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Italy and the Completion of the Euro Area

Summary

Italian perceptions of the recent economic and financial crisis tend to focus on the role of banks and financial markets rather than competitiveness or public finances. As a result, Italians stress the importance of reforming euro area institutions to stabilize cross-border capital flows. This emphasis runs alongside a more general ambivalence that Italians feel toward the role of European institutions in structuring macroeconomic policy coordination and imposing fiscal discipline. There was a time when Italians believed that they need 'Europe' to act as an external constraint in order to shore up domestic policymaking; that time is now past. Hence Italians are unlikely to support reforms that emphasize strict conditionality in the provision of emergency lending or that focus on new ways to impose fiscal discipline on member state governments using European institutions. They are also unlikely to support any measure to reduce risks across the Italian financial system that they view as counter-productive.

How strongly Italians will express these preferences remains to be seen. The country will head to elections on 4 March 2018 and the outcome looks likely to result in a hung parliament or a broad, technical coalition government. Should Italy face either of these outcomes, the ability of Italian politicians to assert themselves at the European level will be limited. Italians will still have strong preferences about what is wrong with Europe and what should be done to fix it. The point is simply that they will be unable to influence the wider European reform process without strong and effective domestic political leadership.

Introduction

Europe's heads of state or government are making a strong push to 'complete' Europe's economic and monetary union through a raft of institutional reforms related to macroeconomic governance and financial market stabilization. There are a number of different reform packages on offer, from the very detailed proposals made by the European Commission across the course of 2017 (and building on the multiple 'Presidents Reports' that emerged during the five years prior), to the telegraphic German non-paper released by Wolfgang Schäuble in October 2017 just prior to his standing down after eight years as German Finance Minister — with a range of bold and synthetic efforts scattered in between.

The challenge is to recognize where the multiplicity of proposals reflects an emerging consensus and to anticipate where there might be strong national disagreement. That is at best a piecemeal task. The purpose of this short contribution is to reflect upon the Italian perspective — both as a matter of public policy and as a reflection of popular perception.

The argument has five parts. The first offers a brief overview of Italy's experience in the single currency that runs from the 1992 exchange rate crisis through the onset of the global economic and financial crisis in 2009. The second looks at Italy's performance during the European

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sovereign debt crisis and its aftermath. The third draws lessons from this experience from the perspective of the governing Democratic Party (PD) and extrapolates from those lessons to sketch negotiating positions that any PD-led government would be expected to adopt. The fourth explains why the results of the upcoming 4 March elections are more difficult to forecast in terms of negotiating positions. The fifth part concludes with more general suggestions as to Italy's role in any future reform of the euro area.

Different Perspectives on the Crisis

The Italian perspective in the macroeconomic governance reform debate has two different sources – one proximate, rooted in the recent crisis, and the other more distant, emerging out of Italy's experience with European monetary integration both prior to and after the adoption of the euro as a common currency. Of the two, the recent crisis should be addressed first, if only because the current wave of macroeconomic governance reforms is meant to fix what was apparently broken. Everyone agrees that there are flaws in the architecture of European financial markets and in the single currency; where they differ is in their understanding of which flaws were important in bringing the crisis about and hence also in what should be given priority in the process of reform.

Consider four different hypotheses for why the countries of the euro area got into such serious trouble, centering on the loss of competitiveness within an irrevocably fixed exchange rate, the irresponsibility of governments in failing to match their taxes and expenditures, the willingness of households to rely on debt in living beyond their means, and the collective irrationality of financial market participants who try to safeguard the value of their assets by liquidating investments in ways that bring the entire financial system to the brink of catastrophe. There is no real necessity to choose between these 'explanations'; national economies can suffer from uncompetitive firms or excessively rigid labor markets, irresponsible politicians, spendthrift households, and destabilizing financial market flows all at once. Nevertheless, the solutions to these different problems work at cross-purposes, at least when introduced all at once. Building a coherent reform agenda, therefore requires some agreement on the correct order of operations (Jones 2015).

