

REFORMS AND CONTINUITY IN THE ITALIAN ECONOMY: EMU AT RISK?

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Abstract:

Some concerns have been advanced that the Italian economy would cause harm to the EMU. In this paper we will analyze the extent of divergence between the main Euro-zone countries and highlight the dynamics which produce such strains. In particular we will question the effective functioning of price and wage flexibility adjustments, which are presupposed in the present EMU framework, in the case of the Italian economy. The main findings are that such channels are not working as expected and some self-reinforcing process of divergence is in place. That depends both on the EMU and national institutional frameworks. Institutional reforms directed to flexibilise the labour market are not obtaining the expected results. Moreover, the German policies to increase competitiveness by controlling wages have exported tensions to Italy.

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REFORMS AND CONTINUITY IN THE ITALIAN ECONOMY: EMU AT RISK?

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1. Fixed Exchange Rates, Monetary Union and Divergences: The Case of Italy

Divergences of inflation, interest rates and public deficit between the (future) member countries of the European Monetary System had been at the heart of the debate about the Maastricht process during the 1990s. The convergence criteria which every country had to fulfil give a clear idea of what had been regarded as a necessary precondition for joining the Union. *After* the launch of the Euro 1999 the official strategy was to concentrate on the public deficit (Stability and Growth Pact) and forget about the other criteria. Obviously the European Central bank, too, was convinced that with a purely formal change – the introduction of the new currency – the economic reality in Europe had been modified up to a point that inflation differentials could be left in the hands of the ‘real exchange rate channel’, i.e. the market based forces that work in an equilibrating manner. In the first years after the launch of the EMU the question why these forces were not effective during the EMS-period, but should have done so immediately after the introduction of the Euro, was carefully avoided. Inflation rate divergences within the monetary union were treated as anathema. This was as more astonishing as actually none of the equilibrating channels which the *optimal currency area* (OCA) theory considers the precondition for a monetary union was affected by the introduction of the Euro.

The issue of convergences and divergences across the member countries of the EMU and the effects on the development of international price and cost competitiveness only recently has regained some prominence.¹ The ECB’s contributions to this debate aim at an interpretation which acknowledges divergences, but regard inflation differentials primarily as a necessary

¹ Hein/Truger. 2005, Thomasberger 2005, Horn/Mülhaupt/Rietzler 2005, IMF 2005, Bibow 2006.

dimension of every market based adjustment process.² Only the fact that nominal divergences within the EMU are much more *persistent* than, for example, in the United States was considered a somewhat disturbing fact. But the official doctrine holds on the view that inflation differentials have to be seen as part of an equilibrating adjustment mechanism based fundamentally on wage and price flexibility. If wages and prices do not adjust smoothly enough, ‘pathologic learning’³ may do the rest.

A look on the coefficient of variation of tab.1 indicates how the EMU economies tend to converge *and* diverge. Even if there is a tendency in direction of convergence for what concerns inflation – both in growth rates and price levels –, average hourly labour costs, employment and unemployment rates, divergences of some basic variables such as investment, productivity and per capita GDP tend to increase. Interest rates first converged in response to the common monetary policy, then it started to reflect the underlying divergences.

The Mediterranean countries, Spain, Greece, Portugal and Italy are at the very heart of the discussion. The reason is that the four countries are loosing cost and price competitiveness in comparison with other member-countries, especially Germany and Austria. After seven years of monetary union there is some evidence that doubts about the effectiveness of market based forces which work in an equilibrating and stabilizing manner are justified. The question is, whether the real exchange rate channel is strong enough in order to enforce equilibrating forces in both directions: wage and price increases in countries with export surpluses and corresponding reductions in countries with deficits.

² ECB 2003, ECB 2005.

³ Issing in one of his last interviews as chief economist of the ECB in the German newspaper ‘Handelsblatt’ (‘Issing warnt vor großen Spannungen in der Währungsunion’, 2006/05/29).

Tab.1 Convergence within the euro area

<i>Coefficient of variation – Eurozone</i>	1997	1999	2002	2005
<i>Converging</i>				
Consumer prices growth rates°	0,615	0,485	0,410	0,372
Consumer prices levels°	0,132	0,134	0,144	0,114
Average hourly labour costs°	0,333	0,327	0,314	0,266
Employment rate°	0,103	0,097	0,086	0,067
Unemployment rate°	0,431	0,470	0,421	0,288
<i>Ricochet</i>				
Bank short term interest rates°	0,287	0,125	0,122	0,167
<i>Diverging</i>				
Gross fixed capital form. Private, %GDP*	0,116	0,115	0,133	0,159
Productivity – hour worked*	0,221	0,237	0,221	0,248
Productivity – employed person*	0,184	0,199	0,187	0,217
Per capita GDP in pps°	0,270	0,311	0,309	0,369
Per capita GDP, constant prices°	0,427	0,442	0,457	0,475

(*)OCDE (°)Eurostat - Calculated on levels except when noted

Italy plays a special role in this debate, on the one hand because Italy is not only a founding member of the European Union and one of the ‘large’ countries in the EU and, therefore, could – in the case of unsustainable divergences – create a risk for the monetary union as a whole, on the other hand because already in the 1990s there existed divergences between Italy and ‘northern Europe’ which, until 1997, seemed to make an early participation of Italy in the EMU impossible. Even if Italy in the late 1990s realized important reforms, in the two years before the launch of the EMU only favourable *external* circumstances – the United States’ “new economy” boom together with the U.S. dollar strength – made it possible that 11 countries, including Italy, fulfilled the Maastricht criteria. Some authors now seem to take up the chance of demonstrating that warnings about Italy’s participation in the EMU in the 1990s had been brushed aside too easily. Did W. Münchau, columnist of the Financial Times, simply bring up an obsolete prejudice when he wrote that «Italy’s problem is lack of readiness for life in a monetary union»?⁴ Or is there a real danger? Is the departure of Italy from the German path a major threat that might lead to the collapse of the EMU?

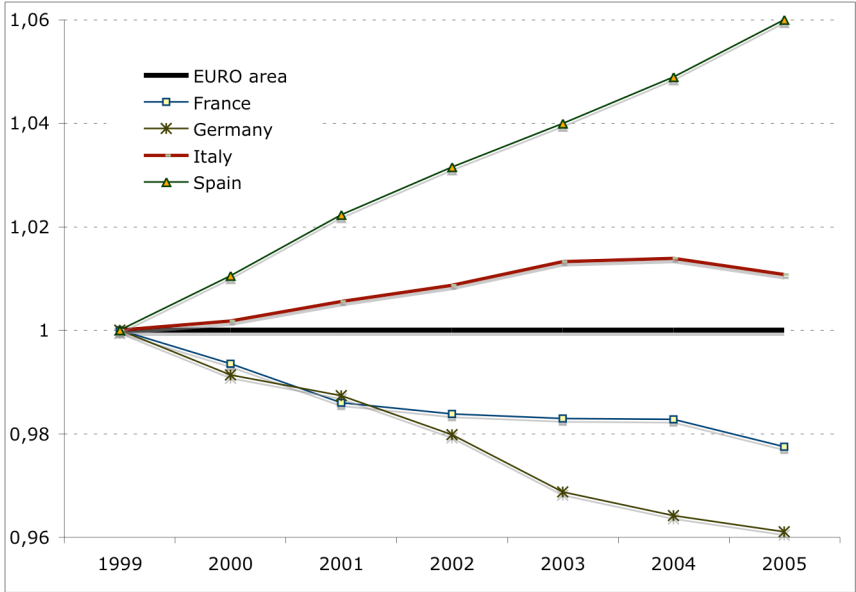
⁴ W. Münchau: ‘Prodi’s lamentable poll is bad news for the euro’, Financial Times, 2006/04/17; see also Münchau: ‘Prodi und der Euro’ FTD, 2006/05/03.

A closer look on Italy may also deepen our understanding of some more general topics: is it reasonable to expect that the switch from a system of fixed exchange rates to a single currency implies such a fundamental change that inflation divergences, which during the EMS-membership had been (and still are) regarded as a reason to exclude countries from the EMU, lose their importance as soon as the country joins the monetary union? Why should the introduction of a new rigidity (the single currency *downgrades* the flexibility of the economic system as a whole) simplify convergence? Does it make sense to regard inflation differentials as a problem during the preparation, but not *in* a monetary union? What about the assumption that the equilibrating channels which in a system of fixed exchange rates are considered insufficient, in a monetary union are supposed to work smoothly? Or simply: Why should wage and price flexibility in the EMU be higher than in the EMS?

2. The position of Italy in Europe today

If we start with the inflation rates, we can see persistent divergences. Inflation differentials can be best depicted from fig.1 where consumer prices indexes are compared relatively to the Euro-area average. Germany and France tend to control prices much better than Spain and Italy. Even if Italy does not diverge much from the Eurozone average, in 2002 it accumulated a gap of 2.5% relatively to France and 2.9% relatively to Germany. Such differentials in 2005 became respectively 3.3% and 5.0%.

