



INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

ISAE REPORT

Forecast on the Italian Economy

The Italian industry between stagnation and
structural changes

FEBRUARY 2006

CREDITS

The present Report is the result of the team work of a wide group of researchers coordinated by Sergio de Nardis.

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The Report is based on the information and data available up to February 15, 2006.

Summary and Introduction¹

A still-growing international economy...

In 2005, the world economy remained on a positive path, showing just a slight slowdown compared to the extraordinary 2004 expansion (which was the largest of the past three decades). According to the ISAE estimates, the world GDP – still prompted by the US and Chinese locomotives – grew by 4.5%, compared to a 5% rise registered in 2004. If, on the one side, the production has substantially held, on the other side, a larger brake was observed in international trade, which increased by slightly less than 7%, after the 10% leap forward observed in the previous year. Owing to those different dynamics, the trade share of the world GDP rise diminished again, thus inverting the 2004 trend: indeed, the international trade elasticity equalled 1.5 (2.1 in 2004), thus getting closer to the figures which – unlike what happened in the late-Nineties - had characterised the beginning of the decade. Even though it is difficult to identify the specific causes for those oscillations in the trade-production relationship, a possible reason may be the purchasing power transfer between countries characterised by different purchasing capacities due to strong price rises in combustibles.

...in spite of growing tensions and imbalances

The world development has been going on in spite of the growing tensions and imbalances. The oil price – affected by the ongoing lack of supply as against a structurally high demand due to the needs of the large emerging and energy-fond economies – further increased in Summer, getting close to the record 70 dollars per barrel. Indeed, geopolitical tensions and natural disasters played a catalysing role in price rises, because of the lack of investments of the extractive industry in the cheap-oil period. In the wake of the oil question and due to the high Asiatic demand, there were considerable rises in the prices of the main industrial raw materials, with a peak up to 40% in ferrous metals. At the beginning of 2006, the European energy scene became more complicated because of some gas delivery difficulties (over the past few years the gas demand has increased as an alternative to oil because of the oil price rises), because of a smaller gas supply from Russia caused by political problems and by climatic factors (see Box on *Natural Gas*).

¹ While introducing the forecast scenario for 2006-2007, it is worth underlining that the estimates for Italy are based on the existing yearly and quarterly National Accounts available up to 2004 and to 2005 Q3 respectively. At the beginning of March, ISTAT shall disseminate the new official data on 2005 elaborated on the basis of the new methodology consistent with the EU rules. The ISTAT review concerns all historical (yearly and quarterly) series of National Accounts, which will no longer be directly comparable with those used in the present forecast.

The overall world imbalances have been widening and the Asiatic economies (namely China) started to finance the America foreign deficit (which amounted to about 6% of the GDP in 2005), by fuelling the US growth either directly (by lending financial resources for imports) and indirectly (by limiting the long-medium term tax rates in a highly indebted system). Those imbalances are a potential source for instability for international capital flows and tax rates, which may register sudden moves due to shifts in investors' expectations having a negative impact for all market operators. During 2005, the currencies showed erratic trends without univocally flowing towards the adjustment of the large trade deficits and surpluses. In particular, in the second half of the year, the US dollar fully recovered its depreciation against the euro and the yen registered in the previous 18 months and, at the end of 2005, its quotations were close to the ones of 2003 Q3 and Q4. Quite the reverse, the dollar has lost ground against the currencies of some emerging economies of Asia and, to a smaller extent, of Latin America. However, the trade exchanges with China were just skimmed by those movements. Indeed, the Chinese decision to revalue (by 2.1%) its currency renminbi in July and to abandon the dollar peg in favour of a basket of currencies led to a "symbolic" appreciation against the US dollar (0.6% between July 2005 and January 2006).

The balance of 2005 and the early-2006 cyclical signals

The international expansion has gone on without being affected by the raw materials price rises and with no impact on the market operators' confidence. The thrusts coming from the United States and China were accompanied by the higher Indian dynamics in the emerging economies and by the Japanese recovery in the industrialised economies. Indeed, in the second half of 2006, the euro area also showed signals of strengthening, particularly in terms of confidence indicators.

With reference to the American economy, the year 2005 ended with a larger-than-expected brake which was affected by a steep fall in car purchases (mainly due to the end of rebates on car sales), by an investment slowdown and by a decreasing Government expenditure. In spite of the slowdown registered in the past quarter (+0.3% as against the previous quarter), the US growth remained within the annual average range (+3.5%), thus close to its potential. The early-2006 cyclical leading indicators, signalling a quicker growth rate in Q1, showed that the end-2005 weakening was probably a transition phase.

In 2005, Japan confirmed the favourable dynamics emerged in 2004 and definitely joined the group of growing economies. The significant restructuring of the banking and company sectors contributed to reduce the excesses of productive and financial capacity accumulated in the Nineties, causing an improvement in the gaining capacity and a recovery in the firms' and households' confidence climate. Thanks to those developments, the Japanese GDP rise in 2005 (+2.4%) was

mainly underpinned by domestic demand components, while the long deflation phase was eventually replaced by a slightly positive price dynamics.

An economic activity strengthening emerged in the euro area, particularly in the two central quarters of the year, but it was followed by a downfall in the past few months (the average GDP rise amounted to 1.4% in 2005). The most lively phase coincided with a large export contribution, fostered by the euro depreciation which had been going on since Spring. The export acceleration stimulated investments, while the households' consumption showed a generally modest evolution.

Improvement in the European leading indicators

In the late-2005 and early-2006, the positive signals coming from the business confidence indicators in the euro area became more intense, with rises in Italy, France and particularly in Germany, where the IFO index expectations reached its highest peak since 2000. Positive indications also came from the labour market and from the consumer confidence indicator. Those quality indicators should bring about a cyclical strengthening in Europe, but the analyses are cautious, as in past occasions promising confidence rises did not trigger an equally-convincing European recovery, and the disappointing results emerging in some economies in Q4 might suggest that this is the case. However, unlike what happened in the past, there are elements of novelty in the recent set of positive confidence indicators, as, on the one side, the rises are uninterrupted and, on the other side, the improvements mainly come from the German economy, which recently registered a process of deep restructuring and recovered its effectiveness. Quite the reverse, the evidence of the present Report shows – also because of the reorganisation of the German industrial sector based on delocation and on the intensification of the trade relations with non-euro area suppliers – weaker links between the German industry and the industrial sectors of its main European partners, with a reduction in the German leading role towards its partners (particularly Italy): see on this topic the Box on *Common Cycles and Asymmetric Reactions of the German, French and Italian Industries*.

Forecasts for 2006-2007: raw material markets

In its definition of the international scenario, ISAE assumes ongoing tensions on the main raw material markets. With reference to rough oil, the demand pressures and the political-military uncertainties characterising the major suppliers (namely Iran and Nigeria) should contribute to maintaining the quotations around 60 dollars per barrel in 2006, with a gradual fall only in 2007, when the barrel price should be worth 57 dollars in the second half of 2007. In average annual terms, the oil price should equal 61 dollars per barrel in 2006 and about 58 dollars in 2007.

