

EDITORIAL

A FEW RISER DRIVEN BY OIL

INFLATION CLOSE TO A TURNING POINT: 2006 AVERAGE OF 2.2%

Inflation in Italy has remained steady at a little over 2% in the first half of 2006. It is the result of a balance of forces in which disinflationary trends attributable to the prices of a few core mass consumption components such as clothing, footwear and electrical domestic appliances are offset by pressure from energy tariffs, transport services and local tariffs.

These are months in which prices upstream from consumption are changing rapidly: producer inflation has exceeded 5% and the direct impact of the oil price shock is completing its course. Increases in the energy component today are mainly affecting electricity and gas prices which are fuelling further pressure on company costs.

The failure of inflation to react to rises in crude oil and other raw material prices last year was favoured by the weak pricing power of companies both because of consumer demand which hardly flourished and the competition suffered on the domestic market from products from emerging countries. Inflation was contained right from the first stages of the commercialisation process and increases in production costs were absorbed by narrower profit margins.

The first signs of a weather change are being observed in this respect. The improvement in the economic situation, the result of a recovery in consumption is creating the conditions for increased production costs to spill over into price increases and a recovery of profit margins.

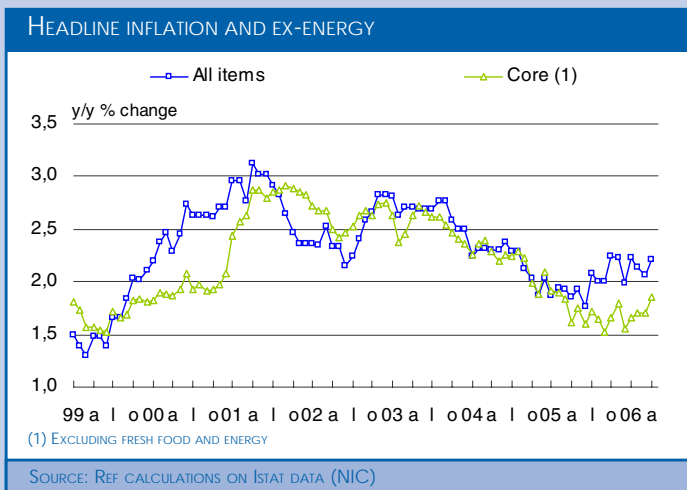
The change is already visible in the producer prices of consumer goods. The past increases in the prices of energy and intermediate products are already rising again and affecting the distribution chain: producer prices of end consumer goods have recently accelerated, especially with regard to the durable goods component. It seems that a path of a gradual rise in consumer inflation is being followed in the non energy industrial goods market.

The forecast for average inflation in 2006 is 2.2%.

The major question marks today concern next year when the effects of the indirect impact of the oil price shock will be complete. The risks include not only tariff recoveries, but also a possible increase in VAT rates as a potential way of covering intervention to reduce the tax wedge.

This is why the most accredited scenario for 2007 is one of inflation accelerating

to 2.3%, although much depends on where crude oil prices will level off. One of the alternative inflation scenarios, less probable but not without foundation, is that of a fall in oil prices below 50 dollars per barrel and a sharp depreciation of the dollar connected with a slowdown in the US economy.

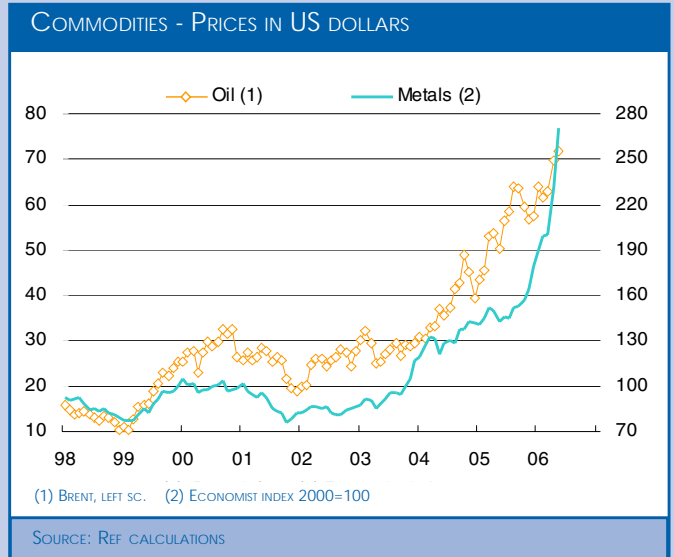




INTERNATIONAL PRICES MODERATE INFLATION DESPITE EXPENSIVE RAW MATERIALS

The path followed by the international economy was one of more solid growth than the forecasts anticipated in the first half of 2006. One consequence of sustained growth was the intense reaction of raw materials markets which over reacted to increases in demand.

