

INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

# ABRIDGED QUARTERLY REPORT

*forecast  
on the Italian  
economy*

*JANUARY 2001*

### **CREDITS**

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*The Report is based on the information and data available up to January 27, 2001.*

## **SUMMARY**

*After the strong acceleration of the first half of 2000, the world economy has considerably slackened in the late-2000 owing to the oil price increases and to the slowdown of the US economy. The Euro area too has witnessed a growth deceleration, though much less marked than in the United States. According to the ISAE forecasts, the world gross product should increase in 2001 by 3.5% -1% less than in 2000-, reflecting a significant deceleration in the first half of the year and a recovery in the second half. All major areas should witness a slower economic activity: the growth rate in the United States falls from 5 to 2.2%, while in the Euro area it goes from 3.3 to 2.8%. The year 2001 should thus mark Europe's outstripping the United States.*

*According to ISAE, the higher European growth compared to the US and the significant narrowing of the gap between the interest rates of the two economies favour the Euro strengthening, as the European currency tends to reach parity vis-à-vis the dollar by the end of 2001. The cyclical international weakening goes alongside with the tension easing on the oil market. The technical assumption underpinning the ISAE projection is an oil price at 25 dollars per barrel on average in 2001.*

*Italy follows the cyclical evolution of the Euro area, characterized by a smaller growth in the first half of 2001 and an acceleration in the second part of the year. The Italian GDP rises on average by 2.4% per year as against 2.7% in 2000. The slowdown reflects the contraction of net export contribution, due to the world trade deceleration and the disappearing of the stimulating effect of the Euro depreciation. Conversely, domestic demand significantly prompts growth, being influenced by the terms-of-trade increase and by the reduction of fiscal pressures on households and firms envisaged in the Budget law for 2001.*

*Employment, which significantly rose in 2000 (by 388,000 workers) owing to the positive cycle and to some market - flexibility introduced over the past few years, should follow a favourable trend in 2001 as well. According to the forecasts, the number of employed should grow by 450,000 units. The unemployment rate should continue to contract as well, reaching on average 9.8% in 2001 (from 10.6% in 2000).*

*The easing of external inflationary pressures should favour the slowdown of consumer prices during the year. This process is likely to fully emerge only since the second quarter of 2001, as the past increases in imported raw materials and the tensions introduced by the BSE crisis should still affect the first months of 2001. According to the ISAE forecasts, the average Italian inflation in 2001 should amount to 2.2%, while the figure for the Euro area amounts to 2%. The narrowing of the inflationary gap between Italy and its major European partners is therefore significant.*

*The public finance situation indicates that the reduction of the deficit-to-GDP ratio is still going on, confirming the diminishing trend indicated by the Stability and Growth Pact. In 2000, the General Government net borrowing equalled 1.5% (1.9% in 1999) and will fall down to 1.3% in 2001. These figures are slightly higher than the targets recently confirmed by Government in the updated Stability Programme (1.3% in 2000 and 0.8% in 2001). The differences are due to a weaker growth in the ISAE forecasts than in the Stability Programme and to a more pessimistic evaluation of some items of the General Government revenue and expenditure.*

## THE ITALIAN ECONOMY IN 2000 AND 2001

At the end of 2000, the world economy went through a strong slowdown. In spite of the brake experienced in the past few months, the average results of the international economic activity have been exceptionally favourable: in 2000 the gross product rose by 4.7%, the world trade of goods by about 11%. One has to go back to the mid-1980s to find similar figures.

These trends mirrored the brilliant performances of the main economic areas in the first half of 2000: the strengthening of the already-extraordinary US expansion, the rebound of the Asian emerging economies since the 1997-1999 crisis and the recovery of the Euro countries have prompted the international cycle up to considerable development rates. The only shadows in this framework were Japan's uncertain cyclical trend and the persistent threats of financial instability and macroeconomic difficulties in some emerging economies (Turkey, Argentina, Russia, Korea). All in all, the expansion of the world gross product in the first half of 2000 exceeded 6% on annual average.

*The  
international  
scenario*

Tab. 1 WORLD TRADE - VOLUME  
(percentage variations)

AREAS	IMPORTS				EXPORTS			
	1998	1999	2000*	2001**	1998	1999	2000*	2001**
<i>OECD</i>	6.6	6.8	9.3	6.1	3.9	4.5	10.2	6.5
Europe	7.1	5.1	8.1	6.2	4.9	4.5	10.5	7.3
Euro area (1)	7.3	5.4	9.0	6.8	5.6	4.7	11.5	7.6
United States	11.6	11.8	12.9	6.2	2.2	3.8	9.7	6.0
Japan	-6.0	6.3	8.8	6.5	-1.3	3.1	10.3	4.8
<i>NON OECD</i>	-1.7	1.9	14.9	11.2	5.0	5.9	12.9	10.0
Emerging countries	-2.2	3.1	16.0	12.0	5.0	5.9	13.3	10.1
<i>OPEC</i>	-4.0	-12.0	12.0	8.0	2.5	-3.0	7.0	5.5
Transition countries	2.0	-6.0	8.0	6.0	5.0	6.0	10.0	9.5
<i>WORLD</i>	4.0	5.3	11.1	7.7	4.2	5.0	11.1	7.6

Sources: IMF, OECD.

(\*) ISAE estimates.

(\*\*) ISAE forecasts.

(1) Excluding Greece. By including it - as it belongs to the Euro area since January 1, 2001 - the import/export growth for 2001 remains unchanged.

