

ISAE REPORT

Forecast on the Italian Economy

Synthesis

JULY 2003

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 and Marco Fioramanti (Chapter 1); Cristina Brandimarte and Claudio Vicarelli (Chapter 2); Giancarlo Bruno, Maurizio Bovi, Sandro Calabresi, Claudia Cicconi, Enrico D'Elia, Massimo Mancini, Mara Meacci, Maria Cristina Mercuri, Carlo Milana, Carmine Pappalardo, Gianfranco Piras, Giovanni Principe, Daniela Rossi, Rosetta Salvini e Franco Sartori with the collaboration of Maria Cozzolino and Raffaele Malizia (Chapter 3); Roberto Basile and Mariannaa Mantuano (Chapter 4).

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The editing was ensured by Beatrice Mariani, the composition was carried out by the ISAE Unit "General Technical Services", coordinated by Silvia Fanfoni. The English version was translated by Paola Felli. .

The Report is based on the information and data available up to July 23, 2003.

Summary and Introduction

The international economy: unexpected shocks and main difficulties

The first half of 2003 has elapsed without witnessing that recovery of the world economy which analysts, according to the estimates elaborated up to 7-12 months ago, had foreseen for this period.

The wrong forecast may be due either to a misconception of the variables at stake or to some unexpected shocks which have changed the course of events. Indeed, the past two years have registered many irregular factors of this kind, namely the terrorist attacks in New York, the scandals which have hit the American Stock Exchange and skimmed the European ones, the harshening of geo-political tensions which peaked with the war in Iraq and the explosion of the SARS epidemic. However, only attributing the mistake to those factors – which have somehow affected entrepreneurs' and consumers' spending decisions – means forgetting the basic problems of the world economy, mostly due to the difficulties met by the main economies. Those difficulties refer to the situation of “post-bull economy” characterising the United States, which implies the long-term clearing of the financial and real excesses of the late-nineties, a standstill of the macroeconomic policies to regulate the cycle and the end of policies aimed at relaunching the long-term growth of the euro area.

The world economy in the first half of 2003

In the first six months of 2003, the international economy registered a general weakness. In the late-2002 and early-2003, the uncertainties which have accompanied the evolution of the Iraqi crisis led consumers and entrepreneurs in industrialised countries to take up a sort of “wait-and-see” approach and this brought about a standstill in the productive activity. In the first quarter, the GDP of the OECD area was slightly more than stagnating, with a 0.4%-rise in the United States and a 0.1%-growth in the euro area and in Japan. Also in emerging economies the dynamics has diminished because of the smaller thrust from industrial countries. Owing to the brake of the world economy, international trade has stopped expanding, after the strong recovery which had characterised the six months between the late-2002 and the early-2003.

Admittedly, the rapid end of the war at the beginning of April eliminated part of the uncertainty on the international scene, bringing about a better trend for some indicators. Share quotations increased almost everywhere compared to the pre-war minimum values of March. There were rises of more than 20% in the United States, between 20 and 30% in the United Kingdom, in France ad

in Japan, more than 50% in Germany. Confidence improved among American consumers (but not among European ones). Oil, even though it did not decrease too much, witnessed however a reduction compared to the peaks over 30 dollar per barrel which were reached in the first half of 2003. Within this framework, the dollar depreciation against the euro and – to a lesser extent – against the pound and the yen, which had started in 2002, accelerated and stimulated the US economy while braking the other economic systems.

In spite of the improvement of the international climate indicators, in the second quarter there was not the expected leap forward in the economic activities which was to be triggered by the overcoming of the standstill caused by the war in Iraq. In the United States, the April-June trend was close to that of the first quarter, being affected by the failure to start the expected investment recovery. In the euro area, the second quarter evolution remained, braked by an anaemic domestic demand, by the impact of the single currency strengthening and by the great difficulties met by Germany in exports. Alongside with all that, the productive dynamics of some industrial economies (Canada) and, in particular, of the Far East emerging countries were affected by the SARS. Its economic consequences were limited in China, but proved more relevant in some countries of the Pacific Basin (Singapore and Korea).

All in all, the world economic trend in the second quarter 2003 seem to have reiterated, with marginal variations, those of the first three months of the year, in spite of the overcoming of the geo-political tensions which had dominated the early-2003. According to this interpretation, the Iraqi crisis simply played the role of catalyser of uncertainties and difficulties which are altogether present at international level.

Expectations for the second quarter

While making forecasts for the next six months, one cannot forget the standstill slowing down the world cycle, which presumably shall affect next year's recovery.

In the United States there are all the necessary ingredients for a recovery strengthening. Indeed, some days ago, the Business Cycle Dating Committee of the National Bureau of Economic Research officially “certified” that the American recession, started in March 2001, ended in November 2001, with a length (eight months) slightly shorter than of average American recessions. Indeed, NBER technicians underline that the end of the recession does not automatically mean that the economy is back to its normal functioning conditions. Indeed, the end of the US recession has taken at an unusually slow pace. This was due, on the one side, to the fact that private consumption has never diminished, thus there was not that usual “jump forward” which the resumption of the

households' expenditure normally brings about during the first phases of the economic recovery; and, on the other side to the excessive capital formation created in the years of the so-called irrational exuberance, which became a sort of brake to investments in machinery and equipment, which are still lacking in the American recovery.

