



ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

*Forecast on the Italian Economy*

Italy in the European integration

Synthesis

*MARCH 2007*

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## Introduction and summary

### *BETTER PROSPECTS*

2006 was a positive year for Italy. ISAE estimates for the next two years confirm that, providing the international situation continues to hold, the Italian system should abandon the ‘zero growth’ path to which it was confined during the early 2000s and may return to more robust annual dynamics – slightly below 2% – similar to those which characterised the second half of the 1990s. These are trends which in themselves were not outstanding, but not negligible either if one considers the period from which they originated and the fact that, given low demographic growth, they correspond to similar trends in the *per-capita* magnitudes. They may form the basis for a more decisive strengthening of the productive potential yielded by modernisation of those sectors of the economy and civil society which still resist the efficiency drive provided by international competition.

Forecasters had already envisaged an improvement in Italian growth potential, but – as often occurs at turning points and at times of complex restructuring – they underestimated the intensity of the recovery. If one reviews the trends in forecasts, one can see that at the beginning of last year, analysts (including ISAE) foresaw at most a 1-1.4% increase in economic activity for 2006; the estimate was raised in subsequent forecasting rounds, rising to 1.4-1.5% in the summer. Only in the predictions of the last months of the year were forecasts of increases of 1.7-1.8% made. Such underestimation did not concern Italy alone, but also the whole of Europe, which was still seen as lagging behind (adrift from, according to the most negative observers) the United States. The scepticism of most analyses concentrated, however, on Italy, and – besides the more or less sluggish growth predicted – ruled out, given the structural inertia which seemingly characterised the country-system, any possibility of adjustment unless profound economic policy reforms were undertaken (regarding human

capital, infrastructures, and liberalisation), all of which were conducive to development but would take time before they bore fruit.

However, an adjustment did in fact come about. It was spontaneous (that is, without the intervention of policymakers). It was driven by the forces of global competition (the market), it involved the sectors most exposed to foreign competition, and it was shaped in accordance with the structural characteristics of the economy (factors endowment, technological advantage, legacies from the past, institutional arrangements). Furthermore, it was achieved within a framework of trends in public finance that were better than feared, a finding which may also have implications for the potential long-term growth of the productive system.

During these years ISAE has sought to delve beneath the surface of Italy's disappointing macroeconomic performance, pointing out the weaknesses in the interpretative paradigm applied in explanation of the decline (Report of February 2005), providing evidence on the changes underway during the prolonged period of industrial crisis (Report of February 2006), and studying the characteristics of the atypical negative cycle of the first years of this decade to determine a turning point (identified in the first few months of 2005) in the phase of economic stagnation (Report of July 2006). In this report we continue further in this direction because we believe that the developments of the past few years – the complex process of adaptation to the Euro, global competitive pressures, and changes in the workings of the labour market – have complicated the interpretation of Italian events and have exaggerated the gravity (though present) of negative phenomena, such as the slump in productivity and the loss of competitiveness, giving rise to highly pessimistic predictions of the country's structural regression.

## **RESTRUCTURING**

***Cyclic recovery,  
but founded on  
restructuring***

The analysis is grounded on the observation that although Italy's recovery in 2006 (but already underway in the preceding year) may have been a cyclic phenomenon connected to European recovery and the return, after a long absence, of the German 'locomotive', it also finds explanation in the restructuring undertaken by manufacturing

firms over the past few years. The cyclic recovery has therefore been a feature shared by Europe as a whole; and it has highlighted the results of Italian adjustment.

Because the intensification of competitive pressures on our economy has been (almost exclusively) international in origin, the sector which has been forced to react, by adjusting and reorganising, is the one most exposed to foreign competition, namely manufacturing industry. We identify two main forces responsible for the Italian change induced by globalisation: China's entry into world markets and the introduction of the Euro (in the latter case this was globalisation 'close to home' but with maximum impact). While the effects of Chinese competition can be rapidly described, given that they unleashed formidable pressure for the crowding-out of low market-segment products in sectors of traditional specialisation for Italian industry, in the case of the Euro the repercussions appear to have been more complex. They have certainly required producers to adapt to the loss of the important tool of adjustment – much used in the past by Italy – constituted by the exchange rate. However, this has not been the only development. Integration, which culminated with the single currency, has been accompanied by various changes in Europe's economic landscape, exerting asymmetric effects on intra-area trade, in respect to which Italy has found itself in an atypical and, in part, relatively disadvantaged position. This has had some serious repercussions, notably on Italy's cyclic convergence on the dynamics of the Euro zone. Several chapters in the second part of the Report are devoted to these latter aspects.

***Transformations  
in industry***

Our purpose here is to describe the nature of industrial restructuring. Examination of the available data yields various essential characteristics which can be summarised as follows: 1) in contrast to earlier episodes of reorganisation (the beginning of the 1980s and the early 1990s), no overall labour saving has come about (employment in industry in the strict sense decreased by 0.6% a year compared with a 2.7% fall on previous occasions, in the presence of production downturns similar to those of the first years of this decade); 2) it has been inter-sectoral, accompanied by a certain retrenchment of traditional sectors (textiles, clothing, leather goods, footwear, furniture and household products), growth in other specialised sectors (mechanical engineering) and medium technological branches (food,

