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Italy on the brink?

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It has become fashionable to identify Italy as the "sick man of Europe" and to indulge in catastrophic scenarios (the country defaults on its debt, leaves the eurozone; etc.). This tendency has arisen because most observers do not look beyond the headlines which suggest that the country has three main weak points:

1. Public finance
2. Loss of competitiveness
3. Unwillingness to reform

On all three fronts, however, a closer look reveals that the problem, while serious, is not so severe as to justify the catastrophic scenarios often brandished about.

1. Public finance

The key weakness here is that Italy has a high public debt/GDP ratio. In terms of the deficit the record is actually not that bad in the sense that Italy's fiscal deficit has over the last years been rather similar to that of France or Germany (the average for all three large eurozone countries is between 3 and 3.5% of GDP over the years 2001-06).

How serious is the higher debt level? Italy's public debt/GDP ratio is now just below 110%, around 50 percentage points above the Maastricht reference value of 60% of GDP. This represents certainly a burden for fiscal policy, but it is manageable in the current low interest rate environment. With nominal interest rates around 4% the higher debt level requires higher tax revenues of just 2% of GDP to achieve the same deficit as in a country with the same expenditure but a debt level of 60% of GDP. Given that the overall ratio of public sector revenues to GDP is anyway around 50% of GDP in most member countries this additional burden of 2% of GDP should be manageable. France, with a much lower debt ratio (below 70% of GDP) has a much higher ratio of taxes to GDP.

The danger of shorter term difficulties to refinance public debt at reasonable rates seems also limited give that most of the Italian public debt is now in instruments with long maturities. The yield spreads compared to Germany have remained consistently very low, indicating that financial markets to not perceive a serious risk of default.

2. Loss of competitiveness

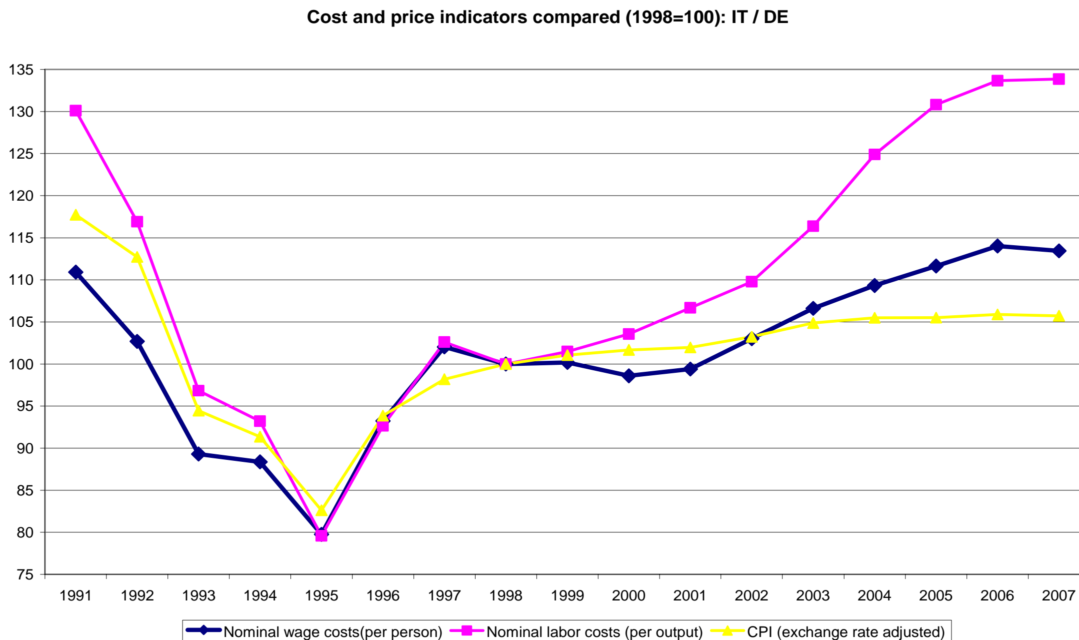
The one weakness most often mentioned of Italy is that the country has lost competitiveness as costs and prices have increased by more in Italy than the eurozone average and in particular much more than in Germany. Most observers have focussed so far on one particular measure of competitiveness, namely unit labour costs. This indicator suggests that if one compares Italy to Germany the loss of competitiveness amounts to over 30 % since the start of EMU.

