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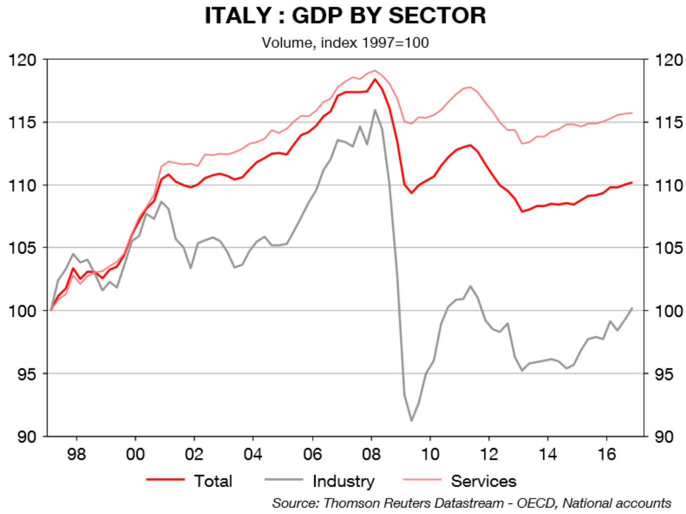
ITALY: COMPANIES' DIFFICULTIES ARE HAMPERING INVESTMENT AND GROWTH POTENTIAL

- Italian companies' financial situation started to deteriorate from the 2000s, with the end of productivity gains in the Italian economy. The increase in unit labour costs and the continued erosion of their competitiveness weakened companies' returns. All the while, labour market rigidities substantially restricted their ability to adjust. As a result, there was a sharp decline in corporate margins.

- The double recession that followed the 2008 crisis crystallised Italian companies' difficulties and had a knock-on effect on the banking system. Companies' difficulties in accessing credit are now hampering investment and the recovery. A vicious circle is therefore setting in since the banking sector needs growth to improve its balance sheet and companies need financing to strengthen their position and modernise their production facilities.

- There were numerous issues, in light of the structural difficulties of the Italian economy, on the agenda of reforms implemented since 2012: labour market flexibility, pension reform, improvement in the effectiveness of administrative procedures, State aid for the banking system, etc.

- However, while these reforms have helped restore confidence and stimulate the labour market, they will no doubt be insufficient to boost Italy's long-term growth potential and restore corporate margins.



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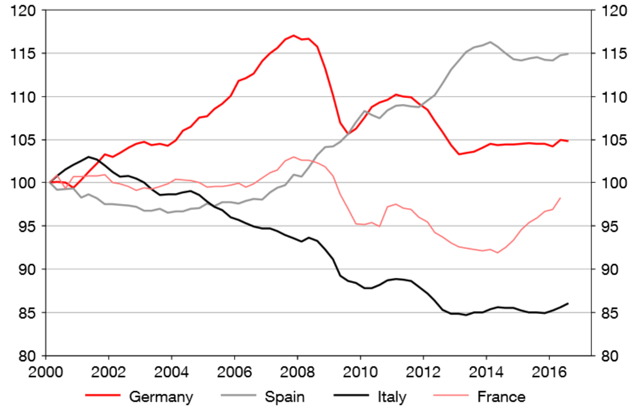
I - COMPANIES' SITUATION HAS DETERIORATED OVER THE LAST 15 YEARS

Italian companies are in a very weak financial position: profit margins fell constantly between 2001 and 2013 and are now 15% less than it was in 2000 (Graph 1). However, profit margins have stabilised over the last 3 years due to the improvement in financing conditions and the decline in oil prices. There is nevertheless a striking difference with Spanish companies, whose margins have recovered significantly since 2006, but also with French companies which have benefited from favourable tax measures since 2015 (competitiveness and employment tax credit (CICE) and Responsibility Pact).

