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Macroeconomic Imbalances Italy 2013

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Macroeconomic Imbalances –
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Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

ITALY is *experiencing macroeconomic imbalances, which require monitoring and decisive policy action*. In particular, export performance and the underlying loss of competitiveness as well as high public indebtedness in an environment of subdued growth deserve continued attention in a broad reform agenda in order to reduce the risk of adverse effects on the functioning of the Italian economy and of the Economic and Monetary Union, notably given the size of the Italian economy.

More specifically, in a context of elevated risk aversion in financial markets, Italy's high public debt weighs on the country's growth prospects through several channels, in particular the high tax burden needed to service the debt, funding pressures for Italian banks and thus for the private sector, increased macroeconomic uncertainty and a severely limited margin for countercyclical fiscal policies and growth-enhancing public expenditure. In order to put the high public debt-to-GDP ratio on a steadily declining path, Italy has been pursuing a strategy of sizeable fiscal consolidation, but subdued growth prospects make it challenging – but even more essential – to achieve and sustain the necessary large primary surpluses. Italy's declining external competitiveness since the late 1990s is reflected in substantial export market share losses. Stagnant productivity, outpaced by labour cost growth, has implied increasing unit labour costs compared to peers, and the sizeable appreciation of Italy's nominal effective exchange rate between 2003 and 2009 further undermined cost competitiveness. The high tax burden, especially on labour and capital, also negatively affects competitiveness. In addition,
Italy's export performance continues to suffer from an unfavourable product specialisation, and the country's weak human capital endowment hampers a move towards a technologically more advanced specialisation model. Institutional and regulatory barriers, an unfriendly business environment and structural firm-level features hinder the ability of many Italian companies to grow, limiting productivity gains and international expansion. These factors also limit the inflow of foreign direct investment, thus missing out on a further important potential source of productivity enhancements. Finally, the double-dip recession has seriously weakened the ability of the Italian banking sector to support the adjustment needed to address imbalances.

Excerpt of country-specific findings on Italy, COM(2013) 199 final, 10.4.2013.

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EXECUTIVE SUMMARY AND CONCLUSIONS

In May 2012, the Commission concluded that Italy was experiencing serious macroeconomic imbalances, in particular related to the high government debt and declining external competitiveness. In the Alert Mechanism Report (AMR) published on 28 November 2012, the Commission found it useful, also taking into account the above conclusions, to examine further in a second in-depth analysis the risks involved and progress in the unwinding of imbalances. To this end, this In-Depth Review (IDR) takes a broad view of the Italian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). Italy's high government debt, as well as the loss of external competitiveness and its underlying sluggish productivity performance, continue to be the main macroeconomic imbalances identified. While some important measures have been adopted over the past year to address these imbalances, their full implementation remains a challenge, and there remains scope for further action in many areas. Meanwhile, the prolonged crisis has weakened the ability of Italy's banking sector to support the required economic adjustment.

The most important observations and findings from this in-depth analysis are the following:

- **Long-standing structural weaknesses have reduced Italy's capacity to withstand and absorb economic shocks.** Compared to other euro-area countries, Italy entered the global crisis with fairly strong private sector balance sheets and a sound banking sector. The crisis however has highlighted the country's long-standing structural weaknesses. Real GDP contracted by more than 7% since the onset of the crisis in mid-2008. According to the Commission services' Winter 2013 forecast, the protracted recession is set to bottom out in mid-2013, under the assumption of a stabilisation in financial markets and restored investor confidence. However, financial conditions remain fragile and growth prospects in the medium term remain subdued.

- **The high government debt remains a heavy burden for the Italian economy, especially against the background of persistently slow growth, and is a major source of vulnerability.** During the past two years, the negative feedback loop between high debt and low growth has increased concerns among investors regarding the sustainability of Italy's high debt. Indeed, the sharp rise in the sovereign risk premium in 2011-12, which increased the pressure arising from structural weaknesses, translated into a higher cost of capital for the private sector, hampering productive investment. Moreover, in the context of banks' high exposure to government debt and a euro-area financial market highly fragmented across national borders, funding problems in the banking sector worsened. In response, a sizeable consolidation effort was undertaken by the government, which entailed significant short-term economic costs as the tax burden was raised and spending was compressed. This has decisively helped to reduce the borrowing cost of the government since the second half of 2012. However, Italy remains vulnerable to sudden changes in market sentiment, highlighting the need to maintain the budgetary improvement in structural terms in order to put the debt ratio on a steadily declining path. The potential economic and financial spillovers to the rest of the euro area remain sizeable, should financial market turmoil related to the Italian sovereign debt intensify again.

- **The loss of external competitiveness of the Italian economy highlights Italy's productivity growth problem.** Persistently slow growth of productivity – in particular total factor productivity – is the key factor that has been hampering overall economic growth for several years. As stagnant productivity growth has not been fully reflected in wage dynamics, Italy's cost competitiveness has deteriorated, as reflected in increasing unit labour costs (ULC) compared to peers. The appreciation of Italy's nominal effective exchange rate (NEER) between 2003 and 2009 has also played a role. After steadily deteriorating since the adoption of the euro, the current account balance improved significantly in 2012, as imports collapsed and export growth was sustained by demand from non-EU trade partners. From a saving-investment point of view, the recent improvement in the current account is mainly driven by a fall in investment, while the national saving rate has stabilised at the low level reached in 2009. A recovery in investment would entail a new worsening of the current account balance if it is not accompanied by a corresponding rise in national saving.

- **Italy's export performance continues to suffer from an unfavourable product specialisation model and the limited ability of Italian firms to grow.** Italy's specialisation model is very similar to that of emerging markets such as China, with most of the value added in relatively low-tech traditional sectors, mainly due to Italian firms' limited innovation capacity. The predominance of micro- and small enterprises highlights the difficulties faced by Italian firms to grow and become international players, owing to institutional and regulatory barriers, structural firm features and an unfriendly business environment. These factors also limit the inflow of foreign direct investment (FDI), preventing Italy from taking advantage of the direct and indirect benefits that inward FDI entails, such as the transfer of capital and knowledge, increased involvement in world trade and the impulse for a more competitive business environment and modern corporate management.

- **The resilience of the Italian banking sector has severely weakened since mid-2011, undermining banks' ability to support economic activity and adjustment.** The loss of access of Italian banks to international wholesale funding following the extension of the euro-area sovereign debt crisis to Italy has significantly increased the sector's dependence on Eurosystem refinancing. The double-dip recession in Italy has increased credit risk in the private sector, burdening Italian banks with a large stock of non-performing loans (NPLs), mainly to private companies. In combination with subdued credit demand, this has led to a protracted contraction in credit, while the average cost of new credit remains elevated despite an accommodative monetary policy at euro-area level. Low net interest margins, increased NPL provisioning and low cost efficiency all act as a drag on Italian banks' profitability.

- **Italy is thus confronted with severe adjustment challenges.** The improving current account does not alter Italy's need to address the serious productivity and competitiveness challenges which the country faces. However, a particularly unfavourable environment – characterised by a high cost of capital, lack of support from the financial sector and fiscal policy, as well as limited scope to raise investment without increasing the economy's reliance on external financing – constrains the needed adjustment. In this context, improving the allocation efficiency in the Italian economy becomes essential in view of channelling the available resources in both the private and public sector to their most growth-enhancing uses.

- **Key fiscal measures and structural reforms have been adopted over the past months to address the main challenges of the Italian economy, which need full implementation to bear fruit.** Italy has embarked on a wide-ranging strategy to restore fiscal sustainability and improve long-term growth. Together with determined action at the euro-area level, this helped to restore some market confidence. To consolidate these benefits and strengthen Italy's resilience against possible renewed financial tensions, Italy's public debt-to-GDP ratio needs to be put on a steadily declining path. To support fiscal consolidation and unleash the country's growth potential, the gains from structural reforms should be secured by ensuring their full implementation and maintaining the reform momentum.

The IDR also discusses the policy challenges stemming from these developments and possible policy responses. While acknowledging the efforts which have already been made since the end of 2011, the IDR highlights a range of domains in which Italy's policymakers could act further to strengthen the adjustment capacity of the Italian economy. These include the strengthening of competition in some product and service markets, the development of a more growth-friendly tax system, the further decentralisation of the wage bargaining framework, the upgrading of the educational sector, and the decisive improvement of public administration efficiency and of the business environment. The IDR also highlights the need to improve the capacity of the Italian banking sector to support the adjustment of the Italian economy. Finally, regarding Italy's public indebtedness, the IDR confirms the necessity to pursue sustained high primary surpluses in order to put the country's high public debt-to-GDP ratio on a downward path, in full compliance with its budgetary commitments and the reinforced Stability and Growth Pact (SGP).

1. INTRODUCTION

On 28 November 2012, the European Commission presented its second 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” (IDR) 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 follow-up it will recommend to the Council.

This is the second IDR for Italy. The previous IDR was published on 30 May 2012 on the basis of which the Commission concluded that Italy was experiencing serious imbalances, in particular as regards developments related to the export performance, competitiveness and the high government debt. Overall, in the AMR the Commission found it useful, also taking into account the identification of serious imbalances in May, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this IDR takes a broad view of the Italian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

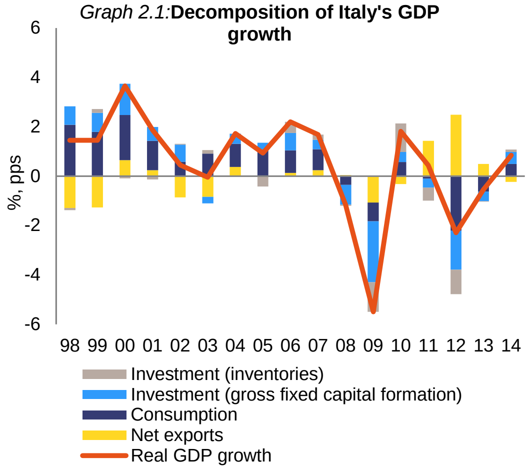
2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

2.1. MACROECONOMIC SCENE SETTER

During the decade leading up to the current crisis, long-standing structural weaknesses significantly constrained Italy's growth potential. Between euro adoption and the year preceding the global financial crisis, Italy's real GDP growth averaged 1.5%, around 0.75 pp. below the euro-area average. The main reason for the protracted underperformance was weak growth in productivity, in particular as total factor productivity stagnated (see Section 3.1), indicating low absorption of new technologies and limited innovation capacity by Italian firms, an unfavourable business environment and insufficient human capital accumulation.

The Italian economy's capacity to withstand the negative economic shocks stemming from the crisis was therefore limited. Italy's real GDP contracted sharply during the 2008-09 economic and financial crisis. The recovery that followed was modest and short-lived: economic growth started contracting again in the second half of 2011, when the euro-area sovereign debt crisis spread to Italy. Over 2012 as a whole, real GDP contracted by 2.4% owing to a strong fall in domestic demand. Despite significant measures at national and EU level in 2011-12 to tackle the economic crisis and rebuild confidence, uncertainty in financial markets remained elevated until the final months of 2012, affecting households' and firms' confidence. Net exports on the other hand have contributed positively to Italy's real GDP growth – mainly because of a fall in imports, but also thanks to some export dynamism – implying a strong improvement in Italy's trade balance since mid-2011. Available indicators point to some further contraction in economic activity in the first quarter of 2013, before growth is expected to gradually resume in the second half of the year as demand from non-EU trade partners supports exports and the assumed lower yields on Italian government securities gradually translate into improving financing conditions and confidence. However, the negative carry-over from 2012 implies that real GDP in 2013 as a whole is still projected to decline by 1.0% (Graph 2.1).

