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Highlights in this issue:

- **Italy's exports are increasingly losing ground.**
- **The loss of market share largely reflects Italy's unfavourable product specialisation.**
- **Structural weaknesses are holding back the necessary economic adjustment.**

Stuck in a rut? Italy's weak export performance and unfavourable product specialisation

*By Martin Larch**

Summary

The Italian economy has shown weak growth ever since the beginning of the 1990s. More recently it has developed two particularly striking, interlinked symptoms: a discouraging performance by exports and the longest stagnation of output in the tradable goods sector in post-war history. In contrast to previous episodes of weak growth, the current difficulties are not caused by supply shocks such as excessive wage increases. On the contrary, the dismal export performance has fallen within a period of wage moderation, and, since the late 1990s, of buoyant employment growth. The persistent loss of export market share would seem to chiefly result from the unfavourable product specialisation of the Italian economy – more recently coupled with a marked slowdown in productivity growth. Italy's product specialisation, unlike that of countries such as Germany or France, has not significantly changed over past decades in reaction to global economic developments. Italian industry remains strong in traditional, low-skilled labour-intensive sectors for which global demand is growing below average. The inertia is generally attributed to a number of structural factors which are hampering change, including low levels of R&D investment, low human capital, low competition – issues that fall within the remit of the Lisbon strategy.

Catching up and falling behind: The ill health of Italy's tradable goods sector

The current economic policy debate in Italy, in both the policy arena and academia, revolves around one weighty question: is the country's economy in decline? Following its achievement of full economic convergence with the rest of the EU in the mid-1980s and subsequent period of consolidation until the early 1990s, Italy's relative income position is now weakening again. In 2004 income per capita, expressed in purchasing power standards, was around 97 percent of the EU-15 average down from 104 percent some 10 years earlier. It is true that other 'mature' economies have also experienced a decline in relation to the EU-15 average, but theirs have been less marked.

Italy's dismal growth performance was already the focus of a comprehensive country study by the European Commission published in 1999 (European Commission 1999). In line with the then prevailing view the study concluded that temporary factors such as monetary policy and fiscal consolidation played a role in explaining sluggish growth. However, the temporary factors vanished yet the sluggish growth remained, becoming a structural feature of the Italian economy.[1]

*** Directorate for the Economies of the Member States.**

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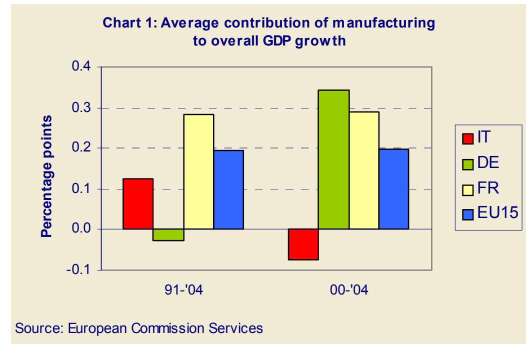
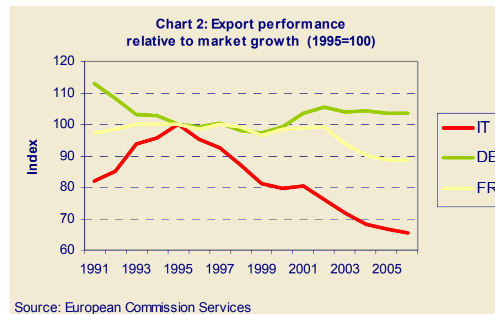
Italy's relative income position is declining ….

Over recent years the growth malaise has developed two particularly striking and mutually dependent symptoms. First, the level of output of the manufacturing sector, the sector most exposed to international competition, has essentially stood still since the beginning of 2001 – the longest period of stagnation in post-war history. This is in clear contrast with the rest of the EU where, as shown in Chart 1, the manufacturing sector continued to contribute to overall GDP growth. In Germany in particular the manufacturing industry became a main driver of growth again this decade in the face of sluggish overall economic activity. The other side of the coin is Italy's disappointing export performance. While a mature economy is no longer expected to consistently gain additional market share, especially in view of the advance of emerging economies, Italy's performance nevertheless compares unfavourably with other large euro-area countries. It is not only losing shares in global trade; its exports of goods and services, at constant prices, have also consistently underperformed the rate of expansion of its own export markets. Over the past decade the loss of market share amounts to some 30% in cumulative terms. The decline continued at unremitting rates even in 1997-2001 when the nominal exchange rate followed a relatively stable path at a level well below the one recorded in the early 1990s and late 1980s (see Chart 2). Moreover, in contrast to Germany and France, Italy has only partially benefited from the recent buoyancy of world trade.



