

INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

ABRIDGED QUARTERLY REPORT

*forecast
on the Italian
economy*

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CREDITS

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SUMMARY AND INTRODUCTION

After the shock to the general confidence climate caused by the September 11 events, the international economy seems on its way towards a slow improvement. The best signals come from the United States, where the GDP preliminary data in the IV quarter 2001 are better than expected and the information coming from the various short-term indicators (consumers' and firms' confidence climates, synthetic leading indicators) show that the lowest point of the American cycle was reached and a new upturn might loom ahead in the early-2002. Positive indications also emerge for the euro area and - though they are less strong and diffused than those concerning the United States - they point to a stabilisation of the slowdown at the beginning of 2002 and to a stronger recovery in the second half of the year.

In the international scenario depicted by ISAE, the American GDP increases in 2002 by 1.1% and by more than 3% in 2003. The euro area GDP reaches 1.4% in 2002 and 2.7% in 2003. The Japanese economy is still experiencing a contraction which shall partially come to a halt only in 2003. All other major areas shall witness more favourable trends.

Within this framework, Italy registers a gradual acceleration too, which becomes stronger in the second half of 2002 and in 2003. The Italian GDP grows by 1.5% in 2002 (1.9% in 2001) and by 2.8% in 2003, by maintaining a marginally faster dynamics than the euro area. Following upon these trends, the average development rate of the four-year period 2000-2003 equals 2.3%, which means 0.7% more than the average growth registered in the adjustment phase of the macroeconomic imbalances characterising the late-nineties.

The labour market conditions continue to improve. The ISAE forecast indicates a rise by about 450,000 employed in two years. The unemployment rate continues to diminish, falling from 9.5% in 2001 to below 9% in 2003.

Thanks to the disappearance of external inflationary thrusts and to the persistently moderate trend of production costs, consumer inflation equals 1.9% in 2002 - 0.8% less than in 2001 - and 2% in 2003. ISAE estimates that there will be a marginal impact of the currency changeover on the average inflation in 2002 by about 0.04%.

The public finance situation shows that the ongoing decreasing trend of the deficit-to-GDP ratio shall continue. In 2001, the General Government net borrowing amounts to 1.2% of GDP - which is substantially in keeping with the Stability Programme updating (1.1%)

- and then falls down to 0.9% in 2002 and - if no corrections are introduced - to 0.8% in 2003. The ISAE forecasts on the net borrowing for 2002 and 2003 are less positive than the Government's, who indicates a deficit of 0.5% in 2002 and of 0.3% in 2003. This derives from the weaker growth forecast by ISAE compared to the Government and from a different evaluation on the part of ISAE of some revenue items in particular. However, the public deficit performance in Italy is generally better than that observed in the other major euro countries.

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***The
international
scenario***

The brake the international economy experienced in 2001 was very intense indeed. The development of the world GDP has more than halved compared to the previous year, by reaching about 2%, an all-time low growth rate and indeed lower than the figure reached in the 1998 financial crises which had hit emerging countries. International trade registered an even more marked deceleration, reaching about 1.5%, which means 1/8 of the pace of growth registered in 2000 and - for the first time in the last fifteen years characterised by the growing integration between economies - even smaller than the development of the world GDP.

The reasons for the strong international slowdown are to be found in the synchronic deceleration affecting all the world economies and in the shock caused by the September 11 attacks, which have simultaneously hit - through the confidence deterioration - the industrialised countries at a time when some signals of cyclical stabilisation were looming ahead both in the United States and in Europe.

Within this framework, the substantial "held" of the world economic activity - although e in strong deceleration - may be valued as a positive factor. Indeed, the weak international growth has taken place in a situation of marked slowdown in the largest world economy, of productive standstill in the euro area and of deflation processes in countries such as Japan and Argentina, which exert a considerable influence in their areas. Those negative factors might have brought about a world recession, as some observers had indicated. Fortunately, this did not happen, perhaps also thanks to the persistent expansion of some major emerging economies - China, India and Russia - relatively closed to foreign trade and therefore less exposed to the depressive

effects coming from the industrialised world. The heavier weight those countries have taken up in the international growth might contribute to account for the strong lowering of the world trade dynamics observed in 2001. This phenomenon may have been partially determined by the comparatively larger growth experienced last year by economies structurally characterised by a lower propensity to import.

In the late-2001, the world economy deceleration was stressed by the negative effects of the terrorist attacks to the United States and by the subsequent strong deterioration of the international political climate. Those events, by determining an abrupt contraction of the market-operators' confidence, have negatively influenced aggregate demand in the industrial area and have made the slowdown longer and deeper. The greater uncertainty due to the terrorist attacks has inevitably affected forecasts, which were made at a time when expectations suddenly became very negative. In those conditions, the risk emerged to overestimate the September events' negative impact. ISAE, aware of the very uncertain climate of the post-attack period, decided in its October 2001 Quarterly Report to present two alternative scenarios diversified in their degree of pessimism and optimism. In the present Report we dispel all doubts by providing one single scenario which stems, on the one side, from the awareness that many of the darkest events feared in October have not taken place and, on the other side, from the observation that the slowing trends existing before the September shock were exacerbated and indeed caused a delay in the recovery timing and intensity as against the optimistic scenario depicted three months ago.

