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Italy’s economic miracle is in the eyes of the beholder

Lorenzo Codogno

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Italy's overperformance relative to France and Germany since the pandemic needs to be put into perspective. Indeed, if we remove the temporary factors and the demand stimulus, there is probably not much to cheer about. Real GDP extra growth and its improvement do not appear to be material.

Is Italy experiencing a new economic miracle? When manipulated, numbers can say anything you want them to. But there are limits. And if we leave the demagoguery aside, the figures still do not seem to offer much hope for Italy's long-term economic prospects.

First, we should put aside the bad habit of attributing the economy's successes and failures to the current and previous governments. In the short term, economic performance rests on factors that are not entirely under the control of any government in office. It mostly depends on exogenous variables and policies cumulated over the years—for better or worse.

It would instead be more beneficial to make a careful and independent estimate of the effectiveness of the specific new policies introduced—something that has been done very little and sometimes even badly in Italy. Effective economic policy actions can make a difference in a country's prospects if consistently built up over time.

Putting things into perspective

According to current figures up to 1Q24, Italy's GDP exceeded its level in 4Q19 by 4.2%. This compares with 3.5% for the whole Eurozone, -0.2% for Germany, 1.9% for France, and 2.9% for Spain. It looks like a decent performance at face value, especially considering how badly Italy managed to exit previous crises.

Yet, at least five temporary factors explain Eurozone countries' performance since the pandemic. First, a significant element is obviously how hard the lockdowns and stringency policies hit the economies. Italy was affected the hardest in 2020, but things changed somewhat relative to other countries in 2021 and 2022. Second, the intensity of the negative impact was related to the economy's sectoral composition, with wholesale and retail trade, hospitality, lodging, art, entertainment and recreation being the most affected. Due to its sectoral composition, Italy was slightly more affected than the Eurozone average and France, and a lot more than Germany, but less than Spain and other Southern European countries. Third, industrial activity started to slow down in mid-2021 following the rebound after the initial

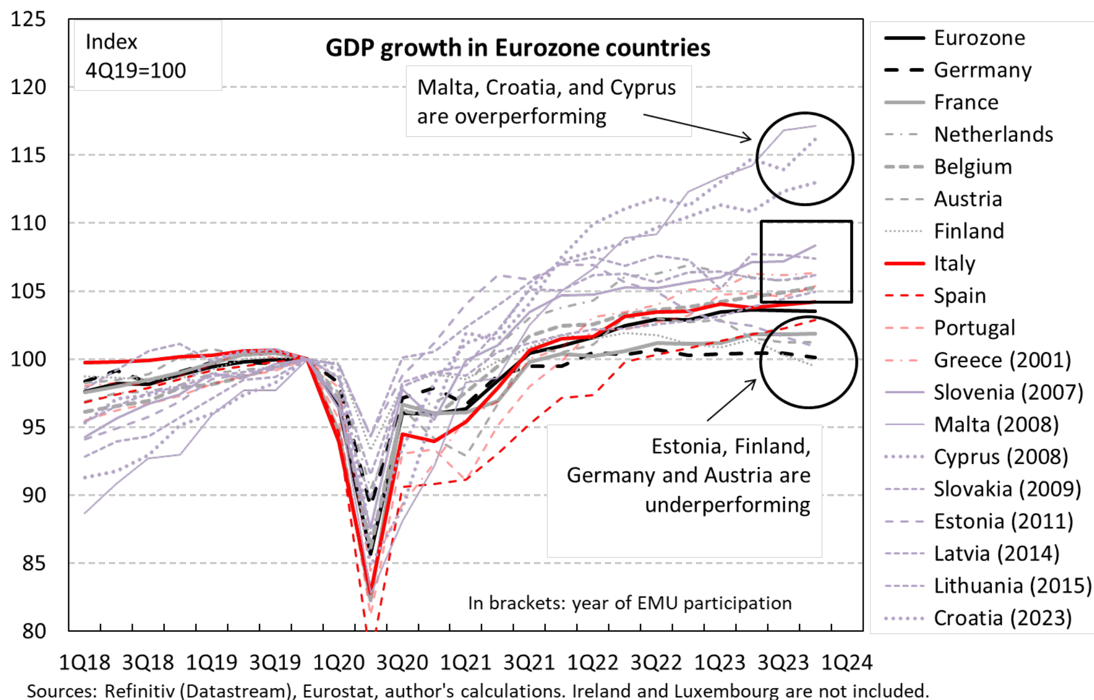
[1] Based on the article "Italy's economic miracle is not what it seems" published on the OMFIF website: https://www.omfif.org/2024/04/italys-economic-miracle-is-not-what-it-seems/