The conditions which would foster a strengthening of the economic activity in the next few months lie in a mix of expansionary macroeconomic policies. In terms of monetary policy, an anti-cyclical approach includes not only interest rate cuts (the interest rates went down to 1% at the end of June), but also the behaviour of the Federal Reserve President who, in his latest public communications (for instance, his intervention at the Congress of July 15), constantly reiterated his readiness to intervene in support of the economy, whenever it is necessary. In terms of fiscal policy, it refers to the approval of the ten-year 350-billion-dollar Plan for Tax Reduction which has been bringing tax reimbursements in the pockets of American citizens since July. The non-provisional nature of that stimulus may cause tensions in the medium term, owing to the imbalance it creates in the State budget (the Federal deficit should exceed 4% of the GDP in 2003), which weights on the high indebtedness of the American economy, which so far has been financed by foreign funds (the current account deficit should reach 5% of GDP in 2003). However, in the short term, the effects of the tax reductions should remain substantially favourable.

On the demand-side, signals referring to consumption and construction continue to be positive. The former is favourably affected by the (low-rate) re-financing of mortgage loans "freeing" resources for households' expenditure and by the mentioned tax reductions which were enforced in July. The latter is fostered by the lower interest rates facilitating loans for home purchases. The conditions became more advantageous for investments as well, thanks to the easing of the monetary squeeze and to the considerable stock exchange rise implying a less expensive access to the capital market. With reference to the stock market, it is worth noticing that investors have "bet" on the American recovery, thus raising prices to levels which may only be justified by a remarkable (future) gain growth.

The strengthening of the American business cycle should have a positive impact on the euro area, which apparently is unable to find an autonomous engine for its recovery. Various braking elements affect the European business cycle compared to the American one.

Firstly, the single currency strengthening which – even though it was interrupted in the past few weeks – weakens the US leading role. Estimates show that, every 5%-appreciation of the real nominal exchange rate of the euro, the EMU loses 3-4 tenths of one percent of GDP, taking account of the (opposite sign) effects connected to the deterioration of competitiveness and to the trade benefit brought about by the smaller imported inflation.

Secondly, the uncertainty tends to cause standstill in Europe more than in the United States. Since the end of the war in Iraq, unlike what happened in the American economy, there were no significant reaction of European confidence indicators. Indeed, the Stock Exchange did show a recovery, but this did not happen in the confidence climate, which means that the lack of confidence which goes beyond the war.

Finally, a further constraint to growth in Europe lies in the “lack of fuel” to prompt its main engine, namely the German economy. The case of Germany, with its business cycle which has long remained in-between stagnation and recession, highlights the problem of whether the EMU policy mix is suitable or not. The mix is adequate, if one looks at the area as a whole, but it is by no means satisfactory if one considers the present situation of its main economy. According to the evaluations of the present Report (see Box on Asymmetric effects of the single monetary policy), since 1999 –the euro birth year - the ECB interest rate has been on average 120 basic points above the rate which would suit the German economy, taking account of its inflation (lower than in the rest of the EMU) and business cycle (the German output gap is among the widest of EMU). That gap has been widening over the past few years and almost reached 200 basic points. The restrictive effect of the monetary policy was partially offset by a German competitiveness trend which was less negative than the European partners’ one, thanks to its lower domestic inflation dynamics. In turn, its persistent stagnation - which is also due to its extremely severe monetary policy - affects the German public finances, thus making the resumption of the 3% reference standard of the deficit/GDP ratio ever more difficult.

The figures of the international scenario

On the basis of these trends, the international framework depicted by the ISAE forecast foresees for the second half of 2003 a slight improvement in the world cycle, which is confirmed to be a rather flat year in terms of average results. The expansionary phase is shifted forward by few months and should take place in 2004. However, the evolution should remain on limited rhythms compared to similar periods of general recovery. In 2003, the world gross product should grow by 3%, which is in keeping with the present experience, and by 4% in 2004. In the industrial area, the GDP dynamics should stop at 1.6% in 2003, thus marking a slight slowdown compared to 2002 (when the growth amounted to 1.7%) and then should go up to 2.4% in 2004. Conversely, the area of emerging economies should register a moderate acceleration, with a GDP rise of 4.6% in 2003 (4.1% in 2002) and of 5.7% in 2004.

United States, EMU and Japan

Turning to single economies, the United States should give the “starting kick” to the strengthening phase of the world cycle. The American economy is supposed to expand on average by 2.2% in 2003 and by 3.5% in 2004. Taking account of the estimates on the US potential growth (about 3.5%), these dynamics implies the maintenance of a negative gap between the real and the potential production levels in 2004 too.

The euro area should follow the United States with a delay in the timing and intensity of the recovery. In 2003, the GDP should grow by 0.7%, which is one tenth of one percent less than in 2002. In 2004, the growth should amount to 1.8%, thus remaining below the potential area development.

In Japan, the persistent deflationary trends should continue to brake the domestic demand strengthening. The prospects for the Japanese economic development remain linked, on the one hand, to the United States and, on the other, to the other Asian countries, particularly China. We estimate that Japan substantially remains close to stagnation in the second half of 2003 and weakly accelerates during 2004. Given the particular trend characterising the Japanese economic activity in the past quarters, this profile should lead to an average annual GDP growth of +0.8% in 2003, which is more sustained than in 2004 (+0.5%).

Emerging areas

With the overcoming of the SARS crisis, Far East countries should witness again the highest dynamics in the world. After the slight deceleration of 2003 (from 5.7% in 2002 to 5.4% in 2003), the rhythm should exceed again 6% in 2004. China, with a growth between 7.5% and 8% in 2003 and 2004, should be the main engine of this part of the world.

