

## ARGUMENT

# Italy's Populists Can Beat Europe's Establishment

They're young, untested — and, if they play their cards right, they can transform the EU.

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BY **LUIGI ZINGALES** | APRIL 3, 2018, 12:45 PM

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**T**he recent Italian elections are a greater setback for Europe than Brexit. The British, after all, have always been Euroskeptic. The United Kingdom joined the then-European Economic Community late and reluctantly, and for most of the last 45 years the majority of Brits did not see the European Union as beneficial. The Brexit vote was little more than a political legitimization of this deeply rooted aversion.

By contrast, Italy, one of the founding members of the European community, has always been a Europhile country. Historically, more than 80 percent of Italians saw the benefits of the EU. When on March 4 Italians voted en masse for Euroskeptic parties it was not because they dislike Europe, but because they feel Europe failed them. Some coalition involving one or more of these parties will most likely make up Italy's next government.

The critical question now — not just for Italy, but for all of Europe — is what a new Italian government, composed of new parties and politicians, can do about it. That will depend on the ability of Italy's untested populist political class to find leverage to effectively use against the rest of Europe. And Italian populists, if they are creative, have an opportunity to do just that.

## It's the economy, stupid

Before Italy's election, the prestigious German magazine *Der Spiegel* published a column describing Italy as a country of **children who vote for clowns**. This was obviously offensive. But it also showed a complete lack of understanding of Italy's situation. For Italian voters — to paraphrase James Carville, former U.S. President

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The Italian economic crisis since 2008 is comparable to the crisis in 1930s Germany: Three major banks have collapsed, 30 percent of firms have defaulted, unemployment reached 12 percent and youth unemployment 35 percent, and tens of

thousands of talented people are forced to leave the country every year to find a job. Given these numbers, what is surprising is not the protest vote, but how mild that protest vote was. The Five Star Movement (which got about 32 percent of the vote) is more similar to Germany's mainstream Greens than to the far-left Die Linke, and it is clearly more moderate than anti-establishment Podemos in Spain or Syriza in Greece. Meanwhile, the Lega (which got 17 percent of the vote) is more moderate than Alternative for Germany, which got 13 percent in the latest elections in a country with unemployment of only 3.6 percent and where per capita income increased 30 percent in the last two decades.

While Europe is certainly not the only culprit behind Italy's abysmal economic performance, it is not without fault, either. The design of the common European currency contained some major flaws — including a combination of rigid budget rules and lack of automatic stabilizers (such as the U.S. unemployment insurance system paid in part by federal funds) — that were well known to its creators, including those in Italy. Despite these acknowledged flaws (and a major intervening crisis), no progress has been made to fix them over the past nearly 20 years.

Other problems became apparent during the euro crisis itself — like the lack of a mechanism for prompt intervention to avoid panics in the sovereign bond market. Any country with Italy's precarious fiscal situation needs to know that the central bank stands ready to intervene to sustain the government debt should a crisis of confidence break out. Look at the difference in government bond yields in the United Kingdom and Spain after the financial crisis. The countries had similar levels of debt and deficits. But the market was demanding much higher yield from Spain, because it was uncertain about the willingness of the European Central Bank (ECB) to intervene.

To be sure, the ECB did eventually intervene in both the Spanish and the Italian cases, but only after a long delay. This delay was not due to incompetence, but to the explicit desire to impose “market discipline” — that is, to put pressure on the government to improve its fiscal situation. It was a form of economic waterboarding that has left the Italian economy devastated and Italian voters legitimately angry at the European institutions.

### **... But it's immigration, too**

Meanwhile, just as immigration played an important (one might argue

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fundamentally different than in the United States and Germany. Most immigrants do

not want to relocate to Italy. They come to Italy only as a launching pad to reach Germany, France, and the United Kingdom.

So why do Italians resent these immigrants? Because European rules are designed such that the country of entry (generally Italy) must bear all the cost of the assistance. It's as if all the immigrants in the United States came through New Mexico and this state were responsible for assisting them all on its state budget — with the additional difference that new immigrants to New Mexico can freely move to the rest of the union, while new immigrants to Italy cannot. Last week, the Italian media reported about a pregnant Nigerian immigrant, who was dying of cancer and trying to reach her sister in France to entrust her baby to her, but was pushed by the French policy back to Italy, where she died.

To add insult to injury, the Italian immigration crisis is a European-made disaster. The intervention that made Libya a failed state — one that promotes terrorism and illegal immigration — was advocated by then-French President Nicolas Sarkozy, who wanted to increase France's power abroad and possibly cover up the money he allegedly received from former Libyan leader Muammar al-Qaddafi for his election campaign.

