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Italy can save itself and the Euro

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The euro currency may soon collapse even though there is no fundamental reason for it to fail. Everything depends on Italy, because financial markets now fear that it may be insolvent. If the Italian government has to continue paying a seven or even eight per cent interest rate to finance its debt, the countryâ€™s total debt will grow faster than its annual output and therefore faster than its ability to service that debt. If investors expect that to persist, they will stop lending to Italy. At that point, it will be forced to leave the euro. And if it does, the value of the â€œnew liraâ€ will reduce the price of Italian goods in general and Italian exports in particular. The resulting competitive pressure could then force France to leave the euro as well, bringing the monetary union to an end.

But this need not happen. Italy can save both its own economic sovereignty and the euro if it acts decisively and quickly to convince the financial markets that it will balance its budget and increase its rate of economic growth so that the ratio of its public debt to its gross domestic product will decline in a steady and predictable way. If markets have confidence in that, Italyâ€™s interest rate could decline to the four per cent that it paid before the crisis began.

Italy is in a good position to achieve this. It already has a â€œprimary budget surplusâ€, with tax revenues exceeding total non-interest government outlays. It can eliminate its small overall budget deficit if it cuts spending and raises revenue by a total of just three per cent of its GDP â€“ an amount not impossible to find in a public budget that now equals 50 per cent of GDP.

The country also has a positive growth rate of about one per cent per year. If reforms to strengthen incentives and reduce regulatory impediments raise that growth rate to two per cent, that together with a long-term balanced budget would cause Italyâ€™s public debt to decline from todayâ€™s 120 per cent of GDP to about 65 per cent over the next 15 years. That is similar to what happened in the US after the second world war when a combination of a balanced budgets, 2.3 per cent growth and 3.3 per cent inflation brought the debt to GDP ratio from 109 per cent in 1946 to 46 per cent in 1960.)

Italyâ€™s situation is totally different from Greeceâ€™s. The latter has a budget deficit of nine per cent of GDP and its real GDP is declining at seven per cent, driving its debt from 150 per cent of GDP today to 170 per cent after just one year. The over-valued exchange rate results in a current account deficit of ten per cent of its GDP. Greece would be better off if it abandons the euro, devalues its new currency, and defaults on its debt.

A decision by Athens to leave the euro and default could cause a run on the euro and on Italian debt in particular. Thatâ€™s why it is so important for Italy to stress that its conditions are totally different from those in Greece, and that its new policies will soon produce budget balance and a declining ratio of debt to GDP.

Italy can do all of this itself. It does not need assistance from Frankfurt, Brussels, or Washington. The proposed policies for help from the European Central Bank, the European Commission, and the International Monetary Fund would ultimately weaken Italy and undermine its economic independence.

There are strong voices, including the French government, calling for the ECB to buy the sovereign debt of Italy and other countries in order to keep the level of their interest rates within about 200 basis points of the rate on German bonds and therefore low enough to avoid an automatic rise in their debt to GDP ratios. But this would violate the â€œno bail-outâ€ provision of the Maastricht treaty, put Germany at risk if any countries are eventually forced to default, cause an explosive inflationary supply of euros, and remove any market feedback about whether Italy and other governments have done enough to control future deficits.

In exchange for supporting the debt of these countries, the ECB or the EC would have to be able to veto national budget decisions. Italy, like Greece today, would become an economic vassal of Germany.

After the clear failure to expand the European Financial Stability Facility from â‚¬400bn euros to the thousands of billions needed to backstop borrowing by Italy and Spain, the EC recently proposed an alternative policy of creating â€˜stability bondsâ€™. Every EMU country would be able to issue these â€˜eurobondsâ€™ that would be guaranteed by all 17 eurozone members. This would only be feasible if the national budgets were subject to control by the EC, which would be dominated by Germany as the primary guarantor of the new bonds.

The IMF in turn has suggested that it create a fund that would lend to troubled eurozone members and perhaps be used to put a cap on their interest rates. This fund would be financed by loans from the ECB, thus deftly circumventing the Maastricht treatyâ€™s rules against bail-outs and against buying new bonds issued by member governments. Under this plan, some combination of the IMF and the EC would have to control the budgets of the borrowing nations.

Any of these proposed programmes would create new conflicts within Europe as borrower governments are forced to relinquish their ability to set their own national tax and spending policies. Moreover, what would start as EC limits on fiscal irresponsibility could evolve into limits designed to prevent trade advantages. Irelandâ€™s low corporate tax rate would be an obvious target for its eurozone competitors. The riots and political upheavals in Greece are a symptom of what would happen more generally if the Brussels bureaucracy and the German Chancellor came to dominate national economic policies.

Fortunately, none of this is necessary if Italy now acts forcefully to create budget and growth conditions that imply sustainable debt outcomes. But impatience and scepticism in financial markets may cause a deeper financial crisis before Italy has time to prove itself.

The writer is professor of economics at Harvard University and former chairman of the Council of Economic Advisers and president Ronald Reaganâ€™s chief economic adviser.