



INSTITUTE FOR STUDIES AND ECONOMIC ANALYSES

# ISAE REPORT

*Forecast on the Italian Economy*  
Growth and productive structure

Synthesis

*FEBRUARY 2005*

## **CREDITS**

*The present Report is the result of the team work of a wide group of researchers coordinated by Sergio de Nardis.*

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*The Report is based on the information and data available up to January 31, 2005.*

## Summary and Introduction

### *The international framework*

The year 2004 registered a growth peak in the past three decades: the world GDP increased by 4.7%, which confirmed last Summer's estimates. The world trade expansion got close to 10%, which exceeded any expectation. The acceleration doubled the trade-to-economic activity elasticity compared to the (low) figure of the beginning of the century (about 1 between 2000 and 2003), though the level was somehow below the figures characterising the second half of the Nineties (about 2.5). Indeed, this latter period is an exceptional phase in the world integration process, maybe due to the wave of globalisation started in the early-Eighties.

### *A strong growth...*

The economic recovery of 2004 was mainly prompted by the United States (+4.4%) and by Asia (+7.2%). In China, in spite of the provisions introduced during the year, the growth exceeded 9.5%, thus marking the best score since 1996. In Japan, the GDP dynamics skimmed 3% thanks to a good Q 1 followed by a brake in the course of the year. Thanks to exports, the vigour of the American and Asian developments also had an impact on the Latin-American economies, the expansion of which (+5.5%) marked the best results since 1980. The economic cycle acceleration contributed to bring Europe out of the standstill registered in 2002-2003. The recovery observed in the euro area remained on moderate rhythms (the GDP is estimated to have grown by 1.8%, after a 0.5% rise in the previous year) and still below the growth potential of the area (about 2%).

### *...in a framework of tensions*

The favourable trend of 2004 ran counter the growing tensions due to international raw material prices and the instability generated by the American imbalances affecting the currency markets. The oil price growth – in October the average Brent oil price was worth about 50 dollars per barrel - caused neither considerable rises in the consumer countries' inflation rates, nor significant braking effects on their productive activities. The smaller need for crude oil in the industrial systems, compared with what happened 10/15 years ago, probably explains the small impact of the oil rises. Indeed, the real rises –compared to the prices of goods and services of the importing countries - eventually proved smaller than their “face” values.

In terms of exchange rates, the decreasing American saving, prompted by the expansive budget policy pursued over the past few years, fuelled the current deficit enlargement, the foreign debt (which reached about 30% of GDP at the end of 2004) and eventually the American dependence on foreign financing. This situation, together with the benevolent approach shown by the American Authorities towards the exchange rate trend, was mirrored in the dollar weakness. However, in the face of the pegging exerted by emerging economies either explicitly (China, Hong Kong, Malaysia) or implicitly (Taiwan, Brazil, Mexico) and of the interventions of the Bank of Japan aimed at strengthening the yen, the dollar fall ended up disproportionately affecting the European currency: at the end of December the euro exchange rate exceeded the record peak of 1.36.

### ***Is the American imbalance sustainable?***

The rapid dollar contraction called the attention on the doubts and concerns on the sustainability of the American situation. In spite of the evident dimension of the U.S. imbalance, the debate did not reach a homogeneous evaluation, as the very concept of sustainability is somehow arbitrary. Admittedly, it is the market reaction which decides whether an imbalance is still sustainable or not, but this follows different modalities in the various situations. The United States benefit from the unspoken clause whereby they are “too big to fail”, namely there is some sort of implicit insurance accepted by operators who grant the USA more credit and time to implement the announced adjustments. That implicit clause is underpinned by a whole range of arguments, the most important of which is that the USA hold a “reservation” currency – which is at the centre of a mini Bretton Woods system involving emerging countries – and, for this reason, their deficit is in dollar and its value does not rise if the exchange rate depreciates. This obviously does not mean there are no exchange rate fluctuations if the fundamentals deteriorate (even the Bretton Woods Agreement broke down), but these events are unlikely to occur suddenly and to concentrate in time, as indeed a currency crisis would do.

### ***The exchange rate stabilises the US debt***

Just to have an idea of the figures, the Report estimates that a stabilisation of the American foreign debt at the end-2004 level requires – on the basis of standard hypotheses on the export and import price elasticity to the exchange rate and with unchanged economic policies within and outside the United States - a real nominal depreciation worth 55% (see Box on *The Current Account Deficit and Foreign Debt Dynamics in the United States*). This is obviously a merely theoretical indication, both because the choice of the sustainable foreign debt is arbitrary (the market interpretation is

unforeseeable and is subject to a whole range of circumstances), and because the adjustment – if any – involves not only the exchange rate but also other economic policy instruments and interacts with the other major economic systems having trade relations with the United States.

### ***The roles of Asia and China***

All in all, the world economic developments confirm that, in 2004, Asia was a major character of the international scene both as a pole of attraction of a growing share of trans-national trade and investments, and as powerful competitor bound to occupy an increasing space, given the population involved in international trade. China obviously plays a central role in this phenomenon, particularly in the light of its trade policy. The yen/dollar close relation makes the competitive pressure on the goods of industrial countries, particularly from Europe, even harsher, which creates a distortion in the global adjustment process. The American deficit is offset by the Asian surpluses. Indeed, the yen/dollar parity ends up transferring onto Europe the burden of the international adjustment, thus creating adverse effects on the growth of the whole area.

### ***Italy and France are taken aback by China, but not Germany***

On the basis of an econometric analysis of gravitational models, the present Report computes the intensity of the Chinese competitive pressure on the exports of Italy, Germany and France in the past decade (see Box on *The Chinese Competitive Pressure on the Exports of Italy, Germany and France: An Econometric Analysis*). The evidence shows a displacement effect on Italian and French commodities in the OECD markets and in intermediate goods (leather, rubber, wood, steel, ferrous and non-ferrous metals). Apparently, the Chinese pressure seems not to have penalised German goods in a statistically significant way. The negative impact on Italy slightly increased in the recent past (1993-2003), eventually proving to be similar to the one observed in France in the same lapse of time.

### ***The late-2004 and early-2005 situations***

At the end of 2004, the international economy started to slow down. In the past quarter, the United States registered a slight slowdown in expectations, particularly following upon the trade balance worsening. The consumption and investment levels had a loss in speed, though their rhythms remained strong. Growth in the euro area was moderate, and it was affected by the smaller support of foreign demand, also due to the exchange rate appreciation and to the uncertain domestic demand

evolution. In the Far East, the tsunami disaster of December 26 caused enormous human losses, but had limited economic effects. India, Indonesia and Malaysia seemed able to absorb the shock in the short run, as they had a sufficiently diversified economic structure and neither the main infrastructures nor the areas where the agricultural and manufacturing activities were concentrated were hit. Conversely, Thailand and Sri Lanka had a stronger impact because of the enormous damage they had and because of the role played by tourism in those economies (see Box on *The Tsunami in Asia: a Human Tragedy With a Limited Macro-Economic Impact*).

