From Miracle to Decline
Italy's long-term development trajectory between core and periphery

G. Celi[a], D. Guarascio[b], F. Zezza[b,c]

(a) University of Foggia (IT)

(b) Sapienza University of Rome (IT)

(c) Levy Economics Institute of Bard College (USA)

THE EVOLUTION OF GERMAN AND ITALIAN INDUSTRIES AND THE CHANGING COMPETITIVENESS OF EUROPE

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Outline

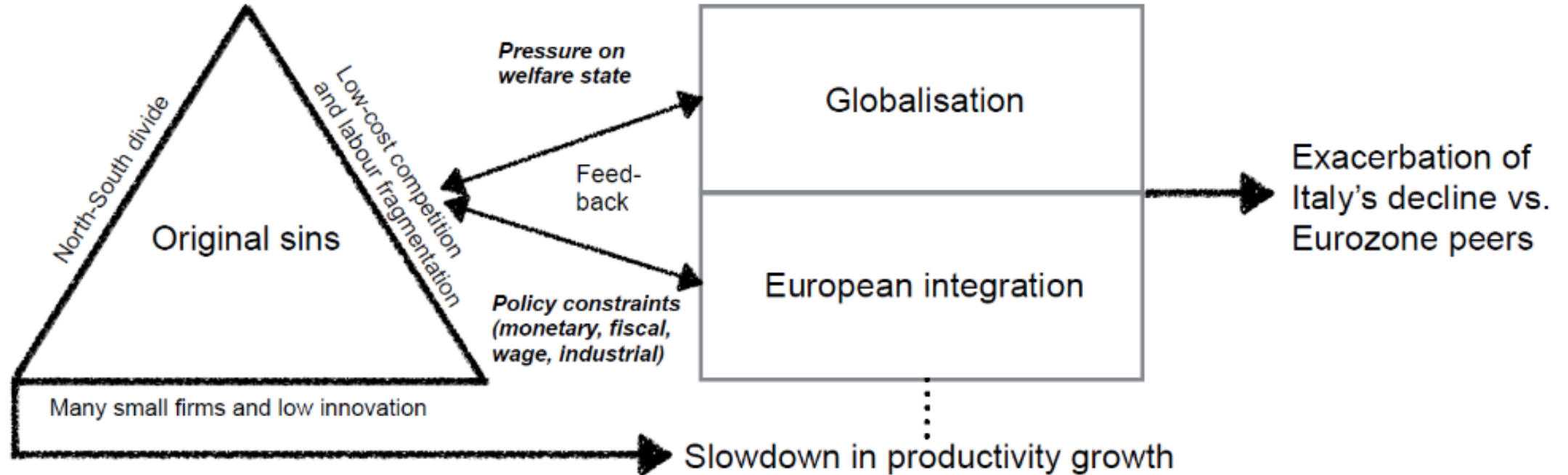- **Understanding the long-term evolution of the Italian economy, from post-WWII 'miracle' to the current decline:** how factors spurring growth at the beginning turned into inherent weaknesses limiting Italy's capacity to withstand external constraints?

- **Italy and Germany at the mirror:** i) 'asymmetric complementarities' shaping specialization patterns and competitiveness, in good times as well as in bad ii) the German influence on the construction of European institutions, another important piece of the puzzle

- **Crisis after crisis (Oil shocks, 1992, 2008),** Italy's vulnerability begins to epitomize the self-defeating nature of Europe's export-led growth model

- **Europeanization and the Italian trajectory:** blind adherence to the EU rulebook – e.g., fiscal restraint, wage moderation and labor market fragmentation, state retrenchment and the abandonment of selective industrial policies, etc. – may support exports, but at the cost of undermining the structural prospects of the economy in the medium term

