

Fiscal Adjustment and Internal Devaluation

by

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3 Questions

How serious is the competitiveness problem of Italy?

What should be the right strategy for “internal devaluation”?

What is the desired fiscal policy (speed/composition) going forward?

Answers

Very, very serious, no quick fix

Loss of Competitiveness': Wage growth and productivity growth are the culprit

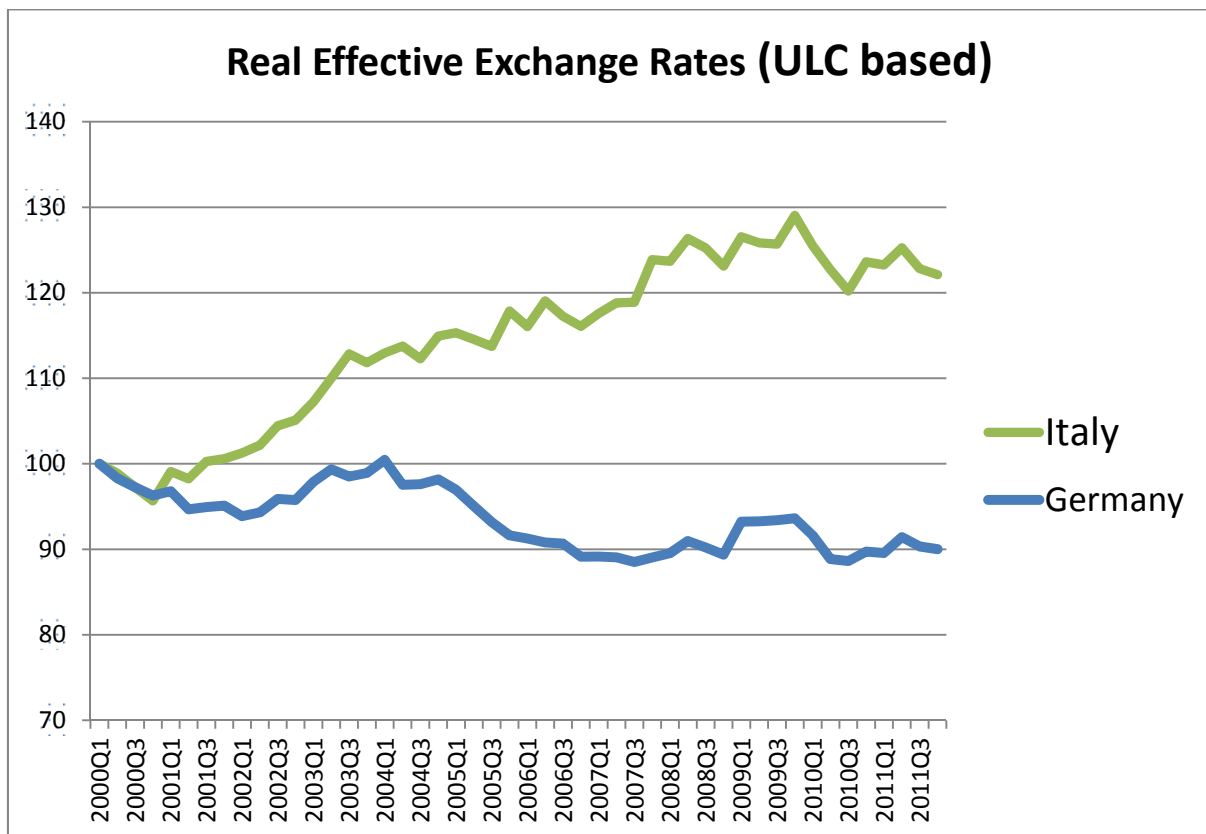
Fiscal Appreciation in Italy vs Fiscal Depreciation in Germany contributed

Interpretation: The Role of Wage Rigidity

Competitiveness

REER (trade-weighted shares)=

$$P/eP^* = ULC/eULC^* = 1/C$$



Source: Darvas, Zsolt (2012a) 'Real effective exchange rates for 178 countries: A new database', Working Paper 2012/06, Bruegel, 15 March 2012

- Between 2000-2013 the Italian ULC relatively to trading partners rose by 23%
- German ULC fell by 9.7%

