BANCA D'ITALIA

Economic Bulletin

Number 29 October 1999

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. 290, 14 October 1983 - *Director:* GIANCARLO MORCALDO

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SYMBOLS AND CONVENTIONS

— the phenomenon in question does not occur;

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

.. the value is known but less than the minimum considered significant.

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

EDITORIAL NOTE

This issue of the Economic Bulletin presents a number of changes, especially in the sections ***Articles*** *and* ***Documents*** *and in the structure of the analysis of the economic situation.*

The changes have been prompted by the need to take account of the inclusion of the Italian economy in the euro area.

In the chapters on the real economy and the public finances, the emphasis has been placed on analyzing developments in Italy in relation to the euro area as a whole and to the other leading member countries.

The analysis of monetary and financial aspects and inflation takes as its starting point the developments in the entire euro area, which are the focus of the Monthly Bulletin published by the European Central Bank and translated into Italian by the Bank of Italy. Within this framework, a more detailed examination is conducted of price developments and the evolution of the monetary and financial sector in Italy. The analysis has also been affected by the reorganization of the statistical system, which is still under way.

The ***Articles*** *section provides brief overviews of the results of ongoing research, while the* ***Documents*** *section offers summaries of key monetary and credit documents.*

Finally, the changes also take account of the fact that the Bank of Italy has its own Internet site, which provides visitors timely access to more detailed data and information and the full version of documents.

Economic Developments and Policies

THE INTERNATIONAL ECONOMY

The world economy is now recovering from the unsatisfactory performance it recorded in 1998, which was affected by the Asian crisis of the previous year. The risk of activity stagnating or falling in vast areas of the world, which had seemed possible in the wake of the crisis in Russia in the summer of 1998 and even more likely following the one in Brazil in January of this year, did not materialize. According to recent IMF forecasts, the growth in world output should amount to 3.0 per cent in 1999, compared with 2.5 per cent in 1998; this is more than half a point faster than was forecast in the spring.

The pick-up in activity was due partly to the expansionary stance of fiscal and monetary policy, especially the latter, and to the financial support provided by the international community for the countries affected by the crisis. The expansion of the US economy, which was more vigorous than expected, continued to sustain world demand.

Activity rose substantially in the Asian countries embroiled in the 1997 crisis, aided by strong export growth. Progress with the restructuring of their financial systems laid the basis for a gradual resumption of foreign capital inflows; in the first half of the year, with exchange rates broadly stable, conditions were conducive to a substantial reduction in interest rates.

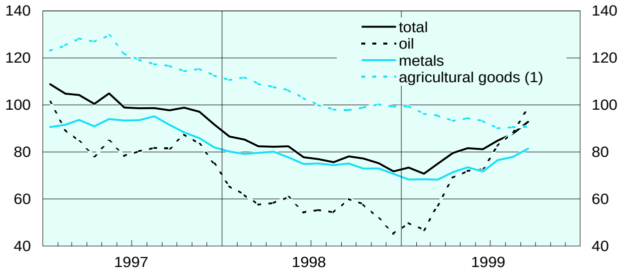
The ending of the recession in Japan, thanks in large part to massive public investment, gave an important boost to growth in Asia.

In China the rate of growth in GDP remained high, and only slightly lower than in 1998. Fiscal policy was aimed at sustaining demand at a time of falling prices, and from June onwards monetary policy was directed towards the same objective. Fears of a devaluation of the yuan receded.

The recovery in the terms of trade of oil-producing countries had a positive effect on their growth. The fall in crude oil prices that had begun at the end of 1997 came to a halt in mid-February. In March OPEC and other oil-exporting countries agreed to cut production by about 3 per cent. Between mid-February and mid-October demand picked up and oil prices more than doubled to $23 a barrel (Figure 1). In contrast to past experience, the agreement has held so far, partly because of the need to make up for the serious losses sustained last year. The acceleration in world economic activity was also a factor in the rise in metals prices by about 19 per cent since the beginning of the year.

Figure 1

World prices of raw materials
(indices, 1990=100)



Source: IMF.
(1) Comprises food and non-food products, beverages and fertilizers.

In the United States domestic demand grew much more rapidly than potential output in the first half of 1999 and the deficit on the current account of the balance of payments increased further. The exceptional and persistent growth in consumption was financed partly by a large increase in households' debt against the background of a further rise in the value of their financial assets. Labour market conditions remained tight, and price pressures appeared in the second quarter. The high probability of the economy overheating prompted the Federal Reserve to adopt a more restrictive monetary stance from the end of June onwards; nevertheless, monetary conditions are still more expansionary than they were before the international crisis in the summer of 1998.

In the euro area the slowdown in economic activity in the first half of the year was mild. Demand drew support from the reduction in official interest rates by the national central banks at the end of 1998 and by the Eurosystem in April in a context of stable prices. Fiscal policies were broadly neutral. Signs of a revival in activity have become more evident in recent months and have also spread to Germany and Italy, where growth was modest in the first half of the year.

The international outlook is not free of risk, however. A sudden fall in share prices could lead to a sharp contraction in private spending in some industrial countries. In the United States a fall in share prices and the difficulties this would cause for financing the current account deficit, not least because of its sheer size, would trigger a substantial depreciation of the US dollar.

There is still uncertainty as to the intensity of the recovery in Japan, given the erosion of competitiveness due to the appreciation of the yen and the possibility that the fiscal stimulus will wane in the second half of the year. The strengthening of the yen, which has appreciated by 27 per cent in nominal effective terms over the past twelve months, could exacerbate deflationary pressures by leading to a further rise in real interest rates, which are already high. With the aim of curbing the tendency for the yen to appreciate, the meeting of G7 ministers in Washington in September urged the Bank of Japan to increase the supply of yen in the foreign exchange markets by refraining from sterilizing inflows of foreign exchange with sales of securities in the domestic market.

In Russia the effects of the crisis in August 1998 on economic activity were less damaging than expected, but serious imbalances remain in the macroeconomic situation, in the banking and financial system and in the working of the institutions. These problems could block the granting of further loans to the country, with adverse consequences for growth.

In Latin America exchange rate pressures reappeared in the spring; the cyclical disparities among countries in the region worsened and their balances of payments continued to show worrying deficits. In the summer it became more difficult for them to tap international financial markets.

For these and other reasons, the international financial markets remain highly volatile, more so than before the crisis in Asia. The exchange rates between the leading currencies fluctuated widely on the foreign exchange markets.

At the recent annual meetings of the IMF and the World Bank it was decided to reduce the debt of some developing countries with very low per capita incomes in order to support programmes to combat poverty. The initiative will be financed partly by bilateral contributions from donor countries and partly by the IMF, using the capital gains on gold transactions conducted off the market with certain central banks.

The decision of the main European central banks at the end of September that over the next five years they will not sell gold from their reserves over and above the quantities already planned and the decision of the IMF at the beginning of October to finance the measures to support poor countries by selling gold off the market led to a sharp rise in the gold price, which in mid-October was 30 per cent above the low of $252.30 an ounce touched on 25 August. The rise augurs well for the IMF plan, as well as bolstering the terms of trade of gold-producing countries.

Economic activity and policies in the industrial countries

In the United States gross domestic product increased at an annual rate of 4.1 per cent between the second half of 1998 and the first half of this year

(Table 1). Consumption grew by just under 6 per cent, and household saving was negative (-1 per cent of disposable income). According to provisional estimates, output was still growing at an annual rate of 4 per cent in the third quarter. Throughout this decade's long period of expansion, there has been no reduction in the inequality of personal income distribution, which is high by international standards.

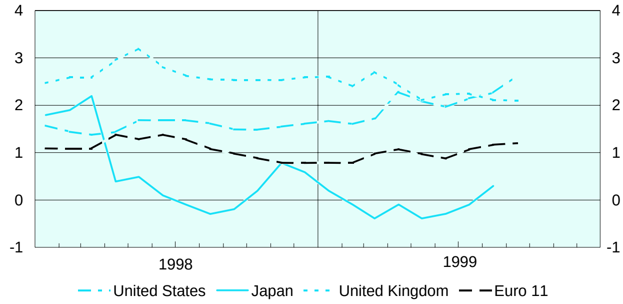
Job creation continued; in the first nine months of the year the number of persons in employment rose by 1.4 per cent in the non-farm private sector; the unemployment rate declined to 4.2 per cent in September.

Signs of inflationary pressures became more discernible in the labour market as well as in the financial markets, where long-term interest rates rose. In the second quarter unit labour costs in the non-farm private sector were 1.1 per cent higher than in the preceding quarter, owing partly to the marked slowdown in productivity growth. However, there is still uncertainty about the scale of the inflation risk, given the downward trend in underlying inflation. Whereas consumer price inflation reached a twelve-month rate of 2.6 per cent in September, compared with 1.4 per cent in the early months of 1998 (Figure 2), the rise in the index that excludes the prices of energy products and the more volatile items declined from 2.3 per cent in February 1998 to 2 per cent.

Figure 2

Consumer prices (1)

(percentage changes on same period of previous year)



Sources: National statistics and Eurostat.

(1) For the euro area, harmonized index; for the United Kingdom, retail price index excluding mortgage interest payments.

The tightening of monetary conditions by the Federal Reserve was cautious and gradual (Figure 3); in June and August the target rate for federal funds was raised by a total of 0.5 percentage points to 5.25 per cent, and in August the discount rate was increased from 4.5 to 4.75 per cent.

The economic impact of fiscal policy is expected to be broadly neutral in 1999; according to IMF estimates, the structural budget balance will be more or less the same as in 1998 in relation to GDP. The strength of the economy, which grew more rapidly than expected, increased the federal budget surplus for the fiscal year to the end of September to $123 billion, equal to 1.4 per cent of GDP, compared with a forecast of 0.9 per cent made in May.

Table 1

Economic indicators for the main industrial countries

	GDP (1)		Domestic demand (1) (2)		Net exports (3)		Current account balance (billions of dollars)		
	1998	1999 H1	1998	1999 H1	1998	1999 H1	1998	1998 H1	1999 H1
United States	3.9	4.1	5.1	5.3	-1.4	-1.7	-220.6	-95.4	-149.3
Japan	-2.8	3.4	-3.5	4.4	0.6	-0.9	121.2	74.0(4)	70.1(4)
Euro area	2.7	1.5	3.3	2.4	-0.5	-0.8	67.6	50.0 (4)	38.6 (4)
Germany	*2.2*	*0.7*	*2.5*	*1.6*	*-0.3*	*-0.9*	*-4.1*	*-3.9 (4)*	*-7.2 (4)*
France	*3.4*	*2.0*	*3.9*	*2.4*	*-0.4*	*-0.3*	*40.2*	*18.3*	*17.8*
Italy	*1.3*	*0.3*	*2.5*	*2.7*	*-1.1*	*-2.3*	*20.0*	*16.4 (4)*	*10.7 (4)*
United Kingdom	2.2	1.1	4.1	2.6	-1.8	-2.0	0.2	-1.5	-12.5
Canada	3.1	4.1	2.2	5.3	1.0	-0.5	-11.2	-8.4	-3.5

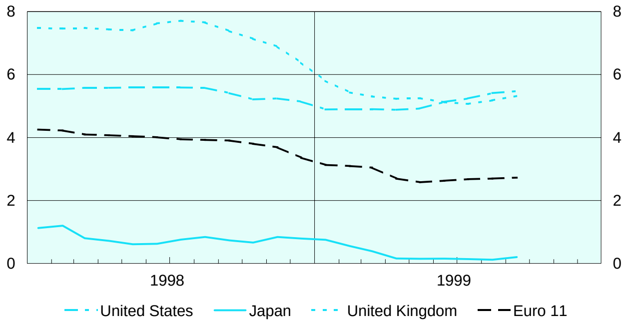
Sources: National statistics and ECB.

(1) Annualized percentage changes on preceding period. - (2) Includes change in stocks. - Contribution to growth in GDP in relation to preceding period, at annual rate. - (4) First eight months.

Figure 3

Short-term interest rates (1)

(monthly averages)



(1) For sources and definitions, see the notes to Statistical Table a5.

In Japan an exceptionally large increase of 8.1 per cent in GDP in the first quarter was followed by a modest 0.9 per cent in the second. The index of consumer confidence rose in the first quarter but remained almost unchanged thereafter, reflecting the adverse prospects for incomes and employment. The unemployment rate rose to almost 5 per cent in June. Nominal wages and salaries, which had begun to decline in 1998, continued to fall; in the first eight months of the year they were 1.4 per cent lower than in the same period of 1998. The strong appreciation of the yen caused producer prices to decline further, despite the rise in oil prices.

From February onwards money market operations by the Bank of Japan were aimed at keeping the call rate close to zero. The sterilization of foreign exchange intervention curbed the expansion of liquidity. Monetary base grew at twelve-month rates of around 6 per cent during the summer, compared with 9 per cent in 1998.

The expansionary fiscal impulse of the first quarter stemmed from the supplementary budget measures approved in December 1998. According to official estimates, the general government budget deficit, net of the surplus of the social security system, should equal 9.2 per cent of GDP in the 1999-2000 fiscal year.

In the euro area, where fiscal policies were neutral and monetary policy expansionary, economic activity was brisker than in the fourth quarter of last year. The depreciation of the euro and the rise in oil prices caused the average unit values of imports to increase substantially from the low levels recorded at the end of 1998. The surplus on the current account of the area's balance of payments decreased to 0.9 per cent of GDP in the first half of the year.

Economic activity in the United Kingdom slowed down sharply, although the results were better than forecast, a fall in output having been predicted. The annualized growth rate of 1.1 per cent in the first half (Table 1) was generated by increases of 5.1 and 4.4 per cent in private and public consumption respectively. Net exports reduced the growth rate by a good 2 percentage points, reflecting the significant real appreciation of sterling in recent years.

Demand derived a substantial boost from the expansionary monetary conditions. The Bank of England reduced base rate in several stages between October 1998 and June 1999, by a total of 2.5 percentage points to 5 per cent. In view of the pronounced responsiveness of the British economy to changes in interest rates, the easing of monetary conditions led to a sharp acceleration in private consumption and a large increase in house prices. According to the monetary authorities, inflation could be higher than the target rate of 2.5 per cent in the next two years. The Bank of England responded to the rapid rise in house prices by unexpectedly changing the direction of monetary policy; in September base rate was raised by 0.25 points to 5.25 per cent.

Economic activity and policies in the emerging countries of Asia and the economies in transition

The economy of South Korea staged a strong recovery without generating inflationary pressures (Table 2). Renewed inflows of foreign capital caused the currency to appreciate and interest rates to fall below the level prevailing before the crisis. Despite the rise in the nominal exchange rate, in September the real rate was still 15 per cent below the 1997 average. Progress was also achieved in Thailand and Malaysia, but the situation in Indonesia, where GDP declined further, remains a cause of concern.

Table 2

Economic indicators for selected countries in Asia and Central and Eastern Europe

	GDP (1)		Domestic demand (1) (2)		Net exports (3)		Current account balance *(billions of dollars)*		
	1998	1999 H1	1998	1999 H1	1998	1999 H1	1998	1998 H1	1999 H1
Asian emerging economies									
China	7.8	7.6	–	–	–	–	29.3	–	–
South Korea	–5.8	7.3	–18.6	10.3	12.2	–1.3	40.6	28.0 (4)	16.6 (4)
Taiwan	4.7	5.4	6.5	0.9	–1.7	4.5	3.5	2.7 (5)	7.5 (5)
India (6)	6.0	5.5 (7)	–	–	–	–	–6.9	–4.7	–2.1
Indonesia	–13.2	–4.1	–17.3	–8.1	4.8	4.0	4.0	1.0 (7)	1.4 (7)
Thailand	–10.0	2.1	–15.2	0.6	5.0	1.5	14.3	7.0	6.0
Philippines	–0.5	2.4	–2.0	2.9	1.7	–0.8	1.2	0.0 (7)	1.3 (7)
Malaysia	–7.5	1.4	–25.2	–8.6	19.4	9.2	9.6	....	....
Hong Kong	–5.1	–1.2	–8.9	–11.9	4.3	11.7	....	....	....
Singapore	0.2	3.6	–5.7	–1.8	5.4	5.2	17.7	7.4	8.9
Central and Eastern European countries									
Russia	–4.6	–0.7	–8.4	....	3.6	....	1.6	–5.2	9.0
Poland	4.8	2.3	7.2	....	–1.5	....	–6.8	–2.6 (4)	–6.8 (4)
Czech Republic	–2.3	–1.9	–3.2	–0.8	1.1	–1.0	–1.1	–0.2	0.0
Hungary	5.1	3.6	8.1	5.1	–3.1	–1.6	–2.3	–1.0 (4)	–1.2 (4)

Sources: National statistics and OECD.

(1) Percentage changes on same period of previous year. – (2) Includes change in stocks and statistical discrepancies. – (3) Contribution to GDP growth in relation to same period of previous year. – (4) First eight months. – (5) First three quarters. – (6) GDP at factor cost, financial year (April to March). – (7) First quarter.

In China growth slowed down, but GDP was still 7.6 per cent higher in the first half compared with the same period of last year. As in 1998, activity benefited from massive public investment in infrastructure, while consumption and private investment continued to rise at a moderate pace. Export growth resumed in March, fuelled by the recovery in other Asian countries; in the first seven months of the year, however, the trade surplus was less than half as large as in the same period of 1998. The deflationary tendencies that had emerged in early 1998 became more marked; between January and August of this year consumer prices were on average 1.7 per cent lower than a year earlier. Nominal wages in the private sector fell even more sharply. The financial situation of the industrial sector, which largely comprises public enterprises with low profitability, remains critical and is having an adverse effect on the banking sector, which is almost entirely publicly owned. The creation of public agencies to manage the bad debts of the state-owned commercial banks is a step towards the restructuring of the sector; the first such agency began operations in September.

In Russia GDP has been increasing since the final quarter of last year; the reversal of the trend can be attributed to a brisk recovery in industrial production for the domestic market, aided by the very large depreciation of the rouble against the dollar. Activity in the farm sector and in construction remains weak. Inflation continues to cause concern: it rose from a twelve-month rate of 97 per cent in January to one of 121 per cent in August. The budget measures for 1999 should make it possible to meet the objective of a primary surplus of 2 per cent of GDP agreed with the IMF in April. In exchange for the disbursement of the first instalment of $630 million on the loan of $4.5 billion scheduled for the next two years, the Duma approved a package of measures to tighten monetary conditions.

The Central and Eastern European countries suffered a large reduction in exports to Russia in the first half of this year; worst affected were Ukraine and the Baltic nations. Poland and Hungary recorded positive growth rates in the first half, despite the decline in exports; domestic demand was sustained mainly by private investment. Signs of recovery also emerged in the Czech Republic.

The international foreign exchange and financial markets

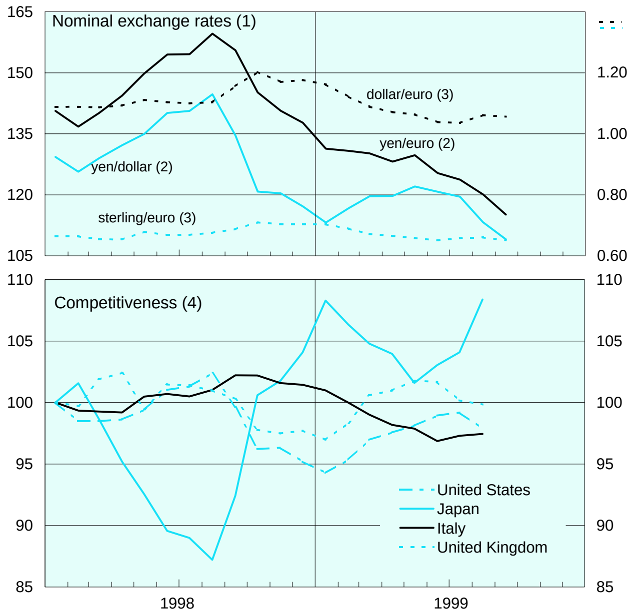
On 20 October the yen was trading at 106 to the dollar and 114 to the euro; it had appreciated against these currencies by 12 and 10 per cent respectively since beginning to strengthen in early June. The rise in the exchange rate was accompanied by a brisk recovery in share prices, but bond prices remained relatively stable against the background of pronounced increases in long-term interest rates in all the other leading markets.

The damaging effect of the appreciation of the yen on the competitiveness of exporting firms was mitigated by the far-reaching industrial restructuring that has been taking place in recent years, which has led to substantial reductions in unit costs. According to recent estimates from the Economic Planning Agency, the exchange rate level at which exporters can maintain their place in the market is now around ¥110 to the dollar.

The pronounced depreciation of the euro, which began in February as a result of the widening of the cyclical disparity between the United States and Europe, continued until the second half of July, when the currency's decline against the dollar since the beginning of January touched 14 per cent (Figure 4). Subsequent months saw a reversal of the trend, mainly reflecting the euro area's better growth prospects. On 20 October the depreciation since the beginning of the year amounted to 8 per cent.

Figure 4

Nominal exchange rates and indicators of competitiveness of leading currencies
(monthly averages)



(1) Units of the first currency per unit of the second. Up to 1 January 1999 the exchange rates of the ecu were used instead of those of the euro. - (2) Left-hand scale. - (3) Right-hand scale. - (4) Indices, January 1998=100, calculated using the method adopted by the Bank of Italy with reference to 24 trading partners on the basis of the producer prices of manufactures. A rise corresponds to a loss of competitiveness.

In the industrial countries bond yields rose from the early part of the year onwards. On 20 October long-term interest rates were around 1.6 percentage points higher in the United Kingdom and 1.5 points higher in the United States, at 5.9 and 6.2 per cent respectively (Figure 5). The increase spread to the euro area, where 10-year yields rose by 1.6 points to 5.6 per cent; most of the movement occurred in June and July, when expectations of an acceleration in economic activity and a possible tightening of monetary policy by the Eurosystem hardened. In Japan long-term rates rose significantly between November and February as a result of the public sector's large borrowing requirement. They fell back later in the year, helped by inflows of foreign capital, and are now around 1.8 per cent.

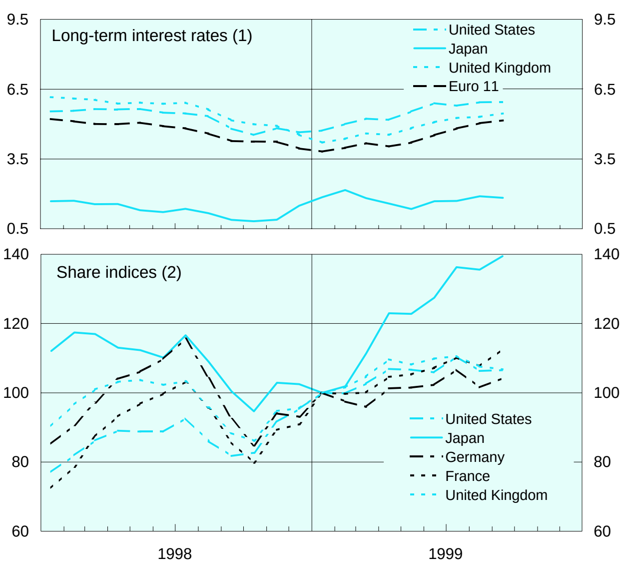
The differentials between 10-year swap rates and rates on government securities of the same maturity have increased by 0.2 percentage points in the United

States and by 0.3 points in the United Kingdom since the beginning of March and are now only marginally less than the record highs of 1 and 1.2 points respectively recorded last autumn after the Russian crisis. The widening appears to be due not to an increase in the credit risk of particular counterparties but to specific factors, such as a reduction in the supply of government securities in connection with the marked improvement in budget balances and an increase in private sector credit demand triggered by expectations of a further rise in long-term rates and fears of liquidity problems at the time of the date change at the end of the year.

Figure 5

Long-term interest rates and share indices in the main industrial countries

(monthly averages)



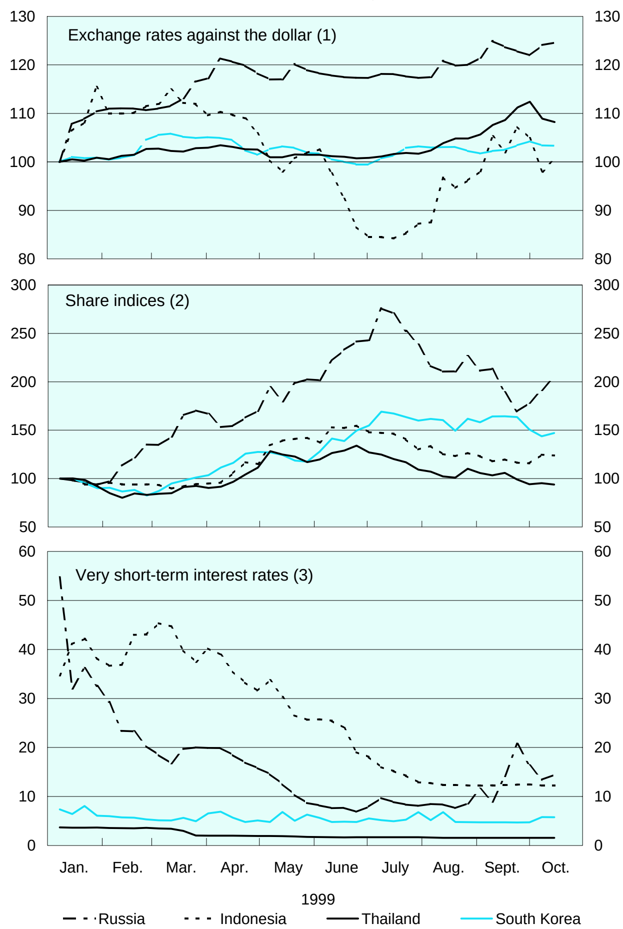
Sources: National statistics and Reuters.
(1) Yields on 10-year government bonds. - (2) Indices, January 1999=100.

After rising in the first half of the year, share prices fell back in almost all industrial countries from July onwards, affected mainly by fears of a possible rekindling of inflation in the United States and a tightening of monetary conditions (Figure 5). Between mid-July and 20 October share prices fell by 9 per cent in Italy, 8.5 per cent in the United States and the United Kingdom, 5.6 per cent in Canada and 2 per cent in France, whereas in Germany they rose by 3 per cent. To many observers, the stock markets in the United States and other important industrial countries appear to be overvalued in the light of economic growth prospects, the level of real interest rates and the riskiness of equity investment. Japan differed from the other major economies in that share prices rose by 39 per cent, with all index components showing a gain, whereas in 1998 the index had fallen.

Figure 6

Exchange rates, share indices and interest rates in selected Asian countries and Russia

(average weekly data)



Sources: Datastream and Reuters.
(1) Units of national currency per dollar; indices, first week of January 1999=100. - (2) Indices, first week of January 1999=100. - (3) Percentages.

The terms for obtaining international credit improved for the Asian economies during the year. The yield differentials between dollar bonds issued by countries in the region and equivalent US Treasury securities narrowed by 7 percentage points in

Malaysia, 4 in Indonesia, 3 in South Korea and 1.5 in Thailand. They nevertheless remained higher than before the 1997 crisis, at about 5 percentage points in Indonesia and less than 3 in the other three countries.

The easing of tensions in the foreign exchange and financial markets facilitated a substantial decline in very short-term interest rates. By comparison with the levels obtaining at the beginning of the year, overnight rates on 20 October were 24 percentage points lower in Indonesia, around 2 points lower in South Korea and 1 point lower in Thailand, at 12.6, 4.7 and 1.5 per cent respectively (Figure 6).

The currencies of these countries remained stable against the dollar between January and June. In July they began to depreciate in connection with the monetary tightening by the Federal Reserve; between the beginning of that month and 20 October the fall in relation to the dollar was 8 per cent in Indonesia, 6 per cent in Thailand and the Philippines and almost 4 per cent in South Korea. As signalled by futures prices, some uncertainty also arose as to the resilience of the exchange rate of the Chinese currency against the dollar, despite the central bank's large foreign exchange reserves. The Chinese monetary authorities recently undertook to defend the current exchange rate, which has been made more sustainable by the recovery in exports and the depreciation of the yuan in nominal effective terms owing to the appreciation of the yen.

The improvement in economic conditions and the decline in interest rates in Asia fostered a steep rise in share prices, which in South Korea exceeding the pre-crisis level in dollar terms. The rise in the stock market indices, expressed in national currencies, between the beginning of the year and 20 October was 53 per cent in South Korea, 41 per cent in Indonesia and between 26 and 30 per cent in China, Hong Kong and Malaysia.

Very short-term interest rates in Russia had returned to their pre-crisis levels by the end of last year and have declined further in 1999; in recent weeks they have fluctuated between 10 and 20 per cent. The rouble depreciated by a further 17 per cent against the dollar between January and March, but it has remained stable since the beginning of April, at just under 26 roubles to the dollar, compared with 7 before the crisis. Share prices, which had already staged a strong recovery in the fourth quarter of last year, rose even more sharply in the first part of 1999. Expressed in national currency, they were around 175 per cent higher by mid-July than at the beginning of January, aided by the beneficial effects of devaluation on the profits of raw-materials exporters, the reaching of agreements with the IMF and, from March onwards, the large increase in oil prices. Share prices subsequently fell by around 25 per cent, hit by the emergence of serious financial scandals allegedly involving the country's institutions and by the rise in US interest rates.

Table 3

Economic indicators for the main Latin American countries

(percentages)

	GDP (1)		Consumer prices (1)		Public sector balance (2)		Current account balance (2)		Real exchange rate 1990=100 (3)		Total foreign debt (2)	
	1998	1999 H1	1998	1999 H1	1998	1999 (4)	1998	1999 (4)	1998	1999	1998	1999 (4)
Argentina	3,9	–4,0	0,9	–0,6	–1,2	–1,9	–4,9	–4,0	117,5	125,4	45,9	51,6
Brazil	0,1	–0,4	3,8	3,2	–8,0	–9,0	–4,3	–3,8	97,0	76,8	30,0	46,5
Chile	3,4	–2,9	5,1	3,8	–0,8	–2,2	–6,2	–2,6	121,6	125,7	47,0	52,0
Colombia	0,6	–6,1	16,7	13,2	–3,3	–5,0	–6,4	–2,0	116,9	103,0	36,0	45,0
Ecuador	0,4	–4,9	36,1	50,0	–5,7	–4,0	–10,8	3,4	140,7	112,1	84,0	130,0
Mexico	4,8	2,5	15,9	18,2	–1,2	–1,2	–3,8	–2,3	99,2	118,4	38,3	36,4
Venezuela	–0,7	–9,5	35,8	26,4	–4,5	–3,9	–1,9	4,8	161,6	171,2	34,0	33,0

Sources: IMF, national bulletins, Consensus Economics and J.P. Morgan.

(1) Percentage changes on same period of previous year. – (2) As a percentage of GDP. – (3) December average for 1998, September average for 1999. A rise corresponds to a loss of competitiveness. – (4) IMF forecasts; where lacking, Consensus Forecasts and J.P. Morgan.

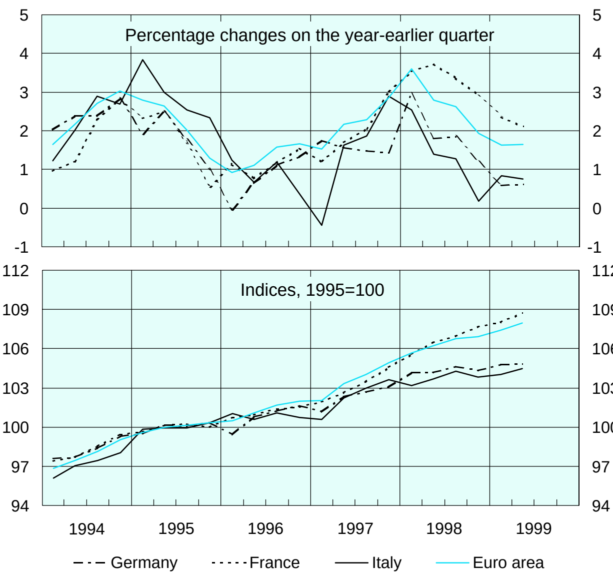
ECONOMIC DEVELOPMENTS IN ITALY AND THE EURO AREA

Economic activity slowed down in the first half of 1999, more sharply in Italy than in the euro area as a whole. At constant prices, Italian GDP grew by only 0.2 per cent with respect to the second half of 1998 and was up by 0.8 per cent on the corresponding period of the previous year, compared with figures of respectively 0.7 and 1.6 per cent for the euro area as a whole. The growth gap between Italy and other euro-area countries consequently widened again, after nearly closing in the second half of 1997 (Figure 7). The continuation of the economic expansion in Spain (1.5 per cent) and France (1 per cent) was accompanied by modest growth in Germany (0.3 per cent; Table 4).

Figure 7

GDP in Italy and the euro area

(seasonally adjusted quarterly data at constant prices)



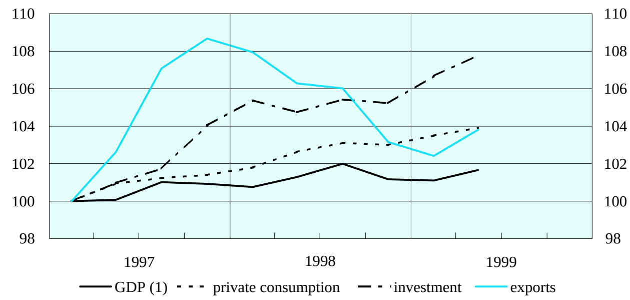
Sources: Eurostat and national statistics.

Domestic demand sustained the increase in output in the first half of 1999, both in Italy and in the euro area as a whole. Investment and household consumption contributed in equal measure. In Italy, gross fixed investment was especially lively (Figure 8), mainly owing to the recovery in construction, especially public works and residential building renovation. National accounts data show further stockbuilding; as in 1997 and 1998, inventory expansion appears to have made a large contribution of about half a percentage point to the growth in GDP compared with the second half of 1998.

Figure 8

Main components of demand in Italy

(at constant prices; indices, 1997-Q1 = 100)



Source: Based on Istat data.
(1) Net of the change in stocks.

The demand for consumer goods continues to be checked in Italy by households' caution in the face of continuing uncertainty and sluggish growth in disposable income, which picked up only recently. Purchases of consumer goods rose by 0.6 per cent through June, whereas in the euro area as a whole they rose by 1 per cent.

The deterioration in net exports subtracted 1.2 percentage points from the increase in Italian GDP. Net exports also had a negative impact on GDP growth in the other main countries of the area, albeit to a much more limited extent (0.4 percentage points in Germany and Spain, 0.2 points in France). The result in Italy was primarily due to a further contraction in exports, which nonetheless rose in the second quarter for the first time since the end of 1997 (Table 5). In addition, imports continued to expand, indicating high penetration of the domestic market by foreign products, especially capital goods and transport equipment.

Table 4

GDP and some component items in the leading euro-area countries
(seasonally adjusted data at constant prices; percentage changes)

	On year-earlier period						On preceding period				
	1998			1999			1998		1999		
	Q3	Q4	Year	Q1	Q2	H1	Q3	Q4	Q1	Q2	H1
						GDP					
Germany	1.8	1.2	2.2	0.6	0.6	0.6	0.4	−0.3	0.4	. .	0.3
France	3.4	2.9	3.4	2.4	2.1	2.2	0.5	0.6	0.4	0.6	1.0
Italy	1.3	0.2	1.3	0.8	0.8	0.8	0.6	−0.4	0.2	0.4	0.2
Spain	4.3	3.2	4.0	3.2	3.6	3.4	1.2	0.6	0.6	1.1	1.5
Euro area	2.6	1.9	2.7	1.6	1.6	1.6	0.5	0.1	0.4	0.5	0.7
						Household consumption					
Germany	2.8	2.5	2.1	1.9	1.5	1.7	0.9	0.4	0.7	−0.5	0.7
France	4.1	3.2	3.6	2.7	1.9	2.3	0.6	0.6	0.2	0.5	0.7
Italy	1.8	1.6	1.7	1.7	1.2	1.5	0.5	−0.1	0.5	0.4	0.6
Spain	4.3	4.9	4.1	5.0	4.4	4.7	1.0	1.5	0.5	1.4	1.9
Euro area	3.4	3.0	2.9	2.6	2.1	2.4	0.8	0.5	0.6	0.3	1.0
						Investment					
Germany	1.0	−0.3	0.9	1.4	4.0	2.7	2.6	−1.1	3.2	−0.6	2.3
France	6.6	6.4	6.1	7.1	6.7	6.9	1.6	1.5	2.1	1.3	3.5
Italy	3.6	1.1	3.5	1.2	2.9	2.1	0.6	−0.2	1.4	1.0	1.8
Spain	8.3	10.3	9.2	7.9	11.6	9.7	3.3	2.9	1.7	3.2	4.8
Euro area	4.5	3.3	4.2	4.1	5.7	4.9	2.2	0.2	2.5	0.6	3.0
						Exports					
Germany	4.8	0.6	6.4	−0.6	. .	−0.3	. .	−3.0	0.9	2.1	0.4
France	6.1	1.8	6.9	. .	2.0	1.0	1.4	−1.1	−0.9	2.6	−0.2
Italy	−1.0	−5.1	1.2	−5.1	−2.3	−3.7	−0.2	−2.7	−0.7	1.4	−1.4
Spain	4.6	2.5	7.1	5.0	5.2	5.1	. .	0.7	2.9	1.6	4.1
Euro area	4.4	1.0	6.3	−0.3	0.6	0.1	0.1	−1.4	−0.1	2.2	0.3
						Imports					
Germany	7.4	5.3	8.1	3.2	3.7	3.5	0.6	. .	1.0	2.1	2.0
France	7.9	5.5	9.4	1.7	2.5	2.1	0.6	0.9	−1.0	2.0	0.5
Italy	3.4	−0.2	6.1	. .	3.2	1.6	−1.2	0.8	2.3	1.4	3.4
Spain	11.7	9.8	11.1	10.4	12.4	11.5	3.3	2.2	2.3	4.1	5.5
Euro area	7.5	4.5	8.5	2.3	3.4	2.8	0.6	0.2	0.5	2.1	1.6

Source: Based on national statistics.

In the first eight months of the year the euro area’s external current account surplus contracted appreciably with respect to the same period of 1998, falling to 36.4 billion or around 0.9 per cent of GDP (Table 6). In the same period Italy’s surplus fell from 2.1 to 1.4 per cent of GDP. As in the other euro-area countries, the deterioration in the balance on goods and services was only offset in part by the reduction in the deficit on income and public transfers.

Table 5

Resources and uses of income

(seasonally adjusted data at constant prices; percentage changes on preceding period except where indicated otherwise)

	% of GDP in 1998	1998				1999			
		Q3	Q4	H2	Year	Q1	Q2	H1	H1 (1)
Resources									
GDP	–	0.6	−0.4	0.6	1.3	0.2	0.4	0.2	–
Imports	24.4	−1.2	0.8	−1.7	6.1	2.3	1.4	3.4	−0.8
Goods	21.0	0.4	0.2	−0.3	6.8	1.5	1.8	2.6	−0.5
Services	3.4	−10.9	4.9	−10.0	2.0	6.9	−1.3	8.7	−0.3
Total resources	–	0.2	−0.2	0.2	2.2	0.6	0.6	0.8	1.0
Uses									
Gross fixed investment	18.9	0.6	−0.2	0.2	3.5	1.4	1.0	1.8	0.3
Construction	8.0	−0.3	0.9	−0.5	0.1	1.0	2.0	2.5	0.2
Machinery, equipment and sundry products	8.8	0.8	−0.6	0.4	5.1	1.2	−0.2	0.8	0.1
Transport equipment	2.0	3.9	−2.5	2.6	10.8	3.5	2.9	3.7	0.1
Household consumption	60.2	0.5	−0.1	0.8	1.7	0.5	0.4	0.6	0.4
Non-durables	27.0	−0.2	−0.1	0.1	1.1	0.6	0.1	0.6	0.1
Durables	7.1	2.4	−1.3	2.2	3.4	3.2	0.5	2.8	0.2
Services	26.2	0.6	0.3	1.2	1.9	−0.3	0.6	0.1	. .
Other domestic uses (2)	19.5	−0.1	2.8	1.5	4.1	1.8	. .	3.1	0.6
Total domestic demand	98.7	0.4	0.4	0.8	2.5	0.9	0.4	1.4	1.3
Exports	25.7	−0.2	−2.7	−2.4	1.2	−0.7	1.4	−1.4	−0.4
Goods	22.0	0.3	−3.1	−1.5	1.7	−1.2	2.8	−1.4	−0.3
Services	3.7	−3.4	−0.5	−7.5	−2.0	2.2	−7.2	−1.8	−0.1

Source: Based on Istat data.

