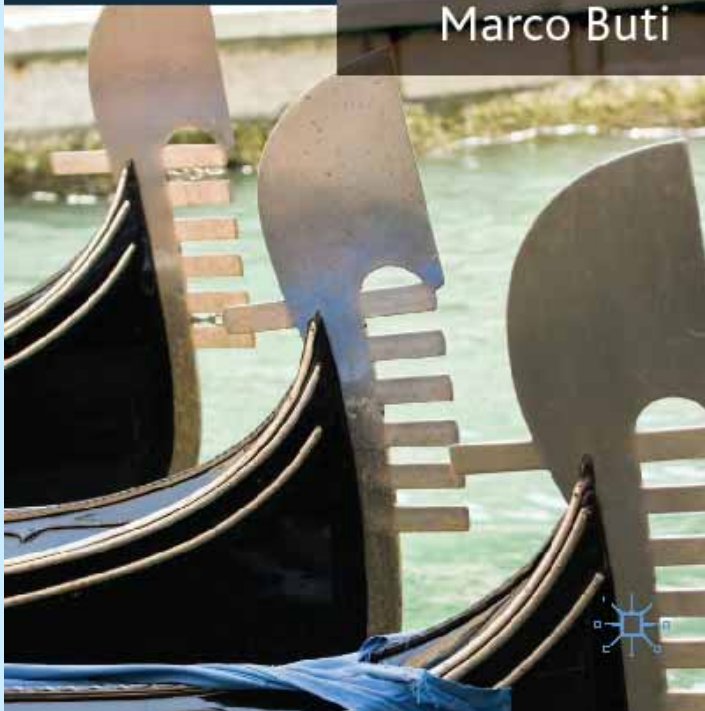


Italy in EMU

The Challenges of Adjustment and Growth

Edited by
Marco Buti

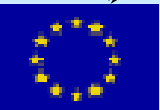


Marco BUTI
Director General – DG
ECFIN

Florence, 16 January 2009

Outline of the presentation

- The book
- The new policy environment created by the euro
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 - Key developments
 - The adjustment experience
- Medium-term challenges ahead
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The new policy environment created by the euro

Potential benefits

- Lower interest rates and price stability
- Reduced uncertainty and enhanced confidence
- Better allocation of resources
- Healthier public finances

Potential cost

- Loss of the exchange rate as policy instrument

Key challenge

- Implementing structural reforms



Adjustment in the euro area: the theoretical framework

The adjustment channels:

- **the competitiveness channel:** dominates the adjustment dynamics. Crucially depends on the degree of wage and price flexibility
- **the real interest rate channel:** pro-cyclical (potentially destabilising) effect but relevant in the short term and less relevant in the context of economic, financial and monetary integration
- **policy-based adjustment:**
 - Fiscal policy
 - Structural policies: labour markets, product markets, financial markets

Higher reform needs in monetary unions

- Larger share of adjustment via markets requires flexible wages and prices to steer factor allocation
- Higher spillovers in monetary union with nominal rigidities
- Combination of single currency with better functioning financial markets leads to higher reform multipliers
- ➔ Benefits of reforms and costs of non-reforms are higher in euro area
- ➔ Cross-country differences in reform ambitions may cause higher divergences in economic performance

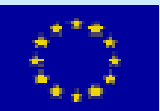


The run up to the euro: Italy's achievements

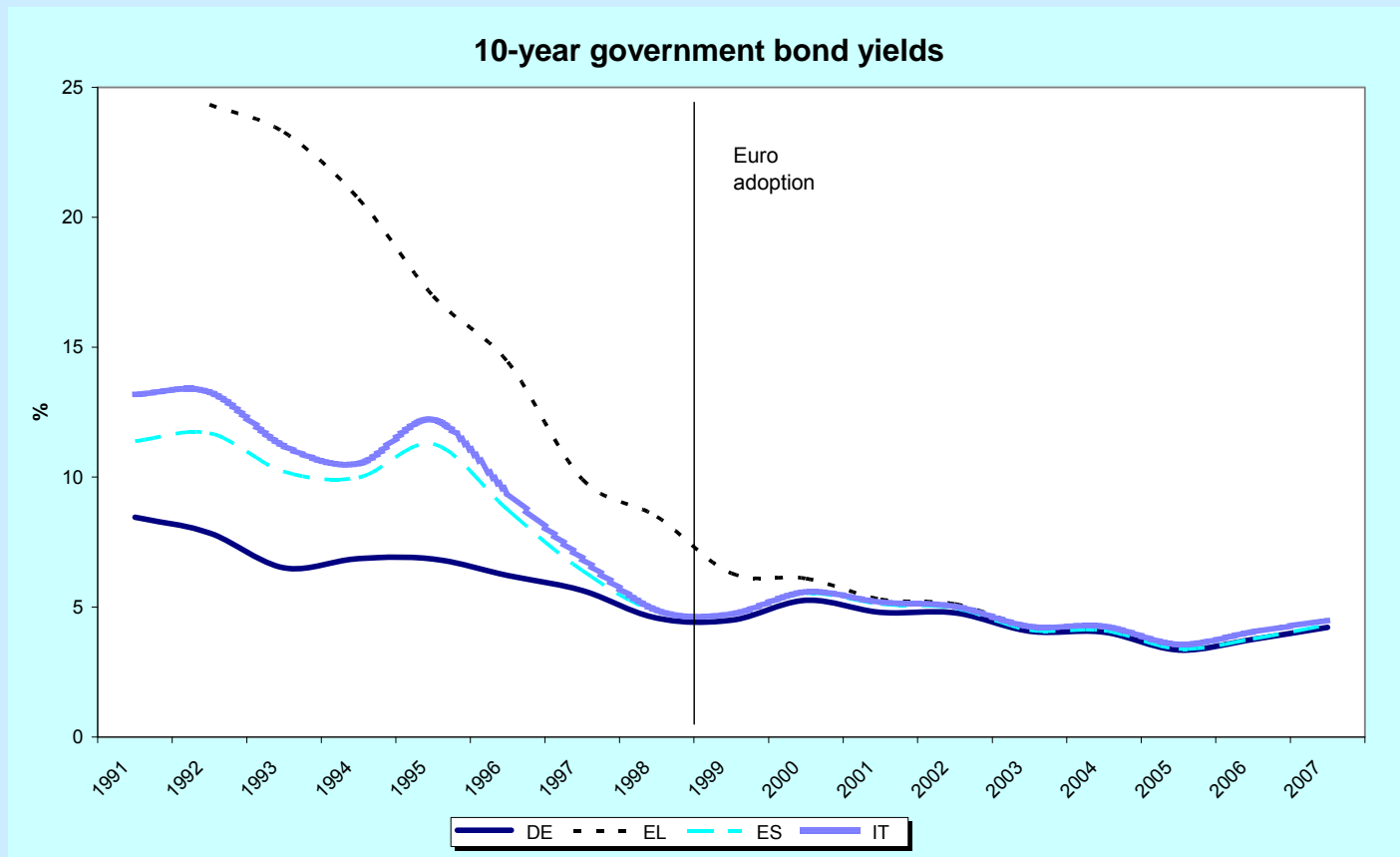
- **Steep fall in inflation:** from >6% in the early '90s to just >2% from 1999 onwards
- **The risk premia declined more than on average in the euro area:** the spread between Italy's and Germany's 10-year government bond yields fell from >500 bps in 1992 to 25 bps in 1999
- **An impressive fiscal consolidation:** from double-digit levels in the '80s & early '90s, the government deficit declined to 1.7% of GDP in 1999
- **Confidence boost & increase in households' financial wealth** helped make the Maastricht adjustment less painful
- **The pace of structural reform accelerated, notably in the labour market**

