INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

ISAE REPORT

Forecast on the Italian Economy

Synthesis

JULY 2005

CREDITS

The present Report is the result of the team work of a wide group of researchers coordinated by Sergio de Nardis. In particular, the drawing up of the Chapters was edited by Robert Basile, Maurizio Bovi, Cristina Brandimarte, Margherita Cagiano de Azevedo, Sandro Calabresi, Tatiana Cesaroni, Mauro Costantini, Roberta De Santis, Marco Fioramanti, Alessandro Girardi, Massimo Mancini, Marco Malgarini, Patrizia Margani, Maria Cristina Mercuri, Chiara Oldani, Carmine Pappalardo, Giovann Principe, Daniela Rossi, Rosetta Salvini, Franco Sartori, Luisa Sciandra and Claudio Vicarelli.

Our thanks go to Emma De Angelis and Paolo Fanfoni for their support.

The editing was ensured by Maurizio Brioni and Fernanda Turella, of the ISAE Function "Management of Technical Services", co-ordinated by Silvia Fanfoni. We thank Pietro Dramis for his collaboration. The English version was translated by Paola Felli and edited by Sergio de Nardis himself.

The Report is based on the information and data available up to July 26, 2005.

Summary and Introduction

The international economy

The world economic prospects for the next eighteen months continue to be favourable, even though they show a modest slowdown compared to the intense development registered between 2003 and 2004.

The world economic activity and, in particular, international trade, showed signals of standstill in the late-2004 and in the early-2005, as they were affected by a contraction in the cyclical dynamics of the industrialised area, which is partly due to the strong oil price rises. The latest indications point to a slight recovery in all regions ever since Q2, which – once again – was led by the two major locomotives of the latest years, namely the United States and China. Within this framework, the euro area has been registering a modest pace and even a slowdown, as it did not benefit from the thrust coming from foreign demand, it was affected by the exchange rate braking effect and it did not experience a sustained domestic demand recovery.

According to ISAE, the overall GNP should rise by about 4% both in 2005 and in 2006 (after the 4.9% peak of 2004); a growth which should exceed the average upturn experienced in the past three decades. This evolution should coincide with peaks in crude oil prices, equalling more than twice the average prices of the past ten years. The indifference (apart from few temporary oscillations) shown by the international cycle to oil prices seems to be connected, on the one side, to the smaller dependence of consumer countries from crude oil imports and, on the other side, to the larger spending capacity of producer countries (compared to two or three decades ago), which benefit from international trade changes and purchase manufactured goods from industrialised countries. Globalisation, meant as the increased supply of low-cost goods and as the enhancement of the overall competition in tradable sectors, favourably affects the general situation, by limiting the inflationary tensions in the industrialised area.

The ISAE forecasts on the ongoing favourable trend take account that the uncertainty caused by the new terrorist attacks on the international scene does not significantly affect national economies (apart from their effects on specific sectors), particularly in terms of households' and of investors' confidence. That assumption is based on the recent experience which might however indicate that the latest terrorist attacks are of a completely different nature (in terms of frequency and diffusion).

.

Exchange rate markets

In the first part of 2005, the US dollar appreciated against the other major currencies: this took many observers aback, as they expected a dollar depreciation due to the considerable imbalances of the American economy. The dollar reverse of trend against the euro was influenced by the good US economic performance compared to the euro area, by the reiterated interest rate rises imposed by the Fed in the face of the EMU stability and by the Spring institutional crisis of the European Union.

The Peking decision

And it was against that framework that on July 21 the Chinese Central Bank unexpectedly announced its intention to modify the yuan exchange rate system. It is premature, and indeed very difficult on the basis of the information contained in the communication describing the novelties of the new regime, to imagine the impact of the Peking decision. The fact that the Chinese Authorities (even partially) met the pressures of the international community (which demanded the appreciation of the Chinese currency against the dollar and, in some cases, the adoption of a pegging as against a diversified basket of currencies) marks a major step forward, which contributes to ease – together with the China-EU recent agreement to temporarily limit exports of some textile products to Europe - the trade and financial tensions emerged in the past year. Apart from its political value, the impact of that initiative might be limited in the short term. The key currency in international trade continues to be the dollar (which, for the time being, has been slightly appreciated), even though the Chinese Authorities announced they maintained (through the new managed floating architecture) a larger margin of flexibility compared to the previous regime in managing the yuan appreciation against the US dollar, according to a timing and procedure which will be conditioned more by the complex problems of domestic equilibrium than by the need to adjust the international financial imbalances.

The (symbolic) appreciation of the Chinese currency brought about a realignment of the exchange rate markets, with a generalised appreciation of the other Asiatic currencies and, particularly, of the yen. Some observers warned that the operators' perception of the Chinese opening towards a more flexible currency management, combined with a "one-side bet" condition on the direction the exchange rate is taking, would eventually encourage speculations (pending a yuan appreciation which will take place sooner or later), which compels the Chinese authorities to intervene more than before (when there was no opening) to defend the parity and allow more liquidity in the country and in the international system.

Forecasts on the exchange rate

The uncertainties on the future of the Chinese currency are to be seen within a monetary framework which, in the past few years, has been characterised by a relative stability and where – unless something changes - the analysts' evaluations on the dollar have taken different directions. The different stands, even recognising the unprecedented dimension of the American imbalances, range from those who consider a further dollar depreciation as inevitable (up to 90% according to some) to those who exclude the need for any depreciation whatsoever. Indeed, the discriminating element seems to be the evaluation of the degree of sustainability of the United States' foreign debt and of the functioning of the adjustment mechanism (see Box: *The Dollar Perspectives*).

According to ISAE, the sustainability of the American public debt should not be in danger in the next eighteen months: at present, it equals about 25% of GDP with a dynamics which is limited by many factors (firstly, the so-called appreciation effects connected to US liabilities being in dollars whereas revenues are in foreign currency). Besides, the Chinese currency correction – if it is followed by further adjustments – might contribute to limit the US trade balance. On the top of it, the US adjustment process is continuing gradually. In our scenario, the dollar-euro exchange rate equals 1.20 in 2005 (1.24 on average) and is close to that figure in 2006, though with some fluctuations around that average value during the year. In particular, there should be an appreciation in the first half of 2006, considering the great political difficulties Europe is experiencing and the slower EMU cycle compared to the United States.