energy products, intermediate metal products, paper), and a further contraction of high technology; 3) it has also been intra-sectoral, bringing about, as in the past, with the growth of competition by low-cost countries, the demise of less efficient companies in the traditional industries, and the consequent shift of these productions to higher quality segments more sheltered against competition by emerging economies; 4) notwithstanding retrenchment of the sectors producing ‘Made-in-Italy’ consumer goods, there has been no change in the country’s specialisation model in regard to industrial partners, so that traditional branches in Italy, together with mechanical engineering and several intermediate manufactures, still have a proportionately larger role compared with Europe and other systems with a similar degree of development; 5) inter- and intra-sectoral movements have been accompanied by a recomposition of exporters, with turnover (the exit of several companies from foreign markets and the entry of ‘new exporters’) being particularly intense in both the sectors that suffered most during the competitive crisis of the early 2000s (cars, clothing, leather goods/footwear) and those with greater resilience on international markets (mechanical engineering), or those that have strengthened their competitiveness (metallurgy and metal products) and, furthermore, with several impacts on firms’ size, given that the new composition of exporters has mainly concerned large productive units, while ‘swelling the ranks’ (with the influx of new exporters exceeding the egress of the old ones) of small-to-medium sized firms.

Do these trends reveal a weakness in the type of restructuring undertaken by Italian industry? Given the limited reduction of employment, which has been reflected in decreased productivity, and the stagnation of the specialisation model, which seem to have given rise to continuing exposure to competition by emerging countries, one might be induced to reply in the affirmative: this has been fragile restructuring which does not eliminate the risks for Italy. In our opinion, however, the situation is otherwise, for various reasons.

**Efficiency  
factors and  
levers**

With regard to adjustment on the employment side, one should ask why Italian companies have not taken advantage, to increase productivity levels, of a labour market which in the current decade has been much more flexible than in the 1980s or 1990s, periods in which episodes of restructuring led to large-scale labour lay-offs (with great tension with the trade unions in one case and state intervention in the

other). In our opinion, this did not occur between 2000 and 2005 for two reasons. Firstly, labour – owing to moderation in wage demands and the reduction of labour costs made possible by flexibility – was no longer the factor that allowed savings on operating costs (as instead happened when, after years of complex industrial relations, they were ‘expensive’ or ‘rigid’). Instead, labour seems almost to have become a factor to be hoarded by firms (reducing, perhaps, its use at times of low demand), and therefore a resource to be used with greater intensity in production processes, in combination with other inputs. From this perspective, the downturn in productivity was in part the consequence of a technology change strategy to adjust factor mixes which reflected relative prices (explicit, and above all, implicit) for productive resources quite different from those of the current situation.

Secondly, in order to improve efficiency, the restructuring of the 2000s seems to have required action on aspects of the production system other than the simple cost reductions obtained by shedding personnel. Instead it has required measures regarding, on one hand, internal reorganisation for efficiency and the already belated adoption of new technologies (with complementary investments in technological innovations) and, on the other, the repositioning of product lines on higher quality segments, especially in the traditional sectors exposed to the low labour cost economies (with investments in intangible assets such as research, design, brand name, marketing etc.). In both cases the success of efforts by firms to recover competitiveness has not been determined by the percentage of dismissals, but by quality and the choices made by company managements: factors often neglected in macroeconomic analysis of the Italian situation.

Nor does assessment of the apparent inertia of the specialisation model in Italy tend to be negative. Firstly – as already underlined by the ISAE Report of February 2005 contrary to the view current at that time of the Italian model’s obsolescence – there do not exist, *a priori*, some specialisations that are preferable to others. If a given production structure matches the productive capacities of a country – and this seems to be the case of Italy, given that not even the impact of the large emerging economies has been able to undermine Italian industry in its traditional areas of comparative advantage – then that specialisation is the best one available. Under the given conditions, forcing resources to shift to industries considered better ‘in theory’ (because they are

***Is specialisation important?***

presumed, rightly or wrongly, to be more high-tech, with higher growth in demand, with more value added, with greater productivity, etc.) may be damaging to oneself and others (as well as being an undertaking at high risk of waste detrimental to the community at large). Secondly, the extremely polarised conditions of competitive advantages and disadvantages which characterise Italy in fact subsume a composite matrix of supply. From this perspective, specialisation indicators may be misleading, for they only measure a relative phenomenon: high specialisation in the fashion/household products value chain indicates that in Italy these sectors are 'represented' more than they are in the industrial partners: Italian output is, however, more diversified than one might be led to believe on the basis of these indicators. In conclusion, as the (surprising) Italian experience of lock-in in traditional sectors should have taught, what is important is the behaviour of firms, their capacity to innovate, to exploit the opportunities offered by internationalisation, to reorganise with new technologies, and to propose products different from those of their competitors able to count on labour costs that are a fraction of those in Italy. Therefore, for the purposes of competitive growth, the sector of specialisation or de-specialisation seems less important than the fact that in both cases the successful firms are those able to operate on the frontier of their productive capabilities. The relatively intense reshuffling of exporters, which the ISAE survey sample shows has affected several sectors, gives cause for optimism that in effect, even belatedly and problematically, there has been a movement in this direction.

### **CYCLE AND FORECAST**

**Essential facts  
of 2006**

The acceleration of economic activity in 2006 (+1.9%), with improvements in almost all sectors (except agriculture), is indicative of a return to a sustained growth path in industry in the strict sense, whose value added increased in volume by 2.8% in the seasonally adjusted data. It had decreased by 1% per year between 2000 and 2005 (-5.5% cumulatively). The rise in 2006 brought manufacturing activities to the average levels of three years previously, although it was still 3% lower than the peak of 2000.

