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In-Depth Review for ITALY

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

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EXECUTIVE SUMMARY AND CONCLUSIONS

This in-depth review takes a broad view of the Italian economy in order to identify actual or potential imbalances and the possible macroeconomic risks that they may entail. The main imbalance affecting the Italian economy is the high government debt. Combined with the unsatisfactory growth prospects, it represents the main vulnerability of the Italian economy, with negative impact on the banking sector and the real economy and potential negative spillovers to the euro area as a whole. In addition, Italy has been losing external competitiveness since euro adoption, mainly due to stagnant productivity growth and an unfavourable export structure. While the current account deficit remains contained, its negative trend could entail significant macroeconomic risks for Italy and the euro area as a whole. The main observations from this review are:

- **The high government debt represents a major imbalance of the Italian economy with negative effects on the real economy and potential spillovers to the euro area as a whole.** The high public debt could affect Italy's growth prospects mainly via the higher - present and expected - distortionary taxation needed to service it and put it on a sustainable path. This weighs on labour and capital costs. In addition, the higher risk premia associated with a high public debt affect the cost of capital also for the financial sector and the real economy. Other channels are the increased macroeconomic uncertainty and a reduced margin for countercyclical fiscal policies. Finally, the euro-area sovereign crisis has shown the potential negative spillovers from debt accumulation in a monetary union. Although during the crisis the increase in the debt ratio was more moderate than in the rest of the euro area, also because the banking sector did not require public support, its high level has exposed the country to investors' concerns about sustainability, especially against the background of a lacklustre growth performance.
- **Italy has been recording declining competitiveness since the end-1990s, due to both cost and non-cost factors.** This is most evident in Italy's world market share losses, while it is only partly reflected in Italy's external position, given the relatively subdued growth of domestic demand. The current account balance moved from a surplus of around 2% of GDP in the late 1990s to a deficit of 3.2% in 2011, mainly reflecting a deteriorating trade balance. While the current account deficit does not breach the scoreboard threshold, its negative trend needs to be reversed to continue ensuring the sustainability of Italy's external position.
- **Stagnation in productivity is the key factor behind Italy's loss of cost competitiveness since the euro adoption.** Cost competitiveness, measured by the real effective exchange rate (REER) based on unit labour costs (ULC), worsened against the main euro area competitors in the first years of euro-area membership. While Italy's productivity has lagged relative to the euro-area average, wages have grown broadly in line, if not somewhat faster, resulting in more sustained ULC dynamics. The most recent estimates point to a relatively small overvaluation of Italy's REER and thus to a still manageable adjustment if wage developments are consistent with the need to regain cost competitiveness and if the implementation of bold structural reforms is successful in boosting productivity growth.

- **An unfavourable product specialisation and geographical destination of exports also explain declining competitiveness.** With an export product mix that is rather similar to that of emerging economies, Italy has been exposed more than other euro-area countries to increasing global competition. As a partial response to these competitive pressures, restructuring had started in the tradable sector before the crisis: while maintaining its specialisation in labour-intensive sectors, Italy's exports moved up the quality ladder. Italy's exports are also held back by their still relatively low penetration into fast-growing emerging markets, especially in Eastern Asia. The small size of the Italian firms plays a key role in hindering the reorientation of exports towards distant markets.

In this context, **the in-depth review concludes that Italy is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed.** In particular, macroeconomic developments in the area of export performance deserve attention as Italy has been losing external competitiveness since euro adoption. Given the high level of public debt, enhancing the growth potential should be a key priority so as to reduce the risk of adverse effects on the functioning of the economy.

Against this background, the Commission proposes a number of policy responses in the context of the European Semester, the broad thrust of which appears relevant to address Italy's internal and external imbalances.

1. INTRODUCTION

On 14 February 2012, the European Commission presented its first Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) no. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device, helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of policy follow-up it will recommend to the Council.

In the AMR, Italy displays scoreboard values above the indicative thresholds in the areas of public debt and the development in export market shares. The country has experienced significant deterioration in competitiveness since the end-1990s: this is most evident in the persistent losses of market shares, while it is only partly reflected in Italy's current account balance. While private sector indebtedness is relatively contained in Italy, the level of public debt is a concern.

Against this background, section 2 of this review looks more in detail into these developments covering both the external and internal dimensions. Section 3 focuses on Italy's external competitiveness. Section 4 presents possible policy considerations.

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

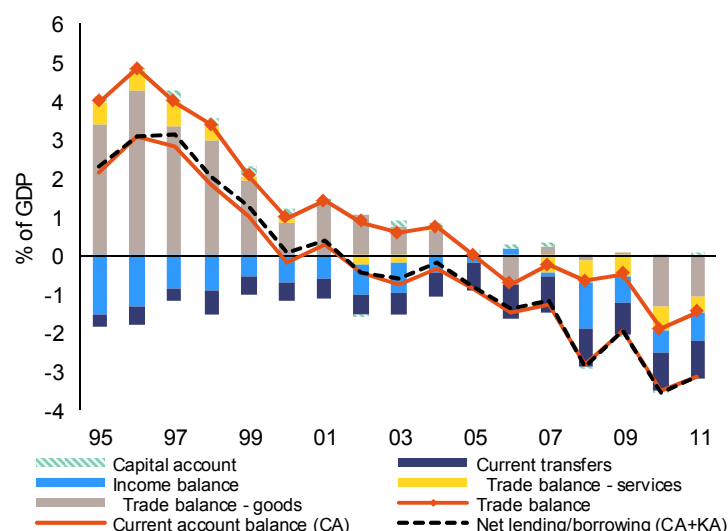
2.1. Macroeconomic scene setter

The economic and financial crisis exacerbated the long-standing structural weaknesses that in the previous decade had already significantly restrained Italy's economic growth. Over 1999-2007, Italy's real annual GDP growth averaged 1.5%, i.e. around $\frac{3}{4}$ pp. below the performance of the euro area as a whole. This mainly reflects low productivity growth, in particular as total factor productivity (TFP) growth dramatically declined¹. Italy's dismal TFP developments since the end-1990s indicate a disappointing absorption of new technologies, with structural weaknesses that limit the organisational efficiency and ability to innovate by Italian industry, market competition especially in the non-tradable services sector and human capital accumulation. In addition, a segmented labour market and a still-insufficiently-decentralised wage setting system hamper the adjustment of the economy.

The global crisis produced a sharp contraction in Italy's real GDP – by of around 7 pps. - between the second quarter of 2008 and the second quarter of 2009, as exports and subsequently investment collapsed. The modest recovery that followed came to a halt in the second half of 2011 due to the euro-area sovereign debt crisis. As domestic demand was severely affected by low economic agents' confidence, poor labour market prospects and tight credit conditions for firms, the Italian economy went back into recession in the second half of 2011. The Commission services' spring 2012 forecast projects a 1.4% contraction of real GDP in 2012 followed by a moderate recovery in 2013 (+0.4%), under the assumption of no further worsening in financial market conditions and yields on 10-year Italian sovereign bonds slightly below 6%.

2.2. Sustainability of external positions

Graph 1: Italy's current account balance and its components



Source: Commission services

¹ See for instance Bardone and Reitano (2009).

Italy's current account balance has been steadily declining since euro adoption. The steady worsening of Italy's current account balance since euro adoption – from +1.8% of GDP in 1998 to -3.2% in 2011 - is mainly related to the negative trend in the trade balance (Graph 1). Part of this can be ascribed to Italy's high dependence on imported energy (Graph 2), as the sharp increase in oil prices has affected the trade balance since the mid-2000s and in particular over 2005-07. The high sensitivity of the current account to Italy's energy dependence is a structural feature of the Italian economy and cannot be expected to change in the short/medium term. Some temporary elements also played a role in the current account deterioration during the recent crisis. In 2008-09, the income balance worsened significantly as income from investment abroad dropped dramatically, more than offsetting the lower interests paid on Italy's debt instruments held by foreign investors. In 2010-11, imports of photovoltaic cells accounted for around ½% of GDP of the increase in the trade deficit under the impact of generous government subsidies for the promotion of renewable energy. Still, the negative trend in the trade balance also reflects the significant loss of Italy's share in world exports since the end-1990s (Graph 3).