Interest rates

In our forecast, in the next few months, the Federal Reserve should continue its policy of periodical rises which leads the adjustment of the US economy towards the potential growth pace. The Federal Fund rate will be 4% at the beginning of 2006 and should then remain unchanged for the rest of the year. Conversely, the ECB should leave the official interest rates stable till the mid-2006 and then start a growing phase. The repo rate should be gradually adjusted and become 2.5% by the end of 2006.

Raw material prices

In the first half of 2005, commodity prices considerably increased, not only with reference to oil, but also for the other raw materials. Those rises - particularly in the industrial sector – showed signals of slowing down only in the latest months, when they registered levels just below their all-time peaks. The crude oil price – which had already grown in 2004 – skyrocketed in the early-2005, when the Brent oil price reached the unprecedented price of 60 dollars per barrel (between the end of June and the first half of July). The reiterated rises in production ceilings set by the OPEC played a marginal role compared to the many factors which influenced prices, namely the scarce know-how in all the productive chain steps (production, refining, transport infrastructures), the strong demand rise in emerging countries, the consumers' response to price rises, the uncertainties of environmental (hurricanes) and political nature (Nigeria, Venezuela, Iran and Iraq).

According to the ISAE forecasts, the Brent oil price should remain around 52-55 dollars per barrel for some months and then decrease (in the mid-2006) because of the smaller demand pressure on supply. In terms of yearly average figures, the results will amount to 51.5 dollars per barrel in 2005 (which means a rise by more than 30% for the second year in a row) and to 47.7 dollars in 2006.

With reference to raw materials, the ISAE forecast shows that the average rise will equal about 5% in 2005, as the synthesis of a moderate growth in foodstuff (1.3%) and a larger growth in industrial products (11.7%). In 2006, in the face of an average reduction by about 1% in the energy sector, industrial commodities should register a 2% contraction.

World trade

The temporary world trade slowdown experienced in the late-2004 caused an upturn in the first half of 2005 and reduced any forecast on the world trade growth compared to expectations. The world trade accelerated in Q2 2005, owing to a thrust coming from emerging economies, in particular from the Asian area (China). All in all, the world demand should rise at a pace just below 6% in 2005 and at about 7% in 2006. On the basis of those trends, the world trade elasticity to the world economic activity should diminish to 1.5 in 2005 and 1.7 in 2006. After the temporary rise observed in 2004, the ratio between the trade dynamics and that of the world GDP should differ from the exceptionally high figures characterising the second half of the Nineties, when there was an acceleration peak due to the trade and production integration among the various economies.

Forecasts on the economic activity of the main areas

With reference to the major countries, the leading role in the industrialised area is played by the United States, whose GDP – which grew by 4.4% in 2004 – should rise by 3.5% in 2005 and by 3% in 2006. The slowdown witnessed in the American economy, which should however remain close to its potential development pace, somehow mirrors the end of the economic policy boost (caused by the interest rate growth and the end of the fiscal policy expansionary approach) and the consequent smaller thrust coming from domestic demand.

The Japanese economy will be volatile, but it should remain on a favourable path and indeed it is strengthening: the Japanese GDP will rise by 1.5% in 2005 (2.6% in 2004) and by 1.8% in 2006.

Asia is characterised by a slightly smaller growth than in 2004 (+7.3%), though maintaining a considerable growth rate (+6.5%) both in 2005 and in 2006. The leading nation continues to be China, which should succeed in managing the new exchange rate without excessive domestic consequences. India, thanks to an expansion which was less dramatic and more balanced than the Chinese one, should remain among the main characters of the global development phase (as it reckons on high-tech sectors and on robust financial markets; see Box *The share market in India*). A favourable evolution – even though decelerating compared to the expansionary peak of 2004 – is emerging in Latin America as well as in Central-Eastern Europe. Africa might confirm the more dynamic trend emerged over the past few months, even though its *per capita* income evolution is still unsatisfactory and the gaps between the performances of the different economies are too wide.

With reference to the EMU, the latest indications show that the past euro appreciation had a negative impact on the industrial production trend of Q2, which in turn caused a brake in the overall economic activity. The recent exchange rate weakening might give new thrust to the euro area, as the signals coming from the Surveys seem to indicate. On the basis of the recent joint ISAE-IFO-INSEE forecasts, the euro area GDP, which increased by 0.5% in Q1, grew between April and June (+0.2%). A slow improvement is expected for 2005, with an 0.3% rise in Q3 and an 0.4% growth in Q4. All in all, this trend should lead in 2005 to an average GDP growth by 1.3% in the EMU. In 2006, the cyclical trend should go on in Europe, also thanks to a relatively favourable exchange rate and this should bring about a 1.8% growth in the area.

The European standstill and the strategies for recovery

The outcomes of the French and Dutch referenda and the harsh debate on the EU budget marked a severe stop in the process of economic and political integration of the European Union. They brought in the forefront the worrying disaffection of European citizens from the EU institutions and the divergent approaches of national Governments to the future of the Union. The crisis experienced in the European political cycle seems to be directly connected with the disappointing economic situation. The euro introduction did not give rise to that development acceleration which many observers were expecting. On the top of it, the gap between the euro area and the other major economic system, namely the United States, has been widening in the first years of the EMU life.

The situation of wide-spread discontent led many experts to wonder whether the reasons why the European economic performance is worse than the American one, apart from mirroring the imperfect nature (compared to the US benchmark) of the EMU currency area (for the rigidities characterising the commodities and factors market) are also connected to a lack of governance. Indeed, observing the different behaviours of the euro zone (soon after its birth) and of the United States during the slowdown phase soon after the 200 expansion corroborates that assumption. In the United States, the fiscal and monetary policy mix was effective and contributed to finding a quick way out of the recession, even though it was necessary to mine the domestic and external equilibria. Conversely, the EMU anti-cyclical reply was non existent and proved ineffective in terms of monetary policy, which was not well coordinated and was braked by the public finance imbalances. Indeed, there those who feel that stabilisation policies are unlikely to be effective in a single currency area whenever they are carried out at national level. Given the rules of the Stability and Growth Pact, whenever the budgets are far from balance (which is an ideal condition to let automatic stabilisers play their role), the public finances tend to be either moved in a pro-cyclical way (by becoming looser when the cycle is positive and stricter when it is negative) or, in case of a correct anti-cyclical action, to meet the existing limits in the slowdown phases not to worsen the imbalances. Furthermore, even when the budget allows it, the stabilisation policies carried out at national level in a high-integration area tend to be adopted in a sub-optimal way: the corrective actions introduced in small open economies –as the European economic systems are – partially tend to go to the benefit of other countries and this disincentives the cycle regulation effort compared to the extent which would be most suitable for the whole Union. Finally, a stronger (and more effective) European stabilisation policy would be necessary for structural reforms which are difficult to be implemented in a situation of low growth. Those reforms, which are necessary to make the systems more effective (and somehow reduce the gap between the European and the American systems) have long-term consequences; indeed, in the short-run they may even cause adverse effects on the cycle and thus meet stronger resistance if the cycle remains weak.

