ufficio parlamentare di bilancio

The President

Rome, 5 April 2018

Dear Minister,

Law no. 243/2012 establishes that the Parliamentary Budget Office (PBO) shall carry out analyses, audits and evaluations on macroeconomic forecasts, on the basis of an annual programme which also provides for the performance of the functions assigned in accordance with the European Union ruling. EU Regulation no. 473/2013 requires that the macroeconomic forecasts on which the Stability Programme is based be endorsed by an independent national institution.

The Memorandum of Understanding between the PBO and the Ministry of the Economy and Finance (MEF) dated 15 September 2014 governs the macroeconomic forecast endorsement process. In it, the parties have agreed to also carry out the endorsement exercise on trend macroeconomic forecasts published in the Economic and Financial Document (DEF).

In view of the uncertainty surrounding macroeconomic forecasts, the PBO has assessed the plausibility of the estimates on the basis of a range of acceptable figures for the macroeconomic variables subject to endorsement.

The PBO Council – having examined the trend forecasts for the years 2018-2021, updated on the basis of the new national accounts published by ISTAT and sent by the MEF to the PBO on 4 April last – confirms the endorsement communicated on 29 March, inasmuch as the forecasts are within an acceptable range in the light of the information currently available.

The explanatory note to this letter is attached hereto.

Very sincerely,

Professor Pier Carlo Padoan
Minister for Economic Affairs and Finance
Via XX Settembre, 97
00187 ROME

Explanatory note to the endorsement letter of the Parliamentary Budget Office regarding the trend macroeconomic scenario of the Economic and Financial Planning Document 2018

This note, attached to the letter of endorsement from the Parliamentary Budget Office (PBO) regarding the trend macroeconomic scenario drawn up by the Ministry of the Economy and Finance (MEF) for the Economic and Financial Planning Document (DEF) 2018, contains a brief description of the procedure that led to the endorsement of the forecasts and a summary analysis of the risks affecting them.

Procedure for validating the tendential macroeconomic scenario

On 5 April 2018, the PBO sent the MEF a letter endorsing the 2018-2021 trend macroeconomic forecasts of the DEF 2018 (sent by the MEF on 4 April last) after it had previously communicated its observations on an initial provisional version of those forecasts. As usual, the observations were made on the basis of an overall analysis of the Italian economic situation carried out by the PBO through: 1) PBO estimates based on short-term models of GDP and demand components; 2) annual estimates obtained by the PBO using the ISTAT forecasting model, as part of the Framework Agreement signed with the same Institute; 3) annual estimates produced separately by independent forecasting institutions (CER, Prometeia, REF.ricerche) which are part of the PBO panel; 4) monitoring of the latest available forecasts from other national and international institutions. The evaluation is also based on an analysis of the internal consistency of the macroeconomic scenario developed by the MEF and with the set of international exogenous variables. The overall assessment, which focuses on all these instruments, takes into account the margins of uncertainty characterising the forecasts. Finally, it should be noted that in order to ensure a consistent comparison with the trend forecasts of the MEF, the estimates of the PBO panel forecasters (including also the PBO forecasts obtained using the Istat model) have been formulated on the basis of the same assumptions on international exogenous factors as those adopted by the MEF.

Risks associated with the trend macroeconomic scenario

The 2018-2021 forecast of real GDP as regards the DEF trend scenario - which for 2019 and 2020 takes into account the increases in VAT linked to the safeguard clauses - appears, on the whole, to be within an acceptable interval, even if there are minor misalignments with respect to the upper bound of the PBO panel forecast in the years 2019 and 2020. It should be noted that the overall assessment of the acceptability of the DEF estimates takes into account: a) the modest amount of misalignments, particularly in 2019, also considering the degree of uncertainty which characterises the forecast; b) a DEF estimate of nominal GDP - a variable which is more directly relevant to public finances - substantially aligned, in 2019 and 2020, to the upper bound of the PBO panel, reflecting relatively lower DEF assumptions on the GDP deflator which counterbalance the higher real growth.

