

Europe Is in *More Trouble* Than You Think

BY WOLFGANG MÜNCHAU

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Remember Sam Wang, the Princeton professor who famously put Hillary Clinton's chance of winning the 2016 U.S. presidential elections at between 98 percent and 99 percent? Or the various pre-Brexit polls in the United Kingdom that had Remain so far ahead that Remainers effectively stopped campaigning? Or the various Italian pointyheads who kept reassuring their international audiences that the Five Star Movement would never get to power?

One of the reasons why the so-called populists have become so successful on both sides of the Atlantic is the persistent tendency of the liberal elites to underestimate them. The deep issue is not the failure to get a result right or wrong on election night. It is about the failure to understand what is behind the growth of anti-establishment forces. That failure is systemic. We keep getting it wrong. And when we do, our tendency is not to blame our underlying models but seek comfort in conspiracy theories, or blame the allegedly right-wing press or Russian interference.

The simple truth is that Professor Wang relied on a silly model that fails to capture the underlying political dynamics of today's United States. The same is true of the majority of opinion pollsters in Europe as well. Many macroeconomists are still reliant on rational-expectation-based economic models that have no hope of capturing the dynamics of our complex

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Five thousand AfD supporters held a mass demonstration in Berlin in May 2018 to express their anger at the policies of Chancellor Angela Merkel's government, especially her welcoming stance toward refugees. Anxiety over foreigners, hostility toward elites, and patriotism were the themes of the chants of the AfD crowd and the speeches held on the stages, Deutsche Welle reported. A nearby counterprotest drew a crowd of twenty thousand, with two thousand police on hand to keep order.

post-crisis economies. I would agree with the assertion that Brexit is a tragedy for Europe but it is specifically a tragedy for the economics profession because its massively exaggerated warnings about the economic impact of Brexit were unmasked. The International Monetary Fund, the OECD, the UK Treasury, and the Bank of England look no better than Professor Wang. What they all have in common is a failure to grasp dynamic shifts that have taken place in our societies. Their models are the alchemy of the twenty-first century.

If you want to get a better sense of what is going on, you might want to spend some time in less fashionable parts of eastern Germany or northern Italy. These are, by comparative European standards, wealthy regions. But East Germans have been through a long period of de-industrialization, brain drain, and rising immigration. The hope of catching up with western Germany is lost at least for the current generation. This is where the Alternative for Germany (AfD) has its deepest roots. The core of its membership are angry older people, who feel overwhelmed by the fast social changes around them: the extremely visible rise in immigration that followed Angela Merkel's decision to open the border in 2015, or the changes brought by the introduction of the euro. Economically, Germany benefited from the euro. But German politicians and journalists managed to persuade themselves that the euro triggered massive fiscal transfers to the south. The AfD started life as an anti-euro party, and now occupies the entire spectrum of right-wing conspiratorial narratives. The decision by the SPD to join a grand coalition earlier this year has elevated the AfD to the status of Germany's largest opposition party.

The situation in Italy is worse. Ever since Italy adopted the euro in 1999, the Italian economy has failed to generate hardly any productivity growth. The flailing economy left it with an unsustainable public sector debt burden and a febrile banking system. It is the nature of a malfunctioning monetary union, together with a tendency to kick the proverbial can down the road, that has left Italy's political system vulnerable to a populist insurgence of the kind that occurred in this year's election. The establishment of a government led by the Five Star Movement and the Northern League is no accident.

If you had only looked at the relatively robust rates of GDP growth over the last two years, you would have missed the picture. I spend quite a bit of time in Northern Italy, where like so many other Germans, my family and I own a house. Illegal immigration from northern Africa has

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soared, and is highly visible especially in the coastal towns of the Mediterranean Sea. The economic situation in my Ligurian neighborhood has declined despite the rise in officially recorded growth statistics. Former Prime Minister Silvio Berlusconi once famously said there was no crisis since the restaurants were full. We all laughed at the time. Last summer, I noted that the restaurants were shockingly empty. Many shops that had been there for decades have closed. I thought initially that it could be a local recession. But when I visited Pisa in neighboring Tuscany a few months later, I heard exactly the same stories. Italy is in a slow-burning depression. It should come as no surprise that the Italians decided to throw out the two political parties they hold responsible for this mess.

One of the big questions in European politics right now is whether the Italian insurrection will survive into May's elections for the European Parliament. These will be the most important elections ever held in the European Union's sixty-year history because they might result in another Brexit-style surprise.

I believe the best way to confront the so-called populists is to let them govern for a while. Italy's government has made many electoral promises, many of which they will not be able to fulfil. The costliest promise consists of a universal basic income, for which the Five Star Movement has campaigned vigorously. When the party won the elections, unemployed Italians queued up at their local town halls the next morning to collect the money. Five Star at least managed to introduce a slimmed-down version of the basic income from next year onwards—a policy that is hugely popular among the large number of Italians who have no permanent income. If you had only looked at the country's improving unemployment statistics, you would not have seen this coming.

The European Commission has decided to challenge the Italian budget that showed a projected fiscal deficit of 2.4 percent of GDP. The

Commission's arguments are technically correct. The deficit estimate relies on unrealistic growth assumptions, and the deficit is more likely to edge toward 2.8 percent, or possibly higher during a recession, a rate that is clearly not consistent with debt sustainability. The relationship between Italy and the European Union is an accident waiting to happen. The spreads between Italian and German ten-year bonds are now trading persistently at over 300 basis points. Add another 100 basis points, or may 200 basis points, and you may have the next phase of the never-ending eurozone crisis. Italy has to refinance €254 billion in government debt next year alone.

