

Why can't Italy be more like Germany?



by David Marsh

 **LONDON AND OXFORD GROUP**

Need for a European role transformation

PROFESSOR HIGGINS

Why can't a woman be more like a man?
Men are so honest, so thoroughly square;
Eternally noble, historically fair.
Who, when you win, will always
give your back a pat.
Why can't a woman be like that?
Why does every one do what the others do?
Can't a woman learn to use her head?
Why do they do everything their mothers do?
Why don't they grow up, well,
like their father instead?



Growing EMU diversity in key areas

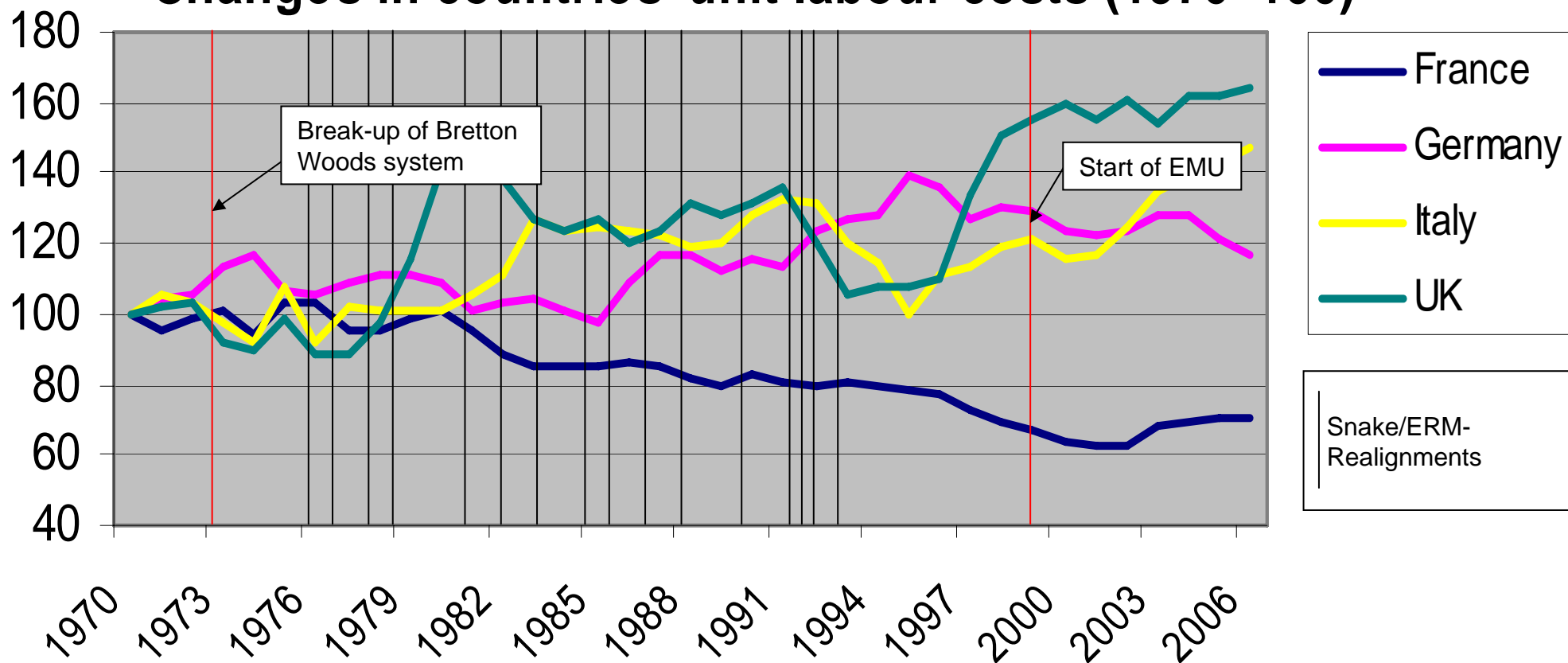
EMU split increasingly likely unless policies change

