



ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Forecast on the Italian Economy

Synthesis

JULY 2004

CREDITS

The present Report is the result of the team work of a wide group of researchers coordinated by Sergio de Nardis. In particular, the drawing up of single Chapters was edited by Roberto Basile, Maurizio Bovi, Cristina Brandimarte, Giancarlo Bruno, Margherita Cagiano de Azevedo, Sandro Calabresi, Claudia Cicconi, Clemente De Lucia, Roberta De Santis, Marco Fioramanti, Massimo Mancini, Marianna Mantuano, Mara Meacci, Maria Cristina Mercuri, Carmine Pappalardo, Gianfranco Piras, Gianni Principe, Daniela Rossi, Rosetta Salvini, Franco Sartori, Claudio Vicarelli with the contribution of Mariella Cozzolino.

We thank Emma De Angelis, Paolo Fanfoni, Gabriella Gasparini and Giuseppina Marasca for their collaboration.

The editing was ensured by Maurizio Brioni and Fernanda Turella, 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 21, 2004.

Summary and Introduction

The international growth has considerably stepped up in the late-2003 and early-2004. The maximum acceleration was probably reached in Spring; after that, the overall economic activity reduced its pace, though it remained on satisfactory expansion rhythms. Thanks to that trend, 2004 might show the largest development in the past three decades. The world gross domestic product should grow by 4.7%: only in four past occasions (namely in 1976, 1984, 1988 and 2000) similar growth rates were registered.

The international framework

The cycle strengthening is however accompanied by considerable imbalances in the countries which had played a leading role on the international scene and by the emergence of tensions on the raw materials markets. At the same time, great uncertainties remain in the geo-political framework, having their epicentre in the instable Middle-East. The scenario adopted by ISAE envisages that - in the next eighteen months - the risky elements of the international scenario remain under control and the imbalances and tensions which have recently accumulated will cause no inverse of the cyclical trend. The Report provides some elements corroborating this assumption.

The United States and the Far East led the world dynamics. Boosted by a supportive economic policy, the American economy rapidly found a way out of the 2001 recession and - after the uncertainties connected with the war in Iraq - reached again its solid expansion pace of Q4 2003 and Q1 2004. Once overcome the SARS epidemic, the Far East started again to grow vigorously, stimulated by China, which led Japan out of its long standstill and had a positive impact on the other economies of the region thanks to its intense intra-regional trade relations. In the first months of 2004, the development in India and Russia was particularly lively: in the latter case, the high oil quotation keeps underpinning the Russian economy. The recovery started in 2003 in Latin America is consolidating: the cyclical situation is improving in Brazil, while, at the beginning of 2004, Argentina

The early-2004 trend

registered annual development rates above 10%.

Within this framework, the euro area followed the wake of the international recovery with a certain delay and, in particular, with a slower recovery compared to the other major economies. The GDP growth in Q1 (+0.6% q-o-q; +1.3% y-o-y) was higher than expected, but considerably lower than the one observed in the same period in the United States (+1% q-o-q, +4.8% y-o-y) and in Japan (+1.5% and +5% respectively). At the beginning of 2004, the EMU acceleration mainly mirrored a consumption rebound in France and Italy, while in Germany the domestic demand remained weak and exports witnessed a better trend than those of the other EMU partners.

***The impact of
macroeconomic
policies on the
European
performance***

The ISAE Report of February 2004 stated that the delay of the European recovery compared to the United States, apart from deriving from the different flexibility and efficiency of the markets of goods and services in the two economies, also mirrored the different macroeconomic approaches adopted on the two coasts of the Atlantic - particularly in terms of expansionary policies - to face the weaker economic cycle.

The present Report provides a further deepening on this topic, trying to verify through a series of historical simulation which might have been the euro area dynamics in the period 2001-2003, had different fiscal and monetary policies been adopted (see box on *The performance of EMU in the period 2001-2003 under different hypotheses of macroeconomic policy: some counterfactual exercises*). The question of cycle-regulating policies in Europe has two facets. On the one side there is monetary policy: the ECB choices in terms of interest rates - even though they were consistent with the general EMU trend - were particularly restrictive in Germany, eventually subtracting fuel to the European engine and thus braking the growth of the whole area. Indeed, we tried to test the effects on the euro zone of a monetary policy taking the German inflation rate and output gap as reference standards and attaching the output gap the same weight as price stability on the other side, there is the delay in the adoption of policies meant to implement the ambitious Lisbon objectives. Those structural provisions should aim at enhancing the efficiency and strength of the European economy in the long term, particularly through a relaunching of investments in infrastructures and human capital which should be implemented through forms of partnership between public and private

bodies and through the EIB funds. Even though they are conceived for the long run, those provisions should have an important short-term impact on demand as well. The Report provides exercises testing the impact in support of the European cycle which those provisions might have exerted, had they been implemented in the low-cycle period 2001-2003.

Admittedly, those simulations - aimed at evaluating the impact of alternative provisions - assume stable parameters in the econometric model in different economic policy regimes, which is a prerequisite difficult to accept in the presence of expectations and forward-looking behaviours on the part of market operators. We are well aware of that. That is why we do not use the results to show an alternative story, but simply as a further instrument to understand whether the macro-policies adopted in the euro area were suitable. In this case, given that the U.S. case is the benchmark, our evaluation of the coordination between the European fiscal policies and between those policies and the centralised monetary policy is rather unfavourable. More specifically, the recent experience reveals the bad functioning of the EMU cyclical policies, harshly questioned by the moderately negative cycle the euro zone had to face in its short life. Indeed, our exercises show that, in the three years between 2001-2003, there was room for more supportive - and at the same time fairer - economic policies which could have sustained the European cycle and, in particular, could have triggered a higher growth of the European citizens' *per capita* income compared to the United States. Our assumptions show the role which an economic policy more focused on the German trend would have played. There would have been an inflation above the EMU average (about 2.5 rather than 2,) but perhaps more in keeping with an heterogeneous single currency area and with the efforts made to maintain the public deficits within the limits set by the Stability and Growth Pact. On the top of it, the adoption of an investment-supporting strategy in keeping with the Lisbon objectives since 2001 - accompanied by a monetary policy not jeopardising its stimulating effect - could have brought about the short-term cyclical advantages which the provisions aimed at promoting the long-run European development normally have. A suitable mixture of monetary policies and investment-supporting policies could have been the right EMU reply to the aggressive (and imbalanced) American macroeconomic

strategy, and this would have benefited all European countries and the world cycle.

