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India vs. China; Italy vs. EMU

Summary. Over the past three years India has enjoyed robust growth with minimal inflation. The economy is reaping the benefits of the financial deregulations started in 2000. Lower cost of capital and greater availability of credit to the private sector are chief reasons behind the current upswing in domestic demand. Strong export growth and abundant rains have also contributed to buoyant performance. India's trend growth rate has risen to 6.5%, from 4% in the 1980s. The current government's weak majority has inhibited reforms, particularly on labour deregulation and privatisation. But bright spots exist, proving that India remains committed to change. Stock market buoyancy reflects positive fundamentals.

In a second article, Gabriel Stein looks at the technical aspects of one country (Italy) leaving EMU. Whilst it certainly is possible, politically and technically, for a country to leave the single currency, it would be both costly, difficult and possibly also painful.

Main Points

- Domestic demand is riding a strong cyclical upswing. Exports account for 17% of GDP, one-third of which in growing service exports. India is much better placed to withstand global headwinds than most of the other Asian economies.
- The country compares negatively on infrastructure, particularly with China. But India offers a better investment environment in the form of a democratic set up, a language advantage, better securities regulation and rule of law – fundamental conditions specified by Adam Smith!
- The government is engaging in the first serious commitment to fiscal rectitude since the 1990/91 balance of payment crisis. The goal is ambitious and difficult to achieve especially after the next business cycle downswings begins. However, the benefits are already visible. To lift the potential rate to pre-crisis Asian Tigers levels, fiscal consolidation is necessary as well as labour deregulation.
- The key issues for a county leaving EMU are 1) how its current partners will view the exit; and 2) how to deal with euro-denominated assets and liabilities. Provided both assets and liabilities are redenominated in the new lira, the medium-term effects should be limited. The real question is whether a devaluation would be seen as an opportunity for reform (Britain post-1992) or as a panacea, obviating the need for any other action.

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Could India outshine China in the long term?

India has great catch-up potential

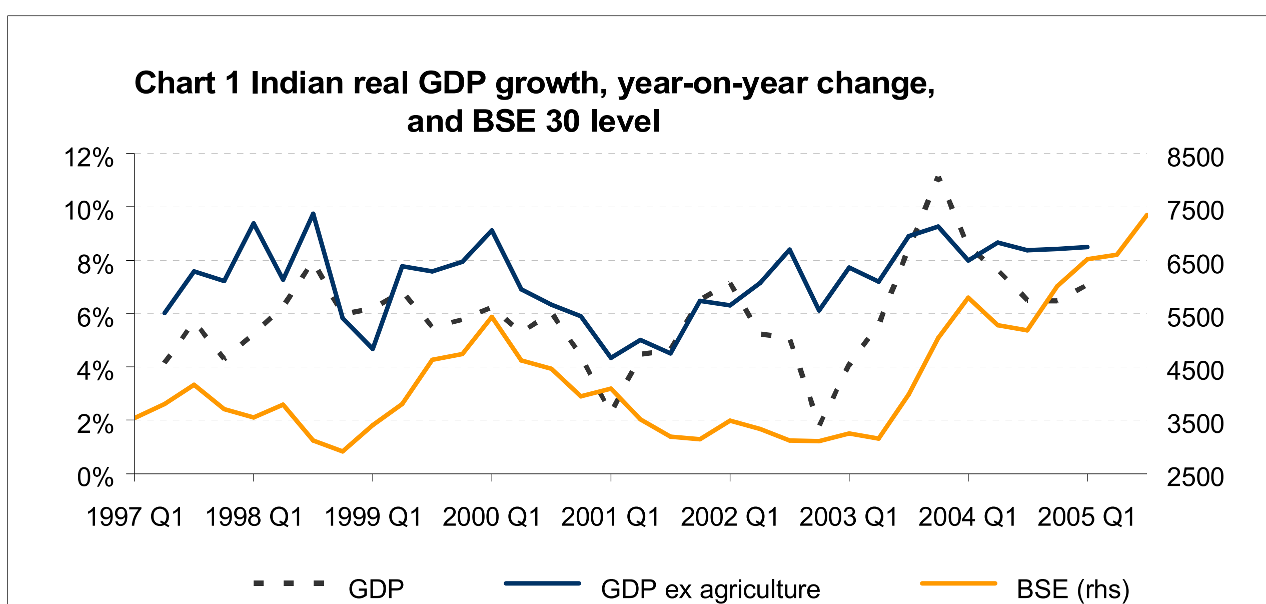
Over the past three years India has enjoyed consistently robust growth with minimal inflation. With a population of 1.1bn. and a GDP of $680bn. in 2004, per capita income remains less than one-tenth of that of the US even at purchasing power parity. India has great catch-up potential. The economy's trend growth rate has been rising since the early 1990s, aided by bold financial deregulation. Gifted a large labour force, English speaking population and a solid democratic environment, India may outshine China in the long term.

Trend growth is estimated to be 6-6½%

Domestic demand is the stronghold of India's recent growth performance. Falling capital costs over the past five years and, more recently, greater credit availability to the private sector, coupled with decent rainfall, have underpinned the current domestic demand boom. Exports play a lesser role in final demand (17% of GDP) than elsewhere in Asia, notably China. However, India's high reliance on growing service exports has contributed to consistently stronger growth in recent years. *LSR* estimates potential real output growth to be 6-6½% p.a. – the growth rate which can be sustained without inflation accelerating. But to raise further the long term performance of the economy, India must tackle the two serious underlying barriers to growth: a burgeoning fiscal deficit and stubborn labour policies. The former crowds out private investment and limits the government's resources for badly needed infrastructure investment, crucial to decouple the economy from the volatile agricultural production. The latter has caused one of the poorest and most populous countries in the world to have a capital-intensive manufacturing sector.

The stock market is roaring ahead

Indian share prices have more than doubled in the past couple of years. Has India really turned the corner or is the stock market getting ahead of fundamentals? The current government's weak majority, meaning the dependence on the extreme left, has inhibited reforms. Proposed labour policy changes have almost completely disappeared from political



Discussion on labour policy and privatisation is hardly advancing

debate, and discussions on the future of privatisation risk a similar fate. But there are bright spots. Recently implemented fiscal reforms and the Special Economic Zones prove that India is still willing to change – positively responding to competitive pressures from an aggressively expanding China. But domestic pressures are probably more important than mounting external competition. This is the first business cycle upswing largely decoupled from the agricultural sector. Past reforms are paying off, making it increasingly difficult to reverse the process.

Stock market buoyancy therefore reflects positive fundamentals. Subject to temporary corrections, the performance is likely to remain strong.

Structural developments

India's trend growth rate has been increasing over the past two decades

A striking difference between India and most of the Asian tigers today is that while India's potential rate of growth has risen over the past decade, it has fallen in the other countries. Korea's trend growth has weakened by less than the others, reflecting the transition from largely export-led to more balanced growth. Without going into country details, two important observations should be made. First, slower Asian Tigers' trend growth simply reflects a narrower catch-up potential (see Table 1, opposite page). Secondly, East and Southeast Asian countries growth has been centred on either exports or investment booms. On the other hand, the development of domestic demand has been largely neglected until very recently. The investment boom finished in tears in 1997 and capital spending has been easing since. China's rise together with strong world trade growth has lifted the performance of the Asian Tigers. But over the long term, it will be increasingly difficult for them to experience continuously strong growth without bolder reforms to support household spending. Meanwhile, with the majority of exports directed to demand-deficient countries (that is: themselves), business cycles will necessarily be dominated by developments in the US and China.

