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C O N T E N T S

BOXES

SYMBOLS AND CONVENTIONS

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

In the following tables:

— the phenomenon in question does not occur

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

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

( ) provisional

( ) estimated

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Economic Developments and Policies

THE WORLD ECONOMY

Overview

In 2005 the world economy continued to expand rapidly, growing by almost 5 per cent, which was only slightly less than in the previous year. World trade in goods and services increased by around 7 per cent, compared with 10.3 per cent in 2004. As in 2003-04, the expansion was driven mainly by growth in the United States and China.

Economic activity benefited from the persistence of favourable financial conditions and was barely affected by the rise in the price of oil. Although this pushed up the average level of consumer prices, it did not trigger widespread or repeated increases in the prices of non-energy goods and services; core inflation and expected inflation remained moderate throughout the world. The expansionary stance of economic policies was attenuated.

The growth gaps between the main industrial regions of the world remained large. In the United States output expanded by 3.5 per cent (Table 1), sustained as before by consumption, which was boosted by a further rise in property prices and higher employment. In Japan GDP grew by 2.7 per cent, in response to the recovery in domestic demand after two years of stagnation. In the euro area growth was slower than expected at 1.3 per cent; after a sluggish start, economic activity picked up in the summer. In the United Kingdom GDP growth (1.8 per cent) was affected by a downturn in consumption in the first half of the year as house prices slowed and the delayed effects of the monetary tightening between November 2003 and August 2004 came into play.

In the emerging countries economic activity continued to expand at a very rapid pace – around 7 per cent – owing to further exceptionally fast growth in Asia (where high-tech products experienced a cyclical upturn) and an improvement in the terms of trade of the countries producing raw materials. In China, where growth was close to 10 per cent, the increased contribution of the foreign sector offset the slackening of investment.

Government bond yields remained low in all the industrial countries, as did the corresponding yield differentials of their corporate bonds and the government securities issued by the emerging economies. Equity prices rose but displayed limited variability.

Table 1

GDP and national demand in the main industrial countries and areas

(chain-linked volumes; percentage changes)

	2004		2005	
	GDP	National demand (1)	GDP	National demand (1)
United States	4.2	4.9	3.5	3.8
Japan	2.3	1.5	2.7	2.5
Euro area	2.1	2.0	1.3	1.5
United Kingdom ...	3.2	4.0	1.8	1.9
Canada	2.9	3.8	2.9	4.2

Sources: National statistics.
(1) Contribution to GDP growth in percentage points. Includes contribution of changes in stocks.

Continuance of the favourable world cycle is still at risk from oil price rises, payments imbalances and geopolitical tensions.

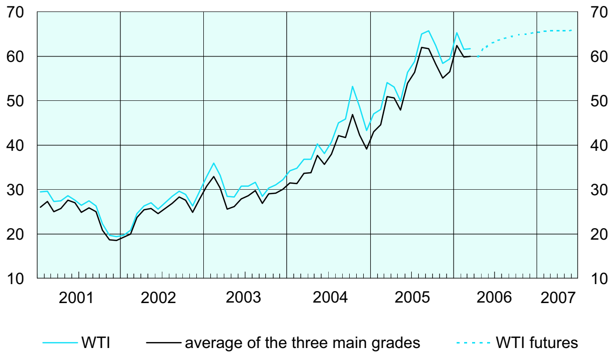
The oil market and payments imbalances

In 2005, as oil demand continued to rise steeply, rigidities on the supply side pushed up prices and increased their variability. The average price of the three main grades rose from $39 a barrel in December 2004 to over $56 at the end of 2005, after topping $60 in August and September (Figure 1). This year the price has fluctuated around $60 a barrel, reflecting harsh weather conditions in Europe and the United States and heightened geopolitical risks in several oil-producing countries. Oil market tensions spread to the market for natural gas, the spot price of which almost doubled in the US from December 2004 to December 2005; by February 2006 it had eased back to 14 per cent over the initial level. In Europe, where the gas market is regulated and prices are fixed on the basis of long-term contracts indexed to the price of oil, the adjustment is taking place with a lag of a few quarters.

Figure 1

Crude oil: spot prices and futures (1)

(dollars per barrel)



Sources: IMF and Thomson Financial Datastream.

(1) Monthly averages for spot prices. The three main grades are Dubai, Brent and WTI. For futures: prices on 10 March 2006.

The price of West Texas Intermediate could rise to as much as $65 or $67 dollars a barrel in the last quarter of this year. Futures contracts expiring in 2010 assume that the price will then drop slightly, to around $63.2. The International Energy Agency's planning scenario also projects a lessening of tensions in the oil market in the medium term.

The prices of non-energy raw materials also continued to climb at a rapid pace in 2005 (10.3 per cent compared with 18.5 per cent in 2004), almost entirely due to the prices of metals, which rose by 26.4 per cent. Food prices, which had risen by 14.3 per cent in 2004, recorded a small fall of 0.3 per cent.

The growth gaps and the massive transfer of resources brought about by the rise in raw material prices widened the payments imbalances between the main regions of the world. The deficit in the US balance of payments on current account reached $800 billion, equal to 6.4 per cent of GDP (Table 2). The oil-exporting countries used only a small part of their larger revenues to boost consumption and domestic investment; the current account surplus of this group of countries (which includes Norway and Russia) almost doubled with respect to 2004 to more than $400 billion. In Asia, China's surplus rose to $116 billion, from $69 billion in 2004, while those of Japan and the other countries remained large ($164 billion and $82 billion respectively).

Movements in the exchange rates of the main currencies did not contribute to the adjustment of these imbalances. Between January and November 2005 the dollar gained 16 and 17 per cent respectively against the euro and the yen before settling at around $1.2 to the euro and ¥117 to the dollar (Figure 2). The strengthening of the US currency was the result of very substantial net inflows of private capital, amounting to $869 billion in the first nine months of 2005 compared with $682 billion a year earlier, mainly attracted by the wider short-term interest rate spreads in favour of dollar-denominated assets. Over the same period net capital inflows of foreign authorities declined from $300 billion to $146 billion.

The Chinese monetary authorities continued to accumulate dollars at a rapid pace ($183 billion in 2005, compared with $206 billion in 2004, countering sharp upward pressures on the renminbi in the first half of the year due to heightened expectations of an imminent change of currency system (Table 2). When the changeover did take place in July the renminbi

Table 2

Current account of the balance of payments and foreign exchange reserves of the main countries and regions

	Current account				Foreign exchange reserves			
	2004		2005 (1)		2004		2005 (2)	
	$ billion	% of GDP	$ billion	% of GDP	$ billion	% of GDP	$ billion	% of GDP
United States	**-668.1**	**-5.7**	**-804.9**	**-6.4**	**75.9**	**0.6**	**54.1**	**0.4**
Euro area	**57.5**	**0.6**	**-35.7**	**-0.3**	**211.3**	**4.6**	**184.7**	**4.0**
Japan	**172.1**	**3.8**	**164.0**	**3.6**	**833.9**	**8.7**	**831.1**	**8.4**
Asia	**184.9**	**4.1**	**198.1**	**3.9**	**1339.0**	**29.9**	**1555.8**	**30.8**
Newly industrialized Asian economies (3) .	89.1	7.1	83.9	5.9	434.8	34.6	448.5	31.6
Hong Kong	*16.1*	*9.8*	*17.8*	*10.3*	*123.5*	*75.3*	*122.4*	*70.5*
Singapore	*26.3*	*24.6*	*33.2*	*28.8*	*112.2*	*105.1*	*115.8*	*100.4*
South Korea	*28.2*	*4.1*	*16.6*	*2.1*	*199.0*	*29.2*	*210.3*	*26.3*
Taiwan	*18.5*	*6.1*	*16.4*	*4.9*	....	....	....	....
Asean-4	26.9	4.3	15.1	2.3	163.1	26.1	172.0	25.8
Indonesia	*3.1*	*1.2*	*-1.1*	*-0.4*	*35.0*	*13.6*	*33.0*	*12.2*
Malaysia	*14.9*	*17.5*	*17.9*	*18.8*	*66.4*	*78.3*	*72.7*	*76.3*
Philippines	*2.1*	*1.8*	*2.0*	*1.5*	*13.1*	*11.1*	*15.5*	*11.7*
Thailandia	*6.9*	*4.2*	*-3.7*	*-2.2*	*48.7*	*29.8*	*50.7*	*30.2*
China	68.7	3.6	115.6	5.2	614.5	31.8	797.5	35.8
India	0.2	..	-16.6	-2.2	126.6	19.0	137.9	18.5
Oil-exporting countries	**219.1**	**8.3**	**412.5**	**12.8**	**425.9**	**16.0**	**531.5**	**16.5**
OPEC (4)	132.6	11.6	262.4	18.8	196.7	17.1	234.8	16.8
Algeria	*11.1*	*13.1*	*20.0*	*19.1*	*43.2*	*51.0*	*56.3*	*53.6*
Indonesia	*3.1*	*1.2*	*-1.1*	*-0.4*	*35.0*	*13.6*	*33.0*	*12.2*
Iran	*4.0*	*2.5*	*17.8*	*8.7*	....	....	....	....
Kuwait	*15.1*	*29.2*	*30.6*	*44.8*	*8.2*	*15.9*	*8.9*	*13.0*
Libya	*6.6*	*23.6*	*14.9*	*39.4*	*25.7*	*91.7*	*38.5*	*101.8*
Nigeria	*3.3*	*4.6*	*9.0*	*9.5*	*17.0*	*23.8*	*23.9*	*25.4*
Qatar	*11.7*	*41.0*	*19.3*	*50.3*	*3.4*	*11.9*	*4.5*	*11.7*
Saudi Arabia	*51.6*	*20.5*	*101.9*	*32.4*	*27.3*	*10.9*	*26.5*	*8.4*
United Arab Emirates	*12.3*	*11.8*	*29.1*	*21.8*	*18.5*	*17.8*	*19.8*	*14.8*
Venezuela	*13.8*	*12.7*	*20.9*	*15.9*	*18.4*	*17.0*	*23.4*	*17.8*
Mexico	-7.2	-1.1	-5.7	-0.8	64.1	9.5	74.1	9.8
Norway	33.8	13.5	54.0	18.3	44.3	17.7	46.7	15.9
Russia	59.9	10.3	101.8	13.2	120.8	20.8	175.9	22.8

Sources: IMF and national statistics.

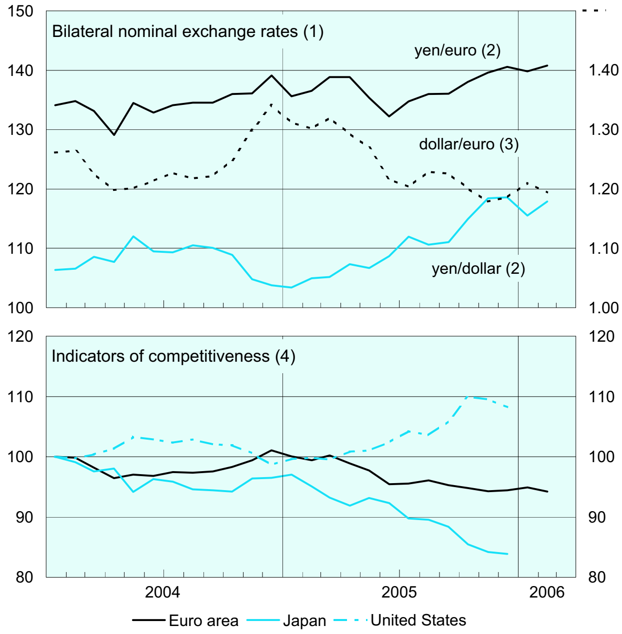
(1) For India, first nine months on an annual basis – (2) For China, Hong Kong, India, Japan, Libya, Malaysia, Philippines, Qatar and Venezuela, figures for end-November. For Nigeria, figures for end-October. For the UAE, figures for end-June. – (3) The stock of foreign exchange reserves does not include Taiwan. – (4) The OPEC aggregate does not include Iraq. The stock of foreign exchange reserves does not include Iran.

had appreciated by 2.1 per cent against the dollar, but remained broadly stationary afterwards. At the end of 2005 China's foreign reserves amounted to some $800 billion, equal to 36 per cent of GDP. The oil-exporting countries also built up their foreign reserves as in the previous year (by $106 billion against $98 billion in 2004), to over $500 billion at the end of 2005.

Figure 2

Exchange rates of the leading currencies and indicators of competitiveness

(monthly averages)



Sources: ECB and our calculations.

(1) Units of the first currency per unit of the second. – (2) Left-hand scale. – (3) Right-hand scale. – (4) Indices, January 2004=100. Based on producer prices of manufactured goods. A rise indicates a loss of competitiveness. For the method of calculating the indicator for Japan and the United States, see "A new indicator of competitiveness for Italy and the main industrial and emerging countries" in the series *Supplements to the Statistical Bulletin, Methodological Notes*, No. 66, December 2005.

The outcome of the 6th World Trade Organisation meeting of ministers in Hong Kong in December 2005 confirmed that the Doha Round had made little progress in liberalizing multilateral trade. The agreement that was reached will completely eliminate agricultural export subsidies by 2013, later than the most competitive countries had hoped. While decisions were taken in favour of the poorest countries – such as exemption from customs duty for almost all goods exported to the advanced countries by the year 2008 – controversy still surrounds the most important issues on the agenda, including the liberalization of the agricultural sector, the reduction of duties on imports of industrial goods, offers to open up to international investments and trade in services.

Recent developments and economic policies in the United States and Japan

United States. – GDP growth slowed to an annualized 1.6 per cent in the fourth quarter of 2005, compared with 4.1 per cent in the third (Table 3). The expected slowdown in household consumption – from 4.1 to 1.2 per cent – was due to the contraction in motor vehicle purchases once the large discounts offered by the main manufacturers in the summer had come to an end. By contrast, the slowdown in corporate investment, from 8.5 to 5.4 per cent, was not expected.

Motor vehicles aside, consumption rose by 4.6 per cent, compared with 3.5 per cent in the third quarter, thanks to the increase in disposable income (7.1 per cent on an annual basis) as the labour market picked up and energy prices fell. It was also sustained by the continuously strong performance of the property market in 2005.

After a pause following the hurricanes in the Gulf of Mexico, non-farm payroll employment rose sharply from November onwards. The average monthly increase was 179,000 in the fourth quarter and 207,000 in the first two months of 2006.

Although the gain in labour productivity in the non-farm sector of 2.9 per cent in 2005 was smaller than in the previous three years, during which it averaged 3.8 per cent, it nonetheless helped to limit the rise in unit labour costs to 2.6 per cent. Consumer price inflation averaged 3.4 per cent during the year, but following the rise in energy prices the twelve-month rate reached 4.7 per cent in September. Core inflation, which does not include food and energy products, held steady at around 2 per cent.

The Federal Reserve again raised the target rate on federal funds in 2005, putting it up a quarter of a point at each meeting of the FOMC (Figure 3). On the last occasion, at the end of January, the Committee set the rate at 4.5 per cent and, without commenting on

Table 3

Economic indicators for the main industrial countries

(chain-linked volumes; annualized percentage change on previous period, except as indicated)

	GDP	Household consumption (1)	Government consumption	Investment (2)	Change in stocks (3) (4)	National demand	Net exports (3) (5)
United States							
2004	4.2	3.9	2.2	9.7	0.4	4.7	-0.7
2005	3.5	3.6	1.8	8.1	-0.3	3.6	-0.3
H1	3.6	3.7	1.8	7.7	-0.4	3.5	-0.2
H2	3.3	3.2	1.9	7.5	-0.4	3.3	-0.1
Q3	4.1	4.1	2.9	8.0	-0.4	4.0	-0.1
Q4	1.6	1.2	-0.7	4.4	1.6	2.9	-1.4
Japan							
2004	2.3	1.9	2.0	1.1	-0.2	1.5	0.8
2005	2.7	2.2	1.7	3.5	0.2	2.6	0.2
H1	4.0	2.9	2.4	5.9	0.5	4.0	0.1
H2	3.2	2.5	1.4	4.0	-0.3	2.3	0.9
Q3	0.8	1.7	1.6	5.2	-1.8	0.7	..
Q4	5.4	3.5	1.0	0.1	0.7	3.0	2.4
Euro area							
2004	2.1	1.5	1.1	2.3	0.4	2.0	0.1
2005	1.3	1.3	1.4	2.1	..	1.5	-0.2
H1	1.2	1.4	0.8	1.9	-0.1	1.3	..
H2	2.0	1.2	2.5	4.0	-0.1	2.0	0.1
Q3	2.7	2.2	3.4	4.3	-0.8	2.1	0.7
Q4	1.0	-0.9	0.1	3.4	1.5	1.7	-0.7
United Kingdom							
2004	3.2	3.6	3.2	5.2	0.1	3.8	-0.8
2005	1.8	1.8	2.1	3.3	-0.3	1.8	-0.1
H1	1.5	0.8	1.9	2.6	-0.6	0.7	0.7
H2	2.1	2.3	3.2	5.1	-0.3	2.6	-0.6
Q3	2.1	2.5	3.3	11.9	-0.2	3.9	-1.9
Q4	2.3	3.0	3.3	-3.1	-0.7	1.4	0.9
Canada							
2004	2.9	3.4	2.7	6.6	..	3.9	-1.0
2005	2.9	4.0	2.8	6.6	0.2	4.3	-1.8
H1	2.5	4.9	2.5	6.4	-0.8	4.8	-1.7
H2	3.3	2.9	3.9	7.9	-0.4	4.1	-0.4
Q3	3.5	2.4	4.4	8.9	-0.5	4.2	-1.0
Q4	2.5	2.9	3.6	8.9	-0.8	4.3	-0.7

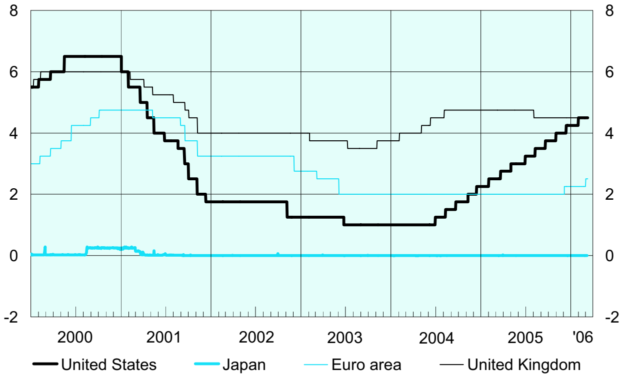
Sources: National statistics and Eurostat.

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

the stance of monetary policy, did not rule out further increases to contain potential inflationary pressures due to high energy prices and a reduction in idle capacity. Real short-term interest rates calculated on the basis of core inflation, which had been increasing since the summer of 2004, stood at 2.6 per cent in February 2006, a broadly neutral level.

Figure 3

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



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

In the fiscal year ending in September of last year the federal deficit contracted to 2.6 per cent of GDP, compared with 3.6 per cent in 2004, thanks to strong economic growth and an unexpected and temporary increase in revenue from corporate taxation. Expenditure continued to increase at a rapid pace.

Japan. – GDP growth, which had slowed to an annualized 0.8 per cent in the third quarter of 2005 as a result of heavy de-stocking, accelerated to 5.4 per cent in the next quarter as net exports and consumption gained strength (Table 3).

Household expenditure increased by 2.5 per cent in the second quarter, benefiting from the current and expected improvement in the labour market. There was a renewed expansion in full-time employment, which had been partly replaced by more flexible and less well-paid jobs over the previous five years. The improvement in the terms and conditions of contracts were reflected in nominal wages, which rose by 0.6 per cent between 2004 and 2005, the first increase in seven years. In December the index of consumer confidence was higher than it had been for fifteen years.

Good corporate profits continued to sustain investment. Non-residential private investments increased by 7.9 per cent during the year, compared with 4.6 per cent in 2004. In the second quarter residential investment also picked up, rising by 3.4 per cent.

Exports rose by 6.9 per cent during the year, against 13.9 per cent in 2004, gaining momentum in the spring in response to the revival of demand for high-tech goods.

The expansion in domestic demand and the rise in energy prices towards the end of the year brought the downward trend of consumer prices to a halt; in January 2006 the index which excludes fresh food products, used by the Bank of Japan as an indicator of core inflation, rose by 0.5 per cent.

Until the beginning of this month the Bank of Japan maintained the policy of increasing liquidity it had pursued since March 2001. However, faced with evidence that the economy had overcome the deflationary phase of recent years, at the meeting of 9 March the Bank decided to adopt a new operating target for monetary policy, replacing the balance of financial institutions' current accounts at the central bank with the overnight interest rate, which it announced would be kept close to zero. The Bank also explained that the final objective of medium-term price stability should be interpreted as a twelve-month change in the general consumer price index of 0 to 2 per cent.

According to OECD estimates, the general government deficit remained unchanged between 2004 and 2005 at 6.5 per cent of GDP. Given the recent adjustment to nominal GDP for 2004 and 2005, which the OECD does not take into account, the deficit may have shown a small improvement last year. However, because of the increasing weight of interest expense, the reduction in the primary deficit from 6.5 to 4.8 per cent of GDP between 2002 and 2005, which was obtained mainly by reducing expenditure on public investments, was not enough to counter the large deterioration in the public finances; in 2005 gross debt rose to 158.9 per cent of GDP.

The principal emerging economies

China. – GDP expanded at a rapid pace in the fourth quarter as well, with growth of 9.9 per cent in 2005, compared with 10.1 per cent in 2004 (Table 4). Investment increased by 25.7 per cent in nominal terms, slightly less than in 2004, and together with exports provided the main impetus to growth. Inflation dropped below 2 per cent in the spring, compared with 3.9 per cent 2004, mainly thanks to the slower rise in the prices of food products.

China's trade surplus widened to over $100 billion, or 4.6 per cent of GDP, compared with $33 billion in 2004. Exports continued to expand rapidly (28.4 per cent in value), but the increase in the surplus was mainly due to the sharp slowdown in all categories of imports, from growth of 36 per cent in 2004 to 17.6 per cent in 2005. Imports of machinery and electronic goods, which represent 40 per cent of the total, rose by only 13 per cent, compared with 33 per cent in 2004.

In January China's national statistics institute announced that GDP figures for 1993-2004 had been revised and that both the value and real growth during the decade were higher than previously estimated. In particular, output in 2004 was raised by 16.8 per cent at current prices. The adjustments concerned almost exclusively the service sector, which consists largely of private companies and sole proprietorships that were previously heavily under-represented. Although the revision applies to the supply components of output, it follows that the structure of China's economy has undergone profound changes on the demand side as well. In fact, with a larger and less capital-intensive service sector, consumption should represent a greater percentage of GDP (and investment a smaller

Table 4

Economic indicators for selected emerging countries

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

PAESI	% of world GDP in 2004 (1)	GDP				Domestic demand (2)				Net exports (3)			
		2004	2005	2005 H1	2005 H2	2004	2005	2005 H1	2005 H2	2004	2005	2005 H1	2005 H2
Latin America													
Argentina	0.9	9.0	....	9.2	9.2 (4)	11.8	....	9.6	9.5 (4)	-2.1	....	0.0	0.0 (4)
Brazil	2.6	5.0	2.2	3.4	1.2	....	....	....	....	....	....	....	....
Mexico	1.8	4.2	3.0	2.9	3.0	4.1	....	3.9	4.8 (4)	0.2	....	-1.2	-1.6 (4)
Asia													
China	15.0	10.1	9.9	9.5	9.9	....	....	....	....	....	....	....	....
India (5)	5.9	7.4	8.0	8.3	7.8	....	....	....	....	....	....	....	....
Indonesia	1.4	5.1	5.6	5.9	5.3	9.7	....	6.7	8.0 (4)	-3.6	....	-0.2	-4.2 (4)
Malaysia	0.5	7.1	5.3	5.3	5.2	10.8	4.0	3.3	4.7	-2.5	1.5	2.2	0.9
Philippines	0.7	6.0	5.1	4.9	5.3	2.9	4.6	2.9	6.3	2.9	0.1	1.6	-1.3
South Korea	1.9	4.6	4.0	3.0	4.9	1.3	2.5	2.2	2.8	3.4	1.7	1.0	2.3
Taiwan	1.1	6.1	4.1	2.7	5.4	7.0	1.7	3.3	0.2	-0.2	2.5	-0.2	5.2
Thailand	0.9	6.2	4.5	3.9	5.0	7.9	7.5	11.2	3.9	-0.6	-2.1	-6.0	1.7
Europe													
Poland	0.9	5.4	....	2.5	3.7 (4)	5.0	....	....	....	0.3	....	....	....
Russia	2.6	7.2	....	5.7	7.0 (4)	9.5	....	8.3	11.5 (4)	-1.2	....	-1.6	-3.7 (4)
Turkey	1.0	9.0	....	4.4	7.0 (4)	14.1	....	5.4	11.0 (4)	-4.9	....	-1.5	-3.5 (4)

Sources: National statistics, IMF and OECD.
(1) On the basis of purchasing power parities. – (2) Includes change in stocks and statistical discrepancies. – (3) Contribution to GDP growth in relation to the same period of the previous year in percentage points. Includes goods and services. – (4) Third quarter. – (5) GDP at factor cost.

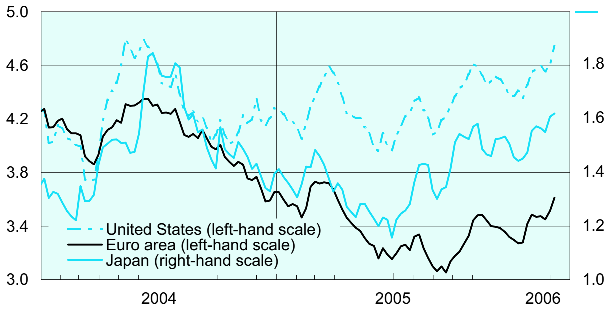
The financial markets

Conditions on world financial markets remained easy throughout 2005 and the early months of 2006. Neither the prices of securities nor their variability reacted to the gradual tightening of monetary policy in the United States, the raising of official rates by the Eurosystem or the heightened expectations of a shift towards a less expansionary monetary policy in Japan. Despite moderate increases, the yields on long-term public bonds in the industrial countries have remained low since last autumn; the yield differentials vis-à-vis US Treasury bonds both of corporate bonds and of dollar-denominated government bonds of emerging economies were close to their minimum levels; equity prices rose throughout the world, albeit unevenly, and their volatility was limited. Prices of corporate bonds in the industrial countries, public bonds issued by the emerging countries and equities all benefited from the sustained growth of the world economy, the very strong performance of corporate profits, partly in response to extensive reorganization in recent years, and the continuing abundance of international liquidity.

Figure 1

Yields on ten-year public bonds in the main regions (1)

(average weekly data; percentages)



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

In the United States, the euro area and Japan yields on ten-year public bonds currently stand at 4.7, 3.6 and 1.6 per cent respectively. In the United States, despite a 0.4 point rise since the beginning of this year, they are still slightly below the level of June 2004, on the eve of the monetary restriction (Figure 1).

Real long-term interest rates continue to be low by historical standards in all the main regions: those on index-linked ten-year public bonds are around 2.2 per cent in the United States and 1.4 per cent in the euro area and the United Kingdom; in Japan the ten-year interest rate adjusted for current consumer price inflation is 1.1 per cent.

The low level of nominal long-term interest rates in the main industrial countries is due to expectations of persistently moderate inflation thanks to credible and transparent monetary policies, less variable GDP growth and the wider range of instruments available to investors to diversify portfolios, diminishing their riskiness. Other likely contributory factors were large-scale purchases of long-term bonds by the Asian countries, whose saving far exceeds investment, and by the oil-exporting countries, which benefited from resource transfers due to the rise in energy prices. Finally, bond prices were sustained by purchases on the part of pension funds and insurance companies in the industrial countries, notably the United Kingdom, as they shifted the composition of their portfolios in response to changes in the regulation of their activities and the gradual ageing of the population.

In the United States, after a pause of about four years the Treasury resumed issues of thirty-year bonds in order to lengthen the average life of the debt and reduce its cost. At the first auction, which was held on 9 February, the demand was more than twice the supply; the bonds are currently quoted at 4.7 per cent on the secondary market.

The slope of the yield curve in the United States, measured as the spread between ten-year and three-month interest rates, which had been declining steadily since mid-2004, turned slightly negative in December of last year. All US recessions since the end of the 1950s have been preceded by about a year by a downward slope in the yield curve. However, in some instances economic

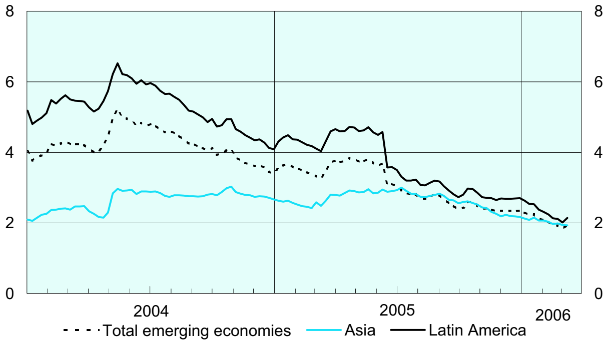
one) than previously estimated, thus making the composition of demand more balanced. However, the adjustment does not seem to have been large enough to alter one of the principal features of the Chinese economy: a very strong propensity to save and invest, by both historical and international standards.

Despite high rates of economic growth during the past decade, averaging 9 per cent a year, *activity did not slow, despite the interest rate differential slipping below zero. In particular, the flattening of the curve between the spring of 1994 and the end of 1995, which was similar in degree to that observed recently and ended with a negative differential, was followed by a long period of economic growth. Indications that a slowdown of the US economy is not imminent come from the forecasts of analysts and from the traditional leading financial indicators, such as the strong performance and limited volatility of equity prices and the low level of risk premiums on corporate bonds.*

Figure 2

Yield differentials between long-term dollar-denominated bonds issued by selected emerging countries and 10-years US Treasury bonds (1)

(average weekly data; percentage points)



Source: J.P. Morgan Chase.
(1) The last available data refer to the week ending 10 March 2006.

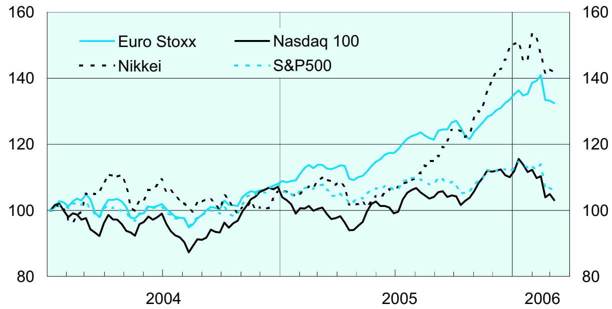
The robust growth in firms' profits helped to contain the yield differentials between corporate bonds and ten-year public bonds. They have remained virtually stationary since the end of September 2005, standing at around 1.2 points for BBB-rated firms and 3.6 points for high-yield securities. Borrowing costs increased, by 0.4 points to 6 per cent for the former class of firms and by 0.2 points to 8.4 per cent for the latter.

In the main emerging economies the yield differentials between their issues of dollar-denominated long-term public securities and the corresponding US Treasury bonds narrowed again after last autumn (Figure 2). At present the gap is small by historical standards, standing at around 2 per cent in all the regions of the world, which reflects not only the good underlying performances of most economies, but also the search for higher yields by foreign investors.

Figure 3

Stock market indices in the United States, the euro area and Japan (1)

(average weekly data; indices, 1st week of January 2004=100)



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

World stock market prices, which began to climb in the spring of 2003, have maintained this trend in recent months, although with some differences from region to region (Figure 3). Since the end of October prices have risen moderately in the United States (6 per cent for the Standard & Poor's 500 and 5 per cent for the Nasdaq 100), more sharply in Japan (18 per cent for Nikkei), the euro area (17 per cent for Dow Jones Euro Stoxx) and the main emerging Asian economies (19 per cent for the regional index developed by Thomson Financial Datastream). At present prices around the world are almost back to the peak values recorded just before the high-tech bubble burst in March 2000. However, thanks to the robust performance of profits in recent years, the average price/earnings ratio is now much lower, close to the average values recorded in the first half of the 1990s.

some 150 million Chinese live in extreme poverty according to the World Bank. Income distribution and access to essential services such as health and education appear increasingly unequal, favouring towns over rural areas. The five-year plan for 2006-10, which should be definitively approved by the National Assembly by the end of this month, reduces the previous emphasis on GDP growth in favour of equal and sustainable development. The main interventions planned concern: increased public spending on health, education and social security, especially in rural areas; improvements in the transport infrastructure, electricity grid and water supply; phasing out of the tax on farm income; reduction of barriers to the internal mobility of workers; more efficient use of energy, with savings of around 20 per cent per unit of output, and the development of alternatives to coal.

India. – Economic activity continued to expand very rapidly during 2005, at an average rate of 8 per cent compared with 7.4 per cent in 2004. Output growth was again driven by the expansion of the service sector, particularly ITC services and finance and insurance. In manufacturing, the capital goods sector picked up considerably. Household consumption benefited from the strong performance of farm incomes, which were sustained by favourable weather conditions.

The rise in energy prices, although attenuated by fiscal and administrative measures, and the increase in domestic demand pushed up inflation to 5.6 per cent in the twelve months to December 2005. To counter these inflationary pressures and the large increase in asset prices, the central bank raised the discount rate by 0.75 percentage points between April 2005 and early 2006, to 5.5 per cent. The exchange rate with the dollar held fairly stable at around 43.6 rupees in the first eight months of 2005; in the autumn it depreciated by 6 per cent before returning to around 44 rupees in the following months.

India's trade deficit reached 5 per cent of GDP in 2005, compared with 3 per cent in 2004, owing to the sharp increase in imports of capital goods and energy products. It was matched by abundant inflows of capital: the Government forecasts that foreign direct investment in the fiscal year ending in March 2006 should reach $6 billion, an increase on 2004 but barely a tenth of China's inflows in 2005.

The expansion in output fostered a small contraction in the public deficit to an estimated 8.3 per cent of GDP in the fiscal year ending in March 2006.

Brazil. – GDP growth slowed more than expected in 2005, from a robust 5 per cent in 2004 to 2.2 per cent, reflecting the slackness of domestic demand, especially for investment. The surplus in the current account of the balance of payments increased to 1.8 per cent of GDP thanks to the strong performance of exports. Inflation fell from 8.1 per cent in the spring to 5.7 per cent in December as the real appreciated by 13.9 per cent against the dollar during the year. The central bank lowered the reference rate for monetary policy by a total of 3.25 percentage points in September, setting it at 16.5 per cent. The primary budget surplus rose to 4.8 per cent of GDP in 2005, higher than the Government's target of 4.25 per cent, partly as a result of progress in broadening the tax base. In February 2006 the Government announced its intention to buy back, by mid-April, the dollar-denominated securities issued after the 1994 financial crisis and not yet redeemed, for an approximate value of $6.6 billion. This measure is the first of a set of programmed repurchases of government securities totalling $16-20 billion and designed to improve the management of the public debt by lengthening its average residual life and reducing interest expense and foreign currency exposure.

In view of the favourable economic situation other countries in Latin America decided to reduce the stock of debt denominated in foreign currencies. In February 2006 Venezuela and Colombia announced repurchases to the tune of $3.9 billion and $4.25 billion respectively. In Mexico, on the other hand, a similar operation for $5 billion will be financed by issuing new foreign-denominated securities.

Russia. – After weakening briefly in the first part of the year output began to expand again at a rapid pace. In the first three months of 2005 GDP grew by 6.2 per cent on the year-earlier period, compared with 7.2 per cent in 2004 as a whole. The sharp increase in domestic demand and the rise in energy prices drove inflation up to a twelve-month rate of 10.9 per cent in December, compared with an official target of 8.5 per cent. The massive inflow of foreign capital exerted upward pressure on the rouble, which the authorities countered with market interventions, accumulating $55 billion of reserves. Some of the liquidity created by the foreign sector was absorbed by means of a stabilization fund. In the course of 2005 the country repaid its debt with the International Monetary Fund early, as well as part of the loans from the Club de Paris and private investors, for a total of $23 billion.