Graph 2: Sectoral trade balance

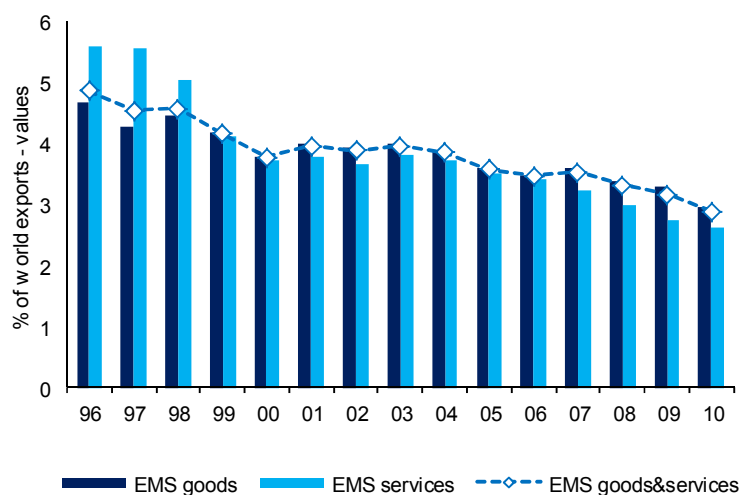
Contribution to overall trade balance (in %)*



*The indicator compares the trade balance in a certain sector to the absolute value of the overall trade balance in goods

Source: Commission services

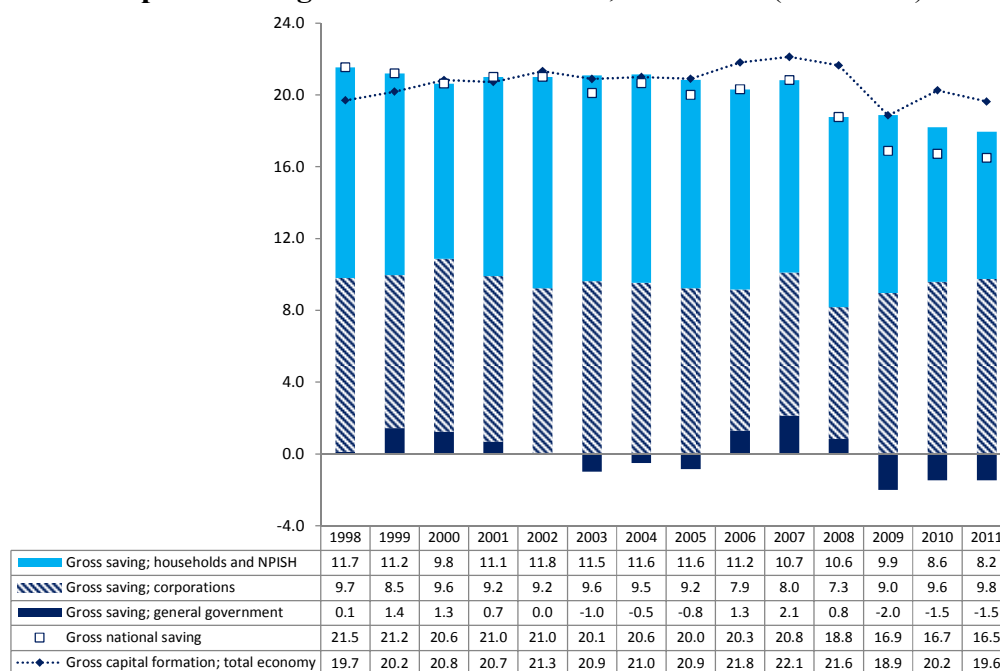
Graph 3: Developments in Italy's Export Market Shares (EMS)



Source: Commission services

From a saving-investment perspective, since the mid-2000s annual savings by the Italian economy have been insufficient to fund its investment activity. The decline of Italy's current account balance to a negative position over 2006-2007 mainly reflected the increase in the investment ratio, as growth improved and financial conditions were still favourable, while the overall saving ratio improved only moderately thanks to the consolidation in the government sector (Graph 4). In the following years, the crisis determined a sharp fall in the household saving rate, as households did not adjust their consumption to a disposable income that remained on average flat over 2008-2010. The saving rate fell below the euro area average, as the latter benefitted from more favourable developments in disposable income (Graph 5). This, together with cyclical negative developments in the general government savings, more than offset the fall in the investment ratio. Overall, developments in saving and investment trends in Italy seem to reflect what is suggested by their long-run empirical determinants (European Commission 2011). In particular, according to the findings of that study, the large decline in Italy's private saving rate since the beginning of the 1990s seems to have been driven by the large fiscal consolidation and lower inflation². Using the same findings, the large increase in oil prices and negative developments in GDP per capita may have exacerbated these negative historical trends during the crisis.

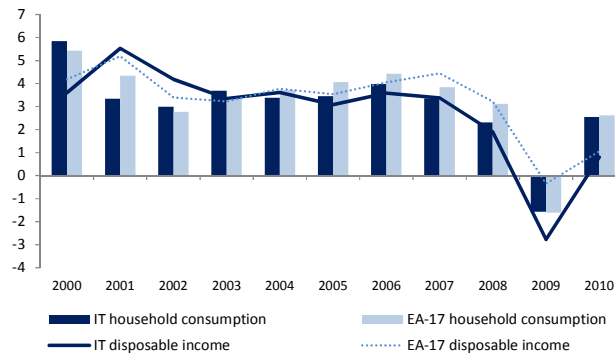
Graph 4: Saving and investment flows, 1998-2011 (% of GDP)



Source: Commission services

² By contrast, Brandolini and Rosolia (2011) estimate that the decline in the household saving rate in Italy over 1989-2006 is mainly explained by population ageing and a lower propensity to save by the younger cohorts.

Graph 5: Households' consumption and disposable income (% ch.)



Source: Commission services

The current account deficit is expected to narrow in the coming years mainly due to the contraction in domestic demand. In the Commission services' spring 2012 forecast, the current account deficit is set to narrow to around 1¼% of GDP by 2013. The significant planned fiscal consolidation is expected to bring Italy's general government budget close to a balanced position by 2013. This, in turn, would increase Italy's overall saving rate by 2013 despite some further reduction in households' savings due to the expected consumption smoothing. The negative financing conditions and growth prospects are also set to reduce the investment ratio in the short term.

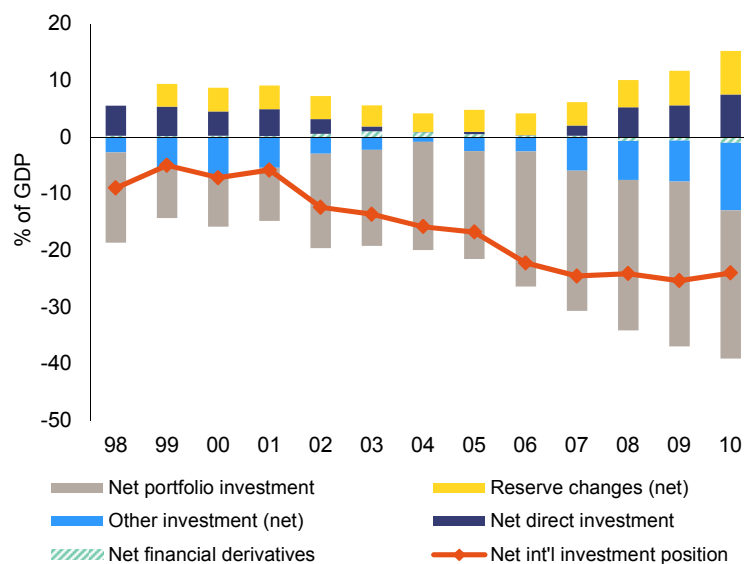
Italy's net international investment position (NIIP) is negative, but, at around -22% of GDP at end-2011, does not appear to be excessively large³. Italy's NIIP was already negative before euro adoption, but declined by over 10 pps of GDP in the first half of the 2000s and has remained below -20% of GDP since end-2006. While still within the critical threshold of the scoreboard, even a small negative NIIP implies reliance on external financing and liquidity. The 2008-09 global financial crisis dramatically changed the risk perception among investors, as shown by the recent tensions in the euro-area sovereign debt market. Following the escalation of the sovereign-debt crisis and severe stress in the euro-area interbank market in the final months of 2011, Italian banks massively resorted to the ECB liquidity provisions through its non-standard monetary policy measures. This avoided a major credit crunch and improved credit supply condition in the first quarter of 2012 (Bank of Italy 2012a), but it can only be expected to ease financing pressures in the short term.

