Global economy

Italy and the euro – are investors lost in translation?

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- Italy leaving the euro would be very different from the UK leaving the EU. The costs of any country leaving a monetary union are extremely high.
- Italian savings are far more important than Italian borrowings. That creates a strong practical argument against changing the currency.
- Bond market moves do not kill monetary unions. Bank runs kill monetary unions. If people thought Italy was going to leave the euro, they would be taking money out of banks quickly. This is not happening.
- The high costs of exiting the euro include: banking runs; a short-term lack of lira (it takes time to print); government and some corporate defaults; credit problems for Italian importers; potential exit from the EU; social instability.

Italy's bond market swung wildly after Italian President Sergio Mattarella refused to accept a proposed finance minister, Paolo Savona. President Mattarella was worried about Savona's past comments on Italian membership in the euro. Savona had written about preparing to exit the euro.

Mattarella's decision led to talk of an Italian exit. Investors worried that any future election would be a vote "for" or "against" the euro. This may be an example of a "searing analogy." If an event is bad enough, the memory of it is "seared" into investors' minds. Investors view any slightly similar future event as a repeat of the past crisis. In this case "it is always the eve of the Greek crisis." Traders and investors who had been through the Greek crisis were dramatizing an Italian problem that was not as bad.

A new Italian coalition government of the League and Five Star is not a natural alignment. The original policy programs of the two parties are far apart. However, both parties have clearly said that they are committed to the euro. The new finance minister, Giovanni Tria, said that no political force wants to exit the euro. The message (in Italian) and logic against leaving is very clear. International investor sentiment, with the "searing analogy" in mind, may not always reflect this.

Italian households have EUR 9.6trn of assets. There is EUR 2.3trn of public debt. That is a very strong reason to vote to defend the value of savings, and not to devalue to help borrowers. Italians probably prefer their assets being in euros rather than new lira. Italian investors own most of Italy's government debt (almost 70%). The Italian central bank runs the ECB's Italian bond buying.

While markets may remain volatile, Italy's membership in the euro should not be a concern for investors. Fiscal policy and its impact on the markets and economy is a more relevant concern. How the new Italian government changes the outlook for European reform is also important. An Italian exit from the euro, or any country's exit from the euro, is not likely. Monetary unions are like "Hotel California." Members can check out, but they can (almost) never leave (per the Eagles song, 1976).

What would happen if Italy left the euro?

The huge costs of leaving the euro help to explain why it is unlikely to happen. The costs help to explain why parties are keen to say they do not wish to leave the euro. The economics of this are nothing like the UK's departure from the EU. The economics of leaving a monetary union is probably most similar to hyperinflation (but worse). Like a monetary union exit, hyperinflation destroys the value of money.

If Italian citizens believe that Italy will leave the euro, they will take euros out of Italian banks before it happens. Leaving the euro would convert euros into new lira. Sensible people will assume that the euro would be worth more than the new lira. People would try and keep their money in euros. People could move euros from Italian banks to other euro area banks. People could also take euro bank notes out of their bank and hold the cash at home.

This is a bank run. Bank runs and capital flight were behind every monetary union collapse in the last century. It is the cost of bank runs that kills monetary unions. There is no sign of a bank run in Italy today. This signals that Italians see a very low risk of Italy leaving the euro.

The risk of a bank run also explains why a negotiated exit from the euro cannot happen. If an Italian government said it was going to talk about leaving the euro over six months, bank depositors would react and move their money on day one. The Czechs and Slovaks announced a six-month negotiated end to their monetary union in January 1993. The union only lasted a matter of days. Money flowed from Slovakia into the Czech Republic immediately.

The time between the start of a bank run and Italy leaving the euro would drive how much wealth the economy would lose. It would also determine how badly the bank run would damage the banking system. In addition to the political decision, a bank holiday would have to be declared to slow the bank run as the government introduces the new lira. It would also be necessary to have border checks to stop people carrying cash out of Italy. People carrying suitcases of cash across borders were a problem in the Czech-Slovak breakup of 1993 and in the Austro-Hungarian breakup of 1919.

From a practical point of view, Italy could not introduce new lira bank notes at once. Printing bank notes takes time. This was one of the key reasons why there was a two-year gap between the start of the euro in 1999 and the use of physical notes and coins in 2001. One option would be for the government to use an electronic new lira. The government might allow people to use euro coins for small transactions. There would be a period of economic chaos while the government did this.

To be practical, the Italian government and some Italian corporates would have to default on their debt. The Italian government would no longer get tax revenues in euros. Italian companies that rely on Italian customers would be in a similar position with regards income. Borrowers would convert debt into new lira at an official exchange rate. The currency borrowers owed could then match the currency they earned. Lenders would treat this as a default.

Default could be a smaller problem for the Italian government than for some Italian companies. Italy runs a primary surplus. This means the government could fund spending without the need to borrow, were it not for interest payments. However Italy might find fiscal stimulus difficult in the wake of a default. There would also be a negative wealth effect for domestic bond holders in Italy which would have economic implications. Bond holders would go to bed with euro bonds, and wake up with new lira bonds that have substantially less spending power.

Larger Italian companies could manage a euro exit if they had sales outside Italy. An Italian exporter to Germany would still earn euros, and could use those euros to pay euro debt. An Italian company that had mainly Italian customers but had borrowed euros under international law, would have problems. Such a company would have lira income and euro debt. Smaller companies might find it more difficult to manage a default. Credit required for international trade would be harder to get. Capital controls could further complicate this. If companies could not import things that they needed, the Italian economy would suffer even more.

Investors would question whether Italy could stay part of the EU if it left the euro. Leaving the euro breaks the Treaty of Rome – the "constitution" of the EU. Legally a country cannot leave the euro. The Maastricht Treaty makes the monetary union legally "irrevocable." Italy would have the economic problems of abandoning its currency, and the additional economic problems of leaving the EU. The consequences of leaving the EU would probably be worse for Italy than for the UK. The EU may be even less kind to Italy than to the UK, given the chaos that Italy would cause by leaving. A political solution (reworking international treaties) may keep Italy in the EU. That assumes quite a lot of goodwill toward a country that has just left the single currency.

Finally to quote Keynes: "Lenin was certainly right. There is no subtler, no surer means of overturning the exiting basis of society than to debauch the currency." Monetary union breakups nearly always lead to social instability or authoritarian governments to stop the social instability. The costs of leaving the euro are more than economic.

Appendix

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