



Italy and Germany Convergence or divergence for the euro laggards?

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Abstract

Germany and Italy have been the laggards in terms of growth since the start of EMU in 1999. Both have had problems bringing their public finances under control and both have recently had elections without a clear cut winner. However, these similarities mask a number of diverging trends which are likely to put the two countries soon on quite different trajectories. The diverging trends, whose effects are only becoming visible now, concern the structure of public finance, real estate markets and international price competitiveness. On all three accounts the path taken by Italy since 1999 is not sustainable and is likely to lead to serious problems over the remainder of this decade. Germany, by contrast, has laid the basis for solid growth.

The key reason for this divergence seems to be a difference in the openness of the economic and political systems of the two countries: Germany has become much more open, especially in economic terms whereas the Italian economy and its political system have remained relatively closed.

Does this imply that Italy is on the brink (of a major disaster)? This does not seem to be the case. The loss of competitiveness, while real, is probably smaller than widely believed and the budget could be brought under control by a determined government. Italy seems to be moving slowly towards the brink, but it is still time to prevent it from reaching it.

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Introduction

Italy and Germany have been on the bottom of the euro growth league since 1999, with growth rates around 1.1-1.2 % compared to around 3 % for the rest of the Euro zone. Both have had problems bringing their public finances under control and both have recently had elections without a clear cut winner. In both countries the incoming government seems to be serious about addressing the fiscal problem, but does not seem equally determined and able to undertake structural reforms, especially reform of the labor market or the health system. Another similarity is that in both countries the new government has taken a much more positive stance on European issues. Table I below summarizes the main indicators of macroeconomic performance.

Table I: The macro performance of the laggards compared since the euro

	Growth rates		Fiscal policy
	Real GDP	Domestic demand	Deficit as % GDP
Rest of Euro zone	3.0 %	3.2 %	1.2
Italy	1.1 %	1.6 %	3.5
Germany	1.2 %	0.5 %	3.4

Source: own calculations based on WEO and AMECO data.

Rest of Euro zone: unweighted average excluding Luxembourg.

Fiscal policy: average 2001-2006 to avoid the distortion due to the mobile phone licenses in 2000.

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The next section looks at Italian public finances in a European perspective. The following section documents the difference in the evolution of housing markets. Section 3 provides some new evidence on the size of the loss of competitiveness experienced by Italy since the start of EMU. Section 4 then documents the growing difference in

openness between the two countries and argues that it is likely to be a factor behind a divergence in fundamental political choices.

1) Public finances on both sides of the Alps: a European comparison.

Both Italy and Germany have been violating the Stability and Growth Pact for some time, whether in form (Germany), or in substance (Italy). But the similarity ends here. The underlying trends have been quite different.

1.1 Low growth as a constraint on fiscal policy

In 2005 (last year with complete data) Italy had the second highest deficit and the second highest debt level in the Eurozone. One can thus find countries that have done worse. But Italy is unique with (in) its combination of high debt and low growth potential. Moreover, the gains coming from lower interest payments in EMU have been 'spent' already through higher expenditure elsewhere, so that there is little scope for tax reductions. This is in contrast to other member countries (also with a low growth potential), particularly Germany, where expenditure has been reduced so that there is room for tax reductions without increasing the deficit to unsustainable levels. With this unfavorable starting point it will remain much more difficult for Italy to respect the Maastricht parameters and to reduce the tax burden than for other member countries.

The constraint weak growth imposes on fiscal policy can be illustrated by looking at the steady state debt/GDP ratio that results from different combinations of deficits and growth rates. Table 1 below (drawn from Gros et al. 2005) shows that a low growth potential has huge implications for the sustainability of fiscal policy.

Table 1 shows that for a slow growth economy like Italy deficits of only 2% of GDP would be the maximum allowable as this would barely keep the debt to GDP ratio close to the 60% limit. Continuing deficits of 4% of GDP would keep the debt level roughly constant at the present level. The potential growth rate of 1.5 % assigned to Italy in this table is the one that has been used by the Commission, a figure that has also been incorporated into the latest DPEF.

Table 1.1 Steady state debt levels (as % of GDP)

		Cyclically adjusted deficit in % of GDP			
		2%	3%	4%	5%
Trend growth of real GDP in % p.a.	Italy (Germany?): 1.5%	57	86	114	143
	EU today (?): 2%	50	75	100	125
	Maastricht: 3%	40	60	80	100
	Italy with price adjustment (1 % lower inflation)	80	120	160	200

Source: Own calculations.

The calculations assume an inflation rate of 2% so that nominal GDP growth is 2 percentage points higher than the real rates indicated in the first column (except for the last row).

Slower growth thus implies a much tighter long term constraint on fiscal policy.¹ Table 1 also contains a last row entitled ‘Italy with price adjustment’. In this row it is assumed that Italy has to have a 1 % lower inflation rate than the average of the eurozone. Indeed, one can argue that this is what Italy needs over the next decade in order to regain the competitiveness it lost, especially vis-à-vis Germany. It is apparent that in this case the solvency constraint becomes even tighter. In such a scenario, which combines low growth and very low inflation, the debt/GDP ratio would tend to increase towards 120 % of GDP even if the deficit were kept at 3 % of GDP. If the deficit were to stay close to 5 % of GDP the debt ratio would go towards 200 % of GDP.

A combination of slow growth and low inflation to regain competitiveness is a likely scenario for Italy over the next decade. It follows that Italy has even less leeway than most of its partners in the EU to run large deficits.

1.2 How heavy is the debt burden?

One could sell Italy on the basis that others have done worse: over the last decade the share of Italy in the total public debt of the Euro zone has actually declined somewhat whereas that of France and Germany has increased.

¹ It is important to keep in mind that the long term solvency of fiscal policy is determined by overall growth, not growth on a per capita or hourly basis. This is one of the many ways in which the long term demographic decline of Italy exerts its negative effects already today.

In 1998, just before the start of EMU Italian public debt accounted for about 28 % of the total of the Euro zone countries. Now this share has actually somewhat fallen, to 27 %, equal to that of Germany (which had been somewhat lower, at 26-27 %). The share of France has also increased strong recently. In this sense it appears that Italy has done less badly than the other two large Euro zone economies.

