ufficio parlamentare di bilancio

The Chairman

Rome, 1 April 2016

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 validated 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 validating macroeconomic forecasts. In the Memorandum, the parties also agreed to perform the validation 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 validated.

The Board of the PBO hereby validates the 2016-2019 macroeconomic trend forecasts transmitted by the MEF to the PBO on 25 March 2016 as they fall within the range deemed acceptable based upon currently available information.

Pleased find attached an explanatory memo, which will be transmitted to the Parliament following the presentation of the EFD.

Sincerely,

Pier Carlo Padoan
Minister for the Economy and Finance
Via XX Settembre, 87
00187 ROME

Attachment to the validation letter of the Parliamentary Budget Office for the macroeconomic trend scenario in the 2016 EFD

This attachment to the validation letter of the Parliamentary Budget Office (PBO) for the macroeconomic trend scenario (25 March 2016) prepared by the Ministry for the Economy and Finance (MEF) for the 2016 Economic and Financial Document offers a short description of the procedure used to validate the forecasts and a summary analysis of the threats to those forecasts.

Validation procedure for the macroeconomic trend scenario

On 1 April the PBO sent the MEF its validation letter for the macroeconomic trend forecasts for the 2016-2019 period in the 2016 EFD, after having previously transmitted its comments on an initial version of the forecasts to the Ministry.

The validation 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: 1) the PBO estimates for the current year based on short-term models of GDP and the components of aggregate demand; 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 and specifically by the independent forecasting institutes (CER, Prometeia, and REF.ricerche) consulted by the PBO; 4) monitoring the forecasts of other national and international institutions. The validation 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.

Threats to the forecasts in the macroeconomic trend scenario

The MEF macroeconomic trend scenario for 2016-2019, which as from 2017 reflects the increase in VAT and excise taxes associated with the safeguard clauses, appears to be essentially in line with the forecasts of the PBO panel with regard to growth and inflation, which are essential for the public finances. However, the scenario forecasts are generally close to the upper limit of the range of panel projections.

More specifically, the increase in GDP in 2016 and 2018 (1.2 per cent in both years) lies at the upper limit of the forecasts of the PBO panel; in 2017, the GDP growth expected by the MEF (1.2 per cent) is below that limit. The main driver of these results is household consumption. The MEF forecast for growth in that aggregate in 2016 (1.4 per cent) exceeds the highest projection of the PBO panel by a tenth of a point. The forecast for 2018 (1.3 per cent) exceeds that limit by three-tenths of a point. In the MEF scenario, the relatively faster growth in household expenditure appears to reflect the assumption of a higher propensity to consume in 2016 and, despite the increase in indirect taxes in the trend scenario, more favourable developments in real disposable income in 2018. The forecast for the pace of general government consumption also appears higher than the highest assumed by the PBO panel, especially in 2016, 2017 and 2019. With these differences, the MEF forecast is characterised by a higher estimate of the contribution of final domestic demand to GDP growth than the highest forecasts of the PBO panel forecasters, exceeding the panel estimates by two-tenths of a point in 2016 and 2018; in 2017, the contribution of final domestic demand in the MEF scenario is close to the highest projection in the PBO panel estimates. The assumption of more robust domestic demand compared with the upper bound of the PBO panel forecasts is offset in 2016 and 2018 by lower projections for the contribution of net foreign demand.

Under the trend scenario for inflation there are no substantive divergences with the PBO panel forecasts. However, in this case as well, the forecasts are close to the panel's upper limits, reflecting the assumption of a relatively rapid shifting of the VAT and excise tax increases in 2017 and 2018 onto prices. Specifically, the consumption deflator is near the uppermost limit of the PBO forecasts for the 2017-2019 period; the GDP deflator is at the uppermost bound for 2016-2017.

The growth and inflation assumptions of the MEF's trend scenario combine to cause nominal GDP growth to be at the upper limit of the range of PBO panel forecasts over the entire forecasting period (2016-2019). Any adverse surprises on the growth and inflation front would threaten the expansion in nominal GDP and, with it, the reduction of the debt/GDP ratio

These comments are, as noted, based on assessments with reference to the extreme uppermost limit of the range of PBO panel forecasts. Compared with the central tendency of the forecasting interval, the divergences are much greater, further underscoring the risk inherent in the trend scenario forecast. For example, the divergence of the MEF forecast for nominal GDP growth with the median of the PBO panel forecasts is three-tenths of a point in 2016, five-tenths of a point in 2017 and 2018, and three-tenths of a point in 2019.

Additional comments are in order with regard to the assumptions about exogenous international variables, which are exposed to a number of uncertainties in the current environment. For world demand variables (international trade and imports in Italy's main destination markets), the MEF scenario incorporates the assumptions of the European Commission for 2016 and 2017 and uses its own estimates for 2018 and 2019. Taken together, these assumptions appear to fall within the range of the most recent available forecasts. For oil prices, the MEF scenario is based on developments in futures prices, which after a decline of 25 per cent on average for the current year, rise towards $50 a barrel at the end of the period. For the euro exchange rate, the MEF scenario adopts a technical assumption, agreed with the Commission, of no change in rates, but it extends this assumption to cover the entire four-year forecasting period (the Commission adopts the assumption for 2016-2017 only). It is primarily this last technical assumption that appears clouded by the greatest uncertainty. Among other things, it runs counter to the expectations of a gradual appreciation of the euro between 2016 and 2019 that are reflected in forward exchange rates (expectations that are more consistent with the futures prices for oil used in the MEF forecast). An additional risk is therefore the possibility of a less favourable path for the euro exchange rate than that assumed in the MEF scenario, which would thereby impart less impetus to growth and have a weaker impact on inflation than assumed in that scenario.