ECONOMIC DEVELOPMENTS IN THE EURO AREA AND ITALY

Overview

Growth in euro-area GDP slowed to 1.3 per cent in 2005, from 2.1 per cent in 2004; the gap vis-à-vis the United States and the emerging Asian countries remained substantial.

The slowdown was uneven among the major euro-area countries. Fuelled by domestic demand, growth in France remained slightly above the average for the area, whereas in Germany it was held back by persistently weak consumption; this almost completely offset the impulse provided by exports, which in any case was not as strong as in 2004. In Spain economic activity gained pace (Figure 4 and Table 5).

In Italy there was no growth. Sluggish household spending was accompanied by declining investment and stationary exports. The latter highlights the structural difficulties the economy faces in adapting to the new technological and competitive international environment.

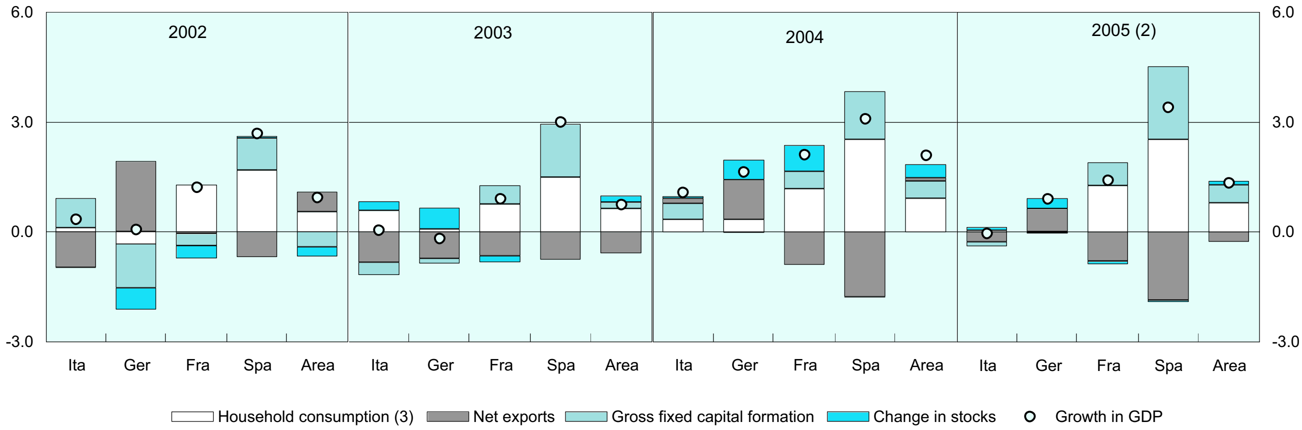
In the euro area growth weakened from 0.7 per cent in the third quarter to 0.3 per cent in the fourth, reflecting the sharp slowdowns recorded in Germany, France and Italy; the rate of increase in industrial production also declined. The latest data suggest a recovery but do not diminish the uncertainty concerning its duration or strength. The EuroCOIN coincident indicator for the area as a whole remained stable in January close to its long-term average (Figure 5). Qualitative indicators are more positive: since the summer of 2005 both the climate of confidence among industrial firms and orders have returned to their levels at the end of 2004 (Figure 6). In Italy household and business surveys also point to an improvement in cyclical conditions, which is not yet confirmed by the performance of real variables.

In 2005 the area's balance of payments on current account deteriorated significantly, primarily owing to the sharp increase in raw material prices. In Italy the large reduction in the trade surplus, which virtually disappeared for the year as a whole and turned negative in the last quarter, and the worsening of the balance on services caused the current account deficit to grow to 1.5 per cent of GDP.

Figure 4

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

(chain-liked volumes)



Sources: Based on national statistics.

(1) Excludes consumption of general government. – (2) For France and Spain, estimated on the basis of raw quarterly national accounts data. – (3) Consumption of resident households and non-profit institutions serving households.

Table 5

GDP, imports and the main components of demand in the euro-area and the major euro-area contries

(chained-linked volumes; annualized percentage changes on previous period)

	2003	2004	2005 (1)	2004 (2)		2005 (2)			
	Year	Year	Year	Q3	Q4	Q1	Q2	Q3	Q4
					GDP				
Germany	-0.2	1.6	0.9	-0.3	-0.4	2.4	1.2	2.5	..
France	0.8	2.3	1.4	0.2	2.7	1.0	0.2	2.8	0.9
Italy	..	1.1	..	1.6	-1.5	-2.2	3.0	1.1	....
Spain	3.0	3.1	3.4	3.1	3.8	3.3	3.4	3.6	3.8
Euro area	0.7	2.1	1.3	1.2	0.8	1.1	1.8	2.7	1.0
					Imports				
Germany	5.1	7.0	5.3	9.8	2.1	-4.3	8.9	22.6	4.6
France	0.7	6.9	6.3	6.9	4.0	3.7	5.8	11.4	10.1
Italy	0.8	2.5	1.4	4.4	0.7	-10.7	18.0	4.4	....
Spain	6.0	9.3	7.1	14.5	8.1	-3.9	13.8	14.1	3.5
Euro area	2.9	6.6	4.5	8.2	5.4	-5.8	9.7	13.2	3.8
					Exports				
Germany	2.4	9.3	6.3	-2.0	1.9	8.8	4.3	21.3	1.8
France	-1.7	3.1	3.1	-0.2	4.3	-1.9	3.9	13.5	3.6
Italy	-2.4	3.0	0.3	17.9	-15.7	-17.1	22.3	11.9	....
Spain	3.6	3.3	1.0	5.8	-3.9	-7.0	11.4	9.2	-4.6
Euro area	1.1	6.5	3.8	4.7	1.3	-3.5	8.2	14.5	1.9
					Household consumption (3)				
Germany	0.1	0.6	..	0.2	3.1	-1.6	0.1	1.3	-2.4
France	1.4	2.1	2.3	-0.7	5.2	2.4	-0.6	2.9	2.6
Italy	1.0	0.6	0.1	-0.2	1.6	0.1	2.4	1.4	....
Spain	2.6	4.4	4.4	5.6	6.1	2.8	3.8	4.6	4.8
Euro area	1.0	1.5	1.3	0.8	3.5	0.4	1.3	2.2	-0.9
					Gross fixed capital formation				
Germany	-0.8	-0.2	-0.2	3.7	-1.6	-4.6	1.3	7.5	2.9
France	2.7	2.5	3.2	-1.8	5.2	6.3	..	4.4	2.6
Italy	-1.7	2.2	-0.6	-5.4	-6.4	-4.1	6.6	5.5	....
Spain	5.6	4.9	7.2	5.6	10.8	7.3	6.6	4.7	8.6
Euro area	0.8	2.3	2.1	0.8	1.7	1.0	4.0	4.3	3.4
					National demand				
Germany	0.5	0.4	0.2	4.0	-0.4	-2.7	2.7	1.7	1.0
France	1.5	3.4	2.3	2.2	2.6	2.6	0.8	2.4	2.9
Italy	0.9	0.9	0.2	-2.0	3.7	-0.1	2.0	-0.9	....
Spain	3.7	4.8	5.4	6.1	7.5	3.7	4.7	5.6	6.1
Euro area	1.3	2.0	1.5	2.3	2.2	0.4	2.2	2.1	1.7

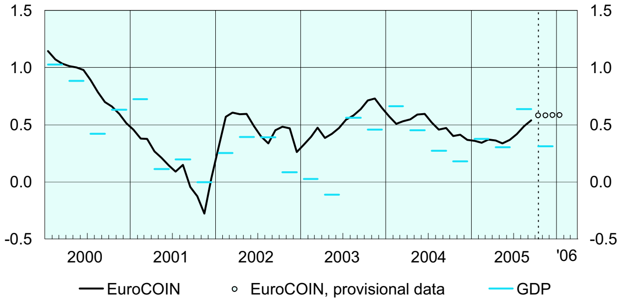
Sources: Based on national statistics for individual countries; Eurostat estimates for the euro area.

(1) For Germany, Italy and the euro area, annual data. For France and Spain, changes estimated on the basis of raw quarterly national accounts data. – (2) Seasonally adjusted and corrected for differences in the number of working days. For Italy, the data are available only for the first three quarters and are not yet based on the new methodology for preparing national accounts, which has already been adopted for the annual accounts. – (3) Consumption of resident households and non-profit institutions serving households.

Figure 5

EuroCOIN coincident indicator of the euro-area business cycle and euro-area GDP (1)

(three-month percentage changes)



(1) The method of constructing the indicator is described in the "Note metodologiche" section of the Appendix to the Bank's Annual Report for 2004 in Italian. For each month the change in GDP is the average variation for the relevant quarter.

The euro area

Production. – The growth in GDP was modest and significantly less than in 2004. Economic activity accelerated in the second and third quarters, sustained by investment and exports, which benefited from the weakening of the euro. However, the slowdown in the fourth quarter took the rate of growth back to its level at the beginning of the year.

The national accounts in the EU were substantially revised in connection with the introduction of the new European rules on the treatment of financial intermediation services and the procedure for deflating series at current prices.

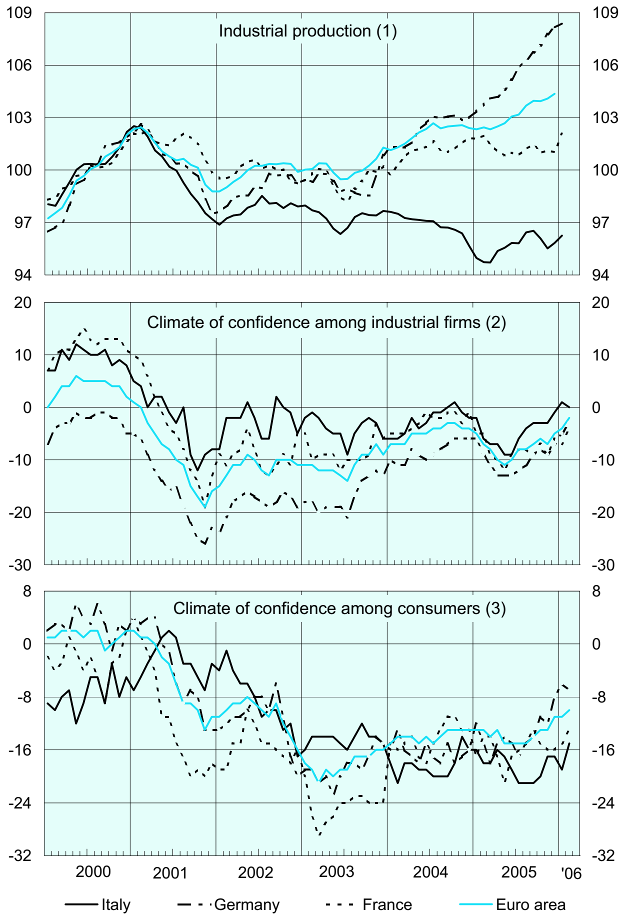
In *Germany* the slowdown in economic growth from 1.6 to 0.9 per cent can be attributed to the smaller contributions of consumption and net exports. In *France* and *Spain* the growth in GDP amounted to respectively 1.4 and 3.4 per cent and benefited from the performance of domestic demand, especially household consumption. In both countries net exports made a negative contribution.

In 2005 the index of industrial production, adjusted for calendar effects, rose by 1.2 per cent in the area as a whole, by 3.5 per cent in *Germany* and by 0.7 per cent in *Spain*. It remained unchanged in *France* and fell by 0.8 per cent in *Italy*. From the summer onwards industrial production turning-point indicators showed an upturn in output in the area and the leading euro-area countries (Figure 7).

Figure 6

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

(monthly data)



Sources: Based on national statistics and European Commission data.

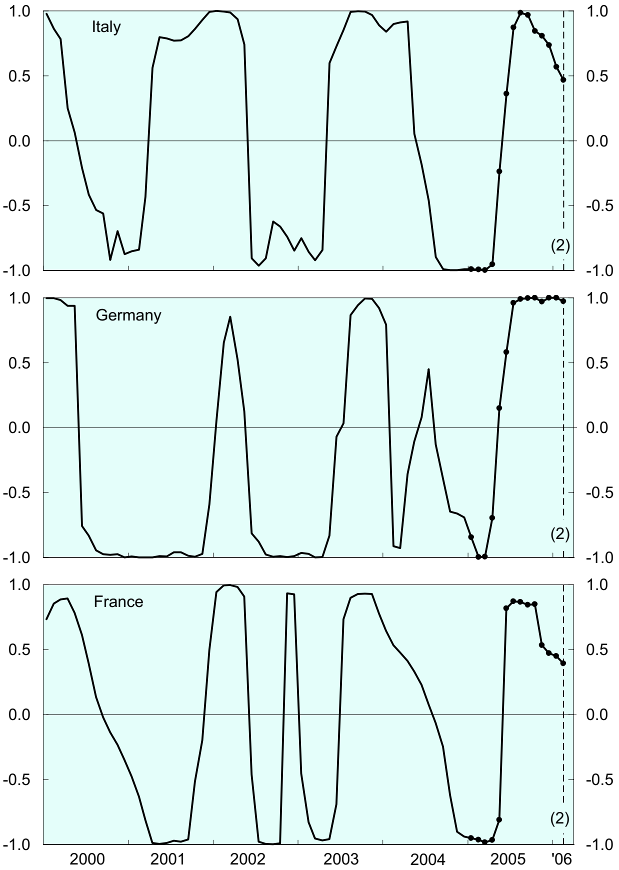
(1) Index, 2000=100. Moving averages for the three months ending in the reference month. Data adjusted for the different number of working days in the month and seasonally adjusted. – (2) Climate of confidence calculated by the European Commission as the average of the seasonally adjusted percentage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

Household consumption. – Euro-area household spending grew by 1.3 per cent, slightly less than in 2004. The rate of growth increased until the autumn, in parallel with the recovery in the climate of confidence and the fall in the unemployment rate; in the fourth quarter there was a reduction in consumption.

Figure 7

Industrial production turning-point indicators (1)

(monthly data)



Sources: Based on national statistics.

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

In *Germany* household spending stagnated for the fourth successive year. The steady decline in the propensity to consume has been influenced by the changes under way in the labour market and the related reform of the system of social shock-absorbers. With cyclical conditions still uncertain, the measures to make the labour market more flexible have led consumers to adopt a cautious approach. The increase in employment mainly reflects the creation of low-paid temporary jobs, known as mini-jobs and 1-euro jobs, which incur lower social security contributions and, in the case of the latter, are compatible with unemployment benefits. In the first three quarters households' real disposable income was approximately half a percentage point down on the corresponding period in 2004, reflecting the stagnation of total wages and the increases in energy prices. Consumer confidence did not improve significantly until the last few months of the year; on average for 2005 it was below the long-term level, thus confirming the widespread sense of insecurity.

In *France* consumption continued to grow at the high rate recorded in 2004. In the first half of the year, as the effects of the temporary measures to boost spending introduced by the Government at the end of 2004 wore off, it slowed progressively and contracted by 0.6 per cent in the second quarter. From the summer onwards, the rate of growth was again in line with the average of the last five years, receiving support from the increase in real disposable income, which rose by more than one percentage point in the first nine months of the year.

Investment and stocks. – All the components of investment contributed to the aggregate's growth of 2.1 per cent in the euro area in 2005. After falling in 2002, investment has shown a strong recovery, although falling short of the average increases recorded during the preceding cyclical upturn. Favourable financing conditions, together with rising capacity utilization rates, made firms more optimistic: the six-monthly European Commission survey of industrial firms' investment plans indicates stronger growth in investment next year.

In *Germany* investment stagnated for the third successive year, with the various components recording different performances. Spending on machinery and equipment accelerated, boosted by the improved outlook for demand, the limited amount of idle capacity, the low cost of financing and firms' strong balance sheets. In February of this year the index of confidence among manufacturing firms was at its highest level of the last four years.

Investment in construction declined; the structural adjustment under way since the boom that followed reunification continues to hold back capital spending. In the second half of 2005 there were some positive signs: the climate of confidence among building firms improved; in the third quarter investment grew at the fastest rate of the last six years, driven by a series of large orders (in the rail and road transport and postal sectors), and remained strong in the fourth quarter.

In *France* investment contributed 0.6 percentage points to the growth in GDP. The acceleration in capital spending was similar in the construction, machinery and other equipment sectors. Construction benefited from lively demand in the residential sector, where advantage was taken of easier access to mortgage loans and historically low interest rates. The climate of confidence in this sector improved significantly. The acceleration of investment in machinery was driven mainly by building firms and service companies.

Exports and imports. – On the basis of national accounts data euro-area exports increased in 2005 by 3.8 per cent, which was well below the growth in world trade (7 per cent) despite the fall in the real exchange rate of the euro that began in the second quarter. With imports rising by 4.5 per cent, net foreign demand made a negative contribution of 0.2 percentage points to the growth in GDP. After falling in the first quarter, exports rose in the second and third quarters, especially those to China and the Asian countries. In the last quarter the growth slowed.

In *Germany* the gains in competitiveness helped exports to grow by 6.3 per cent, while imports grew by 5.3 per cent. Net exports thus made a positive contribution to the expansion of GDP for the second successive year. With domestic demand basically flat, the growth in GDP reflected the fluctuating performance of exports, which grew very strongly in the third quarter (by 21.3 per cent compared with the second), especially those to the Asian and OPEC countries, and were virtually unchanged in the fourth.

In *France* net exports made a negative contribution of 0.8 percentage points to the expansion in GDP. For the fourth successive year the growth in imports, driven by consumption and investment, outpaced that in exports. The latter were adversely affected by the persistently weak demand conditions in Germany and Italy, which offset the positive effects of the improvement in competitiveness from the beginning of the year onwards.

The balance of payments. – The euro-area balance of payments on current account swung from a surplus of €45.6 billion in 2004 to a deficit of €29 billion (0.4 per cent of GDP; Table 6). The deterioration was mostly due to the rise in the price of oil. The deficits on income and current transfers grew larger, while the surplus on services increased slightly. The current and capital accounts showed a combined deficit of €16.9 billion, while the financial account recorded a net inflow of €39.6 billion (compared with a net outflow of €8.3 billion in 2004). Errors and omissions were again negative, but were down from €54.7 billion in 2004 to €22.7 billion. Reserve assets, the changes in which are included in the financial account, decreased by €18.9 billion.

The trade surplus (on the basis of *cif-fob* statistics) fell from €71.5 billion to €23.4 billion; the deficit on energy products widened from €136.4 billion to €196.2 billion (2.5 per cent of GDP). At current prices imports grew by 12 per cent, exports by 7.1 per cent. The foreign trade indices, available for the first eleven months of the year, show that the average unit values of exports, which approximate export prices, rose by 2.3 per cent and those of imports by 7.4 per cent. The area's terms of trade worsened by approximately 5 per cent overall but were virtually unchanged for manufactures alone. The price competitiveness of euro-area products improved slightly on the basis of producer prices: on average for the year the real effective exchange rate of the euro decreased by 1.5 per cent (compared with a decrease of 0.8 per cent in the nominal exchange rate). In 2004 the real exchange rate had risen by 3 per cent.

The financial account recorded net direct and portfolio investment outflows of €12.8 billion (compared with net inflows of €24.4 billion in 2004) owing to the prevalence of purchases of foreign equity securities over sales abroad of euro-area debt instruments. In the period May-July there were very substantial flows of direct investment abroad and portfolio investment in euro-area equity securities,

Table 6

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

	2004			2005		
	Year	H1	H2	Year	H1	H2
Current account	**45,594**	**18,232**	**27,362**	**-29,024**	**-10,127**	**-18,897**
Goods	106,669	60,542	46,127	58,538	33,922	24,616
exports	*1,133,107*	*552,482*	*580,625*	*1,223,083*	*583,758*	*639,325*
imports	*1,026,438*	*491,940*	*534,498*	*1,164,544*	*549,836*	*614,708*
Services	28,294	12,765	15,529	31,381	13,389	17,992
Income	-33,087	-30,928	-2,159	-52,956	-29,085	-23,871
Current transfers	-56,284	-24,149	-32,135	-65,985	-28,351	-37,634
Capital account	**17,416**	**7,427**	**9,989**	**12,163**	**5,039**	**7,124**
Financial account	**-8,314**	**-11,649**	**3,335**	**39,566**	**69,326**	**-29,760**
Direct investment	-46,778	-35,352	-11,426	-155,340	-31,618	-123,722
outward	*-130,798*	*-50,162*	*-80,636*	*-207,933*	*-58,258*	*-149,675*
inward	*84,020*	*14,811*	*69,209*	*52,593*	*26,640*	*25,953*
Portfolio investment	71,199	31,696	39,503	142,585	107,112	35,473
Equity securities	34,674	-53,326	88,000	144,118	14,497	129,621
assets	*-102,824*	*-68,388*	*-34,436*	*-126,022*	*-48,691*	*-77,331*
liabilities	*137,498*	*15,062*	*122,436*	*270,140*	*63,188*	*206,952*
Debt instruments	36,529	85,025	-48,496	-1,533	92,614	-94,147
assets	*-227,934*	*-111,225*	*-116,709*	*-297,049*	*-163,736*	*-133,313*
liabilities	*264,463*	*196,250*	*68,213*	*295,516*	*256,350*	*39,166*
Financial derivatives	-4,820	1,567	-6,387	-15,916	-3,919	-11,997
Other investment	-40,438	-16,252	-24,186	49,342	-10,204	59,546
Reserve assets	12,524	6,691	5,833	18,894	7,955	10,939
Errors and omissions	**-54,698**	**-14,011**	**-40,687**	**-22,707**	**-64,240**	**41,533**

Source: ECB.

attributable in part to a restructuring transaction in July that involved the exchange of equity securities between a multinational having its registered office in the area and a non-resident subsidiary.

The growth in portfolio investment inflows was primarily due to purchases of equity securities issued in the area, which rose from €137.5 billion to €270.1 billion, partly in connection with the restructuring transaction referred to above. Investment in euro-area debt instruments rose further compared with the already high level recorded in 2004. Residents increased their net purchases both of foreign debt instruments, following the widening of the spread between long-term interest rates in the United States and the euro area, and, although to a lesser extent, of foreign equity securities. The growth in direct investment net outflows was mainly due to the increase in resident firms' investments abroad, spurred in part by the growth differentials between some regions of the world and the euro area.

In *Germany* the current account and trade surpluses widened slightly: the former from €84.5 billion to €90.4 billion and the latter from €143.8 billion to €145.4 billion. The deficit on services was virtually unchanged, while income passed from balance to a small surplus. Inflows of investment in debt instruments continued to accelerate and, following net outflows in 2004, there were again net inflows of direct and portfolio investment in equity securities. In *France*, by contrast, there was a sharp increase in the current account deficit, which grew from €6.8 billion to €34.1 billion, in connection with the deterioration in the trade balance. The financial account recorded increases in direct investment outflows and all forms of investment inflows. In *Spain* the current account deficit for the first eleven months rose from €38.3 billion to €60.8 billion and there was a large increase in non-residents' investment in Spanish debt instruments.

Italy

Production. – GDP in 2005 was unchanged compared with the previous year, when it grew by 1.1 per cent. Consumption, especially that of general government, and the change in stocks made a modest contribution to the growth in economic activity that was barely sufficient to offset the fall in investment and net exports (Table 7). The quarterly data available for Italy – for the first three quarters

Table 7

Italy: resources and uses of income

(chain-linked volumes; percentage changes, except as indicated)

	As a percentage of GDP in 2005	2002	2003	2004	2005	Contribution to GDP growth in 2005 (1)
Resources						
GDP	–	0.3	..	1.1	..	–
Imports of goods and services	26.3	-0.5	0.8	2.5	1.4	-0.3
Total resources	–	0.2	0.2	1.3	0.2	–
Uses						
Gross fixed capital formation	20.9	4.0	-1.7	2.2	-0.6	-0.1
Construction	9.4	4.8	1.4	0.9	0.5	0.1
Machinery, equipment and sundry products	9.6	3.1	-2.3	4.0	-1.0	-0.1
Transport equipment	2.0	4.7	-11.4	-0.3	-4.6	-0.1
Consumption of resident households	59.1	0.2	1.0	0.5	0.1	..
Non-durable goods (2)	22.2	-0.1	0.8	-0.8	0.2	..
Durable goods (2)	6.7	-1.7	1.3	8.0	1.4	0.1
Services (2)	23.5	0.6	1.3	1.3	0.3	0.1
Consumption of general government and non-profit institutions serving households	20.0	2.2	2.1	0.6	1.2	0.2
Changes in stocks and valuables (3)	….	..	0.3	0.1	0.1	0.1
Total national demand	100.9	1.3	0.9	0.9	0.2	0.3
Exports of goods and services	25.5	-4.0	-2.4	3.0	0.3	0.1
Net exports (3)	-0.9	-1.0	-0.8	0.1	-0.3	-0.3

Source: Based on Istat data.

(1) In percentage points. – (2) Comprises spending in Italy by resident households and non-residents. For 2005, first 9 months. – (3) Contribution to the growth of GDP, in percentage points.

only and not yet based on the new methodology for preparing national accounts, which has already been adopted for the annual figures – show that GDP, after contracting in the last quarter of 2004 and the first quarter of 2005, expanded in the second and third quarters (Table 5). It follows that it virtually stagnated in the fourth quarter.

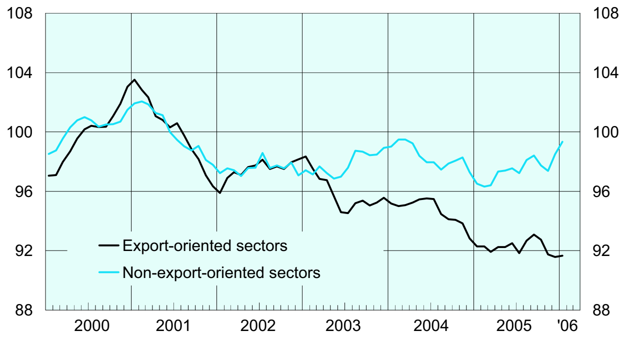
Value added grew only in the service sector, at much the same rate as in 2004; it declined in industry, continuing the downward trend under way since the beginning of the decade.

The difficulties encountered by industry are confirmed by the further fall in the index of industrial production. In the expansion recorded by industry in Europe, albeit with fluctuations, between 1993 and the end of 2000, Italy fell behind euro-area growth in production by 5 percentage points. The gap subsequently widened by another 8 points. In the euro area industry has been recovering since 2003, while in Italy it has continued to lose ground. In this period the sectors with more than 40 per cent of turnover consisting of exports have recorded a larger-than-average fall in production (Figure 8).

Figure 8

Italy: industrial production

(monthly data; 3-term moving averages; index, 2000=100)



Source: Based on Istat data.

In 2005 the fall in production concerned all the main categories of product and was most pronounced for consumer and capital goods. By contrast, as in the preceding years, the production of energy expanded.

There was a further fall in the output of the sectors in which Italy has traditionally specialized and which are more exposed to competition from the emerging countries. Output of textiles, clothing, footwear and other leather products, on a downward trend since the beginning of the decade, fell by another 7 per cent and reached a much lower level than in previous cyclical downturns. The crisis has also affected sectors with a higher technological content: there was a fall of nearly 5 per cent for electrical machinery, electrical and electronic equipment and transport equipment.

Industrial production fluctuated over the year: a recovery in the spring was followed by a new decline; in December the index recorded a sharp rise (of 1.2 per cent) that was followed by a small fall in January 2006. Bank of Italy estimates indicate that it was basically stable in the two following months (Figure 9).

There were signs of improvement in the cyclical outlook in 2005. After falling to a low in April, the climate of confidence among firms rose to its highest level of the last three years in December (Figure 6). A less clear signal of recovery is provided by the industrial production turning-point indicator: after rising in August to a level compatible with a high probability of an expansion in activity, it progressively declined, reflecting the increase in uncertainty about the recovery (Figure 7).

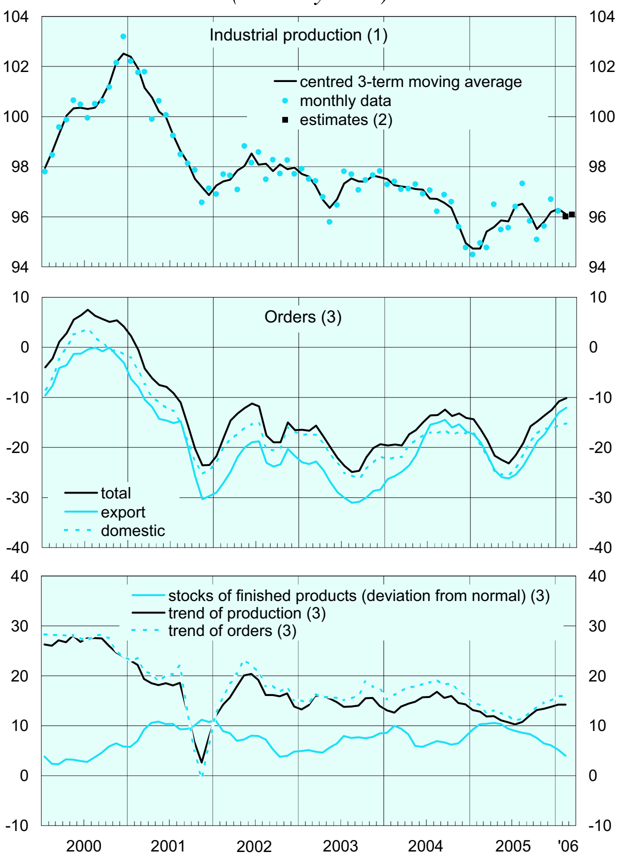
Household consumption. – Household expenditure was virtually unchanged; it increased by 0.1 per cent at constant prices after the rate of increase had slowed to 0.5 per cent in 2004 (Table 7). On the basis of the old methodology, in the first nine months purchases of durable goods steadily recovered, while those of non-durable goods and services declined. New car registrations were flat in the last quarter after recovering in the second and third; Italian cars did not suffer from this pause and their market share, sustained by the success of new models, stabilized at 28 per cent.

According to preliminary Bank of Italy estimates, which incorporate the new national accounts, in 2005 households' disposable income at constant prices increased by little more than 0.5 per cent or approximately half as much

Figure 9

Italy: industrial production, orders and stocks

(monthly data)



Sources: Based on Istat and ISAE data.

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

as in 2004. The increase was mostly due to that in gross earnings, which was produced above all by the increase in per capita earnings. There was no longer a contribution from self-employment income as the number of free-lance workers fell sharply. There was further strong growth in gross operating profit, which includes rental income and accounted for one fifth of the increase in disposable income. Households' propensity to save increased further, in line with a trend under way since 2001 that reflects precautionary motives in connection with developments in the social security system and the increased flexibility of the labour market. There was a corresponding rise in households' net wealth in both the financial component and the real-estate component, which benefited from the further rise in house prices (up 9.7 per cent over the year). Household debt continued to grow but nonetheless remained lower than in the other industrial countries, as regards both consumer credit and mortgage debt.

The ISAE consumer confidence indicator improved considerably in the second half of the year; in December and in January 2006 it deteriorated and then picked up sharply in February. It is nonetheless still close to the historically low levels reached in 2003.

Investment and stocks. – Investment fell by 0.6 per cent after rising by 2.2 per cent in 2004 (Table 7), although on the basis of the old quarterly accounts it picked up over the year. A sharp contraction in the second half of 2004 continued in the first quarter of 2005 but gave way to substantial increases in the second and third quarters, especially as regards spending on machinery and equipment.

The slowdown of investment in construction continued. Residential building was also affected, despite the stimulus provided by the persistent rise in house prices and the favourable conditions for obtaining mortgage loans. The ISAE survey of households' intentions to buy a house showed a progressive decline from the high levels reached in 2002.

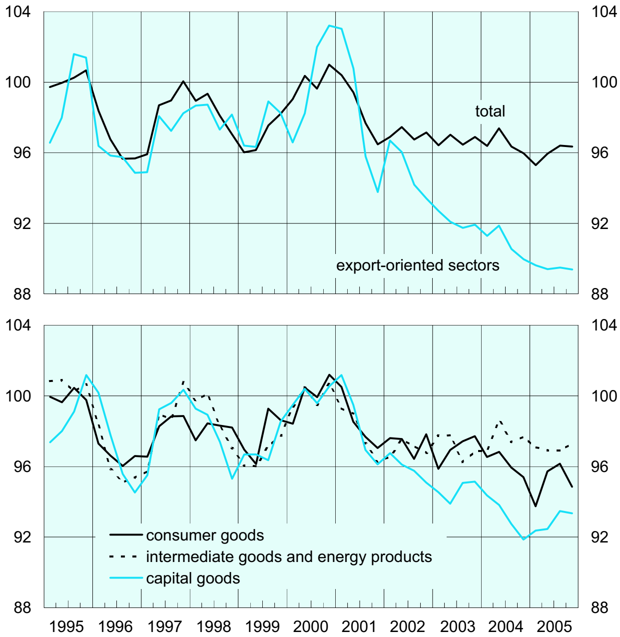
ISAE's indicator of construction firms' confidence gradually deteriorated over the year, with the residential building sector maintaining a higher level. According to the Bank of Italy branches' survey of firms that operate mainly in the public works sector, the average level of activity fell compared with 2004. Forecasts for 2006 tend to be prudent.

Investment in capital goods decreased by 1 per cent overall; that in transport equipment recorded a larger fall of 4.6 per cent. In industry as a whole unutilized capacity was abundant on average in 2005, while it increased further in export-oriented sectors (Figure 10). Signs of a gradual improvement emerged during the year, especially for capital goods, with firms taking a more optimistic view of their order books.

Figure 10

Composite indicator of capacity utilization in Italian industry (1)

(quarterly data; index, 2000=100)



Sources: Based on Istat and ISAE data.

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

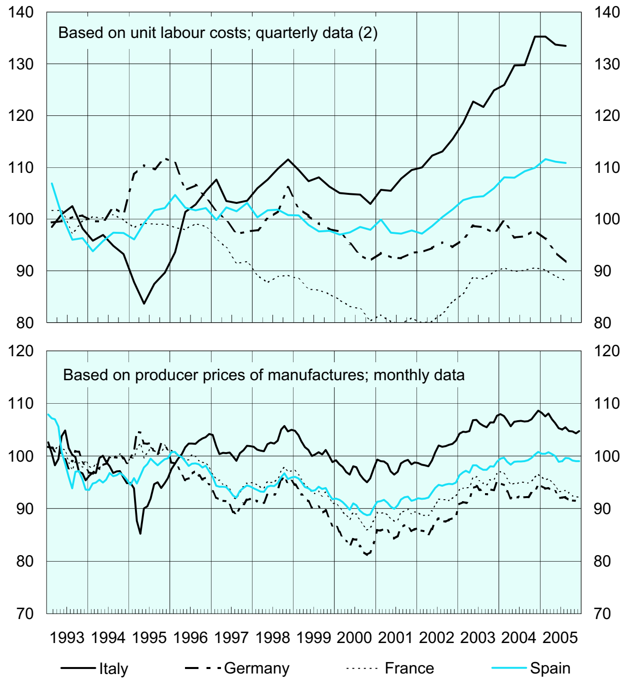
The change in stocks contributed virtually nothing to the growth in GDP. After building up inventories in the first quarter, firms reacted to the persistent uncertainty regarding the strength of the recovery by running them down to meet part of demand. According to ISAE surveys of industrial firms, the reduction in stocks of finished goods gathered pace over the year (Figure 9).

Exports and imports. – Despite the further strong growth in world trade, the national accounts show Italian exports of goods and services as having grown by just 0.3 per cent in 2005, after recovering in 2004, when they grew by 3 per cent. Export volumes improved steadily over the year, benefiting from the depreciation of the euro and the related gain in competitiveness of approximately 4 percentage points on the basis of producer prices (Figure 11). The gain in competitiveness followed a long-term downward trend, however. On the basis of unit labour costs adjusted for the exchange rate, the rapid erosion in 1995-96 of the competitiveness gained from the devaluations of the lira in the three preceding years was followed by a period in which Italy's competitiveness remained basically stable, while the other main European countries were recording gains. Between 2001 and 2004 there was a new loss, of about 30 per cent, caused primarily by the stagnation of productivity. In this period the competitiveness of Germany, Spain and France also deteriorated, although to a lesser extent, by approximately 6, 12 and 13 per cent respectively (Figure 11).

