



ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Forecast on the Italian Economy

Synthesis

FEBRUARY 2004

CREDITS

The present Report is the result of the team work of a wide group of researchers coordinated by Sergio de Nardis. In particular, the drawing up of single Chapters was edited by Margherita Cagiano de Azevedo, Clemente De Lucia, Roberta De Santis, Maria Teresa Fiocca and Marco Fioramanti (Chapter 1); Cristina Brandimarte and Claudio Vicarelli (Chapter 2); Giancarlo Bruno, Maurizio Bovi, Sandro Calabresi, Claudia Cicconi, Massimo Mancini, Mara Meacci, Marco Malgarini, Maria Cristina Mercuri, Luigi Minelli, Carmine Pappalardo, Gianfranco Piras, Giovanni Principe, Gaia Rocchetti, Daniela Rossi, Emanuela Tassa and Franco Sartori, with the contributions of Mariella Cozzolino and Rosetta Salvini (Chapter 3); Roberto Basile and Marianna Mantuano (Chapter 4). We thank Emma De Angelis and Paolo Fanfoni for their collaboration.

The editing was ensured by Maurizio Brioni, Giuseppina Marasca and Fernanda Turella, coordinated by Silvia Fanfoni. The English version was translated by Paola Felli and edited by Sergio de Nardis himself.

The Report is based on the information and data available up to February 3, 2004.

Summary and Introduction

In the late-2003, the world economic activity became stronger and was characterised by a general confidence growth, a stock market improvement and an investment recovery, after the long contraction caused by the crisis of the new economy and fuelled by the uncertainties due to the corporate accounting scandals in the United States, to terrorist attacks and to military conflicts.

***The
international
framework***

The acceleration of the overall growth took place with different timing and pace in the different areas and in the various countries. The stepping up of the international economy was triggered by the United States and by the Far East. In the former case, the thrust came from the strongly expansive policy mix adopted by the American Authorities over the past few years, the impact of which has been fully spreading since the mid-2003, namely once the perplexities due to the Iraqi war were overcome. This favoured a profit gain, hence an investment relaunching, which prompted the American economy together with a positive private consumption dynamics. In the case of the Far East, the rapid expansion of China – whose only obstacle was SARS - provided a strong development engine to the whole region, thus contributing to the significant leap forward of the Japanese economy. The recovery of Japan after a long period of stagnation - during which the productive system showed no signs of reaction to the incentives adopted by the Japanese Authorities - was a surprise for analysts and good news for all those who trusted the effectiveness of traditional cycle-regulating instruments. However, Japanese sustained growth rates are by no means taken for granted, given that they mainly depend on foreign demand and the credit system reform meant for prompting development has not been completed yet.

Turning to emerging countries, growth was very rapid in Russia, which drew benefit from the large oil gains and from intense foreign investment flows mainly coming from the energy sector, and in India, which was prompted by the information technology recovery. Signals

of improvement also came from Latin America, where the financial conditions of large economies (Brazil and Argentina) improved.

The euro area recovery took place late, both in terms of timing and intensity: the main countries (Germany, France and Italy), which registered a stagnation/recession in the first half of the year, benefited from the strengthening of the overall economy, being prompted, on the one side, from the more lively world trade and being braked, on the other side, by the euro appreciation as against the dollar and the main currencies. The different cyclical performance of the euro area as against the United States should lead us to reflect. Maybe it was affected by the flexibility/rigidity characterising the markets of goods and factors in the two economic areas. However, it is difficult to deny that the completely different macroeconomic approaches adopted on the two sides of the Atlantic played a major role in the past cyclical phase. The present Report (see Box on *Economic Policies in the Euro Area and in the United States*) compares the intensity of the tax and monetary incentives introduced in the United States with those adopted in the euro area, given the decreasing cyclical trend of the past three years. The differences emerging in the provisions adopted by policy-makers in the euro area and in the United States are enormous.

**Final balance for
2003**

The final balance for 2003 – which is affected by the unfavourable trend of the first half of 2003 – shows, in our estimates, a world GDP growth by 3.3%, with a 0.5% rise compared to 2002, and a 3.6% increase in world trade (computed as the average of exports and imports), which marks a slight improvement (+0,2%) as against 2002, due to a more gradual economic activity recovery.

With reference to single countries, the GDP dynamics equalled 3.1% in the United States (2.2% in 2002), 2.2% in Japan (-0.3% in 2002) and only 0.5% in the euro area (0.9% in 2002). The modest figure of the euro area was wholly due to the favourable evolution of the second half of the year. In emerging countries, it is worth noticing the 9% bounce of China and the 7% growth of India and Russia.

**Less uncertain
forecasts...**

Thus, for the first time since a long time, the early-2004 international framework laying the basis for the ISAE forecast shows less uncertainties: indeed, the long-lasting period of world stagnation ended in late-2003 and the looming-ahead recovery is spreading in all countries with different intensities.

If the overall trend is generally favourable, there are however some tensions which might affect the future development of the world framework in the short and medium term and which must be taken into account when making forecasts for 2005. The main reasons for tension are to be found in the imbalances characterising the American economy, in their impact on currency markets, in the standstill of the process of international economic integration and in the reverse of trend of trade policies.

*...with
imbalances and
tensions*

The aggressive policy adopted by the United States caused twin deficits for the second time in twenty years, namely the Federal deficit and the current account one, both slightly below 5% of GDP. The re-emerging of such an imbalance had a great impact on the international capital flows and raised some questions on the long-term sustainability of the American budget, unless major policy changes are introduced (see Box on *Twin Deficits in the United States*). According to recent forecasts of the Congressional Budget Office (CBO), the Federal budget – on the basis of virtuous hypotheses - should be balanced again in 2014. However, things might go differently. If more realistic assumptions on the dynamics of discretionary expenses and on the evolution of taxation are adopted, a deficit is foreseen in the next decade equalling 7% of GDP, with a Federal deficit (now worth 35%) around 50%. The American public accounts are bound to worsen in the next few years, when the baby boomers retire and weight on the social security and health care systems; according to some CBO estimates, in the presence of unfavourable revenue and expenditure trends, the Federal deficit might exceed the threshold of 100% of GDP between 2020 and 2040.

