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Abstract	This paper provides an overview of EU economic governance reforms in the last two years and places emphasis on the positive steps taken in 2012, as opposed to the growing political resistance emerged by early 2013. Attention is particularly attached to Italy, which was able to start a credible national plan of structural adjustments, thus earning the right to play a leading role in shaping EU reforms, making them effective and pushing for their implementation. The effectiveness of the reforms hinges on the political power balance between major EU Member States. By re-opening a credibility gap with its partners in 2013, Italian political instability risks compromising its efforts towards the implementation of both rigorous and sufficiently flexible EU reforms. The paper finally suggests the next steps Italy and the EU as a whole need to take in order to further advance the ongoing reform process of the EU economic governance.

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In and Out the Doldrums: Italy and the EU Economic Governance

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Introduction

2012 marked a milestone in the EU economic integration process. Financial turbulence and a dramatic slowdown in the real economy stimulated substantial improvements in the EU economic governance. Although most of the improvements are taking place only on paper – with their implementation postponed to 2013 and the years to come – what was achieved is still impressive.

Italy played a crucial role in triggering the main reforms of the EU governance. Indeed, this role was determined by the country's peculiar condition: a very large debt held abroad, under attack by strong speculative capital outflows in 2011. In this regard, Italy is the clearest example of European interdependence. On the one hand, financial and economic stability closely depends on other countries' stability elsewhere in the Eurozone; on the other, the euro area cannot withstand Italy's financial problems without suffering from an almost unmanageable contagion. Despite all the troubles, throughout 2012 the Italian government was able to restore credibility in the country's public accounts, thus earning the right to adopt a proactive and smart diplomatic stance. This, in turn, prompted a fundamental change in the EU political climate: a diminished role for the awkward Franco-German pseudo-leadership, followed by important reforms in the macroeconomic governance of the Union.

It seems therefore of great importance to compare the role Italy played in 2012, when the government's unity was momentarily restored, with the one it performed during periods of higher domestic instability. A focus on Italy's role can also serve as a case study on the level of concerted diplomatic actions actually required to reform EU's macroeconomic governance and foster economic integration and financial solidarity among Eurozone and EU Member States. A closer look at EU-level diplomatic interactions can also be useful to highlight the relevance of international political dynamics among Member States when considering prospective EU macroeconomic policy reforms. Scholars and policy advisors should always keep in mind that what seems perfectly reasonable and valid to them must also be considered politically feasible (often implying painful, incremental steps) to policymakers, lest their advice falls on deaf ears.

In this view, the first section of this paper looks at how the Italian crisis peaked in 2011, causing the fall of the government amid very little intra-EU macroeconomic cooperation, hampered by fierce political clashes. In the second and longer section, this paper discusses how the very sense of urgency that originated from the untamed crisis was the catalyst for all the progresses achieved by EU macroeconomic policymaking during 2012. It also delves deeper in the Italian role, looking at what Italy aimed at and at what it managed to achieve. Finally, the third section describes how the temporary return to more normal economic conditions, coupled with the recent Italian political deadlock, hampered new reform bids and weakened Italy's international position. The final section also advances some policy recommendations that Italy and the EU should heed in order to

strengthen the prospects for better future macroeconomic policy coordination, and clearer shared reform outcomes.

2011: The peak of the crisis

The premises for a more influential Italian role have their roots in the country's financial and political difficulties during 2011. The contagious financial troubles of the Eurozone originated from Greece, Spain and other so-called "peripheral" countries. Italy's fiscal adjustment was made uncertain by the hesitations and the internal divisions of a weak national government. In this context, the spread between the yields of Italian and German sovereign bonds peaked during the summer (see Fig. 1). In the meanwhile, a "sudden stop" in cross-border interbank credit and other net capital inflows stoked speculations on a possible return to the lira and, from there, resulted in an unsustainable peak in the Italian debt position within the central banks system of the Eurozone. Against this background, the government of the then prime minister Silvio Berlusconi seemed about to ask for emergency European financial support. This would have put national policymaking under the unkind supervision of the "troika" – the European Central Bank (ECB), the European Commission, and the International Monetary Fund (IMF). In fact, the ECB had already started to purchase Italian sovereign bonds and had gone beyond its institutional role in sending a hard-worded letter,[1] mandating detailed adjustments and reforms to the Italian authorities. As a result, issues of national independence in economic policymaking started to emerge in the Italian public debate.[2]

Until summer, the situation looked dangerous but manageable. Yet from here on the Italian experience can serve as an instructive case-study, showcasing the slowness and inadequacy of European authorities' reaction to financial disorders, and the need for a decisive step towards a deeply revised EU economic governance. Macroeconomic coordination was weak and short-sighted; it lacked the tools to insure its own implementation and it was excessively focused on quite abstract indexes measuring government deficits instead of meaningful real economy indicators. Moreover, Italy's economic policy disorder was mixed with EU's governance shortcomings. No sooner than July 2011, Italy's fiscal adjustment program (forecasting a balanced budget by 2014) had been given the green light by the European Council. The Council had indeed recommended a more concrete design of the proposed measures and their implementation, still considered too vague, but all in all everything seemed to be in order.[3] In August, instead, the ECB requested to balance the Italian budget by the end of 2013, and this demand was then included in the adjustment plan that Italy and the EU Commission had already agreed upon. All this caused a sudden discontinuity that was difficult to manage, bringing about stronger market speculation against Italian sovereign bonds,[4] and triggering a political crisis. Insisting on an earlier rebalancing of the budget was inappropriate also because Brussels still lacked the necessary tools to control for the quality of the measures aiming at reining in the deficit, as well as for their effective implementation.