**Slowdown  
causes**

The acceleration grew alongside with a considerable sharpening of tensions and imbalances which eventually triggered a slowdown in the second half of 2000. In particular, international growth contributed to fuel the huge oil price rise, which peaked in November 2000 (32.7 dollars per barrel for the Brent), when it tripled compared to the (low) 1998 levels (about 10 dollars per barrel in the late-1998). The oil shock penalized the terms-of-trade of industrial economies and of those Asian emerging countries which are strong fuel importers, thus inducing an economic slowdown in those areas.

At the same time, in the late-1999 and in the early-2000 the US expansion reached unsustainable rates (about 6%, on annual average, in the second half of 1999 and in the first half of 2000, after 14 quarters of uninterrupted growth at the average rate of 3.9%), even when compared with a potential growth considerably reviewed upward (4% according to the recent OECD estimates). The "off line" growth of the American economy, fuelled by the strong private sector borrowing (about 6% of GDP, financed by foreign capital for almost 3/4), led the Federal Reserve to raise the official interest rates by 1.75 points between June 1999 and June 2000, facing a contemporary 1.2 point acceleration of inflation. The monetary squeeze contributed to determine a strong fall of share prices compared to the record values of early-2000, leading to a reduction in the stock exchange bubble, particularly in technological shares. The considerable growth in interest rates has also brought about a more sudden productive activity brake than expected, particularly in the industrial sector. The strong deterioration of the manufacturing activity, together with the fall in the operators' confidence indicators, have contributed to raise concerns on the dimensions of the US economy deceleration. In our estimates, the US GDP should rise by about 2.7% on annual average in the second half of 2000, and reach a quasi-standstill in the fourth quarter.

The slowdown of the past few months had an impact on almost all economic areas, particularly those strongly depending on US imports (Far East and many Latin American countries), which were immediately hit by the American slackening. In the late-2000, the Euro area witnessed a deceleration too, though to a lesser extent than in the United States thanks to a still-favourable trend of domestic demand components. In particular, the GDP of the Euro area rose by about 2.5% in the second half of 2000 on annual average, as against a 3.6%

increase in the first six months. In 2000, the Euro area growth rate should be about 3.3% on average.

Tab. 2 GROWTH AND INFLATION IN THE INDUSTRIALIZED COUNTRIES  
(percentage variations)

COUNTRIES	GROSS DOMESTIC PRODUCT (at constant prices)				CONSUMER PRICES (1)			
	1998	1999	2000*	2001**	1998	1999	2000*	2001**
France	3.2	2.9	3.2	2.9	0.7	0.6	1.8	1.6
Germany	2.1	1.6	3.1	2.6	0.6	0.6	2.1	1.8
Italy	1.3	1.4	2.7	2.4	2.0	1.7	2.6	2.2
Spain	4.3	4.0	3.9	3.3	1.8	2.2	3.4	2.8
United Kingdom	2.6	2.3	3.0	2.5	3.4	1.4	0.8	1.8
United States	4.4	4.2	5.1	2.2	1.6	2.2	3.3	2.7
Japan	-1.1	0.8	2.0	1.8	0.6	-0.3	-0.6	-0.2
Euro area (2)	2.8	2.4	3.3	2.8	1.1	1.1	2.3	2.0
Industrialized countries	2.8	2.9	3.8	2.4	1.4	1.4	2.3	2.0

Sources: IMF, OECD.

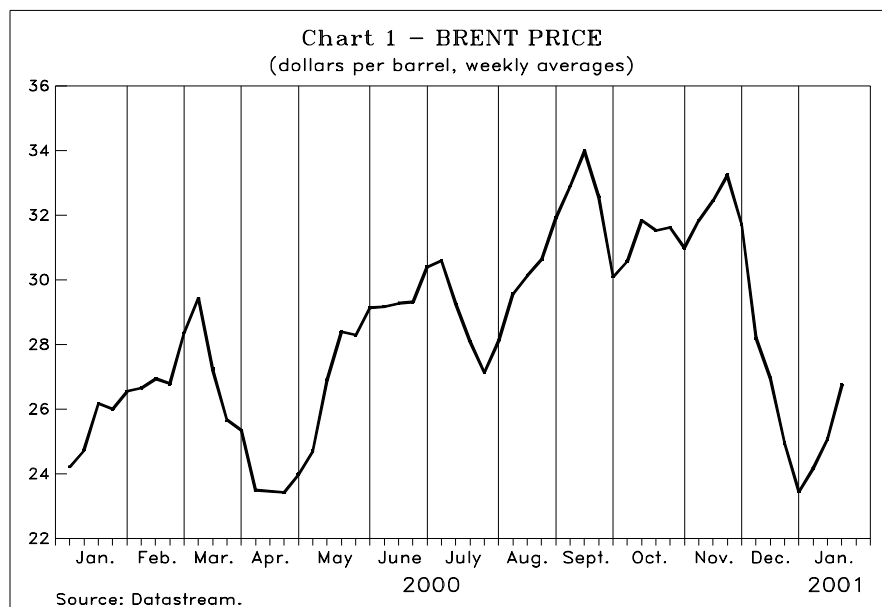
(\*) ISAE estimates.

(\*\*) ISAE forecasts.

(1) For the European countries, harmonized index.

(2) Excluding Greece. By including it - as it belongs to the Euro area since January 1, 2001 - the GDP growth for 2001 equals 2.9% and the consumer price rise (harmonized index) equals 2.1%.

Between the late-2000 and the early-2001, alongside with the **Oil and euro** strong slowdown of the US economy, other two major elements have



inverted their trends of the past twelve months. The oil price registered

a marked decrease, falling below 24 dollars per barrel at the end of December. The Euro exchange rate, prompted by the United States slowdown and by the concerns raised in early-January by the sudden half-point reduction in interest rates imposed by the Federal Reserve, rapidly gained about 13% in mid-January compared to the levels reached at the end of October. Those drastic variations in the oil price and in the Euro exchange rate were partially corrected in the following weeks owing to the OPEC production cuts and to some signals of cyclical weakening in Europe respectively.