In terms of raw materials, the crude oil price diminished from the October peaks, probably being affected by a demand contraction, but it continued to show wide-spread tensions. In January, the growing geo-political uncertainties (due to the approaching Iraqi elections and to the rekindling of the Iranian problem) favoured the rise of the risk premium component, with a Brent oil price exceeding 46 dollar per barrel.

Turning to the currency market, in the wake of the signals sent by the American Authorities who wish a strong dollar and aim at reducing the federal deficit, the dollar/euro exchange rate partially gained ground compared to the December troughs, slightly exceeding 1.31.

### ***Forecasts for 2005-2006: oil and raw materials***

In its forecasts for 2005-2006, ISAE assumes a slow shift towards more balanced values both in the raw material prices and in exchange rates. With reference to oil, the uncertainty caused by the political tensions in the Middle East should maintain oil above 40 dollars per barrel for H1 2005. After that, the rough oil price might start decreasing and reach about 30 dollars in H2 2006. In terms of annual average, the quotation will be worth around 38 dollars in 2005 and 33 in 2006.

With regard to the other raw materials, the strong Chinese demand rise and the dollar depreciation contributed to the 2004 jump in this sector (+24.8%). According to the ISAE forecasts, the slowdown of the economic cycle and the end of the dollar weakening might stop price rises and cause some contractions. This profile will cause a small rise in the average value of 2005 (+2.5%) and a fall in 2006 (-5%).

### ***Forecasts for 2005-2006: interest rates and the dollar trend***

According to the ISAE assumptions, in 2005 the Federal Reserve continues the gradual growth policy (each rise worth 0.25%) which has been accompanying the American economy slowdown for some time. At the end of 2005, the Federal Fund rate will be worth 3.5% and it will further grow by 0.25% in 2006. In the euro area, the uncertainties on the economic cycles of the main economies and the decreasing inflationary pressure should lead the ECB towards a cautious wait-and-see approach. In our assumptions, the official interest rate remains unchanged for a long period of time; the growing phase will only start at the beginning of 2006, when the destiny of the European recovery is clearer. The provisions will be introduced gradually and the repo rate should equal 2.75% at the end of 2005.

This behaviour is subject to the assumption that there are no interruptions in the (non brilliant) co-ordination efforts between European economic policy-makers. In other words, the path towards a renewed interpretation of the Stability and Growth Pact (SGP) is supposed not to raise reactions on the part of the ECB, due to the fear for a negative impact of a loose fiscal discipline.

The hypotheses on the exchange rate foresee a weak dollar in the first half of 2005. After that, in the wake of the opposite behaviours of the monetary Authorities on the two sides of the Atlantic and of signals showing a correction of the American public finance imbalance, there might be a reverse of trend. The dollar strengthening might step up on the late-2005 and then go on in 2006. The average euro quotation would be worth 1.33 in 2005 and 1.29 in 2006 (1.25 at the end of 2006).

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

	2004*	2005**	2006**
<b><i>Domestic references</i></b>			
Gross domestic product (1)	1.3	1.8	2.0
- North-West	1.1	1.7	1.9
- North-East	1.6	2.0	2.1
- Centre	1.4	1.9	2.0
- Mezzogiorno	1.3	1.8	2.0
Imports of goods and services	2.4	4.2	6.3
Exports of goods and services	3.5	3.7	4.7
Resident households' expenditure for consumption	1.3	1.9	2.1
Expenditure of General Government and NPISH (2)	0.5	0.7	0.9
Gross fixed investments	2.3	2.7	4.3
Contribution to the GDP growth			
- of domestic demand (net of stock changes)	1.3	1.8	2.3
- of stock changes and valuable objects	-0.4	0.1	0.2
- of net exports	0.3	-0.1	-0.4
Current and capital account balance (as a percentage of GDP)	-0.9	-0.7	-0.8
Consumer prices	2.2	1.9	1.9
Producer prices	2.8	1.2	0.7
Propensity to consume (percentage level)	87.0	86.9	86.7
<i>Per capita</i> gross earnings in the economy	3.2	2.7	3.0
Total employment (3)	0.6	0.6	0.9
Unemployment rate	8.1	7.9	7.6
General Government net borrowing (as a percentage of GDP)	-2.9	-2.9	-3.4
General Government primary surplus (as a percentage of GDP)	2.1	2.0	1.5
Fiscal pressure of General Government	41.7	41.0	40.8
General Government debt (as a percentage of GDP)	105.8	104.4	103.0
3-month Treasury Bills yield (4)	2.2	2.4	3.5
<b><i>International references</i></b>			
Dollar/Euro exchange rate (level)	1.24	1.33	1.29
World demand	9.7	7.0	6.9
Official exchange rates (3)			
- ECB	2.00	2.00	2.75
- Federal Reserve	2.25	3.50	3.75
Prices of raw materials (in dollars)	25.0	-1.2	-4.5
- energy	35.3	-0.7	-9.8
of which: Brent (\$/barrel)	38.2	38.0	33.0

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

\* ISAE estimates.

\*\*ISAE forecasts, scenario for 2006.

- (1) The GDP and its components refer to seasonally adjusted data and to figures adjusted for different annual working days.
- (2) Non-Profit Institutions Serving Households.
- (3) In standard labour units.
- (4) End-of-year annual yields. Gross compound Treasury yield bills.

### ***The international growth in 2005-2006***

Within this framework, the forecast for the two years 2005-2006 include a moderate world growth. The deceleration as against the cyclical peak of 2004 should however be limited, as it benefits from a significant support from emerging areas, particularly from Asia.

The US GDP evolution will be worth 3.4% in 2005 and 2.9% in 2006, which is in keeping with the potential growth. The slowdown compared to the high 2004 dynamics will be affected by the gradually stricter monetary policy and by the decreasing fiscal measures adopted in the past few years. Indeed, a federal deficit reduction might start in 2005. In Japan, the brake registered in 2004 will have an impact on the 2005 trend, thus giving rise to a 1.7% growth in the economic activity due to the reduction of the net export contribution and to the ongoing domestic demand weakness. In 2006, the Japanese economy might moderately step up to 3.2%, following upon a competitiveness recovery prompted by the dollar strengthening and by the structural improvements obtained thanks to the financial efforts made in the past few years.

