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Competitiveness in Europe: confronting Italy and Germany

Mezzogiorno and Neue Bundesländer: what lessons can Germany learn from Italy?

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Focus of the analysis

- We develop a comparative analysis of Neue Bundesländern and Mezzogiorno

- We argue that there are strong similarities between the two regions in terms of the “core” causes of their poor economic performance, beyond locational disadvantages

- In particular we examine the role played by intranational banking integration in improving the support to the regional economies and reducing the dependency on public transfers:
  - Retail banking remains regional, since proximity to clients, access to information and long term relationships are key competitive drivers
  - Greater banking integration may be needed to acquire local expertise, access high margin deposits or diversify

Common and distinctive features of Neue Bundesländer and Mezzogiorno

Common features:

- Persistent dependency on resource imports
- Persistent dependency on public transfers
- Persistent gaps in the convergence process

Distincitve features of Neue Bundesländer:

- Infrastructures similar to those of the other Bundesländer
- Normative framework effective in ensuring the well functioning of competition and markets
- Higher quality of human capital
- Positive trend of exports since 1995, which has decreased the dependency on external funding
- Lower banking integration with the other Bundesländer

The Italian and German banking sectors shared similar characteristics early in the 1990s in terms of a large number of banks, mainly publicly owned, but have evolved in different directions since then

- De Vincenzo, Fiorentino, Heid, Karmann, Koetter (2009), examine the effects of liberalization and concentration in the banking sector providing a comparative evidence for Italy and Germany

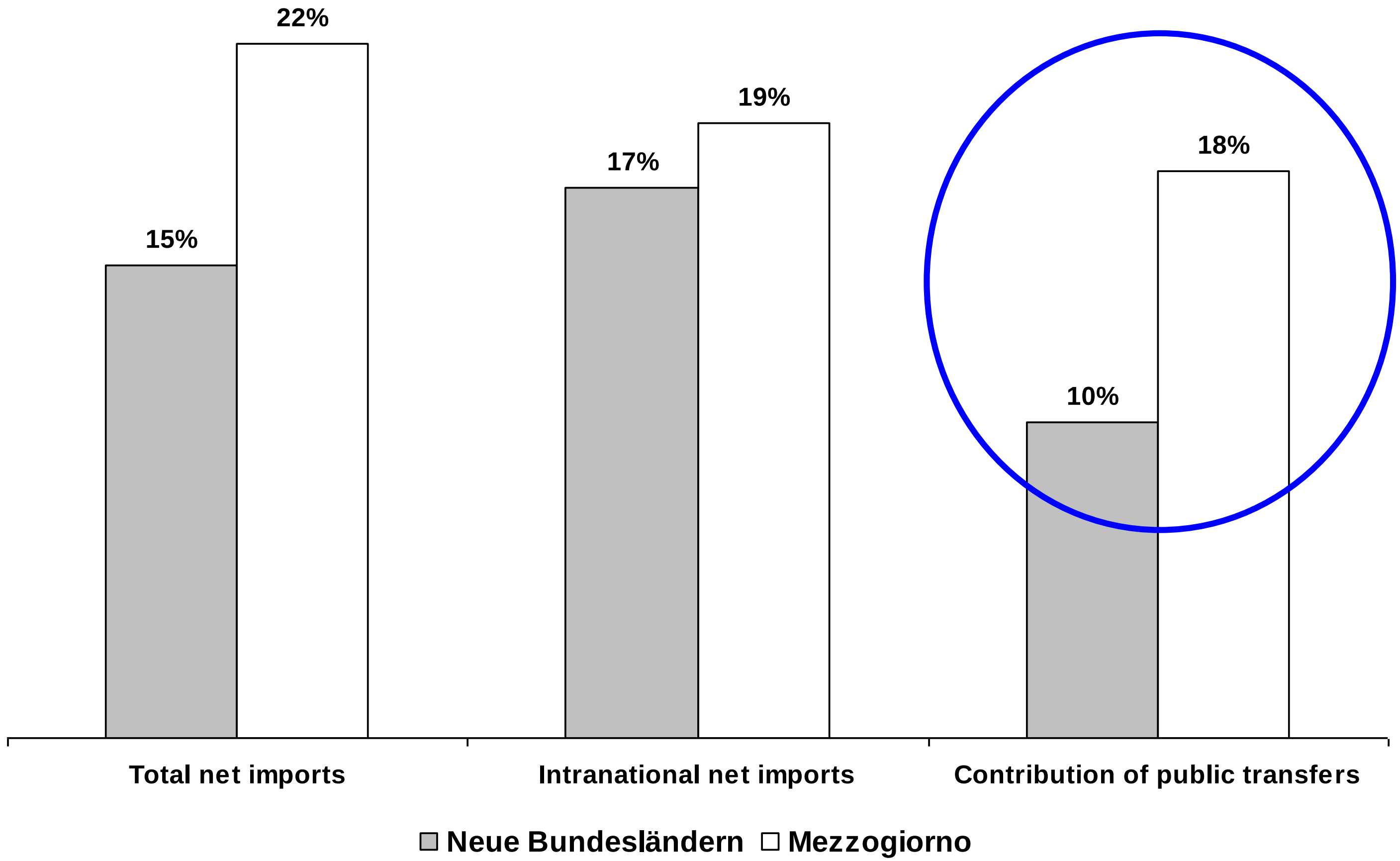
- Over the last two decades both countries have undergone an intensive process of consolidation through mergers and acquisitions. However, Italy privatized all its publicly-owned banks, whereas Germany kept its “three-pillar” system of private banks, cooperative banks and state-owned savings banks

