Why is Italy doing so badly?

- Italy’s second recession in two years is largely due to the loss of competitiveness in manufacturing, reflecting low productivity growth rather than rapid growth in wage costs. This has been compounded by Italy’s specialisation in areas of production which are increasingly exposed to international competition. The fact that the poor performance of the external sector is largely responsible for Italy’s problems goes a long way towards explaining national concerns about the euro.

- In our view, there is a real danger that Italy has already fallen into a vicious spiral of low technology production, poor productivity growth and weak overall GDP growth, which it will find difficult to extricate itself from anytime soon. Indeed, forward-looking indicators such as the manufacturing PMI surveys show that the immediate outlook is poor. As a result, even Italy’s comparatively low unemployment rate compared to France and Germany could soon be under threat, which would also hit domestic demand.

- Though some of Italy’s under-performance has undoubtedly already been priced into equity markets, the full extent of Italy’s woes and, in particular, the extent to which Italy underperforms the euro-zone in successive economic downturns, may not have been fully appreciated. As a result we expect the Italian equity market to under-perform the rest of the euro-zone, with the mid-cap sector especially vulnerable.

- In terms of bond market impact, the relatively low risk premia that Italy has enjoyed since joining EMU could eventually come under threat if, as we expect, Italy’s deteriorating economic situation ultimately leads to a severe deterioration in its fiscal position as well.

Julien Seetharamdoo
Why is Italy doing so badly?

Back in recession

Italy has entered its second recession - defined as two successive quarters of negative GDP growth - in just over two years. (See Chart 1.) As we shall show, this has been led by a deeply disappointing performance from the external sector.

Indeed, Italy has been under-performing the rest of the euro-zone since the mid-1990s, even though the region itself has not performed well in recent years. (See Chart 2.) Thus, Italy’s relatively poor performance pre-dates the euro.

Causes of decline

Italy suffers from the usual euro-zone problems of high unemployment compared to economies such as the UK and US, and consequently relatively weak consumer confidence and household spending. But Italy’s unemployment rate has actually fallen below that in France and Germany in recent years. (See Chart 3.)

Although household consumption growth in Italy has been weak, it is still stronger than in Germany and only marginally below that of France. (See Chart 4.) Again, the savings ratio is high when compared to the UK and US, but not much different from that of Germany.

A comparison of other components of domestic demand, such as government spending, reveals a similar picture. Government spending grew more slowly in Italy than in France and Germany in the late 1990s, but growth rates have since been much the same. Indeed, similar trends in the government deficit as a share of GDP suggest that the constraints of the Stability and Growth Pact (SGP) cannot be blamed for Italy’s underperformance compared to the rest of the euro-zone.

Investment in machinery and equipment has been weak, especially since 2000, but again other euro-zone countries, such as Germany, have exhibited similar trends. Indeed, total investment in Italy has actually been stronger than in Germany, due to
growth in construction investment because of a housing market boom. (See Chart 5.)

**Chart 5: Italy & Germany, Investment in Machinery & Equipment and Construction (1994 = 100)**

Source - Bloomberg

Italy’s especially weak GDP growth has been caused instead by the poor performance of the external sector. As Chart 6 shows, export growth has been much lower than in either Germany or France in the past ten years.

**Chart 6: Exports of Goods and Services (1994 =100)**

Source – Thomson Datastream

Whereas in Germany the volume of exports has doubled since 1994, and in France exports have increased by more than 60%, in Italy they have increased by less than 40%. Furthermore, most of this increase occurred in the late 1990s. Since 2000, export volumes have stagnated. The result has been a gradual deterioration in Italy’s trade balance since the mid-1990s, with a substantial trade deficit recorded in Q1 2005 for the first time since the early 1990s. (See Chart 7.) Perhaps significantly in light of the current debate about the euro, Italy benefited from a one-off boost to exports in the early 1990s, after leaving the ERM in 1992 and devaluing its currency.

**Chart 7: Italy Trade Balance (% of GDP)**

Source – Thomson Datastream, Capital Economics

What’s more, over the past ten years the contribution from net exports to GDP growth (exports minus imports) has actually been negative. (See Table 1.)