- German economic comeback raises the stakes
- Fall in Italian/Portuguese/Spanish competitiveness
- Growing internal trade/ current account imbalances
- Legitimate rises in ECB interest rates will exacerbate strain
- French elections bring potent challenges
- Italy can escape by copying what the Germans did
- UK's competitive position outside EMU also looks unsustainable
- Squabbles ahead may make 1990s look like a picnic

Sharp fall in Italian competitiveness

Competitiveness changes 1970-2006

Changes in countries' unit labour costs (1970=100)



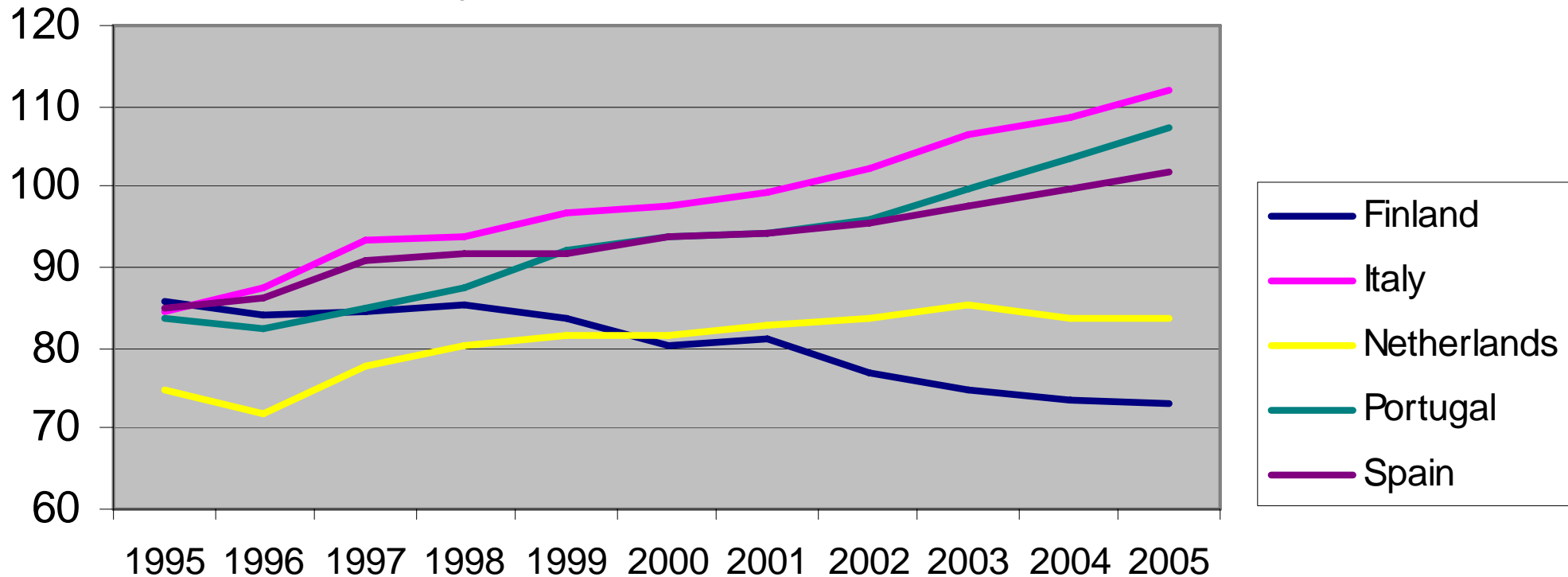
Source: OECD

 LONDON AND OXFORD GROUP

London & Oxford Capital Markets plc is authorised and regulated by the Financial Services Authority (FSA)
Copyright © 2006 LONDON AND OXFORD GROUP – 5 Frederick's Place, Old Jewry, London EC2R 8JQ – www.londonandoxford.com

Italy, Portugal no longer low-cost countries

Relative unit labour costs Initially low-cost countries (Euro area=100)



