

CSE WORKING PAPERS 18 | 03: giugno 2018

ISSN (on line): 2384-969X

ISSN (print): 2385-0310

## **Leaving the Euro** **A feasible option for Italy?**

Giovanni Santambrogio

### **ABSTRACT**

The Financial Crisis of 2008 has been especially hard on European Southern countries which, although some cautious signs of recovery, are still struggling to find their way out of it and return to previous levels of occupation and growth. During the last decade, many prominent scholars and politicians have blamed the Euro for such difficulties and paved the way for debate about its break-up as a possible solution. Unsurprisingly, such debate has been particularly lively in Italy. The paper deals with the possibility of Italy leaving the Euro and seeks to address the question of its feasibility, not only from an economic perspective of cost-benefit analysis but also by examining legal issues and possible political repercussions and technical difficulties. It does so by reviewing the main arguments from pro-exit literature and by assessing them according to the European Treaties and to official stances of EU officials and other important politicians.

**Keywords:** Euro; Italy; Europe.

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Tutti i testi pubblicati sono preventivamente sottoposti a due referees anonimi.

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# Leaving the Euro

## A feasible option for Italy?

Giovanni Santambrogio

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## I. INTRODUCTION

In recent years, the debate about the possibility of leaving the common currency has grown exponentially, especially since the financial crisis outbreak in 2008. It is no surprise that such debate has been particularly lively in Italy, a peripheral country marked by low growth and high levels of unemployment and public debt. Many political forces are, in fact, calling for the country to ditch the common currency. But should Italy do so? And, more importantly, is there a way to legally exit the common currency? In this essay, I try to address the legal and political issues that Italy would have to overcome if decides to leave the EMU. As a result of such analysis, I seek to demonstrate that, especially because of the enormous political costs Italy would suffer, leaving the Euro is not a feasible option.

In the first section, I will analyze the main characteristics of the Euro-exit debate, focusing especially on the Italian situation. Later on, in the two main sections, I will try to address all the major legal issues and political repercussions Italy would face when exiting the currency union and briefly deal with the main economic and procedural difficulties the country would undergo. In doing this, I will also try to show some of the biggest flaws pro-exit literature presents and ultimately display why Italy should not leave the common currency. Finally, in the conclusions, I will sum up the main reasons which make ditching the Euro not a feasible option for Italy.

## II. THE DEBATE ON THE BREAK-UP OF THE EUROZONE

The current Europe-wide debate on the possibility of the break-up of the Euro should not surprise anyone. This scenario was already discussed even before the single currency existed (cfr. Scott, 1998). Even in the first years of the Euro, its appreciation against the dollar and problems of slow growth led some politicians to blame the ECB for disappointing economic performance and to argue for the dismantling of the Euro.<sup>1</sup> Though, the turning point has been the financial crisis of 2008, which has surfaced and exacerbated many of the pre-existing problems, especially divergence in productivity performances, current account deficits and excessive amounts of external debt. This has obviously led Euro break-up debate to gain momentum.

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<sup>1</sup> In June 2005, Italian Welfare Minister Roberto Maroni declared that “the Euro has to go” and called for the reintroduction of the lira. The then prime Minister Silvio Berlusconi followed by calling the Euro “a disaster”.

The southern countries<sup>2</sup> are trapped in recession and since they are in a Monetary Union (MU) they cannot restore competitiveness through the typical mean of devaluating their currencies. At the same time, the northern countries are being asked to compromise their prudential fiscal policy and accept expansive monetary policies by the ECB to help the South get out of the recession. This has brought us to a situation where southern countries are risking outbreaks and social unrests and public supports for European integration is falling behind everywhere in Europe.

Across the continent many prominent scholars and politicians have started to believe that the Euro is at the base of such crisis and have raised their voices. To them, the Common Currency is producing “divisions and tensions that undermine the very foundations of the European Union and the Common Market” and has turned into a “serious threat to the project of European Integration” (Amaral Do et al., 2013, 1). According to Tepper (2012), for instance, the Euro “is like a modern-day gold standard where the burden of adjustment falls on weaker countries. Like the gold standard, the Euro forces adjustment in real prices and wages instead of exchange rates” and “So long as the peripheral countries stay in the Euro, they will bear the burdens of adjustment and be condemned to contraction or low growth” (Tepper, 2012, 2). Eichengreen (2010) carries this point even further. It is his opinion, in fact, that sticking to the gold standard was the major factor preventing governments from fighting the Great Depression and the same argument could now apply to the Eurozone crisis. Basically, the common currency is what is keeping Europe away from solving the crisis. A strong *j'accuse* has even come from the Nobel prize winner Joseph Stiglitz, who has blamed the Euro for poorer growth and more divisiveness in his latest book (Stiglitz, 2016b).

These people think that leaving the Euro would be the optimal solution, especially for the peripheral countries who have suffered the most from the crisis and have the most to gain from the wide devaluation their new currencies would suffer (or enjoy?) after ditching the monetary union. Most *pro-exiters* admit that leaving the Euro would come at high costs. Yet, such costs are negligible compared to the situation of perpetual below-potential growth and high unemployment these countries would suffer if they remain in the Eurozone. They are a necessary evil that southern countries must bear if they want to benefit from having their own currency and eventually start growing again.

