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The Uncertain Path to Monetary Union

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Ten years after they began discussing the idea, and seven years after the completion of the Maastricht treaty, the member states of the European Union are on the verge of forming a full monetary union. Monetary union will replace national currencies with a single European currency, the euro, managed by an independent European Central Bank after 1998. But participation in monetary union is not automatic; instead, member states must meet the convergence criteria of the Maastricht treaty, including a stable exchange rate, low inflation, a government deficit near 3 percent of gross domestic product, and a stock of government debt approaching 60 percent of gross domestic product.

Most of the political uncertainty and debate about monetary union in Italy and elsewhere during the mid-1990s has centered around the costs and benefits of meeting these criteria before the Council of the European Union decides in May 1998 which countries will participate in this new venture in European integration. Despite occasionally loud and acrimonious disputes among Italian parties and interest groups, and a brief government crisis in late 1997, the Prodi government elected in 1996 has made unprecedented progress towards participation in monetary union.

From Divergence to Convergence

Participation in monetary union requires that member states' macroeconomic policies converge around small budget deficits, low inflation, and currency stability. The Italian record of convergence on these indica-

tors since the 1970s has been decidedly mixed. Until 1988, Italy experienced large budget deficits, relatively high inflation, and exchange-rate depreciation. From 1988 to 1992, inflation declined and the lira was stable, but budget deficits remained large. The deficit was reduced but the lira depreciated sharply from late 1992 through 1995 (see Table 1). While the bulk of this chapter analyzes the more positive record of convergence since 1995, this section briefly explores the political dimensions of these earlier policy changes.

TABLE 1. Macroeconomic Indicators (Averages of Annual Data)

	1980-87	1988-91	1992-95
Percentage Depreciation of Lira against the Deutsche Mark	5.4	0.6	10.1
Budget Deficit as a Percentage of Gross Domestic Product	11.1	10.5	8.8
Current Account Balance as a Percentage of Gross Domestic Product	-0.9	-1.5	0.7
Percentage Change in Gross Domestic Product Deflator	13.3	7.1	4.4
Percentage Change in Real Gross Domestic Product	2.1	2.5	1.1
Unemployment Rate	7.9	9.6	10.6

Sources: Exchange-rate data calculated from Federal Reserve Bank of St. Louis, *Federal Reserve Economic Database*; remaining data from *OECD Economic Outlook 60* (December 1996).

The first phase of Italian macroeconomic policy lasted until 1987, when Italy had a series of weak coalition governments centered around the *Democrazia Cristiana* (DC) that lacked the political and institutional capacity to deal with high inflation, large budget deficits, and industrial conflict.¹ Instead, they delayed adjustment to these problems in three ways. First, governments devalued the lira frequently to maintain the competitiveness of Italian industry: the lira was realigned every year between 1980 and 1987 with the exception of 1984, and between devaluations the lira was allowed to depreciate within its wide ± 6 percent fluctuation band in the exchange-rate mechanism (ERM) of the European Monetary System (EMS). Second, Italian negotiators, supported by the European Commission and their counterparts in France and Belgium, advocated changing the *de facto* asymmetry of the EMS to reduce German influence over monetary policy throughout western Europe. German pol-

icy-makers set interest rates to keep domestic inflation low, and policy-makers in other countries had to choose between devaluing or matching German monetary policy. Since this gave German policy-makers significant freedom of maneuver, they naturally opposed any significant changes to the rules of the EMS.² Third, Italian governments ran very large budget deficits that boosted domestic demand, provided unemployment compensation, and maintained public employment but built up a large stock of government debt.³

Although this policy mix helped keep Italian industry competitive and maintained firms' profitability, it was clearly unsustainable by the mid-1980s. The second phase of macroeconomic policy, which lasted from 1988 until the withdrawal of the lira from the ERM in September 1992, saw policy-makers undertake serious but only partially successful efforts to adjust all three elements of economic policy as part of a strategy of convergence with the rest of Europe. There were no realignments of the currency, with the exception of a small "technical" devaluation when the lira's ERM fluctuation band was narrowed to the normal range of ± 2.25 percent in January 1990. After 1990, the goal of the Bank of Italy, supported by Finance Minister Guido Carli, was to use exchange-rate and interest-rate policies to press for a more sustainable fiscal policy.⁴ On political grounds, drawing attention to the fact that a large deficit led to higher interest rates, real appreciation of the lira, and large current account deficits (see Table 1) promised to increase support for significant changes in fiscal policy. On economic grounds, a credible commitment to the ERM reduced the risk premium attached to the lira and reassured investors that policy-makers would not resort to an inflationary monetary policy to finance the deficit. Policy-makers also began to accept that the rules of the EMS would remain asymmetric, and in 1987 agreed to the *Basle-Nyborg* accords that committed member-states to liberalizing capital movements and to using interest rate policy as the primary tool for stabilizing exchange rates. During the negotiations that culminated in the *Maastricht* treaty, Italian negotiators accepted the German-inspired plan for a lengthy transition to a monetary union based on an independent European Central Bank and strict fiscal and monetary convergence criteria.⁵ Despite these important changes, they made only modest progress in reducing the budget deficit; by 1991 the "primary" deficit (that is, the deficit excluding interest payments on government debt) moved from deficit to surplus, although the overall deficit did not decline until 1991 and the ratio of government debt to gross domestic product exceeded 100 percent in the same year.

