ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Forecast on the Italian Economy

Synthesis

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CREDITS

The present Report is the result of the team work of a wide group of researchers coordinated by Sergio de Nardis. In particular, texts have been written by Roberto Basile, Maurizio Bovi, Cristina Brandimarte, Sandro Calabresi, Tatiana Cesaroni, Mauro Costantini, Enrico D'Elia, Roberta De Santis, Marco Fioramanti, Flora Fullone, Alessandro Girardi, Andrea Imperia, Marco Malgarini, Massimo Mancini, Marianna Mantuano, Maria Cristina Mercuri, Chiara Oldani, Carmine Pappalardo, Daniela Rossi, Franco Sartori, Riccardo Scarpulla (Ministry of International Trade), Luisa Sciandra and Claudio Vicarelli..

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Synthesis

The positive phase in global development continues

The world economy is going through its strongest expansionary cycle since the mid-1970s. This positive phase does not seem likely to end during the time considered by this forecast, namely the next 18-24 months: stable global growth of 4-5% for a five-year period has not been seen in the past thirty years. The main players on the international stage have increased, and the progressive geographic expansion of development has off-set the American slowdown through the stimuli arising from the other large areas and greater European and Asiatic intra-regional trade. Europe has recovered beyond expectations, after the disappointing start to 2000, evincing the possibility that productive capacity may increase beyond what most analysts believed possible only a few months ago. The large rapidly developing countries – China, India and Russia – are imparting, each in its specific way, decisive impetus to world demand and furnishing new opportunities for the internationalisation of the productive system of the advanced economies.

But financial market uncertainty grows

In parallel with these positive real trends, there has been mounting uncertainty in international markets. Concerns that the recent prolonged period of moderate inflation has come to an end have induced central banks to restrain expectations by planning further rises in Europe, and instead by postponing cuts in the United States. As a consequence, the slope of the American profits curve, has, after a long time, normalised and begun to turn upwards: the likelihood of a recession in the North-American economy, inferable from the differential between long and short-term rates, has notably diminished.

Scant repercussions for the real economy

By contrast, operators are worried about a private-sector credit squeeze, especially in the United States, where household mortgage conditions have worsened mainly because of more rigid standards applied in the lower-quality segment. In a macroeconomic context dominated by the large imbalance in American current accounts, and in markets where the weight of high-risk derivatives had reached exceptional proportions, the increased fear of losses on securities linked to subprime mortgages triggered by announcements of rating downgrades have led to a further fall of the dollar against most other currencies. The 'shift to quality' accompanying these movements has further increased longer-term risk premiums.

Another – largely independent – source of volatility is the trend in oil prices. With diminished stocks of refined products in the USA, and supply management by the oil-producing countries intent on not accommodating short-term demand fluctuations, strong international geopolitical instability has recently generated new price rises: Brent crude rose to over 77 dollars in concomitance with a worsening situation in Nigeria.

It seems unlikely that these uncertainties, which to various extents have intensified in recent weeks, will derail global expansion. The spikes in oil prices should subside, as they have on other occasions in the recent past (consider what happened during the Israel–Lebanon crisis a year ago), once their contingent cause has passed. However, this does not imply a substantial fall in the price of crude oil, which will continue to remain at historically high levels, reflecting a market structurally unfavourable to buyers owing to the effect of the fundamentals (persistently dynamic demand which pressurizes rigidly controlled supply). We expect the price of Brent crude – more than 70 dollars in the third quarter – to drop slightly over the last three months of the year, settling at a 67-dollar average for this year and a 65-dollar one in 2008: quotations which, in light of recent experience, can be absorbed by the consumer countries without repercussions on growth.

Exchange rates and interest

Greater doubts concern the dollar exchange rate. The issue is whether or not the recent downturn implies a base adjustment, with a barrier of resistance breached and transition to a stable band of oscillation against the euro whose margins consist of levels more depreciated than those of recent months. It is likely that the exchange rate has been pushed close to the ceiling of the current fluctuations band by a combination of events influencing the expectations of uncertain operators about whether the Federal Reserve intends to reduce interest rates to counter the risk of a credit squeeze. In this climate of high 'sensitivity', any report on economic trends may cause spot quotations to oscillate in one direction or the other.

