**With Italy stagnant, it’s time for drastic Euro intervention**

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The European Central Bank needs to start buying more bonds from Eurozone countries. Images\_of\_Money

The departure of Silvio Berlusconi does not seem to have eased the pressure on Italy, with reports suggesting the International Monetary Fund is reading a 600 billion euro [emergency bailout](http://www.bloomberg.com/news/2011-11-27/imf-readying-600-billion-euro-loan-offer-for-italy-stampa-says.html) for the Eurozone’s third-biggest economy.

Meanwhile, the condition of Italy’s economy look rather grim. The [spread](http://www.ehow.com/about_4688172_what-bond-spread.html) between Italian and German 10-year bonds was 4.97% on November 8, when Berlusconi lost the absolute majority in a parliamentary vote and announced his intention to resign. The day after, the spread hit 5.53% and was still 4.92% in the aftermath of Berlusconi’s actual resignation, on November 14.

New Prime Minister Mario Monti, an internationally reputed economics professor, was appointed on November 16, when the spread hit 5.19 percentage points. He quickly formed a technocratic cabinet consisting of academic and professional economists and bankers of high profile and credibility. Still, the spread on November 25 was still 5% points.

The stock market also failed to display any significant positive response to the end of the Berlusconi era. In fact, the FTSE MIB index of Italian securities has decreased by a cumulative 10% since November 8. Given that the resignation of Berlusconi was welcomed by many in Italy (and in Europe) with relief, these figures might well be regarded as “disturbing”.



New Italian PM Mario Monti. AAP

**Unresolved domestic issues**

Whether or not Berlusconi is a scapegoat, his resignation was inevitable. His once-large majority in the parliament was rapidly vanishing and both markets and European partners no longer believed that his government would be able to take the actions needed to address the crisis.

Nevertheless, it should be clear that the debt crisis arises from structural weaknesses that are not just Berlusconi’s fault. The debt-to-GDP ratio in Italy has been very high since the early 1980s, when government expenditure was used as a tool to maintain cohesion within the ruling coalition centred around the Christian Democratic Party and at the same time to achieve a compromise with the Communist-led opposition.

The Italian economy has been stagnant for more than a decade. Neither Berlusconi’s centre-right governments nor the centre-left governments, which ruled Italy for seven of the last 15 years, have been able to implement those economic reforms needed to revitalise growth. The roots of Italian problems go well beyond Silvio Berlusconi’s responsibilities, so nobody could have reasonably expected that his simple removal from office would have suddenly made things better.

There was however the expectation that Monti’s technical government could hinge on its widespread consensus, credibility, and strong backing from the President of the Republic to act quickly to restore confidence and alleviate some of the pressure on the Italian debt.

However, this effect has failed to materialise so far, possibly because Mario Monti, after a quick start with the formation of the cabinet, has not yet been able to present any significant austerity plan or economic reforms. In this regard, attention is now focused on the next cabinet meeting, which will take place on December 5.

It is expected that the core of the budget measures and some crucial reforms will be announced at this meeting. This will be a first important test for the new government in its fight against the crisis.

**The fall of Europe**

Monti’s task appears to be even more crucial when set within the context of the current European economic turmoil. The troubles of the fiscal pariahs of the EU are being transmitted to the champions of fiscal parsimony and threaten the stability of the European monetary arrangements.

The [failure of a German bond auction](http://www.reuters.com/article/2011/11/23/us-markets-bonds-bunds-idUSTRE7AM0Y920111123) on November 23 and the upsurge in Austrian bond yields are just two signs of the growing fears of contagion and uncertainties surrounding the future of the common currency.

Not surprisingly, the top authorities in Brussels continue to describe the situation as very serious. However, what probably matters the most today is not much what they think in Brussels, but rather what they think (and do) in Frankfurt.

Concerned with the inflationary pressure and moral hazard that lending of last resort could trigger, the European Central Bank (ECB) has so far offered only strictly limited help to its most strained member states. **This behaviour responds to an interpretation of the ECB mandate which, in the current situation, might be too conservative.**

Certainly, it is the fiscal profligacy of several member states that has brought the Eurozone on the verge of the collapse. Blaming the euro for the debt crisis in Italy, Spain, Greece or other countries would mean reversing the causality: the home grown problems in member states are weakening the common currency and not vice-versa. In this sense, nobody would deny that the primary effort to overcome the crisis must be produced by national governments through the implementation of austerity measures and economic reforms.

Nonetheless, the depth of the crisis appears to be such that the ECB ought to back the effort of member states with massive purchases of national bonds. This type of intervention should mostly concern the debt stock of countries that are solvent (Italy in particular, but also Spain) and be aimed at reducing spreads and yields to a pre-determined, publicly announced level.

Someone, especially in Berlin, might object that this would be a violation of the independence of the ECB and that it would ultimately compromise ECB’s ability to achieve its price stability goal. But this argument fails to recognise that the greatest menace to price stability today comes from the debt crisis itself.

The speculative attacks against the debt of some member states are disrupting the monetary policy transmission mechanism across the Eurozone. In these conditions, the ECB is very unlikely to be able to run a common monetary policy that can effectively guarantee price stability in the Eurozone.

Perhaps more importantly, the worsening of the crisis would prompt greater price volatility. There would be risks of deflation associated with the recession that would inevitably hit Europe in 2012, but also risks of accelerating inflation arising from the loss of value of the Euro on the international market.

Above all, failure to stop the crisis might lead to the implosion of the monetary union and the return to national currencies, with potentially large inflationary effects in many countries. These are hardly desirable outcomes from the point of view of ECB.

In this context, large-scale bond-buying is likely to be more conducive to the objective of price stability than the conservative approach adopted so far. That is, by intervening more strongly in support of its solvent member states, the ECB would not compromise its independence and give up its primary goal, but instead it would fulfil its mandate.

A time will come, after surviving the peak of the crisis, to introduce reforms to the European economic institutions. These reforms might include the strengthening of fiscal integration, for instance by providing the European Commission with more power over national budgetary policies and or by allowing the issue of jointly guaranteed Eurobonds, and even a review of the role of ECB.

But in the immediate, the ECB should purchase bonds to a much greater extent than what it has done until now. And it should do that in the very interest of price stability.