ufficio parlamentare di bilancio

## *Summary* [*]

*In 2019 the international economy recorded its slowest growth of the decade, reflecting the marked deceleration of trade and heightened uncertainties about economic and trade policies. According to the forecasts of the International Monetary Fund (IMF), global economic activity should begin to strengthen again this year, but current data do not yet signal an inversion of the cycle.*

*The Italian economy also weakened last year. According to preliminary national accounts estimates, GDP is expected to have increased by 0.2 per cent, more than half a percentage point less than in 2018. Overall, the slowdown was mainly attributable to the components of domestic demand, which also kept consumer price inflation low. Employment has held steady against the background of moderate output growth, but the Parliamentary Budget Office (PBO) indicator of household and business uncertainty continues to rise. In the last three months of 2019, the economy experienced an unexpected setback in conjunction with the more moderate slowdown observed in the other European economies. The PBO's short-term forecasting models for Italy indicate no recovery in the current quarter.*

*In this Report, the PBO provides its medium-term macroeconomic projections for the Italian economy. GDP is expected to have expanded by 0.2 per cent in 2019, a smaller increase than that estimated in October (0.5 per cent) on the occasion of the endorsement exercise for the forecasts of the Ministry of the Economy and Finance (MEF). The downward revision mainly reflects the deterioration in economic conditions in the final part of 2019, as well as the worsening of international exogenous variables. In 2021, GDP growth is forecast to strengthen to 0.7 per cent (between one and three-tenths of a point less if the indirect tax increases provided in the safeguard clauses are levied).*

*Despite the recent partial easing of trade tensions and the elimination of uncertainty about Brexit, risk factors are strongly slanted towards the downside. Concerns about geo-political tensions and environmental factors remain high and new risks are emerging in relation to the health emergency in China. Furthermore, despite the expansionary stance of the main central banks, the financial markets appear to be exposed to the risk of rapid corrections, which would swiftly have an impact on the yields of sovereign debt securities.*

[*] *Prepared by the Macroeconomic Analysis Department. Information updated to 10 February 2020.*

## *The international environment*

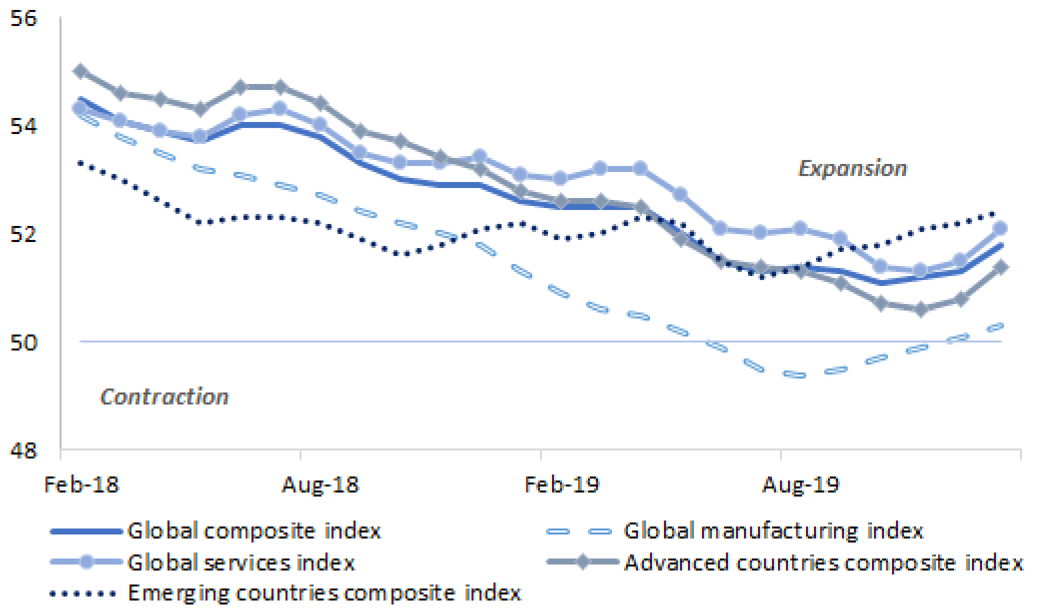
### *International economic conditions continued to weaken in 2019*

Last year, global economic growth showed a marked deterioration compared to 2018, being the lowest in the last decade (2.9 per cent); restrictions on trade between the United States and trade partners, mainly China, as well as geo-political tensions have affected.

