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Does it pay to have the euro? Italy's politics and financial markets under the lira and the euro

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EUROPEAN CENTRAL BANK

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WORKING PAPER SERIES

NO 1064 / JUNE 2009

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HAVE THE EURO?**

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AND FINANCIAL
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THE LIRA AND THE
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DOES IT PAY TO HAVE THE EURO? ITALY'S POLITICS AND FINANCIAL MARKETS UNDER THE LIRA AND THE EURO¹

by Marcel Fratzscher and Livio Stracca²



In 2009 all ECB publications feature a motif taken from the €200 banknote.

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Abstract

There is a broad consensus that the quality of the political system and its institutions are fundamental for a country's prosperity. The paper focuses on political events in Italy over the past 35 years and asks whether the adoption of the euro in 1999 has helped insulate Italy's financial markets from the adverse consequences of its traditionally unstable political system. We find that important political events have exerted a statistically and economically significant effect on Italy's financial markets throughout the 1970s, 1980s and 1990s. The introduction of the euro appears to have indeed played a major role in insulating financial markets from such adverse shocks. The findings of the paper therefore suggest another important economic dimension and channel through which Italy may have been affected by EMU. Our analysis could also be potentially interesting for other countries with weak institutions considering adopting a currency based on stronger institutions.

Keywords: Euro, Italy, political economy, exchange rates, asset prices, financial markets, shocks.

JEL Classification: F31, F33, G14.

Non-technical summary

Ten years after its creation, the economic benefits and costs of the euro for its member states has been analysed and emphasised extensively in the literature and in the public debate. A question that remains open is whether the loss of policy autonomy brought about by EMU is, on balance, a net gain or a net cost for individual countries.

One contribution of this paper is to emphasise that economic policy making is ultimately in the hand of elected politicians, and the effectiveness and quality of the political system has a major impact on it. Building on this intuition, the present paper argues that domestic economic policy making not only responds (hopefully in an optimal manner) to idiosyncratic shocks, but is also itself subject to a number of shocks and instability of political nature. Therefore, removing a degree of policy autonomy also implies reducing the impact of such shocks on domestic economic policy (and therefore economic outcomes).

To shed light on this channel, we conduct an empirical exercise on data from Italy, a euro area country with an inherently weak and unstable political system. "Revolving door" governments (more than 60 in the postwar period), political instability, scandal, and corruption have characterized Italian politics, although the country has nevertheless managed to sustain a strong economy and reach high living standards.

There is significant evidence in the literature pointing to a significant negative effect of political instability on economic growth. Some prominent Italian policy-makers have also argued that the euro is an effective "shield" against financial turbulence and geopolitical risks. In this paper, we focus on the question whether the euro is indeed an effective shield against Italy's own political instability, in the sense that it helps insulate financial markets from adverse shocks that have a political origin from within Italy.

We analyse the effect of political developments and events on Italy's financial markets, following an event study approach. We focus on financial markets (interest rates, equity markets and the exchange rate) because asset prices are the most accurate available measure of expectations about future economic prospects. A significant innovation of this paper is to consider a broad set of events that may capture the notion of political instability, as we construct a novel database of a broad and comprehensive set of important political and other events that have shaped Italy over the past four decades, spanning the period 1973-2007. Events covered include political elections, the establishment of new governments, resignations, politically-related suicides, important referenda, and politically-motivated terrorist attacks.

We also include a number of other important events, such as major natural catastrophes, accidents, and military confrontations. Importantly, many of the events we consider are purely exogenous to economic developments, which solves to some extent the possible reverse causality problem that political events may in part reflect economic developments.

The main results of our study are two:

(i) Political events in Italy have traditionally exerted a statistically significant and economically meaningful impact on Italy's financial markets: they have tended to substantially raise short-term interest rates, lower equity returns and depreciate the effective exchange rate of the lira. These effects also tended to have a lasting effect on markets.

(ii) Italy's adoption of the euro in 1999 appears to have insulated financial markets almost entirely from the adverse consequences of political shocks. Although it is hard to date this structural break precisely, it seems to have occurred in close proximity to the introduction of the euro in 1999.

These results are robust to various sensitivity tests and extensions, such as when including macroeconomic controls or removing outliers from the sample.

Our findings suggest that the reduction in policy autonomy which Italy has experienced from the late 1990s onwards (in monetary policy by relinquishing responsibility to the European Central Bank, in fiscal policy through the limits imposed by the Stability and Growth Pact) have indeed played an important role in insulating financial markets from political events in Italy. At the same time, it should also be emphasised that the insulating role of the euro and / or the Stability and Growth Pact may entail not only benefits but also costs, especially in terms of a reduced responsiveness of asset prices to domestic events, which may reduce the disciplining role of financial markets to some extent.

The results for our analysis of Italy could be interesting for other countries, especially politically unstable ones, who have adopted or are considering costs and benefits of adopting a common currency or the currency of a more politically stable country (such as, say, Latin American countries for the US dollar, or Eastern European countries for the euro).

"On Friday Roberto Maroni, the Italian welfare minister, said that [the euro] had proved incapable of dealing with the problems of slow growth and high unemployment. "*Isn't it perhaps better to return, temporarily at least, to a system of a dual circulation of currencies (the euro and the lira)?*" he said in an interview in *La Repubblica*, the Italian newspaper. "*In Europe there is a virtuous example and it's Britain, which is growing and developing, maintaining its own currency.*" *The Sunday Times*, 5 June 2005.

"(...) *the Italian economy, like the leaning tower of Pisa, should have toppled over long ago. The country has a huge budget deficit, high tax rates, tightly regulated labour markets and a notoriously unstable political system.*" *The Economist*, *The flawed Renaissance. A survey of the Italian Economy*, February 1988.

1 Introduction

The euro has just celebrated its 10th birthday. The economic benefits of the euro for its member states has been analysed and emphasised extensively, in particular the resulting increase in policy credibility, lower interest rates, more stable financial markets and ultimately higher and more robust economic performance of the economies.¹ Yet there have also been critical voices about whether the overall benefits from the euro outweigh its costs, which some link to the elimination or at least significant curtailment of domestic policy autonomy in areas such as monetary policy, fiscal policy (through the establishment of the Stability and Growth Pact) and exchange rate policy. The question is therefore whether the loss of policy autonomy is, on balance, a net gain or a net cost for individual countries.

Economic policy making is ultimately in the hand of elected politicians, and the effectiveness and quality of the political system has a major impact on it. Building on this intuition, the present paper departs from the earlier literature and focuses on key political economy aspects of the euro adoption, which have not been dealt with in previous work on the costs and benefits of the euro. The basic idea is that domestic economic policy making not only responds (hopefully in an optimal manner) to idiosyncratic shocks, but is also itself subject to a number of *shocks and instability of political nature*. Therefore, removing a degree of policy autonomy also implies reducing the impact of such shocks on domestic economic policy (and therefore economic outcomes).

To shed light on this channel, we conduct an empirical exercise on data from Italy, a euro area country with an inherently weak and unstable political system. "Revolv-

¹See, among others, Rose (2000), Baldwin (2006), Engel and Rogers (2004), Giannone and Reichlin (2006), Issing (2005), Lane (2006), Trichet (2005). See Mongelli (2005), ECB (2008) and European Commission (2008) for an overview of the issues.

ing door” governments (more than 60 in the postwar period)², political instability, scandal, and corruption have characterized Italian politics, although the country has nevertheless managed to sustain a strong economy and reach high living standards. In the most recent decade, political stability defined in terms of government duration appears to have improved, but this is seen by many observers as illusory since governments are based on fractious coalitions of several political parties that can paralyse government action.³

There is significant evidence in the literature pointing to a significant negative effect of political instability on economic growth (e.g. Alesina et al 1996). Some prominent Italian policy-makers have argued that the euro is an effective "shield" against financial turbulence and geopolitical risks (e.g. Draghi, 2007).

In this paper we focus on the question whether the euro is indeed an effective shield against Italy’s own political instability, in the sense that it helps insulate financial markets from adverse shocks that have a political origin from within Italy. We analyse the effect of political developments and events on Italy’s financial markets, following an event study approach in the spirit of Brown and Warner (1985). We focus on financial markets (interest rates, equity markets and the exchange rate) because asset prices are the most accurate available measure of expectations about future economic prospects. A significant innovation of this paper is to consider a broad set of events that may capture the notion of political instability, as we construct a novel database of a broad and comprehensive set of important political and other events that have shaped Italy over the past four decades, spanning the period 1973-2007.⁴ Events covered include political elections, the establishment of new governments, resignations, politically-related suicides, important referenda and politically-motivated terrorist attacks. We also include a number of other important events, such as major natural catastrophes, accidents, and military confrontations. We are able to determine the precise day when these events occurred and were reported in the media so that we are able to identify cleanly their financial market impact. Many of the events we consider are purely exogenous to economic developments, which solves to some extent the endogeneity problem that political events may in part reflect economic developments. We emphasise that the results for our analysis of Italy could be interesting for other countries, especially politically unstable ones, who have adopted or

²Immediately after writing the first version of this paper, the Italian government collapsed due to a no confidence vote in the Senate and new elections were held in April 2008. Our sample period, however, ends in 2007.

