ufficio parlamentare di bilancio

*Summary**

The slowdown in the international economy is on-going, with activity also impacted by uncertainty about restrictions on global trade. The outlook is deteriorating, especially in the advanced countries most directly involved in international trade. The weakening of global demand has caused oil prices to decline and the euro-area inflation has returned below two per cent.

Last year the Italian economy gradually slowed, decelerating more than in the rest of the euro area. Beginning in the summer, economic activity contracted, reflecting the deterioration in domestic demand and exports. According to preliminary estimates, GDP in 2018, unadjusted for calendar effects, expanded by 1.0 per cent, more than half a percentage point less than in 2017. The labour market also weakened, albeit to a lesser extent than output. Wage growth strengthened slightly, but inflation remained low. The indicator of uncertainty continues to rise, and business confidence is worsening. The most recent economic data does not yet show signs of a reversal of the economic cycle.

In this Report, the PBO provides its own macroeconomic projections for the Italian economy in 2019-2020. The GDP is expected to grow by 0.4 per cent this year, held back by the negative statistical carry-over associated with the contraction in the previous six months. Growth should pick up in the second half of the year, thanks to the stimulus to the domestic demand provided by the measures in the budget package. Investment will continue to expand at a moderate pace, however, due especially to the deterioration in firms' expectations.

Next year, GDP growth is forecast to strengthen to 0.8 per cent, still driven by domestic demand. Nevertheless growth in 2020 remains exposed to the risk of an increase in indirect taxes, as provided for in the safeguard clauses for the public finances. If those clauses are activated, the rate of GDP growth would be reduced by a quarter.

The risks colouring the outlook are many and predominantly on the downside. More specifically, the international environment is burdened by concerns over trade policies, although recently these have subsided somewhat, as well as other specific sources of geo-political instability. Moreover, high-debt countries such as Italy are still exposed to the uncertainties about the yields on sovereign debt.

* *Prepared by the Macroeconomic Analysis Department. Information updated to 4 February 2019.*

The international environment

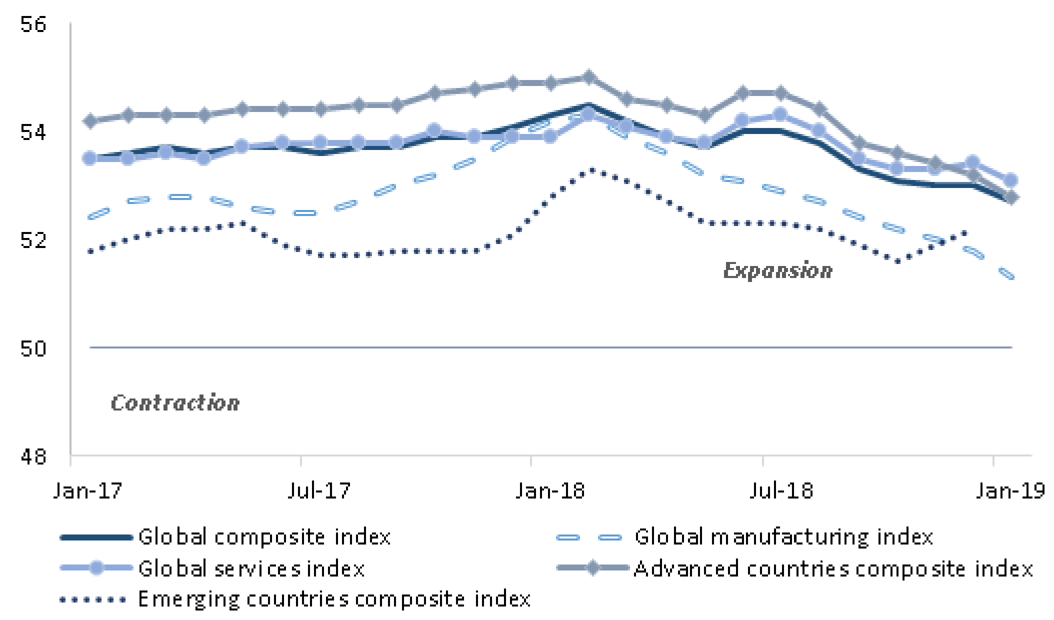
Economic activity slowed in 2018, especially in the advanced countries

The world economy is continuing the deceleration first observed last summer (Figure 1). The normal slowdown after one of the longest post-war expansions has been exacerbated by the imposition of measures to restrict trade. The direct effects of those measures have been limited so far, but the uncertainty engendered by the associated announcements, which have not always been clear and unambiguous, appears to have had a substantial impact. The ongoing negotiations between China and the United States could ease tensions, but the risk of further restrictions remains significant. The effects of trade restrictions could also combine with those resulting from the normalisation of monetary policies, as well as with the volatility of financial markets, currencies and commodity prices. Other downside global risk factors include the possibility of the United Kingdom leaving the European Union in March without a formal agreement with the Union and the consequences of the government shutdown in the United States.

For the United States, 2018 was the ninth consecutive year of economic expansion, the third longest expansion after those of 1959-1973 and 1992-2007. In the first three quarters of the year, output grew by an annualized 3.3 per cent, mainly buoyed by consumption and investment. Leading analysts expect the pace to have slowed down in the final quarter, to 3.0 per cent. The labour market improved overall, with an increase of 2.5 million jobs and a decrease in the unemployment rate to below 4.0 per cent. The recent deadlock in the political situation resulted in a 35-day shutdown of non-essential federal government business. According to the Congressional Budget Office,[2] the shutdown trimmed GDP growth by one-tenth of a point in the fourth quarter of 2018. In 2019, if the shutdown does not resume, the macroeconomic impact should be negligible, since the loss registered in the early weeks of January would be offset over the course of the year.

[2] *The Effects of the Partial Shutdown Ending in January 2019*, 28 January 2019.

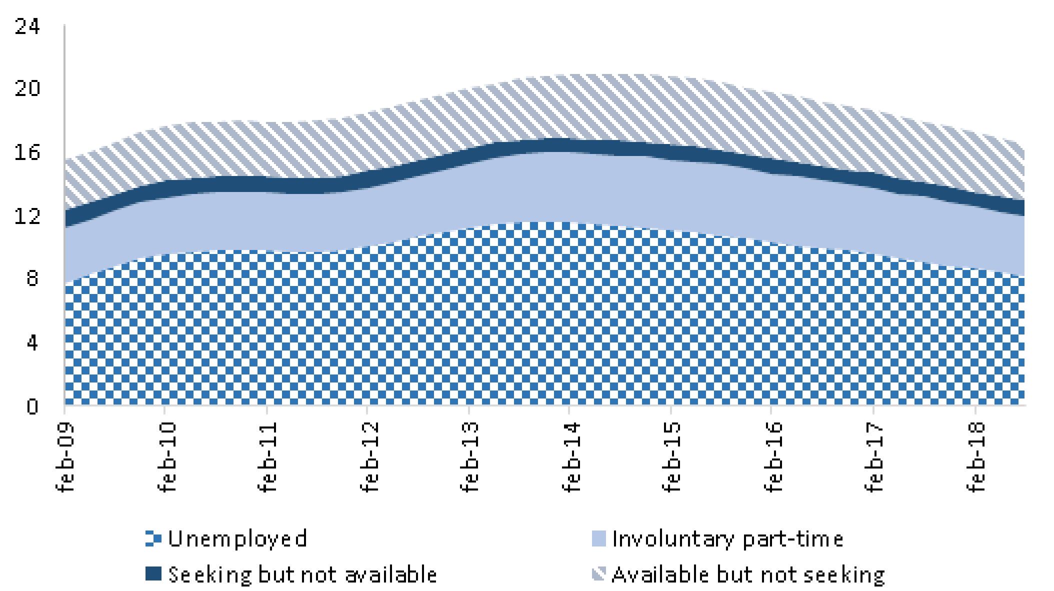
Figure 1 – JP Morgan Global Composite PMI



Source: Thomson Reuters Datastream .