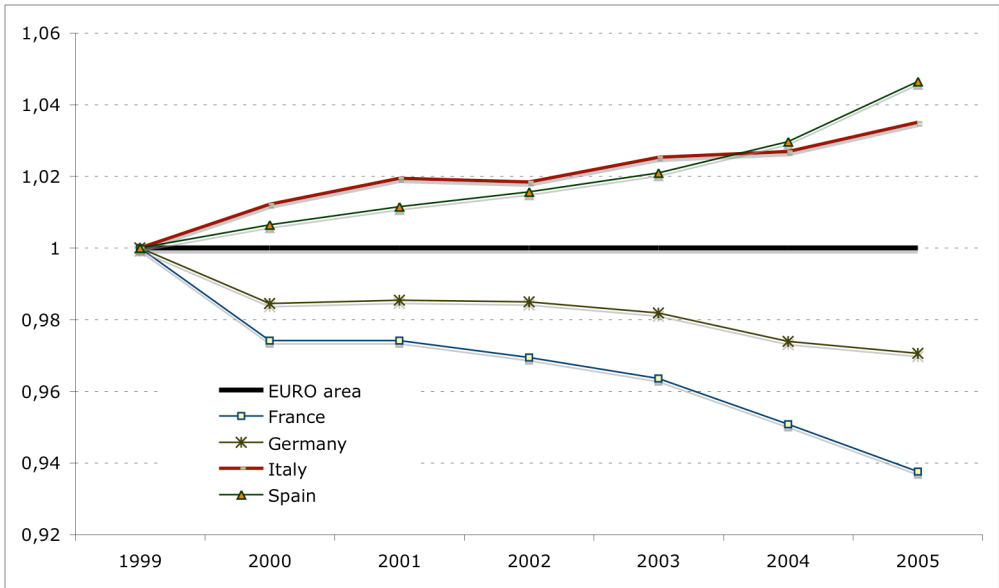
Fig.1 Consumer prices



Calculation on OCDE data

If we take into consideration the development of the producer prices (fig.2), the situation is even worse. Italy followed the same increase as Spain and in 2002 it had already accumulated a gap of 4.9% relatively to France and 3.3% relatively to Germany, which in 2005 became respectively 9.7% and 6.5%.

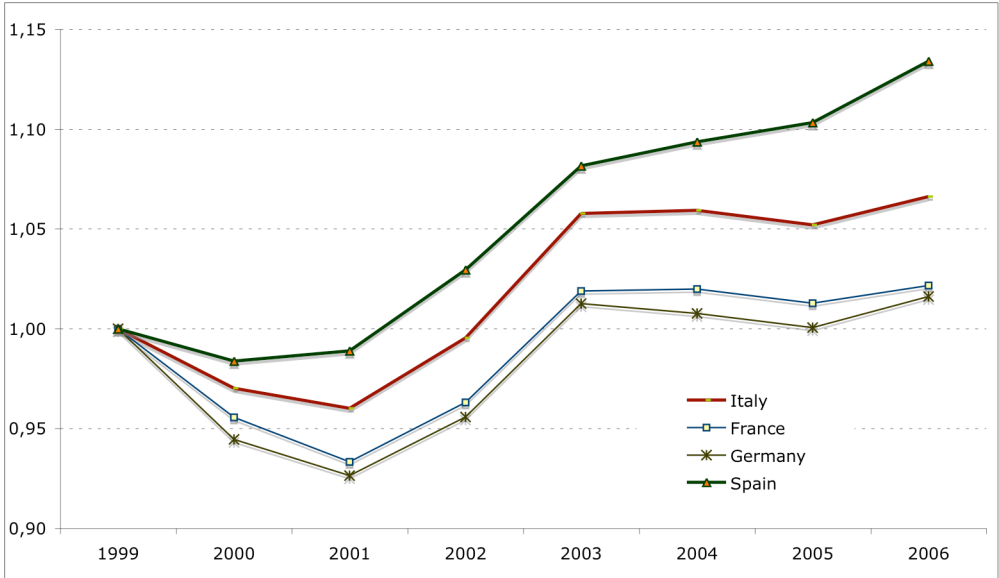
Fig.2 Producer prices



Calculation on OCDE data

The evolution of real effective exchange rate (fig. 3) shows one consequence of the cost and price developments. The depreciation of euro at its beginning induced a general fall in real effective exchange rate, which was then reversed after its actual emission in 2002. As a consequence, all countries experience a common fluctuation.⁵ However, the Spanish and the Italian rates tend to diverge sensibly from the French and German. This determines a relative appreciation of the Spanish and Italian ‘real euro’. In 2002 the Italian real effective exchange rate had already accumulated a 3.2% appreciation compared to France and 4.0 to Germany. In June 2006 that became respectively 4.5% and 5.0%.

Fig.3 Real effective exchange rates



BIS data, Real (CPI-based), Narrow Indices 24 countries

Since the start of the EMU (1999) the four largest countries in EMU experience different developments of the balance of payments (tab.2). Germany doubles its surplus in the goods balance while the other countries display some rising difficulties. In the case of Italy, the deficit comes from the income and the transfers balance. The selling abroad of public debt bonds

⁵ This fluctuation is not so pronounced as the fluctuation of euro against the dollar because most of trade is intra-European.

which begun in the middle of the 1990s now displaces its effects in the form of an out-flow in interest payment. Nonetheless, most of the Italian worsening of the balance of payments comes from goods, even if in 2003 it still enjoys an active balance in that section.

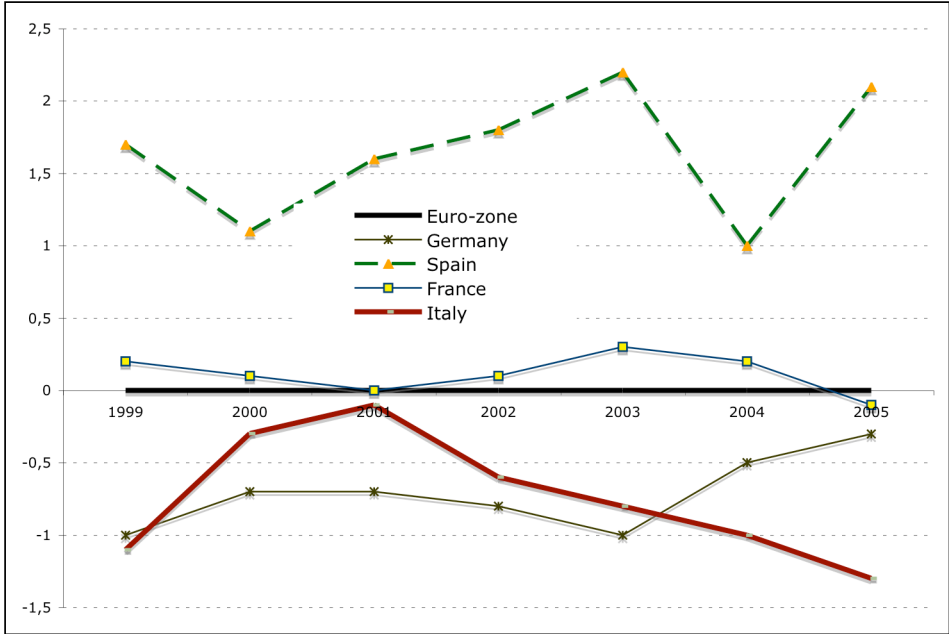
Tab.2 – Balance of payments, current account

GOODS	1999	2003	SERVICES	1999	2003
Germany	3,2%	6,2%	Germany	-2,6%	-2,1%
Spain	-5,4%	-6,2%	Spain	4,0%	4,5%
France	1,4%	0,1%	France	1,4%	0,9%
Italy	2,4%	0,9%	Italy	0,1%	-0,3%
INCOME	1999	2003	TRANSFERS	1999	2003
Germany	-0,5%	-0,6%	Germany	-1,2%	-1,3%
Spain	-1,7%	-1,7%	Spain	0,5%	0,0%
France	0,7%	0,5%	France	-0,9%	-1,2%
Italy	-1,1%	-1,8%	Italy	-0,6%	-0,7%
TOTAL	1999	2003			
Germany	-1,1%	2,2%			
Spain	-2,5%	-3,4%			
France	2,7%	0,3%			
Italy	0,8%	-1,9%	<i>Eurostat</i>		

Calculation on Eurostat data

Since 1999 economic growth (measured as year by year increase of GDP) in Italy was constantly lower than the average of all member countries of the monetary union. If we concentrate on the four bigger countries, we see a remarkable distance from Spain in the range of 2% in average and from France in the range of 0,5%. Only Germany shows a performance which is – if we consider the whole period – nearly as unsatisfactory as the Italian. But while at least since 2004 Germany shows a tendency to come closer to the European average, Italy fails to keep up.