**Expectations on
the international
cycle in H2 2004
and in 2005**

After the positive results obtained in H1 2004, we expect a moderate international cycle in the second part of the year. The reduction of the recovery pace is due to the slowdown of the economies which have led the cycle so far. The expansion of the world scenario - though less intense - should remain robust both in H2 2004 and in 2005.

**The United
States**

A slight deceleration might be registered in the United States. In the April-June period, positive indicators emerged together with signals of weakening, particularly with reference to the job creation pace, the building sector and consumption. Maybe consumption was affected by the decreasing impact of the recent tax benefits and by the effects of the energy price rises on the households' purchasing power. According to our forecast, in H2 2004 the American economy grows at a slightly slower pace than in H1, thus leading the GDP growth on average in 2004 to 4.3% (3.1% in 2003). The moderate expansion is confirmed in 2005, also because of the ongoing interest rate rises which the Federal Reserve started in June 2004 and which should increase after the Presidential Election of November 2004. The election might mark a turning point also for the fiscal policy, should the new Administration decide to introduce provisions to correct the long-term imbalances emerged in the national health care system and in social security. Under the assumption of a slowing quarterly dynamics in H2 2005, ISAE estimates the average American growth for 2005 at 3.4%.

Japan

After the lively pace characterising the late-2003 and the early-2004, even Japan might experience a small brake, particularly because of the slower Chinese dynamics. According to the ISAE forecasts, the quarterly evolution of the Japanese GDP would amount to 0.5-0.6% in the next six months, and the economic activity would thus rise by 4.4% in 2004 (2.5% in 2003) and by 2.4% in 2005.

China

The provisions recently adopted in China to fight the signals of overheating are bringing about their first effects on the investment dynamics and on the sectors mainly hit by speculation excesses (namely the iron and steel industry and the cement sector). Also the GDP evolution showed some weak signals of reduction in Q2.

In the case of China, the introduction of slowing-down measures

might raise problems given the large bank overdues which could further grow because of a larger-than-desired productive activity slowdown and because of the difficulties met in surveying the real economic trend owing to the unsuitable market signals and to the poor quality of statistical data. This exposes the Chinese economy to the risk of harsher-than-expected cyclical involutions affecting the whole area. The Report deepens this particular topic, which shall be mentioned later on.

In the euro area, after a better-than-expected Q1, GDP is expected to return to more moderate growth rates in the remaining quarters of the year. According to the estimates of the *Euro-zone Economic Outlook* - jointly elaborated on July 15 by ISAE, IFO and INSEE - the EMU economic activity should increase by 0.5% in Q2 and by 0.4% in Q3 and Q4. The average growth rate of 2004 should equal 1.8% (0.5% in 2003). The ongoing dynamics mirrors the decreasing stimulus of foreign demand, which supported growth in H1 2004, while domestic demand will show signs of strengthening. For 2005, ISAE foresees that - in the presence of a less dynamic foreign situation and of rosier consumer and investment trends - the GDP growth should be around 2.2%. The Member States' dispersion around the euro area average figure should decrease in 2004 as against 2005.

The euro area

On the basis of those trends, the world economic activity dynamics - which is significantly strengthening in 2004 - should slightly decelerate in 2005, thus registering a 4.2% rise, which means 0.5 percentage-point less than in 2003. The slowdown should concern all the main geo-economic areas. In industrialised systems, the GDP growth should pass from 3.3 to 2.8% between 2004 and 2005 (2% in 2003). In emerging areas, the GDP dynamics - equalling 6.3% in 2004 (5.1% in 2003) - should fall down to 5.8% in 2005. The slowdown mirrors in particular the evolution of Asia (from 7.6% to 6.7% between 2004 and 2005), while Latin America should hold.

Growth forecasts in large areas

Forecasts on international interest rates envisages a gradual growth due to the consolidation of the world recovery and to the abundant money flow characterising strongly accelerating economies. In the United States, the rises started at the end of June will go on for the next eighteen months, with a profile of small but regular touch-ups. According to the ISAE estimates, the tax rate on Federal Funds - which at present amounts to 1.25% - might reach 2% at the end of 2004 and

Interest rates

3.5% in the late-2005. In the euro area, even though the decreasing phase of official interest rates ended, no ECB touch-up seems likely. The still-uncertain signals on the domestic demand strengthening, the limited inflation caused by high oil prices and the maintenance of a substantial wage moderation, all might lead the European monetary Authority to wait till the recovery is consolidated before starting a squeeze. In our assumptions, the *repo* tax rate remains unchanged throughout the whole 2004 and at least for Q1 2005 and then will gradually rise till 2.5% within the end of 2005. Consequently, the gap between Europe and the United States in short-term yields would be annulled by the end of 2004, when the interest rates of both areas should equal 2%, and then should become favourable to the American economy, gradually widening till it reaches 1 percentage point at the end of 2005.

The dollar

With reference to the exchange rate market, ISAE assumes an extremely moderate dollar appreciation in H2 2004. In 2005, after the Presidential elections, the U.S. dollar might witness a gradual recovery in the wake of the Federal Reserve action on interest rates, of the consequent narrowing of the yield gap between the USA and the EMU and of the introduction of measures to correct the Federal deficit. On the basis of those trends, the euro exchange rate against the dollar should equal an average 1.22 in 2004 (going towards 1.20 by year-end) and then reach 1.19 in 2005.