India's potential growth rate has risen to 6-6½%, up from 4% in the

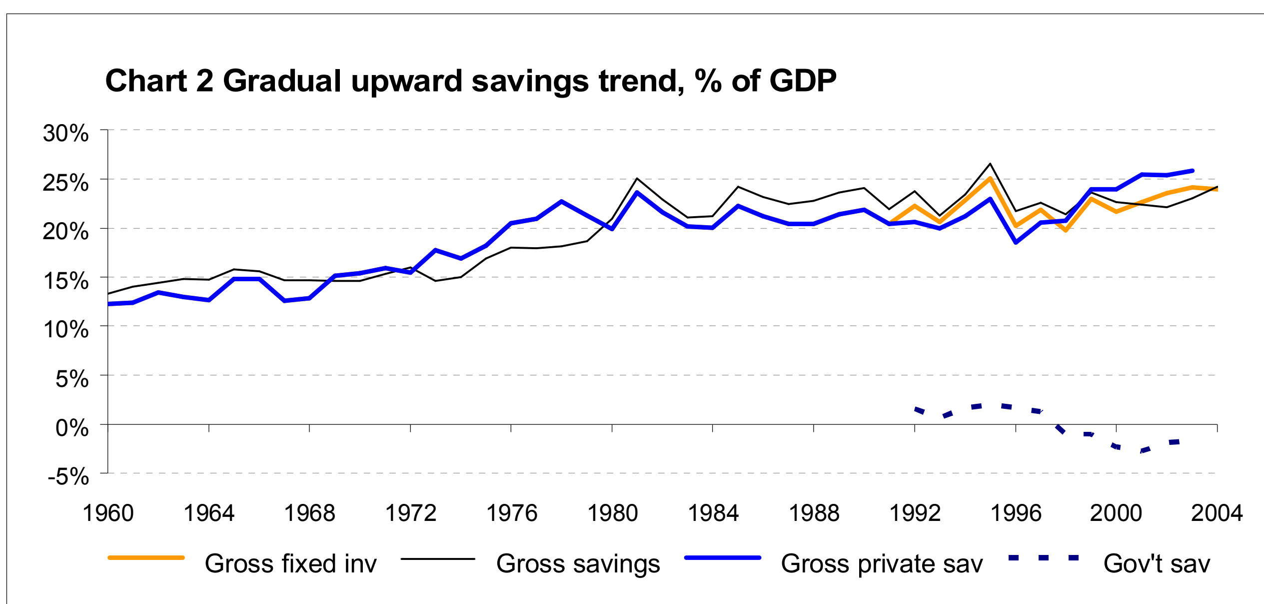


Table 1. India vs Asian tigers

	India			Korea		
	1980	1990	Latest	1980	1990	Latest
Real GDP growth 10-year average* to date	3.0	5.8	6.2	7.4	6.0	5.0
Domestic savings rate**	20	22	24	23	37	34
Investment rate**	20	24	24	32	38	30
Per capita income % of US'***	5	6	8	20	32	48

	Hong Kong			Singapore		
	1980	1990	Latest	1980	1990	Latest
Real GDP growth 10-year average to date	9.0	6.7	3.5	9.0	7.1	5.1
Domestic savings rate	54	35	32	27	41	56
Investment rate	35	28	22	46	36	13
Per capita income % of US'	53	70	72	43	51	65

	Malaysia			China		
	1980	1990	Latest	1980	1990	Latest
Real GDP growth 10-year average to date	8.3	8.2	5	5.3	9.3	8.7
Domestic savings rate	30	31	35	35	35	44
Investment rate	30	32	21	35	35	42
Per capita income % of US'	18	19	25	3	6	13

	Taiwan			Thailand		
	1980	1990	Latest	1980	1990	Latest
Real GDP growth 10-year average to date	9.7	7.9	4.5	6.8	7.8	3.1
Domestic savings rate	32	29	26	23	33	32
Investment rate	34	21	20	29	41	27
Per capita income % of US'	17	32	33	11	16	20

* 10 year moving average is a good indicator of the trendgrowth rate of an economy when data on labour and capital is limited or suffers from significant bias.
** in % of GDP
*** Per capita income as measured in PPP terms, US $.

The gross domestic savings ratio has risen

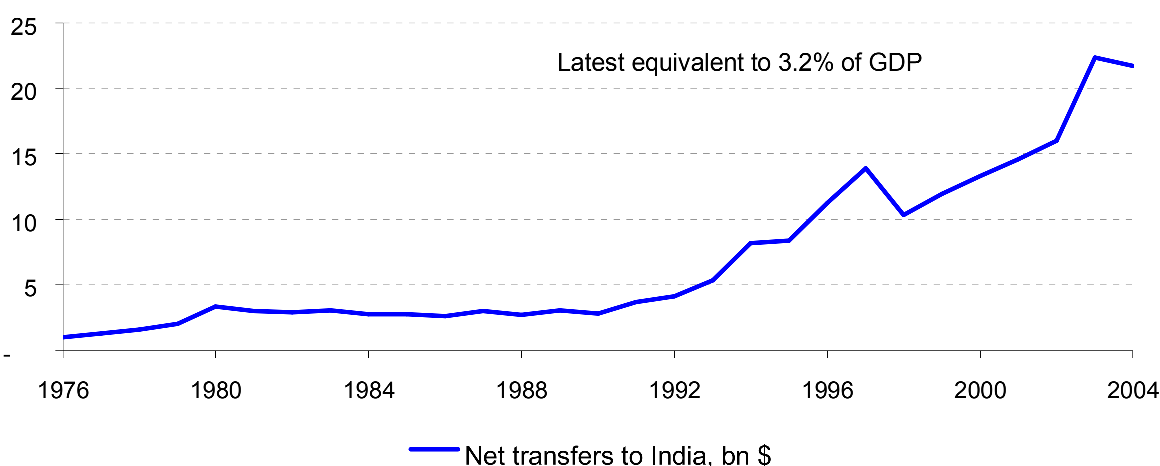
1950-80. The gross savings ratio is estimated to have risen to 24% in 2004, moderately up from 19% ten years earlier[1]. Private sector savings have picked up substantially over the past eight years. An increasingly strong inflow of remittances, mainly from non-resident Indians depositing money in domestic banks, has benefited domestic savings. Net transfers received by India were $21.7bn. in 2004, equivalent to 3.2% of GDP, and ten times the $2bn. received in 1990. However, widening public dis-saving has eroded much of the improvement. The investment rate stood at 23% of output last year, moderately up from the 22% in 1994 and just a touch up from the 19.6% average of the 1990s and the 19.7% of the 1980s. This is rather disappointing given the development stage of the economy. Looking ahead, lifting the domestic savings ratio to 30% and maintaining a modest current account deficit of 1-2% of GDP would boost the investment rate to 32% of output. This would go a long way towards solving current infrastructure problems and could raise India's potential growth rate by a further percentage point.

The fiscal deficit and stringent labour regulations hold back India

Despite poor success in lifting the domestic savings rate, over the past two years annual real output growth has been above trend: 8.4% in 2003, 7.4% in 2004 and will probably stay above 7% in 2005. Inflationary pressures have stayed under control, mostly reflecting rising oil prices. Has India's potential growth rate already increased further? Unfortunately, this is unlikely to be the case. India has a long way to go to tackle two key problems: an excessive fiscal deficit and stringent labour regulations. These represent the two most important barriers to "Chinese-level" medium term growth.

The consolidated fiscal deficit was just below 9% in FY2004

The combined fiscal deficit of the central and state governments stood at 8.7% of GDP during the last fiscal year (2004/05), an improvement after five years of a consolidated deficit above 10% of GDP, but excessive by any standard. (The central government fiscal deficit stood at 4% of GDP in 2004/05, lower than the 4.7% of state governments.) With a financial sector dominated by publicly owned banks and a bond market in its infancy, public excesses have not been difficult to fund: either by direct



bank borrowing or by allocating public sector bonds to them.

No looming crisis in the horizon…

Public sector debt reached 86% of output in 2004, up from 66% ten years earlier. Admittedly, the fiscal deficit is unlikely to trigger a crisis in the near term. Potential growth of the economy is high. External debt is small, 17% of GDP, and easily covered by the burgeoning foreign exchange reserves ($135bn. in Q2 2005, equivalent to over ten months of imports). The share of short term external debt has also decreased, from 10% of total external debt in 1990/91 to 4% now.