The macroeconomic policy mix changed again with the withdrawal of the lira from the ERM in September 1992. During this third phase of macroeconomic policy, lasting until 1995, the lira depreciated sharply

against the mark, repeating the pattern of the early 1980s. But fiscal convergence accelerated as the Ciampi, Berlusconi, and Dini governments succeeded in reducing budget deficits. At the same time, substantial lira depreciation encouraged exports, industrial production, and employment in the North of the country, and gave them the political support to maintain progress towards the other Maastricht criteria.⁶

What explains these policy shifts, and what light do they shed on recent Italian debates about full monetary union? One explanation of the halting attempts to achieve convergence after 1987 looks to policy-makers' fear of exclusion as other European states moved towards monetary union. Inability to match the policies of other member states would have excluded Italy from influencing this process and would have reduced Italy's political standing in the European Union. The Maastricht treaty, which aroused little political debate in Italy during its negotiation, strengthened pro-convergence élites by providing multilateral surveillance over, and clear targets for, fiscal policy.⁷ But most Italian voters and élites always favored closer European integration in general and stronger European monetary institutions in particular; they simply proved unwilling to pay the full costs of convergence in the face of a threat of exclusion from monetary union. Italian governments found it impossible to achieve a consistent record of convergence after 1987: they only tightened monetary and exchange-rate policies during 1988-92 and achieved only fiscal consolidation from 1992 to 1995.

So some sort of political change was necessary to bring about an alteration in Italian macroeconomic policy. In this regard the collapse of the DC and the Italian Socialist Party (PSI) after 1992 opened political space for more "responsible" control over economic policy. With many of the traditional political forces weakened, the technocratic Giuliano Amato, Carlo Azeglio Ciampi, and Lamberto Dini governments of the 1990s could assume power and change the direction of economic policy. Although all three of these governments did make sustained and largely successful efforts to reform public finances, each took office *after* the shift in the direction of policy began in the late 1980s. In other words, while political crisis allowed non-political governments greater legitimacy and power, it alone did not start the process of policy change.⁸

Finally, the shift in macroeconomic policy was supported, or at least not actively opposed, by important segments of Italian society. Until the mid-1980s Italian industry favored devaluation, arguing that high inflation and low productivity growth reduced their competitiveness in European export markets. The major Italian banks did not oppose this position, since they lent heavily to industry and were dependent on firms' ability to repay their loans. The union confederations and many other groups opposed a significant tightening of fiscal policy that threatened

the social spending commitments they had secured in the 1970s. They formed an unlikely alliance with some DC and PSI politicians who opposed spending cuts that could threaten their extensive patronage networks. This pattern of powerful interests in favor of devaluation and heavy government spending began to change in the late 1980s. Importantly, after 1989 Confindustria began to draw attention to the negative effects of fiscal policy rather than advocate further devaluations. Deficit spending forced the central bank to maintain high interest rates, which in turn attracted capital inflows and appreciated the lira. Smaller deficits, in turn, would reduce industry's borrowing costs as well as prevent further appreciation. The union confederations also moderated their stance on fiscal policy and accepted the need for smaller budget deficits and reforms of pensions and industrial relations in the early and mid-1990s, and established close political ties to the Amato and Ciampi governments.⁹

The Transition to Monetary Union, 1995-97

After the 1996 elections a stable government led by Romano Prodi and centered around the *Partito Democratico della Sinistra* (PDS) in the Ulivo coalition, but relying on *Rifondazione Comunista* for its majority in the Chamber of Deputies, took office and proved willing to achieve substantial progress towards macroeconomic convergence for two of the reasons identified above. First and most important, support for monetary union was quite strong among most of the political parties and major interest groups. Few opposed the concept of monetary union outright, although *Rifondazione* and union confederations argued that the convergence criteria should be relaxed and that Italian attempts to participate should not require changes to social security spending. Second, France, Germany, and the European Commission made it clear that Italy would have to comply as fully as possible with the convergence criteria if the country was to participate in monetary union. These implicit threats of exclusion helped the Ulivo government mobilize its supporters — most of whom favored monetary union — around the goal of convergence, especially when drawing up the 1997 budget.