Figure 11

Indicators of competitiveness in the major euro-area countries (1)

(indices, 1993=100)



Sources: Based on national statistics.

(1) In relation to all competitor countries. An increase in the index indicates a loss of competitiveness. – (2) The unit labour costs series are based on the quarterly data of the old national accounts. The Italian series is based on the compensation data adjusted to eliminate the effect of the abolition of some employers' social security contributions with the introduction of the regional tax on productive activities in 1998 (Irap).

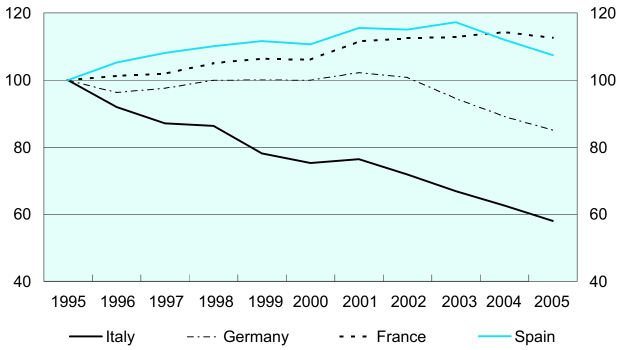
The poor performance of productivity in Italy is not only a consequence of the cyclical weakness of the last few years; it is largely attributable to structural factors that limit the organizational efficiency and ability to innovate of Italian industry, as revealed by the gradual worsening of total factor productivity since the middle of the 1990s.

Since 1995 Italy's share of world exports at constant prices has gradually contracted, falling from 4.6 to 2.7 per cent. France's share fell from 5.7 to 4.9 per cent, Spain's remained basically unchanged, while Germany's rose from 10.3 to 11.7 per cent (Figure 12). In 2005 Italian producers' pricing policies in export markets and the domestic market again diverged: in the former, where demand grew more strongly, they widened their profit margins at the expense of market share. Italy's product specialization is still concentrated in low-tech sectors compared with the country's main European partners.

Figure 12

Share of world merchandise exports at constant prices: Italy, France, Germany and Spain (1)

(indices, 1995=100)



Source: Based on Istat and IMF data.
(1) The figures for 2006 are estimated; 1995 prices and exchange rates.

On the basis of Istat's indices of foreign trade, Italy's exports at constant prices lost ground above all in EU markets, with a particularly large fall in the United Kingdom and a smaller one in Germany. Outside the Union, exports to Russia grew very rapidly. In all the other main non-European markets, including the United States and China, Italian exports fell, despite strong growth in demand, especially in China. In the case of the United States exports diminished above all in traditional sectors, notably furniture and footwear; in China's case there was a continuation of the fall in exports of mechanical machinery and equipment, an additional symptom of growing difficulty in traditionally strong sectors of Italian trade. Overall, exports increased for basic metals and metal products, electrical equipment and precision instruments and chemical products (Table 8); they decreased for mechanical machinery and equipment and traditional products in general (textiles and clothing, leather products and footwear, furniture and non-metallic mineral products).

National accounts data show growth of 1.4 per cent in imports at constant prices, attributable primarily to services (including residents' travel abroad). The slowdown from growth of 2.5 per cent in 2004 reflected the weakness of domestic demand. Net exports made a negative contribution of 0.3 percentage points to GDP growth (Table 7).

According to *cif-fob* trade data, the increase in merchandise imports from non-EU countries was accompanied by a fall in those from the European Union. Imports from China continued to grow at a rapid pace (18.1 per cent) and their share of the total rose to 4.6 per cent. By contrast, the increase in imports from the United States was small.

Imports of furniture, leather and leather products, crude oil and natural gas increased, while those of refined petroleum products, mechanical machinery and equipment, and electrical equipment and precision instruments decreased.

Italy's terms of trade deteriorated by 2.2 per cent in the first 11 months of 2005 compared with the corresponding period of 2004. For manufactures excluding oil refined products, they were basically unchanged.

The balance of payments. – Italy's deficit on current account in 2005 amounted to €21.2 billion (1.5 per cent of GDP), up from €12.8 billion in 2004 (Table 10). The increase in the deficit was due almost entirely to the substantial fall in the trade surplus, although the balance on services also deteriorated. The overall deficit on current and capital account was matched by net financial inflows of €18.5 billion. Reserve assets decreased by €0.8 billion, while the amount for errors and omissions was very small.

The trade surplus on an *fob-fob* basis fell to almost zero, compared with €8.1 billion in 2004. The deterioration reflected the increase in the deficit on energy minerals and products, including refined petroleum products, caused by the sharp rise in their prices (Table 8). For manufactures excluding refined oil products, for which the terms of trade were substantially unchanged compared with 2004, there was a surplus of €37.6 billion on a *cif-fob* basis, with improvements in the results for mechanical machinery and equipment and electrical equipment and precision instruments. More specifically, the positive performance of exports of machinery was accompanied by a fall in those of home appliances and lighting equipment. On the other hand there were worse results for transport equipment and traditional products. As in the three previous years, the shift in the composition of exports of the latter towards higher quality and prices only offset part of the reduction in volume.

The balance on services swung from a surplus of €1.5 billion in 2004 to a deficit of €0.7 billion. In the first ten months of last year, for which sectoral figures are available, the largest contributions to the

Table 8

Italian exports and imports *cif-fob* by branch of economic activity and balances, January-November 2005: values, indices of average unit values and volumes (1)

(*percentage changes on corresponding period of 2004, except as indicated)*

	Exports				Imports				Change in balance (millions of euros)
	% composition of values in 2004 (2)	Change			% composition of values in 2004 (2)	Change			
		Values	Average unit values	Volumes (3)		Values	Average unit values	Volumes (3)	
Total	**100.0**	**5.4**	**6.4**	**-0.9**	**100.0**	**8.4**	**8.7**	**-0.3**	**-7,848**
Products of agriculture, forestry and fishing	1.3	7.3	7.4	-0.9	3.2	-0.1	4.0	-3.9	266
Energy and non-energy minerals (4)	0.3				11.1	37.1	33.3	2.5	-10,467
of which: crude petroleum and natural gas (4)	*0.1*				*9.8*	*39.2*	*34.7*	*2.9*	*-9,818*
Manufactures	96.3	5.4	6.3	-0.9	82.6	4.9	5.5	-0.5	2,794
Food products, beverages and tobacco	5.5	3.5	-0.4	3.9	6.9	2.8	3.3	-0.5	-6
Textile products and clothing	9.3	0.7	6.2	-5.1	5.1	4.8	1.2	3.5	-482
Leather and leather products	4.5	-0.2	6.8	-6.7	2.2	6.9	1.9	4.9	-421
Wood and wood products	0.5	-2.5	5.0	-7.1	1.2	0.4	3.6	-3.1	-45
Paper and paper products, printing and publishing	2.2	4.5	2.5	2.0	2.2	4.5	0.6	3.8	-4
Refined petroleum products	2.2	51.9	34.2	11.6	1.7	18.0	39.7	-13.8	2,241
Chemical products and man-made fibres	9.6	11.6	8.2	2.6	13.5	8.0	9.0	-1.0	64
Rubber and plastic products	3.8	5.6	7.1	-1.4	2.1	5.5	4.9	0.6	245
Non-metallic mineral products	3.2	-2.3	4.0	-6.1	1.1	4.1	5.3	-1.1	-308
Basic metals and metal products	9.6	10.3	8.0	2.3	10.4	8.7	11.8	-2.7	247
Mechanical machinery and equipment	20.3	2.9	6.0	-2.8	7.4	1.9	5.6	-3.7	1,149
Electrical equipment and precision instruments	9.1	7.1	5.0	1.9	13.1	1.8	2.8	-0.9	1,049
Transport equipment	11.2	2.4	3.4	-0.9	14.1	2.9	1.1	1.9	-375
Other manufactures (including furniture)	5.4	-1.3	6.1	-7.1	1.6	8.7	3.3	5.0	-561
Electricity, gas and water (4)	..				0.6	28.2	4.6	23.4	-469

Source: Based on Istat data.

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

worsening of the overall balance were the reduction in the surplus on travel and the increase in the deficit on other business services, which include commercial services, operational leasing and technical and professional services (Table 11).

According to the sample survey of tourism conducted by the Ufficio Italiano dei Cambi, which covers travel for personal and business reasons, the surplus on tourism began to contract again, falling from €12.2 billion in 2004 to €10.5 billion (0.7 per cent of GDP). Whereas the number of Italians who went abroad and the amount they spent increased sharply (by 6.4 and 10.4 per cent respectively, compared with falls of 15.4 and 9.4 per cent in 2004), foreign tourists' expenditure in Italy stagnated (rising by 0.1 per cent, compared with an increase of 3.8 per cent in 2004), despite the relatively satisfactory results for arrivals. Receipts from travel in Italy by EU citizens, which account for two thirds of all the sector's revenue, declined by 3.1 per cent. After a recovery in 2004, there was a decrease in both the number and the spending of tourists from Germany, the most important country in both respects; there was also a decrease in the spending of British tourists, while that of tourists from Spain and the main new EU member states increased considerably. Non-EU receipts grew by 6.5 per cent, primarily in connection with the spending of tourists from the other European countries and the Americas. There was a further increase in the spending of US tourists, after the sharp contraction in 2002-03. The spending of Italian visitors abroad began to rise again, at much the same pace in the European Union and elsewhere.

Table 9

Italian exports and imports *cif-fob* by main countries and areas, January-November 2005: values, indices of average unit values and volumes (1)

(*percentage changes on corresponding period of 2004, except as indicated)*

	Exports				Imports			
	% composition of values in 2004	Change			% composition of values in 2004	Change		
		Values	Average unit values	Volumes (2)		Values	Average unit values	Volumes (2)
EU countries	**60.0**	**4.2**	**5.6**	**-1.3**	**60.4**	**3.9**	**5.2**	**-1.3**
EU-15	**54.2**	**3.1**	**5.2**	**-2.0**	**56.5**	**1.9**	**5.2**	**-3.1**
of which: France	*12.4*	*4.9*	*5.8*	*-0.9*	*11.0*	*-1.0*	*4.8*	*-5.5*
Germany	*13.6*	*1.6*	*3.0*	*-1.4*	*18.0*	*3.1*	*3.6*	*-0.5*
United Kingdom	*7.1*	*-4.5*	*3.9*	*-8.2*	*4.3*	*1.0*	*5.5*	*-4.6*
Spain	*7.3*	*7.9*	*6.3*	*1.4*	*4.7*	*-2.8*	*7.1*	*-9.1*
New EU countries (3)	**5.8**	**14.2**	**8.8**	**4.9**	**3.9**	**32.7**	**5.7**	**25.5**
Non-EU countries	**40.0**	**7.2**	**7.7**	**-0.5**	**39.6**	**15.2**	**13.9**	**1.2**
of which: China	*1.6*	*1.9*	*9.9*	*-7.0*	*4.1*	*19.3*	*1.2*	*18.1*
Japan	*1.5*	*5.0*	*7.6*	*-2.5*	*1.9*	*-10.5*	*1.1*	*-11.5*
DAEs (4)	*3.2*	*1.4*	*6.8*	*-5.1*	*2.6*	*10.1*	*3.7*	*6.2*
Russia	*1.7*	*23.4*	*5.9*	*16.5*	*3.4*	*20.4*	*29.0*	*-6.5*
United States	*7.9*	*6.0*	*7.9*	*-1.9*	*3.5*	*8.7*	*7.3*	*1.3*
Total	**100.0**	**5.4**	**6.4**	**-0.9**	**100.0**	**8.4**	**8.7**	**-0.3**

Source: Based on Istat data.

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

Table 10

Italy's balance of payments
(millions of euros)

	2004			2005		
	Year	H1	H2	Year	H1	H2
Current account	**-12,767**	**-9,830**	**-2,937**	**-21,166**	**-14,357**	**-6,808**
Goods	8,064	1,925	6,138	329	-46	375
exports	*283,120*	*139,378*	*143,742*	*299,325*	*148,702*	*150,623*
imports	*275,056*	*137,453*	*137,603*	*298,996*	*148,748*	*150,248*
Services	1,528	374	1,154	-711	-1,941	1,231
Income	-14,711	-9,103	-5,608	-12,718	-9,164	-3,554
Current transfers	-7,647	-3,026	-4,621	-8,067	-3,206	-4,860
Capital account	**1,820**	**310**	**1,510**	**1,763**	**728**	**1,036**
Financial account	**8,884**	**10,528**	**-1,644**	**18,539**	**15,752**	**2,787**
Direct investment	-1,971	-3,216	1,245	-20,461	-1,604	-18,857
outward	*-15,513*	*-11,645*	*-3,868*	*-33,181*	*-6,332*	*-26,849*
inward	*13,542*	*8,429*	*5,113*	*12,720*	*4,728*	*7,992*
Portfolio investment	26,447	22,477	3,970	46,527	52,653	-6,126
Equity securities	518	-11,205	11,723	-14,325	-32,830	18,505
assets	*-12,863*	*-4,930*	*-7,933*	*-19,309*	*-6,498*	*-12,811*
liabilities	*13,381*	*-6,275*	*19,657*	*4,984*	*-26,332*	*31,316*
Debt instruments	25,929	33,682	-7,753	60,852	85,483	-24,631
assets	*-8,202*	*-2,708*	*-5,494*	*-65,589*	*-30,185*	*-35,404*
liabilities	*34,131*	*36,390*	*-2,260*	*126,441*	*115,668*	*10,773*
Financial derivatives	1,833	660	1,173	2,124	2,671	-547
Other investment	-19,687	-8,007	-11,680	-10,461	-38,770	28,309
Reserve assets	2,262	-1,386	3,648	810	802	8
Errors and omissions	**2,062**	**-1,008**	**3,071**	**863**	**-2,123**	**2,986**

(1) Provisional data for November and December 2005.

Increases were recorded by all the main destinations (France, the United States, Austria, Spain and the United Kingdom), except for Germany and Switzerland.

In 2005 the deficit on the income account fell from €14.7 billion to €12.7 billion. The result benefited from the fall in the deficit on income from portfolio investment: the widening of the interest rate differential between the United States and the euro area led to a larger increase in inflows than in outflows.

The deficit on current transfers grew from €7.6 billion to €8.1 billion. Immigrants' remittances increased further, rising from €1.6 billion in the first ten months of 2004 to €2 billion in the same period of 2005.

Turning to the financial account, direct and portfolio investment produced a net inflow of €26.1 billion, compared with €24.5 billion in 2004. The substantial increase in net inflows of portfolio investment, from €26.4 billion to €46.5 billion, was mostly offset by the growth in net outflows

Table 11

Italy's trade in services
(millions of euros)

	2004			January-October 2004			January-October 2005		
	Credits	Debits	Balance	Credits	Debits	Balance	Credits	Debits	Balance
Total	**67,529**	**66,001**	**1,528**	**57,904**	**55,004**	**2,900**	**61,045**	**61,323**	**-277**
of which: travel	*28,665*	*16,515*	*12,150*	*25,963*	*14,329*	*11,634*	*26,107*	*16,058*	*10,050*
transport	*11,247*	*15,777*	*-4,530*	*9,421*	*13,159*	*-3,738*	*10,359*	*14,427*	*-4,068*
construction	*1,643*	*2,161*	*-517*	*1,327*	*1,739*	*-412*	*1,436*	*1,479*	*-43*
other business services	*19,581*	*21,438*	*-1,857*	*16,000*	*17,447*	*-1,446*	*17,709*	*20,040*	*-2,331*

of direct investment. Foreign direct investment in Italy remained at the low level recorded in 2004, but Italian direct investment abroad more than doubled, largely in connection with an acquisition made by an Italian banking group.

The very large net inflows of portfolio investment were almost entirely due to non-residents' exceptional purchases of non-equity securities, mostly government securities, which amounted to €126.4 billion (8.9 per cent of GDP), compared with €34.1 billion in 2004. After falling sharply in 2004, foreign investment in public debt instruments rose substantially in the first half of 2005, as in the other main euro-area countries. The growth involved both BOTs and BTPs and may have been due to expectations of a further strengthening of the euro against the dollar, which in the event did not occur.

Table 12

Foreign portfolio investment in Italy (1)
(millions of euros)

	2004			2005	
	Year	H1	January-October	H1	January-October
Government securities	**9,949**	**25,940**	**22,793**	**96,716**	**108,384**
BOTs	*-12,044*	*-2,133*	*-6,614*	*36,653*	*43,039*
BTPs	*17,677*	*5,136*	*9,794*	*52,386*	*65,356*
CCTs	*10,630*	*14,486*	*10,562*	*5,180*	*5,702*
CTZs	*-7,145*	*2,946*	*4,764*	*2,549*	*-3,478*
Republic of Italy issues	*999*	*5,470*	*3,956*	*-2,785*	*-4,856*
Other government securities	*-168*	*35*	*332*	*2,733*	*2,621*
Bonds	24,182	10,450	16,509	18,952	23,966
Equity securities (1)	13,381	-6,275	7,337	-26,332	-31,337
Total	**47,512**	**30,115**	**46,639**	**89,336**	**101,013**

(1) Including investment fund units.

Net purchases in the second half of the year were much smaller, partly as a consequence of the further widening of the interest rate differential between the United States and the euro area (Table 12). In the first ten months of the year foreign investment in private bonds continued to increase, encouraged by the growth in issues by banks and other resident financial institutions. By contrast, investment in bonds issued by non-financial companies was slightly negative. In 2005 non-residents invested €5 billion in shares of Italian companies, a significant decrease on the €13.4 billion recorded in 2004; this result was also largely in connection with the major acquisition by an Italian banking group mentioned earlier.

Last year also saw a very large increase in residents' net purchases of foreign debt instruments, from €8.2 billion to €65.6 billion; the increase in their net purchases of foreign shares was much smaller, from €12.9 billion to €19.3 billion.

The net outflows of "Other investment" (which consists mainly of bank deposits and loans and trade credits) decreased from €19.7 billion to €10.5 billion. The net fund-raising abroad of the Italian banking system amounted to €28.8 billion, which covered most of the gap between the growth of domestic loans and deposits. In 2004 resident banks had made net loans abroad amounting to €10.8 billion.

The labour market

Overview

Employment in the euro area grew at about the same pace last year as in 2004. In Italy, after remaining unchanged in 2004, labour input as measured by standard labour units declined, reflecting the stagnation of economic activity. However, the number of persons employed still increased marginally. The unemployment rate in the euro area came down in the first part of the year and then stabilized at the level reached in August. The pattern for Italy was similar.

The rise in labour costs for the area remained moderate. The cost of labour per employee rose slightly less than in 2004, so that despite a slowdown in productivity growth, unit labour costs rose only a little faster. As in the last several years, unit labour costs rose faster in Italy than in the rest of the area, reflecting the deceleration in labour productivity.

The euro area

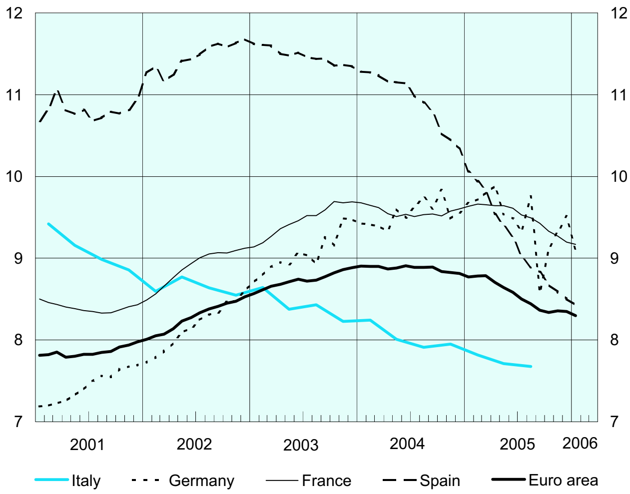
According to preliminary national accounts data, the number of persons employed in the euro area grew by 0.6 per cent in 2005, nearly the same as in 2004. On a seasonally adjusted basis the unemployment rate, which had held stable at 8.9 per cent in 2004, diminished through the first part of 2005. The decline ended in August, and the rate steadied for the rest of the year at 8.3 per cent (Figure 13).

In the four largest economies of the area the slowdown in per capita labour costs was smaller than that in productivity, so that unit labour costs accelerated (Table 13). In the service sector the trends in the two variables remained virtually unchanged, and unit labour costs rose by 1.4 per cent, slightly faster than in 2004. In industry excluding construction productivity growth was rapid but still 1.5 percentage points lower than in the previous year. Nevertheless, the sharp slowdown in the cost of labour produced a further fall in unit labour costs of 0.9 per cent, after the 1.2 per cent decrease of 2004.

Figure 13

Unemployment rates in the main euro-area countries (1)

(seasonally adjusted data; percentages)



Sources: Istat and Eurostat.

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

In *Germany* employment contracted marginally. The unemployment rate, after swinging widely during the second half of the year owing to the revision of unemployment benefit eligibility standards, fell to 9.1 per cent in January, 0.6 points less than a year earlier (Figure 13). Unit labour costs fell further, thanks to a sharp productivity gain in manufacturing and broad stability in labour costs per employee, which significantly boosted the country's international competitiveness. The metalworkers' contract expired in February 2006, and the trade unions have asked for a raise of 5 per cent for the year. In the past, the outcome of bargaining has generally been an increase in contractual wages of about half the original demand and a much smaller rise in actual earnings, owing to firms' increasingly widespread recourse to safeguard clauses in derogation to the national agreement.

Table 13

Labour costs per employee, productivity and its components, and unit labour costs
(percentage changes on corresponding period)

	Labour costs per employee (1)		Labour productivity (1)						Unit labour costs (1)	
					Value added (2)		Employment (1)			
	2004	2005	2004	2005	2004	2005	2004	2005	2004	2005
					Industry excluding construction					
Germany	2.1	1.2	6.0	4.4	4.4	2.6	-1.5	-1.7	-3.7	-3.1
France	3.6	2.5	3.5	3.3	0.5	0.7	-2.9	-2.5	0.1	-0.8
Italy	4.0	2.4	2.5	-0.7	1.3	-2.3	-1.2	-1.6	1.5	3.2
Spain	3.9	2.8	1.5	0.8	0.6	1.1	-0.9	0.3	2.4	2.0
Euro 4 (3)	2.9	1.7	4.1	2.6	2.5	1.1	-1.6	-1.4	-1.2	-0.9
					Services (4)					
Germany	-0.3	-0.1	0.1	0.3	1.4	0.9	1.3	0.6	-0.4	-0.3
France	2.8	3.3	1.4	1.3	1.9	1.9	0.5	0.6	1.4	1.9
Italy	3.3	3.2	0.4	0.3	0.8	0.8	0.4	0.3	2.8	2.6
Spain	3.3	2.7	0.5	0.8	3.6	3.9	3.1	3.1	2.8	2.0
Euro 4 (3)	1.7	1.8	0.4	0.4	1.7	1.5	1.2	1.1	1.2	1.4
					Total economy					
Germany	0.3	0.2	1.7	1.3	2.1	1.0	0.4	-0.2	-1.4	-1.1
France	2.9	3.1	1.9	1.3	1.9	1.4	0.0	0.1	1.0	1.7
Italy	3.5	2.9	1.3	0.5	1.3	0.0	0.0	-0.4	2.2	2.4
Spain	3.3	2.5	0.4	0.2	3.0	3.4	2.6	3.1	2.9	2.3
Euro 4 (3)	1.8	1.6	1.3	0.6	2.0	1.2	0.7	0.6	0.5	0.9

Sources: Based on Istat and Eurostat data.
(1) For Italy, France and Spain, refers to standard labour units. – (2) Chain-linked volumes. – (3) Weighted average for France, Germany, Italy and Spain. – (4) Comprises wholesale and retail trade, transport and telecommunications, financial and real estate intermediation, and “other services”.

In *France* employment held broadly unchanged last year. The unemployment rate declined to 9.2 per cent in January 2006, 0.4 points less than in December 2004. Labour productivity rose significantly in industry and even more sharply in the service sector but even so did not fully offset the very fast rise in per capita labour costs. Unit labour costs rose by 1.7 per cent, compared with 1 per cent in 2004.

In *Spain* employment expanded by 3.1 per cent, the largest gain since 1991, driven by rapid GDP growth of 3.4 per cent, and the unemployment rate fell by 1.7 percentage points, from 10.1 to 8.4 per cent, between January 2005 and January 2006. Labour costs per employee were not affected by the improved labour market conditions and slowed to growth of 2.5 per cent. As a consequence, despite slow productivity growth the rise in unit labour costs eased to 2.3 per cent.

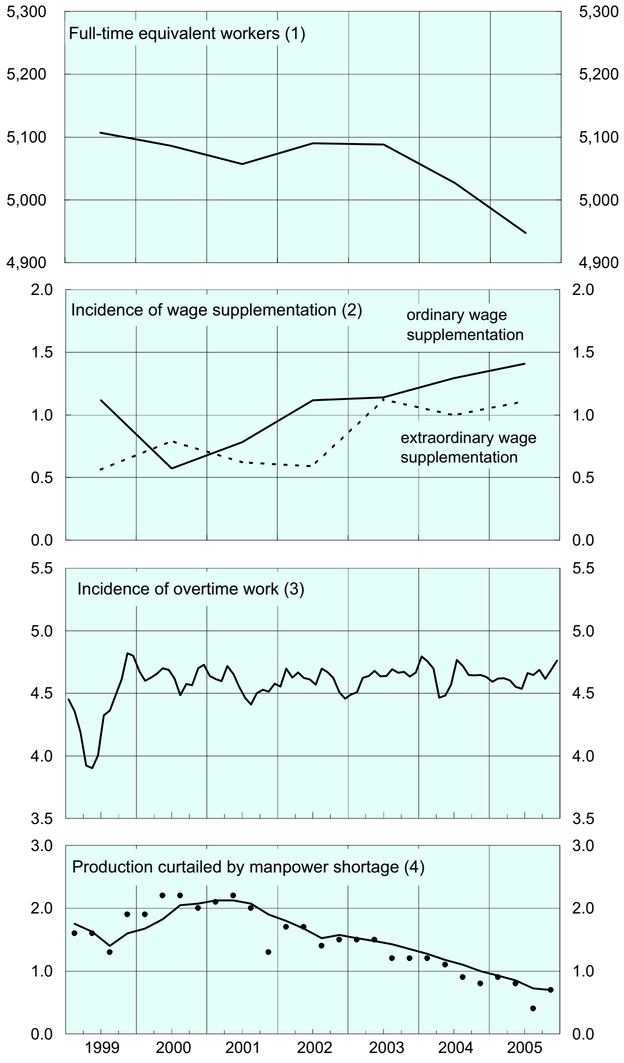
Italy

Employment. – According to the revised national accounts, total employment in Italy as measured by standard labour units contracted last year for the first time since 1995, falling by 0.4 per cent after holding almost unchanged in 2004. However, the number of persons employed edged up by 0.2 per cent. The difference in the signs of the two indicators, which is exceptional in recent experience, stems above all from the sharp rise in the number of part-time employment positions and to a lesser extent from increased recourse to the Wage Supplementation Fund (workers receiving benefits are classified as employed but their benefit hours are not counted in calculating standard labour units).

Figure 14

Employment, wage supplementation and overtime work in industry excluding construction in Italy

(seasonally adjusted data; thousands of persons and percentages)



Sources: Based on Istat, national accounts and *Indagine sulle grandi imprese*, INPS data and data from ISAE, *Inchiesta sulle imprese manifatturiere ed estrattive.*

(1) Standard labour units as defined in the national accounts. Annual data. – (2) Average number of equivalent employees on ordinary or extraordinary wage supplementation during the year as a percentage of the number of full-time equivalent workers according to national accounts. – (3) Monthly data. Total number of overtime hours as a percentage of total number of regular hours in industrial companies with at least 500 employees. Moving averages of the three months ending in the reference month. – (4) Companies so reporting as a percentage of the total; quarterly data; moving averages of the four quarters ending in the reference quarter.

The new data incorporate a broad statistical revision of the previous national accounts data, correcting an overestimate of employment growth due to the regularization of immigrants. The 2002 regularization measure for these workers, who were already employed but not officially resident, produced their progressive inclusion in civic registers, resulting in a significant increase in the number of employed residents counted by the labour force survey (*Economic Bulletin* No. 41, November 2005). This increase in turn was reflected in an overestimate in the preliminary national accounts data released by Istat on the growth in the number of standard labour units of residents and non-residents (0.8 per cent in 2004 and 0.4 per cent in the first three quarters of 2005) and an underestimate of labour productivity growth. The revision makes the employment figures more consistent with the stagnant trend in output.

The reduction in the number of standard labour units in 2005 reflected the sharp fall in labour input in agriculture and in industry excluding construction, which more than offset increases in services and construction (Table 14). The decline in employment in industry, even larger than in 2004 (1.6 as against 1.2 per cent), reflected a 2 per cent contraction in output. Wage Supplementation benefit hours for the year also increased, recording the highest figures since 2000 (Figure 14).

The data for 2005 provided by the labour force surveys – which unlike the national accounts measure of standard labour units refer only to the number of residents employed, regardless of the number of hours worked – continue to reflect the statistical impact of the regularization measure. The surveys found that in the first three quarters of the year the number of persons in employment averaged 22,522,000, 0.9 per cent more than in the same period of 2004 (Table 15). The growth was limited to the Centre and North, while the South saw a small decline (0.2 per cent).

The employment rate for the population aged 15-64 rose by 0.1 percentage points to 57.4 per cent. In the third quarter, however, with the waning of the statistical effect of the regularization of immigrant workers and the continued stagnation of the economy, the labour force survey also found a contraction in employment. On a seasonally adjusted basis the number of persons employed fell

Table 14

Employment by sector in Italy, 2005
(standard labour units)

Paesi	2005	Average 2005 on average 2004		
	Percentage share of national total	Absolute change	Percentage change	Contribution, percentage points
Agriculture	5.2	-110,100	-8.0	-0.5
Industry	28.2	-37,200	-0.5	-0.2
excluding construction	*20.4*	*-79,600*	*-1.6*	*-0.3*
construction	*7.7*	*42,400*	*2.3*	*0.2*
Services	66.6	45,400	0.3	0.2
Total ...	**100.0**	**-101,900**	**-0.4**	**-0.4**

Source: Istat, national accounts.

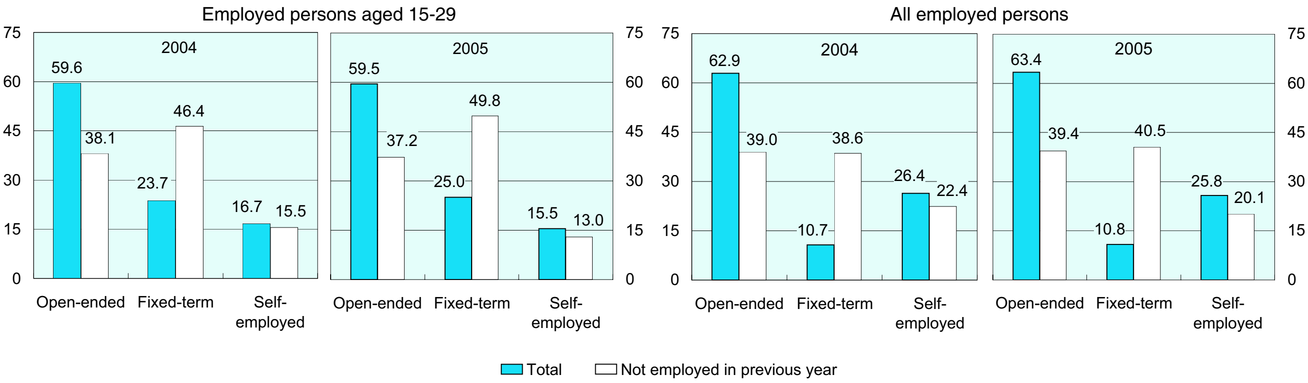
by 54,000 quarter on quarter (0.2 per cent); almost all of the loss (42,000) came in the South. The fall also affected the employment rate for the working-age population, which decreased by 0.3 percentage points by comparison with the third quarter of 2004; the decrease was sharpest in the Centre (0.5 points) and the South (0.8 points).

The 0.9 per cent rise in employment of residents found by the labour force surveys came exclusively in payroll employment, which gained 2.6 per cent and in absolute terms more than offset the 3.5 per cent fall in self-employment. The share of self-employment, still significantly higher than the European average, fell from 28.1 to 26.9 per cent of persons employed. The reduction involved all the sectors of the economy, but more than half of it was in the "trade, hotel and restaurant" sector, where the process of restructuring, though very gradual, brought the share of self-employment down to 43.1 per cent (in 1993 it was 57.2 per cent).

In the first three quarters fixed-term employment relationships (fixed-term employees, collaborators and occasional workers) accounted for 10.8 per cent of total employment and 25 per cent of jobs held by persons aged 15 to 29 (Figure 15). For persons finding work in the twelve months preceding the survey date, the share is much greater. It rose from 38.6 per cent in 2004 to 40.5 per cent in the first three quarters of 2005; and for workers under 30 from 46.4 to nearly 50 per cent.

Figure 15

Employment by occupational status in Italy
(average for first three quarters of the year; percentages)



Source: Based on Istat labour force surveys.
N.B.: Fixed-term employment comprises fixed-term employees, collaborators and occasional workers.

Table 15

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

	2004 average		2004 Q1-Q3 average		2005 Q1-Q3 average	
	Number	Percentage share (1)	Number	Percentage share (1)	Number	Percentage share (1)
Employees	**16,117**	**71.9**	**16,060**	**71.9**	**16,472**	**73.1**
open-ended contracts	14,209	63.4	14,169	63.5	14,477	64.3
full-time	12,618	56.3	12,601	56.4	12,772	56.7
part-time	1,590	7.1	1,568	7.0	1,705	7.6
fixed-term contracts	1,909	8.5	1,891	8.5	1,995	8.9
full-time	1,491	6.7	1,475	6.6	1,575	7.0
part-time	418	1.9	415	1.9	420	1.9
Self-employed	**6,287**	**28.1**	**6,270**	**28.1**	**6,050**	**26.9**
full-time	5,454	24.3	5,433	24.3	5,306	23.6
part-time	833	3.7	837	3.7	744	3.3
Total persons in work	**22,404**	**100.0**	**22,329**	**100.0**	**22,522**	**100.0**
men	13,622		13,594		13,724	
women	8,783		8,735		8,798	
Unemployed	**1,960**		**1,941**		**1,858**	
Labour force	**24,365**		**24,270**		**24,380**	
men	14,546		14,506		14,623	
women	9,819		9,764		9,758	
Unemployment rate	**8.1**		**8.0**		**7.6**	
men	6.4		6.3		6.1	
women	10.5		10.5		9.8	
Participation rate (ages 15-64)	**62.5**		**62.3**		**62.2**	
men	74.5		74.4		74.3	
women	50.6		50.4		50.1	
Employment rate (ages 15-64)	**57.5**		**57.3**		**57.4**	
men	69.7		69.7		69.7	
women	45.3		45.0		45.1	

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

Table 16

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

(percentages)

	Fixed-term		Part-time	
	2004 Q1-Q3 average	2005 Q1-Q3 average	2004 Q1-Q3 average	2005 Q1-Q3 average
Men	9.9	10.5	3.7	3.8
Women	14.3	14.3	24.2	25.3
North	9.3	9.7	12.8	13.7
Centre	11.6	11.8	13.6	14.1
South	16.2	16.8	10.7	10.6
Agriculture	46.9	50.7	9.4	7.3
Industry excl. construction	7.8	7.8	5.6	6.1
Construction	12.7	13.4	4.8	5.5
Services	11.9	12.2	16.0	16.7
Total economy...	**11.8**	**12.1**	**12.3**	**12.9**

Source: Istat, labour force survey.

Among employees proper, the incidence of fixed-term positions is slightly greater, the share rising to 12.1 per cent on average in the first three quarters of 2005 from 11.8 per cent a year earlier (Table 16). Among young people aged 15-29, 26.4 per cent of all employees were on fixed-term contracts, up from 24.3 per cent.