Graph 2.1: **Decomposition of Italy's GDP growth**

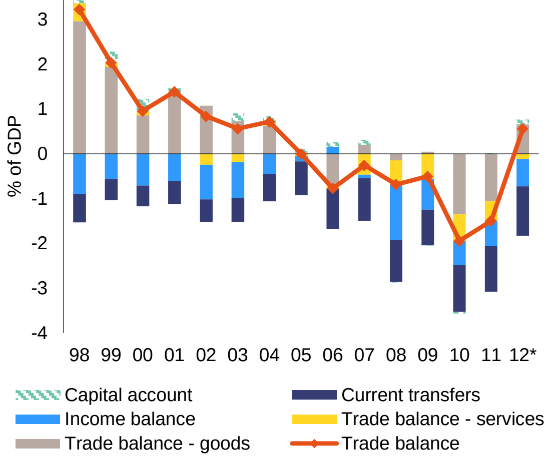


Source: Commission services
Note: Figures for 2013-14 are forecasts based on the Commission services' Winter 2013 forecast.

2.2. SUSTAINABILITY OF EXTERNAL POSITIONS

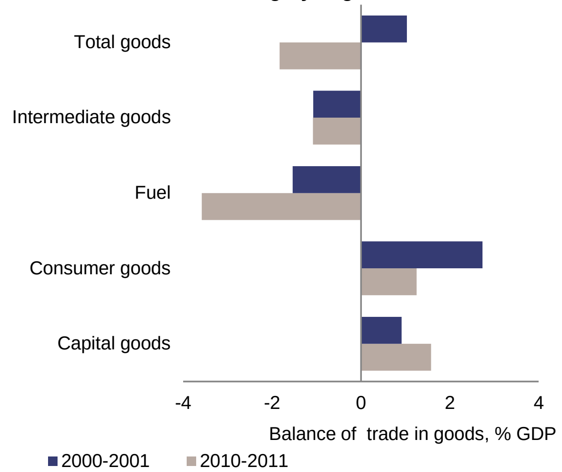
Italy's current account balance deteriorated steadily since the adoption of the euro and up until mid-2011. From a surplus of 1.8% of GDP in 1998, the current account balance turned slightly negative over 2002-05 and deteriorated significantly after the 2008 financial crisis, reaching a deficit of more than 3% of GDP in 2010-11 (Graph 2.1a). Part of the decline in the current account balance was driven by worsening terms of trade as the increasing price of imported oil – on which the Italian economy is structurally dependent – negatively affected the goods balance (Graph 2.1b). As from 2007, this was compounded by a negative services balance. Finally, ever since the late 1990s, both the income balance and the transfers balance have recorded a deficit. In 2008-09, the dramatic drop of (mostly equity) income from abroad as a consequence of the financial crisis opened up the deficit on the income balance. The deficit on the transfers balance gradually widened over the decade and reached almost 1% of GDP by 2011, mainly due to Italy's net contribution to the EU budget (more than 0.3% of GDP) and foreign workers' remittances, which rose to around 0.5% of GDP.

Graph 2.2a: **Decomposition of Italy's external accounts**



Source: Commission services
Note: 2012 figures are estimated using quarterly data.

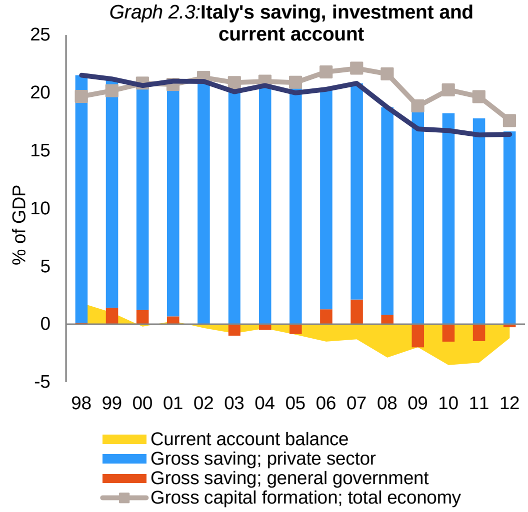
Graph 2.2b: **Italy's goods trade balance, by category of goods**



As from mid-2011, the Italian current account balance has improved significantly. In 2012, the deficit narrowed to 0.6% of GDP. The lower deficit is due to an improving trade balance, which in turn is driven by a decline in imports owing to weak domestic demand, but also some recovery in exports. While demand from other EU countries remains weak, exports to non-EU trade partners improved in 2011-12, also owing to the depreciation of the euro that enabled Italy to regain some cost and price competitiveness vis-à-vis non-EU trade partners.

From a saving-investment perspective, the recent improvement in the current account is mainly driven by the fall in investment, while the national saving rate has remained broadly stable at the low levels reached in 2009. The stable national saving rate is the result of an increase in the government saving rate – as a consequence of the ongoing fiscal consolidation – offset by a decrease in the private-sector saving rate (Graph 2.3). A recovery in investment as the economic outlook improves would entail a new worsening of the current account balance if not accompanied by a corresponding increase in the national saving rate.

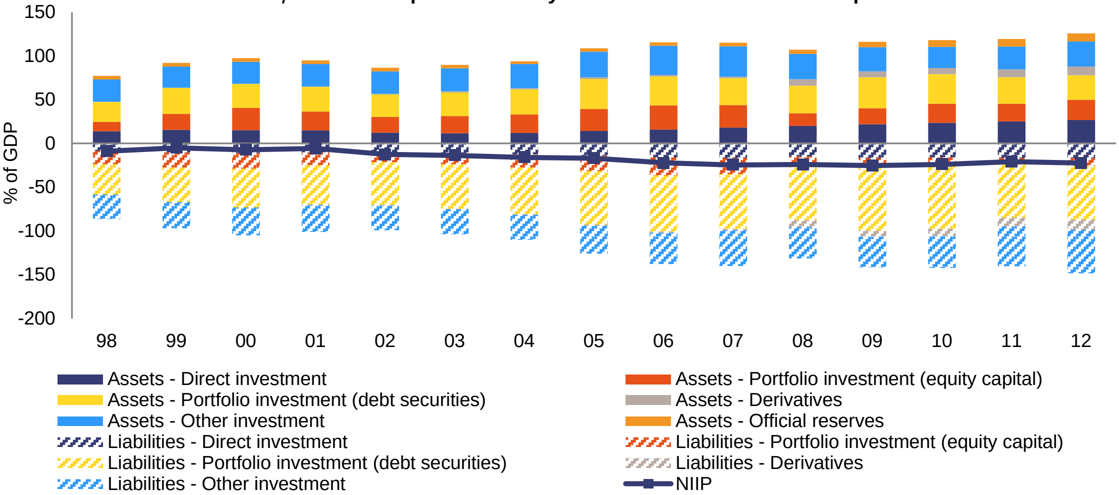
Graph 2.3: **Italy's saving, investment and current account**



Source: Commission services

Italy's net foreign financial liabilities increased between 1999 and 2012, but their level remains moderate. Italy's net international investment position (NIIP) deteriorated since euro adoption: it stood at -9% of GDP at the end of 1998, but declined to -22.5% by the end of the third quarter of 2012 (Graph 2.4). This compares with a NIIP at around -92% of GDP in Spain and -105% of GDP in Portugal at the end of 2011. The accumulation of current account deficits since 2006 explains only part of the deterioration of Italy's NIIP. The main drivers were negative valuation effects linked to the appreciation of the euro between 2003 and 2009 (which reduced the value of assets held in foreign currencies, mainly US dollar) and lower

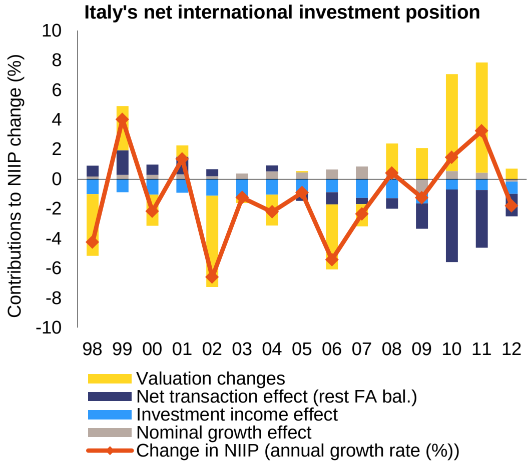
Graph 2.4: **Decomposition of Italy's net international investment position**



Source: Bank of Italy. Note: Data for 2012 run up to the third quarter only

interest rates up to 2011 (which implied an increased market value of liabilities in the form of debt securities). The negative valuation effect has been partially reversed since the financial crisis in 2008 when the US dollar appreciated and the market value of Italian equities fell sharply (Graph 2.5). Looking at the composition of the NIIP, the negative net portfolio investment position is related to rising overall indebtedness of the Italian economy, with foreign investors holding around 62% of GDP of Italian debt securities at the end of the third quarter of 2012, against a stock of foreign debt securities worth 28% of GDP held by Italian residents. This is partially compensated by higher holdings by Italian residents of portfolio equity capital (around 23% of GDP versus 8.5%). By contrast, Italian investors' FDI abroad has consistently been higher than foreign investors' direct investment in Italy (around 27% versus 17% of GDP respectively at the end of the third quarter of 2012). Finally, the increase in other investment liabilities in 2011-12 is mainly related to higher liabilities of Italian banks towards the Eurosystem.

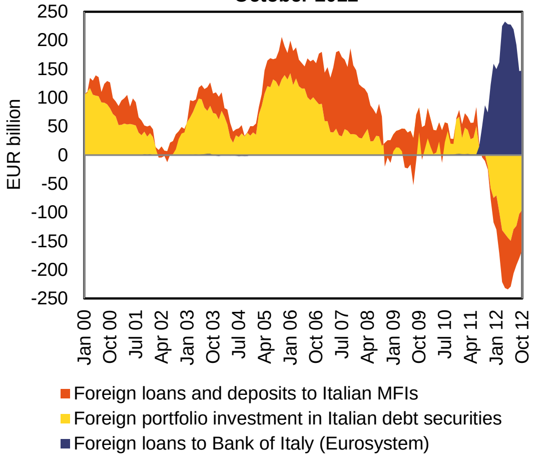
Graph 2.5: **Decomposition of the changes in Italy's net international investment position**



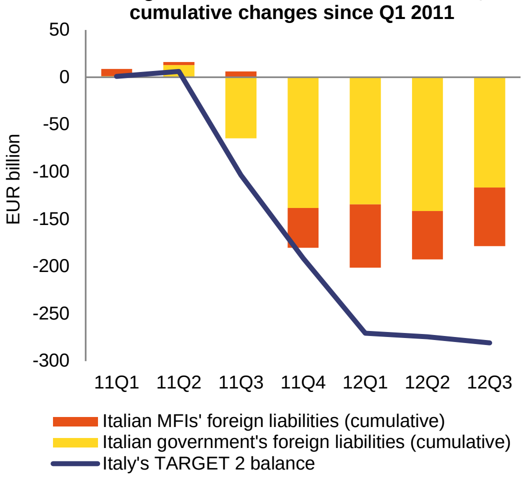
Source: Commission services
Note: Data for 2012 run up to the third quarter only

Amid increased risk aversion towards vulnerable euro-area economies, the negative NIIP has become a source of vulnerability for the Italian economy. Capital flows into Italy dried up with the global financial crisis in 2008-09. In 2010, Italian monetary and financial institutions (MFIs) regained some access to international financial markets, and the net inflow of foreign capital into Italy – measured by the financial account in Italy's balance of payments – rebounded somewhat (Graph 2.6a). However, as of mid-2011 the flow of private net foreign claims started to decline quickly as investor sentiment towards Italy deteriorated and the sovereign debt crisis hit the country. As a result, the composition of the external financing of Italy's NIIP changed

Graph 2.6a: **The external financing of Italy's current account in flow terms, January 2000 - October 2012**



Graph 2.6b: **Italian government's and MFIs' foreign liabilities and TARGET 2 balance, cumulative changes since Q1 2011**



Source: Bank of Italy, Commission services
Note: The graph shows selected monthly flows of external funding of Italy's current account.

dramatically. First, private foreign investors drastically shed their holdings of debt securities issued by the Italian sovereign and to a lesser extent Italian MFIs. The resulting sharp fall in net portfolio investment in Italy was to some extent offset by Eurosystem purchases of Italian sovereign bonds under the Securities Markets Programme between August 2011 and March 2012 (around EUR 100 billion). Second, foreign loans and deposits to Italian MFIs also declined substantially due to the strong link between the (weakening) Italian sovereign and banks (see Box 1). Third, the net outflow of private foreign funding was compensated by a very strong increase in external liabilities held by the Bank of Italy, which on behalf of Italian banks took in ample Eurosystem liquidity under the two 3-year long-term refinancing operations (LTROs). Following the collapse of interbank market activity between surplus and peripheral euro-area countries in the course of 2011, ([1]) Italy's TARGET 2 liabilities vis-à-vis the Eurosystem increased ([2]) and stood at EUR 256 billion (or 16% of Italy's GDP) at the end of February 2013. As foreign private-sector funding of Italy's negative NIIP has to a significant extent been replaced by official-sector funding in 2011-12, the overall exposure of foreign investors to Italy has remained broadly stable. The expected surplus in the current account in 2013, as set out in the Commission services' Winter 2013 forecast, will help to improve the NIIP going forward.