Politicians and policymakers in many parts of Europe tend to emphasize explanations grounded in competitiveness, fiscal irresponsibility, and excessive household borrowing. There is of course evidence to support those claims. Much of that evidence does not, however, apply to Italy. Although aggregate data for the Italian economy paints a picture of very slow productivity growth, that aggregate data does not actually translate into a lack of competitiveness for Italian firms. It also does not result in large accumulated current account deficits. On the contrary, Italian firms have robust access to internal markets and while the country ran modest current account deficits in the years running up to the crisis, those deficits were nowhere close to the magnitudes you would expect to trigger an economic catastrophe. A similar point can be made about government indebtedness. It is true of course that the Italian state has a large outstanding public debt. Prior to the crisis, however, Italy was running larger primary surpluses (meaning excesses in revenues over expenditures net of debt servicing requirements) than almost any other governments in the euro area. Meanwhile, Italian households did not borrow excessively either in relation to their net household income or as a ratio of household wealth. Italian firms were not highly leveraged either (Jones 2016).

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Whatever the problems of countries like Greece, Italy did not show much evidence of huge deficiencies in competitiveness, government borrowing, or private indebtedness. Hence, Italian narratives of the recent crisis tend to focus on financial market participants and particularly on banks. They worry about the influence of cross-border financial flows in particular. If there is an order of operations in the macroeconomic governance reform process, they would address this matter first. Specifically, they seek to shore up the confidence of financial market participants so that they will not panic in moments of crisis and liquidate their Italian assets in ways that are likely to destabilize the country's entire financial system. Other countries may not see such concerns as top priority. Given their understanding of the recent crisis, however, Italians have a very different perspective (Messori and Micossi 2018).

Italy's Experience with Euro Membership

The longer-term influences on the Italian position in the macroeconomic governance reform debate are less precise or clear-cut. Probably the best way to describe Italy's experience with euro membership — and with monetary integration more generally — is cognitive dissonance, or the simultaneous embrace of contradictory positions. Moreover, Italians are not the only ones who suffer from this psychological distress. To explain why, it is best to start with Italy's decision to join the narrow band of fluctuations for the Exchange Rate Mechanism (ERM) of the European Monetary System in the late 1980s. Economists heralded this decision as offering the credibility 'advantages of tying one's hands' (Giavazzi and Pagano 1988). Italians would be able to escape the cycle of wage and cost push inflation by using an 'external constraint' (or *vincolo esterno*) to demonstrate their commitment to price stability. This would allow Italy to borrow more cheaply from abroad — hence external constraint would create new forms of flexibility.

This combination of constraint and flexibility worked only until it did not. In 1992, foreign investors lost faith in Italy's commitment to maintain its position within the ERM and, by dint of speculative pressures, they forced the Italian government to devalue the Lira against other European currencies. Worse, in 1993, market participants attacked Italy's exchange rate position again because they saw they had the power to turn speculation into a one-way bet. In both instances, Italy was targeted because of its adherence to a transparent exchange rate target. The flexibility they sought became the instrument to undermine the constraint they reluctantly embraced.

The challenge for Italians was to decide whether currency devaluation within the ERM (or depreciation in the markets) was a good or bad thing. Predictably, the answer was both. Anyone who took advantage of exchange rate stability to take out mortgages or business loans in Deutschmarks saw the return of downward flexibility as a bad thing because the decline in the value of the Lira increased the outstanding principal of their borrowings. Workers and trade unions who saw the real value of their wages diminish were also unimpressed. Other Italian economists, however, drew the lesson from Italy's experience during the exchange rate crisis that Italy needs to maintain flexible exchange rates to ensure it can recapture its international competitiveness (De Cecco 2007). This economic view was curious insofar as any improvement in Italy's current account position resulted more from the compression of demand for imports than from any increase in Italian exports; it was also curious insofar import price increases pass quickly through to the export sector given Italy's heavy dependence on important energy and productive inputs. Nevertheless, it was widespread.

The center-left government elected in 1996 contained a large group of economists who did not embrace the argument about currency flexibility and manufacturing competitiveness. Instead, they argued that capital costs are more important and so Italy should make even greater efforts to commit credibly to the goal of joining the euro. To support this commitment, they pushed for coordination with trade unions on wage bargaining and pension reforms to hold down the growth in relative real unit labor costs. They also pushed for greater efforts at fiscal consolidation. This was a stronger form of the external constraint — or vincolo esterno — argument. The fact that Italy was selected to join the euro among the first group of countries in 1998 was a measure of this government's success. As a result, borrowing costs fell so quickly for Italy that neither the Prodi government nor the government headed by Massimo D'Alema that followed on its heels ever had to run a significant additional primary surplus to support consolidation efforts. Instead, they offset intended spending cuts (which never actually materialized) with savings they made on debt service accounts.