***Italian economy***

The year 2000 marked a favourable period for the Italian economy as well. According to the ISAE forecasts, the Italian GDP increased by 2.7%, which is a significantly higher growth rate than the modest pace which had characterized the past few years (+1.6% on average in the period 1997-1999), but is still smaller than the Euro area figures. In 2000, the gap with the European partners narrowed, reaching 0.6 percentage points compared to 0.8 points registered on average in the three years 1997-1999. By taking France and Germany as benchmarks - two countries characterized by development levels closer to the Italian one -, the growth gap has substantially narrowed compared to the French economy (0.5 percentage points last year as against 1.3 percentage points on average in the period 1997-1999), while it has slightly widened compared to the German economy (0.3 percentage points as against an almost null differential in the previous three-year period).

As happened in the Euro area, the economic activity slowed down in the late-2000 in Italy as well, thus attaining - according to the ISAE estimates - a 1.9% annual growth rate (+3 % in the first half). The real income erosion caused by the strong oil price rise and by the Euro depreciation had a heavy impact on the second-half deceleration. On the top of it, there emerged a growing uncertainty on the general economic situation which, after the improvements witnessed in summer, has influenced the general confidence climate.

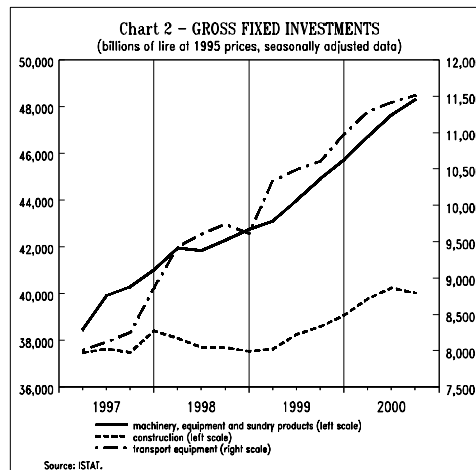
***Demand components***

The good results obtained in 2000 by the Italian economy on annual average drew benefits from both domestic demand components and net exports. The significant deceleration of economic activity in the second half of the year has been mainly caused by domestic demand, negatively affected by the terms-of-trade deterioration. Conversely, net foreign demand continued to support growth also in

the second half of the year thanks to persistently favourable exports.

According to ISAE, in 2000 the contribution of the overall domestic demand to the GDP growth equalled 2.1 percentage points. Total investments accelerated compared to the already-sustained growth rates of the previous two years. Households' consumption maintained a moderate pace. Among investments, machinery, equipment and transport equipment were particularly dynamic. The markedly-improved entrepreneurs' expectations registered in the first half of 2000, the incentives to invest deriving from the new capital taxation system and finally the high degree of capacity utilization had all a positive impact on the accumulation process. With reference to the third factor, it is worth noticing that firms' investments - though remaining mainly rationalization-oriented - were increasingly oriented to capacity enlargement. The ISAE surveys carried out in 2000 pointed to a supply bottleneck going alongside with a very dynamic demand. According to the entrepreneurs' evaluations, the main factors braking the 2000 production rise were not coming from insufficient demand, but from obstacles on the supply side, connected both to an extremely high degree of capacity utilization and to persistent difficulties - particularly in the Northern area - in finding workers with adequate skills.

Also investments in construction showed, on annual average, a considerable acceleration mirroring a recovery started in 1999. The positive evolution of investments in construction was influenced by tax reliefs for home restructuring, by the completion of the Jubilee public works and by the already-mentioned industrial firms' needs to enlarge their productive capacity.



In 2000, private consumptions rose more than in the previous year, thus reflecting a rise in households' uncertainty. The ISAE indicator of consumers' confidence climate - after considerably improving before summer and peaking in August - deteriorated in the following

months. That pointed to a worsening in the evaluations on the general economic situation, as well as to growing concerns for inflation and for the households' financial situations. Those unfavourable opinions seem to have been partially overcome in the latest evaluations. Indeed, the ISAE December and January consumer surveys show an improvement in the confidence climate, which in the early-2001 came back to the relatively more sustained levels of last October. Should this trend be confirmed in the forthcoming months, it might stimulate growth in the Italian economy.

In 2000, the households expenditure, though braked by uncertainty, increased more than the real disposable income, as had already happened in 1999, with a consequent further increase in the consumer propensity. Besides, a large share of Italian consumption was aimed at durables (cars, electronics, mobile telephones, home appliances, etc.). Maybe that behaviour was influenced by the expectations for a merely transitory disposable income reduction, partially offset by a contraction in the average saving propensity.

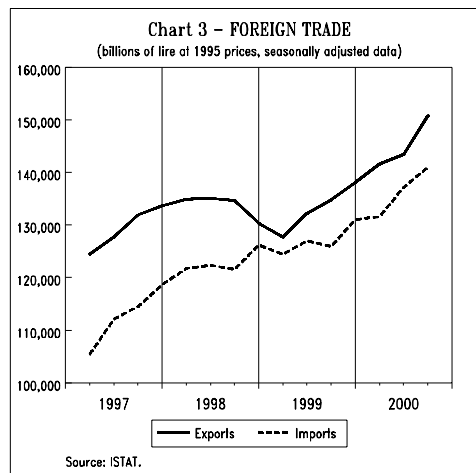
The generally favourable trend of the final domestic demand was partly offset in 2000 by a considerable decumulation of inventories (according to ISAE estimates, it equalled -0.6% of GDP). Both the high prices in lire of raw materials and of imported intermediate products and the above-mentioned difficulties of domestic supply to keep pace with a particularly dynamic aggregate demand (especially in the first part of the year) had an impact on inventories.