Premise: A sketched history of the Italian economy

Real GDP growth rate
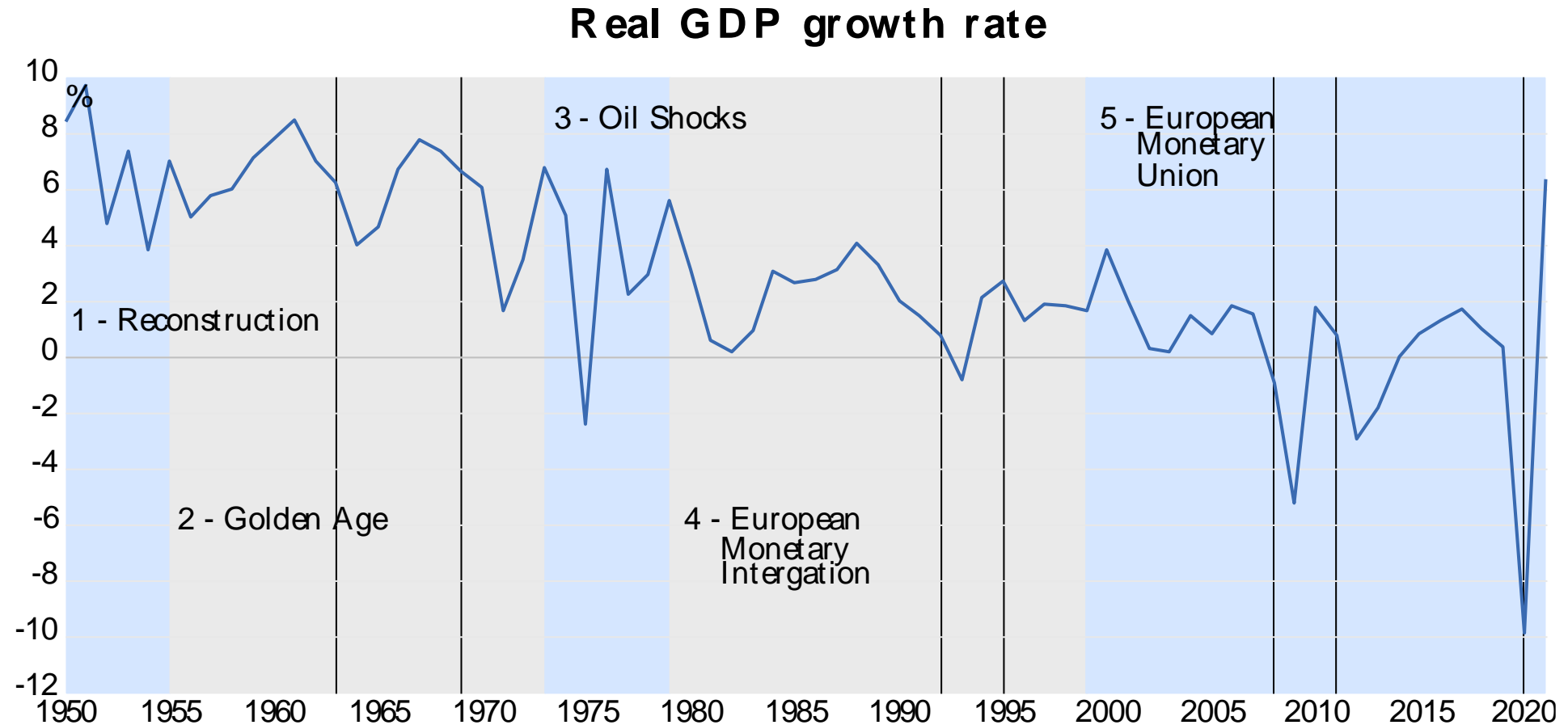
Source: AMECO (Autumn 2022); Osservatorio CPI; own calculations.

The interaction between structural weaknesses and external constraints

The interaction between structural weaknesses and external constraints.

Triangle labeled "Original sins" with edges: "North-South divide", "Low-cost competition and labour fragmentation", and base "Many small firms and low innovation". Arrows point to a box containing "Globalisation" and "European integration" via "Pressure on welfare state", "Feed-back", and "Policy constraints (monetary, fiscal, wage, industrial)". The box points to "Exacerbation of Italy's decline vs. Eurozone peers". Dotted lines lead to "Slowdown in productivity growth".

Source: Guarascio, D., Heimberger, P., & Zezza, F. (2023). The euro area's Achilles heel: Reassessing Italy's long decline in the context of European integration and globalisation (No. 470). wiiw Research Report.

Cost competitiveness: Downward pressure on wages has exacerbated demand-side problems

Real compensation per employee

Signs of stagnation in the 1980s

Real compensation per employee in 2021 below the level in 1990

Legend: Germany, France, Italy, Spain
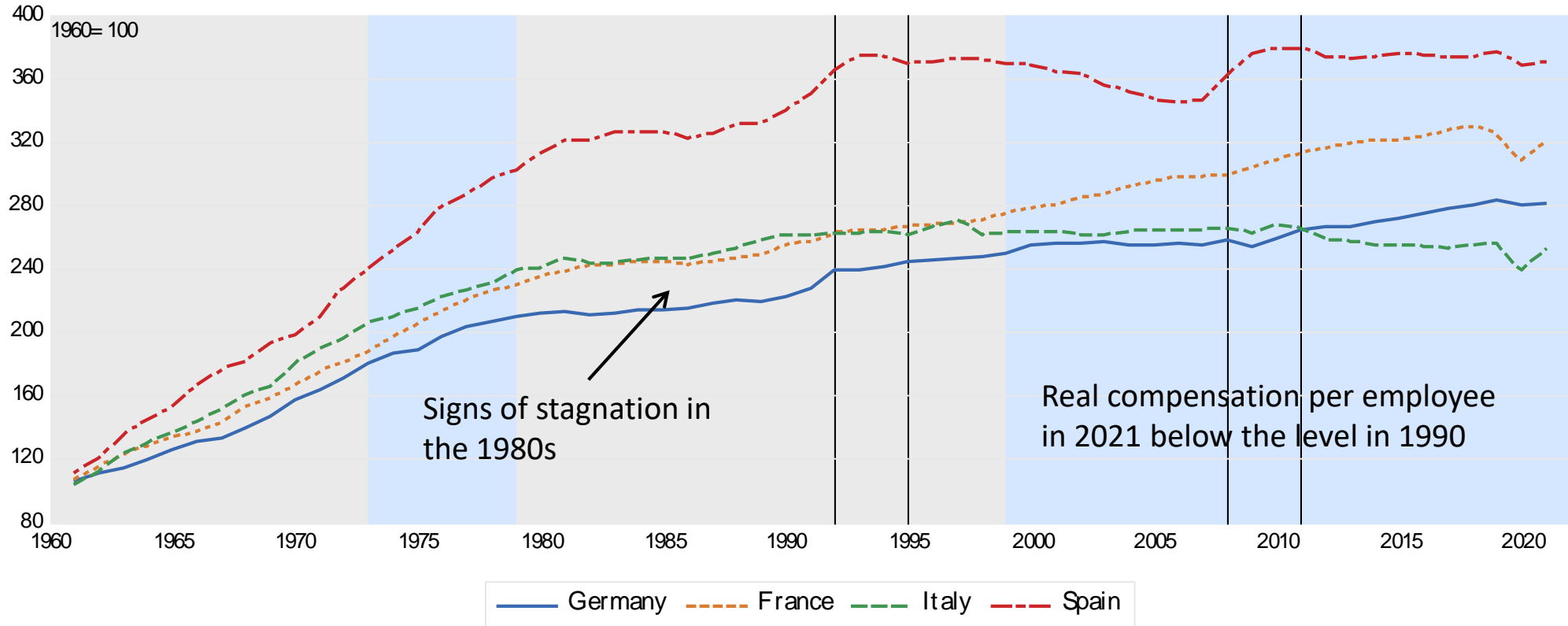
Source: AMECO (Autumn 2022); own calculations.