…but the large fiscal deficit crowds out badly needed investment

However, the lack of fiscal rigour has been to the detriment of investment. Starving the private sector of capital has curbed manufacturing, which still accounts for only 17% of output, less than agriculture. Its share has been stable over the past two decades. Stubbornly rigid labour regulations have further exacerbated the shortage of credit constraining the industrial sector's development. On

Chart 4 India's consolidated fiscal deficit as % of GDP

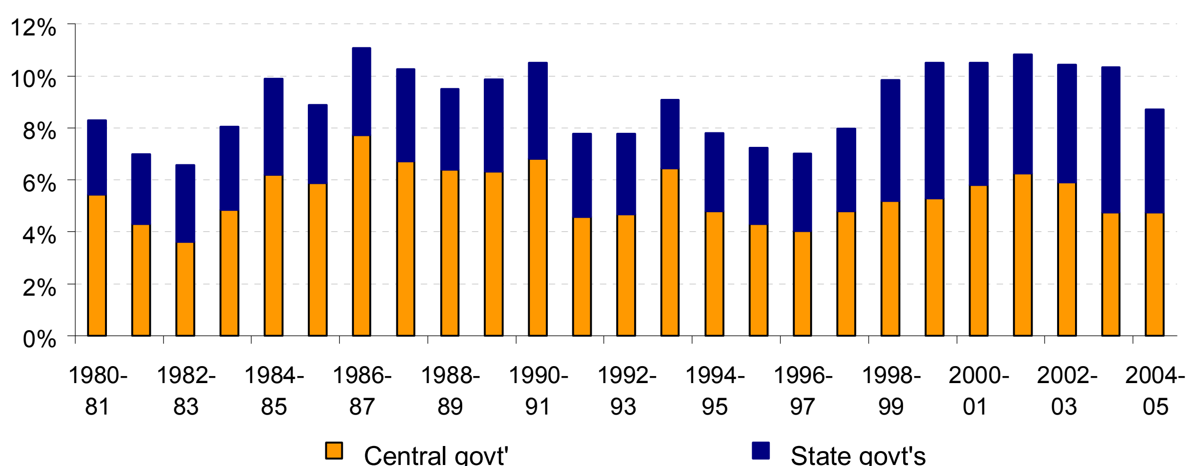
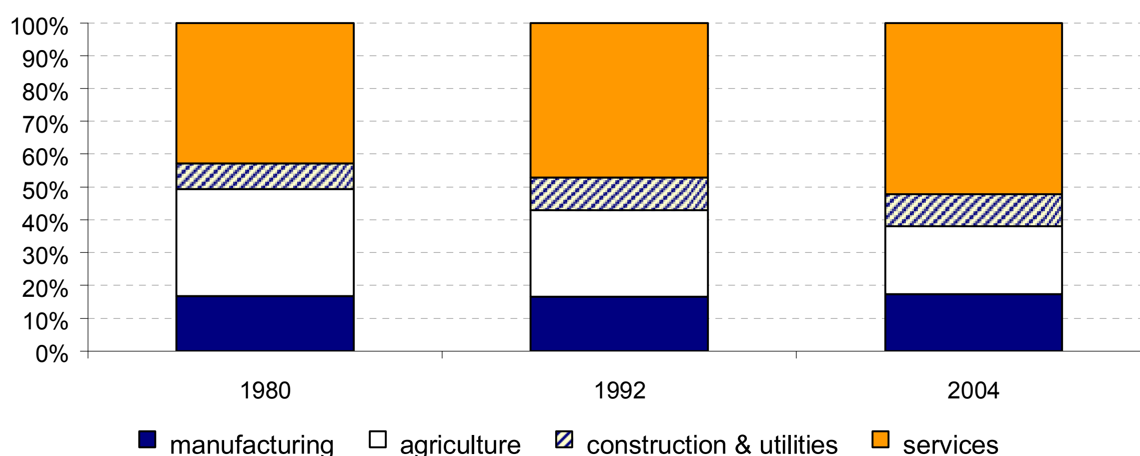


Chart 5 Sectorial breakdown of Indian GDP since 1980



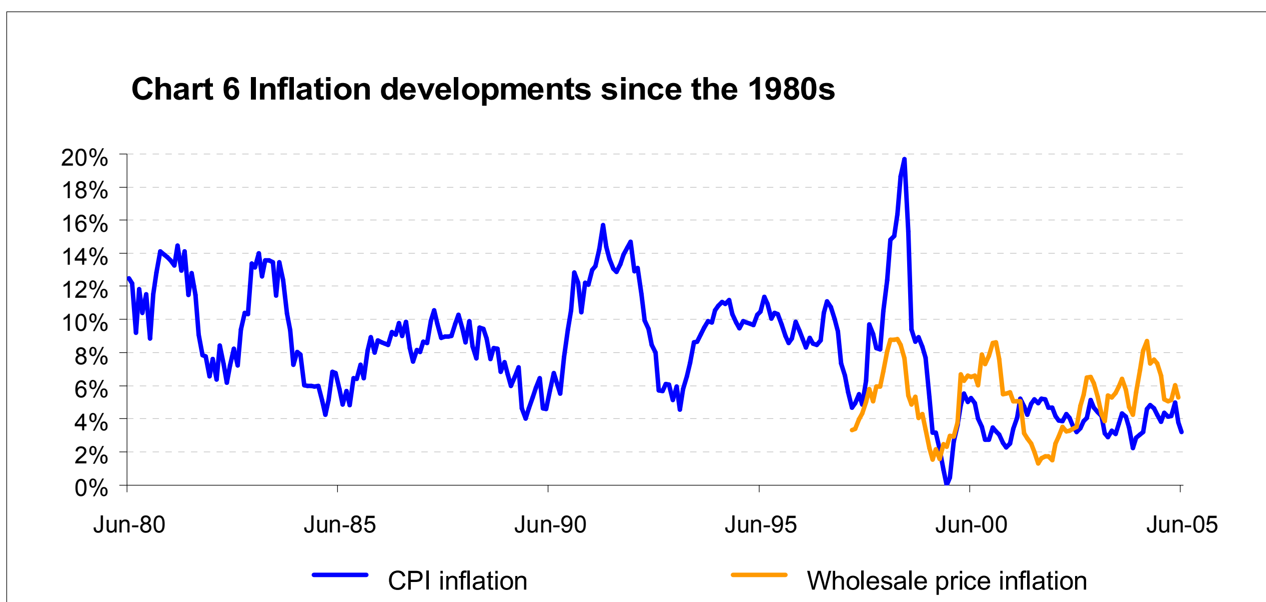
top of this, inward looking policies in the early 60s to late 80s favoured the growth of heavy industries instead of sectors where the country would have had a comparative advantage over the rest of the world. These three factors together led to the development of a capital intensive industrial sector – paradoxical as it may seem – in the second most populous economy in the world. A larger manufacturing sector is a necessary step to decouple the economy from volatile agricultural production, largely dependent on the monsoon season for water. During periods of scarce precipitation, rural incomes deteriorate. This in turn leads the government to buy public support at the expense of bigger deficits, by introducing implicit or explicit support to the agricultural sector, thus feeding into a vicious circle.

India seems to have embarked in a period of serious fiscal consolidation

Last year, the government finally committed itself to fiscal rectitude. The Financial Responsibility Act (FRA) passed in the Spring of 2004, commits the central government to eliminate its revenue deficit completely by 2008 and thereafter to maintain a surplus. Importantly, the FRA does not compel state governments to fiscal rectitude. Recognising that any serious commitment to fiscal consolidation must involve state governments, the central government is pushing for voluntary sign up of the FRA in exchange for some debt forgiveness. In the July Quarterly Review the Reserve Bank of India claims that already eleven states have enacted such agreement and a few more are on track to underwrite it next year. Furthermore, VAT was introduced in the attempt to improve revenue collection.