… in the wake of stagnating industrial output …



… and dismal export growth.

Sometimes Italy's export performance is attributed to the geographical composition of its foreign sales. The argument goes that its exports are weak because of a strong exposure to slow-growing Germany and a low exposure to fast-growing Asia. However, since France has about the same geographical composition, but with an even higher exposure to Germany, the argument would seem to be flawed.

Cost competitiveness: Wage moderation offset by productivity slowdown

The ongoing growth and export malaise in Italy is not linked to aggressive wage claims by trade unions. Nominal wages in the manufacturing industry have actually remained very moderate since the beginning of the 1990s and real wages have even declined slightly. This was mainly thanks to the agreement reached between the social partners in 1992, which effectively interrupted a detrimental wage-price-spiral. However, as shown in Table 1 below, a marked slowdown of productivity growth has largely offset the achievements of wage moderation.

The productivity slowdown resulted from two factors: (i) the weakness of manufacturing output, as mentioned, in combination with (ii) atypically resilient employment growth since the late 1990s. In the mid-1990s the Italian government had started to implement a series of labour market reforms aimed at increasing flexibility and reducing the relative price of labour. As the successive reform steps took hold employment continued to grow, also helped by generous employment subsidies, even in the face of slowing economic activity. By far the largest share of new jobs was created in the services sector. However, the overall effect was strong enough to also halt the negative employment trend in manufacturing industry. This was in clear contrast with the rest of the euro area where manufacturing firms increased the number of layoffs.

The productivity puzzle is affecting real unit labour costs…

Table 1: Real unit labour costs (RULC) and its components in the manufacturing industry
percentage change

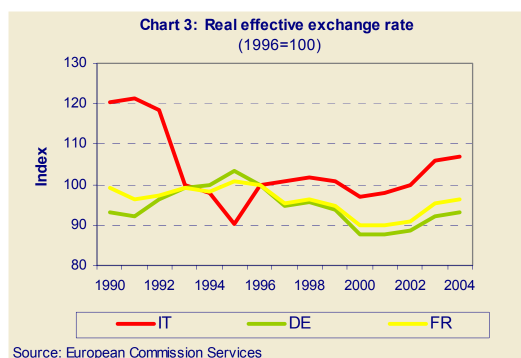
		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	*cumulative 95-04*
RULC	IT	-4.0	1.1	-1.0	-3.6	0.4	-2.0	0.6	1.1	1.2	0.6	-5.7
	DE	*0.6*	*1.4*	*-3.8*	*-0.8*	*2.2*	*-0.6*	*1.5*	*-1.5*	*-2.1*	*-4.7*	*-7.8*
	FR	*-4.1*	*0.1*	*-3.9*	*-5.2*	*-1.1*	*-2.5*	*-1.2*	*-1.8*	*-1.8*	*-4.3*	*-23.5*
Productivity	IT	3.6	-0.6	2.8	-0.4	0.3	2.9	0.0	-1.9	-1.2	0.3	*6.0*
	DE	*2.6*	*-0.2*	*5.0*	*1.7*	*-0.9*	*4.9*	*-0.9*	*1.5*	*2.9*	*6.0*	*25.1*
	FR	*4.8*	*0.8*	*5.9*	*5.0*	*3.7*	*3.3*	*1.9*	*2.5*	*1.8*	*5.9*	*42.5*
Real wages	IT	-0.3	0.5	1.8	-4.0	0.7	0.9	0.6	-0.7	0.1	0.8	*0.2*
	DE	*3.2*	*1.2*	*1.2*	*0.9*	*1.4*	*4.3*	*0.6*	*0.1*	*0.8*	*1.3*	*16.1*
	FR	*0.7*	*0.9*	*2.0*	*-0.3*	*2.6*	*0.9*	*0.7*	*0.8*	*0.0*	*1.6*	*10.5*

Source: European Commission services

The limited response of output growth to the resilience of employment since the late 1990s remains a largely unresolved puzzle. Several explanations have been put forward, yet none of them is conclusive.[2] On the aggregate, the productivity slowdown entailed an increase of real unit labour costs, including in the manufacturing sector, which in turn affected Italy's cost competitiveness as measured by the real effective exchange rate. Chart 3 shows that, since the sharp depreciation in 1992 and the adjustment in 1995, Italy's position vis-à-vis Germany and France has gradually worsened.

… but is not the main cause of the lacklustre export performance.

Since the adjustment effect of the labour market reform is likely to be temporary, its potential impact on the cost competitiveness of export firms via productivity should, sooner or later, fade away. Moreover, there is evidence that part of the decline in productivity is cyclical rather than structural (see for instance IMF, 2005). However, cost competitiveness is not the only and, according to a number of studies, not even the most important reason for Italy's weak export performance. Indeed, Italy seems to be losing export market share even in times of stable real effective exchange rates.



