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Il Presidente

Rome, 13 October 2018

Law no. 243/2012 establishes that the Parliamentary Budget Office (PBO) shall carry out analyses, audits and evaluations on macroeconomic forecasts, on the basis of an annual programme which also provides for the performance of the functions assigned in accordance with the European Union ruling. EU Regulation no. 473/2013 requires that the macroeconomic forecasts on which the Stability Programme is based be endorsed by an independent national institution.

The Memorandum of Understanding between the PBO and the Ministry of the Economy and Finance (MEF) dated 15 September 2014 governs the macroeconomic forecast endorsement process.

In view of the uncertainty surrounding macroeconomic forecasts, the PBO has assessed the plausibility of the estimates on the basis of a range of acceptable figures for the macroeconomic variables subject to endorsement.

The Board of the PBO does not endorse the 2019 policy macroeconomic forecasts published in the Update of the 2018 Economic and Financial Document as they lie outside the range of acceptable values on the basis of the information currently available.

A more detailed analysis of the motivations for not endorsing the forecasts is provided in the attached document.

Very sincerely,

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Comments of the Parliamentary Budget Office to the Ministry for the Economy and Finance on the policy macroeconomic scenario in the Update to the 2018 Economic and Financial Document

Introduction

As established in the Memorandum of Understanding between the Parliamentary Budget Office (PBO) and the Ministry for the Economy and Finance (MEF), this document contains the PBO's comments on the policy macroeconomic scenario published in the Update to the 2018 Economic and Financial Document (the Update).

The trend macroeconomic forecasts in the 2018 Update were endorsed by the PBO, with the letter sent to the MEF on 19 September 2018.

The endorsement exercise was formulated on the basis of a comprehensive analysis of the economic situation conducted by the PBO using: a) the PBO's estimates based on short-term models of GDP and the components of demand and supply; b) 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; c) the annual forecasts produced separately for the occasion by the independent forecasting institutes (CER, Prometeia, and REF.ricerche) that make up the PBO forecasting panel; and d) the monitoring of the most recent forecasts of 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 its consistency with a set of exogenous international variables.

As usual, the analysis on the policy scenario was conducted by modifying the forecasts (of the four members of the PBO panel) already used in the endorsement exercise for the trend scenario, solely and exclusively to take account of the preliminary information on the budget measures provided by the MEF to the PBO. Recall that, under European rules, the ultimate objective of the entire exercise is the validation of the *policy* macroeconomic scenario, which will be incorporated in the Draft Budgetary Plan. The endorsement of the trend macroeconomic scenario – whose publication is not a common practice at the European level but rather represents a special feature of the Italian system - only serves to verify that there is no excessive misalignment already present in the macroeconomic forecasts on a current legislation basis. The final assessment of the PBO remains focused on the policy scenario in its entirety.

Note that the assessment of the PBO seeks to verify that the Government's forecasts are based on realistic scenarios, use the most up-to-date information and are inspired by the prudence criterion (Article 4, paragraph 1, and Article 9, paragraph 3, of Directive 85/2011, part of the so-called Six-Pack).

On the basis of the Memorandum of Understanding between the PBO and the MEF concerning the transmission of the information necessary for the certification of macroeconomic forecasts and the assessment of the public finances (of 15 September 2014), the main macroeconomic variables, indicated in the paragraph 3.1 of the Protocol, are assessed in the endorsement process.

Comments on the policy macroeconomic scenario

The elements considered in the exercise conducted with the PBO panel for the purpose of the joint evaluation of the Government's policy scenario presented in the 2018 Update are discussed below.

The main factor preventing endorsement of the MEF's policy macroeconomic scenario is that the growth rates for the key variables of economic activity and prices appear to be generally unrealistic by comparison with the projections of the PBO panel.

- The growth estimated by the MEF for 2019 GDP exceeds not only the median value among the panel forecasts, but also, to a not negligible extent (two-tenths of a percentage point), the upper limit of the panel forecasts as well. Compared with the current legislation scenario, the assessment of the positive impact of the budget measures on real growth is, for all the forecasters of the PBO panel, lower than that implicit in the Government's forecast. The misalignment derives entirely from the forecasts for the major components of domestic demand, namely consumption and investment. More specifically, the growth of investments in capital goods, which are mainly driven by the private sector, was more than two percentage points higher in the Update than the upper limit of the panel forecasts. The prudence of the panel projections is due in part to the fact that this component has by now substantially returned to the levels recorded before the sovereign debt crisis, meaning that further improvements in corporate profit expectations are needed to sustain the pace of investment growth. Moreover, the recent signs of a restriction in lending, likely prompted by the volatility registered in the fixed-income bond markets, would counsel caution in issuing forecasts for private investment that far outpace trend developments.
- The differences with respect to the panel forecasts for price developments are not negligible either. In the MEF forecasts, the GDP deflator exceeds the upper bound of the range of PBO panel forecasts, albeit only slightly. Compared with the MEF's trend scenario, the smaller acceleration in inflation (as measured by the private consumption deflator) amounts to eight-tenths of a percentage point. This appears consistent with the suspension of the increase in VAT rates and is in line with the panel estimates. On the other hand, the GDP deflator is only 0.2 percentage points lower than in the trend scenario, thus considerably less than the expect fall given the share of consumption on GDP. The assumption that the policy GDP deflator would benefit in the Update from the expansionary character of the budget measures is not reflected in the dynamics of the components of demand. With substantial invariance in import and export prices, the deflators that make the greatest contribution to the increase between the policy and trend scenario are those for public consumption (with an impact on the GDP deflator of at most 0.1 per cent) and inventories (which is a statistical aggregate that is very challenging to estimate and interpret). At the same time, the investment deflator, i.e. the component that is mostly affected by the budget measures in the Update, remains at the same values as the trend scenario in the MEF forecasts. Ultimately, the differential between the GDP deflator in the MEF's policy and trend scenarios appears to be too small and difficult to interpret in terms of the components of demand.
- Taking account of the aforementioned deviations in the real variables, nominal GDP growth, which is directly linked to developments in the main public finance aggregates, differs considerably from the panel consensus: the gap in the growth rate is seven-tenths of a percentage point compared with the median value and four-tenths compared with the upper bound of the panel forecasts. For a complete interpretation of the panel estimates, note that the median value of the nominal GDP forecasts is the same in both the trend and policy

