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EXPORT GOOD, DOMESTIC DEMAND LESS SO

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SUMMARY AND CONCLUSIONS

1. For the second time in this decade, the world economy has seen a slowdown in growth. For the second time, the slowdown stems from the adjustments of excessive financial exuberance in the United States: first the *new economy* bubble; today the real estate bubble, to which the subprime loan crisis is connected.

2

A specific element of todayô s situation is the involvement of the banking sector, which determines a systemic risk of a financial nature. Even if, in fact, the risk seems to concern the "Anglo-Saxon system" more than the Eurozone banking institutions. The Monetary Fund estimates adjust the budget losses of the Eurozone banks to $45 billion, a limited value compared to the 144 billion of the United States and the 40 billion in the United Kingdom alone. And yet the various banking systems have similar intermediation margins; the propensities to risk are not evidently similar: seemingly rewarding in the expansion phases, but amplifying the adjustment costs in periods of decline.

3

The degree of exposure of the national credit systems explains the behavior practiced by central banks up to today. Economic theory justifies last minute intervention in case of bank bankruptcy. The Bank of England and the Federal Reserve Bank took this path, intervening directly in the rescue of some banks. Particularly significant is the case of the United States, where the need to avoid the bankruptcy of an investment bank of primary importance presented itself. The intervention of the central institution infringed the practice which required rescue to be confined to commercial banks, as they are subject to more rigid supervision. Besides which, the maneuver was carried out using a commercial bank as the operating arm, to whom a substantial coverage for any loss was guaranteed. In fact, the Federal Reserve Bank seems to have gone beyond the theoretical requirements relating to bank rescue.

4

In addition, the American monetary authority decidedly used interest rate leverage. Over a quarter, official returns more than halved (from 4.25 to 2 %). Measured in terms of real rates, the maneuver of the last months presents a higher intensity than that at the end of 2000, when in the previous slowdown, waning inflation absorbed part of the reduction in nominal yields.

5

Incipient bank bankruptcy in the Eurozone does not appear to be a risk. The budgetary results of 2007 have shown a sustainable reduction of profits and the number of cases of banks in states of real loss is limited. The European system is also concerned by an interbank liquidity crisis, a sign that a shrinking of credit conditions is in progress in Europe as in the USA.

6

The solidity of the banking system allows the ECB to move cautiously. The rates were not lowered; they limited themselves to interrupting the uptrend that was initiated before the crisis in the subprime manifested itself. Announcements by the European Central Bank indicated the desire to return down this road as soon as the financial conditions were back to normal.

7

As the simulations in the report show, the change in attitude of the central banks affects the trends of the Euro/Dollar exchange rate. The differential in yields drives appreciation of the European currency; at the same time, the trade imbalance and lowering of the prospects for growth feed the devaluation of the dollar.

8

Monetary management should expect an acceleration of inflation. The increases in oil prices ï highly unusual - are accompanied by an increase in the rates of raw material of foodstuff. The two phenomena correlate on the supply side, since food prices are strained because crops were reoriented towards the production of alternative energy. There will be persistent inflationary effects as long as this replacement process has not reached a sufficient level of maturity. European inflation has exceeded 3.5 %, in the United States 4%.

9

In coherence with its statutory objective, the ECB reserves priority to price control. In comparison with the Federal Reserve Bank, a trade-off, which seemed exhausted at the beginning of the 1980s, is reproposed. The European authority is prepared for an excess of a real slowdown, despite adjuring persistence and spread of inflation phenomena. In the United States, also because of the fragility of the banking system, the preference is for a move to lower interest rates, which supports the real cycle but entails greater inflation. With respect to valuations that take account of purchasing power equality, the Euro/Dollar exchange rate therefore incurs the prospect of a widening of inflation differentials.

10

Taking into account the difficult conditions of the context, the European industry cycle is manifesting a great holding capacity. Increased integration towards the east (ex-socialist and Asian countries) limits the impact of reduced American absorption of the demand for European exports. In the US also, the drop in demand is still in line with what has happened in past episodes of "moderate recession".

11

However, even if the global cycle does not see a real setback, the scenario, which the European economy will face in the coming years, must be considered as changed. According to the valuations in the report, expansion of world trade will remain moderate for at least three years, the Euro will maintain a rate of 1.5 to the dollar and the European Central Bank will not relax interest rates.

12

Under these conditions, a redefinition of exchange rate relations with Asian countries with balance of payment residues, may acquire importance in the European agenda. Avoiding labour cost differentials being amplified by the loss of competitiveness induced by the appreciation of the Euro is an alternative response to the request to intervene on trade relations through the return to protectionist measures.

13

The strength of the Euro re-offers the possibility to target large international funding towards the implementation of projects on a European scale: a proposal originally related to major infrastructure networks that have found resources in appropriate European funding. New objectives may now be identified: for example, the freeing of Europe from energy dependence and exposure to exogenous oil price shocks.

14

In the evaluation of international organizations, the Italian economy continues to be represented, even in perspective, as the turtle of European growth. It is a portrait based on real data, but it may underestimate the elements of dynamism that have emerged over the past two years. In 2007 Italian exports increased by 5%, more than the import demand of our major outlet markets (4.5%) has increased. Despite a context of widespread slowdown in growth, global share prices have been maintained. Revision of the Central Institute of Statistics data shows that exports between 1999 and 2006 increased by 23 %, twice what was previously estimated (11%).

15

The CER forecast confirms the announced decline in the Italian growth rate in 2008 (0.7%). The current year should be the minimum year of the cyclical phase; the expected recovery in the following period would also appear barely sufficient to reduce the rate of development on potential values (1.4 % in 2011). In this cyclical sinking, we estimate that a shift in growth contributions towards foreign demand components will take place. Net exports, in our forecast, account for almost half of the growth expected for 2008-2009.

16

The manufacturing industry recovery on foreign markets is a stabilization factor of the Italian cycle. Going in the same direction is the recovery of productivity that seems to have started in 2007 and that may be consolidated in the forecast period. The increase of labour productivity should stabilize on average to 0.5% (against the 2000-2006 stases). The slowdown should deflect against the dynamics of employment. The increase of employees in the private sector should drop this year to 0.6% (2% in 2007) and remain below one per cent in the 2009-2011 period. The unemployment rate should continue to decline, but at a slower pace than in the recent past: this year dropping below 6%, to be equal to 5.4% at the end of the period.

17

Unlike foreign demand, our forecast identifies significant elements of weakness in domestic demand. The contribution to the growth of this component should be less in 2008-2009 compared to 2007. In particular, we estimate that increase in consumption remains below one percent, while for non-residential private investment we expect a downturn this year (- 1%) and zero increase for 2009. Only the public dimension of investments appears in expansion and for the year 2008, the part of public consumption due to the income of workers of the public administration (over 8%).

18

The diagnosis on the causes of the slowdown in domestic demand cannot be uniform. In the case of expenditure, increase in inflation weighs heavily (3.3%), resulting this year, in a slowdown in real income, despite a formation of nominal disposable income in line with that of 2007 (3.9% against 3.8%). The acceleration of prices also pushes wage increases in the private sector above 3% both this year and in 2009, just sufficient to maintain purchasing power, but such as to push labour costs per unit of product above 2%.

19

Inflation has exogenous causes, linked to international raw material prices. In the report, we estimate that the stabilization of the price of oil to 120 dollars per barrel (against our basic assumptions of 100 dollars) should increase the rate of inflation by half a point and reduce expansion of domestic demand by two 10ths. Greater than the crisis of the subprime loans, the risk for the Italian economy seems to lie in the deterioration of the terms of trade.

20

The worsening of the terms of trade has, moreover, asymmetric effects: on the one hand it compresses the margins of corporations and reduces the purchasing power of families, on the other it increases income tax from inflation (according to our ratings this year, the nominal GDP will show an acceleration). The resulting distribution conflict could be defused by mechanisms for the refund of the fiscal drag or the sterilization of certain excise duties. Agreements on labour cost could provide more wage increases in the case of improvement of the terms of trade (today only sterilization of increases in inflation caused by international prices is contemplated). This last measure, ensuring future restitution of that which is being lost today in terms of purchasing power, would avoid a prices-wages spiral, helping to stabilize inflation expectations. The forecasts in the report indicate that from 2009 an improvement of the terms of trade could register.

21
As regards investment ï since attenuation of the constructions cycle must be discounted ï the question to ask is how to strengthen the accumulation propensity of enterprises. Despite good export performance and an expected increase in profit margins, the accrual rate decreases in the forecast period by one point at current prices, by half a point at constant prices. Tax measures in favor of investment choices - as suggested in the Biasco Commission - could contribute in reversing this decline.

22
Our analysis therefore identifies some guidelines with which to address a policy of stabilization of the cycle. In the presence of an exogenous inflationary acceleration, measures of direct support of aggregate demand do not seem appropriate. As mentioned above, taxation may be used both to maintain the purchasing power of families and to stimulate investment. Is there room in the budget to activate similar measures?

23
According to the public finance forecast, which we illustrate in the last chapter of the report, debt will amount to 2.2 % this year and 1.4 % in 2011 (discounting the "legislation in force"). This would allow ending the procedure of excessive deficit, without however, reaching zero deficit, which remains the medium term objective.

24
Since the budget results would be achieved in the face of a substantial invariance of the tax burden ï and considering the poor results obtained through the re-parceling of revenue strategies ï it seems inadvisable to use taxation levers in the absence of structured measures to reduce expenditure. All the more reason that the expected changes are not sufficient to achieve the cancellation of the deficit agreed in the European Union. Therefore, margins to maneuver budgetary policy remain reduced.

25
An opportunity is however offered with the launch of the XVI legislature and by a bipartisan spirit that could manifest itself on some major issues. Budgetary actions could be articulated on two separate levers. The first lever, consisting of the containment of current expenditure, is intended to retain the current values of the primary surplus. The second, represented by a rapid reduction of debt, could provide the necessary resources to reduce the tax burden. In the last chapter of the report we calculate the size of the extraordinary resources of the public budget in the past decade, but not wholly directed towards debt reduction. Actions for the use or disposal of real estate today may launch a policy to reduce public debt: approaching the European average; giving flexibility to the budgetary policy: and making the aim of lowering the tax burden credible and permanent.

IN THE UNITED STATES: WAITING FOR THE STORM

1
From the second half of last year, the world economic picture has progressively worsened. All major international organizations have negatively revised their forecasts. In 2008, in respect of what was expected last autumn, the principal areas and are now showing lower rates of growth and higher rates of inflation: the expected slowdown, more pronounced in the hypothesis of the Monetary Fund, is particularly intense for the United States where the yearly average should register an expansion of just half a percentage point, about a third of that of Europe and Japan (Table 1).

2
In this context, the group of Cassandras, who predict the "perfect financial storm", has become increasingly larger, convinced by the worrying signs arriving strong and clear from the United States.
- According to the most recent estimates of the Monetary Fund, the direct and indirect losses arising from the subprime crisis amount to approximately 1000 billion, five times those budgeted last September (1); at the same time, the liquidity knot has not loosened in the interbank market which makes it difficult and expensive to access the funding.
- In the last six months, the' temperature' of the real cycle continues to fall, knocked down by the freeze in the real estate sector. In the last quarter of last year, growth was practically zero and domestic demand, for the first time since 1995, registered a negative cyclical change, determined primarily by residential investments (enduring a record reduction of 25 percentage points).
- Consumer price tension rises. Inflation, driven by oil prices above $100/barrel, reaches 4%, close to the highest of the last 15 years.

3
Facing the clear danger of a stagflation aggravated by risks of financial contagion, "helmsman" Bernanke opted for a tight "jibe" in the management of monetary policy. After having acted with extreme caution in the four months following the subprime affair, since last December, the Federal Reserve intervened with a series of massive cuts that within three and a half months brought the official rate from 4.25 to 2 %. It was a maneuver that surprised the markets themselves (2), which in real rates was in excess of that carried out by Greenspan from the end of 2000 (then, in fact, inflation was waning and absorbed part of the reduction of nominal yields, graph 1).

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(1) Compare respectively World Economic Outlook of *October 2007 and* The Global Financial Stability Report *of April 2008. The quantification of the losses is still controversial. In the last* Financial Stability Report *of April 2008, for example, the Bank of England warns about the possible risks linked to their "overestimate".*
(2)Last December the futures contracts discounted that this year the American rates at three months would not have fallen more than 3.5%.

THE FORECASTS FOR 2008 **Table 1**

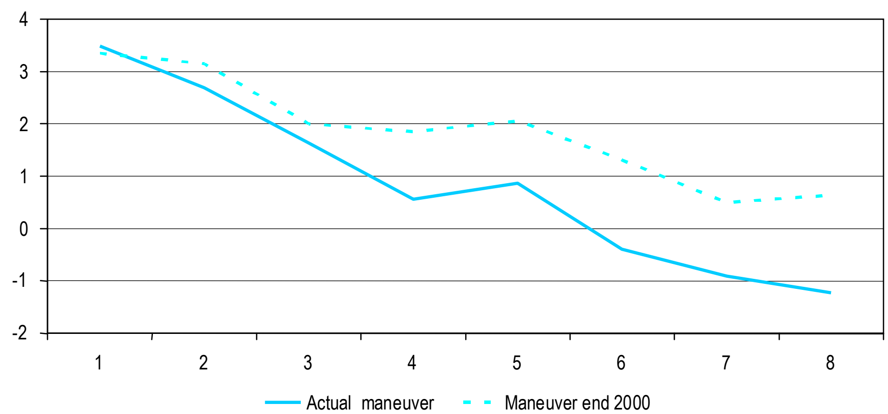
(% values)

	IMF		EU	
	Actual	Differential vs. October 2007	Actual	Differential vs. October 2007
United States				
- GDP	0.5	-1.4	0.9	-0.8
- internal demand	-0.6	-2.2	0.1	-0.8
- inflation	3.0	0.7	3.6	1.7
Eurozone				
- GDP	1.4	-0.7	1.7	-0.5
- Internal demand	1.4	-1.0	1.8	-0.6
- inflation	2.8	0.8	3.2	1.1
Japan				
- GDP	1.4	-0.3	1.2	-0.7
- internal demand	0.9	-0.7	0.4	-0.9
- inflation	0.6	0.1	0.7	0.5
Developing Asia Countries				
- GDP	8.2	-0.6	-	-
- inflation	5.9	1.5	-	-

ACTUAL AMERICAN TAXES **Graph 1**

TWO EXPANSIVE MANEUVERS COMPARED

(monthly from the start of the maneuver)



4

At the same time the central bank intervened on the market to actively manage the crisis of a colossus of the world of finance, Bear Stearns. From this operation we noted that:

(i) it was carried out following a series of tight cuts of the official rate which would have therefore been a rather checked weapon to restore conditions of tranquility in the money market (3);

(ii) it concerned an investment bank, breaking the golden rule (until now) that "rescue" is reserved only for commercial banks (subject to more rigid supervision);

(iii) it was made using a commercial bank, JP Morgan, as the operating arm, who was guaranteed coverage for any losses of up to 30 billion dollars, enough to come out as the "winner" of the whole affair (shares in the last two months were rewarded by the stock exchange): in fact, therefore, the central bank has twice distorted the so-called "pure" competition of the market.

Beyond any judgment on its timeliness and opportunities, the intervention is testimony of regulatory/transparency shortcomings that in recent years have accompanied the development of the financial markets, now associated with the risk of a "domino effect" for the banking sector, or, however, a widespread collapse of the large market operators.

5

The "fury of the elements" therefore cleared out the group of optimists that liquidated the turbulence of the subprimes as a "local reversal of contained impact and of limited duration". In this context, today we set out from the assumption that the American economy is already in recession and that the recovery time will prove longer than that experienced at the beginning of 2000.

6

Moreover, it should be noted that the slowdown of the US cycle may be of contained intensity. What remains to be verified is what, and how, the financial and real estate crisis will transmit to the domestic demand. The possible transmission channels are known: on the one hand, the drop in house prices undermines the confidence of families who, in the end, reduce their consumption; secondly, the progressive increase in losses pushes the banking sector to limit loans thereby triggering a real credit crunch.

7

In this respect however we note that a sharp contraction, both of consumption and non-residential investment, does not yet appear in the American accounting data. The visible slowdown of private expenditure is still in line with that experienced, entitled "soft", in the early years of 2000 and it has yet to be seen if it will turn into the more consistent slowdown of the 1990s (graph 2); at the same time, productive investments showed signs of difficulties only in the first quarter of 2008 and are prospectively com-

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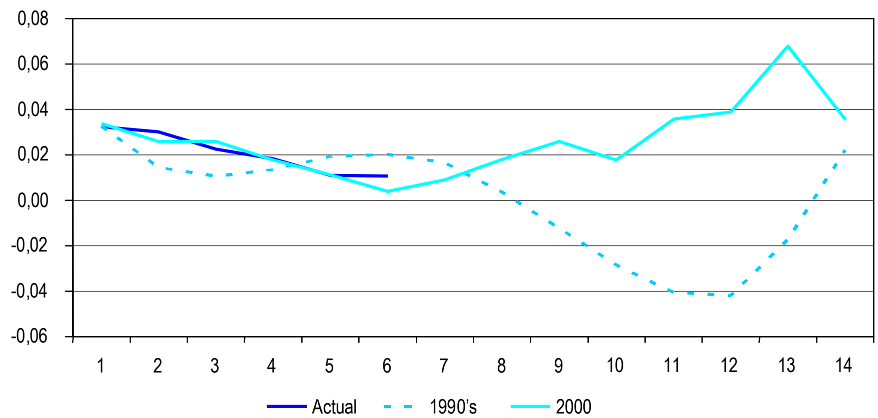
(3) According to the information available, the difficulties of Bear Stearns were mostly of liquidity and not particularly poor quality of assets.

forted by a degree of production capacity that remains near 80%. Under these conditions it therefore seems premature to assume a true tightening of the situation with a prolonged recession attached and to exclude that the American growth remains positive even if weak and below its potential for several years.

