Ministero dell'Economia e delle Finanze

Dipartimento del Tesoro

Can Italy Grow?

Presentation on “The Real Economy: How to Boost Potential Growth and Competitiveness?”

Brussels, 2 March, 2007

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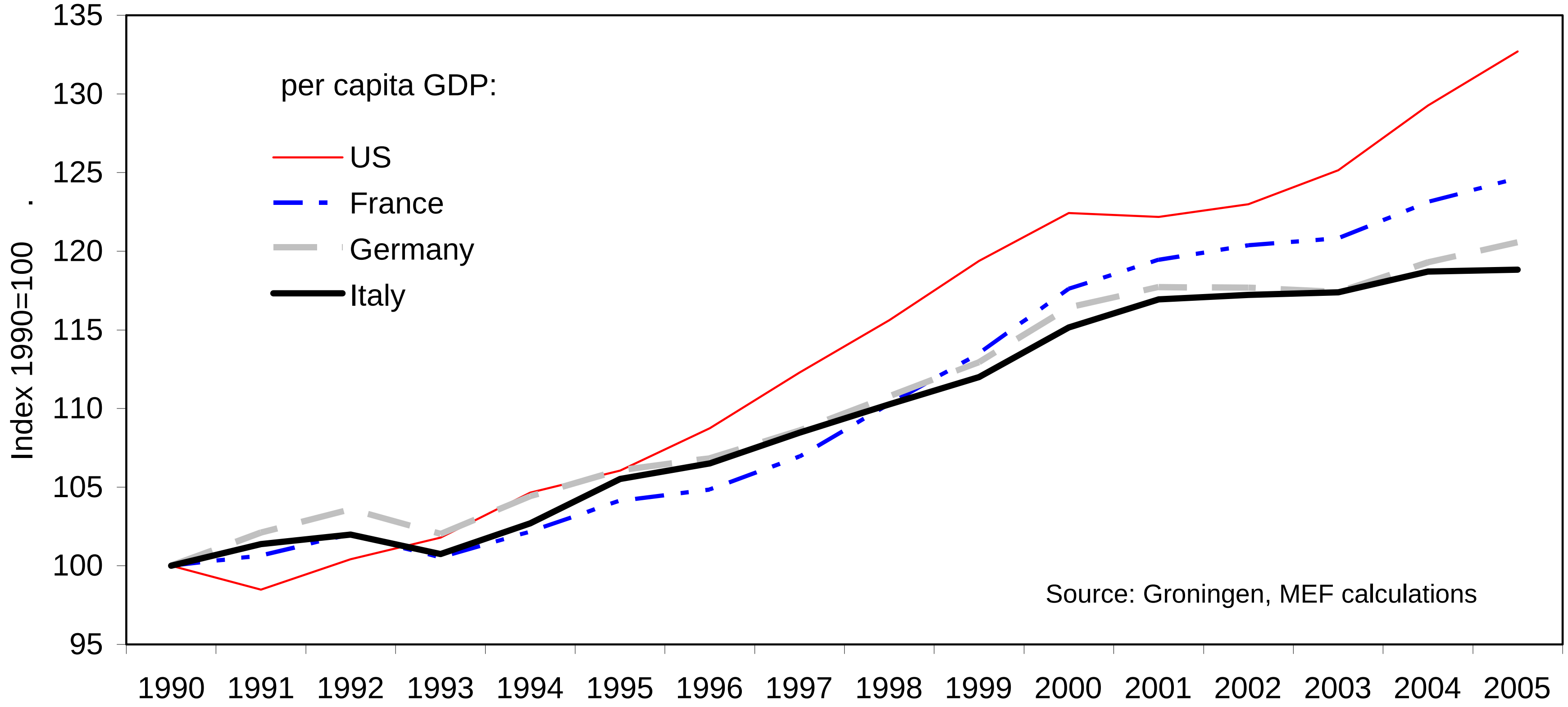
Focus on productivity and competitiveness

- Can Italy adjust and grow? The short answer is yes. It is fully within the potential and reach of the Country.
- Focus on productivity and competitiveness: problems are still sizeable. However, there are some distortions at play and encouraging signs of improvement.
- How to boost potential growth and competitiveness? The priority goals of Italy's reform process.
- A few examples of reforms.

REAL GDP GROWTH

Italy’s per-capita GDP has lost ground over the years



Since the early ’90s, the gap in per-capita GDP has widened to almost 14 percentage points versus the US and 6 percentage points versus France (up to 2005). Such worsening has proven significant since 2000.

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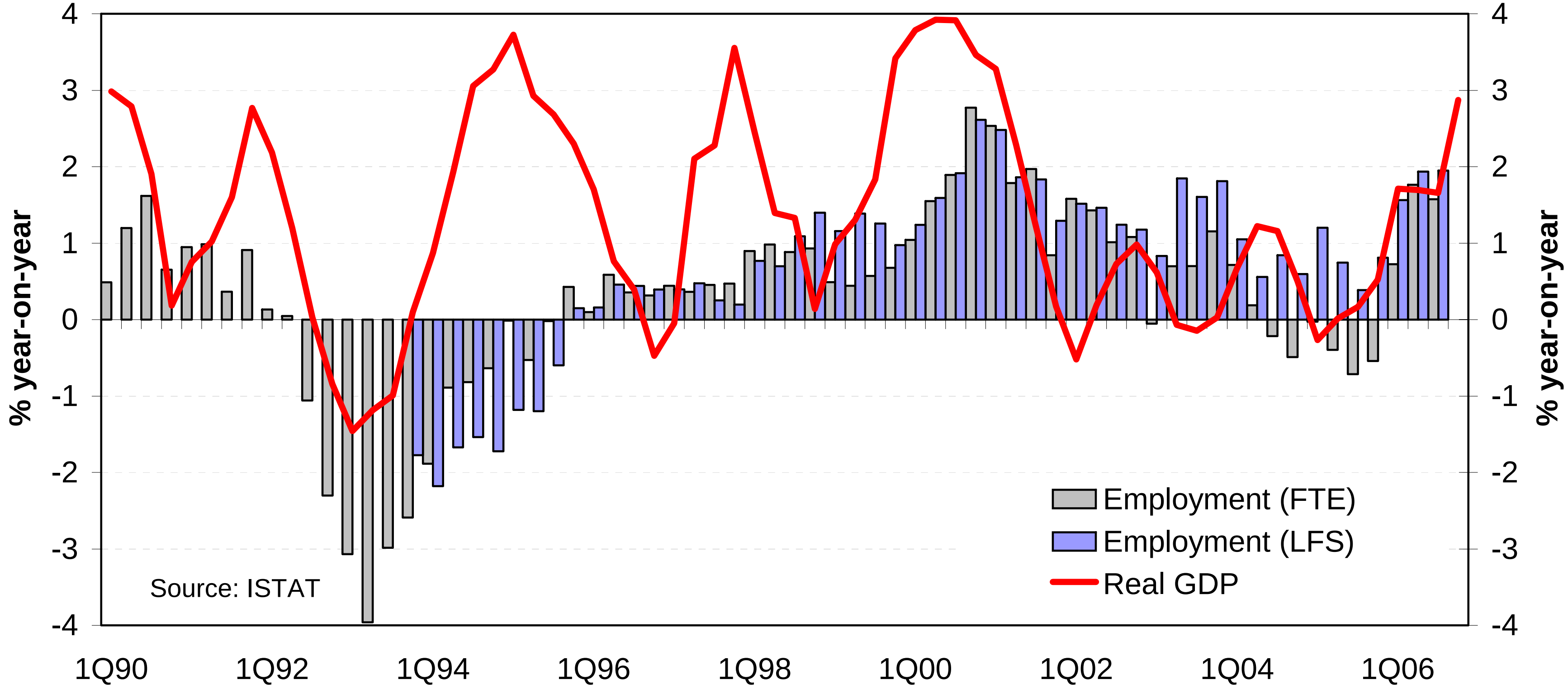
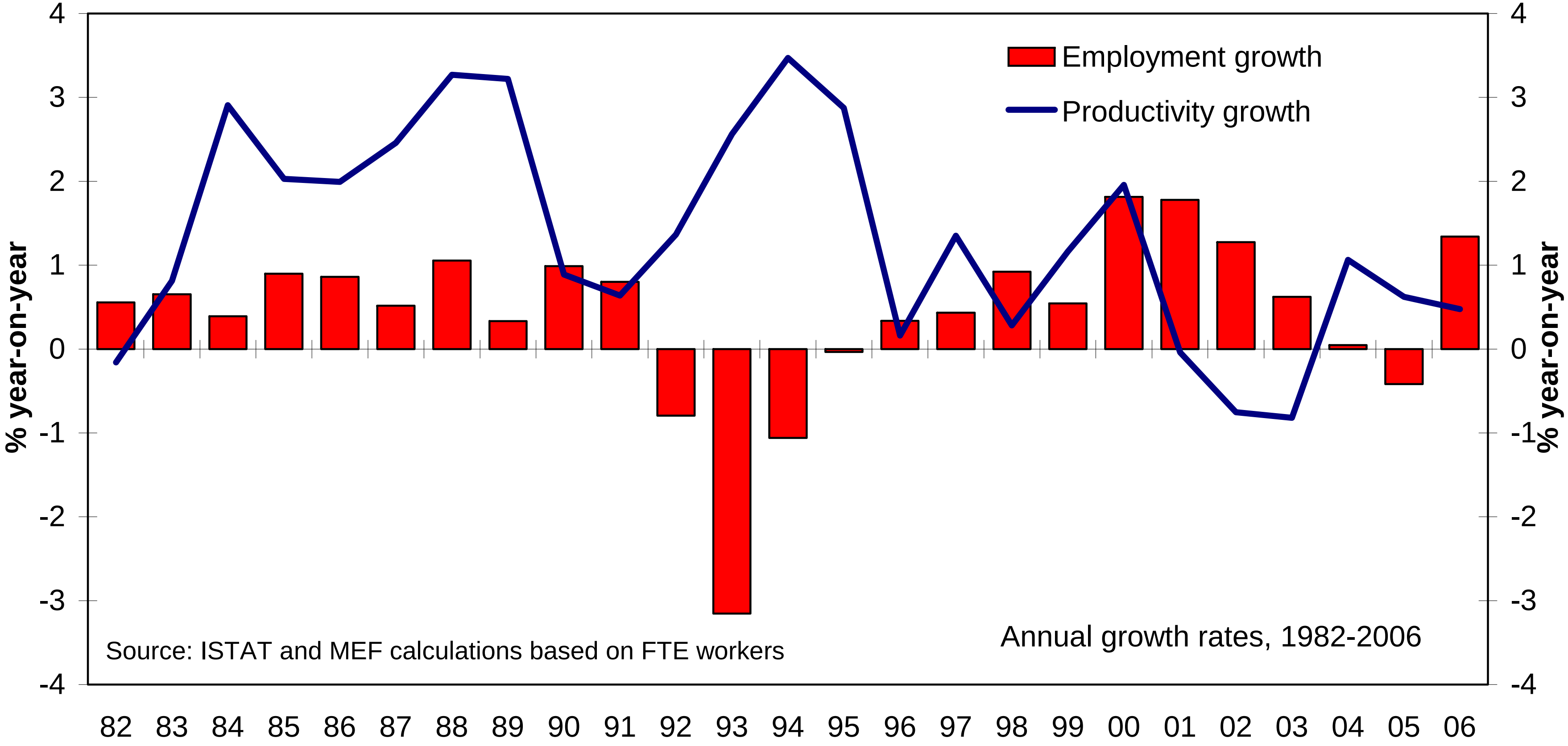
The odd couple: weak GDP growth, strong employment rises



Since the mid'90s, and notably early in the current decade, a strong labour market performance has been matched by weak GDP growth.

EMPLOYMENT AND PRODUCTIVITY

Another odd couple? Employment vs Productivity



In the ’80s employment growth combined with robust productivity gains. Following the ’92-’93 currency crisis, employment collapsed and productivity jumped. Since the mid-’90s weak productivity growth has combined with persisting gains in employment.