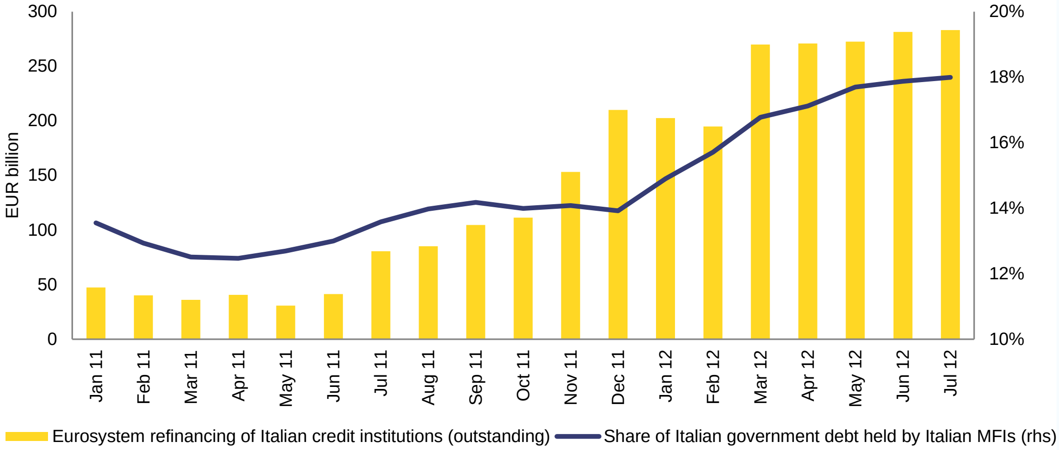
([1]) See for instance De Grauwe, P. and Y. Ji (2012).
([2]) See for instance Cecioni, M. and G. Ferrero (2012).

Box 2.1: The role of the Italian financial sector in Italy's adjustment

The longest economic recession since World War II has significantly impaired the Italian financial sector's capacity to support the economic recovery and favour the needed adjustment towards more productive activities.

Compared to some other euro-area Member States, the Italian financial sector proved to be relatively resilient during the global financial crisis of 2008-09, requiring only marginal public support. Contributing factors included a largely traditional intermediation-based business model, a sound regulatory and supervisory regime, the absence of a real estate bubble in the country and the low level of household debt. Since 2011 however, the vulnerability of Italian banks has increased significantly, owing to the negative feedback loops between fiscal sustainability concerns, banks' exposure to the Italian sovereign and weakening real economic activity, resulting in a loss of access to international wholesale funding markets. The risk of a liquidity crunch in Italy and other vulnerable euro-area countries led the Eurosystem to provide ample long-term funding through the two 3-year long-term refinancing operations (LTROs) in December 2011 and February 2012. The participation of Italian banks in these operations corresponded to a net increase in Eurosystem funding of EUR 117 billion between November 2011 and March 2012, up to a total of around EUR 270 billion. However, the actual uptake of LTRO funding was significantly higher than EUR 117 billion as almost all outstanding short-term funding under the Eurosystem's main refinancing operations was replaced by LTRO funding. Banks invested a significant share of the allotted LTRO funds in Italian sovereign bonds, while foreign investors were reducing their sovereign exposure to Italy (Graph 1). Despite the relaxation of liquidity constraints, the average cost of new credit to firms in Italy remained significantly higher than in Germany or France, indicating continued impairment of the monetary policy transmission mechanism (Graph 2a).

Graph 1: **Share of Italian government debt held by Italian MFIs and Eurosystem refinancing of Italian credit institutions**



Source: Bank of Italy, Commission services

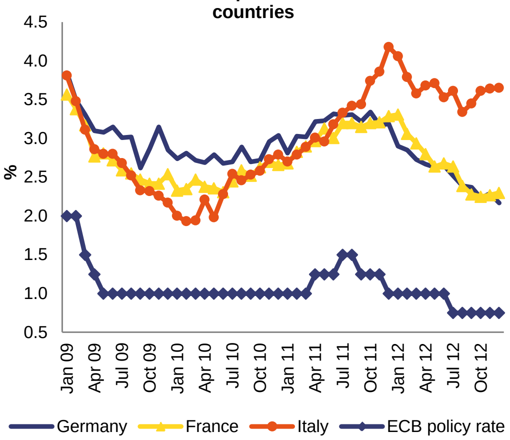
Although the liquidity situation of Italian banks has improved considerably since the LTROs, other weaknesses have emerged which prevent the Italian banking sector from playing its role of supporting the real economy adjustment. The double-dip recession has burdened Italian banks' balance sheets with a large and rapidly increasing stock of non-performing loans (NPLs) (Graph 3), mainly to non-financial corporations (NFCs), a problem that is further aggravated by the slowness of credit recovery procedures. In response, credit supply conditions tightened considerably over the period bridging 2011 and 2012 (Graph 2b). SMEs, which for their financing are very dependent on banks, were particularly affected: compared to larger companies, they pay significantly higher interest rates on loans and more often face a rejection of their

(Continued on the next page)

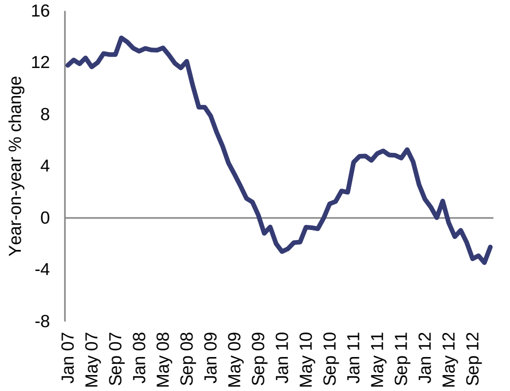
Box (continued)

loan applications. ([1]) Demand for bank loans is also subdued, and this situation is expected to last well into 2013. Furthermore, lending growth has been held back by the need to maintain tight control over capitalisation in view of increased credit risk. Finally, the profitability outlook for Italian banks does not look encouraging. Net interest margins are under pressure from low benchmark interest rates and still elevated funding costs, while the credit contraction causes a decrease in core revenues and slows down the re-pricing of banks' assets. The cost efficiency of Italian banks is low in an international context: high cost-to-income ratios, mainly due to extended branch networks, act as a further drag on profitability.

Graph 2a: **Interest rates on new bank loans to non-financial corporations in selected countries**

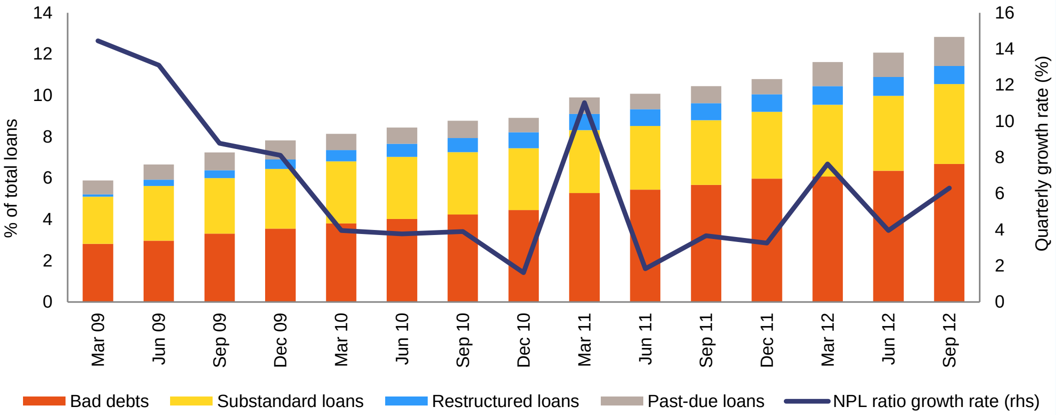


Graph 2b: **Volume of loans to Italian non-financial corporations**



Source: European Central Bank (a) and Bank of Italy (b)

Graph 3: **Evolution of Italian non-performing loans**



Source: Bank of Italy
Note: International comparisons of NPL stocks involving Italy should take account of the fact that Italian accounting criteria to determine loan quality are stricter than in other countries, resulting in a positive bias in Italian NPL ratios.

([1]) See for instance European Central Bank (2012).

2.3. PRIVATE AND PUBLIC SECTOR INDEBTEDNESS

The net financial position of Italian households continues to be relatively strong. Italian households have continued to accumulate assets as they have maintained a positive, though declining, saving rate (Graph 2.7). Their net financial wealth is still above the level estimated for France (135%), Germany (122%), and the euro-area average (128%), even though the fall in market prices reduced its value from 177% of GDP at the end of 2010 to around 165% at the end of 2011. Overall household wealth – i.e. including real assets – is estimated to be around 550% of GDP. ([3]) The indebtedness of Italian households continues to be among the lowest in the euro area and their financial vulnerability – measured as the ratio of debt service to income – remains low. ([4])Nevertheless, the fall in households' real disposable income since the onset of the financial crisis has been significant due to both a weakening labour market and the impact of the sizeable fiscal consolidation. This, combined with some consumption smoothing, has implied a decline in the household saving rate to historically low levels.

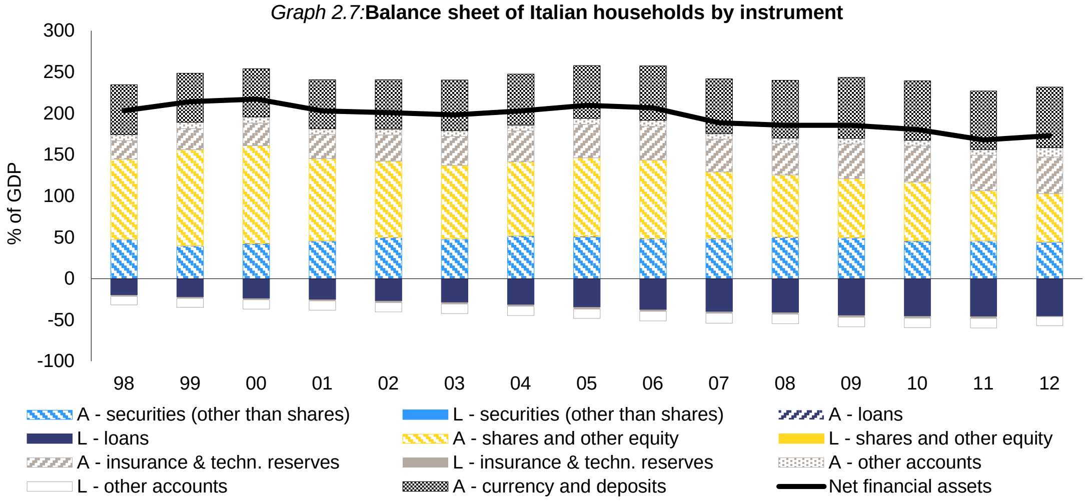
The increasing trend in non-financial corporations' indebtedness has come to a halt since 2008. Indebtedness of non-financial corporations (NFCs) increased by around 25 pps. of GDP over the decade up to 2008. As the total amount of loans to Italian NFCs fell by more than 2% year-on-year in December 2012, the stock of consolidated debt of Italian NFCs stabilised at around 80% of GDP and remains slightly below the euro-area average. While this is largely reflected in depressed investment, the corporate sector has somewhat increased its reliance on self-financing. Taken together with the low level of household indebtedness, the overall indebtedness of the Italian private sector as a share of GDP remains nearly 20 pps. below the euro-area average (Graph 2.8).