(1) Contribution to the growth in GDP. – (2) Includes public consumption, change in stocks and valuables and statistical discrepancies.

In the first half of 1999 the Italian labour market confirmed the signs of improvement that had appeared in 1998, with employment in July up by 1.2 per cent (256,000 workers) compared with a year earlier. After the upward revision of the results for the last few years following the introduction of new survey methods, the increase in employment in Italy is now in line with that for the euro area as a whole, estimated at around 1 percentage point. Driven by services and construction, the growth in employment in Italy was limited to the Centre and North and only regarded salaried employment, particularly that of women and persons on fixed-term contracts. With the possibility of offering more flexible contracts, businesses are now better disposed to respond to even short-term increases in demand by employing extra workers.

Nonetheless, some two-fifths of the total increase in salaried employment is attributable to the rise in the number of workers on permanent full-time contracts (131,000). While the participation rate edged up from 59.1 to 59.6 per cent (compared with 65 per cent for the euro area as a whole), the unemployment rate declined from 11.4 to 11.1 per cent; the gap between unemployment in the South (22 per cent) and the Centre and North (5.9 per cent) widened.

After reaching a low in the early months of the year, euro-area consumer price inflation picked up owing to the surge in the dollar prices of oil and the depreciation of the euro. The twelve-month rise in the harmonized index increased from 0.8 per cent in February to 1.2 per cent in September for the euro

Table 6

Euro-area balance of payments
(billions of euros; for 1998, billions of ecus)

	1998				1999				
	August	Jan.-Aug.	Jan.-Dec.	H1 % of GDP	Q1	Q2	August	Jan.-Aug.	H1 % of GDP
Current account	**4.3**	**45.5**	**60.3**	**1.1**	**11.9**	**14.8**	**1.5**	**36.4**	**0.9**
Goods	9.0	79.8	118.8	1.9	21.5	24.8	7.0	66.7	1.5
Services	0.1	1.1	–0.9	0.0	–3.2	0.2	–1.1	–3.4	0.1
Income	0.2	–8.0	–11.9	0.2	–0.8	–0.9	0.4	–2.9	0.1
Transfers	–4.9	–27.4	–45.8	0.7	–5.5	–9.3	–4.8	–24.1	0.5
Capital account	**1.5**	**8.5**	**12.7**	**0.2**	**2.8**	**3.4**	**0.6**	**7.5**	**0.2**
Financial account	**4.3**	**4.3**	**–69.1**	**0.6**	**–33.1**	**–28.3**	**32.9**	**–32.0**	**2.0**
Direct investment	–7.6	–39.6	–102.6	0.9	–15.6	–52.6	–5.9	–79.7	2.3
Portfolio investment	8.0	–32.9	–85.3	1.9	–54.7	–7.0	1.8	–56.9	2.0
Equity securities	–4.0	–11.8	–0.4	0.5	–27.1	–9.6	–7.3	–39.7	1.2
Debt securities	12.0	–21.2	–84.9	1.4	–27.6	2.6	9.0	–17.2	0.8
Derivatives	2.2	–3.2	–8.2	0.1	–1.4	–0.6	1.5	1.3	0.1
Other investment	3.7	82.7	118.5	2.3	33.0	25.3	34.9	91.5	1.9
Change in official reserves	–2.0	–2.7	8.5	0.0	5.5	6.6	0.5	11.9	0.4
Errors and omissions	**–10.1**	**–58.2**	**–3.8**	**0.7**	**18.4**	**10.1**	**–35.0**	**–11.9**	**0.9**

Source: ECB.

area as a whole and from 1.4 to 1.9 per cent for Italy. The rises in the components most closely tied to underlying inflation remained stable at around 1 per cent for the area and 2 per cent for Italy. The inflation gap between Italy and the other main European countries reflects the different trends in unit labour costs, particularly as regards productivity, and larger increases in the prices of some services less exposed to competition.

In Italy and the rest of the euro area, the effects of the moderate recovery in activity during the first half can be seen in the acceleration in the producer prices of non-energy intermediate goods, which are more sensitive to fluctuations in demand.

Although expected inflation is rising over all time horizons, it remains below 2 per cent both in the euro area as a whole and in Italy.

The trend of Italy’s public finances in the first nine months of the year was consistent with the latest official forecasts for general government net borrowing (2.4 per cent of GDP, down from 2.7 per cent in 1998). The primary surplus is forecast to contract from 5.2 per cent of GDP in 1998 to 4.7 per cent this year; the Economic and Financial Planning Document for the years 1999 to 2001 had indicated it would be unchanged.

The figures for tax receipts and the state sector borrowing requirement offer positive signs. The behaviour of the general government borrowing requirement appears less satisfactory, in view of local authorities’ increased borrowing in the market, which may be partly due to a larger-than-forecast rise in spending.

In the euro area as a whole, the ratio of general government net borrowing to GDP is likely to be in line with the objective of the stability and convergence programmes submitted (1.8 per cent, compared with 2.1 per cent in 1998). The reduction in the deficit would reflect the fall in interest payments.

Production, demand and the balance of payments

Economic activity

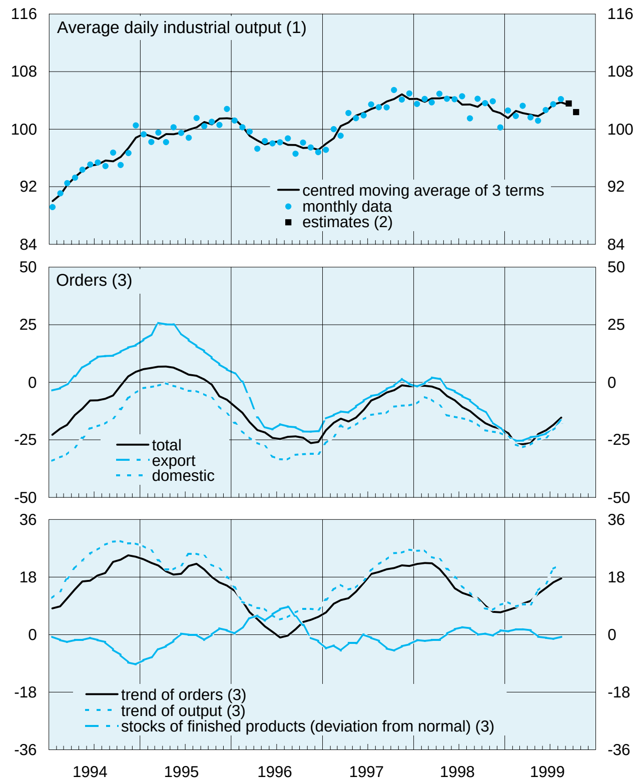
In the first half of this year economic activity in the euro area showed renewed growth, after basically stalling in the fourth quarter of last year. The trend was common to all the main countries except Germany, where signs of recovery in the first quarter subsequently dimmed. In Italy, after declining in the fourth quarter of 1998, GDP showed a moderate recovery, which was more limited than in the area as a whole.

The largest contribution to Italian GDP growth was made by the services sector, where value added at constant prices rose by 0.6 per cent in the first half compared with the preceding six months. An additional contribution came from the 2.5 per cent increase in the value added of the construction sector, where activity had begun to improve rapidly in the fourth quarter of last year. By contrast, GDP growth was slowed by the weakness of industry excluding construction, whose value added was 1.7 per cent lower than in the second half of 1998; the decline was concentrated in the first quarter (the quarter-on-quarter drop of 1.1 per cent followed one of 1.6 per cent) and was moderated by the rise of 0.4 per cent recorded in the second.

Industrial production extended the phase of stagnation that began at the start of last year: the average level of the unadjusted index was 1 per cent lower in the first eight months of 1999 than in the same period of 1998. During the summer the ISAE cyclical indicators pointed to a recovery in manufacturing that has been confirmed by the recent performance of output (Figure 9). According to the Bank of Italy's survey of manufacturing firms most companies expect orders to rise in the months ahead, and signs of optimism are also to be seen among export-oriented firms.

Figure 9

Industrial output, orders and stocks



Sources: Based on Istat and ISAE data.

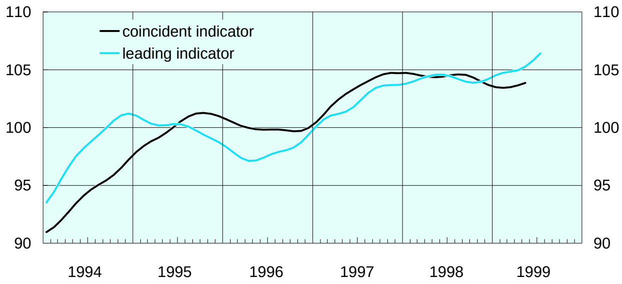
(1) Index, 1995=100. Data adjusted for the different number of working days in the month and seasonally adjusted. - (2) Based on electricity consumption and ISAE indicators. - (3) Moving averages for the three months ending in the reference month of the percentage difference between positive replies ("high, "increasing") and negative replies ("low, "decreasing") to ISAE surveys, not weighted by firm size. The trend figures refer to the responses for 3-4 months ahead. Seasonally adjusted except for stocks of finished products.

The composite leading indicator, prepared by the Bank of Italy and the ISAE, which has been rising since the final months of last year, showed an acceleration at the beginning of the summer, suggesting that activity could strengthen in the second half of 1999 (Figure 10). The indicator leads the business cycle by an average of five months.

Figure 10

Italian business cycle indicators

(indices, 1995 = 100)



Sources: Based on Istat and Bank of Italy data.

Consumption and disposable income

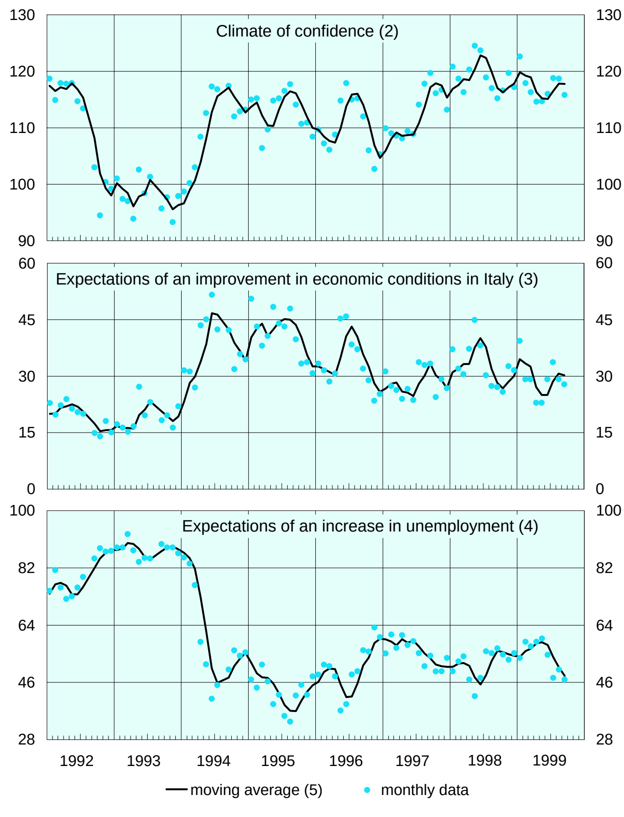
In the first half of 1999 households' domestic consumption at constant prices grew by 1 per cent in the euro area; the increase was smaller in Italy, amounting to 0.6 per cent (Table 4). Signs of a slowdown in households' spending with respect to the second half of 1998 emerged in all the main countries. However, developments during the period were very different (Table 5), with a sharper deceleration in Germany, where confidence deteriorated despite the stimulus of an improvement in households' disposable income.

In Italy, the sluggishness of the demand for consumer goods continues to reflect mainly two factors.

The growth in households' disposable income in real terms has been modest in the past two years. Only recently does it appear to have picked up. The increase at constant prices in the first half of this year on the same period of 1998 can be put at almost 2 per cent points, after allowing for the smaller loss of purchasing power of net financial assets due to the reduction in inflation. The result reflects a further fall in net interest income, largely attributable to the intensification of the shift of portfolios towards shares and investment fund units, whose capital gains are excluded from the accounting definition of disposable income. Households' spending capacity was sustained primarily by the acceleration in earnings from salaried employment, which rose by 1.3 per cent at constant prices before direct taxes and employee social security contributions, almost all of it due to the increase of 1.2 per cent in the number of standard labour units. The growth in income from self-employment was smaller, amounting to an estimated 0.5 per cent before tax and social security contributions in conjunction with a slight rise of 0.3 per cent in the number of standard labour units.

Figure 11

Climate of confidence among consumers and their expectations with regard to the Italian economy and unemployment (1)



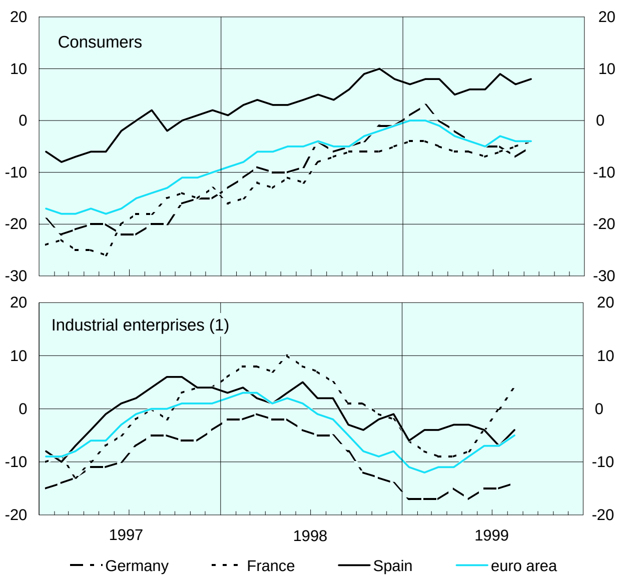
Source: Based on ISAE data.

(1) Until 1994 no survey was conducted in August; the data for that month were calculated as simple averages of adjacent data. Since January 1995 interviews have been conducted by telephone instead of on site and the interviewee is no longer necessarily the head of the household but any adult member who contributes to its income. Since January 1998 the sample has referred to consumers instead of households. - (2) Index, 1980=100. - (3) Percentage of those interviewed who expected an improvement in economic conditions in Italy in the subsequent 12 months. - (4) Percentage of those interviewed who expected an increase in unemployment in the subsequent 12 months. - (5) For the three months ending in the reference month.

The demand for consumer goods was checked by the persistence of uncertainty among households regarding the economic outlook. This is confirmed by the notable fluctuations in the consumer confidence indicator (Figure 11), which were more accentuated than those in the corresponding indicators in the other main euro-area countries (Figure 12). In Italy, the consumer optimism that followed the end of the war in Kosovo in May has weakened in more recent months, essentially owing to the deterioration in expectations regarding economic developments in Italy.

Figure 12

Climate of confidence among consumers and enterprises in some euro-area countries



Source: European Commission.

(1) Calculated by the European Commission as the average of the seasonally adjusted balances of the responses to questions regarding assessments of demand, expectations for output and stocks of finished products.

The most dynamic component of households' spending in Italy in the first half of the year was purchases of durable goods; the increase of 2.8 per cent on the previous six months was driven by purchases of goods other than motor vehicles. New car registrations and existing order books suggest that the number of new car purchases for the year as a whole could remain unchanged, in line with industry forecasts.

Investment and stocks

Capital spending in the euro area has continued to lag behind the fast pace of that in the United States. In the first half of 1999 it increased by 3 per cent at constant prices with respect to the preceding six months. The expansion was particularly rapid in Spain and France (4.8 and 3.5 per cent respectively) and more moderate in Germany (2.3 per cent; Table 4).

The growth in gross fixed investment in Italy recovered to the level recorded before the spring of 1998, but at 1.8 per cent it remained much lower than that for the euro area as a whole, confirming the gap that appeared in 1997. In the first six months of this year it was spurred primarily by investment in construction, which had turned upwards in the last quarter of 1998 and grew by 2.5 per cent (Table 5). A contributory factor was the consolidation of the recovery in investment in public works, fueled partly by the approaching deadlines relating to the Jubilee Year, and in residential building activity, supported by the tax incentives in place. Cresme, a building industry research centre, estimates that the renovation component will grow by around 8 per cent at constant prices over the whole year.

Investment in equipment, machinery, intangible assets and transport equipment grew by 1.4 per cent in the first half. Purchases of transport equipment on the one hand and those of equipment, machinery and intangibles on the other contributed in equal measure.

Given firms' good liquidity conditions and the full unfolding of the effects of the lower cost of money, the recovery in investment in Italy reflected the gradual improvement in business opinion concerning the outlook for demand. According to the ISAE cyclical indicators, manufacturing companies' expectations for orders six months ahead have been improving since the end of last year (Figure 9); after falling at the start of 1999, orders rebounded and in August reached the highest level since the previous summer on the strength of the domestic component and, more recently, export demand as well. In these circumstances, the recent shrinking of idle plant capacity suggests the likelihood of a step-up in capital spending in the coming months.

According to national accounts data, the change in stocks and valuables, which includes the statistical discrepancies between demand and supply estimates, contributed around 0.5 percentage points to the slight growth in GDP in the first half of the year. According to the ISAE survey, in recent months stocks of finished products have remained near the levels that companies consider to be normal.

Exports and imports

Net exports slowed down GDP growth in the first half of the year, in all the main euro-area countries and most markedly in Italy, where their contribution to the change in output was negative by around 1.2 percentage points.

In the first half, Italian exports of goods and services at constant prices were down by 1.4 per cent from the preceding six months, in contrast with the slight gain of 0.3 per cent for the euro area as a whole. The gap was particularly large with Spain, which recorded export growth of 4.1 per cent, and was smaller with Germany, where exports rose by 0.4 per cent. In France exports declined by 0.2 per cent.

After falling continuously since the start of 1998, Italian exports picked up by 1.4 per cent between the first and second quarters of this year but still remained below the very high levels reached at the end of 1997. The recovery reflected the improvement in international economic activity, particularly in Europe, and the recent gain in price competitiveness deriving primarily from the depreciation of the euro. The growth in Italian export outlet markets is estimated to have doubled between the first and second quarters, rising to 8 per cent on an annual basis. Italian export competitiveness, measured on the basis of the prices of manufactures, returned to the levels recorded before the Asian crisis, improving by 4.7 per cent in August 1999 over September 1998, which was the low point since 1992; however, the gain was far smaller vis-à-vis the other EU countries (1.7 percent) and almost negligible in relation to those of the euro area (0.6 per cent).

Italian imports of goods and services rose by 3.4 per cent in the first half of 1999 from the previous six months. The increase, fueled by the recovery in domestic demand, particularly for capital goods and consumer durables, was larger than that recorded in the euro area as a whole (1.6 per cent). The rise in imports was very sharp in Spain (5.5 per cent) and more moderate in Germany and France (2.0 and 0.5 per cent, respectively).

The balance of payments

According to provisional data, in the first eight months of 1999 the euro area's external current account surplus amounted to €36.4 billion (equal to around 0.9 per cent of GDP), a decrease of more than €9 billion on a year earlier (Table 6). The result principally reflects the weakness of world trade, which slowed down merchandise exports especially in the early part of the year. In the first eight months Italy's current account surplus fell to 19.2 trillion lire (e9.9 billion, equal to 1.4 per cent of GDP; Table 7).

In the same period Italy's trade surplus on a *cif-fob* basis was down sharply from the same period of 1998, falling to 21.6 trillion lire (€11.2 billion). The deterioration reflected a 4.9 per cent decline in the value of exports against no change in that of imports. According to available data on the first seven months, the fall in the value of exports was largely due to a contraction in volume (down by 4.5 per cent from a year earlier), which involved nearly all the main branches of manufacturing; imports at constant prices increased by 3.8 per cent, while their average unit values decreased by 4.8 per cent.

Despite the recovery in the second quarter, Italian exports were down sharply (by 9.8 per cent) to non-EU countries and more moderately (by 1.0 per cent) to the rest of the EU in the first eight months compared with a year earlier (Table 8 shows the geographical breakdown for first seven months). In the first seven months the result for exports to the EU was mainly due to the decrease in average unit values (-1.4 per cent), that for exports to the rest of the world to the decline in volume (-9.0 per cent).

Table 7

Balance of payments (1)
(balances in billions of lire)

	1998				1999					
	Q1 lire	Q2 lire	Jan.-Aug. lire	Year lire	Q1		Q2		Jan.-Aug.	
					lire	euros	lire	euros	lire	euros
Current account	**170**	**13,029**	**28,998**	**34,905**	**1,070**	**553**	**6,505**	**3,360**	**19,177**	**9,905**
Goods	9,968	17,305	45,191	61,912	6,876	3,551	9,466	4,889	29,576	15,275
Exports	103,003	111,897	282,570	420,764	94,697	48,907	106,669	55,090	268,562	138,701
Imports	93,035	94,592	237,379	358,852	87,821	45,356	97,203	50,201	238,986	123,426
Services	–835	3,976	6,983	7,330	–2,214	–1,143	3,011	1,555	4,035	2,084
Income	–5,608	–5,686	–14,914	–21,381	–3,445	–1,779	–3,451	–1,782	–10,461	–5,402
Transfers	–3,355	–2,566	–8,262	–12,956	–147	–76	–2,521	–1,302	–3,973	–2,052
public	*–3,104*	*–2,366*	*–7,513*	*–11,083*	*167*	*86*	–	–	–	–
Capital account	**3,023**	**11**	**3,448**	**4,165**	**1,014**	**524**	**1,154**	**596**	**3,489**	**1,802**
Intangible assets	–62	–51	–168	–300	–46	–24	–	–	–	–
Transfers	3,085	62	3,616	4,465	1,060	548	–	–	–	–
public	*3,112*	*90*	*3,700*	*4,557*	*1,121*	*579*	–	–	–	–
Financial accounts	**14,085**	**96**	**2,192**	**5,961**	**–1,347**	**–696**	**–11,764**	**–6,075**	**–28,125**	**–14,526**
Direct investments	–4,112	–7,384	–15,193	–17,198	–323	–167	8,403	4,340	9,046	4,672
Portfolio investments	–13,263	26,544	–3,601	4,350	–5,609	–2,897	–23,453	–12,112	–41,072	–21,212
Derivates	227	176	453	348	1,028	531	1,435	741	–79	–41
Other investment	29,766	–32,658	–216	–18,516	–13,269	–6,853	2,110	1,090	–10,814	–5,585
Change in official reserves	1,467	13,418	20,749	36,977	16,826	8,690	–259	–134	14,794	7,640
Errors and omissions	**–17,278**	**–13,136**	**–34,638**	**–45,031**	**–737**	**–381**	**4,105**	**2,119**	**5,459**	**2,819**

(1) The items of the balance of payments are calculated using the new methodology adopted by Eurostat and the ECB in accordance with the fifth edition of the IMF Balance of Payments Manual. The time series were reconstructed and may be revised. For June, July and August 1999, provisional data.

On the basis of available details, which refer to the first five months of the year, the contraction in Italy's overall surplus on services in January to August 1999 from a year earlier was attributable to the transport and construction sectors; the improvement in the income account stemmed from an increase in interest receipts on foreign securities. The deficit on current transfers fell by 4.3 trillion lire (€2.2 billion) in the first eight months from a year earlier.

In the same period the balance on the financial account for the euro area as a whole was in deficit by €37.0 billion (about 0.8 per cent of GDP), compared with a surplus of €4.3 billion (0.1 per cent of GDP) a year earlier.

Table 8

Merchandise trade *cif-fob* by country and area in the period January-July
(billions of lire and millions of euros; percentage changes on year-earlier period)

	Exports				Imports				Balance		
	1999		changes	% composition 1999	1999		changes	% composition 1999	lire		euros
	lire	euros			lire	euros			1998	1999	1999
Industrial countries	**181,382**	**93,676**	**–1.6**	**75.0**	**166,524**	**86,002**	**–0.6**	**74.4**	**16,830**	**14,858**	**7,674**
EU countries	141,482	73,069	–1.9	58.5	137,336	70,928	0.3	61.4	7,240	4,146	2,141
euro area	*114,195*	*58,977*	*–1.2*	*47.2*	*116,733*	*60,288*	*0.4*	*52.2*	*–634*	*–2,538*	*–1,311*
France	*32,202*	*16,631*	*–2.2*	*13.3*	*28,783*	*14,865*	*–2.6*	*12.9*	*3,390*	*3,419*	*1,766*
Germany	*40,880*	*21,113*	*–1.9*	*16.9*	*43,017*	*22,216*	*3.5*	*19.2*	*112*	*–2,137*	*–1,104*
Spain	*15,646*	*8,080*	*6.4*	*6.5*	*10,131*	*5,232*	*–2.9*	*4.5*	*4,267*	*5,515*	*2,848*
United Kingdom	*17,530*	*9,053*	*–6.5*	*7.3*	*13,130*	*6,781*	*–9.2*	*5.9*	*4,293*	*4,400*	*2,272*
Other industrial countries (1)	39,900	20,607	–0.8	16.5	29,188	15,074	–4.7	13.0	9,591	10,712	5,532
Japan	*3,576*	*1,847*	*–16.0*	*1.5*	*5,932*	*3,064*	*17.4*	*2.7*	*–794*	*–2,356*	*–1,217*
United States	*22,666*	*11,706*	*4.9*	*9.4*	*10,886*	*5,622*	*–8.9*	*4.9*	*9,651*	*11,780*	*6,084*
Rest of the world	**60,363**	**31,175**	**–15.9**	**25.0**	**57,161**	**29,521**	**–2.3**	**25.6**	**13,282**	**3,202**	**1,654**
Central and Eastern Europe and former USSR	17,963	9,277	–15.9	7.4	17,046	8,804	5.1	7.6	5,137	917	474
Russia	*1,577*	*814*	*–57.7*	*0.7*	*3,983*	*2,057*	*0.5*	*1.8*	*–241*	*–2,406*	*–1,243*
OPEC	7,837	4,047	–9.9	3.2	10,512	5,429	–11.3	4.7	–3,156	–2,675	–1,382
Latin America	8,074	4,170	–12.7	3.4	4,741	2,449	–9.0	2.1	4,035	3,333	1,721
Other countries	26,489	13,680	–18.5	11.0	24,862	12,840	–1.5	11.2	7,267	1,627	840
China	*2,113*	*1,091*	*–5.0*	*0.9*	*5,386*	*2,782*	*5.6*	*2.4*	*–2,873*	*–3,273*	*–1,690*
5 Asian countries in crisis (2)	*2,564*	*1,324*	*0.2*	*1.1*	*4,714*	*2,435*	*–0.6*	*2.1*	*–2,181*	*–2,150*	*–1,110*
Total	**241,745**	**124,851**	**–5.6**	**100.0**	**223,685**	**115,524**	**–1.1**	**100.0**	**30,112**	**18,060**	**9,327**

Source: Based on Istat data.
(1) Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the United States. – (2) Indonesia, Malaysia, Philippines, South Korea and Thailand.

Between January and August euro-area direct investment abroad rose to €122.5 billion, from €93.8 billion in 1998, while inflows of direct investment fell to €42.8 billion, from €54.2 billion the previous year. Inflows of portfolio investment contracted from the corresponding period of 1998, falling from €188.2 billion to €133.8 billion; expectations of a depreciation of the euro in connection with the widening of the interest rate differential with the United States were a contributory factor. Outflows of portfolio investment also shrank, from €221.2 billion to €190.7 billion.

Italy's financial account, which had been in surplus in the first eight months of 1998, was in deficit by 28.1 trillion lire (€14.5 billion) in the same period this year. A slight surplus was shown under "errors and omissions", which had recorded very large deficits in recent years. The adoption of the new criteria for recording and compiling the accounts, agreed within the European System of Central Banks, influenced these results.

The Italian balance of payments showed net direct investment inflows of around 9 trillion lire (€4.7 billion, equal to 0.6 per cent of GDP; Table 9). Net foreign direct investment in Italy rose from the low levels of the same period of 1998 to 4.4 trillion lire (€2.3 billion); Italian direct investment abroad gave rise to net inflows of around 4.6 trillion lire

(€2.4 billion), thanks to exceptionally large net disinvestment in June (13.8 trillion lire).

The latter result was largely due to the complex takeover of Telecom Italia, which involved the disposal of shareholdings in a foreign company. The same operation also gave rise to gross inflows recorded under portfolio investment and “other investment”. Even excluding this operation, Italian direct investment abroad contracted appreciably from the previous year: in the first five months it was equal to 6.9 trillion lire (€3.6 billion), less than half the amount recorded a year earlier.

Inflows of foreign portfolio investment in Italy fell by 22 per cent to 125.8 trillion lire (€64.9 billion). Italian portfolio investment abroad, totaling 166.8 trillion lire (€86.2 billion), was up slightly from a year earlier. The decline in inflows may have reflected the convergence of Italian interest rates with the already low average level prevailing in Europe; it continued in the second quarter of the year. In the first six months foreign investors purchased Italian Treasury securities amounting to 111.6 trillion lire (€57.6 billion), 8.2 per cent less than in the same period of 1998; they modified the composition of their holdings, buying BOTs, BTPs and CTZs and disposing of CTEs (Table 10). In view of the underperformance of share prices in Italy relative to those in the other industrial countries in the second quarter, there was a drastic decline in foreign investors’ net purchases of Italian equities in the first six months. Net Italian purchases of foreign equities totaled 32.5 trillion lire (€16.8 billion), in line with the amount recorded a year earlier.

Under “other investment”, large flows of assets and liabilities gave rise to net outflows of 10.8 trillion lire (€5.6 billion) in the first eight months, compared with 0.2 trillion a year earlier.

Table 9

Financial account (1)
(balances in billions of lire and millions of euros)

	1998			1999				Jan.-Aug.		
	Year lire	Q1 lire	Q2 lire	Q1		Q2		1998 lire	1999	
				lire	euros	lire	euros		lire	euros
Direct investment	−17,198	−4,112	−7,384	−323	−167	8,403	4,340	−15,193	9,046	4,672
Abroad	−21,731	−4,423	−7,870	−2,904	−1,500	9,770	5,046	−17,904	4,606	2,379
In Italy	4,533	311	486	2,581	1,333	−1,367	−706	2,711	4,440	2,293
Portfolio investment	4,350	−13,263	26,544	−5,609	−2,897	−23,453	−12,112	−3,601	−41,072	−21,212
Assets	−192,079	−75,601	−56,013	−59,509	−30,734	−65,063	−33,602	−164,523	−166,825	−86,158
Liabilities	196,429	62,338	82,557	53,900	27,837	41,610	21,490	160,922	125,753	64,946
Other investment	−18,516	29,766	−32,658	−13,269	−6,853	2,110	1,090	−216	−10,814	−5,585
Assets	−42,672	1,457	−31,110	−17,808	−9,197	−15,347	−7,926	−14,467	−49,627	−25,630
Liabilities	24,156	28,309	−1,548	4,539	2,344	17,457	9,016	14,251	38,813	20,045
Derivatives	348	227	176	1,028	531	1,435	741	453	−79	−41
Change in official reserves	36,977	1,467	13,418	16,826	8,690	−259	−134	20,749	14,794	7,640
Total	**5,961**	**14,085**	**96**	**−1,347**	**−696**	**−11,764**	**−6,075**	**2,192**	**−28,125**	**−14,526**

(1) The time series were reconstructed and may be revised. For June, July and August 1999, provisional data.

Table 10

Portfolio investment (1)

(balances in billions of lire and millions of euros)

	1996 lire	1997 lire	1998 lire	1998		1999			
				Q1 lire	Q2 lire	Q1		Q2	
						lire	euros	lire	euros
Government securities . . .	100,472	102,879	151,854	41,094	80,542	51,290	26,489	60,328	31,157
BOTs	13,719	7,947	52,909	8,793	26,708	25,607	13,225	9,982	5,155
BTPs	68,785	83,907	23,712	4,636	18,879	20,611	10,645	40,747	21,044
CTEs	−1,816	−914	−3,980	−425	−673	−5,336	−2,756	−798	−412
CCTs	6,041	6,329	52,539	25,591	14,299	−11,519	−5,949	−2,768	−1,430
CTOs	−2,456	−5,237	−2,967	−2,910	−57	–	–	–	–
CTZs	4,757	7,803	22,239	5,443	12,275	21,295	10,998	8,945	4,620
Republic of Italy issues .	11,299	3,485	4,758	170	4,764	552	285	3,915	2,022
Other government securities	143	−441	2,644	−204	4,347	80	41	305	158
Bonds	927	195	1,612	322	238	−120	−62	–	–
Bank securities	−1,062	5,755	18,479	13,574	375	564	291	–	–
Equity securities	14,416	16,028	24,881	7,916	1,608	2,062	1,065	–	–
Other securities	−81	802	−397	−568	−206	104	54	–	–
Total	**114,672**	**125,659**	**196,429**	**62,338**	**82,557**	**53,900**	**27,837**	**41,610**	**21,490**

(1) The time series were reconstructed and may be revised. For June, July and August 1999, provisional data.

The labour market

In the last two years employment in Italy has moved broadly in step with that in the euro area as a whole. Average employment found by the revised Istat labour force surveys for January (see the box "The effects of the revision of Istat's labour force survey"), April and July was 1.2 per cent higher than the average for the same period of 1998. The corresponding figure for the euro area was 1 per cent.

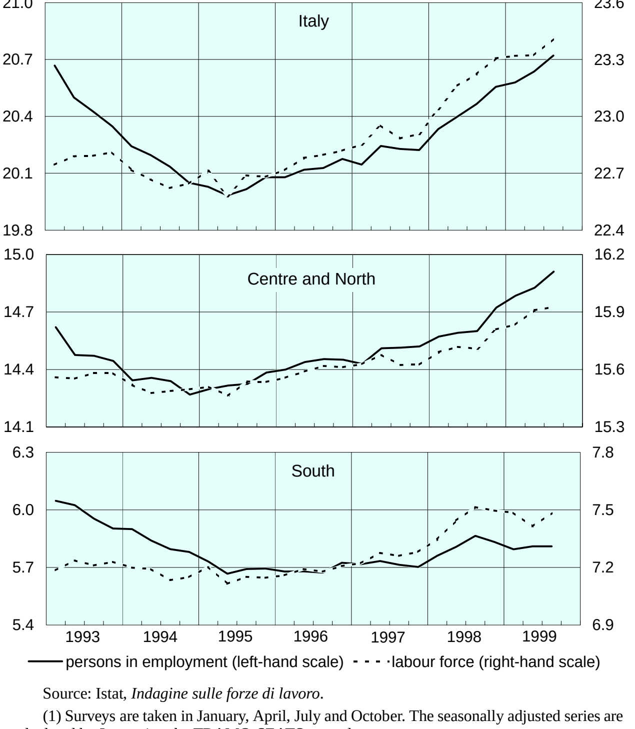
The number of persons in employment in Italy was 20,893,000 in July, a 12-month increase of 256,000, or 1.2 per cent (Figure 13); excluding the agricultural sector the rise was 1.6 per cent. The net increase was entirely due to gains in the number of wage and salary earners, which rose by 322,000, while the number of self-employed workers fell by 66,000, mainly in agriculture and the distributive trades. Employment increased for the seventh consecutive quarter, recording a gain of 84,000 persons, or 0.4 per cent, on a seasonally adjusted basis.

The significant increase in employment despite the slower pace of economic growth in Italy is explained by three main factors. The first is the gradual reallocation of the labour force from industry to services, especially household and business services, where the employment content of a unit of value added is greater. In the first three quarters of 1999 the number of persons in employment increased by a year-on-year average of 2.4 per cent in the services sector and 1.8 per cent in construction; in industry excluding construction it was broadly unchanged.

The second factor in the rise is the spread of part-time employment (Table 11). In the twelve months to July, the share of part-time workers in total salaried employment increased from 7.7 to 8.2 per cent in the economy as a whole and from 9.2 to 10.2 per cent in services. Part-time work is more common among women, where it accounts for 15.6 per cent of overall female employment and 16.8 per cent in the services sector, compared with 3.4 and 4.2 per cent respectively for men. Obviously, the rise in the number of part-time workers slowed growth in employment measured in terms of standard labour units: according to national accounts data this rose by 0.9 per cent compared with a year earlier.

Figure 13

Employment (1)
(*millions of persons*)



Source: Istat, *Indagine sulle forze di lavoro.*

(1) Surveys are taken in January, April, July and October. The seasonally adjusted series are calculated by Istat using the TRAMO-SEATS procedure.

Finally, willing to respond to even short-term increases in demand by increasing staff. In the 12 months ending in July, the share of workers on fixed-term contracts increased from 9.1 to 9.9 per cent of total salaried employment (from 8.1 to 8.9 per cent excluding agriculture, where the

The effects of the revision of Istat's labour force survey

In July Istat released the data of its labour force survey, entirely revised from October 1992 on. The revision has produced the following major adjustments:

- *An increase in the total number of persons employed and, since 1996, the rate of growth in employment (see figure). On average for the period from October 1992 to April 1999, the number of persons in employment was revised upward by 90,000 (0.4 per cent); but the size of the correction increases over time. For April 1999 it amounts to 225,000, or 1.1 per cent. Year-on-year employment growth is revised from nil to 0.4 per cent in 1997 and from 0.5 to 1.1 per cent in 1998. The revision primarily affects the male segment; for women it results in only slight downward changes in numbers and in employment growth.*

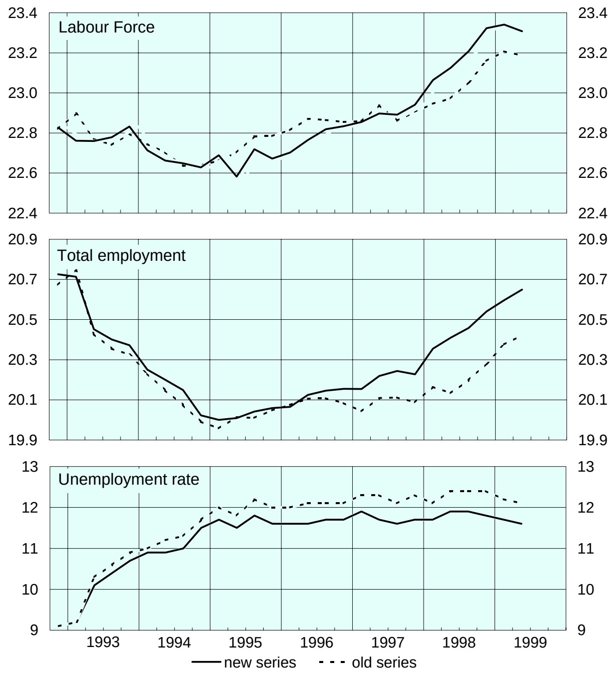
- *A decrease in the number of unemployed persons averaging 82,000, or 3.1 per cent, for the period. Starting in 1995 the unemployment rate shows a significant downward revision compared with the old series; the size of the variation increases slowly with time, reaching 0.4 percentage points in April 1999.*

- *From the middle of 1997, an increase in the labour force that amounts to 142,000 persons (0.6 per cent) by April 1999. This reversed a smaller downward revision of the figures for the years from 1995 to 1997. On average over the entire period, the labour force revision was comparable to that of the population, so the national labour force participation rate remained broadly unchanged.*

- *A pronounced change in the sectoral composition of employment, with an increase in industry's share from 24.3 to 25.6 per cent on average for the period, the equivalent of 286,000 workers, and a reduction in that of agriculture from 7.3 to 6.5 per cent, or 147,000 persons.*

Figure

The labour force survey:
the old and new series compared
(seasonally adjusted, in thousands)



Essentially, the revision modified the procedures for calculating the weights used to extrapolate from sample data to the entire population. The most important change was that in the method of estimating the age structure of the population. This is now based on data from municipal civic registers covering the entire population and no longer on the series of yearly

cont.

changes used under the old procedure to update the most recent national census figures.