AMERICAN CONSUMPTION **Graph 2**

(annualized growth rates, monthly data from the beginning of the slowdown)



In Europe: Rounding the Cape of Good Hope

8

Although slowing down, the economic situation in Europe is more toned than that of the US: the latest National Accounts refer to a growth of around 1.5 percentage points while more updated indications are comforting with regards to industrial production capacity (in particular in Germany); negative signs are coming instead from consumption, penalized by a climate of low confidence of families. Looking ahead, the contagiousness of the financial crisis, the effective intensity of the real contraction of American industry, the size of its effects on the international cycle and on exchange rates represent the reference points from which the "bearings" for the European cycle in the coming years are taken.

AMERICAN AND EUROPEAN BANK RESULTS IN 2007 **Table 2**

(% share on bank totals)

	Profit reduction		Total
	total	with reduction > 20% of profits	losses
United States	**71**	**52**	**21**
Eurozone	**36**	**15**	**2**

9
A basic consideration is that this year, and in the two years to come, the negative effects on the Eurozone of the American financial-real estate crises may be relatively contained. The financial plan, from what has so far emerged, is certainly concerned but does not appear to be of an extent as to leave glimpses of dangers comparable to those post Bear Stearns. We limit ourselves here to recalling just a few figures. The same Monetary Fund estimated that the possible losses incurred from the whole Eurozone banking system would total 45 billion, against the 144 of the United States and the 40 billion of just the United Kingdom. Differences that are all the more significant in that the various banking systems have similar intermediation margins.

10
Scrolling then through the closing budgets of the financial year 2007, we find an appreciable difference in the dynamics of bank results: the European ones registered a less important reduction of profits (both of the number and the entity) and more sporadic cases of real loss (Table 2). In those circumstances, keeping the fear alive that this apparently manageable situation may instead constrict, remains a strong caution with which the credit institutions are willing to provide each other with mutual funds. The spread between the rate applied in the short term to guaranteed interbank loans and that applied to loans not guaranteed is still equal to 70 base points, seven times the level prior to the outbreak of the crisis.

11
Limiting the impact on European foreign demand could contribute at least two types of factors. The first considers the recent dynamics and expectations of world trade: a significant deceleration already occurred in 2007. This expectancy compared to the expected slowdown in world growth actually reflects an adjustment to the period 2005-2006 when trade increases were particularly strong (+9%) taking also into account the robust expansion of advanced economies and those in the developing world. Be that as it may, it is likely that at least part of the impact of the decrease of the global cycle of European exports has already been absorbed.

12
Secondly, the capacity of Asian expansion will count. So far, at least looking at the national account data, the emerging giants show a high degree of "water tightnessòto the difficulties of the western economic-financial cycle, remaining anchored to the higher growth rates of the last two years: China and India voyage at 8.5-10%, the slower ones, Korea and Thailand at 6% (see the lower part of table 1).

EUROPEAN UNION EXPORTS A25 **Table 3**

(% composition on the values at current prices)

	2006
Other European	28,3
United States	22,7
Central and Eastern Asia	21,3
of which	
- China	5,4
- Japan	3,8
- South Korea, Hong Kong, Malaysia, Singapore, Thailand, Taiwan	8,0
Other non European	27,7

13

In the medium term, of primary importance is that a possible (and physiological) slow-down be managed and absorbed without trauma. Starting from the Chinese economy, a first correction of the "out of line" values seems to effectively already be in place. The stock exchange, following a boom in the 2005-2007 period, has registered in the last four months a correction of 35%: a massive drop but which helped to restore the price/earning ratio to around 20 to 50, which six months ago was certainly a most "normal" level and similar to the current US Standard & Poor index.

14

At the same time inflation increased to 9 %, the highest of the last ten years: even if for now it focused on foodstuff, these pressures have activated a gradual tightening of monetary conditions (for now visible mainly in the revision of ratios of the bank reserves). For the European foreign demand the "soft glide" of China and other economies of the area are secondary: the EU exports at 25 to Central Asia and Eastern Europe weigh almost as much as those to the US and only seven points under those directed towards the Extra-Community Europeans (including Russia, table 3).

15

Beyond the size of the slowdown of the International cycle, it is likely that inflationary pressures in the Eurozone that emerged in the last six months will prove quite persistent (currently, consumer prices moving to 3.5 %, almost double the mid term objective and the highest since the early 1990s). In perspective, at least for the period 2008-2009, this is a double hook.

16

In the first place, the increase in prices of raw materials (energy and non) could be an "supply" rather than a "demand" shock: in this sense it is significant that in the face of the first signs of heavy decline of the American economy, and more generally, the revision of the forecasts of world growth, the price of crude oil instead of falling, increased (from 90 dollars/barrel at the end of 2007 to 115 dollars in April).

17
To then be considered are the tensions traversing the wage negotiations in the major European economies: the conflict on renewals is harsh in both Germany (renewal for employees of public administrations) and France (rise in minimum wage) and feeds the fear of the creation of the notorious prices-wages spiral.

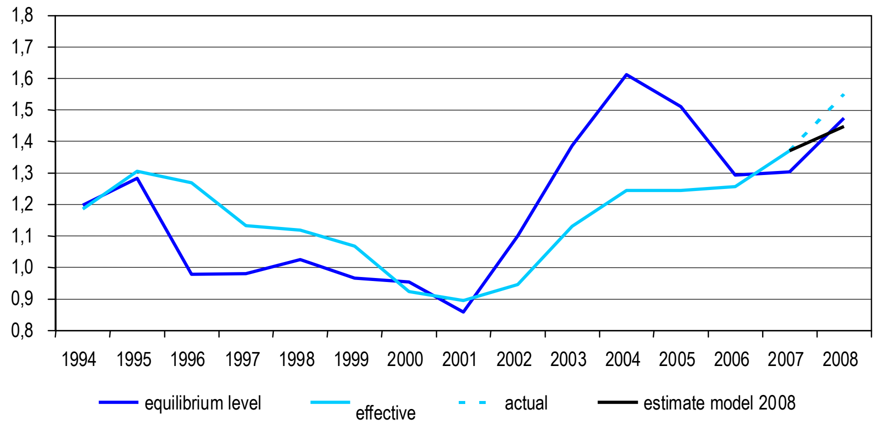
18
In this context it is not surprising therefore that the European Central Bank, despite the core inflation remaining under control and close to 2%, decided not to follow the American example and left official interest rates stable at 4 %.

The currency lull
19
The different monetary strategies contribute, from a medium term perspective, to the Euro remaining "strong" and to not correcting the massive appreciation in recent years (counting only from 2006, the nominal effective exchange rate, calculated in respect of the 22 major trading partners, rose by 15%).
As noted, this dynamic was first determined in the long period of depreciation of the dollar which in early April exceeded 1.55, almost 20% more than it was just a year ago and double the opposite peak reached at the end of 2000: considering the long-term, reasoning on the old German Mark, the current exchange rate is the lowest ever and approximately 10% less than the previous low in 1995.

20
To assess whether this is a level of "excessive" weakness and to have a prospective indication, we placed the dollar/Euro exchange rate in relation to a set of four explanatory variables in a broad time span (1981-2007): the bilateral trade balance between the two areas, the differential in the expansion rate of the economies (taken from the output gap), the spread between the interest rates in the long term, a control variable to take account of the launch of the single currency. The financial year, presented in detail in the "an estimate of the dollar/Euro exchange rateò panel, offers some basic data.

21
The current value of the exchange rate of 1.55 is only a little more than that which we estimated for 2008 (about 10 cents, shown in graph 3 between the two dotted lines): the gap between the actual and estimated level is further reduced if reference is made to "the exchange level balance" taken from the long term relation of the regression (in relation to 2008 the exchange rate is situated near the 1.50 ratio).

THE RESULTS OF OUR ESTIAMTE OF THE EURO/DOLLAR EXCHANGE RATE **Graph 3**



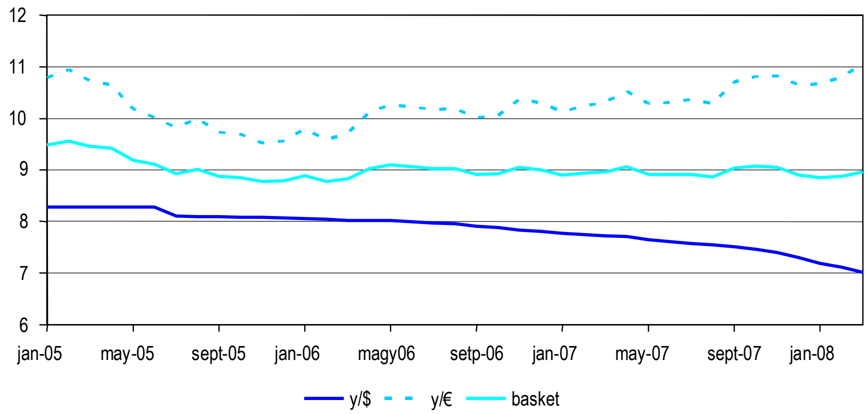
22

The recent expansive shift of the US monetary policy helped to raise the level of equilibrium, which until 2006 was drawing closer, once again, to the level of the launch of the single currency. In particular, following our formulation, in the long run towards depreciation of the dollar in the last six years, three stages can be seen (Table 4). The initial, between 2002 and 2004, when a strengthening of the Euro, practically twice that actually registered, would have been justified, driven substantially by the deterioration of the US trade balance (witnessed both directly by the bilateral balance, and indirectly through the output-gap which is entered with a plus sign in the regression and must therefore be interpreted as an indicator of future deficits). In the following two years, instead, the change of equilibrium has shown a tendency to fall (drawing close once again therefore to the actual datum), thanks mainly to restrictive monetary policy moves following the Greenspan Bernanke handover.

THE DETERMINANTS OF THE CHANGE OF THE EQUILIBRIUM EXCHANGE **Table 4**

	Bilateral trade balance	Long rate differential	Output gap differential	Equilibrium Exchange	Effective Exchange
2001-2004	6,5%	-0,3%	56,9%	63,1%	32,8%
2004-2006	-0,1%	-28,2%	6,2%	-22,1%	21,0%
2006-2008	-6,4%	45,1%	-25,6%	13,1%	21,0%
2001-2008	0,1%	16,5%	37,5%	54,1%	54,8%

CHINESE RENMINBI EXCHANGE RATE **Graph 4**



That said, from 2007 the abrupt "jibe" made by the new Governor to respond to the heightening real estate crisis again gave rise to a tendency to increase the equilibrium exchange which more than offset the first signs of adjustment in foreign accounts. On balance, therefore, not counting any further abrupt monetary actions, our analysis suggests that the dollar/Euro should stabilize at around 1.50-1.60.

23
The strengthening of the Euro against the dollar is accompanied by the strengthening of the main Asian currencies: counting from 1999, the Yen and Yuan, followed by the other "minor" local currencies, have lost about 20 %. In addition, in this case, in the medium term, a turnabout seems rather unlikely, whilst moving towards a gradual stabilization of the ratios is possible.

24
With regard to this, it is significant that the Chinese currency, since they formally abandoned exclusive anchorage to the dollar (July 2005), seems in fact to be hooked to a basket made of only two coins of weight similar: the dollar and the Euro (we show in graph 4, that a synthetic change constructed in this way has almost no volatility). A similar pegging can also be seen for the Thai Baht and the dollar in Taiwan and Singapore. This new system of references, in addition to limiting in perspective the bilateral exchange rate fluctuations, has the advantage of avoiding that a possible overshooting of the dollar exclusively unloads on the Euro and, in general, to foster a more rapid adjustment of the imbalances in international payments (starting with the American deficit).

25
From the point of view of economic analyses, revisiting of the pegging is consistent with an interpretation scheme that considers a fixed exchange rate (underestimated) essential for the developing Asian economies in respect of a "Central" economic zone to ensure the absorption capacity of the goods exported by supporting the development of the domestic production fabric: up to 2005, as happened to some extent with

Bretton Woods for the Euro countries immediately after the war, this role was played by the United States (4). In recent years, however, the gradual intensification of bilateral trade with the Eurozone has pushed our currency towards a role of "second to none": in the last three years Chinese exports to the EMU more than doubled and are now 90% of those intended for the United States.

(4) *In this respect see "*An Essay on the revived Bretton Woods systemö, *Dooley et al. NBER Wp n. 9971, August 2003.*

AN ESTIMATE OF THE EURO/DOLLAR EXCHANGE RATE

With a gradual acceleration in recent months, the Euro to Dollar exchange rate has reached 1.55. To assess the consistency of such a level with the macroeconomic fundamentals, we have regressed the change on a set of explanatory variables: the bilateral trade balance between the United States and the Eurozone (expressed as a percentage of nominal GDP of the first); the differential between the respective rates of interest to 10 years; the growth differential between the two areas; a control variable for the launch of the monetary union. The results of the estimate, carried out on annual OECD data for the 1980-2007 period according to the error correction technique, are shown in the table below.

DEPENDENT VARIABLE: annual variation of the dollar/Euro exchange rate

	Coefficient
Costant	-0.09*
Log FX (-1)	-0.52**
DISCOM (-1)	-0.13*
DIFTAS (-1)	-0.18**
DIFGAP (-1)	0.10**
d(DIFTAS)	-0.09**
d(DIFPIL)	0.03**
UME	0.13*
R^2	0,82
S.E	0,056
Durbin-Watson	1,906

Where:
FX = Dollar/Euro exchange rate level
DISCOM = bilateral trade balance
DIFTAS = long term differential rates (USA-Euro)
DIFGAP = output gap differential (USA-Euro)
d(DIFTAS) = differential long rate changes (USA-Euro)
d(DIFPIL) = differential growth rate changes (USA-Euro)
UME = dummy for the launch of EMU

Several considerations emerge:
(i) the regression coefficients, which have good explanatory powers of the series of changes, are as expected, with only one limitation: the growth differential (represented by the output gap in the long term and the change of GDP in the short term) tends to anticipate future deficits and is therefore entered with a plus sign.
(ii) according to our estimate, the launch of the Monetary Union has led to a permanent appreciation of the European currency of almost 13%.
(iii) the rate of interest has a relatively greater weight in determining both the levels of balance in the long term and the short-term adjustments.
(iv) for 2008, discounting the inversion of differentials in both interest rates and growth rates, our regression estimates a change to 1.45, which does not differ much from the equilibrium value fixed at 1.47.

MAIN INTERNATIONAL EXOGENOUS FACTORS **Table 5**

(% change)

	2006	2007	2008	2009	2010	2011
United States GDP	3.3	2.2	1.0	1.6	2.0	2.2
Eurozone GDP	2.7	2.7	1.6	1.8	2.2	2.2
Global commerce	8.2	6.2	4.3	4.8	5.5	6.0
Italian export demand (a)	8.0	4.5	3.8	4.3	5.0	5.5
Eurocurrency at 3 months						
- Euro	3.1	4.3	4.4	4.0	4.0	4.1
- Dollar	5.2	5.2	2.7	2.8	3.5	4.2
Long term interest rates (b)						
- Eurozone	3.8	4.2	3.9	4.0	4.1	4.4
- United States	4.8	4.6	3.3	3.7	4.1	4.5
Dollar-Euro exchange rate	1.26	1.37	1.55	1.55	1.55	1.55
- % changes	0.9	9.1	13.1	0.0	0.0	0.0
Actual exchange rate (c)						
- nominal	-0.5	-2.1	-2.6	0.0	-0.1	0.0
- actual	-1.0	-3.0	-2.4	0.1	-0.3	-0.3
Inflation rate G-7 (d)	2.4	2.0	2.3	1.9	1.9	1.9
Foreign production price index (c)	4.0	2.7	3.9	3.9	2.5	2.1
Raw material prices (in dollars)						
- oil (e)	65.4	72.7	100.0	100.0	100.0	100.0
- energy goods	26.8	7.5	37.6	0.0	0.0	0.0
- non-energy raw materials	18.6	14.9	15.0	4.0	3.0	3.0
Import price (in Euro)						
Total goods and services imported	7.6	2.3	4.7	3.0	2.0	2.0
- manufactured	3.4	2.1	2.8	3.9	2.3	2.3
- energy goods	25.6	-1.5	21.6	0.0	0.0	0.0
- capital goods	9.1	6.2	1.9	3.7	3.1	3.1

(a) Volume of imports in the first 10 Italian export outlet markets
(b) Rates on benchmark securities
(c) Index weighted with Italian export volumes in the first 10 importing countries
(d) Average variations of the consumer price index.
(e) Dollars per barrel

Conclusions and exogenous factors of the forecast

26

On this basis, even if the global cycle were to experience a real setback, we believe that the international reference scenario that the Italian economy must face is deeply and radically changed with respect to that which marked the first half of the decade. The novelty elements are different.

ŏ Global growth should remain moderate for at least three years, in view of the fact that the American economy will have time to recover and adjust its rather long excesses.

ŏ The current exchange rates and, in particular, a "strong" Euro are destined to continue: they represent an essential mechanism for rebalancing American imbalances and an indispensable flywheel essential for emerging Asian economies.

