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Building the future of the Italian economy

Address by the Senior Deputy Governor of the Bank of Italy Salvatore Rossi

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In the past quarter century Italy has suffered three recessions.

The first one, in 1992-93, was the result of the last major crisis of the lira. It lasted a year and a half, reduced GDP by just 1.5 percentage points but cost over 1 million jobs, which were subsequently recouped.

The other two recessions are much more recent and occurred in rapid succession, to the point that they can be considered as one long downturn. It was triggered by the great financial crisis of 2007-08 and rekindled by the sovereign debt crisis in Europe in 2010-11. In the past seven years Italy has lost over 9 per cent of GDP and a million jobs.

Between 1994, the year of the upturn after 1992, and 2007, the last year before it entered the dark tunnel that we are still in, there was a fundamental shift in the environment surrounding our economy: the world's dominant technology changed, accelerating the globalization of markets,[1] and the single currency was created. Taken as a whole, Italy's manufacturing system was slow to react to the combined effects of these epochal changes.[2] It proved unable to take advantage, if not in limited and belated fashion, of the new ICT technologies in order to improve efficiency, something that other national systems succeeded in doing;[3] it did not immediately see that its dependence on repeated devaluations of the lira, with its short-lived competitive gains but lasting inflationary consequences, had to end and that

[1] Bugamelli, Fabiani and Sette (2015).
[2] Banca d'Italia (2009).
[3] See Rossi (2003).

competitive capacity had instead to be structurally reinforced. In reality it was unable to do because of flaws in its original configuration. I will return to this point shortly.

The damage done to our economy by the double-dip recession of these years has been heavier than that suffered by others. Restricting the comparison to the other three main euro-area countries, GDP in Germany and France today is up by 5 and 2 points respectively from 2007 levels; in Spain it is down by 5 points and in Italy, as we said earlier, by 9. The gaps can be explained by the fact that Italy's social and economic fabric was already frayed by the inertia of previous years, even before it entered the tunnel of recession.

This is the basic problem. However, even just to glimpse solutions to this problem we must have first exited the tunnel. To quote Aristotle, first live, then philosophize.

1. First live, then philosophize

Today's categorical imperative is to exit the recession. We are doing this, with uncertainties and hesitancies that must be remedied.

After three and a half years of practically unbroken decline, the first quarter of 2015 is expected to post a small increment in GDP, as the short-term indicators available suggest. According to the projections of most forecasters, including the Bank of Italy,[4] this will be the first in a series of quarterly increases that are expected to continue through 2016. All as small as the first, however, so only enough to recover in two years the ground lost since the end of 2012 and not the much more severe losses of the previous five years.

This scenario of excessively slow recovery is based on models that by construction do not take account, or do so with difficulty, of such elusive or hard-to-measure factors as confidence in the future. That confidence which in Italy, even more than in the rest of the world, has played and continues to play a pivotal role in shaping the behaviour of economic agents, consumers and businesses. Agents,

[4] Banca d'Italia (2015).

moreover, whose lumping together in a single category is increasingly senseless as they tend to split into groups whose behaviour is different if not diametrically opposite, greatly complicating the job of those responsible for macroeconomic forecasting.

I will illustrate this point briefly by distinguishing between the cases of investors and consumers.

The crucial variable at this juncture of Italy's economy is the accumulation of physical capital in enterprises: production sheds, warehouses, machinery, offices, computers and software. Investment is the component of aggregate demand that is most sensitive to the business cycle; it is to investment that we look today to kick-start the economy. Well, it can be estimated that only half of the 28 per cent decline in gross fixed investment in the last recession is attributable to the usual macro determinants: the world cycle, interest rates, and fiscal policies. The remainder is attributable to selective credit tightening, uncertainty about the outlook for demand and lack of confidence.[5] Conditions that all vary from firm to firm.

Italy's productive system, with respect to both industry and private-sector non-financial services, is by now heavily polarized. The discriminating factor is size.[6] If we choose, entirely conventionally, 50 employees as the dividing line between small- and medium-large enterprises, the 25,000 firms above that threshold produce almost half the sectors' total value added (€330 billion of the total €690 billion in 2012) and employ almost half of payroll employees (over 5 million out of 11 million). The rest are divided among the 4.3 million small firms, where the payroll workers are joined by 4 million self-employed workers, the firms' owners. Value added per worker, i.e. productivity, is much lower in smaller firms; the cost of labour is also lower but by much less, so small firms are generally less competitive that medium-sized and large ones. It is no accident that almost all manufactures exports originate at these larger enterprises. The latter are also less conditioned by credit restrictions: they finance themselves; if they want additional funds they can turn directly to the financial

[5] See Busetti, Giordano, Scoccianti, Zevi (2014).