In 2000, the contribution of net exports strongly improved. This reflected the great acceleration of Italian exports of goods and services. In particular, growth in the former component, favoured by the Euro depreciation, was primarily prompted by sales on markets outside the EU (exceptionally high increases were observed in China, in the newly-industrialized Asian economies, in the United States, in Turkey, Russia and Eastern Europe). Instead, the growth of Italian exports towards the EU market was considerably smaller. Generally speaking, Italian goods recovered their positions on the international markets, after the almost uninterrupted contraction characterizing the second half of last decade. The market share increase reflected a strong gain on markets outside EU, while the competitiveness of Italian goods within the EU continued to deteriorate.

In 2000, service exports were particularly favourable, drawing

benefits from the improvement of "tourism", connected both to the competitiveness gain due to the Euro depreciation, and to the Jubilee. According to the ISAE estimates, the real net contribution of "tourism" to the GDP growth in 2000 equalled 0.2 percentage points.

In 2000, imports increased at a growing pace too, though they maintained a slower dynamics than exports. The recovery in the domestic economic activity strongly accelerated imports. As occurred in other phases of strong cyclic expansion, the elasticity to domestic demand of imports of goods and services in 2000 registered a



strong rise, which should be corrected in 2001. The import rise was mainly fuelled by foreign purchases of investment and intermediate goods.

In spite of the strong export recovery and of a slower import dynamics compared to exports, the year 2000 was characterized by a further deterioration of the foreign trade balance. The worsening was determined by the oil price rise and by the impact of the Euro depreciation on import prices. Hence, the terms-of-trade contraction more than offset the improvement of the net exports volume. Net of energy, the Italian trade balance reversed the negative trend characterizing the past few years. In particular, the surplus observed in the trade of manufactured goods - which had been decreasing between 1996 and 1999 - has grown again in 2000, particularly thanks to the strongly positive performance of the specialization sectors of the Italian economy (investment goods, textiles, clothing, shoes, leather, furniture, non-metallic minerals).

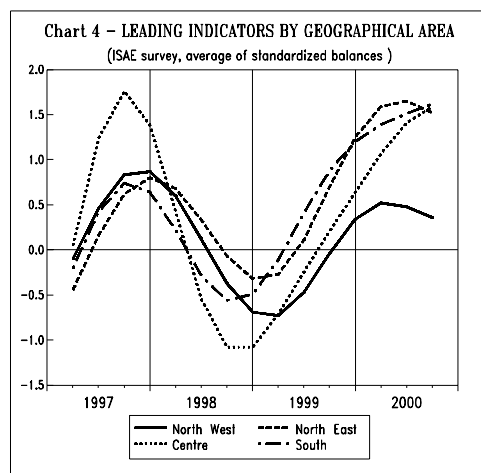
**Trade balance**

In sectoral terms, the Italian economic recovery of 2000 was fundamentally stimulated by private services (credit, insurance, professional services, software-related industries). The industrial activity strongly accelerated in the first half of the year and then stopped since summer, though it remained on substantially high levels. Construction registered a marked recovery in the first six months, prompting pro-

**Productive sectors ...**

duction in other construction-related sectors (mainly furniture), and then came to a halt in the second half of the year.

... and  
geographical  
partitions



With reference to the cyclical evolution observed at territorial level, the ISAE surveys point to homogenous trends in the main geographical Italian partitions in the acceleration phase marking the first half of 2000, and to stronger disparities in the slowdown characterizing the late-2000. In particular, the productive deceleration seems to have hit

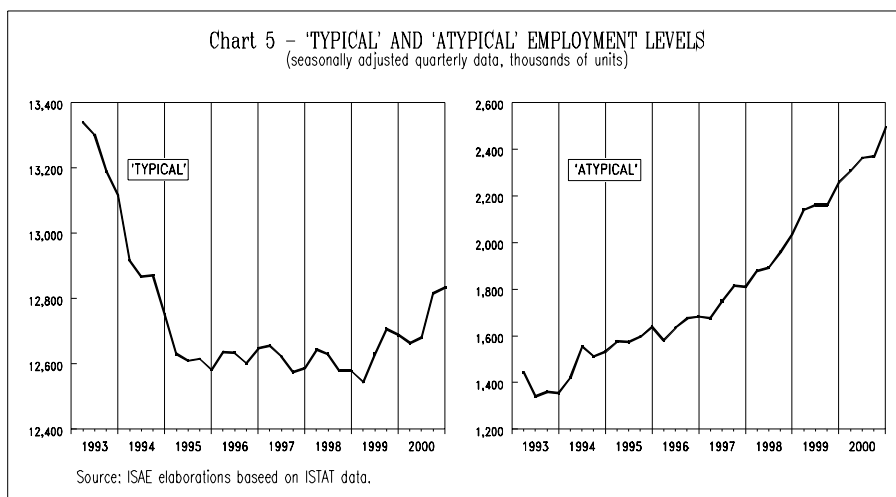
mainly Northern regions and particularly the North-West. The recovery was instead more continuous in the Centre and South of Italy. With reference to Southern regions, it is worth signalling the extremely favourable trend of exports, whose dynamics was faster than that of the Northern areas, as well as the significant employment rise observed in the last quarter of 2000.

Even considering the little role which the industrial sector and exports play in the economy of Southern regions, those indications seem to partially confirm the more lively economic situation of those regions which the new regional accounting schemes have pointed out. According to the new accounts, the *Mezzogiorno* of Italy registered the highest growth rate between 1995 and 1998 (+1.7% per year as against +1.5% on national average), i.e. in a time-span when public transfers in favour of Southern regions have been decreasing.

