BANCA D'ITALIA
EUROSISTEMA

Economic Bulletin

Number 43 November 2006

This abridged English edition of the *Bollettino Economico* has been translated from the Italian by the Governor's Secretariat

Registration with the Court of Rome No. 426, 19 September 1985 – *Director*: SALVATORE ROSSI

C O N T E N T S

BOXES

SYMBOLS AND CONVENTIONS

Unless indicated otherwise, figures have been computed by the Bank of Italy.

In the following tables:

— the phenomenon in question does not occur

.... the phenomenon occurs but its value is not known

.. the value is known but is nil or less than half the final digit shown

( ) provisional

( ) estimated

This publication is available on the Internet at www.bancaditalia.it

Economic Developments and Policies

THE WORLD ECONOMY

Overview

The protracted expansion of the world economy continued with rapid growth in the first nine months of 2006. The growth gaps between the main industrial areas narrowed: in the euro area and the United Kingdom output expanded strongly, by 2.5 per cent (Table 1); in Japan growth strengthened to 3 per cent; in the United States, which recorded growth of 3.4 per cent, economic activity slackened beginning in the second quarter, as the property market cooled sharply. The emerging countries, primarily China and India, again contributed significantly to the expansion of the world economy, with growth in the two large Asian economies of almost 10 per cent.

Table 1

GDP and consumer prices in the main industrial countries and areas

(percentage changes on year-earlier period)

	2005		2006 first nine months	
	GDP (1)	Consumer prices	GDP (1)	Consumer prices
United States	3.2	3.4	3.4	3.7
Japan	2.7	-0.3	3.0	0.2
Euro area	1.4	2.2	2.5	2.3
United Kingdom	1.9	2.0	2.5	2.2
Canada	2.9	2.2	3.0 (2)	2.2

Source: National statistics.
(1) Chain-linked volume indices. – (2) First half.

World output is projected to increase by around 5 per cent in 2006 as a whole, more than the 4.3 per cent forecast issued by the International Monetary Fund in the autumn of last year. The effects of the much larger than expected increases in raw material prices and of the newly restrictive stance of monetary policy in the leading countries were offset by the protraction of very favourable financial conditions. The high prices of real and financial assets and their low variability, owing in part to the improvements in the structure and operation of the financial markets, continued to encourage investors to seek higher yields and occasionally to take high-risk positions. There has been a rapid increase in leveraged buy-outs, in demand for complex derivative instruments and in carry trades. The implications of these developments for financial stability are now under study and are being closely monitored by the authorities in the Financial Stability Forum.

The continuance of the favourable world cycle and the rise in raw material prices caused consumer prices to accelerate in the industrial countries. In the first nine months of the year inflation rose to 3.7 per cent in the United States, 2.3 per cent in the euro area and 2.2 per cent in the United Kingdom; it turned positive in Japan (Table 1). The central banks sought to prevent these pressures from affecting medium and long-term expectations by raising official rates, at different times and by different amounts depending on the seriousness of the threat of inflation and the performance of the economy. The Federal Reserve maintained the tight monetary policy stance adopted two years earlier until the end of June. In view of the recent signals of a sharper than expected slowdown in the US and the slight easing of long-term inflation expectations, at the beginning of August the authorities called a halt to their programme of rate increases.

Until now, the downturn in the US property market has only led to a slackening of activity in residential construction, but there is a danger it could spread to the rest of the economy.

Other risks looming in the present international scenario are the large, global external current account imbalances and the possibility of a reversal of the currently favourable international financial market conditions.

Recent developments and economic policies in the United States and Japan

United States. – GDP grew at an annualized rate of 3.9 per cent in the first half of 2006, which is in line with the average recorded in the previous three years (Table 2). Household consumption, up by 3.2 per cent, again provided the largest contribution to growth, sustained by the 4.1 per cent rise in real disposable income. This was in turn driven by labour income, which rose by 6.5 per cent in real terms, faster than at any other time since the beginning of the current expansionary phase. The saving rate remained negative at -0.5 per cent, compared with -0.9 per cent in the second half of 2005. There was a small slowdown in investment, mainly due to a decline in the residential housing sector in the second quarter of the year.

In the third quarter output growth slowed sharply to 1.6 per cent following a further drop (17.4 per cent) in residential investment. The contribution to growth of net exports and changes in inventories turned negative. Consumption rose by 3.1 per cent, benefiting from the favourable performance of the labour market: non-farm payroll employment rose by 501,000, compared with 346,000 in the second quarter. After slowing briefly in the second quarter, investment in machinery accelerated to 6.4 per cent.

Labour productivity in the non-farm sector gained an annualized 2.4 per cent in the first half of the year, with a sharp slowdown in the second quarter; in the third quarter it remained stationary. As a result of the revision of national accounts data announced in July, the average annual rate of growth in labour productivity in 2001-05 was adjusted downwards from 3.3 to 3.1 per cent. The Federal Reserve therefore decided to make a similar adjustment to the estimated potential growth rate of the economy, setting it at 3 per cent.

In the first half of 2006 corporate profits in the narrowly-defined non-financial sector, which recorded faster growth in labour productivity (annualized 6.3 per cent), increased by almost 30 per cent on an annual basis. Financial analysts predict that the profits of companies listed in the Standard&Poor's 500 index will be higher in 2007 than the already substantial figure estimated for the whole of 2006.

Large current and expected profits sustained share and corporate bond prices. The stock exchanges, which started the year at high levels, recorded further gains. The losses of May and June, when there were widespread expectations of a sharper than expected tightening of monetary conditions, were more than recouped in the months that followed. In the year to 10 November, the Standard&Poor's 500 index increased by 11 per cent and the Nasdaq 100 by 6 per cent. Price variability, which had increased briefly in May and June, returned to the low levels recorded in the early months of the year. The price/earnings ratio, which had been falling since March 2000, rose back to the average level of the last thirty years (18:1).

The risk premiums on corporate bonds remained moderate. The yield spread between the issues of firms with a high credit rating and ten-year Treasury bonds settled at about 1.4 percentage points in June, compared with an average of 1.2 points in 2005. The spread on high-yield bonds fell from 4 points at the end of 2005 to 3.1 points at the beginning of May 2006 before climbing back to around 3.5 points (Figure 1).

In fiscal 2006, which ended in September, the gross federal deficit decreased to 1.9 per cent of GDP, compared with 2.6 per cent in 2005. The improvement can be ascribed primarily to large and partly unexpected increases in revenue from individual income tax, up

Table 2

Economic indicators for the main industrial countries

(chain-linked volume indices; annualized percentage change on previous period, except where indicated)

	GDP	Household consumption (1)	Government consumption	Investment (2)	Change in stocks (3) (4)	National demand	Net exports (3) (5)
United States							
2005	3.2	3.5	0.9	7.5	-0.3	3.3	-0.3
2006 – H1	3.9	3.2	2.4	4.3	0.6	3.8	-0.1
Q1	5.6	4.8	4.9	8.2	..	5.3	..
Q2	2.6	2.6	0.8	-1.6	0.4	2.0	0.4
Q3	1.6	3.1	2.0	-1.4	-0.1	2.1	-0.6
Japan							
2005	2.7	2.3	1.7	3.2	0.1	2.5	0.3
2006 – H1	3.0	1.1	0.4	5.1	0.4	2.3	0.8
Q1	3.2	-0.2	0.1	9.9	0.8	3.0	0.4
Q2	1.5	2.0	0.8	2.4	-0.1	1.7	-0.1
Q3	2.0	-2.9	0.4	2.9	1.2	0.3	1.6
Euro area							
2005	1.4	1.3	1.4	2.6	0.1	1.7	-0.3
2006 – H1	2.9	1.8	2.6	4.5	-0.2	2.3	0.6
Q1	3.1	2.8	3.5	3.9	-1.6	1.6	1.6
Q2	3.8	1.1	2.0	8.6	0.9	3.7	0.1
Q3	2.1	....	....	....	....	....	....
United Kingdom							
2005	1.9	1.4	2.8	2.7	-0.1	1.8	..
2006 – H1	2.7	2.3	1.8	5.4	0.3	3.0	-0.3
Q1	2.6	1.5	1.3	8.1	1.6	4.1	-1.5
Q2	2.8	3.7	3.1	2.4	-1.6	1.8	0.9
Q3	3.0	....	....	....	....	....	....
Canada							
2005	2.9	3.9	2.7	7.1	0.5	4.3	-1.9
2006 – H1	3.0	4.5	3.6	7.3	-0.2	4.9	-2.1
Q1	3.6	5.1	2.6	9.4	-1.3	5.5	-0.8
Q2	2.0	4.2	4.7	2.7	1.7	4.0	-4.2

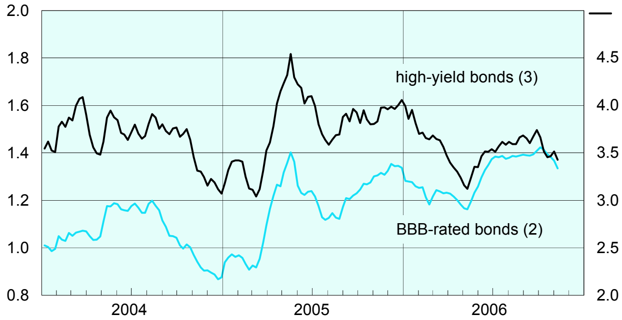
Sources: National statistics and Eurostat.

(1) Comprises consumption of resident households and non-profit institutions serving households. – (2) For the United States, private investment; public investment is included under "government consumption". – (3) Contribution to GDP growth with respect to the previous period, at an annual rate, in percentage points. For the United States, calculated following the methodology of the Bureau of Economic Analysis. For the United Kingdom and Canada, our estimates. – (4) Includes statistical discrepancies and, for the euro area and the United Kingdom, changes in valuables. – (5) Goods and services.

13 per cent, and taxes on corporate profits, up 27 per cent. At the end of fiscal 2006 the total federal debt decreased slightly, to 37 per cent of GDP, marking the end of four years of growth.

Figure 1

United States: yield differentials between corporate bonds and 10-year Treasury bonds (1)
(average weekly data; percentage points)



Source: Merrill Lynch.
(1) The last available data refer to the week ending 10 November 2006. – (2) Left-hand scale. – (3) Right-hand scale.

Japan. – GDP grew by 3 per cent in the first nine months of 2006, compared with 2.2 per cent in the year-earlier period. The contribution of private investment increased, while that of consumption remained stationary.

Household consumption rose by 1.6 per cent in the nine months, sustained by the increase in employment. From January to September, the number of employed persons rose by 0.7 per cent and the unemployment rate declined by 0.2 points, to 4.2 per cent. In the same period real wages averaged 0.5 per cent lower than in the corresponding period of 2005.

Given the high capacity utilization rate, the upswing in private investment – to growth of 7.6 per cent in the first nine months, compared with 6.3 per cent a year earlier – was fostered by good corporate profitability. This was particularly marked among large companies, whose profits increased by 13.2 per cent in the first half over the year-earlier period. According to the Tankan survey of September, firms plan to continue increasing capacity in the coming months.

In response to the strong performance of corporate profits, the Nikkei share index, which had begun to climb in the middle of 2005, continued to make gains throughout the first four months of 2006. It declined sharply from the beginning of May to mid-July owing to heightened uncertainty about the timing of the reversal of the monetary policy stance, but later picked up. By 10 November it had recouped part of its losses and returned to a level close to that of the beginning of the year.

According to IMF estimates, the structural public deficit (including social security), will remain unchanged with respect to 2005 at 5.2 per cent of GDP, while the structural primary deficit should decrease by 0.2 percentage points to 3.8 per cent. Recent estimates released by the Bank of Japan indicate that at the end of September the gross public debt amounted to 162.3 per cent of GDP.

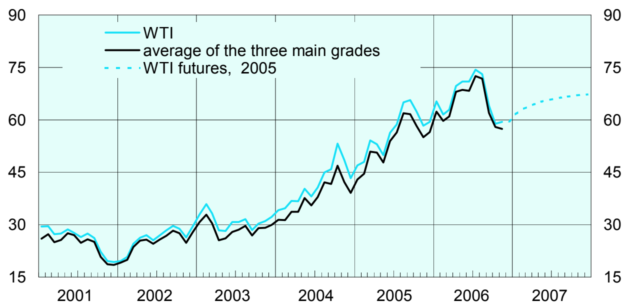
Oil prices, inflation and monetary policy in the leading industrial regions

Inflationary pressures, which had developed in 2005 as the leading industrial areas approached full employment and the prices of oil and other raw materials spiralled upwards, gained strength in the course of 2006.

The price of crude oil, which had risen by around 40 per cent during 2005, jumped by 30 per cent between December of that year and the average of July and August 2006, from \$56 to over \$70 a barrel (average of the three main grades; Figure 2). While demand still ran high, market supply was rigid: although the unexploited capacity of the OPEC

Figure 2

Crude oil: spot prices and futures (1)
(dollars per barrel)



Sources: IMF and Thomson Financial Datastream.
(1) Monthly averages for spot prices. For futures: prices on 10 November 2006. The three main grades are Dubai, Brent and WTI.

countries (excluding Iraq) had risen slightly above the previous year's exceptionally low levels, it was still only no more than 2.8 million barrels a day in October, corresponding to around 3 per cent of estimated world demand in 2006. As a consequence, prices were highly sensitive to even small shocks. This year's price rises have been triggered mainly by tensions associated with the delicate political situation in the Middle East, the frequent terrorist attacks on oil infrastructures in Nigeria, and, in the summer, to the halting of production at a major plant in Alaska. In September, after the tensions had eased and current and expected demand in the US had slackened, prices fell sharply to $58 a barrel by 10 November.

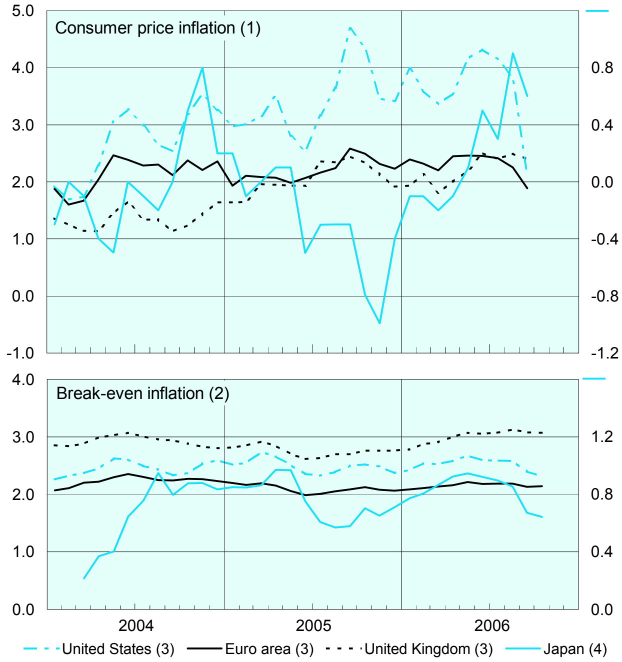
On 19 October OPEC decided to cut actual production by 1.2 million barrels a day (about 1.4 per cent of world demand) as of 1 November. The decision was taken in response to the declining price of crude oil and reports of a rapid expansion of US oil reserves and did not lead to any significant changes in spot prices. Futures contracts on WTI grade, now standing at $60 a barrel, indicate an increase to an average of about $65 in 2007. The prices of options on futures also suggest that the likelihood of a surge in oil prices diminished sharply after the beginning of August, and is now on a part with that of an equivalent drop.

In the United States the rise in oil prices began to push up prices as early as the middle of 2005: consumer price inflation rose brusquely from 2.5 per cent in June 2005 to 4.3 per cent a year later (Figure 3). Core inflation too has been increasing since the spring of this year: on the basis of the general consumer price index it accelerated from 2.1 to 2.9 per cent between March and September inflation, while on the basis of the deflator of consumption (excluding energy and food products) it rose from 2 to 2.4 per cent, a level the monetary authorities judge to be incompatible with price stability. The sharpening of inflationary pressures can also be ascribed to the rapid increase in unit labour costs in the non-farm sector, at an annualized rate of 6.6 per cent in the first half of the year (compared with 2 per cent in 2005) and again of 3.8 per cent in the third quarter.

In the first half of the year the Federal Reserve raised the federal funds target rate by 0.25 percentage points on four separate occasions. At the FOMC meeting of 30 June it reached 5.25 per cent, bringing the total rise since June 2004 to 4.25 points (Figure 4). In the same period the yields

Figure 3

Consumer price and break-even inflation in the main industrial countries

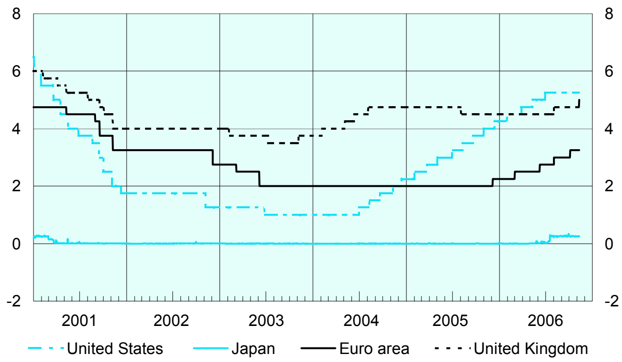


Sources: Thomson Financial Datastream and Bloomberg.

(1) General price index. Monthly data; twelve-month percentage changes. – (2) Spread between nominal interest rates on 10-year government bonds and corresponding yields on inflation-indexed government bonds. Average monthly data; percentage points. – (3) Left-hand scale. – (4) Right-hand scale.

Figure 4

Official interest rates (1)
(daily data; percentages)

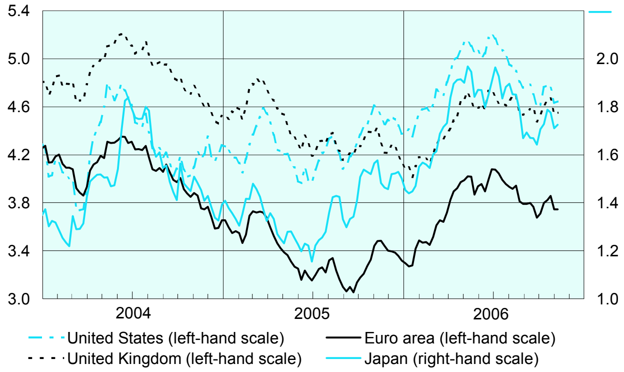


Sources: ECB and national statistics.

(1) For the United States: federal funds target rate; for Japan: money market overnight rate; for the euro area: interest rate on the main refinancing operations; for the United Kingdom: repo rate. The last available data are for 10 November 2006.

Figure 5

Yields on 10-year government bonds in the main areas (1)
(average weekly data; percentages)

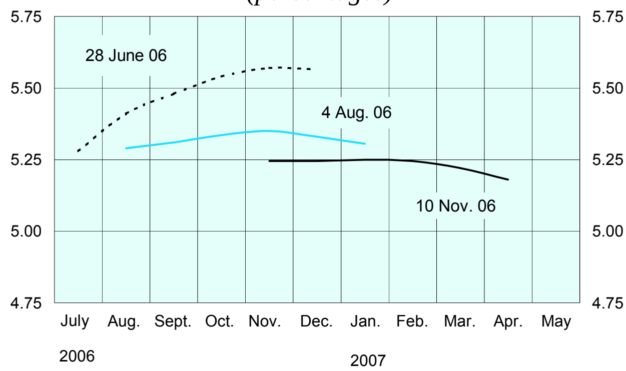


Source: Thomson Financial Datastream.
(1) The last available data refer to the week ending 10 November 2006.

on ten-year Treasury bonds rose by 0.8 points to 5.2 per cent (Figure 5). Between mid-May and the end of June, as the risk of inflation sharpened, the markets increasingly expected official rates to be raised further in the second half of the year (Figure 6). However, at the end of the FOMC meeting of 30 June the Federal Reserve announced it had become less concerned about price pressures and was convinced that the slowdown in economic activity would encourage a deceleration. Expectations for monetary policy were quickly revised and the markets correctly anticipated the Federal Reserve's decision to leave interest rates unchanged at the meetings of August, September and October.

Figure 6

United States: forward interest rates implicit in futures on 30-day federal funds at various dates (1)
(percentages)

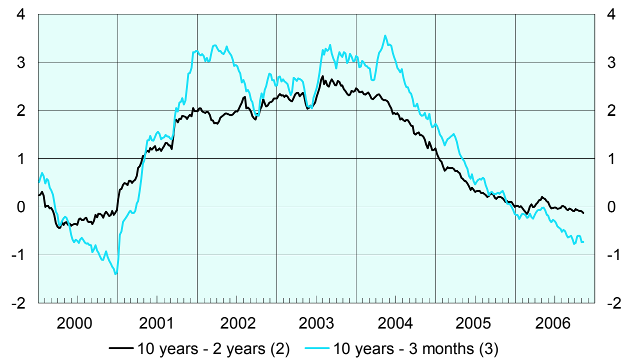


Source: Thomson Financial Datastream.
(1) Each curve relates to the contract date indicated. The horizontal axis shows the settlement dates for the futures contracts to which the yields refer.

Long-term interest rates fell rapidly from the end of June onwards, reaching around 4.6 per cent by 10 November. The spot yield curve measured by the differential between ten-year and two-year interest rates remained virtually flat; the differential vis-à-vis three-month interest rates, which had turned slightly negative at the end of 2005, widened to around 0.7 points by 10 November, the lowest value since January 2001 on the eve of the last US recession (Figure 7). This term structure of interest rates suggests there are expectations that the economic slowdown will continue in the coming quarters; moreover, the markets apparently assume that the current and expected slowdown, together with the lagged effects of the monetary tightening, will be sufficient to curb inflationary pressures. The prices of futures on the 30-day federal funds rate on 10 November indicate that operators do not expect any change to monetary conditions at the next FOMC meeting on 12 December (Figure 6). The trend of long-term inflationary expectations based on the differential between the yields on ten-year Treasuries and the yields on inflation-indexed government securities with the same maturity, which narrowed by 0.3 percentage points between the end of June and mid-November to 2.3 per cent, is compatible with this scenario.

Figure 7

United States: spot yield differentials (1)
(average weekly data; percentage points)



Source: Thomson Financial Datastream.
(1) The last available data refer to the week ending 10 November 2006. – (2) Differential between interest rates on 10-year and 2-year Treasury bonds. – (3) Differential between interest rates on 10-year Treasury bonds and 3-month dollar-denominated interbank eurodeposits.

Demand for US shares and corporate bonds remained strong from July onwards, partly in response to the sharp drop in yields on Treasury paper. The signals from the two markets appear to be in conflict in that a rise in the prices of corporate issues reflects expectations of a strengthening of the economic cycle, while a fall in the yields on government securities points to expectations of a slowdown. However, the trends can be reconciled if one considers that strengthening expectations of a less restrictive monetary policy could have had the same effect as an unexpected increase in liquidity, prompting investors to step up their demand for both types of securities.

In Japan the recovery of economic activity strengthened in 2006, gradually helping to overcome the long deflationary phase of recent years. In the middle of July the central bank raised the overnight call rate, which had been fixed close to zero since the spring of 2001, to 0.25 per cent. This decision ended the uncertainty about the timing of the monetary policy reversal that had arisen in the spring when the central bank abandoned its earlier policy of increasing liquidity. At the end of August, a revision of the consumer price index was announced following the updating of the basket; it showed overall and core inflation to be lower than previously believed. The new figures indicate that the change in consumer price inflation had not turned positive until May 2006 and stood at 0.6 per cent in September; in that month, the measure of core inflation used by the monetary authorities, which excludes fresh food prices, was 0.2 per cent. After the release of these figures the Bank of Japan pointed out that the revision did not alter the assessment of the economic situation and that, given the persistent upward trend in inflation and robust performance of demand, it could not rule out a second 0.25 point increase in the reference rate before the end of the year.

From the end of 2005 the Eurosystem also gradually made monetary conditions less accommodating as the area's growth prospects improved and risks for price stability increased with the rise in energy prices and in medium-term inflationary expectations. Between December 2005 and mid-November 2006 the rate of interest on the main refinancing operations was raised five times, from 2 to 3.25 per cent.

In the United Kingdom consumer price inflation increased from the spring onwards, reaching 2.4 per cent in September (Figure 3), under the influence not only of the robust growth of output, but also of the rises in raw material prices and some contingent factors. Long-term inflationary expectations deduced from index-linked securities gradually increased from 2.8 per cent in January to 3.1 per cent in October. The Bank of England sought to counter these tendencies by raising the reference rate for monetary policy in August and November by a total of 0.5 percentage points, to 5 per cent.

China, India and Latin America

China. – GDP expanded more rapidly than expected throughout 2006, with growth averaging 10.7 per cent in the first nine months, compared with 9.9 per cent in the year-earlier period (Table 3). The acceleration was driven mainly by capital investment, while the increase in consumption was virtually unchanged from the previous year. The increase in consumer prices, most of which are still administered, was very moderate, averaging 1.3 per cent in the first nine months of the year.

With abundant inflows of capital, domestic monetary and credit conditions remained extremely expansionary despite the measures taken by the monetary authorities, such as raising interest rates on bank loans and the reserve ratios. M2 growth, which peaked at twelve-month rates of more than 19 per cent in January and May, declined only slightly at the beginning of the summer and in September stood at 16.8 per cent; in the same month the volume of bank lending was 15.2 per cent larger than a year earlier.

The favourable financial conditions, combined with high corporate profits, continued to fuel investment. In the first nine months of 2006 investments in urban areas, accounting for 86 per cent of the total, increased by 28.2 per cent in nominal terms with respect to the year-earlier period, although performances differed by sector. Investment activity was again substantial in property services and building (30 per cent) and in plant and machinery (46 per cent), sectors which together draw a third of the total. Fixed assets increased by over 50 per cent in banking and insurance, which account, however, for

Table 3

Economic indicators for selected emerging countries

(constant prices; percentage change on year-earlier period, except where indicated)

	% of world GDP in 2005 (1)	GDP					Domestic demand (2)					Next exports (3)				
		2005	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2005	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2005	2005 Q4	2006 Q1	2006 Q2	2006 Q3
Latin America																
Argentina	0.9	9.2	9.0	8.8	7.9	....	9.7	10.1	10.2	8.5	....	-0.2	-0.8	-1.0	-0.3	....
Brazil	2.6	2.3	1.4	3.4	1.2	....	....	....	....	....	....	....	....	....	....	....
Mexico	1.8	3.0	2.7	5.5	4.7	....	3.8	3.6	6.6	5.7	....	-0.9	-1.1	-1.2	-1.2	....
Asia																
China	15.4	10.2	9.9	10.3	11.3	10.4	....	....	....	....	....	....	....	....	....	....
India (4)	5.9	8.2	7.5	9.3	8.9	....	7.6	....	....	....	....	1.1	....	....	....	....
Indonesia	1.6	5.6	4.9	4.7	5.2	....	6.7	3.3	1.6	3.7	....	-0.5	1.9	3.2	1.8	....
Malaysia	0.5	5.2	5.2	5.5	5.9	....	4.2	2.9	11.5	9.6	....	1.3	2.4	-4.5	-2.8	....
Philippines	0.7	5.0	5.3	5.7	5.5	....	4.0	3.2	0.5	-1.9	....	0.6	1.8	5.1	7.6	....
South Korea	1.6	4.0	5.3	6.1	5.3	4.6	2.8	2.5	5.9	3.1	3.5	1.4	2.9	0.8	2.4	1.4
Taiwan	1.0	4.0	6.4	4.9	4.6	....	1.7	-2.8	1.3	-0.9	....	2.5	9.0	3.7	5.4	....
Thailand	0.9	4.5	4.7	6.1	4.9	....	7.6	6.8	-2.1	-2.6	....	-2.2	-1.1	8.1	7.4	....
Europe																
Poland	0.8	3.2	4.3	5.2	5.5	....	1.9	....	....	....	....	1.3	....	....	....	....
Russia	2.6	6.4	7.9	5.4	7.5	....	9.7	10.4	10.5	11.9	....	-2.4	-1.8	-4.0	-3.4	....
Turkey	0.9	7.4	9.5	6.5	7.5	....	8.8	11.6	8.6	10.0	....	-1.7	-2.3	-2.8	-3.6	....

Sources: National statistics, IMF and European Commission.

(1) On the basis of purchasing power parities. – (2) Includes change in stocks and statistical discrepancies. – (3) Contribution to GDP growth in relation to the same period of the previous year in percentage points. Both goods and services. – (4) GDP at factor cost.

a very small proportion of total investment and need strengthening in view of the authorities' intention to develop the financial markets. Investment in energy amounted to 16.1 per cent.

India. – Gross domestic product, which had been expanding rapidly since the summer of 2003, recorded a year-on-year increase of 9.1 per cent in the first half of 2006, compared with 8.5 per cent in that of 2005. Activity was again powered by the expansion of the service sector, which recorded growth of 10.7 per cent, as in the same period of 2005. The acceleration of GDP reflected that in manufacturing and agriculture, which recorded growth of 10 and 4.5 per cent respectively, compared with 9.4 and 2.1 per cent in the year-earlier period.

The robust expansion in economic activity and rise in energy prices heightened the inflationary pressures that had emerged in 2005. In June of this year consumer price inflation rose to 7.7 per cent. The restrictive measures adopted by the central bank, which gradually raised the repo rate by 1 percentage point between October 2005 and November 2006, helped to contain inflation, which eased to 6.8 per cent in September.

According to official estimates in the current fiscal year ending in March 2007 the public deficit should fall to 6.5 per cent of GDP, compared with 7.5 per cent in fiscal 2005. The government has launched a programme to adjust the public finances, mainly by progressively broadening the tax base.

Latin America. – GDP growth, which resumed at a rapid pace in all the main Latin American countries in 2004, is expected to accelerate from 4.4 per cent in 2005 to 4.8 per cent in 2006, mainly thanks to the strengthening of economic activity in Brazil (from 2.3 to 3.2 per cent) and Mexico (from 3 to 4.4 per cent); in Argentina growth should remain very rapid at 8 per cent (9.2 per cent in 2005). The acceleration in output in the area was mainly driven by domestic demand, which was boosted by more expansionary economic policies. Financial conditions remained easy; the yield differential between dollar-denominated government securities and US Treasury securities, which averaged 2.8 percentage points in the area at the end of 2005, narrowed to 2 points by the second half of 2006.

The easing of monetary conditions during 2006 in some of the main countries was rendered possible by the newly acquired credibility of monetary policy, which succeeded in curbing the inflationary impact of the acceleration in economic activity. According to the IMF, inflation in the region as a whole should fall from an average of 6.3 per cent in 2005 to 5.3 per cent in 2006.

The sharp rises in raw material prices, of which the Latin American countries are major producers and exporters, sustained public sector revenues and permitted improvements in government fiscal balances despite the substantial increases in public spending.

Global imbalances and exchange rates

The global balance-of-payments disequilibria widened further in 2006, notwithstanding the moderating impact of the narrowing of the growth gaps between the leading industrial areas. The performance of the terms of trade further boosted the revenues of the oil and raw material exporting countries; as in the previous two years, most of these funds were invested on the international financial markets.

The current account deficit of the United States increased to $863 billion on a yearly basis in the first half of 2006, equal to 6.6 per cent of GDP (Table 4), compared with $792 billion and 6.4 per cent in 2005. The widening of the positive growth differential between export and import volumes fostered the basic stabilization of the non-energy trade deficit. The rise in energy prices led to a $45 billion increase in expenditure with respect to 2005. The balance on investment income turned negative by $7 billion; until last year it had been positive ($18 billion in 2005) despite the increase in the net debtor position of the United States.

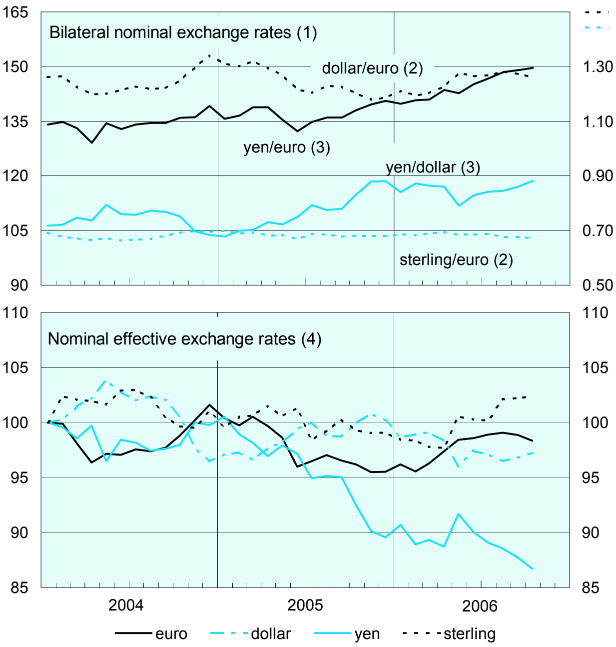
In the first half of 2006 China's current account surplus increased by $25 billion with respect to the year-earlier period, to $92 billion. Customs data indicate that in the first ten months of this year, the trade surplus reached $134 billion, some $54 billion more than in the same period of 2005. This was the outcome of a 27 per cent surge in exports and an acceleration in imports to growth of 21 per cent, from 17 per cent in the year-earlier period. The increase in the current account surplus in 2006 as a whole with respect to the previous year is therefore expected to top the IMF's estimate of $23 billion. The current account surpluses of the other Asian countries, including Japan, are expected to remain at the same high levels as in 2005.

According to IMF estimates, the current account surplus of the main oil exporting countries should reach $541 billion in 2006, equal to 14 per cent of GDP, compared with $367 billion and 11.4 per cent in 2005. In the Latin American countries the surplus should stabilize at 1.2 per cent of GDP, compared with 1.4 per cent in 2005.

The overall performance of exchange rates did not help to reabsorb the imbalances in the external accounts. In the first ten months of the year the dollar depreciated by just 2.9 per cent in nominal effective terms (Figure 8), owing to sharply divergent

Figure 8

Exchange rates of the leading currencies
(monthly averages)



Sources: ECB and our calculations.
(1) Units of the first currency per unit of the second. – (2) Right-hand scale. – (3) Left-hand scale. – (4) Indices, January 2004=100. A rise indicates an appreciation.

Table 4

Current account of the balance of payments and foreign exchange reserves

	Current account						Foreign exchange reserves	
	2004		2005		2006 (1)		2005	2006 (2)
	$ billion	% of GDP	$ billion	% of GDP	$ billion	% of GDP	$ billion	$ billion
United States	**-665.3**	**-5.7**	**-791.5**	**-6.4**	**-863.2**	**-6.6**	**-21.8**	**1.5**
Euro area	**63.0**	**0.6**	**-28.7**	**-0.3**	**-50.0**	**-0.5**	**-26.7**	**4.0**
Japan	**172.1**	**3.8**	**165.8**	**3.6**	**163.8**	**3.7**	**0.4**	**29.1**
Asia	**183.1**	**4.1**	**257.7**	**5.0**	**269.9**	**4.7**	**234.8**	**221.7**
Newly industrialized Asian economies (3)	88.7	7.0	86.2	6.0	78.5	5.0	15.6	32.6
Hong Kong	*15.7*	*9.5*	*20.3*	*11.4*	*16.4*	*8.7*	*0.7*	*3.1*
Singapore	*26.3*	*24.5*	*33.2*	*28.4*	*38.0*	*28.5*	*3.6*	*14.1*
South Korea	*28.2*	*4.1*	*16.6*	*2.1*	*3.3*	*0.4*	*11.3*	*15.3*
Taiwan	*18.5*	*5.7*	*16.1*	*4.7*	*20.7*	*5.8*	*....*	*....*
Asean-4	24.9	4.0	19.0	2.8	24.8	3.1	6.9	25.8
Indonesia	*1.6*	*0.6*	*0.3*	*0.1*	*0.7*	*0.2*	*-2.0*	*7.3*
Malaysia	*14.9*	*17.2*	*20.0*	*20.3*	*22.9*	*19.6*	*4.0*	*9.1*
Philippines	*1.6*	*1.4*	*2.4*	*1.8*	*2.8*	*1.9*	*2.8*	*2.4*
Thailand	*6.9*	*4.2*	*-3.7*	*-2.1*	*-1.6*	*-0.8*	*2.0*	*7.0*
China	68.7	3.6	160.8	7.2	184.2	7.2	207.0	166.4
India	0.8	0.1	-8.3	-1.1	-17.6	-2.1	5.3	27.8
Latin America	**18.2**	**0.9**	**33.7**	**1.4**	**34.7**	**1.2**	**34.8**	**27.1**
Argentina	3.4	2.3	5.8	3.2	2.2	1.0	8.3	-0.9
Brazil	11.7	1.9	14.2	1.8	5.8	0.6	0.8	13.0
Chile	1.6	1.7	0.7	0.6	2.5	1.8	0.9	..
Oil-exporting countries	**212.5**	**7.9**	**366.8**	**11.4**	**540.7**	**14.0**	**112.9**	**137.5**
OPEC (4)	126.0	10.9	238.6	17.1	355.0	20.5	45.3	49.0
Algeria	*11.1*	*13.1*	*21.7*	*21.3*	*30.8*	*24.8*	*13.1*	*14.1*
Indonesia	*1.6*	*0.6*	*0.3*	*0.1*	*0.7*	*0.2*	*-2.0*	*7.3*
Iran	*1.4*	*0.9*	*14.0*	*7.3*	*24.5*	*10.0*	*....*	*....*
Kuwait	*17.3*	*31.1*	*32.3*	*43.3*	*48.8*	*52.5*	*0.6*	*1.8*
Libya	*7.3*	*24.2*	*15.6*	*40.2*	*23.5*	*47.9*	*13.8*	*7.6*
Nigeria	*3.2*	*4.6*	*12.3*	*12.4*	*19.1*	*15.7*	*11.3*	*10.9*
Qatar	*7.6*	*26.5*	*7.1*	*20.6*	*22.0*	*49.1*	*1.1*	*0.8*
Saudi Arabia	*52.0*	*20.7*	*90.8*	*29.3*	*119.8*	*32.9*	*-0.8*	*-1.1*
United Arab Emirates	*10.6*	*10.2*	*19.1*	*14.7*	*37.2*	*21.0*	*2.5*	*4.0*
Venezuela	*13.8*	*12.5*	*25.4*	*19.1*	*28.7*	*17.5*	*5.5*	*3.7*
Mexico	-6.7	-1.0	-4.6	-0.6	-0.5	-0.1	9.9	9.6
Norway	34.6	13.6	49.7	16.8	66.0	19.9	2.7	2.6
Russia	58.6	9.9	83.2	10.9	120.1	12.3	55.1	76.3

Sources: IMF and national statistics.