This change resulted in a reduction in the population share of young people and an increase in that of adults in the central age-groups. As a consequence of differences in age-specific unemployment and employment rates, when extrapolated this adjustment increased the number of persons employed and reduced that of job-seekers (see table).

Similar effects were produced by the more rapid updating of population data from the civic registers under the new procedure. Before the revision, the extrapolation of the sample to the entire population was reproportioned using an estimate of the population structure for one or two years earlier; given their rapid contraction in recent years, this produced an overestimate of the younger age-groups. Quarterly weights are now calculated on the basis of demographic data for the end of the previous year and forecasts for the current year.

Furthermore, the unemployment series has been altered by aligning the definitions with EU standards. Previously unemployment figures included respondents who in the four weeks preceding the survey had engaged in "passive" job search (such as waiting to learn the outcome of public recruitment examinations or companies' response to applications submitted). By Eurostat's more restrictive interpretation, "passive" actions do not qualify a person as seeking work.

Finally, the procedures for correcting errors and handling missing data have been changed. The main effects here involve the sectoral structure of employment, which under the new survey corresponds much more closely to that found by the intermediate census of industry and services in 1996.

Table

Composition of the population aged 15 and over by sex, age-group and labour market status
(averages, 1998)

	Old series		New series	
	thou-sands	percen-tage	thou-sands	percen-tage
Employed	**20,197**	**41.8**	**20,435**	**42.0**
Men	12,833	26.5	13,090	26.9
15-34	4,713	9.7	4,677	9.6
35-64	7,884	16.3	8,163	16.8
65	236	0.5	250	0.5
Women	7,364	15.2	7,345	15.1
15-34	3,104	6.4	3,006	6.2
35-64	4,170	8.6	4,244	8.7
65	90	0.2	95	0.2
Unemployed	**2,837**	**5.9**	**2,745**	**5.6**
Men	1,346	2.8	1,314	2.7
15-34	978	2.0	933	1.9
35-64	366	0.8	377	0.8
65	2	0.0	4	0.0
Women	1,491	3.1	1,431	2.9
15-34	1,090	2.3	1,020	2.1
35-64	398	0.8	406	0.8
65	3	0.0	5	0.0
Non-labour-force	**25,307**	**52.4**	**25,473**	**52.4**
Men	9,076	18.8	9,008	18.5
15-34	3,017	6.2	2,765	5.7
35-64	2,486	5.1	2,488	5.1
65	3,573	7.4	3,755	7.7
Women	16,231	33.6	16,466	33.8
15-34	4,365	9.0	4,127	8.5
35-64	6,558	13.6	6,653	13.7
65	5,309	11.0	5,686	11.7
Population aged 15 and over	**48,340**	**100**	**48,653**	**100**
Population aged under 15	**8,643**		**8,387**	
Total population	**56,983**		**57,040**	

Source: Istat, *Indagine sulle forze di lavoro.*

Table 11

Labour force status of the Italian population

(*thousands of units and percentages*)

	July 1998	July 1999	Variation		% composition July 1999
			absolute	percentage	
Salaried employees	**14,650**	**14,972**	**322**	**2.2**	**26.2**
open-ended contracts	13,311	13,492	181	1.4	23.6
full-time	12,602	12,733	131	1.0	22.3
part-time	709	759	50	7.1	1.3
fixed-term contracts	1,339	1,480	141	10.5	2.6
full-time	921	1,011	90	9.8	1.8
part-time	418	469	51	12.2	0.8
Self-employed	**5,987**	**5,921**	**–66**	**–1.1**	**10.4**
full-time	5,581	5,508	–73	–1.3	9.7
part-time	406	413	7	1.7	0.7
Total persons in employment	**20,637**	**20,893**	**256**	**1.2**	**36.6**
Unemployed	**2,667**	**2,597**	**–70**	**–2.6**	**4.6**
Labour force	**23,304**	**23,490**	**186**	**0.8**	**41.2**
Non-labour-force	**33,731**	**33,575**	**–156**	**–0.5**	**58.8**
non-working age (under 15)	8,377	8,304	–73	–0.9	14.6
working age (15-64)	15,887	15,655	–232	–1.5	27.4
not actively seeking work but would be immediately available	*1,216*	*1,215*	*–1*	*–0.1*	*2.1*
non-working age (over 65)	9,467	9,616	149	1.6	16.9
Population	**57,035**	**57,065**	**30**	**0.1**	**100.0**

Source: Istat, *Indagine sulle forze di lavoro.*

incidence of seasonal labour has always been high). The share of female employees on fixed-term contracts rose to 12.1 per cent, while that of persons under 35 years of age was 15.9 per cent. According to Confinterim (a trade association representing temporary employment agencies), 76,000 workers were hired for temporary positions in the first six months of 1999, 44 per cent more than in all of 1998.

The pronounced increase in part-time and fixed-term contracts was accompanied by a significant rise (1 per cent) in the number of workers hired on full-time and open-ended contracts. This component contributed two fifths of the overall increase in the number of persons in salaried employment, far more than in 1998.

In the first part of the year, employment in industry reflected the decline in productive activity, which had steepened in the second half of 1998. In April the number of employees was about 41,000 lower than the previous October, on a seasonally adjusted basis. There was a fall in hours worked per capita and overtime, while recourse to the Wage Supplementation Fund increased, albeit modestly. Industrial employment then turned upwards in the summer, rising by 29,000 between April and July thanks to the recovery signalled by cyclical indicators. The ISAE survey of industrial firms' expectations indicates that the growth in industrial employment should continue in the coming months as the recovery in economic activity consolidates. Nevertheless, according to the Bank of Italy's survey employment in manufacturing firms with more than 50 employees is expected to be not higher at the end of 1999 than a year earlier.

As in past years, the increase in employment consisted primarily in gains by the female component, which rose by 187,000 persons (2.5 per cent) in the twelve months to July; the male component increased by 69,000 (0.5 per cent). Employment in the North and Centre increased by 207,000 and 111,000, or 1.9 and 2.7 per cent, respectively. Most of the rise came in the services sector, especially wholesale and retail trade and the restaurant segment (Table 12). Employment in the South fell by 62,000 (1 per cent) from the historically high level recorded in July 1998. Most of the decline came in agriculture and construction.

The labour force grew by 186,000 persons in year to July. The participation rate for persons aged 15 to 64 rose from 59.1 to 59.6 per cent, remaining well below the euro-area average of over 65 per cent. The unemployment rate fell from 11.4 to 11.1 per cent, declining appreciably in the North and Centre (from 5.6 to 4.9 per cent and from 9.1 to 8.4 per cent, respectively). But the rate rose from 21.6 to 22 per cent in the South, after the anomalous sharp decline registered in April. Joblessness in the euro area fell from 10.9 to 10.2 per cent over the same period. In the second quarter, the seasonally adjusted rate of unemployment was 9.1 per cent in Germany and 11.2 per cent in France, both about 0.5 points lower than a year earlier; in Spain the rate was 16.3 per cent, a drop of nearly 3 points.

Table 12

Employment by branch of activity and geographical area

(*number of persons; percentage changes on corresponding period*)

	Italy					North–West	North–East	Total North	Centre	South and Islands
	% of total (1)	October 1998	January 1999	April 1999	July 1999	July 1999	July 1999	July 1999	July 1999	July 1999
Agriculture	5.5	–7.3	–8.6	–4.9	–4.4	–4.6	3.6	0.3	–1.5	–8.5
Industry excluding construction	25.0	1.3	0.5	–0.6	–0.2	0.1	–0.9	–0.3	–0.3	0.2
Construction	7.6	–0.8	–0.8	2.9	3.3	11.1	3.2	7.7	2.3	–1.8
Services	62.0	2.9	2.7	2.4	2.1	2.9	2.3	2.7	4.0	..
wholesale and retail trade	*19.6*	*2.9*	*2.2*	*2.8*	*2.8*	*10.3*	*0.7*	*5.9*	*6.9*	*–5.0*
Total	**100.0**	**1.5**	**1.2**	**1.3**	**1.2**	**2.3**	**1.5**	**1.9**	**2.7**	**–1.0**
Unemployment rate (2)	–	11.9	11.9	11.7	11.1	5.5	4.1	4.9	8.4	22.0
male	–	*9.1*	*9.2*	*8.8*	*8.5*	*3.5*	*2.5*	*3.1*	*6.0*	*17.2*
female	–	*16.5*	*16.2*	*16.3*	*15.2*	*8.4*	*6.4*	*7.6*	*12.0*	*31.6*
Participation rate (2) (3)	–	59.3	58.8	59.3	59.6	63.1	65.7	64.2	60.9	53.3
male	–	*73.1*	*72.7*	*73.1*	*73.6*	*74.3*	*76.8*	*75.3*	*73.6*	*71.4*
female	–	*45.4*	*44.9*	*45.6*	*45.7*	*51.9*	*54.3*	*52.9*	*48.3*	*35.4*

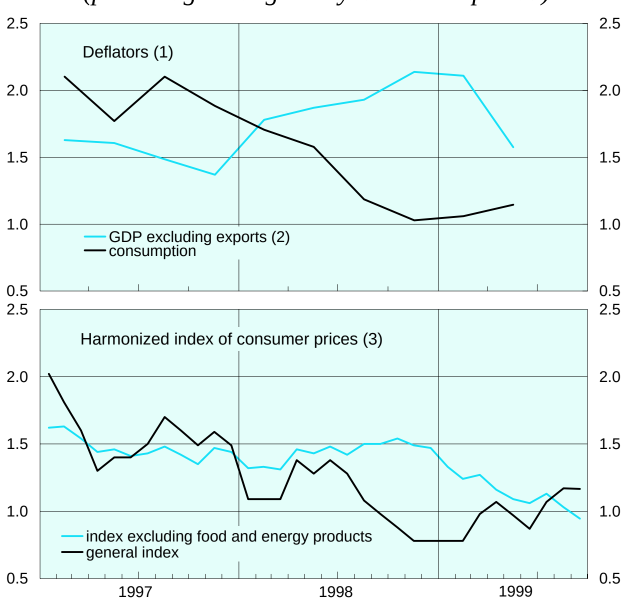
Source: Istat, *Indagine sulle forze di lavoro.*
(1) Average of surveys taken in January, April and July 1999. – (2) Percentages. – (3) The participation rate is calculated with reference to the working age population (15-64).

Prices, costs and competitiveness

Inflation in the euro area has gradually increased from the low recorded at the end of 1998. In September the twelve-month increase in the harmonized index of consumer prices for the euro area was 1.2 per cent; the annualized and seasonally adjusted six-month increase was 2 per cent (Figure 14). The rise was caused by the reversal of the trends in the same factors that had worked to curb inflation in the previous months. In particular, the prices of imports began to rise again under the impulse of higher oil prices and the depreciation of the euro.

Figure 14

Inflation indicators in the euro area
(percentage changes on year-earlier period)



Source: Based on BIS and Eurostat data and national statistics.
(1) Quarterly data. Weighted average of deflators for Germany, France, Italy, Spain, the Netherlands and Finland. - (2) Exports are estimated excluding their content of imported goods and services. - (3) Monthly data. Weighted average of the indices in the euro-area countries.

The indicators of underlying inflation and inflation of domestic origin in the euro area have not risen; in fact, they have declined slightly, benefiting in part from deregulation in some sectors, notably telecommunications. The inflation expectations of consumers, leading professional forecasters and the financial markets have risen.

The risk that the current increase in inflation could prove lasting is not negligible. The effects of the moderate economic recovery under way in Europe are reflected in an acceleration in the prices of non-energy intermediate goods, which respond more quickly to fluctuations in demand, while wage growth could be affected by the worsening of inflation expectations.

In Italy, the increase in the inflation rate from the low recorded at the beginning of the year was similar to the average increment in the euro area. In September the twelve-month rise in the harmonized index of consumer prices was 1.9 per cent; the annualized and seasonally adjusted six-month increase was 2.8 per cent. The differential vis-à-vis the euro area average remains large, especially if calculated in relation to the index excluding food and energy products, where it is about 1 percentage point.

Given that demand remains less buoyant in Italy than in the other countries of the area, the difference in inflation is explained by the more rapid rise in unit labour costs, attributable to smaller productivity gains, and exceptionally large increases in the prices of certain services whose markets are less exposed to competition.

On the basis of preliminary data provided by national statistics institutes, the year-on-year increase in the national consumer price indices rose further in October, from 1.8 to 2.0 per cent in Italy and from 0.7 to 0.9 per cent in Germany.

The weakness of the euro has improved the competitiveness of Italian industry in 1999. The gain is larger when measured in terms of producer and export prices; smaller when based on unit labour costs.

Consumer prices

The acceleration in consumer prices in the euro area is entirely attributable to the sharp rise in energy prices, whose twelve-month rate of change has swung from -4.7 per cent in December 1998 to 6.5 per cent in September this year. The other main components of the index decelerated (Figure 15).

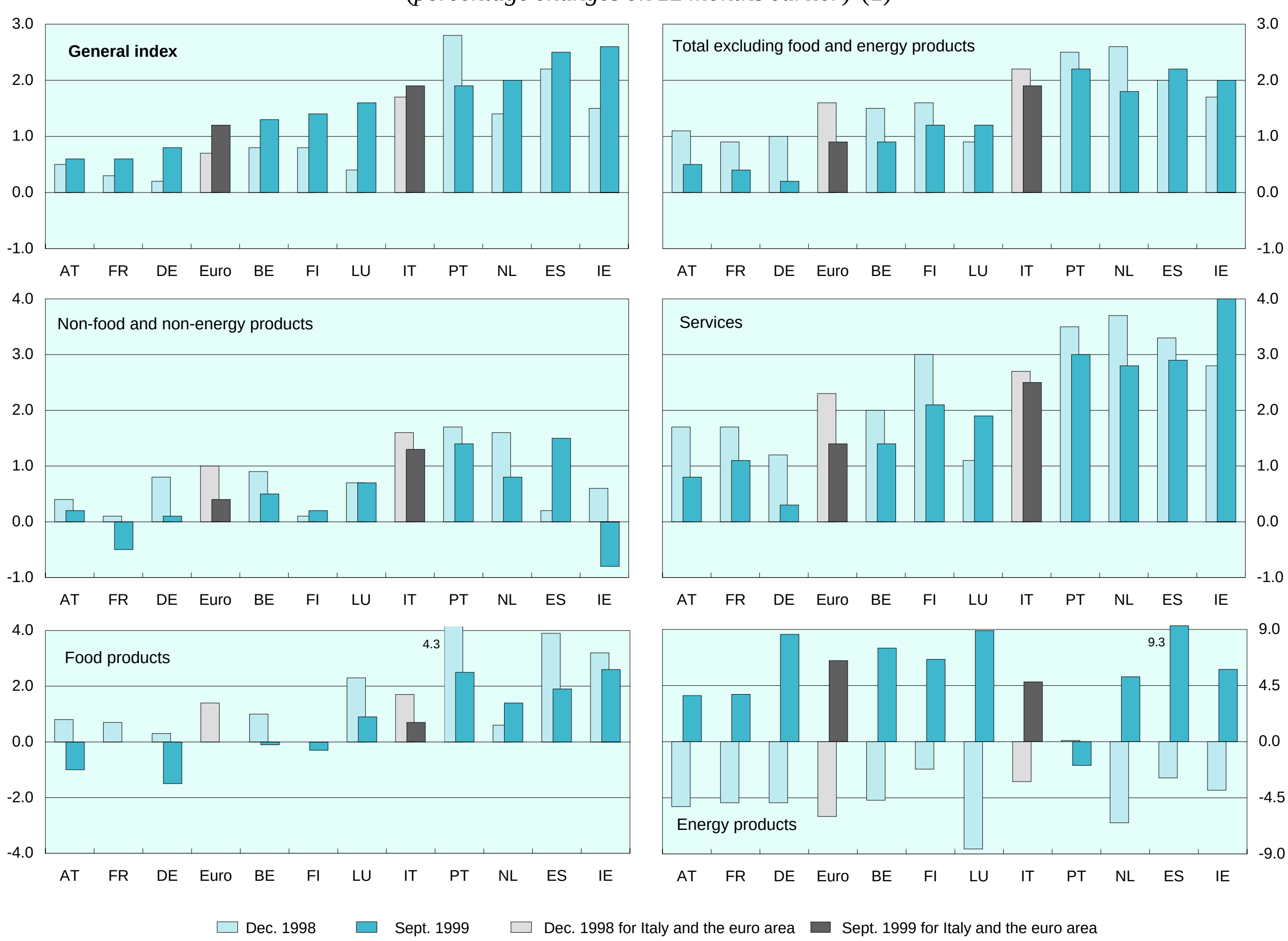
The rise in oil prices is primarily the consequence of concerted production cuts by OPEC. The average dollar price in the first three weeks of October was at its highest since 1996, about 70 per cent above its level a year earlier.

The prices of food products gradually declined, primarily owing to good harvests in the Mediterranean area. The twelve-month change in the prices of unprocessed food products, equal to 0.8 per cent in December 1998, turned negative in the second half of this year (-1.1 per cent in September).

Among the less volatile components of the index, prices decelerated most sharply in the services sector, from 2 to 1.4 per cent. About half of the fall is attributable to price reductions in the telecommunications sector, especially in Germany. The rate of increase in the prices of non-food and non-energy goods also declined, from 0.9 to 0.4 per cent.

Figure 15

Harmonized indices of consumer prices in the countries of the euro area
(*percentage changes on 12 months earlier*) (1)

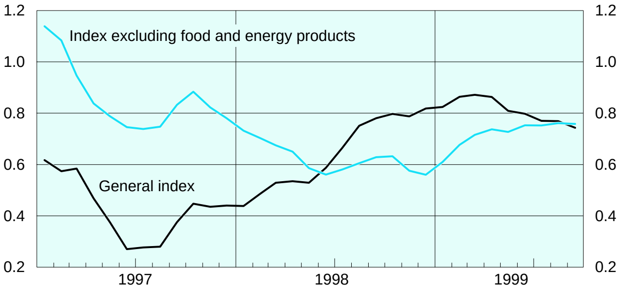


Source: Based on Eurostat data.
(1) The figure for the euro area is the weighted average of the indices of the eleven countries.

Inflation remained highest in the euro area countries where demand grew most rapidly (Spain, Portugal, the Netherlands and Ireland). The dispersion of overall inflation rates began to decline after increasing markedly in 1998. However, differentials in underlying inflation widened, primarily owing to developments in the prices of services (Figure 16).

Figure 16

Dispersion of inflation in the euro area (1)
(*standard deviation of inflation rates in the euro-area countries; percentage points*)



Source: Based on Eurostat data.

(1) The inflation rate in each country is measured as the 12-month change in the moving average of the three months ending in the reference month of the harmonized index of consumer prices. The indicator does not take account of the relative weight of the individual economies.

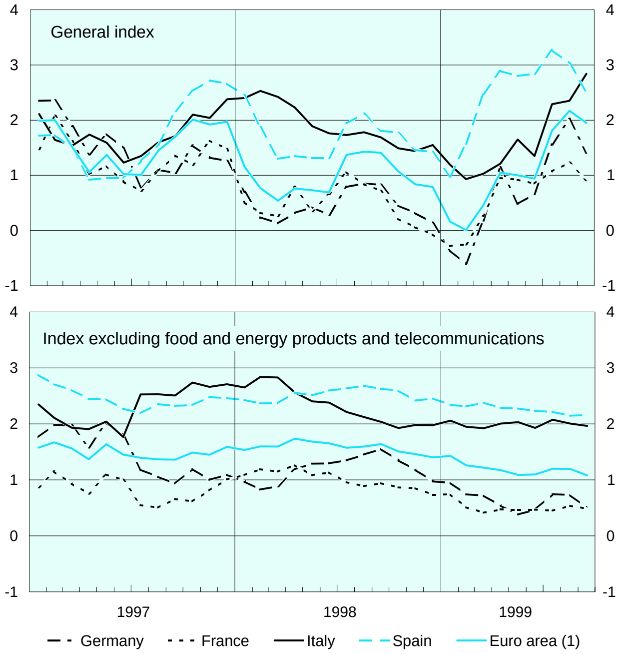
In September, the annualized and seasonally adjusted six-month increase in the harmonized index was about 2.5 per cent in Spain and Italy, 1.4 per cent in Germany and 0.9 per cent in France, presaging an increase in the twelve-month rate in the immediate future. The index excluding food products, energy and telecommunications (where the price cuts recorded in some countries are unlikely to be repeated) fluctuated around values close to 2 per cent in Italy and Spain and under 1 per cent in Germany and France (Figure 17).

As in the rest of the euro area, the twelve-month increase in the harmonized index of consumer prices in Italy turned upwards from the low registered at the beginning of the year. However, the differential with the euro-area average narrowed from 1.1 to 0.8 points in September. This reflected differences in the behaviour of energy prices and the components of underlying inflation.

In the current environment of rising oil prices, the greater stickiness of energy prices in Italy than in the rest of the area helped to contain inflation differentials.

Figure 17

Harmonized indices of consumer prices in the countries of the euro area
(*seasonally adjusted; annualized 6-month percentage change*)



Source: Based on Eurostat data.

(1) Weighted average of the indices of the countries in the euro area, excluding Ireland and Luxembourg.

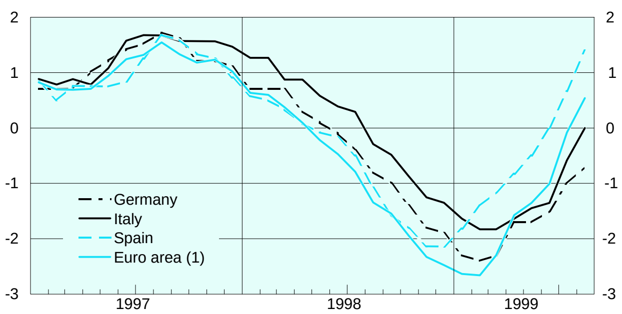
The underlying inflation differential has widened to more than 1 percentage point in recent months, reflecting not only smaller productivity gains in Italy but also structural factors that have an impact on the behaviour of the prices of some services, which has diverged from that in the other leading European economies. In September, the prices of telecommunications services in Germany were 10.9 per cent lower than at the start of the year, compared with a decline of 2.6 per cent in Italy. Prices in other sectors in Italy rose sharply over the same period. In particular, the prices of insurance services rose by 16.3 per cent, compared with an increase of 4.9 per cent in Germany and a decline of 3 per cent in France, while those of financial services increased by 6.0 per cent, compared with changes of 0.4 and -0.5 per cent in Germany and France, respectively. These developments are in line with those recorded since January 1996: over the period, the prices of insurance services have risen by 55 per cent in Italy while falling by 4 per cent in Germany and nearly 8 per cent in France; those of financial services have increased by 23 per cent, compared with 0.6 per cent in Germany and 6.5 per cent in France.

Producer prices and the export and import prices of manufactures

After falling sharply in 1998, the producer prices of manufactures for the domestic market in Italy and the euro area began to rise again in the early months of this year. The twelve-month changes in the general index turned positive for the area average and Italy (Figure 18).

Figure 18

General index of producer prices of manufactures for the domestic market in the countries of the euro area
(*percentage changes on 12 months earlier*)



Sources: Based on Istat and Eurostat data.
(1) Weighted average of the indices in Germany, France, Italy, Spain, the Netherlands and Finland.

In addition to the rebound in the prices of energy products, this behaviour reflected the pickup in demand and the prices of other primary products, which caused the prices of non-energy intermediate goods to accelerate (Figure 19). The increases have not yet been passed through to the producer prices of final non-food and non-energy consumer goods.

The pricing intentions of firms measured in surveys conducted by Reuters and the European Commission suggest that the acceleration in producer prices in the euro area and Italy will continue in the coming months, in step with the strengthening of productive activity (Figure 20).

Figure 19

Index of producer prices of manufactures for the domestic market in Italy excluding energy products and items subject to price controls
(*annualized percentage changes on 6 months earlier; seasonally adjusted*)

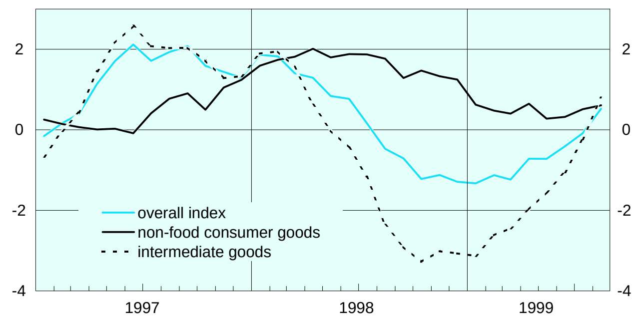
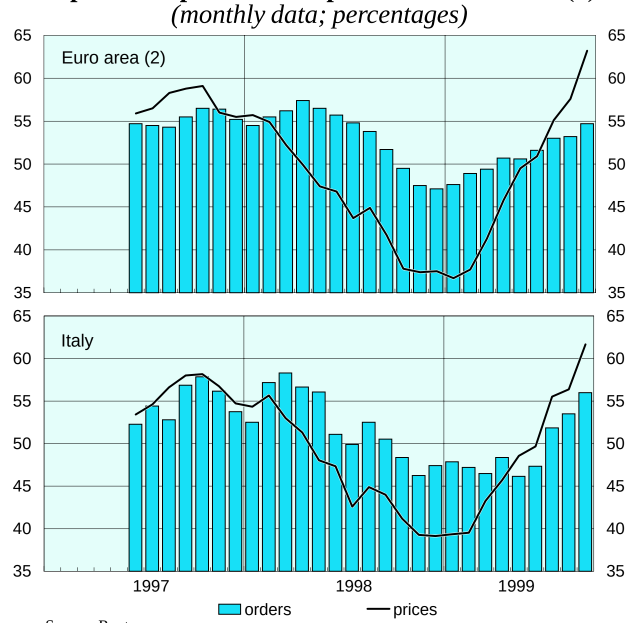


Figure 20

Manufacturing firms: intended changes in producer prices and expectations for orders (1)
(*monthly data; percentages)*



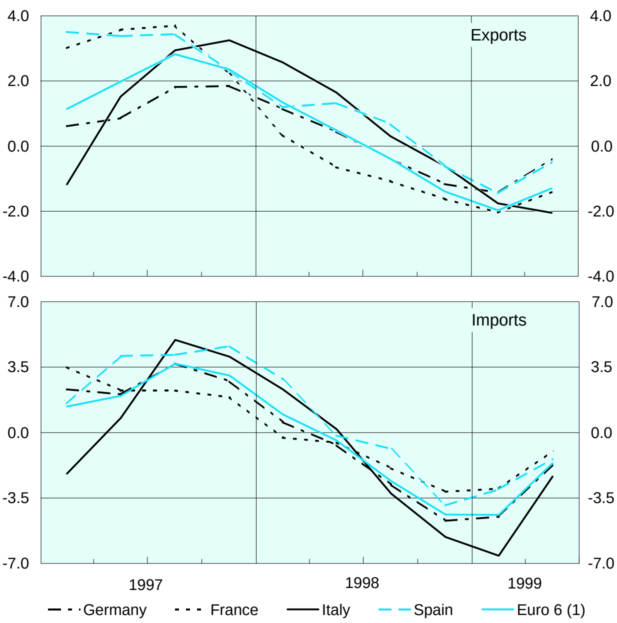
Source: Reuters.

(1) Diffusion index. The value, expressed as a percentage of all firms, is obtained by summing the number of firms that expect orders (prices) to increase to half the number of those that expect orders (prices) to remain unchanged on the previous month. An index value of 50 therefore indicates a situation of equilibrium; higher (lower) values indicate expectations of an increase (reduction) in orders and prices. - (2) Weighted average for Germany, France, Italy, Spain, Austria and Ireland, with weights based on value added in 1995.

In the first half of 1999 Italian firms narrowed their profit margins in foreign markets by more than they did at home in an effort to stem the erosion of market shares. The implicit deflator of exports of goods and services continued to decline in the second quarter, falling by 2 per cent with respect to the year-earlier period; that for goods alone declined by 2.5 per cent, compared with a decrease of 1.5 per cent in the producer prices of manufactures for the domestic market. The deflator of exports of goods and services in Germany and Spain remained broadly stable over the same period after having declined in previous quarters. In France, the deflator fell by 1.4 per cent, compared with 2 per cent in the first quarter (Figure 21).

Figure 21

Export and import deflators in the countries of the euro area
(*quarterly data; percentage changes on year-earlier period*)



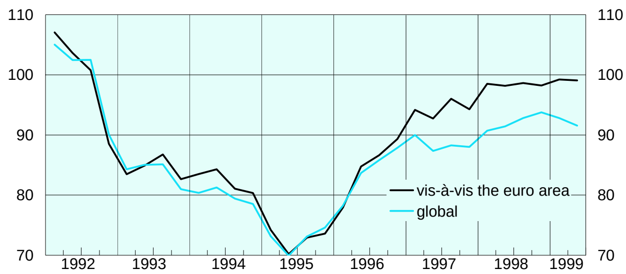
Sources: Based on Istat and BIS data and national statistics.

(1) Weighted average of deflators for Germany, France, Italy, Spain, the Netherlands and Finland.

With the depreciation of the euro, Italian competitiveness improved by more than 4 percentage points with respect to the last quarter of 1998 measured in terms of producer prices and average unit export values. When measured by unit labour costs the gain was smaller (less than 3 points). However, the improvement came on the heels of a deterioration in Italy's competitive position that began in 1995. During this period, most of the gain achieved between 1992 and 1995 vis-à-vis the other euro-area economies due to the weakness of the lira was lost (Figure 22).

Figure 22

Indicators of Italian competitiveness (1)
(*indices, 1992=100*)



Sources: Based on Istat, OECD and IMF data and national statistics.

(1) Quarterly data. The indices are based on unit labour costs. An increase indicates a loss of competitiveness.

Import prices reversed their downward trend in the second quarter of 1999, boosted by the rapid increase in the prices of raw materials, the depreciation of the euro against the dollar and the recovery in the Asian economies.

Firms' costs and profit margins

Preliminary national accounts data compiled using the SEC 95 criteria show an acceleration in unit labour costs in manufacturing in the leading euro area countries. The change on the year-earlier period went from an average decline of 1.4 per cent in 1998 to an increase of 2.4 per cent in the first half of 1999 (Table 13). With the rate of increase in labour costs per employee steady at 2 per cent, the rise is explained by the sharp, largely cyclical, slowdown in productivity gains. The recovery in productive activity in Europe should reverse this trend.

Unit labour costs accelerated in Italy as well. The rate of change on the year-earlier period rose from an average of 1.4 per cent in 1998 to 3.2 per cent in the first half of this year.

Table 13

Unit labour costs, per capita compensation and productivity in manufacturing in the main euro-area countries (1)
(*percentage changes on year-earlier period*)

	Unit labour costs		Cost of labour per employee (2)		Labour productivity		Components			
							Value added		Labour units	
	1998	1999 H1	1998	1999 H1	1998	1999 H1	1998	1999 H1	1998	1999 H1
Euro area (2)	**-1.4**	**2.4**	**2.2**	**2.0**	**3.6**	**-0.4**	**5.4**	**0.0**	**1.8**	**0.4**
Italy	**1.4**	**3.2**	**2.4**	**1.8**	**1.0**	**-1.3**	**2.7**	**-1.8**	**1.6**	**-0.5**
Other euro-area countries (3)	**-2.3**	**2.1**	**2.1**	**2.0**	**4.5**	**-0.1**	**6.3**	**0.6**	**1.8**	**0.7**
Germany	-3.4	2.8	2.1	2.1	5.8	-0.6	7.5	-0.7	1.7	-0.1
France	-2.9	0.1	2.1	2.0	5.0	1.9	5.2	2.0	0.2	0.1
Spain	2.4	4.4	2.0	1.6	-0.4	-2.7	5.3	1.3	5.7	4.0

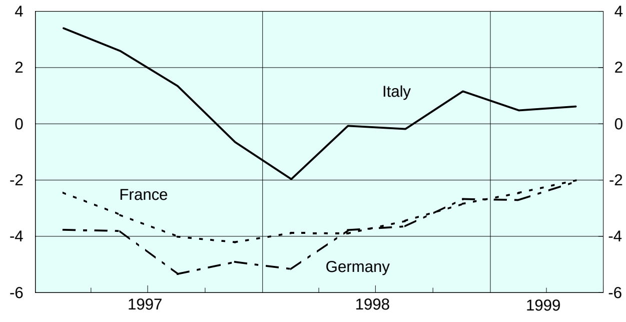
Sources: Based on BIS and Istat data and national statistics.
(1) For Germany and France, gross earnings. For Italy, the data for 1998 are adjusted to take account of the introduction of Irap (see Economic Bulletin, October 1998).- (2) Weighted average of Germany, France, Italy and Spain.- (3) Weighted average of Germany, France and Spain.

Excluding cyclical effects, the longer-term trend in unit labour costs, which is more significant in gauging their impact on prices, remains negative but is turning upwards in Germany and France; it is positive but stable in Italy, which continues to suffer a differential of more than two percentage points that is narrowing only slowly (Figure 23). Given the broad convergence of rates of increase in compensation per employee, the difference is attributable to the slower growth in Italian productivity.

Contractual wage increases continue to be moderate in most of the euro area. In France, contract renewals provided modest increases accompanied by reductions in working hours and measures to increase labour market flexibility. In Germany, after a period characterized by wage moderation the bargaining season that opened at the start of the year saw the concession of raises in excess of 3 per cent. The increase in effective earnings could prove to be smaller than that in contractual wages, however, primarily owing to the only partial implementation of the nationally-agreed increases by firms located in the eastern regions and the postponement of company-level bonuses announced by German industrial employers.

Figure 23

Trend in unit labour costs in manufacturing (1)
(*quarterly data; percentage change on year-earlier period*)



Sources: Based on Istat and BIS data and national statistics.

(1) Unit labour costs calculated as the ratio between labour costs per employee in the reference quarter and long-run productivity, obtained as the moving average of the 16 quarters ending in the quarter indicated.

The wage increases agreed in Italy last summer in the metal and engineering, banking and wholesale and retail trade sectors were broadly in line with the target inflation rate. On the basis of national accounts data and the principal trends that have emerged in contract renewals, gross earnings per employee in manufacturing industry should rise by just over 2 per cent on average for 1999, compared with 2.4 per cent in 1998, with an additional small deceleration in 2000. The slowdown in 1999 should be even more marked in the private services sector, where the rate of increase is expected to fall from 2.8 to about 2.0 per cent.

Competitive pressures prevented Italian firms from passing all of the increase in the prices of raw materials and unit labour costs through to prices. As a result, the share of gross operating profits in total manufacturing value added declined slightly in the first part of the year, although it remained at historically high levels.

Inflation expectations

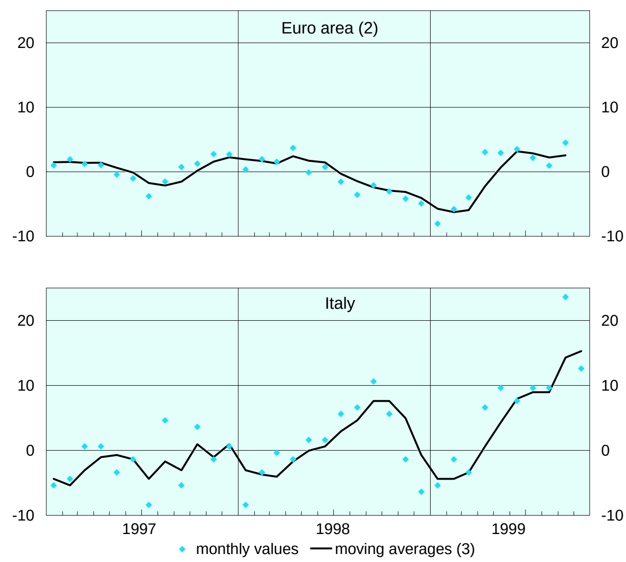
The improvement in inflation expectations for the euro area came to a halt at the start of 1999. The subsequent deterioration was most pronounced for the expectations of consumers and financial markets. The short and long-term inflation rates expected by professional forecasters are below 2 per cent both for the euro area and for Italy.

The survey of consumer households coordinated by the European Commission signaled an increase in inflation expectations for the euro area from the first quarter of the year (Figure 24). In Italy this indicator has risen further in the last two months.

The inflation expectations of professional forecasters surveyed by *Consensus Forecasts* for the euro area average in 1999 rose only slightly from their low in March (from 1 to 1.1 per cent); those for 2000 remained unchanged at their January level of 1.6 per cent (Figure 25). A larger increase is forecast for Italy: since March, inflation expectations for 1999 have risen from 1.3 to 1.7 per cent and those for 2000 from 1.5 to 1.8 per cent. Nevertheless, the differential with Germany should narrow to 0.4 percentage points in 2000.

Figure 24

Consumer expectations concerning

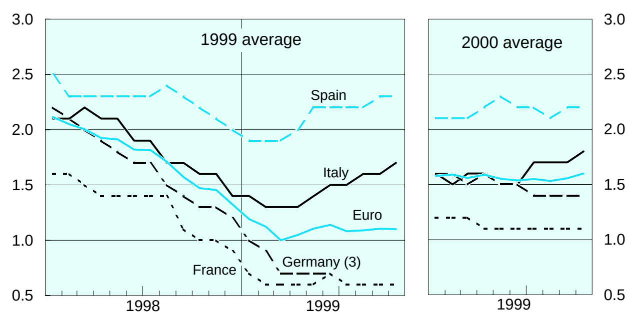


Sources: Based on ISAE and European Commission data.

(1) Balance between the percentage of consumers that expect inflation to hold steady or increase in the following 12 months and that of those who expect it to fall. The balance is expressed in terms of the percentage difference from the average for 1996-1999. - (2) Weighted average of the balances of the euro-area countries, excluding Luxembourg. - (3) 3-month moving average ending in the month indicated.

Figure 25

Consensus Forecasts **expectations concerning average consumer price inflation in 1999 and 2000 in the euro area** (1)
(percentage changes on previous year)

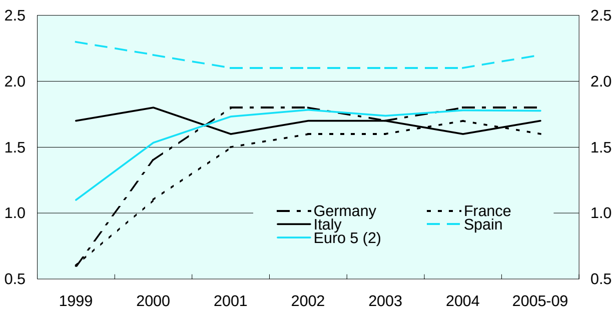


Source: Based on *Consensus Forecasts* data.
(1) Average annual rate of consumer price inflation expected by professional forecasters. The horizontal axis shows the months in which the survey is conducted. - (2) Weighted average of the forecasts for the countries of the euro area, excluding Luxembourg. - (3) Since July 1999 the forecasts for 1999 for France and Germany have been the same.

The results of the October edition of the twice-yearly *Consensus Forecasts* survey show inflation expectations for more distant time horizons remaining stable at levels just above those forecast for 2000 and in any case below 2 per cent in all the main euro-area economies bar Spain. For the period between six and ten years ahead, inflation is expected to average 1.8 per cent in the euro area and 1.7 per cent in Italy. Differentials between countries should therefore narrow further (Figure 26).

