



INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

ISAE REPORT

Forecast on the Italian Economy

Synthesis

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CREDITS

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Summary and Introduction

Still growing world economy in 2006 H1

Between the late-2005 and the early-2006, the world expansion gradually widened, eventually benefiting also Japan and Europe, which had experienced cyclical and structural inertias and had difficulties in keeping up with the US and Chinese locomotives. The growth gap remains wide, particularly between the two sides of the Atlantic, which experience different development potentials characterising the two productive systems. However, the recovery process had never been so diffused in geographical terms – from Asia to America, from Europe to some regions of Africa – as in 2006 H1. A further element of novelty (concerning in particular the Italian situation) is that the rosier European situation drew advantages not only from the more stimulating export profile, but also from the stronger domestic demand, which had long been missing in the euro area.

Problems are looming: fears for the economic growth?

The global development acceleration of the past few years was fuelled by the abundant liquidity available on the international markets (mainly originating from Asia) and by monetary policies which had long been pursuing an expansive approach in the main productive systems. On the top of it, the past cycle was also characterised by a world expansion, which – thanks to technological changes in the industrialised countries and to the inflation-reducing benefits deriving from globalisation – was left unscarred by the frequent oil price rises due to the structural imbalances of the market and to the geo-political tensions in the oil-producing countries.

In both those sectors, the international framework has undergone recent changes. The fear for the final effects of the oil price rises and for the cyclical strengthening of the euro area and Japan modified the monetary policies of those economies, which eventually decided to introduce a gradual interest rate rise, as the Federal Reserve has been doing ever since 2004. Indeed, the novelty is the interest rate rise introduced by the Japanese Central Bank last week, which marked the abandoning of the “zero interest rate” policy adopted during the long years of deflation (with no interruption since 2000); it was part of a process of quick liquidity drain on the part of the credit system started few months ago.

Quite the reverse, the most important change concerns oil, with the outburst of the Middle East conflict, which amplified the already strong uncertainties of that area, thus further raising the risk premium and bringing the oil price to an unprecedented peak. The hostility outburst had an

immediate impact on the financial markets, which had already to face the financial operators' behaviours aimed at adjusting their portfolios to the new risk/yield conditions induced by the monetary changes.

The question is whether those modifications may affect the future world cycle, considering that they emerge in a situation where the major world economy continues to be hit by wide domestic and external imbalances (financed by the considerable surpluses coming from Asia) and shows a slowdown, also due to changes in the real estate prices.

The ISAE international scenario

In the ISAE scenario for the next 18 months, those risk elements still have few chances to materialise. With reference to the monetary policies, the Central Banks' actions should be rather cautious in adopting their restricting decisions, by accompanying the economic evolution and verifying the correspondence between policies and cyclical developments. In particular, the different Japanese approach will bring about a gradual growth and the Japanese interest rates, though remaining positive, will be low for some time. Indeed, the US monetary squeeze might come to an end, given the deceleration signals coming from the American productive system, particularly from the real estate sector and from the households' expenditure. The ISAE assumption envisages a further 0.25% modification by the end-2006 (5.5%), which might however be "suspended", should the freezing process intensify. Two 25-point rises are expected in the euro area (3.25%), alongside with a substantially unchanged policy in 2007, which will be the year of the slowdown (with a negative output gap), where the efforts to recover public finances should be concentrated in the three main economies. Those shifts between the main economic areas, by interacting with the ongoing geo-political uncertainties, should be accompanied by a dollar oscillation against the euro within 1.28 and 1.30.

With regard to oil, the ISAE assumptions (rough oil above 70 dollars per barrel in Q3 and Q4 and a slight reduction in 2007, with an average annual quotation of about 68 dollars due to a slight weakening of the consumer countries' demand) were formulated before the Middle East military crisis. Considering the volatile upswings caused by sudden widening of risk premia and by the speculative capital movements, the basic scenario was changed and the oil price was supposed higher (assuming that the oil price peaks are no single episodes), in keeping with the yield profile of the most feasible baseline model, which is however not so far from the macroeconomic scenario presented here. Thus, an alternative simulation model (which is described later on) was performed to compute the impact of a different scenario assuming a longer oil shock (with an involvement in the conflict of oil-producing countries and the use of oil as an instrument for international pressure).