We tend to rule out the likelihood of an imminent monetary slowdown in the USA. The credit crisis seems restricted to a minority portion of the mortgage market, and for the time being there are no signs that credit rationing will be extended either to households with normal risk characteristics or to the business sector. The American monetary authorities will therefore probably continue to focus this year on curbing inflation and the expectations of operators. On this forecast, the rate on federal funds will remain stationary in the second half of 2007. Reductions may be decided in the first six months of 2008, with a couple of quarter-point adjustments raising the interest rate to 4.75%, presumably followed by stabilisation.

In Europe, in a situation of growing domestic demand, the ECB may increase official rates further by the end of 2007 and in the first months of 2008. This would result in a 4.25% rate at the end of this year and 4.5% one in the first quarter of 2008.

In this context, exceeding the 1.37 threshold for the dollar/euro exchange rate is, we believe, a temporary episode. We expect in particular that the dollar will remain at relatively low rates during the third quarter but will gradually recover in concomitance with the recovery forecast for the American economy and consolidation of an American monetary stance anchored to countering the risk of inflation. For the current year, the average rate will be around 1.34; in 2008, we forecast an average rate of 1.33 dollars per euro over the year.

The possibility of a weaker dollar

Whilst this is the working hypothesis that the ISAE regards as most likely to come about, one cannot rule out that recent fluctuations are not more persistent phenomena. Operators, with their uncertainties on credit risks and future manoeuvres by the monetary authorities, may for a relatively long period of time prefer to adhere to weaker dollar exchange rate positions. In 2008, this would shift a certain amount of Europe's growth to the USA through variations in net foreign demand. According to simulation exercises (see below), this eventuality would not compromise the positive development expected for the euro zone, which is mainly centred on revival of the domestic components of demand.

The overall indications are therefore favourable. In the United States, after a greater-than-expected slowdown in the first three months, economic activity should strengthen markedly in the second quarter. On the other hand, further decreases in house prices and rising mortgage interest rates may induce greater caution in household spending, which to date has shown no signs of retrenchment. At the same time, profitability conditions remain positive, and those of the cost of capital use are extremely favourable, with beneficial effects on investment. On average over the year, GDP should increase by 2%, with an acceleration during the last months of 2007. In 2008 economic activity would increase by a 2.6%.

Positive cycle in the euro zone

In the euro zone, confidence climate indicators stand at high levels for both companies and consumers, while labour-market conditions have constantly improved over the past few months. The growth of economic activity appears to be driven especially by domestic demand via a marked acceleration in investments. After the slowdown at the beginning of the year, due the rise in German VAT, household consumption too should provide an appreciable impetus to growth. Investment spending is affected by the high use of productive capacity and the restructuring undertaken, to various extents, in the main European countries. Public consumption has been influenced by the increase in employment and the good climate of confidence among European households. According to our estimates, economic activity will maintain its favourable pace, increasing on average by 2.8% for 2007. Not to be excluded is that, if constantly sustained rates (similar to those of the first quarter) continue, GDP in the euro zone may rise even further, reaching the 3% threshold in the current year. In 2008, the European development rate will decelerate on average, owing to the statistical profile of the GDP dynamic, albeit in the presence of significant quarterly trends; we foresee a growth rate of 2.4%. Estimates of potential development suggest, after the fall-back of the last decade, that European performance will approach that of the United States.

Consequences of euro appreciation

If this is the situation with an average 1.33 dollar/euro exchange rate over the next year, what would happen in the case of a stronger exchange rate? To determine the consequences of this eventuality, it was hypothesised that, rather than diminishing during the last three months of this year, the dollar/euro exchange rate reaches an average value of 1.40 – imagined as central in a new, more ‘devalued’ fluctuation band – and remains at this level for the whole of 2008 (with a strengthening of the euro against the dollar of about 6% with respect to the initial scenario). The simulation showed a rate of GDP increase in 2008 which was three-tenths of a point lower (with respect to the base). This reflected a deterioration in net foreign demand and investments which would more than off-set the increased consumption stimulated by the improved terms of trade. The effects on growth may be more limited if the ECB reacts in time by modifying its interest rate strategies (nominal and, above all, real) in response to the worsening of monetary conditions brought about by the high exchange rate.

