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ISOLATION OR CONVERGENCE:

ITALY ON ITS WAY TO THE EUROPEAN COUNCIL MEETING OF JUNE 2018

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1. Setting the stage for the summit of June 28-29, 2018

The reform of the European Union and of the euro area has been at the center of the European leaders' reflections ever since the most critical phases of the 2009-2010 crisis. At the time of the first rescue of Greece (spring 2010), the European Commission and a Task-Force established ad hoc and headed by President of the European Council Hermann Van Rompuy advanced large-scale proposals that led to the adoption of the European Semester, to the outline of the new Stability and Growth Pact, which focused on strengthening the public debt rule, and to the first examination of macroeconomic imbalances. These initiatives then resulted in European directives and regulations, such as those contained in the Six Pack and the Two Pack, as well as in the international treaty known as the Fiscal Compact (March 2012). Simultaneously, the desire to avoid a new "Greece-case," that is, the loss of control of national public accounts and an ineffective European reaction, led to the construction of temporary assistance mechanisms for euro-area countries (e.g. the EFSF) and resulted in the establishment of the European Stability Mechanism, which was later redefined by means of an international treaty concurrent with that of the Fiscal Compact.

Together with the initiatives launched by the European Central Bank (ECB), under Mario Draghi's presidency, between the end of 2011 and the first months of 2012 (LTRO) and culminated with the affirmation of the irreversibility of the euro and with the related adoption of the OMT (summer 2012), such reforms in European economic governance have deeply influenced the EU's institutional framework, conditioning the entire crisis management strategy of the euro area. However, the reforming process has not induced a significant convergence between national economies, something that represents a fundamental requirement for the realization of an optimal currency area. Moreover, the current governance framework has not eliminated the risk of "redenomination" or "convertibility," that is, the involuntary exit of one of the member states from the monetary union. The Greek problems of 2010 showed the concreteness of this risk, which reappeared in a more dramatic form during the new Greek crisis in the summer of 2015 and which is present today due to the political-institutional risks coming from Italy (cf. below, section 5).

After the approval and implementation of the first two pillars of the banking union (2012-2014) and the Four Presidents' Report (2012), the reforms of the euro area entered a phase of relative political-institutional

inertia that lasted until the middle of 2017. During that phase the European institutions made important contributions, such as the Five Presidents' Report (middle of 2015), which envisioned a process with multiple stages: the completion of the banking union and the implementation of the financial one, the gradual fiscal union designed to result in a political union. Despite the efforts of the European Commission, these guidelines remained a dead letter for at least two reasons. The first is that the various forms of quantitative easing introduced between the fall of 2014 and the spring of 2016 by the ECB - after years in which there was a decline in liquidity provision to the economic system (July 2012-September 2014) - ended the long European macroeconomic crisis of 2011-2013 and mitigated the financial emergency of the euro area. The second reason is that the European institutions understood that many of the previous governance reforms could not be implemented. In particular, the more fragile economies of the euro area were not able to carry out an appropriate adjustment of their public debt stock.

The fact is that convergence between euro-area countries has not progressed and the fragmentation of national financial markets has increased. The need for reforms for greater integration remained latent until the re-emergence of the concrete Grexit threat (August 2015) and Britain's traumatic choice to abandon the EU (June 2016). Only the election of Emmanuel Macron as President of France (May 2017) and the rather strenuous re-confirmation of Angela Merkel as German Chancellor (September 2017 – March 2018) ushered in a phase of political stability in the two largest euro-area countries and allowed for the recommencement of more open dialogues between Brussels, Berlin and Paris. The long phase of stagnation that European economic governance went through before May 2017 thus transformed into a multitude of proposals. The European Commission was particularly active in the second half of 2017 (cf. below, section 3).

2. The institutional steps preceding the upcoming summit

These events charged the summits of 2018 with excessive expectations. On the occasion of the Eurosummit of December 2017, the leaders of the nineteen euro-area countries declared: "The improved economic situation provides an opportunity to discuss the challenges ahead and the ways to tackle future crises (…) a strategic question, therefore, is how to ensure that we, the Member States and the monetary union as a whole, have the appropriate means to face potential shocks." These finalized actions later transformed into a specific allocation of tasks for the relevant ministers of the Eurogroup and ECOFIN, who "should concentrate on areas where the convergence of views is the greatest. Progressing step-by-step on issues such as the completion of the Banking Union, and the transformation of the ESM into the so-called European Monetary Fund, should significantly strengthen the resilience of the EMU". The new president of the Eurogroup, Portuguese Finance Minister Mário Centeno, has had to collect the results of the activities performed by the components of the Eurogroup and ECOFIN in order to later refer them – as a guest– to the members (heads of state and of government) of the European Council and of the Eurosummit in the various meetings of 2018. The agenda, established at the end of 2017, envisioned that the Eurosummit members would enter into a live discussion starting with the meetings of March and June 2018.