Many small firms

Micro-firms account in Italy for

- 94.4% of firms
- 25.3% of VA
- 41.9% of employment
- Very low productivity levels vs peers in DE and FR
- Even worst in Mezzogiorno, where the share is 96.1%

Italian medium-to-large firms (50-249) have highest productivity level. There are just too few!

Table 1. Firms statistics by size. 2019

	Country	0-9	10-49	50-249	250+	Total
Number (%)	Germany	83.3	14.1	2.2	0.5	100
	Spain	94.2	5.04	0.6	0.1	100
	France	94.7	4.48	0.7	0.2	100
	Italy	**94.4**	**4.92**	**0.6**	**0.1**	**100**
	- Centre North	*94.3*	*4.97*	*0.7*	*0.1*	*100*
	- Mezzogiorno	*96.1*	*3.51*	*0.3*	*0.04*	*100*
Value Added (%)	Germany	13.1	17.0	16.8	53.1	100
	Spain	22.4	18.6	16.1	42.9	100
	France	17.2	13.1	12.5	57.2	100
	Italy	**25.3**	**20.7**	**17.8**	**36.2**	**100**
Employment (%)	Germany	18.7	22.1	17.2	42.0	100
	Spain	35.7	19.9	12.8	31.6	100
	France	22.5	15.9	12.9	48.7	100
	Italy	**41.9**	**20.9**	**13.3**	**23.9**	**100**
	- Centre North	*43.9*	*24.9*	*18.9*	*12.3*	*100*
	- Mezzogiorno	*57.5*	*22.5*	*12.4*	*7.6*	*100*
Productivity (%)	Germany	42.5	46.3	59.2	76.6	60.6
	Spain	27.3	40.3	54.5	59.0	43.4
	France	50.4	54.1	63.6	77.2	65.8
	Italy	**30.7**	**50.5**	**67.9**	**76.8**	**50.7**

Source: EUROSTAT; own calculations.

Low innovation

Table 2. R&D expenditure (% of GDP)

	1970	1980	1990	2000	2010	2020	Var.*
France	1.8	1.7	2.3	2.1	2.2	2.4	+0.6
Germany	2	2.4	2.6	2.4	2.7	3.1	+1.1
Spain	0.2	0.4	0.8	0.9	1.4	1.4	+1.2
Italy	**0.9**	**0.8**	**1.3**	**1.0**	**1.2**	**1.5**	**+0.6**
- Pub. Admin.	*0.4*	*0.3*	*0.5*	*0.5*	*0.5*	*0.6*	*+0.2*
- Pvt. Corporations	*0.3*	*0.3*	*0.5*	*0.5*	*0.7*	*0.9*	*+0.4*
- SOEs	*0.1*	*0.2*	*0.3*	*…*	*…*	*…*	*…*
- Centre-North°	…	…	…	**1.1**	**1.3**	**1.7**	**+0.6**
- Mezzogiorno°	…	…	…	**0.7**	**0.8**	**1.0**	**+0.3**