*Twin deficits in
the United
States*

The potential risks connected with those trends mainly concern the medium and long term and not exactly a two-year forecast. However, the idea of long term might “shorten”, if growing public deficits and the lack of feasible corrections modify the (present) market expectations and reduce confidence both inside and outside. In our scenario, we assume that, after the “turning point” of next November’s Presidential election, the new American Administration will introduce budget policies to fight the deficit-widening trend. However, in the lapse of time between now and the onset of the new Administration, the US macroeconomic imbalance is a major cause for unsustainability as against the variables most exposed to oscillating expectations,

***Exchange rates
and monetary
policies***

particularly exchange rates.

In 2003, alongside with the widening of the twin deficits, markets changed and started focusing on the selling and buying decisions of financial assets in different currencies and on the American imbalances rather than on growth differentials between the United States and the euro zone, as it used to happen in the past. This was accompanied by the policy-makers' perception of the different policy pursued by the US Authorities, who showed a sort of benign neglect of the dollar exchange rate, let alone a stand in favour of its weakening. The Asian countries' hostility towards their currencies' appreciation (Japan with massive interventions, China with its stickiness to the US dollar and with its controls on the capital movements) implies that a huge share of the American foreign adjustment concerns the euro area, with the risk of stopping the European recovery.

Thus, the major question concerns the behaviour of the most important Central banks and the degree of cooperation they will adopt while trying to condition markets. With regard to the euro area, the ECB is assumed not to reduce interest rates until the dollar/euro exchange rate remains stable under the "tolerance threshold" (which is around 1.30) that does not compromise the productive recovery of the area. This approach goes alongside with attempts to limit excessive upward oscillations of the euro, with interventions on the currency market which the Europeans – and other monetary Authorities - will try to influence as soon as possible (perhaps in the forthcoming G7).

With reference to the Federal Reserve, we assume that the negative output, the low inflation and the weak labour market reply to the economic expansion characterising the present year all lead to postpone upward corrections of the official interest rates. According to some observers, the change noticed over the past few days in the words used by the Open Market Committee in describing the monetary policy behaviour ("can be patient in removing its policy accommodation" compared to the previous wording "policy accommodation can be maintained for a considerable period") might mean that some initiatives are taken before Summer. In our assumption, the economic-political situation of the United States – namely a robust growth with a small number of jobs and a modest price dynamics – requires that no upward adjustments of interest rates will take place before the forthcoming elections.

On the basis of this assumption, the forecast points to stable interest rates on the present level up to the late-2004 both in the euro area (2%) and in the United States (1%). There should be rises in 2005, which might be more marked in the United States. At the end of 2005, the official interest rate should equal 2.75% in the euro area and 3% in the U.S. economy. Alongside with those developments, the November elections in the United States might represent a turning point for exchange rates as well. Indeed, once overcome that date, the new macroeconomic approach (both in fiscal and monetary terms) of the United States towards targets of stability should favour a monetary tension easing. According to our estimates, the euro should equal the average figure of 1.27 dollar in 2004 (1.13 in 2003) and then fall down to 1.14 on average in 2005, which is closer to the balanced euro-dollar exchange rate. With reference to the yen, a policy based on Central Bank interventions would run counter the dollar appreciation which should take place in 2004, and the yen-to-dollar exchange rate should equal 106.5 (115.9 in 2003). In 2005, the yen-dollar exchange rate should be worth 113.

Over the past few years, a marked slowdown emerged in the process of integration of the economies compared to the fast pace characterising the second half of the last decade. In the three-year period 2001-2003, the international trade elasticity to the world gross product decreased to one third of the average value registered between 1996 and 2000 and to 50% of the figures observed between 1985 and 1995. Indeed, cross-border investments of multinationals witnessed an even stronger contraction (see Box on *Recent International Trade Trends and Standstill of Multilateralism*). Those developments may be partially due to the impact of an unfavourable world cycle. This might hold true in particular for direct foreign investments, which are strongly pro-cyclical. However, such a slowdown in the international integration dynamics had never taken place before - either for trade or for investments - in the last twenty-three years' globalisation process. Besides, those evolutions went alongside, on the one side, with a general deterioration of the geographical-political framework and a consequent higher risk to start either export or production activities abroad, and, on the other side, with a reverse of trend of policy-making towards international integration with the crisis of multilateralism (failure of Cancun), a cautious approach to China and the spreading

World trade

tendency to regulate trade at a bilateral and regional level. Indeed, one might think that the diminishing trade dynamics is by no means a transitional phenomenon linked to unfavourable cyclical phases. Indeed, even the political developments concerning the two major areas (Presidential elections in the United States and EU enlargement) lead policy-makers to focus their attention on domestic problems rather than on the major topics which caused the standstill in the trade negotiations between the North and South of the world (first of all, agriculture).

In our forecasts, those trends are taken into consideration, and a rather cautious estimate of the world demand dynamics is made. In particular, a world trade acceleration is foreseen (+7.1% in 2004 and +7.4% in 2005) which leads to an increase in the trade elasticity to the world gross product compared to the very low levels of the past three years (in our assumption, elasticity should pass from about 1 in 2001-2003 to an average 1.8 in the two-year period 2004-2005), but which is below the figure reached in the second half of the past decade (3).

*International
figures for
2004-2005*

On the basis of those estimates, the ISAE forecasts for 2004-2005 point to a strengthening of the international economic cycle. This year, the expansionary effect of the policy mix and the dollar depreciation should enable the United States to grow by 4.4%. In 2005, the American economy dynamics might decelerate down to 3.2%, thus being affected by the monetary and fiscal policy corrections and by the end of the exchange rate support. In Japan, the GDP growth should be about 2% both in 2004 and in 2005, which means the process of economic reform, confidence improvement and high expenditure propensity in the private sector is going on.