With reference to the euro area, the cyclical indications between the late-2004 and the early-2005 were nor univocal. The industrial production difficulties, experienced in particular in Germany and in Italy, go alongside with rosier evaluations of the leading indicators. Indeed, the business confidence trend in December-January exceeded expectations, thus reducing the fear for a negative impact on the area due to the euro appreciation and to the slower world economy dynamics. The most favourable signals come from Germany, as the IFO indicator rose for two months in a row and the growth overcame the ZEW expectations. Rosy indications also come from Italy and France, as the entrepreneurs' confidence climate substantially held. Within the ISAE forecasts, the euro area grows in 2005 by 1.8%, thus showing the same rhythms as in 2004. The reduction in the foreign demand support will be gradually offset by a domestic demand improvement. Indeed, domestic demand will benefit from the inflation fall and from the provisions geared towards reducing the fiscal pressure adopted in some euro-area economies. In 2006, the EMU growth might be favourably affected by a more balance euro/dollar exchange rate. In our hypotheses, the GDP dynamics is in keeping with the potential development dynamics (2%).

In emerging countries, Asia will keep a good expansion rhythm (about 6.5% in the two years). Also Latin America (4.2% in 2005 and 3.8% in 2006) and Central-Eastern Europe (5.2% in 2005 and 4.9% in 2006) will remain on a high rhythm. The emerging countries are developing at a more than double pace compared to the industrialised area.

International trade, affected by the slower world economy dynamics, will decelerate down to 7% in 2005: a similar expansion will characterise 2006. According to the trade geography, the role of emerging economies is further developing, particularly in Asia, to the detriment of industrial economies. The overall GDP elasticity will be slightly below (1.8%) the 2004 figure.

### ***Italy between the late-2004 and the early-2005***

After registering a contraction above expectations in Q1 2004, the Italian economy witnessed a slowdown over the past three months, mainly because of the contraction of the (already weak) industrial activity. The sa and wda GDP increased by 0.5% in Q1 2004 and by 0.4% in Q2 and Q3. According to ISAE, the trend observed in October-December stopped at 0.2%. All in all, the average growth in 2004 was worth 1.3% (0.4% in 2003), 1.5% below the euro-area figure. Looking at non wda data (working days in 2004 exceeded the 2003 figure by 5 days), the economic activity rise was worth 1.4%.

The late-2004 deceleration was mainly affected by the slowdown observed in exports of goods, after the considerable recovery experienced in the two previous quarters. The deceleration of exports went alongside with a limited domestic demand, mainly weak in investment.

### ***A weak industrial cycle***

The marked industrial production slackness goes on. After the end of the 2001 recession, the Italian manufacturing sector has never showed a real recovery. Indeed, while up to the mid-2003 the standstill was a phenomenon common to Italy, Germany and France, over the past 18 months the Italian manufacturing sector was the only one not to show signals of recovery. A similar trend also characterised the period of export acceleration which took place between Q1 and Q4 2004. According to the National Accounts and to the ISAE Surveys, that evolution was only partially explained by the thinning inventories characterising Q2 and Q3.

In particular, the manufacturing activity experienced a slight decreasing trend between the late-2003 and the early-2004, which was affected by two contractions in a row (registered in October and in November) caused by the export decline. According to the short-time ISAE forecasts, the industrial activity in December might show a modest recovery (+0.3%) which will reduce the Q4 deterioration to 0.5%. The average 2004 (non wda) variation will be positive and slightly below 1%; indeed, this upswing follows three years of continuous contractions. According to the ISAE estimates, industrial production might gain ground in the early-2005, with a small downturn in

January and a larger leap forward in February. This evolution will raise the average figure for the two months by 0.4% above the figure of Q4 2004.

### ***Rosier prospects for services***

Unlike what happens in manufacturing, services experience a rosier evolution than in 2004. After the brake of Q3, private services registered a recovery in the following three months. The ISAE data signal considerable leaps forward in the turnovers of financial and business services between the end of 2004 and the beginning of 2005, while services to households had a deterioration.

### ***The confidence climate***

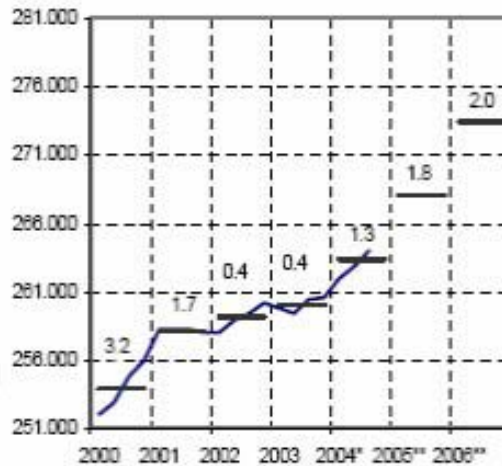
The firms' confidence, which grew between the end of 2003 and last Summer, had a stop in September and October and then decreased again in the last two months of 2004. The contraction mirrored a rise in inventories up to the "Above Normal" level, alongside with less favourable expectations on production. However, the fall came to an end in January, when the index signalled a new, moderate recovery caused by decreasing inventories and slightly rosier assessments on order books.

After five months' rises, the consumers' confidence fell again in November and in December. In January, it remained substantially stable (the sa balance being 0.2% less than in December), being affected by growing expectations on the labour market evolution and, in particular, by more favourable assessments on the respondents' own and financial situations, alongside with worsening evaluations on the future general and households' situations. Indeed, intentions to purchase durables seemed to be growing.

### ***The leading indicator***

The ISAE leading indicator - describing the economic evolution in the next 4/5 months – kept growing in 2004, even though it decelerated in the last few months (the latest figure refers to October), thus suggesting a moderate growth at the beginning of 2005.

GROSS DOMESTIC PRODUCT  
(millions of euros, base year 1995, sa – wda)



Source: ISTAT

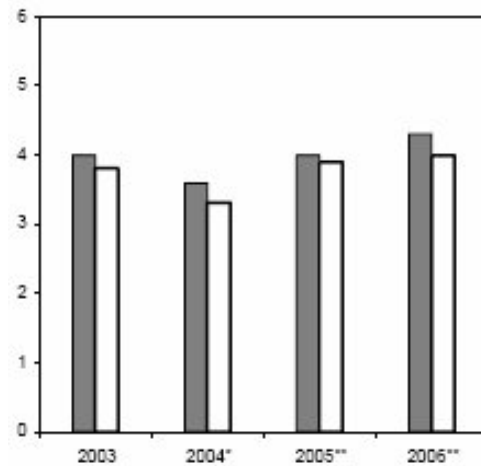
\* ISAE estimates.

\*\*ISAE forecasts, scenario for 2006.

### ***Forecasts for 2005-2006***

On the basis of the available data, the early-2005 evolution of the Italian economy might still be affected by the weak exports caused by the euro appreciation and by the moderate international economic cycle. The slightly rosier evolution of the industrial activity expected by ISAE should bring about a sort of recovery compared to the late-2004 dynamics. The wda data show a better trend than non wda figures. Indeed, the stimula deriving from a domestic demand strengthening will emerge during the year. A euro/dollar exchange rate stabilisation at the beginning of 2005 and a reverse of trend in H2 2005 will prompt exports. On the basis of those evolutions and considering the positive 0.4% dragging which the year 2005 should inherit from 2004, the wda GDP is expected to rise by 1.8% in 2005, which is in keeping with expectations on the euro area. Looking at non wda data, the rise should be worth 1.7%. At the end of 2005, the economic activity might exceed the same period in 2004 by about 2%. That profile would enable a 0.8% dragging onto 2005. On the basis of this assumption, in a still favourable international framework and in a domestic scenario for the financial trends the Italian growth in 2006 should be worth 2%, as the one of the euro area.

