



ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Forecast on the Italian Economy

Introduction and Synthesis

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CREDITS

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Introduction and Synthesis

In the first half of the year, the world economy confirmed its slowing-down phase, even though the speed loss was less intense than what foreseen by last Spring's dooming forecasts. The overall *scenario* is heavily affected by the explosion of the real estate and housing bubble, by the financial crisis peaking in the past few weeks and by the strong oil shock. The shock caused inflation thrusts and had a braking impact on growth in oil-producing nations, which brought to a rekindling of stagflation similar to the one experienced in the Seventies.

***The
International
framework***

It is worth recalling that the stagnation/recession formula emerged in the industrialised economies on the occasion of the previous oil shocks was also due to wrong economic policies (particularly the monetary policy adopted during the 1973-1974 oil rises) aimed at supporting aggregate demand in the face of a supply negatively affected by discontinuous energy rises, which – in turn – were caused by a stop-and-go oil production, hence, the increasing prices of goods and production factors, having no significant effect on the economic activity, and the negative impact on the crisis timing and cost.

The oil shock

The present situation has different sources. The oil shock was not sudden, but it was the result of a gradual development (the growing trend starting in 2002), which led to a long-lasting economic growth fuelled by the expansive monetary policies adopted in all geographical areas. Thus, the oil scarcity derives from insufficient oil supply (both in terms of extraction and of refining). The present geo-political tensions have not caused oil supply interruptions, as happened in the Seventies, but there were further elements of volatility increasing the risk share included in the oil price. Indeed, the overall raw oil demand today seems less reactive to prices than 30 years ago, because a considerable oil demand share comes from emerging economies, which pursue policies of development support, limit the full transfer of oil price rises onto consumers and are characterised by low energy

efficiency. In this situation, a smaller oil demand in industrialised countries due to their economic slowdown is not sufficient to invert the oil price trend. Hence, the retroactive mechanism which is typical of the oil market (where a price rise automatically causes an immediate demand fall) cannot act as it did in the past. At the same time, the partial isolation of part of the world (the emerging countries) from the depressing impact of the oil shock fosters the world demand, thus benefiting the advanced economies which are most hit by the crisis. That stimulating factor is further strengthened by the larger export revenues of oil-producing countries compared to the Seventies.

The small price elasticity of the oil demand increases the already-strong power of the cartell of oil-producing countries, which are even less sensitive to price increases (as price rises do not boost production) and index the energy price to the dollar exchange rate to maintain their purchasing power. This amplifies speculative behaviours. The large liquidity of emerging countries and the low interest rates which industrialised economies have been experiencing for a long time have attracted capital flows from other, no-longer-attractive economic sectors, which contributed to the exchange rate upturn.

**Energy
prospects for
2009**

According to the prospects for 2009, this *scenario* will marginally change in the forthcoming 18 months, thus reducing some elements of tension without causing a remarkable inverse of trend. In particular, a reduction in the speculative pressures will emerge, alongside with a moderate deceleration in the emerging economies. Thus, the main thrusts should continue to push up prices, even though no further upswing similar to those experienced in the past 18 months should emerge. In particular, after a strong phase of volatility affecting the summer months, the oil price might stabilise in the last quarter and then – in keeping with the slowdown coming from the emerging countries - register a gradual reduction in 2009. In terms of annual average quotations, this profile might lead to a barrel worth 123 dollars in 2008 and 120 in 2009.

**Monetary
squeezes**

In the advanced economies, the monetary policy is aiming at reducing the second round of the oil shock effects and is trying to stop expectations for a generalised price rise. Indeed, the smaller is the inflation cycle, the quicker is the ability of energy-importing countries to adjust to the new exchange rates. However, in reaching this objective, monetary authorities have to cope with economic systems

which have been experiencing a long-lasting slowing down, a financial shock and a serious credit crunch. Within this framework, the role of stopping inflationary effects might be somehow performed by the weak economic cycle, reducing the monetary squeeze impact.

