

THE YEAR OF NON-RECKONING

Carlo Bastasin

The political setup within member states is becoming a priority for the survival of the European Union and the euro-area. European integration, through economic interdependence, has advanced through the interaction of grand coalition governments of various countries. The migrant crisis, instead, is polarizing national politics. 2017 will be the year when some of the largest countries in both the core and the periphery will see whether mainstream parties can take back control of the agenda. A cooperative game between member states could thus take place, favoring this outcome. Tackling the migrant crisis would thus go hand-in-hand with an accommodative fiscal and monetary policy.

OVER THE COURSE of the next 12 months, popular consultations will take place in all the largest euro-area countries. Between December 2016 and September 2017, citizens will vote in a referendum in Italy, a general election in the Netherlands, a presidential election in France, and a federal election in Germany. Depending on whether a new election occurs in Spain, countries whose political systems are subject to popular vote in the next twelve months would correspond to roughly 70-85% of the area's GDP.

National electorates have become less predictable since new arguments about open versus closed societies have taken center stage in political debate. New political movements, inclined to protect national borders, have emerged in most countries. They have also substantially undermined the traditional predominance of established parties that championed open borders and bore the standard of the old consensus in favor of Europe. In a third of EU countries, anti-EU parties are now members of government coalitions. They currently hold more than 1,300 seats in 25 national parliaments. With borders an essential part of the rhetoric in the debate regarding closed vs. open societies, the new parties' political orientation is unusually focused on international affairs, defining their politics as protecting against external threats. Although we keep referring to them as "fringe" or "non-mainstream,"

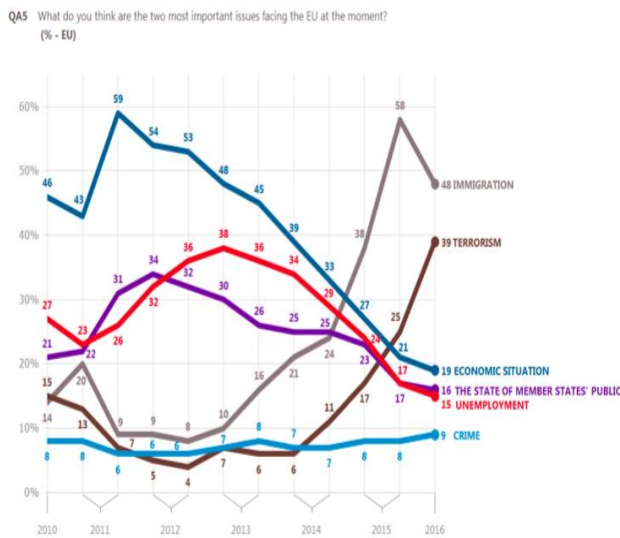
Carlo Bastasin is senior fellow at the LUISS School of European Political Economy and a nonresident senior fellow in the Foreign Policy program at The Brookings Institution. As an economist and editorialist, his work focuses on European political and economic analysis.

these parties are actually hijacking the political agenda and forcing mainstream parties to align along their positions.

Inevitably, the question that would emerge by next year's round of popular consultations is whether 2017 will become Europe's year of "*redde rationem*"?

A Fundamental Change in Agenda

One of the key determinants of next year's political events is the change in the electorate's priorities throughout the euro-area. Until 2014, the economy's weakness was the primary concern for European citizens by a large margin. Perceptions have dramatically changed. As shown by the following Eurobarometer graphs, four years ago, 59% of Europeans rated economic problems as their main concern; the number has fallen to only 19%. In this time, two new priorities have dominated the political agenda: immigration and terrorism.

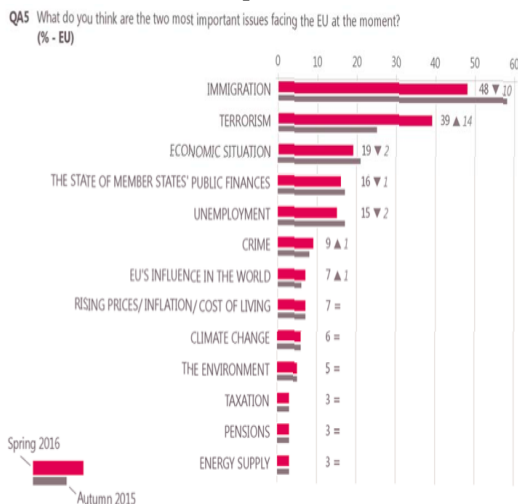


Economic or security concerns have fundamentally different political natures, and this difference impacts political balances at the national level, as well as the relationship between domestic politics and European cooperation.