Figure 26

***Consensus Forecasts* expectations concerning long-term consumer price inflation in the euro area** (1)
(*percentage changes on previous year*)



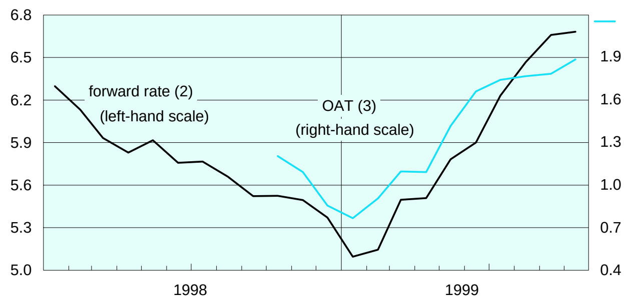
Source: Consensus Forecasts.

(1) October 1999 survey. - (2) Weighted average of the forecasts for Germany, France, Italy, Spain and the Netherlands.

Financial market indicators signal an increase in inflation expectations in the euro area from the low recorded at the start of the year (Figure 27). In France the differential between the yield on 10-year OATs with a nominal coupon and those of analogous real bonds (see *ECB Monthly Bulletin*, February 1999) rose from 0.8 points in January to 1.9 points in October. Over the same period, the forward rates for more distant horizons implicit in euromarket interest rate swaps rose by about 1.6 points.

Figure 27

Indicators of inflation expectations in the financial markets (1)
(*percentages*)



Source: Datastream.

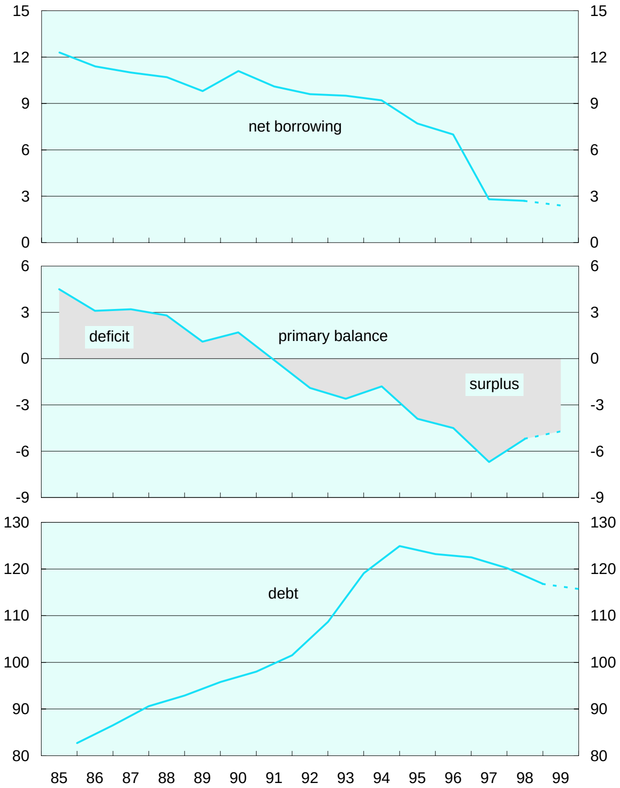
(1) The figure for October 1999 is the average for the first twenty days of the month. - (2) Average of 1-year forward rates between 6 and 9 years ahead on euro interest rate swaps on the euromarket. - (3) *Obligation assimilable du Trésor indexée*; difference in percentage points between the yield on securities with a nominal coupon and the corresponding index-linked securities paying a real coupon, maturing in 2009.

The public finances

The performance of the public finances in the first nine months of the year was consistent with the more recent official forecasts for general government net borrowing (2.4 per cent of GDP in 1999, compared with 2.7 per cent last year). The primary surplus is expected to decline from 5.2 per cent of GDP in 1998 to 4.7 per cent (Figure 28). A slightly better result is possible, given the particularly large inflow of tax revenue.

Figure 28

General government net borrowing, primary balance and debt (1)
(as a percentage of GDP)



Sources: Based on Istat data and, for debt, Bank of Italy data. Data from 1995 onwards are prepared using the new version of ESA (ESA95). For 1999, forecasts from *Relazione previsionale e progammatica*, September 1999.

(1) General government net borrowing includes reimbursements of tax credits in securities and as a rule excludes settlements of other past debts; does not include privatization receipts.

The substantial decline in the state sector borrowing requirement in the first three quarters of the year by comparison with the same period of 1998 is a positive sign, but the available data on the borrowing requirement of local authorities, which relate to the first eight months, indicate that this item has increased substantially.

The policy of restructuring the public debt in order to lengthen its residual maturity and reduce the sensitivity of interest expenditure to changes in interest rates has continued. The ratio of debt to GDP should fall by more than 1 percentage point; last year it came down by 3.5 points.

According to IMF estimates, the average ratio of general government net borrowing to GDP in the euro area should be broadly in line with the level indicated in the stability and convergence programmes (1.8 per cent, compared with the 2.1 per cent achieved in 1998). Recent information on the performance of the public finances in some countries indicate that a better result may be achieved. The reduction in relation to the preceding year is expected to stem mainly from a fall in interest expenditure.

Budgetary policy

The Economic and Financial Planning Document (EFPD) for 1999-2001 published in April 1998 set a target of 2.0 per cent of GDP for general government net borrowing in 1999 and one of 5.5 per cent for the primary surplus. The budgetary measures planned for that year were aimed at reducing net borrowing on a current programmes basis by 8 trillion lire, based on assumptions of GDP growth of 2.7 per cent and a gross interest rate of 4.5 per cent on 12-month Treasury bills. The Forecasting and Planning Report (FPR) of September 1998 confirmed the targets for both net borrowing and the primary surplus.

The budget approved by Parliament in December provided for allocations of more than 10 trillion lire for social and economic development policies as well as the planned adjustment in net borrowing (see *Economic Bulletin*, No. 28, February 1999). More than a third of the adjustment stemmed from temporary measures relating to the sale of contribution credits by INPS, licence fees for the provision of telecommunications services and privatization receipts; the increase in revenue generated by such measures was partly offset by the repayment of a portion of the special Europe tax.

The estimates for the current year were revised in the Quarterly Report on the Borrowing Requirement (QRBR) published in March. The report took account of the results for 1998, which were not as good as expected, and the substantial fall in interest rates that year; the GDP growth forecast was revised to 1.5 per cent and the overhaul of the national accounts by Istat at the beginning of 1999 was also taken into consideration. The estimate for net borrowing was prudently raised from 2.0 to 2.4 per cent; the reduction in forecast interest expenditure by half a point to 7.0 per cent of GDP partly offset that in the primary surplus from 5.5 to 4.5 per cent. The ratios to GDP of both expenditure and tax and social security contributions were expected to be marginally less than in 1998, each falling by 0.1 percentage point; the improvement in net borrowing was ascribed to an increase of 0.3 percentage points in other revenue not taken into consideration when calculating the ratio of tax and social security contributions to GDP.

The EFPD for 2000-2003 and the FPR for 2000, which were published in June and September of this year respectively and were based on the new edition of the European System of Accounts (ESA95), broadly confirmed the data contained in the QRBR.

The results for the first nine months of the year

The performance of the budget balances is in line with the main assessments contained in the EFPD and the FPR.

The earliest available indicator of developments in the public finances is the state sector borrowing requirement. Net of settlements of past debts and privatization receipts, it came to around 45.4 trillion lire in the first nine months, compared with almost 59 trillion a year earlier (Table 14 and Figure 29). The improvement, which was due mainly to the performance of tax revenue, was more than 10 trillion larger than expected.

Table 14

State sector and general government borrowing requirement

(billions of lire and, in brackets, millions of euros)

	1996	1997	1998	1999 (1)
	Net state sector borrowing requirement (2)			
January-August	70,128	31,480	40,056	25,228 *(13,029)*
January-September	96,412	51,444	58,949	45,446 *(23,471)*
	Gross state sector borrowing requirement			
January-August	76,673	28,392	33,890	32,618 *(16,846)*
January-September	103,157	48,648	53,165	53,139 *(27,444)*
	Net general government borrowing requirement (2)			
January-August	72,591	28,802	35,309	37,972 *(19,611)*

(1) Provisional. – (2) Excluding settlements of past debts and privatization receipts.

There are a number of reasons for caution, however, when using the behaviour of the state sector borrowing requirement in the first nine months to obtain an estimate of general government net borrowing in the year as a whole. These relate in particular to the scale of the financial factors that affected the borrowing requirement but not net borrowing and the uncertainty whether expected receipts from the sale of INPS credits can be counted when calculating net borrowing. Moreover, taxpayers have been given the option to pay the first tranche of self-assessed taxes in instalments, but sufficient data is not yet available to make an accurate estimate of the full year’s revenue from this source. Finally, on the basis of available data for the

State sector revenue and expenditure

Revenue in the first nine months of the year

State sector tax receipts amounted to 401.4 trillion lire in the first nine months of the year, 10.2 per cent more than in the corresponding period of 1998 (37.2 trillion lire, Table 1). There were particularly large increases in VAT (in connection with the incentives for restructuring property), lotteries, excise duties and sales taxes. Administrative actions and measures to reduce tax avoidance also had positive effects on tax revenue: the completion of sectoral studies and an initial partial application of the results, an increase in the auditing of tax returns, and changes in the procedures for submitting tax declarations, in particular the introduction of the unified return, which may have discouraged taxpayers from declaring amounts for different tax bases that were clearly inconsistent with one another.

Receipts of direct taxes *increased by 11.4 per cent (22.4 trillion), partly because of the measures to reduce avoidance and partly as a result of a further expansion in the tax bases for Irpef and Irpeg due to the replacement of health contributions and other duties by the regional tax on productive activities (Irap).*

Withholding tax on employees' wages and salaries and similar forms of income rose overall by 10.8 per cent (11.6 trillion); the changes in the various components (Table 1) reflect the fact that from April onwards withholding tax on the wages of public employees has been managed and paid directly by the Social Security Institute for Public Sector Employees (INPDAP) via the unified tax payment system and comes under the budget heading for wages and salaries of private sector employees.

The withholding tax on investment income and capital gains, which was affected by the reform that came into effect on 1 July 1998, rose by 16.1 per cent (more than 2.2 trillion). The tax on securities held in managed savings portfolios, which is paid in February and calculated on the net operating income for the second half of 1998, yielded 2.9 trillion; around one-third of this amount probably represents fresh revenue, as it relates to the portion of net operating income deriving from capital gains. Withholding tax on interest income on securities administered on behalf of customers yielded about 2.5 trillion less than in the same period of 1998, owing mainly to the introduction of the new tax regime; receipts of the new tax on capital gains on such securities came to 2 trillion. Revenue from the tax on interest income from bank deposits increased by 600 billion while that from the tax on non-residents' incomes fell by 400 billion.

Indirect taxes *increased by 8.8 per cent (14.8 trillion lire). VAT receipts, which rose by 6.6 per cent (6.1 trillion), benefited from increases in fuel prices and the income tax relief granted in respect of the restructuring of properties, which not only created an incentive to bring forward spending decisions but may also have helped reveal taxable income that would otherwise have remained undeclared.*

Table 1

State sector tax revenue (1)
(billions of lire and, in brackets, millions of euros)

	1999 January-September (2)		% change in relation to 1998
Direct taxes			
Personal income tax	156,558	(80,856)	10.7
withholding tax on public employees	*20,875*	*(10,781)*	*–14.2*
withholding tax on pensions and private sector wages and salaries	*97,801*	*(50,510)*	*18.1*
self-assessed balances	*9,309*	*(4,808)*	*9.7*
self-assessed payments on account	*11,073*	*(5,719)*	*10.7*
Corporate income tax	29,283	(15,123)	43.5
self-assessed balances	*13,620*	*(7,034)*	*68.6*
self-assessed payments on account	*15,193*	*(7,847)*	*30.0*
Local income tax	527	(272)	–90.3
Withholding tax on interest income and capital gains	16,162	(8,347)	16.1
Other (3)	15,887	(8,205)	6.8
Total	**218,417**	**(112,803)**	**11.4**
Indirect taxes			
VAT (4)	97,734	(50,475)	6.6
Other business taxes	24,348	(12,575)	–2.4
Excise duties on oil products	30,158	(15,575)	6.3
Other excise duties and sales taxes	10,903	(5,631)	15.6
Monopolies	9,347	(4,827)	5.9
Lotteries	10,446	(5,396)	113.7
Total	**182,936**	**(94,479)**	**8.8**
TOTAL TAX REVENUES	**401,353**	**(207,282)**	**10.2**

Sources: Based on Bank of Italy and Treasury Ministry data.

(1) Net of accounting transactions with the Sicily and Sardinia regions. – (2) Provisional. – (3) Includes receipts of inheritance taxes, which are recorded under "Business taxes and duties" in the state budget, the state's share of Irap and the excess of the regions' share of Irap, which they repay to the budget (together totalling 6,703 billion lire). – (4) Includes the VAT accruing to the EU.

cont.

The increase of 8.6 per cent (3.2 trillion) in excise duties and sales taxes was due mainly to the implementation of the carbon tax package and hence to the increase in excise duty on methane gas and mineral oil and to the new tax on the consumption of coal and similar products in large combustion plants.

Revenue from lotteries more than doubled, rising by 5.6 trillion lire, owing partly to changes in game rules and more effective marketing.

Receipts from state monopolies rose by 5.9 per cent (more than 500 billion) in connection with the increase in the basic rate of sales tax on tobacco.

Expenditure in the first half of the year

In the first six months of the year state sector expenditure totalled 339.3 trillion lire, an increase of 3.2 per cent or 10.5 trillion over the same period of 1998 (Table 2). The sharp decline in interest payments (14.1 per cent, or 11 trillion) was outweighed by an increase of 8.6 per cent (21.5 trillion) in primary expenditure.

The majority of primary current expenditure items increased substantially. Only current transfers to households, recipients abroad and former autonomous government agencies decreased. Capital spending and financial expenditure also rose.

Spending on public sector wages and salaries rose by 8.5 per cent (4.7 trillion), mainly owing to the payment on account to the INPDAP in respect of the additional annual contribution required to cover the shortfall in the state pension funds.

Current transfers as a whole rose by 0.7 per cent (900 billion) as a net result of opposing movements in the components of the aggregate. The decrease of 7.6 trillion in transfers to households was partly offset by an increase of 4.8 trillion in those to social security institutions; the two movements reflect mainly the assignment of responsibility for the payment of civil disability pensions to the INPS from November 1998 onwards. Transfers to former autonomous government agencies fell by 3.7 trillion, but it should be noted that capital transfers to these bodies rose by 1.2 trillion. The decrease of 2.2 trillion in transfers to recipients abroad related mainly to transactions with the European Union. Transfers to local authorities rose by 7.7 trillion, most of which was attributable to an increase in health expenditure and the postponement of deadlines for the payment of Irap, which inflated the regions' borrowing requirement in the first half of the year.

The increase of 17.4 per cent (3 trillion lire) in capital expenditure was associated with higher transfers to firms for measures financed by the Technological Innovation Fund. The rise of 17.0 per cent (2.3 trillion) in financial expenditure reflected partly the above-mentioned capital transfers to former autonomous government agencies and partly an increase in lending to firms.

Table 2

Main expenditure items of the state sector
(billions of lire and, in brackets, millions of euros)

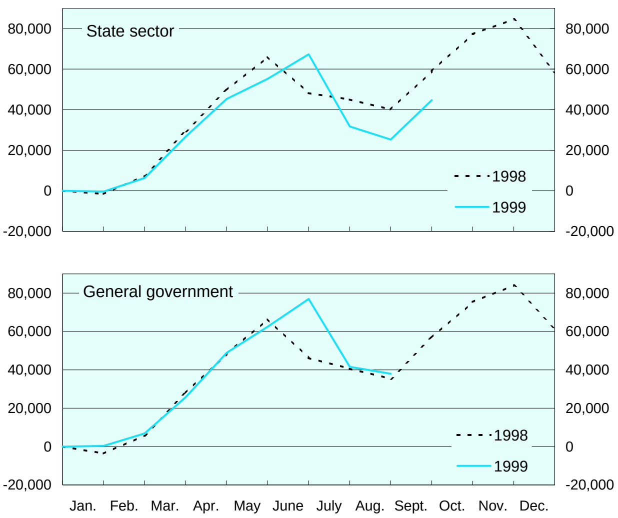
	1999 H1		% change in relation to 1998
Current expenditure (1)	**303,463**	**(156,726)**	**1.8**
Wages and salaries	59,887	(30,929)	8.5
Goods and services	11,348	(5,861)	26.6
Current transfers to:	138,343	(71,448)	0.7
social security institutions	*49,805*	*(25,722)*	*10.6*
regions	*49,322*	*(25,473)*	*14.5*
municipalities and provinces	*14,154*	*(7,310)*	*11.3*
households	*5,418*	*(2,798)*	*–58.3*
enterprises	*8,044*	*(4,154)*	*22.0*
former autonomous government agencies	*–886*	*(–458)*	*–131.9*
recipients abroad	*4,913*	*(2,537)*	*–31.2*
other	*7,573*	*(3,911)*	*6.6*
Interest payments	67,429	(34,824)	–14.1
Tax rebates	18,146	(9,372)	61.2
Other	8,310	(4,292)	20.1
Capital expenditure	**20,010**	**(10,334)**	**17.4**
of which: *investments*	*2,079*	*(1,074)*	*–13.6*
capital transfers	*17,892*	*(9,240)*	*22.2*
Financial expenditure	**15,798**	**(8,159)**	**17.0**
of which: *equity investment*	*7,320*	*(3,780)*	*20.9*
loans and advances	*7,635*	*(3,943)*	*45.4*
TOTAL EXPENDITURE	**339,271**	**(175,219)**	**3.2**

Source: *Relazione sulla stima del fabbisogno di cassa,* presented by the Treasury Minister on 30 September 1999.
(1) Net of accounting transactions with the Sicily and Sardinia regions.

first eight months of the year, the general government borrowing requirement has performed less well than that of the state sector (Table 14 and Figure 29): the former was around 3 trillion lire higher than in the same period of 1998 (rising from 35.3 to 38 trillion), whereas the latter improved by almost 15 trillion (from 40.1 to 25.1 trillion). The divergence reflects an increase in borrowing in the market by local authorities, which may be coupled with a larger-than-expected rise in expenditure. In this regard, the Technical Note to the Finance Bill for 2000 points out that the local authorities' deficit for 1999 is above the targets set in the Domestic Stability Pact (see the box *The budget for 2000* in the chapter *Short-term economic prospects, prices and monetary policy*).

Figure 29

State sector and general government borrowing requirement (1)
(cumulative balances; billions of lire)



(1) Excluding settlements of past debts and privatization receipts.

In the first nine months of the year state sector tax revenue increased by 10.2 per cent (see the box *State sector revenue and expenditure*). There were particularly large increases in receipts of VAT (partly owing to incentives for property restructuring), lottery taxes, excise duties and sales taxes (as a result of the revamping of excise duties on mineral oil). Tax yields were also boosted by administrative actions, measures to reduce tax avoidance and changes in the procedures for submitting tax returns.

The performance of state sector receipts is expected to lead to a higher ratio of general government tax revenue to GDP than planned.

State sector expenditure in the first six months of the year was 3.2 per cent higher than in the same period of 1998. An appreciable increase of 8.6 per cent in primary expenditure more than offset a reduction of 14.1 per cent in interest expenditure.

The borrowing requirement and the public debt

In the first nine months of the year the gross state sector borrowing requirement, in the aggregate that includes privatization receipts and payments in settlement of past debts, came to about 53.1 trillion lire, more or less the same as in the same period of 1998.

Net privatization receipts amounted to 1.8 trillion lire, whereas in the same period of 1998 they had totalled 8.2 trillion, mainly owing to the privatization of a block of ENI shares. The EFPD for 1999-2001 indicated privatization proceeds of 15 trillion in 1999. The current privatization of a tranche of ENEL shares should generate receipts in excess of this figure. During the period under examination past debts of 9.5 trillion lire were settled, compared with 2.4 trillion a year earlier. The QRBR of last March scheduled debt settlements of almost 12 trillion for the year as a whole.

The borrowing requirement for the first nine months was covered by issuing 83.7 trillion lire of medium and long-term securities, offsetting net redemptions of other forms of financing and a large increase in the balances on the Treasury's accounts with the Bank of Italy. The average residual maturity of the public debt lengthened from 4.9 years at the end of 1998 to 5.5 years. Net redemptions of Treasury bills and Treasury credit certificates (15.8 and 36.6 trillion respectively) led to a further reduction in the sensitivity of interest expenditure to interest rate changes. Net redemptions of foreign loans came to 8.1 trillion.

According to the EFPD for 1999-2001, the ratio of general government debt to GDP should fall by 3.6 percentage points in 1999. The EFPD for 2000-2003 and the FPR of September indicate a smaller reduction, from 116.8 per cent in 1998 to 115.7 per cent. The difference reflects mainly a revision of the estimate for GDP growth. In 1998 the ratio of debt to GDP had diminished by 3.5 percentage points. The smaller reduction expected this year reflects a number of factors: a slowdown in GDP growth from 4.2 per cent to an estimate of 3.0 per cent for 1999; a build-up of the Treasury's balances with the Bank of Italy; an increase of about 5 trillion in settlements of debts; and the behaviour of the euro exchange rate, which on the basis of the latest figures caused the lira value of liabilities denominated in dollars and yen to rise by more than 9 trillion (in 1998 the appreciation of the lira had reduced their lira value by more than 1 trillion). Privatization proceeds, which totalled about 14 trillion lire in 1998, should have an effect in the opposite direction.

Objectives and forecasts in the euro area

Budgetary policy in the euro area countries is geared towards gradually achieving a budget position close to balance or in surplus, in accordance with the Stability and Growth Pact. The stability programmes submitted between December 1998 and February 1999 indicated that general government net borrowing in the countries of the area would be reduced by an average of 0.5 per cent of GDP in 1999 (to 1.8 per cent) and by 0.2 per cent in 2000 (Table 15). A slight fall in the ratio of debt to GDP was forecast, amounting to 2.1 percentage points over the two years.

Table 15

General government net borrowing, expenditure, revenue and debt in the euro area and the EU (1)
(as a percentage of GDP)

	1998		1999		2000	
	Euro 11	EU	Euro 11	EU	Euro 11	EU
Net borrowing						
Objectives	2.3	1.6	1.8	1.4	1.6	1.2
1998 outturn and forecasts						
– EU Commission	2.1	1.5	2.0	1.5	1.7	1.3
– OECD (2)	2.1	1.6	2.0	1.6	1.7	1.4
– IMF	2.1	1.5	1.8	1.4	1.1	0.9
Cyclically-adjusted net borrowing (2)						
OECD	1.6	1.3	1.3	1.1	1.2	1.0
IMF	1.1	0.8	0.8	0.6	0.4	0.2
Revenue and expenditure						
EU Commission						
Total expenditure	49.0	48.1	48.7	47.9	48.2	47.4
Interest payments	*4.6*	*4.5*	*4.3*	*4.3*	*4.1*	*4.0*
Current revenue	46.9	46.6	46.8	46.5	46.5	46.1
Debt						
Objectives	73.7	69.6	72.8	68.6	71.6	67.2
1998 outturn and forecasts						
– EU Commission	73.4	69.6	72.7	68.7	71.4	67.1

Sources: Stability and convergence programmes submitted between December 1998 and February 1999; EU Commission, *Spring Forecast*, June 1999; OECD, *Economic Outlook*, June 1999; IMF, *World Economic Outlook*, October 1999.
(1) Weighted averages based on nominal GDP expressed in ecus. – (2) Excluding Luxembourg.

The outturn for 1998 shows that the average net borrowing of the euro area was less than had been predicted in the stability programmes (2.1 per cent, against 2.3 per cent). On the basis of forecasts from the EU Commission, most of the countries in the area should achieve the net borrowing targets in 1999. According to recent IMF estimates, the average net borrowing of the euro area in 1999 should be in line with that shown in the programmes, but more up-to-date provisional forecasts suggest that a better result is possible; a reduction in relation to the preceding year of the order of that indicated in the programmes may be achieved.

The estimates from international organizations agree in foreseeing that the results for 2000 will also be almost in line with the programmes; all the countries are expected to have deficits of less than 2.2 per cent of GDP in that year. Likewise, the targets for reducing the ratio of debt to GDP should broadly be met in both 1999 and 2000.

The planned reduction in net borrowing for the EU as a whole (0.2 points in both 1999 and 2000) is smaller than that for the euro area. The decline indicated for the ratio of debt to GDP is larger (2.4 percentage points over the two years) owing to the budget surpluses of Sweden and Denmark and the more or less balanced budget in the United Kingdom. The forecasts from leading international organizations for 1999 and 2000 indicate that the objectives should be largely achieved.

The OECD and IMF estimates of cyclically adjusted budgets indicate that structural net borrowing should improve by 0.3 percentage points in the euro area and 0.2 in the EU as a whole in 1999. The OECD foresees a slight improvement of 0.1 percentage point in the structural balances of both areas in 2000, while the IMF estimates a larger improvement of 0.4 points. On the basis of provisional forecasts of interest expenditure, cyclically adjusted primary balances should remain virtually unchanged.

There is expected to be a very slight reduction in the relative size of budgets in 1999 and 2000. According to forecasts from the EU Commission, the ratio of total revenue to GDP is likely to decline marginally in the two years (by 0.4 percentage points for the euro area); similarly, primary expenditure as a proportion of GDP is expected to decrease by 0.3 percentage points.

THE SINGLE MONETARY POLICY AND FINANCIAL INTERMEDIARIES AND MARKETS IN ITALY AND THE EURO AREA

Monetary developments in Italy and the euro area

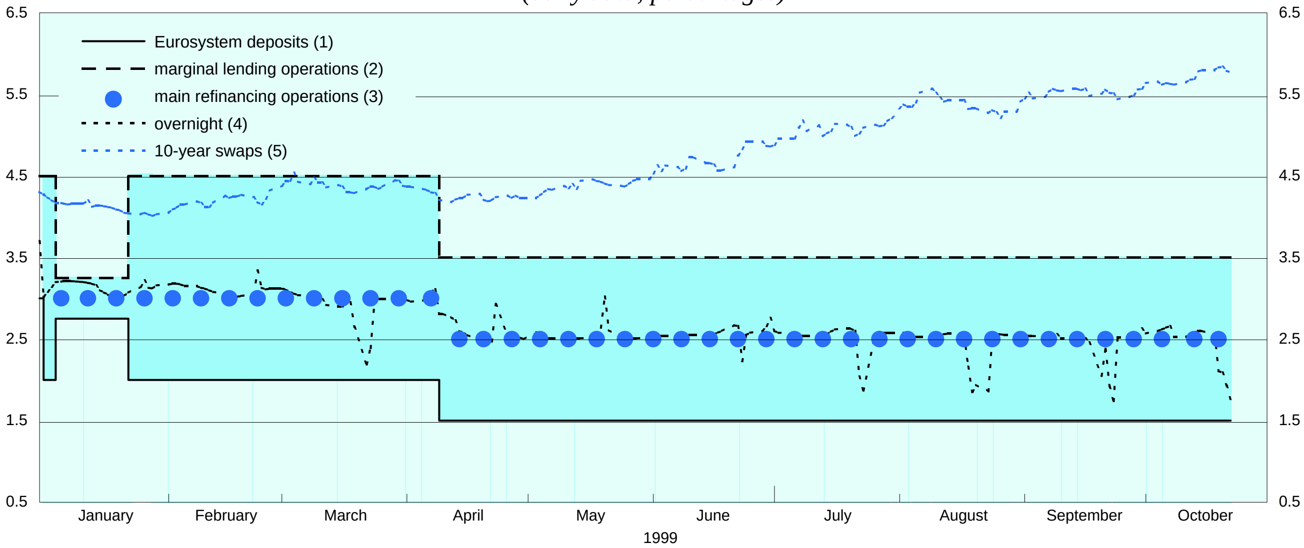
In the early months of this year, against a background of moderate inflation and weak economic activity in the euro area, conditions were ripe for the European Central Bank to take its first monetary policy measure. At its meeting on 8 April the Governing Council of the ECB lowered the interest rate on the ECB's main refinancing operations by half a percentage point to 2.5 per cent. At the same time the rate on the marginal lending facility was reduced by one point and that on the overnight deposit facility by half a point. Today, these rates, which delimit the corridor of official rates, are equal to 3.5 and 1.5 per cent, respectively (Figure 30). Money market rates came into line promptly: the three-month interbank rate, which had been just above 3 per cent from the beginning of the year, fell to 2.6 per cent in the middle of April. The reductions in the ECB's refinancing rates did not significantly affect longer-term rates in the area, which had already fallen to a particularly low level.

Long-term euro interest rates began to rise in May. An upward trend had already emerged in the United States at the end of 1998 in connection with the protraction of rapid economic expansion and fears of an acceleration in inflation. The transmission of this trend to the euro area was fueled by the signs of a pick-up in economic activity in the area, which have become more pronounced since the summer. Although the rise in the prices of raw materials, especially oil, and the weakening of the euro may have a temporary impact in the coming months, inflation expectations remain moderate.

Figure 30

Official interest rates and money and financial market rates

(daily data; percentages)



(1) Rate on the Eurosystem's overnight facility. - (2) Rate on the Eurosystem'smarginal lending facility. - (3) Rate on the Eurosystem's main refinancing operations. - (4) Euro overnight interest average (Eonia). - (5) Rate on Euromarket 10-year euro interest rate swaps.

The money market in Italy and the euro area

Since the very beginning of January the efficient working of the euro area's money market and payments system has ensured that monetary policy signals have been clear and transmitted promptly to the markets.

The Eonia rate has displayed low volatility: the standard deviation based on daily data was 0.19 per cent at an annual rate, with an increase in the few days before the end of reserve maintenance periods. The dispersion of yields in the national markets was even lower (1.5 basis points). The efficiency with which liquidity is redistributed is demonstrated by the limited recourse to the marginal refinancing facility and overnight deposits with national central banks. The simultaneous use of these two instruments was high in the area as a whole during the system's start-up phase but decreased dramatically from the end of February onwards, reaching significant levels only in the last few days of each reserve maintenance period. In the last six months recourse to the marginal lending facility in the area has averaged €400 million a day and that to overnight deposits €700 million.

The use of fixed-rate tenders for main refinancing operations, which are the Eurosystem's main instrument for controlling liquidity, has helped stabilize expectations about money market rates. Whenever demand for liquidity has exceeded the amount that the Eurosystem wishes to distribute, applications have been met only in part. The allotment ratio (the percentage of bids that is actually allotted) has shown a downward trend, falling from an average of 8.8 per cent in the first ten operations to 6.2 per cent in the last four months.

The differential between Eonia and the rate on main refinancing operations averaged 13 basis points in January and February and vanished in subsequent months, partly because Eonia has consistently declined in the last few days before the end of the maintenance period; in five periods the differential has been negative. Overall, it has not proved possible to earn profits by obtaining funds at tender and reinvesting them in the money market.

In Italy the average size of bids for main refinancing operations increased during the year to more than €7 billion at the beginning of October. An average of 40 banks have participated in the tenders.

The country breakdown of financing from the Eurosystem is determined by the liquidity needs of each banking system, which in turn are influenced by national factors. The proportion of financing allotted to Italian counterparties in main refinancing operations has increased during the year; on average it has been close

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Between the end of April and the middle of October the yields on ten-year government securities in the euro area rose by 1.5 percentage points to around 5.5 per cent. Over the same period the rates on equivalent US Treasury bonds rose by 0.9 points to 6.2 per cent.

The euro depreciated from the beginning of January to the middle of July by 13.5 per cent against the dollar and by 9.1 per cent in effective terms. In the following weeks it recovered, albeit with fluctuations, against the dollar but weakened against the yen. In the middle of October the euro had depreciated by 8.6 per cent both against the dollar and in effective terms.

The growth in the main monetary and credit aggregates indicates the prevalence of relaxed liquidity conditions in the area.

M3 for the area grew by 6.1 per cent in the twelve months ending in September; the three-month moving average rate of growth was 5.9 per cent, compared with the reference value of 4.5 per cent fixed by the ECB (Figure 31).

to the Italian banking system's share of the area's liquidity requirement and the changes in it are positively correlated with the differential between the overnight rate and the rate on main refinancing operations.

Italian counterparties have shown a low propensity to engage in longer-term refinancing operations; the liquidity obtained in this way has been equal to about one third of their main refinancing operations.

Liquidity management by Italian banks has also been notable for the limited recourse to the standing facilities; since the beginning of the year recourse to overnight deposits has averaged €77 million per day (9.6 per cent of the area total) and that to the marginal refinancing facility €25 million (2.4 per cent).

Since the beginning of the year the overnight rate struck on e-MID (1) has been broadly in line with Eonia and the volatility of the two rates has not differed significantly. The number of banks operating on e-MID has declined: the daily average so far this year is about 170, compared with 190 in 1998 as a whole. Trading has become even more concentrated among large institutions. Trading in overnight funds, the market's main instrument, has been 7 per cent lower this year than in the same period of 1998 and the volume of transactions for other maturities has contracted more sharply.

Two characteristics of e-MID make trades more transparent than in over-the-counter markets abroad: real-time access to all quotations via the screen-based network and the automation of trading and settlement procedures. Non-resident intermediaries are allowed to trade on a fully automated basis by opening an operating account with the Bank of Italy, which enables them to settle transactions within the Italian segment of the payment system (BI-REL). A semi-automated procedure has also been set up, which does not entail the opening of an operating account in Italy but requires the payment order to be input manually.

The integration of the national money markets within the euro area has been ensured by the good functioning of the TARGET system, which has handled transactions amounting to more than €27 billion a day in each direction between Italian banks and the rest of the area. The net amount of liquid funds lent or borrowed has averaged about €3 billion per day. These flows via TARGET have offset changes in domestic liquidity caused by autonomous factors and central bank operations.

(1) During 1999 the Italian interbank market turned itself into a joint stock company under the name of e-MID Spa (Electronic Market for Interbank Deposits).

Among the components of M3, current accounts grew particularly fast, rising by 14.8 per cent in response to the reduction in their opportunity cost brought by the fall in short-term yields. Deposits redeemable at a period of notice of up to three months (which, under the classification adopted by the Eurosystem, consist mainly of savings deposits) grew by 6.1 per cent, those with an agreed maturity of up to two years (primarily CDs) contracted, while marketable instruments (repos, shares in money market funds, money market paper and debt securities issued with a maturity of less than two years) remained unchanged.

As regards the counterparts of the monetary aggregates, credit to the private sector expanded strongly (by 10.5 per cent over the twelve months), while that to general government showed only limited growth (1.3 per cent). The liabilities towards residents in the area that are not included in M3 expanded by 5.6 per cent. The faster growth in credit than in fund-raising within the area was reflected in a rapid increase in net fund-raising abroad.

The signs of an economic upswing in the euro area have gradually became more pronounced and influenced expectations concerning the stance of

The new data on financial assets and credit

Publication of the new supplement to the Statistical Bulletin, *entitled* Aggregati monetari e creditzi dell'area dell'euro: le componenti italiane, *commenced in September; (1) the supplements* Base monetaria *and* Aggregati monetari e creditzi, *which contained statistics that were no longer appropriate to the changed situation, ceased to appear in March 1999.*

Publication of the Italian components of the monetary aggregates makes it possible to make a like-for-like comparison with the corresponding data for the other euro-area countries that release them. This will improve understanding of the monetary aggregates of the area, which play an important role in defining the strategies of the ECB. The data contained in the new publication also provide useful indications for analyzing portfolio decisions of national economic agents. An initial group of statistics relating to the Balance Sheet of the Bank of Italy and the Italian components of the euro area monetary aggregates accords with the harmonized matrix of the ESCB (see the box "The monetary aggregates for the euro-area and their Italian components", Economic Bulletin *No. 28, February 1999).*

A second group of data on financial and credit aggregates is not part of the harmonized matrix. Although they have been adapted so that they are consistent with the matrix, they are intended to ensure continuity with the data published in the past by the Bank of Italy. There are inevitably breaks due to the use of data on the entire Italian banking system in place of the so-called "Research Department sample" (see the box "New developments in the statistical information disseminated by the Bank of Italy", Economic Bulletin *No. 28, February 1999) and a definition of sectors that differs from the one used previously.*

The most important methodological change concerns the definition of the sector holding financial assets, represented by the "non-state sector" in the old matrix. The new definition coincides with that of the "money-holding sector" introduced by the ECB. It comprises all residents of Italy except monetary financial institutions (the Bank of Italy, banks and money market investment funds) and central government; by contrast with the "non-state sector", it includes non-money-market funds (Table 1).

In the case of credit, the "non-state sector" and the "state sector" have been replaced by "other residents" and "general government" respectively, but these changes in classification do not have a significant impact on the aggregated items "total domestic credit" and "total credit" (in other words, including loans from abroad; Table 2).

In the case of financial assets, the adoption of the new sectoral breakdown necessitated substantial changes in the previous matrix (figures based on the latter are to be found in Table D4 in the Italian edition of the Annual Report for 1998). The item "investment fund units" is no longer included among financial assets but reported as a memorandum item, and the assets of non-money-market funds are included directly among financial assets. In view of the large proportion of total financial assets consisting of investment fund units (21.1 per cent in December 1998), these modifications lead in some cases to pronounced changes in the behaviour of the components of financial assets.

Table 1

Definitions of the financial asset holding sector: mapping between the new and old statistical matrices

<table>
<tr><th colspan="3">New matrix</th><th colspan="3">Matrix used until December 1998</th></tr>
<tr><td colspan="2" rowspan="4">Monetary financial institutions</td><td>ECB</td><td colspan="3">Central bank</td></tr>
<tr><td>National central banks</td><td colspan="3"></td></tr>
<tr><td>Banks</td><td colspan="3">Banks</td></tr>
<tr><td>Money market investment funds</td><td colspan="3">Money market investment funds</td></tr>
<tr><td rowspan="9">Money-holding sector</td><td rowspan="7">Other residents</td><td>Non-money-market funds</td><td colspan="3">Non-money-market funds</td></tr>
<tr><td>Other financial institutions</td><td colspan="2">Other financial institutions</td><td rowspan="9">Non-state sector</td></tr>
<tr><td>Non-finanial enterprises</td><td colspan="2">Non-finanial enterprises and quasi-enterprises</td></tr>
<tr><td>Insurance companies</td><td colspan="2">Insurance companies</td></tr>
<tr><td>Households</td><td colspan="2">Households</td></tr>
<tr><td>Non-profit institutions serving households</td><td colspan="2">Non-profit institutions serving households</td></tr>
<tr><td></td><td colspan="2">Former autonomous government agencies (railways, monopolies, post office)</td></tr>
<tr><td rowspan="2">Other general government</td><td>Local authorities</td><td rowspan="6">General government</td><td>Local authorities</td></tr>
<tr><td>Social security institutions</td><td>Social security institutions</td></tr>
<tr><td colspan="2" rowspan="4">Central government</td><td>Other central governemnt agencies</td><td>Other central government agencies</td></tr>
<tr><td>State (budget and Treasury)</td><td>State (budget and Treasury)</td><td rowspan="3">State sector</td></tr>
<tr><td>Deposits and Loans Fund</td><td>Deposits and Loans Fund</td></tr>
<tr><td>Former autonomous agencies of central government (ANAS and state forests)</td><td>Former autonomous agencies of central government (ANAS and state forests)</td></tr>
</table>

cont.

Table 2

Growth in the financial and credit aggregates in accordance with the new and old statistical matrices
(end-of-period data; twelve-month percentage changes)

	New matrix (1)				Matrix used until December 1998			
	Total domestic credit	Total credit	Domestic financial assets	Total financial assets	Total domestic credit	Total credit	Domestic financial assets	Total financial assets
August 1998	–	–	–	–	4.6	4.4	4.3	6.0
September 1998	4.4	4.3	0.2	5.6	4.7	4.4	3.7	5.5
October 1998	4.1	4.1	0.3	5.5	4.5	4.4	3.6	5.2
November 1998	5.0	4.9	0.3	5.6	5.1	5.0	3.2	4.9
December 1998	4.4	4.4	0.2	5.6	4.7	4.6	2.3	4.2
January 1999	5.2	5.0	–0.5	5.6	–	–	–	–

(1) Provisional.

In particular, on the basis of the old statistics medium and long-term securities contracted by 9.7 per cent in 1998; using the current definition, which includes securities purchased by residents indirectly via non-money-market funds, the item rose by 6.5 per cent over the same period (Table 3).