In trying to find a solution to this dilemma, the Fed and the ECB initiatives may have been different for some time. In the United States the rosier expectation profile observed in the first part of the year has contributed to the shifting of the Fed's attention from growth to inflation risks. This has levelled expectations for an upward rate correction already in 2008, thus interrupting the long-lasting stimulating phase which has been going on since last summer. That situation was impacted by the drastic rekindling of the financial crisis emerged in the past few days, when a saving bank declared bankruptcy and the Government intervened to support two major home mortgage companies. In our assumption, due to the financial crisis, the American monetary Authority will postpone to the post-election period any initiative to support currency, as it is bound to correct the interest rates by the end of the year anyway. If the real economy improves, it might take further initiatives in 2009 and the interest rate on federal funds might be brought up to 3%.

The euro area expectations are somehow different. In particular, the rise in the official interest rates introduced on July 3 is interpreted as a signal to reduce inflationary expectations and to avoid the indirect effects of the increasing raw material prices, given the wage acceleration looming in the first quarter. Future trends are particularly uncertain. Indeed, the Taylor-rule estimates obtained within the ISAE *scenario* on economic growth and inflation indicate that there is still room for reducing interventions. Quite the reverse, the markets expect further rises. Given the uncertain *scenario* and the economic deceleration signals emerging in Spring, the ECB is assumed to make no further interventions till the end of 2009, maintaining an unchanged repo rate at 4.25%.

The monetary approach on both sides of the Atlantic should affect the dollar-euro exchange rate in 2009. In particular, the dollar exchange rate against the euro is supposed to range between 1.55 and 1.60 in the second half of 2008, thus reaching an average figure of 1.55. In 2009, in keeping with the general narrowing of the gap between the euro area and the USA, there should be a gradual

**The impact on
the dollar
exchange rate**

strengthening of the dollar-euro exchange rate which will reach an average of 1.48.

***Economic cycle
and future
prospects for
industrialised
countries***

The USA are experiencing a harsh braking phase, but the technical recession ghost (with an official GDP fall) has been avoided so far. The small economic activity rise of the first quarter should be followed by a weak, but still positive, evolution in the April-June period. The good May retail trade trend – in spite of the consumers' confidence fall – was influenced by the pro-family initiatives, which should impact by the end of the third quarter. This might cause a deceleration in the final part of 2008, thus giving rise to a weaker average 2009, in spite of the gradual improvement in the quarterly growth rates expected for next year. On the basis of this profile, the US GDP should rise by 1.4% in 2008 and then slow down to 1.2% on average in 2009.

The start-of-the-year dynamics was stronger than expected also in the euro area. Still favourable evolutions of the domestic demand components contributed to this end, together with the marginally positive contribution of net exports, in spite of the euro appreciation. However, exceptional climatic conditions (which supported, in particular, the construction sector) had an impact on the result of the first quarter. The confidence fall on the part of households and business firms highlights the weak economic cycle in the euro area. The estimates show a remarkable deceleration in the second quarter (with a null variation according to the joint ISAE, INSEE and IFO estimates), which mainly mirrors a marked stop in Germany (where the economic activity registers a reduction). The main braking factor comes from the wage erosion caused by the inflation rekindling. Besides, the exchange rate strengthening might reduce the export dynamics. Thanks to its good start, the year 2008 should close with a 1.6% GDP rise and the economic growth should equal 1.4%.