Also industrial non-fuel raw materials should hardly register decreases in 2006. According to the ISAE assumptions, the dynamics will be moderate starting from Q2, which means further average rises in 2006 (12.8%) and in 2007 (5.9%). With reference to foodstuff, after the early-2006 upswing due to the climate changes, smaller evolutions are expected in the following months, together with some modest recovery in 2007 in connection with the expected dollar depreciation. Considering the past evolutions and the irregular profiles of 2006, the average outcome should register a higher price rise in 2006 (about + 8%) than in 2007 (around +3%).

Interest and exchange rates

As far as monetary policies are concerned, after the fourteenth interest rate rise in a row set in January, the phase of interest rate increases in the United States should come to an end. The gradual reduction in the economic growth – together with the signals of a real estate market freezing – might lead the US monetary authority to stop the squeezing phase: indeed, in our assumption, in the H1 of the year, the Federal Reserve should increase by 0.25% the Fed Fund Rate target, which will be worth 4.75% and will remain unchanged throughout the whole year.

In the euro area, the European Central Bank – following upon the 0.25% rise introduced in September after 2 ½ years of unchanged rates – should accompany the expected strengthening of the recovery with some further initiatives. According to our assumptions, the repo rate should be raised by 75 basis points and reach 3% in the second half of 2006. After that, the European monetary Authority should leave the intervention rates unchanged, in view of a possible reduction in the euro area growth pace rate, of the ongoing negative output gap and of gradually decreasing inflationary pressures from abroad (for a synthesis of the assumptions on the European monetary policy see Box on *Interest Rate Forecasts in the Euro Area*).

With regard to exchange rates, in January the US dollar – after its appreciation against the euro (and against the yen) experienced in 2005 H2 – showed again signals of weakening. According to the ISAE assumptions, the elements causing the dollar depreciation (mainly connected to the US external imbalance) should affect the dollar exchange rates both in 2006 and in 2007; even the gradual narrowing of the growth gap between the two sides of the Atlantic might contribute to that. Hence, the dollar-euro exchange rate should continue to remain stable on the average values of 2006, thanks to a gradual weakening which might bring the rate to 1.26 in Q4 (1.24 is the annual average). The dollar shifting should go on in 2007, with a dollar-euro exchange rate at about 1.30 at the end of the year and at 1.28 as annual average figure.

The 2006-2007 international growth

Within this framework, the forecast for 2006-2007 points to positive trends for the current year and to a possible moderate deceleration in 2007.

Such a profile mainly mirrors the evolution of the US economy, where the expansion shows a decreasing profile in 2006 due to a moderate, though still positive, demand trend and particularly to the households' consumption. In 2006 the average GDP grows by 3%; the development pace might slightly fall down in 2007, when – according to the ISAE forecast – the US economic activity should rise by 2.8%. The Japanese growth should equal around 2% both in 2006 and in 2007 following upon the efficiency improvements which might offset the braking effect on expansion exerted by the unfavourable demographic evolution.

With reference to the euro area, if the recent positive indications of the quality surveys are confirmed by the improved productive dynamics, the 2006 economic recovery (1.9%) may get close to its potential figure again after so many years. Its strengthening is due to domestic demand, which mirrors, on the investment side, the companies' budget improvements and, on the households' side, the rosier labour market conditions. On the top of it, specific stimulating factors in Germany – probably connected to the households' expenditure growth coming from the VAT rises expected in January 2007 - should contribute to sustain the European cycle.

During next year, the European expansion rate should diminish, getting close to the average 1.8% in 2007. This is mainly due to the smaller thrust coming from exports, following the euro appreciation and the slowdown in the international demand dynamics registered during the year. Furthermore, the larger households' expenditure in Germany anticipated to 2006 might have an impact on that.

Outside the industrialised area, Asia should gradually decelerate in 2006, being affected by a slight reduction in the extraordinary Chinese dynamics (from around 10% estimated for 2005 to 9.2% in 2006). All in all, the Asiatic area should grow by 7.4% and 7.3% respectively in 2006 and 2007 (7.9% in 2005). Sustained by the favourable trade due to the oil price rises, the GDP in the Middle East should grow at a 5% pace both in 2006 and in 2007. Latin America should confirm in 2006 the 2005 growth rate (4.2%) and then experience a slowdown (3.8%), thus mirroring the smaller stimulus coming from North-American demand.

The world GDP as a whole should grow in 2006 at a similar pace as in 2005 (+4.3%), and then slightly slow down in 2007 (4.1%).

After the stagnation of 2005 Q2 and Q3, international trade showed signals of awakening at the end of 2005. Given the better trend of the late-2005, a more sustained growth is expected in 2006

(+7.3% as average growth rate of the world imports and exports) compared to the previous year and a similar average evolution should emerge in 2007 (about +7%).

Risks on the international scenario

This favourable scenario assuming a gradual slowdown of the international growth may be affected by few risks which may modify our forecast. The former risk is of geo-political nature and has been looming ahead in many occasions ever since 2001: this time it is strictly connected to the Iranian nuclear question, but usually it hinges around the harsh Middle-East tensions (which are even stronger since the Palestinian elections). A possible new conflict harshening centred in Iran may affect the operators' confidence and the oil prices. In spite of the analysts' expectations, the industrialised area eventually absorbed the oil price three-fold rise occurred in four years. However, at present, the 60 dollar-per-barrel standard – which was the oil price in the past few months – might be the starting point for further rises and the countries' ability to accept them remains to be checked, particularly because the new oil shock goes alongside with a deterioration of the investors' confidence.

Another risk is to be found in the US economic evolution. The scenario which is at the basis of the present forecast foresees a gradual and modest deceleration in the American economy: indeed the large majority of observers agree on this prospect. However there are few alarming bells which have been ringing over the past few months. The first bell rang in the building sector: the most recent evolution showed that both prices and the sale volume were moderate. Such a dynamics might appear an encouraging signal, as it also means that the sudden fall in the real estate prices caused by a bubble which some were (and still are) fearing did not take place. However, one cannot ignore that increasing real estate prices did raise the American households' expenditure (financed through deficit spending), hence still or decreasing real estate prices might bring about a larger-than expected brake in their consumption.

On the top of it, the curve flattening upon the interest rate expiry remains at the basis of the US situation. Because of that phenomenon, the seven economic slowdowns occurred since 1960 – as they were “officially” classified by the National Bureau of Economic Research - were correctly forecast with an advance ranging from 5 to 12 months. According to the ISAE Report estimates (see Box on *The Interest Rate Curve Inversion in the United States*), on the basis of the yield differential between 10-year and 3-month Treasury Bills identified on average in January 2006, the chances that a recession occurs within the following 12 months is 33.35, where 30% is the threshold the regular overcoming of which has historically anticipated all the recessive phases of the past 45 years².

² The European Central Bank (see ECB, Monthly Bulletin, February 2006) reaches very similar conclusions.

Admittedly, in the present situation there are many and convincing explanations finding a connection between the interest rate curve and factors other than the forthcoming recession (from excessive liquidity to the role of China as a major buyer of American Bonds, which would all cause a considerable long-term yield reduction). However, considering the intense imbalances characterising the US system, the evolution of interest rates upon expiry must be carefully monitored together with other leading indicators of the US economic cycle.

