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People vs Finance
How Brussels should deal with italy's populist government

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Rather than Italy leaving the euro, so far it is the euros that are leaving Italy.

Since mid-May, after doubts had emerged about the government's will to remain in the European monetary union, Italians have transferred dozens of billions of euros across the borders.

It took just a few days after the formation of the new government and the financial situation almost sled out of control. Italy's liabilities with the euro-area (as tracked by the Target2 payment system) rose by €39bn to a record €465bn at the end of May, largely reflecting capital flight. Swiss monetary authorities detected money flows from across the southern border as large as to affect the exchange rate of the Swiss franc with the euro.

In a matter of a few more days, after a short rhetorical trip on Mars musing over monetary sovereignty and limitless debts, the financial gravity law brought Italian new political leaders back on the earth. A strong increase of the interests that Italy pays on its huge public debt piled pressure on the new executive. Though more reasonable voices are being heard in Rome now, it is still too early to say that a financial emergency has been staved off. A clear retraction of the original plan to pull Italy away from Europe has yet to be spelled out by the head of the government, Giuseppe Conte, and by the guardians of the populist revolution. More importantly, it is of little use denying that the government wants to abandon the euro, while at the same time clinging on to economic policies that are not compatible with Italy staying in the monetary union.

Eventually this contradiction must come to a head.

Since its conception, the populist DNA of the new government - formed by a coalition between League and Five Star Movement – was genetically modified by the president of the Republic, Sergio Mattarella, through the insertion of a few technocrats in critical positions, first of all the Finance and the Foreign Ministries. What came to life was an unprecedented “techno-pop” government and what we are watching now is the intestine war between the rational and the irrational sides of the hybrid creature.

On June 10, Finance minister, Giovanni Tria, declared in a reassuring interview that he will not deviate from his predecessors’ Euro-rigorous fiscal stance. In the same hours, during his first G7 meeting, prime minister Conte tried to break loose from Italy’s European bonds in a number of critical issues, from relations with Moscow, to trade. On the same day, League’s leader Matteo Salvini denied Italian harbors’ access to a boat carrying 629 migrants saved in the Mediterranean. The “techno” and the “pop” are, as a minimum, still out of sync.

My sense is that the big clash has yet to come: on one side there are political movements legitimated by strong electoral results and a clear parliamentary majority, although obtained through false promises; on the other a few technocratic figures made “strong” by the fear and fury of financial markets. Populists will say that it is the “people vs finance”.

People vs finance is obviously a false antinomy but the EU must be ready to respond to this claim. Normally, fiscal discipline would determine the outcome. No populist government has ever thriven without spending public money with largesse. If money is limited, policy choices need to be made according to their consequences, thus rationality prevails suffocating populism. The government claims that it wants to reduce Italy’s debt burden and stay in the euro. However, the coalition plans to raise spending, cut taxes, and reverse the pro-growth reforms approved under the past four governments. The described policies would worsen the fiscal position and weaken Italy’s potential growth. With interest rates going up and a possible recession after 2020, the sustainability of Italy’s debt-to-GDP ratio would soon become questionable. Who would buy today

a 3-years government bond maturing after 2020? In fact, mistaking Italy for Greece and letting a financial crisis do the dirty job of bringing the country back into the EU line, would be a fatal error. Italian populists will have an easy hand claiming that political will needs to prevail on the power of finance, also because Italy’s problem is not one of financial weakness. While other Euro-countries needed financial assistance, Italy does not depend on net capital imports. It has a current account surplus of 2.8% of its GDP, showing an excess of savings over investments. Private wealth is among the highest in the world. About 70% of Italy's sovereign bonds are held at home, including a 20% share bought by the Bank of Italy under the ECB's asset purchase program. Moreover, part of the foreign held bonds are also in the portfolios of Italian investors. As the recent weeks have shown, market discipline comes from within the country with Italians ready to run for the door at the first signs of instability, at least until the door is kept open. Finally, differently from other indebted countries, Italy has a stable primary surplus (the budget surplus without the cost of servicing the debt) and this means that closing capital flows, defaulting on the debt and losing the trust of the markets would not hamper the functioning of the state. If Greece had no choice but cave in and receive European aid, Italy's populists may go their way and claim that they want to shrug off the EU's yoke and follow Plan B, a footprint that the most experienced among the ministers, Paolo Savona, wrote about leaving the euro. Ultimately, Plan B hides a trap: since the plans for exit must be kept secret, no disavowal of the plan is entirely credible.

