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A Good Start for Mario Monti

di Hugo Dixon

Mario Monti's ability to take a crisis and turn it into an opportunity may one day be taught as a case study in political economy. When Italy's technocratic premier succeeded Silvio Berlusconi last November, the country's 10-year bond yield was above the 7 percent level that had driven Greece, Ireland and Portugal to seek bailouts. Now it is 5.6 percent — still high but moving in the right direction.

Countries with high debt levels like Italy — its borrowing is 120 percent of G.D.P. — are prone to self-fulfilling prophecies on both the upside and the downside. If investors think a government will go bust, borrowing costs rise, which in turn makes bankruptcy more likely. But if markets think it is solvent, borrowing costs fall and that means it is unlikely to fail.

In Italy, where I spent much of last week, there have been spirals within spirals. One has been in domestic politics. Mr. Monti has so much credibility that he has been able to overhaul the pension system, liberalize a raft of monopolistic industries and begin a high-profile crackdown on tax evasion. That has helped cut Italian bond yields, further improving his credibility.

Another spiral has been in international politics. The prime minister's credibility was an important factor in persuading the European Central Bank to let euro zone banks borrow €500 billion, or $660 billion, before Christmas. Italy was the biggest beneficiary. Its banks are no longer staring into the abyss, with the result that the credit crunch that threatened to suffocate Italian industry is going to be less severe. Moreover, some of the E.C.B. money is finding its way into government bonds, lowering Rome's borrowing costs.

Mr. Monti's credibility has also helped persuade Chancellor Angela Merkel of Germany to ease up a bit on her austerity mantra. One consequence is that if Italy misses its target of a balanced budget next year, it is unlikely to be forced to tighten fiscal policy again — something that would risk sucking Italy into a Greek-style austerity spiral. President Barack Obama even complimented Mr. Monti during an audience last week, saying he had restored faith in Italy and generated confidence in Europe.

The contrast with the end of the Berlusconi era is stark. The then prime minister had little credibility at home and so was unable to push through changes. He was considered a naughty boy abroad and so was cut no slack. He was shunned by Mr. Obama, being left to hang around with the likes of Vladimir V. Putin of Russia and Col. Muammar el-Qaddafi of Libya. And rising bond yields pushed the country and its banking system to the brink, while tipping the economy into its current recession.

But Mr. Monti cannot declare victory. Yields are still high. The economy is forecast by the International Monetary Fund to shrink 2.2 percent this year. And the debt has not gone away. This makes the country vulnerable to shocks like a blow-up in Greece.

While there is little Mr. Monti can do about short-term growth, he can get yields down further with three more measures: labor changes; a structural overhaul in taxes and spending; and privatization. Such measures will not have an immediate effect on productivity. But they would further enhance credibility and so cut Italy's borrowing costs, giving further rapid twists to the virtuous spiral.

Mr. Monti is well on the way to tackling the labor market, with measures to make it easier to hire and fire people. He should also find it surprisingly easy to push these through, given that his trust rating with the electorate is at an extremely high 57 percent, according to the Italian pollsters SWG. Even the radical pension overhaul, which increased retirement ages and cut benefits, provoked only a three-hour strike.

The new government has been more circumspect about fiscal changes. Here what is required is to cut waste and recycle the savings into lower taxes on employment. Similarly, Mr. Monti has not committed himself to privatization. Given that the state has assets worth more than €1 trillion, it should be possible to sell off large chunks in a multiyear program to cut the country's debt well below 100 percent of G.D.P.

But the most fundamental change Mr. Monti could help engineer is in Italy's self-serving culture, where rules are not observed and cheating is given a nod and a wink. Mr. Berlusconi made that worse by going soft on tax evasion (which is estimated to cost €120 billion, or nearly 8 percent of G.D.P., each year), by using Parliament as a tool of his personal interests and through his long-running battles with the judiciary.

Mr. Monti, by contrast, has started to change the discourse of politics. He is sober, not flamboyant — and comes across as honest. His crackdown on tax cheats has also created a stir. But he has pledged to resign after the general election next year, meaning he has little time to bring about cultural changes.

The good news is that the people are thoroughly fed up with the current crop of politicians, who have an extraordinarily low trust rating of 12 percent, according to SWG. That means there is a chance that new politicians could come in to fill the vacuum. The bankrupt electoral system, which allows party bosses rather than the electorate to pick the MPs, may be altered. But there is no guarantee of a clean sweep. What is more, it seems unlikely that Mr. Monti's successor will be as good as he is — and it would be hard for the prime minister to stand for election himself without going back on his word and so undermining what he stands for. Still, he has made a remarkable start.