Diverging Competitiveness in the Euro area[1]

Anne Sibert

Birkbeck College, University of London and CEPR

Executive Summary

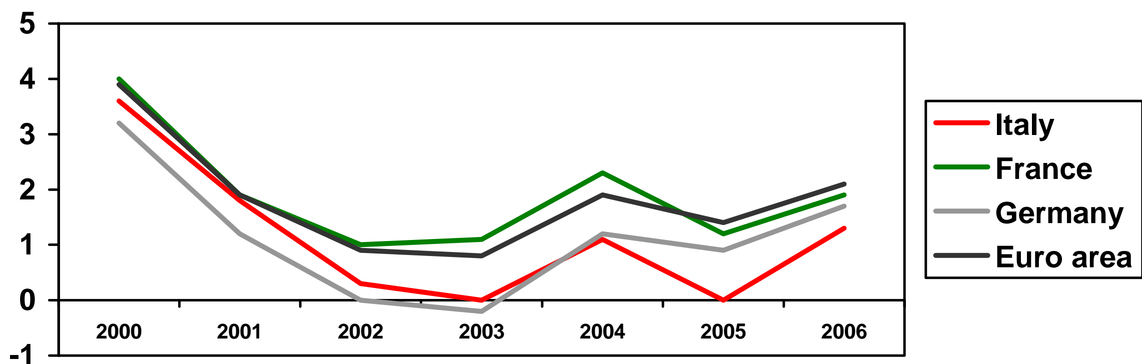
- Italian growth has lagged behind growth in the rest of the Euro area as Italian unit labour costs have risen.
- The rapid rise in unit labour costs in Italy is due in part to rises in nominal wages, but primarily to a decline in labour productivity in Italy relative to that in the rest of the European Union.
- Poor labour productivity in Italy is due to structural rigidities in Italian product and labour markets and impediments to doing business.
- A dire Italian fiscal situation should lead to increases in Italian interest rates, reflecting default risk and further dampening economic growth.
- Without further market reforms in Greece, Portugal and Spain and fiscal reforms in Greece and Portugal, growth prospects in these countries are likely to be poor as well.
- The prospect of prolonged low growth in several Euro area member states calls for no monetary policy response. But, it threatens the European Monetary Union if member governments use the one-size-fits-all monetary policy as a scapegoat for their failure to enact needed reforms.

Italian economic performance over the past seven years has been poor relative to that in the rest of the Euro area, with real GDP (as shown in Figure 1) growing more slowly than the Euro area average and more slowly than in either France or Germany. In its 2006 Annual Report on the Euro Area, the European Commission stated that, "a major

[1] Briefing paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament for the quarterly dialogue with the President of the European Central Bank.

characteristic of persistent growth differences in the euro area is that price and cost competitiveness have tended to adjust too slowly in some member states.”

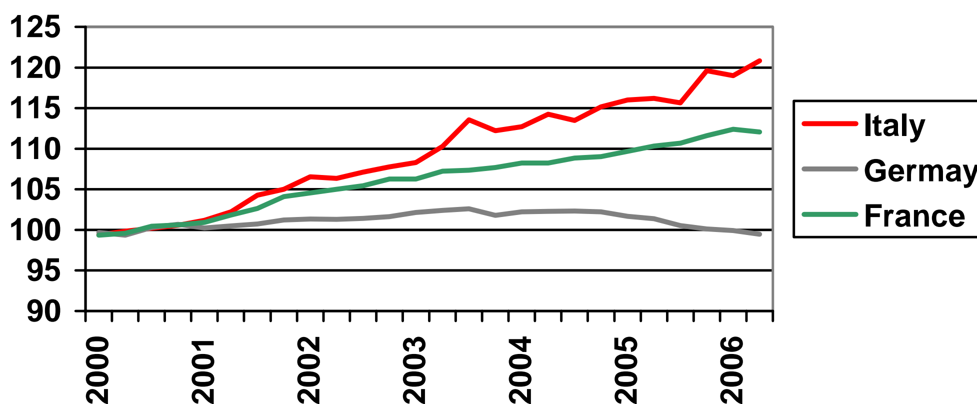
Figure 1. Real GDP Growth (Percentage Change)