However, the comparison with France and Germany might be misleading since Italy started with a much higher debt to GDP ratio and thus had an obligation to reduce it towards the Maastricht reference value of 60 %. Hence one should compare Italy to the other two high debt countries in the Euro zone: Belgium and Greece. On this account the comparison is less flattering. When EMU started Belgium, Italy and Greece had roughly the same debt to GDP ratio. But the Belgian ratio is now about 15 percentage points lower than that of Italy, whose value remains very close to the Euro zone's basket case in terms of public finances, namely Greece.²

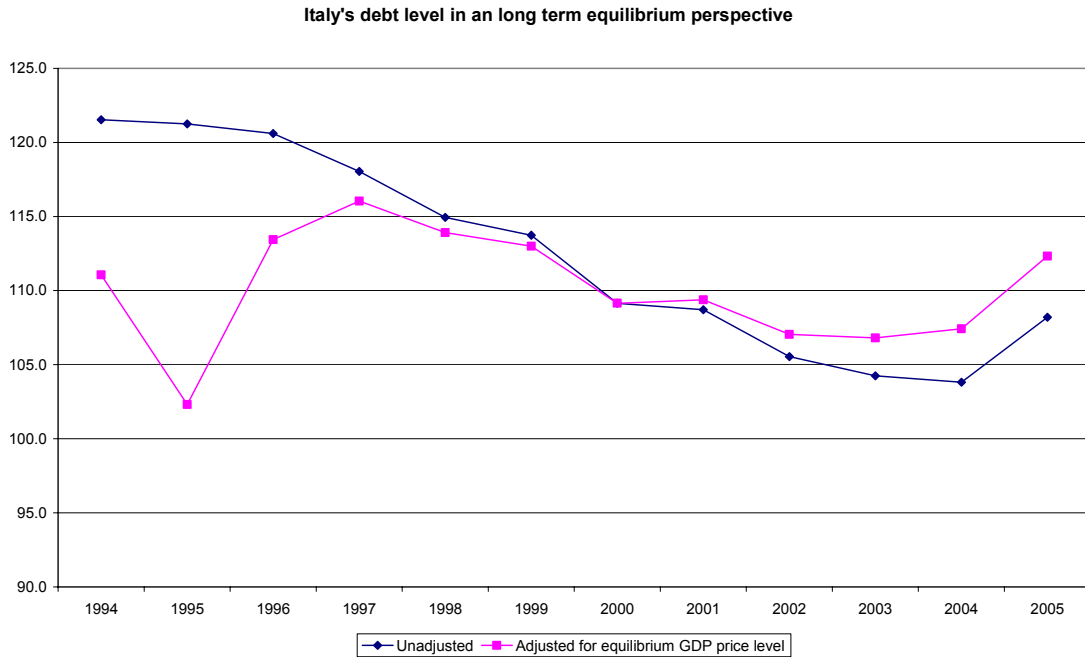
The raw numbers thus suggest that Italy has barely been able to stabilize its debt/GDP ratio at a dangerously high level. But this description does not capture fully the problem because the current value of the denominator of the debt/GDP ratio, namely nominal GDP, is probably not at its long term equilibrium. Part of the increase in nominal GDP in Italy is not sustainable since it reflects just a loss of competitiveness. When this has to be corrected prices will have to increase less in Italy than in the rest of the Euro zone, implying that nominal GDP will grow less (even assuming real GDP can grow along its potential).

In a longer term perspective one should thus look at the evolution of the debt ratio by relating debt to GDP evaluated at a competitive price level. This is done in figure 1.1 below, which shows the debt/GDP ratio as conventionally measured and the debt to GDP ratio that results if one assumes that Italian prices had increased in line with the Euro zone average.³ On this basis the Italian debt ratio is now roughly back to the level it was when EMU started. Since 1999 the difference between the adjusted and the unadjusted figures is around 5 percentage points. The loss of competitiveness over this period has thus covered up the deterioration in public finances by an amount that is equivalent to a deficit of around 0.8 % of GDP every year.

² Another question one might ask is whether the evolution of Italian public debt was Maastricht conform. As is well known among economists the combination of the Maastricht parameters of a debt ratio of 60 % of GDP and a deficit of 3 % of GDP implies that trend-wise the debt GDP should decline towards the 60 % level. However, this has not been the case for Italy. As shown by Gros (2006), since the start of EMU Italy's debt ratio should have declined to around 98 % if the Maastricht parameters had been fully observed. However, debt is now about 10 % points of GDP higher than that. By contrast, Belgium, which had to share the same weak environment as Italy, did observe the Maastricht parameters as its debt level is now below 95 % of GDP.

³ This is the traditional debt/GDP ratio multiplied by the ratio of the shares of Italy's GDP in the GDP of the eurozone in nominal and in real terms ($\text{nominal GDP}_{IT}/\text{nominal GDP}_{\text{euro}}/(\text{real GDP}_{IT}/\text{real GDP}_{\text{euro}})$).

