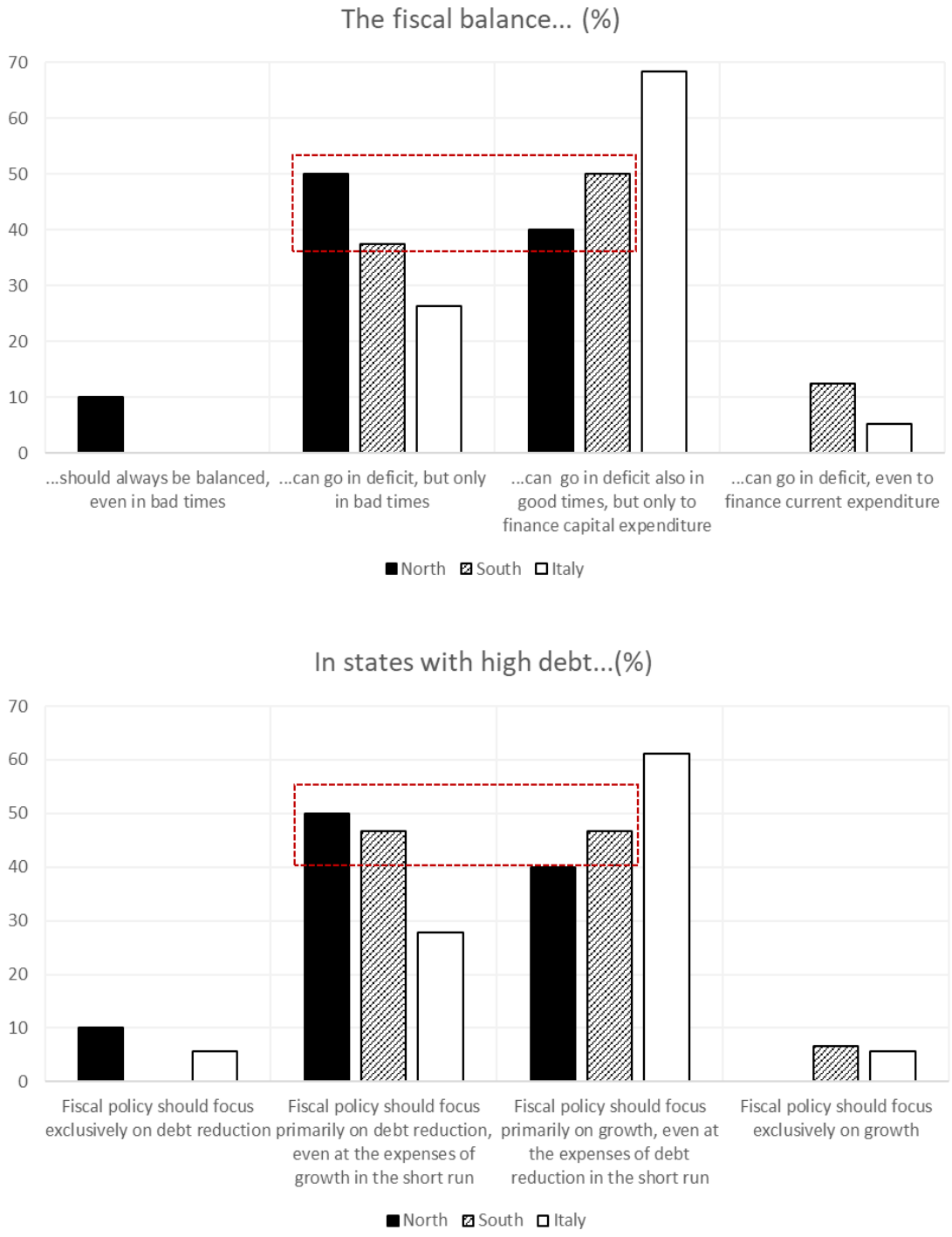
**Figure 5 Monetary policy and redistribution in the Eurozone...**




Source: author's elaboration based on data from (Merler & Nicoli, 2018-2019)

**Figure 6 The fiscal balance...**




Source: author's elaboration based on data from (Merler & Nicoli, 2018)

When asked how fiscal policy should be run over the cycle (***Figure 6***, top), Northern respondents are split almost equally among those who say that deficits should only be allowed in 'bad times' (50%) and those conceding that deficits could occur in 'good times' too, but only to finance capital investment (40%). So, while there seems to be some truth to the perception of Northern fiscal hawkishness, Northern experts are not as overwhelmingly conservative as one might expect, in their views about the role of fiscal policy over the cycle. Positions are somewhat reversed for Southern respondents, 50% of whom state that recurring to fiscal deficits to finance capital investment is acceptable in good times, but again the significant polarization that one might have expected does not seem to be there. The difference of views between *North* and *South* is even narrower when asking specifically about optimal fiscal policy for Eurozone countries with high debt (***Figure 6***, bottom). Northern and Southern experts are similarly split on this topic, with 50% of respondents in each group stating that fiscal policy should focus primarily on debt reduction even at the expenses of growth in the short run, and the other half arguing instead that the priority should be given to stimulating growth even at the expense of debt reduction in the short run. Once again, Italian respondents appear to be an idiosyncratic group, much more internally polarised and more extreme in their positions. An overwhelming majority of them (70%) expresses support for the idea of resorting to fiscal deficits even in good time for the purpose of financing capital investment and, concerning the role of fiscal policy in high-debt countries, 60% of the Italian sample state that the focus should be primarily on growth even at the expenses of debt reduction.

Intrigued by these unexpected results, in 2019 Francesco and I ran a second wave of the survey to extend the sample. We wanted to understand if the pattern described above could be further qualified by accounting for the background of respondents, in particular whether any difference of views existed among experts working exclusively in academia and think-tanks versus those working exclusively in EU or national institutions[80]. This could shed light on whether the views of policymakers – used to confront the political constraints that typically arise in an institutional setting – were systematically different from those of experts who instead enjoy the full intellectual freedom of academia or academic-like contexts. Results suggest that such difference exists. Among Northern experts with an exclusive institutional background, the share of stating that the ECB should focus exclusively on targeting inflation is above 50%, but the same position garners only 11% support among Southern 'institutional' experts and 17% among their Italian peers. Northern academics are significantly less hawkish: 50% of them would prefer the ECB to focus *primarily* on inflation but also take unemployment into account. This position is shared by 60% of Southern experts with an exclusive institutional background, whereas Southern academics are far more dovish and overwhelmingly support a dual mandate (60%). Italy again stands out: Italian experts with an institutional background are markedly more dovish than their Northern and Southern peers, as 67% of them support an explicit dual mandate. Italian academics, on the other hand, are more conservative than their fellow countrymen with an exclusive institutional background: among them, only 36% supports a formal dual mandate, whereas the most preferred option is a primary focus on inflation with unemployment only coming in as a secondary consideration.

[80] A number of experts declare multiple affiliations, i.e. to have worked in both academia and institutions over time. In the analysis described here, I have excluded experts with multiple affiliations, and only kept experts with 'exclusive' experience (either in academia/research or in institutions). The rationale is to get the 'cleanest' possible breakdown of positions across experts with clearly different backgrounds.

This Italian ideological oddity is not confined to the field of monetary policy. When asked about the most appropriate conduct for fiscal policy over the cycle, Northern experts with an exclusive institutional background are split almost 50-50 among those saying that recourse to fiscal deficits should only be allowed in 'bad times' and those conceding that fiscal deficit could be incurred also in 'good times' to finance capital investment. A relative majority (45%) of Southern policymakers is of the view that fiscal deficit should be considered only in bad times – which is probably a testament to the fact that the macroeconomic adjustment endured during and after the Eurozone crisis has left important scars and levelled whatever any pre-existing North-South ideological difference in the conception of fiscal policymaking. The position of Italian respondents with an exclusive institutional background is once again more internally polarised and extreme, as 88% of them are of the opinion that fiscal deficit should be resorted to also in good times to finance capital expenditure. Once again, Northern and Southern academics tend to be *less* conservative than they institutional peers, whereas Italian academics tend to me *more* conservative than their domestic policymaking community.

On the matter of what fiscal policy conduct would be more appropriate for high debt Eurozone countries, Northern and Southern respondents with an exclusive institutional background again share similar views. Between 60% and 70% of them in fact state that fiscal policy should focus primarily on debt reduction, even at the expenses of growth in the short run. For 86% of Italian respondents working in institutions, however, the appropriate fiscal policy stance would be one focusing primarily on growth even at the expenses of debt reduction. Once again, Italian academics are more conservative – with 57% arguing in favour

of focusing primarily on debt reduction – while Northern and Southern academics are less conservative and overwhelmingly favour focusing primarily on growth. Lastly, it is on intra-Eurozone redistribution that the Italian ideological oddity is probably most evident. On this topic, a majority of Southern respondents with exclusive institutional background supports policies with *permanent* redistributive effects for agreed goals (e.g. reducing poverty). Southern academics are even more skewed in favour of the same position, which is the preferred option for 80% of them. Northern policymakers instead show a relative preference for temporary redistribution (40%), but a large share of them is open also to permanent redistribution although mostly limited to small and conditional programmes (30%). In Italy, 75% of respondents with an exclusive institutional background favour permanent redistribution for agreed goals, again singling out Italian policymakers as holding an idiosyncratic ideological position. Once again, Italian academics are more conservative and far less polarised in their preference for redistribution.

## 2.7 Implications

Differently from the other OCA criteria, the issue of homogeneous preferences has been relatively under-explored in the literature, probably because it is more difficult to quantify and assess than e.g. labour mobility or business cycle synchronisation. When looking into this criterion, researchers have tended to proxy preferences by means of various measures of macroeconomic outcome, such as growth rates or inflation rates[81], with the idea that those different outcomes should be taken as *symptomatic* of different underlying macroeconomic

[81] See, among others, the discussion of this topic in Baldwin and Wyplosz's 'Economics of European Integration'

policy preferences. While informative, this view is partial and does not fully address the question of whether macroeconomic preferences today are dis-homogeneous enough to justify a fear of moral hazard from fiscal solidarity, despite a prior process of macroeconomic convergence. Although admittedly limited in scope, the data presented in this section aim to bridge this gap by mapping more directly the extent to which preferences differed across the Euro-*South* and the Euro-*North* on the eve of the COVID-19 crisis. This data adds an original angle to the way in which this component OCA theory has been operationalised so far and provide three important insights in relation to the puzzle of European fiscal solidarity laid out in Chapter 1. The analysis presented in this section suggests that a *North-South* gap in macroeconomic policy preferences does exist, but the picture is far less clear-cut than one might have expected on the basis of both the prevailing sinners-vs-saints narrative of the Eurozone crisis and of the polarization on policy issues connected to risk sharing that I discuss in section 2.2. Ideological diversity *within* each of the two groups is quite significant, a fact that is at odds with the narrative of a cohesive 'Rhine Divide' in prevailing economic culture and ideology. At the same time, views *between* the two groups are not as extremely polarised as one might expect. While it is possible to identify a difference in the macroeconomic preferences of respondents in the Euro-*North* and Euro-*South*, this gap is small. On some of the topics investigated in the survey, there really seem to be no 'battle of ideas' as such, but rather a largely shared middle ground, which opens interesting research avenues to explore whether and how the macroeconomic adjustment programmes endured by the Euro-*South* can be held responsible for the apparent levelling of ideological differences on macroeconomic policy preferences. While those respondents who enjoy the intellectual freedom of academia seem to form a very homogeneous ideological community across *North* and *South*, views are more polarised when we restrict the sample to respondent with an

institutional background. This finding disputes the idea that Europe is divided into monolithic economic ideologies and rather points to the role of political and institutional constraints on the formation of macroeconomic policy preferences. It also weakens any attempt to explain the puzzle of European solidarity by arguing that, despite macroeconomic convergence, preferences are still dis-homogeneous enough for the Euro-*North* to fear that engaging in fiscal solidarity with the Euro-*South* would inevitably lead to permanent transfers. The third insight – and the most important for the purpose of explaining the puzzle – concerns the existence of an 'ideological oddity', i.e. a country that stands out as an outlier in terms of its macroeconomic policy preferences. That country is Italy. The Italian sample of experts with an institutional background displays significantly more extreme and polarised views than the corresponding constituency in either the Euro-*North* or the Euro-*South*. Those views suggest a unique preference for deeper intra-Eurozone fiscal redistribution, but without accepting an increased individual fiscal responsibility for high-debt countries. It is in this peculiar ideological position, which to some extent embodies the Northern nightmare of moral hazard, that I think the solution of the puzzle of European solidarity should be sought. The first question to answer, then, is the following: why is Italy such an 'ideological oddity' within the EMU? Chapter 3 will explore whether this idiosyncrasy can be mapped into the macroeconomic performance of Italy compared to its Eurozone neighbours.

# 3. An Economic Outlier

## 3.1 Prologue: who is *North* and who is *South*?

Is the Italian ideological 'exceptionalism' consistent with Italy's macroeconomic performance compared to its Eurozone peers? In setting out the puzzle of European fiscal solidarity that is central to this work, I have highlighted how the Eurozone crisis and the COVID-19 crisis can be framed as part of a single model whose outcome largely depends on policy choices made in resolving the trade-offs associated to the original decision of sharing a single currency. When that decision was taken, the EMU was a an economically heterogeneous group of countries, lacking the macroeconomic attributes identified in the literature for Optimum Currency Areas (OCA). While EMU members are and were already all very open to international trade – more so than the US – the trade effect of the single currency proved to be smaller than anticipated. Rose and van Wincoop (2001) expected the euro to increase intra-EU trade by over 50%, but ex post studies generally estimate the euro-related increase in bilateral intra-EMU trade to be between 5 and 10 percent only[82]. Regarding Kenen's criteria of industrial specialisation, there is some evidence suggesting that European countries experienced a moderate increase in specialisation following currency unification, thus increasing the EMU's vulnerability to asymmetric shocks[83]. The hope that currency unification would endogenously lead the EMU to morph into an OCA proved misplaced, as the single monetary policy fuelled – rather than tamed – the divergence in the economic and financial

[82] See for example (Baldwin , et al., 2008) for a review of the literature and estimates.
[83] See (Persson, 2011)

cycles within the Eurozone[84]. This divergence becomes very clear if we look at macroeconomic developments before the Eurozone crisis, by comparing countries' *relative* macroeconomic dynamics. The first step in this analysis is to produce a 'ranking' of countries based on measures of their macroeconomic performance, using a statistical classification system as neutral as possible, which does not require any *a priori* decision on the side of the researcher. To this end, I perform a very simple exercise, which builds upon the framework of the EU Macroeconomic Imbalance Procedure (MIP)[85]. I start by collecting data on several indicators that the European Commission uses in its MIP scoreboard, for 11 Eurozone countries[86]. For each indicator, I calculate the median across all countries. Then, I assign each country to one of two groups: those who perform 'worse' than the median (the Euro-*South*) are assigned a score of 0, the others (Euro-*North*) are given a score of 1. I do this for each country, on each indicator, and each year. Lastly, I average the scores for each country across all indicators, to obtain the time-varying macro positioning on a *North-South* macroeconomic scale – which may or may not align to the one identified in Chapter 2 in relation to ideological positions. An example may help explain the mechanics of this simple ranking system. In 2007, the median value of the general government debt to GDP ratio across the 11 countries was 64.4%. According to this simple classification system, all countries whose 2007 general government debt ratio was above 64.4% would be assigned to the Euro-*South* group and given a score of 0, for that year. In 2007, these countries were Austria, Belgium, Greece, Italy and Portugal. Finland, France, Germany, Ireland, Netherlands and Spain – whose debt ratio

[84] See (Merler, 2015) for a discussion.

[85] The MIP – introduced in 2011 – is intended to monitor macroeconomic developments across the Eurozone, to prevent (or respond to) imbalances. The MIP scoreboard is made of 14 indicators, but the time series for one of them (long-term unemployment) is too short for us to use it in this exercise, so we exclude that variable.

[86] These are the early Eurozone members: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain. Luxembourg is excluded because it tends to be an outlier on most macroeconomic and financial indicators.

was below the median value – would be classified as Euro-*North* and assigned a score of 1. Fast forward to 2017, and things have obviously changed. The median value for the general government debt to GDP ratio in 2017 was much higher, almost 97%. When assessed against this this benchmark, Belgium, Greece, Italy, Portugal and Spain would qualify as *South* in 2017 and get a score of 0. The remaining countries would qualify as *North* and be assigned a score of 1. This reasoning can be repeated for each indicator in each year. The second step is to calculate the average score across all indicators for each country. In each year, this average score will be a number between 0 and 1: numbers closer to 0 will identify countries that qualify as *South* on a relatively larger number of indicators; numbers closer to 1 will indicate countries that score as *North* on a relatively larger number of indicators. A country's score and relative position will change over time, depending on performance of both the country itself and its peers. While simple, this exercise allows ranking countries dynamically: when determining what group each country belongs to, we also consider how everyone else has changed, by using as a threshold the time-varying median position. Moreover, by its being based solely on relative positions, this classification system is also more transparent than alternatives relying on arbitrarily set exogenous and fixed policy thresholds.

**Table 1 North and South before the crisis**

| | 1960s | 1970s | 1980s | 1990s | 2000-08 |
|---|---|---|---|---|---|
| **Austria** | N | S | S | N | **N** |
| **Belgium** | N | N | N | N | **N** |
| **Finland** | S | S | S | S | **N** |
| **France** | S | N | N | N | **N** |
| **Germany** | N | N | N | N | **N** |
| **Greece** | N | N | N | S | **S** |
| **Ireland** | S | S | N | N | **S** |
| **Italy** | N | S | N | N | **N** |
| **Netherlands** | N | N | N | N | **N** |
| **Portugal** | S | S | N | S | **S** |

| | | | | | |
|---|---|---|---|---|---|
| **Spain** | N | N | N | S | **S** |

Source: authors' calculations based on the indicators reported in **Table A 1**

One interesting result from this exercise is the evidence that *North* and *South* are not static concepts, within the Eurozone (***Table 1*Error! Reference source not found.**). Countries have traded places often, over the past 50 years. During the decade preceding the Global Financial Crisis (2000-2008), this ranking system identifies as Euro-*South* those countries that had developed exceptionally large macroeconomic imbalances and eventually would require EU/IMF assistance (Greece, Ireland, Portugal and Spain). The Euro-*South* broadened during 2009-2013 to encompass also countries that, while not getting to the point of losing market access, did come under heightened market pressure (Belgium, France and Italy). Germany and the Netherlands, on the other hand, consistently qualify as *North* throughout the whole period of observation. But the devil is in the details, and Germany would score as *South* if one only looked at labour market indicators between the mid-1990s and the mid-2000s – in line with the timing of the Hartz labour market reforms. Similarly, the Netherlands would score as *South* if we were to restrict our focus on its private debt to GDP levels. The macroeconomic performance of Finland – a Northern hardliner, in the Eurozone political discourse – would have also been very much in the Southern camp until the early 2000s.

Despite this historical variability, it is the relative positioning of countries during the 2000-2008 period that gave rise to that narrative of the Eurozone crisis as a battle between 'sinners' and 'saints' – a narrative casting a long shadow well into the initial policy reaction to the COVID-19 crisis. In assessing the degree of macroeconomic divergence and convergence between *North* and *South*, I will therefore define the two poles according to the classification

in column 6 of **Error! Reference source not found.**, i.e. based on the grouping that my ranking s ystem identifies for the pre-crisis decade. The reason for choosing this particular definition of *North* and *South* for the macroeconomic analysis that will be carried out in the rest of the chapter is simple: I think it best allows establishing whether the pre-crisis macroeconomic asymmetry that served as a justification for the Brussels-Frankfurt consensus of forced adjustment still exists today. When the Eurozone crisis erupted, capital flows – which the OCA literature expected to play a stabilising function – ended up amplifying the crisis by triggering a fully-fledged sudden stop and balance of payment crisis in the hardest-hit countries[87]. Despite free movement of people being one of the fundamental tenets of the EU, cross-country labour mobility affected only 0.1% of EU working age population before the crisis, against 2-2.5% annual interstate mobility in the United States[88]. While emigration from countries in the Euro-*South* increased massively during the Eurozone crisis, significant frictions and obstacles remained for this mechanism to be able to absorb a significant part of the macroeconomic shock. The most political of the OCA criteria – the will to engage in transfers to compensate asymmetric shocks – was assumed by the financial markets to be fulfilled, as discussed, but turned out to be illusory when the Eurozone crisis hit. The crisis was instead managed through a massive unilateral macroeconomic adjustment of countries in the Euro-*South* – thus forcing the very process of real convergence that endogenous OCA theory had expected to occur naturally. Understanding whether that same *North-South* macroeconomic asymmetry still exists is therefore key, for two reasons. First, it is instrumental to understand whether the difficulty in agreeing to a new consensus of European solidarity during the COVID-19 crisis can be traced to the continuing existence of

[87] See (Merler & Pisani-Ferry, 2012)
[88] See (Bonin , et al., 2008)

misalignments in the economic structures of EMU members, which may induce in some members the fear that fiscal solidarity will lead to permanent transfers and moral hazard. If, on the other hand, those macroeconomic asymmetries have disappeared or been significantly reduced on the back of the macroeconomic adjustment programmes, the claim that dis-homogeneous preferences play a key role in the puzzle of European solidarity would be strengthened. Second, this exercise allows assessing the individual macroeconomic performance of Italy – which has been identified in Chapter 2 as an outlier from an ideological and preference standpoint – against the performance of the two polar groups that have defined the character of the Eurozone crisis. From the data presented in ***Table 1***, Italy seems to be a hybrid between the two groups: closer to a Euro-*North* country in terms of its pre-crisis macroeconomic performance, it came under the same kind of market pressure and experienced a sudden stop like its Euro-*South* neighbours, during the crisis.

## 3.2 Competitiveness and Productivity

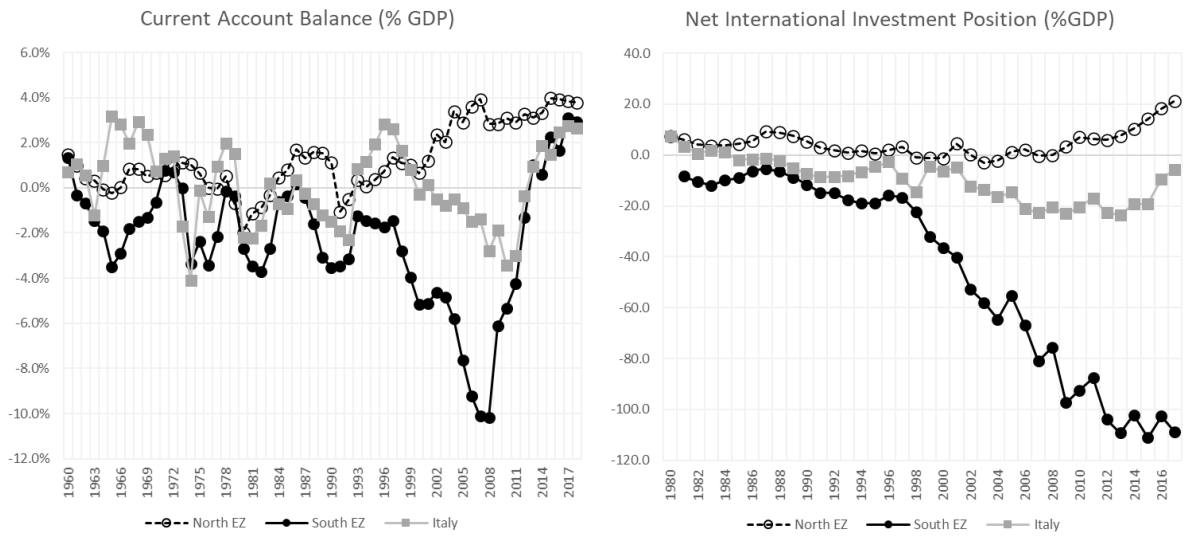
EMU member countries posted very divergent performances in terms of productivity and external competitiveness, before the Eurozone crisis, and the drivers of growth differed significantly across *North* and *South*. In the Euro-*North*, average demand growth was slower than average GDP growth – a sign that countries were saving more than they invested domestically. The excess savings were channelled abroad (to the Euro-*South*), as reflected in a positive and growing current account position and a steady accumulation of foreign assets. On the other hand, the exceptional economic growth rates experienced by Greece, Ireland, Portugal and Spain prior to the Eurozone crisis were largely demand-driven. Between 1999 and 2007, domestic demand in the Euro-*South* grew on average faster than GDP – driven

mostly by a boom in private consumption and investment. As the single currency removed the exchange rate risk, nominal interest rate differentials narrowed across the Eurozone, both on the sovereign and in the interbank markets. As a consequence, the interest rates charged by banks on their lending to the private sector were also lowered. Greek banks, for example, used to charge a rate in excess of 20% on their loans to Greek non-financial corporations in the late 1990s. These rates dropped to 5% in the early 2000s. Similarly, in Portugal, the bank lending rate to the non-financial corporate sector went from 15% to 5% during the same period[89]. At the same time, inflation in the Euro-*South*, while being low in historical perspective, remained consistently higher than in the Euro-*North*. These persistent inflation differentials led to the real cost of debt being even lower than the nominal cost. Borrowing had never been cheaper, in the Euro-*South*. Predictably, the result was a surge in private credit demand. Before monetary unification, this heightened credit demand would have met a credit supply constrained by the boundaries of the domestic deposit base, and hence higher rates would have been needed to restore an equilibrium. But in a monetary union, banks in the Euro-*South* could access an EMU-wide funding pool. Intra-Eurozone bank lending exploded, as Southern banks borrowed from Northern banks to meet a booming domestic demand for credit. Across the Euro-*South* bank credit to the non-financial private sector more than doubled in percentage of GDP between 1999 and 2009. In the North credit tended to stagnate, and in Germany bank credit to the private sector decreased by almost 20 points of GDP from 1999 to 2012, signalling that domestic savings were not re-invested at home. As imbalances accumulated in the private sector indebtedness, the conditions were set for the Euro-*South* to grow increasingly dependent on external lending, and hence more vulnerable

[89] See (Merler, 2015) for a detailed discussion.

to a sudden halt in the credit lifeline from the *North*. This dynamic was predictable: economic theory in fact suggests that in the absence of frictions, savings should naturally flow 'downhill', i.e. from capital-rich countries towards those countries where capital was relatively scarcer and its remuneration relatively higher (like the Eurozone *South* at the end of the 1990s). The prominent role that cross-border capital flows played in the Southern credit boom is evident in the divergence of intra-EMU current account positions – an indicator of the net position of countries vis-à-vis the rest of the world (Figure 7). While the Eurozone aggregate current account remained balanced, the Euro-*South* was a running a persistent current account deficit that widened from 2% of the group's GDP in 1999 to about 10% in 2008, and the Euro-North was running a comparable and growing current account surplus.

**Figure 7 External Dependence**



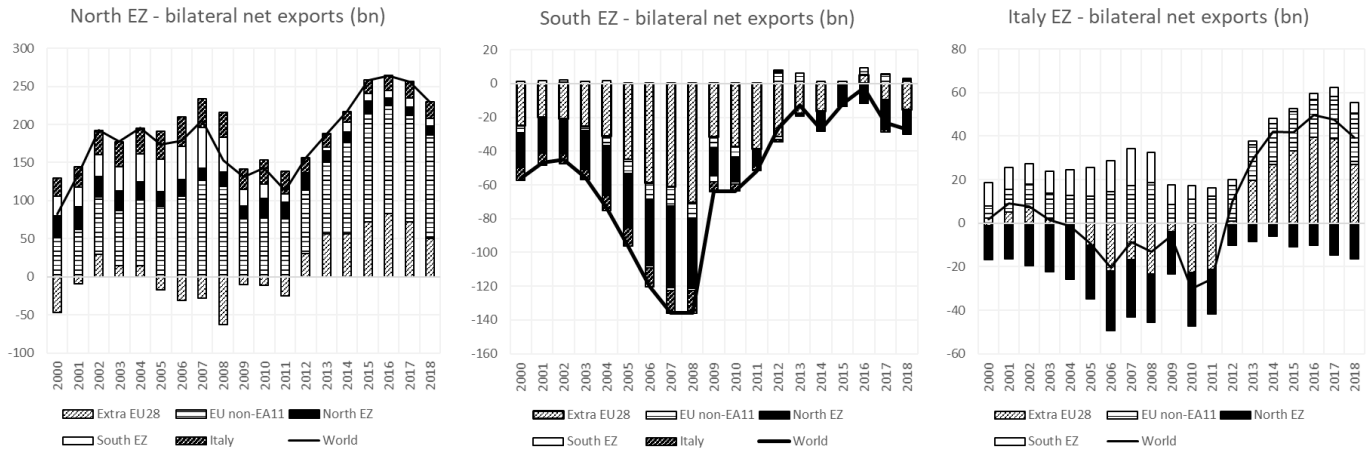

Source: own calculation based on AMECO, IMF
Note: North EZ = Austria, Belgium, Finland, France, Germany, the Netherlands;
South EZ = Greece, Ireland, Portugal, Spain

This imbalance was initially saluted by economists as a good sign that capital was finally flowing downhill, but a long-term assessment would prove much less positive. In a paper published in 2002, Olivier Blanchard and Francesco Giavazzi argued that the persistent and widening current account imbalances within the EMU should be taken as evidence that currency unification was working, and it had brought an end to the so-called "Feldstein-Horioka Puzzle", i.e. the puzzling empirical evidence of positive and strong correlation between domestic saving and investment across advanced economies[90]. As the counterpart of its growing current account deficit, the Euro-*South* accumulated a sizable external debt burden (worth almost 100% of the group's total GDP in 2017). This external debt reflected to a significant extent the accrual of non-core banking liabilities, which tend by nature to be more volatile than the domestic deposit base[91]. For banks in the Euro-*South*, non-core funding grew from 34% in 1997 to 60% of total funding in 2008 – mostly due to an expansion in intra-EMU non-core deposits, which grew threefold between the early 2000s and the outbreak of the crisis[92]. This funding model exposed the Southern economies to the risk of experiencing a 'sudden stop' in capital inflows – a phenomenon commonly observed across emerging markets but deemed impossible in the case of countries sharing the same currency[93]. Yet, when the Eurozone crisis erupted, capital flows – which the OCA literature expected to play a stabilising function – ended up amplifying the crisis. In a paper published in 2012[94], Jean

[90] See (Blanchard & Giavazzi, 2002)
[91] By "non-core liabilities" we mean liabilities vis-à-vis domestic non-bank financial institutions, borrowing from foreigners and issuance of banks debt securities. This definition is based on the work of (Hahm, et al., 2012).
[92] See (Merler, 2015) for a more detailed discussion.
[93] See for example (Calvo, et al., 2004) for a discussion of the phenomenon in emerging markets and of one methodological approach to identifying sudden stops. As discussed in chapter 1, Ingram (1973) and the European Commission's One Market, One Money report (1990) are two examples of a widespread conviction that the introduction of a single currency would make it impossible to observe balance of payment crises across members, as intra-EMU payments were expected to become akin to payments across regions within individual countries.
[94] See (Merler & Pisani-Ferry, 2012)

Pisani-Ferry and I showed that the private capital outflows observed from Greece, Ireland, Portugal and Spain between 2008 and 2013 were large enough to qualify as a sudden stop, according to the definition typically applied to similar phenomena in emerging markets. Absent the compensating inflows of ECB extraordinary liquidity provision and the funds disbursed under the EU/IMF programmes – these countries would have experienced a full-blown balance of payment crisis. Italy also experienced sizeable capital outflows, in the summer and fall 2011, before the appointment of the Monti government. As far as the pre-crisis drivers of growth are concerned, however, Italy is not a classic Southern story. Italian GDP and demand grew at about the same pace before the crisis. Real long-term rates declined but remained higher than in the programme countries. Accordingly, domestic credit increased, but more moderately than in the Euro-*South*, and Italian private debt to GDP peaked at 125% in 2012 – lower than the aggregate figure for the Euro-*North* in the same year (not to mention the 194% accumulated by the Euro-*South*).

**Figure 8 Geographical breakdown of net export**




Source: own calculation based on Eurostat ComExt
Note: North EZ = Austria, Belgium, Finland, France, Germany, Netherlands;
South EZ = Greece, Ireland, Portugal, Spain

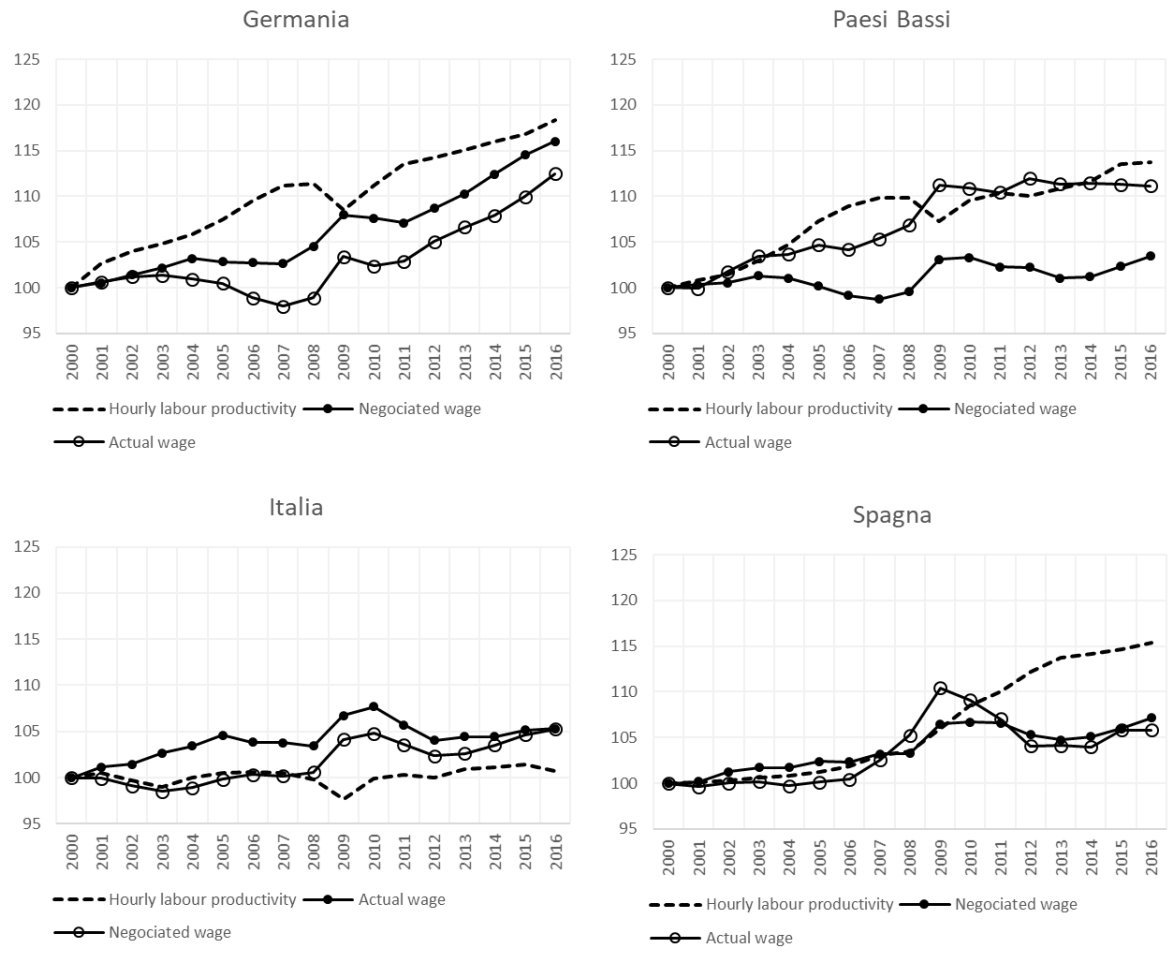
While not accumulating sizeable external imbalances, Italy nevertheless experienced a deterioration of its external competitiveness position in the period preceding the Eurozone crisis, as suggested by the expansion of the current account deficit to -3.4% of GDP between 2000 and 2008,. Another indication of a progressive deterioration in external competitiveness emerges from the bilateral net export positions within and outside the Eurozone (Figure 8**Figure *8***). Italian net exports were broadly balanced until 2004 but turned negative between 2005 and 2012. When looking at the detailed geographical composition of the trade balance, Italy was a net exporter to the Euro-*South* but was running a net trade deficit vis-à-vis the Euro-*North*. The rebound in net exports visible after 2013 is almost entirely explained by extra-EU positions: the intra-EMU net position vis-à-vis the Euro-*North* remained negative, and the positive position vis-à-vis the Euro-*South* had shrunk and almost disappeared. This geographical breakdown points to the continued existence of an underlying competitiveness problem of Italy vis-à-vis its Eurozone peers, which was limited to the Euro-*North* before the crisis and had extended to the Euro-*South* afterwards. This loss of competitiveness was not a price-side phenomenon driven by the development of large macroeconomic imbalances – like what happened in the countries that eventually needed EU/IMF adjustment programme – but rather a slow and steady cost-side development tied to poor underlying productivity dynamics. A recent ISTAT report reveals that between 1995 and 2018, the average annual growth of labour productivity in Italy was 0.4%, compared to 0.7% for the productivity of capital, and to 0% for Total Factor Productivity (TFP). In 2018, the growth of both labour productivity and TFP was negative.

This dismal performance is unmatched in the rest of the Eurozone[95], and many possible explanations have been proposed. Certainly, the sectoral specialisation of Italian manufacturing, and the structural bias of the Italian industrial landscape towards micro and small firms that invest little in R&D and skilled labour is an important factor. Some researchers have pointed also to judicial inefficiency and poor the quality of governance, while others have highlighted the role of a structural lack of human capital and of inefficiencies in the allocation of credit supply[96]. In part, the problem is also rooted into a dysfunctional labour market, which produces a significant mismatch between wage and productivity dynamics (Figure 9**Figure *9***). German wage dynamics have consistently remained below the growth rate of labour productivity since the early 2000, and between 2003 and 2007 actual wage growth was negative even against a positive growth rate of productivity. The Netherlands went through a similar experience from 2004 to 2008, and wages and productivity have remained closely aligned thereafter. In Spain, wage growth overshot productivity growth significantly, between 2006 and 2009, but collapsed during the crisis signalling a massive internal devaluation process. Since 2011, Spanish labour productivity has been growing fast while wage growth has remained subdued. Italian wages have instead been growing positively (although very slowly) since 2000, but the growth rate of aggregate hourly labour productivity has completely flatlined. Looking at an even more granular picture, (Manasse & Manfredi, 2014) show that Italian wage dynamics not only are not reflective of sector productivity in the short run, but in the long run wages seem to rise in those sectors where productivity falls. (Calligaris, et al., 2018) points to the existence of significant misallocation, mainly within

[95] See (ISTAT, 2019) and (Garnero, 2019)
[96] See (Amici, et al., 2018) for an in-debt discussion of the various explanations offered in the extensive literature on Italian productivity.

rather than between sectors, which is most prominent in those sectors where the world technological frontier has expanded faster and that helps explain 20% of the lack in TFP growth between 1995 and 2018. Absent that misallocation, they estimate that Italy would have experienced a 1% higher GDP growth per-year, which would have helped close the growth gap with France and Germany. The problem of stagnant wage growth is a recurrent topic in in the Italian public debate, but less attention is paid to the fact that even the minimal Italian wage growth observed in the recent past has exceeded productivity growth. In a recent IMF working paper, (Kangur, 2018) finds that 45% of Italy's manufacturing ULC-gaps relative to Germany can be attributed to wage developments and 60% to lagging labour productivity. This sort of dynamic, if sustained over time, is a recipe for a gradual loss of external competitiveness.