Bias towards mature markets: the unfavourable product specialisation of Italy

Italy specialises in mature and traditional sectors ….

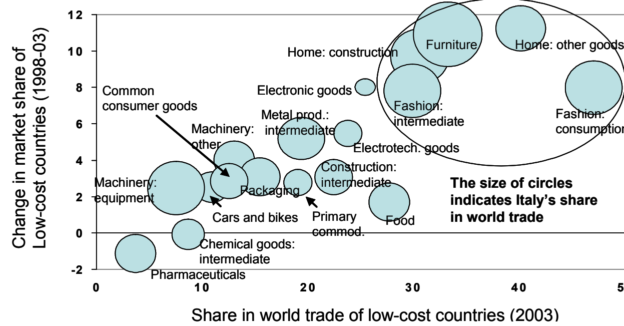
The export performance of goods 'made in Italy' would seem to be mainly affected by an unfavourable product specialisation. A series of studies carried out by Prometeia, a leading Italian economic research Institute, provides a relatively detailed chain of evidence. Italy's export shares in the most dynamic sectors of global trade are found to have been consistently lower than those of Germany, France and even Spain since the early 1990s. Conversely, Italian foreign sales have been particularly strong in the less dynamic sectors, especially in the period after 1995 (Prometeia, 2000 and 2003a).

It can be shown that the slow-growing export sectors are largely dominated by producers of what in Pavitt's taxonomy is called *supplier dominated products*, i.e. goods with a relatively low level of technology exhibiting relatively high price elasticity.[3] In concrete terms, Italy exhibits strong comparative advantages in the home and fashion sector comprising such goods as furniture, tiles, textiles and shoes.

Looking at the main competitors of Italian exports, the studies also showed that in 1996-2001 Italy's losses of market share were particularly strong in sectors where the advance of low-cost producers like China, Mexico and India was particularly fast (Prometeia, 2003b). Data up to 2003 confirm the conclusions (see Chart 4). The situation appears to be markedly different in Germany, whose main competitors are located in Europe or the USA.

Chart 4: Competitive pressure from low cost countries

(Wage costs lower than one fourth of Italy's)



… where competition from low-cost producers is high.

Never change a losing product mix?

In spite of yielding a comparatively poor export performance, Italy's product specialisation has shown little or no sign of change. On the contrary, unlike Germany and France which seem to be moving towards high-skill production in reaction to fiercer competition on low-skilled labour-intensive goods, Italy appears to have actually strengthened its unfortunate product mix over time (Bugamelli, 2001, ISAE, 2005).

The product specialisation has shown no sign of improvement over time….

Until the late 1980s, before the new low-cost producers burst onto the global trade scene, Italy's product mix had in fact secured a tangible advantage. A simple calculation illustrates the point. The overall growth rate of Italian exports obtained by applying the rates observed on a global scale by type of product was well into positive territory, indicating that Italy was comparatively strong in dynamic segments. Some 10 years later, in 1997-2001, the same exercise tells a completely different story. Even if exports by type of product had grown at the rates observed at a global level, overall exports would not have kept pace with global trade. Thus, Italy's specialisation has a negative impact on the performance of exports (see Faini and Sapir, 2005), while the specialisation effect is estimated to be positive for Germany and France. The size and sign of the specialisation effect is confirmed by a study recently carried out by the European Commission for the 2000-2003 period (European Commission, 2005).

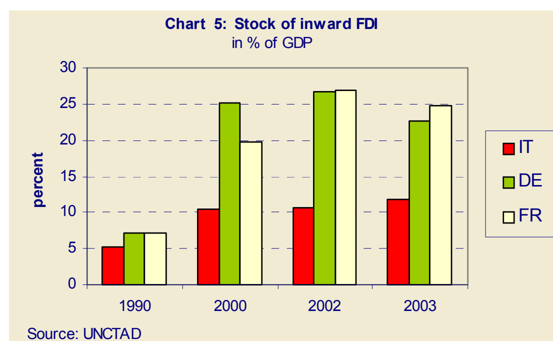
All of this begs the question: why does the Italian manufacturing sector exhibit such a high degree of inertia in its product specialisation in the face of such glaring disadvantage vis-à-vis the other large euro-area countries? Faini and Sapir (2005) focus on the issue of factor endowment, arguing that Italy's product mix simply reflects the low level of human capital in the economy evidenced by the abundance of low-skilled labour. The average level of education of working age population in Italy measured by the average number of years spent in school is below the EU-average and the gap has been increasing over time. The recent growth literature (see for instance Acemoglu, 2003) shows that the causality between education, technological progress and growth can go both ways. In particular, the prevailing level of product specialisation may shape the process of education creating virtuous or vicious circles. Italy would seem to be caught in a vicious circle.