How should Europe relate to the new government? A confrontational strategy is not well advised. Standard arguments about financial advantages of being in the EU club need to be handled with care. Rome gives to the EU budget over 3bn euros more than it gets back, so a EU threat to cut the financial ties would not be convincing. Should Italy violate the fiscal rules, the EU could eventually impose a fine of 0.2% of GDP after a lengthy procedure. In fact, a decision about potential penalties would probably not be taken before June 2019, and possibly much later. Finally, the dispute would serve well the populist anti-Europe movements.

On 23 May 2018, the EU Commission concluded that Italy had complied with the fiscal rules in 2017. However, the EU Commission waved a red flag on Italy's 2018 budget and had strong reservations about its medium-term fiscal plan beyond 2019. According to EU calculations, the structural deficit would widen to 2.0% in 2019 (even taking into account a VAT hike that is resisted by all political parties) instead of narrowing to 0.8% of GDP as Rome projects and as Brussels demands so that Italy can comply with the rule to reduce its debt burden at a sufficient pace.

Next September, the government will have to present new estimates and commitments. Before the end of that month the government is expected to produce the adjourned version of the Documento di Economia e Finanza (DEF). The DEF sanctions rules and criteria of government policies according to a clear schedule and to the most recent estimates of the relevant economic variables. The described policies

should be accompanied by their expected outcomes in the coming three years. Immediately after and anyway before October 16, the government transmits its draft 2019 Budget to the parliament and to the EU Commission. Before the end of November, after some to-and-fro between Rome and Brussels, the EU Commission is expected to pass its verdict on the 2019 budget. That is one of the critical junctures, since the EU Commission normally delivers its judgment on the effectiveness of the new budget law in bringing down the fiscal deficit or the debt-to-GDP ratio. During the traditional EU Summit of mid-December, EU leaders may confirm the EU Commission's negative verdict on Italy's 2019 budget. Under the "excessive deficit procedure", Italy could then be given six months (or possibly only three months if EU leaders consider the breach of fiscal rules "serious") to present a concrete plan to correct the excessive deficit. In Spring next year, the EU Commission will assess whether Italy complied with the fiscal rules in 2018 based on the actual budget outcomes for that year under the separate "significant deviation procedure". Finally, in June 2019, an EU summit may decide to impose sanctions on Italy

if Rome has breached its 2018 fiscal commitments and/or failed to correct its 2019 budget plan in line with the recommendations the EU may have issued in December 2019.

The eventuality of the EU imposing a fine on Italy is remote. In fact, the EU never imposed genuine sanctions on any Eurozone member for breaching the fiscal rules. In July 2016, Spain and Portugal narrowly escaped sanctions by promising a stronger fiscal correction. As potential sanctions, the EU could reduce Italy's access to the European Investment Bank (EIB), suspend regional support funds, demand a non-interest bearing deposit until the excessive deficit has been corrected or even levy a fine of up to 0.2% of Italy's GDP. With continued non-compliance, the fine may be raised year by year thereafter. If the Commission proposes sanctions, an EU summit could only reject them with a qualified majority representing at least 15 countries with at least 65% of the EU population. For example, if France, Germany and the Netherlands were all to agree with the EU Commission that Italy should be fined, their votes would suffice to validate such an EU Commission proposal.

In fact, the EU Summit can postpone its negative judgement or even avoid a sanction if these initiatives were politically problematic. Considering that the European Parliament elections will take place in May next year, there might be serious political reasons to avoid a direct confrontation with a populist government – and its populist allies throughout Europe - next Spring. In fact, the real mistake on Brussels' side would be

threatening Italy now. Given the harsh rhetoric prevailing against Brussels and the still high consensus enjoyed by the new parliamentary majority, an open confrontation could be seriously counterproductive for the European Institutions.

Moreover, it would be superfluous: in the coming months, financial markets and rating agencies will keep a close eye on Italy's political developments and the government's economic policy decisions. A couple of downgrading of Italy's rating grade, connected with government's faux pas, would be sufficient to cut off Italy's banks from the ECB liquidity provision, likely triggering a brutal crisis. This must be prevented.

Before this happens, Europe must adopt a new strategy. Since Italy is stuck in the false populist antinomy opposing "people" and "finance", Europe should adapt its narrative and admit that Italy's real problem is not "finance", neither a slightly higher deficit, nor even its stubborn debt level struggling to decline. The problem is that populist economic plans are seriously detrimental for Italy's growth and employment, thus they are ultimately detrimental to the Italian "people". The only vital question for Europe is to facilitate the reforms and the investments that Italy needs to restore growth and jobs, in return for a sensible fiscal commitment. For the EU, sanctioning would be easier than building projects, just like for populists destroying comes easier than constructing. Europe needs to rise above this existential challenge.