Beyond Competitiveness

$$C = eP_m^*/P_x = \frac{ew^*a^*(1+s^*)(1+\tau)}{wa(1+s)(1+\tau^*)} = \frac{ew^*\pi(1+s^*)(1+\tau)}{w\pi^*(1+s)(1+\tau^*)}$$

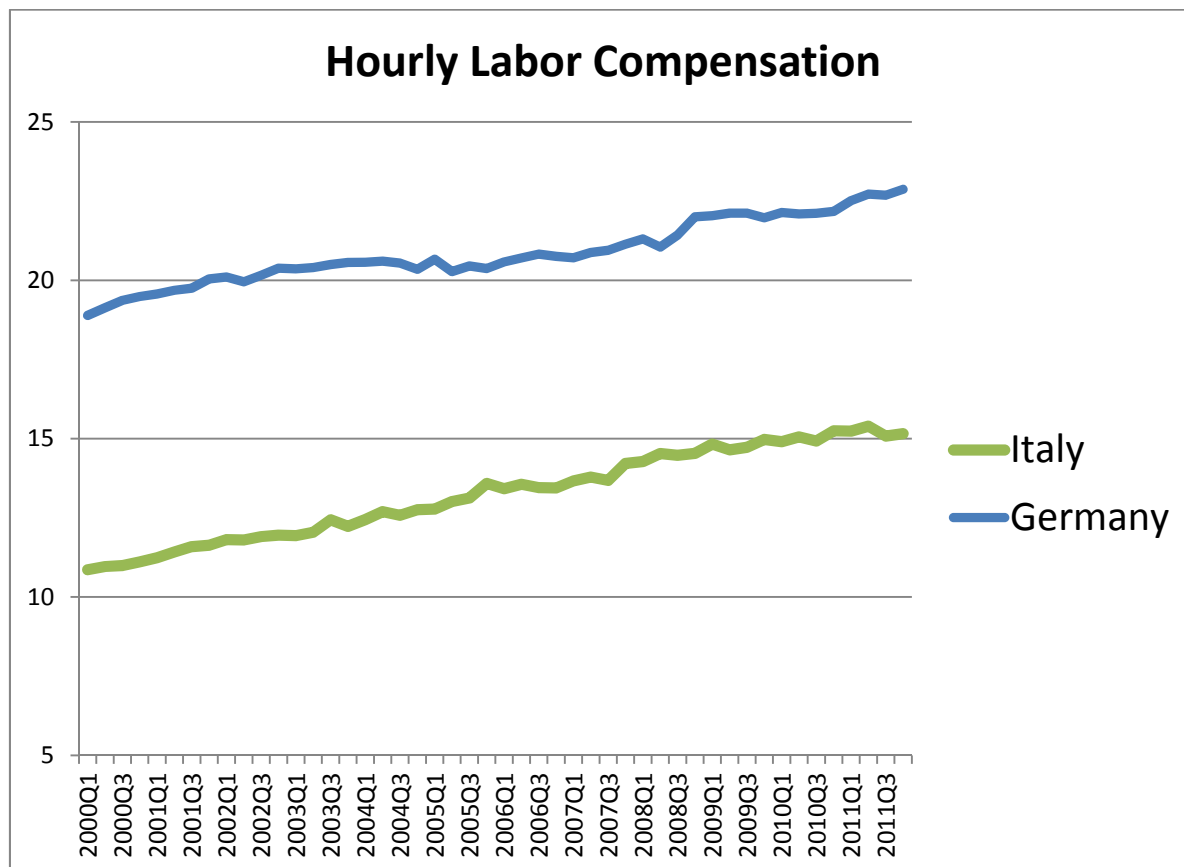
w = hourly wage rate, a = labor input per unit of output = $1/\pi$, e = price of foreign currency, s =social sec.contribution for employer, τ = consumption tax rate

- w^*/w , π/π^* ,
- s^*/s , τ/τ^*

- neglect other issues (changes in trade shares ; changes in composition of value added)