The share of part-time workers rose by 0.6 points to 12.9 per cent of all employees. Among women, part-time positions accounted for more than a fourth of the total; among men, the share remained unchanged at 3.8 per cent.

Unemployment and the supply of labour. – The reduction in the unemployment rate came to a halt in the third quarter of 2005, when it stood at 7.7 per cent nationwide, 4.1 per cent in the North, 6.2 per cent in the Centre and 14.5 per cent in the South. These rates represented a decline of 0.3 percentage points since the third quarter of 2004 for Italy as a whole and comparable declines on a regional basis. In the South the decline was due entirely to a contraction in the labour force, especially among women, and not to an increase in the number of persons employed. Among young people the unemployment rate turned back upwards, rising between the third quarter of 2004 and that of 2005 from 19 to 20.2 per cent for men and from 24 to 28.3 per cent for women.

The labour force participation rate fell to 61.8 per cent in the third quarter, 0.5 points less than a year earlier, owing to a further expansion of the resident working-age population and the decrease in the number of persons employed and job-seekers. In the South, the rate fell by 1.2 points, as the female rate dropped from 37.8 to 36.5 per cent.

Labour costs and industrial relations. – Gross employee compensation per full-time equivalent worker rose by 2.9 per cent last year, compared with 3.5 per cent in 2004 (Table 13). Actual and contractual earnings increased by 3.1 per cent, about 1 point more than the rise in consumer prices. The decline in the rate of growth in labour costs per full-time equivalent worker was accompanied by that in productivity, from 1.3 to 0.6 per cent. Unit labour costs thus rose at about the same rate as in 2004 (2.4 per cent).

Figure 16

Italy: per capita contractual and actual earnings

(seasonally adjusted data; percentage change on corresponding period)

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

The metalworkers' contract

Thirteen months after it expired at the end of 2004, the national contract covering workers in the metal and engineering industries was renewed on 19 January 2006, with the agreement of all the major trade unions for the industry (the previous two times the largest union, FIOM, did not sign). For the first time since the 1980s there was no mediation on the part of the Government or the national trade-union confederations. The wage increases recoup past inflation and are in line with forecast inflation up to June 2007. Hours flexibility is increased, reducing the cost of overtime and augmenting the ability to adapt to demand peaks. The contract also governs the new institution of "job-oriented apprenticeship", which significantly lowers the cost of labour for newly hired workers, continuing a tendency under way since the 1990s.

Wages *– The new contract calls for an increase of €100 a month for the middle grade of worker (Grade 5), in three tranches: €60 in January 2006, €25 in October, and €15 in March 2007. The raise is equal to 6 per cent of the conventional earnings taken as benchmark in contract renewals; of the total, 0.9 percentage points recoup the difference between target and actual inflation in 2003 and 2004. Net of this, and considering that the new agreement stretches over 30 months, the raise comes to 2 per cent yearly, essentially in line with actual inflation in 2005 and forecast inflation to June 2007. Finally, as compensation for the period without contract coverage, workers receive a one-off payment of €320 (in two equal tranches, February and July 2006).*

Weekly working hours *– The agreement allows a worker's weekly working time to range from 32 to 48 hours depending on particular production or market necessities. Over the year, the average work week remains unchanged at 40 hours. This type of flexibility, which previously involved only installation and assembly companies and those active in sectors with highly seasonal demand, is thus now extended to all firms in the metal and engineering industries.*

Apprenticeship *– The agreement establishes rules for the new "job-oriented apprenticeship" contract introduced by the so-called Biagi Law.[1] It sets earnings, the maximum duration of apprenticeship for each job category, the annual number of hours of training and its content. The contract provisions are pursuant to the law, which gave collective bargaining exclusive powers to draft implementing rules, pending the enactment of regional legislation.*

The new agreement provides that an apprenticeship contract may run from a minimum of 36 to a maximum of 60 months, with an annual average of 120 hours of training to attain skills that are specified in the contract itself. The training period is divided into three phases; initially the worker's classification is two grades lower than the norm for the job, and he moves up one grade with each phase. The length of the phases is proportional to the overall duration of the apprenticeship. Training periods with different employers are cumulative, as long as they are not separated by interruptions longer than one year. As the law provides, the employer cannot terminate the apprenticeship contract before it expires without cause or a justified reason. Tax law continues to defray virtually all social contributions out of general revenues.

The new contract and the 1993 protocol *– The new contract differs from its predecessors, which all referred to the framework established by the protocol of July 1993, in according wage increases representing productivity gains to workers not covered by supplementary company-level collective bargaining agreements. In June 2007 a one-off payment of up to €130 will be due to workers without company-level contracts whose annual earnings are not €130 above the contractual minimum. In practice, this alters the 1993 rules, which distinguished between the functions of national and company-level contracts. The purpose of the former was to raise contractual wages in line with inflation, that of the latter to adjust wage increases to company productivity gains. There was thus no bargaining instrument to distribute productivity gains to workers in firms lacking company-level accords. It is hard to estimate exactly how many workers are affected by the new clause, because elementary data on individual wages are lacking. The annual survey by the employers' federation Federmeccanica for 2003 indicates that 55 per cent of its member firms, with a work force of 44,000 or 13 per cent of the total, had no company-level contract.*

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[1] Legislative Decree 276 of 10 September 2003, implementing Law 30 of 14 February 2003, known as the "Biagi Law", modified the entire set of rules governing "mixed" employment contracts, i.e. contracts calling for training activities together with work. Replacing the old apprenticeship contract, which was restricted to persons aged 16-24, the law defines new types of apprenticeship. "Job-oriented apprenticeship," the type most closely resembling the previous arrangement, raises the minimum age to 18 and the maximum to 29 (minors are eligible for the so-called "training apprenticeship" contract) and extends the possible maximum duration from 4 to 6 years, to be specified in collective bargaining agreements.

Contractual earnings in the public sector rose by 2.4 per cent, those in the private sector by 3.4 per cent. The slower rise in the public sector was due to lateness in renewing the wage agreements for the years 2004 and 2005. Those covering workers in the school system, central government ministries and independent State agencies were not signed until almost the end of 2005, and they lapsed again at the end of the year. The entire public sector is thus now awaiting contract renewal.

In industry excluding construction the cost of labour per employee rose by 2.4 per cent, compared with 4 per cent in 2004. Earnings rose by about the same amount (Figure 16). Despite the reduction in the number of persons employed, the even sharper contraction of output resulted in a 0.7 per cent fall in labour productivity and an accelerating rise in unit labour costs of 3.2 per cent. The wage agreement for metalworkers, which had expired in December 2004, was signed in January 2006 [see box].

In the service sector, labour costs and productivity both rose at the same pace as in 2004. The growth in unit labour costs eased slightly to 2.6 per cent.

Labour conflict intensified in 2005, the number of hours lost to strikes increasing to 5.5 million in the first three quarters, 37 per cent more than in the year-earlier period; 60 per cent of the strike activity involved contract disputes. With the expiry of a large part of wage agreements in January, contracts awaiting renewal now represent about two thirds of the total wage bill.

Prices and costs

Overview

In 2005 consumer price inflation remained almost unchanged in the euro area (2.2 per cent, compared with 2.1 per cent in 2004). The surge in energy prices was offset by a fall in core inflation from 2.1 to 1.5 per cent, due in part to the sharp slowdown in some regulated prices.

In Italy, the annual increase in the harmonized index of consumer prices edged down from 2.3 to 2.2 per cent, benefiting from declining food prices. Core inflation in Italy, though higher than the area-wide average owing to less favourable cost developments, fell from 2.3 to 2 per cent, reflecting the weakness of demand.

In the course of the year the professional forecasters interviewed by Consensus Economics progressively raised their projections of euro-area inflation both for 2005 as a whole and for 2006 in view of the persistent increases in oil prices. Their expectations for Italian inflation remained stable. The latest surveys have found that inflation is expected to ease slightly in 2006, in both the euro area and Italy, to about 2 per cent.

Table 17

Consumer prices and producer prices
(percentage changes on year-earlier period)

	Italy						Euro area					
	2004	2005	2005				2004	2005	2005			
			Q1	Q2	Q3	Q4			Q1	Q2	Q3	Q4
Harmonized consumer prices												
Overall index	2.3	2.2	2.0	2.2	2.2	2.3	2.1	2.2	2.0	2.0	2.3	2.3
Excluding unprocessed food and energy products	2.3	2.0	2.1	2.1	1.8	1.8	2.1	1.5	1.7	1.5	1.4	1.5
of which: non-food and non-energy products	*1.6*	*1.4*	*1.3*	*1.7*	*1.1*	*1.4*	*0.8*	*0.3*	*0.3*	*0.3*	*0.1*	*0.4*
services	*2.6*	*2.4*	*2.7*	*2.5*	*2.4*	*2.1*	*2.6*	*2.3*	*2.4*	*2.3*	*2.2*	*2.1*
Unprocessed food products	2.0	-0.7	-1.8	-1.0	-0.6	0.5	0.6	0.8	0.5	0.8	0.8	1.4
Energy products	2.4	8.7	6.0	8.2	10.3	10.3	4.5	10.1	7.6	8.8	12.7	11.1
Producer prices												
Overall index	2.7	4.0	4.7	3.7	3.7	3.9	2.3	4.1	4.1	3.9	4.2	4.3
Excluding food and energy products	3.0	2.1	4.0	2.3	1.3	1.0	1.7	2.1	3.3	2.3	1.5	1.4
of which: final consumption goods	*0.6*	*1.8*	*2.0*	*2.2*	*1.7*	*1.4*	*-0.6*	*1.6*	*1.6*	*1.9*	*1.5*	*1.3*
intermediate goods	*4.9*	*2.5*	*6.0*	*2.7*	*1.0*	*0.6*	*3.5*	*2.9*	*5.1*	*3.1*	*1.7*	*1.7*
Energy products	2.4	15.5	12.2	13.7	17.2	18.8	3.9	13.4	10.0	12.1	15.7	15.6

Sources: Based on Eurostat and Istat data.

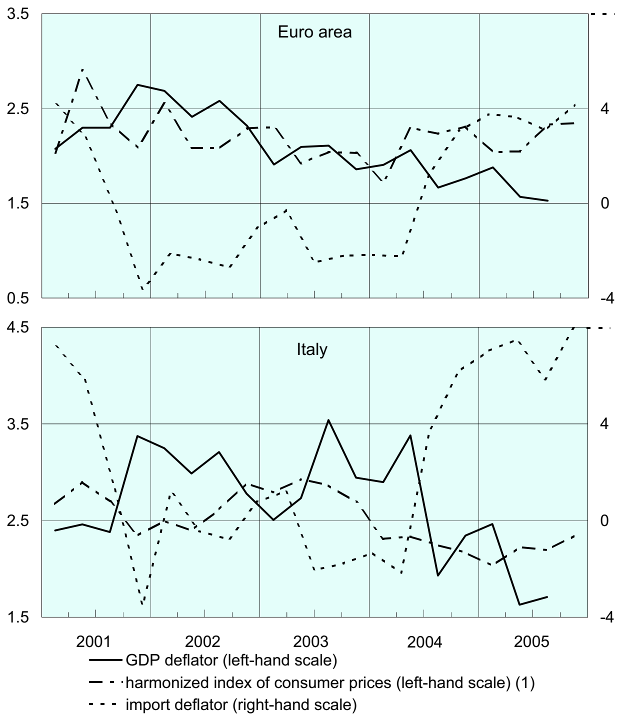
The euro area

Consumer and producer prices. – The increase in the euro-area harmonized consumer price index on the corresponding period of the previous year rose from 2 per cent in the first half of 2005 to 2.3 per cent in the second, owing to an acceleration in the more volatile components of the index in all the major countries (Figure 17 and Table 17). Core inflation, down sharply with respect to 2004, fluctuated around 1.5 per cent (Figure 18). The annual increase in the prices of non-food and non-energy goods fell from 0.8 to 0.3 per cent, largely because of a deceleration in the prices of medical products in Germany. In France, the reduction of 0.2 per cent in the prices of industrial goods was accompanied by one of 0.8 per cent in unit labour costs.

Figure 17

Inflation indicators

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



Sources: Based on Istat and Eurostat data.

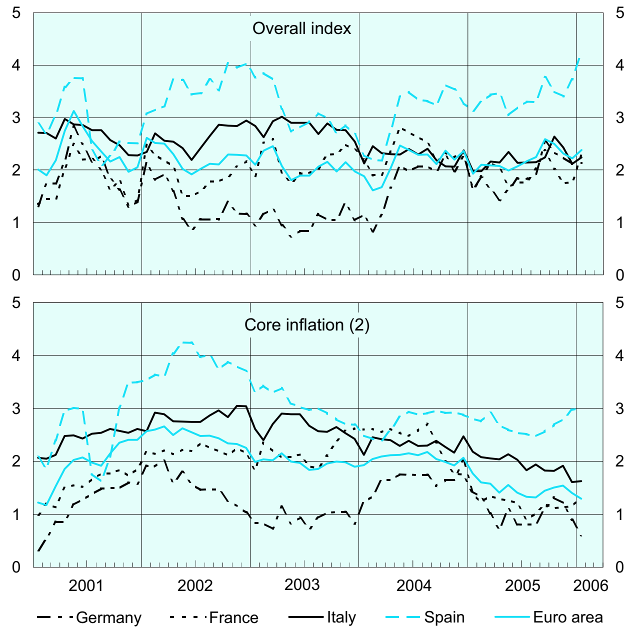
(1) For Italy, for 2001 the percentage changes are calculated with reference to harmonized indices that exclude price reductions for special offers.

Service price inflation abated steadily in all the major countries of the area, from 2.4 per cent in the first quarter to 2.1 per cent in the fourth. The differential between the inflation rate for services and that for non-energy industrial goods held at around 2 percentage points, in line with the differential between the rates of increase in unit labour costs in the two sectors.

Figure 18

Harmonized index of consumer prices (1)

(monthly data; twelve-month percentage changes)



Source: Based on Eurostat data.

(1) For Italy, for 2001 the percentage changes are calculated with reference to harmonized indices that exclude price reductions for special offers. – (2) Overall index excluding energy and unprocessed food.

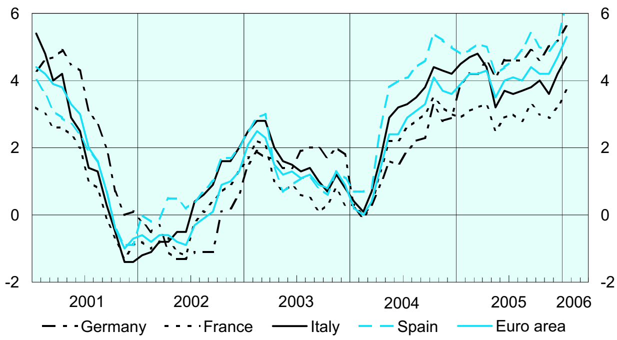
In January 2006 the euro-area harmonized index of consumer prices showed a twelve-month increase of 2.4 per cent, driven up from 2.2 per cent in December by the energy component.

Producer price inflation rose in the euro area from 2.3 per cent on average in 2004 to 4.1 per cent in 2005 (Figure 19). It increased from 1.6 to 4.6 per cent in Germany, from 2 to 3 per cent in France, and from 2.7 to 4 per cent in Italy.

The acceleration of producer price inflation in the euro area was due largely to the jump in the energy component, whose annual growth rose from 3.9 to 13.4 per cent. The producer prices of both non-food consumer goods and capital goods also accelerated on average for the year, reflecting the emergence of input cost strains in the last two years (recorded by the Reuters survey of manufacturing firms) and the recovery of orders in the second half of 2005 (Figure 20). The inflationary pressure in these sectors was moderated only in part by the progressive slowing during the year in the producer prices of non-energy intermediate goods, which with a lag of several quarters incorporated the deceleration recorded in 2004 in the world prices of the corresponding raw materials. The outcome was a slight increase in the core component of producer price inflation.

Figure 19

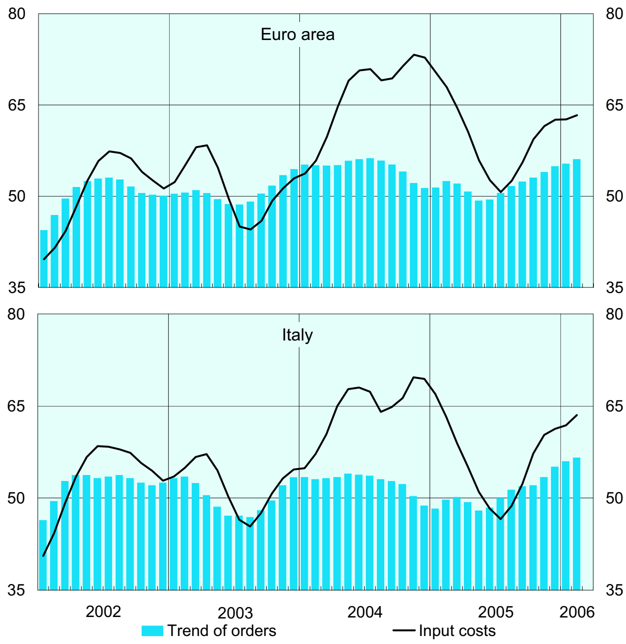
Index of producer prices (1)
(twelve-month percentage changes)



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

Figure 20

Demand and input costs for manufacturing firms (1)
(monthly data; percentages)



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

Costs. – Cost pressures on area firms deriving from imported inputs increased in 2005. The deflator of imported goods and services, which began to rise faster in the second quarter of 2004, paused in the first half of 2005 but then resumed its acceleration in the third quarter. On average, in the first nine months the deflator was 3.6 per cent higher than in the corresponding period of 2004. Imported inflation was limited in Germany and France (2.2 and 3.2 per cent respectively), but pronounced in Italy (7.1 per cent).

With the rate of growth in labour costs per employee holding basically steady, the deceleration in labour productivity led to a modest rise in the area-wide rate of increase in unit labour costs (from 0.5 to 0.9 per cent; see Table 13 in the chapter on the labour market).

Italy

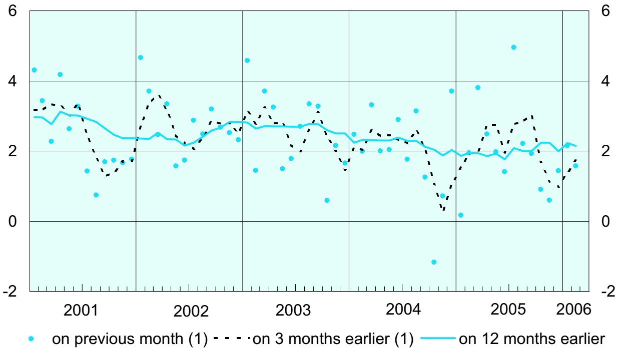
Prices and costs. – The index of consumer prices for the entire resident population rose by an average of 1.9 per cent in 2005, 0.3 percentage points less than in 2004 (Figure 21 and Table 18). Excluding the components whose prices are regulated and the more volatile items (food and energy products), the rate of increase in consumer prices eased marginally (from 2.1 to 2 per cent).

Owing to the rising prices of energy goods, consumer price inflation increased slightly during the year, from 1.9 per cent in the first quarter to 2.1 per cent in the fourth. Despite the acceleration in unit labour costs in industry (from 1.5 to 3.2 per cent) and price rises for raw materials, the increase in the prices of unregulated non-food and non-

Figure 21

Italy: index of consumer prices for the entire resident population

(percentage changes)



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

energy goods remained modest at 0.9 per cent (0.8 per cent in 2004), reflecting the weakness of demand and the falling prices of high-technology goods. As in 2004, the latter component reduced the inflation rate for unregulated non-food and non-energy goods by just under 0.5 percentage points. During the year, however, the rate of increase in the producer prices of non-food consumer goods rose from 0.6 to 1.8 per cent, fueled as in the rest of the euro area by a recovery of orders and rising input costs. This suggests that the increases in raw material prices registered between 2004 and 2005 have begun to pass through to producer prices in manufacturing.

The inflation rate for services whose prices are not regulated fell in 2005 by 0.4 percentage points to 3 per cent in connection with a slight decline (from 2.8 to 2.6 per cent) in the annual increase in unit labour costs in the sector. Particularly sharp price increases were recorded for air transport (18.1 per cent, compared with 11.6 per cent in 2004), which was affected by rising fuel prices, and banking

Table 18

Consumer prices in Italy (1)

	Percentage changes on previous year		Percentage weights	Contributions to average inflation (percentage points)
	2004	2005	2004	2005
OVERALL INDEX	**2.2**	**1.9**	**100**	
Unregulated goods and services	**2.3**	**1.9**	**81.8**	**1.55**
Unprocessed food	2.0	-0.8	6.6	-0.05
Processed food	2.3	0.7	10.0	0.07
Non-food and non-energy products	0.8	0.9	30.0	0.27
of which: computers	*-9.4*	*-10.6*	*0.2*	*-0.02*
telephones	*-23.3*	*-20.4*	*0.6*	*-0.12*
Unregulated services	3.4	3.0	31.9	0.96
of which: air transport	*11.6*	*18.1*	*0.8*	*0.14*
banking services	*6.6*	*8.3*	*0.7*	*0.06*
Energy	5.8	11.0	3.3	0.36
Regulated goods and services	**1.9**	**2.1**	**18.2**	**0.38**
Medical products	-1.0	-5.1	2.8	-0.14
Tobacco products	9.8	8.9	2.1	0.19
Rents	2.8	2.4	3.0	0.07
Public services and utilities	0.9	2.6	10.2	0.27
of which: energy	*-1.2*	*6.1*	*2.8*	*0.17*

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

services (8.3 per cent, compared with 6.6 per cent the previous year).

The inflation rate for regulated goods and services rose marginally to 2 per cent owing to higher energy prices, but the rate of increase in the other categories of regulated prices declined, thanks mainly to the reduction of 5.1 per cent in the prices of medical products, in spite of an 8.9 per cent increase for tobacco products.

The consumer prices of regulated energy goods rose by 11 per cent. The acceleration imparted to the overall index by the energy sector was offset by a reduction in the prices of unprocessed foods and a deceleration in those of processed foods, the latter development reflecting the slackening of food commodity prices in world markets.

Producer price inflation in Italy rose from 2.7 to 4 per cent in 2005, driven up mainly by the energy component (15.5 per cent; Table 17). Smaller price increases than in 2004 for other intermediate goods and food products moderated the rise in the overall index. Excluding the more volatile components, producer price inflation fell from 3 to 2.1 per cent.

Profit margins. – Istat's indicators of input and output prices show that the output deflator for manufactures sold on the domestic market rose less in the first nine months of 2005 than in the corresponding period of 2004, despite an increase of more than 5 per cent in unit variable costs (Table 19). Unit profit margins narrowed accordingly. By contrast, the prices of goods sold on export markets rose by 6 per cent, benefiting from more favourable demand conditions. A similar difference between the domestic market and export markets can be seen for services, where, however, the reduction in unit profit margins on the domestic market was not as large and the share of foreign demand is very small.

The sizeable gap between the prices applied by Italian firms on the domestic and export markets is confirmed by the trend in the average unit values in euros of goods exports. In the first eleven months of 2005 the average unit values of goods exported to the EU-15 outpaced producer price inflation, rising by 5.6 per cent on the corresponding period (up from 4.4 per cent in 2004). The increase for goods sold on non-EU markets was sharper (to 7.7 per cent, from 4.1 per cent in 2004). The performance of the average unit values of Italian exports appears to reflect an

Table 19

Unit variable costs and output deflator in Italy (1)
(percentage changes on year-earlier period)

	Manufacturing (2)			Market services		
	Percentage weights in 1995	2004	2005 Jan.-Sept.	Percentage weights in 1995	2004	2005 Jan.-Sept.
Unit variable costs	**100.0**	**3.1**	**5.2**	**100.0**	**2.7**	**3.4**
Labour inputs	35.9	2.5	5.8	73.6	2.4	2.8
Other inputs	64.1	3.5	4.9	26.4	3.3	4.7
Domestic	*38.3*	*1.5*	*5.0*	*19.9*	*3.9*	*4.8*
Imported	*25.8*	*5.8*	*4.7*	*6.5*	*1.7*	*4.2*
Output prices	**100.0**	**3.1**	**3.6**	**100.0**	**2.2**	**2.2**
On the domestic market	*58.3*	*2.3*	*1.3*	*91.3*	*2.2*	*2.0*
On export markets	*41.7*	*3.8*	*6.0*	*8.7*	*3.0*	*4.3*

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

attempt by manufacturers to compensate on more dynamic foreign markets for the compression of their profit margins at home.

Inflation expectations in the euro area and Italy

In January and February 2006 the professional forecasters interviewed by Consensus Economics expected inflation this year to average 2.1 per cent in Italy and 2 per cent in the euro area (Table 20). For 2007 inflation was expected to come down to 1.9 per cent in Italy and remain at 2 per cent in the area.

Table 20

Professional forecasters' inflation expectations for 2005 and 2006 in the euro area (1)

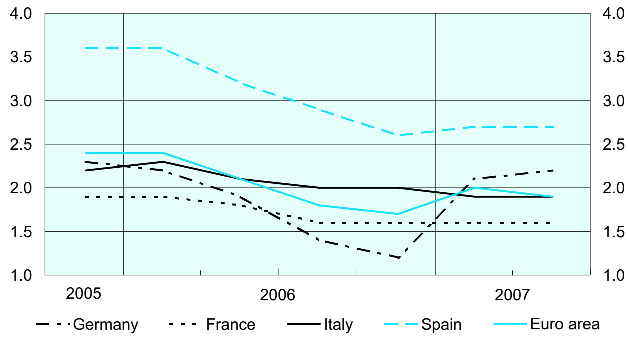
	Forecasts for 2006		Forecasts for 2007	
	January 2006 survey	February 2006 survey	January 2006 survey	February 2006 survey
Italy	2.1	2.1	1.8	1.9
France	1.8	1.7	1.6	1.6
Germany	1.7	1.7	2.3	2.3
Spain	3.1	3.2	2.8	2.8
Euro area	2.0	2.0	2.0	2.0

Source: Consensus Economics.
(1) Monthly survey.

According to the quarterly survey conducted in December, during 2006 euro-area inflation was forecast to decline gradually from 2.5 per cent in the first quarter to 1.7 in the fourth. Italian inflation was expected to decline more moderately during the year, falling to around 2 per cent in the fourth quarter (Figure 22).

Figure 22

Professional forecasters' inflation expectations for the eight following quarters
(December 2005 survey; percentage changes on year-earlier quarter)



Source: Consensus Economics survey of professional forecasters.

In the quarterly survey of a sample of around 450 Italian industrial and services firms conducted jointly by the Bank of Italy and *Il Sole 24 Ore*, the respondents expected to raise their prices by an average of 1.7 per cent over the next twelve months, well below expected consumer price inflation over the same time horizon (2.5 per cent). Strains in raw materials markets were the factor most often cited as a possible source of inflationary pressure.

The longer-term expectations that can be derived from the prices of inflation-indexed government securities indicate euro-area inflation holding steady at around 2 per cent. Professional forecasters' expectations are also in line with this level.

THE PUBLIC FINANCES IN THE EURO AREA AND ITALY

Overview

According to the data now available, general government net borrowing in the euro area declined from 2.8 per cent of GDP in 2004 to 2.5 per cent in 2005. The deficit exceeded the threshold of 3 per cent of GDP in Portugal, Greece, Italy and Germany.

In Italy, in 2005 net borrowing amounted to 4.1 per cent of GDP, compared with 3.4 per cent in 2004 (Table 21). General government debt increased by 2.6 percentage points of GDP to 106.4 per cent, ending a decade of progressive reduction.

Table 21

Italy: general government net borrowing, borrowing requirement and debt (1)
(*as a percentage of GDP*)

	2002	2003	2004	2005
Net borrowing	2.9	3.4	3.4	4.1
Primary surplus	2.7	1.7	1.3	0.5
Interest payments	5.5	5.1	4.7	4.6
Gross borrowing requirement.......................	2.9	3.0	3.5	4.8
Borrowing requirement net of privatization receipts	3.0	4.3	4.1	5.1
Borrowing requirement net of settlements and privatization receipts	2.6	3.6	4.0	5.1
Debt	105.5	104.3	103.8	106.4

Sources: Istat; Bank of Italy for the borrowing requirement and the debt.
(1) Rounding may cause discrepancies in totals.

In September 2004 the Government had confirmed the net borrowing target of 2.7 per cent of GDP for 2005. To achieve this target, measures expected to produce an adjustment amounting to 1.7 per cent of GDP were approved. The target was revised steadily upwards in the course of 2005, and in July the deficit for the year was estimated at 4.3 per cent. In the same month the EU Council found that Italy had an excessive deficit and called for corrective action to bring net borrowing back below 3 per cent of GDP in 2007.

The primary surplus fell from 1.3 per cent of GDP in 2004 to 0.5 per cent in 2005, prolonging the downward trend under way since 1998 (Figure 23). The reduction in net borrowing produced by one-off measures decreased from 1.5 to around 0.5 percentage points of GDP. Excluding the effects of these measures, the primary surplus was virtually nil, showing a slight improvement on the previous year.

The general government borrowing requirement net of privatization receipts increased from 4.1 to 5.1 per cent of GDP. Excluding the effects of one-off measures it came to around 6 per cent of GDP, the same as in the previous two years.

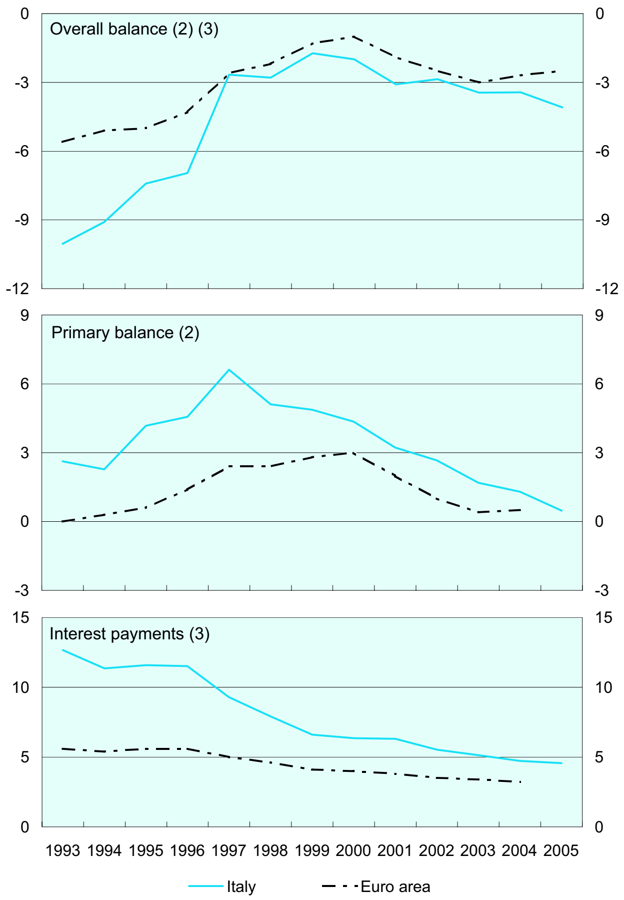
The large rise in the debt ratio in 2005 was partly due to the stagnation of GDP in real terms, with the primary surplus on a cash basis virtually nil. The increase in the debt was contained by means of one-off measures and privatization receipts, totalling over one percentage point of GDP.

In the medium-term scenario laid out in last December's stability programme update, stabilizing the debt ratio will require an improvement in the structural primary surplus on a cash basis of about one percentage point of GDP with respect to 2005. To set the process of debt reduction in motion again the stability programme projects an increase in the primary surplus, adjusted for cyclical effects and one-off measures, of 2.6 per cent between 2005 and 2009.

Figure 23

Italy and the euro area: general government overall balance, primary balance and interest payments (1)

(as a percentage of GDP)



Sources: Based on Istat and EU Commission data.

(1) Following the switch to ESA95, there is a break in the euro-area series between 1994 and 1995. As regards the 2005 euro-area data, see footnote 3 to Table 22. – (2) Excludes the proceeds of sales of UMTS licences in 2000 for Italy and in 2000-02 for the other euro-area countries. – (3) Includes the effects of swaps and forward rate agreements.

The euro area

According to available data on the outturns for several countries and the recent updates to the stability programmes, in 2005 general government net borrowing in the euro area amounted to 2.5 per cent of GDP, compared with 2.8 per cent in 2004 (Table 22). The improvement is only slightly less than the figure indicated in the updates submitted between the end of 2004 and June 2005 (0.5 per cent of GDP), despite lower-than-expected GDP growth by about 1 percentage point. This contrasted with the forecasts issued by the European Commission and main international organizations towards the end of last year, which indicate a slight increase in the deficit.

In Germany net borrowing declined by 0.4 per cent but remained in excess of the 3 per cent threshold for the fourth successive year at 3.3 per cent of GDP. Spain moved from virtual balance to a 1 per cent surplus. On the basis of the stability programmes (Table 23) net borrowing declined considerably in France (by 0.7 points to 3 per cent of GDP), Greece (by 2.3 points to 4.3 per cent) and the Netherlands (by 0.9 points to 1.2 per cent). Apart from Germany and Greece, deficits in excess of 3 per cent were posted by Portugal (6 per cent of GDP) and Italy.

According the information available, the ratio of debt to GDP in the euro area rose for the third year running, from 70 to 70.7 per cent. In Italy it increased by 2.6 percentage points and in Germany by 2 points, while in Spain it decreased by 3.2 points. The stability programmes indicate increases of 6.1 points in Portugal and 1.3 points in the Netherlands and a decline of 2.2 points in Finland.

The excessive deficit procedure was opened in respect of France and Germany in 2003, Greece in 2004 and Italy and Portugal in 2005 (see *Economic Bulletin*, No. 37, 2003 and subsequent issues). In January the procedure was also initiated against the United Kingdom in view of the estimates given in December in that country's stability programme update (3.1 per cent in the 2005-06 financial year compared with 3.3 per cent in 2004-05). At the same time the EU Commission recommended that within the next six months the country should adopt adjustment measures to bring the deficit below the threshold of 3 per cent of GDP by the 2006-07 fiscal year. The procedure is under way for six of the new member states (Cyprus, Malta, Poland, the Czech Republic, Slovakia and Hungary).

On the basis of the stability programmes, net borrowing in the euro area should fall to 2.3 per cent of GDP in 2006 and then progressively to 1.4 per cent in 2008. The ratio of debt to GDP is expected to decline from 2006 onwards.

Table 22

Euro area and EU general government net borrowing, expenditure, revenue and debt: government programmes, European Commission and international organization estimates, outturns (1)

(as a percentage of GDP)

	Euro area			EU-15			European Union		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Net borrowing (2)									
Objectives set in stability and convergence programmes (Nov. 04-June 05)	2.8	2.3	1.8	2.6	2.1	1.7	2.7	2.3	1.8
IMF (September 2005)	2.7	3.0	3.1	–	–	–	–	–	–
European Commission (November 2005)	2.7	2.8	2.8	2.6	2.7	2.7	2.6	2.7	2.7
OECD (December 2005)	2.7	2.9	2.7	–	–	–	–	–	–
Objectives set in stability and convergence programmes (Nov. 05-Feb. 06) (3)	2.7	2.5	2.3	2.6	2.4	2.2	2.7	2.5	2.3
Outturn for 2004 and preliminary outturn for 2005 (4)	2.8	2.5	–	–	–	–	–	–	–
Cyclically-adjusted net borrowing									
IMF (September 2005) (5)	2.2	2.3	2.3	–	–	–	–	–	–
European Commission (November 2005)	2.5	2.3	2.3	2.4	2.2	2.2	2.5	2.3	2.3
OECD (December 2005) (5)	2.2	2.2	2.1	–	–	–	–	–	–
Expenditure and revenue (European Commission, November 2005)									
Expenditure	47.8	48.0	47.7	47.6	47.8	47.6	47.4	47.6	47.4
of which: interest payments	*3.2*	*3.1*	*3.0*	*2.9*	*2.9*	*2.8*	*2.8*	*2.9*	*2.8*
Revenue	45.1	45.1	44.8	45.0	45.1	44.9	44.8	44.9	44.7
Debt									
Objectives set in stability and convergence programmes (Nov. 04-June 05)	71.0	70.6	69.5	64.6	64.3	63.5	63.7	63.3	62.5
European Commission (November 2005)	70.2	71.1	71.1	63.9	64.7	64.8	63.0	63.7	63.8
Objectives set in stability and convergence programmes (Nov. 05-Feb. 06) (3)	70.3	70.9	70.7	64.1	64.9	64.7	63.1	63.8	63.7
Outturn for 2004 and preliminary outturn for 2005 (4)	70.0	70.7	–	–	–	–	–	–	–

Sources: Based on: European Commission, *Autumn Forecasts*, November 2005; OECD, *Economic Outlook*, December 2005; and the updates to stability and convergence programmes submitted by some countries in early 2006.