Oil

Crude oil prices, which had strongly grown in 2003, have registered a further rebound in H1 2004. The Brent quotation - which skimmed \$39/barrel between late-May and early-June - is worth \$37 in the first part of July. The rises are prompted by demand. The consumption growth mainly concentrated in emerging countries, particularly China and India, which need a double and triple quantity of crude oil per GDP units compared to industrial countries. Even considering those pressure-causing elements, the current oil price rise seems not strictly connected to a supply-demand equilibrium problem, but rather to a high and variable risk premium, mirroring the market concerns for attacks to the oil infrastructures and for a new oil shock if the Middle-East situation deteriorates. According to analysts, that price component - which is not linked to the fundamentals - oscillates between \$4 and 8/barrel, even up to \$10 (see box on *The oil market*).

The recent crude oil price rises are however rather limited - in a

long run optics - if one considers them against the inflation trends of the buyer-countries. Indeed, if the nominal price is dangerously close to the peaks reached in the 1990 shock, and particularly in the (even harsher) shock of 1980, in real terms it is below those figures. In particular, the crude oil price - adjusted for inflation with the Consumer Price Index (CPI) of industrialised countries - is still slightly below the 1990 figure and it is about 2.5 times smaller than the 1980 price (and 1.5 times smaller than the 1973 price). Those considerations, together with the changes introduced in the degree of exposure to oil rises of industrial countries (see below the remarks made on Italy), reduce the concerns on the risk that the current oil prices might drastically interrupt the international expansion.

The prospect would change, if prices significantly and persistently rose owing to supply shock caused by terrorist attacks and by the worsening of the Middle-East situation. The ISAE forecast - which obviously cannot include this uncertain events - envisages that, in the medium term, there is no possibility that the high risk premium weighting on oil is annulled, so that the Brent price would be worth \$33.3/barrel on average in 2004 and \$31.4/barrel in 2005.

The demand recovery and the dollar depreciation favoured considerable rises in industrial raw materials. In this case too, the role of the Chinese economy - heavy metal consumer - was fundamental in prompting the rises. On the basis of the HWWA index, the price rises in dollars of those primary materials exceeded 27% in H1 2004. According to the ISAE assumptions on H2, a demand slowdown and a possible stop in the dollar sliding should somehow reduce the price rises. The price deceleration should however be larger in 2005. On the basis of those assumptions, the dollar-based world market prices of raw materials should further grow by about 22% in 2004 and then should go down by 1.4% in 2005. Prices of foodstuffs should rise at a similar pace in 2004 and should remain generally stable in 2005.

Non-energy raw materials

International trade, mirroring the greater dynamics of the world economy, had a new thrust in the past twelve months. The American economy and the emerging areas contributed to the acceleration, particularly Asia and - to a lesser extent - Central-Eastern Europe. All in all, there should be a rise by about 8% in international demand in 2004 and by 7% in 2005. Also the trade elasticity to the economic activity should grow from the depressed levels of the past three years

World trade

**Consequences
of the Chinese
hard landing**

(when the average value amounted to 1). That elasticity should go up to 1.7, which is the highest figure of the past three years, but still below the exceptionally high level (above 2) of the late-nineties.

Among the risk factors weighting on the international scenario, there is also the possibility of a sharper-than-expected slowdown in China. In 2003 and in H1 2004, the Chinese economy played a leading role in the Asiatic cycle. Indeed, the Chinese giant also exerted pressure on international trade, by wrong-footing, on the one side, some productions of industrial countries and triggering, on the other side, upward pressures on raw materials prices. Hence, it is worth quantifying the overall consequences of a Chinese slowdown. This might happen both for the difficulties met by the Chinese Authorities to dose freezing interventions and for the risks of a worsening of the banking system situation. In our simulation (see box on *The effects of a hard landing of the People's Republic of China*), the reduction in the financings to the manufacturing and building sectors has been accompanied - since H2 2004 - by a drastic rise in uncollectible credits and by the fall of the stock exchange indices, similarly to what happened in the Asiatic crisis of 1997-1998.

Within this framework, the exchange rate - because of the strict controls in capital movements - might limitedly decrease. Hence, the Chinese development rate would slow down by 3.8 percentage points in 2005, reaching the figure of 4.1%. Its impact on investments - hence on imports - would be particularly strong. The Chinese slowdown should reduce the support to the Asiatic economies, whose GDP should rise between 1 and 2% less than the basic scenario. Also Japan would be damaged, even though to a lesser extent as against the emerging countries. It would register a smaller economic activity growth by about half percentage point. Conversely, the impact on the United States and the euro area should be marginal. Those economies, on the one side, should be relatively modestly affected by the Chinese slowdown owing to the less intense trade relations with China, and, on the other side, should even draw benefits from the lower international prices of raw materials due to the Chinese demand weakening. Indeed, the oil price dynamics should be more than 3% slower, while the one of other raw materials should fall by about 1%.

After the void registered in Q4 2003, the Italian economic evolution was eventually slightly better than expected in Q1 2004. The brusque consumption fall, alongside with the deterioration of the households' confidence and the marked export fall due to the decreasing competitiveness had caused the late-2003 brake. In Q1 2004, the GDP increased by 0.4% (on a seasonal and working-day adjusted basis), thus being affected by the positive trend of some market service sectors and of agriculture and in the presence of a less dynamic industrial value added. The result of the January-March period is rosier than expected particularly with reference to the demand composition. The economic activity growth was boosted by the final domestic demand components (which generally grew by 1%), with particularly sustained rises in private consumption (+0.8%) and investments (+2.5%), which were accompanied by a marked fall in inventories, after the late-2003 rebound. Though showing signals of improvements, exports continued to diminish; foreign demand - net of imports - subtracted about 1 percentage point to the GDP growth.

Italy at the beginning of 2004: better-than-expected trends

With reference to the post-Q1 trends, the economic activity seems to develop more positively than the industrial one, while signals on the demand side seem relatively more encouraging than those on the production side. Maybe that situation is affected by the ongoing reduction of the inventories accumulated in H2 2003, when the weaker-than-expected demand had increased the stocks of unsold products. In that situation, the strengthening of the final (domestic and foreign) demand components might go alongside with a subdued domestic supply dynamics for some time, particularly in the manufacturing sector.