The 'quality' of the recovery in industry in 2006 was backed by a revival of labour productivity. After increasing by 1% in 2005, value added per employee rose by a further 1.5% last year. More importantly, the rise in manufacturing productivity was concomitant, in 2006, with a significant recovery of industrial employment (+1.3% in terms of standard labour units), after five years of continuous decrease (although moderate in relation to the fall in productivity).

During the course of the year, the industrial cycle also displayed characteristics of growing diffusion. From the beginning of 2006 the recovery was also apparent in the fashion and furnishings sectors, which had suffered the largest downturn and which appeared to be late in showing signs of recovery. Between the end of last year and the beginning of this one, the spread of the expansionary phase, despite a slight reduction with respect to mid-2006, concerned 65% of manufacturing branches (out of 180), a percentage close to the values of the middle months of 2000.

In regard to spending, the main developments concern the dynamics of consumption and exports. Household costs began again to rise, being estimated at slightly more than disposable income, so that the fall in the propensity to consume that marked the five years between 2001-2005 was halted and showed a small rise last year. On the other hand, exports accelerated substantially, increasing by 5.5% – the largest increase since 2000. The revival of foreign sales certainly stemmed from the robust expansion of world trade (about +9.5%) and, in particular, from the recovery of intra-European trade. To be noted, therefore, is a first, partial slowdown in the erosion of Italy's market volume share, which, although it diminished, did so to a lesser extent than in recent years. The revival in foreign sales then generated an increase in investment expenditure and greater purchasing from abroad.

The acceleration of economic activity brought substantial improvement to the labour market. Employment, measured in terms of standard units, grew after two years of stagnation. This was driven both by the already-mentioned recovery in the industrial sector and by a large expansion of services. These dynamics led to a further reduction in the unemployment rate, which by the end of the year had fallen to 6.5%, and to the recovery, after a two year interruption between 2004-05, of gradual rises in the employment rate (to 58.5% at the end of

2006) and activity rate (to 62.9%). If one compares this ‘snapshot’ of the labour market with that of only ten years ago, the differences are striking: the percentage of the unemployed has almost halved, that of the employed in relation to the working-age population has increased by about seven points, nine points for women, and the participation rate has risen by five points. Certainly, with the exception of the unemployment rate, these figures are still distant from the European average, not to mention the targets set at Lisbon. They also subsume important new imbalances and dualisms between labour-market ‘insiders’ and ‘outsiders’ which raise various problems of no lesser complexity relative to, especially, the work entry of young people, their career advancement, and low pension prospects. However, one cannot fail to remark that something has changed profoundly in the Italian labour market and that this change has taken place notwithstanding a very modest period of growth. The two phenomena (increased employment and slower development) should not have gone together – unless one imagines large errors in their statistical measurement – without a change, such as that already mentioned for industry, in the relative economic convenience of the factors, and at the same time a substantial reduction in structural unemployment: aspects to which a chapter is devoted in the second part of the Report.

Inflation remained low in 2006, despite the strong pressures applied by the prices of energy products and the further fall in the unemployment rate. Foreign pressures were off-set by generally moderate domestic price increases: consumer prices recorded a rise of 2.1%, which was only two-tenths more than in 2005. In terms of the harmonised index, inflation was 2.2% and therefore in line, as in 2005, with the average of the countries in the ESM.

The year ended with public accounts in decidedly better shape than expected. Net public debt was 4.4% of GDP; excluding liabilities of an extraordinary nature (essentially the reimbursement of VAT on company cars and the cancellation of state credit with regard to TAV), the deficit has been notably reduced and now stands at 2.4% of product: a fall from the 4.1% of 2005. In the presence of a stabilisation of expenditure in ratio to GDP, the improvement was due to the very favourable dynamics of current revenue, estimates of which were repeatedly revised upwards in the course of the year. This expansion was linked to the economic recovery, the higher-than-expected yield

from various one-off taxes levied by the 2006 budget law, the effects of the campaign against tax evasion, and the (permanent) increase in the revenues yielded by the budget manoeuvre. The primary surplus was 2.2% (0.2% taking account of the extraordinary liabilities), returning to the levels of five years earlier. The debt/GDP ratio was 106.8%, six-tenths of a point more than the year before.

As mentioned at the beginning of this introduction, and as we have argued, the good results of 2006 do not constitute an isolated rebound after a long negative trend. Italy's prospects seem to set on a more stable and favourable path, and they may be further enhanced in the medium-to-long term if the spontaneous adjustment is combined with action to improve the quality of production factors (infrastructure, human capital, training) and greater openness to the push imparted by competition and the merit criteria in those sectors of economic activity (services, public administration, the professions) with little or no exposure to the influence of international competition.

Obviously of crucial importance for an open system like Italy's is the resilience of the global framework, which is subject to several risk factors mainly connected with the repercussions of the bursting of the real-estate bubble in the United States and the possible interactions between segments of the American banking system with the increased volatility recently seen in various financial markets.

In the scenario assumed here – which is substantially in line with that envisaged and adopted by international bodies – there will be no traumatic episodes of world economic breakdown. It is presumed that the critical elements present in the current situation can be governed, on the one hand, by shrewd action on the monetary policy levers of the main economies, and on the other, by virtue of the favourable incidence of various drivers of the international conjuncture.