Source: for Germany, France, and Spain, World Bank; for Italy, (Antonelli and Barbiellini Amidei 2007), Istat, World Bank. Notes: (*) variation from first available data; (°) share in local GDP.
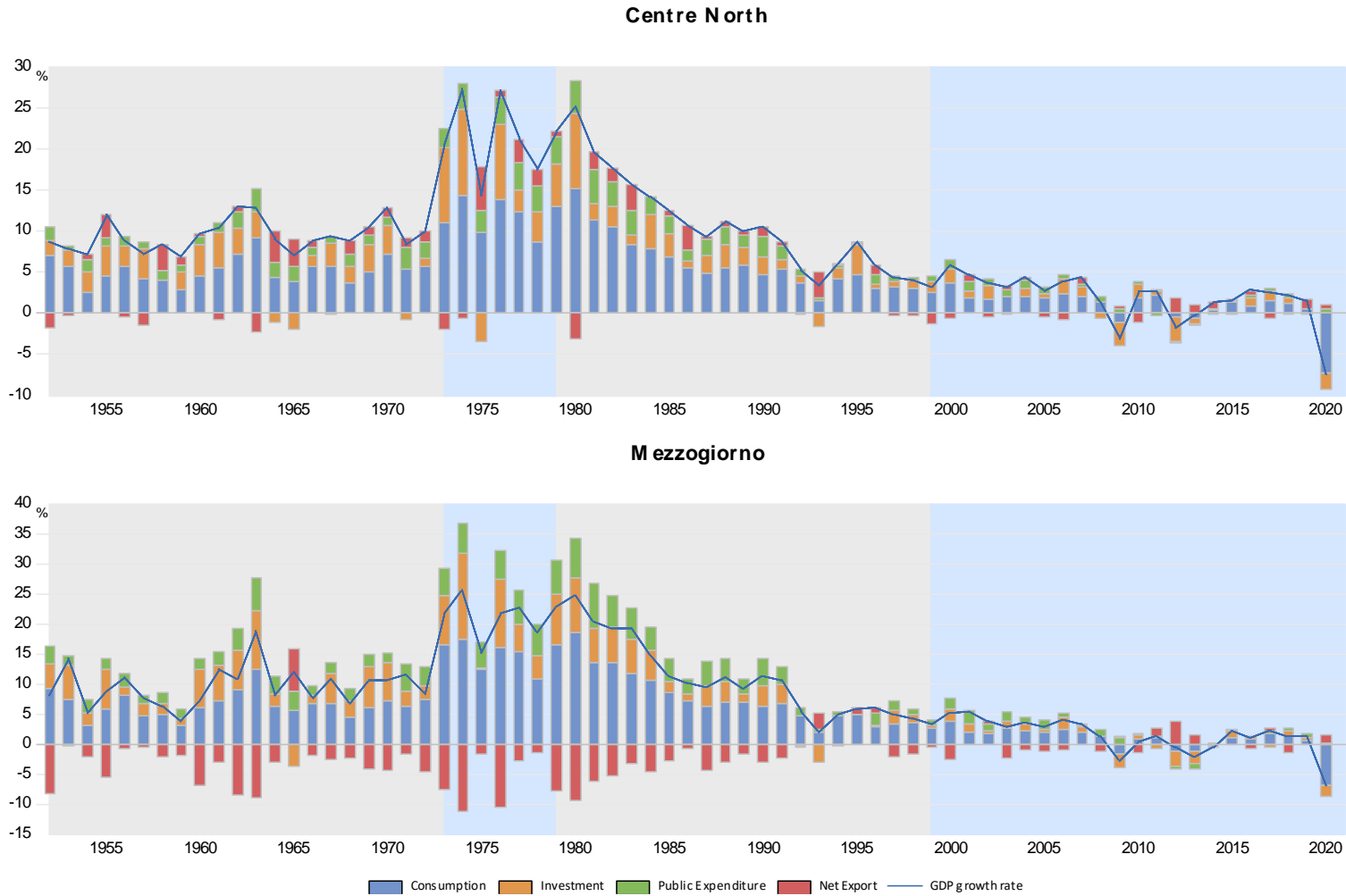
When major SOEs stepped back (e.g., IRI's dismantling and privatization), so did R&D

North-South divide

GDP of Mezzogiorno in % of Centre North

Cassa per il Mezzogiorno
1950-1984

Source: SVIMEZ; Istat; own calculations.

North-South divide: demand contributions to GDP growth

Centre North

Mezzogiorno

Consumption   Investment   Public Expenditure   Net Export   GDP growth rate

Source: SVIMEZ; Istat; own calculations.

Diverging **growth models**, in good as well as in bad times

- **North:** net exporter, higher consumption, lower contribution of the State

- **South:** net importer, higher investment, higher government expenditures

From the early 1990s, investment run out of steam (negative contribution in the south in the austerity period!), and the same goes for government expenditure

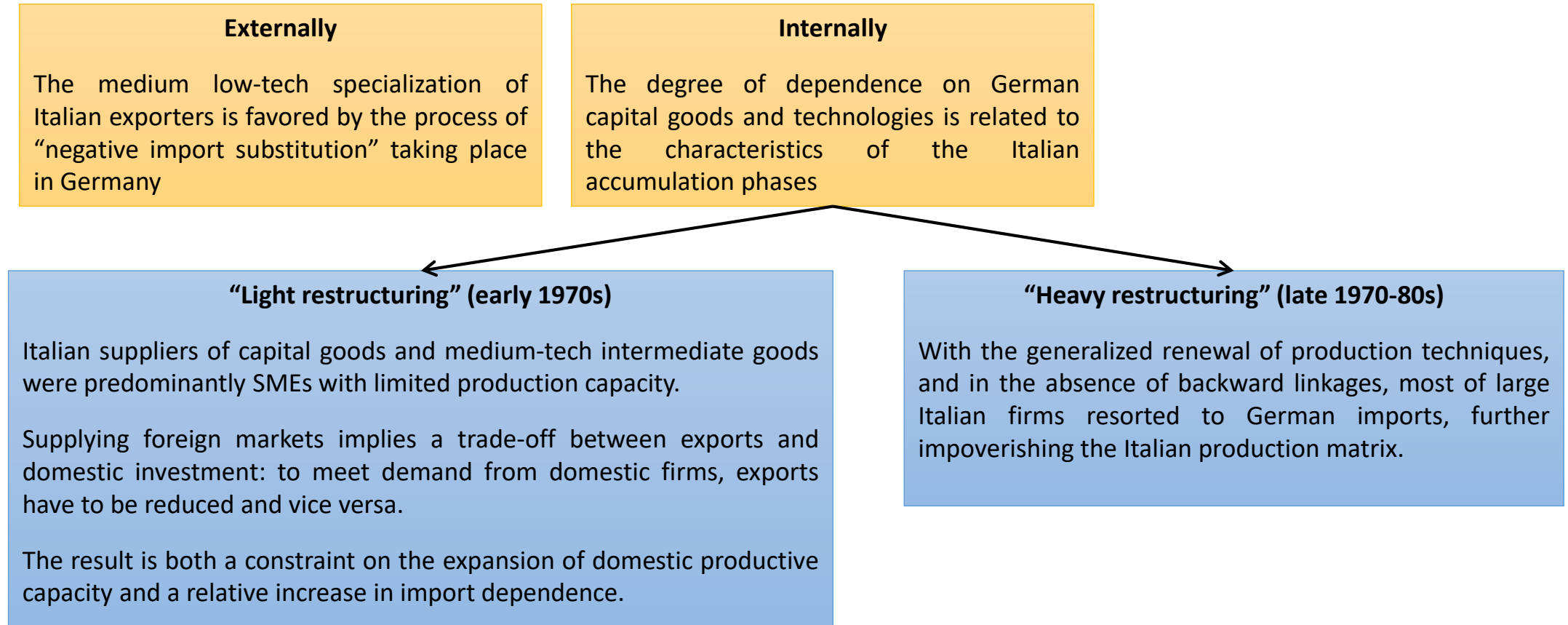# Italy and Germany: asymmetric complementarities (1)

