Ministero dell'Economia e delle Finanze

Forecast and Planning Report for 2009

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Forecast and Planning Report for 2009

Submitted by the Minister of the Economy and Finance

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on 23 September 2008

TABLE OF CONTENTS

TABLES

FIGURES

I. SUMMARY

Since the 2009-2013 Economic and Financial Planning Document (DPEF) was submitted last June, the international economic situation has deteriorated due to the increasing impact of the financial crisis and the persistence of inflationary pressure caused by soaring food and energy prices. Moreover, the euro area suffered the impact of the euro appreciation in the first half of the year.

Italy's economic situation appeared weak amidst this welter of uncertainty. GDP decreased in the second quarter of 2008 as did private consumption. In line with the signals coming from indicators generally pointing to a decline, growth forecasts have been revised down from the estimates in the DPEF. GDP is forecast to grow by 0.1 per cent in 2008 and 0.5 per cent in 2009 -i.e. a 0.4 percentage point decrease in each year compared to last June's estimates. GDP growth over the 2010 – 2011 period is also expected to be weaker (1 per cent as against 1.2 per cent in the DPEF) although forecast to reach the previously estimated rate at the end of the period considered (1.5 per cent).

Despite the worsening economic situation, the update of estimates for General Government accounts for the 2008-2013 period confirms the target of 2.5 percent of GDP net borrowing for 2008 and the achievement of a balanced budget by 2011, as stated in the DPEF.

TABLE I.1: PUBLIC FINANCE UPDATED SUMMARY [1] (percentage of GDP)

		2008	2009	2010	2011	2012	2013
NET BORROWING	(RPP 2009)	-2.5	-2.1	-1.2	-0.3	-0.1	0.0
	(DPEF 2009-2013)	-2.5	-2.0	-1.0	-0.1	0.0	0.1
INTEREST	(RPP 2009)	5.1	5.1	5.1	5.0	4.9	4.8
	(DPEF 2009-2013)	5.0	5.1	5.0	5.0	4.9	4.9
CURRENT BALANCE - NET OF INTEREST	(RPP 2009)	6.2	6.6	7.2	7.5	7.6	7.6
	(DPEF 2009-2013)	6.2	6.7	7.4	7.8	7.8	7.8
PRIMARY BALANCE	(RPP 2009)	2.6	3.0	3.9	4.6	4.8	4.9
	(DPEF 2009-2013)	2.6	3.1	4.0	4.9	4.9	5.0
STRUCTURAL BALANCE (2)	(RPP 2009)	-2.5	-1.8	-0.7	0.2	0.2	0.2
	(DPEF 2009-2013)	-2.3	-1.7	-0.6	0.3	0.2	0.2
DEBT	(RPP 2009)	103.7	102.9	101.3	98.4	95.1	91.9
	(DPEF 2009-2013)	103.9	102.7	100.4	97.2	93.6	90.1
STATE SECTOR BORROWING REQUIREMENT	(RPP 2009)	-2.9	-1.4	-0.6	0.5	0.8	0.9
	(DPEF 2009-2013)	-2.9	-1.3	-0.4	0.7	1.0	1.1
PUBLIC SECTOR BORROWING REQUIREMENT	(RPP 2009)	-2.9	-1.8	-1.0	0.1	0.4	0.5
	(DPEF 2009-2013)	-2.8	-1.6	-0.8	0.4	0.7	0.7

1) Data do not include the reclassification of Equitalia, still being defined.
2) Cyclically-adjusted net borrowing, net of one-off measures .

Updated estimates for the current year imply an adjustment of General Government accounts, which on the revenue side incorporates the impact of slower growth of tax revenues, partly offset by an increase in social security contributions due to better-than-expected buoyancy in employee compensation in some private sector industries. As for expenditure, the increase in interest as a result of financial turmoil is offset by spending cuts.

After 2008 the overall impact of the above-mentioned factors causes primary surplus to decrease by 0.1 percentage points of GDP over the 2009-2013 period, except for 2011, when it's forecast to decrease 0.3 percentage points.

Net borrowing is forecast to increase by 0.1 percentage points of GDP in 2009, 0.2 percentage points in 2010 and 2011, and 0.1 percentage points over the last two years considered due to different interest.

The debt-to-GDP ratio is expected to edge down below 100 per cent in 2011, as stated in the DPEF, and reach 91.9 per cent in 2013.

In 2008 the structural balance (the cyclically-adjusted net borrowing net of one off measures) worsens by 0.2 percentage points compared to DPEF estimates DPEF, due to a lower output gap and additional one-off measures. The fiscal consolidation resumes as of 2009 in line with the European criteria for annual structural adjustment. After temporary deterioration in 2008, the structural deficit is forecast to continue its downward trend. Over the 2008 – 2011 period the overall adjustment is equal to over 2 percentage points, thus ensuring progress towards the medium-term goal of a balanced budget.

II THE INTERNATIONAL ECONOMY

II.1 THE INTERNATIONAL SITUATION

The international economic situation has deteriorated in 2008 due to a worsening of the impact of the financial crisis and soaring energy and food prices.

A year on, the crisis of the financial system shows no signs of abating and is also affecting major international banks and insurance companies. The monetary authorities in the most important economic areas have provided massive injections of liquidity to stabilise markets in a coordinated fashion. The banking sector has suffered heavy losses globally and, as a result, has had to carry out significant recapitalisation transactions.

Oil prices continued to increase in the first eight months of 2008, reaching an all-time high of $145 a barrel at the beginning of July and dropping to $86 approximately in mid-September. The International Energy Agency (IEA) revised downward estimates for global oil demand growth, projecting that it will be 86.8 million barrels a day in 2008 and grow by 1.0 per cent in 2009. Uncertainty about future crude oil prices is still very high.

Since the beginning of the year the euro has appreciated against the main currencies reaching an all-time-high of 1.59 against the dollar; it then strongly depreciated to below 1.40 in September. Up until August, the real effective exchange rate of the euro increased by about 35 per cent from the low levels of October 2000.

Given these developments, and in line with all the main international forecasts, global growth has been estimated at 3.7 per cent for the current year, 1 percentage point less than in 2007, and at 3.4 per cent in 2009. In the following four years, an average growth of 4.1 per cent is expected. World trade is estimated to grow by 5.2 per cent on average in the 2008-2009 period, thus slowing down by 2 percentage points compared to 2007. In the remaining years of the forecast period, world trade is projected to grow at an average rate of 7.2 per cent. Technically assuming oil price average from a 2-week period reference period before the finalisation of this report, the oil price is forecast to hover around $109 a barrel on average in 2008 and decline in the following years. As of 2009, the euro is forecast to average 1.43 against the dollar.

In the United States, GDP grew by 0.8 per cent in the second quarter over the previous period, 0.6 percentage points more than in the first quarter, thanks to higher contribution of exports, public spending and private consumption; the latter was sustained by tax measures introduced in Spring 2008. In the second part of the year the lack of tax measures supporting consumption could affect households' disposable income, thus contributing to depress private consumption. Residential investment continued to decrease, although to a lesser extent versus the previous quarter.

In the labour market the employment contraction that started towards the end of 2007 is continuing. Consumer inflation (CPI) has increased steadily over the year, exceeding 5 per cent. This is mainly due to soaring energy prices: CPI, excluding energy products, was about half.

The lingering financial crisis has repeatedly contributed to policy rate cuts by the Federal Reserve from 4.25 at the beginning of the year to 2 per cent. In addition, the monetary authority has injected massive liquidity in an effort to restore orderly conditions in financial markets.

US economic growth is set to continue to weaken in the second half of the year, with a substantial recession risk due to persisting financial tensions, weak consumption performance and foreign demand slowdown . In 2008, GDP is forecast to grow by 1.5 per cent, 0.7 percentage points less than in the previous year. In 2009, growth should slow down further and pick up again in 2009 -2013 at an average growth rate of 2.0 per cent.

After a first quarter of robust growth (0.8 per cent), in the second quarter Japan suffered a 0.6 per cent GDP contraction compared to the previous period, due to a drop in domestic and foreign demand. In addition, residential investment suffered a sharp drop. CPI newly became positive end-2007, reaching 2.3 per cent in July. At its latest meeting of 18 September the Bank of Japan agreed to keep its policy rate unchanged at 0.5 per cent.

Japan's GDP is forecast to grow, on average, by 1.0 per cent in 2008 and 2009 and 1.6 per cent in the following four years.

Asia's emerging economies have shown signs of a slowdown, due to a less positive global scenario. However, Asian exports have remained strong with domestic demand driving growth, even though households' purchasing power was eroded by inflation.

China's GDP growth has slowed down somewhat, reaching 10.1 per cent in the second quarter, 0.5 percentage points less compared to the first quarter 2008. Export growth was less sustained in the first seven months of 2008 compared to the previous year, whereas imports accelerated. Inflation decreased to 4.3 per cent in August, from 8.7 per cent in February.

The Indian economy continued to grow briskly at a rate of 7.9 per cent in the second quarter of the year, even though inflation has been strongly increasing in recent months.

Growth forecasts continue to be positive, even though they point to slightly more moderate growth compared to previous years. According to the main international institutions, the emerging Asian economies should grow by approximately 8 per cent over the 2008-2009 period. China's economy is forecast to grow by 10 per cent in 2008 (almost 2 percentage points less versus 2007) and by 9.3 per cent in the following year. The Indian economy is forecast to grow by 7.8 per cent this year and 7.2 per cent next year.

TABLE II.1: INTERNATIONAL MACROECONOMIC FRAMEWORK (percentage change)

	2006	2007	2008	2009	2010	2011	2012	2013
GDP								
Industrialised countries	3.0	2.7	1.7	1.3	2.1	2.3	2.5	2.5
United States	2.9	2.2	1.5	0.8	2.0	2.3	2.4	2.4
Japan	2.4	2.1	1.0	0.9	1.3	1.5	1.7	1.7
EMU	2.7	2.6	1.4	1.1	1.7	1.9	2.1	2.1
France	2.0	1.9	1.0	0.9	1.8	2.1	2.4	2.4
Germany	2.9	2.5	1.8	1.0	1.4	1.4	1.4	1.5
United Kingdom	2.9	3.1	1.1	0.9	2.6	2.6	2.8	2.8
Spain	3.9	3.8	1.4	0.9	3.0	3.3	3.4	3.4
World excluding EU	5.4	5.2	4.3	4.0	4.4	4.6	4.7	4.7
World	4.9	4.7	3.7	3.4	3.9	4.1	4.2	4.2
World trade	9.3	7.2	5.2	5.1	7.0	7.2	7.2	7.2

Source: Our calculations on IMF, OECD and EU data.

TABLE II.2: COMMODITY AND OTHER PRICES (percentage change)

	2006	2007	2008	2009	2010	2011	2012	2013
Oil (Brent FOB dollar/barrel)	65.1	72.5	109.0	101.0	101.0	101.0	101.0	101.0
Non-energy raw materials	16.5	25.7	23.7	0.0	0.0	0.0	0.0	0.0
Manufactured goods	4.8	6.7	9.5	2.0	1.5	1.5	1.5	1.5

Source: Our calculations on IMF. OECD and EU data.

II.2 TRENDS IN EUROPE

After a still robust performance in the first quarter of 2008, the economic performance of the euro area in the second quarter was affected -to a greater extent than expected- by weakening international cycle. Turmoil in financial and real estate markets caused banks to tighten credit standards and domestic demand to grow much more slowly. Increasing commodity prices -notably energy and food products- have pushed inflation up to historically high levels. Last July the European Central Bank increased the monetary policy rate by 25 basis points to 4.25 per cent. The high values recorded by the euro against the dollar until last summer failed to support foreign demand, while economic uncertainty and consumers lower disposable income weakened domestic demand.

In the first quarter of 2008, some temporary effects pushed growth in the euro area beyond expectations, with a 0.7 per cent GDP increase versus the previous period. However, in the second quarter, GDP in the euro area declined by 0.2 per cent over the previous period. Except for General Government consumption expenditure -increasing by 0.5 per cent over the previous quarter- all aggregate demand components declined. Domestic demand showed marked weakening, with gross fixed investment decreasing by 1.2 per cent and household consumption by 0.2 per cent versus the previous quarter.