The economic agenda that prevailed until 2014 was forged by a strong and inescapable sense of mutual financial interdependence that made it inevitable for national governments to search for consensus around the European table. While a "financial hierarchy" was dictated onto countries, financial interdependence was accompanied by the acknowledgement of political interdependence. The consequence

was a string of European negotiations that even brought constitutional changes at national levels, with the aim of making national legislations conform with the European consensus. This framework was conducive to national political systems predominantly based on grand coalition governments at the national level.

The agenda dictated by the migrant crisis leads to opposite political consequences. National isolation appears physically possible. Favoring isolation over interdependence, national governments sitting at the European table make unilateral decisions instead of searching for a consensus. Once political discrimination takes hold, it produces a form of contagion different



from the financial kind—what could be called a domino of unilateralism. Rather than exalting interdependence, the interaction of unilateral closings of national borders leads to further isolation. Consequently, while economic negotiations, determined by the financial crisis that embroiled Europe until 2014, were conducive to grand coalitions at the national level, the new principle of discrimination, ingrained in national immigration agendas, plays into the hands of radical fringe anti-European parties.

The change in the preferences of European citizens is thus leading to completely different political equilibria at either the national or European level. Consequently, European negotiations moved from inevitable, though highly controversial, cooperation to a contentious form of unilateral “beggar-thy-neighbors” policies.

In fact, the two agendas—economic and security—are linked. Secular stagnation in Europe (defined as an excess of savings over investments) has a strong impact on the middle class and thus over the mainstream consensus for open societies, feeding into protectionist policies by populist parties.

Germany and Italy

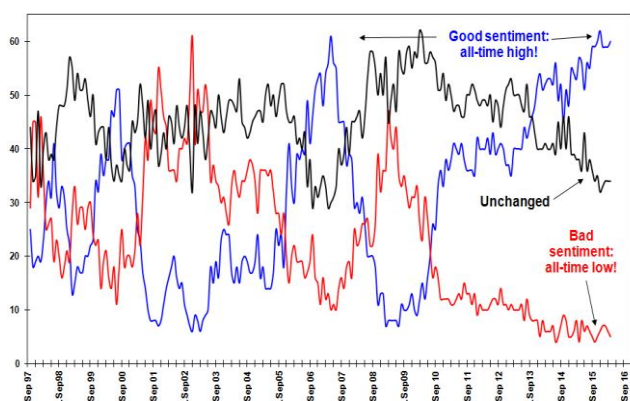
The political challenge now confronting both European institutions and national pro-European political forces is how to jointly address the economic malaise of the middle class, along with their security concerns, in such a way that the majority of voters does not consider the pro-European choice in local elections as synonymous with a borderless society deprived of national control.

Against this backdrop, it is of critical importance to understand what could happen in the upcoming months in two countries—Germany and Italy. They are emblematic of the monetary union because one is the largest euro-area country in the so-called core, while the other is the largest country in the periphery. If the agendas of these two countries are not aligned, the euro-area may wind up under enough pressure to break up. Moreover, both economies suffer from excess savings or underinvestment. Thus, they are among those responsible for Europe's stagnation, which feeds middle-class discontent. Finally, their citizens seem to be poles apart in terms of preferences, with Germans mostly concerned about the consequences of uncontrolled migration and Italians still mainly fretting about their weak economy.

Before Writing Off Angela Merkel...

The German political landscape is going through historical changes. Merkel's party, the Christian Democratic Union of Germany (CDU), is suffering from an unprecedented hemorrhage of voters. Together with its traditional antagonist, the Social Democratic Party of Germany (SPD), CDU is suffering from what looks like a long-term trend of mainstream parties declining across much of the western world.

Against this backdrop, Angela Merkel is often written off from the German political future. Since August 2015, she has been considerably weakened by the consequences of her sudden invitation to Syrian refugees, offering Germany as a safe haven from the war. The influx of roughly 900 thousand migrants in 2015 alone has strained the formerly unconditional admiration of the German electorate for the chancellor.