In Latin America too there should be a slow improvement thanks to the relatively more favourable conditions of Argentina and to the substantial held of Brazil. After the negative trends of the two years 2001-2002, the GDP of this area might expand at a 2.4%-pace in 2003 and then accelerate in 2004 (+3.8%).

In Central-Eastern Europe, the economic evolution should show again a considerable dynamics after the slight weakening of 2002. A major thrust comes from the forthcoming entry into the European Union of eight countries of this area. The progress made in view of this major event has attracted a significant direct investment flow and has brought about an improvement in the overall

economic conditions. In the whole area, growth should reach 3.9% in 2003 (3.4% in 2002) and 4.1% in 2004.

The US dollar

With reference to the exchange market, the ISAE forecast envisages a weak dollar in the second half of the year, even though the prevailing cyclical evolution on the two sides of the Atlantic should lead to think that the maximum depreciation level of the American currency was reached with the May ad June peaks. In our assumptions, the dollar-euro exchange rate should amount to 1.14 in the second half of 2003 and then reach 1.10 on average in 2004. Therefore, those quotations are very close to the theoretical values of the equilibrium exchange rate between United States and the EMU estimated on the basis of different assumptions and methodologies. Indeed, according to the approach based on the Purchasing Power Parity (PPP), the exchange rate ensuring equal prices (expressed in the same currency) of similar baskets of goods and services in the two economies equals 1.12 dollars per euro; according to a different approach, the exchange rate compatible with the fundamental macroeconomic equilibrium conditions in the two areas is around 1.15¹.

Interest rates

With reference to monetary policies, given the gradual improvement of the American economy, we assume that – since the latest cut of June 25 – the interest rate decreasing phase introduced by the Federal Reserve has come to an end. An upward correction of interest rates might take place in the second half of 2004, alongside with the consolidation of the American recovery. The weaker cyclical conditions of the euro area leave room to further monetary easing on the part of the ECB who, according to our assumption, shall reduce the main re-financing operations by 0.5% between the late-2003 and the early-2004, bringing them to 1.5%. At the end of 2004, with the strengthening of recovery, the European interest rates might grow again and reach 2% in the last quarter.

¹ See on this point also the third ISAE Report on the State of the Union, July 2003.

Raw materials

After the rises of the first months of the year due to the growth of the premium for the war risk and to the loss of the production from Nigeria and Venezuela, the raw oil quotations weakened again in the second quarter, when the Brent price was close to 26 dollars per barrel. Recently, limited tensions emerged again in connection to the reduction of American inventories and to the unstable Iraqi situation. Taking account of this persistent uncertainties, ISAE forecasts that the Brent oil price shall amount on average to about 27 dollars per barrel in 2003. In 2004, in spite of the strengthening of the world growth, there will be no major rises, also given the presence of the Iraqi oil production on the world market, as it is no longer bound to the Oil for Food programme. The raw oil quotation in 2004 should amount to 25 dollars, with a 7% contraction compared to 2003.

As for other raw materials, the dollar depreciation experienced in the first half of 2003 has probably favoured the considerable rises registered in that period, particularly in industrial commodities. With the smaller dollar depreciation expected for the second half of the year, also the evolution of primary products prices should decrease. Conversely, in 2004, the higher dynamics of the international cycle might bring about higher rises. Hence, as a consequence of the rises registered at the beginning of the year, ISAE foresees an average price rise of non-energy raw materials stronger in 2003(+9.6%) than in 2004 (+3.2%).

World trade

After the standstill witnessed in the late-2002 and in the early-2003, international trade should gain strength. The greater support to the demand dynamics should come from the emerging economies, particularly those of the Far East (mainly China) and, to a lesser extent, of Central-Eastern Europe. In the industrial area, in keeping with the expected evolution of the economic activities in the various economies, the trade recovery should be led by the United States, while the European market – even though it is expanding after the standstill of 2003 – should witness smaller rises. All in all, the world trade – expressed as the average of exports and imports – should grow in 2003 by about 4% and should accelerate to 6.5% in 2004. Taking account of the expected trend of the world economic activity, the estimated growth pace for international trade implies that the trade elasticity to the GDP rises again after the drastic fall of the past two years, exceeding 1%, which is however above the average figure which has characterised the nineties (namely 3).

ISAE FORECAST ON THE ITALIAN ECONOMY: GENERAL SUMMARY

(percentage changes, unless specified)