Looking more specifically at the DEF, the forecast as regards the trend for real GDP growth (considered rounded off to one decimal place) is in line with the upper bound of the PBO Panel's forecast estimates for 2018 (1.6 per cent), is marginally above these in 2019 (1.4 per cent, less than one tenth of a point above the panel’s ceiling) and in 2020 (1.3 per cent, one tenth above the ceiling) and returns to the level of the panel's upper bound in 2021 (1.2 per cent). When compared to the median value of the panel’s estimates, the distance is very small in 2018, amounts to about three and four tenths of a point in 2019 and 2020, respectively, and then decreases substantially again in 2021.

The composition of the growth of the DEF scenario is characterized over the entire forecast period by a positive contribution to the change in GDP of domestic final demand (equal to 1.5 percentage points in 2018 and to slightly more than one percentage point in the following years), against a contribution of net exports amounting to zero or marginally positive (two-tenths of a point in 2019 and 2020). The contribution of stocks is zero in all years with the exception of 2019 (one tenth of a point). With reference to the individual components of the demand, in the trend DEF scenario, the increase in VAT tends to slow down the dynamics of household consumption in 2019 and 2020, while the end of tax benefits tends to affect investments starting in 2020. On the foreign demand side, exports slow down with a drop in the speed of world trade, falling slightly below this year’s increase in imports, above it in 2019 and 2020 and below it again in 2021.

This 2018-2021 growth scenario - characterized by the pull of domestic demand in the presence of a neutral or slightly positive contribution from net foreign demand - is essentially shared by the PBO panel's forecasters. Elements of difference emerge mainly from the dynamics of private consumption which appears in the DEF to be systematically higher than the upper bound of the PBO panel of forecasters. These greater dynamics in estimating household expenditure seem to contribute mainly to explaining the misalignment in the evolution of real GDP, to a relatively greater extent in 2020.

As for inflation, the evolution of the private consumption deflator projected in the DEF trend scenario is similar to that forecast by the PBO panel, with an acceleration in 2019-20 for VAT increases and a subsequent weakening in 2021. For 2019 and, above all, 2020, the dynamics estimated in the DEF trend scenario are slightly higher than the upper bound of the PBO panel, presumably due to the impact of a more sustained evolution of the import deflator assumed in the DEF scenario. With reference to the GDP deflator, as highlighted in the introduction, the expected evolution within the DEF trend scenario is within the range put forward by the PBO panel's forecasters and close to the median value of such estimates.

Given the projected developments in real GDP and the GDP deflator, the nominal GDP dynamics of the DEF scenario are broadly in line with the upper-bound (PBO) panel forecast over the entire forecast period. With reference, in particular, to 2019 and 2020 (years of relative "real" misalignment), the dynamics of the lowest GDP deflator in the DEF estimate compared to the upper bound of the PBO panel counterbalance the marginally higher real GDP growth, giving rise to nominal GDP dynamics of the DEF substantially in line with the upper bound of the panel forecasters. Compared to the median value of the PBO panel, the change in nominal GDP assumed in the DEF macroeconomic scenario is three tenths of a point higher in 2019 and five tenths in 2020, while it is close to this central value in 2021.

On the whole, therefore, the main risk elements of the macroeconomic scenario for 2018-2021 seem to concern growth over the next two years (2019-2020), when the increase in VAT and the gradual disappearance of investment incentives could lead to a relatively more severe slow down (in particular in 2020) than that projected by the DEF scenario. On the other hand, the impact of lower real growth on nominal GDP, the dynamics of which are more relevant to the implications on the public finances adjustment path, could be offset by relatively lower DEF estimates with regard to the GDP deflator.

Finally, it should be noted that the risks involved in the international scenario are significant. The forecast is conditioned by the DEF assumptions concerning the external exogenous variables also adopted for consistency by the PBO forecasting panel. These hypotheses prefigure the substantial continuation of global expansion, albeit at a progressively slower pace. A continuation of the recovery to 2021 would mean achieving record upward cycle phase durations in the major economies. Given the available information, it is obviously difficult to determine any turning points of the global cycle. However, there are a number of risk factors in the current global picture that should be taken into account. A first risk element is that financial instability could worsen as monetary policies normalise more rapidly than expected due to the emergence of stronger inflationary pressures in advanced economies. A second risk element is represented by the geo-political tensions that could favour the exacerbation of the protectionist attitudes present in major economies with adverse impacts on world trade. The possible materialisation of these risk factors, although not specific to Italy, could have significant repercussions on the forecast situation of our economy.