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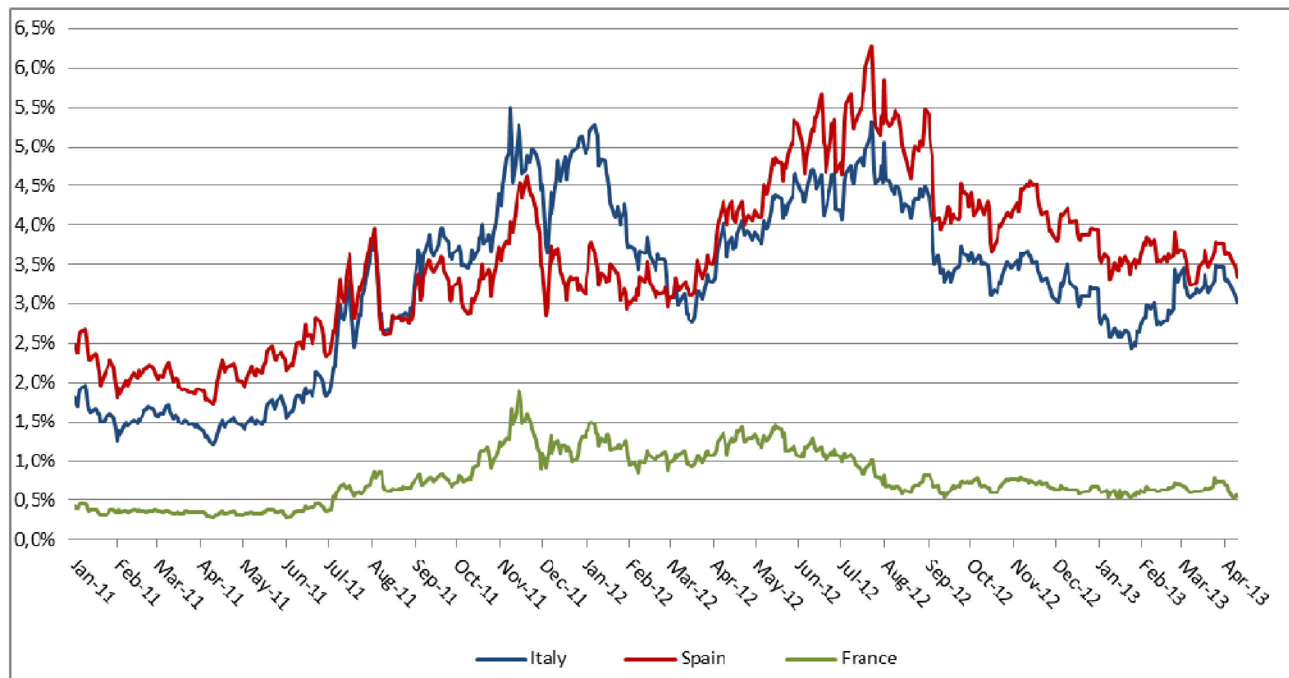
[1] Dated August 5th, 2011. The letter was meant to be confidential but was later leaked to the media and was published by several newspapers.

[2] See also an article by the future premier Mario Monti (*Il podestà forestiero*, Corriere della Sera, August 7, 2011) who, paradoxically, was later accused to have been appointed under international pressures.

[3] Just three months before also the Bank of Italy had stated that the government's fiscal plans looked "coherent with the current European fiscal rules" (statement contained in the Governor's document to the budget committees of the Parliament, 20 April 2011).

[4] The main credit rating agencies downgraded Italian bonds between the end of September and the beginning of October, citing political uncertainty among the reasons for the deteriorated outlook of the country.

Fig. 1 – Yield spreads between 10-year national government bonds and 10-year German bunds



Data: Bloomberg.

After some muddled successive reformulations of the budget, the Italian government resigned and a new "technical" government was appointed in November. It was obviously very urgent to take decisions in order to stop speculative attacks. The fiscal adjustment plan, agreed with the Commission in the very last weeks before the government's resignation, was probably considered inappropriately timed by the incoming cabinet. But its renegotiation would have reduced the government's credibility, already weakened by the abrupt change. New and very harsh measures, involving a deep pensions reform and immediate and substantial tax hikes, looked inevitable and were very soon passed in order to confirm Italian commitments to Brussels. The measures turned out to have a strongly pro-cyclical effect, and were further complicated by frequent downward revisions of GDP forecasts in the Eurozone. However, from then on and throughout 2012, the government avoided further pro-cyclical budget cuts, preserving the projected multi-annual profile of the government accounts despite new downward revisions of forecasted GDP.

The fiscal policy strategy adopted by the new government was twofold: the commitment to an early balancing of the structural budget was coupled with the decision to allow worsening GDP figures to push up the unadjusted deficit/GDP ratio, thus making some room for automatic stabilizers. In the meanwhile, a while a plan for structural reforms was still in its early stages, trapped in complex debates between the government and Parliament. This dual framework was coherent with Italy's stance towards Eurozone macroeconomic policymaking during 2012: adopting domestic austerity measures barely sufficient to earn the right to pressure for changes in the EU rules. Italy aimed at a more growth-friendly discipline, in which the quality of structural reforms (both in the private and in the public sector) would receive more attention, focusing less narrowly on purely nominal adjustments of the public deficit.

