

INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

ABRIDGED
QUARTERLY
REPORT

*FORECAST
ON THE ITALIAN
ECONOMY*

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CREDITS

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The Report is based on the information and data available up to July 16, 2001.

INTRODUCTION AND SUMMARY

The July ISAE Report is drawn up in a period fraught with uncertainties and question marks both at international and at national level. Making forecasts in a climate of growing uncertainty is at the same time more difficult - as mistakes are easier - and more stimulating - because in a scenario with less variables on which a consensus may be reached, the imagination efforts and evaluation capacity of the forecaster are more stimulated.

The unpredictable nature of the present international framework is daily analysed by experts. The world economy comes from a first half of 2001 characterised by a strong slowdown. In order to reach the (modest) growth rate forecast by the international organisation, a cyclical U-turn should occur in the second part of the year. The information on this point are however scattered and do not help those who want to dispel in one way or the other the doubts on the short-term trend of the main industrialised economies.

The question marks project their shadows on the Italian situation too, which is characterised by the same uncertainty of the international framework. On the top of it, consider the implications of the Government change - implying a different economic policy which is now being set and will become operative in the mid-2001 -, the non-fluid changeover from the previous to the present Government in terms of public finance and the consequent wave of uncertainty emerging over the past few weeks on the real estimate of their situation in 2001. This uncertain situation caused the shifting of the presentation date of the Economic and Financial Planning Document (DPEF), which indeed last till the moment when the ISAE Quarterly Report was about to be closed, as the first figures on the Planning Document for 2002-06 were only made known since the evening of Monday, July 16.

Thus, the present Report is unable to make a thorough evaluation of the forecasts and objectives of the DPEF concerning 2001 and 2002. Conversely, it reports the assessments and estimates which the ISAE researchers reached autonomously over the past few weeks. The larger or smaller distance between our scenario and the one illustrated by the Government in its Economic and Financial Planning Document may therefore be considered as an indication of the differences and

similarities of the ISAE short-term forecasts compared to the Government plans and projections.

It is finally worth to point out some novelties contained in the present ISAE Report. Firstly, more attention is devoted to the long-term macroeconomics of Italy: in particular, the cyclical analysis is carried out with an eye to the constraints to growth existing in Italy, namely the adequacy and efficiency of the Italian productive capacity (three boxes in the Report specifically deal with these aspects utilising the original information deriving from the ISAE surveys). Secondly, compared to the previous Reports, more room is left to territorial analysis, by devoting one whole Chapter to our estimates on the recent cyclical trends by geographical area and presenting the ISAE macroeconomic forecasts for 2001-02 by Administrative Regions. The reason for this larger attention to territorial breakdown is that the international integration of the Italian economy, the single currency adoption and the prospect of the European Union enlargement highlight the problem of the Italian economic geography not only in terms of structural problems, but also of monitoring the cycle and short-term forecasts.

* * *

**The
international
scenario**

The slowdown of the world economy in the first six months of 2001 exceeded any expectations. This was due to the United States experiencing a rougher brake than expected, with a cyclical growth in the first six months slightly over zero; to Japan registering again - after some recovery signals - warning signs of contraction of the economic activity which, if confirmed in the second quarter, should "technically" indicate a new recession; to Europe quickly slowing down, more than one could have expected on the base of trade links with the US economy.

The deceleration in the industrial area had a negative impact on the emerging economies. The consequences of the US stagnation on Asia went alongside with the negative effects of the brusque contraction witnessed by high-tech sectors (consumer electronics and intermediate goods used in high tech) in which many Far East countries are specialised. In Latin America, the strong trade link with the United States was mirrored in the deterioration of the growth rate of the main countries. The slowdown was only partially compensated

by the larger room left to monetary policies, following upon the interest rates reduction introduced by the Federal Reserve. In Central-Eastern Europe, the effects of the cyclical weakening of the European Union were added to the need to face the constraints linked to the adoption of the *acquis communautaire*, in the prospect of the future entry into the European Union. Generally speaking, the emerging economies are characterised by a considerable deceleration and by the persistence of two alarm bells for the international financial stability: Argentina and Turkey. In both countries, the crisis has led to the adoption of less rigid exchange rates and harsh financial adjustment measures.

Tab.1 WORLD TRADE - VOLUME
(percentage variations)

AREAS	IMPORTS					EXPORTS				
	1998	1999	2000	2001*	2002*	1998	1999	2000	2001*	2002*
OECD	8.0	7.4	11.2	6.1	6.4	4.2	5.1	11.2	5.9	7.7
Europe	8.7	5.9	10.0	6.5	6.6	5.4	4.8	11.3	7.5	7.2
Euro area (1)	8.7	6.0	10.6	6.4	6.5	6.2	5.0	11.7	7.9	7.8
United States	11.6	10.9	13.5	5.4	6.5	2.2	4.9	11.9	3.5	7.4
Japan	-6.6	5.8	9.8	5.6	5.2	-1.3	3.0	10.3	1.3	9.2
Non OECD	-3.1	1.1	15.5	6.8	10.6	3.1	5.9	14.1	7.3	8.4
Emerging countries	-3.8	2.2	15.9	6.7	10.7	3.0	5.9	14.0	7.2	8.4
OPEC	-6.0	-4.5	10.5	8.0	8.0	-6.0	-3.8	7.0	4.0	5.0
Transition countries	2.0	-7.8	12.6	8.0	10.0	4.0	6.0	15.0	8.0	8.0
WORLD	4.6	5.5	12.5	6.3	7.7	3.9	5.3	12.1	6.4	7.9

Sources: IMF, OECD.

* ISAE forecasts.

(1) Including Greece since 2001.

If one has to name the major responsible for the worse-than-expected performance of the international economy in the first part of the year, the choice falls onto the euro area. The forecasts made at the beginning of the year - including the one by ISAE - were based on the assumption that the United States brake would be partially compensated by the European growth persistence. Those forecasts were considering, on the one side, the limited trade exposure of the euro area to the US slowdown; on the other side, they were expecting a sustained trend of the European domestic demand prompted by the terms-of-trade gains due to the end of the oil shock and to the tax reliefs decided upon by the different Governments for the present year.