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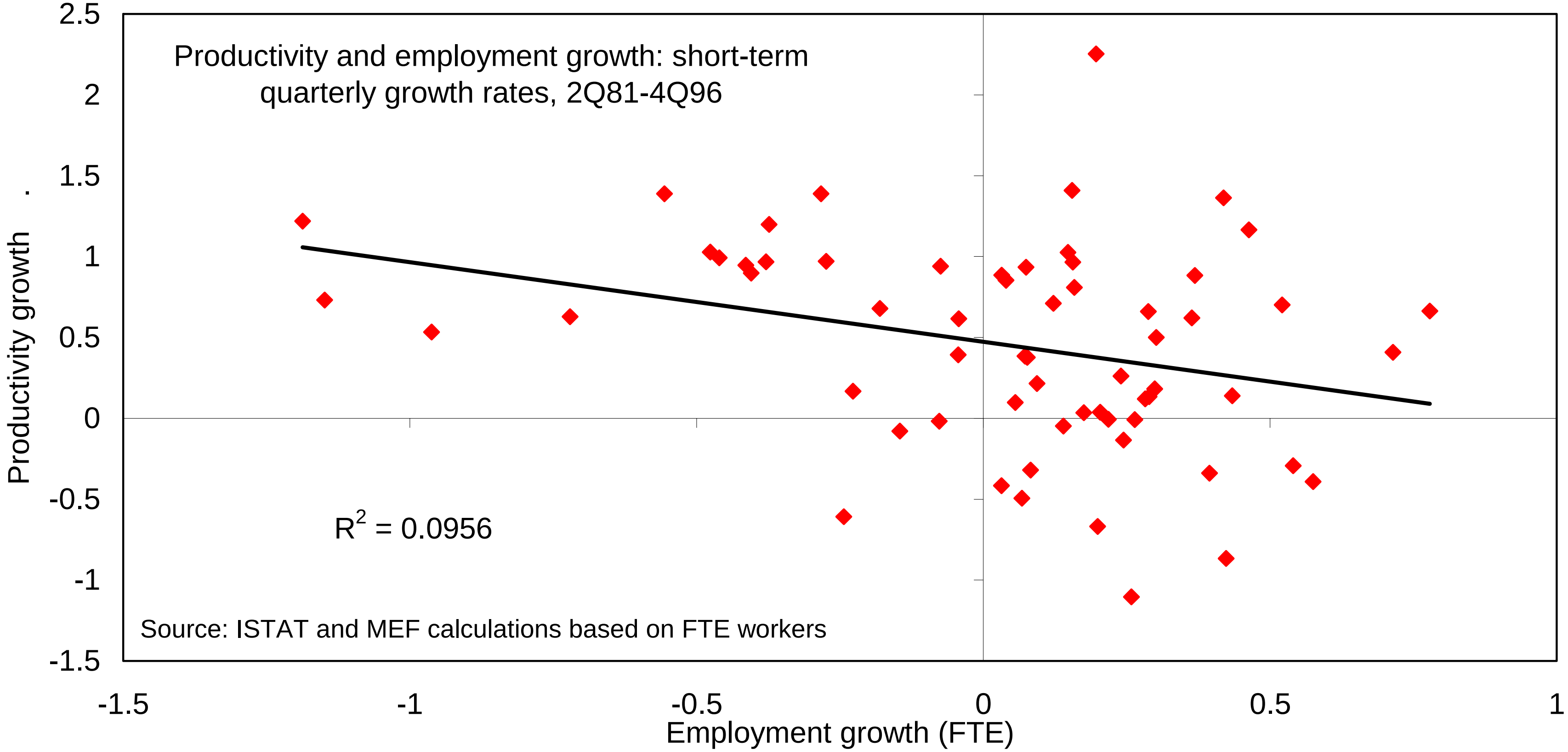
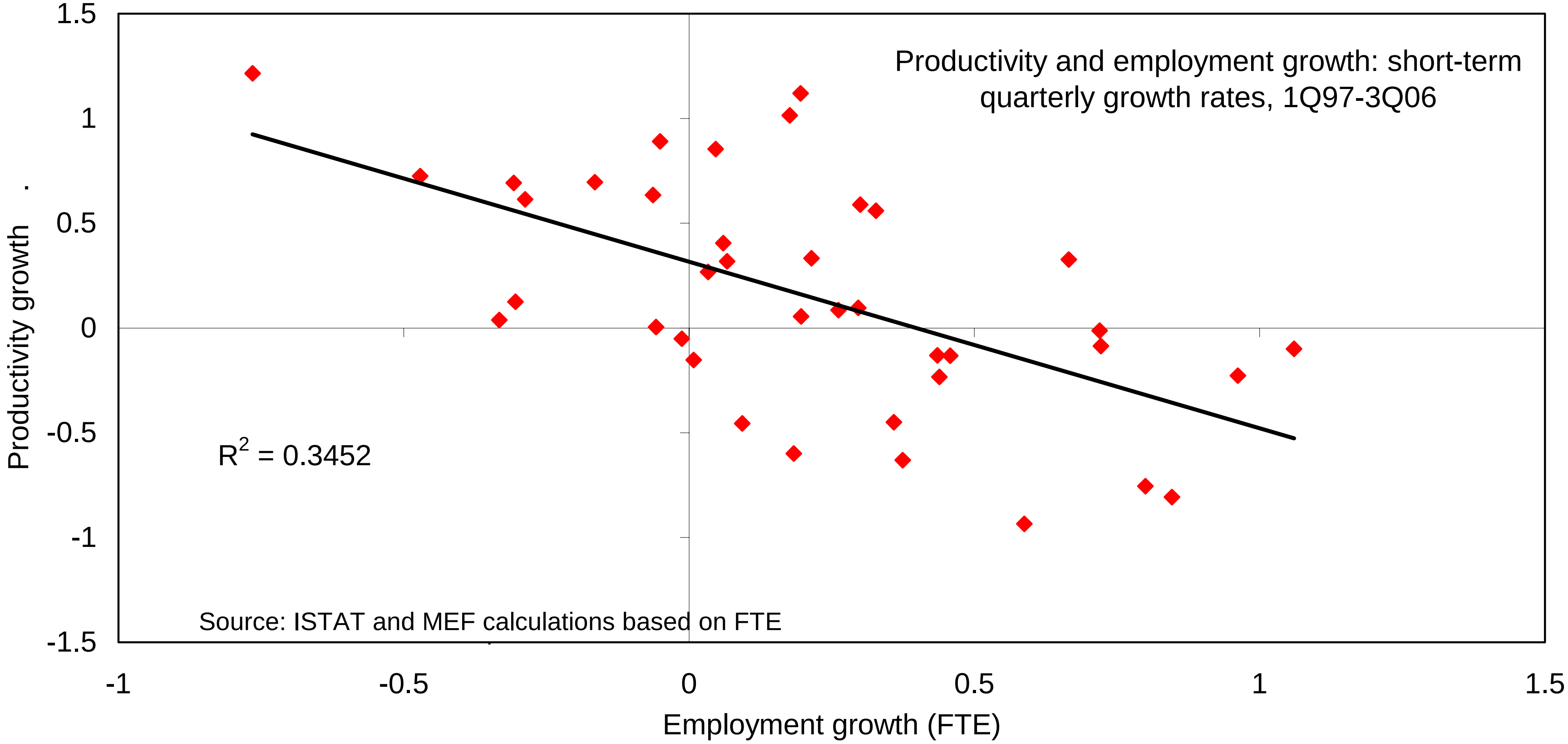
A weak relationship up to 1996...



There seemed to be a weak negative link between employment growth and labour productivity growth between the early ’80s and mid-’90s.

... but stronger since 1997



The relationship has been stronger since 1997. At the same time, there has been a surge in temporary contracts and part-time jobs.

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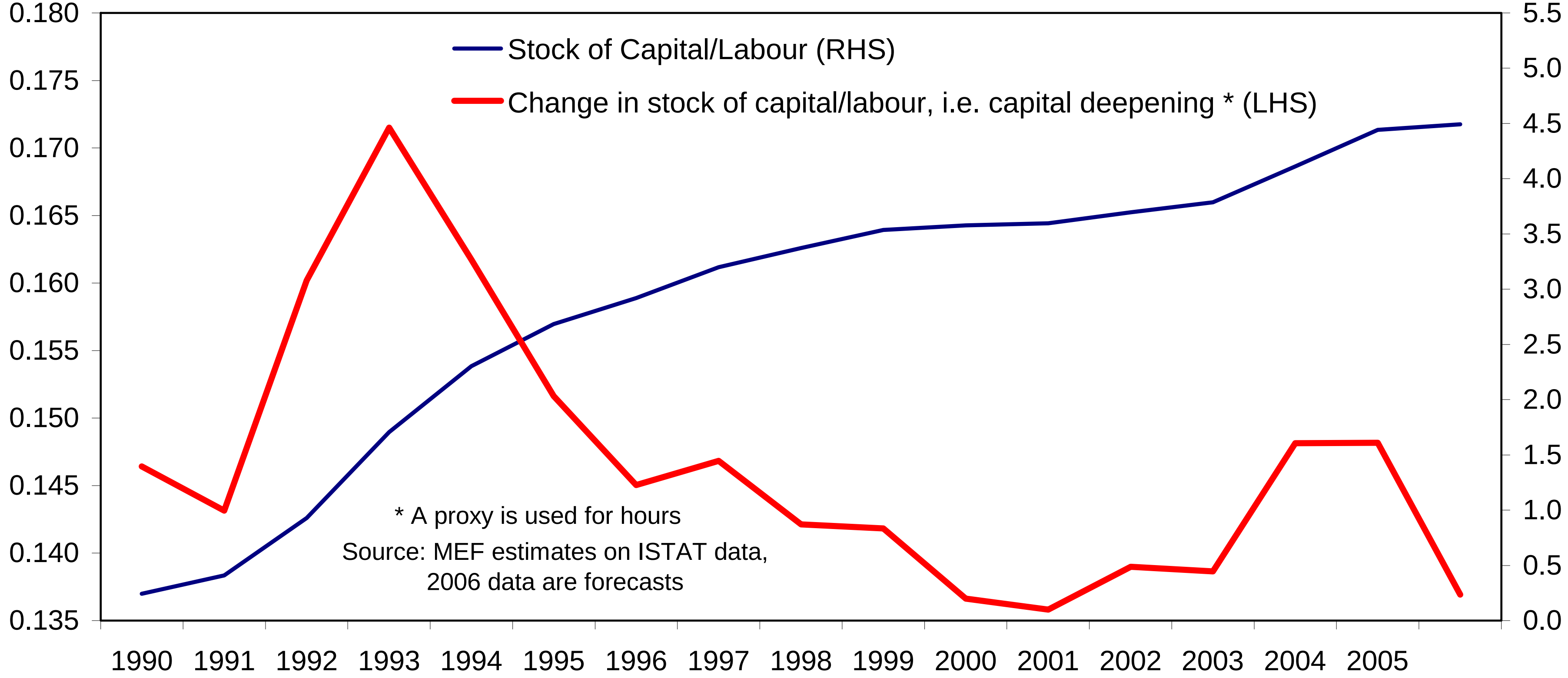
A shift in favour of labour utilisation



Since the early '90s there has been a slowdown in the growth of the ratio between the stock of capital and labour, thus indicating an increase in labour utilisation as a production factor.

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Partly a mirror image of labour market achievements?

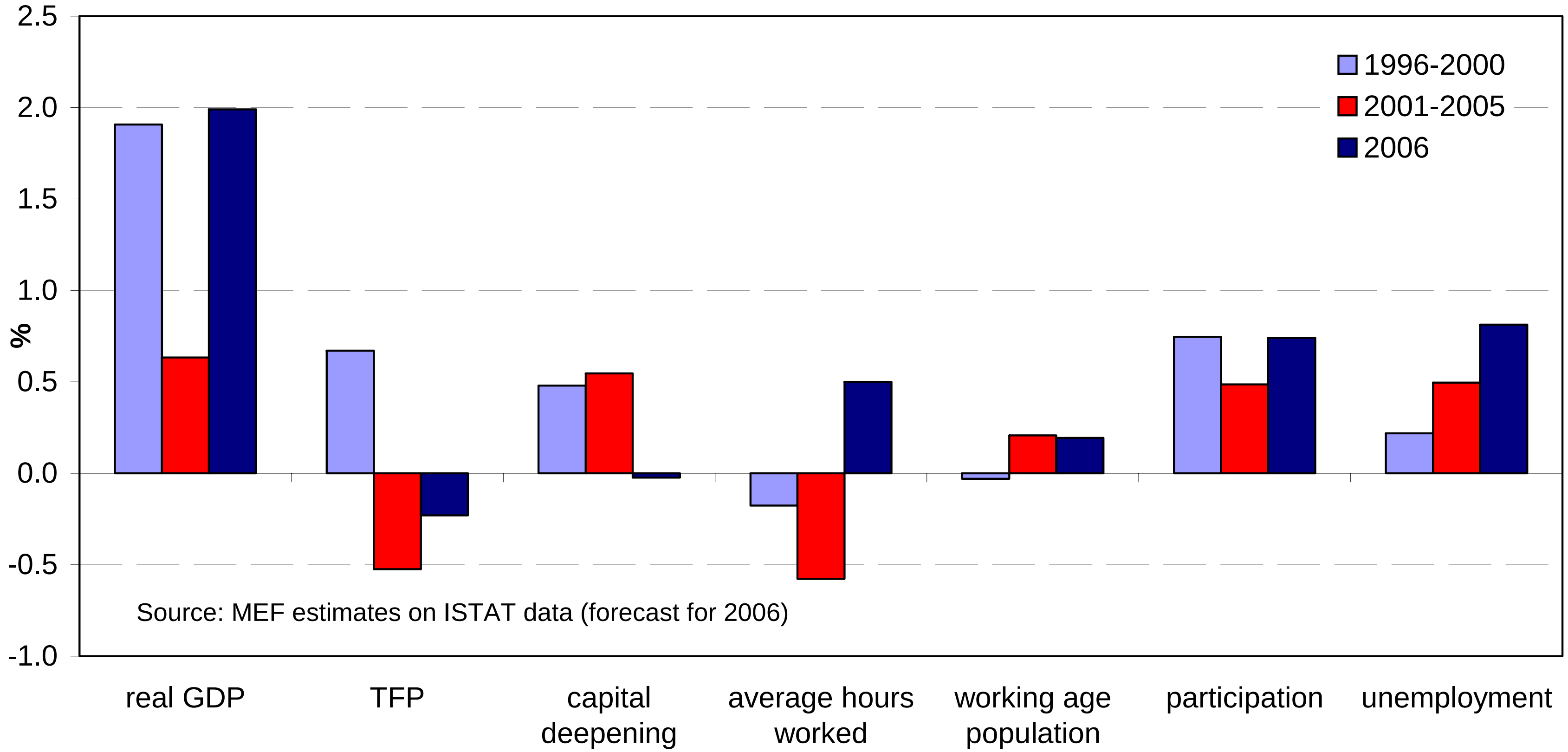
- The black economy is estimated and included in GDP data, unrecorded workers are not. Large-scale regularisation of illegal immigrant workers may have caused distortions, boosting employment and depressing productivity.

- Moreover, the effect at the margin of low-skilled workers entering the labour market may have unduly depressed labour productivity (and presumably also TFP).

- The increasing use of part-time and temporary contracts has affected average hours worked per person.

- These phenomena are already abating, although they have been sizeable over the past few years.

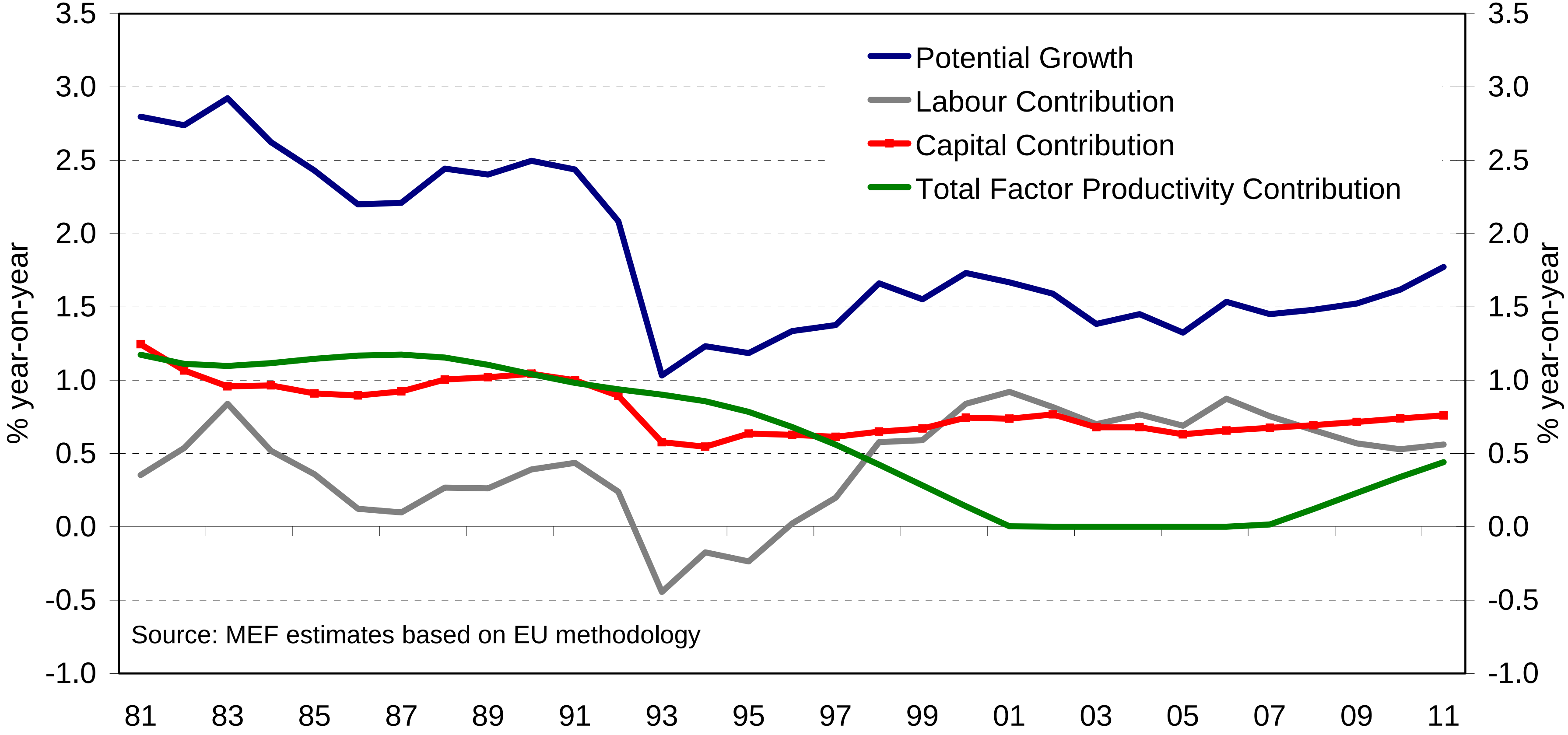
TFP and average hours worked to blame



The recorded decline in economic growth is mainly linked to poor performance in average hours worked and total factor productivity. Labour participation has improved, though it is more likely due to a secular trend rather than the result of reforms (no significant acceleration).