pandemic shock. Despite the strength of services, industry is still de facto in a recession in many Eurozone countries. Italy, having a higher share of industry in value added than other countries, was affected marginally more than the Eurozone average, more than France and Spain, but far less than Germany. Fourth, since Russia's invasion of Ukraine (and even before), Eurozone countries have been overwhelmed by the surge in energy prices. The shock was asymmetric and uneven, as well as the related policy responses. Italy was affected more than France and Spain, but somewhat less than Germany, despite relying heavily on Russian gas.

Finally, and most importantly, these shocks were counteracted by fiscal policy measures, both at the EU/Eurozone and national levels. Italy benefitted more than most other Eurozone countries from temporary demand support. Removing all the above factors, it is hard to assess whether Italy's underlying performance is better than that of other EU/Eurozone countries and whether it indicates a structural improvement. Maybe the labour market is the only area with some encouraging performance. Besides that, there is no evidence that the secular weakening trend recorded in the past has changed.

Figure 1 shows that Southern European countries have struggled to perform since the pandemic, with Spain being hit very hard but then catching up rapidly, and Portugal and Greece doing better than Italy. Instead, former Eastern European countries and, in general, convergence countries have resumed their convergence path towards richer countries, overperforming the rest of the Eurozone. Instead, Germany, Estonia, Finland, and Austria underperformed.

Figure 1. GDP performance of Eurozone countries since 4Q19.

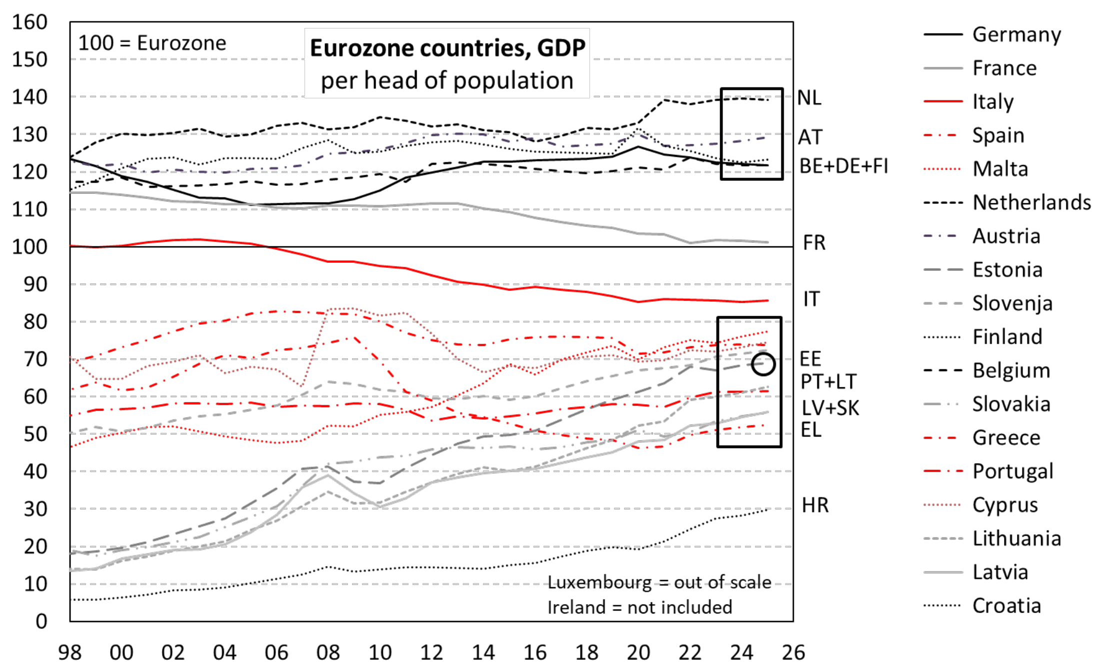


Sources: Refinitiv (Datastream), Eurostat, author's calculations. Ireland and Luxembourg are not included.

