Summary [*]

The British vote on 23 June in favour of Brexit has heightened the uncertainty of firms and consumers and increased the risk aversion of investors. It is difficult to quantify the impact of the vote on growth prospects, particularly those of the European countries. The effects will depend on how long the uncertainty lasts, the impact of financial instability on the supply of credit and the effectiveness of any countervailing measures taken by economic policy-makers. In updating its forecasts for July, the International Monetary Fund (IMF) lowered its projections for global growth only slightly, assuming the gradual easing of financial tensions, thanks in part to the actions of the central banks. Nevertheless, the IMF emphasized the increase in the adverse risks that Brexit poses for Europe.

After strengthening in early 2016, the economic indicators available for Italy point to a deceleration in the recovery. The PBO's own estimates put GDP growth in the second quarter at around 0.2 per cent (+0.3 in the first quarter). The slowdown is expected to continue in the third quarter (about +0.1), when the uncertainty engendered by the British referendum will be a factor. Based on these estimates, achieving the growth of 1.2 per cent assumed in the Economic and Financial Document (EFD) appears out of reach (the pace of GDP growth would have to be close to 1.5 per cent in the fourth quarter). Assuming moderate but still positive growth in the final quarter of the year (0.2-0.3 per cent), the growth rate in 2016 as a whole would be just under 1 per cent. The recovery is expected to be less dynamic than previously forecast in 2017 as well. The PBO's simulations put the impact of Brexit on growth at 0.2-0.4 percentage points, depending on the severity of the repercussions for the financial markets.

With foreign demand dampened by the international slowdown, domestic spending has been sustaining the Italian recovery. The support has been relatively weak, however, especially in the light of the improvement in purchasing power that the Italian economy has recently been experiencing due to the decline in oil prices. A significant portion of the increased income has not been channelled into expenditure, but rather has gone into rebuilding savings and creating reserves on the part of households and firms.

In the labour market, employment has continued to improve. The reduction of contribution relief in 2016 was reflected in a decline in open-ended hiring. Inflation remains negative, reflecting the deflationary pressure of raw materials prices and weak internal pressures as a result of spare capacity.

[*] *Prepared by the Macroeconomic Analysis Department. Information updated to 25 July 2016.*

The international environment

Uncertainties after Brexit

The outcome of the British referendum of June 23 in favour of the United Kingdom leaving the European Union (Brexit) came in a global context characterized by low growth and weak inflationary pressures.

It is difficult to predict the influence that the British vote will have on these trends, which will also depend on the amount of time it takes to establish a new framework for relations with the European Union (EU) and the economic policy measures taken at the global level to contain any potential instability engendered by a prolonged period of uncertainty.

A large majority of analysts concur that the net long-term (over 10-15 years) impact will be negative for the British economy as a result of the weaker integration of the country with the EU. According to some forecasts, the cost associated with non-optimal resource allocation and the reduction in choice for UK consumers and businesses, net of the benefits of the withdrawal (reduction/elimination of contributions to the EU budget), will permanently reduce British per capita income by 1-3 per cent, depending on assumptions about the agreements that will be reached with the EU. These losses would be compounded by the adverse consequences for productivity growth, although measuring the precise impact is highly uncertain. A number of attempts to quantify the loss, which consider the dynamic effects and those associated with a reduction in foreign direct investment and migration flows, put the long-term reduction in British output at up to 9-10 per cent.[1]

The uncertainties surrounding the ultimate effects of Brexit extend to its short-term repercussions as well. In addition to impacting the British economy, these could also affect the international economy and, in particular, that of the European countries if not effectively countered. The main channels through which the Brexit shock could affect current conditions are essentially three.

- *International trade effect*: a deceleration in the United Kingdom due to the slowdown in investment pending clarification of the framework of commercial/financial relations with the EU. The impact on the rest of the world would be felt through lower English demand for imports.

- *Financial markets effect*: increased risk aversion on the part of investors in financial markets, fuelled in part by the political uncertainty associated with the elections scheduled to be held in Europe in the second half of 2016 and in 2017. In this case,

[1] See Dhingra, S., H. Huang, G.I.P. Ottaviano, J.P. Pessoa, T. Sampson and J. Van Reenen (2016) "*The Costs and Benefits of Leaving the EU: Trade Effects*", *Centre for Economic Performance Technical Report*. For a comparison with the estimates of other institutions and authors that fall within the range of values indicated here, see IMF (2016) "*Country Report no. 16/19, United Kingdom, Selected Issues*", June.

the impact would be transmitted through a decrease in riskier financing, especially in respect of banks, with a reduction in the supply of credit.

- *Confidence effect*: a decline in the confidence of businesses and households as a result of uncertainty about the future of the European area. The impact of a decline in confidence could drag on domestic demand in the various economies.

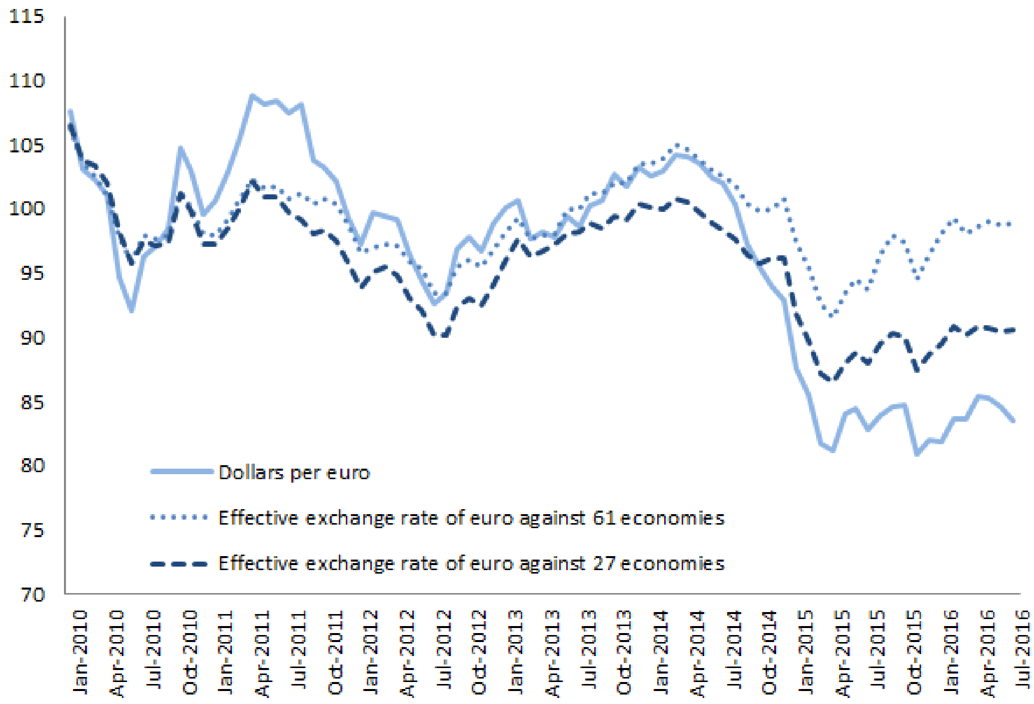
Given the relatively limited weight of the United Kingdom in world trade (exports of goods and services to the UK amount to just over 3 per cent of GDP for the euro area, and less than 2 per cent for Italy), the impact on financial channels and confidence is potentially the most relevant factor, one that must be monitored in the coming months.

The financial repercussions in the aftermath of the referendum have been substantial. They have also reflected the backlash from the upending of expectations for the result, which were generally pointing to a different outcome. Within just a few weeks the pound lost 13 per cent of its value against the dollar, and 8 per cent against the euro. The single currency, in turn, offset the appreciation against the British currency by depreciating against the dollar and yen, remaining broadly stable in average effective terms (Figure 1). The tensions in the foreign exchange market subsequently began to subside, although downward pressures on the British currency and the euro against the dollar remain.