The first ten years of the euro: the gains for Italy

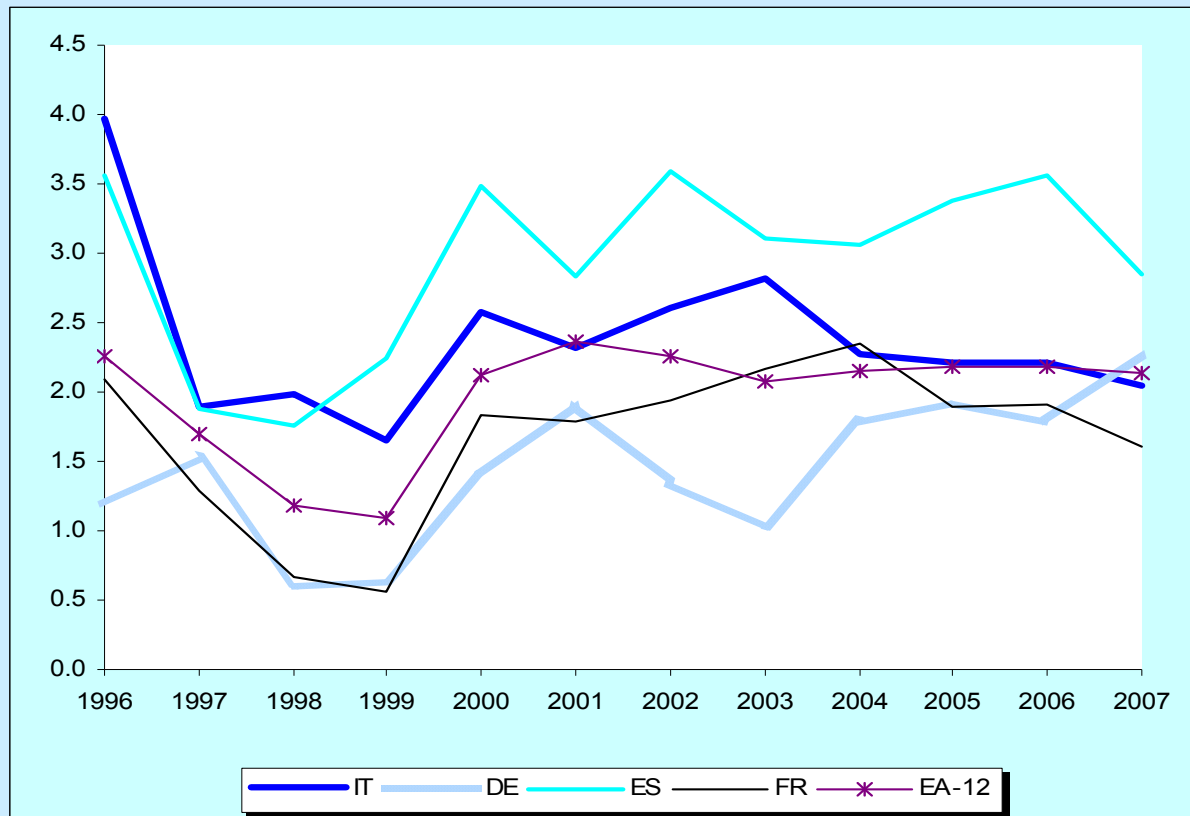
- Low cost of borrowing and price stability
- Absence of intra-area exchange rate volatility
- Spectacular job creation
- Greater resilience to external shocks