	2002	2003*	2004*
Domestic references			
Gross domestic product	0.4	0.6	1.7
- North-West	0.2	0.4	1.6
- North-East	0.3	0.6	1.7
- Centre	0.8	1.3	2.2
- Mezzogiorno	0.6	0.8	1.7
Imports of goods and services	1.5	2.2	6.1
Exports of goods and services	-1.0	0.6	4.5
Resident households' expenditure for consumption	0.4	1.3	1.9
Expenditure of General Government and NPISH (1)	1.7	1.3	0.8
Gross fixed investments	0.7	-0.2	3.3
Contribution to GDP growth attributable to (percentage points):			
- domestic demand (net of stock changes)	0.7	1.0	2.0
- stock changes and valuable objects	0.4	0.1	0.2
- net exports	-0.7	-0.5	-0.4
Current and capital account balance (as a percentage of GDP)	-0.5	-0.7	-0.7
Consumer prices	2.5	2.5	2.1
Producer prices	0.2	1.6	1.1
Propensity to consume (percentage level)	87.6	87.4	87.6
<i>Per capita</i> gross earnings in the economy			
Total employment (2)	1.1	0.7	0.9
Unemployment rate	9.0	8.8	8.6
General Government net borrowing (as a percentage of GDP)	-2.3	-2.3	-2.1
General Government primary surplus (as a percentage of GDP)	3.4	3.0	2.9
Fiscal pressure of General Government	41.6	41.8	40.8
General Government debt (as a percentage of GDP)	106.7	105.8	104.7
3-month Treasury Bills yield (3)	2.9	1.75	2.2
p.m. Nominal GDP (millions of euros) (4)	1,258,349	1,305,809	1,356,709
International references			
Dollar/Euro exchange rate (level)	0.945	1.122	1.100
World demand	2.6	4.1	6.5
Official exchange rates (3)			
- ECB	2.75	1.75	2.0
- Federal Reserve	1.25	1.0	1.75
Prices of raw materials (in dollars)			
- energy	3.0	8.9	-1.3
- of which: Brent (\$/barrel)	1.7	8.1	-6.7
	25.12	26.95	25.00

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

* ISAE forecasts.

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

Italy in the first months of 2003

In the first quarter of the year, the (weak) recovery of the Italian economy which had been characterising the whole 2002 came to an end. The GDP dynamics (-0.1%) was smaller than the one registered in the euro area, mainly because of a further contraction of the industrial activity. The Italian outcome of the first quarter of 2003 is even more disappointing, if one considers the aggregate demand composition which lies behind it. Indeed, the economic activity contraction went alongside with a strong inventories growth and all the final demand components showed unsatisfactory trends. The Italian households' consumption stopped after the positive evolution which characterised the last three quarters of 2002. Gross fixed investments registered a strong deterioration. The considerable export reduction exceeded the contemporary import contraction.

Those evolutions were partially expected. However, they were more unfavourable than expected. In particular, a fall in the expenditure for investment goods and in motor-vehicles (either commercial or not) was expected after the strong acceleration witnessed in those sectors in the late-2002 in view of the end of the tax relief period (pursuant to the Tremonti-bis Law for investments in machinery and equipment and to the incentives to the old car disposal). However, the deterioration was very strong, with peaks of 7.3% in machinery and 10.7% in means of transportation. Compared to what happened in the previous experience of investment incentives in 1994-95, the expenditure oscillation (growth and contraction) after the expiring of the tax relief provisions was stronger, probably because of the different investment decisions taken in the completely different cyclical situations of the two periods. Indeed, the business cycle of 2001-02 was much more unfavourable than the one of 1994-95.

Mid-2003 cyclical trend

The available cyclical indicators depict a still uncertain situation of the Italian economy. Since the early-2003, the households' confidence climate has been oscillating around the historically low levels reached at the end of 2002, at the end of an almost uninterrupted fall started in February. Low confidence does not automatically mean no expenditure, as also highlighted by the 2002 trend (when consumption was increasing while confidence was decreasing). Indeed there are factors (such as the disposable income, interest rates, etc.) which affect the operators' purchases, alongside with the psychological ones. However, as some estimates contained in the Report show, the households' perception on their own situations and on the current situation (concerning both the overall economy and their own financial situations) eventually affect some expenditures,

particularly purchases of non-durable goods (see the Box on Households' confidence and expenditure for consumption).

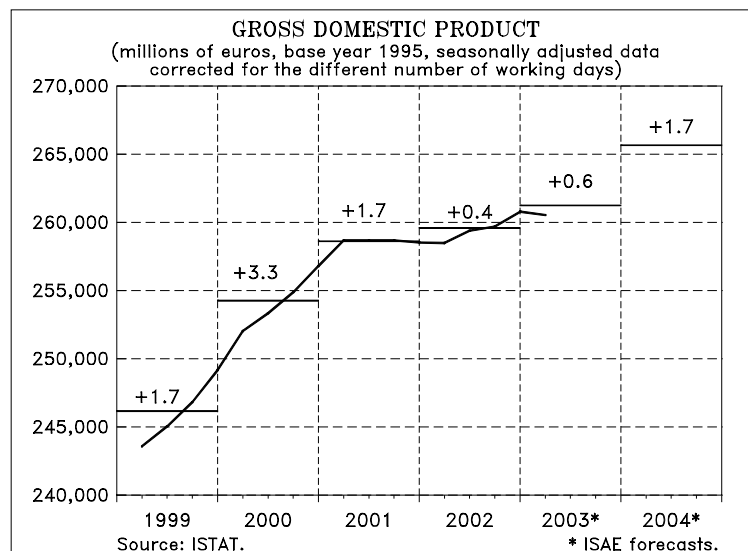
Also the entrepreneurs' confidence has been characterised by a swinging evolution around a decreasing trend since the beginning of the year, which is the symptom of a persistent uncertainty. Over the past few months, a pessimistic approach on the current production and demand trends was accompanied by rosier expectations on the future evolution of those same variables. In July there was a new marked contraction of the Italian firms' confidence climate which involved expectations as well.

With reference to quantitative leading indicators, ISAE estimates that industrial production – after the strong fall registered in May - witnesses such a bounce in June that the productive levels of the second quarter are slightly above those of the first. In the following three months, the industrial activity should observe a further slight rise. For the overall economic activity, the synthetic leading indicator elaborated by ISAE, which remained unchanged for some months on the high levels reached at the end of last summer, slightly decreased according to the latest estimates, thus confirming the general weakness of the Italian business cycle.