Similarly, foreign assets increased by 42.2 per cent in 1998, compared with 20.9 per cent on the basis of the old definition, and their share of total financial assets at the end of the year was 17.1 per cent, against 11.3 per cent according to the previous definition.

The reclassification also affects the figures on movements in domestic financial assets, which remained broadly unchanged in 1998, whereas the statistics based on the old definition had them increasing by 2.3 per cent (Table 2). The differences in growth rates between the new and previous methods of calculation are due to the above-mentioned changes in the sample of Italian banks and in the definition of sectors.

(1) The English translation of the new supplement will also be published shortly.

Table 3

Credit and financial assets according to the new statistical matrix (1)
(end-of-period data; percentages)

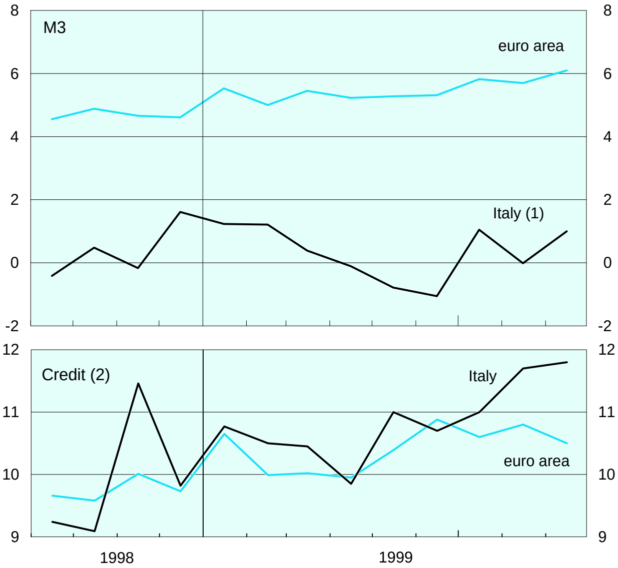
	12-month percentage changes		Percentage shares of stocks	
	December 1998	June 1999	December 1998	June 1999
Total credit	**4.4**	**6.9**	**100.0**	**100.0**
General government debt (2)	1.5	3.0	61.5	60.6
Total finance to "other residents"	9.2	13.3	38.5	39.4
Bank lending	9.0	10.5	34.2	34.2
Bonds	–28.6	–2.0	0.3	0.3
Loans from abroad	15.4	39.9	4.0	4.9
Financial assets of the "money-holding sector" (3)	**5.6**	**6.5**	**100.0**	**100.0**
Domestic	0.2	–0.8	82.9	77.7
Monetary assets, other deposits and BOTs	–5.3	–4.9	45.5	41.9
Medium and long-term securities	6.5	6.1	35.1	34.1
Other financial assets (4)	43.1	–19.0	2.2	1.8
Foreign	42.2	44.8	17.1	22.3

(1) Provisional. Data on items with the rest of the world may be subject to revision once the work to bring the balance-of-payments statistics into line with the new IMF standards has been completed. Rounding of decimals may cause discrepancies. – (2) According to the EU definition. – (3) All Italian residents other than MFIs and central government. – (4) Include companies' security deposits and shares held by non-money-market funds.

monetary policy; this has contributed in the last few weeks to the rise in interest rates spreading to the short end of the market. Since the end of September the three-month rate has risen to 3.5 per cent, also owing to expectations of a temporary increase in the first few days of 2000. Futures contracts on Euromarket interest rates currently reveal that short-term euro interest rates are expected to have risen to 3.7 per cent by March of next year (Figure 32).

Figure 31

Monetary and credit aggregates for the euro area and the Italian components
(monthly data; percentage changes on year-earlier period)



(1) Italian contribution to euro-area M3. - (2) Financing granted by MFIs to euro-area residents other than general government and MFIs.

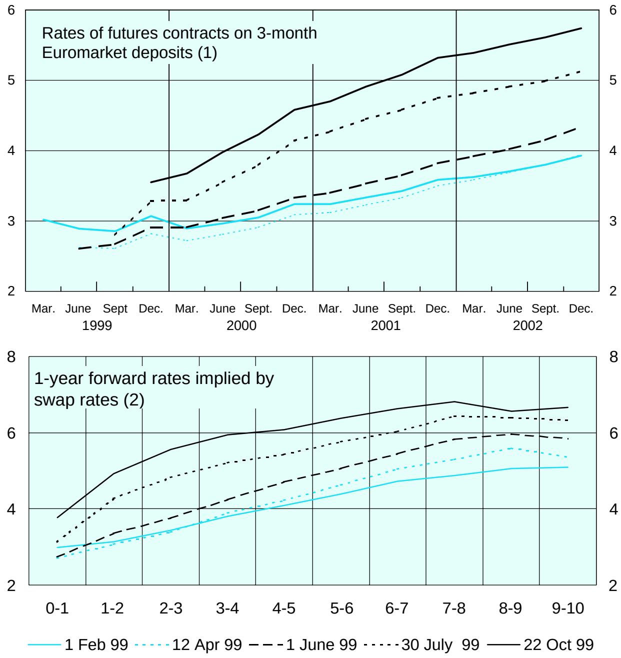
Monetary developments in Italy showed similar trends to those of the euro area for credit and interest rates but were marked by slower growth in bank fund-raising, especially as regards the components included in M3.

The short-term rates observed in the market for interbank deposits in euros (e-MID) were aligned with the average for the euro area from early January onwards, demonstrating that the European liquidity market had rapidly achieved a high degree of integration and efficiency.

The interest rate on benchmark ten-year BTPs rose to 5.6 per cent in the middle of October, an increase of 1.7 percentage points compared with the level at the beginning of the year. The rate differential with respect to the Bund remained within a band ranging from 0.2 to 0.3 percentage points.

Figure 32

Euro yield curve in the Euromarket
(percentages)



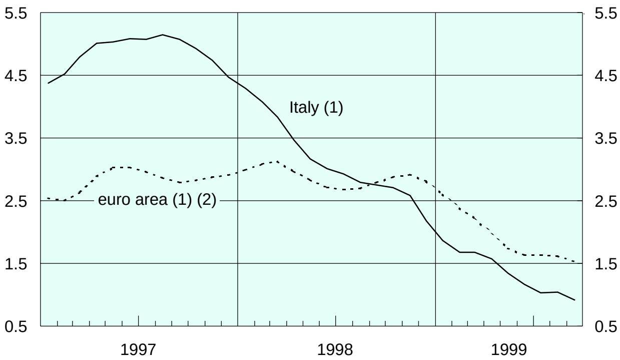
(1) The horizontal axis shows the settlement dates for the futures contracts to which the yields refer. The date on which the contract was concluded is shown in the legend. - (2) The horizontal axis shows the period to which the yield refers, expressed in years from the contract date indicated. The date on which the contract was concluded is shown in the legend.

The short-term interest rate adjusted for the rise in the Italian consumer price index in the twelve preceding months, which had already fallen by more than 2 percentage points in 1998, fell further in the first seven months of this year, declining by around one percentage point. The real short-term yield is currently around 1 per cent, or 0.6 percentage points less than the euro-area average (Figure 33). On the basis of the forward yields derived from Euromarket futures contracts and the inflation expectations of professional forecasters, the real short-term rate of interest expected at the end of 2000 is around 1.5 per cent in Italy and the euro area (Figure 34).

In Italy credit supply conditions remained relaxed. Bank lending rates fell substantially for all maturities. The cost of medium and long-term financing began to rise again in August, in the wake of the increase in securities yields in the preceding months. The increase in bank lending rates was much smaller than that in securities yields and in the case of lending to households was smaller than in the rest of the euro area. The spread between lending and deposit rates narrowed for all maturities to the lowest levels since the sixties.

Figure 33

Real short-term interest rates in Italy and the euro area
(monthly data; percentages)



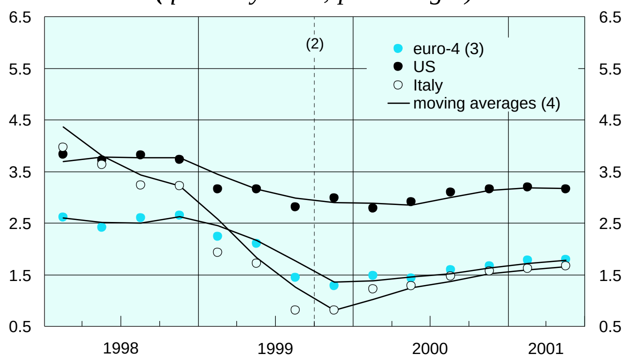
(1) Three-month Libor rates deflated using the change in the harmonized consumer price indices in the preceding 12 months. - (2) From January 1999 onwards, average of the interest rates of all the euro-area countries, weighted using each country's GDP at current prices in national currency, translated using purchasing power parities (averages for the three years 1994-96); up to January 1999, averages for France, Germany, Italy and Spain.

Domestic credit expanded substantially, in line with the rest of the euro area. The growth in medium and long-term lending to households made a major contribution, and financing from abroad also increased sharply.

Italy's contribution to euro-area M3 showed a small increase of 1 per cent in the twelve months ending in September. The rapid growth in currency (10.3 per cent) and current account deposits (13.1 per cent) was offset by the contraction in repos and in deposits and debt securities with maturities up to two years. The sharp expansion in the most liquid components can be attributed primarily to the fall in their opportunity cost: after falling by more than half a percentage point in the second half of 1998, the yield differential between three-month Treasury bills and current account deposits declined by another 0.7 points in 1999 to reach 1.3 points. Non-M3 bank liabilities towards euro-area residents grew by 7 per cent; the growth in debt securities issued with a maturity of more than two years continued at a rapid pace (13.3 per cent).

Figure 34

Expected and actual real interest rates on 3-month Euromarket deposits (1)
***(**quarterly data; percentages)*



(1) The nominal interest rate on Euromarket deposits deflated using the inflation expectations measured by the *Consensus Forecasts* quarterly survey with reference to the same time horizon. - (2) From December 1999 onwards, the interest rates are those on Euromarket futures contracts. - (3) The average of the interest rates for France, Germany, Italy and Spain, weighted using each country's GDP at current prices in national currency, translated using purchasing power parities (average values for the three years 1994-96). Based on OECD data. - (4) Moving average of each figure and the preceding one.

In June the total financial assets of the general public were 6.5 per cent up on the same month of 1998. The increase in the share of the foreign component, which rose from 17.1 to 22.3 per cent in the first six months of 1999, was primarily due to the very large volume of investments abroad made by investment funds, whose portfolios are attributed under the new classification introduced by the ECB to the holders of the shares.

Banking

The main items of banks' balance sheets have developed in parallel in Italy and the rest of the euro area in 1999 (Table 16). Lending to the economy has increased rapidly, outstripping domestic fund-raising; among the components of the latter, current accounts and debt securities have continued to grow at a lively pace. Banks' net liabilities towards non-residents of Italy have also increased (Table 17).

Table 16

Bank funding and lending in the euro area (1)

(harmonized definitions; billions of euros (2) and percentage changes on year-earlier period)

	Deposits (2)										Debt securities issued (3)		Loans (4)	
			excluding central government											
			Current account		With agreed maturity		Redeemable at notice		Repurchase agreements					
	Balances	% change	Balances	% change	Balances	% change	Balances	% change	Balances	% change	Balances	% change	Balances	% change
							Euro area (5)							
1998 – May	4,797.1		1,242.3		1,910.6		1,347.9		208.2		2,013.3		5,624.2	
June	4,824.6		1,289.8		1,890.8		1,346.5		203.4		2,042.4		5,682.1	
July	4,798.5		1,250.8		1,893.9		1,345.9		215.5		2,063.1		5,718.4	
Aug.	4,798.3		1,241.8		1,905.4		1,347.6		208.2		2,074.7		5,720.3	
Sept.	4,803.2	4.1	1,263.5	10.3	1,890.8	0.7	1,347.6	4.7	211.3	2.1	2,093.9	9.5	5,764.3	7.7
Oct.	4,821.8	4.1	1,268.8	10.6	1,889.2	0.0	1,350.8	4.8	222.3	7.4	2,096.9	9.0	5,804.6	7.6
Nov.	4,845.5	4.1	1,308.8	11.4	1,888.9	0.2	1,353.5	4.8	202.4	−6.2	2,112.8	9.0	5,855.7	7.7
Dec.	4,949.3	4.0	1,382.2	12.6	1,908.3	0.6	1,385.9	4.5	177.2	−13.7	2,113.9	9.5	5,911.6	7.6
1999 – Jan.	4,940.3	5.0	1,402.8	19.1	1,974.2	−0.3	1,310.3	4.4	171.2	−19.2	2,148.4	10.1	5,921.3	9.0
Feb.	4,929.3	4.3	1,375.9	16.5	1,971.5	−1.1	1,312.6	4.3	183.9	−13.0	2,173.7	9.8	5,930.7	8.6
Mar.	4,937.8	4.5	1,382.0	14.2	1,987.0	0.9	1,310.8	4.1	178.9	−13.8	2,193.6	9.7	5,972.1	8.6
Apr.	4,950.2	4.0	1,402.1	14.3	1,983.8	−0.2	1,314.2	4.3	172.3	−14.6	2,223.8	10.1	5,991.2	8.2
May	4,967.7	4.1	1,428.3	14.8	1,974.1	−0.7	1,314.1	4.2	172.5	−15.2	2,247.9	10.5	6,025.2	8.6
June	5,001.0	4.2	1,473.8	14.1	1,959.9	−0.4	1,318.5	4.6	166.8	−16.0	2,269.4	9.9	6,115.5	8.9
July	5,004.9	4.9	1,464.3	16.9	1,976.9	0.4	1,320.8	4.8	164.0	−22.0	2,276.0	9.1	6,136.9	8.6
Aug.	4,988.8	4.5	1,436.1	15.5	1,987.1	0.3	1,320.0	4.6	162.5	−20.0	2,290.8	9.1	6,129.0	8.4
							Italy (6)							
1998 – May	571.8		316.7		113.7		60.0		76.4		223.8		704.2	
June	578.7		333.8		109.2		59.5		70.4		236.0		723.2	
July	560.1		314.0		106.7		59.0		74.7		236.9		725.5	
Aug.	556.1		308.6		104.3		59.4		77.7		239.8		716.4	
Sept.	555.5	−5.0	310.3	9.2	103.6	−32.7	59.8	0.2	75.5	−6.8	241.7	27.4	719.0	7.7
Oct.	563.7	−3.5	312.5	8.0	102.4	−31.1	59.2	−0.5	82.9	1.5	244.0	24.9	718.3	7.5
Nov.	553.9	−3.6	311.8	10.1	101.0	−29.4	59.4	0.4	74.4	−12.1	247.8	24.0	734.3	9.3
Dec.	577.6	−2.1	348.7	12.5	100.5	−27.3	61.2	−0.6	60.0	−19.6	251.0	23.1	752.1	8.2
1999 – Jan.	577.0	−1.2	349.0	17.0	97.6	−26.6	60.8	0.2	61.2	−29.4	251.0	21.9	753.8	8.8
Feb.	570.2	−1.0	338.5	14.3	94.3	−26.7	60.1	0.5	69.2	−19.6	254.5	21.1	754.7	8.7
Mar.	566.7	−1.8	342.2	10.6	92.8	−25.2	59.3	−0.8	64.5	−17.7	256.4	19.2	758.7	8.5
Apr.	569.6	−1.0	351.6	11.1	90.2	−24.5	59.4	−0.2	60.7	−19.1	258.5	18.6	760.9	8.4
May	566.3	−1.2	352.6	11.2	87.9	−23.6	59.3	−1.2	58.7	−23.2	261.7	17.3	763.3	9.3
June	572.3	−1.3	364.4	9.1	86.5	−21.7	59.2	−0.5	54.5	−22.6	263.8	11.7	785.4	9.4
July	565.9	0.7	357.4	13.7	84.5	−22.0	59.6	1.0	57.0	−23.8	263.2	11.1	789.6	9.7
Aug.	553.9	−0.7	345.2	11.7	83.5	−21.4	59.9	0.7	57.8	−25.7	264.0	10.0	783.4	10.1

(1) End-of-period data; the percentage changes are adjusted to take account of reclassifications, other revaluations, exchange rate variations and any other changes which do not arise from transactions. The data are consistent with those published in the *Monthly Bulletin* of the ECB. – (2) Denominated in euros and other currencies. – (3) By convention they are attributed entirely to residents in the reporting country. – (4) Including bad debts and repos. – (5) Funding and lending of the monetary financial institutions (MFIs) of the euro-area countries (excluding the Eurosystem) from and to non-MFI customers resident in the area. – (6) Funding and lending of Italian MFIs (excluding the Bank of Italy) from and to non-MFI customers resident in Italy.

Table 17

Main items of banks' balance sheets (1)

(end-of-period data; percentage changes on year-earlier period; billions of lire and, in brackets, millions of euros)

	1997	1998	1999			Balances August 1999	
			March	June	August	Lire	euros
Assets							
Securities	−10.5	1.1	−0.4	−1.5	−0.6	343,352	(177,327)
government securities (2)	*−11.3*	*−2.8*	*−2.5*	*−3.6*	*−2.7*	*281,806*	*(145,540)*
Loans (2) (3)	5.4	6.0	6.2	8.4	8.6	1,274,434	(658,190)
short-term	5.5	5.7	5.4	7.4	6.2	626,789	(323,710)
medium and long-term (3)	5.3	6.4	7.0	9.4	11.0	647,645	(334,481)
Repos	−27.8	41.7	16.9	1.3	0.7	11,898	(6,145)
Bad debts	−2.5	2.2	1.1	−4.5	−3.8	120,636	(62,303)
Bad debts at estimated realizable value	*−4.5*	*−1.0*	*0.5*	*−12.9*	*−6.1*	*63,245*	*(32,664)*
External assets (2)	2.1	5.8	−5.7	−11.2	−13.2	290,512	(150,037)
Liabilities							
Domestic funding (4)	3.0	1.8	1.9	2.3	2.2	1,401,250	(723,685)
Deposits (averages) (5)	−7.7	−1.2	0.4	3.2	4.2	848,034	(437,973)
current accounts	*9.2*	*13.1*	*13.0*	*14.8*	*15.8*	*622,550*	*(321,520)*
short-term CDs	*27.4*	*−13.4*	*−18.0*	*−22.4*	*−19.9*	*61,764*	*(31,899)*
medium and long-term CDs	*−49.0*	*−45.3*	*−42.2*	*−38.4*	*−39.9*	*52,559*	*(27,144)*
Bonds	34.8	15.4	11.4	8.6	7.1	451,489	(233,175)
Repos	10.6	−18.0	−17.0	−25.0	−24.7	101,727	(52,538)
External liabilities (2)	6.3	−0.1	−8.7	−9.1	1.3	429,450	(221,792)

(1) The figures for August 1999 are provisional. The adjustments described in notes 2 and 3 relate only to the percentage changes. – (2) The foreign currency component is net of exchange rate adjustments. – (3) Adjusted for the effects of the transactions in January 1997 between Banco di Napoli and the non-bank company SGA. – (4) For deposits, monthly averages of daily data; for bonds, end-of-period data. — (5) In lire and other euro-area currencies; partly estimated.

Loans granted by Italian banks to residents increased in the first eight months of the year by 8.9 per cent on a seasonally adjusted annual basis, compared with 6 per cent in the whole of 1998 (Table 18). Growth was stimulated by the easy conditions of supply: the ratio of credit drawn to total overdraft facilities on current accounts fell by more than two percentage points compared with the corresponding period of 1998 and the spread between the average interest rate on short-term loans and the minimum rate narrowed by 0.4 percentage points to 2.5 points.

The acceleration in lending was common to the whole country (Table 18): in the first eight months of the year it amounted to 9.4 per cent in the Centre and North and to 4.6 per cent in the South, compared with 6.6 and 2.5 per cent respectively in the whole of 1998. The differential between short-term lending rates in the Centre and North and those in the South narrowed by 0.2 percentage points in 1999 to 1.8 points.

The increase in short-term lending of 6 per cent in the first eight months was slightly larger than that recorded in 1998 and was marked by two temporary spurts: the first in January, in connection with the introduction of the single currency, and the second in June as a result of the financing granted to the companies that took part in the acquisition of Telecom.

The sharp acceleration in the growth of medium and long-term credit, from 6.4 per cent in 1998 to 12.6 per cent in the first eight months of 1999, mainly reflected the rapid expansion in mortgage loans to consumer households (23.4 per cent in the twelve months ending in August) in response to the low level of interest rates, the recovery in the property market and the incentives for the renovation of residential buildings.

Table 18

Bank lending (1)

(end-of-period data; percentage changes; billions of lire and, in brackets, millions of euros)

	Changes on previous period									
	Short-term		Medium and long-term (2)		Total (2)		Centre and North (3)		South (2) (3)	
	Absolute change	Percentage change	Absolute change	Percentage change	Absolute change	Percentage change	Absolute change	Percentage change	Absolute change	Percentage change
1997	30,876	5.5	28,230	5.3	59,106	5.4	57,211	6.1	1,895	1.2
1998	33853	5.7	36,358	6.4	70,210	6.0	66,000	6.6	4,210	2.5
1998 – 1st qtr.	–8659	4.8	4,438	5.2	–4,221	5.2	–6,237	5.6	2,016	1.6
2nd ”	10,004	4.3	9,410	5.7	19,414	4.4	19,368	3.9	46	0.5
3rd ”	–2,505	7.8	1,517	6.0	–988	6.9	–1,558	7.0	570	5.3
4th ”	35,013	5.8	20,993	8.5	56,005	8.2	54,428	10.0	1,578	3.0
1998 – first 8 months (4)	–2,928	5.1	12,440	5.6	9,512	5.3	8,890	5.5	623	1.1
1999 – 1st qtr.	–10,937 *(–5,648)*	4.2	8,247 *(4,259)*	7.7	–2,690 *(–1,389)*	5.4	–5,870 *(–3,031)*	6.2	3,180 *(1,642)*	4.1
2nd ”	22,101 *(11,414)*	12.2	23,974 *(12,382)*	15.5	46,075 *(23,796)*	13.1	45,450 *(23,473)*	13.6	625 *(323)*	2.1
1999 – first 8 months (4) (5)	–148 *(–76)*	6.0	40,257 *(20,791)*	12.6	40,109 *(20,715)*	8.9	35,406 *(18,286)*	9.4	4,703 *(2,429)*	4.6
	Balances									
	Short-term		Medium and long-term		Total		Centre and North		South	
1999 – August (5)	626,789 *(323,710)*		647,645 *(334,481)*		1,274,434 *(658,190)*		1,099,531 *(567,860)*		174,903 *(90,330)*	

(1) The figures disaggregated by geographical area are partly estimated. The changes in the foreign currency component are net of exchange rate adjustments. The quarterly percentage changes and those from the beginning of the year are seasonally adjusted and annualized. – (2) Adjusted for the effects of the transactions in January 1997 between Banco di Napoli and the non-bank company SGA.– (3) The calculation of the seasonal component of lending by geographical area is based on a shorter period than that used for the seasonal adjustment of total lending. – (4) Changes in the first 8 months on the basis of seasonally adjusted data; the percentage changes are calculated with reference to the figure for the preceding December and annualized. — (5) Provisional.

The slowdown in the growth in lending to non-financial enterprises, from 6.4 per cent in December 1998 to 4.6 per cent in June 1999 (Table 19), was concentrated in the industrial sector, while the financing of services companies and sole proprietorships accelerated. There was also a substantial increase in lending to financial companies, especially consumer finance, leasing and factoring companies, whose business expanded rapidly.

The writing-off of bad debts, in part by means of securitization operations, helped to bring their ratio to total lending down from 9.1 per cent at the end of 1998 to 8.6 per cent in August. The gross flow of new bad debts in the first half of the year amounted to 0.7 per cent of total lending, compared with 0.81 and 0.66 in the first and second half of 1998, respectively.

The interest rate on short-term loans in Italy fell from 6.7 to 5.9 per cent in the first quarter of 1999 (Figure 35); it came down by another 0.6 percentage points between April and August in response to the half-point cut in the rate on the ECB's main refinancing operations. The fall in this period was

Table 19

Bank lending and bad debts by sector of economic activity (1)
(percentages)

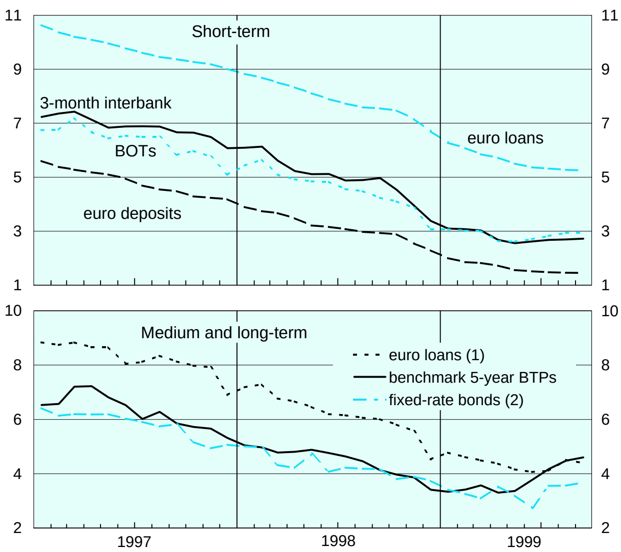
	General govern-ment (2)	Finance and insurance compa-nies (3)	Enterprises						Households		Total (3)
				Holding companies	Non-financial enterprises						
						Industry excluding construction	Construction	Services	Consumers	Sole proprietor-ships	
						12-month percentage changes in lending					
1997 – December . .	1.7	21.7	4.2	3.1	4.3	7.3	–5.2	5.0	7.7	2.5	5.4
1998 – June	–7.2	8.6	6.4	–2.7	7.1	9.3	0.0	7.1	9.8	1.2	5.1
1998 – December . .	–4.3	10.5	5.6	–3.4	6.4	6.2	–0.1	8.8	12.6	4.2	6.0
1999 – June	5.0	16.1	5.5	17.1	4.6	3.0	–0.2	9.7	17.2	6.8	8.4
						12-month percentage changes in bad debts					
1997 – December (4)	–22.5	–17.5	–5.9	–15.6	–5.5	–8.1	–2.7	–3.2	13.1	–4.6	–2.5
	–16.3	*0.0*	*5.5*	*–8.6*	*6.1*	*0.1*	*13.3*	*4.9*	*20.1*	*2.5*	*7.1*
1998 – June (5)	–60.8	37.6	4.0	–14.6	4.7	0.7	6.1	8.7	10.7	4.5	5.5
	–60.8	*38.9*	*6.9*	*–10.1*	*7.5*	*1.5*	*11.3*	*10.4*	*13.7*	*5.1*	*7.8*
1998 – December . .	–92.8	–2.3	0.5	–12.9	1.0	–6.3	6.8	3.0	8.5	3.9	2.2
1999 – June	–58.4	–38.8	–6.4	–2.4	–6.5	–9.0	–3.2	–7.4	0.4	0.3	–4.5
						Ratio of bad debts to total lending (6)					
1997 – December . .	0.6	2.0	9.7	4.7	10.1	6.5	20.6	9.6	11.5	15.9	9.4
1998 – June	0.3	2.8	10.0	4.9	10.3	6.3	21.7	10.0	11.4	16.2	9.6
1998 – December . .	0.0	1,8	9.3	4.2	9.7	5.8	21.7	9.2	11.1	15.9	9.1
1999 – June	0.1	1.5	8.9	4.2	9.3	5.6	21.2	8.5	9.9	15.4	8.6
						Interest rates on short-term loans (7)					
1997 – December . .	8.10	7.15	9.04	6.97	9.20	8.63	10.61	9.44	10.83	11.23	9.13
1998 – June	7.21	5.97	8.04	6.35	8.13	7.52	9.67	8.45	9.91	10.16	8.10
1998 – December . .	6.05	4.81	6.92	4.87	7.04	6.49	8.46	7.39	8.72	9.18	6.89
1999 – June	4.65	3.41	5.49	3.83	5.58	5.00	7.15	5.92	7.29	7.85	5.48
						Percentage composition of lending					
1998 – June	8.8	9.7	52.4	3.5	49.0	23.6	6.0	18.4	16.6	12.4	100.0
1999 – June	8.4	10.4	51.0	3.7	47.3	22.5	5.5	18.6	17.9	12.2	100.0

(1) The figures from June 1998 onwards were obtained by reaggregating the subgroups of the different sectors of economic activity according to the classification criteria in force until May. Changes in the foreign currency component are net of exchange rate adjustments. – (2) Includes loans raised by the State Railways with the costs borne by the government, as established by Eurostat. – (3) Percentage changes in lending are adjusted for the effects of the transactions in January 1997 between Banco di Napoli and the non-bank company SGA. – (4) The figures in italics are the percentage changes obtained after reattributing the bad debts transferred from Banco di Napoli to SGA and those retained on the books of Sicilcassa in liquidation. – (5) The figures in italics are the percentage changes obtained after reattributing the bad debts retained on the books of Sicilcassa in liquidation. – (6) The denominator includes bad debts. – (7) Up to December 1998 the interest rates refer to financing in lire; thereafter they refer to financing in lire and other euro-area currencies. Source: Central Credit Register data.

slightly more pronounced than that in the rate on loans to enterprises up to one year for the euro area as a whole (0.4 percentage points; Figure 36). The reduction in short-term bank lending rates in Italy from the beginning of the year was larger than past experience suggested was to be expected in the light of monetary conditions and the performance of the main macroeconomic aggregates. In the second quarter of 1999 the arithmetic mean of the interest rates on individual current account overdrafts of between 1 and 5 billion lire was 6.3 per cent, more than a full percentage point less than the cost of new current account overdrafts of similar size in Germany.

Figure 35

Bank interest rates in Italy



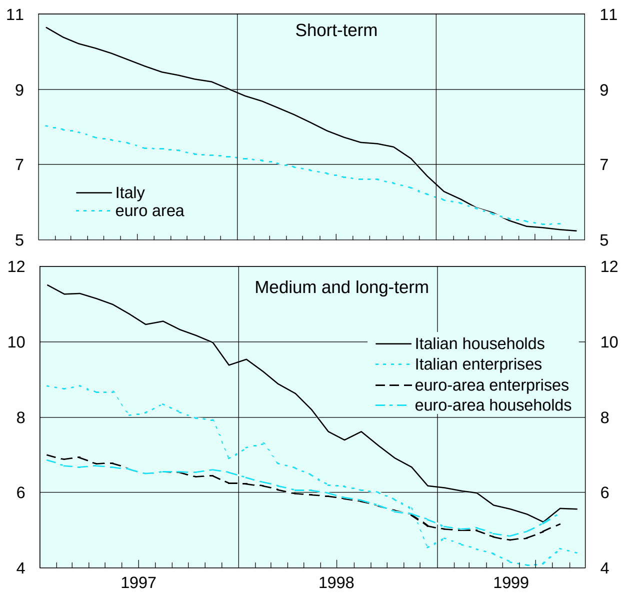
(1) Average rate on euro loans disbursed during the month to resident firms. - (2) Average rate on issues of euro bonds during the month.

In the first half of the year the interest rates on medium and long-term loans to households fell in Italy by more than twice the average for loans to households for house purchase in the euro area, declining by 0.7 as against 0.3 percentage points. Whereas in the rest of the euro area the cost of such financing rose by 0.25 percentage points in both July and August, in response to the general rise in medium and long-term interest rates, in Italy it continued to fall in July. The decline of 0.2 percentage points in that month was followed by a rise of 0.36 points in August and virtual stability in September. The reduction in the first half of the year in the interest rates on long-term loans to enterprises was entirely offset by the increases recorded in July and August.

Figure 36

Bank lending rates in Italy and the euro area

(monthly data; percentages)



Source: ECB. These euro-area retail bank interest rates should be used with caution and for statistical purposes only, primarily for analyzing their development over time rather than their level. They are calculated as the weighted average of national interest rates provided by the national central banks. The national rates represent those rates that are currently available from national sources and which are judged to fit the standard categories. The national interest rates are not harmonized in terms of their coverage (new business and/or outstanding amounts), the nature of the data (nominal or effective) or the compilation method.

Banks' total domestic fund-raising (deposits, bonds and repos) grew at a modest pace (2.2 per cent in the twelve months ending in August). The growth was entirely attributable to current account deposits, which increased overall by 15.8 per cent, and especially those of non-financial companies and investment funds. The further reduction in short-term CDs and savings deposits resulted in an increase in short-term fund-raising amounting to 4.1 per cent. Medium and long-term fund-raising declined slightly: the increase of 7.1 per cent in debt securities in issue was more than offset by the net redemptions of CDs with original maturities of more than 18 months.

Italian banks' funding rates came down less than their lending rates in the first eight months of the year: the average rate on deposits declined from 2.3 to 1.5 per cent, and the rate on currrent accounts from 1.7 to 1.1 per cent. The spread between the average short-term lending rate and the average deposit rate narrowed by 0.6 percentage points to 3.8 points in August, the lowest level since the beginning of the sixties. The cost of fixed rate bond issues declined until June; it then rose by half a point to 3.6 per cent in August.

Excluding exchange rate adjustments, Italian banks' net foreign borrowing increased by 60.2 trillion lire in the first eight months of 1999, compared with a reduction of 5.8 trillion in the corresponding period of 1998; the increase was the result of a fall of 44.6 trillion in assets and a rise of 15.6 trillion in liabilities. Their securities portfolios contracted by 3.8 trillion in the same period, compared with an increase of 1.9 trillion in the first eight months of 1998.

Banks' profitability continued to be positive. The fall of 6.5 per cent in net interest income compared with the first half of 1998 and that of 20 per cent in income from securities and foreign exchange trading were more than offset by the increase of 16 per cent in income from services and that of nearly 100 per cent in dividends, which consisted largely of 1998 profits distributed by companies within banking groups.

Operating costs remained virtually unchanged, with a reduction of 1.7 per cent in staff costs as a result of a fall of equal size in the number of employees. Value adjustments to asset items decreased by 13.8 per cent. The return on equity of the banking system amounted to 10 per cent on an annual basis, compared with 8 per cent in the first half of 1998.

July saw the renewal of the national labour contract of the banking industry, which had expired 18 months earlier. The new contract contains numerous innovations aimed at curbing the rise in labour costs, increasing labour flexibility and linking earnings more closely to productivity, in accordance with the guidelines established in the February 1998 agreement reached between the Italian Bankers' Association, ABI, and the trade unions.

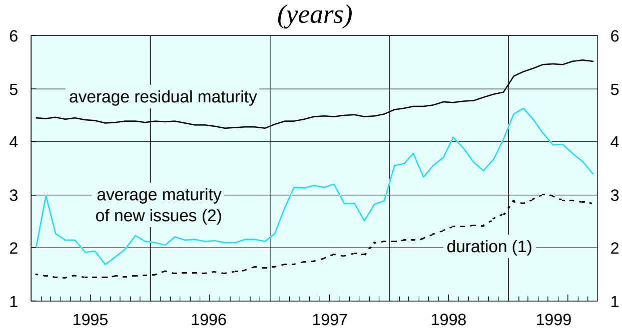
Financial markets

In the first nine months of 1999 the Treasury continued its policy of lengthening the average residual maturity of the public debt, which rose from 59 to 66 months (Figure 37). The duration of the debt increased somewhat less, from 32 to 34 months; the positive effect of the lengthening of the average maturity was diminished by the increase in medium and long-term yields.

Figure 37

Average maturity of outstanding government securities and of new issues

(years)



(1) Calculated with reference to securities listed on MTS. - (2) Moving average for the three months ending in the month indicated.

Net issues of government securities in the first nine months of the year amounted to €30.1 billion or 58.3 trillion lire (Table 20), a decrease of €4.4 billion in comparison with the corresponding period of 1998 that reflected the fall in the borrowing requirement. As in the first nine months of 1998 no buyback operations were carried out. Net issues of fixed-rate securities (BTPs) and zero-coupon securities (CTZs) amounted to €71.6 and €1.4 million, respectively. By contrast, there were net redemptions of BOTs and CCTs amounting to €8.2 and €18.9 billion, respectively. The share of short-term and variable rate securities in the total fell from 38 to 34 per cent.

The Treasury's net funding in international markets was negative (€3.4 billion, as against €0.3 billion in the corresponding period of 1998). Around one quarter of the stock of Republic of Italy issues is denominated in euros.

In the first six months of the year Italian investment funds acquired €8 billion of government securities, a very large reduction on the €53 billion acquired in the corresponding period of 1998 (Table 21); in particular, they made net purchases of BTPs amounting to €8.6 billion. Households and enterprises further reduced their direct holdings of government securities, despite substantial purchases of BTPs (€13.7 billion or three times the quantity bought in the corresponding period of 1998). Banks' net investments in government securities were virtually nil, even though they also substantially increased their net purchases of BTPs to €7.4 billion.

In the first six months of 1999 non-residents acquired €57.6 billion of government securities. At the end of June they held 36.2 per cent of the Italian public-sector securities in circulation, as against 32.2 per cent at the end of 1998.

The bonds placed abroad by residents of the leading euro-area countries increased considerably in the first nine months of 1999, while the volumes placed domestically were virtually unchanged (Table 22). The Euromarket issues made by Italian, French and German residents amounted to €194.1 billion, compared with €125.3 billion in the whole of 1998. The issues made in the three countries' domestic markets totaled €258.4 billion, with an average

Table 20

Issues and stocks of government securities (1)

(billions of lire and, in brackets, millions of euros)

	1998	1998 Jan. - Sept.	1999 Jan. - Sept.	1998	1999 September
		Gross issues (2)		**Stocks** (2) *(end-of-period data)*	
BOTs	425,768	330,768	302,542 *(156,250)*	266,768	250,974 *(129,617)*
CTZs	97,779	80,094	86,052 *(44,442)*	171,973	179,010 *(92,451)*
CCTs (3)	42,502	34,964	34,820 *(17,983)*	525,403	488,513 *(252,296)*
BTPs	261,441	206,520	240,228 *(124,067)*	908,508	1,046,581 *(540,514)*
Other	38	16	0 *(0)*	114,151	89,887 *(46,423)*
Republic of Italy issues	17,949	13,889	19,581 *(10,113)*	102,717	104,974 *(54,215)*
Total	**845,476**	**666,251**	**683,222** ***(352,855)***	**2,089,521**	**2,159,939** ***(1,115,515)***
		Net issues		*(percentage composition)*	
BOTs	–35,482	–23,982	–15,794 *(–8,157)*	12.8	11.6
CTZs	6,598	22,194	2,771 *(1,431)*	8.2	8.3
CCTs (3)	–42,097	–23,175	–36,606 *(–18,905)*	25.1	22.6
BTPs	149,343	125,566	138,703 *(71,634)*	43.5	48.5
Other	–38,090	–33,153	–24,167 *(–12,481)*	5.5	4.2
Republic of Italy issues	3,454	–596	–6,641 *(–3,430)*	4.9	4.9
Total	**43,726**	**66,854**	**58,266** ***(30,092)***	**100.0**	**100.0**
Buybacks and redemptions	**20,161**	**0**	**0** ***(0)***		

(1) Rounding may cause discrepancies in totals. – (2) Face values. The item comprises buybacks and redemptions drawing on the sinking fund for the redemption of government securities. – (3) Floating rate issues only.