(1) GDP-weighted averages. – (2) Includes the effects of swaps and forward rate agreements. – (3) Figures included in the stability and convergence programme for the United Kingdom refer to the fiscal year not the calendar year. – (4) Figures are based on outturns for certain countries (Italy, Spain, Germany, Ireland and Finland for net borrowing, and Italy, Germany and Spain for debt) and on the updates to stability and convergence programmes submitted at the end of 2005 and in early 2006. – (5) Does not include Luxembourg.

France expects to curtail its deficit to 2.9 per cent of GDP in 2006. Subsequently, the deficit should improve more rapidly and under the macroeconomic scenario adopted by the Commission, which is the less favourable of the two submitted in the stability programme, a surplus of 1 per cent should be achieved in 2009. The improvement is intended to come mainly from reductions in the ratio of expenditure to GDP. The ratio of debt to GDP will fall below 60 per cent in 2010. In its assessment of the stability

Table 23

Objectives set for net borrowing and debt in the updates to stability and convergence programmes
(as a percentage of GDP)

	Net borrowing						Debt					
	2004	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008	2009
Germany	3.7	3.3	3.3	2.5	2.0	1.5	65.5	67.5	69.0	68.5	68.0	67.0
France	3.7	3.0	2.9	2.6	1.9	1.0	65.1	65.8	66.0	65.6	64.6	62.8
Italy	3.2	4.3	3.5	2.8	2.1	1.5	106.5	108.5	108.0	106.1	104.4	101.7
Spain	0.1	-1.0	-0.9	-0.7	-0.6	–	46.6	43.1	40.3	38.0	36.0	–
Netherlands	2.1	1.2	1.5	1.2	1.1	–	53.1	54.4	54.5	53.9	53.1	–
Belgium	0.0	0.0	0.0	-0.3	-0.5	-0.7	94.7	94.3	90.7	87.0	83.0	79.1
Austria	1.0	1.9	1.7	0.8	0.0	–	63.6	63.4	63.1	61.6	59.5	–
Greece	6.6	4.3	2.6	2.3	1.7	–	109.3	107.9	104.8	101.1	96.8	–
Finland	-2.1	-1.8	-1.6	-1.6	-1.5	-1.5	44.9	42.7	41.7	41.1	40.6	40.1
Ireland	-1.4	-0.3	0.6	0.8	0.8	–	29.4	28.0	28.0	28.2	28.3	–
Portugal	3.0	6.0	4.6	3.7	2.6	1.5	59.4	65.5	68.7	69.3	68.4	66.2
Luxembourg	1.2	2.3	1.8	1.0	0.2	–	6.6	6.4	9.6	9.9	10.2	–
Euro area	2.7	2.5	2.3	1.9	1.4	–	70.3	70.9	70.7	69.5	68.1	–

Sources: Based on the updates to stability and convergence programmes submitted starting in the last few months of 2005.

programme for France the Commission pointed to the risk that the planned corrective measures would not prove sufficiently effective and that economic growth might not fulfil expectations.

The stability programme for Germany sets a target for net borrowing of 3.3 per cent of GDP in 2006 and elimination of the excessive deficit in 2007, when the target is set at 2.5 per cent. A further overall improvement of 1 per cent is planned for the following two years. The adjustment should be achieved mainly by means of measures to increase revenues. More specifically, from 2007 the standard VAT rate will be raised by 3 percentage points and there will be increases in the top personal income tax rate and in the tax on insurance policies. These measures will be offset in part by reductions in social security contributions. According to the Commission the planned measures should bring the deficit below the 3 per cent threshold in 2007.

In December the EU Council approved a Regulation concerning the quality of the statistics provided in the course of excessive deficit procedures. The regulation is intended to create a legal basis for practices in matters of statistics that have taken hold in recent years, partly taking up the provisions of the *Code of Best Practice*. In the event of problems Eurostat will be able to send missions to the countries concerned to examine the methodological aspects. The transparency and accountability of assessments of public finance statistics will be further enhanced by publishing the data provided by the countries and the reports of the missions.

Targets and results in Italy

The Economic and Financial Planning Document Update and the Forecasting and Planning Report in September 2004 set the objective for net borrowing in 2005 at 2.7 per cent of GDP, against a current-programmes projection of 4.4 per cent. At the same time the Government presented a budget correction

Table 24

Italy: public finance objectives and estimates for 2005
(billions of euros and percentages)

	State sector borrowing requirement (1)	General government				Memorandum items	
		Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate	Nominal GDP
Objectives (2)							
Economic and Financial Planning Document (July 2004) ...	….	….	….	….	….	2.1	1,409.0
as a percentage of GDP	*4.2*	*2.7*	*2.6*	*5.3*	*104.1*		
Forecasting and Planning Report and Economic and Financial Planning Document update (September 2004)	61.0	38.7	33.8	72.5	….	2.1	1,413.9
as a percentage of GDP	*4.3*	*2.7*	*2.4*	*5.1*	*104.1*		
Stability programme update (November 2004)	….	….	….	….	….	2.1	….
as a percentage of GDP	….	*2.7*	*2.4*	*5.1*	*104.1*		
Estimates released during the year (2)							
Quarterly Report on the Borrowing Requirement and Forecasting and Planning Report update (April 2005)	44.0	41.0	29.3	70.3	….	1.2	1,394.5
as a percentage of GDP	….	*2.9*	*2.1*	*5.0*	*105.3*		
Economic and Financial Planning Document (July 2005) ...	65.2	59.6	8.7	68.3	….	0.0	1,382.2
as a percentage of GDP	*4.7*	*4.3*	*0.6*	*4.9*	*108.2*		
Forecasting and Planning Report (September 2005)	65.2	59.6	8.7	68.3	….	0.0	1,384.0
as a percentage of GDP	*4.7*	*4.3*	*0.6*	*4.9*	*108.2*		
Stability programme update (December 2005)	….	….	….	….	….	0.0	….
as a percentage of GDP	….	*4.3*	*0.6*	*5.0*	*108.5*		
Outturn (March 2006) (3)	60.0	57.9	6.6	64.5	1.507.6	0.0	1,417.2
as a percentage of GDP	*4.2*	*4.1*	*0.5*	*4.6*	*106.4*		

(1) Net of settlements of past debts and privatization receipts. – (2) Figures released before the methods of calculation used for the national accounts were revised on 1 March 2006. – (3) The figure reflect the new methods of calculation used for the national accounts since 1 March 2006. The figure for the state sector borrowing requirement was released by the Ministry of the Economy and Finance in January 2006.

officially estimated at €24 billion, equal to 1.7 per cent of GDP. The primary surplus was expected to be 2.4 per cent of GDP, the reduction in the debt ratio, 1.9 percentage points. The economy was forecast to grow by 2.1 per cent (Table 24).

The adjustment was to come mostly from receipts from property disposals (0.5 percentage points of GDP), savings from the introduction of curbs on expenditure (0.7 points), additional revenue from the revision of sector studies (0.3 points), and the receipt of deferred instalments under the building offences regularization scheme introduced in 2004 (0.1 points). Much of the adjustment (0.6 points) was of a temporary nature. Alongside this corrective action, personal income tax relief measures amounting to approximately 0.3 per cent of GDP were introduced (see the box “The implementing provisions of the budget for 2005”, *Economic Bulletin* No. 40, March 2005).

General government expenditure and revenue

Expenditure

General government expenditure amounted to €687.3 billion in 2005, an increase of 3.1 per cent on 2004; in relation to GDP it rose from 48 to 48.5 per cent.

Interest payments fell by 1.8 per cent to €64.5 billion, declining from 4.7 to 4.6 per cent of GDP. The contraction was due to an increase in the net proceeds of swaps from €1 billion to €2.1 billion. Excluding this item, the reduction in outlays due to the decline in the average cost of the debt (from 4.6 to 4.4 per cent) was essentially offset by the expansion of the stock of liabilities.

Primary current expenditure increased by 3.5 per cent; as a ratio to GDP it rose by 0.6 percentage points.

Compensation of employees grew by 4 per cent, primarily as a consequence of the renewal of the labour contracts for 2004-05 covering employees in the school system and ministries.

Intermediate consumption expanded by 3.6 per cent after growing by 5.4 per cent in 2004.

Expenditure on social benefits in kind, for the most part in the health sector, grew by 4.9 per cent. The rise reflects increased outlays stemming from the renewal of the conventions with general physicians and pediatricians, while spending on pharmaceuticals diminished slightly. The latter's average price edged downwards, thanks above all to the across-the-board discount of 4.12 per cent that the Government imposed on producers up to 31 October 2005 and to increased use of generic drugs.

Social benefits in cash expanded by 3 per cent (4.5 per cent in 2004). About two thirds of the increase was due to the inflation indexing of pensions. The increase was curbed by a decline in the number of new long-service pensions awarded to private-sector employees, partly in response to the recently introduced incentive to postpone retirement.

Capital expenditure – excluding the proceeds of property sales (€2.7 billion, as against €4.4 billion in 2004), which are accounted for as a reduction in public investment – increased by 1.4 per cent. Fixed investment contracted by 4 per cent.

Revenue

General government revenue grew by 1.7 per cent to €629.4 billion; in relation to GDP it fell from 44.6 to 44.4 per cent.

Tax revenue and social security contributions fell from 40.7 to 40.6 per cent of GDP. The sharp fall in capital taxes (from 0.6 to 0.1 per cent of GDP) in connection with the drying up of receipts from tax amnesty schemes, was offset by increases in the proceeds of indirect taxes and social contributions, which rose faster than GDP.

Direct tax revenues increased by 2 per cent, remaining unchanged in relation to GDP. On the basis of the data contained in the State budget,[1] *a decrease of €7.6 billion in some extraordinary revenue items*[2] *was offset by increases in personal income tax (€4.3 billion), corporate income tax (€4.7 billion) and the flat-rate withholding tax on interest income and capital gains (€0.8 billion).*

The rise in withholding tax on employees' earnings was slowed to 1.9 per cent (€1.8 billion) by the effects of the recent tax reform (see "The second step of the reform of personal income tax", Economic Bulletin No. 40*, March 2005). Receipts of self-assessed income tax rose sharply (7.4 per cent, or €1.5 billion). The rise mainly reflects large payments in 2005 in settlement of tax liabilities for 2004, following relatively low payments on account during that year. The measures to strengthen sector studies enacted with the 2005 budget were not sufficient to increase the amount of tax due in respect of 2004 income (i.e. the sum of the payments in settlement in 2005 and those on account made in 2004); this remained broadly unchanged in nominal terms (see "The implementing provisions of the budget for 2005",* Economic Bulletin No. 40*, March 2005).*

The rise in corporate tax receipts (16.3 per cent, or €4.7 billion) was fuelled by the increase in the percentage paid on account, the higher taxes on cooperatives introduced by the Finance Law for 2005, and special measures affecting energy firms introduced with the 2006 budget. It also reflected the reform that went into effect in January 2004.

Indirect tax receipts rose by 3.3 per cent, driven by VAT (up by 5.6 per cent, or €5.6 billion) and IRAP (up by 6.8 per cent, or €2.2 billion). Excise duties on

General government expenditure and revenue
(millions of euros and percentage changes)

	2004	2005	Percentage change on previous year 2004	2005
EXPENDITURE				
Final consumption expenditure	275,482	287,558	4.8	4.4
of which:				
compensation of employees	*149,609*	*155,533*	*3.4*	*4.0*
intermediate consumption	*74,660*	*77,317*	*5.4*	*3.6*
purchases of social benefits in kind	*37,975*	*39,819*	*9.0*	*4.9*
Social benefits in cash	234,627	241,692	4.5	3.0
Interest payments	65,753	64,549	-4.0	-1.8
Other current expenditure	36,318	36,442	4.1	0.3
Current expenditure	**612,180**	**630,241**	**3.6**	**3.0**
as a percentage of GDP	*44.1*	*44.5*		
Current expenditure, net of interest payments	**546,427**	**565,692**	**4.6**	**3.5**
as a percentage of GDP	*39.3*	*39.9*		
Investment (1)	33,276	33,499	1.5	0.7
net of property disposals	*37,682*	*36,193*	*6.0*	*-4.0*
Investments grants	17,728	18,909	-8.9	6.7
Other capital expenditure	3,492	4,642	-27.5	32.9
Capital expenditure (1)	**54,496**	**57,050**	**-4.5**	**4.7**
Total expenditure, net of interest payments (1)	**600,923**	**622,742**	**3.7**	**3.6**
as a percentage of GDP	*43.3*	*43.9*		
TOTAL EXPENDITURE (1)	**666,676**	**687,291**	**2.9**	**3.1**
as a percentage of GDP	*48.0*	*48.5*		
REVENUE				
Direct taxes	185,400	189,052	3.7	2.0
Indirect taxes	195,398	201,859	4.6	3.3
Social security contributions	176,550	182,416	4.6	3.3
Other current revenue	49,953	50,083	10.3	0.3
Current revenue	**607,301**	**623,410**	**4.8**	**2.7**
as a percentage of GDP	*43.7*	*44.0*		
Capital revenue	**11,723**	**5,964**	**-47.4**	**-49.1**
of which:				
capital taxes	*7,912*	*1,808*	*-55.9*	*-77.1*
TOTAL REVENUE	**619,024**	**629,374**	**2.9**	**1.7**
as a percentage of GDP	*44.6*	*44.4*		
NET BORROWING	**47,652**	**57,917**	**3.5**	**21.5**
as a percentage of GDP	*3.4*	*4.1*		
Primary surplus	**18,101**	**6,632**	**-19.5**	**-63.4**
as a percentage of GDP	*1.3*	*0.5*		
Memorandum item:				
GDP	1,388,870	1,417,241	4.0	2.0

Source: Based on Istat data.
(1) This item includes the proceeds of property sales entered with a negative sign.

methane rose by 11.7 per cent (€0.4 billion), while those on mineral oils remained roughly unchanged.

Receipts from the tax on consumption of tobacco products held essentially stable despite price increases on many brands of cigarettes in 2005. Lotto and lottery receipts fell significantly from the very high levels of 2004.

Social security contributions rose by 3.3 per cent. The rise in effective contribution payments (3.5 per cent) was smaller than that in gross earnings (4.4 per cent). The difference may have been due to the decrease in the number of self-employed workers.

[1] The changes in the various taxes are analyzed with reference to the cash data recorded in the State budget. In order to increase the significance of these data for the analysis of the table of the general government consolidated accounts (prepared prevalently on an accrual basis), they have been adjusted to take account of the main timing differences between receipts on a cash and an accrual basis.

[2] Comprising: 1) the flat-rate tax on revaluations of corporate assets, introduced by the Finance Law for 2000 and repeatedly extended; 2) the tax on value increases in equity held by natural persons and on buildable land, introduced by the Finance Law for 2002 and extended several times; 3) the flat-rate tax on capital gains on the sale of companies, revenue from which – after the very large receipts of 2004 in connection with extraordinary transactions involving major corporations – fell to nil in 2005 as the tax was abolished; and 4) the tax on the actuarial reserves of insurance companies, receipts of which fell in 2005 as a result of an increase in the percentage payment on account, which led to much of the revenue for 2005 being received in 2004.

General government debt

In this issue of the Economic Bulletin data are released on general government debt and the borrowing requirement for 2005.

General government debt is calculated by the Bank of Italy in compliance with the rules laid down in the Treaty on European Union and Council Regulation (EC) No. 3605 of 1993, as amended. It consists of the total financial liabilities of the general government sector at face value, consolidated within and between the sub-sectors, i.e. excluding liabilities included among the assets of bodies belonging to the same sector.

The aggregate is made up of the following financial instruments:

a) *currency and deposits: coins in circulation, deposits with the Treasury of bodies not belonging to general government, and post office deposits included among general government liabilities. As of December 2003, when Cassa Depositi e Prestiti ceased to be part of general government, these deposits include only the portion of post office certificates attributed to the Ministry for the Economy and Finance and the post office current accounts of private individuals (see the box "The transformation of Cassa Depositi e Prestiti into a company limited by shares: the impact on the public debt",* Economic Bulletin No. 38*, March 2004);*

b) *securities other than shares (excluding financial derivatives) issued by central and local government;*

c) *loans to general government bodies or to be repaid by them. This category includes the proceeds of some securitizations classified as loans and not as transfers of assets on the basis of the statistical criteria laid down by Eurostat.*

Pursuant to Eurostat's decision of 23 May 2005, securities and loans include, respectively, bonds issued and loans contracted by Infrastrutture S.p.A. to finance high-speed railway investments.

In conjunction with this Economic Bulletin two revisions have been made to the statistics on general government debt and the borrowing requirement for the years prior to 2005.

One revision is the result of new data from Poste Italiane on the amount of post office current accounts held by private individuals. In particular, the debt is revised downward by €0.5 billion for 2002 and upward by €1.6 billion and €2.1 billion respectively for 2003 and 2004 (for details of the methodology used see the box "Changes to the statistics on the general government borrowing requirement and debt" in Economic Bulletin No. 38*, March 2004).*

The second change is due to the inclusion of the Treasury account held by the EU among the liabilities of the general government sector. For 2002 this has led to an upward revision of the debt by €2.5 billion and for 2003 by €1.3 billion, while the impact in 2004 was negligible.

Overall, for 2002, 2003 and 2004 the revisions produced increases in the debt of respectively €2 billion, €2.9 billion and €2.2 billion. Correspondingly, the borrowing requirement was raised by €0.9 billion for 2003 and reduced by €3.5 billion and €0.7 billion for 2002 and 2004.

The changes in the debt ratio also reflect the revisions made to GDP following the adoption of new methods of calculation for the national accounts.

At the end of 2005, 82.7 per cent of general government debt consisted of securities, 9.9 per cent of currency and deposits and 7.4 per cent of loans (Figure 1). Compared with 1990 this represents a decline of 4 percentage points in the proportion of loans, while currency and deposits increased by 2.6 points and securities by 1.4 points. Medium- and long-term fixed-interest securities accounted for 74.7 per cent of the total at end-2005, floating-rate securities for 15.9 per cent and short-term securities for 9.4 per cent; in 1990 the share of short-term and floating-rate securities was 71.5 per cent.

Also at end-2005 central government debt represented 94.2 per cent of the total and local government debt 5.8 per cent, while the social security institutions' debt was virtually nil. In 1990 the shares were respectively 97, 2.9 and 0.1 per cent.

The ratio of debt to GDP, which had risen from around 60 per cent in 1980 to 121.5 per cent in 1994, fell by 17.7 percentage points between 1995 and 2004, to 103.8 per cent. In 2005 it increased anew, to 106.4 per cent. The change can be put down to: net primary

Figure 1

General government debt and its components
(as a percentage of GDP)

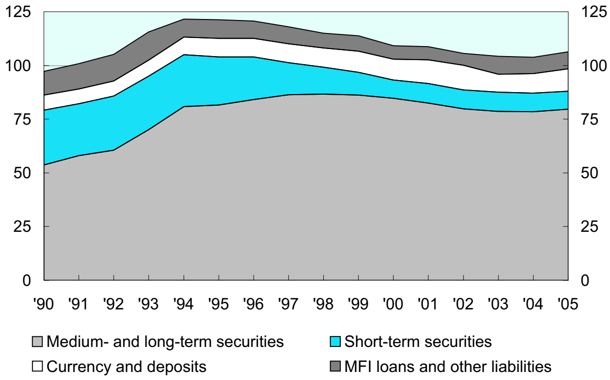
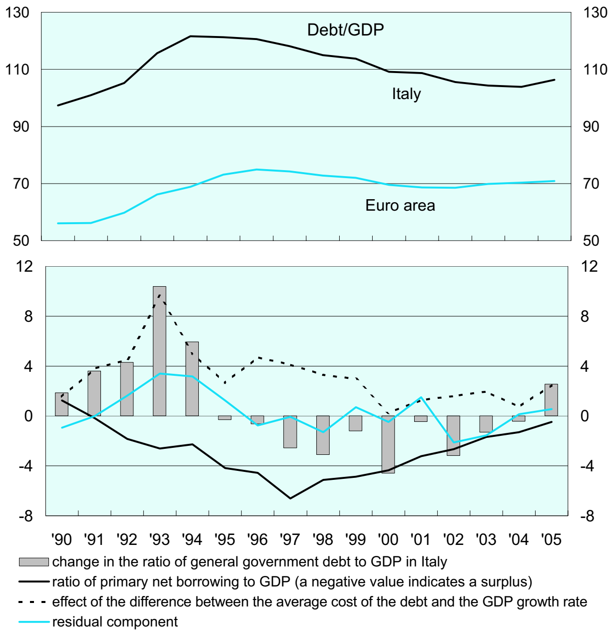


Figure 2

General government debt ratio in Italy and the euro area and breakdown of the change in the ratio in Italy (1)
(percentages and percentage points)



(1) For the method of obtaining the breakdown of the change in the ratio of debt to GDP, see the footnote to Figure 30 in *Economic Bulletin No. 32*, March 2001. Following the changeover to ESA 95, there is a break in the euro-area debt series between 1994 and 1995.

borrowing; the difference between the average cost of the debt and nominal GDP growth; and a residual component (Figure 2). The latter, which is equal to the difference between the change in debt and net borrowing, is affected by several factors: the different accounting methods used for net borrowing and the borrowing requirement (on an accrual basis, the first and on a cash basis, the second), net purchases of financial assets, settlements of past debts, changes in deposits with the Bank of Italy, the effects of debt restructuring, issue discounts, and movements in the exchange rate.

The primary balance has shown a surplus since 1991, amounting to 0.2 per cent of GDP in that year and rising to 6.6 per cent in 1997. Subsequently, it declined progressively to 0.5 per cent in 2005.

Since the end of the 1980s there has been a positive differential between the cost of the debt and the rate of GDP growth, which widened to nearly 10 percentage points in 1993; it then narrowed and had almost disappeared by 2000. Between 2001 and 2004 it averaged 1.4 points and then increased to 2.5 points in 2005. The average cost of the debt declined progressively from 13.3 per cent in 1991 to 4.5 per cent in 2005. Nominal GDP growth was more irregular, with two low points in 1993 (3 per cent) and 2005 (2 per cent).

The residual component had a negative impact on the debt in 1990, 1996-98, 2000 and 2002-03. In particular, the effects of an exchange of securities with the Bank of Italy in 2002 amounted to 1.9 per cent of GDP while in 2003 sales of assets totalled 1.3 per cent.

In 2005 the ratio of debt to GDP increased by 2.6 points, against a reduction of 0.4 points in 2004. The favourable impact of the primary surplus, which amounted to 0.5 per cent of GDP (compared with 1.3 per cent in 2004), was more than offset by the upward pressure exerted by the differential between the average cost of the debt and the nominal GDP growth rate (2.5 per cent in 2005 and 0.7 per cent in 2004). The residual component increased the debt by 0.5 points, against 0.1 points in 2004. In particular, sales of financial assets reduced the debt by 0.7 per cent of GDP in 2005 (1 per cent in 2004).

In April 2005 the European Commission forecast that Italy's deficit would be 3.6 per cent of GDP. In the Quarterly Report on the Borrowing Requirement published in the same month, the Government revised its estimate for net borrowing to 2.9 per cent of GDP and for the primary surplus to 2.1 per cent. The Government also pointed to a number of problem areas that might cause the deficit to widen to 3.5 per cent of GDP, proposing to adopt any additional measures needed to keep it below the threshold set in the European budgetary rules.

In the meeting of July, the Council found that Italy had an excessive deficit and allowed a period of six months in which to enact corrective measures; it called for measures to bring the deficit below the threshold of 3 per cent of GDP by 2007. The structural correction required for 2006 and 2007 was estimated at 1.6 percentage points of GDP, at least half of which to be accomplished in 2006.

In the Economic and Financial Planning Document approved at the end of July, the Government raised the estimate for net borrowing to 4.3 per cent of GDP and lowered that for the primary surplus to 0.6 per cent. These calculations were based on the assumptions that economic growth would be nil and the effects of the corrective action less than planned; they were confirmed in the Forecasting and Planning Report of September and in the stability programme update in December.

On 1 March 2006 Istat published the outturn for 2005 together with statistical revisions and accounting reclassifications that reduced the deficit by €0.2 billion in 2001 and increased it by €2.6 billion in 2002, €4.3 billion in 2003, and €4 billion in 2004. Compared with previous estimates net borrowing declined by 0.1 per cent of GDP in 2001 (to 3.1 per cent) and increased by 0.2 points in 2002, 2003 and 2004 (respectively to 2.9, 3.4 and 3.4 per cent). The changes in the deficit ratio also reflected the upward revisions made to GDP.

General government net borrowing in 2005 was equal to 4.1 per cent of GDP. Interest payments declined from 4.7 per cent of GDP in 2004 to 4.6 per cent in 2005, partly owing to swaps. The primary surplus, which had been shrinking since 1998, fell from 1.3 to 0.5 per cent of GDP, returning close to its level in 1991. The deterioration in 2005 was due mainly to the increase in primary expenditure in relation to GDP of 0.7 percentage points (see the box "General government revenues and expenditure").

The reduction in net borrowing resulting from one-off measures amounted to approximately 0.5 per cent of GDP, compared with around 1.5 per cent in the previous three years. Excluding the effects of these measures, the primary surplus showed a slight improvement, but has remained virtually nil since 2003.

Primary current expenditure rose by 0.6 percentage points to 39.9 per cent of GDP, slightly above the peak of 1993. The increase was 1.5 per cent in real terms, compared with an average of 2.4 per cent in the 1998-2004 period.

Excluding the proceeds of property sales, which are included in the accounts with a negative sign under investments, capital expenditure remained unchanged at 4.2 per cent of GDP; investment declined from 2.7 to 2.6 per cent. Sales of property decreased from 0.3 to 0.2 per cent of GDP, against the 0.5 per cent planned.

According to the adjustment provided for in the budget for 2005 gross general government expenditure (excluding social benefits in cash, interest on government securities and some minor items) was not to exceed the preliminary outturn for 2004 estimated in the Forecasting and Planning Report by more than 2 per cent. In the final outturn for 2005, however, total expenditure, excluding social benefits in cash and interest outlays, was around 4 per cent higher than it had been in 2004.

The ratio of tax revenue and social security contributions to GDP declined from 40.7 to 40.6 per cent. The substantial decrease in some one-off revenues (0.9 per cent of GDP) was largely offset by the increase in revenue from the main direct taxes, VAT and IRAP.

The borrowing requirement and the public debt in Italy

In 2005 the total general government borrowing requirement amounted to 4.8 per cent of GDP, 1.3 percentage points more than in 2004 (Table 25).

Privatization receipts fell from 0.6 per cent of GDP in 2004 to 0.3 per cent. Settlements of past debts were virtually nil, as in 2004.

Table 25

Italy: general government borrowing requirement
(millions of euros and percentages)

	2002	2003	2004	2005 (1)
General government gross borrowing requirement	37,553	40,178	48,577	68,286
as a percentage of GDP ..	*2.9*	*3.0*	*3.5*	*4.8*
General government borrowing requirement net of privatization receipts	39,482	57,034	56,250	72,604
as a percentage of GDP ..	*3.0*	*4.3*	*4.1*	*5.1*
Memorandum items:				
Settlements of past debts	5,328	8,537	533	190
Privatization receipts (2)	1,929	16,855	7,673	4,318

(1) Provisional. – (2) The figure for 2003 includes the effects of the disposals in connection with the transformation of Cassa Depositi e Prestiti into a company limited by shares (€12,041 million).

Excluding privatization receipts, the general government borrowing requirement rose from 4.1 to 5.1 per cent of GDP. Apart from the one-off measures that reduced net borrowing, securitizations of INPS credits contributed to containing the borrowing requirement by almost 0.4 per cent of GDP. Net of the impact of one-off measures, the borrowing requirement amounted to approximately 6 per cent of GDP as in the previous two years.

In 2005 the borrowing requirement net of privatization receipts exceeded net borrowing by 1 percentage point of GDP, compared with 0.6 points in 2004; even excluding the impact of one-off measures, the gap widened slightly. This was partly due to the increase in interest payments associated with redemptions of postal savings certificates; the interest accrued in previous years had already been included in net borrowing on an accrual basis.

In 2005 general government debt amounted to €1,507.6 billion, equal to 106.4 per cent of GDP (see the box “General government debt”). This represented an increase of 2.6 percentage points compared with a decrease of 0.4 points in 2004. In nominal terms the debt grew by €65.7 billion, against €49.8 billion in 2004 (Table 26), slightly less than the gross borrowing requirement (€68.3 billion compared with €48.6 billion in 2004). The difference was due to the decline in the Treasury’s balance on its accounts with the Bank of Italy (€1.2 billion, compared with an increase of €2.6 billion in 2004); issues of securities at a premium, which caused the nominal value of liabilities to increase less than the borrowing requirement (€2.5 billion against €0.4 billion in 2004); and movements in the exchange rate, which increased liabilities denominated in other currencies by €1.1 billion, compared with a decrease of €1 billion in 2004.

The average residual maturity of government securities lengthened slightly, from 6.5 years in 2004 to 6.6 years in 2005.

Table 26

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

	2004	2005 (1)
Change in debt	**49,767**	**65,677**
General government gross borrowing requirement	48,577	68,286
of which: settlements of past debts	*533*	*190*
privatization receipts	*7,673*	*4,318*
Change in the Treasury’s deposits with the Bank of Italy	2,578	-1,197
Issue discounts and premiums	-366	-2,527
Euro equivalent of foreign currency liabilities	-1,022	1,115

(1) Provisional.

MONETARY POLICY, FINANCIAL INTERMEDIARIES AND MARKETS

Overview

With the world economy expanding rapidly, the prospects for growth in the euro area began to improve in the autumn of 2005, while the rise in oil prices during the summer was reflected in a faster growth in prices and an increase in inflation expectations to just above 2 per cent. In order to adapt the monetary policy stance to the altered cyclical situation and in view of the risks for price stability, the Governing Council of the European Central Bank raised official interest rates by 0.25 percentage points in December, after keeping them unchanged for more than two years, and by another 0.25 points in March 2006. The minimum rate on main refinancing operations was brought to 2.5 per cent (Figure 24).

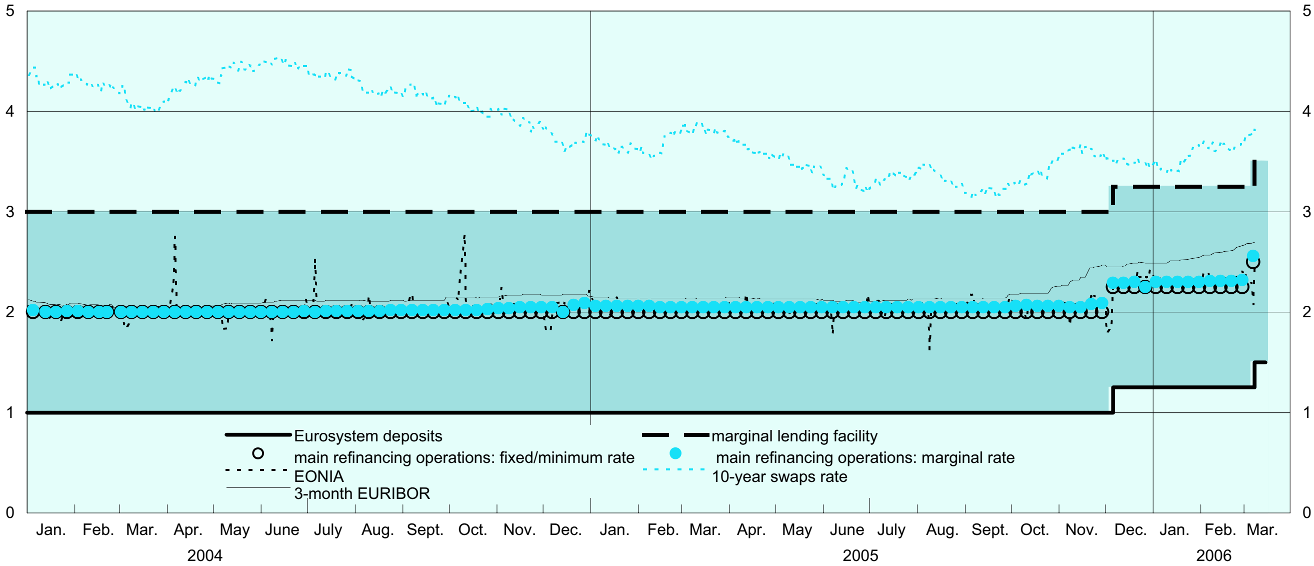
Even after the increase in official rates, monetary conditions remain expansionary. The effective exchange rate of the euro has weakened somewhat by comparison with its levels before the summer. Real short-term interest rates currently stand just above zero; the market expects them to return in 2007 to values in line with those seen in similar cyclical phases in the past. Long-term interest rates have risen since the summer but remain low. Credit has accelerated; the rate of growth in the money supply has fallen but remains high.

In the euro area the yield spreads of corporate bonds over government securities, though still very narrow, widened slightly following a reassessment of firms' financial conditions. The improvement in companies' expected earnings performance helped to lift share prices.

In Italy the terms of financing for firms remain favourable. Although bank lending rates adjusted to the rise in official rates in December, they are still historically low in both nominal and real terms. The robust growth in bank credit mainly reflected the

Figure 24

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



Sources: ECB, Reuters and Telerate.

expansion in loans connected with the real-estate sector, while manufacturing firms' demand for credit remained limited. Italian non-financial firms reduced their bond issues, whereas banks made ample use of this form of fund-raising.

The financial situation of Italian firms remains solid as a whole, despite the prolonged period of weak economic activity, but signs of deteriorating financial conditions have nonetheless emerged among listed companies operating in traditional sectors.

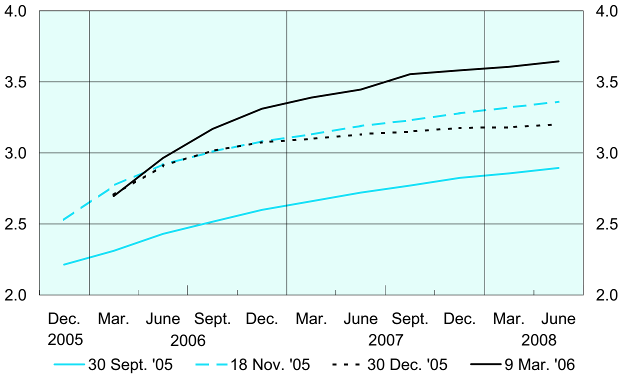
Italian households began to invest again in instruments characterized by higher risks and returns, such as equities, investment funds and corporate bonds. Although continuing to grow, household debt remains low in relation to disposable income.

Interest rates and the exchange rate of the euro

After remaining close to 2 per cent for over two years, short-term yields in euros gradually rose between early October and the end of November, anticipating the change in official rates. They have continued to rise in 2006, reaching 2.7 per cent. In the first ten days of March the forward three-month yield curve had shifted sharply upwards from the autumn and reflected expectations of a further increase in official rates during the year (Figure 25).