Forecast on the Italian economy

Those indications lead ISAE to estimate a generally stagnating trend in the Italian economy in the first half of the year, followed by a very marginal improvement in the second part of the year. Mirroring these trends, the GDP should increase on average by 0.6% in 2003, which is two tenths of one percent more than 2002, almost in keeping with the expected growth for the euro area. The present forecast on the Italian economy for 2003 is considerably smaller (by six tenths of one percent) than the April one. The misconception is due to the darker international situation, to an economic evolution in Italy which falls short of our expectations in the first quarter and to an unfavourable composition of the aggregate demand in the same period (a strong fall in the final components and a considerable inventories' growth).

In 2004, the development rate should equal 1.7% (1.8% in the euro area) and be slightly above 2% in the last quarter. The strengthening of the Italian recovery should draw benefit from a modest push effect (four tenths of one percent) coming from the greater dynamics of the second half of 2003, from the international business cycle acceleration, from the overcoming of the uncertainty which slowed expenditure in 2002 and from a thrust (equalling one-two tenths of one percent) coming from the Government action described in the Economic and Financial Planning Document (DPEF).



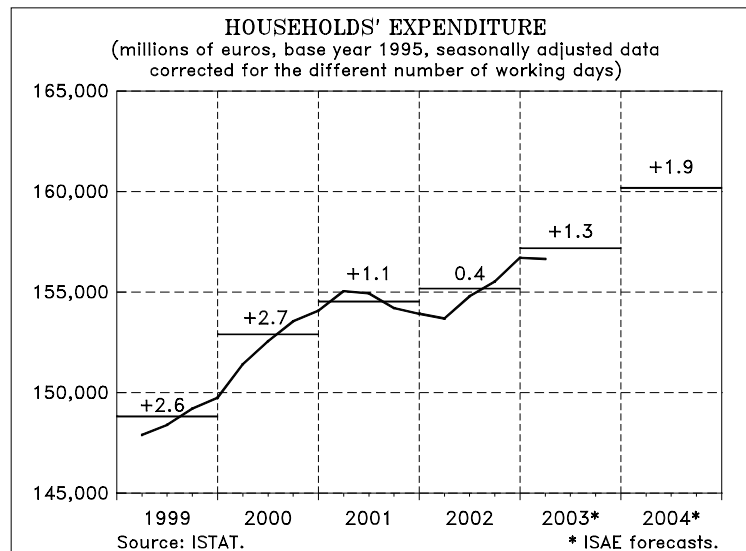
Contributions to the GDP growth

The evolution of the Italian economy in 2003 should be mainly affected by the still-negative contribution of net exports, which should subtract five tenths of one percent from the GDP, which is slightly less than what happened in 2002 (-0.7%). Conversely, a positive contribution should stem from the final domestic demand, fundamentally mirroring the final consumption which, between the private and public component, should underpin the economic activity evolution for about one percentage point. The change in inventories - due to a reduction after the strong leap forward of the first quarter - should account for one tenth of one percent.

In 2004, the Italian growth acceleration should benefit from the significant support coming from all components of the final domestic demand (amounting to two percentage points), while a contribution of two-tenths of one percent should come from inventories. The contribution of the net foreign demand should be still negative (four tenths of one percent).

Consumption

The resident households' expenditure for consumption should grow by 1.3% in 2003, with a rise by about one percentage point compared to 2002. The annual acceleration is mainly affected by the constant push effect stemming from the previous year's profile (equalling one percentage point). Indeed, in the second half of the year, a more favourable dynamic will emerge, once the end of the incentives to the purchase of motor-vehicles has had its impact on the purchase of durables. The strengthening of private consumption will be affected by the favourable trend of the households'



disposable income, supported by the wage rises deriving from the latest wage bargaining round and by the evolution of the overall employment which – though being decreasing compared to the previous year – will follow a still -positive average trend in 2003. Further stimulating factors should come from the fall in the reference interest rates for consumer credit and from the easing of inflationary tensions on the second half of 2003, also due to the euro appreciation. In 2003, owing to the strong elements of uncertainty which have braked the expenditure in the first months of the year, the private consumption dynamics should be on average smaller than that of the disposable income, with a consequent new reduction in the average spending propensity.

In 2004, consumers' expenditure should continue to expand, benefiting from the persistently favourable wage evolution and from a new employment acceleration. The expenditure for consumption should grow by 1.9%: in correspondence to this trend there should be a slight growth in the households' propensity to purchase, which should reach again the average figures of 2002.