Source: Eurostat

Indeed, as shown in Figure 2, unit labour costs, defined as compensation per employee divided by labour productivity, have risen dramatically in Italy in comparison

Figure 2. Unit Labour Cost Index (2000=100)

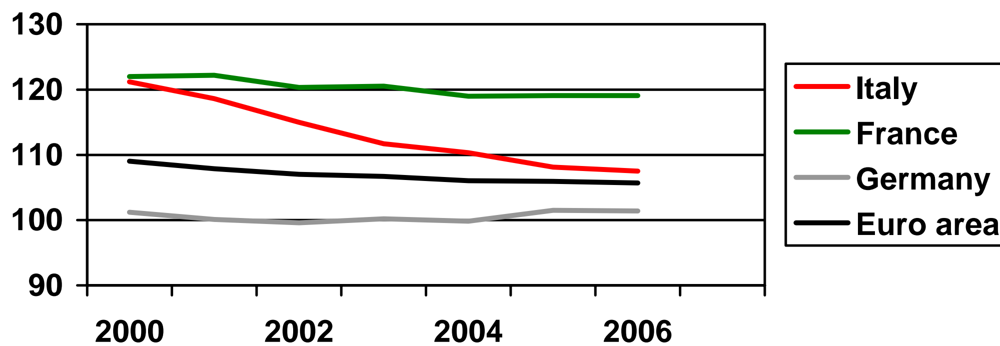


Source: European Central Bank.

with those in France and Germany. The increase in unit labour costs could lead to the conclusion that, with no possibility of nominal exchange rate adjustment in a common

currency area, Italy's loss of competitiveness is due to a failure of Italian *nominal* wages to adjust. This, however, would be an unwarranted conclusion. While nominal wage growth in Italy over the period 2001-2004 was slightly higher than nominal wage growth in the Euro area as a whole, it was lower than in either France or the Netherlands.[2] Instead, the primary reason for the decline in Italian competitiveness is the dramatic decline in labour productivity, defined as GDP divided by people employed; this is shown in Figure 3.

Figure 3. Labour Productivity Relative to the EU-25 (=100)



Source: Eurostat

Italy's poor competitiveness relative to the rest of the Euro area is only minimally affected in anything other than the short run by the nature of its nominal exchange rate regime. Instead, the decline in labour productivity is a consequence of real inefficiencies and a disastrous fiscal policy. An example of the real distortions that characterize the Italian economy are those induce by its intrusive product market regulation. Figure 4 provides a measure of product market regulation computed by the OECD, including such factors as the pervasiveness of state ownership, the prevalence of price controls, the

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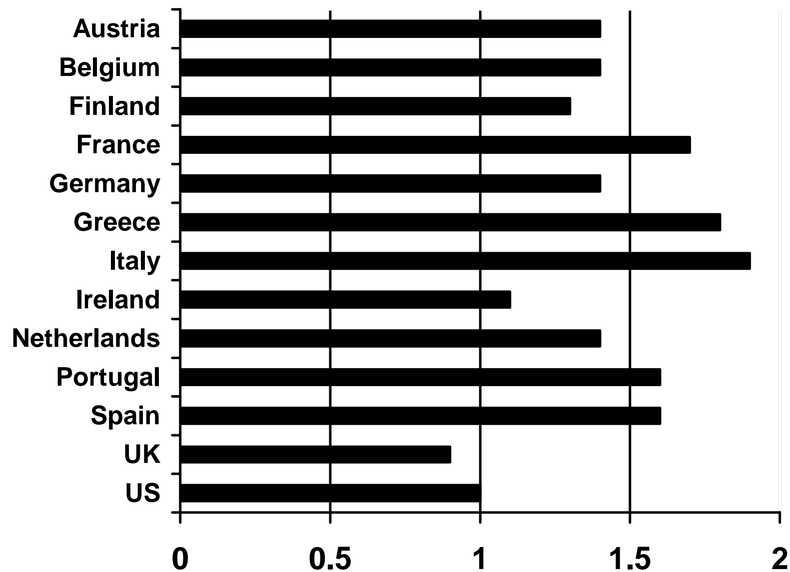
[2] International Monetary Fund, *Italy: 2005 Article IV Consultation, Staff Report*, 2006.

administrative burdens and the barriers to ownership. As is seen, Italy has the most regulated product markets in the Euro area. This discourages entry and distorts the allocation of resources.