Table 21

Stocks and net purchases of securities (1)

(billions of lire and, in brackets, millions of euros)

	Government securities						Corporate bonds	Total public sector securities and corporate bonds	Italian listed shares
	BOTs	CTZs	CCTs	BTPs	Other (2)	Total			
					Stocks				
June 1999									
Central bank	. .	687	10,133	26,856	76,208	113,884	370	114,253	12,186
	(. .)	*(355)*	*(5,233)*	*(13,870)*	*(39,358)*	*(58,816)*	*(191)*	*(59,007)*	*(6,294)*
Banks	42,486	22,724	118,329	95,774	8,961	288,274	66,706	354,980	11,314
	(21,942)	*(11,736)*	*(61,112)*	*(49,463)*	*(4,628)*	*(148,881)*	*(34,451)*	*(183,332)*	*(5,843)*
Investment funds	21,748	56,531	88,625	197,259	5,222	369,386	8,674	378,061	62,948
	(11,232)	*(29,196)*	*(45,771)*	*(101,876)*	*(2,697)*	*(190,772)*	*(4,480)*	*(195,252)*	*(32,510)*
Non-residents (3)	121,180	58,047	111,134	378,667	118,314	787,340	. . . .	. . . .	. . . .
	(62,584)	*(29,979)*	*(57,396)*	*(195,565)*	*(61,104)*	*(406,627)*	*(. . . .)*	*(. . . .)*	*(. . . .)*
Other investors (4)	75,991	41,643	161,225	324,374	10,711	613,945	. . . .	. . . .	. . . .
	(39,246)	*(21,507)*	*(83,266)*	*(167,525)*	*(5,532)*	*(317,076)*	*(. . . .)*	*(. . . .)*	*(. . . .)*
Total	**261,404**	**179,634**	**489,446**	**1,022,930**	**219,414**	**2,172,828**	**487,774**	**2,660,601**	**950,379**
	(135,004)	***(92,773)***	***(252,778)***	***(528,299)***	***(113,318)***	***(1,122,172)***	***(251,914)***	***(1,374,086)***	***(490,830)***
					(percentage shares)				
Central bank	0.0	0.4	2.1	2.6	34.7	5.2	0.1	4.3	1.3
Banks	16.3	12.7	24.2	9.4	4.1	13.3	13.7	13.3	1.2
Investment funds	8.3	31.5	18.1	19.3	2.4	17.0	1.8	14.2	6.6
Non-residents (3)	46.4	32.3	22.7	37.0	53.9	36.2	. . . .	. . . .	. . . .
Other investors (4)	29.1	23.2	32.9	31.7	4.9	28.3	. . . .	. . . .	. . . .
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
					Net purchases *(billions of lire)*				
January – June 1999									
Central bank	−230	−93	−1,574	−1,990	−172	−4,060	33	−4,027	155
	(−119)	*(−48)*	*(−813)*	*(−1,028)*	*(−89)*	*(−2,097)*	*(17)*	*(−2,080)*	*(80)*
Banks	−4,066	1,359	−13,207	14,253	2,194	532	5,880	6,413	353
	(−2,100)	*(702)*	*(−6,821)*	*(7,361)*	*(1,133)*	*(275)*	*(3,037)*	*(3,312)*	*(2,450)*
Investment funds	−2,930	−13,019	15,337	16,636	−610	15,415	2,205	17,620	−13,761
	(−1,513)	*(−6,724)*	*(7,921)*	*(8,592)*	*(−315)*	*(7,961)*	*(1,139)*	*(9,100)*	*(−7,107)*
Non-residents (3)	35,589	30,241	−14,288	61,358	−1,282	111,618	−155	111,463	. . . .
	(18,380)	*(15,618)*	*(−7,379)*	*(31,689)*	*(−662)*	*(57,646)*	*(−80)*	*(57,566)*	*(. . . .)*
Other investors (4)	−33,726	−13,976	−21,979	26,616	−17,918	−60,983	9,768	−51,214	. . . .
	(−17,418)	*(−7,218)*	*(−11,351)*	*(13,746)*	*(−9,254)*	*(−31,495)*	*(5,045)*	*(−26,450)*	*(. . . .)*
Total	**−5,363**	**4,512**	**−35,711**	**116,873**	**−17,789**	**62,522**	**17,732**	**80,255**	**3,266**
	(−2,770)	***(2,330)***	***(−18,443)***	***(60,360)***	***(−9,187)***	***(32,290)***	***(9,158)***	***(41,448)***	***(1,687)***

(1) Stocks of government securities and corporate bonds are stated at face value, while those of shares are stated at market value; net purchases are stated at market value. – (2) Includes Republic of Italy loans and other public sector securities. – (3) Non-residents' holdings of CTZs are partly estimated. – (4) Households, enterprises, social security institutions, the Deposits and Loans Fund, securities investment firms and insurance companies; the figures for shares are partly estimated.

monthly flow analogous to that recorded in 1998. The large increase in Eurobond issues was stimulated by the elimination of the exchange rate risk, which reduced the segmentation of the market in the euro area. It may also have reflected a strategy on the part of issuers aimed at acquiring visibility in the euro-area bond market by means of highly liquid issues.

Table 22

Bond issues in the leading euro-area countries (1)
(millions of euros for 1999; millions of ecus for 1997-98)

	1997		1998		1999
	H1	H2	H1	H2	9 months
Italy					
Domestic market	4,300	3,800	14,000	17,200	20,900
fixed rate	*1,500*	*2,400*	*10,900*	*12,300*	*15,900*
Euromarket	6,800	4,400	11,300	6,800	43,400
fixed rate	*3,400*	*2,500*	*7,800*	*4,700*	*18,300*
France					
Domestic market	14,100	20,600	22,700	13,600	16,900
fixed rate	*11,300*	*13,100*	*21,200*	*11,500*	*15,000*
Euromarket	12,400	9,100	21,000	7,600	43,500
fixed rate	*7,400*	*4,800*	*15,900*	*7,000*	*29,700*
Germany					
Domestic market	75,200	94,400	136,000	142,900	220,600
fixed rate	*66,700*	*79,500*	*126,200*	*125,900*	*191,200*
Euromarket	45,500	23,100	53,400	25,200	107,200
fixed rate	*41,900*	*20,400*	*46,200*	*15,900*	*63,000*
Total					
Domestic market	93,600	118,800	172,700	173,700	258,400
fixed rate	*79,500*	*95,000*	*158,300*	*149,700*	*222,100*
Euromarket	64,700	36,600	85,700	39,600	194,100
fixed rate	*52,700*	*27,700*	*69,900*	*27,600*	*111,000*

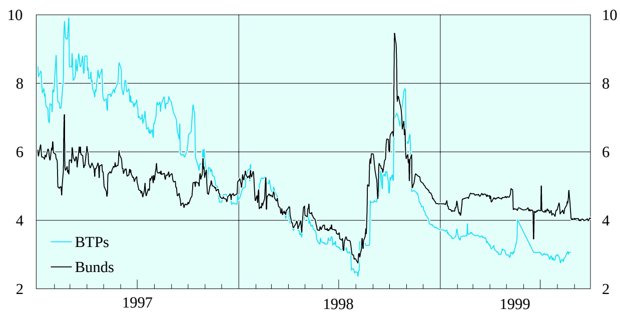
Source: Capital Data.
(1) Issues include private placements. Domestic market issues do not include issues of government securities. The fixed-rate component includes issues with warrants and zero-coupon bonds. The amounts are calculated using the exchange rates obtaining at the date of issue.

The growth in Eurobond issues by Italian residents, from €18.1 billion in the whole of 1998 to €43.4 billion in the first nine months of 1999, was fueled by variable-rate issues, which rose from €5.6 billion in 1998 to €25.1 billion. Some 80 per cent of the issues were made by non-banks. The issues made in the Italian market amounted to €20.9 billion and were nearly all made by banks; the monthly flow was 10 per cent down compared with 1998.

Following the reduction in official rates in April, the yield curve, which in the first quarter of 1999 had had an upward slope only for maturities beyond one year, acquired an upward slope for all maturities. Subsequently, the slope steepened: the differential between the yield of ten-year BTPs and the three-month interbank rate widened from 1.5 percentage points at the end of April to 2.2 points in the middle of October. The rise in medium and long-term nominal euro yields appears to have been accompanied by a smaller increase in real yields. On the basis of the reduction in the prices of the euro securities linked to consumer prices issued by the French Treasury, the increase in real interest rates was just over half a percentage point.

Figure 38

Implied volatility of BTPs and Bunds listed on LIFFE (1)
(percentage points on an annual basis)

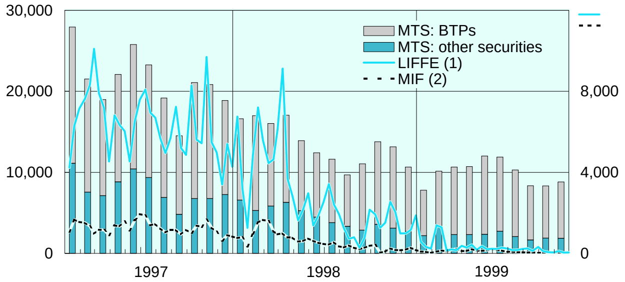


(1) Standard deviation of the probability distribution implied by the price of the at-the-money option closest to expiry with respect to the price of the futures contract on the 10-year government bond.

The implied volatility of ten-year BTPs stabilized at around 3 per cent on an annual basis, which was slightly less than for Bunds with the same maturity (Figure 38). In the first nine months of 1999 trading in both BTPs and BTP futures contracted. Monthly turnover in BTPs in the screen-based secondary market MTS was equal to €7.9 billion, compared with €9.1 billion in 1998 and €13.4 billion in 1997 (Figure 39). The fall in trading in forward contracts was even more pronounced: daily turnover in BTP futures in London contracted from €2.9 to €0.3 billion. The ratio of turnover in Bund futures to the total volume of trading in futures on long-term Italian, French and German government securities rose from 83 to 85 per cent (Figure 40).

Figure 39

Turnover in government securities in the spot and futures markets
(average daily turnover in millions of euros)

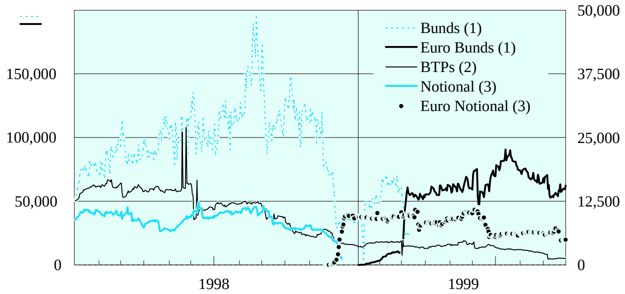


(1) Turnover in futures contracts on 10-year BTPs. Right-hand scale. - (2) Turnover in futures contracts on 5 and 10-year BTPs. Right-hand scale.

Italian share prices remained flat in the first nine months of the year after rising strongly in 1998. Share prices rose in this period by 3 per cent in the euro area, 6 per cent in the United Kingdom, 11 per cent in the United States and 39 per cent in Japan.

Figure 40

Open interest in the main euro-area futures markets
(daily data; millions of euros)



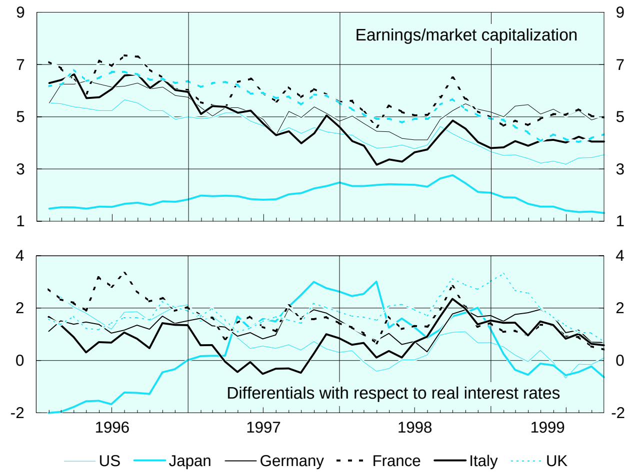
(1) Left-hand scale. - (2) Right-hand scale. - (3) Notional and Euro Notional bond futures are futures contracts traded on Matif. They differ mainly in the currency of denomination (euros for the latter) and the underlying securities (as of June 1999, the latter refers to a basket of French and German government securities).

In Italy the ratio of expected earnings to market capitalization remained close to 4 per cent (Figure 41). The rise in real long-term yields reduced the differential between the two rates of return. The reduction is consistent with an upward revision of the expected growth in profits combined with a reduction in the risk premium demanded by equity investors. The signs of a recovery in economic activity and the lower variability of share prices may have been contributory factors. The implied volatility derived from the prices of options on the Italian index fell from 40 per cent in the last quarter of 1998 to 25 per cent (Figure 42).

In the first nine months of the year the differential between the ratio of earnings to market capitalization and the real interest rate narrowed in the leading markets: in the euro area it narrowed from 1.7 to 0.7 percentage points, in Japan it turned negative and in the United States it was nil in September after being negative during the summer.

Figure 41

Expected earnings/market capitalization ratio and differential with respect to real 10-year interest rates on the main international stock exchanges
(percentages and percentage points)



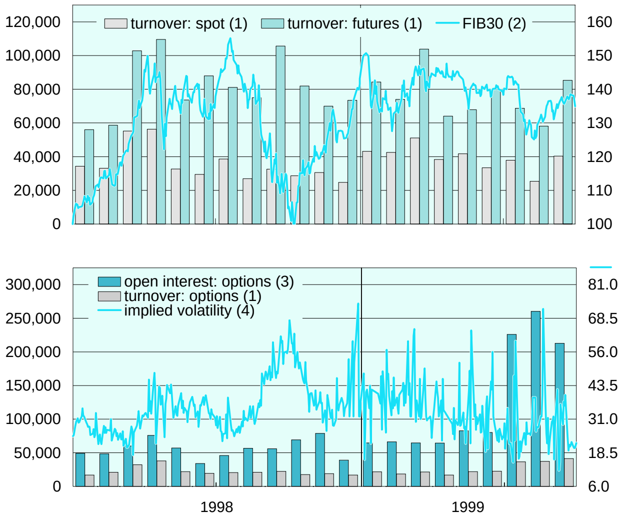
Source: Datastream.

The sectoral indexes of the Italian share market performed in a basically uniform manner in the first nine months of the year. In the euro area, by contrast, the prices of industrial shares rose by 23 per cent, while those of banks and service companies fell by 1 and 17 per cent, respectively.

In September the market capitalization of the Italian stock exchange amounted to €519 billion or 48 per cent of GDP. The increase of three percentage points in the ratio from the beginning of the year was due to the listing of 16 new companies and to share issues by listed companies, which contributed €14.1 and €21.7 billion, respectively, compared with €7 and €18 billion in the corresponding period of 1998.

Figure 42

Italian stock exchange: spot and futures markets



(1) Monthly turnover in millions of euros; left-hand scale. - (2) Index, 31 December 1997=100; right-hand scale. - (3) Number of contracts; left-hand scale. - (4) Standard deviation of the probability distribution of the percentage changes in the FIB30 index implied by the price of the at-the-money option closest to expiry; left-hand scale.

Daily turnover in the first nine months of 1999 rose by 4 per cent from the already high level recorded in the corresponding period of 1998 to reach €1.8 billion. Turnover in the futures contract on the stock market index declined by 9 per cent, while trading in the options contract increased by 11 per cent. The open interest in the options contract doubled.

At the end of September investment funds' net assets amounted to € 454.5 billion, an increase of 22.1 per cent on the end of 1998. Net sales of units by Italian investment funds in the first nine months of the year amounted to € 76.3 billion, compared with €141.8 billion in the corresponding period of 1998. In September net subscriptions turned negative for the first time since November 1995; for bond-based funds the net outflow had already begun in July.

In the first nine months of 1999 investment funds made net purchases of foreign securities totaling €73.4 billion, including € 21.2 billion of shares. Their net purchases of Italian government securities amounted to € 3.5 billion, while they made € 6.7 billion of net sales of Italian shares. As a result of the foregoing and the changes in the prices of the funds' assets, there was a shift in the composition of their portfolios: in particular, the share of foreign securities rose by 13.9 percentage points to 46 per cent in September.

The assets managed by investment funds in the euro area amounted to € 2,055 billion in March, a twelve-month increase of 27.8 per cent. The share of the total accounted for by Italian investment funds rose over the same period by nearly 5 percentage points to 20.5 per cent, compared with 28.1 per cent for French funds, 21.2 per cent for Luxembourg funds, 10.2 per cent for Spanish funds and 8.6 per cent for German funds. The less developed state of other institutional investors in Italy helps to explain the fact that Italian investment funds' market share is much larger than that of Italian banks (11 per cent). For the euro area as a whole, equity funds accounted for 25 per cent of the total, with higher values in Belgium, Germany, Luxembourg and the Netherlands.

The net inflow of funds to Italian portfolio management services in the first half of 1999 amounted to € 31.8 billion, compared with € 46.8 billion in the corresponding period of 1998. At the end of June assets under management totaled €306.7 billion, an increase of 9.3 per cent from the beginning of the year; units of foreign investment funds and securities issued by non-residents rose from 11.5 to 16.6 per cent of total assets.

SHORT-TERM ECONOMIC PROSPECTS, PRICES AND MONETARY POLICY

The international situation

The international economic situation improved during 1999. According to preliminary IMF estimates, world output will rise by 3.0 per cent this year (compared with 2.5 per cent in 1998), more than half a percentage point more than was forecast in the spring. Output in the industrial countries is expected to increase by 2.6 per cent.

The emerging countries affected by the 1997-98 crisis began to recover. In Japan the fall in GDP came to an end. In the United States the predicted slowdown did not materialize. In the euro area the deceleration in economic activity was less pronounced than expected; signs of an acceleration in output have assumed greater substance in the last few months.

Despite having overcome the turbulence of last year, the international financial markets remained highly volatile. Long-term interest rates increased in all the leading countries from the end of 1998 onwards.

The scenario for 2000 published by the IMF (Table 23) indicates a further improvement: world output is expected to increase by 3.5 per cent, thanks to the strengthening of activity in Asia and the recovery in Latin America; the growth in world trade should rise from 3.7 to more than 6 per cent, close to the rates recorded in the first half of the nineties. Output in the industrial countries is likely to increase by 2.5 per cent.

This would bring about the hoped-for reduction in the disparities between the leading economies, with growth slowing to 2.6 per cent in the United States and rising to 2.8 per cent in the euro area; in Japan GDP growth is expected to accelerate slightly to 1.5 per cent. Despite the slowdown in economic activity, the US current account deficit is likely to remain unchanged at 3.5 per cent of GDP, the same as in 1999.

If the widely-held expectation of a slight fall in oil prices in the coming months proves correct, inflation in the industrial countries should increase only moderately, from 1.4 per cent in 1999 to 1.7 per cent in 2000.

This favourable outlook presupposes that the risks to which both the industrial and emerging economies are exposed do not materialize. In Japan there is still uncertainty about the durability of the recovery; in particular, the strength of the yen may prolong deflation and impede growth. In the United States, where activity continued to increase very rapidly in the third quarter and the labour market remains tight, the inflation outlook could worsen, necessitating increases in interest rates, which would have adverse repercussions on share prices and households’ propensity to spend. Shifts in international investors’ portfolio preferences away from US financial assets could have the same effect.

As regards the emerging economies, the main source of uncertainty is the situation in Latin America owing to large current account deficits and vulnerability to changes in US monetary policy.

Economic developments in Italy and the euro area

Economic activity slowed down slightly in the euro area in the first half of this year but then showed signs of strengthening again. Significant differences remain between countries, with growth being much more rapid in France and Spain than in Germany and Italy.

In Italy the slowdown in growth was pronounced. In the first half of 1999 GDP was 0.2 per cent higher than in the previous half-year, an expansion in services and construction being offset by the weak performance of manufacturing, where signs of recovery did not appear until the summer. The increase in output reflects the growth in domestic demand, especially gross fixed investment; the rise in consumption was extremely small.

Table 23

Actual and forecast performance of selected international macroeconomic variables

(percentage changes on previous year)

	1998	1999			2000	
		IMF		Consensus	IMF (a)	Consensus
		(a)	(b)			
GDP (1)						
World	2.5	3.0	2.3	–	3.5	–
Industrial countries	2.4	2.6	2.0	–	2.5	–
United States	*3.9*	*3.7*	*3.3*	*3.8*	*2.6*	*2.9*
Japan	*–2.8*	*1.0*	*–1.4*	*0.9*	*1.5*	*0.4*
Euro area	*2.7*	*2.1*	*2.0*	*2.1*	*2.8*	*2.8*
Developing countries	3.2	3.5	3.1	–	4.8	–
ASEAN-4 (2)	*–9.8*	*1.4*	*–1.1*	*1.9*	*3.6*	*4.1*
China	*7.8*	*6.6*	*6.6*	*7.2*	*6.0*	*7.4*
Latin America	*2.2*	*0.1*	*–0.5*	*–0.5*	*3.9*	*3.2*
South Korea	–5.8	6.5	2.0	8.4	5.5	6.2
Russia	–4.6	. .	–7.0	–0.2	2.0	1.4
Consumer prices						
Industrial countries	1.3	1.4	1.4	–	1.7	–
United States	*1.6*	*2.2*	*2.1*	*2.2*	*2.5*	*2.5*
Japan	*0.6*	*–0.4*	*–0.2*	*–0.3*	. .	. .
Euro area	*1.1*	*1.0*	*1.0*	*1.1*	*1.3*	*1.5*
Developing countries	10.3	6.7	8.8	–	5.8	–
ASEAN-4 (2)	*29.1*	*11.4*	*13.3*	*11.4*	*4.2*	*4.9*
Latin America	*10.6*	*9.8*	*14.6*	*8.0*	*7.6*	*7.1*
South Korea	7.5	0.7	1.8	1.2	2.8	3.3
Russia	27.6	88.4	100.5	45.9	23.4	27.2
World trade (3)	3.6	3.7	3.8	–	6.2	–
Raw material prices (4)						
Oil	–32.1	27.7	–8.3	–	7.8	–
Non-oil	–14.8	–7.2	–4.0	–	3.4	–
Current account balances (5)						
Industrial countries	–24.0	–127.0	–86.0	–	–118.0	–
United States	*–220.6*	*–316.0*	*–309.9*	*–316.0*	*–325.0*	*–336.0*
Japan	*121.2*	*143.0*	*148.2*	*117.0*	*138.0*	*122.0*
Euro area	*67.6*	*80.0*	*99.9*	*70.8*	*95.0*	*78.5*
ASEAN-4 (2)	29.1	–	–	28.5	–	21.2
Latin America	–89.0	–56.0	–60.7	–58.9	–56.0	–61.5
South Korea	40.6	23.6	26.1	20.8	15.2	10.3
Budget balances (6)						
United States	1.3	1.6	1.4	–	2.0	–
Japan	–5.3	–7.3	–7.9	–	–7.1	–
Euro area	–2.1	–1.8	–2.1	–	–1.1	–

Sources: National statistics, ECB, IMF and Consensus Economics.
(a) IMF, *World Economic Outlook*, October1999. (b) IMF, *World Economic Outlook*, May 1999.
(1) At constant prices. – (2) Indonesia, Malaysia, Philippines and Thailand. – (3) Goods and services, at constant prices. – (4) In US dollars. – (5) Billions of dollars. – (6) As a percentage of GDP.

The negative contribution of net foreign demand to GDP growth increased to 1.2 percentage points, owing mainly to the fall in exports. The decrease in the trade surplus led to a conspicuous contraction in the current account surplus. In the last few months, however, the growth of imports has slowed down and exports have picked up, aided by the improvement in the international economic situation and the depreciation of the euro.

Table 24

Forecast outturns and planning scenario for the Italian economy

	1998	1999 (1)	2000 (1)
	(percentage changes)		
Real aggregates			
Gross domestic product	1.3	1.3	2.2
Domestic demand	2.5	2.1	2.5
Imports	6.1	3.5	5.2
Exports	1.2	0.0	3.8
Deflators			
Gross domestic product	2.8	1.7	1.7
Private consumption	2.3	1.9	1.7
Imports	–1.7	1.2	1.2
Exports	1.0	0.2	1.0
	(percentage ratios)		
Balance/GDP			
General government net borrowing	2.7	2.4	1.5
Balance-of-payments surplus on current account	1.7	1.3	1.3

(1) Estimates and forecasts contained in *L'economia italiana nel 2000: relazione previsionale e programmatica*.

The modest growth in GDP was matched by the more favourable performance of employment, which has risen gradually for seven consecutive quarters; the large increase in recourse to part-time and fixed-term contracts was a contributory factor. Between July 1998 and July 1999 the unemployment rate fell from 11.4 to 11.1 per cent owing to an improvement in the Centre and North; in the euro area it came down from 10.9 to 10.2 per cent.

Economic activity should accelerate in the last few months of the year; the rise in GDP in 1999 as a whole could exceed 1 per cent, although not by much.

In the light of the favourable international scenario outlined by the IMF and the budgetary policy set out in the Finance Bill, the growth in Italy's GDP is expected to rise to fractionally over 2 per cent in 2000 (Table 24). In the euro area as a whole growth is likely to accelerate from 2.1 per cent in 1999 to 2.8 per cent.

The recovery in exports should allow Italy's GDP to rise at a rate similar to that in domestic demand. With households' consumption still rising only slowly, the main stimulus is expected to come from fixed investment, aided by the cyclical upturn. Building investment may benefit from the reduction in the rate of VAT on the restructuring of residential property, and expenditure on machinery and equipment is likely to rise, thanks partly to the reduction in the rate of tax on profits from investment financed with equity capital.

The labour market is expected to continue to improve; employment is likely to rise modestly and the unemployment rate to decline slightly.

Inflation and monetary policy

Within the euro area the period of falling inflation that began in the second half of 1998 has come to an end; retail prices began to accelerate again in May, and by September inflation was running at a twelve-month rate of 1.2 per cent (an annual seasonally adjusted rate of 2 per cent in relation to six months earlier). The reversal of trend was due to an increase in the prices of imports, especially oil, and to the depreciation of the euro. The IMF expects an average rise of around 1 per cent in 1999.

In Italy the rise in inflation was broadly the same as in the euro area and the inflation rate remained about half a percentage point higher. The disparity amounts to about one point if food and energy prices are excluded, reflecting both the more rapid increase in unit labour costs in connection with the small increase in productivity and price rises in some parts of the services sector.

In October the twelve-month rate of increase in retail prices rose to 2 per cent; the average for the year as a whole should be below the rate of 2 per cent recorded in 1998.

The budget for 2000

The Finance Bill for 2000, which the Government presented in September, aims to reduce general government net borrowing on a current programmes basis by 11.5 trillion lire.

As well as reducing expenditure by 11 trillion lire and increasing non-tax revenue by 4 trillion, the bill provides for the allocation of 3.5 trillion for social and development policies, consisting of 1 trillion for additional current commitments, 1.5 trillion for new capital expenditure and 1 trillion for tax relief.

In the Update to the EFPD published in September, the Government revised the estimate for tax revenue on a current programmes basis for the years from 2000 to 2003; it is expected to exceed previous forecasts by 9.3 trillion lire in 2000, 9.5 trillion in 2001 and 2002 and 10.5 trillion in 2003. In accordance with the stated objective of reducing the ratio of tax and social contributions to GDP, the Government announced that in 2000 the additional revenue would be used to grant tax relief over and above the reductions already contained in the Finance Bill; the overall reductions in 2000 would amount to 10.3 trillion.

After taking account of the tax relief, the budgetary measures as a whole should, on the basis of official estimates, cut net borrowing on a current programmes basis by around 2.2 trillion, as a result of net reductions of 8.5 trillion in expenditure and 6.3 trillion in revenue. Some of the pension and public debt measures classified as reductions in expenditure entail increases in the non-tax revenue of general government (around 2.5 trillion), so that expenditure actually comes down by around 6 trillion and revenue by about 3.8 trillion. Some expenditure-reducing measures relate to interest payments (about 1.5 trillion); the adjustment in the primary surplus can therefore be estimated at 0.7 trillion lire.

Revenue

Increases in revenue *— The revenue increases contained in the bill stem not from taxes but from the sale of real estate assets and property rights belonging*

Effects of the budget on the consolidated general government income statement (1)
(billions of lire)

REVENUE	
Increases in revenue	**4,000**
Property sales	4,000
Reductions in revenue (social and development policies)	**–10,300**
Incentives for investments in 1999 and 2000	–1,000
Tax relief on incomes and other provisions	–9,300
NET REDUCTION IN REVENUE	**–6,300**
EXPENDITURE	
Reductions in expenditure	**–11,000**
Domestic Stability Pact	*–3,300*
– Stability Pact for 2000	–2,200
– Recovery of shortfall in savings under 1999 Stability Pact	–1,100
Debt management	*–2,500*
– Management of treasury balances	–1,000
– Renegotiation of loans	–700
– Early redemption of Post Office savings certificates	–600
– Repurchase agreements	–200
Intermediate consumption	*–2,400*
– Postponement of expenditure	–1,100
– 5% reduction in appropriations	–700
– Rationalization of procurement procedures	–200
– 3% reduction in supply contracts	–100
– Other	–300
Pensions	*–1,700*
– Special fund for electricity workers	–1,350
– Special fund for telephone workers	–300
– Other	–50
Public employment	*–700*
– Restrictions on recruitment	–350
– Freeze on revaluation of allowances	–200
– Reduction in school personnel	–150
Other expenditure	*–400*
Increases in expenditure (social and development policies)	**2,500**
Increases in current expenditure	*1,000*
Support for capital expenditure	*1,500*
NET REDUCTION IN EXPENDITURE	**–8,500**
TOTAL REDUCTION IN NET BORROWING	**–2,200**

(1) Based on official estimates.

cont.

to public pension agencies and the state (4 trillion). Assets and rights may be sold to real estate intermediaries, which undertake to resell them within an agreed period, or assigned to property funds, whose units will then be offered for sale in the market. The Minister of the Treasury will be responsible for defining the programmes of sales, overseeing the entire operation and intervening directly if sales are significantly delayed.

***Social and development policies: tax relief** — The bill appropriates 1 trillion lire in each of the next two years to finance the incentives for investment undertaken in 1999 and 2000 that were introduced in the so-called Visco Decree, which was subsequently incorporated into the law accompanying the budgetary measures for 1999.*

In addition to the measures set out in the bill, the Government intends to grant further tax relief estimated at 9.3 trillion lire. The greater part of the additional relief, details of which are still being finalized, relates to income tax, especially that on personal incomes (around 6 trillion). The following changes have been proposed: a reduction in the rate of tax on the second band of income from 27 to 26 per cent; larger allowances for dependents and income from self-employment and employment; larger deductions for the primary residence. The other concessions relate mainly to taxes on the transfer of property and restructuring work.

Expenditure

***Reductions in expenditure** — The bill provides for a reduction of 3.3 trillion lire in transfers to regional and local authorities in application of the Domestic Stability Pact introduced in 1998, which called on local authorities to contribute to achieving the public finance objectives set at national level by reducing their deficits by 0.1 per cent of GDP (around 2.2 trillion) in both 1999 and 2000. However, the reduction shown in the budget for 2000 is larger (3.3 trillion), as it includes 1.1 trillion to make up for the shortfall in 1999.*

The savings of 2.5 trillion lire to be produced by public debt management measures derive from a reduction in interest payments and an increase in interest income. The bill provides for the investment of treasury balances in higher-yielding assets (1.1 trillion), the renegotiation of loans to public bodies entailing repayments by the state (0.7 trillion), the early redemption of post office savings certificates and their replacement by longer-term securities at interest rates that are lower than those on the instruments they replace but still above market rates (0.6 trillion) and repurchase agreements on government securities (0.2 trillion).

The reductions in intermediate consumption (2.4 trillion) stem largely from the postponement of expenditure. There is also provision for a 5 per cent reduction in budgetary allocations (0.7 trillion), the rationalization of procurement procedures (0.2 trillion) and the renewal of supply contracts only on condition that the value of the contract be reduced by at least 3 per cent (0.1 trillion).

On the pensions front, the bill provides for the abolition of the pension fund for the staff of ENEL and private electricity companies and that for the staff of public telephone services. They will become part of the employees' pension fund, with separate accounting. The pensions paid by the two funds are subject to more generous rules than those paid by the compulsory general scheme. In order to compensate for the higher cost, the electricity and telephone companies will have to pay around 1.7 trillion lire to the INPS in 2000 and further sums in 2001 and 2002.

In the field of public sector employment, the limits on the hiring of staff and the freeze on the cost-of-living adjustment for certain allowances are expected to produce savings of 0.7 trillion.

***Social and development policies: increases in expenditure** — The EFPD published in June provides for an increase of 1.5 trillion lire in capital spending and one of 1 trillion in allocations for the renewal of labour contracts and the development of public and social services.*

In the first half of 2000 the twelve-month rise in prices is likely to be above 2 per cent, albeit only slightly; it is then expected to decline gradually, on the assumption that external price pressures abate as expected. The annual average rate should be below 2 per cent. At present there is no significant risk of an acceleration due to the behaviour of nominal wages. On the basis of market expectations, the inflation differential with the euro area should disappear in the course of the year.

The performance of the monetary and financial variables in the euro area indicates that liquidity conditions are rather generous.

The growth in the M3 money supply has been consistently above the reference value of 4.5 per cent; in September the moving quarterly average of twelve-month rates of growth touched 5.9 per cent. The largest increase was in the more liquid components of the aggregate. Lending to the private sector rose sharply.

The yield curve has shifted steadily upwards during the year and its slope has steepened. Ten-year swap rates are currently 5.6 per cent and the differential with 3-month rates is 2.1 percentage points. The shift in the curve reflects an improvement in the area's growth prospects and fears of an acceleration in inflation.

These trends are affecting expectations about the direction of monetary policy. Futures contracts in euros due to mature in the middle of next year indicate expectations that short-term rates will rise to 3.9 per cent.

In Italy bank lending has increased rapidly and the spread between lending and deposit rates has become very narrow. The rise in medium and long-term bank interest rates in August, which followed a considerable decrease earlier in the year, was less than that in rates on securities with a comparable maturity.

The growth in credit reflects above all that in mortgage lending to households. Even after the August rise in the context of a general increase in long-term rates, bank lending rates are still 0.5 percentage points lower than at the beginning of the year.

The improvement in Italian banks' results in the first half of the year reflected mainly an increase in earnings from services, which contrasted with a decrease in net interest income. Some of the factors that facilitated the particularly large growth in earnings could wane in the foreseeable future; maintaining the results achieved in terms of profitability will depend on the banks' progress in curbing costs.

Economic policy in Italy

The behaviour of the public finances in the first three quarters of the year is in line with the Government's objective of general government net borrowing of no more than 2.4 per cent of GDP in 1999, compared with 2.7 per cent in 1998. The primary surplus is forecast to decline from 5.2 to 4.7 per cent of GDP, instead of remaining unchanged as indicated in the Economic and Financial Planning Document (EFPD) for 1999-2001. The balances may turn out slightly better, owing to the higher-than-forecast growth in tax revenue.

The reduction in net borrowing is less than the fall in interest expenditure. Revenue and primary expenditure are likely to increase in relation to GDP. The ratio of debt to GDP is expected to diminish by more than one percentage point, compared with 3.5 points in 1998.

Budgetary policy for 2000 is designed to bring the budget deficit back into line with the reducing trend set out in the EFPD for the three years from 1999 to 2001. General government net borrowing should come down to 1.5 per cent of GDP and, in accordance with the indications in the EFPD for 2000-2003 published in June, should continue to decline gradually thereafter until broad balance is reached in 2003. The primary surplus, which fell by about two percentage points between 1997 and 1999, is expected to rise to 5.0 per cent of GDP in 2000 and 5.2 per cent in 2003; such an increase would help achieve overall balances consistent with the Stability and Growth Pact and ensure a more rapid reduction in the ratio of debt to GDP.

In September the Government issued an "Update to the EFPD" for the years from 2000 to 2003 in the light of the growth in revenue in 1999, setting out an improved scenario for the public finances and introducing additional tax reductions over the next four years; in 2000 the tax cuts should amount to 9.3 trillion lire.

The Finance Bill recently presented by the Government follows the lines set out in the EFPD. The correction of 11.5 trillion lire in the primary surplus will be achieved by reducing expenditure by 8.5 trillion and increasing revenue by 3 trillion. By comparison with the new figure on a current programmes basis, the adjustment in net borrowing comes to about 2.2 trillion (see the box *The budget for 2000*).

Budgetary policy for 2000 is aimed at reconciling achievement of the financial objectives set out in the EFPD with support for the recovery in activity; more than half of the measures to reduce the deficit should have no significant restrictive effect on demand. The budget package includes measures of a temporary nature; some produce initial savings and entail higher costs later. Around half of the cuts in expenditure and increases in revenue are not permanent.

The expected improvement in economic conditions in Italy must materialize if the targets for net borrowing and the primary surplus are to be fully attained, recourse to temporary measures is to be reduced and additional resources are to be found for public investment.

The medium-term objectives indicated in the EFPD would be easier to achieve if measures relating to local government financing were introduced to ensure that the Domestic Stability Pact is fully effective. If the public finances are to be kept on a sustainable long-term path, adjustments will have to be made in the trend of social security spending. Action to curb primary current public expenditure is essential in order to ensure that adequate resources are available for investment and to permit a progressive reduction in the tax burden.

In a favourable European and international economic climate, the Italian economy is showing signs of recovery. Economic policy must be aimed at strengthening and consolidating this process by eliminating the growth differential with the rest of the euro area.

Competition from newly industrialized countries is becoming increasingly keen, given Italy’s specialization in sectors with a low technology content. The preponderance of small enterprises, while being a factor of flexibility and strength for the economy, restricts the introduction of technologically advanced processes and products.

In a situation of growing market integration, economic policy must be used incisively to enhance the competitiveness of the economy by increasing public investment in human capital and infrastructure and encouraging investment in the private sector.

The efficiency of the public administration must be improved. A climate conducive to business initiative must be created by removing the constraints on entrepreneurial activity and completing the reform of company, bankruptcy and labour law. Such action could give an immediate boost to investment via the business expectations it would engender. Wages must be related more directly to productivity and must reflect more closely the cyclical development of the economy. Competition in the markets in factors of production, goods and services must be increased.

Based on information available at 29 October.

Articles

New indicators of the Italian business cycle (*)

Indicators that by appropriately combining a multiplicity of data offer a synthetic description of the economy's cyclical performance and make it possible to detect signals of a reversal of trend in advance play an important role in measuring and forecasting the ups and downs of the business cycle. In a joint research project, the Bank of Italy and the Institute for Economic Research and Analysis (ISAE) recently prepared two new monthly indicators of the business cycle in Italy: a coincident index serving to represent the cyclical position of the moment, and a leading index of use for forecasting short-term developments, particularly reversals of trend.

The construction of the new indicators for the Italian economy starts out from a concept that was introduced after the war and still enjoys broad consensus in the literature: the notion of the aggregate business cycle as a "common factor" underlying the fluctuations of the main macroeconomic variables.[1] The business cycle as such is not directly observable, but emerges as a characteristic common to the fluctuations of a sufficiently representative set of indicators of economic activity. In practice, the following procedure is used to test for the existence of common movement and select the set of variables that best represents it. To begin with, a limited number of reference series are identified whose behaviour can be reasonably assumed to correlate strongly with that of the aggregate cycle. All the available indicators are then scrutinized to find those that move in common with the reference series, are measured at frequent intervals and, taken together, are sufficiently representative of aggregate economic activity. In searching for co-movement the focus is on so-called cyclical frequencies, i.e. those corresponding to fluctuations of between one and a half and eight years in duration (the minimum and maximum conventional duration of the business cycle in the industrial countries). The empirical analysis thus began with a very broad set of monthly or quarterly indicators: a total of 183 variables for which time series spanning at least 25 years were available, including all the real and financial variables considered useful for measuring the cyclical behaviour of economic activity in Italy. Spectral analysis was applied to the time series in order to focus on the cyclical frequencies. This technique allows a given series to be represented in the frequency domain as the sum of components corresponding to fluctuations of differing periodicity. In particular, with spectral analysis one can evaluate the contribution of each frequency to the overall variability of the series examined and extract the movements associated with cyclical fluctuations. By evaluating the correlation between solely the cyclical components of the different series, *inter alia* in the light of their turning points, it was possible to select from among the 183 variables those whose behaviour at the above-mentioned cyclical frequencies conformed most closely with that of three reference variables: GDP, the index of industrial production and the composite coincident indicator developed by Isco in the seventies. It was

(*) *Prepared by the Economic Research Department. The full text of the paper on which this article is based, "The Italian Business Cycle: New Coincident and Leading Indicators and Some Stylized Facts", is forthcoming in the Department's* Temi di Discussione *series.*

assumed that although the cycle could not be identified with any one of these alone, it must correlate strongly with all three. From the resulting set of variables a minimum subset was selected that would be as representative as possible of the various aspects of economic activity and productive sectors. Finally, the series in the subset were aggregated in a *composite coincident indicator* whose function is to provide a synthetic measure of the behaviour of the business cycle in Italy.

