Riccardo Faini Memorial Conference

Italy’s lost productivity and how to get it back

Bank of Italy, Via Nazionale 91

Opening remarks

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I am pleased to welcome all participants to this conference to remember Professor Riccardo Faini.

I first met Riccardo in 1978 when I presented a paper written with Stefano Micossi in the famous monetary workshop held by Franco Modigliani and Stan Fisher at MIT (Riccardo was then a PhD student with Giampaolo Galli and Luca Barbone…). We met often in the following years inside and outside of Italy, socially and professionally, exchanging views and commenting on each other writings. Indeed, issues related to the topic of today's conference – long-standing poor productivity dynamics in Italy – happened to be at the centre of a couple of professional exchanges between us in the mid-1990s and early 2000s, which I would like to briefly share with you.

In 1994, at a seminar on "The New Frontiers of Economic Policy" (*Le nuove frontiere della politica economica*) organised by the Innocenzo Gasparini Institute for Economic Research (IGIER), I discussed – along with Luigi Spaventa – a paper by Riccardo on wage and productivity differentials (*Stesso lavoro, diverso salario?*, i.e. "Same jobs, different wages?") between Northern Italy and Southern Italy – the *Mezzogiorno*. The starting point of Riccardo's analysis was that a convergence in nominal wages between the two regions since the late-1960s had not been accompanied by a parallel convergence of productivity levels; the ensuing higher unit labour costs in Southern Italy were thus contributing to higher unemployment there.

In order to achieve more wage flexibility in Southern Italy's labour market, Riccardo's main proposal was to introduce a third type of wage bargaining arrangement – a regional one – to complement or replace bargaining at the centralised and firm levels, with a view to bringing closer wages and productivity levels while addressing higher unemployment in the South.

In my comments I raised some criticisms, but on one major point we were in close agreement, namely that the issue of lower productivity (and higher unit labour costs) in Southern Italy should be addressed not only by reforming the labour market but also by implementing broader structural reforms to overcome well-known distortions of the general institutional, economic and social environment, notably infrastructural gaps, enforcement of property rights, efficiency of the justice system and the public administration. I cannot help but notice that these areas are the same where reforms are called for still today for the Italian economy as a whole.

In 2003 Riccardo and I wrote two papers on the dismal performance of the Italian economy. While I was considering a number of structural deficiencies that were risking to have serious consequences on our growth capabilities in the years to come, Riccardo tried to put the unsatisfactory Italian productivity outcome in a hystorical perspective. It is interesting that the titles of our papers had two elements in common: the word "decline" (so popular today) and a question mark. [Riccardo's paper: *Fu vero declino? L'Italia degli anni Novanta* ("Was it truly a decline? Italy in the 1990s"); my paper: *È veramente in declino l'economia italiana?* ("Is the Italian economy really in decline?"). Also noteworthy is that later that year a further paper was published by Giacomo Vaciago, with the word decline in the title but without question mark: *Il declino dell'economia Italiana*, ("The decline of the Italian economy").] And it is also interesting that in December 2003 we participated in a conference whose title used exactly these two elements to raise the provocative question: *L'Italia: un Paese in declino?* ("Italy: a country in decline?"). The conference was jointly organised by Mediocredito Centrale and the Associazione Borsisti Marco Fanno, under the leadership of Michele Salvati, critical of the use of the word, and introduced by Mario Draghi, the then President of the Association. To be sure, as Mario put it in his introductory words, the risk of decline was to be understood not only as Italy-specific but rather as a broader European issue.

Riccardo and I were also both somewhat critical of the use of the term "decline" to define Italy's situation at the time. But we both argued that the risk for the coming years had not to be undervalued. I remember pointing out that Italy's economy was rather undergoing a phase of "long and difficult transition" because of the need to adapt and respond to the shocks posed by both the "new economy" and technological progress, which had taken the Italian productive system rather unprepared. These issues were already widely debated in the Bank of Italy (where Salvatore Rossi was leading work on the "new economy" and Pierluigi Ciocca summarizing Italy's challenges as a "problem of growth"). And they were very much being discussed and analysed in the Economics Department of the OECD, that I had been leading, within a wide-ranging and global project on "The sources of growth".