***The European
slowdown***

All that did not happen. The faster domestic demand dynamics did not materialise, in fact the statistical information on the first quarter of 2001 and the indications concerning the second quarter both show a consumption and investment deterioration.

That unsatisfactory performance was also influenced by the inflation acceleration registered in the euro area in the first part of the year, following upon a temporary oil price rise, due to the transfer of past energy rises onto final goods, to the effects of the BSE crisis on foodstuff and to the persistently weak euro exchange rate. The inflation rekindling at the beginning of 2001, eroded the real incomes of European consumers, constrained the ECB, weakened the confidence of households, worried that the labour market improvement was about to stop. The most hit economy was indeed Germany, where the weakening cyclical phase overlapped with the crisis of the construction sector due to the excesses of the post-unification period. The difficulties of the German economy are also of structural nature and are linked to the persistent rigidities characterising the German labour market. Because of those braking elements, Germany lost the role of "locomotive of Europe" it used to play. France too has been registering a significant deceleration over the past few months. Apart from an export contraction, it was also influenced by the investment activity deterioration. Indeed, the French households' consumption level has continued to show a relatively favourable trend.

Tab.2 INFLATION IN THE INDUSTRIALISED COUNTRIES
(percentage variations)

COUNTRIES	CONSUMER PRICES (1)				
	1998	1999	2000	2001*	2002*
France	0.7	0.6	1.8	2.0	1.5
Germany	0.6	0.6	2.1	2.8	1.6
Italy	2.0	1.7	2.6	2.8	1.9
Spain	1.8	2.2	3.5	3.6	2.2
United Kingdom	1.6	1.3	0.8	1.6	1.9
United States	1.6	2.2	3.4	2.9	2.4
Japan	0.6	-0.3	-0.6	-0.5	0.7
Euro area (2)	1.1	1.1	2.3	2.8	1.8

Source: OECD, Eurostat.

* ISAE forecasts.

(1) For the European countries, harmonised index.

(2) Including Greece since 2001.

After a worse-than-expected six-month performance, we deem that the international situation may gradually improve in the second half of the year. In particular, the most pronounced phase of deceleration is estimated to have occurred in the second quarter of the year. The trend of the main economies should prove more favourable, but still weak, in the third quarter. Only since the fourth quarter 2001, more lively development rates should emerge.

When will a U-turn emerge in the international scenario?

As already stressed, the available information are still unable to determine an "optimistic" or a "pessimistic" forecast. With regard to the United States, the ISAE evaluation - which one might label as "cautious optimism" - is based on the prompt response of fiscal policy, which will become expansionary since the late-summer 2001, and to the monetary policy, with an unprecedented cut to official rates by the Federal Reserve: 275 points in six months, equalling an average monthly cut of about 46 points. In the early-nineties, the US monetary authorities substantially lessened the monetary policy. That monetary easing was however more diluted through time: in twenty-six months the official rates were reduced by 525 points, with an average cut (about 19 points per month), equalling less than half the one experimented in the first six months of 2001.

The expansionary stance of monetary policy goes alongside with personal income tax reliefs planned by the new Administration for the period 2001-11, part of which shall be enforced at the end of the Summer. Whatever the use of American households of the gains deriving from tax reliefs (more purchases or reduction of debts), this should alleviate the overall situation of a crucial sector of the US economy, which analysts study with particular attention, being afraid that a sudden fall in consumption expenditure emerges.

The ISAE evaluation on the developments of the second half of 2001 is relatively more favourable for European countries as well. In this case, the improvement should come from the gradual easing of inflationary tensions in the second part of the year, mainly due to the supply shock overcoming (oil and BSE) which have pushed prices up in the early-2001. The inflation easing should favour, on the one side, the recovery of the purchasing power of European consumers - with positive effects for domestic demand -, and, on the other side, it should let the ECB successfully loosen its monetary policy. Under this hypotheses, a 25-points cut of the official European rates should take

place by Autumn. In this framework, the European recovery should also be fuelled - through exports - by the recovery of the US economy.

It is too early to evaluate whether these assumptions be corroborated by real trends. The available indicators on the international situation do not release univocal messages. Nevertheless, the latest US data give signals of a stabilisation of the negative trend and, in some cases, they point to the beginning of a U-turn. The NAPM index for the manufacturing industry, though still identifying a contracting sector, has stopped decreasing since February and has been registering a considerable rise in June. The NAPM index on services, after a three-month continuous decline, in June exceeded again the threshold of 50. The consumer confidence climate has been also stabilising since February and indeed in May and June it showed remarkable rises: the households' expenditure dynamics is still favourable and the purchases of durables and of new dwellings have grown. One might also interpret as an indirect indication of the slow improvement of the US situation the latest decision of a limited cut (0.25%) of the official rates adopted in June by the Federal Reserve, which in a way reveals the doubt that the monetary stimulus could be already in the pipeline.

The indications on the euro area are less clear, as the indexes of the firms' and households' evaluations are still downward-oriented. However, in this area, some favourable indications are emerging from the latest data: namely the good June trend of the European car market, the May recovery of industrial production and retail sales in Germany, the June increase in the PMI index in France.

***The figures of
the international
scenario***

Considering the latest trend and the above-described hypotheses on the developments of the second half of the year, the international scenario assumed by ISAE as the basis for its forecasts for 2001-02 registers a gradual recovery of the international growth due to the US economy recovery and to the strengthening of the European cyclical situation. In particular, under the assumption of a slow improvement of the US economy in late-2001, the American GDP growth should be on average 1.7%. In 2002, the recovery consolidation should lead the growth rate of the US economy to 2.7% on annual average and to above 3% in the last quarter.