At the beginning of 2002, once the consequences of the terrorist attacks were overcome and the Afghanistan war came to an end, the industrialised area - hence the world economy - seems to be on its way towards a slow improvement. The latest indications coming from the major economies point to a cycle stabilisation, let alone to the gradual recovery of the production activity. This evolution is influenced by the emergence of new confidence among operators, by the first effects of the expansion-aimed policy provisions adopted by the major economies and by more dynamism in the emerging areas.

The most important signals of recovery come from the United States. According to the preliminary estimates, the US GDP - after the contraction registered in the III quarter 2001 - remained still in the IV

***Post-September
uncertainties***

***More favourable
indications
emerge...***

***...in the United
States***

quarter of the year. This result may be revised but, if confirmed, it shows a trend better than that expected, which conversely indicated a fall similar to that of the previous quarter.

The American economy should have touched the lowest point of its economic cycle and a recovery might already emerge at the beginning of 2002. In fact, various positive short-term indicators have added up between the end of 2001 and the beginning of 2002 and led the President of the Federal Reserve, in his January 24 statement in front of the Budget Committee of the Senate, to mention openly, for the first time, favourable developments for the U.S. economy.

A first positive signal comes from the recovery of the households' confidence climate. The consumers' confidence climate measured by the Michigan University started to grow again since October and in January it got close to the Summer figures. The Conference Board Index rebounded with a certain delay, but it recovered in December and particularly in January the fall registered after the September events. At the same time, the long deterioration of the manufacturing sector has been reducing as shown by the rise of the Index of the Institute of Supply Management (former NAPM Index) in December for the second month in a row. The similar indicator computed for the non-manufacturing sector reached in November the critical level of 50 (marking the turning point between contraction and growth). In the wake of the evolutions registered in the different sectors of the American system, in December the Conference Board leading synthetic indicator registered an increase for the third month in a row. Finally, the short-term prospects of the American economy are strengthened by the abrupt contraction of inventories made by US firms over the past few months. In the presence of very thin inventories, even a slight sale recovery might be sufficient to induce a considerable leap forward in production, with consequent positive effects on the American consumers' income and expenditure.

Indeed, if uncertainties on the American recovery seem to fade away, some questions emerge on the intensity of the cyclical reverse of trend. The reason is to be found in the persistently positive trend which has been characterising the American households' expenditure for consumption in the latest slowdown phase. If, on the one side, this evolution has contributed to reduce the brake of the American economy, on the other side, it will hamper a significant leap forward of

this demand component in the phase of cyclical recovery. Subdued consumption growth should contribute to reduce the speed of the American recovery.

The euro area has followed suite the international cycle slowdown, by showing a progressive weakening even before September 11. The marked European deceleration was mainly caused by the domestic demand weakening which hit both consumption and investments. Those two expenditure items were also influenced by the sudden deterioration witnessed in the households' and business firms' confidence climates after the September attacks. In the wake of the world trade brake, also exports registered a halt. Given the contemporary strong import downturn due to the domestic activity deceleration, the contribution of net foreign demand remained marginally positive.

...and in the euro area

In the last months of 2001, some positive signals emerged also for the euro area: though less clear and diffused than those concerning the United States, they might point to a stabilisation of the slowdown phase in the first months of 2002 and precede a more considerable recovery in the second half of 2002. The rosier indications come from consumers' confidence climate, which registered in December its first reverse of trend, after the contraction caused by the September events. Also business firms' confidence climate grew in December and - according to partial indications - in January too, after the almost-uninterrupted fall observed since late-2000. Other leading indicators of the European Union activity showed upsurges, such as the IFO index of expectations on German production and the Belgian entrepreneurs' confidence climate, which - thanks to their strong integration with the European productive system to which they mainly provide intermediate goods - are reliable indicators for the economic activity trends in the euro area.

All in all, the European short-term situation should witness a slow recovery pushed by the American one, with a few months' delay compared to the United States. The short-term delay reflects the euro area structural rigidities, which tend to soften fluctuations both in negative and in positive phases. Namely, the slower European speed is mainly due to the German pace which, even because of the mentioned rigidities, might take longer to recover as against other countries.

**International
forecasts for
2002/03**

Taking account of these trends, the international scenario assumed by ISAE for its macroeconomic forecasts for 2002/03 is based on a gradual recovery of the international growth. Owing to the negative heritage coming from the slowdown of the second half of 2001, the short-term acceleration would be "hidden" in the average annual outcomes which, in 2002, would not be better, and sometimes would be worse, than those of 2001.

With reference to the United States, the economic recovery - as already mentioned - should be characterised by a gradual profile. Apart from the weak consumption, purchases of durables might witness a deceleration in early-2002, after the considerable rise registered in late-2001 pushed by aggressive commercial policies. Also demand for investments should follow a moderate trend, at least initially, owing to weak firms' earnings and to the low degree of plant utilisation in the productive system. Generally speaking, the American GDP growth would equal 1.1% this year, thanks to a slow improvement in the first part of the year and to a progressively quicker rise in the second half of 2002. In 2003, the recovery consolidation might bring the American growth just over 3%.

Europe should have a profile similar to the US one, though with a few months' delay. The prospect of the European recovery might be influenced by the "political cycles" of France and Germany, where general elections are planned (at the beginning of the Summer and in September respectively). In particular, the households' consumption should draw advantage from the favourable real income trend, thanks to the lower inflationary tensions and to the fiscal pressure easing introduced in some economies. The GDP rise in the euro area would equal 1.4% in 2002 (1.5% in 2001) and should reach 2.7% in 2003. On average, the German growth in 2002 should be very modest (0.6%) following upon the strongly negative trend witnessed in late-2001; in 2003 the growth should strengthen in this country too, with a 2.5% development rate.