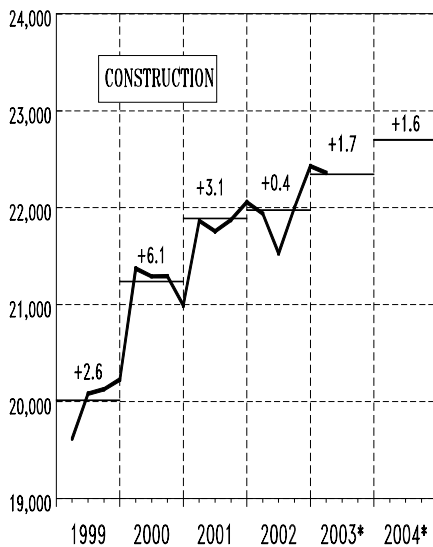
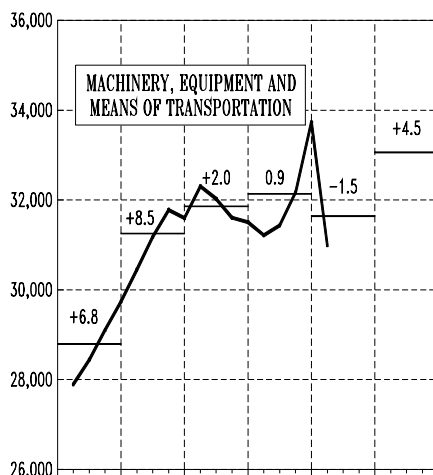
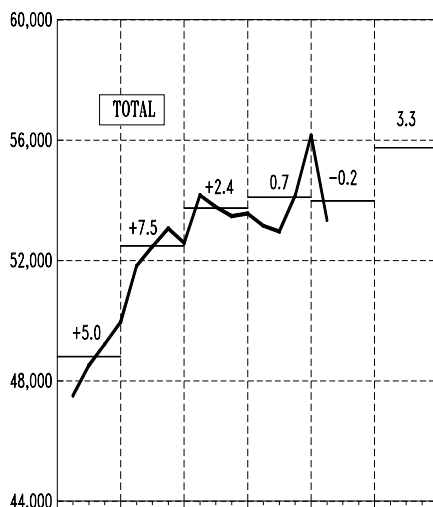
Investments

With regard to investments in machinery and equipment, the ISAE forecast, after the strong fall of the first quarter, foresees for the second quarter a substantially stagnating trend as a consequence of the negative repercussions of the end of tax incentives and of the low degree of plant utilisation. In our assumptions, a positive variation in investments might take place in the second half of the year, in connection with the improvement of the prospects of domestic and international growth and with the reduction of the cost of capital deriving from the favourable evolution of the general financing conditions. However, the recovery should not be sufficient

GROSS FIXED INVESTMENTS

(millions of euros, base year 1995, seasonally)

adjusted data corrected for the different number of working days)



Source: ISTAT.

* ISAE forecasts.

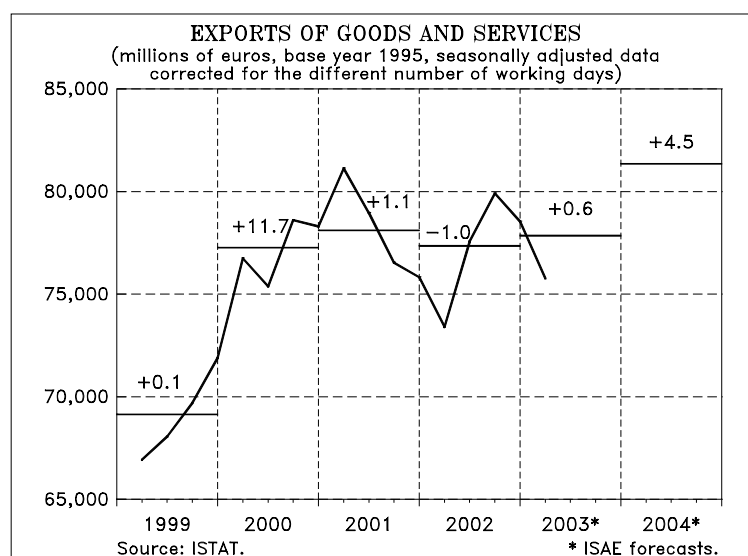
to offset the losses of the beginning of the year, which shall lead to an average deterioration in 2003 which, for machinery, equipment and means of transportation, should amount to 1.5%. In 2004, the dynamics of this expenditure component should be positive again and should reach 4.5%, in keeping with the acceleration of the Italian cycle.

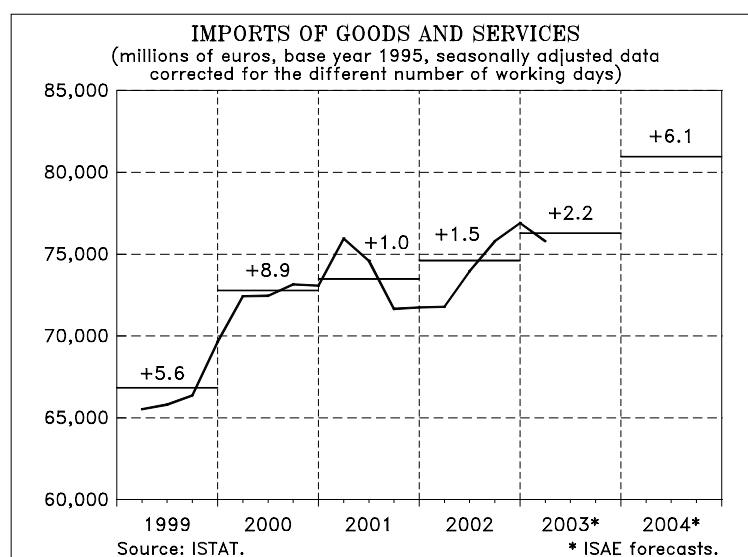
With reference to construction, next year the major thrust should come from public works, a sector which might draw benefits also from the start of the European Action for Growth. Indeed, a smaller push might derive from home construction. According to the ISAE forecast, the investment growth rate in construction should amount to 1.7% in 2003 and to 1.6% in 2004.

