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AFTER ITALY: DEALING WITH THE POPULIST MENACE IN EUROPE

Berenberg Macro Flash

Financial markets have taken the surge in support for radical anti-establishment parties in Italy in their stride so far. Does that make sense? Yes and no. Yes, the ultimate tail risk that Italy may leave the euro remains very small, although it has edged up a bit. No in the sense that the success of the 5Stars and Lega has raised some serious risks for Italy and some challenges for Europe. In terms of country risk in Europe, Portugal is now probably a safer bet than Italy. Even more so than before, Italian political accidents are the top risk to our positive economic and political outlook for the Eurozone. Fortunately, the experience with other smaller populists upsets in the Eurozone in the last few years suggests that even anti-establishment populists can get real when they join a government. So the current calm may turn out be largely justified in the end.

ITALIAN RISKS

Look at the risks first. After the election, no government can be formed unless at least one of the two big radical parties support it. In the Chamber of Deputies, the 5Stars have 229 and the Lega 124 out of 630 seats; in the 315-seat Senate, the combined tally of the 5Stars (114 seats) and the Lega (57) would also add up to a majority for a hypothetical alliance of the two major protest parties. The scare scenario of 5Stars and Lega teaming up and pursuing a radical agenda is numerically possible.

The leaders of both parties, Luigi di Maio for the 5Stars and Matteo Salvini for the smaller Lega, have already staked their claim to become prime minister, with Salvini presenting himself as the candidate for the centre-right alliance that includes Silvio Berlusconi's Forza Italia and two smaller groups with a combined result of 267 seats in the Chamber and 135 seats in the Senate.

Both Di Maio and Salvini give the impression that they would like to govern. To advance their prospects of finding partners, both seem to have ditched the most dangerous part of their erstwhile agenda, a euro exit, with even Salvini explaining yesterday that "holding a referendum on the euro is unthinkable". That still leaves three other significant risks:

1) The **period of serious reforms** in Italy ranging from Mario Monti's pension reform to Matteo Renzi's labour market reforms to some modest progress on banking issues under Paolo Gentiloni seems to be over. Instead, a government in which one of the two radical parties plays a leading role is more likely to reverse some of these reforms, for example parts of the Monti pension reform that both radical parties had promised to scrap in their campaigns. During a cyclical economic recovery, partial reform reversals may not matter much. But every step that makes Italy's fiscal position less sustainable in the long run could come to haunt the country during and after the next cyclical downturn.

2) Both radical parties have made **unfinanceable tax cut and spending pledges** such a guaranteed monthly minimum income of Euro 780 (5Stars) and a 15% flat personal income tax (Lega). Even if they put only a fraction of their wilder promises into practice, they would likely get in trouble with the fiscal watchdogs in Brussels. That conflict could escalate over time. Whereas I expect France to advocate a more lenient approach than in the past, we would have to brace ourselves for a lot of noise. In the end, bond markets may force an Italian government that tries to implement some of the radical ideas back into line. Over the course of such a conflict, the issue of a hypothetical Italian euro exit may come up again.

3) As a matter of principle or as a bargaining chip, an Italian government under the sway of one of the big radical parties may try to obstruct whatever **reforms** France, Germany and other countries may be planning **for the EU and the Eurozone.** While it is possible that France and Germany may decide to accept this, it is quite possible that they would still go ahead while excluding an obstructionist Italy from such deeper co-operation. However, Italy could be a prime beneficiary of some reform steps such as turning the ESM into the ultimate backstop if a big bank needs to be wound down or a gradual build-up of a Eurozone deposit insurance. Even a government in which Italian radicals play a key role may think twice about blocking progress in Europe.

EXPERIENCE SHOWS THAT POPULISTS CAN GET REAL

The Italian election result is by far the worst populist upset in the Eurozone so far, somewhat akin to the rise of the Brexiteers in the UK and of Trump in the US. But it is not the first such accident. So far, pro-European common sense has prevailed in all such cases in the Eurozone.

In **Greece**, left-wing Syriza won elections in January 2015, forming a coalition with an ultra-right party. A futile confrontation with creditors derailed Greece's post-crisis upswing that had started in 2014 and triggered massive capital flight that forced the country to close its banks in July 2015. While then-finance minister Yanis Varoufakis secretly prepared a plan to ditch the euro, prime minister Alexis Tsipras backed down at the last minute. Having had to ask official creditors for a new bailout, a chastened Tsipras has since recast himself and his Syriza party in a more traditional pro-European centre-left mould.

In **Finland**, the anti-euro "True Finns" (or just "The Finns") entered government as a junior coalition partner with 38 out of 200 parliamentary seats in 2015. Not much has been heard of them on the European level thereafter. The party split in 2017 with the moderate wing (now called "Blue Reform") staying in government. While the radical wing still advocates a Finnish euro exit ("Fixit"), it has lost popular support.

In **Portugal**, the Socialist Antonio Costa forged an alliance with the Greens and two left-wing anti-EU parties in 2015. The left-wingers have loyally supported the pro-European Costa ever since. Maintaining a tight fiscal policy, Costa has presided over Portugal's remarkable recovery from the euro crisis for which the prior conservative government had laid the foundation with serious structural reforms.

In **Austria**, the right-wing FPÖ turned increasingly euro-sceptic in the wake of the euro crisis. In early 2016, the party still called for an Austrian euro referendum. But to broaden its appeal in the presidential elections of 2017, the FPÖ quietly dropped that demand. Having narrowly lost the presidential vote, the FPÖ garnered 20.5% of the popular vote in the parliamentary election of 2017. Upon entering into a coalition as junior partner with the conservative ÖVP, the FPÖ abandoned all remnants of euro-scepticism. Austria's president Alexander van der Bellen had made that a precondition for giving his assent to the coalition. Caring more about power and office than ideology, the FPÖ accepted that without complaint.

In Italy, president Sergio Mattarella may now play a similar role, asking the 5Stars and/or Lega for clear reassurances on EU and euro issues before giving a mandate to a politician to form a coalition that would include one of these two radical parties.

We could add some further examples including the period in which the Dutch right-wing PVV supported a centrist government in 2010-2012 without holding any cabinet seats. All these cases are different. Also, populists in Italy have now garnered a bigger share of the popular vote than they managed to do elsewhere except for Greece 2015. Nonetheless, the examples show that, in the pursuit of power, populists often abandon their most dangerous demands and drop their euro scepticism. We may now see the same in Italy. The real risk in Italy may not be whatever campaign themes the populists had but their lack of experience. In governing the city of Rome since 2016, the 5Stars have already shown a remarkable capacity for incompetence.

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