Monetary and Exchange-Rate Policies

One of the criteria for joining monetary union is that each member-state participate in the ERM for two years "without severe tensions" and without devaluing "on its own initiative." This criterion posed obvious

problems for Italy, which devalued the lira and then withdrew from the ERM in September 1992. One of the Ulivo government's first priorities was to arrange the re-entry of the lira, but it delayed action until November as it balanced two competing interests regarding the lira's new central parity. Confindustria, and prominent industrialists and bankers such as Cesare Romiti of Fiat and Mario Sarcinelli of the Banca Nazionale del Lavoro, warned against entering at an uncompetitive rate, and Romiti even suggested delaying monetary union for a year if France or Germany did not meet the convergence criteria.¹⁰ Conversely, the French, who had complained vociferously about the depreciation of the lira after 1992 and in 1995, warned against a "hasty" re-entry at an overly-competitive parity.¹¹ After a weekend of hard bargaining in Brussels, the lira re-entered the ERM on 25 November. The Italian delegation, led by budget and finance minister Carlo Azeglio Ciampi, requested a parity against the mark near the prevailing market rate between 1,000 and 1,010 lire; most other member-state preferred a more appreciated rate between 950 and 960 lire. They eventually settled on a parity of 990 lira after a "masterful performance" by Ciampi in persuading his colleagues that this parity was sustainable and not too competitive.¹²

In line with the Maastricht treaty, the Bank of Italy now has statutory independence from the government when implementing monetary policy. The central bank used its new-found independence to press for two goals. First, Governor Antonio Fazio tried to convince the government to adopt a more sustainable fiscal policy, arguing that its economic forecasts were overly optimistic and that its deficit reduction measures avoided long-term reforms of social security spending. Central bankers also pointed out that smaller budget deficits would reduce domestic demand and inflationary pressures, therefore allowing reductions of interest rates. This in turn would reduce the current cost of financing the government debt and make it more likely that Italy could meet the deficit criteria for participation in monetary union. Since much of the government debt consists of short- to medium-term obligations with an average maturity of four years, a 1 percent reduction in interest rates would save the government about 15 trillion lire over eighteen months.¹³

Second, the Bank of Italy has demonstrated that its' independence commits it to maintaining price stability by refusing to cut interest rate quickly or in large increments. Instead it relied on gradual reductions only *after* clear indications that inflation was falling, economic growth was slowing, and the government was taking serious steps to reduce the budget deficit. This behavior led to complaints from the government, industry, and the union confederations, all of whom favored larger and more rapid reductions in borrowing costs. For example, the Bank of Italy reduce the discount rate from 8.25 percent to 7.5 percent only after pre-

liminary consumer price data released in October 1996 showed that the inflation rate had fallen to 3 percent, the lowest level in 25 years, and the government had announced plans to reduce the 1997 deficit. Its decision to further reduce the discount rate to 6.75 percent in January 1997 came after the release of unexpectedly low forecasts of inflation, lira appreciation, and a fall in interest rates in the financial markets.¹⁴

Political pressure on the central bank for further interest rate cuts mounted in 1997. By April the consumer price index had fallen below two percent, its lowest level since 1969, leading the government and industry to call for further interest rate reductions. But Governor Antonio Fazio replied "I will not drug the economy" with lower interest rates. He was not impressed by the size of the 1997 mini-budget, argued that forecasts of economic growth and employment were overly optimistic, and wanted to wait to see if the government would have the political support to make changes to social security spending.¹⁵ Prodi replied that the discount rate was "enormously high", and the vice-president of the Council of Ministers, Walter Veltroni, while respecting the independence of the central bank, felt that the low rate of inflation warranted a cut in the discount rate.¹⁶ Even Ciampi, himself a former governor of the central bank, carefully reiterated the government's progress in reducing inflation.¹⁷ The central bank relented on 29 June by reducing the discount rate from 6.75 percent to 6.25 percent, although shortly thereafter Fazio would complain that continued slow economic growth was caused by an excessively high level of taxation. Political authorities, Confindustria, and the large union confederations, all praised the move, although Prodi said he was only "mildly satisfied" with the size of the cut.¹⁸

Fiscal Convergence

Fiscal convergence has been the most difficult challenge to Italian participation in monetary union. According to most interpretations of the Maastricht treaty, the government deficit as a percentage of gross domestic product (GDP) must come close to 3 percent in 1997 for the country to convince its partners to allow it to adopt the euro. The Ulivo government encountered some opposition to fiscal convergence from the union confederations and *Rifondazione*. Both opposed proposals to reduce government spending on pensions, social security, and healthcare.