Taking a longer-term view and moving from GDP growth to GDP per capita (Figure 2), there is no indication that past trends have changed much. Relative to the Eurozone average, Italy has lost ground over the past 25 years, accompanied by France (although France started from a

higher level). Other 'core' Eurozone countries have slightly improved their relative position over the years. Germany had underperformed in the early years of the monetary union and up to the Global Financial Crisis. Then, it recovered in relative terms due to the much more severe crisis recorded in other countries, followed by the sovereign debt crisis that mainly affected the periphery of Europe. Southern European countries have not done very well, de facto hovering around the same fraction of the Eurozone average GDP per capita over the past 25 years. Instead, 'catching-up countries' continued to converge, with speed and intensity partly linked to the timing of their entry into the Eurozone (Figure 2). This shows that convergence to levels of income prevailing in core European countries has been, by and large, a success story for new entrants but not for existing Southern European members. Among them, Italy stands out for its poor performance, starting from a higher position and steadily sliding towards countries that have benefitted from structural and cohesion funds.

Figure 2. Italy (& France) have steadily underperformed in GDP per capita.



Source: Refinitiv (Datastream), European Commission AMECO, author's calculations (2024-2025 are Commission's forecasts).

Attempts at economic reform

A question remains about whether, with the slightly more reassuring data of recent times, it is appropriate to talk about a structural recovery of Italy's economy that goes beyond the short-term stimulus to demand. After all, the fundamental objective of Next Generation EU and the various anti-crisis packages was to facilitate structural reform through investments and temporary demand support. It is an economic objective, but it is also a political one.

The various attempts to reform the Italian economy have always clashed with the need to make the reforms socially acceptable and somehow compensate for the short-term political and social costs. Temporary demand support is a way to overcome these obstacles, linking them with supply-side enhancing investments. Therefore, European and national funds for

digitalisation and climate transition should not only be spent well but also help to raise the country's economic growth potential. Can we say that this is happening?

Despite a few undoubtedly positive measures linked to the National Recovery and Resilience Plan, the impression is that the current efforts are aimed at ticking the boxes agreed with the European Union to obtain new funds but without the current government convincingly taking ownership of the reform process. The €45.6bn of the NRRP resources spent by the end of 2023—2.2% of gross domestic product—is insufficient to change these prospects. But there is three times as much left to spend by 2026; thus, there is still hope on paper.

Deteriorating public finances

During the pandemic, Italy introduced the Superbonus 110%, a generous subsidy scheme to allow for the energy-efficient renovation of residential buildings. It ended up impinging on the same sectors supported by the EU-funded investment plan, resulting in significant capacity constraints and misallocation of resources. It also brought about a massive deterioration in public finances.

Its returns in terms of economic growth appear to be short of expectations. According to data up to March 2024, total investment reached €118.8bn, of which €117.2bn was allowed as tax credits and €111.6bn of the works were completed (according to ENEA figures, which underestimate the total of housing incentives). Adding all other bonuses, the total amount has exceeded €200bn, i.e. more than 10% of Italy's GDP. Where has the money gone?

Even assuming that only half of the renovation works would not have happened without the benefits and that other types of investment activity have been crowded out, the GDP impulse appears modest. The impact might have been much more significant, and the underlying performance was most likely dismal. With such a massive fiscal stimulus, one wonders whether Italy's 4.2% GDP rise since 4Q19—slightly above the euro area's 3.5%, as mentioned—is indeed worth celebrating.

