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PAGE 11 | CULTURE

20

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After rescue for Spain, focus turns to Italy's risks

VENICE

Rome fears a contagion amid doubts over Monti's ability to engineer change

BY LIZ ALDERMAN AND ELISABETTA POVOLEDO

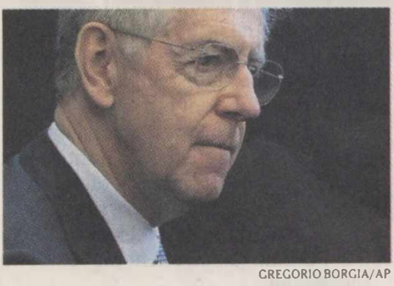
As Spain became the fourth euro zone country to accept an international bailout, investors turned their nervous gaze Monday to Italy, selling Italian stocks and bonds on worries that Rome could be the next victim of Europe's financial infection.

Italian officials are now privately expressing concern that even a €100 billion, or $125 billion, bailout for Spanish banks may not stop the troubles from spreading.

"It seems likely that the risk of contagion to Italy may become real, especially if the situation worsens in Spain and Greece," said one official who spoke anonymously, citing the sensitivity of the situation. "It's very worrisome."

Even the Italian prime minister, Mario Monti, the vaunted European technocrat who came to office in an emergency after the euro crisis forced out Silvio Berlusconi last November, has begun to acknowledge the dangers posed to his country's too-big-to-fail €1.56 trillion, or $1.95 trillion, economy. The big fear is that Italy cannot grow its way out of a recession fast enough to pay a mountainous national debt.

"There is a permanent risk of contagion," Mr. Monti told an economics conference near Venice over the weekend, speaking by telephone. "That is why



GREGORIO BORGIA/AP

"There is a permanent risk of contagion," Prime Minister Mario Monti of Italy said.

strengthening the euro zone is of collective interest."

Investor euphoria over the Spanish bailout deal Monday morning was short-lived, giving way to an essentially flat day on many European stock markets. But Italy's benchmark index was the Continent's worst performer, ending down 2.8 percent.

Italian 10-year government bonds dropped in value for a fourth straight trading session. The yield — a measure of the government's borrowing costs and of investors' perception of risk — climbed 0.26 percentage point Monday to just over 6 percent, and at one point reached 6.03 percent, the highest level

ITALY, PAGE 16

BANK AID FAILS TO REASSURE MARKETS
Investors sold Spanish and Italian stocks and bonds amid skepticism that the euro crisis was [illegible] n. *PAGE 15*

Contagion fear shifts to Italy after Spanish rescue

ITALY, FROM PAGE 1

since January.

"There's no doubt contagion will come to Italy," Daniele Sottile, a managing partner at the financial advisors Vitale & Associati in Milan, said at the same conference that Mr. Monti addressed. "It's proof that the European mechanisms designed to stop the crisis are not working."

Sergio Marchionne, the chief executive of Fiat and Chrysler, was more blunt at the conference, which was convened by the Council for the United States and Italy on an island near Venice. "Somebody better do something before we get to the point of no return," he said.

Mr. Monti, a former European commissioner for internal markets and for competition, has a reputation as a savvy leader trusted by international officials. But he faces a host of problems at home.

The pressing issues include the fact that Italy, with the third-largest European economy, after those of Germany and France, will have to shoulder a large portion of the bailout bill, even as Rome grapples with its own sharp economic downturn.

Because Italy does not have enough economic growth to generate the money itself, the government will have to borrow it at high interest rates, adding to an already heaving debt load.

Few question Mr. Monti's competence: Within the first six weeks of coming to power, he managed to pass more economic measures than Italy had seen in a decade, including increasing the retirement age, raising property taxes, simplifying the operation of government agencies and going after tax evaders. And still pending is his legislative slate of economic changes meant to revitalize growth, including an effort to overhaul Italy's notoriously inflexible labor rules.

But his government is also shackled by the legacy of decades of political unwillingness to make painful changes.

As a result, "market attention looks set to shift to Italy," Commerzbank analysts wrote Monday in a note to clients. Combined with weak growth, they said, the difficulties Mr. Monti faces in getting lawmakers to implement economic change means "it may be just a matter of time before Italy also seeks help."

In fact, Mr. Monti faces daunting, perhaps insurmountable, obstacles embedded in the very fabric of Italian politics and society.