ITALY'S PRODUCTIVITY

Gradual enhancement in potential growth



Despite poor demographic trends, reforms in the labour and, more recently, product markets should help to enhance potential growth over time. Estimates of potential growth may have been unduly affected by distortions in labour market statistics (participation rate understated).

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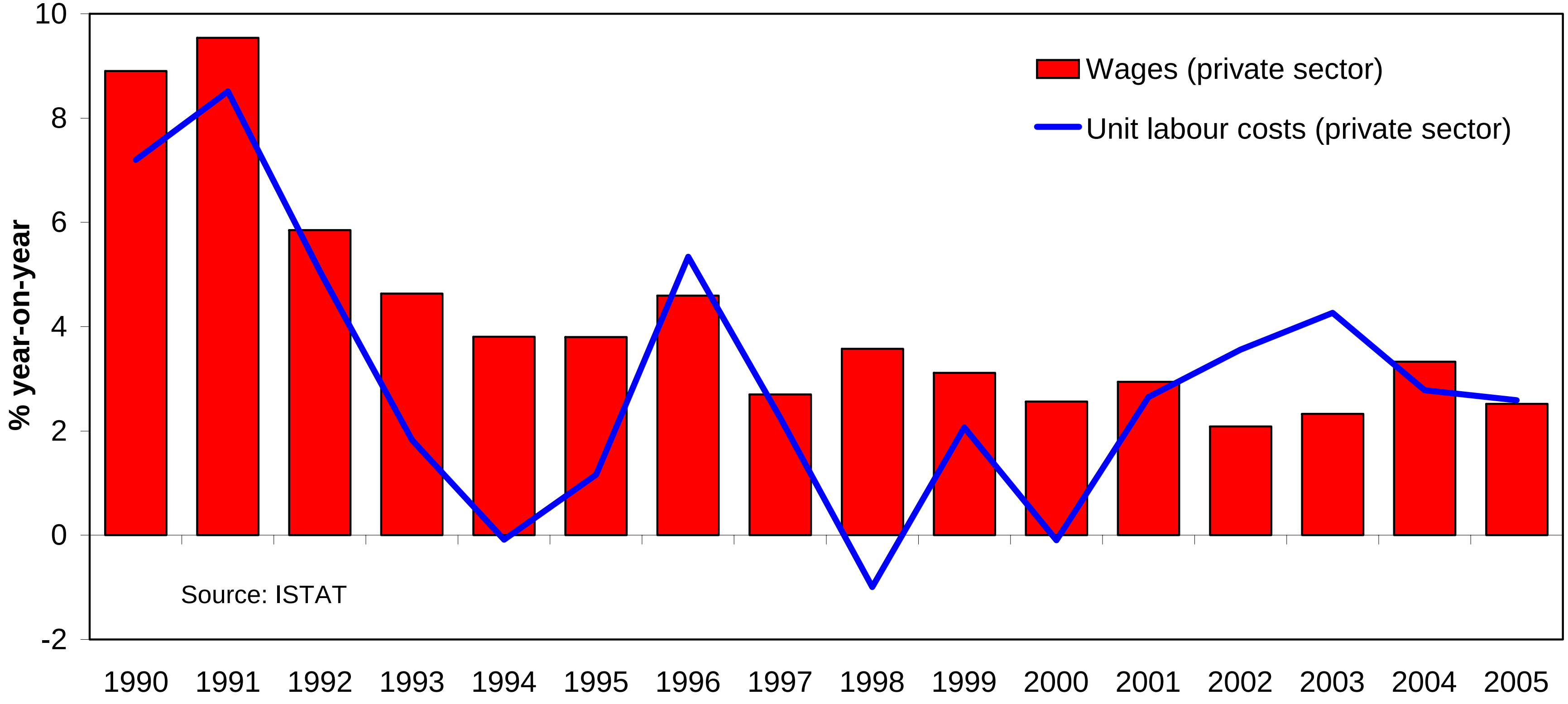
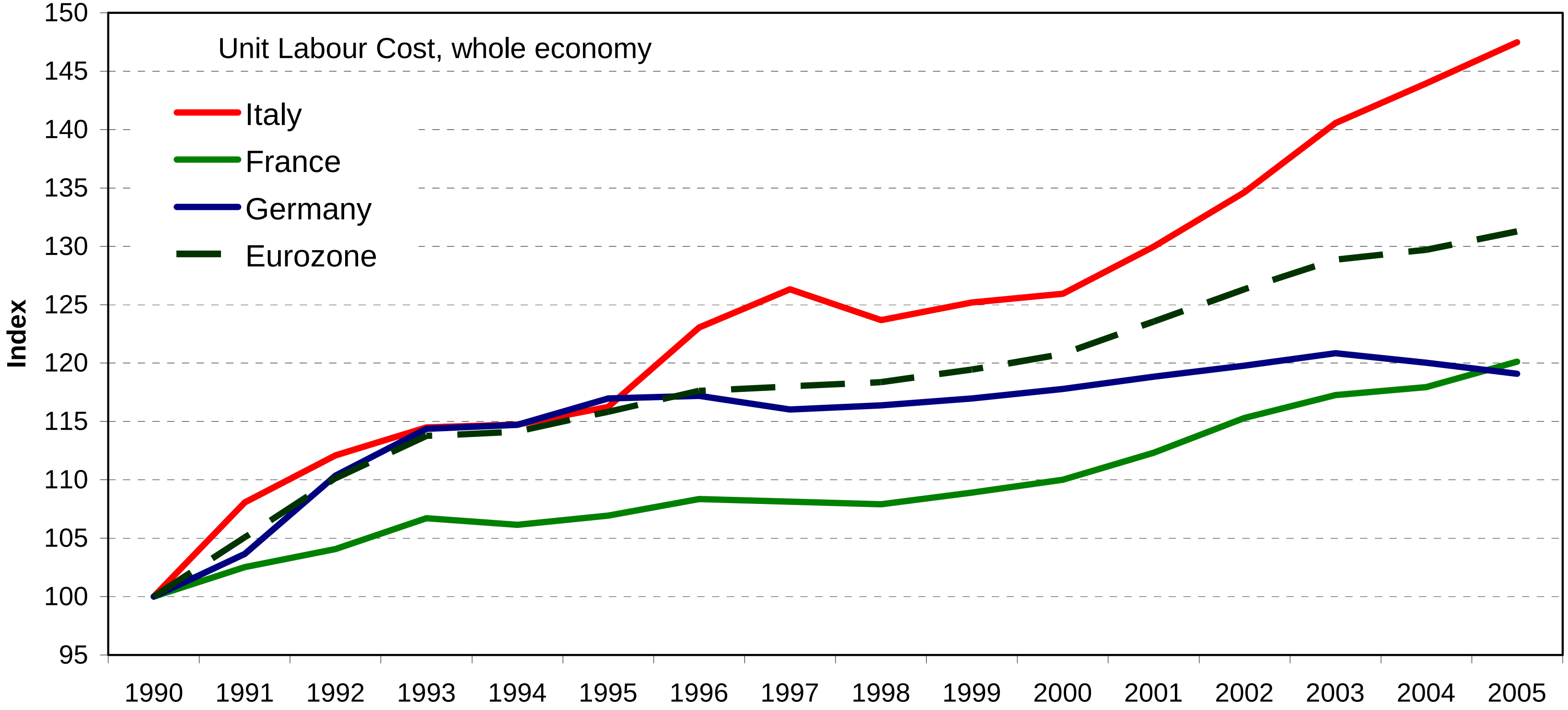
Wage moderation has not prevented a rise in ULCs



In the private sector wage growth has been moderate, albeit higher than the level the economy could have afforded in consideration of poor productivity developments.

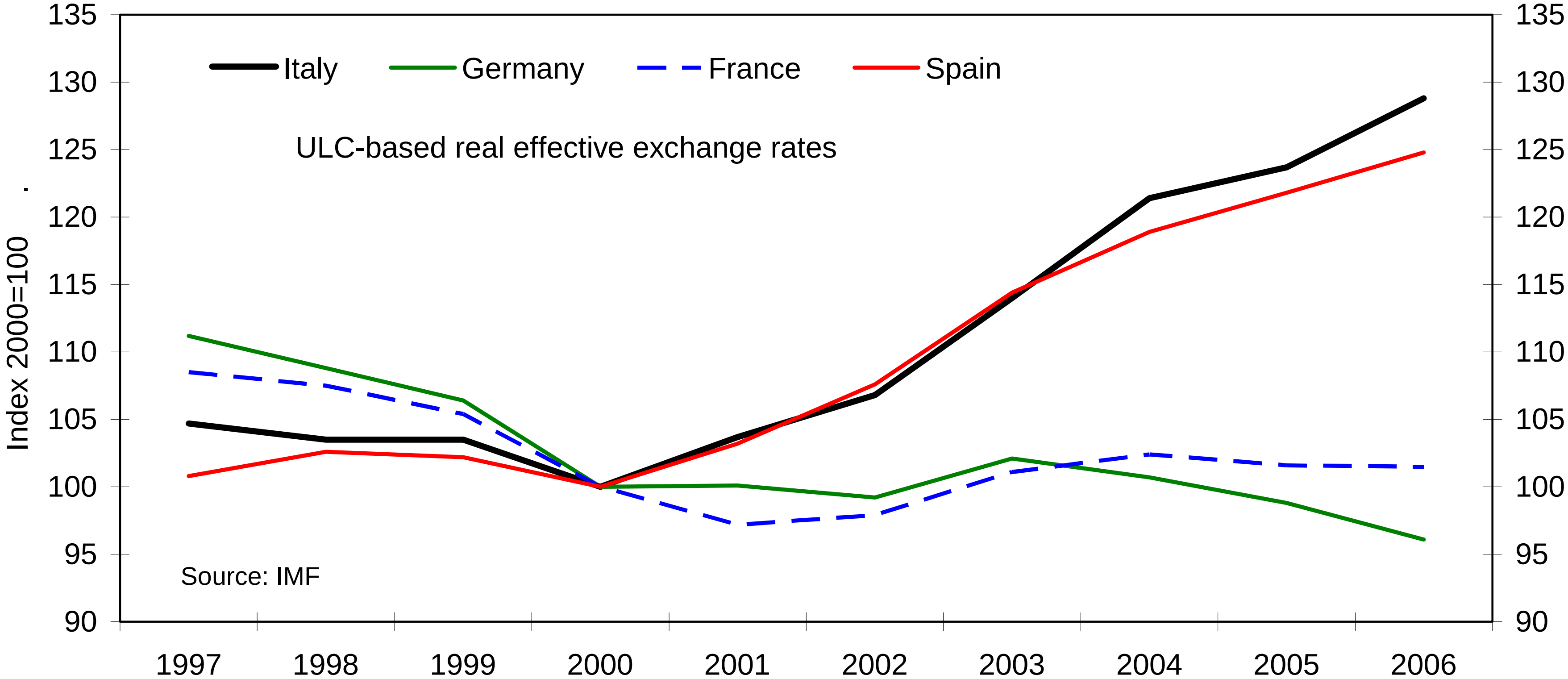
The gap in ULCs versus other Countries has widened



Source: Database AMECO, EU Commission.

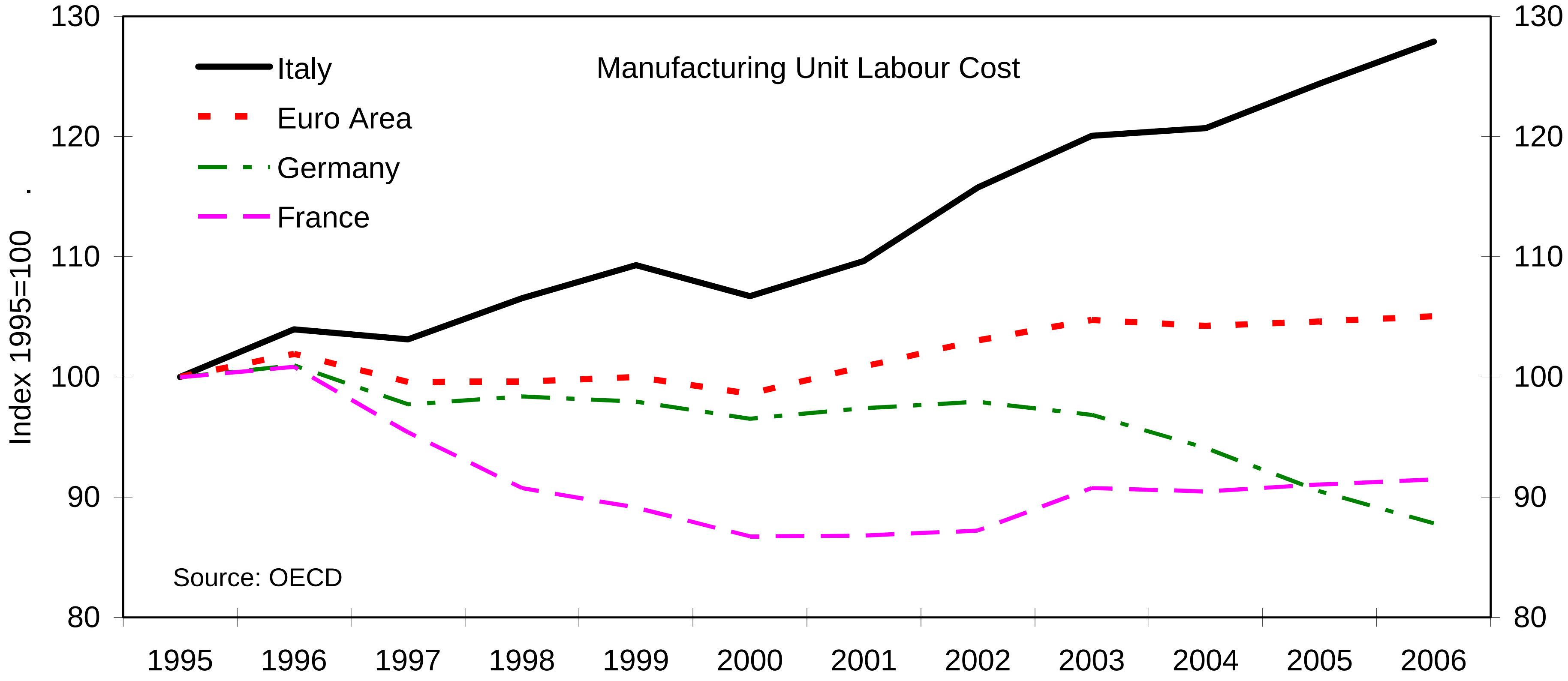
Amid low productivity growth, unit labour costs have been higher than in other major Euro-Area economies.