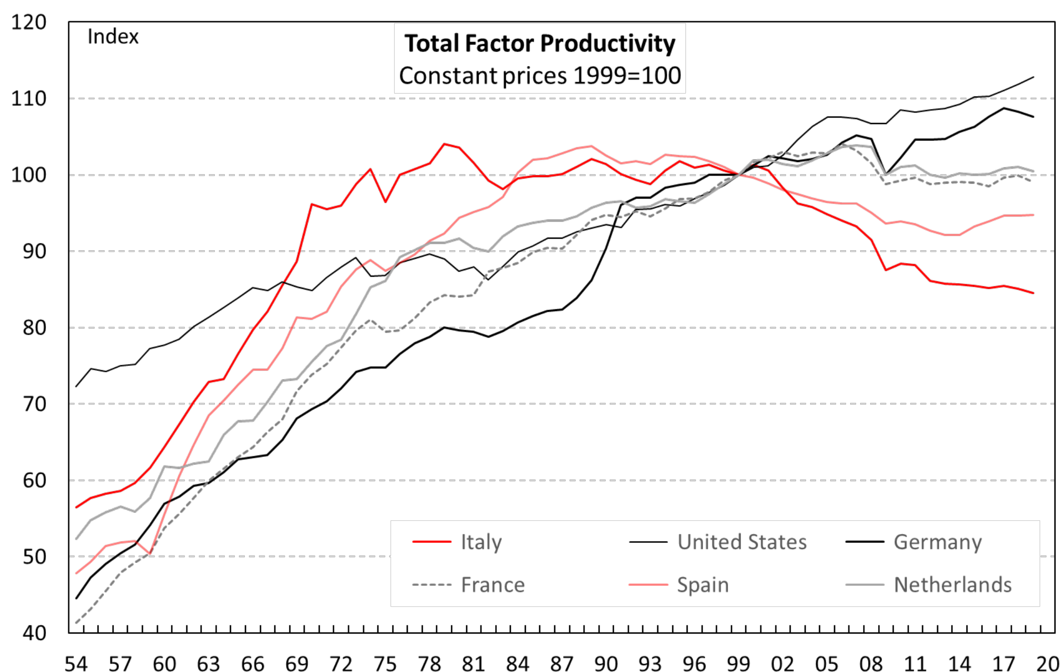
The effects of demand stimulus on GDP growth, whether related to European funds for digitalisation or linked to the Superbonus, tend to vanish if they do not lead to an increase in productive capacity. Meanwhile, the debt remains, and interest on debt tends to grow as a percentage of income. Italy will also have to repay its part of the EU debt on top of the additional national debt in the future. The Maastricht-definition accrual-basis net borrowing was 7.4% in 2023, boosted by the frontloaded recording of the Superbonus. The impact on cash borrowing, and thus on public debt, is mostly yet to come as it will emerge once tax credits offset fiscal revenues. This will make it challenging to reduce Italy's public debt ratio over the coming years.

Amid a political and economic constraint not to further increase taxes and the well-known difficulty in compressing current public spending, the risk is that Italy is moving ever closer towards a point of no return. Radical and politically difficult actions would be needed that only a government with a medium-term perspective can undertake. The current government enjoys a large majority in parliament and opinion polls. Therefore, regardless of political colour, it should be able to take up this challenge.

Declining productivity and growth

Italy has been in structural decline, and not just since the 1990s. Productivity problems are much longer-standing, deeper, more entrenched and thus more concerning. Total factor productivity—a measure of technological advancement, innovation and the ability to efficiently use factors of production—has stopped growing since the mid-1970s. Since the 1970s, Italy has artificially propped up its GDP growth with continuous devaluations of the lira and an enormous expansion of public debt. However, once these artifices were no longer possible due to the process of convergence towards the monetary union, Italy's GDP stopped growing (Figure 3).

Figure 3. TFP had stalled since the mid-'70s and has declined since 1999.



Source: Refinitiv (Datastream), University of Groningen, Penn World Table, author's calculations.

It is not enough to move incrementally to reverse all this. An unprecedented commitment and a true economic revolution is needed. Everything should be directed towards a long-term vision, including the funds granted by the EU, precisely to help Italy face its challenges.