ŏ The European monetary policy will have relatively narrow margins of maneuver, having to also face persistently high prices of raw materials. A redefinition of exchange rate policies towards Asian countries could soon become important in the European agenda and be an alternative response to a request to intervene on trade relations through recourse to protectionist measures.

27

Consequently, the exogenous factors adopted for the forecast year provide that, in 2008, the growth of world trade and of the demand for Italian exports will continue the decline that began last year (Table 5), to then recovered slowly but without approaching the peak of 2006: a low profile but without the crashes that reflect American and European expansion constantly below their potential. In this context, the combination of consumer inflation that is already relatively high and oil prices that are "resistantò to the cyclical world slowdown (stable at 100 dollars/barrel) should, for the next two years, keep the short-term European rates firm at 4% and the American rates at the levels reached with the recent expansive maneuver. The differential of yield should help fix the Euro/dollar exchange rate at around 1.55.

The Forecast

28

In Italy the downturn of the economic cycle began in the second half of 2007 and was accompanied in the first part of this year by a generalized retreat of the confidence indices. In the CER forecast, this contributes to define a cyclical profile that is characterized by a lower rate of growth to 0.7% in 2008, and by a subsequent acceleration up to 1.4 % in 2011 (Table 6). The current year would therefore, from the point of view of statistical measurement, be at the minimum of the cyclical phase; the recovery expected in the following years is, however, just enough to reduce the development rate on potential values (1.4%); for the forecast period, growth should remain below the maximum achieved in 2001 and 2006 (1.8%) (Figure 5).

29

The intensity of the current slowdown is similar to that of 2004-2005, when the growth rate declined from a rate of 1.5% to 0.5 %. However, the determinants of the current cyclical phase are different, where a move from growth contributions towards the components of foreign demand can be seen; against this, support of the public budget to domestic demand (Tables 7 and 8) remains strong.

Net Exports

30

According to our forecasts, the contribution of net exports to growth should increase to three tenths of a point in the current year (0.1 % in 2007) and then to four 10ths in 2009. This component of demand should explain almost half of the expansion expected for the period 2008-2009; these would be the highest contributions of the whole decade (Graph 6).

31

In view of contained expansion of world trade (see Chapter 1), the positive developments of net exports is one of the novelty factors of the analysis of the Italian economic cycle. Our forecast shows, in this regard, a sharp reversal in respect of the 2001-2006 period, when the external balance deducted, on average, three-tenths of a point of the growth of product. Such a reversal is determined by a clear acceleration of the incremental rate of exports, which we estimate will climb, around the middle of the forecast period to 3.9% (1.6% in 2001-2006). Imports should also increase on average, but in lower proportions in respect of exports (from 2.6 to 3.0%).

32

The forecast confirms overcoming the stagnation that has concerned Italian industry in the first part of the decade and that most acutely manifested itself in falling sales abroad in 2002-2003 (- 2%), followed by the failure of that growth component in 2005 (1%, compared to the expansion of world demand exceeding 6%). The health of the Italian manufacturing industry has much improved since then and the reaction capacity compared to the deterioration of the conditions of the International picture is confirmation of this (see panel "Recent trends in industrial production")

PRINCIPAL ECONOMIC INDICATORS — Table 6

(% change)

	2006	2007	2008	2009	2010	2011
Gross domestic product	1.8	1.5	0.7	1.0	1.2	1.4
- cyclical components (a)	-0.2	0.0	-0.6	-1.1	-1.3	-1.3
Imports of goods and services	5.9	4.4	2.5	2.6	3.5	3.5
Final national consumption	1.0	1.4	0.7	0.8	1.1	1.2
- of families	1.1	1.4	0.7	0.7	1.1	1.2
- collectively	0.9	1.3	0.8	0.9	1.1	1.2
gross fixed investments	2.5	1.2	0.2	0.3	0.5	1.3
- private non-residential	2.8	0.7	-1.0	-0.1	0.9	1.5
Exports of goods and services	6.2	5.0	3.6	4.0	4.0	4.0
Internal demand excluding stockpile	1.3	1.4	0.6	0.7	1.0	1.2
Internal demand including stockpile	1.8	1.3	0.4	0.6	1.0	1.2
Consumer price	2.1	1.8	3.1	2.6	2.2	1.9
GDP deflator	1.7	2.3	3.4	2.4	2.3	2.1
Export deflator	4.5	3.6	3.7	3.8	2.7	2.4
Import deflator	7.6	2.3	4.7	3.0	2.0	2.0
Private sector unitary remuneration	2.9	2.6	3.1	3.1	2.9	2.7
Private sector labour cost per product unit	2.2	1.9	2.5	2.6	2.4	2.1
Balance of payments:						
current balance and in capital account (b)	-36.3	-33.9	-34.1	-23.9	-17.7	-12.5
- in % of GDP	-2.5	-2.2	-2.1	-1.4	-1.0	-0.7
balance of goods and services (b)	-12.3	-4.7	-3.9	7.1	14.2	20.3
PA current surplus (b)	19.9	34.7	27.7	31.2	37.0	40.3
debt net of PA (b)	-49.6	-29.2	-34.7	-33.5	-27.2	-24.9
- in % of GDP	-3.4	-1.9	-2.2	-2.0	-1.6	-1.4
- adjusted for the cycle	-3.2	-1.9	-2.0	-1.6	-1.0	-0.8
PA primary surplus (b)	18.6	47.5	43.6	48.4	55.4	58.4
- in % of GDP	1.3	3.1	2.7	2.9	3.2	3.3
- adjusted for the cycle	1.4	3.1	2.9	3.4	3.8	3.9
PA debt (EU definition) in % of GDP	106.5	104.0	102.7	102.2	101.2	100.1
Average rate on ordinary treasury bonds (c)	3.2	4.0	4.4	4.0	4.0	4.1
Actual average rate on ordinary treasury bonds (c)	1.1	2.2	1.3	1.4	1.8	2.2
Average cost of debt (d)	4.4	4.8	4.8	4.9	4.8	4.8
Disposable income of families:						
- nominal	2.8	3.8	3.9	3.1	3.3	3.2
- actual	0.1	1.6	0.6	0.3	0.8	1.1
Consumption propensity (e)	88.3	88.2	88.2	88.6	88.9	89.0

(a) Deviation percentage of the structural component

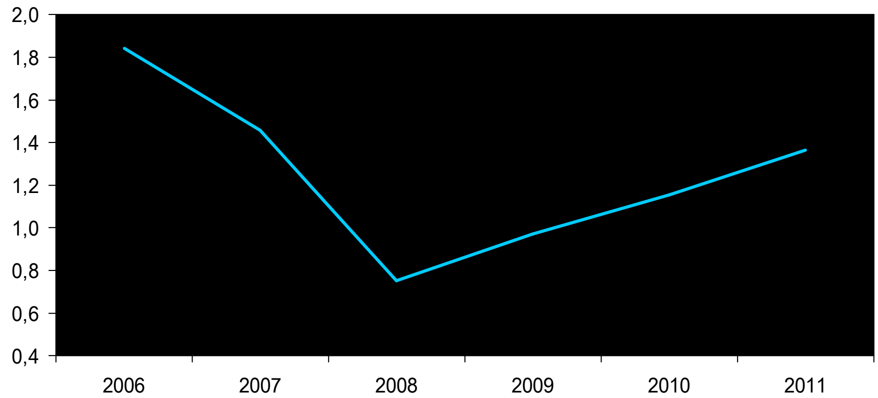
(b) Billion Euro.

(c) Percentage values.

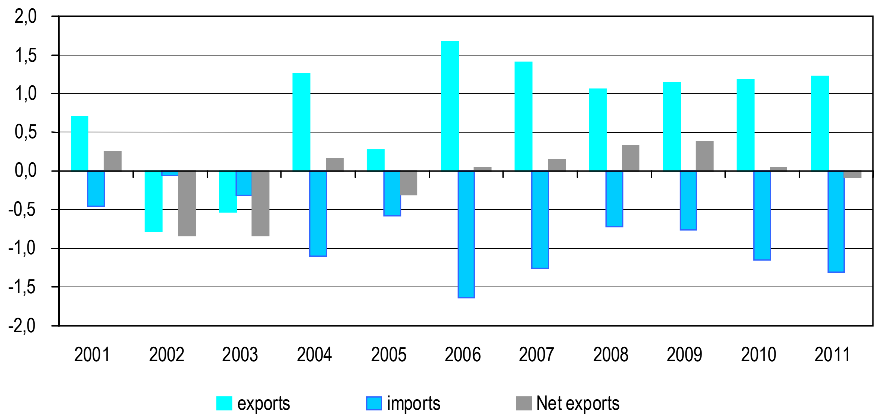
(d) Interest on debt as a percentage of public debt.

(e) In percentage of disposable income.

THE GDP CYCLE IN ITALY **Graph 5**



CONTRIBUTIONS OF NET EXPORTS TO GROWTH **Graph 6**



CONTRIBUTIONS TO ACTUAL GDP GROWTH **Table 7**

(% change)

	2006	2007	2008	2009	2010	2011
Imports of goods and services	-1,6	-1,3	-0,7	-0,8	-1,1	-1,1
Final consumption	0,8	1,1	0,6	0,6	0,9	1,0
Gross fixed investments	0,5	0,3	0,0	0,1	0,1	0,3
Stockpile variations	0,5	-0,1	-0,2	-0,1	0,0	0,0
Exports of goods and services	1,7	1,4	1,1	1,2	1,2	1,3

33
With reference to the specific determinants of exports in the forecast period, two-thirds of the expected increase is reflected in increased foreign demand, which we estimate will go from a minimum of 3.8 % this year to a maximum of 5.5% at the end of period (see Chapter 1). In substance, the dynamics of foreign demand will remain in line with the result observed in 2007, certainly very distant from the values of increase in the first part of the decade, characterized by a more expansive international environment than the current one (again, see Chapter 1).

34
In 2008, as in 2007, the re-evaluation of the Euro against the dollar and the new exporting economies should also slow down export activity. The effect should be less in the next three years of the forecast period, but we do not believe that an opposite movement of the exchange rate can be foretold, one that can sustain, through nominal depreciation, the competitiveness of our export price.

ECONOMIC ACCOUNT RESOURCES AND INVESTMENTS **Table 8**
(billion Euro)

	2006	2007	2008	2009	2010	2011
CURRENT PRICES						
GDP	1,480.0	1,535.5	1,599.6	1,654.0	1,712.0	1,771.4
Imports of goods and services	424.2	453.0	485.9	513.2	541.5	571.5
Final national consumption	1,173.5	1,210.3	1,269.4	1,306.8	1,350.8	1,393.5
- of families	868.6	900.3	936.0	969.0	1,003.8	1,037.0
- collectively	304.9	310.0	333.4	337.8	347.0	356.5
Gross fixed investment	311.2	323.3	330.0	337.6	344.4	355.3
Domestic demand (a)	1,484.7	1,533.6	1,599.5	1,644.4	1,695.2	1,748.8
Stockpile variation	7.6	6.7	4.1	2.5	2.5	2.3
Exports of goods and services	411.9	448.3	482.0	520.3	555.7	591.8
Total demand (a)	1,472.4	1,528.9	1,595.6	1,651.5	1,709.5	1,769.1
CONCATENATED - YEAR 2000						
GDP	1,266.4	1,284.9	1,294.5	1,307.1	1,322.2	1,340.4
Imports of goods and services	362.0	378.0	387.3	397.3	411.1	425.6
Final national consumption	998.5	1,012.4	1,019.6	1,027.4	1,039.0	1,051.7
- of families	743.1	753.8	758.9	764.4	773.1	782.6
- collectively	255.3	258.6	260.7	262.9	265.8	269.1
Gross fixed investments	268.7	272.0	272.6	273.5	274.9	278.5
Domestic demand (a)	1,267.1	1,284.4	1,292.2	1,300.9	1,313.9	1,330.2
Exports of goods and services	354.3	372.1	385.6	401.1	417.1	433.6
Total demand (a)	1,259.4	1,278.5	1,290.6	1,304.7	1,319.8	1,338.3

(a) Excluding stockpiles

35

Given this context, maintenance of exports is linked, in our estimate, to a realignment of the relative prices of our industry in relation to competitors of industrialized countries. A development that should result in recovery, in the medium term, of productivity and the stabilization of labour costs per product unit (see below). These two elements would expedite the return of competitiveness of our export industry, which in recent years would have leveraged on elements of quality over the control of relative prices. An economic policy aimed at containing the rise of production costs should facilitate, from all the evidence, this virtuous process.

36

The favorable development of net exports derives from, apart from the growth of our export industry, the factors that contribute to slow down the increase in imports. Increases in international prices of raw materials, and the related increases in production prices in all countries, should deduct throughout the forecast period around a point of the growth of import. At the same time, the weakness of domestic demand should account in 2008 for a further reduction of the rate of increase of imports compared to 2007.

37

In 2009 as well, absorption linked to the domestic demand (less than two points of major imports) should remain well below the values recorded during the 2006-2007 period (average 3.7 points). Only in the final two years of the forecast should the rates of increase of imports match the values observed in 2006-2007.

Domestic demand

38

We estimate that in 2008 the rate of expansion of domestic demand should fall, net of stocks, to 0.6 %, almost a point less than in 2007. A similar result should be achieved in 2009 (0.7%). The cyclical downturn is extended to all the components of domestic demand, including stocks, which would deduct two tenths of a point from growth in 2008, and one tenth in 2009. A recovery in domestic demand is expected only in the period 2010-2011, with a stock contribution that should be nil.

Final National Consumption

39

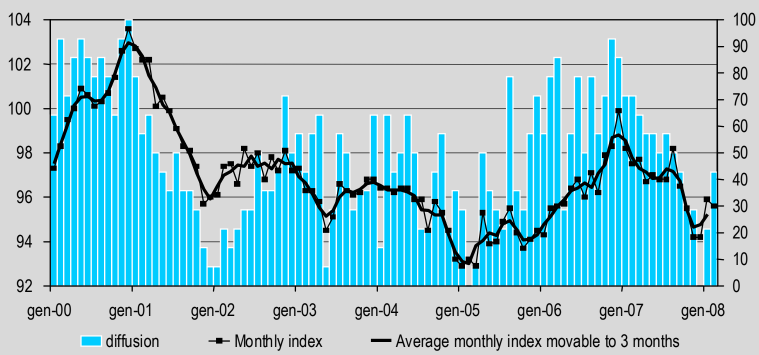
In 2008-2009 the rise in consumption should remain below one per cent, to then sit at 1.2 % at the end of the forecast period. The increase in consumption expected for this year (0.7%) is equal to half that recorded in 2007.

RECENT TRENDS IN INDUSTRIAL PRODUCTION

According to estimates available today, in the first quarter of the year, industrial production should increase by 1.1 % in respect to the last quarter of 2007. Therefore, a break in the inflected trend extended from January last year will register. The industrial diffusion index moved in the same direction. This, which measures the number of divisions in expansion over the corresponding period a year earlier, after having decreased to a minimum point in December 2007, grew again to exceed 40% s in February (Chart A).

ADJUSTED MANUFACTURING AND DISTRIBUTION PRODUCTION INDEX GRAPH A

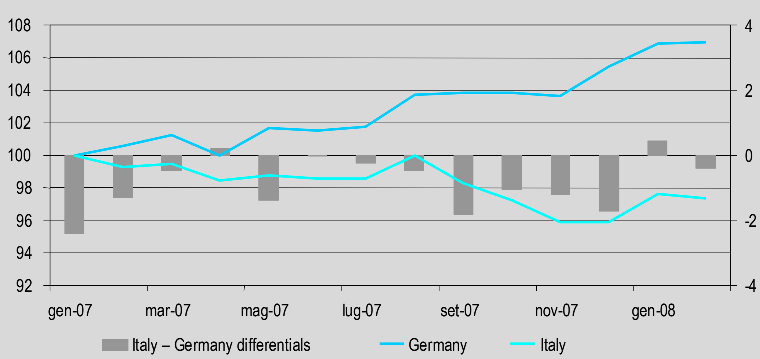
(diffusion: % share of the sectors in expansion on trend bases)



Amongst the areas in expansion, compared to February 2007, food (+4.1%), rubber/plastic (+3.2%) and transport (+1.2%) stand out. Negatively, however, the fall in production volumes in the tanning/leather products sector (- 11.6%) stands out. Also in relation to Germany, which continues to tow the entire European cycle, a recovery seems manifest. Graph B shows that in the two-month January-February period, the price scissors dropped, with respect to German production, highlighted in the second half of 2007. Although the stabilization of the latest data does not make recovering the slowdown of the past few years possible.

ITALY AND GERMANY. MANUFACTURING AND CYCLICAL GROWTH DIFFERENTIALS GRAPH B

(base 2007=100, seasonally adjusted figures)



DISPOSABLE FAMILY INCOME **Table 9**

(% change)

	2006	2007	2008	2009	2010	2011
Gross disposable income						
nominal	2.8	3.8	3.9	3.1	3.3	3.2
actual	0.1	1.6	0.6	0.3	0.8	1.1
- gross operating result	5.4	5.6	3.4	3.5	3.2	3.2
- income from employees	4.7	3.6	5.0	2.6	3.2	3.2
- income from self-employment	-0.5	2.0	3.0	2.7	2.0	2.2
- Pensions and income from capital	10.3	6.5	3.4	3.4	2.6	3.1
- Social benefits	4.4	5.2	4.3	3.5	4.3	3.6
- Tax on income and assets	8.4	7.4	5.3	2.7	2.9	2.6
- effective social contributions	4.4	8.0	4.2	2.2	2.7	2.6
- imputed social contributions	4.5	1.4	4.8	1.7	2.9	2.8
Net labour income (a)	2.5	1.5	4.4	2.8	2.9	3.0
Income tax (b)	8.0	7.2	4.8	2.6	3.2	2.6
Labour income net of tax	2.2	3.5	4.2	3.1	3.3	3.2
Tax burden on families (in % of total family resources)						
- gross	28.6	29.3	29.5	29.3	29.2	29.1
- net of the imputed contributions	27.8	28.5	28.7	28.6	28.5	28.3
- net of income tax						
from capital	28.1	28.8	28.9	28.8	28.7	28.6
Consumer propensity (in % of disposable income)	88.3	88.2	88.2	88.6	88.9	89.0

(a) Sum of employee remuneration and self-employment income net of social contributions.
(b) Net of income tax from capital.