- The reform of public banks ownership structure and other important changes took place in the 1990s in Italy
  - Public banks transformed into joint-stock companies and split into two separate entities, a “foundation” and a “stock corporation”
  - The mandatory specialization was gradually removed
  - Restrictions on geographical diversification were lifted
  - The concept of a “banking group” was introduced in the legislation

- As a result, in Italy the number of banks decreased considerably, whereas the average size of banks increased. Even though Germany did not witness an analogous process of liberalization, thanks to the consolidation process the number of banks dropped considerably and the average size of banks increased as well

Both regions strongly depend on external funding, mainly transfers from the public sector

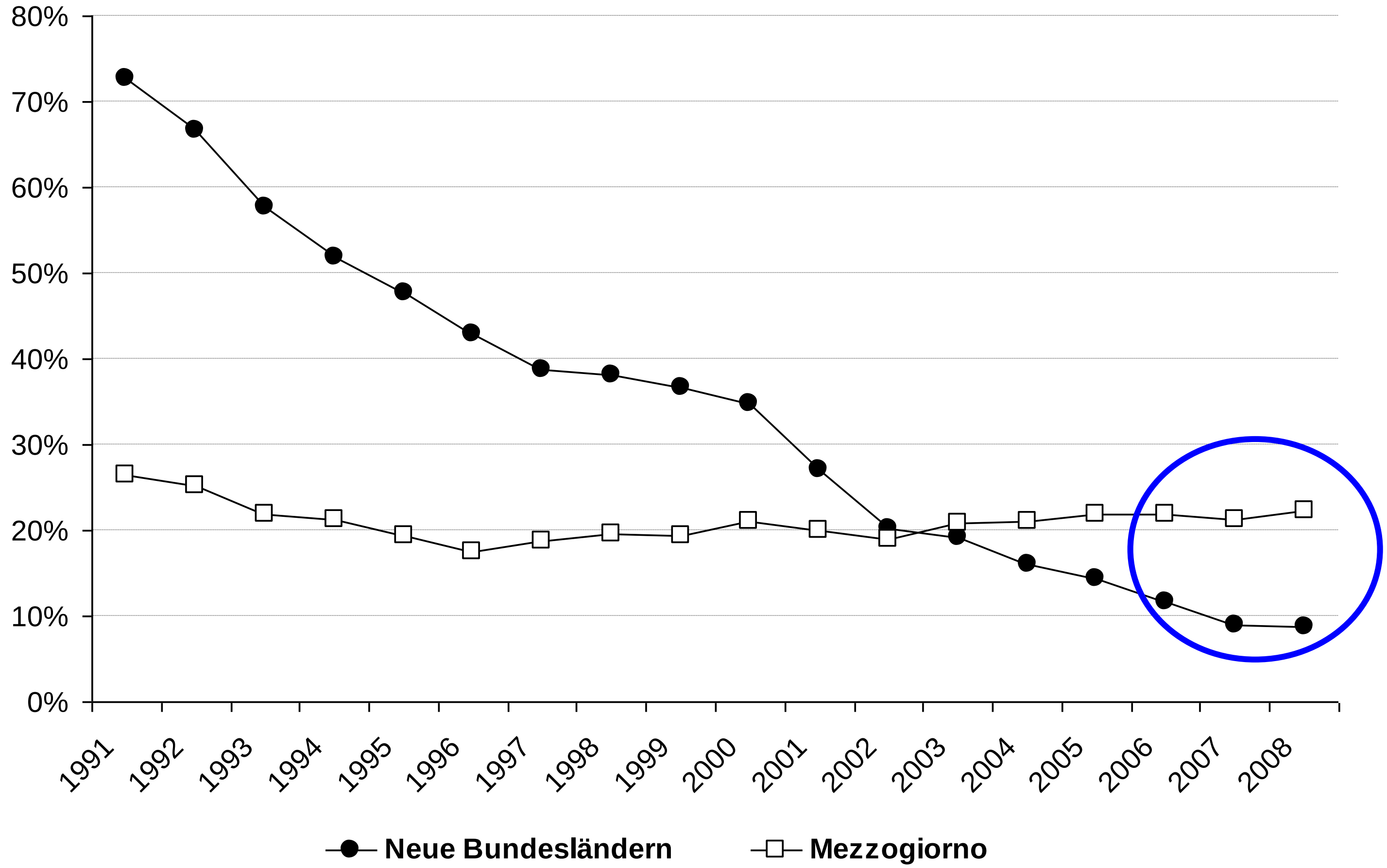
Dependency on external funding (total and intranational net imports and contribution of public transfers as % of GDP, 2006)



Source: our elaborations on data from Iuzzolino (2009) and Prometeia. Methodology of Sinn (2002) for Neue Bundesländern and of Cannari-Chiri (2006) for Mezzogiorno. Total net imports is the sum of international net imports plus intranational net imports.

