

Economic Conference to commemorate the
150th Anniversary of Diplomatic Relations between Italy and Japan
The Economics of Italy and Japan: Historical Development
and Future Policies for Stability and Growth

**The Economic Progress of Italy:
Historical Heritage and Future Prospects**

Salvatore Rossi
Senior Deputy Governor of the Bank of Italy

Tokyo, 23 May 2016

I would like to warmly thank the organisers of this Conference for inviting me to offer my view on the Italian economy before such a distinguished audience, and on such a solemn occasion. I am particularly pleased to share the task of animating this second Part of the Conference with my old friend Deputy Governor Nakaso, and I look forward to hearing from him about the Japanese economy with great interest.

We are here to celebrate the 150th anniversary of the diplomatic relations between Japan and Italy: one century and a half, during which our two countries have undertaken enormous transformations, with differences but also with analogies. And because this occasion is a historical one, my approach will be historical as well.

I am not a professional historian, so I beg the pardon of those who are. Yet I was helped, in preparing this speech, by experts in the Historical Studies Division and also in the Structural Economic Studies Division of the Bank of Italy, whose contribution I gratefully acknowledge.

I will concentrate on the evolution of the Italian economy since the political unification of the country, which took place only five years before the beginning of diplomatic relations with Japan. But let me start with a quick glance at a more remote past, because when looking at the evolution of societies, the ampler the view, the deeper the comprehension.

A long historical cycle

The Italian peninsula came out of the European Middle Ages, in the late XIII century, as a nascent economic power. It's interesting to notice that one of the main driving forces was monetary: gold, which had almost disappeared from coinage after the fall of the Roman empire, reappeared in Florence in a coin named florin, minted in 1252. A monetary system was

actually essential to replace barter and develop manufacture and trade, which were the engines of prosperity.

Since then, for about three centuries, and well into the Renaissance period, Italy maintained the lead in western economic growth. The perfection of the arts, from Piero della Francesca to Michelangelo, is witness of the wealth and sophistication of Italian society in those times (slide 2).

But after that a long period of decline set in, both economic and political. The guilds, which had been a growth factor in earlier times, became jealous custodians of their privileges, stifling innovation. The ruling classes, satiated with consumption, stopped searching for new horizons.

Most European countries achieved national unification in the XVI century, not Italy, which became just their battlefield. In terms of GDP per capita, Italy fell far behind in the European ranking.

The very same perception of Italy by foreigners changed. In the XVII and XVIII centuries our land was avidly trodden by young aristocrats and wealthy bourgeois from all over Europe, in search of Roman temples, and eager to buy antiques. Finally, Italy had become the scenario of her majestic ruins (slide 3). Johann Wolfgang von Goethe, the famous German poet and thinker, being a genius, was among the few able to break this arid and exploitative scheme during his journey in Italy, the *Italienische Reise* he made in the late XVIII century: to him, Italy offered not only the Coliseum, but also interesting conversations with craftsmen, innkeepers, civil servants.

In the first half of the XIX century Italy was plagued by underdevelopment and poverty, hitting the bottom of the European ranking in terms of per capita GDP.

The evolution since the creation of a unified state

Following a struggle lasted half a century, political unification was achieved in 1861, though still partial: Rome and Venice joined the new kingdom only in the following ten years. The new Italian state had to embark on a painstaking effort to put in place the physical as well as the legal infrastructure of a modern country. The first two decades of unity were far from brilliant in terms of growth. One of the major bottlenecks was the inadequate transportation network, especially railways.

Only in the 1880s the annual growth rate of the economy surpassed 1 per cent. Early in that decade Italy joined the Gold Standard, which was proof – at that time – that it had a viable economic management. It seemed, for a moment, that the country had reached its place among the European powers. But the international financial crisis of the Nineties had a devastating effect on the economy: foreign capital fled and a housing bubble burst, leaving many bankruptcies behind. Currency convertibility was soon suspended. Financial reconstruction had to start again, but this time under the guidance of a central bank: the Bank of Italy was founded in 1893. While not yet formally monopolist of the currency, the newly created institution had the size and the capability to lead the reorganization, and to avoid major financial crises until the Great Depression.

In the XX century Italy benefited from two successive "golden ages" of sustained growth and catching-up with respect to the older economic powers: the fifteen years period preceding the First World War, and the twenty years following the end of the Second World War.

We might have expected, or hoped, a third episode of sustained growth following the ICT revolution and the spurt of globalization taking place in the Nineties of the past century, as we could observe in a number of countries, but that did not happen. On the contrary, years of sluggish

economic growth and slowing productivity followed. I shall come back to this.

The early XX century were a true *belle époque* for the Italian economy: it became almost self-sufficient in the production of steam engines and locomotives, the equivalent of today's smartphones as icons of progress (slide 4); it entered new fields, such as chemical production. Overall, average annual real GDP growth over the whole period was a hefty 2.6 per cent (slide 5). Substantial merit for this result must be given to millions of Italian migrants: their savings, sent home, allowed the country to pay for the machinery needed to modernize the industry.