Within the aggregate of final domestic consumption, the dynamics attributable to the expenditure of families and expansion of the public budget are essentially the same. Both components, in 2008-2009, halve their contribution to GDP growth compared to 2007 (respectively, from 0.8 to 0.4 points and 0.25 to 0.17 points).

40

The slowdown in household consumption is occured despite the nominal disposable income being just above that of 2007 (3.9 against 3.8%) (Table 9). In more detail, we believe that this year, the increase in the mass of employee income passes moves from 3.5 to 5.1 %, with an even more pronounced acceleration in unit terms (1.9 to 4.5%). Of absolute importance is the role played by the public sector, within which the increase in unitary remuneration should be positioned at 8.6% (3.1 % in the private sector) (Table 10). Less favorable are the trends of the other income components: we expect increases of 3.4% of income from capital (against 6.5% in 2007 and 10.3% in 2006) and 4.3% for social benefits (5.2 % in 2007).

Remuneration, income and cost of labour **Table 10**

(% change)

	2006	2007	2008	2009	2010	2011
Unitary remuneration						
- total	3.0	2.1	4.5	2.2	2.4	2.3
private sector	2.9	2.6	3.1	3.1	2.9	2.7
public services	3.9	0.9	8.6	-0.3	1.3	1.1
Unit income from employment						
total	2.5	1.9	4.5	2.1	2.4	2.2
private sector	2.1	2.5	3.1	3.1	2.9	2.7
public services	4.0	0.9	8.6	-0.3	1.3	1.1
Remuneration mass						
- total	5.2	3.6	5.0	2.6	3.3	3.2
private sector	5.6	4.5	3.7	3.7	3.9	3.9
public services	3.9	1.1	9.0	-0.2	1.4	1.1
Income mass from employment						
total	4.6	3.5	5.1	2.6	3.2	3.2
private sector	4.8	4.4	3.7	3.7	3.9	3.9
public services	4.1	1.1	9.0	-0.2	1.4	1.1
Labour productivity						
- total	0.1	0.6	0.3	0.6	0.6	0.7
private sector	-0.1	0.6	0.6	0.5	0.5	0.6
Labour cost per product unit						
- total	2.3	1.6	3.8	1.8	2.0	1.7
private sector	2.2	1.9	2.5	2.6	2.4	2.1
Private sector gross operating margin						
- in % of added value	24.8	25.2	25.2	25.5	25.7	25.9
- in % of added value net of tax	20.3	19.7	19.9	20.3	20.1	20.2

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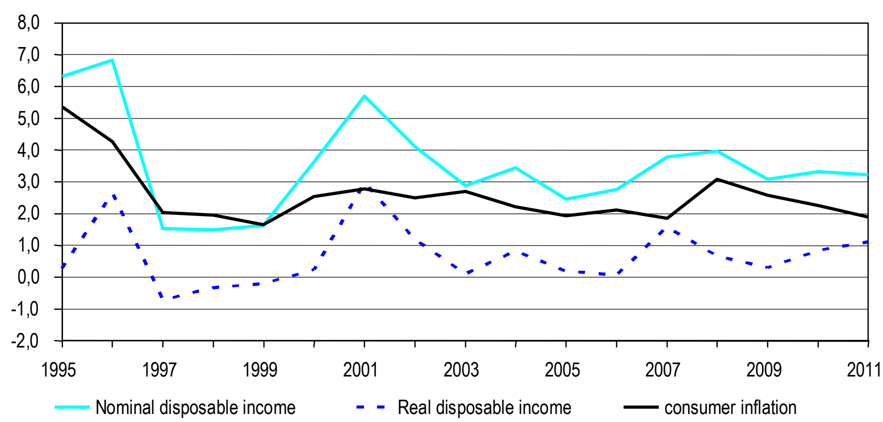
The increases in income are partly absorbed by increases that are still sustained by taxes and contributions (respectively, 5.3 and 4.2%). In substance, these two items should show a clear slowdown compared to 2007 (7.4 and 8%), but should also retain this year higher growth rates than those of nominal income. This situation should be reduced only from 2009.

42

Another item that affects the capacity of household expenditure is inflation, which is expected this year to be confirmed at 3.1% (3.3% measured with the consumption deflator, see below for a full description). The acceleration of prices should lead to a deceleration of the increase in real disposable income to 0.6% (1.6% in 2007). A similar situation should recur in 2009, when we estimate that a growth of nominal disposable income of 3.1 % should correspond to a change in the consumption deflator of 2.8% and therefore the increase in the real income contained to 0.3%. Only for the 2010-2011 period, should we return to more sustainable growth values in real income (respectively 0.8 and 1.1 %, with increases in the average nominal income of 3.2 % and inflation around 2%) (Figure 7).

Disposable income and inflation **Graph 7**

(tendential % rates of change)



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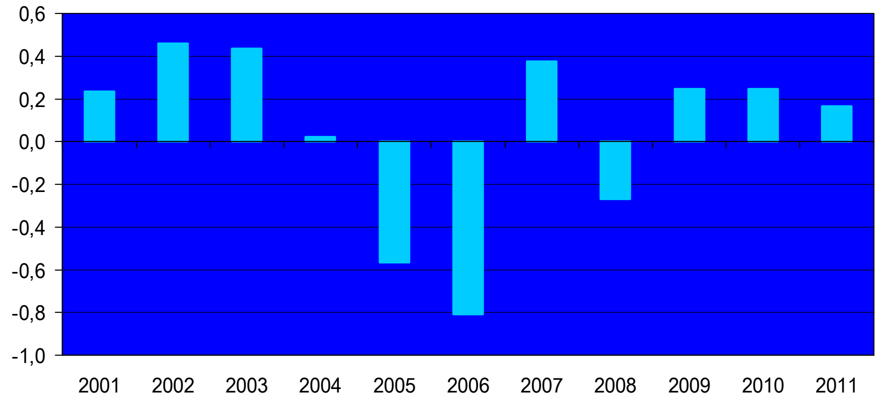
In the current conditions of uncertainty, we do not believe that the slowdown of real income can be compensated by an increase in the propensity to consume. According to our estimate, the value of this parameter will remain unchanged in 2008 (88.2%), to rise slightly in the following years, reaching 89% in 2011.

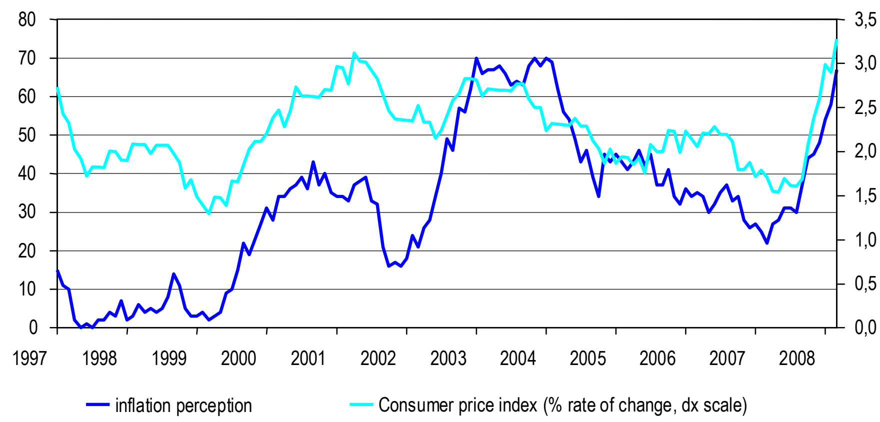
44

According to our simulations, inflationary acceleration will therefore have a significant impact on the dynamics of consumption and the GDP. This is the usual effect that occurs when the exchange rates worsen. For this year we measure a deterioration of 0.9%, against the improvement of 1.3% in 2007. Appreciation of the exchange rate allows, however, containing worsening of the exchange rates much below the value recorded in 2005-2006 (almost 2.5% on average). This means that the loss of product attributable to the increase of international prices can this year be contained to three tenths of a point; it was equal to eight tenths in 2006 and six 10ths in 2005 (graph 8).

Effect of the changes of the exchange rate on the dynamics of the GDP **Graph 8**



Real and Perceived Inflation **Graph 9**



45
The exchange rate developments absorb a large part of inflationary pressure generated through higher prices of raw materials. In addition, the forecast shows that even in virtue of the appreciation of the Euro, the unfavorable effect of the exchange rate could run its course in 2008. The increase in inflation remains a risk factor. The price increases focus on necessities (food, but also petrol), generating an income effect of particular importance and helping to raise the perceived level of inflation (Graph 9). It is up to economic policy to find tools to prevent a similar perception altering the expectations of medium-term inflation and generating a price-wage spiral.

46
A greater risk if one considers that the forecast, however, discounts a cooling of inflationary pressure already in the second part of the year. In March the so-called inflation "gainedò was already equal to 2.4 %, and extrapolating the cyclical downturn that registered in the first quarter to the subsequent nine months takes inflation close to 4 %. Noting the values broken down by product type, it emerges how at the time, rising prices concerning raw materials began transmitting to the other sectors, not presenting however elements of differentiation with respect to the rest of Europe (see panel "inflation transmission and differentials with Europe"). As the prices of energy and foodstuff are structurally extremely volatile, we think that it will still be possible to observe a slowdown of these in the course of the year.

47
This valuation would be reduced in the event of failure of the return of the tensions of raw materials on international markets. In that regard, it should be noted that our assumptions about average oil price imply a return of the current prices, remaining at around 120 dollars/barrel. Stabilization of the more recent prices should determine compression counter effects against effects on growth. With respect to the base simulation, the increase of the product should be less than a tenth of a point, while domestic demand should show a negative difference of two tenths of a point. Inflation should increase to an average of 3.5% in 2008 (for more details see panel "Effects of a stabilization of the price of oil to 120 Dollar/Barrelò

48
Turning to public consumption, we expect a slowdown in 2008 (0.8%) and an increase in 2009 (0.9%). Direct support to the growth of the GDP will be lower than that of 2007. The situation is different when assessed at current prices, an increase of consumption of the public administration of 7.6%, is in clear acceleration when compared to 2007 and with the maximum value of the whole forecast period. The shift is the result of increased public salaries, in turn linked to the renewal of contracts, and the payment of arrears and one-off payments (see the chapter on public finance). It is therefore from the income side that the public budget exercises an expansive effect in 2008. This contribution should diminish radically from 2009 and, in our scenario of the "legislation in force" should be substantially less in 2010-2011.

Gross fixed capital investments
49
In our forecast, non-residential private investment (approximate aggregate to the ñmachinery and equipmentò national accounts) is the weaker component of domestic demand. This is due to the pronounced cyclical profile that typically characterizes the trend. We estimate a real decline in 2008 (- 1%), followed by zero growth in 2009 and a successive acceleration in the period 2010-2011 (0.9 and 1.5%).

INFLATION TRANSMISSION AND DIFFERENTIALS WITH EUROPE

Following a period of relative stability, in 2007 a rising trend manifested itself in dollar prices of many raw materials traded on international markets.

In just 15 months, between January last year and March this year, the index number of the price in dollars of all raw materials imported from Italy showed an increase of 67.6%, for reasons of increases sustained particularly in the price of fuel (+88%), fiber (+46.2%) and in raw materials of foodstuffs (+37.3%). A part of these increases (40%) was sterilized from the re-evaluation of the Euro on the dollar, while the remaining 60% transferred to the economic system in the form of higher production costs. The result was a significant acceleration in production prices (with a tendential growth rate that reached 5.7% in February this year) and its transfer on consumption inflation between January 2007 and March this year rose from 1.7 to 3.3%, the maximum value of the last 11 years.

In view of the changed inflationary picture we pose two questions.

The first: has the rise in prices concerning raw materials remained located in the sectors that gave it origin ï energy and foodstuff, or spread, and to what possible extent, to the other sectors of the economy? In the search for an answer it is necessary to distinguish between energy inflation, foodstuff inflation and core inflation, using the harmonized index of consumer price indices calculated for that reason by Eurostat. To this end the rate of change has been calculated to three months (1) annualized of the harmonized index of consumer prices calculated from the Eurostat, after having properly cleansed them of seasonal and accidental components using the TRAMO-SEATS software (2) (Table A).

INFLATION IN ITALY **Table A**
(variations annualized to 3 months)

	2007									2008		
	apr	may	jun	jul	aug	sept	oct	nov	dec	jan	feb	mar
Total	1,8	1,9	2,1	2,3	2,5	2,6	3,0	3,5	4,0	4,2	4,1	4,0
- Energy	-0,3	1,4	4,9	7,9	7,7	4,3	2,1	4,3	11,0	17,3	18,9	15,9
- Non processed foodstuff	0,7	1,4	2,3	3,0	3,6	4,5	5,3	5,5	5,3	4,8	4,0	3,3
- Core-inflation	1,9	2,0	2,0	2,2	2,3	2,4	2,5	2,6	2,8	2,8	2,9	2,9

(1) the choice to evaluate the dynamic of prices on such a limited range, instead of annual, seems preferable in the presence of rapid change.
(2) The Software is currently used by ISTAT to deseasonalize historical series using a model-based process. For the identification of the model for the breakdown of the series, a largely automatic identification procedure of the model was used.
Tramo and Seats, Instructions for the Users, Gomez, V., Maravall, A. (1997), downloadable from (www.istat.it).

The results show a significant acceleration in consumer prices: the growth rate reported for the year, recorded values near 4% in the first three months of this year. The greater inflation mainly concerns the energy sector and, to a lesser extent, unprocessed foodstuff; for the remaining goods and services instead, around 2.9 %, is expected with an increase of about one percentage point in a year. The conclusion drawn is that inflationary impulses deriving from the international markets of raw materials are beginning to spread to other sectors of the economy.

The second question is focused, instead, to ascertain whether the increase recorded by core inflation in Italy is in line with that of the other countries in the Eurozone. To this end, the same inflation measure previously used for Italy was calculated with reference to the Eurozone, and to the main countries that comprise it (Table B).

BASIC INFLATION IN THE EUROZONE **Table B**
(variations annualized to 3 months)

	2007									2008		
	apr	may	jun	jul	aug	sept	oct	nov	dec	jan	feb	mar
Euro	2,0	2,0	2,1	2,2	2,3	2,3	2,5	2,6	2,7	2,7	2,7	2,7
- France	1,2	1,4	1,7	1,8	1,9	2,1	2,2	2,4	2,6	2,7	2,8	2,8
- Italy	1,9	2,0	2,0	2,2	2,3	2,4	2,5	2,6	2,8	2,8	2,9	2,9
- Germany	2,3	2,2	2,2	2,3	2,3	2,2	2,3	2,3	2,4	2,3	2,2	2,2
- Spain	2,6	2,7	2,8	3,0	3,1	3,2	3,4	3,5	3,6	3,6	3,6	3,5

In the period January-March 2008, there is substantial alignment between the Italian domestic base inflation and that recorded for the whole Eurozone (the differential is just two tenths of a point). This leads to exclude that the spreading, within the Italian economy, of shocks coming from the raw materials markets is significantly different from that registered in other countries of the monetary union.

EFFECTS OF THE STABILIZATION OF OIL PRICES TO 120 DOLLARS/BARREL

One of the risks of the forecast is the possibility that the price of oil will stabilize on the exceptionally high values reached in these days. For this reason, it was decided to play a simulation alternative in which it is assumed that the price in dollars of oil remains at the value of 120 dollars per barrel for the course of the year. The main results, for the year 2008, are shown in the table with a comparison of the basic scenario and the differences highlighted.