scenarios. The reason for this is that the improvement in real GDP (which benefits from the budget measures) is entirely offset by the deceleration of the GDP deflator (which incorporates the suspension of the VAT increase). The increase in nominal GDP in the Update's policy scenario compared with the trend scenario is therefore not consistent with the panel assessments. In previous years, the PBO has validated macroeconomic scenarios with slight divergences in growth, but only because the projections for nominal GDP growth fell within the range of variation defined by the panel forecasts. The deviations in nominal GDP take on particular importance in this case, as they impact the prudence required for the macroeconomic scenario, partly due to their implications for the public finance indicators (in one example, simply taking into account the nominal GDP figure in the PBO forecast - the closest among those produced by the panel to the Update forecast - the debt/GDP ratio in 2021 would be one percentage point higher than the official projection).

Another set of considerations concerns intra-annual developments, both with regard to cyclical trends and the timing of the budgetary stimulus.

- The Italian economy gradually weakened in the first half of the year and, according to the PBO forecasts, economic growth will remain very slow in the short term as well. Incorporating a scenario of GDP growth of 0.1 per cent in both the third and fourth quarters of this year, the statistical carryover to 2019 would be very low (0.2 per cent). It follows that in order to achieve annual GDP growth of 1.5 per cent, a strong and rapid acceleration will be necessary as early as the first quarter of 2019, at a pace of no less than 0.5 per cent (quarter on quarter) in all four quarters (this has not occurred in Italy since the end of the 1990s). On the other hand, more progressive and more realistic growth would remain consistent with the MEF's trend scenario (to achieve annual GDP growth of 0.9 per cent, an increase of 0.3 per cent quarter on quarter in the four quarters of next year would suffice).
- The foregoing is also relevant in view of the probable temporal distribution of the measures planned by the Government in the coming quarters. The increase in public investment, which is typically very expansionary, in the policy scenario is added to the sharp reversal already projected in the current legislation scenario. It follows that the component ascribable to the policy measures is likely to be concentrated in the second half of 2019 rather than in the early months of the year. The launch of the "Citizens Income" minimum income scheme, which will increase the disposable income of the most disadvantaged households (which normally have a high propensity to consume) could also take a number of months to be implemented.

Finally, note that the expansionary effects of the budget measures on growth could be attenuated due to the reaction of financial investors. Following the announcement of the public finance objectives at the end of September, the tensions in the market for Italian government securities quickly began to worsen significantly. Since the Italian economy is more exposed to such turbulence than others, given the large stock of public debt to be refinanced, decreases in the value of financial assets can impact confidence and thus the spending decisions of households and businesses.

The doubts raised about next year are even stronger for 2020-21. The response of the economy to the fiscal stimulus remains high, despite the fact that over the period the VAT increases are only partly defused. The pace of economic growth exceeds the upper bound of the interval of PBO panel forecasts in both years. Among the components of demand, in addition to high values for investment in machinery and equipment, similar to projected developments in 2019, differences also emerge with respect to the panel projections for private consumption.

There are also divergences in the forecasts for prices developments, especially with regard to the consumption deflator, while the rate of nominal GDP growth in 2020 exceeds the upper bounds of the panel interval.

The 2020-2021 period is therefore characterized by a relatively high multiplier for the shock represented by the public finance measures with regard to both economic activity and prices.

Conclusions

The PBO conducted an overall assessment of the Government's policy forecast, using, as it normally does, the analysis conducted by the PBO panel of forecasters. On the basis of this assessment exercise, it was concluded that the macroeconomic forecasts for 2019 in the 2018 Update's policy scenario cannot be endorsed by the PBO. This conclusion is prompted by the significant and multiple divergences between the main variables in the policy forecast, comprising both economic growth and prices, and the forecasts produced by the panel. The decision is also corroborated by the most up-to-date information on recent economic developments and by comparison with the forecasts of other institutions. Finally, the MEF's macroeconomic forecasts for the following years (2020-2021), which are not subject to endorsement, are also considered optimistic.

13 October 2018