- Next: Italy vs Germany

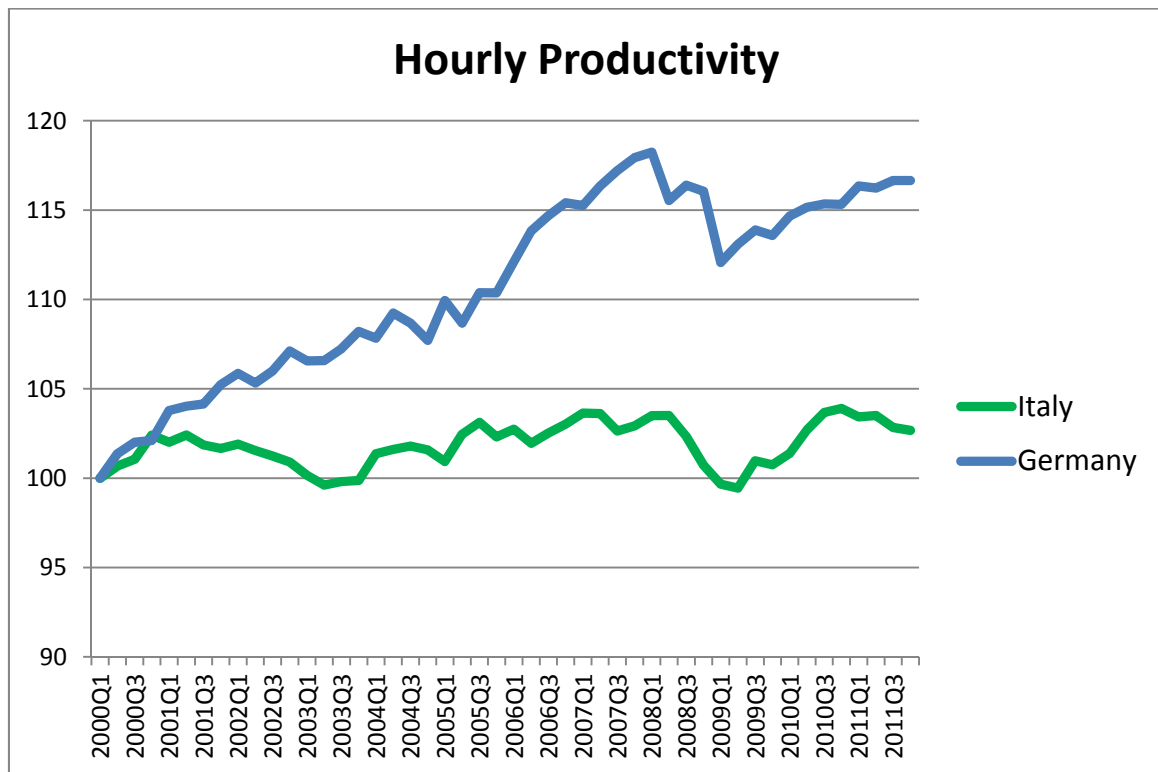
Hourly Labor Compensation



Source: Darvas, Zsolt (2012a) 'Real effective exchange rates for 178 countries: A new database', Working Paper 2012/06, Bruegel, 15 March 2012

Convergence in hourly wages 2000-2013: w^*/w fell
- Italy (+39.5%), Germany (+21.1%)