The rewards to fiscal rectitude are high

The crucial question is whether beyond these initial positive developments, the commitment to consolidation will be honoured in coming years. The goal is ambitious and difficult to achieve, especially after the next business cycle downswing begins. So far, the fiscal deficit remains close to the 1990-91 crisis level. And, the rewards from consolidation outweigh the benefit from not honouring the commitment.



Banking & monetary policy developments

India's financial system used to resemble China's today

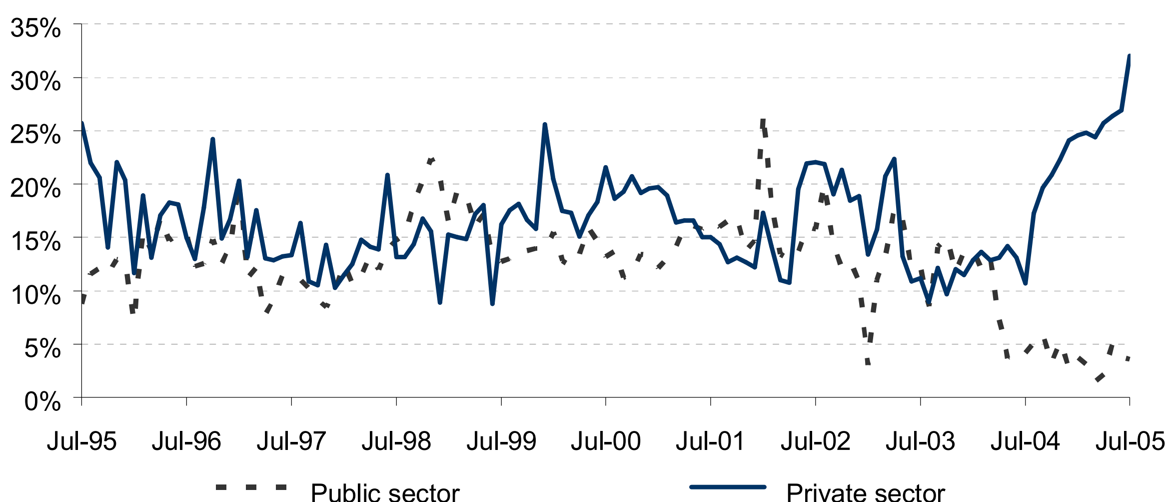
Between the 1960s and early 1990s India's financial system closely resembled China's today. Most banks were nationalised in the middle of the 1960s, transforming the banking sector into nothing more than a mechanism to collect savings and redirect them where the authorities saw fit. Liquidity was controlled by changes in banks' cash reserves with the central bank (CRR) and banks' holdings of government bonds (SLR: statutory liquidity ratio). Strict sectoral credit directives were given, channelling what was left of banks' assets after public sector borrowing to specific sectors: mainly agriculture and small and medium enterprises. All interest rates were regulated.

Sectoral credit allocation guidelines remain but their scope has broadened

Much of this system has been liberalised, but India remains in a transition between a command and a market-economy. The banking sector continues to be dominated by public sector banks. State owned banks (state and nationalised banks together) hold 77% of total banking assets. The remainder are split between foreign banks (7%) and Indian private banks (16%). Interest rates have been fully deregulated, except for interest rates on small savings accounts, export financing and interest rates on non-residents Indian deposits (to allow the authorities control over the inflow of remittances). Importantly, while credit directives remain in place, their scope has been significantly broadened allowing for more coverage of non-agriculture related lending.

Total banking sector holdings of government debt was 36% of assets in July

Despite deregulation, the need to cut the public deficit and to deepen the financial market is clear from banks' huge holdings of government debt. Indian banks held 36% of assets in government bonds in July, down from an average rate of 40% of assets in 2004 but well above the 25% statutory required level. With bond yields falling almost continuously since 1995, banks have earned healthy profits relatively easily. However, the recent reversal of yields hit banks' profitability quite significantly.



The cost of borrowing has fallen over the past five years

The RBI's base rate has stayed at an historical low (6%) since April 2003. The prime lending rate is currently at 10¼-10¾%. However, since 2001 banks are allowed to price loans below the prime lending rate resulting in the effective cost of borrowing being 200-300bps that. Weaker public sector bank borrowing and lower interest rates have initiated a private sector credit boom in 2004. The twelve-month change of total commercial sector borrowing stood at 27% in Q2 2005, expanding above 20% for a fifth quarter in a row. The sector lending breakdown is only published annually and the time series is rather patchy. However, the provisional estimates from the central bank show housing credit growing in the region of 40% in the year, after two years of expanding at or above 50%. (Latest data available for total household borrowing show the year-on-year change at 35% in Q1 2004.) Lending to the industrial sector appears to have slowed a touch to 18% in Q1 2005, down from 23% a year ago, but up from 16% the year before that. Priority sector lending remains strong, growing by over 30%.

The interest rate channel remains too sticky

The RBI has often stated its intention to shift fully to an interest-rate-directed monetary policy. However, lending rates remain too sticky and the interest rate channel remains too slow to allow the Bank to only rely on interest rates to control inflation. Importantly, as the economy is finally reaping the benefits of a deregulated financial market, and given that the RBI's remit is to maintain price stability and to support growth, the Bank has an intrinsic bias to be slow in changing interest rates.

Monetary policy relies heavily on exchange rate management as well as interest rates

The results of the past five years show that the RBI's preferred range for consumer price inflation is between 2% and 6%, and for wholesale price inflation between 2% and 8%. India is no exception to the trend of managed exchange rates and rapid accumulation of foreign exchange reserves. Forex rose to $131bn. by June, from $31bn. in 2000 and an average of only $15bn. in the 1990s. However, the RBI has been more responsive than most Asian central banks to rising external inflationary pressures by allowing for a stronger exchange rate appreciation last year. However, this should not be interpreted as a radical shift towards a fully

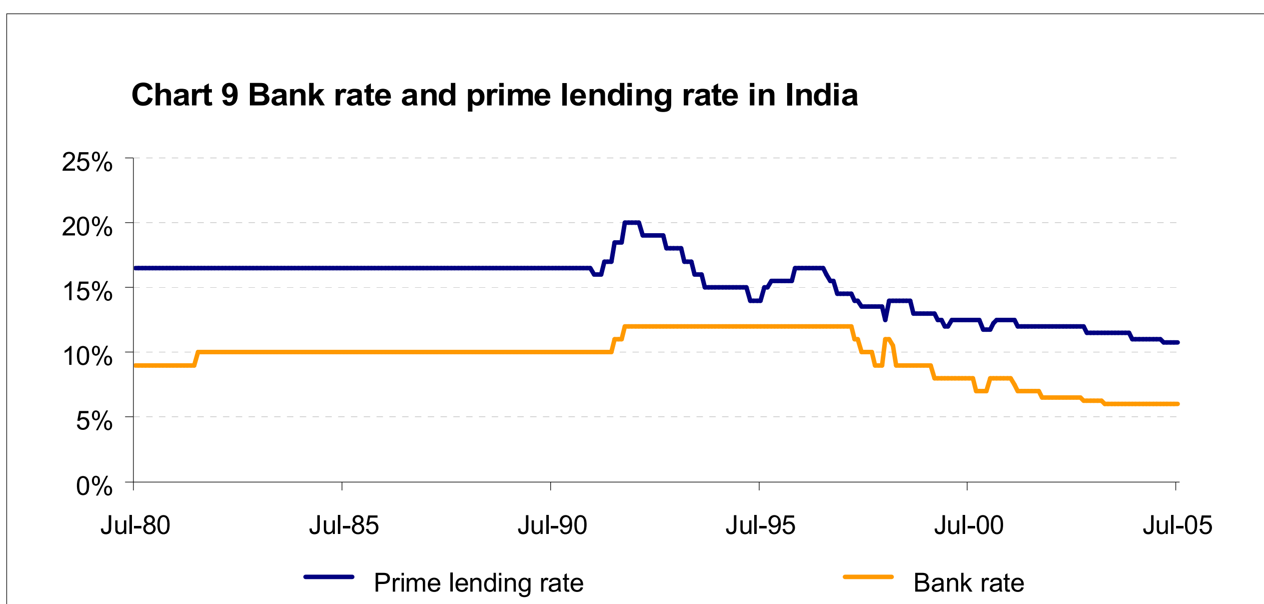
floating exchange rate regime. India only appears more responsive than others in maintaining inflation within the preferred range.