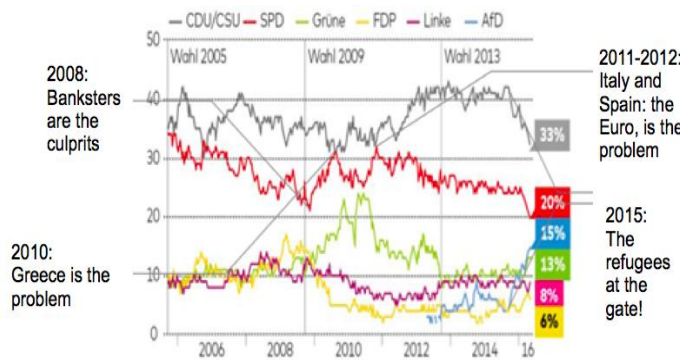
In fact, before writing off Mrs. Merkel, the German political sentiment should at least be dissected along the economy-security cleavage, separating appreciation for the German economy from unease over identity issues related to migration and terrorism.

Regarding the economic situation, it is worth considering that the public's assessment of the German economy has never been better, as shown in the EPM graph below. Notwithstanding the crisis hitting the euro

and euro-area, German citizens safely admit that negative sentiments about the economy are at an all-time low. An even clearer pronouncement of confidence emerges when people are asked to express their opinion on their own economic situation.

During the roughest patch of the euro-crisis, characterized by an existential threat for the Italian and Spanish economies in Autumn 2011 and Spring 2012, the bad sentiments indicator in Germany showed no upward blip at all. This is both striking and revealing. The euro-area's predicament was reflected by a decrease in optimism, based on the number of respondents saying that their country's economic situation was unchanged rather than getting better and better. The Germans seem isolated from the troubles surrounding them.

However, the economic situation does not explain the entirety of factors affecting the German public's political preferences and their current discomfort with the political leadership. In fact, over the past years, it has become very observable how different narratives can radically change the public discourse and powerfully affect the political balance.

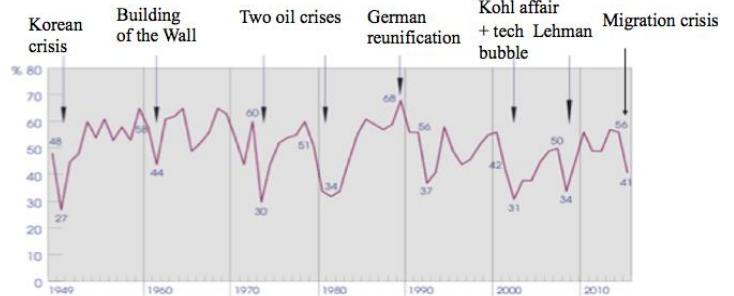


The graph to the left (data provided by Allensbach Institut für Demoskopie) shows how four powerful narratives have significantly changed the public's preference for single political parties during the last ten years.

Between 2007 and 2014, economic events—or, rather, the resulting narratives—dictated the changes in parties' consensus. In the last two years,

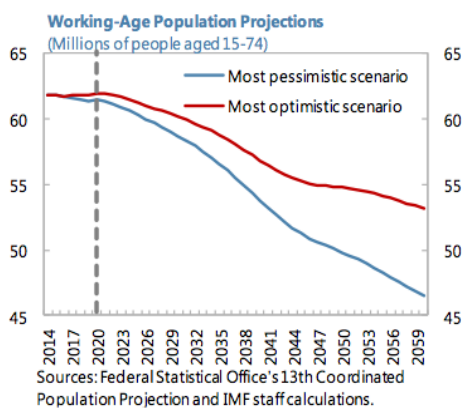
strengths and weaknesses have been entirely determined by the events related to the refugee crisis.

According to the polls, the extent of the emotional impact of the unexpectedly strong flow of refugees coming from Syria, was extraordinary even under historical comparisons. Polls attempted to gauge how much the events affected the respondent's assessment of the country's future. Germans reacted, as they often do when faced with unexpected events, by slashing down their optimism. Indeed, the shockwaves caused by Chancellor Merkel's sudden decision to open the borders were comparable with those caused by some of the major events of the last decades.



As pictured in the graph to the right, the German public's reaction was similar to those accompanying the building of the Berlin Wall in 1961 or the Lehman crisis in 2008.