The Italian cycle

After the considerable fall registered in the late-2004 and in the early-2005, the Italian economy has been experiencing a recovery which has been decreasing in the second half of the year. The GDP dynamics – which has considerably risen in Q2 – has reduced its growth pace in Q3 and, according to the ISAE estimates, even more so in Q4. The July-September slowdown mainly concerned production, but not the final demand which has indeed continued to rise at a relatively sustained rhythm similar to that of Q2, thus contributing to the GDP variation by 1 percentage point. The gap between the production and the demand evolutions shed light on the major role played by stocks in determining the Italian economic growth in the recent cyclical phase. The stock reduction experienced in the two central quarters of the year offset the involuntary rise occurred between the end of 2004 and the beginning of 2005.

For 2005 Q4, ISAE foresees a stock reduction and a smaller evolution in the final demand components. Taking account of the less favourable indications coming from the average industrial production trends in 2005 Q4, ISAE estimates a further slight GDP deceleration in the period October-December compared to the previous quarter. That dynamics should lead to an average 0.1% non-wda rise in 2005. The working day adjustment (the 2005 working days were less than in 2004) should cause a 0.2% GDP growth: a dynamics which falls short of the one experienced in the euro area in the same year by 1.2 percentage points.

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

	2005	2006*	2007*
<i>Domestic references</i>			
Gross domestic product	0.1	1.3	1.4
GNP wda	0.2	1.4	1.3
Imports of goods and services	1.9	3.5	3.2
Exports of goods and services	0.2	3.2	2.8
Resident households' expenditure for consumption	0.9	1.3	1.3
Expenditure of General Government and NPISH (1)	0.9	0.4	0.8
Gross fixed investments	-0.7	2.0	2.3
Contribution to the GDP growth			
- of domestic demand (net of stock changes)	0.6	1.3	1.4
- of stock changes and valuable objects	0.0	0.0	0.1
- of net exports	-0.5	-0.1	-0.1
Current and capital account balance (as a percentage of GDP)	-1.5	-1.8	-1.4
Consumer prices	1.9	2.1	2.0
Producer prices	4.0	2.6	1.1
Propensity to consume (percentage level)	85.8	85.3	84.9
<i>Per capita</i> gross earnings in the economy	2.5	3.0	2.7
Total employment (2)	0.3	0.5	0.6
Unemployment rate	7.7	7.6	7.3
General Government net borrowing (as a percentage of GDP)	-4.3	-3.9	-4.2
General Government primary surplus (as a percentage of GDP)	0.7	1.0	0.8
Fiscal pressure of General Government	41.4	41.4	41.2
General Government debt (as a percentage of GDP)	108.5	108.1	107.9
12-month Treasury Bills yield (3)	2.60	3.25	3.60
<i>International references</i>			
Gross domestic product			
- World	4.5	4.3	4.1
- USA	3.5	3.0	2.8
- EUR-12	1.4	1.9	1.8
Dollar/Euro exchange rate (level)	1.24	1.24	1.28
World demand	6.7	7.3	6.9
Official exchange rates (3)			
- ECB	2.25	3.00	3.00
- Federal Reserve	4.25	4.75	4.75
Prices of raw materials (in dollars)			
- energy	5.5	10.0	4.0
- non-energy	36.5	10.9	-3.8
of which: Brent (\$/barrel)	54.7	61.0	58.1

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

* ISAE estimates.

**ISAE forecasts.

(1) Non-Profit Institutions Serving Households.

(2) In standard labour units.

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

Industrial cycle: promises and disappointments...

The intensity of the Italian economic recovery continues to be affected by the uncertain industrial cycle. The manufacturing activity – after registering a further severe contraction in the second half of 2004 and in the early-2005 – showed a considerable upswing in Q2, followed by a moderate (though favourable) trend in July-September. The new remarkable reductions registered in Autumn were followed by recoveries in November and in December, which were however not sufficient to avoid a fall in 2006 Q4 (-0.7%). The late-2005 weakening put a stop to the ambitious expectations for a recovery in the central quarters of the year.

...but signals of improvement peep out ...

Beyond the short-term swinging and the difficulties experienced by the industrial sector, which has been facing a long-lasting process of adaptation and restructuring, our analysis of the manufacturing cycle points to a slow and fragmented improvement compared to the trough registered soon after the 2001 recession. Also the signals indicating a spreading of the favourable cycle among industrial sectors – since March a growing share of industrial sectors has been facing a positive trend, particularly in investment goods and energy – and growingly favourable information on the entrepreneurs' sentiment corroborate this assessment.

...within a framework of rosier quality indicators

The entrepreneurs' confidence indicators have been showing a positive evolution in 2005 H2, as happens in the other European countries. Significant improvement occurred in Italy over the past few months, when the manufacturing capacity showed a further weakening. The confidence indicator, underpinned by rosier assessments on order books and by a stock reduction, has been growing since May, attaining in January its highest peak of the past 3 ½ years. The largest rises concerned investment and intermediate good producers. At the end of 2005, the rising industrial capacity degree of utilisation and the decreasing share of firms declaring obstacles to production due to lacking demand confirmed the improved entrepreneurs' perception on the industrial cycle.

The problem – which is fundamental for analysts – of the connection between quality indicators and quantity developments seems to have become “more complex” because of the latest event occurred in Italy more than in other European countries. The Report investigates the reliability of the leading confidence indicators surveyed by ISAE with reference to the manufacturing cycle (see Box on *The Relationship Between Confidence Climate and Industrial Production From An Historical Perspective*). The estimates show that the indicators' reliability has been growing ever since the Nineties. However, there is some discontinuity in the latest industrial stagnation. Considering those

recent difficulties, the indications of industrial improvement coming from the Business Surveys are taken in due account, but more cautiously than in the past. Indeed, our estimate on the early-2006 industrial production assumes a moderate trend of the manufacturing activity, with a 0.4% reduction in January, a substantial stability in February and a 0.3% rise in March. Also thanks to the productive growth registered in December (+1.2%), the first quarter of 2006 should mark a 0.6% rise compared to the previous quarter.

Service and Construction Surveys

With reference to the other sectors, the ISAE Surveys on Services show an overall improvement in turnover assessments for the late-2005 and early-2006, due to the rosier trends in financial and business services and to the reduction in the households' services. With reference to construction, characterised by intense quarterly data oscillations, the ISAE Surveys indicate a remarkable confidence growth in the last months of 2005, following upon rosier assessments on the current productive activity and longer ensured production for the following months.

