

ECONOMIC SURVEY OF ITALY 2007:

*This is an excerpt of the OECD Economic Survey of Italy, 2007,
from the chapter 1: “Italy’s key challenges”.*

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Abstract: The Italian economy rebounded significantly in 2006. However, challenges lie ahead: lack of total factor productivity growth; low relative human capital accumulation, weak market competition, a large regional gap, still low labour market participation, and a fiscal policy in need of consolidation.

Keywords: Macroeconomic performance, macroeconomic policy, competitiveness, real exchange rate, labour, productivity, total factor productivity, unit labour cost, inflation, GDP growth, export performance, supply side

[...]Last year’s acceleration was largely cyclical (demand led) and Italy’s challenge is to ensure a more durable turnaround. Supply potential is limited by a sharp productivity growth slowdown which began around 1995 and an absolute total factor productivity decline after the turn of the millennium – a rare event in the OECD context. Ageing is at the same time starting to bite as the working age population declines. Per capita income growth has been propped up in recent years by rising total hours worked associated with labour market reforms (Table 1.3).

Table 1.3. Decomposing Italy's per capita GDP growth, 1970-2005
Annual average growth rates

	Per capita GDP	GDP per hour worked	Hours per working age person	Working age population over total population
1970-1980	3.1	4.7	-1.6	0.0
1980-1995	2.0	2.2	-0.6	0.4
1995-2005	1.2	0.9	0.6	-0.3
1995-2000	1.9	1.5	0.6	-0.2
2000-2005	0.9	0.7	0.5	-0.4

Source: OECD Economic Outlook 80 database and OECD Productivity database, September 2006.

Difficulty in coping with globalisation

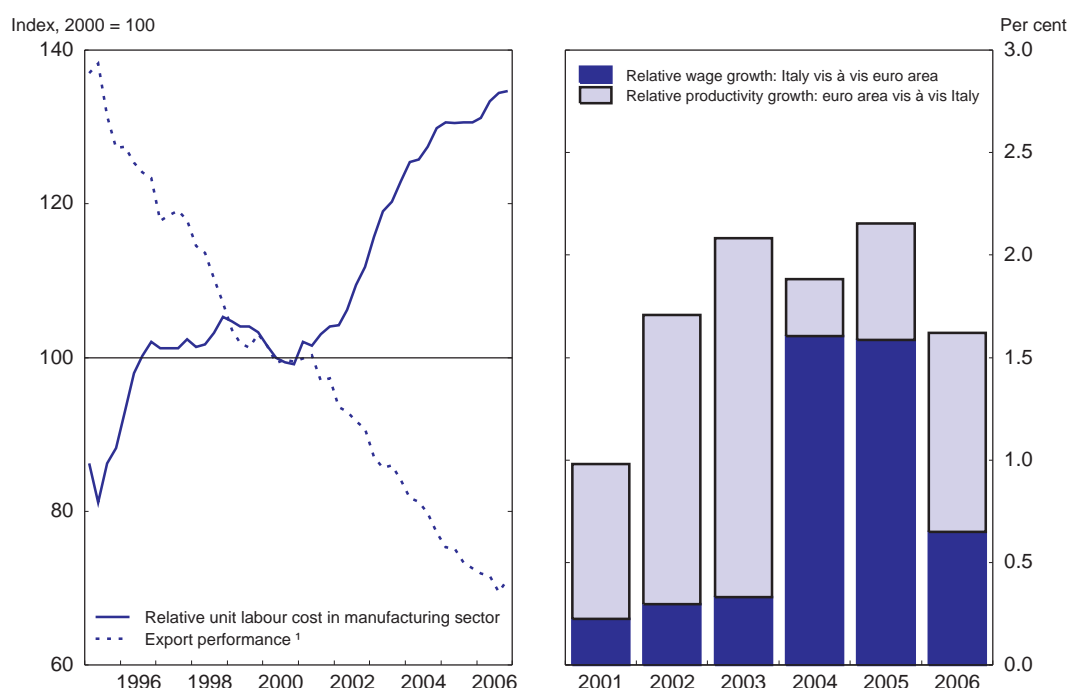
Collapsing competitiveness and market shares