(1) For United States, Japan and euro area, first six months on an annual basis; for the other countries and areas, IMF forecasts, *World Economic Outlook*, September 2006, and national statistics. – (2) First eight months; for China, first nine months; for Latin America, Brazil, Philippines and Hong Kong, first seven months; for South Korea, UAE and Libya, first six months. – (3) The flow of foreign exchange reserves does not include Taiwan. – (4) The OPEC aggregate does not include Iraq. The flow of foreign exchange reserves does not include Iran.

performances with respect to the main currencies. Between the end of 2005 and 10 November 2006 the dollar weakened heavily against the euro (9 per cent) and sterling (11 per cent) as the growth gap between the United States and the European countries narrowed and the expected short-term interest rate differential in favour of the US currency diminished accordingly. By contrast the dollar remained stable against the currencies of the leading Asian countries, which account for around half of the US trade deficit. The US currency's initial 5 per cent depreciation against the yen in the first five months of 2006, in conjunction with the strengthening of expectations of an imminent change in Japan's monetary policy, was entirely absorbed in the months that followed; this was partly due to investors' resumption of carry trades, with short-term borrowing of yen to buy dollars. The dollar depreciated slightly against the renminbi, by just 2.6 per cent, and remained virtually stationary with respect to the currencies of the oil-exporting countries.

In the first nine months of the year the Chinese monetary authorities countered upward pressures on the renminbi by rapidly building up their dollar reserves, increasing them by around $170 billion, against $207 billion in the whole of 2005, and bringing the stock to $990 billion in September. In the first eight months of 2006 the leading oil exporters accumulated more currency reserves than in the whole of the previous year ($138 billion against $113 billion), augmenting the stock to around $680 billion.

ECONOMIC DEVELOPMENTS IN THE EURO AREA AND ITALY

Overview

The cyclical recovery under way in the euro area since the summer of 2005 gained strength. In the first six months of this year GDP accelerated to annualized growth of around 3 per cent with respect to the second half of 2005. The difference vis-à-vis the United States, now equal to one percentage point, continued to narrow. According to preliminary estimates, in the third quarter GDP grew at an annualized rate of 2.1 per cent.

Amidst national variants, common developments are discernable (Figure 9 and Table 5). From the second half of 2005 onwards, in conjunction with the rapid expansion in world demand, the upturn in euro-area firms' competitiveness assisted a recovery in exports. The effects were gradually transmitted to investment, especially in machinery and equipment, partially as a consequence of a reduction in stocks and the erosion of spare capacity. Labour market conditions also improved.

In Italy, after stalling in the fourth quarter of 2005 GDP returned to growth, driven by both domestic and foreign demand. In the first six months of 2006 it expanded at an annualized rate of more than 2 per cent. The growth gap vis-à-vis the other main countries of the area narrowed but persisted, confirming the Italian economy's structural problems.

Economic activity continued to expand after mid-year, though at a slightly slower pace than in the first half. According to the preliminary estimate released by Istat, GDP grew in the third quarter at an annualized rate of 1.3 per cent. In the same quarter the index of industrial production rose by 0.6 per cent with respect to the second. After falling by one percentage point in September, the index is estimated to have remained more or less stationary in October and November. Business confidence, which had improved uninterruptedly in the first half of the year, began to falter in August (Figure 10).

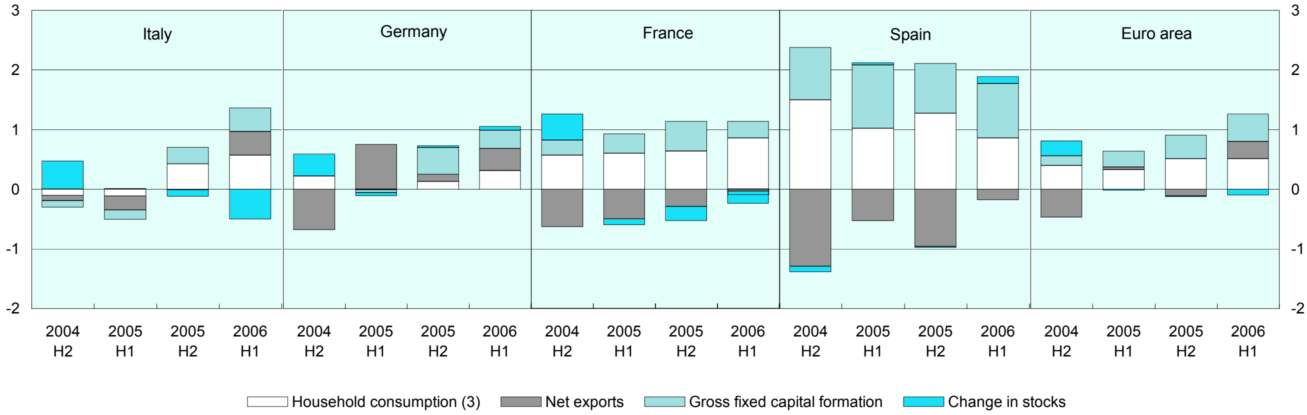
The euro area

Production. – In the first half of 2006 the rate of growth in euro-area GDP rose to about 3 per cent

Figure 9

Contributions of the main components of demand to the growth of GDP in the euro area and the major euro-area countries (1)

(percentage points; chain-linked volumes) (2)



Source: Based on national statistics.

(1) Excludes consumption of general government. – (2) For France, volumes at 2000 prices. – (3) Consumption of resident households and non-profit institutions serving households.

Table 5

GDP, imports and the main components of demand in the major euro-area contries
(chain-linked volumes; percentage changes)

	On the corresponding period							On the previous period, annualized					
	2005			2006				2005		2006			
	Q3	Q4	Year	Q1	Q2	Q3	H1	Q3	Q4	Q1	Q2	Q3	H1
							GDP						
Germany (1)	1.5	1.7	0.9	1.9	2.7	2.8	2.3	2.1	1.1	3.2	4.4	2.6	3.0
France (1)	1.3	0.9	1.2	1.3	2.6	1.9	2.0	2.8	0.8	2.0	4.9	..	2.4
Italy (1)	0.1	0.5	..	1.7	1.7	1.7	1.7	1.3	-0.1	3.1	2.6	1.3	2.2
Spain (1)	3.6	3.6	3.5	3.6	3.7	3.8	3.7	3.4	3.9	3.8	3.8	3.6	3.8
Euro area (1)	1.7	1.8	1.4	2.2	2.7	2.6	2.4	2.5	1.5	3.1	3.8	2.1	2.9
							Imports						
Germany	7.8	7.9	6.5	14.0	10.6	….	12.3	14.6	7.0	19.5	2.1	….	11.8
France	6.0	7.7	6.1	8.0	10.3	….	9.2	11.3	10.8	5.8	13.6	….	8.9
Italy	2.3	1.4	1.4	4.8	3.4	….	4.1	0.2	3.5	5.7	4.2	….	4.8
Spain	7.7	6.6	7.0	12.4	7.9	….	10.1	14.4	3.7	17.9	-3.0	….	8.7
Euro area	5.8	5.6	5.3	9.7	8.2	….	8.9	10.1	6.7	11.3	4.7	….	8.4
							Exports						
Germany	9.5	8.9	6.9	12.7	11.3	….	12.0	17.5	4.8	21.3	2.7	….	12.2
France	4.6	4.0	3.1	7.8	9.1	….	8.5	13.3	3.4	13.5	6.6	….	9.2
Italy	-0.1	1.8	0.3	5.9	5.2	….	5.5	-0.9	5.3	9.7	6.9	….	7.9
Spain	2.5	2.3	1.5	9.5	5.3	….	7.4	8.6	-4.7	25.1	-5.0	….	9.1
Euro area	5.4	5.0	4.2	9.3	8.6	….	9.0	10.8	3.8	15.4	4.8	….	9.7
							Household consumption (2)						
Germany	1.0	-0.6	0.1	0.9	0.5	….	0.7	2.4	-3.0	4.4	-1.4	….	1.0
France	2.5	1.8	2.0	2.2	3.0	….	2.6	3.3	2.2	3.3	3.0	….	3.0
Italy	0.7	0.4	0.1	1.9	1.5	….	1.7	1.6	-0.3	3.6	1.0	….	1.9
Spain	4.2	3.8	4.2	3.8	3.7	….	3.7	4.6	4.8	1.9	3.4	….	3.0
Euro area	1.8	1.1	1.3	1.8	1.7	….	1.8	2.6	0.4	2.8	1.1	….	1.8
							Gross fixed capital formation						
Germany	1.5	3.0	0.8	2.7	6.2	….	4.4	7.7	5.2	-2.3	14.8	….	3.7
France	4.4	4.2	3.6	3.4	4.5	….	4.0	7.1	4.2	0.1	7.0	….	2.8
Italy	1.0	0.1	-0.6	3.7	2.9	….	3.3	4.6	-5.7	8.5	4.8	….	3.9
Spain	7.1	6.6	7.2	6.3	6.1	….	6.2	4.6	8.6	5.4	5.7	….	6.3
Euro area	3.4	3.4	2.6	3.8	4.8	….	4.3	4.9	1.8	3.9	8.6	….	4.5
							National demand						
Germany	0.5	1.0	0.5	1.7	1.7	….	1.7	0.4	1.8	1.2	3.5	….	1.9
France	1.8	2.1	2.1	1.5	3.1	….	2.3	2.4	3.3	-0.3	7.1	….	2.4
Italy	0.8	0.4	0.2	1.4	1.1	….	1.2	1.5	-0.5	1.8	1.5	….	1.1
Spain	5.3	5.0	5.0	5.0	4.7	….	4.9	5.6	6.3	3.3	3.8	….	4.1
Euro area	1.7	2.0	1.7	2.2	2.5	….	2.3	2.1	2.5	1.6	3.7	….	2.3

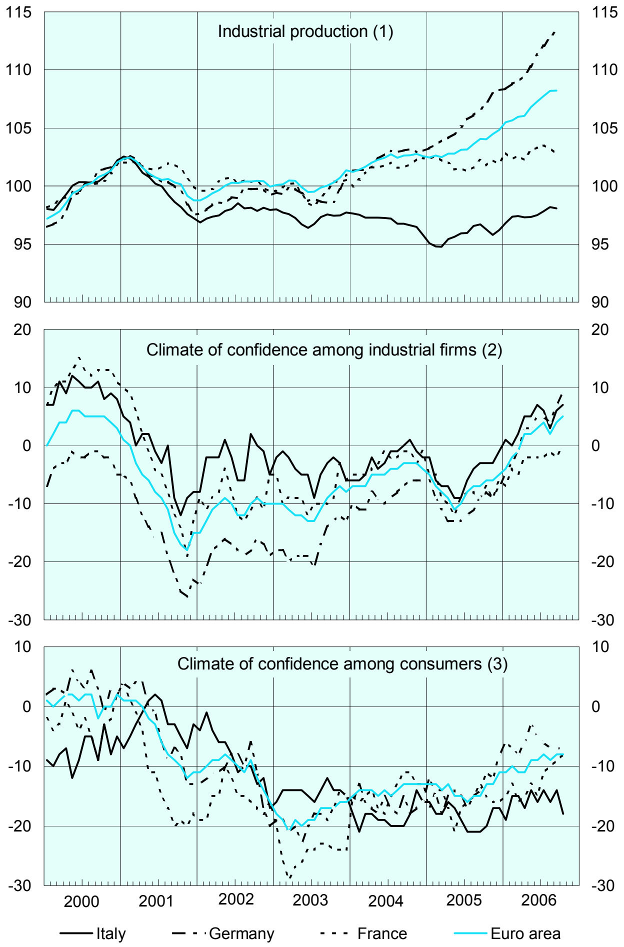
Sources: Based on national statistics for individual countries, Eurostat estimates for the euro area.

(1) Interim GDP figures are provisional and not necessarily consistent with the performance of the components. – (2) Comprises consumption of resident households and non-profit institutions serving households.

on an annualized basis (Table 5). The expansion was especially strong in industry (4.7 per cent). Domestic demand grew at the same pace as in the previous six months; the acceleration in GDP, due to net foreign demand, reflected the pick-up in exports accompanied by a slowdown in imports. During the first half the contribution of investment increased.

Figure 10

Industrial production and the climate of confidence among firms and consumers in the euro area and selected euro-area countries
(monthly data)



Sources: Based on national statistics and European Commission data.

(1) Index, 2000=100. Moving averages for the three months ending in the reference month. Data adjusted for the different number of working days in the month and seasonally adjusted. – (2) Climate of confidence calculated by the European Commission as the average of the seasonally adjusted percentage balances between positive and negative responses to questions regarding the level of orders, stocks of finished products and production expectations. – (3) Climate of confidence calculated by the European Commission as the weighted average of the seasonally adjusted percentage balances between positive and negative responses to questions on consumers' expectations regarding the economic situation, their personal financial situation, unemployment and the possibility of saving.

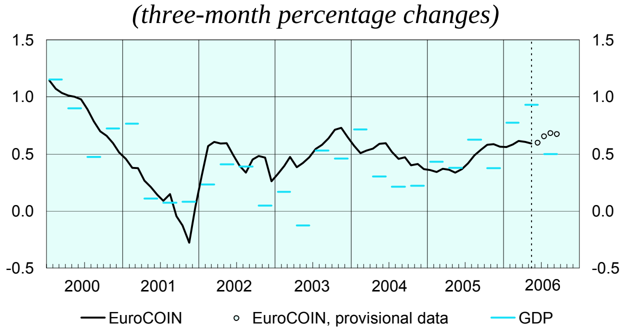
The growth differentials between the main euro-area economies diminished in the first half of 2006. In Germany the expansion – 3 per cent on an annualized basis – was sustained primarily by the recovery in domestic demand and is now more balanced among the different components. In France and Spain, where national demand continues to grow swiftly, fuelling imports, it was the acceleration in exports that lifted the pace of GDP growth to 2.4 and 3.8 per cent respectively. The improvement in exports sustained the acceleration in GDP in Italy as well.

The manufacturing sector recorded high and rising rates of growth in the main countries, confirming the signs of expansion given by the surveys of business confidence (Figure 10). In the first six months of the year the value added of industry rose at an annualized rate of 2.5 per cent in Germany, 2.1 per cent in France and 1.3 per cent in Spain, but remained stationary in Italy.

The preliminary estimates of GDP signalled a slowdown in the third quarter, sharper in France, where output stagnated, and less marked in Germany, Italy and Spain, where the pace of expansion was 2.6, 1.3 and 3.6 per cent respectively. In the same period the EuroCOIN cyclical indicator, which has shown an uptrend since the spring of 2005, held constant at levels consistent with GDP growth slightly above its long-term rate (Figure 11). The euro-area index of industrial production is estimated to have risen by about one percentage point with respect to the previous quarter. The climate of confidence among manufacturing firms improved further, pointing to a continuation of the current cyclical expansion (Figure 12).

Figure 11

EuroCOIN coincident indicator of the euro-area business cycle and GDP (1)
(three-month percentage changes)

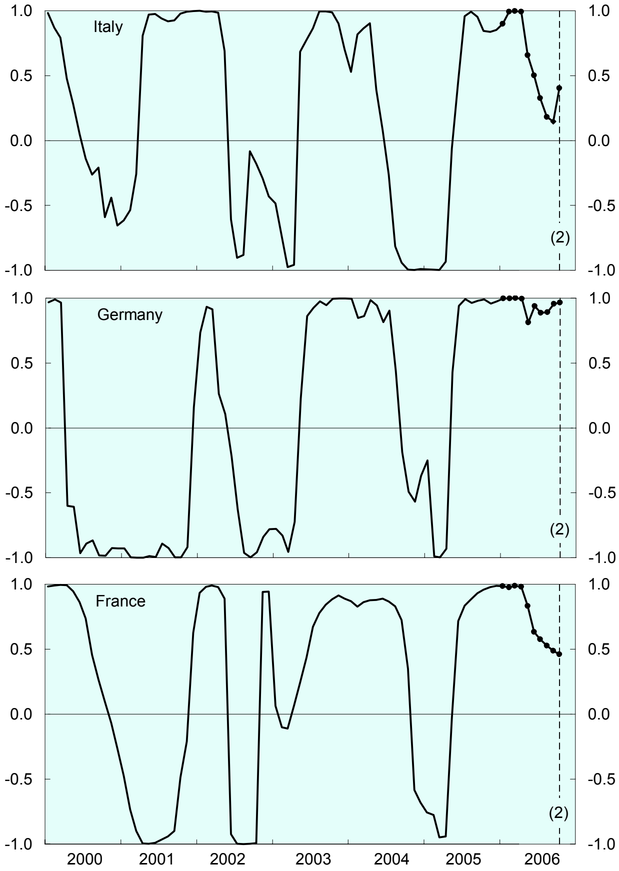


(1) The method of constructing the indicator is described in the "Note metodologiche" section of the Appendix to the Bank's Annual Report for 2002 in Italian. For each month the change in GDP is the average variation for the relevant quarter.

Figure 12

Industrial production turning-point indicators (1)

(monthly data)



Source: Based on national statistics.

(1) For the method of construction of the indicators, see the box "Indicatori dei punti di svolta della produzione industriale nell'area dell'euro e nei principali paesi membri", *Bollettino Economico* No. 42, 2004. The indicators are given by the difference between the estimates of the probability of a cyclical expansion and a cyclical recession in industrial production. – (2) Updated to October.

Household consumption. – In the first half of 2006 euro-area household consumption rose at an annualized rate of 1.8 per cent, as in the second half of 2005. For some years now its moderate growth has been the outcome of differing developments at national level, weak spending by households in Germany and, to a lesser extent, Italy, contrasting with a brisker trend in France and Spain.

In Germany the pick-up in consumption to annualized growth of 1 per cent in the first half, from 0.4 per cent, appears to reflect a moderately more optimistic attitude of households, signalled by the recovery in confidence towards the end of 2005 and in the first half of this year (Figure 10). With real disposable income basically flat, households' confidence was probably buoyed primarily by the employment level, which has been rising constantly since the start of 2006, notably as regards permanent jobs. In the most recent months, however, the climate of confidence appears to have been dampened by the announced increase in VAT as of 1 January 2007. After peaking in May, the index fell steadily during the summer before stabilizing in the last two months. Uncertainties as to the measure's impact on spending behaviour persist.

In France consumption grew at an annualized rate of 3 per cent in the first half of 2006, compared with about 2 per cent in the previous half. Spending was boosted by the growth in households' real disposable income resulting from the reduction in unemployment, the increase in nominal wages and moderate inflation. The saving rate declined slightly, in line with a trend under way for about three years, but still remained higher than in the late 1990s. The climate of household confidence, stable in the first six months of the year, has been improving sharply since mid-year.

Investment and stocks. – Though with differing trends at national level, euro-area investment maintained a rapid pace in the first half, expanding at an annualized rate of 4.5 per cent. Investment has strengthened progressively since the autumn of 2005, favoured by the reduction in spare capacity to a five-year low and by still advantageous financing conditions.

In Germany gross fixed investment grew at an annualized rate of 3.7 per cent, lower than in the second half of 2005. Robust expansion in spending on machinery and equipment was accompanied by essentially flat investment in construction. The acceleration in the former component was sustained by greater optimism among firms, which expect the recovery to strengthen. The reduction in spare capacity in all branches of economic activity prompted firms to focus again on expanding the base of production. In the construction sector too the climate of confidence among firms and the rise in orders foreshadow the start of a recovery after the recession of the past decade.

In France the pace of investment growth fell in the first half to 2.8 per cent, from approximately 5 per cent in the second half of 2005, reflecting the sharp slowdown in spending on capital equipment, which more than offset the acceleration in that on construction. Although the climate of confidence among firms has improved steadily since the summer of last year, the capacity utilization rate remains below the peak recorded during the previous cyclical expansion. After improving in the first half of the year, firms' opinions regarding the level of orders for capital goods worsened slightly in the third quarter. Construction investment gained pace during the first half. Residential building has been expanding very rapidly over the last two years: easy access to credit, tax incentives for renovation work and favourable borrowing terms continue to sustain housing demand. Non-residential construction, decidedly less dynamic, suffers primarily from the weakness of public works.

In the area as a whole, the improvement in demand is also confirmed by the broadly-based reduction in stocks of finished products reported by the European Commission's survey of manufacturing firms.

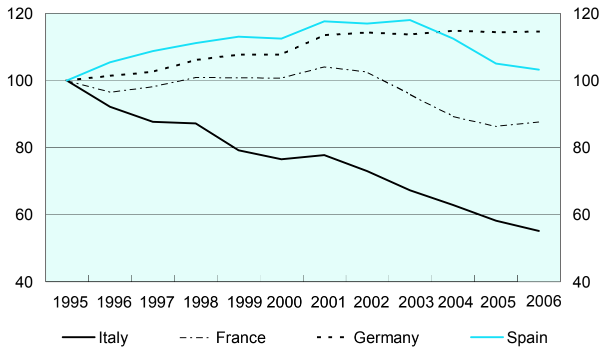
Exports and imports. – All the main euro-area countries recorded high rates of export growth in the first half of the year as global demand expanded vigourously.

Germany's exports grew at an annualized rate of 12 per cent, as in the previous half. Given an unfavourable movement in the euro's exchange rate, export flows were strongest towards other euro-area countries and the EU's new members. Imports grew at similar rates, reflecting the high proportion of imported inputs used in producing export goods. Net exports contributed 0.7 percentage points to the growth of GDP on an annualized basis.

Germany benefits more than the other major euro-area economies from the stimulus of foreign demand. Between 1995 and 2005 its share of world trade in goods at constant prices rose by 1.5 percentage points, while France's fell by 1 point and Italy's by 2 (Figure 13). Over the same period the ratio of exports to GDP at current prices rose in Germany from 24 to 40 per cent, while it basically held constant in Italy and France at around 25 per cent. Confirming the German economy's high propensity to export, Germany's national statistical institute has calculated that in 2005 some 25 per cent of all jobs in payroll employment originated from foreign trade (17 per cent in 1995).

Figure 13

Shares of world merchandise exports in volume terms: Italy, France, Germany and Spain (1)
(indices, 1995=100)



Sources: Based on Istat and IMF data.
(1) The figures for 2006 are estimated.

In France, exports accelerated in the first half of 2006 to annualized growth of about 9 per cent. The French economy's problems of competitiveness in recent years, shown in the progressive loss of market shares, were attenuated by the recovery in demand in Germany, France's leading export market. Fuelled by very robust domestic demand, imports also grew by approximately 9 per cent. The contribution of net exports to GDP growth in the half was basically nil, compared with a negative contribution of 0.4 percentage points on average in the last five years.

The balance of payments. – In the first eight months of 2006 the euro-area current account deficit rose to €22 billion (0.4 per cent of GDP), from €8.7 billion in the corresponding period of 2005 (Table 6). The merchandise trade surplus plunged from €43.7 billion to €5.4 billion, owing mainly to the jump in oil prices. By contrast, the surplus on services improved slightly and the deficit on income diminished. The balance on transfers remained about the same. Against an overall deficit on the current and capital accounts of €17.1 billion, the area's financial account showed a surplus of €125.2 billion, compared with

Table 6

Balance of payments of the euro area
(millions of euros)

	2005			2006	
	Year	H1	January-August	H1	January-August
Current account	**-23,148**	**-8,954**	**-8,707**	**-20,469**	**-21,953**
Goods	54,085	33,162	43,653	3,507	5,386
exports	*1,220,048*	*583,650*	*783,878*	*671,527*	*894,825*
imports	*1,165,961*	*550,486*	*740,223*	*668,020*	*889,440*
Services	34,754	14,374	20,353	16,871	21,687
Income	-43,749	-24,309	-28,828	-8,907	-3,345
Current transfers	-68,238	-32,181	-43,884	-31,940	-45,680
Capital account	**12,515**	**5,004**	**6,584**	**2,999**	**4,815**
Financial account	**79,142**	**68,306**	**69,735**	**116,858**	**125,184**
Direct investment	-156,286	-38,463	-135,550	-43,686	-55,902
outward	*-232,665*	*-69,529*	*-174,262*	*-161,578*	*-176,418*
inward	*76,380*	*31,066*	*38,713*	*117,890*	*120,515*
Portfolio investment	155,411	114,764	178,513	121,747	107,275
Equity securities	138,897	16,306	125,922	78,761	105,739
assets	*-140,577*	*-49,919*	*-75,091*	*-77,925*	*-93,645*
liabilities	*279,474*	*66,225*	*201,013*	*156,686*	*199,384*
Debt instruments	16,513	98,457	52,590	42,986	1,535
assets	*-302,152*	*-165,769*	*-217,607*	*-157,289*	*-204,939*
liabilities	*318,665*	*264,226*	*270,197*	*200,275*	*206,474*
Financial derivatives	-15,245	-5,993	-5,272	-10,223	-12,318
Other investment	76,491	-9,958	21,586	44,289	83,015
Reserve assets	18,768	7,954	10,455	4,732	3,115
Errors and omissions	**-68,510**	**-64,356**	**-67,613**	**-99,391**	**-108,050**

Source: ECB.

a deficit of €69.7 billion in the year-earlier period. As has been the case for some years now, the errors and omissions item was therefore again large and negative (-€108.1 billion); the amount is expected to diminish once the provisional data are superseded by the final data. Reserve assets fell by €3.1 billion.

Exports grew strongly in both value and volume (11.5 and 7.6 per cent respectively in the first eight and seven months of the year), fuelled by the global expansion and favoured by a moderate improvement in price competitiveness (1 per cent with respect to the average of the first eight months of 2005).

In the first eight months of 2006 direct and portfolio investment showed overall net inflows of €51.4 billion, compared with €43 billion in the year-earlier period. The sharp drop in net direct investment outflows and portfolio investment inflows reflected the fact that in 2005 outward direct investment and inward portfolio investment had included a major exchange of shares between a euro-area multinational corporation and one of its non-euro-area affiliates. Thanks in part to the resurgence of mergers and acquisitions, in the first eight months of the year both outward and inward direct investment remained substantial (€176.4

billion and €120.5 billion respectively). In portfolio investment, the equity component grew among assets while remaining stationary among liabilities. Flows of portfolio investment in debt instruments issued by non-residents were basically unchanged, while investment by non-residents in securities other than equities issued by area residents declined.

In January-August 2006 the reduction in Germany's current account surplus (€57.7 billion, against €64 billion in January-August 2005) was caused by the contraction in the merchandise trade surplus (€88.9 billion, down from €98.3 billion). Net direct and portfolio investment outflows rose from €0.4 billion to €14 billion, primarily owing to the drop in net portfolio investment inflows. In France the current account deficit widened slightly to €20.7 billion, reflecting an increase of just under €3 billion in the trade deficit. The financial account recorded stable net outflows of direct investment and a large rise in those for portfolio investment, concentrated in debt instruments.

Italy

Production. – In the first half of 2006 GDP grew at an annualized rate of 2.2 per cent, compared with 1.2 per cent in the second half of 2005. As in the last five years, growth was lower than in the rest of the euro area. The increase in GDP was driven by national demand and, to a lesser extent, by exports (Table 7). Value added rose by 2.7 per cent in

Table 7

Italy: resources and uses of income

(chain-linked volumes; seasonally adjusted and adjusted for number of working days; annualized percentage changes on the previous period, except as indicated)

	As a percentage of GDP in 2005 (1)	2005				2006			
		Q3	Q4	H2	Year	Q1	Q2	Q3	H1
Resources									
GDP (2)	–	1.3	-0.1	1.3	..	3.1	2.6	1.3	2.2
Imports of goods and services	25.0	0.2	3.5	3.4	1.4	5.7	4.2	....	4.8
Goods	19.9	-0.1	2.3	2.9	-0.1	2.4	2.5	....	2.4
Services	5.1	1.4	8.5	5.3	7.5	20.4	11.0	....	15.0
Uses									
Gross fixed capital formation	20.5	4.6	-5.7	2.7	-0.6	8.5	4.8	....	3.9
Construction	9.6	1.8	..	3.0	0.5	5.6	0.4	....	2.9
Machinery, equipment and sundry products	9.1	6.7	-11.1	2.8	-1.0	8.9	2.7	....	2.0
Transport equipment	1.9	9.6	-7.1	0.7	-4.6	23.1	42.2	....	19.2
Consumption of resident households	58.3	1.6	-0.3	1.5	0.1	3.6	1.0	....	2.0
Durable goods	6.1	11.8	-3.0	7.3	0.6	1.9	3.2	....	1.0
Non-durable goods	6.5	-2.0	-3.6	-0.9	0.7	1.1	-2.6	....	-1.0
Semi-durable goods	18.2	3.5	2.7	2.3	-3.7	8.7	5.4	....	6.3
Services	28.6	2.5	2.7	2.0	0.2	4.2	2.9	....	3.5
Consumption of general government and non-profit institutions serving households	20.4	0.4	0.3	0.4	1.2	0.7	0.9	....	0.7
Changes in stocks and valuables (3)	0.3	-0.5	0.8	-0.2	0.1	-2.2	-0.3	....	-1.0
Total national demand	99.6	1.5	-0.5	1.3	0.2	1.7	1.4	....	1.1
Exports	25.4	-0.9	5.3	3.2	0.3	9.7	6.9	....	7.9
Goods	20.3	-4.1	-1.7	-1.1	-0.8	13.2	6.5	....	7.6
Services	5.1	13.4	36.6	22.4	4.6	-1.9	8.5	....	9.1

Source: Based on Istat data.

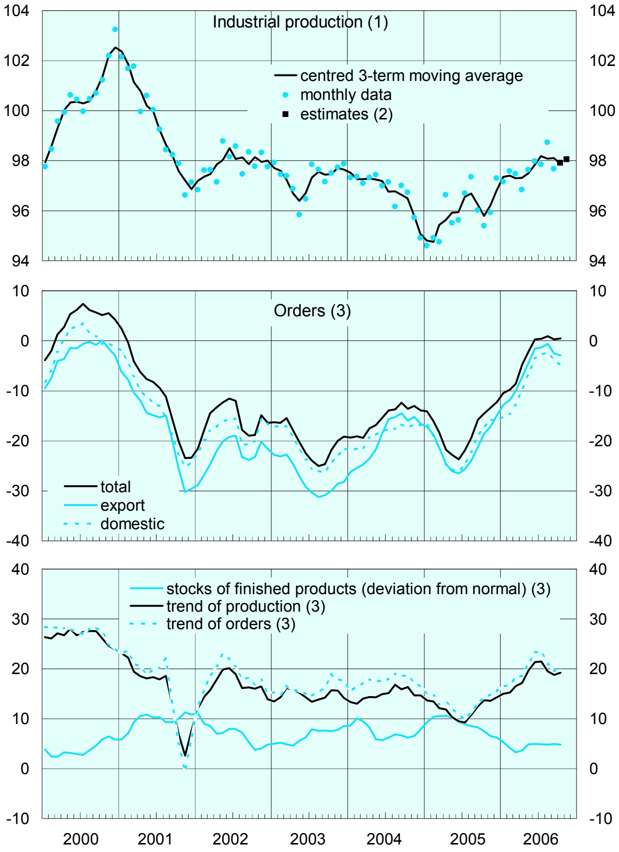
(1) Volumes at previous year's prices. – (2) Interim GDP figures are provisional and not necessarily consistent with the performance of the components. – (3) Annualized contribution to GDP growth with respect to previous period, in percentage points.

services, accelerating sharply with respect to the two previous half-years, while in industry it remained more or less stationary.

Figure 14

Italy: industrial production, orders and stocks

(monthly data)



Sources: Based on Istat and ISAE data.

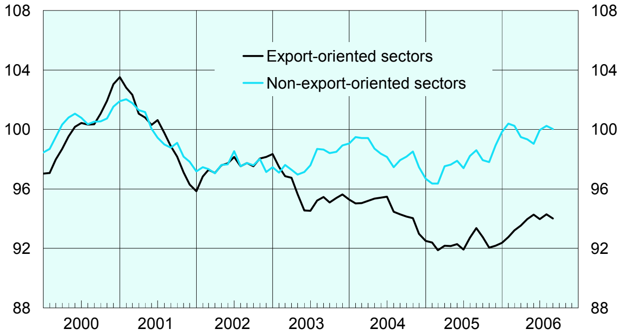
(1) Index, 2000=100. Data adjusted for the different number of working days in the month and seasonally adjusted. – (2) Based on electricity consumption and ISAE indicators. – (3) Moving averages for the three months ending in the reference month of the difference between the percentage of positive replies ("high", "increasing") and that of negative replies ("low", "decreasing") to ISAE surveys, weighted by size, sector and location of firm. The trend figures refer to the responses for 3 months ahead. Seasonally adjusted data.

Industrial production has trended upwards over the past year (Figure 14). The expansion has concerned both products intended for the domestic market and those of the more export-oriented sectors, whose performance in recent years had been especially poor (Figure 15). Among the sectors, the most significant recovery was in the production of capital equipment, against the background of a progressive reduction in spare capacity in industry (Figure 16) and a recovery in both domestic and foreign demand for capital goods. In the most recent months signs of a slight slowdown have emerged: after falling in September, according to our preliminary forecasts the index of industrial production will be flat over the two months October and November; the ISAE indicator of confidence among industrial firms has also registered a pause in the last three months.

Figure 15

Italy: industrial production (1)

(monthly data)



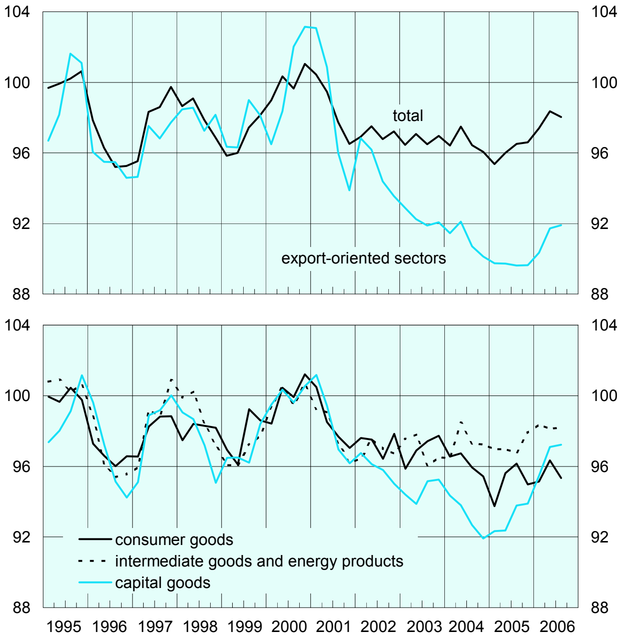
Source: Based on Istat data.

(1) Indices, 2000 = 100. Moving average for the three months ending in the reference month. Data seasonally adjusted and adjusted for different number of working days in month.

Figure 16

Composite indicator of capacity utilization in Italian industry (1)

(quarterly data; index, 2000=100)



Sources: Based on Istat and ISAE data.

(1) Arithmetic mean of the Bank of Italy (Wharton) and ISAE indicators.

Household consumption. – Household consumption rose by 2 per cent in the first half of the year, led by spending on semi-durable goods and services. After declining slightly towards the end of 2005, consumption rose vigorously in the first quarter of this year and then slowed in the second.

According to our preliminary estimates, in the first half of 2006 households' disposable income showed a modest gain with respect to the same period at current prices while remaining practically unchanged in real terms. The growth in gross compensation of employees, mainly reflecting higher per capita earnings, was accompanied by the weak performance of income from self-employment, which was curbed by the decline, under way since the second half of 2004, in the number of self-employed workers. The growth in gross operating profit, which includes imputed rental income, was not as strong as in recent years. The net interest income component continued to reduce households' spending capacity, reflecting both the wider spread between the rates on the financial liabilities and assets held by households and the growth in loans for house purchases and consumer credit. Continuing a trend that began several years ago, households increased their recourse to the latter, although consumer credit is still not as widespread in Italy as in the other industrial countries, where the interest rates applied to this form of borrowing are lower (see box "The results of the bank lending survey for Italian banks").

Available data indicate that household wealth continued to grow in both the financial and the real-estate component. The latter benefited from the further rise in house prices (6.4 per cent in nominal terms in the first half of 2006 compared with the year-earlier period), even if this was not as steep as those registered in the preceding half-years.

Consumer confidence fluctuated over the last twelve months (Figure 10). The improvement in assessments of the current economic situation contrasted with more uncertain developments in expectations, whose deterioration was responsible for the index's decline in October. Conflicting signs also come from the other indicators of consumer behaviour: retail sales at constant prices have remained stationary in the last twelve months, while new car registrations have fluctuated.