Generally speaking, following upon these trends, the overall investments of the Italian economy should register a 0.2% contraction on average in 2003 and should grow again in 2004 with a 3.3%-rate.

Exports and imports

In 2003, exports of goods and services should grow on average by 0.6%. After the contraction registered in the last quarter of 2002 and in the first quarter of 2003, Italian sales abroad might expand again in the wake of the international trade recovery. The euro appreciation against the main currencies and the unfavourable geographical composition of the world demand (the European countries, which are the main outlet for our products, grow less than the rest of the world) should however maintain the Italian export dynamics below the one of the world demand, with a new erosion of the market share. Exports should accelerate next year, pushed by the strengthening of the world economy; the growth rate should equal about 4.5%.





Also for imports, the ISAE estimates point to an acceleration in the second half of 2003, following upon the gradual strengthening of the economic activity. The growth in 2003 should amount to 2.2% on average, while in 2004 the rise in the growth rate should further fuel exports, which will grow by 6.1%,

Labour market

With regard to the labour market, in the second half of 2003 a slowdown is foreseen in the employment dynamics, due to the delayed effects of the economic activity deceleration. In terms of standard units, the number of employed should grow at a considerable pace equalling 0.7% (+1.1% in 2002). The labour demand will accelerate in 2004, when the output should grow by 0.9%. Following upon this evolution, the employment elasticity to the GDP should decrease in 2003, after the strong and strange uproar of 2002 (when the figure reached 2.8%), remaining above unity. Only in 2004 the elasticity should be again close to the average values – favourable compared to the Italian standards - of the period 1998-2001. The flexibility provisions introduced by the so-called Biagi Law - which the Report thoroughly investigates in the Box on The labour market reform – should contribute to maintaining the employment trend in keeping with the positive trends which have characterised the late-nineties.

In terms of people, the overall employment growth should amount to 490,000 units in the period 2003-04. The unemployment rate will continue its decreasing process started in 1998 (when job seekers accounted for 11.8% of the labour force), reaching 8.8% in 2003 and 8.6% in 2004.

Alongside with these evolutions, the employment rate continues to grow and attains 56.6% in 2004, which is not far from the “intermediate” objective set by Government for 2005 (58.5%).

Wages

With regard to wages, the forecasts for 2003 and 2004 take account both of the already foreseen provisions and of the wage bargaining round which will take place in the two years considered. Within the ISAE scenario, the per capita gross earnings in the overall economy (+2.6% in 2002) shall rise by 3.1% in 2003 and by 3% in 2004. In industry excluding construction the corresponding dynamics will reach 2.7% and 3.1% respectively. Taking account of the productivity trend, the labour cost per product unit will grow in 2003 at a pace similar to the one of 2002 (+3% around), thus being affected by the high employment growth which still characterises 2003. In 2004, labour productivity will accelerate again, enabling a fall in the labour cost per product unit which should reach 2% only.

Inflation

The new start of the disinflation process came to a stop in the first half of 2003. The consumer price dynamics was supported by both oil rises and by endogenous thrusts concerning industrial goods and services, which have been emerging, once the foreign contribution has diminished.

The prospects for the second half of 2003 are more favourable, with a gradual tension easing. Apart from the “advantageous” statistical comparison with a period of 2002 characterised by strong price dynamics, the favourable impact of the euro appreciation should reduce the thrusts coming from international prices. The inflation measured on the consumer price index for the whole country will amount to 2.5% on average in 2003, as in 2002. At the end of the year, if there are no further shocks, the price growth might fall down to 2.2-2.3%. The decreasing process should go on in the first half of 2004, also favoured by acceleration of the unitary labour cost, till it reaches a trough of 2% in the mid-2004. In 2004, inflation should equal on average 2.1%, which is one of its minimum figures since 1999.

In terms of harmonised index, which is generally closer to the trend of the households’ consumption deflator in national accounting, inflation should equal 2.6% in 2003 and 2.2% in 2004. The gap from the euro area partners – three tenths of one percent in 2002 – might widen and reach five tenths of one percent both in 2003 and in 2004.

This unfavourable evolution seems to confirm a statistical regularity which has been characterising the Italian economy over the past few years. Indeed, whenever general price tensions diminish, the gap between the Italian inflation and the EMU widens, while it narrows whenever price tensions grow. This trend is the symptom of the higher rigidity (either upward and downward) characterising the Italian markets of goods and services compared to those of the other European countries, when exogenous disturbances emerge. According to the Report, between 1996 and 2003, each percentage point of inflation decrease in the euro area corresponded to an average worsening of thirty-six hundredths of one percent of the differential of consumer price growth in Italy compared to its European partners (see the Box on The inflation differential of Italy compared to the euro area).

Geographical partitions

Turning to geographical partitions, the ISAE estimates show for 2003 an evolution in the Mezzogiorno still slightly better than the one of the rest of the country. According to our estimates, Southern regions should register a GDP rise by 0.8% as against rises by 0.4% in the North-West and by 0.6% in the North-east. Only in the Centre – in keeping with what happened in 2002 - a higher dynamics (1.3%) should emerge. In 2004, all geographical partitions will be affected by the better evolution of the national and international cycle, and the Centre should experience better economic activity trends over 2%. Next year, Southern regions should experience higher rhythms than those witnessed in the North.