³For a book length analysis on the fundamental reasons and consequences of Italian political instability see Ginsborg (2003). The lack of political stability has been reflected in a traditionally inefficient public sector. For example, according to Afonso, Schuknecht and Tanzi (2003), Italy scores well below the EU and euro area average on public sector performance indicators. Perhaps most tellingly, still in 2006 Italy had a very low score in the Political Stability index, the lowest in the OECD after Poland, Turkey and Mexico.

⁴Typically, in the literature political stability is measured by either the propensity to observe government changes (executive instability) or by measuring phenomena of social unrest (e.g. Alesina and Perotti 1996).

are considering costs and benefits of adopting a common currency or the currency of a more politically stable country (such as, say, Latin American countries for the US dollar, or Eastern European countries for the euro).

Two main results stand out from the empirical analysis. First, political events in Italy have traditionally exerted a statistically significant and economically meaningful impact on Italy's financial markets: they have tended to substantially raise short-term interest rates, lower equity returns and depreciate the effective exchange rate of the lira. These effects also tended to have a lasting effect on markets. We identify what we dub the "rollercoaster" behaviour of Italian financial markets around the frequent collapses and formations of governments. We find that during the weeks around government collapses short-term interest rates, on average, rose by close to 40 basis points (b.p.), Italian equity markets fell by 5% and the lira depreciated. The formation of new governments then subsequently tended to have the opposite effect, but inducing only a partial reversal of those adverse effects by lowering interest rates and raising equity returns. Moreover, we find that Italian political turmoil has not only adversely influenced the level of asset prices, but has also raised significantly financial market volatility and uncertainty, specifically in periods following the collapse of governments when the country was without a formal government in place - which in some cases lasted up to four months.

As the second main finding, Italy's adoption of the euro in 1999 appears to have insulated financial markets almost entirely from the adverse consequences of political shocks. Although it is hard to date this structural break precisely, it seems to have occurred in close proximity to the introduction of the euro in 1999. Moreover, before 1999 there appears to have been little difference in financial market responses related to Italy's participation in the European exchange rate mechanism (ERM), or lack thereof. These results are robust to various sensitivity tests and extensions, such as when including macroeconomic controls or removing outliers from the sample.

Overall, therefore, the findings of the paper suggest that the reduction in policy autonomy which Italy has experienced from the late 1990s onwards (in monetary policy by relinquishing responsibility to the European Central Bank, in fiscal policy through the limits imposed by the Stability and Growth Pact) have indeed played an important role in insulating financial markets from political events in Italy. They also suggest that the conclusions reached for Italy can plausibly be extended to other countries, especially those with a traditionally weak and unstable political system. It should be emphasised that our results allow two possible interpretations, which on the basis of the analysis of this paper we are not able to discriminate between. First, the reduced sensitivity of Italy's asset prices to domestic political shocks could have been due to the fact that, by adopting the euro, Italy has been able to import good institutions (such as the Stability and Growth Pact and a stability oriented monetary policy framework) that was not able to build before the introduction of the euro. If this is the predominant explanation, then it could be argued that a country could achieve the same results by reforming its domestic institutions, for

example by imposing fiscal limits similar to the Stability and Growth Pact. Second, our results could be explained by the fact that Italy, by the simple fact of adopting an international currency which is expression of a much larger economy, has been able to share risks and therefore reduce the fall-out of its own political instability; in a catchword, a bigger ship rocks less when the sea is wavy.

We make the educated guess that both factors contribute to explaining our results. Fratzscher and Stracca (2009) analyse the sensitivity, albeit of stock prices only, to political shocks in a panel of 30 countries and report that EMU has had a dampening impact on the stock market reaction to political events. They also find that the reduced sensitivity to domestic political shocks identified around the time of the introduction of the euro affects both the so-called "euro area core" and, to an even greater degree, the so-called "euro area periphery" countries.⁵ The former ought to have already had good institutions before the euro and therefore only the risk pooling dimension should be relevant for them. For the latter group, the introduction of the common currency should have represented both a pooling of risks, as for the core countries, but also an improvement in economic policy institutions.

It should be added that the insulating role of the euro and / or the Stability and Growth Pact may entail not only benefits but also costs, especially in terms of a reduced responsiveness of asset prices to domestic events, which may reduce the disciplining role of financial markets to some extent, as we will discuss in more detail in the conclusions.

The paper is related to two strands of the literature. One strand links political economy factors to financial market outcomes. Our results confirm previous empirical findings identifying a nexus between political news and asset price movements, for example in currency markets (see, e.g., Freeman, Hays and Stix, 2000). Several of these papers focus on the effect of elections and the political cycle on exchange rates (Bachman, 1992; Blomberg and Hess, 1997; Lobo and Tufte, 1998; Siokis and Kapopoulos, 2003) as well as the two-way nexus between exchange rate movements and government popularity (Bernhard and Leblang 2006). There is also a more limited literature on the impact on exchange rates of violent acts such as terrorism and war (Eldor and Melnick, 2004; Rigobon and Sack, 2005; Guidolin and La Ferrara, 2005).⁶

The second strand is the extensive work that has been undertaken on identifying and measuring the costs and benefits from joining a monetary union.⁷ However, the

⁵See in particular Figure 4 in Fratzscher and Stracca (2009).

⁶Moreover, Kugler and Weder (2005) analyse the role of unexpected world geo-political events on the the Swiss franc. Other papers focus on the effect of this type of events on stock markets, see e.g. Chen and Siems (2004) and Zussman and Zussman (2006). Fornari et al. (2002) analyse the impact of some political news on the exchange rate of the lira and the Italian long-term interest rate over the 1994-1996 period.

⁷For the pre-EMU literature see among others Giavazzi and Torres (1993) and Frankel and Rose (1997). See, in particular, Feldstein (1997) for a pessimistic assessment of the common currency. Among post-EMU contributions see Artis (2003) and Eichengreen and Frieden (2001).

present paper is fundamentally different from both strands of the literature in that it concentrates on the question whether joining a monetary union helps a member of this monetary union which has a comparably weak and unstable political system insulate its economy from the adverse consequences of its domestic political instability. Unlike Fratzscher and Stracca (2009), in this paper we look more closely at Italy, which is a particularly interesting country in view of its traditionally unstable politics, by looking at a much longer sample period starting from the 1970s and analysing not only equity but also interest rate and exchange rate data. Ehrmann et al. (2007) document a convergence in the bond market reaction to economic news within the euro area; in this paper, we look at political news and again look at different financial markets. Nonetheless, the results obtained in this paper are largely consistent with those in Fratzscher and Stracca (2009) and Ehrmann et al. (2007).

The paper is organised as follows. In Section 2 we introduce our novel database and describe the political and other shocks that we consider in our analysis. Section 3 discusses identification and the empirical methodology of the paper. The presentation of the empirical findings and various robustness and sensitivity tests follows in Section 4. Section 5 concludes.

2 Political news in Italy: 1973-2007

We collect a series of events whose common thread is to represent unexpected shocks which increased (on a temporarily or lasting basis) political tension and instability in Italy. Some of them are intimately linked to the long-standing weakness of the political system in Italy; in other words, their nature and impact might have been different in a country with a more stable and solid political system. We focus strictly on Italian events and therefore we do not include international political news such as, say, the fall of the Berlin Wall or 9/11.⁸

We divide the "political news" into *six* categories: (i) the elections of the national and European Parliaments; (ii) news affecting the formation and dissolution of national governments⁹; (iii) terrorist attacks and killings with a political connotation or ramifications; (iv) natural catastrophes and accidents; (v) national political consultations (referenda); (vi) other events. *Tables 1 to 6* show the events collected under these six categories. The inclusion of natural catastrophes and accidents is not obvious since these are events with both economic and political ramifications, and in many of them the first dimension is likely to be more important. We decided to add data on this category mainly as a robustness check, since these events have two

⁸For this reason, we also exclude the assassination attempt on the Pope in 1981, even though it certainly was influential in Italian politics.

⁹Note that we are not able to distinguish cases in which a government collapse was expected or not. Theoretically, one would expect that an unexpected government collapse has a larger impact on financial variables than an expected one; our estimates, therefore, should be seen as a *lower bound* for the effect of a genuine unexpected collapse of the government coalition.



desirable properties: first, they are generally truly unexpected; second, unlike events in all other categories they are largely independent of the institutional and political regime.

It should be emphasised that data for the first two categories are meant to be exhaustive, while the data on the subsequent four categories are a selection which contains an unavoidable degree of subjectivity. Moreover, the actual importance of the events obviously varies over time and across events. The best way to interpret this selection is to view it as a random pick of events with a potential political significance; as long as the choice of the events is not systematically related to the explanatory variables whose impact we set out to study.

3 Empirical methodology

In this section, we describe the construction of the political event database (section 3.1) and the empirical methodology (section 3.2) for our analysis.

3.1 Classification of political and other events

Concerning the construction of the event dummies for the political and other news described in Section 2, we build a composite dummy D_t which takes value of 1 on any day when an event took place, and zero otherwise. As several of the individual types of events comprise relatively few observations, it may be difficult to extract any meaningful, statistical evidence about their effect on financial markets. One approach for reducing this small-sample problem is to group different types of events into larger categories. To do this, it is important to formulate hypotheses of how one would expect these various events to influence financial markets. More specifically, we group these seven types of events into three categories.