Figure 25

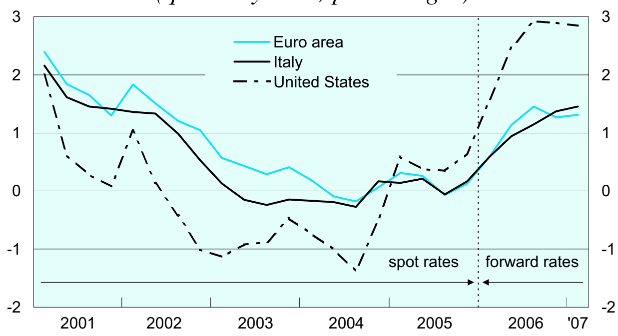
Rates on three-month Euribor futures contracts (1)
(percentages)



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

Figure 26

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

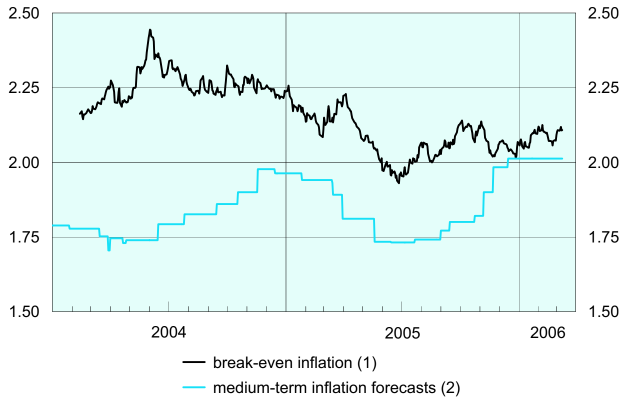


Sources: Based on Reuters and Consensus Economics data.
(1) Nominal three-month rates on Euromarket deposits (averages of daily data in the last month of the quarter; from March 2006, nominal rates implied by futures contracts in March), deflated using inflation expectations for the subsequent quarter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

Real short-term interest rates in euros rose moderately to reach 0.6 per cent in March, from nearly nil in the previous quarter (Figure 26). The curve implied by market expectations suggests that these rates will continue to rise gradually in 2006 and stand just above 1 per cent in 2007, in line with their level in similar cyclical phases in the past.

Figure 27

Break-even inflation and inflation forecasts
(daily data; percentages)



Source: Based on Bloomberg data.
(1) Differential between the nominal yield of BTPs maturing in 2014 and that of BTPs of equal maturity indexed to euro-area inflation. – (2) Average of the forecasts for euro-area consumer price inflation by the European Commission, IMF, OECD, *Survey of Professional Forecasters*, and Consensus Economics, based on forecasting horizons of between 6 and 10 quarters.

Long-term yields rose over the last six months (Figure 24). Albeit with fluctuations, those implied by ten-year interest rate swaps increased by

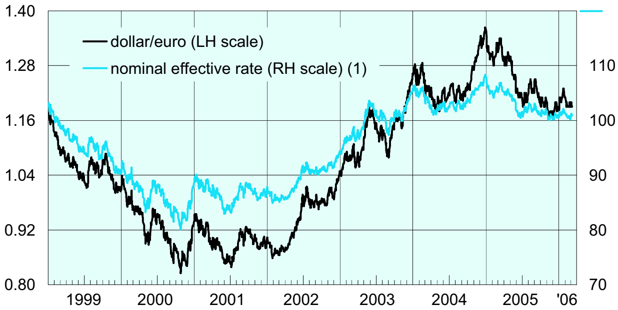
0.5 percentage points to 3.8 per cent. Yields on government securities indexed to consumer prices recorded increases similar to the corresponding nominal securities, reflecting the improvement in growth prospects and broadly stable long-term inflation expectations (Figure 27).

In the period from July 2005 onwards the nominal effective exchange rate of the euro fell by an average of 3 per cent with respect to the first half of 2005 (Figure 28), helping to make monetary conditions in the area more accommodating. The weakening was the result of a deprecation against the dollar (about 6 per cent) and some Asian currencies, a slight appreciation against the yen (1.5 per cent) and broad stability vis-à-vis sterling.

Figure 28

Dollar/euro exchange rate and nominal effective exchange rate of the euro

(daily data)



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

The money supply and credit

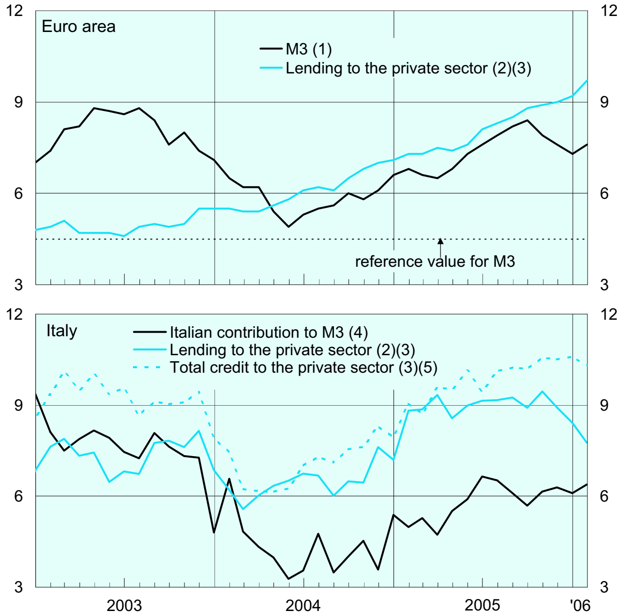
Euro-area M3 continued to show rapid growth (7.6 per cent in the twelve months ending in January; Figure 29). However, the aggregate's expansion began to slow in October; the deceleration was concentrated in the long-term components, which were affected by the shift of households' portfolios towards risky assets (primarily shares and equity funds). By contrast, there was an acceleration in the component consisting of current account deposits, demand for which was stimulated by the narrowing of the yield differential with respect to other forms of deposit.

As in the past, the growth in financial intermediaries' deposits was very substantial, while that in households' deposits was moderate (around 26 and 4 per cent respectively in the twelve months to January; see the box "The sectoral distribution of the money supply in the euro area and Italy", *Economic Bulletin* No. 41, March 2005).

Figure 29

Monetary and credit aggregates

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



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

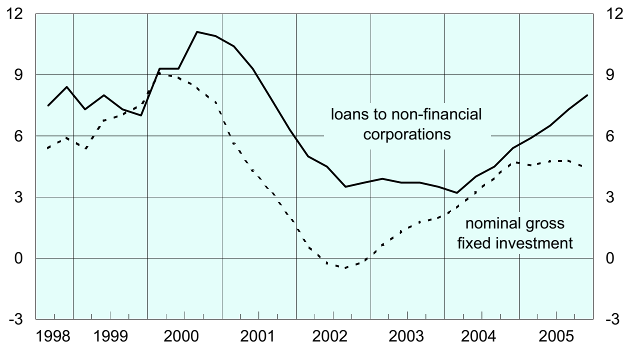
Bank lending to the private sector in the euro area continued to gather pace, growing by 9.7 per cent in the twelve months to January. The expansion was fuelled both by loans to households for house purchases and by lending to non-financial corporations, partly in connection with the recovery of investment (Figure 30).

In Italy the monetary aggregates accelerated slightly. The Italian component of M3, calculated net of currency in circulation, grew by 6.4 per cent in the twelve months ending in January. Credit continued to expand rapidly (Table 27); the increase in total credit to the private sector – bank loans, foreign financing and domestic bond issues – was equal to 10.3 per cent.

Figure 30

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

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



Sources: Based on ECB and Eurostat data.

Households' financial saving and the financing of firms in Italy

Households. – In the first nine months of 2005 Italian households' financial saving (the balance between the changes in financial assets and liabilities) amounted to €63 billion, compared with €53 billion in the corresponding period of 2004; Table 28). Households shifted towards instruments characterized by higher risks and returns: they began to purchase shares, investment fund units and corporate bonds again, sold government securities and reduced their net new investment in domestic deposits and bank bonds.

In the twelve months ending in September 2005 the proportion of shares and other equity

Table 27

Credit in Italy (1)

(end-of-period data)

	Total credit (2)	Total credit to the private sector (3)	Bank lending	Bonds (4)	Other finance from abroad (5)
		Twelve-month percentage changes			
2002 – Dec.	5.4	8.6	6.8	38.2	0.2
2003 – Dec.	5.3	7.9	6.9	20.9	3.3
2004 – June	5.4	7.0	6.7	17.2	-1.1
July	5.4	7.3	6.7	16.4	2.3
Aug.	5.3	7.1	6.0	16.3	4.9
Sept.	5.5	7.5	6.5	17.1	4.8
Oct.	5.0	7.6	6.4	18.2	4.7
Nov.	5.5	8.3	7.6	17.1	3.8
Dec.	5.6	7.9	7.2	17.6	3.0
2005 – Jan.	6.1	9.1	8.8	14.0	5.5
Feb.	5.8	8.7	8.9	13.0	3.4
Mar.	6.2	9.6	9.3	16.1	4.5
Apr.	6.3	9.5	8.6	20.3	4.7
May	6.7	10.1	9.0	20.4	6.6
June	6.5	9.4	9.1	15.0	5.3
July	6.8	10.1	9.2	17.2	8.4
Aug.	6.9	10.2	9.2	17.4	8.6
Sept.	6.9	10.2	8.9	17.2	10.6
Oct.	7.4	10.6	9.4	17.3	10.2
Nov.	7.6	10.5	8.9	18.1	….
Dec.	7.6	10.6	8.4	22.7	….
2006 – Jan.	….	10.3	7.8	24.2	….
			Percentage shares of stocks		
2005 – Oct.	100.0	50.5	37.6	7.0	5.9

(1) Rounding may cause discrepancies in totals. The November and December and January figures for total credit and total credit to the private sector are estimated – (2) Sum of general government debt and total credit to the private sector. – (3) Italian residents other than central government and MFIs: households, non-financial corporations, insurance companies, non-profit institutions serving households, non-money-market investment funds and other financial institutions. Corresponds to "Other residents" in the harmonized statistics of the ESCB. – (4) Bonds issued by Italian firms and local authorities. – (5) Loans and other assets of the rest of the world vis-à-vis Italian residents (excludes bonds and shares; mainly comprises technical reserves, trade credit and investment fund units).

Table 28

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

(millions of euros)

	Households (2)			Non-financial corporations		
	Flows		Stocks	Flows		Stocks
	Jan.-Sept. 2004	Jan.-Sept. 2005	Sept. 2005	Jan.-Sept. 2004	Jan.-Sept. 2005	Sept. 2005
Assets						
Domestic assets	**90,112**	**82,076**	**3,184,793**	**11,510**	**6,656**	**872,742**
Cash and sight deposits	12,849	14,883	529,114	11,484	10,288	146,359
Other deposits	8,893	5,004	313,168	1,437	-348	10,140
Short-term securities	15,681	-14,633	1,134	-264	-1,582	12
Medium and long-term securities	32,024	7,229	594,898	10,242	211	43,068
of which: government securities	*17,806*	*-10,697*	*194,168*	*746*	*-3,045*	*11,038*
corporate bonds	*-7,820*	*6,025*	*49,989*	*8,523*	*2,473*	*18,503*
Investment fund units	-11,172	-2,132	281,554	-155	-30	3,921
Shares and other equity	-9,152	34,392	900,013	2,820	7,150	394,728
Other financial assets (3)	40,989	37,333	564,912	-14,054	-9,033	274,514
of which: life insurance reserves	*30,605*	*27,283*	*338,078*	–	–	–
External assets	**-2,059**	**19,575**	**249,657**	**17,282**	**34,135**	**330,643**
of which: deposits	*-4,750*	*1,082*	*3,079*	*-614*	*11,817*	*18,536*
short-term securities	*-20*	*445*	*857*	*-118*	*584*	*1,865*
medium and long-term securities	*-3,412*	*7,266*	*98,186*	*-850*	*1,020*	*18,101*
shares and other equity	*920*	*-649*	*87,726*	*2,386*	*1,707*	*156,348*
investment fund units	*5,203*	*11,431*	*59,809*	*242*	*414*	*9,983*
short-term loans	–	–	–	*15,111*	*18,842*	*68,088*
Total assets	**88,053**	**101,651**	**3,434,450**	**28,792**	**40,791**	**1,203,385**
Liabilities						
Domestic liabilities	**34,970**	**39,064**	**452,047**	**19,874**	**54,972**	**2,299,124**
Short-term debt (4)	-1,770	-280	52,906	-9,332	-6,329	306,566
of which: bank	*-1,797*	*-300*	*51,228*	*-7,876*	*-2,992*	*277,877*
Medium and long-term debt (5)	35,086	37,543	367,327	30,152	29,292	438,743
of which: bank	*30,513*	*32,043*	*330,659*	*21,247*	*24,553*	*351,756*
Securities	–	–	–	8,681	3,759	45,904
of which: medium and long-term	–	–	–	*5,923*	*1,158*	*33,944*
Shares and other equity	–	–	–	1,390	32,396	1,147,167
Other financial liabilities (6)	1,654	1,801	31,814	-11,017	-4,146	360,744
External liabilities	**–**	**–**	**–**	**9,275**	**-9,819**	**268,357**
of which: short-term debt	–	–	–	*-511*	*10,316*	*67,715*
medium and long-term debt	–	–	–	*846*	*337*	*6,271*
medium and long-term securities	–	–	–	*2,712*	*-1,440*	*14,794*
shares and other equity	–	–	–	*7,809*	*-17,948*	*152,612*
Total liabilities	**34,970**	**39,064**	**452,047**	**29,149**	**45,153**	**2,567,481**
Balance	**53,083**	**62,587**	**2,982,403**	**-357**	**-4,362**	**-1,364,096**

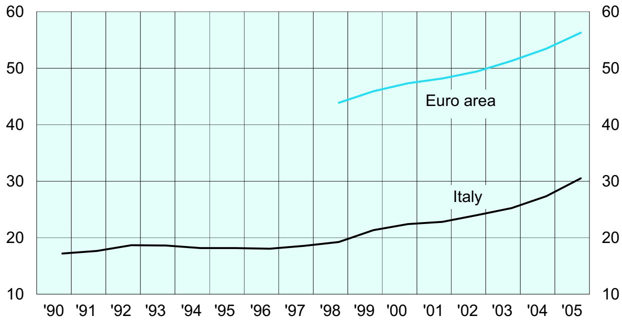
(1) Rounding may cause discrepancies in totals. Flows differ from the change in stocks because they do not include revaluations and other changes in volumes.– (2) Comprises consumer households, sole proprietorships with up to 5 workers and non-profit institutions serving households. – (3) Comprises the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

and investment fund units in households' financial assets increased from 33 to 39 per cent, mainly as a consequence of the rise in the stock markets. Households' financial assets grew to €3,400 billion, or around 2.5 times GDP.

Household debt continued to increase but remains low by international standards (30 per cent of GDP, compared with roughly 56 per cent in the euro area; Figure 31). The ratio of households' debt-servicing to disposable income in Italy consequently remains low, about half the average for the euro area (see the box "Households' financial debt"). Most of the new debt is medium and long-term and consists largely of mortgage loans.

Figure 31

Households' financial debt (1)
(as a percentage of GDP)



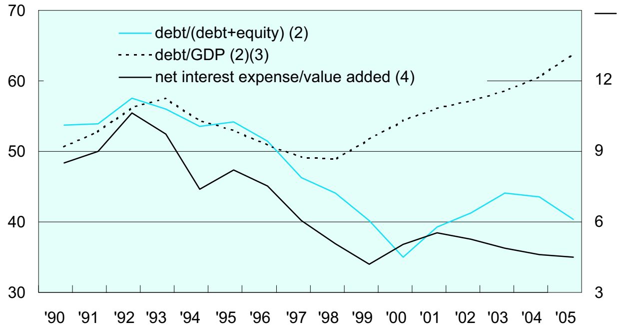
Sources: ECB and Bank of Italy; Eurostat and Istat for euro-area and Italian GDP.
(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. Stocks of financial liabilities at September of each year. GDP for the full year (the figures for 2005 are estimated).

Firms. – In the first three quarters of 2005 the corporate sector's borrowing requirement amounted to €4.4 billion. The slight increase compared with the corresponding period of 2004 was due to the decline in self-financing.

The weak cyclical phase was reflected in a slight fall in firms' operating profitability. According to estimates based on national accounts data, the ratio of gross operating profit to value added was lower than in the first nine months of 2004. Owing in part to the decline in interest rates, financial expense was broadly unchanged at 4.5 per cent of value added (Figure 32). On the basis of the quarterly reports of a sample of medium-sized and large listed companies, in the first half of 2005 the decline in operating profitability appears to have regarded the traditional service and manufacturing sectors.

Figure 32

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



Source: For GDP and value added, Istat.
(1) From 1995 onwards the data refer to the new definitions of instruments and sectors of economic activity introduced by ESA95. – (2) Left-hand scale. The stocks of debt and equity refer to September of each year. – (3) GDP for the full year (the figure for 2005 is estimated). – (4) Right-hand scale. Net interest expense and value added are for the full year except for the figure for 2005, which refers to the first three quarters. Bank of Italy estimates of net interest expense. Value added for 2005 is estimated on the basis of quarterly national accounts data.

Firms' leverage (the ratio of financial debt to the sum of financial debt and equity at market prices) fell by about 3 percentage points to 40.4 per cent, in line with the figure for the euro area, reflecting a larger rise in companies' share prices than in their total debt. Total debt rose to 63.8 per cent of GDP, but this was still more than 10 points below the euro-area average.

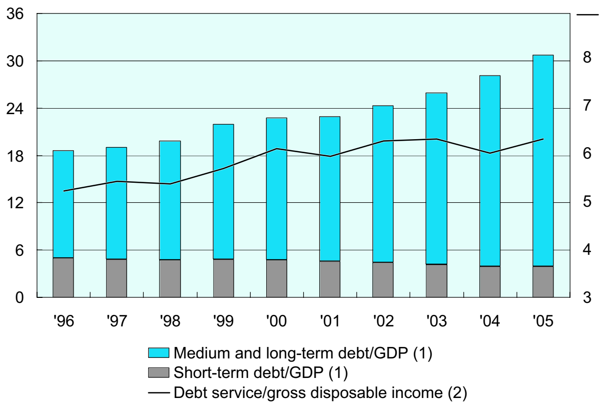
In the first nine months of 2005 firms increased their net investment in liquid financial assets and in shares and other equity. A factor in the latter development was the upturn in mergers and acquisitions. According to Thomson Financial, around 90 mergers or acquisitions of majority shareholdings by Italian non-financial corporations were announced, for a total value of €7 billion. With the exception of a €3.8 billion transaction in the energy sector, the average deal size was small (less than €200 million) and involved cash payment. The number of transactions with foreign counterparts was greater than in the three preceding years but still below that of 2000-01, when acquisitions reached historically high levels. In the first nine months of 2005 Italian firms acquired 23 foreign companies, most of them located in other EU countries, for a total value of €1.3 billion, while around 40 Italian non-financial corporations were acquired by foreign

Households' financial debt

Italian households' debt has grown rapidly over the last decade, rising to 30 per cent of GDP in September 2005, compared with 18 per cent in 1996 (see figure). Nevertheless, this is not large compared with the euro area and the United States, where the figures are 56 and 90 per cent respectively.

The growth in debt mainly concerns loans for house purchases, which have been fostered by the sharp decline in nominal and real interest rates and the structural increase in the supply of bank mortgages. Following the reform embodied in the 1993 Consolidated Law on Banking, the number of operators in this segment of the market has risen, new forms of contract have been adopted to satisfy a wider range of customers, and the amount of loans has increased in proportion to the value of the property.

Households' financial debt (1)
(yearly data; percentages)



Sources: Istat for GDP and gross disposable income.
(1) Left-hand scale. End-of-period data. The figure for 2005 refers to September. – (2) Right-hand scale. Debt service includes payment of interest and reimbursement of principal. Interest is calculated by multiplying the amounts outstanding in each period by an average rate of interest that takes account of the term structure and types of lenders. Repayments of principal are estimated from supervisory reports. Gross disposable income of all consumer households. The figure for 2005 refers to September.

Although aggregate household debt has grown considerably, debt service has increased only moderately. On the basis of the financial accounts and supervisory reports it is estimated that payments of interest and principal by consumer households have risen by about 1 per cent of their disposable income, to 6.3 per cent. The increase was contained above all by the decline in interest rates, although the longer duration of mortgages and consequent reduction in the size of single instalments also contributed. Considering only long-term borrowing, for which an international comparison is possible, Italian households' debt service as a proportion of disposable income is about half the average for the euro area, mainly owing to their lower level of indebtedness. For the last three years the ratio of new bad debts to outstanding bank loans of Italian consumer households has been steadily low, at around 0.7 per cent.

According to the Bank of Italy's Survey of Household Income and Wealth, between 1995 and 2004 the proportion of households with debts rose by 1 percentage point to 22 per cent (see table). The average value of loans per borrower household doubled, however, to €27,000, an increase of around 60 per cent in real terms.

In 2004 some 12 per cent of households borrowed to buy or modernize property. This type of loan was more common among upper-income households, with a high level of education, residing in the Centre and North. Loans for consumer purchases, mostly cars, were taken out by 13 per cent of households and were spread more evenly across geographical areas, income classes and educational levels.

Household debt is not large in relation to wealth or income. In 2004, households with mortgages had debts amounting to 14.4 per cent of their total wealth, compared with 9.1 per cent in 1995, while those with consumer loans, which are not usually backed by collateral, had debts amounting to 38.3 per cent of their financial assets alone, against 37.1 per cent in 1995. The Bank's survey also collects information on the service of mortgage loans for the purchase of borrowers' main place of residence; for the households concerned this cost averaged 14 per cent of disposable income (11.6 per cent in 1995). The average residual amount of the

Italian household debt (1)
(percentages unless specified otherwise)

	Share of indebted households					Households with debts				
	1995	2004				1995	2004			
		Total	Loans for home purchases	Consumer loans	*of which: for vehicles*	Average amount of loans (€)	Average amount of loans (€)	Loans for home purchases/ total assets (2)	Consumer loans/ financial assets	Mortgage instalment/ disposable income (3)
Geographical area										
Centre and North	22.6	23.9	13.4	13.6	*9.6*	15,036	29,810	14.3	37.1	13.9
South and Islands	18.5	18.3	8.7	11.5	*7.1*	10,489	20,660	14.9	41.7	14.2
Annual disposable income										
1st quartile (4)	11.1	9.6	3.6	6.5	*2.8*	9,406	20,418	30.0	93.7	29.7
2nd quartile (5)	18.4	18.8	9.4	11.4	*6.9*	12,621	21,594	22.6	61.2	23.8
3rd quartile (6)	26.3	28.0	14.5	17.3	*13.3*	13,014	27,916	19.4	46.3	16.5
4th quartile (7)	30.2	32.6	20.6	16.7	*12.5*	16,790	32,602	10.3	25.0	10.6
Total ...	**21.2**	**22.1**	**11.9**	**12.9**	***8.8***	**13,728**	**27,387**	**14.4**	**38.3**	**14.0**

Source: Bank of Italy, *Survey of Household Income and Wealth.*

(1) Referred to the population as a whole. Figures below the 1st percentile and above the 99th percentile are included in the percentiles. – (2) Financial assets, property, businesses and valuables. – (3) Only loans taken out for home purchase. Annual disposable income does not include interest payments on outstanding debt. – (4) Up to €11,900 in 1995 and up to €15,800 in 2004. – (5) From €11,900 to €18,500 in 1995 and from €15,800 to €24,200 in 2004. – (6) From €18,500 to €28,800 in 1995 and from €24,200 to €37,200 in 2004. – (7) Over €28,800 in 1995 and over €37,200 in 2004.

mortgage loan was equal to about a quarter of the market value of the property.

The incidence of the mortgage instalment increases as income diminishes. For 25 per cent of households in the upper-income bracket, which account for about 40 per cent of the total value of mortgage loans, debt service represents just over a tenth of disposable income. For households in the lowest-income quartile (holding 8 per cent of total mortgage debt) instalments are just under a third of their annual income.

It is estimated that the effect on the average cost of households' mortgage loans of a 1 percentage point change in interest rates would be equal to around 0.7 per cent of disposable income, rising to about 1.6 per cent for the lowest-income quartile. In the case of households with floating-rate mortgages, which represent the majority of the sample, debt service would increase by 1.3 per cent, or 3.6 per cent for the least well-off households. These estimates do not take account of any extensions to the duration of the mortgage designed to spread the increased burden over a longer period.

purchasers for a total of €11.5 billion (of which €10.2 billion referred to the acquisition of an operator in the telecommunications sector).

Bank lending

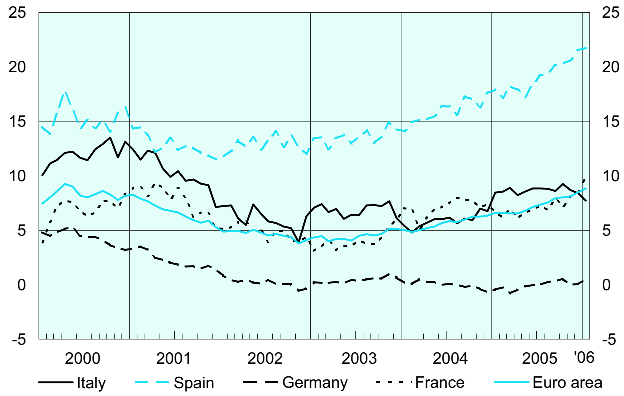
In recent months the stock of bank loans in the euro area continued to grow at a fast pace, rising by 8.9 per cent in the twelve months ending in January; Table 29). Bank lending accelerated further in Spain, reflecting the rapid growth in economic activity and the expansion of the property sector, but continued to stagnate in Germany (Figure 33).

In Italy, bank loans grew by 7.7 per cent in the twelve months ending in January (Table 30), mainly as a consequence of the expansion in

Figure 33

Lending by monetary financial institutions in the euro area (1)

(monthly data; twelve-month percentage changes)



Sources: Based on ECB data and national statistics.

(1) Lending by euro-area MFIs (excluding the Eurosystem) to non-MFI resident customers. The percentage changes are calculated net of reclassifications, value adjustments, exchange rate variations and other variations not due to transactions.

Table 29

Bank funding and lending in the euro area and Italy (1)

(harmonized definitions; twelve-month percentage changes)

	Funding							Lending
		Deposits					Debt securities issued (2)	
			Excluding central government					
			Overnight	With agreed maturity	Redeemable at notice	Repurchase agreements		
				Euro area (3)				
2003 - Dec.	6.2	5.5	7.9	1.7	8.4	-4.4	7.5	5.1
2004 - Dec.	7.8	6.0	6.6	4.9	6.4	10.7	11.3	6.3
2005 - Mar.	7.6	6.1	7.7	5.8	5.8	3.7	10.4	6.5
June	8.6	7.0	9.5	6.8	5.2	10.2	11.5	7.1
Sept.	8.6	7.6	9.7	8.3	4.8	8.6	10.4	8.0
Dec.	7.9	7.4	11.2	7.2	3.0	-3.4	9.0	8.5
2006 - Jan.	8.1	7.4	9.5	8.2	3.3	3.2	9.5	8.9
				Italy (4)				
2003 - Dec.	4.4	2.2	5.9	-10.2	5.1	-15.7	8.6	6.7
2004 - Dec.	7.3	5.2	6.2	-4.0	4.7	5.7	10.8	6.7
2005 - Mar.	7.6	5.2	5.9	-2.0	4.2	7.3	11.5	8.9
June	9.0	7.1	6.9	-3.8	4.7	18.2	12.3	8.8
Sept.	7.9	7.0	6.8	-2.5	3.9	18.5	9.2	8.6
Dec.	7.8	6.9	8.0	2.7	2.5	4.9	9.3	8.4
2006 - Jan.	7.7	6.8	6.8	1.2	1.9	16.4	9.2	7.7

(1) End-of-period data. The data for January 2006 are provisional. The percentage changes are calculated net of reclassifications, value adjustments, exchange rate variations and other variations not due to transactions. The data are consistent with those published in the ECB's *Monthly Bulletin.* – (2) Total debt securities, including money-market securities, issued by banks. By convention they are entirely attributed to euro-area residents. – (3) 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. – (4) Funding and lending of Italian banks from and to non-MFI customers resident in Italy.

Table 30

Main assets and liabilities of Italian banks (1)

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

	2003	2004	2005	2005 (2)				January 2006	
				Q1	Q2	Q3	Q4	12-month % change	Stocks (millions of euros
Assets									
Securities	4.2	-2.8	19.4	6.9	20.8	20.5	28.6	21.5	214,174
of which: government securities	*-4.0*	*-12.4*	*14.3*	*4.3*	*14.0*	*14.2*	*23.7*	*17.9*	*113,132*
Loans	6.7	6.7	8.4	10.9	8.7	6.5	8.1	7.7	1,259,962
of which (3): *short-term (a)*	*-2.0*	*-4.4*	*2.1*	*6.1*	*2.7*	*0.1*	*0.2*	*2.0*	*447,427*
medium and long-term (b)	*13.6*	*14.2*	*13.0*	*14.3*	*11.7*	*12.4*	*13.6*	*11.5*	*752,146*
(a)+(b)	*6.2*	*6.0*	*8.7*	*11.0*	*8.1*	*7.5*	*8.4*	*7.7*	*1,199,573*
repos	*-1.2*	*88.5*	*48.5*	*222.0*	*28.1*	*-68.4*	*273.3*	*64.7*	*10,871*
bad debts (4)	*10.6*	*6.0*	*-16.6*	*-1.6*	*2.1*	*6.8*	*-54.9*	*-15.2*	*45,835*
Memorandum item:									
net bad debts (5)	*7.9*	*-1.2*	*-32.8*	*-8.8*	*-24.6*	*-3.9*	*-69.1*	*-21.4*	*16,956*
External assets	1.3	10.8	10.6	-4.0	24.8	6.0	17.9	19.3	286,111
Liabilities									
Domestic funding (6)	4.4	7.3	7.8	9.3	9.8	5.1	7.4	7.7	1,257,263
Deposits	2.2	5.2	6.9	7.5	8.9	5.5	6.1	6.8	773,644
of which (7): *overnight*	*5.9*	*6.2*	*8.0*	*9.2*	*8.8*	*7.1*	*7.4*	*6.8*	*579,525*
with agreed maturity	*-10.2*	*-4.0*	*2.7*	*1.8*	*-15.0*	*-3.4*	*33.1*	*1.2*	*41,184*
redeemable at notice	*5.1*	*4.7*	*2.5*	*4.8*	*4.4*	*1.3*	*-0.5*	*1.9*	*68,869*
repos	*-15.7*	*5.7*	*4.9*	*1.7*	*28.3*	*2.9*	*-9.5*	*16.4*	*76,472*
Bonds (6)	8.6	10.8	9.3	12.1	11.2	4.5	9.6	9.2	483,619
External liabilities	11.2	4.0	11.9	25.6	24.5	7.6	-6.8	15.7	368,115

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

long-term financing connected with the real-estate sector. Loans to firms grew by 5 per cent, compared with 4.8 per cent in 2004 (Table 31), in line with the slight increase in firms' borrowing requirement. There was an acceleration in lending to companies in the construction and energy sectors and, to a lesser extent, manufacturing firms. The rate of growth in loans to service companies fell from 7.8 to 4.5 per cent, owing in part to securitizations.

Reversing a trend under way since the end of 2002, in 2005 there was faster growth in Italian bank lending to large companies than to smaller businesses (7.3 against 6.4 per cent on average for the year). A contributory factor was the sharp increase in syndicated loans in connection with mergers and acquisitions, which at the end of December amounted to €87.4 billion and accounted for 16 per cent of all outstanding loans to large corporations.

The stock of loans to consumer households grew by 14.2 per cent in the twelve months to January, down from 15.8 per cent in 2004. The deceleration was due to the slower rate of growth in loans for house purchases (17.1 per cent, against 20.7 per cent in 2004), which was still 5 percentage points higher than the euro-area average. Consumer credit provided by banks and specialized financial companies accelerated further, expanding by 19.4 per cent.

Bank loans to customers in the South of Italy continued to grow faster than in the rest of the country (13.8 and 6.8 per cent respectively; Table 31). The geographical differential is especially large for loans to firms, in all the main productive sectors and all size classes (Table a39). It is likely that the limited self-financing capacity of southern firms contributes to the difference (see the box "Lending to firms in the South and Islands", *Economic Bulletin* No. 41, November 2005).

Table 31

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

	General govern-ment	Financial and insurance companies	Non-financial corporations (a)		Households		Firms = (a) + (b)				Total
				with under 20 workers (2)	Pro-ducer (b) (3)	Consumer		Manu-facturing	Con-struction	Services	
					Twelve-month percentage changes (4)						
					Centre and North						
2004 - Dec.	-2.5	-1.7	4.1	3.9	6.9	15.6	4.4	-0.6	8.4	7.5	5.3
2005 - Mar.	-1.0	3.9	7.0	3.7	6.8	15.0	7.0	2.2	9.1	11.0	7.8
June	2.2	2.0	6.7	4.4	7.9	15.8	6.8	0.4	11.3	11.4	7.8
Sept.	1.7	3.8	6.4	4.2	8.1	14.9	6.6	1.3	12.4	9.2	7.7
Dec.	5.5	6.9	5.6	3.7	7.0	14.7	5.7	1.4	13.0	7.1	7.9
2006 - Jan.	5.6	8.7	3.6	4.3	7.8	13.8	4.0	....	....	....	6.8
					South						
2004 - Dec.	2.0	4.6	7.8	7.7	8.1	16.5	7.9	3.5	10.5	10.3	10.5
2005 - Mar.	7.0	16.5	8.6	7.5	8.2	14.7	8.6	4.5	11.7	11.0	10.9
June	1.2	8.0	8.8	8.4	9.7	16.2	9.0	5.2	11.3	11.3	11.2
Sept.	6.6	-4.0	9.9	7.4	10.9	15.5	10.1	6.6	11.4	11.4	11.6
Dec.	13.4	34.5	11.3	7.5	10.8	16.9	11.2	9.4	14.0	11.8	14.0
2006 - Jan.	16.0	9.0	12.7	8.2	10.8	15.8	12.4	....	....	....	13.8
					ITALY						
2004 - Dec.	-1.9	-1.6	4.5	4.4	7.2	15.8	4.8	-0.2	8.7	7.8	6.0
2005 - Mar.	0.1	4.2	7.2	4.2	7.1	14.9	7.2	2.4	9.5	11.0	8.2
June	2.1	2.2	7.0	4.9	8.3	15.9	7.1	0.9	11.3	11.4	8.2
Sept.	2.4	3.6	6.8	4.6	8.7	15.0	7.0	1.9	12.2	9.4	8.2
Dec.	6.6	7.7	6.3	4.2	7.8	15.1	6.4	2.2	13.1	7.6	8.7
2006 - Jan.	7.2	8.7	4.6	4.8	8.5	14.2	5.0	2.0	14.8	4.5	7.7
					Stock of lending at December 2005 (5) (6) *(millions of euros)*						
Centre and North	45,265	145,239	540,485	62,032	56,269	239,124	596,754	168,783	73,072	302,232	1,026,382
South	8,129	5,083	72,637	9,755	16,593	63,837	89,230	21,649	13,789	43,554	166,279
ITALY	53,394	150,322	613,122	71,787	72,862	302,961	685,984	190,433	86,861	345,786	1,192,790
					Percentage composition of lending at December 2005 (6)						
Centre and North	4.4	14.2	52.7	6.0	5.5	23.3	58.1	16.4	7.1	29.4	100.0
South	4.9	3.1	43.7	5.9	10.0	38.4	53.7	13.0	8.3	26.2	100.0
ITALY	4.5	12.6	51.4	6.0	6.1	25.4	57.5	16.0	7.3	29.0	100.0

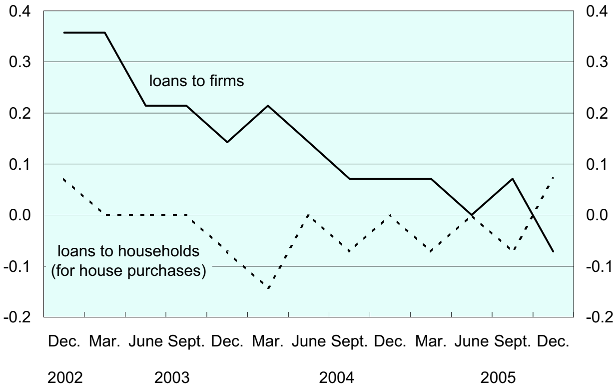
(1) Loans exclude repos, bad debts and other minor items included in the Eurosystem harmonized definition of the agggregate. The breackdown by geographical area is based on customer residence. The Figures for January 2006 are provisional. – (2) Limited partnerships and general partnership with fewer than 20 workers; informal partnerships, de facto companies and sole proprietorships with between 5 and 19 workers. – (3) Informal partnership, de facto companies and sole proprietorships with up to 5 workers. – (4) Calculated net of reclassifications, exchange rate variations and other changes not due to transactions. – (5) The sum of stocks according to geographical area may differ from the total, as the data are derived from other items of the supervisory reports. – (6) Rounding may cause discrepancies in totals.