This led the government to propose a relatively modest program of fiscal convergence shortly after taking office in 1996. The government's first Finance and Planning Document (DPEF) of July forecast a deficit of 4.5 percent of GDP in 1997, the year on which decisions about participation in monetary union will be based, and planned to reduce the deficit

to 3 percent of GDP only in 1998. The government decided on this program to avoid conflict with *Rifondazione* and because it calculated that other member-states would allow Italy into the first wave of monetary union if it came reasonably close to meeting the deficit criterion. Ministers made a political judgment that since the Italian deficit had declined from 9.0 percent of GDP in 1994 to 7.1 percent of GDP in 1995, and would decline further to 4.5 percent of GDP in 1997, Italy would qualify for participation in the euro because, in accordance with Article 104c of the Maastricht treaty, this figure "has declined substantially and continuously" towards the reference value of 3 percent of GDP.¹⁹

But in September the government reversed course and decided on a crash program to reduce the deficit to below 3 percent of GDP in 1997, rather than in 1998, having been convinced that failure to do so would exclude Italy from initial participation in monetary union. In a meeting between Prodi and Spanish prime minister José Maria Aznar in Valencia in September, Aznar made it clear that his government was determined to meet the convergence criteria in 1997, and was not interested in joining Italy to persuade the other member-states to adopt a flexible interpretation of the deficit criterion. Prodi and Ciampi also received indications from European Commissioner Mario Monti and European finance ministers that France and Germany were unlikely to approve such a flexible interpretation. Prodi's shift in emphasis was backed by the PDS, and Prodi assured *Rifondazione* and the union confederations that, as previously agreed, the issue of pension reform would not be discussed until 1998. The government introduced a new DPEF in September to reduce the 1997 deficit by 62.5 trillion lire (rather than the initial figure of 32 trillion lire) by cutting spending, raising taxes (despite an electoral pledge not to do so), introducing a "Euro tax", implementing treasury operations such as delaying repayment of withholding tax, and introducing a corrective mini-budget in the spring of 1997.²⁰

This new proposal to reduce the deficit was welcomed by the opposition parties and Confindustria; indeed, *Forza Italia* also issued a budget proposal that would reduce the deficit to 3 percent of GDP. But both *Forza Italia* and Confindustria criticized the content of the budget because it was based on tax increases rather than spending cuts and relied heavily on ill-defined treasury operations to meet the deficit target. The lack of detailed plans, partially a function of the lateness of the decision to further reduce the deficit, proved useful on October 10 when it won approval in the Chamber of Deputies with the support of *Rifondazione*, and on 16 November, when the lower house approved the budget unanimously with the abstention of *Forza Italia* and the *Lega Nord*. *Rifondazione* supported the legislation after the government announced that the Euro tax would be quite progressive and that the package would not affect

pension spending. Progress in the Senate was only a little less rapid. On December 16 the government won three votes of confidence on "maxi-amendments" to the budget, and the later in the month it received final approval from both houses of the legislature.

In November the government defined the Euro tax, intended to raise 5.5 trillion lire in 1997, as a withholding on income earned in 1996. The tax would be repaid beginning in 1999 as tax rebates or bonds entitling the owner to purchase shares in privatized firms at a discount. This repayment schedule could not be written into law, since doing so would make it a forced, non-interest bearing advance rather than a tax increase, and therefore it would not reduce the deficit in the judgment of the European Commission, which later approved its repayment as merely a "political commitment". The tax again was attacked by the *Forza Italia* and the *Lega Nord* but supported by the trade unions, which successfully threatened a general strike unless the tax fell more heavily on the wealthy. The final tax levied 1.5 percent on incomes up to 60 million lire, 2.5 percent on incomes up to 100 million lire, and 3.5 percent on higher incomes.²¹

Even before the 1997 budget was approved in December, politicians began floating the idea of an early mini-budget in the spring for three reasons.²² First, it became clear that the 1996 budget would significantly overshoot the final target of 6.6 percent of GDP. This was caused by slower than expected economic growth and the fact that, unlike in the previous year, no expenditures were carried over into 1997, the year on which the decision about participation in monetary union would be based. Second, the projections for 1997 were based on a forecast of 2 percent GDP growth, but by late 1996 the growth rate seemed more likely to be about half of this figure, resulting in estimates of a 1997 deficit on the order of 3.5-3.6 percent of GDP. Third, rumors in financial markets that monetary union might be delayed led the lira to depreciate and convinced the government to announce the mini-budget on 19 February. Fausto Bertinotti of *Rifondazione Comunista* immediately questioned the need for such a move, arguing that Italy could participate in monetary union but avoid a rigorous interpretation of the Maastricht criteria, and Sergio Cofferati of the CGIL stated that a mini-budget could lead to social conflict. Both *Rifondazione* and all of the union confederations argued that the mini-budget must not further increase taxes or reduce social spending.²³