The first category is political events which we would expect to have a negative effect on markets (or what we will below refer to as "political events - negative"). This category comprises government collapses and other adverse political events - such as the resignation of the head of state, politically linked suicides or military confrontations. The second category captures political events for which it is ambiguous whether they should a priori have a positive or a negative effect on markets and the economy. This includes the formation of a new government, referenda and elections. Whether such events are positive or negative in terms of their market impact depends on a number of factors, which are hard to predetermine. We will therefore refer to this category as "political events - ambiguous". Finally, the third category captures other events "external" to the *direct* political sphere and influence of the Italian state ("external events"), such as terrorist attacks and natural catastrophes.

A crucial point, and one that is illustrated in this discussion, is that events should have an impact on financial markets only to the extent that either they come unexpected for market participants or they change the degree of market uncertainty. For

instance, the formation of a government could be "good" news and be reflected in a positive market reaction if investors believe that such a formation will improve the economic outlook or reduce uncertainty. But it may equally have a negative market effect if markets are sceptical, or had expected a more favourable political constellation. This point is important to keep in mind throughout the paper as it is essential for grasping why markets may react to certain events but not to others. The point is also important for understanding the classification of the seven event types into three categories. The argument applies fully to the second category of what we label "ambiguous political events", which comprises the formation of new governments, referenda and elections.¹⁰ The timing of elections and referenda are well known in advance, markets form expectations about their outcome and hence the effect on asset prices crucially depends on how the outcome differs from those expectations. However, the argument applies much less to the first and third categories. Terrorist attacks and natural catastrophes are highly unpredictable, and even collapses of governments may not or at least not be fully anticipated by financial markets.

Hence our theoretical priors for the first and third categories is that they affect markets adversely, i.e. lead to a depreciation of the lira, a decline in the stock market and a rise in short-term interest rates, while our prior for the second category is that such events should have *no systematic* effect on financial markets - though of course individual events in this category may have an impact. In total, we have 131 events in our dataset; 39 in the first category, 52 in the second and 39 in the third.

3.2 Empirical model

Turning to the empirical model, we are interested in whether and how Italian events D_{kt} affect Italian asset returns r_t and estimate

$$r_t = \mu + \alpha r_{t-1} + \sum \beta_k D_{kt} + \sum \gamma_j z_{jt} + \varepsilon_t \quad (1)$$

with z_{jt} a vector of controls, which includes day-of-the-week effects and also other type of shocks and news such as Italian macroeconomic announcements. We focus on daily returns for three asset prices: the effective exchange rate, short-term interest rates and stock returns.¹¹ Our prior is $\beta_k > 0$ for interest rates and $\beta_k < 0$ for stock returns and the exchange rate, i.e. adverse shocks should raise short-term interest rates, lower stock returns and depreciate the lira. The vector of controls also includes the corresponding external asset price, i.e. the short-term interest rates in

¹⁰We have tried to control for expectations for elections by distinguishing the outcome of the elections from prior expectations derived from opinion polls. However, the empirical results below change little when using this unexpected component.

¹¹We do not include bond yields in our analysis; partly due to the difficulty of how to interpret the response of long-term yields to shocks - which may either reflect a change in inflation expectations or in expectations about the economic outlook or in monetary policy - and partly due to the lack of a sufficiently long time series for the analysis.

German/euro area for the model for Italian interest rates; and world equity returns for the model of Italian equity returns. We decided to include these controls so as to ensure that our estimates for the effect of Italian events do not partly capture contemporaneous shocks elsewhere.

Daily asset returns exhibit heteroskedasticity, i.e. $\varepsilon_t = N(0, \sigma_t^2)$, and also skewness and kurtosis which need to be accounted for. Moreover, the events may not only affect the first moment of asset prices but also influence their conditional volatility. This conditional volatility is modelled in an ARCH framework, more precisely an exponential GARCH (EGARCH) specification following Nelson (1991). We will turn to discussing these volatility results in the robustness section 4.4.

For the construction of the empirical specification, it is important to take into account Italy's involvement and commitments in the exchange rate mechanism (ERM) of the European Monetary System (EMS). *Table 7* provides a history of Italy's exchange rate policy since the breakdown of the Bretton Woods system in the early 1970s, leading up to the adoption of the euro in January 1999. The table underlines that Italy underwent a number of changes in its exchange rate regime; most notably, it joined the EMS in March 1979, moved to a soft peg in February 1987 (and a narrower peg of $\pm 2.25\%$ bands around its central parity in February 1990), then was forced to exit the ERM in September 1992, before rejoining it at wider bands in November 1996.

These changes in Italy's exchange rate regime are important because they are likely to influence how various asset prices have reacted to shocks. In particular, under a pegged exchange rate regime, the exchange rate of the lira has little room to respond to shocks, and instead short-term interest rates may have to adjust relatively more in order to maintain the peg. This has been formalised in a standard UIP setting and target zone models (e.g. Bertola and Caballero 1992). In section 4.2, we will investigate how financial market responses change depending on the exchange rate regime, and relatively to the period since Italy adopted the euro.

Moreover, another related issue is whether to analyse the response to shocks by the lira bilateral rate against the Deutsche Mark (DM) - the EMS anchor currency - or in effective terms. We decided to use the nominal effective exchange rate (NEER) of the lira for two reasons.¹² First, the overarching question of our analysis is whether Italy's adoption of the euro has made Italy's financial conditions and asset prices more immune to adverse political and other shocks emanating from within Italy. This means that we are not only interested in the bilateral lira exchange rate vis-a-vis the DM, but more generally in changes to Italy's terms of trade against all countries. Second, using the NEER enables us to take into account that Italian events may move not just the lira within the ERM, but could in some instances may move all currencies with the ERM against outside currencies such as the US dollar.¹³

¹²Note that since we are using data at the daily frequency it makes sense to use nominal, rather than real exchange rates.

¹³However, note that all of the analysis presented below has also been conducted for the bilateral

As to the financial market data, given the daily frequency of our news events, our empirical analysis is conducted using daily financial market data. The sources of the data are the BIS for the effective exchange rate and Datastream for interest rates and stock returns. Interest rates are 12-month interbank rates, and equity indices are Datastream market indices. Short-term interest rate data is available only since 1 September 1977, thus shortening the sample for this series somewhat. Quotes for all are European closing quotes. This raises the difficulty that events sometimes occur or are reported only in the evening after the closing of financial markets. Others, such as elections, usually take place on a weekend. In those cases where we could verify that events took place in the evening or on weekends, they are included in the empirical analysis on the subsequent business day. Figure 1 reports the data used in the empirical analysis.

4 Results

Our main interest is to understand how Italy's political and other events have affected Italy's exchange rate and other asset prices throughout the decades; and in particular, whether there has been a change and structural break with the introduction of the euro. This section starts by presenting the benchmark results (section 4.1) before discussing dynamic effects (section 4.2), the results for the importance of the introduction of the euro (section 4.3) and concluding with various robustness tests (section 4.4).

4.1 Benchmark results

Do Italian political and other important events have a marked impact on financial markets? *Table 8* provides the estimates for the composite dummy D_t and three sub-categories and *Table 9* for the individual types of events.¹⁴ For all events, *Table 8* indicates that overall Italian political events have exerted a statistically and economically meaningful effect on Italy's financial markets. On average, a political event has raised Italy's short-term interest rates by 4.2 basis points, lowered Italian equity returns by 0.31% and led to an effective depreciation of the lira by 0.09%.

Table 8 and *Table 9* confirm our theoretical priors formulated above in that it is collapses of governments and other political shocks ("political events - negative") and "external events" such as natural catastrophes and terrorist attacks that have exerted a substantial influence on Italian markets. Each event in these categories raised Italian short-term interest rates by about 8 to 9 basis points, lowered equity returns by 0.4-0.9% and depreciated the lira by 0.10-0.25%. By contrast, elections

lira-DM exchange rate. These results are available upon request.

¹⁴Note that we report robust standard errors which correct for heteroskedasticity and serial correlation.

referenda and the formation of governments did not exert a systematic influence on Italian asset prices. As discussed above, this finding seems sensible as whether and how such events move financial markets depends on the extent to which they were anticipated and expected.

Are these financial market effects economically meaningful? One may argue that after all these contemporaneous effects are limited in size - neither a single 1% drop in equity values nor an isolated 0.1% depreciation should have a sizeable effect on Italy's economy. However, the effect shown in the tables are those that an event *individually on average* exerted on Italy's financial markets by *each* of the events we consider. Thus, the results indicate that in total the *cumulated* effect of the 131 events in the data have raised Italy's short-term interest rates by 550 basis points, lowered Italy's equity markets by more than 40% and depreciated the lira in effective terms by 12%. These numbers are indeed meaningful and substantial. One could interpret political stability as a capital stock, which is depreciated a little by each adverse shock. The impact of each individual shock may be small, but the overall impact on all shocks is to significantly depreciate the capital stock.¹⁵

4.2 The rollercoaster of Italy's political cycle

A clear limitation of the analysis conducted so far is that it identifies only the contemporaneous effects of the various political and other events. As discussed in detail in section 3.1, an important caveat is that events may have an impact on financial markets beyond the day when they occur and are reported. Moreover, to the extent that they are anticipated, events may already move asset prices before they take place. As outlined above, some of the events we analyse are arguably truly unexpected, such as terrorist attacks, natural catastrophes, accidents, and possibly also some resignations and other political events. By contrast, collapses of governments and outcomes of elections may partly be anticipated and hence are likely to have dynamic effects beyond what we can capture in our empirical model.