The United States' recovery should produce favourable effects on the main areas and economies. The only relevant exception is Japan,

where the structural reform policies adopted by the new Government might show positive effects only in the medium-term, while in the short-term they might induce negative repercussions on the cyclical situation (following upon restructurings, re-organisations, firings, unemployment rises). In our hypotheses, the Japanese GDP experiences a standstill in 2001 and shall grow by 1.2% in 2002.

In the euro area, thanks to the expected domestic demand recovery in the second part of the year, the growth of 2001 should equal 2.2% (2.1% for EUR-11). It is a significantly lower development rate than the one ISAE expected at the beginning of 2001 (2.8% for EUR-11 and 2.9% for EUR-12). The dimension of the downward re-assessment made as against the January forecast (0.7 points) - which is larger than the one concerning the United States (0.5 points) - shows the serious nature of the brake registered by the European economies in the first half of 2001. In 2002, the euro area GDP, drawing advantages from the expected terms-of-trade gains and from the income-supporting provisions adopted by the main Governments, should increase by 2.7%, as in the United States.

Tab. 3 WORLD GDP
(percentage variations)

Areas	1998	1999	2000	2001*	2002*
Industrialised countries	2.8	3.0	3.7	1.7	2.4
United States	4.4	4.2	5.0	1.7	2.7
Japan	-1.1	0.8	1.5	0.1	1.2
United Kingdom	2.6	2.3	3.0	2.2	2.5
Euro area (1)	2.8	2.5	3.4	2.2	2.7
France	3.5	3.0	3.3	2.4	2.7
Germany	1.8	1.4	3.1	1.4	2.3
Italy	1.8	1.6	2.9	2.3	2.7
Emerging countries	1.9	3.9	6.1	4.6	5.2
Asia	2.0	6.5	7.5	5.7	6.2
Middle East	3.6	0.8	5.4	2.9	4.5
Latin America	2.0	0.0	3.9	3.3	4.0
Africa	3.3	2.3	3.0	4.2	4.3
Central-Eastern Europe	-0.9	2.4	5.9	3.7	4.1
WORLD	2.4	3.4	4.8	3.0	3.7

Source: ISAE elaborations based on IMF and OECD data.

* ISAE forecasts.

(1) Including Greece since 2001.

All in all, following upon these trends, the industrialised area should increase by 1.7% in 2001 and reach a 2.4% development rate in

2002. Similarly, the world GDP growth rate should reach 3% in 2001 and 3.7% in 2002.

The drastic growth slowdown observed in the first half of 2001 led to a brusque world trade halt. International trade should have experienced a substantial standstill in the first quarter in terms of volume and a considerable deterioration in the second quarter. By assuming a recovery in the second part of the year, the world demand might increase by 6.4 on annual average, which is about half the growth rate registered in 2000. During 2002, the consolidation of the international cyclical recovery should go alongside with an acceleration of trade, whose growth rate might exceed 7.5%.

With regard to international prices, the substantial balance characterising the oil market and the efficacy of the supply control policies introduced by OPEC should favour - unless seasonal oscillations and tensions linked to the political instability in the Middle-East - the stabilisation of the oil price in the reference range adopted by OPEC (22-28 dollars per barrel). According to the ISAE forecasts, the (Brent) oil price should equal 26.6 and 26.3 dollars per barrel in 2001 and 2002 respectively (in the average of the first ten days of July, the price was worth 25.4 dollars). For other raw materials, both the agricultural products prices and those of industrial commodities should register significant contractions on annual average in 2001. In 2002, the demand recovery coming from the industrialised area might bring about increases for both kinds of raw materials, which should however be limited (the expected price rise in dollars is 2-3.5%).

With regard to the currency market, the ISAE forecast assumes a gradual recovery in the euro/dollar exchange rate during the second part of the year, in consideration of the inversion of the interest rate differential between the two economies and of the needs to correct the wide American external deficit (equalling 4% of GDP). Also the currency changeover of the beginning of 2002 might contribute to the euro appreciation, with the overcoming of the uncertainty connected to that date and the coming back of funds which were moved abroad out of prudential reasons. In the ISAE scenario, the euro exchange rate on annual average should equal 0.89 dollars in 2001 (0.90 in the average of the first half of the year; 0.85 in early-July). The gradual appreciation should be confirmed in 2002, never reaching parity with

the dollar. In 2002, the euro exchange rate should equal 0.93 dollars on average.

The risks weighting on this scenario are mainly "downward". In the American economy, in spite of the recent string of favourable data, the risk of a new cyclical worsening is still not far enough. The United States continue to be a highly indebted economy, financed by large flows of foreign capitals, where the dollar is overvalued, productivity is significantly slowing, corporate profits are deteriorating and productive capacity is excessive owing to the large past investments in information technology. Thus, the macroeconomic situation is exposed to the risk of a deterioration, which the Federal Reserve has so far proved able to control, thanks, to a certain extent, to the dollar strength. Should in the future an "escape from the dollar" be accompanied by a further productivity deterioration, the margin of intervention for the American monetary authority would be drastically limited by the danger of a strong inflation rekindling.

The risks

A further element of risk in the international scenario concerns the fragility of some emerging economies. This is especially the case of Argentina, whose adjustment plan meets strong domestic oppositions and does not convince international operators. The experience of the financial crises of 1997-98 shows that, in situations of uncertainties, the turbulence quickly passes from one market to another, in spite of the geographical distance. The explosion of a new instability in Latin America, with its contagious effects, might negatively influence the international recovery.

In Europe, those developments would have obvious negative effects. Over the past few years, experts have repeatedly sustained that any deterioration in the international cyclical situation (both in the case of the Asiatic crisis and in the case of the US brake) might leave Europe almost unscarred, as it is somehow relatively "closed" to foreign trade. Indeed, as experience has shown, the trade links underestimate Europe's degree of exposure to external shocks. Indeed, financial links are as important as commercial ones, as indeed is the confidence of operators who are ever more internationalised, not only because they possess foreign investments in their portfolios, but also because they simply know the "facts of the world" and take them into consideration while making their choices of saving or consuming. It is no surprising, therefore, that external events, even far-off episodes, do

influence the expenditure decisions also in the relatively "closed" European economy.