***Emerging
economies***

Emerging economies have been the engine of the world cycle for 2007 and for the first part of 2008. The larger purchasing power of energy-producing countries and the sustained dynamics of the rapidly-developing Asiatic nations fuelled the industrialised countries' export demand. However, worrying tension factors have been looming ahead in this area too. The monetary and exchange rate policies towards the USA have been causing inflation, particularly because the American monetary Authorities' attention has been focusing on the risks

dooming the American financial system. The larger dependency of the baskets of goods and services of those systems on raw material price rises in the food sector and on their heavy energy imports have increased their sensitivity to inflation. Those countries should learn to reduce their expansion paces to ease domestic tensions without causing drastic stops which would not be sustainable from a social viewpoint, for instance in China, and without renouncing to their role of “ultimate consumers” of the world economy, a role which they have been playing in the latest economic phase. For those reasons, such a change of approach cannot take place in a night, but must be the result of a gradual and long-lasting shift starting in the second half of 2008 and continuing in 2009. In the ISAE estimates, the emerging countries’ growth rate should equal 7% and 6.5% in 2008 and 2009 respectively (+8% in 2007). The deceleration is headed by Asia, but a gradual slowdown has emerged in Central-Eastern Europe and in Latin America too.

Within this framework, the world growth should decelerate from 4.8% in 2007 to 3.9% in 2008 and to 3.6% in 2009. Given the GDP deceleration, the world trade might substantially hold on a much slower pace than the one characterising the latest expansion phase. That evolution will be impacted by the different cyclical profiles expected in 2009 for the industrialised area, which is gradually strengthening, and for the emerging countries, which are moderately slowing down. In this situation, according to the ISAE estimates, the world trade should develop with an average growth rate of about 6% both in 2008 and in 2009.

***Growth and
world trade***

After the productive leap experienced at the beginning of 2008, the Italian economic trend seems weakening and tends to follow the other European partners, even though with some difference in timing. Indeed, apart from the strong irregularities which have been characterising the Italian cycle in the past quarters (a fall at the end of 2007 and a new start in 2008), the Italian deceleration started in 2007, as it was due, on the demand side, to the worsening of the internal expenditure components and, on the supply side, to the quick deterioration of the industrial sector, whose recovery started in 2005 and stopped between the late-2006 and the early-2007.

The Italian cycle

Did an industrial restructuring process take place?

Experts are debating the degree of industrial restructuring of business firms, which was highlighted by recent business surveys (see, for example, ISAE, *Previsioni per l'economia italiana: comportamenti di impresa*, March 2008) and by the export improvement. Indeed, the generally disappointing results of the industrial sector (a short and modest recovery) apparently shows that there was no wide-spread restructuring at all as it was a marginal phenomenon concerning a few successful business firms. However, the other industrial cyclical indicators – showing less unfavourable evolutions - run counter this conclusion. The present Report analyses the evolution of the firms' turnover computed with an output price including, in its foreign component, the industrial product prices on foreign markets recently diffused by ISTAT (see box *Indicatori di attività industriale negli anni duemila: produzione e fatturato* – Industrial activity indicators in the XXI century: production and turnover). Those prices indicate a manufacturing sector recovery starting from its all-time low in 2005 and developing with a more evident and long-lasting profile than the one shown by industrial production. The productive activity growth in terms of real turnover rose in the second quarter 2007 with an average intensity (the productive gain in-between the minum and maximum points divided by the number of quarters) which was almost double (i.e. with a rise by 1.7 percentage points) than the one emerged in industrial production. An explanation of that gap is to be found in the different aspects which are measured when computing the turnover and the production indicators. In particular, turnover mirrors the changes introduced in the productive mix to obtain a qualitative improvement and a better manufacturing performance; both aspects played a remarkable role in the Italian business firms' adjustment process to the changed competitive conditions of the XXI century.

Exposure to the oil shock: raw oil need...

