



Italy After COVID-19: Betrayal or Renewal?

By Simon Clark June 18, 2020

The United States has the opportunity to help Italy rebuild its economy as it recovers from the coronavirus pandemic and to provide a set of practical tools that it can use to work with its European partners to do so. Supporting Italy's recovery is a wise investment that can yield a more stable Europe and a safer Mediterranean, as well as demonstrate the good that the United States can accomplish. This is a task that the administration can take on quickly with confidence that an early focus will pay off.

The COVID-19 pandemic has been devastating for Italy, killing more than 34,000 people to date.¹ It has closed down an economy already weakened by a quarter-century of austerity and a failure to adapt to the pressures of globalization. This is not just a national tragedy; it could become a geopolitical catastrophe. As the European Commission recognized, the divergent impact of the pandemic risks tearing the eurozone apart.² Italy's position as a core European nation and a primary provider of security in the troubled Mediterranean could collapse under the strain. The Greek crisis was contained—albeit at the cost of great suffering in Greece—because its economy was relatively small and disconnected. Yet Italy has the third-largest economy of the European Union, one that is a deeply integrated part of the block. Given the size of Italy's debts, rescuing the country could cost trillions of euros and trigger a constitutional crisis between Germany and the European Union as Germany's Federal Constitutional Court starts questioning the union's powers.³

It would be a mistake for Americans to feel as though Italy's situation is a distant problem that is irrelevant to them. The deep economic and cultural links that come from the nearly 18 million Americans of Italian extraction—the fourth-largest ethnic group in the United States—are only part of the story.⁴ Since the founding of the Italian Republic, the United States has been a close partner in the development of its democracy, in large part due to fear throughout the Cold War that Italy could fall under Soviet influence. Italian defense and security cooperation complements U.S. interests in the Mediterranean, the Balkans, Afghanistan, and across the Middle East,⁵ and Italian foreign direct investment supports nearly 80,000 U.S. jobs.⁶ Most importantly, the European Union cannot survive and prosper if Italy continues to flounder;

even a remote chance of Italy leaving the European Union puts the whole project at risk, endangering the stability of the continent, which remains a core U.S. interest in an unstable world.

What went wrong? 25 years of austerity

Italy entered the COVID-19 crisis in terrible financial shape. The country had built up an unsustainable debt burden during the oil crisis of the 1980s. Governments of varying political persuasions were united in pursuing a policy of austerity from 1995 in preparation for joining the European Union in 1999; then, they maintained the squeeze on public finances to stay within the European rules for the two decades that followed. Italy has run a primary budget surplus in 24 out of the past 25 years, averaging 3 percent of gross domestic product (GDP) per year during a period of 14 years.⁷ But this painful sacrifice only stabilized the debt at 130 percent of GDP, while the country's infrastructure decayed and demand fell. The theory that expansionary fiscal austerity could act as a remedy to Italy's deep-seated economic challenges turned out to be an illusion,⁸ leading to a long stagnation that left Italian per-capita GDP lower than it had been two decades ago.⁹

Italy practiced austerity but failed to reform. The economic problems and debt overhang were far deeper than a few years of budget cuts could fix. As one senior U.S. official and keen observer of Italian matters explained: "Italy did a much worse job than many of its EU neighbors, including France and even Greece, in addressing its competitiveness problem."¹⁰ Italy's economic base of subscale, family-owned, and bank-financed commodity manufacturers was particularly vulnerable to Chinese competition after it joined the World Trade Organization. Italy could have taken advantage of the low interest rates and global growth at the start of the century to restructure its economic model, but the populist, corrupt government of Silvio Berlusconi wasted this opportunity, while Matteo Renzi's later efforts to fix the labor markets lacked public support and policy space. Italy was let down by both sides of the political divide: The Berlusconi right concentrated on stripping away constraints on corruption to enrich a small group of politically connected cronies, while the Renzi center-left— itself internally divided—tried to impose EU-mandated austerity with little in the way of tangible benefits to its increasingly impoverished citizens. Italian business remained stuck in a nonmeritocratic, family-based structure that was wholly unsuited for a technologically enabled global economy.¹¹ Meanwhile, the Italian patronage-based banking system remained a disaster, with too many banks suffering from bad loans and political interference while stuck in a doom loop in which they were required to buy government debt while the government continually bailed them out.¹² The tragic result was a quarter-century of stagnation.

Meanwhile, many ambitious and talented Italians left. Economist Luigi Zingales, himself an Italian expatriate at the University of Chicago, emphasized the scale of

the Italian brain drain both as a visible symptom and cause of the country's decay.¹³ More than 125,000 Italians leave the country each year, representing 2 percent of the total cohort. These tend to be the best-educated young single adults and new families, who move to the United Kingdom, Germany, the United States, or other European countries in order to find opportunities that are not available at home—in a stultified economy rife with patronage, where secure employment options are reserved for the old.