Forecast on the main economic areas

According to the baseline model, the overall economy should expand on average in 2006 more than in 2005, thus reaching the highest growth rate of the past three decades (4.8%), as happened in 2004. That evolution implies a dynamics slowdown in the second half of the year which will emerge in the average figures for 2007, when the growth rate equals 4.3%. International trade will rise by about 9% in 2006 (thus marking a strengthening as against 2005), and then grow by about 7% in 2007. Owing to those dynamics, the (apparent) trade elasticity to the world GDP should be between 1.5 and 2 (as in 2005).

The moderate growth reflects a slower expansion in the main areas. In particular, the US GDP growth rate – though remaining robust – will fall from 3.5% in 2006 to 2.8% in 2007, being affected by the impact of the interest rate rises introduced in the previous three years and by the gradual reduction of the real estate patrimony, which had been fuelling most private consumption in the Two Thousands. Asia should remain the main locomotive of the world economy, prompted by the rapid development of China (above 9%). Japan should not be much braked by its stricter (monetary-fiscal) policy mix, registering economic activity increases by 2.9 and 2.3% in 2006 and 2007 respectively.

With reference to EMU, the latest cyclical indications on industrial production and on the entrepreneurs' economic sentiment show substantially positive trends with a partial decoupling as against the American deceleration. On the basis of the experience of the past few years, it is hard to imagine that the gap between the European and the world cycles (particularly the cycle of the other major industrial giant) lasts more than a few quarters. However, in 2006 H1, domestic demand – both in its consumptions and in its investment components – finally contributed to growth in the area. The improved labour market conditions, the good profitability and the strong confidence recovery in the industrial sectors favour the households' and entrepreneurs' spending decisions. According to the *Eurozone Economic Outlook* – elaborated by ISAE on July 12, in close collaboration with IFO and INSEE -, the euro area GDP should rise in 2006 at a quarterly pace similar to the one of 2006 Q1, with an average rise of 2.1%. Also the euro area will face a deceleration in 2007 (+1.8%), as it is affected – apart from the smaller stimulus coming from the world economy - by the impact on domestic demand of policies aimed at restoring public finances. In particular, the slowdown of German consumption due to the early-2006 VAT rise should play a considerable role.

Effects of a long-lasting oil price rise

The risks dooming this scenario mainly come from the geo-political situation. The growing uncertainty deriving from the long-lasting Middle East conflict might trigger instability of the world economy. Admittedly, since September 2001 western countries have been proving they can live (and grow) also in a high-risk situation. In the light of the Israeli military reaction to the Islamic terrorists' attacks from the Lebanese border, a long-lasting oil shock is feared, similarly to what happened in the past for the direct or indirect involvement of oil-producing countries. To take due account of this possibility, the impact of a steady oil price at 80 dollars per barrel was simulated for the 1 ½ year considered in the forecast. This assumption foresees average price rises by 7% and by 18% in 2006 and 2007 respectively as against the baseline scenario. The dimension of the growth reduction should be similar in all the three areas considered, i.e. United States, Japan and the euro area should all experience an expansion 0.3-0.4% smaller in the two-year period 2006-2007, which marks an evident slowdown but is by no means a recession. A larger contraction in the world GDP dynamics might occur if prices further grow, i.e. an oil price at 90-100 dollar per barrel for the whole period.

A cyclical improvement in Italy as well

In the first part of the year, the economic dynamics of Italy was perfectly in keeping with the productive recovery described in the ISAE February Report, which was then confirmed by the May updating. The GDP growth in Q1 (+0.6% as against 2005 Q4, +1.5% as against 2005 Q1) and, even more so, the final (either domestic and international) demand rise, net of inventories (+1% as against 2005 Q4, +2% as against 2005 Q1), together with generally favourable indications for the rest of the year, point to a more robust evolution of demand and supply in our economic system.