The cyclical trend

In spite of the decreasing trend of 2003, the manufacturing firms' economic sentiment is growing. However, the recovery was rather limited and indeed characterised by considerable oscillations, which point to elements of uncertainty. Thus, the evolution seemed rather diversified between the main sectors of activity: the confidence growth was indeed marked and continuous for investment goods producers, thanks to their domestic, and in particular foreign, order-book recovery. A rise was registered in Q1 in consumer goods, probably due to the households' expenditure rebound, while in intermediate goods the trend was rather disappointing.

Survey indicators

The role of inventories as buffer softening the demand effect on

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

	2003	2004*	2005*
Domestic references			
Gross domestic product	0.3	1.3	2.0
- North-West	0.1	1.2	1.8
- North-East	0.4	1.5	2.1
- Centre	0.5	1.3	2.1
- <i>Mezzogiorno</i>	0.4	1.3	2.0
Imports of goods and services	-0.6	3.5	6.8
Exports of goods and services	-3.9	3.0	5.6
Resident households' expenditure for consumption	1.3	1.5	2.0
Expenditure of General Government and NPISH (1)	2.2	0.8	1.6
Gross fixed investments	-2.1	3.0	3.7
Contribution to GDP growth attributable to (percentage points):			
- domestic demand (net of stock changes)	0.7	1.6	2.2
- stock changes and valuable objects	0.5	-0.2	0.2
- net exports	-0.9	-0.1	-0.3
Current account balance (as a percentage of GDP)	-1.4	-1.6	-1.4
Consumer prices	2.7	2.3	2.2
Producer prices	1.6	2.4	1.3
Propensity to consume (percentage level)	87.0	86.9	86.9
<i>Per capita</i> gross earnings in the economy			
Total employment (2)	0.4	0.6	0.9
Unemployment rate	8.7	8.5	8.1
General Government net borrowing (as a percentage of GDP)	-2.4	-2.9	-4.2
General Government primary surplus (as a percentage of GDP)	2.9	2.1	0.7
Fiscal pressure of General Government	42.8	41.4	40.8
General Government debt (as a percentage of GDP)	106.2	106.1	106.7
12-month Treasury Bills yield (3)	2.3	2.4	3.3
p.m. Nominal GDP (millions of euros)	1,300,926	1,354,209	1,418,101
International references			
Dollar/Euro exchange rate (level)	1.13	1.22	1.19
World demand	5.1	8.2	7.3
Official exchange rates (3)			
- ECB	2.0	2.0	2.5
- Federal Reserve	1.0	2.0	3.5
Prices of raw materials (in dollars)			
- energy	12.9	21.9	-2.6
of which: Brent (\$/barrel)	14.4	21.6	-5.3
	28.78	33.30	31.43

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

* ISAE forecasts, tendential scenario for 2005.

(1) Non-Profit Institutions Serving Households.

(2) Standard labour units.

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

the productive activity, is particularly evident in the data provided by the Business Surveys on consumer goods. In the face of improving order books on both the foreign and the domestic markets, the entrepreneurs' evaluations on their current production levels seem negative and, in the latest Surveys, even worsening. These opposing evolutions are accompanied by decreasing assessments on inventories compared to the late-2003: admittedly the higher demand was satisfied drawing from inventories.

With reference to the households' confidence climate, the June and July Consumer Surveys show a recovery after the May fall, which was probably affected by the growing violence in Iraq. It is interesting to note that the instability characterising the domestic political framework in July had a small impact on the consumers' confidence climate (the Survey was carried out in the first half of July). While analysing the replies, one notices better evaluations on the part of respondents on their own situations and on the current situation, while opinions on the general economic situation and on future prospects are worsening: these last might have been influenced by the increasing political uncertainty.

On the basis of the indications coming from the above-mentioned ISAE Surveys, the industrial sector evolution is starting a very gradual improvement path. After the contraction observed in Q1 (-0.4%), industrial production showed a better-than-expected trend in April (+0.6%) and in May (when witnessed a standstill, in spite of the expected contraction). According to the ISAE estimates, a further weakening might take place in June, so that there would be a slight improvement in Q2 (0.2%). Looking at the next months, a rise is expected in July ((+1.6%), followed by a similar contraction in August. The August estimate is however more uncertain, as this month is characterised by a strong variability due to the firms' decisions on closing periods, which are not known *a priori*, even though they are a function of the cyclical trend.

**Industrial
indicators**

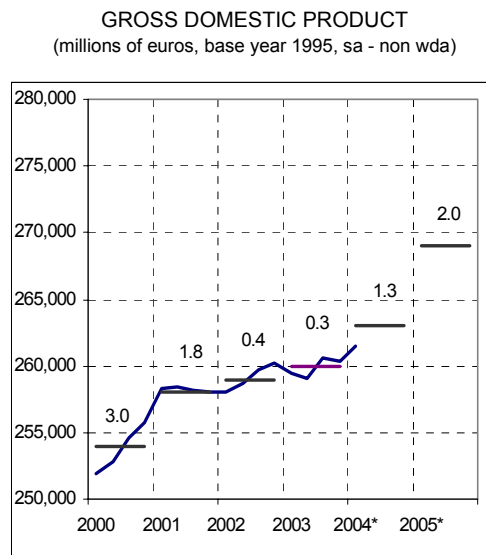
In spite of the lustreless dynamics of the manufacturing sector, the industrial sectors showed some cyclical improvement which, in some cases, led to abandon cyclical contraction strategies in favour of expansionary approaches. According to the ISAE diffusion index elaborated on more than 180 industrial sectors, the share of sectors registering a cyclical growth since July 2003 is above 50%. However,

and this confirms the extreme moderation of the 2003 cyclical improvement, that indicator showed no particular signs of improvement in the following twelve months and remained stable just above the line separating expansion from contraction.