The composite coincident indicator comprises the following variables: industrial production, ratio of overtime hours to hours worked in large industrial companies, valued added of market services,[2] rail transport of goods, investment in machinery and equipment, and imports of capital goods. The aggregation procedure is based on the methodology developed by the NBER and still widely used at the international level — in particular, by the Conference Board, which is responsible for producing the official US business cycle indicators, and by the OECD, for its own system of leading indicators. Briefly, the rate of change in the composite index is obtained as the weighted average of the changes of the elementary series, seasonally adjusted and filtered to eliminate the erratic component (identified as that corresponding to fluctuations of less than six months in duration). The weights are inversely proportional to the cyclical variability of each component.

Analysis of the behaviour of coincident indicators also supplied the information necessary for revision of the chronology of the aggregate cycle since the start of the seventies. In particular, the turning points of the composite coincident index, of each of its six component series and of GDP were considered. This exercise used the classical definition according to which expansions and recessions are measured by the absolute level of the indicators (i.e. including the trend). The differences with the dating previously proposed by Isco, generally accepted as the "official" chronology of the Italian business cycle, proved quite limited and did not alter the overall profile of the Italian economy's fluctuations in the period examined. A succession of short but pronounced cycles in the seventies was followed in the eighties by a single cyclical movement marking one of the longest post-war expansions. By contrast, the nineties have seen a new sequence of brief expansions and contractions. The latest turning point identified is that of November 1996, which marked the start of the current expansion. Although the coincident indicator has shown a halt in growth since the beginning of 1998 and some of the variables considered have signalled a decline, the conditions for identifying a cyclical reversal proper have not yet occurred.

The next step was to construct a *composite leading indicator* by selecting from among the 183 variables those whose properties make them most likely to anticipate movements in the aggregate cycle, measured using the new coincident indicator. The forecasting content of the variables was evaluated with various methods: correlation analysis, formal tests of predictive power, lag/lead with respect to the turning points. The result was a list of nine variables characterized by satisfactory leading behaviour and derived from different sources. Three are drawn from the ISAE surveys of industry: the balance of responses concerning domestic orders for consumer goods, that of opinions regarding the trend of production and that of responses regarding the level of stocks of finished products. The other six are: hours of ordinary wage supplementation in industry, the ISAE index of consumer confidence, bank deposits in real terms, the differential between bank lending rates and the average yield on Treasury bonds, imports of manufactures and German industrial production. These variables were aggregated into a composite leading indicator which, on the basis of past behaviour, appears to provide useful information for short-term forecasts of general cyclical movements. In the last twenty-five years this composite indicator has regularly led the cyclical turning points by an average of about five months; of the ten reversals in the trend of economic activity since 1974, the turning point of the leading indicator failed to lead that of the coincident indicator in only one case (both occurred in the same month). Broadly in line with the results for the turning points, the ability of the leading indicator to predict a rise in the coincident indicator reaches a peak at a six-month forecasting horizon; for all horizons between one and twelve months, its predictive power is greater than that of each of the 183 variables examined.

The existence of a common factor underlying the cyclical fluctuations of the two composite indicators' component variables was confirmed by the results of the more recent techniques of time series analysis, e.g. dynamic principal components analysis. The time profile of the first dynamic principal component relative to the six variables forming the coincident indicator was very close to the cyclical profile of the composite coincident indicator. Similar empirical evidence was found for the composite leading indicator and the first principal component of its nine components. Thus, dynamic principal component analysis broadly confirmed *a posteriori*, in the Italian case, the validity of the traditional NBER approach on whose basis the two new composite were constructed.

[1] The methodologies used in the analysis are based on the NBER approach, described in V. Zarnowitz, *Business Cycles: Theory, History, Indicators, and Forecasting* (Chicago: The University of Chicago Press, 1992), and the developments proposed in J. Stock and M. Watson, *Business Cycle Properties of Selected U.S. Economic Time Series*, NBER Working Paper No. 3336, 1990.

[2] The series of value added of market services used in the historical analysis is that contained in the quarterly national accounts based on ESA79. With the changeover to ESA95, which ends the distinction between market and non-market services, until sufficiently long time series are available it was decided to update the series using the value added of the branches "Wholesale and retail trade", "Hotel and restaurant services", "Transport and communications", "Financial intermediation" and "Real estate, renting and business services", which account for around 90 per cent of the activities covered in the previous definition.

Taxation and the cost of labour (*)

Introduction

In the past few decades the incidence of general government revenues on GDP has increased significantly. In the countries of the European Union this ratio averaged around 40 per cent of GDP in the first half of the nineties, distinctly higher than in Japan or the United States (Table 1); and this fiscal burden rose further in the years immediately following, as action to adjust the public finances intensified.

Table 1

Fiscal burden in industrial countries
(tax and social security revenue as a percentage of GDP)

	1965-69	1980-84	1990-96
EU	**31**	**38**	**40**
France	35	43	44
Germany	32	38	38
Italy	26	33	41
United Kingdom	33	37	35
Other industrial countries	**25**	**28**	**29**
Japan	19	27	30
United States	25	27	28
OECD	**27**	**32**	**34**

Source: EU Commission, based on OECD data.

Throughout the industrial countries, the fastest-rising component of government revenue has been social security contributions. The rise has been especially pronounced in Europe, where they have gone from 9 per cent of GDP to 14 per cent in the last thirty years. The increase in the fiscal burden has thus been accompanied by a change in its composition. Social contributions, in Europe, have gradually become the main source of revenue (Table 2).

Table 2

Composition of tax revenue in OECD countries (1)

	1965-69	1980-84	1990-96	1965-69	1980-84	1990-96
	as a percentage of GDP			*percentage composition*		
EU	**31**	**38**	**40**	**100**	**100**	**100**
Income tax	9	12	12	29	32	31
Social contributions	9	13	14	29	34	34
Consumption taxes	11	11	12	35	28	29
Wealth taxes	2	2	2	7	5	5
OECD (excluding EU)	**25**	**28**	**29**	**100**	**100**	**100**
Income tax	12	13	13	48	46	44
Social contributions	4	7	8	15	24	28
Consumption taxes	6	5	5	22	19	17
Wealth taxes	4	3	3	14	10	11
OECD	**27**	**32**	**34**	**100**	**99**	**100**
Income tax	11	13	13	41	41	39
Social contributions	5	9	10	20	28	30
Consumption taxes	7	7	7	27	22	22
Wealth taxes	3	3	3	12	8	9

Source: EU Commission, based on OECD data.
(1) Any failure of percentage composition totals to square is due to rounding.

(*) Prepared by the Economic Research Department. This is a summary of "Tassazione e costo del lavoro nei paesi industriali", in course of publication in the Bank of Italy's Temi di Discussione *series.*

Much of the increase in the fiscal burden in Europe can be attributed to rising payroll levies. The “tax wedge” on salaried employment - i.e. income plus social security taxes as a ratio to the total cost of labour - has risen from 29 per cent in the sixties to 42 per cent in the nineties.[1] The largest increment, of 18 percentage points, has come in Italy, where the overall wedge has widened from 26 to 44 per cent. Unlike those of the other countries, this rise reflected a substantial increase not only in social contributions but also in personal income taxes, from 4 to 15 per cent (Table 3).

Table 3

Effective taxation on labour income
(percentages)

	1965-69	1980-84	1990-96	1965-69	1980-84	1990-96
	Personal income tax			**Total fiscal levy**		
EU	**11**	**15**	**15**	**29**	**38**	**42**
France	6	9	10	35	43	49
Germany ..	13	16	16	31	39	42
Italy	4	11	15	26	36	44
United Kingdom	14	16	13	24	29	24
OECD (excluding EU)	**11**	**14**	**14**	**18**	**26**	**28**
Japan	6	9	11	16	24	28
United States	12	15	15	18	26	27
OECD	**11**	**14**	**14**	**22**	**30**	**33**

Source: EU commission, based on OECD data.

This heavy taxation levied on labour may have played a role in Europe’s unsatisfactory employment performance. The issue is complicated by the operation of many other macroeconomic and microeconomic factors; employment is also influenced by labour market institutions and rules that affect labour demand and supply and the activity of firms.

An initial step in responding to the question consists in determining whether, other things being equal, a rise in taxation increases labour costs and, if so, whether the increase is permanent or temporary. The literature is not unanimous on the point. There is consensus on the significance of the temporary effect but not of the permanent impact.[2] The extent to which taxation is passed on to labour costs might depend on the institutional arrangements for wage bargaining: its relative degree of centralization, contract coverage, unionization rates, and level of cooperation between labour and management.[3]

It has also been suggested that the extent of the cost shift does not depend on the composition of the tax wedge (the hypothesis of invariance of tax incidence). Here too, the empirical findings are mixed.

Preliminary analysis of the data

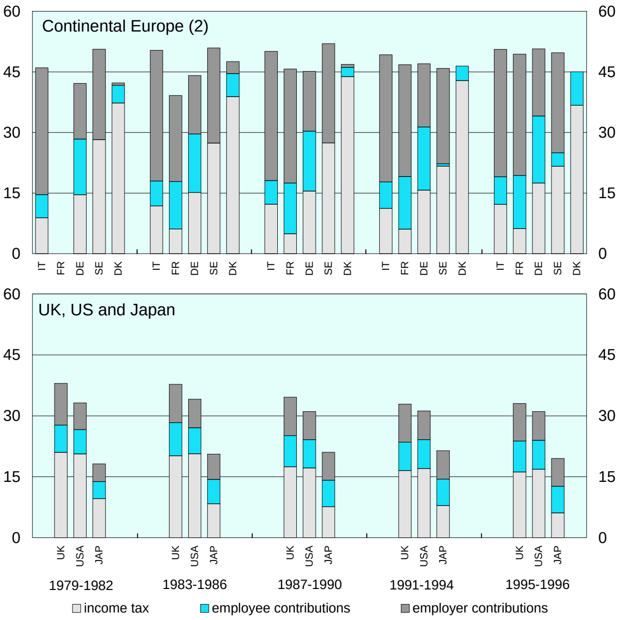
International comparative data on the tax wedge for the “average production worker” (an unmarried worker earning the average wage) in fourteen industrial countries[4] between 1979 and 1996 offer some suggestive findings:

(i) The tax wedge in the UK, US and Japan is substantially smaller than in Scandinavia and the rest of continental Europe (see figure). In 1995 and 1996 Sweden, Finland and the three largest continental countries had a tax incidence near 50 per cent of the cost of labour, as against barely over 30 per cent in the US and the UK and under 20 per cent in Japan.[5]

(ii) Whereas in the UK and the US the wedge has been gradually reduced, it has widened progressively everywhere in continental Europe except Spain. In the UK and the US the composition of the wedge is stable over time, income and social security taxes being roughly equal in incidence.

(iii) In northern Europe the wedge consists essentially of income taxes and (except in Denmark) employer social security contributions. In the rest of continental Europe the largest component of the wedge is employer contributions, followed by the substantial, though smaller, contributions of employees. In these countries social contributions account for a very large part of the total tax wedge, ranging from 65 per cent in Germany to 88 per cent in France.

Tax wedge on labour in the leading industrial countries (1)
(percentages)



Source: Based on OECD, *The Tax/Benefit Position of Employees.*

(1) For the average wage of an unmarried worker in manufacturing industry. - (2) Including Scandinavia. For France in the years 1979-1982 data on employer social contributions are not available.

Econometrics

Regression estimates taking real labour cost as the dependent variable and using as explanatory variables manufacturing productivity, the output gap (the difference between potential and effective output, to adjust for cyclical effects), and the tax wedge for the average manufacturing worker. The analysis is conducted by stages. Initially, using a panel with random effects,[6] we investigate whether the level of per capita labour costs is affected, apart from productivity, also by the level of the tax wedge. Next, using a dynamic panel, we tackle the question of whether the first differential of the wedge also significantly influences production costs. Finally, we test the hypothesis of invariance of tax incidence according to composition and the hypothesis that the incidence on the cost of labour varies with the basic characteristics of the wage bargaining system.[7]

The results of the regressions are as follows:

(i) The effect of the level of the tax wedge is statistically significant both in the random-effects and in the dynamic panel; for the latter, the effect of changes in the wedge also appears to be significant.

(ii) In the short term there is no empirical confirmation of invariance of tax incidence: income taxes and employer contributions have a greater effect on the cost of labour than do employee contributions.

(iii) The passing of the tax burden on to production costs is greatest in the main countries of continental Europe, those with the intermediate system of wage bargaining.

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1 The standard method of calculation of taxation on productive factors in the literature is now that of Mendoza, Razin and Tesar, "Effective Tax Rates in Macroeconomics. Cross-Country Estimates of Tax Rates on Factor Incomes and Consumption", Journal of Monetary Economics, No. 34, 1994, pp. 297-333.

2 For a summary, see Nickell and Layard, "Labour Market Institutions and Economic Performance", mimeo, 1997. See also Jackman, Layard and Nickell, "Combatting Unemployment: Is Flexibility Enough?" in OECD Macroeconomic Policies and Structural Reform, Paris, 1996.

3 The indices for these variables are given in OECD Employment Outlook, July 1997. The degree of centralization and the level of cooperation are determined on the basis of a scoring system; the unionization rate is the percentage of payroll workers who are union members; contract coverage is the percentage of employment contracts in the entire economy that are signed on the basis of central wage agreements between employer organizations and trade unions.

4 Austria, Belgium, Canada, Denmark, France, Finland, Germany, Italy, Netherlands, Portugal, Spain, Sweden, United Kingdom, United States. Using the average production worker has a major advantage: it obviates the need to distinguish between marginal and average tax rates, which have different effects on the cost of labour and on employment. See Sørensen, "Public Finance Solutions to the European Unemployment Problem?", Economic Policy, October 1997, pp. 221-251.

5 In northern Europe, the smallest tax wedge is that of Denmark (45 per cent). In all of continental Europe the smallest is that of Spain (under 40 per cent).

6 First random-effects and fixed-effects panels were compared, and the standard statistical tests indicated that the former was more appropriate.

[7] For the inquiry into the impact of bargaining arrangements, the sample countries can be divided into three groups. One consists of those with markedly decentralized bargaining, a relatively modest role of unions, low level of cooperation between labour and management, and limited contract coverage. At the other end of the scale is a set of countries featuring centralized bargaining, extensive contract coverage, high cooperation and high unionization. Most of the sample countries fall into an intermediate group. The group characterized by decentralization comprises Canada, the United Kingdom and the United States; the highly centralized group, the Scandinavian countries of Sweden, Finland and Denmark; and the intermediate group, the rest of continental Europe (Austria, Belgium, France, Germany, Italy, Netherlands, Portugal, Spain). By this gauge, Japan could be classed either in the high- or low-centralization group. It has a complex industrial relations system that fosters significant coordination and wage uniformity across firms; but there is no formal centralized wage bargaining, and unionization is low. For these reasons, Japan was excluded from the analysis.

APPENDIX

Results of the econometric analysis

The starting point of the analysis is the hypothesis that there exists a relationship between manufacturing labour costs per employee at constant prices (LC/P), where P is the index of producer prices of manufactures, and labour productivity (Y/L).[1] The relationship could also be affected by the size of the tax wedge for labour earnings (TAX WEDGE), calculated with reference to an unmarried worker with earnings equal to the average for the manufacturing sector. In other words, the tax wedge could be part of the equilibrium relationship between labour costs and productivity, depending on the importance of the mechanisms whereby it is passed through to labour costs. In order to capture the effects of the economic cycle, the output gap calculated by the OECD has been included among the regressors. The estimation of the relationship is based on a panel of fourteen industrial countries and covers up to seventeen years, from 1980 to 1996.[2] The model, which includes random effects, is as follows:[3]

$$\log (LC/P)_{k,t} = \text{cost.} + \alpha_1 \cdot \log (Y/L)_{k,t-1} + \\ + \alpha_2 \cdot \text{TAX WEDGE}_{k,t-1} + \alpha_3 \cdot \text{OUTPUT GAP}_{k,t-1} + \varepsilon_{k,t}$$

where *k* and *t* are the indices for, respectively, the country and the years. The estimates, reported in column A of Table A1, show that the tax wedge has a statistically significant impact on labour costs. The coefficients of the other variables have the expected sign and are statistically significant.

The relationship estimated is not dynamic, however. The large number of observations over time with respect to the number of countries, and the annual frequency of the observations, nonetheless suggest that it would be desirable to estimate a dynamic panel by including the lagged dependent variable.

$$\log (LC/P)_{k,t} = \text{cost.} + \alpha_1 \cdot \log (Y/L)_{k,t-1} + \\ + \alpha_2 \cdot \text{TAX WEDGE}_{k,t-1} + \alpha_3 \cdot \text{OUTPUT GAP}_{k,t-1} + \\ + \alpha_4 \cdot \log (LC/P)_{k,t-1} + \beta_1 \cdot \Delta\text{TAX WEDGE}_{k,t} + \varepsilon_{k,t}$$

Table A1

VARIABLES (1)	A	B	C
Constant	1.964 (5.764)	0.018 (0.134)	0.023 (0.162)
Lag [log (LC/P)]	– –	0.928 (33.456)	0.898 (18.802)
Lag [log (Y/L)]	0.724 (22.361)	0.063 (2.573)	0.089 (2.286)
Lag (Output gap)	0.006 (3.033)	0.003 (2.033)	0.002 (1.765)
Lag (Tax wedge)	0.009 (7.281)	0.001 (2.406)	– –
Lag (Income tax)	– –	– –	0.002 (1.969)
Lag (SSCER)	– –	– –	0.001 (2.382)
Lag (SSCEE)	– –	– –	0.002 (1.875)
Δ Tax wedge	– –	0.011 (6.396)	– –
Δ Income tax	– –	– –	0.012 (3.716)
Δ SSCER	– –	– –	0.010 (5.802)
Δ SSCEE	– –	– –	0.002 (0.526)
R^2	0.712	0.977	0.977

(1) The figures in brackets are the t statistics.

Another difference between this equation and the previous one is the inclusion among the explanatory variables of the change in the tax wedge, which is an appropriate regressor in the new dynamic context. In this case, as is well known, the OLS estimator is not consistent since the lagged dependent variable is correlated with the fixed effect included in the error term. Using the procedure suggested by Arellano and Bond,[4] recourse has been made to an "instrument" for one-period lagged labour costs (the same variable with a two-period lag). The results, reported in column B of Table A1, show a statistically significant effect, both for the wedge and for the changes in it.

Table A2

VARIABIES (1)	COUNTRIES BY TYPE OF WAGE BARGAINING (2)		
	Decentralized	Intermediate	Centralized
Costant	0.069 (0.485)	0.069 (0.485)	0.069 (0.485)
Lag [log (LC/P)]	0.839 (11.898)	0.839 (11.898)	0.839 (11.898)
Lag [log (Y/L)]	0.136 (2.320)	0.136 (2.320)	0.136 (2.320)
Lag (Output gap) . . .	0.002 (1.242)	0.002 (1.242)	0.002 (1.242)
Income tax	0.005 (1.758)	0.005 (1.984)	0.003 (1.739)
SSCER	0.017 (1.659)	0.002 (1.738)	0.002 (2.154)
SSCEE	–0.018 (–1.479)	0.003 (1.946)	0.006 (2.154)
Δ Income tax	0.002 (0.180)	0.027 (5.706)	–0.003 (–0.492)
Δ SSCER	0.039 (4.497)	0.012 (6.259)	–0.002 (–0.225)
Δ SSCEE	–0.049 (–2.155)	0.006 (1.077)	–0.007 (–0.745)
R^2	0.982	0.982	0.982

(1) The figures in brackets are the t statistics. – (2) The countries with decentralized bargaining are Canada, the United Kingdom and the United States; those in an intermediate position are Austria, Belgium, France, Germany, Italy, the Netherlands, Portugal and Spain; and those with centralized bargaining are Denmark, Finland and Sweden.

In order to test the invariance of tax incidence hypothesis and the role of the institutional characteristics of the labour market in encouraging or discouraging the pass through of the tax wedge, the following model has been estimated:

$$\text{Log}\,(LC/P)_{k,t} = \text{cost.} + \alpha_1 \cdot \log\,(Y/L)_{k,t\text{-}1} + \\ + \alpha_2 \cdot \text{OUTPUT GAP}_{k,t\text{-}1} + \alpha_3 \cdot \log\,(LC/P)_{k,t\text{-}1} + \\ + \alpha_4 \cdot \text{INCOME TAX}_{k,t\text{-}1} + \alpha_5 \cdot \text{SSCEE}_{k,t\text{-}1} + \\ + \alpha_6 \cdot \text{SSCER}_{k,t\text{-}1} + \beta_1 \cdot \Delta\,\text{INCOME TAX}_{k,t} + \\ + \beta_2 \cdot \Delta\,\text{SSCEE}_{k,t} + \beta_3 \cdot \Delta\,\text{SSCER}_{k,t} + \varepsilon_{k,t}$$

where the tax wedge (TAX WEDGE) is broken down into its components: income tax (INCOME TAX), employees' social security contributions (SSCEE) and employers' social security contributions (SSCER).

The results reject the invariance of tax incidence hypothesis in the short term: changes in employers' social security contributions and in personal income tax on earnings have a greater effect on labour costs than changes in employees' social security contributions (column C of Table A1).

The results of the estimation suggest that the pass through of the tax wedge to labour costs is greatest for the European countries marked by wage bargaining with an intermediate degree of decentralization and mainly concerns employers' social security contributions and personal income tax.

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[1] Both variables are valued at 1991 prices and converted into US dollars using the exchange rate for the same year. Labour costs are calculated with reference to a typical manufacturing worker, whose productivity is approximated by dividing the value added of manufacturing by the number of employees in the sector.

[2] The time span is limited to 1986-95 for Spain, 1980-94 for Sweden and 1986-93 for Portugal, owing to lack of data on the manufacturing sector in the earlier years.

[3] This implies that the error term is the sum of a random variable, *u*, specific to each country, and a common white noise error term. It is assumed that the relationships between these two variables are those normally assumed in the literature (see Greene, *Econometric Analysis*, London, Macmillan, 1993, 2nd edition). The specification with random effects was adopted on the basis of the Hausmann test; in particular, the null hypothesis of absence of correlation between fixed effects and explanatory variables is not rejected.

[4] Arellano and Bond, *Dynamic Panel Data Estimation Using DPD. A guide for Users*, Institute for Fiscal Studies, Working Paper no. 15, 1998.

Documents

The Regulation on asset management companies and investment funds issued by the Bank of Italy pursuant to the 1998 Financial Services Law (*)

The 1998 Financial Intermediation Law (Legislative Decree 58 of 24 February 1998) revised the whole legal framework within which securities investment firms operate,[1] especially as regards collective asset management. The regulation of many aspects of this matter was removed from the sphere of statutory legislation and entrusted to the Minister of the Treasury, Consob and the Bank of Italy.

The Bank of Italy issued its first implementing regulations on 1 July 1998,[2] to give immediate effect to the new rules on collective asset management.

With the Regulation issued on 20 September 1999 (published in *Gazzetta Ufficiale della Repubblica*, no. 230 of 30 September 1999), the Bank has essentially completed the new legal framework in this field.

In particular, the Regulation covers:

- the equity interests that asset management companies may hold and mergers and divisions in which they are involved;
- the prudential rules on limiting and spreading risk applicable to investment funds and SICAVs. This completes the reform of the regulatory framework for collective investment undertakings, the main lines of which had been laid down in Treasury Minister Decree 228 of 24 May 1999 (published in *Gazzetta Ufficiale della Repubblica*, no. 164 of 15 July 1999);
- the methods for valuing the assets of collective investment undertakings and calculating the value of units;
- mergers between investment funds;
- the characteristics of certificates representing fund units.

Lastly, the Regulation lays down the conditions that banks must satisfy in order to act as a depository bank for collective investment undertakings and regulates the procedures for subdepositing the assets of investment funds and SICAVs.

(*) Prepared by the Financial Supervision Department. The text of the regulation described in this note is available on the Internet at www.bancaditalia.it

[1] For an analysis of the innovations introduced by the 1998 Financial Services Law, see “The Consolidated Law on Financial Intermediation”, statement by the Deputy Director General of the Bank of Italy, Pierluigi Ciocca, to the Finance Committee of the Chamber of Deputies, in Banca d’Italia, *Economic Bulletin*, no. 26, 1998.

[2] For a description of this measure, see “The regulations on intermediaries issued by the Bank of Italy in implementation of the Consolidated Law on Financial Intermediation”, in Banca d’Italia, *Economic Bulletin*, no. 27, 1998.

Supervisory activity (*)

Analysis of the organizational structure of banks

The evolution of the framework of supervisory regulations at both the national and international levels has seen an increase in the importance given to the role of organizational analysis. After setting out a number of principles to be adopted by banks' systems for internal control and risk management for specific sectors, the Basle Committee for Banking Supervision subsequently addressed the issue in relation to banking activities in general in the document *Framework for internal control systems in banking organisations*, which laid down general guidelines for supervisory authorities to follow when assessing internal control systems. The current review of the Capital Accords also provides for the inclusion of effective organizational arrangements and internal control systems among the parameters considered when assessing capital adequacy.

The supervisory regulations issued by the Bank of Italy concerning internal controls and the duties of the Board of Auditors, in line with the resolutions adopted by the Interministerial Committee for Credit and Savings, confirm the general principles and best practices approach defined internationally, adapting them to suit the specific characteristics of the Italian banking system.

The procedures and tools for analyzing and investigating organizational arrangements hitherto used by the Bank of Italy have been redefined to provide a more meaningful picture of banks' strategic choices, the measures adopted to pursue the declared objectives and organizational measures required.

The analysis conducted by supervisory authorities aims to assess the adequacy of each bank's organizational structure - which banks decide autonomously in accordance with the general guidelines laid down in regulations - in order to identify possible organizational weaknesses that could jeopardize its economic, financial or capital situation or its ability to handle competitive pressures (so-called organisation risk). Rather than seek to identify an optimal organizational structure, the analysis aims to examine the effects of corporate strategies on the level of organization risk.

Banks have been informed of the principles underlying examinations and the criteria adopted.

Survey of outsourcing of corporate activities other than IT

The far-reaching transformation now sweeping both the Italian and international banking systems is prompting operators to take organizational measures to rationalize their structures and productive processes. Cost containment and improving the quality of service are among the objectives being pursued.

As part of this process, the performance of some activities or processes may be entrusted to legally independent third parties, sometimes within the same banking group.

The Bank of Italy has conducted a survey among banks aimed at:

- discovering which corporate activities other than IT are being outsourced and why;
- analyzing the procedures adopted when outsourcing.

(*) Prepared by the Banking Supervision Department. The full text of the paper on which this summary is based will be published in the October issue of the *Bollettino di Vigilanza.*

A total of 29 primary and secondary activities were identified. These were divided into four areas: secondary/auxiliary, administrative/accounting, strategic/control and business, which in turn was broken down into finance and credit.

Particular attention was paid to factors subject to *contractual bargaining* with outsourcers and to the tools and procedures used to monitor bank/outsourcer relationships owing to their importance in the prevention of operational, legal and reputation risks.

The questionnaires revealed that 267 banks, or 95.7 per cent of those surveyed, either have already outsourced corporate activities or processes or are about to do so. Specifically, almost all banks are involved in outsourcing their auxiliary and administrative activities (90.2 and 93.6 per cent respectively) and more than half are outsourcing strategic and finance activities (62.1 and 52.9 per cent), while credit activities are less affected (31.6 per cent).

The survey showed that for some functions in the strategic and finance areas (planning, management control, inspectorate/internal auditing, risk management) outsourcing is almost always linked to acquisitions or restructuring within banking conglomerates and mainly affects small banks. The outsourcer is generally the parent bank or another member of the conglomerate.

In the case of other activities and processes outsourcing is mostly seen as a means of reducing costs or making them more variable.

The complete results of the survey have been sent to banks.

Speeches

Fact-finding preliminary to the budget for 2000

Statement by the Governor, Antonio Fazio,
to the Joint Session of the Fifth Committees of the Italian Senate and Chambers of Deputies

Rome, 14 October 1999

1. The macroeconomic environment

In the first half of this year economic activity slowed down in the euro area. Production in France and Spain decelerated but nonetheless increased at a rapid pace; in Germany and Italy it stalled. Activity was helped by the cuts made in short-term interest rates, against a background of price stability, by the national central banks in December 1998 and by the Eurosystem in April this year.

The climate of confidence in the euro area improved during the summer; the growth in production gathered pace; the recovery was also visible in Germany and, to a lesser extent, in Italy. The outlook for the final months of the year brightened for the area as a whole.

There continued to be significant differences between the growth rates of the eleven countries.

In Italy GDP declined in the final months of last year but in the first six months of 1999 it was 0.2 per cent higher than in the preceding half-year. The increase was concentrated in services and construction; industrial production continued to be weak and only began to show signs of recovery in June.

Production was sustained by domestic demand, especially investment, which in the construction sector benefited from the incentives for renovating residential buildings and the low interest rates. Consumption expanded, but only at a modest pace. The improved conditions in the labour market should result in disposable income rising faster, which would benefit households' spending plans. The contribution to growth of net foreign demand fell further, from -1.1 percentage points in 1998 to -1.4 percentage points in the first half of 1999 in comparison with the same period in 1998. There was a sharp contraction in the current account surplus of the balance of payments that was mostly due to the slowdown in exports, although the latest available data indicate a partial recovery in this component.

Employment has been expanding now for seven consecutive quarters, partly on account of the spread of new types of contract, such as part-time and fixed-term. Between July 1998 and the same month this year there was an increase of 256,000 units, or 1.2 per cent; the unemployment rate declined from 11.4 to 11.1 per cent; the gap between the rates in the Centre-North and the Mezzogiorno widened from 15 to more than 16 percentage points.

The official growth forecasts for this year are substantially the same as those contained in the Economic and Financial Planning Document published in June. For GDP the forecast of 1.3 per cent growth is confirmed. The composition is slightly changed: the expansion in domestic demand is expected to increase from 1.9 to 2.1 per cent; in particular, the contribution of spending by general government and non-profit institutions is forecast to rise; the expected contribution of stockbuilding, which in the June Document was forecast to be -0.3 percentage points, is set at 0.1 points; the negative effect on growth of net exports has been increased from -0.3 to -0.9 percentage points.

The present cyclical recovery will have to strengthen if the Government's target for growth is to be achieved; the expansion in economic activity in the second half-year would need to be at least on the order of 3 per cent on an annual basis.

2. The public finances in 1999

The Forecasting and Planning Report for 1999 and the subsequent Stability Programme both forecast a reduction in the budget deficit for this year from 2.6 to 2 per cent of GDP as a result of the decline in interest payments. The target for the primary surplus was accordingly left at 5.5 per cent of GDP, as forecast for 1998. In order to achieve this objective, budget measures were needed to reduce net borrowing by 8 trillion lire compared with the figure on a current programmes basis.

The Quarterly Report on the Borrowing Requirement of last March updated the forecasts for the public finances for 1999 to take account both of the less favourable results attained in 1998 and of the deterioration in the outlook for growth. The rise in economic activity forecast for this year was reduced by one percentage point, from 2.5 to 1.5 per cent, and the target for net borrowing set at 2.4 per cent of GDP, as confirmed in the subsequent Planning Document; the primary surplus was set significantly lower.

In the first nine months of this year the state sector borrowing requirement net of settlements of past debts and privatization receipts amounted to 45.5 trillion lire, 13.5 trillion less than in the corresponding period of 1998. According to the forecasts prepared by the Ministry of the Treasury for October, the improvement in the first ten months of the year will be 15 trillion lire, 8 trillion more than expected.

The figures for the general government borrowing requirement, influenced by local government operations, are not so good. The available data cover the first six months of the year and are affected by the postponement of payment of about 25 trillion lire of self-assessed taxes; net of this item the deterioration is about 6 trillion lire.

By contrast, the state sector borrowing requirement for the same period shows an improvement of about 6 trillion lire, net of postponed tax receipts; the divergence of the results of the two sectors is attributable to the considerable volume of borrowing by municipalities and provinces.

The increase in local authority spending is probably larger than forecast. The Technical Note to the Finance Bill refers to the failure to achieve the objectives of the Domestic Stability Pact for 1999 and to a limited overshoot for the year.

Tax receipts in the first nine months were higher than expected, with a consequent increase in their ratio to GDP for the year. The update of the Economic and Financial Planning Document gives no estimate of the increased revenue, leaves the expected value of the ratio for 1999 unchanged and only quantifies the carryover effects from 2000 onwards. The unexpected rise in revenue is attributable to VAT on domestic trade, corporate income tax and receipts from Lotto and other lotteries.

The rise in VAT is due to several factors. The direct tax incentives granted for building renovation projects have had an expansionary effect; as well as providing an incentive to anticipate spending decisions, they may have contributed this year to bringing incomes into the open on which tax would otherwise have been avoided.

Part of the increase is probably the result of administrative measures and steps taken to combat evasion, such as the introduction of sector studies, more incisive controls and the deterrent to reporting manifestly inconsistent income levels following the introduction of the new unitary payment system, and amendments to the procedures for making income tax returns.

Receipts from Lotto and other lotteries have increased substantially; in the first nine months of 1999 they amounted to 10.5 trillion lire, compared with 4.9 trillion in the same period of 1998.

In evaluating the result for the state sector borrowing requirement so as to make an estimate of general government net borrowing for the entire year, there are several factors calling for caution that the Government has rightly taken into account. The Forecasting and Planning Report for 2000 and the Update of the Economic and Financial Planning Document have confirmed the figure of 2.4 per cent for the ratio of net borrowing to GDP in 1999. A better result is possible.

In addition to the difficulty of quantifying the actual size of the increase in revenues, there are uncertainties concerning the instalments of self-assessed taxes still to be received and the receipts from the planned sale of claims of the National Social Security Institute (INPS).

According to the Forecasting and Planning Report, the ratio of debt to GDP will decline by 1.1 percentage points in 1999, from 116.8 to 115.7 per cent, which is less than in 1998. The smaller reduction is primarily due to the slower growth in GDP: at current prices the figure for 1999 is expected to fall short of those recorded in the two previous years by more than one percentage point; other secondary factors contributing to the less pronounced reduction in the debt ratio include the movements on the accounts the Treasury holds with the Bank of Italy and the smaller balance between receipts from the sale of assets and expenditure on debt settlements (forecast at about 3 trillion lire in 1999, compared with almost 10 trillion in 1998). Finally, on the basis of the latest exchange rates, the lira value of liabilities denominated in dollars and yen increased by about 9 trillion lire.

3. The objectives for the public finances in the four years 2000-2003

The Forecasting and Planning Report for 2000 and the Update of the Economic and Financial Planning Document for the four years from 2000 to 2003 confirm the medium-term planning framework. Net borrowing is expected to be close to zero at the end of the four-year period (0.1 per cent of GDP in 2003), after declining from 2.4 per cent of GDP in 1999 to 1.5 per cent in 2000, 1 per cent in 2001 and 0.6 per cent in 2002.

More than 75 per cent of the reduction in net borrowing is expected to come from the fall in interest payments. Even though the official estimates assume an increase in interest rates on twelve-month Treasury bills, this item is forecast to fall from 7.1 per cent of GDP in 1999, to 6.5 per cent in 2000 and to 5.3 per cent in 2003 as a result of the lagged effects of the steep decline in yields in recent years. The primary surplus is forecast to increase from 4.7 per cent of GDP in 1999 to 5 per cent in 2000 and then to rise gradually to 5.2 per cent in 2003.

The ratio of debt to GDP is projected to fall by more than 15 percentage points over the four-year period, from 115.7 per cent in 1999 to 100 per cent in 2003.

The June 1999 Planning Document forecast that revenue would fall from 46.5 per cent of GDP in 1999 to 44.9 per cent in 2003, with the ratio of taxes and social security contributions to GDP falling by 1.3 percentage points over the four years.

Current primary expenditure was forecast to fall from 37.9 to 36.2 per cent of GDP and capital expenditure from 4 to 3.6 per cent. The task of finding the resources needed to increase the latter was deferred to subsequent Finance Laws and seen as depending on the achievement of more favourable macroeconomic results than those projected.

The planned figures for revenue and primary expenditure in the four years from 2000 to 2003 were basically the same as those on a current programmes basis.

Considering that at least part of the increase in tax revenue expected in 1999 was of a structural nature, the Government has increased the estimates on a current programmes basis by 9.3 trillion lire in 2000, by 9.5 trillion in 2001 and in 2002, and by 10.5 trillion in 2003. The Government proposes to use the increased receipts to grant a roughly equal amount of tax relief, so that the reduction in the fiscal ratio indicated in the June Planning Document remains confirmed.

The actual fall in the fiscal ratio in 2000 will be larger than that indicated in the Planning Document; compared with 1998, it will be two tenths of a percentage point.

In particular, personal income tax is to be reduced next year by around 6 trillion lire by lowering the second income bracket tax rate by one percentage point to 26 per cent, increasing the deduction for the first home and increasing the tax credits for large families. In addition, 3.3 trillion lire of relief is planned to sustain the building industry and reduce the levy on property transfers; the possibility of reducing VAT to 10 per cent for building works is also being considered. Lastly, measures are planned to bring forward the application of Dual Income Tax and extend its application to partnerships with effect from 2001.

4. The budget for the year 2000

Setting the additional tax cuts of 9.3 trillion lire outlined above against the deficit reduction of 11.5 trillion lire estimated in the original budget shows that the correction compared with the new improved value of the deficit on a current programmes basis is equal to 2.2 trillion lire.

The expenditure measures are intended to produce a net saving of 8.5 trillion lire; the revenue measures, a net reduction in revenue of about 6.3 trillion.

The contraction of 8.5 trillion lire in disbursements is the net effect of 11 trillion of cuts and 2.5 trillion of increases (1.5 trillion of additional capital expenditure and 1 trillion of additional current expenditure). The cuts comprise 3.3 trillion for transfers to regions, provinces and municipalities, 2.5 trillion for the management of the public debt, 2.4 trillion for intermediate consumption, 1.7 trillion for social security items, 0.7 trillion for public employment and 0.4 trillion for minor items. Around 1.5 trillion of the forecast reduction in expenditure refers to interest payments.

The reduction in transfers to regions, provinces and municipalities (3.3 trillion) is obtained under the Domestic Stability Pact, which was introduced in 1999 and requires local authorities to contribute to the achievement of the objectives for the public finances. In the four years from 2000 to 2003 they must reduce their net borrowing by at least 0.1 per cent of GDP every year (about 2.2 trillion lire in 2000); the larger saving indicated in the budget reflects the inclusion of the planned saving that was not achieved in 1999.

The saving connected with the management of the public debt (2.5 trillion) is due to lower interest payments and higher interest receipts. Action is foreseen on four fronts: the renegotiation of loans raised by public entities with the related cost borne by the State (0.7 trillion); the early repayment of postal savings securities and their replacement by others with yields that are lower, although still above market rates (0.6 trillion); the investment of treasury balances in higher-yielding assets (1 trillion); and the introduction of repo operations in the government bond market (0.2 trillion).

The saving in intermediate consumption (2.4 trillion) is achieved in large part by postponing certain expenditures (1.1 trillion), the remaining part primarily by reducing the related budget appropriations by 5 per cent, making the renewal of supply contracts conditional on price reductions and rationalizing procurement procedures.

The saving in social security expenditure (1.7 trillion lire) is to consist primarily of payments by electricity and telephone companies to make good the deficits of their respective pension funds.

Public sector hiring will be restricted further and school personnel reduced. Cost-of-living adjustments to certain allowances will also be frozen. The related saving is expected to amount to about 0.7 trillion.

