

## Impact of the crisis on the Italian economic cycle

⊙ Italy is currently experiencing its tenth recession of the past 40 years. The recessionary phase began in the second quarter of 2008.

⊙ The present crisis is said to be as severe as that of the 1930s. GDP has plummeted due to the sharp contraction in industrial activity.

⊙ On the strength of the leading indicators, the speed at which Italy's economy is contracting should moderate in the short term. But in view of the structural problems the country faces (low productivity, loss of competitiveness and a deterioration in the public finances), compounded by the financial crisis, Italy's economic recovery looks set to be slow and laborious.

### Description of previous cycles

According to ISAE (2009), Italy passed through ten recessions<sup>1</sup> between the first quarter of 1963 and the first quarter of 2008. This finding is similar to that made by the IMF (2009). The IMF reckons that the Italian economy has experienced nine recessionary phases over the past four decades, compared with four in France and eight in Germany. The Italian economic cycle lasts 4.5 years on average, slightly less than that of the eurozone as a whole (ie, five years). In view of the standard deviations in real GDP, the cycle's volatility is greater in Italy, at 1.35%, than the eurozone's 0.84%, but it is comparable to that of the United States. In Italy, the expansionary phase of a cycle lasts 13 quarters on average, while recessionary phases last nine quarters. Of the ten recessions, one was triggered by an oil shock (that of 1974-75), while the two others, that of 1992-1993 and the present one, by a financial crisis. The IMF recently demonstrated that recessions triggered by oil shocks are highly costly in terms of falling activity but are generally short-lived. Recessions due to financial crises are also severe, but, more importantly, last longer. Recovery from a financial crisis, for its part, is particularly difficult, with slow recoveries hampered by weak private demand and credit. The time required to return to pre-crisis activity levels is

<sup>1</sup>Dates of recessions estimated by ISAE: 1964Q2 – 1964Q4; 1974Q4 – 1975Q2; 1977Q2 – 1977Q3; 1982Q1 – 1982Q4; 1992Q2 – 1993Q3; 1996Q2 -1996Q4; 2001Q2 – 2001Q4; 2003Q1 – 2003Q2; 2004Q4 -2005Q1; 2007Q4 -

on average as long as the recession itself – at least a year. Recessions triggered by financial crises are therefore the most costly.

### What is a cycle?

An economic cycle breaks down into two main phases – a recession, which goes hand in hand with a downturn in economic activity, and an expansion phase. A cycle is characterised by its length, ie, the number of quarters between a peak and a trough for a recession, and by its scale, ie, the change in real GDP or industrial production between the peak and the trough in the recessionary phase.

### What is a recession?

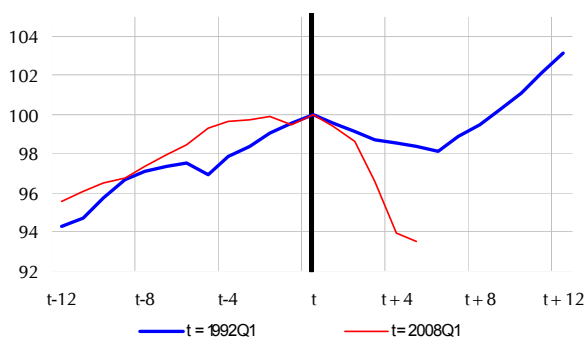
There is no official definition of a recession. Usually, it means a period when economic activity falls. Thus we talk of a recession when a country registers two consecutive quarters of falling real GDP. But this rule is limited to an appreciation of GDP only. The *Centre for Economic Policy Research* (CEPR) and the National Bureau of Economic Research (NBER), the body responsible for dating the beginning and end of recessions in the United States, both diagnose recession when industrial production and employment are also sharply down. A recession begins after activity has reached a high – the peak – and ends when it has reached its low point, the trough of the cycle.

### Similarities and special features of the present recession

ISAE estimates that the ongoing recession began in Q4 2007. **The Bank of Italy (BoI), however, more recently established that the recessionary phase of Italy's economic cycle had only begun in Q2 2008**, ie, at the same time as in France and Germany. This more recent estimate seems in our view more realistic, as a recession is diagnosed when all sectors of the economy are shrinking – not only output, but also incomes and employment. At the end of 2007, conditions on the labour market were still satisfactory. It was only after late 2008 that employment began to fall. Not all sections of the Italian economy, therefore, were already in recession in Q4 2007.

Since WWII, the worst recession in Italy was that of 1974-75, following the first oil shock. **However, it is obvious that the ongoing recession is even more severe**, as real GDP has contracted by 6% since spring 2008. In 1974-75, GDP fell by only 3.8% and by 1.9% in 1992-93. According to the Bol, the scale of the current crisis is similar to that of the 1930s.

