The bond markets turned on Italy during the first weekend of July 2011 as part of a wider loss of confidence in European efforts to manage the sovereign debt crisis. On Friday, 1 July, the difference—or “spread”—between Italian and German 10-year government bond yields was 178 basis points or 1.78 percent. The following Monday, 4 July, it was up to 183 basis points and rising. By Friday, 8 July, the spread was 237 basis points. It remained above that level to the end of the year.¹ The center-right government led by Silvio Berlusconi attempted to head off this change in sentiment by pushing through successive reform packages to promote fiscal consolidation and stimulate growth. Bond traders consistently shrugged off these actions as too little, too late. Ultimately, the pressure became so great that the center-right coalition fractured and President Giorgio Napolitano replaced Berlusconi’s Cabinet with a technocratic government headed by Mario Monti. Even this, however, was not enough to appease the markets, and the year ended with Italian bond yields again rising.

The purpose of this chapter is to interpret that market assessment. It has six sections. The first provides the background for Italy’s role in the European sovereign debt crisis, culminating in the July legislative packages to promote growth and ensure financial stability. The second reviews the crisis in early August and the subsequent efforts to negotiate a revised fiscal consolidation package. The third examines the ratings downgrades in September and early October. The fourth
looks at the late October growth package. The fifth describes the dramatic events of early November. Finally, the sixth section concludes with a brief look at the post-Berlusconi period (covered in more detail elsewhere in this volume) and speculates about the prospects for Italy and for Europe.

**Italy Is Not One of the PIGS**

The sovereign debt crisis that befell Greece, Ireland, Portugal, and Spain—here referred to as the “first four” rather than using the unflattering “PIGS” acronym—is fundamentally different from the more recent bond market troubles experienced by Italy. The reason is twofold. To begin with, although Italy has a long history of high indebtedness, the Italian treasury is very skilled at debt management. The public debt has been higher than the country’s gross domestic product for almost two decades. Nonetheless, Italy has managed a gradual consolidation, the average maturity of the debt is long at seven years, and even the shock of the recent financial crisis has not erased all of the gains made since the debt peaked in 1994 at 122 percent of GDP. So while most Italians agree that the debt is a problem, it is a problem that they have learned to accept.

Such acceptance is painful, and yet the Italians can afford it. This is the second aspect of the difference. While the “first four” are heavily indebted to the outside world, Italy is not. Italy has a large public sector debt, and it has correspondingly large annual financing requirements as a significant fraction of that debt rolls over at maturity. But it has a relatively conservative banking sector, a large stockpile of domestic savings, and an even larger stockpile of household wealth. So while the public sector is heavily indebted, those debts can be covered by domestic resources. The flight of foreign capital from Italy would cause significant problems, but Italian government borrowing could be financed so long as domestic savings remain within the country.

The situation with the “first four” is not like that. Each of the smaller peripheral economies of the Eurozone is indebted in large measure to the countries of Europe’s core—France and Germany in particular, but also smaller wealthy member states like Austria, Belgium, and the Netherlands. Whether the “first four” started with large public debts (Greece), small public debts (Ireland), or mid-sized public debts (Spain and Portugal) was largely irrelevant. The reason that they descended into crisis was that the money they had borrowed from foreigners was suddenly withdrawn and they did not have any domestic resources to fill the gap.
Comparative data for current account balances give a sense of the relative magnitudes involved (see table 7.1). The current account provides the balance between exports and imports. When that balance is negative, it signals that the money spent on imports is greater than the money earned from exports—which means that the economy must have borrowed money from abroad. The more that these deficits accumulate from one year to the next, the more money that the economy has to borrow in order to cover the excess of imports over exports. The first column in table 7.1 gives the cumulative current account balance from 1999 to 2008. The cumulative data for current account balances are a proxy for the level of accumulated external indebtedness experienced since the start of the single currency. What is immediately obvious from the data is that the “first four” accumulated significant external debts that Italy did not replicate.