Gr1. PROFIT MARGINS OF ENTERPRISES

Index 2000=100

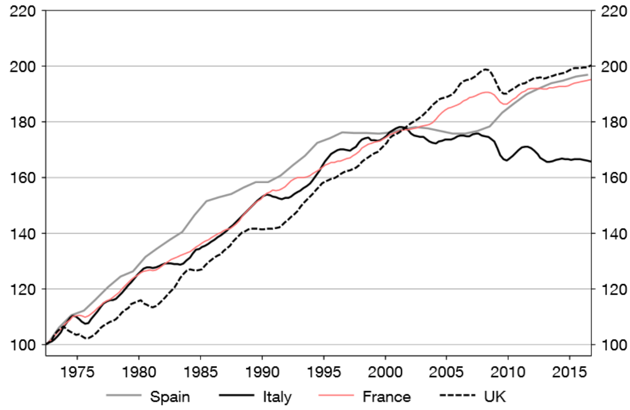


Source: Thomson Reuters Datastream - Eurostat

The deterioration in the financial situation of Italian companies is not a new phenomenon. It began after the bursting of the internet bubble in 2001 and the main cause is the decline in productivity gains, which is much more pronounced in Italy than in other European countries (Graph 2).

Gr2. LABOUR PRODUCTIVITY

Index 1972=100



Source: Thomson Reuters Datastream - OECD

FLAGGING PRODUCTIVITY…

The productivity trend in Italy can be divided into three phases: rapid post-war growth during the "Glorious Thirties" (average of 5% per year), followed by a phase of more moderate growth from the first oil shock in 1973 to the technology bubble in 2000 (around 2% per year), and finally a period of decline in productivity since 2001 (-0.4% per year).

There is abundant literature that attempts to explain this rupture in the productivity trend, and points primarily to the structural weaknesses of the Italian economy[1]. These are well-known and include: goods, services and labour market rigidity; insufficiently developed capital markets; a tax structure that weighs excessively on the factors of production (capital and labour); the weaknesses of the public administration and the civil justice system (regulatory barriers, cumbersome administrative procedures, length of legal proceedings, corruption); a failing educational system[2] and finally a substantial delay in the dissemination and use of information and communication technologies (internet use, the population's level of competence in ICT, etc.).

We can add to this list the substantial proportion of micro-enterprises (95% have less than 10 employees), which is likely to be a factor accounting for fewer productivity gains and a lower contribution to exports[3]. Micro-enterprises in the services sector have a particularly low productivity level (half that of French micro-enterprises).

A recent study[4] puts forward another explanation in order to understand the decline in Italian productivity: namely, that it is related to the poor allocation of resources (capital and labour) within the entrepreneurial fabric. If markets were efficient, the flow of resources should migrate from the least productive firms to the most productive ones, and the least productive firms should disappear. However, we observe an increase in the dispersion of productivity between firms, which reflects a deterioration in the allocation of resources over the last 20 years. According to this study, if dispersion had remained at its 1995 level, Italian productivity would now be 18% higher in industry and 67% higher in the services sector.

Moreover, the deterioration in the allocation of resources is more pronounced in the industrial region of the North-West and among large companies. This goes

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[1] *See for example: D. Pinelli, I. Székely and J. Varga, "Italy's productivity challenge", CEPR's Policy Portal, 22 December 2015*

[2] *School failure is high in Italy with 40% of the population (25-64 years old) not reaching secondary education level, vs. 22% on average in the OECD; the proportion of the population reaching tertiary education level peaks at 17.5%, vs. an average of 35% in the OECD.*

[3] *According to the WTO, there is a positive relation between the size of companies and their contribution to exports, with the contribution rate being lower for micro-enterprises (9%) and small companies (38%) than for medium-sized (59%) and large companies (66%).*

[4] *See: S. Calligaris et al., "Italy's productivity conundrum: The role of resource misallocation" CEPR's Policy Portal, 28 June 2016*

against the idea that micro-enterprises are likely to be responsible for the decline in Italian productivity.

The study also notes that the fall in productivity is mainly related to the increase in the number of firms with low productivity. The Great Recession of 2008 has not had the expected effect of "creative destruction" that would have led to the disappearance of the most fragile companies. This is likely to be due to several factors: firstly, the bankruptcy proceedings and procedures for the reallocation of assets of firms that have been wound up are ineffective. Secondly, the process for the allocation of bank credit would have led to "zombie loans" (when loans are extended to companies with low productivity to prevent them from going bankrupt). Lastly, the private equity fund market is still under-developed in Italy, perhaps due to the regulations for private equity funds and the restructuring constraints for companies.