Japanese prospects remain more unfavourable, as the labour market deterioration, the firms' earnings contraction and the continuous bankruptcies in the banking sector continue to brake the economic recovery. A possible export acceleration - favoured by the yen depreciation - should be more than offset by the modest domestic demand trend. On average, the Japanese economy should register in

2002 a new GDP contraction, equalling, according to our estimates, - 0.7%; only in 2003 some positive signals might emerge, with a growth which would however not exceed 1%.

The major contribution to the international recovery should come from emerging countries, which are growing very rapidly after the contraction registered in the late-2001, following upon the US recovery and the gradual overcome of the crisis of technologically advanced sectors.

All in all, owing to those trends, the industrialised area should grow by 1% in 2002 (1.1% in 2001); the recovery acceleration should become clearer in 2003, when the development rate of the major economies equals 2.6%. At the same time, the world GDP growth rate should be 2.1% in 2002 and 3.9% in 2003. The international activity recovery should favour the world trade expansion, which should reach about 2.5% in 2002 and 7.6% in 2003.

With regard to international prices, the world economic recovery should only cause moderate upward thrusts in oil prices. That evaluation takes account of the difficulties met by the OPEC cartel to adopt (and impose to non-OPEC producers) further supply cuts to stabilise prices in the central bracket of the target-range (22-28 dollars), considering the production overshooting which already took place and which might be further encouraged by the world demand strengthening. In our hypotheses, the raw oil price (Brent) would equal 21 dollars per barrel on average in 2002 (20 dollars at the beginning of 2002), with a contraction by about 15.5% compared to the average quotation of 2001. In 2003 it might reach 22.5 dollars. For 2002, the room for significant rises seems limited also for other basic products, considering the supply abundance characterising many raw material markets. Some more significant rises might emerge in 2003 for industrial raw materials.

With regard to the exchange rate market, the ISAE assumption considers a gradual, slow recovery of the euro against the dollar during 2002 and its stability in 2003 on the levels reached in the end of 2002. This evolution - apart from the very short-term oscillations due to the alternation of the news on the two economic cycles - mirrors an interest rate differential in favour of Europe which continues also for 2002, a "confidence effect" in favour of the European currency - once the changeover has been successfully completed - and the need to correct

the American foreign deficit. With reference to the monetary policy, the consolidation of the recovery on both sides of the Atlantic is supposed to put a stop to the official interest rate reduction process and induce both the United States and Europe to raise interest rates in the second part of the year. That evolution would leave the official European interest rates in late-2002 to an even higher level compared to the United States (3.5% as against 2.75% expected in the United States). The gap would gradually narrow during 2003, thus mirroring a more rapid reaction of the Federal Reserve to the strengthening of the American expansion. At the end of 2003, the official American interest rates (equalling 4.75% in our estimates) would marginally exceed the European ones (4.5% in our assumptions). In correspondence to these movements, the euro exchange rate would be on average 0.918 dollars in 2002. In 2003, the European currency strengthening would come to an end and its quotation against the dollar would remain on average on the end-2002 levels (0.93).

The Italian economy in 2001

In the wake of the international brake, also the Italian economy registered a slowdown in 2001. After a still-positive evolution in the first three months, the GDP growth has stopped since the II quarter. In our estimates, the standstill should have continued in the IV quarter 2001. The average growth rate thus equalled 1.9% in 2001, with a very limited positive carryover for 2002 (0.1%). The slowdown of the Italian growth was mainly influenced by the negative trend of the manufacturing activity, while construction and services have shown a better - though decelerating - "held". On the demand side, the very modest evolution of private consumption and the drastic lowering of the investment dynamics influenced the economic slowdown. Resident households' expenditure for consumption was influenced by the purchasing power erosion induced by the inflation acceleration in early-2001. At the end of III quarter 2001, this was accompanied by the negative effects of the confidence climate fall due to the terrorist attacks to the United States. With regard to investments, the 2001 slowdown was presumably influenced by the firms' expectations for the introduction of the new incentive law. Subsequently, the drastic international climate worsening has probably exerted a further braking effect. A relatively better trend characterised net foreign demand.

Italy between late-2001 and early-2002

The data on the Italian economy available between late-2001 and early-2002 show a gradual overcome of the deterioration emerged

since the terrorist attacks. As happened in other countries, the September shock seems to have exacerbated - particularly in the manufacturing industry - the economic slowdown, by postponing the recovery by some quarters.

The short-term indicators show - for the first months of 2002 - a diversified situation in the various Italian economic sectors. In the manufacturing industry, after the long negative phase characterising 2001, the ISAE forecast indicates an industrial production stabilisation in the I quarter of 2002. Although available information do not provide yet evidence for a turning point, the past experience suggests that this might take place since the II quarter. The trends continue to appear relatively more favourable in the other sectors, such as construction and private services. The leading synthetic indicator elaborated by ISAE - which is mainly influenced by the persistent difficulties registered in the industrial sector - points to a growth characterised by a substantially moderate pace in early-2002.