Valuation effects have shaped the NIIP since euro adoption. Italy's NIIP before euro adoption was -9% of GDP. It decreased to -24.5% of GDP at the end of 2007 - just before the global financial crisis – mainly due to negative valuation effects, while the overall accumulation of external deficits over 1999-2007 accounted for less than 3 pps of GDP. The stabilisation of the NIIP during the global financial crisis, despite the accumulation of significant external deficits (11.5 pps. of GDP over 2008-11), is mainly due to the more favourable market valuation of investments made abroad relative to domestic investments. Going forward, Italy cannot expect to continue relying on favourable valuation effects.

³ According to the Bank of Italy (2011a), at end-2010 Italy's net external debtor position would improve by around 7 pps. of GDP if the assets that escape observation are taken into account, while the overall undeclared assets of Italian residents are estimated in a range between 7.9% and 12.4% of GDP at end-2008 (Pellegrini and Tosti, 2011).

In the first nine years of the euro, the composition of Italy's NIIP changed significantly (Graph 6). Over 1999-2007, foreign financing of debt instruments increased significantly mainly thanks to their new denomination in euro. By contrast, investment in equity abroad by Italian residents increased more than that of non-residents in Italy. Part of this shift may be explained by the increased use by Italian investors of mutual and other investment funds located abroad also for taxation purposes. The amount of government securities held by non-resident investors continued to increase up to around 48% of GDP at the end of 2010 (from 42% in 2007), then declined in 2011 as a consequence of the sovereign-debt crisis. The stock of direct investment abroad rose (to 23.5% of GDP in 2010 from 18.3% in 2007) also due to acquisitions in the energy sector, while the stock of foreign direct investment in Italy remained stable at very low levels (around 16% of GDP – see section 2b). Reliance on foreign financing of debt instruments rose further during the financial crisis but declined in the final months of 2011 as foreign investors reduced their exposure to Italy.

Graph 6: Italy's Net International Investment Position by instrument



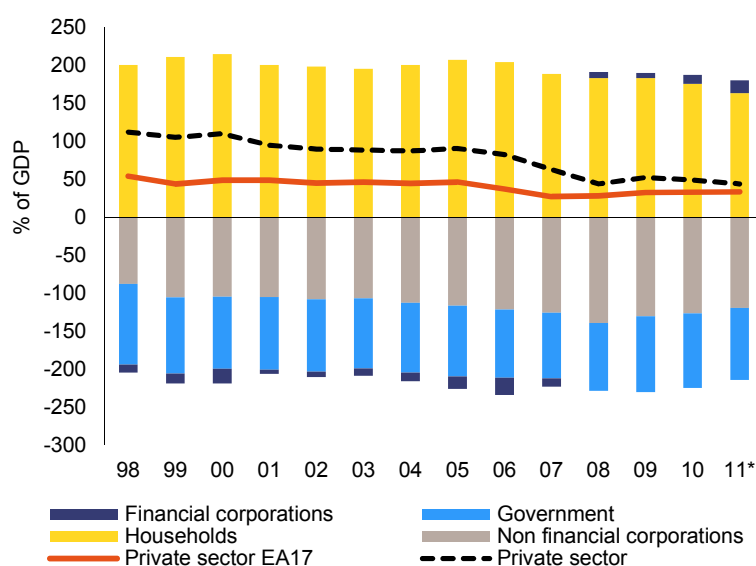
Source: Commission services

2.3. Sustainability of internal positions

In sum, Italy still has a relatively sound NIIP, on account of the strong financial position of the household sector. The latter largely offsets the negative financial position of the general government and corporate sectors (Graph 7). Italian households still hold sizeable net wealth: including real assets, it is estimated at around 560% of GDP at end-2010, i.e. more than 8 times their disposable income, compared with around 7.5 times in France and 5 times in the USA⁴.

⁴ See Bank of Italy (2011b).

Graph 7: Italy's net financial position by sectors



Source: Commission services

Loans granted to Italian households amounted to 45% of GDP in 2010, significantly less than the euro-area average of 63%. Loans to households have increased sharply since euro adoption, going up by 25 pps of GDP compared to the ratio in 1998 (Graph 8). This increase in households' leverage mainly reflects the wider use of mortgage loans for the purchase or renovation of real estate, but as indebtedness is more common among households with medium/high-incomes, financially vulnerable households⁵ remain relatively few (Bank of Italy 2012b).

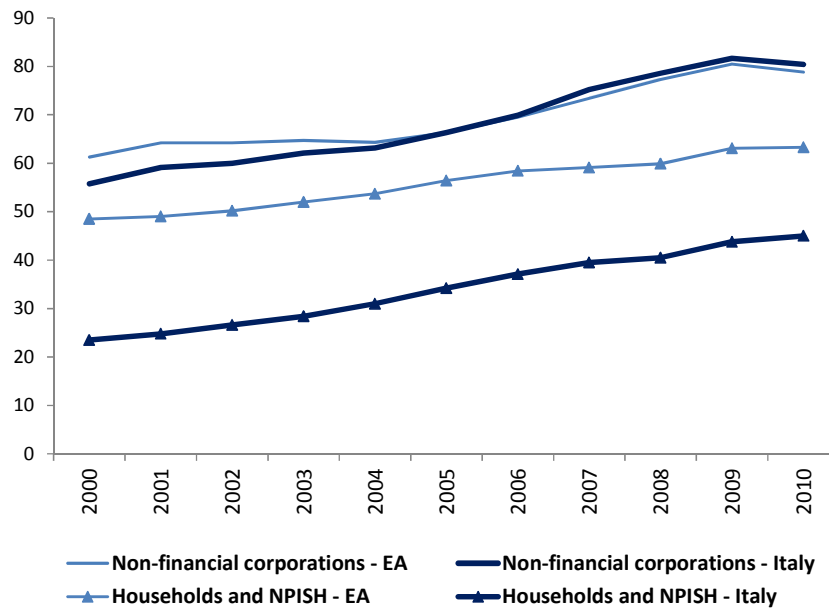
There was no major housing boom before the crisis. The increase in house prices in the pre-crisis years was more contained than in many other euro-area countries and was not followed by a sharp price adjustment (Graph 9). The share of residential investment to GDP rose from 4.8% in 1998 to 5.8% in 2006 (vs. 6.9% in the euro area), before falling to 5.4% in 2011 (vs. 5.6% in the euro area).

The indebtedness of Italian non-financial corporations stood at 80% of GDP in 2010. This level is close to the euro-area average when looking at consolidated figures⁶, although it increased by more than 20 pps. over the last decade (Graph 8). While it is essential to avoid a credit crunch in the short term, further large increases in the leverage of non-financial corporations could become problematic for the financial stability of the Italian banking sector and thus for medium/long term growth prospects (see for instance 2011, Cecchetti *et al.*). The tax allowance for corporate equity (ACE) introduced in December 2011 will support equity investment by reducing the “debt bias” in corporate taxation, contributing to avoid an excessive leverage of the corporate sector in the future.

⁵ In 2010, the share of financially vulnerable households - conventionally defined as those with debt service payments equal to more than 30 per cent of their income - was stable at around 11% of households with debts.

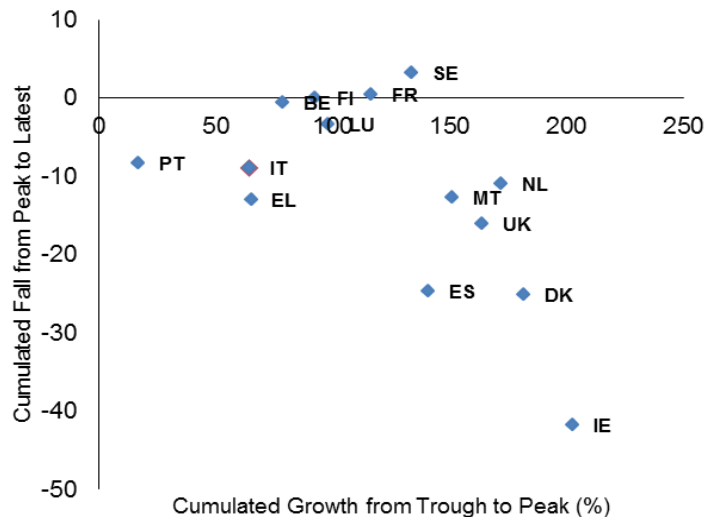
⁶ If non-consolidated data are taken into account, indebtedness of Italian non-financial corporations remains around 20 pps. of GDP lower than the euro-area average. This indicator also includes intra-group loans.