If the accumulated stock of deficits shows the level of indebtedness, changes in the deficit from one year to the next show the path of adjustment. As the current account deficits get smaller, money is flowing out of the country (or not coming in). As these deficits get larger, the flow of funds is reversed, and money is flowing into the country (or less of it is flowing out). The next three columns in table 7.1 show the annual data for 2009, 2010, and 2011. The point to note is that as money started to flow out of the “first four” countries after 2008 (meaning the deficits got smaller) it was flowing into Italy instead (the deficits got larger). Only later—in 2011—did this flow of funds into Italy begin to reverse as foreign investors started to lose confidence and the country found it more difficult to borrow from abroad.

The data for government balances net of debt service requirements reveal another important difference between Italy and the “first four.”

### Table 7.1: Current Account Deficits as Percent of GDP

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<tbody>
<tr>
<td>Greece</td>
<td>-119.3</td>
<td>-14.0</td>
<td>-11.8</td>
<td>-8.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>-18.2</td>
<td>-3.1</td>
<td>-0.7</td>
<td>1.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>-97.7</td>
<td>-10.7</td>
<td>-9.8</td>
<td>-7.5</td>
</tr>
<tr>
<td>Spain</td>
<td>-60.8</td>
<td>-5.5</td>
<td>-4.5</td>
<td>-4.1</td>
</tr>
<tr>
<td>Italy</td>
<td>-8.7</td>
<td>-3.0</td>
<td>-4.2</td>
<td>-3.5</td>
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These data are assembled in figure 7.1. Where this balance is positive, then the government is making progress in containing its own public indebtedness; where the balance is negative, by contrast, public indebtedness starts to build under its own momentum, as borrowing to cover the cost of servicing the debt gets added to the total debt outstanding. The story these data tell is that while Italy has made consistent progress in managing its public debt, the “first four” experienced major slippage once the economic and financial crisis began to take its toll. The data also show that two of the most problematic countries—Greece and Portugal—have a long history of spending beyond their means, while Ireland and Spain have only a more recent history of instability.

These two differences between Italy and the “first four” explain why Italian governments bonds traded at higher prices and lower yields than the bonds issued by other Eurozone countries on the periphery. So long as Italy continued to manage its public debt responsibly, and so long as it could count on private savings to finance public borrowing, international bond markets had only one major concern—contagion spreading.

FIGURE 7.1 Public Revenues Less Expenditures Net of Debt Service

through the European banking sector. Should European banks take substantial losses from their exposure to the “first four,” then the appetite for banks to invest in the debt of other countries might diminish and so make the routine refinancing of Italian sovereign debt more complicated. Given that Italy is one of the largest issuers of sovereign debt obligations in the world, the prospect that it would not be able to roll over its debt at maturity is hardly a trivial concern.

The coincidence in May, June, and early July of difficult negotiations surrounding the second Greek bailout and the unconvincing second round of stress tests by the European Banking Authority were the perfect formula to activate concern about contagion. The second Greek package reinforced the importance of “private sector involvement” and so underscored the reality that banks could incur significant losses on their holdings of sovereign debt. Meanwhile, the stress tests revealed the underlying fragility of the European banking system and the complex web of cross-country exposure. Hence, it fell to the Berlusconi government to forge a persuasive response in order to reassure bond investors that Italy would not only reinforce discipline in the management of its public accounts, but also bolster economic activity sufficiently to be able to grow out of its high level of indebtedness.

The legislative packages that passed into law on 12 and 15 July were intended to serve both goals. The first set of measures had been debated since late in the spring, close to the 24 May 2011 announcement by Standard & Poor’s (S&P) of a negative outlook on Italy’s credit rating, and were framed as focusing on “development.” The second package had a much shorter gestation in the first weeks of July because it contained “urgent measures for financial stabilization.”

The development measures included initiatives to promote scientific research, employment, and investment in the South. The package also promised to simplify the public procurement process, streamline taxes, and cut through bureaucratic red tape. All of this was intended to create a more business-friendly environment in order to encourage investment and job creation. Finally, the package included changes to improve the function of real estate and credit markets, to strengthen the relationship between the private sector and universities, and to encourage the use of electronic communication in the provision of public services.