Economic indicators

Signals coming from the economic cycle indicators elaborated by ISAE are relatively better. The coincident indicator confirms the rosier evolution of the January-March period, highlighting some signals of moderation at quarter-end. The leading indicator - after the weakening experienced in the late-2003 - has been growing again since February, and has been showing a gradual cyclical improvement since Summer.

Forecast on the Italian economy



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

All in all, these indications lead ISAE to estimate a moderately positive evolution of the Italian economy in the period between April and June and a still-favourable trend in H2 2004. The non-working day adjusted (wda) GDP should rise by 1.3% in 2004, which is 1 percentage point more than in 2003. By adjusting it on a working-day basis, (as the year 2004 has one additional working day compared to 2003), the 2004 growth should be smaller by 0.1-0.2%. The gradual cyclical strengthening throughout the year should bring about a GDP tendential growth rate which should pass (non-wda data) from 0.8% in Q1 to slightly more than twice as much in Q4. Hence, the year 2004 should leave a positive left-over to the following year by slightly less than 1 percentage point. In 2005, the average Italian development rate should go up to 2% and about 2.2% in Q4. By adjusting figures on a working-day basis, (as the year 2005 has one working day less compared to 2004), the GDP growth would be about 0.1% more and it would be slightly below the figure expected for the euro area.

Forecasts for 2005 are based on a scenario with unchanged

policies and include the provisions of the recently approved version of the July Decree. They do not include any of the measures aimed at correcting the public finances or sustaining the economic development which are introduced by the Economic and Financial Planning Document for 2005-2009 (DPEF), which was not yet known upon the elaboration of the ISAE forecast.

In 2004, the Italian economic dynamics should benefit from the domestic demand contribution equalling 1.6 percentage points. Indeed, the final domestic demand components sustained (for 0.7 percentage points) the (modest) GDP growth in 2003 as well. In particular, as happened in 2003, it was the households' expenditure for consumption which provided the main thrust (1 percentage point). Investments should positively contribute to growth (0.6%) after the negative results of 2003. The contribution of public consumption (0.2%) should decrease, particularly because of the provisions to hold back the General Government expenditure adopted for the second part of the year. Inventories -which had prompted the economic activity in 2003 (for 0.5%) - should witness a negative variation in 2004 (0.2%). An improvement might emerge in net exports, the contribution of which should remain slightly negative (-0.1%), but decreasing compared to 2003.

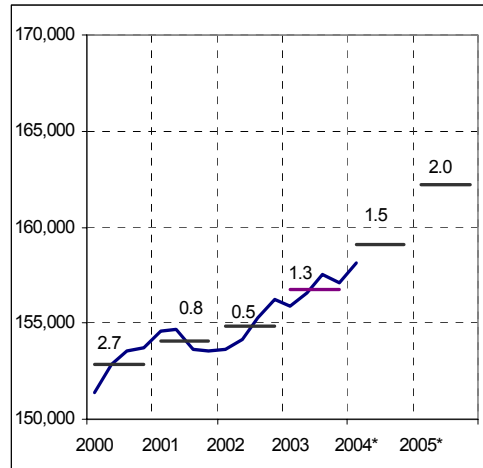
**Demand
contributions**

Next year, Italy should still benefit from a significant final domestic demand support (2.2 percentage points), alongside with a hardly positive contribution of inventories (0.2%) and a negative contribution of the net foreign demand (-0.3-0.4%).

Resident households' expenditure for consumption should rise on average in 2004 by 1.5%, with a 0.2% acceleration compared to the 2003 dynamics. The favourable trend mirrors the considerable leap forward registered in Q1 and embodies the generally favourable indications coming from the latest cyclical data, particularly with reference to purchases of durables. The strengthening of private consumption is affected by the evolution of the disposable income, prompted by the earnings rises due to the wage bargaining and by the persistently positive employment trend. Besides, the households' purchasing power should take advantage from the inflation easing. The consumption evolution should remain generally in keeping with the households' income development, with a consequent substantial stability in the average consumer propensity compared to the 2003 levels.

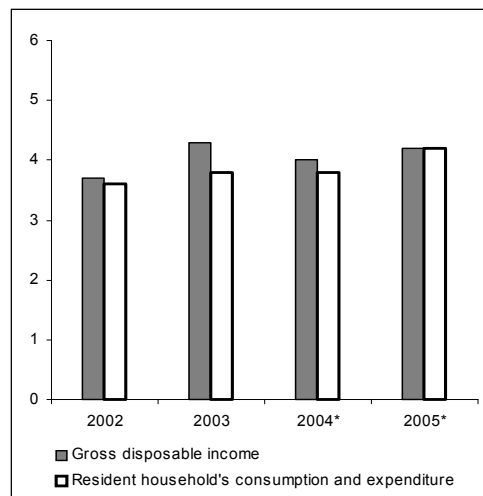
Consumption

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



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

HOUSEHOLD'S INCOME AND CONSUMPTION
(nominal percentage changes)



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

Investimenti

made in the late-2002 to take advantage from the tax benefits granted by the Tremonti-bis Law and from incentives for scrapping. On the other hand, the low degree of plant utilisation and the entrepreneurs' negative assessments on their productive capacity make us think that investment decisions will be cautious till the economic recovery is fully consolidated.