Figure 1.1



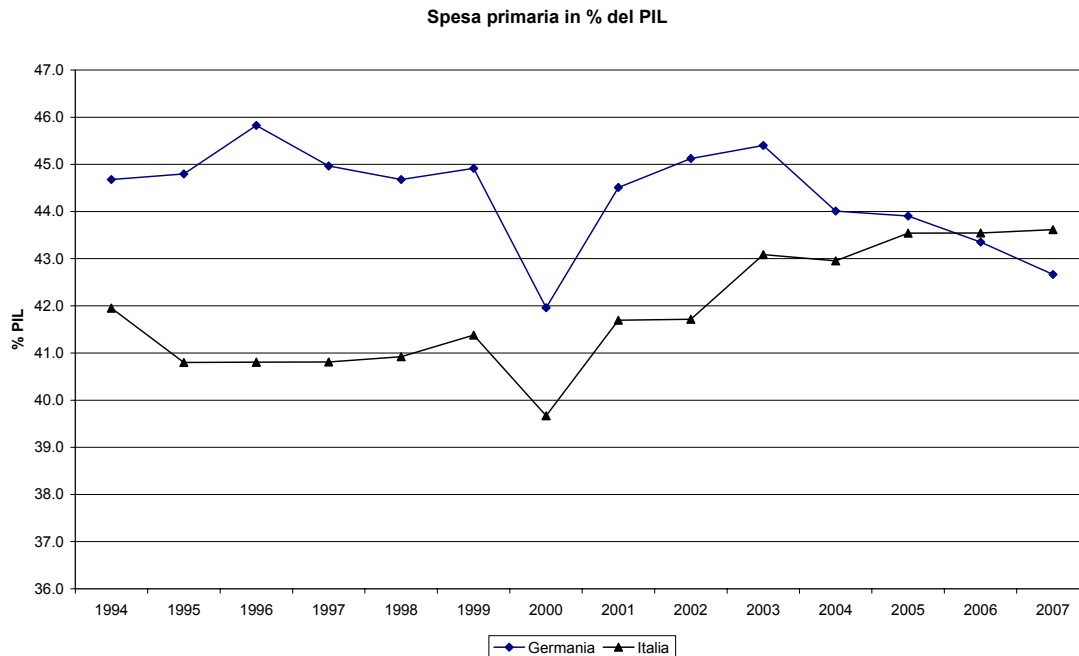
Source: AMECO

1.3 Where have all the interest savings gone? How to squander a gift

One of the biggest advantages of joining the EMU was for Italy the bonus it got in terms of lower interest expenditure, as the differential between BoTs and Bunds fell from 400-500 basis points to close to zero. During the early 1990s interest payments on public debt amounted to over 11 % of GDP. By 2005 this had declined to 5 % of GDP, a gain of about 6 % of GDP. But total public expenditure did not decline over this period. It follows that other (primary) expenditure must have increased over this period (by about the same amount). This implies that most of the gains from lower interest rates the Italian Treasury was able to reap over the last years have been used to finance higher primary expenditure. Other countries which also reaped a large gain from lower interest rates (such as Portugal and Greece) also increased primary expenditure, but the eurozone average went the other way. In particular, Germany stands out because it significantly reduced primary expenditure over the EMU period (by about 1.5 % points of GDP, with more reductions planned for 2006). Figure 1.2 below shows the evolution of primary expenditure as % of GDP for Italy and Germany over the last decade. During the early 1990s the difference of about 5-6 % points did correspond to the difference in interest expenditure. However, by now primary expenditure in Italy is at the same level as in Germany, while Italy has to pay about 2 percentage points more in interest on its public debt, which is much higher. Italy has thus lost a lot of ground vis-à-vis Germany, not

only in terms of competitiveness, but also in terms of public finance and the ability to reduce the tax burden.

Figure 1.2 Primary expenditure as % of GDP



Source: AMECO

The fact that the overall level of expenditure has not been reduced in spite of the gains through lower interest rates is important because it implies that there remains no room for reducing taxes in Italy. Expenditure is the most reliable indicator of future tax pressure because if (total) expenditure fluctuates constantly in a narrow range of 48-49 % of GDP taxation must yield, on average, also about 48-49 % of GDP.

The Berlusconi government made much of the slight fall in tax pressure (total revenues as a percentage of GDP) it achieved over the last years. This claim was always empty. If expenditure stays high, taxes will have to be increased sooner or later to make up for the shortfall. This is exactly what is happening right now.

With the new government Italian public finances will become more transparent. The new Minister of Finance will certainly break with the tradition of creative accounting and one-off operations, which have so often been used to reduce the deficit. However, the starting point is difficult with a much higher debt burden than Germany, but a higher level of primary expenditure that needs to be financed somehow.

1.4 Preparing for lower revenue growth

As will be discussed in more detail below the composition of growth has been quite different in Italy and Germany. In Germany net exports have contributed about 5 % of GDP since the start of EMU (the current account swung from a deficit of close to 1 % to a surplus of close to 4 % of GDP) whereas Italy experiences a swing in the opposite direction of about 2 % of GDP (from a small surplus in 1998 to a small deficit in 2005). The difference in the contribution of external demand amounts thus to about 7 % of GDP. The composition of growth has important implications for fiscal policy since the home countries does not levy VAT on exports. It is not easy to estimate precisely the exact importance of this effect, but with VAT close to 20 % (in Italy, and soon also in Germany) and taking into account that parts of consumption have lower rate of VAT, one can conclude that the difference in the composition of growth should be worth a difference in government revenues of close to 1 % of GDP. It will thus be relatively much easier for the German government to get its deficit under control once the drivers of growth change to domestic demand in Germany.⁴

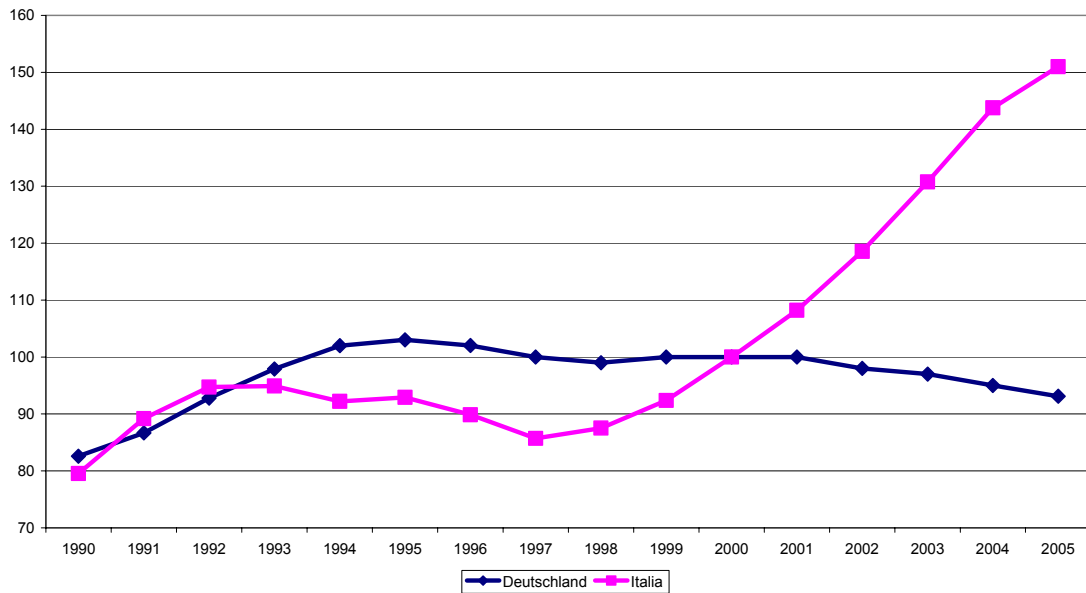
2) Housing markets on a different trajectory