The point here is not that Italy failed to reform in the run-up to the euro. On the contrary, incremental Italian reform programs accumulated across the 1990s to represent a substantial change in how the economy was organized (Ferrara and Gualmini 2000). The point is that the 'vincolo esterno' argument delivered in terms of credibility--enhanced access to international credit. According to data from the International Monetary Fund, where only 6 percent of outstanding Italian sovereign debt was held by foreigners in 1992, roughly 27 percent was foreign held by the end of 1998. The spread between Italian and German sovereign debt fell from six percentage points to less than one-half of one percent over the same period. Italy's domestic inflation rate declined over the period as well. The Prodi government had promised that inflation in Italy would approximate the norms in Northern Europe, and they delivered.

Ironically, Italians were the first to deny this progress. The D'Alema government collapsed and the prime minister resigned after losing regional elections between the time Italy joined the single currency and the European Central Bank substituted national currencies with euro notes and coins. Meanwhile Italian public opinion soured toward the single currency, and the changeover to the euro in particular. Although inflation was down, borrowing costs had fallen dramatically, and access to credit was increasing, Italians complained that the euro creat-

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ed inflation and that shopkeepers used the changeover to gouge consumers (European Commission 2002: Tables 14, 16b). The more officials produced statistics to show that aggregate prices had not been more stable since the 1960s, the more Italians were convinced they had been swindled. This is when the Lega Nord and the center-right began campaigning against the single currency. The issue did not gain much traction with the voters, who generally disliked the single currency and yet put other political priorities ahead of it. It is fair to say, however, that at least part of the reason that Silvio Berlusconi came to power is his rejection of the legacy of then European Commission President Romano Prodi. And while politicians on the center-right have periodically stepped back from their more extreme attacks and promises to leave the euro, they have never fully abandoned the euroskeptical rhetoric.

Italian industry prospered under the single currency nonetheless. This is another area of cognitive dissonance. Between 1999 and 2007, Italian real effective exchange rates appreciated by 8.4 percent against Italy's major trading partners. German real effective exchange rates fell by 17.3 percent over the same period. Viewed as a head-to-head comparison, this looks like a massive loss of competitiveness. But such a comparison ignores what happened in the years prior. Between 1991 and 1999, Italy's real effective exchange rate fell by close to 23 percent. Once relative rates of price inflation are taken into account, only about half of that was due to changes in the nominal effective exchange rate; the rest was due to the decline in relative real unit labor costs. Over the same period, German real effective exchange rates increased by 8.3 percent. By implication, what happened in the first eight years of the euro is that Italy and Germany traded places; Italy gave up some (but not all) of the competitiveness it gained while Germany recaptured the competitiveness it lost (Jones 2016).

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By the start of the global economic and financial crisis in 2007, Italy was in a better position than Germany in many respects. Italy had preserved a larger share of the total manufacturing employment it started with in the early 1990s; Italy retained a larger percentage of its (admittedly smaller) share of global export markets as well (Jones 2009). Italy also had comparable borrowing costs, significantly larger household wealth, and a substantially lower rate of unemployment. Most important, Italy had a more conservative banking sector. The integration of European financial markets had fostered some consolidation of the Italian banking system, but it did not change the tradition among Italian banks to focus on raising and using funds locally. Unicredit and Intesa San Paolo were notable exceptions. By contrast, the German banks took greater advantage of the opportunities they found abroad. As a result, German banks were subjected to major losses both directly from the fallout in United States (U.S.) real estate markets and indirectly from the turmoil that arose in interbank markets when the U.S. subprime mortgage industry collapsed, dragging the major U.S. investment banks and insurance industries down with it (Hardie and Howarth 2013).