Fig.4 Real GDP growth rate relative to Euro-zone



Calculation on Eurostat data

As a provisional result we may say that there is a visible shift of price and cost competitiveness in Europe and that Italy has lost ground in relation to Germany and France – not so much as Spain, but enough in order to create preoccupations. But while in Spain internal demand compensates for the loss of competitiveness, in Italy a similar effect is missing. Inflation differentials between Italy on the one hand and Germany on the other hand are not high, but persistent. During the first seven years of EMU-membership the increase of producer prices in Italy is nearly 10% higher than in Germany. Up to now the effect on the overall balance of payments is limited, but the loss of price and cost competitiveness not only in comparison to Germany, but also to other European countries excludes that exports may work as a substitute for weak internal demand.

The decisive question now is: Is there a realistic hope that market forces are able to re-equilibrate the divergences without political intervention? In order to answer this questions we will first have a short look on the past and compare Italy’s standing during the EMS-period with its position as a member of the EMU. In a second step we will have a look on the

origins of that divergences and the question, if there is any chance that the real exchange rate channel re-establishes competitiveness automatically in the near future.

3. The 1980s and 1990s: Italy's position in the European Monetary System

The divergence and a higher than average inflation rate in southern European countries, including Italy, are not a new phenomena at all, but they characterized the whole monetary integration process from the 1970s up to 1999. Occurrences over the 1980s and 1990s foretold many of the problems that Italy experienced under EMU conditions more recently.

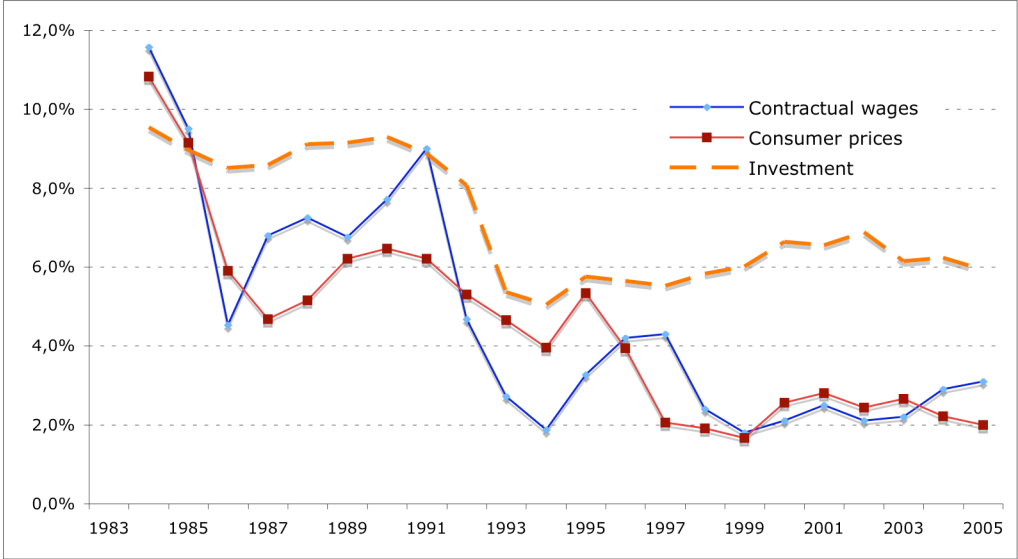
The inflationary dynamics in Italy begun in the 1970s when the exchange rate system of Bretton Woods was broken down and the oil shock hit the country which was depending on cheap energy imports for its development. Italy in the 1970s never applied consequently a restrictive policy focused on price stability, but used the revaluation of the German mark as against the US-Dollar in order to follow what Graziani, Parboni⁶ etc. discussed in term of 'differentiated exchange rates'. Taking into consideration the position of Italy in the international division of labour, Italy could exploit the gap between US-Dollar and German mark, importing cheap (raw material) and selling high-priced (finished or semi-finished products) to Northern Europe. Logically this strategy could work only as long as the dollar lost ground vis-à-vis the German mark. What remained at the beginning of the 1980s when the US-Dollar began to reevaluate in relation to the European Currencies were high inflation rates. Unresolved social conflicts and the structural specificity⁷ contributed equally to the high inflation (21% in 1982) and to the enduring inflation differentials with the major trading partners in Europe. During the 1980s stabilizing policies were successful in reducing inflation to a level of around six

⁶ Parboni 1985; Graziani 1987.

⁷ The high proportion of people living out of free professions and entrepreneurship, which reaches 1/3 of working population, implies that inflation cannot be controlled by blocking labour contracts only.

percent in the second half of the decade. In the first years of the 1990s inflation remained on this level. Only from 1997 on inflation was reduced to a level of between 2% and 3%.

Fig.5 Wages, prices and investment



Elaborations on ISTAT data

During the whole period the inflation differential vis-à-vis other European currencies was counterbalanced by nominal devaluations of the lira which at the beginning of the EMS took place in the average once a year. Only the Single Market Programme and the liberalization of the capital markets 1990 put an end to the possibility of ordered nominal devaluations. But the counterbalancing effect of the nominal devaluations did not offset the higher-than-average inflation completely. Obviously the exchange rate link was used as an instrument with the intention of reducing inflation (in the case of Italy) or of increasing competitiveness by undervaluation (in the case of Germany). The consequence was a continuous appreciation of the Lira’s real effective exchange rate.

Fig.6 Nominal exchange rate Lira-DM

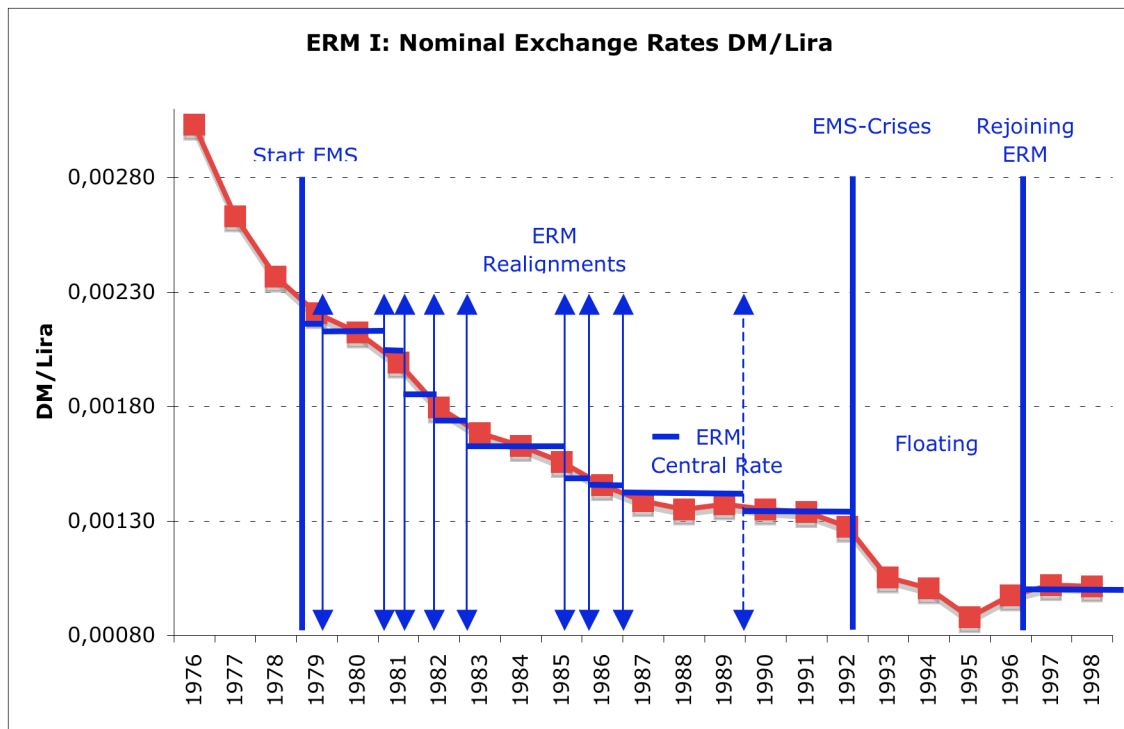
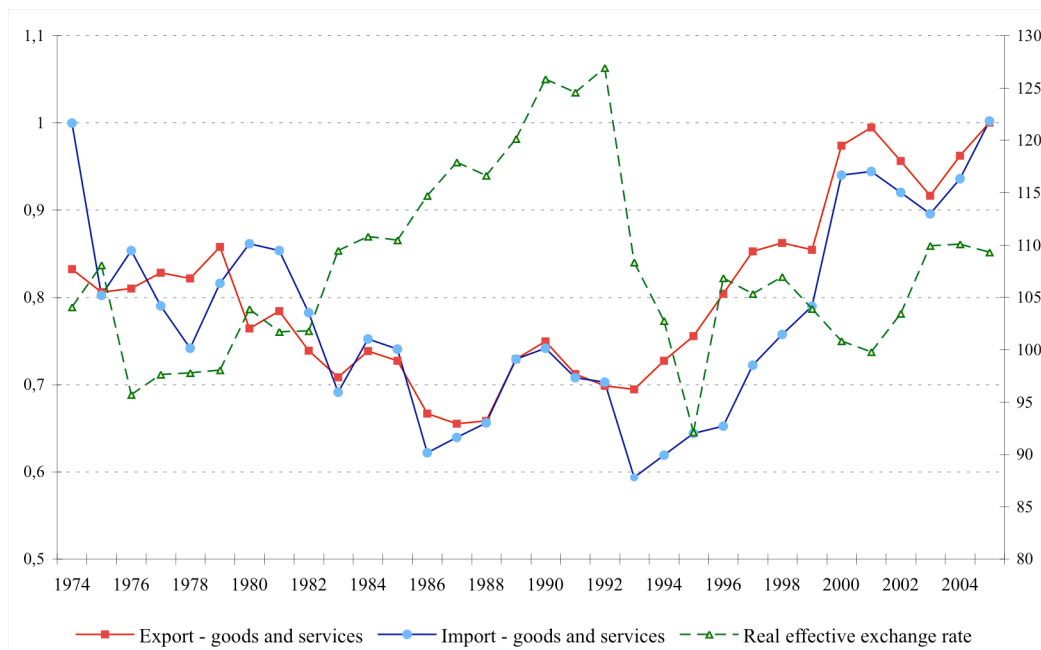