[6] Data taken from Istat (2014).

market, and they have done so; in some instances it is banks themselves that have knocked on their door with offers of credit, which have sometimes been refused. By contrast, insistent pleas for bank credit by many smaller firms, obviously precluded from bond issuance, are being rejected today because banks are fearful of swelling an already large stock of non-performing loans.

Size is also a central determinant of investment decisions. Large and very large firms have continued to accumulate capital stock even in these years of recession, while many small firms have stopped investing, if not for "lifeline" replacements. But many profitable and liquid medium-sized exporting firms too have suspended their investment plans until they can get a clearer picture of international and especially domestic developments. The strength and pace of the recovery will depend on the decisions that they make in the coming weeks and months. If these are positive and lead to an even modest rise in employment, the spark of renewed confidence will be transmitted to consumer households. If negative, they could foreshadow the outward flight of a lot of Italy's good productive capacity.

Consumers and consumer behaviour have also differed in recent years. Let's look for a moment at the aggregate data. Comparing the three recessions since 1990 one difference is immediately apparent.[7] In the latest recession, faced with a reduction in disposable income Italian households as a whole did not engage in the phenomenon typically known as *consumption smoothing*. In other words, contrary to expectations they did not attempt to maintain at least in part their living standards, cutting back yes, but by less than the fall in disposable income; instead, they retrenched even more sharply and actually increased their saving rate. This kind of behaviour, which the econometric models could not factor in,[8] is explicable only if households judged the contraction in income not to be temporary, as in every economic downturn, but permanent; or even, permanently deteriorating.

[7] See Rodano and Rondinelli (2014).

[8] The equation of consumption in the Bank of Italy's econometric model succeeds in explaining less than half the actual behavioral trends with the usual determinants considered. The remainder is reported as an "error".

But did all Italian households really think this way? To answer we need data on individual households. The best we have are those from the Survey of Household Income and Wealth, which the Bank of Italy has conducted for many years. Analysing them,[9] we see how the youngest households have been the ones to tighten their belts most: the widespread precariousness of employment arrangements has weighed on payroll employees, while self-employed workers, especially owners of small and micro-businesses, have had to dip into their own income to overcome problems in their firms.

Aggregate consumption stopped falling, however, in mid-2013, though an upward trend has yet to take root. It is clear that consumers remain cautious and are waiting for some sign of a let up in the labour market and stabilization of their incomes before increasing expenditure. But if confidence returns, the rebound in consumption could surpass that in disposable income.

2. *Future scenarios for the advanced countries*

Let us now turn from economic trends and look instead, if only briefly, at the current debate on the medium and long-term prospects for the advanced economies and thus place Italy within a broader context in the immediate and long term.

One pessimistic scenario that has been much discussed is "secular stagnation". I mention it here because of the fascination it has exerted over many commentators, especially nowadays with reference to Europe. The theory was invoked over a year ago by the American economist Lawrence Summers,[10] with reference to the United States. Today he explains it in terms of a future trade-off between economic growth and financial stability.[11]

The weak point of this hypothesis is its exclusively macroeconomic reasoning, all on the demand side. In reality, we know that technological innovation generates demand for previously non-existent products. The same amount of investment

[9] See Rodano and Rondinelli (2014).
[10] Summers (2014).
[11] Summers (2014). See Pagano and Sbracia (2014) for an in-depth discussion of the theory.

requires, as Summers contends, fewer financial resources, but the hypothesis of constant aggregate investment is fallacious – innovation also increases it because it makes the new capital goods cheaper and accessible to a much greater number of potential entrepreneurs. We also know that financial bubbles can be prevented by suitable macro-prudential supervisory tools.

The spectre of secular stagnation cannot be completely dispelled, of course, but it does have to be put in perspective. What other possible scenarios are there? The most interesting approach remains that which looks to businesses and product supply. It is within firms that growth is generated, income produced, and wealth distributed to the nation through taxes, profits, wages and salaries. It is within firms that new or restyled products are created, fuelling consumption and investment demand, revealing needs, desires and opportunities that consumers and investors failed to spot earlier.

Constant innovation is the hallmark of the modern era. A century ago it was not uncommon for manufacturers or traders to spend their entire working lives dealing in a single, immutable good or service that customers demanded to a greater or lesser extent depending only on their changing economic circumstances. These days a product or service cannot remain identical for long before it has to be renewed in substance, or at least in appearance, on pain of possible expulsion from the market. Consumers expect to be constantly surprised by something whose existence they never suspected. Capital goods too must change in order to accommodate and drive innovation in final consumption goods.