Robust trends in other economies

With regard to other areas and economies, early 2007 saw particularly robust dynamics in Japan and continuing very high development rates in China and India. Notwithstanding conjunctural downturns in Latin America and various Eastern European countries, the outlook is that the emerging countries will continue to contribute crucially to international growth. Gross global product, which increased by 5.1% in 2006, will rise by 4.7% and 4.6% in this year and the next respectively. World trade, with an elasticity to global economic activity close to the values of the past few years (1.6-1.8) will increase by about 7% in 2007. Potential demand for Italian goods may increase to a greater extent, reflecting the stronger growth of European outlet markets. In 2008, trade could, as an annual average, accelerate (+7.6%) owning to a strengthening of the US dynamic and good European and Asiatic resilience.

Slowdown of the Italian cycle in early 2007

The Italian economy's slowdown in early 2007 in contrast to a positive Europe-wide trend prompts the question of whether Italy's productive dynamics are again falling behind those of its partners in the euro zone, as they did in the first half of this decade. Our reply with this forecast is that the loss of velocity of the first months of the year should be interpreted as a settling-down phase amid still favourable overall trends – though more moderate than those of 2006. The prolongation of recovery will be accompanied by certain strengthening of potential growth with respect to the very modest rates forecast in past years.

Final demand and inventory cycle

The deceleration in early 2007 reflected, on the supply side, a retrenchment of manufacturing after its strong jump of the previous year. On the demand side, the decrease in production activity was mainly due, according to three-monthly ISTAT data, to a specific negative cycle in inventories. Contrary to developments in the European partners, final demand net of stocks increased significantly in Italy during the first three months, more so than in the euro zone, where final expenditure, excluding the Italian economy from the calculations, weakened owing to a downturn in German consumption.

Stock accounting is notoriously imprecise and subject to frequent revisions. However, the good resilience of final demand satisfied mainly by products accumulated in warehouses seems confirmed, for manufacturing industry, by ISAE surveys as well, in that they signal a decrease in inventories since the end of 2006, after their inflation over the previous twelve months.

Operators confident, business buoyant

The fact that it was mainly a reduction in warehouse stocks that curbed Italian growth in early 2007 reduces the severity of the slowdown and may be a good sign for the future, even though confidence indicators are rather contradictory in regard to businesses and households. The overall situation is still positive with regard the former. Confidence was higher in the second quarter than in the first, and close to the peaks achieved in the second quarter of last year. Overall, aside from the highs and lows of the latter period, industrial confidence effectively ceased to increase midway through 2006 and substantially stabilised at the high values reached at that time. It is mainly the producers of investment goods that have maintained business confidence. This confirms, apart from the halt in the first three months, the favourable economic trends of this sector, which has also benefited from strong demand in Europe.

…consumers confused

More negative is the state of consumer confidence, which has dipped since the beginning of the year. While there is no strict link between the willingness to buy, measured by the confidence indicator, and actual spending (consumption surged in the first quarter of the year), the unfavourable trend requires more detailed examination of what lies behind the overall dynamic of the index in order to evaluate the braking effect on consumer spending. A decomposition of confidence shows that the negative trend at the end of last year mirrored a downturn in the components most ‘distant’ from the interviewees’ capacity for judgement (the future and the state of the economy) but was more positive in the case of aspects that they know better (the present and their personal circumstances): that is to say, the segment of confidence that probably has more influence on spending decisions. The uncertainty of Italian consumers about the external situation (although the phenomenon is not confined to Italy alone) is confirmed by *ad hoc* surveys conducted in recent months by ISAE on

FORECAST FOR THE ITALIAN ECONOMY: SUMMARY
(variations in percentages unless otherwise stated)