One key difference between Italy and Germany, is the evolution of the real estate sector. The key facts here are quite simple: in Germany real housing prices peaked around 1995, and then declined slightly in nominal terms (and more strongly in real terms) whereas Italy has experiences an unprecedented boom in the housing sector over the last decade. Figure 2.1 shows that since the year 2000 house prices have increased by almost 50 % more in Italy than in Germany. It is apparent that the steep increase over the last year cannot continue for long.

Figure 2.1

⁴ This argument is valid at constant rates of VAT. It should not be confused with the increase in VAT rates decided by the new German government.

Nominal House Price Index

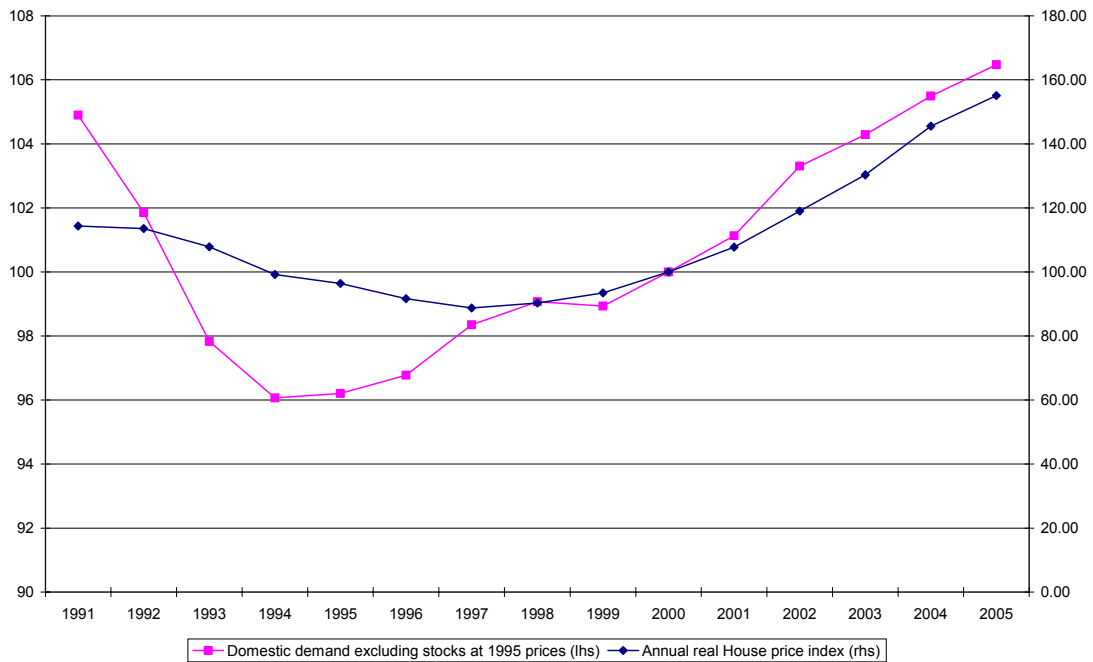


Source: Own calculations based on OECD data

This difference in the evolution of house prices had important macroeconomic consequences. As shown in Gros et al. (2006)⁵ there is a strong correlation between house prices and private consumption. This is natural as most households in Italy own their place of living and will feel richer when they know that its value has increased. Consumption is thus likely to increase even in the absence of US style mechanisms to extract equity from house ownership via the re-pricing or extension of mortgages. The opposite mechanism seems to have operated in Germany where the real value of housing has been declining for almost a decade. As Figure 2.2 below shows relative housing prices and the relative evolution of domestic demand were almost always closely linked. The only exception was the period of exchange rate turbulence surrounding 1995 (In statistical terms they are highly correlated, with a correlation coefficient of close to 90 %).

Figure 2.2 Domestic Demand and Real house price index compared: IT/DE

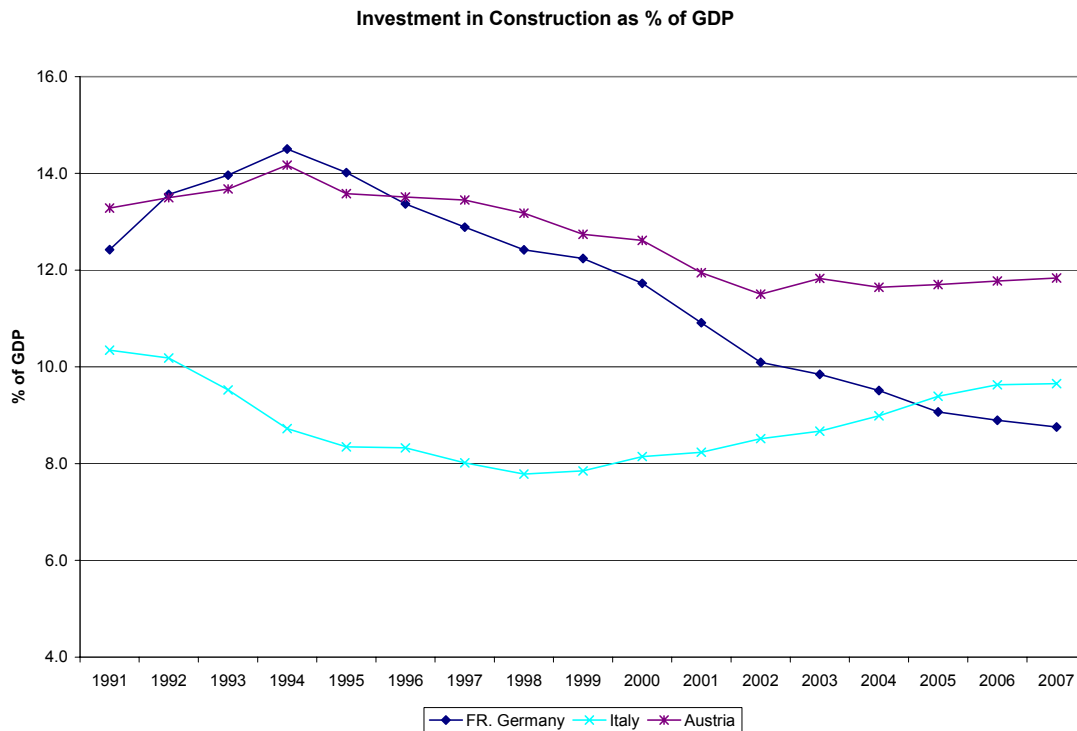
⁵ See “A world out of balance?”, a special report of the CEPS Macroeconomic Policy Group, May 2006.