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<sup>2</sup> Southern countries/peripheral countries and Northern countries/core countries are interchangeable labels for two groups of countries. The former includes Greece, Italy, Portugal, Spain and Ireland. The latter includes Germany, the Be-Ne-Lux and the Scandinavian countries. France is a particular case which probably stands in the middle of these two groups. I will use both definitions of both groups in this paper without any distinction.

Not surprisingly, the debate about the exit from the Euro (and even from the European Union) is particularly hot in Italy, a peripheral country experiencing high levels of public debt, high unemployment and low competitiveness.

Many politicians have been surfing the Eurosceptic feeling for some time now. The latest to join the club was the former prime minister Silvio Berlusconi. After having already supported anti-Euro positions in the past and most recently in 2014, the “Cavaliere” recently claimed that he is now “fully convinced” that Italy should introduce a separate currency alongside the Euro. In his opinion, this would help Italy recovering its monetary sovereignty as the Euro would still be used for import and exports while the new currency would serve domestic transactions and state payments to “help the left behinds” (Newman, 2017). Needs to be said, this is probably just politics. Having Forza Italia (FI)<sup>3</sup> lagging in the polls, he is probably trying to regain some territory playing the moderate-Eurosceptic card. He knows that calling for Italy to fully exit the euro would be too big a step for his party (and for his country).

Though, there are two other significant Italian political parties that support more clearly anti-euro stances. Whether this being because of political or ideological purposes is only a matter of speculation. What does matter is that both the Five Star Movement (M5S) and the Northern League have been steadily gaining ground in recent years. The M5S has called for a referendum on the exit of Italy from the Euro for some time now and is currently polling just shy of 28% (Figure 1), disputing first place in the polls with the only big pro-European party, the Centre-left Democratic Party (PD).

The extreme-right-populist Northern League (LN) is arguably the most Eurosceptic party in Italy and has always supported an Italian exit from the Euro, even flirting with the idea of abandoning the European Union altogether. Latest polls show that the LN falls just one point behind FI. Although an alliance between NL, M5S and FI is unlikely, these three parties could well give the next Italian Parliament a Eurosceptic majority. A wide alliance on the right, including FI and the NL along with smaller, profoundly Eurosceptic party Brothers of Italy (Fdi) would have the edge on the PD alone and might be the most viable Eurosceptic government hypothesis.

Aside from politics, signs coming from popular feels are not encouraging either. Albeit most Italians are still in favor of the common currency (Figure 2), this support has declined by 11 points between September 2016 and February

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<sup>3</sup> A moderate-right political party founded by Silvio Berlusconi in 1994. Its english translation would literally be “Come on, Italy”.

2017 according to a poll conducted by Euro Metra Montrose (Figure 3)<sup>4</sup>. Still, although with some influential exceptions<sup>5</sup>, most Italian economists, government officials (current ones, though) and business executives have been resolute advocates of the Euro. “These days Italexit scenarios are very fashionable but they give me the chills” Pier Carlo Padoan, Italy’s finance minister, said last March, adding that those promoting such a concept “had no idea of the economic, social and cultural damage that would hit our citizens” (Politi, 2017).