**Figure 9 Wages and Productivity dynamics**



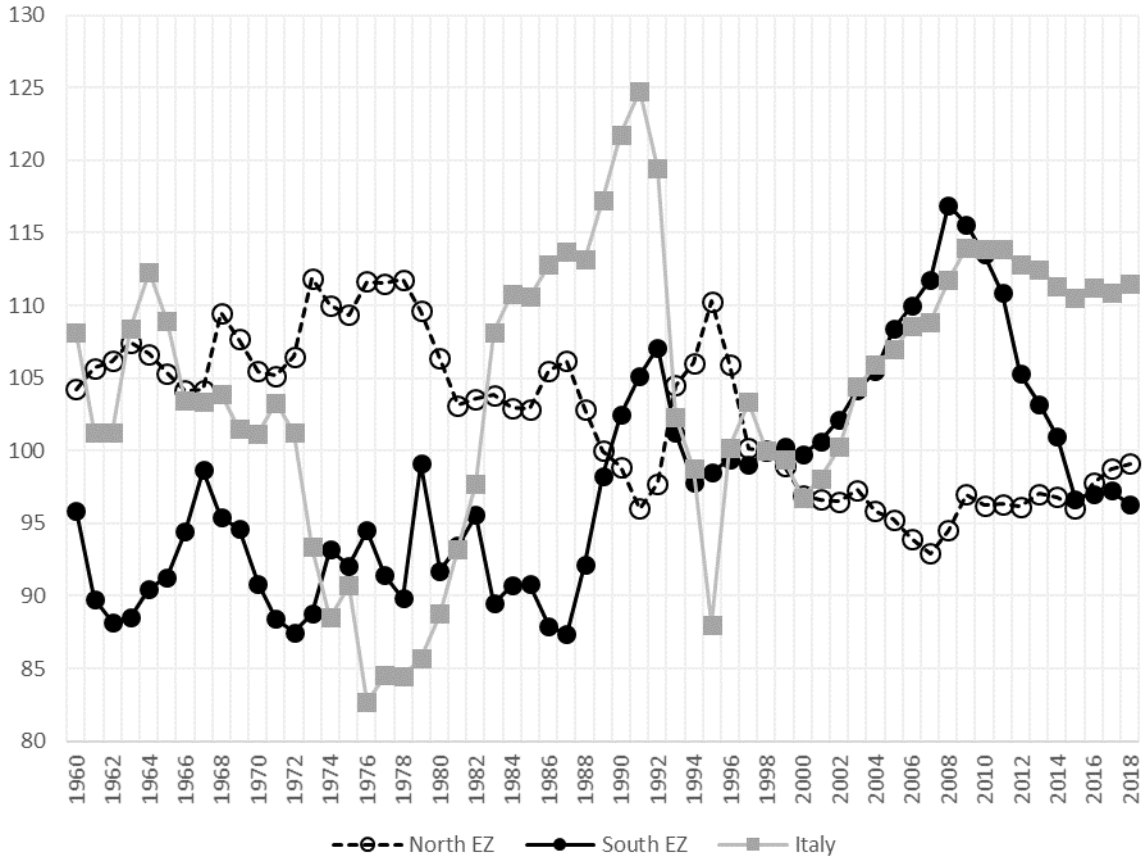

Source: OECD Employment Outlook 2018, Chapter 3

The loss of external competitiveness is evident when looking at the dynamics of Real Effective Exchange Rates (REER) adjusted for Unit Labour Costs (ULC). The REER is an indicator of a country's price or cost competitiveness relative to its competitors in the international markets. For countries that share a single currency, it is an especially informative measure because it allows proxying the over or under-valuation of the non-existent nominal exchange rate. Today, the Italian ULC-adjusted REER is overvalued vis-à-vis the rest of the EU-15 by around 10-15%, compared to 1998 (Figure 10**Figure *10***). The choice of 1998 as a base year

may not be inconsequential, because at the time the Italian government was compressing wage growth to prepare for entry in the EMU, and because at the same time Germany was still experiencing the fallouts of the post-unification shock. Yet it is the latest year before the euro came into existence (on 1st January 1999) and thus an especially informative cut-off date for evaluating the successive competitiveness development before and after the Eurozone crisis. Figure 10**Figure *10*** shows that between 1999 and 2010 the average REER for Italy and for the Euro-*South* underwent an appreciation that is entirely comparable, despite the relative lack of macroeconomic imbalances in the Italian context. Starting in 2010, however, the Southern countries embarked on an equally massive real devaluation. As a result, their REER – i.e. their external competitiveness *within* the EMU – today has become fully aligned with that of the Euro-*North*. Italy did not undergo any comparable adjustment, and the ULC-adjusted REER in 2018 was still about 10% overvalued compared to 20 years earlier. The increase in the ULC has weighed on profit margins, employment, and investment, imposing a drag on Italian exports and on growth. The risk of such a scenario was not unforeseen. In May 1998, then-governor of the Central Bank of Italy Antonio Fazio warned that: *"participation to the European single currency achieves definitive monetary stability. This could bring economic development, employment and a stabilisation of the public finances, if economic policies and the attitude of the social partners will be coherent. On the other hand, it could also bring a loss of competitiveness, a weakening of the productive structure, an increase in unemployment. The outcome crucially depends on fiscal policy choices and labour costs"*[97].

[97] The original quote, on page 36 of (Fazio, 1998) reads: La partecipazione alla moneta unica europea acquisisce definitivamente la stabilità monetaria. Da essa potranno derivare sviluppo, occupazione e risanamento delle finanze pubbliche se le politiche economiche e i comportamenti delle parti sociali saranno coerenti. Ne discenderanno altrimenti una minore competitività, un indebolimento della struttura produttiva, un aumento della disoccupazione. L'esito dipende crucialmente dalle politiche di finanza pubblica e di costo del lavoro, delle quali nelle pagine precedenti abbiamo inteso indicare la direzione e alcuni punti nodali. Dipende altresì dalla risposta del sistema economico all'esigenza di una più elevata flessibilità nell'allocazione delle risorse e nell'utilizzo dei fattori produttivi.

**Figure 10 REER (ULC-adjusted, EU 15), 1998=100**




Source: own calculation based on AMECO
Note: North EZ = Austria, Belgium, Finland, France, Germany, Netherlands;
South EZ = Greece, Ireland, Portugal, Spain

## 3.3 Human Capital

Human capital – the knowledge, skills, competences, and attributes embodied in individuals that facilitate creation of personal, social, and economic well-being – is a major driver of

productivity, and of economic growth[98]. Italy produces considerably less human capital compared to other European and non-European industrialised economies. This under-production is partly due to high early school dropouts. Dropout rates among the 18-24-years-old decreased markedly over the past 20 years and were down to 14.5% in 2018 from around 30% at the end of the Nineties. While an improvement, this figure is still above the average dropout rate in the Euro-*North* (9.2%) and slightly above the corresponding figure for the Euro-*South* (13.9%). It is in tertiary education enrolment and graduation rates, however, that Italy has been consistently losing ground since the Nineties. In 2017, only 18.7% of the Italian population had a tertiary education degree. It is a figure low enough to place Italy in the second-to-last position among OECD countries. As a comparison, in 2017 the share of population with tertiary education was 32.6% on average across the Euro-*North* and 36.1% in the Euro-*South***Error! Reference source not found.**. This gap cannot be entirely accounted for b y demographics – i.e. by the fact that the Italian population tends to be older. The share of the college educated is below OECD average even when looking specifically at the 25-34 age cohort. Among those who do attain tertiary education[99], the largest share (23.8%) pursues degrees in the STEM fields (science, technology, engineering, and mathematics). While lower than the 35.2% recorded in Germany, this figure is not too far from OECD average. More interesting is the breakdown of graduates into the different STEM subfields. While Italy tops the OECD ranking in natural sciences, mathematics, and statistics, it ranks low in information and communication technologies and engineering, manufacturing, and construction. The

[98] See (Amici, et al., 2018) for an excellent review of the literature. Some important works in the Italian and international context – from where I draw the findings referred to in this chapter – are (Cipollone & Sestito, 2010), (Biagi & Parisi, 2012), (Hall, et al., 2013), (D'Amore & Iorio, 2017)

[99] For a more detailed discussion of this topic, see this report published last year and written in collaboration with the Italian think-tank Tortuga (Bassetto , et al., 2019)

country is under-producing skills in fields that are becoming key for productivity and economic growth, and where skills are also in high demand – as evident from the fact that the youth unemployment rate for ICTs graduates is the lowest across all the tertiary education STEM sub-fields.

Why is Italy so inefficient at accumulating human capital, compared to its Eurozone peers? Explaining the gap requires taking both demand and supply factors into account. On the supply side, the Italian education and training system does not seem to be efficient at providing students with skills comparable to those of their peers in other countries[100]. The latest OECD PISA report shows that in 2018, Italian students tended to score below OECD average in both reading and science, and close to the average in mathematics. The performance of the Italian average student in reading and science has declined since 2012, and the performance in science has declined most markedly amongst the highest-achieving students (OECD, 2018). The OECD Survey of Adult Skills (PIACC)[101] yields a sobering picture of the skill set of Italian university graduates. On average, the language skills of Italian tertiary educated graduates were found to be on par or below those of Finnish and Dutch young adults holding only an upper secondary degree. Despite this dismal record, spending on education has not typically been a priority in the allocation of public resources. Italian public spending on education is low as a share of GDP (3.8% in 2017, compared to 4.9% in the Euro-*North* and 4% in the Euro-*South*) and lower still as a proportion of total general government expenditure (7.9% in 2017, compared to 9.9% in the Euro-*North* and 10% in the Euro-

[100] See for example (Schivardi & Torrini , 2011) and (Colonna, 2017)
[101] The PIACC country note for Italy can be found at: http://www.oecd.org/skills/piaac/Country%20note%20-%20Italy%20(ITA).pdf

*South*[102]). While the share of funding for primary and secondary education is in line with the rest of the Eurozone (3.2 % of GDP in Italy, against 3.3% in the *North* and 3% in the *South)*, tertiary education is underfunded by a factor of two or three times (0.3% of GDP in Italy, 0.8% in the *North* and 0.6% in the *South*). Across the Eurozone, Finland and the Netherlands are the countries spending the most on tertiary education, while Italy is the country spending the least.

Incentives also play an important role in explaining low human capital accumulation in Italy, especially when focusing on the trade-off between the costs of studying and the return on education. Tuition fees in Italy are among the highest in the EU and 80% of the students do not receive any form of financial support[103]. At the same time, studying is an investment – and the decision to invest in one's own education will also depend on the expected pay-off from that investment. In Italy, the expected pay-off from tertiary education is low. This is evident when looking at the private internal rate of return (IRR) on education, i.e. the real interest rate that would equalise costs and benefits of investing in one's own education. The IRR can be interpreted as the 'premium' that an individual can expect to receive annually during a working-age life, thanks to the investment made to achieve a certain educational level: the higher the IRR, the strongest the incentive will be to pursue a higher education. Across OECD countries, the average IRR from attaining tertiary education compared to upper secondary is 14% for men and 16% for women. Based on data reported in the OECD's

[102] These numbers, as well as the following ones on primary and tertiary education, have been computed as the total expenditure for the group divided by the group's total GDP. They therefore look at North and South *as if* they were standalone countries.

[103] (OECD , 2017). In a bid to improve access to tertiary education, in 2017 the government introduced a tuition fee exemption for students coming from households with an income below €13,000, and partial exemptions for incomes between €13,000 and €30,000.

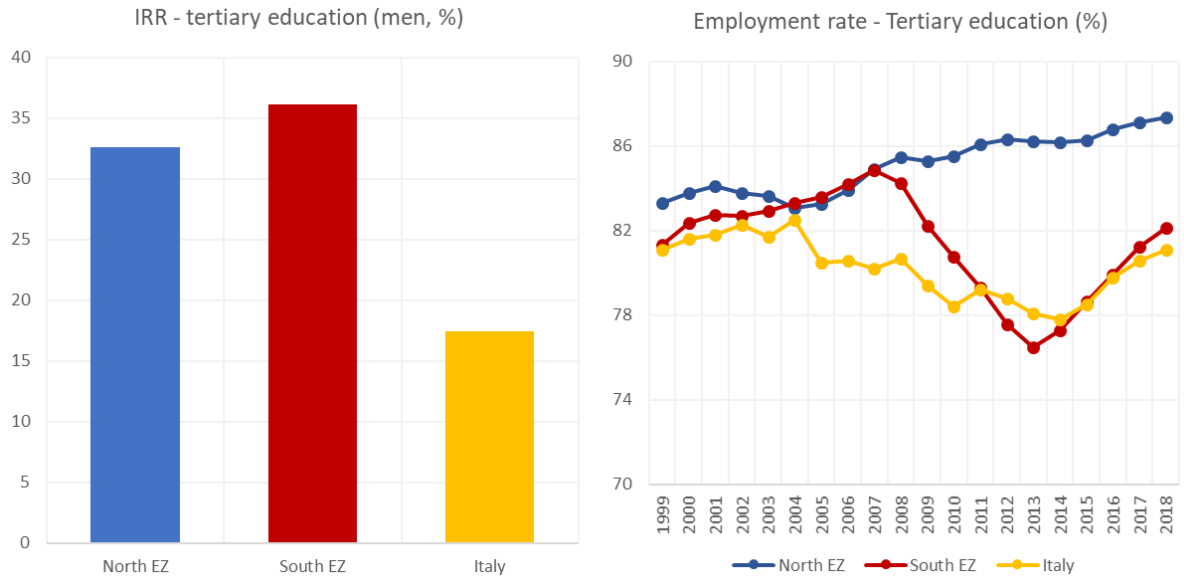
'Education at a glance 2018', the private IRR for male students in Italy is the second lowest in the OECD (8%)[104], and lower than the corresponding average rates in the Euro-*North* and Euro-*South* (Figure 11**Error! Reference source not found.**, left). At the same time, e mployment rates for university graduates in the 24-65 years old population are still relatively low in Italy compared to the Euro-*North,* and today they are also lower than in the Euro-*South*. Even more concerning is the fact that a gap in graduate employment rate vis-à-vis the Euro-*North* was already visible in 2005-08 – which points to a structural weakness in the labour market for high-skilled graduates rather than to a mere cyclicality phenomenon.

On the demand side of the human capital equation, the Italian industrial landscape is dominated by micro enterprises. Recent data from ISTAT[105] show that the number of Italian firms per 1000 inhabitants has increased from 64.7 in 2004 to 71.4 in 2016, higher than the average figures for the Euro-*North* and Euro-*South.* At the same time, the average Italian firm remains tiny – posting a workforce of around 4 employees. This 'dwarfism' of the Italian industrial landscape is associated to a structurally low demand for high-skilled labour, and hence contributes to hamper human capital accumulation. Research suggests that the demand for workers with tertiary education is concentrated in bigger firms, mainly in the north-western and central areas of the country, and predominantly in the services sector[106]. The widespread presence of family management may also help explain why demand for university graduates is weak: in a 2011 paper, Schivardi and Torrini suggest that entrepreneurs who do not themselves hold a tertiary degree may have a lower propensity to

[104] A similar figure is found in earlier works, for example (Cipollone & Cingano, 2011)
[105] The data in this section is available on ISTAT website, in the "Noi Italia 2019" section: http://noi-italia.istat.it/
[106] See (Montanari , et al., 2015)

hire graduates[107]. Familyism is also associated with a proclivity to select, promote, and reward people based on loyalty rather than merit – an important factor in explaining why Italy was ill-equipped to take full advantage of the ICT revolution, as discussed in a 2017 research paper by Pellegrino and Zingales[108]. Compounding the problem, small firms tend to have more difficulties to invest in Research & Development (R&D) – as reflected in a low share of business R&D expenditure to GDP in Italy (0.8%) – and thus tend to be less innovative[109]. The fact that they are less innovative in turns further reduces SMEs' need of for high-skilled educated workers.

**Figure 11 The Return on Tertiary Education**



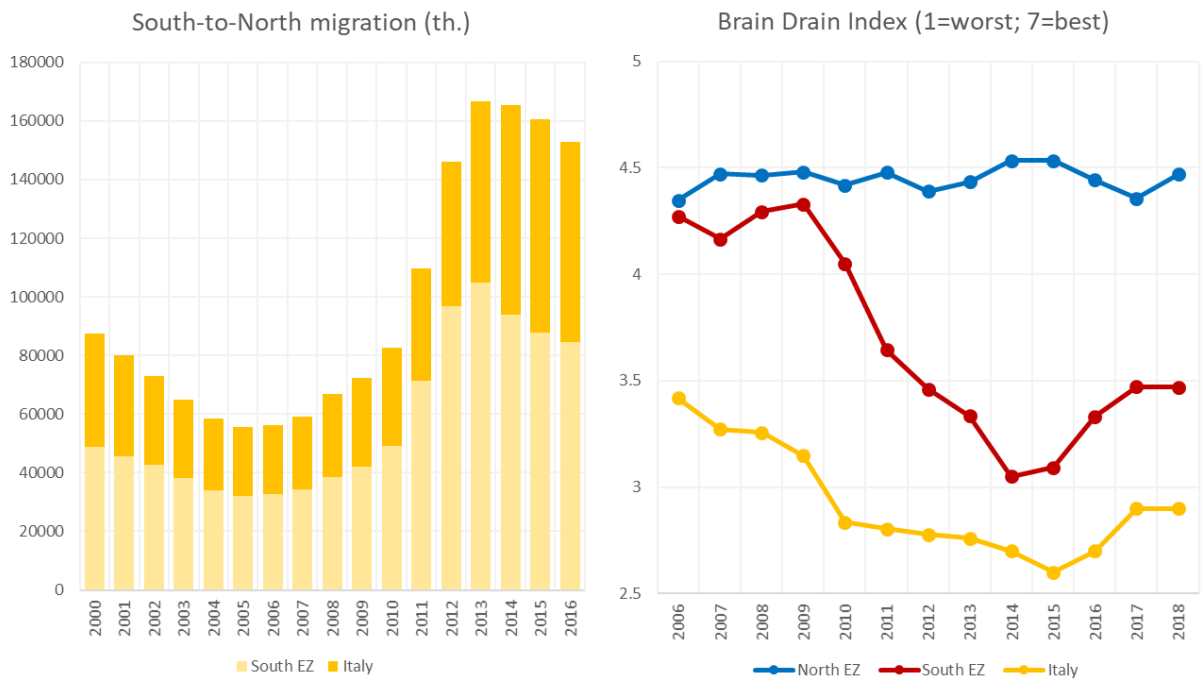

Source: own calculations based on the OECD Education Outlook 2018 and Eurostat
Note: Data refers to 2014 for Italy and France and 2015 for the other countries;
no data is available for the Netherlands

[107] See (Schivardi & Torrini , 2011)
[108] See (Pellegrino & Zingales, 2017)
[109] See (Bugamelli, et al., 2012) for a discussion.

The reduced return on education coupled with structurally low demand for human capital contribute to explain the 'surge in high-skilled Italian emigration observed in the context of the Eurozone crisis. 'Brain Drain' – the emigration of highly educated and skilled workers – is a commonly observed across developing countries, but recently experienced also by industrialised economies. Among OCED members, the number of migrants with tertiary education has grown by almost 130% between 1990 and 2010. Over the same period, low-skilled migration has increased by 40% 'only'. As discussed in (Bassetto , et al., 2019), Italy has also experienced this phenomenon. In 2018, there were 250 emigrants for every 100 thousand inhabitants and the emigration of Italian citizens neared a five-decade high, close to levels last seen in the 1970s. Emigration is not a phenomenon exclusive of Italy: during the Eurozone crisis, the dire economic conditions across the Euro-*South* led to sizeable emigration towards the Euro-*North*. The crude net migration rate turned negative – signalling net exit – in Ireland in 2009, in Greece in 2010, in Portugal in 2011 and in Spain in 2012. Emigration from the countries that were subject to EU/IMF adjustment programmes more than doubled between 2007 and 2013, and emigration from Italy increased significantly thereafter. Outflows had started to level off before the pandemic, but they continued to be larger than prior to the Eurozone crisis (Figure 12, left). The counterpart to this haemorrhage from the Euro-*South* has been a deterioration in the ability of these countries to attract and retain talent, which can be quantified using the 'brain drain index' data collected by the World Economic Forum (Figure 12**Error! Reference source not found.**, right). When looking at the e volution of this indicator over time, Italy appears to suffer from a structural problem pre-dating the Eurozone crisis. The gap in attractiveness between the Euro-*North* and the Euro-*South* widened considerably during the crisis and remained sizeable on the eve of the COVID-19 pandemic. Up until 2010, however, the ability to attract and retain talent was entirely

comparable between Euro-*North* and *South*. Italy, on the other hand, already displayed a lower and declining level of attractiveness in the mid-2000s.

**Figure 12 21st Century Italian Emigration**




Source: **Left** - authors' calculations based on OECD international migration database; **Right** - authors' calculations based on data from the World Economic Forum Global Competitiveness Reports
Note: In the left-hand figure, South = Greece, Portugal, Spain (no data for Ireland). North = Austria, Belgium, Finland, Germany, Netherlands (France is excluded due to missing data before 2012).

The recent Italian emigration wave is mostly composed of young and well-educated migrants, as evident in the survey of Italian graduates run periodically by the Italian Statistical Institute (ISTAT). The data reveals that the educational attainment of emigrants has been increasing over time. In the 2011 survey wave, the share of respondents holding a Masters degree or equivalent was less than 17% among graduates who were resident in Italy, and 33% among those who had moved abroad. In the 2015 wave, the share of Italians resident abroad who held a Masters or equivalent was 43%, pointing to a sizable outflow of skills in the space of

just 4 years[110]. Among those who migrate, there is also a strong self-selection: in the same ISTAT survey mentioned above, students who graduated with the highest marks (honours, or *110 cum laude* in Italian) account for 40% of the Italian respondents living abroad but for less than 25% of the respondents who remained in Italy after graduation. The picture emerging from this data hence suggests that Italy is not only under-producing human capital compared to its Eurozone peers, but it is also losing its 'best and brightest' to emigration – with important repercussions on productivity and economic growth,

## 3.4 Labour and Product Market

The scarcity of human capital described in Section 3.3 is compounded by severe mismatching through an inefficient labour market. Data from the 2018 OECD Employment Outlook show that, among the OECD members, Italy is the one with the highest share of workers who are under-qualified for the job they perform (22%). The data from the ISTAT's survey of graduates discussed in Section 3.3 align with this evidence: when looking at the occupation of respondents by residency, we find that the share of those employed in highly specialized professions is much higher (51%) among the graduates who reside abroad than among those who stayed in Italy (39%). In reaction to these inefficiencies, the Italian labour market institutions have been the object of several reform attempts, most recently by the Monti and Renzi governments. The Monti labour market reform aimed at addressing the characteristic dualism of the Italian labour market by rising protections for temporary and young workers

[110] See (Bassetto , et al., 2019) for details.

and somewhat softening or restructuring the safety net for permanent workers[111]. The parliamentary and public debate about the reform, however, focused on proposed changes to the symbolic Article 18 of the Workers' Statute, a provision imposing on firms with less than 15 employees a mandatory requirement to reintegrate fired workers whenever a labour court ruled their dismissal to be illegitimate. The first version of the Monti reform intended to modify this provision for the dismissals predicated on economic grounds, where the firing firm would have been only obliged to pay compensation benefits to the worker but not to reintegrate him/her, unless the worker could demonstrate a discriminatory or disciplinary intent. This change was strongly opposed by the unions, but the government tried nonetheless to push it through Parliament. Following a backlash with the public opinion, the government changed course and softened the stance by partly reinstating the previously existing provisions. The result was a reform that to many felt unfinished, marginal, and potentially worsening the uncertainty in the functioning of the labour market institutions that it had initially aimed to reduce.

The 'Jobs Act' enforced in 2014 by the Renzi government represented a wide-ranging welfare state and labour market reform that featured the introduction of a new open-ended contract, a reorganization of unemployment benefits, a temporary lay-off benefit schemes, and more focus on Active Labour Market Policies (ALMPs). For its critics, the Act significantly reduced workers' protection rights. For its supporters, it was a radical shift in focus compared to the strategy of 'flexibility at the margin' characteristic of the previous reforms. The Act introduced a new contract for new hires (*contratto a tutele crescenti*), with workers' protection

[111] For a more detailed discussion, see (Banca d'Italia, 2012), (Cencig, 2012), (Culpepper, 2014), (Boeri & Garibaldi, 2012), (Tiraboschi, 2012).

increasing over time but without the right to be re-hired in case of economic dismissal. This succeeded where Monti's reform had failed, i.e. in significantly downsizing the Article 18 of the Workers' Statute. Ex-post data evidence suggests that the Act did lead to some increase in the share of new hiring by open-ended contracts and in employed workers. (Sestito & Viviano, 2016) for example, find that provisions of the Act contributed to double the monthly rate of conversion of fixed-term jobs into permanent positions and that the new firing rules appear to have made firms less reluctant to offer permanent job positions to yet untested workers. (Boeri & Garibaldi, 2018) find evidence of a causal increase in open ended hiring by firms with more than 15 employees relative to smaller firms, an increase in the transformation from fixed term to open ended contracts. (Pinelli, et al., 2017) also notice the Act helped bring Italian labour market institutions more in line with international benchmarks and with the principles of flexicurity. But there are also negative assessments, such as (Cirillo, et al., 2017) who highlight the existence of frictions in the distribution of new contracts by time structure (part vs. full-time) and by age groups (young vs. old workers). More recently, various provisions of the Jobs Act have been altered or scaled back both by decisions of the Constitutional Court and by the 'Dignity Decree' legislated by the Lega-M5S government in 2018[112].

One element that remains unaddressed by the patchwork of Italian labour market reforms is the wage bargaining system. Today, wages in Italy are set for each industry and occupational level through national agreements between the unions and the employers. Overall, there are 346 national agreements, covering about 97.7% of dependent employment in the social

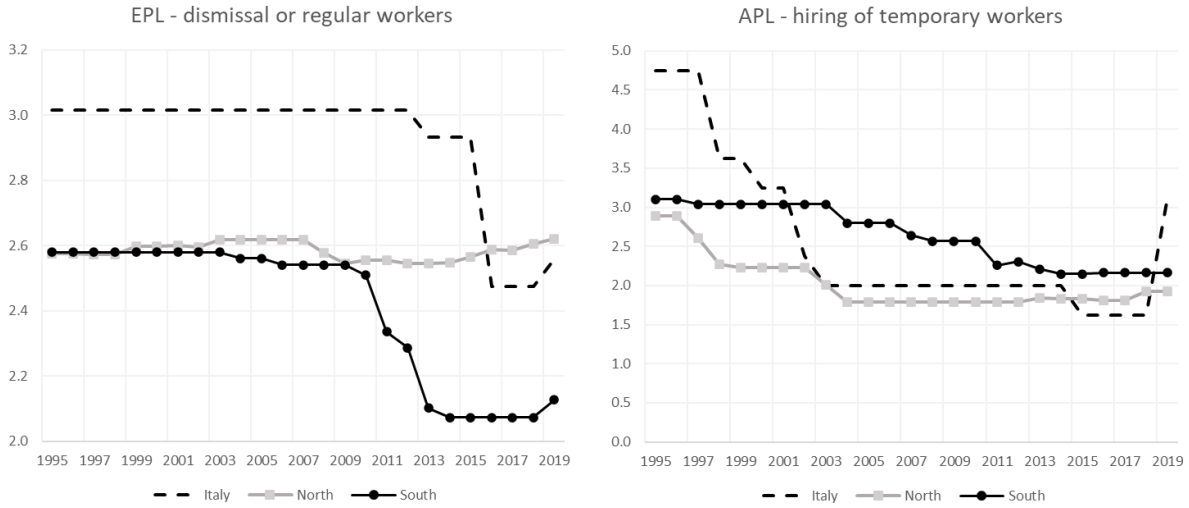
[112] See (Ichino, 2018) for a discussion of the latest developments.

security system and 99.3% of firms[113]. Theoretically, this system does not prohibit a more decentralised bargaining. In practice, however, the latter can only be used by firm to set wages at a *higher* level than the one agreed in the nation-wide agreement. In a country that displays a marked internal economic dualism – which we will explore better in Chapter 4 – this bargaining structure contributes to the dis-anchoring of wage and productivity dynamics described in the previous section. The Ideally, shifting the main level of wage determination to the regional or even firm level would ensure a more coherent link between wage dynamics and productivity. Yet, the topic of wage bargaining decentralisation is especially toxic in the Italian political environment because it is reminiscent of the tends controversial system of 'wage cages' (*gabbie salariali*) – a statutory geographical (mostly north-south) differentiation of wages that was abolished in 1968. The consequences of the single country-wide wage bargaining system are clearly visible in the continuing economic backwardness of the Italian sout. The Italian system of unemployment benefits also warrants reform. (Calligaris, et al., 2018) for example, show that the wage supplementation scheme (*Cassa Integrazione Guadagni*) tends to be used disproportionately by low productivity firms and is associated to misallocation, because it protects the job match between workers and firms even when no longer productive. The fact that the CIG system shows points of weaknesses and is exposed to the risk of abuse has emerged very clearly in the context of the COVID-19 crisis (as it will be discussed in Chapter 5). A reform of the system with a clearer focus on the worker, rather than on the job could help make the system more efficient in downturns. The Citizenship Income (CI) introduced by the Lega/M5S government – a hybrid between a generous unemployment insurance and an anti-poverty measure – could have been an opportunity to

[113] For a more detailed discussion, see (Boeri, et al., 2019), (Manasse & Manfredi, 2014) and (Terzi, 2016)

achieve this improvement in efficiency, but the latest data available suggest that the CI has not succeeded in fostering the re-employment of beneficiaries. Out of 791,000 recipients, in fact, only 28,763 had successfully found a job at the end of 2019[114].

**Figure 13 Strictness of Employment protection**




Source: author's calculations based on OECD data

A cross-country comparison of the degree of employment protection (EPL) offers an interesting picture (Figure 13), with two important insights regarding the convergence of macroeconomic models within the EMU. On average, the degree of employment protection on the dismissal of regular workers has remained unchanged in the Euro-*North* over the past 35 years (although some differences exist within the group, notably the Netherlands retaining a higher degree of employment protection than its Northern peers). In the Euro-*South*, exit

[114] According to data from the Italian Agency for Active Labour Market Policies (ANPAL), reported in e.g.: https://www.ilsole24ore.com/art/reddito-cittadinanza-10-dicembre-28763-beneficiari-hanno-trovato-lavoro-ACPXr87

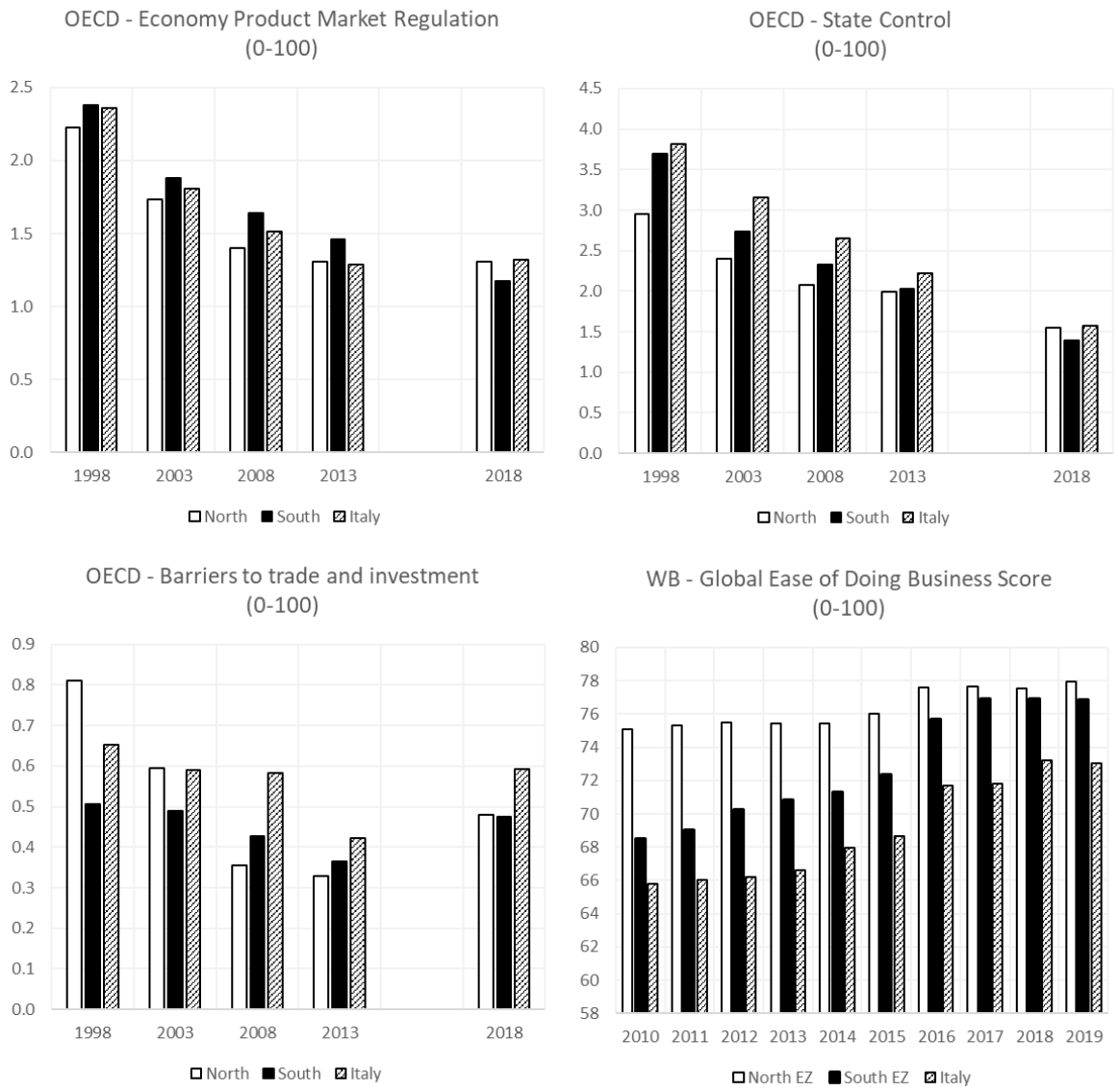
from the labour markets used to be more rigid than in the North in the Nineties, but by 1995 the group was on average aligned with the Euro-*North* (mostly due to changes in the Spanish labour market). When the Eurozone crisis hit, the dismissal provisions in Southern labour markets were de-regulated even further as part of the structural reform component of the EU/IMF bailouts, and today the Euro-*South* labour market is significantly more flexible than the Northern one. Italy, on the other hand, had a higher level of protection on dismissals than both the Euro-*North* and Euro-*South* throughout the Nineties, the pre-crisis decade, and the Eurozone crisis. The Monti reform of 2012 is almost an invisible blip on Figure 13, and the first visible reduction in the degree of Italian EPL is in 2015, following the entry into force of the Jobs Act. This reform brought Italy in line with the degree of flexibility prevailing in the Euro-*North*, but by that time the Euro-*South* had been deregulating even further. On the entry side, reform in the Euro-*South* has been more contained and Italian deregulation has been more significant, as a result of which the country has been aligned with conditions prevailing across the Euro-*North* since the early 2000s. The increase in EPL visible in Italy in 2019 is the counterpart of the so-called 'Dignity Decree' adopted by the M5S-League government in 2018. Hailed by M5S Ministers as 'the abolition of poverty', the Dignity Decree has visibly tightened EPL in Italy compared to its Euro-*North* and Euro-*South* neighbours, a move that risked even before COVID-19 to be counterproductive in the struggle to lift competitiveness.

Moving beyond the labour market and looking more broadly at the structure of the economy and the business environment, economic theory suggests that strengthening competition and reducing product market regulations may help create a business environment conducive to entrepreneurship and have a sizable impact on productivity and growth through efficiency

gains[115]. The OECD compiles cross country comparable data on several Product Market Regulation (PMR) indicators, published and updated every 5 years[116]. The economy-wide PMR measure – presented in the top-left corner of Figure 14 below – suggests two things. First, PMR have been on a de-regulating trend across Eurozone countries over the past 20 years, and differences between groups have not been particularly large on this aggregate measure. Second, and similar to what has been already discussed in terms of EPL, today it is the Euro-*South* that has the least strict product market regulations – following a decade of de-regulation that started well before the Eurozone crisis. Italy has also undertaken significant reforms in the field of PMR between 2003 and 2013 and is now broadly in line with the Euro-*North,* in terms of the economy-wide degree of PMR. Some noteworthy reforms have been the liberalisation of the energy sector (started in 1999 with the unbundling of the distribution network in the electricity sector and extended to the gas market later), some liberalisations of regulated professions (started in 1998 and followed by important steps in 2006/2007 and in 2011), and the reorganisation of local public services and transports, where several measures were taken in 2011 and 2013[117]. These market opening measures are found by economic research to have had a positive impact on firms' productivity in the sectors concerned and in the downstream sectors[118]. As visible in the top-right panel of Figure 14, this trend has gone together with a reduction in the level of State control on the economy, which in Italy used to be higher than both in the Euro-North and Euro-South but is today aligned across the three regions.

[115] See e.g. (Barone & Cingano, 2011), (Andrews & Cingano, 2014), (Amici, et al., 2018)
[116] Unfortunately, the OECD PMR methodology has been changed in 2018, so the PMR numbers for 2018 are no longer fully comparable with the previous years. However, they remain comparable across countries in any given year.
[117] See e.g. (Brandolini & Bugamelli , 2009), (Bianco, et al., 2013)
[118] See (Pinelli, et al., 2016), (Lanau & Topalova, 2016), (Giordano , et al., 2015)

**Figure 14 Business Environment**




Source: own calculation based on OECD World Bank data
Note (both figures): the OECD PMR methodology was changed in 2018, so while the 2018 data point is comparable across countries it is not entirely comparable over time. North EZ = Austria, Belgium, Finland, France, Germany, Netherlands; South EZ = Greece, Ireland, Portugal, Spain

Where Italy has done less well, however, is in developing a business-friendly environment.

Barriers to trade an investment remain today significantly higher in Italy than in the Euro-

*North* and the Euro-*South* on average (Figure 14, bottom left panel). In its flagship 'Doing Business' publication, the World Bank has been measuring the regulations that enhance or constrain business activity across countries and over time. Italy has lifted its global 'ease of doing business' score considerably since 2010, but a gap remains vis-à-vis both the average scores of the Euro-*North* but also the Euro-*South* (Figure 14, bottom right panel**Error! R eference source not found.**). The prevailing impediments to entrepreneurial activity in the Euro-*South* were similar to those observed in Italy when the debt crisis hit in 2010, but the structural adjustment that followed resulted in the full alignment of the Euro-*South* with the Euro-*North* on this dimension, in the space of just 6 years. The Southern improvement in the area of *entry barriers* to entrepreneurship (i.e. cost, time and complexity of starting a business) has been massive: the aggregate average score went from barely above 60 in 2004, to almost 90. As far as *exit barriers* are concerned – most notably the process to resolve insolvency – progress seems to have stalled in both Italy and the *South,* and the gap with the *North* is still sizeable.

## 3.5 Debt and Public Finance

The relationship between public debt and economic growth is probably one of the most researched in macroeconomics[119]. It is a two-way street: on one hand, growth is a key element in ensuring the sustainability of public debt; on the other hand, macroeconomic literature has also shown that high public debt can be closely associated with subdued growth. In Italy, the relationship between debt and growth is especially salient, because of

[119] See (Presbitero, 2019) for an excellent review of the macroeconomic literature on this topic.

the size of Italian public debt. In 2019, it surpassed EUR 2,400 billion – equivalent to 134% of the country's GDP. Among advanced economies, only Japan and Greece have higher debt-to-GDP ratios. While debt to GDP ratios increased across the Eurozone during the crisis, Italy has historically a higher debt to GDP ratio than both the average Northern and Southern EMU position. This heavy debt load has built up intermittently over 6 key time periods[120]: (i) a stable phase, when debt hovered around 30% of GDP (1950-64); (ii) a fast-growing decade, during which the public debt ratio doubled from 27% to 56% of GDP (1964-75); (iii) a second stabilisation between 55% and 60% (1975-80); (iv) an explosive 15 years, with debt to GDP skyrocketing to 120% (1980-1995); (v) a consolidation phase, during which the ratio declined to 103% (1995-2007); (vi) the most recent expansion, starting during the Global Financial Crisis (GFC), with the ratio reaching above 130%.

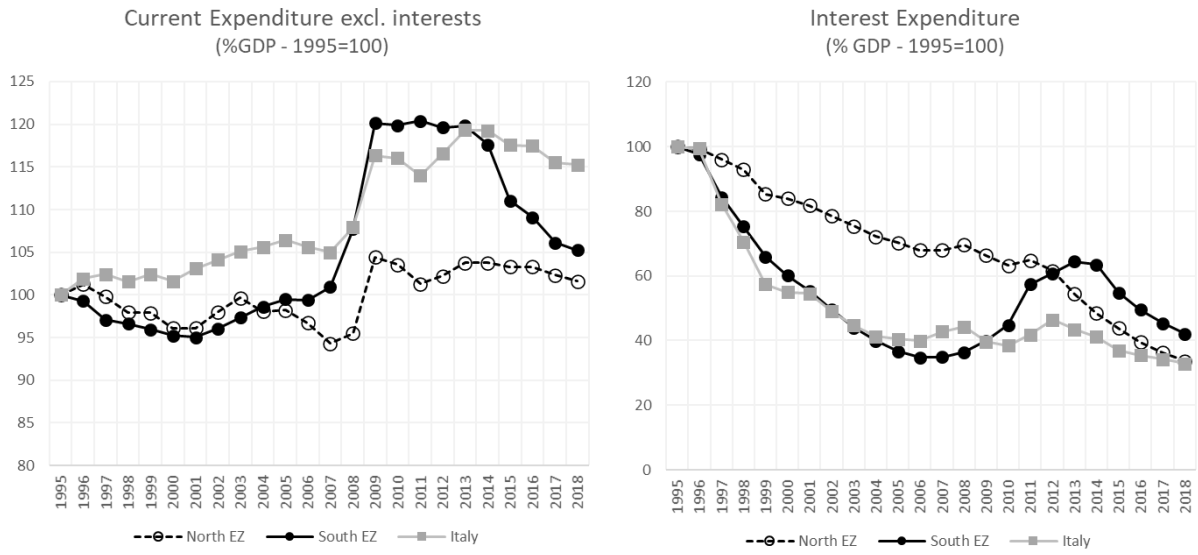
Theoretically, public debt deleveraging could be achieved in several ways: by means of faster economic growth, by running an offsetting fiscal policy of primary surpluses, by drastic cuts to the outstanding obligations (through defaulting and restructuring), or by a combination of high inflation and what (Reinhart & Sbrancia, 2015) have labelled 'financial repression' – i.e. the capping of interest rate costs by exerting explicit or implicit pressure on the private sector to lend to the government. In the Italian case, several of these different mechanisms were at work over the past decades. The stabilisation achieved during the 1970s was mostly the result of double-digit inflation rates, more than offsetting the negative effect of large primary deficits on debt sustainability. This was possible because the Central Bank of Italy at the time was not wary of engaging in monetary financing. With the 1981 institutional 'divorce' – which

[120] See (Panizza , 2019)

marked the independence of the Bank from the Treasury – inflation was brought under control, but fiscal policy did not adapt immediately to this new normal. The Italian governments continued to run large primary deficits throughout the 1980s and these – together with the increase in interest rates – led to a sizeable increase in the debt-to-GDP ratio. Starting in the early 1990s, Italy inaugurated what would become a long and uninterrupted series of primary fiscal surpluses. Following the agreement on the Maastricht Treaty, which set in stone the commitment to set up a European monetary union, nominal interest rates started to decline across the board. The mere expectation of Italy joining the EMU was enough to trigger a sizeable drop in the risk premium that investors were demanding to hold Italian debt, and on the back of the exchange risk elimination, the share of debt held by non-resident investors increased from 21% in 1997 to 51% in 2006[121]. Interest expenditure as a share of GDP dropped by 60% between 1995 and the early 2000s (**Error! R eference source not found.**, right).

[121] In 2012, Jean Pisani-Ferry and I collected data on European countries' government debt, broken down by different holding sectors. This data allows comparing the changes in the ownership structure of debt, before and during the crisis. The methodology is explained in (Merler & Pisani-Ferry, 2012). The data is publicly available on Bruegel's website at this link: https://bruegel.org/publications/datasets/sovereign-bond-holdings/.