0.1 Italy is an export-oriented economy. In the past, the manufacturing sector enjoyed high productivity growth which, along with elimination of automatic indexation and periodic lira devaluations (notably following the 1979 oil shock), secured a high degree of international price competitiveness and export performance. But the engine has seriously stalled: between 1995 and 2005, nearly 50% of Italy's export market shares evaporated and Italy's share of world trade in value terms declined by one-third, while net exports detracted from growth. In turn, this reflected a severe loss of international competitiveness, as relative unit labour costs jumped by more than 50% over the same period (Figure 1.4). Though the real exchange rate as measured by relative consumer prices appreciated only by about half as much, the gap between the two measures suggests a marked profit squeeze. As this period coincides with dismantling of trade barriers between OECD and non-OECD countries and the entry of Italy into EMU at an irrevocably fixed exchange rate, it seems that Italy has found it difficult to cope with the shock of globalisation solely *via* structural flexibility, without the aid of monetary independence as in the past.

Entrenched low skill specialisation

0.2 Italy has been especially vulnerable to the globalisation shock because it started out with a production structure quite similar to emerging market competitors, *i.e.* heavily based on traditional low skill products. What is more, it seems to have reinforced this comparative disadvantage by shifting its relative specialisation even more toward such products (Faini and Sapir, 2005). Countries that seem to be coping better with globalisation are shifting resources toward areas less sensitive to low-cost competition, notably high tech goods and services or other niche areas. Other euro area countries (though less so Spain) appear to be in this category and have better preserved market shares. Other OECD countries have also been moving much more rapidly than Italy toward higher shares of university educated people to not only supply the knowledge base for high tech production but also to be able to adequately diffuse new technologies throughout the economy (Faini and Sapir, 2005). Furthermore, deindustrialisation has elsewhere triggered processes leading to an increasing specialisation in dynamic non-tradeables service sectors (see below). Germany, like Italy, has been slower to shift to services than countries like the US and UK, but under very different circumstances: it has maintained strong international competitiveness in terms of both quality and price.

Figure 1.4. Competitiveness indicators



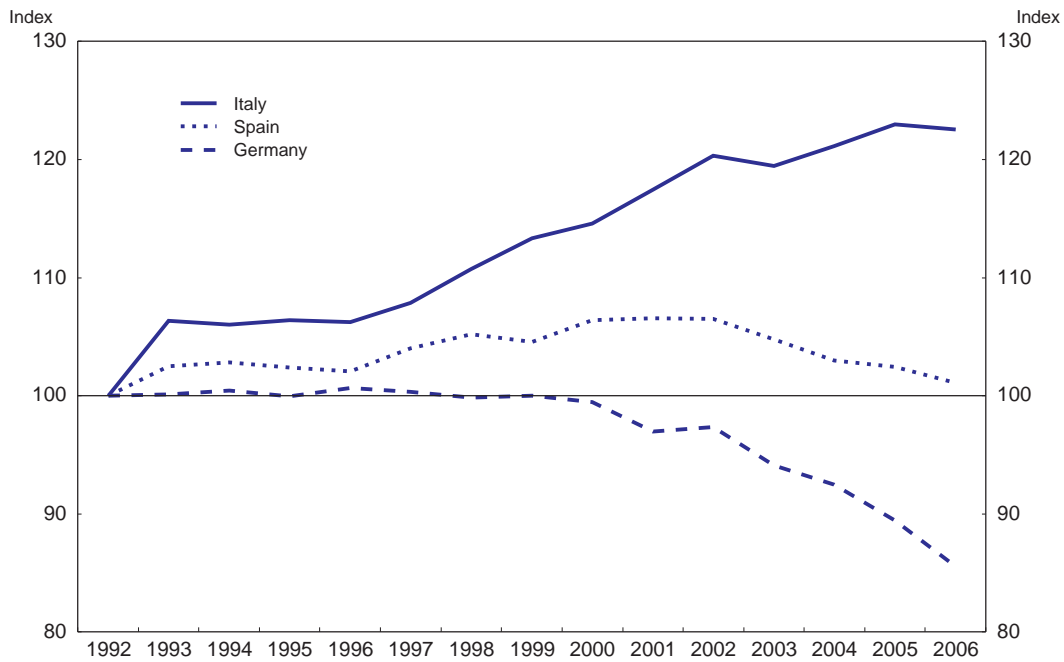
1. Defined as the ratio between export volumes and export markets weighted by Italian trade shares.