Even if the reduction of public transfers and the increase of exports abroad have both contributed to a significant decrease of total net imports of Neue Bundesländern, values are still around 10% of GDP (20% for Mezzogiorno)

Dependency on external funding (total net imports as % of GDP)



Source: our elaborations on data from Prometeia, Istat and Destatis. Total net imports is the sum of international net imports plus intranational net imports.

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Why should we be concerned about high dependency on external funding?: The “leaky bucket” metaphor

- De Bonis, Rotondi and Savona (2010) provide an empirical evidence for the “leaky bucket” metaphor (Savona 1970, 1991) in the case of Mezzogiorno

- Regions with persistent high external trade deficit are affected by a “compensation stress”: i.e. they require persistent high public spending in order to compensate for structural imbalances (the “leaky bucket”)

- This “compensation stress” implies:
  - Crowding out of loanable funds: lower loans to GDP ratio compared to Center/Northern regions
  - Crowding out of private investments and weakening of local manufacturing sector compared to Center/Northern regions
  - Worsening of firms credit risk: higher nonperforming loans to GDP ratio compared to Center/Northern regions

- Triggering a vicious circle: the above factors further disadvantage firms access to credit and increase dependency on resource imports, implying lower growth

An alternative theoretical scheme for the two “Mezzogiornos” of Europe: the “Dutch disease” metaphor

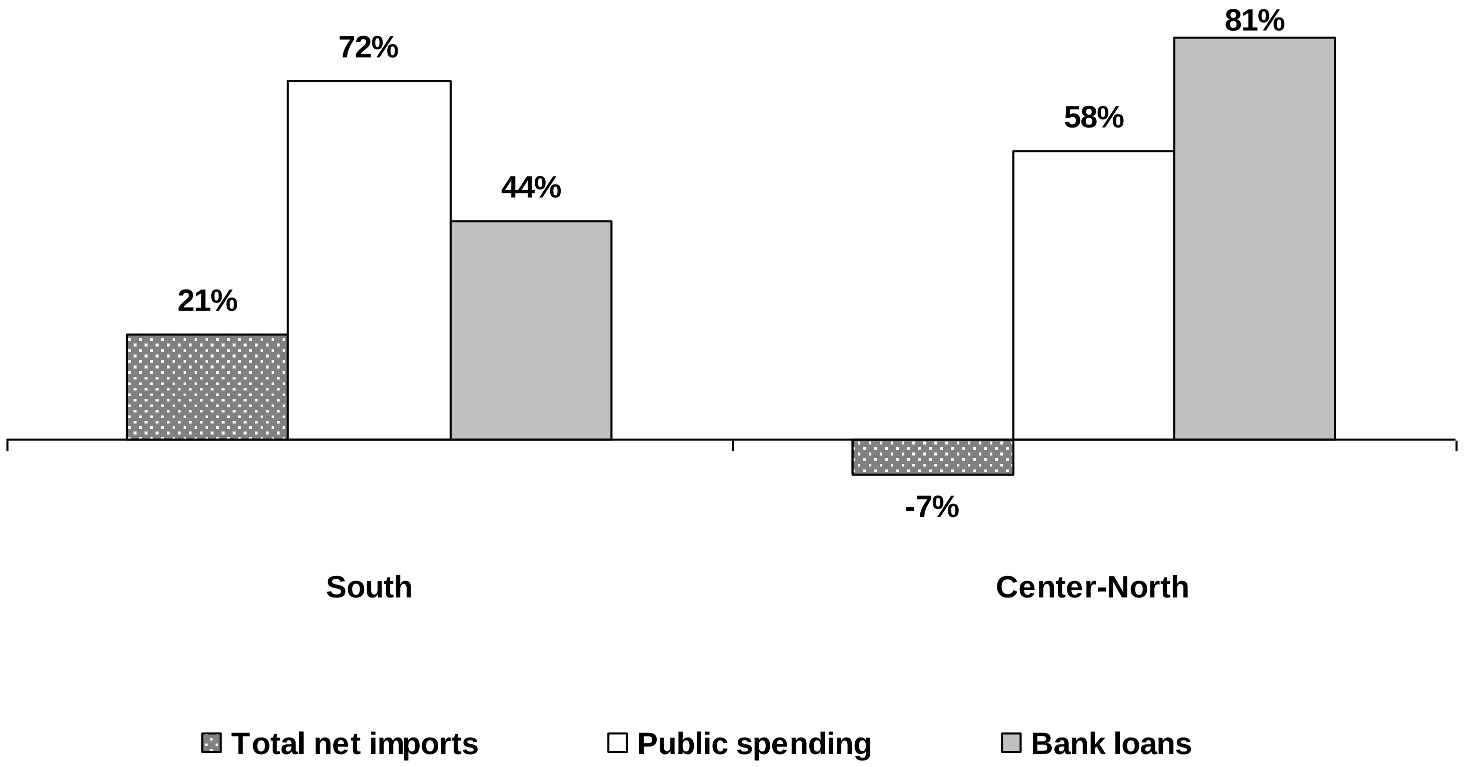
- According to Sinn and Westermann (2001) persistent inflows of public funds have consequences similar to the detection of a large quantity of natural resources (Ducth disease phenomenon discussed in the early 80s)

- Welfare state interventions, motivated by the wish to compensate for regional disadvantages, change the incentive structure of the economy and draw human resources away from productive activities towards subsidized activities