Fig.7 Real effective exchange rate and trade balance



Real effective exchange rate: BIS. Import-export from ISTAT.

As evident from fig.6 and fig.7, devaluations inside the EMS could not neutralise such trend and Lira appreciated despite its nominal decreasing value and Italian international trade de-

creased. This notwithstanding Italy's trade balance was more or less in equilibrium up to 1992. The process came to an end in 1992 with the EMS-crisis and the massive fall in real effective exchange rate of Lira. That determined an explosion of exports followed by a rise in the value of (more costly) imports. Italy enjoyed a trade surplus in goods and services up to 2005, when the 1992 push came to an end because of the euro re-evaluation and oil price increase.

Note that the EMS-crisis 1992/3 was also a result of a de-synchronization of business cycle conditions in Europe, caused by the German unification, together with the Bundesbank's concentration on price stability in Germany which, according to the central bank's view, seemed to be endangered by the post-unification boom. From 1989 till 1992 Germany experienced a period of high growth, while the rest of the continent was in the middle of a recession. But not only the cyclical de-synchronization as such was the problem. The conflict was aggravated by the central bank's reaction to the different conditions. Indeed, in 1991-2 the Bundesbank – at least till the outbreak of the crisis – did not behave as the central bank of the European key-currency with responsibilities for the currency area as a whole, but mainly as a national institution which concentrated on the conditions within Germany. Only the following crisis opened the chance for Italy to compensate for the loss of competitiveness due to the increase of the real effective exchange rate and the overvaluation of the Lira in real terms during the period of the hard EMS.

Analysing the implications of inflation differentials between Italy and other European countries it is important to have in mind that Italy experienced higher-than-average inflation rates during the whole period of European monetary integration. During the 1980s, that is before the Single Market Programme, it was possible to limit the negative effects of the inflation differentials by orderly nominal devaluations which were coordinated on a European level. The situation in the 1990s was different. Here, besides the liberalization of capital markets,

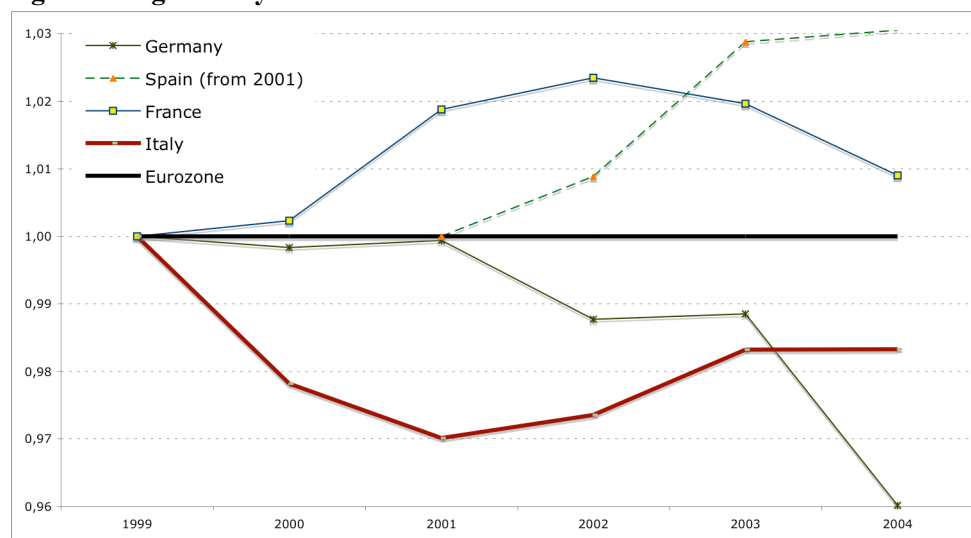
the cyclical de-synchronization between the German economy and the rest of Europe played a crucial role. Indeed, the reestablishment of Italy's cost and price competitiveness came mainly as a result of the EMS-crisis which forced Italy to abandon the exchange rate system for a certain period and provoked a strong devaluation of the now floating Lira.

Reviewing the last decades, the figures indicate that in Italy there are structural particularities which induce a higher-than-average inflation rate relatively to other European countries in addition to cyclical de-synchronizations. During the existence of a system of fixed but adjustable exchange rates the differences could be re-equilibrated by nominal devaluations, in the 1980s coordinated, in the following decade 'spontaneously'. The open question obviously is if in a monetary union there are market forces strong enough in order to control the effects of the structural particularities. Is the competitiveness channel able to re-establish equilibrium? Are the supposedly self-equilibrating forces of wage and price flexibility strong enough to make realignments once for all superfluous? An answer to this question requires that we have a look on the origins of inflation in Italy.

4. Inflation, productivity and competitiveness from 1999

Growing employment combined with stagnating output is the most astonishing fact in the Italian economy during the last years. This fact is not in harmony with the predicted mechanism of market adjustment within the euro constraints. The causes of this anomaly may be understood better by shifting the focus to the structural level and to the process of institutional change that Italy is experiencing due to the Single Market and to the EMU. Some difficulties of integrating Italy (and, more in general, the Mediterranean economies) into EMU can be singled out by analysing the specific dynamics of competitiveness, costs and labour productivity at the aggregate and sectoral level.

Fig.8 Average hourly labour costs

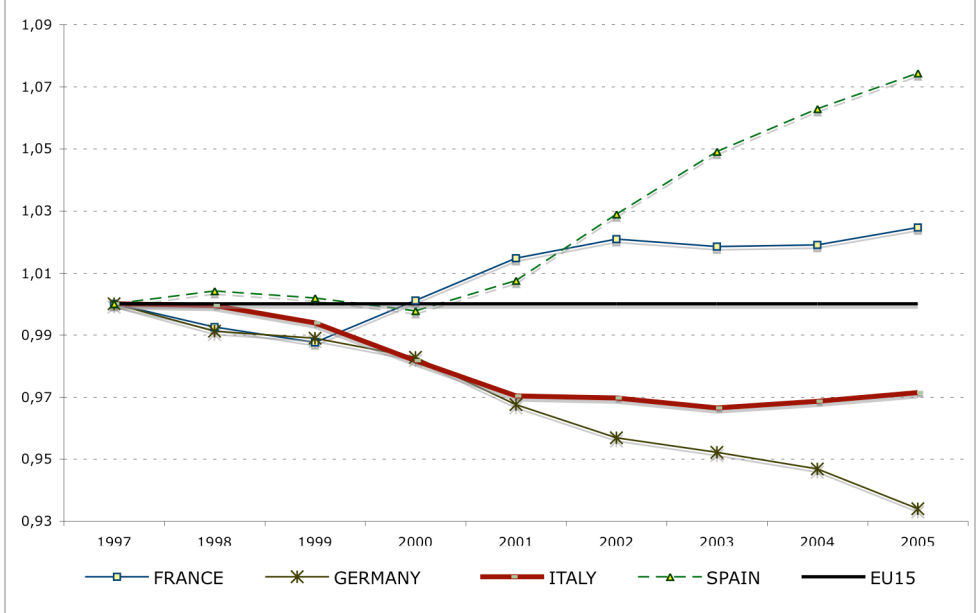


Total labour costs divided by the corresponding number of hours worked provided by Eurostat – Spain: break in series in 2000.

