Financial Crisis Costs Job of Italy's Longtime Leader

By ALESSANDRA GALLONI And STACY MEICHTRY

ROME—Italian Prime Minister Silvio Berlusconi pledged to step down after Parliament approves austerity measures, as the euro-zone's third-largest economy tried to stave off the nightmare scenario of a bailout that would test the currency union.

A growing investor exodus from Italian bonds, spurred by the political crises in Italy and Greece, raises the stakes even further in the euro zone's two-year-old debt crisis. Yields on 10-year Italian bonds touched 6.73% on Tuesday, a high for the euro era, in a sign that investors are fast losing faith in the world's third-biggest sovereign bond market.

Mr. Berlusconi explained his exit from the scene—which he said would occur only after Parliament approves a budget bill that includes promised welfare spending cuts and changes to Italy's rigid labor laws—as a way to restore investors' faith in his country, which is struggling under a €1.9 trillion ($2.6 trillion) debt burden.

"The markets don't believe Italy is able to approve measures that Europe has asked of us," the premier said in a broadcasted phone call to an Italian evening newscast. "We have to show markets that we’re serious."

majority during a routine vote on budget matters, makes Italy's controversial leader—the nation's dominant political figure for nearly two decades—one of the highest-profile casualties of the financial crisis that has been ripping through Europe for the better part of two years.

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A lot is riding on the gambit. If Italy, the world’s eighth-largest economy, loses access to market funds, its partners likely wouldn’t have the political or financial firepower to bail it out. Such a huge financial strain on the euro zone—much greater than that of the previous rescues of Greece, Ireland and Portugal—has the potential to trigger a collapse of the single-currency project, with huge reverberations on the world’s financial system.

Over the past few months, Mr. Berlusconi has been seen as the main impediment to improving Italy’s finances because of infighting among his coalition members and a perceived unwillingness to undertake austerity measures that would alienate his electorate. As a result, Mr. Berlusconi’s exit could be seen as the start of a new wave of economic rigor.

Mr. Berlusconi’s pledge to step down, which came during afternoon trading in the U.S., boosted the euro against the dollar. The Dow Jones Industrial Average rose 101.79 points, or 0.8%, to 12170.18, its highest closing level of the month.

Fernando Napolitano, a board member of Italian energy giant Enel SpA, said he expects the euro crisis to finally force Italy’s ruling class to make long-overdue changes, such as slashing welfare entitlements and freeing up the labor code. "It’s time to tell the truth to Italians. No. 1: The party is over," said Mr. Napolitano.

Yet Tuesday’s developments could also set off months of uncertainty as the country’s political establishment decides whom to name as the head of an interim government—or whether to call early elections.

Opposition forces and recent defectors from Mr. Berlusconi’s political ranks are pushing Italian President Giorgio Napolitano—the official who will manage the transition period after the premier’s resignation—to form a national-unity government that can take the immediate steps needed to slash its debt pile.

Raffaele Lauro, a senator in Mr. Berlusconi’s party, said parliamentarians were likely to back an emergency government if Mr. Napolitano appointed a respected figure to helm it.

But Mr. Berlusconi and his lieutenants are likely to push for early elections, a move that would allow his party to regroup, plunging the country into months of political flux as Italy’s fractious political parties prepare to face voters.

"We’re more in favor of early elections," Education Minister Mariastella Gelmini said in an interview. She said she doubted Mr. Berlusconi would back a technical government, because his coalition partners are against the idea.

Whoever Mr. Berlusconi’s successor will be faces a huge challenge pushing through potentially painful austerity measures amid a lack of political and popular consensus. At the same time, if Italy’s borrowing costs keep rising, it may help a future leader push through any social or political gridlock.

"Everyone wants Berlusconi to leave," Sergio Romano, a former Italian ambassador and political commentator
said. "But are we sure that whoever comes next will be better able to resolve Italy's problems? I'm not sure the answer is yes."

A first sign of Italy's progress could come next week when Parliament sits down to begin approving the 2012 budget and the adjoining set of austerity measures aimed at breathing new life into Italy's economy, which has stagnated for a decade. Mr. Berlusconi has promised Italy's European partners and the European Central Bank that he would put together a bill including changes to Italy's labor laws, cuts to costly welfare entitlements and privatizations. Details of that bill are due to be unveiled on Wednesday, an official at Italy's Economy Ministry said.

Italy's opposition parties will be hard-pressed to vote against the austerity package that everyone realizes is a necessity for Italy to stick to its European commitments. As a result, Mr. Berlusconi is likely to be spared from a defeat in Parliament that would undercut his ability to push for his preferred option of early elections.

Mr. Berlusconi's plan to resign was announced after the prime minister held talks with Mr. Napolitano, Italy's head of state. Earlier Tuesday, Mr. Berlusconi's conservative government won a routine budget vote in the lower house of Parliament. But that victory came only thanks to abstentions by rival center-left lawmakers and a group of formerly faithful Berlusconi allies who defected. Mr. Berlusconi secured 308 votes in the 630-person chamber, clearly indicating that he no longer has the legislative backing he needs to govern.

At one point during the vote, Mr. Berlusconi was seen writing on a piece of paper on his desk. Close-up photos of the paper showed the words "Eight traitors" alongside scribbles of the words "Vote" and "Mutiny."

After huddling with advisers in Parliament, Mr. Berlusconi traveled across town to the office of Mr. Napolitano to discuss the future of his government. In a statement afterward, Mr. Napolitano's office said Mr. Berlusconi would step down after the government pushes its annual budget—including the economic overhaul—through both houses of Parliament. Passage of these measures was an "urgent necessity," the statement said.

"Once this duty is done, the premier will hand in his resignation."

—Giada Zampano, Liam Moloney and Matt Phillips contributed to this article.

Write to Alessandra Galloni at alessandra.galloni@wsj.com and Stacy Meichtry at stacy.meichtry@wsj.com