Households' confidence climate

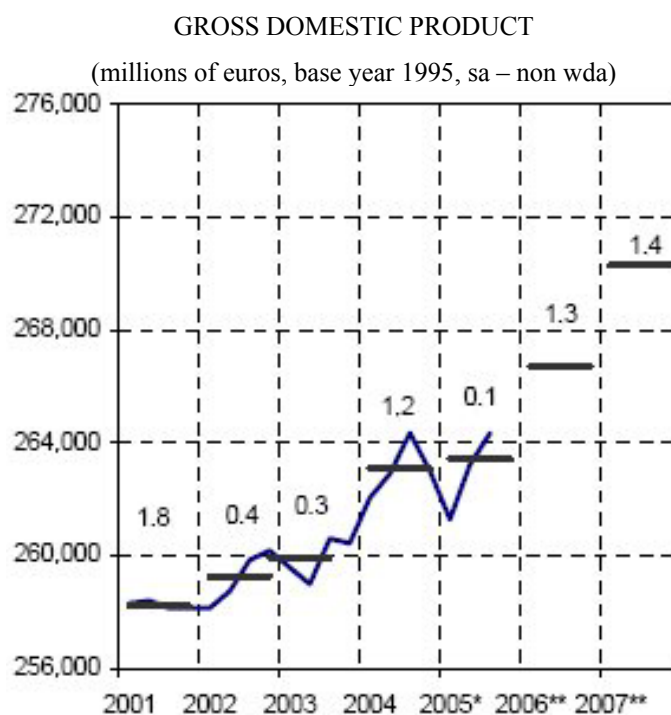
On the consumers' side, the confidence climate has risen in 2006 H2, after registering a fall between the end of 2005 and the beginning of 2006, due in particular to deteriorated assessments on the general economic situation and to rosier evaluations on the households' own situations. It is worth recalling that – in spite of the 2005 recovery – the households' confidence remains on historically low levels, after the uninterrupted confidence decrease registered in mid-2002 and early-2004.

Coincident and leading indicators of the economic activity

The overall picture emerging from cyclical data seems to be characterised by extremely weakening trends, due in particular to industry in 2005 Q4, and by rosier indications referring to the beginning of 2006. Such a gap is mirrored in the opposing dynamics of the coincident and leading economic indicators, which are both elaborated by ISAE on the basis of various indicators. The former, which was decreasing in late-Summer and early-Autumn, signals a weakening in the economic production of that period; the latter – which should anticipate the economic evolution by about six months - has been growing for some months (the latest Survey refers to December) being mainly fostered by the Surveys' trends.

Forecast for 2006-2007

Indeed, on the basis of the available indications, at the beginning of 2006 the Italian economic evolution might gradually recover as against the braking profile characterising the late-2005. That trend will be affected by a larger support on the part of domestic demand, given a weak contribution of the net foreign demand. In the rest of the year, the stimulus coming from domestic components should grow. With reference to exports, the euro appreciation within the favourable international framework should limit the Italian exports' dynamics, which should remain positive. Taking account of the 0.5% heritage coming from 2005, those evolutions should lead to an average annual GDP growth by 1.3% (non wda figure). The rise should amount to 1.4%, taking into account the different working calendar (the year 2006 shows two working days less than 2005), which is a development falling short by 0.5% compared to the expected figure for the euro area.



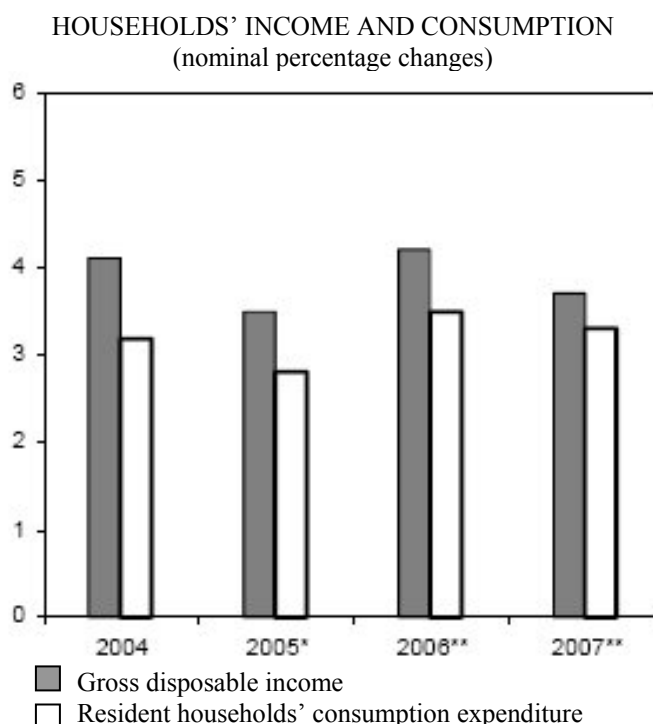
Source: ISTAT
* ISAE estimates.
**ISAE forecasts.

Thanks to the gradual acceleration registered during the year, the economic activity in 2006 Q4 might exceed by 1.3% the same period of 2005. That profile should cause a 0.5% heritage handed over to 2007. On the basis of this cyclical figure, within an international situation characterised by a slight slowdown and with a domestic scenario affected by the public finance trend, the non-wda Italian GDP growth should equal 1.4%. The rise should amount to 1.3% (wda figure, as there are three working days more in 2007 compared to 2006), 0.5% less than in the euro area.

Consumption

In 2005, on the basis of the National Accounts wda data, the resident households' expenditure increased by 0.9%, following upon a rather weak trend of Q1, which became quicker in the remaining quarters. As happened in 2004, the dynamics was mainly prompted by purchases of durables, whose growth mirrors the larger availability of consumption credit, apart from changes in the consumers' preferences in the face of a growing supply of innovative products in the sectors of telecommunication and electronics. Quite the reverse, a substantially lower profile emerges in non durables and in services (with the exception of services somehow connected with durables, such as bills, bank services, expenditure for communication).

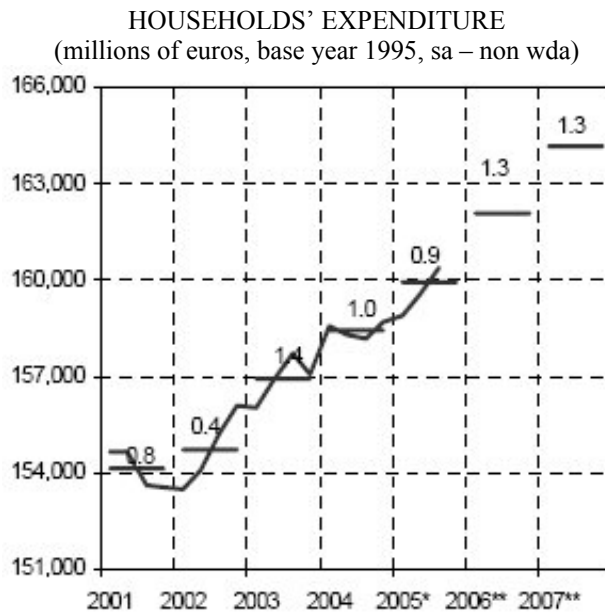
The average 2006 data on private consumption should show an acceleration as soon as the growth rate reaches 1.3%, which is in keeping with the expected GDP evolution. As already happened in the previous years, the households' expenditure should be favourably affected by the available income trend, which in 2006 should benefit from the favourable development of the *per capita* income, deriving from the bargaining round of both the public and private sectors and from an employment dynamics strengthening as against 2005.



Source: ISTAT

* ISAE estimates.

