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Consumption and growth in Italy

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Contents

Consumption trends in Italy

Per capita consumer spending today is more than twice what it was in 1970, although its growth has stalled in the last six years after averaging 1.7 per cent in the 1990s (Figure 1). From 1990 onwards consumption nevertheless rose faster than per capita disposable income, which remained more or less stationary over the entire period.

These trends diverge from those in the other major countries of the European Union (Figure 2). In the last fifteen years per capita income grew briskly in France and, above all, in the United Kingdom, fostering a rapid expansion of consumption. In Germany, which until two years ago was going through a phase of quasi-stagnation similar to that in Italy, consumer spending grew in line with income, which benefited from extensive corporate restructuring, productivity gains and the improved export performance of the German economy. This confirms the essentially different nature of the Italian and German cases: our system suffered from a crisis of international competitiveness, Germany's from a crisis of consumer confidence.

The data for our economy raise two interconnected questions. First: what factors explain the increase in consumption against a background of stationary income in the 1990s? Second: should the lack of growth in household consumption in the last six years be considered a transitory episode or as heralding a structural slowdown in demand that we will face in the years ahead?

The recent stagnation of consumption: an aggregate explanation

In the life-cycle model, which still constitutes the theoretical framework for analyzing consumer expenditure, households' choices are the result of planning that takes account of all available resources, both current and future. Unexpected increases in income or wealth that are deemed permanent stimulate an expansion in consumption plans because they ease the intertemporal budget constraint.

According to estimates that will be published before the end of the year by the Bank of Italy, the wealth of Italian households — excluding public pension wealth, in accordance with international statistical conventions — has increased sharply since the mid-1990s. At the end of 2004 household wealth was equal to about eight times disposable income; even bearing in mind the differences across countries in the valuation of real assets, this is a similar multiple to that in the United Kingdom and decidedly higher than those in Japan, France, Germany and the United States. In our country financial assets amount to almost half of total net wealth, a larger share than in France, virtually the same as in Germany and the United Kingdom and far smaller than in the United States and Japan. Although household debt is rising significantly, it is very low in Italy compared with the other countries.

The effect of wealth on consumption depends on the form in which it is held. The fungibility between the different types of wealth tends to be imperfect, because of the differences in the motives for their accumulation and in the transaction costs they involve. Financial wealth is mainly a store of value and has relatively low holding costs, while housing wealth is not only a store of value but also a consumer good in that it provides housing services whose cost varies with the market price of houses. The effects on consumption of a change in the value of home ownership are more difficult to assess, since they are influenced by the way the purchase of a house is financed and, more in general, by the development of the capital markets.

For purposes of empirical estimation, we can hypothesize a relationship in which aggregate household consumption is a function of income, the stock of housing wealth and the stock of financial wealth. For the Italian economy in the years between 1980 and 2006, an estimated long-term relationship shows that an increase of €100 in disposable income translates into €60 of additional consumption; an increase of €100 in wealth translates into €6 of additional consumption in the case of financial wealth and only €1.5 in the case of housing wealth.[1] The latter increase is smaller than those found by similar studies for the Anglo-Saxon economies, which range between 5 and 10, presumably reflecting the difference in the availability of financial instruments that permit transaction costs to be reduced and changes in the value of real estate to be transformed into purchasing power. The propensity to consume with respect to financial wealth is about the same as in the other countries, while that with respect to income is slightly higher in Italy.[2]

If pension wealth is included in the estimate, its impact on consumption is negligible in the period in question, contrary to the positive effect found for the forty years up to the early 1990s. It appears that the repeated changes in social security rules since then have made benefits and retirement dates more uncertain, reducing the

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[1] See A. Bassanetti and F. Zollino, “The effects of housing and financial wealth on personal consumption: aggregate evidence for Italian households”, paper presented at the conference “La ricchezza delle famiglie italiane” [Household Wealth in Italy], S.A.Di.B.A., Perugia, 16-17 October 2007.

