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The Italian's Job: Premier Talks Tough to Save Euro

Italian Leader Has Become Most Determined Challenger to Germany's Approach Toward Tackling Crisis

BY ALESSANDRA GALLONI
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During an all-night European summit in June, Mario Monti, the Italian prime minister, gave German Chancellor Angela Merkel an unexpected ultimatum: He would block all deals until she agreed to take action against Italy's and Spain's rising borrowing costs.

Ms. Merkel, who has held most of the euro's cards for the past two years, wasn't used to being put on the defensive.

"This is not helpful, Mario," Ms. Merkel warned, according to people present. Europe's leaders were gathered on the fifth floor of the European Union's boxy glass headquarters in Brussels.

"I know," Italy's premier replied.

The nine-hour confrontation between Italy and Germany that night led to a compromise that wasn't the sweeping action Mr. Monti wanted. But it has helped to pave the way for a possible intervention by the European Central Bank to stabilize the teetering bond markets of Italy and Spain—a high-risk step that could be Europe's last chance to save the euro.

The Italian-German conflict has also exposed a deep philosophical fissure at the heart of the euro zone: Are painful reforms and austerity in countries such as Italy and Spain, enough to restore confidence in the common currency, as Germany has insisted? Or do they need Europe's collective financial support while they fix their economies, as Mr. Monti argues?

That question still hasn't been answered. Investor flight from Italy and Spain still threatens both countries with financial meltdown. Markets doubt Europe's common currency will survive in its current boundaries. Germany remains deeply skeptical about massive ECB intervention in government bond markets, fearing that it would take the pressure off countries to overhaul their economies.

Last week, ECB President Mario Draghi disappointed markets' hopes that the bank would act right away. But he said the ECB "may" soon buy bonds of crisis-hit countries that meet certain conditions established by European authorities.

"If I were Draghi, I would feel morally and politically protected in making bold moves at the right moment," thanks to the June 28 summit outcome, Mr. Monti said in an interview soon after the summit. In a conversation on Monday, Mr. Monti described Mr. Draghi's comments last week as a "bold move" that is starting to define the "operational terms" of the late-June summit.

Mr. Monti didn't comment on Mr. Draghi's condition for ECB aid—that Italy and Spain first apply for bond-market support from Europe's bailout fund and sign a list of economic-policy promises. Such a move could be politically risky for Rome and Madrid, since it would likely be construed as tantamount to a loss of national sovereignty.

Three years into Europe's financial turmoil, Mr. Monti—an understated, 69-year-old economics professor named in November to head a temporary government of nonpartisan technocrats—has become the most determined challenger to Germany's approach toward tackling the euro crisis.

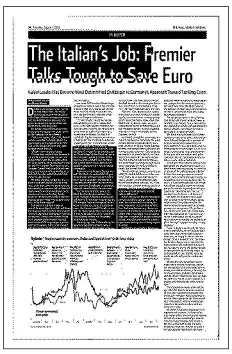
Over his nine months in power, Mr. Monti has introduced a number of economic overhauls, fulfilling a promise Italy had made to its European partners and the ECB last year. Yet investor demand for its bonds is drying up, risking a financial disaster that Europe wouldn't be able to contain. Mr. Monti argues that a concrete sign of help on the European stage would be to show skeptical Italians that his painful overhauls bring rewards.

"Germany says that if the market is forcing you to pay high borrowing rates, it means you haven't done enough to fix your local economy. This view neglects the fact that high spreads in the recent past also reflect market fears of a breakdown of the euro," Mr. Monti said in the July interview.

"What we ask is that European authorities certify Italy's good conduct by translating that into interventions to keep spreads within reasonable limits. I have often told Merkel that, if this isn't done, she risks finding herself before an Italian Parliament that repudiates Europe, monetary stability and the euro and is not friendly toward Germany," he said.

Ms. Merkel, through her spokesman, declined to comment for this article. Yet senior German officials concede Mr. Monti has a point. Investors are fleeing Italian and Spanish debt, even though Rome and Madrid are shaking up their economies. That means Europe needs to do more to help its two large Southern members. But the cautious chancellor fears massive bond-market intervention could trigger a political backlash in Germany—and might not work, according to people familiar with her thinking.