Those considerations highlight the need to identify the role of the EU in terms of fiscal policy, thus resuming the original idea which accompanied the first steps of the Community life and which re-emerge more or less explicitly whenever the problem of the solution to prompt the European economy is tackled: from the MacDougall Report of 1977, to the Delors Report of the early Nineties, till the declarations of intent of the present decade started with the Lisbon Strategy and continued with the Van Miert Report and then resumed with the Italian Presidency semester producing the European Action for Growth, and then with the Sapir Report adopted by the

Commission and with the latest Kok Report denouncing the delays of the implementation of the Lisbon Agenda.

But how could a wide-encompassing European strategy for growth be structured, how could it be funded and which is the target? The present ISAE Report (see Box: *A strategy to relaunch the European growth*) provides examples of the forces which might be involved, with a possible estimate of the necessary allocations and a simulation of the possible results. The schedule foresees a coordinated action between three main characters, namely the European Union, single nations and private operators. The objective should be relaunching a growth strategy based on three pillars identified as the main fundaments of development, as they have always been mentioned in the European projects, but have always remained dead letter in the Governmental actions, namely infrastructures (TENs), research and development, education and training. The action should hinge around a European Agency for Lisbon, i.e. an *ad hoc* EU institution with the task of coordinating the partners involved in the action and of contributing, wherever necessary, to the action funding. The Agency should gather resources by issuing EU bonds and selling them on the market, with the support of the European Investment Bank (EIB) as global advisor. That debt will be subject to the golden rule principle applied to the EU budget. The single countries would co-finance the projects through deficit spending (similarly to what happens with structural funds) by resorting to the flexible SGP interpretation - whenever this implies overcoming the Maastricht Treaty standards – considering that the new investments will accelerate the growth pace of the economies to such an extent that the deficit should fall back below the 3% threshold within two or three years. Private operators will contribute to the action through project financing and through a public-private partnership, thus obtaining the funds from the market and from the EIB. Indeed, the Bank would have the double role of advisor in the selling of Union bonds and of investor and pole of attraction of market investments.

The EU budget will contribute to fund the interests on the debts made by the European Lisbon Agency and those matured by the EIB towards private operators, It would therefore foot part of the bill and provide at the same time incentives to private contributors. But which will be the role of the EU budget, considering that now it is set at 1.02% of GDP and any proposal to enlarge it finds enormous opposition? In the example mentioned in the ISAE Report on the role division between the characters involved, 1% of GDP of additional investments will be funded by the European Lisbon Agency for a share worth 0.20%, by national budgets for another 0.20% and by the private sector for the remaining 0.60%.

According to the simulations made through the Oxford Economic Forecasting econometric model, the consequences of a similar project would be a larger EMU growth, particularly if the overall coordinated project succeeds in involving the other main character of the European macroeconomic policy, namely the ECB, which should contribute to the relaunching action by avoiding to hamper any possible pressure on demand and prices which the larger investment thrust should exert in the transition phase, before the larger accumulation of physical and human capital becomes larger development in the euro area. Thus, if, within five years, the additional investments gradually rise till they reach 1% of the European GDP, the euro-area growth would grow each year by 0.30-0.40 % compared to the figure it would have obtained without that project. Besides, considering the modest dynamics of the European population, this trend should coincide with the one of the *per capita* income, which would rise again, after so many years, at a pace close to the US one. At the end of the five years, the overall gain in terms of GDP will be considerable and will more than compensate the effort made by the private and the public sectors to accelerate the European development. At the end of the period considered, the European endowment of physical and human capital would register a growth which would be simply unconceivable without a coordinated action of the many characters at stake who, if they acted alone, would be subject to budget constraints, would not "see" opportunities for an overall improvement going beyond their national boundaries and would not perceive the existence of economic incentives.

Italy in the early-2005

After the strong contraction registered by the GDP in Q4 2004 and in Q1 2005 (by about 1% in the two quarters taken together), the cyclical indicators for Italy show a recovery in April-June, which should be followed by a favourable – though moderate – evolution during H2 2005.

The latest cyclical phase highlighted a considerable gap between Italy and the rest of the euro area. This is particularly evident in Q1 2005, when the GDP fall was running counter the favourable EMU trend. From the viewpoint of supply, the contraction Italy experienced between the end of 2004 and the beginning of 2005 mirrored the industrial production deterioration observed after the long-lasting stagnation and, in Q1 2005, the weakening of agriculture and construction, two smaller sectors which had contributed with their positive performances to sustain the 2004 growth. Also services brought a slightly negative contribution to the economic activity evolution. From the viewpoint of demand, the heavy export contraction (about -9% in the whole period comprising Q4 2004 and Q1 2005) went alongside with persistent investment difficulties, while private consumption substantially held.

Trends in Q2 2005

The severe contraction was followed by an economic activity recovery in Q2 2005, so that Italy is once again going in the opposite direction compared to the rest of the euro area, which is experiencing a slowdown. The strong and unexpected industrial production jump witnessed in April was only partially eroded by the May contraction. On the basis of the ISAE estimates, which take into account a new weakening in the June manufacturing activity, industry should close Q2 with a rise of about 0.5% in terms of production, and even more so in terms of value added.

The data on the other sectors for the period April-June seem to be contradictory. With regard to services, the relatively unfavourable signals stemming from the ISAE Surveys go alongside with the favourable trend of employment which characterised Q1. In construction, the production indices show a relative stabilisation after the early-2005 contraction. All in all, on the basis of those indications, the economic recovery in Q2 seems to offset, at least partially, the fall of Q1.