After Second World War, Italy, in a new democratic political environment, started reconstruction. A burst of hyper-inflation was successfully extinguished in 1947, which allowed entrepreneurs, workers and consumers to focus on re-building the real economy. Italian politicians understood that the future of the country was laying in its ability to thrive in a larger community. The decision to join the European Community in 1957 allowed Italian exports to expand at a dramatic pace. Italian country lands, especially in the South, supplied enough workforce for fast-growing industrial sectors: construction, motorcycles, car making, domestic appliances. While untrained, this workforce was good enough for the mass production of those days. The Italian “miracle” (parallel to the Japanese one) set in. Between 1958 and 1963, real GDP grew at an average rate of 7 per cent, 6 per cent on a per capita basis.

To this miracle the Bank of Italy contributed by preserving a stable money, but also by funneling savings towards key projects, such as road and telephone networks. In those days, central bank independence was not perceived as a crucial issue. The central bank shared with the Government the responsibility for key economic policy decisions, and implemented

those decisions using the powers it had on the financial market and on banks.

Let me recall that in the Sixties Keynesian thinking became dominant in economics, and the Phillips curve oriented decision-making in most countries. Stable money had ceased to represent a goal *per se*, and was often sacrificed in order to achieve a higher rate of employment. Monetary stability was essentially being judged in terms of the exchange rate, rather than in terms of consumers' purchasing power.

The landscape dramatically changed in the Seventies and Eighties, with the oil shocks, double-digit inflation rates in several countries, and a renewed emphasis put on the need for central banks' independence.

The hypothesis of a new long- term decline

From the end of the Nineties, the Italian economy slowed down markedly. Low GDP growth, falling total factor productivity and shrinking export market shares suggested the idea that Italy was entering a phase of long-term decline (slides 6 and 7).

How come? There is a wide consensus by now, to which research done at the Bank of Italy gave a significant contribution, that some features of our economic and social structure had become unfit to the new technological paradigm and global trade environment. I am referring first of all to the insufficient dynamics in firm demographics: that is to say, we had - and still have - too many small firms, too few capable and willing to grow. That reduced the general ability of the economy to exploit the potential gains from new technologies and global export markets.

The reasons for such a chronic dwarfism of the Italian corporate sector were rooted in our peculiar "doing business" ecosystem, characterized by a cobweb of laws and regulations affecting economic

activity, sometimes redundant and incoherent, often inspired by an anti-market ideology; suffocating red tape; inefficient judiciary.

To give you an example, suppose that a successful Italian small firm saw the concrete opportunity to make a dimensional jump, either through internal investment or acquiring a competitor: more often than not it just gave up, and stayed as it was. Why? Because it feared to become too visible to bureaucrats, to tax officials, to unions, to local politicians, to judges. But even when those fears were not justified, the family owners of the firm could decide anyway not to leave the small dimensional class in order not to lose control of the firm.

The prevalence of small and medium sized firms was a strength of the Italian economy during the Seventies, thanks to their flexibility, and helped Italy to navigate through the turbulent oil crisis and the subsequent years of stagflation. This same strength turned instead into a weakness when the combined two economic revolutions of the late XX century - ICT and globalization - shocked the world. But the implication drawn by some that Italy had entered a phase of historical decline, like the one following the Renaissance age, was too simplistic. Actually, it was wrong.

During the first years of the new century the Italian economy as a whole showed clear signs of reaction and dynamism. But the corporate sector started to split into two diverging buckets: in the first one we could find firms - mostly manufacturers, medium-large size, exporters - that were able to catch the opportunities of the new global environment and raised their productivity and competitiveness. In the second bucket we could find other firms - mostly in the services sector, small, domestically oriented - which were not.

According to revised figures recently released by our national statistical office (Istat), labor productivity in the manufacturing sector has increased by 23 per cent since 1995, that of the services sector has

remained almost stagnant. As a result, total economy's productivity has increased by a meagre 6 per cent in twenty years, one of the worst performances in the advanced world.

Clearly the future of our economy will depend on the relative weights of the two buckets and on the ability of the regulatory and institutional framework to incentivize corporates to climb from the lower to the higher.

Since the mid-Nineties, and more decisively after the global crisis, a series of important structural reforms started to be enacted. The inspiring principles were: less state in the economy, a more market-friendly environment, a lighter regulatory burden. The markets of several products and services were progressively liberalized: the banking system was fully privatized, several utilities and publicly-owned firms were transformed into privately-owned companies. Notably, the pension system became a full “pay-as-you-go” system, making it one of the most sustainable in the world, notwithstanding the progressive ageing of the population.

The Great Recession damages

In the most recent years the impact of the global financial crisis, first, and of the European "sovereign debt" crisis, right after, have rocked the Italian economy, just while it was struggling to adjust to the new technological and global market environment.

To give you a sense of the blow inflicted to the real economy by these two shocks combined, the cumulate drop in GDP during the crisis reached 9 percent; industrial production fell by a quarter. The fall in global demand severely hit exporting firms, precisely those that were fighting hard to “go global”. It was the Great Recession.