"Monti's defining strength is not just his ability to rebuild confidence in Italian economic policy, but to help lead Europe toward a stronger set of institutions and a more effective growth strategy," U.S. Treasury Secretary Timothy Geithner said in an interview. "He has a lot of credibility, in



Germany and internationally, and that makes a difference."

In late autumn, Ms. Merkel's diplomatic pressure on Italy to step up economic reforms was instrumental in ushering Mr. Monti into power. Italy has long suffered from deadening bureaucracy, chronic tax evasion, and a business sector riddled with cartels. With a stagnating economy, Italy's huge debt, currently 123% of gross domestic product, was affordable when the country enjoyed low interest rates on bond markets. No longer.

Mr. Monti is an anomaly in Europe: an unelected leader brought in to make unpopular changes that the country's politicians had shied away from. Mr. Monti relies on the tolerance of Italy's main political parties and has no power base of his own, except his personal credibility.

His disciplined nature is more German than Italian and his wry sense of humor is decidedly more British. He is a devout Catholic, educated by Jesuits and appreciated by Vatican officials, even though he reintroduced taxes on church property.

Mr. Monti was criticizing Italy's billowing debt as early as the go-go 1980s and believes balanced budgets are a question of fairness toward future generations. As prime minister, he has cut pension costs by forcing Italians to work longer. But in an attempt to show equity, even amid austerity, he has gone after tax evaders with police raids on stores and restaurants in elite vacation resorts, such as Portofino.

As Europe's chief antitrust official in the early 2000s, Mr. Monti became known as a cartel buster, famously levying a record fine on Microsoft for anticompetitive behavior. In Italy, he is trying to open up cosseted sectors, such as pharmacies and notaries, to competition and is trying to dilute what he says is a disproportionate influence of business lobbies and labor unions on national policy. Government negotiations with these players are "like toothpaste," he says: "If you don't put the lid on, it all flows out."

Mr. Monti has brought a more sober style to Italian government affairs, which under former Prime Minister Silvio Berlusconi were often punctuated by off-color gestures and bawdy jokes. The professor bats off his critics with soft, cutting jokes. When Mr. Berlusconi was reported as saying he could "unplug" the Monti government whenever he wanted, the professor replied: "We don't consider ourselves a home appliance."

Fluent in English and French, Mr. Monti is more comfortable on the European diplomatic stage than among Rome's raucous politicians, for whom he doesn't hide his disdain. When a lawmaker from the populist Northern League party railed that the Italian premier had celebrated New Year's Eve on taxpayer money, Mr. Monti released a long statement on the family dinner, including details of the tortellini, pork and lentils his wife had paid for, cooked and served.

Mr. Monti's calm, disciplined manner makes him a cautious statesman, and not the revolutionary that some might have expected, says Alberto Alesina, a Harvard University economics professor who studied with Mr. Monti. "Monti is the best that Italy has right now. But he is not a radical; He is prudent and someone who seeks compromise."

The compromises began a few months ago, when Mr. Monti's austerity measures hit consumer spending and dragged Italy deeper into recession. Political parties fretted that their support for Mr. Monti would hurt voter support, without winning Italy rewards in the markets, where its bond yields were rising.

Mr. Monti toned down legislation to deregulate service sectors. To lower Italy's high energy prices, the government ordered the sale of a state-controlled gas network from the energy company that owned it. But then a state fund bought the stake, prompting complaints that the deal was a lost privatization opportunity. Mr. Monti unveiled a landmark labor reform that makes it easier for businesses to lay off staff and makes jobless benefits more inclusive. Yet under pressure from left-leaning lawmakers, he diluted the measure by allowing courts in some cases to allow fired workers to be rehired.

Mr. Monti says he is doing what he can to change Italy—and Italian behavior—but he needs parliamentary approval for laws to go through. "I had to gather the minimum consensus necessary to get the bills approved in Parliament," he said in the interview.