Figure 4. Product Market Regulation



Source: OECD[3]

It takes 48 days to enforce a debt contract in the Netherlands and 1,390 days in Italy, longer than in any other country in the world except Guatamala.[4] Another indication of why Italy is performing so poorly is given by its ranking in the World Bank's Ease of Doing Business Index. This is computed by measuring such things as how easy it is to start a business, to employ workers and to enforce contracts. As seen in Table 1, Italy ranks as the 82nd easiest country in the world to do business, down from number 69 in 2006 and behind Kazakhstan (63rd), Nicaragua (67th) and Pakistan (74th).

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[3] Conway, Paul, Véronique Janod and Guiseppe Nicoletti, "Product Market Regulation in OECD Countries: 1998 to 2003," OECD, 2005.
[4] World Bank, *Doing Business 2006: Creating Jobs*, 2006.

Table 1. Ease of Doing Business Index

	2006	2007
United States	3	3
United Kingdom	5	6
Ireland	10	10
Finland	13	14
Belgium	20	20
Germany	21	21
Netherlands	22	22
Austria	30	30
France	47	35
Spain	38	39
Portugal	45	40
Italy	69	82
Greece	111	109

Source: World Bank, *Doing Business 2007: How to Reform*, Report Overview, 2006 and World Bank, *Doing Business 2006: Creating Jobs*, 2006.

As shown in Table 2, part of Italy's poor ranking can be accounted for by its rigid labour markets. As can be seen, Euro area labour markets are rigid compared to the United Kingdom and especially compared to the United States and Italy has one of the more rigid labour markets in the Euro area. It is the fourth most difficult country in the Euro area both in which to hire workers and in terms of the rigidity of employment. Along with many other Euro area countries it scored an 80 in the rigidity of its hours, compared to zero for the United States. Hiring costs are 33 percent of a worker's salary – the third highest in the Euro area and compared to 8 percent in the United States; firing costs are 47 weeks of salary, compared to nothing in the United States.

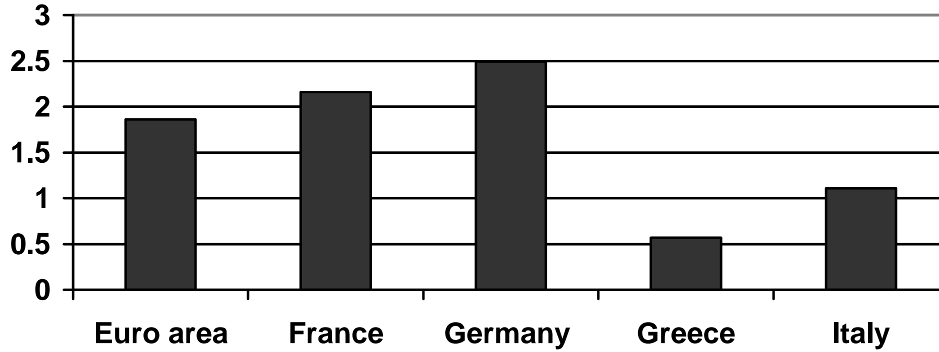
Table 2: Hiring and Firing Workers

	Difficulty Hiring*	Rigidity of Hours*	Difficulty Firing*	Rigidity of Employ-ment	Hiring Cost**	Firing Cost***
US	0	0	10	3	8	0
UK	11	20	10	14	9	34
Austria	11	80	40	44	31	55
Belgium	11	40	10	20	55	16
Finland	44	60	40	48	22	24
France	78	80	40	66	47	32
Germany	44	80	40	55	21	67
Greece	78	80	40	66	30	69
Ireland	28	40	30	33	11	52
Italy	61	80	30	57	33	47
Nether.	28	60	60	49	16	16
Portugal	33	80	60	58	24	98
Spain	67	80	50	66	32	56