HOUSEHOLDS' INCOME AND CONSUMPTION  
(nominal percentage changes)



Source: ISTAT  
 \* ISAE estimates.  
 \*\*ISAE forecasts, scenario for 2006.

HOUSEHOLDS' EXPENDITURE  
(millions of euros, base year 1995, sa – wda)



Source: ISTAT  
 \* ISAE estimates.  
 \*\*ISAE forecasts, scenario for 2006.

**Consumption**

In 2004, private consumption increased by 1.3%, following upon a good Q1, a weakening in Q2 and Q3 and a slight recovery in Q4. That dynamics hinted to a favourable evolution in purchases of durables, prompted by a consumer credit expansion and by moderate purchases of services and, in particular, of non durables.

The Italian households' consumption will accelerate in 2005 and in 2006, when the growth rates are worth 1.9 and 2.1% respectively. The 2005 evolution will be affected by the more sustained trend of the real disposable income, which benefits from some favourable factors, namely the wage bargaining rounds, the expected inflation cut, the still favourable employment dynamics and the tax cuts in favour of households. In 2006, also in the wake of the previous acceleration (indeed, the dragging onto 2006 might be worth 1 percentage point), the consumers' expenditure should slightly strengthen. Considering the disposable income dynamics, the spending intentions of Italian households – which decreased between 2000 and 2003 after the upturn characterising the previous years – should further diminish.

### ***Investments***

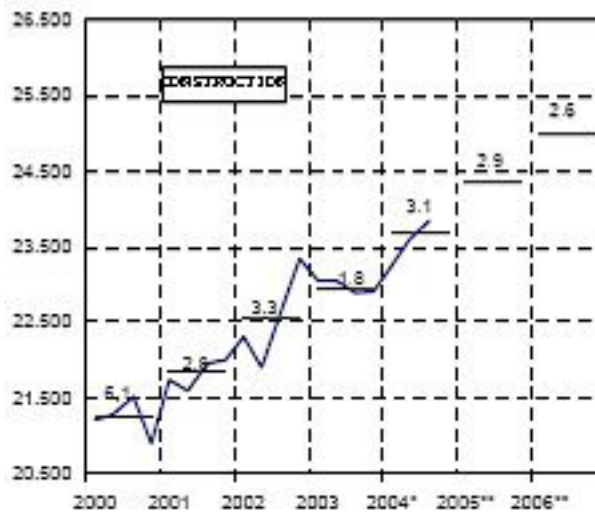
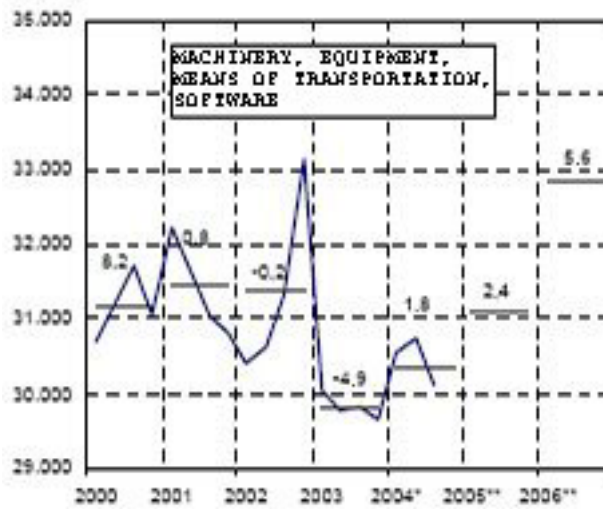
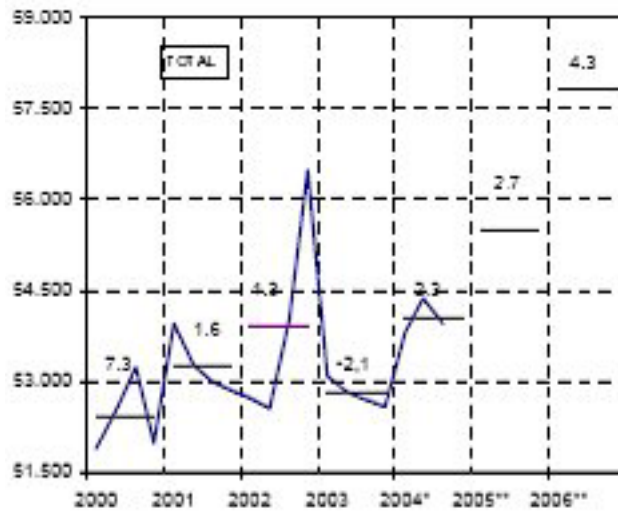
After the substantial recovery registered in H1 2004, total investments had a stop in Q3. According to the ISAE estimates, this expenditure component was weak in the past quarter, being affected by the uncertain exchange rate evolution at the international level. The 2004 rise is worth 2.3% (-2.1% in 2003).

Forecasts for 2005 point to a further strengthening in machinery, equipment, means of transportation and software, which – after the first hesitant months - will rise by 2.4% (an estimated 1.8% in 2004). Indeed, the ongoing favourable situation - together with moderate interest rates, favourable profit margins and, in particular, the cancelling of the prospect of exchange rate skyrocketing - should all encourage a recovery in this area.

A better dynamics characterised investments in construction in 2004, as – in our estimates – they rose by 3.1% thanks to favourable evolutions of both the residential and of the non residential components. The year 2005 will be moderate, particularly because of residential investments: a sustained dynamics will characterise non residential construction and public works. All in all, investments in construction should grow by 2.9%.

In 2005, the overall investment dynamics will exceed 4%, being affected by the 2004 accelerating profile and by the consolidation of the main components, particularly in machinery and means of transportation, within a domestic and foreign economic cycle which remains favourable to the accumulation process.

GROSS FIXED INVESTMENTS  
(millions of euros, base year 1995, sa – non wda)

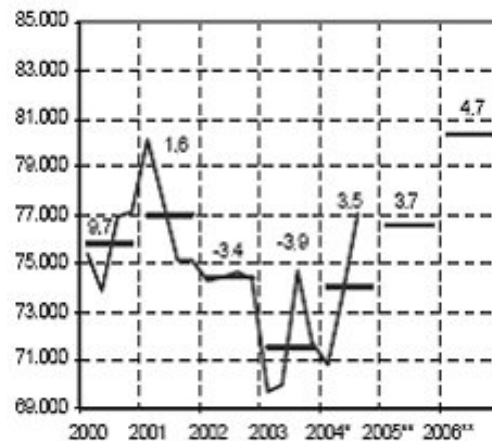


Source: ISTAT  
 \* ISAE estimates.  
 \*\*ISAE forecasts, scenario for 2006.

