

## TECHNICAL ASSUMPTIONS AND THE INTERNATIONAL ENVIRONMENT

The assumptions underlying these short-term forecasts are quite similar to those used within the Eurosystem for the forecasts for the euro-area economy released in the ECB's June Monthly Bulletin. What slight differences there are concern the assumptions regarding exchange rates, oil prices and interest rates, which have been updated to take account of the observations of the ten working days to 4 July.

The expansionary phase of the world economic cycle is expected to continue for all of this year and next, with world trade expanding by about 6 per cent in 2007 and 7 per cent in 2008. Oil prices, as implied by futures contracts, average around \$67 a barrel this year and rise to \$73.5 next year. The assumption regarding short-term interest rates, as measured by 3-month Euribor, is based on market expectations and implies a progressive rise to 4.5 per cent. Long-term rates, corresponding to the yield of a basket of government securities with a duration of about 6 years, average 4.5 per cent in 2007 and 4.8 per cent in 2008. The assumption that bilateral exchange rates remain stable at the average registered between 20 June and 3 July 2007 implies a dollar/euro conversion rate of 1.35.

Projections for the public finances take account only of the effects of measures already adopted or drafted in sufficiently detailed form. They do not diverge significantly from the estimates presented by the Government in the recent Economic and Financial Planning Document for 2008-2011.

## SHORT-TERM FORECASTS

### The outlook for economic growth remains favourable

Starting from the spring of this year and for the whole of 2008 the Italian economy is expected to expand at rates in line with or slightly above our estimates for potential growth. GDP is forecast to grow by 2 per cent on average in 2007 and by 1.7 per cent in 2008 (Table 10). The figure for 2007 reflects the strong carryover effect produced by the sharp acceleration in GDP in the fourth quarter of 2006. The recovery in economic activity, driven as in previous quarters by export and investment demand, also benefits in 2007 from the upturn in household expenditure. After the sharp increase in 2006, the incidence of taxation is beginning to stabilize.

The Government projects GDP growth of 2 per cent this year and 1.9 per cent in 2008 (Economic and Financial Planning Document for 2008-2011). The OECD expects Italian GDP to increase by 2 per cent this year but by 1.7 per cent in 2008 (Table 11), with annual inflation forecast at 2 and 2.1 per cent respectively. The IMF offers a slightly lower prediction for GDP this year. The projections of the private analysts surveyed by Consensus Economics are identical to those of the European Commission for GDP growth (1.9 per cent this year, 1.7 per cent in 2008), but slightly more favourable as regards consumer price inflation.

Table 10

Forecasts of the main macroeconomic variables  
(annual percentage changes, except as indicated)

	2006	2007	2008
GDP	1.9	2.0	1.7
Domestic demand excluding stocks	1.3	1.9	1.5
Household consumption	1.5	1.9	1.5
Government consumption	-0.3	0.4	0.2
Gross fixed capital formation	2.4	3.5	2.8
Total exports	5.5	3.7	3.3
Total imports	4.5	2.5	2.6
Change in stocks and valuables (1)	0.4	-0.2	0.0
HIPC (2)	2.2	2.0	2.0
World trade	9.1	5.8	6.9
Export competitiveness (3)	-3.9	-6.6	-1.3

Sources: Istat and Bank of Italy. Chain-linked volumes; changes estimated on the basis of data adjusted for seasonal and calendar effects.  
(1) Contributions to GDP growth; percentage points. – (2) Harmonized index of consumer prices. – (3) Calculated by comparing the price of foreign manufactures with the deflator of Italian merchandise exports (excluding energy and agricultural products).

### Exports continue to fuel growth

According to our projections, world trade, after slowing in 2007 compared with the previous year, continues to sustain Italian exports, which expand by 3.7 per cent and contribute 1 percentage point to GDP growth. However, the lagged effects of the prolonged loss of competitiveness due to the strengthening of the euro and the rapid rise in export prices hold back sales abroad. The forecasting exercise envisages the decline in the competitiveness of Italian producers coming to a gradual end, thanks to the effects of corporate restructuring programmes initiated in recent years. The increased internationalization of firms, the improved quality of the human capital used in production and the enlargement of the range of products supplied are reflected in a slowdown in costs and a realignment of the price dynamics on internal and external markets. The quarterly rate of expansion of exports rises from about 2 per cent on an annual basis in the early part of 2007 to more than twice that at the end of next year. The average annual increase falls to 3.3 per cent in 2008 and the contribution to GDP growth to 0.9 percentage points (Figure 27), but the slowdown is entirely due to the smaller carryover effect than in 2007. There remains a large growth differential, of about 3 percentage points, with respect to world demand (Figure 28); this is reflected in a further fall in Italy's market share at constant prices and exchange rates, from 2.5 per cent in 2006 to 2.3 per cent. At current prices, instead, the share is unchanged compared with last year, at 3.5 per cent. The gap tends to narrow progressively.