Figure 1

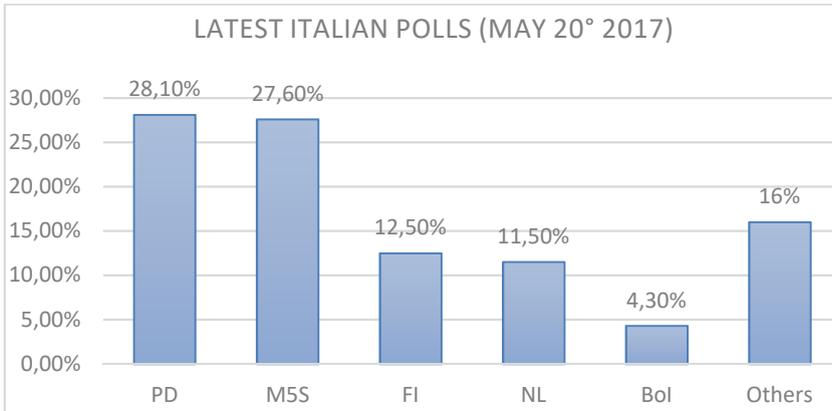


Figure 2

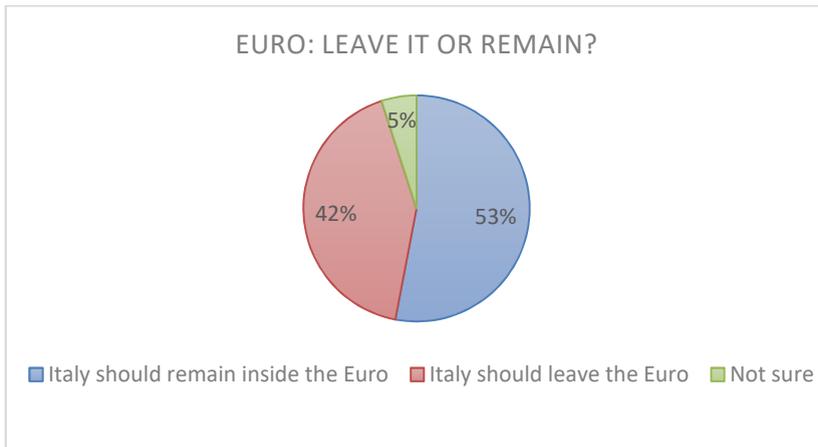
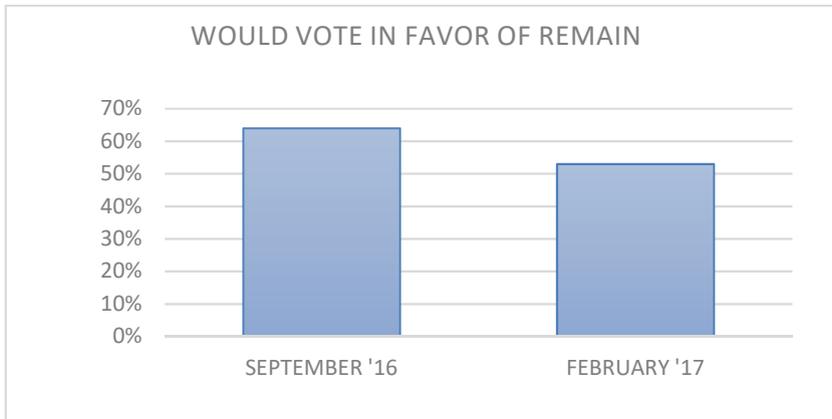


Figure 3

<sup>4</sup> [http://www.termometropolitico.it/1247131\\_sondaggi-elettorali-referendum-uscita-euro-intenzioni-di-voto.html](http://www.termometropolitico.it/1247131_sondaggi-elettorali-referendum-uscita-euro-intenzioni-di-voto.html)

<sup>5</sup> See for example the work of Alberto Bagnai, an Economics Professor at Pescara University.



### III. HOW COULD ITALY LEAVE THE EURO?

Allow to briefly sum up the logic and the rationale behind a possible Eurozone break-up.

In *“Leaving the Euro: A practical guide”*, Bootle (2012) gives us a good explanation of which is the real problem of the Eurozone. Basically, the introduction of the Euro was carried out by fixing an exchange rate meant to compromise between the different strength of the currencies of the initial members. This has inevitably forced peripheral countries to sustain an “artificial” exchange rate higher than their effective exchange rate while the opposite occurred for most of the core countries, notably to Germany. Therefore, countries like Italy or Spain are now dealing with a stronger currency than the one their capacities would allow. This has translated in higher real costs and prices, thereby causing a loss of competitiveness that resulted in large current deficits. Poor competitiveness, together with excessive debt, made peripheral countries face chronic shortage of aggregate demand that, in turn, has led to high levels of unemployment.

The EU has tried to solve this situation through austerity programs. This has failed.

In his latest book, Stiglitz points out that “each country that undertook one of the programs went into a deep downturn, sometime a recession, sometime a depression, from which recovery was at best slow” (2016a, 339). There is now wide consensus<sup>6</sup> that any other attempt to regain competitiveness and

<sup>6</sup> See for example the European Solidarity Manifesto (2013), signed by more than 20 professors, chief economists, etc.

work down public debt through austerity is bound to face the same faith. So, if austerity proved ineffective (and backfiring), what can the solution be? Many are now convinced that for countries affected by these problems, leaving the Euro could offer a way out.

As already said before, the real problem for peripheral countries is that they face severe and unsustainable imbalances in real effective exchange rates and very high external debts. The introduction of the Euro has taken away the principal policy tool that countries traditionally used to adjust to external shocks and losses of competitiveness, i.e. the capacity of managing their own currency's exchange rate. Hence, Eurozone countries cannot "export their way back to prosperity" (Tepper, 2012, 38). Only by ditching the Euro they could restore their capacity to devalue their currencies. By letting their currency fall they could then regain competitiveness and start growing again through increased net exports.

Let us put aside all economic long-term theoretical speculations for a moment now and focus on a bigger question: is ditching the Euro a *feasible* option for Italy?

In order to answer to this question, we must look deep into the legal, economic and political consequences that the process of exiting from the common currency would cause to the country. The first set of considerations that should be cleared out are of legal nature. The biggest question here is, in fact, how could Italy legally get out of the monetary union. In other words, is leaving the EMU even an option?

If we look at what the official stance of the European Institutions has been in the recent past, the answer is clearly negative. On January 2015, following concerns whether the upcoming Greek elections at the time could have eventually led the country out of the common currency, Brussels official refused even to speculate on the topic, and strongly reminded everyone that it exists no legal mechanism to be applied for a country wishing to leave the Eurozone. European Commission spokesperson Annika Breidhardt emphasized this point during a press briefing calling EMU membership "irrevocable"<sup>7</sup>. More recently, on January 2017, the Commission confirmed its stance in response to a question from Green MEP Rina Ronja Kari, who asked whether EU membership and the Euro were linked considering the defeat of Italian premier Matteo Renzi in last December's referendum. Conversely, in its reply, the EU Commission stressed again that "The substitution of the legacy currency by the euro is irrevocable" (Gutteridge, 2017).

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<sup>7</sup> RT news (2015).