#### Employment

In 2000, labour market conditions further improved, with an acceleration in the creation of new jobs and a contemporary unemployment reduction. The number of employed increased by 1.9% on annual average (that is 388,000 workers compared to the average 1999 level). At the end of 2000, it exceeded 21 million people, thus reaching the highest figure since October 1992. Employment growth was relatively less sustained when measured in terms of standard units (+1.4% according to our estimates, that is 333,000 units), due to the higher incidence of "atypical" labour contracts (part-time or para-subordinate workers).

The remarkable employment growth mirrors the productive recovery observed during the year and the favourable effects of the



flexibility introduced in 1997. In particular, the main thrust to the creation of new jobs came from the wider diffusion of fixed-time labour contracts. In 2000, the rise in those who are known as "atypical" workers amounted to 233,000 people. The incidence of temporary workers on total workers reached 10.5% at the end of the year; while the incidence of part-time workers equalled 8.9%. In spite of the sustained rise registered over the past few years, the weight of these kinds of jobs is smaller than the European average: the share of temporary workers in the EU equals 13.2% and that of part-time workers amounts to 17.7%.

In 2000, as indeed happened in 1999, the employment increase went alongside with the reduction in the number of job-seekers. Consequently, the unemployment rate - equalling 11.4% in 1999 - reached 10.6% on average in 2000 and 10% at the end of the year. Though the general picture was improving, the strong imbalances characterizing the Italian labour market remained basically unchanged. At the end of 2000, job-seekers in the North and in the Centre accounted for 4.2% and 7.5% respectively of the labour forces of these two areas. In the South of Italy, in spite of an improvement by 1.2 points compared to early-2000, the unemployment rate was 20.5% and peaked over 50% for the bracket between 15 and 24 years of age.

Labour market conditions improved also in the Euro area, where the unemployment rate reached 9.6% at the end of the year (1.5 points

less than twelve months before). Spain continued to rank last, with an unemployment rate equal to 13.6%. Italy however still maintains its primacy in youth unemployment: 30.5% as against 16.9% in the Euro area.

**Wages and  
labour cost**

In 2000, company-level wage agreements and effective wages followed a substantially moderate dynamics as in the major Euro countries. The moderate wage trend was favoured by the effectiveness of the July 1993 Protocol on incomes policy and collective bargaining. The increase of *per capita* wages in the whole economy (+2.6%, according to our estimates) was substantially in keeping with the consumer price evolution. Wage increases slightly higher than average occurred in the public services and in industry excluding construction; more moderate trends characterized private services and, particularly, agriculture.

Thanks to the productivity acceleration (+ 1.3% according to our estimates, based on the trend of the value added for the whole economy), in 2000 *per capita* unit labour cost showed an extremely moderate trend (+1.2%), with variations lower than 1% in industry excluding construction and negative for construction. However the rise exceeded 2% in both private and public services.

**Inflation**

Consumer inflation has rapidly grown in the first half of 2000 reaching 2.7% in June (1.3% was the lowest level reached in March 1999) and then remained close to that figure for the second half of the year. In 2000, the average inflation rate amounted to 2.5%, which is more than the 1999 average (+1.7%) and overshoots the Government target (2.3%).

The inflation acceleration mirrors the increase in raw material prices - particularly oil - and the Euro depreciation, which have more than offset the moderating effects coming from the domestic cost component. Only in the late-2000, the external inflationary thrusts eased thanks to the fall in oil prices and to the exchange rate appreciation.

The more favourable picture of the international cost variables should lead to the gradual softening of inflationary tensions in the forthcoming months. However, the process will be gradual, at least at the beginning of the year, because the impact on final goods and services of the rises of input prices registered in 2000 has not been fully completed yet. Besides, a further source for disturbance deriving

from the BSE does influence foodstuff prices. The worrying inflation figure of January (+2.9-3%, according to the anticipations for sample cities) signals a strong variability which might still characterize the consumer prices both in Italy and in Europe in the early- 2001.

During 2000, the inflation differential of Italy compared to the Euro area, measured on the harmonized consumer price index, has been progressively reducing till it became almost null at the end of the year. The gap narrowing is fundamentally linked to the moderate reply of Italian inflation to the oil shock. This is due to the lower incidence of energy in the basket of goods considered in Italy, and to the smaller rise of Italian energy prices compared to Europe following upon the reductions of the excise tax since Autumn 1999. Indeed, the differential in terms of core inflation, though diminishing, remained significant enough. At the end of 2000, it amounted to about 0.5 compared to the average of the European countries and to 1% and 1.5% respectively compared to Germany and France.

In 2000, further progress was made in reducing the ratio of the General Government deficit to GDP, though the corrective measures implied the substantial reduction of the otherwise-sustained revenue dynamics. According to the ISAE estimates, the General Government net borrowing in 2000 should amount to 1.5% of GDP (1.9% in 1999), which slightly overshoots the target (1.3%) recently indicated by the Government while updating its Stability Programme. The disparity comes from the smaller growth forecast by ISAE and, in particular, from the more pessimistic evaluation on the feasibility of the so called Domestic Stability Pact, aiming at restraining expenditure of local bodies.

**Public finance**

The information which were available over the past few months (i.e. the figures on the State Sector borrowing requirement in 2000, the expected Administrative Regions borrowing requirements and the Public Sector cash flows in the period January-September) show trends outstripping the Government indications. Even if the larger State Sector borrowing requirement - for the share connected to tax reimbursements referring to past financial years, to the increased INPS borrowing requirement due to the partial shifting to 2001 of the credit securitization for 2000 and to the larger expenditure for EU-funded programmes - will not affect the General Government net borrowing of 2000, an overshooting seems inevitable. Indeed, the expected strong

increase in the Administrative Regions borrowing requirements (+10%), mainly connected to the health care spending, seems as worrying as the trend of the Public Sector primary expenditure (+7% in the first nine months).