Therefore, I underscored that Italy's low growth was first and foremost due to structural internal causes, most notably low investment in capital (physical, human, knowledge-based) and correspondingly low ability to innovate, which underpinned what still can be seen as the hallmark of Italy's fundamental problems: the disappointing dynamics of total factor productivity over the last twenty years or so.

Riccardo too related the increased attention paid to the worsening of Italy's economic performance to the changes in the international economic situation: globalization and the rise of emerging market economies, which threatened Italy's comparative advantages in sectors of specialization with low intensity of both human capital and technology.

To counter the decline story, his main argument was that Italy's worse aggregate growth in the 1990s in comparison with its peers (France, Germany and the US) was biased by demographic factors: in per capita terms Italy's growth was only marginally slower (he drew similar conclusions in terms of purchasing power parity). Besides, Riccardo gave heavy weight to the importance of economic developments in the South: in his view, Italy's decline – to be played down in itself – was mainly a Southern Italy's problem ("*un problema meridionale*").

Contrary to what was often stated, in Riccardo's view the 1990s were not a time that set the beginning of the decaying phase. Signals of underperformance had indeed appeared even earlier: in his paper of 2005 with André Sapir in *Oltre il declino* ("Beyond the decline", a book edited by him and others well known Italian economists, some of them here today), he underscored that average labour productivity growth began to fall in the 1960s and 1970s (a result not limited to Italy and, I would say, not unexplainable for a country that had so quickly caught up after WW2 with the most advanced world economies). More importantly, he believed that the 1990s had in many respects laid the groundwork – in terms of adoption of some initial structural reforms – for the country's economic revenge. He aptly warned of the perils of not continuing the structural reform effort.

I shared this warning, and to some extent also the observation that we should look deeper into the past to understand the present. Somehow, I felt that behind the difficulty to disinflate the economy until the mid-1990s and the dismal growth performance following the establishment of the monetary union there were common factors, most notably the very low productivity growth in the (protected and inefficient) service sector of the Italian economy. This made it very difficult to disinflate in the former period, as the increases in nominal wages that were matching the rise in productivity in the manufacturing sector became the benchmark for a service sector lacking the ability to produce similar productivity gains, with higher costs for the same manufacturing sector. With a single currency, in a much wider area and lacking the necessary investment response, global competition and the monetary union were not well responded and resulted in a prolonged period of low growth overall.

Perhaps I was less optimistic than Riccardo, but our views were the closest on a few key issues: the structural nature of Italy's problems, the specific challenges that globalization posed to the country and the "absolute priority" for economic policy: strengthening human capital and investing in education.

Italy's productivity problem today

It is unfortunate – to say the least – that Italy's structural problems of today are broadly the same as those of 15 years ago and the key question remains how to resume Italy's growth. To this end, getting back "lost productivity" is obviously critical. Perhaps the main difference from past discussions is that today these challenges have to be addressed in a more complex global environment dominated by the legacies of the global financial crisis and faster technological progress.

The former has left most developed economies in a period of sluggish economic growth, spurring a lively debate among economists on longer-term prospects and raising increasing concerns among policy-makers. Many scholars have highlighted how financial crises are characterized by slower recovery with respect to non-financial recessions because of *inter alia* a larger decline in capital accumulation, the stronger impact of the credit shock on young and fast-growing firms, and the huge costs incurred for banks' recapitalization. Currently, growth is also held back by financial deleveraging, subdued demand, and low inflation (which raises real interest rates).

Besides these short-term factors, future growth prospects are weakened by the long-term decline in productivity growth that is affecting all developed countries. Economists have pointed to several factors to explain this slowdown. According to one view, growth in advanced economies may be hampered by inadequate aggregate demand, driven by demographic trends, growing inequality and raising government debt, resulting in a "secular" decline in interest rates. Others link the slowdown to the types of innovation that have emerged overtime: those which took place in the second half of the 20th century ("general purpose technologies" such as electrification) may be much more significant than those that characterize the 21st century (such as ICT and the digital economy). Recent evidence based on firm-level data from several OECD countries seems to show that innovation has not slowed down; rather, the pace at which innovation is spread across the economy ("the diffusion machine") has weakened.