The high government debt represents a major burden for the Italian economy, especially against the background of subdued growth. With a general government debt which is estimated to have reached around 127% of GDP by the end of 2012, Italy has by far the highest public debt-to-GDP ratio among the large euro-area countries. After a major fiscal consolidation in the run-up to euro adoption, Italy did not take advantage of the lower interest expenditure in the years preceding the global financial crisis to ensure sound public finances. On the contrary, the erosion

([3]) Bank of Italy (2012b)

([4]) According to Magri, S. and R. Pico (2012), "The percentage of vulnerable households, i.e. those with a high debt service to income, remained unchanged from 2008 to 2010, when the sharp reduction in income was offset by a marked fall in interest rates; simulations for 2011-2012 show modest changes in this indicator. Over-indebted households, i.e. those permanently unable to repay their debt, are estimated at 160,000 or 0.6 per cent of the total."

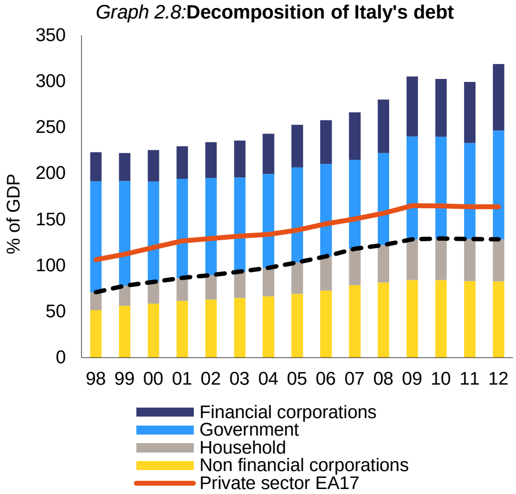
Graph 2.7: **Balance sheet of Italian households by instrument**



Source: Commission services
Note: 2012 figures are estimated using quarterly data.

over the years of the primary surplus achieved at euro-area entry slowed the pace of reduction of the debt-to-GDP ratio (Graph 2.9). While low growth makes it more difficult to achieve and maintain the large primary surpluses required to put Italy's government debt-to-GDP ratio on a steadily declining path, a high stock of public debt may in turn hamper growth prospects. ([5]) In particular, the present and expected high level of taxation needed to service the debt dampens domestic demand and may raise the distortionary costs of taxation. Indeed, the tax burden in Italy is high and weighs heavily on labour and capital, to the detriment of growth (see Section 3.2). Furthermore, the high interest expenditure to service the debt may crowd out productive public expenditure, especially to support human capital accumulation and physical and technological infrastructures. In 2012, government interest expenditure was at around 5.5% of GDP, almost 3 pps. higher than in Germany and France. By contrast, structural primary expenditure, just below 43% of potential GDP, was in line with that in Germany and more than 8 pps. lower than in France.

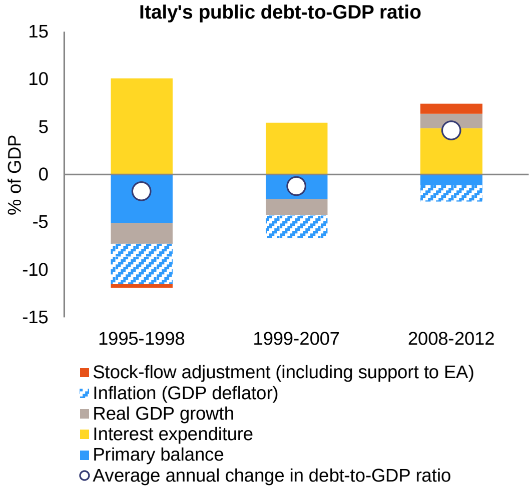
Graph 2.8: **Decomposition of Italy's debt**



Source: Commission services
Note: 2012 figures are estimated using quaterly data.

([5]) See also European Commission (2012b).

Graph 2.9: **Decomposition of the changes in Italy's public debt-to-GDP ratio**



Source: Commission services

The public debt represents a major vulnerability for Italy, with potential spillovers to the rest of the euro area. The sovereign debt crisis has exacerbated the negative feedback loop between high debt and low growth. Between end-2007 and end-2012, Italy's government gross debt ratio increased by around 24 pps. of GDP. This was largely explained by the sharp GDP contraction, while in a context of limited fiscal space the authorities maintained a prudent fiscal stance. Meanwhile, as Italy's sovereign risk premium soared between 2011 and 2012, the cost of capital for the private sector also increased, hampering productive investment. Moreover, given the considerable fragmentation of the euro-area financial market across national borders, the exposure of Italian banks to Italy's high government debt has exacerbated the funding problems of the banking sector (see Box 1). As the Italian economy is the third largest in the euro area and Italian government debt at around EUR 2 trillion the second largest, the potential economic and financial spillovers of financial market tensions to the rest of the euro area are sizeable. However, thanks to the credible fiscal strategy and growth-enhancing reforms at national level as well as progress towards more economic integration at euro-area level, yields on government bonds have declined significantly since the last months of 2012.

The debt sustainability analysis presented in the Commission's Fiscal Sustainability report 2012 ([6]) underscores the importance of securing high primary surpluses to put the Italian public debt-to-GDP ratio on a steadily declining path. Provided that the expected structural fiscal adjustment is achieved – i.e. that the structural primary surplus is increased to 5% of GDP by 2014 and is maintained at that level afterwards – the downward trajectory of the debt ratio over the medium term is preserved under temporary interest rate shocks, even if they are rather sizable or result in temporarily lower growth. However, if the primary balance targets are not achieved, then the debt ratio remains vulnerable to adverse interest rate and growth developments. The negative feedback loops between higher interest rates and lower growth would exacerbate the vulnerabilities. The reinforced SGP provides the appropriate framework to secure a steadily declining path of the government debt-to-GDP ratio, as the new debt rule requires that the gap between the actual debt ratio and the reference value of 60% of GDP is reduced at an average rate of one twentieth per year as a benchmark. Compliance with the debt rule might also help anchor market expectations and lower the risk premium on Italy's government debt.

2.4. REAL ESTATE MARKET DEVELOPMENTS

The risk of a severe downturn in the Italian real estate market, with adverse effects on household wealth and a sharp fall in the value of banks' collateral, appears limited. Italy did not experience a housing bubble during the pre-crisis years. At the end of August 2012, mortgage lending in Italy constituted only around 18% of total bank credit, which is significantly below the euro-area average of 33%. Two thirds of outstanding mortgages are variable-rate contracts, which limit banks' exposure to interbank interest rate changes. Loan-to-value ratios are relatively low in Italy and have decreased considerably since the mid-2000s, as banks have applied conservative policies when granting mortgage loans.

The Italian real estate market has weakened considerably against the background of the deep economic recession in Italy. Construction firms' weak turnover and the restricted capacity to obtain financing in this sector led to a sharp contraction in construction activity. Real estate prices (in nominal terms) have declined modestly since mid-2011, slightly more for non-residential property than for houses. Real estate transaction volumes have decreased more significantly. Households' demand for mortgage loans has contracted, while the amount of building permits – especially for housing – has remained at a low level. The increase in recurrent taxation on immovable property ('*Imposta Municipale Unica*') from a relatively low level, adopted with the December 2011 economic and budgetary package (see Section 3.2), may have also affected the real estate market in 2012.

The weakening of the construction sector weighs on banks' balance sheets. In December 2012, the construction sector represented around 18% of all loans granted by banks to NFCs, while the sector's share of total NPLs (related to NFCs) amounted to 24%. On average one third of the monthly net increase in NPLs since mid-2011 is due to the construction sector.

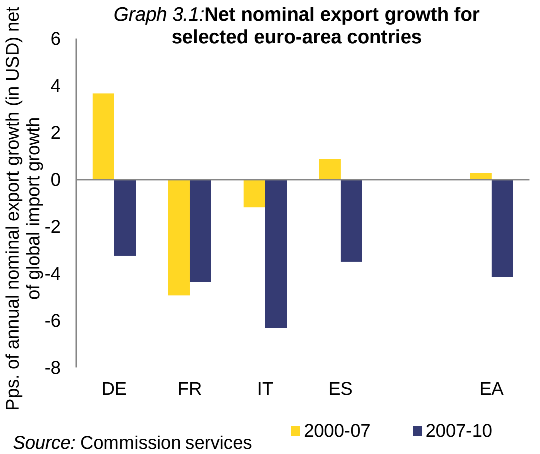
([6]) European Commission (2012a)

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

3.1. COMPETITIVENESS DEVELOPMENTS IN ITALY

Italy has been losing export market share since euro adoption, and the pace of erosion has accelerated with the eruption of the global crisis. Although it is normal for a mature economy to lose export market share in the context of strong export-led growth of emerging markets, Italy's export performance nevertheless compares unfavourably with that of other euro-area countries. Graph 3.1 shows nominal export growth in value terms for selected euro-area countries net of global nominal import growth, distinguishing between the pre-crisis years (2000-07) and developments over the crisis period (2007-10). During the pre-crisis years, Italy was already losing market share, although at the moderate pace of 1.2 pps. per year on average, while the euro area as a whole maintained its market share. France experienced a more dramatic loss while in Germany and Spain exports grew faster than global imports. The Italian export market share fell dramatically – by a sizeable 6.3 pps. on average per year – during the crisis years 2007-10, i.e. more than the euro-area average of -4.2 pps.

Graph 3.1: **Net nominal export growth for selected euro-area contries**



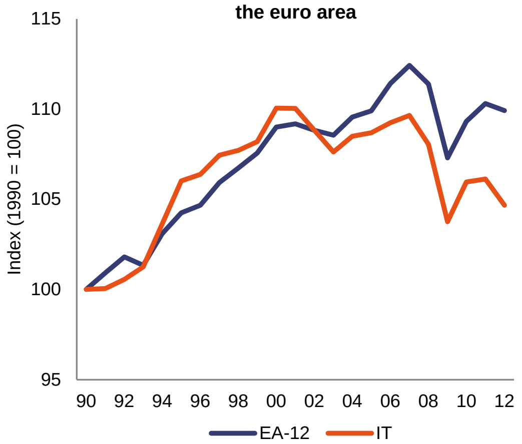
Source: Commission services
Note: A country's net nominal export growth is defined as nominal export growth net of global nominal import demand. Positive/negative net nominal export growth implies a gain/loss of export market share.

The loss of cost and non-cost competitiveness vis-à-vis Italy's trading partners has been a key driver of the country's subdued export performance. The following factors are relevant in this respect:

- **Unit labour costs in Italy have increased more rapidly than in the rest of the euro area since 1998.** During the period 1999-2012, Italian nominal unit labour costs (ULC) grew by 2.3% per year on average, implying labour cost pressures on prices above the ECB inflation reference value. In France, ULC grew by 1.9% per year, while in Germany the average annual growth rate, at 0.7%, was well below the euro-area average of 1.6%.

- **Persistently weak productivity growth is the key driver of increasing unit labour costs.** Total factor productivity growth came to a halt at the beginning of the 2000s and has been subdued or even negative since then (Graph 3.2). This reflects a reduced ability of Italian firms to incorporate new technologies in their production processes and improve labour force organisation consistently with a changing and more competitive environment, as well as the scarcity of skilled labour (see Box 3.1).