ALESSIA PIERDOMENICO/BLOOMBERG NEWS

Window shopping in Rome. Analysts at Commerzbank warned Monday that "it may be just a matter of time before Italy also seeks help."

As he fields frequent euro crisis phone calls from President Barack Obama and Chancellor Angela Merkel, he is under mounting criticism within his own country. Italy's dominant political parties, the center-right People of Liberty and the center-left Democratic Party, are participating in Mr. Monti's government, but are terrified of being too closely associated with the tough measures he has already put in place and the others he is still pushing for. Some opposition parties have been pressing for new elections to be held before Mr. Monti's term ends in 2013.

And so it has become a political paradox for Mr. Monti's government: Even as he has been one of the euro zone's loudest opponents of the economic austerity long advocated by northern-tier countries like Germany, his opponents at home attack his domestic economic proposals as too austere.

Since he came to power, the Italian economy — like most of Europe's — has grown weaker, expected to contract 1.5 percent this year and increase just 0.5 percent in 2013. Italian banks have sharply curtailed lending, pushing thousands of small and midsize Italian businesses into bankruptcy.

The country's unemployment rate has rapidly marched above 10 percent, well above Germany's 5.4 percent, according to Eurostat, the European Union's statistical agency.

The government debt, already at 120 percent of gross domestic product, will almost certainly continue to rise, especially if Italy must foot a larger portion of the bill for shoring up the monetary union. Beyond the bailout of Spain, few can predict how things will play out for the region, if Greece takes a step toward the euro zone exit in next weekend's elections.

In many respects Italy is still better off than Spain and the three other bailout recipients — Greece, Ireland and Portugal. The current annual budget deficit has shrunk to 2.8 percent of G.D.P., which is down from 4.2 percent a year earlier and below the 3 percent level required by the euro union's membership rules.

It has Europe's second-largest manufacturing and industrial base, after Germany's, and is one of the biggest export-oriented economies in the euro zone. "Made in Italy" is still a brand asset the world over, led by icons like Ferrari cars, Gucci handbags and Ducati motorcycles. The country is also filled with state-owned assets like power companies and the national postal service that could bring in billions of euros should the government manage to privatize them to raise money.

Despite recent downgrades by the rating agency Moody's Investors Service, Italian banks are relatively sound — at least compared with Spain's — because they are not saddled with bad debts from a real estate bubble. And even though the Italian government issues more bonds than any other euro zone country, the Italian public owns about half that debt, meaning the banks are less vulnerable to fluctuations in the bonds' value than banks in Spain, which are heavily invested in their government's risky bonds.

Even so, deposits have been fleeing Italian banks for havens in Switzerland, according to several bankers at the weekend conference, on concern that Mr. Monti will raise taxes for the wealthy and as a hedge if the euro zone economy takes a turn for the worst.

Contagion is as much about fear as economic fundamentals, which is why if Mr. Monti cannot muster the political backing soon to push through his changes, there is a widespread assumption that the crisis will quickly breach Italy's borders.

"Monti has a good agenda, and has clear in his mind what should be done for Italy," said Cinzia Alcidi, a research fellow at the Center for European Policy Studies in Brussels. But his approach is that of a technocrat, "and when it is confronted with political and social reality, that makes things more difficult."

Ferruccio de Bortoli, the editor of the Corriere della Sera newspaper, said Mr. Monti would have a tough time getting changes implemented by a caste of civil servants who were installed in key government positions long before he got there, and will remain long after he leaves. Many of these officials are out to protect their own fiefs and privileges, Mr. de Bortoli said.

Across Italy's political spectrum, support for Mr. Monti has been tepid at best. But many observers agree that any attempt to hold early elections would be disastrous, blocking Mr. Monti's efforts at change and thrusting Italy back into political mayhem. It is unlikely that any other party or coalition would receive enough support to govern comfortably.

"The good news" said Sergio Fabbrini, director of the school of government at Luiss Guido Carli University in Rome, is that Italy has veered away from becoming a "failed state in Europe" because of Mr. Monti.

The bad news, he said, is that Italy's embedded politicians have still not acknowledged the reasons for Italy's problems. "And when the quality of the political elite is as low as it is in Italy, or in Greece, it is difficult to create the structural conditions for growth."

Elisabetta Povoledo reported from Rome.

Markets skeptical Spanish bailout will help ease euro crisis

MARKETS, FROM PAGE 15

Wall Street seemed unimpressed, with the Standard & Poor's 500-stock index down 0.4 percent in midafternoon trading in New York.