The signals concerning the market-operators' confidence are rosier. Consumers' confidence climate (adjusted for seasonal and erratic factors) has constantly increased since September and, in January, it has come back to the (historically high) average figures of last Summer. The business firms' confidence, which was particularly hit by the terrorist attacks, has followed a more irregular trend, which was further affected in Autumn by the worsening of large and medium-sized firms' confidence climate, which offset the positive signals emerged among smaller-size firms. This opposing trends seemed overcome in December, when the confidence reached again the September levels. The rise was due to the strongly improved expectations on production and short-term order books, which counterbalance the still-negative evaluations on the current situations of respondents. An encouraging signal also come from the strong decumulation of finished products inventories shown by the ISAE sample firms, which might lead - in the presence of a demand rise - to a gradual production recovery. Generally speaking, these qualitative indicators seem to corroborate the expectations for recovery of the manufacturing activity since the II quarter 2002.

If at the beginning of 2002 a gradual overcome of the standstill of the Italian economy should emerge, several factors should thereafter contribute to make the recovery more robust. Firstly, the acceleration

***Recovery-
stimulating
factors in Italy***

**Outlook for the
Italian economy
for 2002-03**

of the international economy should thrust exports. This shall go alongside with a more lively domestic demand, following upon the stimula coming from the terms-of-trade gains due to the oil price reduction and from the provisions sustaining investments and households' income adopted by the previous Government at the end of its mandate and by the new one in its first months.

In this more favourable framework, ISAE forecasts a relatively limited economic activity dynamics in Italy in the early-2002 and an acceleration in the second half of the year. That profile, apart from mirroring the international cycle, is also influenced by the larger thrust domestic demand should exert both on consumption and on investments. The end-of-2002 acceleration and the maintenance of a generally positive short-term evolution should further strengthen the Italian development rate in 2003.

In the first half of the year, the evolution of the Italian GDP should maintain a slightly higher pace than that which has been characterising the second half of 2001, and then accelerate in the rest of the year, coming back to the positive short-term growth rate registered between late-2000 and early-2001. This means a GDP rise by 1.5% on average in 2002, which is 0.4% less than the previous year. The slowdown reflects the brake registered in 2001. The growth differential in favour of Italy as against the euro area, equalling 0.4% in 2001, should amount to 0.1% in 2002. In 2003, the expansion rate shall reach 2.8%, which is still slightly over the euro area figures. Following upon these trends, the average development rate of Italy in the four-year period 2000-03, would be 2.3%, which is 0.7% more than the average growth registered in the strong adjusting phase of the macroeconomic imbalance of Italy of the second half of the nineties.

The deceleration of the Italian economy on average in 2002 is fundamentally due to the net foreign demand worsening: its contribution to growth will be negative in 2002 (-0.5 percentage points). The supporting role will be played by domestic demand, whose contribution to GDP shall amount to about 2 percentage points. In 2003, domestic demand should substantially contribute to the acceleration of the Italian growth (for more than 3 percentage points), which will offset the persistently negative contribution of net foreign demand.

Abridged Quarterly Report

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

	2000	2001*	2002**	2003**
Gross Domestic Product	2.9	1.9	1.5	2.8
Imports of goods and services	8.3	1.8	4.1	9.0
Exports of goods and services	10.2	3.4	2.1	7.2
Resident households' consumption	2.9	1.3	1.7	2.8
Gross fixed investments	6.1	1.3	4.0	5.5
Contribution to GDP growth attributable to:				
- domestic demand (net of changes in inventories)	3.2	1.2	2.0	3.0
- changes in inventories and valuable objects	-1.0	0.2	0.0	0.3
- net exports	0.6	0.5	-0.5	-0.4
Foreign trade balance (fob-fob) (1)	1.0	1.3	1.5	1.1
Current and capital account balance (1)	-0.2	-0.1	0.2	-0.2
Dollar/Euro exchange rate (level)	0.924	0.896	0.918	0.930
Interest rates (2)				
- euro area (3)	4.75	3.25	3.50	4.50
- United States (4)	6.50	1.75	2.75	4.75
Prices of raw materials (in dollars)	16.3	-9.9	-7.6	5.8
- energy	50.9	-11.7	-15.7	7.3
- non-energy	-3.6	-8.8	-3.0	4.9
World demand	12.6	1.4	2.5	7.6
Consumer prices	2.5	2.7	1.9	2.0
Producer prices	6.0	1.9	0.1	1.7
Propensity to consume (% level)	88.4	88.4	88.5	89.0
<i>Per capita</i> gross earnings in the economy	3.1	3.2	2.7	2.6
Total employment (5)	1.5	1.6	0.4	1.9
Unemployment rate	10.6	9.5	9.0	8.5
General Government net borrowing (1)	-1.5	-1.2	-0.9	-0.8
General Government primary surplus (1)	5.0	5.0	4.9	4.8
Fiscal pressure of General Government	42.4	42.1	41.8	41.1
General Government debt (1)	110.5	107.9	104.9	101.4
Twelve-month Government bonds (BOTs) (2) (6)	4.6	3.2	3.8	4.8
p.m. Nominal GDP in millions of euro	1,165,677	1,220,999	1,272,579	1,333,042

Sources: ISTAT, IMF, OECD, HWWA, ECB.

* ISAE pre-balance.

** ISAE forecasts.

(1) As a percentage of nominal GDP.

(2) End-of-year percentage values.