Industrial cycle weakness

The favourable GDP dynamics of April-June is affected by the strongly erratic trend followed by the Italian cycle. The rise is accompanied by a persistent weakness of industry, where the indicators showing the recovery diffusion continue to signal (in May) that most manufacturing sectors are undergoing a phase of cyclical contraction. The generally negative situation is however much diversified in the different sectors, with unfavourable indications in consumer goods (in particular, durables, which were affected by the growing preference of Italian consumers for foreign goods) and in intermediate goods, while rosier trends seem to characterise investment goods producers (see Box: *The Italian industrial cycle*). The ISAE forecasts on industrial production, going beyond Q2 2005 (-0.1% in July and +0.6% in August) show a recovery in the manufacturing sector, which however remains limited.

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

	2004	2005*	2006*
Domestic references			
Gross domestic product	1.2	-0.1	1.3
- *North-West*	*1.1*	*-0.4*	*1.1*
- *North-East*	*0.8*	*0.1*	*1.7*
- *Centre*	*2.6*	*0.0*	*1.2*
- Mezzogiorno	*0.6*	*0.0*	*1.3*
GNP wda	1.0	0.0	1.4
Imports of goods and services	2.5	0.6	3.8
Exports of goods and services	3.2	-1.1	3.4
Resident households' expenditure for consumption	1.0	0.8	1.3
Expenditure of General Government and NPISH (1)	0.7	0.8	1.2
Gross fixed investments	2.1	-1.0	1.7
Contribution to the GDP growth			
- of domestic demand (net of stock changes)	1.1	0.4	1.4
-of stock changes and valuable objects	-0.1	-0.1	0.0
- of net exports	0.2	-0.5	-0.1
Current and capital account balance (as a percentage of GDP)	-0.7	-1.3	-1.5
Consumer prices	2.2	2.0	2.1
Producer prices	2.7	3.5	1.3
Propensity to consume (percentage level)	86.4	85.5	85.2
Per capita gross earnings in the economy	3.0	3.1	3.0
Total employment (2)	0.8	0.3	0.4
Unemployment rate	8.0	9.0	7.8
General Government net borrowing (as a percentage of GDP)	-3.2	-4.2	-5.1
General Government primary surplus (as a percentage of GDP)	1.8	0.8	-0.2
Fiscal pressure of General Government	41.7	41.3	40.6
General Government debt (as a percentage of GDP)	106.6	108.2	108.5
3-month Treasury Bills yield (3)	2.2	2.2	2.8
International references			
Gross domestic product			
- World	4.9	4.0	3.9
- USA	4.4	3.5	3.0
- EUR-12	1.7	1.3	1.8
Dollar/Euro exchange rate (level)	1.24	1.24	1.20
World demand	9.7	5.8	6.9
Official exchange rates (3)			
- ECB	2.00	2.00	2.50
- Federal Reserve	2.25	3.50	4.00
Prices of raw materials (in dollars)	16.7	5.3	-1.3
- energy	35.3	30.1	-3.7
of which: Brent ($/barrel)	38.2	51.5	47.7

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

*ISAE forecasts, scenario for 2006.
(1) Non-Profit Institutions Serving Households.
(2) In standard labour units.
(3) End-of-year annual yields. Gross compound Treasury yield bills.

A positive signal comes from the Survey on Manufacturing Firms…

With reference to the confidence indicator, the one referring to manufacturing firms shows that the deterioration process which had been going on since the end of 2004 has stopped and indeed inverted its trend in July, getting back to figures above those reached in March. The rise, wide-spread in the main sectors, was particularly remarkable in investment goods producers. All in all, in spite of those rosier indications, it is necessary to wait till next Survey to realise whether the many uncertainties which have characterised the industrial activity of the past few months are over.

…but not from the Consumer Survey

The consumers' confidence climate trend is less favourable, as it significantly fell in the past two years, after a phase of stability. The recent deterioration was affected, in particular, by the worried assessments on the general economic situation, while estimates on the respondents' own situations are slightly rosier. A similar gap is observed between the consumers' negative expectations on the future (general or own) prospects and the generally rosier estimates on the current situation.

The economic cycle leading indicator improves

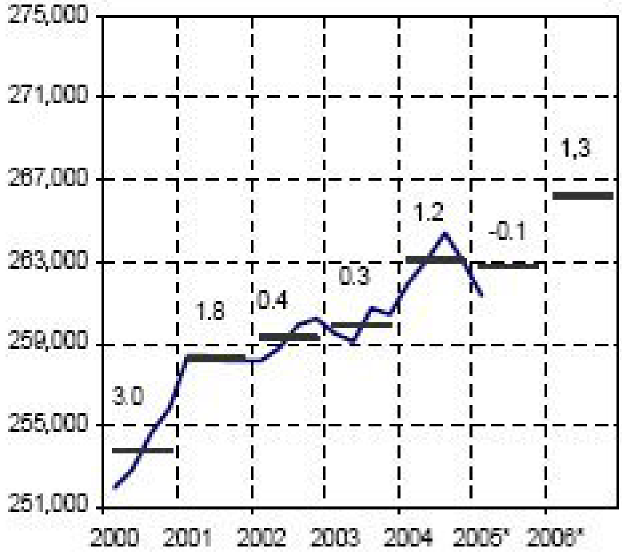
The signals coming from the synthetic leading indicator of the overall economic cycle elaborated by ISAE are more encouraging, as the index stabilised and then, after the worsening experienced in the late-2004, started to grow again in Match-April. Taking account that the leading indicator covers at least five-sic months ahead, the improvement might suggest even rosier (even though limited) trends in the second half of the year.

Generally speaking, in the light of the previous remarks, according to the ISAE estimates, a recovery of the strong contraction of Q1 is foreseen in Q2 and a moderately positive profile is expected in H2. The improving trend of H2 is affected by the world demand recovery, after the slowdown experienced at the beginning of the year, by the reduction in the braking effects deriving from the euro appreciation and by more sustained consumption and investment trends. Within this framework, the Italian GDP variation rate in 2005 equals -0.1% (non wda figure, as in 2004 there were 4 four working days less than in 2004). The annual dynamics should be slightly higher and brings stability (no variation) in the wda estimate.