Source: OECD Economic Outlook 80 database.

Some signs of adjustment

0.3 This is not to say that there has been no adjustment in Italy. To the contrary, competition is forcing exposed sector firms to adjust in order to merely survive. This could partly be inferred from the fact that export prices are rising relative to general product prices much more in Italy than elsewhere (Figure 1.5), allowing it to maintain market shares much better in value than in volume terms.¹ Hence, the share within each sector of firms producing higher value-added seems to be growing, either because such firms themselves are upgrading and able to exercise greater market pricing power, or because lower value added firms drop out of the market. Both effects are probably relevant, though as noted above there is no evidence yet of inter-sector or major cross product shifts. There could also be more pricing to market in the strong global upswing. Indeed, average price rises have been especially sharp in luxury high ends of traditional goods, for which there is a growing demand by an emerging middle class in non-OECD countries. A higher variability of profit outcomes in Italian industry, along with a descending mean value, seems to corroborate this evidence. Larger firms seem much better able to outsource and innovate in order to survive than are smaller ones – perhaps aggravated by the fact that small firms find it difficult to grow to medium (later large) size in Italy as a means of adjusting (Figure 1.6).

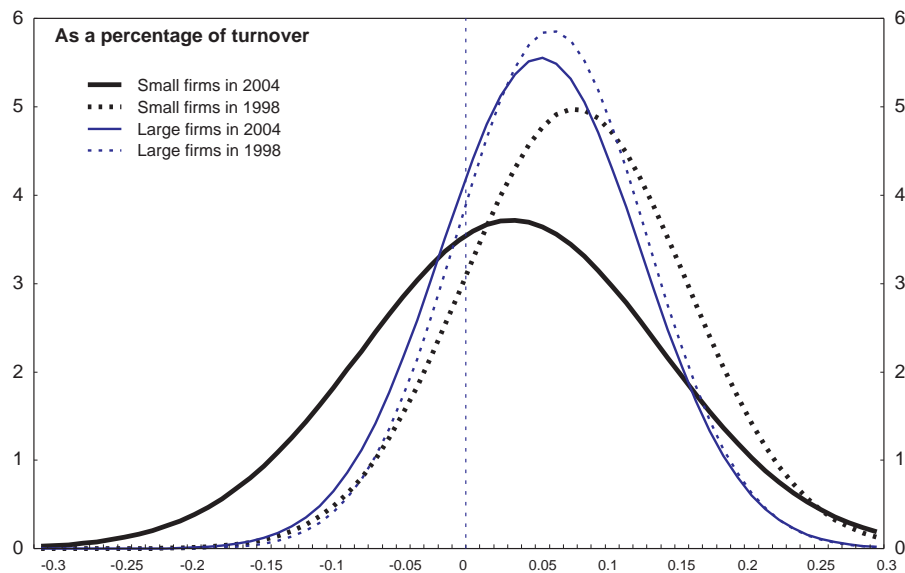
Figure 1.5. Relative export prices
1992 = 100



1. Export unit prices of goods and services deflated by producer prices index.

Source: OECD Economic Outlook 80 database.

Figure 1.6. Restructuring is under way with evidence of rising variability in profitability
Earning before interest and tax (EBIT) on turnover distribution according to firms size¹



1. Small firms are firms with less than 2 billions euros turnover. Large ones have a turnover of more than 50 billions euros.

Source: Confindustria.

0.4 Another way to view the situation is that rising stars like India and China are themselves shifting into high tech areas and investing in human capital. New OECD areas of comparative advantage may before long become contested and overcrowded. Export prices of such goods have in fact been falling, also because of technology, so that the terms of trade for countries specialising in them are an income loser. Italy may one day look to be better placed for the long run: it has a solid export base featuring high grade consumer items and the machinery to make them, much prized by China and others. Italy, for all its export woes, has avoided current account balance deterioration after netting out oil imports (Banca d'Italia, 2007), while the extra-euro-area trade balance has held up better than that *vis-à-vis* the euro area (Cotis, 2006). It is probably wise to build upon traditional strengths even while restructuring.