By the end of 2011, while the new Italian government was moving its first steps, the European Council and Eurogroup meetings resulted in controversial and disorienting outcomes, revolving

around discussions over a first draft of the so-called “fiscal compact”.[5] The latter was conceived as a more rigorous and reassuring pact, requiring member countries to introduce a rather rigid balanced-budget rule in their national Constitutions or a juridical equivalent.[6] In the meanwhile, a carefully-designed reform of the Stability Pact had just been introduced via measures contained in the “six pack”; therefore the additional German-inspired strictness of the compact looked to many superfluous and far-fetched, adding just another dividing issue to the relationship between the EU and the UK, which in the end refused to sign it.

Political disorder appeared to be Europe’s real problem, with countries trying to unload domestic problems and electoral tensions on the EU, and a “Merkozy” – the marriage of convenience between French President Nicolas Sarkozy and German Chancellor Angela Merkel – less and less effective. The EU disorder risked being used as an excuse by Italy and all the troubled member countries, thus weakening the diligence and timeliness of their own “homework”. Without a coherent and shared EU action program, domestic efforts to “put their house in order” could turn out to be insufficient, or be overcome by internal difficulties. If Europe really wanted to cope with the Eurozone crisis, it needed to strengthen the complementarity between domestic and EU actions .

The Italian government was explicit in its aims, setting its European diplomatic strategy for 2012.In particular, when it comes to the the “fiscal compact”, the Italian position aimed at: (a) adequately taking into account the cyclical phases in the evaluation process of excessive deficits; (b) avoiding to exacerbate the strictness of the rules aiming at reducing debt/GDP ratios; (c) tightly tying macroeconomic discipline to a plan to complete the single market; (d) strengthening the existing solidarity mechanisms without ruling out, at least in the medium term, the introduction of some form of mutualistic sovereign debt like the so-called “Eurobonds”.

2012: The path towards a ‘Grand Project’

Despite a very bad start, under the acute pressures of the economic and financial crisis, in 2012 European macroeconomic policymaking took substantial and tangible steps. Not only did policymaking manage to be ever more effective during the emergency, but it also embarked on systematically and orderly tackling an ambitious medium-to-long term project, aimed at strengthening the Economic and Monetary Union, by trying to fill in the blanks what the Maastricht Treaty had left open to negotiation. The European Council, the European Commission and the European Parliament all supplied original contributions to the project.[7] In December 2012 the European Council (though still leaving a feel of incompleteness, a fear that projects could remain such for too long) ratified the progresses made throughout the year, thus leading to a sharp improvement in financial markets’ expectations.

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[5] F. Bruni, “L’Italia nella crisi finanziaria e la denazionalizzazione della politica economica”, in A. Colombo, E. Greco (eds.), *La politica estera dell’Italia: edizione 2012*, Il Mulino, 2012, pp. 35-36.

[6] “The rules (…) shall take effect in the national law of the Contracting Parties (…) through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes”; art. 3.2 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, March 2, 2012.

[7] In the wake of H. Van Rompuy’s *Towards a Genuine Economic and Monetary Union*, written in collaboration with J. M. Barroso, J.-C. Juncker and M. Draghi, on December 13-14 the European Council adopted a “Roadmap for the Completion of EMU” (see European Council, *Conclusions*, Brussels, December 14, 2012; the Council also makes reference to the Communication presented by the Commission on November 30, 2012 (*A Blueprint for a Deep and Genuine Monetary Union: Launching a European Debate*); on its part, the European Parliament adopted a Resolution filled with specific recommendations: *Towards a Genuine Economic and Monetary Union*, November 20, 2012, Strasbourg.

The improvement in European economic prospects during 2012 was produced by a political progress which seemed already underway by the start of the year, notwithstanding disagreement and contradictions. Since January, despite the emergence of populist and Eurosceptic/anti-European attitudes in various countries, one could see that "all new governments - elected or appointed, left-wing or right-wing - endorsed a strong pro-European stance. The political posture of distancing oneself from 'sacrifice dictated by Europe' no longer had currency. The first step of the political solution was secured".[8]

During 2012, Italian and European economic policy reacted to market trends in a rather peculiar way. To understand it, we must look on the one hand at the evolution of the yield spreads between Italian and German government bonds, and on the other at the outcomes of the main European Council and Eurogroup summits.

The spread (see again Fig. 1) followed three main trends, omitting shorter fluctuations: it decreased until after mid-March, mainly thanks to adjustment measures implemented by the Italian government, which improved its credibility; it climbed again until the end of June, because of increasing obstacles to government action and because of complex systemic contagion processes occurring throughout the Eurozone, spreading expectations of a possible collapse of the currency union; and it finally oscillated around a decreasing trend until late 2012. The decrease of the spreads during the final part of 2012 took place also thanks to the ECB's statements, expressing its willingness to contrast speculation attacks which were largely believed to be unjustified, despite the considerable uncertainties surrounding Italian politics and macroeconomic policies, the Spanish situation and the Greek crisis.

Progress in the European Council and the Eurogroup occurred in five main stages, in January, March, June, October and December. The Italian stance was very influential and, especially in June, it contributed to foster an intergovernmental environment that facilitated July and August ECB declarations . Such declarations played a crucial role in lowering spreads around Europe, including the Italian one.