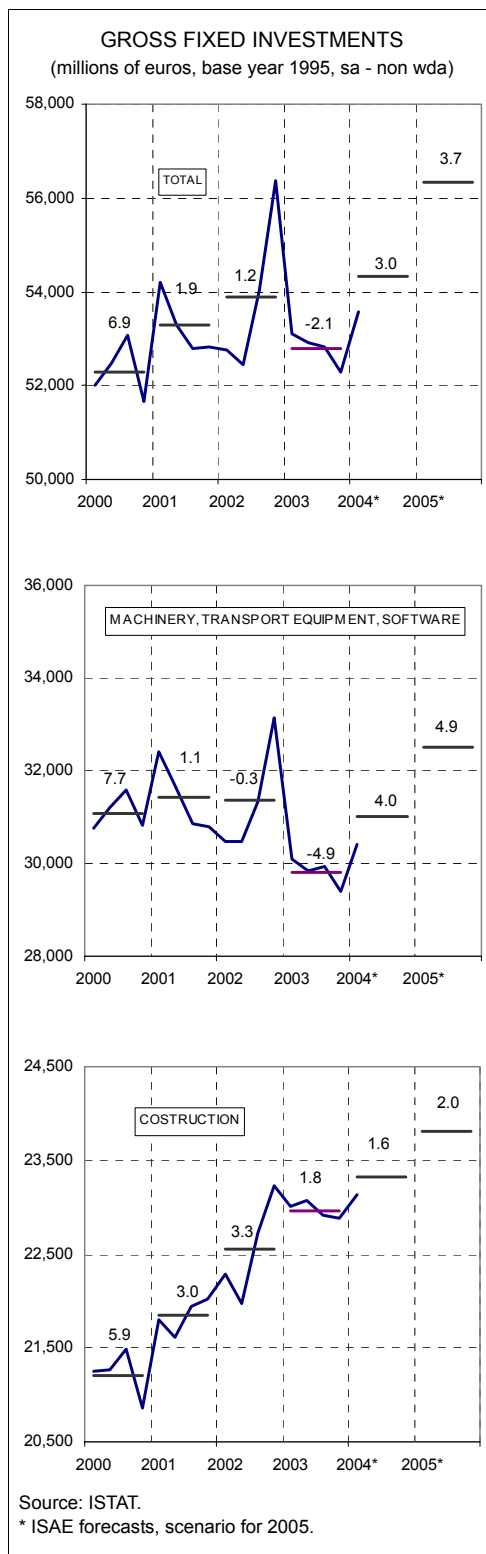
In 2005, the households' expenditure capacity should grow - in the tendential scenario assumed by ISAE - at a slightly quicker pace than that of 2003, under the thrust of the still-favourable wage dynamics and of an employment acceleration. The expected slight inflation reduction might further prompt the consumers' purchasing power. The consumers' expenditure should grow by 2%, if the consumer propensity remains unchanged as against the figures of the two previous years.

After the strong leap of Q1, investments might register a general moderation, though remaining on a positive trend. The early-2004 data and the indications coming from the ISAE Surveys and from the other cyclical indicators (commercial vehicle registrations and orders of machine-tools) mark in particular the end of the downward process following upon the expenditure advances

In our evaluations, investments in machinery, transport equipment and software should grow by 4.1% in 2004. In 2005, investments in machinery should further rise by 5.1%, drawing benefit from a considerable cyclical advantage deriving from the 2004 acceleration and from the favourable impact of the better domestic cycle and of the higher export dynamics.

This evolution is accompanied by a growing trend in transport equipment investments both in 2004 and in 2005 (+3.8 and +3.9% in the two years respectively) in keeping with the overall strengthening of the accumulation process.

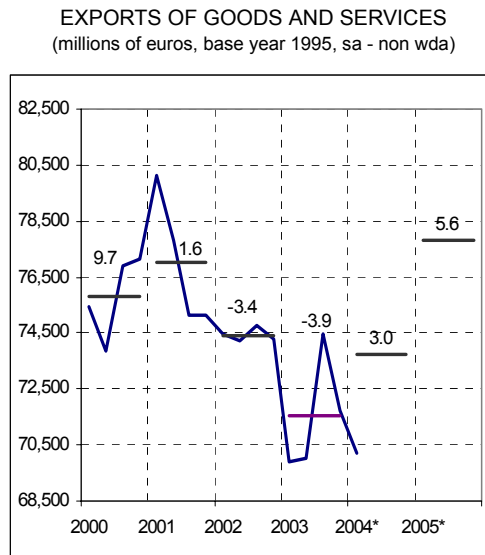
With reference to construction, the 2004 rise should equal 1.6%, mainly because of the favourable trend of residential construction; indeed the prolongation of incentives on home maintenance should have a positive impact on this sector. In 2005, a strengthening is foreseen also in non-residential construction, including public works. Investments in construction should rise on average by 2%.



All in all, total investments (including, machinery, equipment,

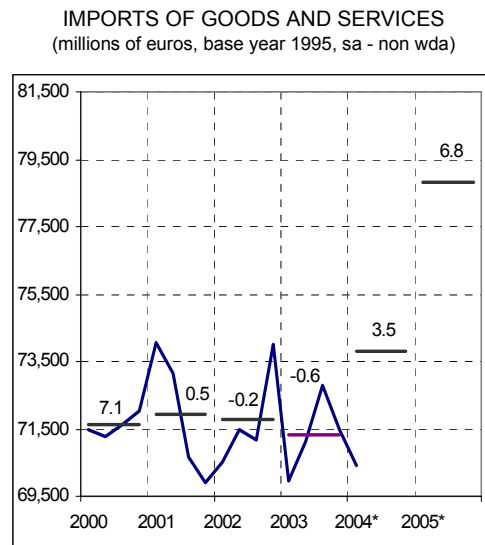
Exports and imports

software, means of transportation and construction) should grow by 3% in 2004 and by 3.7% in 2005.



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

export recovery in 2004 and in 2005 might be affected by the contraction of the world demand dynamics. The acceleration which should affect the European area in 2005 will prompt a higher evolution of the potential outlets for Italian goods than the one assumed for international trade.