The increase in risk aversion has impacted equity markets, especially those in the euro area and the Italian stock exchange in particular, which has been driven downward by the spread of fears about the condition of banks' balance sheets. The average price of bank stocks in Italy fell by about 30 per cent between June 23 and the low point reached in the first ten days of July (about -20 per cent for the rest of the euro area). The decline was then partially recouped, partly in response to the decisions taken by the Italian Government and approved by the European Commission about possible public guarantees in raising new liquidity in 2016 and the room found in Community rules to permit, if necessary, public intervention to meet the recapitalization needs of individual institutions.

Fluctuations in the risk premiums in the sovereign debt market were much more contained, thanks in part to the support offered by the monetary policy of the European Central Bank (ECB). The yield spreads on 10-year bonds issued by Italy and Spain with respect to the corresponding German securities rose to around 160 basis points in the days immediately following the British referendum, also reflecting the slip into negative territory of yields on German paper. The limited increase in spreads then dissipated in the following weeks: at the end of the third week of July, the spread on Italian BTPs had returned below 130 basis points, while the spread on Spanish securities was less than 120 basis points. At the same time, the yields on the 10-year bonds of the two countries approached the lows reached in March 2015 (Figure 2).

Figure 1 – Euro exchange rate against the dollar and nominal effective rate
(*indices; 2010 = 100*)

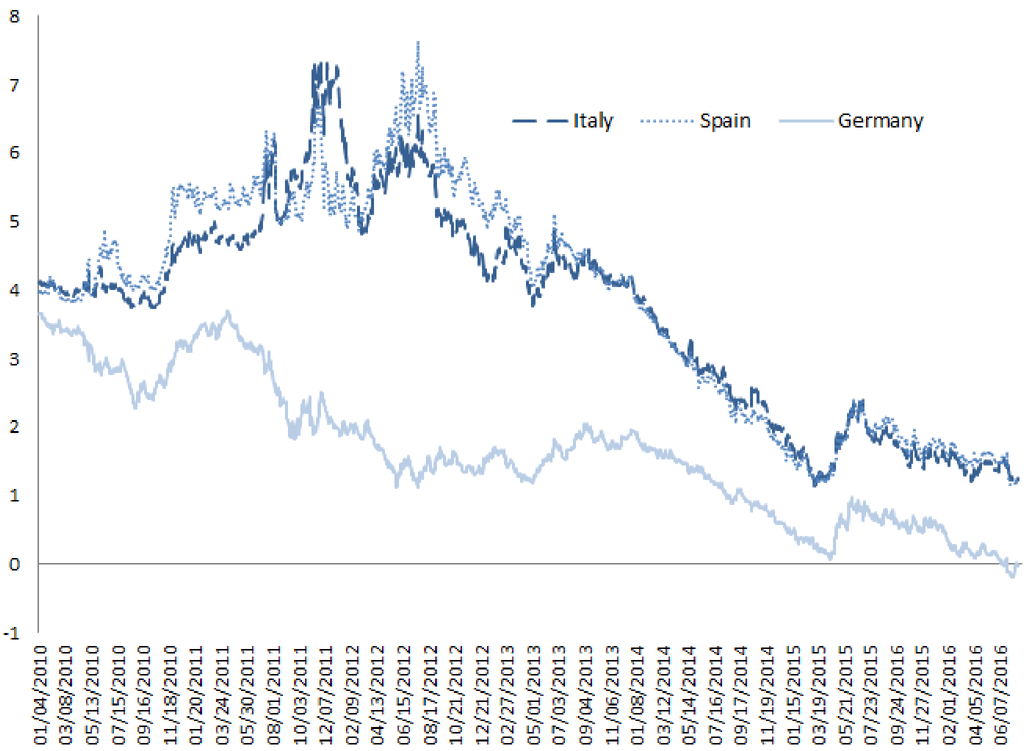


Source: European Central Bank, Bank for International Settlements and PBO estimates.

Overall, financial tensions have been subsiding in the past few weeks, thanks to the actions of the central banks. The picture is, however, marked by uncertainty, with a preponderance of downside risks for global growth.

In updating its forecasts in July (post-Brexit), the IMF cut its projections for global growth only marginally: world GDP growth was put at 3.1 and 3.4 per cent in 2016 and 2017 (a tenth of a point less in both years compared with the April forecasts). The correction of the forecast for international trade in 2016 was more significant (down four-tenths of a point to 2.7 per cent), followed in 2017 by a slight upward revision (one-tenth of a point, to 3.9 per cent). The new scenario is based on the assumption that growth slows in the UK but the economy does not fall into recession and that the international uncertainties triggered by the British vote gradually dissipate without giving rise to significant financial instability. The IMF emphasises the predominance of downside risks inherent in these assumptions.

Figure 2 - Yields on 10-year government securities



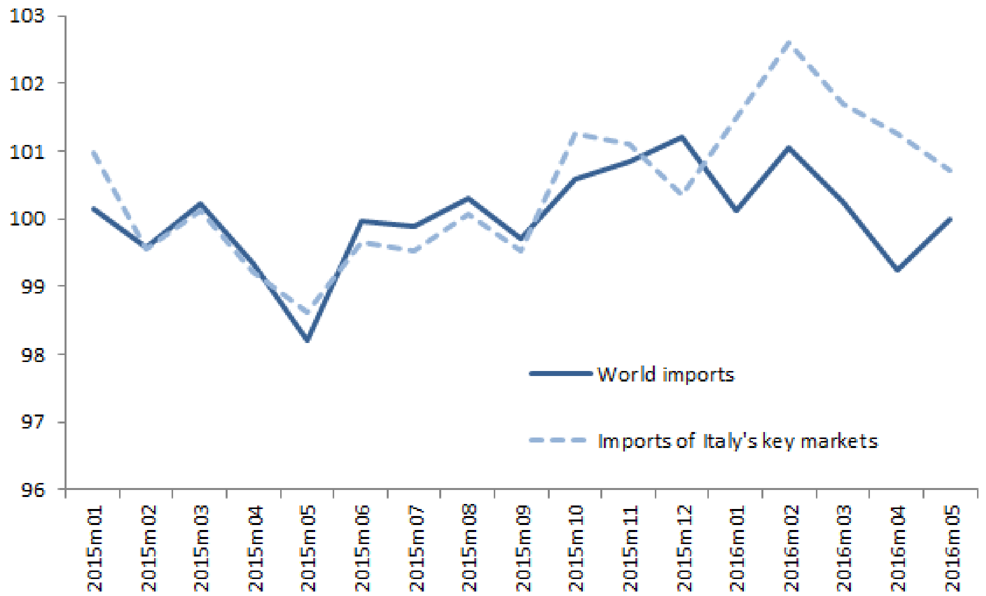
Source: Bloomberg.

Short-term indicators on the international economy

The most recent economic indicators are signalling a change in conditions in the world economy, which in the first half of 2016 expanded at a moderate pace. The slowdown in the emerging countries was offset by moderate growth in the advanced economies. World trade growth remained weak in the first four months of 2016. Growth in Italy's key markets, which was relatively positive in late 2015 and early 2016, has also slowed appreciably (Figure 3).

Among the major economies, the United States continued to drive the global economy, despite seeing growth slow in the first quarter. The evidence for the second quarter was positive, but overall the recovery seems to have stabilized at a more moderate pace than in previous years. Moderate inflation, ambiguous signals on employment and the uncertainties in the international markets have prompted the Federal Reserve to delay any rise in official interest rates. After the British vote, the market generally does not expect any increases in 2016.