Silvio Berlusconi, back in power after a brief two-year interlude of government on the center-left, was quick to insist that Italy had somehow escaped the crisis (Rovelli 2010). He was also quick to point a finger at what he described as the failings of the euro and the European Central Bank (Jones 2009). Much of Italy agreed with him. When polled in 2009, more than 53 percent of Italian respondents asserted that Italy would have handled the global economic crisis better if it had retained the Lira as a national currency (European Commission 2009: 19).

External Constraint and the Recent Crisis

The Italian crisis started in earnest only in 2011 (Jones 2012). Between 2009 and 2011, Italian growth slowed down and unemployment increased much as happened elsewhere in Europe outside of Germany. The explanation was a result of slack demand in Italy's traditional export markets, rising financing costs, and tightening restrictions on access to credit. This combination of factors quickly chipped away at the business models of the Italian banking system. As households dipped into their savings, they had less money to hold on deposit or to invest in bank bonds. Banks facing tightening funding opportunities cut back on their lending and raised lending requirements. Local small and medium sized enterprises faced shortages in raising working capital and deferred plans for investment. Italy's many local economies entered into a negative spiral as a consequence. Before long, both firms and households began to fall behind on their payments to the banks; non-performing assets piled up, forcing the banks to set aside additional loan-loss provisions and to raise fresh regulatory capital. As a consequence, the negative local spiral accelerated.

The turning point came in June 2011. Prior to that month, international investors had been slowly and quietly reducing their exposure to Italy's sovereign debt market. Toward the end of that June, however, they stopped worrying about being quiet and focused more intently on finding the exit. The timing is not immediately obvious, but it relates to the debate about increasing the haircuts on private investors during the negotiation of the second Greek bailout. Italy was not as fragile as Greece and so the probability of default was very low, but international exposure to Italian debt was much larger than exposure to Greece and so the expected value of any losses was very high. As investors started selling down the price of Italian government bonds, the trend quickly assumed a self-reinforcing dynamic. The capital flight can be seen in Italy's net position in the euro area's real time gross settlement mechanism called TARGET2. Italy's position was a net surplus for most of its participation in the single currency prior to the crisis; that surplus fell gradually during the

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period from 2008 to 2011. As the capital poured out in June 2011, Italy's position moved massively into deficit. This sell-off in Italian government bonds is important because it represented a sharp spike in local borrowing costs and a sharp contraction in locally available liquidity. No one in Italy was left unaffected — Berlusconi's center-right coalition included.

What followed over the next five months was a series of humiliating moments both for Italy's center-right government and for the country as a whole. The narrative is too detailed and complicated to try to summarize. Three anecdotes capture the essence of the experience. The first took place in August. European Central Bank President Jean-Claude Trichet signed a joint letter with Bank of Italy governor Mario Draghi offering to support Italian government bonds in secondary markets if Berlusconi's center-right coalition would show concrete progress in implementing a specific reform agenda. The letter was transmitted in secret at the start of the month. When its existence was revealed at the end of August, the impression it created was that politically independent central bankers were dictating terms to elected politicians. If anything, this public symbolism damaged the already fraught relationship between Berlusconi, his finance minister Giulio Tremonti, and his Lega Nord coalition partners. The euro as an external constraint made agreement on the reform package more rather than less complicated.

The second anecdote comes after six weeks of trying to find agreement on necessary reforms within the center-right coalition. As this process dragged on, European leaders quickly and very visibly lost patience with Italy. They also lost any semblance of respect for Berlusconi. He had always been a problematic figure, but he was a head of government and so publicly other European leaders treated him with some measure of respect. By this time, however, not even his official status seemed to matter. Hence when German Chancellor Angela Merkel and French President Nicolas Sarkozy were asked in a joint press conference held on the margins of a 23 October 2011 European crisis summit whether they trusted Berlusconi, they smirked. Such disregard only increased tensions within the Berlusconi government and the Italian center-right put those tensions on full display. Berlusconi and Tremonti travelled together to a G20 summit at Cannes in early November. The focus for concern at the summit was the escalating crisis in Greece and yet Italy was also attracting attention. Berlusconi and Tremonti held a joint press conference at the summit. Their mutual distain was apparent. So was their disagreement on how to proceed (and specifically whether to seek support from the International Monetary Fund). Their very public infighting was broadcast widely on Italian television. Once again, nothing constructive emerged from Italy's 'external constraints'.

