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EUROPEAN ECONOMIC PERSPECTIVES

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Darren Williams

Europe Economist
Global Economic Research

European Economic Perspectives

Is Italy Becoming The New Sick Man Of Europe?

Fourth-quarter GDP data showed a huge divergence in economic performance among the major euro-area countries. While the French and Spanish economies grew by 0.8% on the quarter, Germany contracted by 0.2% and Italy fell by 0.3%. This continues a pattern we have witnessed for several years, with Germany and Italy lagging behind the rest of the euro area. Looking forward, an improved competitive position makes us more optimistic on Germany than Italy.

Growth divergence in the euro area is not a new phenomenon. Over the last 10 years, average annual economic growth has ranged from 1.2% in Germany and 1.5% in Italy, to 3.2% in Spain, 3.5% in Finland and 7.9% in Ireland. If we exclude Italy and Germany from the euro area, average annual growth over the last 10 years rises from 2.0% to 2.5%.

The divergence in economic peformance is even more striking if we consider final domestic demand[1]. Since the beginning of 1999, final domestic demand has risen by 8.6% in Italy and just 0.4% in Germany. This compares with 14.7% in France and 21.9% in Spain. Germany's final domestic demand growth has been even worse than Japan's **(Display 1).**

Germany and Italy share some features which help explain their weak growth performances. Both have been handicapped by poor demographics **(Display 2)** and by unusually severe regional disparities. Both also possess inflexible labour and product markets. However, as many European countries have similar rigidities, these do not necessarily help explain the growth gap with the rest of the euro area.

Beyond this, it is easier to explain Germany's poor performance. Reunification at the beginning of the 1990s placed a huge burden on Germany in the form of a sharp deterioration in cost competitiveness and the hollowing-out of the construction sector. Both have acted as huge drags on economic growth.

[1] Household and government consumption plus fixed investment.

By contrast, Italy received a massive boost to its competitive position following the devaluation of the lira in the early 1990s. Meanwhile, short-term interest-rate convergence in the run-up to Economic and Monetary Union (EMU) led to a sharp fall in real interest rates from an average 5.5% in the first half of the 1990s to just 0.8% since 1999[2]. The performance of other euro-area countries suggests that Italy should have benefitted much more than it did from the combination of these events.

Germany's saving grace has been the performance of its export sector. Since the beginning of 1999, German exports of goods and services have grown by 46% in volume terms. This compares with 31% for Spain, 23% for France and just 15% for Italy. Some of this can be explained by different rates of export-market growth. However, OECD data show that Germany is the only large euro-area country that has increased its export-market share in recent years **(Display 3)**. Italy's export performance has been terrible.

There are several reasons for this marked divergence in export performance. First, as we noted last year, German companies have now recouped all of the competitiveness lost against the rest of the euro area after reunification. This means that other euro-area countries have been losing competitiveness **(Display 4),** with adverse consequences for economic growth. Indeed, among the countries where competitiveness has fallen the most—Italy, the Netherlands, Portugal and Spain—only Spain has (so far) avoided a hard-landing.

A second reason may be industrial structure. Italian firms are much more exposed to low-cost foreign producers than their German counterparts. European Commission data show that Italian output has a higher input from unskilled (low cost) labour and a lower technological content than production in many other euro-area countries, especially Germany. In

[2] Over the same period, German real interest rates fell from 3.6% to 1.9%. As a result, German real interest rates have gone from being the lowest in the euro area to the highest.

addition, German exports tend to be concentrated in price-inelastic sectors whereas the opposite is true for Italy.

Conclusions

Germany and Italy have been the slowest-growing economies in the euro area for several years and they continue to act as a drag on aggregate performance. Looking ahead, an improved competitive position makes us more optimistic on Germany than Italy. Indeed, in spite of weak nominal GDP growth last year, Germany posted the strongest profits growth among the major euro-area countries **(Display 5).** Although the consumer will be slow to recover, the outlook for corporate Germany is improving.