In 2019, purchasing managers' confidence indices (the Purchasing Managers' Index, PMI) declined until the summer before recovering slightly in the final months of the year. The global manufacturing indicator, which had fallen below the threshold separating contraction from expansion, returned to just above 50 in December. The services component also exhibited a similar trend, although it never registered values foreshadowing to a recession (Figure 1).

In the United States, 2019 was the tenth consecutive year of GDP growth, although the pace was relatively modest (2.3 per cent). On the whole, developments in consumption, net exports and government spending appeared in line with those in recent years, while private investment decreased significantly. In the euro area, where the final part of the year was weaker than expected (0.1 per cent in the fourth quarter), 2019 also closed with slower growth than in 2018 (1.2 per cent, from the previous 1.9 per cent). Chinese growth

***Figure 1*** – JP Morgan Global PMI (1)
*(three-month moving average)*




Source: IHS Markit.
(1) Confidence indicators based on the assessments of corporate purchasing managers. A value of more than 50 indicates an expansion.

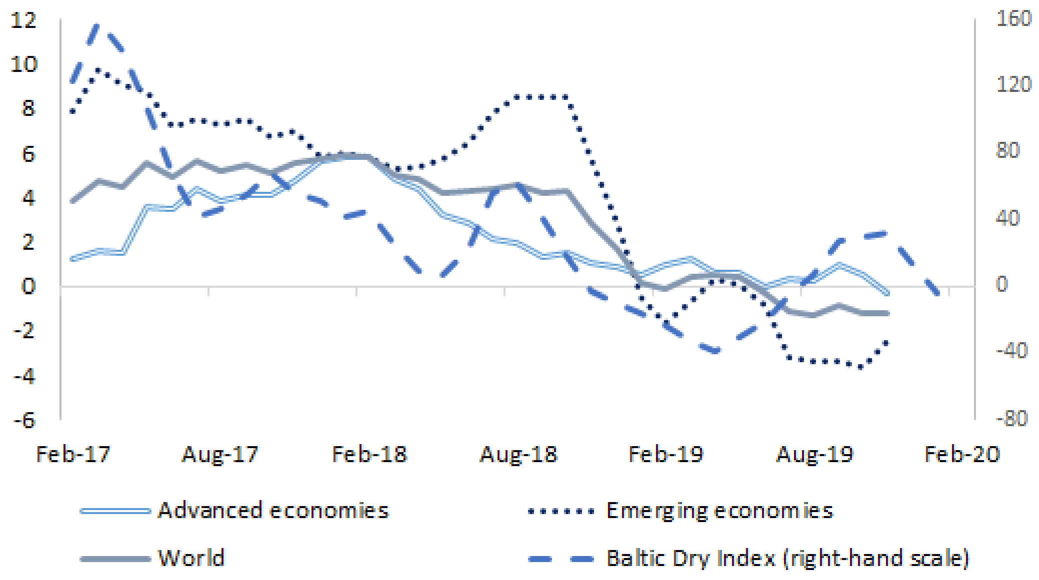
in 2019 was only 6.1 per cent, the slowest since 1990, due to the deceleration of manufacturing activity; the industrial sector was affected by the slowdown in international trade, as well as by the trade dispute with the United States. For the remaining BRICS countries (Brazil, Russia, India and South Africa), the pace of economic activity also subsided to a relative low. GDP in Venezuela and Argentina continued to decline in 2019.

