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The Italian Election and the Reform of the Euro Area

CARLO BASTASIN

Italy's current electoral campaign has been unprecedented in at least two regards. First, its uncertain outcome is being determined by an intentionally paralyzing electoral law. Second, it has antagonized roughly 97% of the Italian parties against Europe's fiscal rules. These two factors are connected. By expecting that no party will clearly prevail, all political leaders feel free to sell the most unreal and reckless programs. Eventually, it is possible that this infantile strategy might only breed voter abstention, making the outcome of the vote on March 4 even less predictable

From the day after, whoever will emerge as the new prime minister will have to relate much more seriously with Europe and its rules that are currently in a potentially profound reform process. In this perspective, Italy should assume a rational bargaining attitude and forget the emotional, nationalistic overtones that have plagued the electoral campaign so-far. In fact, the "battle of ideas" that is underway in the EU reform process has little to do with nationalism.

Before reviewing which visions of Europe are currently at stake, it is critical to understand that the current juncture offers a remarkable three-pronged opportunity: political, economic and institutional.

Although the political prong is hanging by a thread to the problematic completion of a new grand coalition government in Germany, the indication that social-democrat Olaf Scholz might serve as minister of Finance is highly significant for Europe. The last social-democrat serving as Finance minister was Peer Steinbrueck, who in January

2009 mused over a banking union, the pooling of European resources into a sizable investment fund, and a common safe asset for the Euro area. However, caution by Chancellor Angela Merkel caused a delay in Steinbrueck's plans until it was too late. In October 2009, Wolfgang Schaeuble took over exactly when the Greek crisis was exploding. The revelation of Athens' fiscal misbehavior put risk-sharing at the European level on the back-burner. A common response to the crisis became a priority of secondary order relative to risk-reduction performed at the national level by all member states. Relinquishing political coordination in a climate of growing mistrust gave the upper hand to financial market pressures as they became the major factor of discipline in national politics. The Euro area became increasingly fragmented and divergent. Nevertheless, at least until June 2012, a common European answer remained confined to "ultima ratio". A decade-long crisis has eroded what remained of European trust. For Olaf Scholz, as for any other German Finance ministry candidate, reconnecting to the plans of 2009 is not possible. What is achievable though is a more proficient alignment between the French and the German governments. This political opportunity is only strengthened by the economic momentum. All of Europe is experiencing a phase of strong growth, recently certified by the "Winter forecasts" published by the EU Commission. Until recently, the "crisis mind-frame" was the only game in town. In some cases, this crisis mode was even seen as a good thing since each country is expected to adopt growth-enhancing reforms when it has its back against the wall. Now, a new policy mentality is necessary. A new political strategy needs to be embraced if Europe is not to waste the good times. Common European initiatives on both the supply and demand side of the political economy could be activated as European responses to either the U.S. menacing and competitive fiscal strategy, or China's unprecedented technological endeavors.

The last factor working in favor of stronger European cooperation is of an institutional nature. Within the current year, top positions in many institutions need to be renewed. Candidacies for the next presidency of the EU Council and EU Commission need to be identified, as well as a large number of ECB board members. In parallel to the debate on personality, member states will need to redesign a strategy for the EU after the European Parliamentary elections in May 2019.

Along the next few months, and, in particular, at the Euro-summits in March and June, the medium-long-term design for Europe will start to become recognizable. This is the crucial juncture that might overlap with Italy's power vacuum.

Currently, two different philosophies are battling for the future design of the Euro area. The first, more heartily supported by the EU Council, aims at focusing on policy targets that are perceived as more consensual or less divisive. This means essentially limiting the reforms to the accomplishment of a banking union. In this domain, some progress looks indeed easy to reach: common financial resources (backstop) can be destined to support the Single Resolution Fund through an upgrading in the role of the European Stability Mechanism. In this context, even a system for a common deposit insurance is within reach.

A different and more ambitious philosophy does not limit itself to only shoring up the consensual issues related to a banking union by going through legislative or political decisions by June 2018. This approach also aims at achieving targets that are less consensual; first of which, is a centralized fiscal capacity and the availability of a “safe asset” (that is a risk-free common bond that can prevent the “doom loop” between sovereign and bank debts to take place in the more fragile countries). The second approach aims to define a more advanced balance between fiscal discipline rules and the forces of discipline imposed by the financial markets, allowing the latter to be helpful in encouraging discipline without being disruptive.

Italians should not think that the current situation is an abstract dispute between different philosophies of public policies where each country can tightly sit in its corner and demand without giving. This is instead a complex negotiation between different targets. A negotiation that requires bargaining skills and solid common sense.

A clear test will come just days after the Italian elections. On March 13, Brussels will debate an action program regarding the non-performing loans of European banks. Past achievements on this front will emerge as significant such as the solutions used in Italy for solving some of its bank exposures to bad loans, the enforcement of new pieces of banking legislation, and, finally, the overall improvement of its economy. In this context, it will be possible to re-discuss the establishment of national “bad banks”. All in all, Italy could claim success in its risk-reduction efforts and demand in return something on the side of risk-sharing at the common European level.

Such opportunity will present itself in the same weeks, as the Euro-summit will discuss some important proposals that were outlined in December last year. The main issue concerns the future of the EU budget. Obviously, part of the negotiation is influenced by the loss of revenues caused by Brexit. However, a relevant and wide-ranging debate will open on the issues of European common goods and policies of economic stabilization intended to encourage convergence and help laggard countries (Italy is one of them) catch up with the others; opening for the first time a dimension of the EU budget dedicated only to the Euro area.

The bargaining between risk-reduction and risk-sharing is by its nature complex. It is even more so for Italy at the moment as political uncertainty cast its shadow over Rome. Bargaining requires some strategic skills opposite to the simplified nationalistic assertiveness that has been the hallmark of the electoral campaign so far.

It is no secret that Italy's risk coincides with its public debt. Without addressing it, there is exactly no point in calling for the abolition of the Fiscal Compact. In fact, such a strategy, common to the vast majority of Italian political parties, is counterproductive. If there is a margin of reform on the Euro-area fiscal rules, this is grounded on the very logic of the Fiscal Compact, which simplifies the regulatory jungle presiding over each country's fiscal deficit and enhances the importance of a more simple rule presiding over the reduction of public debt.

Whoever will govern Italy after March 4th should be ready to put on the table a plausible trajectory for the reduction of the country's public debt so that it can request credible support from the EU institutions in strengthening the structures of the Italian economy.