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EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Euro-Area Growth: Italy Sounds a Discordant Note

Euro-area GDP growth was in line with expectations at +0.5% in the first quarter. However, the rise in aggregate growth masks huge variations between individual member states. Although not all countries have reported, first-quarter growth ranged from +1.0% in Germany to (0.5)% in Italy **(Display 1)**.

Germany's impressive performance owes much to the resilience of its export sector. It is also flattered by calendar-adjustment problems that artificially depressed growth in the fourth quarter. This, coupled with the fact that many of the smaller economies recorded negative growth during the first quarter, means we should treat the euro-area number with some caution.

By far the most worrying aspect of the first quarter was the woeful performance of Italy. Indeed, its 0.5% contraction followed a 0.4% drop in the fourth quarter. The last two quarters were the worst back-to-back quarters since the recession following the lira's eviction from the European Exchange Rate Mechanism (ERM) in 1992.

Earlier this year, we asked if Italy was becoming the new sick man of Europe[1]. We highlighted a number of factors that help explain why Italian growth has been so weak, such as its acute ageing-population problem and its high share of low value-added production. However, Italy's biggest problem is that the wage-formation process has not adjusted to life in a single currency. As a result, Italy has squandered the improvement in competitiveness that followed its exit from the ERM.

Display 2 shows the scale of this problem. Italy's real exchange rate against the rest of the euro area and the other industrial nations (as reflected by inflation differentials) has trended higher since the mid-1990s. It is now back close to levels immediately preceding its exit from the ERM. This has had a profound negative impact on Italy's export market share, which has collapsed, and industrial production, which is not much higher than it was a decade ago **(Display 3)**.

When Italy's real exchange rate hit similar levels in 1992, the authorities responded by devaluing the lira and tightening fiscal policy. The economy initially slowed sharply, but the boost from the exchange rate and lower short-term interest rates allowed it to post a speedy recovery.

This policy response is not available today. Membership in the single currency means that exchange-rate devaluation can be ruled out, at least against the other euro-area countries, which account for half of external trade. Moreover, the structural weakness of the US dollar means there will be only limited respite against currencies outside the euro area.

Therefore, the only way for Italy to regain lost competitiveness is to follow the German model. This means holding wage growth below that of its main trading partners for an extended period of time. As we have seen in Germany, this will have a prolonged negative impact on consumption.

Conclusions

For several years, Germany has been the euro area's weakest economy. This mantle is now being passed to Italy. It may be that the first quarter represents the low point for Italian growth, but any recovery is likely to be modest, and Italy will probably to continue to lag well behind the rest of the euro area. Indeed, Italy's predicament may be even worse, given the dire state of its public finances and the need to reduce its budget deficit in a low-growth environment **(Display 4)**.

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[1] See European Economic Perspectives, 18 February 2005.

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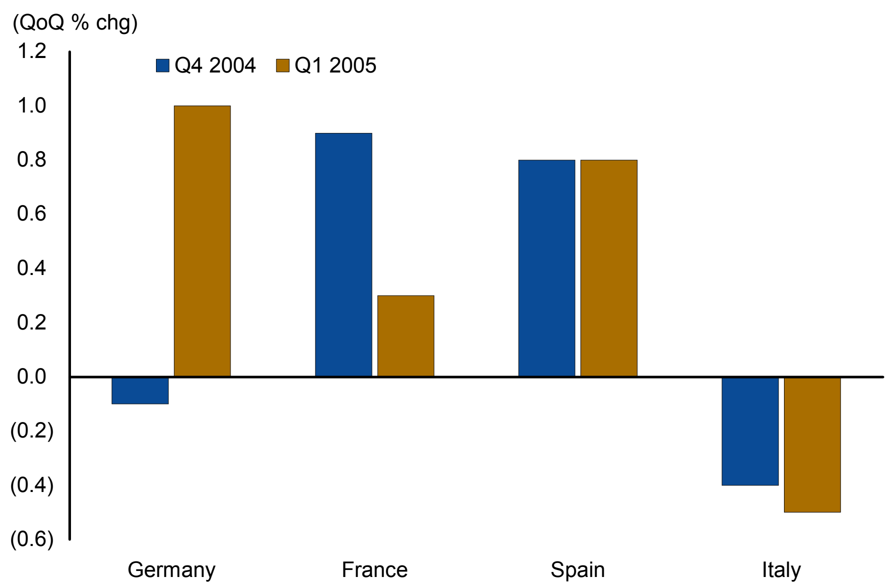
Display 1: Euro-Area Growth Diverged Markedly in the First Quarter
Real GDP Growth