During the preparation for the first of the planned meetings, it emerged that various issues that the finance ministers were dealing with had been so divisive as to gather only a limited degree of consensus. It was thus assumed that in order to achieve significant progress, "the direct involvement and the guidance of leaders" were becoming necessary. The Heads of State and government therefore decided to take over the whole agenda that was announced at their meeting of December 2017. The agenda could be summarized in two blocks of interconnected questions. The first block, which is related to the capacity of the European budget, responds to three questions: (1a) is it opportune to anticipate that a part of the EU budget is reserved for the Eurozone?; (1b) should that part remain a component of the EU budget or should it acquire a large degree of autonomy so as to serve as an independent instrument?; (1c) what objectives should that "euro-area budget" have (e.g. macroeconomic stabilization, support for investments and employment, implementation of structural reforms)? The second block, which is related to the promotion of effective policies, is instead characterized by four questions: (2a) is it opportune to promote, at a European level, structural reforms that favor competitiveness and growth?; (2b) is it desirable to reduce imbalances among member states so as to

guarantee a long-lasting convergence? (2c) should more be done to guarantee budget responsibility?; (2d) which instruments should be used to achieve this goal?

The discussions that took place in March 2018 were based on a note that President Donald Tusk had sent to the Eurosummit members and that was oriented to emphasize precisely the existing link between budgetary capacity and a sound and responsible elaboration of policies. The conclusions that Tusk drew from the meeting sounded very optimistic: “"We are experiencing the most favorable economic situation since the introduction of the euro. It is therefore the best time to reflect strategically on our long-term ambitions.” Yet, the partial results obtained by the nineteen leaders of the euro-area countries were modest. In particular, the first issue discussed concerned question 1a: Is it opportune to anticipate budgetary capacity for the euro zone? The lack of sufficient consensus forced the leaders to turn their attention to the agenda’s political priorities, or rather, “to the reinforcement of the banking union and to the reform of the European Stability Mechanism.” However, a decision was not reached in this case either. The choices were therefore postponed for the summit of June 2018.

3. The unresolved problems of European economic governance

The agenda and possible solution set by the European Commission in the second half of 2017 offer an articulated list of the many problems of economic governance that have remained unsolved in the euro-area framework. Without claiming to be exhaustive, here we state five problems that we think are of particular importance: (i) the introduction of a public backstop in the resolution process of bank crises; (ii) the construction of the European Deposit Insurance Scheme (EDIS) for banking deposits not exceeding 100,000 euros; (iii) the creation of countercyclical funds and stabilization funds in the event of symmetric and asymmetric shocks; (iv) the transformation of the ESM into a European Monetary Fund; (v) the creation of a European Finance Ministry.

Each of these issues leads to further problems. The following are just two examples. The construction of EDIS is tied to the reduction of risks in bank balance sheets and therefore requires the examination of the procedures for liquidating non-performing loans and the introduction of diversification constraints for banks holding of government bonds of their country; on the other hand, such constraints require the creation of an asset that is devoid of risks in the European financial markets. The possible transformation of the ESM into a European Monetary Fund would modify the competencies of the ESM and raise the problem of the separation of tasks between the new Monetary Fund and the Commission. In turn, these new problems require a discussion on bailouts and on the possible introduction of quasi-automatic restructuring mechanisms for public debt of member states in need of entering a European assistance program.

The aim of this paper is not to go into details of points (i)-(v) and the problems related to them. It is enough to underline that in the first five months of 2018 the repeated discussions between Brussels, Berlin and Paris led to the emergence of profound differences that separate the German and French positions on a significant part of these aspects. Thus, while Macron conceives the new European Monetary Fund as an ESM that is reinforced in its original task of managing financial and state crises and as an essential technical branch of the future European Finance Ministry, Merkel sees this fund as a new intergovernmental fiscal authority that decides – within predefined rules – the restructuring of public debt of countries in difficulty that weakens the role attributed to the European Commission and to the future European Finance Ministry. The only element of partial convergence between the two countries concerns the introduction of a public backstop (without the EDIS) in the second pillar of the banking union.

