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Madeleine Johnsson

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The Limitations of the Euro:
A Case Study of the COVID-19 Pandemic in Italy

by
Madeleine Johnsson

Thesis Submitted to the Master of Arts
in Economic Theory and Policy

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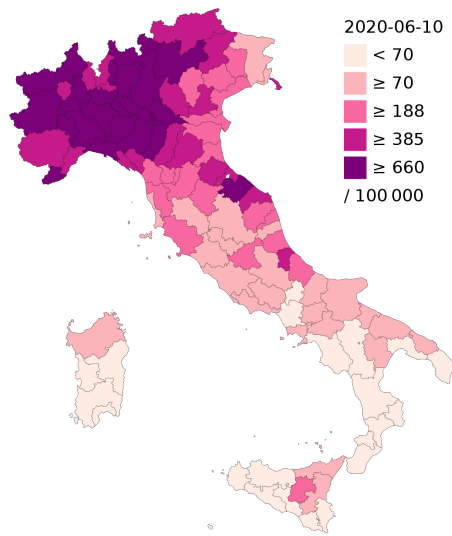
Introduction

The COVID-19 pandemic in Italy is the latest event following the 2010 European sovereign debt crisis and the 2015 European migrant crisis to expose the limitations of the euro. While the worst of the COVID-19 pandemic is over in Italy, the Italian economy faces a new dilemma. Italy finds itself in a potential deadlock as other countries outside and inside the Economic and Monetary Union (EMU) are able to mitigate the impact of the pandemic through greater fiscal relief measures. Therefore, the fate of Italy's economic woes lies in the hands of the European Central Bank (ECB) and the Economic Commission. The difficulty, however, is that the EMU and its governing institutions not only are predicated on neoclassical economics that strips away vital monetary and fiscal policy space for member states during a crisis but also lacks an autonomous fiscal policy mechanism on the supranational level that can act decisively in a health crisis which asymmetrically affects Eurozone countries. Provided an appropriate policy response from the ECB and European Commission, everything would be alright in Italy, or as they say, "Andrà tutto bene."

Section One

COVID-19 in Italy

Italy became the second deadliest epicenter of the global pandemic four months after Sars-Cov-2 was discovered in Wuhan, China.¹ The first known case of COVID-19 in Italy was on 31 January 2020 after two Chinese tourists had arrived in Milan and traveled to Rome on a tourist bus. Even though the Italian government immediately declared a state of emergency and suspended all flights from China, it was not long until a cluster of cases was reported in Lombardy on 21 February including the first death reported the following day. By March, the virus had spread to



all regions in Italy. To stop the spread of the virus, Prime Minister Giuseppe Conte expanded his initial lockdown from red zone regions Lombardy, Piedmont, Emilia-Romagna, Veneto, and Marche on 8 March 2020 to the entirety of Italy the following day.² In a nationally televised address, he stated that any movement other than for necessity, work, or health was restricted including large events and public venues. The lockdown, however, proved to be a little too late as Italy's coronavirus death toll of 3,405 soon surpassed China's 3,249 by 19 March despite the fact that the latter had a population 20 times larger than the former. (Kennedy 2020) While the province Bergamo became the hub of the pandemic in Italy by 24 March (a result of the super-spreader Champions League football match dubbed "Game Zero" attended by 40,000 fans on 19 February³), other regions were making progress with testing.

For example, one week after the lockdowns, Veneto was able to test all residents and eliminate the virus. Italy in total started to show signs of recovery three weeks after the lockdown. By 20 April 2020, the total active cases of COVID-19 had declined and Italy slowly reopened its economy by 4 May. As of 9 June 2020, Italy had a total of 32,872 active cases, 235,561 confirmed, 34,043 deaths, and 163,646 recoveries. The figure to the left depicts the confirmed cases of COVID-19 per 100,000 residents according to each province in Italy, highlighting the concentration of cases per capita in Northern Italy.⁴

Impact of COVID-19 on Italy compared to Eurozone

The outbreak of the pandemic asymmetrically affected Italy earlier and harder than other member states in the Eurozone. A crisis is asymmetric when the effect is disproportionate across Eurozone member states, meaning greater in one country than another. This could either be relative, in which the COVID-19 outbreak had a greater impact on Italy more than Germany, or absolute, such as a forest fire that takes place in only one country but nowhere else in the

¹ The earliest confirmed virus in China is traced back to November 2019. (*South China Morning Post*, March 2020)

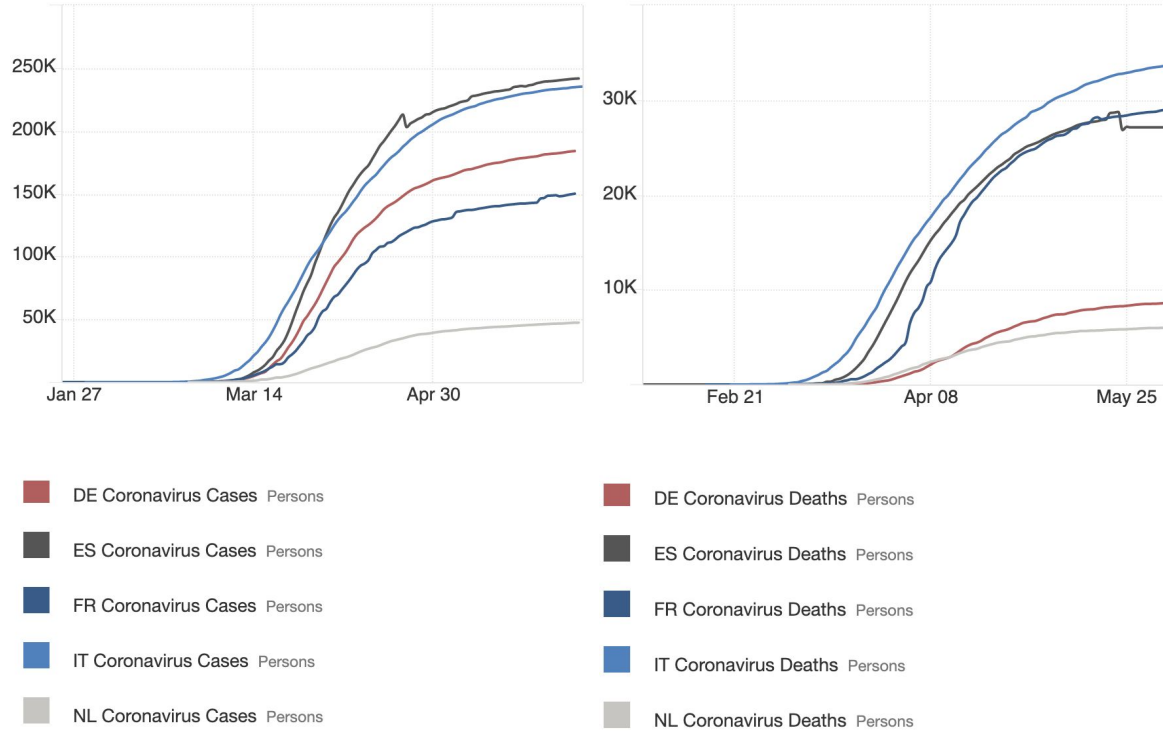
² The red zone region included major cities: Milan (Lombardy) and Venice (Veneto).

³ This football match between Bergamo club Atalanta and Spanish club Valencia was also responsible for the subsequent outbreak in Valencia, Spain. The mayor of Bergamo later explained that the football match contributed to "a strong escalation of contagion between people." (Giuffrida, 24 March 2020)

⁴ Source: Wikimedia Commons, User Ythlev.