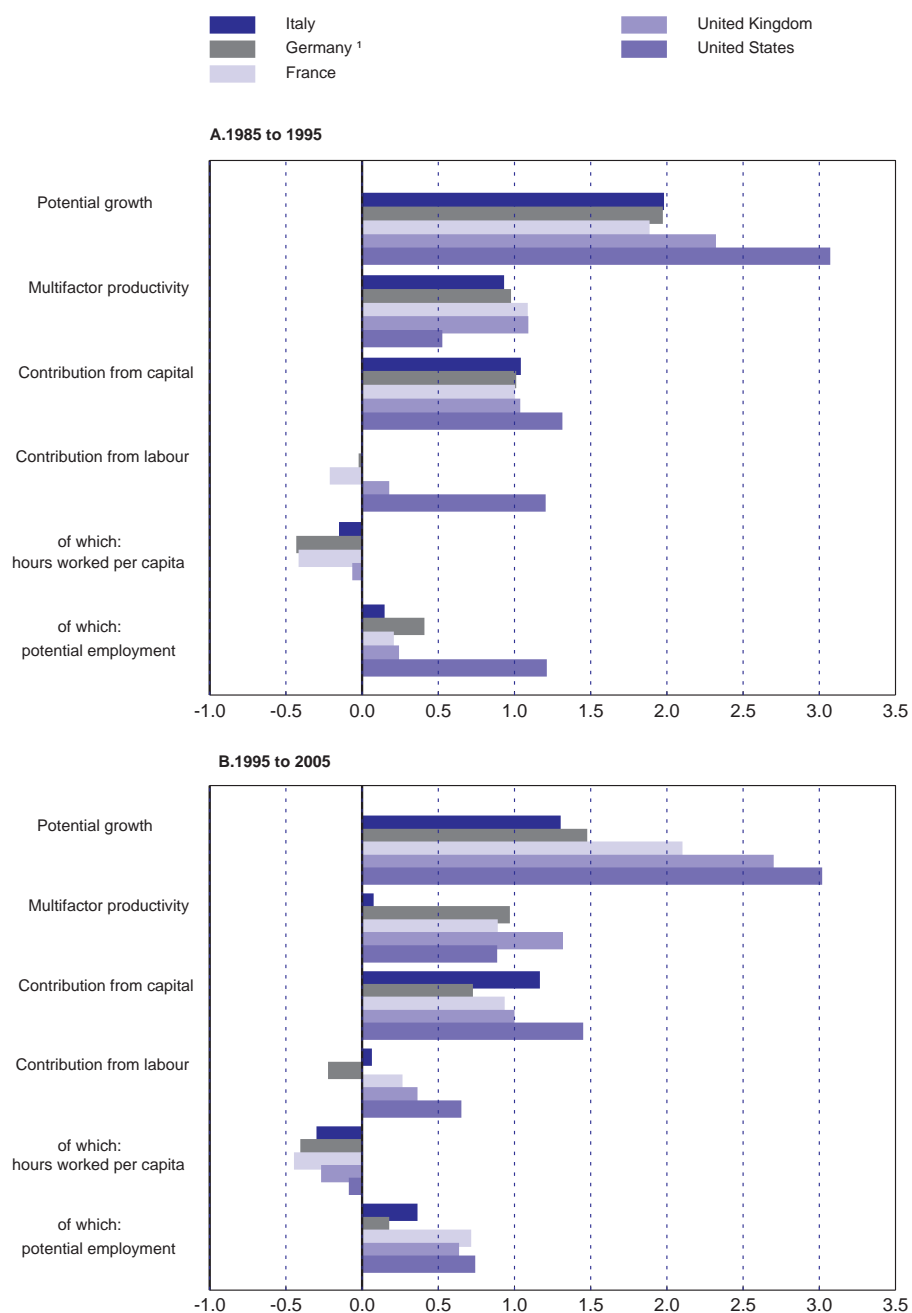
Low TFP growth is the core problem

0.5 But the fact that export market shares are still being lost, and at a significant rate, suggests that at the aggregate level the adjustment is still unsatisfactory; more export firms are exiting the export market than are staying in and thriving.² That labour is being released by the many less efficient firms exiting traditional sectors could itself be another encouraging sign of adjustment. Yet such resources are apparently not yet being used productively enough in the sheltered sectors. All in all, an inability to adjust the structure of production to the demands of globalisation suggests a fundamental problem with dynamism and innovation, normally associated with total factor productivity (TFP).³