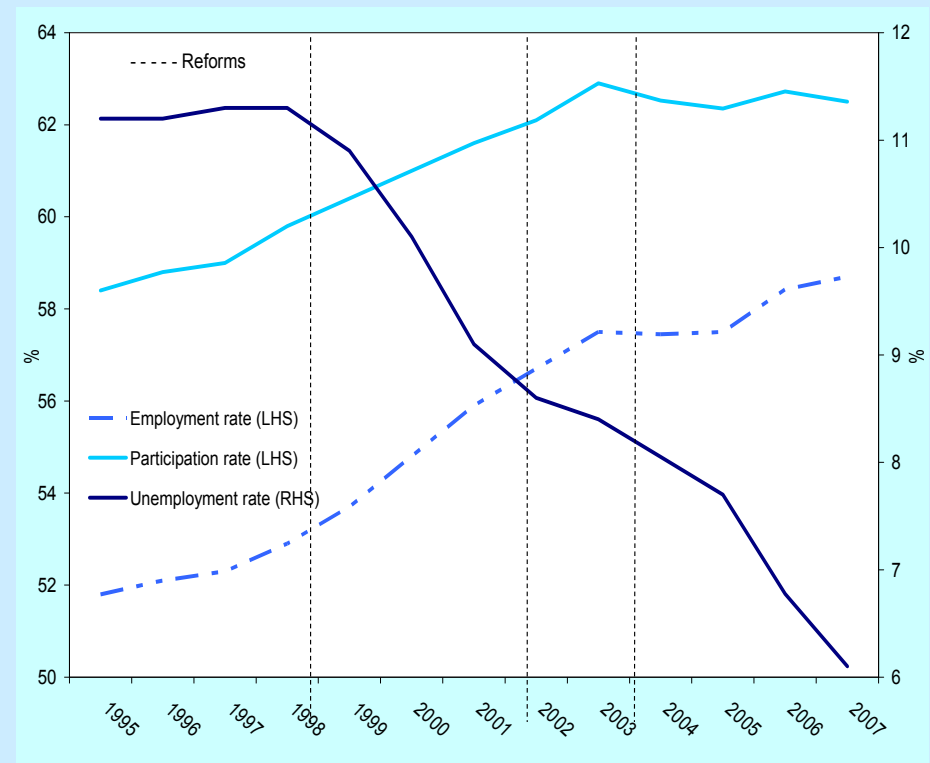
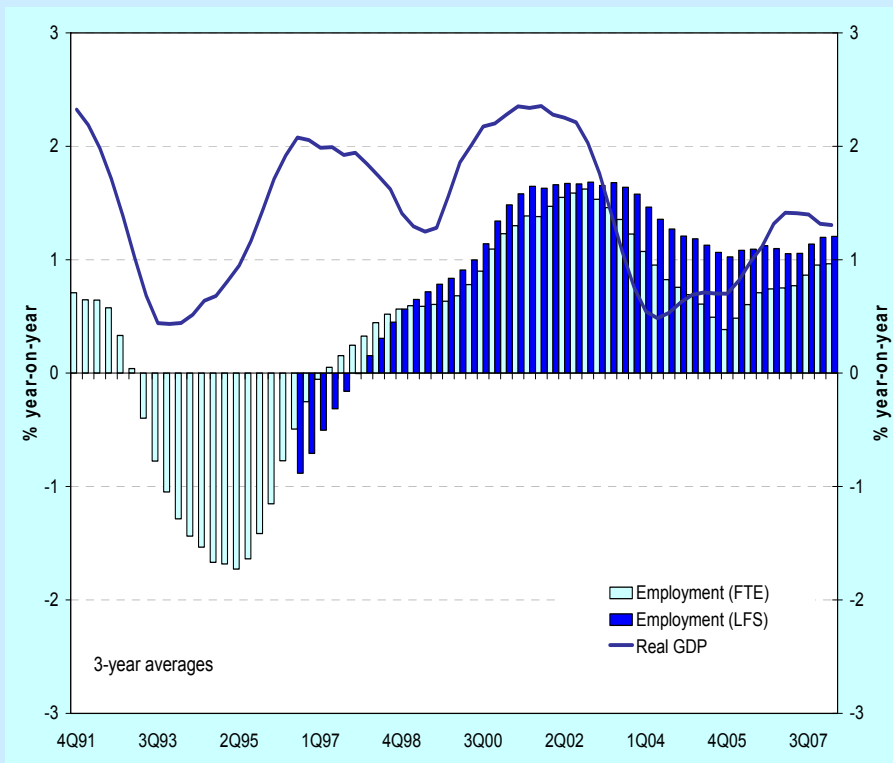
The cost of borrowing has remained contained