European decisions and the Italian stance

Mario Monti, the Italian prime minister, held two policy briefings at the Chamber of Deputies, Italy's lower chamber, on January 12,[9] and at the Senate of the Republic, Italy's upper chamber, on January 25, articulating Italy's position in the diplomatic meetings already underway at the EU level, preparing anti-crisis measures and discussing the next steps of the EU integration process. When it comes to the information of Italy's diplomatic stance, Monti was crystal clear , in particular with respect to the position Italy should keep with the French president and the German chancellor. He underlined that the European agenda revolved around two complementary issues: budget discipline and growth policies. He also reminded everyone that the December 2011 European Council's outcome had been "only partially satisfying". The government, he added, would strive to strengthen European tools in order to limit financial contagion, which hit even countries that had rebalanced their public budgets. The Italian government was also supposed to avoid that any decisions over the "fiscal compact" would result in a diminished attention towards growth and development policies and in additional obligations and sanctions. Italy was also concerned about the

[8] C. Bastasin, *Saving Europe: How National Politics Nearly Destroyed the Euro*, Brookings Institution Press, Washington, 2012, p. 341.

[9] Presidenza del Consiglio dei ministri, "Informativa alla Camera dei deputati del presidente del Consiglio, Mario Monti, su due punti: sviluppi recenti e prospettive della politica europea", January 12, 2012.

potential impact, in terms of EU unity, of the United Kingdom's decision not to sign the "fiscal compact".

All in all, the diplomatic plan seemed to be directed towards breaking the inefficiency trap caused by the Franco-German leadership, which had "blocked" a positive evolution in the EU in 2010 and 2011. Besides, January's briefings to the Chambers showed the determination to assure partners that Italy would comply with European rules on financial discipline. This was obviously a credibility requirement in order to retain influence over the evolution of those very rules. The new government reinforced the deficit and debt adjustment profile to which Italy had already committed to before Monti took office. At the same time, in the wording and implementation of the "fiscal compact", the new premier vowed to defend those elements of flexibility that the previous government strove to preserve, to better gauge Italy's public debt sustainability. In other words, Italy was willing to respect the obligation of a balanced budget, even including it in the national Constitution, to the extent it was worded in such a way as to avoid excessive rigidities and inappropriate strictness, which in turn would stifle cyclical shock absorbers and render the quality of public revenues and expenditures irrelevant.[10]

In January's statements one can trace the essence of Italian influence over January's informal Council, Eurogroup and ECOFIN, and March's European Council meeting, in which participants drafted a European strategy for recovery and growth soon to become, after June's Council, a "Compact for Growth and Jobs".[11] The Italian contribution was crucial since the so-called "letter of the twelve", titled *A Plan for Growth in Europe*: on February 20 a group of member countries, among which Italy played a leading role, addressed the letter to the Presidents of the Commission and the European Council. It was underwritten by the United Kingdom, but not by France and Germany.[12] The main aim of the letter was the completion of the single market, but it also searched for a rebalancing of European economic policy, by switching from an exclusive focus on financial discipline to an effort to reach widespread and durable growth. The idea that Europe's growth opportunity revolves around the wherewithal of its internal markets, once adequately unified, has been behind the European construction since its inception. A proposal on these themes found its way in Monti's May 2010 report,[13] later translated into the Single Market Act.[14] In the Compact, these beliefs were concretely articulated and timed, pointing out the necessary actions and focusing in particular on the digital single market, a decrease on normative burdens, and on the internal energy market.

The Growth Compact and the European Stability Mechanism (ESM)

June's Compact for Growth and Jobs also includes measures to finance growth, also through the intervention of the European Investment Bank (EIB) and the launch of an initiative of European loans aiming at financing transport, energy and broadband communication projects: overall, these measures may mobilize around €120 billion. The Compact distinguishes between the "action[s] to be taken at the level of the Member States" and the "contribution of European policies": this

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[10] See paragraph 2.2 and Tab. 1 and 2 in F. Bruni, "Curing and Preventing Euroarea's Sovereign Debt Crises: Some Issues and a Recipe", 30th SUERF Colloquium, Zurich, September 5-6, 2012, Paolo Baffi Centre Research Paper No. 2012-127, The Social Science Research Network Electronic Paper Collection, October 2012.

[11] European Council, 28/29 June 2012, *Conclusions*, EuCo 76/12, Brussels, June 29, 2012.

[12] Number 10 Downing Street, "Joint Letter to President Van Rompuy and President Barroso, David Cameron and 11 other leaders suggest priority areas for growth in Europe", HM Government, February 20, 2012.

[13] Mario Monti, "A New Strategy for the Single Market – At the Service of Europe's Economy and Society", Report to the President of the European Commission, José Manuel Barroso, May 9, 2010.

[14] EU Commission, Single Market Act I, 2011-2012.

clarifies the political responsibilities in the process but also helps to highlight that EU's rebalancing and growth prospects are the outcome of an indispensable mixture between decentralized national decisions and common policy orientations. The Compact also includes an important statement about the new relevance given to the "quality of public spending" in budget rebalancing, which must be "differentiated" in a "growth-friendly fiscal consolidation", "taking into account country-specific circumstances" and giving "particular attention [to] public investment".[15] As was previously noted, the Italian prime minister had repeatedly underlined the latter point, even at a scholarly level, having been a long-time supporter of an approach based on the so-called *golden rule*, which calls for a balanced budget on current expenditures but allows (some) deficit financing of public investments.