Source: OECD

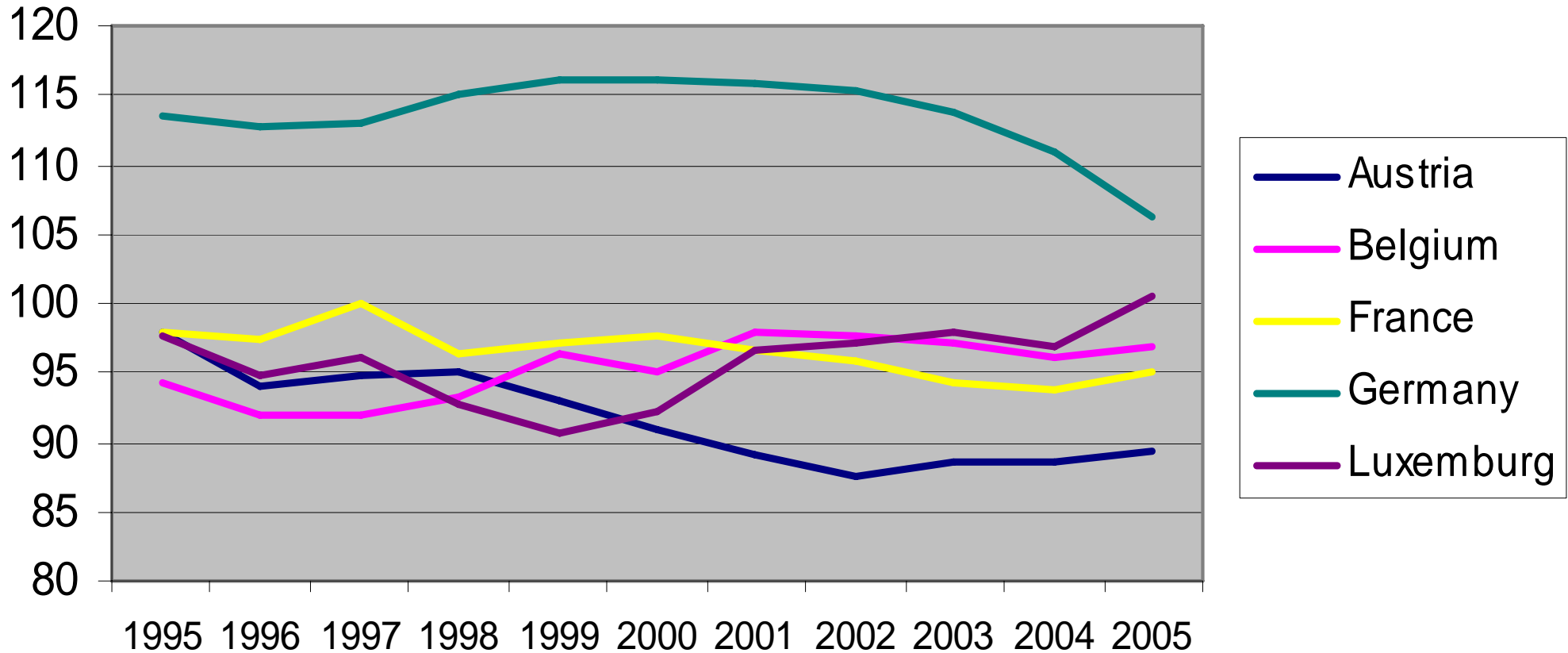
 LONDON AND OXFORD GROUP

London & Oxford Capital Markets plc is authorised and regulated by the Financial Services Authority (FSA)
Copyright © 2006 LONDON AND OXFORD GROUP – 5 Frederick's Place, Old Jewry, London EC2R 8JQ – www.londonandoxford.com

Germany recovers from 1990s weakness

Relative unit labour costs

Initially higher-cost countries (Euro area=100)