The cyclical improvement characterising H2 will leave over to 2006 a favourable drain by about 0.50%. Also thanks to this advantageous "starting point", the average Italian growth rate in 2006 will equal 1.3% (non wda). The foreseen GDP variation will be slightly above that figure in Q4

2006. Looking at wda figures (in 2006 there are two working days less than in 2005), the average GDP rise will marginally larger and will equal 1.4% (as against the expected 1.8% for the EMU). The estimate for 2006 is made without adjusting to forecasts on public accounts and without considering development-prompting provisions.

GROSS DOMESTIC PRODUCT
(millions of euros, base year 1995, sa – non wda)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

The contribution of expenditure components to GDP

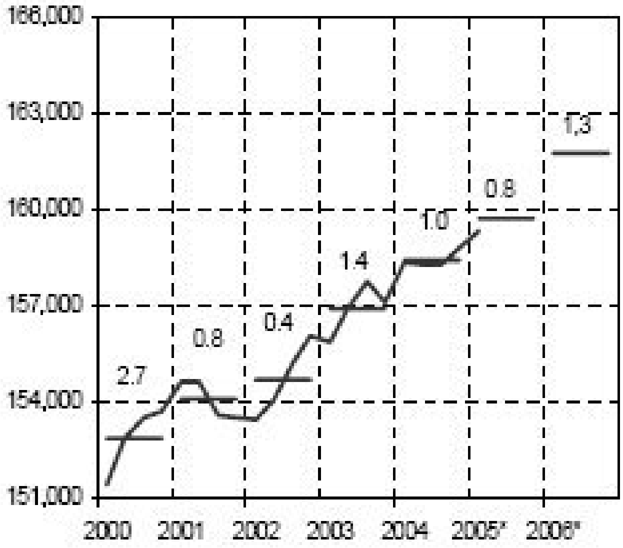
The 2005 standstill of the Italian economy is mainly affected by the unfavourable contribution of net exports, which should be negative again (-0.5%) after the 2004 improvement. The domestic demand net of inventories will go on supporting the economic growth (with a contribution worth 0.4%) The thrust will mainly come from consumption (particularly households' consumption) in the face of a negative contribution of investments. Indeed, inventories, which were subject to strong oscillations in 2004 with a remarkable process of accumulation at the end of the year, should subtract about 0.1% to the GDP variation.

In 2006, the Italian growth is still based on the domestic demand evolution (which brings 1.4 points to the economic dynamics). It is fuelled by consumption and by the investment recovery. Conversely, the net export contribution is improving (even though it is still slightly negative), while inventories are expected to bring neither negative nor positive stimula to the economic activity.

Consumption

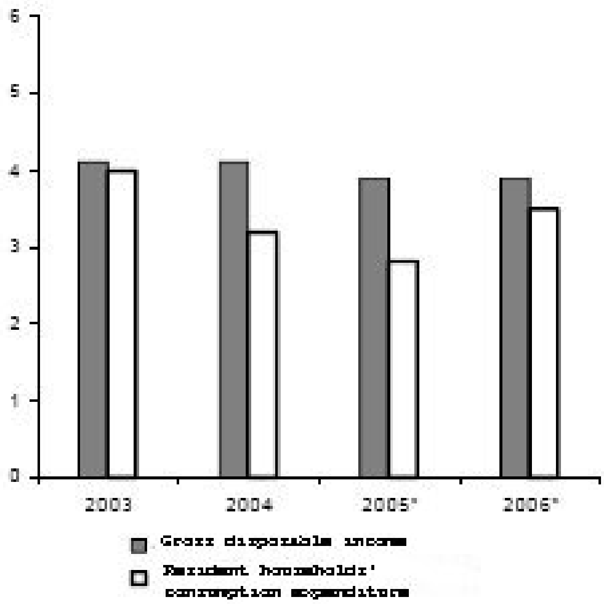
Private consumption was the final demand component which "held" most to the strong contraction hitting the Italian economy between the end of 2004 and the beginning of 2005. In our assumption, the resident households' expenditure should continue to have a positive (though moderate) trend, being affected, on the one side, by the favourable trend of the disposable income and, on the other

HOUSEHOLDS' EXPENDITURE
(millions of euros, base year 1995, sa – non wda)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

HOUSEHOLDS' INCOME AND CONSUMPTION
(nominal percentage changes)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

side, by the braking effect deriving from a confidence climate still conditioned by many uncertainties and doomed by the new wave of international terrorist attacks (even though an analysis of the consumers' confidence determinants tend to limit the effects of this kind of events when they occur in far-off areas; see Box: *What determines the Italian households' confidence climate? A disaggregated analysis of the respondents' working conditions*).

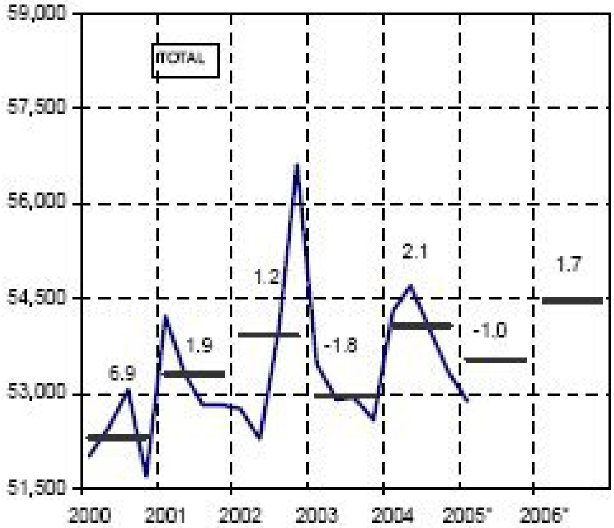
In particular, the disposable income should continue to benefit from the favourable dynamics of the *per capita* incomes and from the relatively moderate inflation trend. Though being affected by the ongoing influence of the factors which have braked the households' expenditure over the past few months and have prompted their saving propensity (among which uncertainty and the larger tendency to indebt to purchase houses), private consumption will rise at a 0.8% pace in 2005 (after a +1% growth in 2004).

