ufficio parlamentare di bilancio

The Chairman

Rome, 25 March 2019

Law 243/2012 requires that the Parliamentary Budget Office (PBO) performs 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 2019-2022 macroeconomic trend forecasts transmitted by the MEF to the PBO on 22 March 2019 as they fall within a range deemed acceptable based upon currently available information, although they are exposed to significant downside risks associated with numerous factors.

An explanatory memo of this letter will be transmitted subsequently.

Sincerely,

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Explanatory note to the endorsement letter of the Parliamentary Budget Officefor the trend macroeconomic scenario in the 2019 EFD

This note which supplements 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 2019 Economic and Financial Document (EFD) offers a short description of the procedure used to validate the forecasts and a summary analysis of the risks associated with those forecasts.

Endorsement procedure

On 25 March 2019 the PBO sent to the MEF its endorsement letter for the trend macroeconomic forecasts in the 2019 EFD (transmitted by the MEF on 22 March), 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 based on short-term models for GDP and its supply and demand components; 2) 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; 3) the annual forecasts produced separately by the independent forecasting institutes (CER, Prometeia, and REF.ricerche) that make up the PBO forecasting panel; and 4) the most recent forecasts available from other national and international institutions. The comments were also based on the analysis of the internal consistency of the macroeconomic scenario developed by the ME, also with the 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 all PBO's panel of forecasters were formulated on the basis of the same assumptions for the exogenous international variables used by the MEF.

Outcome of the endorsement exercise

The forecast for real GDP growth in 2019-2022 contained in the trend macroeconomic scenario of the 2019 EFD - which reflects the increases in indirect taxes provided in the safeguard clauses for 2020 and 2021 - appears to fall within an acceptable forecasting range, although some of the variables subject to the endorsement diverge slightly from the upper bound of the forecasts prepared by the PBO panel. The overall acceptability of the EFD trend forecasts takes account of: a) the modest size of the overshoots, also bearing in mind the degree of uncertainty affecting the short-term outlook; b) the forecasts for real and nominal GDP growth, which do not exceed the PBO panel’s upper bound. However, various sources of uncertainty must be noted, in both the short term and the medium term, mainly representing downside risks for the EFD macroeconomic scenario.

The comments on the forecast are summarised below for the main variables considered in the endorsement; a number of risk scenarios of relevance t for the Italian economy in the short and medium term, are also delineated.

The MEF trend macroeconomic scenario forecasts a sharp slowdown in real GDP growth this year, to 0.1 per cent (from 0.9 per cent in 2018), followed by a recovery to 0.6 per cent in 2020 and a progressive acceleration in 2020-2021. The MEF’s GDP growth projections in each of the forecast years lie below the upper bounds of the PBO panel forecasts.

However, this year’s rate of economic growth remains exposed to uncertainty about quarterly economic developments. The forecasts of both the MEF and the PBO panel foresee a gradual improvement in economic conditions this year, with a sharper upturn in the second half of the year. Since the growth rates for the first two quarters have a larger statistical impact on the annual change than the rates in the third and fourth quarters, if growth in the winter is unexpectedly slow a stronger acceleration would be necessary later in order to achieve the 0.1 per cent GDP growth forecast for 2019.

In the MEF scenario, growth is almost entirely driven by internal components of demand, since the contribution of net exports is substantially zero over the entire forecast horizon. Household consumption replicates last year’s growth (0.6 per cent) in 2019-2020, but in the following two years it accelerates slightly. By contrast, the PBO panel sees consumption slowing in the next two years, especially in 2021 (the average forecast deceleration is half a percentage point), reflecting the increase in indirect taxes. On the capital formation front, the MEF forecasts a contraction in the machinery and equipment component this year and a less marked slowdown in construction. Over the remainder of the forecast horizon, investment in capital goods is expected to strengthen, while the pace of growth in the real estate component is projected to continue. According to the PBO panel, the slowdown in total investment is expected to be more pronounced this year, while the recovery envisaged by the MEF in the following three years does not exceed the upper bound of the panel forecasts.

For foreign trade, export growth is expected to be slightly faster than in 2018, thanks in part to the depreciation of the euro and despite the slowdown in world trade. This assessment of 2019 is shared by the PBO panel, whereas over the next three years the panel expects market shares to stabilise, while the MEF expects them to continue contracting.

The forecasts for employment (measured in terms of full-time equivalent units) are very similar to the PBO panel median projections for 2019-2020 and only slightly higher in the subsequent two years. The unemployment rate is also virtually identical through next year and more favourable thereafter. It should be noted that the panel forecasts are mixed, since the difference between the upper and lower bounds is around 1.5 percentage points over the next three years, due to the complex and uncertain assessment of the impact of the Citizenship Income on the labour supply both in economics and in the official statistics.