The net reduction in revenue of 6.3 trillion lire is the result of the additional tax relief (9.3 trillion lire), the temporary investment subsidies introduced this year (1 trillion) and the measures to increase non-tax revenue by 4 trillion lire.

The increase in non-tax revenue will be generated by the disposal of real estate, mainly by social security institutions. The sales may be made through intermediaries that will subsequently place the assets with final buyers. The public administration may intervene to accelerate the disposals.

For general government as a whole, it should be noted that some of the measures concerning the public debt and social security are stated as reducing expenditure by around 2.5 trillion lire, whereas they will actually increase revenue. Expenditure will therefore be reduced by 6 trillion lire and revenue by 3.8 trillion.

5. Assessment of the budget adjustment and the outlook

The forecast reduction in the deficit from 2.4 per cent of GDP this year to 1.5 per cent in 2000 can be considered adequate for the purposes of achieving a budgetary situation close to balance in a context in which the economic recovery is still uncertain. About two thirds of the improvement is due to the further decline in interest payments.

As mentioned earlier, the Update of the Planning Document assumes that the better-than-expected result foreseeable for revenue in 1999 has a structural component that will increase tax revenue by more than 9 trillion lire in 2000 and even more in subsequent years. As regard VAT, the additional receipts attributable to the incentives for renovating residential buildings are certainly temporary and matched by future revenue losses as the related personal income tax credits mature. Lotto receipts depend on the behaviour of players; it is therefore difficult to identify the structural component.

The uncertainty arising from the inclusion in the calculation of general government net borrowing of receipts from the assignment of contributions claims of the National Social Security Institute also applies to the forecast of receipts of 5.9 trillion in both 2000 and 2001. The trend of the general government borrowing requirement and the failure to achieve the objective the Domestic Stability Pact set for local authorities in 1999 suggest that there is a risk of their expenditure growing faster than expected.

The budget measures can usefully be assessed from three points of view: a) the ability to ensure the objective is met; b) the presence of structural measures; and c) the implications for the competitiveness of the Italian economy.

Some expenditure reduction measures may be difficult to implement. Incentives or more stringent constraints are needed for non-state public bodies. There must be adequate procedures to ensure achievement of the benefits of the measures concerning the management of treasury balances and repo operations, and the rapid disposal of real estate.

In the years to come, new measures will be necessary to offset the increased expenditure deriving from the planned postponement of certain items and the drying up of the temporary effects of the payments by electricity and telephone companies, the measures concerning postal savings and property disposals in order to strengthen the structural character of the budget adjustment.

Italy continues to grow more slowly than the other European countries, in part owing to the larger and more intense effort it made to consolidate the public finances. It is also the result of insufficient competitiveness. The weakness of growth in turn prevents a significant increase in productivity, thus increasing unit labour costs.

Since 1997 foreign trade has slowed the growth in GDP. A model of specialization based on low-technology products exposed Italy more than other countries to the effects of the Asian crisis. Despite the modest expansion in domestic demand, the current account surplus is shrinking. The available indicators signal the erosion of Italian industry's competitiveness.

In the forecasts presented at its recent annual meeting, the International Monetary Fund pointed to an improvement in the outlook for the world economy in the year 2000. Differences in growth rates in the leading economies are expected to narrow. GDP in the euro area is expected to expand by 2.8 per cent, as against 2.1 per cent this year. The growth rate of the industrial countries as a group is expected to remain at 2.5 per cent.

Gross domestic product in Italy could increase by between 2 and 2.5 per cent in 2000; the Government has reasonably forecast a rate of about 2.2 per cent.

Recent budgets have sought to sustain production through incentives aimed primarily at stimulating households' demand and, to a lesser extent, investment.

In order to strengthen the outlook for growth, it is necessary to boost private and public investment.

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Economic policy for the year 2000 is oriented in the right direction. Economic activity will be stimulated by the planned resumption of public investment, the incentives for private investment in 1999 and 2000 and the acceleration of the planned reduction in the rate of corporate income tax made possible by Dual Income Tax. Nevertheless, in order to achieve faster investment growth it is necessary to improve expectations and, more fundamentally, increase the competitiveness of the Italian economy.

In the medium term, raising competitiveness requires a substantial reduction in the tax burden and a significant expansion of the country's stock of infrastructure, especially in the South. Plans for streamlining government departments and increasing the quality of services must be carried out. Constraints that often restrict the activities of firms without producing corresponding benefits for the public interest must be eased.

Expectations can be improved significantly and a more favourable business environment created at no cost by amending company law, the reform of which is under study, and more generally by reforming business law within a unitary framework.

The Financial Services Law brought the regulation of listed companies closer into line with that in the other leading countries. The reform must be extended to unlisted companies - the most dynamic component of the Italian economy - in order to turn their entrepreneurial drive to full advantage. Bankruptcy procedures are long and costly; they should be adapted to take account of the reform of company law. The new laws should ensure more rapid and final solutions to commercial disputes. The process of simplifying legislation and administrative procedures must be accelerated. The completion of the plans to increase the efficiency of the tax authorities will bring benefits.

Firms must implement strategies that enable them to seize the opportunities for growth offered by the international recovery, technological development and the innovations in economic policy.

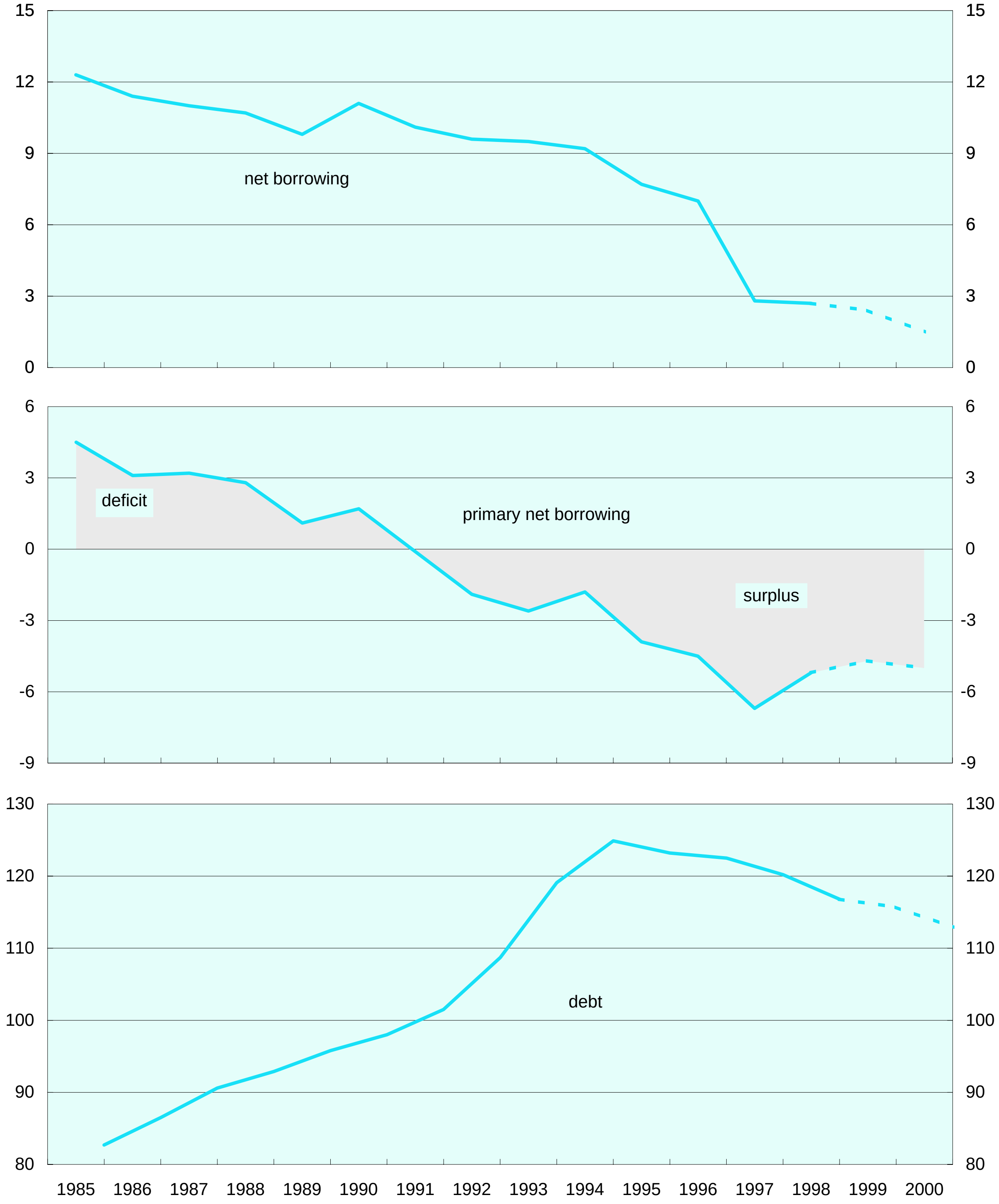
Social security reform is a necessary condition for achieving, albeit in the medium term, the objectives for economic growth and tax reductions mentioned above. It is essential to head off the difficulties that will begin to arise in the middle of the next decade. Independently of the budget for the year 2000, the Minister of the Treasury has suggested that it is necessary to reduce social security spending by between 3 and 4 per cent of GDP.

A significant reduction in the ratio of public pension expenditure to GDP could be obtained by tightening the criteria that govern eligibility for long-service pensions while still leaving the necessary margin of flexibility for individual decisions, increasing the age at which citizens qualify for the standard old-age pension and extending the use of mixed (earnings and contributions-based) mechanisms. Ceilings on pensions whose cost is borne by the budget must be accompanied by corresponding limitations on pension contributions. Individuals can achieve the desired level of pension coverage with supplementary pensions.

In a situation in which competitiveness can no longer be recouped through exchange rate adjustments and in which markets are increasingly integrated, it is essential to create conditions more favourable to capital accumulation and to curb costs and increase the flexibility of the system in appropriate ways. Italy has the potential to raise its rate of growth even above that prevailing in the euro area and to increase employment by using the available resources of savings and labour.

Figure 1

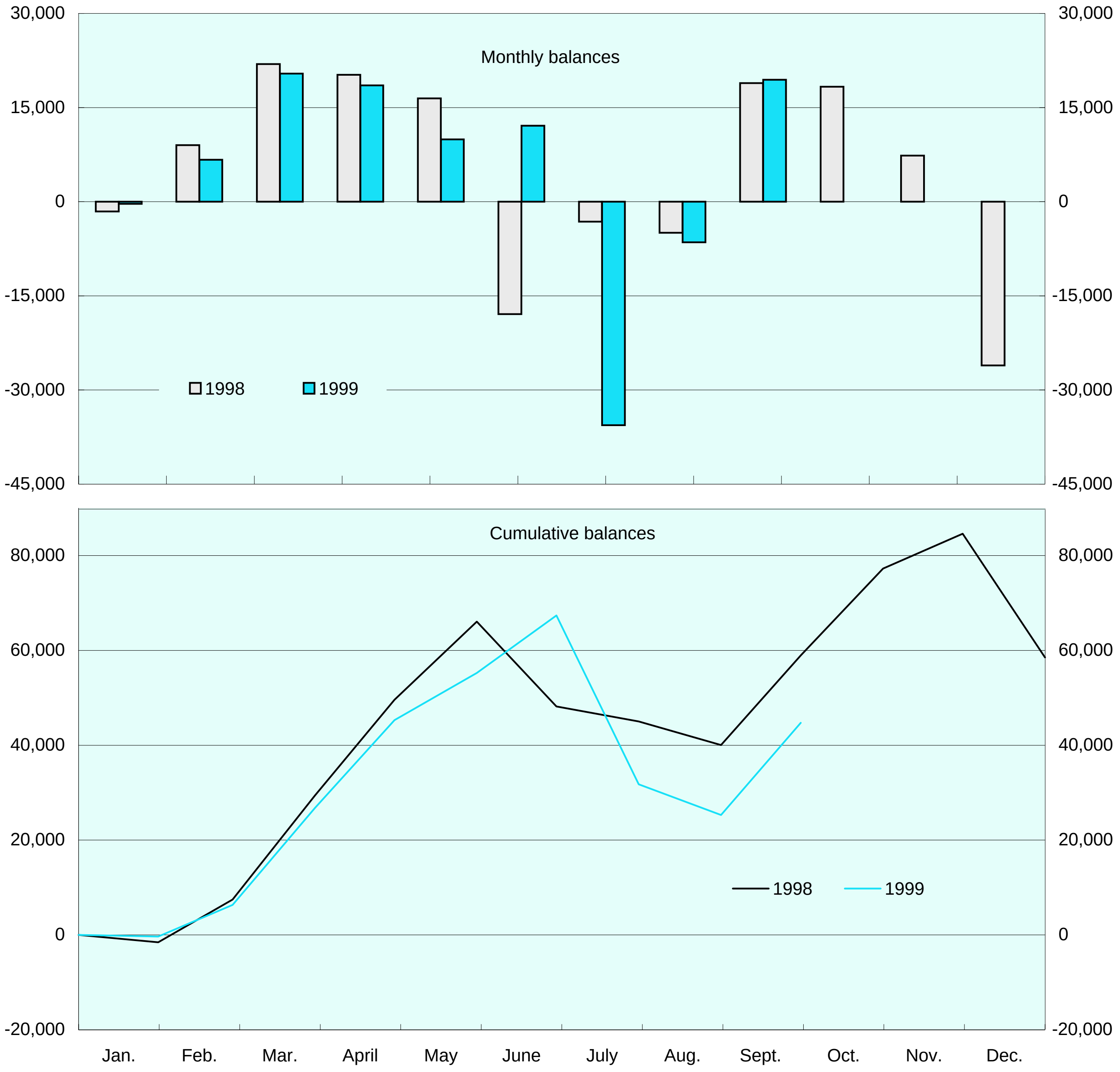
General government net borrowing, primary net borrowing and debt (1)
(as a percentage of GDP)



(1) As of 1995 the data are shown according to the new version of the European System of Accounts (ESA95). For 1999 and 2000, forecasts taken from the *Relazione previsionale e programmatica* (October 1999).

Figure 2

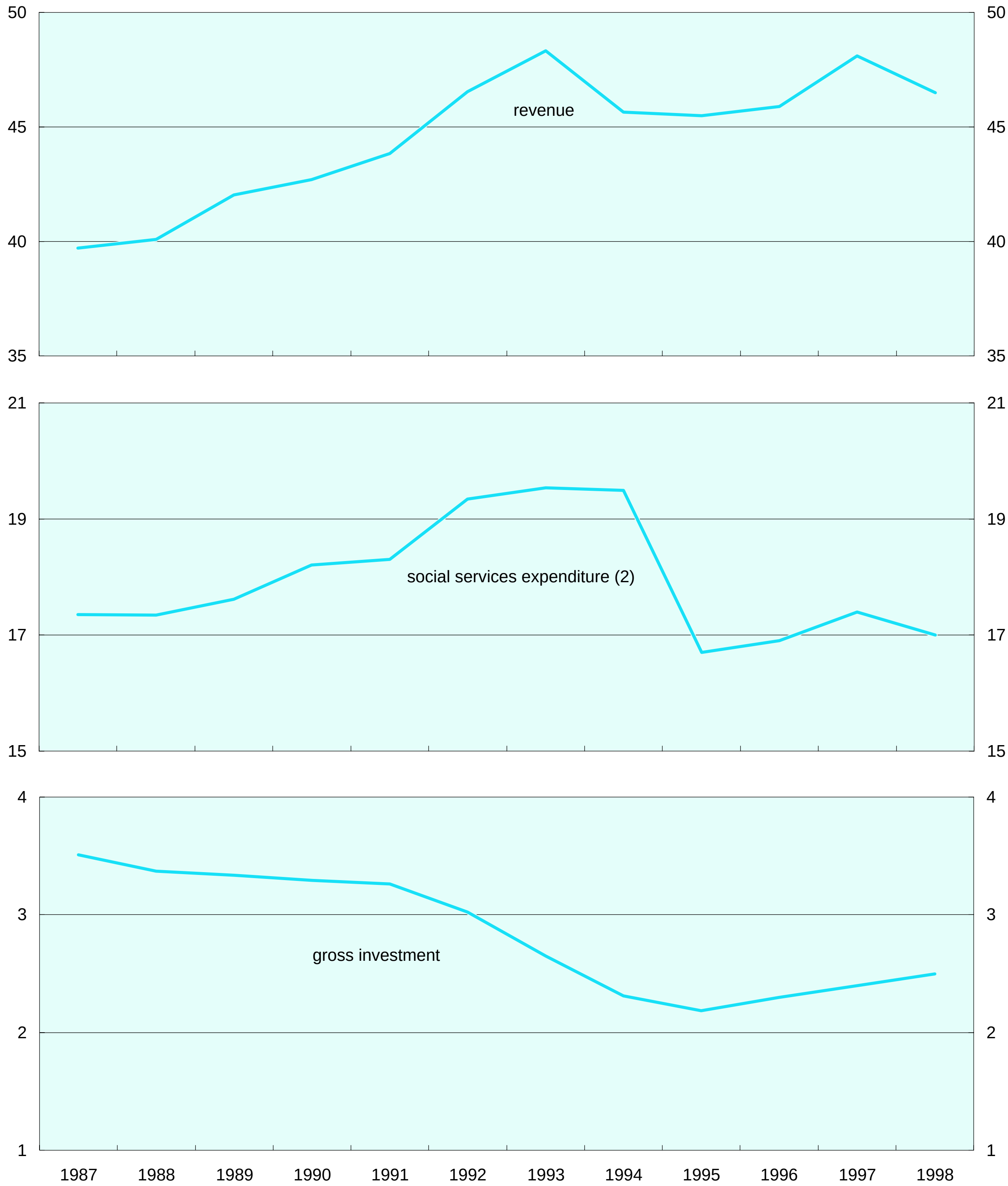
State sector borrowing requirement in 1998 and 1999 (1)
(billions of lire)



(1) Net of settlements of past debts and privatization receipts.

Figure 3

General government revenue, social services expenditure and gross investment (1)
(as a percentage of GDP)



(1) As of 1995 the data are shown according to the new version of the European System of Accounts (ESA95).
(2) The break in the series between 1994 and 1995 is due to the reclassification of social services in kind under intermediate consumption, according to ESA95.

Table 1

State sector balances (1)

(billions of lire and percentages of GDP)

	Year			First 9 months	
	1996	1997	1998	1998	1999 (2)
Primary surplus	**66,129**	**124,148**	**91,730**		
as a percentage of GDP	*3.5*	*6.3*	*4.5*		
Borrowing requirement net of settlements of past debts and privatization receipts	**128,871**	**56,670**	**58,523**	**59,949**	**45,446**
as a percentage of GDP	*6.8*	*2.7*	*2.8*		
Settlements of past debts (3)	13,502	–409	4,770	2,368	9,461
Privatization receipts (4)	–6,226	–21,179	–14,291	–8,152	–1,768
Total borrowing requirement	**136,147**	**31,081**	**49,002**	**53,165**	**53,139**
as a percentage of GDP	*7.2*	*1.6*	*2.4*		
Financing					
Medium and long-term securities	126,909	99,009	79,662	94,171	83,651
Treasury bills in lire and ecus	–27,453	–82,310	–35,483	–23,983	–15,793
Treasury current accounts with the BI	17,370	–3,020	15,578	–6,295	–14,660
Other BI-UIC financing	304	435	384	228	130
Post Office funds	12,798	11,641	6,364	2,067	11,231 (5)
current accounts	*–1,541*	*–1,062*	*–6,104*	*–3,844*	*0*
Bank lending	–9,356	1,074	–6,668	–4,355	–3,334
Other domestic financing	194	194	405	334	47
Foreign loans (6)	15,380	4,059	–11,241	–9,002	–8,132

(1) Based on Eurostat general government accounting rules. – (2) Provisional data. – (3) Includes Local Health Unit debts and early redemption of a bond loan granted to IRI by the Deposits and Loans Fund. – (4) Includes Treasury purchases of shareholdings in STET drawing on the sinking fund for the redemption of government securities: 3,000 billion lire in 1996, 13,500 billion in 1997 and 8,166 billion in 1998. – (5) Estimated data. – (6) As of 1999 includes commercial paper.

Table 2

Estimated effects of the budget for the year 2000
(billions of lire)

REVENUE	
Increase in revenue	**4,000**
Property sales	*4,000*
Social and development policies	**–10,300**
Incentives for investments in 1999-2000	*–1,000*
Reduction in the 27% personal income tax rate to 26% and tax relief for dependents and housing	*–6,000*
Tax credits for building renovation works - Reduction in taxation of transfers of ownership - Other measures	*–3,300*
TOTAL REVENUE (net increase in revenue)	**–6,300**
EXPENDITURE	
Reduction in expenditure	**11,000**
Domestic Stability Pact	*3,300*
– Stability Pact savings in 2000	2,200
– Recovery of shortfalls in 1999 Stability Pact savings	1,100
Debt management	*2,500*
– Management of treasury balances	1,000
– Renegotiation of loans	700
– Post Office savings	600
– Repurchase agreements	200
Intermediate consumption	*2,400*
– Postponement of expenditure	1,100
– 5% reduction in appropriations	700
– Reorganization of procurement procedures for goods and services	200
– 3% reduction in supply contracts	100
– Other	300
Pensions	*1,700*
– Special fund for electricity workers	1,350
– Special fund for telephone workers	300
– Other	50
Public employment	*700*
– Restriction on recruitment	350
– Freeze on revaluation of allowances	200
– Reduction in school personnel	150
Other expenditure	*400*
Social and development policies	**–2,500**
Increase in current expenditure	*–1,000*
Support for capital expenditure	*–1,500*
TOTAL EXPENDITURE (net reduction in expenditure)	**8,500**
TOTAL REDUCTION IN PRIMARY NET BORROWING	**2,200**

Table 3

The public finances: outturns and objectives
(billions of lire and percentages)

	1998	1999	2000	1998	1999	2000
	(billions of lire)			*(as a percentage of GDP)*		
State sector						
Borrowing requirement (1)	58,523	53,800	41,333	2.8	2.5	1.9
Interest payments	150,253	143,400	137,939	7.3	6.7	6.3
Primary surplus	91,730	89,600	96,606	4.5	4,2	4,4
General government						
Net borrowing	56,238	51,400	33,000	2.7	2.4	1.5
Interest payments	164,058	150,200	142,500	8.0	7.1	6.5
Primary surplus	107,820	98,800	109,500	5.2	4.6	5.0

Source: *Documento di Programmazione Economico-Finanziaria per gli anni 2000-2003.*
(1) Net of settlements of past debts and privatization receipts.

Address by the Governor, Antonio Fazio,

to the Association of Italian Savings Banks on the occasion of the 1999 World Savings Day

Rome, 30 October 1999

After slowing down significantly in 1998, the world economy has resumed expansion at a quicker pace. The International Monetary Fund has raised its estimates for output growth in 1999 to 3 per cent.

The expansionary stance of economic policies in most of the world and the substantial support provided by the international community to crisis-stricken countries succeeded in overcoming the tensions in financial markets and helped to foster the upturn in economic activity.

Asia has emerged from the severe recession triggered by the crisis of 1997. In Japan the prolonged contraction in output has come to an end, owing mainly to massive public investment. In Russia, the collapse of the economy was averted. In Brazil, the decline in economic activity proved less sharp than originally expected.

A fundamental contribution to these successes came from the easing of monetary conditions by the Federal Reserve in the autumn of 1998. The expected slowdown in the growth of the US economy has not materialized.

Private capital flows to the emerging economies of Asia have resumed. The rise in oil prices has brought a sharp improvement in the oil exporting countries' terms of trade.

In the United States, the expansion of domestic demand in the first half of this year remained well in excess of the economy's growth potential; the balance-of-payments deficit on current account rose to $300 billion on an annual basis, or 3.5 per cent of GDP. At the end of June the Federal Reserve tightened monetary conditions.

International financial markets remain very volatile. Long-term interest rates have risen in all the main industrial countries. The upward trend has spread from the United States to Europe.

The world economic situation is not without risks. Uncertainty over the sustainability of the Japanese recovery persists; Latin America's balance-of-payments deficit on current account remains large; from the summer onwards exchange rates have come under renewed pressure in several countries, and the conditions of access to international financial markets have deteriorated again.

Within the euro area the slowdown in economic activity in the first half of this year was modest. Demand was bolstered by the reductions in short-term interest rates made by national central banks at the end of 1998 and by the Eurosystem in April. Consumer confidence improved over the summer months; production rose appreciably.

The Italian economy

In Italy, industrial production had already begun to weaken slightly in the first half of 1998; the decline became more pronounced in the second half of the year and continued until May 1999. During the summer the index of industrial production rose significantly.

The September business survey conducted by the branches of the Bank of Italy suggests that the expansion will continue in the fourth quarter. Firms are optimistic about the outlook for domestic and export demand; the growth expected nonetheless appears modest.

In the first six months of the year economic activity was stimulated by fixed investment, public works and the renovation of residential buildings. Purchases of equipment, machinery, transport equipment and intangible goods continued to expand. The growth of consumption remained limited.

As in the two previous years, the effect of net exports in the first half of 1999 was to slow Italian growth by about one percentage point. GDP grew by 0.2 per cent.

Exports are now showing signs of an upturn in response to the acceleration of world demand and the appreciation of Asian currencies.

Employment has increased for seven consecutive quarters. In July the number of persons in work was up by 250,000 or 1.2 per cent on a year earlier, the gain coming in services and construction. The number of permanent full-time employees rose by about 1 per cent, while that of workers on fixed-term or part-time contracts increased by about 10 per cent.

The increased elasticity of the demand for labour with respect to output stems from firms' greater use of more flexible employment contracts. In industry, little scope was left for further lengthening of effective working hours, in addition to what past corporate restructurings had required. Employment now tends to increase more than output, partly owing to the expansion of the service sector, where average productivity is lower than in industry.

The unemployment rate fell to 11.1 per cent in July. The gap between the South and the Centre and North, widened to over 16 percentage points.

In the first ten months of 1999 the state sector borrowing requirement was 61.7 trillion lire, some 15.5 trillion less than in the same period of 1998. The result for the broader general government sector was less satisfactory owing to the high level of local authority borrowing.

Caution is called for in evaluating the results for 1999 as a whole, in view of the uncertainty regarding developments in the last part of the year and the relationship between the state sector borrowing requirement and general government net borrowing. The latter may nonetheless turn out to be just under 2.4 per cent of GDP, the level indicated in the Quarterly Report on the Borrowing Requirement published in March.

Inflation in Italy has gradually accelerated over the year. Commodity prices have been rising since the spring, energy costs have surged and the euro has depreciated in the first ten months of 1999 by 10.3 per cent with respect to the dollar and by 9.9 per cent on a trade-weighted basis.

In October the twelve-month rate of increase in consumer prices was 2 per cent; since July the seasonally-adjusted annualized rate has been about 3 per cent. The underlying rate of increase in producer prices has remained just under 1 per cent.

The inflation differential with respect to the euro area has narrowed but remains significant. Italian unit labour costs continue to rise appreciably faster, owing to smaller productivity gains.

There are regional differences in the situation described above, which have been analyzed with the help of our branches.

The contraction in industrial production in the early months of 1999 was most pronounced in the North-West and the South. By sector, the sharpest falls in output occurred in the textile, clothing and footwear industries.

The signs of recovery observed during the summer were widespread. Some 38 per cent of the firms covered by the Bank's survey reported production increases since June. In many regions the growth appears set to continue in the last part of the year, albeit at a subdued pace.

In the first nine months of 1999 some 420,000 applications were made for tax relief in connection with the renovation of residential buildings; the demand was concentrated in the Centre and North, where the ratio of applications to buildings was more than three times as high as in the South.

The schemes for cooperation between firms, unions and local government to foster development in the southern regions are making slow progress. Local authorities' ability to develop projects continues to be limited and entrepreneurial capabilities are in short supply.

In many cases, businessmen are aware of the need for renewed efforts to curb costs, increase efficiency and flexibility, and improve product quality. Traditional sectors with mature technology are more exposed to competition from the newly industrialized countries. In some regions, including those of the North-West, firms are embarking on plans to strengthen their presence in sectors with a higher value added and internationalize production. In other areas, especially those where small firms account for the bulk of industry, there appears to be less scope for applying technological innovations.

Lending and interest rates

The signs of recovery in economic activity that emerged during the year were promptly reflected in the financial markets. The downward trend of interest rates has reversed, first at the long end of the market and more recently at the short end.

For longer maturities, euro yields began to rise in May. The upward movement first appeared in the United States at the end of 1998; it spread to the euro area in response to the signs of an upturn in economic activity and fear that the increase in commodity prices, especially that of oil, and the depreciation of the euro might rekindle inflation.

From the low values reached in April, the interest rate on ten-year BTPs has risen by 1.4 percentage points to 5.4 per cent, returning to its level at the end of 1997. The yield differential with respect to equivalent German securities has remained stable in a range of 20-30 basis points; since April the yield differential between 10-year bonds denominated in dollars and euros has narrowed from 1.2 to 0.7 percentage points.

The recovery in economic activity has contributed in recent months to interest rates rising at the short end of the market as well. The rate on three-month interbank deposits is currently about 3.5 per cent, some 0.9 points above the low reached in the spring; in part this reflects expectations of a temporary rise in connection with the Year 2000 problem.

The rapid expansion in bank lending, which has been common to the whole of Italy, owes much to the 23 per cent growth in home mortgage, spurred by low interest rates and the tax incentives for the renovation of residential buildings. Signs of recovery in the real-estate market have emerged as a consequence. Lending to Italian firms by foreign intermediaries has also risen sharply.

The cost of medium and long-term credit began to rise again in August in the wake of the increase in the preceding months in the yields on securities; bank rates have nonetheless risen much less and, as regards lending to households, less than in the other countries of the euro area.

The banking system

Banks' accounts showed an improvement in profitability in the first six months of 1999. The fall in net interest income and profits from securities and foreign exchange trading was offset by the increase in income from services. Operating costs were broadly unchanged. Staff costs declined by 1.7 per cent compared with the first half of 1998 as a result of an equal reduction in the number of employees.

Profitability benefited from the smaller volume of loan losses. The return on equity was 10 per cent on an annualized basis, compared with 8 per cent in the first half of 1998. The performance in the second half of the year could be less satisfactory owing to the decline in the value of banks' securities portfolios.

Intermediaries from other areas had already begun to enter local markets in the eighties. There has been a major redistribution of market shares in the different geographic and product segments; the leaders in markets for mature banking products have been joined by other intermediaries in the supply of innovative services.

Competition is intensifying in lines of business where transaction volumes are growing rapidly. New channels of supply are spreading, based on telematic systems, the telephone and the Internet; they enable customers to compare and choose among the products offered by a wide range of intermediaries.

Supply is especially abundant and diversified in the field of asset management. In September there were 58 management companies of open-end investment funds operating in Italy. Customers can choose from among nearly 800 Italian investment funds; about 1,000 foreign funds are marketed in Italy under distribution agreements with domestic intermediaries.

The presence of foreign banks has expanded, especially in areas such as corporate finance, lending to households and wholesale securities trading. By introducing products and techniques typical of more advanced financial systems, these banks have stimulated innovation and efforts to increase operating efficiency in the banking system as a whole.

Foreign banks have also entered the market by acquiring large interests in Italian banks. They now hold more than 10 per cent of the capital of each of the five largest domestic banking groups, which is more than comparable foreign holdings in the other leading countries.

No more than seven years ago, at the end of 1992, some 68 per cent of total bank assets were held by public-sector banks. Today, the share is 17 per cent, one of the smallest in continental Europe; with the sale of Mediocredito Centrale, it will fall to 15 per cent.

In recent years the increase in competition has accentuated the fall in bank interest rates. The spread between average lending and deposit rates has narrowed to its lowest value since the early sixties.

Banks must continue to improve their organization and management structures.

The operating efficiency of the banking system must be raised by rationalizing the use of human resources and consolidating the benefits of technological innovation and changes in distribution networks. The greater flexibility envisaged in the labour contract signed in July will contribute to this by increasing the scope for productivity gains. Banks must persevere in their efforts to reduce operating costs to the levels prevailing in the main foreign banking systems.

Achieving more rapid growth in high-value-added services requires very large-scale production. This can be accomplished through mergers and acquisitions and collaborative alliances with banks that have extensive local networks.

In a situation where banks' branch networks are widely diversified and markets are fully open to new entrants, mergers do not reduce competition. When they do lead to dominant positions, the Bank of Italy takes measures to foster competition, such as ordering the disposal of branches or prohibiting the opening of new outlets for a specified period.

When it was first opened to international competition, the Italian banking system was highly fragmented.

Between 1990 and 1997 some 265 banks were involved in mergers; another 90 were taken over. The banks merged or acquired in the period held 22 per cent of the banking system's total assets.

At first, the process of consolidation mainly involved small banks, some of them in trouble; more recently it has spread to major institutions. Last year's operations involved 54 intermediaries, accounting for 11 per cent of the banking system; this year's have involved 49 banks, with assets equal to 10 per cent of the system total.

The spread of competition to regional markets has spurred medium-sized banks into adopting expansionary policies too. In the last four years 9 such intermediaries have acquired 67 mostly local banks and raised their share of total assets from 6 to 11 per cent.

In the two years 1997 and 1998 banks involved in mergers and acquisitions recorded an increase of 54 per cent in non-interest income and a reduction of one per cent in operating costs. Their operating profits rose by 40 per cent; those in the rest of the system fell by 8 per cent.

Mergers and acquisitions have benefited from the favourable conditions of the stock market, in view of the growing demand for forms of investment other than government securities. After raising 4.5 trillion lire of equity capital on average in each of the years between 1994 and 1996, banks completed capital increases amounting to 5.1 trillion in 1997 and 14.2 trillion in 1998; in the first half of this year they raised a total of 2.7 trillion lire.

The plans for reorganizing the credit system have been well received by investors; in the last three years bank shares have risen more than industrial shares.

Restructuring has been accompanied by a considerable improvement in the system's capital strength: at the end of last year the shortfalls in relation to the 8 per cent minimum solvency ratio had fallen to 250 billion lire, while the surpluses had risen to 61.5 trillion.

The concentrations between major insurance companies launched in the last few weeks may alter the situation as regards the control of some banks, further consolidating the ownership structure of the leading banking groups.

The planning of mergers, their accomplishment by the most suitable means and the process of integration are left to the discretion of banks' managements.

The Banking Law, which implements the EU's Second Banking Directive, requires these operations to be authorized by the Bank of Italy in order to ensure that they do not conflict with the sound and prudent management of banks.

The successful outcome of a merger depends on a high degree of cohesion among the various components of the new structure and the proper functioning of the system of corporate governance, on the rationalization of the use of productive factors and on the development of internal control systems able to ensure that the whole company complies at all times with the risk/return criteria established.

The Bank's supervisory instructions were recently amended to bring them closer into line with the markets' information and operational needs. The Bank of Italy must be informed of proposed concentrations when the outline plan is ready to be submitted to the board of directors and at least seven days before the board meets to approve the plan. Where such operations involve an irrevocable undertaking to purchase a significant shareholding, the time limit for authorization has been reduced from 60 to 30 days.

In Europe, the organization of supervision at the national level corresponds to a design for regulatory harmonization intended to ensure timely and effective control.

The legislative approach adopted consists in harmonizing the aspects that are deemed essential, necessary and sufficient, and leaving the remaining aspects to mutual recognition of the supervisory systems of individual member states, where banking is governed by provisions of public and private law that differ from one country to another.

The framework agreed at the European level is consistent with the need to recognize the links between supervisory authorities and other institutions whose legal bases are of an exclusively national nature and far from uniform.

Extraordinary measures to safeguard the system's stability are charged to national budgets; the European Central Bank takes them into account merely for liquidity management purposes.

The institutional framework for banking and financial supervision is fully specified, as is recognized in the Treaty on Monetary Union.

The coordination of supervisory authorities has proved fruitful and is worth strengthening further; it should be extended beyond the European Union to embrace the rest of the industrial world and emerging countries as well.

The Committee on Banking Supervision and the Financial Stability Forum at the Bank for International Settlements have been chosen as the most suitable bodies for this coordination. The Group of Seven, supplemented by other financially important countries, will provide an important linkage in this respect.

The risk of instability that is ever present and increasing in international markets can only be properly addressed by stronger cooperation at the global level.

The outlook

In the first six months of this year the seasonally adjusted and annualized monthly increase in consumer prices averaged just over 1.5 per cent. In the four months from July to October the average monthly increase exceeded 3 per cent on an annual basis. A contribution to curbing inflation can come from the Government's decision to reduce the taxation of oil products.

With the level of consumer demand remaining low, the rise in inflation is due to the lagged, and still not fully exhausted, effect of the rise in oil and other commodity prices and the depreciation of the euro, and hence the lira, against the dollar; it also reflects the increases in the prices of some services.

The prices of industrial products have stopped declining and are now rising significantly again.

After stagnating in the first five months of this year and recovering strongly between June and August, industrial output appears to have stalled in September and October.

GDP growth in 1999 will not be much more than 1 per cent.

Average annual inflation should be around 1.7 per cent.

Italy's economic performance can be compared with Germany's, where GDP is expected to grow by around 1.5 per cent and inflation to be around 0.6 per cent. In France the growth in output will be 2.5 per cent and inflation 0.6 per cent.

In the euro area there is relatively high inflation in Spain and the Netherlands, where GDP is growing by around 3.5 and 3 per cent, respectively.

Inflation in Italy continues to be higher than the average for the euro area, notwithstanding the weakness in demand and persistent uncertainty about future growth.

The limited growth in domestic demand will not prevent the external current account surplus from contracting to 1.3 per cent of GDP, from 1.7 per cent in 1998. The loss in trade competitiveness has immediate repercussions on industrial output and employment.

The structural difficulties afflicting the Italian economy prevent it from achieving its full growth potential. The same difficulties tend to impinge on prices.

The slow growth recorded in the nineties will continue next year. GDP will expand by just over 2 per cent, less than in Germany and France. Inflation is forecast to subside from its current levels, but it will remain higher than in these two countries and above the average for the euro area.

The persistence of a heavy burden of taxation and social security contributions in order to finance expenditure has contributed to the unsatisfactory rate of growth.

The Government's decision to initiate a significant reduction in the fiscal burden is the best and fastest way to regain competitiveness, to end the spiral of low growth and rising costs.

It appears increasingly necessary for a start to be made as early as 2000 on structural reforms that will allow the fiscal burden to be reduced steadily and substantially over the following years. More scope must be created for the growth already under way in public investment.

A recovery in growth will help to keep the public finances in balance.

Further effort along the lines of action already taken to increase the efficiency of the public administration and the labour market will create a more favourable environment for private investment.

Actual and forecast inflation is closely monitored by the Eurosystem. It is necessary to avoid a deterioration in price expectations, to consolidate confidence in the European currency and, ultimately, to curb the rise in medium and long-term market interest rates. Productive investment is influenced by the level of those rates and how they move. However, the propensity to invest depends above all on conditions in the real economy.

Apart from an improvement in the public sector's ability to develop projects and an increase in the infrastructure serving business and society, investment depends crucially on expectations of stable growth in a secure and orderly social environment that is perceived as favourable to economic activity.

It is necessary that firms should grasp the opportunities offered by profitability conditions that are much better than in the past.

In an economy like Italy's, characterized by a sizable outflow of savings for investment abroad, only an increase in private investment can bring a lasting increase in the economy's rate of growth, reduce unemployment among young people, and shrink the large pockets of irregular work and related evasion of tax and social security contributions.

The reorganization under way in the banking system has resulted in the five largest groups holding 49 per cent of the total volume of assets, compared with 35 per cent only three years ago. It will provide the core of the financial infrastructure needed for the fruitful employment of domestic savings, by transforming them into investment, and ensure the efficient use of savings that flow in from abroad.

Examples close to us demonstrate that, in a context providing the necessary institutional stability, resolute and consistent economic policies are a valid instrument for turning missed opportunities to account, for putting idle resources to use, to the benefit of the entire national community, above all of young job-seekers.