### *2020 opens with signs of easing in trade disputes...*

The final days of 2019 saw the first signs of a relaxation in trade relations between the United States and China, which led to the signing of an agreement in mid-January for an initial phase of negotiations. The agreement warded off the imposition of new tariffs scheduled for December and halved those introduced back in September. China also undertook to increase goods imports from the United States by €200 billion, to strengthen intellectual property protections, to eliminate forced technology transfers and to limit exchange-rate manipulation. Although the new agreement represents a step forward compared with the trade war being waged just a few weeks earlier, a number of critical issues remain. In particular, the Chinese commitment to import more US goods could harm other trading partners, merely redirecting the flow of goods without changing the total volume of international trade. Furthermore, since the commitment refers to a subset of total goods imports, China could decide to reduce imports of US goods that are not covered by the agreement to compensate its partners for trade losses, undermining the effectiveness of the pursuit of the basic objective of the United States, namely to reduce its trade deficit with China and the rest of the world.

Currently available data on world trade from the Central Planning Bureau (CPB) do not yet reflect the possible benefits of the new agreements, as the figures only go up to November last year. According to the data, in the first eleven months of 2019 the year-on-year rate of change in the three-month moving average of world trade gradually declined, reaching -1.3 per cent in November. The data for maritime freight rates (Baltic Dry Index - BDI), which are available to the end of January, indicate a new deterioration in commercial traffic after the recovery registered in the last four months of 2019 (Figure 2).

**Figure 2** – Growth rate of imports and index of maritime freight costs
*(annual percentage change in 3-month moving average)*




Source: based on CPB and Refinitiv data.

### *... but the most recent IMF forecasts do not consider the impact of the coronavirus*

In January, the IMF revised its growth forecasts for the world economy downwards for the sixth consecutive time. In addition to reducing its estimate for 2019 to 2.9 per cent, the IMF trimmed that for 2020 by one-tenth of a percentage point (to 3.3 per cent) and that for 2021 by two-tenths of a point (to 3.4 per cent). The revisions involved both the advanced countries and the developing economies. The estimated growth rate for world trade was also revised downwards by three-tenths of a point for this year and one-tenth for next year (to 2.9 and 3.7 per cent respectively). The IMF's expectations for world trade growth in 2020 show a stronger recovery in its apparent elasticity to GDP than that implied in the estimates of other forecasters. The average change in global trade forecast by the European Central Bank (ECB), the World Bank, the OECD and Oxford Economics is 1.4 per cent in 2020, essentially in line with the assumptions adopted by the PBO in the medium-term forecasting exercise presented in this Report.

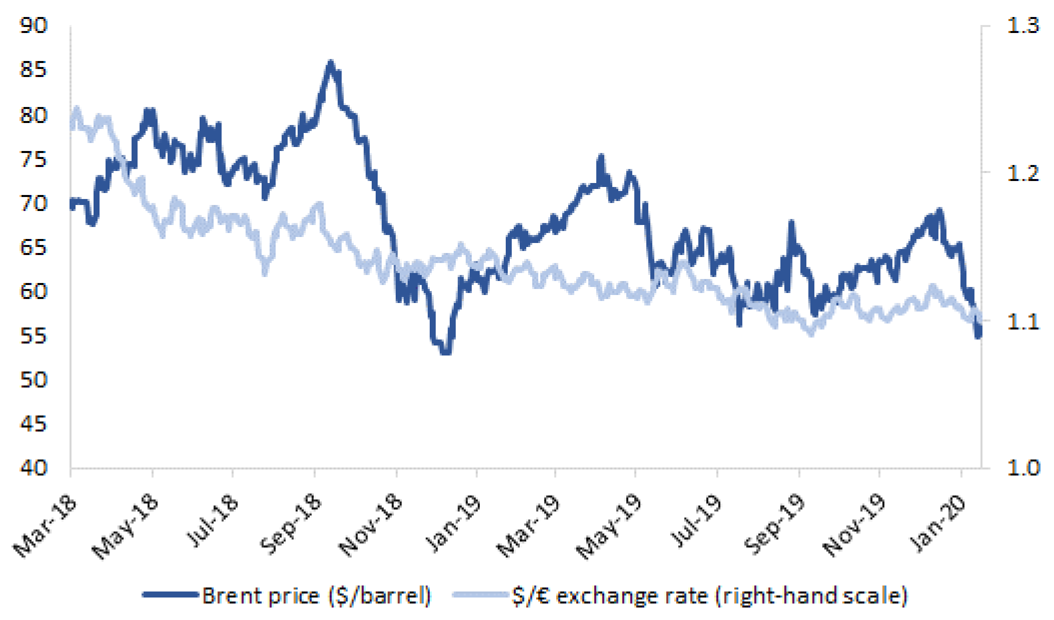
The IMF forecasts were prepared before the coronavirus epidemic in China spread to other countries. Although it is still premature to obtain robust estimates of possible economic effects, a number of preliminary assessments have been performed by comparing the current epidemic with past outbreaks, in particular the SARS epidemic in 2003. Considering the sectors most affected (travel, entertainment and retail), as well as the effects of many Chinese companies' decision to prolong the holiday period connected with Chinese New Year, Morgan Stanley estimates that the loss of GDP for China could range from 0.5 to 1.0 percentage points in the first quarter, assuming the spread of the disease peaks between February and March. On the other hand, if the peak comes between March and April, the loss of output in the first half of the year will be slightly higher. For the world economy, GDP growth could be reduced by between 0.15 and 0.3 percentage points in the first quarter. According to Oxford Economics, however, the loss of GDP in the first three months of 2020 could be close to double that estimated by Morgan Stanley.

