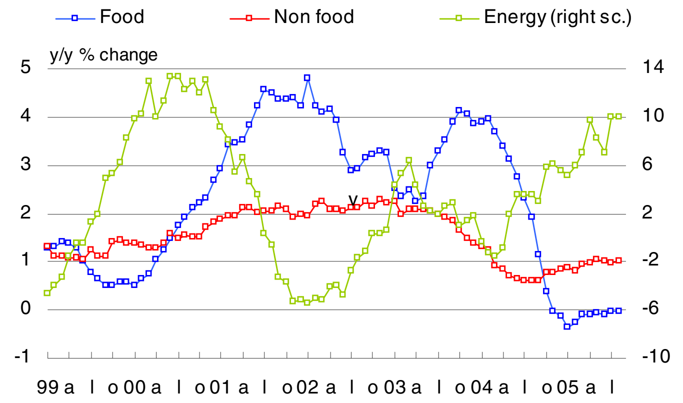
# EDITORIAL
# INFLATION RISING IN THE LAST FEW MONTHS OF THE YEAR

## THE INCREASE IN CRUDE PRICES IS THE MAIN SOURCE OF PRESSURE ON PRICES. DEMAND FOR GOODS IS RECOVERING: EXPECTED PRICE RECOVERIES ON THE HORIZON

*Consumer inflation remained anchored at 2% in the first nine months of 2005 despite constant rising oil prices.*
*Accelerating energy prices were offset by a slowdown in public and private sector services prices. The most convincing explanation for the latter attributes the slowdown in inflation to the fall in consumer demand: the large decrease in labour productivity and the rigidity caused by low levels of competition have helped make disinflation gradual and prevent a fall in consumer inflation. The case of "financial and insurance services " is emblematic in this respect with costs growing again at rates of more than 4%.*
*For public sector tariffs, on the other hand, negative year on year trends have been achieved by postponing some increases and freezing increases in postal tariffs and motorway tolls with cuts to the cost of purchasing pharmaceuticals. Total spending on pharmaceuticals therefore fell, but not spending by private individuals.*
*Inflation on the goods market remained under control: foodstuffs benefited from both the fall in fresh fruit and vegetable prices and from moderate producer prices for mass consumption packaged foodstuffs continuing to record year on year inflation which was either negative or close to zero. For non foodstuff industrial goods (motor vehicles, clothing, footwear, furniture, etc.) year on year inflation remained at 1%, but net of electrical domestic appliances and consumer electronics goods other prices increased at a rate of about one percent higher. The non foodstuff markets of our main partners in the European Monetary Union, France and Germany, have been deflating since the start of the year.*
*The special focus contained in this report looks at the inflation transmission mechanisms of the impulses generated by shock of soaring oil prices. If it is assumed that crude prices will fall back towards 50 dollars per barrel, the direct impact is destined to persist until the Spring of next year. The indirect effect will therefore start to affect "core inflation" in the Spring of next year. The chances of the shock overflowing to affect wages and expectations are however slight. Given a scenario characterised by falling crude prices and a recovery in goods consumption, inflation will increase slightly to 2.2% in 2006. The forecast assumes a recovery of inflation in the foodstuff and other goods market: by exploiting the greater pricing power afforded by the recovery in demand firms will seek to claw back profit margins eroded by higher production costs.*
*The road to recovery for public sector tariffs seems unavoidable given the precarious conditions of public sector finances and the cuts in transfers to local administrations. The deceleration in private sector services should be assisted by feedback of demand still penalised by past increases.*

CONSUMPTION PRICES




SOURCE: REF CALCULATIONS ON ISTAT DATA

# DOMESTIC PRICES
# INFLATION CONSTANT AT 2%

At the end of the holiday period consumer inflation showed no signs of changing significantly: the situation continues to be one of moderate prices despite new record prices on international markets. A strong euro, low demand and competition from Asian producers has extinguished inflation for non foodstuff products. In some sectors such as clothing and footwear, increases in list prices have been offset by increasing the intensity of promotions: prices in sales promotions are the same as those of twelve months ago. Inflation for private sector services has sunk to levels below 3%. The key to interpreting this is the feedback effect of demand on prices: lower consumption has led to more moderate pricing. Public sector tariffs have fallen to lower levels than those of 2004 on average but monetary spending by households is increasing.