The reason Chancellor Merkel took what later appeared to be a poorly calculated risk can be traced back to the graph by the International Monetary Fund that landed on her desk only days before. It shows the dramatic decline in German working-age population projections (actually including people aged between 15 and 74).



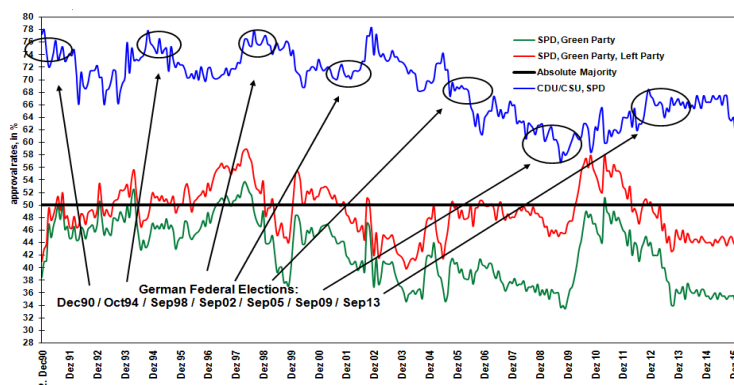
According to the IMF estimate, the German labor force would decline by a third in 40 years. Back of the envelope calculations, based on a similar change in the labor factor of production, indicatively show that the German potential rate of growth would flatten out or even become negative in the considered period. Relative to other countries, the German economy would slide back to such levels that it could become irrelevant in global governance. Meanwhile, the decline and aging of the German population would likely produce an increase in precautionary saving by German households. Eventually, this would result in a further increase in the trade surplus vis-a-vis other European countries. Demographic developments in Europe and elsewhere might ultimately prejudice the sustainability of the common currency. Thus, it should not be a surprise that Chancellor Merkel decided to open borders and embrace refugees when the humanitarian crisis in the Middle-East also called for an act of generosity.

Unfortunately, the political consequences of well-intentioned politics have been dramatic. The most significant side-effect of Merkel's decision was a boost to Alternative for Germany (AfD) party. Initially founded as a Euro-critical party, the AfD has led the criticism of Merkel's immigration policy, lingering on openly xenophobic positions. By taking a hard line, the AfD has seen its support in the polls climb from around 4-5% in the summer of 2015 to 12-16%. The increased support for the AfD came mostly at the expense of the CDU/CSU, which saw poll ratings decline from above 40% in the middle of 2015 to 30%. However, the Social Democrats have also lost some support, starting from an already low level.

The coalition parties—CDU and SPD—have been severely battered as the main actors behind the excessive and disordered influx of migrants. The German electorate perceived the dramatic arrival of hundreds of thousands refugees as a loss of control by the government. For the first time in history, in the summer of 2016, the combined support for the two main popular parties temporarily bucked below the 50% threshold, giving an awkward sense to the definition of grand coalition.

However, the increasing fragmentation of the German political landscape, due also to the re-emergence of the Liberal Party (FDP), has the paradoxical consequence of making a new grand coalition government the most likely outcome of the next elections. The blue curve in EPM's graph below (ending in June 2016) shows that the current grand coalition is the only combination that allows the SPD to form a stable government. The red line shows the performance of an alliance among SPD, the Green party and the left-wing Linke. The Green curve shows the combined votes of SPD and the Greens. Given these parameters, it is likely that a new government resulting from the next federal elections will consist of a renewed grand coalition led by a weaker Chancellor Merkel.

Merkel's strategy for the legislature would then follow the old Adenauer adage: *Keine Experimente, no experiments*. Basically her agenda would be focused on stronger control of migration flows, either through patrolling European external borders and via Turkey-like agreements with Egypt and African countries. This priority, however, requires both a pooling of European resources and a degree of institution-building apt to provide



political accountability for the use of common resources. Once migration is brought back under control, Germany would still need to counter the depressive demographic trends. This could happen through internal European migration rather than external. Plans to facilitate young unemployed mobility from the periphery to the core have already been brought up in Berlin.

Inevitably, under the pressure of xenophobic sentiments, the economic agenda of the grand coalition will shift to a distant second place. In the “Keine Experimente” state of mind, no “risk-sharing” at the euro-area level could be embraced without first tackling a major “risk-reduction”. In particular, Italy's risk-reduction—essentially linked to its high public debt—will become preliminary to any form of further economic integration in the euro-area. Any kind of risk-sharing would ultimately be preceded by an agreement on the automatic restructuring of public debt, in the case that financial assistance is required from the European Stability Mechanism by any country. This is a far from congenial way to reduce the systemic risks in the euro-area or to offer Italy's instability the remedy of a solid European framework.