Italy's economic development has been strongly influenced by its relations with Germany (De Cecco, 1971; Valli, 1981; Ginzburg, 1984):

1. Productive complementarities represented an important growth opportunity for the Italian economy:

- (i) greater sectoral (and intra-sectoral) specialization and diversification

- (ii) increase in investment and employment triggered by German demand

- (ii) knowledge flows and innovation at the industry-level

2. All that glitters is not gold, though. Italy is dependent on the evolution of the German business cycle bringing about a peculiar type of 'external constraint':

- (iv) the changing composition of German investments pushed Italy towards low-value-added sectors: productions that were gradually abandoned by German firms (also due to the repeated revaluation of the Deutsche Mark) become areas of specialization of their Italian counterparts

- (v) Coinciding with each wave of accumulation in Italy, the growing dependency on German capital goods reduces the value of the Keynesian multiplier, with negative consequences for the Italian labor market (further weakening of the 'Kaldorian' engine of growth/structural upgrading)

Italy and Germany: asymmetric complementarities (2)

Such co-movements (on the export and import side) contributed to increasing Italy's vulnerability in two directions:

Externally	**Internally**
The medium low-tech specialization of Italian exporters is favored by the process of "negative import substitution" taking place in Germany	The degree of dependence on German capital goods and technologies is related to the characteristics of the Italian accumulation phases

"Light restructuring" (early 1970s)	**"Heavy restructuring" (late 1970-80s)**
Italian suppliers of capital goods and medium-tech intermediate goods were predominantly SMEs with limited production capacity. Supplying foreign markets implies a trade-off between exports and domestic investment: to meet demand from domestic firms, exports have to be reduced and vice versa. The result is both a constraint on the expansion of domestic productive capacity and a relative increase in import dependence.	With the generalized renewal of production techniques, and in the absence of backward linkages, most of large Italian firms resorted to German imports, further impoverishing the Italian production matrix.

As these 'accumulation modes' continued to interact/overlap, import dependence increased and Italy's technological/productive gap vis-à-vis Germany deepened

# Italy and Germany: asymmetric complementarities (3)

Golden Age: convergence is ensured by the flexibility of Italy's production system → technology gap compensated by lower labor costs and/or, at most, incremental innovation and the adoption of foreign technologies

- Instead of increasing productivity through wage incentives (virtuous productivity-wage interaction), Italian firms exploit the large "industrial reserve army", mostly coming from the agricultural sector of the Mezzogiorno, and resort to a high turnover rate of workers

- From Germany and other advanced economies, large amounts of capital and innovative goods are imported, while large flows of Italian workers move to these countries to meet the growing demand for low-wage jobs

Globalization, financialization and growing international competition: trapped into a medium-tech specialization the Italian production matrix remained relatively underdeveloped

EMU build-up and the emergence of the German manufacturing core: fiscal constraint, wage compression and the crowding-out of Italian suppliers (Simonazzi et al., 2013), reorientation of German imports towards Chinese low-priced/low-quality consumer goods

Italy and Germany: asymmetric complementarities (4)

(A) High- and medium-tech VA (% of VA)