The Italian economy: a better start compared to other European countries...

In the first three months of 2001, the Italian economy has overcome the international slowdown relatively better than other European countries. The GDP change was in line with the previous quarter and proved better than the main European economies. The export trend proved favourable even in the presence of a world demand standstill and of a fall in the European partners' foreign sales. Employment witnessed a new growth in a phase when the European labour market started to lose its dynamics.

In the early-2001, further elements differentiating the Italian economy from its European partners may be found in the climate indicators identified by the ISAE surveys. The consumers' confidence, which was considerably growing in March, reached its apex in June. In the same period, the European households' confidence climate has been diminishing. The entrepreneurs' confidence, though declining in a marked and continuous way since the late-2000, has shown signals of stabilisation since March - though they are still very frail - particularly thanks to more favourable expectations on order books and production. In this case too, the European confidence indicators follow a relatively worse trend and show no improvement in the short-term expectations.

The reasons for the (partly surprising) different cyclical situation in Italy in the early-2001 as against the European partners, are to be found, on the one side, in a possible competitiveness recovery of the Italian exports - which has been emerging in the second half of 2000 with an increase in the international market shares - and, on the other side, in a sort of "political cycle" determined both by the domestic demand-supporting measures adopted by the previous Government few months ago and by the announcements of a new intervention of the present Government, influencing the operators' general confidence climate. Another explanation could be found in the rigidities characterising Italy as against the other European countries. Such rigidities enable Italy to get near and eventually exceed the euro countries in the unfavourable phase of the European cycle, and instead to lag when European growth accelerates.

...but in a slowdown situation

The relatively good performance of the Italian economy at the beginning of 2001 is to be seen within a situation of general slowdown which should emerge more markedly in the second quarter of 2001.

Abridged Quarterly Report

The strong brake of the productive system in April-June is signalled by the industrial production fall (seasonally adjusted data), which is to be added to the negative effect of a smaller number of working days compared to the previous quarter; by the turnover and order-book

Tab. 4 ISAE FORECAST ON THE ITALIAN ECONOMY: GENERAL SUMMARY
(percentage changes, unless specified)

	2000	2001*	2002*
Gross Domestic Product	2.9	2.3	2.7
Imports of goods and services	8.3	5.8	8.8
Exports of goods and services	10.2	6.1	6.4
Resident households' consumption	2.9	2.1	2.6
Gross fixed investments	6.1	3.3	7.2
GDP growth contributions:			
- domestic demand (net of changes in inventories)	3.2	2.2	3.2
- changes in inventories and valuable objects	-1.0	0.0	0.1
- net exports	0.6	0.2	-0.6
Foreign trade balance (fob-fob) (1)	1.5	1.7	1.4
Current account and capital account balances (1)	-0.3	0.0	-0.2
Dollar/Euro exchange rate (level)	0.924	0.894	0.935
It. Lira/Dollar exchange rate (level)	2,100	2,170	2,070
Prices of raw materials (in dollars)			
energy	16.3	-5.5	2.0
non-energy	50.9	-5.4	0.3
	-3.6	-5.7	2.9
World demand	12.3	6.3	7.8
Consumer prices	2.5	2.8	1.9
Producer prices	6.0	2.9	0.3
Propensity to consume (% lev.)	88.4	89.2	89.7
<i>Per capita</i> gross earnings in the economy	3.1	3.5	2.7
Total employment (2)	1.5	1.6	1.3
Unemployment rate	10.6	9.9	9.2
General Government net borrowing (1)	-1.5	-1.4	-0.8
General Government primary surplus (1)	5.0	4.9	5.1
Fiscal pressure of General Government	42.4	42.0	41.5
General Government debt (1)	110.5	107.2	103.8
Nominal GDP (3)	2,257,066	2,382,407	2,504,364

Source: Istat.

* ISAE forecasts.

(1) As a percentage of nominal GDP.

(2) In standard labour units.

(3) Billions of lire.

deterioration; by the prospect of an inventories' contraction after a strong rise registered in the first quarter of 2001; by the export decrease

which, as in other European countries, should be influenced by the international slowdown in the second quarter of 2001. Those negative trends should more than offset a possible private consumption rise which, after the standstill of the past few months, should emerge in the second quarter, also following upon a disposable income improvement, as shown by the households' replies to the ISAE surveys.

What do the leading indicators say?

The expectations of the second half of 2001 point to a gradual improvement in the Italian cyclical situation as a consequence of the international economic recovery and of the adoption of domestic demand-supporting measures (either new or already introduced). The main leading indicators signal a third quarter better than the second but still weak, and a fourth quarter characterised by higher growth. In particular, ISAE business surveys and the short-term forecasts on industrial production show a no longer negative trend in the July-September period. The indications on the industrial production - still uncertain - improve in the fourth quarter. This is substantially confirmed by the leading indicator of the Italian economic cycle elaborated by ISAE, which shows a possible acceleration of the economic activity in late 2001.

Forecast for the Italian economy

On the basis of those indications, ISAE substantially confirms its January forecasts for 2001 - reiterated in the updating of the May forecast - of a 2.3% GDP growth. The slight reduction as against the previous estimate (2.4%) takes into consideration the non-favourable aggregate demand composition of the first quarter, as it stems from the ISTAT data, namely stagnation of households' consumption and strong inventory accumulation. Thus, in 2001, the Italian economy, after several years, would marginally grow more than the euro area (the euro area GDP should increase by 2.2%, 2.1% if one refers to EUR-11). This already happened in 1995; however in that year Italy was advantaged by the strong lira depreciation as against its European partners. In 2002, the recovery of the Italian economy would consolidate, with a GDP growth by 2.7%, which is in keeping with the average development of the euro area. At the end of 2002, the Italian economic growth might equal 3%.