Source: World Bank, *Doing Business in 2006: Creating Jobs*, 2006.
*Index: 0 – 100
**Percentage of Salary
***Weeks of Salary

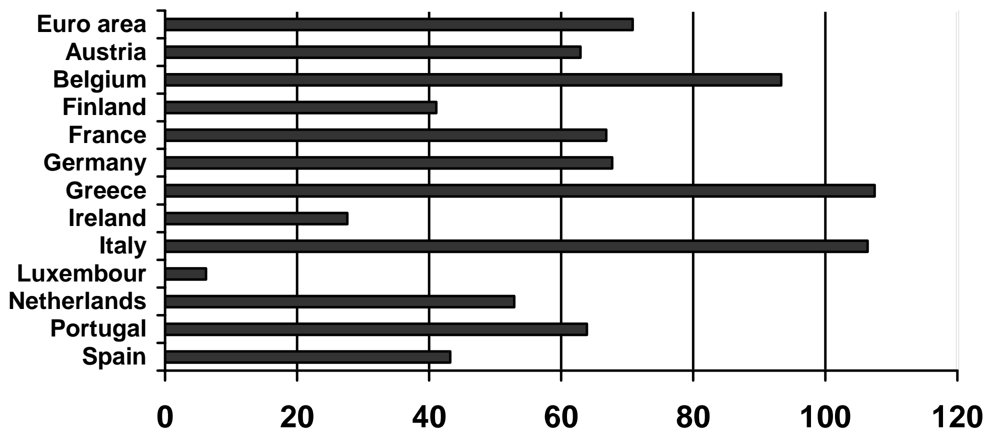
A consequence of the detrimental product market innovation and other barriers to entrepreneurship is that spending on R & D as a share of GDP is among the lowest in the Euro area. This is shown in Figure 5.

Figure 5. Gross Domestic Spending on R&D as a Share of GDP in 2004



As a member of the Euro area, Italy has benefited from interest rate convergence. Currently, the spread between German and Italian long-term interest rates is very small, although Standard & Poor's rates Italian debt as AA- with a negative outlook, as opposed to AAA with a stable outlook for Germany. Italy has one of the highest debt-to-GDP

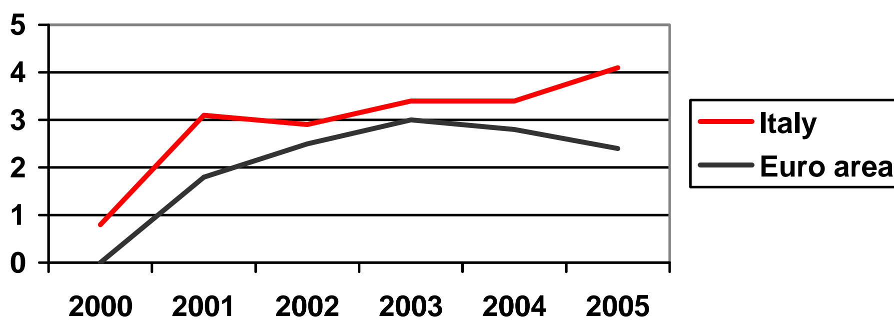
Figure 6. Government Debt as a Percentage of GDP



General Government Consolidated Debt as a Share of GDP. Source: Eurostat.

ratios in the world (shown in Figure 6). This coupled with a profligate fiscal policy in recent years (shown in Figure 7) raises the possibility that at some point the market will demand a substantial risk premium to be willing to hold Italian debt. Significantly higher Italian interest rates would make Italian growth prospects even more dismal than they currently are.