(B) VA in German exports. Transport equipment (%)
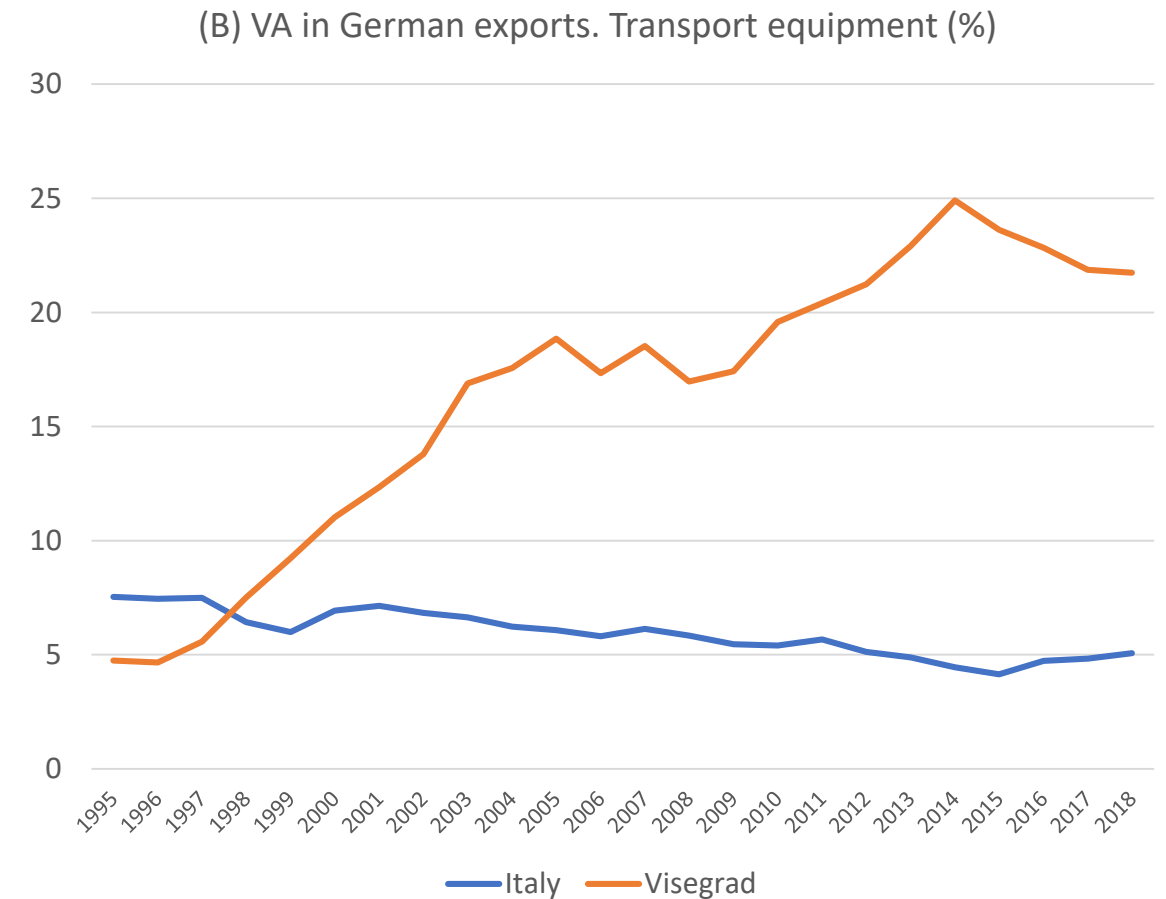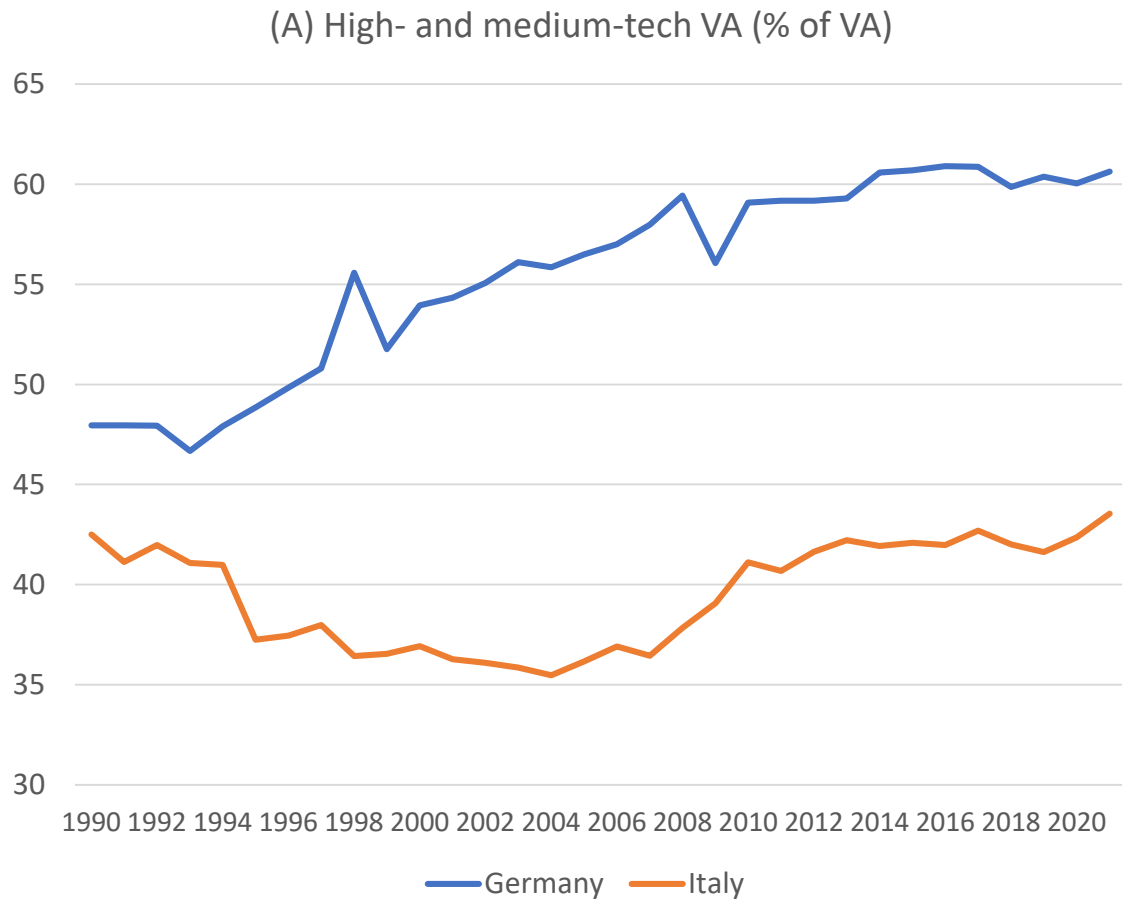
Source: (A) World Bank; (B) authors' elaboration on OECD TiVA database