Compared to the official data, the ISAE estimates that the interest payments as a ratio of GDP will decrease to 6.4% (as against the official figure of 6.5%), but it also forecasts smaller revenue (46.6% as against 46.8%) and larger expenditure excluding interest payments (41.7% as against 41.6%), mainly prompted by larger expenditure for intermediate consumption. The primary surplus is expected to be 4.9% (as in 1999), as against a figure of 5.2% contained in the Stability Programme.

**Short-term prospects: the international scenario**

The ISAE forecasts for 2001 a significant slowdown in the international cycle. The world GDP growth in 2001 is estimated at 3.5%, more than one percentage point less than in 2000. The deceleration is extended to all areas, but it is particularly marked in the United States, where the growth rate (2.2%) is more than halved compared to 2000. The slowdown reflects the prolonging to the first two quarters of 2001 of the productive activity brake and a gradual recovery in the second half of the year. In this scenario, the possibility that the United States GDP falls for one or more quarters is excluded.

Tab. 3 WORLD GDP  
(percentage variations)

Areas	1997	1998	1999	2000*	2001**
<b>Industrialized countries</b>	3.2	2.8	2.9	3.8	2.4
United States	4.4	4.4	4.2	5.1	2.2
Japan	1.9	-1.1	0.8	2.0	1.8
Euro area (1)	2.3	2.8	2.4	3.3	2.8
<b>Emerging countries</b>	5.1	2.2	3.8	5.9	5.0
Asia	6.1	2.7	6.3	7.6	6.3
Middle East	4.7	2.7	0.7	4.5	4.0
Latin America	5.4	2.0	0.1	4.0	3.5
Africa	2.9	3.1	2.2	3.0	3.0
Central-Eastern Europe	1.7	-0.7	2.5	4.5	3.5
<b>World</b>	4.1	2.5	3.3	4.7	3.5

Source: ISAE elaborations based on IMF data.

(\*) ISAE estimates.

(\*\*) ISAE forecasts.

(1) Excluding Greece. By including it - as it belongs to the Euro area since January 1, 2001 - the growth for 2001 equals 2.9%.

This assumption takes due account of the considerable margins for interventions in support of the productive activity which the US

economic policy has at disposal.

Even the Euro area is witnessing a growth rate lowering, though to a lesser extent than the United States. This forecast is based on the hypothesis that the European domestic demand trend is more sustained, reflecting the terms of trade improvement and the more expansionary budgetary policies adopted by the Governments of the main Euro countries. These policies were launched when the economic cycle was still positive and had mainly medium-term targets, as they were aimed at accelerating the European growth process by reducing the fiscal pressure. They might indeed prove effective anti-cyclical measures to face the consequences of the weakening international situation. Admittedly, it is most unlikely that the stronger domestic demand - though it is sustained by budgetary policies and by terms-of-trade improvements - fully offsets the effects of the world cyclical slowdown. According to ISAE, the European growth decelerates in 2001 to 2.8%, as a result of a slowdown in the first half of the year, followed by an acceleration in the second half.

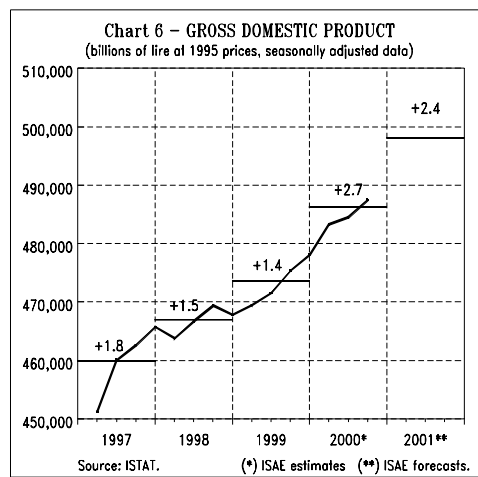
The different slowdown dimensions in the United States and in the Euro area should bring about a significant narrowing of the interest rate gap between the two economies. In our estimates, the official American interest rates - 6% in January - should fall down to 5.25-5% at the end of 2001. The ECB should bring the refinancing rate of the Euro area - 4.75% in January - to 4.25% at the end of 2001. Hence, the gap between the monetary market three-month rates in the United States and the Euro area should fall from 1.2 points of the late-1999 to below one percentage point in the late-2001. At the same time, the real interest rate gap - which, on the basis of the gap between consumer inflation rates, was about 0.5 points higher in the United States in December 2000 - should reverse at the end of 2001, when the European real interest rates should exceed the American ones. The narrowing of (both nominal and real) interest rate gaps and the European growth outstripping the United States should favour the Euro appreciation against the dollar. According to ISAE, the dollar-to-Euro exchange rate should tend to parity at the end of 2001, attaining an average annual rate of 0.974.

The oil price weakening, opposed by the OPEC policy based on production cuts, should be confirmed in the light of the slowdown of the international economic cycle. The OPEC policy is aimed at

avoiding oil price fluctuations exceeding the band of prices informally taken as reference by the oil cartel. The ISAE forecast is based on the technical hypothesis of a 25-dollar average oil price, with a deterioration by about 11% as against 2000. The relatively more sustained trend of non-oil fuels (gas, coal, etc.) should limit the overall reduction of the fuel prices in dollars within 6.5-7%.

**Forecast for the Italian economy**

According to the ISAE forecasts for 2001, Italy substantially follows the Euro area cycle, with a slower growth in the first part of the year and an acceleration in the second part.