The stabilization measures included proposals to cut costs in the public sector by freezing salaries, restricting benefits, reducing payrolls, decreasing financial support for political parties, and harmonizing as much as possible the electoral calendar. The package also called for a more comprehensive and systematic review of public spending,
the rationalization of procurement practices and capital outlays, the reorganization of public institutions, and the reform of health care, pensions, and education. The overall objective was to balance the budget by 2014—with three euros in new taxes raised for every two euros in spending cuts.3

The measures were controversial within Italy, but they received political support from abroad. German Finance Minister Wolfgang Schäuble described them as “ambitious” and European Economics Commissioner Olli Rehn gave them a warm welcome.4 Nevertheless, the bond markets remained unimpressed, as is evident from the sudden increase in the cost of borrowing. These data are presented in figure 7.2, which provides the yield spreads on long-dated government bonds for Italy and Spain relative to Germany. The German bond yields provide the benchmark for what in the European context might be considered the most risk-free tradable asset. Hence, the yield spread provides a measure of market assessment of risk. The Spanish yields are included to make it possible to see how

**FIGURE 7.2** Italian and Spanish Long-Term Interest Rate Differentials with Germany

Source: IHS Global Insight.
much of the sudden surge in the cost of borrowing for the Italian government is simply a reflection of the more general deterioration in market confidence.

What the data reveal is a loss of confidence in both countries. While it was not clear at the start of August that Italy was being singled out by speculators, it was evident that the reform packages introduced by the Berlusconi government had failed to reassure the markets. To a large extent, this lack of confidence stemmed from Italy’s poor growth performance. In his declaration on the financial crisis of 2 August, President Napolitano was vocal in complaining that the government should do more to stimulate economic performance. At a deeper level, however, the lack of confidence reflected a different aspect of Italy’s public indebtedness.

**Europe Asks for More**

The problem is that Italy is such a large player in sovereign debt markets. The total volume of long-term outstanding Italian public debt is more than 1.5 trillion euros, and the amount that must be redeemed from one year to the next is measured in the hundreds of millions of euros.\(^5\) When the short-term debt that matures in less than 12 months is added into the equation, the financial requirements for the Italian state stretch to 2 trillion euros. Thus, a crisis of confidence in Italian bond markets would have major consequences for the balance sheets of investors across Europe.

European Central Bank (ECB) President Jean-Claude Trichet and Bank of Italy Governor Mario Draghi wrote directly to Berlusconi on 5 August to express their concern that events seemed about to slide out of control. Reflecting on the deliberations of the ECB Governing Council, Trichet and Draghi called for a detailed set of reforms, the contents of which were kept secret from the public. Specifically, the central bankers called for the privatization of public services and the liberalization of professional services, a reform of collective bargaining at the firm level, and a thorough review of employment protection legislation. They also called for an acceleration of fiscal consolidation efforts, including a reform of public and private pensions and further reduction in public sector pay packets. Finally, they urged that local and regional governments be placed under stricter financial control, and they called for the introduction of an automatic fiscal adjustment mechanism at the national level. They also advised the government to make a sweeping reform of the public administration to make it less bureaucratic and more business friendly.\(^6\)
These recommendations were hardly new. The staff of the International Monetary Fund (IMF) generated a similar list of priorities as part of its annual consultations with the Italian government about the country’s macro-economic performance. Moreover, many of these issues are touched upon in the stabilization and development laws referred to above. Nevertheless, the central bankers regarded the recalibration of reforms as an important signal to the markets, and the ECB was willing to pay a high price to buy the time for Italy to make the necessary adjustments. Once Berlusconi acknowledged that he would take action, the ECB announced on 7 August that it would “actively implement” its program of buying distressed government bonds in secondary markets. As figure 7.2 reveals, the drop in bond yields both for Italy and Spain was precipitous.

