ufficio parlamentare di bilancio

THE CHAIRMAN

Rome, 15 September 2017

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 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 trend macroeconomic forecasts published in the Update of the Economic and Financial Document (Update).

Taking due consideration of the uncertainty inherent in macroeconomic forecasts, the PBO assessed the plausibility of the trend macroeconomic scenario on the basis of a range of acceptable values for the macroeconomic aggregates to be endorsed.

The Board of the PBO hereby endorses the 2017-2018 trend macroeconomic forecasts transmitted by the MEF to the PBO on 13 September. As regards the trend forecasts for the years subsequent to the first two years of the forecasting period, i.e. 2019-2020 (which did not undergo the endorsement process), the PBO emphasises the prevalence of negative risk factors in the MEF scenario for 2020, which have a substantial impact on developments in real variables.

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, 97
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Attachment to the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the Update of the 2017 EFD

This attachment to the endorsement letter of the Parliamentary Budget Office (PBO) for the trend macroeconomic scenario (sent on 13 September 2017) prepared by the Ministry for the Economy and Finance (MEF) for the Update of the 2017 Economic and Financial Document (the Update) 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 for the trend macroeconomic scenario

On 15 September 2017 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts for the Update of the 2017 EFD (transmitted by the MEF on 13 September), 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 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 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 an analysis of the internal consistency of the macroeconomic scenario developed by the MEF and consistency with a set of 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 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.

Risks associated with the forecasts in the trend macroeconomic scenario

The following offers separate assessments of the risks related to the 2017-2018 period, which was the focus of the endorsement exercise, and those for 2019-2020, for which a general assessment is provided. A number of comments are then reserved for the risks associated with the external scenario.

2017-2018. The MEF forecast for real GDP growth in 2017-2018 appears to lie within a generally acceptable forecasting range, although in 2018 it is slightly above the upper limit of the range of PBO panel forecasts. In offering a comprehensive assessment, it is important to note that this figure for real growth is counterbalanced by a lower MEF forecast for the GDP deflator, particularly in 2018. This means that the MEF's forecast for the rate of nominal GDP growth - the variable of greatest importance for the public finances – is below the upper bound of panel estimates for 2017 and 2018.

Analysing the main forecasts compared with the PBO's estimates, real GDP growth for 2017 (1.5 per cent) is slightly higher (about a tenth of a point) than the median value of the panel projections, lying just below the upper bound of those forecasts. In 2018, trend growth (1.2 per cent) declines due to less favourable developments in international economic conditions (a deceleration in world trade and the appreciation of the euro) and to the adverse effects of public finance measures on a current legislation basis (VAT increases, elimination of investment incentives and termination of tax relief for open-ended hiring). The deceleration expected by the MEF between 2017 and 2018 (about three-tenths of a point) is smaller than that seen in the median forecasts of the PBO panel (equal to four-tenths of a point) but is close to the upper bound of those estimates. The growth rate for 2018 forecast in the MEF trend scenario (1.2 per cent) is marginally higher (about a tenth of a point) than the upper bound of the panel forecasts (and about two-tenths of a point greater than the median).

The composition of growth in the Update scenario shows a positive contribution from domestic demand (1.5 percentage points) and inventories (a tenth of a point), while net exports make a negative contribution (a tenth of a point). In 2018, with the increase in VAT and the elimination of the various incentives, the contribution of final domestic demand decreases (to 1 percentage point), while that of net exports is slightly positive (a tenth of a point), as imports are expected to slow down more sharply than exports. This structure of contributions to growth in 2017-2018 is fairly similar to that assumed by the PBO panel analysts, with some differences with regard to certain components of demand. More specifically, the MEF forecast for investment appears to be more robust than the panel forecasts, mainly reflecting the assumption in the Update of a more pronounced acceleration in this type of spending in the second half of 2017.

Inflation developments in 2017-2018 in the MEF trend scenario lie within the range of acceptability represented by the PBO panel projections. The consumption deflator, despite weak external inflationary impulses due to appreciation of the euro, accelerates between 2017 and 2018 (from 1.5 to 2 per cent) due to the increase in VAT. The GDP deflator rises by a very small amount in 2017 (0.6 per cent). In 2018, it rises above the deflator of total domestic demand (to 1.8 per cent), reflecting the small improvement in the terms of trade forecast in Update for next year. Overall, these developments, taking into account the different assumptions for import and export prices, seem to be substantially in line with the 2017-2018 PBO panel forecasts. In 2017, the GDP deflator assumed by the MEF is slightly above the median of the panel forecasts (about one-tenth of a point) but below the upper bound (about two-tenths of a point). In 2018, it is below both the upper bound (about two-tenths of a point) and the median value (about a tenth of a point).