**Figure 15 Interest vs Current expenditure**




Source: own calculation based on AMECO
Note: North EZ = Austria, Belgium, Finland, France, Germany, Netherlands;
South EZ = Greece, Ireland, Portugal, Spain

Initially at least, the gains from lower interest costs were reinforced by a conservative fiscal policy – allowing for a slow but steady reduction in the public debt ratio. The primary surplus was one element of a broader government strategy to boost the country's credibility in the eyes not only of the markets, but also of Italy's European partners, ensuring the country would make the first cut into the EMU[122]. Things changed after Italy joined the single currency. The primary surplus shrank from the 4-6% prevalent in the 1990s to 1-3% in the first half of the 2000s. Current expenditure (net of interests) increased as a share of GDP between 1995 and 2005 (**Error! Reference source not found.**, left). By then, the convergence of n ominal rates was complete and inflation (whose management had been outsourced to the ECB) was stable, so there was nothing counterbalancing the effect of lower primary surpluses on the debt dynamics. As a result, the decrease of the debt ratio had stopped already before

[122] See (Jones, 2018)

the outbreak of the Global Financial Crisis in 2008. The period immediately following Italy's entry in the EMU can therefore be seen as a missed adjustment opportunity: had the primary surplus remained at the levels that prevailed during the Nineties, the country would have secured a path towards a structurally lower debt-to-GDP ratio and it would have entered the GFC and the Eurozone crisis with a much larger room to use its fiscal policy to stimulate the economy during the ensuing downturn. What happened after 2008, on the other hand, was largely a denominator effect, as the collapse of GDP led to a further increase in the debt ratio. With foreign investors fleeing towards safer assets (mostly the German Bund), Italian banks responded by increasing their holdings of domestic government securities from 11% of the total Italian debt outstanding in 2007 to 24% in 2013. Since 2014, public debt-to-GDP has been hovering over 130% and the commitments to deleverage – from the different governments that have alternated in office since then – have failed. This contrasts sharply with the development in the aggregate debt-to-GDP ratio of the Euro-*South.* Until the mid-1990s, the debt dynamics of the Southern Eurozone members tracked very closely that of the *North.* Following agreement on the Maastricht Treaty, the Southern members ran a very conservative fiscal policy that – coupled with the convergence in nominal interest rates – led to a steady decline in the group's aggregate debt-to-GDP ratio down below 50% in 2007[123]. During the Eurozone crisis, Southern debt-to-GDP ratio more than doubled in just 5 years – due to the cost of bailing out domestic banks, the recession, and the increasing risk premia. However, as economic growth picked up in 2014 following the phase out of the

[123] Greece was an exception to this rule, as it became clear in 2009 when it was discovered that the country had been running (but not disclosing) large fiscal deficits.

macroeconomic adjustment programmes, the aggregate debt ratio of the Euro-*South* embarked again on a steady decline[124].

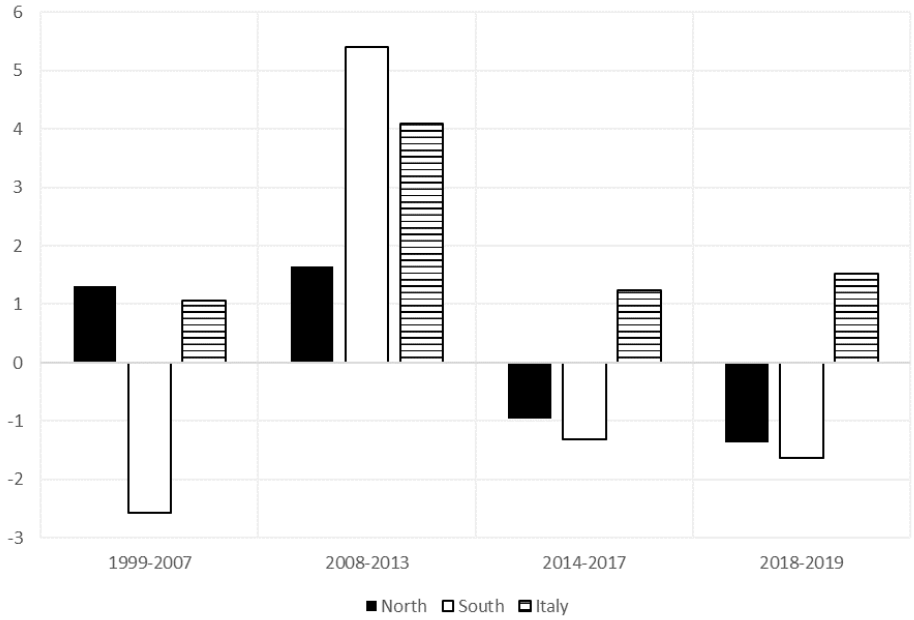
The 'exceptionalism' of Italy is not only in its historically higher public debt ratio, but also in a uniquely unfavourable differential between interest costs and GDP growth – a key indicator that economists identify as (r – g). This differential is at the core of debt sustainability analysis: all other things equal, a negative (r – g) differential in fact facilitates debt sustainability and deleveraging. Despite the low interest rates that have prevailed across the Eurozone since the early 1990s, the Italian (r – g) differential has remained always positive, setting the country apart from the rest of the Eurozone. For the Euro-*South,* on average, the (r – g) differential turned negative before the sovereign-debt crisis, went back to an average positive 5% during the 2008-2013 period, but has become negative again following the rebound of growth in 2014. For countries in the Euro-*North*, (r – g) was positive in the pre-crisis period – as interest rates were already low and the *North* did not experience bubble-like growth rates – but it has dropped into negative territory since the Eurozone crisis. In Italy, (r – g) has been positive before and after the Eurozone crisis, increasing in 2018 and 2019 – partly on account of the perceived political risk from the formation of a government coalition between two Eurosceptic and populist parties (M5S and the League)[125]. Over time, the persistence of a positive (r – g) differential has narrowed the path to Italian debt sustainability, which appears

[124] Compounded annual growth of real GDP growth in the program countries averaged 4% over the 2014-2018 period, compared to 1% in Italy.

[125] A look at balance of payment data – comparing the outflows of foreign capital recorded during the summer of 2011 and the summer of 2018 – would suggest that foreign investors in Italian government debt may have become progressively less tolerant of the country's political volatility and associated risk. See Merler (2018): https://www.lavoce.info/archives/54754/capitali-stranieri-la-grande-fuga/

more and more critically dependent on success in lifting the country's dismal economic growth – an issue made more pressing by COVID-19.

**Figure 16 (r - g) in the Eurozone (&)**




Source: own calculation based on AMECO
Note: North EZ = Austria, Belgium, Finland, France, Germany, Netherlands;
South EZ = Greece, Ireland, Portugal, Spain

Under pressing need for delivering elusive growth, Italian politicians have flirted with the idea that fiscal expansion may offer a simple solution to this difficult problem by reducing the debt-to-GDP ratio through a boost in the denominator rather than a cut in the numerator. This view is very much evident in the survey data discussed in Chapter 2, particularly with regards to the question of how fiscal policy should be used over the cycle in countries with high public debt. While appealing, however, this prescription is not guaranteed to deliver success. Looking at 30 episodes of sizeable debt reduction occurred after World War II, (Bernardini, et al., 2019) show that none of them was achieved solely through expansionary fiscal policy, i.e. by cutting taxes or increasing public spending. The historical experience of Italy itself shows

that whenever debt reduction has been achieved in the past, this has been at least in part the result of conservative fiscal policy. Overall, there is no lack of evidence suggesting that high debt limits the effectiveness of economic policy in general, and in particular the space for countercyclical fiscal stabilisation. The history of the Italian VAT 'safeguard clauses' illustrates this point very clearly. These clauses were first introduced by the Monti government in 2012, as a binding mechanism to enforce fiscal discipline. They legislate a VAT hike triggered automatically in case the government is unable to finance by reducing expenditure. The first VAT clause was fully offset through spending cuts by the Monti government in 2012, but in the following years the clauses have been repeatedly financed through higher deficits – in contradiction with their original purpose. Over time, the clauses have become fig leaves to avoid formally pencilling in a higher deficit in future years' projections and the credibility of the mechanism is so compromised that the European Commission discounts the effect of the clauses when assessing the Italian draft budgets (Codogno & Merler, 2019). As fiscal adjustment kept being postponed, the size of the safeguard clauses increased over time, and so did their constraining effect on the government economic policy. In the 2018 budget, the League-M5S government decommissioned a EUR 12.4 billion VAT hike for 2019 by full recourse to higher deficit. To square the circle and comply on paper with the deficit reduction path agreed with Brussels, the government increased the size of existing safeguard clauses for 2020 and 2021. Following a government reshuffle in the summer of 2019, a new PD-M5S government was faced with the need to find EUR 23.1 billion to avoid a VAT hike in 2020. Although only part of the VAT clause was covered with offsetting resources, this constraint limited the government's room for manoeuvre in allocating budget resources to pro-growth policies. Moreover, the offsets were heavily tilted on the revenue side, i.e. compensation was mostly achieved through new taxes (which have a worse impact on growth) rather than

spending cuts. Never has the constraints imposed by public debt on Italian fiscal space been more painfully evident than in the context of the COVID-19 crisis, and never has the benefit from ECB's expansionary monetary policy been clearer than at a time when the country needed to fund an amount of spending that was double in size compared to any 'normal' year (see Chapter 5). Prominent economists have argued that the classic economic concerns with high public debt may be less binding in today's 'new normal' of exceptionally low interest rates and accommodative monetary policy (Blanchard, 2019). But easy financing conditions do not make debt accumulation cost-free, particularly for countries that have a high debt stock combined with a high political volatility. Under such circumstances, (Blanchard & Zettelmeyer, 2018) have argued that a large fiscal expansion might end up having an outsized effect on confidence and produce a counterintuitive contraction of activity Moreover, as shown in (Romer & Romer, 2018), countries that have a very narrow fiscal space when a crisis hit face a drop in GDP by 10% on average, with persistent effects. And while the literature has been unable to prove that a high public debt to GDP ratio *causes* low growth, plenty of empirical evidence points to the existence of a negative correlation between these two variables. In a very recent paper, for example, Fatas et al. (2019) show that average GDP growth rate drops from 3.7% to 2.5% when debt to GDP increases from below 30% to between 30% and 90%, and to 1.2% when debt to GDP surpasses 90%. (Reinhart, et al., 2012) famously identify 26 episodes of debt overhang and show how these were associated with a significant decrease in GDP growth rates.

## 3.6 The Credit System

The narrow fiscal space, constraining the ability of the government to stimulate the economy, has been compounded by unresolved weaknesses in the private credit system – where the delay in addressing long-lived problems slowed the recovery after the Eurozone crisis. Differently from the Euro-*South*, where banks had fuelled a domestic boom in private debt and found themselves over-exposed to the ripple effects of the housing market crash in the US and their own countries, Italian banks were generally resilient to the first wave of the global financial crisis, thanks to their low exposure to US sub-prime products and no domestic housing bubble. Troubles started during the summer of 2011, when Italian government debt came under market pressure and the GFC morphed into the sovereign-banking vicious circle. Italian Monte dei Paschi di Siena (MPS) – the world's oldest bank – had to resort to the ECB's emergency lending and in 2012 the European Banking Authority's (EBA) stress tests identified a capital shortfall of EUR 3.3 billion, attributable to the market valuation of EUR 25 billion Italian government bonds that the bank was holding as assets. In December 2012, the European Commission approved a EUR 3.9 billion recapitalisation of MPS for reasons of financial stability. The injection took the form of hybrid capital instruments ('Monti bonds', after the then-Prime Minister). In 2013 the bank posted a net loss of EUR 1.44 billion and in summer 2014 the results of the ECB's stress tests singled out MPS as one of the weakest banks in the Eurozone. In 2016, the ECB demanded a EUR 10 billion reduction in MPS' net Non-Performing Loans (NPLs) to be achieved over the next three years and released a new round of stress tests showing that the bank's capital would be wiped out under an adverse scenario.

Scrambling to find a solution to the situation of MPS, Italian authorities found themselves operating in an EU regulatory environment that had undergone a massive shift towards stricter rules on the use of public funds in bank rescues. In November 2014 the Single

Supervisory Mechanism (SSM) had taken over the supervision of Eurozone's significant institutions from national supervisors and at the end of 2013 the European Parliament and Council Presidency had reached an agreement on the Bank Recovery and Resolution Directive (BRRD), which introduced a toolkit to deal with banks in resolution and set limits on the feasibility of public bailouts. BRRD was due to enter into force on 1st January 2015, with bail-in rules to take effect one year later. To manage the transition period, the Commission issued in 2013 a Banking Communication that amended the rules for state aid to banks adding a "burden-sharing" requirement, whereby losses would need to be adsorbed by equity, hybrid capital and subordinated debt before public money could be used[126] [127]. This requirement was problematic in the Italian context because some banks had mis-sold their junior debt with retail customers in the run up to the crisis, understating the actual risk associated to those financial instruments[128]. Italian households historically held a relatively large share of bank bonds in their portfolios, partly due to a preferential tax treatment of interest income on bonds which was in place between 1996 and 2011. Despite declining since 2005, the share of Italian bank bonds that were held by Italian households was still 30% of the total in 2015, the highest across Eurozone countries, excluding in Latvia and Malta. The retail placement of subordinated bonds helped banks access funding at an especially dire time but carried risks that appear to have been clear to the regulators from the start: the then-Director General of the Bank of Italy admitted in 2015 that the Bank wanted to prohibit these sales but had no

[126] Differently from the BRRD full bail-in regime, this transition did not prescribe any contribution from senior debt and uninsured depositors.
[127] Negotiations also led to the establishment of a Single Resolution Mechanism (SRM) for banks under SSM supervision, which was expected to manage resolution through a single resolution board and a single resolution fund.
[128] The Commissioner for Financial Services, Jonathan Hill, is reported to have commented on the case that "These banks in question were selling unsuitable products to people who maybe didn't know what they were buying", http://www.reuters.com/article/italy-banks-rescue-death-idUSL8N13Z31O20151210. This is confirmed by journalistic reporting http://www.reuters.com/article/italy-banks-bonds-idUSL8N1490SJ20151221

legal power to do so on its own. The significant exposure of financially unsavvy retail clients to subordinated bank debt became a major obstacle on the road to address the problems that surfaced in the Italian banking system in 2016 and the following years. The risk of a major politic backlash from bailing in retail bondholders was heightened by the fact that the Italian constitution includes a widely misinterpreted provision (Article 47) stating that "the Republic encourages and safeguards savings in all forms. […]", creating widespread expectations that retail bank clients should be protected from any losses even on their investment activities[129].

These factors acted as a powerful political incentive to delay bank resolutions and either prevent or compensate the losses that junior bondholders might incur as part of the process. The first signals of this attitude of political ring-fencing emerged in July 2015 on the occasion of the liquidation of Banca Romagna Cooperativa (BRC). BRC's assets and liabilities were transferred to Banca Sviluppo, part of the ICCREA Group. In the process, subordinated loans were not transferred to the buyer of BRC's asset and liabilities but left behind in the liquidation estate. The operation was conducted under national insolvency law, by selling only parts of assets and liabilities out of liquidation[130]. Although junior bondholders were effectively bailed-in, they did not suffer any losses because the Italian mutual sector's Institutional Guarantee Fund decided to reimburse them in full and became the only senior

[129] Proponents of this view went as far as to argue that the BRRD bail-in provisions imposing losses on bondholders should be considered unconstitutional, in Italy. In summer 2016, the president of ABI - Antonio Patuelli - sent a letter to the Italian daily Sole 24 Ore arguing that bail-in was at odd with the provision of Article 47, and that the latter should have superiority. Patuelli stated that previous initiatives aimed at preventing the application of bail-in in Italy after the entry into force of BRRD were "laudable". This view neglects a fundamental difference between savings and investment: placing savings in a bank's junior bonds is de facto an investment, and as such it bears risk. By equating investment to savings, the proponents of the unconstitutionality view essentially argued that the Constitution should be read as granting a right to be unconditionally bailed out of bad investment decisions.

[130] See (Merler, 2016) for a more detailed discussion.

creditor of the entity in liquidation[131]. The decision was justified as a way "to preserve the reputation of the sector"[132], probably on account that all junior debt in BRC had been sold to retail clients. In November 2015 – two months before the bail-in rules legislated in BRRD were due to enter into force – four small Italian banks were put into resolution[133]. Italian authorities initially eyed the intervention of the Interbank Deposit Protection Fund (FITD), again with the intention to shield subordinated creditors completely, but this option was deemed incompatible with the European Commission's rules on State Aid[134]. Eventually, the banks' balance sheet was split into 'good' and 'bad' banks, after absorbing part of the losses with equity and subordinated debt[135]. The Resolution Fund, financed by contributions from the Italian banking sector, contributed EUR 3.6 billion to the operation. As the fund did not have enough liquidity available in 2015, the money was advanced by three Italian banks (Intesa Sanpaolo, Unicredit and UBI Banca) at market rates and with a maturity of 18 months. This allowed limiting the contribution of bondholders to the pre-BRRD regulatory minimum, while keeping the State formally out of the picture. There were about 10,500 subordinated bondholders who had to bear losses, for a total value of EUR 789 million. After one of them committed suicide in December 2015, the government introduced a compensation scheme to speed up their reimbursement[136]. In April 2016, two more banks (Banca Popolare di Vicenza and Veneto Banca) launched a capital raise operation to avoid being put into

131 The Institutional Guarantee Fund is technically not public money, as it is financed by contributions from banks.
132 See the note issues by the rating agency (Fitch, 2015)
133 Banca Marche, Cassa di risparmio di Ferrara, Banca Etruria and CariChieti..
134 See a discussion in (Banca d'Italia, 2016)
135 The "good" bank was assigned all the balance-sheet assets except "bad debts" and on the liability side it kept deposits, current accounts and ordinary bonds. The capital of the good bank was reconstituted by the Resolution Fund to approximately 9% of risk-weighted assets. A single "bad bank" (asset management company) was assigned all bad debts remaining after the absorption of the losses.
136 Law decree n° 59 of May 2016 stated that junior bondholders who had bought the bonds before 12th June 2014 could ask for a reimbursement of 80% of the principal without having to go through arbitration, provided that their wealth was less than 100'000 euros and their 2014 annual income was less than 35'000 euros.

resolution. An *ad hoc* fund (Atlante Fund) was launched to support the recapitalisation operation and thus shore up confidence in the Italian banking sector. In practice, its mission was to "ensure the success of capital raising requested by the supervisory authority for banks that face market difficulties", by acting as a subscriber of last resort and by buying mezzanine and junior tranches of securitized NPLs. A draft of the Atlante that leaked to the press suggested the initiative was motivated by fears that the perspective of bail-in in case of failure to raise capital could lead to a bank run. The fund was financed by Italian banks and privately held institutions – although it included also EUR 500 million from the Italian national promotional bank (CDP) – and it ended up becoming the majority shareholders in the two banks, with a 90% share. Newspapers reported that one of the objectives of Atlante was to "prevent the arrival of foreign funds, able to put on the table enough resources to […] recapitalise the banks acquiring control"[137]. Italian finance minister Padoan denied the allegation, arguing that the aim was to prevent dismissal of Italian banks' assets at fire sale prices, but in practice the fund would end up preventing foreign entry by buying at higher prices than those at which foreign investors were willing to bid.

It was not the first time that foreign entry was prevented to preserve the control of Italian banks in Italian hands (a concept known as *Italianità*). The root of what would later morph into the 2015 Italian banking crisis can be traced back to 2005, in a major instance of *Italianità*. Dutch ABN Amro and Italian Banca Popolare Italiana (BPI) had made rival public offerings for the Italian bank Antonveneta, while Spanish BBVA and Italian Unipol had bid against each

[137] See this reporting article in Italian daily Repubblica: http://www.repubblica.it/economia/finanza/2016/04/11/news/banche_incontri_decisivi_al_tesoro_per_il_fondo_su_aumenti_e_sofferenze-137359161/

other for Banca Nazionale del Lavoro (BNL). Excerpts of tapped phone conversation suggested that the then-Governor of the Central Bank of Italy – Antonio Fazio, later sentenced to 4 years in jail for market-rigging – had been openly favouring the offers from the Italian perspective buyers over those of the foreign competitors. The concept of *Italianità* had far-reaching institutional roots, reaching all the way back to the reform of the Italian credit system enacted during the Great Depression, when the State and the central bank had saved the major commercial banks from collapse. In 1933 the fascist regime established an Institute for Industrial Reconstruction (IRI), which took over the banks' stakes in large industrial companies, in exchange for a controlling stake in the banks. The Banking Law of 1936 drastically changed the Italian banking landscape. Article 1 stated that banking was an "activity of public interest", and the law concentrated supervision in the Inspectorate for the Defence of Savings and the Exercise of Credit (a newly created state body), using resources and personnel from the Bank of Italy, but directed by a ministerial committee chaired by the Prime Minister[138]. The mixed-banks that had been taken over by IRI were turned into "banks of national interest" and five other banks became public-law credit institutions. This system remained in place relatively unchanged until 1990, when the Amato-Carli Law restructured the public-law banks splitting them into two entities: a bank (joint stock company) and a bank-foundation (public law entity) that remained a shareholder of the spin-off bank. Until 1994, bank foundations were required by law to keep a majority stake in the capital of savings banks. This forced them to set aside reserves to ensure that they would be able to participate in any capital raise needed by the off-spring banks[139]. In 1994, this requirement was eliminated, and fiscal incentives were introduced for the dismissal of the foundations' stakes

[138] Banca d'Italia – History of the Bank of Italy; Cova et al.
[139] See e.g. (Guzzetti, 2015)

in the banks. As of 1995, however, almost 70% of all bank foundations still had stakes larger than 50% in the off-spring banks. In 1998, the Ciampi Law transformed the foundations into private-law entities and introduced a requirement to dismiss their majority stakes in banks by the end of 2005. Most foundations have since reduced their participations, but back in 2015 – on the eve of the Italian banking crisis – less than 40% had completely exited the capital of the off-spring banks. Differently from banks – which are supervised by technocratic institutions such as the Bank of Italy, and now the ECB – bank foundations are under the supervision of the Ministry of Economy and Finance (MEF). The members of foundations' board are nominated by local government and civil society[140], and in the years leading up to the Italian banking crisis the presence of members with a local political history was pervasive. In some cases, the share of politicians in board membership reached above 70%[141]. In 2012, the Italian Association of Foundations and Savings Banks (ACRI) issued a voluntary ethical code, including a call to prevent political conflicts of interest, but implementation was left to the discretion of each foundation. Only in 2015 did the MEF and ACRI agree on a protocol for bank foundations, as well as on a binding 33% limit to the concentration of foundations' exposure to individual subjects, including their off-spring banks[142]. ACRI estimates that between 2008 and 2013 bank foundations contributed EUR 7.5 billion to the recapitalisation of the Italian banks they participated, and EUR 1.1 billion in convertible bonds. Where the weight of foundations in the assets in the off-spring bank had remained high, the crisis led to

[140] For details on the MPS case, see the concluding report of the Tuscan Region's 2016 Commission of Inquiry regarding the relation of MPS with the Region (Commissione d'Inchiesta "in merito alla fondazione Monte dei Paschi di Siena e alla Banca Monte dei Paschi di Siena. I rapporti con la regione Toscana"). (Jassaud, 2014) and (Allegranti, 2015) offer accounts of the strong interlinkages between politics and finance in the story of the bank; (Paolucci & Bottero, 2013) highlights that not only many members of the foundations' board were politically appointed, but also all the mayors of Siena over the previous 25 years had come from the bank.

[141] See (Boeri, 2013)

[142] See (MEF, 2015)

a vicious circle: banks with foundation ownership displayed weaker asset quality metrics on average than other Italian banks and were less resilient to macroeconomic shocks (Jassaud, 2014)[143]. By participating so prominently in banks' recapitalisation, foundations avoided a dilution of their influence and contributed to preserve the *Italianità* of banks' capital. The banks in turn made no mystery of their appreciation: the CEO of Intesa San Paolo, for instance, argued as recently as 2017 that requiring foundations to reduce their stake in banks was "stupid", because depriving the banks of Italian investors meant weakening them[144]. At the same time, by keeping outsiders (foreign investors) out of the banks' capital, the foundations delayed the moment of reckoning with the underlying problems besetting the Italian banking system – which came in 2016.

In 2016, the Atlante operation was not enough to save the two banks, which were found in need of an additional recapitalisation less than one year later. Eventually, Banca Popolare di Vicenza and Veneto Banca were liquidated and the entire equity stake held by Atlante – and through it, by other Italian banks in the system – was wiped out. By acting as a shareholder of last resort for those banks that were too weak to raise capital on the market, Atlante had prevented bank resolution and the haircut of subordinated debtholders in the short run, but

[143] The case of MPS is paradigmatic in this respect. The MPS foundation still had a stake of 56% in MPS bank in 2007, when the Antonveneta acquisition was decided, and the stake remained above 33% until 2013. During the crisis, the foundation got heavily indebted in order to prevent a dilution of its stake in the bank. (Paolucci & Bottero, 2013) mention 51% as the share below which the foundation was implicitly not allowed to go, as requested by the "local community". (Boeri & Guiso, 2012) mention 33% as the control stake below which the foundation was not willing to go. Similar stories are common to other foundations. A detailed account of the MPS' case is available in the concluding report of the Tuscany Region's 2016 Commission of Inquiry regarding the relation of MPS with the Region (Commissione d'Inchiesta "in merito alla fondazione Monte dei Paschi di Siena e alla Banca Monte dei Paschi di Siena. I rapport con la regione Toscana").

[144] As reported by Sole 24 ore at: http://www.ilsole24ore.com/art/finanza-e-mercati/2017-01-26/messina-intesa-sanpaolo-difende-l-italianita-210614.shtml?uuid=AEizTtI&refresh_ce=1

at the cost of spreading risk onto the balance sheets of the rest of the banking system[145] and delaying a solution. The MPS moment of reckoning in 2016 was therefore the culmination of a two-years long process that had consistently aimed at delaying bank resolution to avoid bailing in the banks' retail clients. In MPS, junior debt at the end of 2016 amounted to EUR 5 billion, almost 65% of which had been sold to retail clients. Under EU rules, additional capital requirements like those identified for MPS in 2026 should be covered from private sources[146], and while there is an exception to this rule in the case of the so-called 'precautionary recapitalisation'[147], this is limited to solvent institutions and[148] remains subject to the burden-sharing requirement of equity and junior debt. It was decided that MPS would try to raise EUR 5 billion of capital from private investors, but the operation failed. MPS applied for precautionary recapitalisation, which was granted by the European Commission subject to the bank's disposal of its NPL portfolio on market terms and to a bail-in shareholders and junior bondholders. Once again, retail clients who held junior bonds were reimbursed. The strategy of delaying a solution to the Italian banking problems – most of which were long-dated and with deep institutional roots, as discussed in this section – becomes clearly visible when comparing banks performance and the dynamics of credit provision to the real economy, across countries. The return on equity (ROE) for banks in Italy remained negative on average over the 2014-17 period[149], hampered by the burden of NPLs that was

[145] This became evident as participating banks significantly wrote down the value of their investment in Atlas, in late 2016 and 2017. Reuters: http://www.reuters.com/article/us-eurozone-banks-italy-insight-idUSKBN15I2BW
[146] The fact that a bank requires public support is normally a trigger for resolution, and in that case the BRRD prescribes a bail-in of 8% of total liabilities before public capital can be used.
[147] Article 32(4.d) of BRRD
[148] the conditions are that the extraordinary public support shall be of a precautionary and temporary nature, and not be used to offset losses that the institution has incurred or is likely to incur in the near future. Moreover, the extraordinary injections are limited to the amount necessary to address a capital shortfall established in a stress test, asset quality reviews or equivalent exercises.
[149] See (Merler, 2019) for a discussion.

accumulating on banks' balance sheets, while the same indicator was rebounding strongly in Spain following the restructuring of the banking sector in the context of the EU/IMF programme. Loan-deposit margins – a measure of banks' ability to generate interest revenues – also remained lower for longer, in Italy. The delayed adjustment had consequences on banks' ability to lend to the real economy, and hence on the speed of the recovery: a look at the real cycles in bank lending to the private sector shows that the financial cycles of the Euro-*North* and *South*, while diverging significantly before the Eurozone crisis, have aligned thereafter. In Italy, on the other hand, the slump in bank credit to the real economy has been much more prolonged, dragging all the way till the eve of the COVID-19 crisis.

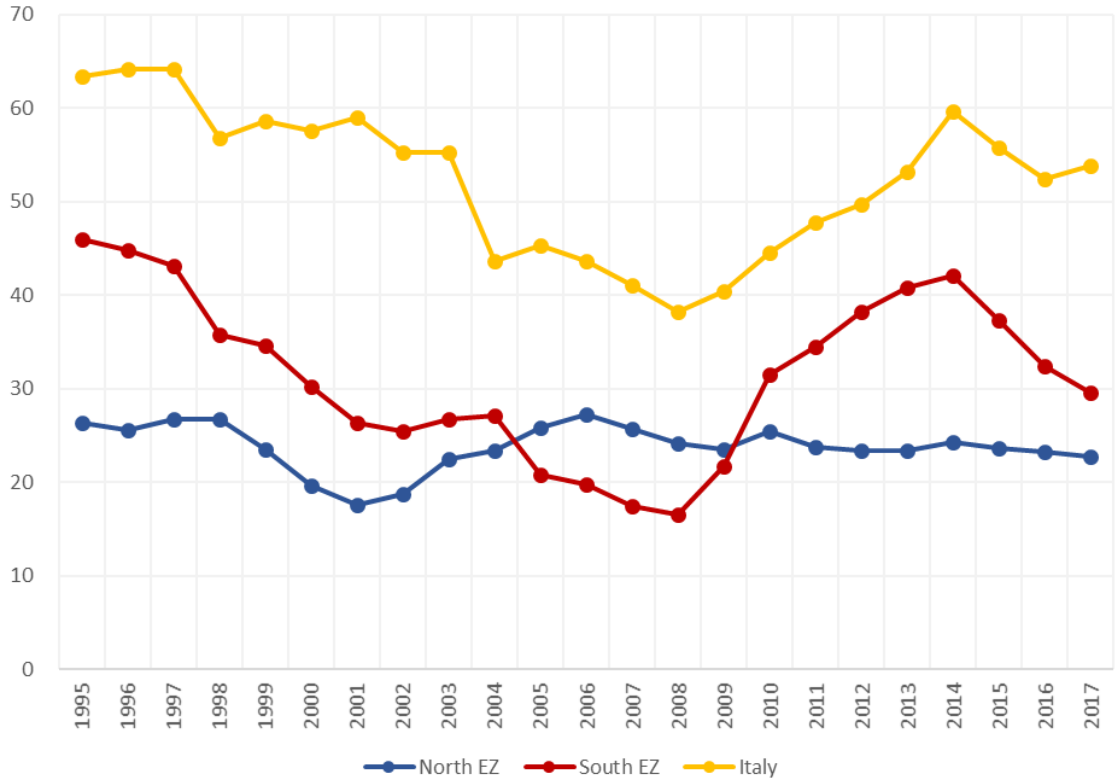
## 3.7 Poverty and Inequality

Two decades of anaemic growth and a delayed post-crisis recovery have exerted a heavy toll on Italian society. The country's total unemployment rate – which had decreased from 11% in the mid-Nineties to 6% in 2007 – increased again to 12.7% in 2014. In 2018, the total unemployment rate was still at 10.6%. As a comparison, the average[150] unemployment rate in the Euro-*South* was 18% at the beginning of the Nineties, it dropped to 8% between 1995 and 2007, it skyrocketed during the Eurozone crisis to 24% in 2013, but since then it has decreased faster than in Italy. Youth unemployment peaked at an average 50.6% in the Euro-*South* in 2013 and at 42.7% in Italy in 2014. But by 2018, youth unemployment in the Euro-*South* had dropped below the comparable figure for Italy – even though about a third of the young population was still unemployed in both regions. What is more concerning, however,

[150] I use a weighted average, using as weights the shares of each country in the aggregate nominal GDP of the group to which it belongs.

is the duration of youth unemployment. In the Euro-*North* the share of long-term unemployment in total youth unemployment has remained low and constant, between 20% and 30%. The Euro-*South* started off from a much worse position but had been converging to northern standards prior to the Eurozone crisis: while 45% of young people who were unemployed in 1995 had been in such condition for longer than 1 year, this figure had dropped below 20% in 2008. The weight of long-term unemployment increased again after 2010 but has been declining again with the return of growth since 2014. The Italian share of long-term youth unemployment on the other hand hovered around 60% in the early 2000s, structurally higher than everywhere across the EMU (except for Greece), and it remained at 40% in 2008. On the eve of the COVID-19 pandemic, about 50% of the young Italians who were unemployed had been in that condition for more than 1 year (Figure 17).

**Figure 17 Share of long-term unemployment in youth unemployment (%)**




Source: own calculations based on data from OECD
Note: long-term unemployment is defined here as lasting longer than 1 year

Prolonged unemployment weighs heavily on the probability of future re-employment of young workers, as it may result in skills deterioration unless countered through a solid structure of training and active labour market policies (ALMPs). This is not the case in Italy, which in 2018 posted the highest share of young adults being neither in employment nor in education nor in training (the so-called NEETs) of all the countries surveyed in this book[151]. The higher the share of NEETs among the youth, and the higher the risk that the long-term unemployment prevailing among the younger generation will translate into a structurally higher total unemployment going forward, due to the lower re-employability of workers that

[151] 25% for the population aged 15 to 34, and 29.7% in the 25 to 34 cohort.

have remained so long out of the labour market. While many young people have been emigrating as a response to poor domestic employment prospects – as seen in Section 3.3 – not everyone can afford to leave. Italians from better-educated families are in fact relatively more likely to emigrate in response to unfavourable domestic economic conditions. (Bassetto , et al., 2019) show that the share of Italians whose parents hold a university degree is proportionally much higher among those living abroad than among those living in Italy, while the share of Italians whose parents did not attain upper secondary education is much lower among the tertiary educated emigrants than amongst those who stay.

This data suggest that Italy was at a high risk of becoming locked into a self-fulfilling vicious circle of stagnation, emigration, low potential growth, high unemployment, poverty, and inequality –already before the outbreak of the pandemic. The share of Italians at risk of poverty and social exclusion increased steadily after 2010, reaching 27.3% at the end of 2018. In a poverty report published in the summer of 2019, ISTAT estimated that more than 1.8 million households were living in absolute poverty in 2018 – corresponding to an incidence of 7%, still at the highest levels since 2005. Households living in condition of relative poverty were as many as 3 million (an incidence of 11.8%) and the share of individuals leaving in households experiencing condition of severe material deprivation – which had peaked at 14.5% in 2012 – was still 8.5% in 2018. The risk of being poor is uneven across generations: compared to 2007poverty risk has increased across all age cohorts younger than 65 years and especially so for Italians between 25 and 49, but for those older than 65 the risk has decreased. This intergenerational profile of poverty reflects in part the uneven impact of the GFC and Eurozone crisis on employment prospects of different age groups, but also the effect of broader changes in the composition of employment, and underlying inefficiencies in the

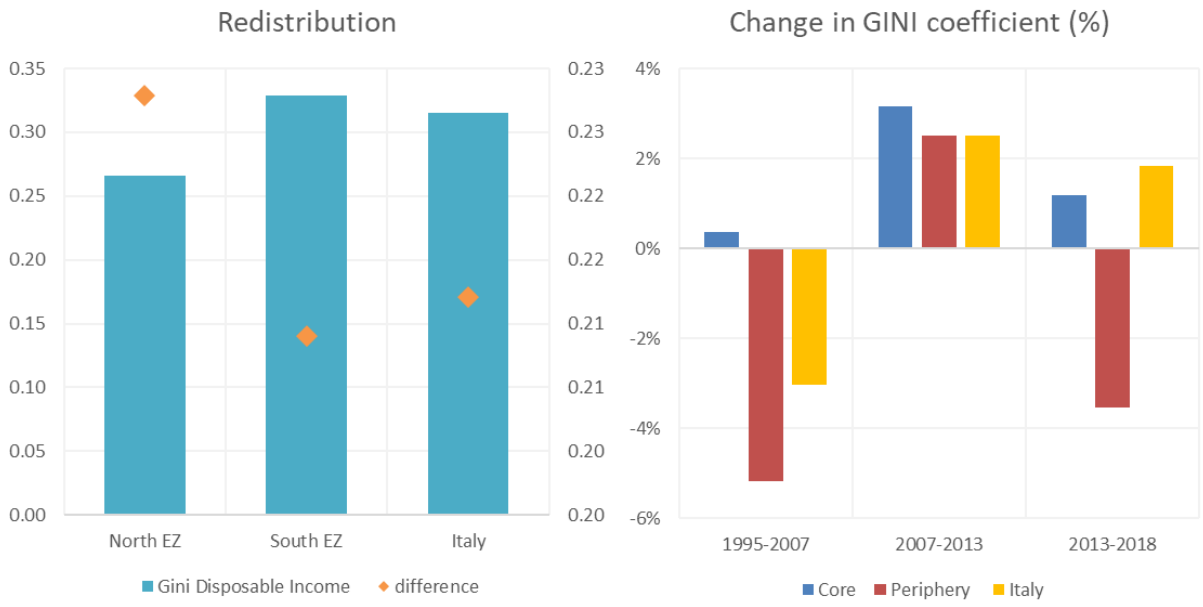
social safety net and Italian welfare state. The share of temporary employment in total employment in Italy has increased from 7.2% in 1999 to 17.1% in 2018. Temporary work is most prevalent among young workers: only 8% of workers who are 50 or older is hired on temporary contracts, but the share reaches almost 30% among those who are between 25 and 34 years old. For 76% of them, temporary employment is not a choice but a backup option in absence of permanent alternatives, and it is often accompanied by involuntary part-time. Fragmented careers, characterized by temporary employment and reduced working hours, tend to pay low wages, and increase the risk of in-work poverty for the younger generations. In 2017, the incidence of in-work poverty was 12.3% in Italy against 9.6% on average in the EU, and the risk of in-work poverty had increased by 1.2 percentage points over the previous 5 years[152]. The incidence of this phenomenon was higher among the self-employed (19.5%) than among employees (10%), reflecting the dualistic nature of the Italian labour market institutions that protect the workers who have permanent employment contracts much better than those with a temporary or self-employed status. In-work poverty has life-long repercussions: with a pension system that shifted from Defined Benefit to Defined Contribution in 1995, fragmented and underpaid working careers are likely to expose today's younger generations to a risk of poverty in old age too.

[152] According to the definition of in-work poverty (IWP) used by the European Commission, an individual is considered in-work poor in a year when i) he/she is aged 18-64 and is in employment (as an employee or a self-employed person) for at least half of the year, and ii) he/she belongs to a household with an annual equivalized disposable income lower than 60% of the median of the national equivalized disposable income. Equivalized disposable income is made up of gross incomes earned in the market from every source (employment, self-employment, capital, land) by all household members, plus cash welfare transfers, net of personal income taxes and social insurance contributions; incomes are equivalized by dividing total income by the so-called equivalence scale to take into account differences in household size. See (Raitano, et al., 2019) for a discussion.

Two decades of lack of growth have had disastrous effects on social mobility, visible all along the income distribution. The 2020 ISTAT annual report compares the social class status attained by individuals belonging to four different generations with that of their parents at the same age, yielding a sombre picture. While all cohorts born until the end of the Seventies have experienced an increasing rate of *upward* mobility throughout their life – i.e. they have been able to attain a higher social class status compared to that of their parents – this is no longer valid for Italians born between 1972 and 1986. Among them, the share of those experiencing downwards mobility (26.6%) is higher than for all prior generations – included their grandparents (21.8%). For Italians belonging to this cohort, downward social mobility is more prevalent than upward social mobility: it is, quite literally, a generation that has been largely left behind by their elders. The especially low intergenerational educational mobility that we observe in Italy constitutes an aggravating factor of these perverse social dynamic. OECD data show that in 2012 – the latest available year at the time of writing – only 36% of Italians whose parents had not completed upper secondary education were able to attain an educational level higher than their parents'. This compares to a percentage of almost 50% in the Euro-*South* and almost 70% in the Euro-*North*. When looking at Italians with the same disadvantaged family background who specifically succeeded in graduating from tertiary education, the share drops to 6%, compared to more than 15% in the Euro-*North* and 20% in the Euro-*South.* Students seem to be keenly aware of the obstacles they face to climb the social ladder: the OECD PISA 2018 report highlights that many high-achieving Italian students hold lower ambitions than would be expected given their academic achievement, and this is especially true amongst high-achieving students with a disadvantaged socio-economic background. Only three in five among them expects to be able to complete tertiary education, compared to seven in eight among the students originating from a more advantaged family

environment. The evidence of such a strong persistence in educational attainment suggests the Italian system is ineffective at offering everyone an equal chance to develop knowledge and skills independently from socio-economic conditions – which in turns reinforces inequality of opportunities and of income.