The very distinction between manufactures and services is becoming blurred. Today, more and more often a manufactured product is purely a receptacle of services, without which it would have no value. It is the services that determine the object's qualitative development. The most obvious current example is the smartphone.

The ways in which the manufactures and services are produced are new as well. The digital revolution has unbundled vertically integrated production into single

tasks – logistics, accounting, production of components, maintenance, marketing, and so on – that can be performed anywhere in the world through outsourcing to external suppliers. Long product chains, or global value chains, have formed, governed by a flagship company but involving dozens and dozens of sub-contractors, often located in emerging countries where low labour costs more than offset the cost of coordination and shipping.[12] Not only the geographical reach of world trade has been radically altered but even its very nature.[13]

Finally, robotics is advancing in leaps and bounds. Authoritative scholars maintain that today's existing technologies still leave enormous untapped potential for innovation in the mode of production, that we are on the eve of an era of practically total robotization of manufacturing,[14] with far-reaching repercussions on the labour market in both the emerging and the advanced countries.[15] Save for some niches of super high-end craftsmanship, making something "by hand" – which by the etymology of the word is the essence of *manu*-facturing – will come to mean not operating a lathe but handling a mouse or a joystick to activate servomechanisms and 3-D printers. Global value chains themselves, given this trend to the automation of material production, could shorten and relocate again, as the cost advantage of the emerging countries erodes.

Yet no one doubts that manufactures – or "robofactures" – will continue to be central to the economy, but as containers of services. Their conception and at least in part their production will necessarily have to be the work of flesh-and-blood workers. These workers will have to be specially educated and trained – an enormous task in which public policy will have an essential role to play.

[12] For the impact on Italian firms, see Baldwin and Lopez-Gonzales (2013) and Accetturo, Giunta and Rossi (2011).
[13] See among others Hoeckman (2014).
[14] For example, Brynjolfsson and McAfee (2014).
[15] See Visco (2014a).

3. *Imagining and building the future of the Italian economy*

Let's get back to the Italian economy. It has become something of a fad to attribute to the great economic historian Carlo Cipolla the observation that Italy's "mission is to produce, *in the shadow of our town steeples* [my emphasis], things of beauty that the world appreciates."[16] No debate on competitiveness and on Italy's destiny has failed to cite this phrase, and I will do no less here. But I must warn you that the quotation is false. What he actually wrote was "we are a people that cannot afford to stop … We must always invent new things that are appreciated and that … are sold beyond our borders."[17] As you can see, not a trace of "our town steeples."

This apocryphal addition to the quotation is singular, but revealing of a certain mind-set. What our unknown hermeneutist had in mind is clear: the medieval and Renaissance Italy of shops and workshops, the era of woolen cloth and silks, but also of our commercial and financial preeminence; that golden age when, even riven by political division, every bell tower in Italy cast its benevolent shadow over people who, each according to local custom, brought the flowering of style, skill, creativity. These were the very people who gave the totality of Italian steeples, North and South alike, economic hegemony over the entire Western world, for three centuries, hegemony that was lost in the course of the next three centuries, in which Italian economic activity wound steadily down, until the middle of the nineteenth century.

The ability to produce and compete with the leading economies was partly recouped around the turn of the twentieth century, and again during the "economic miracle" now half a century behind us.[18] In both those periods, "town steeples" were of very little relevance, especially for the industrialization of Italy prior to World War I. That era saw the foundation and development, in some cases financed substantially by foreign capital, of large, heavy industry – steel and basic chemicals, the core sectors of the advanced economies of the day.

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[16] See, for instance, http://www.sviluppoeconomico.gov.it/images/stories/documenti/OsservatorioPMIREGIONIFEBBRAIO2013REPORT.pdf.

[17] Cipolla (1995).

[18] See Toniolo (2013).

The steeples came back into their own in the 1970s, when the Italian economy began to turn inward in a climate of public opinion that had become bitterly hostile to free enterprise. For the industrial districts – a typically Italian solution to the problem of reconciling small company size and family ownership with the necessities of modern production – localism was fundamental: an industrial district can thrive only in certain areas endowed with abundant social capital.

What future can there be for an advanced economy that puts localism and familism at the core of its way of being? A dim future indeed, in the scenarios I sketched out earlier. Nowadays, to invent and market new things that people appreciate requires organizational capacity, mastery of the succession of new technologies, creativity that is not spur-of-the-moment but systematic, and a power to penetrate geographically and culturally distant markets that only large and constantly growing firms can provide.