The evolution of crude oil prices, which are lower than those forecast several months ago, should have curbed the risks of a slowdown by moderating inflation in importing countries and supporting consumer spending (in the US in particular). We foresee the price of oil as standing at around 57 dollars per barrel on average in 2007 (13% less than in 2006). In 2008 the price will remain substantially unchanged around the previous end-of-year levels (56 dollars). This forecast 'mediates' among the oil fundamentals, which would push the price even lower than that forecast, and the permanent

**Forecasts for  
2008**

**The  
international  
framework**

**Oil**

factors of geo-political tension which act in the reverse direction. If the tensions become acute, oil prices will naturally be affected, with the possibility of new peaks which, though episodic (like those of last summer), would still lead to average prices higher than those forecast.

**Interest rates**

In regard to monetary policies, we expect that the cyclic slowdown and the receding of the dangers of inflation (due to lower energy costs) will induce the Federal Reserve to adopt a more expansionary stance, reducing interest rates during the second half of the year to 4.5%, with further stabilisation in 2008. In the Euro zone, after the rise in March, in early summer the ECB will increase the marginal refinancing rate by a quarter of a point to 4%. The trends of the monetary aggregates, more than the evolution of the economic trend and the prospects of inflation, will induce the ECB to make this further correction. The phase of increases that began in December 2005 may be interrupted until mid-2008, when a new adjustment to 4.25% is forecast in light of possible European growth.

**Currency exchange**

In the currency market, the various cyclic stages undergone by the United States and Europe and continuing reduction in the differential in short-term rates between the two areas should give rise, in the course of this year, to a certain weakness in the dollar relative to the Euro, which will continue to oscillate between the 1.28 and 1.33 of recent months. On average in 2007, the dollar exchange rate has been 1.32. In 2008 a partial inversion of the dollar is forecast, with an average exchange rate of 1.29 with respect to the Euro.

**Global growth**

In this context, we expect, in 2007, a moderation of international growth after the acceleration of the previous year. The dynamics of 2008 will strengthen slightly, reflecting the substantially positive trend in all the main areas. In the United States, the slowdown already evident in 2006 should continue during the first half of the current year. On average in 2007 the increase in American GDP will be 2% (3.3% in 2006). The economic trend in the United States should strengthen next year (with a growth of 2.8%) due to the favourable external context and various moderate stimuli imparted by fiscal and monetary policies. Asia will continue to be the main engine of world development, being driven by the ever-greater expansion of China and India. Japan will take advantage of the region's strong dynamism, and being able to count on buoyant internal demand, will grow by about 2% in two years.

In the Euro zone, the strong acceleration of the last quarter of 2006 is likely to be followed by a slowdown of growth in the first part of the year. The increase of VAT in Germany, which in part slowed German consumption (although, presumably, less than feared), will contribute to the attenuation of economic dynamics. The confidence of European companies, which rose constantly for most of last year, diminished slightly in the last few months of 2006 and then stabilised at historically high levels at the beginning of 2007. This trend was influenced by evolution in the climate of confidence among German companies, which has recently decreased somewhat after the peaks of the winter.

We estimate that GDP in the Euro zone, after increasing by 2.8% in 2006, the best result since 2000, will increase by 2.3% this year, contrary to a first half of the year in relative deceleration. Growth may strengthen during the second half of 2007 and in the course of 2008, although in terms of average annual results the dynamics of 2008 will not be dissimilar from those of this year. Domestic demand components should continue to provide positive impetus for the European economy in both years as a result of improvements in the labour market, persistently favourable credit conditions, and good profit trends. International trade, after its intense expansion in 2006 (+9.4%), will moderate this year. However, it will still remain on a strong growth path (+7.2%), and will accelerate again in 2008 (about +8%) due to the conjunctural strengthening of the main economic areas.

The intense acceleration of the Italian economy at the end of last year will influence the results of 2007, with a very favourable pull effect for the current year. If production remains stagnant at the levels of the fourth quarter of 2006, this in itself will guarantee a 1.2% rise in GDP in 2007, that is to say, an increase close to that expected last autumn by forecasters, who judged it favourably given the previous period of very low growth. This 'inheritance' received in 2006 has evidently been a positive starting point; it has, however, been partly mitigated by the decrease in production which took place during the first months of the year.

***The Italian cycle***

The slowdown in the pace of expansion at the beginning of 2007 was presaged by the autumn halt in the rise which, for two years, had characterised the company confidence index; a stabilisation which

***A pause at the beginning of 2007***

followed a minor fall in the first few months of the year. The pause in the economic trend, as anticipated by qualitative indicators, was confirmed in January by a decrease in industrial production that largely off-set the notable peak of the previous month. These changes also probably reflected the influence of irregular factors that characterised the last month of the year. Inspection of the average for December-January shows that productive activity followed the positive but more moderate trend of the second half of 2006.

The downturn in January has therefore affected the average result obtainable for the first quarter. According to ISAE estimates, manufacturing output will be the same as, or marginally less than, the average of the previous quarter. Taking account of this fall-back, which is in part compensated by signs of good resilience by services, it is estimated that GDP at the beginning of 2007 will slow down the trend that marked the final part of last year.

**The  
consolidation of  
a still positive  
phase**

What appears to have been an abrupt slowdown in the first months of 2007 does not, however, herald the end of the Italian recovery. The international economic trend, although less dynamic, has continued along a positive path, especially in Europe. Furthermore, the industrial confidence index, whilst increasing, stood at historically high levels at the beginning of 2007, evincing a consolidation of the favourable production levels achieved. Moreover, household confidence continues to rise, as it has done for several months, confirming the recovery which started in 2004 after the marked downturns of the early 2000s. The persistence of favourable growth prospects for the Italian economy is signalled by the forecast indicator elaborated by ISAE, which, after a pause in September-October (presumably anticipating the deceleration at the beginning of 2007), began, between the end of last year and the beginning of the current one, to move upwards once again.