Also exports decreased by 0.4 per cent due to weakening world demand and euro appreciation. Finally, imports declined to equal extent.

In the second quarter of the year, industrial production showed the worst performance in the last five years, with a 0.8 per cent decline over the previous period, after a 0.2 per cent increase in the first quarter. Plant utilisation capacity continued to decrease, although it is still higher than the historical average. Business confidence by the European Commission predict weakness in the second half of the year, after lowest levels on record for the last few years reached in several economic sectors, notably industry.

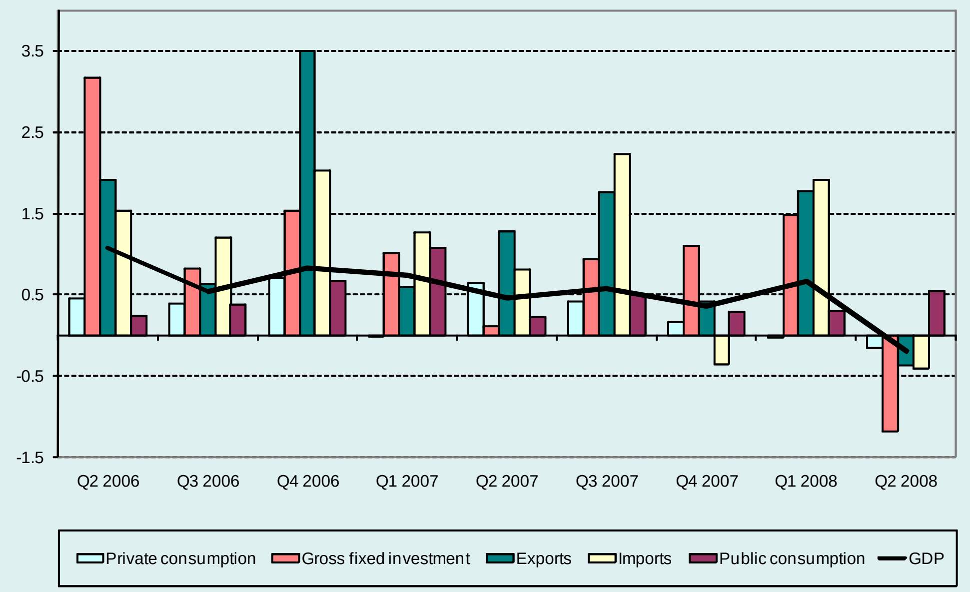
In addition, the euro area labour market showed signs of weakening. In the second quarter of 2008, employment growth was once again more moderate (0.2 per cent compared to the previous period and 1.2 per cent compared to the same quarter 2007), while in April, unemployment rate marginally increased to 7.3 per cent then levelling off over the following three months.

In the first eight months of 2008 inflation in the euro area increased to historically high levels, reaching a 4.0 per cent peak in July and dropping to 3.8 per cent in August. Moreover, core inflation grew from 2.1 per cent in the second half of 2007 to 2.5 per cent in the first half 2008. Processed foods showed the highest increase, with a 7.2 per cent inflation rate in July up from 1.9 per cent in the previous year.

The euro seems to have reversed its long appreciation trend against the dollar, which culminated last July when the euro reached an all-time high of 1.59 against the dollar. In September the euro decreased below 1.40. The current weakness of the single European currency will help sustain growth in the euro area through exports or possibly partially mitigate the negative impact of the previous appreciation.

Major international institutions estimate a 1.4 per cent GDP growth in the euro area in 2008, 0.3 percentage points less compared to the spring forecasts, due to basically flat performance in the second half of the year. Forecasts for 2009 predict a 1.1 per cent GDP growth in the euro area, thereby revising past estimates downwards. In the following four-year period average growth is expected to stay at 1.9 per cent, consistently with previous forecasts.

FIGURE II.1: EURO AREA, GDP AND EXPENDITURE COMPONENTS (percentage change over the previous quarter)



Source: Eurostat and Thomson Datastream.

II.3 RISKS

Uncertainty over international economic trends is first and foremost due to the evidence that a year after the onset of the crisis triggered by the US subprime mortgages an end to financial turbulence is not yet in sight. On balance, the financial system continues to suffer significant losses and major institutions have been hit by the crisis despite the timely intervention of the most industrialised countries' central banks that injected massive liquidity into the system in a coordinated fashion.

The US economic cycle, which proved to be more robust than expected in the first half of 2008, could weaken more than forecast in the next few quarters, due to the slowdown in the main components of domestic and foreign demand. In addition, the adjustment of the real estate market, which has been going on for ten consecutive quarters in the US and has spread over the European market, especially Spain, the United Kingdom and Ireland, could prove to be more significant than expected.

Finally, despite the recent moderation in commodity prices, there is still the risk of new hikes due to a potential mismatch between energy supply and demand and the impact of adverse climate and geopolitical factors. Overall, the current international economic situation remains highly uncertain.

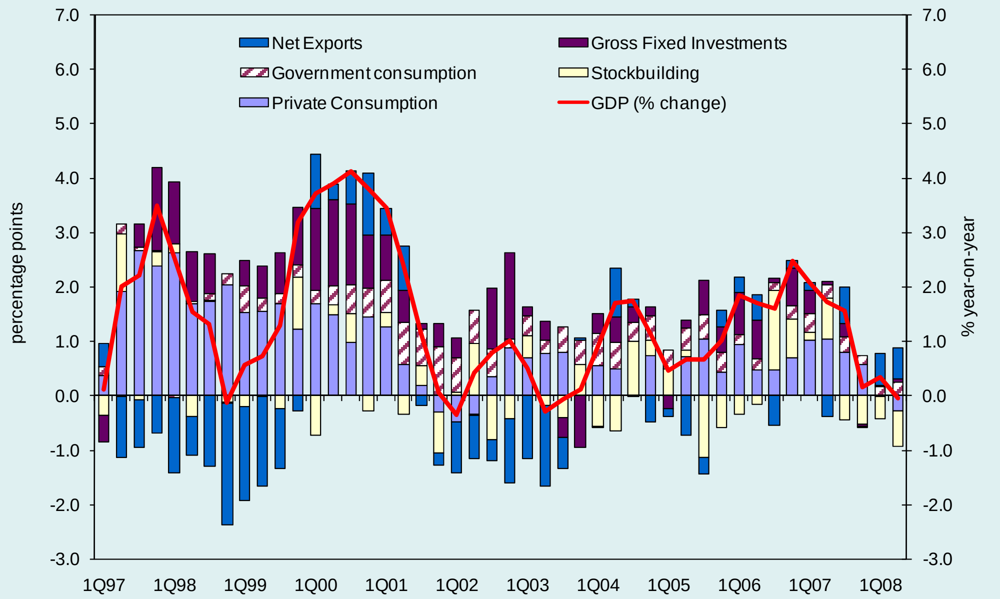
III. THE ITALIAN ECONOMY

III.1 TRENDS FOR 2008

GDP decreased by 0.3 per cent in the second quarter compared to the first quarter. The drop was more marked than forecast on the basis of signals coming from cyclical indicators. There was a simultaneous decrease in the euro area (-0.2 per cent) and a more marked slowdown in Germany (-0.5 per cent) and France (-0.3 per cent).

In Italy, in the second quarter, the contribution of inventory turned positive again (0.2 percentage points) over the previous quarter, while that of net exports and household expenditure accounted for -0.3 and -0.2 percentage points respectively. The contribution from gross fixed investment was nil, while government consumption expenditure accounted for 0.1 percentage points.

FIGURE III.1: CONTRIBUTIONS TO GDP GROWTH (year-on-year)



Source: ISTAT.

In the second quarter, domestic demand remained stagnant. Household consumption decreased by 0.3 per cent over the previous quarter. Household expenditure decisions were affected both by the sustained increase of consumer prices, especially energy and food prices, and dwindling confidence.

Consumer spending on durable goods was very weak. As for tourism, resident spending abroad increased, while non-resident spending in Italy continued to decline.

Investment in construction decreased by 0.9 per cent in the second quarter as did production in construction (-2.7 per cent over the previous quarter). Both results can be attributed to decreasing house demand and lower profitability of construction. According to some sources, in the first half of 2008 home sales diminished by almost 15 per cent over the same period in 2007. In addition, house prices are believed to have gone down in the first half of 2008 compared to the same period of 2007, thus showing a higher-than-expected sensitivity to demand contraction. It is therefore plausible to assume a moderate drop in house prices in the current year.

Dwindling demand for houses is also confirmed by the trend in mortgage loans to households. After years of strong growth, in July mortgage lending suffered a drop (-0.2 per cent) over the same month in the previous year.

Investment in equipment showed a slight cyclical recovery, due to vehicles (usually the most volatile component) which increased by 1.5 per cent over the previous quarter. However, all the signals coming from the degree of plant utilisation and the continuous deterioration of corporate financial accounts are not positive, as borne out by the weakness of expected demand. A negative impact on investment could also come from credit tightening, which in the second quarter of 2008 mainly hit enterprises -especially medium-sized and large ones- and long-term loans, according to the bank lending survey by the Bank of Italy.

In the second quarter, exports decreased by 0.7 per cent, due to the impact of the slowdown in foreign demand, especially European demand, and the euro appreciation. As a result of dwindling domestic demand, imports decreased for the second consecutive quarter compared to the same quarter in the previous year.

As for prices, the import deflator increased by 5.7 per cent in the second quarter compared to the same period in the previous year, pushed up by energy and non-energy commodity price hikes. Due to external inflationary pressure, the consumption deflator increased by 4.0 per cent compared to the previous year.

Prospects for the Italian economy in the second part of the year are uncertain and risks are skewed on the downside. Industrial production, which has been decreasing since the last quarter of 2007, continued to decrease in July (-1.1 per cent over the previous month), especially in the sector of non-durable consumer goods. In addition, private consumption, according to the *Confcommercio* real-term index, increased only marginally in July compared to June (0.2 per cent) whereas it edged down (-0.1) compared to the same month in the previous year. Although still at historically low levels, confidence indicators as to consumers and firms in the retail and service sectors showed signs of recovery in August compared to July, whereas business confidence of manufacturing firms was stable in August and continues to hover around the low levels recorded in 2001.

Bearing in mind the above considerations, growth is expected to edge up in 2008 by only 0.1 per cent, and to remain below the 0.5 per cent level forecast in June in the 2009-2013 DPEF.

In 2008, domestic demand is expected to be very weak. Consumption is forecast to decline, even though only slightly (0.3 per cent), in part, as a result of weaker purchasing power due to recent price hikes.

Fixed investment is forecast to remain stable due to declining investment in construction (-0.5 per cent). Conversely, investment in machinery is projected to edge up (0.3 per cent) compared to 2007.

As to foreign demand, export volumes are expected to suffer a setback (0.7 per cent) compared to the previous year, as a result of the world trade slowdown.

TABLE III.1: NATIONAL ACCOUNTS (percentage change, chain-weighted, base-year 2000)

	2005	2006	2007	2008
GDP	0.6	1.8	1.5	0.1
Imports of goods and services	2.2	5.9	4.4	-0.8
NATIONAL RESOURCES	0.9	2.7	2.1	0.0
Domestic final consumption	1.2	1.0	1.4	-0.1
Resident households' expenditure	0.9	1.1	1.4	-0.3
General Government and NPISH expenditure	1.9	0.9	1.3	0.8
Gross fixed investment	0.7	2.5	1.2	-0.1
Machinery, equipment and others	0.9	3.5	0.2	0.3
Construction	0.5	1.5	2.2	-0.5
Stocks and valuables*	-0.2	0.5	0.0	-0.1
DOMESTIC DEMAND	0.8	1.8	1.3	-0.2
Exports of goods and services	1.0	6.2	5.0	0.7
TOTAL USES	0.9	2.7	2.1	0.0

*) Data measure the contribution to GDP growth.