The European Union should witness an acceleration in the next two years, equalling 2% in 2004 and 2.4% in 2005. Those estimates refer to the EU with 15 Member States. However, in a few months the enlargement will take place and ten new Members will join: they have completely different structural and development characteristics from the Union's incumbents, which is an opportunity deriving from the "specialisation" benefits which the integration will bring to Member States. However, the enlargement is also a reason for concern, as the entry of new States takes place in an unchanged institutional framework (given the failure to find an agreement on the draft Constitution) and within an open discussion on fundamental questions

concerning the political and financial prospects of the new EU (adequacy and dimensions of the EU budget, allocation criteria of the structural funds, CAP reform, immigration rules and the like). Indeed, the new Member States will gradually (and with different timing) become monetary partners of the present EU Members through the endorsement of the II EMS Exchange Agreement, which is a prerequisite to enter the euro club (see Box on *Prospects for Joining the II European Monetary System of the "New" EU Member States*). This perspective provides great opportunities too, thanks to the closer integration which will come out, together with some risks due to the higher exposure of the European exchange system (including euro), should episodes of instability of the new Members' currencies emerge.

In the euro area, the latest indications on the entrepreneurs' confidence apparently show that the benefits deriving from the larger world demand offset the negative impact of the loss of competitiveness due to the euro appreciation. In our assumptions, the initial thrust provided by the export acceleration should be followed by a domestic demand strengthening supported by the higher trade revenues, by the stock market recovery and by an interest rate stability for the whole 2004. The GDP growth in the euro area should equal 1.8% for 2004. In 2005, should the euro attain more balanced figures, there would be a further acceleration of the GDP dynamics, which will step up to 2.4%.

In the emerging economies, the expansion pace should remain high and – according to the information we have so far - in the Central-Eastern Europe (+5% on average in the two years considered) and in Asia (+6.5% both in 2004 and in 2005) the ongoing health care problems should not seriously affect growth. The economic activity in Latin America might become lively again. All in all, the world product will grow by 4.2% in 2004 and 4% in 2005.

With reference to the international raw material prices, ISAE estimates that the Brent quotation may remain high in the first half of 2004, and then gradually fall in the second half of the year and in 2005. The raw oil price should equal slightly more than 25 dollars per barrel on average in 2004 and about 25.5 dollars in 2005. With regard to the other raw materials, the dollar depreciation and the Chinese demand growth – China is a major consumer of industrial commodities – favoured a significant price acceleration in the late-2003. Those effects should gradually decrease during 2004 and, in particular, in 2005,

**Italy between
the end of 2003
and the
beginning of
2004**

when the dollar gains ground again on the international markets. In our assumptions, the prices of all non-energy raw materials (expressed in dollars) should rise by 12.8% on average in 2004 and then moderately fall in 2005 (-0.5%).

Similarly to what happens in the euro area, cyclical information concerning Italy – available between the late-2003 and the early-2004 – show a gradual recovery of the economic activity.

The industrial production, which decreased between mid-2002 and Spring 2003, has been growing again since May 2003, when the all-time trough was reached in the manufacturing cycle. After the November 2003 rise (0.3%), the moderately positive trend went on in December (0.2%) and in January (0.3%). Indeed, a contraction might emerge in February, which would however not mine the positive trend. The rosier evolution is mirrored in the gradual diffusion of the favourable cyclical phase to a growing number of sectors which, however, were still a minority in November as against the whole industrial sector (ISAE estimates that less than 50% of the about 180 manufacturing sectors were registering an expansion).

The slow improvement also emerges from the ISAE Survey on Industrial Firms which in January showed a confidence climate improvement mainly due to growing expectations on industrial production. With reference to the impact of the euro appreciation, assessments on foreign order books do not show difficulties yet. Quite the reverse, investment goods producers point to a reverse of the negative trend, perhaps due to the acceleration of the world demand for machinery and equipment, which has taken place over the past few months. Indeed, the degree of utilisation of industrial plants, which – in spite of the recovery observed at the end of the year – remains at historically low levels, and the relatively high number of firms pointing to a diminishing demand as the main cause for their production standstill, both confirm the limited nature of the ongoing recovery.

On the service side, the ISAE Monthly Surveys have been providing favourable signals since the mid-2003 which partially diminished in December and January. Indeed, the ISAE Annual Survey on Market Service Firms reports favourable expectations for 2004.

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

	2003*	2004**	2005**
Domestic references			
Gross domestic product	0.5	1.7	2.3
- North-West	0.5	1.5	2.1
- North-East	0.5	1.6	2.3
- Centre	0.7	2.3	2.7
- Mezzogiorno	0.5	1.7	2.3
Imports of goods and services	1.0	5.0	7.3
Exports of goods and services	-1.9	4.2	5.7
Resident households' expenditure for consumption	2.3	2.1	2.5
Expenditure of General Government and NPISH (1)	1.8	1.1	1.5
Gross fixed investments	-3.2	1.8	4.3
Contribution to GDP growth attributable to (percentage points):			
- domestic demand (net of stock changes)	1.0	1.9	2.6
- stock changes and valuable objects	0.3	0.1	0.2
- net exports	-0.9	-0.2	-0.5
Current and capital account balance (as a percentage of GDP)	-1.4	-0.9	-1.1
Consumer prices	2.7	2.0	2.0
Producer prices	1.6	0.8	1.4
Propensity to consume (percentage level)	88.1	88.7	89.3
Per capita gross earnings in the economy	3.1	3.0	3.1
Total employment (2)	1.0	0.5	0.9
Unemployment rate	8.7	8.5	8.3
General Government net borrowing (as a percentage of GDP)	-2.5	-2.5	-3.2°
General Government primary surplus (as a percentage of GDP)	2.7	2.4	1.6
Fiscal pressure of General Government	42.1	40.6	40.3
General Government debt (as a percentage of GDP)	104.9	103.8	103.6°
3-month Treasury Bills yield (3)	2.0	2.1	2.9
p.m. Nominal GDP (millions of euros)	1,307,583	1,366,135	1,429,325
International references			
Dollar/Euro exchange rate (level)	1.131	1.272	1.140
World demand	3.6	7.1	7.4
Official exchange rates (3)			
- ECB	2.0	2.0	2.75
- Federal Reserve	1.0	1.25	3.0
Prices of raw materials (in dollars)			
- energy	14.4	-4.3	-6.8
of which: Brent (\$/barrel)	28.8	28.3	25.6

Sources :ISTAT, Bank of Italy, Federal Reserve, HWWA.