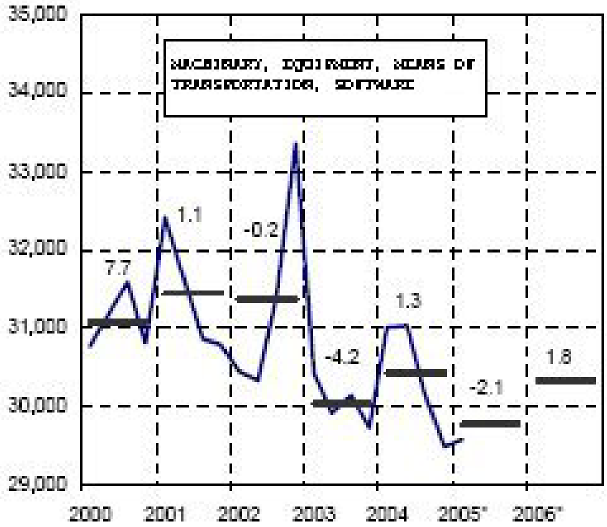
The consumers' spending capacity will rise in 2006, drawing benefit – apart from the favourable income dynamics - from a slight employment acceleration. The resident households' expenditure will grow by 1.3% in the presence of a further rise in saving propensity.

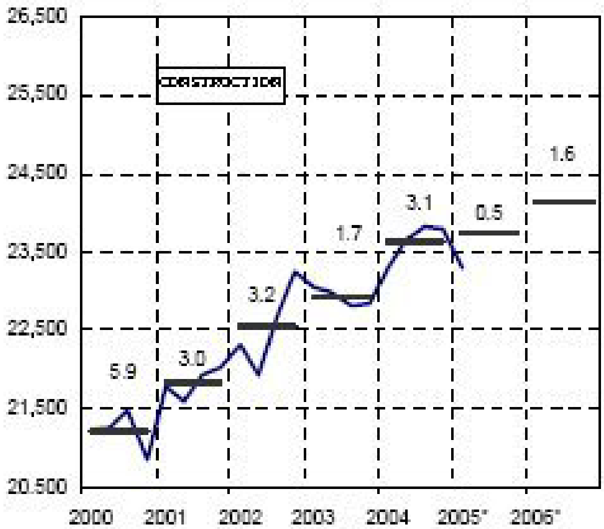
Investments

Investments in machinery, equipment and means of transportation – after the considerable weakening which characterised H2 2004 and Q1 2005 – should gradually recover in the rest of the year. The low cost of money and the expected gradual export improvement might lead firms to make new investments at a higher rate in H2 2005. However, given the negative heritage of the late-2004 and early-2005, investments in machinery, equipment and the like should register an average contraction by 1.4 on an annual basis (after -2.4% in 2004). In 2006, thanks to the previous year's acceleration, the accumulation process should intensify and reach a growth rate worth 1.8%. This dynamics should go alongside with an average evolution of investments in means of transportation – for the third year in a row – which is still negative in 2005 (-1%) and is recovering in 2006 (+1.9%). All in all, the expenditure in investment goods – excluding construction – will diminish by 2.1% in 2005 and will grow by 1.8% in 2006.

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







Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

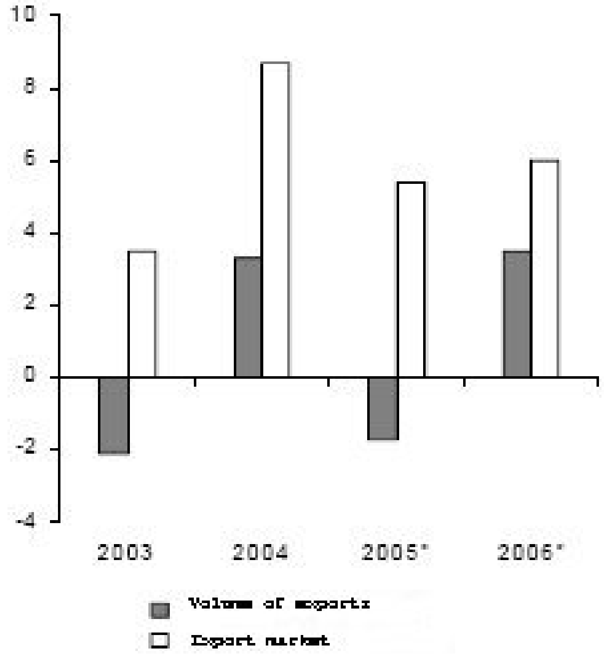
With reference to construction, after the stop experienced in the late-2004 and early-2005, the cyclical indicators show that the negative phase is over. If this improvement is confirmed in the next few months, it will enable to avoid a negative average variation of this expenditure component but it will always imply a very limited growth (+0.5% according to the ISAE estimates, after a 3.1% rise in 2004). A quicker development pace – though below the average figure which characterised the lapse of time 2001-2004 - is foreseen for 2006 (1.6%).

As the synthesis of all those trends, the overall investments (including machinery, software, means of transportation and construction) should fall by 1% in 2005 (+2.1% in 2005) and then rise by 1.7% in 2006.

Exports and imports

Exports of goods and services registered a strong fall in Q4 2004 and in the first three quarters of 2005, as they were affected by the world trade slowdown, by the euro appreciation and by the competitive pressure exerted by emerging countries. Those penalising factors affected both Italy and its European partners, but they had a comparatively more negative effect on the Italian situation, as they hit sectors which are particularly sensitive to low-cost exports and are characterised by low productivity both with reference to labour and to the production factors.

EXPORTS AND OUTLET MARKETS OF ITALY
(percentage changes)



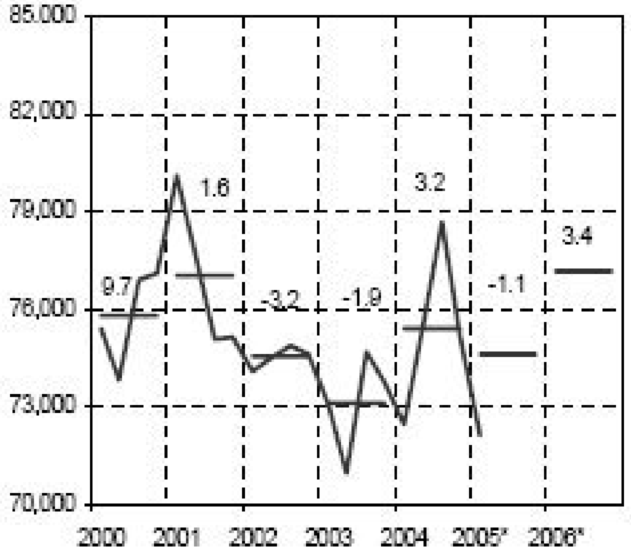
Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