Eurozone. This is evident in the graph below which documents the number of coronavirus cases and deaths in Italy compared to Germany, Spain, France, and the Netherlands.

Graph 1 & 2: Coronavirus Cases and Deaths in Italy, Germany, Spain, France, and the Netherlands⁵



Even though Spain eventually surpassed the number of coronavirus cases compared to Italy on April 4, Italy’s number of coronavirus deaths had exceeded all countries in the EMU⁶. Northern European countries, such as Germany and the Netherlands, were able to flatten their rate of deaths related to coronavirus early on in the crisis, despite the fact that Germany had an extensive number of cases in the country.

There are several explanations for why the pandemic impacted Italy more so than other countries. Sara Belligoni (2020) postulated five main reasons why Italy was a breeding ground for COVID-19— Italy’s higher percentage of elderly people as the country with the sixth-highest life expectancy in the world; Italy’s dense population with an average density of 533 people per square mile compared to 235 in Germany; the close proximity of social interactions, such as greetings with hugs and cheek kisses; the high infection rate without preemptive guidance for emergency management; and the close ties between China and Northern Italy, the financial, business, and fashion hub of Italy that disseminated the disease throughout the country. Ognibene (2020) explains that the Italian government was in denial for too long, crediting the early self-imposed quarantine of the largest ethnic Chinese community in Prato for bringing down the infection rate in the town to half the nation’s average, many of whom had returned

⁵ Data provided by Trading Economics.

⁶ The United Kingdom is not in the EMU, therefore excluded from this analysis.

home from China “afraid for ourselves, our families, and our friends.” Meanwhile, half of the German population believed Italy’s poor governance was to blame. (Posner 2020) According to Behnhhold, Germany’s success was attributed to earlier, widespread testing, tracking and treatment backed by available technology and equipment prepared by hospitals and laboratories prior to the lockdown despite the denial among politicians, and a populace that “widely observed” social distancing guidelines imposed by the government. (Bennhold 2020) German MP Eckhardt Rehbert in Chancellor Angela Merkel’s Christian Democratic Union even stated: “[Italy] bears some responsibility for the situation it is in. Look at Italy’s health system. You cannot blame all your difficulties on Europe and Germany. As a German politician, I find that unfair,” against the backdrop of Italy mourning the loss of nearly 35,000 citizens! (Johnson, Fleming, & Chazan 2020) Alessandro Bramucci, Franz Prante, and Achim Tugger (2020) point to the fact that Italy had been forced to cut back on healthcare spending as a percentage of GDP by Germany as part of the austerity measures following the Euro sovereign debt crisis. Even though the outbreak occurred in Northern Italy where the healthcare infrastructure was superior to other parts of the country, the authors claim that “decades of tight fiscal policy [had] left the health care system in Italy ill-prepared to fight the COVID-19 outbreak” while Germany had been strengthening their healthcare system. Ultimately, Sciorilli and Karnitschnig explain: “Unlike the European debt crisis—partly caused by the affected countries—southern European countries did not cause the coronavirus pandemic, therefore eliminating the appeal to national responsibility.” (Sciorilli & Karnitschnig 2020)

European Commission Delayed Response

Italy’s plea for help at the beginning of the crisis via the Eurozone’s Emergency Response Coordination Center fell on deaf ears. It became clear that member states had abandoned Italy in its hour of need once Germany, France, and the Czech Republic blocked exports on vital emergency medical equipment. The European Commission neither stepped up to the plate as an intermediary to support intergovernmental cooperation nor aid the severely overwhelmed Italian health system that had run short of supplies. (Braw 2020; Henley 2020) Although China and Russia stepped into the void and brought medical supplies, protective equipment, and antiviral drugs to Italy, the lack of European solidarity during the coronavirus onslaught reminded Italians of the European sovereign debt crisis and refugee crisis, adding fuel to an already strong current of Euroscepticism in Italy. Italians felt like they had been treated as a “laboratory for corona” for countries like Germany to just “watch them and try to learn from their experience.” (Johnson, Fleming, & Chazan 2020) According to Italy’s permanent representative to the EU Maurizio Massari, “Countries that are not immediately affected are mostly not willing to help. Different countries obviously have different threat perceptions. We [Italy] feel that the coronavirus is a global and European threat that needs a European response, but other countries don’t see it that way.” (Braw 2020) According to a survey conducted in March, 88% of the Italian population felt that the EU had left Italy on its own during the crisis. (Henly 2020)

Although the President of the European Commission Ursula von der Leyen offered Italy a “heartfelt apology” one month later on 16 April, positively received as “an important act of truth” by Italy’s Foreign Minister Luigi di Maio, the response felt empty to many Italians including Prime Minister Conte as EU ministers balked at Italy and eight other countries’ request to issue “corona bonds.” (BBC 2020; Balmer 2020; Henley 2020) The “Eurobond,” or “corona

bond,” was the first European-wide recovery proposal that had been put forward by Italy, Belgium, France, Greece, Ireland, Luxembourg, Portugal, Slovenia, and Spain to the Council of the EU as a new common debt instrument intended to share the cost of the crisis and fund efforts to rebuild national economies against the stark economic outlook. Despite the widespread support for Eurobonds across the Eurozone, the proposal for debt mutualization was met with fierce resistance from the notoriously frugal northern countries, Germany, the Netherlands, Austria, and Finland, and rejected the following day.⁷ Nevertheless, the fact of the matter was that Italy was at an impasse with the Eurozone for three weeks — what Italy needed most was a helping hand and medical support to assist in fighting the pandemic instead of tough love and criticism. The delayed action, which proved disproportionately fatal for Italy, signaled the urgency for the European Commission to establish an autonomous fiscal policy response on the EU level rather than depend on the generosity of others in the instance of an asymmetric crisis.

European Commission Plan for COVID-19 Recovery

As of 27 May 2020, the European Commission has planned a €750bn stimulus package dubbed “Next Generation EU” and a proposal to extend the EU budget to €1.1tn in order to overcome the impact of COVID-19. The goal was to distribute the “Next Generation EU” program across three pillars, the most prominent being the Recovery and Resilience Facility of €560bn equipped with €310bn in grants and €310bn in loans.⁸ European Commission President von der Leyen said: “These investments will not only preserve the outstanding achievements of the last 70 years but will also ensure that our Union is climate neutral, digital, social and a strong global player. This is Europe's moment.” The largest share of the proposal will be allocated to Italy with €172.7bn followed by Spain with €140bn, despite the fact that both nations are recorded to have the highest level of dissatisfaction with the EU’s coronavirus response. (Follis 2020) The European Commission’s plan came one week after the announcement of the Franco-German proposal for a €500bn recovery fund to be distributed in grants to the hard-hit parts of the EU, albeit conditional on “a clear commitment of member states to follow sound economic policies and an ambitious reform agenda.” (Fleming & Brunsden 2020)

ECB Plan for COVID-19 Recovery

The main recovery plan launched by the European Central Bank on 18 March 2020 was the pandemic emergency purchase program (PEPP), a bond-buying program with a total envelope of €1.35 trillion designed to counter the effect of COVID-19 until the end of June 2021.⁹ The PEPP would support economic recovery in the Eurozone by “[bringing] us closer to the pre-COVID