**Forecast 2007-  
2008**

Overall, after a certain sluggishness in the first part of 2007, we expect production to start increasing again at a more lively pace. The growth of GDP could therefore be, for this year, 1.8%, net of the calendar effect, with a reduction in the development gap from the Euro zone amounting to between nine and five tenths of a point. According to the raw data, unadjusted for working days (2007 has three working days more than 2006), the increase in Italian GDP would be 1.9%, and therefore in line with what was achieved in 2006.

In 2008, in a still generally favourable international context but with an uncertain domestic situation as regards public finances, the growth of GDP should be 1.7% (the calendar effect will not operate next year). The difference with respect to partners in the Euro zone will remain at around 5 tenths of a point. The slight deceleration of the 2007 trend with respect to 2006 will substantially reflect the differing incidences of the economic trend drivers over the past two years.

Overall, during the three years between 2006 and 2008, the Italian economy will achieve an average development rate of 1.8%, a sizeable acceleration relatively to the four previous years (+0.4% between 2001 and 2005) and close to the average dynamic of the second half of the 1990s.

The evolution in 2007 and 2008 will be driven mainly by the positive contribution of domestic demand, as well as by consumption components and investments. The trend of private consumption (+1.6% this year and +1.4% in 2008) should exhibit the positive effects of increased disposable income due to good labour-market performance and increased per capita earnings. The improvement in the terms of trade caused by the reduction in oil prices and appreciation of the Euro will contribute in 2007 to the increase in the consumer purchasing power. The recovery in household confidence should lead, during the current year, to continuation of the slightly more favourable trend in the propensity to spend which began in 2006.

***Stimulus of  
internal demand***

With regard to investments, after the acceleration at the end of 2006 the trend should remain positive, being affected by the persistent need for company restructuring, the favourable economic trend, and improved corporate profitability. Also tending in this direction are the findings of ISAE surveys on the extent of plant use, still at historically high levels at the beginning of 2007, and, at the same time, the lower obstacles to production due to low demand. Overall, fixed gross investments should increase by 3% in 2007 and 2.8% in the following year.

With regard to foreign demand, the available economic trend indicators signal, after the notable surge at the end of 2006, lesser dynamism in exports during the first months of the year. According to ISAE estimates, once the pause at the beginning of 2007 has passed, exports should confirm their improved resilience on international markets recorded last year. Foreign sales should increase by 4.5% in

***The loss of  
exports share  
will decrease***

FORECAST FOR THE ITALIAN ECONOMY: OUTLINE SUMMARY  
(% variation unless specified otherwise)

	2006	2007*	2008*
<b>Domestic situation</b>			
<b>Gross Domestic Product</b>	<b>1.9</b>	<b>1.8</b>	<b>1.7</b>
<i>GDP not adjusted seasonally or for working days</i>	1.9	1.9	1.7
Imports of goods and services	4.5	4.0	4.4
Exports of goods and services	5.5	4.5	4.4
Household expenditure	1.5	1.6	1.4
General government and NPISH expenditure	-0.3	0.1	0.6
Gross fixed capital formation	2.4	3.0	2.8
Contribution to the growth of GDP			
- national consumption	0.8	1.0	1.0
- total investments	0.5	0.6	0.6
- net exports	0.2	0.1	0.0
- changes in inventories and valuables	0.4	0.0	0.1
Consumer prices	2.1	1.8	2.0
Production prices	5.6	1.9	1.4
Per-capita wages and salaries	2.8	2.1	2.7
Total employment (1)	1.6	1.0	0.9
Unemployment rate	6.8	6.4	6.0
General government expenditure (as % of GDP)	-4.4	-2.3	-2.4
General government primary surplus (as % of GDP)	0.2	2.5	2.3
General government fiscal pressure	42.3	42.6	42.4
General government debt (as % of GDP)	106.8	105.6	104.6
Interest rate on 12-month state bonds (BOT) (2)	3.73	4.20	4.60
<b>p.m. nominal GDP (millions of euro) (3)</b>	<b>1,475,401</b>	<b>1,536,938</b>	<b>1,599,858</b>
<b>International references</b>			
GDP			
- World	5.1	4.5	4.7
- United States	3.3	2.0	2.8
- Euro zone	2.8	2.3	2.2
Exchange rate dollar/euro (level)			
World demand	9.4	7.2	8.1
Official interest rate (2)			
- ECB	3.50	4.00	4.25
- Federal Reserve	5.25	4.50	4.50
Raw materials prices in dollars			
- non energy	19.2	14.0	7.4
- energy	19.1	-11.7	-1.4
of which: Brent (\$/ barrel)	65.60	57.00	56.00

Source: ISTAT, Banca d'Italia, BCE, Federal Reserve, FMI, HWWA.

\* ISAE forecasts; 2008 trends.

(1) In standard labour units

(2) Annual end of period rates; gross rate for BOT.

(3) *GDP not adjusted seasonally or for working days.*

2007. Taking the enlargement of Italian markets into account, the erosion of the market volume share in outlets for Italian goods will be only 2.5 percentage points: a marked improvement, therefore, with respect to 2006 (about 5 points) and, even more so, with respect to the competitive crisis of previous years (a 7-8 point reduction in 2004-05). In 2008, exports of goods and services should increase by 4.4%. The reduction in the volume share, in ratio to the enlargement of the market for Italian products, will be about three points, confirming the less negative performance of the recent period.