Effects of the investment-fiscal incentives

The measures underpinning domestic demand adopted by the Government shall have a positive impact on the Italian economic recovery. According to our estimates, those fiscal incentives will only have a marginal impact on the GDP growth of 2001 (namely a 0.1%

increase). They will however have a more remarkable impact in 2002, by raising the growth rate of the Italian economy by 0.3%.

Those estimates are mainly based on the computation of the effects of the two provisions which are likely to have an impact on the investment demand in the short term: notably, what is known as the Tremonti Law, aimed at facilitating the purchases of capital goods, and the Target Law, aiming at prompting and accelerating large public works.

Tab. 5 EFFECTS OF THE INVESTMENT-SUPPORTING MEASURES ADOPTED BY THE NEW GOVERNMENT FOR ITS FIRST 100 DAYS (percentage deviations compared to the reference scenario and contributions to the GDP growth)

	2001		2002	
	Percentage deviations	Contribution to growth	Percentage deviations	Contribution to growth
Investments (excluding construction)	0.6	0.1	2.2	0.3
Investments in construction	0.0	0.0	1.5	0.1
Imports	0.1	0.0	0.5	-0.1
GDP	0.1	0.1	0.3	0.3

Source: ISAE estimates.

To estimate the impact of the Tremonti Law, reference was made to the previous investment-supporting experience made in 1994-95. In that occasion too, the law was enforced in mid-year and, similarly to the present provision, the previous five years (1989-93) were adopted as reference period to evaluate the additional investments eligible to get the fiscal incentive. The main differences between the present experience and the one of 1994-95 are the followings: the investment cycle of the reference five-year period 1996-2000, which is much different from that of the lapse of time 1989-93; the wider enforcement area of the law in its new version and the strong *announcement effect* of the present provision.

With regard to the investment cycle, the new incentive provisions intervene at the apex of an expansionary phase of the accumulation process. Quite the reverse, the 1994 Tremonti Law was being enforced in a phase of prolonged investment weakness and, in general, of economic recession. This difference is indeed of a certain importance, because it might partially reduce the provision effectiveness in sustaining investments.

According to our estimate, the impact of the 1994-95 Tremonti Law accelerated the investment activity dynamics as against its possible trend by about 3.5 percentage points: the effect of the larger investment growth mainly concentrated in 1995. On the basis of that experience, ISAE estimates that the new investment-supporting law might have a smaller impact, but better distributed through time. In particular, in the two years' period 2001-02, the larger growth of investments in capital goods would equal 2.8 percentage points. The smaller impact as against 1994-95 comes from the fact that, as mentioned, the provision is adopted at the end of a high investment cycle and intervenes in a period in which there are already other incentives to accumulation at work, which investors have considered while elaborating their expenditure plans for 2001. The presence of a strong *announcement effect* might indeed favour a more rapid reaction (compared to 1994) on the part of investors, so that some positive consequences on capital goods purchases would already emerge in 2001.

According to our estimates, there should be a 0.6% rise of investments in machinery, equipment and means of transportation compared to the normal trend in 2001 and a 2.2% increase in 2002. Following upon this stimulus, the growth rate of this expenditure component would range between 3.6% in 2001 and 9.1% in 2002. The contribution of investments in capital goods to the GDP growth would equal 0.1% and 0.3% in 2001 and 2002 respectively.

The evaluation of the Target Law is more uncertain, as there are no "historical" points of reference and one has to trust the announced effectiveness of this law in rationalising and accelerating great public works. The law has an impact on investments in construction which should also be positively influenced by the indirect effects of the Tremonti Law (possible enlargement of plants to set the new machinery) and by the liberalisation provisions for home restructuring. All things considered, ISAE estimates that the Target Law and the other provisions shall have a null impact in 2001 and shall bring about more effects in 2002, by causing a 1.5 percentage points increase in investments in construction. The rise in this kind of investments should equal 2.9% in 2001 and 4.4% in 2002 on annual average. The contribution of the stronger dynamics of investments in construction to the GDP growth should amount to 0.1% in 2001.

Thus, the investment-stimulating provisions (concerning capital goods and construction) should "add" 0.1 and 0.4 percentage points in 2001 and 2002 respectively to the Italian growth. Nevertheless, not all the domestic demand increase shall flow into national production, but it shall also fuel foreign productions, thus giving a further thrust to imports. A higher resort to foreign purchases should also occur in consideration of the high degree of plant utilisation characterising capital goods since early-2001. According to the ISAE estimates, following upon the domestic demand-stimulating provisions, the dynamics of imports of goods and services should accelerate by about 0.5% in 2002, thus subtracting 0.1 points to the GDP growth which would have emerged in 2001.

Considering the whole of these effects, one reaches the already mentioned figure of 0.1% in 2001 and 0.3 % in 2002 as the overall impact of the provisions on the GDP growth.

With regard to the other demand components, the resident households' consumption, after the first quarter's standstill, should have a more lively growth pace since the second quarter. The marked improvement in the households' opinions, the expectations for an easing of inflationary tensions in the second half of the year and the good prospects of the disposable income, all prompt a consumption acceleration.

Consumption

In particular, the disposable income dynamics should be positively influenced by the fiscal pressure reduction, by the still-favourable labour market situation and by wage increases exceeding *de facto* inflation on annual average. According to the ISAE forecasts, the consumption expenditure should increase by 2.1% in 2001, thus proving in net deceleration (by 0.8%) as against the very positive result of 2000. The consumption recovery should emerge in particular in 2002, with a growth rate equalling 2.6% on annual average.

With reference to foreign demand, after the good performance of the first quarter, exports should register a halt in the second quarter. According to the ISAE estimates, exports of goods and services shall rise by 6.1% in 2001, which is substantially in keeping with the world market enlargement. In 2002, Italian sales abroad should witness an acceleration (+6.4%) remaining however below the world demand dynamics. In particular, Italian exports might be braked by a market evolution less favourable to Italian products and by the lower

Net foreign demand

competitiveness in extra-European destination countries due to the foreseen strengthening of the euro exchange rate.