*ISAE estimates. **ISAE forecasts, tendential scenario for 2005.

°Assuming that provisions accounting for 1.5% of GDP are introduced, the net borrowing of 2005 falls to 1.8% and the debt decreases to 102.5%.

(1) Non-Profit Institutions Serving Households.

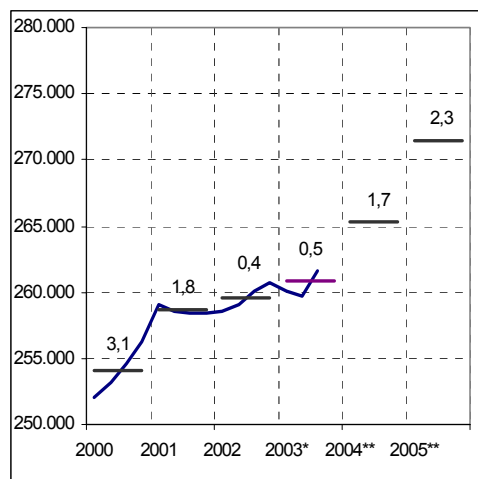
(2) In standard labour units.

(3) End-of-year annual yields. Gross compound Treasury yield bills.

The leading indicator and the GDP dynamics at the end of 2003...

The most favourable note of the Italian cyclical phase is provided by the leading indicator (elaborated by ISAE) which, after a long-lasting standstill, has been signalling a strengthening trend for a few months.

GROSS DOMESTIC PRODUCT
(millions of euros, base year 1995, seasonally adjusted data corrected for the different number of working days)



Source: ISTAT.
* ISAE estimates. ** ISAE forecasts, tendential scenario for 2005.

On the basis of these indications, the Italian GDP – after diminishing in the first two quarters of 2003 and leaping forward in the July-September period (0.5%) - is estimated to have increased by 0.4% in the last quarter 2003 (seasonally adjusted data corrected for the different number of working days). That dynamics should give rise to a 0.5% average growth in the economic activity in 2003 (0.4% in 2002), which coincides with the euro area rise estimated for 2004 (0.5%).

... and in 2004 and 2005

The favourable trend of the Italian economy should go on in the first months of 2004 and be partially slowed by the impact of the euro appreciation and – to a lesser extent – by some limited consequences of the Parmalat crisis and by the connected lack of confidence of Italian households. In the second half of 2004, the thrust coming from the world trade growth, the beginning of a reverse of trend in the exchange rate and the gradual enhancing of the final domestic demand should favour the strengthening of the GDP dynamics. In 2004, Italy should expand on average by 1.7% (with a tendential rise of about 2% in the last quarter), which is in keeping with the euro area figures. Thanks to its acceleration profile, the year 2004 should “leave over” to 2005 a positive heritage of about 1%. In the presence of a persistently favourable cyclical evolution, the development rhythm of the Italian economy should become more lively in 2005: according to our tendential scenario for 2005, the GDP growth equals 2.3%, thus getting close to the expected value of the euro area.

Contributions to the GDP growth

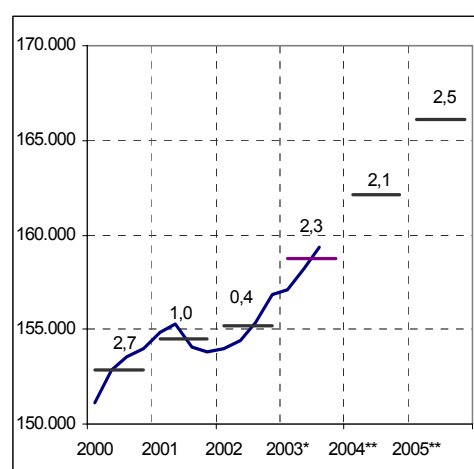
The evolution of the Italian economy in 2004 should draw benefits from the favourable trends of all domestic demand components. The strongest contribution to the GDP growth should come once again from the households' consumption, which should contribute with about 1.3 percentage points (1.4 in 2003, according to our estimates). The contribution of gross fixed investments – which was negative and equalled 0.7 in 2003 – should be positive again and amount to 0.4% in 2004. The net export evolution should go on subtracting some tenths of one percent to the economic activity dynamics (0,2 in 2004, 0.9% in 2003), and the contribution of inventories should be marginally positive (0.1%, and 0.3% in 2003).

In 2005 there will be a further strengthening of the support to growth coming from domestic demand. The contribution of the households' consumption should rise by 1.5 percentage points, while the one of investments will be close to one percent. Conversely, the contribution of the net foreign demand should remain negative (0.5%).

During 2003, the resident households' expenditure for consumption registered a positive evolution. The recovery of this expenditure component started in the late-2002 and was prompted by the State incentives to car purchases. The end of those incentives caused a stop at the beginning of 2003, and then a new acceleration which led to a 0.7% growth in the July-September period compared to the previous quarter and to a 2.5% rise compared to the previous year. That evolution was definitely better than the one experienced by the main euro area economies in the same lapse of time. The Italian advantage is even more evident if one considers the Italian demographic dynamics, which is slower than that of the other European countries. In terms of *per capita* growth, the higher growth of Italian consumption in 2003 was even larger and was not far from

Consumption

HOUSEHOLDS' EXPENDITURE
(millions of euros, base year 1995, seasonally adjusted data corrected for the different number of working days)



Source: ISTAT.
* ISAE estimates. ** ISAE forecasts, tendential scenario for 2005.

the one registered in the United States.