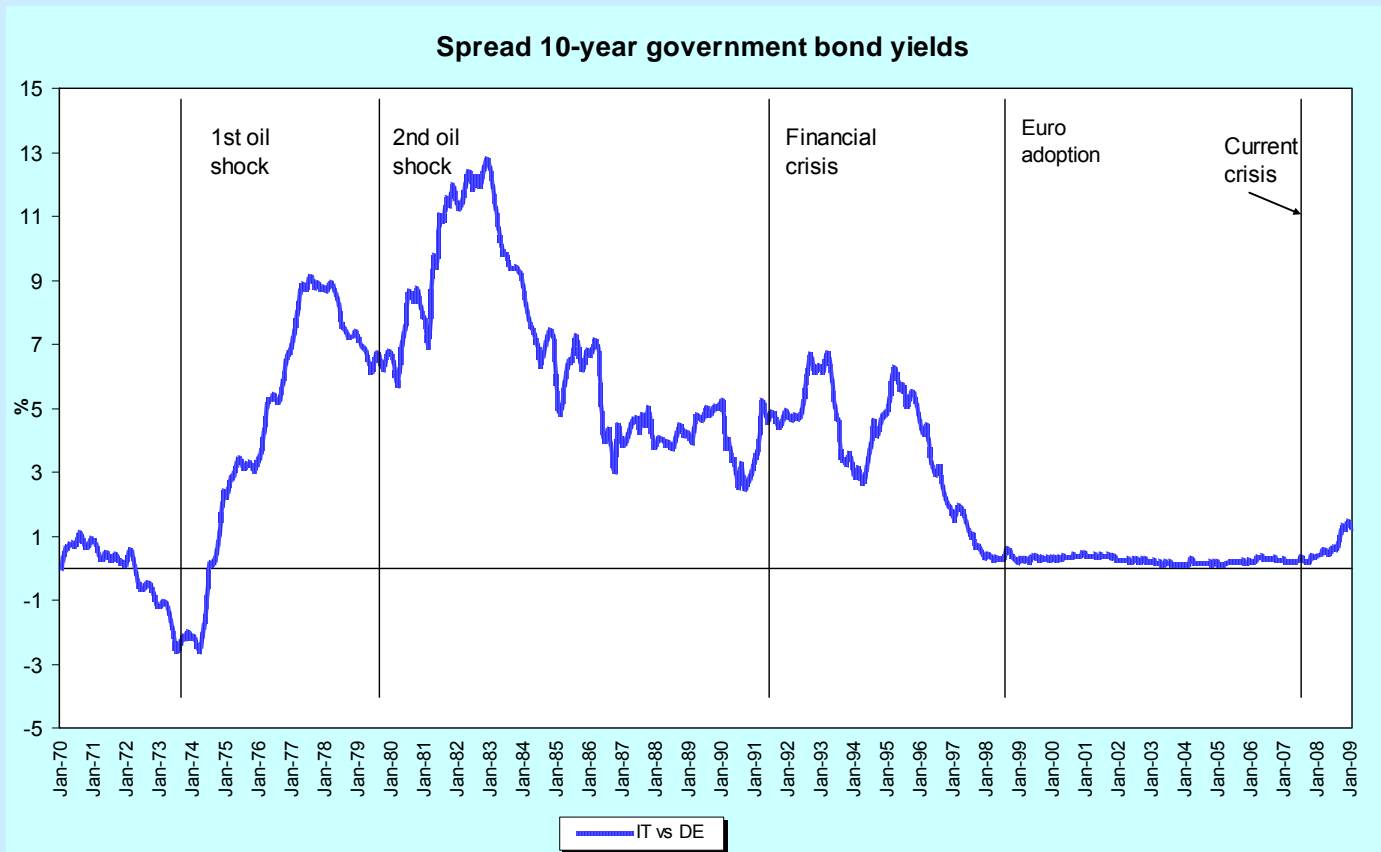
Price stability



Job creation has continued unrelenting



Greater resilience to external shocks

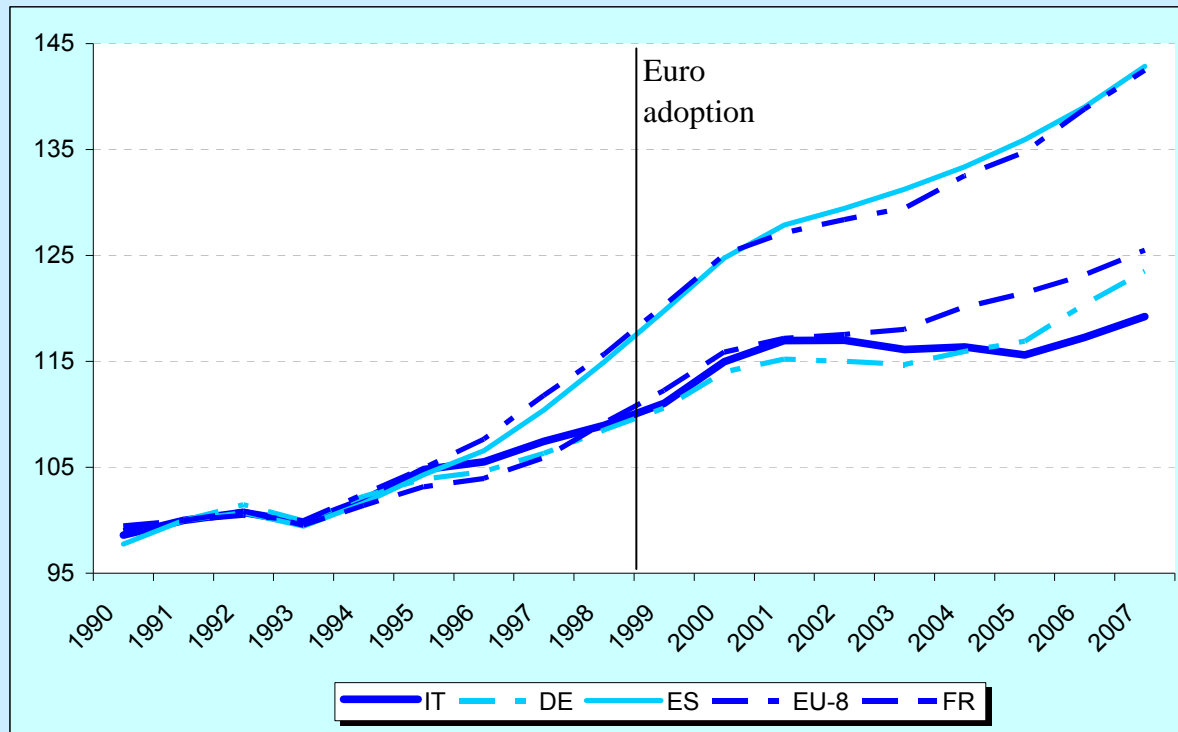


But not all expectations have been fulfilled

- The growth gap with the rest of the euro area did widen
- Productivity continued declining, driven by the slowdown in TFP
- Loss of competitiveness and market shares
- Budgetary consolidation fatigue set in
- The pace of structural reform slowed down: incentives for reform abated once in the euro area

Italy's growth gap with the euro area

Figure 2.1: Real GDP per capita growth in Italy and the euro area
National currencies, 1991=100



Note: EU-8 refers to the euro area of 12 countries excluding Italy, Germany, France and Spain.