Graph 3.2: **Total factor productivity in Italy and the euro area**

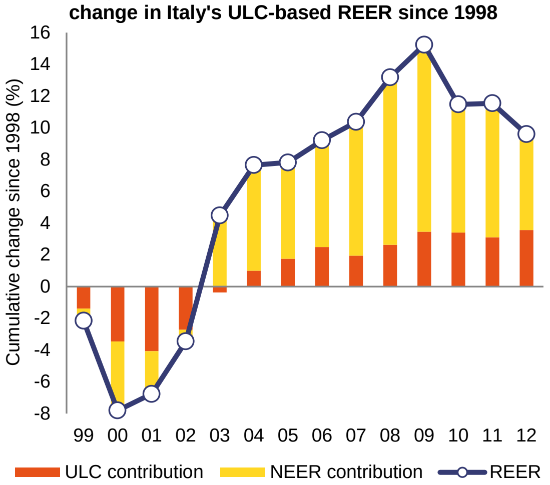


Source: Commission services

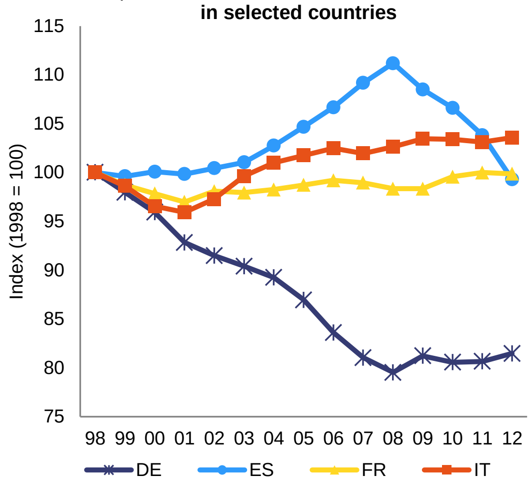
- **The negative impact on competitiveness of rapidly rising ULC has been amplified by the sizable appreciation of Italy's nominal effective exchange rate.** A decomposition of the appreciation of Italy's ULC-based REER ([7]) since 1998 into changes in the nominal effective exchange rate (NEER) and in nominal ULC relative to trade partners shows

([7]) An alternative measure of price competitiveness would be the Italian REER based on the producer price index, especially for traded goods.

Graph 3.3a: **Decomposition of the cumulative change in Italy's ULC-based REER since 1998**



Graph 3.3b: **Evolution of relative nominal ULC in selected countries**

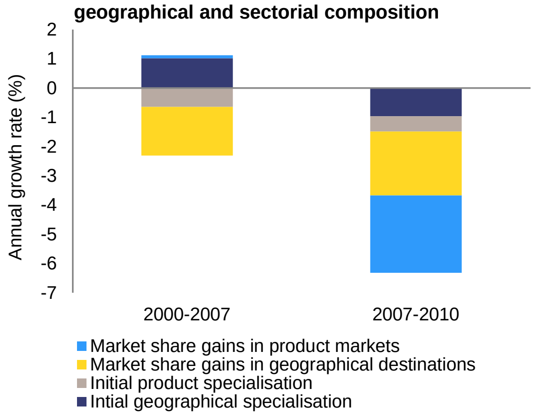


Source: Commission services
Note: Performance relative to 36 industrial countries (double export weights)

that the appreciation of the former component between 2003 and 2009 is the main driver (Graph 3.3a). Germany experienced a similar appreciation of its NEER, but its impact on the REER was offset by declining relative ULC, driven by considerable wage restraint (Graph 3.3b). According to IMF estimates, Italy's real effective exchange rate (REER) is modestly overvalued by around 5–10%.

- **Italy's export performance continues to suffer from an unfavourable product specialisation.** To identify the drivers of the export market share losses that were shown in Graph 3.1, Italian net nominal export growth before and during the crisis is decomposed into two structural indicators showing to what extent Italy's exports have been geared towards dynamic geographic and product markets, and two performance indicators capturing Italy's success in achieving above-market export growth in geographic and product markets due to competitiveness factors (Graph 3.4). At the beginning of the decade, the Italian economy presented an unfavourable product specialisation relative to global export patterns, but its exports remained oriented towards still dynamic destination countries, which allowed it to take advantage of the distribution of global demand. However, as global export patterns evolved, Italian exporters were not able to redirect their products to the countries where import demand was most dynamic. Thus, Italy entered the crisis with an unfavourable product and geographical specialisation of exports, and both these disadvantages were aggravated during the crisis, as the economy lacked sufficient dynamism to adapt to the dramatically changed environment and import demand in some of Italy's key trading partners – especially in Europe – dropped.

Graph 3.4: **Decomposition of Italy's net nominal export growth according to geographical and sectorial composition**



Source: Commission services
Note: more information on the decomposition methodology can be found in European Commission (2012c).

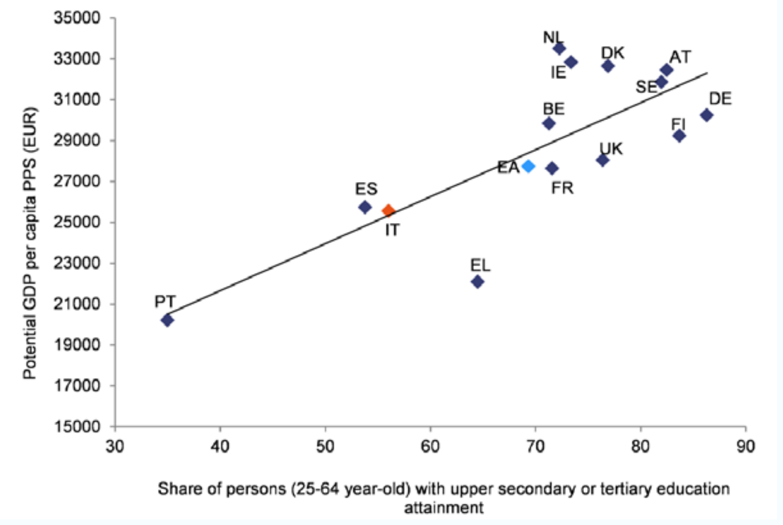
In light of the above, the following sections of this in-depth analysis focus on the main levers for improving Italian competitiveness: wage moderation, a more growth-friendly taxation structure and, most importantly, stronger productivity growth.

Box 3.1: The contribution of education to growth

Education is key for economic growth. The quality of labour is particularly important for advanced economies, which compete in international markets with goods and services with a relatively high technological content. In fact, advanced economies operate close to or at the technological frontier, i.e. the maximum output that can be produced for any given amount of capital and labour using the most advanced technology available. In order to move closer to the frontier or even push it forward, a high-skilled labour force and R&D investment are required (Vandenbussche et al. (2006)). The empirical literature provides evidence that human capital has a positive impact on the macroeconomic performance of a country, notably by increasing productivity (Sianesi and Van Reenen, 2002).

Graph 1 indicates a positive relationship between potential output per capita and the share of the population with upper-secondary or tertiary educational attainment for the former EU-15 countries. It shows that Italy is outperformed by most other European countries.

*Graph 1:***Potential GDP per capita and educational attainment in the EU, 2011**



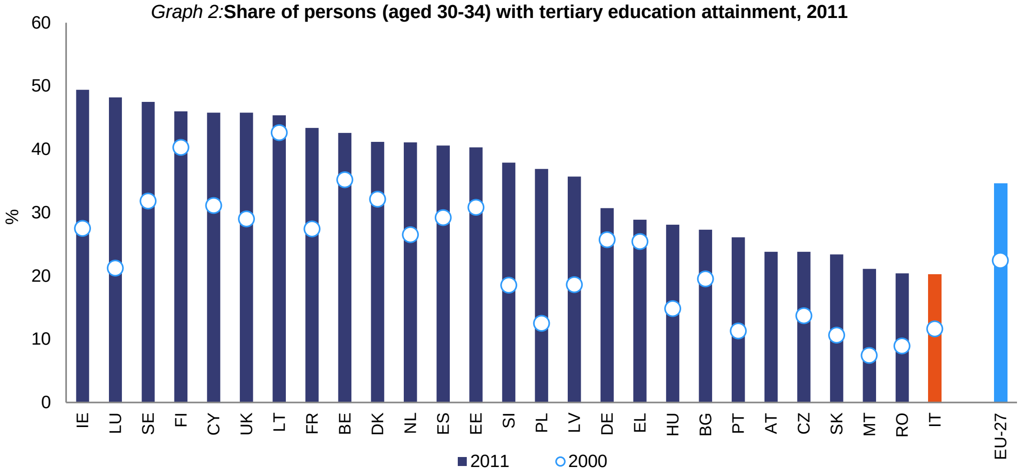
Source: Commission services

Indeed, Italy's human capital endowment remains weak compared to other advanced economies. The proportion of low-skilled people in the population is relatively high: in spite of some significant improvement in recent years, completion of upper secondary education remains below the EU average, and the tertiary education attainment rate among those aged 30-34 is the lowest in the EU, standing at 21.3% compared to an EU average of 35.5% (Graph 2). Similarly, Italy has a high percentage of early school leavers (17.7% in 2012, compared to an EU average of 12.9%) and high rates of inactivity among its young people: in 2011, more than one in five 15-29 year-olds in Italy were neither in education nor employed. Furthermore, PISA test results show that school education produces weak results in terms of basic skills, especially in southern regions, and many children of parents with low levels of education are caught in a low-education group. All this points to a quality of education that still lags behind the OECD average. The gap with other industrialised countries also remains wide in terms of the transition from education to work, and many indicators suggest that the labour market for young tertiary graduates has become more difficult over the past decade.

(Continued on the next page)

Box (continued)

Graph 2: **Share of persons (aged 30-34) with tertiary education attainment, 2011**



Source: Commission services

3.2. WAGE GROWTH, LABOUR MARKET RESPONSIVENESS AND TAXATION

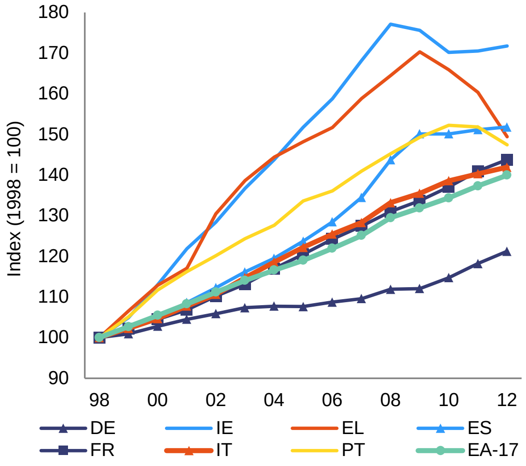
Since euro adoption, wage growth in Italy has been broadly in line with the euro-area average. Nominal compensation per employee grew by 2.5% on average per year over 1999-2012, with some deceleration after 2008 (Graph 3.5a). The euro area and France recorded similar growth rates at 2.4% and 2.6% respectively. By contrast, nominal compensation per employee rose much more significantly in Ireland, Greece, Portugal and Spain before the financial crisis, while afterwards it stabilised or fell sharply in the case of Greece. Germany is an outlier, with flat nominal wages up to 2008 and some acceleration afterwards. Growth of nominal compensation per employee is not only in line with the average growth in the euro area, but it also appeared to be consistent with domestic labour market equilibrium up to the financial crisis in 2008 and only slightly above what is predicted on the basis of fundamentals during the crisis years up to 2011. ([8]) Dispersion in real wage growth (Graph 3.5b) has been more contained as inflation and wage developments have been influencing each other. More specifically, after euro adoption Italy's real compensation per employee increased significantly only over 2009-10, as falling energy prices drove the decline in inflation. This increase was reversed in 2011-12, when higher indirect taxation and oil prices pushed inflation up while wage growth was restrained by the economic slump and the enacted freeze in public sector wages. Over the period 1999-2012, real wages increased by only 0.2% on average per year in Italy. Real wage growth was more sustained in France (1.0%), while it was similar to Italy (0.1%) in Germany.