As a result of decreasing demand and considering the performance of the first half of the year, imports are forecast to decline by 0.8 per cent. Import prices are expected to increase by 5.7 per cent, due to commodity price hikes.

The goods balance as a percentage of GDP is expected to show a surplus (0.2 per cent). The current account deficit is expected to be in line with last year at 2.4 per cent of GDP.

As to the composition of value added, industry (excluding construction) is expected to record the sharpest drop (-1.4 per cent), followed by construction (-0.3 per cent). Private sector services are expected to suffer a marked slowdown compared to the average of the previous two-year period: 0.7 per cent, against 2.3 per cent previously.

The labour market is still sound. Employment measured in full-time equivalent is forecast to grow by 0.9 per cent in 2008. The estimate is based on the performance of the first two quarters, which showed sustained growth in the number of people employed despite the cyclical slowdown.

The unemployment rate is forecast to decline compared to 2007 and stand at 6.0 per cent – allowing for modest growth in labour supply compared to the first quarter of 2008.

Gross wages per employee are forecast to grow by 4.0 per cent, thus recording a notable increase compared to 2007, as a result of the renewal of contracts in both public and private sector. Unit labour costs are expected to accelerate (4.7 per cent) although only temporarily. Consequently domestic inflation measured by the GDP deflator is also forecast to notably increase (3.7 per cent).

Labour market

Labour market data sent conflicting signals in the first half of 2008. Employment was buoyant overall, with a year-on-year increase of 1.1 per cent in the second quarter of 2008. The service sector also showed a satisfactory performance, with 2.4 per cent growth in employment over the same quarter of 2007 compared to 1 per cent decrease in industry. Adjusted for seasonal factors, overall employment grew by 0.5 per cent in the second quarter of 2008 over the first quarter, with contributions from both the service sector (0.8 per cent) and industry (0.5 per cent).

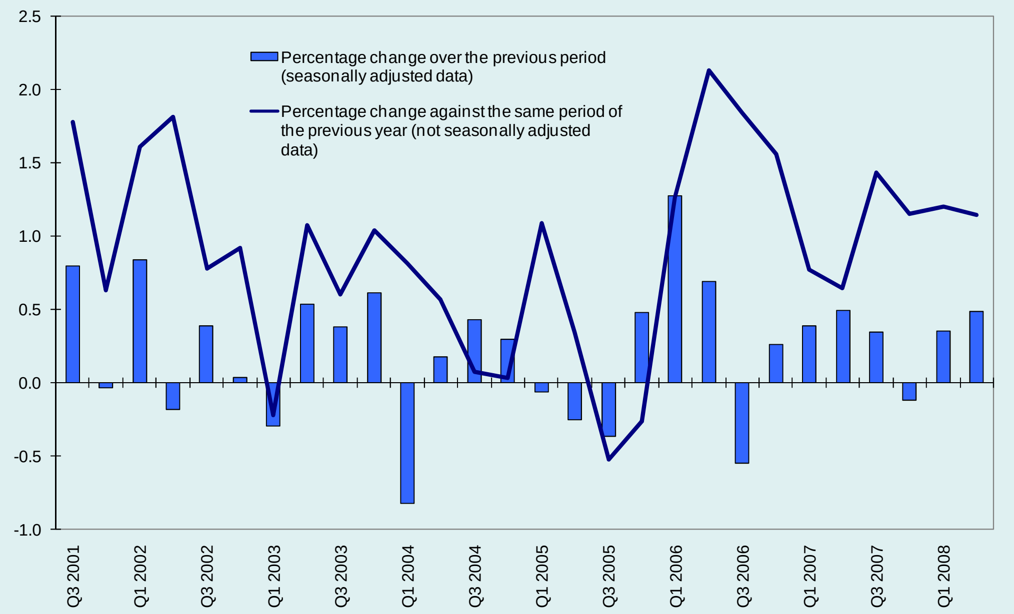
The labour force survey shows that the non-seasonally adjusted unemployment rate went up to 7.1 per cent, seven tenths of a point above the figure for the same period in 2007. Unemployment seems to have increased more in the South (about 1.5 percentage points) and to have affected both men and, to a greater extent, women, whose unemployment rates went up to 10.5 and 17.4 per cent respectively. Compared to the fourth quarter of 2007, the seasonally adjusted unemployment rate went up by three tenths of a point reaching 6.5 per cent.

In the first quarter of 2008, labour supply increased at a seasonally-adjusted rate of 0.4 per cent over the fourth quarter of 2007. On a year-on-year basis the labour supply increased by 2.2 per cent – with males increasing by 1.1 per cent while females rose by 3.8 per cent. Broken down by geographical areas, Central Italy recorded the highest increase on a year-on-year basis, with 4.4 per cent as against 1.6 per cent in the North and 1.5 per cent in the South. The activity rate of the (15-64) working-age population stood at 62.8 per cent -i.e. a nine-tenth-of-a-point increase over last year.

As far as wages are concerned, the index of hourly contract wages increased by 4.3 per cent on a year-on-year basis in July 2008. This increase strengthens the upward trend recorded throughout 2008, after two years of relative moderation also due to delays in contract renewals. In this regard, in July 2008, the share of contracts awaiting renewal went down to 30.3 per cent of all contracts considered and is mainly made up of civil-service contracts.

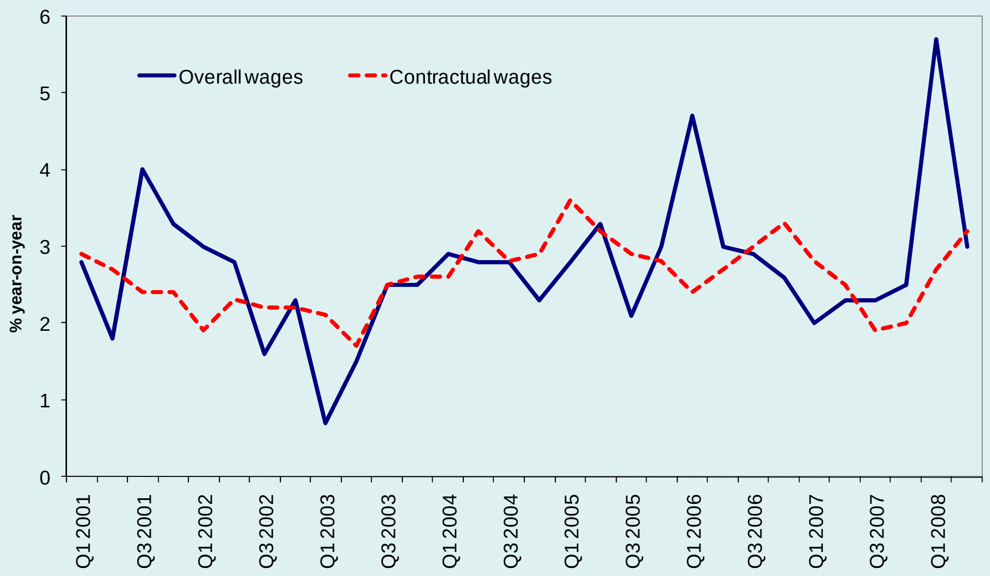
According to the *Employment, Wages and Social Contributions* (OROS) survey, after the marked increase in the first three months of the year, wage growth slowed down in the second quarter of 2008. The year-on-year average growth rate in industry and services went down to 3.0 per cent. The slowdown is largely accounted for by services, where wages per full-time equivalent increased by 1.9 per cent in the second quarter of 2008 over the same quarter of 2007, as against 4.1 per cent in industry.

FIGURE III.2: FULL-TIME EQUIVALENT LABOUR UNITS



Source: ISTAT, National Accounts Data.

FIGURE III.3: WAGES INDICATORS FOR THE WHOLE ECONOMY (percentage change over the same quarter)



Source: ISTAT, OROS Contractual wages.

Foreign trade

Since summer 2007 the international situation has been deteriorating due to persistent effects of the financial crisis and –despite recent adjustment- high commodity prices and the euro appreciation against the dollar. This has created less favourable conditions for Italy's exporting firms.

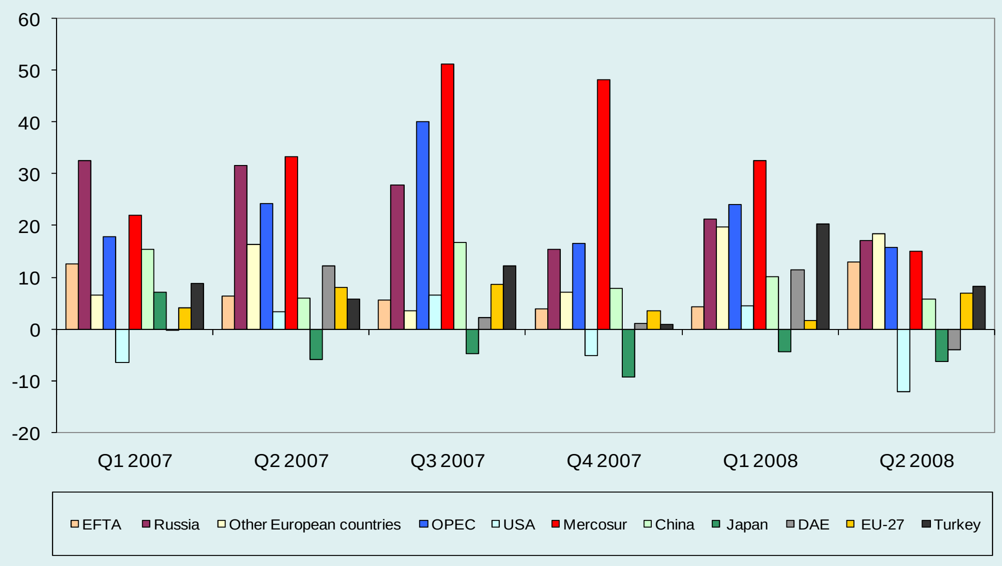
However, in the first half of 2008, the overall cif-fob trade was rather satisfactory: exports and imports increased by about 6 per cent over the same period 2007. Trade developments were positive across all regions: exports to European countries increased by 4.4 per cent compared to the same period 2007, while imports increased slightly more than 1 per cent. Exports to traditional partners such as France and Germany increased by over 5 per cent.

In the first seven months of the year, trade with non-EU partners increased more significantly: imports by almost 13 per cent and exports by 9 per cent. The main recipients of our exports were the Mercosur and OPEC countries and Russia with increases of over 20 per cent. Only exports to Japan and the US continue to decrease (by about 5 per cent).

From a sectoral point of view, most products made in Italy showed a positive performance in the first two quarters 2008, although slightly worse compared to the same period 2007. The fastest growing industries were: processed food, mechanical appliances, equipment as well as vehicles.

In the first six months of the year, the overall trade balance showed a €7.2 billion deficit in line with the previous year, whereas the balance vis-à-vis European countries recorded a €5.6 billion surplus, a marked increase over the same period 2007. In the first seven months of 2008, the trade balance vis-à-vis non-EU countries worsened by €4.3 billion compared to the same period last year (from €10.1 billion to €14.4 billion).

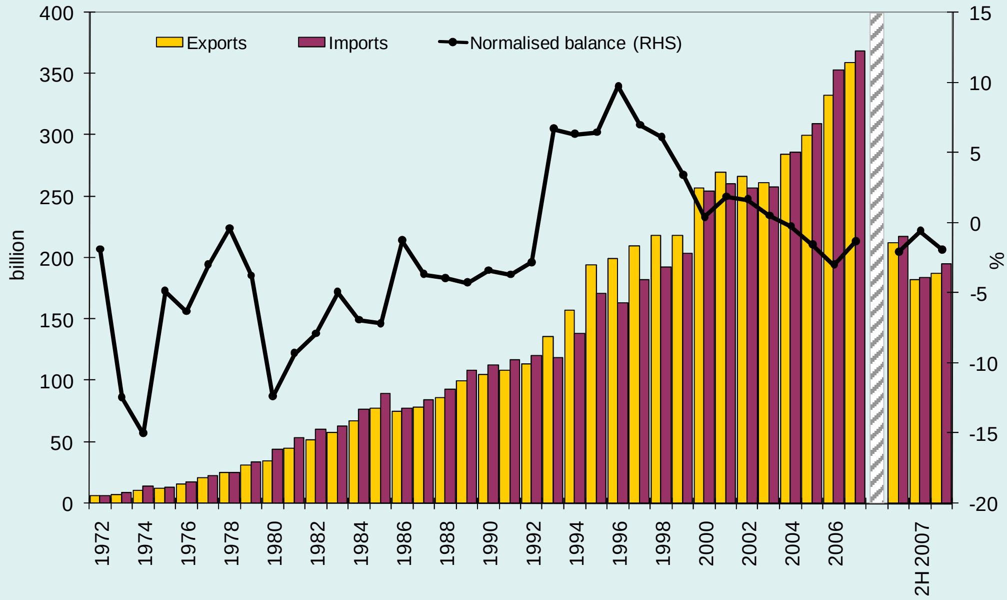
FIGURE III.4: EXPORTS BY GEOGRAPHICAL AREA (year-on-year percentage change)



Source: ISTAT.