As I have already underscored in past occasions, technological progress is today's most powerful agent of change: in the "second machine age", as it has been aptly defined, it poses distinct challenges at both the economic and social level because of a few key features of the digital revolution, first and foremost the greater speed by which new technologies tend to replace labour, even in fields in which human intervention has so far appeared to be decisive. These developments underpin a revival of the concept – proposed by Keynes in 1930 – of "technological unemployment", which has come to be seen as a possible result of the diffusion of automation, robotics and digitalization, with the risk of a substantial decline in job opportunities and stagnation of wages and incomes in a number of industries and countries.

To which extent this general background relates to the Italian economy?

Understanding the sources of productivity growth is of utmost importance for Italy. As we have seen, since the early 2000s Italian productivity has been disappointingly stagnant, performing significantly worse than other European countries. It remains relevant to distinguish how much of this poor productivity growth is to be related to Italy's structural weaknesses or rather due to delayed adjustment to global changes that could be overcome in due time, hopefully earlier than later: I am sure that today's debate will help make progress in this direction.

The work of many Italian economists, some of them are here today including those working at the Bank of Italy, has long highlighted the importance of structural factors that are specific to the Italian economy and to their interaction with the three fundamental changes that have taken place since the second half of the 1990s: globalization, the technological revolution and the demographic transition, especially, but not only, linked to population ageing. On top of all this we have had the establishment of the Economic and monetary union and the adoption of the euro. To all these changes the Italian economy has adjusted very slowly, if at all, and with substantial delay. The result has been the inability to overcome well known structural weaknesses. Some of these weaknesses are internal to Italian firms, which are, when compared to those located in other developed economies, considerably smaller, older, with a lower propensity to innovate and adopt new advanced technologies. Management skills and practices leave much to be desired and are often old-fashioned. To finance their activity firms rely on bank credit much more than what happens in other advanced countries: in this regard, it is well known that this is not the ideal source for financing innovations.

The capability of Italy's productive economy to increase sales and create value added has been also undermined by long-standing institutional weaknesses. Since 2011 Italy has undertaken a vast programme of structural reforms, aimed at creating a more growth-friendly environment. Legislators have approved, in various steps, measures to reduce red-tape, to simplify bureaucratic procedures for starting and running businesses, to improve the efficiency of the public administration and the judiciary system, to prevent and fight corruption, to stimulate innovation, and to achieve a more flexible and dynamic labour market.

The process is still ongoing and far from being concluded, even if in several areas there are first effects. The stock of pending civil proceedings is decreasing: our estimates show that some of the measures adopted in the past to reduce red tape and to simplify business start-up regulations have had positive effects on the entry rate of start-ups. The Jobs Act is a wide-ranging reform, that has tackled employment protection legislation, unemployment insurance, wage supplementation funds, active labour market policies and other aspects. But while its long-term effectiveness still remains to be seen, we must understand the risks of going backwards, as reducing labour market segmentation is fundamental in the quest to allocate labour from less to more productive uses, and to boost aggregate productivity.

Factors that negatively impinge on aggregate productivity growth by constraining both efficiency gains at the firm-level and the efficiency of the reallocation of resources from low- to high-productive firms have to be decisively addressed. More generally, in order to overcome its low productivity problem the Italian economy must improve its ability to fully seize the opportunities of the digital revolution while governing the consequences that technological progress is exerting on labour demand and the skills required to current and prospective workers. So there is a need to fundamentally improve the environment in which firms are formed, grow and operate, and to invest in knowledge, human capital and the new skills needed to succeed in the years ahead.

To a relevant extent, the current wave of technological progress may have made even more difficult to reconcile productivity gains and employment (and wage) growth. This challenge may be greater in Italy if one looks at the past. As recalled by Riccardo Faini in his 2003 papers, Italy did not always succeed to overcome the above potential conflict: between 1992 and 1996, productivity growth was satisfactory but employment decreased dramatically; on the contrary, between 1996 and 2001 rapid employment growth resumed while productivity growth collapsed and its level remained stagnant afterwards.

Avoiding a repetition of these dismal dynamics is perhaps the greatest challenge for policy-makers and academics alike.