Graph 8: Debt of non-financial corporations and households
Loans and securities other than shares (consolidated - in % of GDP)



Source: Commission services

Graph 9: The house price cycle*



*The cumulated house price growth from the latest trough to the latest peak is plotted against the adjustment from the latest peak to the latest data available (Q3-2011).

Source: Commission services

The high government debt represents a major imbalance of the Italian economy. At just over 120% of GDP by end-2011, Italy has by far the highest public debt ratio among the large euro area countries. In the run-up to the euro adoption, Italy's government debt fell from a peak of more than 121% of GDP in the mid-1990s to around 114% at end-1998. After euro adoption, Italy did not take advantage of the reduction in interest expenditure to progress further in ensuring sound public finances. The primary surplus, which averaged 5½% of GDP over 1997-2000, was gradually eroded. Between 1999 and 2007, the debt-to-GDP ratio declined by only 11 pps., also thanks to more 6 pps. of GDP privatisation receipts and other extraordinary revenues. With limited fiscal space, Italy maintained a prudent fiscal stance during the crisis. The increase in the general government debt was thus more moderate than in the rest of the euro area, also because the banking sector did not require public support.

Nevertheless, as real GDP fell sharply and automatic stabilisers were at play, the government debt rose again to around 120% of GDP by the end of 2011.

The high government debt could affect Italy's growth prospects. Economic theory suggests that a high public debt could affect growth mainly via the higher - present and expected - distortionary taxation needed to service it and put it on a sustainable path. This weighs on labour and capital costs. In addition, the higher risk premia associated with a high public debt may affect the cost of capital also for the private sector. Other channels are the increased macroeconomic uncertainty and a reduced margin for countercyclical fiscal policies. Recent empirical studies on the subject confirm the existence of an inverse relationship between the level of public debt and economic growth⁷. This could be the case for Italy (Balassone et al. 2011).

The high government debt represents a major vulnerability for Italy with potential spillovers to the euro area as a whole. This became evident as tensions in the financial markets assumed systemic proportions in the second half of 2011. Spreads between yields on Italian and German sovereign bonds reached a peak in November 2011. Yields on 2-year Italian government bonds neared 8% and the yield curve remained downward sloping (i.e. inverted) for some days, signalling the risk of unsustainable financing costs for the government sector and of a liquidity crisis related to the large debt rollover scheduled for the first months of 2012. Spreads then declined from mid-January to mid-March reflecting the enhanced policy actions at national and euro area level, including the large liquidity injections provided by the ECB with its 3-year Long Term Refinancing Operations (LTROs) of December 2011 and February 2012. The euro area sovereign crisis has shown the potential negative spillovers from debt accumulation in a monetary union (see Box 1).

High government debt and low growth are also adversely affecting the Italian banking system and credit conditions. Italian banks have coped better than their European peers during the financial crisis, thanks to their conservative business model and the absence of a real estate bubble in the country. However, against the background of a generalised increase in risk aversion and the deepening of the sovereign debt crisis, the reduced ability of Italian banks to access market financing implies higher financing costs also for the private sector, despite the ECB decisions to cut the main refinancing operations rate by 25 bps in November and again in December 2011 (to 1%). The higher interest rates paid by Italian firms relative to their euro-area competitors also seriously affects their competitive position. This is all the more relevant for Italy's competitive position given the predominant role that banks traditionally play in the Italian financial system and the relatively limited reliance by firms on other sources of funding.

⁷ For instance, Reinhart and Rogoff (2010) find a 2.6 pps difference in median real GDP growth between advanced countries with public debt below 30% and above 90% of GDP. Kumar and Woo (2010) estimate that for advanced economies a 10 pps increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.15 pp., with some evidence of nonlinearity implying larger negative effects with initial debt higher than 90% of GDP.

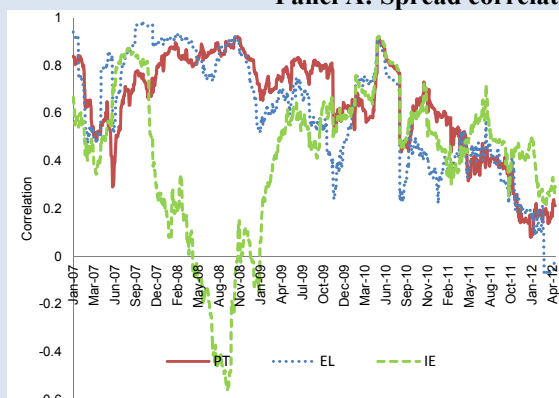
Box 1. Sovereign-debt spillovers

The euro-area sovereign debt crisis has shown the potential for spillovers underlying debt accumulation in a monetary union.

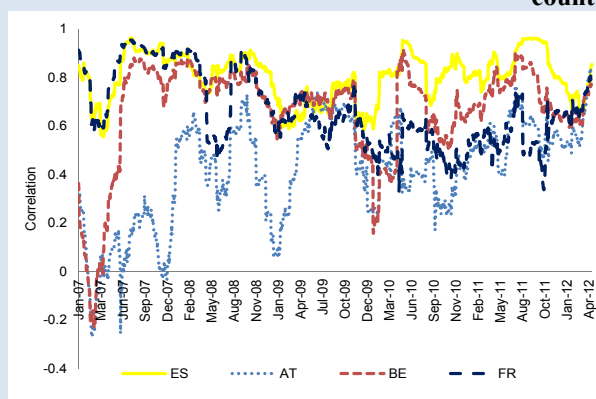
The creation of the European Financial Stability Facility (EFSF) in May 2010 implicitly linked the different bond markets but also contributed to reduce the uncertainty around potential *domino* effects and the potential for contagion has dropped ever since.

Looking at yield spreads with Germany on 10-year sovereign securities, correlations between Italy's and programme countries' spreads have been declining since the May 2010 (Figures 1 – Panel A). By contrast, correlations between spreads of Italy and other selected euro-area countries - Austria, Belgium, France and Spain - remain elevated (Figures 1 – Panel B), signalling the potential for major spillovers through market reactions.

Figure 1: Italy: Spread correlations
Panel A: Spread correlations with programme countries



Panel B: Spread correlations with selected euro-area countries



Source: Datastream

Note: Correlations are calculated on 3-months rolling windows of daily changes in spreads relative to the Germany of yields on 10 year sovereign securities

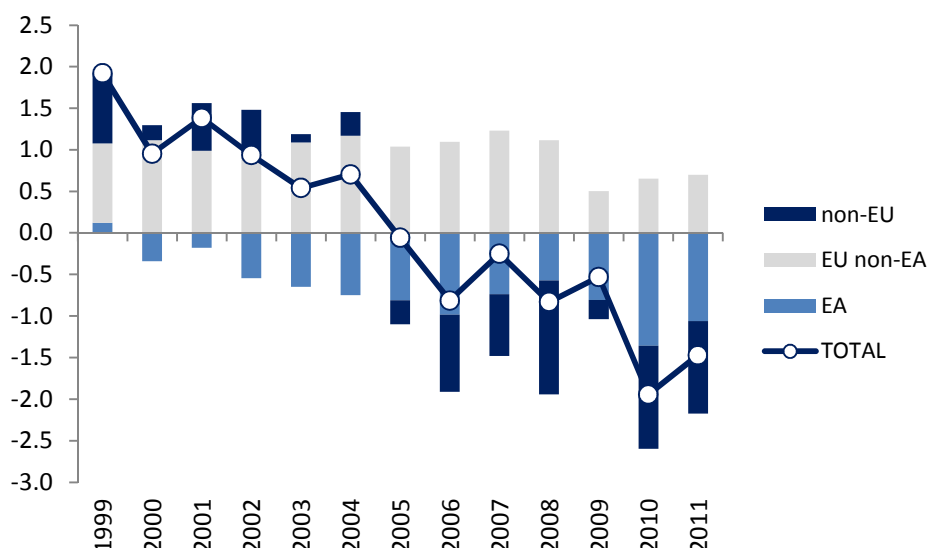
As public debt developments are already under close scrutiny within the Stability and Growth Pact surveillance (European Commission 2012), the following in-depth analysis focuses on macroeconomic developments in the area of external competitiveness.