In the first half of 2008, the normalised balance remained basically unchanged compared to the same period in 2007, despite the increase in energy imports. On the whole, in 2007, the normalised balance improved over the previous year.

FIGURE III.5: NORMALISED TRADE BALANCES



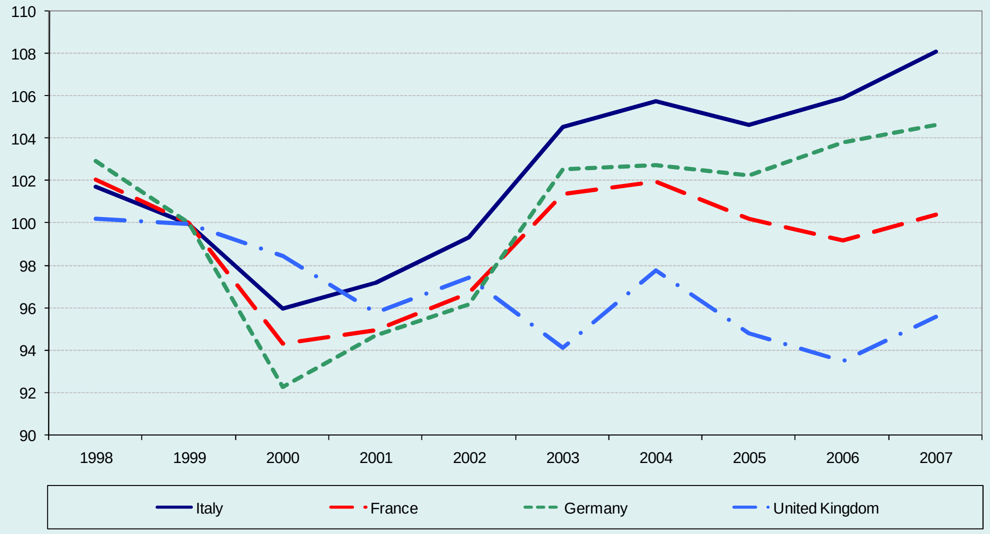
Source: ISTAT.

Note: The normalised balance varies between -100, when a country has no exports, and +100, if a country has no imports. If the trade balance is balanced, the normalised rate is 0 resulting from the percentage ratio of the current balance and the sum of exports and imports.

Most recent data highlighted some uncertainty. In June, overall exports declined by 4 per cent compared to 2007. Imports edged up 0.6 per cent. Exports to EU countries dropped by 3.6 per cent, while imports decreased by 8 per cent, due to weaker-than-expected EU economic performance in the second quarter of the year. Conversely, in July exports to and imports from non-EU countries increased by 9.0 per cent and 12.6 per cent, respectively.

Competitiveness, if measured by real effective exchange rates, shows a more marked worsening for Italy compared to the larger European countries in the last few years.

FIGURE III.6: REAL EFFECTIVE EXCHANGE RATE (index of manufactured goods prices,1999=100)

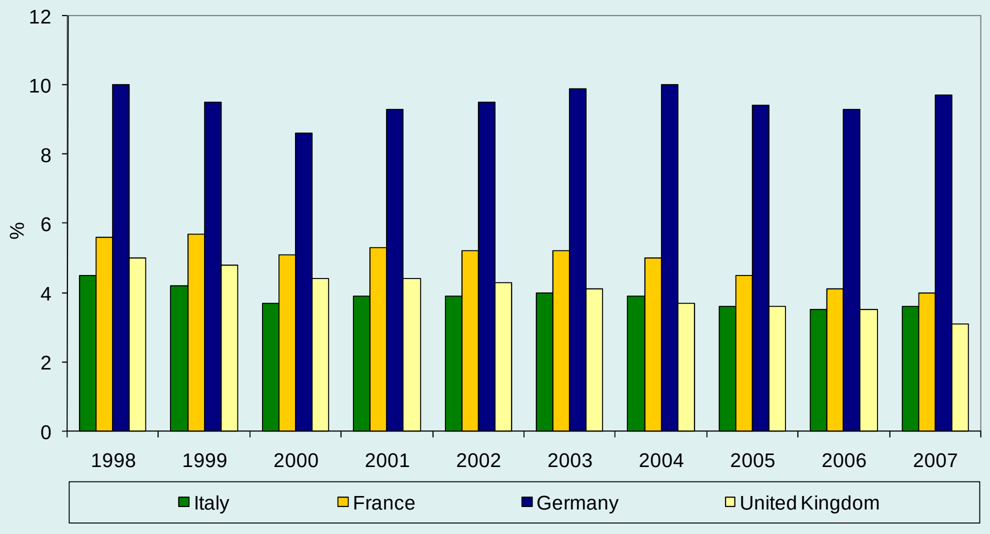


Source: Bank of Italy.

Note: An increase in the real effective exchange rate signals a loss of competitiveness.

Comparison of market shares at current prices since 1998 shows that among the most important European countries, the United Kingdom and France suffered a drop of almost two percentage points, and Italy a 0.9 per cent decline (despite marginal improvement in 2007), whereas Germany's market share remained basically unchanged as against a physiological and strong increase in the market shares of some emerging economies.

FIGURE III.7: MARKET SHARES (percentage change)



Source: ICE-ISTAT, ICE 2007-2008 Report. Data expressed at current prices.

However, recent studies have emphasised that export firms, as opposed to those operating in the domestic market only, reach higher productivity levels, have greater ability to introduce new products and to replace or eliminate less effective products in terms of sales or in-house allocation of resources. Indeed, price competitiveness indicators show a significantly more favourable performance for manufacturing and export firms.

In addition, other non-price factors apparently contributed to maintaining Italian products competitive in international markets. Net of energy products, Italy's trade balance has not worsened in the last few years and even improved in 2007. This competitiveness is borne out by some international trade performance indicators, such as the UNCTAD/WTO *trade performance index,* showing that Italy's industry is highly competitive in international markets.

ITALY'S COMPETITIVENESS IN THE WORLD

According to the Trade Performance Index *(TPI) developed by the '*International Trade Centre *of UNCTAD/WTO*[1] *based on 2006 data Italy ranks second in terms of competitiveness -after Germany- in 14 sectors of world trade*[2]*.*

Italy is the most competitive country in the UNCTAD WTO ranking in three sectors (textile, clothing and leather – leather goods and footwear). It ranks second in four sectors (non-electronic mechanics, electrical mechanics and appliances, basic manufactured goods and miscellaneous products). It ranks sixth in processed foods, including wine production. The country is also one of the most important European exporters of furniture; however, this good performance does not show up in the ranking due to index statistical aggregation.

The Trade Performance Index *shows that the ability of Italy's industry to compete with other countries in world markets is well ahead most advanced economies. Indeed, compared to Italy, France ranks second in vehicles and third in three sectors (chemical industry, processed foods and electronic mechanics), whereas Japan and the United States rank lower, followed by the United Kingdom and Spain.*

The ranking shows Europe's primacy over the US and Asian economies in thirteen out of the fourteen sectors considered. China ranks only second in three sectors (information technology products (IT) and consumer electronics, clothing, leather-leather goods and footwear), despite considerable exports.

[1] Source: Edison Foundation, August 2008. This new competitiveness indicator analyses the performance of 184 countries in terms of export capacity and competitiveness in 14 international trade macrosectors, highlighting gains and losses of market shares and reasons for such changes. The index combines the indices of IMD in Losanne and the *World Economic Forum* which, however, also take into account other general indicators.

[2] The 14 macrosectors considered in the index are: vehicles, non electronic mechanics, chemical industry, manufactured goods, miscellaneous products, electrical mechanics and appliances, IT and consumer electronics, minerals and fuels, processed food, wooden products, farming and fresh foods, textiles, leather and clothing, leather goods and footwear.

Inflation

Based on the performance of imported inputs, in August consumer-price inflation reached 4.1 per cent in Italy (NIC index – the main domestic index for overall national community) whereas producer prices reached 8.3 per cent.

The rapid acceleration phase that started in the last few months of 2007 is mainly due to external pressures coming from energy and food price hikes: the contribution to consumer-price inflation from energy products went up from -0.1 percentage points to 1.1 percentage points from August 2007 to August 2008. Over the same period the contribution from food products increased from 0.4 to 1.1 percentage points.

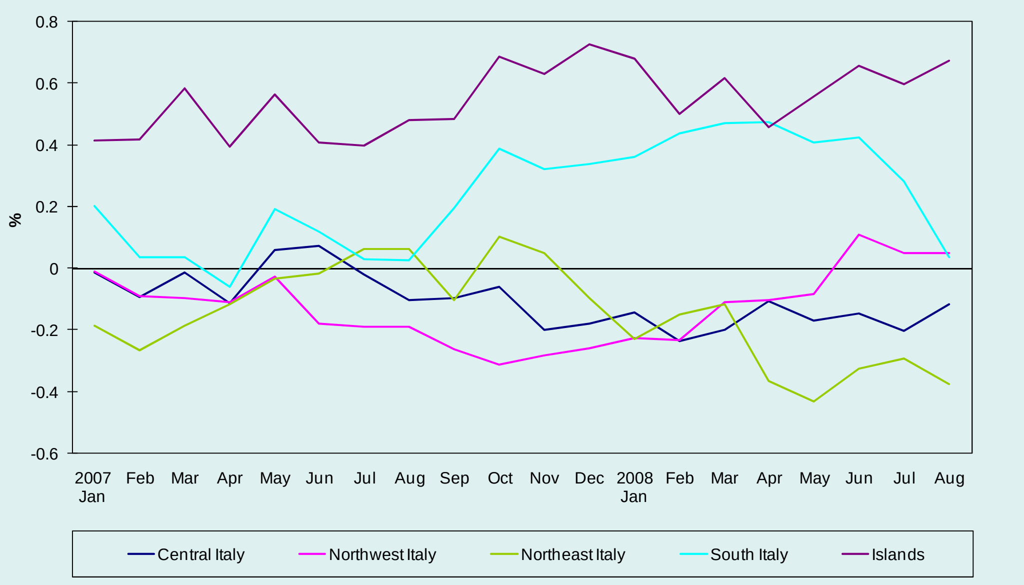
The different path with which of consumer-price inflation, as of the last quarter of 2007, developed in the various regions during the first eight months of 2008 resulted in increasing inflation differentials between groups of regions and the national average.

In the Northeast, Central Italy and the Northwest, consumer inflation in the first eight months of 2008 was lower than the Italian average (3.5 per cent year-on-year) and stood at 3.2 per cent, 3.3 per cent and 3.4 per cent, respectively.

Conversely, on the islands (4.1 per cent) and in the South (3.9 per cent) prices experienced more sustained increases and were constantly above the Italian average. The Regions with the highest inflation levels are all Southern regions and the islands, except for Piedmont.