Such a change took place in spite of a persistently unfavourable households' confidence climate (a long-lasting contraction, net of accidental oscillations, in 2002 and then a stagnation during most of 2003), of the alarms on a higher perceived inflation than the one measured by ISTAT, of the discussions on the euro negative effects, of the indications on a gradual impoverishment of the middle class. It is indeed difficult to reconcile the picture stemming from climate indicators and the partial, and sometimes even anecdotic, empirical evidence with the national accounts figures. Maybe, for the time being, one can only assume – and then verify when more information are available - that the apparent discrepancy between the two pictures is due to the rising dispersion of the households' expenditure behaviours around the average value of national accounts.

What we can estimate, on the basis of the available data, is that during 2003 a rise in the disposable income took place, prompted by the favourable trend of the *per capita* income and of employment, which went alongside with a more than proportional rise in consumption. The growth of the purchasing propensity – which marks a reverse of trend as against 2001 and 2002 – may have been due to a rise in financial wealth and to the consequent stock market recovery and the persistently low level of interest rates. According to ISAE, the resident households' expenditure has increased on average by 2.3%.

In perspective, the conditions which favoured the acceleration of consumption in 2003 should remain. At the beginning of 2004, there was a further households' confidence contraction which was caused by the uncertainty raised by the Parmalat crisis, which eventually brought about a deterioration of assessments on the general economic situation and on saving. The consequences of the early-2004 worsening sentiment on the spending behaviours should be transitional in terms of quantity. The evolution of consumption in 2004 and 2005 should draw benefit from the favourable dynamics of the “fundamentals” and, in particular, from the positive trend of the households' disposable income, as their purchasing power should benefit from the inflation cut due to the euro appreciation. ISAE estimates that the expenditure growth for consumption in 2004 should equal 2.1%. In 2005 – also thanks to the positive “left over” of 2004, the growth pace might reach 2.5%. Taking account of the disposable income dynamics, those trends

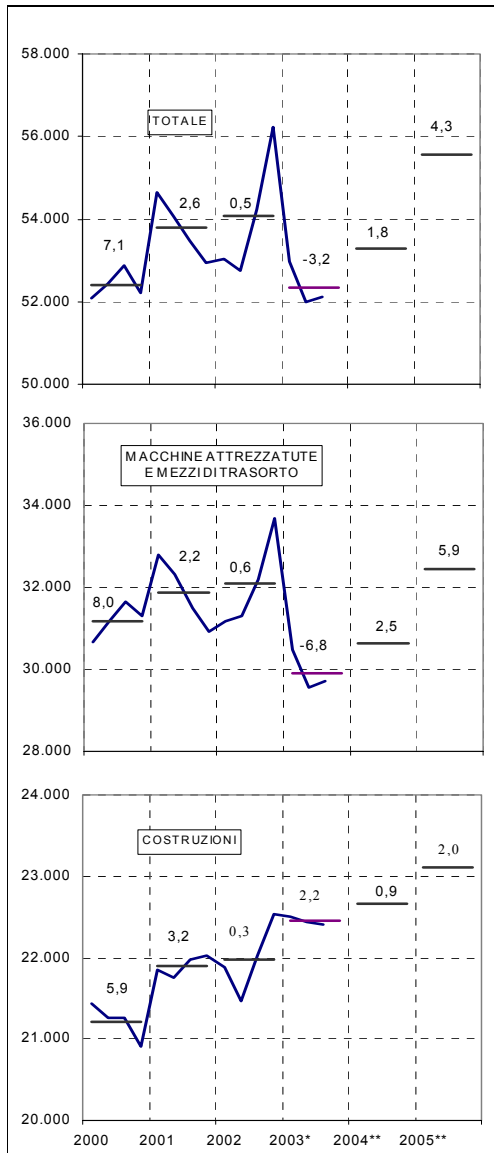
imply that the consumer propensity rises by about one percentage point in both years.

With reference to investments, the negative impact emerged in the late-2002 due to the stop of the tax incentives introduced by the *Tremonti bis* diminished in the third quarter. According to our estimates, this expenditure component stopped decreasing in the last quarter of 2003 but remained very weak. In 2003, the average fixed gross investments fell by 3.2%, thus mirroring the strong cut in investments in machinery, equipment and means of transportation (-6.8%), which has more than offset the positive effect of investments in construction (2.2%). This result was reached in spite of the unfavourable trend registered in 2004 and only mirrors the favourable “left over” of 2003.

In 2004, the improved international and domestic general economic situations should encourage the recovery of the accumulation process, which might step up in the second half of the year, when the braking effects of the euro appreciation diminish. Investments in machinery, equipment and means of transportation will grow by 2.5% in 2004. Also thanks to a considerable “left over”

Investments

GROSS FIXED INVESTMENTS
(millions of euros, base year 1995, seasonally adjusted data corrected for the different number of working days)



Source: ISTAT.
* ISAE estimates. ** ISAE forecasts, tendential scenario for 2005.

**Exports and
imports**

effect, the rise in 2005 might equal 5.9%. With reference to construction, 2004 should be characterised by an average growth slowdown which should remain positive and equal to 0.9% in 2005. Indeed, a more sustained development is expected in 2005 (2%), particularly thanks to a strengthening of non residential construction. Hence, total investments should grow by 1.8% in 2004 and by 4.3% in 2005.