Figure 3 – World imports and Italy’s key markets
(*indices; 2015 = 100*)



Source: based on Central Planning Bureau data.

Economic activity also continued to expand in the United Kingdom in the first quarter and, according to available economic indicators, this growth continued in the second. However, the first indicators to emerge following the referendum point to a substantial deterioration in business confidence (the PMI fell sharply in July, sliding below 50). In response to the risks of financial instability and economic slowdown, the Bank of England took action to support the cycle, reducing capital requirements for banks and announcing further expansionary steps for the summer.

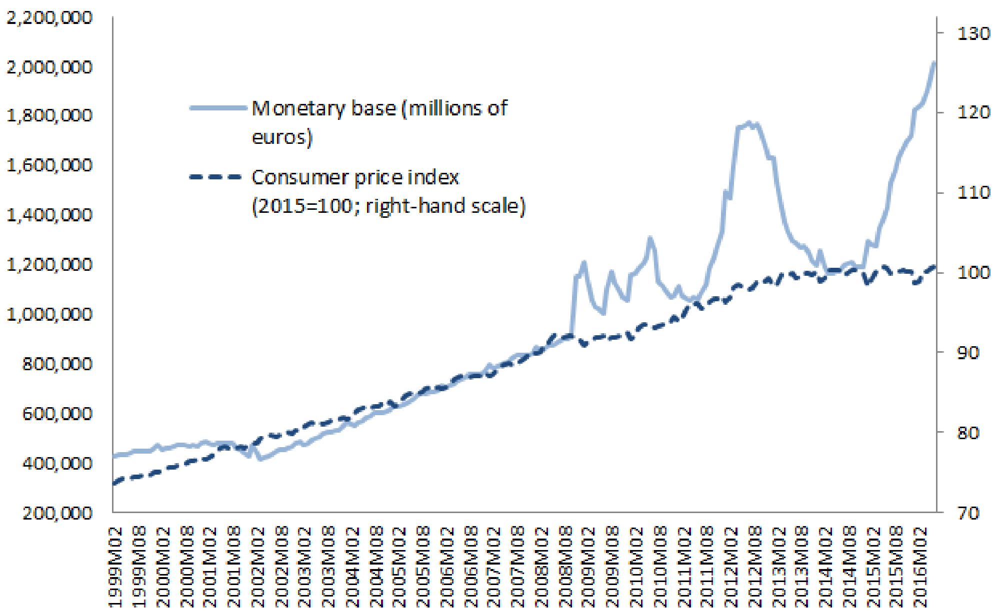
After the acceleration in the first quarter (+0.6 per cent), the recovery in the euro area slowed in the spring months. The weakening of foreign demand was offset by growth in the internal components of expenditure. Leading indicators point to a continuation of modest growth, but risks have increased. According to initial assessments of the European Commission, the British referendum could trim one- or two-tenths of a point from euro-area growth this year and between two- and four-tenths of a point in 2017, depending on the severity and duration of the resulting uncertainty.

The ECB's action to stimulate inflation

In this context, the action of the ECB has been essential in providing liquidity to the system to counter the intensification of financial risks, support the economic cycle and revive inflation. As part of the decisions made last March to strengthen the monetary stimulus even further, in June the Eurosystem extended its monthly purchases of securities to include investment grade bonds issued by euro-area firms and, at the end of that month, carried out the first of four long-term refinancing operations for the banking sector on very favourable terms. At its July meeting, the first after the British vote, the ECB left monetary policy unchanged, waiting to gather more information on economic developments and obtain, in September, new estimates of growth in the euro area.

The central bank's actions are unfolding in a very complex environment for the financial markets and the formation of expectations. The exceptional nature of the situation is highlighted by the difficulty of transmitting the strong monetary stimulus to inflation (Figure 4). In June, inflation in the euro area was only barely positive (+0.1 per cent), while the rate for the less volatile components (excluding oil and food products) was low (+0.9 per cent). Medium-term inflation expectations, as measured on the basis of yields on financial instruments, resumed their decline towards the lows that have distinguished the last few years, despite the strengthening of the monetary stimulus since the beginning of 2016.

Figure 4 - Euro area: monetary base and consumer prices



Source: ECB and Eurostat.

The Italian economy

A slow recovery driven by domestic demand

In the first quarter of 2016 Italian GDP rose by 0.3 per cent (+1 per cent year-on-year), gathering pace after having slowed in the second half of 2015 (+0.1 per cent in the fourth quarter). The growth for 2016 that would be achieved if there were no further changes in the remaining quarters of the year is 0.6 per cent.

The recovery was mainly driven by household consumption spending and by inventories, both of which contributed 0.2 percentage points to GDP growth (Figure 5), while the contribution of investment was nil and that of net exports was negative (-0.2 percentage points), the result of a larger contraction in exports (-1.5 per cent) than in imports (-0.9 per cent).

The gradual recovery of private consumption now under way for over two years thus continues. The positive trend has been influenced by the rise in households' disposable income, which the improvement in the labour market began to affect last year. At the beginning of 2016, increases were recorded in purchases of durable goods (+0.5 per cent) and non-durables (+0.7 per cent). Purchases of services also increased somewhat (+0.2 per cent). Nevertheless, although conditions remain favourable, elements of uncertainty have emerged that are prompting households to exercise prudence in their spending. The climate of consumer confidence has been deteriorating since the spring, with less optimism about personal economic conditions and those of the country in general. Consumers are also taking a dimmer view of the advisability of purchasing durable goods, the component of consumption that has been growing fastest in recent years. This uncertainty is hindering consumer spending. In the first quarter, slightly more than a quarter of the increase in real disposable income (which rose by 1.1 per cent) was transformed into greater consumption, with a consequent rise in the average propensity to save (to 8.8 per cent).

Fixed capital accumulation by firms is growing even more slowly. The slight increase in gross fixed investment in the first quarter (+0.2 per cent) was again driven by investment in transport equipment (+2.5 per cent), while investment in machinery and equipment remained modest (+1.1 per cent) and investment in construction again contracted (-0.5 per cent) after having staged a recovery in the second half of 2015. Improved credit conditions do not appear to have lent any impetus to this component of expenditure and, although the Bank of Italy survey signals an upturn in firms' investment plans, the level of investment remains 30 per cent lower as a percentage of GDP than before the crisis (20 per cent lower excluding construction investment).

Figure 5 - Change in GDP on previous quarter and contributions of the components of demand
(*percentage changes and contributions in percentage points*)

Source: Istat.

The terms of trade and domestic demand

The weakness of the recovery in domestic demand stands out especially when compared with the improvement of the purchasing power of the Italian economy, enabled by the improvement in the terms of trade (the ratio of export and import prices).

The change in the country's purchasing power, a consequence of developments in export and import prices, is measured by so-called command GDP.[2] That aggregate increases faster or slower than GDP depending on whether the terms of trade improve

[2] Command GDP measures the purchasing power of a country's output, i.e. its ability to purchase goods and services on the world market in exchange for its output. It is obtained by deflating, in the GDP accounting identity, the value of exports with import prices, so that improvements in the terms of trade (export prices increase with respect to import prices) are translated into a larger increase in this aggregate than the rise in GDP and vice versa. It is a statistic widely used in the analyses of the OECD and the national accounts of the United States. See Kehoe T. J. and Ruhl K. J., (2008) "*Are shocks to the terms of trade shocks to productivity*?", *Federal Reserve Bank of Minneapolis*, January.

or deteriorate. In recent years, Italy's command GDP has increased substantially faster than GDP (Figure 6). In particular, during the recent recovery, it has increased by more than twice the gain in GDP (+2.6 per cent, compared with +1.3 per cent between the fourth quarter of 2014 and the first quarter of 2016), reflecting the positive impact of the fall in oil prices on Italy's real GDP. Compared with such an improvement in the economy's spending potential, the response of domestic demand (as measured by private consumption and gross fixed capital formation) has been very weak (with an overall increase of 1.7 per cent). This indicates that a significant proportion of the increase in the country's purchasing power has not gone towards expenditure but has instead been used to reconstitute household savings, repay loans and form reserves for firms with limited or uncertain market prospects.