The few figures I recalled just now on the polarization of the Italian productive economy are telling. The feeble, fragmented part of that system must be strengthened through mergers and acquisitions to concentrate, in a smaller number of large corporations, the abilities and latent potential that we need to recoup and retain our competitiveness. This can come about only with the growth in numbers of those enlightened entrepreneurs who set less store by their family's control of the firm than by the firm's leadership in the market.

Nor is that all. If our economy is to be transformed in the way history points, there must be a dissemination of customs, culture and attitudes in favour of innovative businesses and their rapid growth. Public policy is essential. Public programmes must create the premises for the transformation: a legal and administrative environment that is friendly, not hostile, to the free market and entrepreneurship and an educational system that supplies innovative corporations with the best and the brightest. To make progress in both these directions we must overthrow localism and familism. In concluding these remarks, allow me to dwell

briefly on the second of these vital premises, namely education, and university education in particular.[19]

We have to acknowledge that a process of change – slow and laborious, to be sure – has been set in motion in Italian education. Public institutions like the educational testing service Invalsi and the institute for university evaluation Anvur and private institutions like the Agnelli Foundation are doing good preparatory work for serious evaluation of system quality. But Italian universities are still beset by paradox: they train a number of excellent students for post-graduate schools abroad, but only rarely do they compete with the best of those institutions. Our country's professional elite is largely foreign-trained – a characteristic typical of the less developed countries. What is more, aside from the small group of top students who move abroad for their post-graduate studies, Italian university graduates are still in short supply by comparison with the needs of an advanced country, despite the shift to the system consisting in a first, three-year degree followed by a two-year Master's. And in many cases what they have chosen to study and learn is almost irrelevant to those needs.[20]

Why is this? Are our universities, like our firms and banks, too many and too small? Perhaps so, especially if every university aspires to cover every field of knowledge, which is certainly the result of localist pressures and habits that lead families to keep their children as close to home as possible during their academic careers, unlike the norm in America, say.

In my view, however, the problem is more general. Italians have long spent only small amounts to give their children a good university education, maybe because they felt this was the state's job, or maybe because they did not believe it was worth it in terms of job prospects. These notions, especially the second, are quite mistaken. The return from a university degree in terms of job chances and earnings is

[19] See Visco (2014b).
[20] OECD (2014).

substantial in Italy too, although less than the average for the other advanced countries and also less for younger than for older people. The fact is that over the past twenty years, households' spending on education (net of public subsidies) has doubled in proportion to GDP, while public spending has remained constant and per student spending has decreased. But there remains an insidious skepticism of parents and children on the value of higher education.

Italian public spending on universities, at 0.8 per cent of GDP, is at one of the lowest levels in the entire advanced world, including countries where education spending is mostly private. It is far below the "social" yield of education. This is the result not only of our public finance problems but also of historically remote policy choices, motivated after World War II by the persistent plague of illiteracy. Educational policy accordingly allocated spending first to elementary and then to secondary schooling. This spending, in fact, is now practically in line with the OECD average, while spending on higher education is scarcely half as high.[21]

Policies to remedy this state of affairs need to move in the direction of greater operational independence for our universities, combined with effective public information about their teaching and research merits that permits student choice, the alignment of public spending for instruction with those choices, and the allocation of research spending according to objective evaluation.

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The Italian economy is struggling to alter its present historical course and to correct the perilous path embarked on in the final decades of the century. To do so, first of all it must emerge from the protracted recession of recent years. This may be achieved now. After their recent disappointments, households and firms do not trust

[21] OECD (2014).

in announcements that the upturn is imminent, but the recovery will begin precisely with the recouping of confidence, especially among the firms whose accounts and markets are such as to permit an immediate increase in investment. The restoration of confidence can be favoured, in turn, by comprehensive, clear and determined economic policy action.

In these remarks, I have described several possible long-term scenarios for the advanced countries. What emerges is the key role of technological progress, which in the years ahead can continue to provide opportunities for growth and wellbeing, although it will entail possibly quite traumatic change to our societies, and in particular to labour relations.

The Italian economy too has its opportunities. Part of our production apparatus is competitive, equipped to face and overcome the trials of the future. Another part is not. Nor, in general, is the public legal and administrative apparatus. Both must be spurred to change. An effort at reform is under way in Italy. It needs to be observed attentively, criticized when necessary, but in any case acknowledged as indispensable.

The educational system is what forges the future, in every country. Ours can count on a precious store of human resources and historical traditions. It is still seeking, amidst no few difficulties, the type of organization and practices that will enable it to truly serve the present and future needs of our economy.

We must not tire of listing the negative aspects of our country, but at the same time we must not reduce this exercise to one of sterile pessimism. Instead, let us translate it, constructively, into a plan of action for the women and men who have political and administrative responsibilities and for those whose field of action is the economy and society.