3. IN-DEPTH ANALYSIS: EXTERNAL COMPETITIVENESS

Loss of cost competitiveness is a main factor behind the decline in Italy's trade balance. Since 1998, Italy's balance of goods and services deteriorated significantly vis-à-vis the rest of the euro area (Graph 10). This is a symptom of loss of cost competitiveness relative to the euro-area trade partners. Over 1999-2011 nominal unit labour costs (ULC), which indicate the pressure from labour costs on domestic prices, increased by 2.3% on average in Italy, i.e. slightly more than the ECB inflation target.

This compares with 1.6% in the euro area as a whole, 1.9% in France and only 0.5% in Germany. Differences in unit labour cost developments since euro adoption largely explain the more negative development in the Italian profit shares relative to the rest of the euro area - in particular in manufacturing - despite similar producer price developments.

Graph 10: Balance of goods and services (% of GDP)



Source: Commission services

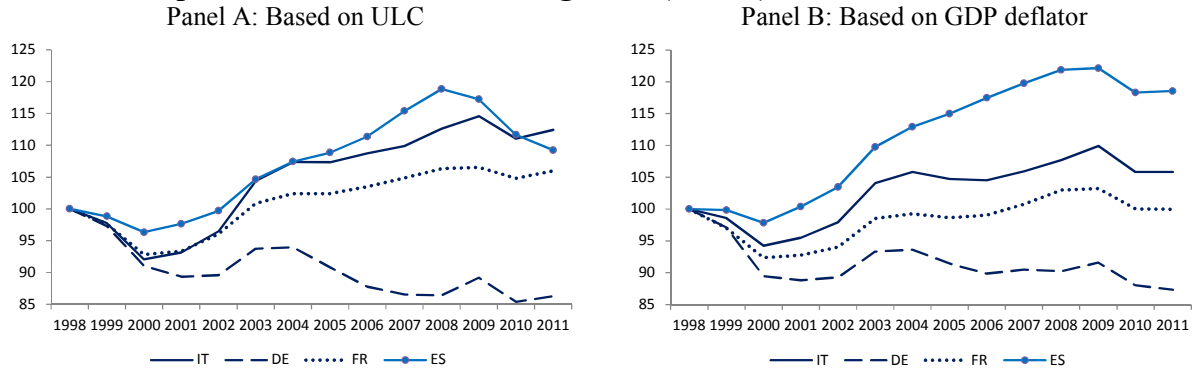
Developments in the real effective exchange rate (REER) indicators suggest the opening up of a competitiveness gap versus other euro-area members, but its size is uncertain. The REER based on nominal ULC measures cost competitiveness relative to a set of competitor countries (Graph 11 – Panel A). Since the introduction of the euro, Italy's cost competitiveness performance worsened significantly when compared to Germany and moderately when compared to France. Stagnation in labour productivity growth in Italy since the end of the 1990s is the key factor behind the rise in the REER based on ULC⁸. It affected both the North and the South of country (Box 2). While productivity has lagged relative to the euro area average, as TFP declined, wages have grown broadly in line, if not somewhat faster (Graph 12)⁹. This is also due to the wage setting framework that - at national level - does not reflect productivity developments and may not leave much scope for negotiations at the level of firms (see Box 3). Productivity stagnation was widespread not only in the non-tradable sector, but, contrary to what happened in the euro area as a whole, also in the tradable sector (Graph 13). However, the appreciation of the REER based on different measures, namely the GDP deflator (Graph 11 – Panel B), the consumer price index and the wholesale/producer price indices, appears significantly more limited (Bayoumi et al. 2011). In addition, the estimate of the possible overvaluation of the REER depends on the methodological assumptions and is subject to large estimation

⁸ In 2010 the combination of job losses and the moderate GDP recovery implied a temporary rebound in productivity.

⁹ Wage growth was slightly faster than the euro-area average in both the tradable and non-tradable sectors.

errors. In 2007, the IMF estimated the REER overvaluation for Italy at end-2005 at around 5-8%.

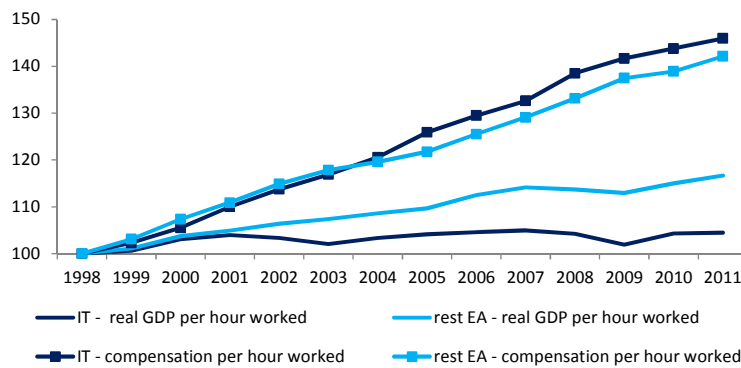
Graph 11: Real effective exchange rate (REER) (index 1998=100)*



*Performance relative to the rest of 35 industrial countries; double export weights

Source: Commission services

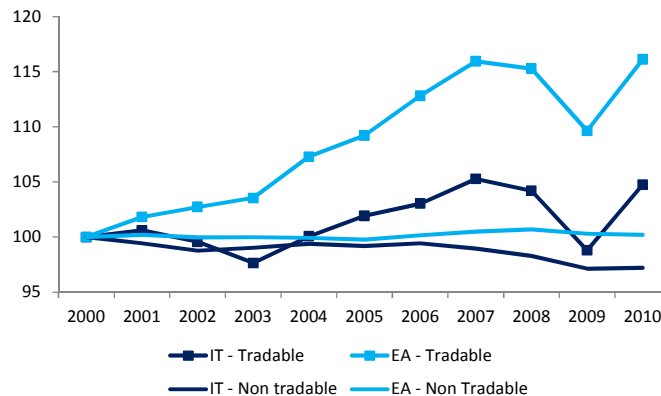
Graph 12: Compensation and productivity development (index 1998=100)



Source: Commission services

Graph 13: Productivity in the tradable and non-tradable sectors

Gross value added per person employed (index 2000=100)



Source: Commission services

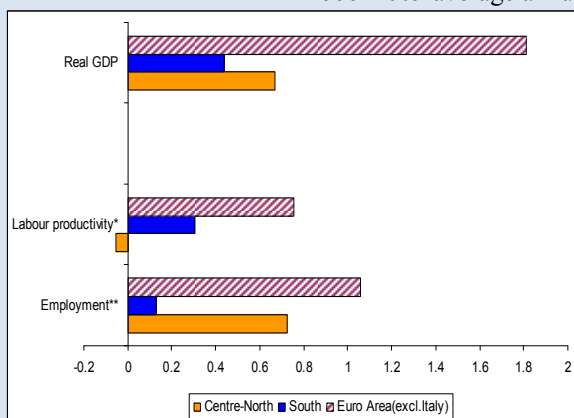
Box 2. The regional divide in productivity and exports

While the existence of a large and persistent regional economic divide in Italy is a well-known phenomenon, the regional performance of exports and their composition are less frequently studied.

The regional divide in Italy is large also as regards export capability (Montanari 2011). Besides being much less open than the Centre-North, the South economy's exports a more limited number of products.