Is the crisis over? Hints but not certainties

In the wake of those trends, the Report wonders whether experts are now able to circumscribe the Italian cycle, which was somehow suspended at the all-time high of December 2000. By strictly adopting the classical criteria to identify turning points, economists cannot yet describe the recession/stagnation cycle and set the minimum trough which followed the late-2000 peak. However, diffused cyclical hints suggest that – if future developments are consistent with the forecast – the beginning of the Italian recovery – which will only emerge from the average 2006 figures – might be advanced, namely it may be set at the beginning of 2005: that was the start of that favourable economic evolution which was prompted by industry, even though with ups and downs, on a path substantially rosier than the one of the past four years.

The negative phase which followed the December 2000 all-time high is by no means a classical recession (characterised by monotonically decreasing economic activity indicators); it rather represented a long period of stagnation (after the 2001 drop), where some attempts of recovery did take place (the so-called “false starts” occurred in 2002 H2 and in 2004 H1), even though they eventually proved out to be single episodes and did not become out and out expansion phases. Thus, for its features and length, this is a rather anomalous phase: if the early-2005 is confirmed as an all-time low, there are about 50 unfavourable months, compared to the 17-month average length of recession phases in the past three decades. However, it is not fully unprecedented; even in the early-Eighties there was a long-lasting stagnation (36 “negative” months between March 1980 and March 1981). Indeed, the similarity goes far beyond the mere statistical comparison: at that time – exactly like now – the Italian industry was hit by a deep competition crisis and by a deep transformation which took the form of major restructuring processes (twenty years ago it was mainly a problem of labour saving). The outcome of that phase was the recovery of adequate efficiency standards and a new wealth for the Italian industry, while the result of the present phase remains to be seen.

Cyclical impulses or structural changes?

The question on whether the rosier trends of the Italian industry stems from cyclical (namely from the European demand recovery) or from structural components (adjustment of the Italian industry) cannot find an answer before having reliable information on the evolution of the past few years. However, this is mere diatribe if one considers that, in the wake of the disappointing experience of the Two Thousands, the fact that Italy is finally catching up with the European favourable cycle is definitely a cyclical phenomenon having structural implications.

ISAE has tried to identify the changes underpinning the long-lasting economic stagnation in its previous Reports - the February 2006 Report (*The Italian Industry Between Stagnation and Structural Changes*) and the February 2005 Report (*Growth and Productive Structure in Italy: A Comparison Between Major Industrial Countries*) –, starting from the (Schumpeter-like) idea that a competition crisis is not only a leap backward, as it also marks an opportunity for a market-induced change (stagnation is no standstill, as reiterated in the February 2006 Report). Indeed, the transformation process experienced in the past few years seems to have led a considerable number of efficient incumbents to enter the international markets. And it is in this optics that one should see the anomalous export price policies aimed at increasing the profit margins on the most dynamics foreign markets - in spite of the exchange rate appreciation and of the competition from emerging countries - pursued by high-quality segments of the traditional made-in-Italy sectors: it is a sort of market power deriving from a quality threshold, which eventually reduces the number of producers

offering low-quality goods (who however steal Italian market shares). Alongside with these forms of intra-sector adjustment (which is no novelty, as the history of the Italian traditional industry is made of a continuous quality upgrading so as to combat the competition based on lower production costs), the industrial crisis has also brought about inter-sector changes. In the mid-2000, the structure of the Italian specialised industry seems substantially unchanged (having points of excellence in activities connected to home-fashion and mechanical instruments and points of weakness in high-tech), but, in the wake of the polarisation of sectors of comparative advantage and disadvantage, activities which used to play a secondary role eventually developed. Indeed, over the past few years, the Italian performance exceeded the European partners' one in some intermediate goods productions, namely foodstuff, publishing-paper-press and, more recently, at the end of a deep restructuring process, the automobile sector.

Thus, if, on the one side, some structural changes took place, on the other side, it is difficult to say whether they were completed, or at least whether they were sufficient to guarantee a satisfactory recovery of the Italian manufacturing sector. Our forecast for 2007 is rather cautious and draws a scenario where the “worse” trends which had characterised the past few years (dropping labour productivity and sudden loss of market shares in volume) tend to diminish (the productivity dynamics is slightly favourable again, as in the past two years, while the loss dynamics is slowing down), leaving room to a gradual improvement of the industrial performance.

