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# Spotlight

## GROWTH IN ITALY

### Italy: Structural impediments to growth not being addressed

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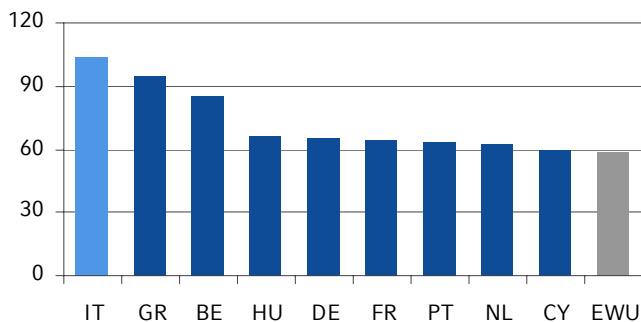
Italy's economic boom belongs to the past. Whereas Italy's economy grew at an annual rate of 2.6% in the 1980s, it has expanded by only 0.8% a year since 2000. The recently published Q1 figures confirm this trend, with merely 0.2% y/y growth. Italy elected a new government in mid-April, and Silvio Berlusconi, the new prime minister, has set economic recovery as his top priority. Reforms that address the structural weaknesses of Italy's economy are needed in order to ensure a sustainable recovery.

#### Stable government majority

#### Consolidation of parties

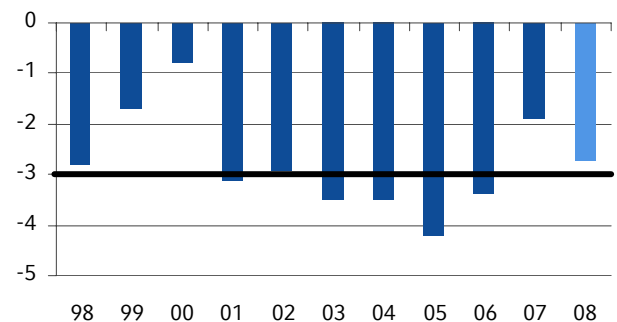
For many years, political instability prevented the implementation of long-term sustainable reforms. The only post-war government to survive the entire legislative period was that of Silvio Berlusconi from 2001 to 2005. The heavily fragmented party landscape and multi-party coalitions – the previous government coalition under Romano Prodi consisted of seven parties – prevented the implementation of long-term sustainable economic policies. On this score at least, there have been a few changes since the general election in April. Following the merger of the two major leftist parties to the Democratic Party, the left-wing and the right-wing camps consolidated around two main groups, with Berlusconi's Forza Italia being the strongest party among the right wingers. There are currently only eight parties represented in the Italian parliament (plus three regional parties with only 1-2 seats). Berlusconi's coalition government, which consists of three parties, enjoys a comfortable majority in the House and in the Senate. This bodes well for a stable government, one that will survive a full legislative period. Thus, for the first time in years, the political foundations have been laid to push through sustainable reforms.

#### General government gross debt % of GDP



Source EcoWin, WestLB Research

#### Budget balance % of GDP



Source EcoWin, WestLB Research estimates

#### Ailing public finances

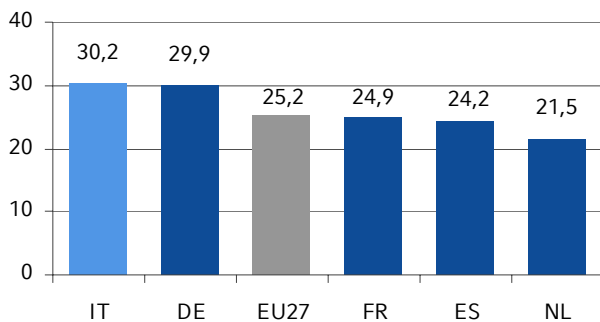
#### Consolidation of parties

The government's capacity to act is severely constrained, however, by Italy's high public debt. With debt totalling 104.0% of GDP, Italy far exceeds the EU27 average of 58.7%

and is also well above the second-highest rate of 94.5%, which belongs to Greece. Thus, the government annually spends nearly 5% of GDP – or roughly 10% of its total revenues – on interest payments. If Italy were able to reach the Maastricht debt ceiling of 60% of GDP, its interest burden could be reduced by half.