The higher competitive pressure of the Italian manufacturing structure seems to have brought about a process of transformation. The Italian model should evolve to reduce the relative weight of the traditional Italian industrial sectors (textiles, clothing, shoes and leather products) as well as to shift those sectors towards a high-quality production which may be better protected by competition from new competitors. This phenomenon is highlighted by the opposite trend of the Italian market share at constant prices (which is continuously and strongly deteriorating) and at current prices (which has remained substantially stable for some years) and by the examination of the diversified trends in the specialisation sectors, of the unitary export values (which have grown for some years both on the EU and on the non-EU markets) and of producer prices on the domestic markets (which have remained stable in those same years; see Box: *Market shares and Italian export price policies*). Maybe the strong rise in unitary values, alongside with effects of export composition, mirrors an out and out component of price diversification on the part of some categories of producers. The information provided by the ISAE quarterly Surveys on exporting firms indicate that North-eastern firms have adopted over the past few years price policies to raise the unitary profit margins on the more dynamic – but also more difficult - foreign markets, rather than on the (low-growth) domestic market (see Box: *Competitiveness factors and price policies of North-eastern export firms*).

Under the ISAE assumption, the strengthening of the world demand and the euro weakening should accelerate foreign sales. The indications coming from the ISTAT data on foreign trade show signals of improvement in Q2. On average, in the two months April-May, exports increased by 2.6% compared to the previous quarter (when they decreased by 1.2% at current prices compared to the previous quarter). The expected acceleration remains below the international trade expansion, which gives rise to a new loss in the Italian market share at constant prices both in 2005 and in 2006. According to the ISAE forecasts, exports of goods and services fall on average by 1.1% in 2005 (+3.2% in 2004) and then grow by 3.4% in 2006, given a world trade dynamics equalling 6-7% in the two years respectively.

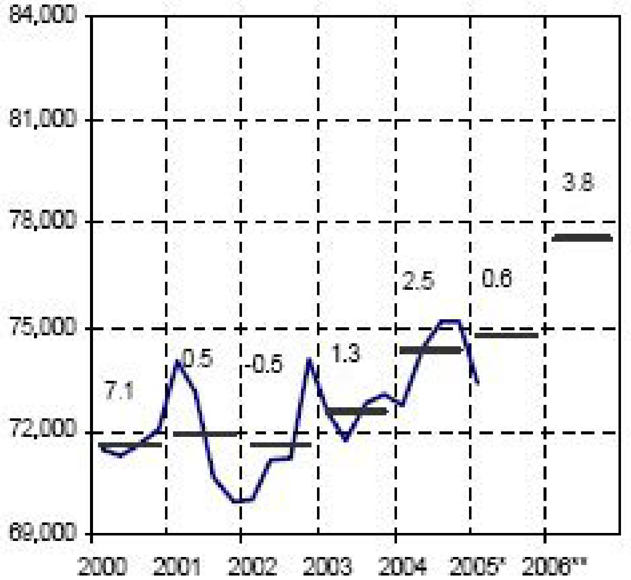
As far as the imports of goods and services are concerned, the productive activity recovery should go alongside with the intensification of imports, which will rise by 0.6% in 2005 (+2.5% in 2004) and by 3.8% in 2006.

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



Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

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

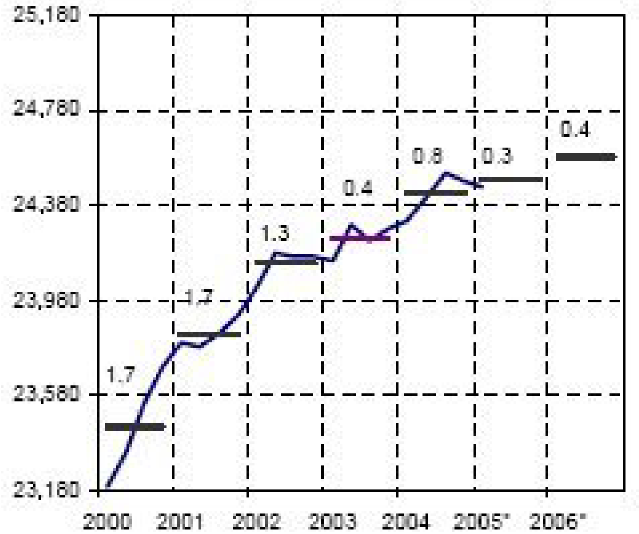


Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

Labour market

The contraction registered in the Italian economy at the end of 2004 and at the beginning of 2005 should eventually affect the employment dynamics in 2005 and cause a slowdown as against the particularly positive evolution of the past few years. Within the forecast, the average variation of standard labour units will equal 0.3% following upon contractions in the industrial and agricultural sectors and a still favourable trend in services. In 2006, with the strengthening of the productive activity, the creation of vacancies should slightly grow, with a 0.4% rise. In terms of workers, the stock of employed should rise by more than 270,000 people between 2004 and 2006, which means more than the standard labour unit dynamics, being still affected by the demographic effects caused by the emersion of illegal employment (on the complicated problems of the computation of illegal employment within the National Accounts through the "labour input" methodology, see Box: *The estimate of illegal employment: estimate methodology and difficulties*). The unemployment rate, equalling 8% in 2005, will remain stable on average and then fall down to 7.8% in 2006.

TOTAL EMPLOYMENT
(labour standard units)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

With reference to incomes, the hypotheses of income dynamics for 2004 are based on the already existing and on the ongoing wage bargaining concerning the forecast period, particularly those concerning the iron and steel sector and the public employees' collective bargaining (the effects of which affect the years 2005 and 2006). According to the ISAE forecast, the *per capita* incomes will rise in the whole economy by 3.1% in 2005 and by 3% in 2006. Taking account of the productivity evolution, which was negative in 2005 and is improving in 2006, the unit labour cost should grow in the whole economy by 3.4% in 2005 and by 2% in 2006.