The most recent economic developments: industry slows

After starting the year in recovery after the slowdown at the end of 2015, the most recent information signals a new weakening of economic activity. Industrial production (which rose by 0.5 per cent in the first quarter) turned downwards in May (-0.6 per cent compared with the previous month). The slowdown in that month was also confirmed by a decline in turnover (-1.1 per cent) and orders (-2.8 per cent), which reflected the contractions recorded in both the domestic and foreign markets. Output decreased in all sectors (-1.8 per cent for capital goods, -0.9 per cent for intermediate goods, -0.6 per cent for energy and -0.3 per cent for consumer goods). By contrast, the manufacture of transport equipment was still expanding (+0.8 per cent). Overall, the weakening of industrial production has been associated with a new deterioration in the scope of the recovery: the percentage of growth sectors fell in April-May to 55 (at the beginning of the year, the figure was estimated at more than 60 per cent; Figure 7). [3]

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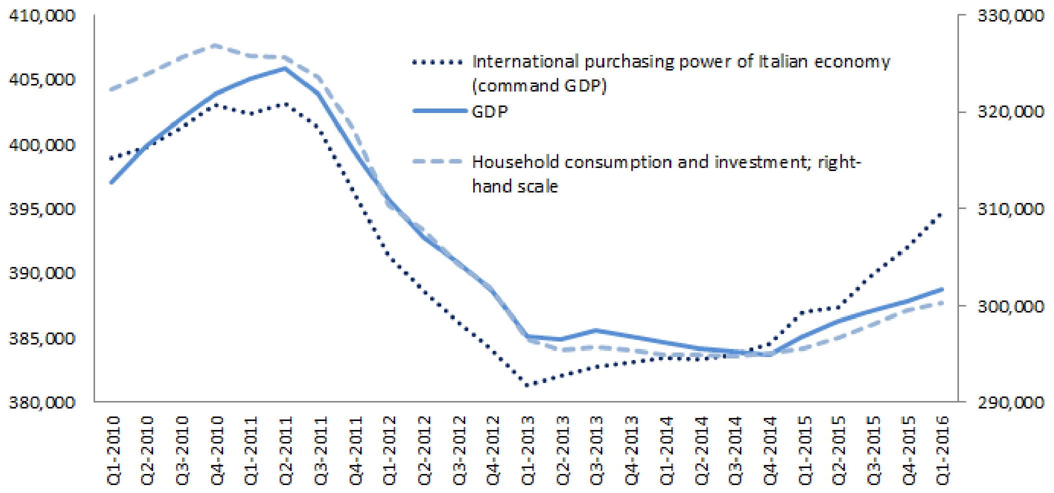
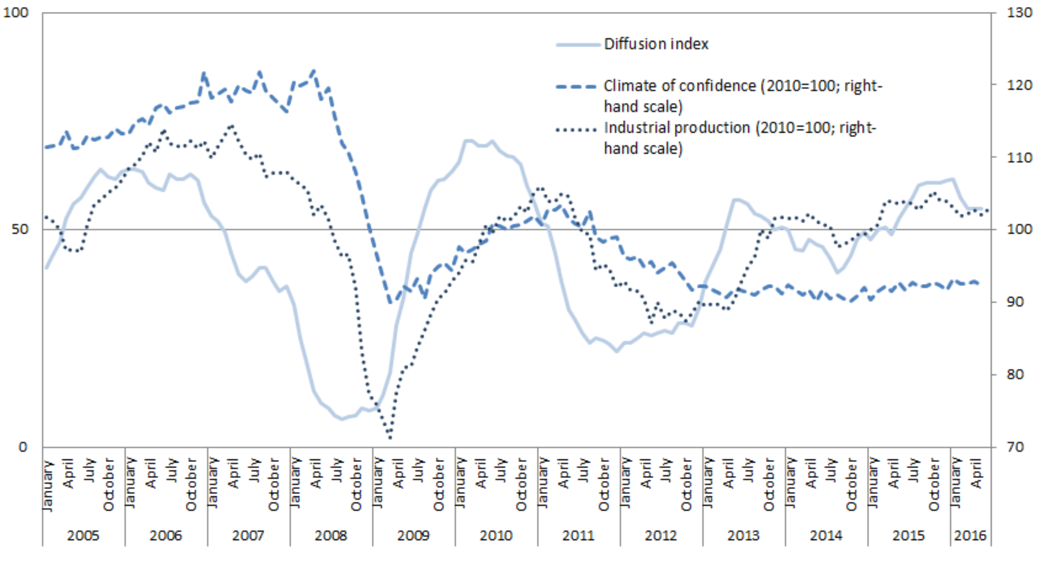
[3] The diffusion index is calculated by taking the share of manufacturing sectors (about 180 ATECO 4-digit sectors, excluding energy) in expansion, i.e. with a positive trend growth rate (obtained with a Kalman filter in an unobserved component model with trend, slope and seasonal components). Thus, a value of 50 indicates that 50 per cent of the sub-sectors are expanding. By construction, all the sub-sectors in the diffusion index have an equal weighting.

Figure 6 - Purchasing power of the Italian economy, GDP and domestic demand
(*millions of euros; chained-linked values, reference year = 2015*)



Source: based on Istat data.

Figure 7 - Diffusion of the recovery in the manufacturing sector
(*percentages and indices; 2010 = 100; seasonally adjusted*)

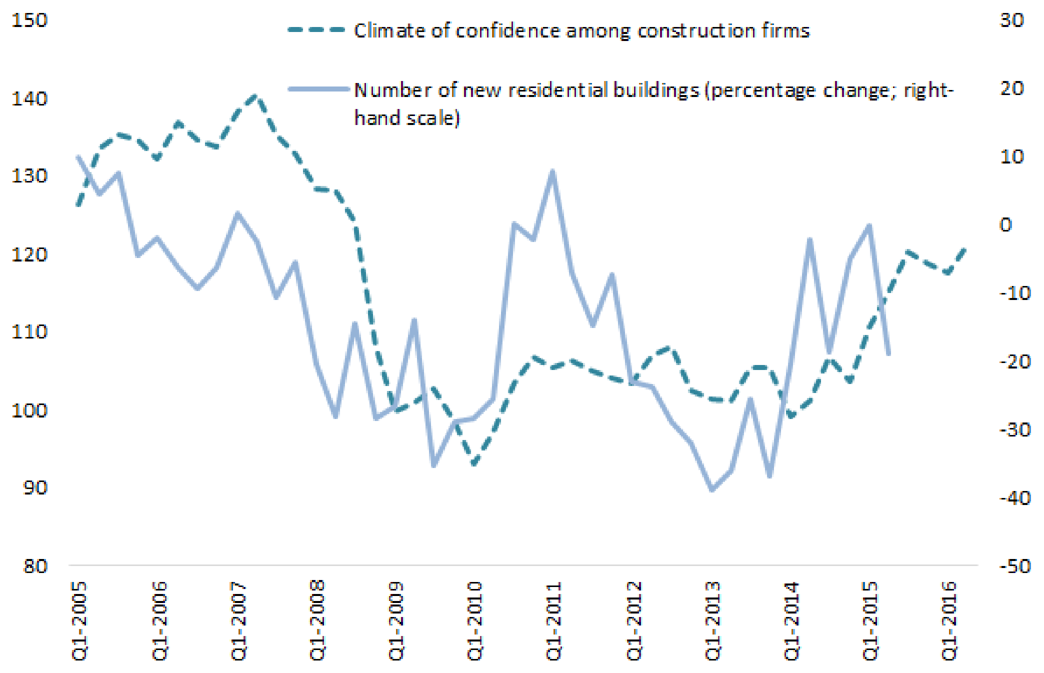


Source: based on Istat data.