⁷ After the proposal for corona bonds was rejected, the European Community met a second time on 9 April for a common Eurozone measure against the pandemic and agreed upon €500 billion in aid and the possibility of the European Stability Mechanism (ESM). The stimulus bill, however, was denounced by Italy’s Prime Minister Conte “unless it [included] a way to share debt among members - something northern EU members like the Netherlands and Germany staunchly oppose.” (BBC 2020)

⁸ The proposal came one week after the announcement of the joint German and French €500bn recovery fund to be distributed in grants to the hard-hit parts of the EU. (Fleming & Brunsden 2020)

⁹ As of 4 June 2020, the ECB had increased the €750bn budget of PEPP by an additional €600bn and extended the program from the end of 2020 to June 2021. This came after several economists and the Governor of the Banque de France François Villeroy de Galhau warned that the “€750bn PEPP will not be enough.” Lagarde responded in favor of the flexibility of the ECB and said: “we will not hesitate to adjust the size, duration, and composition of the PEPP to the extent necessary.” (Arnold 2 June 2020)

inflation path” and acting as a “backstop” to deal with “short-term market stress.” (Arnold, 4

Gap between yields on Italy's and Germany's 10-year bonds



*Pandemic emergency purchase program Note: Through June 10
Source: Tradeweb

June 2020) As shown on the graph to the left, the gap between the Italian and German 10-year bond yields — a measure of risk in eurozone bond markets — dropped when the ECB announced the PEPP on 18 March and decided to expand an additional €600 billion to the program on 4 June. The fall in the Italy-Germany 10-year bond spread signaled confidence in the market and lowered risk.¹⁰ Before the PEPP was established, the ECB added an additional €120bn to the Asset Purchase Program (APP) that purchased a total of €20bn each month in government, regional, corporate, and covered bonds as well as asset-backed securities due to the pandemic. The APP also operated under the self-imposed rule that the purchases of government bonds were proportional to the capital key (the amount per capita each country’s national central bank contributes to the ECB) and a purchase limit of no more than one-third of each country’s debt. (Belz, Cheng, Wessel, Gros & Capolongo, 2020) The PEPP differed from

the APP in that the assets bought by the ECB expanded to include national and regional government bonds, Greek sovereign debt for the first time, supra-national debt, various types of private-sector bonds, and commercial paper issued by non-financial corporations.

Germany’s Federal Constitutional Court Challenge

Although the program was intended to comply with the established rules of quantitative easing in the Eurozone, the PEPP had proven more flexible after the ECB had controversially purchased “€37.4bn of Italian government debt — €8.1bn more than its share of the eurozone economy would suggest — and €23.6bn of French debt — undershooting its share by €11.7bn.” (Arnold 2 June 2020) In retaliation to the disproportional distribution of the ECB’s sovereign bond purchases that favored hard-hit countries, as well as the purchases of Greek sovereign debt rated below the legal investment grade for the ECB, the German Federal Constitutional Court (BVerfG) ruled a ‘legal challenge’ to the central bank’s debt purchases, demanding the ECB provide justification for its bond-buying program. (Arnold 2 June 2020; Arnold & Stubbington 2020) Furthermore, the German national court threatened to prevent the Deutsche Bundesbank from participating in sovereign bond purchases unless the ECB returned to the strict one-third rule of debt per nation.¹¹ Since the German Federal Constitutional Court does not have short-term authority over the Court of Justice of the European Union (ECJ), ECB President Christine Lagarde assured Europeans that the BVerfG “will in no way compromise the independence of the E.C.B” and its “flexibility across jurisdictions” in the pandemic emergency program.¹² (Ewing & Eddy 2020)

¹⁰ Source: Hirtenstein & Minczeski 2020.

¹¹ The Bundesbank President Jens Weidmann also chimed in and warned that the ECB could risk being accused of funding governments if the ECB continues to purchase an “illegal” amount of sovereign bonds greater than the proportion of an economy’s size, such as Italy. (Arnold, 4 June 2020)

¹² Even after Lagarde announced that the PEPP program would add 600 billion euro and extended time into the following year, Bundesbank president Jens Weidmann had the audacity to warn the ECB that buying more sovereign

Italy's Domestic Response to COVID-19

Beyond the horrific death toll, the pandemic heightened the pressure on the already debt-strained Italian economy. Before the crisis, Italy had the second-highest debt-to-GDP ratio at 134.8% (well above the Maastricht limit of 60% debt-to-GDP for Eurozone member states) and surpassed Greece in November 2019 as the riskiest borrower in the Eurozone. (Ghiglione, Romei, & Hall 2020) This prompted the European Commission to warn Italy that its high debt levels would prevent the country's ability to access markets to finance deficits and "limit the capacity to respond to economic shocks and market pressures." (Khan & Dombey 2019; Stubbington 7 November 2019) Since the COVID-19 outbreak had occurred earlier and harder in Italy compared to other Eurozone countries, the European Union economics commissioner Paolo Gentiloni expected "Italy's recovery [is forecasted] to take longer." (Guarascio 2020) This was reflected in the bleak Italian economic outlook published by the European Commission. By the end of 2020, Italy would see a contraction of -9.5% of the GDP, a drop in the government deficit-to-GDP ratio from 1.9% in 2019 to 11.1% in 2020, and a spike in the public debt-to-GDP ratio to 158.9%, the highest rate since World War II which the European Commission had attributed to the "large fall in Italy's gross domestic product." (European Commission 2020, 95) Furthermore, during the pandemic on 28 April 2020, the credit-rating agency Fitch downgraded Italy to BBB-, one notch above junk status, while the rating agency S&P left Italy one notch higher.

The issue is that if the public debt-to-GDP in Italy increases to the expected level of 158.9% by the end of 2020, the Italian credit or default risk increases as it becomes harder for the government to be able to service its debt. This compels credit rating agencies to review the quality of Italian debt. If the risk is too high, the quality of Italy's debt will be downgraded to a lower level. In this case, the only lower level for Italy's debt according to Fitch is junk status at BB+. As a result, this leads to higher interest rates on new debt and higher borrowing costs for Italy. Investors would sell the Italian bond which would trigger a decline in their price and a higher yield, prompting a vicious cycle.

To cushion the economic effects of the pandemic, Italian Prime Minister Conte injected €25bn or 1.4% of GDP into the economy on 11 March, followed by a second government stimulus package worth €55bn in early May that was "long overdue." (*The Economist*, 2020; Johnson 2020) In the second package, the Italian government set aside €25.6bn for Italian workers, €15bn for businesses, and €3.25bn for the Italian health system for the economy to ride out the downturn. Conte also announced guarantees for bank loans and liquidity worth a total of €750bn given to companies affected by the crisis, although reports noted hardly a fraction of the funds have been distributed in the subsequent two months. Italy also has the option to tap aid worth as much as 2% of its GDP from the rescue fund, the European Stability Mechanism (ESM). The country, however, fears an all-too-familiar scenario whereby tough conditions attached would "stigmatize the country [for] being punished for a disaster that was outside of its control." (Johnson, Fleming & Chazan 2020) Provided that the Italian government support is insufficient,

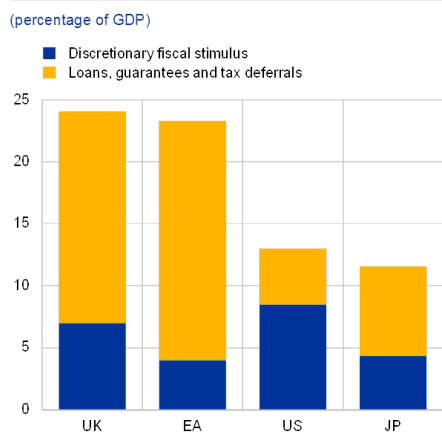
bonds than in proportion to an economy's size, such as Italy's, could risk being accused of illegally funding the monetary financing of governments.