We have already shown how producer prices in Italy increase more than the Euro-zone average. We now will have a look on the development of nominal labour costs. The flexibility doctrine assumes that the equilibrating forces work primarily through this channel. As Fig. 8 shows we may distinguish two phases (fig.8): a first period between 1999 and 2001 where Italian labour costs have been sensibly reduced relatively to French and German labour costs; and a second period between 2001 and 2005 when labour costs in both Mediterranean countries (Italy and Spain) started to increase more rapidly than the European average and the French and German costs underwent a strong deceleration. If we focus on hourly wages in manufacturing between 1997 and 2005 (fig.9), we can see that Italy's labour costs showed a sensible decrease from 1997 to 2001. The social pact promoted by the centre-left government has influenced the nominal wage development in this period. From 2001 on nominal hourly wages in manufacturing remained at a stable level in relation to the European average. The industry association (with a blessing from the centre-right government) refused agreements with the unions and the latter reacted as to recover some of the losses of the previous years. However, such acceleration did not induce an increase of hourly labour costs significantly

superior to the Eurozone average (fig.8 and 9). If we take into account the whole period since the launch of the Euro till today nominal wages only in Germany increased less than in Italy.

Fig.9 Nominal hourly wages in manufacturing



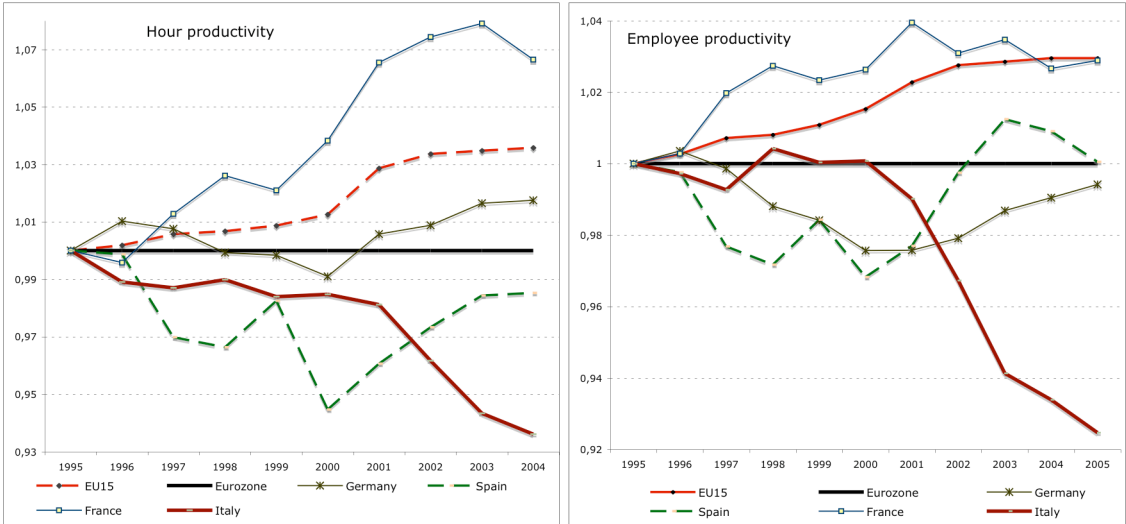
Calculation on OCDE data

As a consequence, from 1999 to 2002, Italy produced a -5.8% difference relatively to France in manufacturing hourly labour costs (-4,9% average labour costs) and a limited disadvantage of 0.8% (still and advantage of -2,9% in average labour costs) compared to Germany. In 2005 such differentials became -5.9% (-2,6%) and 3.3% (2,3%) respectively. We can say that Italy followed the German strategy to control wages up to 2001; then, coinciding with the change of government, it let wages increase as the EU15 average. Over the whole period of the EMU, i.e. since 1999, contractual wages in Italy increased with an average of between 2% and 3%, clearly lower than the European average. Even if it is difficult to decide, if this outcome is attributable more to the blind forces of the market or due to the awareness and the consciousness of the unions, it is clear that the increase of nominal wages during the EMU-period cannot be seen as the main problem. The recent loss of competitiveness expressed by the balance

of payments and by the increase of producer prices cannot be simply explained by labour costs.

Since price competitiveness is not determined by nominal labour costs alone, but by labour costs in relation to productivity, let us have a look on this second aspect. Fig. 10 shows that Italy displays a strong negative development in both hourly and per employee productivity. Since 1995 Italy suffers a loss of productivity relatively to the Eurozone, which becomes quite large after 2001, both in terms of value added per worked hour and per worker.

Fig.10 Productivity growth



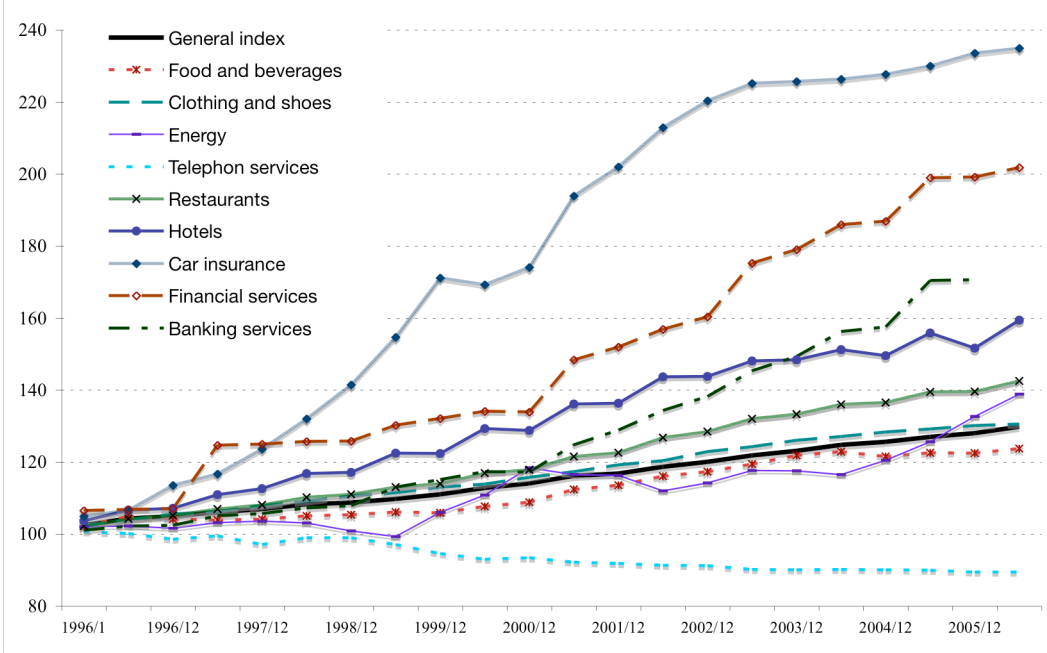
Elaborations from OCDE data

Italy is evidently experiencing some structural problem which results in a fall of productivity and a relatively higher-than-average inflation rate which endangers its competitiveness. Such an astonishing trend deserves a deeper analysis by focusing on sectors contributing most to this performance.

A clearer idea of what is producing inflationary pressures can be developed by looking at sectoral data. Fig.11 shows the monthly price index of the most representative sectors from 1996 till 2005. Services, especially car insurances, financial services, banking services, hotels and restaurants appear as exerting a strong inflationary push, more intense than the stimulus sup-

plied by energy (oil price notwithstanding). The interesting fact is that insurances, banking and finance belong to the privatised or deregulated sectors. Obviously something went wrong in the new economic order induced by the wide reforms of the 1990s.⁸

Fig.11 Inflation by sector



ISTAT data (selected sectors)

Table 3 shows that since 2001 overall employment grows faster than nominal value added or, in the case of declining sectors as textiles and transportation means, value falls steeper than employment.⁹ The productivity crisis – which, according to tab.3, in some important sectors such as Financial and RE intermediation did begin long before 2001 – may be due to an anomalous reaction of the economy to specific economic difficulties with the result that employment increases in presence of GDP slow down. Other sectors such as Industry displayed an increase of productivity between 1993 and 1999 which was able to overcompensate the decline in “advanced services”. Till 2001 the productivity growth in industry was positive,

⁸ The increased prices are generally attributed to a deficit of competition, but just after privatisation these sectors started a process of mergers and acquisitions which absorbed a lot of capitals...
⁹ The difficulty of textiles is due to the GATT agreements which have induced this sector to relocate basic productions. The transportation means industry crisis is due to FIAT and also to motorcycles.

even if the growth rates were declining at the end of the period. Only since 2001 productivity is declining in this sector, too.