Investment and stocks. – Investment in machinery, equipment and transport equipment gained pace in the first six months of 2006 (annualized growth of 4.8 per cent, up from 4.4 per cent in the previous six months), reflecting the briskness of demand – foreign demand especially – and the appreciable improvement in industrial confidence. Despite the recent increases in policy rates, the stance of euro-area monetary policy remains expansionary and borrowing conditions for firms are still favourable. Lending to firms, which has expanded mostly in the short-term component, has accelerated further in the last three months. The results of the latest Bank of Italy surveys of industrial and service firms suggest that the current positive phase is likely to persist for the rest of this year and into the next (see box "The state of the economy: the findings of a survey of Italian industrial and service firms").

In the first half of 2006 construction investment grew at the same pace, on average, as in the previous six months (approximately 3 per cent on an annualized basis), albeit with a deceleration in the second quarter. Investment in residential building grew by about 3 per cent, slowing sharply from 6 per cent in 2005. In non-residential building, which had contracted in 2005, positive signs emerged: growth of around 3 per cent was recorded in the first half of this year and the climate of confidence among building firms shows a resurgence of optimism.

In the first half of the year the change in stocks, which includes statistical discrepancies, subtracted about one percentage point from the growth in GDP on an annualized basis. The reduction in inventories found by the surveys of manufacturing firms appear to confirm the signs of expanding demand.

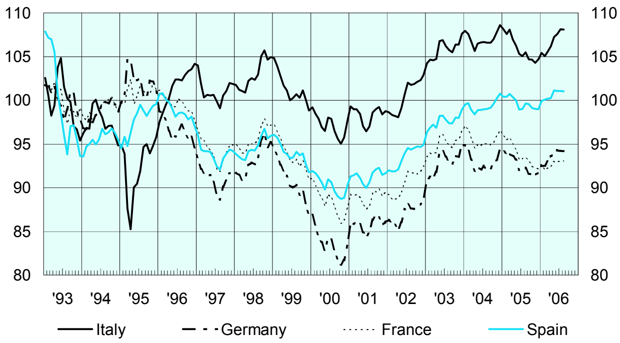
Exports and imports. – According to national accounts data, exports of goods and services grew in real terms at an annualized rate of 8 per cent in the first half of 2006, fuelled by the cyclical recovery in the euro area. After contracting in the second half of 2005, exports of goods returned to growth (8 per cent on an annualized basis); exports of services slowed their expansion, though the rate of growth was still high (9 per cent, compared with 22 per cent in the second half of 2005).

According to non-seasonally adjusted foreign trade data on *cif-fob* basis, which permit geographical and sectoral analysis of exports and imports of goods, in the first seven months of 2006 exports at constant prices rose by 2.5 per cent with respect to the first seven months of 2005, when they had fallen by 0.3 per cent compared with the corresponding period of 2004. With world trade forecast to expand by 8.9 per cent this year, Italy's share of world exports at constant prices would continue to shrink.

After recovering in 2005, price competitiveness as measured by the real effective exchange rate based on producer prices worsened by more than 3 per cent (Figure 17). A similar but not equally pronounced development occurred in the other main euro-area economies.

Figure 17

Indicators of competitiveness in the major euro-area countries (1)
(indices, 1993=100)



Source: National statistics.
(1) Real effective exchange rate. In relation to 61 competitor countries. An increase in an index indicates a loss of competitiveness.

The most dynamic components of Italian exports were capital and intermediate goods, which performed well in all the main outlet markets. Basic metals and metal products, transport equipment and mechanical machinery and equipment stand out (Table 8). Export volumes in the traditional sectors (furniture, textiles and clothing, leather and leather products) contracted or were flat again; they generally declined in the markets of the advanced countries, while they held steady or rose slightly in those of the emerging countries.

The recovery in Italian exports benefited above all from the acceleration of growth in the EU and the euro area. In the first seven months of the year exports to the EU rose overall by 3.1 per cent at constant prices, against a decline of 1 per cent in the corresponding period of 2005. The improvement was largely due to markedly higher growth of exports to Germany (3.9 per cent), where the upturn in investment and the acceleration in exports helped rekindle demand for metal products, machinery, motor vehicle parts and accessories and chemical products. A major boost to exports to Germany came from motor vehicles.

In the first seven months of the year exports to the new EU member countries rose by 11.4 per cent. Exports to non-EU countries were checked by an especially high increase in average unit values and rose by only 1.8 per cent. Sales to China and Russia showed very rapid growth (9.9 and 8.6 per cent respectively), while the volume of exports to the United States and Japan contracted.

In the first seven months of the year the increase in the average unit values of exports compared with the corresponding period of 2005 continued to be greater than that in domestic producer prices. In conjunction with a slight weakening of Italy's nominal effective exchange rate, the growth in the average unit values was greater for goods shipped to non-EU countries than for exports to the EU. There was an especially sharp increase in the prices of exports to China, the United States and the dynamic Asian economies (Table 9).

As a consequence of the hike in the international prices of raw materials, oil in particular, Italy's terms of trade worsened by 4.9 per cent in the first seven months of 2006 with respect to the year-earlier period; for manufactures alone, the deterioration amounted to 0.9 per cent and was concentrated in the basic metals and metal products sector, whose raw materials registered very large price rises in international markets.

Fuelled by domestic demand and by the revival of exports, imports of goods and services grew at an annualized rate of about 5 per cent in real terms in the first six months of the year according to national accounts data. The services component was by far the most dynamic (15 per cent), while imports of goods rose by only 2.4 per cent. Net exports contributed about 0.8 percentage points to the annualized growth in GDP.

The state of the economy: the findings of a survey of Italian industrial and service firms

Between 20 September and 12 October the branches of the Bank of Italy conducted their annual survey of the cyclical state of the economy, interviewing 3,261 non-construction industrial and 1,191 service firms with at least 20 workers. The findings broadly confirm the cyclical upturn of the first part of the year and prefigure positive developments in the months to come as well.

In 2006, for the first time in five years, firms judging that their fixed investment spending will be greater than originally planned outnumber those estimating it to be lower (21 and 16 per cent, respectively; see table). This result, which is more pronounced in the North of Italy, is common to industry and services and reflects upward adjustments by firms with fewer than 200 workers. Among larger firms downward adjustments prevail, presumably traceable to the particularly ambitious original plans that were found by the spring survey of industrial and service firms. In their forecasts for 2007, 55 per cent of firms expect investment to be on a par with this year, a quarter expect an increase and 19 per cent a decrease. The expectations of larger firms are more optimistic than average.

The majority of firms, according to the survey, experienced an increase in total sales in the first nine months compared with the same period of 2005. The same holds for export sales.

Positive signals came from orders in hand, which were greater than at the end of June for 43 per cent of firms and less for only 15 per cent. The best results in industry were recorded by mechanical engineering, chemicals and, to a lesser extent, clothing and textiles; in services, by transport and telecommunications. Two thirds of the firms reporting an increase in orders expect a further increase over the next six months.

Forty-six per cent of firms expect industrial production to expand in the last quarter, fuelled by demand (in 2005, the corresponding share was 37 per cent), and among these nearly two thirds expect a further rise in the first quarter of 2007. Only 10 per cent of firms forecast a contraction of activity in the last part of this year. By region, the signs in the South, while positive, are not as strong as in the rest of the country.

Average employment levels should be higher in 2006 than in 2005 in industry and more markedly so in the service sector. A shortage of skilled labour is reported, which firms attribute chiefly to lack of supply; they do not perceive cost as a significant obstacle. Staffing levels for production workers and managerial personnel are deemed to be slightly higher than desired.

The survey indicates that company-level wage increments above the industry-wide collective bargaining agreements were granted to 45 per cent of workers in industry and 40 per cent in services during the year. The increments, which were more frequent in larger firms, amounted to more than 2 per cent for only a quarter of the workers involved and resulted in an average increase in total wages and salaries of 0.6 per cent.

Nearly 73 per cent of firms expect to close the year with an after-tax profit (up from 67 per cent according to the 2005 survey), while 12 per cent expect a loss. Just under a third forecast that gross unit profit margins on the domestic market will be smaller than last year, against a fifth that expect them to be larger; for export markets opinions are slightly more optimistic.

The share of firms judging that the cyclical situation in their reference market has improved in the last six months is 36 per cent, against 9 per cent seeing recession (the corresponding figures in 2005 were 15 per cent and 24 per cent). The majority of firms (55 per cent) still see the cyclical phase as one of stagnation; of these, 28 per cent expect expansion in the next six months and just 3 per cent expect recession. Further, 86 per cent of the firms experiencing expansion in the past six months expect it to continue. Both judgements of the past and expectations are especially favourable in the chemical and mechanical engineering industries; in textiles and clothing as well as in the hotel and restaurant sector expectations are significantly better than the moderately positive evaluations of the current situation.

Main findings of the cyclical survey of Italian industrial and service firms (1)
(percentage distribution of answers net of "don't know" responses)

RESPONSE	2005			2006		
	Industry excl. construction	Services	Total	Industry excl. construction	Services	Total
	Forecast result for the year					
Loss	14.0	17.6	15.4	11.0	14.0	12.2
Break-even	18.6	16.4	17.7	15.2	15.0	15.1
Profit	67.4	66.0	66.9	73.8	71.0	72.7
	Investment spending this year compared with planned investment at the end of last year					
Lower	21.0	20.0	20.6	16.8	15.3	16.2
Practically equal	62.1	62.9	62.4	62.3	63.0	62.6
Higher	16.9	17.1	17.0	20.9	21.7	21.2
	Investment plans for next year					
Lower	22.0	23.4	22.6	18.0	19.9	18.8
Stable	53.5	53.4	53.4	53.4	56.6	54.7
Higher	24.4	23.2	24.0	28.6	23.5	26.5
	Employment during the year (2)					
Lower	28.2	23.0	25.8	23.3	23.4	23.3
Practically equal	52.4	44.4	48.7	51.2	45.5	48.5
Higher	19.4	32.6	25.5	25.6	31.0	28.2
	Orders at end-September compared with end-June (3)					
Lower	23.8	22.2	23.2	14.9	15.3	15.1
Stable	42.2	44.9	43.3	40.0	44.2	41.7
Higher	34.0	32.9	33.5	45.1	40.5	43.2
	Expectations for orders in the next six months (3)					
Lower	14.8	12.8	14.0	9.6	11.1	10.2
Stable	44.5	47.6	45.7	41.7	48.5	44.5
Higher	40.7	39.6	40.3	48.7	40.4	45.3
	Industrial production in the fourth quarter vis-à-vis the third					
Lower	16.0		16.0	10.2		10.2
Stable	47.1		47.1	44.0		44.0
Higher	36.9		36.9	45.8		45.8
	Cyclical situation in the last six months in the firm's reference market					
Lower	25.0	22.6	24.1	8.9	9.7	9.2
Practically equal	58.6	63.9	60.7	51.4	59.4	54.7
Higher	16.3	13.5	15.2	39.7	30.9	36.1
	Cyclical situation expected for the next six months in the firm's reference market					
Recession	12.6	9.7	11.4	5.1	7.5	6.1
Stagnation	56.1	59.2	57.4	43.1	50.4	46.0
Expansion	31.3	31.1	31.2	51.9	42.1	47.9

(1) Telephone survey. Sample consists of 3,621 firms with 20 or more workers in industry excluding construction and 1,191 in services (wholesale and retail trade, hotels and restaurants, transport and communication, other business services). Percentages are estimated using for each firm a weight which takes account, for distributions by geographical area, size, and sector, of the ratio between the sample size and the population of firms. The standard errors of the percentages estimated over the national total are not greater than 0.7 per cent, i.e. confidence intervals (at 95 per cent) of at most 1.4 percentage points. – (2) Weighted by number of persons employed. Average changes in employment for 2006. – (3) For service firms, "sales trend".

Table 8

Italian exports and imports *cif-fob* by branch of economic activity and balances, January-July 2006: values, indices of average unit values and volumes (1)

(*percentage changes on corresponding period of 2005, except as indicated)*

	Exports				Imports				Change in balance (millions of euros)
	% composition of values in 2005 (2)	Change			% composition of values in 2005 (2)	Change			
		Values	Average unit values	Volumes (3)		Values	Average unit values	Volumes (3)	
Total	**100.0**	**9.5**	**6.8**	**2.5**	**100.0**	**14.7**	**12.3**	**2.1**	**-9,733**
Products of agriculture, forestry and fishing	1.4	4.4	7.7	-2.4	3.0	6.2	5.5	0.6	-234
Energy and non-energy minerals (4)	0.3				14.1	42.6	41.8	0.7	-9,711
of which: crude petroleum and natural gas (4)	*0.2*				*12.7*	*46.2*	*44.8*	*1.0*	*-9,442*
Manufactures	96.2	9.6	6.7	2.7	79.8	10.9	7.7	2.9	409
Food products, beverages and tobacco	5.4	10.1	3.3	6.7	6.5	10.7	5.9	4.6	-286
Textile products and clothing	8.8	2.3	5.7	-3.2	4.9	13.2	8.8	3.9	-819
Leather and leather products	4.2	5.9	5.0	0.8	2.1	15.6	7.8	7.2	-158
Wood and wood products	0.5	9.4	1.6	8.0	1.1	9.2	5.1	3.8	-120
Paper and paper products, printing and publishing	2.1	3.5	2.0	1.4	2.2	5.9	5.5	0.4	-102
Refined petroleum products	3.2	25.0	40.4	-10.1	1.8	35.5	43.3	-7.0	103
Chemical products and man-made fibres	10.1	8.7	8.3	0.5	13.4	8.5	8.9	-0.4	-581
Rubber and plastic products	3.7	7.1	4.6	2.4	2.1	8.6	4.1	4.3	159
Non-metallic mineral products	3.0	8.0	5.1	2.9	1.0	5.1	7.7	-2.6	329
Basic metals and metal products	10.1	21.4	6.8	13.4	10.4	23.3	14.0	8.0	-718
Mechanical machinery and equipment	19.9	9.9	6.4	3.3	7.0	5.3	6.5	-1.1	2,813
Electrical equipment and precision instruments	9.2	7.8	3.9	3.9	12.3	7.2	1.4	5.7	-297
Transport equipment	10.9	8.5	3.4	5.1	13.3	6.1	5.5	0.6	163
Other manufactures (including furniture)	5.0	4.2	10.4	-5.6	1.7	16.2	10.0	5.6	-77
Electricity, gas and water (4)	..				0.7	2.1	26.7	-17.3	60

Source: Based on Istat data.

(1) The change in values for the EU countries and for the total is calculated on data corrected for the estimate of some transactions that starting with 2003 have been observed on an annual rather than monthly basis following changes in the reporting threshold and taking account, based on past experience, of reporting delays. – (2) The values do not sum to 100 owing to the presence of unclassified products. – (3) For the EU countries, the changes in volumes are calculated on the basis of deflated average unit values. – (4) Owing to the highly erratic nature of the time series and the small value of the aggregates, changes in exports are not shown.

According to *cif-fob* foreign trade data, in the first seven months of the year total imports of goods grew in volume by 2.1 per cent with respect to the corresponding period of 2005. The bulk of the increase came in the intermediate and consumer goods sectors, most notably electrical equipment and precision instruments, furniture and leather products.

Purchases from the EU rose by 2.4 per cent, those from outside the EU by 1.8 per cent. A large increase in the volume of goods imported from China (textiles and clothing and machines of various kinds), the new EU countries (transport equipment, machinery, basic metals and metal products) and Germany (transport equipment and chemical products) contrasted with a sizeable reduction in those from Russia (textiles and clothing and transport equipment), the United Kingdom (transport equipment and chemical products) and the United States (transport equipment, chemical products and agricultural products).

Table 9

Italian merchandise exports and imports *cif-fob* by main countries and areas, January-July 2006: values and indices of average unit values and volumes (1)

(percentage changes on corresponding period of 2005, except as indicated)

	Exports				Imports			
	% composition of values in 2005	Change			% composition of values in 2005	Change		
		Values	Average unit values	Volumes (2)		Values	Average unit values	Volumes (2)
EU coutries	**59.2**	**7.6**	**4.3**	**3.1**	**57.8**	**9.0**	**6.4**	**2.4**
EU-15	53.4	6.4	4.0	2.3	53.5	8.0	5.9	1.9
of which: *France*	*12.4*	*3.7*	*2.1*	*1.5*	*10.0*	*3.1*	*4.5*	*-1.5*
Germany	*13.3*	*7.8*	*3.7*	*3.9*	*17.3*	*11.3*	*4.3*	*6.6*
United Kingdom	*6.5*	*1.1*	*6.0*	*-4.6*	*4.0*	*-0.1*	*10.4*	*-9.5*
Spain	*7.5*	*5.7*	*5.5*	*0.3*	*4.2*	*9.9*	*7.5*	*2.2*
New EU countries (3)	5.8	18.9	6.7	11.4	4.4	22.6	12.7	8.8
Non-EU countries	**40.8**	**12.4**	**10.5**	**1.8**	**42.2**	**22.8**	**20.7**	**1.8**
of which : *China*	*1.5*	*24.1*	*12.7*	*9.9*	*4.6*	*23.2*	*12.9*	*9.2*
Japan	*1.5*	*-2.2*	*4.7*	*-6.4*	*1.6*	*10.1*	*1.3*	*8.9*
DAEs (4)	*3.0*	*9.9*	*10.8*	*-0.5*	*2.7*	*2.0*	*4.1*	*-2.2*
Russia	*2.0*	*18.2*	*8.7*	*8.6*	*3.8*	*25.9*	*39.1*	*-9.7*
United States	*8.0*	*7.1*	*12.5*	*-4.6*	*3.5*	*2.9*	*12.0*	*-8.0*
Total	**100.0**	**9.5**	**6.8**	**2.5**	**100.0**	**14.7**	**12.3**	**2.1**

Source: Based on Istat data.

(1) The change in values for the EU countries and for the total is calculated on data corrected for the estimate of some transactions that starting with 2003 have been observed on an annual rather than monthly basis following changes in the reporting threshold and taking account, based on past experience, of reporting delays. – (2) For the EU-15 countries, the changes in volumes are calculated on the basis of deflated average unit values. – (3) Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia. – (4) Dynamic Asian economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

The balance of payments. – In the first eight months of 2006 Italy's current account deficit widened with respect to the same period of 2005 from €14.3 billion to €20.5 billion (from 1.5 to about 2 per cent of GDP; Table 10), reflecting the deterioration in the trade balance. Corresponding to the combined deficit of €19.6 billion on the current and capital accounts were net inflows of €19.7 billion on the financial account. Reserve assets fell by €0.3 billion.

For the first time since the second half of 1992 the *fob-fob* trade balance was in deficit (€6 billion in the first eight months of 2006, against a surplus of €2.8 billion in the year-earlier period). On a *cif-fob basis* (the only method of valuation for which details on products and countries, discussed below, are available), the eight-month deficit amounted to €14.5 billion, owing to the further price rises for energy products. Excluding energy products, the *cif-fob* trade balance for the first seven months of the year showed a surplus of €15.3 billion, €0.4 billion less than in the corresponding period of 2005. The *cif-fob* surplus for manufactures alone, excluding refined petroleum products, rose from €22.6 billion

Table 10

Italy's balance of payments (1)
(millions of euros)

	2005			2006	
	Year	H1	January-August	H1	January-August
Current account	**-22,056**	**-14,626**	**-14,289**	**-20,694**	**-20,542**
Goods	72	30	2,768	-7,185	-5,957
exports	*299,580*	*148,866*	*195,320*	*165,132*	*217,155*
imports	*299,508*	*148,836*	*192,552*	*172,317*	*223,112*
Services	-359	-1,848	-1,557	279	1,047
Income	-13,595	-9,556	-11,199	-9,027	-9,093
Current transfers	-8,173	-3,253	-4,301	-4,761	-6,539
Capital account	**1,779**	**738**	**797**	**881**	**969**
Financial account	**19,041**	**14,920**	**14,642**	**20,733**	**19,723**
Direct investment	-17,556	-1,588	-3,239	13,730	9,365
outward	*-33,575*	*-6,594*	*-9,066*	*-8,229*	*-14,940*
inward	*16,019*	*5,006*	*5,827*	*21,959*	*24,305*
Portfolio investment	43,398	52,344	46,832	42,736	16,763
Equity securities	-15,951	-32,723	-28,591	-30,525	-21,037
assets	*-20,014*	*-6,391*	*-11,883*	*-24,668*	*-23,141*
liabilities	*4,063*	*-26,332*	*-16,708*	*-5,858*	*2,103*
Debt instruments	59,349	85,067	75,423	73,261	37,800
assets	*-67,014*	*-30,174*	*-40,704*	*-2,192*	*-17,698*
liabilities	*126,363*	*115,241*	*116,127*	*75,454*	*55,499*
Financial derivatives	2,332	2,671	2,533	526	-501
Other investment	-9,943	-39,309	-32,115	-36,180	-6,248
Reserve assets	810	802	631	-79	344
Errors and omissions	**1,236**	**-1,032**	**-1,151**	**-920**	**-150**

(1) Provisional data for July and August 2006.

to €22.9 billion. The main positive contributions came from mechanical and electrical machinery and equipment, transport equipment, and metal and non-metallic mineral products. The traditional sectors (textiles and clothing, leather and leather products, furniture) saw their overall surplus narrow further; the balance also worsened for electrical equipment and precision instruments.

The balance on services swung from a deficit of €1.6 billion in January-August 2005 to a surplus of €1 billion in the first eight months of this year. According to detailed sectoral breakdowns, available only for the first six months, the largest contributions to the overall improvement came from the growth in the surplus on travel (from €4.9 billion to €6 billion) and the reduction in the deficit on "other business services" (from €1.5 billion to €1.1 billion; Table 11).

According to the Italian Foreign Exchange Office's sample survey on tourism, the 8.1 per cent growth in receipts was due mainly to spending by residents of the United States and Asia. Spending by visitors from other EU countries contracted by 1.2 per cent. Total outflows for travel decreased by 1.8 per cent, owing mainly to the fall in spending on business trips.

The improvement in the balance on "other business services" – the item includes commercial services, operating leasing, technical and professional services – falls in the context of rapid growth in both inflows and outflows, under way since 2003.

In the first eight months the deficit on income narrowed to €9.1 billion, from €11.2 billion in the same period of 2005, primarily reflecting the reduction in the deficit on income from portfolio investment.

The deficit on transfers grew from €4.3 billion to €6.5 billion, owing mainly to the deterioration in the balance on private transfers. The deficit on workers' remittances continued to expand in the first six months of the year, rising from €1.2 billion to €1.3 billion.

Turning to the financial account, in the first eight months net direct and portfolio investment inflows totalled €26.1 billion, down from €43.6 billion in the same period of 2005. Net direct investment inflows grew because of the sharp increase in inward investment, due to acquisitions of Italian banks in March and April, while outward direct investment rose only moderately.

Under portfolio investment, the reduction in investment in Italy by non-residents, which after surging in 2005 fell back closer to the average level of recent years, concerned debt instruments in particular. There were moderate inflows into equity securities (€2.1 billion), against outflows of €16.7 billion in the year-earlier period. In the first six months of 2006 net purchases of government securities by non-residents fell to €51 billion, from €96.3 billion in 2005; the reduction was concentrated in BOTs and BTPs (Table 12).

As to foreign portfolio investment by Italians, in the first eight months of 2006 the growth in net purchases of equity securities (from €11.9 billion to €23.1 billion), which mainly concerned securities of euro-area issuers, only partially offset the marked reduction in investment in debt instruments (from €40.7 billion to €17.7 billion). This decline proportionately regarded securities issued by euro-area residents and non-residents. More in detail, data for the first six months of the year show net sales of securities of issuers resident in France, Luxembourg and the United States.

Table 11

Italy's trade in services
(millions of euros)

	2005			January-June 2005			January-June 2006		
	Credits	Debits	Balance	Credits	Debits	Balance	Credits	Debits	Balance
Total	**72,500**	**72,859**	**-359**	**32,869**	**34,717**	**-1,848**	**39,096**	**38,817**	**279**
of which: travel	*28,453*	*18,000*	*10,452*	*12,798*	*7,939*	*4,859*	*13,836*	*7,799*	*6,038*
transport	*12,602*	*17,708*	*-5,106*	*5,845*	*8,693*	*-2,848*	*6,548*	*9,061*	*-2,513*
construction	*1,784*	*1,756*	*28*	*816*	*928*	*-112*	*896*	*978*	*-82*
other business services	*22,749*	*24,872*	*-2,123*	*10,370*	*11,883*	*-1,513*	*12,521*	*13,596*	*-1,075*

Table 12

Foreign portfolio investment in Italy
(millions of euros)

	2005		2006
	Year	January-June	January-June
Government securities	90,717	96,289	51,041
BOTs	*24,493*	*28,332*	*11,240*
BTPs	*66,653*	*60,280*	*44,543*
CCTs	*6,575*	*5,180*	*2,896*
CTZs	*-4,027*	*2,549*	*-6,063*
Republic of Italy issues	*-5,248*	*-2,785*	*-3,216*
Other government securities	*2,272*	*2,733*	*1,641*
Bonds	35,646	18,952	24,412
Equity securities (1)	4,063	-26,332	-5,858
Total	**130,426**	**88,909**	**69,596**

(1) Including investment fund units.

Net outflows of “Other investment” (which mainly records banks loan and deposits and trade credit, in large measure items offsetting financial and real transactions) diminished from €32.1 billion to €6.2 billion. Net of loans to non-residents, the Italian banking system raised €29.4 billion of funds abroad, thus compensating for the faster growth of lending than fund-raising on the domestic market.

The labour market

Overview

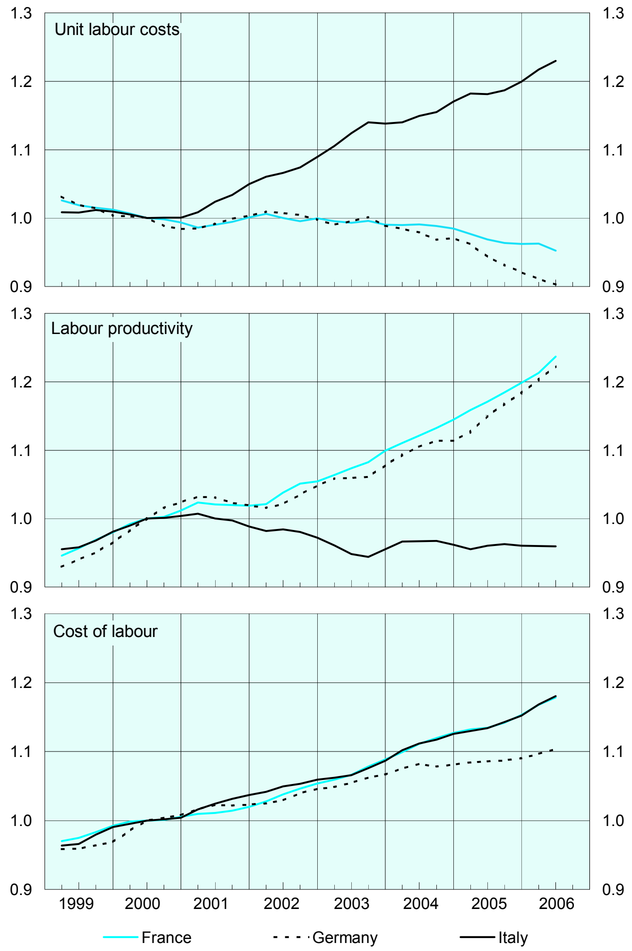
Employment growth in the euro area accelerated in the first half of 2006, with a corresponding further decline in the unemployment rate to its lowest level since 2001. In Italy labour input returned to growth after two years of slack performance, consolidating the upturn that began at the end of 2005.

In the euro area per capita labour costs rose faster than in the second half of 2005, but as productivity accelerated by about the same amount the rise in unit labour costs was practically unchanged. In Italy the cyclical rise in per capita labour costs was slightly faster than in the area as a whole, but unit labour costs rose at a significantly higher rate because of a decline in productivity.

In industry unit labour costs have risen since the start of 2000 by 23 per cent in Italy, while in France they have fallen by 4.7 per cent and in Germany by 9.7 per cent (Figure 18). The difference is due largely to the poor performance of productivity in Italy, with a decline of 4 per cent against gains of 23.7 per cent in France and 22.3 per cent in Germany.

Figure 18

Cost of labour per employee, productivity and unit labour costs in industry excluding construction
(seasonally adjusted data; index, 2000 H1 = 1)



Source: Eurostat, national accounts.

The euro area

National accounts data show that in the first six months of 2006 the number of persons employed in the euro area increased by 1.1 per cent with respect to the year-earlier period, compared with 0.7 per cent in the second half of 2005. The seasonally adjusted unemployment rate fell further, declining to 7.8 per cent in the third quarter (Figure 19).

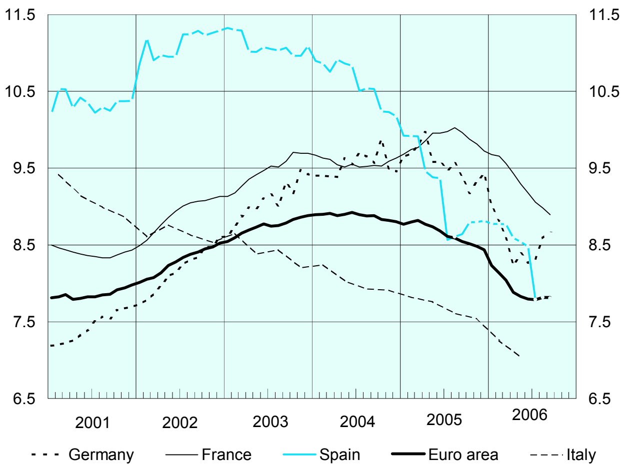
In the four largest euro-area economies per capita labour costs rose by 2 per cent compared with the first half of 2005 (1.3 per cent in 2005). Labour productivity, though still growing slowly, accelerated by about the same amount (from 0.4 to 1 per cent), so the rate of growth in unit labour costs remained roughly constant (Table 13).

In *Germany* employment was up by 0.3 per cent in the first half compared with the first half of 2005. The unemployment rate measured by the labour force survey declined steadily from 9 per cent in January to 8.3 per cent in June, reflecting among other things the fading out of the effects of the reform of unemployment benefit eligibility. In the third quarter, however, the rate rose again, to 8.7 per cent.

Figure 19

Unemployment rates in the main euro-area countries

(seasonally adjusted data; percentages) (1)



Sources: Istat and Eurostat.

(1) Quarterly data for Italy, monthly data for the other countries.

The cost of labour per employee held steady at its average level of two years earlier. Given a significant increase in productivity (1.9 per cent), due mainly to the sharp gain of 6.3 per cent in industry, unit labour costs fell again, by 1.8 per cent; the fall was more pronounced in industry excluding construction (4.3 per cent). The downward trend in unit labour costs since 2003 stems both from the slowdown in labour costs due to great wage moderation – thanks in part to the possibility of derogating from national wage agreements – and growing use of more flexible forms of employment and from the continued improvement in productivity, driven by thorough restructuring, especially in industry.

In *France* employment expanded by 0.6 per cent in the first half compared with the first half of 2005. The unemployment rate continued the decline that had begun in mid-2005, falling from 9.7 per cent in

Table 13

Labour costs per employee, productivity and its components, and unit labour costs

(percentage changes on corresponding period)

	Labour costs per employee (1)		Productivity						Unit labour costs (1)	
					Value added (2)		Employment (1)			
	2005	2006 H1	2005	2006 H1	2005	2006 H1	2005	2006 H1	2005	2006 H1
					Industry excluding construction					
Germany	0.6	1.7	4.7	6.3	2.9	4.7	-1.7	-1.5	-4.0	-4.3
France	2.1	4.0	4.5	5.2	1.9	2.7	-2.4	-2.4	-2.2	-1.2
Italy	2.4	4.5	-0.7	0.2	-2.3	0.2	-1.6	..	3.1	4.4
Spain	2.8	3.3	0.4	2.4	0.7	2.4	0.3	..	2.4	0.9
Euro 4 (3)	1.3	2.7	2.6	3.9	1.2	3.0	-1.3	-0.9	-1.3	-1.2
					Services (4)					
Germany	-0.2	-0.6	0.1	0.3	0.8	1.3	0.7	1.0	-0.3	-0.8
France	2.8	3.4	0.6	1.0	1.5	2.0	0.9	1.0	2.2	2.3
Italy	3.2	3.9	0.5	0.8	0.8	1.8	0.3	0.9	2.6	3.0
Spain	2.1	3.2	0.8	0.2	4.4	3.8	3.5	3.5	1.3	2.9
Euro 4 (3)	1.5	1.8	0.2	0.4	1.5	1.9	1.3	1.6	1.3	1.5
					Total economy					
Germany	-0.1	..	1.2	1.9	1.1	2.1	-0.1	0.3	-1.3	-1.8
France	2.7	3.5	0.7	1.4	1.1	2.0	0.4	0.6	2.0	2.1
Italy	2.9	3.8	0.5	0.7	..	1.4	-0.4	0.7	2.4	3.2
Spain	2.6	3.3	0.1	0.3	3.3	3.4	3.1	3.1	2.5	3.0
Euro 4 (3)	1.3	2.0	0.4	1.0	1.2	2.1	0.8	1.1	0.9	1.0

Sources: Based on Istat and Eurostat data.

(1) For Italy, France and Spain, standard labour units. – (2) Chain-linked volumes. – (3) Weighted average of France, Germany, Italy and Spain. – (4) Comprises wholesale and retail trade, transport and telecommunications, financial and real estate intermediation, and "other services".

January to 8.9 per cent in September. The acceleration in labour costs was offset by that in productivity and thus did not affect the rate of increase in unit labour costs (2.1 per cent, compared with 2 per cent in 2005). In industry, where productivity continued to outpace the cost of labour, unit labour costs fell again, though less sharply than in the past (by 1.2 per cent, compared with 2.2 per cent in 2005).

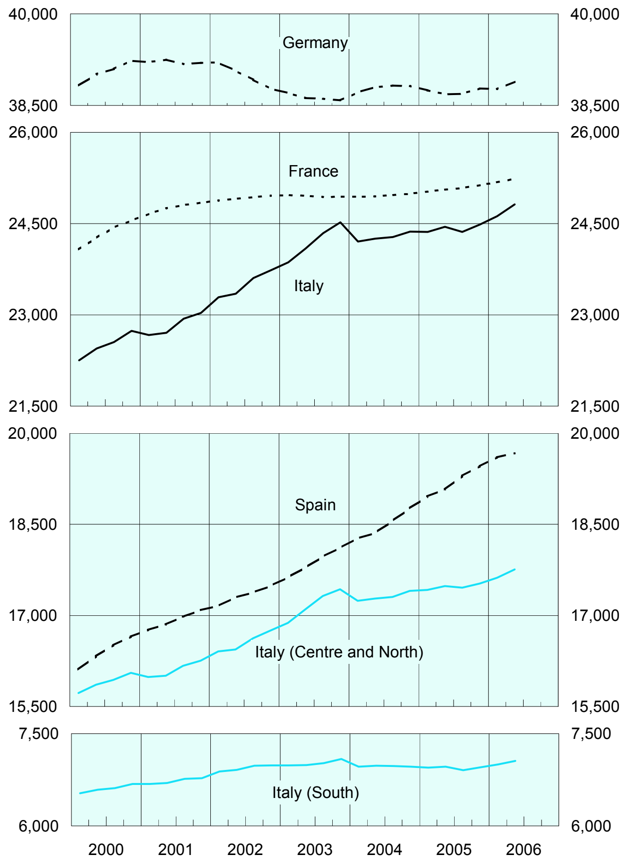
Italy

Employment. – According to the national accounts, on a seasonally adjusted basis the labour input of the entire economy, measured in terms of full-time equivalent workers, increased by 1.4 per cent in the first half of 2006 (and by 0.7 per cent compared with the first half of 2005), thus confirming the signs of recovery that had emerged in the latter part of last year (Figure 20). Employment trends were not uniform. In industry excluding construction there was at least modest growth (0.2 per cent compared with the second half of 2005), interrupting the decline that had been under way since the first half of 2003. The upturn is confirmed by an increase in overtime work and decline in the number of hours of Wage Supplementation benefits, as well as by the clear signs of labour shortage that emerged towards the end of last year and strengthened over the following months, especially in the Centre and North-West (Figure 21). The turnaround in construction from contraction of 1.9 per cent in the second half of 2005 to expansion of 2.4 per cent in the first six months of 2006 and the substantial acceleration of expansion in the private service sector from 0.1 to 1.9 per cent provided the main stimulus to employment growth.

According to the labour force survey, which counts the number of persons in employment regardless of how many hours they work, employment averaged 22,967,000 in the first six months, an increase of 2 per cent or 455,000 with respect to the year-earlier period. The increase was sharpest in the Centre (2.9 per cent, Table 14). More than two fifths of the increase (194,000, including 108,000 women) was accounted for by foreign citizens. In large part this presumably reflects the emersion, in connection with the regularization of immigrants, of workers who were already employed. The number of foreign citizens of working age registered as residents also increased during the same period by 241,000 (152,000 women).