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

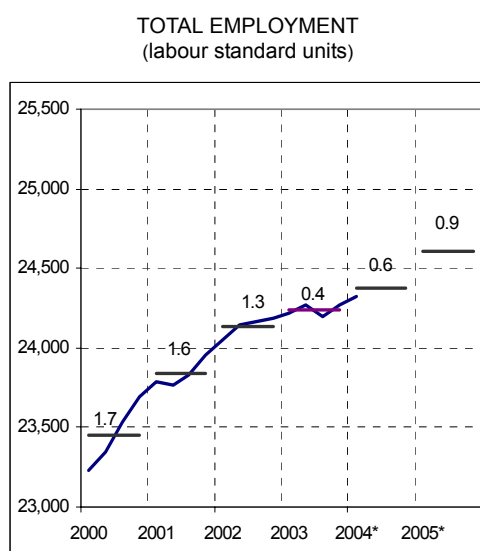
Exports of goods and services registered a strong fall at the end of 2003: the contraction continues with less intensity in Q1 2004. This trend is probably affected by the heavier competitive pressure of the dollar area countries, as well as - particularly in the late-2003 - by the weak demand of the European area, which is the main outlet of Italian exports. Cyclical indications show a significant improvement in Italian exports abroad. The

In our forecasts, exports of goods and services will rise by 3% in 2004. In 2005, thanks to the competitiveness recovery connected with the dollar strengthening, the export dynamics should go up to 5.6%. Taking account of the overall world trade evolution, there would be a further market share erosion for Italy in the international trade in the two years considered (at constant prices).

With regard to imports of goods and services, the

economic recovery should raise imports, which should grow by 3.5% and by 6.8% in 2004 and in 2005 respectively. Under this assumption, the phenomenon observed in the past three years whereby the import penetration of foreign goods in Italy was decreasing should come to an end. That peculiar development might have been a consequence - within the growing international integration of the Italian productive system - of the weakness of Italian exports. The export recovery should raise the import penetration degree.

The production recovery should be accompanied by a gradual job dynamics acceleration. In 2004, the average standard labour units of National Accounting should rise by 0.6% (+0.4% in 2003). The employment dynamics should enhance in 2005, prompted by a consolidation of the economic growth which should register a growth rate just below 1%. The employment elasticity as a percentage of GDP should amount to about 0.5% both in



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

2004 and in 2005, thus marking a reduction compared to the abnormally high levels (above 1) characterising the three years between 2001 and 2003. Labour productivity - always decreasing between 2001 and 2003 - should grow again in 2004 and in 2005 at an average pace close to 1%, with a positive effect for the effectiveness and competitiveness of the Italian economy.

The unemployment rate should equal 8.5% in 2004 (8.7% on average in 2003 according to the “old” labour force surveying method). It should decrease again in 2005, reaching an average value of 8.1%.

A growing role in the employment dynamics of the past few years was played by extra-Community immigrant workers, also following upon the new regularisation provisions adopted in Italy. The role of immigrant workers on the Italian (official) labour market is bound to

Labour market

The role of immigrants

grow, taking account of the demographic dynamics characterising Italy and of the lack of manpower observed in some areas of the national territory. In a wider perspective, the immigrants' contribution is important to favour the long-term development rate acceleration which is limited by the close-to-zero Italian birth rate. In spite of its importance, it is difficult to quantify the penetration of immigrants on the Italian labour market. By crossing the information deriving from heterogeneous sources (data from Census of Population, Ministry of Internal Affairs, *Caritas Italiana*, the Italian Workers' Compensation Authority - *INAIL*), the present Report tries to estimate with some extrapolations the contribution of extra-Community migrant workers to the Italian employment (see box on *Contribution of extra-Community immigrants to the employment dynamics*). According to those estimates, the new extra-Community employment accounted to about 21% of the overall employment growth in 2002. Its share on the employment dynamics further increased in 2003. The extrapolation of the trends experienced in the latest period suggests a growing role of extra-Community employment on the labour market evolution in the next few years. According to the Report estimates, the role of extra-Community migrant workers on the overall Italian employment should pass from about 3% in early-2002 to almost 5% in 2005.

Wages

With reference to wages, the assumptions for 2004 and 2005 are based on the provisions for those two years already included in the latest wage bargaining and on the new wage bargaining round. On the one hand, the foreseen wage rises mirror the smaller inflation growth - which shall have an impact worth 4-5% on wages in the period considered - and, on the other side, they reflect the chance that the higher productivity which will emerge in that period is partially distributed to workers. Under those assumptions, the *per capita* gross earnings should grow by 3.2% in 2004 and by 2.9% in 2005. In industry excluding construction, the corresponding dynamics should amount to 3.2 and 3% respectively. The labour cost evolution per labour units - which draws benefit from the productivity acceleration - should have a growth rate worth 2.4% in 2004 and 1.7% in 2005, which is much less than the three previous years.

Inflation

The inflation-easing process which had started in Autumn came to an end in H1 2004. After decreasing to 2.2% in January, the 12-month growth rate stabilised at 2.3% between February and May, while it

showed a new moderate rebound in June (2.4%). The inverse of trend of the consumer price dynamics was mainly affected by the oil price rises: on the domestic level, further thrusts came from the rises of some controlled prices and, particularly, from the reviews of excise duties on tobaccos. Generally speaking, net of those specific pressure factors, the inflation trend indicators continued to show - in spite of some uncertainties - a more moderate domestic inflationary process.

The substantial inflation stability narrowed the difference between the average Italian figures and the European partners. As often happened in the past, a narrowing of the gap between the Italian and the euro area consumer price dynamics takes place whenever there is an inflation rekindling caused by oil price rises. This mirrors both the smaller role energy plays in the basket of the consumer price harmonised index in Italy compared to other EMU economies, and the gradual nature of the “administrative” process of energy and gas tariff adjustments caused by oil price variations, a procedure aimed at softening the impact on domestic inflation of upward and downward oil price variations.

On the top of it, a limitation also comes from the smaller degree of exposure of the Italian productive system to oil rises. By utilising cross-sectional data on the Italian economy on about three decades (from 1973 to 2000), an analysis was carried out of the variations in the direct and indirect impact of oil import trends on the final output price (see box on *The impact of oil price rises on the Italian economy: an estimate using cross-sectional data*). According to the estimates, compared to the decade 1975-1985, when a 10% oil price rise used to cause an average 1.5% output price growth, the impact in the nineties more than halved, and it was less than 0.5% on average in the latest period. About half of the smaller reaction of the Italian productive structure is due to energy saving (namely reduction in the share of energy expenditure on the overall costs in all sectors); the remaining portion presumably mirrors the structural changes introduced in cross-sector interdependences and the cuts in energy-intensive sectors.