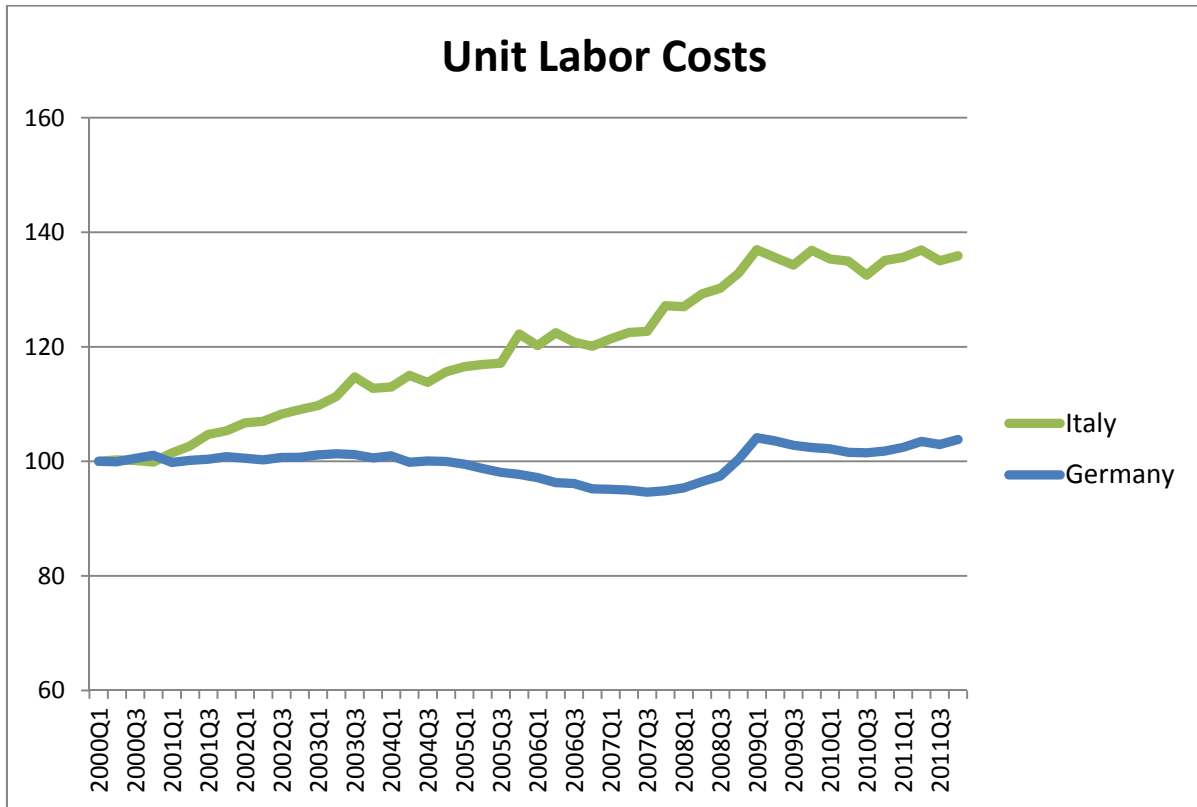
Hourly Labor Productivity



Source: Darvas, Zsolt (2012a) 'Real effective exchange rates for 178 countries: A new database', Working Paper 2012/06, Bruegel, 15 March 2012

Divergence in Labor Productivity π/π^* fell
-Italy (+2.7%), Germany (+16.7%)