### *Oil prices stable overall despite geo-political tensions*

During 2019 the price of oil changed largely offsetting rises and falls. The recovery in prices registered until April was followed by a period of falling prices caused by the slowdown in the world economy and the continuous expansion of US oil production, mainly attributable to shale oil. In the last few months, the escalation of tensions in the Middle East caused temporary price jumps, although they quickly subsided. The average price in 2019, equal to $64.2 a barrel, is close to that in the first month of 2020 ($63.9; Figure 3). In the second half of January, the initial impacts of the spread of the coronavirus epidemic in China began to emerge not only in foreign exchange and equity markets, but also in commodity markets, including oil, due to the risk of a slowdown in the global economy. In early February, oil was trading at just over $55 a barrel.

Last year, the dollar/euro exchange rate experienced much smaller fluctuations than oil prices, not exceeding three percentage points compared with the average of around $1.12 per euro. At the end of January, the rate had edged down slightly, to $1.11 per euro.

***Figure 3*** – Oil prices and dollar/euro exchange rate




Source: Refinitiv.

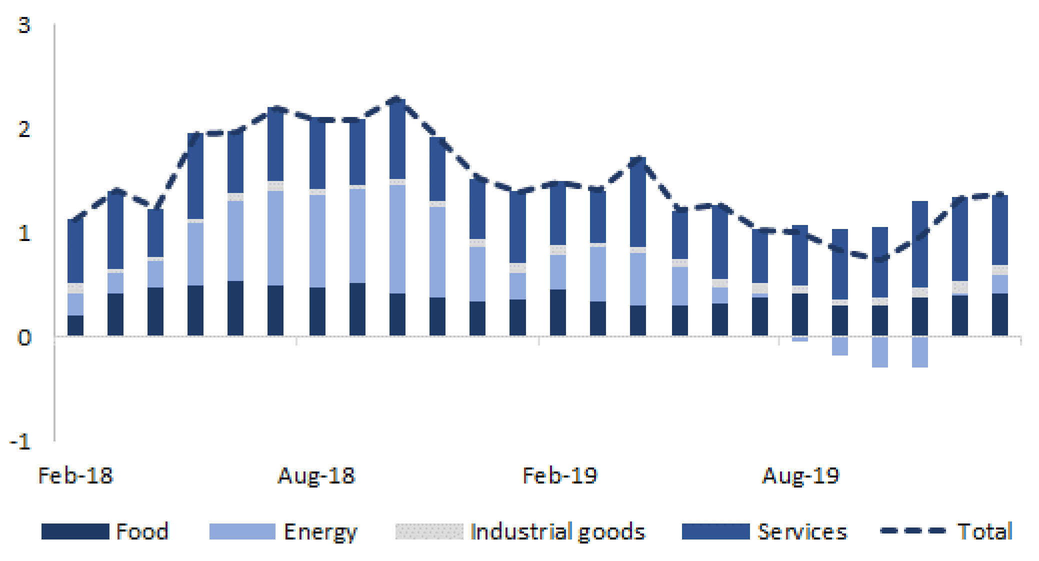
The monetary policy measures adopted by the central banks on both sides of the Atlantic contributed to the relative stability of the exchange rate. The forward guidance and effective communication of both made the direction of monetary policy predictable, thus helping to contain exchange-rate tensions.