## ***Exports and imports***

On the basis of the National Accounts, the recovery of exports of goods and services was particularly intense in Q3 and in Q4 2004. Generally speaking, the export growth in Q2 and in Q3 2004 equalled 8.8%. Indeed, the acceleration in July-September took place in a period when the other European economies gave signals of suffering caused by the exchange rate rise. The Customs' indications on Q4 2004 indicate that the Italian exports had a brake in that period. On average, in 2004, Italian exports of goods and services increased by 3.5%. Taking account of the contemporary expansion of world markets, this dynamics implies that the Italian market share – in spite of the recovery of Q2 and Q3 – considerably decreased in 2004.

EXPORTS OF GOODS AND SERVICES  
(millions of euros, base year 1995, sa – non wda)



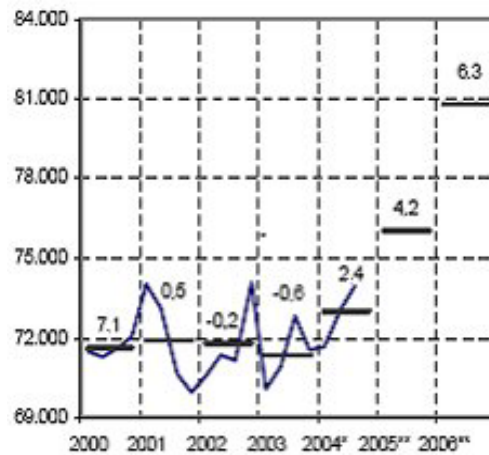
Source: ISTAT

\* ISAE estimates.

\*\*ISAE forecasts, scenario for 2006.

During 2005, the export development will be affected by the exchange rate evolution and by the world trade trend. With reference to the former item, it will continue to have a braking effect in the early-2005. Afterwards, the re-emerging of more balanced figures shall give back Italian exports their competitiveness towards extra-European products. With regard to the world trade, the expected moderation should concern in particular extra-European countries, as the demand for Italian goods will follow a more favourable trend. According to the ISAE forecasts, exports of goods and services will rise by 3.7% on average in 2005, limiting the loss of market share compared to 2004. In 2006, thanks to a euro depreciation, Italian exports will grow by 4.7%, which marks a better ranking of Italy at international level.

IMPORTS OF GOODS AND SERVICES  
(millions of euros, base year 1995, sa – non wda)

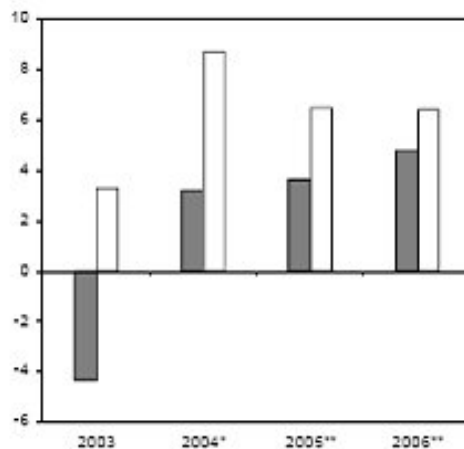


Source: ISTAT  
 \* ISAE estimates.  
 \*\*ISAE forecasts, scenario for 2006.

With reference to imports, the gradual domestic demand strengthening will favour their acceleration, as imports will grow by 4.2% and 6.3% in 2005 and 2006 respectively (2.4% in 2004). That dynamics implies the coming back to a higher import-to-domestic demand elasticity – though it remains a historically low figure if compared to other recoveries – after the contraction registered between 2000 and 2003.

This particular phenomenon – referring to a period of intense changes in the Italian economy, namely the beginning of this decade - led us to investigate more thoroughly the Italian import requirement evolution over the past few years.

EXPORTS AND OUTLET MARKETS OF ITALY  
(percentage changes)



Source: ISTAT  
 \* ISAE estimates.  
 \*\*ISAE forecasts, scenario for 2006.

### ***Import requirement***

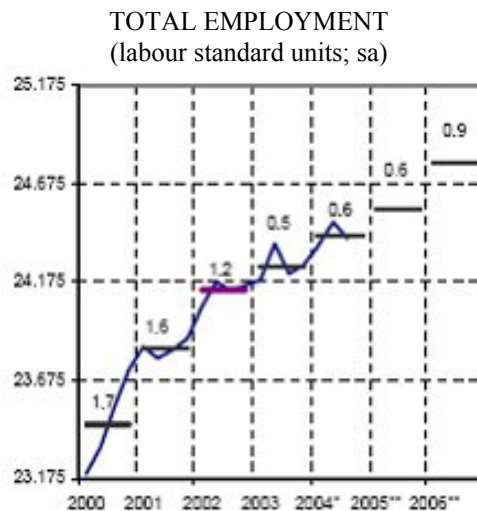
The Italian productive system is traditionally characterised by a strong need for foreign intermediate goods. The import requirement has considerably increased over the past decade because of the process of industrial restructuring, whereby the (imported) intermediate goods have been replacing labour, which has become more and more expensive for the wage shocks and for the rigid industrial relations which had characterised the past years. The evidence of the growing import share in the Italian economy is mainly derived from elaborations made on inter-sector tables. Pending this precious instrument, in the past the evolution of that phenomenon through time could not be monitored. The availability of the input-output tables for the year 2000 enables to update those evaluations (see Box on *The Import Requirement of Final Demand Components*). Indeed, the new analysis shows some surprises. If one takes into consideration a decade (from 1990 to 2000) the final demand “ability” (private consumption, investments and exports) to directly or indirectly bring about imports has considerably decreased. The contraction (worth about 40% for each euro of final demand between 1990 and 2000, at constant prices) mainly concerned the households’ expenditure for consumption and, to a lesser extent, investments and (even less) exports. Those evolutions have modified the impact of the demand changes on imports in two directions, namely (1) the demand growth prompts a smaller (either direct or indirect) request for intermediate good imports on the part of the productive system compared to the early-Nineties; (2) final demand rises fostered by investments and, in particular, by private consumption, prompt less imports than demand rises prompted by exports, compared to what used to happen in the early-Nineties. Those structural changes should help explain the cyclical evolutions observed since 2000, when the domestic demand growth was accompanied by a flat import evolution. Indeed, imports rose thanks to the 2004 export re-launching.

### ***Contribution of the net foreign demand***

The contribution of net foreign demand (exports minus imports) to the GDP variation in 2004 is worth 0.3%. The acceleration of foreign sales, which occurred during the year, enabled net exports to obtain their positive sign again. In 2005 and in 2006, also because of the delayed effects of the loss of competitiveness due to the exchange rate evolutions, the foreign balance contribution to growth will become negative again by 0.1% and by 0.4% in 2006.