The studies therefore point to the structural causes of low productivity, which are likely to be related more to the functioning of institutions than to the industrial choices of Italian companies.

…IN THE FACE OF THE CONTINUED RISE IN WAGES…

At the same time as the decline in productivity, wages continued to rise by an average of nearly 3% per year between 2000 and 2008 (Table 1). They slowed from 2010, but without experiencing a nominal contraction as in Spain. The specific collective bargaining rules in Italy involve the virtually automatic indexing of wages to inflation which causes substantial downward wage rigidity. Consequently, the cost competitiveness of the Italian economy has deteriorated relative to the other industrialised countries since 2002 (Graph 3).

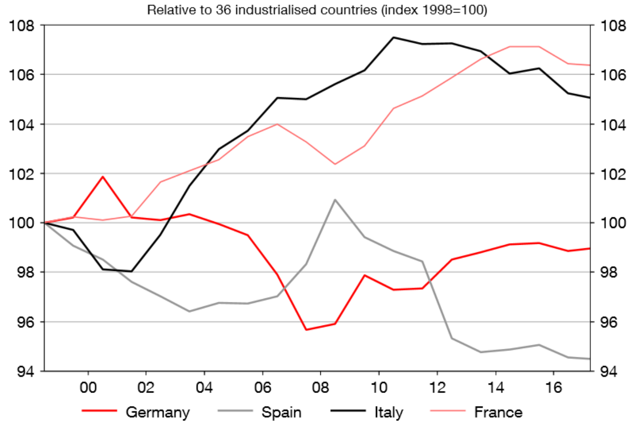
Italian companies have therefore been forced to reduce their margins. Their selling prices are constrained by the growing competition from countries with lower wages.

TABLE 1: AVERAGE ANNUAL TREND

As a %	1960-1974	1974-2000	2000-2008	2008-2016
Wages	12.7	10.9	2.9	0.7
Prices	5.6	8.9	2.4	1.2
Real wages	7.0	2.1	0.5	-0.5
Productivity	5.5	1.9	-0.1	-0.7

Gr3. REAL UNIT LABOUR COSTS

Relative to 36 industrialised countries (index 1998=100)



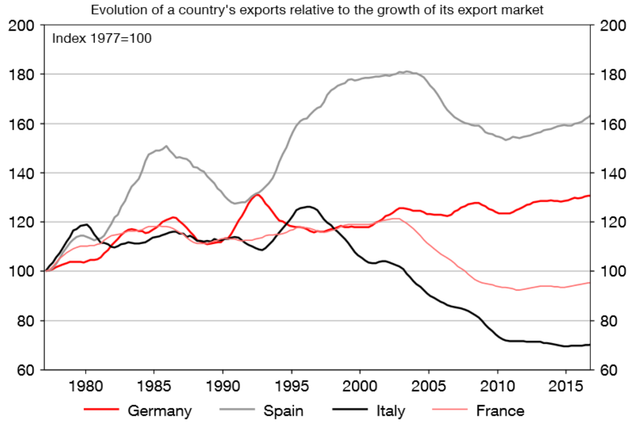
Source: Thomson Reuters Datastream - European Commission (AMECO)

…HAS ADVERSELY AFFECTED THE COMPETITIVENESS OF ITALIAN COMPANIES

However, the reduction in margins has not been sufficient to maintain Italian companies' competitiveness, and export market share deteriorated significantly between 1996 and 2010 (Graph 4).