The government had worried about this opposition and carefully structured the mini-budget to ensure its passage. The initial announcement in February contained few details so that these could be negotiated among the parties of the Ulivo coalition and with *Rifondazione*. Ciampi settled on a figure of 15.5 trillion lire in deficit reduction as the largest

politically practical figure.²⁴ The mini-budget approved by the Council of Ministers on 27 March did not contain significant structural reductions to spending, with the Treasury abandoning its earlier proposals for higher labor taxes and hospital charges, and Ciampi again promising it would not include any pension or healthcare spending measures. Instead, the deficit reduction target was to be achieved by requiring firms with more than fifteen employees to pay in advance tax on severance pay, speeding payment of inheritance taxes, freezing payments to resigning state employees, and by having banks accelerate the rate at which they passed on income tax receipts to the government. These temporary measures attracted criticism from some members of Ulivo, including foreign minister Lamberto Dini's *Rinnovamento Italiano*, some members of the PDS, and Confindustria. These groups argued that the tax of severance pay should increase the number of exempted employees, but their larger criticism was that by placating *Rifondazione* the government avoided reducing long-term spending commitments. From Brussels, Commissioner Mario Monti said that the government would have to attack the issue of welfare spending sooner rather than later if it wished to move to a sustainable fiscal position. The mini-budget was approved by the majority in the legislature despite these complaints.²⁵

The government also tried to convince other member-states and the European Commission that it could credibly meet the budget deficit criterion in 1997. In late April the European Commission forecast that the 1997 deficit would fall only to 3.2 percent of GDP (compared to forecasts of 3 percent of GDP in both France and Germany), while the 1998 deficit would climb to 3.8 percent. The Commission also argued initially that "the measures taken in 1997 are of a temporary nature and should be replaced with structural measures that will have a permanent impact on the budget".²⁶ This prompted a furious round of lobbying in Brussels by Ciampi and Commissioners Emma Bonino and Mario Monti, who observed that the French government had acknowledged its deficit might exceed 3 percent of GDP, and that noted German economists predicted the same outcome for their country, while Italy had already taken corrective measures.²⁷ The final report — re-written three times after Italian lobbying — stated that full implementation of the March mini-budget, combined with structural spending cuts in 1998, would allow Italy to meet the Maastricht target.²⁸ Commissioners Jacques Santer and Yves-Thibault De Silguy emphasized that the forecasts, while technically valid, did not amount to a judgment of which countries would participate in monetary union, and the Council of Economics and Finance Ministers approved Italy's convergence plan in July.²⁹ By the summer the government was optimistic about participation in monetary union. Not only had its fiscal policy been applauded by European finance ministers, but the election of

a Socialist-led government in France changed the calculation of how the Maastricht treaty would be interpreted. French ministers declared before and after the election that they wanted Italy to participate in monetary union and openly admitted that even after taking corrective measures the French budget deficit in 1997 would be greater than 3 percent of GDP, re-opening the possibility that this criterion would be interpreted flexibly.

Domestic and European predictions of structural fiscal problems did lead the government to consider more fundamental reforms to pension and social security spending in spring 1997. *Rifondazione* leaders and the union confederations made it clear that they opposed any changes in addition to those agreed with the Dini government in 1995 but opened technical negotiations with the government. Their opposition shaped the initial government proposal for the 1998 budget issued on 30 May. According to the DPEF, this budget would reduce the deficit by 25 trillion lire to 2.8 percent of GDP. The finance ministry initially planned for 18 trillion lire to come from unspecified reductions in spending, mostly in the areas of pensions, health, and transfers to state-owned firms, but later reduced this figure to 15 trillion lire, including a 4.5 trillion lire reduction in pensions spending.

Rifondazione announced in early October that it would not support the budget proposal, despite progress in the negotiations with the union confederations over the form of pensions reform and the fact that the party had supported the government's much more restrictive budget the previous year. The *Rifondazione* leadership called for a budget with smaller pension cuts, a 35-hour work week by 2000, an end to privatization, and more public employment in southern Italy, but others suspected that the true motivation for opposing the government was to prevent agreement on electoral reform. A furious but unsuccessful round of negotiations between the government and *Rifondazione* ensued, and Prodi tendered his resignation to the president on 9 October.³⁰ Political leaders floated a number of possible solutions to the government crisis, including a "grand coalition" of the PDS and center-right parties or another technical government led by Ciampi, but it appears the most credible was the threat of Massimo D'Alema of the PDS to call new elections immediately. Facing growing divisions within his party and fearing the consequences of an electoral campaign without the support of the Ulivo coalition, Bertinotti of *Rifondazione* returned to the bargaining table.³¹ By all accounts Prodi was able to score a decisive victory over *Rifondazione* this time; in exchange for supporting the government and the budget, Bertinotti got in return only a commitment to reducing the work week to 35 hours by 2001 for firms with more than fifteen employees, exemptions for manual laborers from restrictions on early retirement, and reducing the previously planned cuts in pension spending to 4 from 4.5 trillion lire.³²

Will Italy Be Excluded?

The Maastricht treaty provides that member-states not meeting the convergence criteria can be excluded from initial participation in monetary union; current plans are for the Council of the European Union to make this decision in early May 1998. However, the primary political reason for Italian exclusion would involve German politics. While chancellor Helmut Kohl considers monetary union an absolute priority, many politicians and a substantial part of the public fear that a monetary union including the Mediterranean countries will produce a weak euro, and it is not difficult to imagine that the German government might block the participation of some countries to assuage German public opinion.