Figure 20

Employment in the main euro-area countries
(seasonally adjusted quarterly data; thousands of persons)



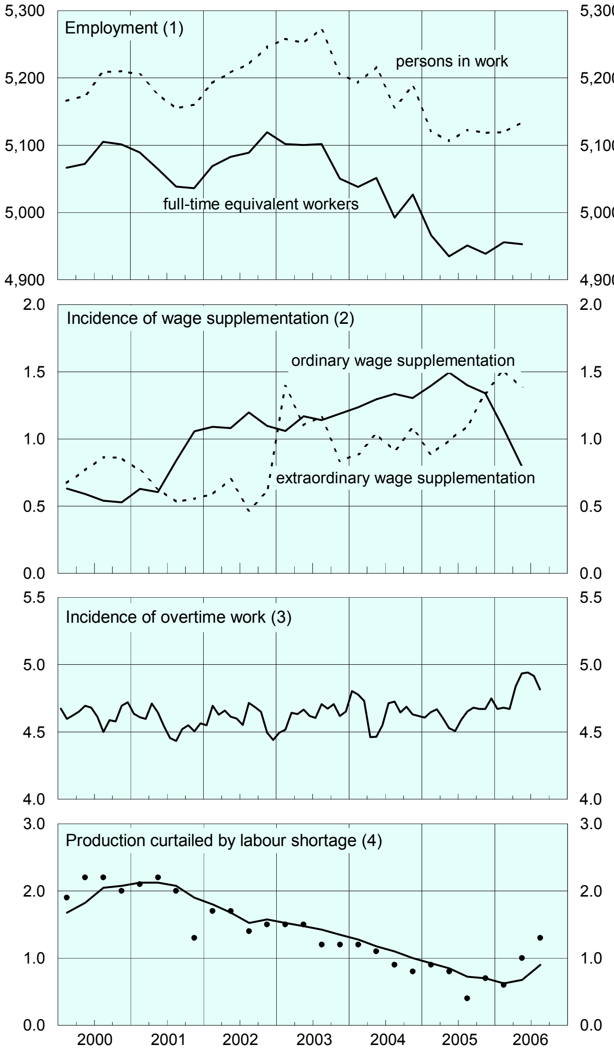
Sources: For Italy, Istat: national accounts and regional estimates. For the other countries, Eurostat, national accounts.

In response to the most recent provision authorizing the entry of 170,000 non-EU workers, applications were submitted for more than half a million foreigners who were presumably already working off-the-books in Italy. The Government has now passed another measure, increasing the entry quotas for 2006 by 350,000.

The employment rate for the population aged 15-64 averaged 58.4 per cent in the first half of the year, against 57.4 per cent in the first half of 2005 (Table 15). The rate rose in the Centre and

Figure 21

Employment, wage supplementation and overtime work in industry excluding construction in Italy
(seasonally adjusted data; thousands of persons and percentages)



Sources: Based on Istat, national accounts and *Indagine sulle grandi imprese*, INPS data and ISAE, *Inchiesta sulle imprese manifatturiere ed estrattive*.
(1) Respectively, total number of persons in work and standard labour units as defined in the national accounts. Quarterly data. – (2) Average number of equivalent employees on ordinary or extraordinary wage supplementation during the quarter as a percentage of the number of full-time equivalent workers according to national accounts. – (3) Monthly data. Total number of overtime hours as a percentage of total number of regular hours in industrial companies with at least 500 employees. Moving averages of the three months ending in the reference month. – (4) Companies so reporting as percentage share of total; quarterly data; moving averages of the four quarters ending in the reference quarter.

North from 63.9 to 64.9 per cent and in the South from 45.7 to 46.6 per cent. The increment was of about the same amount for the two sexes and was accounted for almost entirely by an increase in the employment rate of persons aged 35-64 (from 61.2 to 62.4 per cent), whose share of the working-age population rose from 62 to 62.7 per cent. The employment rate of officially resident foreigners was 67.4 per cent, 1.9 points higher than in the first six months of 2005; for women, the rate rose from 47.2 to 50.9 per cent.

Table 14

Employment by sector and geographical area in Italy, 2006

	2006 Q2	2006 H1 on 2005 H1			2006 Q2 on 2006 Q1 (1)
	Percentage share of national total	Absolute change	Percentage change	Contri-bution to overall growth, percentage points	Percentage change
			Sector		
Agriculture	4.2	46,311	5.2	3.1	-0.5
Industry excl. construction	21.6	6,827	0.1	-1.8	-0.1
Construction ..	8.2	-14,313	-0.7	-2.7	-1.1
Services	66.0	416,240	2.8	0.8	1.1
			Geographical area		
North	51.1	199,590	1.7	-0.3	0.7
Centre	20.5	132,340	2.9	0.9	0.3
South	28.5	123,130	1.9	-0.1	0.6
Italy ...	**100.0**	**455,060**	**2.0**	–	**0.6**

Source: Istat, labour force surveys.
(1) Seasonally adjusted.

The rise in the number of persons in work was accounted for almost entirely by payroll employment, which for the third consecutive half-year rose at a strong pace of over 2.5 per cent with respect to the corresponding period of the previous year. Self-employment stagnated (growth of 0.1 per cent) after the sharp drops recorded in 2005, with further falls in agriculture, industry and the distributive trades.

Table 15

Labour force status of the Italian population
(thousands of persons and percentages)

	2004 average		2005 average		2005 H1		2006 H2	
	Number	Percentage share (1)	Number	Percentage share (1)	Number	Percentage share (1)	Number	Percentage share (1)
Employees	**16,117**	**71.9**	**16,534**	**73.3**	**16,406**	**72.9**	**16,853**	**73.4**
open-ended contracts	14,209	63.4	14,507	64.3	14,431	64.1	14,690	64.0
full-time	12,618	56.3	12,784	56.7	12,714	56.5	12,861	56.0
part-time	1,590	7.1	1,724	7.6	1,717	7.6	1,829	8.0
fixed-term contracts	1,909	8.5	2,026	9.0	1,975	8.8	2,163	9.4
full-time	1,491	6.7	1,598	7.1	1,544	6.9	1,696	7.4
part-time	418	1.9	428	1.9	431	1.9	467	2.0
Self-employed	**6,287**	**28.1**	**6,029**	**26.7**	**6,106**	**27.1**	**6,114**	**26.6**
full-time	5,454	24.3	5,285	23.4	5,343	23.7	5,325	23.2
part-time	833	3.7	744	3.3	763	3.4	789	3.4
Total persons in work	**22,404**	**100.0**	**22,563**	**100.0**	**22,512**	**100.0**	**22,967**	**100.0**
men	13,621		13,738		13,691		13,938	
women	8,783		8,825		8,821		9,029	
Unemployed	**1,960**		**1,889**		**1,924**		**1,748**	
Labour force	**24,365**		**24,451**		**24,436**		**24,715**	
men	14,546		14,640		14,635		14,773	
women	9,819		9,811		9,801		9,942	
Inactive population	**33,188**		**33,683**		**33,604**		**33,660**	
under 15	8,215		8,273		8,267		8,271	
from 15 to 64	14,389		14,547		14,525		14,372	
of which: immediately available but not actively seeking work	*987*		*960*		*915*		*914*	
65 and over	10,584		10,864		10,813		11,018	
Total population	**57,553**		**58,134**		**58,040**		**58,375**	
Unemployment rate	**8.0**		**7.7**		**7.9**		**7.1**	
men	6.4		6.2		6.4		5.6	
women	10.5		10.1		10.0		9.2	
Participation rate (ages 15-64)	**62.5**		**62.4**		**62.4**		**62.9**	
men	74.5		74.4		74.5		74.8	
women	50.6		50.4		50.3		50.9	
Employment rate (ages 15-64)	**57.4**		**57.5**		**57.4**		**58.4**	
men	69.7		69.7		69.6		70.5	
women	45.2		45.3		45.3		46.2	

Source: Istat, labour force surveys.
(1) Percentage of total persons in work.

More than 40 per cent of the additional payroll jobs were fixed-term, raising their share to 12.8 per cent from 12 per cent in the first half of 2005 (Table 16). The increase, which involved both sexes, mainly reflects an increased proportion of fixed-term employment among persons aged 15-34: the share rose from 19.7 to 21.7 per cent in this age-group and from 7.7 to 8.1 per cent among persons 35 and older. As in recent years, the increase in fixed-term positions among the 15-34 age-group was accompanied by a more pronounced fall in permanent jobs.

Table 16

Fixed-term and part-time employees' share of total payroll employment in Italy

(percentages)

	Fixed-term		Part-time	
	2005 H1	2006 H1	2005 H1	2006 H1
Men	10.3	11.0	3.9	4.0
Women	14.4	15.4	25.6	26.6
North	9.7	10.3	13.9	14.5
Centre	11.4	12.9	14.2	14.7
South	16.7	17.4	10.8	11.2
Agriculture	48.5	46.7	7.4	8.9
Industry excl. construction	8.0	8.7	6.2	6.3
Construction	13.2	13.6	5.8	5.0
Services	12.2	13.0	16.9	17.6
Total economy...	**12.0**	**12.8**	**13.1**	**13.6**

Source: Istat, labour force survey.

The share of employees working part-time rose by half a percentage point to 13.6 per cent. Among women it increased by a full point to 26.6 per cent.

Unemployment and the supply of labour. – The seasonally adjusted unemployment rate came down to 7 per cent in the second quarter, the lowest level since the late 1970s. On average for the first half of 2006 it was 7.1 per cent, 0.8 points lower than a year earlier. The reduction was sharper in the South (from 14.8 to 13 per cent) than in the North (from 4.1 to 3.8 per cent), especially among persons younger than 35 (from 26 to 23.1 per cent and from 13.6 to 12.5 per cent in Italy as a whole). For young southerners the decline in unemployment reflects a significant reduction in labour market participation; the participation rate for this group fell by 0.6 percentage points to 47.7 per cent, while holding constant in the Centre and North at 66.3 per cent.

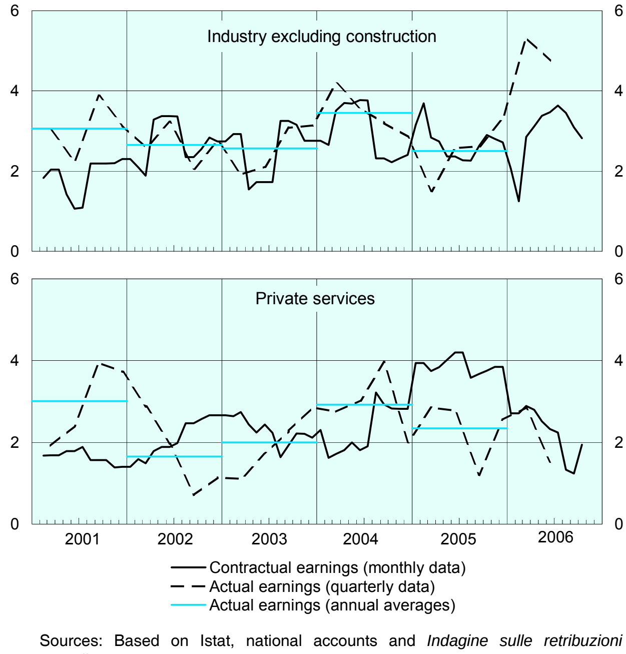
Labour costs and industrial relations. – The cost of labour per standard employee labour unit in the entire economy was 3.8 per cent higher in the first half of 2006 than a year earlier (2.9 per cent in 2005), owing to a stronger rise in actual per capita earnings (4.6 per cent). In large part this increase reflected substantial one-off payments for delays between contracts and for back pay in the first two quarters, made once the new agreements were signed. Contractual wages, which are net of these payments, increased by 2.6 per cent. Given the still slow growth of labour productivity (0.7 per cent), unit labour costs again accelerated, from 2.4 to 3.2 per cent.

The rise in actual earnings in the public sector in the first half of 2006 came to 7.1 per cent, far above the 2.4 per cent increase in contractual earnings, because of payments due under the contracts for 2004-05, which were not renewed until the end of last year. In the private sector per capita actual earnings rose by 3.4 per cent, showing a less pronounced difference over contractual earnings, which increased by 2.7 per cent. Between 1993 and 2005 the earnings growth differential between public employees (net of conscript military personnel) and private employees was 3.4 percentage points.

Figure 22

Italy: per capita contractual and actual earnings

(seasonally adjusted data; percentage changes on corresponding period)



Sources: Based on Istat, national accounts and *Indagine sulle retribuzioni contrattuali*.

In industry excluding construction, where the effect of one-off payments was greater than in the rest of the private sector (Figure 22), the faster growth in per capita labour costs (4.5 per cent, against 2.4 per cent on average for 2005) led to an acceleration in unit labour costs from 3.1 to 4.4 per cent. The new contract for chemical and pharmaceutical workers sets rules for the use of fixed-term contracts and some of the contract types envisaged by Law 30/2003 (job-oriented apprenticeship, temporary employment agency contracts, etc.). Further, it allows firms in contingent difficulties to introduce worse terms than those called for by the collective agreement. Such clauses must receive prior approval from a special commission, they must be temporary, and they must not affect contractual minimum wages.

In the service sector unit labour costs rose less (by 3 per cent), while labour costs increased by 3.9 per cent. In September, collective bargaining agreements covering about half of the sector's total wage bill had expired, and the rest will lapse by the end of the year.

Prices and costs

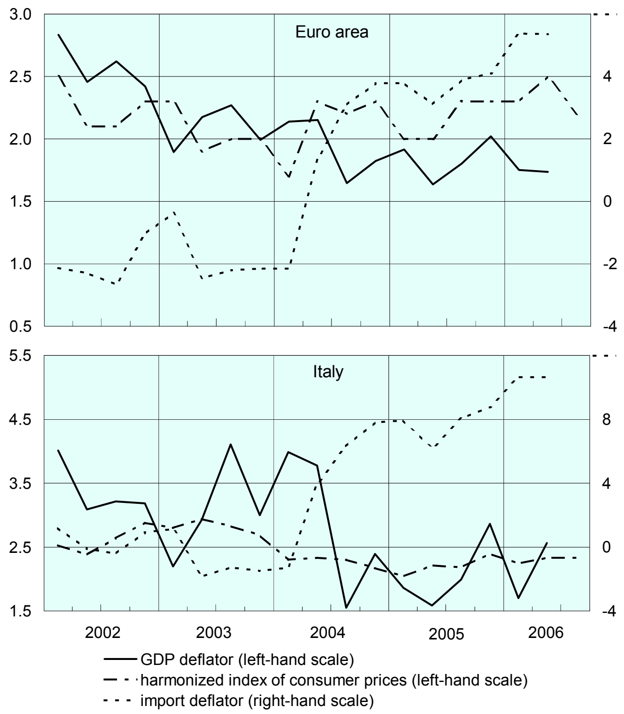
Overview

In the first nine months of 2006 consumer price inflation in the euro area averaged 2.3 per cent, virtually unchanged from 2005 (2.2 per cent). In Italy the harmonized price index rose by a similar amount (Figure 23).

Figure 23

Inflation indicators in the euro area and Italy

(quarterly data; percentage changes on year-earlier period)



Sources: Based on Istat and Eurostat data.

As a result of the 20 per cent increase in oil prices following one of 42 per cent in 2005, the consumer prices of energy products rose by an average of 10 per cent in the first nine months (Table 17). This has not yet affected the other components of the harmonized index.

Core inflation in the euro area (measured by the index excluding energy and unprocessed food products) remained unchanged at 1.5 per cent by comparison with twelve months earlier, benefiting from the continued moderate rise in unit labour costs. In Italy core inflation held steady at around 1.8 per cent, compared with an average of 2 per cent in 2005.

Despite the fall in oil prices from September onwards, the forecasters surveyed by Consensus Economics expect prices in the euro area to rise by more than 2 per cent next year. These expectations take account of the increase in indirect taxes due to take effect in Germany at the beginning of 2007, which is estimated to have an impact effect of around 0.3 percentage points for the area as a whole.

Prices and costs in the euro area

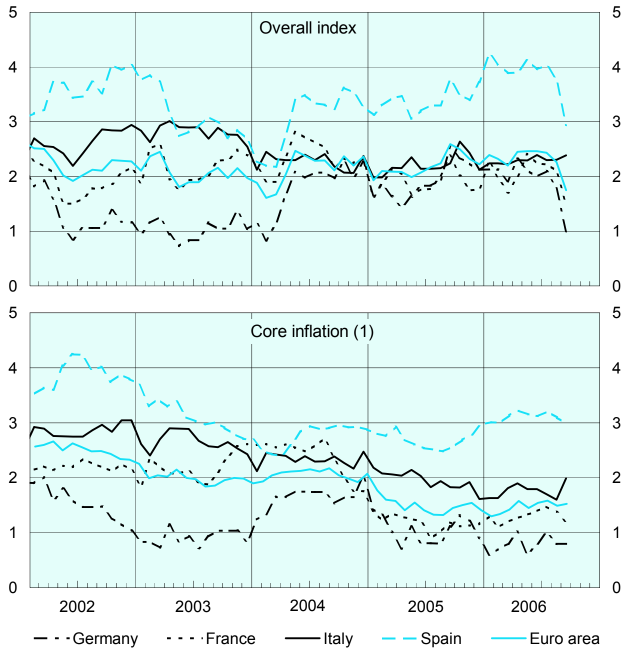
Consumer and producer prices. – The rate of increase in consumer prices slowed in the summer, from 2.5 per cent in the second quarter to 1.7 per cent in September (Figure 24). Inflation in Germany and France showed a similar decrease, falling to 1 and 1.5 per cent respectively in September. According to estimates by Eurostat, inflation in the euro area came down to 1.6 per cent in October.

Core inflation, which fell to below 2 per cent in 2005, fluctuated around the 1.5 per cent mark in 2006. It continued to decline in Germany, reaching 0.8 per cent in September. Only the prices of non-food and non-energy goods continued to rise at a euro-area average rate of less than 1 per cent (Table 17). A contributory factor was the continued moderate rise in domestic costs, which offset the inflationary pressures coming from imported inputs. The prices of services rose more rapidly, by almost 2 per cent, reflecting the less favourable trend in unit labour costs in this sector.

Figure 24

Harmonized index of consumer prices (1)

(monthly data; twelve-month percentage changes)



Source: Based on Eurostat data.
(1) Overall index excluding unprocessed food and energy products.

The contribution of the energy component to inflation, which was more than one percentage point in the first half of the year compared with the same period of 2005, virtually evaporated in September as a result of the sharp fall in oil prices (-14 per cent in relation to August). In Italy the slowdown in the energy component was less pronounced, owing partly to the slow mechanism for adjusting energy prices and partly to the greater impact of excise duty on the price of heating oil. The contribution of unprocessed food products to euro-area inflation increased in 2006 (to 0.3 percentage points in September), and their twelve-month rate of increase has doubled since the beginning of the year, to 5.7 per cent in September.

In the first nine months of 2006 producer price inflation in the euro area averaged 5.5 per cent, compared with 4.1 per cent in the whole of 2005 (Figure 25). The acceleration, which affected all the major countries of the area, stemmed from the sharp rise in the index component for intermediate goods (both energy and non-energy).

Table 17

Inflation indicators in Italy and the euro area

(percentage changes on year-earlier period)

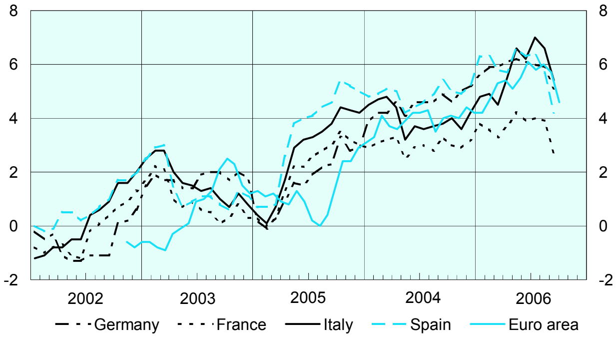
	Italy								Euro area							
	2004	2005	2005		2006			Jan.-Sept. 2006	2004	2005	2005		2006			Jan.-Sept. 2006
			Q3	Q4	Q1	Q2	Q3				Q3	Q4	Q1	Q2	Q3	
Harmonized consumer prices																
Overall index	2.3	2.2	2.2	2.4	2.2	2.3	2.3	2.3	2.1	2.2	2.3	2.3	2.3	2.5	2.1	2.3
Excluding unprocessed food and energy products	2.3	2.0	1.9	1.8	1.7	1.8	1.8	1.8	2.1	1.5	1.4	1.5	1.4	1.5	1.5	1.5
of which: non-food and non-energy products	*1.6*	*1.4*	*1.1*	*1.4*	*1.1*	*1.2*	*1.2*	*1.2*	*0.8*	*0.3*	*0.1*	*0.4*	*0.3*	*0.7*	*0.7*	*0.6*
services	*2.5*	*2.4*	*2.4*	*2.1*	*2.0*	*2.1*	*1.8*	*2.0*	*2.6*	*2.3*	*2.2*	*2.1*	*1.9*	*2.0*	*2.0*	*2.0*
Unprocessed food products	2.0	-0.7	-0.6	0.5	0.5	0.4	2.1	1.0	0.6	0.8	0.8	1.4	1.4	1.6	3.9	2.3
Energy products	2.4	8.7	10.3	10.3	10.3	10.1	8.8	9.7	4.5	10.1	12.7	11.1	12.2	11.6	6.3	9.9
Producer prices																
Overall index	2.7	4.0	3.7	3.9	4.7	6.1	6.3	5.7	2.3	4.1	4.2	4.4	5.2	5.8	5.4	5.5
Excluding unprocessed food and energy products	3.0	2.2	1.3	1.0	1.5	3.1	4.3	3.0	1.7	2.1	1.5	1.4	1.6	2.7	3.8	2.7
of which: final consumption goods	*0.6*	*1.8*	*1.7*	*1.4*	*1.4*	*1.5*	*1.5*	*1.5*	*-0.6*	*1.6*	*1.5*	*1.3*	*1.1*	*1.1*	*1.1*	*1.1*
intermediate goods	*4.9*	*2.5*	*1.0*	*0.6*	*1.6*	*4.6*	*7.0*	*4.4*	*3.5*	*2.9*	*1.7*	*1.7*	*2.3*	*4.4*	*6.4*	*4.4*
Energy products	2.4	15.6	17.2	18.8	20.1	20.4	15.9	18.7	3.9	13.4	15.7	15.6	19.0	17.4	11.8	15.9

Sources: Based on Eurostat and Istat data.

Figure 25

Index of producer prices (1)

(twelve-month percentage changes)



Source: Eurostat.

(1) The index refers to the prices of manufactured goods sold on the domestic market.

The prices of non-energy intermediate goods, which constitute about one third of the basket for the producer price index, accelerated sharply during the year to a twelve-month rate of increase of 6.5 per cent in September (compared with 2 per cent in January) in connection with rises in the world prices of non-energy raw materials (20 per cent in the first half of 2006 by comparison with the preceding period). The prices of capital goods accelerated less markedly (from 1 per cent in January to 1.7 per cent in September).

The rate of increase in the producer prices of non-food consumer goods remained around 1 per cent in all the major euro-area countries owing to the continuing weakness of consumption, which probably limited the extent to which increases in input costs fed through to prices.

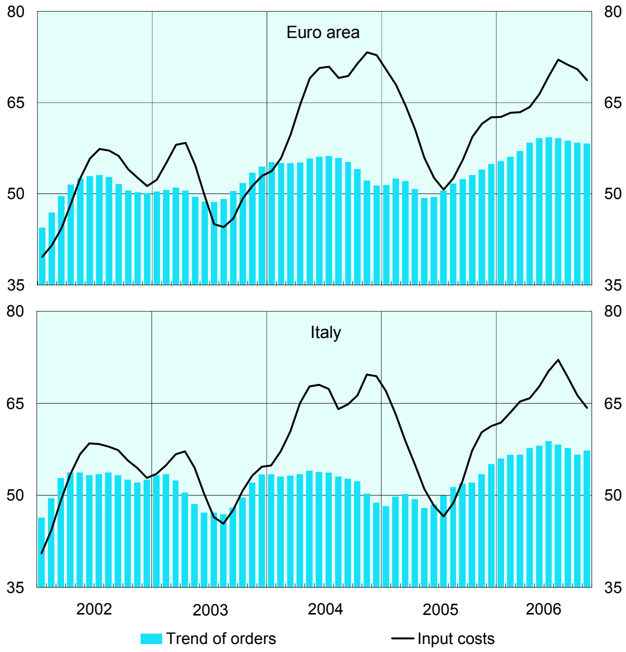
Costs. – In 2006 the pressure on firms' costs (Figure 26) came from imported inputs. In the first half the price deflator for imported goods and services rose by 5.1 per cent by comparison with the same period of the preceding year. Imported inflation was much higher in Italy than in the other major euro-area countries (10.6 per cent, compared with about 4 per cent in Germany, France and Spain), owing partly to the larger proportion of imported energy.

Unit labour costs in the euro area were 0.9 per cent higher in the first half of 2006 compared with a year earlier, the same as in 2005. In Germany they decreased further, by 1.8 per cent in 2006, and fell by 4.3 per cent in industry.

Figure 26

Demand and input costs for manufacturing firms (1)

(monthly data; percentages)



Source: Reuters, monthly survey of a sample of manufacturing firms.

(1) The indicators are current diffusion indices, calculated as the percentage of the sum of replies reporting an increase with respect to the previous month and half of those reporting no change. An index value of 100 indicates that all respondents reported an increase, a value of 0 that all respondents reported a decrease; a value of 50 could indicate that the percentages reporting increases and decreases were the same, or that all respondents reported no change.

Italy

Prices and costs. – The index of consumer prices for the entire resident population rose by an average of 2.2 per cent in the first nine months of 2006 compared with the corresponding period of the preceding year, against 2 per cent in the whole of 2005 (Figure 27). Excluding the more volatile items and those with regulated prices, however, inflation slowed down, from 2 to 1.8 per cent.

The rate of price increase remained virtually stable during the year. In the third quarter a deceleration in the prices of unregulated energy products (fuel and heating oil) was offset by an acceleration in the prices

Table 18

Consumer prices in Italy (1)

	Percentage changes on year-earlier period		Percentage weights	Contributions to average inflation (percentage points)
	2005	Jan.-Sept. 2006	2006	2006
OVERALL INDEX	**2.0**	**2.2**	**100**	
Unregulated goods and services	**1.9**	**2.0**	**81.6**	**1.63**
Unprocessed food	-0.8	0.8	6.4	0.05
of which: fruit	*-6.1*	*-4.7*	*0.8*	*-0.04*
Processed food	0.7	1.8	9.8	0.18
Unregulated non-food and non-energy products	0.9	1.2	30.0	0.36
of which: computers	*-10.6*	*-14.3*	*0.2*	*-0.02*
telephones	*-20.4*	*-13.9*	*0.7*	*-0.10*
Unregulated services	3.0	2.4	32.1	0.77
of which: air transport	*18.1*	*2.1*	*0.7*	*0.01*
financial services	*6.6*	*2.0*	*0.9*	*0.02*
hotel and restaurant services	*2.6*	*2.3*	*8.0*	*0.18*
Unregulated energy products	11.0	9.0	3.3	0.30
Regulated goods and services	**2.1**	**3.1**	**18.4**	**0.57**
Medical products	-5.1	-2.1	2.9	-0.06
Tobacco products	8.9	6.2	2.0	0.12
Rents	2.4	2.5	3.1	0.08
Public services and utilities	2.6	4.1	10.4	0.43
of which: gas	*7.6*	*10.0*	*1.9*	*0.19*
electricity	*3.9*	*12.0*	*1.1*	*0.13*
refuse collection	*4.4*	*4.8*	*0.6*	*0.03*

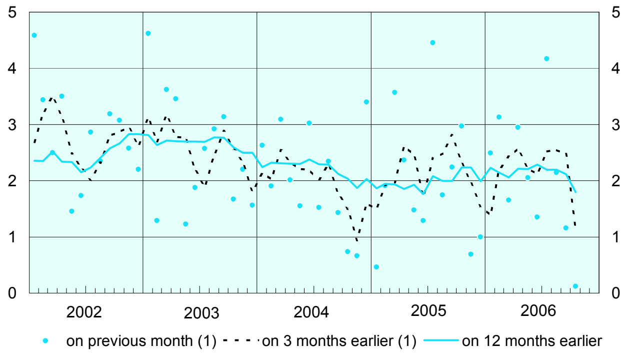
Source: Based on Istat data.
(1) Index of consumer prices for the entire resident population.

of those subject to regulation, which in Italy have a lagged reaction to changes in the prices of energy raw materials (Table a12). In October, according to provisional estimates from Istat, inflation probably declined to 1.8 per cent.

Figure 27

Italy: index of consumer prices for the entire resident population

(percentage changes)



Source: Based on Istat data.
(1) Seasonally adjusted and annualized.

Among the core components of the index, the prices of services with unregulated prices increased by an average of 2.4 per cent in the first nine months, compared with 3 per cent in 2005, despite the acceleration in unit labour costs in this sector. A contributory factor was the slowdown in the prices of air transport and hotel and restaurant services (Table 18). For the first time since 1998, the prices of financial and post-office banking services increased in line with average inflation (2 per cent, against 6.6 per cent in 2005). The prices of non-food and non-energy consumer goods rose by 1.2 per cent (compared with 0.9 per cent in 2005), slightly less than the increase in the producer prices for such goods (an average of 1.5 per cent in the first eight months of the year).

Some of the items in the basket for the consumer price index showed changes that were distinctly out of line with the average rise. As last year, the sharp decline in the prices of cellular phones (-13.9 per cent) and computers (-14.3 per cent) made a contribution to curbing inflation, albeit a marginal one (around 0.1 percentage point). The prices of such high-technology goods have fallen by more than 40 per cent since 2003. Items with regulated prices contributed 0.6 percentage points to the rise in the general index, owing primarily to the increase in the prices of energy products (electricity and gas, which rose by 12 and 10 per cent respectively) and to a lesser extent to that in tobacco prices (6 per cent).

Producer prices accelerated in the first nine months (rising by an average of 5.7 per cent in relation to the same period of 2005, and compared with a rate of 4 per cent in the whole of 2005), reflecting increases in the world prices of raw materials and the acceleration in unit labour costs in industry (to 4.4 per cent in the first half, compared with 3.1 per cent in 2005 as a whole). Excluding food and energy products, producer price inflation rose by around 3 points between January and September to 4.4 per cent, driven by an acceleration in the prices of intermediate goods to 7.2 per cent, compared with 0.9 per cent in January.

Profit margins. – Istat's indicators of input and output prices show that the prices of goods produced for the domestic market rose less than unit variable costs, which were driven upwards by imported inputs. This led to a narrowing of manufacturing industry's unit profit margins. The picture in services was similar (Table 19). These findings are corroborated by national accounts data, which show that in the first half of the year gross operating profit as a proportion of value added in the economy as a whole was slightly lower than in 2005; the reduction in industry excluding construction was more pronounced than in private-sector services owing to an acceleration in labour costs per employee in that sector.

Table 19

Unit costs and output deflator in Italy (1)

(percentage changes on year-earlier period)

	Manufacturing (2)		Private services	
	2005	Jan.-June 2006	2005	Jan.-June 2006
Unit variable costs	3.1	6.9	3.1	2.3
Cost of labour inputs	1.5	2.4	3.7	2.2
Cost of other inputs	3.1	7.7	3.0	2.9
Output prices	2.5	5.4	2.2	2.1

Source: Istat.
(1) Indicators including intrasectoral transactions. – (2) Manufacturing does not include the sub-sectors "Manufacture of coke, refined petroleum products and nuclear fuel" and "Mining and quarrying except energy producing materials".

The first half of 2006 saw a narrowing of the disparity between the prices applied on the domestic market (an increase of 5.4 per cent in producer prices by comparison with the same period of 2005) and those for the export market (an increase of 6.8 per cent). The average unit values of goods exported by Italian firms to EU countries rose by 4.2 per cent on the corresponding period, a smaller rise than that in producer prices (6.7 per cent). By contrast, the prices of exports to non-EU markets were raised by more than 10 per cent (8.2 per cent in 2005), in connection with gains in competitiveness and the brisk growth in world demand.

Inflation expectations

In October the professional forecasters interviewed monthly by Consensus Economics expected inflation this year to average 2.2 per cent in Italy and 2.3 per cent in the euro area (Table 20). Expectations for the euro area have been revised upwards by about 0.3 percentage points since the beginning of the year, gradually adapting to actual price developments. On this basis, Italy's average inflation differential this year vis-à-vis Germany and France would be 0.4 and 0.3 percentage points respectively, virtually the same as in 2005. In 2007 consumer price inflation is expected to fall to 1.9 per cent in Italy and 2.2 per cent in the euro area.

Table 20

Professional forecasters' inflation expectations for 2006 and 2007 in the euro area (1)

	Forecasts for 2006		Forecasts for 2007	
	January 2006 survey	October 2006 survey	January 2006 survey	October 2006 survey
Italy	2.1	2.2	1.8	1.9
France	1.8	1.9	1.6	1.6
Germany	1.7	1.8	2.3	2.3
Spain	3.1	3.7	2.8	2.9
Euro area	2.0	2.3	2.0	2.2

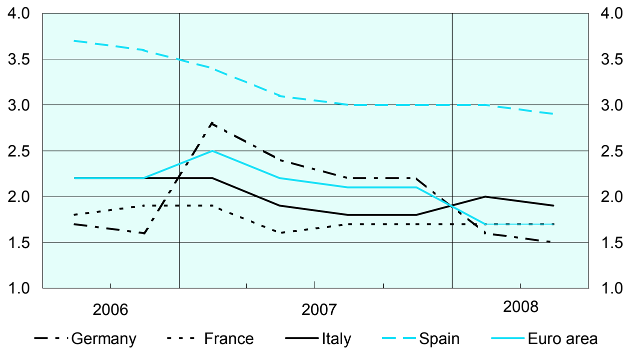
Source: Consensus Economics.
(1) Monthly survey of professional forecasters.

According to the quarterly survey conducted by Consensus Economics in September, the average inflation rate for the euro area is expected to rise to 2.5 per cent in the first quarter of 2007 owing to the announced increase in VAT in Germany and not to fall below 2 per cent until the end of the year. In 2007 inflation in France and Italy is expected to remain below the area average (Figure 28).

Figure 28

Professional forecasters' inflation expectations for the eight following quarters

(September 2006 survey; percentage changes on year-earlier quarter)



Source: Consensus Economics survey of professional forecasters.

The quarterly survey of a sample of around 450 Italian industrial and service companies conducted in September by the Bank of Italy and *Il Sole 24 Ore* indicates that respondents expected to increase their prices by 2.1 per cent in the subsequent twelve months (unchanged from the June survey); as usual, this is below the expected rate of consumer price inflation over the same time span (2.4 per cent). One of the main factors mentioned as being likely to cause inflationary pressure was tightness in raw materials markets.

Over a longer time scale, the expectations that can be derived from the prices of inflation-indexed government securities point to inflation remaining broadly unchanged in the euro area at around 2 per cent, a level endorsed by professional forecasters' expectations.

THE PUBLIC FINANCES IN THE EURO AREA AND ITALY

Overview

There has been a widespread improvement in euro-area public finances. According to the European Commission, general government net borrowing will fall to 2 per cent of GDP in 2006, compared with 2.4 per cent in 2005. The deficit will remain above the 3 per cent threshold only in Italy and Portugal. In many countries the results in 2006 are likely to be better than projected.

Italy's public finances also show signs of an improvement. In 2006 both the borrowing requirement and net borrowing (excluding the cost of the recent European Court of Justice judgment concerning VAT) are expected to be significantly smaller than in 2005. Their performance reflects the substantial increase in revenue as a consequence of the upturn in economic activity and some of the measures in the budget for 2006. Primary current expenditure continues to grow rapidly, however; in relation to GDP it will be at one of the highest levels of recent decades. The ratio of debt to GDP is expected to rise further.

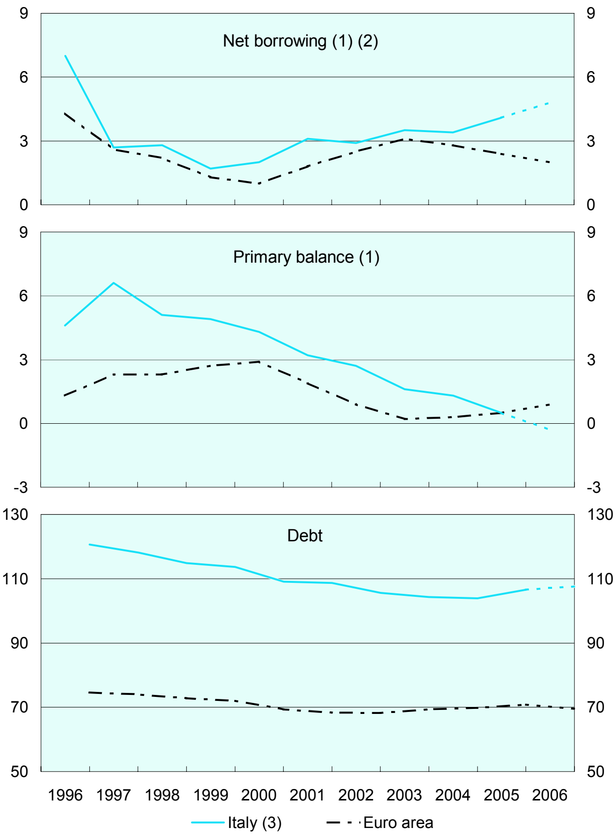
The objective for net borrowing in 2006 was set at 3.8 per cent of GDP in the Economic and Financial Planning Document published in July 2005. In December a budget adjustment estimated at 1.4 per cent of GDP was approved; the objective for the deficit was revised to 3.5 per cent of GDP. The Quarterly Report on the Borrowing Requirement published in April 2006 raised the estimate of net borrowing back to 3.8 per cent. At the end of June the new Government approved a supplementary budget amounting to 0.1 per cent of GDP. In July the new Economic and Financial Planning Document indicated a deficit equal to 4 per cent of GDP.