…. as structural problems and rigidities hamper adjustment.

Allegra et al. (2004) take a different approach towards explaining Italy's dismal export performance, one that looks beyond the manufacturing sector. Focusing on the link between the level of competition and economic performance they find that sectors which depend more heavily on inputs and services produced in sectors suffering from competition problems perform worse in terms of export growth. The analysis also shows that competition problems mainly persist in the services sector. Similar conclusions are drawn by the OECD (2003), which documents a broad spectrum of competition and regulation problems in both the manufacturing and services sectors, which either individually or in tandem hamper the macroeconomic performance. The spectrum ranges from comparatively high mark-ups in some sectors of the manufacturing industry, through low competition in the retail sector to a high regulatory burden in professional services. The empirical connection between the intensity of competition in product markets and productivity outcomes is well identified in a comprehensive study covering all OECD countries (see Nicoletti G. and S. Scarpetta, 2003).

A third line of reasoning looks at foreign direct investment (FDI). An important branch of the economic literature, both theoretical and empirical, provides arguments and evidence that FDI can be a potentially powerful determinant of technology diffusion and of specialisation, and a driver of economic growth. As is apparent from Chart 5, Italy ranks low in terms of its accumulated stock of inward FDI. In 2003, the stock amounted to around 12% of GDP, only half of the figure recorded in France and Germany. On a more global scale and looking further back in time, Italy used to rank 64th among the 140 countries covered by the UNCTAD World investment report at the end of the 1980s. The relatively comfortable position – Germany ranked 84th – reflected the prolonged post-war foreign ownership penetration. A major change took place between then and the mid-1990s when Italy fell to 130th place, before catching up again somewhat to rank 98th in more recent years. A further important piece of evidence concerning FDI is outlined by Mariotti et al. (2002), who show that, in addition to its comparatively low levels, recent inward FDI in Italy is also characterised by a low and decreasing share in high technology industries.

Low inward FDI is both a symptom and a cause of Italy's problem of competitiveness.



Overall, the weak gravitational force of the Italian economy for FDI is particularly telling and is concrete proof of the assessment emerging from the various competitiveness indicators compiled by international institutions. Zanetti and Alzona (2004) compare the results of three particular prominent producers of such indices – the World Economic Forum (WEF), the Institute for Management Development (IMD), and the Economist's Economic Intelligence Unit (EIU) – which cover a wide range of structural variables from the economic and institutional field. Italy consistently comes out at the lower end of the European scale, competing with countries such as Greece or Portugal. The Italian economic system is generally depicted as one in which structural rigidities and a comparatively high regulatory burden imply a high cost of setting up or doing business.

Conclusions

Towards the end of the 1990s, after more than five years of weak economic growth, received wisdom had it that a large part of the problem was due to the overlap of a number of temporary factors such as fiscal consolidation, exchange rate movements and the policy mix. However, as the growth malaise dragged on and even worsened during the following five years the assessment changed. There is now a broad consensus that Italy is suffering from a series of mutually reinforcing structural shortcomings affecting its foreign sales and more generally its overall growth performance.

There is also broad agreement, not just on the diagnosis but also about what economic policy-makers should actually be doing, namely implementing and speeding up a broad range of structural reforms. Specifically, the course of treatment should focus on education and skills, innovation, research and development, more competition and better regulations. The renewed Lisbon strategy launched at the 2005 Spring European Council provides the right setting in which to tackle the Italian economy's structural challenges.

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[1] The issue of slow potential growth in Italy was also discussed in Country Focus Vol. 1, issue No. 8, 23. March 2004 : Relegated to the League of Laggards? Roots of Italy's Slow Growth.
[2] There are three main hypotheses. (i) Measurement problems: employment growth could be overstated as informal labour 'emerges' into the formal sector. While one can not exclude this possibility, national accounts statistic generally include updated estimates of the underground economy. (ii) Gauging human capital: a large proportion of the new jobs are characterised by a low level of human capital. The slowdown in productivity growth would be less dramatic if the employment-head count was adjusted for different levels of education. (iii) Cyclical factors: most measures of total factor productivity do not account for the level of capacity utilisation or hours worked which typically vary over the cycle. Hence, during the economic slowdown in 2001-2003 the sluggishness of productivity could actually be overstated and partly temporary.
[3] Pavitt's taxonomy classifies industries into *science based*, *scale intensive*, *specialised suppliers* and *supplier dominated'* producers based on the innovation and technology content of production. A comprehensive discussion of Pavitt's taxonomy can be found in Archibugi (2001).

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