With reference to the consumer price dynamics of the next few months, ISAE foresees a deceleration in Summer, followed by a limited recovery in Autumn, also because of the unfavourable statistical comparison with the same period of 2003. In the wake of those trends, the inflation rate should equal 2.3% on average in 2004,

which is the lowest figure since 1999, with a 0.4%-reduction as against the previous year. At the end of 2004, the price tendential growth should be worth 2.4%. The inflationary dynamics should remain on those levels up to Spring 2005, and then fall in H2 2005. Hence, there would be an average consumer price rise by 2.2% in 2005, which means 0,1% less than in 2004. The tension easing should be favoured by the lower international raw materials prices and by the smaller domestic costs due to productivity acceleration.

The inflation gap with the euro area - equalling 0.7% in 2003 - should decrease by 0.2% in 2004. In 2005, in keeping with the previous experiences - whereby a gap worsening to the detriment of Italy emerges whenever there is a generalised price tension easing - the inflation gap should equal 0.4%.

**Economic
development by
geographical
partition**

The standstill characterising the Italian economy in 2003 hit all the main geographical partitions, though with some differences. According to the ISAE estimates - obtained through a territorial econometric model breaking down the forecast on Italy by geographical partitions and administrative regions - the North-west should register a GDP variation close to 0. Conversely, the other three partitions should be above the national average: the Centre - with a productive activity rise of 0.5% - should experience the marginally strongest development. In 2004, the North-east should be quicker in drawing benefits from the cyclical recovery of the general framework, registering a 1.5% growth. The Centre and the *Mezzogiorno* of Italy should be both consistent with the national average, while the North-west should lag behind compared to the rest of the country, thus showing more delay in the industrial sector recovery. In 2005, under the assumption of unchanged policies, the Centre and the North-east might experience slightly higher growth rates (2.1%); the *Mezzogiorno* should develop with a pace close to the national one (2%); the North-west should register a 0.2%-smaller GDP growth rate compared to the national figure.

Thanks to the different demographic trends and to the recovery of migration flows from the Southern areas towards the rest of Italy, the *per capita* GDP evolution, at constant prices, should remain favourable to the *Mezzogiorno*. In 2003, the *per capita* income of this partition increased by 0.4% as against a 0.1% variation in the North-centre. The forecasts for 2004 and 2005 envisage a further slight narrowing of the

gap between the South and the rest of the country, with a 1.2% and 1.9% growth rates in the two years respectively, as against 1.1% and 1.6% rises in Northern-central regions.

According to the ISAE forecasts, the General Government net borrowing should amount to 2.9% of GDP in 2004, after the figure of 2.4% registered in 2003. In 2005, if no corrective provisions are introduced, owing to the end of the *una tantum* interventions, the deficit should reach 4.2% of GDP. The deficit reduction within the ceiling of 3% would require a corrective measure equalling 1.3% of GDP, namely 18 billions of euros. Obviously the manoeuvre should be even larger, should the economy-sustaining tax credits be fully funded.

**The public
finances**

The deterioration observed in 2004 compared to 2003 is mainly due to the smaller amount of the extraordinary provisions introduced in the present year. The 5.5-billion-euro manoeuvre foreseen by the July Decree, as well as the implementation of administrative provisions worth 2.2 billions of euros, should contribute to maintain the deficit below the 3% threshold. Those provisions aim at obtaining what the Italian Government indicated on July 5 at the Ecofin Council, who abrogated the European Commission's proposal to send Italy an early warning.

The just-approved interventions have an impact limited to 2004 and do not reduce the dynamics of the public finance items for 2005. For 2003, ISAE forecasts that provisions on the preventive insolvency procedure (*concordato preventivo*) and on the pardon for the infringement of building regulations (*condono edilizio*) are successful at 50% and that considerable sums will be necessary for operations on the building patrimony, which should also envisage the creation of a Fund to include public-office buildings to be sold and then rent.

The Italian primary surplus continues to decrease, passing from 2.9% of GDP in 2003 to 2.1% in 2004 and then fall below 1% in 2005 (0.7%). Those trends are mostly due to the gradual coming back to "normality" of capital account items. In 2004, the reduction worth 0.6% of GDP in expenses net of interest rates - mainly connected to the sales of public buildings - only partially offsets the contraction of 1.3% of GDP of revenues, substantially due to the decreasing revenues from tax amnesties. In 2005, a 0.6% rise in the incidence of primary expenses and a 0.8% cut of revenues (on GDP) - deriving from a reduction in direct taxes and from the end of the effects of

extraordinary measures - will sum up.

The interest rate burden falls in 2004 in absolute value, but it grows again in 2005, even though moderately. That trend is affected by a stable interest rate level in 2004 and a growing rate in 2005. In particular, the average 12-month Treasury Bills yields should remain at 2.2 (as in 2003) and then rise up to 2.9% in 2005. The expenditure for interest rates as a percentage of GDP should fall again by 0.3% in 2004, passing from 5.3% in 2003 to 5%, and by 0.1% in 2005, going down to 4.9%.

Fiscal pressure - computed as the incidence on GDP of direct and indirect taxes, capital account taxes, social contributions, either nominal and real - should diminish by 2 percentage points on GDP in 2004 and 2005. It should decrease from 42.8% in 2003 to 41.4% in 2004 and to 40.8% in 2005, thus mirroring the evolution of the untaxed interventions included in capital account taxes. Net of that item, fiscal pressure should have a more regular dynamics, decreasing from 41.3% in 2003 to 41.1% in 2004 and to 40.8 in 2005.

According to ISAE, the debt/GDP ratio for 2004 might be smaller than in 2003, passing from 106.2% to 106.1%, if sales of State properties worth 15 billions of euros (1.1% of GDP) are made. In that case, the tendential estimate for 2005 should foresee a debt equalling 106.7% of GDP.