ECO FLASH

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Italy's economic weakness: causes and consequences

Jean-Luc Proutat (*)
(*) With contributions from Théodore Humann, Intern

- **Since the mid-1990s the Italian economy has seen a significant economic uncoupling, which has worsened since the 2008 financial crisis.**
- **Its difficulties include a level of productivity that is one of the lowest in the advanced economies, a demographic decline and a relatively inefficient labour market, which still excludes too many young people.**
- **Structural reforms were introduced under the government of Mario Monti, from 2011 on, bringing a recovery in fiscal and trade accounts, but it remains to be seen what the current government will now do.**

How to handle debt at 130% of GDP with no growth? At a time when Italy is seeing a new wave of volatility over its spread[1], the persistent sluggishness of its economy is more than ever at the forefront. Since 2012, growth in Italy has averaged 1% per year, compared to 2% for the eurozone as a whole. At the end of 2018 the country's economy slipped back into recession, for the third time in ten years. This lack of economic vigour is far from new (see Chart 1) and its causes are to be found beyond the global crisis of 2008. In the first section of this report, we look at the economy's structural weaknesses and the deterioration of its potential growth rate[2].

Struggling for investment and financing

Both the estimated level and the make-up of Italy's potential growth rate[3] between 1995 and 2018 suggest a lack of vigour that has no real equivalent in other European Union (EU) countries, and that is also a fairly longstanding concern.

A structural decline

Italian potential growth by factors

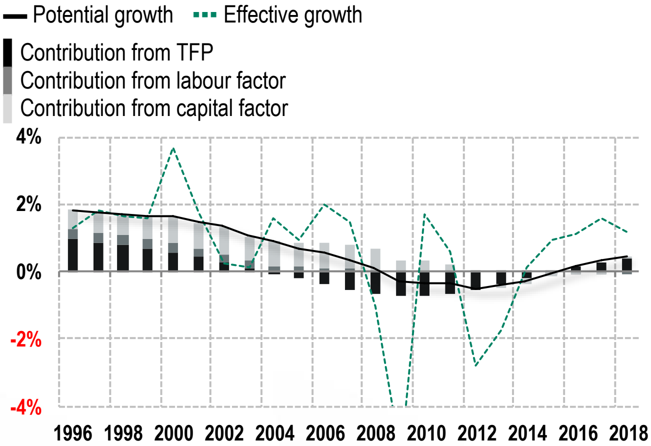

Chart 1 Source: BNP Paribas estimates

Before 2008, the country's potential growth rate was already only half that of the euro zone as a whole (1% per year on average between 1996 and 2007). The two successive crises (financial and sovereign debt) that followed dragged potential growth rates into negative territory[4], and the recovery since 2016 has been hesitant (Chart 1).

Underlying these two 'lost decades' is the stagnation of total factor productivity (TFP)[5], which is currently at the same level as in 1995 (Chart 2). Over the same period, TFP in Germany and France has risen by nearly 13%. In Spain, although it was flat up until 2013, TFP has since risen markedly.

Setting aside structural effects (the expansion of tertiary sector activities, the relatively high weighting of non-merchant public services), the limited gains in productivity in Italy result

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[1] Spread between Italian Treasury bonds and German *bunds,* which widened to more than 300 basis points (for 10-year instruments) at the end of 2018, before narrowing to 200bp on 11 July 2019.

[2] "*The production function methodology for calculating potential growth rates and output gaps*", European Commission economic paper, June 2014.

[3] The potential growth rate is the rate of GDP growth that can be achieved over a long period without generating inflationary pressures.

[4] According to European Commission estimates, which are fairly close to those of the OECD.

[5] The estimation of TFP results from the identification of that part of growth which cannot be explained by changes in the two factors of production: labour and capital.

primarily from a chronic shortfall in investment, with the stock of capital having stopped rising in 2012 (Chart 4).