While the European Commission is right in its criticism of Italian fiscal policies, I doubt that it is wise to pick an existential fight over a few decimal points at this time. The two governing parties have defied expectations not only by winning the elections, but also by increasing their popularity since they came to power. Matteo Salvini, the leader of the Northern League and Italy's interior minister, is one of the smartest, and possibly most dangerous, of the new breed of populist politicians in Europe. He has forged a strategic alliance with Viktor Orban, the Hungarian prime minister, who is a member of Angela Merkel's European People's Party in the European Parliament. In contrast to many other populists, Salvini happens to know the European Union well, having served as a member of the European Parliament. He may have a go to become a candidate for

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Arrogant Elitist

In France, Emmanuel Macron is now struggling to maintain the magic of last year. France is growing disillusioned with a president who is still admired for his economic reforms, but who has found it difficult to communicate with ordinary people. It is not smart to tell pensioners to refrain from complaining, or to tell an unemployed gardener that he should work in a cafe. The man once touted as Europe's best hope has turned out to be as elitist and arrogant as a macroeconomist armed with a DSGE model. Macron's strongest opponent right now is not the traditional parties but Jean-Luc Mélenchon, the leader of the far-left party La France Insoumise, loosely translated as Insurrectional France.



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—W. Münchau

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the job of president of the European Commission. He stands no chance, but he together with an alliance of establishment-critical parties may succeed in toppling the existing grand coalition of the center-right and the center-left that has been governing the European Union and its institutions forever.

A victory of populists is a scenario that is also vastly underestimated by political leaders and their cheerleaders in the media. They are pointing to polls showing that the European People's Party is in first place. Similar to the erring polls in the United States, these polls, too, do not capture the dynamic. In Germany, the CDU, and its Bavarian sister party, the CSU, have seen a dramatic loss of political support recently. So has the Social Democratic Party. The latest polls have the CDU/CSU at around 25 percent and the SPD at around 15 percent. The SPD has now fallen behind the AfD, a party of the extreme right, and the Greens. The Greens are now the main force on the left in Germany—and demographic trends favor the Greens further. The SPD, once the big beast of German politics, the party of Willy Brandt, Helmut Schmidt, and Gerhard Schröder, is on the way to becoming another small party.

What the polls are also underestimating is the importance of voter turnout. It was high turnout that produced Brexit. European elections have a notoriously low turnout.



MARZO VOTA LEG

Matteo Salvini

The Most Dangerous Of the New Breed

Matteo Salvini, the leader of the Northern League and Italy's interior minister, is one of the smartest, and possibly most dangerous, of the new breed of populist politicians in Europe. In contrast to many other populists, Salvini happens to know the European Union well, having served as a member of the European Parliament. He may have a go to become a candidate for the job of president of the European Commission. He stands no chance, but he together with an alliance of establishment-critical parties may succeed in toppling the existing grand coalition of the center-right and the center-left that has been governing the European Union and its institutions forever.

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If the turnout among the populist parties in the European elections is high—as I expect it to be—we could be in for a political shock, especially if the centrist parties fail to mobilize their voters. We are also currently witnessing a deflating political bubble in France, where Emmanuel Macron is now struggling to maintain the magic of last year. France is growing disillusioned with a president who is still admired

for his economic reforms, but who has found it difficult to communicate with ordinary people. It is not smart to tell pensioners to refrain from complaining, or to tell an unemployed gardener that he should work in a cafe. The man once touted as Europe's best hope has turned out to be as elitist and arrogant as a macroeconomist armed with a DSGE model. Macron's strongest opponent right now is not the traditional parties but Jean-Luc Mélenchon, the leader of the far-left party La France Insoumise, loosely translated as Insurrectional France.

And for all of you who pray for a second Brexit referendum in the United Kingdom, consider this: a second referendum would require a prolongation of the exit date. The United Kingdom would then still be a member of the European Union at the time of the European elections. Calling a second referendum would produce a massive electoral setback. It would be fertile ground for

the UK Independence Party, which is part of the populist block in the European Union. The attempt to undo Brexit would in all likelihood end with the undoing of a centrist democratic leadership in the European Union. And there is no guarantee that a second referendum would yield a pro-Remain majority. You may end up with the worst of both worlds. My conclusion therefore is that a second referendum is not in the European Union's interest.

We have arrived here because of the innate tendency of our liberal democracy to kick the can down the road. If we had allowed a restructuring of Greek debt in 2010, the eurozone crisis may never have happened. Italian debt is as unsustainable today as Greek was then. You can easily solve the Italian crisis on a spreadsheet, but not when you consider the politics of two decades of economic depression. This is why it is so essential to resolve crises when they occur.

The policy to kick the can down the road seemed smart at the time. It was fashionable among policy folk to invoke the images of a fire brigade to justify the priority

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of short-term action over long-term solutions. I noted in particular the elevation of Angela Merkel to the status of a global political heroine especially among those who despise Donald Trump. But beware that the enemy of your enemy may not be your friend. Merkel has a lot to answer for. She played a major role in the formulation of policies that helped stabilize GDP across the European Union but that destabilized societies.

Europe is getting closer to the end of that road only to discover that there are lots of cans that have been kicked down from the past. ◆