The aforementioned comments are enough to formulate a prediction: it is unlikely that at the end of June the European Council meeting and Eurosummit will mark substantial progress in the evolution of European economic governance. The ESM will be entrusted with the function of the public backstop in the processes of banking resolutions, subordinating it perhaps to controls on appropriate risk reduction in the banking sector. A compromise based on a list of general shared principles will also be reached for other institutional issues (e.g. the partial function of crisis management performed by the future European Monetary Fund and

the constitution of a European fund for fighting unemployment). Such considerations do not imply, however, that the meetings of the European Council and Eurosummit will not have an impact on the future of European economic governance: albeit limited, the compromises reached will condition the future institutional framework of the banking and financial union and the distinction between the future tasks of the ESM and those of the Commission. In fact, they will modify the pre-existing relationships between risk-reduction and risk-sharing as well as between centralized and decentralized decisions. Furthermore, these meetings will deal with issues that, although related to governance, fall outside the strictly defined economic field. As we will soon specify (cf. section 4), in order to identify areas of convergence with France, Germany is offering cautious openings with respect to European investment projects; and both Germany and France appear to be interested in making progress in the management of immigrants and in the field of the common European defense.

These comments allow us to advance a hypothesis on the probable outcome of the incoming European Council meeting and Eurosummit with respect to economic, as well as non-strictly economic, governance (cf. section 4). In the two subsequent paragraphs (cf. par. 5 and 6) we will try to reexamine the Italian problems within the European context and identify the opportunities.

4. The proposed solutions

The negotiating positions of the various governments of the euro area on the reform of European economic governance and the corresponding proposals of the European institutions can be ordered along three principal guidelines:

(4.1) risk reduction and risk sharing both in the 'weak' form of insurance and in the 'strong' form of mutualization;

(4.2) the search for a minimum convergence between euro-area member states in order to bring the euro area itself closer to an optimal currency area;

(4.3) the preference for procedures of political cooperation that are indispensable for exercising shared sovereignty in fields that are not strictly economic (security, defense, foreign policy), but that are nevertheless consistent with closer economic-political integration.

The conflicting and complementarity relationships between risk reduction and risk sharing have been evident in various phases of the euro-area crises. At the peak of the crises, tensions between the two poles were often overcome with the parallel construction of governance mechanisms. The new Stability and Growth Pact and the Six Pack, for instance, have accentuated the components of risk reduction, imposing severe adjustments with respect to the fiscal and macroeconomic imbalances of a country. On the other hand, the activation of common funds, like the EFSF and the ESM, or the LTROs by the ECB, have introduced a prevalent component of risk sharing by permitting countries or institutions to help member states or European banks in difficulty.

Once out of the most critical junctures, the precarious equilibrium between risk reduction and risk sharing has often morphed into an insurmountable obstacle to progress in European economic governance. An emblematic case is represented by the third pillar of the banking union process. EDIS continues to be blocked because the central countries of the euro area have demanded that risk reduction, embodied by the liquidation of NPLs and by the reduction of national government bonds in bank portfolios, precede risk sharing, which is represented by the gradual construction of a common insurance fund among banks from various countries. On the contrary, peripheral countries have maintained that they would accept stricter European rules for the reduction of bank risks only if there was a pre-emptive launch of the European guarantee fund.

This example shows that in the absence of a crisis the risk reduction-risk sharing polarity generates a high probability of stalemate in the evolution of European economic governance. Every significant factor of tension makes it convenient for the most solid countries of the euro area to decentralize decisions at the national level, leaving the solution of the problems of coordination with the more fragile countries to the distortive discipline of the market. The proof is the impact produced by the recent electoral results in Italy and by the consequent formation of a "sovereignist" government. The recent political developments help explain why Brussels, Berlin and Paris are finding it so difficult to identify a common platform for relaunching European economic governance at the incoming summit. If the difficulties become insurmountable, both Germany and France might be tempted to abandon Italy to itself.