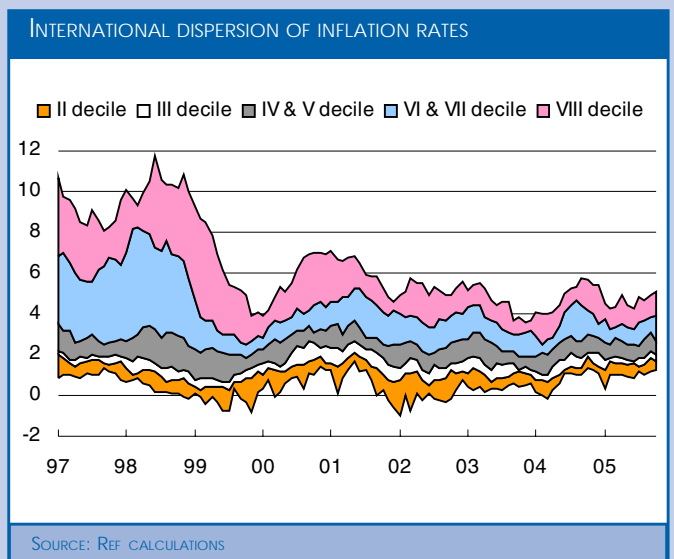
One characteristic of the present cycle is that the increases in raw materials costs have so far mainly affected the energy components of prices. European producer prices are increasing today at rates of 5% annually and to a large extent reflect the rate of growth in the energy component. However, the initial pressure is starting to be transmitted along the supply chain: the producer prices of end consumer goods are on a path of slight acceleration close to an annual growth rate of 1.5%. And while European consumer inflation seems to be stable in a range of between



2.2% and 2.5%, although the growth rate for the prices non energy goods is still increasing at very low rates, it has started to accelerate.

SPECIAL FOCUS INTERNATIONAL INFLATION: CONVERGING DOWNWARDS

International consumer prices have moved along a common path of progressive deceleration over the last twenty years. There has been a process in which inflation differences have reduced permitting convergence of the prices of countries with high inflation on those of low inflation. One of the determining factors in this downwards convergence has been the change in the conduct of monetary policy at international level which has become more attentive to inflation. In many cases central banks have gained credibility in reducing inflation by pegging to strong currencies and thereby basically losing autonomy in the conduct of monetary policy. Another important factor that is playing a role in keeping inflation rates down is the effect of globalisation and increased



international competition, which is pushing the prices of manufactured goods down.

DOMESTIC PRICES

OIL IS STARTING TO FAN THE FLAMES OF CONSUMER INFLATION

The first half of 2006 is coming to an end. Even though oil prices show no signs of falling, consumer inflation has not recorded any acceleration so far. The direct impact of oil increases is complete with the increase in energy tariffs and now the indirect impact is approaching leading to higher producer costs, the prelude to subsequent increases in consumer prices. The core components of consumer inflation have included four important phenomena recently: a recovery of packaged food prices, prices in the non food market passing the bottom of the inflation curve and the acceleration of transport services and local tariffs. Net of fresh fish and fruit and vegetables, the most volatile components of the foodstuffs basket, consumer foodstuff inflation has accelerated from 0.8% year-on-year in December to 1.6% in April. Inflation in the non foodstuff goods market is on a path of weak recovery: the year-on-year rate in April was 1.2% compared to 1.1% in December. Increases in transport services were driven by air flight tariffs which incorporated increases in fuel costs. The start of 2006 also brought with it a new boost in local tariffs which returned to year-on-year growth rates of higher than 3%: the highest of these were for solid urban waste disposal and water utility costs with annual increases of more than 5%; local public transport tariffs also accelerated. Generally speaking core inflation is still lower than 2% but the bottom of the curve has been passed.