Italy must rely on the stimulus packages from the EMU governing bodies to avoid the looming debt crisis.

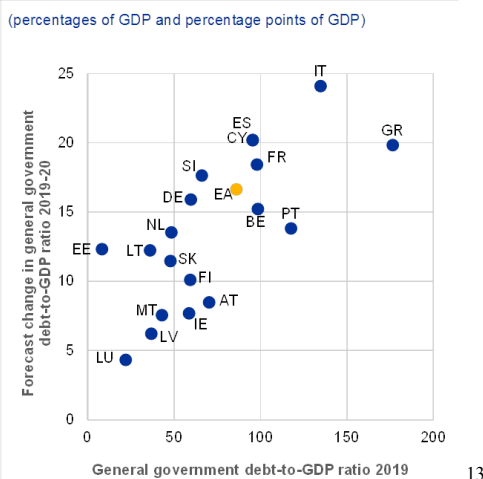
Evaluation of the European Commission and ECB Stimulus Packages

While other countries both outside and inside the EMU are able to mitigate the impact of the pandemic through greater fiscal relief measures, Italy finds itself in a deadlock. The current stimulus packages of €750 billion and €1.35 trillion announced by the European Commission and the ECB respectively may seem generous in size, but in reality obfuscate the actual amount of help provided to Eurozone member states. The Financial Times commentator Wolfgang Münchau (31 May 2020) noted that the commission, as well as the ECB, create big headline numbers to impress “the gullible” with the “statistical sleight of hand.” In reality, the loans are “economically irrelevant since there is no shortage of low interest rate borrowing for the private sector” while the grants are the real substance of the packages. Even then, all grants do not constitute a fiscal transaction, as some are solely for the purpose of lending. For that reason, Münchau notes that the European Commission’s stimulus is anything but Europe’s “Hamilton moment” as Europe would only see an “annual fiscal boost of 0.6 per cent of the EU’s 2019 gross domestic product” over four years. Similarly, the ECB’s stimulus package provides minimal real support. According to Chart 6 in the May 2020 *Financial Stability Review* published by the ECB, the 4% total discretionary fiscal stimulus provided by the Euro area governments as a percentage of GDP remains well below the United Kingdom (6.5%), the United States (8%), and Japan (4.5%).

Discretionary measures and guarantees by governments in major advanced economies



Sovereign indebtedness in the euro area and expected changes in 2020



Italy is further constrained from expanding its fiscal stimulus in the EMU since “the associated increase in public debt levels could [...] trigger a reassessment of sovereign risk by market participants and reignite pressures on more vulnerable sovereigns,” highlighted by the forecasted nearly 25% increase of Italy’s debt-to-GDP ratio by the end of 2020. Italy could also face a surge in their borrowing costs if the ECB cannot absorb the expected extra debt issued by the Italian

¹³ Source: Chart 6 from the May 2020 Financial Stability Review, European Central Bank.

government in the “pathetically small” pandemic emergency purchase program (PEPP) by the end of the year. (McLaughlin 2020)

The external constraint imposed on the Italian fiscal stimulus is further apparent when juxtaposed against the German fiscal stimulus package. On 3 June, Germany made headlines when the government suspended their existing debt rules to pass a €130bn fiscal stimulus package that included an emergency liquidity program for small businesses, value-added tax (VAT) cuts reduced from 19% to 16%, and child care benefits to stimulate consumer demand. In spite of the fact that the outbreak hit Italy *much* harder than Germany, the latter issued a total fiscal relief the equivalent of 4% of expected 2020 GDP compared to Italy’s 3% of expected 2020 GDP. According to German Finance Minister Olaf Scholz, Germany was able to afford the countercyclical fiscal stimulus package to bring the country out of the crisis “with a ka-boom” since “we’ve been financially prudent in recent years and can draw on savings.” (Sandbu 2020)

Scholz’s belief sheds light on the underlying tension in the EMU embodied in the Dutch Finance Minister Wopka Hoekstra’s suggestion to the European Commission to publish a report on why some countries “lacked the fiscal space to weather the current crisis,” an explicit reference to the frugality of the Northern European economies and the profligacy of the Southern European economies. His proposition enraged Southern Europeans, reminded of the 2017 remark by the then-Finance Minister Jeroen Dijsselbloem that the region could not “spend all the money on drinks and women and then ask for help.” (Sciorilli Borelli & Karnitschnig 2020) What Hoekstra and Scholz do not comprehend is that Italy would not have their hands tied if the institutional structure of the Eurozone was not flawed *or* if Italy had its own sovereign currency, regardless of their spending and debt-to-GDP ratio prior to the crisis.

Section 2: The Limitations of the Euro

Institutional Flaw of the Eurozone

The chief architects of the Economic and Monetary Union hoped that the adoption of the euro would promote economic growth, a higher standard of living, and European peace and prosperity. Unfortunately, their experiment came at a grave cost. The institutional flaw of the euro not only stripped away essential domestic policy space particularly in the wake of a crisis but also pitted EMU member states against each other. Using a post-Keynesian economic lens, this chapter exposes the flawed architecture of the Economic and Monetary Union (EMU) in order to analyze its impact on Italy during the COVID-19 pandemic.¹⁴

Two Concepts of Money

The institutional flaw of the euro boils down to a misunderstanding of money. In “The Two Concepts of Money: Implications for the Analysis of Optimal Currency Areas,” Charles A.E. Goodhart (1998) creates a dialogue between two diametrically opposing historical accounts of money, the Metallist and Mengerian “M-Theory” and the Cartalist “C-Theory,” that provide the theoretical underpinnings of mainstream economics and heterodox economics, respectively.

On the one hand, the M-Theory posits that money is a medium-of-exchange that arose out of the private sector to efficiently facilitate market exchanges by removing barter transaction costs. (408) The M-Theory also states that money is determined by its intrinsic value, backed by a precious metal such as gold, given the evolution of money from a precious metal to paper “commodity” money (redeemed on demand for gold) to fiat money (without any backing). Goodhart notes, however, that the M-Theory fails to find a plausible explanation for fiat money: “Even if one should accept the M-Theory of the evolution of metallic coins as money, it is problematic to use that same theory in its pure form to explain why agents should suddenly all be willing to jump from using paper notes which were ultimately claims on precious metals to paper notes which were backed by no specific assets.” The M-Theory’s “[abstraction] from historical and institutional detail” therefore causes neoclassical economists to believe that a government budget is constrained and dependent on taxes and private savings, so that printing too much money will decrease the value of fiat money and cause inflation. (418)

On the other hand, the C-Theory is centered on the idea that the use of currency and the value of money is determined by the power of an issuing fiscal authority. According to the C-Theory, money comes into existence through taxes imposed by the state that require people to pay the state’s currency. In other words, anyone can issue money but the *power* lies in getting it accepted. Therefore, heterodox economists recognize money is a debt, endogenous, and creature of the state because taxes drive money rather than fund government spending. This means that as long as a sovereign independent power is in debt in its own currency, it cannot go bankrupt and insolvent since the government can always issue more money. Divorcing a sovereign currency from a fiscal authority, however, reduces the ability of the state to use fiscal policy to meet societal and economic demands. (413)

¹⁴ The flawed institutional structure of the Eurozone is part of a broader discussion that post-Keynesian economists have exposed since the start of the Eurozone. Please refer to Johnsson (2019) for more on this topic.