**ITALY: BREAKDOWN OF INFLATION**

ANNUAL % CHANGE

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

SOURCE: REF CALCULATIONS ON ISTAT DATA

# FORECASTS
# 2006: INFLATION RISES TO 2.2%

Inflation is destined to rise in October and to reach 2.3%-2.5% in the first few months of 2006: the knock on effect of oil price increases will be added to that of the disappearance of deflation for fresh fruit and vegetables and the settling of consumer electronic goods prices.

Inflation will start to fall again in the Spring of next year.

This forecast, based on oil prices falling back down to 50 dollars per barrel, will be the result of moderate acceleration in the foodstuff and other goods market, lower pressure on energy prices and the recovery of public sector tariffs in a context of gradually falling inflation for private sector services. There will therefore be only a slight acceleration in consumer inflation to 2.2%.

**INFLATION IN ITALY: HISTORICAL DATA AND FORECASTS**

ANNUAL % CHANGE

| | 2003 | 2004 | | 2005 | 2006 |
|---|---|---|---|---|---|
| | *Avg* | *Avg* | *Aug.* | *Avg (*)* | *Avg (*)* |
| **Producer prices: final consumer goods** | | | | | |
| Food products (1) | 3,0 | 0,9 | -0,2 | 0,0 | 1,6 |
| Non-food products | 1,1 | 0,9 | 1,0 | 1,1 | 1,3 |
| *Consumer goods* | *1,7* | 1,0 | 0,6 | 0,7 | 1,4 |
| **Consumer prices** | | | | | |
| Food | 3,2 | 2,2 | 0,0 | 0,1 | 1,4 |
| - ex fresh food | 2,6 | 2,3 | 0,6 | 0,8 | 1,4 |
| Non-energy industrial | 1,8 | 0,9 | 1,0 | 0,9 | 1,4 |
| Energy (2) | 3,1 | 2,4 | 9,9 | 9,1 | 4,2 |
| Services | 3,6 | 3,3 | 2,8 | 3,0 | 2,6 |
| Admistred prices(3) | 0,2 | 1,5 | -0,6 | -0,2 | 2,2 |
| Rents | 2,7 | 2,7 | 2,4 | 2,4 | 2,3 |
| *All-items* | *2,7* | 2,2 | 2,0 | 2,0 | 2,2 |

(*) FORECASTS
(1) EXCLUSIVE TOBACCO AND FRESH FOOD
(2) INCLUSIVE OF REGULATED ENERGY PRICES (ELECTRICITY, GAS, ECC.)
(3) EXCLUSIVE OF ENERGY (ELECTRICITY, GAS, ECC.)

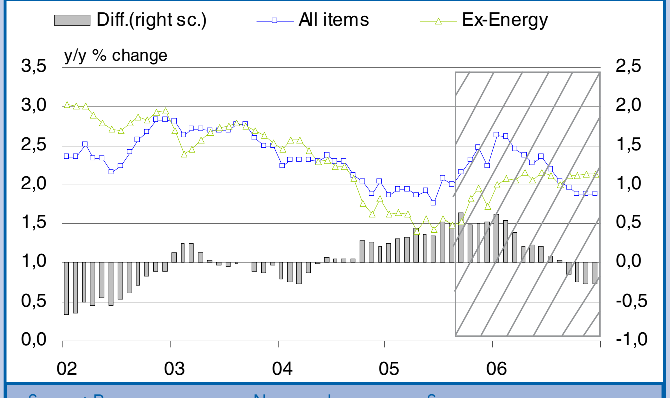
SOURCE: REF CALCULATIONS ON ISTAT DATA

# SPECIAL FOCUS ON ENERGY
# HIGHER CRUDE PRICES AND THE EFFECTS ON CONSUMER PRICES

The large increase in oil prices that started in the middle of 2004 is the result of a stronger international business cycle and the greater demand for oil induced by it. As opposed to the nineteen seventies when the shock price rises were caused by rationing of the supply by the producer country organisation (OPEC), the soaring prices today should be considered as an indicator of the strength of the current economic situation, set against rigid production supply and bottlenecks in the refining industry. The price rise does not seem to be transitory because twelve month consensus forecasts have put prices at higher than 40 dollars per barrel since the Autumn of last year.