Tab.3 Sectoral change in productivity

employment	1993-99	1999-2001	2001-05	1999-05	share of total empl. 2005
Agriculture	-23,6%	-0,3%	-13,5%	-13,7%	4,0%
Industry	-3,2%	-0,9%	-1,1%	-2,0%	21,1%
Textiles and clothing	-18,2%	-1,2%	-8,7%	-9,8%	2,5%
Chemicals and synthetic fibres	-8,4%	-2,3%	-4,0%	-6,2%	0,8%
Rubber and plastics	18,6%	-0,1%	-3,6%	-3,7%	0,9%
Non metal products	-8,9%	3,7%	-4,4%	-0,9%	1,0%
Mineral and metal products	10,4%	0,4%	3,2%	3,6%	3,5%
Machines and mechanics	8,8%	2,0%	6,3%	8,5%	2,6%
Electronics and optics	0,9%	0,5%	2,8%	3,3%	1,9%
Transportation means	-10,9%	-3,9%	-5,6%	-9,4%	1,1%
Commerce, hotels...	0,4%	5,1%	2,8%	8,1%	24,4%
Financial and RE intermediation	24,8%	12,4%	12,4%	26,3%	14,3%
Other services	3,9%	2,8%	5,6%	8,5%	28,6%
Total	1,1%	4,0%	3,8%	7,9%	100,0%

value added	1993-99	1999-2001	2001-05	1999-05	share of total V.A. 2005
Agriculture	16,1%	-4,7%	2,3%	-2,5%	2,9%
Industry	11,9%	1,3%	-4,2%	-3,0%	21,6%
Textiles and clothing	-3,7%	2,7%	-22,5%	-20,4%	1,5%
Chemicals and synthetic fibres	18,5%	-8,2%	0,0%	-8,2%	1,5%
Rubber and plastics	30,5%	-4,6%	0,4%	-4,2%	0,9%
Non metal products	11,8%	8,3%	4,2%	12,9%	1,2%
Mineral and metal products	30,5%	3,8%	5,5%	9,6%	3,4%
Machines and mechanics	18,8%	4,9%	2,0%	7,1%	2,6%
Electronics and optics	13,0%	6,5%	-3,0%	3,3%	1,9%
Transportation means	22,1%	-3,8%	-16,6%	-19,8%	1,0%
Commerce, hotels...	16,5%	9,2%	1,0%	10,3%	24,0%
Financial and RE intermediation	10,5%	3,4%	3,9%	7,5%	25,3%
Other services	5,8%	3,9%	3,6%	7,6%	20,4%
Total	10,7%	4,6%	1,5%	6,2%	100,0%

value added per employed person	1993-99	1999-2001	2001-05	1999-05
Agriculture	52,0%	-4,5%	18,3%	12,9%
Industry	15,6%	2,2%	-3,1%	-1,0%
Textiles and clothing	17,8%	3,9%	-15,1%	-11,7%
Chemicals and synthetic fibres	29,3%	-6,1%	4,2%	-2,2%
Rubber and plastics	10,1%	-4,5%	4,2%	-0,5%
Non metal products	22,7%	4,4%	9,1%	13,9%
Mineral and metal products	18,2%	3,5%	2,2%	5,7%
Machines and mechanics	9,3%	2,8%	-4,0%	-1,3%
Electronics and optics	12,0%	6,0%	-5,6%	0,0%
Transportation means	37,1%	0,2%	-11,6%	-11,5%
Commerce, hotels...	16,1%	3,9%	-1,8%	2,0%
Financial and RE intermediation	-11,4%	-8,0%	-7,5%	-14,9%
Other services	1,8%	1,0%	-1,9%	-0,9%
Total	9,5%	0,5%	-2,2%	-1,6%

ISTAT data, most representative sectors

In order to analyse the structural changes which take place in the Italian economy it may be helpful to distinguish two larger groups of sectors. The first group is formed by two important service sectors, especially 'Financial and RE intermediation' and 'Other Services' which 2005 account for 45,7% of total value added. In the second group we find 'Industry', including 'Textiles and Clothing', 'Machines and Mechanics', 'Electronics and Optics', and 'Transportation Means' which comprise 21,6% of total value added in the same year. The other sectors, including 'Commerce, Hotels etc.', show a mixture of the features of both groups.

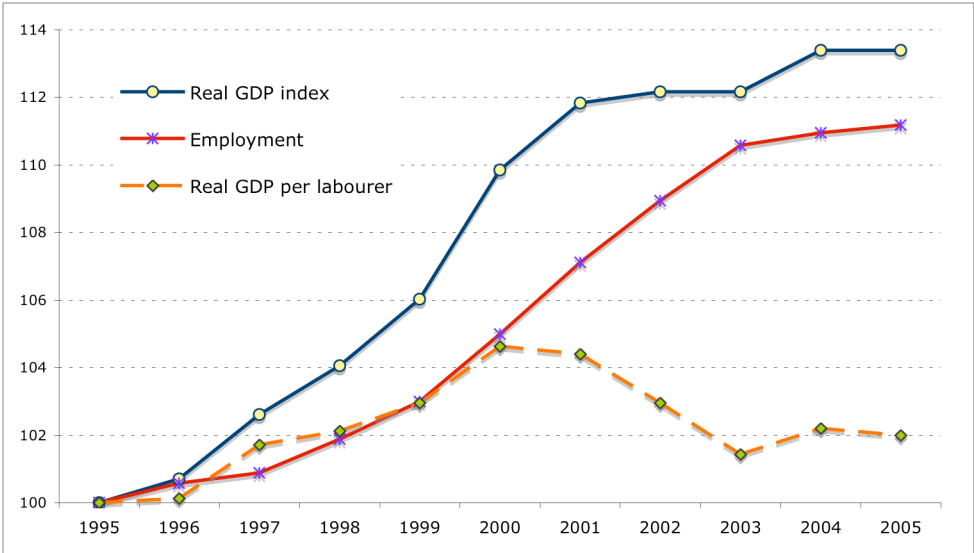
Productivity development in the first group is unsatisfactory during the whole period of consideration. Already in the 1990s productivity growth was weak or even negative. After 2001 the tendency worsened further. Here obviously we have to deal with a structural problem. In the second group productivity development during the 1990s was positive, even after the launch of the Euro till 2001, but became negative in the period between 2001 and 2005. In this latter case it may be more appropriate to speak of a cyclical reaction, first to the economic slowdown 2001-03 and then to the missing recovery. Up to 2001 the productivity growth in the second group overcompensated for the losses of the first group. Since that year both sectors are losing ground.

There seems to be a considerable fraction of the decline in labour productivity in Italy over the last years which is cyclical in character. But in the first group, in the service sectors, the structural dimension predominates. The institutional changes which took place in these sectors since the 1990s, the liberalization, deregulation and the concentration of banking and financial intermediation, and which should have obtained higher productivity, had the opposite effect.¹⁰ The concentration in the banking sector, besides a few major mergers, was mainly caused by larger banks absorbing small peripheral banks. The latter were well funded and enjoyed a good profitability by serving small firms. At the end of the process, concentrated

¹⁰ From 1992 to 2005 Italy experienced 132 mergers and acquisitions in finance (Thompson data) being the third nation in the world for this kind of operations after the USA and UK.

banks appear more and more in difficulty to fit the financing demand of the medium and small firms which constitute the dominant part of the production structure; at the same time they appear as not having reached any promised gain in productivity. Actually, maybe due to increased competition (probably non-price competition if we consider prices increase) and to excess supply of unfit services (concentration of banks, but multiplication of branches) the result is a constant and significant contribution to the reduction of general productivity. The reforms in the financial sector, liberalisation and concentration, have not produced the expected results. The result in terms of GDP per employed person is shown in fig.12.

Fig.12 The evolution of GDP and employment



Elaborations on Eurostat data

As a provisional result we can point out two main factors in the general fall of productivity: Services, especially the “advanced” service sectors show a constant trend of expansion of employment and relatively shrinking value added, while some industrial sectors display some heavy consequences from the cyclical slowdown of economic activity as a consequence of the latest economic downturn, the liberalisation of trade and other difficulties.

Our understanding of this singular reaction may be deepened, if we have a look on the status of employment (tab.4). During the period 1995-2003 the number of employees and of self-

employed grew, but standard employment increased more rapidly so that the proportion of self-employed decreased (except in constructions where self-employment became an anomalous way of obtaining flexibility, cost saving and risk shifting).

Tab.4 Employment by status.