The share of wages negotiated at firm level remains small. ([9]) Contractual wages set at national sectorial level on the basis of the inflation benchmark for a 3-year period have been less responsive to productivity developments than actual wages. Actual wages rose as a result of some positive wage drift just before the financial crisis, as economic conditions were improving. By contrast, a negative wage drift has been visible since end-2008 and became even more apparent since the second half of 2011, following the sovereign-debt crisis that severely hit the Italian economy (Graph 3.6). Firm-level bargaining can play an important role in strengthening wage responsiveness to productivity as well as to local labour market conditions. However, the share of wages negotiated at firm level is still limited and

([8]) Rawdanowicz, L. *et al.* (2013)

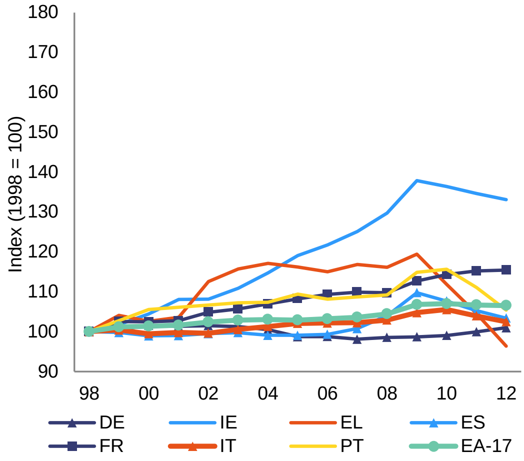
([9]) The adjustment of labour costs to changes in the economic situation can be gauged via different indicators. One such indicator is the wage drift, which measures the difference between the growth in the actual wages received by workers and that in negotiated wages.

Graph 3.5a: **Nominal compensation per employee in selected countries**



Source: Commission services

Graph 3.5b: **Real compensation per employee in selected countries**

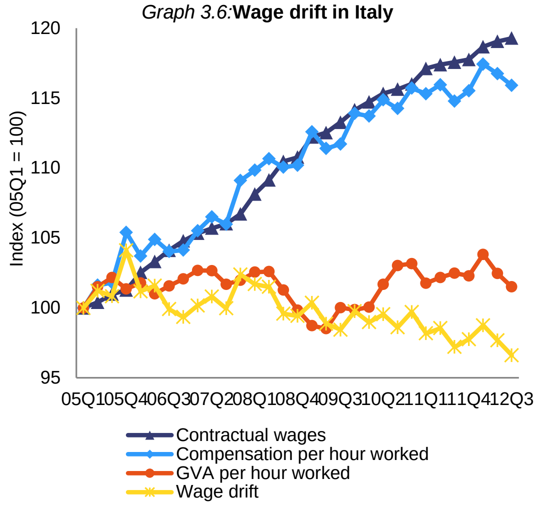


Note: Based on private consumption deflator

this hampers a better alignment of wages to specific economic and competitiveness conditions

The dominant level of collective bargaining in Italy remains the national level, even though important changes to the bargaining framework since the beginning of the 1990s 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. Two further agreements in 2009 and 2011 and a controversial legal provision adopted by parliament in September 2011 constituted additional attempts to further shift the balance towards company-level bargaining, with the latter even allowing firm-level collective agreements to derogate from labour law. By allowing to locally negotiate trade-offs between job security conditions and wage concessions, these agreements may allow for better taking into account the needs of specific production activities. However, the evidence available so far shows that firm-level contracts concern a minority of workers and firms, with this share being particularly low in southern regions. Large and more productive firms still dominate the bargaining process at the national sectorial level, making it difficult for SMEs to adjust wages to internal productivity developments and cyclical conditions. In addition, the 3-year duration of contracts, while reducing the negotiation effort of social partners, might be too long to adjust to unexpected changes in cyclical and competitiveness conditions. Finally, the 3-year inflation forecast excluding imported energy prices, which since 2009 is used as a benchmark for wage setting at national level, does not take into account Italy's need to regain cost competitiveness relative to trade partners.

Graph 3.6: **Wage drift in Italy**

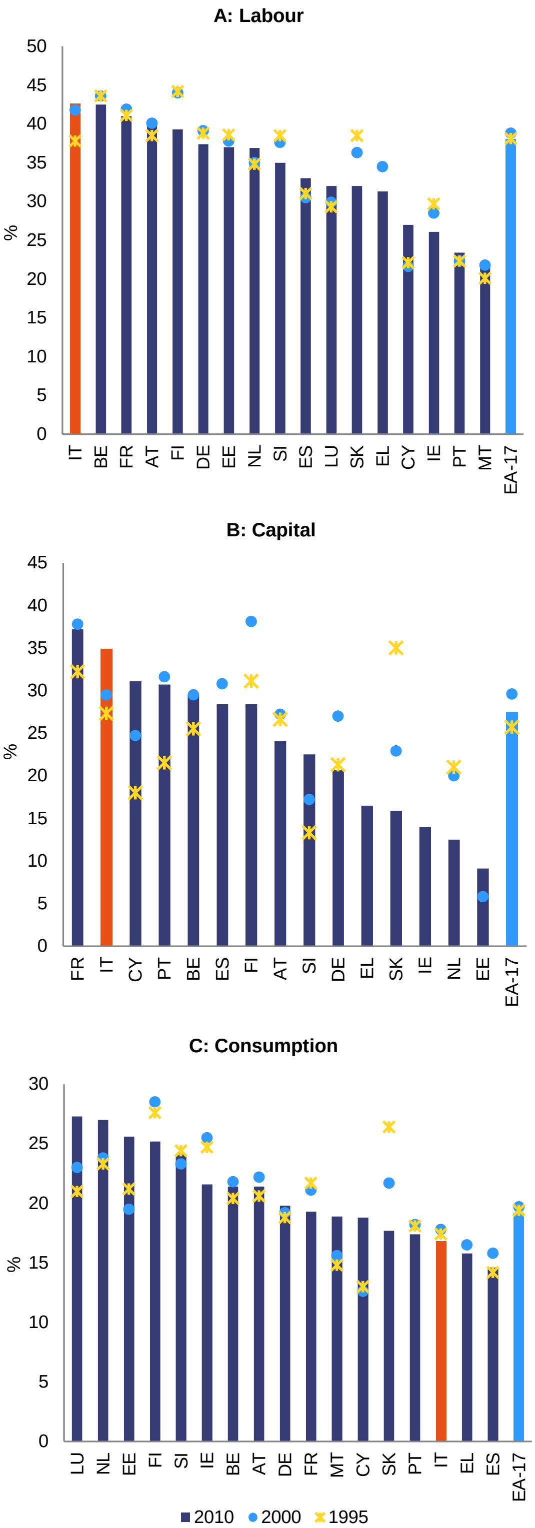


Source: Commission services

The new productivity agreement signed by the social partners at the end of 2012 might further facilitate wage setting at firm level. The agreement was signed on 21 November 2012 by the social partners with the notable exception of the largest union CGIL. It aims to further strengthen the second level of bargaining. The agreement also emphasises the need to better link wages set in national contracts not only to the 3-year forecast inflation, but also to the economic and competitiveness conditions of the country and the sector in question. While confirming the traditional set-up of the collective bargaining regulation in Italy, i.e. with legislation and the government continuing to have a very limited role, the agreement could promote a more efficient bargaining framework. The social partners also committed to further define rules for representativeness in collective bargaining, in view of establishing a more stable and effective industrial relations system. The government will support the agreement with tax rebates on productivity-related wage increases.

The high tax burden on labour raises the pressure on competitiveness on the cost side and contributes to Italy's unsatisfactory employment performance, while the high taxation of capital contributes to weak investment activity. In 2010, Italy displayed the highest implicit tax rate on labour income ([10]) in the euro area, and this rate has actually increased considerably since 1995 (Graph 3.7a). High labour taxation raises labour costs, with negative impact on cost competitiveness. It also adversely affects both labour demand and supply, especially of women, and can create an incentive to resort to the shadow economy. Similarly, in 2010 Italy displayed the fourth-highest implicit tax rate on capital ([11]) (Graph 3.7b). High corporate income taxation can contribute to sluggish investment activity and also to the limited attractiveness of the Italian economy for FDI. Consumption taxes finally, which are acknowledged to be less distortionary, represent only a small share of total revenues. In 2010 the implicit tax rate on consumption was still among the lowest in the euro area, and even declined somewhat between 2000 and 2010 (Graph 3.7c).

Graph 3.7: **Implicit tax rates on labour, capital and consumption in the euro area**



Source: Commission services

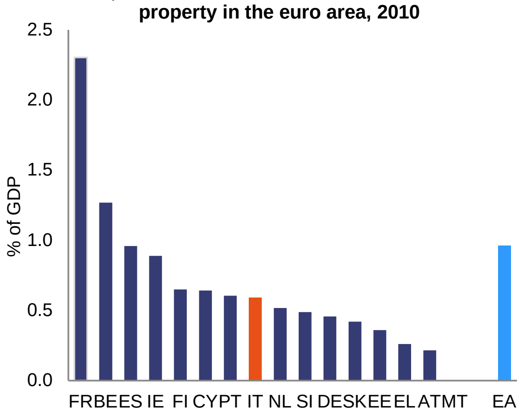
([10]) The implicit tax rate (ITR) on labour is calculated as the sum of all direct and indirect taxes and social contributions levied on employed labour income as a percentage of total compensation of employees from national accounts.

([11]) The ITR on capital is calculated as the ratio between revenue from all capital taxes and aggregate capital and saving income in the economy. It should be stressed, however, that 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, receipts from taxes and social contributions levied on the self-employed, a relatively large group in Italy, are booked as capital taxes.

The fiscal consolidation measures adopted by the Italian government in 2011 and 2012 rebalanced the tax burden towards consumption, immovable property and financial wealth. The fiscal consolidation packages adopted since 2011 increased recurrent property taxation (including the reintroduction of taxation of primary residences), raised the standard VAT rate, increased taxation on luxury durable goods and financial assets, and introduced higher excise duties on transport fuels. At the same time, taxation on the labour income of new hires was lowered by allowing for the deductibility of the labour component from the Italian regional production tax (IRAP), with greater reductions for women, young workers and southern regions, while an allowance for corporate equity (ACE) was introduced. Allowances for dependent children on personal incomes were also increased with the 2013 budget. Finally, a number of new measures and tools were introduced to improve tax compliance, including intensified inspection activities, the reduction of the threshold for the mandatory use of electronic payments and the introduction of the so-called 'income-meter' to detect potential tax evaders based on a comparison between income declared for tax purposes and expenses made.

While increasing the overall tax burden, the recently adopted fiscal measures have some desirable properties in terms of efficiency. Due to the budget constraints, the shift of taxation away from labour and capital was relatively modest and, despite some rebalancing of the fiscal adjustment towards expenditure cuts, the overall tax burden increased. Against the background of Italy's persistently low growth combined with the pressing need to bring the public debt on a declining path, higher taxation of immovable property is preferable to other taxes: it is less harmful to long-term growth, while appearing broadly consistent with equity objectives if properly designed. ([12]) This is especially true for Italy as the country's recurrent taxation on immovable property used to be relatively low (Graph 3.8). Some aspects of the reformed property tax could however be further improved in order to enhance progressivity. Broadening the tax base by bringing real estate taxable values in line with market values could yield equity gains in addition to bringing in additional revenues and reducing distortions. In addition, the enabling law envisaging a comprehensive review of Italy's outdated cadastral values remains to be adopted. Regarding other tax measures, the introduction of ACE can reduce the 'debt bias' in corporate financing (Graph 3.9). As such, it is expected to encourage firms, including SMEs, to expand their capital base to allow for higher investment, and help reduce firms' leverage and reliance on bank financing which has tightened considerably. In addition, own equity and retained earnings are considered the most important source of funding for investment in research and innovation, as immaterial capital goods cannot offer the guarantees demanded by banks.