### In 2007 the acceleration in consumption strengthens domestic demand

The recovery in consumption observed in 2006 gathers pace this year, with that of households growing by 1.9 per cent. Purchases of durable goods, stimulated by tax incentives, continue to grow at a lively pace (2.2 per cent). Households' disposable income accelerates to 2 per cent in real terms after stagnating in 2006 owing to the exceptionally large increase in taxation. The propensity to save, after falling by more than a percentage point in 2006, holds steady at 11 per cent. In 2008 the growth in consumption slows to 1.5 per cent, falling into line with the rise in permanent income.

The expansionary phase of the cycle and the favourable financial conditions give a boost to investment, which grows by 3.5 per cent in 2007; the temporary slowdown in purchases of machinery is offset by a sharp acceleration in construction. In 2008 the increase in real interest rates and the cooling of the property market reduce the rate of capital formation to below 3 per cent. After falling in the two previous years, in the period 2007-08 general government investment, excluding privatization receipts, accelerates significantly.

Table 11

### Forecasts by other organizations (annual percentage changes)

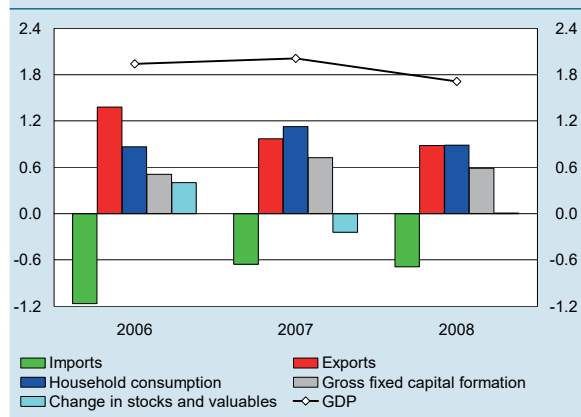
	GDP (1)		Inflation (2)	
	2007	2008	2007	2008
IMF	1.8	1.7	2.1	2.0
OECD	2.0	1.7	2.0	2.1
European Commission	1.9	1.7	1.9	2.0
Consensus Economics	1.9	1.7	1.8	1.9

Sources: IMF, *World Economic Outlook*, April 2007; OECD, *Economic Outlook*, no. 81 – June 2007; European Commission, *Economic Forecasts*, June 2007; and Consensus Economics, June 2007.

(1) The growth rates in the OECD forecasts are adjusted for calendar effects, in contrast with those published by the European Commission and the IMF. – (2) Based on the harmonized index of consumer prices (HICP).

Figure 27

### GDP growth and the contributions of the main components of demand (percentages and percentage points)



Sources: Istat and Bank of Italy.

In the two years covered by the forecast imports expand at an average rate of 2.5 per cent, 2 percentage points less than in 2006; the contribution of net exports to the growth in GDP rises to 0.3 percentage points this year and falls back to 0.2 points in 2008.

**The internal and external pressure on prices diminishes**

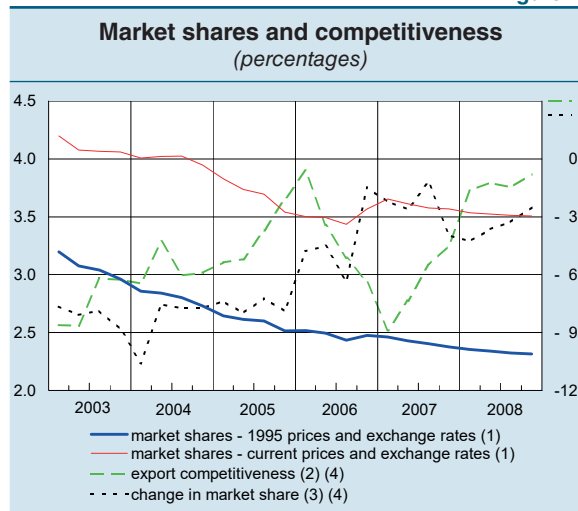
Inflation, as measured by the HICP, falls to 2 per cent in both 2007 and 2008, thanks to the return to a neutral monetary policy stance, the steadying of the oil price and the slowdown in unit labour costs (Figure 29). The latter is entirely due to productivity, which, partly owing to the fading away of the effects of the “Treu” and “Biagi” reforms on the demand for labour, improves at a pace more in line with the past.

**The risks for growth are downside, those for costs and prices balanced**

The assumptions concerning the external environment include a moderate slowing of economic activity in the United States and the persistence of relaxed conditions on the capital markets. If turbulence arises on the financial markets or cyclical developments are less favourable than expected, the forecasts for both GDP growth and consumer price inflation in Italy would have to be revised downwards.

The domestic risks are connected instead with the performance of exports. The forecasts assume that the restructuring and market repositioning begun in recent years by Italian firms will progress, containing costs and raising productivity growth. Italian products would thus cease losing price competitiveness and the gap between the rate of growth of Italian exports and that of world trade would diminish. If the assumption proves unrealistic, the outlook for growth would worsen and inflationary pressures would intensify.