Institutional Flaw of the Eurozone

The architects of the euro mistakenly constructed the single-currency union in the context of the Optimal Currency Area paradigm, “a natural extension of the M team theory” that divorced money from an issuing authority and *de facto* brought an end to “the sovereignty of its component nations and their power to take independent action on major issues.” (Bell 2003, 165; Godley 1992, 4; Goodhart 1998, 409) Member states were thus rendered “the status of a local authority or colony” by giving up their sovereign currency to join a partially unified single-currency union. (Godley 1992, 3; Bibow 2014, 5) This left the financial system of the euro dysfunctional: there are no safe assets, debt is shifted onto weaker shoulders, and national banks (like the Bank of Italy, La Banca d'Italia) are subject to default.

The fatal separation of fiscal policy from a sovereign currency can be understood through the comparison of the Eurozone member states to individual states in the United States to the extent that both “are users, rather than issuers, of a currency.” (Papadimitriou & Wray 2012) Unlike the individual states in the U.S., the EMU member states are not guaranteed the benefit of an “Uncle Sam.” While the U.S. government in the blink of an eye can invest in social programs, such as healthcare and pension funds, or bail out the banking sector, such as in the 2008 financial crisis, the euro member states remain solely responsible for funding national social programs and handling problems with their banking system. As a sovereign currency nation, the U.S. is able to run budget deficits “that accumulate high debt-to-GDP ratios with near-zero interest rates on short-term government debt and nearly historic lows of long-term government bonds.”¹⁵ (Papadimitriou and Wray 2012, 3) During recessions, the U.S. government can enact counter-cyclical fiscal policy and act as the lender of last resort. Unless the U.S. Congress decides to impose a debt limit, the U.S. Treasury cannot involuntarily default — a situation foreign to EMU national central banks.

Policy Implications for the Eurozone

According to the economists Dimiri Papadimitriou and Randall Wray (2012), there are two major implications of the incomplete Economic and Monetary Union. First, in the absence of a federal fiscal authority and unlimited deposit insurance, individual Eurozone member states are handicapped in a financial crisis. The authors explain that the financial liberalization, deregulation, and supervision in the banking system permitted by the Basel Accords freed banks to “run up massive debts that would ultimately need to be carried by governments that, because they had abandoned currency sovereignty, were in no position to bear the burden.” (Papadimitriou and Wray 2012, 2) For that reason, crisis-ridden countries in the euro area will automatically encounter deep budget deficits that create a vicious cycle in which markets raise the risk premium on their debt and prompt interest rates to explode. In the absence of an open-ended wide-deposit insurance system backed by a currency-issuing fiscal authority, euro governments are held hostage by the lending of their own private banking system and can only “rely on the ECB to keep the interest rate down.” Second, the ratification of the “TARGET 2” facility allowed depositors to move euro deposits to any euro member bank which ultimately

¹⁵ U.S. economic policy is determined by the ‘government’ — the Federal Reserve conducts monetary policy while the U.S. Treasury facilitates the fiscal policy determined by Congress. Modern Monetary Theory posits government “credits accounts (by simple keystrokes)” and taxes by debiting accounts. (Mitchell, Wray, & Watts 2019, 346)

bred the conditions for instability in the Eurozone. Since countries moved their deposits to the banks of the strongest economic country during a debt crisis, the Eurozone saw a flow of deposits from the peripheral to the core member states. In other words, Germany, the strongest country during the sovereign debt crisis with the safest available euro deposit, would not be exempt from a crisis of its own if Greece, the weakest country at the time, had chosen to default on its loans. The only solution to avoid “EMU bank runs and cascading solvency crises,” according to Papadimitriou and Wray, is the establishment of “EMU-wide deposit insurance, backed by the creation of a strong European federal treasury, [to] end the bank runs that are afflicting the periphery.” At the time that Papadimitriou and Wray were writing, however, the only existing fiscal mechanism in the EMU was the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), a sum insufficient to directly bail out the banks in the Eurozone. This changed when the then-ECB President Mario Draghi on 26 July 2012 decided to save the euro by introducing a new backstop.

After his infamous “whatever it takes” speech on 26 July 2012, Draghi launched the Outright Monetary Transactions (OMT) program which allowed the ECB to purchase unlimited shorter-term debt in the secondary sovereign bond markets for crisis-ridden countries. Similar to the unlimited deposit insurance mechanism, the introduction of the OMT as an extension of “whatever it takes” restored confidence in markets by ceasing the vicious spiral of sovereign bond spreads that had affected lending rates and quickly stabilized the ECB without having to buy a single bond. (Giavazzi, Portes, Weder di Mauro, & Wyplosz 2013) However, the OMT forced countries to apply through the European Stability Mechanism (ESM) conditional on humiliating austerity policies and structural reform, which the individual states in the United States never had to endure. Furthermore, the OMT program was only a temporary tool and not an automated mechanism. This meant that euro area member states could not rely on the ECB to deploy this crisis-era bond-buying program if their economy went bankrupt and insolvent. Since Eurozone national central banks cannot bail out their banking system or enact counter-cyclical fiscal policy to alleviate the crisis in times of recession, countries burdened by a government and current account deficit must enact fiscal austerity in the midst of a crisis to attract investors to fund their expenditure and be lent credit to spend, albeit on undesirable terms. (Forstater 1999: 33; Bell 2002) Given that the ECB and IMF refused to lend to Greece unless its debt was reduced by fiscal austerity and structural reforms, Eurozone countries are captured by their private banking system unless the European governing bodies decide to get them out of a crisis without their society taking the cut.

Italy in the Eurozone

Beyond the fact that the single-currency union strips away the domestic tool kit for countries in times of crisis, the Eurozone has pitted countries against each other since its inception.

Zero-Sum Game

In a 1992 paper about the Maastricht Treaty, the economist Wynne Godley (1992) extends his Sectoral Balances Approach to expose the foundational flaw of the Eurozone:

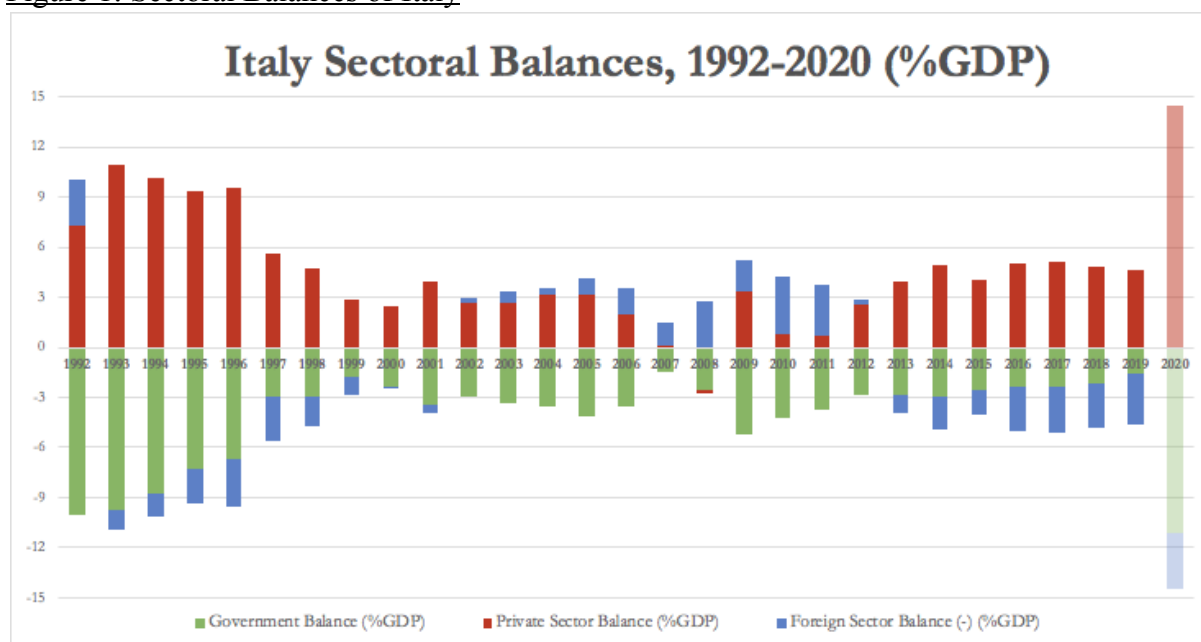
“if one region [in a country] suffers an unusual degree of structural decline, the fiscal system automatically generates net transfers in favor of it. [...] What happens if a whole