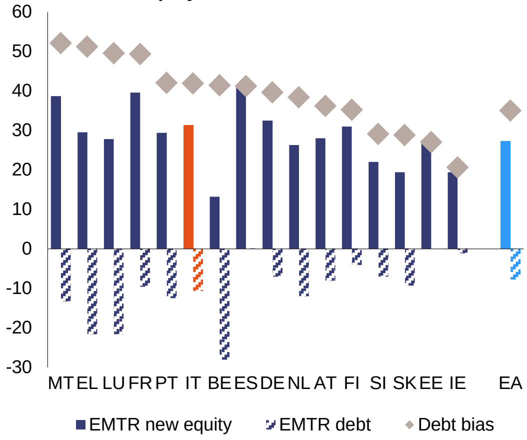
Graph 3.8: **Recurrent taxation on immovable property in the euro area, 2010**



Source: Commission services
Note: This graph does not take into account the increase in recurrent taxation on immovable property enacted in Italy in December 2011.

([12]) See for instance Johansson, Å, C. Heady, J. Arnold, B. Brys and L. Vartia (2008).

Graph 3.9: **Effective marginal tax rates (EMTR) for investment financed by debt and new equity in the euro area, 2011**



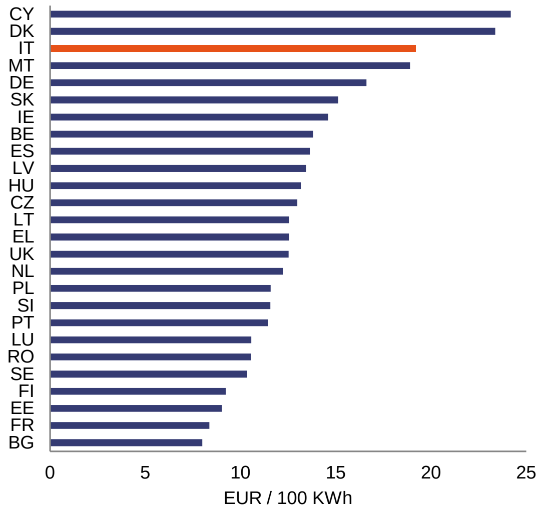
Source: Commission services

3.3. A CLOSER LOOK AT SELECTED DRIVERS OF PRODUCTIVITY SLOWDOWN

3.3.1. The business environment and structural features of firms

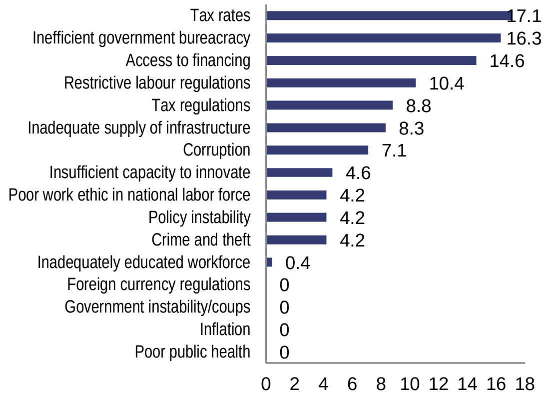
The high cost of doing business and the unfriendly business environment further undermine Italy's external competitiveness. Firms operating in Italy are confronted with high input costs in several areas. The cost of energy in Italy – in particular electricity prices – is among the highest within the EU (Graph 3.10). Rents due to the lack of competition in sheltered sectors imply higher prices for a range of intermediate goods and services. ([13]) As was explained in Box 1, Italian companies – especially SMEs – also face considerably higher interest rates on new bank loans than their peers in other euro-area countries due to the high cost of bank funding and credit tightening. Capital markets meanwhile remain underdeveloped and difficult to access for small firms, despite recent government initiatives such as the possibility for SMEs to issue mini-bonds. With regard to the general business environment, an inefficient public administration, including in the area of public procurement and the civil justice system ([14]), pervasive bureaucracy, restrictive labour market regulations, insufficient infrastructure and an inadequately educated workforce all constitute major obstacles to the creation([15]) and growth of Italian firms, resulting in limited business dynamism. Survey-based evidence from the World Economic Forum (2012) on the most problematic factors for doing business in Italy (Graph 3.11) shows that Italy ranks particularly low in the domains of institutions and goods and labour market efficiency, and to a lesser extent also financial market development and technological readiness.

Graph 3.10: **Electricity prices for industrial consumers in the EU, 2011**



Source: Commission services

Graph 3.11: **The most problematic factors for doing business in Italy**



Source: World Economic Forum (2012)
Note: From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

([13]) See for instance Bank of Italy (2012a).
([14]) According to the World Bank's doing-business indicators, contract enforcement in Italy on average takes 1210 days, compared to an OECD high-income average of just 510 days.
([15]) Italy ranks only 84th in the World Bank's 'doing business' indicator on ease of starting a business.

The predominance of small firms could be explained by a failure of small Italian firms to enter the virtuous circle of firm expansion and productivity growth. In 2011 the average Italian firm employed 4.0 persons, compared to 11.8 in Germany and 5.6 in France. In the same year, micro-firms (i.e. employing less than 10 people) represented almost 95% of all Italian enterprises in 2011, whereas in Germany and France the corresponding share amounted to 83% and 93%, respectively. Among Italian SMEs, especially micro-firms suffer from a significant productivity gap vis-à-vis larger firms, but also vis-à-vis their European peers: in 2011, the productivity of Italian micro-firms amounted to only 63% of that of the domestic NFC sector as a whole, well below Germany and France, where the respective ratios were 78% and 94%. Furthermore, in 2011, the ratio of Italian SMEs' productivity to German SMEs' productivity was 71%, whereas for micro-firms, relative productivity was even lower, at 58%. ([16])

The failure of many Italian small firms to grow prevents them from reaping the benefits of globalisation. A growing body of economic research, based on firm-level data, suggests a strong positive correlation between firm size, productivity and export performance: firms engaged in international activities such as exporting are typically larger, employ more labour and have higher innovation capacity. At the same time, larger firms are typically more productive and the probability of a firm to become active internationally increases with firm size. Moreover, the largest firms tend to have the furthest geographical reach and can pursue complex internationalisation strategies, enabling them to take advantage of the opportunities offered by globalisation, which in turn could trigger further productivity increases (e.g. through the transfer of knowledge and technology). Altomonte *et al.* (2012) show that in order to achieve internationalisation, companies need to move beyond a productivity threshold that enables them to absorb the high fixed (and often sunk) costs related to internationalisation and achieve the necessary efficiency to face international competition.

Several institutional and firm-level features hamper the growth of Italian firms. Low domestic competition in product and service markets shelters unproductive companies which would otherwise have to exit and slows down the reallocation of resources to the best performing firms. Various regulations, for example with regard to the labour market (such as dismissal rules) and the tax system (such as particular tax expenditure items), may act as disincentives to firm growth through the exemptions they provide to small firms and thus represent a *de facto* tax on size. Still limited decentralised wage bargaining continues to prevent employers to set wages in line with local productivity developments, which might act as a further obstacle to the efficient allocation of productive resources to the most efficient firms. Companies may also be encouraged to stay small by the complex tax regime or even organised crime in some regions. Finally, the absence of specific firm-level features conducive to productivity growth, such as a high R&D intensity, performance-related incentives and equity funding, as well as the presence of firm-level attributes hampering productivity growth, such as family ownership and its effect on risk aversion and openness towards (non-)technological innovation and ICT, hamper Italian firms' ability to become active internationally. ([17])

The lack of a business-supporting environment is the main reason for Italy's low inward FDI. All the factors mentioned above that contribute to an unfriendly business environment hold back the inflow of internationally active companies. Italy's limited attractiveness as a business location implies that in 2010 the overall stock of inward FDI as a share of GDP was just around 16%, compared to 27% in Germany and 38% in France (Graph 3.12). This reflects significantly lower foreign investment in financial activities and professional and business services. Given FDI's positive external effects under the form of the reallocation of domestic productive resources to tradable sectors, transfers of technology and knowledge and exposure to alternative corporate cultures, Italy misses out on an important potential source of productivity enhancements.

([16]) Calculations are based on the database accompanying the European Commission's Annual report on small and medium-sized enterprises in the EU, 2011/12.

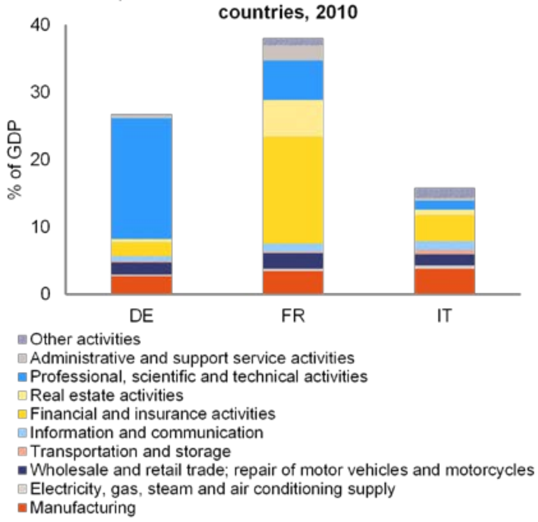
([17]) See for instance Altomonte, C., T. Aquilante and G. I. P. Ottaviano (2012).

A range of measures was adopted over the past months to foster competition in product and service markets and improve the efficiency of the business environment. First, progress was made to remove barriers to competition and open important market segments in the services sector, in particular the professional orders. Other measures were aimed at enhancing transparency and improving market functioning in network industries such as energy and transport, notably through the ongoing unbundling between the incumbent operator and the infrastructure manager in the gas sector and the envisaged empowerment of existing and newly established regulatory authorities. Second, a range of measures was adopted to achieve administrative simplification, improve SMEs' access to finance, modernise the public administration, promote the digitalisation of the economy and improve civil justice efficiency. Regarding the latter, the enacted revision of the judicial geography represents a key step to improve the judicial organisation. It was complemented by measures to accelerate judicial procedures, foster the specialisation of courts and judges, reduce litigation and modernise the use of the judicial service.

The labour market reform adopted in June 2012 could contribute to improving productivity growth while reducing segmentation in the labour market. The reform tackles the asymmetries and segmentation of the labour market, with a view to reconciling security with flexibility. It strives to better regulate entry flexibility by making apprenticeships the main point of entry towards stable jobs and reducing incentives to the use of temporary contracts and non-dependent work by firms. It also improves exit flexibility through a revision of employment protection legislation. Finally, the reform establishes a more comprehensive insurance-based system of unemployment benefits. The revision of employment protection legislation can reduce the uncertainty and cost of dismissals. However, the interpretation by the labour judge of the new legislation will be crucial for the success of the reform, while the new constraints on the use of non-regular contracts could negatively affect labour demand.

The adopted reforms could bring substantial benefits in terms of raising Italy's competitiveness and potential growth. However, their full implementation remains a challenge and further effort is needed in some areas. A more detailed account of the actions taken by the Italian authorities in response to the recommendations issued by the Council in July 2012, which cover many of the issues discussed in this review as underlying Italy's imbalances, will be undertaken in the context of the third EU semester. Overall, it is clear that the adopted reforms can potentially raise Italy's growth potential and competitiveness. Lusinyan *et al.* (2013) estimate that, if fully implemented, the product market reforms can raise GDP by 1.0% in two years, 4.4% in five years, and 8.3% in the long term, whereas the recent labour market reform could increase GDP by 0.6% after two years, 1.1% after five years and 1.8% in the long run. However, implementation remains challenging for some measures, either owing to delays in their concrete operationalisation or due to still pending secondary legislation. In particular, this is the case for the envisaged new regulatory authority in charge of fostering competition in the field of transport which has not yet been set up, as well as for some measures oriented towards simplification for which implementing provisions are still expected. Some of the provisions of the labour market reform, notably those related to incentives for the recruitment of women and older workers, still require implementing legislation.