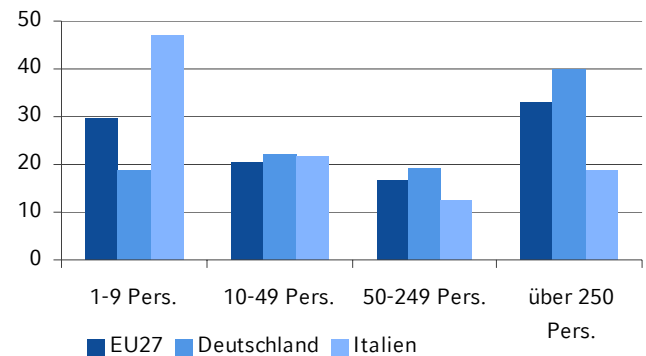
**Restrictive fiscal policy needed** Not only is the government's room for manoeuvre limited by the current level of interest payments, but also the need to reduce its debt burden means that spending must be kept low in order to achieve the targeted medium-term budget surpluses. A restrictive fiscal policy would be needed in order to reduce the public debt; however, this would further aggravate Italy's growth problems – for the short term at least. The consolidation of public finances is making slow headway as a result. Although total debt has been reduced by roughly 10 percentage points since the inception of the monetary union, we do not foresee current budget surpluses for some time. To the contrary, Italy is approaching the critical 3% level again this year.

### Old-age-dependency ratio in %



Source EcoWin, WestLB Research

### Employment by company size Share in %



Source EcoWin, WestLB Research

### Shrinking potential labour force

#### Aging population

Not only is an unfavourable demographic structure a drag on the public purse, it also reduces the potential labour force. Italy has the highest old-age-dependency ratio in the EU (the ratio between the population older than 65 to the working-age population (15-64 years old), followed closely by Germany in second place. For this reason, the pension reform to put the system on a long-term sustainable footing has been a long-standing issue. Moreover, based on calculations of the Italian National Statistical Institute, the number of people who (potentially) left the labour market exceeded the number who (potentially) entered by 12% due to Italy's overaging population. The reduction in potential labour force has a corresponding negative impact on Italy's growth prospects. A pronounced regional gradient also has an influence on employment and unemployment. From north to south, the employment rate trails off sharply, accompanied by a corresponding increase in unemployment.

### Small enterprises are predominant

#### Many small and very small enterprises

Another distinctive feature of Italy is that small and very small enterprises dominate the economic landscape, with 70.9% of the value added of the non-financial sector of Italy's industrial economy generated by SMEs (as per 2005), compared to only 53.2% in Germany. In the past, this size structure was frequently cited as an advantage, as smaller enterprises are able to respond more rapidly and flexibly to changing market conditions.

On the other hand, they are unable to achieve economies of scale; hence, price competitiveness is reduced. With globalisation on the rise, price wars have intensified, leaving Italian companies at a competitive disadvantage owing to their smaller size. As a result, research and development spending is also down, as generally only larger companies are able to afford development departments of their own.

In addition, Italy's economic development continues to be hampered by antiquated structures and the absence of competition in some sectors, as well as strong regional differences (north-south gradient), corruption and the negative impact of organised crime, which renders market-based processes ineffective, particularly in southern Italy.

### **No sweeping reforms planned**

#### Proposed tax cuts

The stimulus package proposed by the new government focuses on reviving the economy primarily through tax cuts, including the elimination of the homeowners tax and overtime tax. Also planned are amendments to the pension reform passed under the Prodi government and the elimination of the IRAP regional tax. The entire package of measures worth €4bn is to be counter-financed by spending cuts so as not to overburden private households. Accordingly, sweeping structural reforms are not on the agenda. The risk remains that the opportunity presented by the current political stability will be allowed to slip away and that only a policy of small steps will continue to be pursued. As a result, Italy's structural growth weakness is likely to persist in the coming years as well. We look for a growth rate of roughly 0.5% this year. The government's stimulus package is not expected to provide a boost to the economy before next year at the earliest, raising the growth rate to 1%.

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