In particular, the Italian GDP growth rate in the first half of 2001 should remain close to the late-2000 values (+2% on annual average) and then grow in the second part of the year, thus going back to the most favourable levels which had characterized the January-June period of the last year (about 3% on annual average). This profile means

an average 2.4% GDP growth in 2001, with a 0.3% slowdown compared to 2000. Under this assumption, the growth gap between Italy and the Euro area would continue to narrow going below 0.5%.

The Italian economy slowdown is mainly due to the worsening of the net foreign demand, whose contribution to growth should become negative again amounting to -0.4%. A positive role should be instead played by the overall domestic demand, whose contribution to GDP should rise to 2.8 percentage points.

**Domestic demand**

All the major domestic demand components should positively contribute to the growth of the Italian economy. With regard to resident households' consumption levels, a 2.3% rise is foreseen. In 2001, the consumers' disposable income - which in the past had been penalized by the deficit-adjusting measures and in 2000 by the terms-of-trade fall - draws benefits from the tax-reducing provisions, from the employment increase and from a rise of real wages. Consumers' expenditure should rise in keeping with the real disposable income, so that, after the rise of the past few years, the average consumer

propensity should remain substantially stable.

Within this picture, the investment prospects remain favourable. According to ISAE, the overall investments increase by 5.1%, those

Tab. 4 ISAE FORECASTS: GENERAL SUMMARY  
(Percentage variations, unless specified)

	1999	2000*	2001**
Gross Domestic Product	1.4	2.7	2.4
Imports of goods and services	3.4	9.0	8.1
Exports of goods and services	-0.4	10.7	6.4
Resident households' consumption	1.7	2.1	2.3
Gross fixed investments	4.4	6.4	5.1
GDP growth attributable to:			
domestic demand (net of changes in stocks)	2.0	2.7	2.6
changes in stocks and valuable objects	0.4	-0.6	0.2
net exports	-1.0	0.6	-0.4
Foreign trade balance (fob-fob) (1)	1.7	0.8	0.9
Current account and capital account balances (1)	0.8	-0.4	-0.1
Dollar/Euro exchange rate (level)	1.066	0.924	0.974
It. Lira/Dollar exchange rate (level)	1,817	2,099	1,990
Prices of raw materials (in dollars)			
energy	30.1	50.9	-6.5
non-energy	-12.7	-3.7	0.3
World demand	5.1	11.1	7.7
Consumer prices	1.7	2.5	2.2
Propensity to consume (% lev.)	87.2	87.8	87.9
<i>Per-capita</i> gross earnings in the economy	2.3	2.6	3.4
Total employment (2)	1.0	1.4	1.3
Unemployment rate	11.4	10.6	9.8
General Government net borrowing (1)	1.9	1.5	1.3
General Government primary surplus (1)	4.9	4.9	4.7
Fiscal pressure	43.3	43.0	42.3
General Government debt (1)	115.1	111.6	106.9
m.p. Nominal GDP (3)	2,128,165	2,225,493	2,341,004

Source: ISTAT.

(\*) ISAE estimates.

(\*\*) ISAE forecasts.

(1) As a percentage of GDP.

(2) In standard labour units.

(3) Billions of lire.

for machinery, equipment and transport equipment by 7%. The prolonging of the accumulation process along a relatively sustained pace is favoured by the high degree of plant utilization and by the tax incentives introduced by the Budget law for 2001 (reduction of the corporate

income tax rates, increase of the Dual Income Tax, tax credits for investments in depressed areas). According to the ISAE investment survey of November 2000, the expenditure share which entrepreneurs intend to allocate to capacity-enhancing initiatives passes from 34% in 2000 to 42% in 2001. There remains a strong need to renew capital stock, through the adoption of innovative and technologically-advanced investment goods so as to raise the Italian firms' efficiency and competitiveness.

Inventories should give a favourable contribution to growth. The prospect of lower raw material prices at international level, the exchange rates strengthening and the interest rate reduction should favour the accumulation of primary and final goods inventories.

***Net foreign demand***

In 2001, the slowdown of the international economy and the Euro appreciation should restrain export dynamics. In turn, the deceleration of the US market - which is stronger than that of the Euro area - should modify the geographical composition of world demand in favour of Italian goods. According to the ISAE assumptions, Italian exports should rise in 2001 by 7.4%; given an increase in world trade by 7.7% the share of Italian goods on international markets should slightly contract. Indeed, the slowdown of the overall exports of goods and services should prove stronger (+6.4%), owing to the considerable fall in tourism after the positive trend of 2000.

Prompted by the favourable domestic demand trend and by the competitiveness worsening, imports should rise (8.1%) more than exports. After the upsurge registered in 2000, connected with the cycle upturn, the import elasticity to domestic demand should attain the normal levels which have characterized the past decade and should remain in line with the situation prevailing in the main European countries.

***Labour market***

The economic activity slowdown should not hamper employment increase. According to ISAE, the creation of new jobs mainly reflects an employment rise in the service sector and in construction. However, also the industrial sector excluding construction should witness an improvement. The overall rise in terms of standard labour units should amount to 1.3% (that is 300,000 units). In terms of workers, the increase involves 450,000 people. Even in the presence of a labour force growth favoured by the improved labour market conditions, the unemployment rate should fall to 9.8% on annual average.

In 2001, wage dynamics should accelerate, with compensations for employees rising by 3.4% in the economy as a whole. The stronger wage dynamics is prompted by the renewed wage provisions of both public and private contracts. To begin with, only a partial recovery is foreseen for the higher inflation (compared to forecasts) registered in 2000. Indeed, the prospect of a gradual inflation reduction, the lower tax pressure on household incomes and, in the manufacturing industry, the opportunity to receive higher productivity-linked wages in company-level agreements should contribute to contain wage increases. What seems to raise most concerns is the dynamics of public employees' wages, which was determined by the wage renewal agreements concluded for school teachers and Ministry employees, and which envisages increases by 4.5-4.6%.