A growth accounting analysis

0.6 A standard OECD growth accounting analysis substantiates that Italy experienced an unusually sharp deceleration in TFP in the last decade (Figure 1.7). At the same time, however, Italy forged ahead of other countries (except the United States) in terms of labour utilisation, thereby limiting the absolute and relative decline in its potential rate of growth. Capital deepening slowed only marginally, and further analysis shows that this reflected a steady growth in the capital to labour ratio along with a slowly falling rate of return to capital. This suggests that the productivity slowdown cannot be attributed to any large extent to “labour deepening” endogenous to labour market reforms themselves.

Figure 1.7. Decomposition of potential growth: an international comparison
Annualised growth rate



1. 1991 to 1995 for Germany.

Source: OECD Economic Outlook 80 database.

0.7 A more refined decomposition of labour productivity, taking into account labour quality, is useful in order to test the hypothesis that TFP may have been momentarily depressed by more low skill people entering employment under the new atypical contracts. In fact, reform-induced composition effects seem to have merely reduced the rate of rise in labour quality otherwise implied by cohort effects, which themselves have been slowing down and could thus explain part of the productivity decline (Table 1.4). By the same token, a large part of the *prima facie* strong TFP growth of the 1980s and early 1990s disappears when correcting for these cohort effects; hence the slowdown in TFP correcting for such effects is smaller, though still substantial.⁴

Table 1.4. Labour productivity and its determinants
Percentage values

Years	Labour productivity	Capital deepening	Capital quality	Labour quality	Supply composition	TFP
Total private sector						
1981-85	1.42	0.66	-0.02	0.49	0.03	0.27
1986-90	2.36	0.69	0.14	0.29	0.01	1.22
1991-95	2.28	0.86	0.03	0.47	0.02	0.90
1996-00	0.74	0.40	0.16	0.22	0.03	-0.07
2001-06	-0.27	0.41	0.05	0.11	0.05	-0.90
Manufacturing						
1981-85	3.47	1.62	0.45	0.12	0.07	1.21
1986-90	3.06	0.70	0.12	0.19	0.04	2.02
1991-95	3.58	1.14	0.04	0.46	0.00	1.94
1996-00	0.80	0.72	0.04	0.31	0.04	-0.31
2001-06	-0.39	0.58	-0.03	0.23	0.19	-1.37

Source: Bassanetti and Zollino (2007).

0.8 Like elsewhere, manufacturing was the quintessential fast growing part of the Italian economy up until 1995 – its TFP growth averaged 1¾ per cent annually during 1980 to 1995. But thereafter it stalled and then fell in the new millennium, explaining virtually all of the aggregate TFP growth collapse. According to Table 1.4, around 20% of the TFP decline in the 2000s has been offset by intra-sector shifts as Italian manufacturing firms are successful in upgrading their products as a strategy against increasing competition from emerging market economies – a factor also reflected in higher export prices, as discussed above.⁵ In the services sector, there was also a TFP slowdown but to a much smaller extent since long run productivity performance was already dismal (Table 1.5). This slowdown may have been largely cyclical (Zollino, 2006). The United States at the same time experienced an important surge in services productivity – finance, ICT services and retail and wholesale trade, from low rates of growth traditionally. This suggests a global technology that was available, and a missed opportunity for Italy.

Table 1.5. Growth accounting by sector
(Percentage changes)

Years	Growth in value-added		Contribution from labour		Contribution from capital		Total factor productivity		
	Total	Manufac- turing	Services	Total	Manufac- turing	Services	Total	Manufac- turing	Services
1981-85	1.7	0.6	2.6	0.7	-1.8	2.4	0.8	1.2	1.0
1986-90	3.1	3.7	3.0	0.8	0.6	1.2	1.0	1.0	1.5
1991-95	1.3	1.5	1.4	-0.2	-1.0	-0.1	0.6	0.6	0.9
1996-00	1.6	0.5	2.1	0.8	0.1	1.1	0.9	0.7	1.2
2001-06	0.7	-0.9	1.1	0.7	0.0	0.9	0.8	0.5	1.4

Source: Bassanetti and Zollino (2007).