Even though the restructuring efforts were significant, the present phase indicates a strong oil shock affecting all operators. The main problems stems from the system exposure to the raw material price rises. A point which is often mentioned for to explain the better performance of the present industrialised countries as against the experiences of the early- and late-Seventies is the smaller oil dependence. This aspect seems to characterise the Italian system too (see box *Fabbisogno di importazioni di petrolio delle componenti finali di domanda e impatto di rialzi del prezzo* – Oil need of the final

ISAE FORECAST ON THE ITALIAN ECONOMY: GENERAL SUMMARY
(percentage changes, unless specified)

	2007	2008*	2009*
Domestic references			
Gross domestic product	1.4	0.4	0.7
- North-West	1.6	0.4	0.8
- North-East	1.8	0.6	1.0
- Centre	1.2	0.2	0.5
- <i>Mezzogiorno</i>	1.2	0.3	0.5
Imports of goods and services	4.0	1.1	3.2
Exports of goods and services	4.5	2.5	3.2
Resident households' expenditure for consumption	1.5	0.2	0.7
Expenditure of General Government and NPISH (1)	1.3	0.7	0.4
Gross fixed investments	0.8	-0.2	1.2
Contribution to the GDP growth			
- of domestic demand	1.1	0.2	0.5
- of total investments	0.2	0.0	0.2
- of net exports	0.1	0.4	0.0
-of stock changes and valuable objects	0.0	-0.1	0.0
Consumer prices	1.8	3.6	2.4
Producer prices	3.5	7.0	2.9
Average propensity to consume	88.3	87.8	87.9
<i>Per capita</i> gross earnings in the economy	2.0	4.1	2.4
Total employment (2)	1.0	0.5	0.5
Unemployment rate	6.1	6.3	6.2
General Government net borrowing (as a percentage of GDP)	-1.9	-2.4	-2.0
General Government primary surplus (as a percentage of GDP)	3.1	2.6	3.0
Fiscal pressure of General Government	43.3	43.0	43.1
General Government debt (as a percentage of GDP)	104.0	103.6	102.9
12-month Treasury Bills yield (3)	4.0	4.5	4.7
Nominal GDP (millions of euros) (4)	1,535,540	1,589,143	1,638,747
International references			
Gross domestic product			
- World	6.8	3.9	3.6
- USA	2.2	1.4	1.2
- Euro Area	2.6	1.6	1.4
Dollar/Euro exchange rate (level)	1.37	1.55	1.48
World demand	6.3	6.2	6.2
Official exchange rates (3)			
- ECB	4.00	4.25	4.25
- Federal Reserve	4.50	2.25	3.00
Prices of raw materials (in dollars)			
- non energy	19.0	31.6	14.5
- energy	7.2	5.4	-1.9
of which: Brent (\$/barrel)	72.7	123.5	120.0

Sources :ISTAT, Bank of Italy, ECB, Federal Reserve, IMF, HWWA.

* ISAE forecasts, scenario for 2006.

(1) In standard labour units.

(3) End-of-year annual yields. Gross compound for Treasury yield bills.

(4) Annual GDP, not working day adjusted.

demand components and impact of the oil price rises). According to the figures on the Italian oil dependence, we estimate that in 1973 and in 1980 a 10% oil price rise in domestic currency caused a final economic output growth equalling 0.7-1.5 percentage points; in 2004 that impact fell down to 0.4 percentage points. The reduction mainly reflects the reduction in (direct and indirect) oil need compared to 25-30 years ago. However, the comparison between those two periods unveils completely different annual dynamics. The oil need reduction stopped at the beginning of the present decade (in 2000 a 10% oil price rise caused a 0.2 growth in the output price) and then witnessed a slight reverse of trend without going back to the levels of the Seventies. This might signal that, during the Nineties, low raw material prices for some time reduced the energy-saving incentives. Some further indication stems from the analysis of the impact of oil price rises on specific sectors: the larger sensitivity of the output price to the oil price rises at the beginning of the present century was mainly due to the larger sensitivity to the extraction sector dynamics, particularly in electricity production and distribution. This is a phenomenon which mirrors the changes both in the efficiency and in the market structure of those sectors.