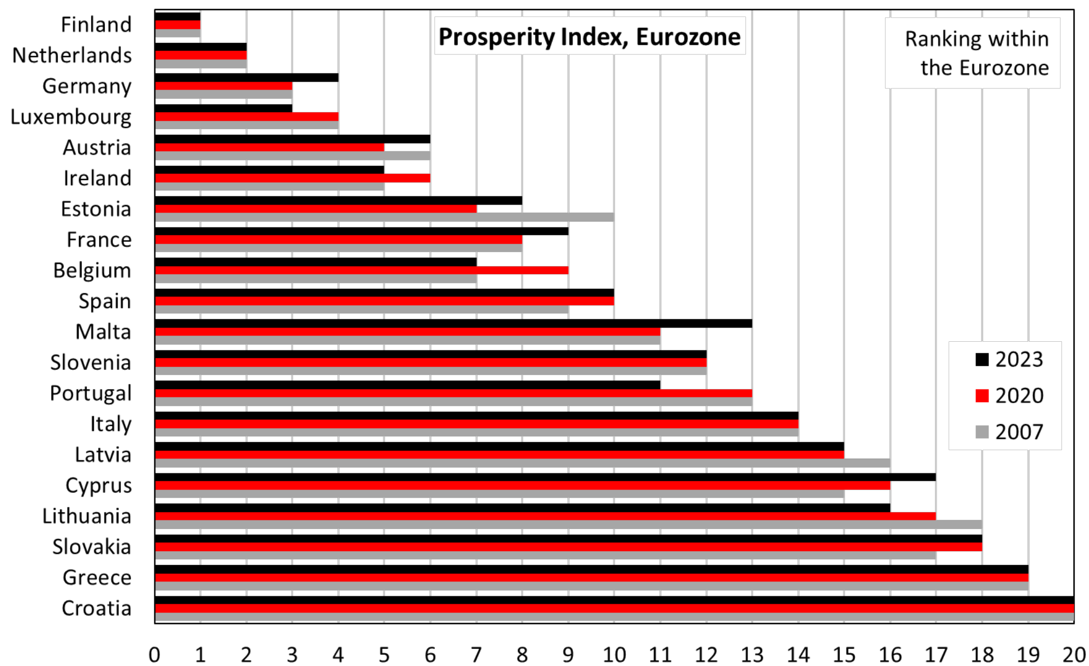
In *'Meritocracy, Growth, and Lessons from Italy's Economic Decline'*, Giampaolo Galli and I identified the red line that runs through Italy's recent history: the lack of meritocracy, or the broader concept of incentive structure or markets and rules. The 'incentives' should not be those of the public budget, given generously to make this or that interest group or voter happy. There should be clear and simpler rules to ensure that economic players do not spend their time trying to evade taxes, grab state incentives or bypass market rules. Instead, they should focus on the critical dimensions of human capital and competitiveness to achieve higher returns. This is the real revolution that Italy deserves. Can we say that this is happening?

Structural indicators show Italy still languishing between 30th and 35th place in international rankings on the various dimensions of growth and prosperity. Even anecdotal evidence allows

for little optimism. Businesses and workers continue complaining about Italy's old problems that have impeded its growth in recent decades.

The Prosperity Index is an all-encompassing structural indicator that goes beyond strictly economic dimensions, taking information from various sources, including the IMF, the WB and the OECD. It shows that Italy's rankings within the Eurozone have not changed over the years. Italy languishes at the bottom of the Eurozone league table, indicating a lack of relative structural improvement (Figure 4).

Figure 4. Eurozone countries' rankings have remained unchanged.



Source: Legatum Institute, author's calculations.

Therefore, the moderate economic recovery from the pandemic seems mostly linked to a massive stimulus to demand, with likely modest repercussions on the supply side, at least so far. It could even be argued that the effects of the fiscal stimulus and the underlying performance were both disappointing. What will remain of the current economic growth when the European funds, the Superbonus and the other demand stimuli financed by Italian or EU public debt have run out in two or three years?

Making the correct diagnosis is an essential first step. But so many diagnoses have been made in the past that it would be enough to act using only part of them to restore momentum to the Italian economy. However, at the moment, leaving aside the box-ticking exercise of the National Recovery and Resilience Plan, there seems to be no overall vision or coherent strategy and no effective implementation of existing plans.

About the author

Lorenzo Codogno is a Visiting Professor in Practice at the LSE's European Institute and founder and chief economist of his own consulting vehicle, LC Macro Advisors Ltd. He is also a Visiting Professor at the College of Europe, Bruges, and Senior Fellow at LEAP in Rome. Prior to joining LSE, Lorenzo Codogno was chief economist and director general at the Treasury Department of the Italian Ministry of Economy and Finance (May 2006-February 2015). Throughout this period, he was head of the Italian delegation at the Economic Policy Committee of the European Union, which he chaired from January 2010 to December 2011, thus attending Ecofin/Eurogroup meetings with Ministers. He also represented Italy at the OECD (EPC, WP1 and EDRC) and was Chair of WP1. He joined the Ministry from the Bank of America, where he had worked over the previous 11 years. He was managing director, senior economist and co-head of European Economics based in London. Before that, he worked at the research department of Unicredit in Milan.