The euro-area economy, which in 2017 grew by 0.7 per cent over the previous year, slowed down in 2018. The pace of GDP growth fell to 0.4 per cent in the first two quarters and to 0.2 per cent in the following two, reflecting the deterioration in Germany and Italy. Despite the cyclical weakening, unemployment continued to decrease, falling below 8.0 per cent of the labour force at the end of year (Figure 2).

Figure 2 – Unemployment, underemployment and potential additional labour force (1)
(4-quarter moving averages; percentages)



Source: Thomson Reuters Datastream.
(1) Persons aged 15-74.

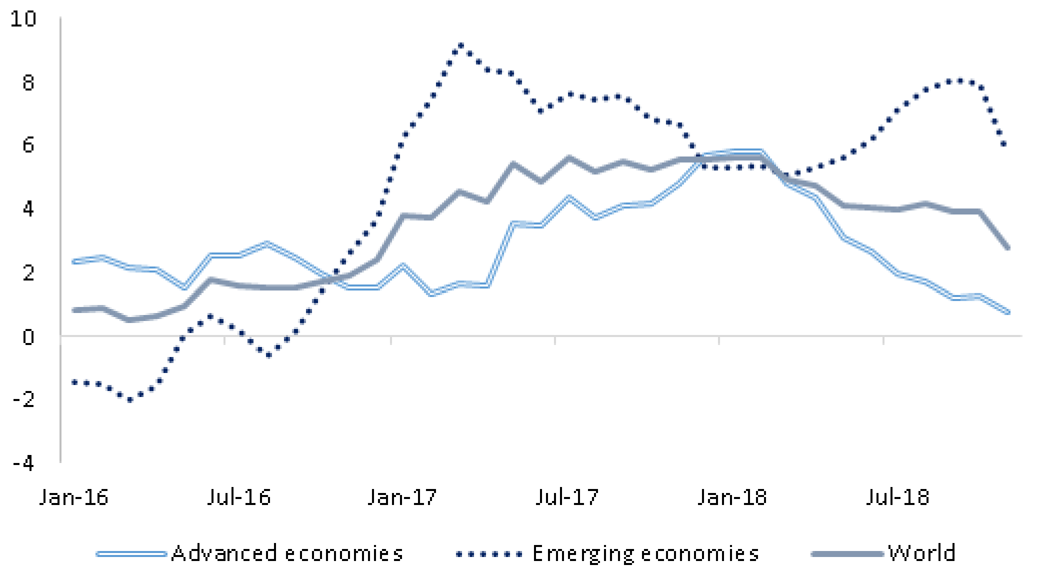
Global trade also slowed by trade tensions

After a long period in which barriers to trade were dismantled, the past year was marked by a sharp reversal led by American trade policy. The United States introduced duties with the primary intention of reducing the country's trade deficit with China, which was also accused of forcing foreign companies that set up in China to transfer their technology. The tariff barriers and the associated deterioration in confidence slowed international trade (Figure 3), which was already weakened by the general slowdown in economic activity.

The global outlook in the forecasts of the International Monetary Fund (IMF)

In January the IMF was revised its global growth estimates downwards because of trade tensions, as well as the specific slowdown in countries like Germany, Italy and Turkey (Table 1).

Figure 2 – Growth rate of imports (1)
(annual percentage change in 3-month moving average)



Source: Thomson Reuters Datastream.
(1) Owing to the shutdown, figures are not available for the United States. US trade flows have been assumed to be unchanged.

Table 1 – IMF forecasts
(percentage changes and differences in percentage points)

	WEO update January 2019			Difference with WEO October 2018	
	2018	2019	2020	2019	2020
World output	3.7	3.5	3.6	-0.2	-0.1
Advanced economies	*2.3*	*2.0*	*1.7*	*-0.1*	*0.0*
United States	*2.9*	*2.5*	*1.8*	*0.0*	*0.0*
Euro area	*1.8*	*1.6*	*1.7*	*-0.3*	*0.0*
Emerging economies	*4.6*	*4.5*	*4.9*	*-0.2*	*0.0*
World trade	4.0	4.0	4.0	0.0	-0.1

Source: IMF, World Economic Outlook update, January 2019.

The volatility of foreign exchange and commodity markets has increased

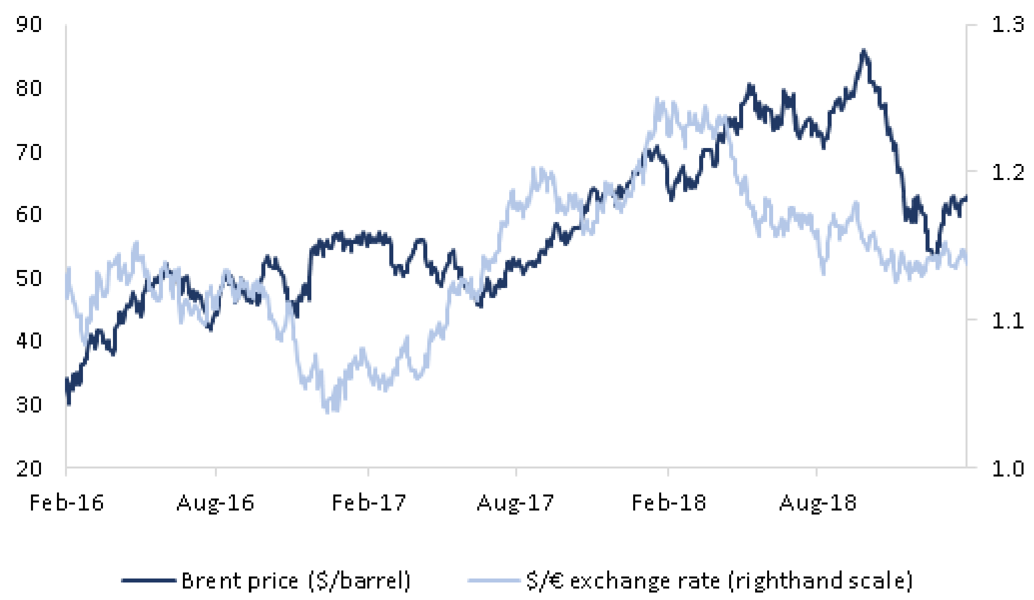
Although the price of Brent rose sharply in the first nine months of 2018, mainly due to supply factors, in October this trend began to reverse as global demand eased. Prices rose from just over $65 a barrel in the winter to around $85 in October, before falling below $55 at the end of the year. A new agreement for further production cuts reached in December led to a slight recovery in oil prices, to just over $60 a barrel.