All three main interest rates should be monitored to understand monetary policy stance

Under the previous RBI Governor, the bank rate used to be the key signal of monetary policy and the rate most commonly used as an anchor to floating rate loans. However, under current Governor Reddy the RBI uses three interest rates to signal monetary policy stance: the repo, the reverse repo and the bank rate[2]. The Bank injects liquidity in the system at the repo rate while it withdraws liquidity at the reverse repo rate. The bank rate and the repo rate have recently been linked such that they coincide. Although the bank rate has lost some importance in the implementation of monetary policy, there seems to be no clear trend yet to use the reverse repo rate as the new anchor for lending rates. Despite the bank rate remaining unchanged for a year and a half, the Bank has responded to rising inflationary pressures and has been careful in setting up the necessary security nets against an excessive build up of consumer debt. Banks' risk weighting for commercial property and household loans has been raised from 75% in Q1 2004 to 125% currently. The CIBIL, a credit information system, was set up four years ago and has been fully operational for almost two years now.

Is the credit boom getting out of control?

The theme of this *MIR* has been to show that while some structural improvements have taken place, India's recent strength has been mostly cyclical, driven by looser monetary conditions. So a fair question to raise is when and how will the credit boom end? Loose but useful parallels could be drawn at this point. Back in the 1960s and 1970s, the UK banking system was also characterised by qualitative and quantitative credit controls. When the lending restrictions were lifted, credit booms resulted. To curb such credit booms, the Bank of England put the controls back on. This alternation resulted in "stop-go" growth. In similar fashion, Korea first liberalised household credit in 2000, but only three years later resorted to administrative measures to control the boom, abruptly slowing the economy.



..it doesn't seem likely

In India's case the likelihood of repeating Korea's or the UK's mistakes appears limited at the moment. The RBI has proven watchful both in monitoring the banking sector solvency given the recent bond yields reversal and consumers' strong increase in borrowing. (Unfortunately data on non-performing loans in Q1 2005 will only be released in November. However, latest figures show that NPL ratio is low: at 3.4% for public sector banks and 2.8% for private ones.) Also, India is on track to implement fully Basel II by 2007, which will require banks to increase their capital to comply with the new provision for operational risk. All these factors function as restrictions on the banking sector ability to lend.

Household borrowing as a % of private credit is the lowest in the region

India starts from a relatively low base for credit: private sector borrowing accounts for only 60% of domestic credit, vs 80+% in the Asian tigers. Household borrowing in India takes 13% of private credit, the lowest in the region. So, there is scope for safe strong growth in the medium term within this framework, especially as India is a favoured destination for surplus Asian savings.

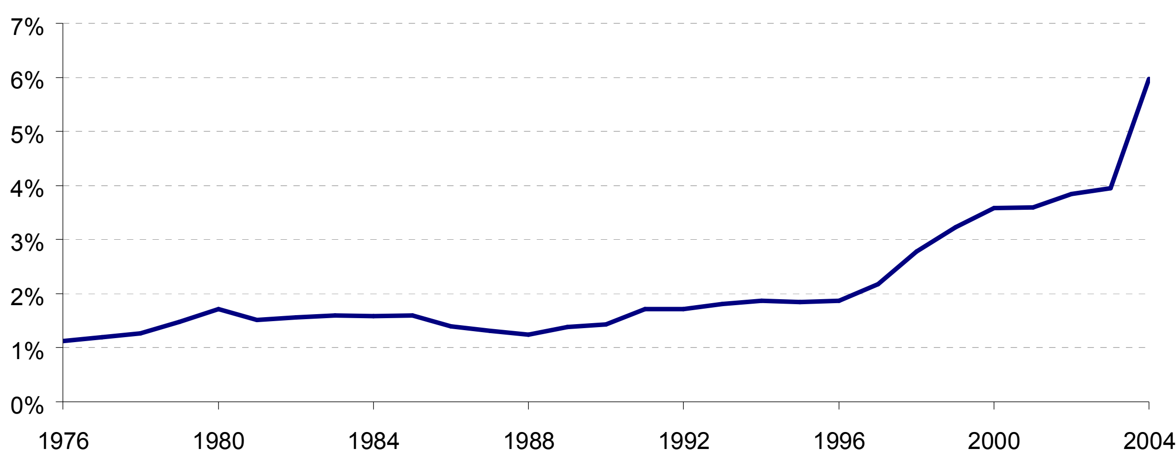
External sector

Export weigh 17% of GDP

India's exposure to exports remains less than the rest of Asia's. The share of exports in GDP rose to 17% in 2004, up from 10% ten years earlier. Service exports continued to grow strongly and accounted for 36% of total exports last year, double their share in 1994. As a share of world exports, Indian exports remain below 1% of total. A new Bill on Special Economic Zones was approved in April, as part of the government's strategy to raise further the profile of exports in coming years. Special Economic Zones are dedicated areas aimed to become eventually the export hubs of the country.

Special Economic Zone benefit from fiscal incentives but lack flexible

SEZs (or export processing zones as they were previously called, EPZs) are not a new idea. EPZs were introduced in India in the early 1960s, but the late 1990s achieved relatively little success both in terms of employment creation and share of total exports. Part of the problem initially was that the regulatory framework was not favourable to their



labour regulations

development: infrastructure was poor and entrepreneurs complained about the significant amounts of red tape. Since 2000, the government has introduced greater fiscal incentives, lesser red tape and more freedom of banking services. A crucial difference between India and China though remains in the approach to employment regulations. While China heavily deregulated labour policies in the SEZs, India never allowed for special treatment of labour in either the EPZs or SEZs. This is likely to limit Indian SEZs' growth. In support to this, a recent survey from the Indian Council for Research on International Economic Relations showed over 62% of respondents indicating labour laws as highly stringent. About 90% of entrepreneurs in the SEZ confirmed that firing employees was difficult and indicated that more flexibility would improve their performance.

Concluding remarks & political headwinds

Is the stock market getting ahead of fundamentals?

The Indian stock markets have risen strongly over the past year. The BSE Sensex index has doubled since its July 2003 level, rising by 30% since the turn of the year. The P/E ratio remains below 17. In the face of the structural shortfalls, it is legitimate to ask whether markets have run ahead of fundamentals. There are three considerations to make. The current P/E ratio is well below the 2000 peak of 28+, when output growth was weaker than present. This P/E inverts to an earnings ratio of 6%. Combined with a trend growth rate of 6-6½% this remains very attractive given the buoyant outlook for growth this year and over the medium term. Domestic demand is strong and much better placed to withstand global headwinds. In a world of excessive savings, India is a relatively underexploited location. Although the country compares negatively on infrastructure with China, India offers far better corporate governance, financial sophistication and rule of law.

Barring political problems, asset prices should

On the other hand, the position over the business cycle argues for a possible cooling of the stock market next year. Much increased credit availability and strong exports continue to reinforce domestic demand more than expected. Also, with the monsoon season better than 2004,

continue to perform well

agricultural production is likely to add to an already strong domestic performance. However, continuing strength will depend on whether the ambitious fiscal consolidation will be achieved. Also a final word of warning should also be given on the political scene. The weak majority of the current government has already undermined the speed of reforms. The chance of a fall of the government remains insignificant, but not impossible, that could lead to a downward correction of the stock market and possibly a halt to reforms.

Raffaella Tenconi

Footnotes

[1] This is lower than the estimates from the Ministry of Statistics and Programme implementation. Domestic savings stood at 29% of GDP in the fiscal year 2003/04, but this estimate contains a large contribution to household sector savings in the form of physical assets. For consistency to international practice, investment and savings ratio are derived from the International Financial Statistics of the IMF.

[2] Before the 29th of October 2004, the repo rate was called reverse repo and the current reverse repo was the repo.

