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Southern Europe in crisis: industrial policy lessons from Italy and Portugal

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Abstract Italy and Portugal have characteristics in common and some relevant differences, both of which provide useful inputs for a comparative analysis. Lucchese et al. (Industrial policy and technology in Italy, 2016) argue that deindustrialization in Italy stems partially from the shortcomings of industrial policy, which has been unable to promote the development of more knowledge-intensive activities. In contrast, our assessment of industrial policy in Portugal indicates that the absence of structural change towards more knowledge-intensive activities does not seem to result from the absence of adequate industrial policy measures. Even though most of the policy instruments that have been put in place in Portugal being of a ‘horizontal’ nature, support has been unevenly distributed across industries, often being concentrated in more technology-intensive industries. We conclude that despite existing room for improvements in the industrial policies, overcoming the current crisis in the Southern belt of the euro zone will require decisive changes in macroeconomic policies.

Keywords Industrial policy · Economic crisis · Deindustrialization · Competitiveness · Innovation · Knowledge-intensive industries

JEL Classification L52 · O33 · O38

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In their paper, Lucchese et al. (2016) argue that deindustrialization is a central feature of the current economic crisis in Italy, and that the retrenchment of manufacturing activities is partially attributed to the shortcomings of industrial policy in recent decades. Although deindustrialization partially results from external factors—particularly, the globalization of production, global financial flows, and EU-related constraints on economic policy, including the austerity strategy adopted in since 2010—industrial policy in Italy, according to the authors, has been unable to promote the development of more knowledge-intensive activities, which would have been less vulnerable to those external pressures.

The main shortcomings of the policies adopted in Italy include: an undue use of currency devaluations until the early 1990s, which fostered the specialization in traditional sectors; labour market deregulation, which has reduced the incentives for innovation; more generally, a lack of strategic vision and undesirable discontinuities in industrial policy, the persistence of 'horizontal' measures, modest resources allocated to R&D and innovation, a high fragmentation of initiatives, and the lack of a true public investment bank.

Accordingly, Lucchese et al. (2016) suggest that in order to overcome the current crisis Italy has to develop an effective industrial policy, focused on the promotion of sophisticated, labour intensive activities that rely on medium and high skills. Such policies should be based on an institutional setup that prevents the capture of public resources by private interests. Moreover, the authors emphasize the need for changes in industrial policies at the EU level, namely less stringent State Aid rules and improved conditions for long-term financing of productive investment.

Italy and Portugal have several characteristics in common and also some relevant differences, both of which provide useful inputs for a comparative analysis of Italian industrial policy.

Regarding the similarities, at a structural level, both countries display low levels of education attainment in comparison with the EU average, are strongly specialized in less technology-intensive industries, and their business structures are dominated by very small firms (Mamede et al. 2014); these structural features are reflected in a lack of a critical mass of technological, production, financial, and managerial capabilities.

Regarding their economic performance in the recent past, both countries have experienced dismal growth since the turn of the century (in contrast with Spain or Greece, where GDP grew above the EU average until the international crisis of 2008/2009), were strongly hit by the euro zone crisis since 2010, and are presently facing bleak prospects of economic and employment growth in the coming years (Mamede et al. 2016). Finally, economic policy in both countries has been severely constrained since the early 1990s by the developments in EU competition policy, international trade agreements, financial liberalization, and budgetary rules. These developments contributed to the privatization of State-owned firms (some of which played a decisive role in high-tech activities), the acquisition of majority shares of leading firms by foreign investors, the increasing role of the financial sector (and related activities) in the domestic economy, and the increasing involvement of non-financial firms in financial activities (Lagoa et al. 2014). All these features and trends contributed to the imbalances that led to the euro zone crisis, while many of them have been aggravated by the crisis itself.

While we have highlighted the similarities, the economies of the two countries differ in some important aspects. First, Italy's territory is three times larger than the Portuguese one, its population six times more numerous, and its nominal GDP nine times higher. Second, Italy embarked in industrialization from an earlier stage. Annual average growth of per capita GDP in the period 1820–1913 was 0.9 %, nearly the same as the UK and three times higher than in Portugal (Maddison 2006). The Portuguese economy remained largely based on agriculture until after the Second World War; by 1980 the labour force share in agriculture was still 24 %, as compared to 13 % in Italy.[1] The differences in the size of the countries and in the timing of industrialization help to explain a third relevant distinction, which has to do with the presence of large, domestic-based corporations. The Forbes' list of *The World's Biggest Public Companies* includes 30 Italian firms and only six Portuguese ones; the numbers are 13 and 3, respectively, if bank and insurance corporations are excluded. Though losing some ground recently, Italy is still home to a number of world leading non-financial firms, including ENI (Oil and Gas), Finmeccanica (Aerospace and Defense), Luxxotica and Prada (luxury goods), whereas no similar global players have their headquarters in Portugal.

In order to proceed with the analysis of industrial policy in Italy from a Portuguese perspective—and keeping in mind the aforementioned similarities and differences between the two economies—it is useful to share our view regarding the origins of the stagnation of the Portuguese economy since the turn of the century and how it relates to the country's productive fabric.