	2006	2007*	2008*
Domestic situation			
Gross Domestic Product	**1.9**	**1.9**	**1.8**
GDP not corrected for seasonality and working days	*1.9*	*2.0*	*1.8*
Import of goods and services	4.5	3.8	4.4
Export of goods and services	5.5	4.4	4.1
Household expenditure	1.5	1.8	1.7
General government and NPISH expenditure	-0.3	0.4	0.7
Gross fixed capital formation	2.4	3.2	2.8
GDP contribution to growth			
- domestic consumption	0.8	1.2	1.1
- total investments	0.5	0.7	0.6
- net exports	0.2	0.1	-0.1
- changes in inventories and valuables	0.4	-0.1	0.1
Retail prices	2.1	1.8	2.0
Basic prices	5.6	2.8	1.6
Per-capita earnings in the economy	2.8	2.5	3.5
Total employment (1)	1.6	0.4	0.8
Unemployment rate	6.8	6.4	6.2
Net general government deficit (as % of GDP)	-4.4	-2.5	-2.2
Primary general government surplus (as % of GDP)	0.1	2.3	2.6
General government fiscal pressure	42.3	42.8	42.6
General government debt	106.8	105.2	103.6
Interest rate on 12-month state bonds (2)	3.73	4.66	4.60
p.m. nominal GDP (millions of euro) (3)	***1,475,401***	***1,541,167***	***1,605,590***
International references			
GDP			
- World	5.1	4.7	4.6
- United States	3.3	2.0	2.6
- Euro zone	2.8	2.8	2.4
Dollar/euro exchange rate (level)	1.26	1.34	1.33
World demand	9.2	6.8	7.6
Official interest rates (2)			
- ECB	3.50	4.25	4.50
- Federal Reserve	5.25	5.25	4.75
Prices of raw materials in dollars			
- non energy	24.4	18.6	12.7
- energy	19.1	0.7	-2.4
of which: Brent ($/ barrel)	65.60	67.10	65.00

Sources: ISTAT, Banca d'Italia, ECB, Federal Reserve, FMI, HWWA.
* ISAE Forecasts; 2008 trend forecasts.
(1) In standard labour units.
(2) Annual end-of-term rates. Gross rate for state bonds
(3) GDP not corrected for seasonality or working days.

the statistical knowledge (entirely inadequate) and quantitative perceptions of inflation (abnormally high) of interviewees. Not surprisingly, operators who are already badly informed are all the more confused by the uncertainty generated by the recent economic policy debate on issues which crucially concern long- and short-term expectations (the state of the economy, public accounts, pension prospects).

Economic recovery

With regard to real trends, the most recent evidence indicates that industrial production, after a negative first four months, rose in May and fully recouped the shortfall of previous months. This development, however, is still rather fitful, so that the second quarter in manufacturing will be substantially stationary with respect to the productive levels of the previous three months. According to ISAE forecasts, industrial activity should resume its growth during the summer.

The ISAE synthetic anticipator index of economic activity also points to recovery in the next period. This indicator, which has recently weakened slightly, rallied during the spring, also forecasting the possible onset of a new growth phase in the summer.

An average 1.9% increase in GDP for 2007-08

Once the slowdown phase has passed, more buoyant average quarterly performances (about +0.5%) will be recorded in the second half of the year. Contributing to this will be the continuing support of domestic demand and confirmation of the recent better performance of exports. On average in 2007, GDP will be 1.9% (as in 2006) in the data net of working days effects; 2% if it is not calendar adjusted. In 2008, in a still favourable international context and with a tendential situation in public finances, the increase in GDP may be 1.8% (net and gross of the calendar effect). The nine-tenths of a point gap with respect to Italy’s partners in the euro zone in 2006-07 will reduce to six-tenths. The slight deceleration of 2008 on 2007 will essentially reflect the differing incidence of economic pull effects over the two years; the quarterly dynamic in 2008 will be above the average for 2007. A euro with a value against the dollar higher than expected in the base forecast (1.40 from the last quarter of 2007 with a circa 6% appreciation of the euro next year in respect to the reference scenario) may erode the dynamic of Italian GDP in 2008 by between two and three-four tenths of a point, depending on the more or less accommodating monetary policy adopted by the ECB.

Overall, the three-year period 2006-08 will be characterised by an average development rate of 1.9%, almost five times higher than that of the previous four years. The strengthening of growth for a several-year period may be accompanied by an increase in productive capacity, whose rate of increase may be between 1.3% and 1.5%, compared with the 1.6%-1.8% estimated in the mid-2000s.