Is Italy's competitive position truly desperate?



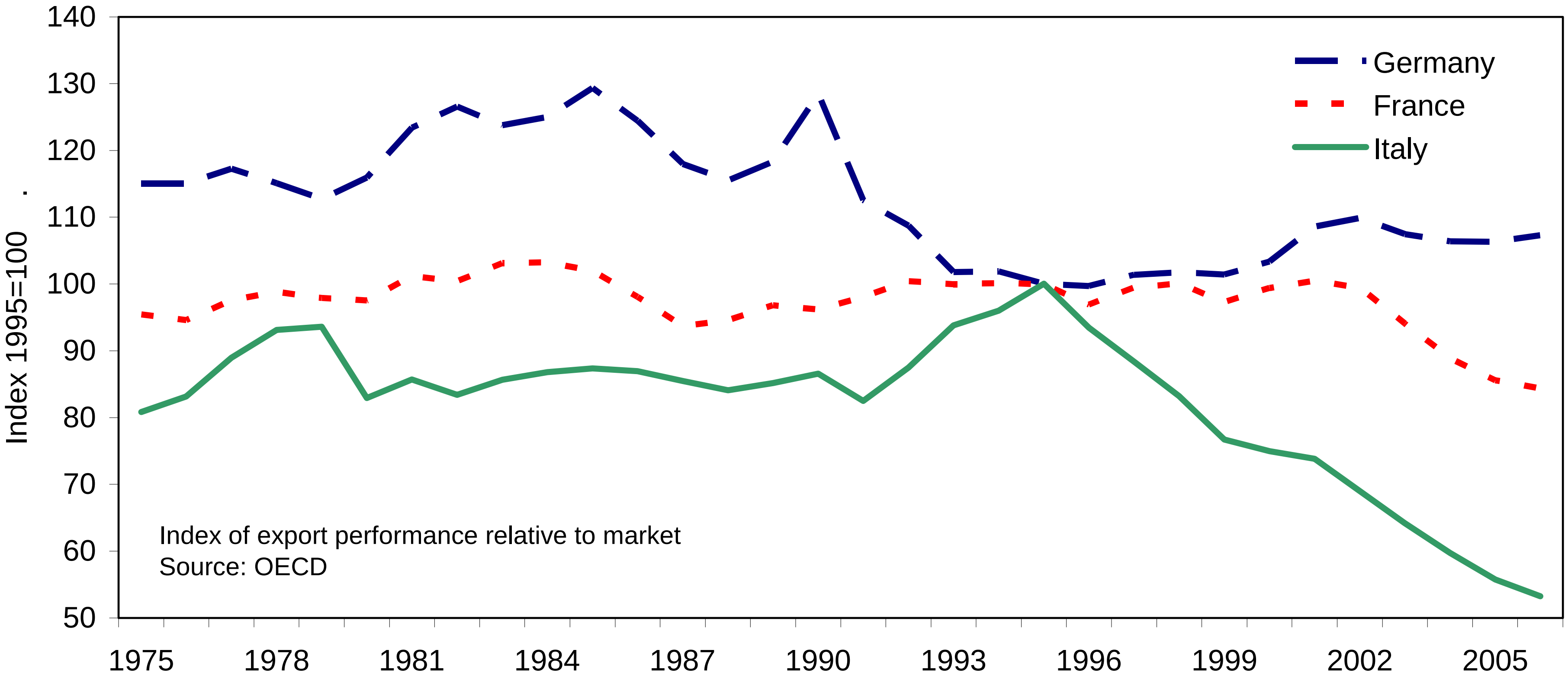
Competitiveness measures, such as ULC-based real effective exchange rates, have sharply deteriorated. Nevertheless, productivity deterioration is overstated, and so are ULCs' deterioration and competitiveness measures based on ULCs.

Deterioration has been less dramatic in manufacturing



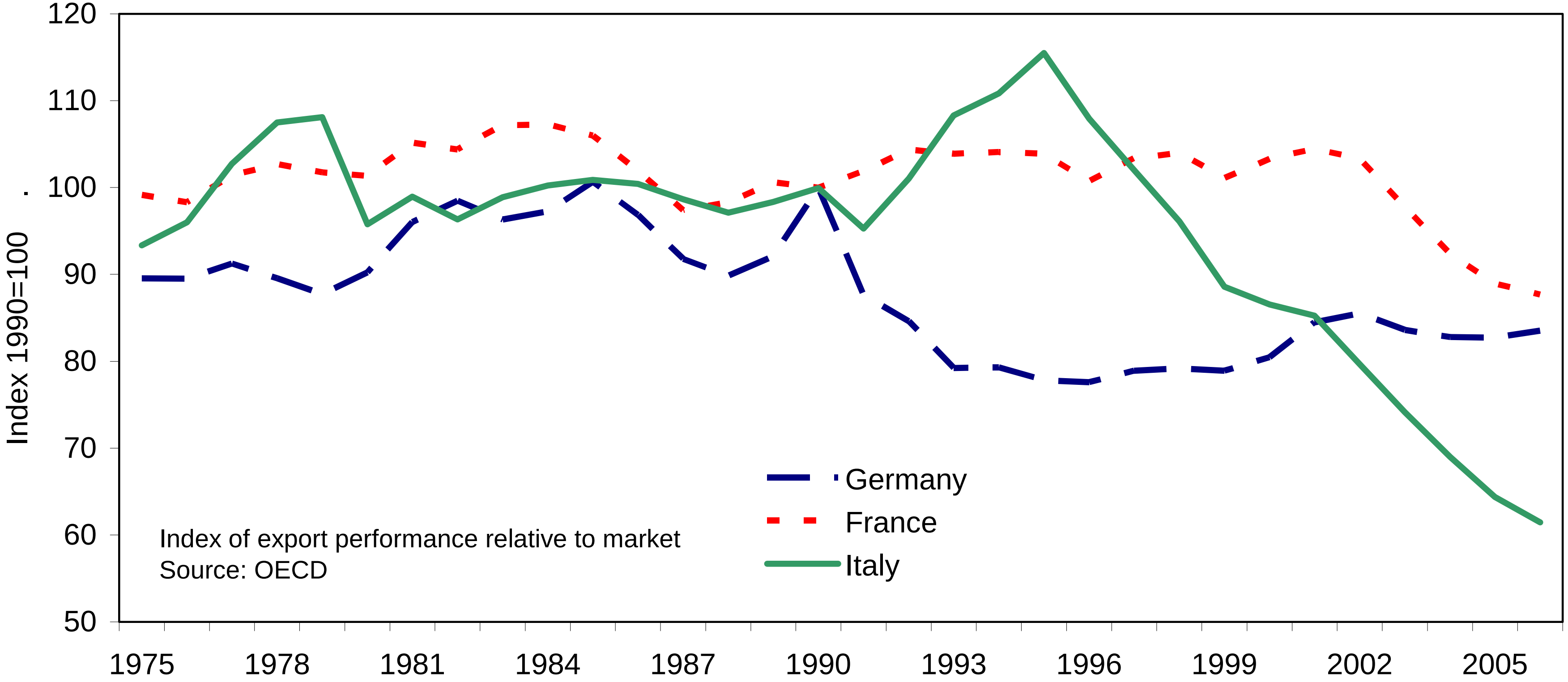
If measured by unit labour costs in manufacturing, deterioration is less dramatic (wages have increased more in the public sector and in sectors less exposed to international competition, notably in services).

Poor competitiveness has affected market shares ...



Italy's export performance relative to market seems to have consistently deteriorated since 1995. As indicated, some statistical issues may have contributed to overstate underlying problems. Nevertheless, deterioration remains significant.

... and it is not just the starting point



Even taking a more neutral base year, the resulting steady deterioration since 1995 remains unchanged and the current position is still indicative of severe problems.

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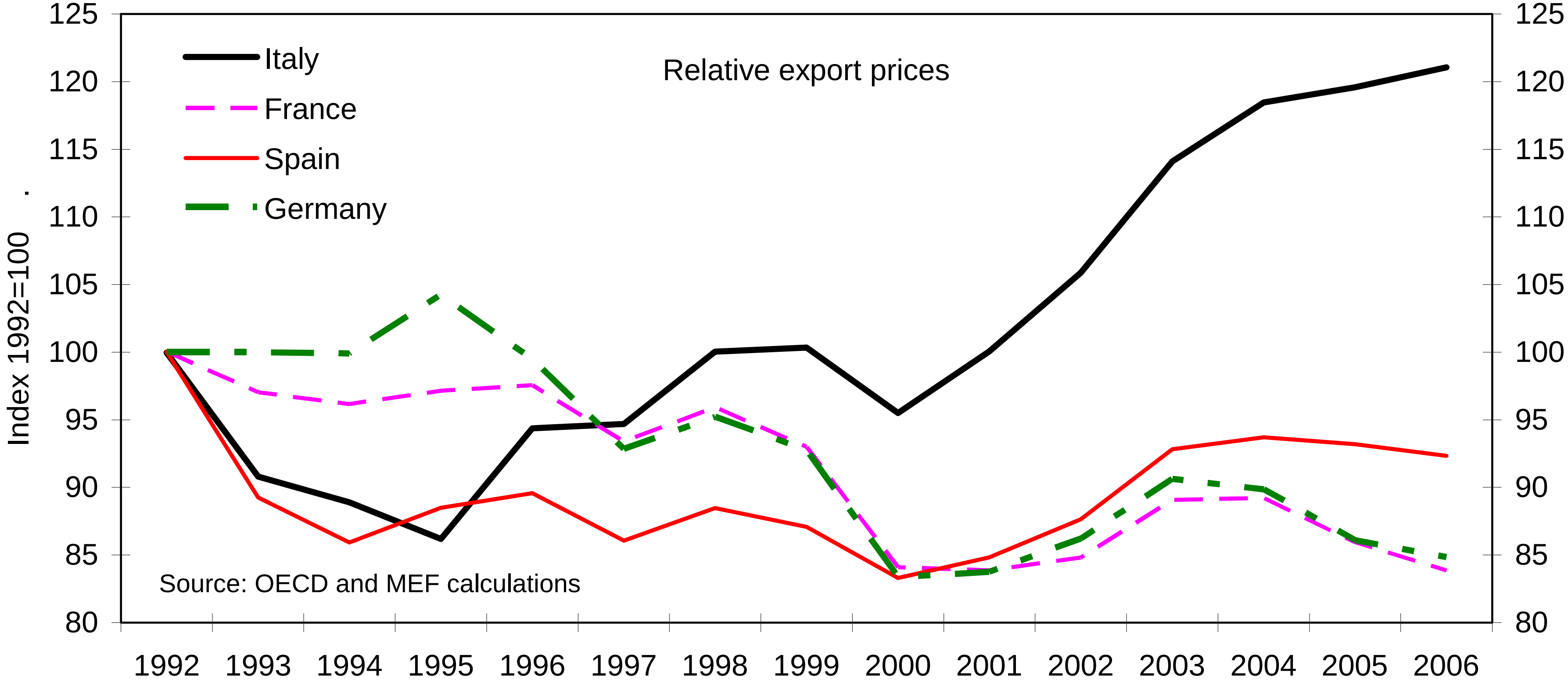
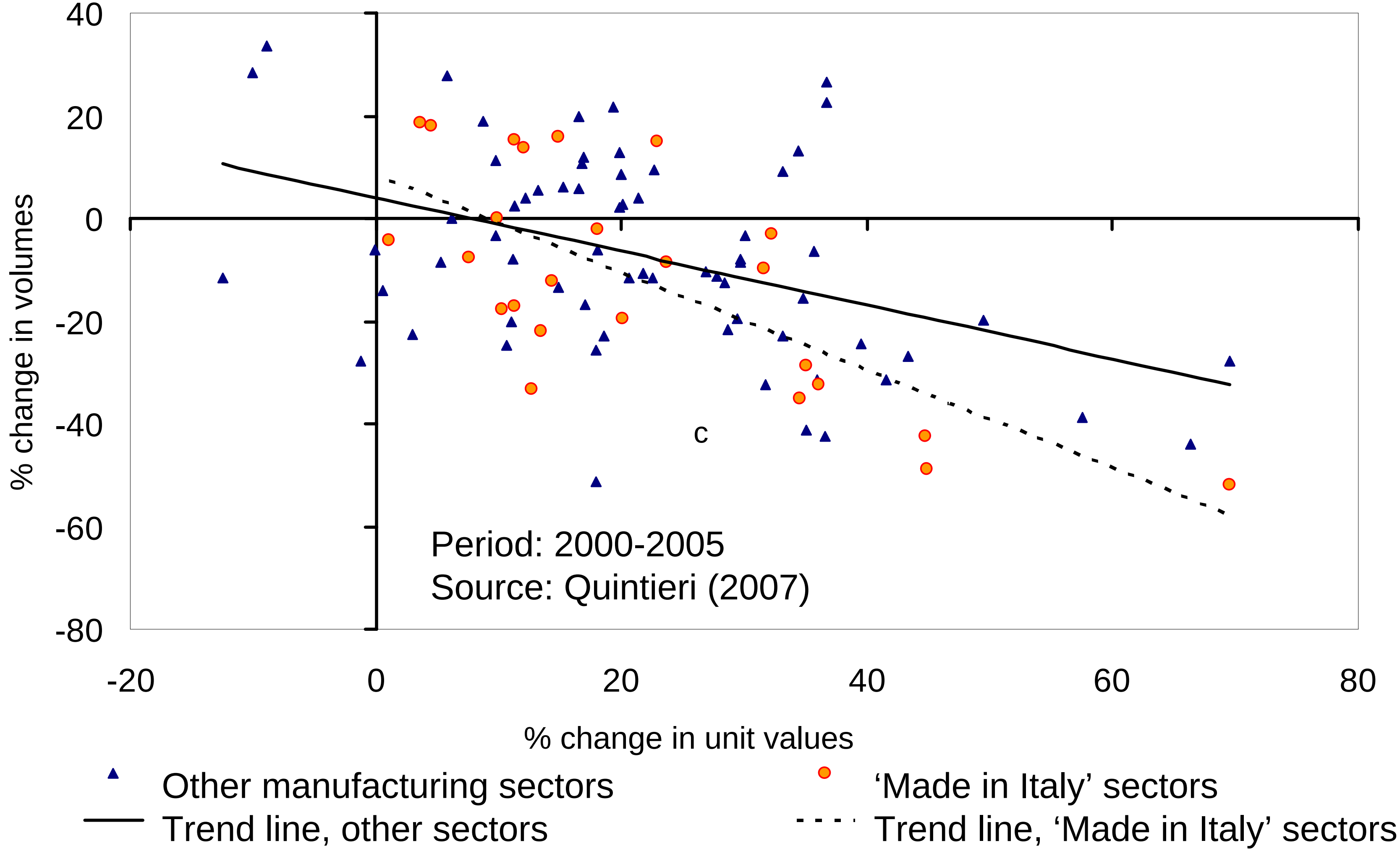
Yet Italian exporters have been able to increase prices



Although a clear loss in market share has occurred, there has been also an equally clear surge in export prices. Are Italian exports trying to protect profit margins at the expense of market shares? Or is there a significant quality upgrading of export products combined with increased pricing power?