Trends since Q1

The GDP rise of Q1 was followed by a moderate phase in April-June, due to a slowdown in industrial production, partially caused by the April “false step” (which was due to the peculiar holiday distribution of that month). In the ISAE forecast, the short-term prospects of the manufacturing industry remain favourable, though they are highly variable: indeed, after a slight reduction in Q2, industry registers more consistent rises in Summer, with a new acceleration in Q3. Those forecasts are affected by the favourable indications coming from the ISAE Business Surveys. In June, the confidence climate – constantly rising in the past year – reached its highest value since the end-2000. The growth mainly concerned intermediate and investment goods: since Spring, also consumer good producers have been experiencing an intense improvement.

In the past few months, consumers seem uncertain, as their confidence indicator – which was recovering in the late-2005 and growing in the early-2006 – oscillates around a steady position. Admittedly, the whole debate on public finances and on recovery determined that trend.

The ongoing favourable trend is also confirmed by the cyclical (leading and coincident) indicators elaborated by ISAE. The coincident synthetic indicator was rising in March, which means in Q1 it

overcame the late-2005 standstill (caused by a GDP stop). A similar signal is provided by the leading synthetic indicator, showing a strengthening between January and April, after the slight reduction of 2005 H2, which indicates a positive cyclical approach in the following five-six months.

Forecast for Italy in 2006-2007

The forecast for Italy in 2006 shows a GDP rise by 1.5% (wda figure), which means 0.6% less than in the euro area (the non-wda figure equalling 1.4%, as 2006 has 2 working days less than 2005). In 2007, the growth rate amounts to 1.3% (wda figure), with a 0.5% gap with the euro zone (the non-wda figure equalling 1.4%, as 2007 has 3 working days more than 2006). The forecast for 2007 was performed excluding correction measures on the public finances and interventions to support the Italian economy. The average development for the two years (1.4%) shows a remarkable improvement as against the first half of the Two Thousands (+0.4%) and is in keeping with the potential growth estimates for Italy.

The geographical division of the productive activity shows a GDP rise consistent with the average national figure in the Centre and in the *Mezzogiorno* of Italy; the GDP dynamics should be above average in the North-East (+1.7% in 2006 and +1.4% in 2007) and marginally below average in the North-West (1.4% in 2006 and 1.2% in 2007).

The Italian recovery in 2006 and 2007 is mainly prompted by domestic demand, thanks to the contribution of both domestic consumption and investments. The contribution of the net foreign demand should be almost null, which marks an improvement compared to the previous years.

The consumption level experienced a considerable leap forward in 2006 Q1, whereby the Italian households' expenditure exceeded the 2005 national average by 1%. The households' expenditure should remain on modest levels in the rest of the year, as the uncertain economic sentiment should act as a brake, but, at the same time, the expenditure should be stimulated by the still-positive disposable income trend, prompted by the rise in the *per capita* earnings and by an employment dynamics acceleration. Consumption should grow by 1.3% in 2006, with a propensity to save close to the 2005 levels. In 2007, the elements (i.e. the dynamics of the *per capita* earnings and of employment) prompting the households' expenditure should remain, which means expenditure will grow 1.2% less than the disposable income.