The reform process proved to be both complicated and controversial. Consider the situation with pensions. Trichet and Draghi called for changes in the eligibility requirements that would require people not only to pay longer into the system, but also to attain a fixed age threshold. They also called for a more rapid realignment of pension requirements for women relative to men. As soon as the center-right coalition sketched new proposals to reform the pension system, Pierluigi Bersani, the leader of the Partito Democratico (PD, Democratic Party), charged that they were trying to use the elderly to fill the gap in the budget. Even proponents of change were critical. Confindustria leader Emma Marcegaglia said that while she recognized the logic in a pension reform that created greater equity across generations, she did not believe this was the right avenue to consolidate the fiscal accounts. The strongest complaints about pension reform came from within the coalition itself. Indeed, LN opposition was such that it was thought the party might even prefer to bring down the government.

Pensions were not the only focus for complaints. The proposal to raise value-added taxation from 20 to 21 percent was another point of conflict. In this case, it was Tremonti who put up the staunchest opposition—again from within the coalition. Tremonti’s concern was that such a tax increase would accelerate the pace of inflation. But Berlusconi and his allies countered that it would bring in much-needed revenue in a way that is hard to circumvent. In the end, the logic of that position won out, but only because the bond markets moved again.

Italian bond yields rose above their Spanish counterparts decisively on 29 August. From that point onward, Italy’s sovereign debt crisis was more country-specific than generic. Spain would obviously fall if Italy failed to service its debts. But that is true for the rest of the Eurozone as well. Hence the pressure on Italy to restore market confidence was
intense and increasing. This can be seen in figure 7.3, which shows the yield differential between Italy and Spain.

**The Ratings Agencies Take Action**

This change in market attitudes toward Italy was a by-product of domestic political conflict. In the run-up to September, the Berlusconi government produced four different consolidation packages, each with its own demerits. Meanwhile, the divisions within the Cabinet only deepened. Politics professor and commentator Angelo Panebianco attributes this to Berlusconi’s decision to hand over responsibility for the economy to Tremonti at the start of the coalition’s term in office in 2008. Having endowed Tremonti with nearly exclusive authority over economic matters, Berlusconi could not reassert himself once the crisis became apparent. The result was a collection of half-measures: ineffective liberalization, inadequate fiscal federalism, and a half-hearted fight against tax evasion.

**FIGURE 7.3 Italian-Spanish Long-Term Interest Rate Differentials**

Source: IHS Global Insight.
The ratings agencies offered a much more fundamental critique. On the night between 19 and 20 September, S&P cut the country’s long-term debt rating from A+ to A and its short-term debt rating from A-1+ to A-1. In doing so, S&P argued that the divisions within the government were exacerbating the weakness of the country’s growth prospects. And while it acknowledged that the coalition had made efforts to consolidate government accounts, S&P argued that the policies were unlikely to be implemented effectively and would soon be overtaken by events. The reason is that indecisiveness is endemic in Italy’s political institutions. The government is not the only source of inaction; vested interests working at all levels play an important part as well.

Berlusconi’s response to the ratings decision was to decry it as politically motivated and overly influenced by scandals covered in the media. In doing so, he challenged only the superficial critique. Few observers, either in Italy or elsewhere, were convinced. One obvious reason is the timing. Berlusconi has been beset by scandal throughout his premiership, and yet the bond markets only began to react in July. The problem was not scandal so much as a loss of confidence in Italian politics more generally. Voices began to press again, and this time much harder, for Italy to move forward with a broader reform agenda—one that tackled many of the same issues raised by Trichet and Draghi on 5 August. At the end of September, the newspapers even managed to publish the Trichet-Draghi letter, the contents of which had been previously kept secret.

Meanwhile, the relationship between Berlusconi and Tremonti continued to deteriorate. The conflict crystallized on the domestic front in the complex scandal deriving from the relationship between Tremonti and his former principal ally, Marco Milanese. This scandal is important primarily insofar as it tarnished Tremonti’s domestic reputation and rendered him vulnerable to attacks from within Berlusconi’s party, the Popolo della Libertà (PdL, People of Liberty). While Tremonti drew support from Umberto Bossi and his party, the Lega Nord (LN, Northern League), Milanese benefited from the patronage of Berlusconi.