(3) ECB: minimum rate on the main refinancing operations.

(4) FED: rate on Federal Funds.

(5) In standard labour units.

(6) Gross yields.

Consumption

The main components of domestic demand should all positively contribute to the Italian recovery. Resident households' consumption should increase in 2002 by 1.7%. The acceleration should be influenced by the overcoming of the uncertainty which has been characterising the post-attack period and by the disposable income favourable evolution. This shall be affected by the outcome of last year's collective bargaining, by the still-positive trend of employment and by the provisions favouring the households' income adopted through the Budget Law for 2002 (increase of minimum pensions and income tax reliefs for children). In 2002, the favourable trend of the nominal disposable income would go alongside with the positive evolution of the households' purchasing power as a consequence of the smaller consumer prices rise. In 2003, the expenditure growth for resident households' consumption might reach more sustained rhythms (+2.8%), thus mirroring the effects of the previous year's acceleration, the still-positive income trend and a slight consumer propensity increase.

Investments

The investment dynamics should be favourably influenced by the interest rate reduction, by tax reliefs and by the public works re-launching. The gradual improvement of the international situation should enable these stimulating factors - which were already present in 2001 - to exert their positive effects in 2002.

**Tremonti Law
and the
accumulation
process**

With reference to the incentives envisaged in the provision known as second *Tremonti Law*, in its July 2001 Quarterly Report, ISAE was stating that its positive consequences for the accumulation process might be relatively smaller than those of the previous tax relief experience (1994-95). This evaluation was fundamentally based on the awareness that the new provisions were introduced - unlike what happened in the mid-nineties - at the peak of an investment expansion phase. The assumption of a more limited impact was corroborated by the survey carried out by ISAE in 2001 on different samples of manufacturing firms (ISAE survey carried out between September 25 and October 10 and published in the October ISAE Quarterly Report) and by the Bank of Italy (survey carried out between September 18 and October 3 and diffused in the Bank of Italy Economic Bulletin published in November). Those surveys showed that a high share of firms were intentioned to draw advantage from the tax reliefs (this was particularly evident from the ISAE survey, whereby more than 50% of

respondents wished to benefit from the tax reliefs), alongside with a smaller share of firms who were intentioned to use the fiscal incentives to foster investments (the percentage oscillated, according to the weighting system adopted, between 20 and 30% in the two surveys).

However, those evaluations provide only a partial idea of the impact on accumulation coming from the adoption of *Tremonti Law*, which refers to a larger group of beneficiaries than those involved by the previous provisions, as it concerns not only investments in capital goods - which are relevant for industrial firms in particular - but also other kinds of investments (for instance training and human capital), which have probably a stronger incidence on the capital account expenditure of business service firms. With reference to these, the January Survey on the IV quarter 2001 showed - for a sample of firms operating in advanced technology - the positive "held" of the investment dynamics, both in 2001 and - as a forecast - in 2002.

Moreover, the cyclical situation has substantially changed compared to the period when the new fiscal incentives were announced. In particular, investments are the demand components more heavily struck by the deterioration of the international situation emerged in the past few months. The ISAE and Bank of Italy surveys were presumably mirroring the impact of the higher uncertainty due to the September events, as they were carried out immediately after the attacks and on the eve of the Afghanistan bombing. In this climate, which does not favour accumulation, the *Tremonti Law* provisions may have played *ex post* an anti-cyclical role which they did not seem to possess when they were originally thought of.

Indeed, the outcome of the investment incentives shall eventually depend on the general economic development, with particular reference to the capacity constraints which the economic system is subject to. To this end, the available indications seem to point to an unutilised capacity margin to which firms might resort without need for additional investments to respond to possible demand increases. In particular, the ISAE survey signals that the negative phase of the industrial sector was accompanied by a contraction of the degree of plant utilisation last year, which reached the lowest level of 2001 in IV quarter. At the same time, the survey shows that firms do not perceive as scarce the production capacity they have at their disposal. Finally, the output gap indicator we use - built on the basis of the information

coming from ISAE surveys - signals a contraction of the actual production level below the potential one since IV quarter 2001. In these conditions, firms might decide to start new investments only if they expect a stable economic recovery.

Thus, considering that there will be a robust recovery of the general economic situation, our estimates indicate that the overall investment growth will be 4% on average in 2002, and 5.5% in 2003. This trend shall significantly accelerate the expenditure for machinery, equipment and means of transportation in the second half of 2002, as the final date to benefit from tax reliefs expires. The growth rate of this investment item will be 4.7% on average in 2002 and 6.6% in 2003. The investment dynamics in construction shall equal 2.9% in 2002 and 4% in 2003.

Exports and imports

In 2002, the contribution of net foreign demand - as already mentioned - becomes negative, mirroring an increase in the export of goods and services (2.1%) smaller than that of imports (4.1%). The contraction of Italian exports - expected in the 2002 average - stems from the effects of the abrupt fall of 2001. Exports should rise gradually in 2002, influenced by the cycle acceleration of Italy's major importing countries. The improvement shall emerge in 2003, when the export rise reaches 7.2%.

In terms of imports, our estimates indicate a significant acceleration in 2001, sustained by the domestic demand recovery and by the leakage towards imports of the incentives to the domestic demand for investment goods. The average annual increase of imports of goods and services equals 4.1%. In 2003, the recovery consolidation shall further prompt imports, which shall increase by 9%.