The good performance of the domestic economy and the still positive export dynamics (demand component with a high imported inputs requirement) should influence the evolution of Italian purchases from abroad. According to ISAE estimates, imports will increase by 4% this year and by 4.4% in 2008. Maintaining the import volume lower than exports should guarantee, in 2007, a still positive contribution of foreign demand net of GDP variations. Next year, this contribution will instead peter out as a consequence of substantial alignment in the growth rates of the two trade flows.

The favourable employment dynamic will continue in 2007 and 2008. In terms of standard units (SLU), the labour input will increase by 1% this year and by slightly less (+0.9%) the next. Considering the trend in productive activity, the (apparent) elasticity of employment to GDP should have a value (0.53) lower than that of 2006 (0.84) but still historically high. The unemployment rate will continue to fall and will average 6% in 2008, a level close to that recorded in the second half of the 1960s. The reduction will take place amid wage pressures (2008 is a year of agreement renewals), but without this giving rise to economic overheating. In other words, it seems likely that the Italian economy will maintain wage moderation even in the presence of a historically low unemployment rate. This is essentially the result of the significant decrease in 'equilibrium' unemployment' due to greater flexibility in the Italian labour market and the consequent greater elasticity on both the labour demand and supply sides..

***The labour market***

With regard to pay, the forecasts for the two-year period 2007-08 are based on the pay levels stipulated by existing agreements and the new bargaining rounds which will mainly take place next year. According to ISAE estimates, per capita earnings will increase in the economy as a whole by 2.1% in 2007 and by 2.7% in 2008. The cost of

labour per unit produced, also reflecting the relative increase in productivity, will slow down this year, with an increase of 1.3%. In 2008 slightly more sustained pay dynamics will raise the unit cost of labour to 1.9%. The trend in industry in the strict sense will lie below these increases because a substantial increase in productivity will offset wages higher than the average for the economy.

**Inflation**

According to ISAE forecasts, the fall in energy prices will keep inflation at moderate levels. This decrease in the pressures applied by fuels will be matched, in fact, by a resumption of the price dynamic of the main base components, as an effect of a more intense knock-on effect of past higher intermediate costs favoured by a better economic trend. On average in 2007, inflation will decrease to 1.8%, which is three-tenths of a point less than the previous year. In terms of the harmonised index, the variation in prices will be slightly higher, but still lower than in 2006 (1.9% compared to 2.2%), with a difference with respect to the Euro zone that should be, albeit marginally, unfavourable. In 2008 inflation will be slightly higher, reflecting the acceleration of unit costs in a relatively robust economic climate. It will average 2%, two-tenths higher than in 2007. Also in terms of the harmonised index, the increase in prices could be 2%, with a gap with respect to the Euro zone which will diminish to zero.

**Public finance**

After the improvement recorded in 2006, favourable trends will continue in the public accounts during 2007-08. The public sector deficit should this year remain at around the levels of 2006, falling slightly to 2.3% of GDP, then returning to 2.4% in 2008. The more positive situation of the public finances has been accompanied by historically high fiscal pressure (only in 1997, the year of evaluation for admission to the Euro zone, was the pressure higher). These levels have also been sustained by 8-10 billion of additional resources deemed by the government to be structural, of which 7.5 should ensure permanent adjustment in 2008. For the current year, ISAE forecasts prudently take account of several cautionary factors, with the impact of the budget manoeuvre revised in light of last year's results. In particular, not accounted for is the income which should derive from the reform of law on taxing income from stock transactions, because the time required for the law's approval is uncertain. Furthermore, revenue lower than the official figures cited in technical reports is calculated to derive from measures to combat tax evasion. This is done

to avoid duplication of yield already incorporated into the trends if, as seems likely, part of the favourable evolution of the revenues in 2006 has been due to an improvement in tax compliance brought about by the measures introduced. In conclusion, given the small amount of certain expenditures in 2006, with a large reduction recorded by the state, more dynamic expenditure is expected in the current year, especially as regards state and local government investments.

In 2008, given the economic trend with the consequent trend in revenues, and owing to the absence of a 'one-off' levy and the permanent nature of the adjustment measures adopted in the last budget, public administrations could record, as said, a deficit in ratio to GDP slightly higher than that of 2006.

The primary surplus should amount to 2.5% of GDP this year (from the 2.2% of 2006, net of extraordinary expenditure) and fall to 2.3% in 2008. Interest costs will grow sizeably in 2007, rising to 4.8% of GDP (from 4.6% in 2006), and fall slightly in 2008.

The debt/GDP ratio should diminish in the two years, thanks to a decrease in public sector spending requirements from the 106.8% of 2006 to 105.6% in 2007, and 104.6% in 2008.

## **ITALY IN EUROPEAN INTEGRATION**

The restructuring phase undergone by Italy during the early 2000s, as discussed above, was a response to the formidable competitive challenges that arose in the second half of the 1990s and the beginning of the current decade. Much has been written about the effects on Italy of 'great' globalisation (the entry of China and other emerging countries into the world market) in micro and macroeconomic analyses. The repercussions are well known, and we have now also begun to understand the reaction of Italian producers. Less studied is 'small' globalisation – that realised by Italy with the other economies in the Euro zone. The adjective 'small' is used only to indicate that a phenomenon took place 'close to home' among countries which already shared a highly important path of commercial and productive interdependence, as well as (from 1993) common institutions and legislation on many aspects of economic activity. Nonetheless, the integration achieved in this case with adoption of the

single currency, maximum levels of intensity, has virtually eliminated all transaction costs in intra-area trade. Since the end of the last decade, for a producer in Lombardy, selling eight hundred kilometres to the south in southern Italy, or at the same distance to the north in Germany, should be the same operation from the point of view of transaction costs.