(1980s)
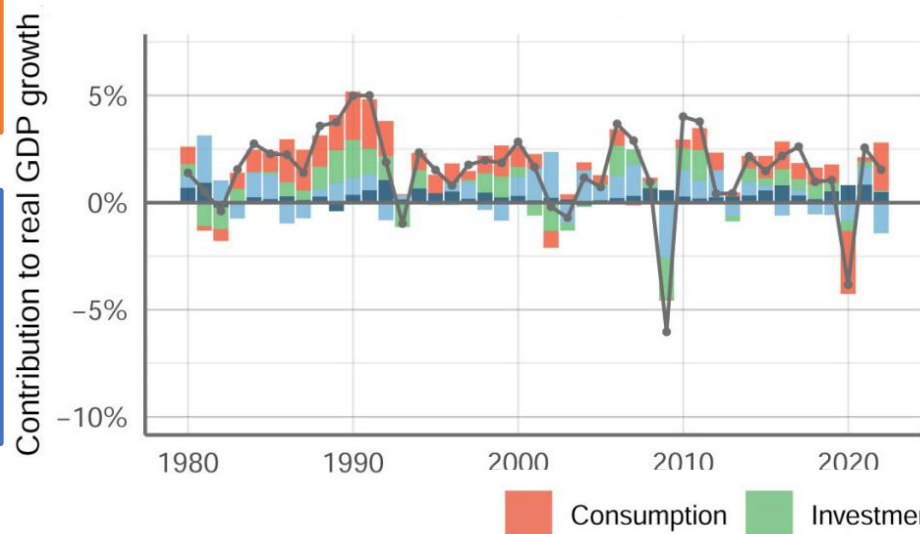- Positive contribution of NX, C, I
- NAFA = CAB

(1990s)
- NAFA = GD, CAB deteriorates
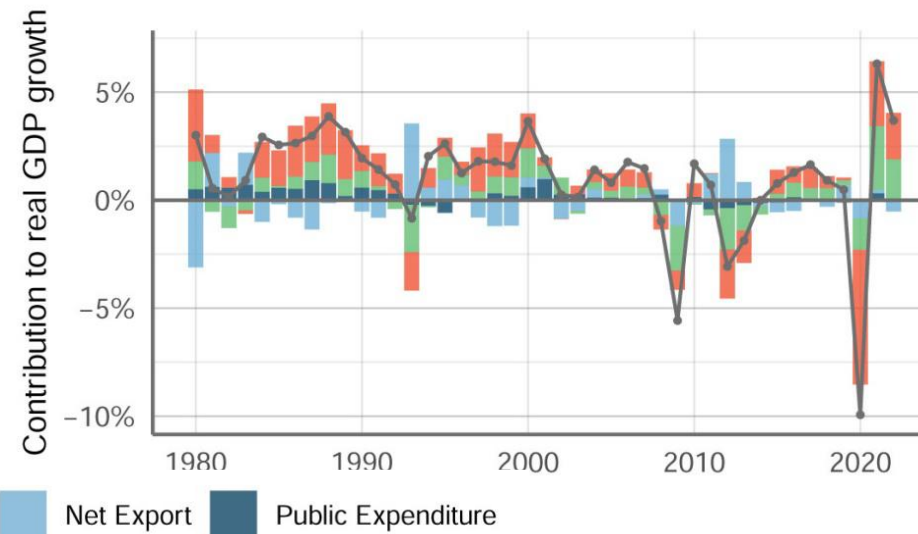- Contribution of C drops permanently

(Since early 2000s)
- Growth sustained by NX
- Corporations achieve a positive net lending position, i.e., S>I
- With the gov. pursuing fiscal surpluses, the private sector accumulates foreign financial assets
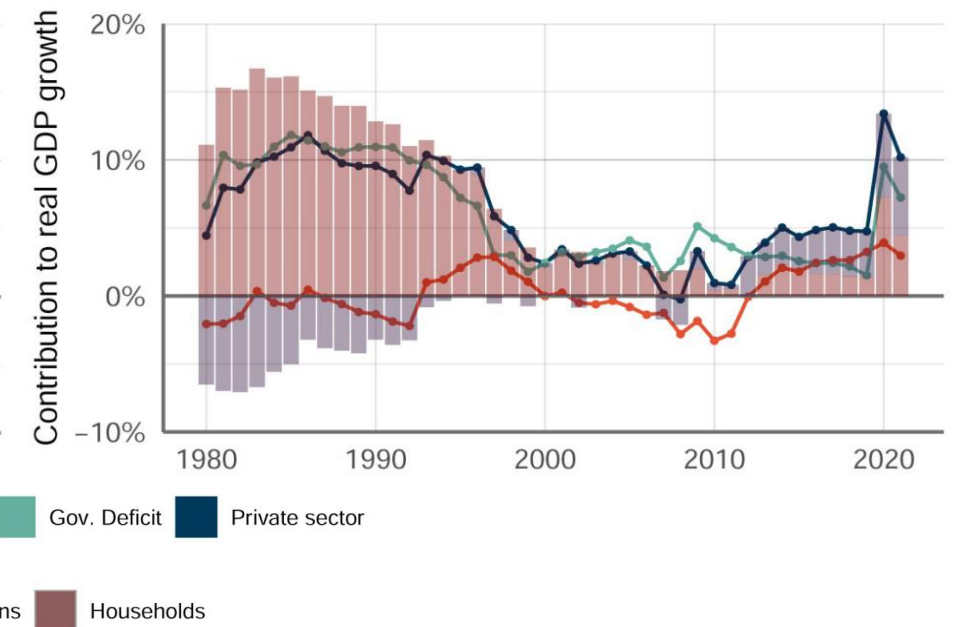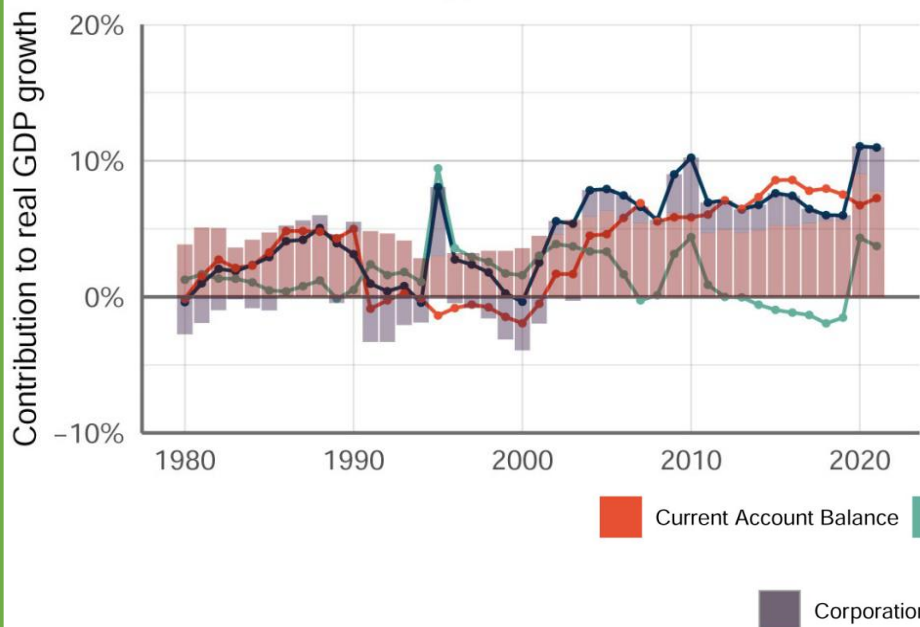
(1980s)
- Growth sustained by C and I
- NAFA = GD; CAB realignes via devaluations