The Report provides some analyses revealing a strong heterogeneity between different geographical and influence areas or phenomena of spatial dependence between close geographical entities (see Box on Territorial convergence in Italy between heterogeneity and spatial dependence). The word heterogeneity refers to the phenomenon whereby different geographical areas do not converge towards a single economic development level. Quite the reverse, the different initial conditions characterising them (in terms of per capita income, infrastructures, human capital endowment, etc.) lead to different degrees of development. This trend runs counter the attempt to obtain the same levels of well-being throughout the whole country. Spatial dependence indicates the contagious effects between geographically-close territorial units. This too tends to run counter the convergence process, as the consequences of the shocks hitting an area is more intense the closer is the area. Besides, the co-existence of heterogeneity and “spatial” influence hints to the existence of obstacles to the wider diffusion of the impact of positive shocks which tend to remain within the cluster of the nearby regions, not affecting other parts of the national territory. This shows that the policy mix chosen to promote growth in backward areas and their convergence towards a homogeneous development model must take into consideration the obstacles caused by economic-geographical mechanisms pointing to divergence.

Public finances

The Economic and Financial Planning Document (DPEF) for the period 2004-07 assumes an Italian GDP growth by 1.8% in 2004, after a 0.8% rise estimated for 2003. On the basis of the existing legislation, the General Government net borrowing should grow from 2.3 to 3.1% between 2003 and 2004. The objective for next year sets the GDP rise to 2% (two tenths of one percent more than the projection) and a deficit/GDP ratio amounting to 1.8%, with a correction equalling 1.3%

of the GDP. However, the DPEF foresees provisions for two billions of euros which are necessary to cover also the expenditures which are by definition not included in the forecast according to the existing legislation. This is the case of expenditures for the public sector wage bargaining (unless there is a contract vacancy) and for the re-financing of public investments. Indeed there is no mention of interventions aimed at covering any possible additional Government commitments, as it is the Financial Bill which provides the full definition of the Government tax policy. Taking account of these further possibilities, the overall bill will exceed 16 billions of euros (corresponding to 1.8% of the GDP) which are contained in the DPEF and will be sub-divided into about 5.5 billions coming from structural interventions and more than 10 billions of euros from one-off measures (una tantum).

According to the Government indications, the one-off provisions should mainly concern the real estate sector. Indeed, the ones with permanent effects should consist, on the revenue-side, of actions to fight against tax evasion and the black economy and, on the expenditure-side, of interventions to reduce special regimes, the enforcement of the domestic Stability Pact, the further rationalisation of purchases of goods and services, as well as the European Action for Growth. Thus, the bill should mainly concentrate on expenditure and should have limited restrictive effects so as to take account of the weak cyclical evolution which the Italian economy is getting through.

All in all, the DPEF provisions are wide-encompassing. Their full enforcement implies a considerable commitment. Indeed, the provisions already implemented in the past and now reiterated might prove less effective, while it might take time for new instruments to bear fruits. It is however worth noticing that, to control the public budget, a sort of “reserve” measures are available aimed at ensuring the full effectiveness of the provisions adopted.

ISAE forecasts a General Government net borrowing amounting to 2.3% of GDP in 2003, which equals the 2002 figure and is in keeping with the Government assumptions. In 2004, the forecast deficit should increase to 3.4% of GDP, if policies remain unchanged. The ISAE estimates exceeds the DPEF figure (3.1%), partially because we assume a smaller growth (by about five tenths of one percent in the two years 2003-2004) compared to the one assumed by Government, and partially because the ISAE figure includes the expenditures for the 2004 wage bargaining and for public investments.

The correction of the foreseen deficit assumed by ISAE amounts to 18.2 billions of euros, namely 1.34 of GDP. It should reduce the General Government borrowing down to 2.1% of GDP. The bill also considers the financial needs to cover the wage bargaining costs and the additional investment figures. Further interventions to support the economy should require additional provisions.

According to the ISAE estimate, the primary surplus falls from 3.4% of GDP in 2002 to 3 and 2.9% in 2003 and 2004 respectively. In 2003, the overall General Government revenues will accelerate following upon the revenues coming from the tax amnesty, and then will slow down in 2004. The GDP incidence should amount to 45.1% in 2003 (44.9% in 2002) and 44.1% in 2004. The fiscal pressure should grow by two tenths of one percent in 2003, equalling 41.8% (41.6% in 2002) and then fall down to 40.8% in 2004. Net of the one-off amnesty provisions, the fiscal pressure will decrease both in 2003 (from 41.5% in 2002 to 40.7) and in 2004 (to 40.4%), thanks to the tax relief on the personal income tax, on the corporate income tax and on the local tax on productive activities.

In 2004, the expenditure dynamics net of interests should be affected by the Government manoeuvre, which will concentrate on expenditures. Indeed, primary expenditure, after the considerable rise registered in 2003 - from 41.6% of GDP in 2002 to 42.1% in 2003 – should go to 41.2% in 2004 with a decrease of about one percentage point. The debt service payments should continue to decrease both as a percentage of GDP and in absolute value, thanks to the favourable trend of interest rates. The incidence of the interest expenditure on GDP should pass from 5.7 in 2002 to 5.2 in 2003 and to 5% next year.

The reduction of the deficit/GDP ratio should slow down in the two years 2003-04. At the end of 2003, the ratio should amount to 105.8% (from 106.7% in 2002). In 2004, owing to the Government provisions, to a larger impact of privatisation and to the acceleration of the economic growth, the debt should go down to 104.7% of GDP.