In 2018 gross fixed capital formation by companies (at constant prices) was still at its 1999 level. R&D expenditure has run at only 1.2% of GDP over the past twenty years according to the Organisation for Economic Cooperation and Development (OECD), compared to 2.1% in France for example. Several causes have been identified for this shortfall: the fragmented industrial fabric (95% of which consists of micro-companies), low levels of competition and the focus on sectors with a low technological component[6]. Most studies show that R&D expenditure rises in line with company sizes, meaning that Italian R&D investment has often fallen below the threshold needed to benefit from technology transfers and access external markets[7]. As a result, the Digital Economy and Society Index (DESI), developed by the European Commission, ranks Italy 25th of the EU nations, very nearly at the bottom of the pile[8].

Lending to companies, which in contrast to the trend seen in other countries, has not recovered in Italy (Chart 4), has been another brake on investment. Following the sovereign debt crisis in the euro zone, and given their exposure to Italian Treasury securities, domestic banks have seen financing costs rise and ratings fall, a phenomenon that has been aggravated by the country's return to recession in 2012-2013 and the deterioration of balance sheet quality. Although the situation has improved since (longer-term loans and asset purchases from the ECB, reduction in the share of non-performing loans, improvements in solvency ratios, etc.), Italian banks are still suffering from low levels of profitability by European standards, and their ability to finance the economy remains constrained (IMF, 2019)[9].

Over and above the shortage of banking resources, their allocation in the post-crisis period has not been efficient. A Bank of Italy study (Schivardi et al, 2017)[10] examined how, in order to address tighter prudential standards, banks with low capital (primarily the regional banks) have sought to avoid materializing losses by extending credit to so-called 'zombie' firms (those whose return on equity stands below their cost of capital). According to the authors, such a misallocation has caused credit restrictions to healthy borrowers and higher probability for them to default.

Labour: a scarce and undervalued resource

Changes in the labour factor in Italy have also contributed to the deterioration of the potential growth rate, despite the reforms of the 1990s and 2010 (including the Jobs Act)[11].

A long decline in productivity

Changes in TFP, 1995=100

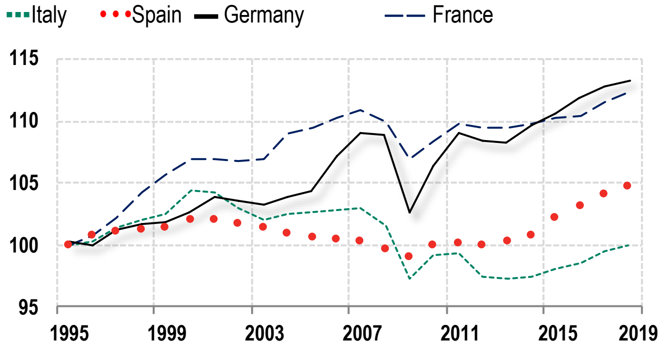

Chart 2 Source: AMECO

The engine has stalled

Average annual change in stock of capital
Average annual change in total volume of hours worked

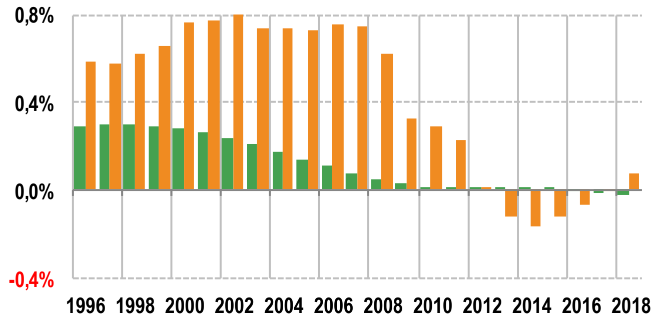

Chart 3 Source: BNP Paribas estimates

Financing in the doldrums

Outstanding loans to domestic companies, 2008=100

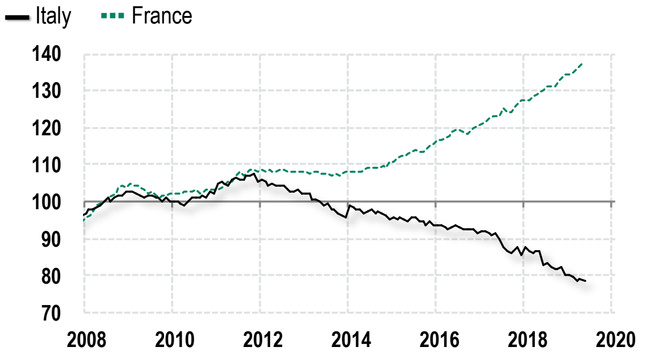

Chart 4 Source: ECB

Average annual growth in hours worked, which was still positive in the 2000s (at 0.3%), has fallen to zero, and its contribution to potential growth became negative from 2014 on (*Chart 4*). The reforms helped drive the growth in jobs, but ignored training and education policies. At 22%, the share of people aged 25 to 34 with a university degree is 7 points