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

	2005	2006*	2007*
Domestic references			
Gross domestic product	0.1	1.5	1.3
- North-West	-0.2	1.4	1.2
- North-East	0.4	1.7	1.4
- Centre	-0.1	1.5	1.3
- Mezzogiorno	-0.2	1.5	1.3
GNP wda	0.0	1.4	1.4
Imports of goods and services	1.8	4.2	3.5
Exports of goods and services	0.7	4.4	3.1
Resident households' expenditure for consumption	0.1	1.3	1.2
Expenditure of General Government and NPISH (1)	1.2	0.7	0.8
Gross fixed investments	-0.4	2.3	2.2
Contribution to the GDP growth			
- of domestic consumption	0.3	0.9	0.9
- of total investments	-0.1	0.5	0.5
- of net exports	-0.3	0.0	-0.1
- of stock changes and valuable objects	0.2	0.0	0.1
Current and capital account balance (as a percentage of GDP)	-1.4	-2.1	-1.8
Consumer prices	1.9	2.3	2.0
Producer prices	4.0	4.8	1.8
Propensity to consume (percentage level)	85.8	85.7	85.5
<i>Per capita</i> gross earnings in the economy	3.1	3.3	2.3
Total employment (2)	-0.4	0.7	0.7
Unemployment rate	7.7	7.4	7.1
General Government net borrowing (as a percentage of GDP)	-4.1	-4.0	-4.2
General Government primary surplus (as a percentage of GDP)	0.4	0.6	0.5
Fiscal pressure of General Government	40.6	41.1	40.9
General Government debt (as a percentage of GDP)	106.4	107.5	108.4
12-month Treasury Bills yield (3)	2.64	3.50	4.00
International references			
Gross domestic product			
- World	4.6	4.8	4.3
- USA	3.5	3.5	2.8
- EUR-12	1.4	2.1	1.8
Dollar/Euro exchange rate (level)	1.25	1.26	1.30
World demand	7.8	8.9	6.9
Official exchange rates (3)			
- ECB	2.25	3.25	3.25
- Federal Reserve	4.25	5.50	5.50
Prices of raw materials (in dollars)			
- non-energy	5.5	16.5	8.5
- energy	36.5	23.9	-0.5
of which: Brent (\$/barrel)	54.67	68.50	67.60

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

* ISAE forecasts, scenario for 2007.

- (1) Non-Profit Institutions Serving Households.
- (2) In standard labour units.
- (3) End-of-year annual yields. Gross compound Treasury yield bills.

With reference to investments, after the leap forward of Q1, the dynamics should remain positive in the rest of 2006, being affected by the cyclical strengthening, by the confidence growth and by the competition-determined restructuring. The signals on the rising degree of plant utilisation and on the decreasing obstacles to production due to lack of demand might bring about a gradual increase in expenditure for rationalisation and for investments to enlarge the production capacity. In the ISAE estimates, purchases of machinery and equipment will grow by 3.2% in 2006 and by 3.4% in 2007. The growth rates in construction amount to 1.4% and to 0.9% in 2006 and 2007 respectively. All in all, total investments will rise by 2.3% in 2006 and 2.2% in 2007.

With reference to foreign demand, exports gave a substantial thrust to the economic activity in 2006 Q1. The recovery mirrored the foreign sale acceleration of investment and intermediate goods. Difficulties emerged in consumer goods (from textiles to clothes and shoes), even though there were signals of improvement. Thanks to the rises of Q1, the average foreign sale rise in goods and services should be 4.4% in 2006, which marks a considerable acceleration as against 2005 (0.7%). In 2007, exports – being partially braked by the exchange rate strengthening and by a less dynamic international demand - should grow by 3.1%. Considering the international trade expansion, the Italian market share in volume should decrease, even though less than in the previous years.

Turning to imports, the domestic cycle growth will lead to foreign purchase increases by 4.2% in 2006 and by 3.5% in 2007, while exports offset the contribution to GDP. The contribution of the net foreign demand to the economic activity, which was null in 2006, should be -0.1% in 2007.

The negative impact on employment of the weak economic evolution of 2005 might come to an end at the beginning of 2006, thanks to a significant acceleration in labour demand. ISAE foresees, after two negative years, a better labour units trend in 2006 and in 2007 (+0.7% in each of the two years). However, that dynamics betrays the smaller effects of the labour market reforms adopted in the past decade, which had caused an abnormal employment evolution, particularly between 2001 and 2003, as against the economic growth of that period, together with productivity contractions. In the two years considered, the employment elasticity to GDP will be close to 0.5%, which is a high figure compared to the Italian standards, but is definitely below the values of the period 2001-2003 (when the average figure was above 2). The recovery of a positive dynamics in the labour market implies that the unemployment rate falls down to 7.4% in 2006 and to 7.1% in 2007.

With reference to wages, the wage dynamics for the two years 2006-2007 is based on the outcome of the wage bargaining rounds referring to the periods considered. According to ISAE, the *per capita* earnings of the whole economy will grow by 3.3% in 2006 and by 2.3% in 2007. Considering the contribution detaxations set in the Financial Law for 2005 and the productivity evolution, the unitary labour cost should grow by 2.4% in 2006 and by 1.8% in 2007.

