

Il Presidente

Rome, 31 March 2017

Dear Minister,

Law 243/2012 requires that the Parliamentary Budget Office (PBO) perform analyses, checks and assessments of the macroeconomic forecasts, following an annual schedule that also incorporates the performance of the functions assigned to it in a manner consistent with European Union legislation. Regulation (EU) 473/2013 requires that the macroeconomic forecasts used in preparing the Stability Programme be endorsed by an independent national institution.

The Memorandum of Understanding between the PBO and the Ministry for the Economy and Finance (MEF) of 15 September 2014 governs the process of endorsing macroeconomic forecasts. In the Memorandum, the parties also agreed to perform the endorsement exercise for the macroeconomic trend scenario published in the Economic and Financial Document (EFD).

Taking due consideration of the uncertainty inherent in macroeconomic forecasts, the PBO assessed the plausibility of the estimates on the basis of a range of acceptable values for the macroeconomic aggregates to be endorsed.

The Board of the PBO hereby endorses the 2017-2020 macroeconomic trend forecasts transmitted by the MEF to the PBO on 28 March 2017 as they fall within a range deemed acceptable based upon currently available information.

An explanatory memo will be transmitted subsequently.

Sincerely,

Pier Carlo Padoan
Minister for the Economy and Finance
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Explanatory note to the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the 2017 EFD

This note, which supplements the endorsement letter of the Parliamentary Budget Office (PBO) for the trend macroeconomic scenario (28 March 2017) prepared by the Ministry for the Economy and Finance (MEF) for the 2017 Economic and Financial Document offers a short description of the procedure used to endorse the forecasts and a summary analysis of the threats to those forecasts.

Endorsement procedure for the trend macroeconomic scenario

On 31 March the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts for the 2017-2020 period in the 2017 EFD, after having previously transmitted its comments on an initial version of the forecasts to the Ministry.

The endorsement and the comments were produced on the basis of a comprehensive analysis of the Italian economy conducted by the PBO using a number of tools: a) the PBO estimates for the current year based on short-term models of GDP and the components of aggregate demand; b) the annual forecasts obtained by the PBO with the forecasting model of ISTAT, which was used under the terms of the framework agreement signed with that institute; c) the annual forecasts produced separately and specifically by the independent forecasting institutes (CER, Prometeia, and REF.ricerche) that form part of the PBO forecasting panel; d) monitoring the forecasts of other national and international institutions. The endorsement and the comments were also based on an analysis of the internal consistency of the macroeconomic scenario developed by the MEF and consistency with a set of exogenous international variables.

In order to ensure the consistency of the comparison with the MEF forecasts, the projections of the PBO panel of forecasters (including the PBO forecasts obtained using the ISTAT model) were formulated on the basis of the same assumptions for the exogenous international variables used by the MEF.

Findings of the endorsement exercise

The MEF trend macroeconomic forecasts for 2017-2020 - which in 2018 reflect an increase in VAT rates connected with the safeguard clauses - appear to fall within an acceptable forecasting range, even if they are not fully consistent with the projections of the PBO panel in each year of the forecasting horizon. More specifically, the trend growth figures over the forecasting interval (a slight slowdown in 2018 followed by broad stability) are generally consistent with the growth expected by the PBO panel forecasters, although they lie close to the upper limits of the panel forecast range. The panel forecasts are characterised by a relatively broad dispersion around the central values, denoting greater uncertainty than in the past. Specifically, the MEF trend forecasts

for growth lie close to the upper limit of the panel estimates as from 2018. In one year (2019), the MEF growth forecast is slightly higher than the upper bound of the panel range. Similar developments can be found for nominal GDP growth, with a slight overshoot of the upper limit of the panel forecasts in a single year (2020). In evaluating these developments, the PBO took account of the small size of the divergences (one-tenth of a percentage point in both cases) and the high level of uncertainty. Nevertheless, the fact that the MEF projections lie close to the upper limit of the panel forecasts for most of the forecasting period has prompted the PBO to underscore the significant risk factors in the trend scenario that could impact the public finance projections.

Considering the individual years in the forecasting period, the risk factors seem relatively minor for the 2017 forecasts. The MEF projection for GDP growth (1.1 percent) is slightly higher than the median of the PBO panel estimates, and is lower (by almost three-tenths of a point) than the upper limit of those forecasts. The composition of growth does not differ considerably from that assumed by the panel forecasters, with a marginally stronger impulse (by comparison with the upper bound of the PBO forecasts) coming from investment (in the construction sector, in particular).

The greatest risks are concentrated in the subsequent years (2018-2020). In 2018, the forecast increase in GDP (1 per cent) is at the upper end of the panel forecasts, which are characterized, however, by an increase in the dispersion around the median (compared with the latter, the difference of the MEF forecast expands to almost three-tenths of a point). In 2019, the MEF growth forecast (1.1 per cent) is slightly higher (about one-tenth of a point) than the upper limit of the PBO panel projections (two-tenths of a point higher than the median). This marginal divergence is mainly due to the expected growth of private consumption, which is impacted by the assumption of an increase in the propensity to consume. In 2020, the rise in GDP (1.1 per cent) is in line with the upper limit of the PBO forecasts (and marginally higher than the median). Investment in construction and general government consumption are the major factors in the divergence from the PBO panel projections.

With regard to inflation, the evolution of the private consumption deflator expected by the MEF is similar to that assumed by the PBO panel (close to the median in 2017 and 2018 and above this value, but within the upper bound, in 2019 and 2020). As with the PBO panel, this reflects higher imported inflation in 2017 and an increase in VAT in 2018 and, partly, in 2019. Consumer price inflation turns downward again in 2020, when the effects of the VAT increases dissipate and external inflationary pressures remain very low. However, different assumptions about the terms of trade bring the MEF projections for the GDP deflator to the upper limit of the PBO panel forecasts in 2020.

The combination of the growth and inflation assumptions of the MEF trend scenario drive nominal GDP growth at a pace equal to the highest of the PBO panel forecasts in 2018 and above that limit (by a tenth of a point) in 2020. Compared with the median value of the panel estimates, the MEF projection is higher in each year of the forecasting period (by two- to three-tenths of a point in each year). These observations underscore the risks that macroeconomic conditions could pose for the

public finance projections. If the actual performance of nominal GDP growth is less robust than expected owing to weaker developments in real growth and inflation, the evolution of the debt/GDP ratio could be adversely impacted.

A number of considerations regard the assumptions about international exogenous variables. The MEF forecasts for world trade show a gradual rise in the elasticity of trade to world GDP growth from the very low values seen in recent years. The threat on this front is mainly represented by the protectionist tensions that have emerged at the global level. Any intensification of such tensions could stifle the expected increase in elasticity, affecting the scope for export growth in international markets for any given level of global growth. In forecasting the price of oil, the MEF has adopted the prices posted on forward markets in recent weeks. These projections are broadly in line with the forecasts currently adopted by international bodies. As for the exchange rate, the MEF, in accordance with the procedure recommended by the European Commission, adopts the technical assumption of invariance over the forecasting horizon. However, this assumption appears to run counter to other forecasts and trends indicated in futures markets, which have been impacted by appreciation of the euro. An appreciation of the euro, such as one consistent with developments reflected in forward markets, would weaken internal inflationary pressures and provide less stimulus to exports and, therefore, the growth of the Italian economy as a whole.