The possibility of excluding Italy from monetary union was mooted frequently in 1997 and, given its strong commitment to participation, it is not surprising that the Prodi government strongly opposed these suggestions. In early February, Lionel Barber of the *Financial Times* reported that "senior European Union central bankers and monetary officials" had been discussing a deal that would guarantee that Italy would be treated the same as initial members if it met the convergence criteria, but would enter the monetary union twelve to eighteen months after it begins. The European Central Bank would allow Italy to narrow its fluctuation band in the new ERM, and might reserve one or two positions on its executive board for Italy and other countries that joined later.³³ Prodi rejected this idea the next day and reiterated his government's commitment to participating in full monetary union from the beginning; French and German officials also denied that such a deal was in the works, maintaining that all countries will be treated equally in May 1998.³⁴ A little over a month later, Foreign Minister Lamberto Dini, while insisting that Italy would meet the convergence criteria, suggested a one-year delay of the start of monetary union for all countries, an idea that was also rejected by the prime minister and the other member-states. In early April Helmut Kohl and Jacques Chirac reaffirmed that the euro would be introduced on schedule in 1999 and denied new rumors of a secret agreement on the choice of initial members.³⁵

By the summer of 1997 ministers were reasonably certain that Italy would be a member of the first wave of monetary union because of the reduction in the deficit and the support of the Jospin government in France. But in July European Commissioner Mario Monti warned against "euphoria", arguing that if the French and Germans relaxed the deficit criterion, they might interpret the *debt* criterion rigorously to maintain monetary stability and German public support. Although the debt-to-GDP ratio was over 120 percent in both Belgium and Italy, this was less of a problem for Belgium because of the government's success in introducing

structural reforms to spending.³⁶ Reports circulated that in the margins of the July Council of Economics and Finance Ministers meeting the French and German finance ministers had discussed this issue. Ciampi quickly replied that Monti's concerns were unwarranted for three reasons. First, participation in the euro would allow lower interest rates that would reduce the cost of servicing the debt; second, he knew of no Franco-German discussion to exclude Italy because of its large debt; and third, the government agreed that structural reforms of pension and social security spending were necessary.³⁷

A related issue that has not received much attention is the ability of excluded countries to block the creation of monetary union. According to the Maastricht treaty, all countries that meet the convergence criteria, with the exceptions of Britain and Denmark, must move to monetary union in 1999. But deciding exactly which countries meet the criteria is a decision left to the Council of the European Union voting by qualified majority. The eight member-states most likely to meet the criteria (other than the debt ratio) and that want to participate in monetary union (Austria, Belgium, France, Germany, Ireland, Luxembourg, Finland, and the Netherlands) will control 42 votes, while the four "Mediterranean" member-states (Greece, Italy, Portugal, and Spain) will control 28 votes. Since a total of 62 votes are needed to pass under qualified majority voting, the first group cannot exclude individual member-states unless they attract some support from the Mediterranean group or from the member-states unlikely to want to participate (Denmark, Britain, and Sweden). Although the Maastricht treaty commits all member-states to the "irreversible" process of monetary union, and prohibits them from blocking its formation, it is possible that the Mediterranean countries acting together could, as a last resort, achieve exactly this. Alternatively, they could seek to block agreement on other issues, such as enlargement.³⁸ Indeed, in May 1997 it was reported that Prodi opposed admitting Spain and Portugal to monetary union if Italy was excluded, and stated that "if the participation of Italy is the object of a negative decision, Italy is determined to use all political instruments available"³⁹ Such threats are not very credible, however. It would be difficult but not impossible for Italy to assemble a blocking minority unless Spain and Portugal are also excluded. A pro-European Italian government is unlikely to want to bear responsibility for scuttling a project it has supported, and it is possible that if they tried to do so, France and Germany might go ahead with monetary union nonetheless. And it is still conceivable that France and Germany could promise Italy entry after a short delay.

Negotiating the Stability Pact and a New Exchange-Rate Mechanism

The Stability Pact and the new ERM were negotiated in 1996-97 to provide guidance for the conduct of macroeconomic policy within the monetary union. Regarding the new ERM, French and German policy-makers wanted to ensure that member-states that do not participate in the first wave of monetary union prevent currency fluctuations that could undermine the single market. In early 1996 the Monetary Committee concluded that any new ERM should have wide fluctuation bands to make it difficult for speculators to target currencies for devaluation.⁴⁰ German policy-makers wanted to place the major responsibility for currency stabilization on the countries outside the euro zone to ensure that the European Central Bank's intervention obligations would be strictly limited. In contrast, the Italians, Spanish, and Portuguese, who had devalued in the recent past and feared the possibility of exclusion from monetary union, favored a more symmetrical arrangement and greater reliance on European Central Bank intervention to support participating currencies.⁴¹