The third anecdote took place toward the end of that November. That is when Italian President Giorgio Napolitano accepted Berlusconi's resignation as prime minister. The symbolism was awkward. Napolitano was a center-left president who showed no great affection for Berlusconi's center-right government. Napolitano also named the two-time European Commissioner Mario Monti a life Senator shortly before Berlusconi resigned. Everyone knew at the time that this was in order to be able to appoint Monti as head of a technical government should Berlusconi step down as prime minister. So there was nothing unexpected in the sequence of events. What was unexpected was the way these events were characterized by U.S. Treasury Secretary Timothy Geithner in the memoirs he published after he left office. Geithner cited unnamed European Commission sources to support a rumor that there was a broader conspiracy to oust the Berlusconi government and replace it with something more trustworthy. To explain the impact of this allegation, it is worth quoting Geithner specifically:

> At one point that fall [2011], a few European officials approached us with a scheme to try to force Italian Prime Minister Silvio Berlusconi out of power; they wanted us to refuse to support IMF loans to Italy until he was gone. We told the President about this surprising invitation, but as helpful as it would have been to have better leadership in Europe, we couldn't get involved in a scheme like that. (Geithner 2014, Chapter 11).

In reading this, it is important to emphasize that Geithner is a former U.S. cabinet secretary and not a journalist. That status gives him a certain unimpeachability even in the lack of corroborating evidence. If true, this would be a massive interference in Italian domestic politics. No additional material was uncovered to support Geithner's allegation. Unsurprisingly, though, the conspiracy theory has flourished among Berlusconi's supporters and on both fringes of the Italian political spectrum. For them, accepting European constraints offers few if any advantages.

These anecdotes are not meant to suggest that there was a sudden break in Italy's perceptions of the merits of having an external constraint to support its domestic reform processes. On the contrary, both the Monti government and the government that followed it cooperated very closely with European partners and institutions. Both governments also made significant progress in pushing domestic reform agendas on complicated policy matters; pensions, first and foremost. Nevertheless, the symbolism of cooperating with Europe was tainted by the crisis experience and so the advantages of tying one's hands have been diminished as a consequence.

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Italian Prime Minister Matteo Renzi was conscious about pushing back against the whole notion of Italy needing a vincolo esterno (Jones 2017). He and his team argued rather that Italy should take advantage of the credibility that it acquired through domestic achievements to push Italy's agenda abroad. The PD-led coalition that Renzi took over from Monti's successor, Enrico Letta, in February 2014 made a point of reversing the logic of the external constraint. They argued that Italy should constrain Europe rather than the other way around. This is a complicated argument that has involved Renzi's ministers pushing back against a number of different European policies. Renzi also made a point about his reluctant willingness to follow rules with which he disagreed and his frustration with being given warnings or instructions by European institutions which lacked his democratic legitimacy. To understand his position, however, it is necessary to take stock of the domestic political context. By the time Renzi was prime minister, his party was the only major political force in the country to espouse a pro-European position.

Renzi also found himself facing problems that his immediate predecessors had not anticipated and yet that flowed directly from Italy's unique position in the crisis. The first of these problems concerned Italy's banks. The negative spiral of economic activities in Italy's local economies took a significant toll on the balance sheets of the countries smaller and mid-sized financial institutions. If there were €78 billion in non-performing assets in 2010, that number had doubled by 2013 and continued to grow at a slower pace even as the crisis abated. By 2016, Italian banks had more than €200 billion in non-performing assets to manage, due primarily to the collapse of local small and medium sized enterprises and the prolonged decline in real estate prices (Banca d'Italia database). If these losses had been reported in 2008, the Italian government would have recapitalized the banks directly. In 2014, however, European heads of state or government engaged a new Banking Recovery and Resolution Directive that required banks to impose losses on investors before receiving public support. From an Italian perspective, this meant imposing losses on the local community, because of the way in which Italian banks recruited their funding. When Renzi tried to do this with four small banks in December 2015, it was a political disaster. When it looked as though Renzi would have to do it again with Monte dei Paschi di Siena the following year, the implications were even worse. The lesson Renzi drew from that experience was that Europeans could not be allowed to dictate how Italians deal with their banks. The challenge was to convince his European partners to agree.