Exports of goods and services registered a continuous and significant contraction in the fourth quarter of 2002 and in the second quarter of 2003, interrupted by the considerable jump (5.7%) witnessed in the July-September period. The recovery of Italian sales abroad mirrored the world trade recovery which offset the loss of competitiveness due to the euro appreciation. That situation – namely the improvement caused by the foreign demand acceleration reducing the penalisation due to the exchange rate – seems to emerge from ISAE Surveys as well, which – as already stated – show signals of deterioration compared to the past. A slowdown in the final part of 2003 also seems to emerge from the November-December ISTAT data on foreign trade. On the basis of all those information, the dynamics of exports of goods and services seems to have decreased in the last quarter of 2003, which led to an average negative variation of 1.9% on an annual basis.

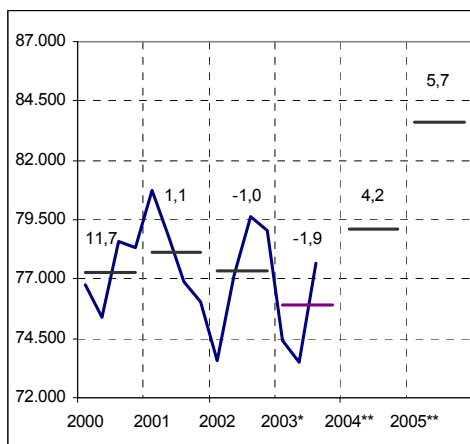
A limited, though positive, evolution seems to characterise also the first part of 2004. The trend should strengthen in the second half of the year, with a fall in the negative impact of the exchange rate appreciation. In 2004, exports of goods and services should rise on average by 4.2%. In 2005, the dynamics of the Italian sales abroad should accelerate, alongside with a reverse of trend in the euro quotation, and reach 5.7%. Those dynamics imply a further erosion of the Italian market share due to the loss of competitiveness and to the unfavourable geographical composition of the world demand. Our major destination countries will grow less than the others, particularly in 2004.

The euro appreciation might have diversified consequences on the Italian exporting firms. The present Report provides an analysis carried out on the micro-data of the ISAE Survey on Industrial Firms, aimed at investigating the persistence of exporting firms on the main destination

markets (see Box on *Persistence and Variability of Italian Exporting Firms on the Main Outlet Markets*).

The ISAE analysis shows that “the rate of survival” of Italian firms is structurally shorter than that of the United States as against what happens in Germany. That result is affected by the stronger effect of the hysteresis emerging on the German market as a consequence of the economic and political links binding Italy and Germany. The examination of exporting firms by geographical partition and by dimension highlights different levels of vulnerability to the dollar depreciation. Indeed, North-western firms and large firms show more stability on the American market as against firms located in other geographical partitions (particularly in the North-east) or smaller firms. Looking at single sectors, the survival rates in the United States are relatively low (compared to the German figures) for exporting operators in clothing, textiles, leather. Conversely, operators in paper, glass, ceramics and precision instruments (spectacles and clocks) are more resistant.

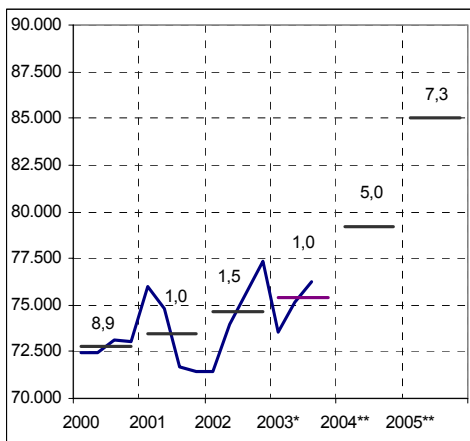
EXPORTS OF GOODS AND SERVICES
(millions of euros, base year 1995, seasonally adjusted data corrected for the different number of working days)



Source: ISTAT.

* ISAE estimates. ** ISAE forecasts, tendential scenario for 2005.

IMPORTS OF GOODS AND SERVICES
(millions of euros, base year 1995, seasonally adjusted data corrected for the different number of working days)



Source: ISTAT.

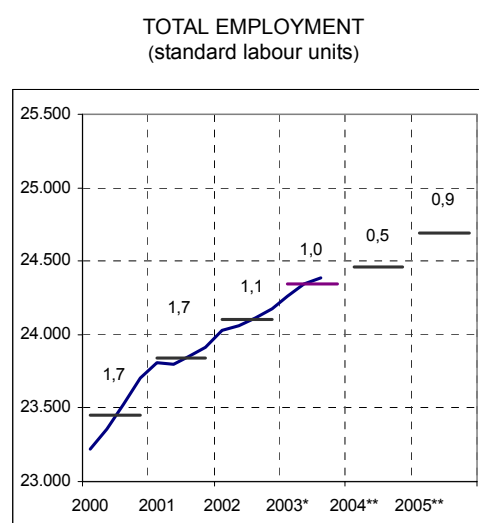
* ISAE estimates. ** ISAE forecasts, tendential scenario for 2005.

On the import side, the Italian economic recovery should lead to a rise of our purchases abroad which should grow by 5% in 2004 (1% in 2003) and by 7.3% in 2005. The GDP elasticity-to-imports of goods

and services should remain close to the levels characterising the two-year period 2002-2003.

Labour market

In 2003, the labour market performance was still favourable, in spite of the standstill caused by the creation of new jobs in the second half of the year. The rise in the overall number of employed amounted to 1%, which is twice the GDP growth. The unemployment rate further diminished and reached 8.7% on average in 2003, falling down to 8.5% at the end of the year, which is below the euro area rate (8.8% in November).



Source: ISTAT.