## ***Labour market***

In 2004, employment continued to grow, though it showed few signals of slowdown compared to the sustained dynamics of the previous years. According to the ISAE estimates, the employment variation in terms of standard labour units equalled 0.6%, thus coming back (after three years) to slower rhythms than those of the GDP. The unemployment rate further diminished and equalled 8.1% on average during the year, which is below the euro-area figures. The new unemployment rate (11.3% in 1997) was mainly affected by the contraction in the number of job-seekers, particularly in the *Mezzogiorno* of Italy.



Source: ISTAT

\* ISAE estimates.

\*\*ISAE forecasts, scenario for 2006.

The economic recovery phase which should take place in 2005 will be accompanied by a positive dynamics of the labour input demand. During the year, the average standard labour units should rise by 0.6%. The employment evolution will strengthen in 2006, in keeping with the productive growth consolidation, registering an upturn just below 1%. The employment-to-GDP elasticity – which diminished in 2004 – will equal 0.4-0.5 in the two years, representing about half of the figures characterising the three-years 2001-2003. At the same time, the labour productivity will rise again at a pace of about 1%, which last happened in 2000.

In terms of heads, the overall rise in the lapse of time between 2005-2006 amounts to around 420,000 units. The unemployment rate will continue to decrease and in 2006 it reaches 7.6%.

### ***The ISAE Survey on firms and the Biagi Law***

One year after its latest Survey (see the ISAE Report *Forecast on the Italian Economy* of February 2004), ISAE decided to verify the impact of the enforcement of the new provisions on the labour market introduced by the Biagi Law. To this end, a questionnaire was submitted to the ISAE respondents to investigate the firms' behaviours in terms of hiring in 2004 and their future hiring intentions, with reference to both the hiring canals and the kind of contracts they offer, which are the areas where the Biagi Law introduced the main novelties (see Box on *Novelties of the Biagi Law and Firms' Hiring in An Ad Hoc ISAE Survey*). The former striking element is that the share of firms declaring to have hired new workers in 2004 is much higher than the number of firms which had stated their intentions to hire one year before. This happens in particular in the service sector. On the one side, this approach suggests an initial cautiousness which disappears as time goes by and, on the other side, the possibility of an mobility of workers through companies which is higher than in the past.

The latter interesting element concerns recruiting. In 2004, both State and private employment agencies – including the new subjects foreseen by the Biagi Law, such as local bodies, schools, bilateral bodies, associations - lost ground. A leading role is played by *ad interim* job providers: given that the new law allows those agencies to act as intermediaries, they often represent a new canal for job-seekers' selection and contact (after the trial period which is represented by the first mandate length). Considering the high cost of this form of recruiting, it is assumed to be considered highly effective by entrepreneurs to meet labour demand and supply (namely find the right person for the right vacancy).

Finally, with reference to the kinds of contracts which are offered, part-time contracts, which were modified by the Biagi Law, seem to be the prevailing formula and they experienced an unexpected success in the industrial sector in particular. Also project-based contracts - which are a novelty introduced by the Biagi Law to replace coordinated and continuous collaboration contracts - raised a considerable interest, particularly among service firms, and this is a remarkable result considering the uncertainties which had accompanied the Biagi Law adoption.

### ***The ISAE-EU Surveys on the labour market: the point of view of consumers...***

The present Report provides the results of the ISAE Surveys carried out on behalf of the EU on consumers and industrial firms with the aim of investigating the ongoing transformations of the Italian labour market. The Survey on Households (see Box on *Propension Towards Labour and Leisure Time and Working Time Flexibility in Italy: The Results of the ISAE-EU Survey*) shows

that, with reference to working time, standard working schedules (35-40 hours) are generally preferred. This preference hides different approaches to working time based on the kind of respondent. For women, who are most interested in part-time and short-time jobs, the choice of standard timetables mirrors their wish to work more than usual. For men, who often opt for timetables longer than normal, the same formula means a working time reduction compared to their usual one. However, generally speaking, there is a diffuse willingness to work more to earn more (particularly among women), which might be linked to the limited wage dynamics which accompanied the long phase of productivity standstill. Finally, the readiness to accept an atypical or flexible working time (particularly on Saturdays or Sundays or at night) is not so wide-spread.

### ***...and of the entrepreneurs***

The Surveys on business firms (see Box on *Employment Structure and Trend in Manufacturing Firms: The Results of the ISAE-EU Survey*) confirm a strong rise in the role of fixed-time or part-time contracts in manufacturing firms. In particular, part-time contracts are diffused in large firms producing consumer goods. Furthermore, the industrial structure is characterised by a large number of employees having a low education attainment, namely 49% with primary school, 39% with lower secondary school and only 12% with BA. This situation is not satisfactory, as firms intend to reduce the percentage of employees with low education level in the next 1-2 years and to raise at the same time the number of employees with lower or upper secondary school diploma. Indeed, this intention seems to crash against the existing difficulty to find educated staff on the labour market, as this lack is considered to be the main obstacle, given the same cyclical situation, to the employment expansion. This problem sheds light on the mismatch problem characterising the Italian labour market.

### ***Wages***

With reference to the wage dynamics, the *per capita* gross wages of the whole economy increased by 3.2% in 2004. The hypotheses for 2005 and 2006 are based on the already-signed contracts and on the latest wage bargaining rounds: hence, according to the ISAE estimates, the *per capita* wages in the overall economy will rise by 2.7% in 2005 and by 3% in 2006. In the manufacturing sector, the evolution will be worth 3.3% in 2005 (3.5% in 2004) and 2.8% in 2006. Thanks to the productivity acceleration, the unit labour cost in the whole economy will remain on relatively high rhythms: after the 2.4% rise experienced in 2004, unitary costs will grow by 1.4% in 2005 and by

1.8% in 2006. The unit labour cost in industry excluding construction will be at around 1.3% in the three years considered.

### ***Inflation***

For the two years 2005-2006, ISAE forecasts the going on of the inflation-decreasing process within a framework characterised by a gradual softening of external pressures and favourable trends in domestic unitary costs. At the beginning of 2005, consumer prices should grow with a higher annual growth pace than in the late-2004 and then they should slow down in the mid-2005 up to a figure below 2%. A slight rise is expected in Autumn, both because of the unfavourable y/y statistical comparison and because of a demand strengthening. In 2005, the average inflation will be worth 1.9%, which marks a 0.3% contraction compared to the 2004 figure. The harmonised index dynamics should equal 2%, with a 0.2% gap between Italy and the other euro-area partners, which is similar to the 2004 divergence.

In 2006, the moderate evolution of unitary costs and a further deceleration of energy prices will enable inflation to remain at 1.9% on average. In terms of harmonised index, the 2006 rise will exceed the growth expected in the euro area by 0.3%.

