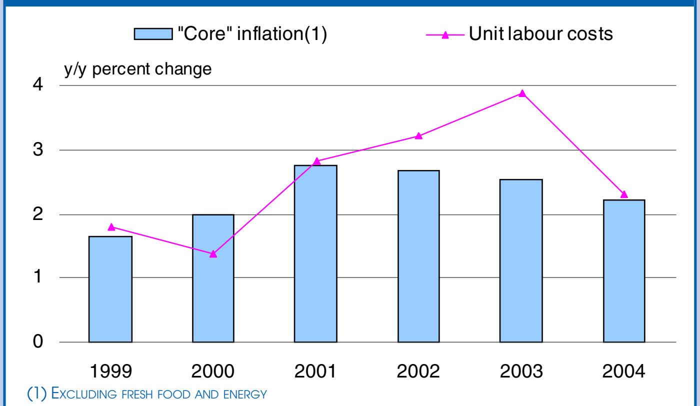
EDITORIAL
INFLATION, LABOUR PRODUCTIVITY AND COMPETITION

THE EXPLANATION FOR OUR INFLATION DIFFERENTIAL COMPARED TO THE EURO AREA IS LOWER LABOUR PRODUCTIVITY AND HIGHER PER UNIT PROFITS

In the first half of 2005 consumer inflation continued at the low levels reached at the end of last year. According to the preliminary figures from ISTAT (Italian national statistics office), the rate of inflation remained steady at 1.9%.
The general picture continues to be characterised by moderate goods prices with deflation in the foodstuffs segment and prices in the non foodstuffs market which are continuing to rise at a rate of 1% y/y despite cost pressures that are already being felt in the intermediate process stages.
In recent months foodstuff deflation has shown signs of diminishing, with a recovery of fish and fresh fruit and vegetable prices and there has been a slight acceleration in non foodstuff prices, with motor vehicle prices increasing and the disinflationary contribution of falling consumer electronics prices is starting to thin out.
Inflation in the private services sector is close to 3%, driven by financial services and renewed boosts to hotel, restaurant and bar prices. Rising prices in these sectors are driven by the fall in the productivity of labour which reflects trends in unit labour costs running at well over 4%.
One of the special focus sections in this edition examines the narrowing of the inflation gap between Italy and the euro area. It is considered transitory because it is linked to the more volatile components of energy and fresh food prices: the gap for underlying inflation, net of non processed foodstuffs and energy products, is in fact half a percentage point (around 2% for Italy and 1.5% for the euro area).
A second special focus section examines the causes of the higher inflation experienced by our economy over the last few years: a recent study by the European Central Bank found that Italy's positive inflation gap was the result of a higher increase for the unit labour costs and profits. While increases in unit labour costs are affected by lower growth in labour productivity, average per unit profits are affected by the aggregate effect of very varied trends both within industrial sectors and between industrial and services.
Looking at the future inflation should now increase in the next months. What we see on the horizon are in fact the price top-ups announced for mass consumption packaged goods, the incorporation of raw materials increases for non foodstuff goods, the end of the downward pressure on public sector tariffs and persistent lower productivity gains forcing up private services prices. They all point to higher inflation in the second half of the year. Leeway for price increases is, however, limited by weak consumption. The forecast for average inflation for the year therefore remains at 2%. 2005 will continue at 2%.

"CORE" INFLATION AND UNIT LABOUR COSTS



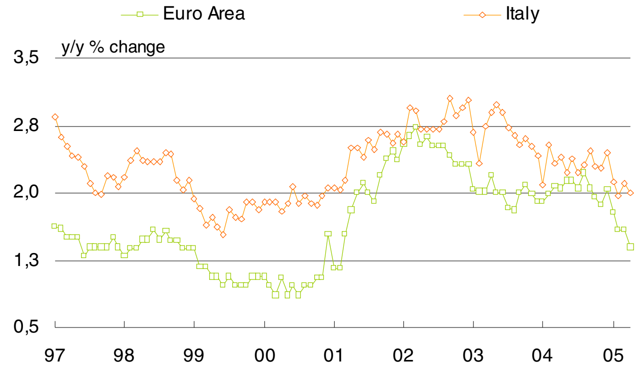
(1) EXCLUDING FRESH FOOD AND ENERGY

SOURCE: REF CALCULATIONS ON ISTAT DATA

EURO AREA
Inflation: an Italy perfectly in line with the European average?