country – a potential ‘region’ in a fully integrated community – suffers a structural setback? So long as it is a sovereign state, it can devalue its currency. It can then trade successfully at full employment provided its people to accept the necessary cut in their real incomes. With an economic and monetary union, this recourse is obviously barred, and its prospect is grave indeed unless federal budgeting arrangements are made which fulfill a redistributive role.” (Godley 1992: 192)

In other words, Godley argues that the structure of the Eurozone renders the single-currency union a zero-sum game in which the public sector balance, private sector balance, and current account sector balance must equal zero across member states. The ability for all countries in the Eurozone to obtain a current account surplus is thus feasibly impossible without a federal fiscal authority in a nominal floating exchange rate regime. Trade surplus countries during financial crises will further benefit from the misfortunes of trade deficit countries since the decrease in the value of the euro will further undervalue the net exporter’s real effective exchange rate and create an even greater current account surplus. Since countries can no longer adjust their exchange rate in times of crisis, the only way countries can acquire a current account surplus is if they underbid their neighbor by enacting harsh austerity policies and structural reform to reduce domestic demand for imports, a tactic known as “beggar-thy-neighbor.” The fundamental issue is that if all countries choose to engage in such actions, the euro will board a deflationary train “to poverty and starvation.” (192)

Although Italy reasoned that joining the EMU would strengthen the country’s weak reputation for price stability to “convince financial markets that it would not use the printing press to inflate away the value of its debt and hence benefit from lower risk premia,” the experience of Italy in the Eurozone proves otherwise. (Gros 2014) Godley’s Sectoral Balances Approach highlights the macroeconomic imbalances of Italy in the Eurozone prior to the COVID-19 pandemic, shown in Figure 1 below.

Figure 1: Sectoral Balances of Italy¹⁶¹⁷

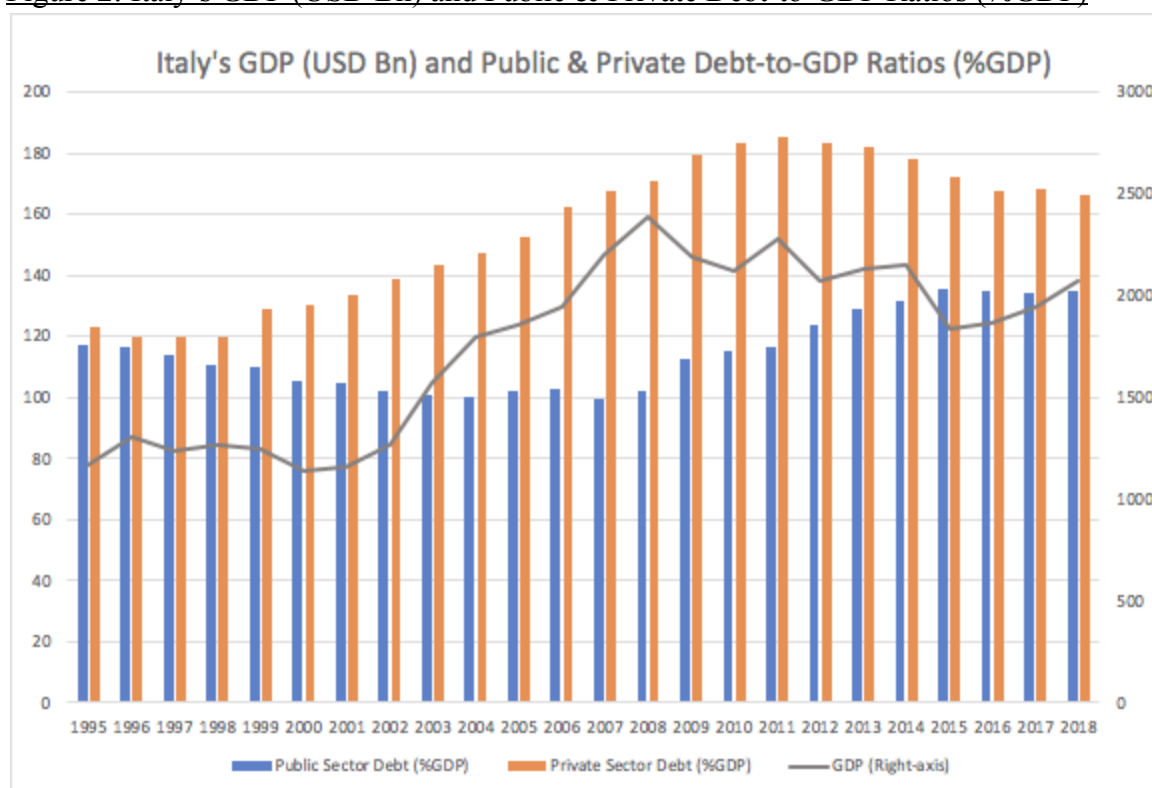


Italy entered the Eurozone as a net exporter, a position that Italy had maintained since 1993. Once the euro was circulated in Italy in 2002, the country’s current account balance quickly reversed. Italy was the role model for the Eurozone — although Italy at times exceeded the budget by at most 1%, Italy had complied with the Maastricht Treaty and balanced its budget until 2008. During this time, Italy had to compensate for persistent current account deficits and moderate private sector surpluses by holding public and private sector debt to finance their economy. (Wray 2012) By the time the global financial crisis occurred in 2008-9, the Italian government had to counteract the economic contraction by increasing its public debt as its government budget deficit to GDP ratio had exceeded the -3% limit. Furthermore, Italy’s minimal government budget in 2007-9 forced the private sector balance into a deficit the following year. This meant that Italy saw its private sector debt-to-GDP increase when the country was a net-importer, while the private debt-to-GDP decreased when the country was a net-exporter from 2012 until 2018, highlighted by the graph below.

¹⁶ Data from Trading Economics; Economic Commission.

¹⁷ The sectoral balances approach maps out the three-sector balances — government balance, private sector balance, and foreign sector balance — for an individual country. On the sectoral balances graph, a government deficit signifies that the government has spent more than it has received, therefore it must be plotted below the x-axis. Government deficits are generally used to offset private sector spending, therefore the public debt tends to rise with government deficits. The private balance is the difference between the private sector investment and household savings, calculated by subtracting the foreign sector (current account) and the government sector (government deficit). Private surpluses, for example, imply that the private sector has spent more than it has saved and therefore should be plotted above the x-axis. The foreign sector balance lastly represents the inverse of the country’s current account — the balance of trade (exports minus imports), net transfer payments, and net factor income (interest and dividends). If a country runs a current account surplus, the country is exporting more goods than they are importing. Hence, a current account surplus is translated into a negative foreign sector deficit and plotted below the x-axis.