Analyses of the repercussions of the Euro have generally focused on two macroeconomic effects. The first of them, which is very positive for a high-debt country like Italy, is the acquisition of macroeconomic stability and elimination of the exchange risk premium (and perhaps also a reduction in the country risk premium) inherent to interest rates. The second is negative and is represented by loss of the exchange rate as an important adjustment instrument frequently used in the past by Italy to realign domestic costs with those of its competitors. An instrument which, had it been still available to the Italian economy would have been useless in adjusting the competitive imbalance with China, which has costs that are a fraction of those in Italy, but would have served temporarily to realign the competitiveness of Italian manufacturing with that of the more similar industrial economies, primarily those of Europe.

However, the experience of the single currency in its first years of operation had far more complex implications than those, though important, indicated in macroeconomic schemes. In the first phase after introduction of the Euro, several productive arrangements were redefined, and integration had different effects according to the countries and sectors involved.

At least initially, this may have amplified the differences among the systems involved in the more intense integration, so that economies were, on one hand, more exposed to specific shocks and, on the other, more liable to suffer the effects of a common shock in differing ways. This observation seems to apply in particular to Italy, given the increase in its heterogeneity with respect to its European partners consequent on both the changes that took place in the economic geography of the area and the differing effects of trade-creation produced by the single currency. The second part of this Report devotes several chapters to these topics, which may shed light on the features of the long adjustment phase traversed by the Italian economy.

That integration may increase the differences between a developed centre and a backward periphery, and also accentuate regional specialisations through the territorial agglomerations made possible by the elimination of transaction costs, is a possibility that has long been envisaged by new economic geography models and highlighted, especially by overseas observers, with reference to the centuries-long experience of monetary union in the United States. In the chapter entitled *Changes in European economic geography after the single market and creation of the monetary union: the situation of Italy*, we shall verify, based on the evidence furnished by a battery of statistical-spatial indicators developed in the literature, to what extent these predictions of increasing differences are able to explain the European case. A first conclusion is that the core/periphery gap in Europe does not seem to have widened between the beginning of the 1980s and the first years of this decade. Indeed, economic activity has, to a certain extent, spread more to areas which originally seemed more peripheral. However, this process of extension has been mainly northwards (involving many Scandinavian areas and Ireland) and westwards (the regions of the Iberian peninsula). The south (in which the Italian *Mezzogiorno* is situated) has remained on the periphery.

**Changes in the  
European  
economic  
geography**

With regard to regional specialisations, in the time-span considered, the composition of European manufacturing output has undergone several important changes, with a loss of weight by industries such as textiles-clothing and, conversely, an increase in that of sectors like electronics. At the same time, there have been changes in the locational patterns of productive activities. In general, the forecast of increased specialisation by area seems to have concerned the food and beverages industry and textiles-clothing-footwear (with a consolidation of the so-called ‘monocentric configuration’). In the former case, monocentres have tended to arise in several Spanish and French regions. In the case of textiles-clothing-footwear, increasing concentration has been accompanied by a progressive polarisation in regions that were already highly specialised in these activities: that is to say, mainly the Italian ones, whose long-standing productive systems rooted in the territory seem to have made them the natural candidates for performing this ‘task’ in the new European division of labour. Furthermore, an electronics monocentre has also emerged in Scandinavian regions previously unspecialised in this type of production.

**The single  
currency and  
commercial  
integration**

Whilst changes in economic geography seem to have been accompanied by increased diversity of specialisation, asymmetric effects are apparent in regard to the impacts on intra-area trade of the introduction of the Euro. A body of literature developed between the end of the 1990s and the beginning of this decade maintained that adoption of the single currency would engender high growth rates (up to three times as high) in trade among the member states, implying the existence of a broad potential for interchange which had earlier not been 'exploited' owing to the segmentations and transaction costs linked to the numerous currencies used. Since then, various empirical studies have generally shown that the impact of the Euro on intra-area trade has instead been indeed positive but rather modest. The estimates presented in the chapter entitled *The effects of the single currency on trade in the Member States, the competitive position of Italy* quantify the increase in intra-area trade brought about by the introduction of the single currency at around 4-5%, which is a figure in the low range of the estimates (3-9%) conducted with similar methodologies. On the other hand, the limited effect should not come as a surprise given that the single currency is only the last step in an integration process which began fifty years ago.

What matters more is that the effect, however small, has concerned the various types of production in different ways. In particular, introduction of the Euro has had considerable consequences in terms of impetus to intra-area trade especially for sectors characterised by economies of scale and high product differentiation. As a consequence, the single currency has had different repercussions on the trade of the countries involved, depending on the most important type of commercial specialisation, average firm size, and the form of branch markets in the various economies.