The Forecasting and Planning Report published at the end of September estimated that net borrowing in 2006 would be 4.8 per cent of GDP and that the primary balance would show a deficit of 0.3 per cent (Figure 29). These estimates include the cost of the European Court of Justice judgment on the deductibility of VAT in connection with spending on company cars. Excluding this amount, the figure for net borrowing would be 3.6 per cent.

Figure 29

Italy and the euro area: general government net borrowing, primary balance and debt

(as a percentage of GDP)



Sources: Based on Istat and Bank of Italy data respectively for the balances and the debt in the period 1996-2005; based on EU Commission data for the euro area in the period 1996-2005. For the 2006 forecasts, the Forecasting and Planning Report for 2007 for Italy and European Commission, *Autumn Forecasts*, for the euro area.

(1) Excludes the proceeds of sales of UMTS licences. – (2) Includes the effects of swaps and forward rate agreements. – (3) The forecasts of the balances for 2006 (4.8 per cent of GDP for net borrowing and -0.3 per cent of GDP for the primary balance) take account of the effects of the judgment of the European Court of Justice concerning the deductibility of VAT in relation to purchases of company cars. The forecast of the debt for 2006 (107.6 per cent of GDP) takes account of disbursements and allocations for refunds in relation to the above-mentioned deductibility of VAT.

Stripping out the refunds required by the ECJ's VAT judgment and the effects of temporary measures, there would be a primary surplus of approximately half a percentage point of GDP, compared with virtually zero in 2005.

Central government tax revenues in the first ten months of 2006 increased by €29.4 billion (11.5 per cent) compared with the corresponding period of 2005. They benefited from the improvement in macroeconomic conditions and the larger-than-expected effects of some of the measures in the budget for 2006. Part of the additional revenue is of a one-off nature.

Between April and September the official estimate of general government revenue, excluding the effects of the ECJ's VAT judgment, increased by 1.3 percentage points of GDP, partially owing to the measures adopted at the end of June (0.3 points). The revision was reflected only in part in an improvement in net borrowing, since the estimate of expenditure was also increased considerably. The current estimate of expenditure, which includes the additional disbursements provided for in the June supplementary budget (0.2 points), is 1 percentage point higher than that published in April.

On the basis of the official estimates and excluding the effects of the ECJ's VAT judgment, in 2006 revenue appears set to rise by 1.1 percentage points to 45.5 per cent of GDP and primary expenditure by 0.6 points to 44.5 per cent. The ratio of primary expenditure to GDP is expected to be about 3 percentage points higher than the average for the second half of the 1990s.

According to the Forecasting and Planning Report, the debt will continue to rise in relation to GDP, to reach 107.6 per cent, compared with 106.6 per cent in 2005. This estimate includes an increase of 0.8 percentage points as a result of disbursements and allocations for refunds following the judgment on the deductibility of VAT.

In the first nine months of the year the general government borrowing requirement net of privatization receipts fell by €16.5 billion compared with the corresponding period of 2005, to stand at €60.2 billion. This result appears consistent with an annual borrowing requirement of approximately 4 per cent of GDP, as against 5.3 per cent in 2005.

Objectives and forecasts in the euro area

The stability programme updates presented between November 2005 and February 2006 showed general government net borrowing in the euro area falling from the 2.5 per cent of GDP then expected for 2005 to 2.3 per cent in 2006 (Table 21).

The European Commission forecasts published in November indicate a euro-area deficit equal to 2 per cent of GDP in 2006, compared with the outturn of 2.4 per cent in 2005. Results in most of the euro-area countries are likely to be better than originally projected, owing in part to the improvement in macroeconomic conditions: the Commission estimates that GDP in the euro area will grow by 2.6 per cent, compared with an average of 2.1 per cent on the basis of the euro-area countries' stability programmes. The primary surplus is expected to rise from 0.5 per cent of GDP in 2005 to 0.9 per cent, mainly as a result of a reduction in disbursements, and interest payments to remain virtually unchanged at 2.9 per cent. On a cyclically adjusted basis and excluding the effects of temporary measures, the budget deficit is expected to fall by 0.3 percentage points to 1.7 per cent of GDP.

Among the countries whose deficits were at or above the 3 per cent threshold in 2005, net borrowing will decrease this year in Greece (by 2.6 points to 2.6 per cent), Portugal (by 1.4 points to 4.6 per cent) and Germany (by 0.9 points to 2.3 per cent; Figure 30). According to the Commission, net borrowing in Italy will increase by 0.6 points to 4.7 per cent of GDP; excluding the effects of the ECJ's VAT judgment, it will decrease by 0.6 points to just under 3.5 per cent.

The Commission forecasts that the debt ratio for the area will fall by 1.3 points in 2006, to 69.5 per cent.

Among the EU countries outside the euro area that had a deficit in excess of 3 per cent of GDP in 2005, net borrowing is forecast to fall in the United Kingdom (by 0.4 points to 2.9 per cent) and Malta (by 0.3 points

Table 21

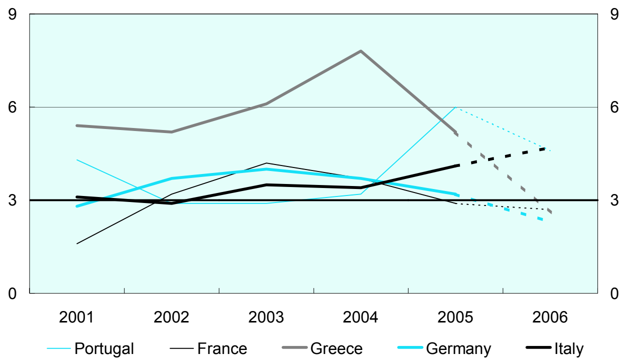
Euro area and European Union: general government net borrowing and debt (1)
(as a percentage of GDP)

	Euro area			European Union		
	2005	2006	2007	2005	2006	2007
Net borrowing (2)						
Stability and convergence programmes	2.5	2.3	1.8	2.5	2.3	1.8
European Commission (May 2006)	2.4	2.4	2.3	2.3	2.3	2.2
OECD (June 2006)	2.4	2.3	2.1	–	–	–
IMF (September 2006)	2.2	2.0	1.9	–	–	–
Eurostat (October 2006)	2.4	–	–	2.3	–	–
European Commission (November 2006)	2.4	2.0	1.5	2.3	2.0	1.6
Cyclically-adjusted net borrowing						
OECD (June 2006)	1.6	1.6	1.5	–	–	–
IMF (September 2006) (3)	2.0	1.7	1.6	–	–	–
European Commission (November 2006)	1.9	1.7	1.2	1.9	1.7	1.3
Debt						
Stability and convergence programme	71.1	70.9	69.6	63.8	63.7	62.7
European Commission (May 2006)	70.8	70.5	70.1	63.4	63.2	62.9
Eurostat (October 2006)	70.8	–	–	63.2	–	–
European Commission (November 2006)	70.8	69.5	68.2	63.3	62.2	61.1

Sources: Stability and convergence programmes submitted between late 2005 and February 2006; European Commission, *Spring Forecasts*, May 2006; OECD, *Economic Outlook*, June 2006; IMF, *World Economic Outlook*, September 2006; Eurostat, press communiqué, 23 October 2006; European Commission, *Autumn Forecasts*, November 2006.
(1) GDP-weighted averages. – (2) Includes the effects of swaps and forward rate agreements but excludes the proceeds of sales of UMTS licences. – (3) Excluding Luxembourg.

Figure 30

Net borrowing of selected euro-area countries (1)
(as a percentage of GDP)



Source: Based on European Commission data. For 2006, *Autumn Forecasts*.
(1) The countries considered are those whose deficit exceeded 3 per cent of GDP in at least one of the years considered. The data include the effects of swaps and forward rate agreements but exclude the proceeds of sales of UMTS licences.

to 2.9 per cent) and to rise in Hungary (by 2.3 points to 10.1 per cent) and Slovakia (by 0.3 points to 3.4 per cent); it is expected to remain basically unchanged in the Czech Republic (at 3.5 per cent).

Excessive deficit procedures are under way for Germany (since November 2002), France (since April 2003), Greece (since May 2004), Italy (since June 2005) and Portugal (since June 2005, after the earlier procedure had been closed in May 2004). In July the European Commission published its assessment of the measures approved by Germany, considering them sufficient to overcome the excessive deficit by 2007. In September the Council gave the green light to the measures adopted by Portugal to bring its deficit below the 3 per cent threshold by 2008. No further steps were taken in 2006 as regards the procedures under way for the other countries.

The EU countries outside the euro area with procedures under way are the Czech Republic, Hungary, Malta, Poland, Slovakia and the United Kingdom. As requested by the Council, in September

Hungary submitted a new update of its Convergence Programme. In October, considering the size of the adjustment required, the Council extended the time limit for completing the reduction of the deficit below the 3 per cent threshold by one year to 2009. In July the Council abrogated the procedure opened against Cyprus in July 2004.

In October, with the second notification to the Commission, some euro-area countries revised the net borrowing figures they had submitted in April. In the case of Belgium the deficit expected in 2005 was revised upwards by 2.4 percentage points of GDP, following the inclusion in expenditure of a transfer connected with the earlier assumption by general government of a part of the public railway company's debt. Greece increased the deficit in the four-year period 2002-05 by an average of 0.6 percentage points of GDP per year. This change does not take account of the upward revision of GDP in recent years by approximately 25 per cent that the Greek statistical institute made in September. Eurostat has announced that it intends to check the revision of the GDP data in view of the latter's size and complexity.

Budgetary policy in Italy

The Economic and Financial Planning Document released in July 2005 set a target of 3.8 per cent of GDP for net borrowing in 2006 (Table 22). A budget adjustment equal to 0.8 per cent of GDP was indicated as necessary to achieve this goal; the economy was expected to grow by 1.5 per cent. At the beginning of the same month the EU Council – after finding that Italy had an excessive deficit – had called for an improvement in the two years 2006-07 in the balance on a cyclically adjusted basis and excluding the effects of temporary measures of not less than 1.6 percentage points of GDP compared with 2005; at least half the correction was to be achieved in 2006.

Table 22

Italy: public finance objectives and estimates for 2006 (1)
(billions of euros and percentages)

	State sector borrowing requirement (2)	General government				*Memorandum items:*	
		Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate	Nominal GDP
Objectives							
Economic and Financial Planning Document (July 2005) ...	….	….	….	….	….	1.5	….
as a percentage of GDP	*….*	*3.8*	*0.9*	*….*	*107.4*		
Forecasting and Planning Report (Sept. - Nov. 2005)	55.8	54.7	13.1	67.8	….	1.5	1.435.4
as a percentage of GDP	*3.9*	*3.8*	*0.9*	*4.7*	*….*		
Stability programme update (December 2005)	….	….	….	….	….	1.5	….
as a percentage of GDP	*….*	*3.5*	*1.3*	*4.8*	*108.0*		
Estimates released during the year							
Quarterly Report on the Borrowing requirement (April 2006)	66.5	56.0	9.4	65.4	….	1.3	1.464.0
as a percentage of GDP	*4.5*	*3.8*	*0.6*	*4.5*	*….*		
Economic and Financial Planning Document (July 2006) ...	59.0	59.3	7.8	67.1	….	1.5	1.466.8
as a percentage of GDP	*4.0*	*4.0*	*0.5*	*4.6*	*107.7*		
Economic and Financial Planning Document update and Forecasting and Planning Report (September 2006)	47.7	71.1	-4.0	67.1	….	1.6	1.468.6
as a percentage of GDP	*3.2*	*4.8*	*-0.3*	*4.6*	*107.6*		

(1) The data taken from official documents published after 1 March 2006 take account of the statistical revisions and reclassifications made by Istat to the national accounts (press release of 1 March 2006). – (2) The figure published in the Forecasting and Planning Report for 2006 (September-November 2005) and that published in the Economic and Financial Planning Document published in July 2006 are net of settlements of past debts and privatization receipts. The Quarterly Report on the Borrowing Requirement (April 2006) shows settlements of past debts equal to zero and reports the borrowing requirement net of privatization receipts. The figure published in the Forecasting and Planning Report for 2007 (September 2006) is net only of privatization receipts.

In September 2005 the Forecasting and Planning Report, presented together with the proposed budget, confirmed the plans set out in the Economic and Financial Planning Document.

In December the budget for 2006 was approved; it was officially estimated to produce an adjustment equal to 1.4 percentage points of GDP, compared with that of 0.8 points indicated in September. The increased severity of the budget offset the simultaneous reduction in the proceeds expected from the sale of real estate included in the baseline projection and made it possible to revise the figure for net borrowing down to 3.5 per cent, as indicated in the stability programme update.

In March 2006 Istat released the outturn for the general government consolidated accounts in 2005: net borrowing amounted to 4.1 per cent of GDP.

In the Quarterly Report on the Borrowing Requirement published in April the Government raised the estimate of net borrowing in 2006 back to 3.8 per cent of GDP, primarily as a result of statistical revisions and the reclassifications made by Istat in the national accounts. The estimate assumed that the budget measures would be fully effective. At the same time the expected growth in economic activity was lowered to 1.3 per cent.

In May the Minister for the Economy and Finance of the new Government appointed a committee to examine the state of the public finances. In its report published in June the committee, taking account of the trends that had emerged in the early months of the year, raised the estimates of both revenue and expenditure in 2006, increased the deficit expected to 4.1 per cent of GDP, and warned of a possible overshoot. In particular, the committee stressed that some of the 2006 budget measures could turn out to be ineffective, with a consequent further increase in the deficit of up to 0.3 percentage points of GDP. The measures in question concerned the control on local authority spending and the agreed assessment scheme and related regularization of positions (see Economic Bulletin, No. 42, p. 76). The committee also stressed that some of the expenditure cuts in the budget for 2006 were problematic, especially those involving road and railway construction works. If it proved impossible to postpone this expenditure, the deficit would increase by at least another 0.2 percentage points of GDP.

At the end of June the Government approved a supplementary budget with measures estimated to reduce the deficit for the year by 0.1 percentage points of GDP and by 0.5 points in a full year. The additional resources in 2006 (0.3 percentage points of GDP) were to come mainly from rules intended to curb tax avoidance and evasion and were to be used in part to finance additional expenditure (0.2 percentage points of GDP), primarily on road and railway construction works. The agreed assessment scheme and related regularization of positions were abrogated.

In light of the results in the first half of the year, the Economic and Financial Planning Document published in July further increased the estimates of revenue and expenditure and indicated a deficit equal to 4 per cent of GDP. At the same time the forecast for GDP growth was raised to 1.5 per cent.

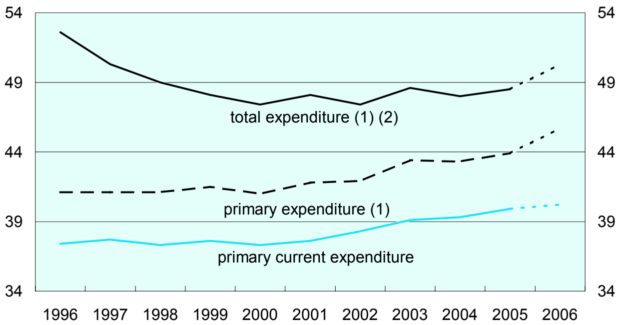
At the end of September the Forecasting and Planning Report and the Economic and Financial Planning Document update increased the estimate of net borrowing in 2006 to 4.8 per cent of GDP. The new figure included the effects of the judgment handed down by the European Court of Justice on 14 September, in which the restrictions on the deductibility of VAT for spending on company cars were declared to be incompatible with Community law. According to the Forecasting and Planning Report the judgment entailed an increase in net borrowing in 2006 of €18.6 billion (of which €17.1 billion of tax refunds for the years 2003-06). Excluding these effects, net borrowing in 2006 was estimated at 3.6 per cent of GDP. The revision of the estimate contained in the Economic and Financial Planning Document reflected the continued strong performance of fiscal revenue. The forecast for GDP growth was raised to 1.6 per cent.

Excluding the effects of the ECJ's VAT judgment, the current estimates of revenue and expenditure are higher than those of the Quarterly Report on the Borrowing Requirement by respectively €18.5 billion (1.3 per cent of GDP) and €15 billion (1 per cent). The latest estimates of revenue take account of the effects of the July supplementary budget (0.3 points), the improvement in macroeconomic conditions (approximately 0.3 points) and the higher-than-expected revenue from some of the temporary measures in the budget for 2006 (approximately a quarter of a point). The revision of the estimate of expenditure was due mainly to capital outlays (0.5 points), including the increase of 0.2 points introduced by the summer supplementary budget; and increases in intermediate consumption and social benefits in kind (0.3 points).

Compared with 2005 there will be a significant increase in both revenue and expenditure in relation to GDP (Figure 31). Primary current expenditure is set to rise by about 2 per cent in real terms; between 1998 and 2005 it increased on average by 2.3 per cent per year.

Figure 31

Italy: general government expenditure
(as a percentage of GDP)



Sources: Based on Istat data in the period 1996-2005. For the 2006 forecasts, based on data published in the Forecasting and Planning Report for 2007.
(1) The figure for 2006 includes increased disbursements amounting to 1.2 per cent of GDP in connection with the refunds payable following the judgement of the European Court of Justice concerning the deductibility of VAT in relation to purchases of company cars. The figures do not include the proceeds of sales of UMTS licences. – (2) Includes the effects of swaps and forward rate agreements.

Excluding the effects of the ECJ's VAT judgment, the Forecasting and Planning Report indicates a primary surplus in 2006 equal to 0.9 per cent of GDP, compared with 0.5 per cent in 2005.

At the beginning of November the European Commission forecast that Italy's net borrowing in 2006 would amount to 4.7 per cent of GDP; excluding the effects of the VAT judgment, the deficit would be just under 3.5 per cent. Compared with 2005 the improvement in the budget balance on a cyclically adjusted basis and excluding the effects of temporary measures is expected to be more than a quarter of a percentage point of GDP (more than half a point excluding the effects of the ECJ's VAT judgment); in the two years 2006-07 it is expected to be close to 1.5 points.

The public accounts in the course of the year

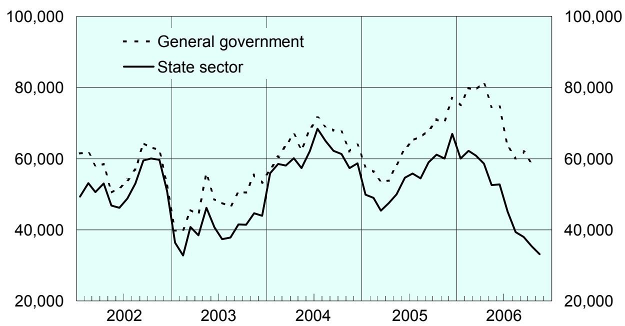
According to Istat estimates general government net borrowing in the first six months of 2006 was equal to 2.9 per cent of GDP, as against 5.1 per cent in the first half of 2005. The primary balance showed a surplus equal to 1.7 per cent of GDP, as against a deficit of 0.2 per cent. Revenue rose from 41.3 to 43.2 per cent of GDP, while expenditure declined by 0.3 percentage points to 46.1 per cent.

Central government tax revenues in the first ten months of the year were 11.5 per cent higher than in the corresponding period of 2005. The increase reflected the higher-than-expected revenue from some of the temporary measures in the budget for 2006, the improvement in macroeconomic conditions and a number of favourable events (see box).

In the first nine months of 2006 the general government borrowing requirement net of privatization receipts amounted to €60.2 billion, about €16.5 billion less than in the corresponding period of 2005 (Table 23). The improvement was due mainly to the rapid growth in revenue. As time went by the general government borrowing requirement showed an unfavourable divergence from that of the state sector (Figure 32) owing to the larger volume of borrowing by local authorities.

Figure 32

Italy: rolling twelve-month borrowing requirement (1)
(millions of euros)



Source: For the public sector borrowing requirement, the Ministry for the Economy and Finance.
(1) Net of privatization receipts.

Tax revenue

In the first ten months of 2006 state budget tax revenue on a cash basis increased by 11.5 per cent (€29.4 billion).

Part of the increase can be attributed to the tax-raising measures of a permanent nature introduced in the budget for 2006, which are estimated to have generated about €3 billion of additional revenue in the first ten months.[1]

Another part of the increase was due to the temporary measures in the budget for 2006. In particular, new deadlines were set for the payment of a number of one-off taxes introduced in earlier years. These taxes generated €5.7 billion of revenue in the first ten months of the year (€1.8 billion in the corresponding period of 2005), which was far more than the original official estimate; specifically, the tax on the revaluation

State budget tax revenue on a cash basis (1)
(amounts in millions of euros)

	January-October				
	2005	2006	% composition 2006	% change on 2005	Contribution to growth in 2006
Direct taxes	**132,762**	**152,076**	**53.5**	**14.5**	**7.6**
Personal income tax	103,604	111,088	39.1	7.2	2.9
of which: withholdings from employee incomes	*82,147*	*88,549*		*7.8*	
balances	*4,905*	*4,909*		*0.1*	
payments on account	*6,588*	*6,764*		*2.7*	
Corporate income tax	17,866	21,364	7.5	19.6	1.4
of which: balances	*7,213*	*8,397*		*16.4*	
payments on account	*10,548*	*12,719*		*20.6*	
Taxes on interest income and capital gains	7,901	10,950	3.9	38.6	1.2
interest on bank deposits	*2,182*	*2,599*		*19.1*	
interest on bonds	*3,800*	*5,131*		*35.0*	
dividends	*443*	*657*		*48.3*	
capital gains	*764*	*929*		*21.6*	
managed assets	*712*	*1,634*		*129.5*	
One-off taxes	1,778	5,734	2.0	222.5	1.6
Taxes on insurance companies' mathematical reserves	134	1,045	0.4	679.9	0.4
Other	1,479	1,895	0.7	28.1	0.2
Indirect taxes	**121,964**	**132,023**	**46.5**	**8.2**	**3.9**
VAT	77,811	84,759	29.8	8.9	2.7
Other business taxes	9,673	10,907	3.8	12.8	0.5
Excise duties on mineral oils	16,678	16,784	5.9	0.6	0.0
Other excise duties and sales taxes	5,877	5,902	2.1	0.4	0.0
Monopolies	7,324	7,735	2.7	5.6	0.2
Lotteries	4,601	5,936	2.1	29.0	0.5
TOTAL TAX REVENUE	**254,726**	**284,099**	**100.0**	**11.5**	**11.5**

Source: State budget.
(1) The figures for 2006 are provisional.

of corporate assets generated €4.3 billion (€0.7 billion in 2005).

In the early months of the year revenue also benefited from: the rise in withholdings on employee incomes due to disbursements of back pay in connection with labour contract renewals; receipts of the tax on interest income for post office savings certificates as a result of a bunching of redemptions in 2005; and the payment of the tax on insurance companies' mathematical reserves, which was not paid in 2005 because it had been moved forward to 2004. Taken together these taxes yielded additional revenue estimated at €2.5 billion.

Excluding the effects of the measures in the budget for 2006 and the favourable events in the first few months referred to above, the growth in tax revenue was equal to a little less than 8 per cent (approximately €20 billion).

Personal income tax receipts rose by 7.2 per cent (€7.5 billion), driven by the increase of 7.8 per cent (€6.4 billion) in withholdings on employee incomes. Excluding the effects of disbursements of back pay in connection with labour contract renewals, the increase in withholdings can be estimated to have been about 6.5 per cent. The growth in receipts of this tax reflects its high degree of progression, which has been accentuated by the reforms of the last few years and gives rise to fiscal drag on a major scale. Self-assessed personal income tax increased by 1.6 per cent (€0.2 billion). This item of revenue, contributed mainly by the self-employed and small businesses, has recorded very little growth recently, despite the revision of a large number of sector studies in the last two years. The receipts for 2005 (the sum of the payments made on account in 2005 and the balances paid in 2006) showed an increase of about 3.5 per cent on those for 2004 (which were virtually unchanged compared with those for 2003).

Corporate income tax receipts rose by 19.6 per cent (€3.5 billion), boosted by the effects of the measures to broaden the tax base introduced in the budget for 2006. In the case of the balances paid for 2005 these effects were offset in part by the consequences of the increase, just for 2005, in the percentage to be paid on account. Considering these factors, it would appear that there has been substantial growth in the tax base in 2006.

Total revenue from the flat taxes on income from financial assets rose by 38.6 per cent (€3 billion). A major contribution to the increase (€0.9 billion) came from the tax on managed assets, reflecting the good performance of share prices in 2005 and the reduction in tax credits, which had almost completely annulled receipts in recent years. The yield of the tax on bond interest benefited from the bunching of redemptions of post office savings certificates in 2005 mentioned earlier. Excluding these two components, receipts of these taxes rose by more than 20 per cent in connection with the increases in interest rates and share prices.

Turning to indirect taxes, VAT receipts rose by 8.9 per cent (€6.9 billion); the revenue associated with imports from non-EU countries (about 14 per cent of the total) grew by 19 per cent, reflecting the increase in the price of oil. The revenue associated with domestic consumption and imports from EU countries grew by 6.9 per cent, compared with an annual increase in household consumption estimated by the September Forecasting and Planning Report at 4.2 per cent.

The yield of mineral oil excise taxes was virtually unchanged. In the first nine months of the year the consumption of all oil products in Italy was virtually the same as in the corresponding period of 2005.

The 5.6 per cent growth in revenue from the tax on tobacco products benefited from the increase in cigarette prices.

---

[1] The estimate is based on the official figures contained in the technical notes accompanying the measures. The budget for 2006 included rules on the determination of entrepreneurial income (with effects on corporate and personal income tax) and provided for measures to rationalize the taxation of lotteries and betting. The estimate also takes account of the reduction in revenue due to the increase in the percentage of corporate income tax to be paid on account, originally introduced just for the year 2005.

Table 23

Italy: main public finance indicators
(millions of euros)

	2003	2004	2005	2006
	General government net borrowing			
Year	46,774	47,641	58,163	71,120 (1)
as a percentage of GDP	*3.5*	*3.4*	*4.1*	*4.8* (1)
	General government borrowing requirement net of privatization receipts			
Jan. - Sept.	52,917	63,504	76,631	60,172
Whole year	57,056	57,819	75,106	–
as a percentage of GDP	*4.3*	*4.2*	*5.3*	–
	Total general government borrowing requirement			
Jan. - Sept.	52,917	63,489	72,606	60,134
Whole year	40,191	49,503	70,488	–
as a percentage of GDP	*3.0*	*3.6*	*5.0*	–
	General government debt			
End of September	1.438.829	1.489.629	1.534.467	1.601.541
End of year	1.392.285	1.442.994	1.510.826	–
as a percentage of GDP	*104.3*	*103.9*	*106.6*	–
	Memorandum items: *Settlements of past debts*			
Jan. - Sept.	6,491	454	366	180
Whole year	8,537	533	403	–
as a percentage of GDP	*0.6*	*0.0*	*0.0*	–
	Privatization receipts			
Jan. - Sept.	1	15	4,025	38
Whole year	16,866	8,316	4,618	–
as a percentage of GDP	*1.3*	*0.6*	*0.3*	–
	State sector net borrowing requirement (2)			
Jan. - Oct.	64,375	65,851	75,954	49,100
Whole year	55,892	49,904	60,036	47,700 (1)
as a percentage of GDP	*4.2*	*3.6*	*4.2*	*3.2* (1)

Sources: For general government net borrowing, Istat; for the state sector borrowing requirement, Ministry for the Economy and Finance.
(1) Estimate contained in the Forecasting and Planning Report for 2007. – (2) Net of privatization receipts.

Excluding the refunds consequent on the ECJ's VAT judgment, the gap between the borrowing requirement net of privatization receipts and net borrowing is likely to narrow from 1.2 percentage points of GDP in 2005 to about half a point, which is in line with the average for the three years 2002-04.

The public debt

According to the Forecasting and Planning Report the debt will rise to 107.6 per cent of GDP (from 106.6 per cent in 2005), primarily as a result of the ECJ's VAT judgment.

In the first nine months of 2006 the debt grew by €90.7 billion, compared with €91.5 billion in the corresponding period of 2005 (Table 24). A sizable part of the decrease in the total borrowing requirement (€60.1 billion, compared with €72.6 billion) was offset by the larger increase in the Treasury's holdings with the Bank of Italy (€29.9 billion, compared with €20.3 billion).

Table 24

Italy: change in general government debt and its components
(millions of euros)

	Jan.-Sept. 2005	Jan.-Sept. 2006 (1)
Change in debt	**91,473**	**90,716**
Total general government borrowing requirement	72,606	60,134
of which: *settlements of past debts*	*366*	*180*
privatization receipts	*4,025*	*38*
Change in the Treasury's deposits with the Bank of Italy	20,322	29,866
Issue discounts and premiums	-2,667	1,993
Change in the euro equivalent of foreign currency liabilities	1,211	-1,278

(1) Provisional.

The increase in the debt due to net issues of securities amounted to €66.3 billion. The deposits with the Treasury of entities outside general government increased by €15.9 billion and MFI loans by €9.6 billion; these results are largely due to transactions with Cassa Depositi e Prestiti s.p.a. Liabilities in respect of the securitization of receivables from health-sector bodies increased by €2.6 billion; at the end of 2005 they had amounted to €2.7 billion. These liabilities were included in the debt with the notification of public finance data to the Commission on 1 October 2006. The revision, carried out in light of a methodological review and the opinion issued by Eurostat in September 2006, led to an increase in the debt compared with the earlier statistics.

At the end of September 2006 the average residual maturity of government securities was 6 years and 7 months, virtually unchanged compared with the end of 2005.

Excluding the refunds and allocations consequent on the ECJ's VAT judgment, the estimate of the debt in 2006 contained in the Forecasting and Planning Report appears consistent with the performance of the general government borrowing requirement to date.

MONETARY POLICY, FINANCIAL INTERMEDIARIES AND MARKETS

Overview

The Governing Council of the European Central Bank has increased official interest rates three times since the beginning of June, by a quarter of a percentage point on each occasion. The minimum bid rate on main refinancing operations reached 3.25 per cent in October; it had been 2 per cent before the first increase last December.

The gradual move away from an accommodating monetary policy stance reflects the data that have become progressively available from the summer onwards: the cyclical situation of the euro area has been marked by strengthening signs of recovery and the risk that the past rises in oil prices might work through to the prices of consumer goods. The monetary aggregates have continued to grow rapidly, and this has been accompanied by a sharp acceleration in lending due to low interest rates and stronger corporate demand for credit to finance fixed investment and mergers and acquisitions.

Real short-term interest rates have gradually risen but are still low in historical terms; the expectations implied by the forward yield curve indicate that rates are likely to rise further in the latter part of this year and in early 2007.

In the financial markets, the yield curve has flattened considerably; long-term yields have remained low, despite the rise at the short end. Spreads on private-sector bonds and the indicators of implied volatility in the equity and currency markets remain very low, reflecting abundant liquidity and optimism about risk.

In Italy lending to the private sector has accelerated (Table 25). Borrowing conditions remain favourable, despite the adjustment of bank lending rates to the increases in official rates. The acceleration in bank lending to firms has more than offset the slight slowdown in lending to consumer households; the strong demand for advances to finance working capital as turnover has begun to grow again has stimulated short-term lending. Issues of bonds by Italian non-financial corporations have revived, mainly owing to placings by a number of large companies.

Table 25

Credit in Italy
(end-of-period data)

	Total credit (1)	Total credit to the private sector (2)	Bank lending	Bonds (3)	Other finance from abroad (4)
	Twelve-month percentage changes				
2002 - Dec.	5.4	8.6	6.8	38.2	0.2
2003 - Dec.	5.3	7.8	6.9	20.0	3.4
2004 - Dec.	5.7	7.9	7.2	17.7	2.9
2005 - Dec.	7.9	11.0	8.7	22.2	13.0
2006 - Jan.	7.9	10.6	8.0	23.3	13.5
Feb.	8.4	11.7	8.8	26.0	14.8
Mar.	8.3	11.4	9.0	24.1	13.4
Apr.	8.3	11.9	10.3	19.5	13.3
May	8.2	11.9	10.6	19.8	10.9
June	8.0	12.1	10.3	20.0	13.9
July	8.1	(12.3)	10.8	(20.3)	….
Aug.	8.4	(12.6)	11.3	(21.6)	….
Sept.	8.5	(13.2)	11.9	(21.8)	….
	Percentage shares of stocks				
2006 - June	100.0	51.8	38.0	7.7	6.0

(1) Sum of general government debt and total credit to the private sector. – (2) Italian residents other than government and MFIs. Corresponds to “Other residents” in the harmonized statistics of the ESCB. – (3) Bonds issued by Italian firms and local authorities. – (4) Loans and other assets of the rest of the world vis-à-vis Italian residents (comprises mainly technical reserves, trade credit and investment fund units).

The debt of the Italian corporate sector has increased, but in relation to GDP it remains lower than in the euro area as a whole. The debt of listed companies continues to be above the euro-area average, although their financial situation improved in the first half of 2006, reflecting the high level of profits, especially in the case of companies in high-technology sectors.

As anticipated to some extent, in October two rating agencies announced a revision of their assessment of Italian public debt. The effect on the yield differential between Italian Treasury bonds and German Bunds was negligible.

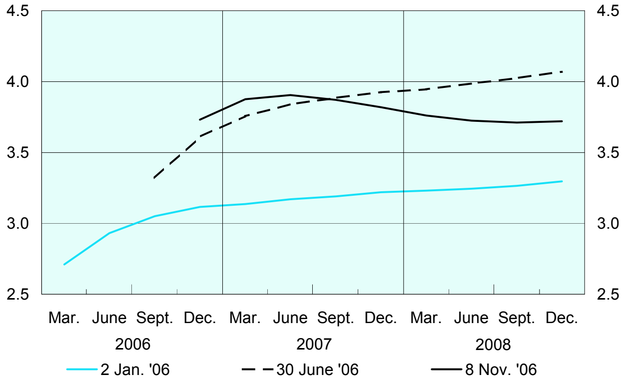
Monetary and financial conditions in the euro area

Interest rates and the exchange rate. – Between the beginning of June and mid-November short-term interest rates rose by about three quarters of a percentage point, mirroring the similar increase in official rates. Three-month rates reached 3.6 per cent in November (Figure 33).

Expectations about the direction of monetary policy have not altered since the early summer; the markets had foreseen the gradual rise in interest rates in response to the improvement in the economic climate and the heightened risk of inflation. In mid-November the forward yield curve indicated expectations of further increases in official rates by the early months of 2007 (Figure 34). Market participants' forecasts for the second half of next year are widely dispersed, reflecting uncertainty about the prospects for the world economy and inflation.

Figure 34

Rates on three-month Euribor futures contracts (1)
(*percentages*)

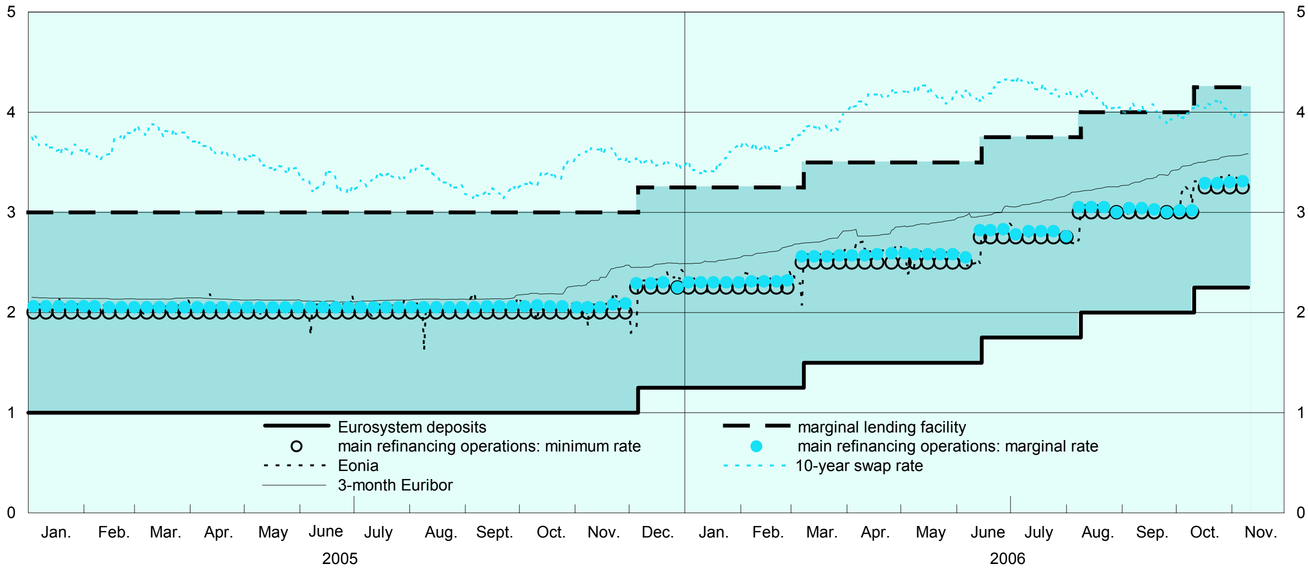


Source: Reuters.

(1) The contract date of each curve is specified in the legend. The horizontal axis shows the settlement dates for the futures contracts to which the yields refer (around the 15th of each month).