There were two crucial developments underlying the evolution of the Portuguese economy since the early 1990s: the extensive liberalization of the Portuguese financial sector, which took place in a macroeconomic context marked by nominal convergence in anticipation of the euro; and the competitiveness shocks that occurred after 2000, when the Portuguese private sector was already highly indebted (Mamede et al. 2016). Financial deregulation and nominal convergence were common trends in all EU member states during the 1990s, especially in those that were preparing to join the euro zone since its inception in 1999. This led to a steep drop in real interest rates and to an almost unlimited availability of bank credit. In the case of Portugal, the impact of those trends was reinforced by two further factors: the comprehensive privatization of the banking sector, which had been almost exclusively State-owned since the 1974 revolution; and the significant inflow of EU structural funds, amounting to an annual average of nearly 3 % of the GDP in the 1990s. All these factors led in the period from 1995 to 2000 to: a rapid increase of bank credit in the Portuguese economy (from 43 to 93 % of the GDP[2]); an investment-led growth spur (over this period gross fixed capital formation was on average 26.0 % of the GDP, as compared to 19.4 % in Italy[3]); and the growth of private sector debt (e.g., corporate debt went up from 58 to 104 % of the GDP;

[1] Source: World Development Indicators (The World Bank).

[2] Source: Bank of Portugal.

[3] Source: AMECO. Unless stated otherwise, the following figures were taken from the same source.

while in the Italian case the figures remained relatively stable, around 57–59 %). In other words, by the turn of the century the indebtedness of the Portuguese private sector had become already a significant constraint on the future growth of internal demand. The subsequent years made clear that the financial vulnerabilities of the Portuguese private sector would not be compensated by an outstanding export performance. Actually the Portuguese export sector suffered three competitiveness shocks: the entering of China to the WTO in 2001; the EU enlargement to the East; and a nominal appreciation of 64 % of the euro against the US dollar in 2001–2008. The specialization profile of the Portuguese economy—strongly reliant on price-competition and overlapping significantly with China and Eastern European countries—was particularly vulnerable to those competitiveness shocks (OECD 2007; IMF 2008).

The competitiveness hurdles of the Portuguese economy after 2000 were, to some extent, shared by other Southern European countries, including Italy. Notwithstanding, the two countries experienced what seems to be rather diverging trends in manufacturing during this period: while in Italy manufacturing value added slightly increased and manufacturing employment stabilized between 2000 and 2008, in Portugal manufacturing value added stagnated and nearly 1/5 of manufacturing jobs were lost. Beneath these apparently diverging trends in manufacturing in the two countries, there are further similarities and differences that are worth noting. In both countries the traditional textiles and footwear industries contracted substantially. Similarly, manufacturing employment dropped substantially in the automotive industry, due partly to de-localization towards Eastern European countries (e.g., Krzywdzinski 2014). However, the loss of jobs in those industries in Italy was more than compensated by an expansion of employment in medium-tech industries, namely fabricated metals, machinery and equipment, and electrical and optical equipment. In contrast, almost all Portuguese manufacturing industries experienced job losses after 2000, the exceptions being rubber and plastics, and fabricated metals.

A relevant question at this point is: why was Italy able to compensate the losses in the industries more exposed to new competition by expanding the activity in some medium-tech activities, while Portugal experienced deindustrialization across almost all manufacturing activities? Mamede (2014) suggests two explanations for this puzzle: first, Italy had already a revealed comparative advantage in medium-technology industries, which had a rapidly expanding global demand in the 2000s; second, the productivity levels of those industries in the Italian case were clearly above the Portuguese ones. In other words, a relevant part of the Italian manufacturing fabric was prepared to seize the opportunities accruing from the growth of global trade after 2000. The lack of large, domestic-based firms and the high levels of corporate debt, together with an overspecialization in low-tech industries, may help to explain why the same did not happen in Portugal.

In line with the arguments put forward by Lucchese et al. (2016), one should consider two further questions: (1) do the weaknesses of Portuguese manufacturing stem from shortcomings in the industrial policy followed in Portugal in recent decades?; (2) can the improvement in Portugal's industrial policy, possibly leveraged by specific industrial policies at the EU level, have a decisive role in overcoming the current economic crisis? Our answers to these questions are to some extent different from the ones suggested by Lucchese et al. (2016).

Our own assessment of the industrial policy in Portugal is presented in Mamede et al. (2014), where we argue that Portugal has put in place virtually all the usual ingredients of an innovation policy mix. Even though most of the policy instruments in place seem to have a 'horizontal' nature, support is unevenly distributed across industries, often being concentrated in a number of non-traditional industries, namely IT services, chemicals and pharmaceuticals, the automobile and components industries, telecommunication equipment and electronic products (Mamede and Feio 2012). This evidence points to the presence of a proactive support of structural change by public authorities, towards more technology-intensive industries since the early 1990s. Moreover, several independent evaluations concluded that the priorities and criteria that guided the implementation of most support mechanisms have been appropriate and broadly aligned with the goal of upgrading the production fabric.

In sum, the absence of structural change towards more knowledge-intensive activities does not seem to result from the absence of adequate industrial policy measures in Portugal. In fact, the efforts in this domain would hardly be sufficient to offset the impacts of financial liberalization and macroeconomic management, combined with the underlying structural weakness of the Portuguese economy, in particular the low level of education and its implications for the dynamic capabilities of the firms. This is not to reject the possibility that the design and implementation of industrial policy in Portugal may yet be considerably improved: in Mamede et al. (2014) we discuss in some detail how policy making in this domain can be made more effective by setting clear priorities and improving governance at the higher policy level, similarly to the remarks made by Lucchese et al. (2016) for the Italian case. Pursuing a permanent improvement of industrial policy effectiveness is a crucial element in any sustainable path out of the present crisis. However, the impact of these changes will arguably be rather limited in the short- to medium-term. Overcoming the current crisis in the Southern belt of the euro zone will require decisive changes in macroeconomic policies, without which the efforts put in industrial policy will remain short of producing the intended effects.

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