Source: AMECO and OECD

House prices influence not only private consumption; their evolution also has a direct influence on the incentive to build new homes. This has certainly played a role also in the relative evolution of construction investment in the two countries shown in figure 2.3 below. In Germany construction investment declined from over 14 % of GDP at the height of the post-unification boom to less than 9 % - a drop of over 5 percentage points of GDP. Italy, by contrast experienced rebound in construction investment about the same time as housing prices turned in 1997, i.e. once membership of EMU was on the horizon.

Figure 2.3

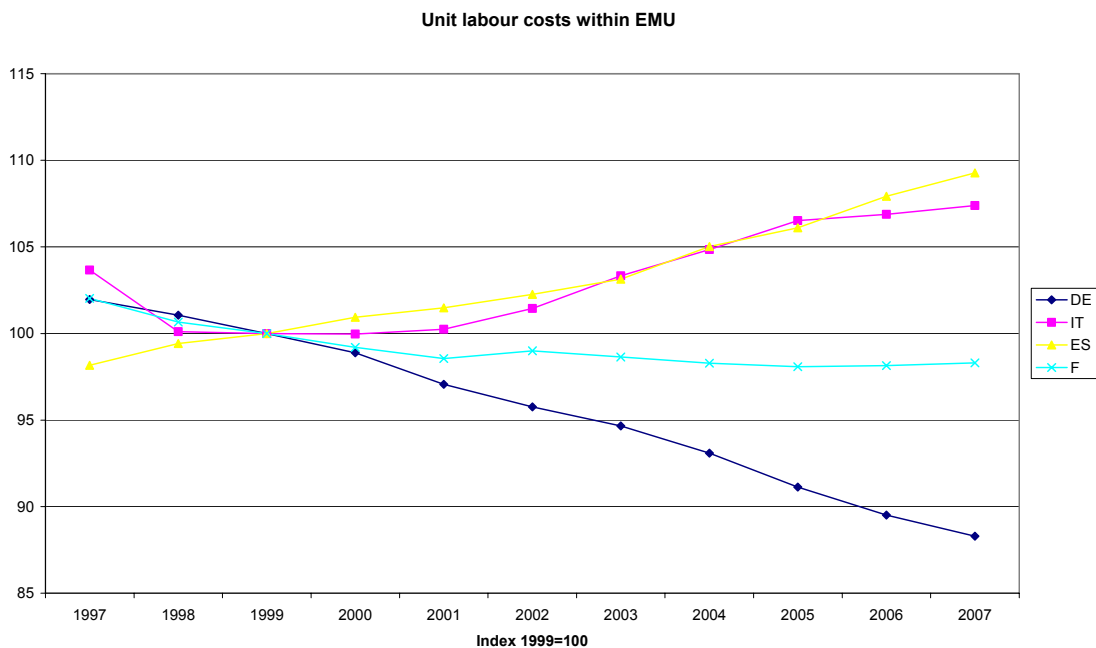


Source: AMECO

3) Competitiveness: the real issue?

It is by now widely recognized that Italy has continuously lost competitiveness since the start of EMU as, despite lower growth, costs and prices have increased by more in Italy than the Euro zone average and much more than in Germany. Most observers have focussed so far on one particular measure of competitiveness, namely unit labour costs. This indicator is used in figure 3.1 which shows by how much costs in Italy have increased compared to its main competitors within the euro area. Figure 3.1 shows how Germany and Italy are at the opposite extremes with respect to their evolution of competitiveness. A bilateral comparison would reveal a difference of well over 20 % in terms of unit labour costs since the start of EMU.

Figure 3.1



Source: AMECO

The loss of competitiveness in terms of unit labour costs is well known. What is less well known is that only part of the loss of competitiveness comes from higher wages, an important part is due to the dismal performance of Italy in terms of productivity.⁶ However, official measures of productivity might be biased by recent developments in Italian labour markets. Officially measured employment in Italy has recently increased, especially during 2001/2003. Most experts agree that a large part of this phenomenon is due to the 'regularization' of employment relations that had previously been unrecorded and had thus not appeared in the statistics. Since the Italian output statistics already contain a large allowance for the underground economy this implies that the regularization of informal employment will lead to lower measured productivity and hence higher unit labour costs. This implies in turn that in the case of Italy it would be misleading to measure the loss of competitiveness using relative unit labour costs.