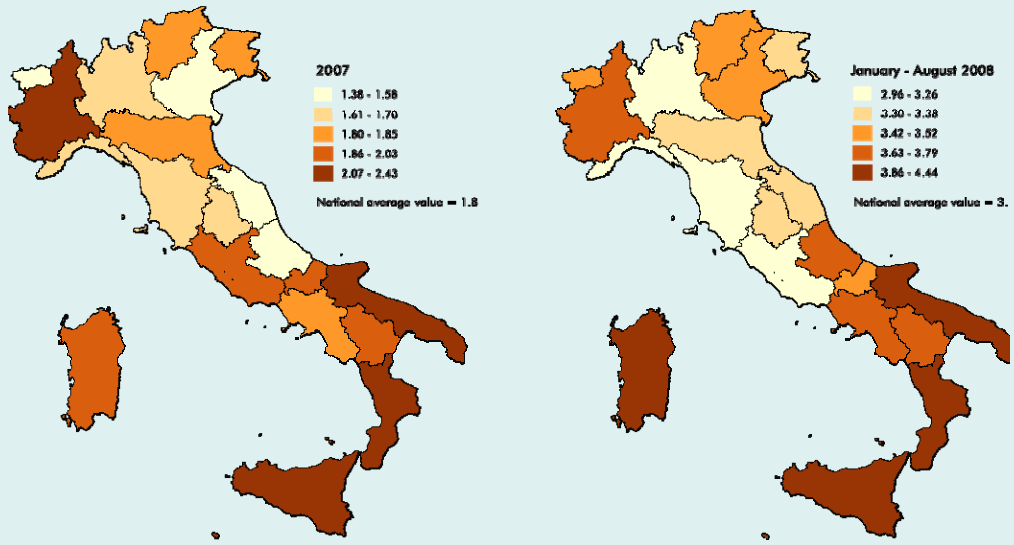
Rising inflation at the regional level is mainly due to energy price hikes. The only exception is the South, where the highest contribution to inflation comes from food price increases.

FIGURE III.8: INFLATION DIFFERENTIALS BY GEOGRAPHICAL AREA – CONSUMER PRICES (year-on-year change on monthly indices; differentials compared to the national average)



Source: Our calculations on ISTAT data.

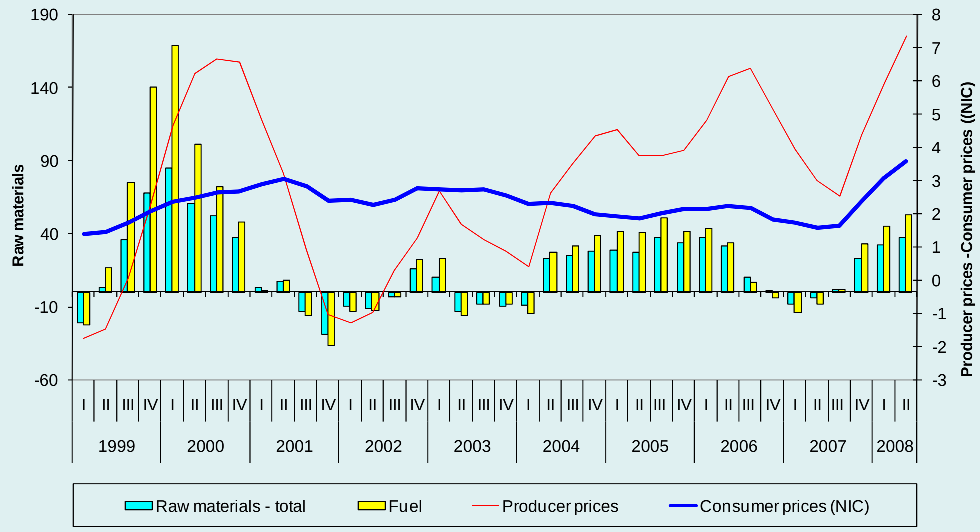
FIGURE III.9: CONSUMER PRICES IN THE ITALIAN REGIONS



Source: Our calculations on ISTAT data.

The trend in the commodity price index expressed in dollars confirms the high impact of fuels and food products, with a cumulative increase of 55.0 per cent in the first eight months, whereas the index increase net of fuels is much smaller (13.6 per cent). The strengthening of the exchange rate caused a smaller rise in the euro index of commodity prices (35.4 per cent in the first eight months; -0.7 per cent when fuels are excluded).

FIGURE III.10: COMMODITY PRICES IN EUROS – PRODUCER PRICES – CONSUMER PRICES (year-on-year change on quarterly indices)



Source: Our calculations on ISTAT data.

The comparison with the euro area, based on the harmonised consumer price index, shows more moderate inflation increases in the first three months of 2008. In the following months the monthly differential rose again, with Italy recording higher inflation.

A comparison between year-on-year growth rates by expenditure items shows that increases in prices for food and non-alcoholic beverages are less sustained compared to the euro-area average as against both Germany and Spain, while they are basically in line with France; conversely, increases in house-related prices are higher than in the euro area and also compared to those in the main European countries. Transport shows price increases below the euro-area and Spanish averages, but above those in France and Germany.

Energy and food prices are still increasing. However, in the last few months pressure has been felt in some services that are especially sensitive to commodity prices (air and sea transport, catering and utilities). Core inflation reached 3.0 per cent in August, 1.3 percentage points more than in August 2007.

In the 'administered' prices aggregate, the 1.6 percentage points of additional inflation accumulated since the beginning of the year have been entirely due to increases in electricity and gas prices, net of which inflation is very low (0.8 per cent) and mainly affected by local tariffs.

TABLE III.2: ADMINISTERED PRICES IN THE NIC BASKET (yearly average percentage change)

		2004	2005	2006	2007	2008 (aug)
TOTAL TARIFFS (net of tobacco products)		0.9	1.5	2.8	0.9	3.3
Of which:	Tariffs administered by Government	0.8	-1.9	-1.4	-2.3	-3.0
	Tariffs administered by Authorities	-1.4	4.2	7.3	1.2	10.1
	Tariffs administered by Local Government	3.8	3.1	3.4	4.8	2.7
	Tobacco products	9.9	8.9	6.3	4.2	5.4
TOTAL DEREGULATED GOODS AND SERVICES		3.4	4.0	2.9	2.1	7.8
Of which:	Unleaded petrol	6.3	9.3	5.5	0.9	10.6
	Heating oil	6.1	16.6	6.6	0.1	26.8
	LPG in bottles	3.5	4.0	7.4	1.7	8.9
	LPG vehicles	-1.3	5.3	14.4	-3.8	11.0
	Diesel oil - vehicles	6.3	18.1	5.3	-0.1	23.8
	Insurance civil liability	0.9	1.7	2.3	1.5	2.3
TOTAL DEREGULATED PRODUCTS NET OF OIL PRODUCTS		2.6	2.0	1.9	2.3	4.6
CONSUMER PRICES – NIC (including tobacco products)		2.2	1.9	2.1	1.8	4.1

Source: Our calculations on ISTAT data.

Price forecasts for 2008 contained in the 2009-2013 DPEF implied lingering tensions in energy and food commodity markets in the first half of the year and a slowdown in the second half. Early in the year, however, pressures were stronger than forecast and the average inflation rate for the NIC index for 2008 was revised up to 3.7 per cent.

For 2009, with a 'technical' assumption of stable crude oil prices at current prices and with a carry-over effect from 2008 of 1.6 per cent, the average inflation rate is estimated at 2.6 per cent.

Regional aspects

Italy's difficult economic situation seems to affect the North and the South to a similar extent. The available indicators point to a weaker labour market in the South, with a negative performance of employment during the year, which lead to weaker purchasing power of consumers and hence a drop in consumption especially of durable goods. However, consumer and business confidence, although it has been on a decreasing trend for over a year, seems to be levelling off according to the latest surveys, while export growth continues at a faster pace than in the rest of the country, also in the aggregate excluding refined oil products. In this context, GDP growth in the South is not expected to be different from the national average either in 2008 or 2009.

III.2 2009-2013 MACROECONOMIC FRAMEWORK

Some exogenous variables underlying the macroeconomic framework, including oil prices and the dollar/euro exchange rate are more favourable compared to those considered in the 2009-2013[3] DPEF, whereas trade and world economic growth are less favourable. Overall, Italy's growth has been revised downward from the June forecasts. GDP growth has been estimated to stand at 0.5 per cent in 2009 (0.9 per cent in the DPEF). Also in the medium-term the forecast is weaker than previously estimated: GDP is expected to grow at a rate slightly above 1 per cent on average.

The Italian economy has been estimated to grow more slowly than the euro area, even though the financial crisis is having a smaller impact on Italy than on other European countries. The weakness of the Italian economy is therefore mainly due to structural factors.

In 2009, domestic demand is expected to make a contribution of 0.5 percentage points (0.1 percentage points accounted for by investment and 0.3 percentage points by household consumption). The contribution of net exports is forecast to be nil.

[3] The macroeconomic framework makes a technical assumption both on the oil price and the euro/dollar exchange rate. For the last four months of 2008 and the following years the oil price and the euro exchange rate are assumed to stay at the average recorded in the two working weeks from 1 to 12 September.

Household consumption is forecast to increase by 0.6 per cent, thus edging up compared to last year. Household spending decisions are believed to be still affected by consumer prices that are expected to remain high on average and partially offset by a sufficiently buoyant labour market. For the subsequent years household consumption is forecast to increase by 1.5 per cent on average.

Investment in equipment and machinery, spurred by brighter demand prospects, is expected to rise by 1.1 per cent. In the medium term, on account of the new buoyancy of exports and world trade, investment in equipment and machinery is expected to increase at rates above 2.0 per cent on average.

Investment in construction is forecast to decline by 0.2 per cent in 2009. Following the end of the residential investment cycle, the growth in the construction sector is forecast to be moderate over the whole period considered.

Next year, export growth in terms of volume is projected to be below that of world trade. However, export firms will slowly regain price competitiveness in the following period, with smaller increases in export deflators (2.0 per cent at the end of the horizon). Imports are forecast to recover due to the most dynamic components of domestic demand.

Considering the improved terms of trade, the trade balance is expected to account for 0.8 per cent of GDP in 2013. By projecting changes in the other balance-of- payment items in line with the latest trends, the current account deficit is forecast to progressively decline to 1.2 per cent of GDP at the end of the period.

As for value added, industry excluding construction is forecast to grow by 0.2 per cent compared to 2008. Construction is forecast to suffer a contraction, whereas services are predicted to grow in line with last year's rates. Even though productivity growth is basically nil, employment growth, measured in terms of full-time equivalent, is still expected to be moderately positive at 0.5 per cent. Private-sector services is the sector recording the highest growth, although it is slowing down compared to 2008.

In the subsequent years employment is estimated to grow by 0.6-0.7 per cent on average. The unemployment rate is forecast to gradually decline from 5.9 per cent in 2009 to 5.5 per cent in 2013.

Taking into account the estimates in the Government's accounts, wages per employee are expected to increase by 2.4 per cent compared to 2008. Combined with flat labour productivity growth, the unit labour cost is forecast to grow by 2.5 per cent.

In the medium term, a moderate increase in nominal wages – of about 2.0 per cent – and a gradual recovery of productivity are expected to curb future increases in unit labour costs and domestic inflation. Consistent with the moderation of external inflationary pressure, inflation measured by the private consumption deflator is expected to be just below 2.0 per cent on average.