### *Inflation in the euro area fell further in 2019*

Euro-area inflation declined in the first 10 months of 2019, bringing the annual change in the general price index to 0.7 per cent in October (from 1.4 per cent in January). By contrast, core inflation remained broadly stable over the same period, at around 1.0 per cent. In the last two months of 2019 and the first month of 2020, the prices of services accelerated slightly, pushing up the overall index, which in January rose to 1.4 per cent on a year-on-year basis (Figure 4). Inflation averaged 1.2 per cent in 2019, compared with 1.8 per cent in 2018.

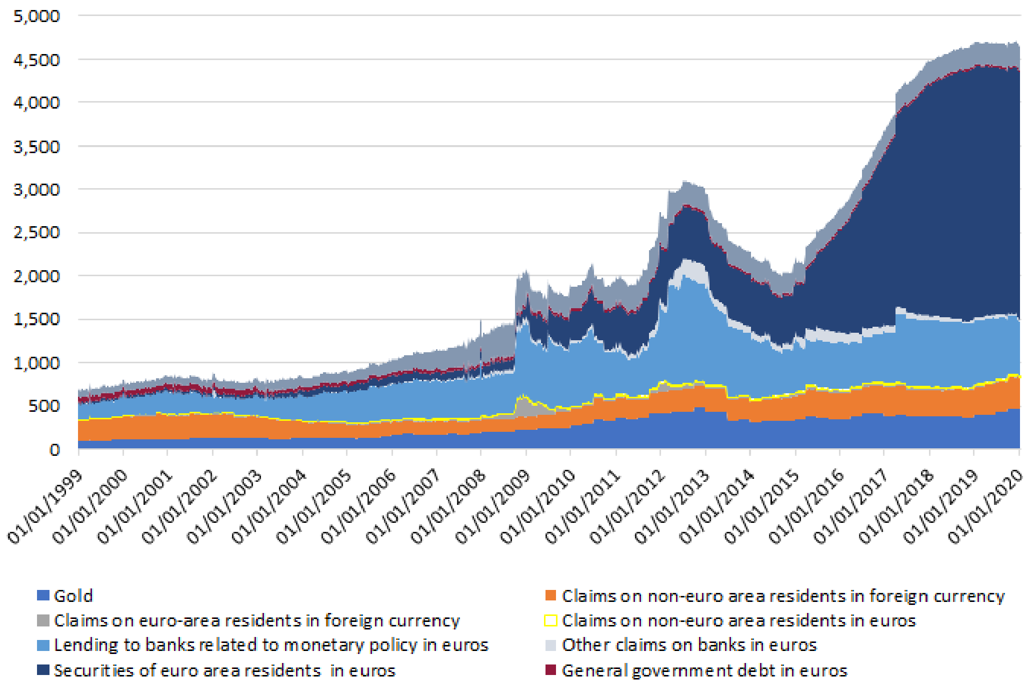
Last November, the ECB launched a new asset purchase programme (Figure 5) to support lending and therefore demand and prices, in order to strengthen the convergence of inflation towards the monetary policy target. According to the ECB, the revival of inflation towards the end of the year was mainly driven by the uptick in oil prices, which however quickly subsided. Both the Eurosystem projections and the Survey of Professional Forecasters (SPF) indicated that inflation is expected to remain well below the target of 2 per cent over the next three years.