**Figure 18 Inequality and Redistribution**




Source: own calculations based on data from Eurostat and Euromed

Inequality has indeed been high and has been on the rise, in Italy. After decreasing in the second half of the 1990s and the first half of the 2000s, the Gini coefficient – a measure of how unevenly income is distributed across a certain population – has increased broadly across the Eurozone between 2008 and 2013. From 2014, however, inequality has been decreasing in the Euro-*South,* whereas it has kept increasing in Italy (Figure 18, right). Redistribution through the tax and benefit system does not appear to be able to mitigate inequality as effectively as it could. In a recent article published on the Italian daily newspaper *Corriere*

*della Sera*, the president of the Italian association *Itinerari Previdenziali*, Alberto Brambilla, estimated that as much as 59% of the revenues from Italy's personal income tax IRPEF was raised by taxpayers with income above 35,000 euros, which account for 13% of all taxpayers. The figure suggests a strong progressivity of income taxation in Italy, but at the same time it is not accompanied with an effective redistribution on the side of social spending. The inequality-decreasing effect of redistribution can be proxied by the so-called Reynolds-Smolensky index, defined as the difference between the Gini coefficient calculated on original pre-tax income and the Gini coefficient based on post-tax disposable income (Figure 18, left). This gap – which measures the impact of redistribution on inequality – is quite small in Italy, pointing to the fact that public policy is not effective at countering inequality. In part, this redistributive inefficiency can be traced to a strong intergenerational bias in the structure of the Italian safety net, which is generous with retirees but does little to support young people living in households whose members are unemployed or under-employed[153]. Total public spending for pensions stood at 15.8% of Italian GDP in 2017, higher than EU average and second only to Greece among the countries that we look at in this book. Total public spending on old-age pensions specifically was also higher than the EU average. Italy also records the highest share of spending on early old-age pensions – which accounted for 2.3% of GDP in 2008 and had decreased to 1% of GDP in 2018 but was still more than double the EU average (0.4%). The Italian pension system also has the highest replacement rate (73%) in the EU, except for Luxembourg[154]. The pension system – put under pressure by the aging of the Italian population – is a salient political topic and it has been subject to several reforms aimed at

[153] See (Ciani & Torrini, 2019) for a discussion

[154] The replacement rate is a measure of how close old-age pensions are with the wage at the end of working life and Eurostat defines it as the ratio of the median individual gross pensions of 65-74 cohorts relative to the median individual gross earnings of the 50-59 age category.

lowering its impact on public finances while making it more sustainable[155]. The 1992 Dini reform increased retirement age gradually, to reach 65 years for men and 60 for women in 2000 (compared to 60 and 55 respectively, before the reform). The required years of contribution for old-age pensions were also increased, and indexation to wage growth was scrapped. The 1995 Amato reform included a complete overhaul of the benefit computation methods for newly hired workers, who would receive their pension based on a notional defined contribution rather than a defined benefit calculation (with workers with less than 18 years of contributions to be covered by a mixed system). The controversial 2011 Fornero reform, bearing the name of the Labour Minister in the Monti government, built on the Amato framework but reduced the transitional phase of the notional defined contribution rule starting in January 2012. It also tightened eligibility requirements for old-age pension and early-retirement options: age requirements for old-age pensions were to be unified for men and women by 2018 and increased to 69 years and 9 months by 2050, with the years of contributions required to access early retirement also increased. Indexation to inflation – which had been retained by the 1992 and 1995 reforms – was scrapped in the 2011 reform[156]. By raising the retirement age, the Fornero reform ended up creating a group of displaced workers (known as '*esodati*') who had opted for early retirement before the reform but were retroactively deprived of their pension because they were not meeting the newly introduced requirements. In 2018 elections, the League-M5S coalition government introduced a new early retirement option (Quota 100, allowing workers to retire once hitting 62 years of age plus 38 years of contribution) which walked back significantly the requirements imposed by the Fornero reform. Quota 100 was justified by the proponents as a one-off measure aimed

[155] For a detailed discussion of the Italian pension system and its reforms see e.g. (Belloni, et al., n.d.)
[156] Although it was later reinstated by the Constitutional Court.

at facilitating generational employment turnover, 'freeing up' jobs for young people. However, the evidence on its success is dubious: by November 209, the turnover rate was only 42%, ie. less than one hiring for each person allowed to retire early under Quota 100[157].

The Italian social safety net also lacks a comprehensive and effective anti-poverty measure – despite having experimented with three different anti-poverty policies over the past few years, with mixed results. In 2014, the Renzi government introduced the so called '80-euro Bonus', aimed at increasing net income for low-middle income earners. The Bonus was effectively a permanent personal income tax deduction, resulting in a monthly bonus of EUR 80 for yearly labour income comprised between EUR 8,174 and EUR 24,600, with a progressive reduction in the benefit up to EUR 26,600 [158]. Due to its design, however, the Bonus did not work primarily as an anti-poverty measure. Because eligibility was based on personal income, there was the risk that the Bonus could be claimed also by individuals living in households with income well above the relative poverty threshold (for example, a part-time worker married to a high earner). An ISTAT assessment of the implementation of the measure shows that the largest share of beneficiaries (45.9%) – as well as the highest average amounts received – were recorded in the second-to-highest quintile of the income distribution[159]. Conversely, by taking the form of a personal income tax deduction, the Bonus was excluding by design all those earning less than the minimum threshold for income tax reporting (the so-called '*incapienti*'). Self-employed were also not entitled to receive it – a problematic flaw, given that self-employed account for roughly 20% of Italian employment

[157] The latest estimates are available here: https://www.ipsoa.it/documents/lavoro-e-previdenza/pensioni/quotidiano/2019/11/07/quota-100-crescita-ricambio-generazionale
[158] See (Raitano, et al., 2019) For a discussion.
[159] See (ISTAT, 2017).

and, as discussed above, tends to be more exposed to in-work poverty. In 2018, the Gentiloni government introduced a national minimum 'Inclusion Income' scheme (REI, from the Italian '*Reddito d'inclusione*'). It was a means-tested monetary benefit based on a household indicator of equivalised economic conditions, taking into account both income and wealth and conditional on signing a 'social contract' aimed at promoting active inclusion. (Raitano, et al., 2019) point out that REI was however based on such a tight mean testing that the eligibility conditions were often not met even by individuals with household income below the absolute poverty line. In 2019, the League-M5S government introduced a 'Citizenship Income' (CI) aimed – in the words of M5S' leader and then-Minister for Economic Development Di Maio – at "abolishing poverty". The CI is a guaranteed minimum income scheme that replaced the REI and was expected to pay up to EUR 780 per month to singles with no income, with adjustments to account for family composition. For at least part of the beneficiaries, the CI was conditional on participating in job-search and training programmes and devoting a certain number of hours to community service. Yet, some features of the CI make it no less problematic than its predecessors. The instrument is similar in inspiration to topping-up schemes adopted in other European countries (such as 'Hartz IV' in Germany) – but significantly more generous[160]. By targeting a national *relative* poverty line, the CI is also in principle more generous for recipients in the south of Italy than in the north, due to the underlying regional differences in purchasing power. One argument that has been put forth in support of the CI's generosity is that the existence of such a generous 'outside option' would also trigger an increase in Italian wages, stagnating for over a decade. This argument however has two weaknesses. First, recent data from ISTAT suggest that about 65% of

[160] Citizenship Income: A Comparison with Europe. Osservatorio Conti Pubblici Italiani. Available at https://osservatoriocpi.unicatt.it/cpi-archivio-studi-e-analisireddito-di-cittadinanza-un-confronto-con-l-europa

working-aged beneficiaries of the CI are low-skilled and have not attained upper secondary education. These are workers who do not have very specific and irreplaceable skills, and hence it is unlikely that the CI would trigger a major increase in the wages for this kind of professional figures – especially given the fact that beneficiaries can only refuse three job offers before losing access to the scheme, which implies the CI does not structurally increase their bargaining power[161]. Absent a national minimum wage scheme – which currently does not exist in Italy – the present structure of CI risks on the contrary to encourage informal employment and creating poverty traps[162]. Moreover, data published by the Italian Labour Ministry show that only 70,000 among the 800,000 beneficiaries for whom the CI was conditional on participating in training and re-employment activities has found a job.

## 3.8 Summing Up

In this Chapter, I have analysed the macroeconomic performance of Italy relative to its Eurozone peers, to understand whether the Italian ideological 'exceptionalism' identified in Chapter 2 is consistent with idiosyncrasies in the country's macroeconomic fundamentals. The key message conveyed by the data evidence presented, is that those countries that before the Eurozone crisis constituted a polar Euro-*North* and Euro-*South* are today much more similar in terms of their macroeconomic performance. *North* and *South* are today almost fully aligned in terms of their external competitiveness positions, and the counterpart of that macroeconomic adjustment has been a significant convergence in the underlying

[161] See (Garnero & Salvatori , 2019) for a discussion.
[162] In Italy, minimum wages for employees are established by national centralized collective bargaining in each sectorial labor contract. As a consequence, all employees are covered by industry-specific minimum wages, while workers who do not belong to the national contractual bargaining system (i.e. para-subordinate workers and all self-employed categories) have no minimum wage.

labour and product market structure of the Southern economic models towards the model prevailing in the Euro-*North*. The macroeconomic and structural heterogeneity that existed within the Eurozone at the end of the Nineties has greatly diminished, and the EU/IMF macroeconomic adjustment programmes have effectively forced that kind of real economic convergence that some expected to happen endogenously after currency unification. Italy, however, stands out as an outlier in which the macroeconomic and structural adjustment has either not happened or happened only partially. This missed adjustment has an important role in explaining the idiosyncratic low growth that has characterised the Italian economy over the past two decades. Starting from 1999, Italy has been growing at half the speed as its Eurozone peers. On the eve of the COVID-19 crisis, Italian real per capita income was at the same level as 20 years earlier, signalling that the country had not even recovered from the effect of Eurozone crisis when the pandemic hit. It is easy to see a link between this prolonged lack of growth and the exceptionalism of the Italian ideological position on EMU macroeconomic governance, discussed in Chapter 1 [163]. The stagnation has had painful social consequences, leading to a vicious circle of unemployment, emigration, poverty, and inequality. These social dynamics fed into an equally exceptional pattern of political contestation, which led in 2018 to a unique government coalition of two populist Eurosceptic parties. While short-lived, the Leage-M5S government experiment (analysed in the next Chapter) put Italy on a confrontational stance vis-à-vis Brussels and European partners, solidifying the position of the country as an economic and political outlier, on the eve of the COVID-19 pandemic that was about to shock Europe.

[163] See among others the recent book by Carlo Cottarelli, who discusses the timing at length (Cottarelli, 2018)

# 4. Macro and Micro-cosmos.

## 4.1 Economic Dualism

In the previous chapters, I have highlighted how the pre-crisis dualism between the Euro-*North* and Euro-*South* has today been largely eliminated from both an economic and an ideological standpoint. I have also highlighted how Italy has become an outlier within today's Eurozone, characterised by an especially bad economic growth performance, and an extreme ideological position on the issue of EMU macroeconomic governance. The evidence presented in Chapters 2 and 3 clarifies that the Eurozone crisis narrative counterposing a Euro-*North* and a Euro-*South* as 'saints' and 'sinners' has become entirely obsolete. As discussed in Chapter 3, the Euro-*South* has undergone a massive and painful macroeconomic and structural adjustment, the result of which has been to deliver growth over the past 5 years and convergence towards the growth model of the Euro-*North*. Italy's idiosyncratic position, on the other hand, testifies to a number missed adjustments on the macroeconomic front and to a structural inability to activate growth drivers that are key for productivity and growth. But what renders Italy an even more unique case is the fact that the country is itself split into a rich productive north and a poor depressed south – thus mirroring internally the kind of economic dualism that characterised the EMU in the run up to the Eurozone crisis. Economic dualism has been a characteristic feature of Italy since the beginning of its existence as a single State. Economic historians have been debating endlessly whether the north-south economic divide pre-dates of post-dates unification, and the literature exploring the origins

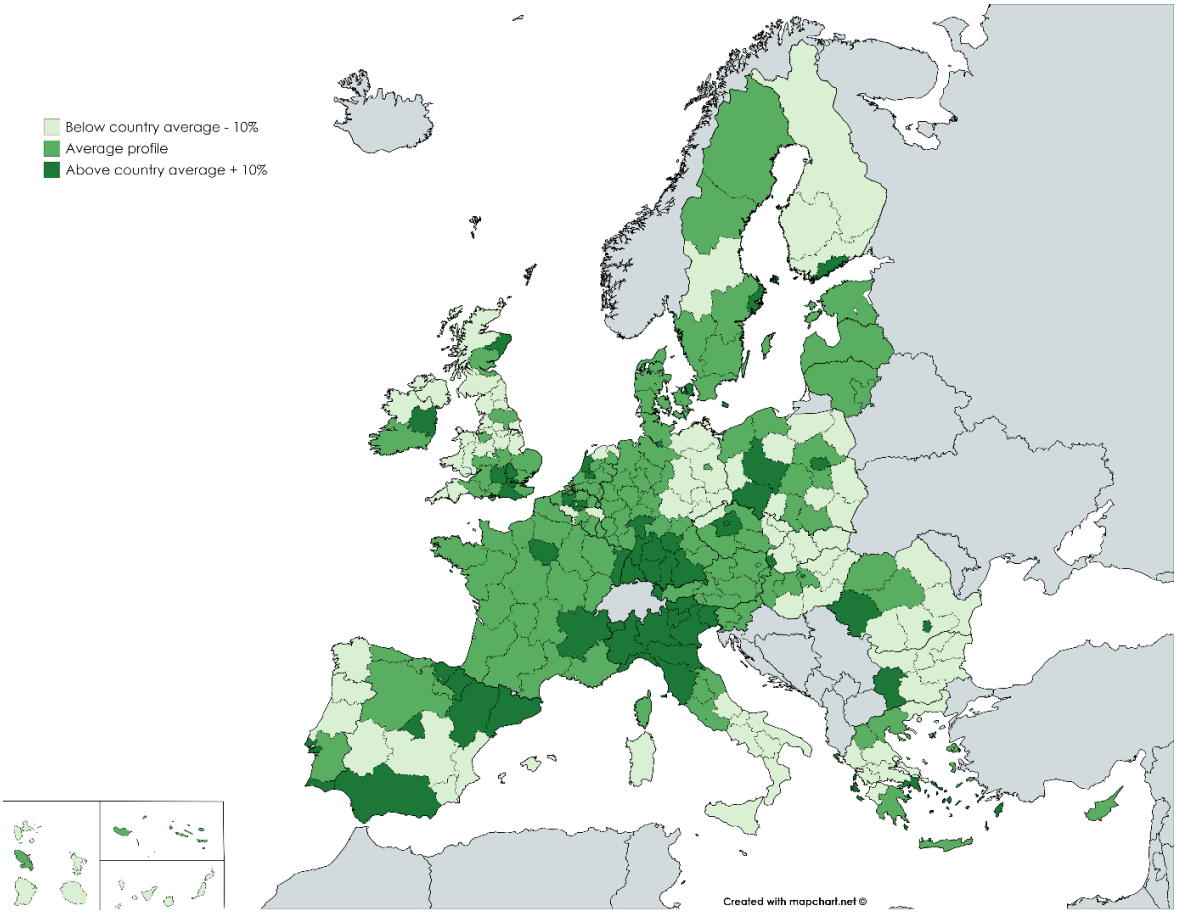
and evolution of the Italian regional divide is plentiful[164]. Without any intention to add to that literature by analysing the Italian regional dualism in depth, in this Chapter I will discuss how this phenomenon can inform our understanding of Italy's place in Europe and how it relates to the idiosyncrasies identified in the previous chapters. I will then also discuss how this deep-rooted economic dualism has been mirrored in recent years by an equally distinctive political dualism.

The characteristic feature of the Italian economic dualism is a process of regional economic convergence that never reached realisation. Although the disparity between the north and south of the country has been reduced on many important socio-demographic indicators, the gap in regional per capita income remains unbridged. Italy is by no means the only country displaying important internal disparities in income distribution – Spain and Germany are two prominent examples, as visible in Figure – but in Italy this phenomenon seems to take an especially severe and persistent character. In the countries of the Euro-*North,* the within-country dispersion[165] of per capita GDP measured in Purchasing Power Standards (PPS)[166] has decreased on average between 2000 and 2018. These countries have become progressively *less* internally diverse, compared to 20 years ago[167]. The Euro-*South* went through a phase of fast decline in income dispersion during the years prior to the Eurozone crisis, but has

[164] In particular, among the analyses published recently I suggest (Barbagallo, 2013) and (Felice, 2013).
[165] The empirical analysis of income convergence originated in the Early-Nineties' work by Barro and Sala-i-Martin, who proposed a testable growth equation derived from the neoclassical model of economic growth. Two different concepts of convergence stem from this approach. The first one – *beta*-convergence – relates to the prediction that relatively poorer economies should grow faster than richer ones (assuming the final level of income to which they converge is the same). The second concept is that of *sigma*-convergence – which looks at whether dispersion within a certain sample – for example across regions within the same country – a has increased or decreased over time.
[166] The purchasing power standard (PPS) is an artificial currency unit used to compare income levels across countries. Theoretically, in fact, one PPS can buy the same amount of goods and services in each country.
[167] The Netherlands is an exception to this rule, as it has seen a sizable sigma divergence since 2000.

experienced an equally fast increase in dispersion between 2011 and 2014. In Italy, internal (regional) dispersion of per-capita GDP was below but close to its 2000 levels until 2008, then it has increased steadily during the crisis and until 2014. Today, the dispersion of income in Italy remains more internally diverse than it was before 2008 – a testament that the twin shock of the GFC and the Eurozone crisis has not affected everyone in the same way across the country.

**Figure 19 Household Income Per Capita (PPS), 2016**




Source: author's calculations based on Eurostat data (series **nama_10r_2hhinc**)

The severe nature of the Italian economic dualism emerges event more starkly when looking at levels of primary income per capita in PPS (ESPON, 2019)[168]. Figure 19 divides the EU regions in three groups, based on their per capita primary income

**Figure 19**. A first group comprises of regions that are significantly better-off compared to the average per capita income level of the country they belong to. A second group includes regions that are significantly worse-off – i.e. posting per capita income levels that are below the national average by more than 10%. All other regions hover around the average – either below or above, but not by much. When plotted on a map (

[168] While GDP per capita is commonly used as a proxy to assess the economic performance of regions, and it serves as the basis to evaluate regions' eligibility for the EU Cohesion funds, GDP also includes items that are not directly related to an individual's feeling of being well-off (e.g. corporate income taxes, undistributed corporate benefits). See (ESPON, 2019) for a discussion.

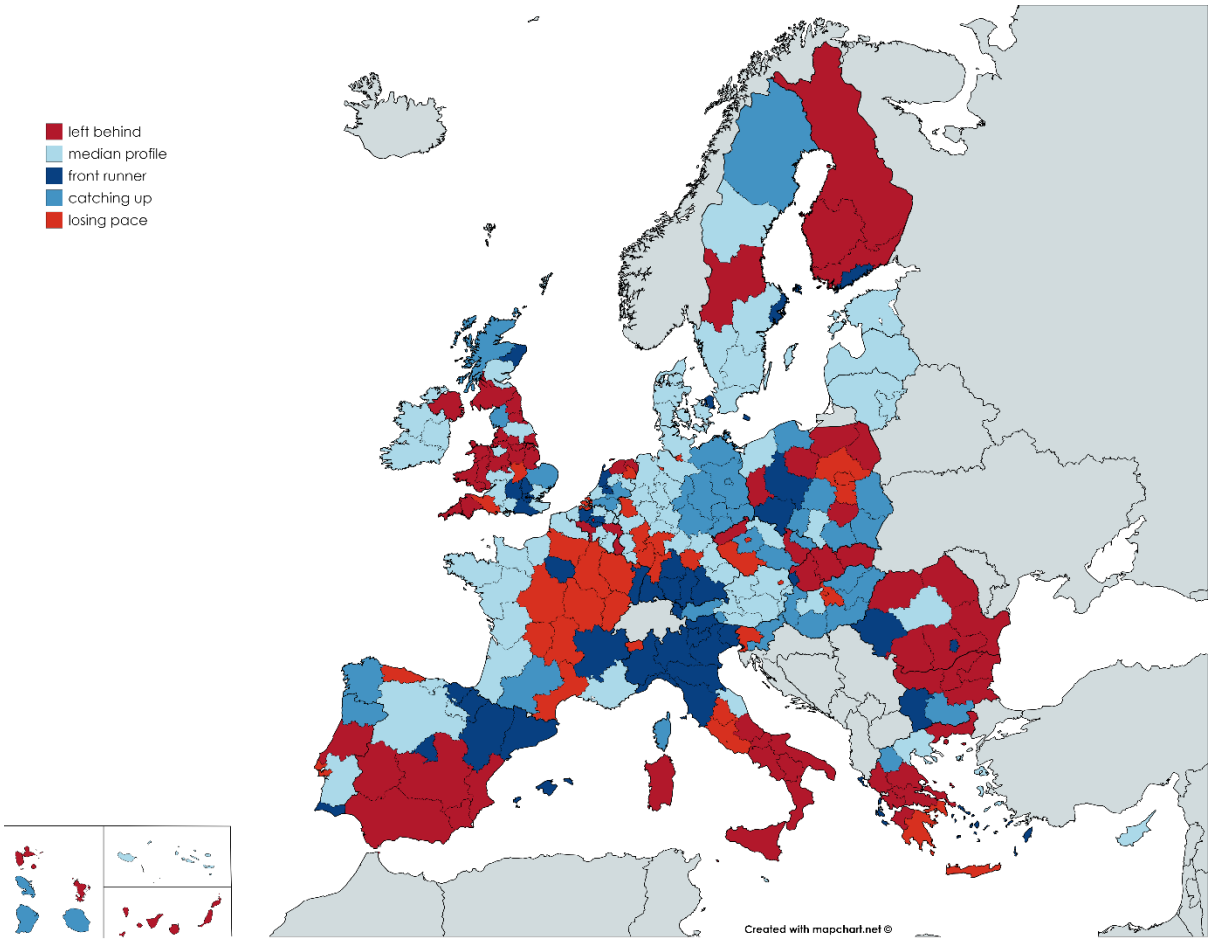
**Figure 199)** these differences suggest the clear existence of a core-periphery pattern. The core is composed of a tight cluster of well-off regions spanning the north of Italy, the south-west of Germany, and part of the French south-east. Surrounding the core, is a broad belt of regions fitting the average income profile, including Italian Lazio, Umbria and Marche, most of the French regions, the north-west part of Germany, Austria and the western part of the Czech Republic. Farther away from the core is a periphery of poor regions – most notably the Italian *Mezzogiorno*, the eastern part of Germany, central Spain and Portugal, most of the UK with the exception of the English south-west and part of Scotland, and almost all regions in the easternmost part of the EU[169].

These peripheries are not only poorer in a static sense, but also at risk of being left behind in a dynamic perspective. Following the methodology in (ESPON, 2019), in Figure 20 I have drawn a second map that combines the 2016 per capita primary income data with the average annual growth rates of the same indicator over the 2007-2016 decade. This allows identifying a taxonomy of five regional types, based on the evolution of their relative income positions over time. The first group is comprised of what we could call *front runners* – i.e. rich regions displaying also medium-high growth rates. It largely overlaps with the 'core' that identified above – spanning from Catalunya to southern Germany, through northern Italy. A second group includes regions that display medium-to-low per capita income levels but are growing much faster than the national average and are therefore catching up. They are found mostly in eastern Europe and other peripheral areas, such as Galicia, or the Scottish Highlands. While starting off at a disadvantage, these regions are on track for a significant improvement. A

[169] Notice that Latvia, Lithuania and Estonia have been assigned to the average profile – like all countries that are only composed of one region.

third group encompasses those regions that display average per capita income and medium income growth. These are places that are effectively preserving their income levels and are representative of the aggregate country average. Fourth, a group of regions with medium-to-high levels of income but below-average income growth: these are decadent places, which are relatively well off but are losing pace vis-à-vis the rest of the country and are therefore at risk of being left behind by their fast-growing neighbours. This is the case most notably in the central and eastern part of France, and the Italian regions of Lazio and Umbria also belong to this group. Lastly, there is a group of regions that has already been left behind. They are characterised by income levels that remain significantly below the national average but also by slow growth, which does not allow them to catch up and lift themselves out of relative poverty. This group comprises of the southern and central areas of Spain, most of continental Greece, many Bulgarian, Czech and Polish regions, Wales and the south-west and north of England, and Northern Ireland. In Italy, the whole *Mezzogiorno* falls in this category. When looking specifically at Italy, it is striking to see the complete absence of catching-up regions. The Italian south and German East are both significantly poorer than the rest of the countries that they belong to, in per capita income terms, but while eastern German regions are all catching up, the southern Italian regions are not. Italian dualism hence appears to be more brutal than in most other countries: regions are split between a group of front runners and a group of left behind, with the few squeezed in between already losing pace.

**Figure 20 Status and Dynamics: EU regions between 2006 and 2016**




Source: authors calculations, following the methodology in (ESPON, 2019), page 25
Note: we use **nama_10r_2hhinc** for 2006 and 2016. For France, Poland, and the Netherlands, data is missing before 2015, due to changes in the NUTS 2016 classification and/or benchmark revisions to the National Accounts. For these countries, I proxy per capita household income using real GDP per capita based on the vintage NUTS2 and assuming that household income per capita was the same share of real GDP per capita in 2006 as in 2016.

The dismal aggregate Italian economic performance – which has been discussed at length in previous chapters – is therefore the combination of two antipodes, and it represents none of them. This 'fallacy of the average' is evident also when looking at the distribution of competitiveness *within* the country. The data presented in Chapter 3, showed that Italy as a whole is an outlier for its lack of adjustment in external competitiveness vis-à-vis both the Euro-*North* and the Euro-*South*. Shifting the focus of observation at the sub-national level shows that this average figure hides very diverse competitiveness positions within the

country. The Italian north is in fact strongly competitive on international markets (Figure 21, left). Lombardy, Piedmont, Veneto, and Emilia-Romagna exported abroad more than 30% of their GDP in recent years, and almost all of them posted a positive net export position before the outbreak of the COVID-19 pandemic. Southern regions on the other hand are significantly less successful at exporting and suffer from a long-lived lack of external competitiveness both within Italy and vis-à-vis the rest of the world. In a recent paper, two Italian economists – Silvia Calo' and Mariarosa Comunale – have analysed the price competitiveness of Italian regions by computing region-level Real Effective Exchange Rates (REER) adjusted by CPI, vis-à-vis the main trading partner countries[170]. It is a very useful work, because REER measures – readily available at the country level – are generally not computed at the regional level. The right-hand panel in Figure 21 reports a map of regional competitiveness built using this data, and it shows that the REERs of southern regions are 'over-valued' vis-à-vis their international trading partners, compared to the REERs of their northern regional neighbours. The picture is similar when looking at net export positions of Italian regions *within* Italy. The exercise is complicated by the fact that national statistical agencies do not normally release regional net-exports or current account positions within a country's borders. To calculate a proxy of Italian regions' net exports vis-à-vis other Italian regions, I have used a collection of input-output data at the regional level[171] that allows mapping where GDP is created and where it is absorbed[172]. Unfortunately, at the time of writing the latest input-output data available at the regional level date back to 2010 – but the situation is unlikely to have changed much, at

[170] See (Calo' & Comunale, 2019)

[171] The input-output data is available at the regional level for all EU regions "EUREGIO: a global IO database with regional detail for Europe for 2000-2010" (Anon., 2018). The database at: http://dariodiodato.com/?p=260. The data has been managed using the STATA code ICIO developed by Federico Belotti, Alessandro Borin and Michele Mancini, and explained in more detailed at (Belotti , et al., 2019 (forth)): http://www.tradeconomics.com/icio/. I am especially thankful to Michele Mancini for having introduced me to the ICIO.

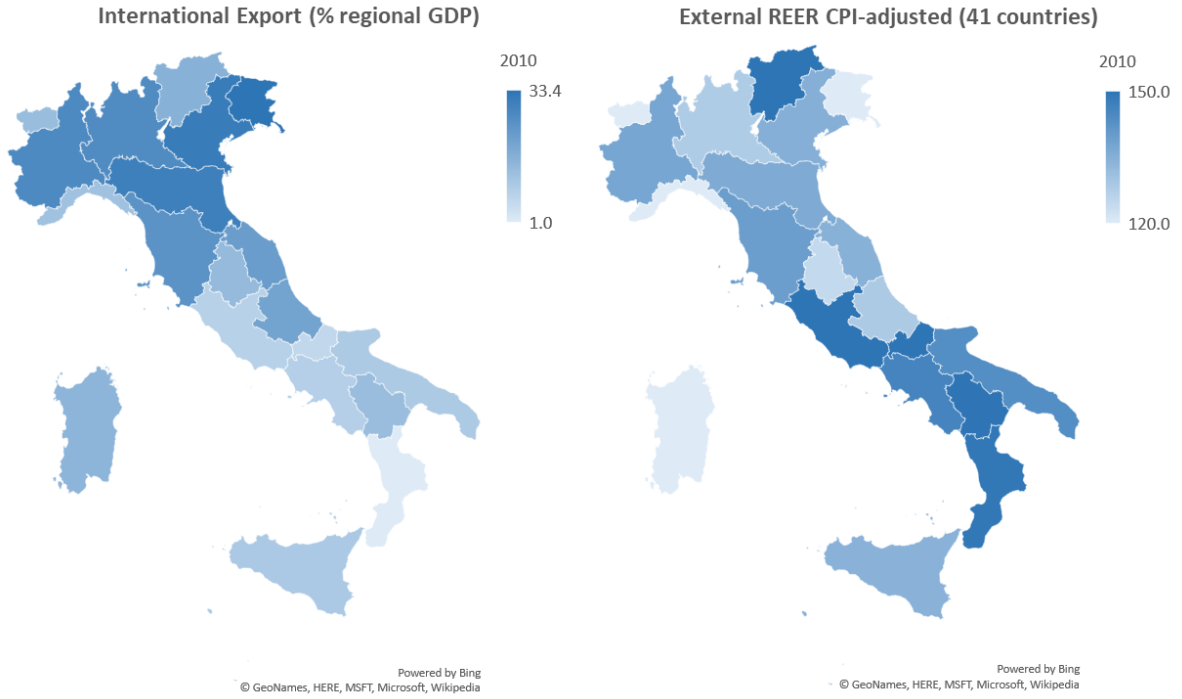
[172] See e.g. (Johnson & Noguera , 2012) for the application of input-output-based analysis to international trade.

least in terms of relative regional positions. Although the divide is slightly less clear-cut than in Figure 21, the picture is again one of marked dualism, with southern Italy generally consuming more than it produces and northern Italy doing the opposite (Figure 22, left). Using regional consumer price indexes, we can map the net export divide into a competitiveness one, by constructing a measure of intra-Italy regional REER[173]. This exercise shows that the south of Italy is uncompetitive not only vis-à-vis the rest of the (external) world but also vis-à-vis the rest of the country it belongs to (Figure 22, right). Within-country current account positions are generally deemed of little interest because balance of payment dynamics is thought to be irrelevant at the subnational level – as discussed in Chapter 1 in relation to the pre-EMU thinking about balance of payment crises in monetary unions[174]. Balance of payments imbalances can occur among regions within a country – as evident in this data – but the existence of federal fiscal schemes normally serves to cushion them. Regions will thus hardly undergo the kind of economy-wide confidence crisis where the geography of risk matters because it translates into a capital flight. Coherently with this, the correlation of savings and investment across regions within countries tends to be low and statistically insignificant.

[173] In any given year, the REER is calculated as: $REER = \frac{NEER * CPI}{CPI^F}$, where:
CPI is the consumer price index of the country under study; $NEER = \prod_{i=1}^{N} s(i)^{w(i)}$ is the nominal effective exchange rate of the country under study, which is in turn the geometrically weighted average of the nominal bilateral exchange rate between the country under study and its trading partner i [s(i)] weighted by the export share [w(i)]; and $CPI^F = \prod_{i=1}^{N} CPI(i)^{w(i)}$ is the geometrically weighted average of CPI indices of trading partners. For regions within the same countries, s(i) is obviously equal to 1, because no nominal exchange rate exists. The intra-country regional REER is thus equal to $REER = \frac{CPI}{CPI^F}$.

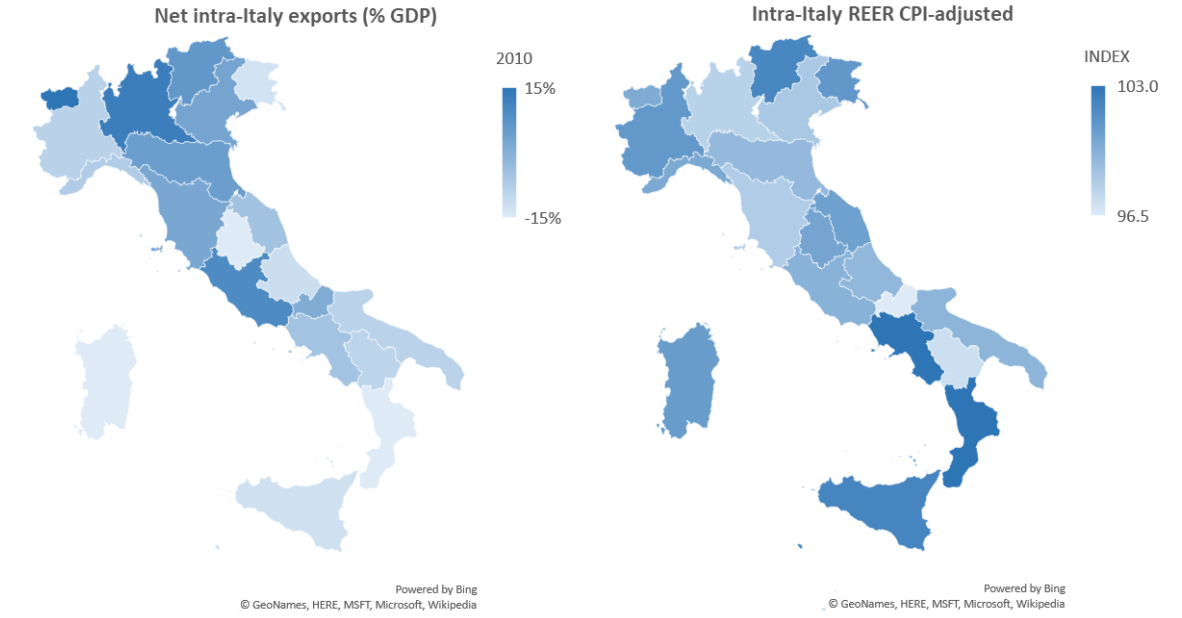
[174] Regions within country normally rely on the national banking systems: this diversification implies that the bursting of local credit bubbles would not translate into a full-blown banking crisis. Even if a banking crisis were to occur, at the local level, regions would normally not bear the responsibility (nor have the necessary degree of fiscal autonomy) for rescuing and restructuring the troubled banks and banking crises would not translate into local fiscal crises.

**Figure 21 International competitiveness**




Source: data on regional export as a share of regional GDP are from ISTAT's territorial indicators. Data on regional REER are from the dataset constructed in (Calo' & Comunale, 2019). The REER has been indexed so that 2001=100, to be comparable with the data presented in Figure 39. Both sides of Figure 38report the 2010 datapoint, despite more recent data being available, to ensure comparability with Figure 39.

**Figure 22 Internal Competitiveness**




Source: **left -** author's elaboration based on IO data from (Anon., 2018), and treated with ICIO as developed in (Belotti , et al., 2019 (forth)); **right -** author's elaboration based on data from ISTAT and (Anon., 2018)

## 4.2 Arrested Development

On Wednesday 13th September 1972[175], Italian daily *Corriere della Sera* published on page 5 an article with the title: "the [Italian] north-south gap will only be bridged by 2020". It was a prediction by Italian economist Pasquale Saraceno, out of a report written for the Minister of Finance. Fast-forward to 2020, and the gloomy prediction turns out to have erred on the side of optimism. Regional fiscal data published by the Italian System of Public Territorial Accounts (SCPT) show that the counterpart of the internal balance of payment imbalance shown in Figure XX has been the transfer of a substantial share of fiscal resources from the centre and north of Italy to the south. Over time, these sizeable fiscal transfers have not succeeded in addressing the roots of the arrested development in the Italian *Mezzogiorno*. On the contrary, over time the Italian economic dualism has crystallised into a situation of outright economic dependence. In a study published by the Bank of Italy in 2011, Giovanni Iuzzolino, Guido Pellegrini and Gianfranco Viesti offer a fascinating recount of Italian regional convergence (and lack thereof) between 1861 and 2011. The premises of dualism were present since the start of Italy's life as a single country, but before the World War I the scale of regional disparities was not abnormal compared to the situation in other European countries. The per capita income gap between the south of Italy and the rest of the country widened rapidly during the Fascist era because emigration abroad was banned, internal migration was significantly curtailed, and the available capital was directed to the already established and thriving industries in the north-west[176]. This trend of geographic agglomeration started with the war effort and was subsequently consolidated with the birth in 1933 of the Institute for

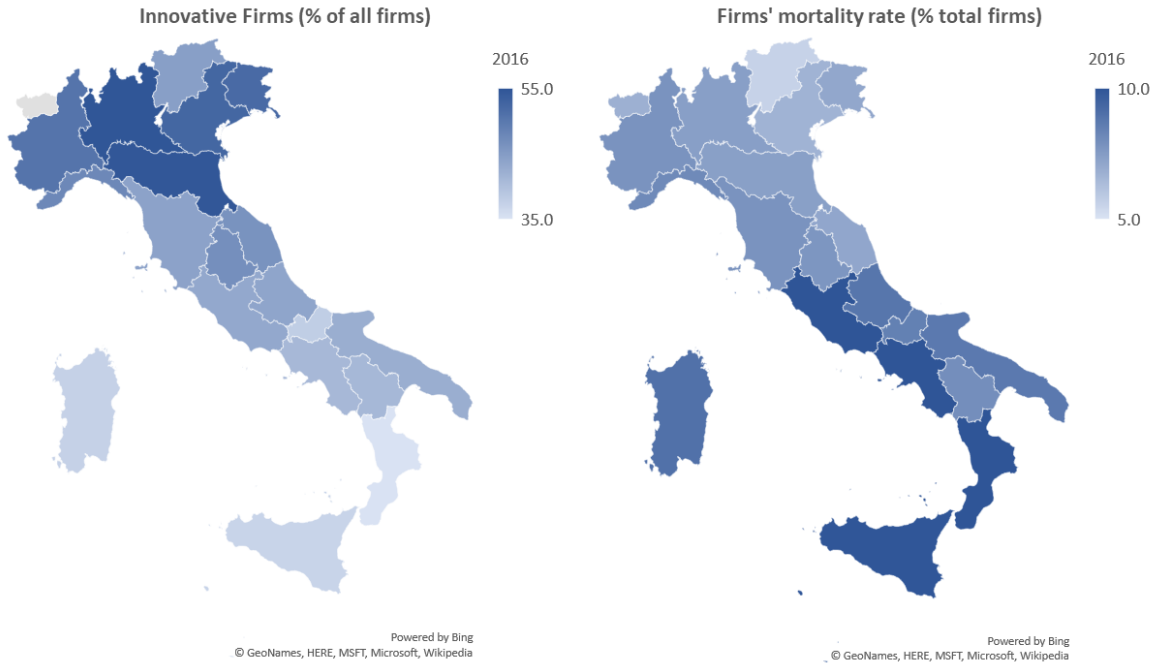
[175] See: https://www.corriere.it/economia/lavoro/20_gennaio_01/divario-nord-sud-sara-colmato-2020-titolo-vero-1972-che-racconta-l-italia-6d59a1ce-2cb0-11ea-afa8-9788b8f8ce6e.shtml
[176] See (Iuzzolino, et al., 2011)

Industrial Reconstruction (IRI), which led to the transfer to the State of a large part of the Italian banking and manufacturing sectors. As a result, in 1951 the position of the Italian south was worse, in relative terms, than it had been at the time of unification. The following 20 years, however, would be a period of marked convergence and catching-up driven mostly by productivity growth and by investment in the south from firms based in the north-west or state-owned corporations, supported by the institution of several southern development programmes – most notably the Southern Italy Development Fund. This cycle of 'passive industrialisation' or 'industrialisation from the outside' came to a premature end in the 1970s[177]. Southern industry was more exposed to the rise in labour and energy costs that hit Italy and the other industrialised economies in the early 1970s, and it was less able to profit off the prolonged and sharp depreciation of the domestic currency – the Lira – which continued throughout the 1970s and in the mid-Nineties[178]. Most importantly, the abolition in 1968 of the so-called 'wage cages' – the system of geographic wage setting briefly discussed in Chapter 3 – resulted in a loss of competitiveness for the Italian south, in a similar way to what happened to Eastern Germany following the imposition of a 1:1 exchange rate between the Eastern Mark and the Deutschmark during the German reunification. Once the geographical constraints were abolished, labour costs in the south of Italy quickly aligned with the national average, which was driven by the higher wages set in the north of the country. At that level, wages stood above the productivity dynamics observed in the south, and the result was the loss of competitiveness of southern exports (vis-à-vis both other regions within Italy and the rest of the world) shown in Figures 21 and 22. The gap in per capita output between the north and south of the country increased from 33% in 1971 to 40% in 1991, with

[177] See 1970s (Felice, 2013; Barbagallo, 2013)
[178] See (Iuzzolino, et al., 2011)

most of the widening (55%) due to the relative productivity loss in the south as discussed in (Iuzzolino, et al., 2011). The counterpart of this economic stagnation was an increase in southern unemployment rate. On a comparable basis, unemployment doubled from 8.3% in 1979 to 15.8% in 1989, against an increase by 1 percentage point in the centre and north during the same period[179].