In the first four months of 2018, the exchange rate of the dollar against the euro settled in the 1.20-1.26 range. Favourable GDP growth in the United States and the normalisation of monetary policy by the Federal Reserve fostered an appreciation of the dollar against the European currency to 1.12-1.18, beginning in the early summer (Figure 4).

European inflation is affected by the decline in oil prices

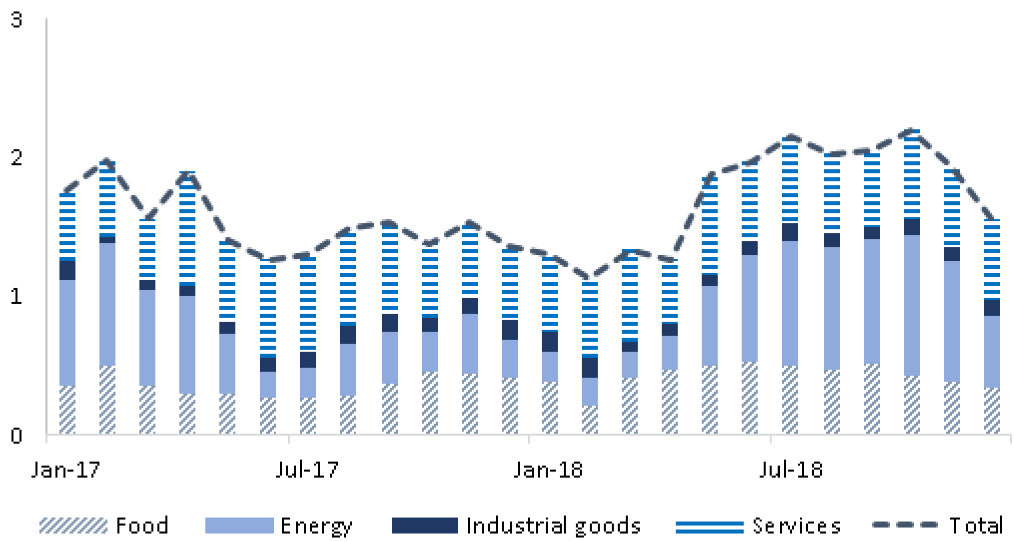
In the first half of the year, inflation in the euro area rose towards the European Central Bank's target rate. Between June and October the 2 per cent threshold was reached and then exceeded, due to pressure from the most volatile components, notably the prices of energy products. The decline in oil prices beginning in October quickly fed through to consumer price inflation, which returned under 2 per cent towards the close of 2018. The more stable core inflation measure continued to fluctuate around 1 per cent last year (Figure 5).

Figure 3 – Oil prices and dollar/euro exchange rate



Source: Thomson Reuters Datastream.

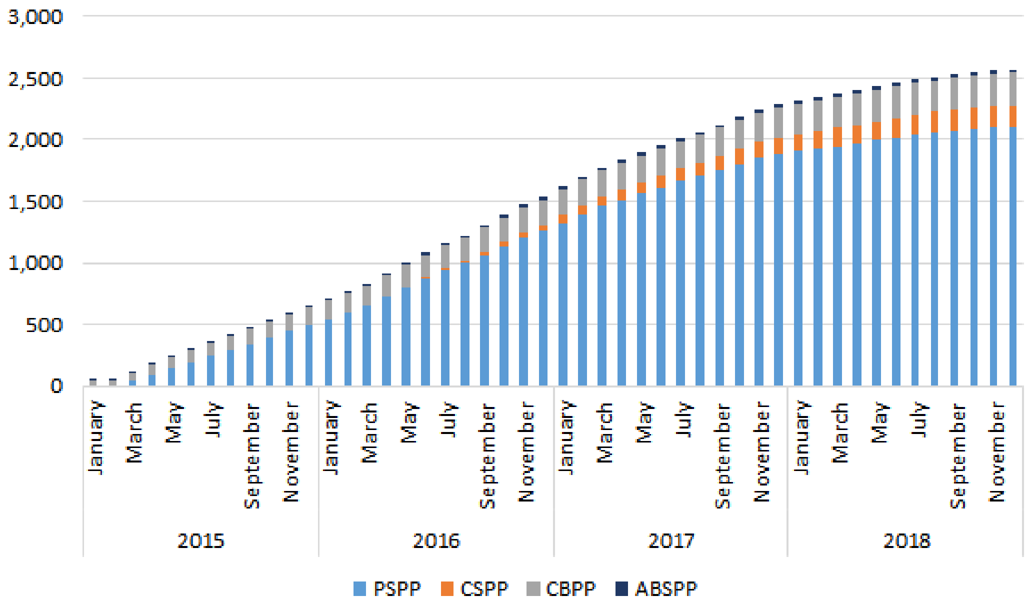
Figure 4 – Inflation in the euro area
(percentage change and contributions)



Source: Thomson Reuters Datastream.

Euro-area monetary policy, while remaining highly accommodative, began the process of normalisation in 2018. Official rates were kept unchanged at the levels set in 2016, but the asset purchase programme was reduced from the initial €60 billion a month, first to €30 billion and then to €15 billion. At the start of 2019, purchases were terminated, but the principal amount of maturing securities will be reinvested for an extended period of time (Figure 6).

Figure 5 – ECB asset purchase programme - stocks (1)
(billions of euros)



Source: European Central Bank.
(1) PSPP – Public sector securities; CSPP – Corporate sector securities; CBPP – Covered bonds; ABSPP – Asset-backed securities.