***Figure 4*** – Inflation in the euro area
*(percentage year-on-year change and contributions)*




Source: based on Eurostat data.

***Figure 5*** – Eurosystem consolidated assets
*(billions of euros)*




Source: ECB.

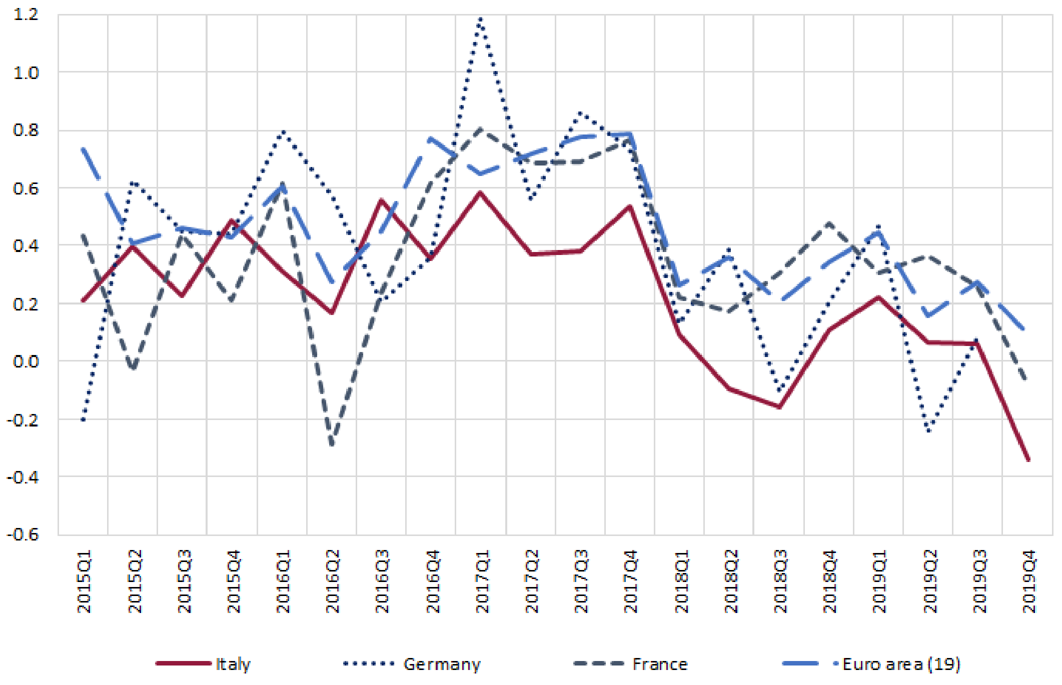
## *The Italian economy*

### *GDP growth was weak last year*

In the first three quarters of 2019, the Italian economy was characterized by barely positive quarterly economic growth. According to Istat's preliminary estimates, in the final quarter of 2019, GDP instead contracted by 0.3 per cent on the previous quarter (Figure 6), compared with consensus estimates by leading forecasters for substantially no change. A sharp deterioration in economic conditions was also observed in France, where GDP decreased by 0.1 per cent (compared with analysts' expectations of an expansion of 0.2 per cent), and in the euro area as a whole, where output increased by just 0.1 per cent, the lowest rate of growth since early 2013. Overall, GDP in Italy increased by 0.2 per cent in 2019, down from 0.8 per cent in 2018. The statistical carry-over impact on GDP growth in 2020 would be a negative 0.2 percentage points.

The contraction in economic activity in the final quarter of last year reflected contractions in output in industry, construction and agriculture, to which temporary factors may have contributed only in part. The business cycle also deteriorated markedly in other exporting countries, such as Germany. Value added in services is expected to have stagnated, after

**Figure 6** – GDP growth in the euro area and in its three largest economies
*(percentage change on previous period)*




Source: based on Eurostat data.