Italian politics offer an unusual opening

What Italy needs is a new vision for its economic future, built on a clear-eyed view of its capabilities, that can inspire its citizens and create a viable social compact. Such a vision would reflect Italian strengths in precision manufacturing, its tradition of craftsmanship, and luxury goods and high-end tourism; its deep integration into the wider European economy and access to the Mediterranean rim; and its strong links to the United States and increasing links to China. Italy's high saving rates and low level of private indebtedness could be a basis for rebuilding a more confident outward-facing economy built on a high-skill workforce. But in order to dig out from a quarter-century of stagnation, it will need help from its friends, most notably from its European partners and a receptive U.S. administration.

Normally, there has been cynicism about the Italian political class's ability and willingness to take such a path. A young, well-informed Italian spoke of her generation's contempt for a political class that has failed them, commenting that talented Italians have abandoned national politics to dropouts and careerists.¹⁴ But a series of unlikely political accidents have given Italy unusually decent leadership in the form of Giuseppe Conte, a law professor with no previous political experience. Conte was appointed as a compromise prime minister when the two populist parties could not agree which of their leaders should be in charge. Soon after, Matteo Salvini—the hard-line euroskeptic leader of the League, the larger and more xenophobic of the two parties—tried to oust him in a parliamentary coup, but to the surprise of many, Conte fought back with dignity and success, ushering in a coalition between the more institutionally minded Democratic Party and the populist Five Star Movement.

Interestingly, the crisis has damaged the standing of Salvini and the League, whose support fell from 34 percent in last year's European elections to 26 percent in recent polling.¹⁵ Italian voters may be fed up with the European Union, but they appear to recognize that the xenophobic, anti-immigrant platform of the League offers no real solution. Though Salvini's approach of blaming the European Union for all of Italy's problems has been exposed as vacuous, a return to the old equilibrium would do nothing to solve the underlying problems. Meanwhile, an even greater political threat is growing in the form of Fratelli d'Italia, an avowedly neo-fascist party whose support has grown from 7 percent in 2019 to 15 percent today.¹⁶ If Conte's government fails to

win the support of its European partners to rebuild after the COVID-19 crisis, the ugly anti-immigrant populism of Salvini's movement could be followed by something far worse, in a country where the debate about its fascist history remains unresolved.

Who are Italy's true friends?

At this moment of crisis, Italians looked to their European partners for support. They were met by lectures by the Dutch finance minister, who accused them of wasting their money on “drinks and women,”¹⁷ and by late-night haggling in the Council of the European Union over the terms of a wholly inadequate offer of financial aid.¹⁸ Meanwhile, China, Russia, and Cuba sent doctors and medical equipment,¹⁹ while the United States provided little more than empty rhetoric and a 10-bed support unit, a response that even pro-American newspaper *Il Giornale* described as miserly.²⁰

Predictably, this has damaged Italian trust in its allies. A poll conducted in mid-March reported that 52 percent of Italians considered China a friend, compared with only 10 percent in 2019, with Russia coming in second at 32 percent and the United States dropping from 29 percent to 17 percent.²¹ In this poll, Germany led the list of Italy's enemies, at 45 percent. China and Russia have attempted to exploit the opportunity created by Italy's increasing disillusionment with its traditional partners, though their clumsy efforts have sometimes backfired. In 2019, Italy shocked its allies by joining China's Belt and Road Initiative but saw little economic benefit from that move.²² And during the height of the COVID-19 crisis, Italy accepted Russian military help only to find that the Russian intelligence services were using this opportunity to spy on Italian installations.²³ When a journalist exposed this, the Russian Foreign Ministry threatened his life, leading the Italian government to issue a formal protest.²⁴ Still, there is real risk that a disillusioned Italian public could abandon its traditional support for an Atlanticist and European foreign policy. What is remarkable is how patient Italians have been with a set of policies that have reduced their median living standards by 15 percent—in constant 2010 price—in the 15 years from 1991 to 2016.²⁵ But one cannot count on such patience forever, as we are now seeing. The current mess is, above all, the result of a policy of austerity and stagnation that reduced living standards while doing nothing to prepare Italians for a more competitive world.