The ISAE forecast envisages an inflation profile slightly more sustained in 2006 H2 compared to the average pace of H1. The impact of the oil price rises on energy bills should lead the dynamics close to 2.5% at the end of the year. In 2006, the average inflation should be worth 2.3%, which means 0.4% above the 2005 figure. In 2007, should oil prices in euro decrease, there might be a price dynamics slowdown. The average inflation for 2007 will be 2%, which is 0.3% less than in the previous years. On the basis of the harmonised index, the 2006 inflation gap compared to the euro area should penalise Italy by 0.1%. In 2007, also because of the impact on the European indicator of the VAT rise in Germany, the differential should be in favour of Italy by 0.2%.

The public finances

In 2006, the public deficit should remain substantially at the same level of the previous year. Compared to the GDP, there might be a General Government net borrowing equalling 4%, which is slightly below the 4.1% level registered in 2005. For 2007, thanks also to the effects of the recent additional financial manoeuvre, the deficit should grow by two tenths of GDP (assuming unchanged policies). That forecast on public finances is in keeping with the Economic and Financial Planning Document (DPEF) agreed by the Council of Ministers of July 7. In 2006, the ineffectiveness of the measures adopted in the Financial Law was partially offset by the additional measures of the Decree Law n. 223 of July 4 and by a larger-than-expected tax revenue flow. The correction included in the ISAE estimates mirrors the evaluations on the Decree in its original formula, namely a 1.4-billion-euro improvement deriving from a net revenue rise by 3.8 billion euros minus a net expenditure rise by 2.4 billion euros.

The ISAE projections for 2007 (with unchanged policies) assume a successful wage bargaining round (at least partial) for public employees and envisage a future evolution of capital account expenditure without considering the re-financing of contributions for the interventions of the State Railways and of the State Road Agency (ANAS). The estimates for 2007 include neither the effects of the correction measures which will be introduced with the next Financial Law, nor the impact of the development-prompting measures.

In 2006, the debt-GDP ratio should grow for the second year in a row, passing from 106.4% of GDP in 2005 to 107.5 in 2006 and to 108.4% in 2007 (assuming unchanged policies and considering no sales in the State real estate patrimony).

After eight years of contractions in a row, the primary surplus will grow in 2006, reaching 0.6% of GDP after the 0.4% of 2005. In 2007, the balance net of interests (without correction measures) should diminish again by 0.1% of GDP. Interests on debt – after decreasing for ten years in a row – should rise in absolute value in both years and will grow again as a percentage of GDP in 2007. The

interest on the Government debt, because of the estimated interest rate trend (the average tax rate on 12-month Treasury Bills should grow in the two years, passing from 2.2% in 2005 to 3.2% and 3.7% in 2006 and 2007 respectively) and because of the expected rise due to the debt stock, will remain at 4.6% of GDP in 2006 and then rise to 4.7% in 2007.

Risks for the Italian scenario

The risks dooming this forecast – as happens for the overall framework - are mainly connected to the international political tensions and to the oil question. The mentioned simulation of a long-lasting oil shock (with an oil price constantly at 80 dollars per barrel in the 1½ years considered) shows that the impact on the Italian economic growth is similar to that observed on the other productive systems. However, given the worse starting point of the Italian economy, the final effect hampers any prospects for development, with a larger negative impact on the public finances compared to other countries. In particular, the oil price rise should slow down the GDP dynamics in Italy, falling short of 0.1% in 2006 and of 0.2% in 2007 compared to the baseline scenario. This means that the Italian development should diminish to about 1% in 2007. The inflation impact, hence the impact on consumption, should be more serious than in other economies. With reference to the public finances, the deterioration of the macroeconomic framework means a heavy burden in 2006 H2, with a harshening in 2007. In particular, the negative impact on the Italian public finances (a deficit above 0.3% of GDP) should exceed the expected average impact in the euro area, because Italy is more exposed to the interest rate rise caused by the inflation rekindling.