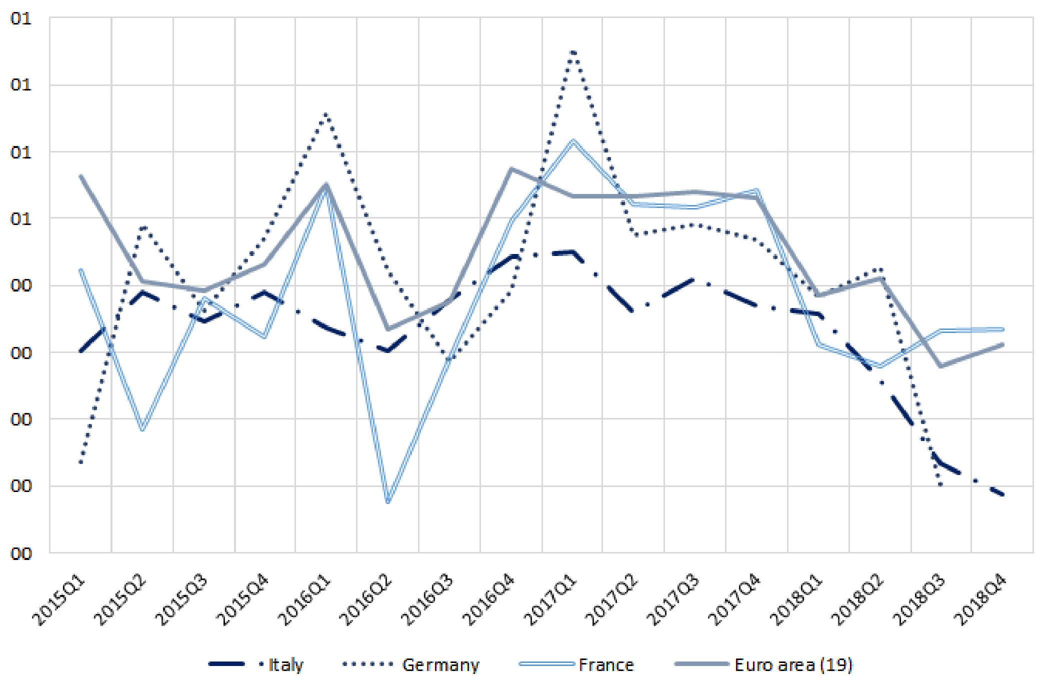
The Italian economy

Economic activity contracts

The Italian economy slowed markedly in 2018, decelerating more than the rest of the euro area (Figure 7). According to preliminary estimates released at the end of January, in the fourth quarter of 2018, economic activity, which had already contracted in the summer, fell by 0.2 per cent on the previous quarter. For 2018 as a whole, GDP is estimated to have expanded by 0.8 per cent, or 1.0 per cent unadjusted for calendar effects. The statistical carry-over impact on 2019 GDP growth is a negative two-tenths of a percentage point.

The available qualitative information mostly attributes the contraction of economic activity in the last six months of 2018 to a decline in industrial output, which was then transmitted in part to the services sector. On the demand side, the negative contribution of domestic demand was only slightly offset by foreign trade.

Figure 6 – GDP growth in the euro area and in its three largest economies
(percentage change on previous period)



Source: based on Eurostat data.

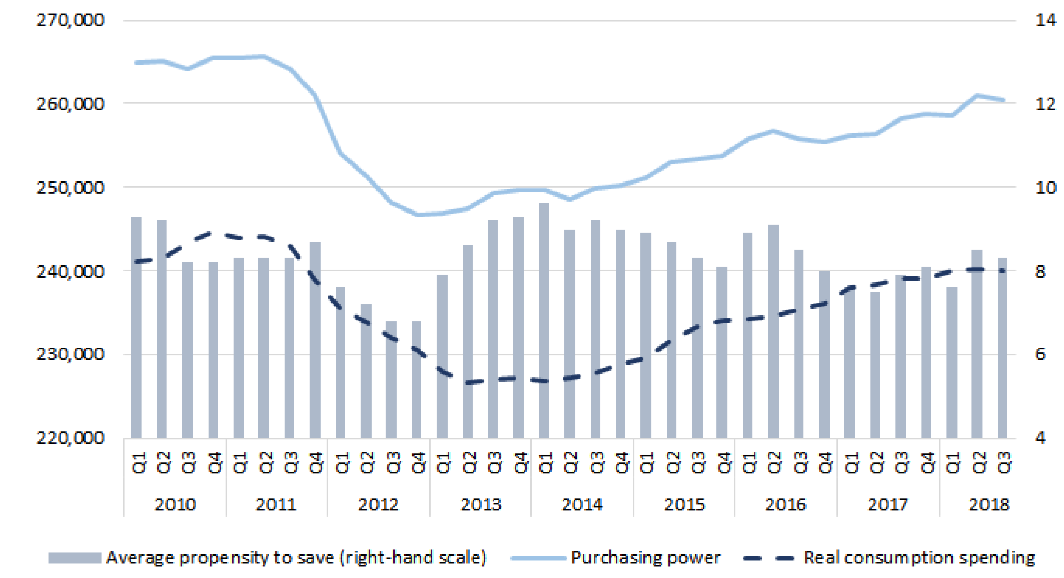
Private consumption spending stalls...

The pace of private consumption growth gradually declined, before contracting in July-September (-0.1 per cent). The growth already achieved in 2018 amounts to 0.6 per cent, compared with an average annual increase of 1.1 per cent in 2017.

The decline in spending in the summer was led by durable and non-durable goods (which fell by -0.1 and -0.5 per cent respectively), partly offset by services (0.2 per cent). Household spending was affected by the contraction of purchasing power in the third quarter, which followed appreciable increases in the two previous periods. Households' propensity to save fell slightly, to 8.3 per cent of disposable income (Figure 8).

Consumer confidence, which had remained high in the first part of 2018, weakened at the end of the year, especially with regard to assessments of the general economic situation and personal financial circumstances. Despite a slight recovery in January, the climate of confidence remains below the average for 2018, which could negatively impact household spending in the short term.

Figure 7 – Household income, consumption and saving
(millions of euros and year-on-year percentage change)



Source: based on Istat data.

... and investment is volatile in quarterly terms

Investment expenditure increased significantly last year (3.9 per cent growth already acquired through the third quarter), although it was affected by strong volatility. There was a sharp quarter-on-quarter downturn in the summer (1.1 per cent), reflecting a reduction in purchases of capital goods. By contrast, capital accumulation in construction continued the moderate growth that began in the second half of 2017. The investment rate (the ratio of gross fixed capital formation to value added) for capital goods excluding construction rose above its level before the global financial crisis, while the real estate component remains about two percentage points lower. Profitability (measured as the ratio of gross operating profit to value added at basic prices for non-financial corporations) fell further from the highs registered in mid-2016.

Surveys point to a continuation of weak capital accumulation in the short term. The Istat survey revealed a progressive deterioration in domestic orders for capital goods as from the second half of 2018. In parallel, lending conditions were gradually tightened, especially for small businesses. The Bank of Italy-Sole 24 Ore Survey on Inflation and Growth Expectations in December also bode poorly looking forward, with a marked deterioration in conditions for capital accumulation across all the main production sectors. Firms also expressed concern about the high level of yields on sovereign debt, which could impact borrowing costs.

In November, the cost of credit remained at historically low levels, only slightly higher than the lows observed last spring. Even the seasonally-adjusted flow of new non-performing loans as a proportion of total loans remained low on an annual basis.

Foreign trade is weak

Exports were affected by the general deterioration of international trade. Despite the recovery observed in the latest national accounts data, exports measured in chain-linked terms remained lower in the summer than in the final part of 2017. Growth already achieved for 2018 was 0.7 per cent, slowing sharply from the considerable increase posted in 2017 (5.7 per cent). The most recent foreign trade data paint a very uncertain picture. Average October-November figures show a recovery in foreign merchandise sales compared with the third quarter (1.6 per cent in volume terms, obtained by deflating with producer prices on foreign markets). However, December data on sales in in value terms for non-EU countries show an abrupt decline.