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Few weeks later, the European Central Bank (ECB) Governor, Mario Draghi, also took on the issue. In a letter to two Italian lawmakers in the European Parliament, Draghi basically threatened Italy saying that “If a country were to leave the Eurosystem, its national central bank’s claims on or liabilities to the ECB would need to be settled in full” (Reuters, 2017). Since according to European Commission’s TARGET2 Balance Report of the time, Italy was owing 358.6 billion of Euro<sup>8</sup>, Draghi was subtly implying that an “Italexit” would be impossible. Many have though noticed that, although labelling it impossible for Italy, Draghi did admit the possibility of a break-up of the Euro-area and described its conditions. Some countries (the majority) in the EMU owe way less than Italy to the ECB in form of TARGET2 funds. What is arguably an unpayable bill for Italy may not be too much of an obstacle for other countries, including the ones that have repeatedly flirted with the idea of ditching the common currency<sup>9</sup>.

Euro-exit supporters have also speculated on the fact that Draghi settled a condition but failed to specify some important details, like the currency the settlement would have to be paid with, or what the ECB could and would do in response to a country which does not “settle its claims in full”. Even if we recognize that at some level Draghi’s statement opens a possibility for the break-up of the Euro, the European Union’s position on the issue remains sky clear: the Euro is irrevocable. Yet, as many could say, this is just politics. It would not be in any interest of the European Union to clear and define possible ways for a country to leave the common currency. Even if there were any, they would not tell you.

The study paper issued by the ECB itself and written by Phoebus Athanassiou (2009) is greatly helpful to understand the legal issues from a more technical and theoretical stand. He poses the question whether a legal right of unilateral withdrawal from EMU exists. The word “unilateral” is intentional as he explains that “a legal right of withdrawal can only concern a non-negotiated withdrawal (negotiated withdrawals are, in principle, always possible)” (Ivi, 8-9). While such right exists since the Lisbon Treaty regarding the withdrawal from the EU as a whole, the Treaties remain silent on the possibility of leaving the Euro. According to Scott (1998) this has to do particularly with three reasons. First, including provisions for break-up could make commitment of the Member States to EMU look less strong; second, providing for the break-up

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<sup>8</sup> TARGET2 Balance Report of March 2017 shows that Italy’s debt have risen to 419.8 billion of Euro. Target2 Balance Report Available at <http://sdw.ecb.europa.eu/reports.do?node=1000004859>

<sup>9</sup> Greece “only” owns 75 billion, France not even one, Ireland is a creditor country for 3.6 billion.

could increase its likelihood; and third, envisaging such possibility would have entailed the enormous and hard task of spelling out of the procedure and consequences of a withdrawal (Scott, 1998, 215). Whatever the explanation for the treaties' silence, its legal consequence is that, to date, there is no clear option for a country to leave the EMU.

With no plain guidance from the European Treaties, can the Vienna Convention on the Law of Treaties be of any help? Athanassiou clearly says no. Community law differs markedly from public international law. With international law, the effect of a norm in the national legal order is determined by national law. In Community law, on the other hand, the effect of a norm is a matter of the Community law itself, not national. This means that "Community constitutes a separate legal system that may be contrasted with traditional public international law in terms of institutional structures and outcomes" (Athanassiou, 2009, 18). It follows that whatever limited right of withdrawal the Vienna Convention establishes, this does not necessarily have legal force within an issue of Community law. In sum, to legally exit from the EMU, a country should somehow fit this process into the European Treaties.

There might be a loophole. If viewed as a remedy or a relief measure, the ECB itself admits three hypothetical circumstances where a Member State could, in a real extreme situation, assert the right of unilateral withdrawal. I will leave aside the first two, since they are no relevant to our case. Let us focus on the third one, which allows unilateral withdraw "if a Member State faces extraordinary difficulties that prevent it complying with its treaty obligations" (Ivi, 19). Could a country like Italy advocate its legal right of withdrawal based on this condition? Some may say yes, but this would be arguably highly controversial. Albeit they are not spelled out precisely, the extreme conditions that Athanassiou talks about probably exceed the economic sphere. To better understand what "extreme conditions" might mean in European law, one must look at the Treaties. For example, in providing the "extraordinary situation" a country could assert to gain a temporary derogation, the Treaties talk about "serious internal disturbances affecting the maintenance of law and order, the event of war, serious international tension constituting a threat of war" or situations where a country must carry out "obligations it has accepted for the purpose of maintaining peace and international security" (cfr. Artt. 297-298 EC).

I seriously doubt that Italy's current situation applies here. The conclusion is then that, if we rigorously stick to the Treaties, there is no legal right to unilaterally withdraw from the EMU and exist no legal provision to do so. So why are still so many people standing in favor of leaving the Euro?

A main argument is that international law has historically been weakly

binding and enforced. Community law is different from international law, true, but it is widely argued that exist no treaty or international provision that cannot be overcome if a strong political compromise comes into play. Athanassiou himself comes to recognize that all legal conclusions drawn in his paper do not take in consideration the political aspects and their possible consequences. As an example, he remembers that “it is, no doubt, political consideration that explains why, despite the founding treaties’ silence on the possibility of secession<sup>10</sup>, no Member State contested the UK’s threatened withdrawal in 1975<sup>11</sup> and why Greenland was allowed to leave European Communities in 1982” (Athanassiou, 2009, 21). After all, if it was to be agreed upon through wide political compromise, it would not be a *unilateral* withdraw anymore.