* ISAE estimates. ** ISAE forecasts, tendential scenario for 2005

The ISAE forecasts for 2004 point to a decreasing trend in the creation of new jobs as a delayed effect of the slowdown of 2003. In 2004, on average, the standard labour units should grow by 0.5%. The employment dynamics should strengthen again in 2005, in keeping with the consolidation of the productive recovery, thus reaching a growth rate close to 1%. That evolution implies a “normalisation” of the employment-to-GDP elasticity, which should fall from the abnormal values registered over the past few years (above 2) to levels equalling 0.3-0.4. Such a decrease shall bring about a further labour productivity growth, after three years characterised by a stagnating (in 2001) and then decreasing (in 2002 and 2003) labour productivity. That improvement should help give back competitiveness to the whole economic system.

In terms of people, the overall growth in the two years 2004-2005 should amount to 350,000 units; the unemployment rate should decrease by 8.3% in 2005, while the employment rate should reach 57% (compared to a 58.5% target indicated in the National Employment Plan).

The changes which have been characterising the Italian labour market over the past few years and the new contracts introduced by the

Biagi Law are worth a further deepening.

In the past five years, the growth in the number of employed mainly favoured older workers with more than 50 years of age. This is only partially connected to the population ageing and to the passage of a growing number of workers to older cohorts. The present Report (see Box on *Working Conditions and Employment of the Elderly*) highlights how the higher employment rate of older workers (with more than 55 years of age) mirrors a change in their behaviours, presumably due to the provisions introduced in the second half of 2003 raising the prerequisites for pension eligibility. The higher “participation” to the labour market of that bracket of workers is mirrored not only in smaller retirement rates (namely a reduction in transitions from employment to pension), but also in a more intense job seeking (a clear cut in the transition from unemployment to pension), which was mostly awarding (increase in transitions from unemployment to employment).

***The elderly and
the labour
market***

The employment dynamics of 2004 and 2005 will be affected by the legal novelties introduced by the *Biagi Law*. Given the information at our disposal, it is difficult to identify the incidence of that *Law* on choices and behaviours of labour market operators. To fill this information gap, ISAE carried out an *ad hoc* Survey on business and service firms at the end of 2003. The results of that Survey are described in the Report (see Box on *The Innovations of the Biagi Law and Hiring Intentions of Firms in an ad hoc ISAE Survey*). The respondents’ replies point to their growing intentions of resorting to private employment agencies and show a considerable interest for the diffusion of *ad interim* labour contracts. A further element which is worth noticing concerns the attentions firms devote to job-on-project contracts: an indication which might contribute to dispel the doubts raised by some observers on the uncertainty deriving from the legal changes introduced in coordinated and continuous collaboration contracts. Conversely, ISAE respondents show a scarcer knowledge of the legal framework concerning the completely new contract formulas introduced by the *Law* (job-on-call, shared jobs, occasional jobs, job vouchers).

***The Biagi Law
and industrial
firms***

The labour market reforms introduced since 1997 have increased the labour market flexibility and have thus contributed to improve the Italian labour performance. The new contracts may affect the

***Job flexibility
and security***

perception of job security in a diversified way. On the one hand, they are characterised by a higher degree of uncertainty compared to traditional labour contracts, on the other side, as they do contribute to provide more fluidity to the job market, they should lead to easier movements from one job to another. The present Reports tries to investigate those aspects (see the Box on *The Italian Workers' Perception of Job Security*) through the replies of the Italian respondents to the European Community Households' Panel. The Survey shows a deterioration of the perception of job security between 1995 and 2000. However, on the basis of our estimates, this does not seem so much connected with the fear to remain unemployed for a long period, but rather to the possibility to eventually have – in 2000 rather than in 1995 – smaller wages owing to the frequent (even short) job interruptions. Hence a higher labour market fluidity seems to emerge and the unemployment periods seems to be shorter, but this goes alongside with a growing trend (as against the nineties) to reduce wages whenever a worker is unemployed even for short lapses of time.

Wages

With regard to wage dynamics, the gross *per capita* earnings of the whole economy increased in 2003 by 3.2%. The assumptions for 2004 and 2005 are based on the contributions already agreed upon during the latest and in the new wage bargaining rounds concerning those two years. On the basis of those trends, the unitary wages for the whole economy increase by about 3% both in 2004 and in 2005. The evolution in the manufacturing industry should amount to 3.1% in 2004 (3% in 2003) and to 2.9% in 2005. Thanks to the increasing productivity, the unitary cost of labour should decrease: after a 3.7% increase in 2003 (and 3% in 2001 and 2002), the Italian unitary labour cost should rise by 1.6% and 1.7% in 2004 and 2005 respectively. In industry excluding construction, the growth should amount to 1.6% on average in the two years considered.

Inflation

In 2003, those who expected a rapid inflation contraction in Italy were disappointed: in fact, an inflation easing took place only in the final part of the year. The inflation-reducing process was hampered by both occasional and temporary exogenous impulses, and by structural endogenous factors linked to the degree of competition of the different markets and sectors. In 2003, the consumer price dynamics on average equalled 2.7%, which marks an acceleration as against 2002 (2.5%). The increase in the inflation velocity between 2002 and 2003

characterised Italy compared to its European partners in the same lapse of time. The divergence between real and perceived inflation (the latter computed on the basis of the ISAE Consumer Surveys) seems to have diminished between the late-2002 and the late-2003, in correspondence with the price freezing surveyed by ISTAT.

The ISAE forecasts for the two years 2004-2005 point to an inflation dynamics slowdown. During 2004, the euro appreciation and the unitary labour cost deceleration should encourage a tension easing. In particular, ISAE estimates that inflation will fall just below 2% in summer: a slightly higher pace might characterise autumn, both in terms of statistical comparison with the same period of 2003 and in terms of economic growth strengthening. On average, the consumer price dynamics should amount to 2%, which means 0.7% less than in 2003 and close to the smallest figures ever registered since 1999. In terms of harmonised index, the average growth in 2004 should equal 2.2% (2.8% in 2003), with a narrowing to 0.3% of the gap between Italy and the EMU economies (0.7% in 2003). In 2005, the favourable impact of the euro appreciation should diminish, but the decrease of unitary production costs should continue. Hence, the inflation rate should remain stable on the late-2004 figures for most of the year, equalling on average 2%. The harmonised index should mark a 2.1% growth with a 0.4 percentage point differential as against the euro area.