The construction industry improves through ups and downs; services post moderate recovery

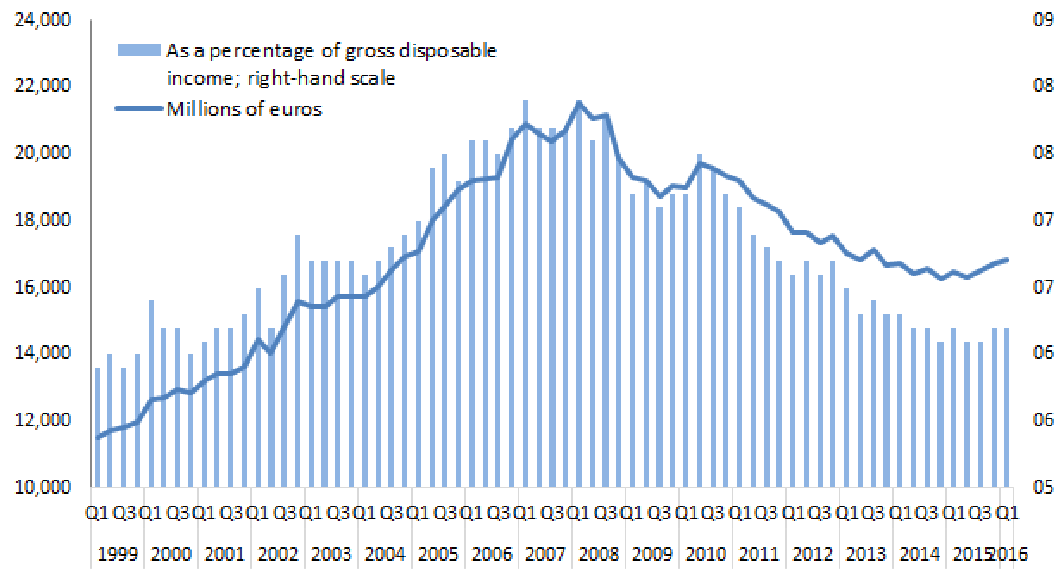
The signs emerging from construction industry appear to conflict. After improving at the end of 2015, investment decreased in the first quarter of this year in both the non-residential sector (-0.5 per cent) and in residential building (-0.6 per cent). The index of production also displays an irregular pattern, rising significantly in April (+2.5 per cent) and then declining steeply in May (-3.6 per cent). Nevertheless. the volatility of the indicators seems to mask an underlying trend of slow improvement. Firms in the sector are more optimistic, mainly reflecting more favourable assessments of order backlogs and building plans (Figure 8). The gradual stabilization of housing prices and the revival of transactions (an increase of 20 per cent in the first quarter of 2016 compared with a year earlier) are supporting the residential component, which is benefiting from the recovery in household disposable income and better credit conditions. Investment in housing has increased, at current prices, at average quarterly pace of 1 per cent since the middle of last year, reversing the trend of almost uninterrupted decline since 2010 (Figure 9).

Figure 8 - Confidence and construction of new housing
(*indices and year-on-year percentage changes*)



Source: Istat.

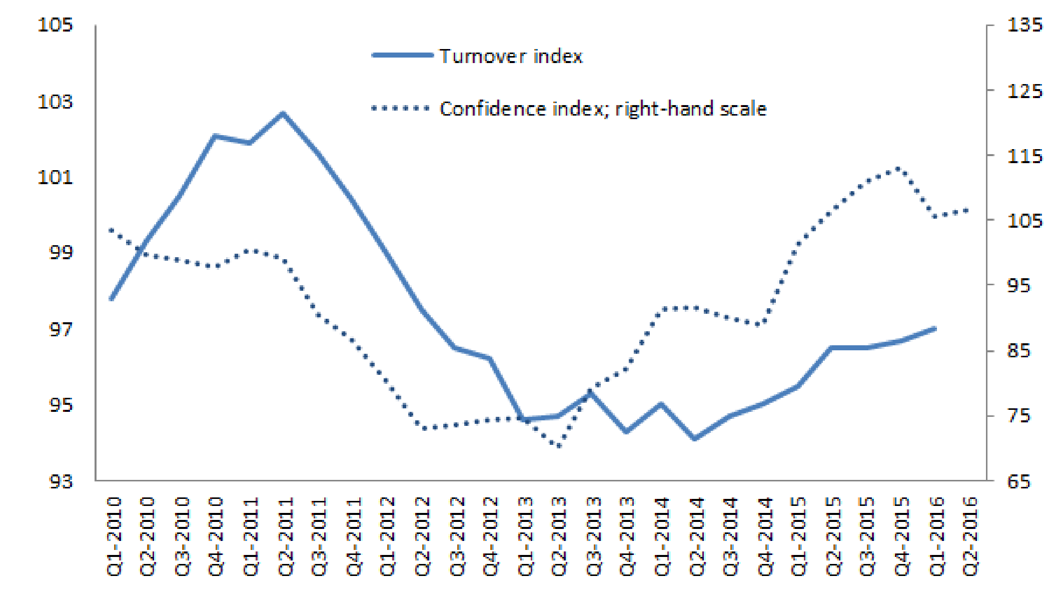
Figure 9 - Household investment in home purchases
(*millions of euros and percentages*)



Source: Istat and statistics based on Istat data.

The services sector appears to be expanding moderately, reflecting the impetus of domestic demand. The climate of business confidence deteriorated slightly in the first half of the year, although it did not stray far from the relatively high levels reached in the second half of 2015 (Figure 10). After the decline in March, retail sales rose slightly in volume terms in the following months (+0.1 per cent in April and +0.2 per cent in May), essentially confirming the signs of recovery provided by the Confcommercio consumption indicator.

Figure 10 - Turnover and confidence in the services sector
(*indices; 2010 = 100*)



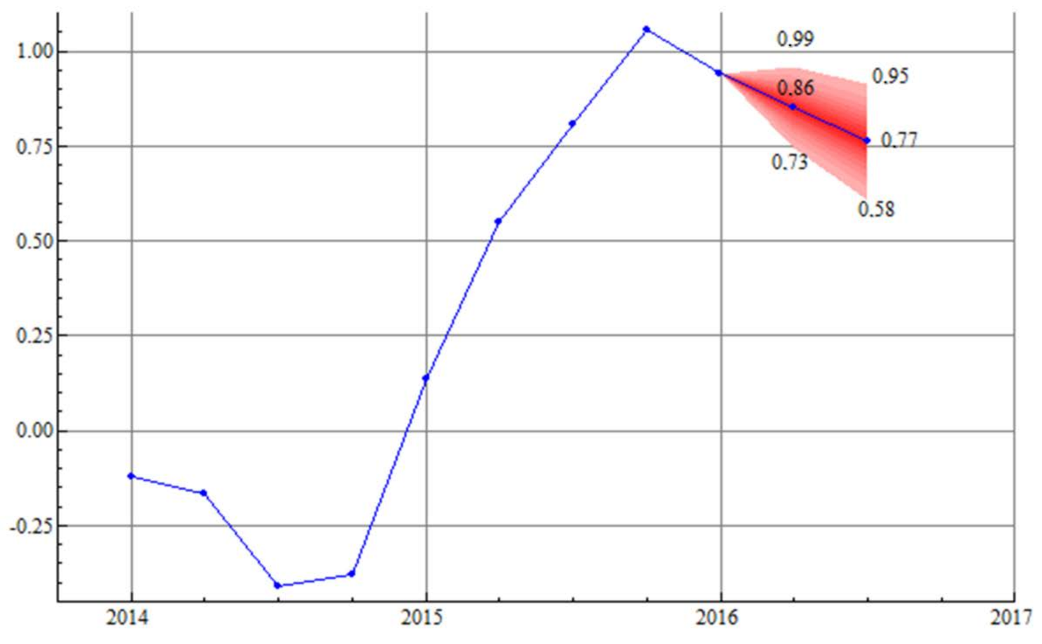
Source: Istat and statistics based on Istat data.