And, as already said, negotiated withdrawals are in principle always possible (Ivi, 9). Some declarations of European leaders led Euro break-up supporters to further speculate on the possibility of a political agreement. For instance, Hollande stated during an interview with France Inter radio that it was “up to Greeks” to decide whether to stay or quit the single currency union<sup>12</sup> and, citing sources in the German government, German magazine Der Spiegel published an article saying that both Merkel and Schauble considered Greek’s exit “manageable”<sup>13</sup>. Moreover, Bootle suggests that it would, after all, be in the interest of the stronger countries to support the exit of their weaker partner, for they would “ultimately benefit from the departing economy be stronger [...] and they might also benefit by being able to a tighter monetary union and a closer fiscal harmony with the remaining members” (2012, 8).

This last argument in particular I find very hard to believe. Bootle implicitly assumes that Italy would be stronger after leaving the Euro, which is highly debatable. Also, in my opinion, historical evidences do not hold water. Greenland leaving the Communities cannot be compared to one founder Member State wishing to leave the Euro. I then honestly doubt that a political agreement could be found *ex-ante*. Furthermore, all the literature supporting Euro-exit agrees on the fact that, in order to avoid bank runs, capital flights and market panic, leaving the common currency must be planned in secret and announced by surprise once everything has been already decided. Sure, a big part of negotiation would follow, but this does not mean it would be a *negotiated* exit.

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<sup>10</sup> We are here talking about pre-Lisbon European Law.

<sup>11</sup> The reference is to the UK’s then new Labour Government’s demand for a renegotiation of its accession terms, followed by a referendum on whether the UK should remain in the Communities. The very holding of this referendum postulated the existence of a right of withdrawal.

<sup>12</sup> RT news (2015).

<sup>13</sup> This was later denied by Vice Chancellor Sigmar Gabriel.

Secrecy makes it as unilateral as it could be.

It follows from all said before, that a country wishing to leave the Euro must find some kind of a loophole in the Treaties to justify it. Countries have historically found a way out of treaties with the most creative excuses, even granting themselves a look of legality. Equally, Italy should also come up with some sort of expedient to advocate its right to withdraw from the monetary union and justify what, in my opinion, would be a clear breach to the Treaties' law.

#### **IV. SHOULD ITALY LEAVE THE EURO?**

Scott argues that a country contemplating withdrawing from EMU is not likely to be deterred by any treaty. This might be true. But it later adds that there would be no "effective enforcement mechanism to compel adherence [...] if a country was determined to withdraw" (1998, 214). I disagree. Whatever the expedient that Italy could allege, I highly doubt it would play on smoothly. If we compare it to a sovereign state, the EU does not have the same effective power to compel a Member State to respect European law, i.e. to force Italy to stay inside the Euro<sup>14</sup>. True, but it does have a wide range of means that could make leaving the Euro so painful that Italy might actually reconsider ditching it.

In particular, political costs are likely to be particularly serious.

Italy's exit might damage, for example, the balance sheets of other Member States' banks and surely would reduce markets' trust in the Euro and in Europe as a whole, driving out investments from the continent. Diplomatic tension and political resentment could follow, and cooperation in any sector, also nonmonetary issues, would suffer. These costs are hard to calculate, but that does not mean they should be underrated. If Italians were to affect their credibility as reliable partners (by planning to exit the Euro in secret, for instance) they will suffer real strong consequences, especially since Italy is inside the European Union, a much more integrated environment than anything else in the world. Most notably, Eichengreen suggests that "the deflector would be relegated to second-tier status in intra-European discussions of nonmonetary issues" (2010, 13). If Italy sees its future as an active partner of the European experience and attaches value to its participation to the process of European Integration, this cannot happen.

Moreover, exit by one member would raise doubts about the future of the

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<sup>14</sup> There is no European police or army to enforce European law.

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monetary union not only abroad but even inside Europe, especially if it is Italy to leave. Let us imagine for a moment if Germany was to leave the Euro. This would mean a depreciation for the Euro and enhanced competitiveness for many Southern countries. Ironically, many think that if it was Germany to exit the monetary union would be better off, and assert a “Germanexit” as a possible solution for the Eurozone crisis (cfr. Eichengreen, 2010). But if it was Italy to leave, residual members would suffer a further loss of competitiveness. This could cause a domino effect as other peripheral countries would see their situation further worsened and might want to follow Italy’s example.

Could the common currency withstand all of this? We cannot know for sure. There is a wide range of possibilities between the two extremes of a smooth Italy’s exit and a dismantling of the Euro. But the very fact that we cannot discard the latter should already constitute a phenomenal warning. Italy does not want Euro’s death on its conscience, that is for sure.