How Europe can help

EU leadership is beginning to recognize the scale of the danger faced by the European Union. On April 16, President of the European Commission Ursula von der Leyden gave a speech admitting this: “Yes, it is true that no one was really ready for this. It is also true that too many were not there on time when Italy needed a helping hand at the very beginning. And yes, for that, it is right that Europe as a whole offers a heartfelt apology.”²⁶ One major challenge is that the instruments she has at her disposal to

address the challenge—the 3 billion euros remaining in this year’s EU budget and a 500 billion euro conditional support package—are nowhere near enough to rebuild a sustainable European economy. The recent agreement between Germany and France to build an EU recovery vehicle untethered from national funding is an encouraging development, though continued opposition from smaller northern European countries and the German constitutional court remains a concern. As Thomas Wright, a scholar at the Brookings Institution, observed: “Italy, Spain, and other countries that suffered mightily in this pandemic and performed heroically will not respond well if the EU fails to move beyond the old orthodoxies of the euro crisis and doesn’t demonstrate the solidarity it prides itself on.”²⁷

A viable path toward restoring the health of Italian society requires a fundamental restructuring of the country’s economic strategy, supported by an appropriate fiscal and monetary policy. All of this will require farsighted help from Italy’s friends in Europe and the United States, a wise investment to restore and strengthen a much-needed anchor of stability in the Mediterranean. The European Central Bank (ECB) can prevent a spike in Italian interest rates that would threaten Italy’s membership in the European Union, but it cannot restore Italian growth or competitiveness—nor will the inadequate proposals that the European Union has made so far.²⁸ Meanwhile, the German constitutional court’s challenge to the ECB’s bond-buying policies raises questions about whether even this minimum emergency support will be viable.²⁹

Where the United States can make a difference

Once again, the United States will need to help Europeans help themselves. Putting pressure on northern European economies, notably Germany, to help their southern neighbors without offering meaningful support is unlikely to be effective. But this time, unlike after the global financial crisis, Angela Merkel and the German political class appear to realize that austerity is not the answer, even if suspicion about Italy’s ability to implement real changes remains high.³⁰ A competent U.S. administration could make a real difference by taking the following actions:

1. Helping the Italian government craft a credible plan to restructure its economy
2. Working with its European partners to encourage public and private sector procurement, with a particular focus on Italy’s world-leading defense and pharmaceutical sectors
3. Negotiating a growth-enhancing U.S.-EU trade deal and removing the tariffs imposed under the Trump administration
4. Rebalancing global trade rules to encourage shared growth among democracies

5. Encouraging equity investment in growing Italian businesses by U.S. and international investors
6. Providing technical help to the Italian government for a program of growth-enhancing reforms of its legal system, commercial code, and protectionist practices

In return for U.S. assistance, the European Union would need to agree to reform its Stability and Growth Pact to emphasize the latter over the former by targeting nominal GDP growth over arbitrary debt-to-GDP ratios and parking the old overhang of Italian debt in a perpetual ECB-funded mechanism that provides confidence to the bond markets. Meanwhile, the international union movement could help Italian unions transition from a primary focus on their retired members to one that aims to rebuild their organizations as representatives of the Italian working class while engaging in dialogue with business owners on how to create shared prosperity. This could start a virtuous cycle that attracts inward investment, restores growth, and tempts expatriate Italians to return.

The United States and the European Union have an existing institutional vehicle that could be particularly useful for this task: the European Bank for Reconstruction and Development (EBRD). Set up after the end of the Cold War, the EBRD's original mission was to support the transition from planned to open economies in the former Warsaw Pact countries. Over time, the mission expanded to cover North Africa and the Middle East and stretched as far as Mongolia. During the global financial crisis, the EBRD began investing in Greece to provide funding to capital-starved small and medium-sized businesses and to help with the development of energy and infrastructure projects while engaging in policy dialogue to support Greek integration into the wider European economy.³¹ The EBRD's president recently complained about the United States' lack of leadership in development banking,³² but with a 10 percent stake and a \$20 billion investment today—and the potential to add much more—the United States could shape the institution's agenda if it chose to do so. As a significant, but not dominant, shareholder, the United States could engage with its European partners to provide additional capital to an institution that has already demonstrated its ability to combine thoughtful lending with policy support. In return, the EBRD's mission would be expanded to provide direct lending to promising private sector businesses in Italy at a sufficient scale to promote meaningful growth.

Conclusion

A healthy European Union remains a core American interest, to safeguard the continent against authoritarian influence and to promote peace, prosperity, and the success of liberal democracies around the world. But the European Union cannot succeed if Italy, its third-largest economy, continues to stagnate. A wise U.S. administration would engage with its European partners to help Italy regain its position as a

growing, successful economy and a lynchpin of stability on the continent and in the Mediterranean. Early action by a U.S. administration committed to European success would demonstrate with deeds that the United States is returning to its traditions of enlightened self-interest that underpinned its policies toward Italy, from the Marshall Plan onward. Action on a practical plan to help an ally would go further than any speech to demonstrate to Italy that the United States they remember as a friend and ally is back, helping to restore confidence and stability to a crucial American ally.

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