With regard to imports, the foreign purchase dynamics should remain in the average of 2001 (+5.8%), namely slightly lower than the export dynamics. In 2002, imports might significantly accelerate (+8.8%), thus mirroring the domestic demand recovery and the leakage in favour of foreign products of the provision stimulating investments in capital goods.

The international price trend and the gradual exchange rate appreciation should enable a recovery of the terms-of-trade by about 1% both in 2001 and in 2002. That improvement should give rise, in 2001, to an improvement of the trade balance (by about 4,000 billions as against the previous year). In 2002, the quantitative deterioration of trade (with an export dynamics slower than that of import) would more than offset the rise in the terms-of-trade thus causing a worsening in the trade balance.

The labour market

The labour market trend remains substantially favourable. In the first quarter 2001, the overall employment - measured in standard labour units - showed a further rise. The indication coming from the labour force surveys signal a slowdown in April in the creation of new jobs, presumably owing to a productive activity deceleration.

An element of novelty in the employment dynamics which has been characterising the first half of the year is the determining role of the employment rise played by "typical" labour contracts, unlike what happened in the recent past. In fact, four fifths of the annual rise of employed registered in April refer to full-time non-fixed term contracts. The larger weight of this component might partially reflect the effect of fiscal incentives (under the form of tax credits) recently introduced to favour a recovery of stable labour contracts.

According to the ISAE forecasts, a brake shall emerge in the creation of new jobs during 2001. However, thanks to the strong rise witnessed in the first quarter, the average dynamics in 2001 should remain high, equalling 1.6%. Employment should considerably rise again in 2002, even though the average annual increase (+1.3%) should be smaller than in 2001, owing to the particular profile which characterises this variable between 2001 and 2002. In the two years, the employment elasticity to GDP, on average, should equal 0.6, thus remaining in keeping with the figure registered on average in the

previous three-year period, and confirming the very high level compared to historical standards which have been characterising the Italian economy.

In terms of persons, the increase in standard units means a rise of about 600,000 employed in the two-year period 2001-2002. The unemployment rate continues its gradual downward trend, by reaching 9.9% on annual average in 2001 and 9.2% in 2002.

The wage dynamics should equal 3.5% in 2001, following upon a 3.7% growth in services (+4.2% in the public sector) and a 3% rise in industry. In 2002, wages should decelerate again, thus reaching a growth rate equalling 2.7% for the whole economy. Considering the provisions on the health care contribution detaxations set in the latest Budget Law and the productivity dynamics, the labour cost per unit of product of the Italian economy should register a larger increase in 2001 (+2.2%) and a slower dynamics in 2002 (+1.1).

During the second half of 2001, the substantial wage moderation and the smaller exogenous price thrusts coming from raw materials and from the exchange rate should favour the gradual easing of tensions on prices. The consumer price growth rate should pass from the present figure of 3% to 2.5% in late-2001. In the absence of new shocks, the inflation rate should continue to fall in 2002, thus reaching a level below 2% in the second half of the year. That trend should lead to a price increase by 2.8% on annual average in 2001 and by 1.9% in 2002. The inflation differential of the euro area should be substantially annulled in the two years.

The Report analyses in some specific boxes some peculiarities characterising the productive capacities and efficiency of the Italian economy. The first aspect on which attention is drawn is that - in spite of the cyclical slowdown - the degree of utilisation of the production factors has continued to signal scarcity and tensions. Such signals come both from the output gap indicator and from the gap between the actual unemployment and the NAIRU. At the same time, as confirmed by the evidence in the Report, the Italian economy is characterised by high capitalisation comparable to the one of the major European economies (namely Germany and France). The capital-intensive nature of the Italian (and European) production exceeds the US one. This is somehow a paradox, if one considers the particular structure of the Italian economy, characterised by the prevalence of small firms and by

Inflation

Productive capacity, bottlenecks and investment-stimulating provisions

an imbalanced output composition in favour of the so-called traditional (labour-intensive) productions.

Tab. 6 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND DYNAMICS
(percentage variations)

	1996	1997	1998	1999	2000	1996-2000 annual average
<i>North-West</i>						
GDP	0.9	1.8	1.9	1.4	3.4	1.9
Net exports	-1.2	-6.0	-10.2	-12.2	7.2	-4.7
Domestic demand (net of inventories)	2.1	2.8	3.3	2.6	4.1	3.0
Private final consumption	1.5	4.3	3.2	2.1	3.2	2.8
Gross fixed investments	5.2	0.0	5.9	5.1	8.4	4.9
<i>North-East</i>						
GDP	1.4	2.3	1.9	2.1	3.0	2.1
Net exports	14.2	3.9	-17.6	-8.0	0.2	-2.1
Domestic demand (net of inventories)	1.8	1.7	3.2	2.7	4.2	2.7
Private final consumption	1.2	2.9	3.2	2.4	3.5	2.6
Gross fixed investments	3.7	0.0	4.4	4.3	7.9	4.0
<i>Centre</i>						
GDP	1.1	1.3	1.3	1.7	2.7	1.6
Net exports	11.9	-14.5	-29.9	-49.0	55.8	-11.8
Domestic demand (net of inventories)	1.2	2.0	2.4	2.7	3.0	2.2
Private final consumption expenditure	1.0	3.2	2.9	2.2	3.4	2.5
Gross fixed investments	2.2	0.4	3.0	5.4	2.8	2.8
<i>Mezzogiorno</i>						
GDP	1.0	2.6	2.0	1.7	2.4	1.9
Net exports	-4.3	7.6	3.5	8.6	1.0	3.2
Domestic demand (net of inventories)	0.6	3.1	2.0	2.3	3.0	2.2
Private final consumption	-0.3	2.6	2.4	2.0	3.2	2.0
Gross fixed investments	2.6	8.2	3.3	3.9	4.1	4.4

Source: ISAE elaborations on Prometeia data.