- Terms of trade adjustments in the form of internal price adjustments: increase of wages, land prices and non-traded commodity prices

Dependency on external funding and the role of banking sector: the case of Italy

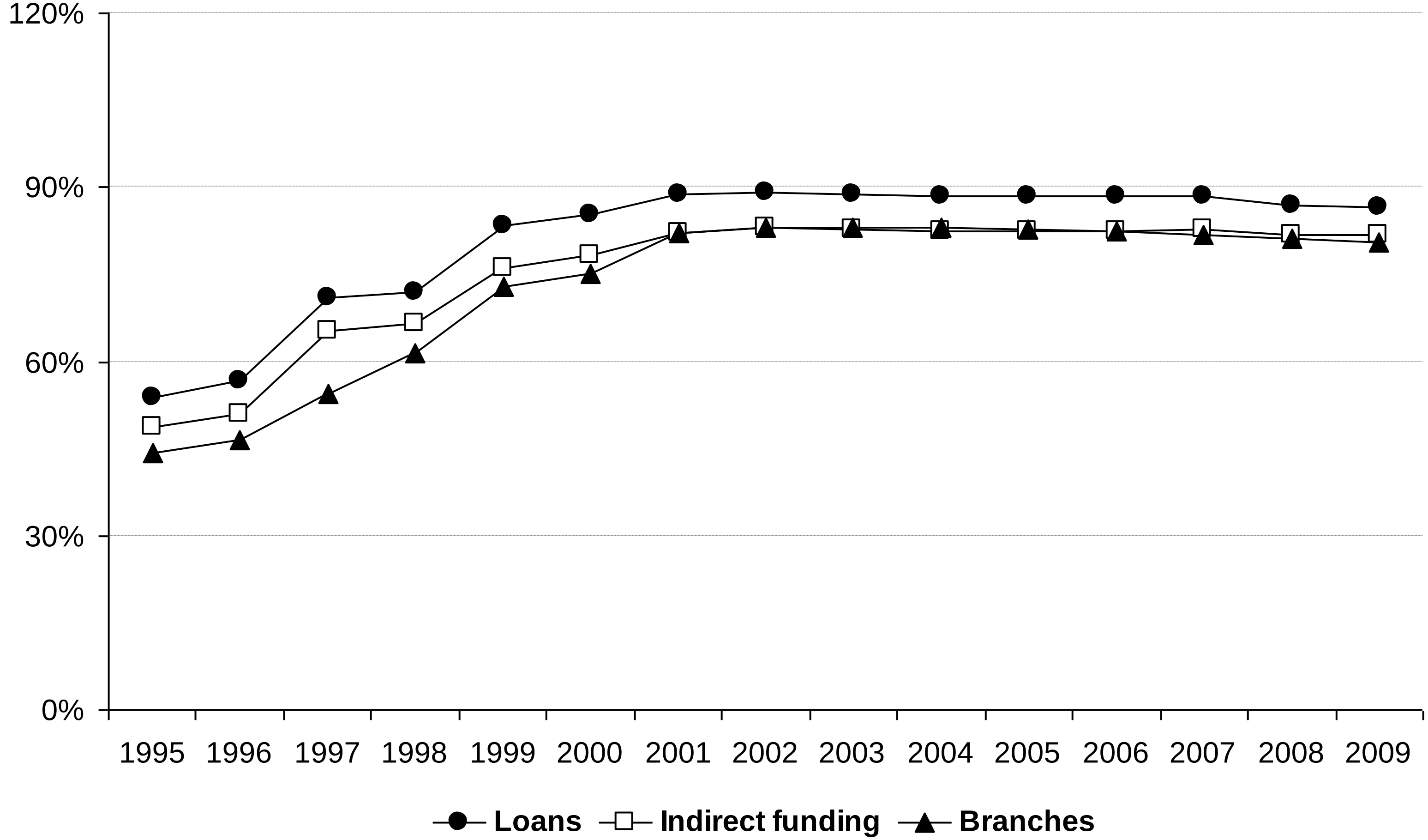
Dependency on external funding, public spending and bank loans in Italy (total net imports, public spending and bank loans as % of GDP, averages 1997-2005)



Source: our elaborations on data from De Bonis, Rotondi and Savona (2010). Total net imports is the sum of international net imports plus intranational net imports.

In Italy the integration of the banking sector of Center-North with that in South Italy has substantially increased