How to leave EMU

Joining EMU was meant to be irrevocable

In the minds of the architects of EMU, joining the single currency was and is an irrevocable step. Once you are in, there is no way out. That was, of course, always a very optimistic view. Previous monetary unions have broken up, even if – like the Scandinavian and Latin Monetary Unions – they may have lasted for quite some time. One difference, however, was that EMU was always intended to be more than "just" a monetary union – note that the 'E' in EMU does not stand for 'European' but for 'Economic'. EMU was always intended to be a step towards political union.

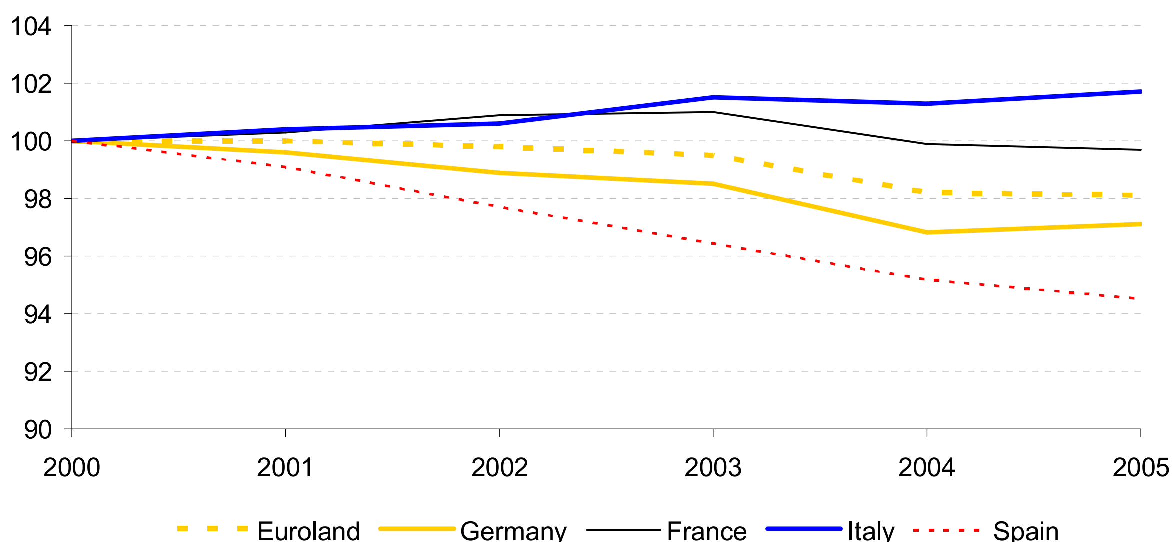
It wasn't really

In reality, as long as political union was not a *fait accompli* (and even after; where are Czechoslovakia, Yugoslavia and the Soviet Union today?) leaving the single currency was always a possibility. But in order to leave EMU, there had to be a political will to do so. And that political will had to come from somewhere. In contrast to the United Kingdom, there was no respectable, main-stream politician in any Euroland member country that opposed (initial or continuing) EMU membership. Without that pre-condition, it was always difficult to see a country exiting monetary union, regardless of the fact that the citizens in quite a few of the member countries seemed less than enthusiastic about the project.

But you need the political impetus

However, following the French and Dutch rejection of the proposed EU Constitutional Treaty, this has changed. Ministers from the Northern League, which is a necessary component in any centre-right Italian government, have begun talking about reintroducing the lira. Much more importantly, Prime Minister Berlusconi has talked about the burden that the euro imposes on Italy. So the first necessary condition for a country leaving the euro – a debate about the possibility and leading politicians advocating such a move – has now been fulfilled.

Chart 12 Euroland unit labour cost developments, index 2000=100



Are Italy's problem the euro's fault?

This is not the place to argue whether it is in fact the euro that imposes a burden on Italy, or whether it is the fact that Italy has failed to take advantage of the opportunity and implement structural reforms. Even if it is the latter, it is always easier to blame someone else for your own troubles. The point with this article is to explore some of the problems involved with leaving a monetary union.

Why leave EMU?

The first question is why any country would want to leave monetary union. Leaving aside the political issue, it could either be because common currency is "too weak" or because it is "too strong". The former is possible; imagine, for instance, a situation where the ECB pursues a loose monetary policy, leading to inflation in the 4-5% range or above as well as a depreciation of the euro. It is quite possible that German voters in that situation would exert pressure on their political leaders to change matters or, in the end, to leave EMU and restore the trusty D-mark. But that scenario is currently hypothetical. A more likely situation is a desire to leave because the common currency is too strong and is impairing a particular country's competitiveness. The motive for leaving is therefore to be able to devalue the currency. This has to be balanced against the fears of market actors that the newly independent currency will indeed be devalued and cause a flight to safety.

And would you be allowed to go?

But there is also a second, follow-up question: would a country be allowed to leave a monetary union if the main motive for leaving is to devalue the currency and improve competitiveness? In one sense, this may be a superfluous question – a sovereign country can do whatever it wants. Equally, however, exiting a common currency can be fraught with enough trouble as it is, without antagonising the countries left behind. As is so often the case in economics, there are two possible answers:

It depends on the agenda of the others

(For simplicity's sake, the country leaving will for the remainder of this article be known as Italy; the countries remaining will be referred to as Germany and France. The new Italian currency will be referred to as the [new] lira.) On the one hand, the Germany and France may well oppose Italy leaving EMU. At the moment, German and French businesses are winning market share from Italian companies, not only in their common export markets, but inside Italy as well. Allowing Italy to leave EMU and introduce its own, devaluation-prone, currency would erode those advantages. It would therefore make sense for Germany and France to make the Italian exit as difficult as possible.

EMU is primarily a political creation

But on the other hand, remember that EMU is primarily a political project. Not only that, ultimately it depends on political union for success. If Germany and France wish to proceed with further political integration, they may well wish to be rid of a country like Italy, whose presence would complicate the process substantially. (They would probably also wish to be rid of Greece and proceed only with the Benelux countries, Austria, Spain and Portugal. The cases of Finland and Ireland is more complicated.) It would therefore be in their interest to facilitate an Italian exit.

What are the problems associated with leaving?

What are then the problems involved in exiting from a common currency? There are the purely practical – though costly and significant – problems involved with minting and coining the new lira. The new notes and coins have to be distributed across the country and there has to be a changeover date or period. In other words, the switch from old liras (etc.) to euros has to be reversed. There will probably have to be a period in which both euros and lira circulate together, but the experience of the switch to euro notes and coins has shown that this parallel circulation period can be fairly limited – probably no more than a fortnight. (Re-educating the population in the use of yet another currency, might take longer.) But this is the least of it. And initially, some of the changeover may be facilitated by using existing euro notes and coins for the new lira. Euro coins already have a "national" side. More importantly, euro banknotes can also be identified by nation through the use of a letter preceding the serial number (in the case of Italy, the letter is 'S'). Assuming an initial fixed exchange rate between the euro and the new lira, Italy could speed up the process by using "Italian" euros as proxies until new lira notes and coins exist in sufficient quantity.

What to do with euro-denominated liabilities

The next issue is, what to do with liabilities currently denominated in euros. In the run-up to EMU, this was dealt with by legislating that all liabilities denominated lira (etc.) would as of a certain date be deemed to be denominated in euros at a pre-announced exchange rate. Again, this process could be reversed by having the Italian parliament pass a law declaring that all Italian euro-denominated liabilities would as of L (for lira) Day be deemed to be lira-denominated. Legally, it seems quite clear that this is perfectly feasible. But here we immediately run into a bigger problem. We are assuming that Italy leaves EMU in order to devalue its currency. The moment there is a serious debate in Italy about leaving EMU, it would have to be assumed that at least foreign holders of Italian liabilities would either leave or demand a higher rate of interest in order to compensate for the imminent currency risk. Initially, this could be dealt with by guaranteeing a temporarily fixed exchange rate between the lira and the euro. This is what happened with the Czech and Slovak korunas when Czechoslovakia split apart in 1993. Initially, the Czech koruna was used in both countries, but early on (after about six weeks) the Slovaks established their own currency, which eventually depreciated vis-à-vis its Czech cousin. But over anything more than an initial period (three months? six months? one year?) such a commitment would lack credibility. After all, if Italy leaves EMU in order to devalue its currency, why would it maintain a fixed exchange rate? So although there would probably have to be some form of interim fixed exchange rate arrangement, it would by necessity be limited and probably subject to speculative attacks from day one. Hence, interest rates would have to rise.