The international dimension is also relevant. Tremonti enjoyed a relatively strong reputation with Italy’s major partners abroad, and he did not hesitate to use it for leverage in maintaining control over his economic portfolio. When there was speculation that Tremonti might be forced out in early July, bond traders were quick to express their concern for Italy’s stability and to argue that Tremonti should be allowed to stay in place. For his part, Berlusconi was aware that his position was made more vulnerable due to the strength of Tremonti’s
international reputation. As he put it: “There is a serious problem here. Tremonti is running around Europe saying that Italy’s credibility is worsening thanks to me, thanks to the changes that I made to the fiscal consolidation package. This is unacceptable. A minister who does not follow the line of his party, who does not tender his resignation after everything that has happened, creates an embarrassing situation. I only improved the package, and if he had listened to me in the first place, everything would have been different.” Yet while Berlusconi could complain about Tremonti, he could not dismiss him without provoking a crisis in the bond markets and the collapse of his coalition. Hence, Berlusconi’s only choice was to continue to work alongside Tremonti, knowing that it was obvious to everyone that they could not work together well.

The domestic and international dimensions of the conflict between Berlusconi and Tremonti came together on 22 September when Tremonti left for a G20 meeting in Washington just as the Chamber of Deputies was due to vote on whether to lift Milanese’s parliamentary immunity. The Chamber voted not to lift it, and yet Tremonti’s absence was still noted. La Repubblica repeated a familiar complaint among PdL parliamentarians in reference to Tremonti’s absence: “We are here to save his colleague, and he isn’t. It’s immoral.”

The tension within the Cabinet continued to mount through the end of September and into October. Meanwhile, Moody’s joined S&P on 4 October in cutting Italy’s credit rating. Again, the reasoning was the same. Italy not only lacked decisive leadership and clear growth prospects, but it also appeared poorly equipped to implement the policies that the Berlusconi government had adopted. Disagreements over how best to move forward with a decree on growth and development only proved the point. So long as Berlusconi and Tremonti held different views on economic policy, government action remained on standby.

A routine vote to approve the 2010 financial accounts on 11 October proved to be the breaking point. Although Tremonti was in the Chamber, he did not cast a ballot, and the government narrowly failed to achieve a majority. This was symbolically important. Since a no confidence motion was not attached to the vote, the coalition did not fall. But it did appear unable to govern. President Napolitano immediately issued a declaration saying that Berlusconi should either demonstrate a workable majority or look to broaden the coalition, and he called upon the prime minister to offer a credible response. Berlusconi scheduled a confidence vote for 14 October, which he won in the Chamber of Deputies with an absolute majority of 316 votes.
Credibility Lost

With hindsight, it could be argued the next two weeks were the most important in Berlusconi’s prime ministership because they showed just how exhausted his coalition had become. The first challenge was to conclude negotiations on the stability legislation in order to shore up support across the various ministries. Specifically, this entailed finding money that had been cut from the budget of the Ministry of the Environment, but it also brought resources to other areas such as defense and security.

Then, on 15 October, a peaceful protest in Rome turned into a violent rampage. The protest was part of the “We Are the 99 Percent” movement, which started in the United States with “Occupy Wall Street” and in Spain with the “Indignados.” The demonstration started without trouble, but soon descended into chaos. The destruction wrought on the capital city by a small band of extremists over a substantial part of the day was the main story in the media. It suggested a return of left-wing political violence (a point later picked up by PdL Social Affairs Minister Maurizio Sacconi), and it called into question the competence of the Rome authorities. Nevertheless, the acts of violence should not be allowed to obscure the grievances that brought the protesters out in the first place—slow growth, persistent unemployment, and rising income inequality.