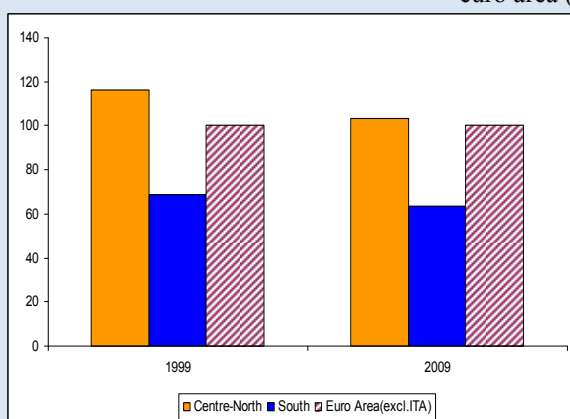
However some weaknesses are common to the two areas. Both experienced stagnation in productivity over the past decade, a development that is at the root of the cost competitiveness losses recorded by the Italian economy as a whole (Figure 1). Moreover, compared to the other advanced economies, neither geographical area has a comparative advantage in high-technology industries. Finally, the South appears less exposed than the Centre-North to competition from China in the EU market and its export growth performance in value terms was slightly better over the last decade, even if its exports were more severely affected by the recent crisis.

Figure 1: GDP developments
Panel A: Real GDP growth and its supply side determinants
 1999-2009 average annual percentage growth



Panel B: Levels of GDP per capita***

euro area (excl. Italy)=100



*Real GDP per full-time equivalent employed. **Full-time equivalent employed.

***In purchasing power standards.

Source: Montanari (2011)

Box 3. Italy's wage bargaining system

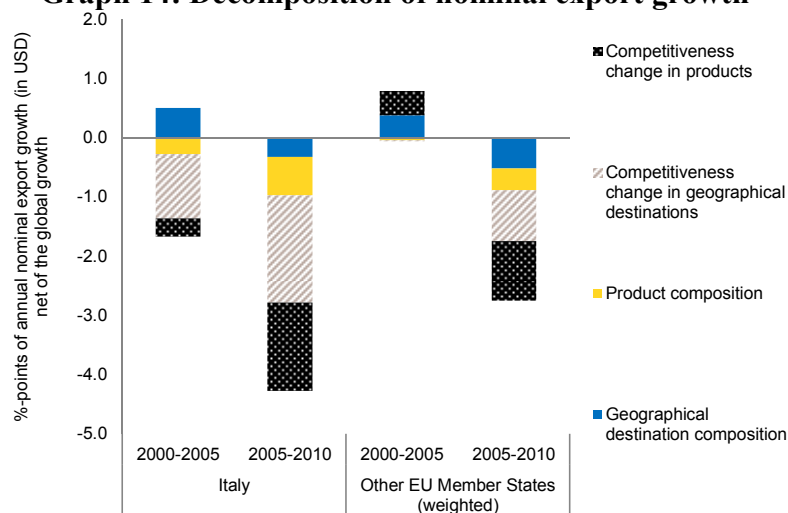
The dominant level of collective bargaining in Italy remains the national level, even though the bargaining framework has undergone important changes since the beginning of the 1990s that have promoted a gradual shift towards the company level. The most important of these changes was the tripartite agreement in July 1993, which formalised the company/local level within a two-tier bargaining framework. In 2009, a new agreement aiming at further shifting the balance towards decentralised bargaining was signed. It stipulated that for centralised bargaining at sectoral level, the new inflation benchmark to be used is the forecast of Italy's HICP inflation excluding imported energy products. The uprating is applied to the fixed components of the wage base, as determined in each sector. With a view to supporting the conclusion of firm-level agreements, wage increases linked to productivity performance set at firm level are receiving a preferential tax treatment, while firms not concluding firm-level contracts have to pay an additional wage component "*elemento retributivo di garanzia*", which is however not necessarily linked to the productivity performance in practice. The 2009 agreement divided the unions and failed to specify rules governing union representativeness. The June 2011 social partners' agreement establishes such rules and further strengthens the use of firm-level contracts. A new provision in the economic and budgetary package approved by Parliament in September 2011 goes further by allowing firm-level collective agreements to derogate from labour law. The June 2011 agreement provides a necessary step to better take into account the needs of specific production activities. However, in light of the still strong prevalence of collective bargaining at the sectoral level only, strengthening the link between wage and productivity requires further action to ensure that also the sectoral wage setting framework ensures a better alignment of wages with productivity developments. In addition, uprating the sectoral wage by the national forecast inflation, even if excluding imported energy prices, may have second round effects on inflation as assumptions on wage increases enter the inflation forecast. In turn any increase in HICP related to higher indirect

taxation would further erode the competitiveness of Italian firms.

The high tax burden weighs on labour costs. At 42.6 % in 2010, the implicit tax rate (ITR) on labour – i.e. the sum of all direct and indirect taxes and social contributions levied on employed labour income as a percentage of total compensation of employees – was the highest in the euro area: it exceeded the (GDP-weighted) EU average by 6½ pps. and the (GDP-weighted) euro-area average by 4½ pps., and was ¾ pp. above the level reached in 2000. This trend is in contrast with the experience of most EU Member States that witnessed a decline in labour taxation in recent years. By contrast, at 16.8%¹⁰, in 2010 the ITR on consumption in Italy was significantly lower than the 19.2% recorded in the (GDP-weighted) euro-area average (see also the analysis of Italy's tax system in the assessment of the 2012 national reform programme and stability programme for Italy).

Non-cost factors affect Italy's competitiveness. A decomposition of total nominal export growth (net of the global trade growth) shows that Italy is specialised in geographical destinations and products with weaker demand. However, Italy's relatively modest export performance over 2005-10 was mainly due to a decrease in its export shares in the geographical markets and products in which it specialises (Graph 14).

Graph 14: Decomposition of nominal export growth*



*Decomposition of total (worldwide) nominal export into four components: i) growth due to the growth of destination markets, ii) growth due to the growth in product markets, iii) export growth to destination markets above their growth, iv) export growth in product markets above their growth.

Source: Commission services

Italy has been exposed to increasing global competition due to its unfavourable export structure. The product mix of its exports is similar to, and hence competes with, that of emerging economies, rather than complementing it. As a partial response to these competitive pressures, restructuring has started in the tradable sector in the pre-crisis years. Italy's trade has moved up the quality ladder. There is some evidence of a restructuring process in the Italian manufacturing sector, whereby less efficient companies in the traditional industries have been forced to exit the market, with a

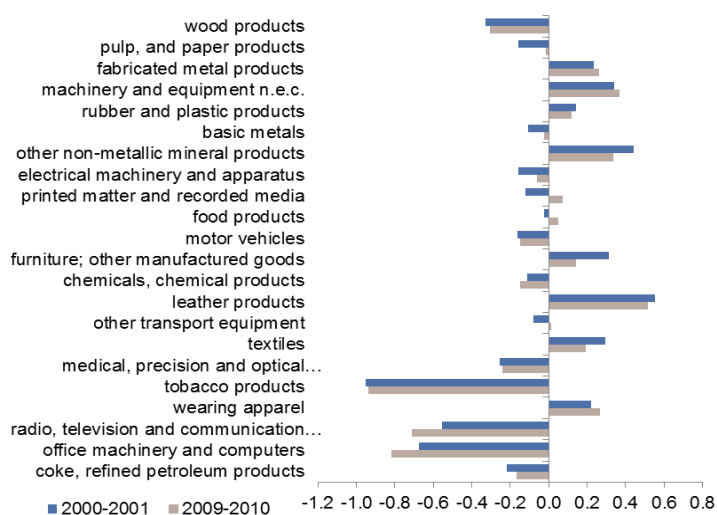
¹⁰ This is before the 1 pp. increase in the VAT standard rate (from 20% to 21%) of September 2011 and the increase in excise duties on fuel products of December 2011. A further 2 pps. increase in both the standard and reduced VAT rates is scheduled for October 2012.

consequent shift of production towards higher quality segments more sheltered from competition from emerging economies (Lanza and Quintieri 2007).

Over the last decade Italy's sectoral specialisation remained stable and mainly concentrated in low-technology and medium-low technology sectors¹¹. Its comparative advantage pattern¹² continues to show a clear specialisation in such sectors as textiles and clothing, metal, mineral and plastic products; machinery and equipment not else classified are the only sector with higher technology content where the country presents a comparative advantage (Graph 15). Mainly due to exposure to competition by emerging countries, Italy's share in world export markets in sectors in which it specialises declined quite considerably in the 2000s (Graph 16). A similar trend also affected exports in more technology-intensive sectors, which account for a significantly lower share of total exports than in the case of Germany and France (Table 1).