TABLE III.3: MACROECONOMIC FRAMEWORK

	2007	2008	2009	2010	2011	2012	2013
EXOGENOUS VARIABLES							
World trade	7.2	5.2	5.1	7.0	7.2	7.2	7.2
Oil prices (Brent FOB dollar/barel)	72.5	109.0	101.0	101.0	101.0	101.0	101
Euro/dollar exchange rate	1.371	1.497	1.428	1.428	1.428	1.428	1.428
ITALY (VOLUMES)							
GDP	1.5	0.1	0.5	0.9	1.2	1.5	1.5
Imports	4.4	-0.8	1.9	3.4	3.9	4.4	4.6
Households consumption	1.4	-0.1	0.5	0.9	1.0	1.5	1.4
- Resident household expenditure	1.4	-0.3	0.6	1.2	1.4	1.6	1.6
- General government and NPISH expenditure	1.3	0.8	0.3	0.0	0.0	1.2	1.0
Gross fixed investment	1.2	-0.1	0.5	0.9	1.5	1.8	2.0
- Machinery. equipment and other items	0.2	0.3	1.1	1.3	1.9	2.5	2.9
- Construction	2.2	-0.5	-0.2	0.5	1.0	1.0	1.0
Exports	5.0	0.7	1.8	3.5	4.0	4.3	4.5
p.m. Current balance of the balance of payments as % of GDP	*-2.4*	*-2.4*	*-2.1*	*-1.8*	*-1.5*	*-1.4*	*-1.2*
CONTRIBUTIONS TO GDP GROWTH (*)							
Net exports	0.1	0.4	0.0	0.0	0.0	0.0	0.0
Stocks	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Domestic demand net of inventories	1.4	-0.2	0.5	0.9	1.2	1.5	1.5
PRICES							
Import deflator	2.3	5.7	2.4	2.0	1.8	1.8	1.8
Export deflator	3.6	4.5	3.2	2.5	2.3	2.0	2.0
GDP deflator	2.3	3.7	2.4	2.0	2.0	1.9	1.9
Nominal GDP	3.8	3.8	2.9	2.9	3.2	3.4	3.5
Consumption deflator	2.2	3.8	2.8	2.0	2.0	1.9	1.9
Inflation (planned)	2.0	1.7	1.5	1.5	1.5	1.5	1.5
EMPLOYMENT							
Labour cost	1.9	4.0	2.4	2.0	2.0	2.1	2.1
Productivity (measured on GDP)	0.5	-0.7	0.0	0.3	0.6	0.9	0.9
ULC (measured on GDP)	1.5	4.7	2.5	1.7	1.4	1.2	1.2
Employment (FTE)	1.0	0.9	0.5	0.6	0.6	0.7	0.7
Unemployment rate	6.1	6.0	5.9	5.8	5.7	5.6	5.5
Employment rate (15-64 age group)	58.7	58.9	59.0	59.2	59.6	60.2	60.8
p.m. Nominal GDP (absolute value in Ml)	*1,535,541*	*1,594,560*	*1,640,242*	*1,687,885*	*1,741,254*	*1,800,558*	*1,863,041*

IV. PUBLIC FINANCE

IV.1 TRENDS FOR 2008

In the 2009-2013 DPEF submitted last June, the Government revised the net borrowing forecast for the current year to 2.5 per cent of GDP to take into account data from the new macroeconomic framework and the latest developments in revenues and expenditure.

The new forecast incorporated both the impact of action to support demand and increase productivity, adopted at the start of this legislature[1], and action to bring forward to 2008 the budget measures for the 2009-2011[2] period. Both actions led to a readjustment of General Government accounts with only modest changes to the final balance.

The new forecast showed an increase of one tenth of a point of GDP and was basically in line with the forecast for 2008 contained in the Combined Report on the Economy and Public Finance (RUEF) published in March, and with the effort to balance the budget which the Government pledged to continue when it was sworn in.

Trends in public accounts in the first eight months of the year resulted in a state sector borrowing requirement of approximately €27.4 billion, with an increase of €2.7 billion over the same period in 2007. On the expenditure side, this trend implies higher debt servicing and the disbursement of advances to the Regional Authorities for the settlement of past health debts as envisaged in the 2008 Budget. The overall trend in borrowing requirements, nonetheless, is in line with forecasts for the whole year.

In the same period, revenues performed well thanks to effective measures to fight tax evasion, which resulted in a notable increase in revenues over 2007. As far as tax revenues are concerned, the buoyancy in direct taxes has partially offset the decline in indirect taxation, linked to the strong slowdown of VAT levied on domestic transactions.

The tracked performance and forecast trends in revenue and expenditure flows expected for the rest of the year warrant confirming General Government net borrowing for 2008 at 2.5 per cent of GDP, in line with the DPEF forecasts.

The estimated balance implies a readjustment in the major aggregates of the account with nominal figures remaining unchanged. The readjustment reflects a €0.7 billion loss of revenues as a result of a €3.6 billion cut in indirect taxes, a €2.3 billion increase in direct taxes and a €0.5 billion increase in social security contributions.

[1] D.L No. 93/2008 confirmed into Law No.126/2008.
[2] D.L No. 112/2008 confirmed into Law No.133/2008.

Following a minor upward revision of nominal GDP, the debt-to-GDP ratio is expected to stand at 103.7 per cent.

TABLE IV.1: GENERAL GOVERNMENT ACCOUNT AT UNCHANGED LEGISLATION – DPEF AND RPP ESTIMATES (€ Mn)

	2007	2008		2009		2010	
	Results	DPEF	RPP	DPEF	RPP	DPEF	RPP
EXPENDITURE							
Employee compensation	164,645	175,082	174,494	179,141	177,790	181,072	179,500
Intermediate consumption	121,460	128,154	128,048	127,550	128,493	128,018	129,672
Welfare benefits	265,284	278,340	278,340	286,995	287,450	296,761	298,370
Of which Pension benefits	214,991	223,810	223,810	232,795	233,240	241,236	242,780
Other welfare benefits	50,293	54,530	54,530	54,200	54,210	55,525	55,590
Other current expenditure net of interest	56,817	59,148	59,277	59,649	60,185	59,341	59,769
Total current expenditure net of interest	608,206	640,724	640,159	653,335	653,918	665,192	667,311
(as % of GDP)	*39.6*	*40.3*	*40.1*	*39.9*	*39.9*	*39.4*	*39.5*
Interest	76,726	79,802	81,133	82,824	83,732	84,777	85,355
(as % of GDP)	*5.0*	*5.0*	*5.1*	*5.1*	*5.1*	*5.0*	*5.1*
Total current expenditure	684,932	720,526	721,292	736,159	737,650	749,969	752,666
Of which Health expenditure	102,290	110,626	110,478	112,736	113,284	115,036	115,436
Total capital expenditure	68,493	63,813	62,881	63,945	64,306	61,763	61,944
Of which Gross fixed investment	36,134	37,637	37,690	36,816	37,672	36,218	37,244
Capital account contributions	24,769	23,690	22,952	24,248	23,549	22,426	21,177
Other transfers	7,590	2,486	2,239	2,881	3,085	3,119	3,523
Total final expenditure net of interest	676,699	704,537	703,040	717,280	718,224	726,955	729,255
Total final expenditure	753,425	784,339	784,173	800,104	801,956	811,732	814,610
REVENUES							
Total tax revenues	459,888	467,843	466,557	482,034	481,101	500,902	499,083
Of which Direct taxes	233,660	244,649	246,957	249,904	253,697	262,844	266,411
Indirect taxes	225,928	222,962	219,368	231,899	227,172	237,827	232,440
Capital account taxes	300	232	232	232	232	232	232
Social security contributions	204,772	214,941	215,438	222,521	223,874	228,707	230,180
Of which Actual contributions	200,911	210,943	211,468	218,477	219,799	224,595	226,034
Imputed contributions	3,861	3,998	3,970	4,044	4,075	4,112	4,146
Other current revenues	55,272	57,072	57,118	58,165	58,202	60,020	59,548
Total current revenues	719,632	739,623	738,881	762,488	762,945	789,397	788,579
Capital account non-tax revenues	4,314	5,349	5,357	4,685	4,709	5,712	5,738
Total final revenues	724,246	745,204	744,470	767,405	767,886	795,341	794,549
p.m. Tax burden	*43.3*	*43.0*	*42.8*	*43.0*	*43.0*	*43.2*	*43.2*
BALANCES							
Primary balance	47,547	40,667	41,430	50,125	49,662	68,386	65,294
(as % of GDP)	*3.1*	*2.6*	*2.6*	*3.1*	*3.0*	*4.0*	*3.9*
Current account balance	34,700	19,097	17,589	26,329	25,295	39,428	35,913
(as % of GDP)	*2.3*	*1.2*	*1.1*	*1.6*	*1.5*	*2.3*	*2.1*
Net borrowing	-29,179	-39,135	-39,703	-32,699	-34,070	-16,391	-20,061
(as % of GDP)	*-1.9*	*-2.5*	*-2.5*	*-2.0*	*-2.1*	*-1.0*	*-1.2*
Nominal GDP	1,535,541	1,588,803	1,594,560	1,637,199	1,640,242	1,689,202	1,687,885

Note: The public finance data do not take into account the reclassification of Equitalia, still being defined.

TABLE IV.1 cont.: GENERAL GOVERNMENT ACCOUNT AT UNCHANGED LEGISLATION, DPEF AND RPP ESTIMATES (€ Mn)

	2011		2012		2013	
	DPEF	RPP	DPEF	RPP	DPEF	RPP
EXPENDITURE						
Employee compensation	182,948	181,433	186,247	184,065	189,322	187,057
Intermediate consumption	127,832	130,531	133,371	135,643	137,763	140,354
Welfare benefits	307,328	308,940	317,338	318,950	329,669	331,280
Of which Pension benefits	249,248	250,790	257,738	259,280	267,529	269,070
Other welfare benefits	58,080	58,150	59,600	59,670	62,140	62,210
Other current expenditure net of interest	59,470	59,719	60,372	60,346	60,964	60,963
Total current expenditure net of interest	677,578	680,623	697,328	699,004	717,718	719,654
(as % of GDP)	*38.9*	*39.1*	*38.8*	*38.8*	*38.6*	*38.6*
Interest	86,583	86,667	88,434	88,094	90,638	89,589
(as % of GDP)	*5.0*	*5.0*	*4.9*	*4.9*	*4.9*	*4.8*
Total current expenditure	764,161	767,290	785,762	787,098	808,356	809,243
Of which Health expenditure	118,685	119,085	123,185	123,185	127,945	127,945
Total capital expenditure	56,702	55,725	57,135	56,588	57,343	57,218
Of which Gross fixed investment	34,552	36,568	35,165	37,399	35,524	37,943
Capital account contributions	20,338	16,343	20,029	16,244	20,067	16,515
Other transfers	1,812	2,814	1,941	2,945	1,752	2,760
Total final expenditure net of interest	734,280	736,348	754,463	755,592	775,061	776,872
Total final expenditure	820,863	823,015	842,897	843,686	865,699	866,461
REVENUES						
Total tax revenues	516,899	513,921	533,872	530,826	550,663	548,503
Of which Direct taxes	272,487	276,635	283,136	287,441	293,037	298,114
Indirect taxes	244,180	237,054	250,504	243,153	257,394	250,157
Capital account taxes	232	232	232	232	232	232
Social security contributions	235,208	236,410	241,206	242,201	248,061	249,107
Of which Actual contributions	231,023	232,185	236,951	237,900	243,736	244,727
Imputed contributions	4,185	4,225	4,255	4,301	4,325	4,380
Other current revenues	61,483	61,124	62,929	63,024	64,373	64,348
Total current revenues	813,358	811,223	837,775	835,819	862,865	861,726
Capital account non-tax revenues	5,743	5,775	5,286	5,324	5,325	5,365
Total final revenues	819,333	817,230	843,293	841,375	868,422	867,323
p.m. Tax burden	*43.2*	*43.1*	*43.1*	*42.9*	*43.0*	*42.8*
BALANCES						
Primary balance	85,053	80,882	88,830	85,783	93,361	90,451
(as % of GDP)	*4.9*	*4.6*	*4.9*	*4.8*	*5.0*	*4.9*
Current balance	49,197	43,933	52,013	48,721	54,509	52,483
(as of GDP)	*2.8*	*2.5*	*2.9*	*2.7*	*2.9*	*2.8*
Net borrowing	-1,530	-5,785	396	-2,311	2,723	862
(as % of GDP)	*-0.1*	*-0.3*	*0.0*	*-0.1*	*0.1*	*0.0*
Nominal GDP	1,742,139	1,741,254	1,799,075	1,800,558	1,858,870	1,863,041

Note: The public finance data do not take into account the re classification of Equitalia, still being defined.

IV.2 BUDGET MEASURES FOR THE NEXT THREE-YEAR PERIOD

The budget strategy adopted by the Government with the 2009-2013 DPEF is strongly innovative in terms of timeframe and content.