**Table 1: Contributions to Growth (1994-2004)**

<table>
<thead>
<tr>
<th>Contributions to growth (% points)</th>
<th>GDP growth (%)</th>
<th>Personal Consumption</th>
<th>Government Investment</th>
<th>Net exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>17.1</td>
<td>11.7</td>
<td>2.3</td>
<td>6.3</td>
</tr>
<tr>
<td>Germany</td>
<td>15.5</td>
<td>7.8</td>
<td>2.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>France</td>
<td>24.4</td>
<td>13.6</td>
<td>4.9</td>
<td>5.9</td>
</tr>
</tbody>
</table>

Source – Thomson Datastream, Capital Economics

But why is Italy’s external sector doing so badly? There are a number of reasons, which we review briefly below. The key point is that unfortunately none of these are likely to change anytime soon.

**Low productivity**

One of Italy’s biggest problems is its productivity performance. Productivity growth (measured by output per employee) has been lagging well behind other euro-zone countries. (See Chart 8.)
As a result, although wage deals have been moderate in recent years, unit labour costs have increased more quickly, leading to a gradual loss of competitiveness. This is shown in Chart 9, which shows the trade-weighted exchange rate adjusted for differences in unit labour costs.

**Chart 9: Real Effective Exchange Rates (1994 =100, Unit Labour Cost Deflated)**

This low productivity growth itself stems from, amongst other things, a lack of investment in human capital and research and development. For example, 40% of 25-34 year olds have only lower secondary education, compared with an EU and OECD average of around 25%. As a result, Italy has specialised in low technology production such as furniture, textiles, clothing and footwear, where the scope for productivity gains are lower.

**High exposure to global competition**

Unfortunately, these sectors are also those most at risk from competition from emerging economies, especially with the relaxation of global quotas on textiles and clothing since January 1st 2005.

Despite recent discussion of re-imposing quotas on imports from China, for example, a return to the full quota system now seems difficult to envisage. Furthermore, even if quotas were imposed on individual countries such as China, production would probably shift out to other emerging/low-cost economies.

**Devaluation no longer an option**

In addition, Italy is no longer able to resort to competitive devaluation as a short-term measure to address its competitiveness problems, as it has done in the past, because it is now locked into the single currency. In fact, the stronger euro against the dollar since 2001 has hit Italy especially hard because the type of goods it exports, such as clothing, tend to be particularly sensitive to price competition and it is a large exporter to dollar-zone markets.

**Burdened by red tape**

Italy also suffers from other obstacles such as the amount of regulation which inhibit business and discourage inward investment. According to the latest World Bank ‘Doing Business’ report, the cost of setting up a business in Italy is more than twice the OECD average (when calculated as a percentage of national income per capita) and there are a third more procedures involved.

This is also reflected in the relatively low level of Foreign Direct Investment (FDI). Because of Italy’s lack of competitiveness, and over-regulation, inflows of FDI are well below other major euro-zone countries. As Chart 9 shows, the stock of FDI as a percentage of GDP is just over 10%, compared to around 25% for Germany, France and new EU entrants such as Poland. The low level of FDI itself creates a vicious circle of even lower growth, and so is a cause as well as a symptom of Italy’s malaise.

**Fiscal follies**

Finally, with national debt currently around 106% of GDP, debt interest payments represent around 5% of total GDP, the second highest in the euro-zone. (See Chart 11.) This limits the funds available for much needed investment in human capital and
infrastructure, which could otherwise help give the required boost to productivity.

**CHART 11: DEBT INTEREST PAYMENTS TO GDP RATIO (%)**

Source – Thomson Datastream

Quo Vadis?

So what does the future hold for Italy? In our view there is a real danger that Italy has already fallen into a vicious spiral of low technology production, poor productivity growth and weak overall GDP growth, which it will find difficult to extricate itself from anytime soon. Moreover, whereas Germany has already made serious attempts at structural reform, in Italy recent attempts at reform have been piecemeal at best.