Graph 15: The sectoral pattern of comparative advantages

Balassa symmetric revealed comparative advantage index*



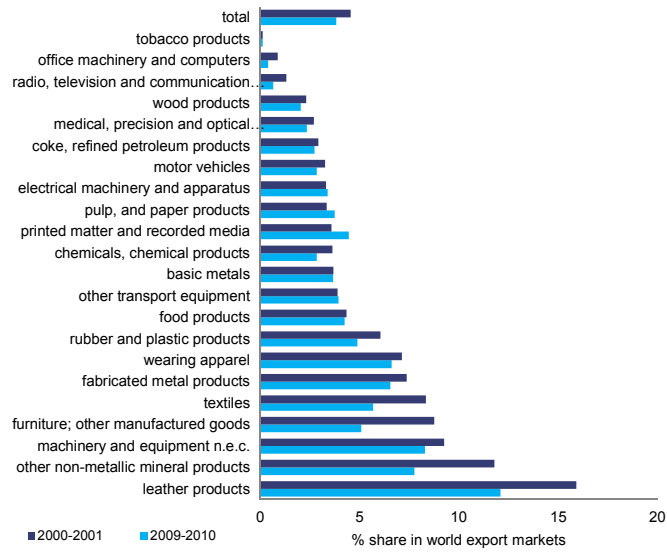
*Positive values indicate a comparative advantage

Source: Commission services

Graph 16: Italy's world market percentage share by products

¹¹ According to OECD (2005) classification.

¹² Measured by the Balassa symmetric revealed comparative advantage index.



Source: Commission services

Table 1: Pattern of manufacturing exports by technological content (2011 vs. 2000 - in %)

| | | 2000 | 2011 |
|----------------|------------------------|------|------|
| Italy | High technology | 11.8 | 10.4 |
| | Medium-high technology | 38.6 | 39.1 |
| | Medium-low technology | 18.7 | 25 |
| | Low technology | 30.9 | 25.5 |
| Germany | High technology | 20.0 | 18.8 |
| | Medium-high technology | 51.3 | 50.5 |
| | Medium-low technology | 14.7 | 17.4 |
| | Low technology | 14.0 | 13.3 |
| France | High technology | 25.7 | 26.2 |
| | Medium-high technology | 39.2 | 35.8 |
| | Medium-low technology | 14.9 | 18.0 |
| | Low technology | 20.2 | 20.1 |

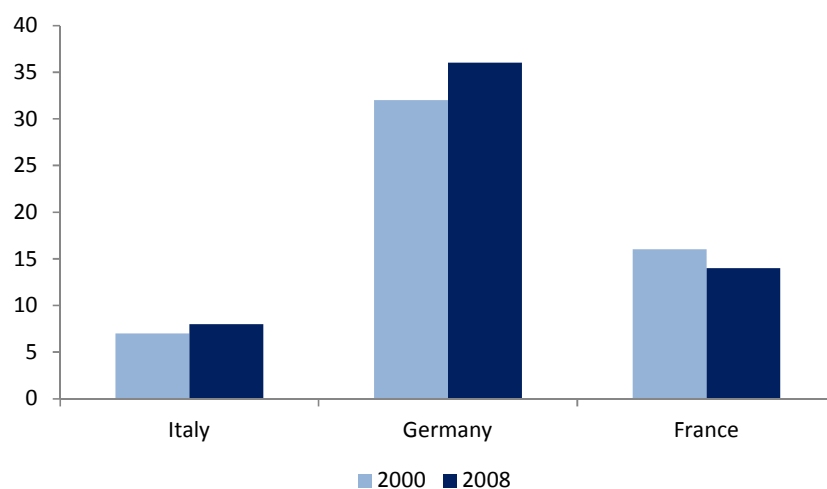
Source: Commission services

A slow reorientation of exports towards emerging markets is taking place and exporting firms are becoming more competitive, but the small size of firms remains an obstacle. The share of Italian exports to extra-EU emerging countries increased over the last decade (Table 2). Nevertheless, Italy is still largely dependent on the euro area markets and is not fully reaping the benefits from the vigorous growth of emerging markets, in particular in Eastern Asia. This is mainly due to the relatively small size of Italian firms (Graph 17) that prevents them to afford the needed high entry costs related to setting up new distribution networks and investing in intangible assets such as patents and brand reputation. Indeed, micro data suggest that the propensity to export and to reach farther markets grows significantly with firm size and that larger firms suffered less during the crisis, although they were more exposed to trade shocks (Bugamelli et al. 2009). Moreover, Italian exporting firms have made progress in terms of quality upgrade and shift of geographical destinations, being more productive, having higher R&D levels and a greater focus on upstream activities (product design, advertising, marketing, distribution) than non-exporting firms (Barba Navaretti et al. 2011).

Table 2: Geographical orientation of Italian exports (% of total)

| Area/Country | 2000 | 2005 | 2011 |
|------------------------------|-------------|-------------|-------------|
| Intra-EU27 | 61.5 | 61.2 | 56.0 |
| Euro area | 48.2 | 46.6 | 42.6 |
| <i>Germany</i> | <i>15.2</i> | <i>13.2</i> | <i>13.1</i> |
| <i>France</i> | <i>12.7</i> | <i>12.3</i> | <i>11.6</i> |
| <i>Spain</i> | <i>6.3</i> | <i>7.5</i> | <i>5.3</i> |
| Extra-EU27 | 38.5 | 38.8 | 44.0 |
| <i>Russia</i> | <i>1.0</i> | <i>2.0</i> | <i>2.5</i> |
| <i>Northern Africa</i> | <i>2.3</i> | <i>2.5</i> | <i>2.9</i> |
| <i>Middle East</i> | <i>3.3</i> | <i>3.9</i> | <i>4.9</i> |
| <i>China</i> | <i>0.9</i> | <i>1.5</i> | <i>2.7</i> |
| <i>Other Emerging Asia</i> | <i>4.0</i> | <i>3.4</i> | <i>3.2</i> |
| <i>Northern America</i> | <i>11.1</i> | <i>8.8</i> | <i>6.8</i> |
| <i>Central-South America</i> | <i>3.9</i> | <i>2.8</i> | <i>3.8</i> |

Source: ISTAT

Graph 17: Employees per firm in manufacturing

Source: Commission services

The small size of Italian firms does not appear to be due to sectoral specialisation, but represents a structural feature of the Italian economy. Barba Navaretti et al. (2011) show that a country's export performance mainly depends on its internal industrial structure; different export performances of European countries are therefore likely to be driven by firm-specific characteristics, while sectoral features play a secondary role. In a counterfactual exercise, they estimate how Italy's export performance would react if Italian firm size and sector specialisation were equal to the German structure while keeping overall employment constant, i.e. shifting employment in the size-sector distribution to replicate the German model. Results show that the value of Italy's total exports would increase by 37%, mostly due

to the firm size effect. For comparison, Spain's exports would increase by around one quarter while those of France would rise by only 9%.

Italy is neither an attractive foreign direct investment destination nor is it exploiting investment opportunities abroad. Italy's foreign direct investment (FDI) performance paints a gloomy picture. As a forward-looking indicator, FDI points also at future prospects for competitiveness and growth. Graph 18 shows that FDI inflows to Italy range at the lower end of the European scale. The technological content of FDI inflows in manufacturing has shifted slightly towards more medium/low tech at the expense of high-tech industries. Italy also underperforms in terms of its capacity to invest abroad, largely due to the small size of its firms (Barba Navaretti et al. 2011). In 2010 the stock of Italy's FDI abroad only amounted to 23.5% of GDP, as against 42.5% for Germany and 60.4% for France¹³.