Consumption

The development of the economy in 2007 and 2008 will stem mainly from the positive contribution made by domestic demand. Consumer spending (+1.8% in 2007 and +1.7% in 2008) will be stimulated by the improved purchasing power of households compared with two years ago. In the course of 2007, moreover, the propensity to spend may slightly rise again, after the upturn recorded in 2006, also as a result of incentives to purchase certain types of consumer durables and a good climate of household confidence.

Investments

A favourable contribution will be made by production investments (+3.2% this year and +4.1% next year) driven by the continuing requirements of company restructuring and competitive recovery and by the high degree of plant use. During the current year, investments in construction will benefit (+3.2%) from tax relief for restructuring and energy saving and then decelerate in 2008 (+1.5%).

Exports

The contribution of net foreign demand will again be positive in 2007 (as it was in 2006) and will be marginally negative in 2008. Exports will confirm their recently improved performance on international markets. The reorganisation of production processes and the shift of companies to quality product ranges less vulnerable to competition by the emerging countries will bring Italian sales abroad to more substantial growth rates. It will not be possible to prevent further erosion in the volume share of the market, which is to some extent inevitable at a time of growing integration into world markets of economies previously excluded from them. However, the loss of position by Italian goods will be much less than it was in the years of most acute competitive crisis (the loss in 2007-08 will be just over three points a year, compared to the 7-8 points of the first half of the decade).

Normalization of the labour market?

A salient feature of the Italian labour market in recent years has been the substantial increase in unit labour requirements for production, to the extent that the long recession of the first half of this decade saw none of the labour shedding which accompanied the recessions of the early 1980s and 1990s which, at that time, enabled companies to regain efficiency. In the first years of 2000, productivity was restored by using methods other than the mere workforce reduction, with large investments being made in corporate reorganisation (on this see also the ISAE Report, *Previsioni dell'Economia Italiana: l'Italia nell'Integrazione Europea*, March 2007). The increase in the labour/output technical coefficient of production has been the consequence of the lower cost (not so much explicit as implicit, i.e. besides that indicated by the statistical monetary costs) of the labour input consequent upon the flexibility reforms adopted in the last ten years. Although these are changes at the margin, they may have major consequences in a productive system traditionally characterised by high capitalisation and savings on a relatively 'costly and rigid' production factor. This change of regime has led to a substantial lowering of the unemployment rate and a rise in the employment and participation rates, notwithstanding the practically zero economic growth of the first years of 2000.

In the course of 2006, signs of change became apparent in this mechanism. Employment growth halted in the middle of the year, while the disequilibrium indicators (the employment and activity rates) ceased their improvement, despite the better conditions for growth. The dwindling of the effects of regularisation may have been influential, but something more structural may have occurred, since the slowdown also concerned the labour input measured in terms of standard units, which should, in principle, be free of the effects of the underground economy. Have the workings of the labour market returned to normality? It is too early to tell. That the unemployment rate has fallen to historically low levels, in some areas of the country especially, may indicate that substitution between production factors is close to the limit. If this is so, although at the moment we do not have sufficient evidence to be sure, account must be taken of two consequences. The first concerns reversal of the unsatisfactory trend in productivity, at least for that 'share part' which depends on production technique decisions: output per worker should resume its upward trend. The second consequence concerns the labour market, which notwithstanding the performance of recent years (extraordinary, given the zero growth conditions in which it has taken place) is still distant from the Lisbon targets. If there has been normalisation due to exhaustion in the effects of past institutional changes, the possibility of further raising the employment and activity rates depends, on one hand, on further reforms (different from earlier ones) aimed at reducing inactivity (not least by increasing the average education level of the labour force) and, on the other hand, by the possibility of staying permanently on a higher growth path (which would bring higher employment with it).

Inflation aligned with the euro zone

Our forecast for 2008 envisages attenuation of employment dynamics: standard labour units will increase by 0.4% this year and by 0.8% next year. Taking account of the trend in productive activity, the (apparent) elasticity of employment to variation in GDP will drop to a level (0.3) notably below that of the first half of the 2000s. The unemployment rate should fall to 6.2% in 2008, also owing to a slowdown in the growth of the labour force. In this framework, productivity (measured by value added per employee) will tend to grow.