The decline in volumes is linked to higher export prices



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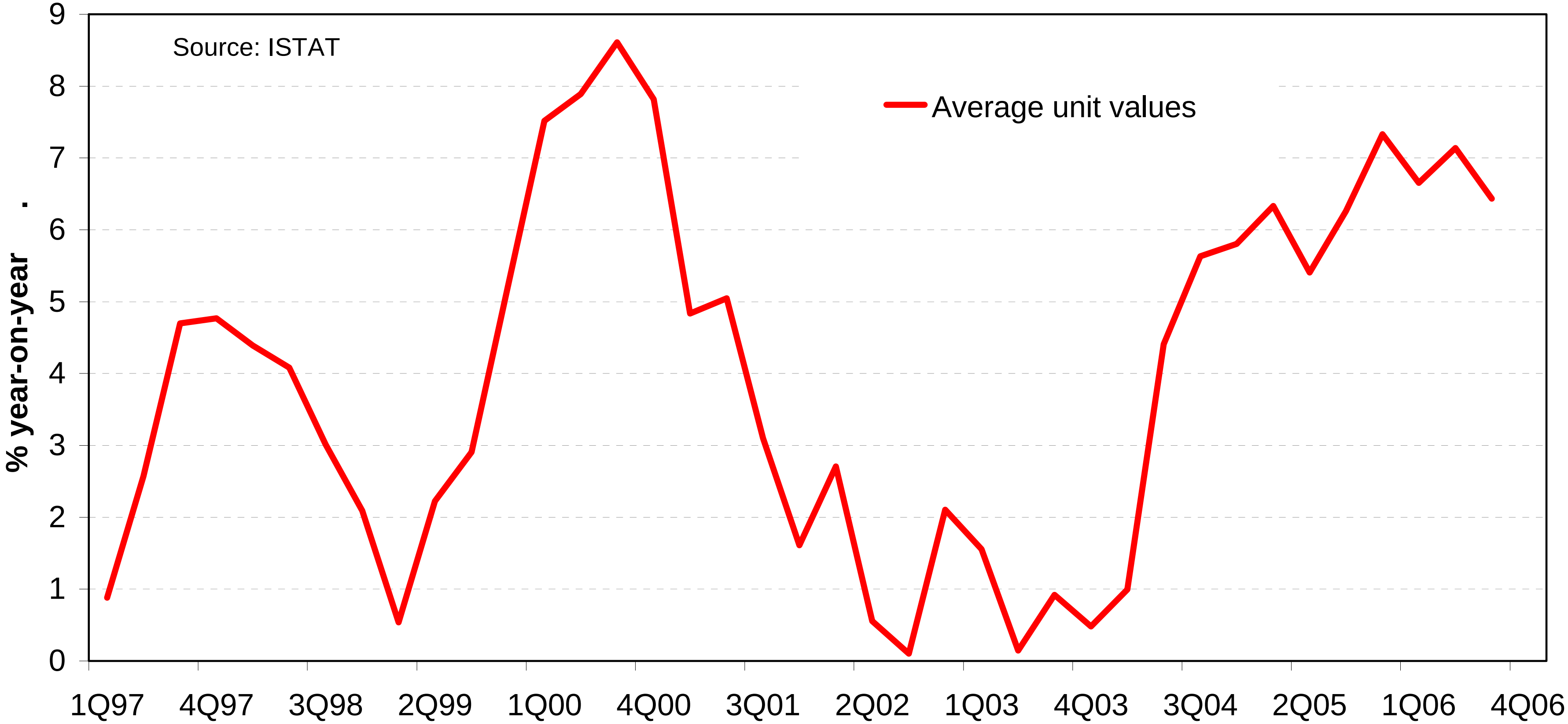
Again some data uncertainty



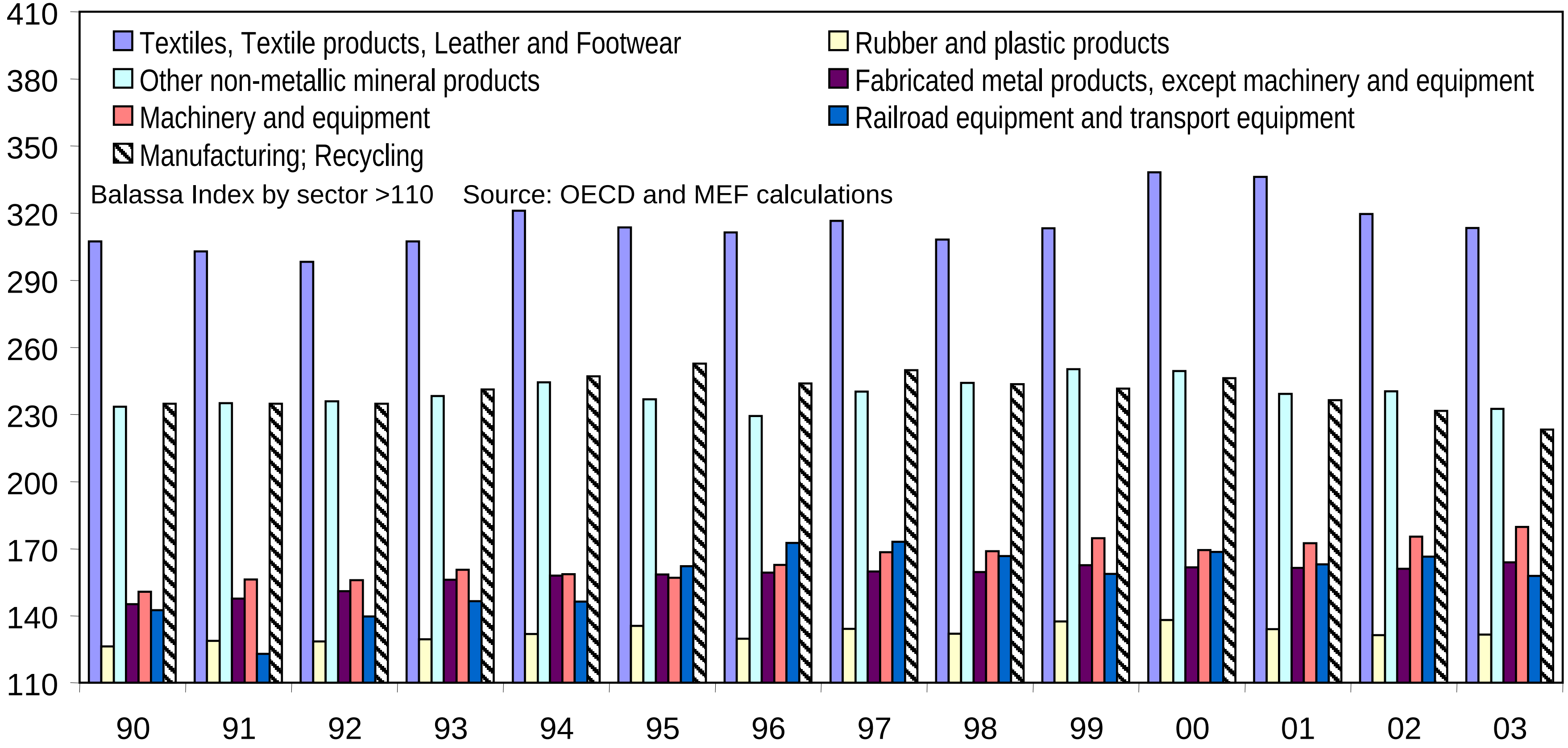
ISTAT is using unit values (i.e. export values divided by quantities) as a proxy for export prices. This puts together changes both in prices and product mix.

How can we solve the puzzle?

Possible explanations:

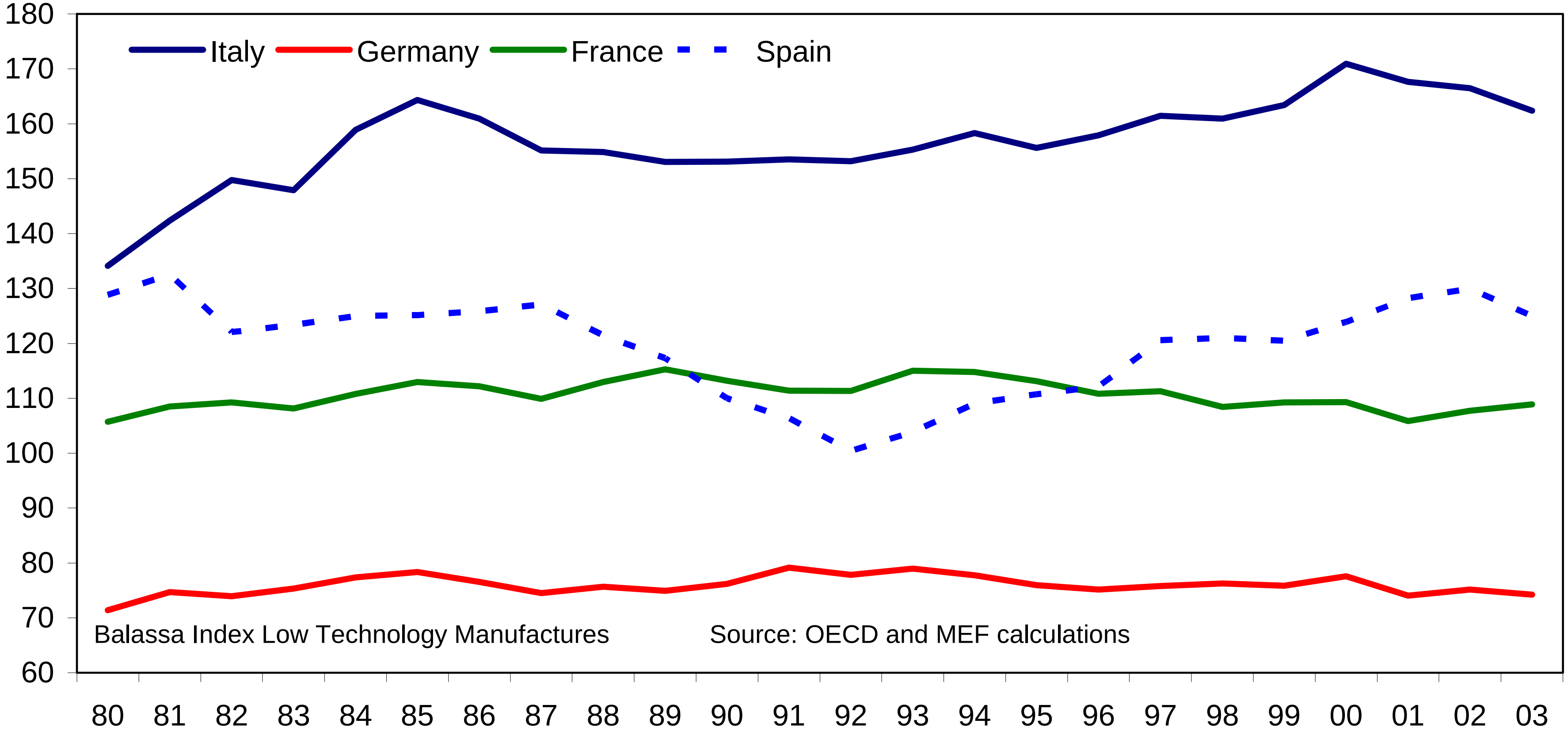
- A suicide attempt to protect profit margins (no)
- Off-shoring of low-quality production / market exit (yes)
- A shift in product mix/specialisation (not very significant)
- Upgrading of product quality (strong evidence)
- Increased pricing power or in general market power (some evidence)
- Enhanced ability to ‘price to market’ by exporters (some evidence)
- Cyclical / exchange rate factors (no significant signs)
- A new model (Cipolletta 2007) tailor-made industry (high content of services)