[2] See M. Paiella, “The stock market, housing and consumer spending: direct wealth effects, common causality and borrowing constraints. A survey of the evidence”, paper presented at the conference “La ricchezza delle famiglie italiane” [Household Wealth in Italy], S.A.Di.B.A., Perugia, 16-17 October 2007.

responsiveness of consumption plans to pension wealth. Uncertainty about the final outcome of the numerous measures adopted for the public pension system and the fall in pension wealth appear to have entailed stepped-up accumulation of other forms of wealth, thereby braking consumption plans.

According to the aggregate consumption function estimated for Italy, since the early 1990s disposable income has made a modest contribution to the growth in consumption. The increase in household spending in the last decade can be ascribed above all to the growth in financial wealth, boosted especially by the equity component thanks to the rise in securities prices. In the last six years the performance of the capital markets has had repercussions on the value of financial wealth and, through it, on consumer spending. On the wave of sharply rising house prices, housing wealth has taken over from financial wealth in sustaining consumption. In the most recent years its contribution has tripled compared with the 1990s, though it continues to be relatively small.

The intertemporal budget constraint and, hence, spending decisions incorporate households' expectations for future public spending trends. The aggregate estimates indicate that Ricardian mechanisms have been at work. In correspondence with the stringent curbing of the deficit in the first half of the 1990s, there was a step-up in households' spending plans.

The fall in real long-term yields, connected with Italy's entry into the monetary union, was presumably also perceived by households as permanent, causing their plans to shift from saving to consumption.

Long-term equilibrium relationships estimated on aggregate data, such as those I have discussed so far, do reflect individual patterns of behaviour and the social and demographic characteristics of the population, but they do not fully capture the variety of factors that at microeconomic level influence the relationship between consumption choices, income and wealth. Estimating the consumption function with individual data, the increase in spending associated with an additional €100 of housing wealth comes to about €3 for owner households, while for renter households it is negligible; the overall effect proves again to be positive, in line with the value estimated using the aggregate data.[3]

As a whole, the aggregate evidence provides a consistent explanation of recent developments, but in order to explain future trends we must turn our attention to the underlying microeconomic factors: life expectancy, length of working careers, perception of the processes governing the evolution of income and wealth.

Demographic changes

In 1996 the number of persons over 65 years of age was about 15 per cent greater than the number of those below age 15; in 2006 it was 40 per cent greater — about three elderly persons for every two youngsters. Life expectancy has continued to lengthen: between 1993 and 2003 that of persons aged 65 increased by about two years.

The number of children has fallen. There are many reasons for this, but one factor has been the growing belief that income conditions and the organization of family life, especially in the big cities, are an impediment to procreation. These trends are common to all advanced economies, but are particularly marked in Italy.

Other changes have concerned the structure of households. From 1993-94 to 2003, there was an increase of six percentage points in the share of one or two-person households, which now account for more than half the total. In particular, the share of one-person households rose by almost 5 points, reaching one quarter of the total, owing mainly to the increase in the number of elderly women living alone.

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[3] See L. Guiso, M. Paiella and I. Visco, "Do capital gains affect consumption? Estimates of wealth from Italian households' behaviour", in *Long-Run Growth and Short-Run Stabilization: Essays in Memory of Albert Ando (1929-2002),* edited by L. Klein, Edward Elgar Publishing, 2006.

These changes have had important consequences with regard to the level, composition and dynamics of consumer demand. The lengthening of life expectancy can imply less expenditure if it is not associated with a longer working life. In the later stages of the life cycle, consumption tends to be financed prevalently by pension payments as well as by wealth decumulation. Retirement can be followed by a greater fall in spending than that attributable to the drop in income or the changes in people’s habits and needs when their working life comes to an end.

Other things being equal, consumption tends to be lower in both young and older households; it tends to increase with household size, although less than proportionally. There are also considerable differences in the composition of expenditure over the life cycle. For example, in the case of persons living alone, in 2005 their spending on health accounted for 1.7 per cent of total consumption for persons up to 35 years old, rising to 5 per cent for those aged over 65, while the proportion spent on clothing was 6.6 per cent and 3.4 per cent respectively.