By this summer, he was in a vicious circle. The more unpopular measures he proposed, the more Italy's political parties threatened to withdraw support for his government. The still-influential Mr. Berlusconi flirted publicly with the idea of returning to power.

The specter of political instability in Rome rattled markets and pushed up Italy's borrowing costs further. Mr. Monti needed more European help to take Italy out of the markets' cross hairs, but none was forthcoming. Instead, Germany wanted to see tougher domestic reforms.

"If Italians think the sacrifices they've made [under the Monti government] aren't going to bear fruit at the European level, well then it's better to bring back Berlusconi who never forced anyone to make sacrifices," says Pierferdinando Casini, leader of the UDC centrist party, which supports Mr. Monti's government in Parliament.

When world leaders from the Group of 20 leading nations met in Los Cabos, Mexico, in June, Mr. Monti unveiled a plan to relieve bond-market pressure on Italy and Spain. He wanted Europe's bailout fund to step in and buy Italian and Spanish bonds, on the basis that both countries were whipping their economies into shape.

Contrary to the bailout fund's present rules, Mr. Monti didn't want Rome and Madrid to suffer the stigma of applying formally for aid or signing a list of policy demands written in Brussels, fearing this would undermine his public standing at home, as well that of his ally, Spain's Premier Mariano Rajoy.

At a late-night discussion in Mexico with key European leaders, U.S. President Barack

Obama supported Mr. Monti's plan, according to people present. But Ms. Merkel dismissed the idea. Over the past two years, she had justified financial help for other euro nations to skeptical German voters by promising there would be a quid pro quo of tough, internationally supervised reforms. Now Italy wanted Germany's money with no strings attached.

Mr. Obama couldn't talk the euro-zone leaders into agreeing.

Mr. Monti didn't give up.

Days before the euro zone's June 28 summit, Mr. Monti took a gamble in Rome to strengthen his hand in Europe. He submitted his controversial labor bill to Parliament, and told lawmakers to back him or sack him. The bill passed. His reforming credentials bolstered, he flew to Brussels.

The summit was supposed to rubber-stamp a "growth pact" to stimulate economic growth by boosting public investment in Europe. The envisioned measures were modest. But they were a vital olive branch to Ms. Merkel's center-left opposition in Berlin, whose votes she needed to ratify her real objective: an earlier European agreement on fiscal discipline.

The evening before the meeting, Mr. Monti hatched a plan to hijack the summit. Unless Ms. Merkel accepted his proposal on bond-market intervention by Europe's bailout fund, Mr. Monti would veto the growth pact—stymieing Ms. Merkel in her parliament. Italy had previously lobbied for the growth pact, so Mr. Monti's threatened veto—announced just before Europe's leaders were due to sit down for dinner—was a bombshell.

"But we need this result this evening," Danish Prime Minister Helle Thorning-Schmidt chimed in about the growth pact. "This is a dark moment," EU Commission President José Manuel Barroso said.

The summit was at an impasse. French President François Hollande briefed reporters on the closed-door events, adding that he sympathized with Mr. Monti's stance.

During a break in the talks, Messrs. Monti and Draghi savored a moment of Italian triumph over Germany on the soccer field. In the bar on the eighth floor of the EU's headquarters, the two men watched a third Italian Mario—soccer star Mario Balotelli—as his goals knocked Germany out of the European soccer championship.

Ms. Merkel, the German national team's most prominent fan, had also been keeping tabs on the match via text message.

Mr. Monti's blockade lasted until 4 a.m., when leaders finally agreed to a text hashed out by their aides. It promised that Europe's bailout funds would be used "in a flexible and efficient matter" to stabilize the bond markets of vulnerable euro members.

It didn't go as far as Mr. Monti had originally wanted: Italy and Spain would still have to apply for any aid and sign a policy memorandum. But by planting the need to stabilize bond markets in the declaration, Italy had convinced Germany to recognize Italian reform efforts and pushed its approach for tackling the crisis into the spotlight.

An ebullient Mr. Monti spoke to reporters, claiming satisfaction for Italy and for Europe. A tired Ms. Merkel slunk off to her hotel.