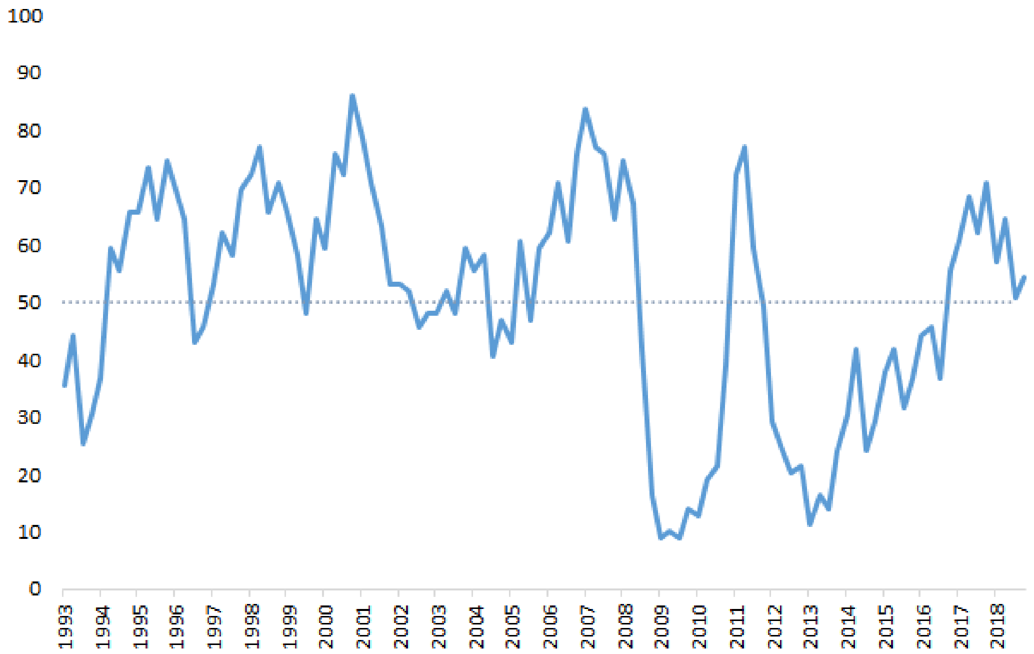
Survey information points to a period of weaker foreign trade, including in the short term. The Istat survey of confidence among manufacturing firms conducted in December shows a further deterioration in assessments of foreign orders and expectations for turnover on international markets.

Imports also slowed overall last year, probably due to the weaker demand for investment and exports, which normally have a strong impact on purchases from abroad.

The latest economic indicators

In the first three quarters of last year, industrial production declined steadily (on average, by about 0.3 per cent quarter-on-quarter). In November, it contracted by 1.6 per cent compared with the previous month, and according to PBO estimates the overall downward trend continued in the fourth quarter at a pace similar to that in the previous three quarters. Expected average growth for the year is about 1 per cent, compared with 3.7 per cent in 2017. Analysing developments in the various segments using the PBO diffusion index (Figure 9), the number of sectors experiencing growth on average in October-December was sharply strongly lower than at the beginning of 2018. Signs of deterioration in the manufacturing sector are also evident in qualitative indicators, including the PMI and the Istat index of manufacturing confidence.

Figure 8 – PBO diffusion index
(percentage shares)



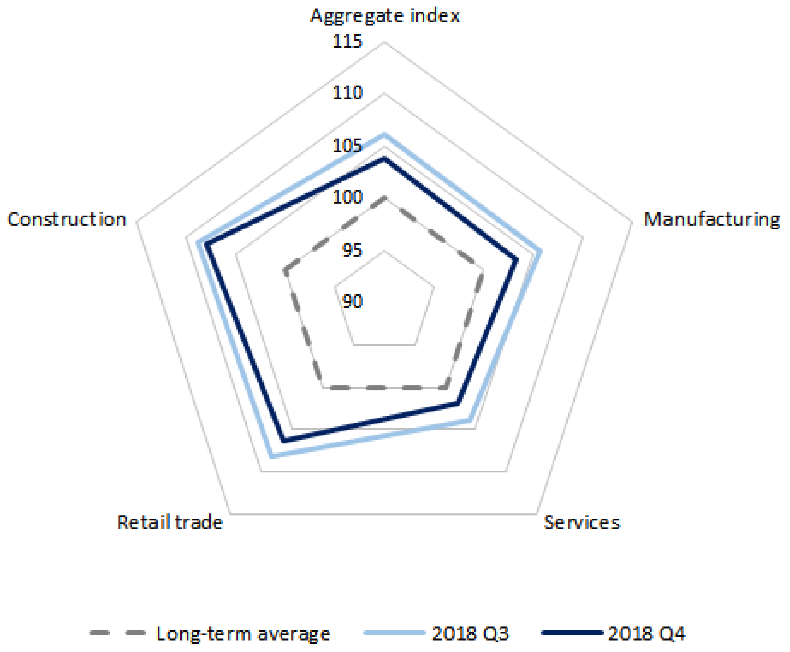
Source: based on Istat data.

Output in construction increased on average in the first ten months of 2018 (1 per cent year-on-year), although it remained close to the historically low levels that characterised the 2015-2017 period. The housing market survey conducted in October by the Revenue Agency, the Bank of Italy and Tecnoborsa found that the expectations of industry operators had improved. However, more recent surveys of building firms show a deterioration in assessments of demand.

Activity in the services sector decreased moderately in the third quarter of 2018 (-0.2 per cent on the previous period), reflecting the weakness of consumption spending. Qualitative indicators point to stagnation. The PMI for services remained below the threshold indicating expansion in January.

For all sectors, the aggregate index of business confidence, obtained as the weighted average of sectoral indices, was slightly lower in the autumn quarter (Figure 10). In January, the aggregate index fell further, reflecting the views of firms in all the major sectors, with the exception of construction.

__Figure 9__ – Confidence in productive sectors (1)
(index; average January 1998 – December 2018=100)

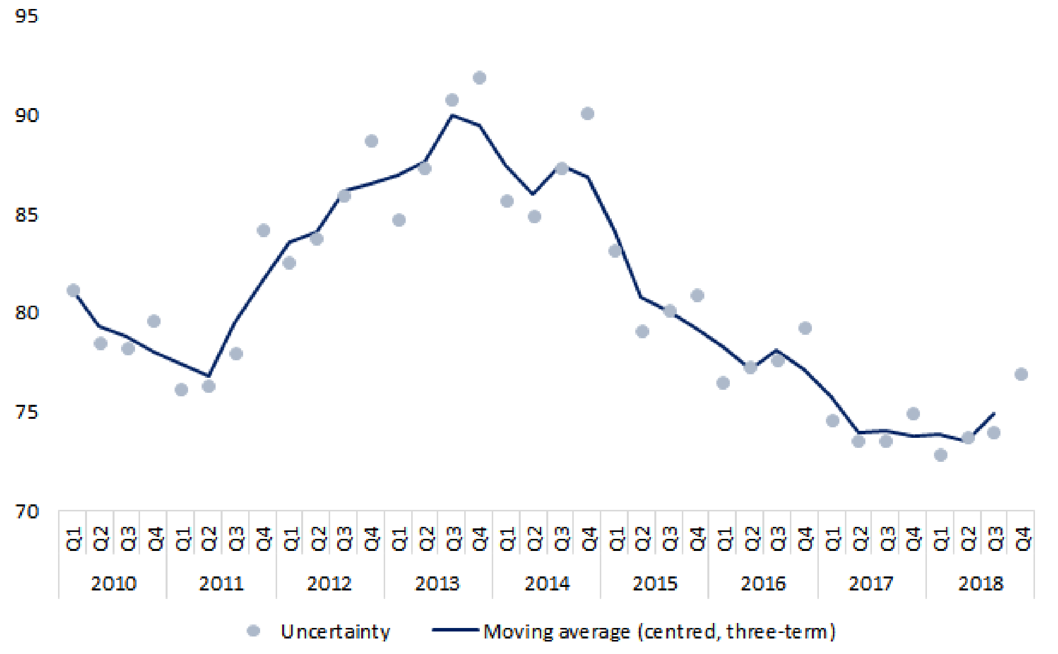


Source: based on European Commission and Istat data.
(1) The aggregate confidence indicator is constructed by applying the weights used by Istat to produce the Istat Economic Sentiment Indicator (IESI) to the time series (standardised) of sectoral confidence indicators of the European Commission.