To evaluate June's summit we must also keep in mind that it took place just little more than a month after the inauguration of the new French president. "It was important that the new French president and the German chancellor could find a common language", Monti noted, and in this context "Italy tried to close the gap between France and Germany".[16] At the same time, Italy's prime minister somewhat anticipated his next move when, on the same occasion, he declared that "each nation's sovereign debt crisis reached systemic significance because of a lack of trust in the European capacity to respond with a common voice". This is why "we need common European solutions in order to avoid that some Member States slide into a recession trap, in which austerity reduces growth and increases debt, thereby making new cuts and the contraction of demand unavoidable". The European Stability Mechanism, the permanent intergovernmental national bailout fund, allows to "stabilize markets in the short term, thus avoiding excessive gaps in the sovereign-bond yield spreads for those states that are already complying with fiscal discipline rules. Italy can and must ask for a mechanism that does not apply only to those who can't make it alone, but also to those who, having timely abided by their obligations on public finances, now ask for an advance payment before the late recognition that comes from the market". On this subject Italy stance managed to reach some kind of partial recognition during June's summit; this reasoning was also shared by the President of the ECB, when he announced the start of the Bank's new operations aimed at stabilizing excessive spreads.

At the end of the first day of the summit in Brussels, on the evening of June 28, when the Compact had already been drafted, Monti and the Spanish prime minister threatened to veto it if it did not go hand in hand with a contemporary decision on the flexibility of the ESM tools. This could be read as a somewhat paradoxical move; after all, the threat to veto the Compact was coming from those countries that had most enthusiastically endorsed it. Moreover, its approval was tied to a different issue, not to be decided by the 27 members of the Council but by the 17 members of the Eurogroup. However, despite "astonishment and temporary irritation by some heads of state and government",[17] the Eurogroup summit reaffirmed the "strong commitment to do what is necessary to ensure the financial stability of the euro area, in particular by using the [ESM] instruments in a flexible and efficient way in order to stabilize markets for Member States respecting their Country Specific Recommendations and their other commitments including their respective timelines, under the European Semester, the Stability and Growth Pact and the Macroeconomic Imbalances Procedure. These conditions should be reflected in a Memorandum of Understanding".[18]

The Eurogroup decision had two shortcomings. The first was the vagueness of the expression "in a flexible and efficient manner": only later was it clarified that this implies that the conditions to be included in the Memorandum would not require further adjustments relative to those already undertaken in compliance with the Commission requirements. The second (and still standing)

[15] European Council, 28/29 June 2012, *cit.*, p. 8.

[16] Pesidenza del Consiglio dei ministri, "Informativa del presidente Monti alla Camera dei deputati", June 26, 2012.

[17] Presidenza del Consiglio dei ministri, "Informativa urgente del presidente Monti alla Camera dei deputati sugli esiti del Consiglio europeo del 28-29 giugno", July 5, 2012.

[18] European Council, "Euro Area summit statement", Brussels, June 29, 2012.

shortcoming is that, while the ESM acts when countries are not responsible of their excessive spreads, its actions are decided in a bilateral way and after the "non-responsible" country subscribes to a memorandum committing her to further adjustment decisions. But the causes for the yield spreads can actually be traced to anywhere in the global financial markets, given the excessive inertia with which markets respond to systemic risks. In order to defeat these systemic risks, an unconditional and unilateral decision by the ESM would have been preferable[19].

Despite these limits, the underlying decision was important. It was wise to condition the approval of the Compact to the adequacy of the ESM stabilization mechanisms, as the effectiveness of growth policies is under strain when systemic instability prevents markets from supporting those very policies.

When one looks at the spread trends, it seems that June 28/29's European summit was more the response to a very serious situation and much less the hint of its ending. Yet, at least some of the progresses were real. These progresses had a role in the gradual process of producing a more coherent European economic governance which, while tackling an emergency situation, also tried to promote growth and stability in the long run. First of all, the Council decided that ESM interventions, including the one possibly needed to solve the Spanish crisis, do not make it a preferential creditor in case of default: that privilege would have discouraged the inflow of non-preferential private capital and, by reducing ESM risk, would have also reduced its solidarity contribution. As a non-preferential creditor, the ESM can be considered an intergovernmental fund and, with all its qualitative and quantitative limits, a preliminary source of fiscal and financial solidarity among member states.

Secondly, the Council determined that the ESM can also intervene by directly recapitalizing a country's suffering banks, without the help being recorded as additional external public debt. This way, the Eurozone equipped itself with a stabilization mechanism which could also operate in the private sector. Thirdly, June's Eurogroup launched the so-called "European banking union" project, which involves the radical unification and centralization of financial regulation and supervision bodies. Germany was assured that the recapitalization of Spanish banks would only take place after the introduction of a unified supervisor. The second and third point are therefore linked: the more the banking union is postponed, the less Spanish banks, urgently in need of a direct recapitalization, can take advantage of it without government intervention. Finally, the banking union is but one of four chapters of a very broad long-term project aiming at advancing "towards a genuine Economic and Monetary Union", appearing in a report by President Van Rompuy.[20] June's European Council took note of this document. The issues presented in the report were addressed by other European summits during the second half of the year.