To-date the knock-on effect of the crude increases on consumer prices has mainly affected the energy component of the price index. The contribution of energy prices to total inflation will remain at between 0.7% and 0.8% until March of next year. The indirect effect, however, will be to buoy up core inflation. Net of energy prices, inflation stands today at 1.5% and will accelerate towards 2% during 2006.

**HEADLINE INFLATION AND EX-ENERGY**

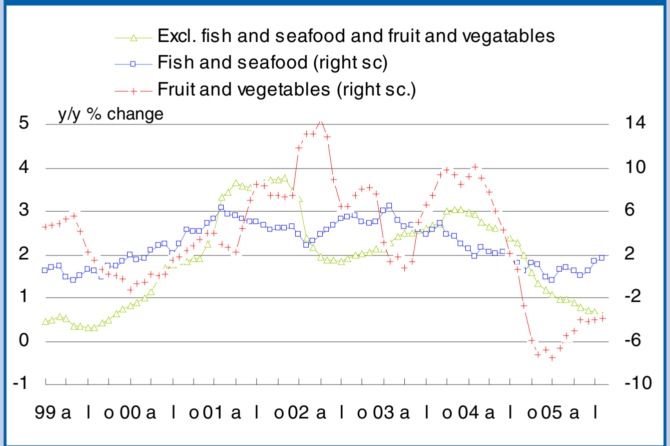



SOURCE: REF CALCULATIONS ON NATIONAL INSTITUTES FOR STATISTICS

# FOODSTUFFS
# FOODSTUFFS DEFLATE

Over the last year foodstuff inflation has levelled off at rates close to zero. Inflation does not exceed 1% in all processed food sectors. In the fresh foodstuff sector fruit and vegetables have fallen over the last twelve months by more than 3.9% while fish prices have increased less than 2%. More recent trends reveal fruit and vegetable prices steady and a marked recovery for fish prices. The disinflationary effect of fresh food prices is destined to diminish in the future.
The fall in inflation for processed foodstuffs is the result of a slowdown in producer prices that had already started in the middle of 2003. Currently trends for producers prices are negative and are still lower than consumer inflation by more than one percent. The absence of inflationary pressure on prices in the initial stages of the marketing process suggests that consumer prices will continue to be moderate in coming months.

FOOD: FOOFSTUFFS INFLATION

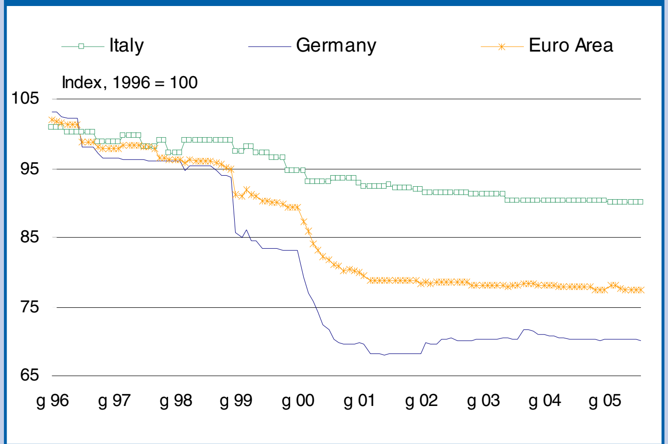



SOURCE: REF CALCULATIONS ON ISTAT DATA

# REGULATED PRICES
# TARIFFS ARE DEFLATING

The Summer months of 2005 saw a new fall in tariff inflation with year on year inflation actually becoming negative, -0.6% in August. The figure is a summary of diametrically opposite trends for prices controlled at local and national level: the latter fell by 2-4% on average over the last twelve months, while the former increased by 2.5%. The fall in national tariffs was led by the fall in the price of medicines which were cut during the year on several occasions including by law. Local tariffs are starting to accelerate again: the reversal of the trend is led by an acceleration in drinking water, urban transport and bus tariffs. Energy tariffs will rise further in the future because they have yet to incorporate a good part of the increase in oil prices.

TELEPHONE AND TELEFAX SERVICES




SOURCE: REF CALCULATIONS ON ISTAT DATA