While dealing with the exposure to the oil shock, we have concentrated our attention on transport fuels having a direct impact on consumption (see box *I prezzi industriali dei carburanti* – The industrial fuel prices). In 2008, the retail fuel prices in Italy remained generally in keeping with the European fees, but that depended on the smaller impact of levies which used to offset an industrial cost of manufactured products (net of taxes) above the European average. That gap, which has been “historically” characterising Italy, has been narrowing over the past few years; however, it remains significant (4% for gas and 6% for gasoline) and means a further burden for Italian consumers compared to the European partners. The unfavourable gap is probably due to both structural factors, linked to the smaller effectiveness of Italian refineries, and to the different competition among companies. The ISAE estimates confirm the fuel price tendency to react more, in Italy as well as in the other European countries, to oil price rises than to oil price reductions. In the case of Italy, the upward reaction to oil price rises is larger for gas than for gasoline.

...and fuel price

The cyclical indications available since the second quarter are unfavourable. The European Spring slowdown has contributed to reduce exports, by weakening the stimula which had sustained the cyclical phase so far. The industrial activity, which has been worsening in Q2, might be positive again in Summer, thanks to the usual August bump. That possible leap means however no improvement at all. The surveys indicate persistent difficulties in the manufacturing sector mainly concentrated in the business firms producing consumer and intermediate goods, while investment goods have held better thanks to foreign demand. For the other sectors, the ISAE surveys signal a slowdown in construction and a worsening in services.

**Deteriorating
cyclical
indicators**

Those indications suggest there will be a very modest evolution in the Italian economy, even a standstill in some quarters, up to the first months of 2009. A very gradual recovery should follow in the second half of 2009. This is bound to happen provided in the next few months exports hold on foreign markets, even though at a slower pace, thus offsetting the modest domestic demand and provided the inflationary tensions decrease in 2009, thus benefiting the households' purchasing power. In 2008, the average Italian GDP growth should amount to 0.4%, with a net deceleration compared to 2007 and a development gap as against the euro area slightly above one percentage point (as in 2007). In 2009, with the reduction of the raw material shocks, the economic activity growth might be worth 0.7%, which means 0.7 less than in the euro area. In a comparison with the ISAE estimates of March 2008, the Italian GDP dynamics decreases by 0.1% in 2008 and by 0.5% in 2009.

**Forecasts for
2008-2009**

It is the significant domestic demand slowdown which causes the Italian economy deceleration. Private consumption should stagnate this year, being hit by the purchasing power erosion. Besides, the credit worsening and the considerable fall in the households' confidence and expectations have both a negative impact, which leads consumers to be more cautious in their spending propensity. Investments signal a slightly negative average dynamics in 2008. Indeed, a smaller gain due to the operational cost rise, to more expensive financing conditions and to unfavourable demand expectations should affect investments in equipment and means of transportation. The low degree of capacity utilisation is a further obstacle, particularly because of the plant upgrading costs. The ISAE Bi-Annual Investment Survey confirms the

unfavourable business plans for 2008; the overall reduction concerns in particular smaller business firms.

In 2008, the lack of stimulus coming from domestic expenditure is offset by a still positive export dynamics. The demand deceleration coming from industrialised countries is partially compensated by the sustained trend of oil-producing countries and of emerging countries. The euro strengthening should put a stop to exports, but less than in the past, owing to the changed productive mix towards high-quality products, which are more diversified as against competitors and less sensitive to price competition. However, the better performance of Italian products on the foreign markets could not avoid an export slowdown compared to 2007, due in particular to the slower dynamics observed in Europe, which is our main outlet. A significant import deceleration is emerging too, and it is stronger compared to exports because of the domestic demand brake: hence, the small GDP rise characterising 2008 will mainly depend on the favourable contribution of the net foreign demand.

The expected improvement of the Italian economy in 2009 heavily depends on the assumption of stabilisation and smaller tensions due to the raw material price rises. The households' spending capacity should be benefited, thus giving rise to a consumption acceleration. The investment dynamics might strengthen again, in keeping with the improvement of both domestic and foreign demand. Alongside with the growing contribution of domestic expenditure, the net export stimulus should fade out and eventually disappear: this reflects the considerable pro-cyclical import acceleration which should offset the expected rosier foreign export trend.