A key consideration in the Spanish bank rescue is how investors will judge the Spanish government's solvency if it is required to add €100 billion of debt guarantees to its already strapped finances. Nor is it yet known just how much money will be needed, though the answer to that question should be clearer on June 21, when the government receives the results of audits conducted by two consulting firms.

Another open question is whether the funds will come from the European Stability Mechanism, the permanent bailout fund that is supposed to begin operating in July, or the European Financial Stability Facility, the existing bailout fund.

If the E.F.S.F. is the vehicle, Finland has demanded that Spain offer collateral. That is not an issue with the E.S.M., assuming it begins operations as planned, because the loans it offers are senior to other debt.

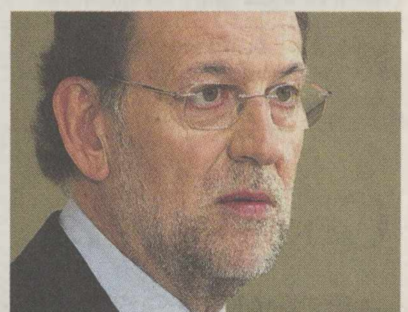
The Spanish Economy Ministry said Monday that the aid would not undermine Spain's public debt, and would, in fact, "reinforce its overall solvency."

That could prove wishful thinking, however, as it was Spain's shaky performance in those auctions that led the government and European officials to get serious about working out a rescue in the first place. Investors and officials will be carefully watching Spain's bond yields over the coming week.

Gilles Moëc, an economist at Deutsche Bank in London, wrote in a note that the fate of the bailout would depend on the ability of the Spanish government "to reduce its deficits at a pace that remains acceptable to Spain's E.U. partners, fast enough to rebuild credibility in the market, but also gradual enough not to send the economy in a recession spiral."

Spain's prime minister, Mariano Rajoy, has sought to characterize the rescue funds as a simple line of credit, rather than the type of bailout that Ireland, Portugal and Greece have received.

In recent weeks, in fact, Mr. Rajoy had sought to have funds injected directly into the banks without the government having to act as middleman, a move he had hoped would have allowed it to keep the assistance off its balance sheet. But other European leaders made clear Monday that they planned to carefully monitor the bank rescue.



ANGEL NAVARRETE/BLOOMBERG

Mariano Rajoy has characterized Spain's bank rescue funds as a simple line of credit.

Joaquín Almunia, the European competition commissioner, told Cadena Ser radio on Monday that the International Monetary Fund, European Union and the European Central Bank — the so-called troika that has managed the other bailouts — would be managing the rescue process.

And Wolfgang Schäuble, the German finance minister, said there would be "just such a troika and it will monitor in exactly the same way that the program is complied with, but it is limited to the restructuring of the banking sector."

Spain, he added, "doesn't need" the macroeconomic supervision Portugal, Ireland and Greece required. But, Mr. Schäuble said, "the restructuring of the Spanish banking sector has to be negotiated in detail and will be supervised in the same way that they abide by it."

Fitch Ratings, which last week cut its grade on Spanish debt by three steps, to BBB from A, on Monday welcomed the bailout plan, saying it "covers a housing market collapse on a par with that seen in Ireland and is at the extreme end of Fitch Ratings' stress estimates."

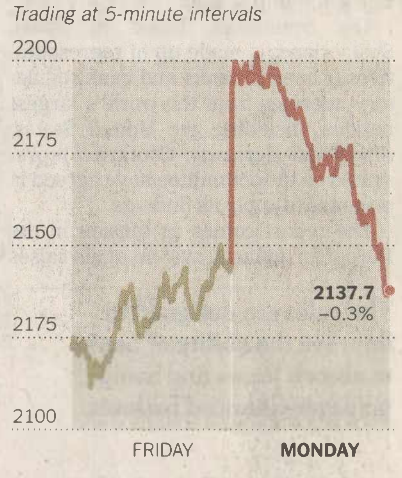
Nicholas Kulish contributed reporting from Berlin, Raphael Minder from Madrid and Bettina Wassener from Hong Kong.

Sweet, but short

Stocks in Europe rallied Monday on news of a bailout for Spanish banks. But by the end of trading, most indexes, including this broad measure of euro zone stocks, had given up their gains.

Euro Stoxx 50 index

Trading at 5-minute intervals



Source: Bloomberg