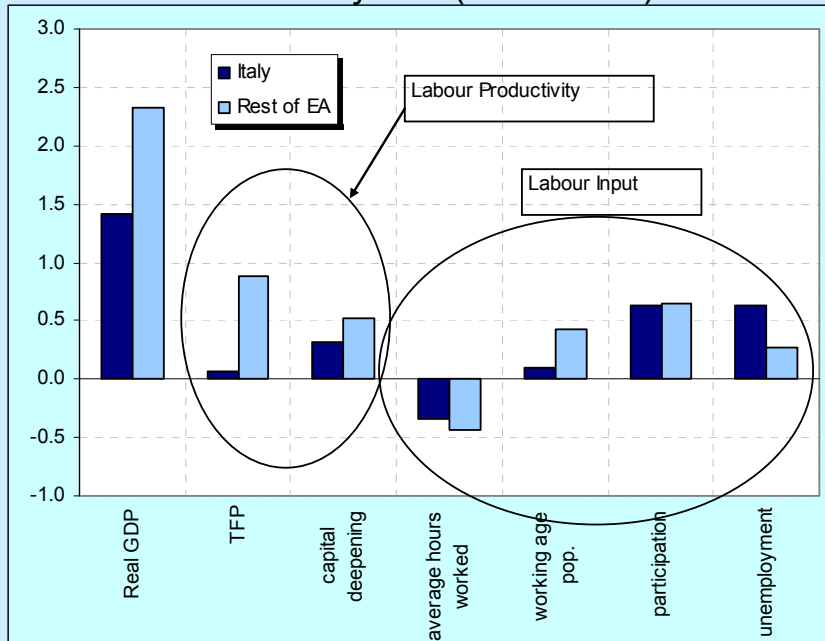
Source: Commission services



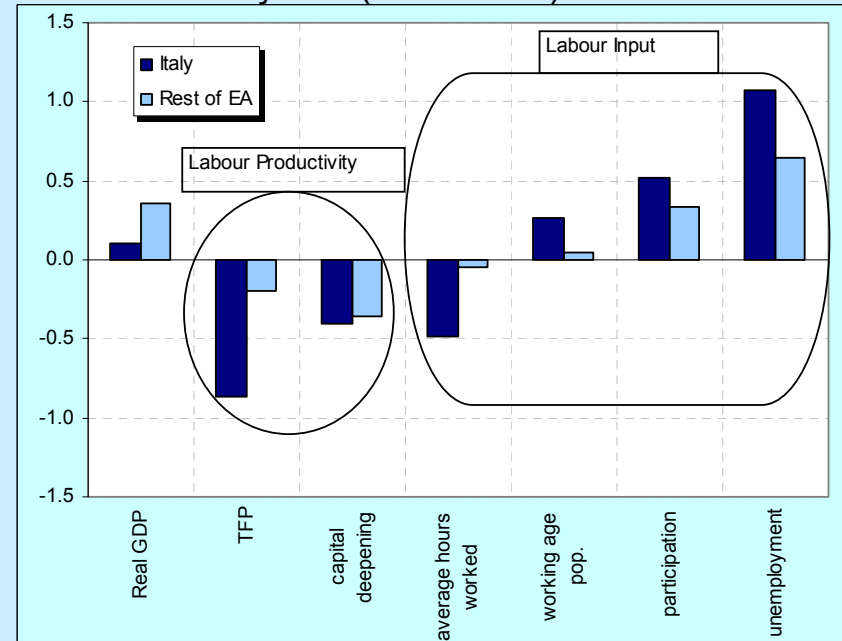
... driven by declining productivity growth

Real GDP growth and its supply side determinants

Euro area years (1999-2007)



Euro area years (1999-2007) vs. 1992-1998



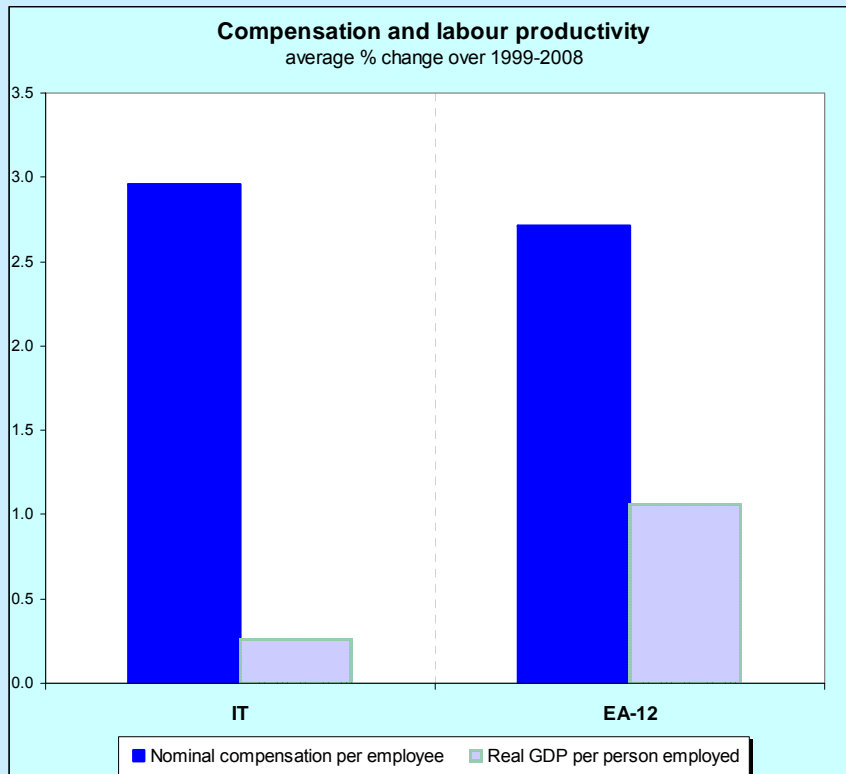
The productivity puzzle

How can an extremely poor performance in productivity growth be combined with strong employment?

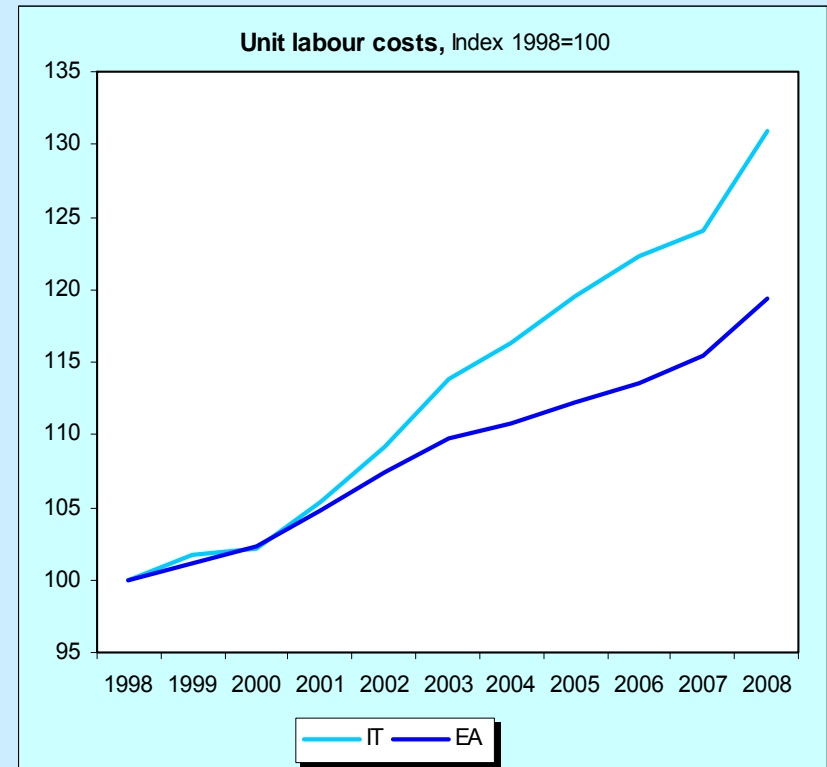
- Possible explanatory factors: the regularisation of the immigrant workforce and ...
- the entry of low-skilled workers into the labour market
- Distortions in labour market statistics

Loss of competitiveness (a):

Moderate wage growth but dismal productivity growth...