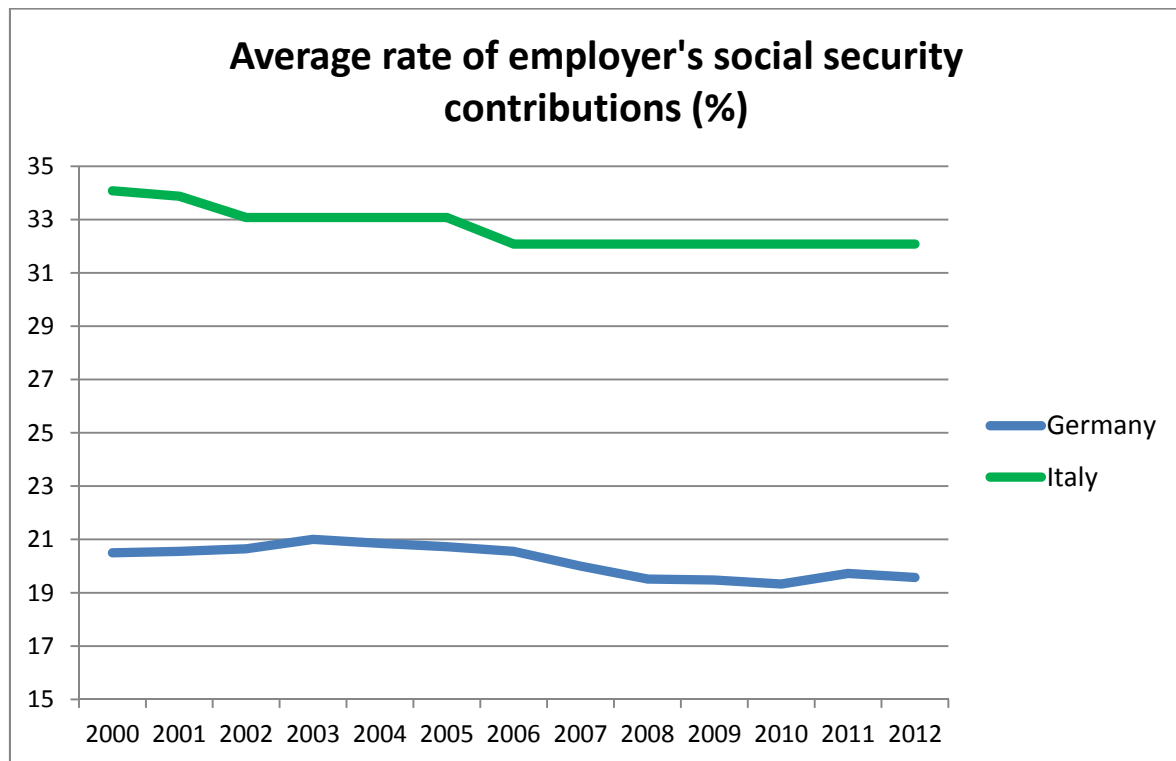
Relative Unit Labor Cost



Source: Darvas, Zsolt (2012a) 'Real effective exchange rates for 178 countries: A new database', Working Paper 2012/06, Bruegel, 15 March 2012

- As a result ULC diverged, Italy (+35.9%), Germany (+3.8%)

Labor Taxes: Social Security



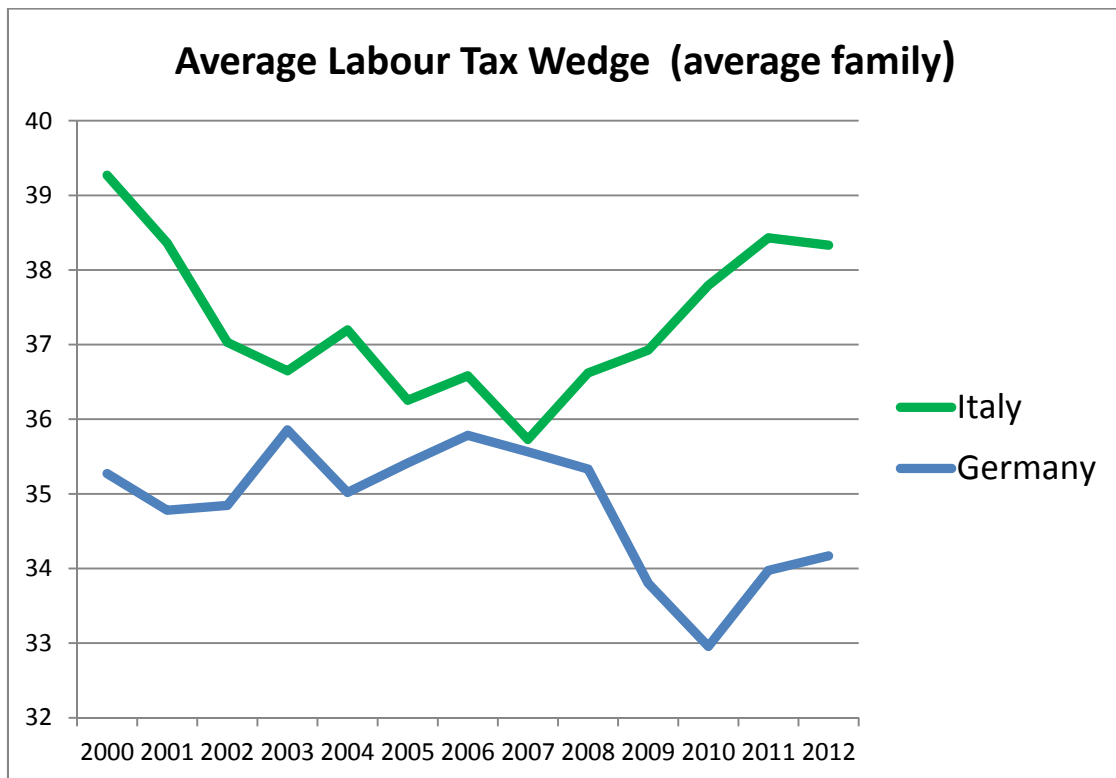
Source: OECD,

http://stats.oecd.org/OECDStat_Metadata/ShowMetadata.ashx?Dataset=AWCOMP&ShowOnWeb=true&Lang=en