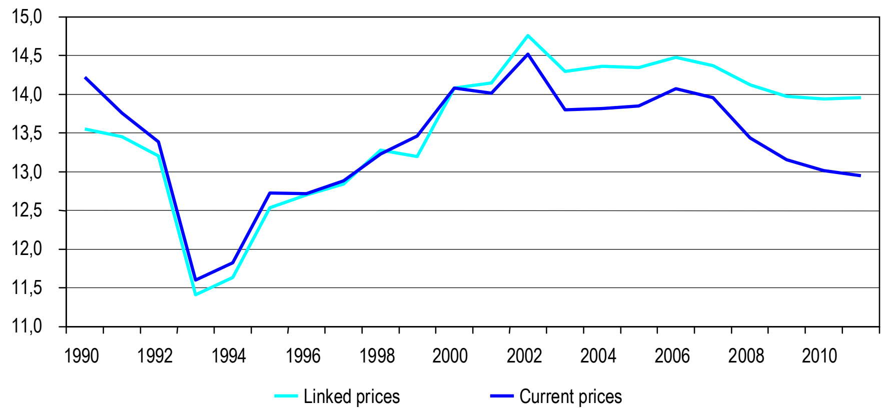
MAIN RESULTS OF THE SIMULATION
(% rates of change)

	Basic Scenario	Alternative Scenario	Difference
Oil price (a)	100,0	120,0	20,0
Import deflator	4,7	8,0	3,3
Consumer price index	3,1	3,5	0,4
Gross domestic product	0,8	0,6	-0,1
Final domestic consumption	0,7	0,6	-0,1
Gross fixed investments	0,2	-0,5	-0,7
Exports	3,6	3,3	-0,4
Imports	2,5	1,8	-0,7
Balance of payments (b)	-2,1	-2,8	-0,7

(a) Price per barrel.
(b) Percentage value of GDP

In summary, the increased cost of oil determines, in the exchange rate, an increase in the import deflator, whose growth is expected at 8% in this scenario, over three points more than prefigured in the baseline scenario of the report. The greatest inflation imported, in turn, determines acceleration in consumer prices, which in this case increase, to an annual average of 3.5% (3.1 in the baseline scenario). The growth of prices, finally, involves a reduction in purchasing power of families, which in part is reflected in a compression of the savings rate, but in part leads to a reduction of purchases. In the scenario examined, private consumption rose by just 0.6%, marking a fall of a tenth of a percentage point in relation to the basic scenario. In addition to families, businesses are negatively affected, and significantly, from the stabilization of oil on its current high levels. In fact, the increase in the cost of raw materials is an increase in production costs and so causes a reduction of profitability, which in turn depresses investment decisions. The total gross fixed capital investments, in the estimate in this scenario, in fact, fell by 0.5%, with a marked deterioration of the already low rate of growth of the baseline scenario (0.2%). Finally, one of the more significant effects resulting from the hypothesized increase in the price of oil is in the deterioration of accounts with foreign countries: the overall deficit of the balance of payments to current prices would extend to 2.8% of the GDP, with a worsening of seven tenths of a point from the deficit prefigured in the baseline scenario.

ACCUMULATION RATE OF THE ITALIAN ECONOMY **Graph 10**



50

The main determinant of the downturn of the accumulation activity is the slowdown of the aggregate demand, to which investment is linked through the acceleration mechanism. This effect began to manifest itself in 2007 and should reach a maximum this year. Compared to 2006, the fall of investment due to lack of demand is quantified by us in 2.5 percentage points. The recovery expected in the last two-year forecast period is not however sufficient to restore the values of 2006, which would be the year of maximum expansion of non-residential investments after 2002 (when however, specific forms of tax incentives were in operation).

51

This year, investments should suffer a momentary stagnation of profit margins, in turn induced by higher costs of imported raw materials. This is a further demonstration of the loss of national income linked to the deterioration of the exchange rate. Profit margins should return to propel investment activity from 2009.

52

On the whole, despite the good export performance, the Italian economy should be characterized in the coming years by a fall of the accumulation rate. Compared to 2007, it should drop by a point in the measurement of current prices, by half a point when computed at constant prices. For economic policy there are two types of problems. From the cyclical point of view it may be desirable to adopt measures that would ease the cyclical profile descendant from investment, in particular in 2008. From a structural point of view the question is how to restore an accumulation rate that is permanently higher than that which prevailed in recent years. An objective, given the structure of our economy, that appears to prescind from a greater growth in consumption (graph 10).

53
The reduction of the cycle of private investment in construction that emerges from our forecast scenario is accentuated. The growth rates are one per cent in 2008, 0.8% in 2009 and 1.6 and 1.2 % in 2010-2011. On average, the estimated growth is 1.2% compared with the 4% registered in the past five years. A similar retrenchment is linked to rising interest rates and is in line with the physiological exhaustion of the cycle of investment observed in most industrialized countries.

54
In the 2008-2009 period, investment activity will be supported by the public component. Maneuvers launched from the month of July should lead to, according to our estimates, increases in public investment equal to 6% in 2008 and 1.9 % in 2009. Given the low weight on the GDP, the contribution to growth will however be contained, with a maximum of 0.1 points in 2008. Furthermore, the importance of public investment for growth is of a long-term nature - affecting the total productivity factor - and can only have limited significance in the short term.

EMPLOYMENT

55
We estimate that this year the falling back of the economic cycle will lead to a reduction in the pace of growth of employment (0.4 %, compared to one per cent in 2007) (Table 11). The adverse effects of the cycle on employment are however attenuated by the demographic tendencies in act, or rather, the contained population growth and its ageing tendency. In detail, the population should register an increase of just 0.1%, while the working age population should be marked by slight decline. Consequently, assuming an increase in the level of activity in line with the trend over the past decade, the work force should grow this year by 0.4 %. Despite the smaller growth, the unemployment rate should therefore continue to fall, at an annual average of 5.9 % of the workforce.

56
The labour market registers further improvements in the course of the three years 2009-2011, dictated by both demographic reasons and by the recovery projected in the macroeconomic frame. In detail, our projections on the working age population and the level of activity lead us to prefigure an average annual growth rate of the workforce of 0.5 % in the three years. At the same time, for the number of employed we prefigure a slightly higher average rate of change. Hence, the continued downturn in the rate of unemployment that at the end of the period will stabilize to 5.4% of the workforce.

57
For all of the forecast period, the increased number of employees should remain below the real growth rate. Therefore, it will mean a return of the medium term labour productivity on positive growth rates, close to 0.5%. Variations that are lower than those of other large countries, but sufficient to stop the long phase of growth without productivity that characterized our economy in the first part of the decade. This would stabilize the variations in costs at around 2.4% for all the forecast period.

EMPLOYMENT AND WORKFORCE **Table 11**

(% changes)

	2006	2007	2008	2009	2010	2011
			Thousands of units			
Population	58.987	59.094	59.185	59.263	59.328	59.377
Workforce (a)	24.662	24.728	24.827	24.951	25.076	25.201
Employed (a)	22.988	23.222	23.353	23.475	23.651	23.848
Employed (b)	24.826	25.071	25.171	25.261	25.410	25.582
- private sector	21.194	21.434	21.521	21.609	21.756	21.928
employees	14.040	14.308	14.388	14.472	14.618	14.791
self-employed	7.154	7.125	7.133	7.137	7.137	7.137
- public services	3.632	3.637	3.650	3.652	3.654	3.654
Unemployed (a)	1.673	1.506	1.474	1.476	1.425	1.353
			Percentage changes			
Population	0,4	0,2	0,2	0,1	0,1	0,1
Workforce (a)	0,9	0,3	0,4	0,5	0,5	0,5
Employed (a)	1,9	1,0	0,6	0,5	0,7	0,8
Employed (b)	1,7	1,0	0,4	0,4	0,6	0,7
- private sector	2,0	1,1	0,4	0,4	0,7	0,8
employees	2,7	1,9	0,6	0,6	1,0	1,2
self-employed	0,7	-0,4	0,1	0,1	0,0	0,0
- public services	0,0	0,1	0,4	0,1	0,1	0,0
Unemployed (a)	-11,4	-10,0	-2,2	0,2	-3,5	-5,1
Activity rate (a) (c)	63,7	63,9	64,2	64,6	65,0	65,3
Unemployment rate (a)	6,8	6,1	5,9	5,9	5,7	5,4

(a) Continuous surveying of workforce.
(b National Accounts (standard unit of work).
(c) Relationship between total labour force and population between 15 and 64 years.

The balance of payments

58

In 2007 the trade deficit of the balance of payments considerably reduced from 12 to 5 billion (from 0.8% to 0.3% in relation to the GDP), mainly due to the strengthening of the exchange rate: the increase on the prices of exports has amplified the modest reduction in the deficit measured in real terms (Table 12). This improvement was almost completely offset by changes of the opposite sign of the other items of the current account, on the whole remaining almost unchanged compared to 2006. The reduction by about 3 billion Euro of the overall deficit of the balance of payments, from 27 to 24 billion (from 1.8% to 1.6% in relation to the GDP), reflects thus a similar increase in the balance in the capital account.

Economic balance of payments **Table 12**

(billion Euro)

	2006	2007	2008	2009	2010	2011
Balance of goods	-12,3	-4,7	-3,9	7,1	14,2	20,3
- in % of the GDP	-0,8	-0,3	-0,2	0,4	0,8	1,1
Exports	411,9	448,3	482,0	520,3	555,7	591,8
Imports	424,2	453,0	485,9	513,2	541,5	571,5
Balance of income from employment	-0,3	-0,1	-0,3	-0,3	-0,3	-0,3
Balance of income from capital	-3,3	-8,7	-8,7	-8,7	-8,7	-8,7
Current transfers	-14,5	-13,9	-14,5	-15,1	-15,7	-16,3
Indirect net taxes	-0,8	1,6	1,6	1,7	1,8	1,8
Current balance	-29,6	-29,1	-29,1	-18,7	-12,2	-6,8
Capital balance	2,4	5,0	5,2	5,4	5,6	5,8
Current and capital balance	-27,2	-24,1	-23,9	-13,3	-6,6	-1,0
- in % of the GDP	-1,8	-1,6	-1,5	-0,8	-0,4	-0,1
- in % of the GDP net of capital income	-1,6	-1,0	-0,9	-0,3	0,1	0,4
aide memoire:						
Exchange rate (a)	-2,9	1,3	-0,9	0,8	0,7	0,5

(a) Percentage changes

59

Based on the financial year forecast, in 2008 the trade deficit expressed in volume should improve more widely compared to last year (by about 4 billion), but the exchange rate should go back to acting strictly on the nominal values of the balance, which in current terms should fall by about one billion Euro (decreasing to 0.2% in relation to the GDP). As the balance of the other components, both the current and capital account, should retain the same values of 2007, the overall deficit of the balance of payments should also remain almost unchanged, at 1.5% in relation to the GDP.

60

From 2009, the rate of real growth of exports should continue to exceed at least that of imports, leading again to a net balance of the transactions in goods and services of value positive. In parallel, containment of international prices of raw materials should determine a further increase of the exchange rates. Overall, therefore, these conditions should lead to a largely positive balance of trade expressed in current prices. In the last year of the forecast, in particular, trade surplus should compensate the structural deficit of the other items of the balance of payments, which when considered as a whole should lead to a position close to the equilibrium (- 0.1% in relation to the GDP).

PUBLIC FINANCE IN EUROPE

61

The favorable evolution of the macroeconomic framework, the reduction of the weight of expenditure and the substantial compliance with the objectives of the Member States with the stability programs submitted at the end 2006, have allowed the Eurozone to achieve, for the fourth consecutive year, a reduction of the budget deficit. According to the latest information disseminated by Eurostat (5), as a percentage of the GDP, the budgetary balance moved from 1.3% to 0.6 (Table 13) compared to a target fixed to 0.8% in the updated stability program (6).

62

A particularly sustained reduction of the deficit was obtained in Italy (see below), Germany and Portugal. To the contrary, an increase in the deficit was registered in Greece and France. Amongst the countries already in surplus, Ireland registered a significant reduction of its own margin. Among the other European countries, the United Kingdom recorded a slight deterioration, whilst Sweden consolidated its position with an increase of surplus from 2.3 to 5%.

63

In general, none of the countries of the Eurozone exceeded the threshold of 3% in 2007. We observe how the countries in deficit have taken greater advantage of the favorable economic climate, nearing their public accounts to a condition of balance. Extending the analysis for the Eurozone to the period 2006-2007, resulting in diagram 11, where the change of debt between 2005 and 2007, in relation to the position of the budget in 2005, is shown. The Eurostat data shows, in fact, for countries with negative balances, an average reduction of the deficit in the period considered, equal to 1.4 points of the GDP, against a substantial fixed value of debt for the countries in budgetary surplus.

64

Net of the cyclical component and the "one-off" resources, the structural deficit recorded in 2007 also shows a significant reduction, but a lesser amount than that observed for the nominal balance: according to estimates supplied by the ECB, the structural balance moved from 1.3 to 0.8% between 2006 and 2007. In the same sense, the European Commission forecasts indicated the reduction expected for the structural deficit for 2007 at 0.4%.

65

In considering the reduction of net debt, the contribution to the reduction from expenditure results as stubbornly high to which, on average, approximately 70% of the reduction of the balance is ascribed, being two tenths of the increase of the share of revenue on the GDP.

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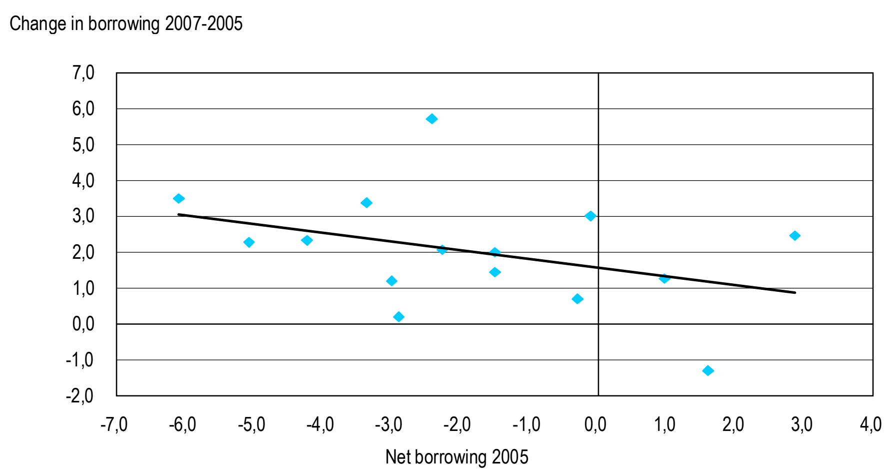
(5) Euro indicators, new release, 54/2008, 18 April 2008.
(6) European Central Bank, Monthly Bulletin, 03 2008.

PUBLIC ADMINISTRATION DEBT **Table 13**

	2000	2001	2002	2003	2004	2005	2006	2007
France	-1,5	-1,5	-3,1	-4,1	-3,6	-2,9	-2,4	-2,7
Germany	1,3	-2,8	-3,7	-4,0	-3,8	-3,4	-1,6	0,0
Greece	-3,7	-4,5	-4,7	-5,6	-7,4	-5,1	-2,6	-2,8
Ireland	4,7	0,9	-0,5	0,4	1,4	1,6	3,0	0,3
Italy	-0,8	-3,1	-2,9	-3,5	-3,5	-4,2	-3,4	-1,9
The Netherlands	2,1	-0,2	-2,0	-3,0	-1,7	-0,3	0,5	0,4
Portugal	-2,9	-4,3	-2,9	-2,9	-3,4	-6,1	-3,9	-2,6
United Kingdom	1,4	0,7	-1,9	-3,3	-3,4	-3,4	-2,6	-2,9
Spain	-0,9	-0,6	-0,5	-0,2	-0,3	1,0	1,8	2,2
Sweden	3,8	1,6	-1,4	-1,1	0,8	2,2	2,3	3,5
Eurozone (15)	-1,0	-1,9	-2,6	-3,1	-2,9	-2,5	-1,3	-0,6
UE (27)	-0,1	-1,6	-2,6	-3,1	-2,8	-2,5	-1,4	-0,9

Source: Eurostat, April 2008

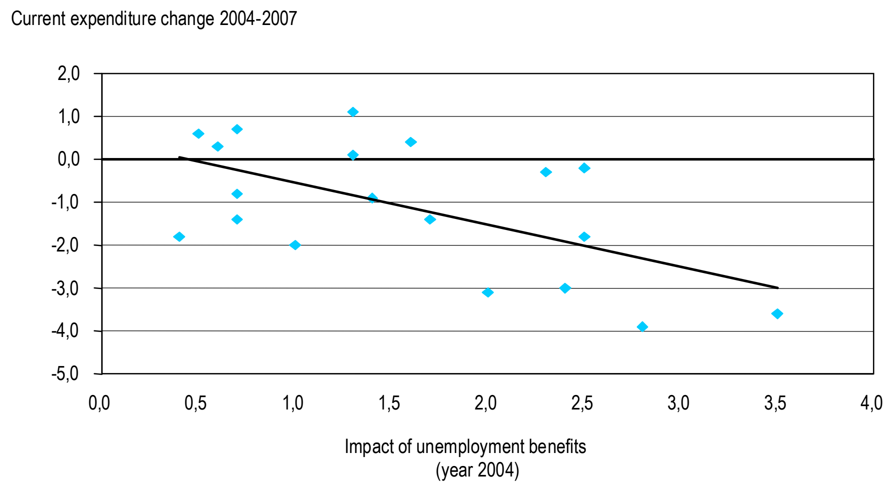
2005 NET BORROWING AND BALANCE REVISION 2005-2007 **Graph 11**
(% of the GDP)



According to data recently disseminated by Eurostat, in the final balance of the year, the reduction of expenditure is equal to about five tenths of a point with a percentage equal to 46.3% of the product, the lowest value recorded after 2000 (46.2%). This reduction was affected by the recovery of the economic cycle observed in recent years. As seen from graph 12, in fact, the reduction of current expenditure appears more vigorous where the price is most important, in terms of impact on the GDP, of public resources destined to the financing of social absorbers.