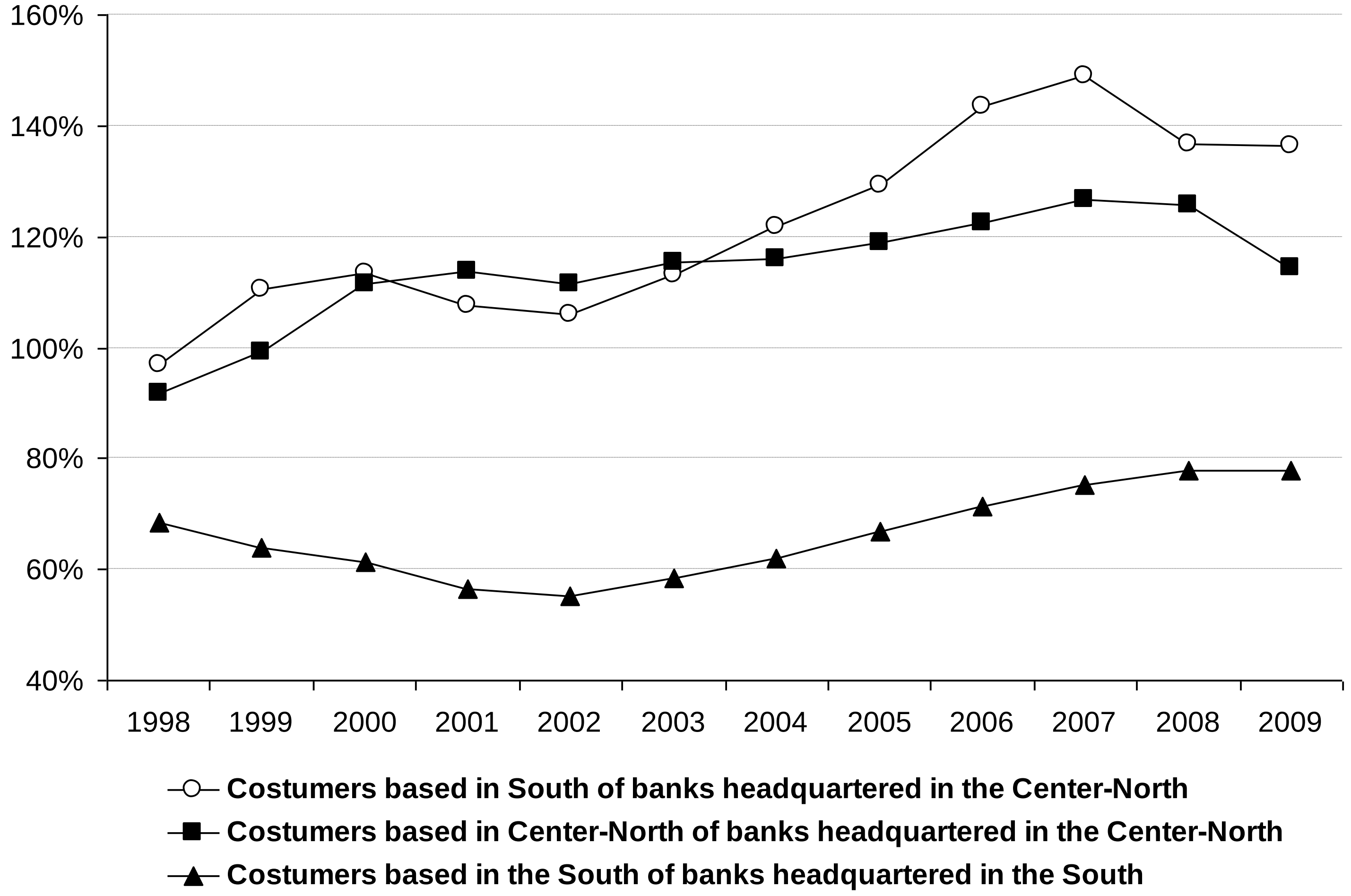
Market shares in the South of banks headquartered in the Center-North of Italy: loans, indirect funding and branches (% values, consolidated basis)



Source: Nuzzo and Oliverio (2010). Loans to households and firms based in the South including non-performing loans and net of repos. Data not adjusted for securitizations and reclassification. Indirect funding includes certificates of deposit and repos. Bancoposta and the Cassa Depositi e Prestiti are not included.

There is no evidence of drain of private funds from South to Centre-North of Italy