Gr4. EXPORT PERFORMANCE

Evolution of a country's exports relative to the growth of its export market



Source: Thomson Reuters Datastream - OECD, Economic Outlook

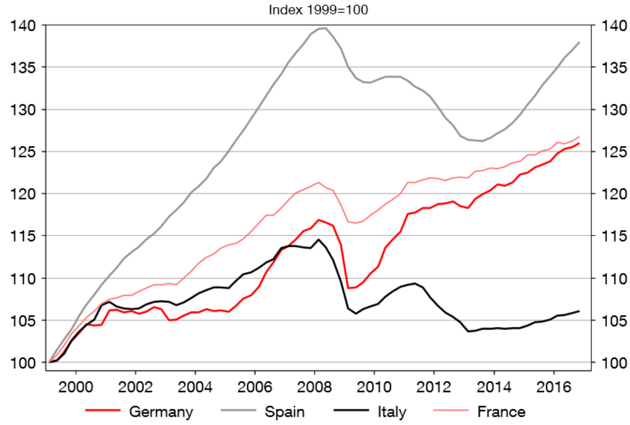
Italy's sector specialisation in products with a high labour content (such as textiles, leather goods, furniture, electrical household appliances, cars) has also adversely affected its export performances, due to competition from countries with low wages in these market segments (Asia and Eastern Europe). Furthermore, the small proportion of high technology products in Italian exports (7% vs. 22% in France) reflects insufficient up-selling that would have allowed the country to offset the loss of cost competitiveness through a range of products less sensitive to prices.

II – THE 2008 CRISIS HAS TRANSFERRED COMPANIES' DIFFICULTIES TO BANK BALANCE SHEETS

Italy therefore approached the 2008 crisis in an already difficult situation for its companies. The country did not experience a financial crisis as a result of excessive debt levels as in Spain or Ireland. However, it did undergo a far-reaching economic crisis that caused GDP to contract by 10% between 2008 and 2015, even though GDP increased only slightly between 2000 and 2007, unlike other so-called "peripheral" countries (Graph 5).

Gr5. GDP LEVEL

Index 1999=100



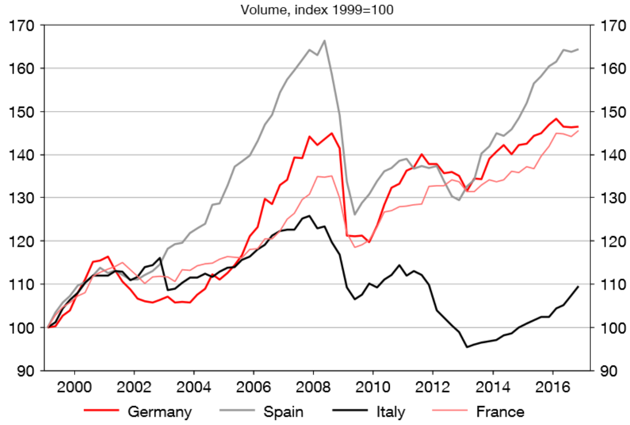
Source: Thomson Reuters Datastream - Eurostat

This long recession had a substantial adverse effect on Italian companies and for several reasons. Firstly, as we described above, wages have continued to rise: wage costs in industry (more sensitive to external competition) have risen faster in Italy than in France or Spain since 2008. Secondly, unlike Spanish companies, Italian companies did not make drastic adjustments to the workforce during the crisis. As a result, productivity continued to decline between 2008 and 2015 whereas it recovered substantially in Spain. Lastly, since 2008, companies have suffered from restricted access to bank financing on which they had become very dependent given their weak self-financing capacity.

Consequently, productive investment has seen a sharp contraction (nearly 25% in 5 years) and maintains a worrying lag. Unlike the other major European countries which have returned to their pre-crisis level, productive investment in Italy remains 13% lower than its 2007 peak (Graph 6). This considerably restricts the modernisation of production facilities and companies' capacity to adapt.

Gr6. PRODUCTIVE INVESTMENT

Volume, index 1999=100

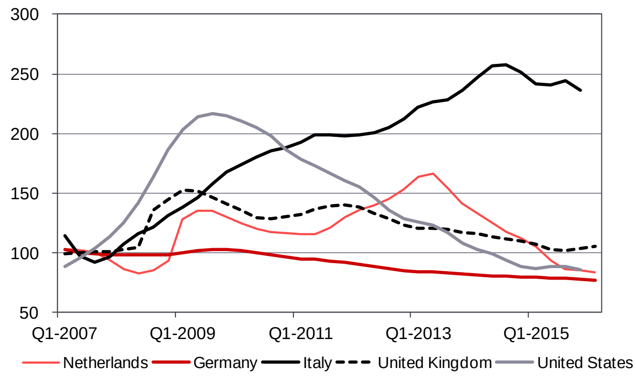


Source: Thomson Reuters Datastream - OECD, National accounts

The crisis has therefore crystallised the difficulties of Italian companies and the number of bankruptcies has increased (Graph 7). Non-performing loans have therefore accumulated in the balance sheet of Italian banks. Corporate loans now represent 72% of Italian non-performing loans, which are spread across all sectors of the economy (retail trade, construction, manufacturing industry).