“We are the 99 percent” was not the only group to put pressure on the government over these issues. The combined leadership of the business community also wanted more action to support growth. Writing jointly on 18 October, representatives from across the industrial community insisted that “the situation is ever more difficult, faith in our country is diminishing quickly despite Italy’s undeniable strengths and the results obtained … It is therefore of fundamental importance that the development legislation contain structural measures that are concrete and credible and that give a clear signal of a change of course. Otherwise, the risk is that all the efforts made to control public expenditure to date will have been undertaken in vain.” The business leaders also warned that “time is up.” The Berlusconi government had to act quickly and decisively in order to restore confidence in the markets.

This refrain was rehearsed by French President Nicolas Sarkozy and German Chancellor Angela Merkel during the run-up to the emergency European Council summit of 23 October. For his part, Berlusconi could respond only that “we are trying to come up with something” and “there is no money.” As it turns out, Berlusconi was true to his word. The preliminary list of proposals included measures such as the
introduction of electronic bus tickets, the wider use of the Internet in education to submit medical certificates of absence and to receive grades, government underwriting for first-time mortgages and natural disaster insurance, and earlier retirement for university professors, in addition to the usual promises of increased investment in infrastructure and reduced government regulation of firms.

The problem was to reconcile the requirements for the development package with the constraints of the stability legislation. Italy was hardly alone in facing the trade-off between growth and austerity, but it was uniquely unable to squeeze out a clear decision favoring one side or the other. As a result, Berlusconi left for the European Council summit on 23 October without a clear set of reform measures. The PdL’s leader, Angelino Alfano, attributed this failing to the complexity of the underlying problem: “You cannot do development by decree.” For his part, Berlusconi complained about the bureaucratic rigidity of the Italian state: “As prime minister, I don’t even have the power to change a minister. If I wanted to substitute someone—let’s just choose a name at random, say, Tremonti—I couldn’t even do that.”

The problem with Berlusconi’s statement was that it played into the diagnosis made by the ratings agencies, further undermining confidence in the Italian state. If a prime minister cannot even manage his own Cabinet, he has no credibility with regard to managing his country. Berlusconi evidently recognized the danger of emphasizing his own powerlessness and so raised expectations for the coming week. He explained how he had reassured Chancellor Merkel about his determination to push through a comprehensive package on growth promotion while at the same time safeguarding the country’s debt. However, when Merkel and Sarkozy were asked whether they had confidence in Berlusconi’s capacity to deliver on his promises, the two leaders looked at one another, hesitated, and chuckled.

This is a clear case where Berlusconi’s personal issues clouded Italy’s international reputation. In fact, the difficulties Berlusconi encountered in negotiating further reforms were not so different from those faced elsewhere. This is important to recognize, not in order to excuse or ignore Berlusconi’s excesses, but rather to qualify any sense of optimism associated with Berlusconi’s subsequent departure from office.

Pension reform lay at the heart of the matter because money saved on pensions could be redeployed to stimulate growth. Confindustria leader Marcegaglia made this point explicitly, as did the leaders of France and Germany. Moreover, Berlusconi agreed. Nonetheless, Bossi and the LN still refused to budge. Berlusconi called for everyone to qualify for a pension at 67 years of age; Bossi said “no.”
This refusal deprived Berlusconi of a key measure in his reform package. As he went to the special European Council summit on 26 October, he took a 14-page letter of intentions instead. Much of the letter explained what the Berlusconi government had already accomplished to promote human capital, increase the flexibility of labor markets, improve competitiveness, lighten regulation, and so on. But the letter offered few details on what the government expected to achieve. It offered short-term milestones at two-month increments, with aspirations attached to each over an eight-month perspective. But some of these goals—such as taking decisive action to tackle the North-South divide over the following four months—seemed overly ambitious, while others—like redefining the institutional context to favor firms—seemed overly vague. The letter explained that the details would be worked out by 15 November 2011.

The European leaders accepted this expression of intentions, but the markets did not. When Italy went into the markets to auction a new 10-year bond on 28 October, it found little demand for its paper, and the spread between Italian and German long-term government bonds widened sharply. The Berlusconi government had received its economic vote of no confidence.