Such a negative conclusion is attenuated by the fact that in order to avoid populist contagion in the euro area, European institutions and the two main euro-area countries may want to avoid that the Eurosummit and the European Council meetings are perceived as unsuccessful. The proof is that either the EU Commission or Merkel-Macron recently proposed the institution of new European support funds for national reforms and the implementation of investments. The dimensions of the constituting European funds, which should be added to the countercyclical ones, may be very different and are – anyway – not yet determinable with precision; their effective functioning also remains to be specified. However, for the first time in the history of the euro, Chancellor Merkel has mentioned a European fund that can finance innovative investments allocated in an asymmetrical manner, that is, concentrated in peripheral countries so as to facilitate convergence processes in the euro area.

In relation to the three political categories underlying the reform of the euro area (as listed at the beginning of this chapter: risk reduction vs. risk sharing; countries' structural convergence; political objectives of economic integration), it has been possible to evaluate with great clarity the Franco-German position after Chancellor Angela Merkel and President Emmanuel Macron signed on June 19, 2018, two weeks before the European Council meeting, the "Meseberg Declaration", which intends to "renew Europe's promises of security and prosperity." The joint declaration does not distance itself from the three political categories that we have identified, but rather accentuates the function of the countries' preventive stability control, assigning the competence to the European Stability Mechanism and prescribing that such control need to work through market discipline. The latter is rendered more effective by the application of an unprecedented procedure of public debt restructuring. Besides this form of risk management, the declaration raises the issue of the structural convergence of the economies, which should be accompanied by European funds that can be activated starting in 2021 and that are dedicated to the objectives of competitiveness and stabilization. Such funds also contribute to strengthening the signal of political integration through the availability of a euro-area budget that can provide resources ad hoc and that would therefore reinforce the political nature of the euro-area governance.

5. The Italian situation

With reference to the three guidelines for the negotiations at the end of June, which are specified in the previous section (cf. points 4.1-4.3), and in view of the political preferences expressed by the current coalition government, Italy presents three negotiating positions that differ from the past tradition and that can prove to be an impediment to an agreement:

(5.1) due primarily to its abnormal public debt to GDP ratio and to the remaining fragility of its banking sector, Italy is experiencing the greatest European pressure in terms of risk reduction;

(5.2) due primarily to the stagnant average dynamics of its various forms of productivity and to the inefficiency of many of its social-economic institutions, Italy reports one of the lowest degrees of convergence compared to the central countries of the euro area;

(5.3) given the new government's inclination for retaining sovereignty and its choices on immigration and international relations, Italy is suffering one of the worst trade-offs between European cooperation and the willingness to partially relinquish national sovereignty.

The stalemate in the evolution of European governance and points (5.1) – (5.3) underline that Italy today is not in the condition to begin an efficient battle for greater risk sharing or to promote a stronger cooperative attitude toward European institutions and other member states. Furthermore, the government's programmatic declarations indicate a backward movement of the structural reforms (firstly the Jobs' Act and the pension system reform), which instead should lead to greater convergence with the economies of the partner countries.

Based on these three political constraints, Italy seems to be left with only one opportunity for instituting a positive interaction with the European institutions and with the other euro-area countries: pursue the convergence of its economic structure and use the funds for investments and reforms that will be on the table at the European Council meeting at the end of June. After all, until the structural divergence between the euro-area economies is not reduced below a certain level, it would be impossible to implement greater risk and cost sharing.

In the case of Italy, the essential obstacle to converging with the other large European countries preceded the constitution of the euro. The dynamics of labor productivity and, more specifically, the dynamics of the total factor productivity have been stagnant since the early 1990s. Together with the significant ageing of the population, such dynamics have drastically reduced the economy's growth potential and have accentuated the imbalances in the distribution of income and wealth between social aggregates and between territorial areas. These imbalances were not corrected, not even in the short term, by public spending and by the (excessive) abundance of bank financing to the 'real' economy. Given the abnormal amount of the public debt inherited from the 1980s and a rigid and inefficient welfare state model, there have been only limited margins of discretion in the allocation of public spending; the unavoidable macroeconomic adjustments only resulted in the collapse of public investment. On the other hand, the allocation of banks loans did not favor innovative private investments but too often contributed to maintaining inefficient firms above the water. That is how a vicious cycle was created between structural supply-side weaknesses and a lack of support for the aggregate demand, which led to the alternation of stagnation and recession.