Gr7. NUMBER OF BANKRUPCIES

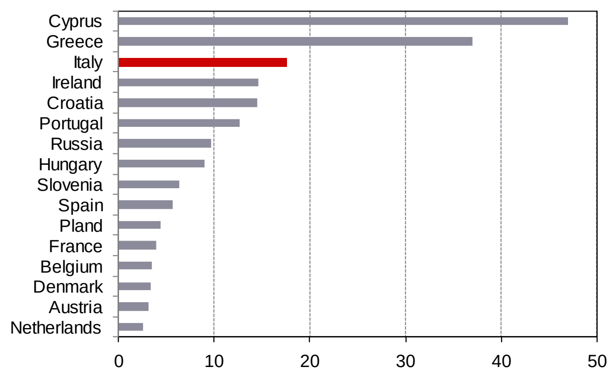
Index 2007=100



Source: OECD, Timely Indicators of Entrepreneurship

Gr8. NON PERFORMING LOANS RATIO (2016)

As % of gross loans



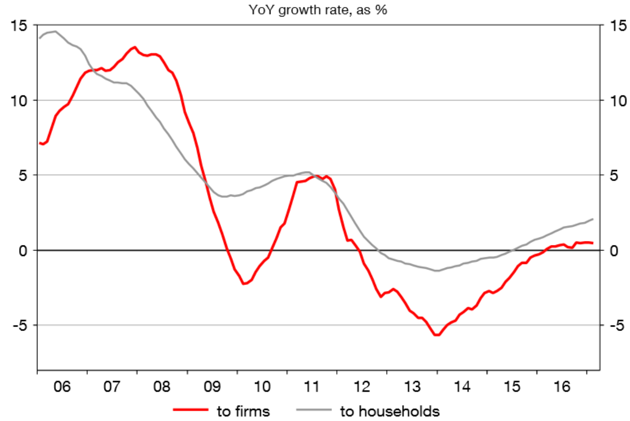
Source : IMF - Financial Soundness Indicators

Italian banks' balance sheets are among the most deteriorated in Europe (Graph 8), with non-performing loans representing 17.5% of total loans (€276 billion according to the EBA). The banks need "fresh" capital to strengthen their capital base and an economic recovery to reduce the amount of non-performing loans. The government recently passed a decree to inject €20 billion into the banking sector. However, these amounts remain insufficient given Italian banks' capital requirements (estimated at nearly €40 billion by the rating agencies).

The difficulties of Italian banks still constitute a constraint for credit supply, limiting the investment opportunities for companies (Graph 9). Corporate loans ceased contracting at end-2015, but they have experienced virtually zero growth. The result is a vicious circle where, because of a lack of financing, companies are unable to innovate or adapt to the competition without an overhaul of their production facilities. The economy's growth potential is reduced and this slows the adjustment of banks' balance sheets.

Gr9. BANK LOANS

YoY growth rate, as %



Source: Thomson Reuters Datastream - ECB, adjusted data

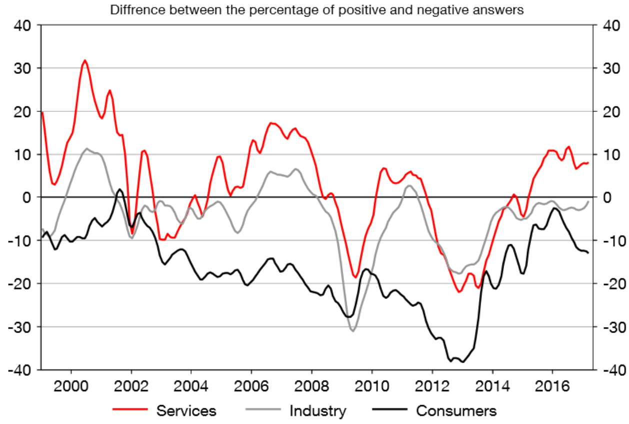
III - THE REFORMS IMPLEMENTED ARE VERY WELCOME…