No significant shift in product specialisation



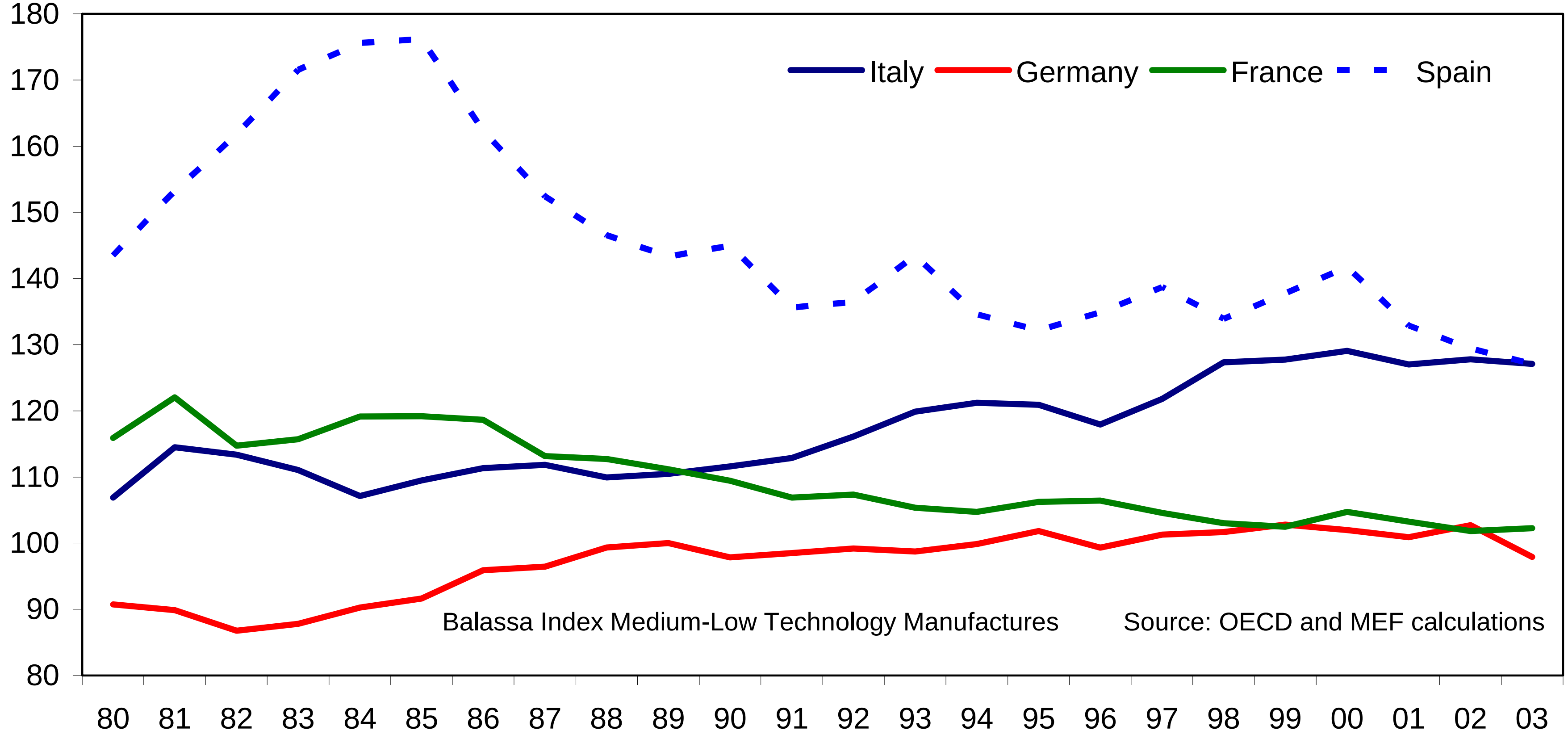
The Balassa index shows a small decline in traditional 'Made in Italy' sectors since 2000. Overall, the shift has been limited. The value of the specialisation index in traditional sectors is extremely high (together with Spain). These sectors are exposed to competition by newly-developed Countries.

No significant shift in product specialisation



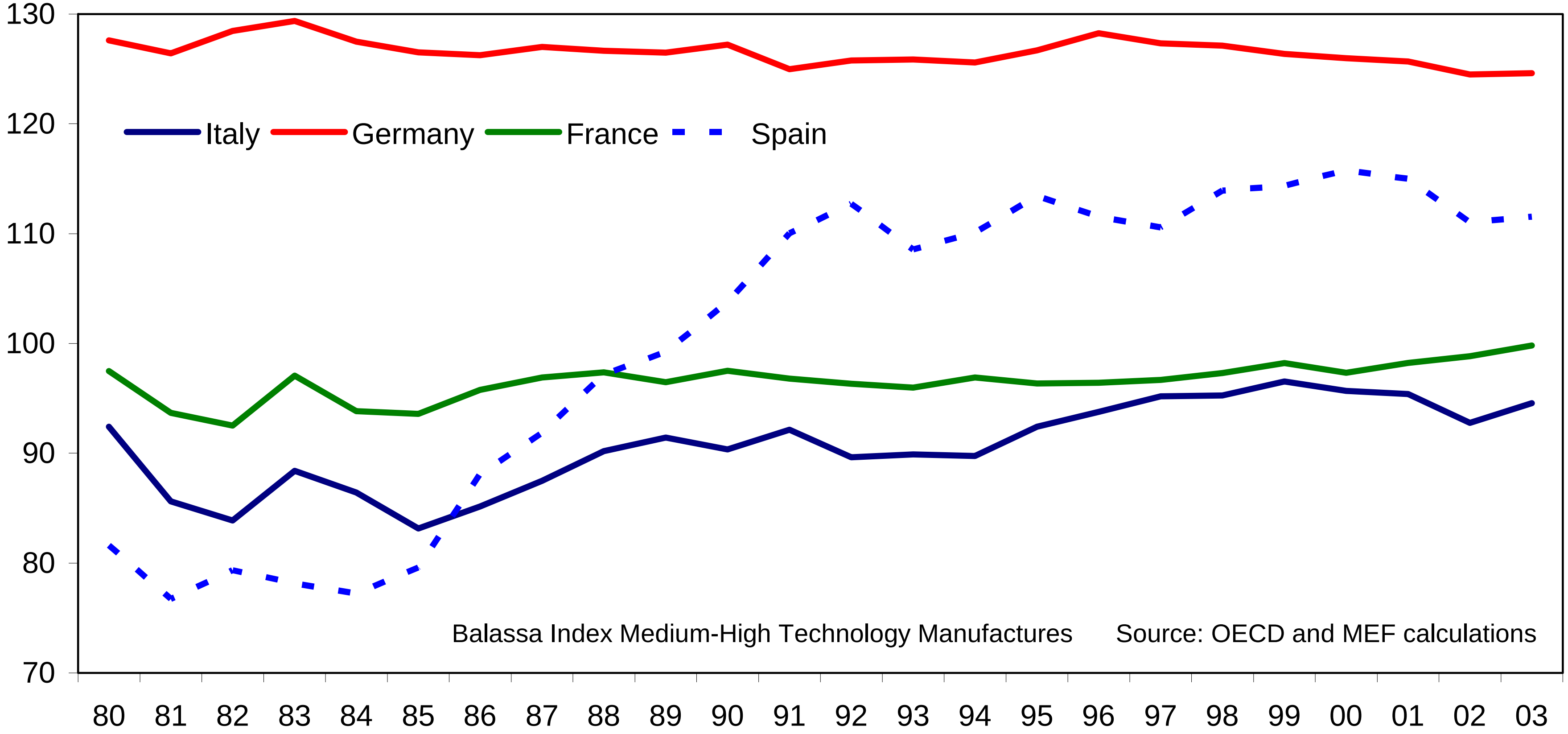
The Balassa index shows a still high specialisation in low technology manufactures, which has been declining only modestly since 2000.

No significant shift in product specialisation



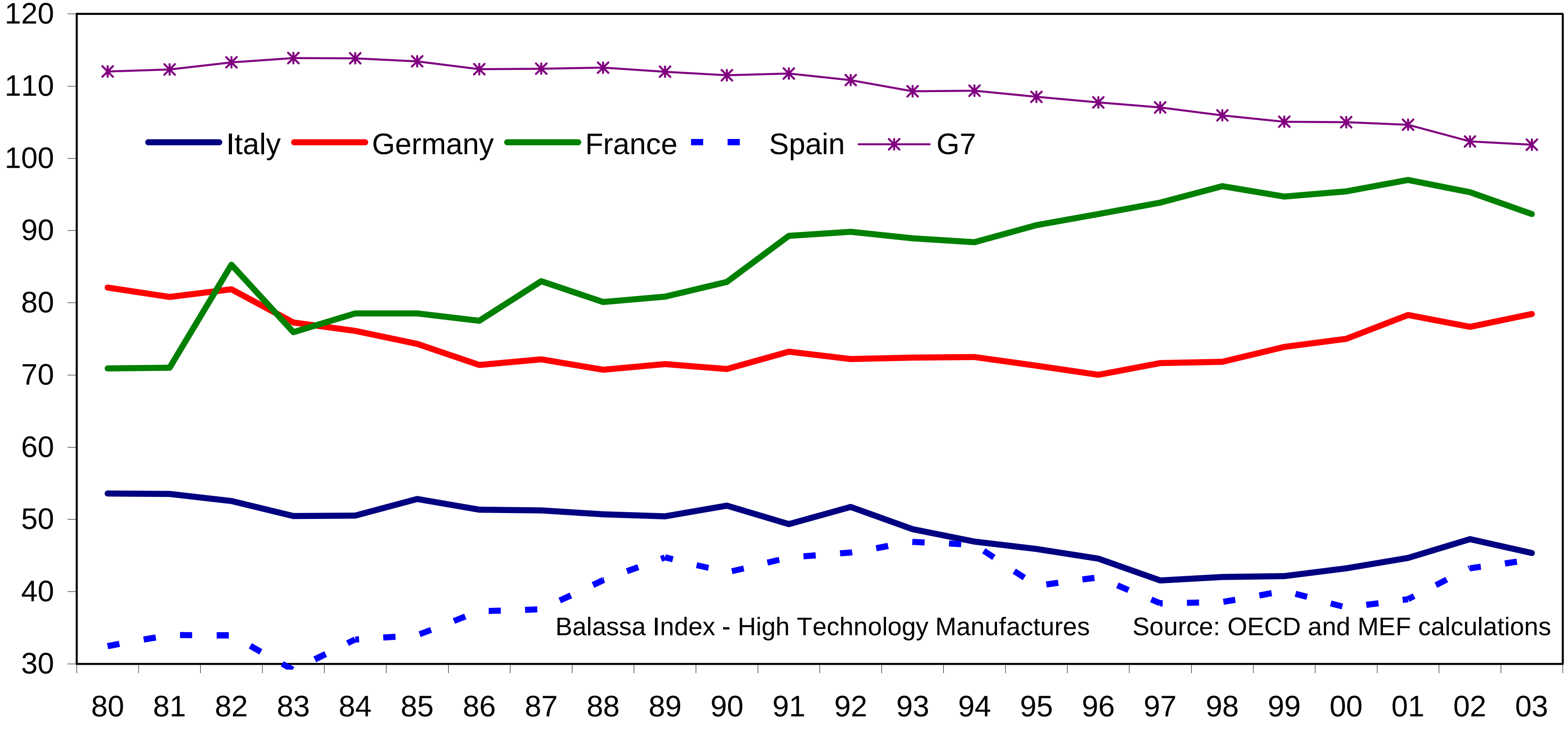
The Balassa index shows a modestly rising specialisation in medium-low technology manufactures, which is now significantly higher than in France and Germany and in line with Spain, where specialisation is declining.

No significant shift in product specialisation



The Balassa index shows a slowly rising specialisation in medium-high technology manufactures, which remains the lowest versus Germany, France, and Spain.

No significant shift in product specialisation



The Balassa index shows a low and declining specialisation in high technology manufactures, which remains significantly below Germany and France (while Spain has caught up with Italy). All European Countries are below the G7 average. Is the OECD classification in sectors truly representative?

Higher pricing power: relative-price elasticity has declined

- Some studies (e.g. Lanza 2007) show a significant reduction in price elasticity of market shares between 1995-1999 and 2000-2005 in traditional "Made in Italy" sectors, such as wine, vegetable oil, ceramic and glass products, furnishing, etc.

- For instance, the Italian olive oil price is circa 140% higher than the EU average. Yet, although unit values have continued to rise (+40% in 1998-05), Italy's market share has remained broadly unchanged.

- A further example: furnishing. The sector is retaining a competitive position: the more complex the production, the higher the ability to include functional and aesthetic features.

INCREASING COMPETITION

Market power: relative-price elasticity has declined

	Relative-price elasticity		
	Clothing	**Shoes**	**Jewellery**
1996-2005	**-1.41**	**-1.58**	**-0.65**
	(-0.07)	*(0.15)*	*(0.05)*
2001-2005	**-1.26**	**-1.40**	**-0.67**
	(0.089)	*(-0.15)*	*(0.06)*

Source: Giovannetti (2007)

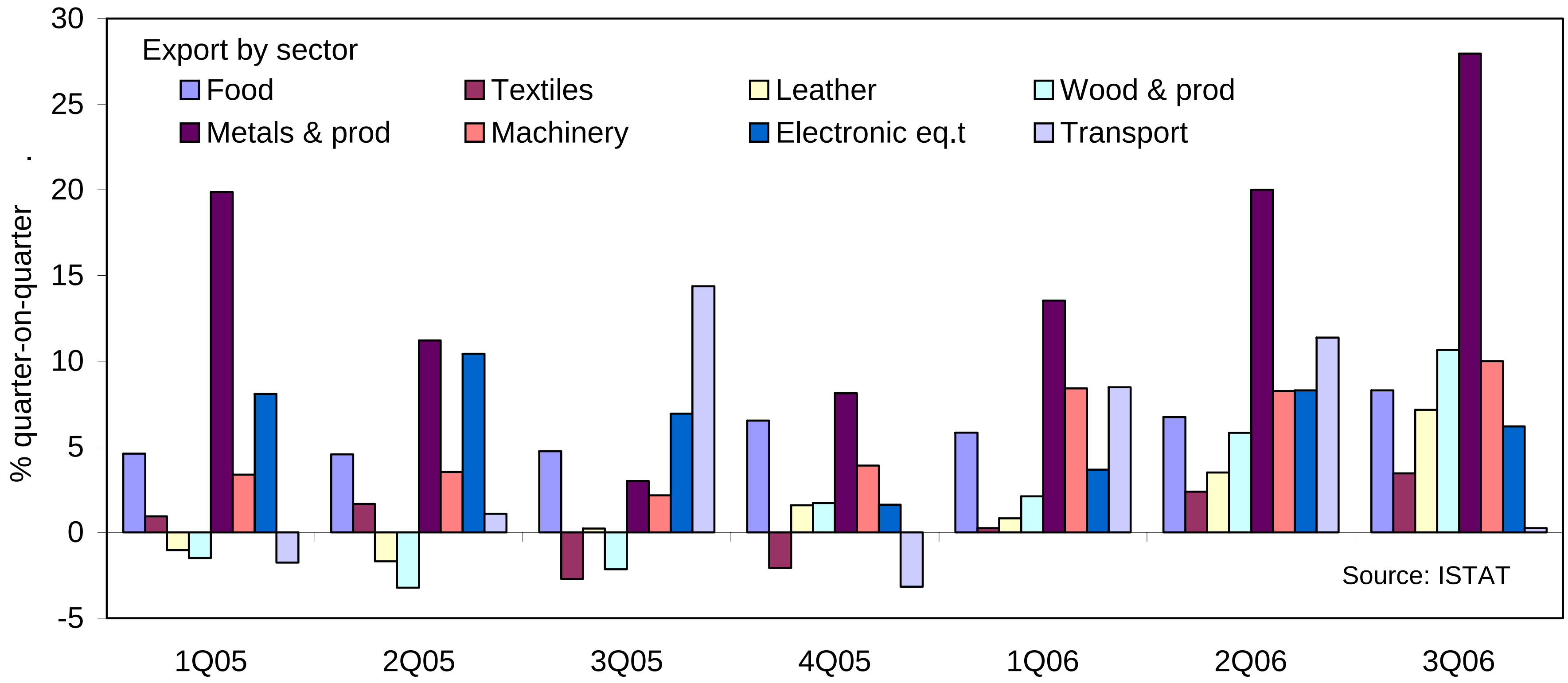
Not all sectors show reduced sensitivity to relative prices. Nevertheless companies appear to enjoy higher pricing power in numerous sectors and especially in traditional ‘Made in Italy’ sectors.