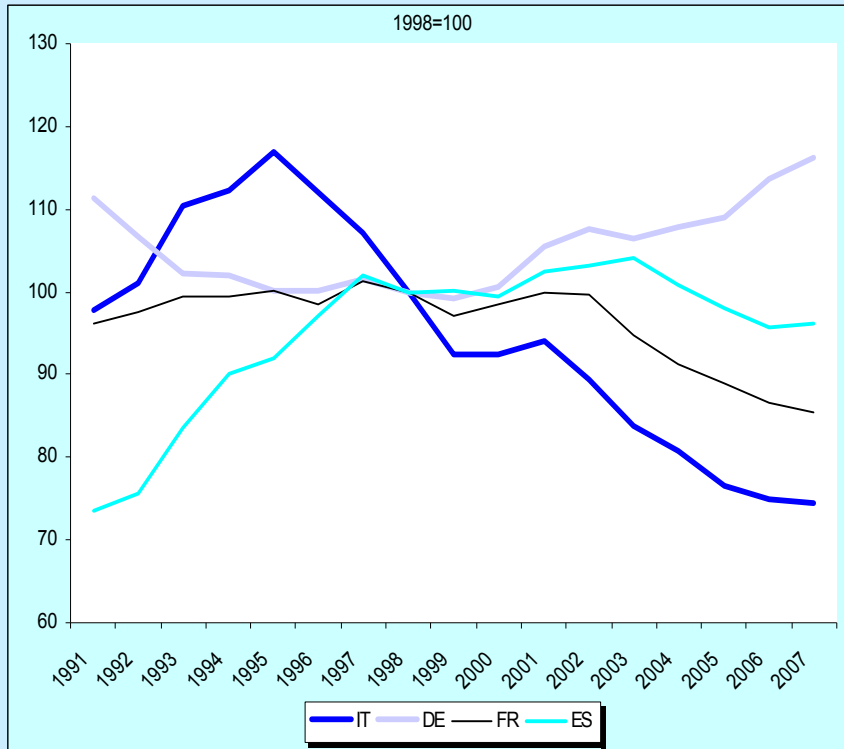


... resulted in dynamic growth of unit labour costs v-à-v the euro area

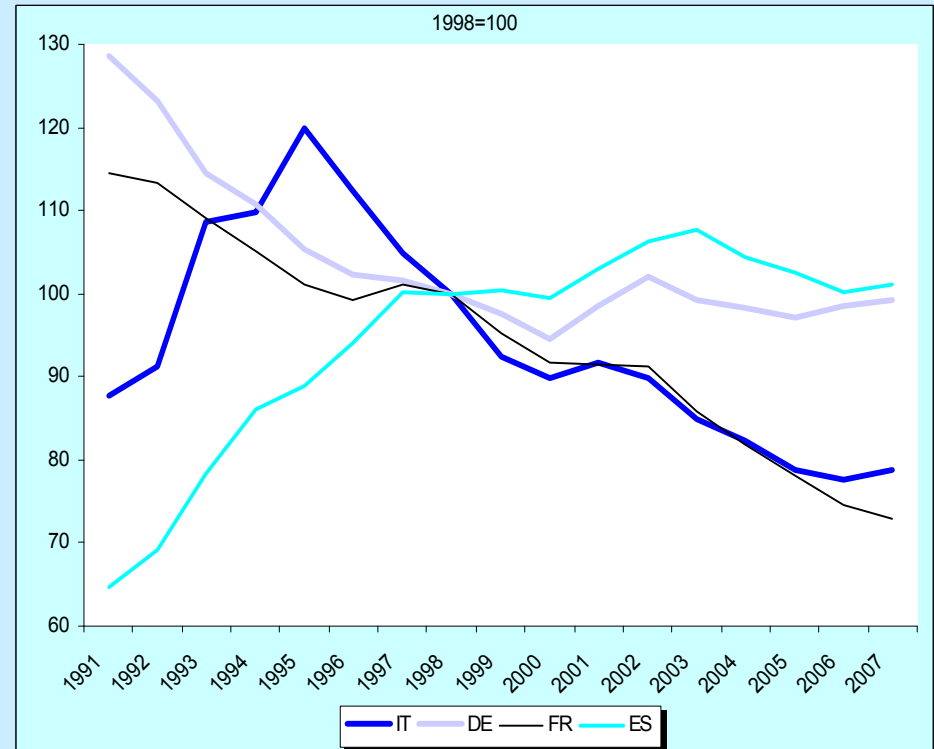


Loss of competitiveness (b):