In line with the need to stabilise public finances, the budget measures for the 2009-2011 period, which were adopted before the summer break, for the first time ensure full convergence of planning and implementation (based on the unchanged legislation) and represent an important step forward as far as fiscal governance is concerned.

By bringing forward the typical impact of the Budget, these measures[3] free up €36.7 billion (through higher revenues and lower expenditure) allotting a large portion (84% of the total when all measures are fully implemented) to fiscal consolidation.

The measures involve an ever increasing adjustment in the 2009-2011 period reaching a net impact of €30.9 billion: the net adjustment of the primary surplus accounts for 0.6 per cent of GDP in 2009 and then edges up to 1.0 per cent in 2010, reaching 1.8 per cent in 2011.

In 2009, a similar contribution to the adjustment of net borrowing comes from net revenues and net expenditure, accounting for 47 and 53 per cent of the overall adjustment, respectively. The contribution of net expenditure becomes more substantial in the years 2010 and 2011, when the net cut in spending accounts for over 70 and 82 per cent, respectively, of the adjustment in the fiscal balance.

Net borrowing declines as a result of a net yearly increase in revenues equal to 0.3 per cent of GDP and of a net cut in expenditures growing from 0.3 per cent in 2009 to 1.5 per cent of GDP in 2011.

TABLE IV.2: IMPACT OF BUDGET MEASURES OVER THE 2009-2011 PERIOD (cumulative figure)

	2008	2009	2010	2011	2008	2009	2010	2011
		(€ Mn)				(as percentage of GDP)		
Higher revenues	2,248	5,765	5,516	6,103	0.14	0.35	0.33	0.35
Lower expenditure	337	1,103	555	580	0.02	0.07	0.03	0.03
NET REVENUE INCREASE	1,911	4,662	4,961	5,523	0.12	0.28	0.29	0.32
Lower expenditure	329	11,332	17,446	30,624	0.02	0.69	1.03	1.76
current	329	8,923	13,776	22.050	0.02	0.55	0.82	1.27
capital		2,409	3,670	8.574		0.15	0.22	0.49
Higher revenues	1,902	6,101	5,270	5,222	0.12	0.37	0.31	0.30
current	1,789	5,182	5,003	4.978	0.11	0.32	0.30	0.29
capital	113	919	267	244	0.01	0.06	0.02	0.01
NET EXPENDITURE CUT	-1,573	5,231	12,177	25,402	-0.10	0.32	0.72	1.46
NET BORROWING ADJUSTMENT	338	9,893	17,138	30,925	0.02	0.60	1.01	1.78

[3] The regulatory instrument through which the Government is implementing the adjustment of public accounts is Decree Law No.112/2008, confirmed into Law No.133/2008.

Higher revenues mainly come from action taken in banking and insurance through measures that readjust the taxable base of banks and insurance companies and from action on energy companies. Additional measures are aimed at: (i) intensifying the fight against tax evasion and the shadow economy through a 10 per cent increase (over the 2007-2008 period) in staff fighting tax evasion; (ii) the development of an extraordinary inspection plan, also through the involvement of municipal authorities; (iii) rules to fight tax evasion by identifying bogus foreign residents; (iv) checks on taxes and social-security contributions owed by non-EU and non-resident individuals; and (v) gradually increasing implementation over the three-year period of tax assessment through acceptance of ascertainment records also to partial income assessments. Other measures concern the increase in Government mining rights, the harmonisation of tax regimes for cooperatives, and the elimination of tax breaks for stock-options.

Lower revenues are mainly due to the authorization of the Fund for the extension of tax breaks. In addition, action taken on the revenue side takes into account the introduction of VAT deductions on hotel services.

On the expenditure side, action is mainly focused on curbing current primary expenditure totalling about 79 per cent a year of total expenditure cuts in the years 2009 and 2010 and by 72 per cent in 2011.

The reduction in expenditure is the result of a pre-emptive cap to curb spending increases through the leeway afforded by the new budget, based on missions and programmes[4]. Further initiatives focus on curbing expenditure in the following sectors: civil service, decentralised finance, health and social security.

In the civil service, lower expenditure[5], with an ever growing financial impact over the three-year period, results from (i) the reorganisation of the recruitment system, with the introduction of stricter limits on hiring new staff, and a new organisation for research studies and professional advice, in line with the enhancement of in-house skills, as well as (ii) staff downsizing in public schools consistent with reducing the gap in the average student/teacher ratio vis-à-vis other countries.

Action on decentralised finance envisages savings linked to the renegotiation of the Internal Stability Pact for the 2009-2011 three-year period, as part of a reorganisation of financial relations between central and local government. Savings will be achieved by setting targets in terms of cutting the balances at unchanged legislation for Provincial and Municipal Authorities and in terms of caps on overall final expenditure growth for the Regional Authorities. Moreover, sanctions have been envisaged in case of failure to meet the targets, as well as rewards for virtuous local government authorities and rules to limit the use of derivatives.

[4] This tool combines with other flexibility elements already envisaged by law and allows the gradual introduction of benefits achieved through both the spending review process and the possibility of readjusting allocated funds among different programmes included in each expenditure mission. This flexibility is further strengthened by Decree Law No. 112/2008 which enables action to be taken on the existing legislation when urgent measures are needed through Decrees of the Minister of the Economy and Finance upon proposal by the relevant Minister.

[5] These measures complement the basic principles underlying the “Business Plan” of the Minister of Public Administration and innovation aimed at promoting meritocracy, reward mechanisms and accountability.

TABLE IV.3: IMPACT OF BUDGET MEASURES OVER THE 2009-2011 PERIOD (sectoral breakdown, cumulative figure)

	2008	2009	2010	2011	2008	2009	2010	2011
	(€ Mn)				(as percentage of GDP)			
FREEING UP FUNDS	2,577	17,097	22,962	36,727	0.16	1.04	1.36	2.11
Higher revenues	2,248	5,765	5,516	6,103	0.14	0.35	0.33	0.35
Energy companies		*2,395*	*1,323*	*1,331*		*0.15*	*0.08*	*0.08*
Banking and Insurance sectors	*2,134*	*2,522*	*3,099*	*2,494*	*0.13*	*0.15*	*0.18*	*0.14*
Tax collection and figth against tax evasion	*50*	*513*	*793*	*1,953*	*0.00*	*0.03*	*0.05*	*0.11*
Others	*64*	*335*	*301*	*325*	*0.00*	*0.02*	*0.02*	*0.02*
Lower expenditure	329	11,332	17,446	30,624	0.02	0.69	1.03	1.76
Lower current expenditure	329	8,923	13,776	22,050	0.02	0.54	0.82	1.27
Employee compensation (net of revenue-driven effects)	*20*	*829*	*1,336*	*1,874*	*0.00*	*0.05*	*0.08*	*0.11*
Decentralised finance (Internal stability pact and other rationalisation measures)		*3,430*	*5,480*	*9,480*		*0.21*	*0.32*	*0.54*
Health expenditure		*357*	*2,351*	*3,344*		*0.02*	*0.14*	*0.19*
Social security		*247*	*267*	*295*		*0.02*	*0.02*	*0.02*
Cuts in spending missions		*3,049*	*3,532*	*6,328*		*0.19*	*0.21*	*0.36*
Others	*309*	*1,011*	*811*	*729*	*0.02*	*0.06*	*0.05*	*0.04*
Lower capital expenditure		2,409	3,670	8,574		0.15	0.22	0.49
Cuts in spending missions		*2,280*	*3,616*	*8,574*		*0.14*	*0.21*	*0.49*
Others		*129*	*54*			*0.01*	*0.00*	
USE OF FUNDS	2,239	7,204	5,825	5,802	0.14	0.44	0.35	0.33
Lower revenues	337	1,103	555	580	0.02	0.07	0.03	0.03
Tax-breaks extension fund		*900*	*500*	*500*		*0.05*	*0.03*	*0.03*
VAT deduction on hotel services	*168*	*147*	*-80*	*-17*	*0.01*	*0.01*	*0.00*	*0.00*
Others	*169*	*56*	*135*	*97*	*0.01*	*0.00*	*0.01*	*0.01*
Higher expenditure	1,902	6,101	5,270	5,222	0.12	0.37	0.31	0.30
Higher current expenditure	1,789	5,182	5,003	4,978	0.11	0.32	0.30	0.29
Employee compensation (net of revenue-driven effects)		*1,984*	*1,984*	*1,984*		*0.12*	*0.12*	*0.11*
Health expenditure		*834*	*834*	*834*		*0.05*	*0.05*	*0.05*
Social security		*410*	*415*	*420*		*0.02*	*0.02*	*0.02*
Measures to State-owned companies and public entities	*613*	*453*	*453*	*450*	*0.04*	*0.03*	*0.03*	*0.03*
Social measures	*170*	*300*			*0.01*	*0.02*		
Supplementary bargaining and security fund		*260*	*100*	*100*		*0.02*	*0.01*	*0.01*
Economic-policy structural intervention fund	*669*	*599*	*615*	*603*	*0.04*	*0.04*	*0.04*	*0.03*
Others	*338*	*342*	*602*	*587*	*0.02*	*0.02*	*0.04*	*0.03*
Higher capital expenditure	113	919	267	244	0.01	0.06	0.02	0.01
Employment fund		*700*				*0.04*		
Local transport fund	*80*	*100*	*110*	*120*	*0.01*	*0.01*	*0.01*	*0.01*
Others	*33*	*119*	*157*	*124*	*0.00*	*0.01*	*0.01*	*0.01*
IMPACT OF BUDGET MEASURES ON PRIMARY BALANCE	338	9,893	17,138	30,925	0.02	0.60	1.02	1.78

In the health sector, an increase in savings is expected over the three-year period. However, the Regional Authorities shall determine how these savings are to be achieved through an agreement with the Government and without prejudice to the implementation of spending cut plans. Failure to meet the targets will result in an adjustment of regional surcharge rates. Further measures to rationalise costs concern the payments to health-care private facilities with a special agreement with the State, strengthening the system to check entitlement to exemption from payment and the adequacy of the provision of health care.

As for welfare benefits, action includes lower spending on civil disability pensions through an extraordinary plan to verify eligibility.

Higher current expenditure is mainly the result of: (i) action taken in the civil service, (ii) the health-care burdens due to the elimination of the fixed charge to cover specialist health-care costs[6] over the 2009-2011 period, (iii) welfare provisions, whereby earning income from employment or self-employment while at the same time drawing pension benefits is no longer prohibited, and (iv) changes to the economic-policy structural intervention fund as well as changes in favour of socially useful companies or entities. Higher capital expenditure is due to the increase for 2009 in expenditure authorized for the employment fund and the establishment of the fund to foster and support local public transport.

The budget measures for the three-year period also envisage action on funds earmarked to reduce the regional divide and their allocation predicated on efficiency and effectiveness criteria, by focusing public development funds on some sectors (such as infrastructure, research and energy) and on some major programmes. In addition to strategically focussing the resources still available for the 2000-2006 planning period in the Fund for Underutilised Areas, a new Fund has been created at the Ministry for Economic Development which is partly financed through the funds appropriated to implement key national infrastructural programmes during the 2007-2013 planning period.

To bring the education and training system of the South into line with the best international standards, the Education Programme of the 2007-2013 National Strategic Framework will be used. Additional funds will be allotted to Innovation and Research policies in the weakest areas.

Moreover, in order to increase the quality of services provided in the South, the 2007-2013 National Strategic Framework sets specific targets for the Regional Authorities, such as the use of incentives and rewards for the most efficient local government authorities in the following fields: quality of education, child care and elderly care services, waste management and integrated water management.

IV.3 2009-2013 PUBLIC FINANCE FRAMEWORK

The public finance framework outlined in the 2009-2013 DPEF basically confirms Italy’s EU commitments to achieve a balanced budget by 2011.

The Update Note, submitted along with this Report, reviews the framework on the basis of track records of General Government revenue and expenditure trends to take into account: (i) the impact of lower GDP growth forecast for 2008 on public accounts, (ii) a more accurate apportionment of budget measures among the various economic aggregates of the General Government account, (iii) the changes to the budget measures introduced when implementation decrees were confirmed into law, and (iv) changes in interest rates. However, the changes that have been made are smaller than those in previous forecasts.