2004 is the year for closing the gap between the growth rates of Italian and European prices. The convergence in overall rates has been made possible primarily by lower Italian inflation in two volatile sectors of the basket: energy and fresh fruit and vegetables. If we look at "core" inflation, we see that Italy gradually pulled away from its neighbours to reach 2% in April compared to 1.3% for the euro area. The gap is in fact continuing to broaden in sectors that have fuelled twin track inflation. These include some categories of non foodstuffs such as clothing and furniture and services, financial and insurance services especially. It is therefore probable that the gap will start to open up again as the transitory factors that caused it to close disappear.

Core inflation (1)



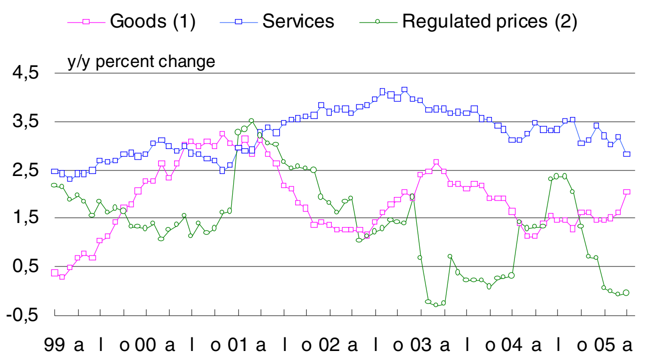
(1) Ex-unprocessed food and energy

Source: Ref calculations on Eurostat data

DOMESTIC PRICES
Inflation steady at 1.9%

Consumer inflation settled at 1.9% in the first five months, held hostage by the weakness of domestic demand and competition from emerging countries. The words that best describe prices on industrial goods (non energy) markets are moderation and disinflation, with year on year increases of 1%. Deflation in the fresh fruit and vegetable sector is continuing to drive down inflation in the foodstuff sector as a whole; signs of inflation higher than 2% among non foodstuffs are to be found in just three sectors: that of furniture and furnishings, that for household utensils and hardware and that of motor vehicles. To complete the picture public sector tariffs remained steady on average at the same level as twelve months previously and prices of private services were lively inflating at a rate not far off 3%.

Inflation: some sub-components



(1) Excluding fresh food
(2) Excluding electricity and gas

Source: Ref calculations on Istat data

SPECIAL FOCUS
LABOUR PRODUCTIVITY AND UNIT PROFITS: THE KEY PROBLEM OF ITALIAN COMPETITIVENESS

That our inflation is higher than the average for the euro area is explained by trends for domestic incomes with practically equal contributions made by the unit labour costs and by per unit profits. Higher growth rates in Italy for unit labour costs are explained by stagnant labour productivity while incomes per worker have increased in line with the average for the area. The causes of lower growth in productivity are to be sought in:

a) the specialisation of Italian production with little presence in sectors where the greatest progress is being made (ITC);

b) lower competition on domestic markets which makes the spread of technological progress slower;

c) the strong growth in employment which has favoured the use of manpower with lower skills.

The persistently higher inflation in Italy is explained also by higher average per unit profits. An examination by sector shows that the growth in per unit profits is the aggregate effect of differing trends because per unit profits are falling in numerous sectors. However there is no lack of cases of sectors in industry and services where prices have continued to rise despite the absence of pressures from unit labour costs, pushed up by higher per unit profits. It would certainly be better if higher competition in these sectors, such as energy and insurance which help worsen Italy's competitiveness, were to pass some of the gains in efficiency on to consumers.