Figure 33

Official interest rates and money and financial market rates in the euro area
(daily data; percentages)

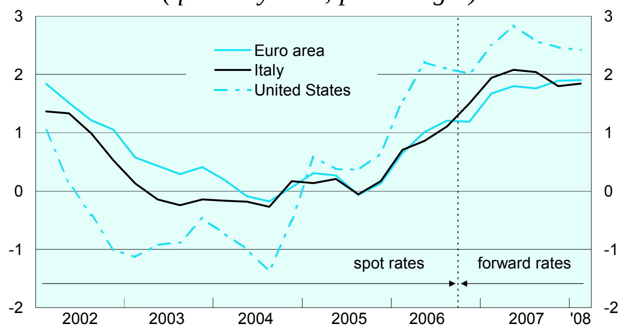


Sources: ECB, Reuters and Telerate.

Real short-term interest rates, which had been close to zero for the previous two years, turned positive in 2006. In mid-November the three-month rate, deflated using inflation expectations, was slightly over 1 per cent (Figure 35). It is currently expected that real euro rates will continue to rise moderately to around 2 per cent in 2007. This is still relatively low compared with the levels of the last twenty years, when real rates in Germany averaged around 3 per cent.

Figure 35

Spot and forward real three-month interest rates (1)
(quarterly data; percentages)



Sources: Based on Reuters and Consensus Economics data.
(1) Nominal three-month rates on Euromarket deposits (averages of daily data in the last month of the quarter; from December 2006, nominal rates implied by futures contracts in the first fifteen days of November), deflated using inflation expectations for the subsequent quarter measured by the quarterly Consensus Economics survey of professional forecasters.

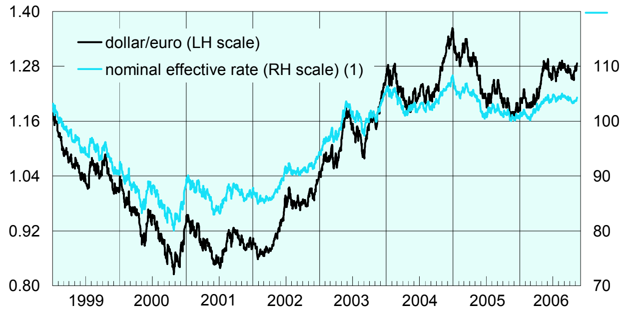
Despite the steady rise in short-term rates, yields on benchmark ten-year government securities have declined by about 30 basis points since the summer, to stand at around 3.8 per cent in mid-November. The decrease reflected both fears that the US economy would slow down more sharply than had previously been forecast and the reduction in inflation expectations encouraged by the recent fall in oil prices. On the basis of the prices of ten-year French government bonds indexed to consumer prices in the euro area, long-term inflation expectations came down by about 10 basis points between June and November, to 2.1 per cent.

The euro, which had strengthened in the first half of the year, remained broadly stable from the summer onwards both against the dollar and in nominal effective terms (Figure 36). Fears of abrupt exchange rate realignments remained subdued; the exchange rate volatility implied by options prices had increased for a time in the spring, but the downward trend then resumed, and in October it reached its lowest level for four years.

Since January the euro has appreciated by 3.5 per cent in nominal effective terms, owing mainly to its strengthening against the dollar and the yen by 8.7 and 8.3 per cent respectively.

Figure 36

Dollar/euro exchange rate and nominal effective exchange rate of the euro
(*daily data*)



Source: ECB.
(1) Index, first quarter of 1999=100. A rise in the index indicates an appreciation.

The money supply and credit. – During the summer the M3 money supply continued to expand at a sustained pace, which rose to 8.5 per cent in September, well above the rate of growth in nominal output (Figure 37). In the euro area the ratio of M3 to GDP reached a historic peak of 90 per cent, about eight points above the level implied by the long-term trend rate. The growth in bank deposits continues to be driven by strong demand from non-bank financial intermediaries, whereas the growth in households' deposits is more modest (4.8 per cent in August).

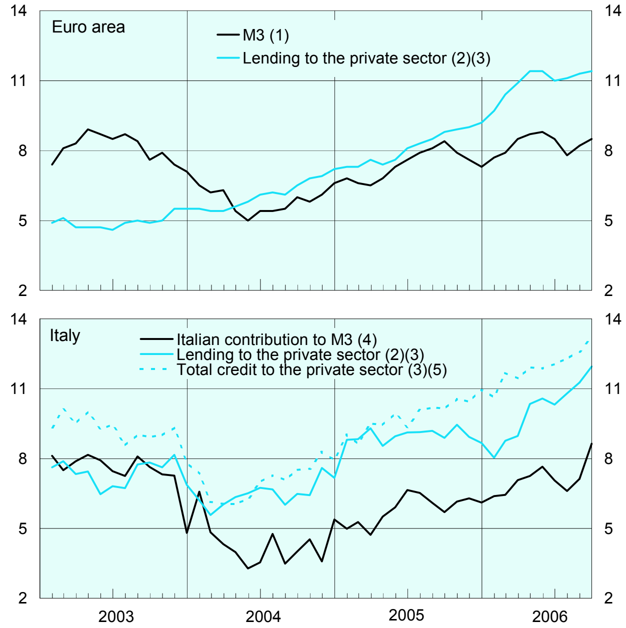
The rise in short-term interest rates has not yet had a significant impact on the rate of growth in the money supply, but it has altered its composition by boosting demand for less liquid monetary instruments earning a higher return, such as deposits with an agreed term of up to two years; the growth in current accounts has been small.

The benign monetary conditions stimulated the growth in lending to the private sector, which accelerated to a rate of 11.4 per cent in September. The expansion in bank lending to firms was particularly rapid, buoyed by the good performance of gross fixed

Figure 37

Monetary and credit aggregates

(end-of-month data; twelve-month percentage changes)



Sources: ECB and Bank of Italy.

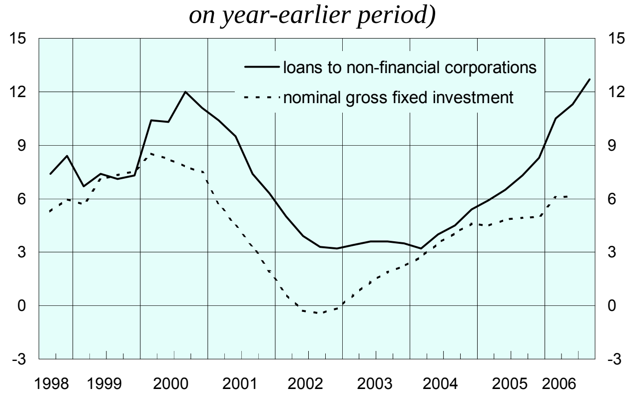
(1) Changes are calculated on the basis of seasonally adjusted data corrected for calendar effects. – (2) Lending in euros and other currencies by monetary financial institutions (MFIs). – (3) The private sector comprises households, non-financial firms, insurance companies, non-profit institutions serving households, non-money-market investment funds and other financial institutions. – (4) Excludes currency in circulation. – (5) Lending by MFIs, bonds and foreign loans.

investment (Figure 38) and the increase in mergers and acquisitions. Lending to households, and in particular loans for house purchases, slowed down somewhat but continued to grow at a sustained rate.

Figure 38

Bank lending to non-financial corporations and gross fixed investment in the euro area

(quarterly data; percentage changes on year-earlier period)



Sources: Based on ECB and Eurostat data.

Households' financial saving and the financing of firms in Italy

Households. – In the first half of 2006 Italian households' financial saving (the balance between the changes in financial assets and liabilities) remained broadly unchanged with respect to the corresponding period of 2005 (€67 billion; Table 26), high by historical standards.

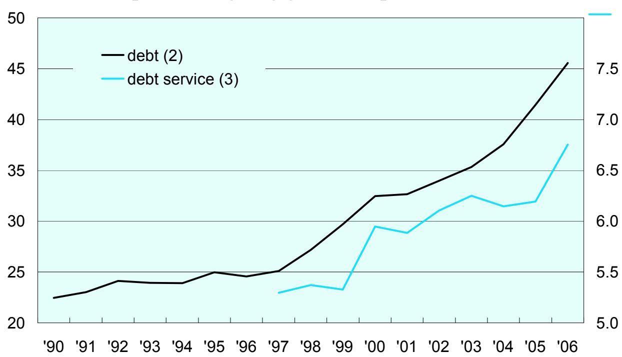
Households invested mainly in financial instruments with low risks and returns; they increased their bank deposits and investments in bank bonds and began to buy government securities again, while reducing their purchases of shares and other equity and selling investment fund units.

Debt, in the form of both mortgage loans and consumer credit, continued to increase. By June 2006 it had risen to 45.6 per cent of disposable income (Figure 39), around half the percentage for the euro area.

Figure 39

Households' financial debt (1)

(as a percentage of gross disposable income)



Source: For gross disposable income, Istat.

(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. The data on disposable income and debt service refer to the twelve months ending in June of each year. Disposable income for 2006 is estimated. – (2) Left-hand scale. The stock data refer to June of each year. – (3) Right-hand scale. The indicator refers to consumer households only. Debt service comprises payment of interest and repayment of principal. Interest is calculated by multiplying the amounts outstanding in each period by an average interest rate that takes account of the term structure and types of lenders; repayments of principal are estimated from supervisory reports.

The cost of debt servicing (payments of interest and repayments of principal) rose but still represents a small proportion of households' disposable income (6.8 per cent in the twelve months to June, compared with 6.2 per cent a year earlier). Although it was affected by the rise in bank lending rates,

Table 26

Financial assets and liabilities of Italian households and firms (1)
(millions of euros)

	Households (2)			Non-financial corporations		
	Flows		Stocks	Flows		Stocks
	Jan.-June 2005	Jan.-June 2006	June 2006	Jan.-June 2005	Jan.-June 2006	June 2006
Assets						
Domestic assets	**81,248**	**67,457**	**3,018,331**	**-23,987**	**-759**	**1,030,348**
Cash and sight deposits	16,930	10,477	563,509	11,023	7,086	159,020
Other deposits	517	9,095	327,295	-937	-463	10,139
Short-term securities	-756	15,137	17,242	-88	330	359
Medium and long-term securities	-1,063	12,952	538,080	-127	2,028	46,175
of which: government	*-4,849*	*2,024*	*167,336*	*-2,287*	*1,234*	*11,293*
corporate bonds	*2,000*	*-780*	*44,263*	*2,132*	*1,198*	*22,681*
Investment fund units	-4,971	-22,685	228,449	-69	-314	3,185
Shares and other equity	43,493	14,405	732,364	-7,204	4,207	520,002
Other financial assets (3)	27,098	28,076	611,392	-26,585	-13,633	291,468
of which: life insurance reserves	*20,868*	*19,967*	*372,498*	–	–	–
External assets	**13,455**	**28,212**	**305,336**	**16,667**	**22,167**	**375,151**
of which: deposits	*1,155*	*2,953*	*5,904*	*-2,035*	*-3,768*	*17,069*
short-term securities	*618*	*94*	*789*	*211*	*789*	*3,408*
medium and long-term securities	*5,132*	*14,179*	*130,486*	*744*	*811*	*18,714*
shares and other equity	*-781*	*1,926*	*93,838*	*810*	*2,004*	*166,195*
investment fund units	*7,331*	*9,060*	*74,319*	*149*	*807*	*10,972*
short-term loans	–	–	–	*14,873*	*15,823*	*92,774*
Total assets	**94,703**	**95,669**	**3,323,667**	**-7,320**	**21,408**	**1,405,499**
Liabilities						
Domestic liabilities	**27,632**	**28,431**	**493,395**	**38,406**	**44,793**	**2,400,189**
Short-term debt (4)	-219	61	53,235	3,673	12,900	329,280
of which: bank	*-286*	*67*	*51,371*	*6,048*	*16,183*	*300,187*
Medium and long-term debt (5)	26,650	27,061	406,437	22,685	23,819	472,522
of which: bank	*22,376*	*22,302*	*362,418*	*16,830*	*21,369*	*376,168*
Securities	–	–	–	3,156	6,415	53,971
of which: medium and long-term	–	–	–	*1,176*	*4,314*	*40,221*
Shares and other equity	–	–	–	32,036	12,700	1,162,219
Other financial liabilities (6)	1,201	1,309	33,723	-23,144	-11,041	382,197
External liabilities	–	–	–	**-21,456**	**-24**	**282,844**
of which: short-term debt	–	–	–	*696*	*304*	*72,436*
medium and long-term debt	–	–	–	*-5*	*-2,020*	*5,625*
medium and long-term securities	–	–	–	*-1,444*	*209*	*13,875*
shares and other equity	–	–	–	*-22,143*	*-2,300*	*156,333*
Total liabilities	**27,632**	**28,431**	**493,395**	**16,950**	**44,769**	**2,683,033**
Balance	**67,071**	**67,238**	**2,830,272**	**-24,270**	**-23,361**	**-1,277,534**

(1) Rounding may cause discrepancies in totals. Flows differ from the change in stocks because they do not include revaluations and other changes in volumes. – (2) Consumer households, sole proprietorships with up to 5 workers and non-profit institutions serving households. – (3) Comprises the insurance reserves of the casualty sector and domestic trade credit; for households, also includes pension funds, severance pay provisions and the insurance reserves of the life sector; for firms, also includes domestic derivatives. – (4) Includes finance provided by factoring companies and repos. – (5) Includes finance provided by leasing companies; for households, also includes consumer credit from finance companies. – (6) Staff severance pay and pension provisions; for firms, also includes domestic trade credit and derivatives.

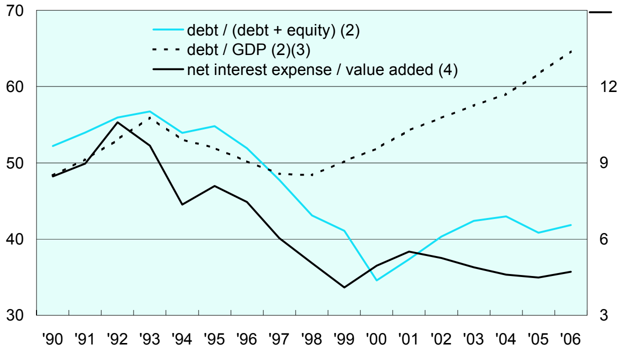
the proportion of debt service consisting of interest payments rose only moderately.

Firms. – In the first six months of 2006, despite an increase in gross fixed investment, the corporate sector's financial deficit remained almost stable in relation to the corresponding period of the previous year, aided by a recovery in profits and a reduction in stocks.

Estimates based on national accounts data show that the economic recovery led to an acceleration in the growth of firms' value added. Net interest expense increased slightly to 4.7 per cent of value added, owing partly to the rise in interest rates (Figure 40).

Figure 40

Financial debt and net interest expense of Italian non-financial corporations (1)
(percentages)



Source: For GDP and value added, Istat.

(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. – (2) Left-hand scale. The stocks of debt and equity refer to June of each year. Equity is valued at market prices. – (3) GDP for the full year (the figure for 2006 is estimated). – (4) Right-hand scale. Net interest expense and value added are for the full year except for the figure for 2006, which refers to the first six months. Bank of Italy estimates of net interest expense. Value added for 2006 is estimated.

According to a survey conducted by the Bank of Italy on a sample of more than 4,000 industrial and service firms, sales and orders increased substantially in the first nine months of the year; the proportion of firms expecting to record a profit for the year rose to 73 per cent, compared with 67 per cent in 2005.

Firms' financial debt rose to 64.6 per cent of GDP, compared with 61.7 per cent in June 2005. Leverage (the ratio of financial debt to the sum of financial debt and equity at market prices) rose to 41.8 per cent, 1 percentage point higher than a year earlier. The proportion of medium and long-term debt continued to rise, to 56.2 per cent of the total in June; the pick-up in net bond issues was a contributory factor.

By contrast, the accounts of a sample of large listed companies indicate that in the first half of 2006 both the ratio of their financial debt to sales and their leverage (at balance-sheet value) decreased, especially in the high-technology sectors where profitability was rising. The debt of listed companies nevertheless remains higher in Italy than in the other major countries.

According to Thomson Financial, around 60 mergers or acquisitions of majority shareholdings by Italian non-financial companies were announced in the first half of 2006; the total value (about €7 billion, of which almost €4 billion related to a single transaction in the services sector) was comparable to that recorded in the same period of 2005. Almost all of the operations involved payment in cash, which the bidders generally raised externally.

In more than two thirds of the announced mergers the target company was also Italian. The remainder, in which foreign companies were acquired by Italian firms, had a higher average value and often involved companies in the same sector. The proportion of bidders from the manufacturing and telecommunications industries decreased, but a large number of mergers continued to be carried out between firms in the energy sector.

The activities of Italian banks

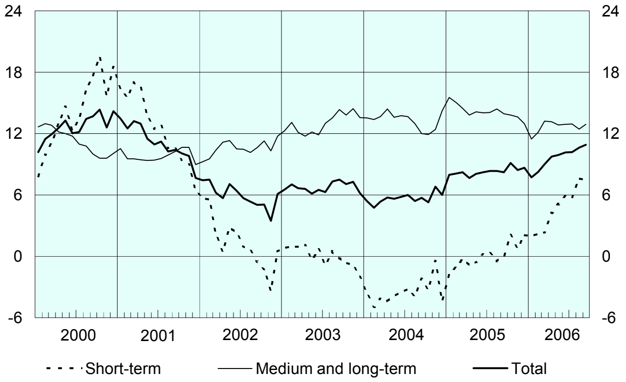
Lending. – In the first nine months of 2006 bank lending in Italy grew at an annual rate of 11.7 per cent, three points faster than at the end of 2005 (Table 27; Figure 41).

The acceleration can be ascribed primarily to corporate demand, with firms increasing their recourse to short-term credit as economic activity quickened.

Figure 41

Lending in Italy (1)

(monthly data; twelve-month percentage changes) (2)



(1) Loans exclude repos, bad debts and some minor items included in the Eurosystem harmonized definition of the aggregate. – (2) Calculated net of reclassifications, exchange rate variations and other variations not due to transactions.

Lending to firms increased by 9.5 per cent (Table 28; Figure 42). There was a sharp acceleration in the growth in short-term lending (from 1.2 to 6 per cent; Table a39), primarily as a result of the increase in advances against trade credit; the expansion in this form of lending was greatest for medium-sized and large companies, whose turnover showed particularly rapid growth.

The acceleration in lending was most pronounced in the sectors where the increase in output was highest, such as those producing energy, office machinery and rubber and plastic products. Lending to service companies continued to grow apace, partly owing to major mergers and acquisitions.

Bank lending to consumer households continued to increase rapidly (by 13.4 per cent), although

Table 27

Main assets and liabilities of Italian banks (1)

(end-of-period data; percentage changes on previous period, except as indicated)

	2004	2005	2006 (2)			September 2006	
			Q1	Q2	Q3	12-month % change	Stocks (millions of euros)
Assets							
Securities	-2.8	19.4	-12.6	5.0	13.4	7.5	220,724
of which: government securities	*-12.4*	*14.5*	*-26.5*	*20.5*	*5.8*	*3.7*	*115,176*
Loans	6.7	8.7	12.2	13.0	12.7	11.7	1,340,296
of which (3): short-term (a)	*-4.4*	*2.0*	*6.7*	*17.2*	*6.6*	*7.5*	*461,869*
medium and long-term (b)	*14.2*	*13.0*	*15.4*	*10.4*	*12.5*	*12.9*	*811,710*
(a) + (b)	*6.0*	*8.6*	*12.1*	*12.8*	*10.3*	*10.9*	*1,273,579*
repos	*88.5*	*48.5*	*43.4*	*52.9*	*737.5*	*187.8*	*16,107*
bad debts (4)	*6.0*	*-16.5*	*10.8*	*-2.7*	*8.2*	*-14.7*	*47,259*
Memorandum item:							
“net bad debts” (5)	*-1.2*	*-27.4*	*43.4*	*-14.1*	*7.1*	*-13.7*	*17,114*
External assets	11.3	11.0	25.3	-3.3	42.7	19.4	316,659
Liabilities							
Domestic funding (6)	7.3	7.8	12.4	8.2	10.0	9.5	1,334,011
Deposits	5.2	6.9	10.5	7.2	9.6	8.4	810,089
of which (7): overnight	*6.2*	*8.0*	*8.8*	*2.7*	*4.1*	*5.7*	*589,792*
with agreed maturity	*-4.0*	*2.7*	*11.4*	*-5.3*	*21.6*	*14.3*	*45,194*
redeemable at notice	*4.7*	*2.5*	*-3.8*	*1.3*	*-0.1*	*-0.8*	*68,632*
repos	*5.7*	*4.9*	*48.2*	*58.7*	*58.5*	*36.0*	*98,623*
Bonds (6)	10.8	9.3	15.5	9.7	10.7	11.3	523,922
External liabilities	4.0	11.8	43.7	8.5	35.9	18.5	407,395

(1) The figures for September 2006 are provisional. The percentage changes are calculated net of reclassifications, exchange rate variations and other variations not due to transactions. – (2) Annualized changes, calculated on seasonally adjusted data where appropriate. – (3) Some minor items in the aggregate are not reported. – (4) The percentage changes are not adjusted for debt cancellations and assignments. – (5) Bad debts net of write-downs. – (6) Includes bonds held by non-residents. – (7) Excludes those of central government.

Table 28

Lending of Italian banks by geographical area and sector of economic activity (1)

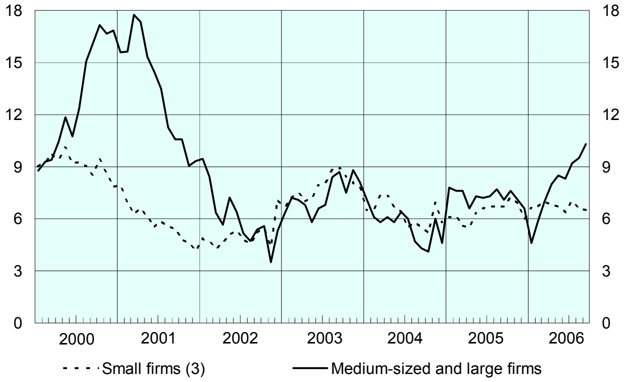
	General govern-ment	Financial and insurance companies	Non-financial corporations (a)		Households		Firms = (a) + (b)				Total
				with under 20 workers (2)	Producer (b) (3)	Consumer		Manu-facturing	Construc-tion	Services	
					Twelve-month percentage changes (4)						
					Centre and North						
2004 - Dec.	-2.5	-1.7	4.1	3.9	6.9	15.6	4.4	-0.6	8.4	7.5	5.3
2005 - Mar.	-1.0	3.9	7.0	3.7	6.8	15.0	7.0	2.2	9.1	10.9	7.8
June	2.2	2.0	6.7	4.4	7.9	15.8	6.8	0.4	11.3	11.4	7.8
Sept.	1.7	3.8	6.4	4.2	8.1	14.9	6.5	1.3	12.4	9.1	7.7
Dec.	5.5	6.7	5.7	3.7	7.0	14.6	5.8	1.3	13.0	7.2	7.8
2006 - Mar.	9.3	4.4	5.8	4.7	7.8	15.5	6.0	1.7	14.6	6.2	8.0
June	6.5	14.9	7.0	4.3	7.4	13.3	7.0	2.6	12.9	7.8	9.5
Sept.	9.1	13.7	8.8	4.5	7.2	12.8	8.7	4.5	13.7	10.5	10.3
					South						
2004 - Dec.	2.0	4.6	7.8	7.7	8.1	16.5	7.9	3.5	10.5	10.3	10.5
2005 - Mar.	7.0	16.5	8.6	7.5	8.2	14.7	8.6	4.5	11.7	11.0	10.9
June	1.2	8.0	8.8	8.4	9.7	16.2	9.0	5.2	11.3	11.3	11.2
Sept.	6.6	-4.0	9.9	7.4	10.9	15.5	10.1	6.6	11.4	11.4	11.6
Dec.	13.4	34.5	11.3	7.5	10.8	16.9	11.2	9.4	14.0	11.8	14.0
2006 - Mar.	14.8	13.2	14.3	9.0	11.5	18.3	13.8	10.6	15.8	15.0	15.5
June	1.6	14.3	15.3	8.5	10.3	16.4	14.4	12.5	17.6	15.3	14.5
Sept.	-3.8	12.4	16.3	9.4	9.9	15.6	15.1	12.3	20.6	17.0	14.2
					ITALY						
2004 - Dec.	-1.9	-1.6	4.5	4.4	7.2	15.8	4.8	-0.2	8.7	7.8	6.0
2005 - Mar.	0.1	4.2	7.2	4.2	7.1	14.9	7.2	2.4	9.5	10.9	8.2
June	2.1	2.2	6.9	4.9	8.3	15.9	7.1	0.9	11.3	11.4	8.2
Sept.	2.4	3.6	6.8	4.6	8.7	15.0	7.0	1.9	12.2	9.4	8.2
Dec.	6.6	7.4	6.3	4.2	7.8	15.1	6.5	2.2	13.1	7.7	8.6
2006 - Mar.	10.1	4.6	6.8	5.3	8.6	16.1	7.0	2.6	14.8	7.3	9.0
June	5.7	14.9	7.9	4.8	8.0	14.0	7.9	3.7	13.6	8.7	10.2
Sept.	7.0	13.7	9.7	5.2	7.8	13.4	9.5	5.3	14.8	11.3	10.9
					Stock of lending at September 2006 (5) (6) *(millions of euros)*						
Centre and North	48,713	149,286	577,088	63,494	59,119	258,655	636,207	174,899	80,873	326,494	1,092,861
South	8,118	3,636	80,563	10,384	17,877	70,485	98,440	22,770	15,808	48,771	180,679
ITALY	56,831	152,922	657,652	73,878	76,995	329,139	734,647	197,666	96,682	375,282	1,273,540
					Percentage composition of lending at September 2006 (6)						
Centre and North	4.5	13.7	52.8	5.8	5.4	23.7	58.2	16.0	7.4	29.9	100.0
South	4.5	2.0	44.6	5.7	9.9	39.0	54.5	12.6	8.7	27.0	100.0
ITALY	4.5	12.0	51.6	5.8	6.0	25.8	57.7	15.5	7.6	29.5	100.0

(1) Loans exclude repos, bad debts and some other minor items included in the Eurosystem harmonized definition of the aggregate. The breakdown by geographical area is based on customer residence. The figures for September 2006 are provisional. – (2) Limited partnerships and general partnerships with fewer than 20 workers; informal partnerships, de facto companies and sole proprietorships with more than 5 but fewer than 20 workers. – (3) Informal partnerships, de facto companies and sole proprietorships with up to 5 workers. – (4) Calculated net of reclassifications, exchange rate variations and other changes not due to transactions. – (5) The sum of stocks according to geographical area may differ from the total, as the data are derived from different items of the supervisory reports. – (6) Rounding may cause discrepancies in totals.

Figure 42

Lending to firms in Italy by size of firm (1)

(*monthly data; twelve-month percentage changes)* (2)



(1) Loans exclude repos, bad debts and some minor items included in the Eurosystem harmonized definition of the aggregate. – (2) Calculated net of reclassifications, exchange rate variations and other variations not due to transactions.– (3) Sole proprietorships and partnerships with fewer than 20 workers.

the pace slackened slightly. Half of the slowdown reflected the effect of the securitization of mortgage loans on outstanding amounts, and the remainder was due to the slower rise in the prices of residential properties and the raising of interest rates. The latter factor caused households to increase their demand for fixed-rate mortgages, which rose from 15 per cent of new disbursements in 2005 to 22 per cent. Interest rates in this market segment rose by more than the euro-area average, owing partly to the rigidity of supply; net of ancillary expenses, they increased by 1 percentage point to 5.2 per cent, compared with a rise of 0.6 points to 4.5 per cent in the euro area.

Consumer credit, especially that granted by financial corporations, also continued to rise at a significant rate, increasing by 19.3 per cent. The expansion occurred in loans for the purchase of motor vehicles, personal loans and loans secured against salary.

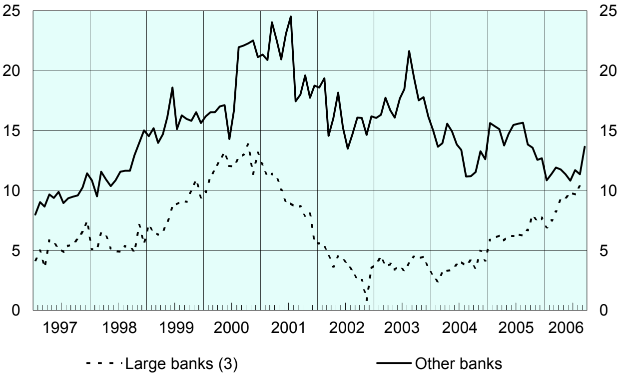
Bank lending to customers resident in the South continued to increase very strongly, by 14.2 per cent compared with a rate of 10.3 per cent in the Centre and North. The more rapid growth in the South was evident in all the main sectors of economic activity except for financial and insurance companies and general government.

The growth in lending by large banks, which in recent years had been affected by the restructuring of the leading banking groups, showed a recovery, reducing the growth gap in relation to lending by “small” and “minor” banks (Figure 43).

Figure 43

Lending by size of bank (1)

(*monthly data; annual percentage changes)* (2)



(1) Loans exclude repos, bad debts and some minor items included in the Eurosystem harmonized definition of the aggregate. – (2) Calculated net of reclassifications, exchange rate variations and other variations not due to transactions. – (3) “Large”, “major” and “medium-sized” banks and “small” and “minor” banks belonging to groups in which at least one bank is “large”, “major” and “medium-sized”.

Loan quality. – In the twelve months ending in June the flow of loans that had become uncollectable remained small.

New bad debts of Italian banks amounted to 0.9 per cent of total outstanding loans (Table 29). The ratio remained higher in the South (1.3 per cent, compared with 0.8 per cent in the Centre and North). The ratio of substandard loans to total lending decreased slightly in all the main sectors of activity.

Credit conditions and interest rates. – In the first nine months of 2006 credit conditions remained easy, even though lending rates gradually responded to the changes in official rates. According to information from the seven Italian banking groups participating in the Eurosystem’s quarterly survey of bank lending in the euro area (see the box “The results of the bank lending survey for Italian banks”), the improvement in the economic climate and the increase in competitive pressure helped to maintain favourable conditions for bank loans to firms and households.

The absence of tightness in the supply of credit is confirmed by the gradualness with which bank lending rates adjusted to the increase in official rates

Table 29

Italian banks' bad debts and substandard loans by geographical area and economic sector (1)

	General government	Financial and insurance companies	Non-financial corporations (a)	Households		Firms = (a) + (b)				Total
				Producer (b) (2)	Consumer		Manufacturing	Construction	Services	
				New bad debts during the year as a percentage of outstanding loans (3)						
				December 2004						
Centre and North	0.0	0.0	1.0	1.3	0.7	1.1	1.4	1.2	1.0	0.8
South	0.0	0.0	1.8	2.0	1.0	1.9	2.8	1.9	1.5	1.4
ITALY	0.0	0.0	1.1	1.5	0.8	1.2	1.5	1.3	1.0	0.9
				December 2005						
Centre and North	0.0	0.0	1.0	1.4	0.7	1.0	1.5	0.9	0.9	0.8
South	0.2	0.1	1.6	2.0	0.9	1.7	2.2	1.7	1.4	1.3
ITALY	0.0	0.0	1.1	1.5	0.7	1.1	1.5	1.0	1.0	0.8
				June 2006						
Centre and North	0.0	0.0	1.0	1.3	0.7	1.1	1.3	1.1	1.0	0.8
South	0.0	0.1	1.7	2.1	0.9	1.8	2.3	1.7	1.6	1.3
ITALY										
				Twelve-month percentage changes in substandard loans						
				December 2004						
Centre and North	-36.4	-35.2	0.0	0.2	3.8	0.1	-4.8	-12.7	5.8	-0.2
South	-51.4	-38.8	-2.4	2.9	2.3	-1.1	-12.6	-2.6	4.6	-0.7
ITALY	-45.8	-35.3	-0.4	1.0	3.4	-0.2	-6.3	-10.1	5.6	-0.3
				December 2005						
Centre and North	-14.4	-30.9	-6.4	-4.1	4.1	-6.0	-1.7	-4.5	-7.6	-4.3
South	-54.3	-42.1	2.0	-2.0	6.7	1.0	-3.1	-19.6	11.8	2.3
ITALY	-36.7	-31.3	-4.9	-3.5	4.7	-4.6	-1.9	-8.6	-4.4	-3.0
				June 2006						
Centre and North	1,331.8	-54.3	-10.6	-4.3	7.7	-9.6	-9.3	-10.8	-10.7	-6.0
South	53.2	-39.0	-1.9	0.1	2.3	-1.4	-2.7	-9.4	2.4	-0.4
ITALY	861.1	-53.6	-9.1	-3.1	6.3	-8.0	-8.1	-10.5	-8.4	-4.8

(1) The breakdown by geographical area is based on customer residence. – (2) Informal partnerships, de facto companies and sole proprieterships with up to 5 workers. – (3) New adjusted bad debts in the previous 12 months as a percentage of outstanding loans other than adjusted bad debts at the beginning of the period. The figures for new adjusted bad debts are taken from reports to the Central Credit Register.

The results of the bank lending survey for Italian banks

Since January 2003 the central banks of the euro-area countries, working in collaboration with the European Central Bank, have conducted a quarterly bank lending survey addressed to the senior loan officers of more than 80 banks.[1] The survey seeks qualitative information on lending standards and the factors determining loan demand. In Italy the survey covers seven banking groups accounting for 52 per cent of total lending.

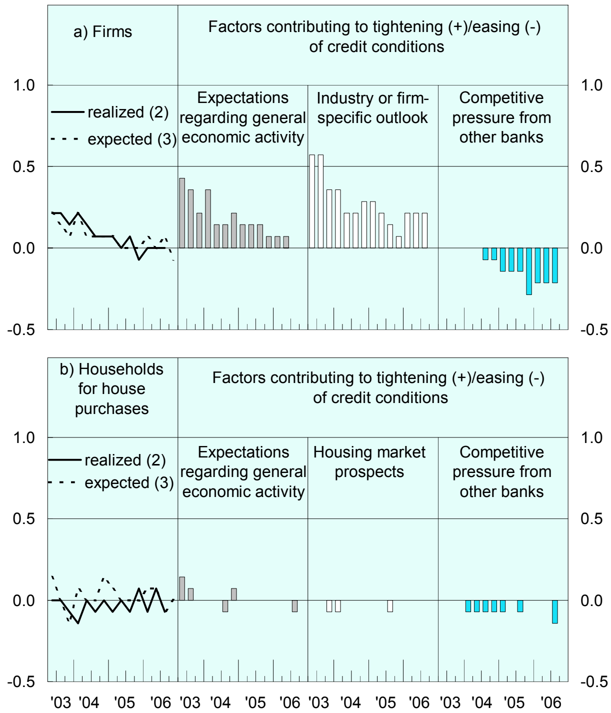
The questions call for qualitative replies on a graduated scale of five levels. A composite indicator ("diffusion index") is calculated from the information obtained. For the supply of loans, the higher the index value, the more restrictive the lending criteria; for demand, an increase in the index value corresponds to an increase in loan demand.

The results of the survey, considered in conjunction with conventional quantitative indicators, facilitate a better understanding of the behaviour of bank lending by making it easier to identify the reasons for movements in the demand and supply curves. For example, the information collected from the banks makes it possible to see whether a change in the supply of credit is attributable to a change in banks' perception of risk or to greater competitive pressure, apart from a variation in the monetary policy stance. The survey also makes it possible to identify shifts in the demand curve due to factors such as, in the case of firms, the need to finance fixed investment and mergers and acquisitions or, in that of households, housing market prospects and consumer spending.

The surveys conducted between 2003 and 2005 indicate that loan supply conditions steadily eased, especially for firms, mainly on account of the increase in competition in the credit market and the improvement in economic prospects, which raised creditworthiness (Figure 1). Loan demand from firms was boosted by the need to restructure debt and, more recently, by changes in the corporate sector's financial deficit (Figure 2). Households' loan demand, for its part, was fueled by the prospects for the property market up to the first quarter of 2005.

Figure 1

Indices of lending conditions and their main determinants in Italy (1)



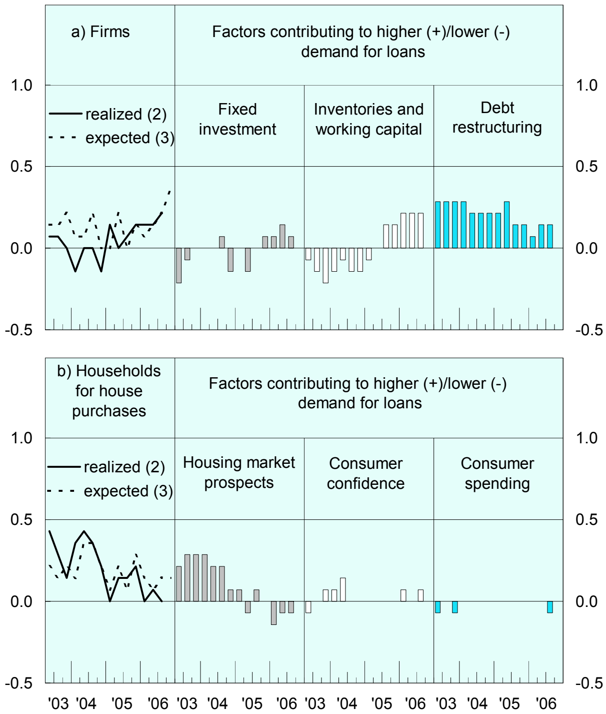
Source: Bank Lending Survey for the euro area.