The real question is the banking system

Next, we come to what is possibly the most difficult issue, namely the banking system. There will be deposits by Italians and foreigners in Italian and foreign (despite Mr. Fazio's valiant attempts to keep them out) banks in Italy, that currently are denominated in euros. There will also be deposits by Italians and foreigners in Italian banks outside Italy, that are currently denominated in euros. These will also have to be dealt

with. Once again, there are a number of possibilities. The Italian parliament can pass a law stating that all deposits in Italian banks in Italy will from L-Day be deemed to be in lira. Holders of deposits outside Italy can be given a choice – to be exercised by a certain date – whether they wish their deposits to be in euros or in lira. Possibly foreigners holding deposits with banks in Italy or even Italians holding such deposits, can be given the same choice.

If you leave, to devalue, why would anyone want to hold your money?

But: once again we come back to the fact that the whole object of leaving EMU is to devalue the lira. So why would anyone – Italian or foreigner – wish to hold lira beyond a minimum necessary for day-to-day transactions? Moreover, although legislation regarding leaving EMU could possibly be passed over a weekend, neither getting there, nor the actual changeover can be quite as fast. For one thing, a majority of Italians – or at least of Italian politicians – would have to agree that the country should leave EMU. There is also the small matter of getting Germany and France to agree. All this presupposes a probably fairly lengthy political debate. In addition, lira notes and coins would have to be produced. (It may be that old lira notes and coins still exist in some quantity, but using those, even if possible, would be unlikely to inspire much confidence in the restored currency.)

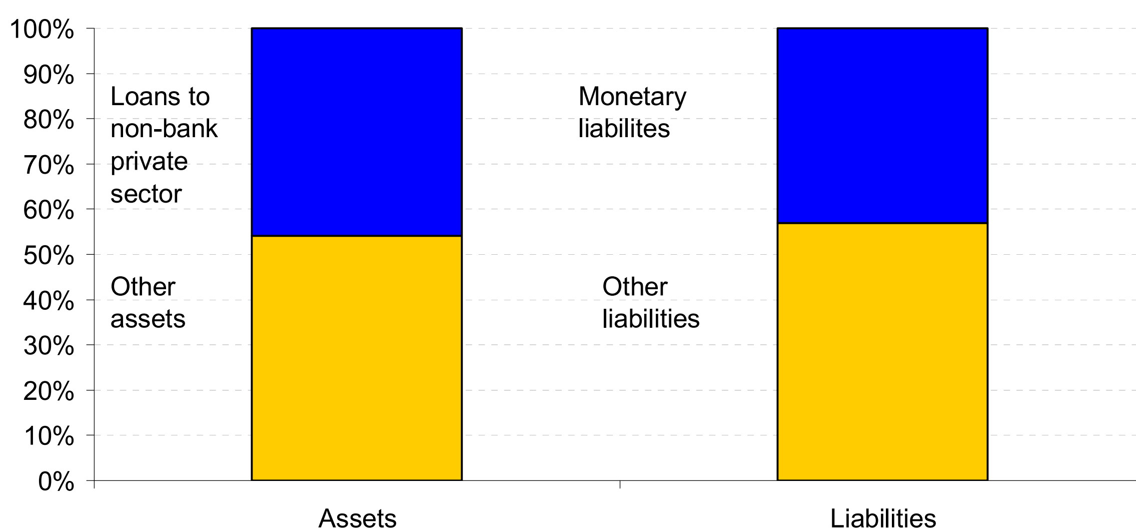
So they abandon it

During this discussion period, anyone not desirous of losing money, would presumably see the writing on the wall and transfer any funds beyond the reach of the Italian state. In other words, close down that deposit account with Monte dei Paschi di Siena and open a new one with Commerzbank in Germany. Keep the cheque account with Monte dei Paschi – you may need it for day-to-day transactions.

Which collapses money supply

But deposits – to be specific, the monetary liabilities of the banking system – are the overwhelming bulk of Italian money supply. So a

Chart 13 Balance sheet of the Italian banking system



wholesale shift from Italian banks to non-Italian banks outside of Italy would collapse Italian money supply. If only overnight deposits remained, Italian M3 would contract by 37%.

It's happened before – and it was bad

Such a collapse would not be unprecedented in a modern economy. In the Great Depression of the 1930s, US money supply contracted by 38% – but this was over the three and a half years from October 1929 to April 1933 – and the effects were certainly dire enough. In the case of Italy, although the fall would be smaller (we should probably assume that not every Italian will, in fact, shift money abroad), it would take place over a much shorter period.

And the banking system balance sheet collapses

Furthermore, if the liabilities side of the banking system's balance sheet shrinks, then the asset side by definition has to shrink as well. Of course, banks' assets are overwhelmingly (66%) claims on the private and public sectors (Chart 13). So Italian banks would be forced to start calling in outstanding loans, bringing about a collapse of Italian business as well.

Unless you raise interest rates

How can this be avoided? One way to stem the flight of deposits can be to attempt to compensate depositors for the perceived devaluation risk. In other words, interest rates would have to rise at the short end as well as at the long end (see above). Although this would represent a tightening of monetary conditions, it would probably be limited in time. Once the exit is completed, 'normal' interest rates would again apply.

…borrow in the inter-bank market

Another possibility is to rebuild the liabilities side by attracting deposits from elsewhere. Initially, these could come from banks in other countries, by Italian banks borrowing in the inter-bank market. However, this does not get away from the problem of having to pay higher interest rates to compensate for the currency risk. And even with the higher interest rates, other banks might be wary of lending to Italian banks if these come to be perceived as credit risks. Conversely, Italian banks may be wary of borrowing at too high rates. **In fact, the first sign of trouble will probably be when (if) Italian banks suddenly encounter problems in the inter-bank market.** A further problem with this method is that if Italian interest rates were much higher than interest rates in the euro-zone, they would also attract speculative flows from other countries. The net effect would be beneficial for Italy – but it would also lead to higher interest rates in the rest of the euro-zone.

… from other central banks

If this source of funds (the inter-bank market) is not available, the next possibility would be to borrow from other central banks in the ESCB (European System of Central Banks, i.e. the ECB and the national central banks). From a European point of view, a collapse of the Italian banking system would clearly be undesirable. However, these banks would equally clearly not be prepared to take on the exchange rate risk. Any agreement to stop the Italian banking system from collapse as a consequence of Italy's leaving EMU, would therefore almost certainly be accompanied by guarantees as to the value of the loans and their repayment – in euros! This means that the Italian tax payer at then end of the day is saddled with the responsibility for repaying the other central

banks in case of a lira devaluation – i.e. all but certainly.

…or from the government

One final possibility is that the Italian government provides the deposits. The government would borrow – massively – in the central bank (not allowed under EMU rules but that could be changed through further legislation) and deposit the money in the banking system. But this too is costly. For one thing, under the assumption made above (all deposits in excess of overnight leave Italy), we are talking about €406bn., the borrowing of which would increase Italy's public debt by just under 30% of GDP – at a time when it already is 104% of GDP. That could again call into question Italy's credit-worthiness and so lead to higher interest rates at a time when the spread of Italian rates over those of the rest of Euroland is likely to have already widened. And, of course, once again the taxpayer is left holding the buck.