Relative unit labour costs are thus likely to overstate the loss of competitiveness of the Italian economy. Relative wage levels might provide a lower bound since a straight comparison of wages would provide a good approximation of competitiveness if

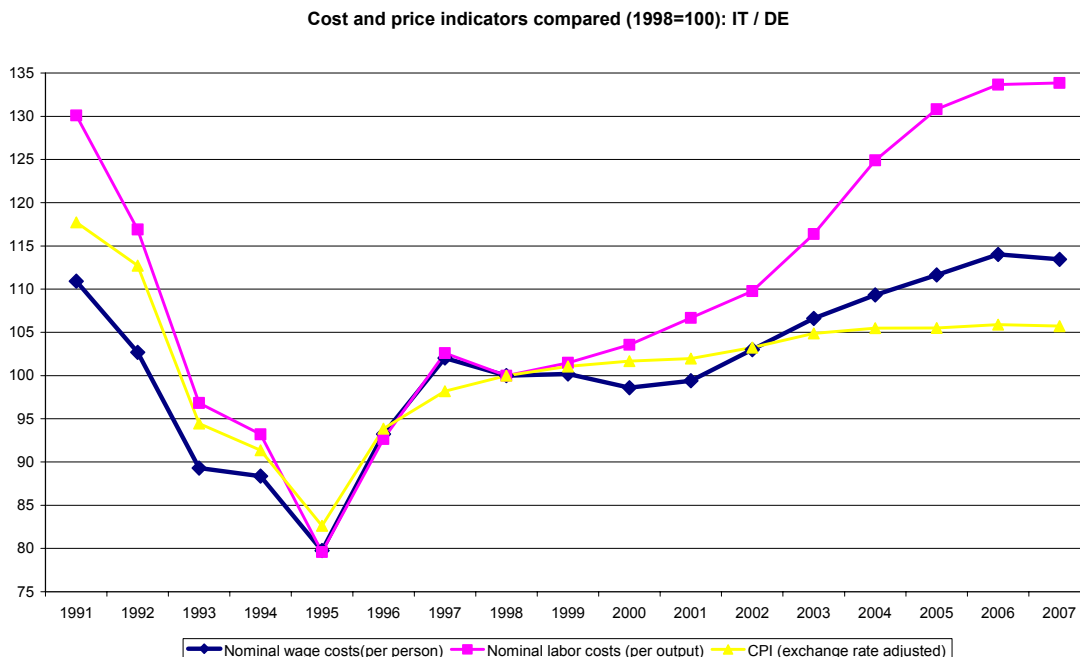
⁶ A reminder: Nominal unit labour costs are the ratio of nominal hourly labour costs (compensation of employees plus payroll tax and fringe benefits tax less employment subsidies, per hour worked by wage and salary earners) to average hourly productivity (real gross product per hour worked by all employed persons). With some arbitrary year chose as the base= 100. Real farm unit labour costs are derived by deflating nominal unit labour costs by the derived implicit price deflator for gross national product. (Again using some year, usually 2000 as the base = 100.)

productivity is growing at the same rate everywhere. Chart 3.2 therefore provides a comparison Germany/Italy for two cost indicators and one price indicator: the cost indicators are nominal unit labour costs (per unit of output) and nominal wage costs (per person). The price indicator is the broadest one, namely the consumer price index.

Figure 3.2 shows that based on unit labour costs Italy would now have lost over 30 % in competitiveness since the start of EMU. However, looking only at wage costs per person the difference is ‘only’ about one half, i.e. around 15 % - but the level is now close to the one reached in 1991, just before a speculative attack forced the government to abandon the European Monetary System and accept a large devaluation of the lira.

Looking at the CPI yields an even less worrying picture in the sense that since 1998 the Italian consumer price index has increased only about 5 % more than that of Germany. This last figure is important since many studies indicate that trade performance can be explained better by relative consumer prices than relative labour costs because labour costs are only a small part of overall costs as exporting firms have to buy many domestic services as inputs for their exports.

Figure 3.2



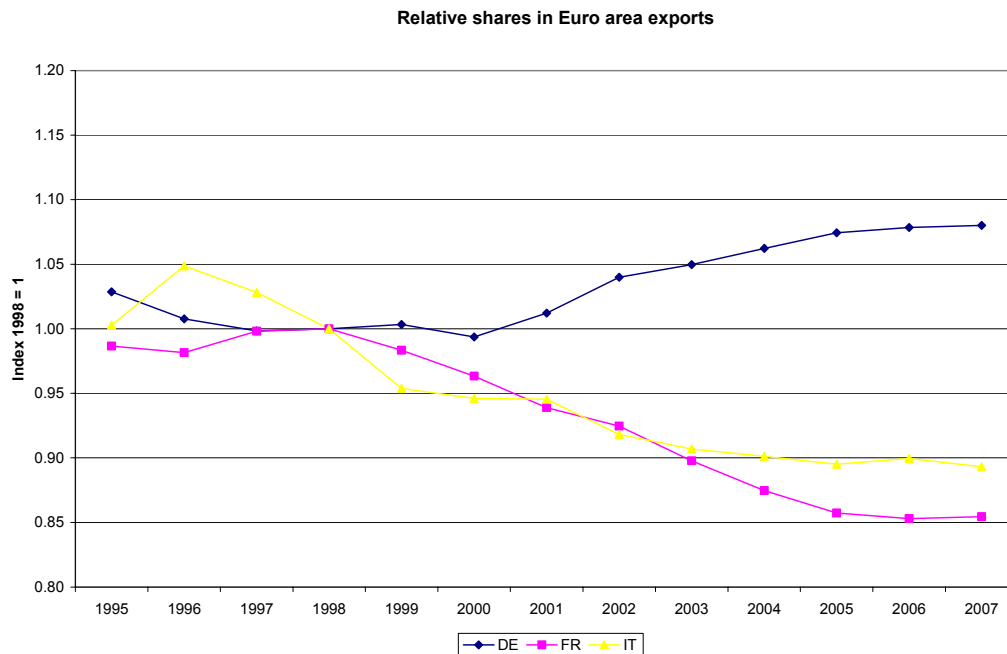
Source: AMECO

One piece of evidence that would support the hypothesis that the loss of competitiveness has not been that severe for Italy comes from the evolution of Italian exports. Within the overall Euro area exports, the share of Italy has indeed declined, but not more so than that of France, which did not have a large loss of competitiveness⁷. In this case the direct

⁷ This is not exactly the case when we take a look at the share in intra-EU exports of France and Italy; however, the difference between Germany and the other countries is still the same.

comparison with Germany is not appropriate since the German economy has overall become more open leading thus an increase in both exports and imports as discussed more in detail in the next section.