Total employment					
	1995	1999	2003	1995-99	1999-03
Agriculture	1.217	1.029	967	-15,4%	-6,0%
Industry	5.093	5.052	5.080	-0,8%	0,6%
Constructions	1.529	1.521	1.742	-0,5%	14,5%
Services	12.400	13.245	14.452	6,8%	9,1%
Total	20.240	20.847	22.241	3,0%	6,7%
Self-employed					
	1995	1999	2003	1995-99	1999-03
Agriculture	714	601	569	-15,9%	-5,3%
Industry	829	790	802	-4,6%	1,5%
Constructions	590	631	675	7,0%	7,0%
Services	3.804	3.954	4.155	3,9%	5,1%
Total	5.937	5.977	6.201	0,7%	3,8%
Self-employed/working population					
	1995	1999	2003	1995-99	1999-03
Agriculture	58,7%	58,4%	58,8%	-0,3%	0,5%
Industry	16,3%	15,6%	15,8%	-0,6%	0,1%
Constructions	38,6%	41,5%	38,8%	2,9%	-2,7%
Services	30,7%	29,9%	28,7%	-0,8%	-1,1%
Total	29,3%	28,7%	27,9%	-0,7%	-0,8%

ISTAT data (thousands)

A reason for this unprecedented success of regular employment in Italy may be the flexibilisation and precarisation of labour contracts (1997 flexibilisation of contracts, 2002 “Biagi” reform). The flexibilisation of labour and the insertion into jobs of less qualified and protected workers may have had, as the IMF maintains, a direct negative influence on productivity.¹¹ INPS data reveal that, from 1998 to 2001, defined time working contracts grew by 36,2% as standard contracts grew by 12,3% only. ISTAT data say that from January 2004 to June 2006 the former contracts grew 23,2% while the latter only 1,8%. All that, however, mainly hap-

¹¹ “Some of the recent decline in Italy’s factor productivity growth may be related to the reinsertion into jobs of lower-productivity workers. ... firms responded to labor market reforms by shifting to less capital-intensive production methods” (IMF 2006, 12).

pens in services (tab.4) where flexibility is mostly demanded, but where evidently productivity increase was not achieved.¹²

The sectoral data which we have presented here give a first insight into some problems which result from the complex relationship between deregulation, increasing competition, structural reforms, and the slowdown of productivity. This is just a first step. We are still far away from having a clear answer to the puzzle: What is behind Italy's productivity slowdown? But we are convinced that an analysis of the mechanisms producing the unsatisfying productivity performance has to take into account the structural changes which took place not only, but primarily, in the service sectors. At the very heart of the problem is the question of how liberalization, deregulation, market reforms influenced productivity.

We do not neglect that other dimensions may also be relevant for the overall development of productivity slowdown. But they should be considered in their relation to the institutional changes. Faini (2003) excludes that the restrictive fiscal policy adopted to reduce the public deficit contributed to the present crisis. He also rules out a fall in investment and shows how an intense deregulation occurred which reduced obstacles to free markets to the OCDE average. He, instead, focuses on the territorial differences in development (Mezzogiorno – a problem common to Germany, however) and the lack of education and investments in research. Yet, the former problem has not changed from the past and the latter cannot supply any insight on the structural problems we presented here.

The fact is that the Italian economy responds in an unpredictable way to the institutional changes of the late 1990s (financial liberalisation, EMU, GATT and labour contracts flexibilisation). Having blocked the depreciation of lira and increased competition, tensions turned out to be destructive in terms of value creation. In any case, flexible labour contracts let entrepreneurs exploit also low value added business opportunities and that particularly in services. So

¹² Industry and small firms in particular do not make recourse to atypical contracts.

liberalisations and exposure to tough international competition tend to turn firms to easier opportunities for profit instead of investing in a serious restructuring. The cases of Pirelli, Benetton and other major business groups are symbolic: selling riskier business activities to buy just privatised public utilities.

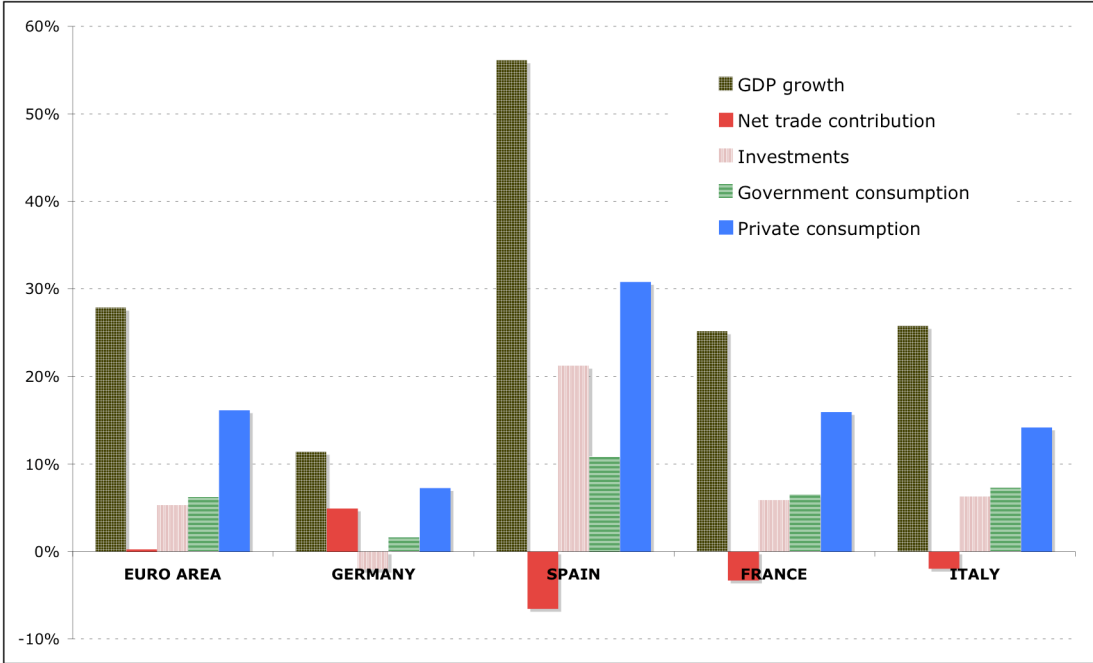
5. External restructuring, Germany's macroeconomic strategy, and the competitiveness channel

At the end of section 2 we asked, if the real-exchange rate or competitiveness channel can be expected to be strong enough in order to control Italy's higher-than-average-inflation bias. We asked if the supposedly self-equilibrating forces of wage and price flexibility can be regarded as a sufficiently strong channel in order to re-equilibrate the losses in terms of competitiveness which Italy has experienced since the introduction of the euro. In section 3 we saw that the economic development in Italy is characterized by the somewhat astonishing combination of employment and output development, i.e. employment which is growing stronger than output resulting in a decline of productivity. If it is true that not the development of nominal wages, but the decrease of productivity, caused by a particular reaction of the Italian economy to the pressures of liberalization, deregulation and privatisation (amplified by the Single Market Programme) are at the heart of the problem, the question remains open, if there is a reasonable chance that the competitiveness channel may be able to overcome the divergences which have their origin in the structural particularities of the Italian economy.

A clear and definite answer to that question is impossible at this moment since our knowledge about the mechanisms which are at the origin of the decrease of productivity is still very limited. But we can say that, at least up to 2005, the effects of Italy's loss of price and cost competitiveness on the balance of payments are less pronounced than in other countries such as France or Spain. Notwithstanding a heavy increase of the real exchange rate, the negative

effects on exports, trade and/or current account are limited.¹³ We simply ask, therefore, what influence the competitiveness channel may have had on the relative stability of the external position of Italy and what other kinds of influences have to be taken into consideration. Since the beginning of the EMU the external trade contributed negatively to the GDP-growth in Italy (fig.13). This is not astonishing insofar as the greater part of the eurozone member countries suffered a loss in current account. Germany is evidently the winner of the changes in inter-European trade. So the euro appreciation was overcome in Germany by low wages and turned into an export success even if it did not succeed to stimulate growth. Moreover, in the other countries it sensibly reduced both exports and growth.