Figure 2: Italy's GDP (USD Bn) and Public & Private Debt-to-GDP Ratios (%GDP)¹⁸



The graph also indicates that Italy prior to entering the Eurozone was able to maintain its high debt-to-GDP ratio without a crisis. Given the fact that Italy had a near 120% debt-to-GDP ratio in 1995, the post-Keynesian economist Stephanie Kelton noted Italy was able to avoid a crisis in 1995 as the Italian government could meet the obligation of its debt through issuing lira, a tool that Italy could not use in the EMU. (Walsh 2018)

Referring back to the sectoral balances in Figure 1, Italy has achieved consistent current account surpluses in the Eurozone since the sovereign debt crisis. This is not because Italy invested and improved the technology and production of their exports, rather a direct result of harsh austerity reforms imposed on the economy. Lastly, the European Commission's forecast is shown for Italy in the year 2020.

Policy Space in the Eurozone

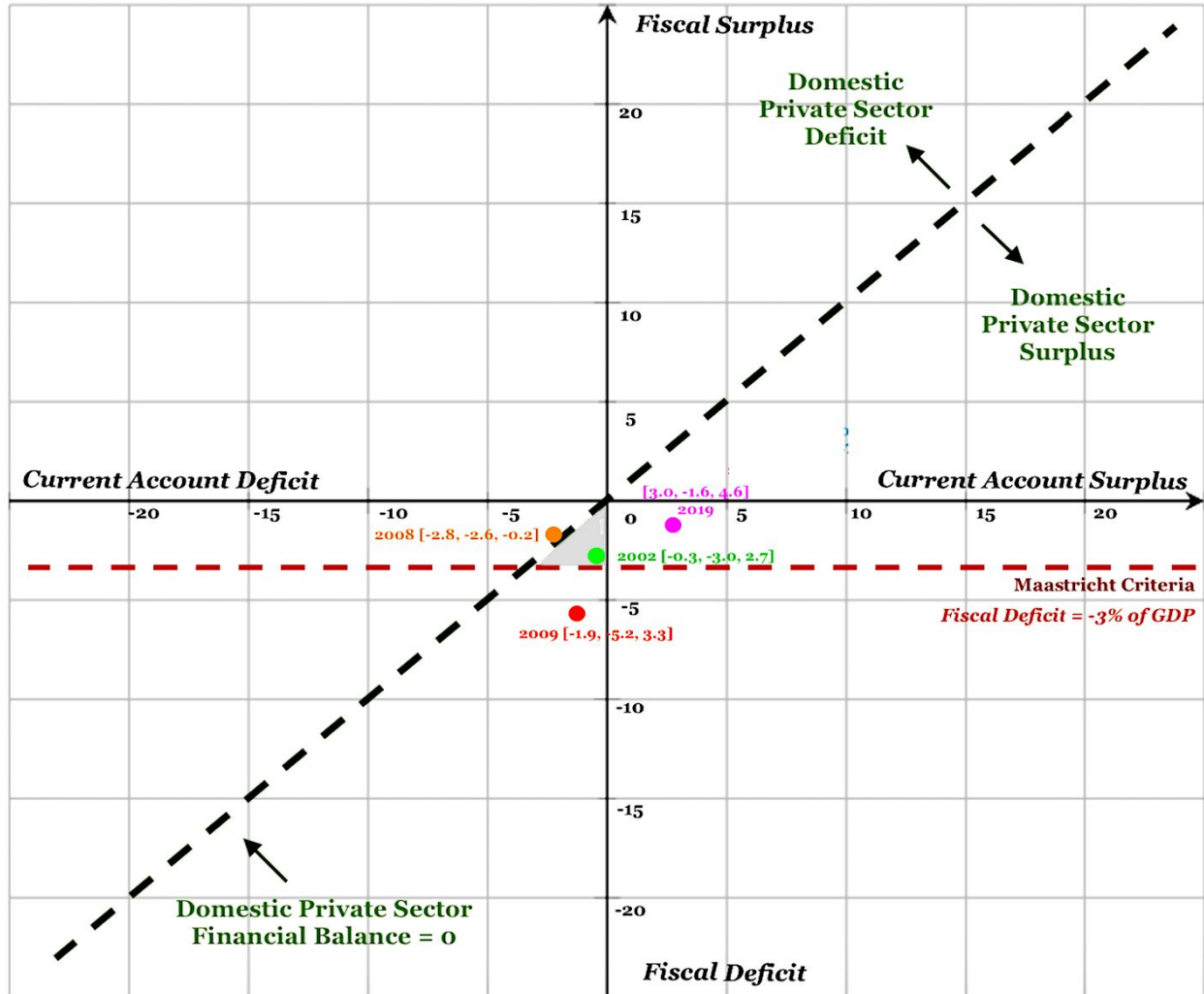
Without the ability to adjust exchange rates in times of crisis, Eurozone member states are heavily dependent on net exports to achieve economic growth. The economist Rob Parenteau demonstrates this in his Parenteau Model, which depicts the available domestic policy space given the fiscal objectives outlined in the Maastricht criteria.¹⁹ According to Parenteau, “the domestic private sector and the government sector cannot both deleverage at the same time

¹⁸ Data provided by Trading Economics.

¹⁹ Euro member states must comply with the strict thresholds mandated by the Maastricht criteria — a maximum of 3% government deficit-to-GDP and 60% government debt-to-GDP — otherwise risk penalties imposed by the Stability and Growth Pact.

unless a trade surplus can be achieved and sustained.” (Mauldin 2011) Parenteau uses the identity “current account balance - fiscal balance = domestic private sector balance,” which is demonstrated in the Parenteau Model of Italy below. The grey triangle section highlights the available policy space for Italy when the country has a current account deficit.

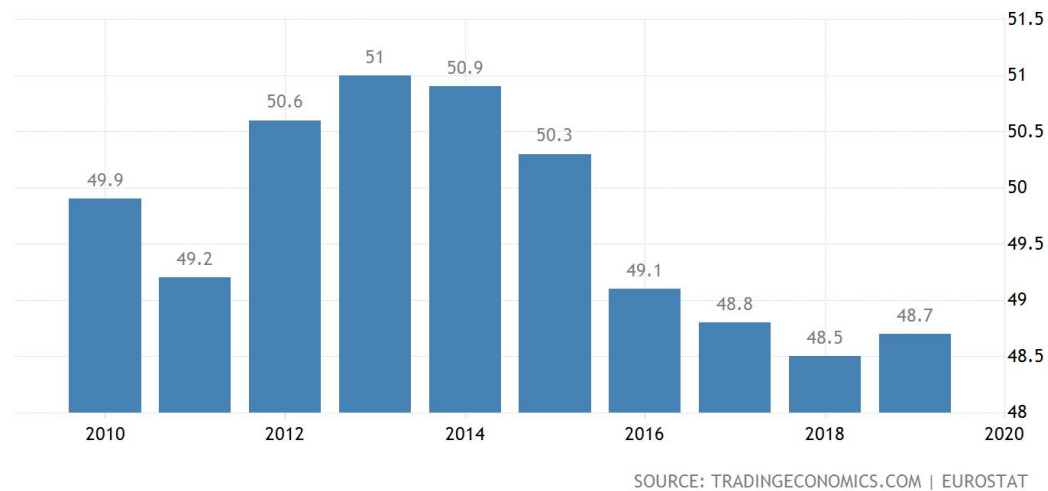
Figure 3: The Parenteau Model of Italy for Years 2008, 2009, and 2019²⁰



Italy only managed to reach the shade triangle 2 years out of 11 years as a net importer in 2002 and 2012. Otherwise, Italy found itself in a position similar to the year 2009 given government deficits that exceeded the Maastricht limit. In those years, Italy did not have sufficient domestic policy space, therefore the country relied on private and public debt to fuel the economy. Since the sovereign debt crisis, Italy’s sectoral balances have been located in the fourth quadrant of the Parenteau model with current account surpluses and government deficits.

