ufficio parlamentare di bilancio

Il Presidente

Rome, 23 September 2019

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.

Taking due consideration of the uncertainty inherent in macroeconomic forecasts, the PBO assessed the plausibility of the trend macroeconomic scenario in the Update to the 2019 Economic and Financial Document (2019 Update) on the basis of a range of acceptable values for the macroeconomic aggregates to be endorsed.

The Board of the PBO hereby endorses the 2019-2020 trend macroeconomic forecasts transmitted by the MEF on 19 September, while underscoring the presence of significant risk factors for real GDP growth. As regards the forecasts for subsequent years, i.e. 2021-2022 (which did not undergo the endorsement process), the MEF forecasts appear to be slightly more optimistic than the acceptable range of forecasts on the basis of currently available information.

Sincerely,

Giuseppe Pisauro

Roberto GUALTIERI
Minister for the Economy and Finance
Via XX Settembre, 97
00187 ROME

Attachment to the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the Update to the 2019 EFD

This explanatory note attached to the endorsement letter of the Parliamentary Budget Office (PBO) for the trend macroeconomic scenario prepared by the Ministry for the Economy and Finance (MEF) for the Update to the 2019 Economic and Financial Document (EFD) offers a brief description of the procedure leading to the endorsement of the forecasts and a summary analysis of the risks associated with those forecasts.

Endorsement procedure

On 23 September 2019 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts for the Update to the 2019 EFD (transmitted by the MEF on 19 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 developments in GDP and the components of aggregate demand; 2) the annual forecasts obtained by the PBO with the forecasting model of ISTAT, 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) were formulated on the basis of the same assumptions for the international exogenous variables used by the MEF (the variables notified to the PBO on 19 September).

Findings of the endorsement exercise

The 2019-2020 forecasts for real GDP growth in the macroeconomic scenario of the EFD Update, which reflect the increases in indirect taxes connected with the safeguard clauses as from next year, appear to fall within an acceptable forecasting range, despite a number of divergences from the PBO panel forecasts. The overall acceptability of the trend projections in the Update takes account of: a) the small size of the upward deviations from the upper bounds, also considering the uncertainty of the current short-term outlook; and b) the fact that the Update's projection for nominal GDP growth

– a variable of direct importance for the public finances – is in line with the upper limit of the PBO panel forecasts. However, various sources of uncertainty, in both the short and medium term, must be noted, mainly representing downside risks associated with the trend macroeconomic scenario in the Update.

The following summarises the comments on the forecasts for 2019 and 2020, which are the focus of the endorsement exercise, offers a general assessment of 2021-2022 and delineates some of the risks, mainly relating to external developments.

The trend forecast for GDP growth in 2019-2020 contained in the Update is in line with the estimates of the panel of PBO forecasters for both years. The Update's forecast for the Italian GDP growth for 2019 (0.1 per cent) is marginally higher than the median value of the panel forecasts, which are marked by very limited dispersion. The MEF forecast for GDP growth in 2020 (0.4 per cent) is broadly in line with the PBO panel's median.

The forecast for GDP growth in 2019 in the trend macroeconomic scenario in the Update mainly reflects stagnant economic activity in the third quarter and a marginal recovery in the fourth. The expectations of modest output growth in the second half of the year are consistent with the weakening of the coincident and leading indicators for the Italian economy and are substantially shared by the PBO panel. The decline in industrial production in July prompts caution in assessing developments in manufacturing, whose weakness could have repercussions on the other sectors of the economy. One factor of uncertainty is also represented by possible revisions, whether upwards or downwards, of the quarterly figures reported in the national accounts, which will be released on 4 October and might directly impact the forecasts for 2019.

With regard to the determinants of growth, the Update scenario for the current year incorporates the boost of the domestic and net foreign demand, entirely offset by the strongly negative contribution of changes in inventories. The developments in the main variables in the sources and uses account appear to be generally consistent with the quarterly national accounts data currently available and with expectations for the second half of the year. An exception is the forecast for investment growth, which despite being consistent with the growth already acquired reported in the national accounts exceeds the upper bound of the PBO panel forecasts. In 2020, the MEF's macroeconomic scenario expects growth to be sustained mainly by domestic demand, whose main components show developments that fall within the range of variation of the PBO panel projections.