Italy's Long Seated Problems in New Clothes

The European crisis has played a special role for Italy's ailing economy. Since the beginning of the European Monetary Union, the Italian economy has struggled to keep pace with the rest of the euro-area. The graph below shows how Italian per capita income has been trailing behind the rest of the area. Even Greece has suffered less than Italy, notwithstanding the dramatic hiccups of its GDP.

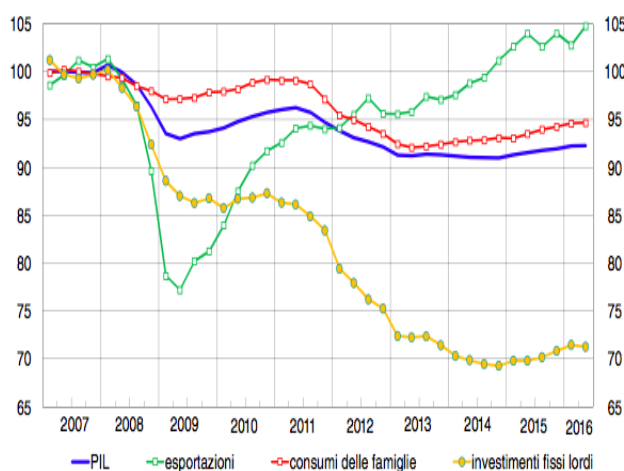
The fact that the causes behind Italy's economic weakness are rooted in long seated problems should not divert from the dramatic consequences suffered after 2008 by the Italian economy as a consequence of the euro-area crisis. A process of industry transformation and of catching up with higher productivity levels in other countries had been interrupted by the crisis in the euro-area and its persistence.

A recent graph published by the Bank of Italy shows the effects of the crisis on the main components of a crawling aggregate demand.

While exports have behaved fairly satisfactorily after the first critical years and consumption has managed to hold up, investments have dramatically collapsed.

There are barely any historical precedents among advanced economies for a 30% drop in investment over the course of a few years.

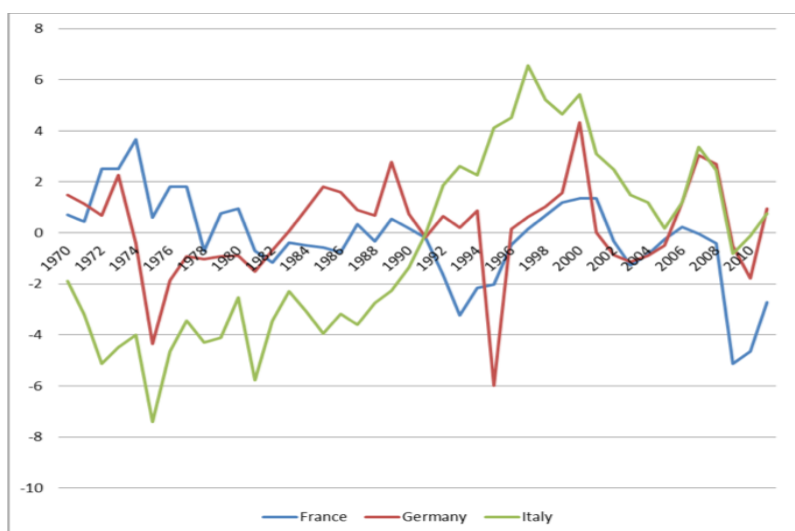
Investment decisions have a different inter-temporal nature vis-a-vis consumption decisions. The economic agent needs to contemplate a much longer time horizon before deciding whether to invest or not. Consequently, what made investment collapse was the Italian economy's bleak outlook for years to come. In colloquial terms, what took place was a loss of confidence in the country's future.



The Fatal Year

In order to understand the special factors behind the lack of investor confidence in Italy, one has to look at what happened in 1992, when the 25-year buildup of mistrust in the country's economy began.