As I said before, the EU has effective means to respond to a hypothetical exit of a Member State from the EMU. If the Commission recognizes that such exit constitutes a breach of the law of the Treaties, it could take, with the support of the ECJ, a variety of actions against the guilty Member State. These are spelled out in Art. 260 of the TFEU and includes among others economy sanctions, fines and European Funds’ cuts.<sup>15</sup> If Italy is not deterred by any of them and still decides to exit, we can imagine that the EU could take further action, this time with the rationale of punishing Italy and deter any domino effects. Could the Union even expel Italy from the EU? As Athanassiou (2012) points out, unlike the Charter of the United Nations, European Treaties do not provide a collective right of expulsion of a EU Member from the Union and “the legitimacy of its assertion or introduction would be highly questionable, both legally and conceptually” (Athanassiou, 2009, 35). Still, according to European Law the only legal way to ditch the common currency would be to leave the EU. On this basis, we can imagine that the Union could somehow “persuade” Italy to leave the Union under Art. 50. Moreover, the Treaties do give the Council the authority to suspend some of a Member State’s rights, including its voting rights in the Council, in the case of a persistent breach of European law. No right of voting in the Council, joint with political enmity, would almost mean a *de facto* political expulsion for Italy.

How likely is all of this to happen is only a matter of speculation. Still, it is something that cannot be discarded altogether. Again, the sole existence of such possibility should constitute a huge deterrent for Italy and should not be

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<sup>15</sup> For a more comprehensive understanding of which kinds of sanction the European Union could take see Scheppele (2013).

underrated. In our times, an Italy out of the European Union just does not make any sense and I won't even discuss the catastrophic consequences that this would mean for the country.

Pro-exit literature seems to generally underrate these problems. There is, in fact, wide consensus that legal issues and political repercussions could be eventually overcome if Italy was to behave "well". Somehow, many scholars are truly convinced that such process would take place in a cooperative environment. The possibility of being forced to leave the EU is not even considered. Bootle states that "the legal status of a country leaving the Euro but wishing to remain within the EU could be clarified by a Treaty amendment which put that country in a similar position to that of the UK and Denmark [...]. This would probably require the agreement of all Member States" (2012, 27). It just cannot be this easy. Such amendment would need a massive political compromise which I doubt Italy could sponsor and eventually earn. Worries about establishing a precedent and spelling out a procedure to ditch the common currency might constitute an insurmountable obstacle.

In sum, it is highly questionable if leaving the Euro is a feasible option for Italy and if there is a legal way to do so. What is most probable is that, even if Italy could find a way out, this would come at huge political costs.

Let us imagine that, despite everything, Italy does decide to leave. The process of leaving the common currency itself still poses many problems. First of all, we need to consider the legal barriers to exit the EMU.

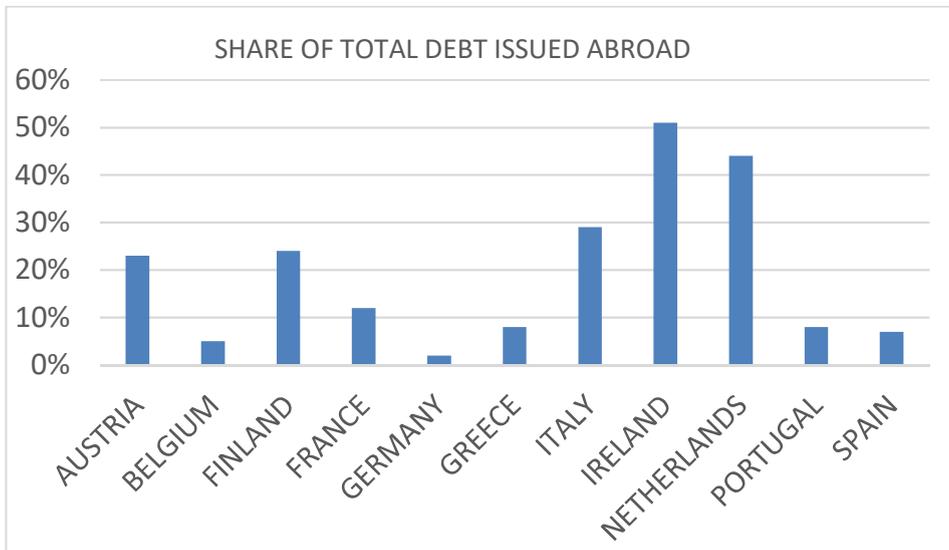
To start with, redenomination of contracts would surely be a great issue to deal with. Private contracts, savings or borrowings are more of an economic problem and, as such, I will deal with them later. I will now focus on the redenomination of the Italian government debt. The common stance here is that Italy should announce its willingness to redenominate all its debt into lira<sup>16</sup> on the same day it announces its willingness to leave the EMU. The problem is that not all such contracts are with Italian creditors, nor are all issued under Italian law. A further complication arises since, as Eichengreen (2010) notes "contracts are not simply being redenominated from one Italian currency to another; rather, they are being redenominated from a European currency to an Italian currency. Foreign courts might therefore take EU law as the law of the currency issuer (Italy) and invalidate the redenomination of certain contracts" (Eichengreen, 2010, 27). Theoretically, when a case involves two currencies, the courts should apply the law specified in the contract. For most of Italian bonds, this is Italian law. But there is a big chunk of Italian bonds that fall within

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<sup>16</sup> For convenience, I assume that Italy's new currency would be called like the one the country used to have before adopting the Euro.

other jurisdictions. There should be no problems with the former, for Italian courts would probably rule in favor of the redenomination of all bonds into liras. Still, as I just pointed out, it might be argued that debts issued in Italy were issued under *European*, not Italian, law. As for the latter, I doubt that foreign courts would rule in favor of something that would highly disfavor their fellow citizens. This might mean that Italy would have to repay in Euro those contracts, which account for almost 30% of the total (Figure 4), a share we cannot overlook.