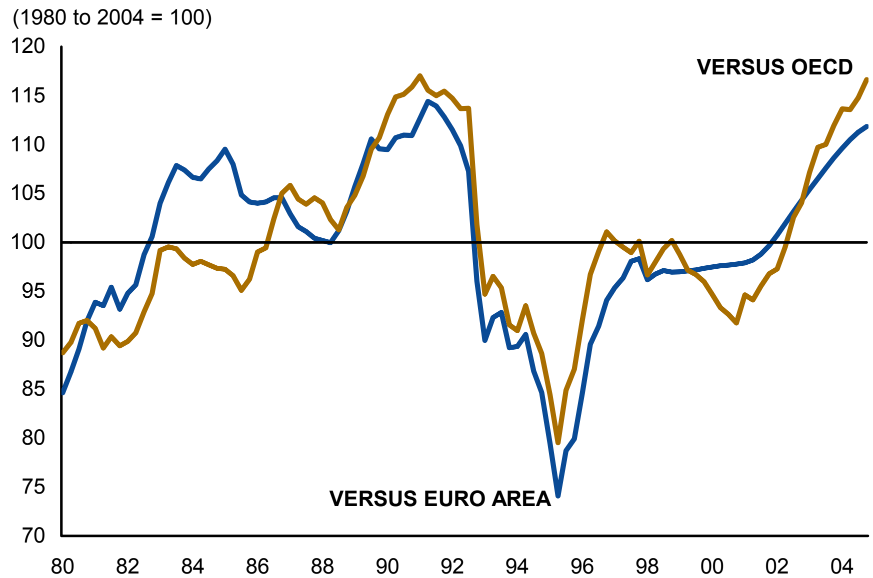


First-quarter data for France and Spain are Alliance Capital Fixed Income estimates.
Source: Reuters and Alliance Capital Fixed Income

Although euro-area growth returned to its trend rate of 0.5% in the first quarter, there was significant divergence between individual countries. As in the fourth quarter, Italy continued to be the worst performing euro-area country.

Display 2: Italian Cost Competitiveness Has Deteriorated

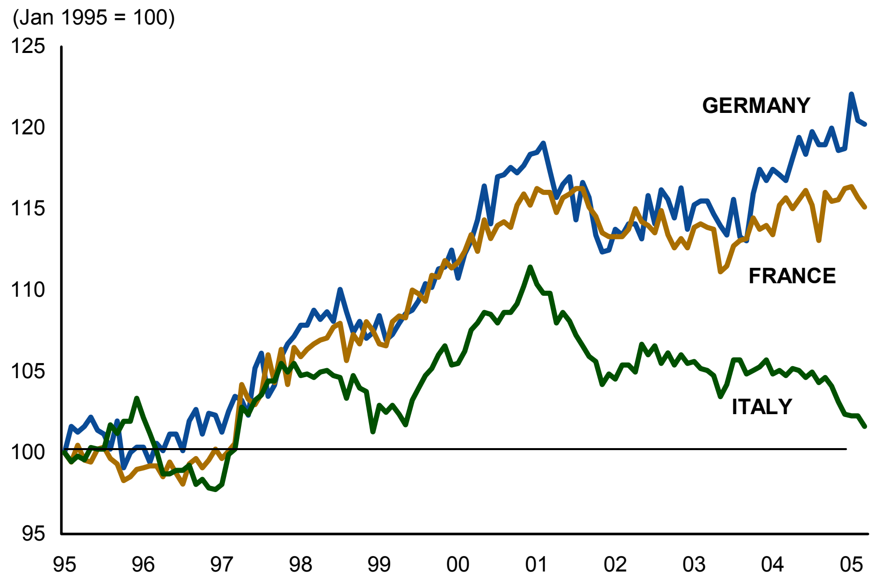
Real Exchange Rate Deflated by Manufacturing Unit Labour Costs



Source: European Commission and Alliance Capital Fixed Income

Italy has now lost the competitiveness it gained in the mid-1990s. Indeed, its real exchange rate is now close to its level immediately preceding the exchange rate's collapse in 1992.

Display 3: The Italian Industrial Sector Has Underperformed
Industrial Production in the Main Euro-Area Countries

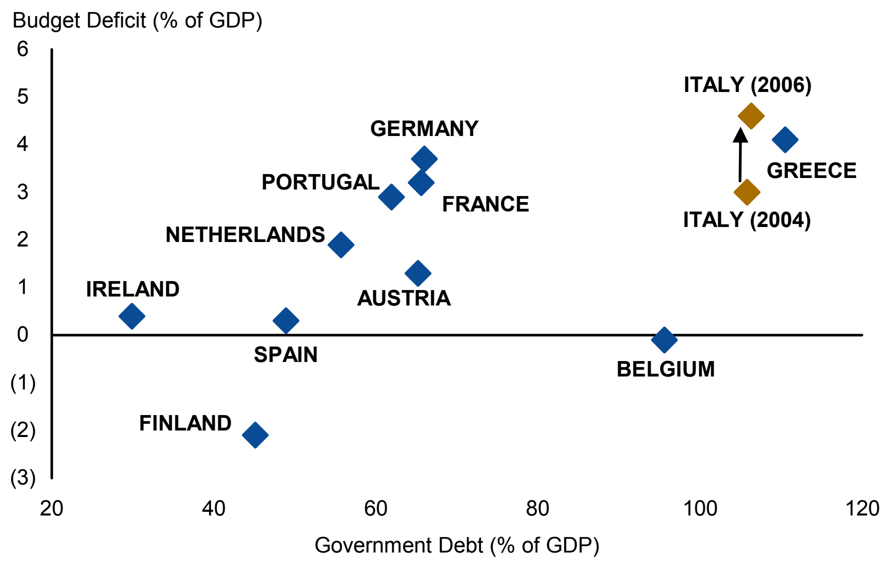


Source: Haver Analytics and Alliance Capital Fixed Income

Although French and German industrial production have followed similar trends, Italy's industrial performance has been terrible. Its output is almost down to its level in the mid 1990s.

Display 4: Italy's Fiscal Position Is Amongst the Worst in Europe

Government Debt and Government Deficits in the Euro Area, 2004



Source: European Commission and Alliance Capital Fixed Income

European Commission forecasts show the Italian budget deficit rising to 4.6% of GDP in 2006 from 3.0% in 2004. This forecast is based upon higher growth than now seems likely. Moreover, the Commission has pointed to irregularities that mean the official data might be understating the true scale of the budget shortfall.