A compelling example of this is the collapse and formation of Italian governments. As Section 2 showed, there have been 31 government resignations and new formations since 1973. This is a remarkable number, amounting to on average almost one government per year, though the frequency of government changes has been substantially lower over the past decade. Moreover, the period in which Italy lacked a formal government was frequently quite long, in one instance more than 4 months. Each government turnover implied a period without a formal government for an average of 35 days. In total, this means that over the past 35 years Italy has been without a formal government for more than 3 years, or close to a staggering 10% of the time.¹⁶

¹⁵Note that here we are assuming that the effects of the political news on asset prices are permanent. That is certainly true in our econometric model, but in reality some form of very slow mean reversion appears to be plausible. Therefore, the numbers presented here should not be taken at face value.

¹⁶In practice, the previous government remains in place for normal administration, but its activity

To investigate the dynamic effects of such a political business cycle in Italy, *Figure 1* illustrates the behaviour of asset prices around the collapses and formations of governments. The first and second categories in the figure show the market reaction during the two weeks around government collapses; the fourth and fifth categories indicate the movements in the two weeks around government formations; and the other category shows the remaining period after the collapse and before the formation of a new government ("no government").¹⁷

The figure underlines quite impressively the dynamics of financial market movements around collapses and formations of governments. In the weeks before and after a collapse, interest rates rise by 24 basis points (b.p.) in cumulated terms. A similar pattern is present in stock markets and FX markets. Equity markets fall by 5.0% around government resignations; while the effective exchange rate of the lira depreciates by 1.9%. A further financial market weakening takes place during the "no-government" period, i.e. before a new government is formed.

Turning to the formation process of new governments, there is a substantial positive reaction both before and after the official inauguration of a new administration: short-term interest rates drop by 30 b.p., equity returns rise and the exchange rate stabilises in the two weeks before and after the formation, respectively.

This "rollercoaster" pattern in the behaviour of Italian financial markets appears quite impressive and the magnitude substantial and economically meaningful. It indeed shows the presence of a clear and distinct political cycle reflected in Italy's financial markets. The importance of this cycle is underscored further by the fact that Italian governments changed on average once per year since 1973.

By contrast, when we repeat such a dynamic analysis for other types of events, we find a quite different picture. *Figure 2* shows the behaviour of asset prices around external events (natural disasters, accidents and terrorist attacks). The figure indicates that financial markets react immediately after the event, but neither directly before or with a two-week delay after the event. This suggests that these types of events truly come unexpected, and have a one-off, permanent effect.

For the empirical analysis, it is hard to conduct a meaningful empirical test of this political cycle around the fall and rise of governments. Financial market reactions to collapses and starts of governments vary substantially, partly due to the fact that some may have been anticipated better than others and partly due to the fact that

and initiative are obviously severely curtailed.

¹⁷The usual length of the time windows for these various categories is two weeks before and two weeks after the collapse; and two weeks before and two weeks after the formation of a government. The length of the remaining period without a government ("no gov.") obviously differs across the individual episodes. In instances when the period without a government is relatively short, the post-collapse and pre-start periods may be shorter so that they do not overlap. All numbers in the figures are cumulated changes over the periods shown. We do not report standard errors because this figure reports the cumulated change and is not a result of some model estimation; nonetheless the statistical significance of the event "Collapse of government" can be evaluated by looking at the first row of Table 9.

some were considered more favourable or desirable than others. We cannot, however, measure those expectations in any meaningful and accurate way in order to include them in the empirical analysis. Moreover, including leads and lags around resignations and formations of governments in the empirical framework of equation (1) does not prove fruitful given that asset prices tend to fluctuate substantially over time. Some statistical evidence, however, is present when looking at the volatility of asset prices, a point to which we turn in the next section. We conclude by emphasising that the contemporaneous effects of political events, which we are able to identify and presented in the previous section, are not only economically meaningful, but they are also likely to constitute the lower bound of the overall effects of such events when taking into account their dynamic effects.

4.3 Has the euro changed anything?

We now turn to the question whether the euro has helped insulate Italy's financial markets from the negative effects of adverse political developments in Italy. There is a large and growing literature that the introduction of the euro has played a key role for financial integration in Europe (e.g. Baele et al. 2004, Ehrmann et al. 2007). Hence, for instance, short-term interest rates faced by Italian investors are no longer determined by developments specific to Italy but to the euro area as a whole. Likewise, equity returns of Italian firms are increasingly influenced and dominated by developments elsewhere in the world. Moreover, with the introduction of the euro the exchange rate for Italian firms and investors is no longer the lira but the euro, the common currency for the euro area countries. All these elements suggest that events specific to Italy should have less of an impact on asset prices relevant for Italian investors and firms. Fratzscher and Stracca (2008) conduct a cross country analysis based on the stock market reaction to political news in 30 European countries and find, by means of a difference-in-difference econometric test, that EMU appears to have dampened the reaction to domestic political news but amplified the reaction to news from other euro area countries.

To test this hypothesis, we try to understand how the sensitivity of asset prices has evolved over time and estimate the model of equation (1) using 10-year rolling windows. *Figure 3* shows this evolution over time of the point estimates for the composite dummy D_t for each of the three asset prices. What is striking from the figure is that there has been a marked reduction in the reaction of Italian asset prices to Italy's political shocks over time. By the late 1990s, around the introduction of the euro, convergence had essentially taken place and asset prices no longer reacted significantly to political shocks. This convergence, however, mainly took place for money markets and equity markets, with no significant reaction of time variations for exchange rates.¹⁸

¹⁸Confidence intervals are not shown in order to make the figure more tractable. For short-term interest rates and equity returns, the effects of political and external events become statistically

Next, we distinguish in the sample between the pre-1999 period and a post-1999 period, by estimating a modified version of model (1):

$$r_t = \mu + \alpha r_{t-1} + \sum [\beta_k^1 D_{kt}(1 - EMU_t) + \beta_k^2 D_{kt} EMU_t] + \sum \gamma_j z_{jt} + \varepsilon_t \quad (2)$$

with $EMU_t = 1$ after 1999 and $EMU_t = 0$ before 1999. *Table 10* provides the point estimates for the composite dummies. Overall, the results confirm that there is a striking difference between the pre-1999 and post-1999 periods. Italian asset prices reacted strongly and significantly to many types of political and other shocks before 1999, but did not seem to matter after 1999.

Two notes of caution are in order here. The first one is that breaking down the sample into sub-categories and into sub-periods reduces the number of observations for each point estimate significantly. This is particularly serious for those types of events which have few observations even for the full sample period. Accordingly, the tests that the coefficients in the pre-1999 and post-1999 periods are different - shown in the three right-most columns in *Tables 10* - do not always exhibit statistical significance. Moreover, one ideally would like to conduct a formal test whether 1999 and the introduction of the euro indeed constituted a structural break. However, conducting a formal Andrews-Ploberger break-point test is inconclusive, again owing to the small sample size. A second point is that a greater insulation of Italian investors to Italian shocks with the introduction of the euro may of course also mean that development elsewhere in Europe or globally may have become more important for asset prices and financing conditions faced by Italian investors and firms. Addressing this issue obviously goes beyond the scope of this paper, but it needs to be kept in mind as a limitation.

Finally, we conduct a finer break-down by testing whether changes in the exchange rate regime have mattered for the transmission of political shocks to asset markets. In particular, it may be that asset prices are less responsive to shocks under a pegged exchange rate regime, if the peg is sufficiently credible. Similarly, it may be that other asset prices respond differently under alternative exchange rate regimes. As discussed in *Section 3*, a shock may primarily affect short-term interest rates, and not exchange rates, under a credible peg, but have the opposite effect under a floating regime. Taking the regime changes for Italy as reported in *Table 7*, we distinguish between a floating regime of the lira (for the periods with a lira de jure float, $FLOAT_t = 1$ and 0 otherwise), a pegged regime ($FIX_t = 1$) and a euro regime ($EURO_t = 1$).

$$r_t = \mu + \alpha r_{t-1} + \sum [\beta_k^1 D_{kt} FLOAT_t + \beta_k^2 D_{kt} FIX_t + \beta_k^3 D_{kt} EURO_t] + \sum \gamma_j z_{jt} + \varepsilon_t \quad (3)$$

We find that again asset prices have largely been insulated from Italy's political shocks under the euro, and they also show that there does not seem to have been insignificant after 1995. For exchange rates, the shocks are not statistically significant for any of the sample periods.

a marked difference in the response patterns between pegged and floating regime periods.¹⁹

In summary, the section so far has shown that Italian asset prices are highly responsive to political shocks, and that there has been a structural break with the euro. Italy's adoption of the euro has helped Italian firms and investors to be largely insulated from Italy's adverse political shocks. We next turn to checking the robustness of these results.

4.4 Robustness and caveats

How robust are our results? We conduct a number of tests to verify how sensitive the results are to alternative specifications. A first test is to ask whether political events affect not only the level of Italian asset prices, but also their volatility. Based on an EGARCH specification discussed in Section 3, we find that financial market volatility has indeed been significantly higher during these periods without a formal government, in particular for money markets and equity markets.²⁰

As a second robustness check, there are of course many factors that influence Italian asset prices, and the political events which we investigate are only a small, albeit important set of events that may affect them. It is therefore useful to check whether the results are robust to the inclusion of other important market drivers. We hence use a broad set of Italian macroeconomic announcement surprises, such as for GDP, industrial production, M2 growth, CPI and PPI inflation, unemployment, the trade balance and so on. But we also include macroeconomic news from Germany/the euro area and the United States as a measure of foreign factors influencing Italian asset prices.²¹ *Table 11* indicates that the inclusion of such important macroeconomic announcements does not alter the effect of political events on Italian asset prices. In fact, the coefficients for the composite dummy D_t in *Table 11* are very similar to those of the benchmark model of *Table 8*, and this in spite of the fact that several of macroeconomic news indeed do exert a significant influence on asset prices. Interestingly and importantly, Italian asset prices do respond not only to Italian shocks but also to foreign shocks.