Little change in s/s^* in 2000-11

- Essc down in Germany (-1%) and Italy (-2%) but not enough

Labor Tax Wedge

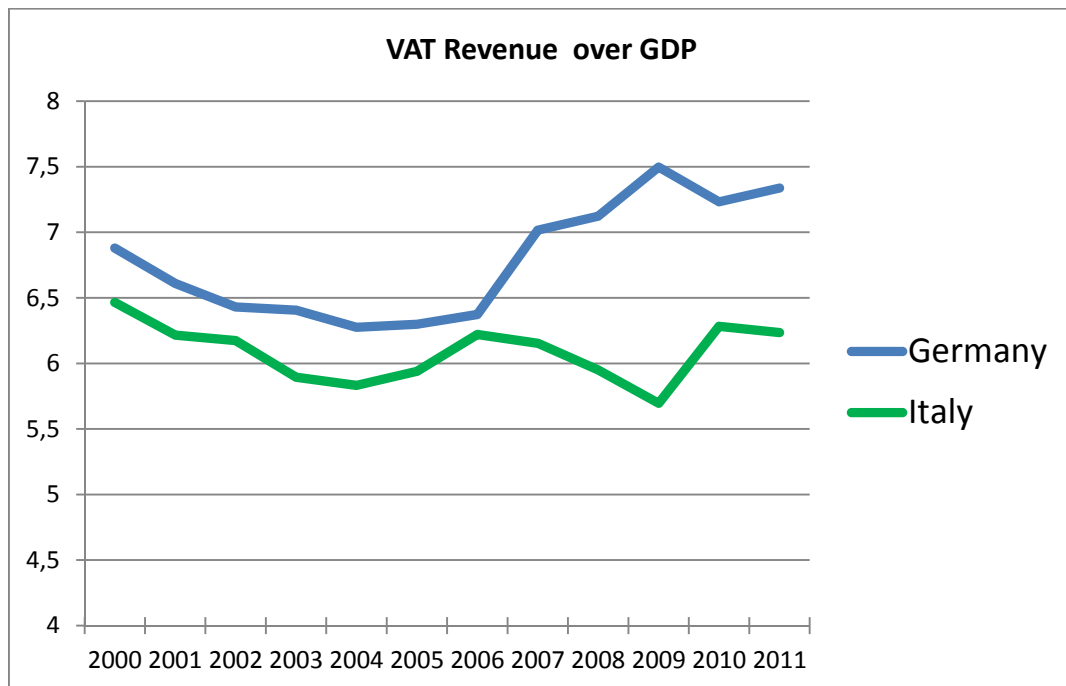


Source: OECD,

http://stats.oecd.org/OECDStat_Metadata/ShowMetadata.aspx?Dataset=AWCOMP&ShowOnWeb=true&Lang=en

Divergence of Labor Tax Wedges after 2007

Consumption Taxes



In 2000-2011 divergence in VAT Revenue/GDP :

τ^* rose by 0.5%

τ declined by -0.23%

$$\tau = \frac{Rev}{GDP} * \frac{GDP}{C} = \frac{Rev}{GDP} * \frac{3}{2}$$

Fiscal Appreciation in Italy (higher s/s^* , lower τ/τ^*)

Summing Up:

	w^*/w	π/π^*	s^*/s	τ/τ^*	ULC^*/ULC
Italy	39,5	2,7	-2	-0,23	35,3
Germany	21,1	16,7	-1	0.5	3.17
	-18,4	-14	1	-0,73	-32,13

- Huge increase in Italian ULC relatively to Germany
- Mostly accounted for relative wage growth (44%), productivity growth (33.6%) and fiscal appreciation of vat (24.5%)