Figure 4



Moreover, there is wide consensus (Eichengreen, 2010; Tepper, 2012; Bootle, 2012) that the redenomination of debt into local currency, although it would not *legally* be a default, it would certainly be considered a *technical* default by rating agencies and international bodies and organizations such as the ISDA or the IMF. Another shared belief is that redenomination and technical default would have to be followed by some sort of debt rescheduling, which must go through strict cooperation with the Paris and London Clubs and the IMF. Having such a big share of debt under non-Italian jurisdiction might raise several legal disputes and render the whole process much more problematic.

Also, in order to prevent capital flights and banking collapse caused by bank-runs, it is likely, and suggested by many, that Italy introduces capital controls the day it announces its willingness to leave the Euro. Some claim that a fix limited amount for cash withdrawal should be put in place, too. Bootle even

suggests that, at the moment that redenomination was announced but before new lira notes were available, cash machines would need to be shut down and the government should declare a bank holiday in which all banking transactions were prevented. Also, borrowing and lending abroad should be limited and foreign businesses should be prohibited from repatriating profits. Again, capital controls at the borders should be immediately established.

This Italian version of the *Corralito*, although only being for a limited period of time, evidently constitutes a breach of European law, which clearly establishes the free movement of capitals. To justify its actions, Italy might try to assert its right to gain a temporary derogation being this a “extraordinary situation”. Bootle remembers that the Treaties do allow a temporary imposition of capital controls for a period not exceeding six months, if approved by the Commission and the ECB and agreed by a qualified majority in the Council. To him, “it would be relatively easy to gain the agreement of a qualified majority” (2012, 28). The argument here is that the ECB and other Member States would probably have substantial exposures to Italy, therefore it would be in everybody’s interest to avoid a complete collapse of the Italian banking system and prevent massive capital flights. Again, I argue that Bootle takes too much for granted. EU’s willingness to cooperate with a country that has controversially left the monetary union some days before is, at the very least, questionable.

In light of everything said so far, I can conclude that the legal issues of leaving the EMU and the political repercussions the country could suffer are the main reasons that make exiting the Euro an unfeasible option for Italy. The literature supporting such scenario generally underrates these dimensions, as it excessively relies on the possibility of political compromise and wide cooperation of the other Member States. Instead, they focus on the economic and technical difficulties which the process of exit itself involves. Bootle remarks that “while it is widely argued that legal obstacles to a country unilaterally reintroducing its national currency are surmountable, (...) the associated difficulties could be quite serious” (Ivi, 12). Even though it is my opinion that those difficulties are of second importance, they deserve to be analyzed.

As I said, the economic rationale behind ditching the common currency is that, reintroducing the lira and let it devalue, Italy could restore its competitiveness and start to grow again.

Going back to a local currency would involve redenomination of debt contracts which could lead Italy to default on its sovereign debt. Though, according to most of the pro-exit literature, for Southern countries orderly defaults and debt rescheduling coupled with devaluations are not only inevitable but also desirable. Although recognizing that this process would accelerate insolvencies (and not create them, as insolvencies are believed to be inevitable in any

case), *pro-exiters* still believe that “Exiting from the Euro [...] would provide a powerful policy tool via flexible exchange rates” and that, this way, “The European periphery could then grow again quickly with deleveraged balance sheets and more competitive exchange rates” (Tepper, 2012).

These long-period assumptions have been widely contested. First, we cannot forget that the Euro brought a wide range of benefits to its members, which would all be lost when leaving it. Especially for those whose commitment to price stability was previously weak and whose interest rates were high and greatly variable, the Euro has proved really helpful and restored their credibility on international markets. As even Eichengreen comes to admit: “Enhanced expectations of price stability have brought down domestic interest rates, bidding up bond, stock, and housing prices. Foreign capital has flooded in to take advantage of this convergence play. The cost of capital having declined, investment rises in the short run, and as households feel positive wealth effects, consumption rises as well” (2010, 15). The ones supporting the exit from the Euro underrate the possible economic and political consequences of a default and of the loss of credibility on international markets. Also, the assumption that, through devaluation, Italy could export his way back to prosperity is far from being widely accepted and does not take into account the existence of global value chains.

The general position is that leaving the Euro would be, also economically, a disaster (cfr. Nordvig, 2014; De Bortoli, 2017; Alesina e Giavazzi, 2017; Prometeia, 2017).

First of all, the international reputation of Italy would arguably suffer. This could lead to credit rating downgrades and higher sovereign spreads. In turn, this would mean higher debt-servicing cost which could spark an even bigger debt crisis. Secondly, alleging that Italy is manipulating its exchange rate to gain an advantage in trade, some European countries might establish a compensatory duty on Italian exports that, joint with renewed transaction cost, would strongly reduce any competitiveness gain. They could even impose taxes on investments towards Italy, on the basis that it is unfairly attracting them. Moreover, the redenomination of all contracts could be incredibly painful to privates, especially to the ones, banks or firms, who operate locally but have borrowed abroad and would see their liabilities instantaneously increased.