The short-term forecast: GDP growth slows in the second and third quarters

Overall, these signals reveal a deceleration in economic growth since the spring. Pending the publication of information on actual performance in the second quarter, estimates generated using the PBO's short-term models indicate that GDP rose by around 0.2 per cent in April-June, offsetting the slowdown in industry with stronger performance in other sectors. Economic growth, which also reflects the uncertainty generated by the British referendum vote, could weaken further in the third quarter, when GDP is forecast to expand only marginally (around +0.1 per cent). Given these developments, the year-on-year rate of GDP growth would come in at around 0.9 per cent in the second quarter and slightly below that level in the third (Figure 11).

Based on these estimates, growth of 1.2 per cent in 2016, as assumed in the EFD, appears unobtainable (to achieve it, GDP would have to accelerate to close to 1.5 per cent in the fourth quarter). The weakening of the leading indicators and the impact of the Brexit vote on the global scenario and, through the channel of uncertainty, on Italy's domestic situation have clouded the short-term outlook. Assuming modest but still positive GDP growth in the last quarter of the year (on the order of 0.2-0.3 per cent), the growth rate for 2016 would be just under 1 per cent. According to the consensus of forecasters, a less dynamic recovery than previously expected will also characterize 2017. According PBO simulations, the Brexit effect would trim GDP growth in 2017 by 0.2-0.4 percentage points, depending on the severity of the impact on the financial markets and the supply of credit (see the box "The impact of Brexit on the Italian economy").

Figure 11 - Short-term GDP forecasts and standard error (1)
(*percentages*)



Source: PBO.
(1) 95 per cent probability.

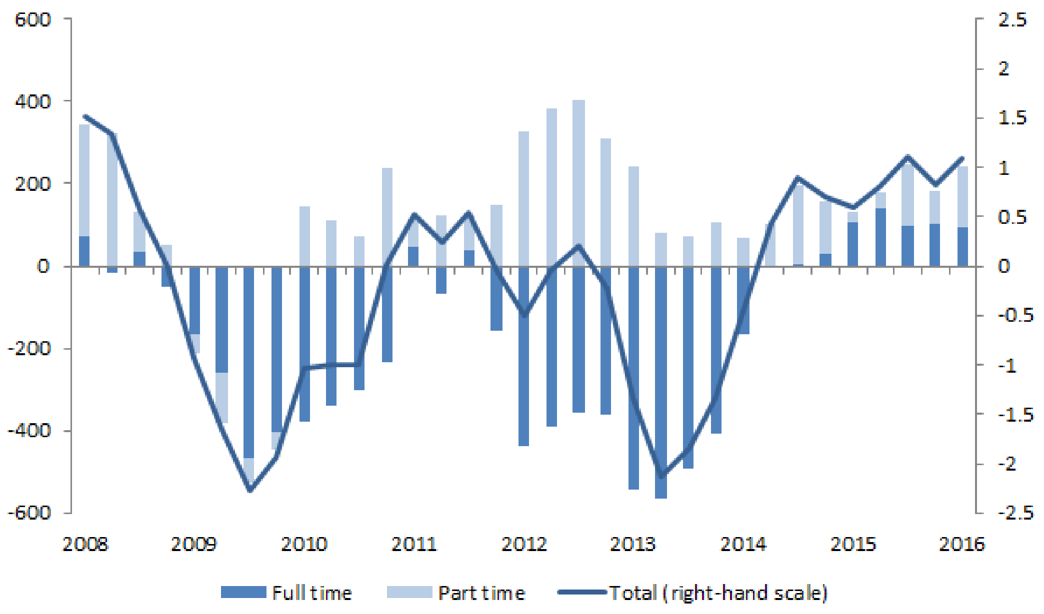
Employment growth continues at a moderate pace

In the labour market, employment continued to grow, although it was impacted by the discontinuity created by firms bringing forward hiring in the final months of last year in order to qualify for full social security contribution relief.

In the first quarter employment increased moderately (+0.1 per cent according to the Labour Force Survey and +0.2 per cent in terms of the standard units used in the national accounts). The rise was entirely attributable open-ended payroll employment (+0.5 per cent and +75,000 units), which expanded at a similar pace to that recorded in the second half of 2015. By contrast the decline in fixed-term hiring steepened (-2.4 per cent and -57,000 units), while self-employment was unchanged. By comparison with a year earlier, the rise in the number of persons in employment (+1.1 per cent or 242,000 units) primarily involved the population aged between 50 and 64 years (+4.6 per cent), compared with reductions in the central age groups. Part-time employment, which was characterised by a larger proportion of voluntary part-time workers, increased by considerably more than full-time employment (+3.7 per cent), accounting for about 62 per cent of the increase in employment on an annual basis (Figure 12).

The flow data on changes over time in labour market status, which are available until the first quarter 2016, confirmed the signals of an increase transitions from fixed-term to open-ended employment (+4.4 percentage points between the first quarter of 2016 and first quarter of 2015 compared with the same period a year earlier), attributable entirely to the male component.

Figure 12 - Full-time and part-time employment
(*absolute and percentage year-on-year changes*)

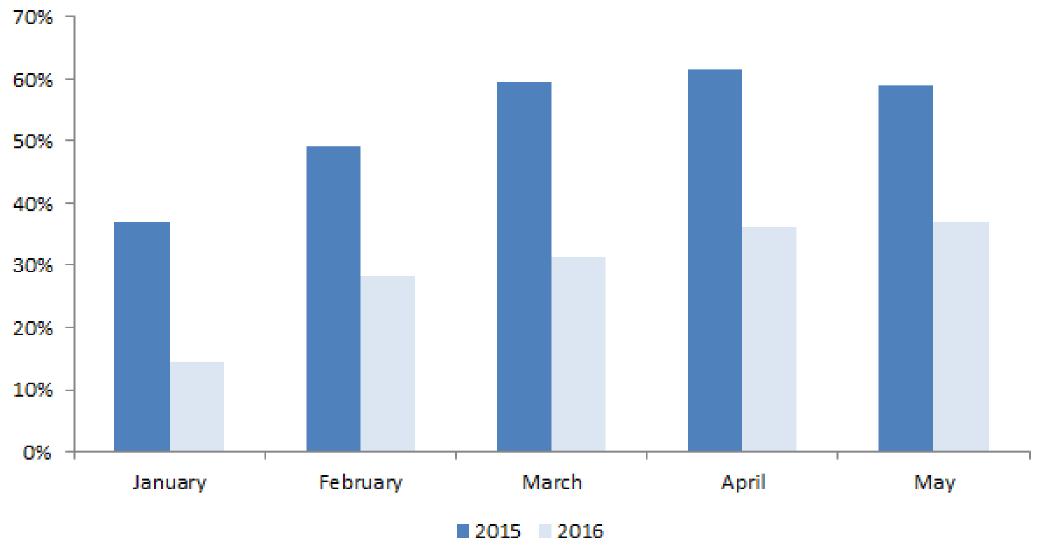


Source: based on Istat data.