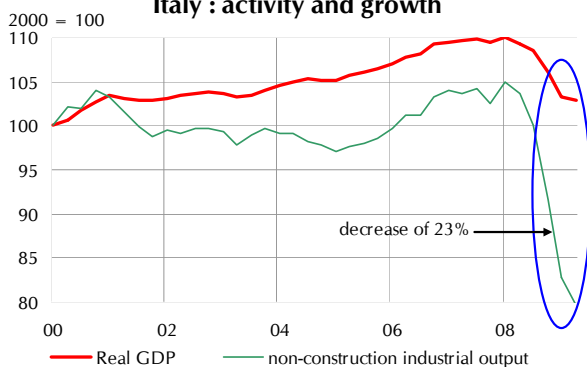
Italy : real GDP



Source : Istat, Crédit agricole sa

The contraction in GDP observed in recent quarters is largely due to falling industrial activity (down 23% since Q2 2008) a sector that accounts for 21% of GDP. The fall-off in industrial production is significantly more marked than in previous recessions (14.4% in 1974-75 and 4.7% in 1992-93). This is due to the overwhelming responsiveness of Italian business leaders to the sudden contraction in global demand, as Italy is dependent on exports. Business leader morale plummeted to an all-time low in March 2009 according to the ISAE survey. Given its synchronised, global character, the present crisis has affected a larger number of branches in the industrial sector than in previous recessions. According to the Bol (July 2009), over 90% of sectors had already recorded two successive quarterly falls in activity by Q1 2009, compared with 87% in 1974-75 and 52% in 1992-93. Moreover, service sector activity is still trending downwards, a year after the beginning of the recession, which was not the case during the crises of the 1970s and 1990s.

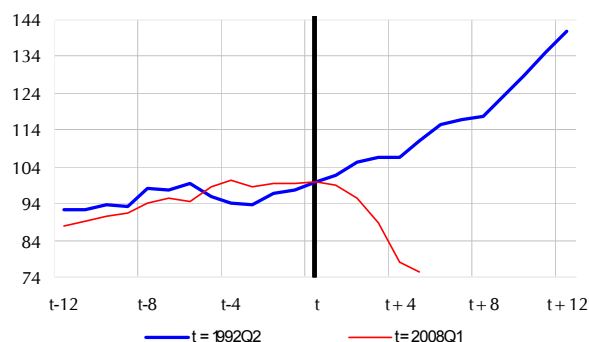
Italy : activity and growth



Source : OECD, Crédit Agricole S.A.

On the demand side, the volume behaviour of exports in the present crisis is unusual, seeing a historically sharp fall since November 2008 (-24.8% yoy throughout the second quarter of 2009). In 1974-75, exports fell only moderately and temporarily, and the pick-up in world trade was rapid and sustained. In the recession of the 1990s, exports remained on an uptrend thanks to the large-scale devaluation of the lira in 1992. The effects of the ongoing crisis are thus especially severe.

Italy : exports

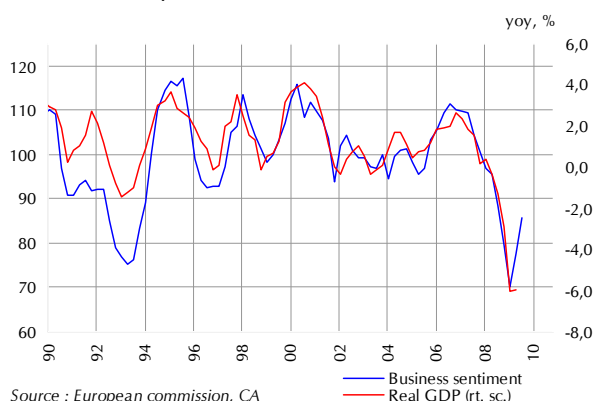


Source : Istat, Crédit agricole sa

### What do the leading indicators tell us about coming quarters?

The OECD's composite leading indicator for July suggests a recovery in the Italian economy. Surveys by ISAE and the European Commission also point to an improvement in the business climate. Confidence indices, for business leaders and households alike, have picked up from their recent lows. But economic agent morale remains depressed. The rebound as seen in the surveys is a long way from having corrected their dizzying fall triggered by the global financial crisis, while the confidence indicators for business leaders are still a long way from their long-term trend level. **These indicators suggest that economic activity in Italy will continue to shrink in the short term but at a more modest rate than in previous quarters.**

Italy: GDP and business sentiment



Source : European commission, CA

However, the adjustment to inventories seems to be nearing its end, as business leaders feel that the level of inventories is particularly low. The ratio of the balance of forecast production to that of stocks of finished goods in the manufacturing sector, derived from the European Commission survey – a leading indicator for changes in inventories within the meaning of the quarterly accounts – suggests that businesses began to rebuild their inventories as of Q3 2009 (after -0.4 of a percentage point of quarterly GDP growth in the first and second quarters of 2009). GDP growth should therefore be very slightly positive in Q3 2009 (+0.1% q/q).

**No improvement is expected on the labour market in the short term.** The downward adjustment to slowing growth was late in coming and has thus not yet run its course. If past recessions are anything to go by, employment will continue to fall over the coming quarters. This is also suggested by the hiring outlook of business leaders in industry, which is at a record low. Recovery on the labour market will be slow and lagged in relation to GDP growth. But the mismatch between the recovery in employment and activity should allow businesses to generate productivity gains in the short term (productivity is still sharply down, at -20.5% yoy in Q1 2009).

**The international financial shock and the global recession combined with Italy's structural problems, will lead to a deep and prolonged economic crisis.** Italy's growth has suffered from low productivity for many years. Between 2000 and 2007, productivity stagnated, leading to an increase in unit labour costs (ULC). Since the start of the crisis, ULC have rocketed (up 14.9% yoy in Q2 2009). Due to the Italy's loss of competitiveness on global markets, its trade balance has steadily deteriorated since the mid-1990s. It is currently negative (11.48 billion euros in 2008). To this should be added the deterioration in the public finances which makes it even more difficult to implement any discretionary recovery measures to cushion cyclical shocks and help trigger economic recovery.

**Taken together, these structural factors, exacerbated by the ongoing crisis, raise fears that Italy's economic recovery will be laborious, timid and slow.** Some analysts are forecasting that it will take at least two years to reach the level of the previous cyclical peak. ■

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