**ISAE forecasts.



Source: ISTAT
 * ISAE estimates.
 **ISAE forecasts.

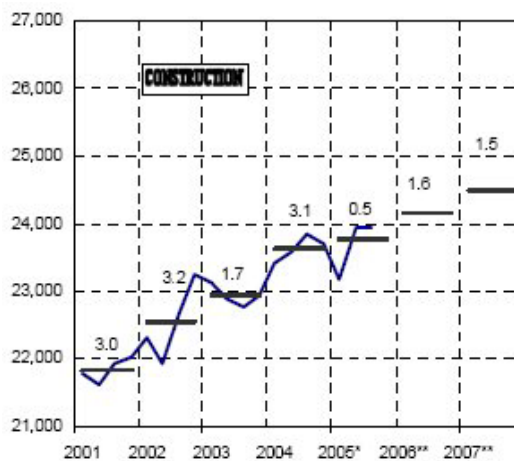
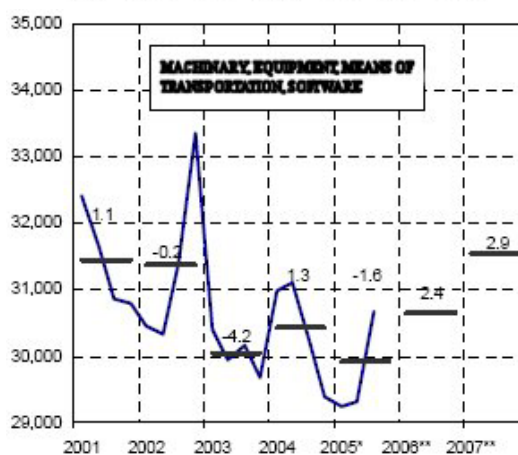
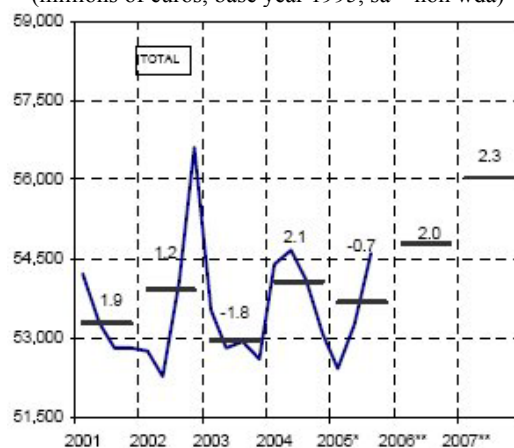
In 2007, in the wake of the acceleration registered in 2006 (the heritage should be worth about 0.4%), the consumption might remain on the same growth rate (1.3%) as in 2006, thus drawing benefit from a favourable development in the households' income.

Considering the available income evolution, which is slightly larger than the expenditure rise of both 2006 and 2007, the average propensity to consume – which has been decreasing since 2000 – should register a further drop in the two years of forecast.

Investments

After the contraction of 2005 Q1 (which followed a 2004 H2 with negative sign), the overall investments showed significant recoveries in Q2 and Q3, in keeping with the export acceleration. According to the ISAE estimates, the expenditure for investments slowed down in Q4, thus mirroring the weakening in the area of means of transportation. In spite of the improvement registered ever since Q2, the average 2005 result should remain negative (-0.7% according to the ISAE estimates), because of the contraction of the average annual investments in machinery and equipment.

GROSS FIXED INVESTMENTS
(millions of euros, base year 1995, sa – non wda)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts.

The prospects for 2006 and 2007 point to a gradual strengthening of the accumulation process. This should be fuelled, in particular, by investments for machinery, equipment, software and means of transportation, which should be positively affected – apart from a growing domestic demand and a constant international demand – by the need to improve the competitiveness of the Italian productive system. The recent progress which has been observed in the economic sentiment of business firms operating in various sectors, the indications of a more intense use of productive capacity in the manufacturing sector and the entrepreneurs' perception that constraints deriving from lacking demand are diminishing should all positively affect the firms' investment plans, thus prompting a recovery. According to the ISAE estimates, this expenditure component should rise by 2.4% in 2006 and by 2.9% in 2007.

As for investments in construction, the slowdown signals which emerged in 2005 as against the robust expansion which had characterised the past few years might partially affect 2006 and 2007. The expected development rates should be worth 1.6% in 2006 and 1.5% in 2007 (as against an average growth by about 3% experienced in the four years 2001-2004).

All in all, as a consequence of those trends, the overall investment dynamics should equal 2% in 2006 and to 2.3% in 2007.

Exports and imports

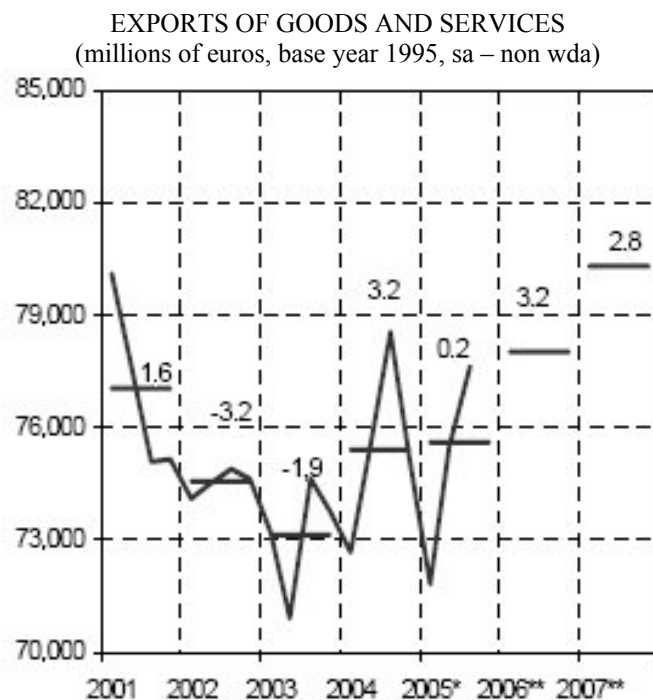
Following upon the strong contractions of 2004 Q4 and 2005 Q1, the exports of goods and services registered a considerable upswing in 2005 Q2, thus getting back on a more favourable path. The recovery drew benefits from the euro depreciation and from the stimula coming from the international trade dynamics. On the basis of the information coming from customs, the export volume is estimated to have decreased in the last months of 2005. However, thanks to the recovery of 2005 Q2 and Q3, the average variation of exports of goods and services in 2005 was slightly positive (+0.2% in real terms).

During 2006, the evolution of Italian exports will be positively affected by the positive international demand trend and will be negatively affected by the harsher competition following upon the expected exchange rate appreciation. According to the ISAE estimates, foreign sales in 2006 should rise by an average 3.2%. In 2007, the further euro strengthening and a moderate international trade evolution might limit the export dynamics down to 2.8%.

Considering the international trade expansion, which amounts on average to about 7% in the 2 years considered, the export dynamics should be accompanied by a further market share reduction in volume, even though it is smaller than the contraction characterising the latest period.