The modest growth of the Italian economy in 2003 concerned the major geographical partitions with scarce differences, just highlighting a slight “advantage” – on the basis of our estimates – in the Centre (0.7%). The results of 2003 hardly modified the medium-term development dynamics observed over the past few years. The *Mezzogiorno* of Italy is the partition providing the best performance. Thanks to the emergence of significant migration flows from the South to the North-Centre (see Box on *Domestic Migration Flows in Italy between 1975 and 2000*), since 1995, the *per capita* GDP in Southern Italian regions slightly narrowed the gap with the rest of Italy. In 1995, the Southern *per capita* income (at constant prices 1995) amounted to 55.7% of the Northern-Central one; in 2003 it was worth almost 58.5% of the Central one.

ISAE estimates that Central regions will have the most sustained growth. The other Italian partitions should grow with a pace closer to the national average: the GDP growth in the South should be worth

Economic activity by geographical partition

1.7% in 2004 and 2.3% in 2005. Following upon the demographic dynamics, the slow process of narrowing of the *per capita* income of the *Mezzogiorno* and the one of the rest of Italy is gradually going on, though with a slower pace than in the past.

In 2003, the process of public finance worsening started in 2001 went on. On the basis of the latest forecasts of the European Commission, the General Government deficit in the 12 EMU countries equalled 2.8% of GDP (2.2% in 2002), thus showing a difference compared to both the Commission data of spring 2003 (2.5%) and, in particular, to the figures contained in the Stability Plans presented between the late-2002 and the early-2003 (1.8%). All countries experienced a budget deterioration, with the only exemption of Belgium. In particular, in 2003, France and Germany registered deficits above 3% of GDP for the second year in a row.

Alongside with the flow worsening, also stocks increased: according to the Commission's estimates, the debt-to-GDP ratio of the euro area grew again in 2003, reaching 70.4% (69% in 2002). Half of the European economies registered a ratio above the threshold set by the Treaty of Maastricht (60%); indeed, in 2003 France joined the group of countries exceeding that threshold.

Given the modest growth and the worsening budget positions, at the end of November, the ECOFIN Council decided with a majority vote to suspend the excessive deficit procedures started against Germany and France between the end of 2002 and the early-2003. This led to a harsh confrontation with the Commission, particularly with reference to problems of procedure (see Box on *The Excessive Deficit Procedure: Rules and Their Discretionary Implementation*).

On the basis of the autumn forecasts made by the Commission, the negative balances of the euro area should stabilise at 2.7% of GDP in the two-year period 2004-2005, while the debt should rise to 70.7%.

In Italy, according to ISAE, the General Government net borrowing equalled 2.5% in 2003, which is in keeping with the target indicated in the Forecast and Planning Report. The debt-to-GDP ratio should diminish from 106.7 in 2002 to 104.9 in 2003, being affected by the currency-denominated debt due to the exchange rate appreciation and by the privatisation of large State-owned companies (*ETI*, shares of *ENEL*, of *Mediocredito del Friuli*, of the *Cassa Depositi e Prestiti*

and, through it, of *ENI*, of the Italian Postal Service and of *ENEL* again).

For 2004, a stable deficit worth 2.5% of GDP is foreseen. That figure mirrors, apart from the economic recovery, the impact of corrective provisions approved by Parliament at the end of 2003 and the hypothesis of ANAS no longer belonging to the General Government. Should this hypothesis not become real, the deficit for 2004 should rise to 2.7% of GDP. Compared to the Government's estimates setting the negative balance for 2004 at 2.2%, the ISAE 2.5% hypothesis assumes a smaller economic growth (0.2% less than the Government's assumption) and a quicker dynamics of some current expenditure items, particularly intermediate consumption.

The ISAE forecast for 2005 is based on a tendential scenario with unchanged policies and considers the rises due to contract renewals for public employees and to the expenditure for new investments. According to our estimates, within this framework the deficit should reach 3.2% of GDP. Should the "ANAS project" fail, the deficit would be 0.2% higher.

The introduction of the large correction provisions foreseen for 2005 by the latest update of the Stability Programme (equalling 1.5% of GDP) should imply a reduction in the GDP tendential dynamics (2.3%) by few tenths of one percent. Taking account of its retroactive impact on public finances, the deficit might fall from 3.2% to 1.8%.

On the basis of the tendential scenario, the debt-to-GDP ratio might decrease to 103.8% in 2004 and then reach 103.6% in 2005. This forecast implies the successful privatisation of large State-owned companies amounting to 0.6% of GDP both in 2004 and in 2005, which would complete an overall privatisation programme worth 2.5% of GDP in the three-year period 2003-2005 indicated in the updating of the Stability Programme. The provisions for 2005 should reduce the debt to 102.5%.

With reference to the primary balance, ISAE estimates a further reduction in the net surplus of interest expenditure, which would pass from 3.4% of the GDP in 2002 to 2.7% in 2003 and to 2.4% in 2004 and 1.6% in 2005 (if no interventions are introduced). The adoption of the provisions indicated in the updating of the Stability Programme should bring the primary surplus again around 3%.

According to the ISAE estimates, the fiscal pressure in 2003 –

computed as the incidence on GDP of direct and indirect taxation in capital account and of either nominal and real social contributions – increased from 41.6% in 2002 to 42.1% of GDP in 2003, due to pardon initiatives for tax evasion. It should go down to 40.6% and 40.3% in the two following years owing to the gradual end of the effects of tax pardons and pending new provisions for 2005. Net of taxes in capital account - hence of most revenues deriving from one-off taxes - the fiscal pressure should gradually diminish in the three years 2003-2005, reaching 40.2% in 2003, which is almost one point below the 2002 figure (41.3%).