What “Should Have Happened”: A Ricardian View

(1977) Samuelson, Dorbusch Fischer

Two Countries, H, F; z tradable goods(0,1), one factor (L,L*)

$$(1) A(z) = \frac{a^*(z)}{a(z)} \quad A'(z) < 0 \text{ (technology)}$$

$a(z)$ = relative labor input requirements

H produces z if $wa(z)(1+s)(1+\tau^*) < w^*a^*(z)(1+s^*)(1+\tau)$ ie if

$$(2) w/w^* < A(z) \frac{(1+s^*)(1+\tau)}{(1+s)(1+\tau^*)}$$

Equilibrium Requires

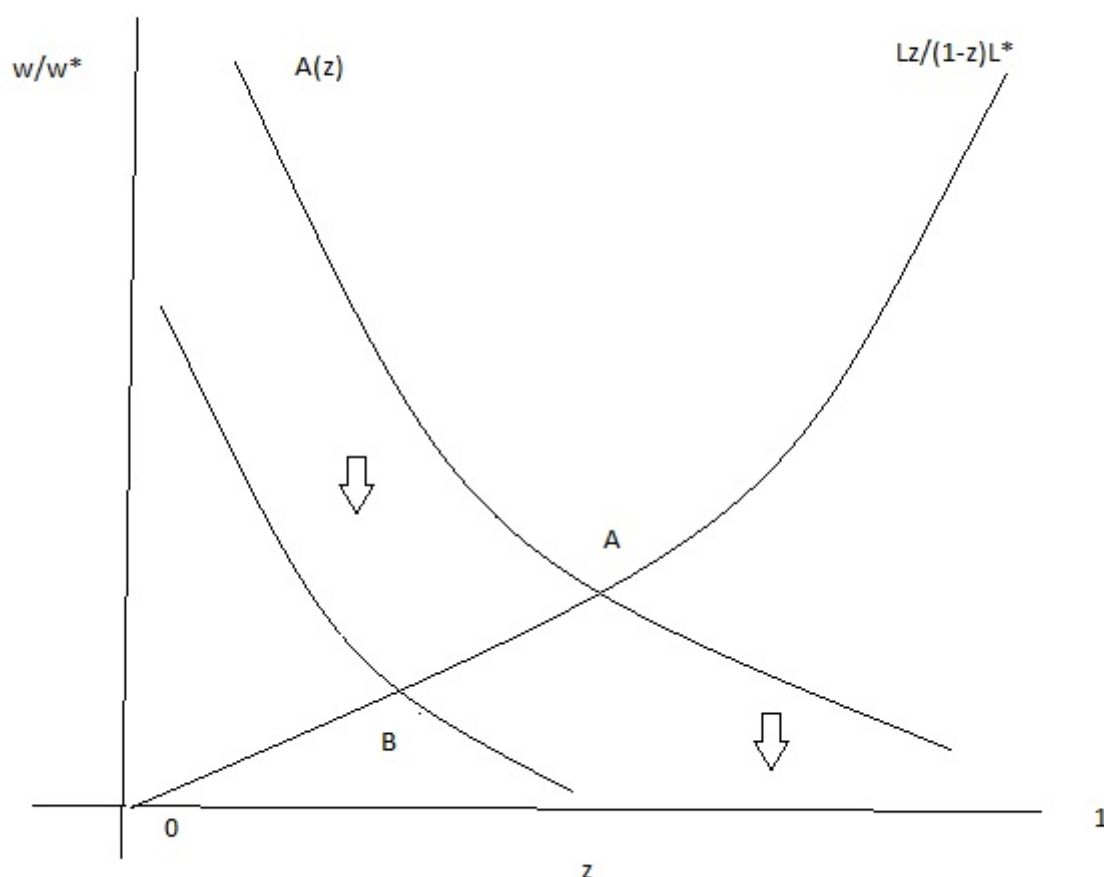
$$(3) P(C + C^*) = wL + w^*L^* \quad (\text{GME}w)$$