The labour market

According to the ISAE forecasts, the labour market continues to be characterised by a favourable employment trend, even though it is slowing down compared to the 2007 results, due to the reduction in the economic activity evolution. The labour input is growing at a similar pace (+0.5%) both in 2008 and in 2009. Taking account of the expected GDP evolution, these figures imply a further rise in the employment elasticity to the economic activity. However, after a constantly decreasing decade, the unemployment rate should grow again in 2008, passing from 6.1 to 6.3%, which reflects a labour force dynamics larger than the employment one. The percentage of unemployed might slight fall in 2009 (6.2%).

With reference to wages, the first available data for 2008 confirm a significant wage dynamics recovery in the first part of the year, which is affected by the collective bargaining round, by the one-off wage rise and by what is known as *indennità di vacanza contrattuale*, i.e. a sort of indemnity for the delay in labour contract renewal. According to our estimates, the *per capita* gross wage growth should reach on average 4.1% in 2008 and 2.4% in 2009. The wage dynamics acceleration expected for 2008, together with the unsatisfactory labour productivity trend, will lead to a new labour cost growth per labour unit which, after two years of gradual deceleration, should grow again and then decelerate in 2009.

The ISAE framework includes a still-sustained inflation dynamics in the second half of 2008 and a more evident slowdown only in 2009. The new oil price peaks and the foodstuff price tensions will further prompt inflation in the short term till it reaches the late-Summer top figure of 4%. A very gradual slowdown should start in Autumn, also thanks to a favourable statistical comparison with 2007, when the cyclical dynamics was rather sustained. Hence, inflation in 2008 should equal an average 3.6%, which is the highest figure since 1996. In terms of harmonised price index, the differential with the euro area should marginally penalise Italy (for 0.1%). In 2009, there should be a more significant inflation cut. The deceleration should start already at the beginning of the year, with a price dynamics below 3% in Q2 and then below 2% in Q4. In 2009, the average consumer price index will rise by 2.4%; the inflation dynamics, measured through the harmonised price index, should be just below the euro area standard.

Inflation

With reference to the public finance trends, the ISAE deficit forecasts are marginally rosier than the Economic and Financial Planning Document (*Documento di Programmazione Economica e Finanziaria – DPEF*) for 2008. In 2008, after the progress observed in the previous year, the General Government deficit should rise from 1.9% to 2.4% (0.1 less than the Government estimate), owing to an economic growth slowdown and to a slightly expansive budget policy. In 2009, even though the economic manoeuvre was less effective than expected, the deficit should decrease by 0.4%, reaching the figure of 2.0%.

Public finances

The primary surplus – assumed to be 3.1% of GDP in 2007 – should diminish in 2008 down to 2.6% and then grow again to 3%,

owing to the corrective manoeuvre. In particular, in 2008, the reduction in the positive balance (net of interests) is affected by a smaller incidence of revenues on the GDP (from 47.2 to 47%) and by a rise in primary expenditure as a percentage of GDP (from 44.1 to 44.3%) caused by the growing current expenses in the face of a diminishing share of capital expenses as a percentage of GDP. In 2009, the primary surplus improvement is totally due to the decreasing primary expenses, particularly current expenses, alongside with a substantial stability of revenues as a percentage of GDP. Within the ISAE estimates, the fiscal pressure should decrease by 0.3% as a percentage of GDP in 2008, equalling 43%, following upon the abolition of ICI (Italian property tax) and the tax reliefs due to the fiscal wedge which were levied on the 2007 IRAP (Regional Tax on productive Activities), but which had their effect in 2008. The 2009 fiscal pressure show a small rise up to 43.1%, thus mirroring the larger revenues coming from the initiatives taken in the oil and gas sector, in the bank and insurance sectors, as well as from the fight against tax evasion.

In 2008, the debt-to-GDP ratio will slightly diminish to 103.8% (from 104% in 2007) and then again down to 102.9% in 2009.