With regard to nominal dynamics, the MEF trend macroeconomic scenario forecasts a change of 1.0 per cent in the private consumption deflator this year, substantially in line with the median assessment of the PBO panel. Prices are expected to accelerate starting in 2020, due to the increase in indirect taxation, with inflation rising to 2.3 per cent, followed by a gradual decline to 1.5 per cent in 2022. The panel produced diverse assessments of the intensity and temporal distribution of price increases over the three-year period, reflecting the considerable uncertainty of the estimates. The GDP deflator in the EFD's trend macroeconomic scenario accelerates to nearly 2 per cent next year and then gradually slows. This dynamic falls within the range of the PBO panel forecasts, not differing considerably from the median values. Given the forecasts for real GDP growth and its deflator, nominal GDP growth in the EFD scenario is broadly in line with the forecasts of the PBO panel.

The EFD's trend macroeconomic scenario for this year incorporates major measures to stimulate the economy, such as the Citizenship Income, and the strong negative impact that would be generated by the increase in indirect taxes provided in the safeguard clauses in the 2019 Budget Act. The simultaneous operation of these various measures makes macroeconomic forecasts complex and uncertain, especially for 2020-2021. In the MEF macroeconomic scenario and the median forecast of the PBO panel, economic conditions are expected to strengthen progressively this year, driven mainly by an increase in transfers to households.[1] Thanks to the budgetary stimulus, consumption growth would remain constant in 2019, despite the slowdown in productive activity. However, from the first quarter of the following year the trend forecast incorporates the activation of the safeguard clauses, the transmission of which to both prices and quantities has an uncertain impact. The transfer of the increase in indirect taxation to consumer prices can in fact vary greatly depending on a variety of factors. Contingent factors include the phase of the cycle, the expectations of firms that set prices, the level of spare capacity and developments in labour costs and commodity prices. However, also important are structural aspects, such as competitive pressures on domestic and international markets, as well as the characteristics of distribution channels, which in recent years have increasingly turned towards online sales. The uncertainty associated with the transmission of taxes to prices then directly impinges on forecasts for domestic demand. A prompt translation mechanically reduces the purchasing power, which directly affects household spending. Conversely, if the tax increase is absorbed by corporate profit margins, firms would see profits and dividend distributions decline, whose impact on demand would be relatively smaller but would remain significant, due to the scale of the increase in tax rates.[2]

[1] The Parliamentary Budget Office's assessment of the macroeconomic impact of the measures in the Budget Act is discussed in the 2019 Budgetary Policy Report, which is available at http://en.upbilancio.it/wp-content/uploads/2019/03/2019-Budgetary-Policy-Report_web.pdf. With specific regard to the Citizenship Income, the PBO conducted an analysis of its macroeconomic impact, which was discussed in the hearing of the Chairman on 5 February 2019 before the Labour and Social Security Committee of the Senate, which is available at http://www.upbilancio.it/wp-content/uploads/2019/02/Audizione_5_2_2019_Pisauro.pdf (text in Italian).

[2] The ordinary VAT rate would increase from 22 per cent in 2019 to 26.5 per cent in 2021; the current 10 per cent rate would rise by 3 percentage points as from next year.

Risks to the forecasts. The medium-term macroeconomic scenario for the Italian economy is exposed to substantial downside risks, of both an international and financial nature and of domestic origin. The following outlines three categories of risks, which prompt caution in the forecasts.

Risk of a further deterioration in international economic conditions. Although the macroeconomic scenario already appropriately reflects a slowdown in foreign demand variables for Italy, the weakening could be even more pronounced in a number of scenarios. Despite the recent resumption of the dialogue between the United States and China, fears of a global trade war remain high, impacting investment decisions. This is accompanied by the specific risk represented by China, which has a significant role in buoying German industry, given the fact that recent data could reveal a sharper slowdown than that expected by Chinese authorities and the markets. Furthermore, uncertainty over Brexit continues to weigh on Europe as the agreement with the European Union has not been approved by the Parliament, despite the approaching date for the United Kingdom to leave the Union. Other potential global risk factors are represented by economic turndowns (Argentina, Venezuela, Turkey) and local geopolitical tensions (in North Korea, Syria, Iran and the Middle East in general), the unpredictable stance of the US administration and the European elections.

Risk of a weakening in supply. According to the latest Istat business surveys, capacity utilisation in the Italian manufacturing sector is just under 80 per cent, a relatively high value in historical terms. Economic activity therefore requires an expansion in the factors of production, which this year could be undermined by a number of issues. Capital accumulation appears to be affected by less favourable investment conditions, due in part to a tightening of lending conditions. This trend could be amplified by the elimination of incentives (such as super- and hyper-depreciation) that according to firms had stimulated investment significantly. As regards growth in the labour supply, which essentially came to a halt in the second half of last year, a further weakening in the initial quarters of 2019, which would trail the decline in production in the second half of last year with the usual lags, cannot be ruled out.

Financial imbalances and investor risk aversion. Economic and monetary policies remain very expansionary at the global level, fuelling financial excesses in both stock prices and in public and private borrowing. In this environment, negative shocks would be difficult for authorities to accommodate and could induce a sudden increase in investor risk aversion. The increase in risk premiums demanded by international investors would penalise economies with public and private issuers with low credit ratings, such as Italy. On the other hand, appropriate institutional communication and measures by economic policy authorities that meet the needs of the financial markets and the productive system could decrease risk premiums on yields, with a beneficial impact on expectations and the spending decisions of households and firms.