CURRENT EXPENDITURE: CHANGES 2004-2007 **Graph 12**

(changes in % of GDP)



PUBLIC DEBT **Table 14**

(in % of GDP)

	Debt		
	2005	2006	2007
France	66,4	63,6	64,2
Germany	67,8	67,6	65,0
Greece	98,0	95,3	94,5
Ireland	27,4	25,1	25,2
Italy	105,8	106,5	104,0
Holland	52,3	47,9	45,4
Portugal	63,6	64,7	63,6
United Kingdom	42,1	43,1	43,8
Spain	43,0	39,7	63,2
Sweden	50,9	45,9	40,6
Eurozone (15)	70,1	68,4	66,4
EU (27)	62,6	61,2	58,7

Source: Eurostat, April 2008

66
Total public administration debt also registered a reduction in the course of 2007. In percentage of the product, the financial deficits fell, in Europe 15, from 68.4% to 66.4 (Table 14). Also in this case, extending the analysis to the period 2006-2007, the deficit reduction is more substantial in those countries that had a higher than average debt in the Eurozone in 2005. In this case, in fact, the reduction is equal to 5.1 percentage points for each Member State in the period considered, against the 1.5 points for the reduction observed for the countries with below average debt. Italy's position deserves particular observation: the only European 15 country to have kept a gross debt ratio exceeding 100% of the GDP, with a deviation of the average of the area considered of almost 40 percentage points.

NET DEBT 2008 **Table 15**
(in % of the GDP)

	IMF	EU
France	-2,8	-2,9
Germany	-0,7	-0,5
Greece	-1,6	-2,0
Ireland	-1,3	-1,4
Italy	-2,5	-2,3
Netherlands	1,1	1,4
Portugal	-2,4	-2,2
United Kingdom	-3,1	-3,3
Spain	0,5	0,6
Sweden	2,1	2,7
Eurozone (15)	-1,1	-1,0
UE (27)	-1,4	-1,2

Source: Eurostat, April 2008

67
For this year, both the European Commission and the International Monetary Fund foresee a setback in the reduction process of the European deficit. In percentage of the product, the overall deficit should be, respectively, at 1% and at 1.1% according to forecasts of the Commission and the Fund (Table 15). The situation of the European public finances should reflect, in part, the reduction of the growth estimates (+3.1 % in 2006, +2.8% in 2007 and +2% in 2008) and for the other part, the reduction in revenue, which add to the cyclical effect, the effects of measures to reduce the tax burden in France and Germany.

Final balance 2007

68

Net borrowing of public administrations fell in 2007, according to the INSTAT data communicated to the European authorities on 1st March this year, to about 29 billion and 1.9% of the GDP (Table 16). The result is as important as it is unexpected: important, because the net debt reduction in respect of 2006 is equal to 1.5 percentage points. Unexpected, because the government forecasts disseminated last October with the forecast and policy report 2008, prefigured a deficit higher by about half a percentage point to the value recorded in the final balance.

THE PUBLIC FINANCE BALANCES **Table 16**

	2006	2007	2008	2009	2010	2011
			Million Euro			
PUBLIC ADMINISTRATION						
Net borrowing	-49.634	-29.179	-34.740	-33.463	-27.154	-24.885
Primary balance	18.610	47.547	43.616	48.361	55.408	58.416
Interest payments	68.244	76.726	78.356	81.824	82.562	83.301
Current balance	19.900	34.700	27.723	31.247	36.980	40.326
Debt (EU definition)	1.575.636	1.596.762	1.643.455	1.691.074	1.733.179	1.773.554
			In % of GDP			
PUBLIC ADMINISTRATION						
Net borrowing	-3,4	-1,9	-2,2	-2,0	-1,6	-1,4
Primary balance	1,3	3,1	2,7	2,9	3,2	3,3
Interest payments	4,6	5,0	4,9	4,9	4,8	4,7
Current balance	1,3	2,3	1,7	1,9	2,2	2,3
Debt (EU definition)	106,5	104,0	102,7	102,2	101,2	100,1

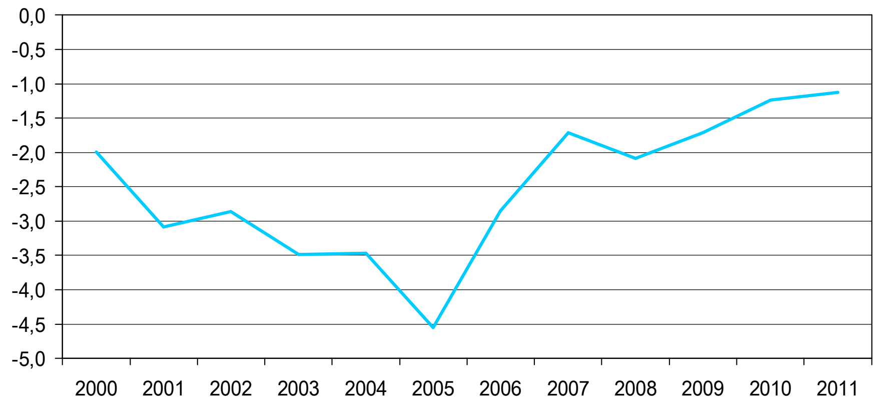
(*a) Net of economic cycle effects.*

69

Comparison with the 2006 result suffers, however, from the effects of non-structural measures arranged in the course of the two years. These measures created, both in 2006 and in 2007, an artificial increase in the level of debt, amounting in total to seven tenths of the GDP in 2006 and about two 10ths in 2007. Net of these operations, according to the reconstruction provided by RUEF, the budgetary balance results thus equal to 3% and 1.7% respectively, in 2006 and 2007. The ñrealò reduction of the deficit is thus slightly more contained, but nevertheless significant.

70
An opposite effect was determined by the sliding, from 2007 to 2008, of some major expenditure arranged in the year with the decree law 81/2007 and 159/2007[7] and of the foreseen renewals of public employment contracts. Effects that in part are compensated by the failure of the full use of some tax benefits (Irap), linked to the measures to reduce the tax wedge. In total, these effects should improve the final year result by about three-tenths of the GDP, which should result in an equal burden for this year.

STRUCTURAL NET DEBT **Graph 13**
(in % of the GDP)



71
Much more favorable could thus be the budget result registered in the final balance of the year: net of major expenditure foreseen by the two decrees mentioned above, and the sliding of expenditure and revenue, the net debt reached a level of 1.4% of the GDP, the lowest value recorded in the last 25 years.

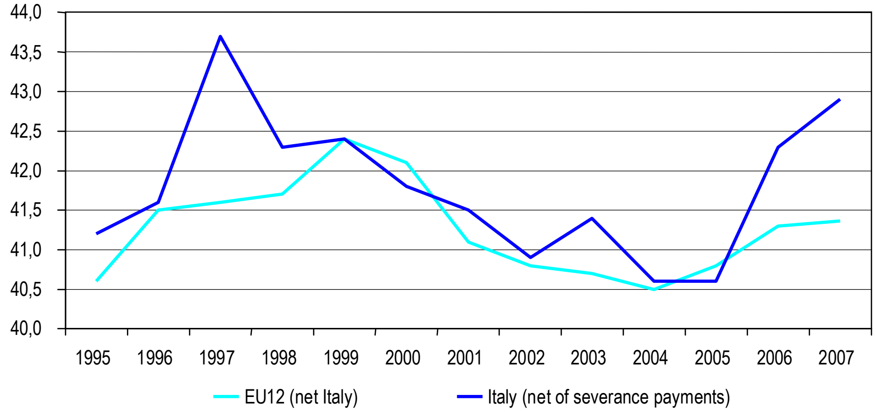
72
In structural terms, net of the cyclical component and temporary measures, net debt was reduced from 2.8 to 1.7% (graph 13). Compared to 2005, this reduction amounts to about 2.8 points of the GDP, taking into this the European recommendation of a structural adjustment of the accounts of at least 1.6 percentage points in the period 2005-2007. This reduction will allow Italy to obtain closure of the procedure for excessive deficit in the course of 2008.

73
The other balances have also seen an improvement. As a percentage of GDP, the current surplus has increased its share by a percentage point. More significant is the increase of the primary surplus, from 1.3% in 2006 to 3.1 % in 2007. In this case also, the change, net of extraordinary measures, would have been more contained, but would still have resulted as 1.6% of GDP.

(7) For a reconstruction of the major expenditure prepared with the two decrees recalled for 2007 please see the CER report nr. 3 2007.

74
A major increase instead concerns the expenditure for interest payments that increased from 4.6 to 5%. The change, nevertheless expected and discounted in government policy documents, feels the effects of more than 70% of the evolution of rates applicable on the market (8).

TAX BURDEN **Graph 14**
(in % of GDP)



75
In terms of composition, the balance results reached in 2007 differ from those observed on the average of other countries in the Eurozone, where the reduction of debt should have been driven mostly by the reduction of costs. The decrease in net borrowing in Italy depends entirely on increases in taxation: net of major non-structural expenditure and of the revenue obtained from severance payments attributed to INPS (National Institute of Social Insurance) both the reduction in net borrowing and the increase in the tax burden amounted in 2007 to eight-tenths of the GDP. The result is a further increase in the gap observed between Italyṡ tax burden and that of the Eurozone (graph 14). This difference, which between 2000 and 2006, was equal to about two tenths of a point on the year average, increased in 2007 1.4 %.

76
Part of this increase, difficult to quantify at this time, should be attributable to the recovery of tax evasions. This would explain the dynamic of the revenue exceeding that of GDP (which approximates the tax base); a difference otherwise not explainable with solely the discretionary tax measures of recent years.

77
From the expenditure side, the increase in expenditure launched with the legislative decrees during 2007 have imparted an acceleration for approximately six tenths of a

(8)Please see the letter sent to Sole 24 March 23rd 2008 by the MEF chief of the general management of public debt

point of product. On the other hand, the increase of expenditure was limited by almost the entire postponement to 2008 of the renewal of the contracts for public employment. In all, in percentage of GDP, between 2006 and 2007, total expenditure has shown a reduction of about two tenths of the GDP. Net of extraordinary items relating to this aggregate (9), an increase of four tenths of the product should have registered.

78

Among the items that make up the aggregate expenditure of current expenditure, a slowdown in the growth rate is recorded for health care spending. The Health Pact signed in 2006 and the application, albeit partial, of the recovery plans provided by the regions that had high levels of structural deficit, have allowed limiting the increase in expenditure to 0.9 % in 2007 compared to a change of still 5.4% in the previous year. Net of the slippage of renewals of public employment and of accounting, in 2006, of arrears relating to the 2004-2005 period, the change would have amounted to about 4%, allowing to substantial respect the estimated value foreseen with the 2008 OPR.

79

The public administration debt in 2007 was to 104% of the GDP, the highest of the Eurozone countries. With respect to the previous year, the debt stock marked a reduction of about 2.5 percentage points, based on the low level of needs expressed by the authorities. Assets held by the Bank of Italy for an amount equal to almost one point of GDP were also utilized.

Forecast for the 2008-2011 period

80

We estimate for this year that public administration debt will increase to 2.2% of the GDP, in line with the average provisions for the rest of the Eurozone. The increase should also be reflected on the structural balance (defined net of non-structural measures and of the effects of the economic cycle) which is expected to rise, in CER estimates, from the 1.5% of 2007 to 2.1%. The forecast of greater debt provides for several factors: firstly, the expansive sign of the public finance maneuvers prepared with the Finance Law 2008 which we evaluate equal to approximately half a percentage point; secondly, the slippages of 2007 of major expenditure and minor revenue for a total estimated by the government of about three tenths of the GDP; lastly, the public employment contracts for the financial biennium 2006-2007 will be completely renewed with the cost of a single provision of contractual arrears of about 3.5 billion. Net

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(9) In 2006, the major extraordinary expenditure concerned the shouldering of the ISPA debt by the State for 12,950 million Euro, the relegation of agricultural credits for 700 million and the refund of taxes paid by the telecommunication operators for 700 million. In the same year a reduction of expenditure was determined by the proceeds from real estate disposal for 1,683 million. In 2007, the major extraordinary outputs concern 847 Million euro of VAT repayments on company cars, 4,939 million for the loss of income paid in advance by collection agencies. In the opposite direction, a reduction of expenditure was produced by disposals from real estate for 1,437 million.

of only the extraordinary measures provided for in 2007 (10) and planned for 2008, the increase of the deficit should be 0.6 points of the product.

81

Among the other balances, primary surplus should be reduced to about 0.4 points, whilst the fall in the current balance (0.6 percentage points) should be more accentuated. The interest expenditure, following the increase registered in 2007, should remain substantially stable with a share of a tenth less than that observed in the final year balance.

82

Among the main items of the economic account, the tax break regimes linked to reducing the tax wedge and property tax on the first property should determine a modest reduction of indirect taxation incidences (Table 17). The major income tax deductions related also to the renewal of public employment contracts should instead support the level of direct taxation. On the whole, the tax burden should therefore remain on levels above 43%, as in 2007.

From the expenditure side, impact on the GDP should increase by about six 10ths for the current primary part, whilst a reduction of about three tenths should be observed, also due to the accounting effect of one-off measures, for the capital account part (Table 18).

83

The increase of current expenditure should be towed by the expenditure for the compensation of employees, while amongst the capital account components, both public investment and investment grants should remain stable on the values of 2007. The reduction of other capital expenditure should be due to the registration in 2007, of lost revenue from collection agencies.

84

In subsequent years, a nominal level of the GDP in the three years 2009-2011, sustained by a value of the deflator (2.70%) higher than that registered in the three years 2005-2007 (2.03%), also helps to lower the deficit values expressed in percentage of the GDP. As a result the expected path for net debt should be a progressive reduction up to 1.4 % in 2011. More maneuvers will be necessary to achieve a balanced budget as agreed by the EU. Such adjustments should not only cover the gap with respect to the balance, but also the necessary resources to cover the expenditure excluded from the forecast of the legislation in force.

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(10) For 2007, to the extraordinary measures on expenditure around €1 billion tax revenue must be added. A further 1 billion Euro resulting from disposals of real estate is considered for 2008 in the forecast.

DIRECT AND INDIRECT PUBLIC ADMINISTRATION TAXES

	2006	2007	2008	2009	2010	2011
			Million Euro			
DIRECT TAX	213.308	233.660	245.202	251.722	263.335	271.519
- income tax (a)	142.033	150.283	158.671	163.796	170.104	175.323
- corporation tax	39.468	50.530	51.720	52.281	57.586	61.598
- replacement tax	8.664	10.626	12.561	13.354	13.166	11.913
INDIRECT TAX	220.181	225.928	232.903	240.960	249.510	257.169
- VAT (b)	111.272	115.846	123.416	128.420	132.669	137.005
- Regional tax on business activities	37.595	39.235	37.655	38.988	41.787	43.270
- Mineral oil (c)	21.354	21.082	21.315	21.379	21.472	21.654
TOTAL TAX REVENUE	433.489	459.588	478.105	492.682	512.845	528.688
			Percentage Changes			
DIRECT TAX	12,4	9,5	4,9	2,7	4,6	3,1
- income tax (a)	7,1	5,8	5,6	3,2	3,9	3,1
- corporation tax	17,1	28,0	2,4	1,1	10,1	7,0
- replacement tax	28,1	22,6	18,2	6,3	-1,4	-9,5
INDIRECT TAX	8,6	2,6	3,1	3,5	3,5	3,1
- VAT (b)	7,7	4,1	6,5	4,1	3,3	3,3
- Regional tax on business activities	8,7	4,4	-4,0	3,5	7,2	3,5
- Mineral oil (c)	0,6	-1,3	1,1	0,3	0,4	0,8
TOTAL TAX REVENUE	10,4	6,0	4,0	3,0	4,1	3,1
			In % of GDP			
DIRECT TAX	14,4	15,2	15,3	15,2	15,4	15,3
- income tax (a)	9,6	9,8	9,9	9,9	9,9	9,9
- corporativon tax	2,7	3,3	3,2	3,2	3,4	3,5
- replacement tax	0,6	0,7	0,8	0,8	0,8	0,7
INDIRECT TAXES	14,9	14,7	14,6	14,6	14,6	14,5
- VAT (b)	7,5	7,5	7,7	7,8	7,7	7,7
- Regional tax on business activities	2,5	2,6	2,4	2,4	2,4	2,4
- Mineral oil (c)	1,4	1,4	1,3	1,3	1,3	1,2
TOTAL TAX REVENUE	29,3	29,9	29,9	29,8	30,0	29,8

(a) the revenue does not cover regional and municipal additions
(b) The revenue is expressed gross of adjusted repayments and adjustments from Sicily and Sardinia net of resources devolved to the EU.
(c) The tax does not cover the regions' partnership share to the revenue from excise duty on petrol.

85

The "legislation in force" criterion, which the CER adopts in agreement with the official estimates of the government, favorably conditions, and in no small measure, the year's results. This effect is particularly evident for expenditure where, in virtue of this criterion, major resources destined for the renewal of public employment contracts are not accountable for the part which exceeds coverage of the expected level of inflation, nor the refinancing of the laws of expenditure, particularly in capital, which find appropriation in each year with the tables attached to the proposed financial law.

86

Also in virtue of the criterion adopted, therefore, in the forecast period, the reduction expected of the current income (0.3%) between 2008 and 2011, should be more than offset by the reduction of the current expenditure (0.8%). For revenue, in percentage of the GDP, the reduction in social contributions should suffer from the modest increase in the earnings value of employee remuneration, whilst amongst indirect increases both VAT and the public dimension of production and property mass will grow less than the GDP. Amongst current expenditure, the expected reduction, as a percentage of the GDP, of income from employees should be partly offset by an increased share of expenditure to social benefits in cash. A slight reduction is estimated for the expenditure for interest in consideration of the reduction provided for the debt stock. Net of income and interests, the current expenditure incidence should result, in 2011, about four tenths higher than that observed in 2007, a level that is still incompatible with the contemporary objective to reach a balanced budget and reduce the tax burden which instead should remain, potentially, on values higher than those of 2006 (Table 19).