Italy, as indeed the other European countries, is therefore characterised by an overcapitalisation as against more dynamic economic systems, such as the United States. The Italian (and European) productive process generally presents excessive and obsolete capital stocks obstructing efficiency and reducing the firms' profitability compared to the United States. The higher capital intensity of Italian (and European) business firms was also the response to the

labour rigidities leading to the adoption of labour-saving techniques, by replacing labour with capital goods and, even more, with imported intermediate goods. That considerably improved the labour average productivity to the detriment of total (or multifactor) productivity, the dynamics of which remained lower and much below that of the American economy.

Thus, the low efficiency of the economic system (measured by total productivity) seems able to reconcile the information of persistent productive capacity scarcity, coming from the ISAE indicators, with the evidence of overcapitalisation. Operators perceive productive capacity as insufficient, because it is hardly efficient.

In consideration of that, a major need of the Italian economy is the capital stock renewal through measures aimed at eliminating the basic causes for overcapitalisation (elimination of the remaining labour rigidities) and through interventions aimed at favouring a more rapid substitution of the "old" low-productivity capital units surviving in the capital stocks of Italian firms. To this end, incentives to investments may prove useful if they do not limit themselves to distributing facilitations to everybody - which would be counterproductive *per se*, as they would thus merely add to the already high and ineffective existing capital -, but if they succeed in accelerating the obsolete capital elimination, thus introducing innovative and technologically-advanced capital goods. In this prospective, a temporary demand-supporting provision might produce permanent effects on the supply-side and on the long term economic growth.

As already stressed, the ISAE Report presents a regional breakdown (Administrative Regions) of the macroeconomic forecasts. A useful reference point to evaluate the framework emerging from regional forecasts lies in the objectives set by the latest Community Support Framework (CSF) for the period 2000-06. Those targets consist of attaining a growth rate for the *Mezzogiorno* of Italy considerably larger than that of the European Union, thus reducing social disadvantage, particularly through the legal employment rise. As against this target, the ISAE forecasts for 2001-02 provide fairly positive indications for the labour market. Indeed, in the forecast scenario, the unemployment rate fall in the *Mezzogiorno* is taking place more rapidly than in the North-Centre. In particular, it goes from 21% in 2000 to 19.2% in 2002. Furthermore, employment should rise

***Territorial
breakdown***

in the South more than in the North-Centre (+1.9% in 2001 and +1.2% in 2002, as against growth rates in the North-Centre equalling 1.3% and 1.2% respectively in the two years). The plan for the emersion of "black firms", defined within the measures adopted by the new Government for its first 100 days, might positively influence the prosecution of this trend.

Conversely, signals out of keeping with the CSF come from the growth forecasts. In the ISAE forecasts, the development recovery in the *Mezzogiorno* compared to the North-Centre - which had characterised the past few years - comes to a halt. The GDP growth in the *Mezzogiorno* of Italy should equal 2.2% in 2001 and 2.5% in 2002, as against rises of 2.3 and 2.8% respectively in the North-Centre. In terms of *per capita* GDP, the gap between the *Mezzogiorno* and the North-Centre remains "frozen" at last year's levels, owing to a relative worsening of Southern labour productivity offset by an employment rate rise as against the North-Centre.

Public finance

According to the ISAE estimates, the General Government net borrowing in 2001 equals 40,000 billion lire, equalling 1.7% of GDP, after the 1.5% registered in 2000. The deficit reduction would start again in 2001, thus reaching a net borrowing of 29,000 that amounts to 1.2% of GDP.

In absence of interventions, the difference between the net borrowing of 2001 and the figure included in the Quarterly Report on the Borrowing Requirement published in April would amount to 15,500 billion lire. Compared to the target of the Stability Programme, the gap would equal 20,500 billion lire. The difference mirrors the economic growth slowdown compared to the original Government forecasts and the worse trends (net of the cyclical effects) of revenues and expenditure. Many elements contributed to that situation: indeed they were already listed in the ISAE President's Hearing of October 2000 and in the ISAE Quarterly Report of January 2001. In terms of expenditure, the scarce effectiveness of the provisions limiting expenditure for purchases of goods and services and the strong expansion of the expenditure for pharmaceuticals, mainly due to the abolition of patient-co-payments; in terms of revenue, the borrowing was influenced by the negative impact of the considerable revenue fall coming from taxes on capital gains and by the incomplete realisation of State real estate dismissions as against the plans.

The provisions adopted by the New Government (100-day manoeuvre) have an impact on the ongoing net borrowing trend. In particular, thanks to the correction effects already introduced in 2001, they should reduce the General Government deficit to 32,700 billion lire, namely 1.4% of GDP, in 2001 and to 20,000 billion (i.e. 0.8% of the GDP) in 2002. To reach the 0.5% target set for 2002 by the updated Stability Programme, it should be necessary to enlarge the manoeuvre by further 6,000 billion lire. This means that the target of an equilibrium balance by 2003 does not seem unfeasible, though it should be reached through a path different from that indicated in the latest updating of the Stability Programme. With reference to 2001, the primary surplus as a percentage of GDP falls by 0.1% compared to 2000 (from 5 to 4.9%). The revenue contraction as a percentage of GDP would be partially offset by the effects of the 100-day provisions. In 2002 the primary surplus would rise again, by reaching 5.1% of GDP.

According to the Economic and Financial Planning Document for 2002-06, the ongoing trends should bring about deficits, as a percentage of GDP, equalling 1.9% in 2001 (45,000 billion lire) and 1.7% in 2002 (42,200 billion lire) respectively. The difference with the ISAE trend estimates amounts to 0.2% in 2001 and 0.5% in 2002. The gap emerges with regard to revenues and, in particular, with regard to expenditures. The Planning Document shows for 2001 much larger capital account expenditures and higher expenditure for interests and intermediate consumption. In 2002, larger estimates are confirmed for the same items, and - on the top of it - a more pessimistic social benefit expenditure than the ISAE figure is reported. With regard to revenues, the Planning Document foresees larger proceeds both for 2001 and for 2002, particularly from personal income revenues and larger capital account revenues other than tax proceeds. The discrepancies between the capital account items (either revenues or expenditure) which should be mirrored in the total gap may however depend on the different accounting of the revenue from real estate dismissions which ISAE, similarly to the national accounting, lists among the expenditure with inverted sign and the Planning Document includes in the revenues.