Of course, the EU is not the only party that deserves blame for Italy's migration woes. The Italian government voluntarily signed the Dublin Regulation, which allocates the immigrant burden to the country of arrival (though it also implies that each country has to take a quota of immigrants, and most of them refuse to do so), and reluctantly followed Sarkozy in the Libyan military adventure.

### **Where is the hope?**

The picture I have drawn so far is pretty bleak. Is there a silver lining? Yes, and it's to be found in the sense of urgency triggered by Italy's election results. Even before all Italian votes had been counted, French President Emmanuel Macron had started to recognize that Italy had been left alone in the migration crisis. The following week, Macron met with German Chancellor Angela Merkel to reaffirm the need to reform European policies and better share the burdens of immigration to the continent.

What's driving Macron's activism isn't just his ambition to make history as the demiurge of a new Europe. It is also his awareness that — if not properly addressed — the Italian vote could eventually lead to Italy's exit from the euro, an exit that

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said of France. An Italy with a devalued currency would subtract market share from many of France's most important sectors, from food and wine to cars and banking services, not to mention tourism. It is already difficult for France to maintain its

expensive welfare state competing head-to-head with German firms. It would become impossible to do so if Italian firms could easily undercut their French competitors thanks to a devalued currency. A “QuitItaly” scenario would be the biggest political gift that could be made to a weakened Marine Le Pen — hence why Macron would do anything in his power to avoid this outcome.

The problem is that his power might be limited: Any reform requires the consensus of the rest of the union and, in particular, Germany. German voters are terrified of becoming the financiers of last resort of a financially broken Europe. For this reason, German politicians resist any form of risk-sharing arrangement, even the mildest and most reasonable ones, like a common deposit insurance for banks supervised by the European Central Bank. It's as if New York state had insisted California pay in full for the losses that IndyMac's failure imposed on the Federal Deposit Insurance Corp.

### **Good cop-bad cop**

Nevertheless, the new Italian government's strategy should be to leverage Macron's clear interest in reforming the euro area to achieve that goal. And it can succeed, if it plays its cards right.

The first step must be to reject the hardball negotiation strategy employed by former Greek Finance Minister Yanis Varoufakis. He thought he could obtain debt concession from his European partners by threatening an intentional default on Greek bonds previously purchased by the ECB in order to disrupt quantitative easing and trigger contagion across the continent. He failed to predict that German politicians would prefer to lose billions rather than cave in to a threat, because they would be replaced by their angry electorate in the subsequent election.

While Italy has more bargaining power than Greece, it can be equally choked financially — as Greece was in 2015 — if it makes the threat explicit. The moment an Italian government threatens to leave the euro, money will start to flow out of the Italian banking system. To remain open, Italian banks would need to obtain some emergency liquidity assistance from the ECB. With the Italian government explicitly considering an exit from the euro, the ECB would have an incentive to deny any such loans, provoking a bank run.

The Italian government could temporarily halt bank runs on its own by imposing

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for any government introducing them, and will most likely lead to a fracturing of the coalition and the parties themselves. Some observers — such as *Financial Times* commentator Wolfgang Münchau — have **argued** that Italy is too big to fail, implying

that the rest of Europe would come to the rescue. He is probably right, but help would only come at the last minute, after months if not years of bleeding deposits and economic recession. In any war of attrition, Italy – regardless of its government — should be expected to cave in first.

But Italy's traditional method of giving up any demand to fundamentally reform the euro area in exchange for some flexibility in the application of the EU's deficit rules (also known as Europe's fiscal compact) isn't a sensible strategy, either. This approach has achieved little for Italy and alienated half of the country's voters.

It would be far better for the new Italian government to take a two-tiered approach: a major effort to redesign the flawed European rules under the implied (rather than explicit) threat that if this strategy fails, the existing Italian government would collapse and the next one would exit the euro. This is where the presence of Italy's two major Euroskeptic parties could be an advantage. If they do not govern together, the first one to negotiate with Europe can credibly claim that if it fails, the next one will be worse.

Prime Ministers Matteo Renzi and Paolo Gentiloni already played a version of this strategy from 2014 to 2017 when they asked for budget flexibility to prevent a populist uprising. But there were two major differences: First, they were mostly isolated in Europe in making this request for more fiscal flexibility, and they were unable to inspire a broader coalition. Today, if Italy frames the battle as a fight for necessary reforms, rather than for flexibility in existing rule, Italy can count on the assistance of France's Macron, who has to mollify his own increasingly Euroskeptic electorate at home or risk being booted out at the next election.

The second difference from Italy's previous attempts at winning concessions from Europe is that the rest of the continent didn't previously believe the populist threat was real, especially after a round of mostly reassuring election results across Europe in 2017, from France to the Netherlands and Austria. Now that Italy's two populist parties together have a majority in the Italian Chamber of Deputies and Senate, the question is not whether the populist threat is real, but what form Italian populism will take.