87

The actual stability of expenditure can be identified from looking to the dynamics of primary expenditure of public administration, net of exceptional costs, measured in real terms. As seen from graph 15 the average percentage change in the years following 2007 should remain, throughout the period considered, on levels close to those achieved in the 2004-2005 period. The variation of expenditure, at the same level as the tax burden, would therefore not be coherent with a budgetary consolidation tending to balance. Further action will be needed to ensure the European agreements, but above all, to bring the evolution of expenditure on a sustainable preordained path. In this regard, the indistinct interventions to control expenditure in recent years have proved partially ineffective and, of last, reproposed for 2008 with the financial act. More favorably seen instead, are the reconnaissance of expenditure initiatives initiated, for now on an experimental basis, on five ministries[11], with the Technical Com-

(11) Home Affairs Minister, Justice Minister, Education Minister, Minister of Infrastructure and Transport Minister.

mittee for public finance. This activity should indeed allow, through a thorough examination of the individual processes of expenditure, to achieve more forceful results both on the mechanisms of expenditure and on the size of the savings expected.

PUBLIC ADMINISTRATION CONSOLIDATED ACCOUNT **Table 18**

	Million Euro					
	2006	2007	2008	2009	2010	2011
A. CURRENT REVENUE	675,366	719,632	749,559	771,335	800,486	825,331
Direct tax	213,308	233,660	245,202	251,722	263,335	271,519
Indirect tax	220,181	225,928	232,903	240,960	249,510	257,169
Social security contributions	189,683	204,772	214,894	220,249	226,924	233,556
Other revenue	52,194	55,272	56,560	58,404	60,717	63,087
Capital Revenue	4,474	4,614	4,370	4,884	5,399	5,914
C. TOTAL REVENUE (A+B)	679,840	724,246	753,929	776,219	805,885	831,245
D. CURRENT EXPENDITURE	655,466	684,932	721,836	740,088	763,506	785,005
Collective consumption	299,074	303,950	327,113	331,216	340,235	349,404
of which:						
- income	162,889	164,645	179,422	179,006	181,433	183,495
- intermediate consumption	118,992	121,460	128,167	130,862	135,462	140,392
Interest	68,244	76,726	78,356	81,824	82,562	83,301
Social benefits	252,119	265,284	277,154	286,999	299,596	310,448
Other current expenditure	36,029	38,972	39,213	40,050	41,113	41,852
E. CURRENT EXPENSES NET OF INTEREST	587,222	608,206	643,480	658,264	680,944	701,704
CAPITAL EXPENDITURE	74,008	68,493	66,833	69,594	69,533	71,125
g. TOTAL EXPENDITURE (D+F)	33,783	34,878	37,844	41,078	40,305	41,221
Other expenditure	40,225	33,615	28,989	28,516	29,228	29,904
G. TOTAL EXPENDITURE (D+F)	729,474	753,425	788,669	809,682	833,039	856,130
CURRENT BALANCE (A-D)	19,900	34,700	27,723	31,247	36,980	40,326
NET DEBT (C-G)	-49,634	-29,179	-34,740	-33,463	-27,154	-24,885

Table 18

	% changes (*)						In % of GDP					
	2006	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010	2011
A. CURRENT REVENUE	8.0	6.6	4.2	2.9	3.8	3.1	45.6	46.9	46.9	46.6	46.8	46.6
Direct tax	12.4	9.5	4.9	2.7	4.6	3.1	14.4	15.2	15.3	15.2	15.4	15.3
Indirect tax	8.6	2.6	3.1	3.5	3.5	3.1	14.9	14.7	14.6	14.6	14.6	14.5
social security contributions	3.4	8.0	4.9	2.5	3.0	2.9	12.8	13.3	13.4	13.3	13.3	13.2
Other revenue	5.2	5.9	2.3	3.3	4.0	3.9	3.5	3.6	3.5	3.5	3.5	3.6
CAPITAL REVENUE	-24.8	3.1	-5.3	11.8	10.5	9.5	0.3	0.3	0.3	0.3	0.3	0.3
C. TOTAL REVENUE (A+B)	7.6	6.5	4.1	3.0	3.8	3.1	45.9	47.2	47.1	46.9	47.1	46.9
D. CURRENT EXPENDITURE	3.5	4.5	5.4	2.5	3.2	2.8	44.3	44.6	45.1	44.7	44.6	44.3
Collective consumption	2.8	1.6	7.6	1.3	2.7	2.7	20.2	19.8	20.4	20.0	19.9	19.7
of which:												
income	4.1	1.1	9.0	-0.2	1.4	1.1	11.0	10.7	11.2	10.8	10.6	10.4
intermediate consumption	0.1	2.1	5.5	2.1	3.5	3.6	8.0	7.9	8.0	7.9	7.9	7.9
Interest	5.5	12.4	2.1	4.4	0.9	0.9	4.6	5.0	4.9	4.9	4.8	4.7
Social benefits	4.0	5.2	4.5	3.6	4.4	3.6	17.0	17.3	17.3	17.4	17.5	17.5
Other current expenditure	0.8	8.2	0.6	2.1	2.7	1.8	2.4	2.5	2.5	2.4	2.4	2.4
CURRENT EXPENDITURE NET OF INTEREST	3.2	3.6	5.8	2.3	3.4	3.0	39.7	39.6	40.2	39.8	39.8	39.6
F. CAPITAL EXPENDITURE	26.8	-7.5	-2.4	4.1	-0.1	2.3	5.0	4.5	4.2	4.2	4.1	4.0
GROSS INVESTMENTS	-1.1	3.0	7.9	3.8	-1.8	2.2	2.3	2.3	2.4	2.5	2.4	2.3
OTHER EXPENDITURE	74.7	-17.6	-15.0	4.6	2.6	2.4	2.7	2.2	1.8	1.7	1.7	1.7
G. TOTAL EXPENSES (D+F)	5.4	3.3	4.7	2.7	2.9	2.8	49.3	49.1	49.3	49.0	48.7	48.3
H. CURRENT BALANCE	1.8	0.9	-0.5	0.2	0.3	0.1	1.3	2.3	1.7	1.9	2.2	2.3
I. NET DEBT (C-G)	-0.3	1.5	-0.3	0.1	0.4	0.2	-3.4	-1.9	-2.2	-2.0	-1.6	-1.4

(*) For the current balance and net debt variations in relation to the GDP

THE TAX BURDEN **Table 19**

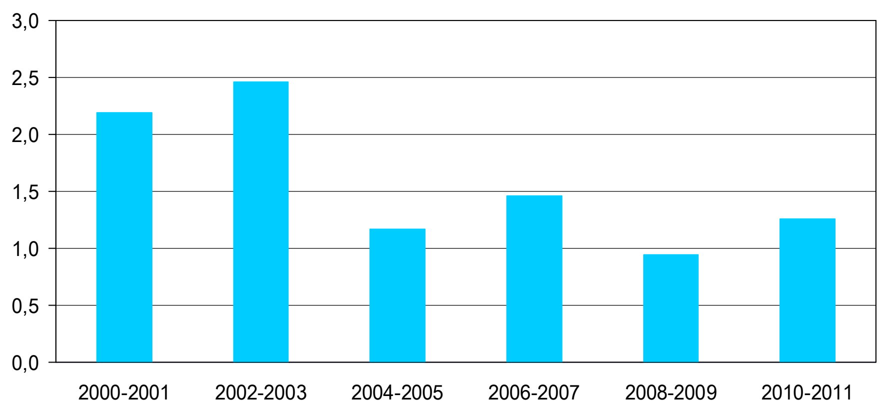
(in % of the GDP)

	2006	2007	2008	2009	2010	2011
Tax burden	29,3	29,9	29,9	29,8	30,0	29,9
Contributory burden (a)	12,8	13,3	13,4	13,3	13,3	13,2
Fiscal burden (a)	42,1	43,3	43,3	43,1	43,2	43,0

(a) Gross of imputed contributions

REAL PRIMARY EXPENDITURE AVERAGE % CHANGE **Graph 15**

(net of extraordinaries)



Similar forms of control are more prevalent in other European realities, where they have produced important results both in terms of control and the programming of expenditure (12).

88

The evolution of public debt should result more favorable which, in the event of an amount of divestiture of securities equal to about 5 billion per year and a progressive reduction of the requirements of public administrations in line with the debt forecast, should fall to below 100% in the last forecast year.

(12) For a more detailed description of the system of the English Spending Review see the CER report n.4 of 2006.

Public administration debt

89 Reaching a debt of about 60% of the product is, together with the tendency to balance the economic account, one of the fiscal rules laid down by the Maastricht Treaty, which the European Commission recommends in order to preserve the economic-financial stability of the Eurozone. An "excessive" level of public debt is in fact considered, by the same Commission (13), a problem for at least three main reasons: (i) high debt stiffens management of the budget, reducing the possibility to find resources to be allocated to possible stabilization interventions of the economic cycle or to reduce the tax burden; ii) high and increasing debt positions may lead to increases in interest rates granted on government bonds to generate displacement phenomena in respect of private investment; (iii) a growing trend of the level of debt over acceptable thresholds, even of only some EU countries, can undermine the stability of prices and the prospects for development of the whole Eurozone.

90
These concerns assume particular value in Italy, which is placed first in the ranking of European countries with the highest level of debt, but to which a position of deficit is also associated which up to two years ago exceeded 3% of the GDP. To the recommendations outlined above, are thus added the benefits that a reduction of debt would be able to produce on net debt through the reduction in expenditure on interest payments associated with it. Italy has a share of expenditure for interest payments of about 2 percentage points higher than the European average. The latest result of this combination of factors is that the adjustment maneuvers carried out annually to meet the recovery from deficit agreed with Europe have led to a level of fiscal pressure beyond which it is hardly possible to go in the coming years. The expenditure, for its part, appears not to show more scope for reductions that do not involve a radical change in institutional models.

91
The difficulties encountered in recent years and the poor results achieved in an attempt to contain public administration expenditure have definitively revealed how the reduction of expenditure cannot pass as an indistinct cut of budgetary allocations. The path towards greater efficiency of expenditure, presupposed, because on par with benefits and services, for expenditure to be attested to a lower level, requires detailed analysis and changes in the formation processes and management of State expenditure and a wide sharing of this objective with the local administrations which are increasingly taking an important role in the management of public resources. These interventions involve a radical change in the way in which the administration manages its own resources and therefore require time that is necessarily longer than the short term.

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(13) Public finances in EMU 2003, *European Commission.*

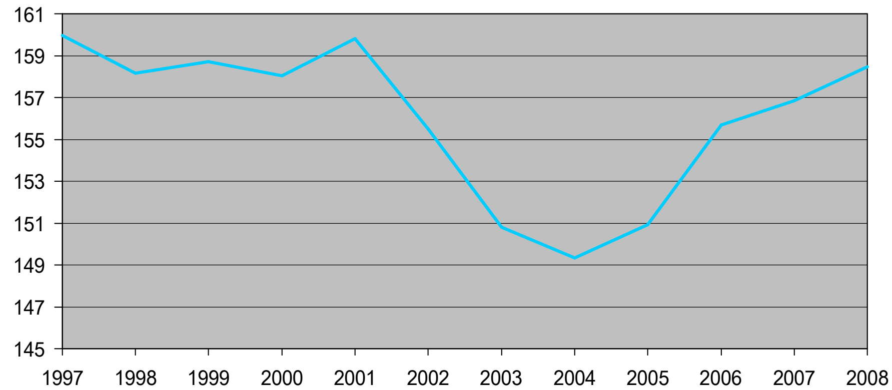
92
The commitments made with Europe, on the other hand, provide that the balancing of the budget be achieved by 2011. Currently debt amounts to about 2% of the product. For the coming years, net debt of the public authorities should, according to CER forecasts with the legislation in force, progressively decline but remain on values higher than 1%. A balanced budget would therefore not be achieved without further corrective action. Without a reconsideration of these commitments, it will be the responsibility of the new Executive to find the resources to honor this commitment. In this sense, a sudden reduction in expenditure on debt would make the path much easier, succeeding in truth, to allow recovery of the budget by itself.

93
A substantial reduction in the debt position would alleviate, in addition, the burden of excessive exposure of the budget to any movements of international interest rates. Just to have an order of magnitude, it is considered that an increase of the cost of the debt (now at 4.8%) of 2.4 tenths of a point would increase the interest payments by more than 5 billion a year.

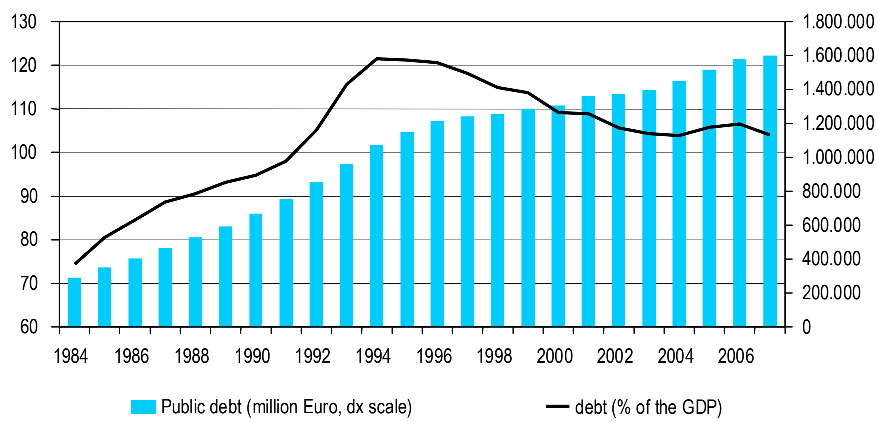
94
The objective of the reduction of the debt stock has for many years occupied a place of importance in government policy declarations. Also in a European sphere, the new formulation of the stability pact, today places greater emphasis on debt control, making its level depend on the rigor with which the countries in deficit pursue the balance. Different positions are verified in the identification of appropriate instruments to achieve this objective. Whether it is better to act through extraordinary measures of debt relief, perhaps through the transfer of relevant public shares; or instead to tenaciously pursue a policy of sustaining the primary balance is still under discussion.

The size of public administration debt
95
The general public administration debt in 2007 was, according to the data recently communicated by the Bank of Italy, equal to 104% of the GDP. In comparison with the rest of Europe, Italy is the country with the highest level of public administration debt with a gap in respect to the EU average, of about 40 percentage points. Of the same measure is the deviation, with respect to the average, of France, Germany, Spain and the United Kingdom. A gap that between 2001 and 2004 showed a reduction of about 10 percentage points has, moreover, increased again from 2005 and a further increase is also forecast for this year (graph 16).

ITALY/EU DEBIT **Graph 16**



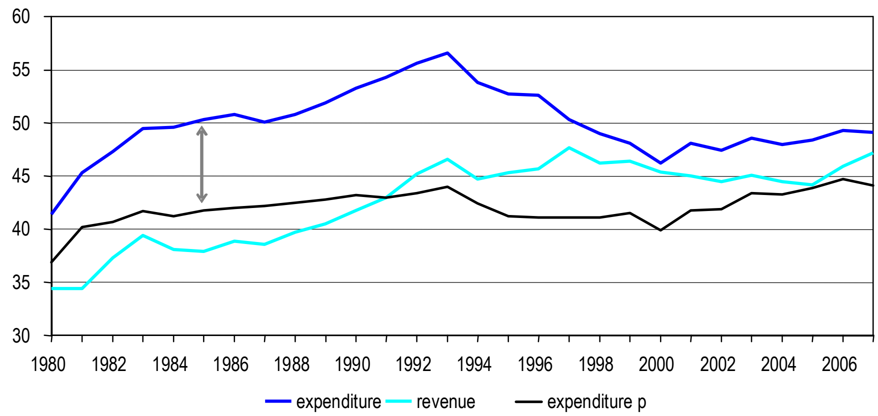
Size and evolution of public debt **Graph 17**



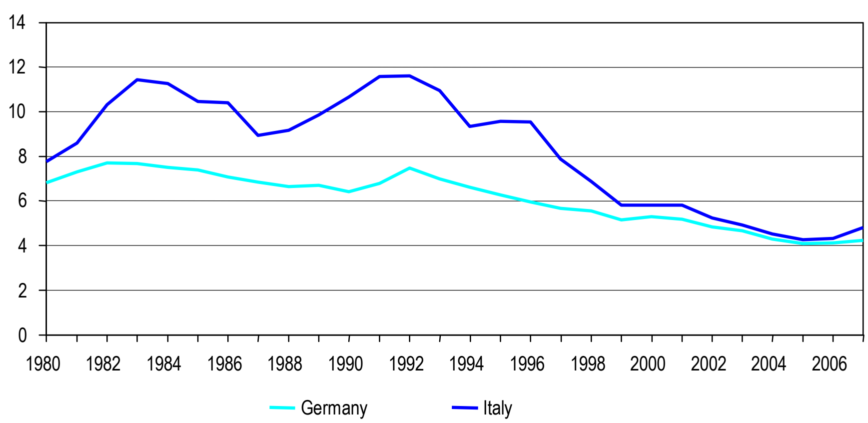
96

In historical terms, the period of maximum expansion is in the 15 years between 1980 and 1994 (graph 17). In absolute value, the public debt grew more than fourfold. In percentage of the GDP, the share doubled, from 60 to 120% (it was a little above 30% in the early 1960s) with an average annual rate of change, measured in differential terms, equal to 4.6 percentage points. The increase was encouraged, in the first decade of this period, from a level of primary expenditure constantly above the level of revenue and an amount of expenditure for interest that, between 1980 and 1994, showed an increase of almost seven points of the GDP (Figure 18). 1995 represented a turning point for public debt, which, though recording a further increase of its absolute value, started to fall in percentage of GDP. The change is however much slower than that observed in the ascending phase: the average annual reduction recorded between 1996 and 2004 added up to 1.8 points of the GDP. To this reduction contributed both the favorable development of the primary balance, which maintained until 2000, a level close to 5%, and the reduction of interest payments, that in the period 1995-2000 fell from 11.5 to 6.3%. The reduction of interest rates prevailing on international markets and Italyôs entry in the monetary union explain most of the result: the interest rate applicable on government bonds, in fact, fell in the same years from 12.2% to 5.6, while the risk premium asked of Italy on government bonds, measured as a differential on the rates charged to the emissions of Germany, descended from 5.4 to 0.3%. The progressive alignment of rates is also evident by reference to the average cost of the debt of the two countries (Figure 19). The debt grew again in the years 2005 and 2006, in consideration of a level of primary balance close to zero, but also due to some extraordinary measures including the Stateôs shouldering of the ISPA debt for the financing of the ñhigh speedò project and increased Treasury funds through the Bank of Italy to finance any VAT reimbursements on company cars following the VAT sentence.