Figure 3.3



Source: own calculations based on AMECO data

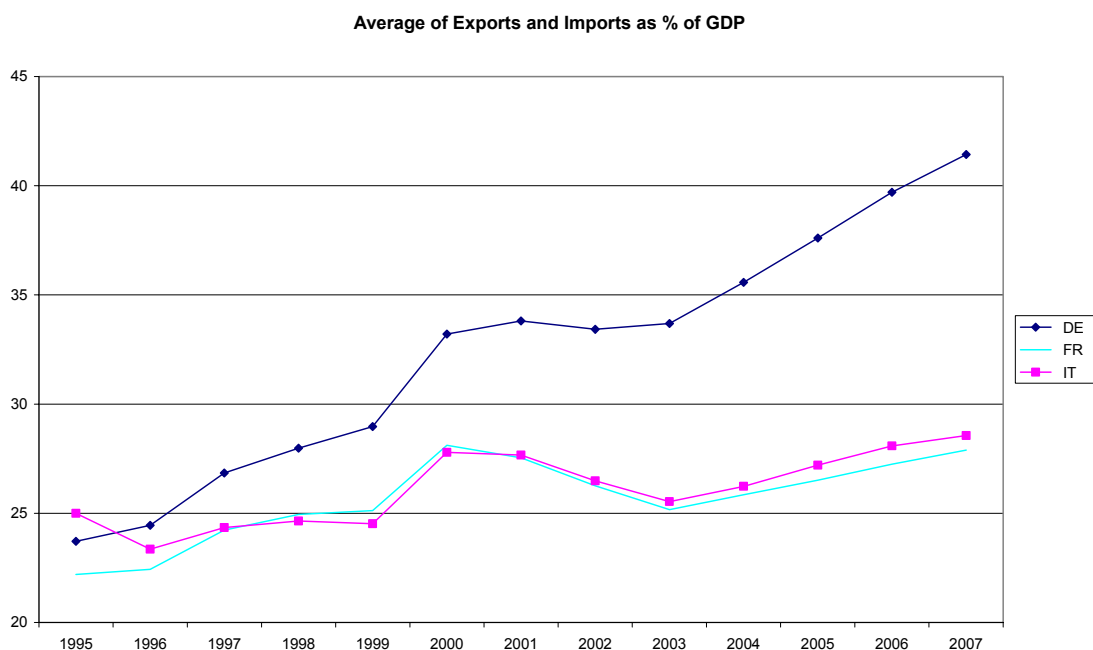
4) Why worry?

The loss of competitiveness Italy has experienced since the start of EMU is thus likely to be smaller than often assumed. However, it is still a real issue that will not go away. Indeed on current trends it would double by the end of the decade. Hence it is crucial to start changing the trend now. However, this does not seem to be happening and this is perhaps the problem that is most important, namely the fact that external competitiveness is not considered the key issue for the country. This is in sharp contrast to the situation in Germany, where the issue of competitiveness has dominated policy making and the public debate for almost a decade. What is behind this fundamental difference in attitudes? One explanation might be history: Germany has a much stronger industrial base and this is not the first time the country had to live with a hard currency by lowering costs.

However, there might be another, deeper, reason why the social and political system of Italy has been, and probably will continue to be, slow to adjust to external challenges. The basic reason is simply that the Italian economy is much less open than that of Germany (and of most other EU member countries). Figure 3.4 illustrates this by comparing the degree of openness of the three large Euro area economies. The degree of openness is measured here by the average of the share of exports and imports in GDP.

This measure is designed to show to what extent a country's economy is affected by international trade (whether it has an external surplus or deficit does not matter in this context). The figures show clearly the gulf that has opened between Germany and Italy (and France) over the last decade. Globalisation seems to have led only to a minor increase in the openness of Italy whereas Germany's degree of openness has almost doubled. As there is no indication that this trend will reverse soon it is likely that the difference in the drivers of economic policy will persist and even increase. Germany's policy is likely to become even more outward looking, primarily based on the idea that it is important to preserve the competitiveness of the country, whereas in Italy this consideration is less pervasive since the economy remains much less open to trade.

Figure 3.4



Source: AMECO

The large gap appears surprising in light of the similar starting position: In 1995, when preparations for EMU were seriously going under way and China was not yet a factor in the global trading system, Italy and Germany started from a very similar position, with trade accounting for about 25 % of GDP. However, their evolution since then has been totally different. Italy's openness has barely moved, whereas that of Germany has soared to over 40 %.⁸ This suggests that one of the difficulties for Italy to adjust to the EMU is that its economy is less open so that it is more difficult to find a constituency that supports the necessary adjustments. Both employers' federations and trade unions realise much more easily in Germany that excessive wages threaten jobs than in Italy because in Italy the link between jobs and a competitive price level is not so direct and important.

⁸ This is partly a return to a historical pattern: Germany had traditionally been significantly more open to international commerce than Italy, but this difference disappeared after unification when Germany concentrated on its internal problems.

A low level of trade integration is not the only indicator of Italy's relative lack of openness: another, well known, indicator is that FDI is much smaller in Italy than in either France or Germany. The stock of FDI amounts to only 14 % of GDP in Italy, compared to 28 % in Germany (and over 50 % in France).

Moreover, as documented recently by Mara Dassù, Italy occupies the last place in Europe in terms of the internationalization of important governing institutions.⁹ In only 1 of its top 75 institutions does one find a non-Italian at the helm. By contrast, in Germany one finds 12 non-Germans. Some of the latter are admittedly from neighbouring Austria and Switzerland, but their presence constitutes nevertheless an indication that talent from outside the national political system can make it to the top.

Does it matter that Italy is so closed? It does because open countries tend to grow faster and to adapt better to external challenges. The world is not standing still and Italy risks becoming an island of stagnation in an otherwise very dynamic global economy.