The Fall of Berlusconi

Berlusconi’s response to the market reaction was to make two claims, neither of which provided much reassurance to the markets. First, he argued that there was no alternative to his government. If true, this assertion offered little hope that Italy would soon turn around. Second, Berlusconi decided to blame the whole crisis on the euro, “which has never convinced anyone as a currency” and so was susceptible to international speculative attacks, thus making it difficult for countries to roll over their public debts. This comment raised a specter of a different sort—that Berlusconi would use popular resentment toward the euro in order to deflect attention away from his government and focus it on the center-left, which had brought Italy into the single currency in the first place. The political response was immediate, and Berlusconi had to take back his comments with an official declaration of support for the euro, which he called “our currency, our flag.” Nevertheless, he refused to retract his charge that the euro is vulnerable to speculative attack and went further by pointing out that “it is precisely in order to defend the euro from a speculative attack that Italy is making such heavy sacrifices.”

This debate about the role of the euro in the Italian sovereign debt crisis played a part in the worsening of Italian bond prices on
31 October. Nevertheless, it was soon overwhelmed by Greek Prime Minister George Papandreou’s decision to call a referendum on the austerity measures being introduced as part of the second Greek bailout package. That decision was announced on 1 November, just days before the G20 summit in Cannes, and it threatened not only to derail the Greek bailout but possibly even to force Greece out of the Eurozone. Given the weakness of the market for Italian bonds, this only intensified the pressure on the Italian government. The spread of Italian 10-year bonds over their German counterparts jumped by 33 basis points or one-third of 1 percent. While Berlusconi tried to pull his coalition together to come up with yet another round of stabilization measures, Napolitano issued a statement on 1 November to indicate that he would play a personal role in monitoring the government’s implementation of the commitments made to the European Council in the 14-page letter of intentions.

Although the bond yields eased slightly after the Greek referendum announcement shock, the pressure continued to mount. On 3 November 2011, the European Financial Stability Facility announced that it would delay its bond issue rather than try to raise funds in such a volatile market. This suggested that the European Union (EU) might not be able to live up to the promises it had made in late October. Napolitano stepped back into the fray that same day, this time at both the European and national level. In a strongly worded statement, he made it clear that he would no longer tolerate the political deadlock over reform. Either the government would have to show the capacity to undertake decisive action, or a broader coalition of social forces would have to be brought into play.

This was still not enough to break the logjam within the center-right government. Berlusconi’s coalition partners in the League refused to make any further concessions, and the prime minister’s advisers had run out of new ideas. Hence, Berlusconi went to the G20 summit empty-handed—but he was not alone. The assembled world leaders also had few ideas about how to resolve the situation. They could cajole Papandreou into reversing his decision to call a referendum, but little more. As for Berlusconi, he pointedly turned down the offer of financial assistance from the IMF but then invited the IMF to play a role in overseeing Italy’s fiscal consolidation measures and related reforms.

The effects of the pressure were evident. At the close of the G20 summit, Berlusconi and Tremonti gave a joint press conference at which their performance was remarkable for its bluntness. The two traded barbs with each other and with individual journalists. Then Berlusconi began his denials: Italy is not a weak economy, “the restaurants are full.” He also trotted out his criticism of the euro again. This time he was careful to focus attention on conversion rates and
exchange rates, rather than the euro as a currency. Nevertheless, he clearly intended to blame the crisis on the center-left coalition that had brought Italy into the euro in the late 1990s.20

Italy’s failure at the G20 robbed Berlusconi of his last source of hope. Soon thereafter, his principal advisers warned him that he had lost his majority. No matter what he might offer or threaten, he could not hold on to the votes. The crucial moment came when the Chamber of Deputies revised the same financial accounts legislation that had tripped up Berlusconi’s coalition on 11 October. If he failed to achieve an absolute majority of 316 votes in favor, he would inevitably face a no confidence vote. The issue came before the Chamber on 8 November, and while the measure passed with a simple majority of those present, Berlusconi’s coalition succeeded in marshalling just 308 votes.