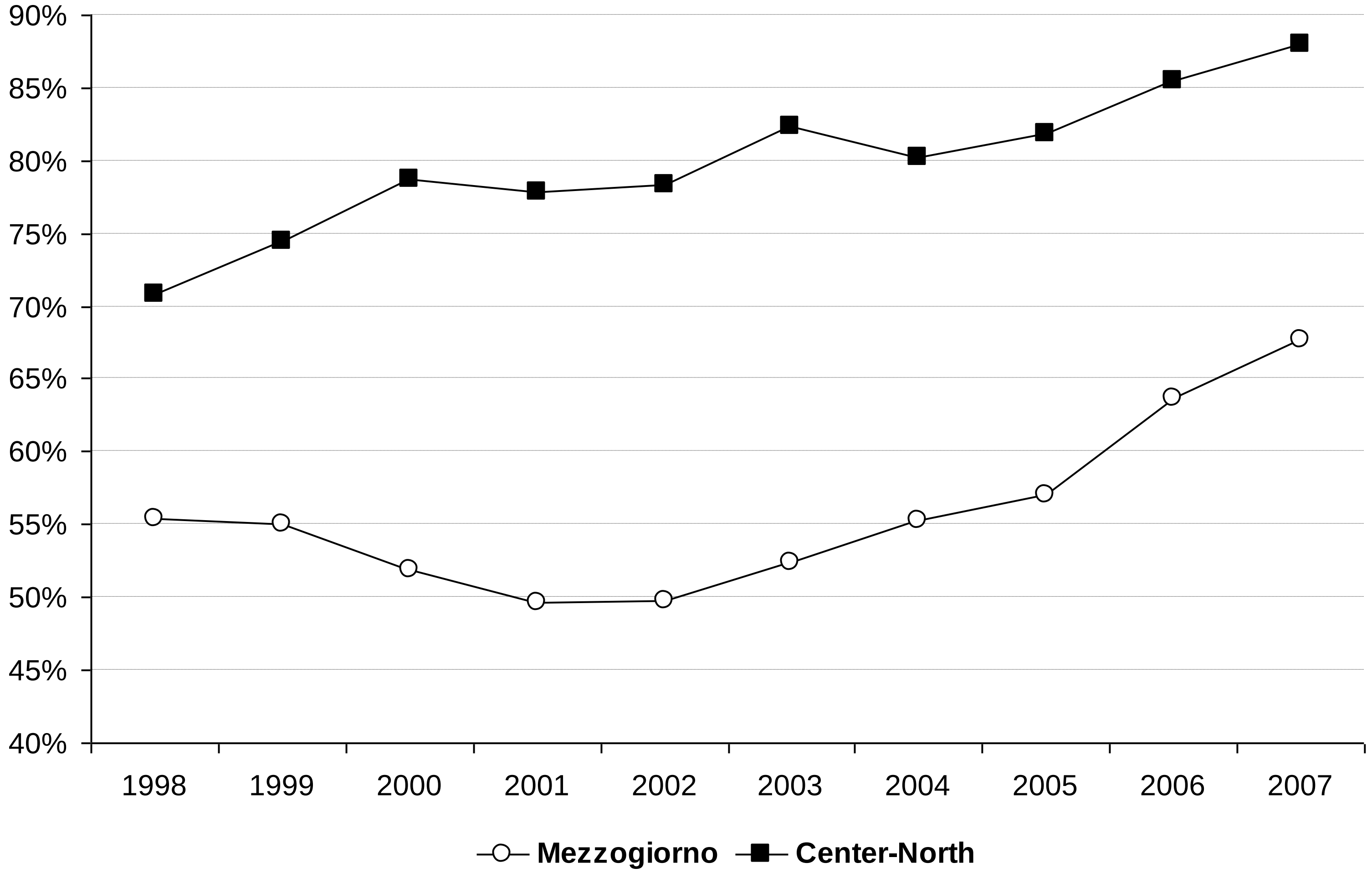
Loans to indirect funding ratio based on banks headquarters and costumers residency in Italy (% values)



Source: De Bonis, Farabullini and Nuzzo (2010). Loans to households and firms based in the South including non-performing loans and net of repos. Data not adjusted for securitizations and reclassification. Indirect funding includes certificates of deposit and repos. Bancoposta and the Cassa Depositi e Prestiti are not included.

Advantages of banking integration for Mezzogiorno: increased support to the economy from the banking sector …

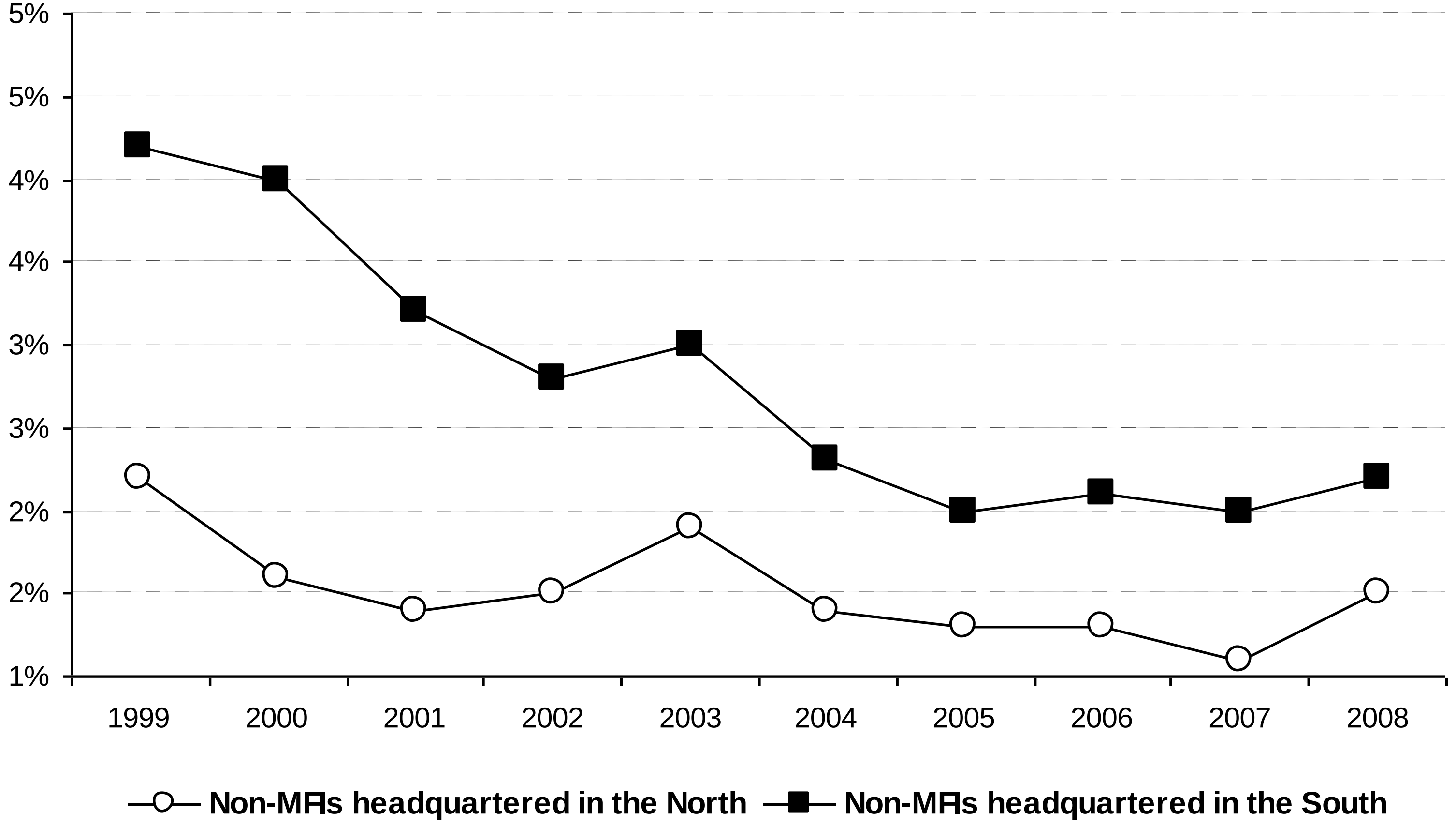
Loans to non-MFIs of manufacturing, construction and services in Italy (as % of value added)