Third, we have stressed throughout the paper that the number of events (131 in total) is relatively limited. This means that the precision of the empirical estimates may suffer from such a limited sample size. But it also means that we cannot rule out that a few important events drive the empirical findings. To check for the sensitivity to outliers, we therefore remove from the estimation the 10 events (i.e. almost 10%

¹⁹Results are not reported for brevity but are available from the authors upon request.

²⁰Again, results are not reported for brevity but are available from the authors upon request.

²¹Macroeconomic news are the surprise components of the data releases, measured as the difference between the announcement and the market expectations. Data for the announcements and the expectations stem from MMS International and Bloomberg. One caveat is that this data is mostly available only from the early 1990s onwards. See Ehrmann et al. (2007) for a more detailed account of the data.

of the whole sample) for each asset price that had the largest daily impact on each asset price. We find that the effect of political events for this reduced sample continue to exert a statistically and economically sizeable effect on asset prices, although of course the point estimates are somewhat smaller.

Fourth, we repeat the benchmark analysis as reported in Table 8 by considering 2-day, rather than 1-day interest rate, stock price and exchange rate changes after a certain event. This robustness analysis may cater for the fact that some of the events became known too late in the day to be incorporated in asset prices on the same day; before exit polls were introduced, for example, the outcome of political and European elections was not known one to two days after the closure of the ballots.²² The results of the 2-day reaction is, however, largely coincident with the benchmark results reported in Table 8.

Fifth, a further potential caveat is that political conditions in Italy have become somewhat more stable over time, which may partly be reflected in the absence of financial market responses to political shocks since 1999. The idea here is that it is not the *propagation* of the political shocks, but rather the *size* of the shocks themselves that is driving our results. On the one hand, this would not change the overall conclusion that EMU has made Italian financial markets less exposed to Italian politics; on the other hand, the channel would be a rather different from the one outline in the Introduction of this paper. It is very difficult to test this hypothesis formally, but there are some indications that more stable politics is *not* likely to be main driver of our results. First, the increased political stability argument should to a large extent also apply to the early and mid-1990s; however, financial markets still responded substantially to political shocks during that period. Second, *Figure 4* reports the World Bank indicator for Political Stability (see Kaufmann et al., 2007) in Italy and in the so-called "EMU core" countries, including Austria, Belgium, France, Germany, Luxembourg, and the Netherlands, i.e. countries which have traditionally been economically and politically stable. Taking this indicator seriously, it can be seen that some improvement in political stability (and in particular some convergence towards the EMU core countries) was visible *before* EMU, but since 1999 there has been if anything a further *deterioration* of political stability in Italy, though short-term fluctuations in this indicator should certainly not be over-emphasised. Third, as we argue more extensively in the Conclusions, EMU could have actually reduced rather than increased the incentives for domestic political stability by curtailing the disciplinary role of financial markets.

Finally, financial integration and the adoption of the euro may, on the one hand, imply the absence of a market reaction to Italian shocks, but on the other hand, make Italy's markets more responsive to external shocks - positive as well as negative - occurring elsewhere in Europe or the world. However, we do not find evidence that Italy's financial markets systematically respond more to foreign macroeconomic news since 1999 than before. This finding is consistent with that of the literature, though

²²We are grateful to a referee for this correct observation.

a more detailed analysis of this issue is beyond the scope of the present paper and has been done elsewhere.²³

In summary, these different pieces of evidence underline that the findings are robust to various extensions and sensitivity analyses, although some important caveats apply and our results should not be over-interpreted.

5 Conclusions

In this paper we have attempted to measure and assess the impact of the instability of Italy's political system, as measured through a broad range of Italian political events, on Italian financial markets (the short-term interest rate, the stock market, and the effective exchange rate). The key question we have addressed is whether the euro has helped insulate Italian asset prices from adverse political shocks originating from within Italy.

Our main result is that a sub-set of the events we consider has had a statistically and economically significant adverse impact on Italian financial markets in the period before the introduction of the euro. This is particularly the case for the collapse of governments and politically motivated terrorist attacks, events that have unfortunately been rather frequent in postwar Italy. We find evidence of a structural break around the introduction of the euro, whereby the impact of political events becomes much more subdued or non-existent. Moreover, these results are robust to a number of extensions and sensitivity tests, although they still remain subject to some important caveats.

The main implication of our study is that, to the extent that Italy remains a politically unstable country (at least in comparison with other advanced countries), the euro may be protecting Italy from the fallout of its own political instability, and that this should be ascribed as an important positive contribution of the introduction of the euro in Italy. On the other hand, this may also imply a lower responsiveness of asset prices to domestic events, which may reduce the disciplining role of financial markets on politicians. Though not covered in this paper due to data limitations, for a country with a high public debt like Italy the effect on long-term government bond yields is going to be particularly relevant in that respect. A cursory look at the evidence on the World Bank data on Political Stability presented in Figure 4 is not totally inconsistent with this interpretation, though short term movements should not be overemphasised. On the whole, our results identify another important economic dimension and channel for countries with a comparably weak political system to be affected by the participation in a monetary union.

²³For instance, Ehrmann et al. (2007) show that bond yields of individual euro area countries - including Italy - have started to respond in a more similar and homogenous manner but not always necessarily more strongly to foreign shocks since the introduction of the euro.

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Table 1. Elections for the national and European Parliament in Italy

| Date | Election |
|------------------|---------------------|
| 20-Jun-76 | National Parliament |
| 03-Jun-79 | National Parliament |
| 10-Jun-79 | European Parliament |
| 26-Jun-83 | National Parliament |
| 17-Jun-84 | European Parliament |
| 14-Jun-87 | National Parliament |
| 18-Jun-89 | European Parliament |
| 05-Apr-92 | National Parliament |
| 27-28 March 1994 | National Parliament |
| 12-Jun-94 | European Parliament |
| 21-Apr-96 | National Parliament |
| 13-Jun-99 | European Parliament |
| 13-May-01 | National Parliament |
| 12-Jun-04 | European Parliament |
| 9-10 April 2006 | National Parliament |

Source: Website of the Italian Government.

Table 2. Formation and resignation of national governments in Italy

| Government | Start | End | Government | Start | End |
|---------------|-----------|-----------|----------------|-----------|-----------------------|
| Andreotti II | 26-Jun-72 | 02-Jun-73 | Fanfani VI | 17-Apr-87 | 28-Apr-87 |
| Rumor IV | 07-Jul-73 | 03-Mar-74 | Goria | 27-Jun-87 | 11-Mar-88 |
| Rumor V | 14-Mar-74 | 03-Oct-74 | De Mita | 13-Apr-88 | 19-May-89 |
| Moro IV | 23-Nov-74 | 07-Jan-76 | Andreotti VI | 22-Jul-89 | 29-Mar-91 |
| Moro V | 12-Feb-76 | 30-Apr-76 | Andreotti VII | 12-Apr-91 | 24-Apr-92 |
| Andreotti III | 29-Jul-76 | 16-Jan-78 | Amato | 28-Jun-92 | 22-Apr-93 |
| Andreotti IV | 11-Mar-78 | 31-Jan-79 | Ciampi | 28-Apr-93 | 16-Apr-94 |
| Andreotti V | 20-Mar-79 | 31-Mar-79 | Berlusconi | 10-May-94 | 22-Dec-94 |
| Cossiga | 04-Aug-79 | 19-Mar-80 | Dini | 17-Jan-95 | 17-May-96 |
| Cossiga II | 04-Apr-80 | 27-Sep-80 | Prodi | 17-May-96 | 09-Oct-98 |
| Forlani | 18-Oct-80 | 26-May-81 | D'Alema | 21-Oct-98 | 18-Dec-99 |
| Spadolini | 28-Jun-81 | 06-Aug-82 | D'Alema II | 22-Dec-99 | 19-Apr-00 |
| Spadolini II | 23-Aug-82 | 13-Nov-82 | Amato II | 25-Apr-00 | 31-May-01 |
| Fanfani V | 01-Dec-82 | 29-Apr-83 | Berlusconi II | 11-Jun-01 | 20-Apr-05 |
| Craxi | 04-Aug-83 | 07-Jun-86 | Berlusconi III | 23-Apr-05 | 16-May-06 |
| Craxi II | 01-Aug-86 | 03-Mar-87 | Prodi II | 16-May-06 | in office at end 2007 |

Source: Centro Studi sulla Resistenza, cross checked with BBC news and other news agencies.

Note that the end indicates the actual collapse of the government coalition or the resignation of the Prime Minister.