### ***The economic activity by geographical partitions***

According to the ISAE estimates, in 2004 the growth rates of the major geographical partitions did not register excessive gaps as against the national average (1.3%). A small negative gap emerges with the North-west (+1.1%) and a positive difference with the North-east (+1.6%). The medium-run dynamics (1995-2004) indicate that the *Mezzogiorno* of Italy has the best GDP growth performance in Italy. For the two years 2005-2006, the ISAE forecasts identify the North-east as the most dynamic partition.

In the mid-Nineties, in the wake of the re-emergence of migration flows from the South to the North of Italy, the *Mezzogiorno* has been gradually reducing the gap with the rest of the country in terms of real *per capita* GDP. The recovery should go on, though to a lesser extent compared to the past, in the two years considered (2005-2006), if the recent migration trends are confirmed. The *per capita* income in the South will be worth 59.9% of the income in the North-Centre in 2006 (it was 55.7% in 1995).

### ***Attractiveness of Italian regions on foreign investors***

Admittedly, Italy is relatively neglected by large multinationals, which prefer to invest in other EU areas. The present Report (see Box on *Multinationals' Localisation in European Regions: Is There an "Italy Effect"?*) highlights that foreign investors tend to see the EU as an aggregation of regions rather than of nations: in the eye of an investor, regions belonging to different countries may be more similar than regions belonging to the same country. It is not a question of national tags, but of characteristics linked to economic and geographical features. Italy seems to be a particular case. Large multinationals – particularly from the USA – are discouraged from setting plants on the Italian territory because of a sort of “country-effect” which is common to all Italian partitions. This penalisation partially depends on real shortcomings, but partially derives from prejudices stemming from imperfect or obsolete information. This idea seems to be corroborated by the smaller role this sort of country-effect plays for European investors, who have more thorough information than American ones. Regardless of its cause, this phenomenon sets Italian regions (even the most advanced ones with better infrastructures) in a condition of inferiority compared to other European regions in terms of attractiveness to foreign investors, who often bring technological and managerial know-how in the territory where they set.

### ***The public finances***

In 2004, in spite of the economic activity acceleration, the deterioration of the public finances in the euro area, which started four years ago, has been going on. On the basis of the Autumn European Commission forecasts, the twelve EMU countries registered an overall deficit worth 2.9% of GDP, which marks a rise compared to 2003 (2.,7%). Except for France, the Netherlands and Finland, all other economies experienced a worsening compared to the previous year. Besides, Germany and France showed deficits above 3% for the third year in a row. Greece upwardly reviewed its data for 2000-2003 and is much above the two major European countries.

Alongside with the flow worsening, stocks became heavier: the debt-to-GDP ratio equals 71.1% in the euro area, as against 70.7% in 2003 and 69.4% in 2002.

### ***New SGP interpretations***

The weak European growth observed over the past three years made a new (more or less unanimous) interpretation of the SGP necessary to draw more attention to the problems of growth, as called by the Lisbon Agenda. Given the different stands, it is difficult to foresee the new

operational modalities. Indeed, they concern not only flexibility (namely introducing more arbitrary and less automatic mechanisms, taking due account of the structural reform actions adopted by the countries and of their investments in infrastructures and R & D, excluding expenditure for defence and EU budget contributions, expanding the one-year deadline for the deficit-correction procedure, giving more importance to the debt value than to the deficit figure), but also the delicate question of the balance of power between the Commission and the ECOFIN Council in the choice of the interpretation criteria. There many different stands. The Commission's proposal submitted at the beginning of September and the very cautious ECB statements were accompanied by the viewpoints of many Member States with diverging opinions, ranging from the advocates of great changes to the fans of soft interventions. All in all, considering the common will to reach a rapid definition, the new interpretation modalities may fund a first practical formula in the March European summit, according to what stated by the European Commissioner for Economic and Monetary Affairs.

### *The Italian public accounts*

According to the ISAE estimates, the General Government net borrowing in 2004 equalled 2.9% of GDP, which matches the target set in the September Forecast and Planning Report thanks to the interventions introduced in H2. The debt-to-GDP ratio will decrease by 0.5%, passing from 106.2% in 2003 to 105.8% in 2004.

For 2005, ISAE assumes the full attainment and effectiveness of the provisions foreseen by the Financial Law approved in December and, should the effects fall short of expectations, the adoption of additional measures so as to maintain the deficit within the Maastricht parameter in 2005 and on a sustainable level in 2006. Under those hypotheses, ISAE sets the public deficit in 2005 below the Maastricht threshold of 2.9% of GDP; within a scenario for 2006, with unchanged policies, the deficit will be worth 3.4%. The ISAE projections differ from the official evaluations because the economic growth is assumed to be less dynamic. According to ISAE, the primary surplus - which in our estimates accounts for 2.1% of GDP in 2004 and 2.9% in 2003 - equals 2% in 2005 and, if no correction measures are introduced, should reach 1.5% in 2006. The interest on debt, according to ISAE, decreases from 5.3% in 2003 to 5% in 2004 and 4.9% in 2005 and 2006. With reference to 2006, a correction manoeuvre slightly above 0.5% of GDP will maintain the deficit below 3%, with generally limited effects on the economic growth.

In our forecasts, the debt-to-GDP ratio decreases down to 104.4% in 2005 and, in the 2006 scenario, to 100.3% in 2006. Those evolutions imply heavier debt-reducing provisions than those adopted in 2004, a higher ratio between General Government net borrowing and requirement compared to the

2004 forecasts and the assumption of a 25-billion-euro sale of public buildings both in 2005 and in 2006, in keeping with the indications contained in the Economic and Financial Planning Document (DPEF).

Within this framework, there might be risk elements both in the specific provisions and in the implementation of a heavy and articulated financial manoeuvre which should envisage tax cut decisions and their coverage. In particular, there might emerge uncertainties from the expected revenues from provisions on the emersion and enlargement of the taxable income. There might also be difficulties in the initial implementation of the rule setting a ceiling to the public spending dynamics.

\* \* \*

The present Report devotes a whole Section to the problem of growth and productive structure in Italy. This choice also derives from the need to investigate the interpretations whereby the Italian economy has long started a path of decline and impoverishment. The intention is not to deny the (considerable) problems – which we thoroughly describe -, but to try and set them within a wider and more articulated perspective where Italy shares many European dynamics and, at the same time, registers its own structural changes, which have been transforming the Italian industrial texture over the past few years and which will eventually lead to a yet-to-be-assessed outcome.

### ***The Italian growth compared to Germany and France***

The analysis of the *per capita* income seems not to identify a specific Italian profile compared to its major European partners: since 1990, the dynamics of the real Italian *per capita* GDP has been consistent with the standards experienced by Germany and France. A slowdown compared to the French economy - but not to Germany - was observed after 1995. In the past few years, France has been playing a leading role both in terms of *per capita* income and of labour productivity.