The uncertainty of households and firms continues to rise. The PBO index, while remaining below the peak registered in 2013-2014, continued to worsen in the final part of 2018 (Figure 11), mainly reflecting the building and services components.

Composite economic indicators all show economic growth coming to a halt. Starting in November, the ITA-coin coincident indicator produced by the Bank of Italy (ITA-coin) slipped into negative territory for the first time since October 2016, reaching -0.25 in January. The Istat leading indicator declined throughout 2018.

Figure 10 – PBO indicator of uncertainty
(index; 1993 Q1=100)



Source: based on Istat data.

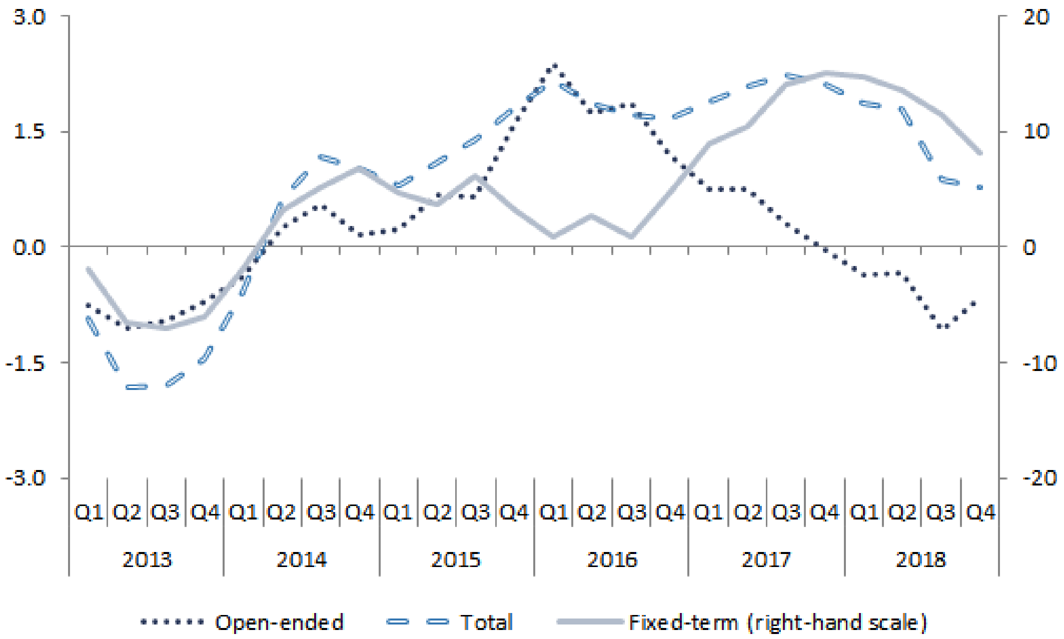
The labour market slows

Conditions in the labour market remained favourable in 2018, although signs of a slowdown emerged in the second half of the year. Employment increased by 0.9 per cent overall, compared with 1.1 per cent in 2017), again driven by payroll employment, especially among those on fixed-term contracts. However, for the first time since 2014 open-ended employment did not provide support to the job figures, reflecting at least in part the reduction in contribution relief measures. The contraction in self-employment under way since 2011 continued. The decline in the number of job seekers steepened, while the contraction in the inactive population grew less pronounced. Wage growth stabilised.

In the summer quarter, labour demand, measured in terms of the number of payroll jobs, turned downward again (-0.4 per cent on the previous quarter), reflecting the deterioration in economic activity. Considered by productive sector, the sharp reduction in services (-0.7 per cent) was only partially offset by the recovery in manufacturing and construction.

Preliminary information drawn from the Labour Force Survey points to a marginal increase in the number of persons in employment in the final quarter of the year (0.1 per cent on the previous quarter). By contractual form, permanent employment showed some resilience, while the expansion in fixed-term employment continued (Figure 12).

Figure 11 – Change in payroll employment
(percentage year-on-year change)



Source: based on Istat data.

Last year, the decline in the number of people looking for employment continued until the third quarter (-5.1 per cent on the previous period), before reversing course in the final quarter of 2018 (2.2 per cent). The unemployment rate, which fell in the middle quarters of 2018, turned upwards in the fourth, averaging 10.6 per cent for the year as a whole (seven-tenths of point lower than in 2017). This decline, which reflected a larger increase in the employment rate than that in the participation rate, also involved the long-term unemployed.

The recovery in wage growth continued. Hourly contractual earnings for the entire economy accelerated to 1.9 per cent year-on-year in the third quarter, buoyed by the renewal of contracts in the public sector. Excluding the public component, growth was nevertheless similar to that in actual earnings, which eased to 1.3 per cent. More recent data for the fourth quarter show hourly contractual earnings rising only slightly more slowly than in the previous quarter. Hourly earnings grew by 1.4 per cent on average for the year (from 0.6 per cent in 2017), driven by the increase in the public sector (2.6 per cent, after essentially no change the previous year), with earnings in the private sector rising more slowly (1.1 per cent).

The decline in hourly productivity in the summer (down 0.6 per cent on an annual basis for the entire economy), which involved all major sectors except construction, reflected an increase in hours worked against a decrease in value added. The deterioration in productivity, the acceleration in wages and higher costs for contributions, reflecting the reduction in contribution relief, boosted average unit labour costs by 1.7 per cent year-on-year in the first three quarters of 2018).

Consumer price inflation remains low

Consumer price inflation remained moderate last year, staying at its 2017 levels for both the global index (1.2 per cent) and for core inflation. Weak domestic demand and the low inflation expectations of firms attenuated the pass-through of higher labour costs to prices.