**Figure 23 Business Dynamism**



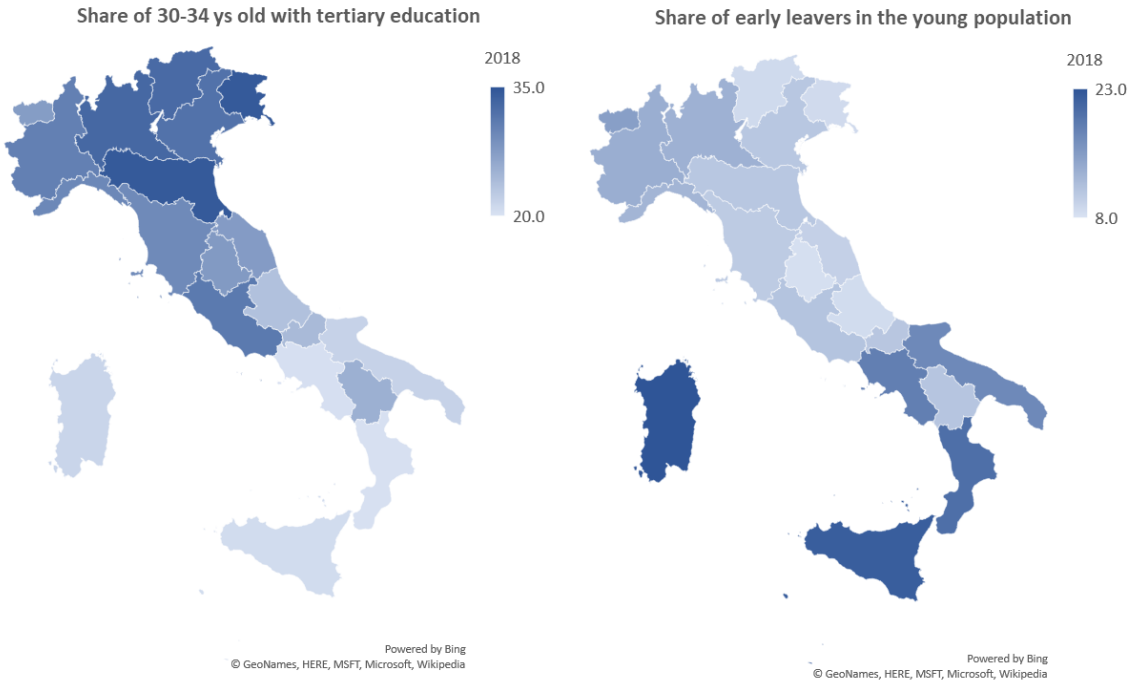

Source: author's calculations based on data from ISTAT

The story of the Italian economic dualism is one of intertwined macro and micro dimensions: the loss of competitiveness that we observe at the macro level for Italy against its EMU peers is mirrored at the sub-national level in the loss of competitiveness of the Italian south vis-à-vis the rest of the country. The role of productivity is crucial also to explain the sub-national dynamics Today, productivity continue to differ markedly across Italy. The geographic distribution of gross value added per worker is very unequal, ranging from EUR 57 thousand

[179] See (SVIMEZ, 2011) for a discussion of these estimates.

in Lombardy and EUR 48 thousand in Piedmont and Veneto, to as low as EUR 29 thousand in Calabria and EUR 31/32 thousands in Apulia and Sicily. Innovation activity and innovative firms are also significantly more concentrated in the north of the country. In 2016 (the latest available year at the time of writing) 55% of firms domiciled in Lombardy reported that they had introducing innovations in their products, processes, organisation, or marketing (Figure 23, left). The corresponding figure for the *Mezzogiorno* was 40% on average, with lows of 35% in Calabria and 37% in Sicily and Sardinia. When looking more specifically at product and process innovation, the share of innovative firms drops to an average of 28% across the *Mezzogiorno,* as opposed to more than 40% in the north of the country. The counterpart of this clustered innovation pattern is that southern firms spend unsurprisingly less on innovation and Research and Development (R&D). Private R&D spending measured as a share of GDP is three times higher in the north of Italy, while it barely reaches 0.33% in the south. This is accompanied by less business dynamism in the south of the country, where the mortality rate of firms tends to be higher (sometimes even double) the one observed in the north of the country, especially in Sicily, Calabria and Campania (Figure 23, right).

**Figure 24 Education Outcomes**




Source: author's elaboration based on data from ISTAT

If Italy lags behind its EMU neighbours in terms of both human capital formation and human capital retention, this is also an area where internal dualism runs especially deep. On one hand, the share of young people dropping out of the education system prematurely can be up to four times higher in the south of the country compared to the north (Figure 24, right) – and it is particularly high in Sardinia (23%), Sicily (22%), Calabria (20%) and Campania (18.5%). On the other hand, the quality of education offered also differs significantly across the country, as evident for example in the outcomes of the nation-wide INVALSI test of students' academic performance (INVALSI, 2019). The scores in Italian, English and Mathematics are lower in the south of Italy than in the north, and the gap widens as pupils progress in education grades. In primary school, only minor differences are detected across geographic macro-areas within Italy. Differences widen in lower secondary school – with outcomes starting to be higher in northern regions – and the gap consolidates in upper secondary

school. By 13th grade, the difference in average scores of northern and southern regions is of 28 points in Italian and 33 in mathematics (INVALSI, 2019). Some regions – particularly Calabria, but also Campania, Sicily, and Sardinia – stand out for especially low results at almost any educational level. In English, the results tend to be low for the whole country, but again significantly worse in the south. This data is consistent with the findings in (OECD, 2018), where northern Italian regions are certified to score above both Italian and OECD average, while southern regions score below both[180]. In the Italian south, not only are educational outcomes worse on average, but the variability among schools and classes is also much higher than in the north, even in the essential primary education. This suggests that the school system in the most disadvantaged Italian regions is not only less effective but also more unequal. The structural variation in quality and access to education across the country has become even more evident during the COVID-19 lockdown, when schools were closed, and teaching had to be done digitally from remote. (Hanushek & Woessmann, 2020) show that while the precise learning losses are not yet known, existing research suggests that the students in grades 1-12 affected by school closures might expect a 3% lower income over their entire lifetimes. For nations, the lower long-term growth related to such losses might yield an average of 1.5% lower annual GDP for the remainder of the century. These economic losses will be more pronounced the longer the period of school closure and will be more deeply felt by disadvantaged students. Recently updated numbers from UNESCO[181] show that COVID-19 resulted in 22 weeks of complete and partial school closures on average globally,

[180] In the latest OECD PISA tests, four regions and provinces in Italy sampled a sufficiently large number of schools and students to enable separate reporting of results. In reading, Trento and Bolzano scored at a similar level as Germany and Slovenia (above the national average); Toscana scored close to the national average; Sardinia scored below the national average, and at a similar level as Greece and Turkey. See (OECD, 2018).

[181] See https://en.unesco.org/news/unesco-figures-show-two-thirds-academic-year-lost-average-worldwide-due-covid-19-school

but in Italy the lost weeks have been 30 (above world average but also significantly higher than in neighbouring countries such as France or Germany). The most penalised will be students whose families are less able to support out-of-school learning – due to e.g. lack of IT skills and equipment, combined with potentially cramped living conditions and lack of space. In Italy, the 2020 ISTAT report reveals that as much as 45,4% of students aged between 6 and 17 (about 3.1 million young people) live in a situation where the lack of digital devices in the households significantly hampers their ability to pursue their education in a digital and remote setting. Once again, the problem is much more pronounced in the *Mezzogiorno*, where the share of students who lack access to either a computer nor a tablet in their households reaches 19%, against 7.5% in the north of the country.

When it comes to graduate and post-graduate education, the internal north-south gap widens even further. The share of university graduates in the 30-34 years old population is much higher in the north of Italy, where it reaches 33% in Lombardy and Emilia-Romagna compared just 20% in southern regions like Calabria or Campania (Figure 24, left). Part of this difference is attributable to 'educational migration' – i.e. a tendency of young people to move from the south to the north of the country to pursue higher education and then access better career opportunities. (Bassetto , et al., 2019) looked at the geographical origin of Italian students interviewed in the ISTAT survey of graduates, and at where they pursued their studies. Among the graduates who decided to move abroad after completing their studies, those who had graduated from northern universities were 57% of the total in 2011 and 60% in 2015, but only 44% and 53% of them respectively were originally from the north of Italy. This data documents a process of 'two-steps-migration', whereby young Italians from the poorer and more backward regions move first to the north of the country to build their human capital,

and then move abroad, to pursue further education or career opportunities. The haemorrhage of talent from the south of Italy is hardly surprising in view of the poor labour market prospects of those who stay. Compared to a national average of 10.6% in 2018, the total unemployment rate in the *Mezzogiorno* was 18.4%, almost three times higher than in the north (6.5%). As discussed in Chapter 3, Italy has a structural problem of high long-term youth unemployment, which is associated to significant skills deterioration. This problem is however much worse in the south of the country. In 2018, about 70% of all the unemployed in Calabria, Sicily and Campania had been in such condition for longer than one year. The youth unemployment rate was 48.4% in the *Mezzogiorno* in 2018 – with peaks of 53.6% in Sicily and Campania – compared to 21.7% on average in the north. Those who have jobs, often face precarious working conditions. The incidence of temporary employment is 21% in the *Mezzogiorno* – with peaks of 26% in Calabria and 23.3% in Sicily and Apulia – compared to a national average of 17%. At the same time, irregular employment (i.e. employment not registered within the national social security system[182]) is more widespread in the south, where it reaches 22% in Calabria and 20% in Sicily. Unsurprisingly, the precariousness of labour market situation has visible repercussions on the local social situation. The incidence of relative household poverty reaches 35% in Calabria and 29% in Sicily, against a mere 4.6% in Emilia-Romagna and 5.5% in Lombardy. The distribution of income is also more unequal in the *Mezzogiorno,* with Sicily, Calabria and Campania posting higher scores on the Gini coefficient than the rest of the country.

[182] See this explanatory note by ISTAT on the black economy in general, and irregular employment more specifically: https://www.istat.it/it/files/2017/10/Economia-non-osservata_2017.pdf

## 4.3 Social Capital

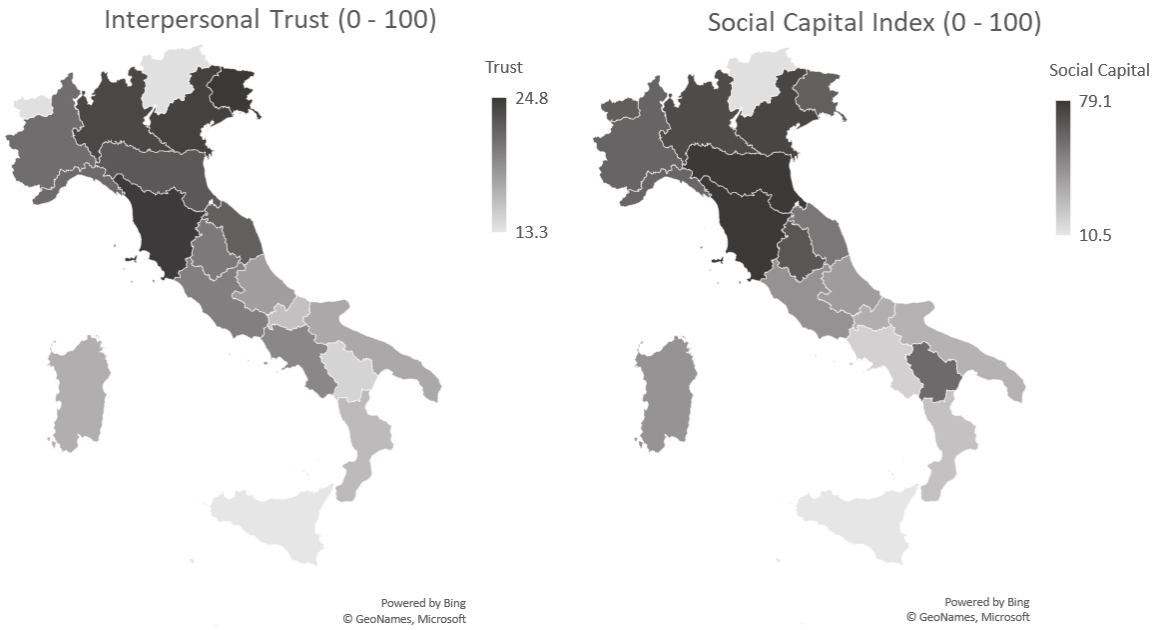
Attempts to explain the arrested development of the Italian south have focused in part on the link between economic backwardness and institutional quality, interpreting economic dualism as the result of diversity in 'social capital' endowments. The concept of social capital is generally taken to indicate the set of all those social ties which, while not being explicitly political, contribute to creating a sense of community, trust, and common interests among the members of a society. Italy has been a case study for scholars set on demonstrating the importance of social capital as an engine of economic development. One such prominent interpretation of the backwardness of the Italian south was advanced in 1993 by Robert D. Putnam. In his book *Making Democracy Work: Civic Tradition in Modern Italy*, Putnam studied 20 Italian regions which in his view shared a similar institutional setting but displayed very different social and economic outcomes, hence constituting a perfect testbed for assessing the independent effect of social capital on institutional performance. Putnam's central thesis is that the structure of the city-state – typical of northern-central Italy during the Middle Ages – fostered a strong tradition of civic engagement, which in turn allowed for the development of horizontal governing structure resting on mutual trust[183]. The feudal system prevailing in the south, on the other hand, produced a kind of autocracy that inhibited civic engagement and fostered dis-trust and individualism, and confining the regions into economic backwardness. A similar view had been offered a few decades earlier by Edward Banfield, in his 1958 book *The Moral Basis of a Backward Society*. On his return from a field trip in Basilicata, Banfield spoke of 'amoral familism' to describe an ensemble of self-interested

[183] See (Putnam, 1993)

attitudes and behaviours aimed at putting the family short-term interest first, to the detriment of the public good and the longer-term interest of society at large[184]. This condition was interpreted as implying a lack of 'social capital', which Banfield saw as a leading cause for the widespread presence of clientelism and generalised lack of civic spirit in the southern regions. While many counterarguments have been offered to these theories over the years, a gap between northern and southern Italy is indeed identifiable in opinion survey data assessing the degree of interpersonal trust in society. In survey evidence collected by ISTAT in 2018, the share of people willing to agree with the statement that "most people are trustworthy" is around 21% for Italy as a whole, but 10 percentage points lower in the south (16%) than in the north of the country (26%). The highest-trusting regions are Tuscany (25%) and Friuli (24%), with Trentino Alto-Adige being an outlier (38%). In the south, the share is consistently below 20% and it drops to lows of 13% in Sicily, 14% in Basilicata and 16% in Calabria (Figure 25). The same regional pattern emerges also when looking at data on the propensity to participate in associations and volunteering activities, which again appears to be significantly higher in the north of the country.

[184] See (Banfield, 1958)

**Figure 25 Social Capital**




Source: author's calculation based on ISTAT data (Aspetti della vita quotidiana)
Note: Valle d'Aosta and Trentino Alto-Adige are omitted because they appear to be outliers and including them could make the rest of the chart difficult to read.

To capture a broader concept of social capital, I have built an index based on several indicators of civic engagement and active participation in community life, out of ISTAT survey data. The indicators used are: (i) the electoral participation rate (measured on the last European elections in 2019); (ii) the percentage of inhabitants who claim to seek information about the Italian political situation at least 'a few times a month'; (iii) the percentage of inhabitants who claim to have carried out at least one of the following political activities: participation in a rally, participation in a parade, free work for a political party, monetary donations to a political party; (iv) the percentage of inhabitants who declare that they have been volunteering and (v) the percentage of respondents who declare that they have carried out activities for non-voluntary associations and/or for the trade union, and/or to have paid monetary contributions in favour of an association. For each indicator, the position of each region was standardized (using the inter-regional mean and variance), and the mean score on

all indicators was then calculated. The result is an index, mapped on the right side of Figure 25. This indicator shows a clear geographical polarization in the distribution of 'social capital'.

Can these regional patterns be mapped into corresponding differences in institutional quality and degree of *civicness,* as the theories of Banfield and Putnam would imply? An ISTAT survey on the 'civic sense' of Italians – published in 2019 – offers interesting insights into the diffusion of norms concerning the respect for others and the life in a community. While the almost totality of respondents disapproves of actions such as littering (84%), driving after the consumption of alcohol (87%) or using a cellphone while driving (80%), Italians appear to be less strict when it comes to clientelist practices or tax evasion. Nationwide, 29.3% of respondents thinks that there are cases in which tax evasion can be justifiable, and almost half of the respondents would second a request to pay for a service off the books. Only 53.5% of respondents believes that tax evasion is a behaviour of the utmost gravity (on a scale up to 10). Among the justifications that are put forward for tax evasion, by far the largest share of respondents mentions the poor quality of public services received in exchange for taxes (22%), and 5.4% would condone this behaviour on the basis of its diffusion across the reference community (i.e. "because others do it"). Interestingly, young adults (25-34 years old cohort) are on average more inclined to justify tax evasion (33.5%) compared to older cohorts (23.4%). Although a much more in-depth analysis would be needed to trace the causes of this attitude, the generational gap in terms of tax responsibility is probably reflective of the socio-economic difficulties of the younger generations and of the unbalanced welfare policies support across generations, which have been discussed in Chapter 3. A generation that has been left behind and that for the first time in nearly a century is experiencing descending social mobility may want also less responsibility in the financing of those welfare

state policies that mainly benefit the more fortunate elderly. A generational rebalancing of the welfare state is therefore crucial: if the younger generations' permissive attitude towards tax evasion is linked to economic and social hardship, then it is unlikely to fade away as they grow older in a defined contribution pension system – and the risk is for society to become as a whole more tolerant towards tax evasion and even less able to finance the welfare state. While the attitude towards tax evasion in general terms is does not appear to display any specific geographical patterns, it is interesting to notice that the share of those answering more specifically that they would be happy to pay for a service off the books "if this was to their benefit" – thus signaling an intentional and individualistic calculation – is unequivocally higher in the north of the country. Another interesting result emerges from the assessment of people's propensity to accept clientelist practices such as asking someone for a recommendation to obtain a job in a preferential way. Overall, 28.3% of respondents would condone this behavior nation-wide, on the basis of either merit or of need. The geographical breakdown of the justifications offered is interesting, however. Respondents in northern regions are more likely than respondents in the south (10% vs 7% respectively) to condone this clientelist practice based on a sense of entitlement, underpinned by a perception of merit (it is right to ask for it "when you are convinced to deserve the job") – although it needs to be stressed that the geographical differences are marginal, on these questions. Respondents in the southern regions, on the other hand, are slightly more likely to justify the behaviour based on need (it is right to ask "if there is no other way to get a job"). At a higher institutional level, practices such as *voto di scambio* (voting for someone in exchange for favors) and corruption are deemed to be actions of the utmost gravity by 76.1% and 72.5% of respondents respectively. At the same time, however, 25% of respondents thinks that corruption is "a natural and inevitable fact" and 36% believes that reporting instances of corruption is

"useless" – testifying to a low level of trust in the institutions supposed to both prevent and counter corruption. Additional evidence of this distrust comes from the fact that 60% of respondents seem to believe that reporting cases of corruption can be "dangerous" – with the share of those who think so being systematically higher in the north. Coming to actual experiences of corruption, on average about 20% of respondents have been involved into at least one instance of corruption (either on the giving or on the receiving end of it) or at least know someone who has been directly involved in such situation. The dualism in institutional quality emerges very clearly, on this dimension: the highest shares are recorded in Apulia (43%) and in Lazio (39%), and the lowest shares are recoded in Friuli Venezia-Giulia (8%) and Trentino Alto-Adige (9%). A clearer north-south pattern emerges also when looking at how many respondents have ever been asked to vote for someone in exchange for favours (or know someone who has). This clientelist practice emerges to be significantly more widespread in the south of the country, with an incidence of 31% in Apulia, 28% in Basilicata and 25% in Sicily. Similar conclusions can be drawn from the data published in the context of the European Quality of Government Index (EQI), a measure developed by the Quality of Government Institute of Gothenburg University – which allows comparing Italian regions to other regions in the EU. In the EQI, institutional quality is defined as a multi-dimensional concept –aimed at capturing citizens' perceptions and experiences with corruption, and the extent to which citizens rate public services as impartial and of good quality in their region of residence (Charron & Lapuente, 2018). In the EQI, the institutional quality in the southern Italian regions is not only lower than in their northern neighboring regions, but also significantly worse than most EU regions (with only Greece and Bulgaria doing equally bad or worse). This institutional dualism certainly plays an important role in the vicious circle that through low social capital, human capital, and productivity results in the economic

backwardness of the Italian *Mezzogiorno* and it is therefore key in explaining how the 'arrested development' of southern Italy weighs on the growth dynamics of the country as a whole. Although regions within a country are unlikely to experience the kind of balance of payment crisis that affected the Euro-*South* in 2010-12, a deep level of economic dependence like the one discussed in this chapter can nevertheless lead to the politicization of the internal balance of payment relationship across regions, as richer areas wish to defend their status and poorer areas feel economically and politically abandoned. In 2018, the Italian political landscape was effectively split on the question of how to manage the solidarity implications of economic dualism in a heterogeneous monetary union (like Italy). This split resembled very closely the cleavage that has been discussed in Chapter 2 for the Eurozone as a whole.

## 4.4 Dualistic Populism

In September 2018, speaking to *Politico* during a tour of European capitals, Steve Bannon stated that Italy had become "the centre of the political universe[185]". The architect of Donald Trump's successful populist campaign narrative probably meant to acknowledge the exceptionalism of a country which – alone in the Eurozone – had voted into office a coalition of populist Eurosceptic parties. Euroscepticism was certainly not an Italian peculiarity: ever since the Global Financial Crisis, Euroscepticism(s) had been flourishing throughout Europe. The plural is warranted, because while sharing a common dislike of Brussels, Eurosceptics in different countries base their narrative on very different premises. While Eurosceptics in the Euro-*South* blame Brussels for its lack of solidarity, Eurosceptics in the Euro-*North* blame

[185] See the quote as reported in: https://www.politico.eu/article/steve-bannon-italy-europe-the-movement-experiment-will-change-global-politics/

Brussels for what they see as an excess of solidarity. The most recent electoral cycle brought these tensions out in the open. In May 2017, France's far right and Eurosceptic presidential candidate Marine Le Pen obtained more than a third of all votes during the second round of the French presidential elections. In September 2017, the far right and Eurosceptic Alternative für Deutschland (AfD) won more than 13% of the votes in the German parliamentary elections. But nowhere did populists perform as spectacularly as in Italy, where the right-wing League and the left-leaning Five Stars Movement (M5S) won about 50% of all votes in March 2018. This remarkable performance had been the result of a clever segmentation of the electorate along a set of deep and geographically well-defined economic and social cleavages. The 2018 political elections yielded the portrait of a country split in two, with the north voting predominantly for the centre-right (and within it, mostly for the League) and the south voting massively for the Five Stars Movement (M5S). League and M5S – while sharing a generally populist and Eurosceptic discourse – tailored their respective political campaigns so as to appeal to the different roots of discontent prevalent in different parts of the country. The core of M5S' agenda was a promise to redistribute income towards the bottom of the distribution, through an expenditure-increasing expansion of the welfare state (the flagship Citizenship Income, already discussed in Chapter 3). This agenda appealed to voters in the south of Italy, struggling with bleak local economic prospects and higher unemployment rates. The economic malaise prevalent in the reference geographical constituency of M5S is also evident in individual-level survey data collected by the European Commission in the context of the Eurobarometer survey: when asked to identify the most important issue preoccupying them personally, 25% of respondents who are resident in M5S-leaning regions picked unemployment, against only 10% of voters in Centre-Right-leaning regions. The latter were instead more driven towards the League's agenda, offering a

revenue-reducing reform of the taxation system (the Flat Tax, initially supposed to apply to all taxpayers). The Flat Tax reform, which would have redistributed income towards the top of the distribution, promised to boost the purchasing power of middle-class workers in the north of the country who, while benefitting from higher nominal wages, were penalised by higher costs of living and a structure of taxation that was especially unfavourable to those relying on fixed labour income[186].

In 2018, both M5S and League were running a populist political discourse, but the two parties located themselves far apart on what would be a more traditional left-right spectrum. The fact that those two rival populist narratives could coexist in almost equal strength within a single polity – including in a government coalition – is anomalous. Yet, it can be rationalised in view of the marked economic dualism discussed in the previous section. Scholars have been investigating at length whether different economic models are structurally prone to produce different varieties of populism. (Mudde & Rovira Kaltwasser, 2013) counterpose an *inclusionary* populism – left-wing in nature and predicated on conditions of economic anxiety – to an *exclusionary* populism – right-wing in nature and underpinned mostly by identity politics. In a more recent study, (Blyth & Hopkin, 2018) see the rise of populism in Europe as a common reaction against a neoliberal growth model but with specific characters strongly linked to the nature of the underlying welfare state regime prevailing in different countries. (Roberts, s.d.) argues that the framing of "the people" and the "other" – concepts that are at the very heart of populistic rhetoric – may indeed be affected by the labour market and welfare state institutions prevailing under different economic models. The implicit intellectual

[186] See (Boeri, 2018) for a discussion

reference framework is that of the Varieties of Capitalism (VoC) political economy school, which focuses on the institutional nature of countries' comparative economic advantages (Hall & Soskice, 2001). Varieties of Capitalism portends that the organizational structures of political economies are "durable social facts, to which governments seeking prosperity and comparative advantage in international markets have to adjust their economic strategies"[187]. According to this view of the world, it is countries' institutional configurations that determine their economic growth models, which will in turn react differently when faced with similar shocks. In the context of the Eurozone, scholars in the Varieties of Capitalism field have identified two very distinct economic models. On one end of the spectrum, the Coordinated Market Economies (CMEs) of the Euro-*North* – Germany, Austria, the Netherlands, and Finland – whose institutional configuration made them natural winners from the macroeconomic conditions prevailing during the first ten years of currency unification. On the opposite end, the group of Mixed-Market Economies (MMEs) of the Euro-*South* – whose economic growth model was traditionally demand and debt-driven. This school of thought naturally produces an interpretation of the divergence in economic performance observed before the Eurozone crisis as a consequence of the structural incompatibility of different domestic models with what (Blyth & Matthijs, 2017) would call the EMU's single macroeconomic regime[188]. Italy however falls in the cracks of the typical Varieties of Capitalism classification – as its pre-crisis macroeconomic performance makes it a hybrid case and an outlier vis-à-vis its Eurozone peers. At the sub-national level, however, the dividing line is much clearer and the Varieties of Capitalism categorisation much more fitting. The south of Italy in fact displays the same features of the demand and debt-driven Mixed Market

[187] See (Hall, 2014) page 6
[188] See (Hall, 2012; Hall, 2014)

Economy models that were characteristic of the Euro-*South* before the Eurozone crisis. From a political standpoint, the 2018 political discourse of M5S and its success in the Italian south are very much consistent with the performance of inclusionary populist parties across the Euro-*South* during the Eurozone crisis (e.g. Syriza in Greece or Podemos in Spain). The north of Italy, on the other hand, displays the typical characters of the Coordinated Market Economy export-led growth model typical of the Euro-*North*, and the political discourse and electoral success of the League are consistent with the trajectory of exclusionary populist parties such as the French Front National, the Austrian FPÖ, or the Belgian Vlaams Belang.

Italy therefore displays within itself a miniature version of those economic and political tensions and polarizations that have been at work at a more macro level between the Euro-*North* and the Euro-*South*. This dualistic nature of Italian populism can be traced more explicitly to the underlying economic and social dualism that characterizes the country. Using province-level socio-economic data[189] from ISTAT, I constructed two aggregate indicators of what we could define respectively 'economic malaise' and 'insecurity'. These aggregate indicators are obtained as the first component from a Principal Component Analysis (PCA) run on the two groups of variables listed in **Table 2** below, where the scoring coefficients are reported[190]. PCA is a data simplification technique, based on the simple idea to 'condensate'

[189] The ideal would be to run this analysis on individual level or municipality-level data, but these are not available

[190] **Share poverty** refers to share of taxpayers declaring less than 10'000 euros on their personal income tax returns (based on IRPEF tax returns data, which is published at the municipality level by the Ministry of Economy and Finance). **Social services expenditure** is the total expenditure by municipalities on social services, divided by the resident population. **Risk of financing** is an indicator of the risk of credit. **Real hourly wage** is the median gross hourly wage for employed workers in 2016 (the latest available year), deflated using CPI. **Disability pensions** is the share of disability pensions on the total pensions. **Residence permits** is the number of residence permits issued to non-EU foreigners divided by total resident population. **Net entry (people)** is the net balance between people moving their residency from the province of interest to another province and people moving their residence from a different province to the province of interest, as % of the total in/out flows. **Crime** is the sum of thefts and homicides per 1000 inhabitants. **Net entry (firms)** is the net number of new firms registered in a province minus the number of

the information contained in a large number of variables of interest (representative of different characteristics of the phenomenon being analysed) into a smaller number of indicators that are easier to represent and read, in a very similar way to what our brain is used to doing when it comes in contact with large amounts of information. In practice, this is achieved through a mathematical transformation of the set of correlated variables into a smaller number of independent indicators – the principal components. The relationship between the components and the original variables is given by coefficients representing the weight of each original variable within each component. These coefficients 'emerge' from the data: they are effectively equivalent to correlation coefficients telling us what the association between each variable and each component is.

**Table 2 PCA Economic Malaise vs Insecurity**

| **Economic Malaise** | | **Sense of Insecurity** | |
|---|---|---|---|
| Youth unemployment rate | 0.43 | Residence permits (non-EU) | 0.50 |
| Total unemployment rate | 0.48 | Net entry (people) | 0.50 |
| Share poverty | 0.49 | Crime | 0.32 |
| Social services expenditure | -0.30 | Net firm growth | -0.39 |
| Real hourly wage | -0.30 | Occupation public sector | -0.49 |
| Disability pensions (% pensions) | 0.40 | | |

Source: author's calculation; see endnote 93 for a definition of the variables;
Numbers reported in the table are scoring coefficients

The scoring coefficients reported in table 2 suggest that the *economic malaise* indicator is coherently higher in areas that record higher total and youth unemployment rates, a higher incidence of poverty, and a higher share of disability pensions. The same indicator is negatively correlated with the median real gross hourly wage and with per capita expenditure

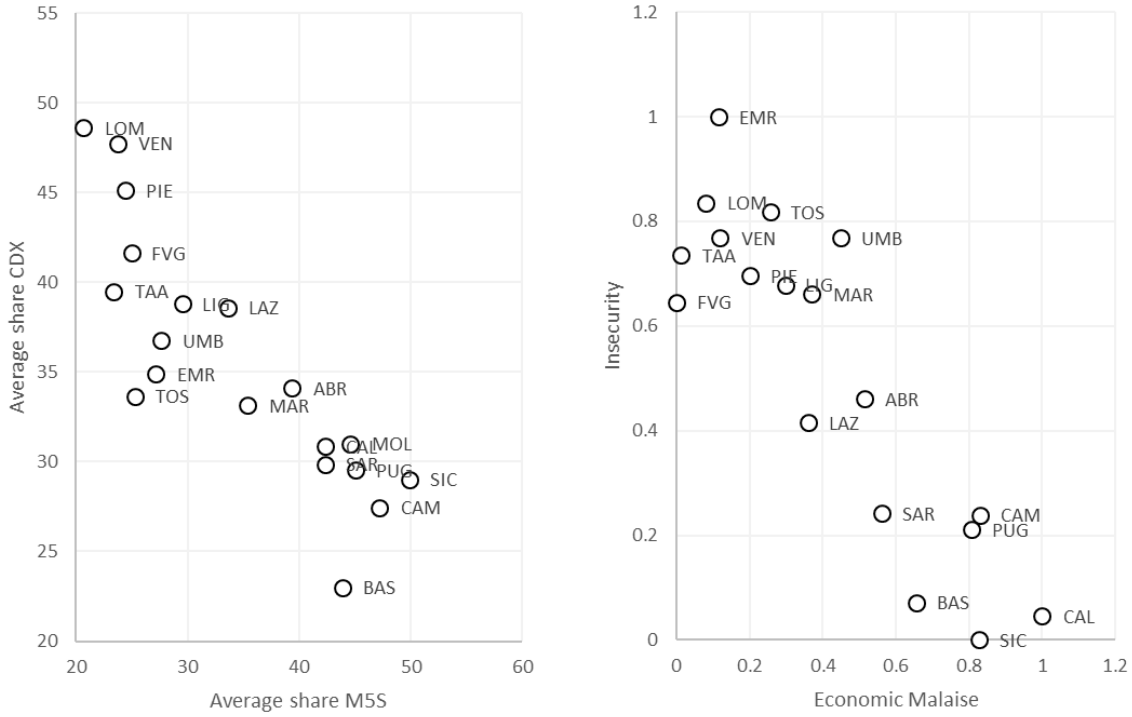
firms de-registered, as a share of total firms. **Occupation public sector** is the share of employment in the public sector out of total employment.

by local government on social services (targeted at family and children, persons with disability, addictions, elderly, immigrants, poverty and social exclusion, homeless). Overall, the provinces scoring higher on this economic malaise indicator are characterised by relatively worse economic conditions. The *insecurity* indicator, on the other hand, is correlated positively with higher reported crime rates, a higher number of residence permits released to non-EU nationals, and larger net entry of people registering as residents in the area of reference. At the same time, the same indicator is negatively correlated with the net entry of firm (defined as the difference between the number of firms initiating economic activity and the number of firms terminating it), and with the share of public sector employment out of total employment. All these indicators relate to a broad concept of insecurity, which goes beyond the immediate and crime-related fear for personal safety. The net entry of people registering as residents is a measure of the attractiveness of a certain area, suggesting it is a place that outsiders find appealing for the opportunities it may offer. But for the insiders, higher entry rates of new residents mean higher competition on the local jobs market, and hence potentially lower job security all other things equal. Areas with negative firm demographics are less dynamic economically, meaning that private sector jobs can be expected to be less secure. The opposite holds for areas where a higher share of employment is in the public sector – which typically offers permanent contracts with significant protection against dismissal. While the economic malaise measure speaks of a situation of outright economic disadvantage, the aggregate insecurity indicator speaks more of a *potential* malaise – i.e. it conveys a broad set of factors that are likely associated to people feeling "at risk" of experiencing a deterioration in their socio-economic status.

Using these two summary indicators, I mapped the position of different Italian regions on a quadrant having economic malaise and insecurity as the two dimensions. The right panel of Figure 26 below shows the existence of a very clear negative relationship between *economic malaise* and *insecurity,* as defined above[191]. The left panel shows that the relative positions on the malaise-insecurity scale map almost 1-to-1 into the different voting patterns observed across Italy in the 2018 political elections: regions where economic malaise prevailed relative to insecurity saw on average a more marked prevalence of the M5S, while regions where the insecurity factor prevailed saw a relatively stronger performance of the Centre-Right coalition (and the League in particular[192]). Unsurprisingly, this political and socio-economic fault line is aligned over a north-south geographical pattern: the economic malaise indicator (and hence the electoral preference for M5S) tended to be relatively more prevalent in the south of the country, while the opposite is true for the insecurity indicator. Looking more specifically at the vote for the League, the same strong correlation with insecurity that characterised the vote for the Centre-Right can be identified, suggesting it would be wrong to reduce the success of this party to a mere 'identity story'.

[191] The data in **Figure 26** have been aggregated at the regional level, for better readability.
[192] A similar scatterplot comparing M5S's share with League's share yields a similar picture.

**Figure 26 Insecurity, Economic Malaise, and voting share**




Source: own calculations based on data from ISTAT, the Italian Ministry of Interior.
Note: we drop Bolzano, due to its specificity (i.e. strength of the SVP party, which only runs in that province)

The League of Salvini made ample recourse to a discourse of nativist nationalism in order to distance itself from its regionalist origin[193], and the 2018 electoral campaign leveraged amply on anti-immigration sentiments. But a closer look at the data suggests that insistence on immigration and crime are not the whole story, when trying to explain the electoral success of the League. **Table 3** below reports the output of a simple regression analysis, assessing the correlation between the vote share of M5S and League at the province level and a number of local socio-economic indicator. This analysis should not be interpreted in a causal sense, as endogeneity factors are likely at play, but simply as an identification of relevant correlations. One thing that stands out is that, despite the party's strong anti-immigration rhetoric, the share of votes collected by the League at the provincial level appears to have no statistically

[193] See (Albertazzi , 2018)

significant correlation with the number of residence permits issued to non-EU citizens in a certain province. While this indicator by definition does not capture the incidence of illegal immigration, it is reasonable to assume that immigrants would tend to concentrate in areas where a larger migrant community already exists, in order to benefit from an established network. If this is indeed the case, the number of residence permits issued to non-EU foreigners can be taken as a proxy for the relative size of migrant communities in different areas, including migrants who do not have any legal residency status. At the same time, the incidence of crime appears to be negatively (not positively) correlated with the vote share of the League, suggesting the latter has been stronger in areas that were relatively safer, rather than in areas characterised by higher crime rates. The two variables that appear positively and strongly correlated with the vote share of the League are the incidence among the resident population of low-middle income levels[194] and (although weakly) the net entry of people registering as residents. Taken together, these correlations suggest that the League performed better in provinces with relatively lower crime and unemployment rates, but a relatively larger low-to-middle income community, exposed to relatively higher inflows of potential job market competitors. Hence, the key factor for understanding the electoral success of the League seems to be insecurity, but in an economic sense. The League vote is probably best understood in terms of what (Hall & Gidron, 2017) have called the "politics of social status", whereby the feelings of hostility to outgroups typically associated to the populist right vote are seen as stemming in large part from economic threats to the social status of voters. Interestingly – and consistently with this reading – the dynamic discussed

[194] The Ministry of Economy and Finance releases municipal-level data on IRPEF tax returns. We calculated the average income across all municipalities as the total municipality taxable income divided by the number of resident taxpayers. Across municipalities, average taxable IRPEF income is EUR 19'500. The MEF data only give us the frequency of tax declaration in the aggregate 15-26'000 range, so we use this as our lower-middle income group.

above seems to be exclusive of the vote for the League and not generalisable to the broader Centre-Right vote. This is consistent with the presence in the broader Centre-Right of Forza Italia – a centrist party of liberalist economic inspiration, traditionally representative of the northern Italian entrepreneurial capital, and hence of voters less likely to feel the kind of economic insecurity described above. The vote for the M5S, on the other hand, seems to be a and simpler straightforward story of outright economic anxiety, as evident from the positive and strong correlation of M5S vote share with local unemployment and poverty rates at the provincial level.

**Table 3 Regression Analysis**

| | Share M5S | Share Lega | Share CDX | Share M5S | Share Lega | Share CDX |
|---|---|---|---|---|---|---|
| | | | - | | - | |
| Crime | 0.187* | -0.388*** | 0.420*** | 0.107 | 0.285*** | -0.339** |
| | (0.072) | (0.076) | (0.097) | (0.075) | (0.078) | (0.101) |
| Unemployment rate | 0.528** | -0.420* | -0.275 | 0.564*** | -0.431* | -0.314 |
| | (0.164) | (0.174) | (0.221) | (0.159) | (0.166) | (0.215) |
| Poverty Incidence ( % <10k) | 0.505*** | -0.592*** | -0.512* | | | |
| | (0.146) | (0.155) | (0.197) | | | |
| Middle Class Incidence | | | | - | | |
| (% 15-26k) | | | | 0.703*** | 0.914*** | 0.708* |
| | | | | (0.204) | (0.212) | (0.275) |
| Net Entry of People | -0.087 | 0.115 | 0.040 | -0.124* | 0.149* | 0.078 |
| | (0.066) | (0.070) | (0.089) | (0.062) | (0.064) | (0.084) |
| Net Entry of Firms | 0.812 | 0.048 | 0.253 | 0.703 | 0.261 | 0.358 |
| | (0.571) | (0.604) | (0.770) | (0.581) | (0.604) | (0.784) |
| Residence permits (non-EU) | -0.444* | 0.265 | 0.129 | -0.439* | 0.237 | 0.126 |
| | (0.209) | (0.221) | (0.282) | (0.209) | (0.217) | (0.282) |
| Constant | 9.097 | 47.69*** | 63.20*** | 47.33*** | -0.267 | 24.64* |
| | (4.592) | (4.861) | (6.193) | (7.558) | (7.858) | (10.198) |
| R squared | 0.817 | 0.763 | 0.475 | 0.817 | 0.771 | 0.474 |
| N | 101 | 101 | 101 | 101 | 101 | 101 |

Note: significance * = 0.05, ** = 0.01, *** = 0.001

## 4.5 Challenged Solidarity

The data and empirical results presented in the previous section highlight the existence of different conceptions of solidarity within Italy at the regional level, coexisting despite Italy being a single economic and political community. As discussed above, the 2018 electoral platforms of League and M5S were rooted on diametrically different conceptions of the social contract that the economic dualism of Italy implies. The core premise in M5S's agenda was an increase in public spending to finance an expansion of the welfare state which, due to the uneven regional distribution of unemployment and poverty, would have benefitted mostly the south. The core of the League's agenda, on the other hand, was a cut in public revenues through a reform of the taxation system which, due to uneven distribution of economic activity and income across the country, would have benefitted mostly the north. Within the strict boundaries of the Italian fiscal space, a revenue-reducing reform of taxation is hardly compatible with an expenditure-increasing expansion of the welfare state. The voters who casted their ballot for either of the two parties were implicitly expressing a preference on how the broader framework for internal solidarity between the north and south of the country should be conceived: the south voted largely for a party that promised to strengthen inter-regional solidarity, the north voted largely for a party that promised to curtail it. In this division, and in other elements of the 'government contract' that was eventually signed by the two parties as the basis for their government coalition in 2018, there is a re-emergence of the ghost of regionalism. The contract included a pledge – out of the League's campaign platform – to enact a system of "regionalism at variable geometry". Requests for a strengthening of regional autonomy and for delegation of more competences "accompanied by the necessary resources" had been advanced before the election by the local governments

in three northern regions (Veneto, Lombardy and Emilia-Romagna), and supported by the League at the national level. While no longer an advocate of secession or a vocal proponent of fiscal federalism – like in the days of its existence as Northern League – Salvini's national League confirmed to be in favour of the disengagement of richer northern regions vis-à-vis their poorer southern neighbours. At their core, the tensions between the exclusionary populism of the League and the inclusionary populism of M5S revolve therefore around a different conception of the model of internal solidarity that is needed to ensure the smooth functioning of a common currency area in conditions of economic dualism. The electoral cleavage that dominated the 2018 election implies a clear politicization of balance of payments relations between the north and south of Italy, not dissimilar from the one discussed in Chapter 1 for the Eurozone: the electoral preferences of the south of Italy convey a request for greater risk sharing, while the preferences in the north convey a request for risk reduction. At the Italian national level, the deep conflict between the two electoral platforms of League and M5S was reconciled by doubling down on those electoral promises in a fiscal budget that was to be financed through ample recourse to fiscal deficits, in open defiance of the EU fiscal rules[195]. Their Euroscepticism therefore allowed the League and M5S to avoid addressing the profound incompatibility of their respective exclusionary and inclusionary political discourses for the internal cohesion of the Italian polity.