The second problem has to do with Italy's sovereign debt crisis. The popular myth is that the crisis was resolved once Monti replaced Berlusconi. On the contrary, international investors continued to shed their exposure and, apart from a brief interlude that resulted from a communications failure at the ECB, the spread between the yields on Italian and German sovereign debt instruments continued to increase despite the change in political leadership. What changed the situation was a shift in ECB lending strategy. The ECB offered two tranches of three-year loans at very low fixed interest rates against high quality collateral for banks to use in funding their operations. What this meant in Italy and Spain is that banks used their existing sovereign debt holdings to borrow money to buy more sovereign debt which they collateralized into loans that they used to purchase sovereign debt. This pattern worked well to stabilize sovereign debt markets in both countries through March 2012, but at the cost of increasing the exposure of banks in both countries to their own country's debt instruments. By implication, domestic banks became the sovereign creditors of last resort. Italy's banks hold large volumes of Italian sovereign debt as a result. When other Europeans began to complain that this constituted a new source of financial risk, the Renzi government could only respond that moving away from this legacy would be a long-term project.

The current Prime Minister, Paolo Gentiloni, finds himself in a similar situation to Renzi on both counts. Gentiloni has had considerable work to do in dealing with Italy's banking sector, including tackling new bank failures in the Veneto region in addition to finalizing the solution to Monte dei Paschi di Siena and strengthening the rest of the financial sector. He is less combative than Renzi and his methods are less abrasive for European partners. But he is no less constrained than Renzi was by the structure of Italian public opinion toward Europe as a *vincolo esterno* and the euro in particular. According to November 2017 Flash Eurobarometer public opinion polling, Italy has the second lowest percentage of respondents (45 percent) who agree that the single currency was good for their country and it is tied with Cyprus for the lowest percentage of respondents (62 percent) who agree that

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the euro is good for the European Union. Only 33 percent of Italians will even admit that having the euro has made traveling easier (European Commission 2017: various tables).

Negotiating Positions to Expect from a Gentiloni (or Renzi) Government

Given this complicated history, what we can expect from an Italian government dominated by the pro-European Democratic Party, led by Gentiloni (or Renzi), and staffed by people like finance minister Pier-Carlo Padoan, is a fairly coherent set of positions. Such a government would support a euro area budget line or additional financial resources to foster investment or to facilitate structural reforms. A PD-led government would embrace a European deposit insurance scheme backed with common resources and they would like to see common funding for bank resolution and recovery measures as well. A PD-led government would acknowledge the advantages of having a European finance minister (or similar actor) to exercise some discretion in allocating these joint resources and in representing the euro to the outside world. They would also like to see greater political accountability for joint European macroeconomic policymaking and for the whole structure of European macroeconomic governance. Such accountability would reach from the top-down and would include greater discretion at the national level – both to facilitate adjustment to the new regime and to adapt common policies to national requirements. Finally, a PD-led government would argue for simpler, more transparent rules in setting targets for fiscal consolidation both relating to deficits and to dealing with legacy obligations (or large outstanding public debts). In an ideal world, they would also support some form of debt mutualization (or Eurobonds) in order to create a common European risk-free asset – although everyone acknowledges that idea is far from being on the table.

That positive agenda would be ring-fenced by a negative one. There are reform elements that such a Gentiloni (or Renzi) government would oppose in order to protect the integrity of the European system. The Gentiloni government is already on record as objecting to pressure from the European Central Bank to accelerate the disposal of non-performing assets in the Italian banking system. The Gentiloni government opposes efforts to introduce a cap on bank exposure to home-country sovereign debt instruments as well, either directly, through quantitative limits, or indirectly, through capital levies. Such risk-reduction measures are not problematic in principle; they are problematic in practice, given where Italy is at the moment. With an appropriate transition period and policies, the Gentiloni government would be happy to see the Italian banking system with a much lower level of non-performing assets and a more diversified asset portfolio. The point is simply that they do not believe it is helpful to damage the Italian economy in order to achieve that goal.