$$(4) wL = zP(C + C^*) = z(wL + w^*L^*) \quad (\text{GME})$$

From which

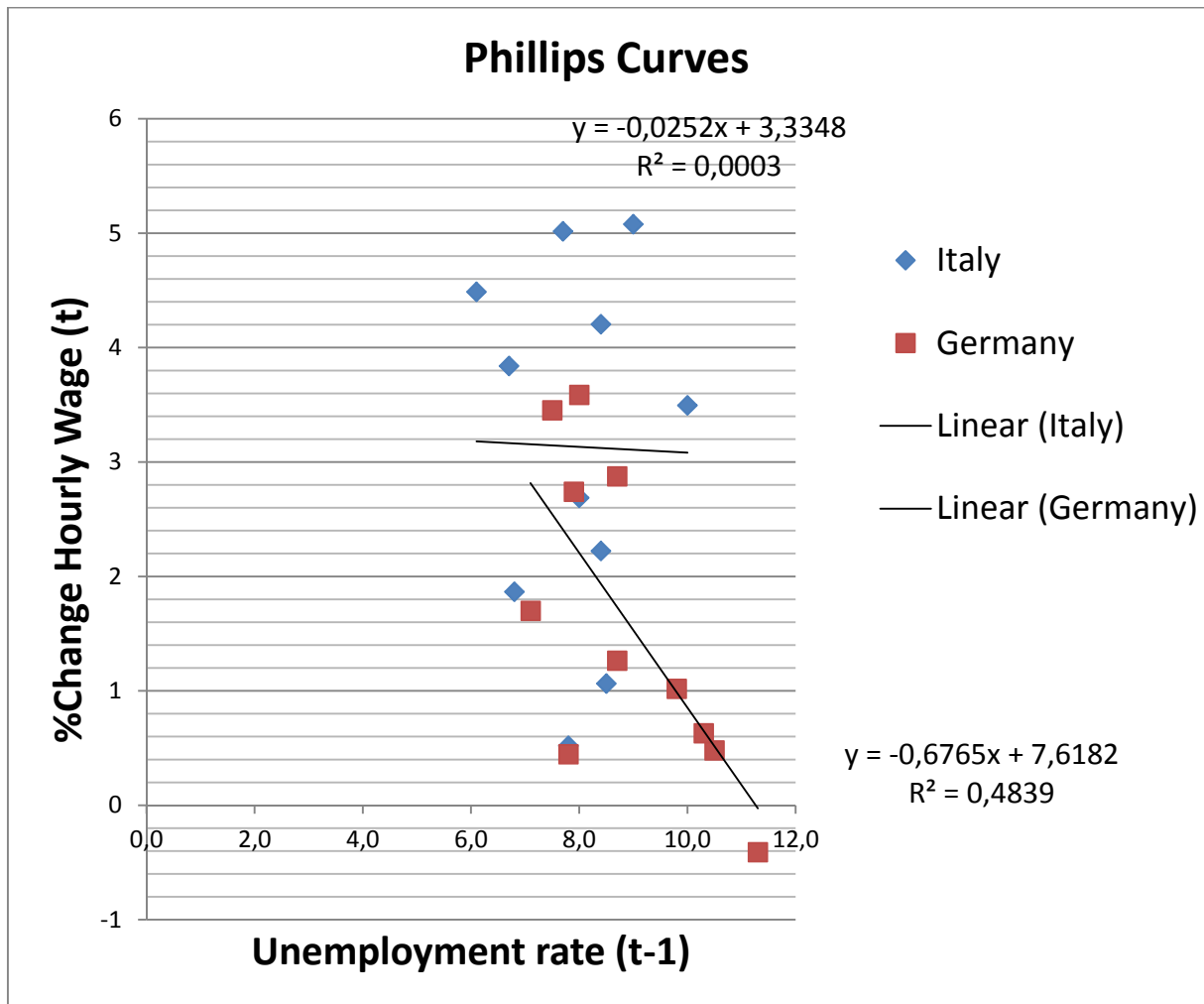
$$(5) \frac{w}{w^*} = \frac{z}{1-z} (L^*/L) \quad (\text{LME})$$

Increase in Productivity F and Fiscal Devaluation in F



- Equilibrium in A, H produces z to the left, F to the right of A
- Reform raising productivity across the board in F
- $A(z)$ shifts down, equilibrium in B, sectors shift from H to F (market share loss)
- w/w^* falls, partially offsetting loss of competitiveness in H, both H, F gain

Nominal Wage Rigidities



- Wages respond to market pressure in Germany but not in Italy

Conclusions

-Productivity Growth

-Wage Rigidity

-Fiscal Appreciation