(1) The indices are constructed by aggregating the qualitative replies from the 7 groups participating in the quarterly Bank Lending Survey, weighted as follows: 1 = tightened considerably, 0.5 = tightened somewhat, 0 = remained basically unchanged, -0.5 = eased somewhat, -1 = eased considerably. The range of variation of the index is from -1 to 1. – (2) In the quarter in which the survey was conducted. – (3) Forecasts made in the preceding quarter.

In the first nine months of 2006, despite the increase in money-market interest rates, lending conditions for firms and households remained very favourable, benefiting from the improvement in the economic situation and the *further increase in competitive pressure, especially in the corporate loan market.*

Figure 2

Indices of loan demand and its main determinants in Italy (1)



Source: Bank Lending Survey for the euro area.

(1) The indices are constructed by aggregating the qualitative replies from the 7 groups participating in the quarterly Bank Lending Survey, weighted as follows: 1 = increased considerably, 0.5 = increased somewhat, 0 = remained basically unchanged, -0.5 = decreased somewhat, -1 = decreased considerably. The range of variation of the index is from -1 to 1. – (2) In the quarter in which the survey was conducted. – (3) Forecasts made in the preceding quarter.

According to the survey, loan supply conditions for firms remained easy, although there were some increases in interest rate margins for riskier classes of customer. The supply conditions for households improved; in particular, the loan-to-value ratio increased and the average term to maturity lengthened.

The participating banks indicate that the conditions for lending to firms and households should remain stable overall in the last quarter of the year.

The acceleration in lending to firms in the first nine months of 2006, which affected primarily short-term loans, was ascribable mainly to demand factors. The index of firms' loan demand reached its highest level since the inception of the survey. According to the participating banks, the main factor in the increase in demand for loans was the need to fund a larger volume of working capital. The demand for medium and long-term loans also increased strongly, in line with the need for more funds for fixed investment. The demand for loans to finance debt restructuring remained high, but decreased slightly as a proportion of overall demand, whereas demand attributable to mergers and acquisitions remained broadly stable. Credit demand from firms is expected to strengthen further in the last quarter of the year.

With regard to households, the survey data show a moderate slowdown in demand for loans for the purchase of houses. This is presumably linked to the increase in mortgage interest rates and the slight deterioration in the prospects for the residential property market, which is consistent with the slower rise in house prices in the first half of the year. According to the banks, during 2006 the demand for consumer credit continued to grow, in line with the increase in spending on durable consumer goods. The participating banks expect that in the fourth quarter of the year demand for house purchase loans and consumer credit will grow at the same rate as in the preceding quarter.

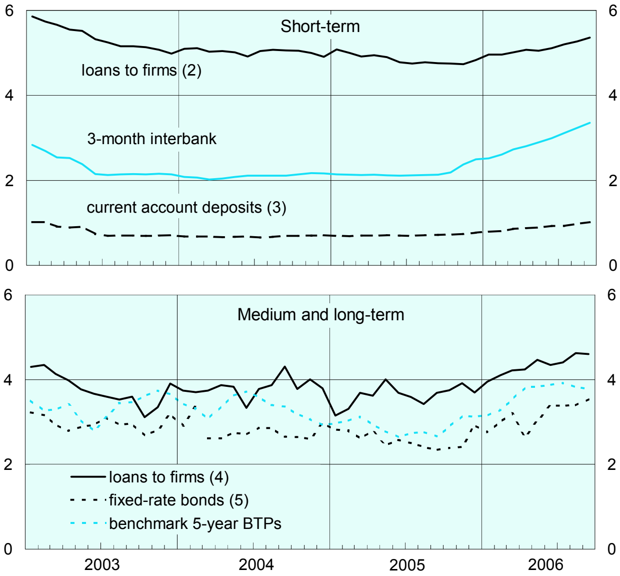
---

[1] *The results of the survey for the euro area are available on the website* www.ecb.int *and those for Italy on the website* www.bancaditalia.it.

(Figure 44). Between November 2005, when rates where at their lowest point, and the end of September the average rate on short-term loans to firms rose by 0.6 percentage points, compared with an increase of 1 point in official rates. The scale and speed of the adjustment were comparable to those observed in past cycles.

Figure 44

Bank interest rates in Italy (1)
(monthly data; percentages)



Sources: Based on Bank of Italy, MTS and MID data.

(1) The bank interest rates refer to transactions in euros and are gathered and processed using the Eurosystem harmonized methodology. – (2) Average rate on loans to firms with a maturity of up to one year. – (3) Average rate on current account deposits of households and firms. – (4) Average rate on new disbursements with a rate fixed in advance for more than one year to firms resident in the euro area. – (5) Average rate on bank bonds issued during the month. Data drawn from 10-day statistical reports. The sample of reporting banks was changed in March 2004.

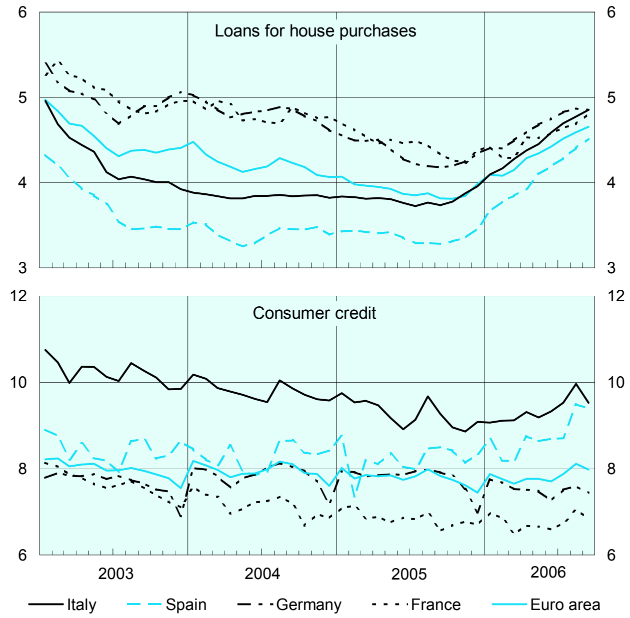
The differential between the rate on short-term loans to firms in the South and those charged to firms in the Centre and North, adjusted for the sectoral and size composition of customers, narrowed slightly, to 1.3 percentage points.

The annual percentage rate of charge (APRC) on new loans for house purchases increased by 1 percentage point to 4.9 per cent, compared with a rise of 0.8 points to 4.7 per cent in the euro area (Figure 45).

The APRC on consumer credit granted by banks rose by 0.7 points. The disparity between the cost of consumer credit in Italy (9.5 per cent) and the average for the euro area (8 per cent) was already large, but it increased slightly (for analysis of the possible causes of the disparity, see the Annual Report for 2005, p. 158).

Figure 45

Harmonized interest rates on loans to households: APRC on new business (1)
(monthly data; percentages)



Sources: Based on ECB data and national statistics.

(1) New contracts concluded during the reference period or contracts renegotiating previous terms and conditions. The annual percentage rate of charge (APRC) includes accessory expenses (administrative expenses, loan examination fees and insurance). It is calculated as the average rate across all maturities, weighted by loan amounts. Households include producer households and non-profit institutions serving households.

Funding. – Banks' domestic funding grew more slowly than lending, rising by 9.5 per cent in the twelve months to September (Table 27). This rate of growth was in line with the euro-area average.

There was particularly strong demand for less liquid deposits, such as those with an agreed maturity and repos, which offer higher returns than current accounts.

The rapid growth of 11.3 per cent in the outstanding volume of bank bonds, which was achieved partly by issuing very large amounts on the Euromarket, helped keep the duration of banks' liabilities in line with that of their assets. Taking into account hedging operations in financial derivatives, the gap between the two durations was only 1.4 months at the end of September, the same as in 2005.

Rates on current account deposits adjusted more slowly than lending rates to the changes in monetary conditions. Between November 2005 and the end of September the average rate on current accounts increased by 0.3 percentage points in Italy, compared with 0.2 points in the euro area as a whole. Coupons on the fixed-rate bond issues of Italian banks, on the other hand, moved in line with market rates, rising from 2.4 to 3.5 per cent.

In order to finance the expansion in lending, which was more rapid than the growth in their deposits and borrowed funds, Italian banks increased their net external liabilities in the first nine months of this year, to 3.4 per cent of their balance-sheet total in September, compared with 2.6 per cent at the end of 2005. The proportion of their external position subject to exchange rate risk (in other words, denominated in currencies other than the euro) was 60 per cent, the same as at the end of 2005.

Profitability. – In the first half of 2006 the return on equity (ROE) of Italian banks, based on financial statements not consolidated at group level, was 15.9 per cent, compared with 10.7 per cent in the first six months of 2005. The increase in profitability was due in part to the substantial improvement in operating profit and an increase in extraordinary income, in particular capital gains on the disposal of shareholdings.

Gross income rose by 17.7 per cent. Net interest income increased by 8.6 per cent owing to the large growth in the volume of business and the widening of the spread between lending and deposit rates. Other income rose by 31.3 per cent, thanks mainly to an increase in dividends on non-bank shares and other equity and income from securities trading; this result may have been influenced partly by the application of the new international accounting standards (IAS/IFRS).

Staff costs rose by 5 per cent owing to wage increases under the national labour contract for the banking industry and the application of the IAS/IFRS, which provide for directors' remuneration and the value of stock options to be recorded among staff costs. Total operating expenses rose by 5.2 per cent.

The government securities market

In the first nine months of the year net issues of Italian government securities decreased from €65 billion to €61 billion (Table 30). The residual term to maturity and the duration of public debt did

Table 30

Issues of Italian government securities (1)
(millions of euros)

	2005	2005 Jan. - Sept.	2006 Jan. - Sept.	2005	2005 Jan. - Sept.	2006 Jan. - Sept.
	Gross issues			**Net issues** (2)		
BOTs	212,666	175,666	175,083	-944	22,916	17,527
CTZs	23,206	21,206	23,818	-3,338	-5,247	-2,480
CCTs	26,011	22,511	18,999	1,515	12,243	4,235
BTPs	131,064	111,614	112,537	29,947	30,913	42,228
of which: indexed (3)	*18,199*	*17,649*	*10,691*	*18,756*	*18,138*	*10,826*
Republic of Italy issues	12,264	12,001	8,801	1,620	3,738	-472
Other	..	..	..	-50	-51	-50
Total	**405,211**	**342,998**	**339,238**	**28,750**	**64,513**	**60,988**

(1) At face value. Rounding may cause discrepancies in totals. – (2) Net of issue discounts and premiums; includes buybacks and redemptions made by drawing on the sinking fund for the redemption of government securities. – (3) BTPs indexed to consumer prices.

not change significantly (Figure 46); they remain approximately 6 years and 7 months and 4 years and 9 months respectively.

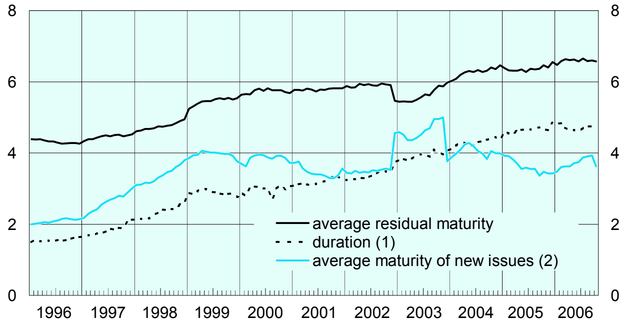
Non-resident investors and households were the main purchasers of Italian government securities (Table 31). Substantial disposals by Italian investment funds, by contrast, reflected the large net redemptions recorded by such intermediaries.

The yield differential between ten-year Italian Treasury bonds and German Bunds with the same maturity widened slightly in the second quarter of the year, mainly coinciding with the election campaign in Italy and the general widening of bond spreads on the leading international markets, but it narrowed again thereafter (Figure 47). In mid-October two rating agencies announced a downgrading of Italian

Figure 46

Average maturity of outstanding Italian government securities and new issues

(monthly data; years)



(1) Calculated with reference to securities listed on MTS. — (2) Moving average for the twelve months ending in the month indicated. The higher level of the series between December 2002 and November 2003 is due to the government bond conversion carried out at the end of 2002 between the Ministry for the Economy and Finance and the Bank of Italy.

Table 31

Outstanding amounts and net purchases of securities issued by residents of Italy, by holding sector (1)

(millions of euros)

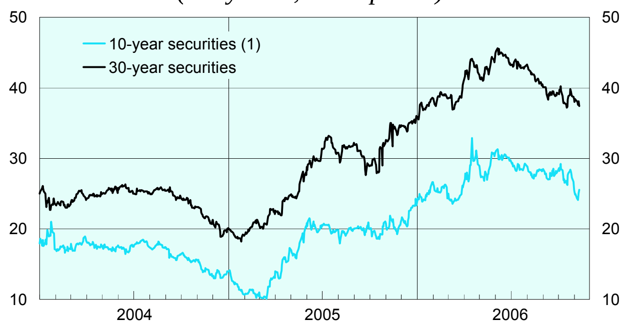
	Public-sector securities						Private-sector bonds	Total public-sector securities and private-sector bonds	Listed Italian shares
	BOTs	CTZs	CCTs	BTPs	Other (2)	Total			
	Net purchases in January-August 2006								
Central bank	..	..	393	3,493	-50	3,836	..	3,834	-219
Banks (3)	-3,170	3,392	-3,015	3,755	1,321	2,282	-13	2,269	3,763
Investment funds (4)	-194	-3,166	-4,775	-7,477	132	-15,480	853	-14,627	-2,273
Other investors (5)	23,340	-4,124	8,106	47,546	-1,012	73,856	53,463	127,319	2,003
of which: non-residents (6)	*11,240*	*-6,063*	*2,896*	*44,543*	*-3,216*	*49,401*	*2,957*	*52,357*	*2,103*
Total	**19,977**	**-3,898**	**708**	**47,317**	**390**	**64,494**	**54,301**	**118,795**	**3,274**
	Outstanding amounts at end-August 2006								
Central bank	..	..	15,811	45,960	912	62,683	195	62,877	6,280
Banks (3)	15,256	9,164	42,781	21,534	18,172	106,907	84,836	191,743	38,039
Investment funds (4)	22,661	7,261	32,885	32,955	2,560	98,322	12,133	110,455	18,121
Other investors (5)	99,865	24,094	107,792	709,866	105,565	1,047,183	650,862	1,698,045	670,215
of which: non-residents (6)	*78,302*	*3,704*	*57,508*	*493,445*	*69,688*	*702,647*	*86,020*	*788,667*	*116,629*
Total	**137,783**	**40,519**	**199,269**	**810,314**	**127,210**	**1,315,094**	**748,026**	**2,063,120**	**732,656**
Percentage share of the total outstanding amount of public-sector securities	**10.5**	**3.1**	**15.2**	**61.6**	**9.7**	**100.0**			

(1) Outstanding amounts of public-sector securities and private-sector bonds are stated at face value and those of shares at market value; net purchases are stated at market value. Rounding may cause discrepancies in totals. – (2) Republic of Italy issues and other public-sector securities. – (3) The figure for listed Italian shares refers to the period January-June 2006 for net purchases and to end-June 2006 for outstanding amounts. – (4) Italian harmonized investment funds and SICAVs. – (5) Households, enterprises, non-residents, central and local government, social security institutions, CDP S.p.A., investment firms and insurance companies. – (6) Provisional figures for the period January-June 2006 for net purchases and for end-June 2006 for outstanding amounts. Excludes the securities of local governments, autonomous government agencies and Ente F.S.

public debt, a move that had been at least partly anticipated. It had only a very limited effect on the yield differential, which in November began to decline again towards the level recorded at the beginning of the year. The premiums on credit default swaps on debt of the Italian Republic (derivative contracts that insure against the risk of default of a bond issuer) also remained virtually unchanged.

Figure 47

Yield differentials between Italian and German government securities (1)
(daily data; basis points)



Source: Bloomberg.
(1) The yield differential is adjusted to take account of the different residual maturities of the reference securities.

The market in private-sector bonds

The euro area. – The first eight months of the year saw large net issues of bank and corporate bonds amounting to €369 billion (Table 32), equal to 7 per cent of the volume outstanding at the end of 2005, in response to the increase in mergers and acquisitions and the pick-up in gross fixed investment.

There were considerable increases both in issues by non-bank intermediaries, owing to an expansion in issues of mortgage-backed securities and collateralized debt obligations, and in those by non-financial companies. Issues of high-yield bonds continued.

Yield spreads between euro-denominated bonds issued by non-financial enterprises and government securities widened slightly from mid-May onwards but remained small (Figure 48), indicating investors' optimistic assessment of risk. Premiums on credit default swaps remained virtually unchanged in subsequent months.

Table 32

Net bond issues by banks and firms in Italy and the euro area (1)
(millions of euros)

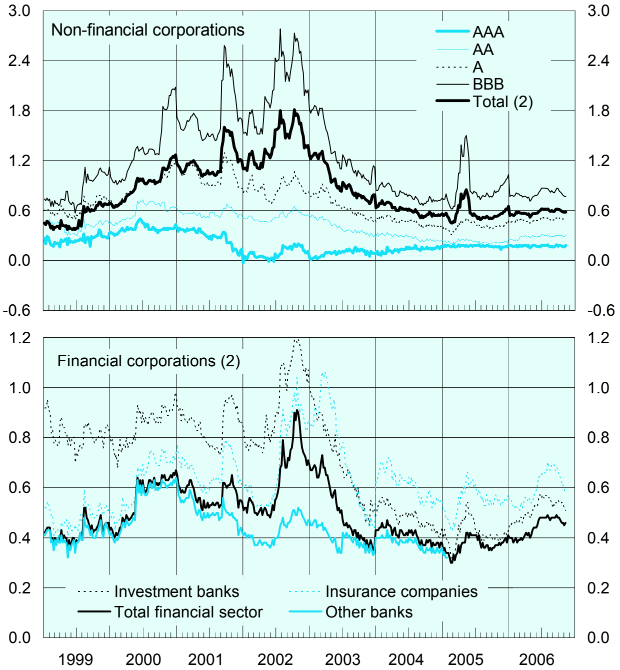
	2004	2005	2005		2006	
			Jan.-Aug.	Jan.-Sept.	Jan.-Aug.	Jan.-Sept.
			Italy			
Banks	43,048	41,502	24,990	27,732	37,032	39,503
Other financial corporations	14,794	35,452	15,083	15,528	12,349	13,310
Non-financial corporations	8,981	1,426	542	545	4,409	4,378
Total ...	**66,823**	**78,380**	**40,615**	**43,805**	**53,790**	**57,191**
			Euro area			
Banks	297,790	292,937	236,591	252,295	219,193	....
Other financial corporations	73,813	177,569	80,342	96,125	132,025	....
Non-financial corporations	12,036	22,203	11,303	13,634	17,305	....
Total ...	**383,638**	**492,709**	**328,236**	**362,053**	**368,523**	....

Sources: Bank of Italy and ECB.
(1) Bonds with a maturity at issue of more than one year issued by resident companies belonging to the sector indicated. Net issues do not include issue discounts or premiums and are therefore equal to the difference between the face value of the securities issued and that of the securities redeemed.

Figure 48

Yield differentials between euro-denominated corporate bonds and government securities (1)

(end-of-week data; percentage points)



Source: Merrill Lynch.

(1) Yields on fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by corporations resident in countries whose long-term foreign currency debt has a rating of not less than Baa3 or BBB- (investment grade). Yield differentials are calculated with respect to French and German government securities. – (2) Only includes bonds with a rating of not less than Baa3 or BBB-(investment grade).

The slight widening of differentials that began in May involved mainly the heavily-indebted telecommunications sector. Spreads also increased slightly in the high-yield segment from the low levels seen in the first half of May. However, there was a narrowing of the differentials on the bonds of some major European and US automobile manufacturers, which had widened considerably during 2005.

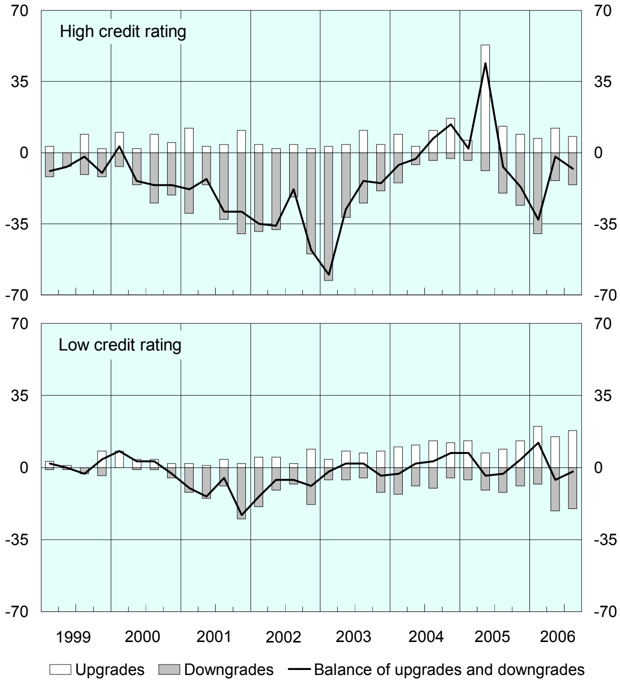
The main indicators of credit quality do not signal significant changes. The default rate remains low, even for firms with a low credit rating. The balance between rating upgrades and downgrades decreased slightly owing to a number of major restructuring operations financed by borrowing (Figure 49).

Italy. – Italian companies made substantial net issues of bonds totaling €57 billion in the first nine months of the year, corresponding to an increase of 9 per cent in the stock by comparison with September 2005.

Figure 49

Revisions of credit ratings of euro-area non-financial corporations (1)

(quarterly data; number of revisions)



Source: Based on Bloomberg data.

(1) Revisions of the rating of long-term debt by Moody's. Includes credit-watch announcements. Companies with high (low) credit ratings are those rated before the revision at least (lower than) Baa3.

In contrast to developments elsewhere in the euro area, issues by the banking sector were very large, and the volume issued by non-bank financial companies declined owing to the contraction in debt securitization by public companies by comparison with the preceding year. Gross bond issues by non-financial enterprises increased but remained relatively small overall (€4 billion net of redemptions). The increase reflected primarily operations by a number of large issuers, partly to refinance loans maturing next year.

The yield differentials between Italian bonds and comparable securities issued by companies in other euro-area countries remained unchanged. In the automobile sector, the spreads on Fiat paper narrowed further, reflecting the improvement in current and expected profitability. In the telecommunications sector, the cost of debt increased for Telecom Italia as a result of uncertainty about the plans for restructuring the company.

The stock markets

The euro area. – The rise in the stock markets of the main euro-area countries came to a halt in May and June, taking the indices back to the levels of the beginning of the year. However, the sustained upward movement in share prices resumed in mid-July. The Dow Jones Euro Stoxx index, which tracks the performance of the largest listed companies in the area, rose by 15 per cent in the first ten months as a whole (Figure 50).

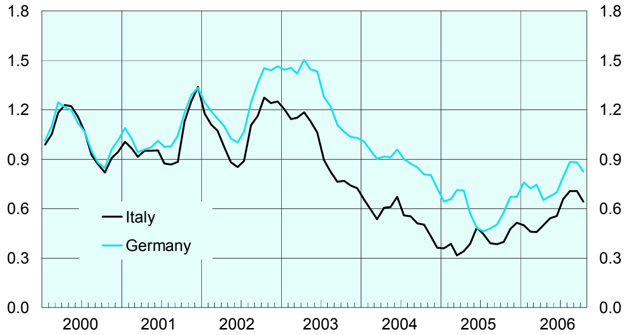
The rise in share prices can be attributed mainly to the high current and expected profitability of listed companies, which continued to pursue a generous dividends policy, distributing more than 3 per cent of their capitalization.

The improvement in expected profits outweighed the effect of the rise in real interest rates on share prices. Indicators of risk aversion based on options prices showed a small rise (Figure 51).

Figure 51

Indicators of risk aversion (1)

(monthly data; moving average for the three months ending in the reference month)



Source: Based on Bloomberg.

(1) The risk aversion indicator is obtained by comparing the distribution of yields of the share indices derived from options prices with the corresponding historical distribution. A decrease in the indicator signals a greater propensity to run risks associated with investment in shares.

The earnings/price ratio is marginally above the long-term average (Figure 52). The real cost of equity capital for firms, calculated on the basis of share prices and expected dividends, remained stable at about 5.7 per cent (Figure 53).

The volatility of share indices implied by options prices rose temporarily in May and June but returned to extremely low levels thereafter.

Figure 50

Share prices (1)

(end-of-week data; indices, 31 December 2004=100)

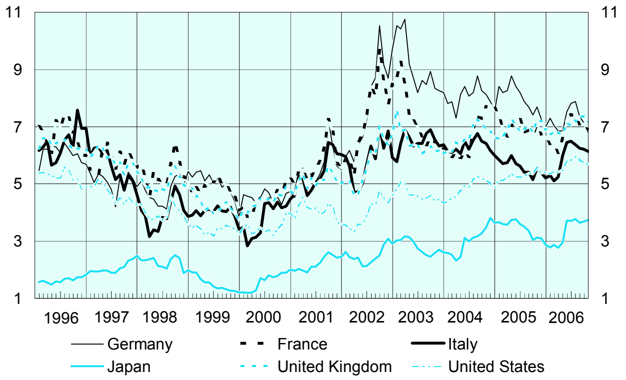
Source: Bloomberg.

(1) MIB for Italy, Dow Jones Euro Stoxx for the euro area, Standard & Poor's 500 for the United States.

Figure 52

Current earnings/price ratios on the main stock exchanges

(monthly data; percentages)



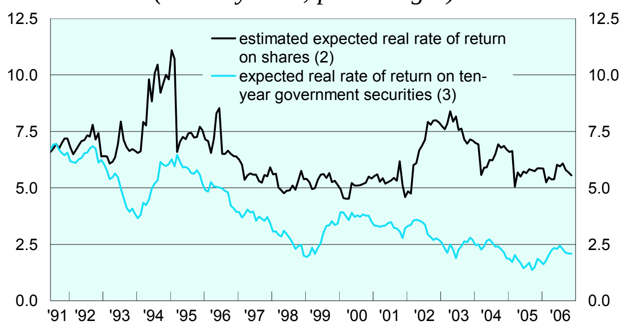
Source: Thomson Financial.

In the first ten months of 2006 initial offering activity was very intense. In the euro area 122 companies came to market, almost twice the number recorded in the same period of 2005.

Figure 53

Expected real rates of return on shares and government securities in the euro area (1)

(monthly data; percentages)



Sources: Based on IBES, Consensus Economics and Bloomberg data.

(1) The stock-market variables refer to a weighted average of the MSCI indices for Germany, France and Italy. – (2) Calculated on the basis of expected dividends less long-term inflation expectations measured by Consensus Economics. – (3) Difference between interest rates on ten-year government securities and long-term inflation expectations.

Italy. – The Italian stock market index rose by 13 per cent in the first ten months of 2006. As in the other leading euro-area countries, the increase was due mainly to good current and expected profits. The current level of share prices incorporates risk premiums that are slightly above the average recorded since the beginning of the nineties.

Bank shares rose significantly, boosted by proposals to restructure certain large credit institutions. The sharp increase in share prices in the automobile sector reflected the recovery in profitability at Fiat. Contrary to the trend in the rest of the euro area, telecommunications shares fell by 5 per cent, owing largely to the performance of Telecom Italia shares.

The STAR segment of the stock market, where small and medium-sized firms committed to meeting particular transparency and governance requirements are listed, rose by 21 per cent, a significantly larger increase than that in the general index.

During the year 14 new companies were admitted to listing, compared with 8 in the first ten months of 2005. At the end of October, 280 companies were listed on the Italian stock exchange, five more than at the end of last year. Their total market capitalization was €746 billion, equal to 50.6 per cent of GDP.

Investment funds and individual portfolio management in Italy

In the euro area, on the basis of data from ten countries, investment funds increased their net subscriptions by 34 per cent in the first half of 2006 in relation to the preceding half-year. In the first nine months of 2006 funds controlled by Italian intermediaries, by contrast, recorded net redemptions of €23 billion (Table 33), reflecting mainly the renewed propensity of Italian savers to invest directly in bonds.

Whereas foreign funds controlled by Italian intermediaries and hedge funds recorded an appreciable increase in subscriptions, there were substantial net outflows of resources from harmonized Italian funds, in particular bond funds. At the end of September the net assets of Italian funds and foreign funds controlled by Italian intermediaries amounted to €391 billion and €195 billion respectively.

The average yield of harmonized Italian funds was low, 2.7 per cent in the first ten months of the year. The highest returns were achieved by equity and flexible funds (8.1 and 3.3 per cent respectively)

Table 33

Net assets and fund-raising of investment funds controlled by Italian intermediaries (1)
(millions of euros)

	2005	2005 Jan.-Sept.	2006 Jan.-Sept. (2) (3)
		Net assets *(end-of-period stocks)*	
Open-end Italian funds	402,268	404,450	374,850
of which: harmonized	*352,775*	*361,725*	*312,940*
hedge funds	*16,957*	*16,098*	*21,342*
Closed-end Italian funds	14,348	10,469	16,202
of which: real-estate funds	*11,963*	*8,392*	*13,570*
Foreign funds (4)	182,846	174,608	194,535
Total	**599,462**	**589,527**	**585,587**
		Net fund-raising *(flows)*	
Open-end Italian funds	-7,038	-3,602	-31,895
of which: harmonized	*-18,344*	*-12,641*	*-42,514*
hedge funds	*4,347*	*3,807*	*4,422*
Closed-end Italian funds	3,306	460	1,497
of which: real-estate funds	*3,248*	*396*	*1,348*
Foreign funds (5)	18,328	12,676	7,653
Total	**14,596**	**9,534**	**-22,745**

Sources: Bank of Italy and Assogestioni.
(1) Including funds of funds. – (2) The figures for closed-end Italian funds refer to the first half of the year. – (3) Provisional. – (4) Value of units held by Italian and foreign investors. – (5) The figures refer to units subscribed by Italian and foreign investors. Net of redemptions.

and the lowest by money-market and bond funds (1.5 and 0.5 per cent respectively).

In the first half of the year the net new cash flow to individually managed portfolios rose to €36.2 billion, compared with €19.5 billion in the previous half-year. At the end of June managed portfolios totalled €538 billion. The average yield for the half-year, measured by the percentage change in net assets adjusted for net new cash flow, was negative (-2.1 per cent).

SHORT-TERM ECONOMIC PROSPECTS

The world economy

In 2006 world output is projected to increase by around 5 per cent, almost equalling the exceptionally fast growth of the previous two years. For 2007 the International Monetary Fund forecasts a continuation of the cyclical expansion, albeit at a slower pace; world trade should keep on expanding rapidly, by about 8 per cent compared with 8.9 per cent in 2006 (Table 34).

In the United States, after the sharp slowdown in growth in mid-2006 there should be a gradual return to more rapid growth, although still below potential. The property market should remain slack until the middle of next year, but this will be offset by the healthy performance of non-residential investment and the steady trend in consumption, again sustained by the growth in disposable income. The Federal Reserve and the leading international organizations expect house prices to settle at their current high levels, but a downturn cannot be ruled out, as many studies have found them to be overvalued by as much as 20 per cent. In the event of a decline in house prices, consumption could be influenced not only by the traditional wealth effects, but also by a deterioration in household confidence. Consensus Economics predicts that GDP growth in 2007 will slow down to 2.6 per cent, almost one point less than the estimate for 2006.

The threat of inflation in the United States has sharpened since the spring of this year, with core inflation rising from 2 to 2.4 per cent between March and September. At the last Federal Open Market Committee (FOMC) meeting at the end of October, the Federal Reserve announced that further increases in official rates might become necessary to keep the risks to price stability and to economic growth roughly in balance. At present the financial markets assume the economic slowdown will be sufficient to calm inflationary pressures: the prices of futures contracts on federal funds indicate that operators do not expect there to be any changes in monetary conditions at the next two FOMC meetings in December and January.

For Japan, Consensus Economics predicts that GDP growth will be 2.2 per cent in 2007, down from 2.8 per cent in 2006. In view of the gradual acceleration in consumer prices, the Bank of Japan will probably maintain the cautiously restrictive monetary policy it adopted in July: the authorities do not rule out a further rise in official rates before the end of 2006.

In China and India very strong growth is again forecast, while in the other emerging Asian countries and in Latin America output should continue to expand at a healthy pace.

Despite the recent decline in the price of oil, which is nonetheless expected to remain high throughout next year, the risks for global growth remain considerable. A decline in house prices in the United States cannot be ruled out, as mentioned earlier; risk premiums for shares and bonds and price variability are at historically low levels, and any increase could lead to a deterioration in financial conditions; over the medium term, the size of payments imbalances in the leading regions of the world continues to be a source of concern.

More balanced growth in the main regions can attenuate but not eliminate the risk of sudden shifts in flows of savings and investment, accompanied by large movements in the dollar and with adverse effects on international financial stability.

Table 34

Forecast performance of selected international macroeconomic variables
(percentage changes on previous year, except as indicated)

	2005	2006 (1)		2007 (1)			
		IMF	Consensus Economics	IMF	European Commission	Consensus Economics	Private forecasters (2)
GDP (3)							
United States	3.2	3.4	3.4	2.6	2.3	2.6	2.4
Japan	2.7	2.7	2.8	2.1	2.3	2.2	2.3
European Union	1.7	2.8	2.7	2.4	2.4	2.2	–
of which: Euro area	*1.4*	*2.4*	*2.6*	*2.0*	*2.1*	*1.9*	*2.2*
United Kingdom	*1.9*	*2.7*	*2.6*	*2.7*	*2.6*	*2.4*	*2.7*
Emerging economies (4)	7.4	7.3	–	7.2	–	–	–
of which: Asia	*9.0*	*8.7*	–	*8.6*	*8.0* (5)	–	*7.7* (5)
of which: China	*10.2*	*10.0*	*10.4*	*10.0*	*9.8*	*9.1*	*9.6*
Latin America	*4.4*	*4.8*	*4.8*	*4.3*	*4.0*	*4.1*	*3.6*
Consumer prices							
United States	3.4	3.6	3.5	2.9	2.5	2.5	2.1
Japan	-0.3	0.3	0.3	0.7	0.4	0.5	0.3
European Union	2.2	2.3	2.2	2.4	2.3	2.2	–
of which: Euro area	*2.2*	*2.3*	*2.3*	*2.4*	*2.1*	*2.2*	*2.1*
United Kingdom	*2.0*	*2.3*	*2.3*	*2.4*	*2.2*	*2.2*	*2.2*
Emerging economies (4)	5.3	5.2	–	5.0	–	–	–
of which: Asia	*3.5*	*3.8*	–	*3.6*	–	–	*3.4* (5)
of which: China	*1.8*	*1.5*	*1.7*	*2.2*	*2.1*	*2.4*	*2.7*
Latin America	*6.3*	*5.3*	*4.9* (6)	*5.2*	–	*5.0* (6)	*4.9*
World trade (3) (7)	**7.4**	**8.9**	–	**7.6**	**7.4**	–	–
Current account balance (8)							
United States	-791.5	-869.1	-855.0	-959.1	-893.5	-847.0	–
Japan	165.8	167.3	158.3	162.9	134.1	166.4	–
European Union	-109.3	–	-94.1	–	-123.9	-95.7	–
of which: Euro area	*-28.7*	–	*-39.2*	–	*-23.0*	*-27.0*	–
United Kingdom	*-49.5*	*-55.9*	*-58.0*	*-58.0*	–	*-64.8*	–
Asian emerging economies	165.3	184.6	188.8 (9)	197.9	49.2 (5)	180.0 (9)	–
of which: China	*160.8*	*184.2*	*154.6*	*206.5*	–	*147.2*	–
Oil-exporting countries (10)	366.8	540.7	519.6 (11)	590.1	–	505.1 (11)	–
Oil prices							
Average of the three leading grades ($ per barrel)	53.4	69.2	–	75.5	66.3 (12)	62.6 (13) (14)	67.3 (13)

Sources: National statistics; IMF, *World Economic Outlook*, September 2006 and *Regional Outlook*, *Western Hemisphere*, November 2006; European Commission, *Economic Forecasts,* autumn 2006; *Consensus Forecasts*, *Asia Pacific Consensus Forecasts*, *Latin American Consensus Forecasts*, October 2006.

(1) Forecasts. – (2) Averages of the latest estimates (on 13 November 2006) published by: Credit Suisse First Boston (except for China), Goldman Sachs, J.P. Morgan (except for consumer prices) and Merrill Lynch (except for Latin America). – (3) At constant prices. – (4) Includes the new EU member countries. – (5) Includes the recently industrialized economies. – (6) Change for the twelve months ending in December. – (7) Goods and services. – (8) Billion dollars. – (9) Based on Consensus Economics forecasts. – (10) Includes: Algeria, Indonesia, Iran, Kuwait, Libya, Mexico, Nigeria, Norway, Qatar, Russia, Saudi Arabia, Venezuela, United Arab Emirates. – (11) Based on Consensus Economics and IMF forecasts. – (12) Brent. – (13) WTI. – (12) Price at the end of October 2007.

The European Union and the euro area

The European Commission forecasts that GDP growth in the EU will be 2.8 per cent in 2006, up from 1.8 per cent in 2005, but will slow to 2.4 per cent in 2007. Consumer price inflation is expected to rise from 2.2 per cent on average in 2005 to 2.3 per cent as a result of higher energy prices, and to hold at that level in 2007. General government net borrowing is projected to decline from 2.3 per cent of GDP in 2005 to 2 per cent this year and 1.6 per cent in 2007.