Demographic conditions can have appreciable macroeconomic effects that are not captured by the data on the growth in incomes and aggregate wealth. An exercise based on the Istat consumption survey shows that if the distribution of the demographic characteristics of Italian households had remained the same as in 1997, in 2005 average household spending would have been about 1.5 per cent greater than it actually was; spending on clothing and transport equipment would have been almost 3 per cent more.

The progressive ageing of the population will contribute to a slowdown in the growth of household spending in the coming years and, together with the reduction in household size, will modify its composition. This conclusion is partial, because it implicitly assumes that for future generations the profiles of income and wealth, like other factors affecting spending decisions, will be similar to those of past generations. Even today, however, we see trends in these variables that contradict this hypothesis.

The labour market and incomes

The generation that is now entering the labour market and will continue to do so in the coming years will live in a radically different world from that of the generations that worked in the second half of the last century.

The functioning of the labour market and the level of earnings are different today.

In the last ten years employment has increased considerably, despite the modest growth in output. This is the result of wage moderation and of the reforms and labour agreements that have increased flexibility in the utilization of labour.

The employment rate among persons between 25 and 35 years old has risen by around five percentage points. However, the marked increase in job opportunities compared with those offered to the same age group in the preceding generations has been accompanied by a considerable drop in entry-level wages. The earnings of high school or university graduates who have entered the labour force in the most recent years are, in real terms, close to those of their counterparts who began to work in the early 1980s and lower than those of graduates who started in the early 1990s.[4] In a context in which average wages have continued to rise, albeit only moderately, lower entry-level wages have not opened the way to faster career progression. The reduction in compensation appears, at least in part, to be of a permanent nature, and more importantly for spending decisions, is perceived as such by workers.

Young people's working experience today also differs from that of previous cohorts because of its greater discontinuity and unpredictability. The share of payroll workers between the ages of 25 and 35 who hold temporary jobs has doubled in the last ten years, reaching 17 per cent. However, the full extent of job insecurity is even greater, since the phenomenon also encompasses the many workers who, though formally self-employed, work under arrangements

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[4] See A. Rosolia and R. Torrini, "The generation gap: relative earnings of young and old workers in Italy", *Temi di discussione* (Working Papers), no. 639, September 2007.

and schedules that are typical of payroll employment. The proportion of young people among these workers is high, touching 45 per cent.

Discontinuity of working careers holds down spending for a large part of the life cycle. Permanent income being equal, in the absence of appropriate financial instruments and knowledge, an increase in volatility can cause prudent economic agents to reduce demand and save more in order to accumulate the resources necessary to cope with possible adverse events.

Wages are lower in Italy than in the other main European Union countries. According to Eurostat data on firms in industry and private services in 2001-02, mean hourly earnings, at purchasing power parity, were €11 in Italy, between 30 and 40 per cent less than in France, Germany and the United Kingdom. As in France, in Italy the curve of earnings rises with age, while in Germany and the United Kingdom there is an inverted U-curve: earnings reach a peak during workers' most productive years and decline thereafter (Figure 3). The differences in earnings with respect to the other countries are only slightly smaller for young workers; they increase for middle-aged workers and tend to fall to nil for the oldest. The differential is smaller in unskilled, manual work. These data refer to averages and reflect the different individual characteristics of workers and their occupations; part of the differences, for example, can be explained by the lower level of training of the Italian work force. Even controlling for individual characteristics, however, monthly net earnings in Italy are around 10, 20 and 25 per cent lower on average than in Germany, the United Kingdom and France respectively.

The greater uncertainty and discontinuity of career paths make it harder to predict the total amount of pension contributions paid in the course of the entire working life. The risks bearing on the amount of pension wealth that will actually be available in the future are greater, since it depends to a significant degree on the performance of financial markets. To this can be added the uncertainty generated by repeated changes to social security rules. All in all, the youngest workers might be induced to retrench further on spending, which is already moderated by lower expected permanent income than in the past.