Table 3. Main terrorist attacks and crime with political connotation or ramifications

| Event | Date |
|--------------------------------------|-------------|
| Bomb attack in Milan police station | 17-May-73 |
| Bomb attack in Piazza della Loggia | 28-May-74 |
| Attack on Italicus train | 04-Aug-74 |
| Pasolini murder | 02-Nov-75 |
| Kidnapping of Aldo Moro | 16-Mar-78 |
| Killing of Aldo Moro | 09-May-78 |
| Murder of Mino Pecorelli | 20-Mar-79 |
| Murder of judge Ambrosoli | 12-Jul-79 |
| Murder of Bachelet | 12-Feb-80 |
| Murder of Walter Tobagi | 28-May-80 |
| Air disaster in Ustica | 27-Jun-80 |
| Carnage at Bologna train station | 02-Aug-80 |
| Publication P2 lists | 20-May-81 |
| Murder/suicide of Roberto Calvi | 17-Jun-82 |
| Murder of Dalla Chiesa | 03-Sep-82 |
| Chinnici carnage | 29-Jul-83 |
| Attack on train 904 | 23-Dec-84 |
| Murder of Ezio Tarantelli | 27-Mar-85 |
| Fiumicino carnage | 27-Dec-85 |
| Murder of Michele Sindona | 20-Mar-86 |
| Murder of Salvo Lima | 12-Mar-92 |
| Murder of Giovanni Falcone | 23-May-92 |
| Murder of Paolo Borsellino | 19-Jul-92 |
| Bomb attack in Via dei Georgofili, I | 27-May-93 |
| Bomb attack in Via Palestro, Milan | 27-Jul-93 |
| Murder of Massimo D'Antona | 20-May-99 |
| Murder of Marco Biagi | 19-Mar-02 |

Source: Ginsborg (2003) and BBC news.

Table 4. Major natural catastrophes and accidents in Italy

| Event | Date | Victims (deaths) |
|---------------------------------|-------------|-------------------------|
| Earthquake in Friuli | 06-May-76 | 965 |
| Seveso dioxine contamination | 10-Jul-76 | - |
| Earthquake in Irpinia | 23-Nov-80 | 2,914 |
| Flooding in Stava | 19-Jul-85 | 268 |
| Moby Prince collision | 10-Apr-91 | 140 |
| Villafranca air crash | 13-Dec-95 | 49 |
| Earthquake in Umbria and Marche | 26-Sep-97 | 11 |
| Cermis accident | 03-Feb-98 | 20 |
| Flooding in Sarno | 05-May-98 | 137 |
| Fire in Monte Bianco tunnel | 24-Mar-99 | 39 |
| Milano Linate air disaster | 08-Oct-01 | 118 |
| Pirelli skyscraper hit by plane | 18-Apr-02 | 3 |
| Earthquake in San Giuliano | 31-Oct-02 | 28 |

Source: BBC news.

Table 5. Main referenda in Italy

| Referendum | Date |
|-------------------------------|-------------|
| Divorce | 12-May-74 |
| Public order | 11-Jun-78 |
| Abortion | 17-May-81 |
| Scala Mobile (a) | 10-Jun-85 |
| Electoral law and others | 19-Apr-93 |
| Public employment and others | 01-Jun-95 |
| Article 18 of Workers Statute | 15-Jun-03 |

Source: Italian Government website.

Table 6. Other important political events, miscellanea

| Event | Date |
|--|-------------|
| Resignation of Head of State Leone | 15-Jun-78 |
| Sigonella confrontation between Italian police and US troops | 10-Oct-85 |
| Lybian rockets on Lampedusa island | 15-Apr-86 |
| Arrest of Mario Chiesa | 17-Feb-92 |
| Mr Craxi resigns from PSI | 11-Feb-93 |
| Parliament denies inquiry authorisation for Mr Craxi | 29-Apr-93 |
| Suicide of Gabriele Cagliari | 20-Jul-93 |
| Suicide of Raul Gardini | 23-Jul-93 |

Source: BBC news.

Table 7: Exchange rate regimes for Italy, 1973-2007

| <i>Period</i> | <i>De facto regime</i> | <i>De jure regime</i> |
|-----------------------|------------------------|-----------------------|
| Feb. 1973 – Mar. 1976 | Managed float | Float |
| Apr. 1976 – Feb. 1979 | Crawling peg | Float |
| Mar. 1979 – Jan. 1987 | Crawling peg | Peg to DM |
| Feb. 1987 – Jan. 1990 | Soft peg | Peg to DM |
| Feb. 1990 – Aug. 1992 | Soft peg | Peg to DM |
| Sep. 1992 – Mar. 1993 | Float | Float |
| Apr. 1993 – Apr. 1996 | Managed float | Float |
| May 1996 – Oct. 1996 | Soft peg | Float |
| Nov. 1996 – Dec. 1998 | Soft peg | Peg to DM |
| Since Jan. 1999 | Euro | Euro |

Source: Garofalo (2005)

Table 8: Benchmark results: Effect of political and external events on Italian asset prices, 1973-2007

| | Full sample 1973-2007 | | |
|---------------------------------|--------------------------|---------------------------|---------------------------|
| | interest rate | equity return | exchange rate |
| All events | 4.198** <i>1.737</i> | -0.314** <i>0.128</i> | -0.092** <i>0.046</i> |
| Political events I - negative | 8.892*** <i>3.012</i> | -0.912*** <i>0.249</i> | -0.229*** <i>0.078</i> |
| Political events II - ambiguous | -2.259 <i>2.908</i> | 0.2 <i>0.19</i> | 0.074 <i>0.047</i> |
| External events | 7.997*** <i>2.398</i> | -0.398** <i>0.194</i> | -0.172 <i>0.105</i> |
| <i>Controls:</i> | | | |
| German interest rate | 0.114 <i>0.099</i> | | |
| World equity returns | | 0.553*** <i>0.018</i> | |
| Monday dummy | 0.198 <i>0.98</i> | -0.054 <i>0.035</i> | -0.009 <i>0.013</i> |
| Friday dummy | 0.98 <i>1.016</i> | 0.063** <i>0.03</i> | -0.003 <i>0.01</i> |
| Constant | -0.466 <i>0.467</i> | 0.017 <i>0.016</i> | -0.014*** <i>0.005</i> |
| # observations | 7836 | 9054 | 9054 |

Notes: The table shows the estimates of equation (4) for event categories. The small numbers in Italics show robust standard errors. ***, **, * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 9: Breakdown by type of event: Effect of political and external events on Italian asset prices, 1973-2007

| Full sample 1973-2007 | | | |
|--|------------------|------------------|------------------|
| | interest rate | equity return | exchange rate |
| Political events I - negative | | | |
| Collapse of government | 7.306** | -0.902*** | -0.221** |
| | <i>3.637</i> | <i>0.298</i> | <i>0.092</i> |
| Other political events | 14.040*** | -0.947** | -0.259** |
| | <i>4.416</i> | <i>0.37</i> | <i>0.125</i> |
| Political events II - ambiguous | | | |
| Elections | -4.099 | 0.692 | 0.154 |
| | <i>4.484</i> | <i>0.455</i> | <i>0.107</i> |
| Referendum | 15.545 | 0.776 | 0.046 |
| | <i>9.793</i> | <i>0.501</i> | <i>0.134</i> |
| Start of government | -4.682 | -0.146 | 0.04 |
| | <i>3.594</i> | <i>0.185</i> | <i>0.053</i> |
| External events | | | |
| Natural disasters & accidents | 3.083 | -0.461* | -0.323 |
| | <i>2.169</i> | <i>0.24</i> | <i>0.3</i> |
| Terrorist & Mafia attacks | 10.345*** | -0.367 | -0.100* |
| | <i>3.256</i> | <i>0.263</i> | <i>0.052</i> |
| Controls | Yes | Yes | Yes |
| # observations | 7836 | 9054 | 9054 |

Notes: The table shows the estimates of equation (4) for the various event types. The small numbers in Italics show robust standard errors. ***, **, * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

**Table 10: Pre-euro vs. post-euro period breakdown:
Effect of political and external events on Italian asset prices**

| | Pre-1999 | | | Post-1999 | | | significance pre-1999 vs post-1999 | | |
|---------------------------------|---------------------------|---------------------------|---------------------------|-----------------------|-------------------------|------------------------|---------------------------------------|------------------|------------------|
| | interest rate | equity return | exchange rate | interest rate | equity return | exchange rate | interest rate | equity return | exchange rate |
| All events | 4.976** <i>2.083</i> | -0.387*** <i>0.145</i> | -0.100* <i>0.053</i> | 0.576 <i>0.503</i> | 0.09 <i>0.218</i> | -0.048 <i>0.041</i> | 0.033** | 0.068* | 0.443 |
| Political events I - negative | 10.344*** <i>3.455</i> | -0.973*** <i>0.278</i> | -0.247*** <i>0.088</i> | 0.475 <i>0.576</i> | -0.492 <i>0.395</i> | -0.104 <i>0.084</i> | 0.005*** | 0.319 | 0.239 |
| Political events II - ambiguous | -3 <i>3.6</i> | 0.12 <i>0.219</i> | 0.105* <i>0.055</i> | 0.698 <i>0.693</i> | 0.583** <i>0.295</i> | -0.079 <i>0.057</i> | 0.301 | 0.207 | 0.019** |
| External events | 9.626*** <i>2.807</i> | -0.440** <i>0.221</i> | -0.211* <i>0.122</i> | 0.4 <i>0.437</i> | -0.16 <i>0.325</i> | 0.046 <i>0.062</i> | 0.001*** | 0.477 | 0.059* |
| Controls | Yes | Yes | Yes | Yes | Yes | Yes | | | |
| # observations | 5565 | 6783 | 6782 | 2271 | 2271 | 2271 | | | |

Notes: The table shows the estimates of equation (5), pre-1999 vs. post-1999. The small numbers in Italics show robust standard errors. ***, **, * indicate statistical significance at the 1%, 5%, and 10% levels, respectively. "Significance" provides the p-values of a t-test for equality of respective point estimates for the pre-1999 vs. post-1999 sub-periods.