In the United Kingdom, economic activity should expand by 2.7 per cent this year, compared with 1.9 per cent in 2005, driven by the sharp recovery in investment; growth is expected to remain strong in 2007. Consumer price inflation, which has been accelerating since the spring, is projected to rise to 2.4 per cent on average this year before slowing to 2.2 per cent in 2007. To offset the threat to price stability the authorities gave monetary policy a more restrictive turn in the summer, raising the base rate by a total of 0.5 percentage points to 5 per cent.

The Commission’s forecasts indicate that euro-area GDP will grow by 2.6 per cent this year, over one percentage point higher than in 2005 and more than the currently estimated growth rate of potential output.

Leading private forecasters and international organizations project slower GDP growth in 2007, in parallel with the cyclical slowdown in the United States and in conjunction with restrictive budgetary policies in Germany and Italy. According to the European Commission euro-area GDP will grow by 2.1 per cent.

In the first nine months of 2006, consumer price inflation in the euro area was virtually stationary, averaging just over 2 per cent despite the sharp rise in energy prices. The Commission forecasts that inflation will be 2.2 per cent in 2006. The slackening of tensions on oil prices should help to curb inflation, although this is expected to stay above 2 per cent in the next few quarters, mainly owing to increased VAT rates in Germany. The Commission projects that inflation will average 2.1 per cent in 2007.

Despite their gradual rise over the last twelve months, real interest rates are still at historically low levels. The ECB Governing Council has announced that it will remain warranted to further withdraw monetary accommodation if the forecasts of rapid economic growth and of inflation above 2 per cent in 2006 and early 2007 continue to be confirmed.

The yield curve embodies expectations of a further upward adjustment of short-term interest rates late this year or in the first half of next year. Market predictions for the second half of 2007 are still widely dispersed, however, reflecting uncertainty over the outlook for world growth and inflation.

In the financial markets, risk assessments are still optimistic, helping to prolong favourable credit conditions. Yield spreads on private issues remain very narrow. Volatility continues to be extremely low for all the main financial asset classes. Long-term yields have stayed low despite the rise in short-term interest rates in the main economic areas.

The European Commission estimates general government net borrowing in the euro area at 2 per cent of GDP in 2006, down from 2.4 per cent in 2005. This is a more marked improvement than that indicated in the latest stability programme updates. The deficit will apparently still be above the 3 per cent threshold only in Italy and Portugal, and the overall ratio of public debt to GDP is expected to come down to 69.5 per cent from 70.8 per cent in 2005.

For 2007, in connection with the favourable cyclical picture, the Commission forecasts a further reduction in the euro-area deficit, to 1.5 per cent of GDP, and in the debt ratio.

The Italian economy

Performance in 2006

Economic activity accelerated in the first part of the year, benefiting from the cyclical upswing in Europe. In the first half Italian GDP expanded by 1.1 per cent and was about 2.2 per cent up on an annual basis, sustained above all by the recovery in exports and the acceleration in investment. Labour input, in terms of full-time equivalent workers, returned to growth after the previous year's contraction, rising by 1.4 per cent in the first half of 2006. Over the same period productivity declined by 0.5 per cent.

According to Istat's preliminary estimates GDP grew by 0.3 per cent in the third quarter. Compared with the year-earlier period, average growth in the first nine months came to 1.7 per cent.

Industrial production expanded by about one percentage point in the first half from the lows recorded in 2005 and by another half-point or more in the following four months. Firms' expectations for economic activity in the next few months remain positive, according to both the Bank of Italy's September survey and ISAE's index of business confidence. The fastest growth is forecast by producers of investment goods, thanks in part to more buoyant export demand. The sectors that depend more heavily on domestic demand expect to continue to suffer from slow growth in household consumption; consumers' expectations are still marked by a high degree of uncertainty.

The latest estimates indicate that Italian GDP, which stagnated in 2005, will record year-on-year growth of between 1.7 and 1.8 per cent in 2006.

Inflation held steady at just over 2 per cent in the first part of the year, as did the euro-area average. The acceleration of energy prices was accompanied by very moderate rises in the prices of non-food, non-energy goods, in line with the limited rise in producer prices.

The European Commission forecasts that the harmonized index of consumer prices in Italy will rise by 2.3 per cent on average in 2006. Private analysts estimate a slightly lower rate.

Credit supply conditions for firms and households are likely to remain favourable in the coming months, although lending rates will continue to adapt gradually to the increases in the official rates of the last few months. The seven Italian banking groups that participate in the bank lending survey did not expect to modify their lending criteria significantly in the near future. They expect that the further acceleration in loan demand from firms in connection with the good performance of the economy will be accompanied by a modest slowdown, after years of rapid growth, in households' demand for consumer credit and home mortgages.

In the Forecasting and Planning Report released in September the Government estimated general government net borrowing in 2006 at 4.8 per cent of GDP and forecast another rise in the ratio of debt to GDP.

These estimates included the cost of complying with the European Court of Justice judgement of 14 September, which quashed certain restrictions on the deductibility of VAT. Excluding this cost, net borrowing would come to 3.6 per cent of GDP, half a percentage point less than in 2005 and 0.2 points lower than was estimated in the Quarterly Report on the Borrowing Requirement in April. The improvement over the April estimate reflects not only the corrective measures adopted in the summer but also a much better revenue performance than expected, whose impact on the final balance has been largely offset by increased expenditure, however.

The outlook for 2007

The European Commission expects Italian GDP growth to slow slightly in 2007, to 1.4 per cent. The IMF and private analysts offer similar forecasts. In the Commission's forecast, the slowdown primarily reflects the behaviour of domestic demand, especially consumption. How consumers' and investors' expectations evolve in the light of international conditions and the economic policies announced and implemented will be crucial.

All the forecasts agree that the rate of increase in prices will diminish next year: inflation is expected to be 2 per cent or less.

Though moderating in 2007, the cyclical recovery in economic activity offers an opportunity for fiscal consolidation.

The budget for 2007

The additional resources to be raised in the budget for 2007 submitted in September amount to €34.4 billion, of which €24 billion from increased revenue and €10.4 billion from expenditure savings. Of these resources, €15.3 billion (or one percentage point of GDP) is allocated to reducing net borrowing and €19.1 to measures for the support of growth and other purposes. Overall, the budget measures result in a net increase in revenue of €18.8 billion and a net increase in expenditure of €3.6 billion.

The budget takes account of the net effect, amounting to €0.1 billion, of the judgment of the European Court of Justice on the deductibility of VAT in connection with outlays on company cars (€5.3 billion) and the offsetting measures contained in the legislative decree attached to the Finance Bill (permanent amendments to the deductibility of the above-mentioned outlays for the purposes of personal income tax, corporate income tax and the regional tax on productive activities).

***Increase in revenue.** – This is expected to come from tax measures (€11.8 billion), the transfer of part of workers' severance pay from firms to INPS (€6 billion), an increase in social security contributions (€5.5 billion) and other non-fiscal measures (€0.6 billion), including measures to use state assets more efficiently.*

Two thirds of the additional tax revenue (€7.8 billion) is expected to come from action to counter tax evasion and avoidance. In particular, there are measures regarding sector studies, which are expected to raise €3.3 billion and include: a broadening of their scope, revisions every three years instead of four, the introduction of additional indicators of consistency and increases in the sanctions for false declarations. To counter evasion, in line with the action taken in July 2006, a number of specific cases marked in the past by high levels of evasion have been identified for the application of improved assessment procedures (€1.2 billion). Lastly, there are some measures regarding the manner of determining tax bases (€2.1 billion).

Provision is also made for local authorities to receive approximately €1.1 billion of additional revenue. In particular, the budget introduces a payment on account of the municipal surtax on personal incomes (€0.5 billion) and contains a series of proposals concerning the cadastre that are expected to raise an additional €0.6 billion of municipal property tax. The increase in revenue deriving from these measures should make it easier for local authorities to achieve the budget objectives laid down by the domestic stability pact.

The reorganization of the taxation of income from financial assets provided for in the enabling bill attached to the Finance Bill is expected to produce at least €1.1 billion of additional revenue in 2007. The aim of the reform is to ensure equal treatment across the various types of financial instruments and intermediaries. The bill provides for convergence on a single tax rate of not more than 20 per cent.

In order to redistribute the tax burden in favour of low and medium incomes, the personal income tax rates and brackets are to be revised and the deductions introduced in 2003 and 2005 are to be replaced by tax credits. Overall, the changes are expected to bring an increase in revenue of €0.4 billion.

The budget adjustment presented in September contains measures modifying the taxation of motor vehicles, inheritances and gifts that are expected to raise approximately €1 billion of additional revenue. The version of the decree law attached to the Finance Bill approved by the Chamber of Deputies contains some amendments to these measures. The new text is currently being examined by the Senate.

The increase in social security receipts is to come mainly from the higher rates introduced for self-employed workers, quasi-employees and apprentices (€3.7 billion) and the increase of 0.3 percentage points in the rate for employee contributions (€1 billion). The latter change brings the rate into line with that used to calculate pension benefits. Another €0.8 billion is expected from the prime minister's decree being drafted on the regularization of new flows of immigrants.

Measures concerning workers' severance pay are expected to produce €6 billion of additional revenue. The introduction of the tacit approval mechanism for the transfer to pension funds of severance pay accruing is brought forward to 2007 and provision made for *half of any amounts not so transferred to go to a new INPS fund, which it is officially estimated will pay out benefits amounting to €0.4 billion in 2007. Relief is granted to firms to compensate them for the higher cost of alternative sources of financing in place of severance pay, with a reduction in revenue of €0.6 billion. An agreement reached between the Government and the two sides of industry after the budget had been presented provides for the transfer of severance pay to INPS to be restricted to firms with more than 50 workers and to consist of the entire amount accruing not allocated to pension funds. Preliminary indications provided by the European authorities suggest a favourable opinion regarding the classification as general government revenue of the amounts transferred to the INPS fund.*

Decrease in revenue. *– The budget provides for revenue reductions amounting to €5.1 billion and consisting primarily of relief for firms. The main measure reduces the tax wedge on labour with the introduction of new deductions from the base of the regional tax on productive activities (€2.5 billion). The new deductions are based on the total number of permanent employees; they differ by region and sector and will be phased in, becoming fully operational in 2008. The new deductions*

Estimated effects of the budget on the general government consolidated accounts (1)

(millions of euros)

REVENUE	
Increase in revenue	**23,950**
Fight against tax evasion and avoidance	7,770
Revision of sector studies	*3,290*
Enhanced tax assessment	*1,160*
Measures to recover tax bases	*2,120*
Collection of assessed taxes	*1,200*
Partial transfer of severance pay to INPS	6,010
Increase in social security contribution rates	4,760
Domestic stability pact (ICI and municipal Irpef surtax)	1,110
Mandate to reform taxation of financial income	1,100
Social security contributions from regularizing immigrants	770
Motor vehicle taxes	700
Reform of personal income tax	430
Taxation of inheritances and gifts	240
Changes in direct taxes following deducibility of company car VAT (2)	120
Health sector - net increase in revenue	110
Other tax revenue	250
Other non-tax revenue	580
of which: exploiting state assets	*500*
Decrease in revenue	**5,110**
Irap deductions and female employment incentives	2,450
Extension of tax reliefs	1,130
Indirect effects of the partial transfer of severance pay to INPS	560
Indirect effects of the increase in social security contribution rates	390
Other	580
Net increase in revenue	**18,840**

EXPENDITURE	
Decrease in expenditure	**10,400**
Current expenditure	8,930
Domestic stability pact	*3,270*
Health service	*2,950*
Ministry intermediate consumption and transfer payments	*2,100*
Public employment	*360*
Reorganization of government departments	*230*
Other	*20*
Capital expenditure	1,470
Ministry capital expenditure	*1,210*
Other	*260*
Increase in expenditure	**13,970**
Current expenditure	7,360
Armed forces and peace-keeping missions	*1,400*
Social benefits (revision of family benefits)	*1,400*
Public employment (new contracts)	*1,070*
Transfer payments to public enterprises	*750*
Subsidies for road haulage	*520*
Benefits in relation to severance pay transferred to INPS	*430*
Social benefits (unemployment, mobility, sickness and maternity)	*420*
Education	*320*
Other	*1,050*
Capital expenditure	3,990
Transfer payments to Trenitalia	*2,400*
Removal of spending caps	*550*
Other	*1,040*
Other net expenditure (3)	2,620
Net increase in expenditure	**3,570**
TOTAL REDUCTION IN NET BORROWING	**15,270**

(1) Based on official estimates contained in the technical report accompanying the Finance Bill and in the second section of the Forecasting and Planning Report for 2007 published in November 2006. The budget includes the measures contained in the Finance Bill, the accompanying decree law (DL no. 262 of 3 October 2006), the proposed legislative mandates concerning taxation, and the prime minister's decree being drafted on the regularization of new immigrant flows. – (2) Net of the effects of the judgment of the European Court of Justice. – (3) The item includes the effects of the changes introduced with the tables attached to the budget and the accompanying decree law.

are an alternative to those already in place reserved to small firms and pegged to increases in employment; the latter are also increased for the recruitment of female workers in economically backward areas.

Some of the tax reliefs granted in earlier years are extended to 2007 (€1.1 billion). Tax credits are introduced for spending on capital goods and research. The loss of revenue, which will begin to make itself felt in 2008, is estimated at €1.2 when the measures are fully operational.

***Decrease in expenditure.** – The main expenditure savings are due to the revision of the domestic stability pact (€3.3 billion), measures regarding the health sector (€3 billion) and those designed to curb the spending of government departments (€3.9 billion).*

The new domestic stability pact rules require an improvement in each local authority's budget balance, excluding central government transfers and some items of capital expenditure, compared with the average in the period 2003-05. A larger improvement is required by authorities that recorded higher current expenditure and bigger deficits in the reference period. In 2007 the expenditure of ordinary statute regions, excluding health care and expenditure in connection with credit disbursements, must not exceed 98.2 per cent of the corresponding figure for 2005. The constraints on the expenditure of the special statute regions must be agreed with the Minister for the Economy and Finance; failing such agreement, the provisions for ordinary statute regions shall apply. Provision has been made for automatic increases in some tax rates for authorities that do not achieve the objectives laid down by the domestic stability pact.

The Finance Bill does not extend the suspension of increases introduced by regions and municipalities in the surtax rates for personal income tax and the regional tax on productive activities. It also broadens the autonomous tax-levying powers of municipalities: the maximum personal income surtax rate they may impose is increased and they are allowed to introduce a special-purpose tax and a levy on visitors' overnight stays to be used for specified purposes.

In the health sector the budget extends the compulsory discount on drugs purchased by the National Health Service (€0.8 billion). Forms of cost sharing are introduced, especially for visits to specialists and emergency room care not followed by hospitalization, with exemption maintained only for certain categories of patients (€0.8 billion). Expenditure savings amounting to €0.9 billion are expected from mechanisms designed to enhance regions' accountability. These include automatic increases in the regions' surtax rates for personal income tax and the regional tax on productive activities when their health deficits exceed given thresholds. A temporary fund is created to support regions with health deficits that, after raising the relevant tax rates, enter into an agreement with the Government containing deficit-adjustment plans.

Savings in central government expenditure are to come from: restrictions on the resources available for intermediate consumption, current transfers and capital outlays (€3.3 billion); measures concerning public employment (€0.4 billion, of which about two thirds as a result of more efficient use of teachers); and rationalization of administrative structures (€0.2 billion).

***Increase in expenditure.** – Additional expenditure is set to amount to €14 billion.*

Approximately €1.1 billion is allocated for labour contract renewals. Provision is made for an increase of €0.8 billion in current transfers to ANAS, Ferrovie dello Stato and Poste Italiane and of €2.4 billion in capital transfers to Ferrovie dello Stato, partly in connection with further work on the high-speed railway project. €1.4 billion is allocated for the revision of family benefits and €0.3 billion for the extension of the measures increasing the duration and amount of unemployment benefits. An additional allocation of €1.4 billion is made for the armed forces and peace-keeping missions.

Some of the increased expenditure is subject to Eurostat approving the inclusion in general government revenue of the part of severance pay transferred to INPS. Some 80 per cent of the €5.2 billion in question concerns capital expenditure, including the €2.4 allocation to Ferrovie dello Stato.

The Government has confirmed the objective of net borrowing equal to 2.8 per cent of GDP in 2007. The improvement in the outlook for growth and the good performance of revenue in 2006 have permitted the size of the budget adjustment needed next year to be reduced to 1 per cent of GDP (from 1.3 per cent in the Economic and Financial Planning Document in July). Taking account of the measures introduced at the start of the summer, the correction with respect to the baseline trend amounts to 1.5 per cent of GDP. After contracting between 1998 and 2005, the primary surplus is expected to increase this year by about half a percentage point (excluding the effects of the judgement of the European Court of Justice) and to rise to 2 per cent of GDP next year, when the ratio of debt to GDP is meant to fall by 0.7 percentage points, to 106.9 per cent. The last-mentioned objective assumes substantial receipts from privatizations.

The budget for 2007 presented in September and now before Parliament is intended to raise €24 billion of additional tax revenue and produce €10.4 of expenditure savings. Of the total resources obtained, €15.3 billion goes to reducing net borrowing and €19.1 billion to measures in support of growth and for other objectives. The deficit reduction is obtained with a net increase in revenue of €18.8 billion (1.2 per cent of GDP), partly offset by a net increase in expenditure of €3.6 billion (0.2 per cent of GDP; see box). The budget's overall impact on economic activity is likely to be moderately restrictive. The quantification of the effects of some measures is subject to a degree of uncertainty, particularly in the case of the measures to curb spending and those designed to counter tax evasion and avoidance, whose effects depend in part on taxpayers' behaviour. The latter measures account for two thirds of the expected increase in tax receipts. A detailed examination of the budget is contained in the testimony of the Governor of the Bank of Italy to Parliament on 12 October. [1]

The increase in the budget deficit in the last few years has basically reflected the gap between the strong growth of primary current expenditure and the modest expansion of GDP. Between 1998 and 2005 primary current expenditure grew on average by more than 4.5 per cent per year. Its ratio to GDP rose to the highest levels seen in Italy in recent decades. The official estimates for 2006 indicate a further increase. Under the planning scenario of the Forecasting and Planning Report, in 2007 primary current expenditure will grow by 2.4 per cent; its ratio to GDP will decline by 0.1 percentage points, to 40.1 per cent.

Careful monitoring of disbursements will be necessary in 2007. To make the consolidation of the public finances enduring and reduce the ratio of tax and social security receipts to GDP, it will be essential to curb primary current expenditure through structural reform of the main components and to rethink the optimal size of all the budget items. Under the Forecasting and Planning Report's planning scenario, the primary surplus in 2009 will be 1.2 percentage points of GDP higher than that in 2007. Achieving this objective without additional increases in revenue will require lower growth in current spending than is planned for 2007, so as to stabilize expenditure in real terms.

The budget does not affect the trends of pension spending. A more comprehensive reform of the rules of the pension system has been announced for next year. From January onwards it should follow the guidelines laid down in the Memorandum of Understanding signed by the Government and the main trade-union confederations. Above all, measures are needed that will raise the effective retirement age, so as to reconcile the payment of adequate pensions with the financial sustainability of the contributions-based system.

According to the official estimates, the improvement in the primary surplus between 2006 and 2007 (1 percentage point of GDP, excluding the effects of the judgement of the European Court of Justice) derives from the increase of 1.2 percentage points in the ratio of revenue to GDP following that of about 1 point expected for 2006. Even excluding the transfer of severance pay to INPS, the ratio of tax and social security receipts to GDP would rise to 42.5 per cent, close to the peaks recorded in Italy.

About half a percentage point of the increase in the fiscal ratio stems from measures to combat tax evasion and avoidance. Besides boosting revenue and reducing the distributive unfairness that is inherent in evasion, the measures in this area can help to limit competitive distortions. Although the ratio of revenue to GDP in Italy is similar to that in the other euro-area countries, Italian statutory tax rates are among the highest. The scale of underground economic activity, which Istat calculates at around 15 per cent of GDP, makes the burden on taxpayers who fulfil their obligations greater than in the rest of Europe. The success of the action against evasion will make it possible to reduce the statutory rates.

The reduction in the fiscal component of the cost of labour, which will be added to the contributions relief that took effect at the start of 2006, is likely to strengthen Italian production's competitiveness in the short term as well as attenuate some distortions in the labour market. However, the effects on competitiveness are one-off and will be reabsorbed over time if unit labour costs continue to rise faster in Italy than elsewhere.

Beyond the short term, the outlook for growth will depend on economic policies that succeed in creating a context more conducive to a sustained and lasting rise in productivity.

[1] The budget's composition and its effects on net borrowing described in this *Economic Bulletin* differ in some respects from those presented in the Governor's testimony in the light of information made available after 12 October, in particular with the publication of the second section of the Forecasting and Planning Report.

Based on information available at 15 November 2006 (10 November for some financial data). The Appendix is updated to 13 November.

Speeches

2006 World Savings Day

Address by Mario Draghi, Governor of the Bank of Italy, to the Association of Italian Savings Banks, ACRI

Rome, 31 October 2006

1. Savings and investment

Half a century ago, when Italy was moving towards prosperity, it was the parsimony of its population that financed economic growth. Right up to the mid-1970s, while expenditure on investment amounted to 26 per cent of gross national disposable income, private saving exceeded 30 per cent, with more than two-thirds of it due to households; their thrift was encouraged and upheld as a social virtue.

Towards the end of the twentieth century, both expenditure on capital goods and private saving diminished to around 20 per cent of national income; household saving dropped below 9 per cent. Since then, Italian households have started to save again, partly in response to the public pension reforms of the 1990s; they continue to be among the thriftiest of the developed countries.

With no more barriers to capital movements and a globalized financial market, savings worldwide are now in search of investment opportunities, wherever they may arise. The link between saving and investment is no longer related to national borders. Only a growing country will attract capital, from both within and without.

Italy's weak economic growth in the past ten years has been aggravated by inadequate investment, not so much in terms of quantity as of quality and composition. The technological component of real assets, human capital and organizational structure are of growing importance. If the present recovery is to last, economic policy and the financial system must support the restructuring of production, channelling savings towards innovative investment.

2. Returning to growth

2006 is about to become another year of record growth in world output. Since the summer there have been increasingly clear signs of slower growth in the United States, where the lengthy property boom appears to be coming to an end. World demand may be affected by the slowdown, but it continues to be fuelled by the exceptional growth of the Asian economies.

Economic growth in the euro area is considerably stronger now than in the previous months. The momentum could be lessened over the next quarters by the decline in demand in the United States and the need for some of the main euro-area countries to consolidate their public finances.

In Italy, too, GDP growth resumed at a rapid pace in the first half of this year. Industrial production recorded an estimated year-on-year rise of over 2 percentage points in the first ten months and is steadily picking up from the low point of early 2005. The substantial increase in indirect tax revenue is another indication of a cyclical upswing. Available indicators point to strong GDP growth in the third quarter as well.

So far the recovery has drawn strength principally from exports and investment. Italian goods have penetrated further on foreign markets, including the fast growing markets of South-East Asia, thereby slowing the erosion of our market shares. Exports to China are soaring, not only those of traditional products but also of capital goods, suggesting an improvement in the competitiveness of some medium-to-high technology firms. The expansion in foreign demand has helped to rekindle investment in machinery and equipment, which has also been fostered by the shortage of spare capacity, ample availability of financial resources and persistently low interest rates. Domestic orders for capital goods have reached their highest level in five years. The Bank of Italy's business surveys indicate that the trend will continue in the coming months.

Although output growth has been stronger than expected, it is still slower than in the rest of Europe. Productivity in industry remained at a standstill in the first half of this year, while in France and Germany the quarterly increase was over 3 per cent. We need to step up the action, just initiated, to overcome the structural constraints impeding Italy's growth.

The aim of the budget for 2007 is to ensure financial stability in the years to come. It is to be hoped that the debate in Parliament will not attenuate the push for structural reform of the public finances. Achieving this objective is a prerequisite, but also a consequence, of economic growth. The best response to the rating agencies' assessments is a country that is growing.

The Government's budget proposals include measures to help firms recover their competitiveness, such as the reduction in the tax component of labour costs. However, most of the policies to stimulate renewed economic growth remain outside the sphere of the budget because they are concerned with measures to change the rules of the economic game more than with changing the volume of public resources.

Five months ago, in my Concluding Remarks, I listed several areas of action for structural policies. Common to all of them was the need to increase competitiveness, in the goods markets as in the markets for factors of production, by eliminating the protection of vested interests and the monopoly revenues that weigh on firms' costs and households' budgets.

In the summer the Government took steps to open up further the market for private services. Various measures to revive the productive system are now set out in bills recently passed by the Council of Ministers. It is to be hoped that progress in this direction will continue, without deviating from the objective of improving competitiveness and efficiency at every point of the productive system.

As far as incentives are concerned, automatic facilities for firms appear preferable as being less costly and distorting than discretionary measures, which rely on the public bodies concerned to select the sectors for promotion and choosing between different technologies and projects. Such a model requires a remarkable capacity for strategic evaluation. If that is lacking, there is a serious risk of scarce resources not being optimally allocated.

To promote growth, improving the environment in which the productive system operates is more important than augmenting or refining the incentives offered to firms. The areas needing action are many and well known. They include simplifying the regulatory and tax system, introducing rewards for merit and mechanisms of competition within the educational and training system, reducing the cost and enhancing the effectiveness of business services and local public services, promoting competition in the production and distribution of those services everywhere possible, and acting to ensure that the legal order and governmental authorities are guided by the values of the market and efficiency rather than the deleterious standards of legal formality and bureaucratic power.

3. The financial system's contribution to growth

3.1. The stock market and institutional investors

Structural reform must also extend to the financial industry. The possibility of direct or indirect recourse to the capital market plays an essential role in facilitating the expansion of firms that have growth potential. Market access is assisted by the presence of a large stock exchange, a good number of institutional investors and a web of specialized intermediaries. Progress on all these fronts is needed.

As we know, the Italian share market is smaller than those of the other advanced countries. Both the number of companies listed and the ratio of their total capitalization to GDP are not only far lower than in the United States and the United Kingdom but also below the euro-area average.

As for specialized intermediaries, in 2005 total private-equity investment in Italy was half the European average in proportion to GDP. The resources invested in Italy go largely to buyouts. Only 15 per cent of Italian private-equity investment in 2005 went to venture-capital operations, compared with a European average of 27 per cent. And even of that, only a marginal portion, far smaller than in the other major European countries, went to start-ups. Investment in high-technology sectors is minimal. A good part of the capital is of foreign origin; the domestic component comes largely from banks, while the role of other investors, especially pension funds, is scant.

As a rule, small firms with highly innovative projects are unable to raise funds directly in the capital market, nor can ordinary bank lending suffice. Even medium-sized companies with opportunities for growth are often incapable of attaining stock exchange listing. There is a need for intermediaries that are able to select risky but promising projects in which to invest, with the ultimate aim of placing the equity on the market. More generally, private equity is also helpful in other corporate transitions, such as generational change, management buy-outs, crises and restructuring.

The expansion of the stock exchange and of specialized intermediaries can also be fostered by an enhanced presence of institutional investors, pension funds above all. In the countries where pension funds play a significant role, even relatively small firms tend to seek stock exchange listing. Institutional investors play an active role as minority shareholders, monitoring management's performance. They reduce informational asymmetries and increase the volume of resources available on the market to finance enterprises. They are among the leading sources of venture capital and, more generally, of funds for intermediaries specialized in supplying risk capital to firms.

The spread of private pension funds in Italy is essential to the equilibrium and the equity of the pension system. The rules governing the allocation of workers' accruing severance pay entitlements will play a key role in shaping the funds' development. While the amounts accumulated must be earmarked for retirement purposes, workers must be given full freedom of choice: free and fair competition between classes of asset managers and types of retirement scheme, at low cost to the saver, constitutes a guarantee for the robust, competitive development of the sector. Workers must be provided with clear and complete information on their pension situation and the alternatives available if they are to be in a position to make informed choices. The Finance Bill's provision for the partial transfer to the social security administration of resources now going to firms' severance pay funds must not conflict with the objective of developing supplementary pensions.

3.2. The shape of the banking system

Banks were once virtually the sole agents for collecting savings in Italy and channelling these resources to firms. Overseeing their stability was tantamount to protecting households' savings. Today, banks and the capital market perform complementary functions in sustaining the operation and growth of the economy, but small and medium-sized enterprises still depend decisively on bank credit. Helping such firms to grow is necessary to strengthen them for competition in an increasingly globalized market. When the technological and human factors and the market conditions are right, the careful and rigorous assessment of creditworthiness does not conflict with a lending policy designed to accompany firms' growth in size.

In the 1990s technological progress, privatization and deregulation triggered a wave of consolidation within the banking industry. In the last ten years the number of banks has diminished; mergers and acquisitions have involved institutions accounting for 80 per cent of total assets. And further significant concentrations are being discussed. Those who propose concentrations – board chairmen and directors – increasingly grasp the necessity and the benefits of consolidation and are showing an ability to transcend the localisms and personal interests that impede it. The Bank of Italy wants the stability and competitiveness of the banking system to emerge stronger still. In a financial system that is open to international competition, it encourages banks to continue on the path of consolidation on the basis of plans decided upon independently by the market.

In bank mergers, rational governance arrangements in the new bank are essential to reap all the benefits of consolidation. Innovative corporate governance models may serve to facilitate concentrations; they must be organizationally effective and not jeopardize efficient decision-making.

A fundamental contribution to the re-organization of the banking system has come from the banking foundations. The great majority of them have disposed of their controlling interests but they are still significant shareholders of banks, even if consolidation has nearly always diluted their holdings. Their conduct is directed today towards enhancing the value of capital invested, in keeping with their role of long-term investors; their interest lies in pursuing institutional objectives. It might be appropriate to reconsider the regulatory discriminations that limit their ability to acquire and manage bank shareholdings, such as the sterilization of voting rights in excess of 30 per cent.

Consolidation has also involved cooperative banks, whose number has fallen from 95 to 36 in the last ten years. Based mainly in the most developed regions of Italy, they diversify the structure of the banking system, draw competitive advantages from their proximity to the productive system at local level, and play a significant role in the investment of households' savings. There is scope for further concentrations permitting potential synergies to be exploited, without the new groups' greater complexity compromising their mission of financing the local economy.

Consolidation has accentuated the differences between cooperative banks. Alongside banks that preserve an exclusively local vocation, there have emerged groups of considerable size and national reach. A reflection is necessary on how to adapt the corporative governance rules typical of cooperative banks to the reality of each bank. Recent events have demonstrated the risks of instability that can derive from inadequate rules. The inflexible rule of one vote per head, limits on the collection of proxies and restrictions on individual shareholdings can result in a self-referential attitude of management, insufficient protection of shareholders and obstacles to capital strengthening. Parliament has examined various reform projects in recent years. Towards the end of the last Government's term of office a broad consensus had been reached on a bill that would have eased the shareholding limits, especially for institutional investors, and strengthened the protection of shareholders of listed cooperative banks, while preserving the essential features of the cooperative form. The matter needs to be taken up again.

The rules imposing rigid separation between banking and industry, particularly those setting strict quantitative limits on shareholding in banks by investors not belonging to the financial sector, constitute an isolated case in Europe and have to be assessed also for their compatibility with the legislative reform proposals now under discussion at Community level.

The need for adequate safeguards is undiminished. It remains essential to ensure the autonomy of the bank vis-à-vis companies that, as a result of conflicts of interest, can unduly influence its decisions, distorting the allocation of loans and imperiling its very stability. But, as with other aspects of supervision, the instruments to be used change. They now consist first of all in governance rules that ensure transparency of decisions, checks and balances, the presence of independent directors, interaction between the different corporate functions and effective internal controls. Secondly, the rules that limit the concentration of risk, particularly vis-à-vis related parties, take on increasing importance.

Likewise, with regard to the restrictions "downstream", on shareholding by banks in firms, the experience acquired and the development of risk management and control techniques make it possible today to ease the existing limits, bringing Italian rules into line with Community provisions. The management of the conflicts of interest that arise in private-equity activity requires adequate transparency safeguards and decision-making guarantees, including the separate conduct of private-equity business by companies within banking groups, and rules on the spreading and diversification of risk.

Replacing rigid regulatory constraints with flexible supervisory principles restores autonomy to banks and entrepreneurs and stimulates efficient decision-making. At the same time, this increases the responsibility of the supervisory authority, demands continual refinement of its technical apparatus and requires it to be fully transparent in accounting for its actions.

3.3. Banks: costs and transparency

The efficiency gains deriving from concentrations must be transferred in full to households and firms.

The costs of banking services for customers are still too high in Italy. Customer protection must be entrusted above all to instruments that guarantee complete information on terms and conditions and the application of a general canon of correctness in business relations. Ordinarily, competition is the most effective means of curbing the costs charged to customers. However, one set of costs – those directly or indirectly connected with closing bank accounts – hinder customer mobility and thus constitute in themselves an impediment to the free working of the mechanisms of competition. Such costs should be eliminated. The full portability of accounts, including accessory services, must also be ensured.

The aim of the recent measure that provides for the closing of accounts without expense and other rules protecting bank customers are therefore commendable. However, the formulation of the measure, based on the dictation of economic clauses by statute, has engendered problems of interpretation, particularly as regards the obligation under certain circumstances to modify lending and deposit rates simultaneously and the exact identification of the items to be considered in the charges connected with closing accounts. A situation of uncertainty has been produced that creates operational problems for banks, keeps customers from taking full advantage of the new rights and may cause costly litigation. It would be better if the statutory provisions were limited to laying down general rules, referring their implementation to secondary legislation and self-regulation.

Besides, it is in the banks' own interest to strengthen the consumer safeguards they have already put in place as part of the sector's self-regulation, by extending their scope and introducing effective mechanisms for settling disputes. In Italy there are already bodies for the out-of-court settlement of banking disputes. For banking business the law on the protection of savings has entrusted the Interministerial Committee for Credit and Savings with the task of regulating the procedures and decision-making bodies. Forms of direct involvement of the supervisory authority could be considered.

Transparency and fairness in customer relations are an integral part of the sound and prudent management of banks. Every transgression creates legal and reputational risks. Banking relationships are based on trust; loss of trust can cause risks of instability, including at a systemic level.

The Bank of Italy must verify that banks' organization and internal controls provide adequate protection against risks deriving from business practices that are unfair to customers. Proposed rules on the compliance function have been sent to financial intermediaries and the public for consultation; the related regulations will be issued shortly.

Transparency of banking business also requires that banks' financial statements and other public information on their financial positions be comparable. There has been a significant increase in such comparability in Europe with the adoption of international accounting standards. Greater convergence is necessary with regard to the methods of classifying impaired loans.

Adopting the strictest definition of defaulted loans – which includes overshoots and payments overdue by more than 90 days – the figures for Italian banks are high owing to the tolerance of late payments. Banks must further shorten their reaction times by speeding up the organizational and procedural interventions that have already reduced overshoots from 1.7 to 1 per cent of the total loans in the last twelve months.

3.4. Payment services

Technological progress offers plenty of scope for increased competition and greater efficiency in the payment system. The spread of mobile telephony, which can be used to provide financial services, and of cards and equipment prepared by the suppliers of electronic payment services is conducive to the entry into the market of new operators and the growth of innovative payment mechanisms, especially for small amounts.

The Bank of Italy has already authorized the purchase of products over the phone, when they are supplied by the operator of the service and it does not involve the creation of payment instruments for general use. But in view of the evolution of technology and the market the rules on the reserves for electronic money and the collection and transfer of funds will need to be re-examined, in line with the revision of the European rules now under way. Access to a variety of competing operators must be ensured, while maintaining the public's trust in the payment system.

4. The Bank of Italy

4.1. Ownership structure

In my recent testimony before Parliament concerning the law on the protection of savings, I drew attention to the need to reflect on the implementation of the provision calling for the redefinition of the Bank of Italy's ownership structure and the transfer within three years of those of its shares held by persons other than the state or other public entities.

As I pointed out, it is not up to the Bank of Italy to choose its owners; but it is in the Bank's interest, indeed it is its duty, to call attention to any solutions that are likely to conflict with the safeguarding of its independence.

A plurality of shareholders, a balanced distribution of shares, non-interference in the Bank's institutional functions, a guarantee of its financial autonomy and, above all, consistency with Community law – an aspect to which the European Central Bank has drawn attention several times – are the principles with which the central bank's ownership structure and corporate governance must conform.

In light of international standards and the experience of other countries, it may prove necessary to reflect on the choice made by the law and move towards a configuration of the Bank's ownership that fully protects its independence, the guarantee of stability and a cornerstone of the European economic constitution.

4.2. Organizational developments

A working document has been sent today to the trade unions present in the Bank of Italy on the overhaul of the Bank's organization. The document identifies and details the medium-term strategic objectives for the performance of the Bank's central banking functions, in harmony with the evolution of the Italian and European institutional framework.

The measures outlined in the document aim to increase the Bank's effectiveness and efficiency both at international level and in Italy, by concentrating its local structure in appropriately strengthened units at regional level. The new organizational structure – which also envisages the incorporation of the Italian Foreign Exchange Office (UIC) – must be able to respond to the challenges imposed by change and to offer staff greater participation in decision-making and operational processes and better opportunities of professional and cultural growth.

The reorganization will call on the vast stock of professional skills available within the Bank. A path will be agreed with the trade unions that sets out the timetable and content of the changes and the manner of achieving the objectives of the reorganization. Clear objectives, gradual implementation and dialogue are what are needed for this to be completed in a reasonably short time and without trauma. The ability of the Bank of Italy to go on playing its role in Italy and the European System of Central Banks efficiently and authoritatively depends on the success of this project, which will require the joint efforts of all concerned.