### **Which populism?**

Historically, populism has taken many forms, some leaning more to the left and

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National Front in France. On the other hand, there is the Five Star Movement, which emphasizes more progressive issues like a universal basic income, the environment, and the fight against corruption.

At the moment, a coalition between the two populist parties seems the most likely, because today ideological divides play less of a role than the desire to replace the existing establishment. On the one hand, this coalition will be the most internally cohesive in negotiating a hard bargain with Europe; on the other hand, it would weaken Italy's bargaining position. If the coalition fails, there is no ready-made alternative but the old regime.

Another possibility is for the Lega to govern with its center-right allies (together they got 37 percent of the vote) with the benign abstention of the Partito Democratico. In this coalition, the Euroskepticism of the Lega would be diluted by the more moderate position of its allies. The problem is that the rest of the coalition (especially former Prime Minister Silvio Berlusconi's party) has little willingness to reform Europe. It would be more of the same.

The third option is a coalition between the Five Star Movement and the Partito Democratico, the big loser of the last elections. At the moment, this seems the least likely possibility since the PD categorically rejects the idea. Yet, it would have several advantages. First, it would empower Italian voters by giving the right to govern to the largest party, the Five Star Movement, while the Democratic Party's presence would provide a guarantee to the European partners and the markets that the government will not pursue the most radical options (like trying to exit the euro). It would also pose a credible threat to Europe. A failure of a Five Star-PD coalition would deliver Italy into the hands of populist nationalists, ready to exit the euro.

### **The three priorities**

The first priority of a new government should be to reform the Dublin agreement on immigration. This is relatively low-hanging fruit, since Macron has already made some overtures on this point. Today, asylum-seekers cannot legally enter Europe, but once they enter they can legally demand asylum. The opposite should be true. When the conditions are met, it should be relatively easy to apply for asylum in the country of origin or in international hotspots, but impossible to do so after illegally entering the continent. Second, patrolling of the European coasts and borders should be done by European joint forces and not left to local ones. Consequently, the immigrants rescued by the border police should be automatically divided among the European member countries in proportion to the receiving country's population, not abandoned in Greece and Italy. Third, the same freedom of movement inside the EU granted to European citizens should be granted to immigrants. This would make

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The second priority would be to create some form of Pan-European unemployment insurance. Italy and Greece are the only countries of the eurozone not to have a

broad form of unemployment insurance. The Five Star Movement campaigned aggressively for some form of unemployment insurance. Everybody else stressed the infeasibility of such a plan under the current European budget limits. The solution could be found in a European-based insurance, which will kick in when a country faces an abnormal recession. Not only would this be a victory for the government introducing it, but it would also start fixing some of the design flaws of the common currency.

Finally, to reassure the Germans that they will not have to pay for a bankrupt Italy, the Italian government could accept the policy proposal advanced by Germany that would allow countries in financial trouble to restructure their sovereign bonds by bailing in creditors, conditional on two provisions. First, that each country could issue senior national bonds up to 60 percent of GDP that are exempted from any bail-in and are cross-guaranteed by the other eurozone countries. In this way, each country can finance itself with some “safe assets” at an attractive rate. Second, that only new bonds can be considered senior and cross-guaranteed. This provision will partially alleviate the Germans’ concern that they would be underwriting existing Italian liabilities. Furthermore, it will de facto make all the existing bonds junior, opening up the possibility for a voluntary restructuring of existing debts in highly indebted countries, as they should have done when they entered the euro.

### **The biggest obstacles**

Pulling off such a deal would not be easy. Yet, the biggest obstacles are not to be found in Italy’s European partners, but inside Italy itself. The first problem is the quality of Italian personnel in Brussels. Even today, Italian political aides and bureaucrats are not known to be the most competent negotiators. It is unlikely that a populist party would be able to identify and promote a new cadre of better negotiators overnight.

The second obstacle comes from the cynical view of Europe prevailing among the Italian establishment. If Italy has been unable to negotiate better deals, it is not the fault of its weak governments and incompetent bureaucrats alone. Much of the Italian establishment has welcomed rigid European rules that force Italians to accept what they would not approve through the democratic process. As the CEO of a major Italian bank once confessed to me: “Italy is better off run by Germany.” Most of the Italian establishment, thus, will root against any renegotiation of the European rules.

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an anti-establishment vote. Italians democratically revolted against an establishment unable to lead them. Either the Italian establishment will have to

learn to follow, or it should be obliged to get out of the way — not just for the good of Italy, but for the good of all of Europe.

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