Public Administration Expenditure and primary balance **Graph 18**



Average cost of debt: Italy-Germany **Graph19**



Determinants of the variations in debt **Table 19**

(in % of GDP)

	Debt	Change in debt	Primary balance	Average cost of debt var. rate GDP	Extraordinary	Residual
1998	114,9	-3,1	-5,1	3,4	-0,7	-0,7
1999	113,7	-1,2	-4,9	3,1	-2,1	2,7
2000	109,2	-4,6	-3,2	0,2	-1,4	-0,3
2001	108,8	-0,4	-3,2	1,3	-0,5	2,0
2002	105,7	-3,1	-2,7	1,7	-2,9	0,7
2003	104,4	-1,3	-1,6	2,0	-1,5	-0,2
2004	103,8	-0,5	-1,2	0,5	-0,9	1,1
2005	105,8	2,0	-0,3	1,9	-0,5	1,0
2006	106,5	0,6	-1,3	1,0	-0,1	1,1
2007	104,0	-2,5	-3,1	1,2	-0,3	-0,2
Total		-11,0	-21,5	12,9	-10,2	7,8

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A different perspective in the evaluation of the dynamic registered from national debt is offered with the analysis of the factors that explain the annual variation. In Table 19, for the period from 1998 to 2007, that change is subdivided into four main items: the influence on the product of the primary balance; the differential between the average cost of debt and the rate of change of the GDP; the value of the disposals of securities and other extraordinary operations; other effects such as the deviation between the level of requirements and the primary balance, the effect of the exchange rate on liabilities held in foreign currencies, the consistency of deposits held by the Treasury at the Bank of Italy and the emission differentials, are generically indicated in the table as "residual".

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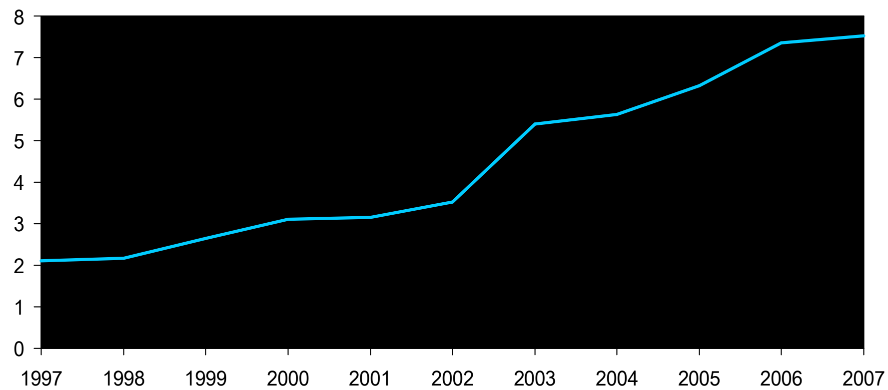
Looking at the individual items, the contribution to reducing public debt provided by the level of primary balance appears particularly sustained. In the absence of other conditions, the value of the balance net of interest between 1997 and 2007 determined a reduction of the stock of existing debt of more than 20 percentage points with a more sustained contribution in the early years of the decade considered. A positive contribution (to debt reduction) was also offered in those same years by the disposal of securities and exchange operations with the Bank of Italy, that overall produced a reduction of the debt of about 10 percentage points. Contribution of the differentials between the average cost of debt and the rate of growth of the GDP was instead constantly negative, despite the fact that the reduction of interest rates gradually approached the two variables by reducing in time the impact of this deviation. A negative effect was also exercised by residuals: among these prevailed the gap that in recent years was observed between cash needs and the relative balance. A negative contribution was also marked over the past two years by extraordinary measures taken and worsening the deficit. Amongst these, some (relinquishing collection agency advances) operate through the primary balance; others (assumption of ISPA debt, VAT refunds on company cars) produce a direct impact on the debt.

Local administration/central administration debt **Graph 20**



Debt by holders **Table 20**
(% values)

	Families	Non financial companies	Financial companies	Rest of world	Other
1995	40.4	2.5	39.7	16.5	0.9
1996	37.1	1.9	40.0	20.1	0.8
1997	32.5	1.6	40.3	24.7	0.9
1998	22.2	1.4	45.4	30.1	0.8
1999	15.1	1.3	44.2	38.2	1.2
2000	16.6	1.3	39.5	41.5	1.1
2001	17.9	1.2	38.5	41.4	1.0
2002	19.2	1.3	35.5	43.1	0.8
2003	16.1	0.8	35.5	47.2	0.4
2004	17.1	0.9	34.6	47.0	0.3
2005	13.2	0.8	33.1	52.6	0.3
2006	12.4	0.8	32.6	53.8	0.4

Local administrations have played an increasing role in the determination of debt in the last ten years, more than tripling their share in respect of the central agencies (Graph 20).

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On the other hand, it is interesting to note that the share of debt held by foreign individuals increased compared to that of families and companies (Table 20). This proportion rose to a little more than 16% in 1995 and to more than 50% in 2006, while correspondingly, that of families decreased from 40 to 12%, and, overall, that of companies from 42 to 33%. This data should not, however, deceive. The displacement observed suffers in large measure from the transfer of family savings to forms of uses that are turning increasingly to the acquisition of shares of common funds, largely taking the form of foreign commissions, rather than the direct purchase of Government bonds. This transpired from observation of data ranging from 1996 to 1999: it is in correspondence to those years that these companies began to operate and that the share of family debt decreased rapidly. It does not seem overly bold to conclude therefore that, at least in fact, still today, a share of between 30 and 40% of public debt, and therefore of its income, is held both directly or indirectly by families.

The contribution of extraordinary measures

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The major resources resulting from the effects of non-structural measures have provided, in the last decade, a contribution of great importance in the management of the balances of public finance. Overall, between 1997 and 2007, the non-structural measures produced a net debt reduction of about 10 percentage points (Table 21). These resources have had a discontinuous trend with values above one percent of the GDP in 1997-1998 and in the years 2002, 2003 and 2004. In 2005, major resources deriving from one-off measures amounted to 0.9 % of the product. The effect was to allow Italy to have access to the single market since its establishment, but also to keep net debt in periods of low growth. There is widespread agreement that by virtue of these adjustments, however, many of the structural interventions needed by the public budget have been postponed, leaving the fundamental problems unsolved and deferring the imbalances to future years.

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The temporary measures have, however, not only concerned management of the economic account. The effects of non-structural measures carried out over the past decade to reduce debt are just as relevant. Overall, including in this definition the proceeds from disposals of securities, the exchange in 2002 made with the securities held by the Bank Italy and the change of deposits held by the Treasury at the Bank of Italy, the relief brought to public debt amounts to over 11% it. If to these the temporary resources relative to borrowing are added, the total of major funds amounts to more than 20 points of GDP.

Public Administration Net Borrowing **Table 21**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
PA debt	118,1	114,9	113,7	109,2	108,8	105,7	104,4	103,8	105,8	106,5	104,0
Extraordinaries on debt:	0,9	1,5	1,4	2,1	0,2	2,0	1,9	0,4	0,4	-0,6	1,1
- disposal of securities	1,0	0,7	2,0	1,3	0,4	0,2	1,3	0,6	0,3	0,0	0,2
- exchange	0,0	0,0	0,0	0,0	0,0	1,9	0,0	0,0	0,0	0,0	0,0
- Deposit changes with BI	-0,1	0,7	-0,6	0,8	-0,2	0,0	0,6	-0,2	0,1	-0,6	0,9
Extraordinaries on borrowing	1,4	1,1	0,1	0,2	0,9	1,7	2,2	1,9	0,9	-0,2	0,1
- disposal of property	0,0	0,0	0,0	0,1	0,2	0,8	0,2	0,3	0,2	0,1	0,1
- extraordinary debt net of property disposals	1,4	1,1	0,1	0,1	0,7	0,9	2,0	1,6	0,7	-0,3	0,0

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In the absence of these measures, the debt would lie today on levels substantially higher than actual ones (Graph 21). If these adjustments had however been achieved by permanent measures and the proceeds of disposals brought to debt reduction, the public debt situation would be significantly better today. These resources in fact, just as those relating to the economic account, have not gone towards the reduction of the debt position, but rather were used to cover suspected or actual deviations of the balances in respect to the programmed values or to those desired. In many cases these operations served to compensate for the poor vivacity of the GDP, in others to compensate for a development not fully controlled by some of the items of the budget.

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Momigliano and Rizza (14) reached this result, when they observed how the extraordinary measures available from 1997 mostly had the role of containing net debt to below 3% in those years in which uncertainty on the budget result could have led to a breakthrough of the European threshold. Moreover, in many cases, the uncertainty of forecasts made on the basis of decisions to resort to these measures, ended up bestowing them a predominantly pro-cyclical aspect rather than anti-cyclical as was forecast.

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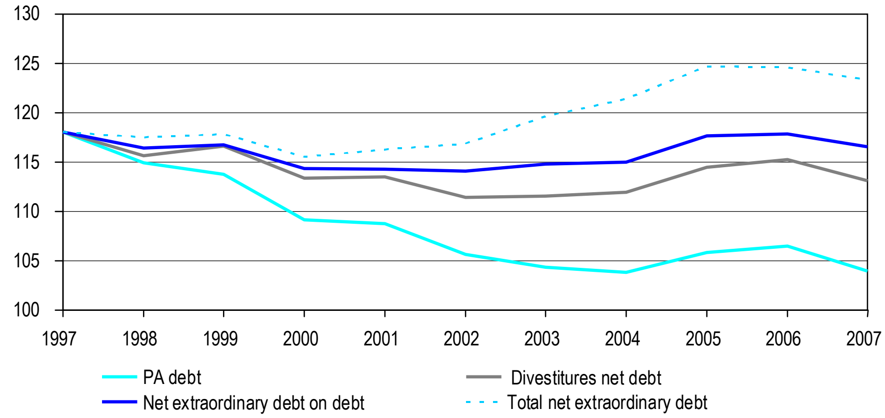
(14) Momigliano S. and Rizza P., Temporary measures in Italy: buying or losing time? *in publication, 2007.*

PUBLIC ADMINISTRATION DEBT **Graph 21**



The reduction of debt: disposal of assets or primary balance?

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The possibility of achieving a substantial reduction of public debt through the divestiture of a significant share of public assets has recently come to the attention of the debate (15). In truth such a prospect is not completely new in the Italian panorama. The transfer of financial holdings (privatization) had already been resorted to, in large doses from the 1990s, when the need to adjust the State budget in order to enter into Europe, but also the push for a greater liberalism of the market on the basis of what happened in other European countries, led the State to divest a substantial part of its fixed asset securities. The transfer of real estate, as an instrument of budget management, began at the end of the 1990s (in 1999 real estate was sold for about 600 million Euro), but the phenomenon assumed a greater dimension, and especially prospects, in the years immediately following. In 2002, the amount of real estate disposals, implemented in large part through securitizations, added up to more than 10 billion Euro. In the same year the Treasury initiated a project of monitoring and evaluation of public property, which through complex and diverse management of assets, was to contribute to reducing the debt stock in a relatively short time. The different options foresaw the direct sale of assets, or through securitization, and their exploitation and gradual transfer, through a company especially created for the management of assets, called Patrimonio Ltd and the management thereof through existing entities (such as the State Property Agency) (16).

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(15) Giuseppe Guarino, European constraints, finance and public assets. Turning the tide*, Il Mulino 2007.*

(16) Domenico Siniscalco, State Assets Ltd and Infrastructure Ltd, two instruments for economic development*, 14 May 2002.*

106
It is in this context, that the idea of aligning the disposal of monetizable goods which constitute the assets of the State and amounting to approximately 430 billion Euro (17), is sited. The disposal of the entire assets would, in a single blow, knock down the debt to about 70% of the GDP. To facilitate the disposal of an asset of such a size, the creation of a specific holding company, initially under the total control of the State to whom the assets in question are conferred, was proposed. The primary objective of the new company would be to make the assets profitable through the increase of their value. As soon as the stock should prove attractive, the transfer of the same holdings should allow obtaining the resources necessary for the original objective of killing off the debt. Of course, the success of the operation would depend on the speed with which this could be done: the longer the time needed, the lower the savings in terms of interest. Furthermore, the operation would have an initial cost equal to the surrendering of income produced in the form of dividends by holdings that would be disposed of, and about a 4.5 billion annual cost for rental charges on 150 billion Euro. All this, does not however obfuscate the results, which if fully achieved, would save interest costs of about 20 billion in each year.

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A different proposal (18) provides for increasing the value of the real estate without actual disposal. Also in this case, the initial tool is the creation of a specific company that responds to the typical Siiq (listed real estate investment companies) figure, created to encourage investment in real-estate activities with the Financial Law for 2007. The Siiq shares of public property, would subsequently be surrendered to a widespread shareholding, guaranteeing the profitability of the investment with rents and concession contracts to be defined for a period of 50 years. The stipulation of long-term concessions would guarantee the possibility of a return on the investment made on the property granted; it would allow the State instead to increase the value of the property without the loss of the assets arising from their sale. The proposal relates to a lower amount of resources amounting to approximately 50 billion: of which 48 billion concern the 13,000 buildings and land for government use and about 2 billion from income from the 400 properties passed on by the Defense to the State Property Agency.

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The conservation of the public finance equilibria however requires that dismantling of the debt continues to be accompanied by an adequate primary surplus value (19). The transfer of financial assets and real estate would complement and not replace the containment action of primary expenditure. Otherwise, the improvement of the balances resulting from the killing of the debt would not be permanent. As shown in Figure 22, the initial cull lowers the level of debt, but does not change the temporal profile. In

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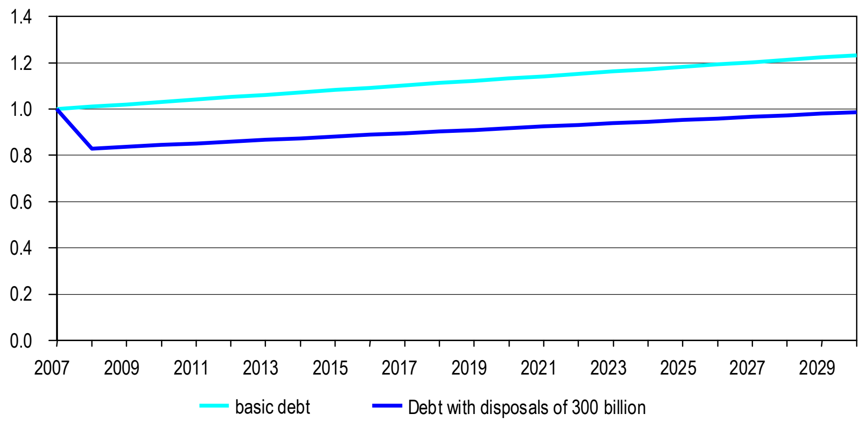
(17) Guarino, op cit.
(18) Il Sole 24 Ore, 25 March 2008.
(19) See D. Franco, Il debito pubblico italiano: è possibile abbatterlo con le dismissioni patrimoniali?*, in U. Mattei, E.Reviglio, S. Rodotà (cur.)* Invertire la rotta. Idee per una riforma della proprietà pubblica, *Il Mulino, Bologna, 2007.*

other words, if the primary balance does not retain a level which makes the evolution of the debt sustainable, the same deficit would grow again bringing public finance into a typical context of temporal inconsistency: the future years would be characterized by growing debt and a new accumulation of debt; and the promise of tax reduction would not be credible.

Effect of disposals on debt **Graph 22**



Conclusions

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There is room to re-launch a policy for an accelerated demolition of debt. The tool with which to achieve this result is the divestiture of a more or less relevant share of public property. This policy has already been adopted in past years, but the results were not satisfactory. Between 1997 and 2007, the amount of proceeds from the disposal of securities and real estate added up to of little over 10 percentage points. Not all the resources obtained concurred however to the reduction of the debt burden. A substantial part of the resources obtained from extraordinary measures was diverted from this purpose and used to cover current account deficits of the budget.

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With respect to the policy objectives already set out, the transfer of assets would allow demolition of the value of the primary balance stabilizer and therefore give substance to a path of permanent reduction of the tax burden. Furthermore, intending debt reduction for the purpose of lowering taxation incidences, within the limits of maintaining a level of primary balance that guarantees its sustainability, would allow redefining the intergenerational pact and liberate public budget management from past choices, whose discontinuity is important to promote today.