The effects of the reduction in contribution relief, with the change in 2016 from almost total relief for social security contributions paid by employers to partial relief, probably begin to emerge in the labour force data for the spring months. In April and May employment continued to grow (+0.4 per cent compared with the first quarter), mainly driven, however, by growth in fixed-term jobs (+2.3 per cent), while open-ended contracts and self-employment expanded at a more modest pace (+0.2 per cent for both).

The decline in the contribution of open-ended hiring to employment growth, while fixed-term employment continues to perform well, was reflected in the data collected by the Observatory on Insecure Employment of the National Social Security Institute (INPS). In the period from January to May, payroll employment, net of terminations, experienced a significant decline (-19 per cent, a contraction of about 102,000 jobs). This reduction reflected the sharp fall in permanent employment relationships (280,000 fewer than in the same period of 2015) as a result of the sharp reduction in those established with contribution relief. According to INPS data, in the first five months of this year, the proportion of new hirings and transformations benefiting from contribution relief (out of total open-ended hiring/transformations) was at least 20 percentage points lower compared with the same period of 2015 (Figure 13).

Figure 13 - Hiring with contribution relief
(*percentage of total open-ended hiring/transformations*)

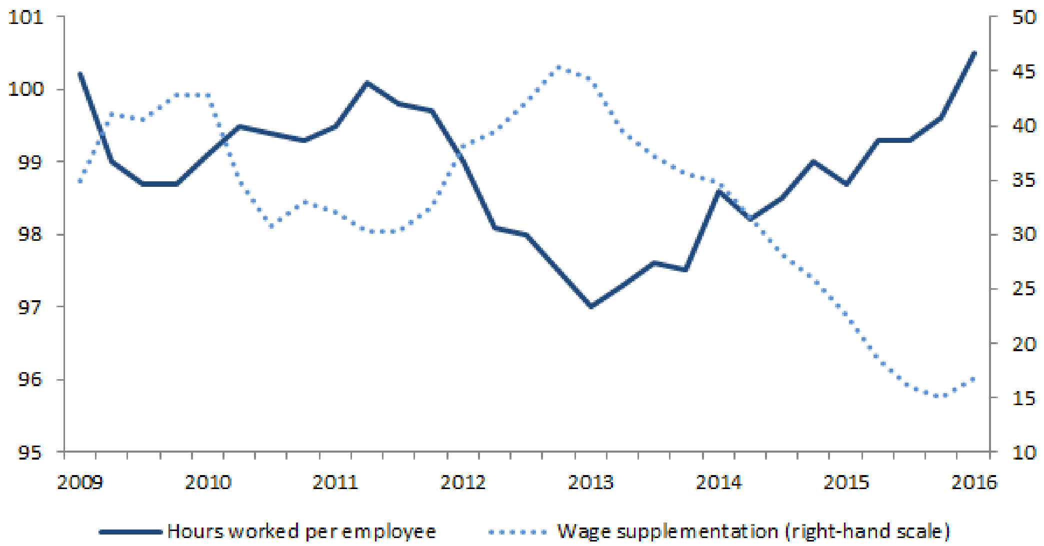


Source: based on Istat data.

In the first three months of the year, the number of job-seekers registered a further increase (+0.3 per cent on the previous period). This performance mainly reflected a decrease in the inactive population. The increase in labour market participation, offsetting the growth in employment, contributed to the stability of the unemployment rate for the third consecutive quarter (11.6 per cent). The proportion of unemployed was again unchanged in April, before declining slightly in May (11.5 per cent). Overall, the improvement in labour market conditions was reflected in a decline in long-term unemployment. According to flow data available until the first quarter of 2016, the rate of long-term unemployment decreased on the previous year (from an estimated 40.4 per cent between the first quarter of 2014 and the first quarter of 2015). At the same time, the balance between transitions from unemployment to employment remained positive (+1.2 percentage points).

Labour market indicators for firms continued to improve gradually, reflecting growing labour demand. A significant increase was also registered in the number of hours worked per employee (+0.9 per cent overall in industry and market services), in the wake of the considerable reduction in the number of hours of wage supplementation, which was especially large in industry excluding construction and in construction (Figure 14).

Figure 14 - Hours worked per employee and proportion of wage supplementation
(Seasonally adjusted indices 2010 = 100; proportion per 1,000 hours worked)



Source: Istat.

Negative inflation rate driven by international factors and the weak economic recovery

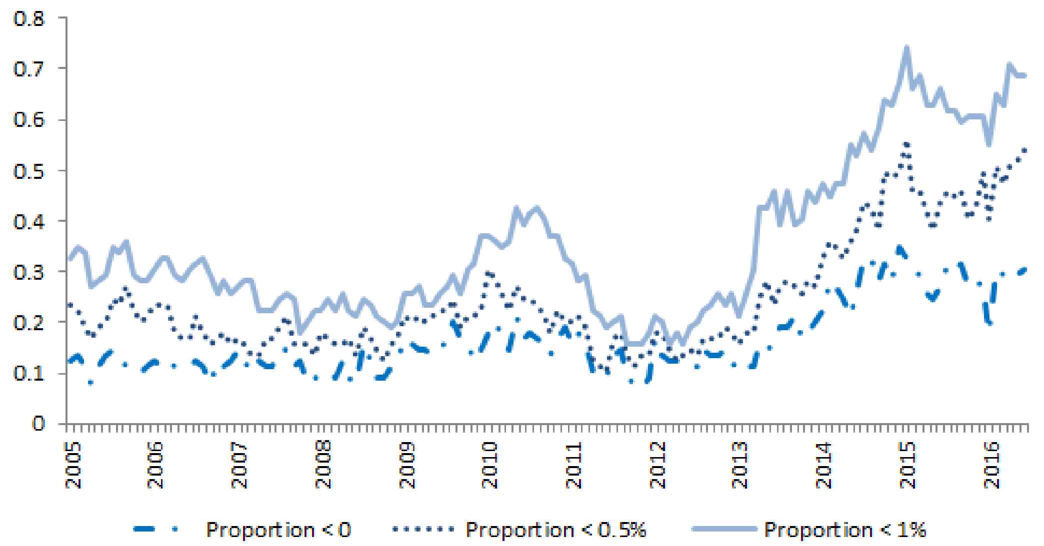
Inflation remains negative, reflecting both downward impulses from abroad and the considerable spare capacity in the economy as a result of the weak recovery.

The year-on-year decline in consumer prices recorded in June (-0.2 per cent) was still attributable to the fall in energy prices (-7.5 per cent), which continued to reflect the decrease in the prices of raw materials. Another factor was the appreciation of the euro in the initial months of the year. In the second quarter, prices began to fall again on average (-0.3 per cent) after no change in the first three months of the year.

Core inflation (excluding energy and fresh food) remained weak (+0.5 per cent in June, one tenth less than in May), reflecting the limited price pressure from non-energy industrial goods and unchanged services prices. Since the beginning of the year, core inflation has declined significantly (four-tenths of a point less than in January).

In the basket of elementary items of the HICP, the share of those whose prices contracted was broadly unchanged in June (just over 30 per cent of the basket). By contrast, the share of items experiencing very low inflation (less than 0.5 per cent) increased significantly (to 54%, up 14 percentage points on January). The share of goods and services whose prices rose by less than 1 per cent was unchanged at 70% in June (Figure 15).