Source: De Bonis, Farabullini and Nuzzo (2010). Loans to households and firms based in the South including non-performing loans and net of repos. Data not adjusted for securitizations and reclassification. Bancoposta and the Cassa Depositi e Prestiti are not included.

… and more efficient credit selection process

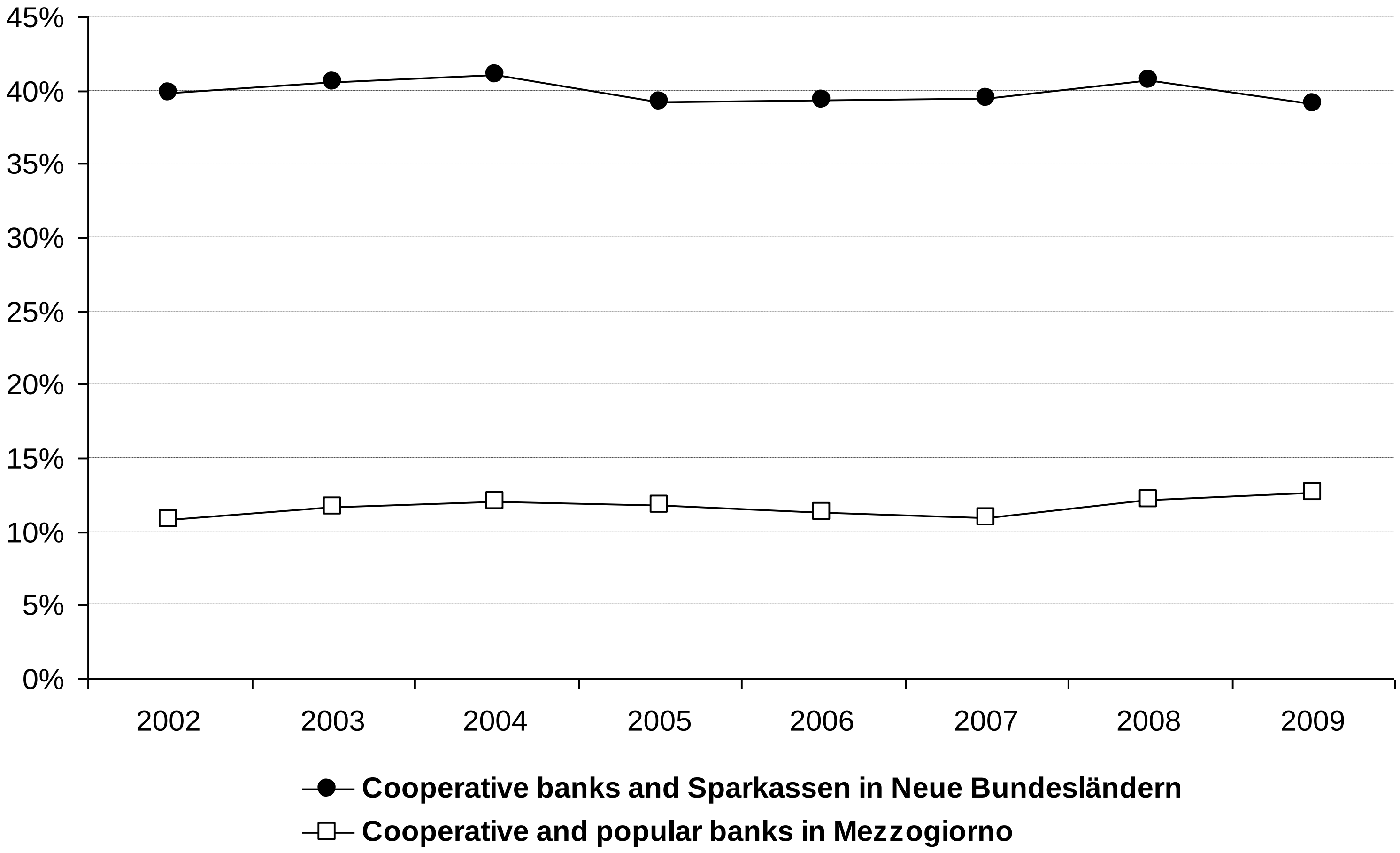
Firms new non-performing loans in Italy (as % of total loans)



Source: De Bonis, Farabullini and Nuzzo (2010). Loans to households and firms based in the South including non-performing loans and net of repos. Data not adjusted for securitizations and reclassification. Bancoposta and the Cassa Depositi e Prestiti are not included.