The immediate outlook over the next few months is certainly not encouraging. Forward-looking indicators such as the manufacturing and services PMIs have deteriorated significantly in recent months, and much more so than for Germany and France. This suggests that again, as in previous downturns, the global slowdown is hitting Italy particularly hard. (See Charts 12 and 13.)

Admittedly, Italian industrial production rose by 1.9% m/m (0.8% y/y) in April, much higher than consensus of -0.2%m/m (-3.3% y/y). But the strength of output was due more to poor seasonal adjustment, due to the early timing of Easter this year, as the Italian statistics office itself conceded, rather than a turnaround in the Italian economy. Indeed, the export components of the PMI survey suggest export growth is likely to weaken especially. (See Chart 14.)

There is even a danger that Italy’s lower unemployment rate compared to France and Germany may soon be under threat. Indeed, the employment components of the PMI surveys have been disappointing recently (see Chart 15), suggesting that employment growth will slow and unemployment may rise. As a result, domestic demand could suffer as well. Overall, we expect GDP to fall by 0.4% in 2005, and, at best, a return to growth of only around 0.5% in 2006.
Looking further ahead, there might be cause for optimism if there at least appeared to be a genuine attempt to implement structural reform, but such measures so far have been half-hearted at best and so far we see nothing that indicates there is better to come. For example, the Berlusconi government’s attempts to stimulate the economy have consisted mainly of cuts to income tax, and in fact do not appear to have had much of an impact on household spending. With general elections due by May 2006, the political cycle also looks unfavourable for reforms anytime soon.

No joy from housing market

An additional worry for Italy is that the housing market is also slowing. Admittedly the link between household spending and house price growth has not been particularly close of late. (See Chart 16.) Nonetheless, the key point is that with house price inflation now on a downward trend, strong house price growth cannot be expected to come to the rescue boosting consumer spending.

Market Impact

So given this downbeat prognosis for the Italian economy, what will be the market impact? The first point is that the Italian equity market is likely to under-perform the rest of the euro-zone. While some of the bad news may already have been priced in, the full extent of Italy’s woes may not yet have been appreciated, especially the fact that Italy underperforms in successive economic downturns, and that domestic demand could now start to suffer as well due to lower employment growth.

So while both the German and Italian equity markets are currently at PE ratios well below their long-term average (see Chart 17), we see a lot more scope for upside performance in German markets than in Italy.

Italian government bonds under pressure

We will address the implications for bond yields in a separate Focus which will also address the wider question of the sustainability of Italy’s public finances. For now it is worth noting that if Italy’s economic and fiscal situation deteriorates significantly, as we expect, then the spread between Italian and German government bond yields, currently very low by historical standards (see Chart 18), could eventually start to widen.
Of course, identifying the timing of when this could happen is fraught with difficulty. Given that bond markets might only react to fiscal crises when they are impossible to ignore, spreads may continue to remain relatively low for a while yet.

**CHART 18: GOVERNMENT BOND YIELDS SPREADS**

![Graph](image)

Source - Bloomberg

The fact that Italy, the euro-zone’s third largest economy, is in such a deep recession is certainly a strong argument against any early ECB interest rate increases. Indeed, if the outlook for the rest of the euro-zone deteriorates significantly, we could see the ECB cutting rates.

**Leaving EMU?**

Finally, it has even been suggested that Italy should leave EMU, in order to restore its competitiveness by devaluing its currency by 20%. In our view this is neither a solution to Italy’s problems, nor a realistic outcome. Again we will address this question in more detail in a separate Focus. Leaving EMU would surely leave Italy with currency risk premia to pay on its national debt which would dwarf any advantage of a competitive devaluation. However, the fact that this option is being discussed at all could add to jitteriness in bond markets and again raise government bond yield spreads.

**Conclusion**

In summary, Italy is in a vicious circle of low technology production, poor productivity growth and weak overall GDP growth, which it will find difficult to extricate itself from anytime soon. This could soon translate into a worsening employment situation, which had at least been one of the few relative positives for Italy until now, leading to weaker domestic demand as well. Italy also underperforms the rest of the euro-zone especially in successive economic downturns. As a result, we expect the Italian equity market to under-perform the rest of the euro-zone and, in time, Italian government bond spreads versus other euro-zone countries to widen.