The perception of a lower permanent income and the greater volatility of current income are also reflected in young people's decisions as to when to leave home, combining with many other cultural and social factors. Compared with the rest of Europe, Italy has the highest percentage of young people who live with their parents and the lowest percentage of households whose head is under 30 years of age. In the past ten years, the percentage of young people between 25 and 35 who are still part of the household in which they were born has increased by around five percentage points, to 45 per cent; the proportion is higher for males than for females. Fertility rates are among the lowest in Europe.

The possible economic policy responses

Income must start to grow steadily once again. Productivity is the key variable. The recent increase in employment has been accompanied by lower labour productivity: the rate of growth in capital intensity has diminished and occupations with low value-added have become profitable. Total factor productivity has not supported growth.

The younger workers of today are earning less than their predecessors because their productivity is less suited to the current technological paradigm than was the productivity of the generations that entered the labour market in past decades under the old paradigm. Restoring a rapidly rising path of productivity will solve the Italian economy's supply problem, permit wage increases and strengthen domestic demand.

Economic policy can help revive productivity and growth. The consensus diagnosis of Italy's ills spotlights the need for measures to reform the rules of the economy and public spending. These "structural" measures, aimed at increasing the efficiency and competitiveness of domestic production, will themselves support household income and consumption, ensuring economic growth.

There is ample scope for public action. In connection with the issues I have discussed here, there are three key areas.

A courageous reform of the education system, in particular from high school up, is needed that will encourage young people about to enter the labour market to invest seriously in their human capital. It must enable them to evaluate and choose the quality of the education they receive. It must make the recognition of talent transparent to employers, so that talent is adequately utilized and also rewarded.

In the labour market, it is necessary to identify instruments that can distribute the costs of greater flexibility more fairly. There are ways, used in other countries, of reconciling the demands of competitive enterprise with the aspirations of new workers entering the market and the need for stability and professional growth for those already working.

An increase in the effective retirement age can restore the balance between people's life expectancy, working career, and consumption plans.

I should add that the need to accumulate wealth for precautionary motives is the less cogent, the more advanced is the supply of financial instruments and insurance products adequate for the new profiles of risk and uncertainty. The development of the financial markets and of the skills and ethical standards of the intermediaries can help to satisfy these needs. We are committed to stimulating them.

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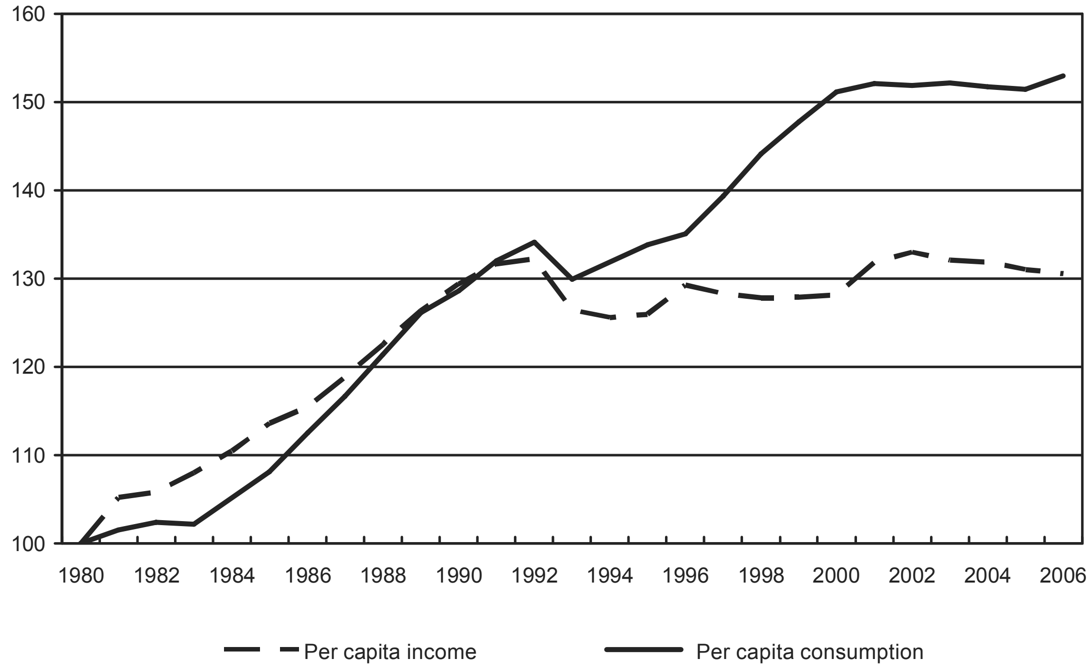
Recovery in the growth of consumption is essential for the general welfare, for the expansion of output and for financial stability itself. The beneficiaries and protagonists of this process are young people in particular. Economic policy will be successful if it helps them to discover creativity in flexibility and entrepreneurship in uncertainty.