Trade balance

The trade worsening in terms of quantity will be more than offset in 2002 by the terms-of-trade recovery due to the oil price fall. Thanks to the more favourable evolution of the oil prices, the 2002 trade surplus should rise by 3.5 billion euros, namely 2% of GDP (1.8% in 2001). At the same time, the current and capital account balance - though influenced by the deficit of the balance in so called invisible components - would settle close to the equilibrium (it was negative in 2001 by a figure equalling 0.1 of GDP). In 2003, a new terms-of-trade deterioration should occur, mainly due to a slight oil price rise. The relative prices worsening would add up to the deterioration of trade in terms of quantity, which would cause a 4.8 billion-euro cut in the trade

surplus, which should settle at . 1.6% of GDP. In correspondence to the trade balance deterioration, the current and capital account balance would become negative again in 2003 (-0.2% of GDP).

The economic slowdown of 2002 shall prompt an employment dynamics deceleration, which would however remain positive. In our forecasts, after a 1.6% expansion in 2001, the number of employees, measured in standard units, would rise by 0.4% in 2002. This implies a brake in job creation between late-2001 and early-2002, owing to the economic slowdown followed by a stronger thrust in the second half of the year. The labour market performance would be again very favourable in 2003, when the employment should rise, in terms of standard units, by 1.9%. Thanks to these trends, the employment-to-GDP elasticity should equal 0.6 on average in the three-year period 2001-03, which is a very high level compared to the historical experience of Italy, and which is marginally higher than the elasticity registered in the positive phase of the period 1998-2000 (0.5). In terms of persons, the overall employment increase shall equal 450,000 units in the two-year period 2002-2003 as against 2001 (i.e. 21,514,000 people). The unemployment rate should continue its decreasing process started in 1998 (when it was 11.8%), to reach 9.1% on average in 2002 (9.5% in 2001) and fall below 9% in 2003.

Labour market

The wage dynamics, which showed a limited pace in 2001, should continue to follow a moderate growth path also in the two-year period 2002-2003. The increase in the compensations per employee in the whole economy should equal 2.7% in 2002 and 2.6% in 2003. Considering the labour productivity trend, unit labour cost should rise by 1.4% in both years and by about 0.5% in the industrial sector. This is in keeping with the forecasts on average for the two-year period 2002-03 for the European partners.

Labour cost

Consumer inflation should equal 1.9% in 2002 - (0.8% less than in 2001) and 2% in 2003. By adopting the harmonised European standards, consumer prices would grow by 2 and 2.1% in the two years respectively. Thus, on the basis of the harmonised index, the differential with the euro area would temporarily widen again in 2002, by reaching 0.5%, and then narrow in the following year. The enlargement of the inflation differential with respect to the Euro partners reflects the higher flexibility of European markets, which responded quicker than Italy to the energy price decrease.

***Inflation and
changeover***

The price growth rate should diminish in 2002 till it reaches its minimum level in the mid-2002 (in correspondence to a 1.6% growth) and then slightly increase in the last months, when inflation amounts to 1.8-1.9%. This profile considers the absence of tensions in production costs, the favourable statistical comparison in the first half of 2002 compared to 2001 and generally limited direct effects on the price dynamics due to the changeover. With reference to the changeover, according to the ISAE estimates the impact of the introduction of the new currency, in terms of higher average annual inflation, is 0.04%. By rounding to the second decimal digit, the consumer price rise equals 1.85% in the ISAE forecasts; it would have equalled 1.81% without the changeover effect. Conversely, the changeover might impact on the inflation intra-annual profile, as a consequence of the gradual process of substitution of the old with the new currency . Any possible adjustment might concentrate in the two-month period March-April, that is at the end of the double-currency period, when the changeover is fully implemented and double-currency price shall be replaced by euro-only price. This might brake - but not annul - the inflation reduction in the first part of the year. In the last months of 2002, the inflation rate should rise again gradually owing to the domestic demand recovery and to the lack of the favourable statistical comparison effect. The consumer price profile in 2003 is slightly increasing, following upon the stronger economic expansion; at the end of 2003, inflation shall equal about 2%.

Geographical trends

The strong slowdown registered at national level in 2001 concerned in particular Central-Northern regions. Conversely, the *Mezzogiorno* of Italy underwent only a slight deceleration: according to the ISAE estimates, its GDP grew, on annual average, by 2.1% as against a 1.9% rise registered at national level. The smaller exposure of the Southern economy to the international events - which were the main causes for the brake hitting the various geographical partitions - probably influenced this trend. Thanks to these different evolutions, the *per capita* GDP in the South started to grow again, after the interruption of 2000, at a rate higher (+2.1%) than that of the North-Centre (+1.6% on average). Relatively positive signals for the *Mezzogiorno* of Italy continue to come from the labour market as well, where the improvement of employment, in keeping with the trend of 2000, concerned Southern regions in particular.

ISAE forecasts at regional level show that the expected slowdown on annual average in 2002 should hit the *Mezzogiorno* slightly less than the whole country: the Southern GDP would rise by 1.6% in our estimates, while that of the whole country should equal 1.5%. In 2003, the productive acceleration will homogeneously concern all geographical partitions.