Preliminary agreement on this issue was reached by the Council of Economics and Finance Ministers meeting in Verona in April 1996, although details were not completed until the Amsterdam summit of the Council of the European Union in 1997. The general aim is to stabilize exchange rates while not compromising the European Central Bank's primary mandate of internal price stability. A second aim is to "foster convergence" of member-states outside of the euro zone by providing them with "a reference for their conduct of sound economic policies." The new ERM will be based on bilateral exchange rates against the euro. Currencies will be allowed to fluctuate within wide bands of 15 percent, although the European Central Bank and individual member-states might negotiate tighter bands as convergence proceeds. Intervention when a currency reaches the margin of its fluctuation band "will in principle be automatic and unlimited with very short-term financing available." Two changes make this arrangement less symmetrical than the current ERM. First the phrase "in principle" makes it clear that marginal intervention by the European Central Bank might not be available in all circumstances. Second, "the European Central Bank and the central banks of the other participants could suspend intervention if this were to conflict with their primary objective [of price stability]."⁴²

Leaders also approved the Stability Pact (later renamed the Stability and Growth Pact) at the Amsterdam summit. Germany promoted the pact's provisions for stronger multilateral surveillance, and possible sanctions, to prevent member-states adopting the euro from running ex-

cessive budget deficits. French governments in particular had long been ambivalent about such a step, fearing that it could limit member-states' ability to deal with unemployment, and would leave the independent European Central Bank as the only institution capable of implementing a counter-cyclical economic policy. The Jospin government that took office in spring 1997 forcefully reiterated these concerns, arguing that the stability pact should be re-negotiated. Italian policy-makers initially supported Jospin's plea that the pact place more emphasis on growth and employment and create a political counterpart to the European Central Bank.⁴³ Faced with a potential breakdown in relations between France and Germany, the Commission and member-states started working on a compromise.⁴⁴ Commission President Jacques Santer, in discussions with the French, reiterated that the Stability Pact could not be re-negotiated but did propose a supplemental declaration on employment based on Articles 102a and 103 of the Maastricht treaty, which the French and German governments found attractive.⁴⁵ The agreement at Amsterdam included the creation of an Employment Committee that could recommend steps to reduce unemployment as part of multilateral surveillance, encouraged the European Investment Bank to open a new lending facility for small and medium-sized firms and to for European-wide infrastructure projects, but at the insistence of Germany did not include significant Union spending on employment and did not dramatically change the Stability Pact.⁴⁶

Conclusion and Prospects

Italian governments have made meaningful progress towards the goal of participating in monetary union, including cuts in the budget deficit, stabilizing the lira in the ERM, and reducing inflation to historically low levels. This successful convergence was brought about largely through the installation of reasonably stable government and broad but not universal societal support for making the sacrifices necessary for participation in monetary union. In this section I speculate briefly about some of the possible effects of inclusion and exclusion in monetary union.

Significant political problems could arise if Italy is excluded from monetary union for a prolonged period. Both Prodi and Ciampi have threatened to resign if Italy does not participate in the first wave of monetary union. Exclusion is also likely to undermine the political position of parties and groups that have supported the government's fiscal policy, and strengthen opponents such as *Rifondazione* and the right-wing *Alleanza Nazionale*. Exclusion also might strengthen the hand of the *Lega Nord*, providing it with strong evidence that national governments are

unable to secure Italy's place in Europe. Political developments along these lines might create strong incentives for future Italian governments to abandon convergence by running larger fiscal deficits and devaluing the lira against the euro so as to maintain political support.

But participation in monetary union might also require further restructuring of Italian society and politics. As discussed above, since the 1970s policy-makers frequently relied on currency depreciation to maintain the competitiveness of Italian industry, which as a result has come to concentrate in sectors that are very sensitive to changes in international prices. Preventing de-industrialization in the euro zone, when the option of devaluation is no longer available, might require more investment in training, infrastructure, and research. In particular, those sectors not exposed to international competition — many financial services, education, public utilities, the state itself — will have to provide their services on much more efficient terms if industry's input costs are to remain low. Participation in monetary union also could require further changes to the industrial relations system and the welfare state so that firms have greater flexibility and that welfare spending be targeted more carefully on those most in need.⁴⁷

Notes

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2. C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Washington: Institute for International Economics, 1994), pp. 195-199.

3. D. Franco, *L'espansione della spesa pubblica in Italia (1960-1990)* (Bologna: Il Mulino, 1993).

4. G. Carli, *Cinquant'anni di vita italiana* (Bari: Laterza, 1993), pp. 395-396, and "La Tenuta del cambio", in *Bancaria*, November 1990, p. 23.

5. J.I. Walsh, *Global Finance, Domestic Politics: International Monetary Policies in Britain, France, and Italy*, Ph.D dissertation, American University, 1996, chap. 6.