(1990s)
- Growth plums up to Lira devaluation in 1992, when CAB recovers
- Restrictive shift in fiscal policy in 1995 => NAFA goes down, CAB deteriorates

(2000s)
- Euro adoption: contribution of I disappears; CAB<0
- After 2010, Italian corporations 'become German': positive net lending position!

Germany

Italy

Contribution to real GDP growth

Consumption   Investment   Net Export   Public Expenditure

Current Account Balance   Gov. Deficit   Private sector

Corporations   Households

Source: AMECO (Autumn 2022).

Conclusions: Italy, Germany (and the EU) in the new global context

Old contradictions continue to constrain the evolution of both the Italian – i.e., downward pressure on wages, internal divides, privatization as a mean to reduce public debt – and the European economy – i.e., austerity is back, external vulnerability and internal conflicts, a 'new industrial policy' that seems unfit for purpose

New divides adding to the old ones? As trade and technological conflicts multiply, the German export-led growth model (and thus the EU) unveils all its vulnerability → lack of productive/technological capabilities in relevant sectors (e.g., digital, solar), energy dependency, US and China's competition, internal conflicts spreading across countries, sectors and regions

Current policy developments don't look promising (e.g., new fiscal rules, asymmetric distribution of State-aid), a radical turnaround is needed: fully exploit the potential of the EU internal market, seeking an alternative to the current military drift (led by the U.S. and China) in industrial policy by investing in welfare, combining ecological transition and inequality reduction (policy mix matters)

Appendix (1) - Financial Balances: theory

Fundamental Identity

$$(S-I) = (G-T) + CAB \qquad \text{or} \qquad (S-I) + (T-G) - CAB = 0$$

- **S** and **I** = saving and investment of households' and firms' (i.e., financial balance of the private sector)

- **G** and **T** = taxes and gov. expenditures (i.e., financial balance of the public sector => primary deficit/surplus)

- **CAB** = current account balance vs RoW

- Everything is expressed at current prices

- **(S-I)** can be thought, if positive, as **net financial investment of the private sector** (i.e., how much the private sector is *lending* to other sectors, called Net Acquisition of Financial Assets, **NAFA**). If negative, as the *net borrowing* of the private sector

- In the same way, **(G-T)** is the **net lending/borrowing of the public sector**

- If domestic sectors cannot finance their expenditures, they must borrow these funds from the RoW

Appendix (2) - Financial Balances: wealth and debt accumulation

This has obvious implications for the accumulation of wealth (and debt)

1. (G-T) > 0 implies that the government is in deficit – i.e., it spends on consumption and transfers more than it gets from taxes – and it will cover the difference by emitting debt. Thus, the stock of debt (D) is given by

$$D_t = D_{t-1} + GD_t$$

   i.e., as the existing stock (i.e., the end of previous period stock, D_{t-1}) plus the current deficit (i.e., the flow, GD_t). Higher D_t => higher future interest payments => higher future deficit, etc.

2. In the same way, a CAB surplus may be interpreted as the private sector's accumulation of net financial assets in foreign currency, denoted VFN. We have

$$VFN_t = VFN_{t-1} + CAB_t$$

   Thus, as CAB_t increases, so does the private sector's stock of foreign denominated financial assets.

3. This implies that the private sector financial balance can be interpreted as the sum of the private accumulation of public and external debt – hence the acronym NAFA (Net Acquisition of Financial Assets). Calling VN the stock of financial assets of the private sector, we get

$$VN_t = D_t + VFN_t = VN_{t-1} + NAFA_t$$

Appendix (3) - Financial Balances: financial (in)stability

This ties in with Minsky's concept of financial fragility.

When a sector has a negative net financial position, its debt-to-income ratio will tend to increase

- *Ex. If CAB is negative, and the Gov. tries to balance the budget, the private sector must necessarily finance the difference (in this case, increasing the debt vs. RoW)*

If this process of private over-indebtedness persists over time, there is a risk that the national financial sector will find itself in a Ponzi scheme, increasing the fragility of the system, with serious risks of financial crises