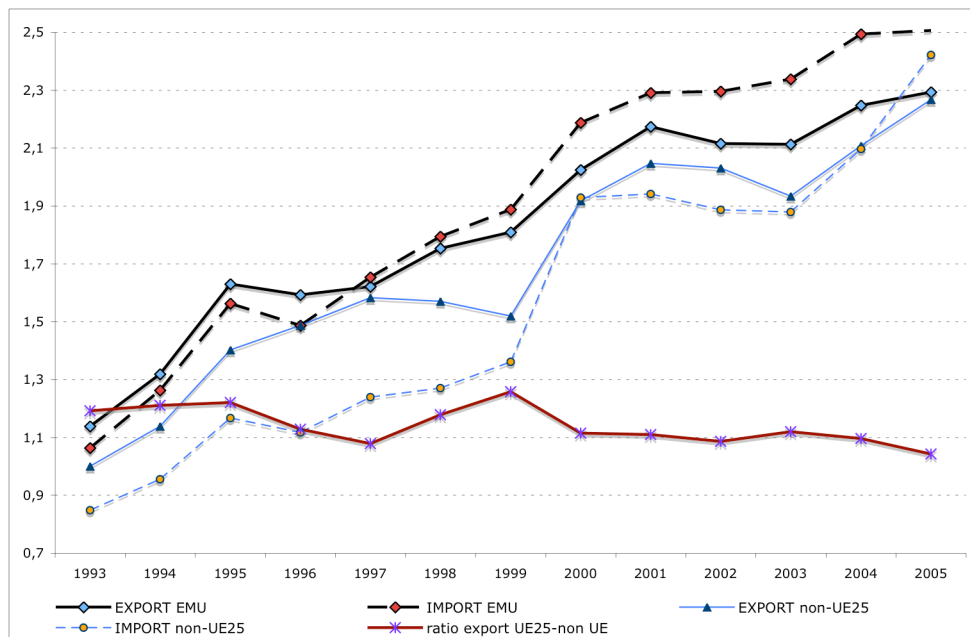
Fig.13 Contribution to GDP growth, 1999-2005 (nominal variables)



Calculation on EUROSTAT data

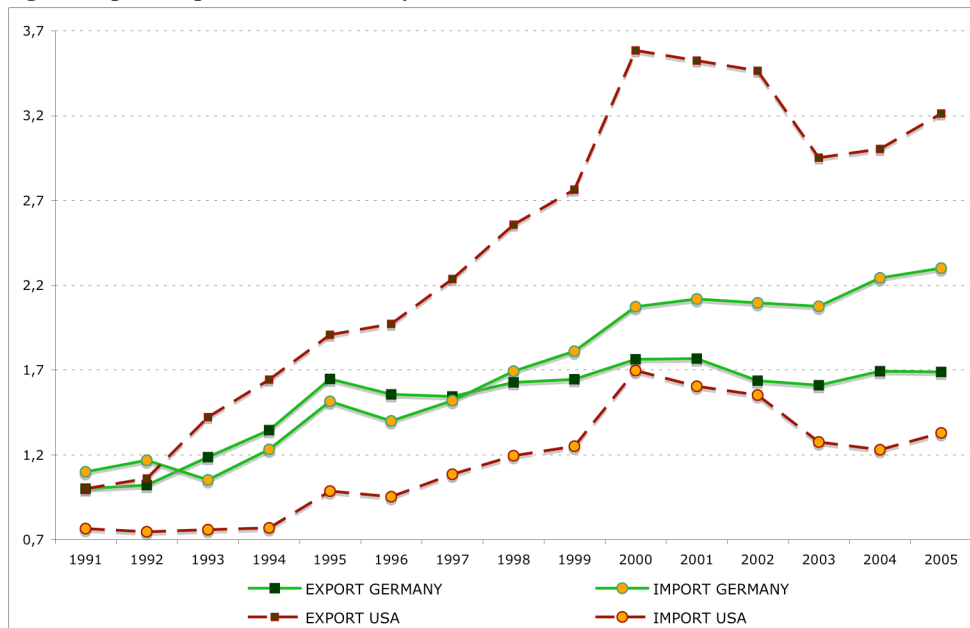
¹³ Fig.12 shows how the trade balance contributed positively for a half of German growth in the EMU years. In the other three countries it contributed negatively while internal consumption was responsible for growth (and investments in Spain). The Italian nominal growth was curbed by inflation while in France it resulted in some real improvement.

Fig.14 Import-export with EMU countries and non EU25



Elaboration on ISTAT COEWEB data. Each export 1991 = 1.

Fig.15 Import-export with Germany and the USA



Elaboration on ISTAT COEWEB data. Each export 1991 = 1.

Concerning the balance of payments position of Italy there are equilibrating forces at work which, at least to some amount, counterbalance the decrease of productivity. What character

do these counterbalancing effects have? Does the competitiveness channel play an important role here? A closer look on the structure of trade may give us an indication.

If we simply distinguish Italy's trade patterns with the member countries of the EMU from those with the rest of the world,¹⁴ we see, fig.14, how the ratio of EU25 vs. non EU25 Italian trade was not relevantly affected by the euro. The strong currency has nevertheless eroded the trade surplus accumulated thanks to the 1992-93 devaluation. Moreover, Italy's trade with the USA (and Eastern European countries) has compensated the erosion of competitiveness inside the EMU. That does not only have an equilibrating effect, but it has also gained importance in relative and absolute terms. The exports in direction of the USA is growing much stronger than the exports to Germany (fig.15). And the trade deficit which Italy is experiencing since 1998 in the bilateral relationship is more than overcompensated by an huge surplus in relation to the USA. Obviously, in the case of Italy the US-economy is functioning as a relief valve which dampens, even if the consequences of the strong euro are visible, the increasing divergences within the Euro-zone. Flexibility, evidently, may have various faces. Price and wage flexibility is only one aspect. Note that this, too, is not a new story. Already during the 1980s, the US-economy played a similar role for the Italian economy as today.

If we have a closer look on the Italian exports to Germany, two aspects are of special interest. In fact, in table 5 we show Italian exports to the whole Euro-zone, Germany and France dividing them by *typical Italian products* (cloths, leather and shoes, ceramics, eyewear, furniture...) and the other goods. In the year 1999 we can see a strong slowdown of Italian exports in general and of typical products in particular. The difficulties concerning the typical products; however, concern mainly Germany while no such decrease affects exports to France and to the rest of Europe. Moreover, even if the quantity of exports to France decreases, value in-

¹⁴ Non EMU countries classification is not available.

creases, which means that prices evolve favourably, but the opposite holds for Germany and in particular for typical luxury goods.

Tab.5 Increase in Italian Export

	GERMANY		FRANCE		EMU	
	1991-1999	1999-2005	1991-1999	1999-2005	1991-1999	1999-2005
Typical products - value	36,3%	-32,4%	45,7%	10,8%	49,6%	-3,2%
<i>end of period %tot value</i>	28,2%	18,2%	22,1%	19,7%	24,5%	18,7%
Typical products - volume	38,8%	-40,3%	39,6%	-0,6%	51,1%	-7,8%
<i>end of period %tot volume</i>	23,5%	14,0%	12,7%	15,0%	16,8%	13,8%
Non-typical - value	75,9%	19,5%	89,0%	27,8%	94,2%	36,5%
<i>end of period %tot volume</i>	71,8%	81,8%	77,9%	80,3%	75,5%	81,3%
Non-typical - vol.	25,9%	12,2%	76,7%	-17,9%	48,4%	16,2%
<i>end of period %tot volume</i>	76,5%	86,0%	87,3%	85,0%	83,2%	86,2%
Total - value	62,6%	4,9%	77,4%	24,0%	81,0%	26,8%
Total - quantity	28,7%	-0,1%	70,9%	-15,7%	48,8%	12,2%

Elaboration on ISTAT COEWEB, Typical include shoes, textiles, clothes, leather, wood and furniture, eyewear, ceramics, etc.

As a consequence, the wage curbing policies in Germany (we may say the whole macro policy in Germany – see fig.13) have assumed the beggar-thy-neighbour feature as suggested by Bibow (2006). Italy has to bear the consequences of this strategy and most of the difficulties with the external demand come from Germany's imports of Italian goods. Italy is now expanding exports to Germany of chemicals, machines, pharmaceuticals, but German employees are no more able (or willing) to buy Italian luxury goods. That has ignited a restructuring of the economic relationships with Germany and a deflationary pressure onto some Italian industries (not on services as we noted before). Consequently, EMU and Germany strategies to fit such constraints are causing a restructuring to the Italian economy and German deflationary and export led policies are worsening the process, amplifying problems instead of helping market adjustments.

6. Conclusion

If we try to draw a first and provisional conclusion, the material we have presented here seems to demonstrate that in the case of Italy since the start of the EMU not the competitive channel helped to limit the divergences between Italy on the one hand and Germany, Austria and other countries on the other hand, but some favourable *external* circumstances. The real exchange rate channel is weak not only because Germany – in 2006 with an expected surplus of 5% of GDP (mainly against countries within the eurozone) – follows a policy of artificially limiting wage and price increases, but also because the economic systems of southern-European countries may react entirely different than expected to the imputed institutional changes within the European Union. The dangers to the stability and convergence in the European Monetary Union are coming from two opposite directions. There is not only the open question of how the flexibility doctrine could be successful, if in the country with the highest (and strongly growing) current account surpluses the increase of nominal wage and labour costs is kept far below the average, in some years even negative. We also have to take into consideration the possibility that the institutional settings of some European Countries – and Italy may here be taken as the most important example – react in an unexpected and unfavourable way to the Single Market Programme and the growing pressures of liberalization, deregulation and privatisation. What in the case of Germany may be seen mainly as a problem of fiscal and wage policy in Italy is much more depending on the structure of the industrial and service sector and the spontaneous adaptation of these sectors to the changing economic environment.

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