What followed was a tense period of negotiation and uncertainty. Berlusconi agreed to resign as prime minister, but only after his coalition passed the amendments to the stability legislation that he had promised at the European Council in late October. This raised questions about how long it would take and what would come after. The bond markets would not patiently wait for clear answers. Despite heavy purchases by the ECB, Italian government bonds looked set for a rout. At least part of the problem was institutional. Once the price of Italian bonds falls low enough, they become less useful as collateral and so more expensive for investors to hold. Thus, the longer the crisis dragged on, the more likely it was that the gap between Italian and German bonds would become permanent.

The threshold was breached on 9 November when one of the major clearing houses, LCH Clearnet, announced that it would be increasing the cost of using Italian sovereign debt as collateral. This caused an immediate spike in long-term Italian interest rates and in the corresponding differential between Italy and Germany. This can be seen in figure 7.4, which provides the Italian yield differential with Germany from mid-October through the end of the year. The low point comes on 27 October just before the Italian government went back into the market on 28 October. The immediate response to the LCH Clearnet decision is the high point.

The rest of Berlusconi’s fall is the denouement, albeit filled with moments of extreme tension. Napolitano stepped in to insist that Parliament consider the stability legislation right away, with voting to take place in the Senate on 11 November and in the Chamber of Deputies on 12 November. This way, Berlusconi could resign and the political impasse could be resolved before the markets opened again on 14 November. This scenario went as planned. Moreover, at each step in the process, the cost of Italian borrowing receded.
Despite a temporary easing in the spread, the installation of a technical government under Monti did not prove sufficient to restore market confidence. Monti and his team quickly tackled an ambitious reform agenda, which included a raft of measures to increase taxes, cut spending, reform pensions, and liberalize professional services. Nevertheless, the impact on bond prices was not lasting. The long-term yield differential between Italy and Germany fell in early December but then surged again toward the end of the year. Auctions held in the last week of the month showed renewed interest in Italian short-term debt but little enthusiasm for obligations longer than five years. The government went into the market on 29 December looking to raise up to 8.5 billion euros. However, it only managed to place 7 billion euros at yields very close to the 7 percent threshold that analysts consider unsustainable. The next day, which was the last trading day for 2011, the yield differential between Italy and Germany rose to 508 basis points.

Neither the EU nor the ECB is going to solve Italy’s problem. Although Monti is popular with other European leaders, including those at the EU level, they remain divided about how best to respond to
the crisis. Such divisions only heighten the sense of uncertainty in the markets, making Monti’s task of restoring confidence all the more difficult. Meanwhile, the ECB under Draghi has reiterated that it cannot buy an unlimited quantity of Italian bonds. Draghi appeared to put a floor on bond prices in his 1 December remarks to the European Parliament, but he made it quite clear during his press conference seven days later that the ECB could not purchase sovereign debt indefinitely. The spread between Italian and German bonds fell to a low of 372 basis points (on 5 December) between the two speeches.

Monti clearly recognizes the scale of the challenge. Once confidence is lost in the markets, it is very difficult to regain. This is due partly to market psychology and partly also to inertia. Much of Italy’s domestic savings went abroad during the crisis as Italian investors looked to find a safe haven.\(^{21}\) If the Italian economy looked very different from the other peripheral Eurozone countries at the start of July, it resembled them more closely by October and November. Hence, the government’s first hurdle is to convince Italian investors to bring their money back home. So far, they have proved reluctant to do so, and international investors are unwilling to fill the gap.

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**Notes**

1. These data are from Global Insight and can be seen in figure 7.2.
13. Ibid.
15. For the Alfano citation, see M. Franco, “Premier certo di durare ma non c’è il decreto da presentare all’Europa,” *Corriere della Sera*, 22 October 2011; for the Berlusconi citation, see F. Vederami, “Il premier: Pronto a reagire con durezza,” *Corriere della Sera*, 22 October 2011.