However, this number overstates the problem. It is not widely appreciated that only part of the loss of competitiveness comes from higher wages; an important part is due to lower (measured) productivity growth.[1] However, official measures of productivity are likely to be biased by recent developments in Italian labour markets. Officially measured employment in Italy has steadily increased over the last years. Most experts agree that a large part of this phenomenon is due to the 'regularization' of employment relations that had previously been unrecorded and had thus not appeared in the statistics. Since the Italian output statistics already contain a large allowance for the underground economy this implies that the regularization of informal employment will lead to lower measured productivity and hence higher unit labour costs. This implies in turn that in the case of Italy it would be misleading to measure the loss of competitiveness using relative unit labour costs.

Relative unit labour costs are thus likely to overstate the loss of competitiveness of the Italian economy. Relative wage levels might provide a lower bound since a straight comparison of wages would provide a good approximation of competitiveness if productivity is growing at the same rate everywhere. Looking only at wage costs per person the difference the measured loss of competitiveness is indeed much smaller ‘only’ about one half, i.e. around 15 %.

Looking at a broad measure of price (as opposed to cost) competitiveness, namely the CPI yields an even less worrying picture in the sense that since 1998 the Italian consumer price index has increased only about 5 % more than that of Germany as shown in chart 1 below.

Chart 1

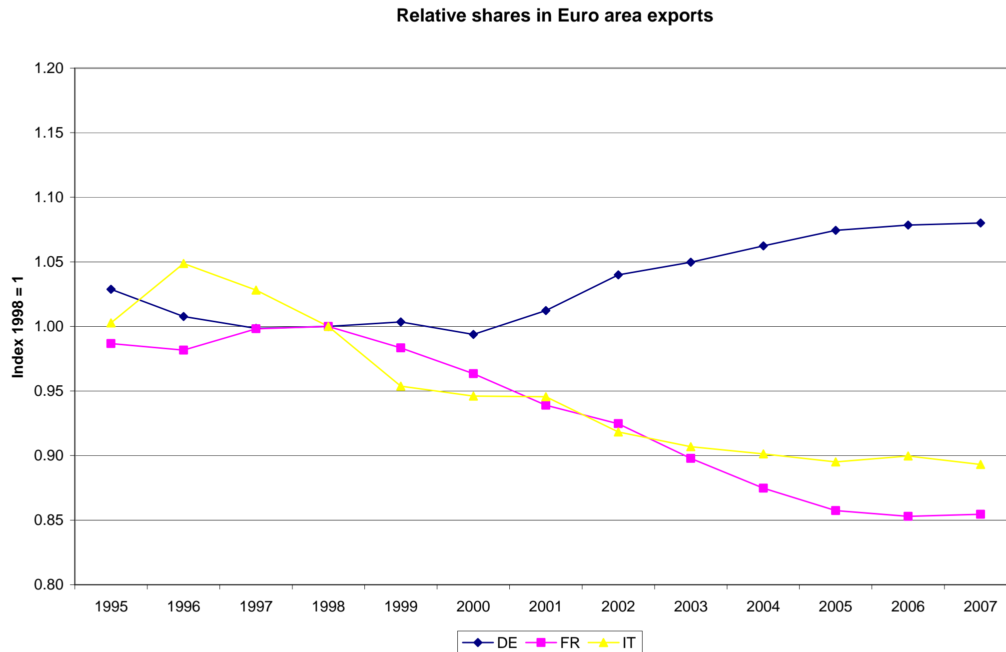


Source: AMECO.

[1] A reminder: Nominal unit labour costs are the ratio of nominal hourly labour costs (compensation of employees plus payroll tax and fringe benefits tax less employment subsidies, per hour worked by wage and salary earners) to average hourly productivity (real gross product per hour worked by all employed persons). With some arbitrary year chose as the base= 100. Real farm unit labour costs are derived by deflating nominal unit labour costs by the derived implicit price deflator for gross national product. (Again using some year, usually 2000 as the base = 100.)

The CPI might actually be the most relevant measure of competitiveness because many studies indicate that trade performance can be explained better by relative consumer prices than relative labour costs because labour costs are only a small part of overall costs as exporting firms have to buy many domestic services as inputs for their exports. The performance of Italian exports is also consistent with this view. Within the euro area, the share of Italy in overall exports has indeed declined somewhat, but not more so than that of France (see chart below).

Chart 2



Source: own calculations based on AMECO data.

3. Unwillingness to reform

Finally it is often said that the Italian political system is unable to undertake the reforms that are needed to prepare the country for the challenges of globalization and the euro. It is undoubtedly true that the Italian governments under both the left and the right have not been able to enact incisive reforms, but there are two indicators which suggest that under the surface there has been important change.