Other areas where we should expect resistance from a Gentiloni (or Renzi) government pivot on the notion of 'external constraint'. They would not support the transformation of the European Stability Mechanism (ESM) into a European Monetary Fund (EMF) outside the institutional framework of the European Union with the goal being to insulate such an institution even further from political oversight. The idea of transferring ever greater authority to the ESM or to a new EMF to manage fiscal policy coordination through strict conditionality both before and after giving program assistance would also not be welcome. The Gentiloni government – like the Renzi government before it – has already pushed back against the interference of the European Commission; a more rigid ESM (or EMF) would only complicate an already problematic situation from the Italian perspective. This is a qualification on the creation of a euro area budget line as well. Such common resources should be a carrot, not a stick.

The unifying themes in the Italian position would be solidarity, risk sharing, and national ownership. These themes are not to deny the importance of issues related to moral hazard, risk reduction, and national responsibility. Rather these themes put those concerns in perspective. The Gentiloni government believes that Italy has shown the capacity to reform and the willingness to make sacrifices on behalf of Europe. It has also shown its ability to tackle significant legacy issues. What it seeks is a supportive framework for those efforts; what it does not want is an external constraint on what it believes to be good policies.

The Complicated Future of Italian Politics

The problem for the rest of Europe is that the Gentiloni government has already stepped down as a political actor and remains in place only as caretaker. Italy faces elections, with a new electoral system and a changing balance of power within and across electoral coalitions. The range of opinions varies widely:

- The far-right Lega Nord (and Brothers of Italy) would like to see Italy exit from the euro;
- The populist Five Star Movement has flirted with holding a popular referendum on continued participation in the euro, but suggests now is not the time to do so;
- The center-right Forza Italia claims to want Italy to stay in the euro but has a history of suggesting otherwise and remains open to experimenting with the use of 'zero coupon government bonds' as a parallel fiscal currency;
- The Democratic Party wants to help lead the reform of the euro area in ways that will make it more equitable and more stable; and,
- Various other movements on the left that are harder to place but broadly supportive of continued participation in the euro and in any case are too small to make much of an impact on the conversation except in coalition with the Democratic Party.

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The situation is further complicated because the anti-euro parties do not coalesce. Although Lega Nord leader Matteo Salvini often talks about having conversations with Five Star Movement leader Luigi Di Maio about a possible tie-up, there is no great affection between the rank-and-file of the two groups and Di Maio keeps changing his mind about whether he will go into coalition after the elections. As a result, Salvini has brought his Lega Nord into partnership with the Brothers of Italy and Forza Italia, ostensibly under the leadership of former prime minister Silvio Berlusconi (although he cannot legally either stand for parliament or serve in cabinet because of a ban on serving in public office imposed after his conviction on fraud charges). Berlusconi has promised to force the Lega Nord to accept continuing participation in the euro as part of their electoral partnership; whether the two groups remain aligned once the votes are counted and the seats distributed remains to be seen.

This ambiguity in the post-electoral politics stems from the fact that the electorate in Italy is roughly evenly divided into three camps. Roughly 35 percent of polling respondents declare an intention to vote for the parties of the center-right. Another 27 percent of polling respondents support the Five Star Movement. A similar number, roughly 27 percent, support the Democratic Party and its much smaller allies on the center-left. The rest of the vote is shared between a center-left splinter group that is opposed to Renzi's political leadership and a host of very small fringe or legacy parties that cannot cross the threshold to enter parliament. Should this polling information prove accurate when Italians cast their votes, then there is no obvious way to form a government because none of the three main blocks will have an outright majority. We should expect to see the usual maneuvering in that context, as pre-electoral coalitions break apart and new coalition opportunities emerge. Nevertheless, it is hard to see clearly enough into the future to imagine the government that results from that process or how much freedom of maneuver it retains given the constellation of its support.

Conclusion

The tempting conclusion would be to ignore Italy's role in the absence of a strong Italian government. Doing so, however, would also be ignoring Italy's complicated history with the euro. The main theme that emerges from this history is ambivalence. That ambivalence could translate quickly into popular discontent if euro area reforms turn out to disadvantage Italy in some structural sense, if they impose too rapid a cost of adjustment on the Italian economy, if they create too many opportunities for European officials to lecture Italian policymakers, and if they undermine the stability of trusted institutions like historic regional banks. Italy's political weakness should be a reason to pay closer attention to what Italians have to say about the euro area reform process and not to dismiss Italian input from consideration – even if the source of that input is a political figure who is not popular at the European level.

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