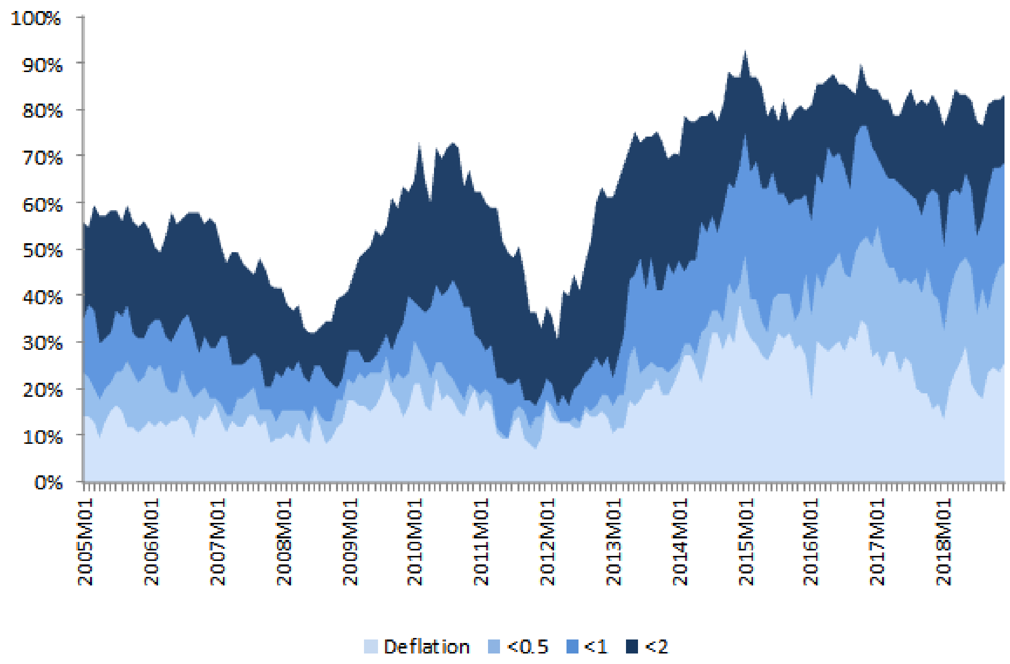
Monthly developments in consumer prices (national consumer price index) were driven by the prices of energy commodities. Inflation fell early in the year, in line with the price of oil, increased in the summer and then fell back at the end of 2018. Preliminary Istat data indicate a further reduction in inflation in January (year-on-year change in the national consumer price index fell to 0.9 per cent from 1.1 per cent the previous month), mainly reflecting the energy component (down from 6.6 per cent to 3.4 per cent in December).

Last year, core inflation, which excludes the prices of energy and unprocessed food, remained at the low levels registered in 2017 (0.7 per cent); in January it fell to 0.5 per cent.

Price reductions continue to affect an appreciable number of expenditure items. Following the summer, the share of items in the basket of the harmonised price index whose prices are decreasing rose (to 26 per cent in December; Figure 13). In December, the share of items characterised by low inflation, i.e. those whose prices are rising year-on-year by less than 0.5 per cent and 1 per cent, amounted to 47 and 69 per cent, respectively. Considering price increases of less than 2 per cent, the share rose to 83 per cent, a high level in historical terms.

Imported inflation was modest in 2018, although producer prices in industry gained momentum in the early part of the year (average growth of 3.4 per cent compared with 2017), before decelerating towards the end due to the slowing of energy prices.

Figure 12 – Proportion of goods and services in the HICP experiencing deflation or low inflation
(percentage shares)



Source: based on Eurostat data.

In the construction sector, the prices of residential buildings continued to rise at a moderate pace (an average of 1.3 per cent in 2018, as in 2017), with a slight acceleration in the second half of the year (an average of 1.7 per cent year-on-year from July onwards, compared with 0.9 per cent in the first six months of the year). In services, producer prices accelerated the rising trend that began two years ago. In the first three quarters of 2018, it registered an average annual increase of 1.8 per cent (0.3 per cent in 2017).

The inflation expectations of businesses and households reported in Istat confidence surveys were moderate over the course of 2018, declining towards the end of the year. Last January, 61.3 per cent of households expected stable or decreasing prices in 2019 (an average of 56.3 per cent in 2018). Firms also appear more cautious, as they have significantly revised their expectations downwards since the autumn. The balance between those who expect prices to increase and those expecting a decrease fell from 8.4 in January 2018 to 3.6 in December, before falling further in January of this year (to 1.7).

Macroeconomic forecasts for the Italian economy

This section outlines the forecasts for the Italian economy for the 2018-2020 period. The forecasting exercise differs from those conducted by the PBO for the specific purpose of endorsing the macroeconomic scenarios of the MEF. In particular, the increase in indirect taxes provided for in the safeguard clauses is not incorporated in the projections for next year.

Economic activity in 2018-2020

The estimates incorporate preliminary data for GDP, which in 2018 is estimated to have increased by 1.0 per cent (as reported in the previous section). The deterioration in economic growth, which turned negative in quarterly terms in the second half of the year, had an unfavourable impact on GDP growth in 2018 and will have a negative statistical carry-over impact of -0.2 per cent this year. The short-term forecasting models of the PBO find that activity in the current quarter will be virtually stagnant or slightly negative. Aggregate demand is expected to gradually strengthen in subsequent quarters, more intensely in the second half of the year, sustained by the expansionary measures envisaged in the budget package. GDP growth is forecast to average 0.4 per cent this year, while in 2020 it is expected to rise to 0.8 per cent (Table 2). These projections appear to fall broadly in the middle of those recently formulated by various organisations (Table 3) for the entire forecast horizon.[3] In making these comparisons, however, it is necessary to bear in mind that they reflect the different assumptions adopted by the forecasters and differences in the dates on which they were published, which impact the short-term data incorporated in the projections.

[3] A number of small differences for 2018 are attributable to the working day adjustment performed by some forecasters.

Table 2 – Forecasts for the Italian economy (1)

	2017	2018	2019	2020
INTERNATIONAL EXOGENOUS VARIABLES				
World trade	5,3	4,0	3,4	3,5
Oil price (Brent, dollars per barrel)	54,3	71,1	61,3	61,2
Dollar/euro exchange rate	1,13	1,18	1,16	1,19
ITALIAN ECONOMY				
GDP	1,6	1,0	0,4	0,8
Imports of goods and services	5,2	1,7	2,7	2,9
Final domestic consumption	1,1	0,6	0,8	0,9
- Consumption of households and non-profit institutions serving households	1,5	0,7	0,9	1,2
- General government expenditure	-0,1	0,1	0,5	0,2
Investment	4,3	3,9	0,8	0,6
Exports of goods and services	5,7	0,8	2,0	2,8
CONTRIBUTIONS TO GDP GROWTH				
Net exports	0,3	-0,2	-0,2	0,0
Inventories	-0,4	0,1	-0,1	0,0
Domestic demand net of inventories	1,6	1,2	0,7	0,9
PRICES AND NOMINAL GROWTH				
Import deflator	3,5	2,5	1,5	1,3
Export deflator	1,6	1,8	2,1	1,7
Consumption deflator	1,1	1,1	1,1	1,3
GDP deflator	0,5	1,1	1,2	1,4
Nominal GDP	2,1	2,1	1,7	2,3
LABOUR MARKET				
Compensation of employees / fte	0,2	2,0	1,9	1,8
Employment (FTEs)	0,9	0,5	0,3	0,6
Unemployment rate	11,2	10,6	11,5	12,0

(1) Percentage changes except for contributions to GDP growth (percentage points), the unemployment rate, the exchange rate and the oil price. Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

Table 3 – Recent forecasts for Italian GDP growth
(percentage changes)

	2018	2019	2020
PBO, unadjusted	1.0	0.4	0.8
REF (29 January), adjusted for calendar effects (1)	0.9	0.0	0.8
IMF (21 January), unadjusted	1.0	0.6	0.9
Bank of Italy (18 January), adjusted for calendar effects (1)	0.9	0.6	0.9
Oxford Economics (11 January), unadjusted	0.9	0.3	0.8
Prometeia (19 December), adjusted for calendar effects (1)	0.9	0.5	0.7
CER (18 December), unadjusted	1.1	0.8	1.4
Memorandum item			
MEF (18 December), unadjusted	1.0	1.0	1.1

(1) 2018 has three more working days than 2017, 2019 has the same number of working days as 2018 and 2020 has two more working days than 2019.