6. F. Rampini, "L'Italia svalutata", in *Il Mulino*, vol. 44 (1995), p. 99.

7. V. Della Scala, *Hollowing and Hardening the State: European Integration and the Italian Economy*, in M. Bull and M. Rhodes (eds.), *Crisis and Transition in Italian Politics* (London: Frank Cass, 1997), pp. 14-33, and K. Dyson and K. Featherstone, "Italy and EMU as Vincolo Esterno: Empowering the Technocrats, Transforming the State", in *South European Society & Politics*, vol. 1, no. 2 (Autumn 1996), pp. 272-299.

8. V. Della Scala, *Hollowing and Hardening the State*, *op. cit.*

9. M. Braun, *The Confederated Trade Unions and the Dini Government*, in M.

Caciagli and D.I. Kertzer (eds.), *Italian Politics: The Stalled Transition* (Boulder: Westview Press, 1996), pp. 205-221, and J.I. Walsh, *Global Finance, Domestic Politics*, *op. cit.*, chap. 7.

10. *La Stampa*, 22 May 1996 and *La Stampa*, 28 September 1996.

11. *Financial Times*, 15 October 1996.

12. Quotation from *Financial Times*, 26 November 1996; see also *La Stampa*, 24 November 1996.

13. For example, see the overview of Governor Antonio Fazio's attitudes towards fiscal policy in *Financial Times*, 14 February 1996.

14. *La Stampa*, 26 January 1997.

15. *Financial Times*, 23 April 1997, and *La Repubblica*, 8 May 1997; Fazio quotation from *La Repubblica*, 13 June 1997, which also contains responses from government ministers.

16. *La Repubblica*, 22 June 1997.

17. *La Repubblica*, 25 June 1997; see also the report of the speeches of Fazio and Ciampi at the annual meeting of the Associazione bancaria in *La Repubblica*, 26 June 1997.

18. *La Repubblica*, 30 June 1997, and *La Repubblica*, 9 July 1997.

19. *Financial Times*, 17 July 1996.

20. *Financial Times*, 27 September 1996, *La Stampa*, 22 September 1996, and *La Stampa*, 1 October 1996.

21. *Financial Times*, 22 February 1997.

22. *La Stampa*, 6 December 1996.

23. *La Repubblica*, 20 February 1997, and *La Repubblica*, 21 February 1997, and *La Repubblica*, 21 March 1997.

24. On the negotiations among the party secretaries, see *La Repubblica*, 21 March 1997.

25. Details of the mini-budget can be found in *La Repubblica*, 27 March 1997, and *La Repubblica*, 28 March 1997.

26. Quoted in *La Repubblica*, 18 April 1997.

27. *La Repubblica*, 23 July 1997.

28. The force of these criticisms was muted by the predictions of the International Monetary Fund, in its *World Economic Outlook*, that the deficits would be 3.3 percent of GDP in France, Germany, and Italy. See *La Repubblica*, 25 April 1997.

29. *Corriere della Sera*, 29 April 1997, and *La Repubblica*, 25 April 1997.

30. *La Repubblica*, 7 and 9 October 1997.

31. *La Repubblica*, 3, 11, and 13 October 1997.

32. *La Repubblica*, 15 October 1997.

33. *Financial Times*, 5 February 1997.

34. *Financial Times*, 6 February 1997.

35. Dini's proposal appeared in *Il Sole 24 Ore*, 25 March 1997; for denials in Italy and elsewhere, see *La Repubblica*, 21 March 1997, *La Repubblica*, 26 March 1997, *The Times*, 10 April 1997, and *Agence France Presse*, 17 April 1997.

36. *La Repubblica*, 14 July 1997.

37. For Ciampi's remarks, see *La Repubblica*, 20 July 1997; for speculation on using the debt to exclude Italy, see the article by G. Nardozi in *Il Sole 24 Ore*, 19 July 1997.

38. See Istituto Ugo La Malfa, *Euro: le procedure per la partecipazione*, Rapporto

n. 2 (6 December 1996).

39. Quoted in *La Repubblica*, 13 May 1997.

40. *Financial Times*, 21 February 1996.

41. *Financial Times*, 12 April 1996.

42. Quotations from Presidency Conclusions, Amsterdam European Council, Annex II: "Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union", June 1997.

43. *La Repubblica*, 10 June 1997, and *The Times*, 3 June 1997.

44. *Financial Times*, 11 June 1997.

45. *Financial Times*, 12 June 1997.

46. *La Repubblica*, 17 June 1997.

47. See especially the comments of Giuliano Amato, chair of the Antitrust Authority, in *Autorità garante della concorrenza e del mercato, Relazione sull'attività svolta nel 1996* (Rome, 30 April 1997), and M. Salvati, "Moneta unica, rivoluzione copernicana", in *Il Mulino*, no. 369 (1997), pp. 5-23.