Loan quality. – New bad debts in 2005 amounted to 0.8 per cent of the value of outstanding loans at the beginning of the year, compared with 0.9 per cent in 2004 (Table 32). The ratio continued to be higher for loans to customers in the South (1.3 per cent, compared with 0.8 per cent in the rest of Italy). Thanks to some major securitizations, the stock of bad debts fell from 4.7 per cent of the value of total outstanding loans in December 2004 to 3.7 per cent in December 2005; calculated at estimated realizable value, bad debts decreased from 2 to 1.3 per cent of outstanding loans. The ratio of substandard loans to outstanding loans diminished slightly, to 1.6 per cent in the Centre and North and 2.7 per cent in the South.

Credit conditions and interest rates. – Banks maintained easy credit conditions in Italy in 2005. The undrawn margin on overdraft facilities remained ample for all categories of customer. The spread between the average rate on short-term loans to firms and the minimum rate, which tends to widen in periods of credit tightening, narrowed further to 2.4 percentage points.

Figure 34

Indices of credit standards applied to the approval of bank loans in Italy (1)



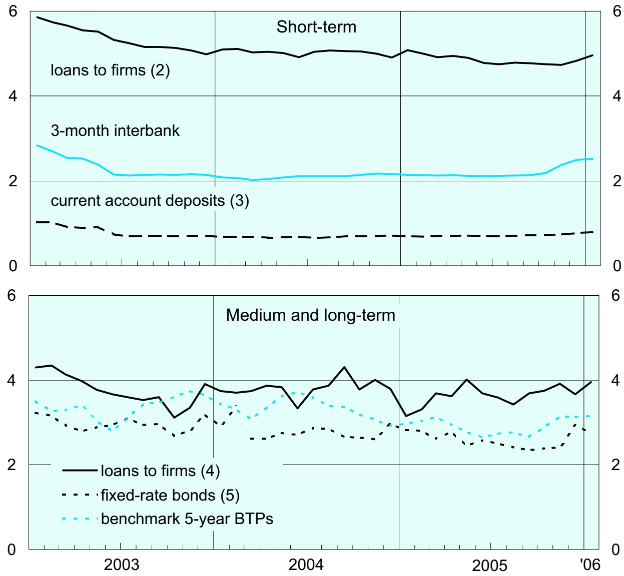
(1) The indices are constructed by aggregating the qualitative responses provided by the 7 Italian groups participating in the quarterly bank lending survey for the euro area using the following weights: 1 = tightened considerably; 0.5 = tightened somewhat; 0 = basically stable; -0.5 = eased somewhat; -1 = eased considerably. The range of variation of the indices is from -1 to +1.

The Italian groups participating in the Eurosystem's quarterly survey of bank lending gradually eased their credit standards as expectations of an improvement in economic activity strengthened. The index that measures the tightness of the conditions for loans to firms, calculated by aggregating the qualitative information provided by the banks, fell to an all-time low in December (Figure 34). By contrast, the standards applied to loans to households for house purchases grew slightly less easy during the fourth quarter, as in the rest of the euro area.

Figure 35

Bank interest rates in Italy (1)

(monthly data; percentages)



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

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

The transmission of the December change in official rates to bank lending rates was similar to that observed in the past. The interest rates on short-term loans to firms in Italy rose by 0.2 percentage points to 5 per cent at the end of January (Figure 35), in line with developments in the rest of the area. The annual percentage rate of charge (ARPC) on loans for house purchases rose by 0.2 points in both Italy and the area, reaching 4.1 per cent (Figure 36). The ARPC on consumer credit increased by 0.2 points to 9.1 per cent in Italy, where it remained higher than in the rest of the area (7.9 per cent).

Table 32

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

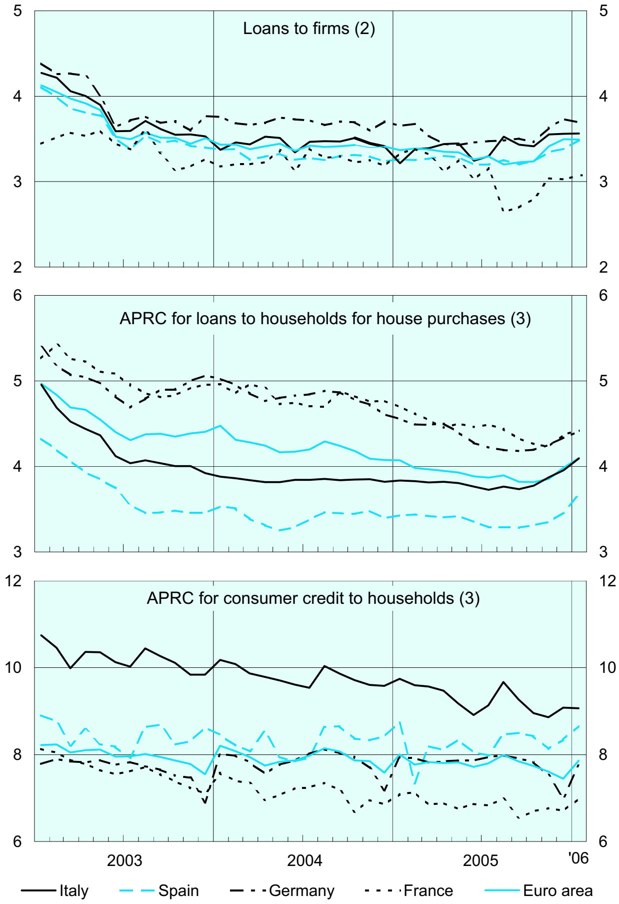
	General government	Financial and insurance companies	Non-finan-cial corpo-rations (a)	Households		Firms = (a) + (b)				Total
				Producer (b) (2)	Consumer		Manu-facturing	Con-struction	Services	
	New bad debts during the year as a percentage of outstanding loans (3)									
	December 2003									
Centre and North	0.0	0.2	1.7	1.3	0.7	1.7	2.5	2.2	1.2	1.1
South	0.0	0.1	2.5	2.2	0.8	2.4	3.6	2.2	2.1	1.7
ITALY	0.0	0.2	1.8	1.5	0.7	1.8	2.6	2.2	1.3	1.2
	December 2004									
Centre and North	0.0	0.0	1.0	1.3	0.7	1.1	1.4	1.2	1.0	0.8
South	0.0	0.0	1.8	2.0	1.0	1.9	2.8	1.9	1.5	1.4
ITALY	0.0	0.0	1.1	1.5	0.8	1.2	1.5	1.3	1.0	0.9
	December 2005									
Centre and North	0.0	0.0	1.0	1.4	0.7	1.0	1.4	0.9	0.9	0.8
South	0.2	0.1	1.6	2.0	0.9	1.7	2.2	1.7	1.4	1.3
ITALY	0.0	0.0	1.1	1.5	0.7	1.1	1.5	1.0	1.0	0.8
	Twelve-month percentage changes in substandard loans									
	December 2003									
Centre and North	20.4	-43.5	4.3	12.1	7.7	5.5	1.3	6.4	7.2	3.5
South	-14.9	-14.9	1.5	24.0	8.4	6.3	11.9	-4.3	5.5	6.6
ITALY	-4.4	-42.7	3.8	15.2	7.9	5.6	3.2	3.5	6.9	4.1
	December 2004									
Centre and North	-36.4	-35.2	0.0	0.2	3.8	0.1	-4.8	-12.7	5.8	-0.2
South	-51.4	-38.8	-2.4	2.9	2.3	-1.1	-12.6	-2.6	4.6	-0.7
ITALY	-45.8	-35.3	-0.4	1.0	3.4	-0.2	-6.3	-10.1	5.6	-0.3
	December 2005									
Centre and North	-14.4	-31.5	-5.7	-4.1	5.5	-5.4	-1.3	-4.5	-6.7	-3.6
South	-54.3	-42.1	1.9	-2.1	9.5	0.9	-3.2	-19.6	11.8	2.9
ITALY	-36.7	-32.0	-4.3	-3.6	6.5	-4.2	-1.7	-8.7	-3.6	-2.2

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

Figure 36

Harmonized interest rates on loans in the major euro-area countries: new business (1)

(monthly data; percentages)



Sources: Based on ECB data and national statistics.

(1) New contracts concluded during the reference period or contracts renegotiating previous terms and conditions. – (2) Average lending rate for non-financial corporations across all maturities, weighted by loan amounts; excludes overdrafts – (3) The annual percentage rate of charge includes accessory expenses (administrative expenses, loan examination fees and insurance). It is calculated as the average rate across all maturities, weighted by loan amounts. Households include producer households and non-profit institutions serving households.

Bank funding

Bank funding in the euro area grew at a high rate (8.1 per cent in the twelve months ending in January), especially the bond component. In Italy it expanded by 7.7 per cent overall, basically in line with the euro-area average. Larger increases were recorded for bond funding and repos (9.2 and 16.4 per cent respectively), while current accounts grew by 6.8 per cent.

The large volume of bond funding in Italy helped to keep the mismatch between the duration of banks' assets and liabilities stable. Adding in off-balance-sheet assets and liabilities, which include hedging transactions in derivatives, the mismatch was equal to 1.3 months in December, virtually the same as at the end of 2004.

Following the increase in money-market yields, between the end of November and the end of January the interest rate on households' current accounts rose in Italy by about 0.1 percentage points to 0.7 per cent, in line with the rest of the area. The yield on Italian banks' fixed-rate bonds increased more markedly, from 2.4 to 2.8 per cent.

At the end of 2005 Italian banks' net external debt was equal to 2.6 per cent of their total liabilities, up from 2.4 per cent a year earlier; the portion subject to exchange rate risk, i.e. denominated in currencies other than the euro, grew from 48 to 61 per cent.

The profitability of Italian banks

Preliminary data indicate an increase in 2005 in Italian banks' operating profitability, calculated with reference to their unconsolidated financial statements; the decline in the first half appears to have been followed by an improvement in the second. After falling by 1.5 per cent in 2004, operating profits rose by 7.5 per cent.

Net interest income was up by 5.9 per cent in connection with the strong growth in volumes. The growth in fee income and dividends (net of those paid by banks) more than offset a significant reduction in earnings from securities and foreign-exchange trading, determining an increase of 4.9 per cent in gross income. Staff costs rose by 3.4 per cent, in line with the pay increases provided for in the national labour contract for the sector. Overall, operating expenses grew by 3.4 per cent.

In June 2005 the banking system's consolidated supervisory capital amounted to €154.1 billion, 7 per cent more than a year earlier (Table a40). The solvency ratio (supervisory capital over risk-weighted assets) was equal to 11.4 per cent, little changed from 11.5 per cent in June 2004.

The government securities market

Net issues of government securities fell from €198 billion in 2004 to €172 billion in 2005 in the euro area. In Italy they rose, instead, from €27 billion to 29 billion (Table 33). Substantial net issues of BTPs led to a further lengthening of the duration of the debt to 4 years and 8 months (Figure 37).

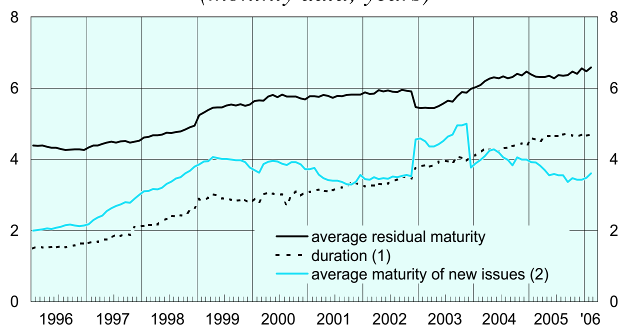
The share of Italian government securities held by non-residents continued to rise, reaching 55 per cent, while the percentage held by households and Italian investment funds fell (Table 34). Reversing a trend of the last few years, banks made net purchases.

The yield spread between ten-year BTPs and German Bunds widened by 10 basis points between March and May 2005, remained just above 20 basis points until the end of the year, and then widened again to 24 basis points (see the box "Government bond yield spreads in the euro area").

Figure 37

Average maturity of outstanding Italian government securities and new issues

(monthly data; years)



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

Bank and corporate bonds

Issuance. – Net issues of bank and corporate bonds in the euro area rose sharply in 2005 to total €491 billion (Table 35). Given favourable financing

Table 33

Issues of Italian government securities (1)

(millions of euros)

	2004	2005	2004	2005
	Gross issues		Net issues (2)	
BOTs	221,300	212,666	-895	-944
CTZs	27,128	23,206	-8,198	-3,338
CCTs	34,527	26,011	325	1,515
BTPs	134,803	131,064	33,558	29,947
Other	..	..	-50	-50
Total	**417,758**	**392,947**	**24,740**	**27,130**
Republic of Italy issues	14,000	12,264	2,469	1,620
Total government securities	**431,758**	**405,211**	**27,210**	**28,750**

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

Table 34

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

	Public-sector securities						Private-sector bonds	Total public-sector securities and private-sector bonds	Listed Italian shares
	BOTs	CTZs	CCTs	BTPs	Other (2)	Total			
	Net purchases in January-December 2005								
Central bank	..	..	3,468	2,093	-58	5,504	..	5,503	-736
Banks (3)	1,023	2,155	4,076	1,884	6,537	15,675	17,404	33,079	7,382
Investment funds (4)	-8,920	824	1,730	-7,029	-232	-13,626	1,410	-12,216	-207
Other investors (5)	6,953	-6,318	-7,759	32,998	4,781	30,655	60,268	90,923	6,161
of which: non-residents (6)	*43,039*	*-3,478*	*5,702*	*65,356*	*-4,856*	*105,762*	*1,190*	*106,952*	*4,984*
Total	**-944**	**-3,338**	**1,515**	**29,947**	**11,028**	**38,208**	**79,082**	**117,290**	**12,600**
	Outstanding amounts at end-December 2005								
Central bank	..	..	15,424	42,626	962	59,012	197	59,209	6,331
Banks (3)	18,426	5,452	44,855	16,569	19,602	104,904	83,302	188,206	37,653
Investment funds (4)	23,577	10,488	37,703	41,572	2,619	115,959	11,312	127,271	19,234
Other investors (5)	75,804	27,244	100,681	661,013	105,266	970,009	601,133	1,571,142	613,388
of which: non-residents (6)	*85,828*	*10,352*	*52,663*	*474,055*	*71,624*	*694,523*	*78,336*	*772,859*	*105,536*
Total	**117,806**	**43,184**	**198,664**	**761,780**	**128,450**	**1,249,884**	**695,945**	**1,945,828**	**676,606**
Percentage share of the total outstanding amount of public-sector securities	**9.4**	**3.5**	**15.9**	**61.0**	**10.3**	**100.0**			

(1) Outstanding amounts of public-sector securities and private-sector bonds are at face value, those of shares at market value; net purchases are at market value. Rounding may cause discrepancies in totals. – (2) Republic of Italy issues and other public-sector securities. – (3) The figure for listed Italian shares refers to the period January-September 2005. – (4) Italian harmonized investment funds and SICAVs. – (5) Households, enterprises, non-residents, central and local government, social security institutions, CDP S.p.A., investment firms, and insurance companies. – (6) Provisional figures as of October 2005; excludes the securities of local governments, autonomous government agencies and Ente F.S.

conditions, banks continued their intense recourse to bonds, particularly covered bonds (securities backed by assets on the issuer's balance sheet), in part with a view to keeping the duration of their assets in line with that of their liabilities. Net issues by other financial corporations more than doubled as a consequence of the large increase in mortgage-banked securities and collateralized debt obligations in some countries of the area (Spain, Italy and the Netherlands). By contrast, there were limited net issues by non-financial corporations (€20 billion), given the good performance of self-financing for the largest corporations and the abundant supply of bank credit.

Government bond yield spreads in the euro area

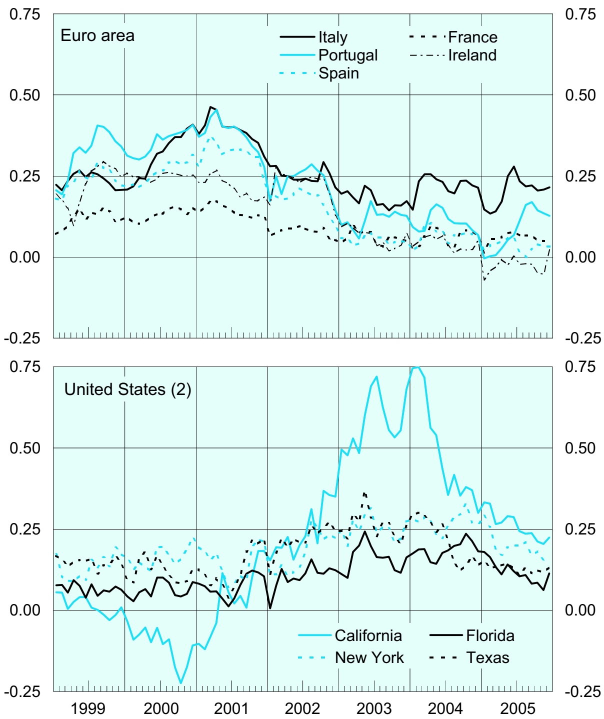
The start of the third stage of Economic and Monetary Union in January 1999 entailed the elimination of the exchange-rate risk component of yield spreads between the government bonds of euro-area countries. Although substantially narrower than before, these spreads have not disappeared and continue to reflect differences in the credit risk and liquidity of the securities.

Between 1992 and 1998 the interest rate spreads between ten-year benchmark securities of the euro-area countries and the equivalent German bonds averaged about 2.2 percentage points; for Italian securities the average spread was 3.4 points. Between 1999 and 2005 the average of spreads in the countries that adopted the euro narrowed to around 0.2 points, ranging from a minimum of -0.6 points for Luxembourg at the beginning of 2003 to a maximum of 0.4 to 0.6 points, recorded in 2001, for Belgium, Italy, Portugal and Greece (see the figure).

In 1999-2005, for the countries (such as Italy and Portugal) whose public debt or budget deficit to GDP ratio was higher than that of Germany, the yield spread was slightly larger and more volatile than the average for the other member states (about 0.2 percentage points). By contrast, the countries (such as Spain and Ireland) whose public finance indicators were better than Germany's recorded a narrower yield spread,

Ten-year interest rate spreads in the euro area and the United States

(monthly data; percentage points)



Sources: BIS and Bloomberg.

(1) Spreads against Germany's ten-year benchmark security. – (2) Spread against Maryland ten-year general obligations.

Net issue volumes were also up strongly in Italy (€80 billion), with banks accounting for the lion's share, as in the rest of the area. There were major securitizations by banks and public-sector companies (secured in the latter case by the proceeds of property sales or by INPS credits). Non-financial corporations, which in 2004 had made ample use of the bond market in order to take advantage of the low interest rates, reduced their net issues from €9 billion to €1 billion at a time of still weak investment; placements by issuers with either low or no rating were again negligible.

Yields.– In recent months yield spreads between euro-denominated corporate bonds and government securities widened slightly for both investment-grade issues (Figures 38) and high-yield securities, nonetheless remaining very narrow for both segments.

For investment-grade bonds, the widening of yield spreads mainly regarded the telecommunications sector, where various companies are highly leveraged; this development was influenced by the downgrading of the securities of a large Spanish *declining from 0.25 points in 1999-2002 to 0.05 points in 2003-05. Finally, countries (such as France) whose public finances were in a similar situation to those of Germany maintained a yield spread of around 0.1 points.*

Econometric studies point to the existence of a relation between yield spreads and public finance indicators. In the euro-area countries, an increase in the deficit/GDP ratio of 3 percentage points between 1992 and 1998 would have widened the yield spread against Germany by about 1 percentage point. This effect continued to be statistically significant, if much smaller, after the introduction of the single currency, amounting to around 0.1 points. Furthermore, there is a significant relation between the yields on government bonds and the ratings of the main agencies, which reflect a broad set of economic, political and social factors. Econometric estimates suggest that a downgrading of a government bond by one class would lead on average to an increase of about 0.1 percentage points in interest rates.

Previous empirical analyses conducted in the United States on episodes of major deterioration in the public finances of certain states indicate the existence of non-linear effects, whereby the change in interest rate differentials is significantly greater in extreme situations than under normal conditions.

Between 1995 and 2005 the yield spread between ten-year general obligations issued by single states and those issued by the State of Maryland (which had the highest credit rating at the time) was 0.1 points on average, only slightly lower than that of the euro area. Fluctuations were larger, however: extreme figures were recorded for the California general obligation, whose spread widened to as much as 0.75 points in July 2003 after a severe deterioration in the public finances led to a downgrading to BBB by the main rating agencies.

This evidence indicates that in the long run a credible fiscal policy for the adjustment of the public finances is essential to ensure narrow interest rate spreads. [1]

[1] On this point see the article "Fiscal policies and financial markets", in European Central Bank, Monthly Bulletin, February 2006.

company following its launch of a debt-financed acquisition and by the growing competition of operators specialized in new technologies. For high-yield securities, it is largely attributable to the automobile industry.

The widening of spreads for issuers of investment-grade paper occurred in concomitance with a slight worsening in the ratings assigned by rating agencies (Figure 39), though in a context of a persistently low default rate. Some of the downgrades were motivated by the increase in debt caused by the intensification of corporate mergers and acquisitions. The increase in share buybacks may also have contributed to making bond issues riskier. In addition, expectations of higher interest rates may have weighed on the issues of the more highly leveraged companies.

The yield spreads between Italian corporate bonds and those of other euro-area bonds of comparable duration and sector narrowed; in particular, the increase recorded in the first half of 2005 in the spread on the issues of smaller companies was annulled.

Table 35

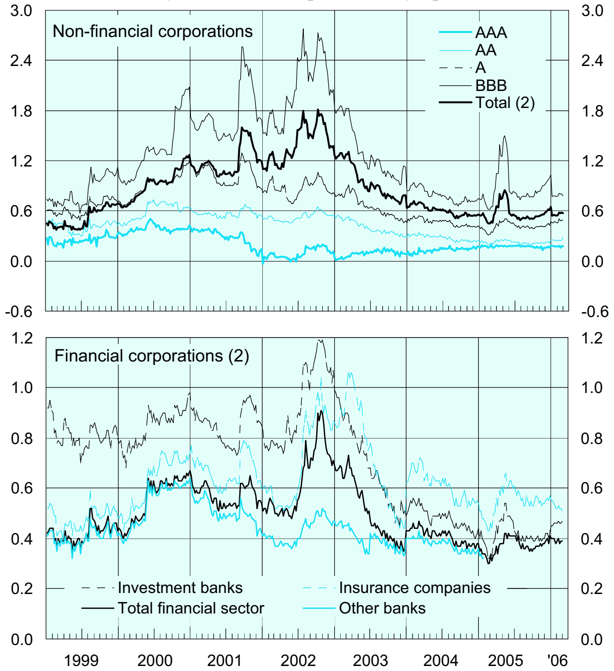
Net bond issues by banks and firms in the euro-area and Italy (1)
(millions of euros)

	2003	2004	2005
		Euro area	
Banks	202,444	298,147	292,339
Other financial corporations	119,733	72,906	178,013
Non-financial corporations	51,288	11,875	20,428
Total ...	**373,465**	**382,928**	**490,780**
		Italy	
Banks	32,036	43,048	41,502
Other financial corporations	26,508	14,825	36,794
Non-financial corporations	-989	8,942	1,381
Total ...	**57,555**	**66,815**	**79,677**

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

Figure 38

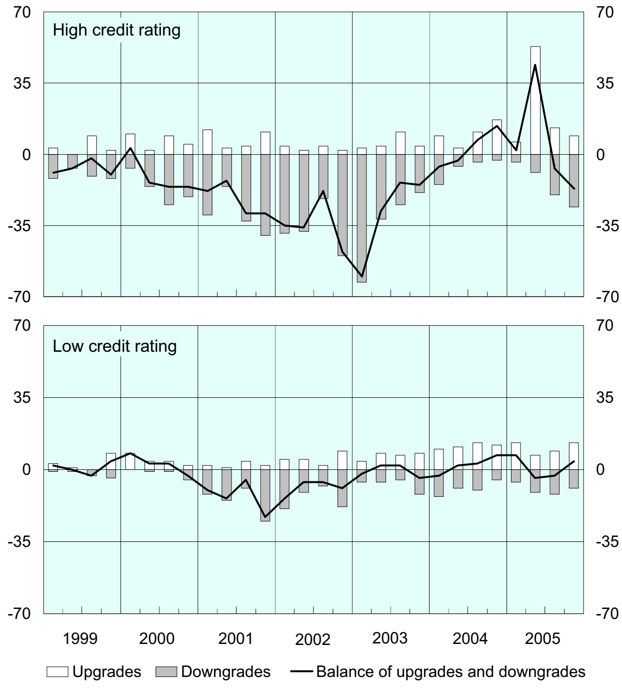
Yield spreads between euro-denominated corporate bonds and government securities (1)
(end-of-week data; percentage points)



Source: Merrill Lynch.
(1) Yields on fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by corporations resident in countries whose long-term foreign currency debt is rated at least Baa3 or BBB-. Yield spreads are calculated with respect to French and German government securities. – (2) Only includes bonds rated at least Baa3 or BBB-.

Figure 39

Revisions of credit ratings of euro-area non financial corporations (1)
(quarterly data; number of revisions)

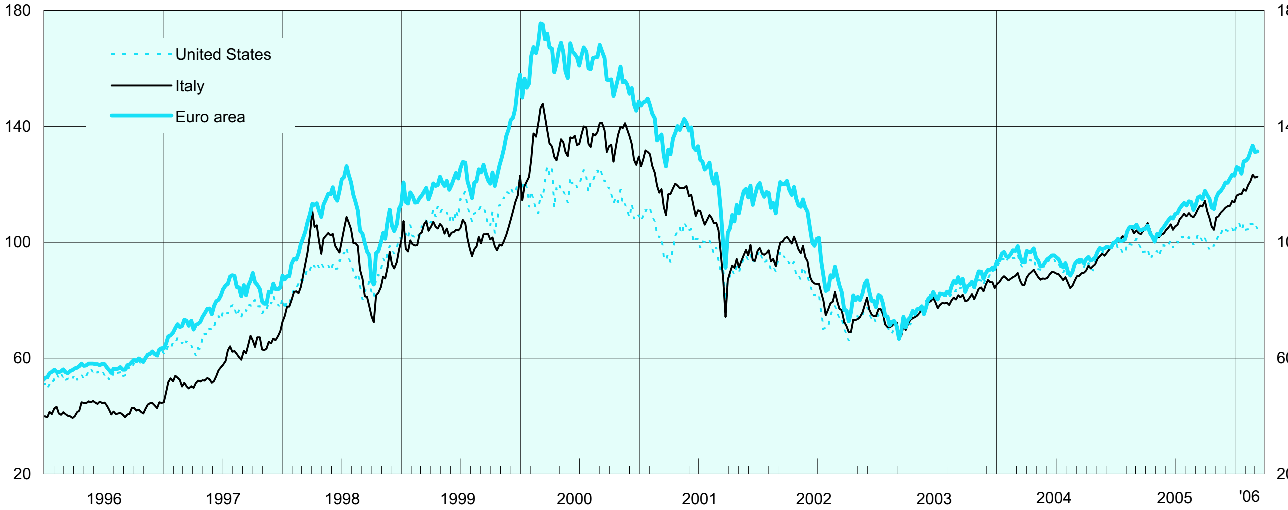


Source: Bloomberg, based on Moody's data.
(1) Revisions for all classes of rating of long-term debt by Moody's. Includes credit-watch announcements. Companies with high (low) credit ratings are those rated before the revision at least (lower than) Baa3.

Figure 40

Share prices (1)

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



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

The stock markets

In the last two months of 2005 the stock market indices in the main euro-area countries turned sharply upwards again (Figure 40). In the period from November 2005 through the first ten days of March 2006, the Dow Jones Euro Stoxx index, which tracks the performance of the largest listed companies in the area, gained 15 per cent. Over the same period the Standard and Poor's 500 index of US stocks rose by 5 per cent and Japan's Topix index by 14 per cent.

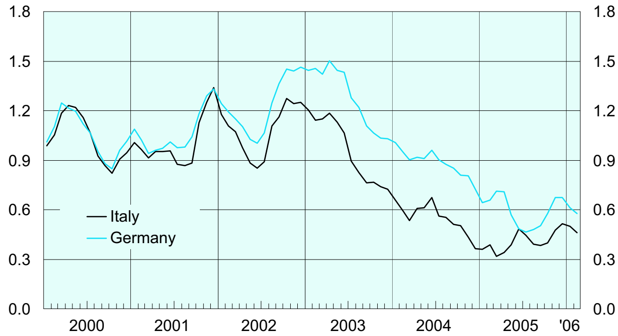
The rise in share prices in the euro area reflected a slight improvement in short-term expectations of corporate earnings growth, in response to good current results. The indicators of investors' risk aversion, based on options prices (Figure 41), and the volatility of the stock indices showed a modest rise, though remaining at low levels.

The ratio of current earnings to prices on the main stock exchanges of the area now ranges between 4.8 and 7 per cent, somewhat higher than the average for the period 1990-2005 (Figure 42). Given very low interest rates, this can be ascribed to the expectations of moderate earnings growth and the relatively high level of equity premiums. The real cost of equity capital for firms, calculated on the basis of share prices and expected dividends net of inflation, has remained around 5.9 per cent, 0.6 points lower than the average for the last 15 years (Figure 43).

Figure 41

Indicators of risk aversion (1)

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

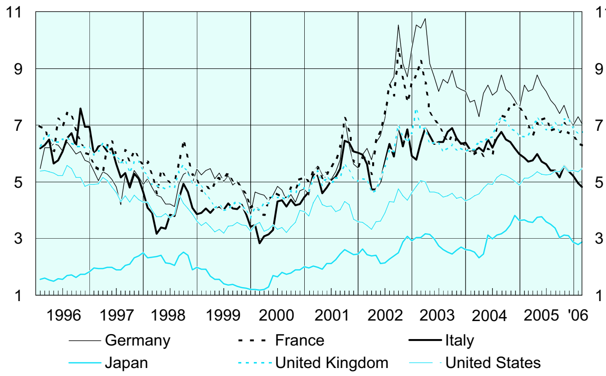


Source: Based on Bloomberg.
(1) The indicator is obtained as the ratio of the probability of a 10 per cent fall in the stock exchange index derived from options prices to that derived from the actual distribution of the rates of return of the stock exchange index. A decrease in the indicator signals a greater propensity to run risks associated with investment in shares.

In the period from November through the first ten days of March, the largest gains in share prices were recorded by the electronics, electricity, insurance and banking sectors (26, 22, 20 and 19 per cent respectively). Telecommunications shares fell by 3 per cent. Those of petroleum products companies rose by 8 per cent, benefiting from the further increase in the price of crude oil.

Figure 42

Current earnings/price ratios on the main stock exchanges
(monthly data; percentage)



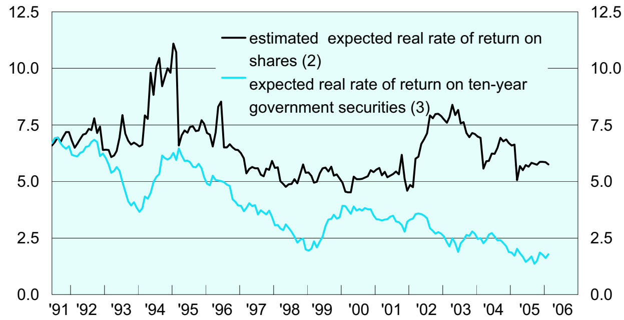
Source: Thomson Financial.

In Italy the overall stock market index rose by 17 per cent, the same as in Germany and more than in France and Spain (13 and 11 per cent respectively). The market's strong performance was due to the large gains for auto, bank and insurance shares (27, 24 and 22 per cent respectively). In the automobile sector the rise in share prices occurred following the presentation of a restructuring plan by the largest listed company, while in the banking sector it probably reflected expectations of changes in the ownership structure of some leading banks. Italy's Techstar index of innovative companies that satisfy more stringent transparency standards rose by 25 per cent, compared with gains of 4 per cent by the Nasdaq index in the US and 17 per cent by the Techmark index in the UK.

In the euro area 95 companies went public last year, compared with 72 in 2004. In Italy the number of new listings rose to 16, compared with 8 in 2004 and an average of 17 per year in the decade 1995-2004. At the end of 2005 there were 275 resident companies listed on the Italian stock exchange; their market capitalization was equal to 49.3 per cent of GDP (compared with 43 per cent at the end of 2004), a value that is still low by international standards.

Figure 43

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



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

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

Investment funds and individually managed portfolios

On the basis of data for eight of the twelve euro-area countries, the good performance of the main international stock markets boosted investment funds' net subscriptions to €218 billion in the second half of 2005, compared with €163 billion in the second half of 2004.

In the second half of 2005 the net subscriptions of funds controlled by Italian intermediaries totalled €12 billion, up from €1.8 billion in the first half (Table 36). All categories of fund except liquidity funds recorded net inflows. In the second half of the year the average yield (not annualized) of harmonized funds set up under Italian law was 3.2 per cent. The best results were achieved by equity funds (9.4 per cent), the worst by bond funds (0.2 per cent), which suffered from the rise in long-term euro interest rates in October. At the end of 2005 the net assets of funds controlled by Italian intermediaries amounted to €598 billion, 9 per cent more than a year earlier.

Table 36

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

	2004	2004 July-December	2005 (2)	2005 July-December (2)
		Net assets *(end-of-period stocks)*		
Open-end Italian funds	390,016	–	402,060	–
of which: harmonized	*358,292*	–	*352,550*	–
hedge funds	*11,768*	–	*16,957*	–
Closed-end Italian funds	9,866	–	13,148	–
of which: real-estate funds	*8,085*	–	*10,630*	–
Foreign funds (3)	148,548	–	182,852	–
Total ...	**548,430**	–	**598,060**	–
		Net fund-raising *(flows)*		
Open-end Italian funds	-18,937	-12,196	-7,058	-1,919
of which: harmonized	*-30,632*	*-15,791*	*-18,367*	*-6,048*
hedge funds	*5,500*	*1,632*	*4,347*	*953*
Closed-end Italian funds	3,747	2,473	2,598	2,138
of which: real-estate funds	*3,407*	*2,396*	*2,255*	*1,859*
Foreign funds (4)	14,774	9,274	18,334	11,810
Total ...	**-416**	**-449**	**13,874**	**12,029**

Sources: Bank of Italy and Assogestioni.
(1) Including funds of funds. – (2) Provisional. – (3) Value of units held by Italian and foreign investors. – (4) The figures for 2004 refer to the net subscriptions by Italian investors only, those for 2005 to net subscritions by foreign as well as Italian investors.

In the second half of 2005 net new cash flow to individually managed portfolios amounted to €20 billion, compared with €16 billion in first half. The average yield for the period (calculated as the percentage increase in net assets adjusted for net new cash flow) was 2.1 per cent. Assets under management totalled €513 billion at the end of the year.

SHORT-TERM ECONOMIC PROSPECTS

The world economy

In 2004 and 2005 world output increased at an average rate of almost 5 per cent and for 2006 international organizations and leading private forecasters project only slightly slower growth.