Since 2012, successive Italian governments have implemented numerous reforms but whose effects on growth will only be felt in the long term. Here is an overview of these reforms:

- **Pension reform (2012)**: setting up of a notional defined contribution system, reduction in early retirement possibilities, retirement age pushed back and contribution period extended.
- **Labour market reform (2012 Fornero Law)**: simplification and reduction in the number of atypical employment contracts; reduction in legal uncertainty related to dismissal (more systematic reintegration in the position after unjustified dismissal); support for apprenticeships; signing of national inter-professional agreements in order to decentralise collective wage bargaining and "enable better matching of wages to productivity".
- **Jobs Act (2014)**: extension of the possible duration of fixed-term contracts (up to 36 months); simplification of apprenticeship contracts; introduction of a permanent contract "with increasing protection" (easier dismissal during the first three years, then a higher cost with length of service); introduction of a new unemployment compensation system (with the possibility of sanctions if job offers are refused).
- **Decline in labour taxation (2015)**: removal of the wage share of the IRAP (equivalent of the business tax) for permanent contracts; removal of social security contributions for 3 years on new permanent contracts with increasing protection, subject to a limit of EUR 8,060 per year.
- **Improvement in the business climate**: freedom to choose opening hours for shops; removal of minimum distances between shops; removal of regulated tariffs for some services (lawyers, notaries, etc.); authorisation to sell non-prescription medicines outside of pharmacies; implementation of a series of measures to simplify the administrative system in favour of SMEs; setting of a 30-day payment period for public administrations, etc.
- **Banking system reforms**: reform of the co-operative banks aimed at accelerating mergers; setting up of a State guarantee scheme (GACS) in order to encourage the assignment of non-performing loans; creation of private funds to help banks in difficulty (Atlante 1 and 2) and lastly, availability of EUR 20 billion of public funds for preventative recapitalisation (December 2016).

Gr10. CONFIDENCE INDICATORS

Diffrence between the percentage of positive and negative answers



Source: Thomson Reuters Datastream - European Commission

These reforms have helped restore the confidence of Italian entrepreneurs and consumers since 2013 (graph 10). The emergence from recession and the return of modest growth have also helped boost employment. Since 2014, 590,000 jobs have been created, including 373,000 permanent contracts. Job creation involving permanent contracts accelerated at year-end 2015 with the implementation of tax benefits (graph 11). However, the unemployment rate remains high (around 11%) due to the increase in the working population (later retirement).

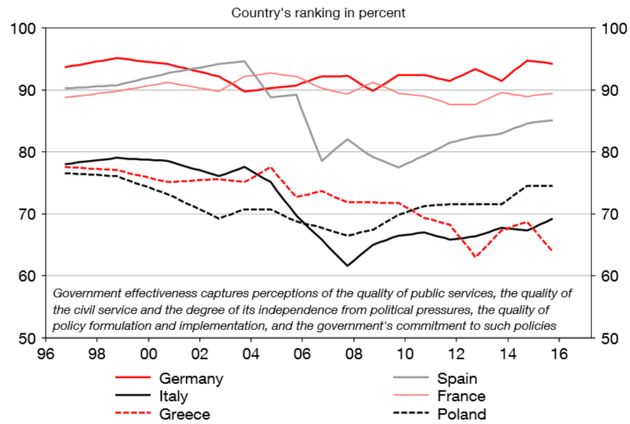
Gr11. EMPLOYMENT

Source: Thomson Reuters Datastream - Istat

IV - …BUT THE ROAD AHEAD IS STILL LONG

Overall, the reforms implemented have helped improve the business climate and the quality of public services. However, the country is still substantially lagging in international rankings in terms of governance and regulations.