The outlook for Italy is more worrying. In a sense, Italy finds itself in a similar position to Germany in the immediate aftermath of reunification. However, this is being compounded by the failure of the wage-formation process to adjust to the harsh reality of life within a monetary union. Until this happens, growth is likely to remain weak and could even deteriorate further, especially given Italy's poor demographic prospects.

Darren Williams
Global Economic Research
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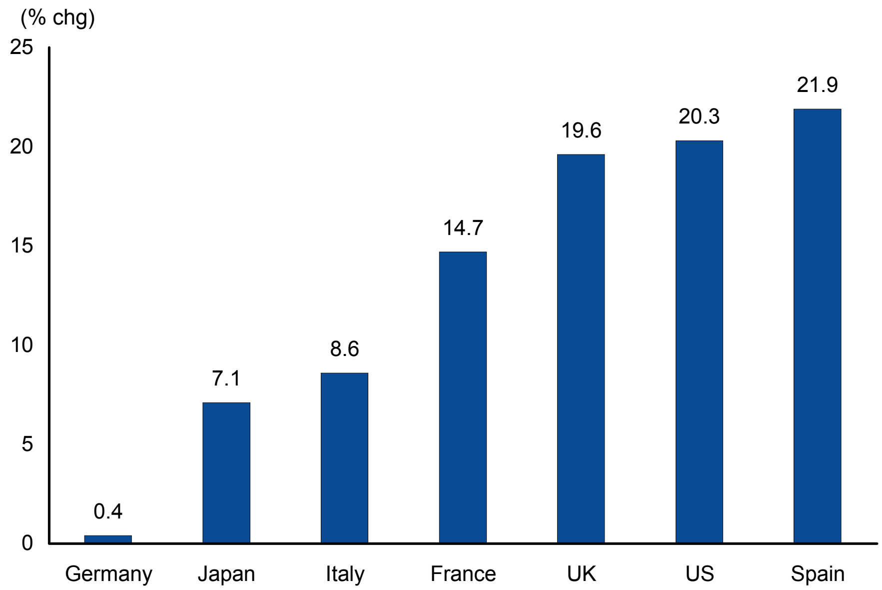
Display 1: German Domestic Demand Has Been Extremely Weak

Cumulative Growth In Final Domestic Demand, 1Q 1999 to 3Q 2004

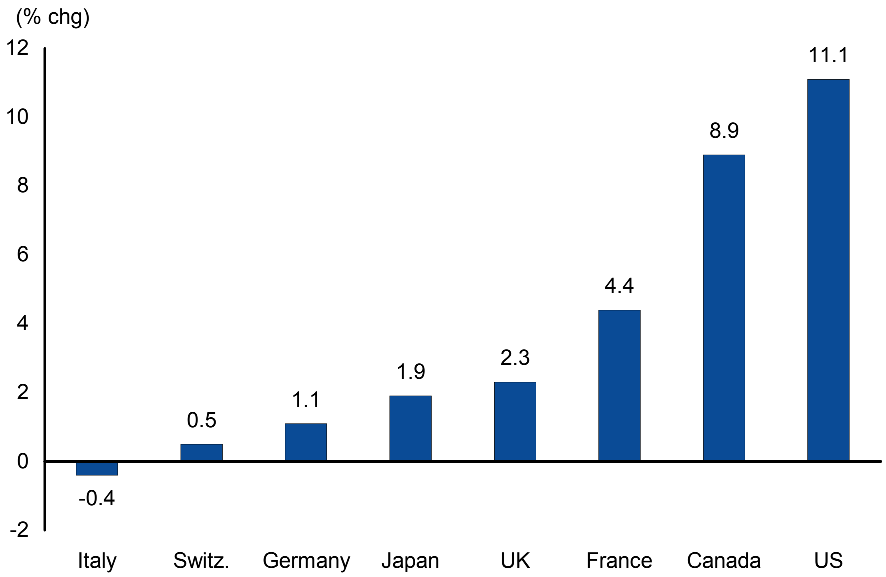


Source: Haver Analytics and Alliance Capital Fixed Income, February 18, 2005

Since the beginning of 1999, German final domestic demand has risen by just 0.4%. This weak performance has been driven by the corporate sector's quest to recoup lost competitiveness, together with structural problems in the construction sector.