After reaching its lowest levels of the past eight years (1.5%) in April-May, inflation should rise in the second half of this year. On average in 2007, the consumer price index will be 1.8%, three-tenths of a point less than 2006. The inflation rate should rise more substantially after the autumn, reaching a level above 2%. A certain slowdown may occur in the second half of next year, with an annual increase rate, first of 2% and then of slightly less. Therefore, in 2008, the average rise in consumer prices should be around 2%.

In 2007, the deceleration of the average inflation rate should be the same as that across the euro zone, which is subject to the upward pressures applied by various economies in the area. On the basis of indexes harmonised at European level, the increase in consumer prices should be 2%, with a reduction of about two-tenths of a point on 2006. In 2008, too, the Italian index, like that for the euro zone, should increase on average by 2%. The inflation gap will therefore be zero in both years of the forecast, as it was in 2005 and 2006.

Inflationary developments will also depend on the repercussions, in terms of cost reduction, of the laws to liberalise and simplify important service activities on some items of expenditure for households. In this regards, the trends of recent months are ambiguous: a fall in the price of medicines, although this is greatly influenced by the policy of the medicines regulatory board, and of communications;

containment of the increase in public transport; greater professional service provision.

Public finance

With regard to public finances, deficit forecasts are in line with those made by the national budget plan (DPRF): in ratio to GDP, the deficit will stand at around 2.5% this year (compared with 2.4% in 2006, net of extraordinary outlays), and then fall to 2.2% next year, in accordance with current legislation. In 2007, the balance will be four-tenths of a point higher than the base trend, as a consequence of the measures introduced by Decree Law 81, which partly mitigated the extent of the large-scale corrective measures adopted with the last budget. This has freed up resources for the central administrations, public-owned enterprises, and the pensions systems. Moreover, the positive trend in revenues (IRES, certain substitute taxes, and the indirect ones levied by the last budget manoeuvre, as well as the social contributions subject to increases in certain rates) may yield results in regard to the deficit even better than those foreseen, with positive repercussions on next year’s trends.

The primary surplus, which began to grow again in 2006 after decreasing for eight consecutive years, is forecast to increase further in the next two years: reaching about 2.3% of GDP in 2007 (from 2.2% in 2006, net of extraordinary items) and 2.6% in 2008. On average, for the three-year period 2003-05, net of interest it was 1.1% of GDP. The cost of servicing the debt will rise in absolute value for both years, owing to the expected trend in interest rates; in 2007, it will begin to grow again also as a percentage of GDP (to 4.8%), after having decreased for ten consecutive years, and then stabilise in 2008. According to the ISAE estimates, fiscal pressure will increase in 2007 by half a point (to 42.8%) owing to the effects of direct taxes and, above all, social contributions inclusive of end-of-service allowances (TFR); it will then drop (to 42.6%) in 2008, also owing to the effects of reducing the fiscal wedge. Net of the revenue deriving from the TFR manoeuvre, fiscal pressure will be less than four-tenths of a point in both years. The debt/GDP ratio should begin to decrease again in 2007 (to 105.2%, from the 106.8% of 2006), and again in 2008 (103.6%, based on current legislation).

If legislation remains unchanged, the deficit for 2008 should enable fulfilment of the target set by the Update of the Stability Programme presented to the European Commission last December, and therefore without having to undertake the net corrective manoeuvre of 0.9% of GDP foreseen by that document. Furthermore, the DPEF envisages spending measures which may be introduced in 2008, and which – amid current commitments, established practices, and possible new initiatives – would amount to just over 21 billion euro (1.3% of GDP) according to a preliminary assessment. In regard to only expenditure categories with policies unchanged, the magnitude would be about 11.3 billion (0.7% of GDP). According to the DPEF, the financial coverage of these outlays – in a so-called ‘gross manoeuvre’ increasing the tendential according to current legislation – should be forthcoming from savings on primary expenditure. This has been confirmed by the Prime Minister’s directive of 11 July concerning the procedure that ministries must follow in proposing changes to the current legislation, which explicitly states that primary expenditure in absolute values should remain unchanged, so as not to increase fiscal pressure.

This approach seems to be the correct one. However, in light of the past record of manoeuvres to curb expenditure, it appears highly unlikely that it will be possible to make savings on primary expenditures of a magnitude such that they cover the amounts estimated by the DPEF. Which suggests that some of the measures envisaged by the planning document, with change to the current legislation, will prove impossible to implement.