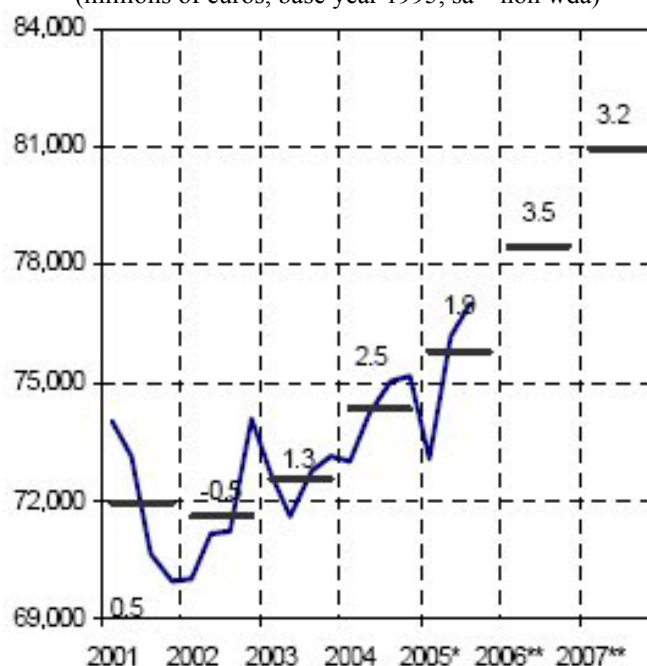
The Italian market share at current prices – which has been characterised by a stable evolution since 2000, which was (surprisingly) not worse than that of the European partners – showed in 2005 a contraction stemming from the rise in the world exports due to the price trends of oil and raw materials, an effect which concerned both the Italian performance (at current prices) and that of other industrial non oil-producing industrial countries. Under our assumptions on the volume dynamics, on international prices and on the quantities and unitary values of Italian exports, the reduction in the Italian market share may decrease in 2006 and then come to a stop in 2007.

Even though it is definitely better than the Italian performance on international markets at constant prices, also the Italian market share trend at current prices registered some sort of negative impact in terms of shift and share, caused by the mix of sectoral exports (which tends towards slow-growth sectors) and a (residual) competitive factor (see Box on *The Share of Italian Exports in the Euro Era: A Comparison Between Germany and France in Value Data*).



Source: ISTAT
 * ISAE estimates.
 **ISAE forecasts.

IMPORTS OF GOODS AND SERVICES
(millions of euros, base year 1995, sa – non wda)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts.

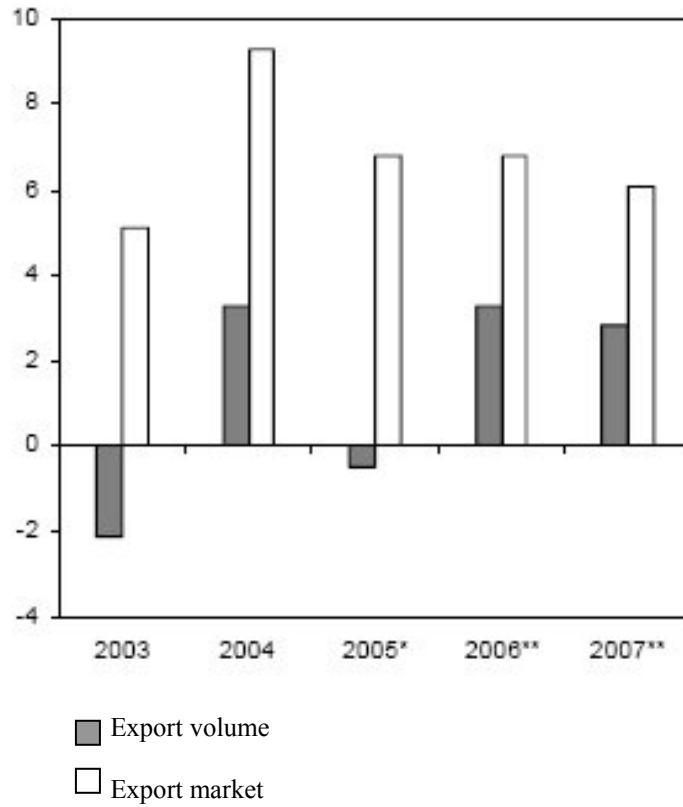
On the import side, the gradual domestic demand strengthening should favour the acceleration of imports of goods and services which should grow – in volume – by 3.5% and 3.2% respectively in the two years considered (after the 1.9% rise estimated for 2005).

All in all, the negative contribution of the net foreign demand (exports minus imports) to the economic activity variation, equalling 0.5% in 2005, should fall down in 2006 and in 2007; foreign trade of goods and services should subtract 0.1% to the GDP dynamics both in 2006 and in 2007.

Labour market

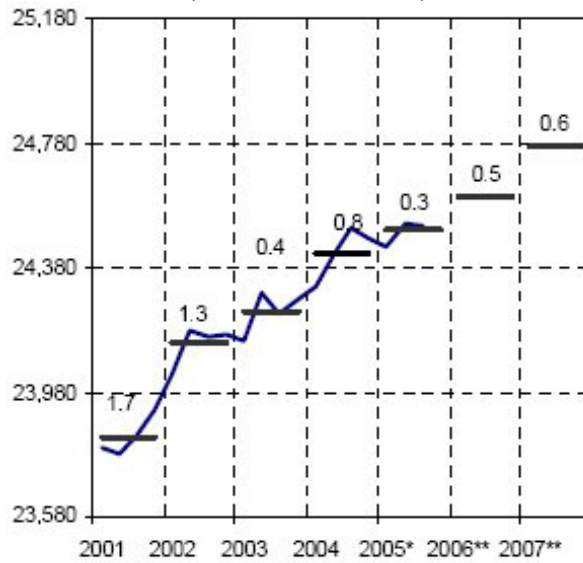
In 2005, the labour market showed a slightly favourable trend, even though it had a deceleration compared to the previous years. On the basis of the National Accounts data on the standard labour units – which were less affected by the legalisation of immigrant workers, which had a deep impact on the employment data surveyed by the Quarterly Survey on Labour Force -, the growth should be modest in 2005 (0.3% according to our estimates). That rise is however larger than that of the economic activity, bringing the employment elasticity to the GDP on anomalous values already experienced in 2002 and 2003.

EXPORTS AND OUTLET MARKETS OF ITALY
(percentage changes)



Source: ISTAT
 * ISAE estimates.
 **ISAE forecasts.

TOTAL EMPLOYMENT
(labour standard units)



Source: ISTAT
 * ISAE estimates.
 **ISAE forecasts.

Expectations for the two years considered in the forecast point to a strengthening in the employment dynamics in keeping with the economic recovery consolidation. The standard labour unit dynamics should be worth 0.5% in 2006 and 0.6% in 2007, thus falling short of the economic activity growth rates. Hence, the product per labour unit, which was decreasing in 2005, should grow again in 2006 and in 2007, alongside with the economic cycle acceleration.

In terms of workers, considering the gradual expansion drop due to the immigrant workers' legalisation process, the overall rise in the two years 2006-2007 should amount to 278,000 units; the unemployment rate -7.7% on average in 2005 – should go down to 7.6% in 2006 and to 7.3% in 2007.