Euro-breakup risks and ECB decisions

After June's Council the Italian and Spanish spreads grew even larger, and expectations for some kind of intervention turned to the ECB. Meanwhile, it became increasingly evident that the trends in the yield spreads were ever more detached from the underlying data of the respective economies and from the evolution of their policy choices. Italian and Spanish interest rates, reciprocally interacting in a clear contagion effect over which Greek and Portuguese spreads also had an influence, increased sharply even at times when both governments recorded internal successes,

[19] See F. Bruni, *Curing and preventing ...*, *cit.*, par. 3.2.
[20] Report by the President Herman Van Rompuy, "Towards a Genuine Economic and Monetary Union", EuCo 120/12, Brussels, June 26, 2012.

adopting adjustment and reform provisions, or external achievements, with Europe endorsing their plans or their own proposals being favorably received by the EU diplomatic community.

The nature of the problem rested therefore on a "systemic" phenomenon, i.e. different than the mere sum of national problems. Market operators had insisted on the systemic nature of the crisis for a long time, managing to raise debates in academic *fora*, but were dismissed by "official" authorities. This phenomenon consisted in the expectation of a euro breakup, with one or more countries leaving the Eurozone and reintroducing national currencies. The likelihood of a euro breakup was perceived as a highly contagious phenomenon: an Italian exit from the common currency was assigned some likelihood not as a unilateral and isolated event, but following the widespread trauma of a Greek exit. Markets translated the euro-breakup risk in a worsening of the spreads because the interest rates of the "weakest" countries, whose currencies would have been highly devalued following a euro exit, had to compensate for this expected devaluation, and therefore their interest rates had to be higher than the rates of those countries who could may revalue their currency after a breakup (e.g., Germany).

Apart from being contagious, euro-breakup risk perceptions – as unfounded as they were – verged towards the self-fulfillment: the efforts to adjust public finances made by countries like Italy, in which the debt burden was ever-growing, were frustrated, and at the same time the cost of debt financing hampered the recovery of aggregate demand and production. A vicious circle may ensue, with the economy tailspinning towards a potential insolvency; an insolvency that could have resulted in something short from leaving the euro, but which markets obviously linked to a likely return to a national and highly-devalued currency.

The "conversion risk", as the ECB would have come to euphemistically refer to this "exchange rate risk" perceived by the markets on Euro-denominated liabilities, segmented the euro area along national boundaries: the Central Bank was no more able to do its job, i.e. to control the short-term interest rates and liquidity in the whole area; different interest rates on government bonds concurred with widespread variations in the cost of credit to businesses and households. Monetary policy was fundamentally neutralized. Interbank payments flows were wary to cross national borders; in fact, banks from "strong" countries, mainly Germany, substantially withdrew the capital they had invested in countries thought to be on the brink of "devaluation". This obstruction to capital movements in the common currency area was the most serious blow to the monetary union. Incidentally, the obstruction to capital movements ended up reinforcing the already pathological trend to place huge amounts of government bonds inside banks of the issuer country, thus reinforcing the confusion between bank risk and country risk.

This decoupling between the scope and trend of the spreads and the actual debt situations and short-term national economic trends was verified by econometric studies. The Bank of Italy, in particular, found that a part of the Italian spread was not statistically correlated to variables explaining a country's insolvency risk, like growing public debt or an economic slowdown. That part was instead significantly connected to indicators of the widespread "panic" on the markets, which acquired a multiplying effect because of rumors, statements, newspaper articles and communiqués underlining Euro breakup risks[21]. This kind of statistical evidence influenced ECB decisions.

In the wake of the sudden deterioration of the situation, the ECB resolved not to limit itself anymore to the simple denial that the Euro was at risk of breaking up. Between July and August, it backed a solemn declaration on the "irreversibility" of the euro with a direct attempt to defend its integrity. It therefore announced its readiness to intervene with an unlimited bond-buying program on the secondary market ("outright monetary transaction", or OMT), directed to those countries which suffered excessive spreads due to the wrongful perception of "conversion risks" and directly asked for assistance to the ESM, subscribing to its conditions. These purchases, which aimed at sustaining

[21] A. Di Cesare, G. Grande, M. Manna, M. Taboga, "Recent Estimates of Sovereign Risk Premia for Euro-area Countries", Occasional papers N. 128, Banca d'Italia, September 2012: see specifically Fig. 13 and 14.

bond prices in order to reduce their yields for the part which was caused by conversion risks, were to be autonomously decided upon by the ECB. The decision is not equivalent to endorsing the idea that the ECB should be some sort of "lender of last resort" for insolvent governments. The determination to create liquidity remained unconnected to governments' debt repayment needs. It only revolved around the need to correct an "unjustified" distortion of market expectations about the strength of the monetary union, which compromised the very working of the monetary union itself. The distortion was considered unjustified on the basis of the belief that the euro was irreversible, and the ECB considered itself its juridical guardian.

The rationale behind OMT actually endorsed the explanation of the crisis favored by the Italian government, which emphasized its strong systemic component, namely the fact that some countries encountered huge problems in financing their debt despite the fact that they were adopting sound economic and financial policies. On the other hand, the ECB did not want to take on the duty to assess whether each national policy complied with EU criteria, and made OMT available only to those countries already under ESM assistance and control. Therefore, the problem of bilateral and conditioned relationships in assistance requests still endures. But this problem must be solved by the ESM itself, not by the ECB.