Money supply still collapses, though

As an aside, it should be noted that both of these possible solutions still mean a collapse in money supply. Neither public sector deposits, nor deposits by financial institutions are included in money supply. But they would still enable banks to maintain the size of their balance sheets, which is what would initially matter. Moreover, once the initial lira devaluation had taken place, assuming it was perceived as a once-off, or at least that Italian interest rates in the future would provide enough reward to compensate for any further depreciation, money would return to Italy, deposits would be reopened and the government deposits would be repaid.

Italy is not Argentina!

It is worth spending some more time looking at the banking system and its balance sheet. When discussing an Italian EMU exit, it is probably unavoidable that the parallel with Argentina springs to mind. Readers will remember that the abandonment of the Argentinian currency board regime among other effects involved destroying that country's banking system. But this was an intentional move by the government. Faced with a change of currency involving a devaluation, there are four things that can be done with (to) the banking system and its balance sheet:

- Assets and liabilities can both be redenominated in the new currency.
- Assets and liabilities can remain denominated in the old currency.
- Liabilities can be redenominated in the new currency, leaving assets in the old currency.
- Assets can be redenominated in the new currency, leaving liabilities in the old currency.

(Of course, there can also be partial redenominations. But we will leave that aside for the moment.)

Assuming they handle the redenominating right

Clearly, options one and two both involve no immediate effect. Both assets and liabilities will bear the same denomination, either in the new or in the old currency. Banks' balance sheets will be unchanged. That is strictly speaking not quite true. As the argument above shows, one effect of redenominating both assets and liabilities in the new currency could be

a run on the banks. But that can be countered in the way explained above, in the final instance by having the government or the central bank lending money to the banks.

There is the banks' dream

Option three, redenominating liabilities in the new currency, but leaving assets in the old, is excellent news for the banking system. If the new currency depreciates vis-à-vis the old, their assets will rise in value and their liabilities will fall. Technically, since assets and liabilities have to be identical, what will happen is that there will be an exchange rate profit appearing on the liabilities side to balance the rise in the value of the assets.

And their nightmare

If option three is a dream for the banks, option four is a nightmare. This leaves banks with assets falling in value relative to liabilities, in other words a clear insolvency risk. In accounting terms, banks' capital is eroded by the exchange rate loss, eventually forcing them into insolvency. This was the option chosen by the Argentinian government.

There is a small risk, but the taxpayer can foot that bill

If we examine the balance sheets of the Italian banking system in greater detail, we find that – assuming that the government eschews option four – the risks are limited. Most likely, the government would actually go for option one, i.e. redenominating both assets and liabilities in lira. There is one possible exception to this. External assets and liabilities may possibly remain denominated in euros. This creates a minor problem, as there is a mismatch between external assets (€100bn. in June 2005) and external liabilities (€170bn.) Assuming, for argument's sake, that the new lira would devalue by 20%. Then the exchange rate loss would be equivalent to 20% of the excess of external liabilities over external assets, i.e. around €14bn. (20% of €70bn.). The aggregated capital and reserves of the Italian banking system was €171bn. A loss of €14bn. would thus involve a loss of 8% of banks' capital. This is not a major disaster. Italian

Table 2 Balance sheet of the Italian banking system, June 2005, €bn.

	Assets		Liabilities
Loans to euro area residents	1,683.5	Deposits of euro area residents	1,292.5
MFIs	460.4	MFIs	523.8
General government	55.0	Central government	9.0
Other euro area residents	1,168.1	Other general government/ other euro area residents	759.7
Holding of securities other than shares issued by euro area residents	315.2	Overnight	568.4
MFIs	80.9	With agreed maturity	49.6
General government	197.3	Redeemable at notice	68.6
Other euro area residents	37.0	Repurchase agreements	73.1
Money market fund shares/units	1.7	Money market fund shares/units	93.7
Holdings of shares/other equity issued by euro area residents	135.1	Debt securities issued	470.7
MFIs	62.5	Capital and reserves	171.3
Other euro area residents	72.6		
External assets	100.3	External liabilities	170.1
Fixed assets	46.6		
Remaining assets	262.8	Remaining liabilities	346.9
Total assets	**2,545.2**	**Total liabilities**	**2,545.2**

banks are reasonably well capitalised, with a tier 1 capital/asset ratio well in excess of 7%. Losing €14bn. would lower the ratio by 0.6%, which is perfectly containable. Most likely, of course, this cost too will ultimately be borne by the government– i.e., the taxpayer.

Interest rates would rise

So it seems that if Italy were to leave EMU with the object of devaluing the new lira, the immediate effect – even before the new currency is established – would be higher interest rates, with the entire yield curve shifting upwards. Add to that the cost and complexity of the actual operation, together with the likelihood of mass litigation (a nuisance, even if ultimately unsuccessful). It could well be that this will lead an Italian government to conclude that – whatever the ultimate outcome – the costs of exit *at any given time* will exceed the benefit. In that case, even discussing the possibility will simply bring on the costs (higher interest rates) without any benefits at all. But, this is not necessarily a permanent condition. If Italy can convince markets that the devaluation is a once-off, there is no reason why interest rates should not then move down – or up – in response solely to Italian developments. It could be argued that markets may take a lot of convincing, which probably is true. However, the experience of both Britain and Sweden following their respective devaluations in September and November 1992, show that countries can flourish after leaving a fixed exchange-rate, even to the point of (in Sweden) having lower interest rates than the fixed-rate zone they left. Much would therefore depend on what course Italy pursues after leaving EMU.

What happens next?

Post-EMU developments are again somewhat outside the scope of this article. Leaving EMU could initially return Italy to the pattern prevalent before the Maastricht conditions began to be imposed; 10% inflation, 10% budget deficit, 10% interest rates. As it happens, these were not necessarily years of weak growth: Italian GDP averaged 2.1% in the 12 years to 1992, compared with 1.4% in the 12 years since.

It depends on the Italians

It is true that this is hardly thought of as a recipe for a long-term successful economy. But by retaking responsibility for its own monetary (and, lest we forget the SGP, fiscal) policy, Italy might be able to lay the groundwork for the structural reform program that the country so badly needs, whether inside EMU or outside. And by setting a monetary policy more suited to Italian conditions, it may even be able to facilitate those reforms. Of course, it can equally be argued that retaking control over national monetary policy would provide reform-averse politicians with another instrument that helps to postpone structural reform. Given the current political scene in Italy, the latter may well be the more likely outcome, at least initially.

Do not assume a slam-dunk profit-making opportunity

While an Italian exit from EMU should present markets with profit-making opportunities, it is important not to rush into irrational exuberance. The lira would fall and interest rate spreads widen. But it is highly unlikely that spreads would return to the 600+ basis points seen pre-EMU, particularly given the general narrowing of spreads globally. And there is another possibility: As noted above, it is vital that the liabilities of the Italian banking system (and, in fact, the entire private

sector) be redenominated in new lira. However, the Italian government might decide to soften the blow to markets – not to mention continue to enjoy low interest rates on its own debt! – by undertaking to maintain central government liabilities in euros, at least until maturity. This would enable the Italian private sector to proceed without worrying about currency risk ("with one bound, he was free"). In addition, it would mean lower long-term interest rates, even is spreads against other euro country debt would widen. Finally, it would stop some of the speculation that would otherwise accompany the exit process. It is true that the government would then be faced with the exchange rate risk. But by proceeding along this route, that risk could well become smaller than otherwise. Moreover, the interest rate paid on the debt would, as noted, most likely be rather lower in euros than in lira.

Much would depend on how Italian politicians presented EMU exit to their voters (as well as to financial markets). In the former case – "the pain will be worth it" – it could be possible to expect a development possibly paralleling the British post-ERM experience, i.e. a virtuous circle. In the latter – "no more pain as long as we leave" – the opposite would be a more likely development.

Gabriel Stein

A final caveat

Note: The argument above assumes that Italian withdrawal from EMU would be negotiated with its EU partners, all of which (not only the euro members) would have to agree to a change in the relevant EU Treaty. As part of this negotiation, it is assumed that the other countries would agree to redenomination of Italian external liabilities, whether public or private sector. If this were not the case, matters would be far more complicated and the risks for Italian non-financial companies and banks would be considerably greater.

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