Display 2: The Italian Population Is Starting To Contract

Change In Population Between 1995 and 2005E

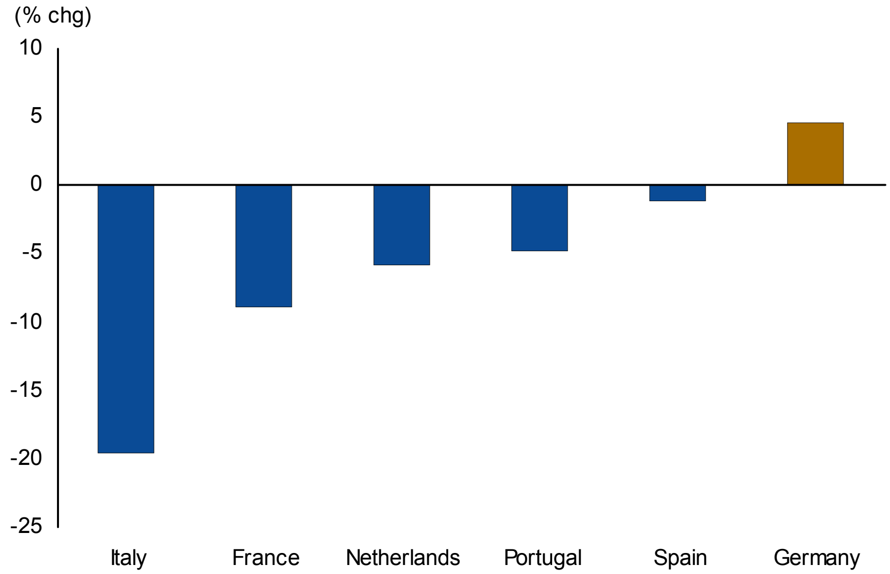


Source: United Nations Population Database, 2002 Revision and Alliance Capital Fixed Income, February 18, 2005

Europe's slowest-growing economies also have the worst demographics. According to United Nations' estimates, the Italian population has declined over the last 10 years.

Display 3: Germany Is Gaining Market Share

Export Performance For Goods And Services: 1Q 1999 to 3Q 2004



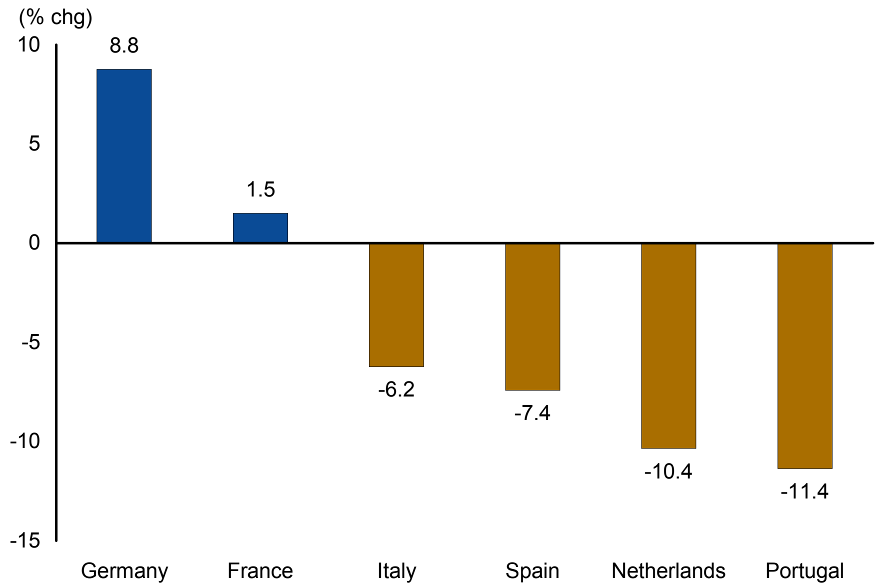
Note: Export performance compares the growth in actual exports to import growth in each country's major export markets. A positive number implies that a country has gained market share.