The ability to “price to market” has increased

- On data between 1Q 1999 and 2Q 2005, “impulse-response analysis shows non-negligible reactions of export-domestic price margins to unanticipated changes in cost competitiveness and in foreign and domestic demand levels”.
- “For the period 1999-2001 a typical pricing-to-market behaviour emerges, while over the most recent years favourable foreign demand conditions have allowed firms to increase their export-domestic price margins in face of a strong deterioration of their cost competitiveness”.

Source: “Pricing to Market of Italian Exporting Firms”, Basile, De Nardis, Girardi (2007), based on ISAE survey data

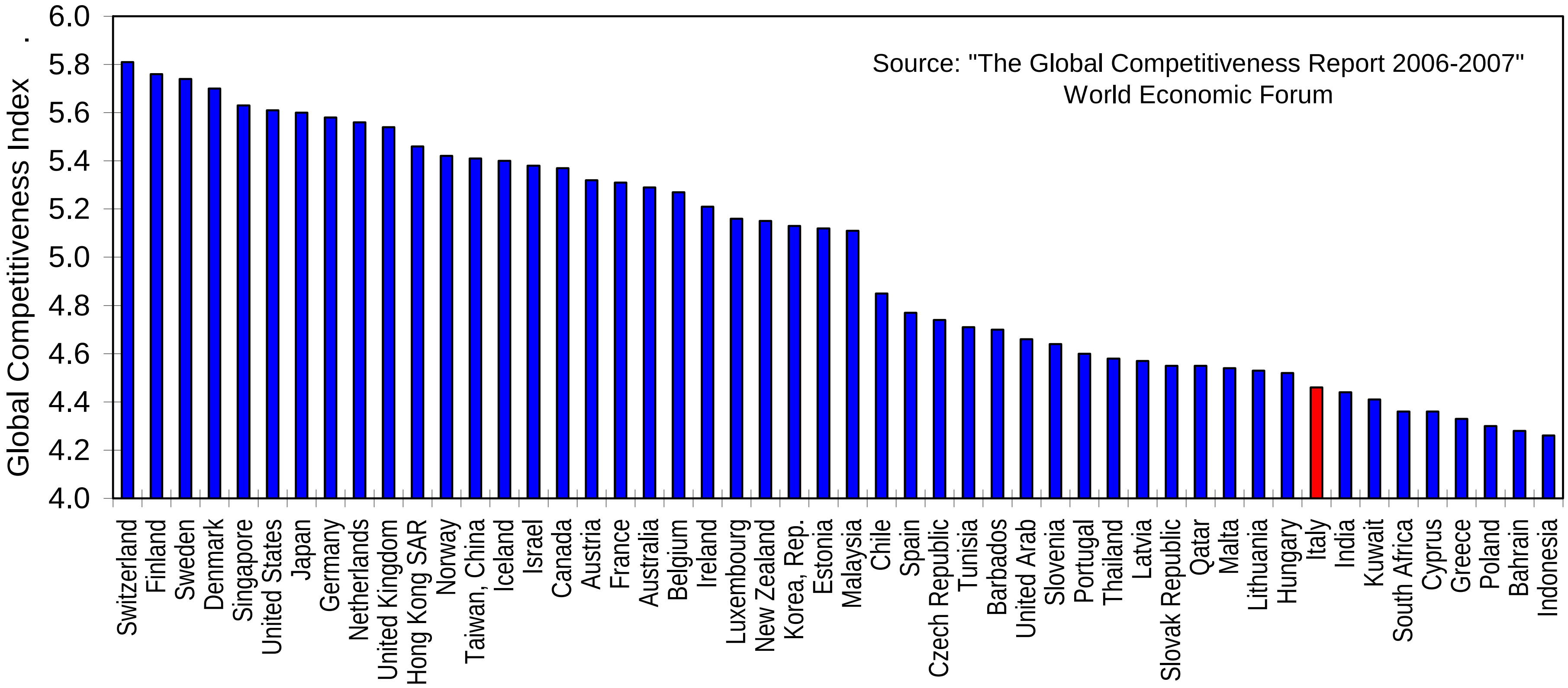
Broad-based recovery of "Made in Italy" sectors. Cyclical?



Quarterly growth has been broad-based, including traditional "Made-in-Italy" sectors, along with a strong upward trend for metals and metal products. Is it just a cyclical phenomenon? There seems to be some catching up in Italy's exports that goes well beyond the cyclical upswing in global demand.

ITALY'S COMPETITIVENESS

Competitiveness is a much broader issue



While the problems of cost competitiveness may have been overstated and the ongoing production restructuring is probably remarkable, 'framework conditions' are still not favourable. The factors that prove critical to driving productivity and competitiveness need to be improved.

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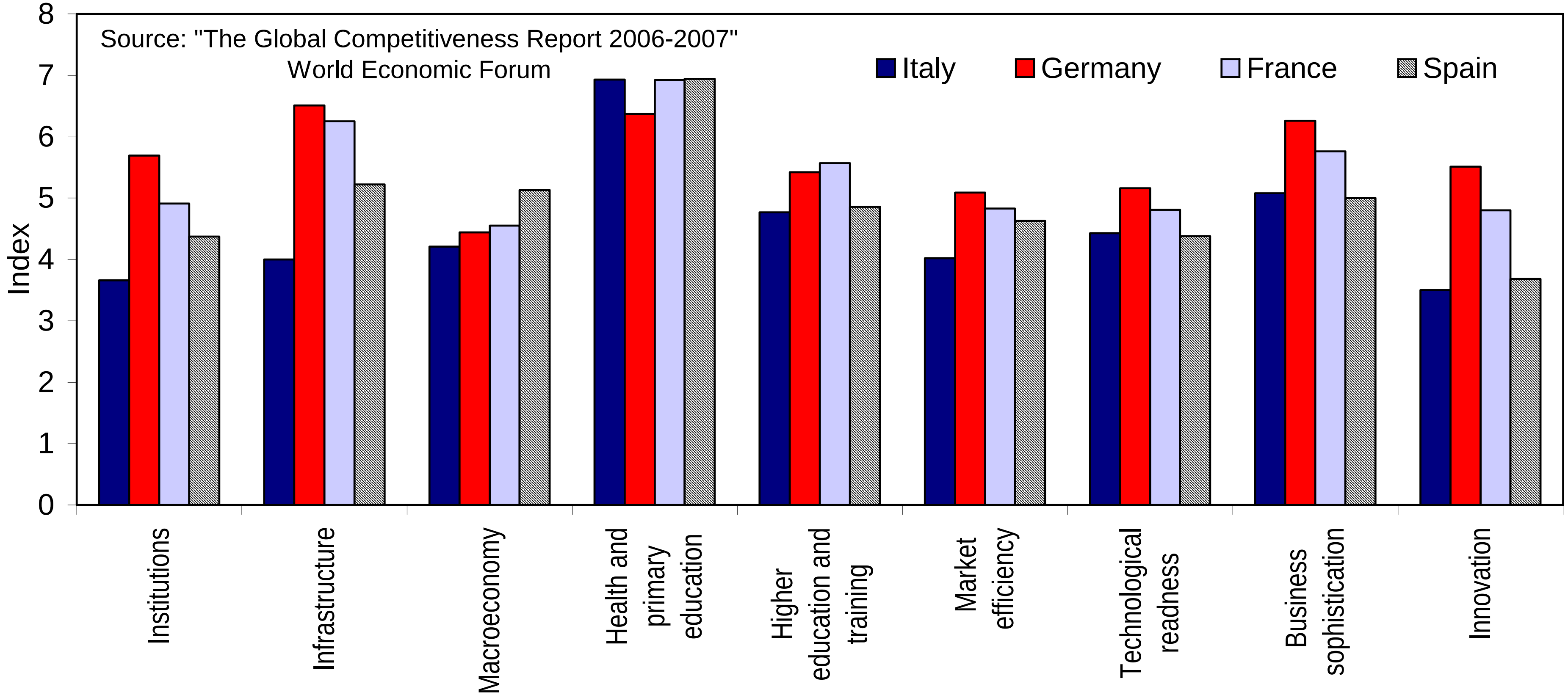
Low marks in numerous pillars



While the indices of the World Economic Forum may not be the best gauge of Italy's competitiveness, Italy scores pretty low in numerous pillars. Thus, a lot more needs yet to be done so as to improve the economic environment for competitiveness.

Objectives confirmed, but Italy also wants to change gear

- Ensuring long-term fiscal sustainability
- Enhancing competition and simplifying regulation, via actions aiming to reduce entry barriers and liberalise services
- Promoting research and innovation
- Increasing participation in the labour market and encouraging investment in human capital
- Upgrading tangible and intangible infrastructure
- Reconciling environmental protection with technological progress

Reforms of product and service markets already introduced

- The "citizen consumer" initiative improves the functioning of markets and extends the area of free choice. For instance:

- Removal of restrictions to market access, e.g. restrictions on supply (bakers), eligibility for doing business (legal and professional services), minimum distance (shops), antitrust caps at local level (trade), etc.

- Removal of restrictions to business, e.g.: product range offered (OTC medicines, professional services), minimum prices and ban on advertising (professional services), discounted products (trade, OTC medicines, car insurance), constraints on portability of accounts (banking services), form of company, etc.

Reorganisation in the electricity and gas markets under way

- Increasing competitiveness through separation of distribution and selling of electricity, and organisational separation of transmission and distribution system operators in the gas sector
- Ensuring energy supply at competitive costs by setting minimum objectives of fuel mix diversification
- Increasing the security of gas supply by encouraging investments in new infrastructures
- Promoting policies to sustain renewable sources by increasing energy efficiency
- Timely transposing of EU Directives

Measures to reduce red tape to the fore

- Strengthening the “one-stop shop” for productive activities and cutting administrative requirements
- Reducing infringements and timely transposing EU directives: creation of an *ad-hoc* task force at the Prime Minister's office, and a technical support unit for a better enactment of EU Law
- Measuring the administrative burden on companies (experimental plan)
- Reducing the stock of existing legislation: so-called “law-cutting” measures
- Reforming bankruptcy procedures

R&D target: 2.5% of GDP by 2010 – 2/3 from private sector

- Introducing incentives for private investments, such as tax credit on research and grants to researchers
- Setting up a specific Fund for investment in scientific and technological research (FIRST)
- Recruiting research staff at universities and research institutes (special three-year plan)
- Supporting the creation of partnerships amongst universities, research centres, private enterprises and financing institutions (Industry 2015 Draft Law)
- Modernising the Public Administration, also through e-Government programmes

Labour market participation and investment in human capital

- Reducing the "tax wedge" on labour (3% businesses, 2% employees)
- Encouraging young people and women into work through active employment policies, in addition to immigration policies
- Introducing re-employment incentives to postpone retirement
- Promoting social policies able to offer more services and assistance, including family-support policies and childcare provisions
- Narrowing the gap between demand and supply of labour via an integrated information system at central and local level (so-called *Borsa Lavoro)*
- Decreasing the size of the black market economy and tackling regional disparities

Infrastructure projects to improve competitiveness

- Improving general productive efficiency and business competitiveness through better logistics (national logistics plan)
- Upgrading the existing networks in order to integrate Italy with the EU transport system
- Implementing the priority TEN-T Projects
- Encouraging innovative projects in the transport sector (i.e. Galileo Programme)
- Reducing the infrastructure gap between Central/Northern and Southern Italy

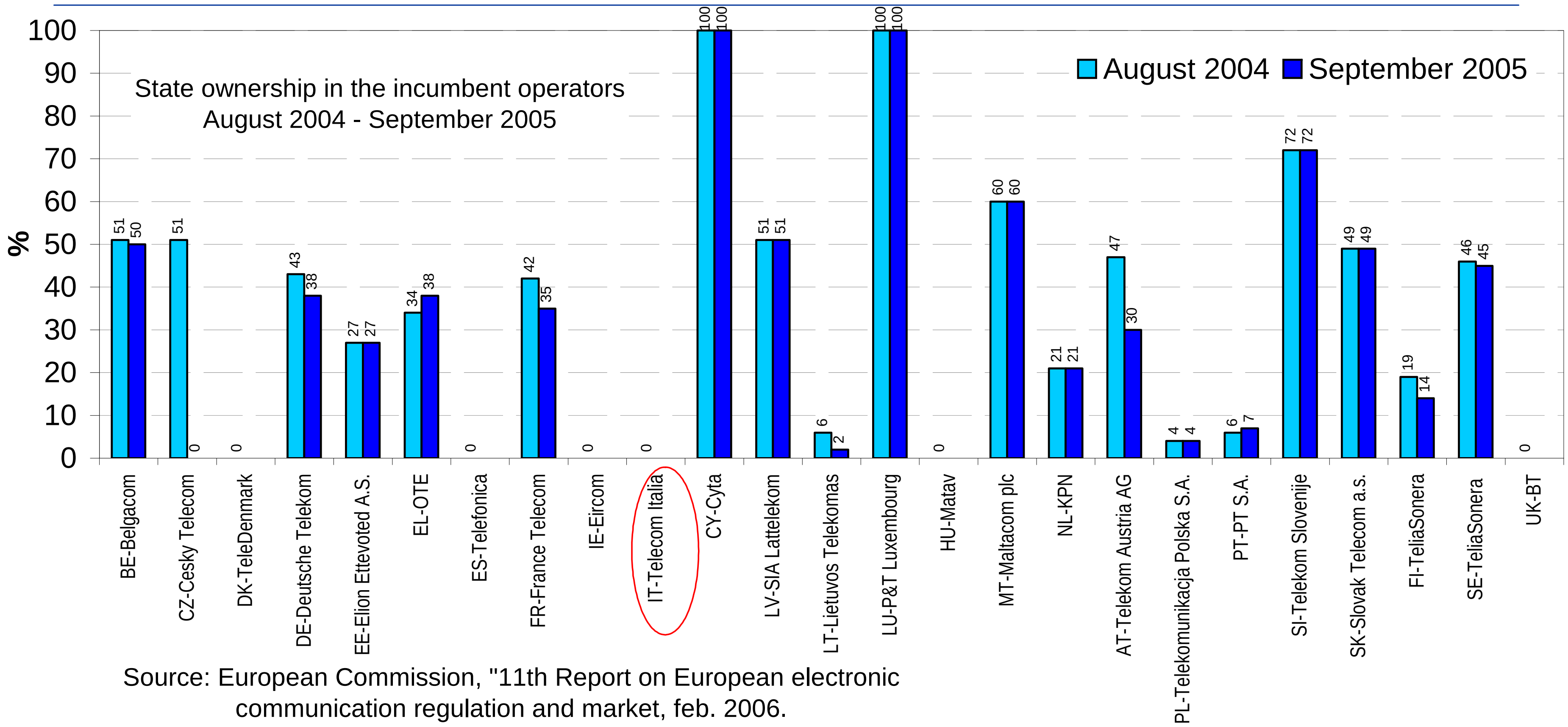
Developing excellence in environmental technologies

- Rising energy efficiency and savings while reducing CO^2 emissions
- Developing environmental technologies, such as hydrogen as an energy carrier, and increasing use of renewable sources in electricity generation
- Reorganising national environmental regulations and introducing environmental accounting into the national budget
- Promoting urban “mobility plans” and developing environmental management systems within SMEs
- Promoting public and private contract competition based on environmental services (“green contracts”)

The new liberalisation measures (January 2007)

- Introducing stronger competition amongst petrol stations: abolishing barriers such as minimum distance, numerical parameters, and ban on sales of non-oil products.
- Abolishing fees for recharging pre-paid mobile phone cards.
- Reducing red tape to set up a firm (from 1 month to 1 week).
- Introducing tax allowances for firms opening their capital to private equity funds or planning to be listed in the Stock Exchange.
- Allowing SMEs to buy natural gas on line instead of importing it from abroad, which requires a strong contractual power.
- Many others.