There is a big difference between the two shocks, and that regards the effects on the banking system. In the couple of years following the

default of Lehman Brothers, Italian banks weathered the storm. Much like Japanese banks, they were not substantially involved in the "toxic" asset kind of problem affecting banks of other countries. Hence, they were able to absorb the turbulence coming from the recession with no support from taxpayers' money.

But the sovereign debt crisis kicked in. It paralyzed the cross border interbank market in Europe. Credit started to decrease, especially to SMEs. The recession deepened. Italian banks, facing a strong rise in non-performing loans and a sharp increase in the cost of funding, saw their profits and capital squeezed, further impairing their ability to support the real economy in a vicious spiral. When the sovereign debt crisis subsided the conditions of our banks improved, but the issue of bad loans still figures prominently on the policy agenda in Italy these days.

Risks and opportunities for the future

The macroeconomic scenario is now getting better in Italy. A recovery started one year ago. Yet the rates of growth projected for this year and the next one look still insufficient to reabsorb unemployment.

We still see a lack of aggregate domestic demand, determining an output gap that we estimate at around 5 per cent. The common monetary policy put in place by the European Central Bank is doing its best to contrast deflationary risks still visible in the euro area. On the fiscal side, Italy has inherited from a long season of excessive current expenditure started in the Seventies a high level of public debt. Hence, fiscal policy has now a limited room for manoeuvre, also given the constraints posed by the European rules. The Government is fully using the available flexibility. In terms of composition of the budget, it is aiming at changing it in a more growth-friendly manner.

Consumers' and investors' confidence has to be restored, with the help of macroeconomic policies, in order for the Italian economy to eventually close the output gap. But we have to solve an even more important problem, one of a longer term nature: productivity and potential growth still too slow.

How to stimulate them is what structural policies should be concerned with. Some important steps forward have been recently taken in this direction: I would just like to mention the labor market reform, the "Jobs Act", which injected a decisive dose of flexibility into the Italian labor market. Other very relevant reforms are in the making, such as that of the judiciary and of the civil service.

Much remains to be done to boost potential growth. It's a long and multifaceted endeavor. A key factor is innovation.

Let me mention an example of a successful innovation of the past which combines most of the strength of the Italian scientific and artistic culture: the "Vespa" scooter (slide 8). This is a symbol of the Italian design, but also of technological ability, which became a global phenomenon so much that it has been exhibited even in the Museum of Modern Art in New York.

The idea of the Vespa came to the manager of an aircraft manufacturer seeking to diversify its products right after the end of WW2. He wanted a totally different product from the existing motorbikes and therefore asked an aeronautical engineer who "hated motorbikes" to design the new scooter. The engineer came up with a completely different design, resembling a wasp, the English for "Vespa", and with several distinctive characteristics that made it extremely comfortable to ride.

It took a few years, but the Vespa turned into an astonishing success, also promoted by Hollywood movies, such as the ride of Gregory Peck and

Audrey Hepburn on a Vespa through the streets of Rome in “Roman Holidays”.

The lesson that we draw from the Vespa example highlights two ingredients that, still today, are crucial for successful innovations: human capital and what can be called “managerial capital”, i.e. the availability of managers with a risk taking attitude, able to use the latest technology, and capable to think out of the box.

While it is difficult to maintain a high propensity to innovate in ageing societies, naturally tending to be averse to “the new”, this is a key challenge for policy, and it requires to keep investing to strengthen the education system at all levels and to promote an entrepreneurial culture in the population, especially among the youths.

What Italy and Japan can do together

Let me conclude this brief overview with a tiny episode of the past, back in the years following the establishment of diplomatic ties between our two countries.

A printmaker, engraver and artist born near Genoa, whose name was Edoardo Chiossone, was selected in 1868 by the Banca Nazionale (the main issuing bank in Italy at that time, subsequently merging with other issuing banks to give birth to the Bank of Italy) to be sent to Frankfurt, Germany, in order to learn updated techniques of banknote printing.

Banca Nazionale slowed down its projects in renewing printing technologies. Chiossone was approached by officials of the Japanese Finance Ministry, and invited to move to Japan, to reorganize the printing activity of the State Printing Bureau.

Chiossone moved to Tokyo in 1875 and became Head Printer within the State Printing Bureau. The Bank of Japan was still to be founded. He

realized there the first modern (i.e. horizontal) Japanese banknotes (slide 9). He maintained this position until his retirement and lived the rest of his life in Japan, never setting foot in Italy again.

This story symbolizes, to my view, some comparative advantages of our two countries and the potential of cooperation between us: artistic inventiveness combined with openness to new technologies, adventurous spirit, individualistic curiosity on the Italian part; superior capacity in organizing productive factors, long-term vision, social cohesion addressed towards collective endeavors on the Japanese part.

Italy and Japan already cooperate in many fields, from trade to finance, to international institutions and policies. We must strengthen our cooperation, exploit our complementarities, in the interest of our peoples' prosperity.