Still enduring is also the risk that some countries with effective assistance needsby the ESM and the ECB might hesitate in asking for it to avoid paying the political price: hesitating might worsen their situation and make the inevitable interventions even more violent, complex and burdensome. Many believe that Spain has been in this dangerous standstill since the first half of 2012. Someone even ventured to ask whether Italy should apply for precautionary assistance to the ESM (thus satisfying the conditions for the possible additional assistance from ECB's OMT), in order to face the huge bond issuances yet to come, at the risk of being put under the invasive surveillance from the Commission, the ECB and even the IMF (which both the ESM and the ECB want as a partner in surveillance activity)[22].

Paving the way to a "banking union"

By mid-October, Italian and Spanish spreads decreased markedly: this probably prevented the European Council and the Eurogroup to achieve any other significant results during their October 28/29 meetings. In any case, both of them were positive summits, and managed to reaffirm June's ambitious targets. The summits inaugurated the monitoring of progresses made in the implementation of the Compact for Growth and Jobs, while leaders expressed the intention to adopt a "contractual" approach between Brussels and individual Member states, in which each state's commitment to implement the agreed reform plans is counterbalanced by special assistance and financing mechanisms (with the Commission using incentives and sanctions in order to encourage effective plan implementation). Moreover, more concrete debates over a banking union were finally started.

The original idea of a banking union lays upon three pillars: centralized, uniform surveillance over all Eurozone banks and the banks of other Member States that agree to take part in it; a common and centralized system to confront banking crises and resolve insolvent banks; a common system to guarantee deposits in case of bank insolvency. The aim is twofold: on the one hand, the application of common best practices everywhere in the Eurozone (and possibly in the rest of the EU), thus preventing supervisors and other national authorities from mismanaging crises or racing to the bottom in leniency; on the other hand, to make the nationality of a bank less relevant, as each institution would have to submit to common regulation and controls. Among other things, such a

[22] See for example P. Guerrieri, "Conviene il no al salva-Stati?", L'Unità, October 18, 2012.

de-nationalization is important because it would avoid the outbreak of confidence crises in the interbank market, usually due to suspicions over inadequate surveillance by some countries' authorities. Getting rid of this distrust would contribute to the free movement of interbank liquidity.

Italy is particularly interested in the banking union. The reason is, again, twofold. First of all, in Italy the quality of bank surveillance and crisis management is better than in other Eurozone countries. Thus, financial instability tends to be "imported" from countries that have a worse surveillance system and act less promptly and efficiently when a bank is illiquid or insolvent. So much the better if banking supervision improves and becomes more homogeneous. Secondly, a climate of reciprocal mistrust and segmentation in the European banking sector reduces liquidity flows towards Italy (thus increasing the discount rate at which government, businesses and households can find credit) because, despite the good Italian surveillance, banking risk tends to mix up with country risk. And Italy's country risk complicates the chances to "save" a bank that might risk insolvency because of its private debtors. What is more, in a European system segmented along national boundaries the government of each country tends to put pressure over national banks in order for them to purchase national government bonds: and again, this mechanism reinforces the confusion between bank and country risk. A banking union would reduce segmentation, thus limiting this kind of confusion.

It is noteworthy that, for a banking union to be established, many political, juridical and technical issues must be preliminarily resolved. But time can bridge the gaps. It is key to let markets believe that such a project is actually proceeding, decisively and coherently, towards a clear goal. During October's European Council a serious problem surfaced: centralized surveillance is less effective if it is not coupled with the power to supervise bank resolutions, and to take key decisions during a bank's liquidity and solvency crisis. But resolution powers require that some temporary liquidity funds can be injected in troubled banks, in order to assuage the effects of the crisis on depositors and preserve the rest of the economic and financial system. In other words, bank crisis management must benefit from some kind of fiscal back-up from national governments.

Therefore, a banking union implies some degree of fiscal union, some degree of joint responsibility between the members of the Union, so as to jointly raise the necessary capital in order to cope with upcoming crises. The EMS itself could be mandated to oversee a "rotation fund" aimed at managing banking crises, and its disbursements could be refunded by the banks themselves, once they have been reorganized or recapitalized as the crisis gradually fades out. It is anyway self-evident that the "fiscal" implications of a banking union make it harder to be achieved, especially for countries like Germany, that fear to commit to mechanisms implying fiscal solidarity, and are unwilling to "pay for other people's woes". This is paradoxical for Germany, where banks are anything but an example of stability and budget transparency, and where surveillance is very protective and overindulgent.

Unfortunately, during October's Council the first "pillar" has been disconnected from the other two, by advancing its timeline while postponing the others: the banking resolution mechanism has been postponed, and the guarantee on deposits has been marked as less fundamental. During December's Council the detachment between the pillars increased: an agreement on common surveillance mechanisms was set for March 2013, and its approval was set for next June, while a discussion on the banking resolution mechanism was postponed again. The project has thus grown weaker and less certain. Moreover United Kingdom's standing has become ever more negative and distant, complicated by the fact that a joint supervisory authority could apply to countries outside the euro area but be exercised by the ECB, over which the UK has no powers. Given London's importance as a financial center and a place for euro-denominated transactions, this has weakened the banking union's prospects. From the Italian point of view this must be considered a diplomatic defeat.

Into 2013: work in progress

In December 2012, the European Council agreed upon a formal schedule on the progress over the four pillars of the "grand project" included in van Rompuy's document (a unitary framework for financial, budgetary, and economic policies, in the framework of a strengthened democratic legitimacy of the EU institutions). However, as noted by many observers a tendency to postpone concrete decisions was reemerging inside the Council.[23] Pessimism was further increased by the failure to reach a satisfactory agreement on the Multiannual Financial Framework of the Union. A poor proposal by the Council – which abandoned any ambition to increase the EU budget and to use it in order to reinforce economic governance and fiscal integration – was rejected by the Parliament early in 2013 and will now need to be renegotiated.