With regard to the Planning trends, the Planning Document reports the Stability Programme objectives (0.8% in 2001 and 0.5% in 2002), and postpones to the Autumn updating note the thorough

indication on the budget provisions and of its feasible results. It has to be noticed that, as far as 2001 is concerned, the Government is committed to make all possible efforts to bring public accounts towards the Programme objectives: in terms of expenditure, through a more efficient domestic Stability Pact, through administrative measures and through a more articulated debt and accounting policy, in terms of revenues, through the effects of the Tremonti Law and through an acceleration of the real estate dismissions. Unlike the indications contained in the Planning Document, the ISAE forecasts already embody the impact of the black economy emersion plan since 2001.

Should the objectives for 2001 and 2002 not be confirmed in the forthcoming Stability Programme updating, this would not imply the impossibility to honour the Stability Pact. Indeed, the Pact envisages the only constraint of reaching a balance equilibrium in the medium-term, with no specific recovery path, as reported in the Opinion of the Monetary Committee adopted by the Council Regulation of Stability and Convergence Pact of October 12, 1998. Indeed, the failure to respect the Stability Programme objectives is likely also for other major European countries, such as France and Germany. In the case of Germany, the deficit estimates for 2001 fall short not only of the Programme target, but also of the result obtained in 2000.

**Areas for
intervention**

According to the ISAE evaluations, the targets listed in the Stability Programme for 2002 (net borrowing equalling 0.5% of the GDP) and in the Stability Pact for 2003 (balance equilibrium) are not unfeasible. The zero balance may be obtained in full keeping with the European commitments. The binding constraints, which however condition their effective and long-lasting realisation, are essentially two: the need for measures acting on the current expenditure and the need to make interventions consistent with the long-term public accounts sustainability, namely taking into account the effects of the population ageing.

Those two conditions lead to identify in the health care and pension expenditures the two main areas where the intervention should concentrate. However, the room to reduce the health care expenditure seems very thin. Italy already has a ratio of health care expenditure to GDP smaller than the European average. Considering that health expenditures are a kind of investments in human capital (as happens in

professional training and in education upgrading), the Italian economy is already partially penalised compared to its European partners.

Given this "constraint", one may find room for manoeuvre in raising funds from health care by making the decentralisation process set by the Budget Law of 2001 (setting stringent rules on deficit formation) function. The Ministry of Health has to ascertain the deficit dimension, in the State-Regions Conference, identify the taxable income for regional taxes and compute the tax rate increases necessary to cover them. Administrative Regions are compelled to act by increasing tax rates, otherwise a Government intervention is foreseen. Besides, the co-payment re-introduction would enable to collect 2,000-2,400 billion lire. However, in this case, the provision should be accompanied by the full and complete functioning of the Indicator of the Equivalent Economic Situation (IEES) so as to select - on the basis of an economic condition rather than of age - the persons eligible for the health care co-payment exemption.

The need for a restoration of the social security expenditure balance (already "constrained" by health care) and for public accounts long term sustainability lead to identify in pension expenditure the main area for Government intervention. After three reforms (the Amato Reform, the Dini Reform and the Prodi Reform), old age pensions in Italy are still a Government *gift* measured by the difference between the benefits received and the contributions paid. That *gift* tends to diminish very slowly. It shall remain for at least twenty years, being particularly generous for the beneficiaries of seniority pensions, while it becomes almost null for men and smaller than in the past for women. Admittedly, in the long run, this shortcoming will be reduced with the shift from a fixed-benefit to a fixed-contribution system. However, even in the long run, it will be possible to retire at fifty-seven in a pay-as-you-go system which shall continue to make (anagraphically young) active workers pay the pension burden. With a quickly ageing population, in the presence of the lowest fertility and mortality rates in the world and with a pension age much smaller than the European average, the public pay-as-you-go pension system is no longer sustainable in Italy.

Even after three reforms, old age and seniority pensions in Italy imply such an enormous and growing outflows of public funds as a percentage of GDP that, even in 2045, their ample share shall not be

covered by contributions. In the absence of interventions, pension spending shall amount to 16% of GDP in 2045 and the additional public debt accumulated by the social security system from now up to that moment shall equal about 1,000 billion euro, i.e. approximately the Italian GDP of one whole year.

These considerations highlight the need to intervene urgently on pension expenditure. In 2001, the occasion to introduce those changes is offered by the testing of pension expenditure trends explicitly foreseen by the 1995 reform. The kind of intervention necessary to make pension expenditures sustainable is well known to experts and analysts: firstly, it is necessary to raise the pension age of Italian workers to the European average (by approximately fixing the minimum of a possible flexible range at 65 years of age for workers of both genders). This provision implies a public finance saving and - at the same time - an increase in *per capita* pension benefits. Retiring later means higher incomes (thus more contributions paid) for the persons remaining in the labour force and, at the same time, higher pensions once they retire.

The second form of intervention concerns the elimination of seniority pensions (with the exception of some particularly stressing jobs), which would raise about 3,500 billion lire in 2002. This measure might contribute to fund the raising of minimum pensions, promised by the Government. The estimates show that - by limiting the pension rise to pensioners having no other income than their pensions - that burden would amount to an overall figure of 2,000 billion lire. With a gradual enforcement of the provision aimed at improving minimum pensions, the elimination of seniority pensions since 2002 would enable both to cover the pension increase and to free resources which would reduce the General Government deficit in 2002 for an amount equalling 0.1% of the GDP.

The two further forms of intervention which would complete an effective action aimed at structurally reversing the pension expenditure trend concern the replacement rate lowering (that is the pension/wage ratio) and the development of the other two pension system pillars, by resorting more to supplementary pension funds and facilitating the use of severance pay to finance pension funds.