[195] See the full final text at:
https://www.repubblica.it/politica/2018/05/18/news/contratto_di_governo_ecco_il_testo_finale-196704873/

## 4.6 Italian Isolation

In the previous parts of this Chapter, I have discussed how the deep-rooted internal dualism that characterises the Italian economy produced in 2018 a peculiar patter of political contestation, in which inclusive and exclusive populist parties offering polar discourses on internal solidarity joined forces in a Eurosceptic government coalition. The socio-economic roots of this uniquely successful populist dualism - which are identifiable in a sense of economic malaise and a sense of insecurity – are not sentiments exclusive of the Italian electorate, but nowhere in Europe have those opposite political instances been as equally successful at the same time, as in Italy. To explore this idiosyncrasy more in depth, in this section I will map those tensions between economic malaise and insecurity that I have identified as key political drivers in the Italian case, onto a European dimension. Applying a similar methodology as in Section 4.4, I performed a factor analysis on a set of questions taken from the Eurobarometer survey, where respondents were asked to identify the 'most important issues' facing their country out of a range of choices that included many diverse economic and social factors[196]. Factor analysis allows to identify 'patterns', i.e. to see whether some of those concerns can be associated together in a meaningful way. The results of this exercise suggest that – similarly to what was previously identified in the Italian case – the concerns of Europeans in 2017-18 seemed to display characters of 'economic anxiety' on one hand, and 'insecurity' on the other[197]. Due to the different data available at the EU level and

[196] The exact wording is: "what do you think are the two most important issues facing (OUR COUNTRY) at the moment?". Both the wording and multiple choices offered have changed over time. The estimation is carried out using country aggregates out of the individual data.

[197] Loadings are estimated on the pooled years 2017-2018, because we want to understand what the important issues for people are *today*. Based on those loadings, we then predict factor scores over the full sample period (2012-2018, because 'government debt' was only included among the multiple choices in 2012). Loadings below 0.45 have been blanked to achieve a simpler representation. The issue "the Environment" has been excluded because it loaded on both factors. "Healthcare" and "Housing" have also been dropped, because they scored very low on the KMO

at the regional intra-Italy level, these two measures are defined in a slightly different way here and in section 4.1. In this case, two factors can be identified, which explain about 96% of the total variance among countries and issues (

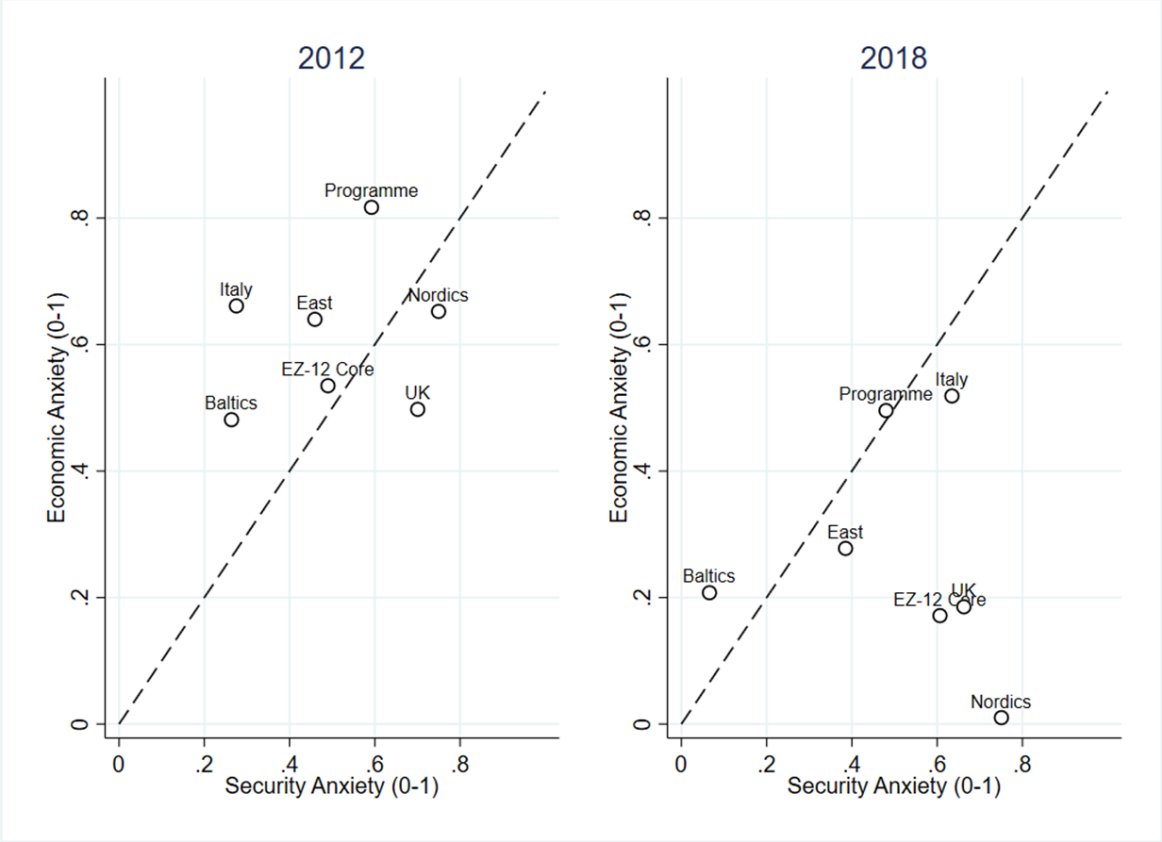
***Table 4*** below). Factor 1 – a measure of economic malaise – is dominated by three issues: the perceived economic situation, unemployment, and government debt. Factor 2 – a measure of insecurity – groups issues that are clearly associated with personal safety ('crime', 'terrorism'), as well as issues touching upon economic security through an effect on the stability of purchasing power ('rising prices/cost of living', 'taxation'). The signs of the loading coefficients indicate that countries scoring higher on the economic anxiety factor have a large proportion of respondents who identify unemployment, government debt or the economic situation among the most important issues facing their countries. Countries that score higher on the insecurity factor have a large proportion of respondents identifying crime, terrorism and immigration among the most important issues.

**Table 4 PCA – Economic Malaise and Insecurity**

| Variable | Economic Anxiety | Insecurity |
|---|---|---|
| Unemployment | 0.87 | |
| Economic Situation | 0.80 | |
| Government Debt | 0.64 | |
| Education | -0.59 | |
| Immigration | | 0.60 |
| Crime | | 0.52 |
| Terrorism | | 0.54 |
| Taxation | | -0.59 |
| Inflation/cost of living | | -0.73 |

adequacy measure. "Pensions" is included in the estimation, but the loading is below 0.45 on both factors so we do not report it in Table 1. With the variables used, the resulting 2 factors explain 96% of the variance, and KMO is at least 0.6 for each variable.

**Figure 27 Economic Anxiety vs. Insecurity – EU group level**




Source: Authors' calculations based on Eurobarometer data
See (Merler & Serra, 2019) for a methodological discussion

Figure 27 shows how various EU countries rank on a scale counterposing economic malaise and insecurity in 2012 and 2018 respectively. In 2012, following the GFC and at the height of the Eurozone crisis, a widespread sense of economic anxiety seemed to prevail across most country groups, highest among those Euro-*South* countries that were undergoing EU/IMF adjustment programmes. Italy ranked second in terms of its level of economic anxiety, in line with the countries of Eastern Europe and the Nordics. In 2018, economic anxiety had receded significantly across the board. It had almost completely disappeared among Nordic countries, and was very low across the Euro-*North*, the Baltics, Eastern Europe and even the UK. In the Euro-*South*, economic concerns remained relevant, but following the economic adjustment and the pick-up in growth discussed in Chapter 3, the score on the economic anxiety

dimension had dropped markedly compared to just 6 years earlier. In Italy, the feeling of economic anxiety had decreased only slightly compared to 2012, and in 2018 the country retained the highest economic anxiety score across all country groups. At the same time, Italy was in 2018 also the country where insecurity had increased the most over the same period. This simple exercise suggests that the two tensions underpinning the Italian populist vote combined also into an exceptionally pronounced mix of economic anxiety and insecurity that by 2018 had clearly set Italy apart from its Eurozone peers, including from countries that had gone through a much tougher economic adjustment just a few years earlier.

This extreme feelings of economic anxiety and insecurity at the national level also naturally have a bearing on how Italians perceived the country's position in Europe. In principle, the EU could be seen as an *opportunity* to resolve the problems at the root of those feelings of economic anxiety and insecurity. Alternatively, the EU could be perceived as a *threat* preventing the solution of, or even causing those problems. To investigate this angle of the issue, I used a subset of Eurobarometer questions where respondents are asked to state what the EU *means* to them personally. The possible answers include positive concepts such as 'peace' or 'economic prosperity', as well as negative ones such as 'unemployment' or 'more crime'. I selected ten concepts that are broadly aligned with dichotomy of economic anxiety and insecurity identified above, and I performed again a simple factor analysis to see if any pattern could be identified in what the EU 'meant to people' over the past 15 years[198]. The output of this statistical exercise is once again a two-dimensional space defined by two factors (**Table 5**). The first factor groups the positive concepts that speak of the EU as an opportunity,

[198] We exclude those choices that do not speak directly of either economic or security anxiety (i.e. 'bureaucracy', 'waste of money') or ambiguous terms ('the euro').'

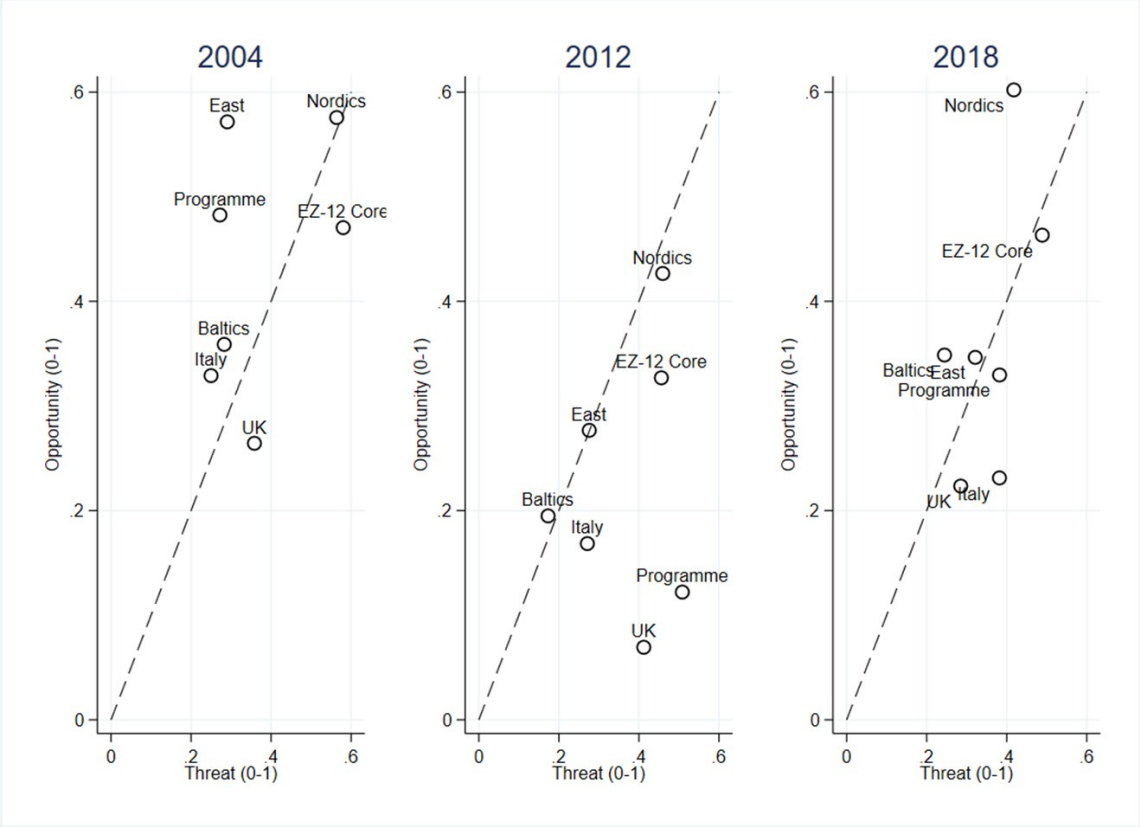
either in economic or in security terms: countries that score high on this factor tend to have a higher share of respondents to whom the EU means 'economic prosperity', 'social protection', 'peace', or 'democracy'. The second dimension is instead dominated by concepts that speak of the EU in terms of a threat, either in economic or security terms: countries scoring higher on this factor have a higher share of respondents to whom the EU means 'unemployment', 'loss of cultural diversity', 'more crime' or 'not enough frontier control'. Based on this factor decomposition, countries can be ranked on a perceived opportunity-threat scale that synthetizes the role of these two factors in their aggregate view of the EU (Figure 28).

**Table 5 - PCA opportunity vs. threat**

| | **Factor 1** | **Factor 2** |
|---|---|---|
| Peace | 0.7559 | |
| Economic Prosperity | 0.6278 | |
| Democracy | 0.8382 | |
| Social Protection | 0.6004 | |
| Travel/study abroad | 0.5535 | |
| Stronger in the world | 0.5755 | |
| Unemployment | | 0.6951 |
| Loss of cultural identity | | 0.6231 |
| More crime | | 0.7993 |
| Not enough frontier control | | 0.7802 |

Source: Authors' calculations based on Eurobarometer data
Note: 2004-2018; 88% of the variance explained

**Figure 28 What does the EU mean to Europeans?**

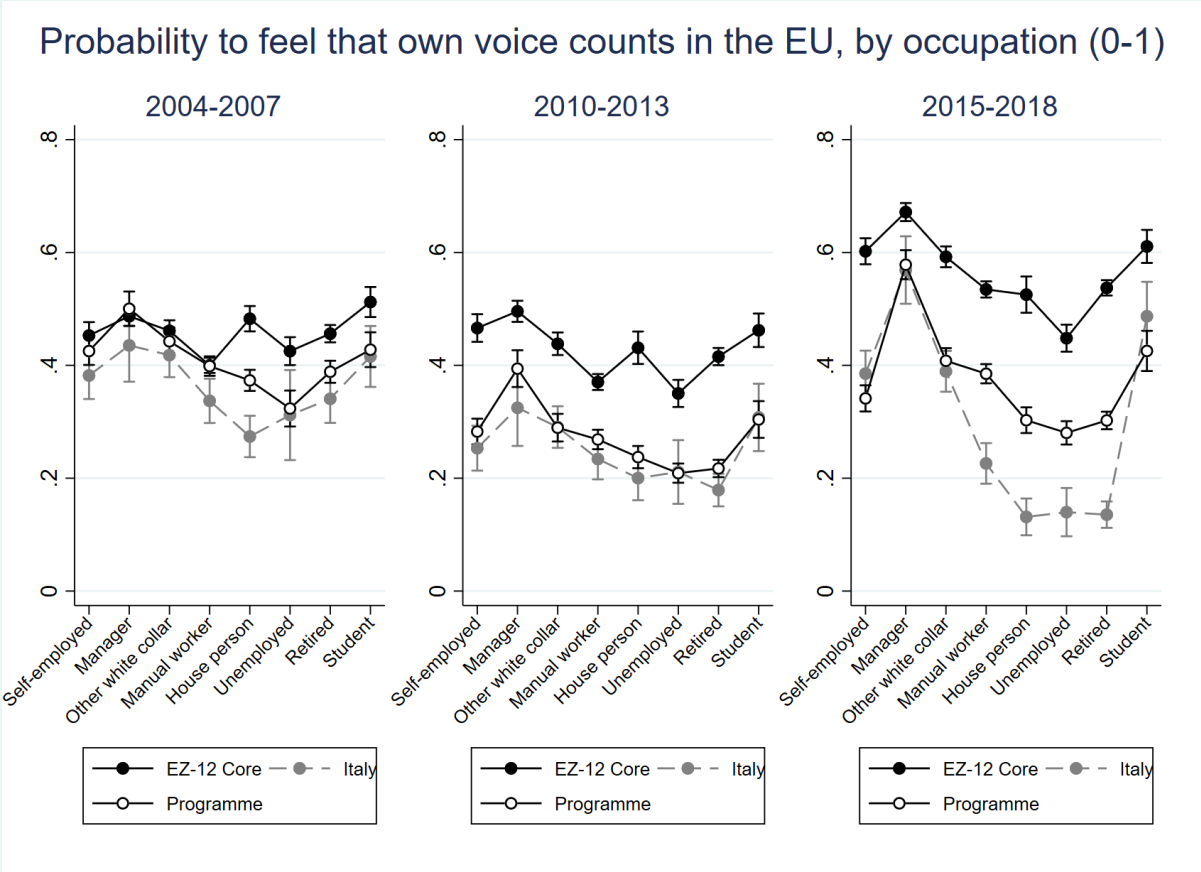



Source: Authors' calculations based on Eurobarometer data
See (Merler & Serra, 2019) for a methodological discussion

Back in 2004, at the time of the accession of eastern EU New Member States, Figure 34 shows that Europeans saw the EU mostly as an opportunity, with the UK and the Euro-*North* holding a marginally sceptical view. In 2012 (Merler & Serra, 2019), at the height of the Eurozone crisis, the EU was seen predominantly as a threat, with the Euro-*South* having become the most sceptic. In 2018, most countries were back to a neutral view of the EU – except for Italy and the UK, markedly more sceptic. When asked more specifically to evaluate whether their country "would cope better with the future outside the EU", only 30% of Europeans agreed with this statement on the eve of the 2019 European elections. In Italy, the share of those favouring EU exit was 43%, very close to the 44% recorded in the United Kingdom, which had voted to exit from the EU just 2 years earlier. Even in Greece, a country that in 2018 was

emerging from almost a decade of continued and painful economic adjustment and that in 2015 had held a referendum widely interpreted as a verdict on the country's permanence in the single currency, the share of citizens favouring EU-exit was lower than in Italy (35%).

**Figure 29 Does your voice count in the EU?**




Source: Author's calculations based on Eurobarometer data.
See (Merler & Serra, 2019) for a methodological discussion.

This data suggests that on the eve of the pandemic, the position of Italy in Europe was one of extreme isolation, rooted into a perception of the EU as a 'threat'. This perception in turn was mirrored into an exceptionally strong feeling of dis-enfranchisement vis-à-vis the EU. Eurosceptic narratives share a promise to 'bring back' control on a variety of matters on which the EU is perceived as an illegitimate decision-maker. This is partly an effect of the Eurozone crisis management choices. The Brussels-Frankfurt consensus of forced adjustment

challenged one of the fundamental premises on which EU integrations rests – the ability of the EU to create economic prosperity for all its 'citizens' – while at the same time raising the question of whether that forced macroeconomic adjustment could be reconciled with democratic representation. The lack of '*input participation* from the people'[199] became especially evident as technocratic governments took office in several of the hardest-hit countries, becoming in the eyes of many the proof that national representative democracy was being weakened for the sake of preserving economic integration[200]. In this context, the feeling of lacking a voice vis-à-vis the EU became widespread, and this phenomenon appears to be especially pronounced in Italy. Using a simple econometric model on Eurobarometer data, I estimated the probability of respondents feeling that their voice 'counts in the EU', based on their individual demographic and socio-economic background. One of the most interesting findings from this exercise concerns the variation of this estimated probability across occupational categories (Figure 29). Before the crisis, the probability to feel 'heard' was low but independent on the occupation of the respondents, both in Italy and elsewhere. During the Eurozone crisis, respondents in Italy and the Euro-*South* started feeling systematically more 'disenfranchised' compared to their peers in the Euro-*North*, and this was still valid across all occupational categories. Moving forward to the 2015-2018 period, however, things had changed and the feeling of disenfranchisement had started to display a clear occupational pattern. In particular, by 2018 the probability of expressing this feeling was significantly higher among respondents employed in low-skilled jobs (e.g. manual workers) or out of the labour market (either unemployed or retired), than among respondents employed in high-skilled professions (e.g. self-employed, managers, other white collars) and among

[199] See (Schmidt 2011, 2013).
[200] See (Blyth 2015; Matthijs 2017; Merler 2018)

students. This cleavage is consistent with the evidence of low-skilled workers and economic outsiders being among the most hardly affected by the Eurozone crisis, and it also resonates with the documented link between economic and industrial decline and anti-EU vote patterns at the regional level[201]. The data also suggests that by 2018 a large segment of the Italian population felt left behind – much more so in Italy than even in countries undergoing an harder economic adjustment. While many decided to "vote with their feet" – as discussed in Chapter 3 – populism and Euroscepticism found a fertile breeding ground among those who could not afford to leave and remained stuck in a socio-economic environment that was becoming progressively poorer and more unequal. On the eve of the most severe macroeconomic shock in post-war history – the COVID-19 pandemic – the economic, social and political idiosyncrasies discussed in the previous Chapters of this work had combined to place Italy in an isolated position of exceptional Euroscepticism. The connection between this Italian 'isolationism' and the puzzle of European solidarity that emerged from the COVID-19 crisis is very strong, and it will be investigated in depth in the next chapter.

[201] See (Dijkstra et al. 2018)

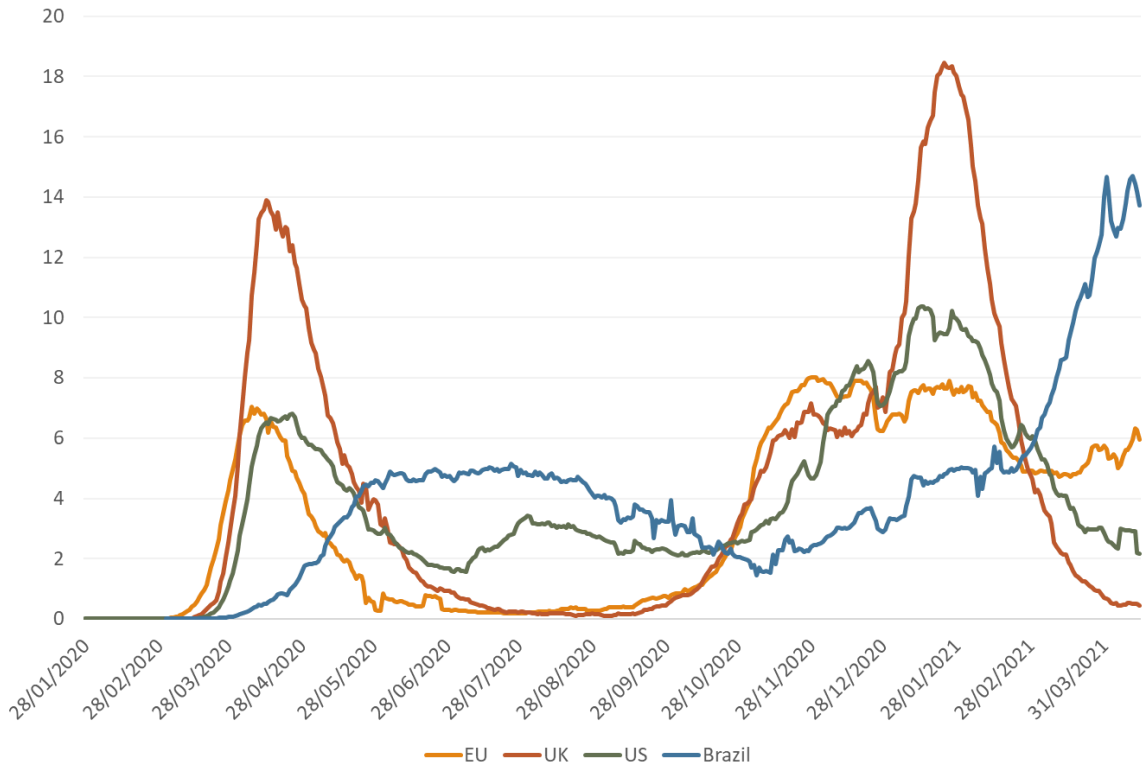
# 5. The Plague.

## 5.1 The Enemy

On 31st December 2019, the WHO China Country Office was informed about a cluster of cases of pneumonia from an unknown origin, detected in the city of Wuhan in the Hubei province. Eleven days later, China reported its first death from the unknown disease – which would officially be named COVID-19 by the WHO on February 11th. COVID-19 infections were caused by a novel strain of severe acute respiratory syndrome coronavirus (SARS-CoV2). On January 23rd, the city of Wuhan – epicentre of the epidemic outbreak in China – was placed under a tight lockdown, which would be soon extended to the entire province of Hubei. One week later, on January 30th, the WHO declared the outbreak a Public Health Emergency of International Concern. On February 9th, the death toll in China officially surpassed that of the 2002-2003 SARS epidemic. In terms of confirmed reported total cases and deaths from SARS-CoV2, however, China would soon be surpassed by European countries and the United States of America. February 21st marked the beginning of the Italian domestic outbreak, with the first identified case of local transmission in Codogno, a city in the Italian northern region of Lombardy. One week later, COVID-19 infections would start accelerating considerably across the EU, most notably in Spain. On March 13th, the United States – after banning all travel from 26 European countries – declared a national emergency over the increasingly worrying domestic outbreak, which was especially severe in the state of New York. Measures to slow

down the speed of contagion started to be introduced widely across most affected countries, and about half of humanity was estimated to be under some form of virus-related lockdowns as of early April, when the world surpassed 1 million of COVID-19 infections. By early May, the figure would triple to 3.3 million and the world would suffer 234,000 deaths – while not having certainties as to the timing and the feasibility of normalisation. One year later, 138 million people had been infected globally, and over 3 million had died (Figure 30).

**Figure 30 COVID-19 daily deaths per million people**




Source: author's calculations based on Our World in Data COVID database

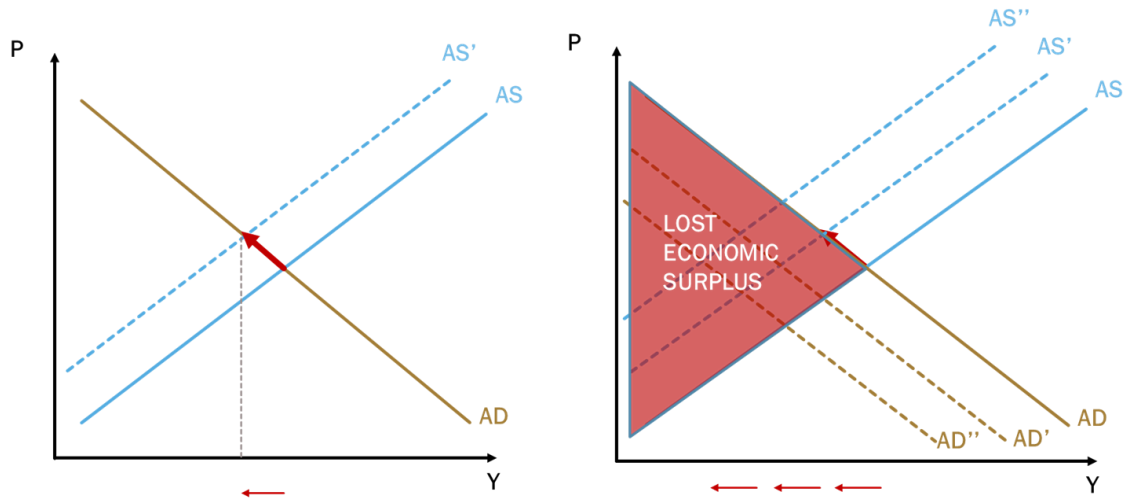
## 5.2 Pandemic Macroeconomics

Beyond the immediate and obvious health costs, a pandemic also has important macroeconomic effects through a self-reinforcing combination of supply and demand shocks

(Figure 31). The outbreak of the disease squeezes the labour supply – as some workers fall ill or even die. This negative effect is reinforced by the measures of containment, such as quarantine and social distancing, which decrease the number of hours worked globally, by preventing part of the workforce to be present on the workplaces and b preventing some economic activities to take place altogether. Measures such as such as school closures – commonly enacted across countries during the COVID-19 outbreak – may significantly reduce working hours and/or labour productivity, as workers must combine their regular work with the need to take care of children during working hours. The disruption to labour supply may result in the temporary shut-down of productive activity in some sectors, beyond those mandated by health authorities. The pandemic supply shock is different from the textbook 'classic' supply crises: in the case of wars or natural disasters, the origin of the supply shock is in the obliteration of physical infrastructure or in a large-scale permanent loss in labour, and the need to rebuild typically results in a natural increase in fixed investment. The supply-side shock triggers a subsequent negative demand shock, via the effect on income and consumption. Quarantines lead to an immediate drop in social consumption (shopping malls, restaurants and bars, entertainment venues, sport and other events et c.). Uncertainty about the evolution of the disease, the length of the shock and the government response feed into a vicious circle that induces households to consume less and increase precautionary savings. As some workers lose their job – initially in the hardest hit industries and/or across the positions with weakest contractual protection – higher unemployment or reduced working hours may lower disposable income and further depress consumption (unless counteracted by effective unemployment insurance benefits). In this context, policies of aggregate demand management run the risk of being ineffective at re-activating consumption, not only because supply is disrupted but also because panic-like behavioural effects may become very relevant.

Faced with lower demand and/or continued limitations to production, companies will soon face liquidity crises and the risk of bankruptcies would increase. Absent swift government action to prevent large scale bankruptcies, unemployment would increase further (even in sectors not directly affected by the mandated restrictions) and trigger second round negative demand and income effects. The likely increase in non-performing loans (NPLs) on the banks' balance sheets would push banks to cut back further on credit to the real economy, thus amplifying the downturn and threatening financial stability. As negative demand and supply shock amplify each other into a race to the bottom, the amount of economic surplus that can get destroyed is massive (Figure 30). Part of the pandemic-induced income loss may drag on in the long term or even become permanent, due to potentially long-lingering psychological effects that may change people's attitudes towards travel, tourism, or social consumption. Psychological effects may also negatively affect trade for a long time: the IMF for example estimated that a ban imposed by the EU on exports of British beef lasted for 10 years following identification of the mad cow disease outbreak in the UK, despite relatively low transmission to humans. The economic repercussions of what was soon dubbed "The Great Lockdown" promised to dwarf those of any recently seen economic calamity. As of April 2020, the IMF expected the world to experience a recession 30 times worse than during the Global Financial Crisis (GFC). Real GDP growth at the global level was expected to be -3% by year-end, compared to -0.1% in 2009. Overall, the cumulative loss to global GDP over 2020 and 2021 from the pandemic crisis was estimated to be around 9 trillion dollars. The Eurozone would be the most affected among advanced economies – with a projected real GDP growth of -7.5% in 2020. Within the Eurozone, Italy was expected to be among the hardest hit.

Figure 31 – The initial pandemic shock (left) and the race to the bottom (right)




Source: author's representation

## 5.2 COVID-19 and the Italian economy

The first case of COVID-19 domestic transmission was reported in Italy on February 21st, 2020. Immediately, the Italian government started to impose restrictions on movement and economic activity aimed at slowing the spread of the virus. The Italian COVID-19 lockdown in 2020 (the period relevant to the discussion of the puzzle of European solidarity) can be divided into three phases, with different implications for the effect of the pandemics on the Italian economy. During the months of January and February 2020, domestic activity remained broadly unaffected except in some sectors that discounted the indirect global value chain effect of the supply shock induced by the initial outbreak in China. A second phase, encompassing the first 3 weeks of March, featured progressively tighter lockdown measures imposed by the government, limited in terms of the range of sectors affected but nonetheless meaningful in terms of their GDP impact. Finally, on March 25th all productive activity was halted in sectors deemed 'non-essential', and Italy entered a hard lockdown regime that

would last until early May and inflict a much more sizable blow to economic activity. According to ISTAT data, Italian GDP contracted by 5.3% in the first quarter of 2020 compared to the previous quarter, with value added declining across all sectors – although with the largest effect being recorded in the industry (-8.6%) and in the commerce and hospitality sector (-9.3%). Throughout the spring of 2020, the end-year forecasts by international bodies such as the IMF, the OECD and the European Commission all displayed equally large margins of uncertainty.

In the first phase of 'mild lockdown', hotels and restaurant services were certainly among the business segments the most. In Italy, the hospitality sector was already under pressure since late 2019. The region of Veneto – which accounts alone for 10% of the Italian hospitality sector – faced a hit in late November 2019 when the touristic hotspot of Venice experienced the most severe high-tide episode in 50 years. As a consequence, hotel bookings for the first months of 2020 were already down 45% pre-COVID (including for the month of February, when the Venice Carnival takes place and usually attracts a large number of visitors). Following the identification of the first case of COVID-19 local community transmission in Italy, things deteriorated fast. Hotels started reporting cancellation rates in the order of 70% during the 1st and 2nd week of March, and the restaurant business (which accounts for 76% of the hospitality sector) also started showing signs of strain. Just in the first two weeks of March, 57% of respondents in a survey conducted by FIPE (*Federazione Italiana Piccoli Esercizi*) estimated they had already incurred a loss of more than 30% of revenues due to COVID-19, and 31% of respondent reported a revenue loss in between 10% and 30%. Even before restaurants and bars were ordered closed on March 12th, Google real-time mobility data suggest that business was down 20% to 30% in the broader commerce and recreation

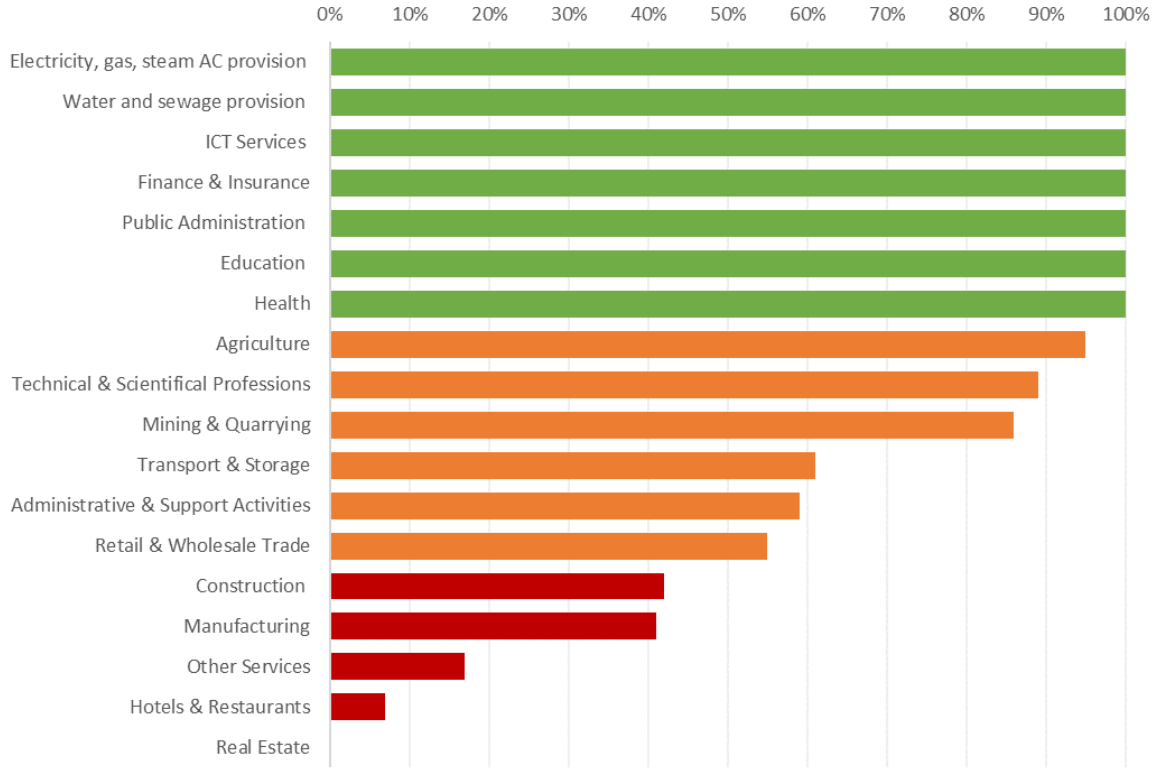
segment of the economy during the first week of March 2020, and 80% thereafter. Retail trade underwent mixed developments: while the food segment (worth 42% of retail trade) saw an initial increase in business – which the Italian sector association (*Federdistribuzione*) estimated in the order of +60/70% – the non-food segment saw a slowdown in business turnover. Wholesale trade, which mostly operates in connection to the hospitality business, likely discounted the effect of the COVID hit on hotels and restaurants. Transport and storage were exposed to the COVID shock both through their connection with the retail and wholesale trade sector, and through the links with the tourism industry. Air passenger transport recorded a drop of between 30% and 50%[202] in the first weeks of March, and most companies completely halted flights to and from Italy thereafter. Real-time data on railway traffic suggested a 55-60% decline in rail travel throughout March and April 2020. Real time data on road traffic suggested that congestion levels in major Italian cities were also down between 40% and 80% in March 2020 compared to the average over the same period of 2019. The manufacturing sector, a very diversified one, experienced a differentiated impact from COVID-19 restrictions. While the pharmaceutical and food segments (which together account for about 15% of the Gross Value Added produced in the entire manufacturing sector) were operating at full capacity, the activity level for the remaining sub-sectors can be estimated to have slowed by 13% in the second week of March, and close to 30% in the subsequent two weeks. Following the shutdown of all non-essential productive activities on March 25th, the reduction in economic activity stabilised around 30% of 2019 level. Some services sectors – such as the entertainment sector or the activities having to do with personal care – were hit very hard early on, while professional, scientific and technical activities (such as those

[202] Estimated in (Focella & Merler, 2020)

performed by lawyers, accountants, engineers, architects, R&D activities as well as marketing and advertisement) could operate normally.

Starting on March 25th, all non-essential productive activities were ordered to shut down. Compared to the previous phase of 'mild' lockdown – when restrictions were imposed spottily on few activities only – this legal certainty gives us a much more cleanly defined perimeter of what economic activity could operate and what the economic impact of restrictions has been. The Italian Statistical Institutes (ISTAT) produced for each economic sector an estimate of the share of revenues accounted for by the firms operating in activities that were classified as 'essential' and therefore allowed to carry on working. This estimate gives us an idea of what the potential economic activity level was, under the hard lock down regime introduced on March 25th (Figure 32). The impact of the containment measure that the authorities phased in to try and slow the transmission of the virus was massive: compared to normal times, the lockdown imposed in Italy between end of March and May 2020 implied a loss in potential economic activity close to 40%.

**Figure 32 Share of revenues produced by essential activities, in each sector**



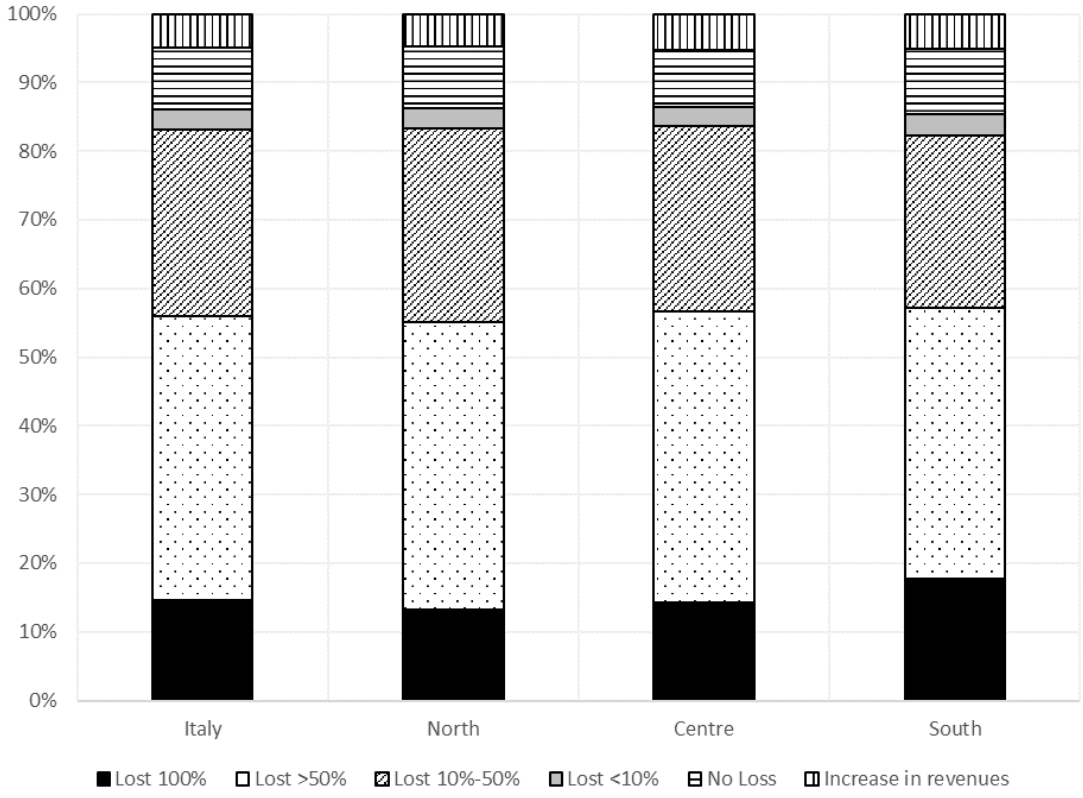

Source: (ISTAT, 2020); (Focella & Merler, 2020)

These estimates do not cater for the fact that at least part of the activity in non-essential sectors could be carried out remotely through various forms of remote-working – which was encouraged. Before the COVID-19 crisis, the recourse to forms of tele-working or remote-working was very limited, in Italy. Data collected by ISTAT in its 2020 Annual Report show that during 2019 only 0.8% of Italian workers (184 thousand people) used their home as their main place of work and altogether less than 6% of workers were ready to work from remote – mostly comprised of high-skilled and employed in research and scientific professions. In an *ad hoc* statistical survey conducted in 2020, ISTAT[203] however found that 21.3% of the

[203] See (ISTAT, 2020). The sample includes 1.02 million firms accounting for almost 13 million workers.

observed sample of firms had introduced or extended the practice of remote-working as a way to organise their productive activity during the COVID-19 crisis. The ability to resort to this tool however appears directly correlated to firm size: while only 16% of micro-firms (i.e. with 3 to 9 employees) were able to implement some form of remote working, the share increases to 89.5% among firms with 250 employees. Across all firms participating to the ISTAT survey, the share of personnel working from remote increased from 1.2% in January and February 2020 to 8.8% in March and April, decreasing to 5.3% thereafter. Firms with more than 250 employees had as much as 31% of their workforce operative from remote at the height of the COVID-19 crisis. When considering all these factors, (ISTAT, 2020) finds that less than a third of Italian firms continued to remain active (without interruption or suspension of activity) during the initial phase of the health emergency, but this group accounted for almost 63% of employment and 69% of revenues. This evidence aligned with the estimate of potential activity shown in Figure 32, pointing to a very sizeable decline in activity of around 30-40%. The impact on firms' revenues has been dramatic. Over 70% of firms (accounting for about 74% of employment) reported lost revenues in March and April 2020: 41% reported a loss in business of over 50%, whereas for 15% of firms (mostly active in the hardest-hit sectors of entertainment, travel and hospitality) revenues were completely wiped out in those two months (Figure 33). About 5% of firms however saw some increase in revenues, but they are mostly active in chemical and pharmaceutical sectors as well as in activities related to telecommunications. Again, large firms (with 250 employees or more) weathered the crisis better – with only 27% of them reporting a revenue loss of more than 50%, against 58% of micro-firms experiencing a similar fate.