After two decades of fiscal profligacy known as “the First Republic”, Italy was rocked by a major political earthquake in 1992, when a three-pronged process came to a head. First, the fiscal budget—more precisely, the primary budget, defined as the difference between tax revenues and public expenditures (interest rates excluded)—turned positive for the first time, with the prospect of remaining positive for the foreseeable future. Second, in the very moment the public became aware that they would have to pay more to the state than what they would receive in services, the political establishment was overthrown by the biggest scandal of the post-war period, with devastating allegations of corruption wiping out an entire political class. Third, while the lira underwent its final devaluation, the process of monetary union gained traction with the ratification of the Maastricht Treaty. In the graph below, the green curve shows the Italian primary budget deficit becoming a permanent surplus after 1992.



The fiscal adjustment of the past 25 years appears to be much larger than those in Germany and France. The general feeling of bitter mistrust in politics and in Italian society led to a roughly 15% collapse in investments. Currency devaluation provided positive support, but what mended the public's discontent was the expectation of joining the European Monetary Union (Italians used the revealing phrase “entering Europe”), which was believed to offer a framework

for better governance surrogating the disappointing domestic political system.

Since 1992, Italy's cumulative primary surplus has amounted to +52% of GDP (Germany's is +17% and France's is -15%). If the German mantra of “living within one's own means” has an economic meaning, then it could be found in the fact that the primary budget is in surplus, meaning the average citizen pays more taxes than the value of the public services he receives. Then, undoubtedly, Italians have been living “below their own means” since 1992. Inevitably, popular anti-establishment anger became a permanent element of Italian politics, with the emergence of different and vigorous populist parties. Since 1992, Italy has had 15 changes in government, while Germany elected only three different chancellors.

Political instability notwithstanding, the Italian economy struggled to stay within the stability framework defined by the European rules. Investment slowly crawled back up and the GDP remained stable, albeit lower than the European average. Belonging to the promising process of European economic and political integration granted the country a moderate return of confidence. The credibility of the European project functioned as a surrogate for the flawed Italian political system.

Unfortunately, starting in 2008, the surrogate narrative crumbled under the weight of the dramatic euro-crisis. The European narrative that had hitherto offset domestic mistrust turned into a source of further mistrust. Europe not only became a source of instability and further austerity, but the political hierarchy—derived from a financial hierarchy—gave Germany unilateral control over the governing processes inside the euro-area. The Italian public, among others, felt increasingly distanced from the political system, which was all too familiar.

Inevitably, once support for the European framework could no longer offset mistrust in the national political framework, the public's trust in their own country collapsed. Investments in the Italian economy fell by 30% over the course of only a few years.

Conclusions

The political setup within member states is becoming a priority for the survival of the European Union and the euro-area. European integration, through economic interdependence, has advanced through the interaction of grand coalition governments of various countries. The migrant crisis, instead, is polarizing national politics. 2017 will be the year when some of the largest countries in both the core and the periphery will see whether mainstream parties can take back control of the agenda. A cooperative game between member states could thus take place, favoring this outcome.

Apparently, Berlin and Rome are irremediably divergent and the national political schedules of the next 12 months can divaricate their differences in the electoral interplay of overlapping, but separate, national public discourses.

In fact, the political agendas of the two countries have a mutual interest in converging. Tackling the migrant crisis would thus go hand-in-hand with an accommodative fiscal and monetary policy.

As described above, Italy's priorities lie in the reconstruction of a stable political framework in the euro-area. In particular, sooner or later, Italy would require some form of economic mutualization or risk-sharing to reduce the sense of irremediable divergence of its public debt. As was the case before 2008, the interplay between austerity, low inflation, and mediocre growth needs to be countered by a more stable horizon within the European framework. Ultimately, some form of mutualization and economic integration will be needed. However, to be approved by other governments, any further progress in European economic integration requires other countries, primarily Germany, to return to a stable political orientation. In particular, mainstream politics—following in the footsteps of grand coalitions and traditionally favorable to political integration at the European level—needs to regain control of domestic politics. In order to achieve this, migration challenges have to be reined in, taking wind out of the sails of fringe parties, while issues related to economic integration must be put on the backburner.

The current combination of fiscal tolerance and monetary largesse is likely to persist in 2017 as a way to muddle through until politics stabilizes. Against this backdrop, German and Italian priorities remain compatible and 2017 seems far from becoming a year of reckoning. On the contrary, it could serve as a transitional period and help re-establish stable political conditions in the largest euro-area countries, allowing a more constructive agenda in the years to come.