One measure which suggests that there have been important reforms comes from the OECD's Product Market Reform (PMR) indicator. In terms of this indicator of structural reforms Italy has made considerable progress since the start of EMU. Compared to the other large eurozone countries (including Spain, France and Germany), progress has actually been quicker, but since the starting point was much worse, Italy is still on most accounts somewhat more heavily regulated than these benchmark countries. A detailed analysis of the PMR indicator shows that there is even one area ('administrative regulation') where Italy seems to have become more liberal than Germany. In terms of reforms Italy thus seems to have made considerable progress, more so than Spain for example, which is often held up as a country on a fast reform track. There is still a gap with respect to the other large eurozone countries, but it is closing relatively fast.

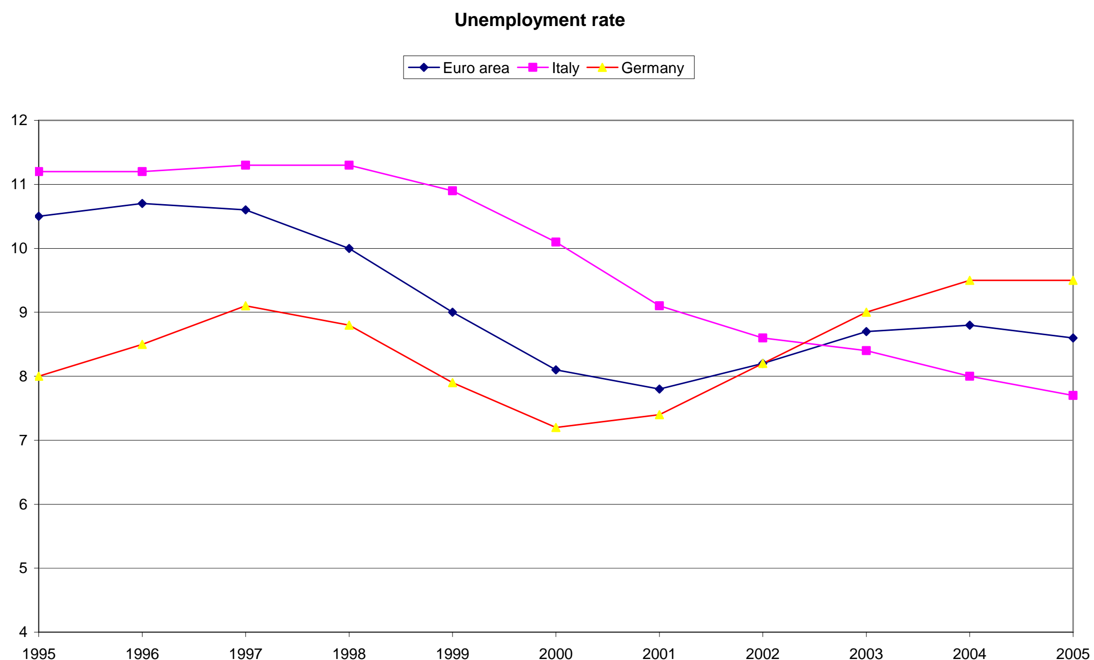
Table 1: Structural reforms

	Product market regulation			Administrative regulation			Economic regulation		
	1998	2003	Change	1998	2003	Change	1998	2003	Change
France	2.5	1.7	0.8	3.2	1.6	1.6	2.8	2.3	0.5
Germany	1.9	1.4	0.5	2.5	1.9	0.6	2.2	1.8	0.4
Italy	2.8	1.9	0.9	3.1	1.6	1.5	3.7	2.6	1.1
Spain	2.3	1.6	0.7	2.8	2.0	0.8	2.5	2.1	0.4

Source: Own elaboration based on OECD PMR database.

Another indicator that the situation has improved comes from the labour market. Over the last decade (measured) unemployment has been declining continuously (the counterpart to the increase in official employment mentioned above). Ten years ago Italy's unemployment rate was stuck above the eurozone average and about 3 percentage points higher than that of Germany. Now Italy performs slightly better than the eurozone average with a rate that is about 2 percentage points lower than that of Germany (see chart 3).

Chart 3



All in all one can thus conclude that while Italy still faces formidable challenges, its economy is not in such dire straights that the country has become a hopeless basket case.

Daniel Gros is Director of CEPS. An edited version of this Commentary was first published in the Financial Times, 7 February 2007.