**Figure 33 Firms by share of revenues lost in March-April 2020**




Source: own calculation based on (ISTAT, 2020)

## 5.3 The Great Equalizer?

While the lockdown started to be lifted in early May 2020, only 15% of firms observed by (ISTAT, 2020) stated that after the initial ordered suspension of activity they had been able to resume production before the re-opening date of May 4th, either through the request for an *ad hoc* derogation or thanks to subsequent intervening changes to the legislated lockdown restrictions. The largest share of respondents (38% of firms) stated that they had to stop production and were not able or allowed to resume it before May 4th. The end-2020 IMF projections – taking into account a second wave of COVID-19 infection triggered by the spread of a more contagious variant in the fall of 2020 – put the drop in Italian GDP close to 9%, one

of the worst performances across the Eurozone and globally. It is still early to evaluate the full extent of the pandemic shock on the Italian internal economic divide – but it is already evident that the shock, rather than triggering more regional cohesion, has deepened pre-existing rivalries. The size of the immediate GDP shock is estimated to be similar across the north and south of the country. Data presented in (SVIMEZ, 2020) suggest that the drop in value added attributable to the 2020 lockdown will be slightly larger in the north of Italy (where restrictions on productive activity affected 39% of value added) compared to the south (where the equivalent figure was 33.5%). The higher reliance of the southern Italian economy on tourism and hospitality potentially exposed the region to a subdued touristic in 2020 and 2021, but the receding of the virus during the summer season seems to have at least partly mitigated that risk. Moreover, the industrial landscape in southern Italy is more fragile than in the north and hence faces a higher risk of seeing a surge in bankruptcies. Medium-large firms are similar across regions in terms of their level of indebtedness, but not in terms of profitability. For medium-large firms in the north of Italy the Return on Investment (ROI) on average is more than enough to cover the cost of borrowing, whereas the opposite is true for medium-large firms in the south, which have a four-time higher probability to default compared to similar firms in the north[204]. It was probably with this risk in mind, that the government contemplated during the summer of 2020 the introduction of significant incentives and tax breaks for firms hiring workers in the south of the country – a choice that did not fail to trigger discontent among governors of the northern regions. At the same time, some southern local government officials were treating northern Italians as plague spreaders. The governor of Campania, Vincenzo De Luca, earned himself the nickname of 'sheriffs' for

[204] See (SVIMEZ, 2020)

threatening to close the region's borders to citizens coming from northern regions, while the governors of Sicily and Sardinia suggested that tourists from Lombardy should be required to produce an 'immunity passport' upon entry on the islands.

These tensions will likely be heightened by the effect of the pandemic shock on the labour market, which is of unprecedented magnitude. At the OECD level, the early impact of the COVID-19 crisis on labour markets has been ten times larger than that observed in the first months of the 2008 global financial crisis: taking into account both the drop in employment and the reduction in hours worked among those who remained employed, total hours worked fell by 12.2% in the initial three months compared to 1.2% in 2008 (OECD, 2020). The real magnitude of the labour market shock in Italy is still unclear at the time of writing, partly due to the unreliable signals coming from statistical collection during the pandemics and partly because of the statutory ban on firing that has been in place for 2020 and so far into 2021. Official data paradoxically showed a decline in the Italian total unemployment rate for the months of March and April 2020, and the figure for April (6.3%) was the lowest recorded unemployment rate in over a decade. This is best described as an optical illusion, due to the underlying statistical definition of unemployment and to several problems affecting the collection of statistics during the pandemic[205] (OECD, 2020). Based on the harmonised EU definition of unemployment, a worker is classified as 'unemployed' if (i) he/she has undertaken at least one job search during the reference observation period and (ii) he/she is available to start working within two weeks. The lockdown restrictions have made it very difficult – if not impossible – for job seekers to meet these two requirements, partly due to

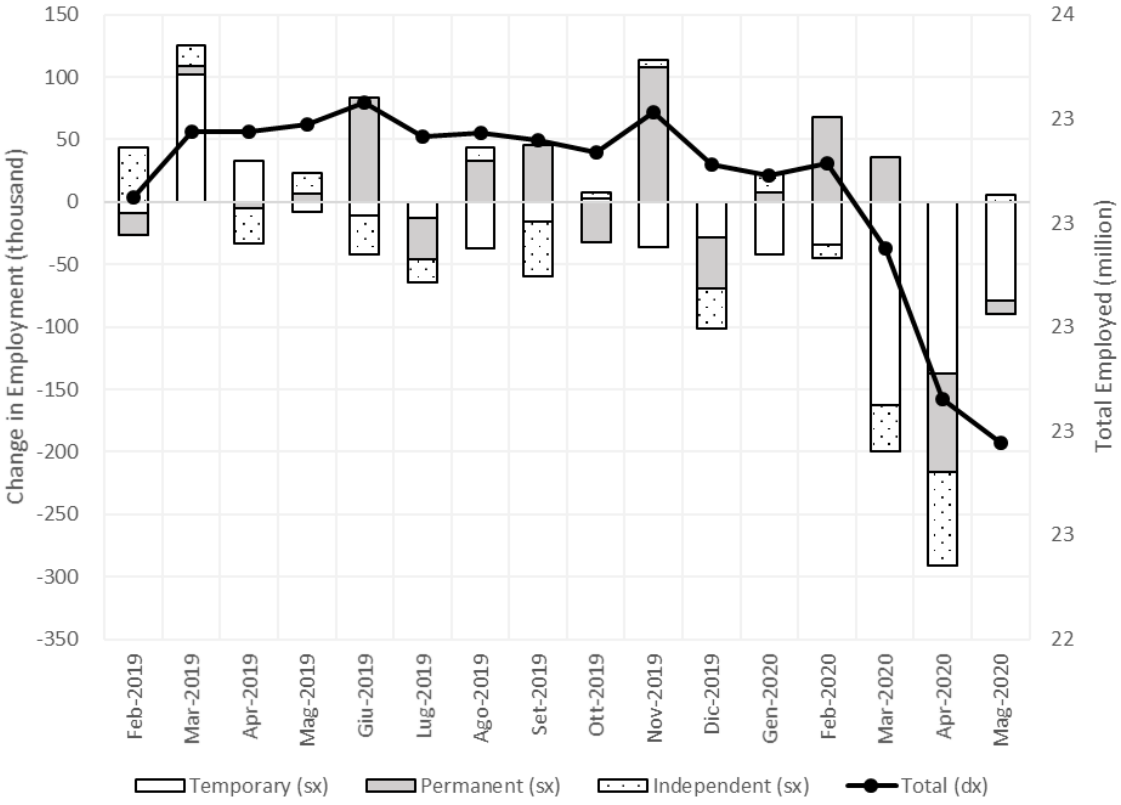
[205] See (OECD, 2020)

the limitations on movement, partly due to job search centres not operating normally, and partly due to general psychological effects that may have discouraged the unemployed from engaging in job search in the midst of a health emergency. Accordingly, the decline in unemployment is mirrored by a spike in inactivity (+746 thousand inactive workers in March and April 2020, or +5.4%). At the same time, however, (ISTAT, 2020) reports a marked decrease in total employment by 124 thousand individuals (-0.5%) in March 2020 and 274 thousand (-1.2%) in April, making this the largest reduction in total employment levels since 2004. This occurred despite the government enforcing a regulatory ban on firing, which would remain in place well into 2021, and despite the unprecedented extension in the scope of the Italian Redundancy Fund scheme (*Cassa Integrazione*) to firms that would typically not have access to it. Among the firms observed by (ISTAT, 2020), 63% report to have made use of the Redundancy Fund during the emergency – and the incidence is homogeneous for firms of different size. Because of these measures, a recognition of the real extent of the labour market crisis may be delayed. (Garnero, 2020) for example, shows that during the month of April 2020, about one third of employed workers was absent from their workplaces, resulting into a decline in total hours worked by 28% compared to April 2019. Another signal of the level of stress on the labour market comes from the job contracts that failed to be initiated: while the legislated ban on firings helped halt the exit of employed workers from the labour market, the entry dynamics froze. An analysis of cumulated daily data on hiring – reported in (ISTAT, 2020) – yields an estimate of 'missing' hiring over the first quarter of 2020 in the order of 239 thousand jobs, of which 44 thousand would have been permanent contracts and 195 thousand temporary contracts. The initial job market effects of the COVID-19 shock have so far been felt overwhelmingly by temporary workers, independent workers and self-employed (**Error! Reference source not found.**). Workers in non-standard forms of employment are s

ignificantly less well covered by social-protection schemes and often less likely to receive any form of income support during an out-of-work spell compared to workers in standard employment positions.

When the statutory ban on firings will be rescinded, the consequences of the COVID-19 shock will become more clearly visible across the labour market. Among the firms recently surveyed by ISTAT, 12% stated that they either had, or were, considering a "substantial reduction in the number of employees" as a strategy to face the COVID-19 crisis. This figure could well end up being higher, if the negative expectations expressed by 38% of these firms about the sustainability of their business activity were to materialise. While about a third of firms interviewed by ISTAT in 2020 expected a decline in domestic demand for their product, the most concerning indicator was certainly the fact that 51% of them identified a risk that liquidity might not be sufficient to meet expenses by year-end – a preoccupation unsurprisingly more widespread across smaller firms. As a result, 43% of firms reported to have requested access to the liquidity measures introduced by the State to face the emergency, but for a majority of respondents (57%) the outcome of such request was still unknown at the time the survey was run, adding yet one more layer of uncertainty about the future level of economic activity. This uncertainty also appears to be paralysing the corporate sector and preventing long-term strategic thinking: a survey run in 2020 by the Italian association of industrialists (*Confindustria*) found that a vast majority of respondents (78%), when asked what strategy they were envisioning to overcome the COVID-19 crisis, answered they were "waiting for the return of normality".

**Figure 34 Employment Dynamics in Italy, Monthly**




Source: own calculations based on ISTAT data

All these factors combine into an increased likelihood of firms' bankruptcy rate, which was estimated potentially at 6.8% from 4.9% in a scenario without COVID[206]. Unsurprisingly, the emergency has spurred a widespread sense of insecurity among workers too: data collected in (ISTAT, 2020) show that in April, 10.2% of employed workers (about 2.3 million people) was afraid to lose their job within 6 months (compared to just 6.7% expressing this feeling a year earlier). The social impact of these labour market dynamics will be very uneven. COVID-19 is a global exogenous shock, but it is far from being a 'great equalizer', as the economic fallout

[206] See (Confindustria, 2020)

is likely to exacerbate already existing cleavages around inequality of income and opportunity. Already disadvantaged groups of workers tend to be the first out of work when a shock hits and last in when the recovery starts, thus suffering most from economic crises. Evidence exists already that low-paid and low-skilled workers have been affected more severely during the initial phase of this crisis. Cashiers, production and food processing workers, janitors and maintenance workers, agricultural workers, and truck drivers all continued working throughout the pandemic to provide their essential services, at a substantial risk of exposing themselves to the virus. Countries in what we have called the Euro-*South* have a relatively larger share of employment concentrated in sectors that are more at risk from this kind of shock, reflecting in part the relatively larger importance of tourism and the hospitality sector in their economies. Workers in those jobs are on average also less educated than the overall workforce and more likely to be low earners (OECD, 2020). Real-time survey data suggest that workers in the top earnings quartile were on average 50% more likely to work from home than those in the bottom quartile and low-earning workers appear to be have stopped working twice as often (OECD, 2020). Looking more specifically at the situation in Italy, the Italian Institute for Public Policy Analysis (INAPP) constructed an index that measures the easiness to work remotely across various professions in the different sectors of the economy, which can be used to rank economic activities according to the easiness of performing them in a way that minimizes in-person contacts. At the top of this ranking, services jobs such as scientific and technical professions, finance and insurance and real estate activities. At the bottom, hospitality, retail and wholesale trade, construction, healthcare, and other personal services. The distribution of Italian value added across sectors with different feasibility of remote working is quite homogeneous, but the distribution of employment is much more uneven (Figure 36, left). About 45% of employment is

concentrated in sectors falling in the bottom third of the INAPP ranking – i.e. sectors where transitioning to remote working would be very difficult if not impossible. These sectors – which include hospitality, construction, and a wide range of personal services – also tend to pay lower hourly wages on average. At the opposite end of the spectrum, the sectors in which working from remote would be easier – such as finance, real estate activities, and various scientific and technical professions – account for 10% of employment but pay higher hourly wages. This data suggest that the COVID-19 shock would naturally exacerbate existing social inequalities by hitting harder those sectors where remote working is less feasible, which account for a significant share of employment but pay lower wages. Moreover, there is a risk that the Italian redundancy fund (CIG) might have been at least partly abused to the detriment of workers. A note published jointly by INPS and the Bank of Italy in July 2020[207] shows that during the initial months of the pandemic about 51% of Italian companies benefited from CIG, and almost 40% of workers in the private sector. Thanks to the reduction in working hours, companies that have made use of the CIG saved on average between EUR 3,900 (for small firms) and EUR 24,000 (for large firms) over two months. The workers that were placed under a CIG regime, on the other hand, suffered an average hourly reduction of 156 hours, corresponding to almost 90% of the monthly full-time working hours and a loss of about 27% of their monthly gross income. The problematic aspect noted by INPS and the Bank of Italy is that while utilization has naturally been higher in sectors that underwent more negative business dynamics during COVID-19, the CIG regime seems to have been used also by many firms in sectors where production levels or turnover have not decreased compared to the pre-pandemic period (about 20% in manufacturing and 30% in services). This potential abuse

of the tool by firms that have not suffered a reduction in turnover has an obvious cost for the State, for taxpayers, and for the affected workers.

**Figure 35 COVID-19 - a Great Equalizer?**

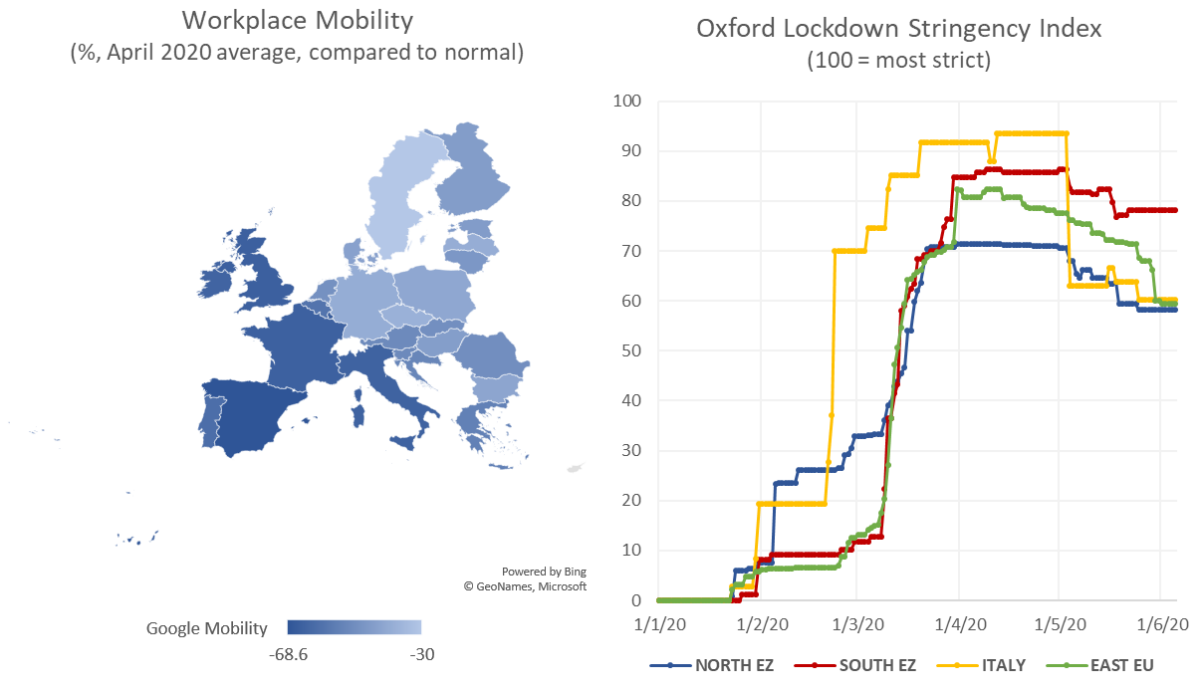

Source: Authors' calculations based on data from OECD, ISTAT and INAPP.
Note (right-hand chart): 'Hardest' include those sectors ranking in the bottom third of the INAPP Easiness of Smart Working Index (NACE P, R, S, Q, F, G, I); 'Easiest' are sectors in the upper third of the ranking (NACE M, K, L, D); 'Medium' is all the other sectors in between these two extremes (B, N, E, C, H)

## 5.4 A New Divergence?

COVID-19 is a symmetric shock that is completely exogenous to economic policymaking, and yet its economic repercussions risked being highly asymmetric. This is evident at the global level, when looking at the different speed of the recovery in 2020 and 2021, as forecasted by the IMF in its March 2021 issue of the World Economic Outlook. The world suffered a 3.3% drop in 2020 GDP but is expected to grow at 6% in 2021 and 4.4% in 2022. China, where the pandemic started, is going to do much better: Chinese growth had already rebounded in

positive territory by the end of 2020, and the Asian powerhouse is expected to grow at 8.4% in 2021 and 5.6% in 2022. The United States, initially slow to understand the severity of the pandemic threat, have seen their GDP contract by 3.5% in 2020 but will rebound robustly to 6.4% in 2021, on the back of a massive monetary and fiscal stimulus. The Eurozone, on the other hand, stands out as the region that will suffer most and recover more slowly from the COVID-19 shock: after 6.6% recession in 2020, The Eurozone's GDP will grow at 4.4% only in 2021 and decelerate to 3.8% in 2022. Within the Eurozone, forecasts also are quite diverse. While Germany suffered a relatively contained loss in 2020 (-4.9%), Italy and Spain have been nit much harder (-8.9% and -11% respectively). In part, this diversity can be traced back to different degree of stringency in national lockdowns. The Italian lockdown has been initially much stricter than the measures introduced by some of its neighbours. The comparative lockdown stringency index produced by researchers of the Blatnavik School of Government at Oxford University show that Italy tightened earlier (consistently with the timing of the outbreak across Europe) and also introduced significantly tighter restrictions on economic activity compared to the countries in the Euro-*North*, but also compared to Spain and the other countries in the Euro-*South* and compared to Eastern European EU members (Figure 34, right). Similarly, real time workplace mobility data from Google show a striking east/west divide in the degree of lockdown stringency: while workplace mobility in Italy, France, Spain and Portugal dropped by 60% to 69% on average in April 2020 compared to normal, workplace mobility dropped by a milder 40% in Germany and 48% in the Netherlands. The decline in workplace mobility in Eastern European countries ranged between 40% and 50% (Figure 34, left).

**Figure 36 Variations in National Lockdowns**




Source: own elaborations based on data from (Angrist, et al., 2020) and Google Mobility.

While the movement of people was restricted in a similar way almost everywhere in Europe, not all countries adopted the same approach to the restriction of productive activity. Italy suspended all (in person) non-essential productive activity for the entire month of April, but France and Germany for example did not go as far. In early April, the German association of industrialists (BDI) even sent a letter to its Italian suppliers stressing the degree of mutual dependence of Italy and Germany in the auto-making sector and expressing hopes for a quick resumption of production in Italy[208]. This diversity in national lockdown and responses constitutes a non-negligible risk factor for Italian economic activity: Italian firms that were not allowed to produce and fulfil orders were at risk of losing at least some of their international clients if the latter had decided to switch their supply chain away from Italy to

[208] See https://www.ansa.it/sito/notizie/economia/2020/04/09/germania-imprese-italiane-ripartano_b2c6af61-5e2e-4d94-a14b-13f1c0870b6f.html

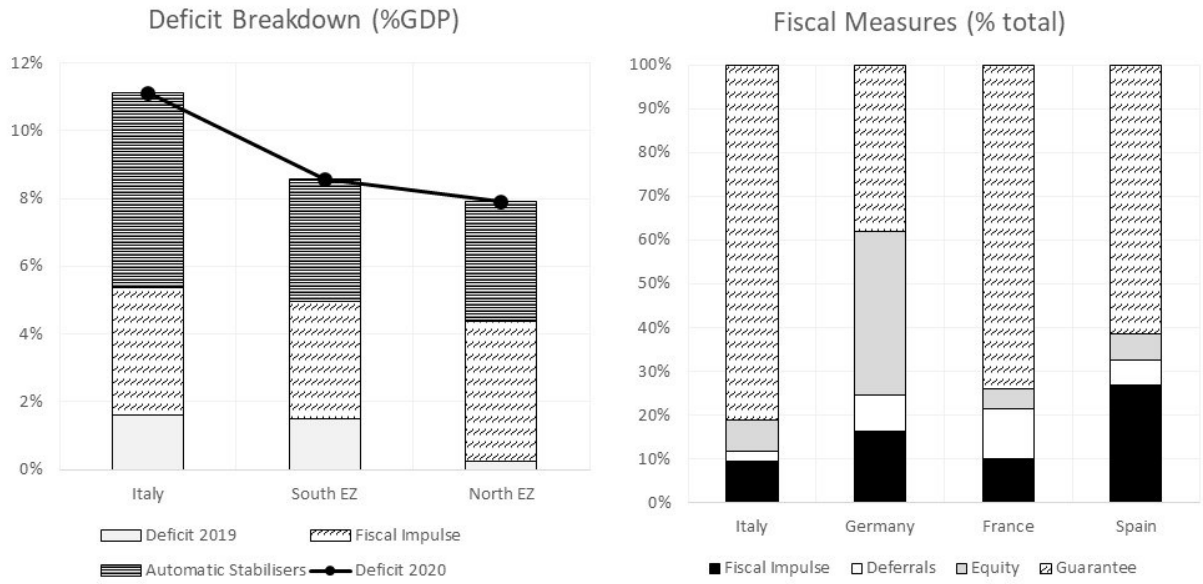
ensure continuity in production. (ISTAT, 2020) estimates the effect of a decline in foreign demand to be limited for the services sector, but more pronounced (between 2.7 and 3.5 percentage points) for the industry, which is more integrated within global trade and value chains. The effect would be especially relevant for the manufacturing sector: OECD trade in value added data show in fact that about 50% of the domestic value added produced in the Italian manufacturing sector is ultimately driven by consumption abroad. The estimate produced by (ISTAT, 2020) also shows that the decline in foreign demand would account for around half the loss in value added for the chemical and pharmaceutical sector, machinery and electrical apparels, metallurgy, textile and automobile sector. In the longer term, these effects can crystallise: the supply side disruptions observed during the COVID-19 crisis might in fact induce producer to consider the domestic re-onshoring of at least part of their supply chain to avoid finding themselves in a similar position in the future.

The risk the OCVID-19 could trigger within the EMU a new wave of economic divergence was heightened by the fact that ability to spend in order to mitigate the shock varied considerably across countries, due to the different legacy of debt accumulated as a result of the Eurozone crisis of 10 years prior. In responding to the economic shock induced by the pandemic, European governments adopted variations from the same policy menu, with a mix of increased healthcare spending, income and employment support, guarantees and grants for firms, as well as tax and payment deferrals. The budgetary impact of discretionary fiscal measures is unprecedented: on average Eurozone countries have implemented a discretionary stimulus of 4% of GDP in 2020, against 1.5% only during Global Financial Crisis. The Italian fiscal response to the COVID-19 crisis unfolded in three phases. The Law Decree 18/2020 ("*Cura Italia"*) issued in March focused on strengthening the National Health Service,

extending the unemployment benefits and income integration, as well as introducing some liquidity support for firms (later broadened with the Law Decree 23/2020, or "*Decreto Liquidità*", issued in April 2020). In May 2020, coincidentally with the initial re-opening phase, the government issued a third Law Decree 34/2020 ("*Rilancio*") aimed at providing further support to workers, firms and the most affected sectors of the Italian economy. Overall, in its assessment of the Italian 2020 Stability Programme, the European Commission expected Italy's headline general government deficit to reach 11.1% in 2020, up from less than 2% in 2019[209]. Italy would therefore post the largest government deficit in the Eurozone in 2020, followed closely by Spain (10.1%) and France (9.9%), whereas the German deficit would be close to 7% of GDP. The Commission's Autumn forecasts revised the expected deficit figure to 10.8%, behind Spain (12.2%) and Belgium (11%). At the time of writing, additional fiscal measures have been introduced in 2021, following a government crisis and the appointment of former ECB's President Mario Draghi as the new Italian Prime Minister, supported by a national unity coalition.

[209] See the EC's assessment of the Italian Stability Programme, published in May 2020.

**Figure 37 National Variations of Fiscal Stimulus**




Source: author's calculations based on European Commission's assessment of countries' Stability Programmes; IMF COVID-19 monitor; IMF Fiscal Monitor; Bruegel database of COVID-19 Fiscal Measures; National Sources. The data reported in this figure is as of summer 2020

If headline deficit figures appear to be of a comparable magnitude across Eurozone countries in 2020, the composition of those deficit numbers varied considerably (Figure 37, left). In the Euro-*North*, on average, the COVID-related fiscal impulse slightly exceeds the effect of automatic stabilisers in explaining the 2020 deficit increase. In the Euro-*South* the increase in the 2020 deficit figure is almost equally split between the two components. In Italy, on the other hand, automatic stabilisers appear to be playing a much larger role in explaining the 2020 deficit increase, compared to the discretionary fiscal impulse[210]. When looking at the relative importance of the discretionary fiscal impulse at the level of individual countries, this is most evident in Germany where the discretionary fiscal impulse accounted for about 6% of GDP in 2020, followed by Spain and Italy (at 4%), and France (at 1.9%). Italy also stands out for its exceptionally high reliance on the tool of government guarantees, which are worth

[210] See a detailed discussion of the fiscal measures implemented by the Italian government in (Confindustria, 2020)

around 32% of GDP and account for almost 80% of the entire fiscal measures rolled out by the Italian government in 2020. On the opposite side of the spectrum, Germany is unique in its relatively sizeable recourse to equity injections and subsidised loans, worth around 14% of GDP and accounting for more than one third of all German fiscal measures as of summer 2020 (Figure 37, right). This variation in the composition of fiscal measures adopted in response to the COVID crisis speaks of underlying differences in countries' ability to spend: Germany could afford shouldering the immediate liability impact of equity injections and other subsidies, while the more tightly fiscally constrained Italy resorted to guarantees, which are accounted for as contingent liabilities until they are called. While containing the cost of the COVID-related measures for the Italian state in the short run, this choice exposed Italy to a massive future fiscal risk in case the economy were not to recover quickly and strongly enough for bankruptcies to be avoided. The different firepower is evident also in the varying degree to which different countries have applied for State Aid under the COVID-19 Temporary State Aid Framework[211] introduced by the European Commission to contain the risk of an EU-wide liquidity and solvency crisis. The first version of the Temporary Framework was adopted on 19th March 2020, and it encompassed five areas of interventions, mostly focused on liquidity aid to the corporate sector: (i) Direct grants, selective tax advantages and advance payments – allowing Member States to set up schemes to grant up to EUR 800,000 for companies to address urgent liquidity needs; (ii) State guarantees for loans taken by companies from banks; (iii) Subsidised public loans to companies; (iv) Safeguards for banks channelling State aid to the real economy; (v) Short-term export credit insurance. The Temporary Framework was amended on 3rd April 2020, to add five more types of aid: (i) Support for coronavirus related

[211] The EU Temporary Framework was set out in C(2020)1863 final and amended by C(2020)2215 final and C(2020)3156 final.

research and development (R&D); (ii) Support for the construction and upscaling of infrastructures needed to develop and test products useful to tackle the outbreak; (iii) Support for the production medicines and treatments; medical devices; disinfectants and other products helpful to tackle the outbreak; (iv) Targeted support in the form of deferral of tax payments and/or suspensions of social security contributions to reduce liquidity constraints on companies and help preserve employment; (v) Targeted support in the form of wage subsidies for employees to help limit the impact of the coronavirus crisis on workers. The amendment also included and expansion of the already existing types of support available for companies in need. For example, within the nominal value of EUR 800 thousand per company, the range of tools that Member States were allowed to use was expanded to include zero-interest loans, guarantees on loans covering 100% of the risk, and even the provision of equity. On 13th May 2020, the Framework was amended a third time, setting out criteria for Member States to provide recapitalisations to companies, in acknowledgement of an increased risk that restrictions on productive activities could result in losses big enough to dent into companies' equity and reduce their ability to borrow on the markets. This latest amendment also introduced the possibility for Member States to provide subordinated debt to companies at favourable terms. The centralised oversight of public support for domestic firms lies at the heart of the Single Market idea – which would be untenable absent a competitive level playing field. COVID-19 has exposed this risk very clearly: as the ability to cushion the economic impact of the shock through state aid was directly correlated to the strength of countries' fiscal position, initially the result was a very asymmetric deployment of public support across the Union. As of mid-2020 – when most State Aid requests had been already made – Germany accounted for almost 59% of the total EUR 2 trillion of state aid that had been approved by DG Competition. This imbalance risked jeopardizing the functioning of

the Single Market, especially if aid was in the form of equity injections or partial public ownership – as in the case of a measure announced by the German Parliament in March 2020. The asymmetry in COVID-19 state aid provision could well imply a biased outcome in which uncompetitive firms in fiscally strong countries would be kept artificially alive to the detriment of competitive firms in fiscally weak countries.

Another major difference – this time singling out Italy from most of its Eurozone peers– has been in the speed of implementation of the fiscal measures. The Italian government adopted the first of its emergency law decrees 23 days after the reporting of 100 cases of COVID-19, whereas the same happened in France and Germany at 12 and 8 cases respectively. While other European countries certainly benefitted from having witnessed the unfolding of the Italian epidemics before facing their domestic outbreaks, the lag in the Italian response is largely attributable to both the difficulty to strike a political agreement on the content and to the complexity of the Italian legislative process. As highlighted in (Confindustria, 2020), the Law Decree 34/2020 alone was composed of 266 articles and it required 90 corollary legislative acts to be enacted. This was mirrored into a very high fragmentation of the enacted measures: Law Decree 34/2020 alone refers to 74 funds, of which 29 newly created and 37 re-financed. Clearly this level of bureaucratic complexity – already problematic during normal times – proved an insurmountable obstacle during an emergency like COVID-19. As a result, the disbursement of economic aid has been much slower in Italy compared to the neighbouring countries. The gap in speed is most evident when looking at the roll-out of liquidity measures. Germany disbursed about EUR 47 billion in loans through the German public bank KfW between the end of March and mid-June 2020. France issued about EUR 88 billion loans over the same horizon. In Italy, the SMEs Guarantee Funs had issued about EUR

34 billion to 646 thousand beneficiaries by early June 2020, while SACE – the tool dedicated to large firms – had issued a mere EUR 718 million to 75 beneficiaries, between April and early June 2020[212].

The different ability to spend, and the differences in speed of implementing the support measures to the real economy would naturally imply a differentiated speed in the recovery but also sizeable difference in the impact of COVID-19 on the public debt burden of different countries. While the general government debt ratio of Germany, Austria, and the Netherlands is expected to remain below 80% in 2020, despite the massive fiscal effort undertaken by some of these countries, the debt ratio of France and Spain was forecasted to reach close to 120%[213]. In particular, the COVID-19 economic crisis will have a massive fallout on Italian public finances -which were already more constrained before the pandemic, due to the pre-existing debt level. Government's forecasts[214] released in the spring of 2020 projected nominal GDP growth at -7% and the budget deficit at 10.4% of GDP. The European Commission initially expected the outcome to be even worse, with the public deficit to reach 11% of GDP. Adding to the existing debt rollover, the Italian public sector faced the need to raise about EUR 370 billion from May 2020 onwards, to finance the response to the COVID-19 shock. Overall, funding needs in 2020 would end up being roughly double compared to an ordinary year. Absent the massive interventions by the European Central Bank, which will be

[212] See the Press Release by the Italian Ministry of Economy and Finance at: http://www.mef.gov.it/ufficio-stampa/comunicati/2020/Credito-e-liquidita-per-famiglie-e-imprese-domande-di-moratoria-sui-prestiti-salgono-a-277-miliardi-oltre-640.000-domande-al-Fondo-di-Garanzia-per-le-PMI.-Sace-concede-garanzie-per-718-milioni-75-le-richieste/

[213] See the European Commission's Spring 2020 Forecasts.

[214] See http://www.upbilancio.it/audizione-dellupb-nellambito-dellesame-del-def-2020/ and http://www.dt.mef.gov.it/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2020/DEF_2020_Sez-I-Programma_di_Stabilitx.pdf

discussed in the next section, the country might have faced pressure on the financial markets. In the longer term, the historically unprecedented debt burden that will be accumulated as a consequence of this crisis (expected to reach well above 150% of GDP) will make it especially difficult for Italy to ensure a credible strategy of consolidation. While the suspension of the rules of the Stability and Growth Pact for 2020, 2021 and 2022 offers respite in the short term, the oversized Italian public debt will remain an elephant in the room.

## 5.5 European Solidarity

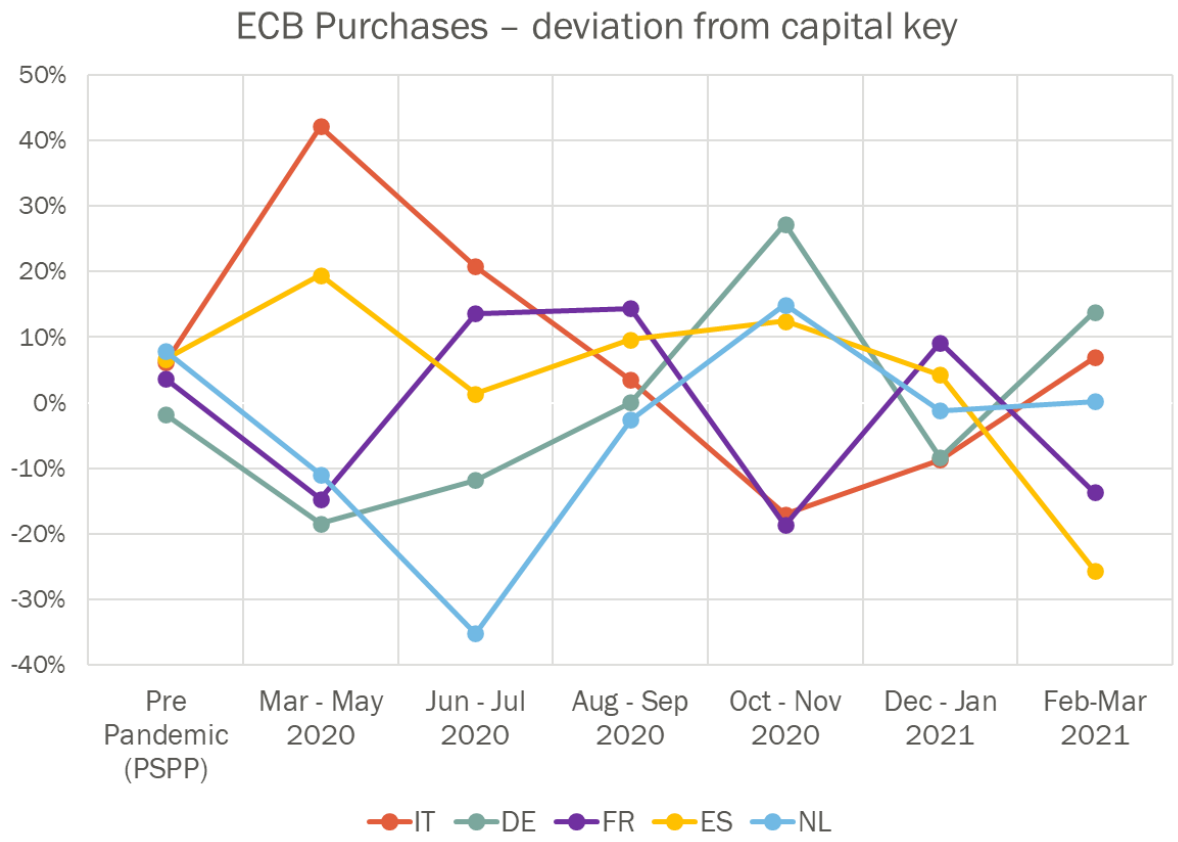
At the time of writing, the data on the full impact of the COVID-19 economic crisis is still partial, but the evidence discussed in the previous sections suffices to highlight the possibility that – due to different pre-existing macroeconomic conditions limiting some countries' ability to spend – the shock could trigger a new phase of economic divergence within the Eurozone, undoing the massive convergence achieved after 2010 and discussed in Chapter 3. COVID-19 made the risk of a 'two-speed' Europe more salient and tangible than possibly ever before, at a time when political cohesion had already been strained by years of growing populist and Eurosceptic sentiments. And yet, the European response was initially very slow to understand what was at stake. As anticipated in Chapter 1, in the early phases of the pandemic – when infections appeared to be still largely contained in Italy and Spain – what emerged was a re-emergence of the Eurozone crisis narrative pitting Euro-*North* against Euro-*South* or sinners against saints. The first EU economic package – the Corona Response Investment Initiative[215] – amounted to EUR 37 bn, of which only 8 bn was 'new' money originating from a

[215] See https://ec.europa.eu/regional_policy/en/newsroom/news/2020/04/04-02-2020-coronavirus-response-investment-initiative-plus-new-actions-to-mobilise-essential-investments-and-resources

Commission's decision to wave the right to require Member States to refund the unspent pre-financing of structural and convergence funds. An additional EUR 28 bn were due to come from yet-unallocated structural funds from the national envelopes and one more billion from the combination of unused resources in the already existing EU Solidarity Fund and Globalization Adjustment Fund. The European Investment Bank (EIB) was then due to get EUR 1 bn in guarantees from the EU budget with the aim to leverage 8 times as much. None of these measures, however, was nearly sizeable enough to address the risk of a renewed economic divergence within the EMU. Meeting on March 4th, the Eurogroup recognised[216] that the virus had hit some areas particularly hard but while anticipating further policy action, it framed it strictly within the flexibility for "unusual events outside the control of government" embedded in the Stability and Growth Pact (SGP). The underlying view seemed to be that, similarly to the Eurozone crisis, this was again an asymmetric shock that some countries had somehow brought upon themselves. Overall, the Brussels-Frankfurt consensus of forced adjustment seemed to be still alive and well, back in early 2020.

[216] See the Eurogroup statement released on 4th March 2020: https://www.consilium.europa.eu/en/press/press-releases/2020/03/04/remarks-by-mario-centeno-following-the-eurogroup-conference-call-of-4-march-2020/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Remarks+by+M%C3%A1rio+Centeno+following+the+Eurogroup+conference+call+of+4+March+2020

**Figure 38 – PEPP Flexibility**




Source: Algebris Policy Forum

The ECB – typically the fastest reacting among EU institutions – initially seemed to underestimate the challenge. After announcing a new round worth EUR 120 billion of the ECB's Asset Purchase Programme (APP)[217], ECB's president Lagarde was asked during the press conference what the ECB would do if sovereign bond yields had increased markedly for those countries that had been hit the hardest, and she infamously replied that the ECB was "not here to close the spreads". The comment spurred a negative market and political reaction, including an unusually strong-worded response by the otherwise mostly silent

[217] See the press release at https://www.ecb.europa.eu/press/pressconf/2020/html/ecb.is200312~f857a21b6c.en.html#qa

President of the Italian Republic.[218] Eventually, the backlash led the ECB to announce on March 19th a new EUR 750bn Pandemic Emergency Purchase Programme (PEPP), later increased to EUR 900bn. Sovereign purchases under PEPP were still formally anchored to the capital key allocation rule – as is the case for prior ECB's bond-buying operations since 2014 – but Frankfurt stated very clearly it would adopt flexibility within the self-imposed limits and was even willing to reconsider those limits altogether if needed. As such, PEPP constituted a radical change from the previous ECB's approach to Quantitative Easing and it constituted the first recognition at European policy level that the crisis might require a forceful and centralised response to stave off the risk of an asymmetric recovery. For Italy, the ECB's action was especially relevant, as the purchases of sovereign debt significantly reduced the potential for market pressure on yields. Given the overall size of the new QE envelope, even modest deviations from the capital key allocation rule would have sufficed to cover 50-to-60% of all the 2020 Italian financing needs (Foa', et al., 2020). But in March and April 2020, the share of Italian debt in the ECB's sovereign purchases reached 34%, higher than ever before and more than double the Italian capital key entitlement. While this imbalance would later be re-absorbed (Figure 38), the frontloading of ECB's support to the country hit first by the pandemic suggested that the ECB approach had changed and had become significantly more 'need-based', allowing also for persistent deviations from the rule.