Graph 3.12: **Stocks of inward FDI in selected countries, 2010**

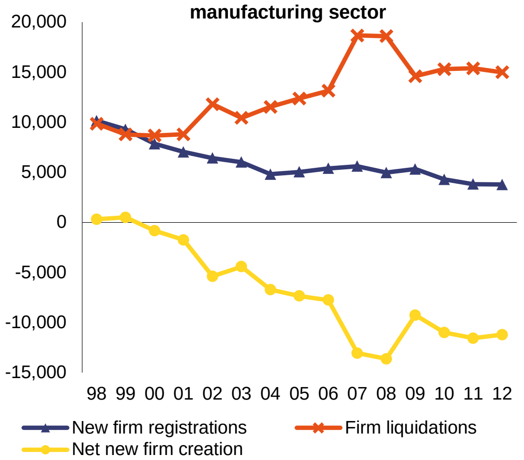


Source: Commission services

3.3.2. The specialisation of manufacturing exports

The Italian economy is characterised by the relative importance of its manufacturing sector. The sector represented 16.7% of the total gross added value of the economy in 2011 (compared to 22.3% in Germany, 11.5% in France and 16.6% for the euro area as a whole). However, this share has been declining over time (it was 21.5% in 1995) and the contraction has been particularly marked since the start of the global financial crisis: industrial output fell by more than one fifth between 2007 and 2012 and the net amount of manufacturing firms created in Italy has been negative throughout the 2000s (Graph 3.13).

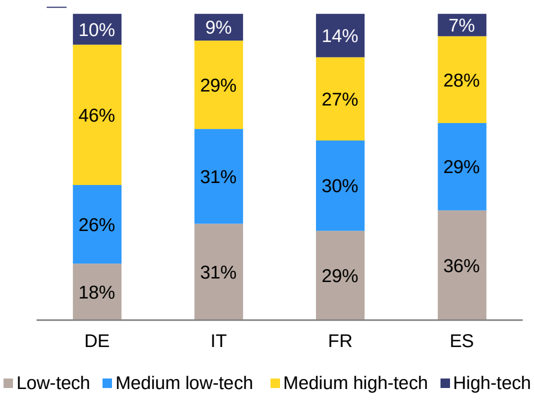
Graph 3.13: **Net new firm creation in Italy's manufacturing sector**



Source: Infocamere (Movimprese)
Note: Excluding sole proprietorships

A significant share of Italy's manufacturing value added is generated by traditional sectors characterised by low technological intensity, with minor changes over time. The share of manufacturing value added in the low and medium-low technology sectors amounted to 62% in 2009, compared to 44% in Germany, 59% in France and 64% in Spain (Graph 3.14). Over the past two decades, Italy's sectorial specialisation remained broadly stable: the high technology sector accounted for 6.7% of total manufacturing gross value added in 2011 compared to 6.5% in 1992, a negligible increase over a time span of almost 20 years.

Graph 3.14: **Manufacturing real value added by technological intensity in selected countries, 2009**

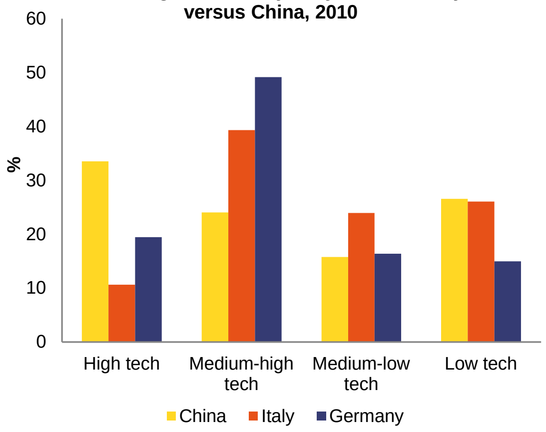


Source: Commission services (Eurostat)
Note: At factor cost

Italy's specialisation model has exposed the economy to fierce competition from emerging economies. Italy's specialisation in low and medium-low technology products implies an export product mix that is very similar to that of China and other emerging markets that can benefit from low labour costs. Indeed, the similarity of Italian exports vis-à-vis China is one of the highest among EU countries and the overlap of Italian and Chinese exports increases with decreasing technological intensity, as in high-tech exports China has built a much stronger position than Italy (Graph 3.15). Thus, the growing role of China in global trade – in particular since its accession to the World Trade Organisation at the end of 2001 – has resulted in some displacement of Italian exports. By contrast, Germany's competitive advantage over Italy and other southern countries – both in terms of costs and non-cost factors, also thanks to its specialisation in medium-high technology exports – resulted in strong demand for German goods (mainly machinery and equipment) by China and the oil producing countries. ([18]) Germany was also better able to exploit the opportunities created by the EU enlargement of 2004 through substantial FDI into the newly acceded Central and Eastern European countries in view of taking advantage of lower labour costs and higher return of capital.

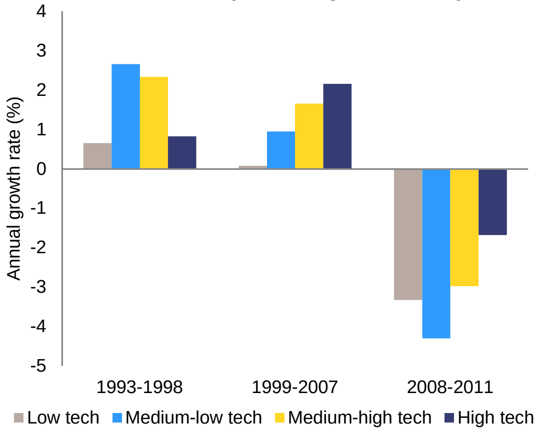
([18]) See for instance Chen, R., G. M. Milesi-Ferretti and T. Tressel (2012).

Graph 3.15: **Share in total exports by technological intensity, Italy and Germany versus China, 2010**



Source: OECD STAN database

Graph 3.16: **Change in Italy's manufacturing real value added by technological intensisty**



Source: ISTAT

As a partial response to the competitive pressures from low-cost countries, there is evidence of some restructuring, within sectors rather than across sectors. The main strategy of Italian manufacturing companies to face increasing competition from emerging markets since the beginning of 2000s and possibly even more during the current crisis ([19]) has been to move up the quality ladder. These structural shifts, however, do not seem sufficient to warrant a full recovery of the country's competitiveness. The impact of the global crisis may have accelerated the process whereby less efficient companies in the traditional industries have been forced to exit the market, with a consequent shift of production towards higher quality segments more sheltered from competition from low-cost economies. In fact, evidence suggests that low and medium-low technology sectors have been hit the most by the crisis (Graph 3.16).

([19]) See for instance Istituto Nazionale di Statistica (2013).

4. POLICY CHALLENGES

The Italian economy continues to be characterised by macroeconomic imbalances. The analysis in Sections 2 and 3 indicates that macroeconomic developments in the areas of export performance and the underlying loss of competitiveness, as well as the high government debt, combined with subdued growth potential, are the main imbalances which Italy is facing. In particular, the high level of public debt represents a major vulnerability for the economy and raises concerns on cross-border spillovers given the country's systemic economic role within the euro area. It should be recalled that these challenges were identified under the MIP in the first IDR and relevant policy responses were reflected and integrated in the country-specific recommendations (CSRs) issued for Italy in July 2012. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of Italy's National Reform Programme and Stability programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the challenges identified in this IDR.

The loss of external competitiveness highlights the adjustment challenge which Italy is confronted with. The recent improvement in the current account does not alter Italy's need to enhance its productivity growth and restructure the economy. Microeconomic evidence shows that stagnating total factor productivity growth, which underlies Italy's dismal productivity performance, is strongly related to the failure of many Italian firms to grow and become international players. Institutional and regulatory barriers to firm growth, structural features of Italian companies, and the high cost of doing business are at the root of this problem. Removing these barriers and nurturing a better business environment would encourage firm creation and growth and foster external competitiveness.

If fully implemented, the recently adopted measures to address Italy's long-standing structural weaknesses should help to raise productivity growth and thus contribute to regaining competitiveness. Since late 2011, Italy has been pursuing a strategy of fiscal consolidation and structural reforms with the respective aims of putting its public debt-to-GDP ratio on a downward path and lifting its economic growth potential. By addressing the existing asymmetries of employment protection legislation, while better regulating flexibility at entry and moving towards a more integrated social safety net, the June 2012 labour market reform could contribute to reducing segmentation in the labour market and improving productivity growth. The recent social partners' agreement could contribute to a better alignment of wage and productivity developments at sectorial and firm level. These challenges were highlighted in the fourth CSR to Italy as part of the 2012 European Semester. Furthermore, Italy has adopted measures aimed at fostering competition in product and service markets and at making the tax system more growth-friendly, as suggested respectively in its sixth and fifth CSR of 2012. While there are signals that some of these efforts are starting to bear fruit in some domains of the economy, the impact of many policy measures – especially the structural ones – is bound to emerge only gradually over the medium term, if fully implemented.

Productivity growth could also be fostered by creating an environment that provides companies with incentives to acquire the appropriate set of structural firm-level features, in particular in the fields of innovation, finance, human resources and management practices. The introduction of a tax allowance for corporate equity (ACE) in 2012, which encourages the use of funding sources other than debt, constitutes a good example. Attracting FDI – best achieved through significant improvements in the Italian business environment – could be an important channel for addressing structural and cultural impediments to firm expansion, productivity growth and ultimately external competitiveness.

Measures to alleviate the pressure stemming from the cost side could contribute to the improvement of the external competitiveness of the Italian economy. Wages in Italy are still not sufficiently responsive to productivity developments. In this area, further progress in promoting the shift of wage bargaining towards the company level would play an important role. In addition, the labour tax wedge in Italy is among the highest in the EU: a further shift of taxation away from labour could help to reduce the labour tax wedge and the cost of labour. Labour cost moderation could therefore help in the short to medium term, while being mindful of the risk of negative feedback loops related to deflationary pressures.

Given the decreased national saving rate and the reduced availability of foreign private financing, growth prospects will necessarily depend more on the quality rather than the quantity of investment. Encouraging investment financed by equity rather than debt, as well as improving allocation efficiency in the Italian economy could be key steps forward in this respect. The ongoing spending review in the public sector could contribute to strengthening the efficiency and effectiveness of government spending. Finally, encouraging inward FDI would be another channel to increase the quality and stability of investment in the domestic market.

The potential role of the Italian financial sector in supporting the country's economic adjustment remains limited for the time being. The crisis has put Italian banks under severe stress, as reflected in their dependence on Eurosystem funding, the further deterioration of asset quality and the low level of profitability. Lending conditions remain tight and interest rates on new loans – in particular to small firms – continue to be high despite accommodative monetary policy. The ability of Italian banks to reassume their role in financing the Italian real economy and supporting its adjustment will crucially depend on the underlying macroeconomic conditions. Key elements in banks' strategies going forward should include improving profitability in view of strengthening and maintaining the capital base, while adequately provisioning for deteriorating asset quality, reducing reliance on temporary Eurosystem funding, and ensuring the allocation of savings to the most productive investment opportunities.

A high primary budget surplus is essential for public debt sustainability, as recommended by the Council in July 2012. The Fiscal Sustainability Report of December 2012 concludes that "Italy does not appear to face a risk of fiscal stress in the short term. Sustainability risks appear to be medium in the medium run, while becoming low in a long-term perspective, conditional upon the full implementation of the planned ambitious fiscal consolidation and on maintaining the primary balance well beyond 2014 at the level expected to be reached in that year. […] Indeed, risks would be much higher in the event of the structural primary balance reverting to lower values observed in the past, such as the average for the period 1998-2012. The focus should, therefore, be on resolutely continuing to implement sustainability-enhancing measures and reduce government debt."

The favourable momentum for reforms in Italy must be maintained. Together with determined action at euro-area level to put in place effective crisis resolution mechanisms, the reform efforts undertaken so far by the Italian authorities have helped to regain some market confidence. To consolidate these benefits and strengthen Italy's resilience against possible renewed financial tensions, Italy should maintain high primary budget surpluses to ensure that the public debt is put firmly on a declining path. To support fiscal consolidation and unleash the country's growth potential, the gains from structural reforms must be secured and the reform momentum sustained.

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