In line with the new estimates, net borrowing for 2009 is expected to be 2.1 per cent of GDP. The upward revision of a tenth of a point is due to a moderate increase in

[6] For 2008 the percent charge was eliminated by the 2008 Budget.

expenditure, which is only partly offset by the revenue trend. The new revenue forecasts imply a readjustment of taxation: lower revenues from taxes, caused by lower indirect taxes, are more than offset by a stronger increase in social security contributions compared to previous estimates. Estimates of tax revenues incorporate a baseline GDP elasticity of approximately 1.1 per cent for 2009 and 0.96 per cent for 2010. These figures reflect the trend forecast in the macroeconomic framework and take into account the differential impact on revenues of (i) all budget measures, including past ones, and (ii) one-off measures.

On the expenditure side, higher debt servicing is offset by spending cuts.

TABLE IV.4: PUBLIC FINANCE INDICATORS AT UNCHANGED LEGISLATION (as percentage of GDP) [1]

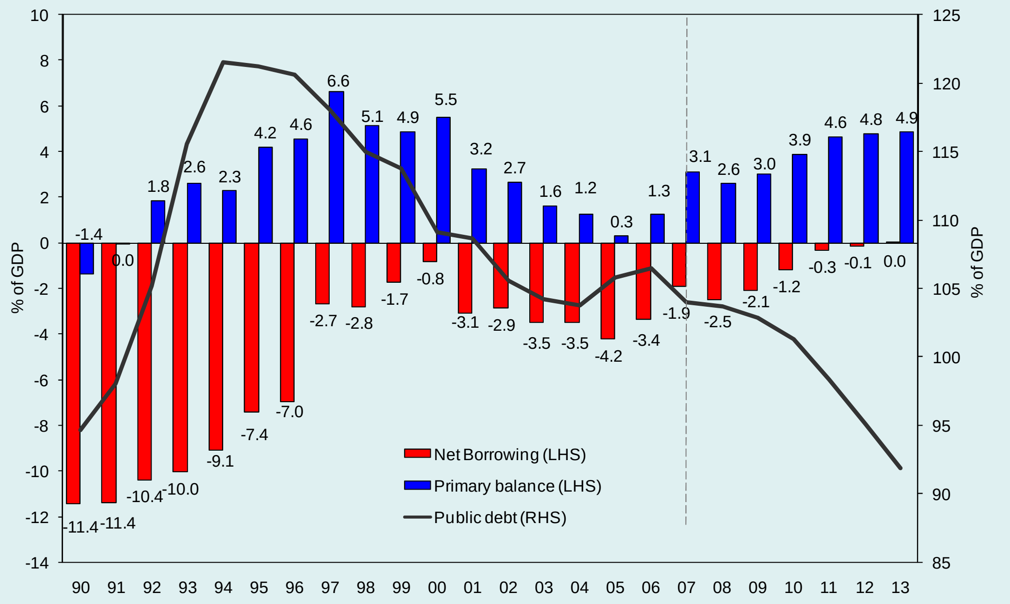
	2007	2008	2009	2010	2011	2012	2013
Net borrowing	-1.9	-2.5	-2.1	-1.2	-0.3	-0.1	0.0
Interest	5.0	5.1	5.1	5.1	5.0	4.9	4.8
Current balance (2)	7.3	6.2	6.6	7.2	7.5	7.6	7.6
Primary surplus	3.1	2.6	3.0	3.9	4.6	4.8	4.9
Public debt	104.0	103.7	102.9	101.3	98.4	95.1	91.9
State sector borrowing requirement	-1.9	-2.9	-1.4	-0.6	0.5	0.8	0.9
Public sector borrowing requirement	-2.3	-2.9	-1.8	-1.0	0.1	0.4	0.5

1) Data do not take into account the reclassification by Equitalia, still being defined.
2) Net of interest.

For the subsequent years the new estimates are consistent with the commitment to continue the consolidation effort. Net borrowing is reduced to 1.2 per cent of GDP in 2010, allowing the achievement of the goal of balancing the budget by 2011. The primary surplus increases steadily from 3.9 per cent of GDP in 2010 to 4.9 per cent in 2013. Interest as a proportion of GDP goes down from 5.1 per cent in 2010 to 4.8 per cent in 2013.

The debt-to-GDP ratio is expected to decline gradually to below 100 per cent in 2011, as stated in the DPEF, reaching 91.9 per cent in 2013.

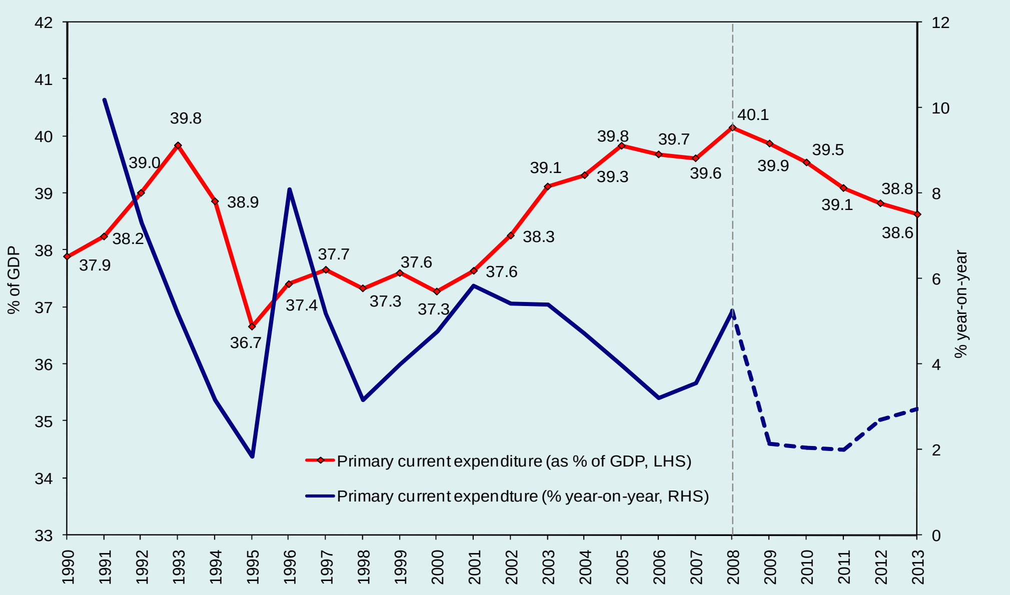
FIGURE IV.1: PUBLIC FINANCE BALANCES AT UNCHANGED LEGISLATION (as percentage of GDP)



The trend outlined above benefits from the initiatives taken with the 2009-2011 budget measures aimed at improving the quality of spending.

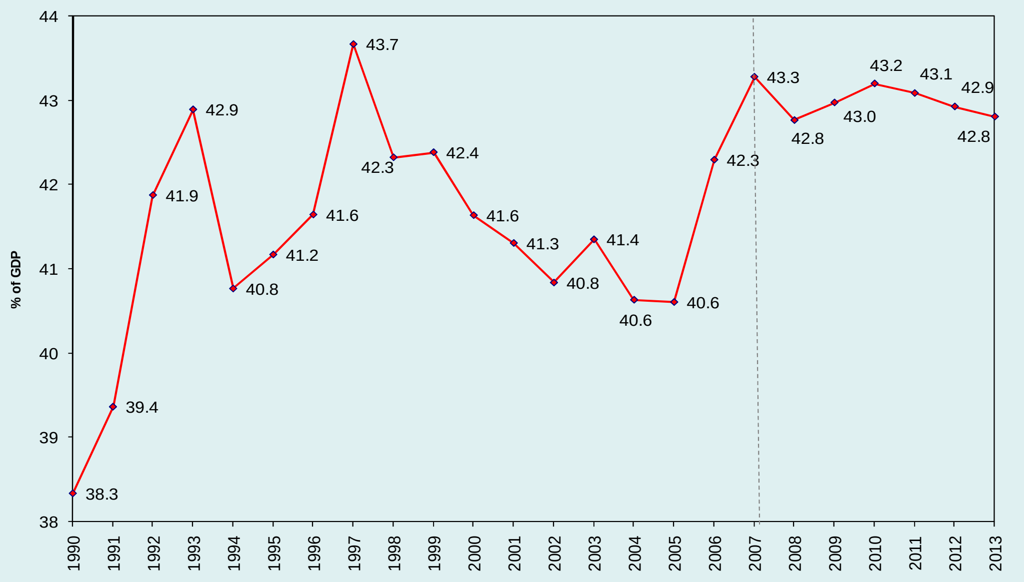
From 2008 to 2013 through increased rationalisation, the incidence of current primary expenditure gradually decreases from 40.1 per cent of GDP to 38.6 per cent of GDP. The rate of change slow down notably in the 2009-2013 five year period, with an average yearly increase of 2.4 per cent in nominal terms as against the average yearly increase of 4.4 per cent recorded in the 2007-2008 period.

FIGURE IV.2: PRIMARY CURRENT EXPENDITURE (as percentage of GDP, year-on-year percentage change)



In line with the medium-term goal, the tax burden is expected to be 43.1 per cent on average over the 2009-2011 period and to go down to 42.8 per cent in 2013.

FIGURE IV.3: TAX BURDEN (as percentage of GDP)



In structural terms, the budget balance in 2008 is expected to worsen by 0.2 percentage points compared to DPEF, as a result of a lower output gap and additional one-off measures. The consolidation effort resumes as of 2009, in line with the European rules for the annual structural adjustment. After a temporary increase, the cyclically-adjusted structural deficit net of one-off measures gradually declines. In the 2008-2011 four-year period, the overall adjustment amounts to more than two percentage points thus ensuring convergence towards the medium-term goal of a balanced budget.

TABLE IV.5: CYCLICALLY- ADJUSTED AND NET OF ONE-OFF MEASURES CHANGE IN NET BORROWING

	2007	2008	2009	2010	2011	2012	2013
Real GDP growth	1.5	0.1	0.5	0.9	1.2	1.5	1.5
Potential GDP growth	1.3	0.9	0.9	1.3	1.2	1.1	1.2
Output gap	0.4	-0.3	-0.8	-1.1	-1.1	-0.7	-0.4
Cyclical component	0.2	-0.2	-0.4	-0.5	-0.5	-0.3	-0.2
Net borrowing	-1.9	-2.5	-2.1	-1.2	-0.3	-0.1	0.0
Cyclically adjusted net borrowing	-2.1	-2.3	-1.7	-0.6	0.2	0.2	0.2
Cyclically adjusted primary surplus	2.9	2.8	3.4	4.4	5.2	5.1	5.0
One-off measures	-0.2	0.2	0.1	0.1	0.0	0.1	0.1
Budget balance net of one-off measures	-1.7	-2.7	-2.1	-1.2	-0.4	-0.2	0.0
Cyclically adjusted and net of one-off measures budget balance	-1.9	-2.5	-1.8	-0.7	0.2	0.2	0.2
Cyclically adjusted and net of one-off measures primary surplus	3.1	2.6	3.4	4.4	5.2	5.1	5.0
Budget balance change net of one-off measures	-1.3	1.0	-0.6	-0.9	-0.9	-0.2	-0.2
Cyclically adjusted and net of one-off measures budget balance change	-1.2	0.6	-0.8	-1.1	-0.9	0.0	0.0

Note: For the years 2010-2013 the working-age population has been calculated on the basis of European Commission data for 2009 and by applying from that year onwards a rate of growth calculated on the basis of ISTAT population projections (2007-2051). The reduction in potential growth recorded between 2010 and 2012 is due to the strongly decreasing trend in the working- age population which reduces the contribution to growth from labour. The drop in the working-age population is inferred from currently available ISTAT population forecasts.
Public finance data do not take into account the reclassification by Equitalia, still underway.

FIGURE IV.4: CYCLICALLY-ADJUSTED AND NET OF ONE-OFF- MEASURES BALANCE (cumulative change)