[6] French Treasury, *Understanding Italy's productivity weakness*, Trésor-Eco n°170, May 2016

[7] OFCE, *Italy: Escaping the high-debt and low-growth trap*, Policy Brief, May 2019

[8] The Digital Economy and Society Index (DESI), 2019 rankings

[9] IMF, 2018 Article IV Consultation on Italy, February 2019

[10] Schivardi F., Sette E., Tabellini G., *Credit misallocation during the European financial crisis*, Banca de Italia, Working paper n°1139, September 2017

[11] Introduced in 2015 under the government of Matteo Renzi, the so-called 'Jobs Act' reform of the labour market consisted mainly of relaxing the rules governing permanent contracts (introduction of a fixed scale for redundancy payments, introduction of the option for agreed termination of contracts, removal of the rule of automatic re-employment, etc.) See French Treasury *Italian Labour Market Reforms,* Trésor-Eco, October 2018.

below the EU average. Moreover, Italy ranks poorly in terms of professional training and adult skill levels (OECD, 2019[12]).

The proportion of the long-term unemployed has remained high and stable, at 60% of the total in 2018, as has structural unemployment. At 10.2% of the active population (European Commission figure), this remains one of the highest rates in the OECD; more importantly, it has not fallen, whilst Spain, Portugal and France have all seen progress in this area recently.

Lastly, the population is ageing (nearly one Italian in four is aged 65 or over, making Italy the second oldest country in the world, after Japan) and the working-age population is shrinking. In addition, Italy's activity rate of 67%, although rising, is one of the lowest in the euro zone (it is 81% in Germany for instance)[13]. Another unwelcome record is that 29% of young Italians (20 to 34 years old) are neither in employment nor in education or training (NEETs, Eurostat), compared to an EU average of 17%[14]; 50,000 young people leave the country every year.

Has the output gap already closed?

The downtrend in the potential growth rate could mean that although it is now seeing a delayed and modest recovery, the Italian economy is already facing capacity constraints. This would appear to be the European Commission's analysis, when it indicates that the output gap (the difference between GDP and its potential level) narrowed in 2018 (*Chart 5*). Although a direct approach (see Box 1) tends to confirm this diagnosis, it is far from unanimously accepted. Both the OECD and the International Monetary Fund (IMF) differ from the Commission, and believe that Italy's output gap is still significantly negative.

This debate is not just theoretical in nature: the economy's position in the cycle determines the cyclical element of the deficit (that part which increases or decreases due to the automatic stabilisers) and the effectiveness of policies to support demand. In its latest report on Italy, the OECD was fairly favourable regarding the budget target of improving the position of the poorest citizens. But the organisation doubts that a minimum guaranteed income will achieve this without structural measures to improve recipients' inclusion in employment[15]. Irrespective of their assessment of the economy, all the major institutions – the Commission, IMF and OECD – share the view that to recover, Italy must first reform.

At its potential?

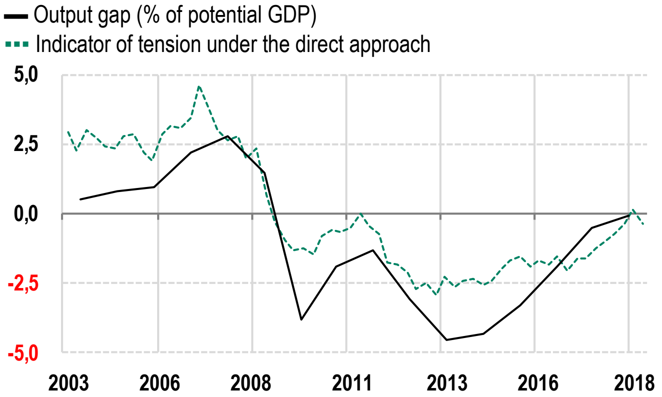

Chart 5 Source: BNP Paribas, European Commission

Estimates of potential GDP

Estimates of potential GDP are based on a Cobb-Douglas type macroeconomic production function