Modified on 21st November 2007

Figure 1

Per capita household disposable income and consumption in Italy
(indices, 1980=100; chain-linked volumes)

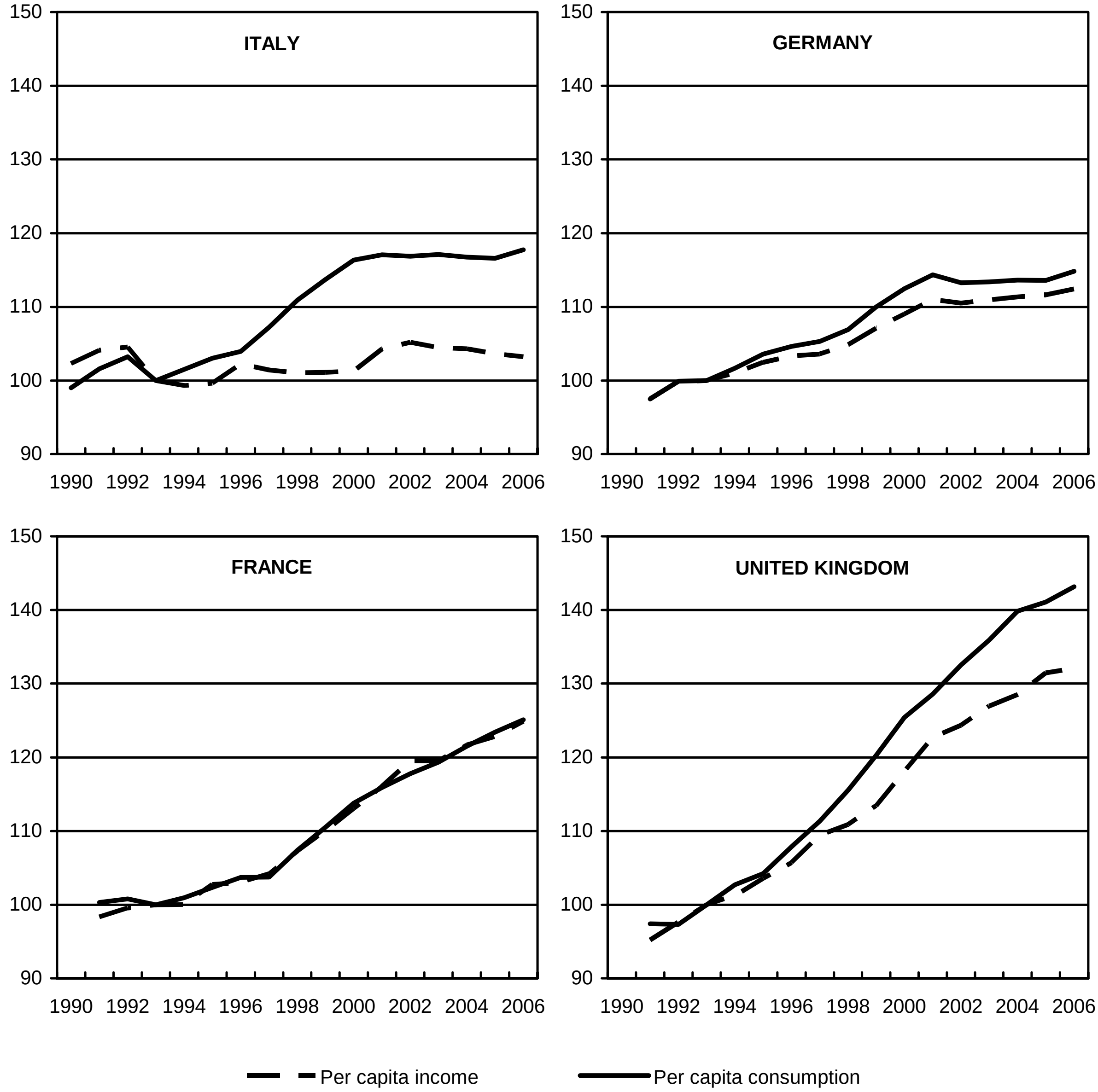


Source: Based on Istat data, *Contabilità nazionale*.

Figure 2

Per capita household disposable income and consumption

(indices, 1993=100; chain-linked volumes)