Figure 7. Government Defict as a Percentage of GDP

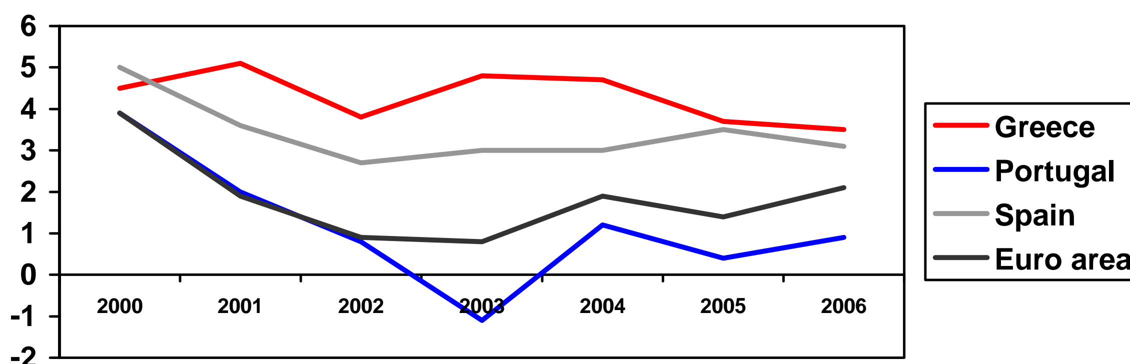


Net borrowing of consolidated public sector as a share of GDP. Source: Eurostat.

Italy is not the only Euro area country that can expect to see diminished competitiveness and lowered economic growth. Spain, Portugal and especially Greece are also characterized by inflexible and distorted economies. As seen in Figure 4, all three of these countries have highly regulated product markets. Spain and Portugal rank 39th and 40th, respectively on the World Bank's Ease of Doing Business Index. In 109th place, Greece is edged out by Uganda (107th) and Nigeria (108th).

Growth in these three countries is shown in Figure 8. Interest rate convergence and catching up initially led to high growth in Portugal and has sustained high growth in Spain and Greece. Growth in Portugal has since declined and growth in the Spain and Greece will not continue without significant economic reforms.

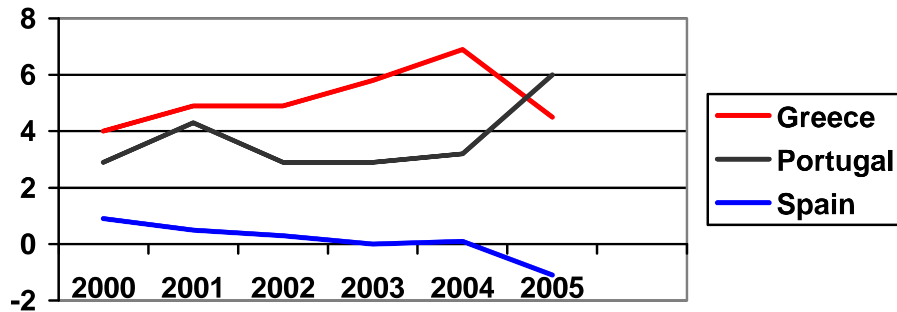
Figure 8. Real GDP Growth (Percentage Change)



Source: Eurostat

Debt-to-GDP ratios for Greece, Portugal and Spain are seen in Figure 6 and their current budgetary policies are shown in Figure 9. Greece and Portugal are in particular danger of higher interest rates and lower growth in the future. Spain at least has a moderate level of public debt and is pursuing a conservative budgetary policy. Portugal has a moderate level of public debt, but is unlikely to maintain this, given its current policies. Greece has an even higher level of government debt than Italy and is also following an unsustainable policy. Standard & Poor's gives Greek debt only an A rating and recent Greek attempts at creative accounting are unlikely to affect market opinion.

Figure 9. Government Defict as a Percentage of GDP



Source: Eurostat

Divergence in competitiveness among member states requires no policy response from the ECB; only the national governments can improve matters by enacting the required reforms. Poor growth relative to the Euro area as a whole will be damaging to monetary union, however, if a one-size-fits-all monetary policy is made a scapegoat for member governments' failures to liberalise.