Forecasts for the components of expenditure

The Italian economy is expected to be driven over the entire forecast horizon by final domestic demand (net of changes in inventories), which is forecast to contribute about one percentage point to growth on average over the three years. Conversely, net foreign demand is expected to subtract two-tenths of a point from GDP growth in both 2018 and 2019. The contribution of changes in inventories to GDP growth would be negligible overall. Among the main components, household consumption is forecast to accelerate in 2019-2020, sustained by the measures envisaged in the 2019 budget package as well as by the increase in employment. This year, household spending will track developments in purchasing power and will be boosted by transfers to low-income households. Private consumption also benefits from price stability due to the non-activation of the VAT safeguard clause. Expenditure on capital goods, however, is forecast to decline, emphasising the key macroeconomic role of investment for the development of the Italian economy over the forecast period. The capital accumulation process is expected to be held back by weak expectations for both domestic and international demand. Also having an impact would be less favourable terms for accessing bank credit, which is affected by the increase in yields on sovereign debt and the revision of tax incentives. The sharpest slowdown in investment is expected to come in machinery and equipment, which has the greatest impact on potential output. By contrast, investment in construction is expected to expand moderately, buoyed by the recovery in public investment and a gradual improvement in the real estate market. After the abrupt slowdown in 2018, foreign demand is expected to revive in the following two years, with the pace of export growth gradually converging towards that in world trade. The growth in imports, which were relatively more buoyant this year, is forecast to stabilise in 2020 at a pace similar to that in exports, reflecting the slowdown in spending on capital goods.

Forecasts for the labour market and inflation

Employment (measured in standard labour units) is expected to stabilise, with average growth of about half a percentage point over the three years of the forecast period (down from 0.9 per cent in 2017). The start of the citizen's income mechanism this year is projected to trigger a rapid and significant expansion in the labour supply, intensifying a trend already under way in recent years. However, the transition from unemployment into employment would be gradual, so there will be a discontinuity in the unemployment rate in the initial years of implementation of the measure, which will rise both this year and the next, due exclusively to the increase in labour market participation.

Inflation, as measured by the consumption deflator, is expected to be just over 1 per cent this year, as it was in 2017-2018, and will then increase slightly in 2020, driven by the strengthening of wages and private consumption spending. The effects of external exogenous factors (the prices of energy commodities in euros) is expected to be negligible. The growth rate of the GDP deflator is expected to be marginally higher than the consumption deflator in both 2019 and 2020 (respectively at 1.2 and 1.4 per cent). Nominal GDP growth is forecast to slow this year (to 1.7 per cent) due to the weakening of real growth, but it should recover to over 2 per cent next year.

Risks to the forecast

The risks to the forecasting scenario are many and predominantly on the downside. Developments in the international variables in the baseline scenario assume the absence of new restrictions on international trade and any further deterioration in European economic conditions, a generally small impact from existing sources of geo-political instability (Brexit, the political crisis in Venezuela) and the orderly normalisation of monetary policies in the major currency areas. Any strains in these areas could accentuate volatility in the commodity and currency markets, with an impact on international growth and Italian exports. An additional significant risk factor is yields on sovereign debt securities. Any increase in their level, especially if persistent, could affect credit supply conditions for the private sector, with a possible loss of confidence among households and firms. Conversely, a further decline in yields on government securities could foster a faster expansion of GDP and disposable income than expected in the baseline scenario of this forecast.

Box – The assumptions adopted in the forecasting exercise

Assumptions about the international environment. The exercise covers the 2018-2020 period and is based on updated international exogenous variables (on the basis of the technical assumptions applied to the market figures available as of January 22, 2018). In particular, it is assumed that: 1) the slowdown in global economic activity will continue, with world trade in goods and services, after the slowdown recorded in 2018 (4.0 per cent, 1.3 percentage points less than in 2017), expanding at a slightly slower pace in 2019 as well (3.4 per cent on average for the two years); 2) monetary conditions and market expectations will gradually normalise, with the short-term interest rate in the euro area being essentially nil this year and slightly positive in 2020; 3) the euro will experience a small, temporary depreciation in 2019, in line with the signals provided by forward market prices, with an average dollar/euro exchange rate of 1.16 in 2019 and 1.19 in 2020; and 4) oil prices will decline over the forecast horizon, with prices observed on futures markets at $61.3 a barrel on average in 2019 and essentially unchanged in 2020.

Assumptions about the public finances. The public finance variables reflect the measures contained in the budget package (the 2019 Budget Act and Decree Law 119/2018), which in the PBO forecasts exert an additional stimulus to 2019 GDP growth of 0.3 percentage points.[4] It should be noted in this regard that the budget package provides for the activation of safeguard clause increases in indirect taxes in 2020. Consistent with the technical assumptions adopted by other macroeconomic forecasters, the baseline scenario (Table 2) assumes that the increases are not activated and that the revenue shortfall is not funded. This technical assumption differentiates this forecast from those formulated by the PBO as part of the endorsement exercises conducted for the MEF macroeconomic scenarios, [5] while making it comparable with the most recent projections of the other main national and international organisations.

Alternative scenarios. In addition to the baseline projection (Table 2), two alternative scenarios were analysed. The first incorporates the activation of the safeguard clauses (on VAT and excise duties) next year, as provided for in the 2019 Budget Act. The hike in indirect taxes would increase the household consumption deflator by one percentage point, with a consequent erosion of purchasing power. Private consumption spending would be lowered by about half a percentage point by the higher taxes in 2020; GDP growth would come to 0.6 per cent (0.2 percentage points lower than the baseline simulation).

The second scenario envisages an additional stimulus to investment, achievement of which would require removing the main factors that are currently preventing this from happening, such as the deterioration in firms' expectations, the tensions on sovereign debt securities and the risk of a tightening of lending conditions. An additional boost to investment expenditure of half a percentage point of ex ante GDP in 2019-2020 (about €9 billion per year) would prevent the deceleration in investment in 2019 anticipated in the baseline scenario, and would produce an acceleration in 2020. The overall expansionary impact on GDP is projected at 0.4 percentage points on average over the 2019-2020 period. Consumer price inflation and other major price dynamics would remain substantially unchanged.

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[4] An assessment of the macroeconomic effects of the budget measures for this year is provided in the 2019 Budgetary Policy Report.

[5] The findings of the endorsement exercise for the macroeconomic forecasts published in the Government's policy documents are available at: http://www.upbilancio.it/rapporti/.