The small size of firms and the difficulty in attracting FDI depend on a number of structural factors. Capital accumulation is hindered by a high level of corporate taxation and a growth-unfriendly business environment. At 10.2% of GDP in 2010 as against a euro-area average of 7.6%, capital taxes in Italy display the second highest share of GDP among euro-area countries. Both the implicit tax rate (ITR) on capital (34.9%), which has risen by more than 5½ pps. since euro adoption¹⁴, and the ITR on corporate income (27.4%) are well above the (GDP-weighted) euro-area average (27.5% and 21.6% respectively), while the statutory corporate income tax rate (31.4%) is the fourth highest in the euro area¹⁵. Moreover, the tax regime for firms appears very complex¹⁶ and favours debt financing rather than equity financing, while small and innovative firms have limited access to capital markets thus reducing the incentive to firm size growth. The costly enforcement of contracts related to flaws in the Italian civil justice system is a key weakness of the business environment and represents a major disincentive to inward FDI. According to World Bank (2011), the country ranks 158th out of 183 (the worst in the EU) as regards contract enforcing procedures; in particular, it takes 1210 days on average to complete a commercial case in Italy, compared with 331 days in France, 394 in Germany and 515 in Spain. Energy costs are also significantly higher in Italy than the rest of the euro area. Cultural elements also hinder firms' growth: family ownership is widespread, often bringing about an outdated governance model, which does not provide for adequate

¹³ Moreover, only one fourth of Italy's FDI stocks went to extra-EU countries in 2009, compared with more than one third for Germany and France. This is another signal of the difficulties experienced by Italian firms in entering farther markets.

¹⁴ The rise of the ITR on capital in the second half of the previous decade also reflected i) windfall tax revenues related to wealth effects and revenues from withholding tax on interest payments (mainly between 2005 and 2008), and ii) one-off proceeds of the extraordinary tax on illegally expatriated assets (*scudo fiscale*) and the withholding tax on the revaluation of corporations' assets according to International Accounting Standards (mainly in 2009-2010).

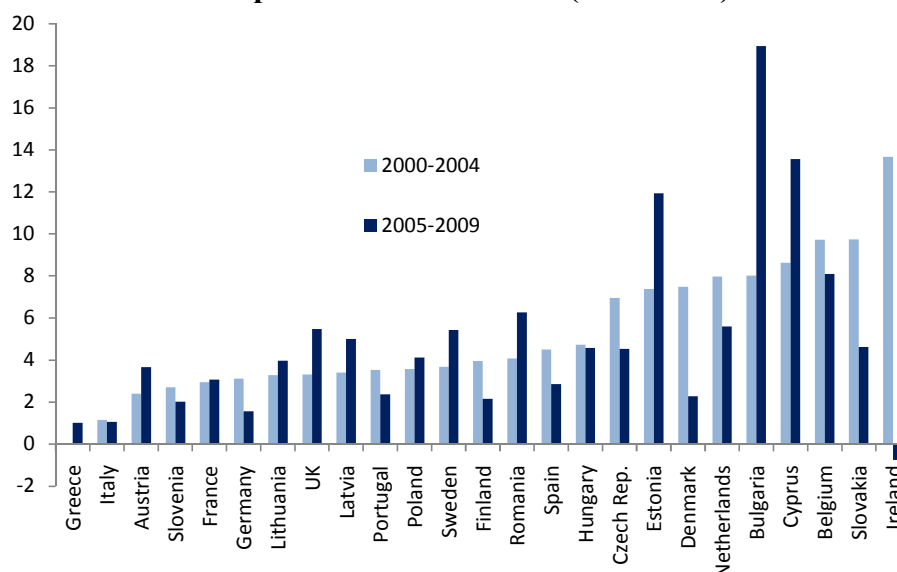
¹⁵ The analysis of the ITR on capital is greatly complicated by the fact that taxes on capital include a variety of taxes paid by both enterprises and households on many sources of revenue. In particular, in these calculations, revenues from taxes and social contributions levied on the self-employed, a relatively large group in Italy, are recorded as capital taxes.

¹⁶ According to World Bank (2011), Italy ranks 134th out of 183 countries as regards the ease of paying taxes.

separation between ownership and control, and scarce diffusion of organisational innovation¹⁷.

¹⁷ Moreover, Italian family-run firms export less than other type of companies even after controlling for firm heterogeneity in productivity, size, technology and access to credit (Barba Navaretti et al. 2008).

Graph 18: FDI net inflows (% of GDP)



Source: Commission services

4. POLICY CHALLENGES

The preceding analysis has shown that Italy is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed. In particular, macroeconomic developments in the area of export performance deserve attention as Italy has been losing external competitiveness since euro adoption. Given the high level of public debt, enhancing the growth potential should be a key priority so as to reduce the risk of adverse effects on the functioning of the economy.

The fiscal consolidation measures adopted in 2010-2011 - if fully implemented – are expected to allow Italy to achieve a structural balanced budget by 2013 and put the debt-to-GDP ratio on a steadily declining path. As highlighted in European Commission (2012), the large primary surpluses targeted in the stability programme are instrumental in putting the debt-to-GDP ratio on a steadily declining path. This could help improve financial markets' perception of debt sustainability and create a virtuous circle by reducing yields on Italy's sovereign securities.

The declining trend recorded in the current account balance since euro adoption is a worrying consequence of Italy's loss of competitiveness. In an environment characterised by high risk aversion and a fragmented euro-area financial market, Italy must endeavour to become more competitive and reverse the negative trend in its current account balance.

A lasting improvement in the current account - consistent with the needed capital accumulation to enhance potential growth - also requires a higher saving ratio in the private sector. In the short term, the private sector saving ratio is set to be affected by the on-going fiscal consolidation. However, in the longer term, a growth-friendly improvement in the current account position should come from a boost in external competitiveness via higher productivity growth. The alternative way of persistent deflationary pressures and consumption cuts implies the risk of negative feedback loops affecting potential growth via the larger adjustment required in the balance sheets of both private and public sectors.

Wages should not outpace productivity developments and the evolution of labour costs should be supportive of competitiveness gains. Since euro adoption nominal unit labour costs in Italy have increased slightly more than the ECB inflation target and more than in euro-area trade partners, in particular Germany. To regain cost competitiveness over the medium term bold structural reforms to enhance productivity growth are needed, but in the shorter term wage developments need to support this action. To this end, the link between wage growth and productivity should be strengthened. In June 2011 the social partners reached an agreement to reform the bargaining framework, with a view to further strengthening the use of firm-level contracts. Tax incentives on performance-related pay, which are negotiated at the firm level, have also been extended to 2012. Further steps appear necessary to ensure that wage setting at the national sectoral level also helps to better align wages and productivity growth (see Box 3).

Further shifting taxation away from labour and capital onto consumption and property may help regain competitiveness. Several measures have been adopted over 2010-11 to consolidate public finances by also increasing the overall tax burden. Nevertheless, these measures have mainly affected indirect taxation with increases in excise duties, VAT and property taxes, which are expected to have a relatively limited harmful effect on Italy's growth prospects compared to taxation on labour and capital. Moreover, the tax burden on labour has been reduced somewhat, mainly by increasing deductibility of labour costs from firms' tax bases, in particular as regards women and young workers. Additional measures in this direction would help recover competitiveness.

Italy has recently adopted structural reforms aimed at boosting productivity and growth. As highlighted in European Commission (2012), the Italian government has made important steps in liberalizing product and services markets, reducing the administrative burden on economic agents, enhancing the efficiency of the civil justice system, promoting firms' capitalisation and modernise the labour market. In particular, the national authorities have adopted some important measures aimed at opening up to competition the services sector, including for local public services and professional services, as well as the gas and electricity markets and the transport sector. A broad range of administrative authorisations and barriers to doing business have been abolished. A number of measures have been adopted with a view to enhancing the efficiency of civil justice, notably by reducing case-handling times and backlogs. A proper implementation of these measures may help to improve the country's business environment and thus attract more FDI inflows. An Allowance for new Corporate Equity (ACE) was introduced in December 2011, allowing companies to exclude the notional return on new injections of equity capital from taxable income. This is expected to facilitate the increase in firm size and investment in innovation. Finally, the government adopted, in February 2012, a labour market reform that could enhance the reallocation of factors of production across sectors and industries with positive effect on productivity growth. The responsibility for the final adoption of this reform now rests with Parliament.

The favourable momentum for reforms in Italy must be maintained and further progress should be pursued. A consistent implementation of these reforms is essential and should be closely monitored, as it is relevant not only for Italy but also

for stability and growth in the euro area as a whole due to the significant financial and economic interconnections.

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