Given developments in real GDP and the deflator, the rate of nominal GDP growth is slightly higher both in 2017 (2.1 per cent) and in 2018 (3 per cent) than the median value of the PBO panel forecasts but below the upper bound. With regard to 2018 in particular, the lower GDP deflator in the MEF forecast compared with upper bound of the PBO panel projections more than offsets the slightly faster real growth, lowering the nominal GDP rate for the MEF below the upper bound of the panel forecasts.

Overall, therefore, the main risk connected with the 2017-2018 trend scenario concerns the level of real GDP growth for 2018 and the closely related issue of the magnitude of the slowdown expected for next year. The favourable developments in economic indicators point to a continuation of positive conditions in the second half of 2017, with a beneficial carry-over impact on growth in the following year. Nevertheless, the external and internal factors weighing on the economy in the 2018 trend scenario could have a greater-than-expected impact on the MEF scenario for the coming year. At the same time, we must not overlook the fact that the threat of slower real growth to nominal GDP growth, a crucial variable for the public finances, appears to be somewhat mitigated by a forecast for inflation (the GDP deflator) that is more closely in line with the projections of the PBO panel forecasters.

2019-2020. The growth assumptions for 2019-2020, a period that lies beyond the time horizon considered in the endorsement exercise, are a source of greater concern. Between 2019 and 2020, real GDP growth in the MEF trend scenario is expected to accelerate (from 1.2 per cent in 2019 to 1.3 per cent in 2020), running partially counter to the developments in global output assumed in the international scenario.

With regard to the individual years, in 2019 the growth rate, while close to the upper bound of the PBO panel forecasts, is further from the median value of these forecasts compared with previous years. The acceleration assumed for 2020 brings the growth rate forecast in the Update above both the median and upper bound of the panel forecasts. This divergence mainly seems to reflect developments in the components of final domestic demand (private consumption, investment, general government expenditure), which appear to have accelerated compared with 2019 and are substantially above the upper bound of the PBO panel forecasts. More specifically, the growth in household consumption implies that the propensity to save will remain at an extremely low level in historical terms in the MEF scenario. The further strengthening of investment would occur in an environment of rising interest rates at both short and long term. The acceleration in general government expenditure in volume terms would require a continuation of very slow growth in the prices of government purchases. Projections for the last year of a four-year forecasting horizon are naturally subject to considerable uncertainty. However, the MEF assumptions for domestic variables appear to be almost uniformly optimistic. Despite the recent emergence of signs of improvement in the Italian economy, it seems imprudent to incorporate their impact in medium-term growth forecasts.

International exogenous variables. An additional comment regards the forecasts for the international exogenous variables in the Update scenario, which were used by the panel forecasters in conducting the endorsement exercise. They imply faster growth in world trade in each year of the 2017-2019 period than assumed in the EFD (2020 is the same). The correction is especially large in 2017. Changes compared with the EFD also involve the exchange rate of the euro (which appreciates in 2017-2018 against the dollar and in effective terms) and, to a lesser extent, the oil price (with somewhat faster growth than in the EFD). Interest rates are expected to rise less steeply than assumed in the EFD. Overall, the exogenous variables do not differ too significantly from those assumed by the panel forecasters in their scenarios. The discrepancy in the EFD between the technical assumption for exchange rate developments and the expectations signalled by forward markets appears to have been partially eliminated in the Update, at least as regards the sign of exchange rate developments (an appreciation of the euro).

While these international assumptions are consistent with the consensus scenario, account must be taken of the factors of uncertainty underlying that outlook, especially over the medium term. In 2020, the recovery will have set a record for duration for some large economies, with an increase in the likelihood of a downturn. In fact, there are a range of risk factors (geopolitical, financial, monetary, trade) in the international scenario. It is clearly difficult to discern possible turning points over the medium term against the background of generally positive information available (including assessments drawn from favourable market expectations). In the forecasting scenarios, these factors are generally considered tail risks. Nevertheless, their manifestation could have major repercussions because of the limited scope for reaction of the economic policies of the advanced countries, unlike in previous cyclical reversals. The implications for the Italian economy, which has emerged from the recession only a few years ago and still has a very large stock of public debt, would be significant.