Telecommunications: the incumbent is no longer State-owned



Source: European Commission, "11th Report on European electronic communication regulation and market, feb. 2006.

The reform in the TLC market, begun with Telecom privatisation, led to a complete withdrawal of the State from incumbent ownership.

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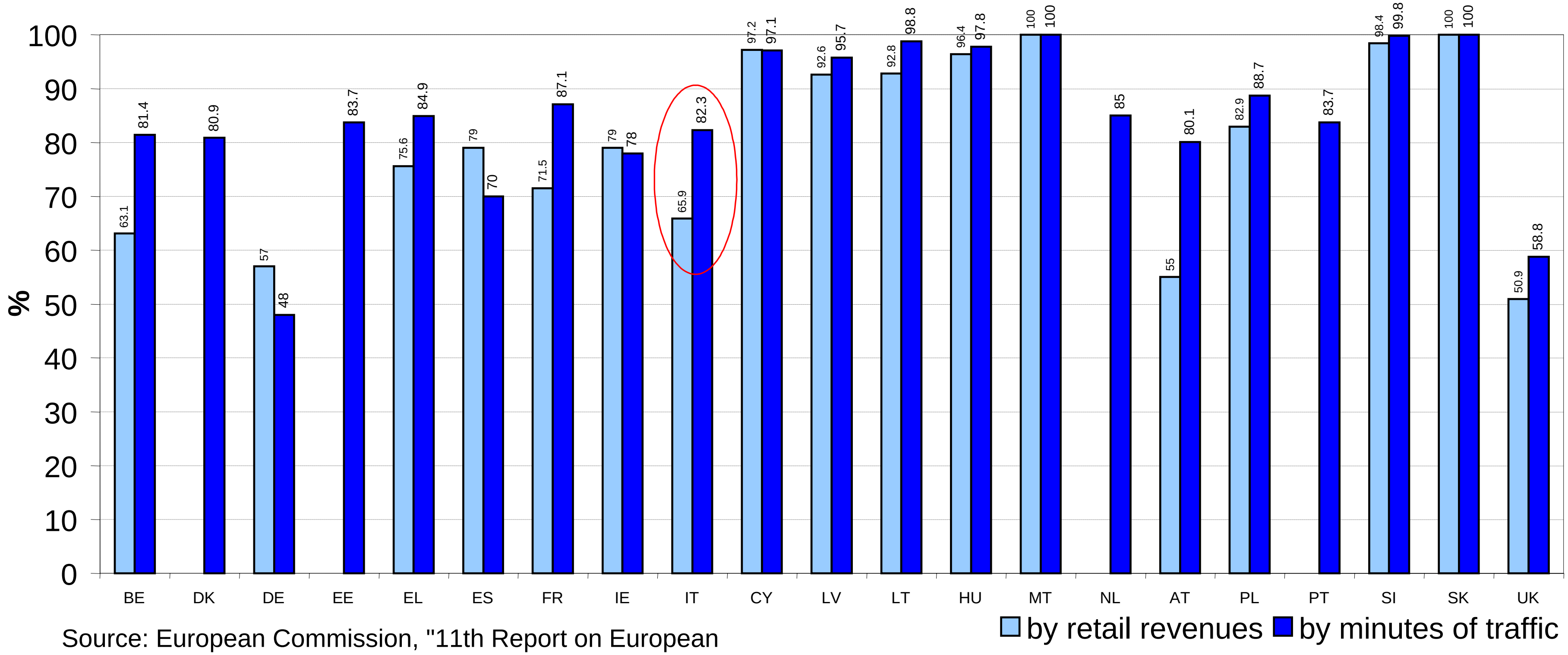
SOME EXAMPLES: REFORM EFFECTS

Telecommunications: lower market shares for the incumbent



Source: European Commission, "11th Report on European electronic communication regulation and market, Feb. 2006.

Incumbents' market share in the fixed telephony market (Dec. 2004)

Market liberalisation and the action implemented by the TLC Authority, contributed to a reduction of the incumbent's market share and a progressive reduction of prices.

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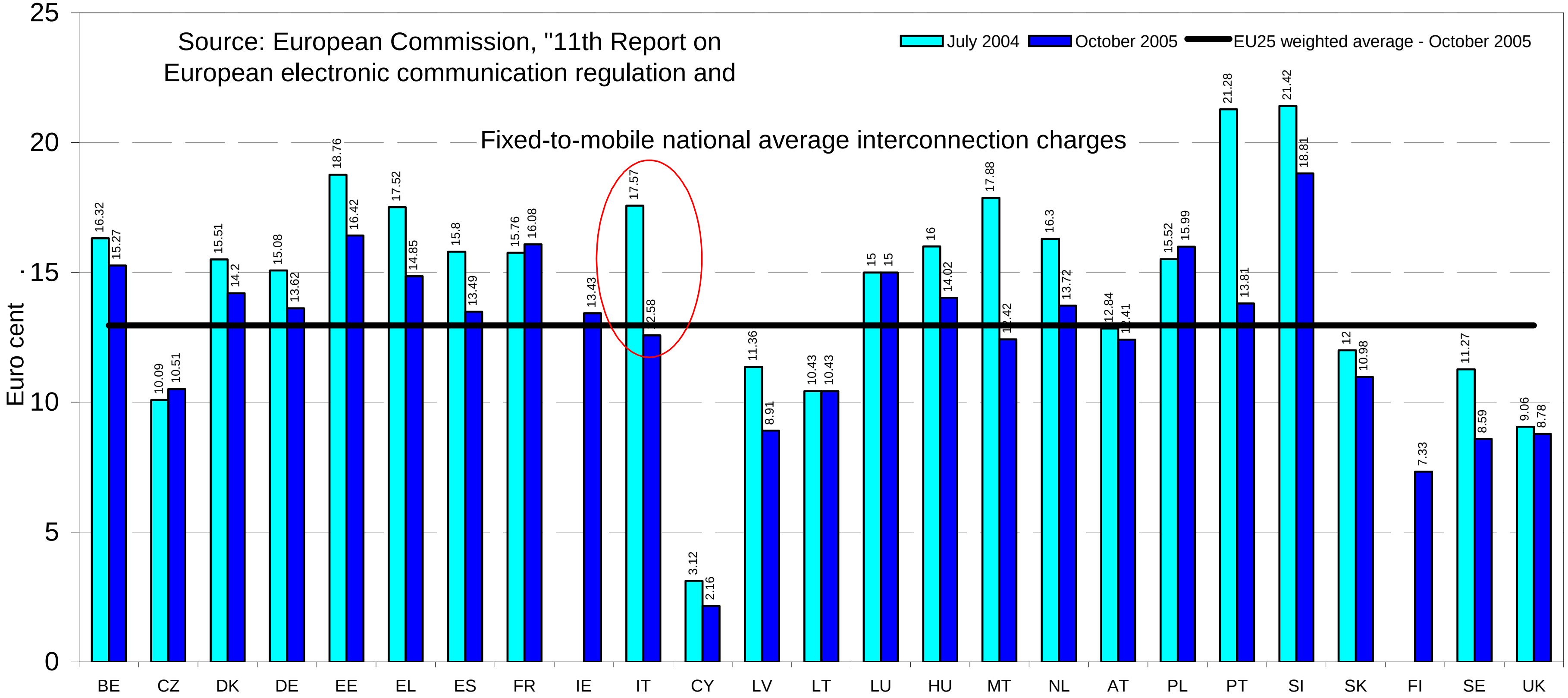
SOME EXAMPLES: REFORM EFFECTS

Telecommunications: costs below the EU25 average



As a result, between 1990 and 2004 telecommunication prices fell by 3% versus a 59% increase in consumer prices (obviously combined with technological advance). Interconnection charges declined below the EU25 average.

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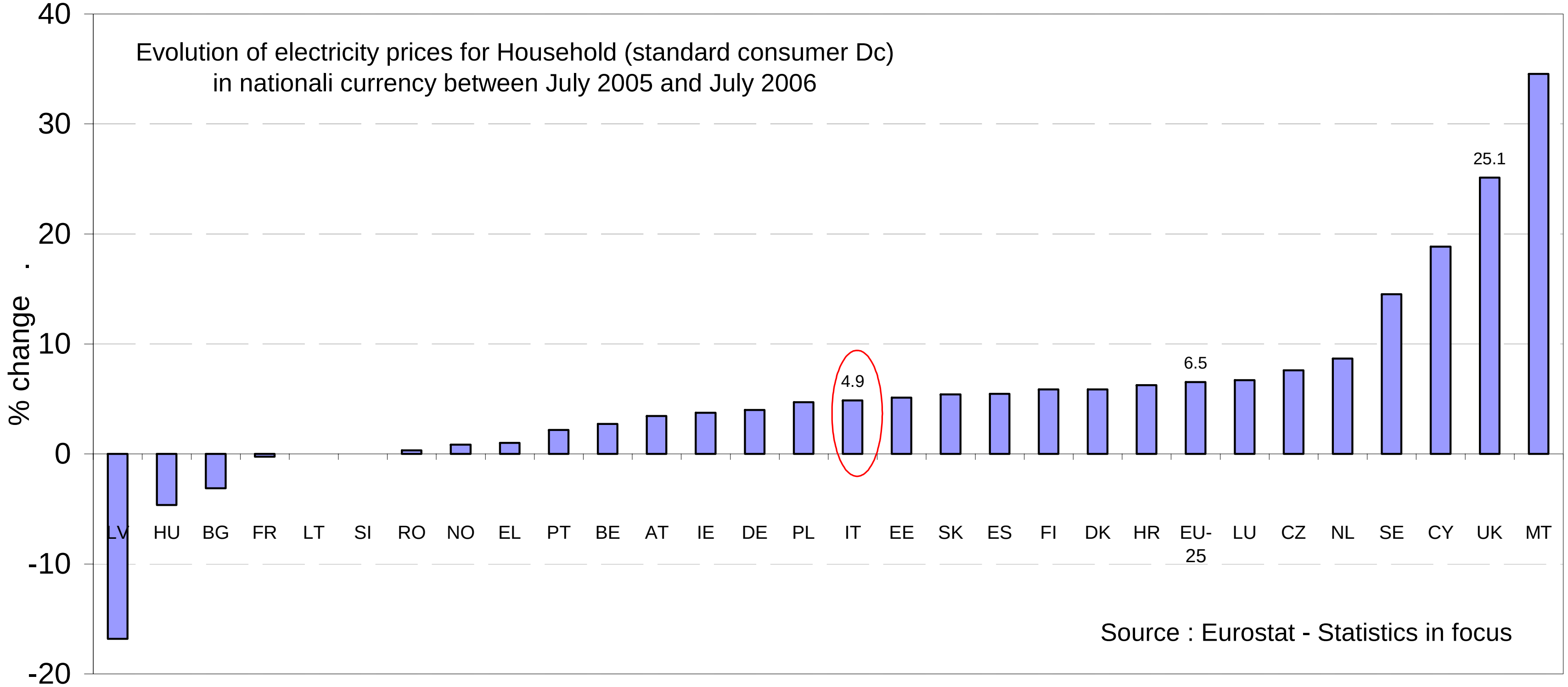
Electricity: higher competition in the market

	Declared Market opening	Number of electricity suppliers	Switching since market opening	
			Large industrial users	Medium/commercial users
Belgium	90%	48	20-50%	5-20%
Denmark	100%	75	>50%	5-20%
Germany	100%	940	20-50%	5-20%
Spain	100%	315	5-20%	<5%
France	70%	166	20-50%	<5%
Ireland	100%	8	>50%	<5%
Italy	**79%**	**400**	**>50%**	**5-20%**
Austria	100%	125	20-50%	20-50%
Netherlands	100%	34	n.a.	<5%
Sweden	100%	130	>50%	<5%
UK	100%	32	>50%	>50%

The market has been gradually opened as of the 1999 Liberalisation Decree. Large industrial users (whose switching rate is >50%) have been liberalised since the beginning, whilst the market for medium industrial/commercial users was opened in 2004. Several Countries, having liberalised 100% of demand, show lower switching rates (Spain, Germany, Austria).

SOME EXAMPLES: REFORM EFFECTS

Electricity: higher competition brings lower prices



In the period July 2005 - July 2006 EU 25 electricity prices increased by 7%, while in Italy the prices rose by circa 5%. The Regulation adopted by the Italian Energy Authority contributed to a smoother dynamic of electricity prices, despite the rise recorded in oil prices.

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Motor fuel distribution network: too many, too small outlets

	Data as at 1st January 1998		1998	Data as at 1st January 2005		2005
	Total sale points	Average throughput	% of self-service	Total sale points	Average throughput	% of self-service
Italy	**27,100**	**1,274**	**12%**	**22,400**	**1,817**	**21%**
France	17,500	2,311	66%	13,835	3,385	99%
Germany	17,100	2,887	94%	15,070	3,553	98%
Spain	6,880	3,706	15%	8,654	3,103	24%
United Kingdom	14,800	2,486	69%	10,300	4,001	96%

Source: Unione Petrolifera, Annual Report 2006.

Structural features of the Italian fuel distribution network are responsible for inefficiency and high prices. There are some improvements, however. Between 1998 (the Reform inception) and 2005 a reduction of 4,700 sale points was recorded, coupled with a 43% increase in the average throughput.

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Motor fuel distribution network: self-service calling