ufficio parlamentare di bilancio

Il Presidente

Rome, 19 September 2018

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.

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

The Board of the PBO hereby endorses the 2018-2019 trend macroeconomic forecasts transmitted on 17 September, while underscoring the presence of significant downside risks for real GDP growth. As regards the forecasts for subsequent years, i.e. 2020-2021 (which did not undergo the endorsement process), the PBO emphasises the prevalence of negative risk factors in the MEF scenario for 2020, which have a substantial impact on expected developments in real variables.

Sincerely,

Giuseppe Pisauro

Giovanni TRIA
Minister for the Economy and Finance
Via XX Settembre, 97
00187 ROME

Attachment to the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the Update to the 2018 EFD

This explanatory note, attached to the endorsement letter of the Parliamentary Budget Office (PBO) for the trend macroeconomic scenario prepared by the Ministry for the Economy and Finance (MEF) for the Update to the 2018 Economic and Financial Document (EFD), offers a brief description of the procedure leading to the endorsement of the forecasts and a summary analysis of the risks associated with those forecasts.

Endorsement procedure

On 19 September 2018 the PBO sent to the MEF its endorsement letter for the trend macroeconomic forecasts as presented in the Update of the 2018 EFD (transmitted by the MEF on 17 September), after having previously communicated its comments on a preliminary version of those forecasts to the Ministry.

As usual, the endorsement and the comments were formulated on the basis of a comprehensive analysis of the Italian economy conducted by the PBO using: 1) the PBO's estimates on the short-term outlook of GDP and its main components, both on the demand and supply side; 2) the annual forecasts obtained by the PBO with the forecasting model of ISTAT, used under the terms of the framework agreement signed with that institute; 3) the annual forecasts produced separately by the independent forecasting institutes (CER, Prometeia, and REF.ricerche) which are part ofthe PBO forecasting panel; and 4) the most recent forecasts available from other national and international institutions. The comments were also based on an analysis of the internal consistency of the macroeconomic scenario developed by the MEF and the consistency with a set of exogenous international variables. The overall assessment based on these tools obviously takes account of the degree of uncertainty that characterises forecasting in general.

In order to ensure the consistency of the comparison with the MEF trend 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 on the exogenous international variables used by the MEF.

Findings of the endorsement exercise

The 2018-2021 forecasts for real GDP growth in the macroeconomic scenario of the Update – which reflect the VAT increases connected with the safeguard clauses for 2019 and 2020 – appear to fall within an acceptable forecasting range, despite a number of divergences from the upper bound of the PBO panel forecasts with regard to the variables subject to endorsement. The overall acceptability of the trend projections in the Update takes account of: a) the small size of the misalignments, also considering the uncertainty of the current short-term outlook; and b) the fact that the Update's projection for nominal GDP growth – a variable of direct importance for the public finances – is in line with the upper limit of the PBO panel forecasts. However, various sources of uncertainty, in both the short and medium term, must be noted, mainly representing downside risks associated with the trend macroeconomic scenario in the Update.

The following summarises the comments on the forecasts for 2018 and 2019, which are the focus of the validation exercise, offers a general assessment of 2020-2021 and delineates some of the risks, mainly related to external developments.

With regard to GDP growth in 2018-2019, the trend forecast in the 2018 Update (1.2 per cent) is slightly higher than the upper bound of PBO panel forecasts, while that for the following year (0.9 per cent) coincides with the upper limit. Due to the low dispersion of the individual forecasts produced by the panel, the Update's projections for the growth of the Italian economy are also very close to the median values in both 2018 and 2019.

The growth forecast for this year is exposed to uncertainty regarding the scale and duration of the current economic slowdown. Business confidence surveys, coincident and leading indicators for the Italian economy have been signalling the weakening of the economic activity since last spring. The figures for industrial production and orders in July, released in mid-September by ISTAT (showing declines of 1.8 per cent and 2.3 per cent respectively on the previous period), point to a possible further decline in the pace of output in the third quarter of the year; this expectation contrasts with a moderate rebound in manufacturing activity in August. These very volatile developments in manufacturing, the nature of which (cyclical or not) is difficult to assess in real time, create uncertainty about GDP growth forecasts for this year and the statistical carryover effect into 2019.