$Y^{pot} = TFP*L^{\alpha} K^{1-\alpha}$

Ypot is potential GDP, TFP is …, K is the stock of capital and L is the labour factor, which in turn is composed as follows: ***L=N*PR*Hrs*(1-NAIRU)***

With:

N *(working age population),*

PR *(participation rate)*

Hrs *(average number of hours worked per worker),*

NAIRU *(non-accelerating inflation rate of unemployment).*

TFP is estimated for each period as a residual (Solow residual), before being filtered (Hodrick-Prescott or Kalman) to isolate the trend component and reduce cyclical effects:

$tfp = y^{realized} - \alpha*l - (1-\alpha)*k$ *The variables are in lower case as they are logarithmic; a value of* α=0.63 *is generally used in the euro zone.*

The method used for the direct approach to the output gap is based on a principal component analysis (PCA), which allows a latent variable to be generated from a series of indicators, serving as a proxy for the position of the economy in the cycle, that is to say the output gap. The indicators of tensions that produce the first principal component relate to supply (shortage of labour in services, industry and construction, unemployment rate, capacity utilisation rate, unit labour costs) and demand (lack of demand in services and industry), with economic data from Eurostat.

Box 1 Source: BNP Paribas Group Economic Research

Jean-Luc Proutat
jean-luc.proutat@bnpparibas.com

Théodore Humann
theodore.humann@bnpparibas.com

[12] The OECD programme for assessment of adult skills -- Programme for the International Assessment of Adult Competencies or PIAAC -- ranked Italy last on the list of countries responding to the survey (in 2015); in addition, only 60% of Italian companies train their employees, compared with an average of 76% in the OECD nations. See. OECD, *Adult learning in Italy, what role for training funds?*, March 2019

[13] Measurement of indicators of labour and its productivity are made complex by the size of the black economy, which according to ISTAT estimates represents nearly 18% of GDP.

[14] Developed by Eurostat, the NEETs rate (neither in employment nor in education or training), is a measure of the efficiency of the transition into employment and the ability to integrate citizens aged between 20 and 34 in the economy.

[15] OCDE, Italy Economic Survey, April 2019

GROUP ECONOMIC RESEARCH

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com
ADVANCED ECONOMIES AND STATISTICS		
Jean-Luc Proutat Head – United States, United Kingdom	+33 1 58 16 73 32	jeanluc.proutat@bnpparibas.com
Hélène Baudchon France – Labour markets	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Louis Boisset European Central Bank watch, Euro area global view, Japan	+33 1 57 43 02 91	louis.boisset@bnpparibas.com
Frédérique Cerisier Euro area (European gouvernance and public finances), Spain, Portugal	+33 1 43 16 95 52	frederique.cerisier@bnpparibas.com
Catherine Stephan Nordic countries – World trade – Education, health, social conditions	+33 1 55 77 71 89	catherine.stephan@bnpparibas.com
Raymond Van Der Putten Germany, Netherlands, Austria, Switzerland – Energy, climate – Long-term projections	+33 1 42 98 53 99	raymond.vanderputten@bnpparibas.com
Tarik Rharrab Statistics	+33 1 43 16 95 56	tarik.rharrab@bnpparibas.com
BANKING ECONOMICS		
Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Laure Baquero	+ 33 1 43 16 95 50	laure.baquero@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+ 33 1 40 14 30 77	thomas.humblot@bnpparibas.com
EMERGING ECONOMIES AND COUNTRY RISK		
François Faure Head	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam, South Africa	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Sylvain Bellefontaine Turkey, Ukraine, Central European countries	+33 1 42 98 26 77	sylvain.bellefontaine@bnpparibas.com
Sara Confalonieri Africa (Portuguese & English-speaking countries)	+33 1 42 98 43 86	sara.confalonieri@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot Korea, Thailand, Philippines, Mexico, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
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