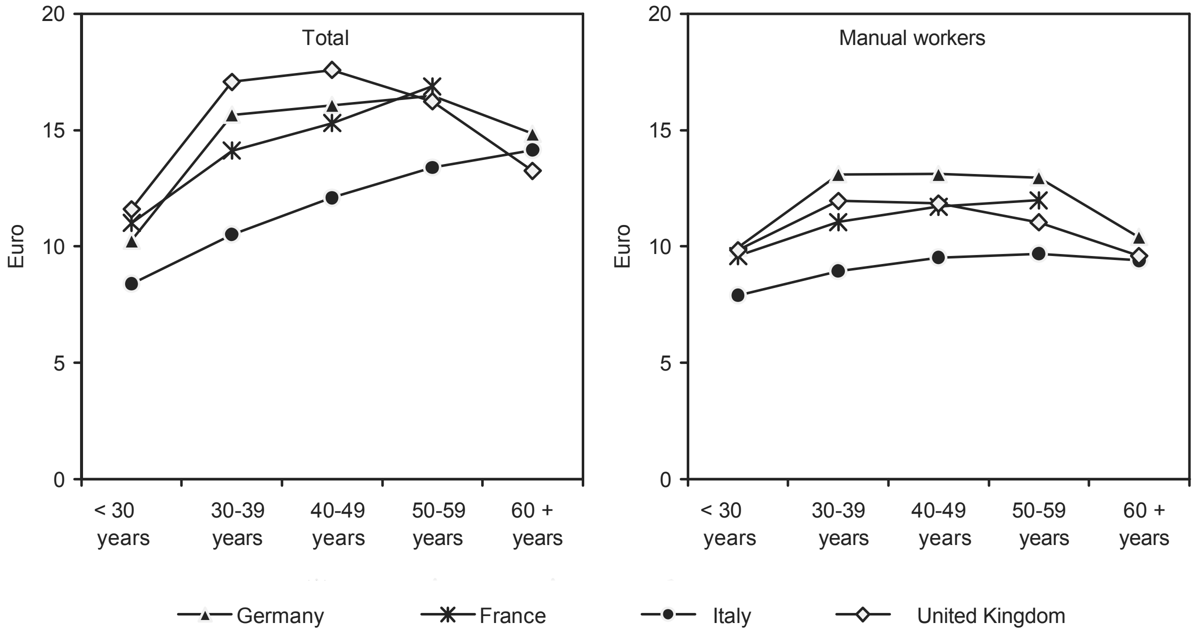


Source: Based on Istat data, *Contabilità nazionale*, for Italy; Eurostat, National Accounts, for France, Germany and the United Kingdom.

Figure 3

Mean hourly earnings in industry and private services

(euros at purchasing power parity)



Source: Based on Eurostat data, *Structure of Earnings Survey*.