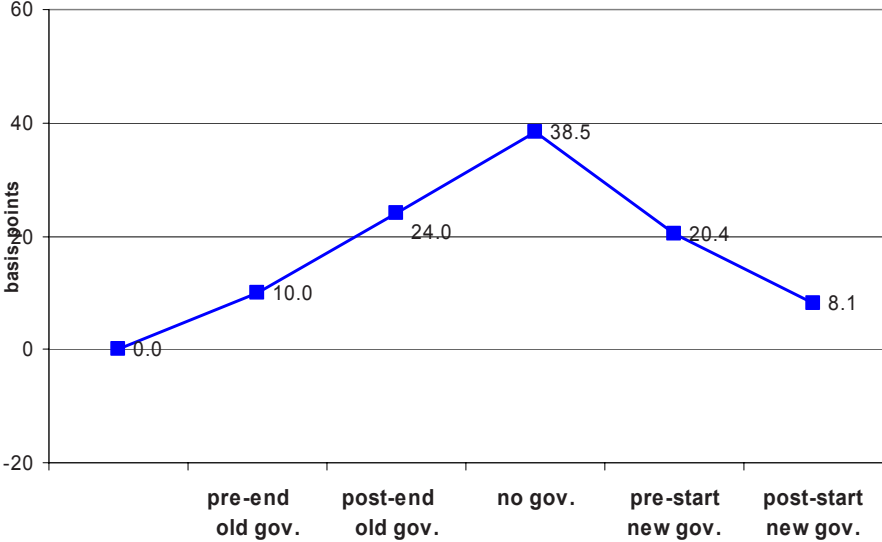
Table 11: Robustness II: Effects on Italian asset prices - controlling for Italian, German/euro area and US macroeconomic news

| Full sample 1973-2007 | | | |
|-------------------------------------|------------------|-------------------|--------------------|
| | interest rate | equity return | exchange rate |
| All events | 4.240** 1.756 | -0.317** 0.129 | -0.091*** 0.046 |
| Italian macro news: | | | |
| GDP growth | 2.124** | 0.507** | 0.014 |
| Industrial orders | 0.752 | -0.071 | 0.022 |
| Industrial production | 0.145 | 0.029 | -0.024 |
| M2 growth | 1.349 | -0.312*** | -0.787*** |
| CPI inflation | 0.038 | 0.087 | 0.061** |
| PPI inflation | 0.995** | -0.203* | 0.032 |
| Retail sales | 0.061 | -0.098 | 0.033 |
| Trade balance | 0.79 | -0.122 | -0.060** |
| Unemployment rate | -1.183 | 0.142 | -0.092 |
| Wage changes | -0.347 | 0.135 | 0.022 |
| German/euro area macro news: | | | |
| GDP growth | -0.107 | 0.818** | -0.285 |
| IFO business confidence | 1.125 | 0.022 | -0.417*** |
| Industrial production | -0.338 | 0.068 | 0.022 |
| M3 growth | 9.105** | 0.222 | 0.141** |
| CPI inflation | 0.011 | 0.006 | -0.071** |
| PPI inflation | 1.085 | -0.046 | -0.007 |
| Retail sales | -0.578 | -0.054 | 0.041 |
| Trade balance | 0.087 | -0.015 | -0.03 |
| Unemployment rate | -0.466 | 0.018 | -0.036 |
| US macro news: | | | |
| GDP growth | 1.246 | 0.579** | -0.132 |
| ISM / NAPM | 1.53 | 0.2 | -0.195*** |
| Non-farm payrolls | 1.123 | 0.400*** | -0.092*** |
| Consumer confidence | 0.21 | 0.466 | -0.212** |
| Industrial production | 0.125 | 0.133 | -0.054* |
| CPI inflation | -1.979 | -0.146 | 0.010 |
| PPI inflation | 0.857 | 0.054 | -0.002 |
| Retail sales | 2.187 | 0.154 | -0.075 |
| Trade balance | 2.737 | 1.102* | -0.620*** |
| Unemployment rate | -3.745 | -0.239 | 0.320** |
| Workweek | 0.837 | 0.095 | -0.101 |
| # observations | 7836 | 9054 | 9053 |

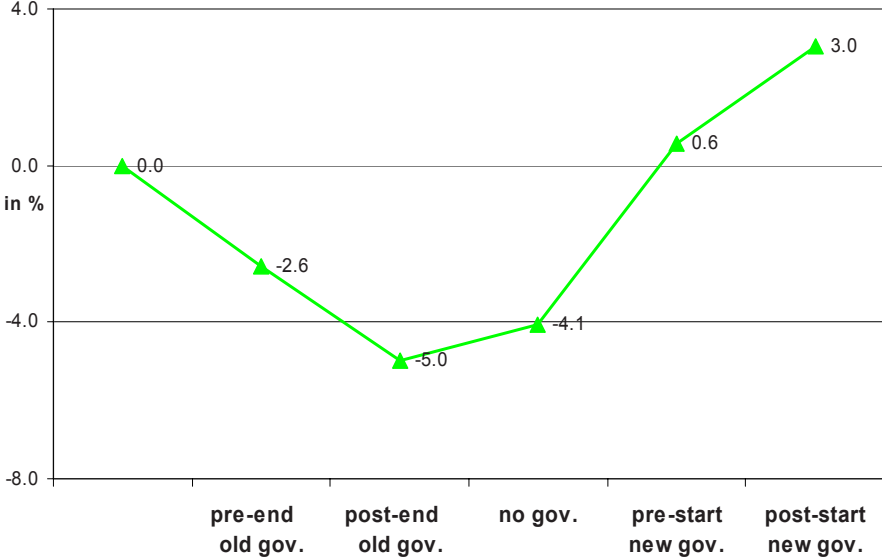
Notes: The table shows the estimates of equation (4), which controls in addition for the most relevant Italian, German/euro area and US macroeconomic news. Standard errors are not shown for brevity reasons. ***, **, * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Figure 1: The Italian “rollercoaster” – asset price movements around collapses and formations of Italian governments, 1973-2007

1.A Interest rates



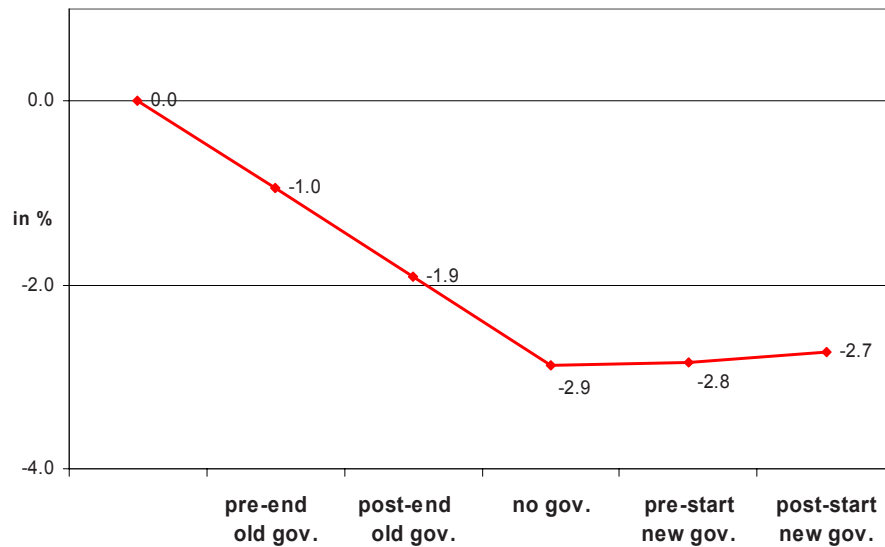
1.B Equity returns



cont. ...

Figure 1: ...cont.