A human capital lag

0.9 TFP growth is often thought to reflect managerial efficiency and innovative activity, the creative process that gives rise to value added. To stimulate it, a strong human capital endowment is needed to supply the requisite skills. But a demand for such skills is also necessary. Competition is the main stimulus to innovation demand by firms, especially if accompanied by a deep and efficient financial system to cushion the risks involved and accelerate the development of small and medium enterprises. But as just seen, Italy's exposed sector is subject to brutal competition, giving it every incentive to innovate; but this was the sector that suffered the TFP collapse precisely because it failed to innovate. The fault must lie on the supply side of human capital and in the institutional basis for risk taking and enterprise growth. However, services sectors utterly failed to respond to a sharp internal terms of trade shift in their favour (as reflected in the real exchange rate), implying a problem with competitive stimuli to innovation there – this issue is taken up further below.

0.10 Human capital indicators for Italy support the conclusion of weak TFP growth (rather than capital adequacy) as the main source of the productivity slowdown (Figure 1.8).⁶⁷ Italy has one of the lowest proportions of researchers and engineers in total employment across the OECD, and more broadly its innovation performance (private R&D spending, patents, ICT diffusion) ranks poorly in international comparison. Active research skills are needed not only to initiate innovations locally but also to absorb knowledge and adapt inventions from abroad. Poor innovation performance can be traced back to deficiencies of the tertiary education system. But technological progress also requires broader human resources in terms of a skilled workforce capable of implementing the needed organisational changes. In this respect, a major weakness for Italy is the very high share of the workforce having little or no formal qualifications beyond compulsory schooling – the mirror image of the productive structure.

NOTES

1. Chaney op. cit. also argues that volumes are incorrectly represented in the data: export unit values are a very poor substitute for export price, and tend to overstate price because of a faulty accounting for quality changes. This would understate volumes and exaggerate the market share losses – and be consistent with his earlier theory that competitiveness measures are not as bad as they seem..
2. The same could be inferred from simulation of a standard export volume growth equation by the OECD (Cotis, 2006). After around 2000, the fitted values of the equation – fully accounting for Italy's price competitiveness as well as market growth – were substantially above the actual ones. This suggests a lack of quality adjustments to compensate for the price disadvantage.
3. Inadequate public infrastructure following years of budget cuts could also play a role. For example, between 2001 and 2005 container traffic grew by around 50% in the ports of the Mediterranean regions of France and Spain as well as in those of northern Europe, while for the main Italian ports the increase was of the order of 10%. Shortages of space, inadequate links with road and rail networks, and road and rail congestion lay behind the loss of market shares to competitor ports. See Banca d'Italia (2006).
4. The estimate of TFP growth is very dependent on how labour input is measured. Productivity is higher if measured as value added per hours worked than per full time equivalent employee, simply because average

working hours have been declining secularly. Thus, Brandolini and Cipollone (2001), using the full time equivalent measure of labour input, find that virtually all of TFP growth in the 1980s and early 1990s captures such cohort effects. Scarpetta et al. (2003) finds a similar result. It also has to be noted that measuring labour quality is not without controversy. The above authors get very large quality effects when assuming that quality is proportional to number of years of schooling completed. Brandolini and Cipollone show that if a milder measure is used, say wage differentials, the quality adjustments are much smaller.

5. Daveri and Jona-Lisinio (2005) indicate that one important exception to the general picture was utilities where productivity stagnated under public ownership for years but zoomed in the 1990s thanks to privatisations – which probably reflected monopoly profits rather than true TFP – though also exerting adverse compositional effects as labour shifted out of these highly capital intensive industries to less capital intensive ones. Agriculture has also stopped contributing to economy wide productivity growth since modernisation has fallen off as have exits to higher productivity activities.
6. The above calculations of TFP are of course only approximate, depending on some strong simplifications and inadvertently capturing measurement errors on factor inputs, notably those related to quality. Thus, it is wise to corroborate them with other evidence.
7. Currently, less than 15% of a generation obtains a tertiary diploma, far below the 40% and up reached in top OECD performers. See OECD (2005) for a discussion of problems and policies for the university sector.