In 2002, the dynamics of the *per capita* GDP in the Southern area should prove marginally smaller than the national average, owing to a slightly better demographic trend. In 2003, the trend of the *Mezzogiorno* of Italy should align to the Italian average. With regard to territorial competitiveness measured in terms of unit labour cost, in 2002 a new slight deterioration will be registered compared to the rest of the country, following upon a *per capita* income trend in keeping with the Italian one, in the face of a slower labour productivity dynamics. The competitive worsening should come to an end in 2003, thanks to more consistent evolutions of income and productivity.

Persisting the growth differential in favour of the *Mezzogiorno* on the levels which have been characterising the past three years - since 1997 the Southern *per capita* GDP has been increasing on average by 0.3% more than in the North-Centre -, the narrowing of the development gap characterising the South will occur very slowly indeed. Thus, to verify to what extent public policies may impact the convergence process, ISAE has carried out some simulations, taking as references the two major regional policy instruments, namely investments in public works and incentives to firms. Simulations show that expenditure in public works does represent a fundamental factor in the development of backward areas, which means this should be the instrument to attain the ambitious convergence objectives included in the Community Support Framework (larger growth of *Mezzogiorno* than the European average).

In 2001, owing to the economic slowdown and to the tax reliefs introduced in many countries, the public finances of the major EU economies have been worsening for the first time since 1993. According to the EC estimates, the deficit of the 15 EU Member Countries rose from 0.1% to 0.5% of GDP between 2000 and 2001, while in the euro area it has risen in the two-year period from 0.8 to 1.1%. Among Member States with most relevant negative balances - namely France, Germany, Italy, Portugal -, only Italy obtained a deficit

**Public finance in
2001...**

reduction last year both in absolute value and as a percentage of GDP. It was a "virtuous" evolution which must be, however, valued also in the light of the different positions which the various countries have with reference to their public debt: in 2001, Germany, France and Portugal registered a debt-to-GDP ratio equalling 60, 57.1 and 53.5% respectively. In Italy that figure equalled 107.9%.

According to the ISAE estimates, the Italian General Government net borrowing in 2001 amounted to 1.2% of the GDP; it was 1.5% in 2000. The figure is in line with the value (1.1%) indicated by Government in the update of the Stability Programme of last November.

The process of public finance adjustment has thus going on in 2001 and has eventually not registered the stop expected in mid-2001 (but not from *Ragioneria Generale dello Stato* - State General Accounting - and from ISAE who were expecting a smaller figure than other forecasters) on the basis of the unfavourable indications coming from the State Sector borrowing requirements. Many factors have influenced the deficit improvement of 2001. On the one side, the considerable and unexpected revenue of some substitutive taxes which offset the contraction of the tax revenue on managed savings; on the other side, the new Government's interventions on the Ministries' expenditure, on pharmaceutical expenses and on the securitisation of part of the real estate patrimony. Those provisions enabled the Government to contrast the main causes for the borrowing requirements deterioration, particularly the low efficiency of the measures for decentralised expenditure control, the very strong rise in pharmaceutical expenses following upon the co-payment abolition and the delays in real estate dismissions.

According to the ISAE estimates, given the stability of the primary surplus at 5%, the deficit cut in 2001 derived by the interest rate reduction (from 6.5 to 6.2% of GDP between 2000 and 2001), Primary expenses have slightly decreased (from 40.8 to 40.6% of GDP), thanks to the smaller capital account expenses. Also revenues marginally decreased as a percentage to GDP (from 45.8 to 45.6%). The fiscal pressure fell by few tenths of point, passing from 42.4 to 42.1%. The debt-to-GDP ratio decreased by more than 2.5 percentage points, equalling - as mentioned - 107.9% (110.5% in 2000). The reduction depends on the nominal GDP growth and on the revenues

from dismissals, equalling 4 billion euros, mostly deriving from the fifth portion of sales of ENI and by the extraordinary dividends of IRI.

As in 2001, also in 2002-03 the Italian public accounts will be better than those of the major euro area economies. According to the European Commission's estimates, both France and Germany show larger deficits as a percentage of GDP than the Italian ones. Furthermore, data show a new worsening during 2002 both for the whole of the European Union and for the euro area.

...and in 2002/03

Contrary to these trends, Italy shall continue to experience public deficit cuts. According to the ISAE estimates, the General Government net borrowing shall fall down to 0.9% of GDP in 2002 thanks to the December 2001 Budget Law and - if no corrections are introduced - to 0.8% in 2003. In spite of the recovery acceleration expected for 2003, the reduction of the deficit-to-GDP ratio is braked both by the smaller efficacy in 2003 of the revenue-increasing provisions and by the delayed effects on income taxation of the slowdown of 2002.

The ISAE estimates are less positive than the official ones, which indicate a 0.5% deficit in 2002 and a negative balance by 0.3% in 2003. According to ISAE, though the possibility to reach the budget equilibrium in 2003 is by no means compromised, the necessary measures to zeroing the deficit are harsher than what the Government assumes. This fundamentally derives - apart from the ISAE forecast of a smaller economic growth compared to the Government's assumptions (according to the ISAE forecasts, in the two years 2002-03 the cumulated GDP increase is 4.3%, while in the Government forecast it is 5.4%) - from a different computation of the impact of investment incentives on revenues and from a more cautious estimate of the substitutive tax revenue, after the extraordinary increases of 2001.