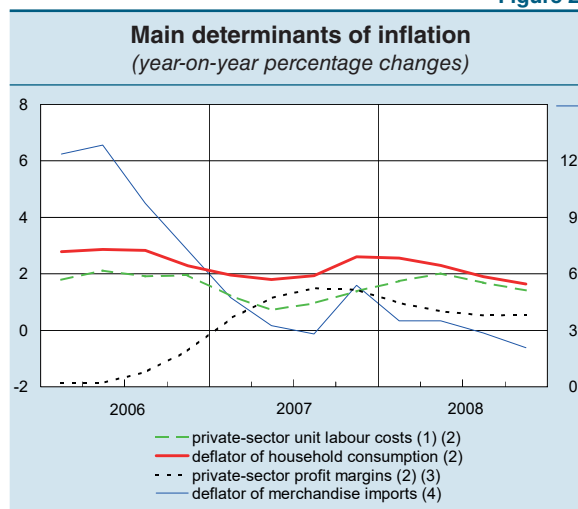
Figure 28



Sources: Istat, Bank of Italy and IMF.

(1) As a percentage of world merchandise trade; left-hand scale. – (2) Calculated by comparing the price of foreign manufactures with the deflator of Italian merchandise exports (excluding energy and agricultural products). – (3) Growth differential between Italian exports and world merchandise trade in real terms. – (4) Percentage change on the year-earlier period; right-hand scale.

Figure 29



Sources: Istat and Bank of Italy.

(1) Private-sector unit labour costs (excluding the energy and agricultural sectors), calculated as the ratio between compensation and output per standard labour unit (output is value added at factor cost). – (2) Left-hand scale. – (3) Ratio between the deflator of the value added at factor cost and unit labour costs of the private sector (excluding the energy and agricultural sectors). – (4) Right-hand scale.

## THE ECONOMIC AND FINANCIAL PLANNING DOCUMENT FOR THE YEARS 2008-2011

The priority objective of the Economic and Financial Planning Document is to provide support for economic growth while complying with the budget constraints.

The growth-oriented policies must tackle the problem of infrastructure shortcomings, increase the efficiency of government action, enhance redistribution, reduce taxation and increase competition.

Strategic importance is attributed to the renewal of the education system, protection of the environment and reduction of Italy's dependence on imported energy.

The Planning Document contains updated figures on a current legislation basis for 2007 and the following years.

For this year the figure indicated for the deficit is 2.1 per cent of GDP, or 0.2 percentage points less than in the Combined Report on the Economy and Public Finances published in March.

Compared with the Combined Report, revenue is more than €2 billion higher, to take account of the favourable performance of receipts in the early months of the year; expenditure is nearly €1 billion less, partly owing to the postponement of some public sector contract renewals to 2008.

Together with the Planning Document, the Government issued a Decree Law and a mid-year budget revision that will result in additional expenditure, officially estimated at 0.4 percentage points of GDP in 2007 and 0.1 percentage points of GDP in each of the following years. In particular, these measures provide for increases in the resources for the functioning of government, in minimum pensions and in expenditure on investment and support for developing countries.

Taking account of these measures, the Planning Document sets a new target for the deficit in 2007 of 2.5 per cent of GDP (down from the 2.8 per cent indicated in the Planning Document published in the summer of 2006, which had been confirmed in the subsequent budget documents and most recently in the Stability Programme update of December 2006). The public debt is seen as falling from 106.8 to 105.1 per cent of GDP.

From 2008 onwards, the adjustment path set for the public finances in the Planning Document is analogous to that indicated in the Stability Programme update, which was based, however, on much less favourable projections. The deficit should fall to 2.2 per cent of GDP in 2008 and to 1.5 per cent in 2009 and come close to balance in 2011. The primary surplus should rise from 2.7 per cent of GDP in 2008 to nearly 5 per cent at the end of the forecasting period. The public debt should fall to 95 per cent of GDP in 2011.

Achievement of the objective for the budget deficit in 2008 does not require any corrective measures with respect to the forecast on a current legislation basis. The Planning Document points out, however, that the use of this criterion leads to the exclusion of a series of outlays that are not yet provided for by law but which it is highly probable, and in some cases certain, will occur. The Planning Document mentions three categories of expenditure, in descending order of "mandatoriness": outlays in relation to commitments entered into by the Government; those deriving from firmly established practices, such as appropriations for future rounds of wage negotiations and in favour of the National Road Agency (ANAS) and the State Railways; and, lastly, those associated with new Government initiatives. The Planning Document estimates the expenditure for commitments already entered into at €4 billion and that for the other two categories referred to above at respectively €7 billion (excluding the resources necessary for the next renewal of public sector labour contracts) and €10 billion.

The Planning Document also clarifies that the inclusion in the budget accounts of the outlays of the first and second category gives an indication of the deficit on a current programmes basis. It is estimated that this would be 2.9 per cent of GDP in 2008, thus revealing the need for corrective measures amounting to about 0.7 percentage points of GDP, plus measures to provide the resources for future contract renewals and new Government initiatives. The Planning Document reaffirms the Government's priority commitment to reducing taxation, so that additional costs will have to be financed by expenditure savings.