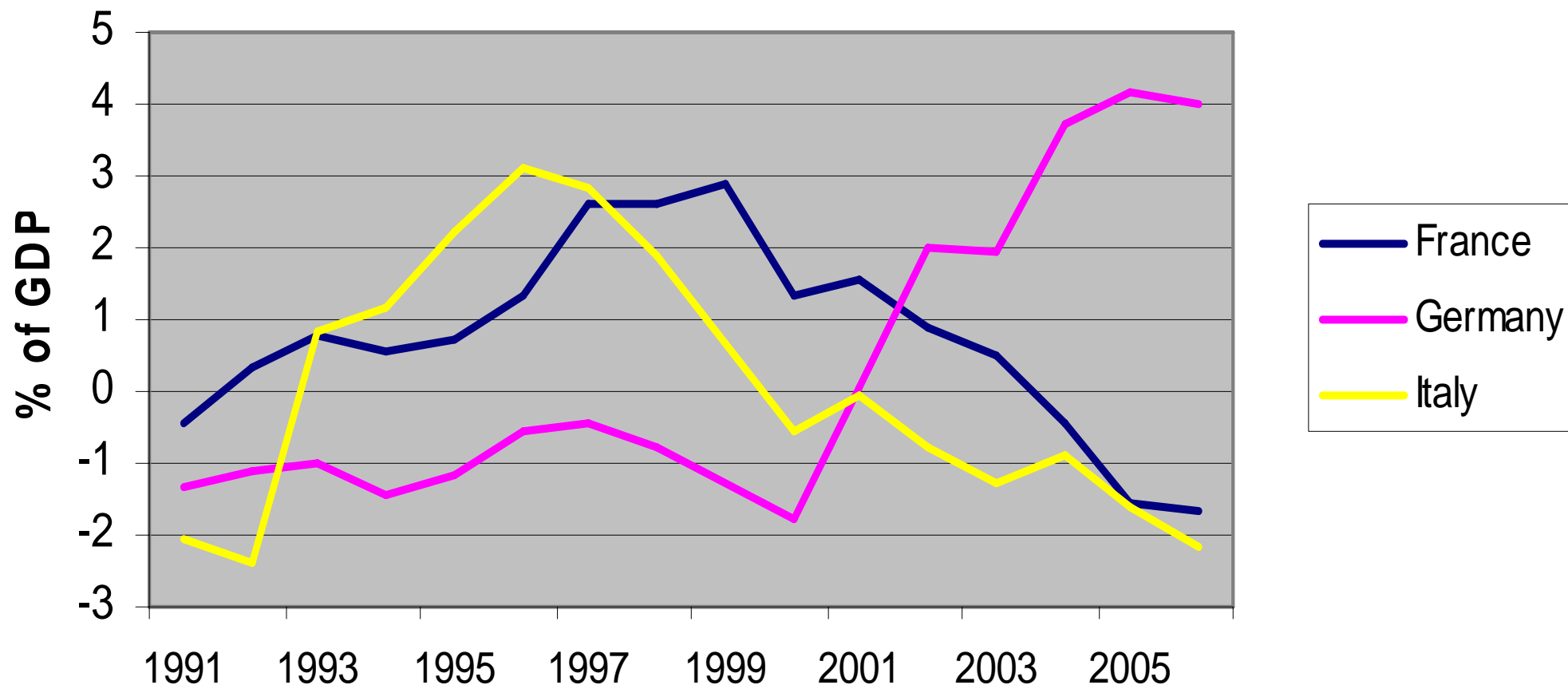
Source: OECD

 LONDON AND OXFORD GROUP

London & Oxford Capital Markets plc is authorised and regulated by the Financial Services Authority (FSA)
Copyright © 2006 LONDON AND OXFORD GROUP – 5 Frederick's Place, Old Jewry, London EC2R 8JQ – www.londonandoxford.com

Big Euro Three diverge on current account

Current account balances (% of GDP)