Here it is not possible to elaborate on the specific causes of the Italian productivity slowdown in the middle of the 1990s. What is certain is that the change of the technological paradigm and the opening of international markets have exposed the organizational inefficiency of Italian business. Firms are overly squeezed to small size and overly dependent on bank loans. The shortcomings in the formation and the use of human resources also emerged very clearly. Adapting to the new global competitive environment was made more problematic by the rigidity of Italian service markets, by the persistence of rent-seeking positions, by excessive bureaucratic burdens and by the low quality of Italy's public administration. In sum, there has been a fall in competitiveness that is mercilessly certified by a few statistics: between the beginning of 2000 and today, Italy's per capita income has drastically declined with respect to the euro-area average, the share of investment on the GDP has diminished by several percentage points and the share of low-skilled workers has increased with respect to medium-high-skilled workers.

6. The opportunities for Italy

In order to get out of the non-convergence trap, Italy has an opportunity to use those Funds for national reforms and innovative investments that should be discussed at the coming European Council meeting. However, this option should not only imply the access to new European financing to increase the endowment of tangible and intangible capital. More importantly, it has to serve to improve the quality of Italy's institutions and to strengthen firms' structure and organization. The Five Presidents' Report defines institutional quality as a "process towards more resilient economic structures"; the new technological trajectories turn into innovations that always have an important organizational component and that

consequently require business dimensions that are sufficiently large. A virtuous interaction between reforms and innovative investments would lead to a more efficient allocation of human and capital resources among institutions and firms. In Italy this requires a profound transformation of the institutions and the bureaucratic apparatuses and the removal of the main endogenous (an overly rigid ownership structure) and exogenous (overly 'banco-centric' financial markets) constraints, which impede the dimensional growth of successful firms.

In order to produce an effective convergence through the relaunch of various forms of productivity, reforms and investments should not be evaluated and controlled only on an aggregate level. In fact they are relevant if efficiently enacted on a microeconomic level. This particularly applies to the Italian case, which is characterized by a very high variance between businesses, between institutions and between territorial areas. Consequently, the access to the new European funds needs to be based on well-defined and fully shared general strategic objectives, effective incentive schemes for various economic players, careful ex ante microeconomic monitoring of the feasibility and impact of each specific project and efficient ex post verification (both at central and local level) of the actual results. If Italy were able to design this combination of national reforms and innovative investments and to show its potential effectiveness for the actual implementation of convergence processes within the euro area, Rome could have access to the new European funds on a relevant scale. We believe that it would be realistic to reckon with funds that in the near future would be able to finance reforms and investments for an amount close to 4-5% of the Italian GDP.

Recent history, however, has shown that we should be cautious with respect to the positive impact of the European projects for investment support or financing. In this regard, it is enough to remember three negative situations. The first is related to the distorted use of European regional funds that Italy and other EU member states systematically practiced in the past. The second refers to the inefficient national allocation of substantial financial resources that were put at the disposal of various peripheral countries (Greece, Spain and Portugal) between the start of the monetary union and the 2007-2009 international financial crisis. The third is based on Italy's improper use of the "flexibility-clause" in its public balance, allowed for by the European Commission Communication of January 2015. Italy was not able to fully utilize all the related resources it obtained in order to carry out additional investments that are essential for its growth.

It is clear that the use of the new European funds for national reforms and innovative investments should be based on rigorous controls that will prevent the reappearance of the three abovementioned situations. As a mere example, the following is a list of six conditions that – if met – would allow for the implementation and strengthening of the proposed scheme:

(i) Verification carried out by the European Commission to make sure that the Stability and Growth Pact and the National Reform Program, as agreed upon within the European Semester in order to improve the country's institutional quality, are actually accomplished;

(ii) If condition (i) is satisfied and if – in particular – the actual evolution in the quality of the institutions satisfies the desired improvement, the Commission can adopt an "Italy Reform Project" based on an action plan and specific "micro" interventions;

(iii) The latter are conceived and proposed by the Italian authorities. However, in order to be financeable with European funds for reforms and innovative investments, they have to get through the following sieve at the European Commission, which, besides being based on assessments of merit, requires Italy to respect the rules and governance of the euro area;

(iv) If condition (iii) is satisfied, the European institutions will divide the project into stages and will authorize the use of the funds for the corresponding tranche, conducting (in cooperation with national and local Italian authorities) will systematically and rigorously monitor the implementation of the related reforms and/or innovative investments and the appropriate use of the related European funds;

(v) The positive result of this monitoring is a necessary condition for acceding to the next stage and to the related tranche of financing;

(vi) During the accomplishment of the “Italy Reform Project”, European supervision of the national banking sector is strengthened so as to allow for an adequate information on the funds track and on tax controls.