Gr12. GOVERNMENT EFFECTIVENESS



Source: Thomson Reuters Datastream - Worldwide Governance Indicators

Among the World Bank's governance indicators, government effectiveness reflects the quality of public services and the independence of the State (Graph 10). Italy is ranked in the 69th percentile, closer to Greece or Poland than the major European countries. However, governance structures are only slowly changing and the current political environment (failure of the referendum on the reform of the constitution, rise of populist parties) suggests that the improvement in the functioning of institutions will take time.

From the viewpoint of the business climate, the situation has improved since 2012, thanks to the reforms which have helped reduce regulatory costs and complexities and strengthened the legal and fiscal institutions. In the World Bank's Doing Business rankings, the distance to the best ranked country has declined. However, Italy has fallen in the ranking to 50th position out of 190 countries, behind countries such as Serbia, Mexico, Thailand and Russia. Therefore, Italy's performance remains well below that of France (29th) or Germany (17th).

Finally, Italy is ranked 44th in the World Economic Forum's 2016 Global Competitiveness ranking, with the labour market as well as the financial and public sectors remaining a weakness. In particular, the report highlights the poor integration of women in the labour market – particularly in the south of the country, the weight of non-performing loans in banks' balance sheets, the need for the recapitalisation of some financial institutions, increased mistrust of the banking system following mutual banks being placed in resolution at end-2015, the weight of public debt, a bureaucracy described as "omnipresent" and a legal system deemed "highly ineffective". However, innovation is cited as a strength of the Italian economy.

Despite the reforms already implemented, the IMF estimates Italian potential growth at 0.5% due to the collapse in investment, the gloomy demographic outlook and weak productivity. In 2016, despite a fiscal stimulus and the easing of financing conditions, Italian growth was only 0.9% and we expect the same this year. Households' situation has benefited from the recovery in the labour market and the decline in inflation, but the domestic demand momentum is not sufficient to boost the economy. There is only a modest recovery in investment and it remains insufficient to renew the capital stock.

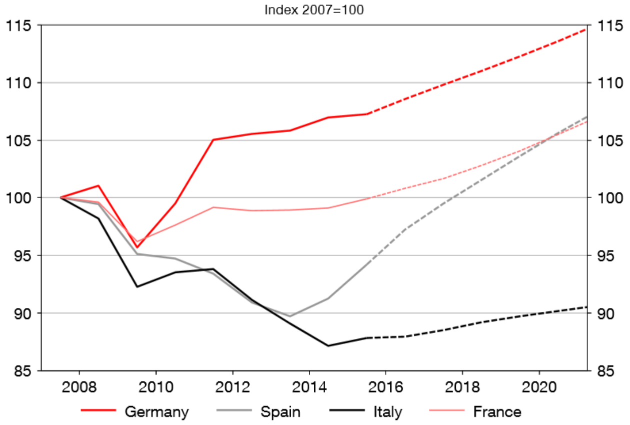
Italy is therefore confronted with a number of structural obstacles hampering the stimulation of growth:

- A problem of critical size of enterprises (38% of workers are employed in companies with less than 5 employees, vs. 29% in France and 14% in Germany);
- A lack of competitiveness that constraints export performance;
- The low margin rate of companies which leaves them little room to invest and modernize their production facilities;
- Financing constraints due to difficulties in the banking system.

It therefore seems difficult to come out of the vicious circle where the lack of financing restricts corporate investment and consequently companies' development capacity. Raising financing in the markets requires a long-term view of the profit outlook for Italian companies, itself directly related to the growth outlook, which currently remains gloomy. According to IMF forecasts, the level of GDP per capita in Italy is likely to remain 8% lower than the pre-crisis level in 2021 (Graph 13).

Recent efforts to recapitalize the banking system are welcome and should help restart of credit growth, which could ultimately support the ongoing investment recovery. Finally, in the current framework of gradual growth recovery with a slight acceleration in inflation, without major tensions on interest rates, the situation of indebted companies should improve.

Gr13. GDP PER HEAD FORECASTS



Source: Thomson Reuters Datastream - IMF World Economic Outlook

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