The cost and price variables indicated in the Update are slightly optimistic in the 2019-2020 period. The developments in the GDP deflator forecast by the MEF for this year are at the limit of the PBO panel's range of acceptability and are also driven by an inversion of developments in the terms of trade. The panel's median projections are more cautious, partly in light of the recent trends observed in the quarterly data. As with the deflator and real growth, nominal GDP growth (1.0 per cent) in the Update's macroeconomic scenario is at the upper bound of the PBO panel estimates. In 2020 the price variables in the MEF macroeconomic scenario incorporate the effects of the activation of the safeguard clauses for indirect tax increases provided for under current legislation. The expected change in both the GDP and consumption deflators for next year falls within the endorsement interval, but is sharper than the median of the PBO panel. This difference reflects the uncertainty in quantifying the effects of the transfer onto prices of the activation of the safeguard clauses. The caution in the

PBO panel forecasts for the deflators also reflects the current weakness of economic activity. The Update's macroeconomic scenario forecast for nominal GDP growth of 2.3 per cent also falls within the panel's range of variation. The forecasts for the labour market in 2019 are generally consistent with the macroeconomic scenario in the Update and fall within the range of variation of the PBO panel forecasts.

For the 2021-2022 period, which is not subject to endorsement by the PBO, the trend forecast for real GDP growth (0.8 per cent and 1.0 per cent respectively) seems slightly optimistic, falling just above the upper bound of the PBO panel interval in both years. In addition, Italy's projected GDP growth rate at the end of the forecast horizon of the Update (1.0 per cent) is higher than the estimates of potential growth produced by the main institutions, including those formulated by the MEF in the 2019 EFD.

In 2022, the projections for the components of demand appear slightly optimistic, especially with regard to domestic demand. Household consumption recovers from the shock associated with the increase in indirect taxation of the safeguard clauses and accelerates to 1.0 per cent growth, compared with decidedly more cautious projections by the PBO panel. In the MEF scenario, capital accumulation strengthens appreciably in 2022, while the intermediate forecasts of the panel show investment growth at the end of the period similar to that in 2021.

Forecasts for end-of-period prices also appear to be affected by optimism about economic activity. The change in the GDP deflator is slightly greater than the upper bound of the PBO panel forecasts. As a result, taking account of the growth gap noted earlier, the nominal GDP growth rate projected by the MEF for 2022 appreciably exceeds the upper bound of the PBO panel range.

Risks associated with the forecast

The medium-term macroeconomic outlook for the Italian economy is exposed to considerable risks, mainly on the downside, that are largely of an international and financial nature. The risks are all more or less directly attributable to the uncertainty surrounding economic policy, which is currently close to historical highs.

The risk of a sharp deterioration in the international environment. The foreign demand projected for Italy in the Update macroeconomic scenario could be overestimated for the coming years. The possible adverse scenarios are many. The global trade war under way between China and the United States is continuing and tariffs are expected to be increased by the end of the year. The initial effects for exporting countries are already emerging. This includes Germany, for which some are forecasting a recession. Specific risks are also threatening China's economy, which is experiencing a weakening of domestic demand despite the expansionary measures implemented by the Government. Increased trade tensions could also lead to a currency war, which would also impact the euro area. In Europe, uncertainty about both the timing and effective implementation of Brexit continues. In addition, the global economy remains exposed to various sources of geopolitical instability, especially in the Middle East, as well as to climate and environmental shocks. Finally, the recent attacks on Saudi refineries have generated tensions that could affect the volatility of oil prices, with repercussions on economic activity and inflation in energy-importing countries.

Global and national financial risks. The slope of the US yield curve is consistent with market participants' expectations of an imminent reversal of the long US expansion. Economic and monetary policies, which have only been partially normalised in recent years, may not have much scope to counter the next recession, thus inducing a rapid increase in the risk aversion of market operators. The increase in yields demanded from issuers with low credit ratings would quickly penalise the Italian economy.