Bank of Italy – CEPR – EIEF Conference

Firm Dynamics and Economic Growth

Opening remarks by Salvatore Rossi
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I am delighted to welcome you all to the Bank of Italy, and to open this workshop, which was jointly organized with the CEPR and the Einaudi Institute of Economics and Finance.

Over today and tomorrow, 29 original papers will be presented, selected from more than 150. These works have been produced by distinguished scholars from academia and research institutions around the world. They cover a wide variety of topics relating to firm dynamics and its effects on economic growth. Two keynote lectures will also be delivered, and I would like to thank the internationally renowned speakers, Professor Ufuk Akcigit from the University of Chicago and Professor Gian Luca Clementi from New York University.

There is no need for me to underline the importance of studying firm dynamics today. The recession which followed the global financial crisis hit the whole world almost simultaneously ten years ago, though to varying degrees in different countries.

Firm dynamics is key to explaining the differences in its impact. Country-specific frictions to the physiological exit and entry of firms in the market may severely limit growth prospects for an economy. Italy is a case in point, as I will discuss later. In the short run, they affect and are affected by business cycle fluctuations and financial shocks.

At this moment in time, after years of recovery, economic growth is slowing down somewhat all over the world. Forecasts made by international organizations are currently reflecting the decline shown by conjunctural data. Growing trade tensions, political uncertainty, and expectations that monetary stimulus will gradually be reduced in the main economic areas of the world are the most cited facts. In many advanced economies, the economic slowdown is raising concerns about potential output, since the recovery of recent years has not been accompanied by as buoyant an increase in productivity as we might have expected.

That's why firm dynamics is more important than ever before. Innovation and technology adoption by as many firms as possible is the main source of growth and jobs in the economy, and they depend very much on the process of firm entry, survival, growth, and exit through which the market selects the most efficient and innovative players. New and young firms are those which drive input accumulation and output growth. If the most productive firms thrive and the less productive ones exit smoothly from the market, the economic system works well.

These ideas are very old, dating back at least to Joseph Schumpeter's 'creative destruction' and they are now an intrinsic part of empirical analyses from all around the world. Indeed, thanks to the efforts of several scholars and research centres, among which I would like to thank the OECD researchers that conducted the seminal FirmDyn project, we now have a lot of comparable data on firms' entry, growth and exit from the market, over their entire age distribution, in each national system.

These country-level indicators are of course deeply affected by business environments and policies. For instance, entry barriers and direct or indirect public subsidies to firms in trouble can alleviate the welfare costs of crises in the short term, but may have long-term negative effects on firm selection and economic growth. To take another example, if the judiciary works badly and private contracts are difficult to enforce, incumbents have a clear advantage over entrants. Finally, if the political system works badly, some firms may escape competition thanks to their political connections.

Finance also plays a role in shaping firm dynamics. New businesses need money, which can't always be provided by banks, because of the riskiness of the venture and the scarcity of collateral. Venture capitalists are the right answer, yet their contribution is quite varied across countries. Technological improvements, for which the Fintech label is a proxy, are now filling these gaps, but the process is uncertain and uneven. For now, at least in some countries, new and young firms have to rely on bank credit and face tight capital constraints.

If we leave aside cross-country differences and do some time-series analyses, we notice a decline in business dynamism since the early 2000s all over the world: for most OECD countries, new firms' entry rates are now significantly lower than at the beginning of the century. What are the causes of this phenomenon? One may be the possible increased market power of incumbents. Another may be the fact that technological change and globalization increase the ability of more productive firms to gain market share. These two possible explanations have markedly different policy implications. The scientific debate is currently ongoing, and during this workshop other possible explanations will be discussed in depth by several presenters.

Recent research has highlighted how firm dynamics may have a role in explaining not only long-term potential growth but also business cycle fluctuations. The procyclicality of entry rates could be driven by a tighter selection of new firms during downturns, and slacker entry requirements when the economy is doing well. While this phenomenon is a stylized fact, its implications for the propagation and persistence of aggregate shocks have only been studied quite recently. Moreover, the impact of recessions induced by financial rather than real shocks is still comparatively underexplored. Today's presentations will also cover these important issues, which have clear implications for policies to stabilize the business cycle.

Let me conclude with a few words on Italy. Its lack of business dynamism has been an important determinant of the sluggish productivity growth over the last 20 years according to most research in this field, much of which has been conducted by the Bank of Italy's economists.

From the mid-1990s onwards, aggregate productivity in Italy has grown at a significantly slower pace than in the rest of the euro area. Total factor productivity (TFP) has been virtually flat, and yet at the same time the ICT revolution and the ensuing globalization of production were exploding, helping most other economies to reap enormous benefits in terms of productivity and growth.

The inability of Italian firms to do the same is normally attributed to the large share of micro and small firms in the system: those firms invest less in innovation and technology adoption, and are more vulnerable to global competition. Yet the small size of most firms is a dynamic malaise of the system, not a static one, and is caused by the lack of business dynamism.

Italian startups grow less and for a shorter period of time than new businesses in other OECD countries. They are poorly selected over their early years of life: exit rates are generally flat over the age distribution, meaning that less productive firms are not wiped out from the market when they are young. As a result, Italian firms are older, smaller and less productive than those from other developed countries.

The causes of this lack of business dynamism are manifold. Italy holds negative records for some of the frictions I discussed before: judicial efficiency is particularly low and financial leverage is among the highest by international standards. We have several specific dysfunctions, such as widespread tax evasion, the political connections of entrepreneurs, and cronyism, all of which distort competition in the economy, and slow down creative destruction and firm churning, with negative consequences for aggregate growth. The structural reforms that are needed to put Italy back on track should address these diverse and complementary issues in a bold and coherent framework.

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Ladies and gentlemen, I believe the discussions you are going to have today and tomorrow will provide important insights for addressing these issues too.

I would like to thank the organizers of the workshop: Francesca Lotti and Francesco Manaresi from the Bank of Italy, Salomé Balsandze from the Einaudi Institute of Economics and Finance and the CEPR, and Luigi Marengo from LUISS-Guido Carli University. I also thank Alessandra Piccinini from the Bank of Italy for taking care of the logistics.

I welcome you once again and wish you a fruitful exchange of ideas, as well as a pleasant stay in Rome.

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