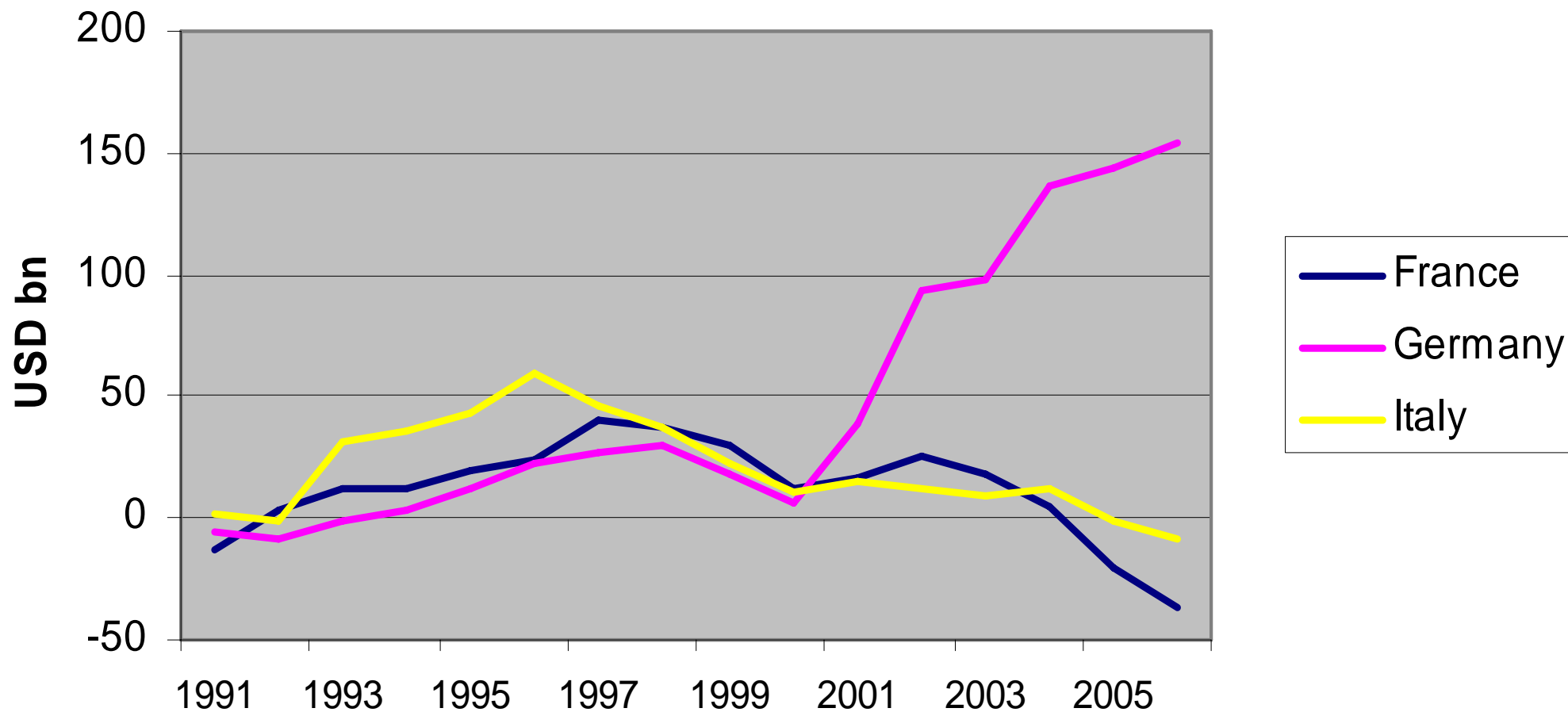
Source: OECD

 LONDON AND OXFORD GROUP

London & Oxford Capital Markets plc is authorised and regulated by the Financial Services Authority (FSA)
Copyright © 2006 LONDON AND OXFORD GROUP – 5 Frederick's Place, Old Jewry, London EC2R 8JQ – www.londonandoxford.com

French trade divergence more marked than Italy's

Trade balances (USD bn)



Source: OECD



LONDON AND OXFORD GROUP

London & Oxford Capital Markets plc is authorised and regulated by the Financial Services Authority (FSA)
Copyright © 2006 LONDON AND OXFORD GROUP – 5 Frederick's Place, Old Jewry, London EC2R 8JQ – www.londonandoxford.com

What Italy now needs to do

Cocktail of measures needed to regain lost ground

- Little hope in waiting for higher German wage growth
- German cost-cutting measures driven by shareholder value
- So no alternative to a programme to
 - reduce budget deficit
 - boost exports
 - restructure corporate sector
 - improve labour market flexibility
 - tackle pensions / health care
- Any Italian flare-up will quickly spread to other EMU members

How former German Chancellor forecast pressures

GERHARD SCHRÖDER

Monetary union will confirm German dominance, since German companies will have financial muscle, long-term policies and higher competitiveness to take advantage of permanently fixed exchange rates. In addition, monetary union will drive German unemployment higher, since it will encourage German companies to rationalise and restructure their activities.

(February 1998, informal conversation)