Gross earnings per employee register a moderate trend (+2.9% in the whole economy), thanks to the provisions on social security detaxation. Taking into account the productivity increases - which would amount to slightly over 1% in the economy as a whole - *per capita* unit labour cost should rise on average by 1.7% in 2001 (with a peak over 3% in public services) substantially in line with the increase of the other major European countries.

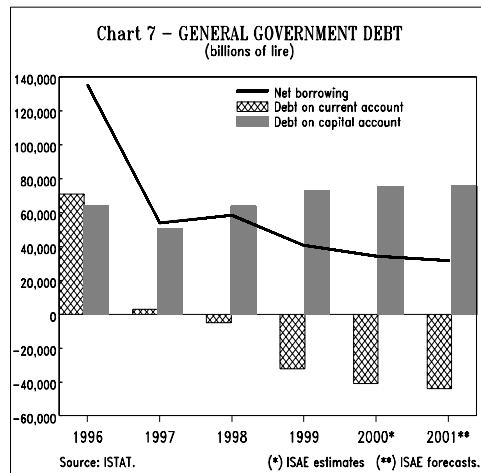
Consumer inflation should be positively influenced by the fall in raw material prices, by the exchange rate appreciation and by the limited dynamics of the unit labour costs. The inflationary tension easing should however be gradual. Inflation should amount to 2.7-2.8% on average in the first quarter, and then begin to fall, reaching rates close to 1.7% in the late-2001. This profile should imply for 2001 an average inflation rate in Italy equalling 2.2%, which is 0.3% less than in 2000. In this prospect, the inflation gap with the Euro area, where consumer prices are expected to rise by 2% on annual average, should tend to zero.

***Inflation***

With regard to public accounts, the efforts to reduce the budget deficit, started at the beginning of the nineties, show a considerable change in 2001. For the first time, after a long phase of corrective measures, the Budget for 2001 foresees interventions to increase the public deficit. In spite of those provisions, the reduction in the General Government net borrowing as a ratio of GDP is going on. According to the ISAE forecasts, the deficit-to-GDP ratio falls down to 1.3%, thus overshooting the Government target of 0.8% indicated in the

***Public finance***

Forecasting and Planning Report and officially confirmed in the updating of the Stability Programme. It is a relatively small overshooting (about 12,000 billion lire), if compared to the trillions of lire of the General Government revenue and expenditure, which admittedly is subject to the margins of uncertainty typical of each stochastic variable and is not large enough to compromise the Stability and Growth Pact.



The difference between the deficit estimated by ISAE and the Government figure can be ascribed for about 40% (about 4,800 billion lire - 0.22% of GDP -) to the deficit worsening registered in 2000 as against the Government hypothesis; for about 30% (about 3,500 billion lire - 0.16% of GDP -) to a different growth picture in 2001, and

for about 30% (3,700 billion lire - 0.17% of GDP -) to some computation differences as against the official estimates of both revenue and expenditure. As for revenue, ISAE forecasts a more cautious evaluation of the capital gain tax revenue and of the proceeds generated by the sale of State properties. As for expenditure, a different computation of the effects of the corrective measures is provided, particularly with reference to the interventions for the intermediate consumption limitation.

The primary surplus should decrease for the fourth year running, amounting to 4.7% of GDP. Also interest payments should go on diminishing both in absolute value and as a percentage of GDP, attaining the figure of 6.1%. The slight primary surplus contraction should derive from the lower incidence on the GDP of both expenditure excluding interest payments and - to a slightly higher extent - of the overall revenue. These trends mirror budget measures aimed at reducing the fiscal burden on households and firms, prompting public investments, supporting disadvantaged situations and rationalizing the General Government functioning expenditure. Within this framework, the General Government debt - equalling 115.1% of

GDP in 1999 - should go down to 106.9% of GDP in the late-2001.

The uncertainties characterizing the forecasts for the Italian economy mainly derive from the international scenario. A slowdown in the United States stronger than expected by ISAE would have negative effects on the Euro area and on Italy as well. In the hypothesis of an economic recession in the United States, domestic demand - both in Italy and in Europe - is most unlikely to offset the depressive effects deriving from the world economy. All the more so, as, if the US economy deteriorates (with further contractions in the stock exchange and a more marked dollar depreciation), a further worsening of the confidence climate would emerge in Europe, which would negatively affect the European domestic demand.

***The forecast risks***

Generally speaking, ISAE deems this pessimistic scenario most unlikely, even though the potential causes for a worsening of the international situation (particularly for the heavily-indebted US private sector) do exist. ISAE attaches a larger probability to a scenario characterized by a considerable slowdown, but not a recession, mainly because it is aware that the US economic policy makers have large margins of intervention at their disposal and that the US market is highly flexible.

A further cause for uncertainty are oil prices. ISAE deems that a decelerating world economy favours an oil price weakening. However, the OPEC cartel policies aimed at avoiding excessive fluctuations might bring about a smaller price reduction than forecast, let alone a new increase. Moreover, the difficult political-military situation in the Middle East is a source of concern for the oil market: a conflict escalation in that area might have an impact on fuel prices. If the oil price does not fall, the terms-of-trade recovery which is at the basis of the ISAE forecasts would be endangered, both for Italy and for other oil consumer countries, and this would jeopardize domestic demand acceleration and the growth of the whole economy.

Besides, in this case the whole process of inflation curbing in the Euro area and in Italy would be mined and the prospects for the European interest rates would differ considerably from those incorporated in the ISAE forecast, thus causing a further braking effect on growth in Europe and in Italy as well.