In the meantime a political crisis caused the resignation, just before Christmas, of Italy's "technical government" and, in March 2013, elections yielded a very complex result, without any clear majority to form a new government. The European role of Italy, that had been crucial in achieving progress in the EU economic governance throughout 2012, was badly damaged, and the spread started to increase again.

In mid-March, the EU Council offered new evidence that progress had reached a stalemate. Nevertheless, from its concluding remarks a sense of constructive anxiety seems to emerge, in view of the duty to seriously start implementing at least the core of what was agreed upon during 2012. In this perspective, the two most urgent and important tasks are:

(a) a careful implementation of the new procedures aimed at coordinating macroeconomic rebalancing and structural reforms in the member countries, abiding by the new rules of the so-called "six pack" and "two pack". This implies that the EU and national governments take very seriously the procedures designed for the so called "European semester" and for the summer pre-approval by Brussels of those economic policy measures to be later voted on by national parliaments;

(b) a very rapid progress on the banking union.

Potentially, on these points Italy seems to be again a crucial player, both in its own interest and for the sake of the EU and, in particular, of the Eurozone.

On point (a), the new growth-friendly flexibility of the Stability Pact will be tested; in particular, it will be key to gauge to what extent the Italian requests will be met. Italy asked that, throughout the in-depth review of its planned fiscal deficits, the EU take into account the ***quality*** of certain public expenditures, like the payment of long-overdue commercial debts of the public administration and a selected set of infrastructure investments.

On point (b), Italy is one of the member countries most eager to see a rapid implementation of rules and institutional arrangements. The aim here is to produce a fully harmonized set of banking rules, supporting centralized crisis management procedures in which the ESM can provide the fiscal backbone to a common bank resolution procedure. The explosion of the Cyprus case in March brought additional evidence of how the lack of a unified banking system can produce monsters in a single currency area: the monster of a totally opaque offshore centre, of careless macro and micro

[23] As an example, see J.A. Emmanoulidis, *Steps but no roadmap towards GEMU – the results of a disappointing summit*, European Policy Centre, 17.12.2012; N. Véron, *Europe takes an important step forward on banking*, Peterson Institute for International Economics, Washington, December 14, 2012, where the fear is expressed that "2013 will be another year of delay for the decisive action necessary to restore trust in the European banking system and put an end to its current creeping zombification".

bank-risk management, of a complete overlap of bank and sovereign risk, of a confusing, contradictory and totally improvised (mis)management of an acute liquidity and solvency crisis, with no clear division of responsibilities between local political institutions, local regulators, the euro group, the ECB, international private banks and public financial institutions. The single currency channeled these disruptive effects towards other Eurozone member countries including Italy (another reason why the spreads returned to increase again), in spite of a completely different and incomparably more solid and well-supervised financial sector, has gone back to be the perfect target of a most dangerous contagion. Releasing regulatory, supervisory and crisis management powers to central European institutions is crucial to prevent further misbehaviors and their contagious effects. Specifically, the Cyprus case calls for a Euro-wide clarification of how the burden of a banking crisis must be shared by national and international bank creditors and taxpayers. Italy will certainly side with the most radical positions in the EU. However, in order for its diplomatic action to have a real effect, the country must be able to regain political unity and confirm its international credibility.

The EU governance architecture will also have to be improved. Besides its formal evolution, what really matters are the political relations taking place during the current transitional period. Realistically, **this is a period of intergovernmental Europe, where national governments' pressures and interests have different weights and powers in shaping European institutions and determining their outcomes**. Among the four major countries, Spain is in obvious pain, while France is showing increasing weaknesses because of its public deficit and debt, its low rate of real growth and a rapid decline in the political consensus around François Hollande. **This is why the "demand for Italy" is still strong in the continental interplay**. As an acute commentator recently put it, "Germany holds the ring: writes the cheques, enforces the rules and increasingly makes them up, as well". This is dangerous, and Germany itself does not want to protract a situation which is "a historic irony, given that the main purpose of the whole European project, from the 1950s onwards, has been to end forever the idea that Germany is simply too powerful to coexist comfortably with its neighbours".[24] In order to bring back Italy to its new role and keep Germany in Europe (instead of pushing for a German Europe), **Italy must be provided with the tools to act confidently: it must settle its domestic problems of political governance, keep its public accounts in order, accelerate structural reforms, streamline and reinforce its European affairs policy**.

As argued all along this paper**, Italian national interest is very much aligned with the EU's, and Italy is among the clearest examples of the deep interdependence among European countries that this period of crisis has so distinctly exposed**. **Much-needed progress in common economic governance is the appropriate reaction to the turbulent impact of that interdependence**.[25]

[24] Gideon Rachman, *The making of a German Europe*, Financial Times, March 25, 2013.

[25] In the June 2012 version of van Rompuy's "grand project" there is a particularly beautiful and neat sentence that links the "progress in the pooling of decisions on budgets" with "commensurate steps in the pooling of risks": European Council, *Towards a genuine economic and monetary union*, Report by President Herman Van Rompuy, Brussels, 26 June 2012, EUCO 120/12, p.5-6.