German media and lawmakers were convinced their chancellor had buckled under Mr. Monti's pressure, granting Italy and Spain unconditional access to Germany's treasury. Her protestations later that morning that the fine print preserved the existing procedure for aid went largely unheard.

But Ms. Merkel's aides say she appreciated that Mr. Monti had scored an important political victory back home—meaning she would be dealing with the professor, not a reform-shy Italian politician such as Mr. Berlusconi, for a while longer.

Markets weren't fooled for long. Italy's borrowing costs rose to as high as 6.6% in late July, in new signs that investor demand for Italian debt was shriveling. Skeptical investors know the euro zone's bailout funds aren't big enough to prop up Italy's huge bond market on their own.

Only the ECB has the necessary firepower to move the market. Senior German officials say the ECB's help is what Mr. Monti has really been after all along. The Italian leader is convinced that the June 28 summit provided political cover for the ECB to take bold action, in the knowledge that euro-zone governments—including Germany—won't oppose it.

"I have no doubt that the night before the disintegration of the euro, the ECB will do whatever is necessary to save it," Mr. Monti says. "The question is: Do we need to get to the night before?"

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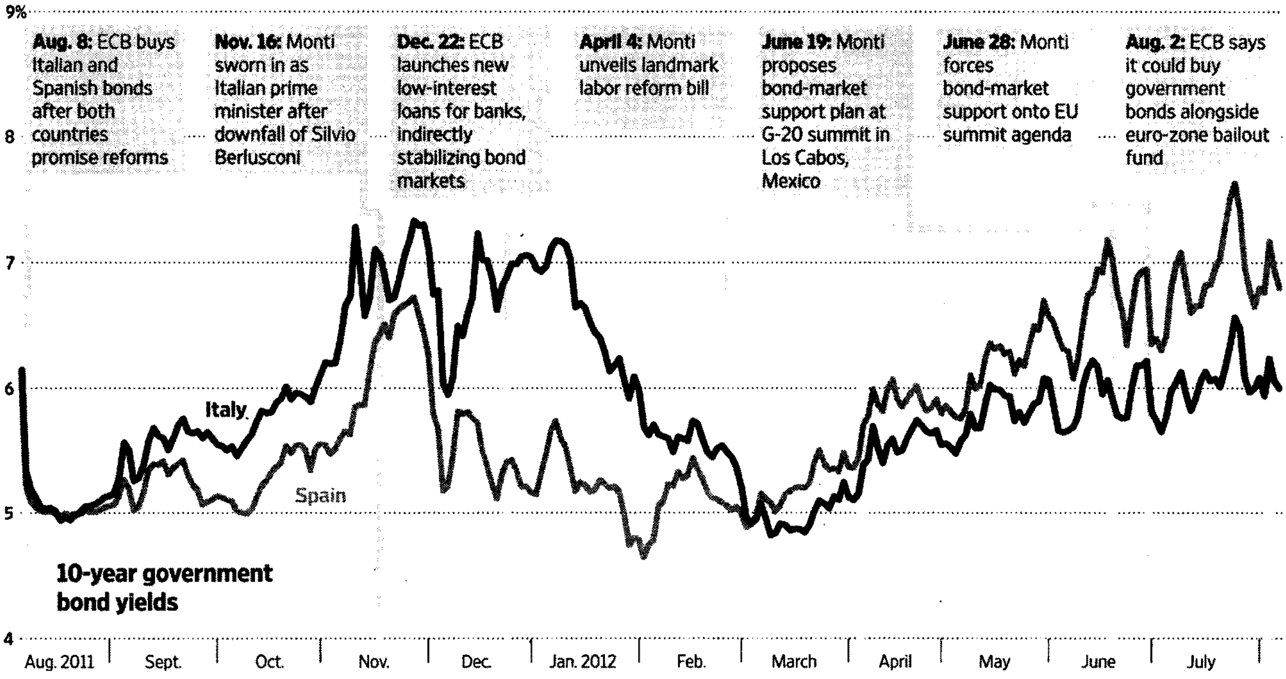

Sources: Tradeweb; WSJ research

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Nadia Shira Cohen for The Wall Street Journal

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