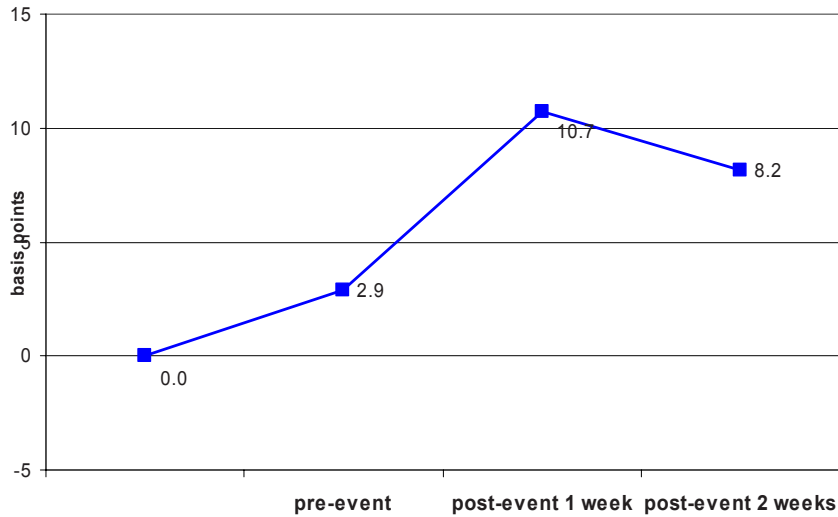
1.C Exchange rates



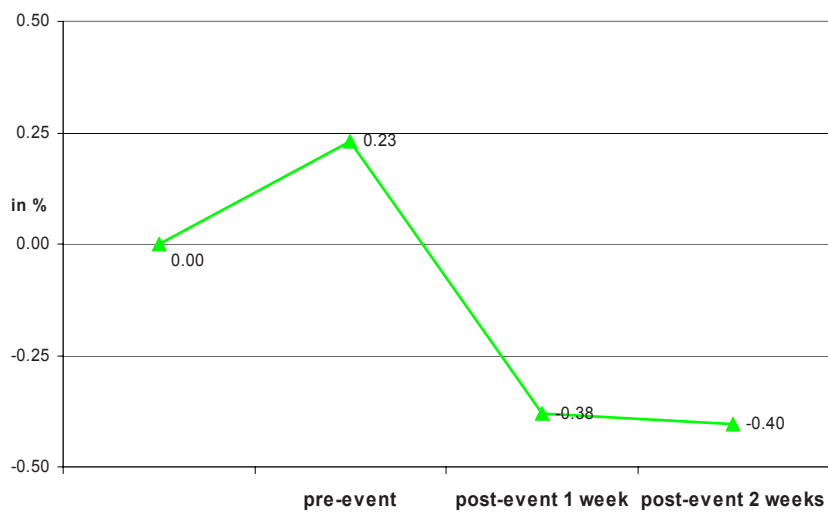
Notes: The figures show the cumulated reaction of asset prices during periods around the collapses and the formations of governments: “pre-end old gov.” for the two weeks before and “post-end old gov.” for the day of and the two weeks after the collapse of a government; “pre-start new gov.” for the two weeks before and “post-stat new gov.” for the day of and the two weeks after the start of a new government. “no gov.” is for the remaining period after the collapse and before the formation of a new government. All numbers are cumulated changes in basis points (for interest rates) or in percent (for equity returns and exchange rates). In total there were 32 governments in 1973-2007; see section 2 for details.

Figure 2: The Italian “rollercoaster” – asset price movements around external events (natural disasters, accidents and terrorist attacks), 1973-2007

2.A Interest rates



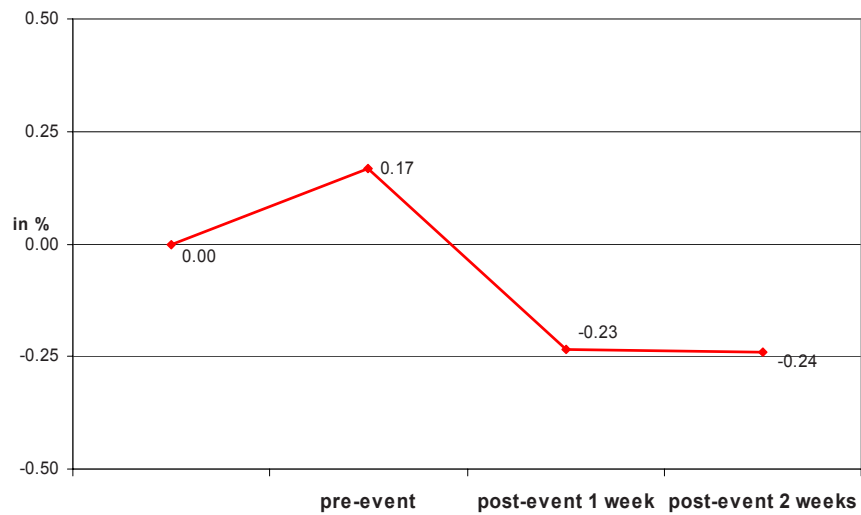
2.B Equity returns



cont. ...

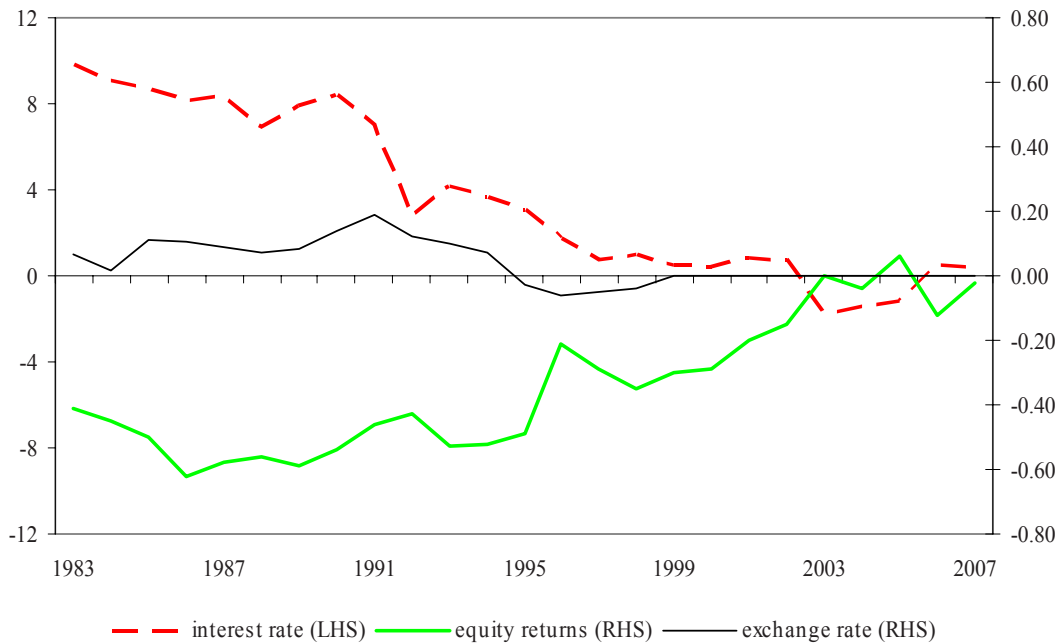
Figure 2: ...cont.

2.C Exchange rates



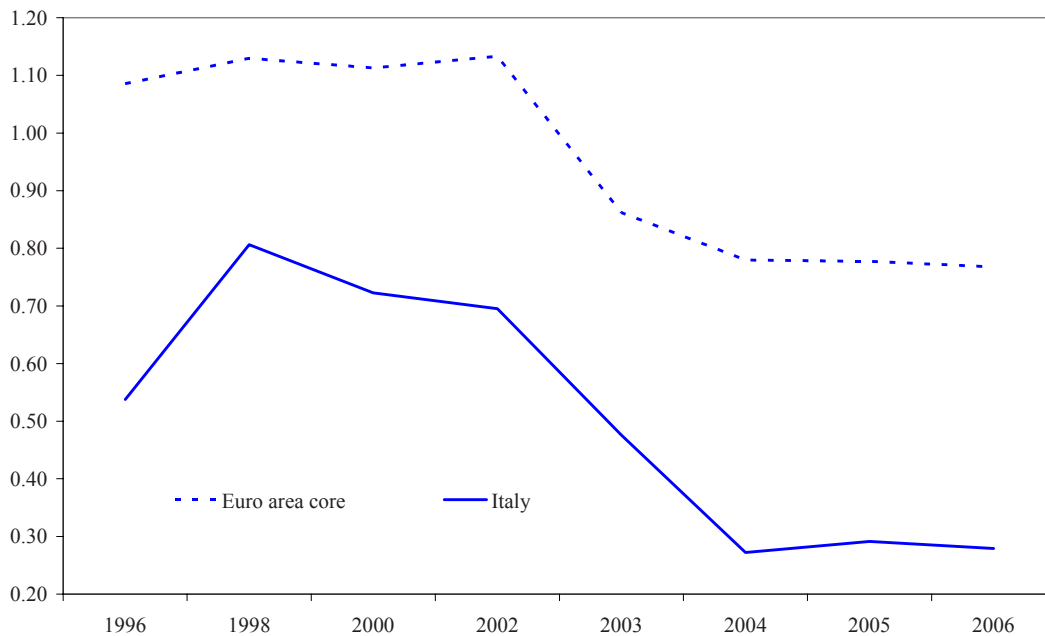
Notes: The figures show the cumulated reaction of asset prices during periods around external events (natural disasters, accidents and terrorist attacks): “pre-event” shows the movement for the week before, “post-event 1 week” for the first week after, and “post-event 2 weeks” for the second week after the event. All numbers are cumulated changes in basis points (for interest rates) or in percent (for equity returns and exchange rates). In total there were 25 of such external events in 1973-2007; see section 2 for details.

Figure 3: Time variations – 10-year recursive estimates for effect of political and external events on Italian asset prices, 1973-2007



Notes: The figure shows the estimates of equation (4), using recursive 10-year windows, with the year in the figure indicating the last year of the window (e.g. the numbers for 1983 provide the parameter estimates for the window 1974-1983). Confidence intervals are not shown in order to make the figure more tractable. For short-term interest rates and equity returns, the effects of political and external events become statistically insignificant after 1995. For exchange rates, the shocks are not statistically significant for any of the sample periods.

Figure 4. World Bank indicator for Political Stability, Italy and “EMU core” countries



Source: World Bank Governance Indicators. See Kaufmann et al. (2007) for further information. The euro area core is an average of the indicator for Austria, Belgium, France, Germany, Luxembourg and the Netherlands. A higher level of the indicator indicates a higher degree of political stability.

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