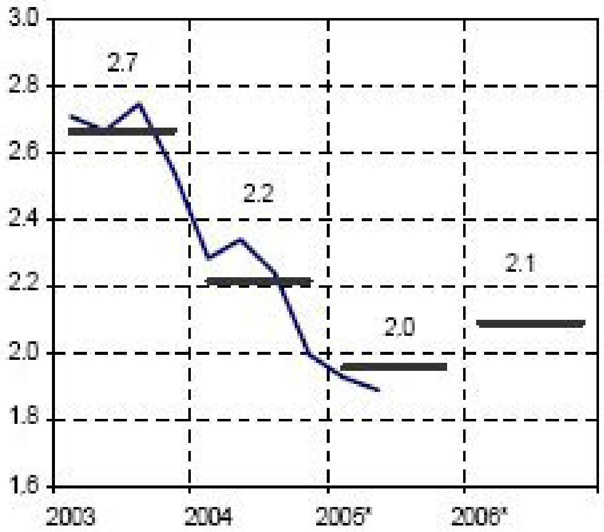
Inflation

In the early-2005, inflation remained stable, in spite of the considerable upward thrust due to the oil price rise. The annual consumer price growth rate remained at 1.9% between January and May (just below the late-2004 figure) and slightly decreased by 1.8% in June.

According to the ISAE forecasts, in the next few months the consumer price dynamics should not be different from the present pace, while it is expected to grow at the end of the Summer, when the expected rate (measured on the basis of the national index for the whole population) should be back at 2%. In Autumn, the inflation should further rise, being affected – apart from the immediate contraction stemming from the high crude oil prices - by the indirect and delayed effects (on non-energy goods and on energy tariffs - of the previous oil price rises.

In 2005, the average inflation rate (measured through the national index for the whole population) should equal 2%, which means a 0.20% reduction compared to 2004. In terms of European harmonised index, the price rise should be slightly higher (2.1%), with a 0.20% improvement compared to 2004 and with a null gap with the average euro-area inflation rate.

CONSUMER PRICES
(national index for the whole population,
percentage changes)



Source: ISTAT
* ISAE estimates.
**ISAE forecasts, scenario for 2006.

Next year, the expected gradual oil price fall, associated to the euro depreciation, should maintain the consumer price dynamics above an annual 2% in the early 2006. The inflation-decreasing process will be more evident starting from Spring, alongside with a quick reduction in the energy price rises and with a deceleration in the unit labour cost. The growth pace compared to twelve months ago should decrease till Summer, while a slight rise is expected in Autumn 2006 following upon the economic cycle growth. In 2006, the average consumer price rise should be equal to 2.1%, with a slight widening of the gap between Italy and the euro area (0.2%).

Development by geographical partitions

The acceleration phase of the economic activity which characterised the year 2004 was not homogeneously distributed among the different geographical partitions. According to the ISTAT estimates, the GDP of the Centre (+2.6%) has grown much more than in the North-west (+1.1%), in the North-east (+0.8%) and, particularly, in the *Mezzogiorno* (+0.6%). The ISAE forecasts for 2005 and 2006 point to a smaller diversification in the dynamics by geographical partitions. In particular, in 2005, the GDP variation should be almost null in all partitions, with the exception of the North-west, which is experiencing a contraction (-0.4%). In 2006, the ISAE estimates indicate a wide-spread recovery throughout the whole country, with a more marked dynamics in the North-east.

In the wake of the different demographic trends, which are affected by the recovery of migration flows from Southern regions towards the rest of the country, the *per capita* GDP (at constant prices) in the *Mezzogiorno*, in the past few years, has grown marginally more than in all other partitions taken together. However, that recovery stopped in 2004, when the geographical growth gaps widened again. It should emerge again in the two years of our forecasts, even though with smaller intensity: indeed, in 2006, the Southern *per capita* GDP should equal (at constant prices) 59.8% of the one of North-centre, while in 1995 that proportion should amount to 55.9%.

The public finances

Being affected by the small economic growth and by the ineffectiveness of the corrective provisions, the 2005 General Government net borrowing should amount 4.2% of GDP, compared to 4.3% as indicated in the Economic and Financial Planning Document (DPEF). In 2006, in the face of a rosier cycle, the expected deficit – leaving policies unchanged - should be worth 5.1% of GDP (as against 4.7% in the DPEF), also because of the end of one-off provisions (*una tantum*) which have underpinned the budget balance for years.

Compared to the provisions contained in the DPEF, the slightly rosier estimate for 2005 seems to be essentially due to the different time schedule forecast in the public employees' collective bargaining. While the DPEF computes the overall effects of the wage round for the two years 2004-2005 in 2005 only, the ISAE assumption subdivides the burden in equal parts in the two years, which means an improvement for 2005 and a worsening for 2006. Apart from that, the smaller expected growth for 2006 and, in particular, the different definition of the public finance items, as ISAE makes its forecast leaving policies unchanged, while the Government considers the current legislation, contribute to the computation of a 2006 deficit larger than the official one. Indeed, the DPEF forecasts, which have to consider the current legislation, are smaller than the ISAE figures, as they do not consider the additional investments which will be allocated and funded within the Financial Law for 2006. Thus, the 2006 forecast includes neither corrective provisions nor interventions to support development, except for the growth trends of the capital account expenditure, which is typical of any forecast leaving policies unchanged. An adjustment as the one indicated in the DPEF, plus development-supporting provisions, might bring the deficit/GDP ratio in 2006 under the 2005 level.

According to the ISAE estimates, the debt/GDP ratio should rise again in 2005 owing to the contraction in the primary surplus and to the unfavourable economic performance. After amounting to 106.6% of GDP in 2004, the debt should grow to 108.2% of GDP in 2005, as foreseen by the DPEF, thus mirroring a still high General Government borrowing requirement and in spite of the foreseen sales of the public real estate patrimony equalling 15 billion of euros, which will considerably accelerate the process. In 2006, considering a similar amount of sales of public patrimony, a strong narrowing of the net borrowing/borrowing requirement ratio (as underlined by the DPEF) and with no correction, the debt should rise up to 108.5% of GDP. Thanks to the adjustment provisions for 2006, the debt/GDP ratio might decrease again.

According to ISAE, the fiscal pressure – computed as the incidence on GDP of the whole of income taxes, indirect taxes, in capital account and of social contributions, either real or nominal - should fall by more than one percentage point of GDP in the two years considered. Indeed, the fiscal burden will fall from 41.7% of GDP in 2004 to 41.3% in 2005, thus mirroring a contraction of the one-off measures computed in the capital account taxes, and should decrease again to 40.6%, according to forecasts, in 2006. The primary surplus, which has been decreasing for seven years, should fall again in 2005, passing from 1.8% in 2004 to 0.8% of GDP in 2005. In 2006, the forecast balance net of interests might be negative, even though by two tenths of GDP.