The ECB's action was certainly helpful to reduce funding pressure in the short-term, but it could not address the long-term imbalance in the economies of Member States that would

[218] The Note released by the Presidency stated: "Italy is going through a difficult phase and its experience in contrasting the spread of the virus will probably be useful to all EU countries. As such, Italy expects, legitimately, at least in the common interest, initiatives of solidarity and not moves that could be an obstacle to its action"

stem from the different legacy left from COVID-19. The exogenous and symmetric nature of the shock constituted a strong rational for centralised fiscal action – at least at the EMU-level. As the initial health shock was completely exogenous to countries' economic policy choices, it also did not warrant the kind of macroeconomic conditionality that had been designed for EU adjustment programmes. On March 20th the European Commission proposed the activation of the so-called 'general escape clause' that effectively suspended the application of all fiscal rules in the Stability and Growth Pact (SGP) for 2020 – later extended to 2021 and 2022. The proposal was endorsed by the European Council, but the most contested topic of discussion was whether the additional debt that countries were expected to incur to finance the post-COVID recovery should stay on national books or could be in some way and to some extent mutualised. Around mid-March, Italian Prime Minister Conte called for the issuance of common debt to finance the post-COVID recovery ('Coronabonds'). EU minsters discussed the idea on March 17th but with no conclusions, even though the German Chancellor had taken an uncharacteristically soft stance on the topic[219] after seven prominent German economists published an op-ed in the conservative newspaper FAZ advocating for EUR 1 trillion in common bonds (Südekum, et al., 2020). Former ECB President Draghi – who would become Italy's new Prime Minister in February 2021 –weighed in on the debate with an op-ed in the FT, in which he argued that the speed of deterioration of private balance sheets should "be met by equal speed in deploying government balance sheets, mobilising banks and, as Europeans, supporting each other in the pursuit of what is evidently a common cause" (Draghi, 2020). The leaders of Austria, Denmark, Sweden and the Netherlands – who rebranded themselves "the frugal four" – were staunchly opposed to any mutualisation of

[219] See https://twitter.com/DeItaOne/status/1240329716453777409

debt and instead argued that any kind of financial support to the countries most affected by COVID should come in the form of loans from the European Stability Mechanism and be subject to macroeconomic conditionality. Meeting on March 24th, the Eurogroup was so divided on the issue that it did not even release a conclusive statement, leaving it to President Centeno to summarize the state of affairs in his remarks to the press[220]. Centeno said that the Eurogroup had discussed "a Pandemic crisis support safeguard based on an existing ESM precautionary instrument, such as the Enhanced Conditions Credit Line (ECCL)", which "would need to be consistent with the external, symmetric nature of the COVID-19 shock" including for any attached conditionality. In the short term it would be "targeted to coronavirus response and in the longer term, countries are expected to return to stability". These remarks suggested that the Eurogroup was warming up to the idea that a global exogenous shock did not warrant the kind of macroeconomic conditionality that ESM lending would normally be subject t but was not yet in agreement on what the alternative framework could be. After an inconclusive summit of European leaders held on March 26th, on April 9th the Eurogroup delivered what appeared to be a first breakthrough in addressing the economic fallout from COVID-19. The plan was articulated around three pillars. First, the Eurogroup endorsed the Commission's proposal to create a centralised unemployment support instrument (SURE) of up to EUR 100 billion in total and building on the EU budget, which would grant support in the form of loans on favourable terms from the EU to Member States. Second, the ministers agreed to establish a Pandemic Crisis Support tool for the ESM, based on the existing ECCL

[220] See https://www.consilium.europa.eu/en/press/press-releases/2020/03/24/remarks-by-mario-centeno-following-the-eurogroup-meeting-of-24-march-2020/ and also the letter sent by the President of the Eurogroup to the President of the European Council https://www.consilium.europa.eu/en/press/press-releases/2020/03/25/letter-of-eurogroup-president-mario-centeno-to-the-president-of-the-european-council-following-the-eurogroup-of-24-march-2020/

precautionary credit line. The details would be published one month later[221]: the special credit line would be available to all euro area Member States until 2022, with a maximum average maturity of 10 years and extremely low interest cost. Each member would be allowed to draw up to 20% of its GDP, for a total Eurozone capacity EUR 240 billion. The only requirement to access the credit line would for the requesting Member States to commit to use the funds to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID 19 crisis. There would be no programme-like macroeconomic conditionality, no enhanced surveillance (which would apply to member states using an ECCL under the regular ESM rules), and eligibility would be determined based on an upfront debt sustainability analysis that was run in April and that all countries passed. Third, the ministers also agreed to work on an EU Recovery Fund to support the recovery, providing funding through the EU budget to programmes in line with European priorities and ensuring EU solidarity with the most affected member states. Importantly, the Eurogroup statement also mentioned that discussion would focus on the fund's "relation to the EU budget" and "on innovative financial instruments", which many observers took as codeword for the possible exploration of joint debt issuance to finance the fund. While no country seemed to be eager to apply to the new ESM Pandemic Support instrument, the Recovery Fund became quickly the focus of attention – as it was clear that the rest of the Eurogroup deal alone was not enough to make a sizable impact on counteracting the fiscal impact of COVID-19[222]. The highly anticipated summit of EU leaders on April 23rd, however, failed to provide any political guidance to ministers on the thorniest point of the Recovery Fund

[221] See https://www.consilium.europa.eu/en/press/press-releases/2020/05/08/eurogroup-statement-on-the-pandemic-crisis-support/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Eurogroup+Statement+on+the+Pandemic+Crisis+Support
[222] See (Creel, et al., 2020)

discussion and instead delegated the European Commission with the task to make a proposal[223]. Meanwhile, on May 5th, the German Constitutional Court delivered a verdict on the ECB's Public Sector Purchase Programme – the arm of the QE programme that was targeted at sovereign bonds – that risked inflicting a very serious blow not only to the post-COVID recovery but also to European monetary integration more generally. While dismissing the plaintiffs' claim that PSPP constituted monetary financing, the Court stated that it was unconvinced by the ECB's arguments as to the proportionality of the programme and requested the ECB to provide further evident to the Court. In so doing, the German Constitutional Court openly went against a previous judgement by the European Court of Justice – opening a constitutional struggle[224] that would lead the European Commission to consider opening infringement proceedings against Germany[225]. By showing the risk that a local constitutional court could force the hand on ECB's monetary policy, the court's ruling showed the importance of agreement on an EU recovery fund to counterbalance the imbalance of national recovery strategy with no State Aid constraints. Possibly as a response to the court ruling, on May 18th Germany and France issued a joint proposal for a EUR 500bn in EU budget spending, skewed towards the most affected countries, re-distributive (as countries would get according to a measure of need, and pay according to their share in the EU budget), financed by effectively federal issuance integrated in MFF[226]. Looked through the prism of previous Franco-German proposals, this was effectively a revolution and the promise

[223] See https://www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/
[224] For an analysis of the constitutional and political implications of the German Constitutional Court judgement, see (Bobic & Dawson, 2020) and (Jones, 2020)
[225] See https://twitter.com/sven_giegold/status/1259141585595437056
[226] See https://www.bundesregierung.de/breg-de/aktuelles/deutsch-franzoesische-initiative-zur-wirtschaftlichen-erholung-europas-nach-der-coronakrise-1753760

of a major step forward in European integration[227]. The Franco-German compromise was taken on board by the European Commission in its proposal for a "Next Generation EU[228]" economic package, released at the end of May[229]. The Commission's proposal was pathbreaking in two ways. First, while not the first time that the EU would issue common debt, Next Generation would increase issuance from a total of EUR 70 bn for the 2010-19 decade to EUR 750 bn for next budget cycle. Second, through its grant component the proposal featured explicit cross-border fiscal transfers, a long-term taboo of European fiscal integration. This aspect was key, because it expressed a political will to reduce the impact of the economic shock of COVID-19 on the budgets of high-debt states.

The Commission's proposal opened a difficult negotiation phase within the European Council. The policy of these negotiations turned out to be acrimonious, and reaching a compromise was difficult. Just as Germany was coming to terms with the idea that temporary fiscal transfers within the EMU could be needed to respond to a shock of the nature and magnitude of COVID-19, the team of the Frugal countries appeared unwilling to concede and demanded that all EU money should come through loans (which would add to the receiving countries' debt load) and not grants. The Netherland quickly became the leader of the new opposition front – as Finance Minister Hoekstra was reported in the press saying that Brussels should investigate why some countries did not have enough financial room for manoeuvre to weather the economic impact of the crisis[230]. Dutch Prime Minister Rutte, on the other hand,

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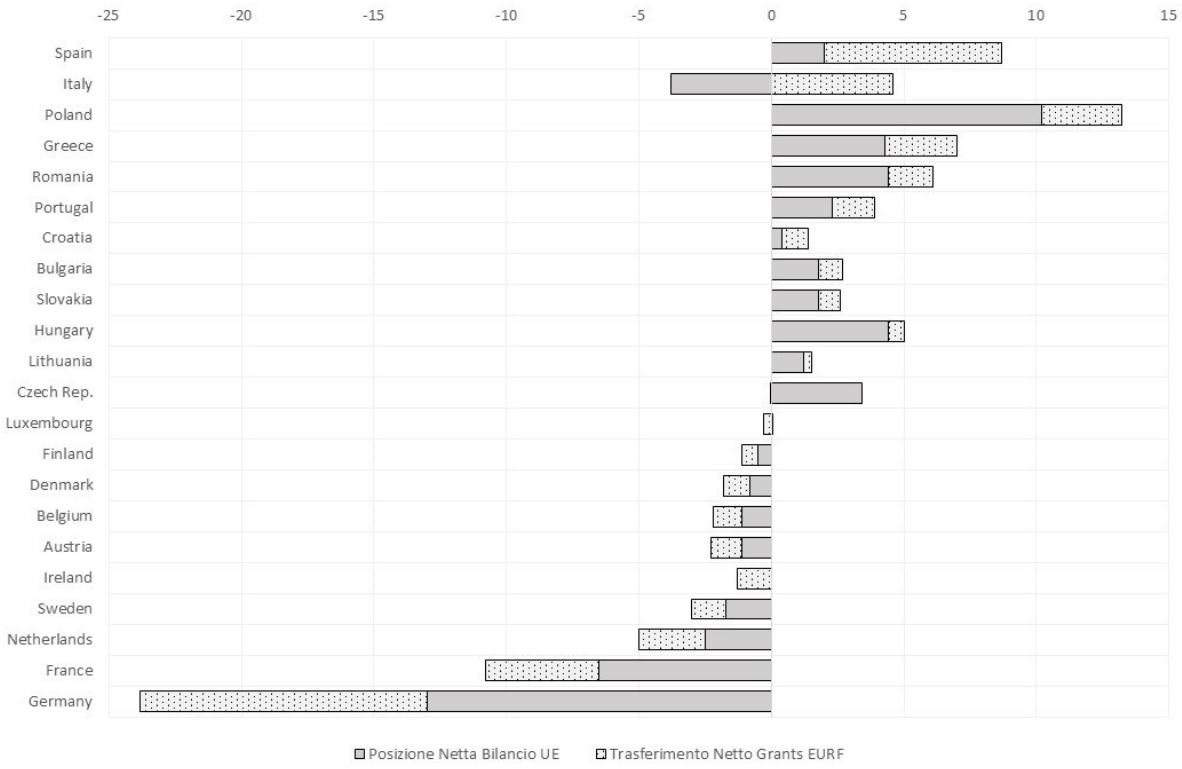
[227] See https://www.algebris.com/policy-research-forum/blog/eu-recovery-fund-a-franco-german-revolution/
[228] See https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940
[229] See https://ec.europa.eu/info/sites/info/files/economy-finance/assessment_of_economic_and_investment_needs.pdf
[230] See https://www.politico.eu/article/netherlands-try-to-calm-storm-over-repugnant-finance-ministers-comments/

was staunchly holding the line that any recovery fund money would need to entail conditionality to ensure the money was accompanied by structural reforms in the receiving countries[231], a demand that southern countries found unacceptable. These tensions came to a head during the EU leaders' summit of July 2020, when discussions were inconclusive for 3 days. Faced with the Frugals' opposition, EU Council President Charles Michel tabled a compromise that would entail a significant reduction in the size of the grant component within the Next Generation EU package and significant changes to the governance of disbursement. The European Commission's original proposal envisioned that countries would need to present national plans on how the money would be used, and that these plans would be approved by leaders using a Reverse Qualified Majority Voting (RQMV) system – where a plan would be approved unless a majority of countries were to vote against, thus making for a fast and relatively smooth approval process. The Dutch staunchly opposed this mechanism, requesting instead that the programmes be voted on with unanimity. The compromise put forward by the President of the Council hence featured a switch to Qualified Majority Voting (QMV) – where majority was required to approve, rather than block, disbursement – featuring also an 'emergency brake' whereby few countries could stall the process if they deemed the national plan of a receiving country unsatisfactory. This change in the governance of the instrument would make it much more prone to politicization – with the risk of reproducing a useless and ineffective instrument as the Budget Instrument for Convergence and Competitiveness (BICC) that had been the outcome of a 2018 Franco-German Meseberg accord. After 4 days of heated discussions, the Council finally reached an agreement on a EUR

[231] See https://www.brusselstimes.com/all-news/eu-affairs/122000/dutch-pm-italy-spain-and-portugal-will-only-get-covid-19-relief-funds-after-reforms/

750 billion economic recovery package and an EU budget of EUR 1.074 billion for the period 2021-2027. The total amount of funds available under Next Generation EU remained unchanged from the original Commission proposal (EUR 750 billion), but the composition was significantly altered. The component of grants – where, as we have seen, the character of fiscal solidarity emerges in full – was reduced from EUR 500 billion to EUR 390 billion, while the share that will be disbursed in the form of loans has been increased from EUR 250 billion to EUR 360 billion. The compromise allocation was different from the original Commission's proposal in one other respect: while the grants allocated to the Recovery and Resilience Facility remained essentially unchanged at EUR 312.5 billion, the funds for the Horizon EU program (which supports EU research) was reduced by 62%; those for InvestEU (for investments in EU internal policies) was cut by over 80%; the allocation to the Just Transition Fund (fund to support local communities in the transition to a green economy) was reduced by 2 thirds and three programs were completely scrapped, including the Solvency Instrument – which would have made it possible to provide aid at EU level to companies in countries that could not afford solvency measures. Overall, the only political compromise feasible seemed to be through cuts of the appropriations to those programmes that would have been administered centrally and would have financed genuinely European public goods. As Next Generation EU was to be financed through common EU debt issuance, allocating part of that issuance to long-term and centralized programs would have increased the likelihood of this this temporary initiative to morph onto some form. of permanent federal spending.

**Figure 39 Budget Contribution vs Allocation of Next Generation EU grants - original proposal (EUR bn)**




Source: author's calculation based on European Commission Next Generation EU proposal

## 5.6 Death of Populism?

Italy and Spain will be the main beneficiaries of Next Generation EU grants, receiving respectively EUR 80 and EUR 78 billion. Due to the way the instrument is constructed, these grants will produce a net fiscal transfer for both countries. To calculate the size of the transfer, I assume that each country will be required to contribute to the financing of the package based on its respective share in the financing of the EU budget. This is a conservative hypothesis, because the final reimbursement will mainly depend on whether an agreement is reached on increasing the EU's own resources, which would in turn reduce the national contribution proportionally. In addition, the allocation of 30% of subsidies will be reassessed

in 2022 based on the decline in real GDP observed in 2020/21, a factor that could further benefit the countries most affected by COVID-19 and those that introduced more restrictive lockdown measures. Italy is the country that exemplifies most clearly the degree of fiscal solidarity implicit in the Next Generation EU package. The country is entitled to about EUR 80 billion in grants under Next Generation EU but – in the conservative hypothesis described above – it will have to contribute, based on its share in the EU budget, only EUR 50 billion. The result is a net transfer of grants for about EUR 30 billion euros to Italy (Figure 38). To put the figures into perspective, it is as if the EU were returning to Italy about 7 years of net contributions paid into the EU budget. Furthermore, Italy is the only country that typically is a net contributor to the EU European budget and becomes a net beneficiary of the grants under Next Generation EU. In contrast, the budget rebates for Austria, Denmark, the Netherlands, and Sweden were increased, while the German rebate remained unchanged. In the next budgetary cycle, the rebates will total EUR 53 billion. In the past, France, Italy and Spain have financed 30%, 22% and 15% of all the EU budget rebates respectively. If things remain unchanged, Italy and Spain could have to bear EUR 11 and EUR 8 billion of rebates respectively, which would reduce the effective net transfer they would benefit from. Funds will be allocated starting in 2021 on a decision by the Commission based on spending plans presented by individual countries. The assessment of the national plans by the Commission will have to be approved by the Council, by qualified majority voting (which requires approval by 15 countries accounting for at least 65% of the EU population). Requesting countries will have to align their plans with the Country Specific Recommendations (CSR), i.e. a set of country-specific economic policy recommendations that the Commission regularly publishes and that have so far been largely ignored. The coherence of the national spending program with the CSRs will be one of the elements on which the evaluation (and therefore the

allocation of funds) will be based, with particular attention to reforms that could strengthen growth potential, facilitate the creation of jobs and improve the economic and social resilience of the requesting country. Governance of disbursement was one of the thorniest issues during the negotiations. The initial proposal envisaged a streamlined process that would feature a central role for the EU Commission – responsible for assessing the implementation of the national spending plan. The Council would have been given the role of approving this assessment with a reverse qualified majority vote, so the disbursement would have been in fact automatically approved unless a majority of countries had voted against. The Dutch counterproposal, which emerged during the July summit, provided that this action was instead conducted unanimously, which would give each country a power of veto and would make the instrument ineffective and difficult to use. In the final compromise, the Commission will produce an assessment of the 'satisfactory achievement of the objectives', by consulting the Economic and Financial Committee (a body of technicians of the Ministries of Finance). There will be the option for one or more members to request that the Commission's assessment be also discussed by the Council. This 'emergency brake', introduced to bridge the gap between the initial proposal and the Dutch request, may slow down the disbursement for up to 3 months but not block it (because in the event of disputes the Commission's assessment should prevail).

As discussed in Chapter 1, Next Generation EU is a historic step forward because it overcomes two taboos: opposition to significant EU common debt issues, and opposition to explicit (albeit temporary) tax transfers between countries). It is a decision that creates a political counterpart to the action of the ECB and sets the stage for a discussion on expanding the Union's own resources. At the same time, however, it is a policy choice that steers clear of –

even partial – debt mutualisation and subjects the approval and disbursement of funds to a process that does not completely break free from the ideological framework of the Brussels-Frankfurt consensus of forced adjustment. As such, the agreement also lays bare the deep tensions that still exist on the question of European solidarity. At the centre of these tension, is the position and role of Italy – the country that exemplifies the degree of fiscal solidarity in Next Generation (through the change in sign of its net contributing position) but whose missed adjustment also exemplifies the concerns with moral hazard that held this unprecedented initiative back from debt mutualisation.

The success of Italy at using the money from Next Generation EU to lift the country's potential growth trajectory and implement previously procrastinated structural reforms will therefore be the factor deciding whether this halfway compromise will graduate into a genuinely new consensus of European fiscal solidarity, securing the future of EU integration. In light of this, it is perhaps unsurprising that the drafting of the country's National Recovery and Resilience Plan (NRRP) became quickly the centre of heightened political confrontation. Started with the insistent requests (initiated by former PM Matteo Renzi) that Italy applied for the ESM's pandemic credit line, the contests, the opposition to the Conte's government swiftly moved onto the ground of the NRRP – the initial drafts of which were largely inadequate and unclear in terms of both the process of project selection, and most importantly the governance that would oversee the execution of projects in a country that had a poor project management history in the context of EU cohesion policy. Eventually, the growing criticism to the Conte government's handling of the pandemic and of the NRRP drafting led to a full-blown crisis of government triggered by Renzi, the deposition of PM Conte and the appointment of former ECB's President Mario Draghi as the head of a government with a strong technocratic

component but supported by a variegated political coalition of 'national unity' – including M5S, League, PD and everyone else with the exception of the far-right Fratelli d'Italia. The alternation of political and technocratic governments has been a well-established tradition in Italian republican history since 1953. In a country characterised by a structurally high political volatility, technocratic Prime Ministers typically serve to push through policies deemed necessary yet too unpopular for politicians to commit political capital to, knowing that elections might be just around the corner. One prominent example of this mechanism at work is Mario Monti's fully technocratic cabinet appointed in 2011, in the midst of the Eurozone crisis when Italy was on the brink of losing market access. Italians tend to display extremely low levels of trust in the country's democratic institutions (political parties in particular), which probably explains why their view of technocratic government is not as negative as one might expect. One key element in determining citizens attitude towards technocratic executives seems to be the strength of the signalling effect coming from their expertise: there is evidence that Italians can be very supportive of the technocratic mode of government – despite the reduced element of input participation that characterises it – as long as the governing experts remain unequivocally technocratic (Merler, 2019). In this respect, the Draghi government is a hybrid creature: the newly appointed PM is eminently technocratic, and technocrats are also the ministers who will be in charge of the most important files in the context of the Next Generation EU spending plan (digital transition; ecological transition; transportation; economics and finance) but these 'outsiders' are surrounded by a vast number of politicians from all sides of the political spectrum, appointed in residual ministries and at various administrative and executive positions. This configuration seems to be a carefully balanced exercise at ring-fencing the key technocrats by ensuring that all parties in the governing coalition have enough 'skin in the game' to remove the temptation of pulling

the plug too early for political interest. In this, the Draghi government is more remindful of Ciampi's technocratically-led government – which secured Italy's accession to the EMU and normalised the idea of using the European 'external constraint' (*vincolo esterno*) as a way to advance difficult domestic policy reforms – than of Monti's fully technocratic cabinet – which staved off the risk of an EU/IMF bailout, but also largely delegitimised the idea that externally constrained policy had merits. The choice is also a symbolism. By deliberately placing himself in the tradition of Ciampi, Draghi implicitly signals an intention to bring back and re-legitimise a view of policy that used to see Europe as a positive external constraint for advancing painful reforms in a context of high political volatility. It is therefore even more striking to see this government relying on the support of M5S and League – previously united in a common populist and Eurosceptic purpose.

Mario Draghi begins his term as PM with one objective: securing the country's share of Next Generation EU, particularly the grants from the RRF, of which Italy is the single largest recipient in absolute terms. This relatively narrow mandate has very broad economic implications, as access to the funds requires alignment with the Commission's Country-Specific Recommendations and hence the NRRP entails a commitment by recipient countries to implement some degree of structural reforms. This reform element of the NRRP expands Draghi's narrow mandate to a more comprehensive task of overhauling the country's long-know structural weaknesses in the attempt to lift growth potential. The elephant in the room will continue to be Italy's outsized level of public debt-to-GDP, expected to climb close to 160% post-COVID. While any talk of austerity would be misplaced at the current juncture, the question of how to deal with the Italian debt load will need to be considered as Europe will enter a discussion of whether and how the rules of the EU fiscal framework will need review.

Draghi has been arguing since the beginning of the pandemic that high levels of public debt are here to stay, but he has also carefully drawn a distinction between 'good' (productive) debt and 'bad' (unproductive) debt. So far, as discussed in Chapter 3, Italy has accumulated a heavy load of debt in the unproductive category. The crucial task of the Draghi government will be to ensure that the debt incurred in the context of Next Generation EU is of the first type. Thanks to the funds from Europe and to the ECB's asset purchases programs, Italian debt is on a sustainable path as long as market confidence. More importantly, if the investment injection from Next Generation EU proves successful in lifting growth, the current financing conditions are consistent with Italy achieving debt stabilisation without the need to run a primary surplus: while a pace of debt reduction aligned with the prescription of the EU 1/20$^{th}$ debt rule would be unfeasible and unwarranted after the biggest economic shock in post-war history, a slower pace of debt reduction would be feasible without imposing undue austerity. In other words: 'good debt', if coupled with reforms to remove the structural bottlenecks that have been holding growth back, could create the conditions for Italy to be able to deleverage 'bad debt' and reconstitute fiscal space for tackling future shocks. The appointment of Draghi as Italy's PM will also have important repercussions at the EU level: one of the most experienced leaders in the Union's policy landscape, Draghi will naturally substitute Merkel in the driving seat of EU integration with a vision rooted in the idea of a trade-off between solidarity and responsibility, which suggests he will leverage European support to stabilise Italy's financial position, but also restore political capital through a clear assumption of responsibility. It will be a careful balancing operation, but if successful, he will also be in a position to shape the future of European integration for decades to come. Not all measures the Draghi government will have to take will be popular and achieving the goal will require political stability, complicated by the raise in polls of *Fratelli d'Italia*, the right-wing

rival of League and one of few parties to stay out of government The open question then is for how long Italian populism will remain dormant.

# 6. Conclusion

Throughout this work, I have attempted to provide an explanation for what I have called the puzzle of European solidarity. Over the last decade, two major crises have marked the history of European integration: the Eurozone sovereign debt crisis in 2010 and the COVID-19 crisis in 2020. From an economic standpoint, they are two diametrically opposed events. In Chapter 1, I have discussed how both crises can be framed within a single intertwined model of change having integration and disintegration as outcomes of choices taken to resolve economic and political trade-offs. The Eurozone crisis was an asymmetric shock, the origins of which were deeply rooted in national economic policy choices. That crisis was the product of a decade of divergence, but it triggered an unprecedented convergence of the countries in the Euro-*South* towards the economic growth model of the countries of the Euro-*North*. From a political standpoint, the Eurozone crisis opened up a deep rift on the issue of solidarity within the EMU and gave birth to the powerful narrative of a continent divided between 'saints' and 'sinners', which completely paralysed the debate on EMU macroeconomic governance reform (as discussed in Chapter 2). In the third chapter of this book, I have examined the relative macroeconomic performance of the Eurozone countries that before the Eurozone crisis constituted two polar groups, a Euro-*North* and a Euro-*South*. This classification, which became prevalent during the Eurozone crisis, served as the underlying intellectual justification for the Brussels-Frankfurt consensus of forced adjustment. This exercise clearly shows how countries are in fact very mobile on that macroeconomic *North-South* scale that Eurozone crisis narrative largely portrayed as immutable. This mobility provides an interesting counterpart to the central tenets of the Comparative Capitalism school of Political Economy, and the long-standing debate about the coexistence of national diversities within the EMU.

The Comparative Capitalism literature suggests in part that different growth models behave differently when subjected to shocks within the macroeconomic boundaries set by the process of European monetary integration. While the export-oriented growth models of Germany and other northern Coordinated Market Economies (CMEs) appear to have been validated by their resilience to the sovereign debt crisis, the demand and debt-driven growth models of Mixed Economies Market (MMEs) seemed to have relegated the Euro-*South* to a vicious circle of economic and political crises. According to this school of thought, it is the very structure of the EMU that intrinsically reinforces the pre-existing differences between models of capitalism, and hence the current account imbalances observed in the pre-crisis period would be the proof that the Euro-*North* and Euro-*South* economic models had grown increasingly incompatible over time. The data presented in Chapter 3, however, highlights that growth models are far from static and can change massively. The adjustment that followed the Eurozone crisis in the Euro-*South* was painful from a social and political point of view, but it has allowed the Euro-*South* to return to a fast growth path after 2014. As a result, today Euro-*North* and Euro-*South* are almost fully aligned in terms of macroeconomic dynamics, and the underlying structure of their economic growth models has become more similar than probably ever in the past. Italy, however, is the exception to this rule. The appointment of the technocratic Monti government in 2011, while sparing the country the need to undergo an EU/IMF bailout, also implied that important structural and macroeconomic weaknesses were left unaddressed. As a result of this missed adjustment opportunity, Italy has become an outlier in today's EMU, unique in its prolonged experience of economic stagnation.

The social implications of this dire economic predicament have been severe and compounded by a structural inability to produce and retain human capital, which put Italy at risk of remaining trapped in a vicious circle of stagnation, emigration, unemployment, poverty, and inequality – even well before the COVID-19 pandemic. These economic and social dynamics in turn have produced a unique pattern of populist Eurosceptic political contestation, which reached its point of highest success in the national election of 2018. In Chapter 4 I have highlighted how the basis for the electoral success of M5S and League are deeply rooted in the Italian internal economic dualism, and how this produces a political discourse that pits inclusive populism against exclusive populism. The combination of these economic, social, and political factors imply that Italy occupies today a completely idiosyncratic position also in the ideological debate on EMU macroeconomic governance reform. Between supporters of an approach based on the principle of 'risk sharing' and supporters of a reform focused on 'risk reduction', Italian institutional experts tend to express extreme opinions in favour of more (and permanent) redistribution combined with less individual fiscal responsibility. But it is particularly interesting to note how Italy experiences a similar ideological divide within its very borders, despite being a single polity. The geographical distribution of electoral results in the 2018 election speaks of a country in which economic dualism maps clearly into different preferences in terms of aggregate fiscal policymaking and internal solidarity. The north of the country – richer and more productive – voted predominantly for a party whose fiscal policy platform envisaged a redistribution towards the right tail of the income distribution, through a reform of the tax system that reduced revenues available for the welfare state (risk reduction). The south, poorer and crippled by unemployment, voted predominantly for a party that promised a redistribution of income to the left tail of the distribution through an expansion of welfare state spending (risk sharing). These apparently irreconcilable fiscal

policy platforms were combined into a government coalition of two parties united only by their common Euroscepticism, where the conflict was resolved through an open challenge to the European fiscal rules. That is when the pandemic hit. COVID-19 was a completely different shock than the Eurozone crisis. It was a symmetric event with origins completely exogenous to domestic economic policy. From an economic standpoint, it risked triggering an asymmetric recovery that could jeopardize the convergence painfully achieved since 2010. As discussed in Chapter 5, the ability to spend to mitigate the economic effects of the pandemic varies widely across the EMU, in a pattern that depended on pre-existing macroeconomic conditions. In particular, the high public debt left as a legacy from the previous crisis was constraining the fiscal space of some of the countries most affected by the pandemic. From a political standpoint, this crisis would appear to be an uncontroversial case for deploying fiscal solidarity at the European level. Yet, reaching an agreement on this kind of solidarity has proved difficult, and the process has been largely dominated by the all too familiar political recriminations pitting the Euro-*North* against the Euro-*South*. The agreement reached in July 2020 by the European Council is historic because it overturns in one step two historic taboos of European integration (large-scale issuance of EU debt and explicit net fiscal transfers across countries). But the agreement stops short of even partial (and even one off) debt mutualisation and the final compromise greatly reduces the share of common issuance that will finance 'federalist' spending on genuinely European public goods.

Why was even an unprecedented economic shock like COVID-19 not enough to produce a genuine shift to a new consensus of European solidarity, even after a decade of massive macroeconomic and structural economic convergence, and even at a time when preferences on the structure of EMU macroeconomic governance appear remarkably aligned across the

EMU? This is the puzzle central to this work. The answer, I have argued, lies in Italy. With a debt expected to reach close to 160% of GDP, a stagnant economy, and a still sizeable populist Eurosceptic constituency, the post-COVID world will be difficult for Italy, from both an economic and social point of view. At the same time, the fact that Italy embodies a case of failure to adjust within the Eurozone makes its political position extremely weak. Italy today does not have the political capital needed to legitimately claim Europe fiscal solidarity as an antidote to the risk of undoing a painful economic adjustment, because Italy never did that adjustment. Decades of anaemic growth and stagnant income dynamics have produced an exceptionally successful Eurosceptic political rhetoric in Italy. But on closer inspection, Italian Euroscepticism is associated with a profound misunderstanding of Italy's position in today's Europe. There was a time when Italians believed with conviction that Italy needed Europe and its 'external constraint' to corroborate difficult internal economic policy choices and address key economic issues for the country. That perception quickly faded after joining the single currency. Since then, the Italian experience in the Euro has been (as effectively summarized by Erik Jones in a 2018 article) a case of cognitive dissonance. Italy is at the intersection of the two extreme positions identified by Martin Sandbu in the analysis cited in the second chapter of this book: it has experienced economic decline, impoverishment, and disenfranchisement (like the countries of the Euro- *South*), all while remaining a net creditor in the EU budget and EMU bailout mechanisms (like the more prosperous countries of the Euro-*North*). Over time, this inconsistency has fuelled a strong Eurosceptic narrative, rooted in a discourse according to which Italy owed nothing to Europe, but rather it was Europe that could not afford the failure of Italy. This is a recurrent theme in Italian foreign economic policy: back in 1978, EU affairs scholar Alan Posner was already arguing that in the history of its interaction with the international political economy 'one of the main negotiating devices [of Italy] was the fact

that his creditors could not afford the country to default'. A more recent variation on this theme was worded by Italian former Foreign Affairs Minister Di Maio in a tweet dated 19 May 2020, where commenting the difficulty to strike a compromise on a EU recovery fund, he stated that 'in the EU there are still countries perched on their twigs, but they must understand that Europe cannot do without Italy. Because if the trunk of a tree is broken, the branches also fall. And nobody is safe'. In 2021, this conception of Italy's role in Europe seems hardly tenable, and the country's economic, political, and ideological idiosyncratic position have put it at the core of an economic and political dilemma for Brussels. On the one hand, in the light of post-COVID economic data, Italy's permanence in Europe could have been seriously jeopardized by a lack of agreement on fiscal solidarity. On the other hand, reaching this agreement proved particularly difficult, precisely because the country needing it most was Italy – the embodiment of missed adjustment. As part of the Next Generation EU package, Italy is the only net contributor to the EU budget that becomes a net beneficiary of the grant component. The agreement is not the Hamiltonian moment that some had invoked but, in the light of the data presented in this book, it is certainly an act of faith in the country that today risks becoming the EMU's weakest link in the country.

For the Italian government – now led by former ECB President Mario Draghi – this creates the responsibility to ensure that trust has not been misplaced: the risk is not just to waste EU funds, but to kill the first timid step in the direction of that fiscal union that Italian politicians are so eager to invoke as panacea for the country's predicaments. The situation of public finances after the pandemic will make it very difficult to ensure the sustainability of public debt in the long term without a significant pick-up in growth. The post-COVID reconstruction requires a change of perspective, which puts growth really at the centre of the agenda for the

next few years through an organic and articulated approach to investment in areas that can ensure sustainable growth in the long term. This will require investing in production and above all in the retention of human capital, creating the conditions for the investment in education to become profitable for those who undertake it and for the education system to actively contribute to intergenerational mobility – which is currently not the case. Investing in knowledge is also key to solving the problem of low productivity that is endemic of Italy, and which is also crucial in explaining the low growth in wages. A generalised digital divide problem emerged strongly during the pandemic, in relation to distance learning, which proved extremely difficult due to both an uneven diffusion of technologies on the territory and a reduced ability to use them. The inability of companies to fully exploit digitalization processes and the ICT revolution of the production chain is an important factor in explaining low productivity, also linked to the fact that Italy has a particularly high percentage of under-skilled workers for the work they perform. In this regard, it is essential to strengthen training systems – of workers, but also of entrepreneurs who, as we have seen, are often reluctant to embrace innovation, particularly in small entrepreneurial realities – and active labour market policies to guarantee to those who remain temporarily out of the job market an upgrade of their skills that allows a productive return. These are areas in which the country was already lagging behind before the COVID-19 crisis, as evident for example in the historically high incidence of long-term youth unemployment, but which become even more important in light of the employment dynamics induced by the pandemic. A reform of the social safety nets system that puts the worker (rather than the workplace) at the centre would be necessary to prevent the CIG from being used disproportionately by low-productivity firms, with the result of perpetrating inefficient allocations on the labour market. At the same time, the pandemic has shown how large sections of employment are not adequately covered by the existing

system of social safety nets, which is not generous with self-employed and self-employed workers (despite these accounting for an increasingly large share of employment. COVID-19 is not a 'great equalizer' and has penalized already more disadvantaged working categories, with the risk of aggravating existing economic disparities. The pandemic should be an opportunity to review the structure of welfare state policies that are effective in reducing inequalities of income and of opportunity. The current system is unfair on the side of taxation, which weighs significantly on the middle class, but is at the same time not effective in redistributing income to the poor, especially when also young. Past anti-poverty measures have been fragmented, and in some cases not targeted to those who need it most. In particular, an issue made urgent by the pandemic but deeply linked to the wage and production dynamics of recent years is that of working poverty, which mainly affects young families with discontinuous and poorly paid careers. The working poor do not benefit from a measure such as the Citizenship Income (which is aimed at the unemployed) or from anti-poverty measures experienced in the past (whose eligibility criteria were often too stringent to guarantee that could punish cases of families in conditions of under-employment or occupational poverty) and in-work poverty is unsurprisingly tied with informal employment and undeclared work which, in addition to depriving the state of legitimate tax revenues, penalize the weakest in emergency situations.

Because of all the idiosyncrasies discussed above, Italy has become the fulcrum of an economic and political conundrum that may make or break the EMU going forward. Its continued permanence in the euro is going to be increasingly difficult, absent a more significant acceptance of fiscal solidarity through either debt mutualisation, long-term transfers, or more implicitly through major changes to the rules of the Stability and Growth Pact (SGP). At the same time, any agreement on such level of fiscal solidarity within the EMU

is and will be especially difficult, precisely because the country that needs it most is Italy. The fact that the Eurozone crisis started in Greece – a country that had been deliberately misreporting its fiscal numbers – resulted in the Euro-*North* being able to frame the whole Eurozone crisis as a 'fiscal crisis' to their domestic audiences, when in fact this was only true for one country. Similarly, the fact that the EU COVID-19 storm touched ground in Italy and that Italy was the first country to call for EU fiscal solidarity in the form debt mutualisation, provides plausible deniability for the 'frugal' front to dismiss the requests for EU-level fiscal solidarity as if it was illegitimate moral hazard from the 'sinners' – when in fact, with the exception of Italy, the Eurozone *South* has adjusted its economic growth model so much that in 2019 it was closer to the *North*'s economic model than ever since the creation of the EMU. Given this background, the fact that Italy switches from being a net contributor to the EU budget to being a net beneficiary of a fiscal transfer under the agreed Recovery and Resilience Facility (RRF) appears to be a more relevant measure against which to assess the degree of solidarity inherent to the Next Generation EU package than the (lacking) agreement for debt mutualisation. It is also the measure against which the success of the RRF will be evaluated and the ambition of any future EMU-wide initiative will be set. As such, it is hard to overstate the responsibility and the centrality of the role that Italy will have in setting the direction of travel for future EU integration (or dis-integration). Writing in 1956, Myrdal argued presciently that the reason why efforts towards international integration in Western Europe had achieved so little was that "it was assumed international integration could be attained without the basis of solidarity that national integration required, and without accepting the consequences of such widened solidarity"[232]. The degree of redistribution implied by the

[232] Page 51 (Myrdal, 1956)

mechanism of countercyclical fiscal stabilization can hardly be achieved without a pre-existing predisposition to solidarity among the participant, but the traditional understanding of solidarity in the European Union was with reference to the idea of *inter*-national solidarity, while the kind of solidarity required for a fiscal and economic union is more similar to the *intra*-national solidarity that exists *within* communities or nation states. The latter requires a much deeper degree of self-identification as members of a same community – in this case, Europe. Italy exemplifies this very clearly, but it also shows the perils inherent to letting unaddressed economic dualism morph into economic dependence. COVID-19 crisis has highlighted deep tensions within Italy, which revolve around the same political contestation of economic solidarity that we see at play at the EU level. Restarting growth in after COVID is therefore an economic and social imperative, for Italy, to preserve its national unity. But at this historical juncture, it is also a political imperative, as it will decide the weight and role that the country will be able to aspire to within the EU in the coming years. Failure will turn for the rest of the EMU what the Italian *Mezzogiorno* has represented for the rest of Italy for decade: a case of failure to adjust within a rapidly changing economic and political regime.

# APPENDIX

*Table A 1 Indicators used for North/South definition*

| Indicator: | Operationalised as: | South definition | Source /Notes | Available |
|---|---|---|---|---|
| Current Account | 3-year backward moving average of CA (%GDP) | < 50-th pc | AMECO | 1960-2017 |
| International Investment Position | NIIP (% GDP) | < 50-th pc | IMF | 1980-2017 (1998 GR; 2001 IE) |
| Export market shares | 5-year percentage change of export market shares measured in values | < 50-th pc | AMECO | 1960-2017 |
| Nominal Unit Labour Cost | 3-year percentage change in nominal unit labour cost | > 50-th pc | AMECO | 1980-2017 |
| Real Effective Exchange Rate - CPI | 3-year percentage change of the real effective exchange rates based on HICP/CPI deflators | > 50-th pc | Darvas (2012); updated version as of 28 June 2018 - The measure used in MIP is relative to 41 trading partner; we use the data in Darvas (2012), relative to 67 partners, because time series is longer | 1960-2017 |
| Private sector debt | private sector debt (consolidated) in % of GDP | > 50-th pc | Eurostat; we construct total private debt as the sum of debt securities and loans liabilities of households and non-financial corporations | 1995-2017 (2001 IE) |
| Private sector credit | private sector credit flow in % of GDP | > 50-th pc | Constructed as the change in credit/GDP ratio, obtained using BIS data on nominal credit from banks to private sector and IMF data on nominal GDP | 1963-2017 (1970 IT) |

| | | | | |
|---|---|---|---|---|
| House prices | year-on-year changes in house prices relative to a Eurostat consumption deflator | > 50-th pc | Eurostat | 2001-2017 |
| General government debt | general government sector debt in % of GDP | > 50-th pc | AMECO | 1970-2017 (1973 PT, 1975 NL, 1977 FR) |
| Unemployment | 3-year backward moving average of rate | > 50-th pc | AMECO | 1960-2017 |
| Youth Unemployment | 3-year p.p. change of youth unemployment rate | > 50-th pc | AMECO | 1991-2017 (1994 AT, 1998 GR) |
| Activity rate | 3-year p.p. change in the activity rate | < 50-th pc | Eurostat | 1996-2017 (2007 FR, 1998 AT) |
| Financial sector size | Financial sector liabilities | > 50-th pc | Eurostat; constructed as total financial liabilities of Monetary Financial Institutions, Other financial Intermediaries, Insurance Corporations and Pension Funds | 1995-2017 (2001 IE) |

Source: Authors calculations based on **Invalid source specified.**

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