With regard to the determinants of growth, the Update scenario for 2018-2019 is primarily driven by domestic demand, mostly thanks to the contribution of fixed capital accumulation, while foreign trade is impacted by the marked weakening of exports observed in the first half of this year. The qualitative nature of these developments is shared by the PBO panel, which, however, is slightly more cautious in its projection for investment in capital equipment this year. The macroeconomic scenario for 2019 is however affected by considerable uncertainty originating mainly in exogenous developments connected with institutional factors or the external context: a) it is difficult to quantify the effects on consumption of an increase in VAT rates, included in the trend macroeconomic scenario, in light of its heterogeneous impact on the macroeconometric models and the possible effect on household confidence; b) the outlook for investment is characterized by the uncertainty about the extent of a possible counter-shock caused by the expiry of tax incentives (so-called "super-depreciation" and "hyper-depreciation") on spending on machinery and equipment; c) although the Update is cautious in its forecast for exports, they should accelerate sharply (growth would increase from 0.4 per cent this year to 2.7 per cent in 2019). In order for this to occur, quarterly growth rates for exports need to improve markedly as from the summer, after posting negative rates in the first half of the year. The uncertainty about demand components mentioned above counsels prudence, also in the light of the significant downside risks associated with external developments, which are addressed below.

Labour market variables , costs and prices in the Update are consistent with the other main indicators of the trend macroeconomic scenario and remain within the median values projected by the PBO panel (with the exception of the unemployment rate, which MEF forecasts put very close to the most optimistic estimates of the PBO panel). The rise in the consumption deflator, which next year will reflect the increase in VAT rates, coincides with the median value of the panel forecasts for 2018-2019. In the same period, the GDP deflator is close to the bound of the range of panel forecasts, for which nominal GDP growth (at 2.5 and 2.7 per cent, respectively, in 2018 and 2019) also does not exceed the upper limit of the panel forecasts.

For the 2020-2021 period, which is not subject to endorsement by the PBO, the two-year average GDP growth forecast (1.1 per cent in both years) in the Update trend scenario lies on the upper bound of the PBO panel estimates. Although acceptable in terms of the range defined by the panel, the medium-term forecast for growth in the Update appears to be relatively high compared with the prevailing estimates of the Italian economy's potential growth (including the projections formulated last spring by the MEF in the 2018 EFD).

The trends in the demand components of growth in 2020-2021 appear qualitatively balanced overall. Export growth gradually converges towards the pace of world trade, achieving substantial stabilization of foreign market shares at the end of the forecasting horizon. Household consumption recovers from the shock connected with the increase in VAT rates in the trend macroeconomic scenario and returns to a growth rate close to the one for GDP. Capital accumulation expands more slowly than in 2016-2017, when it was fuelled by significant tax incentives.

The forecasts for price developments in 2020-2021 are also consistent with the assessments of the PBO panel. Overall, the rises in both the GDP and nominal GDP deflators are not far from the PBO panel median value.

Risks associated with the forecasts

The medium-term outlook is clouded by substantial risks, mainly downside threats to growth. The following are some possible unfavourable scenarios of external origin that could have major adverse consequences on the Italian economy.

Trade war. The year 2018 saw the emergence of protectionist measures whose effects, which are currently not easily quantifiable, may have contributed to the weakening of world trade, even if only through their impact on expectations. Looking forward, the possibility that such tensions could strengthen further and slow international trade more sharply is not negligible. The forecasts for growth in world trade for 2019 could therefore prove far too optimistic ex post. For the Italian economy, which is traditionally open to international trade, such developments would have swift and substantial repercussions on exports and industrial production in sectors that are highly exposed to foreign competition.

Inversion of the economic and financial cycle. There is uncertainty over the duration of the current expansion, both with regard to the number of quarters that global growth is sustainable and the possibility that the prices of financial assets will reverse the upwards trend under way for various years now. Identifying possible turning points in the global economic and financial cycle with the information available is a highly challenging exercise. However, it should be borne in mind that the emergence of such a scenario would have major global repercussions, due to the limited scope for response of the fiscal and monetary policies of a number of advanced countries. The increase in risk premiums demanded by international investors would penalize economies with low-rated issuers, both public and private. This would have a significant impact on the prices of the main financial assets of the Italian economy, possibly also affecting household and business confidence.

Rising oil prices. The weakening of world trade has been accompanied by a decline in the prices of metal commodities, while the prices of energy products have mainly reflected supply-side constraints in the oil-producing countries. The price of crude oil therefore increased in the first half of 2018. Geopolitical tensions in a number of oil-producing countries mean that further restrictions in production cannot be ruled out, with the impact being passed through, at least in part, to prices. Further prices increases above the levels already incorporated in the macroeconomic scenario would have a direct impact on consumer prices. This would erode household purchasing power, which would curb the growth in private consumption spending.

Other potential risk factors with repercussions for Italy, present with varying degrees of probability in the global macroeconomic scenario, concern the challenges associated with the normalisation of monetary policy in Europe, the more restrictive stance that it could take in the United States in response to the fiscal policy of the US administration and the outcome of the Brexit negotiations.