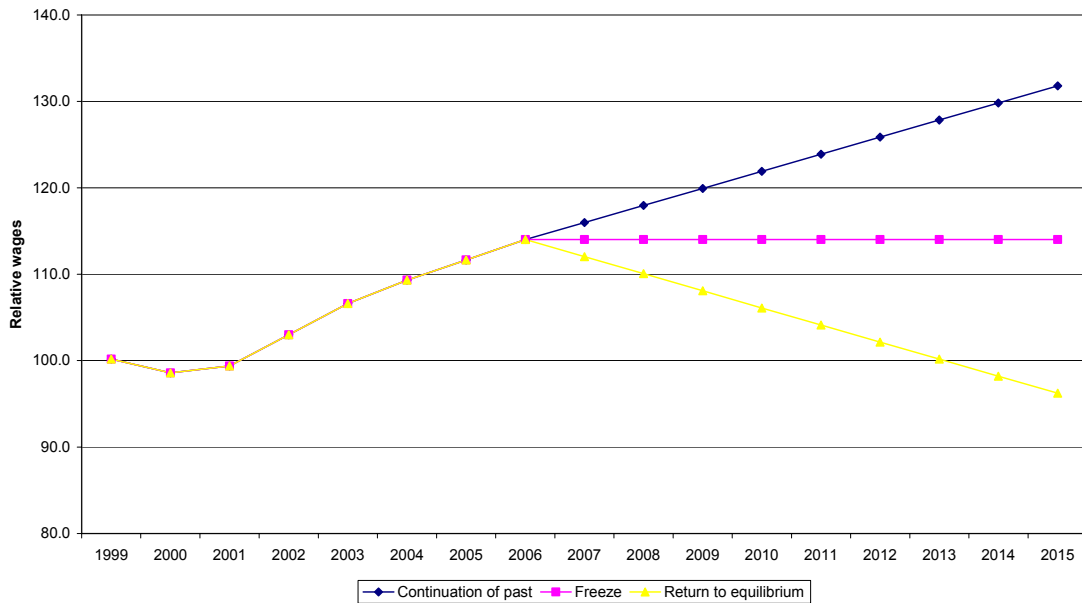
4. Conclusion

Competing in the global economy and membership of the euro area are challenges to the entire political and economic system of a country. If these challenges are properly met the country will actually benefit from euro area membership. The first years of EMU have shown that some countries have fared much better than others in adjusting to the requirements of life under the euro. The problems Italy is facing are not fundamentally different from those of the other large euro area member countries, but it seems that the recognition that global and European competition require strong price and cost discipline is less diffuse in Italy than elsewhere. What does this imply for the future, not only of Italy, but also of EMU in general? It might be useful to consider the consequences of three scenarios outlined in Figure 4.1 which shows the actual evolution of relative wages (Italy/Germany) until now and three different projections for the next decade.

Figure 4.1

⁹ "Corporate Europe ignores diversity at its peril" by Marta Dassu and Daniel Franklin, Financial Times, November 29 2005.

Three scenarios for Italy and Germany in EMU



1. The first scenario could be called “business as usual”. Current trend could continue for some time, leading to an ever increasing loss of competitiveness. This cannot go on literally forever, it however, it would go on for a long time. Italy would slowly price itself out of the euro market, its industry would slowly disappear and the current account deficit would continuously increase. At the end (in the figure the end is 2015), Italy’s participation in EMU would be in doubt as the country would need a massive devaluation. This scenario is unlikely, but not totally impossible, for example if the housing boom continues. This scenario would appear to be quite favourable to Germany until Italy’s problem become unmanageable.
2. The second scenario implies that the status quo is “frozen” as prices in Italy increase only in line with those of Germany (perhaps with a little help from higher German wage settlements. This scenario is not ideal as it implies that certain imbalances are perpetuated. But it would be sustainable, especially if reforms increase somewhat the supply potential of Italy. However, from a general point of view it would not be satisfactory as it would imply that the euro area remains continuously somewhat unbalanced.
3. The third scenario, is the only one that one can consider fully compatible with an “optimal currency area”. Under this scenario equilibrium is re-established by Germany and Italy basically trading places: German costs would for some time increase faster than those of Italy. Probably at the same time the German housing market would recover while that of Italy would slowly disinflate.

It is too early to tell how the experience of Italy and Germany in the same currency area will finish. The countries are both on the bottom of the euro growth league (in itself not a very demanding environment). But this similarity masks deep seated differences as the first years with the euro were dominated by quite different starting conditions: an overvalued DM (relative to the lira) and, in Germany, a housing market that had to work off the excesses of the post-unification boom. Both initial differences have probably now been corrected. The German housing market seems to have found its bottom and in terms of competitiveness it is even likely that Germany has more than offset its initial handicap.

The key for the sustainability of EMU is that the trends over the last few years are stopped. Germany can now enjoy the benefits of its investment in greater competitiveness and a recovery in the housing market. For Italy the situation is more difficult: it must essentially do what Germany did over the last decade. It will probably have to accept a weakening of the housing market and it must somehow re-establish price competitiveness. This is not impossible, but it is made more difficult by the relatively closed nature of the Italian political system and its economy.

Daniel Gros
Brussels, July 2006

Annex: Structural reforms

In terms of structural reforms Italy has made considerable progress since the start of EMU. Compared to Germany progress seems to have been quicker, but since the starting point was much worse Italy is still on most accounts more heavily regulated. Table II shows that in terms of product market regulation and economic regulation Italy has more progress than Germany, but on both accounts it is now only at the point where Germany was then. The only area where Italy seems to have become more liberal than Germany is in the area of ‘administrative regulation’.

Table II: Structural reforms

	Product market regulation			Administrative regulation			Economic regulation		
	1998	2003	Change	1998	2003	Change	1998	2003	Change
Austria	1.8	1.4	0.4	1.8	1.9	-0.1	2.3	1.5	0.8
France	2.5	1.7	0.8	3.2	1.6	1.6	2.8	2.3	0.5
Germany	1.9	1.4	0.5	2.5	1.9	0.6	2.2	1.8	0.4
Italy	2.8	1.9	0.9	3.1	1.6	1.5	3.7	2.6	1.1

Source: own elaboration based on OECD PMR database.