Source: OECD, Haver Analytics and Alliance Capital Fixed Income, February 18, 2005

Such has been the improvement in German competitiveness that it is the only major euro-area country that has gained market share in recent years. By contrast, Italy's export performance has been terrible. Failure of the Italian wage-formation process to adjust to life within a monetary union hints at deep medium-term problems.

Display 4: Germany Is Gaining Competitiveness

Change In Intra-Euro Area Competivive Positions: 1Q 1999 to 3Q 2004



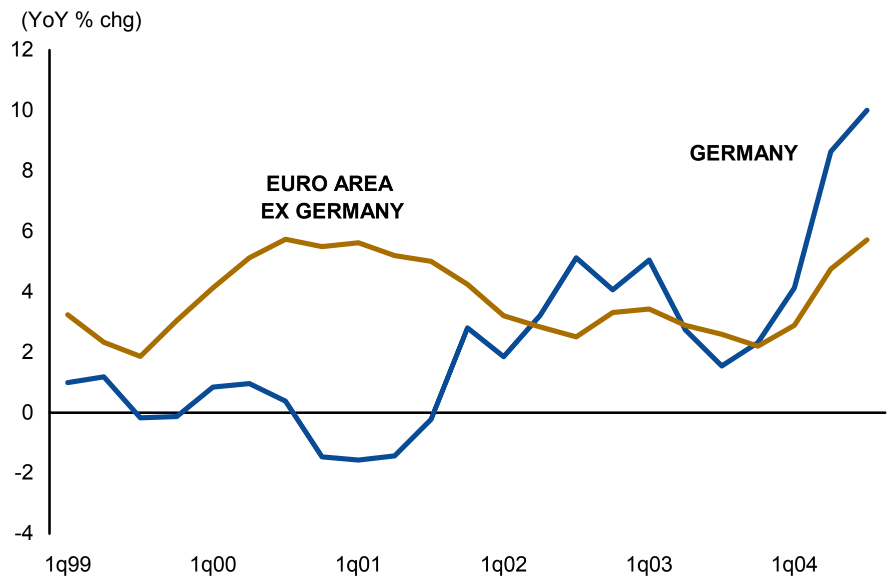
Note: Inverse of the change in relative whole economy unit labour costs against the rest of the euro area. A movement up the vertical axis therefore implies an improvement in competitiveness.

Source: European Commission and Alliance Capital Fixed Income, February 18, 2005

Savage cost-cutting has allowed Germany to gain in competitiveness against its euro-area neighbours. The flip-side of this is that many other euro-area countries have seen their competitive positions suffer. Of these countries, only Spain has so far avoided a hard-landing. However, given continued high wage growth, Spain may eventually run into similar difficulties.

Display 5: German Profits Are Growing Faster Than In The Rest Of The Euro Area

Gross Operating Surplus Growth; 4-Quarter Rolling Average



Note: The gross operating surplus includes self-employment income, some of which is better clasified as wages. The euro area ex Germany is proxied using data from France, Italy and Spain.

Source: Haver Analytics and Alliance Capital Fixed income, February 18, 2005

Although German nominal GDP growth has been weak, downward pressure on labour costs has allowed profits growth to rise sharply. While corporate restructuring should continue to weigh on consumer spending, strong profits growth is likely to give a gradual boost to capital spending.