

THE CHAIRMAN

Rome, 26 September 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 trend macroeconomic scenario published in the Update to the Economic and Financial Document (Update).

In its letter of 23 September, the PBO communicated its assessment of the trend forecasts transmitted by the MEF on 19 September. On 23 September, the MEF also sent the PBO an updated trend macroeconomic scenario that reflected the revision of the national accounts for 2014 and 2015 published on the same date by Istat, which essentially confirmed the previous trend scenario.

On the basis of supplementary analysis by the UPB panel to incorporate the revision of the national accounts in the forecasts, the Board of the PBO confirms the assessment set out in the previous letter, as follows.

The Board of the PBO hereby validates the 2016-2017 trend macroeconomic forecasts transmitted by the MEF to the PBO on 23 September 2016 as they fall within the range deemed acceptable based upon currently available information. As regards the trend forecasts for the years subsequent to the first two years of the forecasting period, i.e. 2018-2019 (which fall outside the forecasting horizon considered in the Draft Budgetary Plan for 2017), we would emphasize the presence of adverse risk factors that sharply affect, in the MEF scenario, developments in real variables and in inflation.

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

Sincerely,

Giuseppe Pisauro

Pier Carlo Padoan
Minister for the Economy and Finance
Via XX Settembre, 87
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Attachment to the validation letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the Update of the 2016 EFD

This attachment to the validation letter of the Parliamentary Budget Office (PBO) for the trend macroeconomic scenario (sent on 23 September 2016) prepared by the Ministry for the Economy and Finance (MEF) for the Update of the 2016 Economic and Financial Document (the Update) 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 trend macroeconomic scenario

On 23 September 2016 the PBO sent the MEF its validation letter for the trend macroeconomic forecasts for the 2016-2019 period in the Update of the 2016 EFD (transmitted by the MEF on 19 September), after having previously communicated its comments on a preliminary version of those forecasts to the Ministry. On 23 September the MEF also sent the PBO an updated trend macroeconomic scenario incorporating revisions in the national accounts, which had been published on the same date by ISTAT, which essentially confirmed the previous trend projections. The updated scenario was assessed on the basis of additional analysis by the PBO panel.

As usual, 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's current estimates 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.

Following the methodology used on previous occasions, 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 trend macroeconomic scenario

For the years 2016-2017, the main components of the MEF's trend macroeconomic scenario are in line with the projections of the PBO panel forecasters. Real GDP growth in 2016 (0.8 per cent) and

2017 (0.6 per cent) is marginally higher (four and five basis points in the two years respectively) than the median forecast of the panel but is still lower than the upper limit of the range of those forecasts. Moreover, the scale of the deceleration in trend growth between 2016 and 2017 (equal to two-tenths of a point) coincides with the median value projected by the PBO panel. The composition of growth in the Update scenario for 2016 includes a positive contribution to the change in GDP (1.1 percentage points) from final domestic demand, offset by a negative contribution from net exports (0.3 percentage points) and stocks (0.1 points). In 2017, with the increase in VAT and excise duties connected with the safeguard clauses, the positive contribution of final domestic demand declines (to 0.5 percentage points), while the contribution of net exports improves (0.2 percentage points) and stocks continue to make a slightly negative contribution (-0.1 percentage points). The developments in the components of demand in 2016-2017 forecast by the MEF are largely consistent with those of the PBO panel, with only marginal divergences from the median values. A relatively more pronounced deviation is found in the evolution of private consumption in the current year, which is slightly higher (around one-tenth of a point) than the upper limit of the range of PBO estimates.

The MEF forecasts for inflation in the trend scenario of the Update for 2016-2017 are also substantially in line with the PBO panel projections (for the GDP deflator, 1 per cent in the current year, 1.3 per cent in 2017). As a result of the forecast developments for growth and inflation, the increase in trend nominal GDP projected by the MEF for 2016-2017 (1.8 per cent in each year) is not significantly different from the median estimate of the PBO panel (1.7 per cent this year and 1.8 per cent in 2017), falling within the upper limit of those forecasts.

Although the Update's trend forecasts for 2016-2017 are close to the median projections of the PBO forecasters, it must be borne in mind that they represent a central scenario exposed to both negative and positive risks. In the light of currently available information, the former appear to predominate, as underscored, internally, by the worrying deterioration in coincident and leading economic indicators of the economic cycle and, externally, by the constant downward revisions in the most recent projections for world growth produced by international bodies.

In the MEF scenario, the adverse risk factors weigh heavily on expected developments in the years following the initial two-year forecasting period, i.e. 2018-2019. In 2018, the MEF's forecast for real GDP growth (1.2 per cent) is significantly higher than that for 2017 (0.6 per cent), implying an appreciable acceleration in the recovery, with relatively robust quarterly growth over the entire forecasting horizon. The MEF's forecast for GDP growth for 2018 is higher (by almost three-tenths of a point) than the upper limit of the range produced by the PBO forecasters. In 2019, the growth expected by the MEF (1.3 per cent) lies within the range of PBO forecasts, but is more than one-tenth of a point higher than the median of those projections. These results appear to depend mainly on the forecast performance of domestic demand. More specifically, the MEF's projection for household consumption appears high, especially in 2018, when account is taken of the general stagnation in real wages, which are also eroded by the effects of the safeguard clauses included in the trend scenario.

The MEF scenario also shows divergences, albeit small, from the PBO forecasts for inflation. In particular, the change in the GDP deflator in the MEF projections (1.6 per cent in both years) is about one-tenth of a point higher than the median for the PBO panel in 2018 and two-tenths of a point higher in 2019.

The higher real GDP growth and the higher deflator combine to produce significantly faster nominal GDP growth in 2018-2019 in the MEF scenario than that forecast by the PBO panel. Compared with the median values, the disparity is greater than five-tenths of a point in 2018 and two-tenths of a point in 2019. Compared with the upper limits of the forecasts, the MEF forecast for nominal GDP is two-tenths of a point higher in 2018 and close to that limit in 2019.

Ultimately, the trend developments for 2018-2019 assumed in the Update differ significantly from the forecasts of the PBO panel for both the real variables and for inflation, with a major impact on the forecast for nominal GDP, which plays a critical role in determining the evolution of public finance ratios.

A final comment regards the assumptions concerning international exogenous variables in the Update scenario and those used by the forecasters in the validation exercise. The assumptions were corrected significantly downwards from the projections used in the EFD in April for developments in international trade variables (total trade, world imports, key Italian markets). Compared with the EFD, the revisions also involved exchange rates (with an appreciation of the euro against the dollar and in nominal effective terms) and oil prices (which are higher than the levels assumed six months ago). Overall, the new scenario for exogenous variables in the Update appears substantially in line with the current projections used by the PBO panel to formulate their independent forecasts. Nevertheless, in view of the repeated downward corrections made in recent years by national and international forecasters for world trade – due in part to the difficulty of determining the new and lower elasticity of trade to global output - the uncertainty about world demand growth remains a risk factor to take into due consideration, given that it can have, as has occurred in the recent past, a significant impact on the scenario for domestic growth.