The ISAE Surveys on firms' recruiting plans

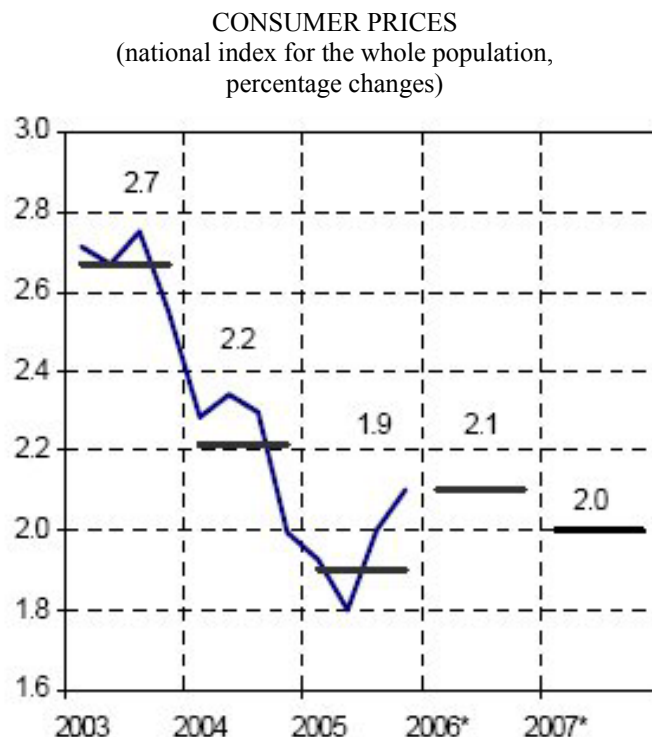
The prospects for a gradual employment rise are confirmed by the *ad hoc* Survey carried out on the ISAE sample of business and service firms, which shows – compared to the two previous years – a rise in the share of firms planning to hire (see Box on *Firms' Hiring Plans and Forecast for the Next 12 Months In An ISAE Survey*). The replies provided by respondents set at 1.8% the overall employment growth in 2006, compared to the workers' stock officially declared by sample firms, corresponding to about 9,600 new hirings (including fixed-term contracts, which account for about $1/3$ of total contracts). The rosier evolution is also mirrored in the respondents' forecasts on the working time distribution: about 56% of firms expecting a rise in the number of worked hours (compared to 2005) declare their intentions to make new hirings (the share is about 63% in services and 53% in industry). That same Survey updated the monitoring – already made in two previous occasions – on the respondents' preferences on hiring modalities and contract typologies. With reference to the former aspect, with reference to 2005 and in prospect to 2006, it is evident that traditional recruitment modalities are marginal, particularly (both private and public) job agencies and the so-called new operators (local bodies, schools, bilateral bodies, representatives' associations). Temporary agencies and executive search companies – utilised by about 19% of firms reporting new recruitments – still play an important role, though slightly decreasing compared to 2004. The informal recruitment method remains the major one (direct employer-employee contacts, CV dissemination, job vacancies, advices, etc.), as it concerned 65% of hirings and it is expected to grow according to the 2006 firms' intentions. With reference to the types of contracts, most new recruitments in 2005 (namely $2/3$ of total) concerned fixed-term contracts (fixed-term contracts, apprenticeship contracts, per-project contracts); quite the reverse, part-time contracts were hardly chosen (8% of the total) and the adoption of the new forms of contracts introduced by Law 30 was even rarer (less than 2%).

Earnings

With regard to wage dynamics, in 2005 gross *per capita* earnings increased by 2.5% in the whole economy. The estimates for 2006 and 2007 are based on the standards already set in the latest wage bargaining (particularly in the mechanical industry and in the General Government) and on specific forecasts on the feasible conclusion of the wage bargaining round in the two years considered. Under those assumptions, the *per capita* earnings for the whole economy will increase by 3% in 2005 and by 2.7% in 2006. Thanks to the productivity cyclical acceleration, the labour cost dynamics per product unit should decelerate from 3% in 2005 to 2.1% in 2006 and to 1.9% in 2007. The labour unitary cost evolution in industry excluding construction should be worth 1.6% in 2006 (3.6% in 2005) and 1.2% in 2007.

Inflation

The inflation evolution in the next few months will be determined by the oil market trends. In the first half of the year, the energy costs should prompt consumer prices, so that inflation should remain on a dynamics similar to that characterising the 2005 Q4. A slowdown might emerge in Summer, also thanks to the rosier comparison with the 2004 data. The strengthening of the euro-



Source: ISTAT
* ISAE estimates.
**ISAE forecasts.

dollar exchange rate should contribute to the drop of exogenous thrusts; indeed, the rises registered in the initial phases of price formation should gradually pass onto the final distribution. Thus, inflation should be gradually rising on average in 2006 as against the previous year, equalling 2.1% (1.9% in 2005). In terms of harmonised index, the consumer price rise should attain 2.2%, which is 0.1% higher than the one experienced in the euro area (after registering a null differential in 2005). In 2007, the expected combustible price decrease in euro and in dollars shall favour the inflation slowdown started in 2006 H2. The price rise should amount to 2% on annual average. The harmonised index should rise by 2.1%, which will bring the gap between Italy and the average euro area in favour of the former by 0.1%: this is due to the impact of the German VAT rise on the average euro area inflation.

The economic activity in regional partitions

In 2005, the North-Eastern (+0.5%) and the Central (+0.3%) partitions had slightly quicker productive dynamics than the national average. Quite the reverse, the *Mezzogiorno* of Italy was characterised by a substantial stagnation, while a marginal contraction emerged in the North-West. In medium terms, between 1995 and 2005, the Southern and Central partitions grew at an annual average rate of 1.5%, the North-East rose by 1.3% and the North-West by 1%. For the two years 2006-2007, ISAE estimates that the most dynamics regions are in the North-Eastern area (with a 1.7% rise in both years); the evolution of Southern regions should however remain slightly below the national average figure.

The migration flows from the *Mezzogiorno* of Italy towards the richest regions of the countries have been emerging again since the mid-Nineties. Indeed, the demographic movements, which are surveyed at provincial level, seem to reflect the “classical” pattern of the Italian development gaps (expressed in terms of income, labour market, industrial structure, etc.; see Box on *The Migration Flow Determinants In The Italian Provinces: 1991-2000*). The new migration flows from the South to the North seem to have triggered labour mobility, which is part and parcel of the process of economic convergence. However, if that mechanism is not accompanied by an adequate flow of productive and financial resources from the North to the South, in the long run it may be insufficient, let alone negative. Inasmuch labour mobility concerns the higher skills – as the empirical evidence shows -, the brain drain widens the gap between the *Mezzogiorno* and the North-Centre.

Public Finances

According to the ISAE estimates, the General Government net borrowing in 2005 equalled 4.3% of GDP, thus reaching the value indicated in official documents since the July 2005 Economic and Financial Planning Document (DPEF). The measures adopted at the end of 2005, as well as the heritage of the public employment wage bargaining, definitely had an impact on that result. The most recent indicators – particularly the ISTAT estimates on net borrowing in the first three quarters and the annual figures on the General Government cash borrowing – might suggest a deficit slightly smaller than the expected one, with positive effects on the following two years.