In the United States the figures on the performance of the economy in the early months of this year suggest that the sharp slowdown in the last quarter of 2005 was only temporary. The strong growth in employment and the improvement in households' confidence should sustain a rapid recovery of consumption in the current quarter. The gradual slowdown in house prices that the Federal Reserve expects during the year is likely to have only limited repercussions on household spending. Consensus Economics predicts GDP growth of 3.2 per cent in 2006 (Table 37).

In January consumer price inflation rose to 4 per cent, while core inflation remained at 2.1 per cent. According to Consensus Economics consumer prices should not increase more than 3 per cent this year. When the Federal Reserve last raised official rates on 31 January it announced that further increases might become necessary to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. The prices of futures contracts on federal funds indicate that the market is assuming a further quarter of a point rise at the FOMC meeting at the end of March and considers a similar increase very likely in May.

According to US government estimates, the federal deficit will widen to 3.2 per cent of GDP in fiscal 2006, compared with the previous fiscal year's 2.6 per cent, owing to a partly temporary increase in spending. In the draft budget for fiscal 2007 presented in February the Administration reaffirmed its commitment to correcting the imbalance and reducing the deficit to 1 per cent of GDP in 2010 by placing a tight curb on discretionary spending, which rose sharply between 2001 and 2005.

In Japan economic activity picked up strongly in the fourth quarter of 2005, prompting private analysts to adjust projected GDP growth in 2006 upwards to 3.3 per cent, with inflation re-emerging at an average annual rate of 0.4 per cent. On 9 March the central bank announced it had abandoned its policy based on expanding liquidity in favour of a target for the overnight interest rate, which it set equal to zero. There was no change in the prices of futures contracts on 3-month yen-denominated deposits, which continued to reflect expectations of a rise in short-term rates in the second half of the year.

The budget for fiscal 2006 presented by the government foresees a reduction in the deficit of almost 1 per cent of GDP, to 5.8 per cent.

The emerging countries should continue to enjoy favourable financial conditions. In Asia very strong growth, in excess of 7 per cent, is again forecast, while in Latin America output is expected to expand by around 4 per cent.

In the short term the risks facing these positive scenarios appear limited. One uncertainty is the price of oil, which might be affected by temporary supply shortages. Another is the possibility of a sudden rise in the risk premiums for bonds, which are at historically low levels.

Over the medium to long term, payments imbalances in the leading regions of the world are a source of concern as they have become too large to be sustained indefinitely. Gradual adjustment is possible in a context of strong and broader global growth. However, brusque shifts in flows of savings and investments cannot be ruled out, accompanied by large movements in the dollar and the prices of real and financial assets, with adverse effects on world economic growth.

Table 37

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

	2004	2005	2006 (1)	
			Consensus Economics February 2006	Private forecasters (2) March 2006
GDP (3)				
United States	4.2	3.5	3.2	3.4
Japan	2.3	2.7	2.3	3.3
Euro area	2.1	1.3	2.0	2.2
Emerging economies	7.3 (4)	6.4 (4)	–	6.3 (5)
of which: *Asia*	*8.2* (4)	*7.8* (4)	–	*7.4* (5)
of which: China	*10.1*	*9.9*	*9.0*	*9.0*
Latin America	*5.6* (4)	*4.1* (4)	*4.1*	*4.2*
Consumer prices				
United States	2.7	3.4	2.9	2.8
Japan	0.0	-0.3	0.2	0.4
Euro area	2.1	2.2	2.0	2.0
Emerging economies	5.8 (4)	5.9 (4)	–	5.1 (5)
of which: Asia	*4.2* (4)	*4.2* (4)	–	*3.8* (5)
of which: China	*3.9*	*1.8*	*2.2*	*2.4*
Latin America	*6.5* (4)	*6.3* (4)	*5.4* (6)	*5.7*
Current account balance (7)				
United States	-668.1	-804.9	-848.0	–
Japan	172.1	164.0	153.2	–
Euro area	57.5	-35.7	-10.3	–
Asian emerging economies	184.9 (5) (8)	198.1 (5) (8)	213.3 (5) (9)	–
of which: China	*68.7* (4)	*115.6* (4)	*126.8*	–
Oil-exporting countries	*219.1* (8)	*412.5* (8)	*394.9* (9) (10)	–
Oil prices				
Average of the three leading grades ($ per barrel)	37.8	53.4	60.1 (11) (12)	63.7 (11)

Sources: National statistics.
(1) Forecasts. – (2) Averages of the latest estimates published by: Credit Suisse First Boston, Goldman Sachs, J.P. Morgan, Merrill Lynch and Morgan Stanley. – (3) At constant prices. – (4) IMF estimates. – (5) Includes the recently industrialized economies. – (6) Change for the twelve months ending in December. – (7) In billions of dollars. – (8) Based on IMF estimates. – (9) Based on Consensus Economics forecasts. – (10) Based on Consensus Economics and IMF forecasts. – (11) WTI. – (12) Price at end-May 2006.

The euro area

Economic activity in the euro area grew by 1.3 per cent in 2005, down from 2.1 per cent in 2004. In France the rate of expansion was slightly higher than the average, in Germany it was 0.9 per cent, and in Italy nil.

Harmonized consumer price inflation rose last year by one tenth of a percentage point to 2.2 per cent on average. The rise in energy prices was partly offset by a slowdown in regulated prices and the prices of services. Core inflation slowed to 1.5 per cent, thanks in part to the very moderate increase in unit labour costs.

Qualitative indicators portray a favourable economic situation. The improvement in the climate of confidence, which at first involved mainly industrial firms, is gradually spreading through the rest of the economy and to households. Nevertheless, industrial production and the €COIN coincident indicator both stagnated in January.

The budget for 2006

The budget for 2006 is intended to reduce net borrowing by €20.5 billion (1.4 per cent of GDP). Compared with the version submitted to Parliament on 30 September 2005, which was officially expected to achieve a reduction of €11.5 billion (0.8 per cent of GDP), the effect of the budget was increased twice: by €4.9 billion in November, to offset the deterioration in the projections on a current legislation basis due to the reduction in the forecast revenue from property disposals (see the box "The budget for 2006" in Economic Bulletin *No. 41, 2005), and by €4 billion in December, so as to improve the objective for net borrowing in 2006 from 3.8 to 3.5 per cent of GDP.*

The changes made to the budget during its passage through Parliament mainly concerned revenue, which is now officially expected to show a net increase of €7 billion instead of €1.4 billion, while the net reduction in expenditure is expected to be €13.5 billion instead of €10.1 billion.

The budget measures are intended to make available €27.6 billion of additional resources, comprising €17 billion of expenditure cuts and €10.6 of revenue increases. As well as serving to reduce the budget deficit, these resources are to be used to finance €3.7 billion of tax reliefs and €3.5 billion of additional expenditure.

Provision is also made for the creation of a fund to give new impetus to the implementation of the Lisbon strategy. The resources of the fund are to come, up to a maximum of €3 billion, from the proceeds of privatizations and asset disposals by central government over and above those included in the estimate of net borrowing on a current legislation basis.

***Increase in revenue.** – The budget provides for €10.6 billion of additional revenue, compared with €7.3 billion in November 2005. The increase is expected to come mainly from the introduction of an agreed assessment scheme and the withholding tax on the disposal of buildings.*

The agreed assessment is an option open to recipients of entrepreneurial income and the self-employed, subject to their being covered by sector studies. Taxpayers undertake to declare a minimum tax base for each of the three years 2006-08 for their ordinary activity, as proposed by the tax authorities on the basis of sector studies, with account taken of the performance of the economy. Adherence to the scheme results in the limitation of some of the tax authorities' powers of audit, together with favourable treatment as regards personal and corporate income tax and complete exemption from the regional tax on productive activities and social security contributions for amounts in excess of the minimum tax base. The scheme is expected to produce €1 billion of additional revenue in 2006.

Taxpayers who take up the option can also regularize their positions as regards income tax, the regional tax on productive activities and VAT for the years 2003 and 2004 by adjusting the bases they had declared for these taxes to the values proposed by the tax authorities on the basis of sector studies. This possibility is expected to bring a one-off increase in revenue of €1 billion.

Further changes are made to the tax treatment of capital gains arising from the disposal of shareholdings in connection with the determination of corporate income and to the period allowed for the amortization of goodwill for tax purposes.

Provision is made in the budget, as an alternative to ordinary taxation, for a 12.5 per cent withholding tax on capital gains accruing to individuals from the sale of buildings acquired or built within the previous five years and from the sale of buildable land. This measure is expected to produce €510 million of additional income. The budget also provides for the cadastral value to be taken as the base for the real-estate transfer taxes applicable to sales of residential properties between individuals, regardless of the value declared in the contract.

A new 25 per cent income surtax is levied on the total net income deriving from the production, distribution, sale and showing of pornographic material and material inciting violence, which is expected to raise €160 million. Lastly, new provisions have been introduced for betting and gaming.

***Decrease in revenue.** – Parliament did not alter the revenue-reducing measures significantly; the expected effects were increased from €3.5 billion in November to €3.7 billion.*

The main changes concerned measures in favour of road hauliers and the introduction of a tax credit just for 2005 equal to 19 per cent of amounts spent to send children to day nurseries.

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

REVENUE	
Increase in revenue	**10,640**
Agreed assessment scheme and regularization of 2003-04 taxes	2,030
Amortization of goodwill	1,680
Increase in taxation of banks and insurance companies	1,340
Increase in taxation of the energy sector	970
Reintroduction of rules on revaluation of corporate fixed assets	910
Property leasing and measures to curb tax avoidance	830
Measures concerning betting and gaming	710
Substitute tax on capital gains arising from disposal of buildings	500
Reform and strengthening of tax collection activity	330
Fight against tax evasion	300
Other measures	1,040
Decrease in revenue	**-3,660**
Tax and social security contributions relief	-2,000
Extension of tax reliefs and allowances to 2006	-1,010
Other measures	-650
Net change in revenue	**6,980**
EXPENDITURE	
Decrease in expenditure	**-14,310**
Domestic stability pact	-3,130
Health service	-2,500
Staff costs	-890
Intermediate consumption	-1,590
Transfers to firms	-3,670
Current transfers	*-1,150*
Capital transfers	*-2,520*
Gross fixed investment	-700
Restrictions on ANAS expenditure	-600
Other measures	-1,230
Increase in expenditure	**3,510**
Support for families	770
Staff costs	660
Social security	160
Increase in outlays under existing legislation	590
Capital expenditure	410
Other measures	920
Other effects on expenditure (2)	**-2,470**
Net change in primary expenditure	**-13,270**
TOTAL REDUCTION IN PRIMARY BALANCE	**20,250**
Disposals	3,000
Measures to boost the economy	-3,000
Interest expenditure	-200
TOTAL REDUCTION IN NET BORROWING	**20,450**

(1) Based on official estimates. The items include the measures contained in the Finance Law and Decree Law 203/2005, ratified by Law 248/2005. – (2) The item includes the effects deriving from the reduction in budget allocations and the changes introduced with the tables attached to the Finance Law.

Decrease in expenditure. *– The budget provides for expenditure cuts amounting to €17 billion, compared with the November forecast of €15.9 billion.*

The main changes involved further reductions to budget allocations and to those included in the tables attached to the Finance Law, for a total of €940 million, and some minor items. In particular, provision was made for the method of calculating interest on Poste Italiane's current accounts with the Treasury to be revised, which is expected to save €150 million.

Some amendments were made to the domestic stability pact rules but without this affecting the savings expected. The limit on regions' current expenditure was unchanged at 96.2 per cent of their expenditure in 2004, while their capital expenditure may not exceed 104.8 per cent of that recorded in 2004, instead of 106.9 per cent as originally intended. The rules for municipalities and provinces were diversified. For current expenditure the limit is equal to 93.5 per cent of the level in 2004 for the authorities whose average per capita expenditure in 2002-04 was below the limit for their population size group and to 92 per cent for the others. In the original formulation of the budget, the limit was 93.3 per cent of the level in 2004 for all municipalities and provinces. For capital expenditure the limit is equal to 108.1 per cent of the level in 2004, instead of 110 per cent.

The freeze on municipal and regional surtax rates in respect of personal income tax and the regional tax on productive activities was extended for a year, up to 31 December 2006.

Increase in expenditure. *– The increase in expenditure is expected to be €3.5 billion, as against the original figure of €3.3 billion.*

The additional expenditure in favour of families was reduced from €1.2 billion to €0.8 billion. In particular, the fund for the provision of support to families was reduced from €1.1 billion to €0.7 billion. Moreover, Parliament specified the interventions the fund was to be used for: €1,000 for every child born or adopted in 2005 and for every child after the first born or adopted in 2006. Families whose income was less than €50,000 in the year preceding the birth or adoption are eligible.

The reduction in the support for families was offset by numerous minor measures such as those in favour of road hauliers, cancer research, schools and security.

The latest forecasts of the European Commission, the OECD and Consensus Economics, which offer a generally favourable interpretation of these signals, are for a quick recovery of area-wide GDP to growth rates between 2 and 2.5 per cent. In 2006 economic activity is seen as expanding by an average of about 2 per cent, narrowing the growth gap with the rest of the world. A similar pattern is foreseen in the recent predictions of the ECB staff. Economic activity is expected to be sustained by exports, despite further losses of world market shares, and by investment.

Nearly all the forecasts, which assume fundamentally stable oil prices, suggest that the average rate of inflation, as measured by the harmonized index of consumer prices, will remain just above 2 per cent in 2006. The estimate is subject to a number of uncertainties, however: the oil prices implicit in futures contracts could prove to be over-optimistic; the past rises in oil prices may not yet have been fully passed on to final prices; and wage moderation could come to an end as the cyclical upswing proceeds.

To counter these risks and ensure continued stability of the inflation expectations of the markets and of those incorporated in wage negotiations, the ECB Governing Council has twice made monetary conditions less expansive, in December and at the beginning of March. The rate on main refinancing operations was increased to 2.5 per cent, a level that still signals an accommodating monetary policy stance. In the coming few months the Council will be carefully assessing economic developments and their implications for inflation.

Market analysts expect short-term interest rates to rise by a further half-point over the rest of this year. In this case they would still be lower in real terms than in past cyclical upswings for all of 2006 and only come into line with historical patterns at the end of the year.

There is no sign of a halt to the expansion of credit. However, a moderate widening of the spread on corporate bond issues is under way, owing in part to rating agency downgrades and higher levels of debt consequent on major mergers and acquisitions.

On the basis of the latest Stability Programme updates, the gradual improvement in budget balances in the last two years will continue in 2006. General government net borrowing in the area is expected to decrease to 2.3 per cent of GDP. Deficits larger than 3 per cent will again be recorded in Germany, Italy and Portugal, countries for which the excessive deficit procedure is in course.

Adjustment of the public finances is essential to reverse the upward trend in the debt ratio of the last three years to create scope for stabilization measures and to tackle the effects of population ageing.

The Italian economy

The Italian economy stagnated last year and the growth gap with respect to the other euro-area countries widened. The number of persons employed rose by 0.2 per cent but total labour input as measured by standard labour units contracted by 0.4 per cent. There was a corresponding increase of 0.5 per cent in productivity.

For the first few months of 2006 Bank of Italy estimates point to the stagnation of industrial production. The qualitative cyclical indicators appear to be more favourable, signalling a strengthening climate of confidence among both firms and households. On the whole, very short-term statistical forecasting models suggest a return to positive GDP growth during the first quarter.

Bank credit supply conditions should remain favourable over the next few months. Demand from firms remains moderate but will probably increase somewhat, above all to finance stocks and working capital.

According to the forecasts of the European Commission and Consensus Economics, in 2006 the Italian economy will grow by an average of just over 1 per cent. Such a result presupposes, however, a return to annualized growth rates of close to 1.5 per cent beginning in the current quarter. The expansion of GDP is expected to be sustained by a recovery of exports, which, though continuing to grow more slowly than world trade, are forecast to increase by nearly 5 per cent on average for the year. Stimulated in part by exports, investment is expected to accelerate considerably, after falling last year. Consumption is expected to continue growing at a rate similar to that of 2005.

The forecasts for inflation in 2006 do not diverge significantly from those for the euro area.

Turning to the public finances, 2005 ended with the primary surplus on a cash basis down virtually to nil, despite substantial one-off measures, and an increase in the ratio of debt to GDP.

The Stability Programme update that the Government submitted to the European Commission in December 2005 sets two priority objectives: to reduce net borrowing below the 3 per cent threshold by 2007, in line with the decision of the EU Council last July that opened the excessive deficit procedure against Italy; and to launch a process of lowering the ratio of debt to GDP based on a large structural primary surplus.

According to the planning scenario, net borrowing will fall to 3.5 per cent of GDP in 2006, 2.8 per cent in 2007 and 1.5 per cent in 2009; the primary surplus will rise to 1.3 per cent in 2006 and reach 3.2 per cent in 2009; the ratio of debt to GDP will fall by 0.5 percentage points in 2006 and more sharply in the following years.

To achieve the objective for the current year, the Government has introduced a budget correction of the order of 1.4 percentage points of GDP (€20.5 billion), including temporary revenue measures amounting to about 0.2 points of GDP. The size of the budget correction, originally planned to be 0.8 points, was increased during the Finance Bill's passage through Parliament.

The budget focuses mainly on expenditure savings (€17 billion); the measures to increase revenue (€10.6 billion), three quarters of which regard the corporate sector, make resources available serving largely to finance tax reliefs (€3.7 billion) and increases in expenditure (€3.5 billion).

On 14 March the EU Council found that the budget for 2006, if fully implemented, would ensure adequate progress towards eliminating the excessive deficit in 2007; the Council stressed that substantial additional measures will be necessary for the coming year. The Council and the Commission will continue to monitor Italy's public finances carefully.

The main risk factors bearing on the achievement of the objectives indicated for the current year concern implementation of the measures to curb expenditure, which largely regard local authorities.

Full implementation of the measures on the expenditure side would increase primary current expenditure by about 1 per cent with respect to its level in 2005. In real terms, it is projected to fall by approximately 1 per cent.

In a medium-term perspective, measures that can permanently influence public bodies' spending behaviour are necessary; in particular, there is a need for budgetary rules and financing mechanisms that will make local authorities active participants in the adjustment of the public finances.

The rapid return of the public finances to a path consistent with the stable reduction of the ratio of debt to GDP is a priority for economic policy, with a view to the more general objective of lifting the Italian economy from stagnation. The two objectives are complementary.

Over the last decade Italy's economic growth has slowed and come to a halt, independently of the world economic cycle. It has been held back by the structural problems that reduce the ability of Italy's productive system to take advantage of the opportunities inherent in the new patterns of world trade and of the innovative technologies that have spread throughout the world. The easing of these problems, their solution, can restore Italian firms' ability to increase their productivity as much as and more than their rivals, so that they can compete effectively on all markets.

The above-mentioned signs of cyclical recovery do not yet delineate an overcoming of the Italian economy's growth gap vis-à-vis not only the most dynamic areas of the world but also the other major euro-area countries, which are themselves laggards by international comparison. This is why sustained action is necessary to bring about far-reaching changes in the productive system and the regulatory and market environment in which it operates.

Information updated to 15 March 2006; for the Appendix, to 13 March 2006.

Speeches

Financial market integration and the intermediation of savings

Speech by Mario Draghi, Governor of the Bank of Italy,
AIAF – ASSIOM – ATIC Forex

Cagliari, 4 March 2006

1. The world economy: expansion and imbalances

The world economy is enjoying a period of strong and widespread expansion. Despite sharp increases in the prices of raw materials, inflationary pressures remain moderate. Yet in some respects it remains fragile.

The expansion began in 2002 thanks to the recovery in the United States and the support from China's booming economy. It gained strength from the middle of 2003 onwards, with the average annual rate of growth rising to nearly 5 per cent, and has spread gradually, if unevenly, to every region of the world, although in somewhat weaker form in Europe.

In Italy, after stagnating in 2005, the economy now shows some signs of recovery. There is still uncertainty, however, about the extent and durability of the country's economic growth, which continues to be weighed down by unresolved structural problems.

World economic activity has benefited from the persistence of stable financial conditions that have been exceptionally propitious for investment. Apart from the expansionary stance of monetary and budgetary policies, other contributory factors have been the integration of financial markets, their development in emerging regions, the spread of more efficient instruments for the management of risk and the progress made in the fields of crisis prevention and financial supervision.

The economic upswing has generated strong demand for oil, especially by China and the other emerging Asian economies. Despite increased supply, this demand has been met with difficulty and at rising prices. The price of oil has doubled in real terms since the spring of 2003. So far this pressure has not been passed on to core inflation, which has remained moderate everywhere, testifying to the credibility gained by monetary policy in the leading countries.

This credibility is precious and needs to be preserved. It is the reason, especially in the euro area, why monetary conditions continue to be very relaxed: interest rates remain near the lowest levels ever. The monetary and credit aggregates continue to expand rapidly; the prices of real assets are high; no restrictive impulses are coming from the exchange rate. Keeping inflation expectations firmly anchored at a level consistent with price stability is essential for economic growth and the creation of jobs. The increase in the key rates decided on Thursday by the Governing Council of the ECB serves this purpose.

Although the world economic expansion is widespread, it is accompanied by very large external imbalances. These are caused by the divergences in the growth of domestic demand between the main regions and the massive transfer of resources from oil-consuming to oil-producing countries.

The US external deficit has been increasing since the middle of the 1990s, although the causes have changed over the years. Initially, it reflected the capital formation associated with the spread of new information technology. Boosted by increasingly good prospects of growth, consumption also rose faster than disposable income. The current account deficit was financed thanks to massive inflows of private capital, attracted by the high yields expected on the stock market, especially for high-tech securities, while the appreciation of the dollar further exacerbated the trade deficit.

In 2001 the determinants of the current account deficit began to change. In the face of the risk of recession, monetary and fiscal policies were made expansionary. The saving rate continued to decline. Consumption was sustained by the rising value of property; households' propensity to save turned negative in 2005. The federal budget balance deteriorated by 6 percentage points of GDP between 2000 and 2004 and will show another large deficit in 2006.

The manner of financing the external deficit also changed. The inflow of private capital slowed between 2002 and 2004. The dollar came under downward pressure, despite much larger purchases by the monetary authorities of countries with current account surpluses. Such purchases are liable to undergo rapid change. In 2005 these countries reduced their accumulation of official reserves, only China recording a further massive increase. However, the widening of the short-term interest rate spread prompted renewed private sector investment in the dollar, which gained strength as a consequence.

The appreciation of the dollar came to a halt last November. However, as things stand, the exchange rates between the major currencies are not conducive to adjustment of the external imbalances. High rates of growth have so far made it possible to postpone the adjustment, but these conditions cannot last indefinitely.

In 2005 various conditions arose that could help initiate a process of adjustment. Domestic demand accelerated in Japan, and to a lesser extent in Europe as well. The reform of China's foreign exchange system, although it has only produced a small appreciation of the renminbi so far, is a step in the right direction; a cooling of the US property market, of which there are signs, might slow the growth of private consumption. An adjustment of the underlying real imbalances is the best guarantee of orderly progress. For this to happen, the current trends need to be supported by a combination of more restrictive fiscal policy in the United States, greater exchange rate flexibility in the Asian economies, and structural reform in Europe.

2. International financial conditions

On the international financial markets real interest rates and the volatility of financial assets are low. Relaxed and stable financial conditions foster economic growth, which in turn is conducive to such conditions. At the same time they may reflect a reduced perception of risk by market participants and encourage them to build up illiquid and highly risky positions.

The low level of long-term interest rates is mainly the result of continuing expectations of moderate inflation, even over a very considerable time span. These expectations are based on the credibility of monetary policies. Investors accept modest returns in part because they have a perception of diminished risk, related to the limited volatility of securities prices and to conditions in the real economy. The expansionary cycle and wage moderation have sustained the growth in corporate profits, thereby improving the state of firms' finances. The insolvency rate is well below the long-run average. The spread between corporate and public-sector bonds is now unprecedentedly narrow.

Other contributory factors in keeping interest rates down have been the investment of current account surpluses by the Asian economies and the oil-exporting countries and an increase in investments by pension funds. These flows have proved unresponsive to the tightening of monetary policy by the Federal Reserve and the ECB; its effect has been limited to the shorter term maturities. The yield curve has flattened, particularly in the United States. In view of the historically low level of interest rates on risk-free assets, there has been a surge in the demand for riskier securities by investors in search of higher returns.

In this context, the reduction in risk premiums no longer reflects only a diminution of the underlying risks, but also agents' reduced risk aversion. Nor can it be ruled out that the premiums asked to hedge risks underestimate their true magnitude. The favourable conditions on the financial markets delay the correction of real imbalances, masking the symptoms without removing the causes.

The international markets have become more robust, contributing to an orderly reallocation of financial flows. The conditions are right for this to take place gradually, in a context of more balanced but strong global growth. However, geopolitical events, such as sharper internal and international tensions in the oil-producing countries or shocks due to individual corporate events or linked to single sectors of production, could trigger brusque changes in agents' attitudes and a sudden reallocation of savings and investments, leading to wide swings in the prices of real and financial assets and in exchange rates.

This possibility is small today but not entirely absent. The widespread use of derivative instruments may offer a better means of risk management, but it could also accelerate the propagation of extreme events.

3. Integrated, efficient and robust markets

Efficient and well-regulated markets, apart from performing their normal function of allocating financial resources in the best way possible, are crucial to ensuring that the system is robust enough to withstand violent shocks, however unlikely.

Policies designed to speed the integration of Europe's financial markets and their infrastructure contribute to orderly and lasting economic growth. Market integration allows firms to exploit economies of scale by reducing the cost of access; it increases the opportunities for diversifying investments; it ensures more efficient allocation of resources; it improves the ability to absorb shocks; it strengthens the stability of the system.

In Europe, market integration has been furthered by the single currency and the stability-oriented monetary policy. It has not gone far enough yet. Additional measures are needed to harmonize laws and regulations and adapt the infrastructure.

The greatest progress has been made in the money market, thanks among other things to the development of the TARGET settlement system. In November 2007 this will be superseded by TARGET 2, which will bring further benefits to firms in terms of liquidity management. As you know, the Bank of Italy has been a key figure in the project, alongside the French and German central banks, and intends to maintain that role.

In the case of government securities, common platforms such as MTS have gradually extended their operations, increasing the liquidity and efficiency of the European market.

The equity market is still fragmented. There are evident advantages, typical of a network economy, in concentrating trades; the attraction of a stock market for issuers and brokers grows with the number of present and prospective participants. On the other hand, for the stock of smaller firms in particular, the information advantages of national markets lead to better liquidity conditions. Forms of horizontal consolidation and federation between national markets would achieve both benefits. Unrestricted and equal access to settlement systems and multiple links between the various markets would foster both competition and efficiency.

Italy's stock exchange faces the challenge of adapting to the new context. Our primary goal should be to ensure ease of access to European markets and infrastructure for our firms and intermediaries. We need to reflect together on the best way to achieve this.

The integration of securities clearing and settlement systems has not yet reached a satisfactory level owing to differences in national infrastructures that pre-dated the launch of the monetary union. The existence of numerous national systems, with their non-standard services, diverse market practices and different laws and tax rules, increases the risks and costs of settling cross-border transactions.

Some specific barriers to integrating post-trading systems have been clearly identified. The removal of those created by differences in laws and regulations will require sometimes complex legislative intervention. The removal of strictly technical barriers and barriers created by market practices can be effected at the initiative of market operators themselves. There is no reason to wait.

A set of European rules is already in place to promote market integration and transparency by regulating such matters as settlement finality, market abuse, collateral, prospectuses and takeover bids. The directive on markets in financial instruments issued in April 2004 will spur competition by abolishing the requirement to conduct all transactions on regulated markets, encourage the provision of cross-border financial services and strengthen investor protection. The complex process of implementing the directive must be speeded up, at both Community and national level.

4. The role of intermediaries in asset management

The saving rate of the Italian economy, especially among households, is still high, despite a long-term downward trend. It is associated with a level of household wealth that is also high. Savings continue to be a fundamental resource for economic growth. Efficient management of the country's savings is a competitive challenge and an opportunity for growth, both of the economy as a whole and of the financial industry.

In Italy as elsewhere the composition of households' financial wealth has shifted in the last few years, as a result of more active, diversified and efficient portfolio management. Between 1995 and 2004 the share of bank and postal deposits fell from more than 40 per cent to barely 25 per cent and that of public-sector securities from 23 to 7 per cent, while the incidence of private-sector bonds, equities and investment fund units increased. Fund units are now as important as in the other leading industrial countries. The share of insurance products and private pension funds is much smaller, however, essentially because of the broad coverage provided by the public pension system. The share of private-sector bonds, in particular bank bonds, is high, as they enjoy a more favourable tax regime than deposits. Full advantage is not being taken of the portfolio diversification that professional managers can provide.

Banks continue to play a crucial role, both because the level of direct intermediation is still high and because the major banking groups include management companies that control almost the entire investment fund market. This market therefore contributes decisively to the size and profitability of banks, which accordingly have a strategic interest in increasing its competitiveness.

Management companies distribute their products almost exclusively through the networks of the group they belong to. This vertically integrated model enabled the Italian investment fund industry to grow rapidly, households to rely on relationships of trust with their banks when turning to asset management services, and banks to diversify their sources of income.

Asset management offers Italian banks considerable scope for expanding their business, increasing their profits and improving their stock market ratios. However, in a fast-changing competitive environment, this will require appropriate strategies for both products and customer relations. The reliance on a captive market and the small size of most asset managers are not conducive to innovation or economies of scale, which are crucial to competitiveness and profitability in this sector. Foreign competitors are gaining ground in the Italian market, especially as regards innovative products; more than 85 per cent of the exchange traded funds listed by Borsa Italiana are managed by foreign groups. The independence of asset managers – whether it is the result of decisions regarding their ownership or of strict corporate governance rules – is essential not only for their growth but also to resolve the conflicts of interest inherent in their relationships with their parent banks.

5. Financial regulation

The large proportion of savings not entrusted to professional investors, the scale of households' investment in financial products and the growing complexity of the financial instruments available require the authorities to refine supervisory regulations and practices constantly.

The law on the protection of savings recently approved by Parliament strengthens some of the safeguards for investors. The division of responsibilities between the Bank of Italy and Consob has always been based on the distinction between safeguarding the stability of intermediaries on the one hand and protecting investors and supervising markets on the other. This distinction, essential for effective action and the clear attribution of responsibilities, requires cooperation among the authorities in drawing up rules, in verifying intermediaries' compliance and in promoting investors' financial education. The Bank of Italy stands ready to continue this cooperation.

Regulation of the markets cannot eliminate risks for investors, nor should it; what it should do is facilitate their allocation by enhancing transparency and limiting and managing conflicts of interest, with a view to protecting the weakest investors. This is necessary on grounds of both efficiency and fairness. In preparing laws and regulations, every effort must be made, with the assistance of the operators involved, to strike a better balance between pursuing objectives and containing the costs borne by issuers, intermediaries and investors. Without breaching the key principle of the distinction between functions, the Bank of Italy verifies intermediaries' compliance with the rules for the protection of savings. Irregular or over-aggressive conduct exposes intermediaries to legal and reputational risks, which need to be addressed by prudential supervision.

The management of both old and new banking risks is now set to reap the benefits of the substantial investments that have been made by banks and regulatory authorities to bring the Basel Accord into operation. The new regime creates incentives for banks to direct their choices towards the objectives of prudential supervision, enhances the effectiveness of the rules and reduces their distortionary effects under a highly innovative approach. Based on the risk management techniques of the most sophisticated banks, it will promote competition and significantly improve the quality of most banks' operations.

The Accord could become the model for the regulation of investment firms and insurance companies as well. The convergence of the three sectors of financial intermediation should reduce the risk of regulatory arbitrage and rationalize the management of financial conglomerates.

The supervisory review process, the second pillar of the Basel Accord, requires each bank to make its own assessment, which should also be forward-looking, of the capital considered adequate in relation to its specific features, its risk exposures not considered for the minimum capital requirements and the quality of its organization. It is up to the supervisory authorities to examine, discuss and approve the systems adopted.

Using the analysis of different scenarios and stress tests, this instrument can also serve to link supervisory authorities' micro- and macro-prudential assessments, by exploiting the wealth of theoretical and empirical models available. But we must aim higher, taking the opportunity offered by the Basel 2 system to arrive at a significant simplification of today's supervisory rules and practices.

The law on the protection of savings expressly provides for the periodic review of legislation, to check its compliance with the principle of proportionality between the objectives and the costs borne by supervised entities, and for the assessment of the impact of each new provision. These are reasonable and useful criteria, to which we must add that of achieving a high degree of convergence among European countries on supervisory rules and practices, a goal whose importance increases with the number of banking groups operating in more than one national market.

6. The Italian banking system

Good laws and efficient supervision are what public institutions can and must contribute to the strengthening of the Italian banking industry, to the benefit of the country's economic growth.

The Italian banking system has made significant progress in recent years. There has been a general increase in productivity. The quality of banks' assets has improved considerably despite the weakness of the economy. The majority of banks have capital in excess of the minimum requirement. The leading groups have completed complex organizational integration and rationalization plans in the wake of mergers, with substantial cost reductions. The positive outlook depends on an improvement in net interest income, which is likely to follow as the European economy picks up, on continued growth in lending, especially corporate loans and consumer credit, and on realization of the major opportunities for synergy afforded by consolidation at the national level. The efficiency gains have been reflected in profitability and market sentiment, which has responded favourably to dividend policies.

The smaller banks have consolidated their positions in local markets, exploiting their comparative advantage in lending to small and medium-sized enterprises.

The European takeover-bid directive, which provides for minimum harmonization, leaves it up to national governments to decide on any further convergence of their laws and regulations and to set the course towards greater or lesser contestability of ownership. The present situation is unsatisfactory because it leaves open the possibility that cross-border consolidation will be undertaken not only on the basis of criteria of industrial and financial advantage but also for reasons of regulatory arbitrage.

Opening the markets for credit and banking services to domestic and foreign competition in conditions of regulatory equality reconciles the private interests of shareholders with the general interest in an efficient allocation of resources. It is the most effective way to stimulate further gains in operational and allocative efficiency, innovation, cost reductions and improvements in the quality of the services supplied to firms and households.

To exploit these opportunities, including by means of mergers and acquisitions, capital is available on a scale that was unthinkable until recently. Protectionism leading to worse regulatory arrangements than today's would entail costs on a comparable scale. We must avoid such an outcome. Hopefully, a rational and constructive spirit will prevail and interest in a level playing field for financial markets quickly re-emerge in the deliberations of the Heads of State and Government and Finance Ministers of the European Union.

7. Closing remarks

Italy continues to benefit little from the favourable developments in world trade and international finance. In 2005 GDP stagnated, exports continued to lose market share, the budget deficit widened. Since the 1990s the economy has been as if bogged down. Cyclical indicators and the short- and medium-term predictions of the main forecasting institutions now point to a pick-up in Italian GDP, but with growth still less than the potential, which is already lower than in the other major countries.

The growth gap reflects Italian industry's difficulty in competing. This is rooted in the lack of improvement in productivity. In other countries the revolution in production sparked by information and communications technology has produced its full effects: firms have adapted their human and organizational capital to the new technologies. Italy has been slow to seize the opportunities of this revolution. The gap is widest in total factor productivity.

New players are coming onto the stage, formidable in Asia but also present in Latin America and Central and Eastern Europe. This has imparted an extraordinary impulse to world trade. It is a great opportunity for growth but also a major challenge, in the face of which Italy has stumbled.

With the end of the illusory remedy of competitive devaluations, productivity growth is the only possible way to achieve prosperity, to create a solid, sustainable foundation for wage increases, and to ensure the development of the country, for ourselves and for future generations.

The structural lags of the Italian economy are not the signs of inevitable decline. They are manifestations of problems that are profound and serious but that can be overcome. We need to devise lasting solutions and explain them clearly to the public.

This week the European Central Bank raised its key rates by a quarter of a point. The time available for the adjustment of the public finances and a return to growth is running out.

Savings, one of the strengths of our economy and our society, are an essential ingredient for growth. It is up to the financial system, markets and intermediaries, to channel them towards the most productive uses, acting in a fully competitive environment and in compliance with the rules. This is your – and our – responsibility.