VALUE ADDED DEFLATOR, UNIT LABOUR COSTS AND PROFITS

ANNUAL % AVERAGE CHANGES: 2001-2004

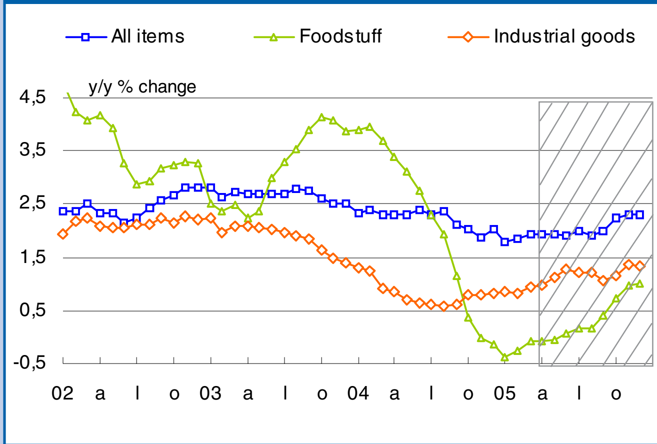
Economic Activity	Annual percent change		
	V.A. Deflator	*Unit Profits*	*Unit labour costs*
Total	**2,9**	**2,7**	**3,1**
Agriculture	**1,2**	**2,5**	**0,2**
Mining, manufacture and energy	**2,3**	**0,9**	**3,0**
Food and beverages	4,3	8,0	2,4
Textiles	2,8	-0,6	4,4
Leather products and footwear	5,0	-1,8	6,8
Wood products	2,2	0,8	2,8
Paper and paper products	4,3	11,2	1,0
Coke, refined petroleum products	3,5	8,8	-2,5
Chemicals products	0,3	-3,7	3,1
Rubber and plastic products	-0,1	-6,7	2,7
Non-metallic mineral products	2,1	-2,2	4,1
Metal products	4,2	9,0	2,5
Machinery and equipment	0,9	-9,6	4,3
Motor Vehicles	2,4	-0,3	3,8
Electricity, Gas and water supply	0,9	3,4	-5,9
Construction	**3,0**	**1,7**	**3,5**
Trade, hotel, transport and commun.	**2,1**	**1,1**	**2,6**
Trade and repairs	1,8	-0,6	3,1
Hotels and restaurants	4,0	-4,0	5,7
Transport and communications	1,7	3,2	0,4
Financial activities	**4,1**	**4,2**	**3,8**
Financial management	0,6	-2,6	3,6
Insurance and pension funding	17,6	30,4	0,1

SOURCE: REF CALCULATIONS ON ISTAT DATA

FORECASTS
INFLATION MOVES BACK UP IN THE SECOND HALF OF THE YEAR

Inflation will start to rise again in the Summer with sharper rises in the Autumn. The reversal of the trend will be led by price recoveries for non energy, foodstuff and non foodstuff, goods. For the former the reason lies in a recovery of profit margins held down for a long time by a long period of advertising campaigns; added to this there is also a negative base effect on fresh fruit and vegetable prices. For non foodstuff goods, the explanation lies in the pressure from past increases in raw materials prices combined with the reduction in the disinflationary contribution of consumer electronics goods. Selective price recoveries for public sector tariffs and a slight acceleration in private services prices under pressure from an acceleration in unit labour costs complete the picture. There are price increases on the horizon for tobacco products. The average annual forecast of 2% is confirmed.

FORECASTS ABOUT 2005

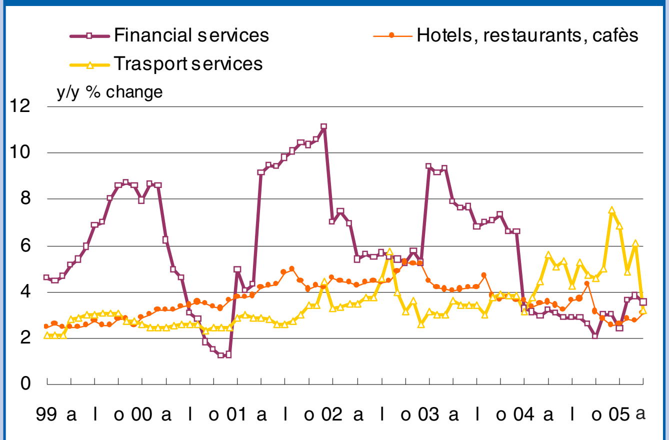


SOURCE: REF CALCULATIONS ON ISTAT DATA. FROM JUNE 2005 FORECASTS.

SPECIAL FOCUS
SERVICES HIGHER THAN THE AVERAGE: IT IS A PROBLEM OF PRODUCTIVITY

Inflation for private sector services has remained constant at growth rates of close to 3% in recent months, unaffected by the generally poor domestic consumer demand. What is preventing and what in the past has prevented a greater slowdown in prices in this sector? We analysed three categories of services, transport, finance and hotels and restaurants, which historically have experienced higher rates of increase in prices than the average for private sector services. An analysis of the main component of the cost, unit labour costs and it determinants found that lower productivity lies at the source of the pressures which are unloaded onto consumer prices.

INFLATION IN SERVICES



SOURCE: REF CALCULATIONS ON ISTAT DATA.