The asymmetry is such that, for some types of goods and for some countries in the ESM, intra-area trade seems to have diminished after the advent of the single currency. This may be indicative of a geographic reorientation of export flows from the intra-Euro market to the external one: a (presumably temporary) effect of distancing from Europe and attraction to other areas. One of the most important cases seem to be the Italian textiles-clothing industry, which suffered a setback. A possible reason for this phenomenon may be a kind of redistributive effect linked to the limited creation of trade brought

about by the Euro. In other words, the beneficial effect of the impetus to intra-area trade was absorbed in its entirety by some sectors (those with decreasing returns to scale, horizontal differentiation of products, and medium-to-large firms), while it may have been detrimental to other sectors (which did not have the technological or firm-size characteristics necessary to reap the benefits), and which were therefore left behind in Europe-wide process.

Also presumably for this reason – and notwithstanding the support of intra-area trade brought by the single currency for other Italian sectors such as automobiles – Italy does not seem to be among the countries that has gained any significant commercial benefits, in terms of greater intra-European integration, from adoption of the single currency.

The evidence presented thus far sheds light on several aspects of European integration which, to some extent, may have left Italy ‘more exposed’ than other partners in the area to the competitive shock of the first decade of this century.

The changes in the productive geography shaped in some industries by the original specialisms of countries reinforced particular regional specialisations in the European division of labour. This is the case of the traditional sectors of Italian industry. On the other hand, the effect (generally limited) of intra-area trade-creation does not seem to have involved (owing to technological characteristics, firm size, and market structure) those traditional sectors undergoing relative consolidation in Italy. It is possible that the two phenomena, on the one hand, have increased the relative exposure of Italian industry (in relation to other European partners) to the shock generated by China and other emerging countries, without offering, on the other, the ‘compensation’ of the positive pro-trade effect of the Euro within the area.

In this situation, it would appear that Italy’s convergence to the European cycle has become more difficult than in the period prior the Euro. The chapter on *The European cycle in the years of integration: specificities of the Italian economy and industry* shows that in the second half of the 1990s European countries, and among them Italy, generally achieved a fairly high convergence in the components of the economic cycle (the correlation is between 0.6 and 0.8). This indicates that, in line with the evidence for the weak effect of commercial

**Convergence on  
the European  
cycle**

integration brought about by the Euro, most of the convergence between European cycles occurred before the advent of the single currency.

It is no coincidence that during the years straddling the creation of the Euro, there was no significant discontinuities in this situation. However, since 2001, generalised, albeit minor, downturns can be observed in the dynamic correlation of Italy with the main economies in the Euro zone. This evidence is further confirmed if the cycles of the various countries are purged of the common European component. The dynamic correlation between Italy's specific cycle indicators displays decreases in comparison to Germany and Spain and negative values in comparison to other economies (like Austria and Holland). Only in regard to France, for the period between 2003 and 2005, did the dynamics of Italy's specific cycle tend to increase.

**Changes in the  
Italian labour  
market**

One crucial feature of Italian adjustment in recent years has been changes in the workings of the labour market. Such changes, of course, have taken place in other European countries as well. However, in Italy they have been accompanied, as we have seen, by rather surprising macroeconomic results which are not found in other economies. The chapter on *Institutional changes and structural transformations in the Italian labour market* describes the emergence of important behavioural discontinuities in labour supply and demand taking the form of significant increases in the elasticity of wages and the real cost of labour to variations in the unemployment rate. In other words, the labour-market actors (workers and firms) have grown more reactive to employment imbalances; a change which is giving rise to a reduction in the Italian structural unemployment rate.

The analysis also highlights that these changes have not taken place recently; rather, they occurred midway through the 1980s with regard to the labour supply and in the mid-1990s with regard to demand. However, these profound changes went unnoticed – the Italian and international literature of the mid-1990s was solely concerned to emphasise the rigidity of the Italian labour market – until when the Italian economy began to grow again, after 1995, and the unemployment rate began to fall steadily, from almost 12% to 6-7% of current levels: a decrease that came about without any overheating of wage demands and thus provides indirect evidence of the decrease in structural unemployment.

Inspection of the dates of regime change identified using econometric tests (the end of 1982 with regard to the labour supply, the end of 1995 with regard to demand) and reforms of labour-market legalisation and the bargaining system that took place in those periods reveals that industrial relations were affected by changes in the wage-setting mechanisms (the downgrading of the wage indexation mechanism at the beginning of the 1980s, abolition of the *scala mobile* (sliding scale mechanism) in 1992, and the Agreement of July 1993) and in the regulation of employment relationships and working time (especially in the mid-1990s). In general, harmonisation, the improved coordination of wage demands between companies and workers, and the introduction of concerted flexibility seem to be the institutional changes that have contributed most to increasing the elasticity of wages and the (real) cost of labour to unemployment.

It should be stressed, however, that the evidence presented does not imply undervaluation of the important labour-market reforms undertaken in the years following the regime changes identified in the chapter. These measures continued in the same direction as the first innovations and helped reinforce them. If they had not been introduced to implement past choices further, the changes in the elasticity identified in 1984 and 1995 would not have emerged. A further consideration concerns Italy's anomalous experience in recent years of increasing employment in a context of very modest growth. The analysis presented in the chapter signals an increase in flexibility and a consequent decrease in structural unemployment. But these elements alone do not explain the phase of growthless job creation of the current decade, which therefore appears to be a distinct phenomenon. It concerns, not the relationship between wages and employment, but the connection between the latter and economic growth. If low growth has not been followed by a similarly modest increase in employment – indeed the opposite has occurred – it is due to the Italian economy's apparent change from being a high capital-intensity system to a more labour-intensive one. The growth of flexibility is part of this mechanism to the extent that it is translated into a reduction of the implicit labour costs and therefore alters, together with lower explicit costs due to wage moderation, the relative economic convenience of the labour factor.