²⁰ Data provided by Trading Economics.

Figure 4: Italy Government Spending to GDP (%)²¹



Lastly, we can see that the Italian government since the peak of the sovereign debt crisis has been reducing its government spending as a percent of the gross domestic product since the sovereign debt crisis. In January 2020, Italy recorded a total government expenditure of €79,038 billion, roughly €5.2 billion less than what it had in the same period in 2010 at the start of the crisis right before the Italian government “delivered a harsh dose of austerity for Italy’s fragile economy” the following year.²² (Mackenzie & Jones 2011) For that reason, the German and Dutch Finance Ministers’ comments during the COVID-19 pandemic are highly misinformed and attempt to blame the crisis on the Italian government.

²¹ Data provided by Trading Economics.

²² Data provided by Trading Economics.

Section 3: Economic Policy Options for Italy

Introduction

The fate of Italy's economic woes, unfortunately, lies in the hands of the EMU governing bodies. In order to prevent Italy from insolvency, the ECB and European Commission should, at a minimum, provide unlimited backing of Italian sovereign debt on the secondary market without conditional fiscal austerity measures and, at a maximum, launch an autonomous fiscal policy mechanism on the supranational level available for euro member states in times of crisis. If the ECB and European Commission fail to provide the necessary assistance, the Italian Prime Minister Giuseppe Conte warned the recourse of #Italeave: "What will we tell our citizens if Europe does not prove capable of a united, strong and cohesive reaction in the face of a symmetrical, unpredictable shock of this historical magnitude?" (Johnson, Fleming, & Chazam 2020)

Unlimited Potential of the ECB

The European Central Bank (ECB) has supported the survival of the Eurozone through funding fiscal deficits and saving the Member States from insolvency. The fact that the ECB announced the Outright Monetary Transactions (OMT) program in 2012 confirmed that the ECB had "unlimited euro capacity" to purchase as much public debt in the secondary markets as necessary to save the euro. (Mitchell 2015, 98) Therefore, Italy can only go insolvent if the ECB refuses to buy unlimited volumes of Italian sovereign debt in the secondary markets. By providing an unlimited backstop, the ECB can set yields at any level it desires, including zero, and avoid capital outflows from private bond investors in Italy by taking them out of the equation. Without a program that pools the risk across all euro members, "investors will be forced to focus on the financial risk each country is taking on to fight the pandemic." (Stubington 15 April 2020)

Alternative One: Pandemic Emergency Purchase Program

The first option for the ECB to assist Italian economic recovery is the continuation of the pandemic emergency purchase program (PEPP). The expansion of the ECB would restore confidence and demand for Italy's long-term bonds to prevent insolvency. (Stafford 2020) Since the head of the ECB Christine Lagarde is open to the possibility of expanding the aid of the central bank, the PEPP should provide an unlimited backstop for purchasing sovereign debt on the secondary market. While this is the best option for Italy, this will most likely reignite tensions between the German Federal Constitutional Court, Bundesbank, and the ECB.

Alternative Two: Outright Monetary Transactions OMT

Should the pandemic emergency purchase program forbid the ECB from purchasing unlimited Italian secondary market bonds, the ECB can resort to the Outright Monetary Transactions (OMT) program put forward by former ECB President Mario Draghi — a program that confirmed the ECB's unlimited euro capacity to purchase as much public debt in the secondary markets as necessary. Simply announcing the unlimited bond-buying program could restore confidence and prevent insolvency in Italy, similar to the aftermath of the sovereign debt crisis. While it is not clear whether the OMT would be an option that the ECB is willing to consider, the ECB President Christine Lagarde signaled the central bank is willing to do whatever it takes by stating that there was "no limit to our commitment to serving the euro area." (Arnold 9 April

2020) The managing director of the European Stability Mechanism (ESM) Klaus Regling also stated that the OMT is not currently needed yet “things may change” given the volatility of the markets. (Fleming & Johnsson 2020) If the ECB commits to the OMT program, the central bank should omit the austerity conditionality inherent in the ESM application required for Eurozone member states to access the OMT provisions. Since the COVID-19 pandemic was beyond Italy’s control, there is no guarantee Italy would accept the OMT alternative with strings attached since austerity is undesirable for the current Italian populist party.

Alternative Three: Autonomous Fiscal Policy Mechanism in the EMU

Ultimately, the looming threat to the Eurozone is no longer economic but political. The ECB has proven that economic insolvency crises can be resolved by the unlimited potential of the central bank. Now, the European Commission must establish a fiscal stabilizer on the supranational level to intervene in a crisis and support aggregate demand when the domestic fiscal stabilizer of a crisis-ridden country is insufficient. Dependence on the current bureaucratic process of the commission or the coordination among Eurozone member states is ill-equipped for a crisis where time lost corresponds to lives lost. Hence, an autonomous fiscal policy mechanism on the EU level without strings attached serves to stabilize and revamp the economy to overcome the crisis in the long run.

Implications for the EMU Member States

Member states in the Eurozone must also realize that they have a stake in the ECB’s decisions. Due to the COVID-19 pandemic, there has been a record demand for 30-year German bonds (Bunds) which signaled investors’ hunger for the current safest asset available in the Eurozone. (Stafford 2020) German banks could see a “potentially catastrophic downside to their financial sectors and their economies were Italy to default.” (Münchau 19 April 2020) Hence, northern Eurozone member states should view the alternatives provided as more of risk insurance than a handout. Furthermore, the autonomous fiscal policy mechanism provides immediate support for all countries when faced with an asymmetric or disproportionate crisis, from a natural disaster and economic crisis to a pandemic.

Democratic Responsibility

On a final note, the Italian government must understand that their democratic responsibility is owed to their own people, *not* to Brussels. (Mitchell 2015) In recent years, Italians have grown increasingly tired and fed up with the harsh conditions imposed by austerity and structural reforms. Austerity does not sit well with the sitting Eurosceptic populist coalition in the Italian government — enacting the humiliating policy on their own people is political suicide. For that reason, the extent of anti-EU sentiment felt from the bottom to the top in Italy must be taken seriously in the Eurozone. (Münchau 19 April 2020)

Conclusion

If political tensions rule out the two alternatives presented in this paper, Italy will most likely be faced with unpleasant options such as a sovereign debt default or a debt restructuring — both could compel Italy to leave. Italians won't easily forgive and forget the lack of European solidarity in their time of need, either. Strengthening Italy's commitment towards the EMU thus requires the establishment of an automatic fiscal policy mechanism on the European supranational level to prevent long delays in bureaucratic decision-making, act decisively in times of crisis, and ultimately complete the project of the single-currency union.

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