Figure 15 - Proportion of goods and services experiencing deflation or low inflation (*as a percentage of total elementary items of the HICP*)

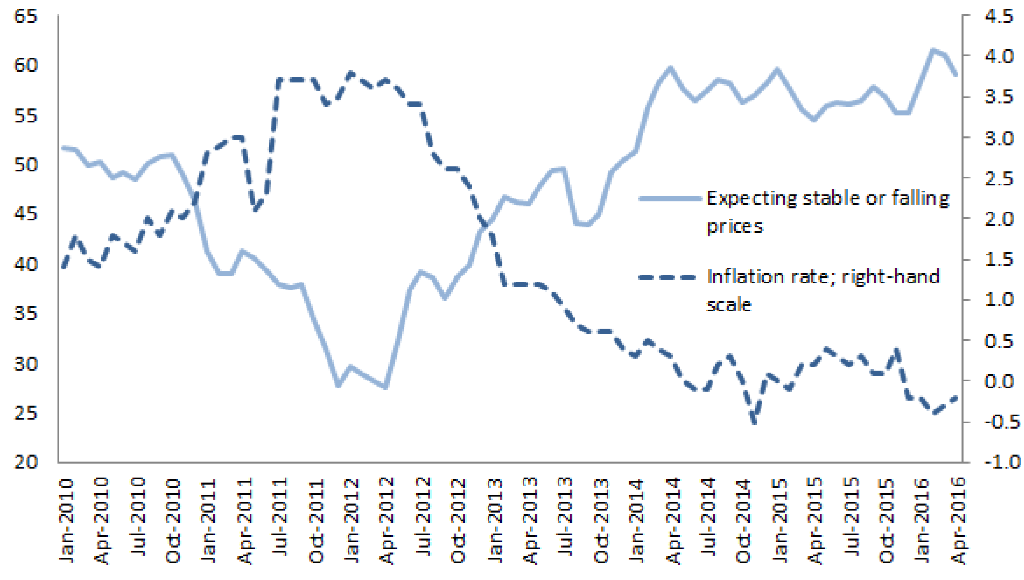


Source: based on Istat data.

The deterioration in the core component reflected the continuing decline in price dynamics in the early stages of the inflation process. The fall in prices of consumer goods sold on the domestic market (-0.7 per cent year-on-year in May), which was entirely attributable to the decline the prices of non-durables, accompanied the more significant reductions in the energy component (-10.6 per cent) and in intermediate goods (-1.8 per cent). Developments in the prices of imported consumer goods, which decreased in May (-1.2 per cent), also reflected steady prices for durables and a marked decline in the prices of non-durables (-1.9 per cent, down 2 percentage points compared with January).

The expectations of households and firms as measured in Istat surveys point to a continuation of weakness, with price developments expected to maintain their current pace. The share of households expecting stable or declining prices has been growing with the decline in inflation and has been at a very high level since the beginning of the year, at close to 60 per cent of respondents (Figure 16). Among firms, expectations of a marked deterioration in sales prices affected the market services and trade segments. In construction, expectations for inflation have been revised downwards to their January level. Signals of a possible rise in the short term were recorded in manufacturing industry, driven by expectations of an increase in the consumer goods segment.

Figure 16 - Percentage of consumers who expect stable or falling prices in the next twelve months and the inflation rate
(*percentages; three-month moving average expectations*)



Source: based on Istat data.

Box - The impact of Brexit on the Italian economy

The estimate of the impact of the British vote on Italy's macroeconomic outlook is, on the basis of the available information, an exercise affected by a high degree of uncertainty. Analysts all agree in observing that, given the limited weight of the United Kingdom in global trade and in bilateral trade with Italy, any shock transmitted to Italy would be transmitted not so much through the trade channel or the exchange rate, but rather through its impact on the confidence of firms and consumers and the repercussions of an increase in investor risk aversion for the Italian economy. This context, if not countered appropriately, would trigger new financial turmoil and could affect the Italian banking system, causing a contraction in credit.

The post-Brexit evolution of the main variables that reflect the operation of these channels point to a limited adverse impact on the forecasting scenario: growth in the United Kingdom is in fact slowing, but financial volatility, which flared immediately after the British vote, has been subsiding and bank share prices have partly recouped the sharp falls of recent weeks. Nevertheless, the situation is uncertain and remains exposed to shocks that could recur in the near future. For this reason, the PBO has attempted to evaluate how Italian growth would be affected in a number of scenarios.

The PBO exercise was conducted using the Oxford Economics econometric model. The pre-Brexit scenario is represented by the June forecast generated by this tool. From this baseline, the profile of Italian GDP in the second and third quarters of 2016 as projected using the PBO short-term models was incorporated into the model. Two scenarios were then constructed to reflect the effects of the British vote.

- The first scenario assumes limited financial effects. In particular, it assumes: a) a deceleration in British economic growth in 2017 of around one percentage point (compared with performance without Brexit); b) temporary uncertainty effects for Italian households and firms, largely confined to the third quarter of 2016. Based on these assumptions, the Italian economy's growth would fall by a tenth of a point in 2016 and by two-tenths in 2017. The slower growth would mainly be attributable to the deceleration in world trade triggered by the British slowdown.
- The second scenario assumes more substantial financial strains that are, however, under control on the whole. More specifically, the scenario assumes that, in addition to the British deceleration, the risk premium on Italian sovereign debt increases (the spread against German 10-year securities rises by 50 points in the fourth quarter of 2016 compared with the baseline and by 30 points in the first quarter of 2017, before converging with the baseline scenario) and a credit squeeze that is still less severe than that experienced in the financial crisis. Under these assumptions, GDP growth would be reduced by two-tenths of a point in 2016 and by four-tenths of a point in 2017. The reduction would be attributable not only to the slower growth in world trade but also to the inhibitory impact on business investment and household consumption.

These forecasts lie within the range of projections developed by Italian and international institutions after June 23. In general, all forecasters have revised growth forecasts downwards, especially for next year. The differences between the forecasts primarily reflect assumptions about the degree of persistence of the financial turmoil and the repercussions on credit: the downward correction for 2016 and 2017 remains within two/three-tenths of a point on the assumption of limited Brexit effects; it exceeds these values when financial market tensions are incorporated (Table B1).

Table B1 - The impact of Brexit on Italian growth

		Brexit impact	
		2016	2017
Confindustria (28 June)		-0.1	-0.5
UBS (28 June)	*(baseline scenario)*	-0.2	-0.3
	(worst-case scenario)	-0.4	-0.9
Oxford Economics (1 July) (1)		0.0	-0.2
Intesa San Paolo (1 July)		0.0	-0.2
Prometeia (4 July) (2)		-0.2	-0.3
Bank of Italy (15 July) (3)		-0.25 in 2016-18	
REF (18 July) (4)		-0.3	-0.2
IMF (19 July)		-0.1	-0.1
UPB (5)	*(baseline scenario)*	**-0.1**	**-0.2**
	(worts-case scenario)	**-0.2**	**-0.4**

(1) The impact is measured relative to the June forecast. - (2) The impact is measured relative to the March forecast. - (3) The impact is measured relative to June forecast. - (4) The impact is measured relative to the April forecast. - (5) Forecast produced using the Oxford Economics model. The baseline scenario assumes a decrease, compared with the trend scenario, of 1 percentage point in UK growth in 2017 and temporary uncertainty effects. In addition to the slowdown in the United Kingdom, the worst-case scenario assumes an increase in the BTP/Bund spread of 50 basis points at the end of 2016 and 30 basis points in early 2017, and a partial restriction of credit.