According to the ISAE forecasts, the primary surplus as a percentage to GDP reduces to 4.9% in 2002 and to 4.8% in 2003. The interest rate expenditure decreases in absolute value in 2002 and then rises again in 2003, in keeping with the interest rate fluctuations. However, its incidence on GDP continues to diminish, reaching 5.6% in 2003. The fiscal pressure falls by 1 percentage point in the two years, passing from 42.1% in 2001 to 41.1% in 2003. In 2003, the debt-to-GDP ratio reaches a percentage of 101.4, with a contraction by 6.5 points as against 2001.

***Financial impact
of the "proxy
law" on
pensions***

The public finance estimates elaborated by ISAE for 2003 are based on the existing legislation and thus take no account of the financial consequences of the "proxy law" on pensions (Parliament is asked to delegate to the Government the power to legislate on that issue). This may affect the 2003 budget both because it envisages the exemption from social security benefits for pension-postponing workers, and because it envisages changes in the contribution tax rate of some categories of workers (new employees and para-subordinate workers, that is self-employed positions concealing dependent work).

With regard to incentives to postpone pensioning, the evaluation of its impact on public accounts is difficult, as it depends on the single worker's convenience to opt either for working or for pensioning. The uncertainty fundamentally derives from the fact that the incentive may be chosen both by those who - had the provision not been introduced - would have opted for pension and by those who - though eligible for seniority pensions - would have continued to work altogether. Thus, the impact on the public budget depends on whether the former or latter share prevails. As none can foresee individual reactions, only very general estimates may be provided. In particular, we estimate that, if all workers who would have continued to work anyway, do opt for the contribution exemption, then - to have no negative impact on public accounts - at least 14% of the workers who would have opted for pension, had this opportunity not be introduced, remain in their working condition. Below this share, the provision would imply a burden for public accounts.

Another aspect of the "proxy law" which might influence the 2003 budget concerns the income wedge reduction (supposedly 3-5%) for new employees and the acceleration of the contribution rate rise for para-subordinate workers (compared to forecasts). The former provision implies smaller revenues; the latter a revenue increase. According to the ISAE estimates, the public finance consequences depend on the dimension of the contribution reduction applied to new employees. Indeed, if a 3% detaxation is applied, there would be a revenue loss (66 million euros) which would be more than offset by the positive effects of the tax rate increase for para-subordinate workers (87 million euros according to the estimates), with a revenue increase by 21 million euros. If however, the contributions on new employees are reduced by 5% (with a larger revenue contraction, amounting to

110 million euros), its impact on public revenues - considering the larger revenue of para-subordinate workers - would be negative and equal to 23 million euros.

Considering the recent trends, the generally positive scenario of the Italian economy described in the present Report is feasible in our opinion. However, the forecast is made in a phase of possible turning point of the cycle and therefore is based more on hints deriving from the various quality and leading indicators than on hard data, which necessarily refer to past trends which are still affected by the negative phase of the cycle. This is a risk for the forecasts, which must be taken into account. Indeed, hints may not translate in effective trends or require more time than supposed to materialise.

In the scenario depicted by ISAE, the risk factors connected to the interpretation of the cyclic signals are both of external and of domestic origin.

With regard to the international situation, the macroeconomic framework assumed as reference for the forecast is mainly based on the "catalysing" role the United States should take up in the recovery. The American recovery - though initially gradual - should strengthen the signs of recovery which have recently been emerging in Europe and should, more generally, prompt the major economic areas. In this case, the risk consists of the possibility that the favourable indications coming from the American cycle in the past few months do not announce a forthcoming recovery, but only reveal an adjustment phase to an excessive deterioration registered since September 11. If this were the situation, the timing of the US recovery would inevitably become longer, with repercussions on the trend of the other major economies, including the Italian one.

On the other hand, owing to the uncertain nature of available signals, even a *positive* risk factor represented by the possibility for the euro area to acquire thrust more rapidly than expected is part of the range of possible events. As Europe is the most important outlet market for Italian goods, the favourable repercussions for our country would be larger under this assumption.

With regard to the domestic situation, the elements for uncertainty are particularly connected to the capacity of the domestic demand components to gain thrust quickly and to "add" to the expected positive effects deriving from the better international cyclical situation. The

***Risks for the
macroeconomic
scenario***

present Report underlines that stimulating factors sustaining both consumption (disposable income) and investments (tax reliefs) are present in the Italian economy. Those factors might however take more time than assumed in our forecasts to induce a real expenditure increase on the part of operators. In particular, there are two potential obstacles hampering the quick recovery of domestic demand. The former is the possibility that what was observed in 2001 takes place in 2002 as well, namely a favourable trend of the households' disposable income accompanied by a generally modest consumption evolution. Although the brake to purchases experienced in 2001 is explained by the specific cyclical aspects of 2001 (inflation acceleration in the first part of the year and uncertainty connected to the terrorist attacks), there is however the risk that elements of *inertia* in the purchasing decisions of households might delay the recovery of consumption in 2002 too. The latter potential obstacle concerns investments and derives from the existence of unutilised productive capacity in the Italian system. The framework we depicted of robust and durable acceleration should push firms to invest again after the standstill experienced for most part of 2001. If however, the economic improvement is characterised - at least in its initial phase - by more fragility and uncertainty, the accumulation process might be affected as well and it might react with a delay to the stimula offered by economic policy. A more contained trend of consumption and investments might bring about a lowering of the growth rate, as against the one assumed in our forecasts, in both years.