### ***Gap between Europe and the United States***

Taken together, the euro-area countries – particularly since the mid-Nineties – have shown a widening gap between their standards of living and producing and the US ones. Italy, though with different characteristics and timing, took part in that gap-widening process.

### ***Convergence and then divergence with the United States***

In the Nineties, the convergence process between the major European countries and the United States - started after World War II – seems to have come to completion. Indeed, the catching up of the *per capita* income had stopped in the Eighties, before its real completion, because of the less intense use of labour in Europe as against the United States, which was partly due to a free choice and/or to the European economic features and/or to distortions and to rigid industrial relations. Conversely, the convergence on productivity had continued and reached its hike in the Nineties. In 1995, the levels of hourly output in France, Germany and Italy were equal or even higher than the American values, which meant that the then available technological opportunities for the European catching up process had been fully exploited up to that moment. From this viewpoint, the slowdown of the European productivity is closely linked to the evolution of the convergence process.

Since 1995, new technological opportunities linked to the ICT revolution became available and once again the gap between the United States and Europe widened and Europe started its new catching up process. However, the already obtained high levels of productivity and the considerable delays of the labour market drew attention on labour again. In this sense, the many evolutions experienced since 1995 respond to the twofold need to narrow the technological gap and to intensify the use of labour.

### ***Productive structure and growth***

The technological gap between Europe and the United States is often interpreted in Europe, and even more so in Italy, as a lack of high tech manufacturing productions. This leads to conceive (more or less intrusive) industrial policies geared towards modifying the specialisations and promoting sectors alleged to be better than the traditional ones. That is not the right perspective. The modern revolution linked to the ICT introduction – as happened for the great innovations of the past - concerns universal technologies which are potentially available to everybody. This particular technology is produced in the United States, but its producing sector plays a limited role in the American economy, accounting for less than 2% of the GDP, if one considers the manufacturing

sectors producing ICT alone. From this viewpoint, most US economic sectors have to import those technologies, as indeed Italy does too. Our point is that what is important is not producing high technology “at home”, but exploiting as much as possible the imported innovations in all the productive activities which are run “at home”. The acceleration of the American production, in the face of the European slowdown, is not explained by the evolution of the ICT productive sectors, but by the better performance obtained with activities which have fully exploited the ICT opportunities, even traditional sectors such as large and retail distribution, different kinds of business services and financial intermediation.

### ***Role of the atypical specialisation of Italy***

Those remarks also concern Italy, whose manufacturing specialisation is rather atypical as it is concentrated in industrial sectors with low technological level. In the case of Italy, this leads to attach great importance to the composition of the manufacturing output and to its impact on growth. However, this approach neglects the fact that the Italian specialisation mirrors real comparative advantages which lead consumers throughout the world to ask for the Italian products: indeed, it is the world demand which determines the manufacturing specialisation of Italy. However, as in the case of the American high tech, one has to consider that those productions play a little role in the whole productive system, namely about 5% of the Italian GDP (considering the most diffused Italian manufacturing products, i.e. shoes, leather, textiles and clothing, furniture, ceramics and home products).

Those remarks highlight the importance of services in determining the performance of the whole economy either directly, for the dimension of that activity, and indirectly, as they provide input for other sectors, particularly the industrial sector which is exposed to international competition. The opening to competition, a reform of rules and regulations setting import quotas and operational constraints in many sectors and markets (distribution, professions, civil justice, local services) and the completion of the single market wherever there emerge protectionism and national segmentations (energy, transports, financial services) should all contribute to enhance efficiency and the intensive use of technologies.

### ***The growing use of labour***

A feature of the Italian and European experiences of the past few years is the worsening productivity of employees and the greater use of labour. The two phenomena are closely connected and seem to be the outcome of the political choices (namely labour market reforms) adopted in the mid-Nineties to increase the case of labour by reducing its cost as against other inputs. This led to a slowdown of the capital deepening process and reduced the role of other factors of production. That process concerned Italy as well (with a certain delay but very intensively). At the beginning of this decade, Italy experienced an abnormal expansion dynamics in the number of employees, even higher than that of other European countries and of the United States, if one considers the different situations. Indeed, the employment growth concerned in particular less productive, unskilled workers compared to the average insiders: the new labour units were mainly absorbed in low-productivity sectors.

### ***The Italian and European structural unemployment decreased***

Those developments contributed to deeply modify the balances of the European economies compared to the situation of, say, 10 years ago. In particular, they reduced structural unemployment. In Italy, the estimate of the non-accelerating inflation rate of unemployment (NAIRU) was above 11% in the mid-Nineties; today it is worth 8% and there are no significant wage tensions, which means that the balance level is even lower.

The balance shift caused by reforms and by the changes in industrial relations, implies the adjustment to new production techniques requiring much labour per unit of output. In Italy, not only did that process affect the capital-labour relation, but it also reduced the use of intermediate goods. Aggregate data show that a process similar to the one occurred in the Eighties has been taking place over the past few years. Indeed, at that time, the wave of rationalisation and restructuring introduced labour-saving techniques which eventually replaced the “expensive and rigid” labour with capital and intermediate goods, particularly imported from abroad. That phenomenon is indirectly confirmed by the contraction in the overall need for imports of intermediate goods identified through the inter-sector tables.

### ***A transitional component in the worsening of labour productivity***

In the wake of those changes, the labour productivity slowdown in Italy and Europe is affected by a transitional component which shall end when a new balance (namely a new structural unemployment level) is reached, which does not mean this is a short-term phenomenon. The target to enlarge the labour force and the number of productive workers in Italy and in Continental Europe is still far away. At the same time, the economic policy strategies aimed at enlarging the labour force (starting from the Lisbon Agenda) seem to imply that, given the high level of productivity obtained, convergence must be obtained by increasing the participation and employment rates.

### ***The need for interventions to underpin multi-factor productivity***

This does not mean one has to necessarily accept an unfavourable trend of labour productivity. Indeed, there are margins to limit the adverse effects deriving from the interventions to raise the activity rates: those margins mainly refer to the possibility to enhance the overall factor productivity. Indeed, the factor productivity dynamics has been worsening in the major European countries since the mid-Nineties (with the exception of France) as against the United States. The Italian trend proved to be particularly negative, as the decreasing productivity of the past few years explains 50% of the labour productivity worsening.

Looking at the whole economy, the multi-factor productivity mirrors the effectiveness of the overall productive system and is affected by the innovation opportunities it contains, by the improved labour organisation and, more generally, by the whole society and system externalities. In this area, the liberalisation policies, aimed at eliminating the rent positions and at updating the service sector should have a favourable impact as they improve the conditions where the productive activities and civil life take place. In Italy there is a wide room for improvement, as the gap between the Italian and the American productivity levels equals 20%.