The 2006 deficit should go down to 3.9% of GDP and in 2007 – in the ISAE scenario and with unchanged policies - should grow up to 4.2% of GDP. Those trends assume none of the expected extraordinary real estate patrimony sales.

The ISAE forecast for 2006 envisages a strict enforcement of the rules contained in the Financial Law and in the connected Decree Law. However, there are elements of risk whereby the manoeuvre may not be fully effective, especially because of the considerable expenditure savings: should those risk materialise, the deficit trend would be maintained within the plan agreed upon at European level. The General Government behaviour for 2007 is supposed to maintain the expenditure/GDP ratio reached in 2006 thanks to the corrections adopted.

Compared to the official evaluations, the less favourable projections described here reflect a slightly smaller economic growth in the two years 2006-2007 and a larger expenditure for interests, which should be added to the different scenario construction.

According to the ISAE estimates, the primary surplus will diminish by more than one percentage point of GDP in 2005, equalling 0.7% (as against the 1.8% registered in 2004). In 2006, it should grow again up to 1% of GDP and then it should fall to 0.8% in 2007 (assuming no corrections).

The debt/GDP ratio went up to 108.5% in 2005 (as against 106.5% in 2004). It should fall down to 108.1% in 2006 and reach 107.9% in the 2007 scenario. The decreasing trend for the two following years derives from the dismissal operations, with privatisations equalling an amount of 15 billion euros in both years.

* * *

Since the 2001 recession, the Italian industry has not succeeded to carry out a long-lasting process of recovery. Unlike what happened in other European countries – which have been experiencing favourable trends since the mid-2003 – the Italian manufacturing industry has been registering false starts and sudden crises and eventually a long stagnation.

The Italian industry was penalised by factors which are peculiar of our country and which have something to see with the national characteristics and with the delays with which Italian firms have been adapting to new situations. Such a picture goes alongside with a “natural” de-industrialisation process, which is amplified by the strong competitive pressures affecting some segments of the manufacturing industry, which used to be (more or less) protected from international competition (think to China joining the WTO at the end of 2001 and to the elimination - which had long been announced - of quotas on textile exports on the part of emerging countries foreseen in the Multifibre Agreement).

Stagnation but not a standstill

Economic stagnation and the ongoing growth drop are no synonyms of standstill. Quite the reverse, if the harshest competitive pressures, on the one side, create difficulties and indeed push out of the market firms and entire industrial sectors, on the other side, they do trigger a process of selection of the “best” producers, of search for effectiveness, of adjustment to the more severe external conditions. In other words, the harsher competitive pressures cause changes in the “hard core” of the deeply-rooted Italian productive tradition. That process does not foresee any discontinuity (a 4% share of the textile industry cannot be transformed into a 4% share in microchips or mobile phones) and that inevitably concerns the same sectors undergoing selection pressures. On the one side, those pressures imply “winners and losers”, but, on the other side, given the very nature of the selection process, they bring about improvements, more effectiveness and a further sectoral lock-in.

Industrial trend and cycle

The final Section of the present Report – devoted to *The Italian Industry Between Stagnation and Structural Changes* – deepens those topics, trying to analyse the trends causing the negative evolution of the Italian industry over the past few years. To begin with, some sort of distinction is made through different methodological approaches between the cycle components and the long-term components which have recently affected the Italian manufacturing activity. That attempt originates from the awareness that the available statistical instruments are unable to define the features of the latest phases of an industrial process, on which the observer’s curiosity and uncertainty is concentrating. Indeed, the empirical evidence shows a considerable industrial trend deterioration in the 21st century, irrespective of the statistical instrument. However, the evaluations made according to the different methods provide different results in terms of worsening dimension and, symmetrically, of the (more or less important) role played by cyclical components in affecting the productive trend: an aspect which confirms the peculiarity of the stagnation which has been

characterising the Italian industry and which highlights the need to acquire new elements of analysis.

Peculiarity of the recent cyclical phase

This is partially done in the following Section, where the styled facts of the Italian industrial cycle of the past three decades are reviewed with parametric approaches, on the basis of the behaviours of the single sectors of our manufacturing system. Indeed, this analysis sheds light on some peculiar anomalies. Firstly, compared to the past experiences, in the 21st century, the width/depth of the recession/expansion periods have widened (in this latter case, because of the larger inertia of the sector of equipment and machinery). Secondly, if, on the one side, this circumstance reduced the losses of negative phases (as the falls were smaller than in the past), on the other side it has considerably reduced the thrust to find a way out of the recessions, whose “attraction” has proportionally increased. That attraction exerted by mild recessions – according to an analysis of the different economic cycles based on the search for common sectoral behaviours - led to the search for “intermediate” cycles which are neither recessions (with the exception of 2001 and, partially, of the latest months) nor expansions.

Changes in the sectoral composition

The analysis of sectoral cycles leads to focus attention on the productive mix changes occurred in the past five years in the Italian industry, particularly with reference to the thrusts coming from the harsher external competition.. The Section on structural modifications states that the pressures to change are connected not only to China, but also to the thrusts to start a wider production reorganisation in Europe following upon the rapid acceleration of the integration process of the Nineties. Indeed, the Italian manufacturing industry has experienced considerable structural changes over the past few years, and the Italian industry has registered the most intense composition changes between 2000 and 2005 compared to the other European countries. At the same time, the Italian manufacturing industry has taken part in the general process of structural divergence affecting the European industries, but Italy was affected more than other countries (which means that the Italian industrial system became even more different from the average European model). Indeed, those changes have not substantially modified the Italian position in labour distribution in Europe. The traditional “made-in-Italy” sectors - even though limited by competition from emerging countries - have experienced an improvement in their comparative advantages towards their European partners; conversely, the traditional comparative disadvantages of Italian high-tech sectors and of sectors with high economies of scale has further increased. More generally, the production distribution

throughout the European territory has become relatively more asymmetric, as each country aims at amplifying its own original vocation. Italy took part in this process more markedly.

Aggressive price policies in foreign markets

Finally, the final Section hinges on a topic already investigated in the July 2005 Report concerning the atypical behaviour of the average export unitary values (increasing in the typical made-in-Italy sectors in spite of the competition difficulties and of the loss of market shares), by verifying, on the basis of the ISAE Surveys, to which extent those trends stem from the price policies adopted by Italian firms on foreign markets. This last aspect has much to do with the problems of selection, adjustment and reorganisation in the industrial sectors. The estimates show that, in the 21st century, there was an anomalous pricing-to-market of our exporters of traditional goods, who have tried to defend/increase their mark-up on foreign markets in spite of the harsher competition from emerging countries and of the euro appreciation. This behaviour is inconsistent with the idea of firms fighting against new incumbents, which suggests the aggressive use of market power on the part of successful producers, presumably thanks to (not new) quality upgrading processes fostered by the enormous rise in the world supply of low-category goods.