ITALY: BREAKDOWN OF INFLATION

ANNUAL % CHANGE				
	Avg. 2004	Avg. 2005	Dec.05/ Dec.04	Apr.06/ Apr.05
Food	2,2	0,1	0,9	1,0
Processed food	2,3	0,8	0,8	1,6
Fish and seafood	1,6	1,2	3,8	4,6
Fruit and vegetables	2,0	-3,8	0,3	-3,8
Industrial goods	0,8	0,9	1,1	1,2
Medical products	1,7	1,3	0,7	0,4
Clothing	2,2	1,5	1,3	1,3
Footwear	1,8	1,5	1,3	1,1
Furniture and furnishings	2,2	2,3	2,1	2,0
Household appliances	-0,3	-0,9	-0,9	-1,0
Radio, Tv, etc.	-13,3	-11,6	-9,7	-7,8
Photog. equip., optical instr.	1,4	0,7	0,5	0,9
Household goods	1,7	1,0	1,0	1,2
Tools and equip. for house	2,6	2,3	2,0	1,9
Products for personal care	1,8	0,5	0,3	0,5
Newspapers, books	2,0	1,5	1,3	1,6
CD, magnetic tape	0,6	0,1	0,2	0,6
Games, toys, sport equip.	1,0	0,7	0,4	0,3
Miscellaneous goods	2,6	2,6	5,3	8,2
Motor cars and access.	-0,1	2,2	2,5	1,7
Energy	2,4	8,9	9,3	9,5
Heating oil and fuels	5,8	10,8	8,8	8,2
Electricity and gas	-1,7	6,4	9,8	11,3
Services	3,3	2,9	2,2	2,5
Personal care, recreation	2,2	1,8	1,5	1,5
Housing	2,7	2,6	2,3	2,3
Transport	4,9	4,7	2,1	4,8
Health	2,9	2,0	2,0	2,3
Financial and n.e.c.	2,9	3,9	3,8	2,0
Restaurants and hotels	3,4	2,6	2,3	2,2
Regulated prices	1,5	0,0	1,3	1,0
Nationally	0,6	-1,4	0,4	-0,4
Locally	3,1	2,4	2,7	3,2
Rents	2,8	2,4	2,4	2,5
Tobacco	9,8	8,9	3,2	6,6
All-items	2,2	1,9	2,0	2,2

SOURCE: REF CALCULATIONS ON ISTAT DATA (NIC)



FORECASTS

INFLATION: THE RISKS NOW ARE OF INCREASES

Inflation has been stable at a little more than 2% for almost a year. Our country is going through a transitory phase in which the factors that determine inflation tend to balance each other. In the future, however, the balance of forces and the consequent risk of inflation seems to move upwards. The change of direction will be led by the increase in consumer demand which will allow companies to unload a part of past increases onto costs. The forecast for average inflation in 2006 is 2.2%.

The major question marks today concern next year. The risks include not only tariff recoveries, but also a possible increase in VAT rates as a potential way of covering intervention to reduce the tax wedge.

INFLATION IN ITALY: HISTORICAL DATA AND FORECASTS

ANNUAL % CHANGE

	2003	2004	2005	2006
	Avg	Avg	Apr	Avg (*)

Producer prices: final consumer goods

Food products ⁽¹⁾	3,0	0,9	-0,3	1,4	1,2
Non-food products	1,1	0,9	1,1	1,5	1,7
<i>Consumer goods</i>	1,7	1,0	0,6	1,5	1,5

Consumer prices (NIC)

Food	3,2	2,2	0,1	1,0	1,1
- ex fresh food	2,6	2,3	0,8	1,6	1,8
Non-energy industrial	1,8	0,9	0,9	1,2	1,3
Energy ⁽²⁾	3,1	2,4	8,9	9,5	8,1
Services	3,6	3,3	2,9	2,5	2,3
Admistrd prices ⁽³⁾	0,2	1,5	0,0	1,0	1,2
Rents	2,7	2,7	2,4	2,5	2,5
<i>All-items</i>	2,7	2,2	1,9	2,2	2,2

(*) FORECASTS

(1) EXCLUSIVE OF TOBACCO AND FRESH FOOD

(2) INCLUSIVE OF REGULATED ENERGY PRICES (ELECTRICITY, GAS, ETC)

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SOURCE: REF CALCULATIONS ON ISTAT DATA

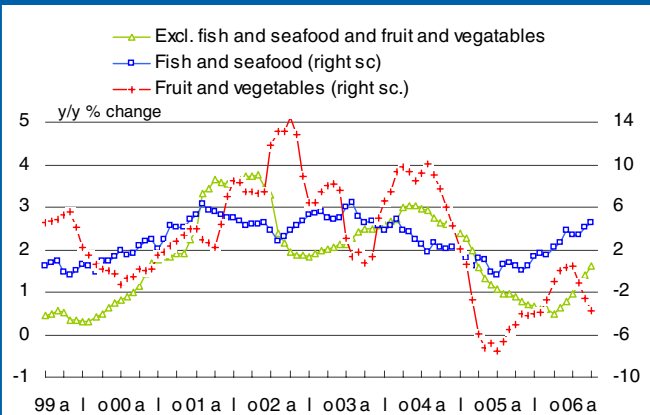
FOODSTUFFS

MODERATE RECOVERY FOR CONSUMER FOODSTUFF PRICES

The year 2006 began with stable inflation at rates of 1% in the foodstuff sector. With the period of moderate prices that started in 2004 now behind us, a new phase of moderate recovery is starting.

Generally speaking, inflation for foodstuffs is still low with increases limited above all to the packaged food and fresh fish sectors. The increases in packaged foodstuffs reflects the reversal of the trend for producer prices which occurred a few months ago now. The phenomena behind it are the increases in beef, pork and veal prices and the simultaneous increase in the oils supply chain, close to 20% annually.

FOOD: FOODSTUFFS INFLATION



SOURCE: REF CALCULATIONS ON ISTAT DATA (NIC)