What is the situation in the Neue Bundesländern?: The market share of local banks is remarkably higher compared to Mezzogiorno …

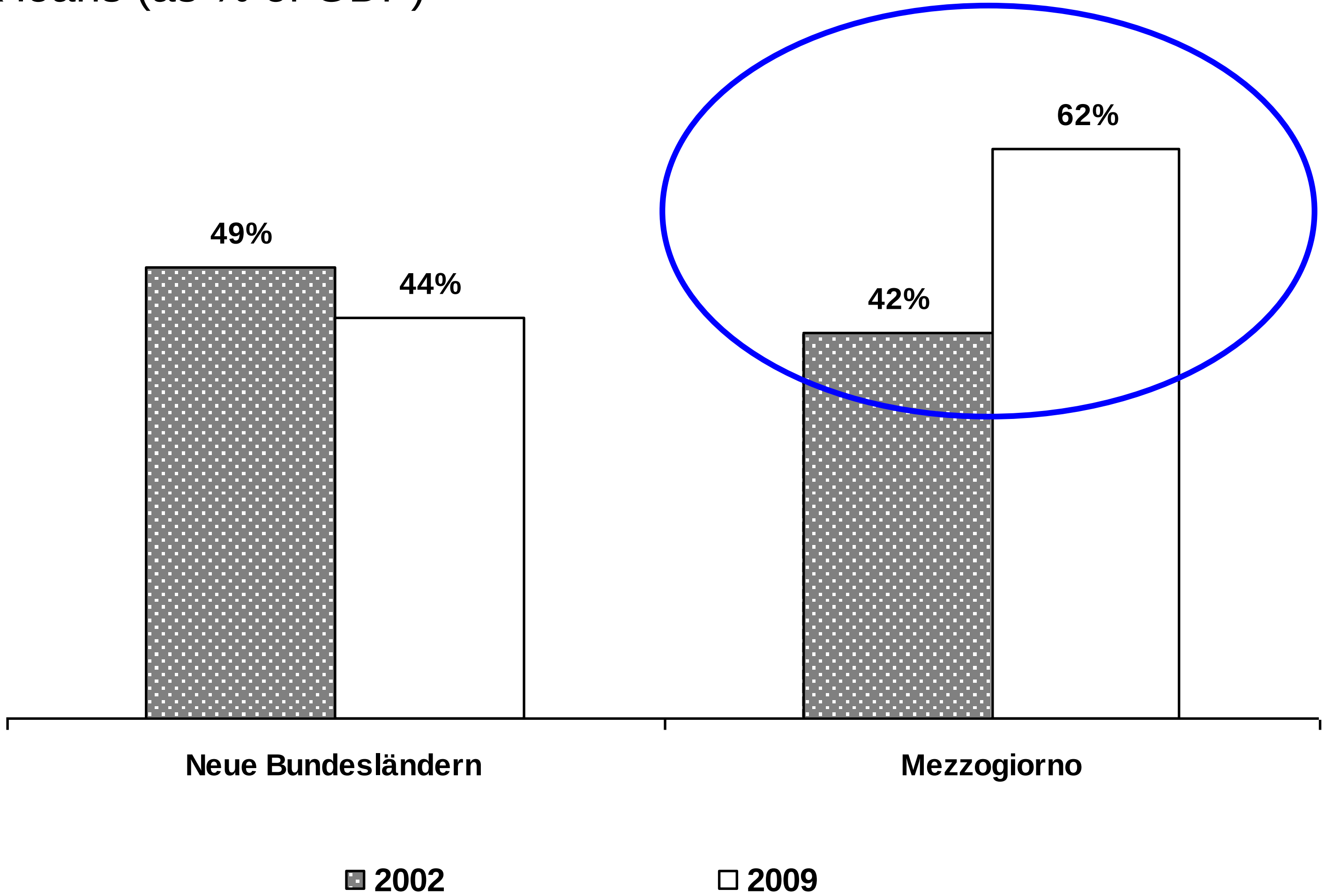
Loan market shares of local banks in Neue Bundesländern and Mezzogiorno (% values)



Source: Nuzzo and Oliverio (2010).

… and the banking sector presents lower credit intensity compared to Mezzogiorno

Bank loans (as % of GDP)



Source: Nuzzo and Oliverio (2010).

What lessons can Germany learn from Italy?

1. Persistent external trade deficits imply persistent dependency on public transfers and difficulties in starting an endogenous development process

2. In order to reduce the dependency on public transfers and at the same time to support the economy, it is necessary to have an efficient and competitive banking sector

3. Greater intranational banking integration can be positive, as it may imply that the geographical area with more efficient banks increases banking activity in the geographical area with less efficient banks