Speculation in the markets could cause the lira to fall way more than expected. It has been proved that, after a certain point, any further fall of the currency produces less marginal benefits up to the point where it even becomes counterproductive (Bootele, 2012; Tepper, 2012). In case of iper-devaluation, iper-inflation could follow, substantially reducing real-wages value. In fact,

wages could not keep up the pace of increasing prices, or else there would not be any gain in competitiveness and the whole thing would have no point. Finally, as I already discussed, internal and external capital controls would have to be established in order to avoid a financial collapse and recession. Also, many suggest that a banking holiday should be announced. These measures would “freeze” the banking system and are also likely to lead Italy into new recession for as long as they are kept.

These are just some of the economic negative effects Italy could face if it does decide to leave the current union. In addition, we can think other technical difficulties that would arise in the following days after the announce.

As already mentioned, it would be better for Italy to plan the exit in secret and announce it by surprise, when everything is decided. But maintaining secrecy over such a huge issue would not be easy, as many people would have to be involved. If there was a leak, the consequences could be catastrophic. Panics in the market, capital flows, bank runs, credit-crunch and potential financial collapse are likely to follow and all of this would take place in a climate of rush and urgency. At this point, the government could try to deny everything, but if it does not work the only solution would be to anticipate the exit with uncompleted planning. Every day of panic before the announce could cause several damages to the banking system and the government might have to intervene and bail some institutions. In order to do so the government might need to borrow internationally in an unfavorable environment at higher interests and the banking crisis could lead to a debt crisis<sup>17</sup>.

Furthermore, in a democracy the redenomination of contracts would need a bill and would have to go through the parliament. The political process is likely to be slow and difficult since, because of secrecy, many political forces would also be caught by surprise. Also, notes would have to be printed and coins to be minted and this would require some time. It follows that there would be a period of high uncertainty where it would be unclear which is the legal tender. Some suggest the possibility of using no cash until notes are ready. Some other argues that “Italian euros”<sup>18</sup> should be printed and used as they were liras and later recollected when the actual lira is ready to be distributed. In my opinion, none of these possibilities could ever play on smoothly.

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<sup>17</sup> The so called “doom-loop”.

<sup>18</sup> Euros “stamped” by Italians authority, so they cannot be confused with “normal” Euros.

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## V. CONCLUSIONS

In this paper, I have tried to address, and later disprove, the main rationale which led many authors to believe that Italy should leave the Euro.

The common currency took away the principal tool a country had to adjust to external shocks, i.e. the capacity to manipulate its own currency's exchange rate. By going back to the lira, Italy would be able to devalue it, restore its competitiveness and grow again. Redenomination of debt contract would likely lead to a technical default and to a rescheduling of the debt which are both seen as desirable for Italy.

After reviewing the main legal, political, economic and procedural issues that the process of leaving the EMU would involve, I concluded that legal issues and political repercussions should alone deter Italy. Ironically, these are the kinds of issues that who is in favor of ditching the common currency is mostly neglecting or underrating.

Since there is no clear provision in The Treaties to leave the Euro, Italy would have to come up with some kind of expedient to justify such exit. Pro-leave literature argues that a political compromise could be easy to find and would make legal issues a surmountable problem. Instead I think that secrecy would make ex-ante political agreement impossible and that Italy would face severe political enmity across Europe. Cooperation in intra-European issues, and not just in monetary ones, would arguably deteriorate and Italy might be relegated to second-tier status partner. It is my opinion that who supports a Euro break-up relies too much on the fact that it would be in everybody's interest to not let Italy fall too hard and ease the process. I disagree. As I showed, it is highly probable that the first concern of the European Union would be to deter any possible domino effect and, therefore, to show how painful can be to ditch the common currency.

Although the EU does not have an army or police corps to force Italy to stay inside the EMU, it does dispense of a variety of means to deter Italy from doing it or, if it still decides to leave, to punish it. Besides economic sanctions, the most painful consequences that Europe could make Italy suffer are, again, of political nature. Suspended voting rights in the council, joint with widespread political enmity, might mean a *de facto* political expulsion for Italy. If Italy attaches any value to its active role within the European integration process this cannot happen. We can even imagine, even though a right of expulsion still does not exist, that the EU could persuade or somehow even force Italy to leave the European bloc altogether. The only fact that such possibility cannot be discarded constitutes a phenomenal deterrent for exit supporters. Furthermore, legal issues concerning the redenomination of debt and the establishment of

capital controls could exacerbate political hostility towards Italy.

From the economic point of view, the alleged long-term benefits of leaving the currency union are widely contested while there is wide consensus that there would be offsetting economic consequences in the short-period, most notably for privates.

Another mistake *pro-exiters* falls into is the excessive trust they give to historic precedents. Indonesia, Argentina or Russia did grow again after devaluating but they were not inside a currency union and they were not part of the biggest integration process mankind has ever seen. Political costs were almost none to them in comparison. When they do provide examples of currency union's break up, they still fail to provide comparable examples. Both Tepper (2012) and Bootle (2012) bring the dissolution of the Austro-Hungarian empire as a historical evidence. The world and its economic features are just too different now to compare them to 1917.

In light of everything discussed, I can then conclude that leaving the Euro, especially because of political costs, is not a feasible option for Italy.

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