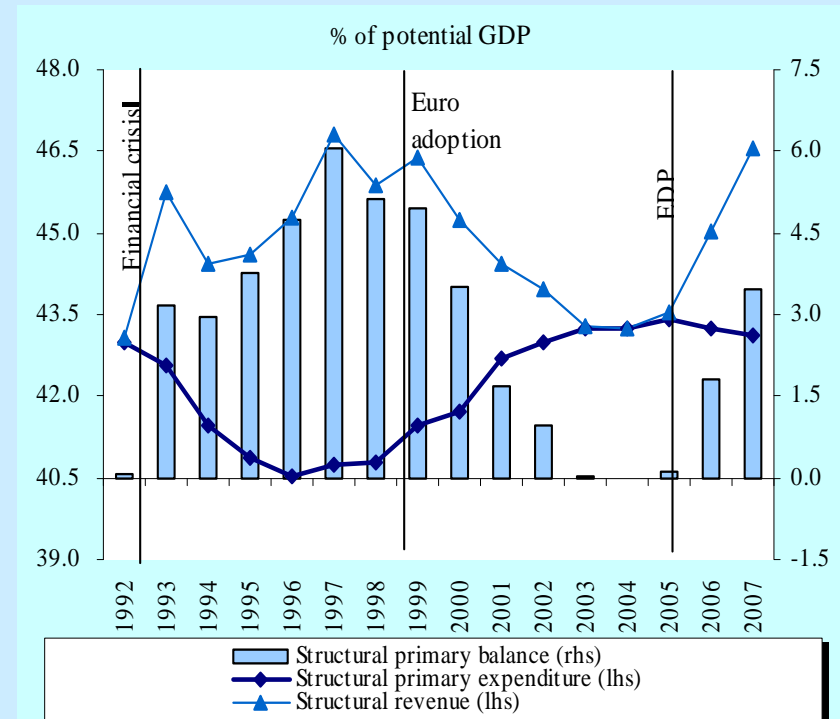
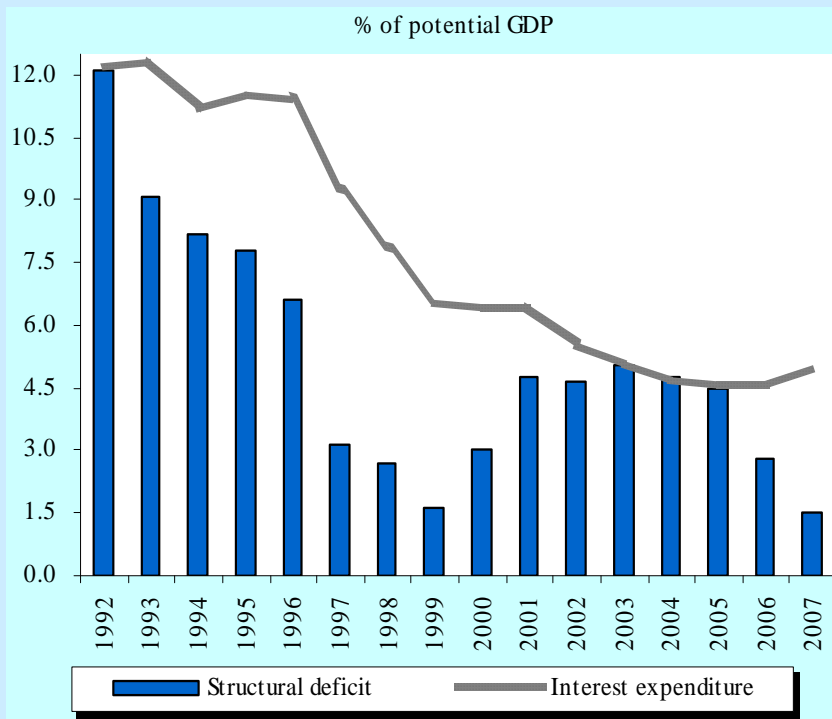
Huge loss of market shares at constant prices...



...but somewhat better evolution at current prices



Fiscal consolidation: a tale of missed opportunities



Disappointing pace of structural reform

Underperforming policy areas v-à-v the EU15

- Labour taxation to stimulate labour demand
- Job protection and labour market segmentation/dualisation
- Specific labour supply measures for older-workers
- Wage bargaining and wage-setting policies
- Labour market mismatch and labour mobility
- (Civil justice)
- Business environment - Regulatory barriers to entrepreneurship
- Business Dynamics - Start-up conditions
- Market integration - Openness to trade and investment
- R&D and Innovation
- Education and life long learning
- Orientation and sustainability of public finances



In sum: Italy's adjustment experience so far

- The monetary convergence bonus was largely offset by subdued disposable income growth
- Loss of competitiveness mainly due to low productivity growth (and the asymmetrical impact of globalisation on the Italian economy)
- ... but some restructuring in the industrial sector has helped
- Labour market reforms and regulatory reforms in the financial sector have also helped
- The increase in structural primary spending and tax cuts largely offset the reduction in interest expenditure

The policy challenges of adjustment & growth

- Addressing the productivity challenge requires far-reaching structural reforms, i.e. fostering internal competition, enhancing the business environment & increasing the innovative capacity
- Tap the unused labour potential & enhance human capital formation
- Put public debt on a sustainable path
- Improve the quality of public finances
- A cross-cutting issue: address regional disparities

How to overcome resistance to structural reforms?

- better inform about gains of reforms
- continue improving financial market functioning so as to enhance both benefits and acceptability of reforms...
- ...and address equity concerns
- address the obstacle posed by the cost of reforms by reallocating expenditure and increasing efficiency of public finances
- at multilateral level, increase peer pressure through a more effective monitoring of reforms (i.e., Lisbon process)

The European Economic Recovery Plan

Two key pillars:

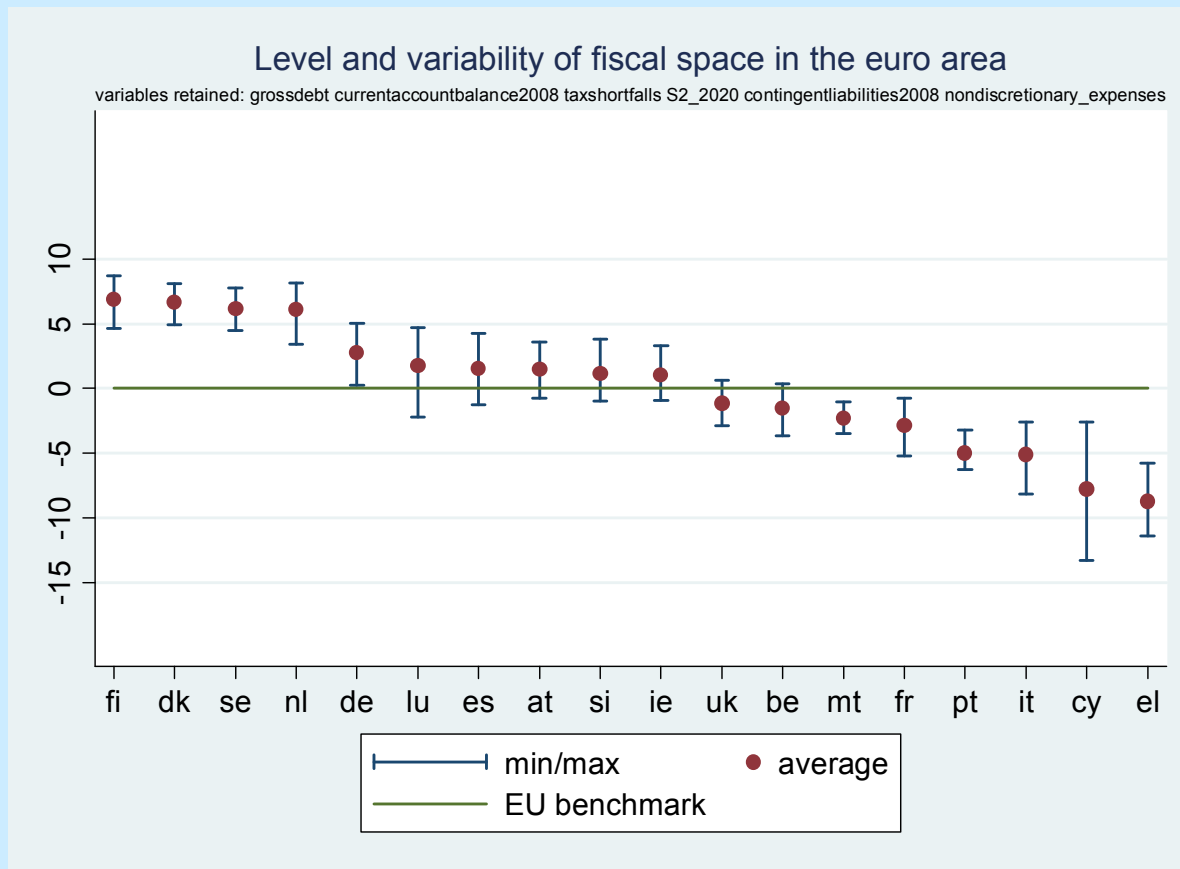
1. Fiscal stimulus to boost demand and stimulate confidence
2. Need to direct short-term action to reinforce competitiveness in the long run – smart investment on skills, energy efficiency, clean technologies and infrastructure. Focus on reforms that can deliver quickly and strengthen resilience of the economy

An expansionary fiscal policy

The budgetary stimulus must be well designed and:

- timely, temporary, targeted, and co-ordinated
- it should be differentiated, taking initial conditions into account
- be conducted within the Stability and Growth Pact
- and accompanied by structural reforms that support demand and promote resilience

Italy's fiscal space is limited!



Italy's fiscal stimulus package in a nutshell

<i>% of GDP</i>	2009	2010	2011
<i>i</i> - Income support to households	0.24	0.03	0.03
<i>ii</i> - Support to companies	0.10	0.08	0.07
<i>iii</i> - Acceleration of public investment	0.04	0.07	0.11
Total new resources into economy	0.37	0.19	0.20

The budgetary impact of the package is officially close to zero: lower revenues or higher expenditure are due to be largely financed

Is there scope for an intertemporal exchange within social protection expenditure?

	Social expenditure	Social benefits	Old age and survivors		Sickness and disability		Family/Children		Unemployment		Housing and Social exclusion	
	% of GDP		% of GDP	% of TSB	% of GDP	% of TSB	% of GDP	% of TSB	% of GDP	% of TSB	% of GDP	% of TSB
EU27	27.2	26.2	12	45.8	9.6	36.6	2.1	8	1.6	6.1	0.9	3.4
EA13	27.8	26.6	12.3	46.2	9.5	35.7	2.2	8.3	1.8	6.8	0.8	3
BE	29.7	28.3	12.7	44.9	9.6	33.9	2	7.1	3.5	12.4	0.5	1.8
DK	30.1	29.3	11	37.5	10.3	35.2	3.8	13	2.5	8.5	1.7	5.8
DE	29.4	28.4	12.4	43.7	10	35.2	3.2	11.3	2.1	7.4	0.8	2.8
IE	18.2	17	4.5	26.5	7.8	45.9	2.5	14.7	1.3	7.6	0.9	5.3
GR	24.2	23.5	12	51.1	7.7	32.8	1.5	6.4	1.2	5.1	1.1	4.7
ES	20.8	20.3	8.4	41.4	7.9	38.9	1.1	5.4	2.5	12.3	0.4	2
FR	31.5	29.6	13	43.9	10.6	35.8	2.5	8.4	2.2	7.4	1.3	4.4
IT	26.4	25.5	15.5	60.8	8.3	32.5	1.1	4.3	0.5	2	0.1	0.4
CY	18.2	17.9	8.3	46.4	5.2	29.1	2.1	11.7	1	5.6	1.2	6.7
LU	21.9	21.4	7.9	36.9	8.3	38.8	3.6	16.8	1.1	5.1	0.6	2.8
MT	18.3	18.1	9.5	52.5	6	33.1	0.9	5	1.3	7.2	0.4	2.2
NL	28.2	26.3	11.1	42.2	10.7	40.7	1.3	4.9	1.5	5.7	1.6	6.1
AT	28.8	27.8	13.5	48.6	9.3	33.5	3	10.8	1.6	5.8	0.4	1.4
PT	24.7	23	10.9	47.4	9.4	40.9	1.2	5.2	1.3	5.7	0.2	0.9
SI	23.4	22.9	10.2	44.5	9.4	41	2	8.7	0.7	3.1	0.7	3.1
SK	16.9	16.4	7	42.7	6.3	38.4	1.9	11.6	0.7	4.3	0.5	3
FI	26.7	25.9	9.6	37.1	10	38.6	3	11.6	2.4	9.3	0.8	3.1
SE	32	30.9	12.5	40.5	12.3	39.8	3	9.7	1.9	6.1	1.2	3.9
UK	26.8	26.3	11.8	44.9	10.5	39.9	1.7	6.5	0.7	2.7	1.7	6.5

...but fiscal stimulus is not enough!

A key priority: quickly restore competitiveness! To this purpose:

- productivity growth must outpace wage developments
- the medium term strategy must be aimed at improving productivity growth
- in the short term, strengthen the link between wages and productivity and allow wages to better respond to regional differences → reform the wage bargaining framework

Some conclusions

- Italy did not make the most of its first 10 years in EMU
- Crisis as an opportunity: align immediate measures to respond to the crisis with the need to address the structural weaknesses that hamper productivity growth
- ... while addressing equity concerns