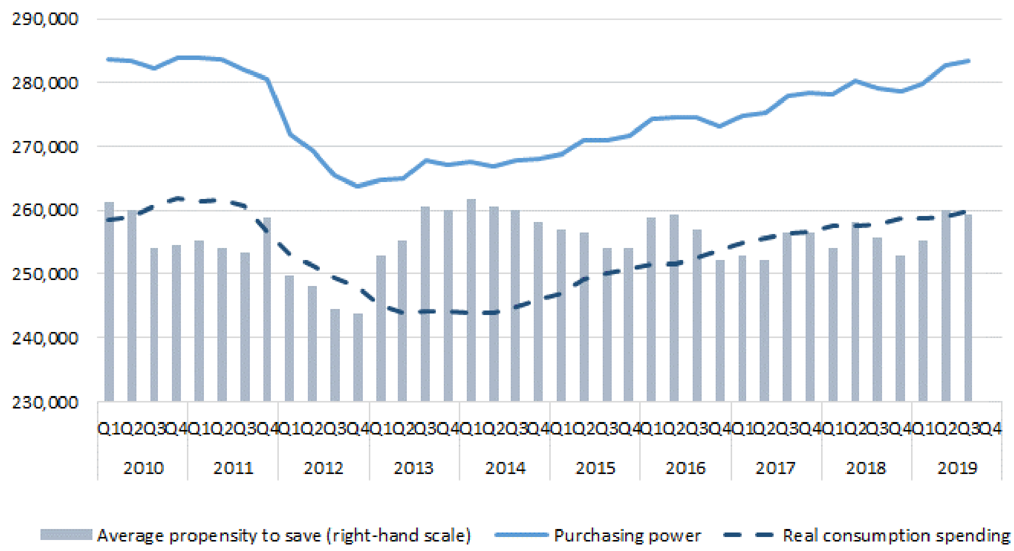
two quarters of growth at an average rate of 0.2 per cent on the previous quarter. On the demand side, the positive contribution of foreign trade was offset by the negative contribution of the domestic component, gross of the change in inventories.

### *Consumer spending accelerated in the summer ...*

The growth in private consumption, which had essentially stagnated in the first half of the year, strengthened in the third quarter to 0.4 per cent on the previous three months. The acceleration may have reflected the initial expansionary impact of the Citizenship Income, which in the summer began to reach a larger pool of beneficiaries. Household expenditure increased by 0.6 per cent in 2019, slightly less than the average annual change in 2018 (0.8 per cent).

The strengthening of spending in the summer was driven by expenditure on goods, especially durables, while services were virtually unchanged. Household spending benefited from the increase in purchasing power, which had already strengthened in the two previous periods. Households' propensity to save essentially stabilised in the summer (at 8.9 per cent of disposable income; Figure 7), after rising in the two previous periods.

**Figure 7** – Household purchasing power, consumption and saving
*(millions of euros, chain-linked values, 2015 and percentage shares)*




Source: based on Istat data.

Consumer confidence, which was relatively high in 2018, weakened last year, especially sentiment about the general economic situation. Despite a slight recovery in January, the climate of confidence remains below its average in the last two years, making a pronounced improvement in household spending developments unlikely.

### *... but investment has weakened*

Last year capital accumulation increased (with growth of 2.4 per cent acquired in the third quarter) more slowly than in 2018 (3.2 per cent). In the summer, there was a slight contraction on the previous period (-0.2 per cent), mainly reflecting a decrease in spending on plant, machinery and armaments. Conversely, investment in construction resumed the moderate growth begun in the second half of 2017 after having declined in the spring. The investment rate (the ratio of gross fixed capital formation to value added) increased to 21.4 per cent in the third quarter, above its average for 2018. Profitability (measured as the ratio of gross operating profit to value added at basic prices for non-financial corporations) continued to decline.

Surveys point to a continuation of weak capital accumulation in the short term. The Istat survey revealed a progressive deterioration in domestic orders for capital goods during the year, despite the improvement in lending conditions in the second half of 2019 for small enterprises as well. The Bank of Italy-Sole 24 Ore Survey on Inflation and Growth Expectations in December also revealed considerable caution looking forward, indicating the persistence of adverse conditions for investing, particularly in construction and services. Firms are especially concerned about political uncertainty and trade restrictions.

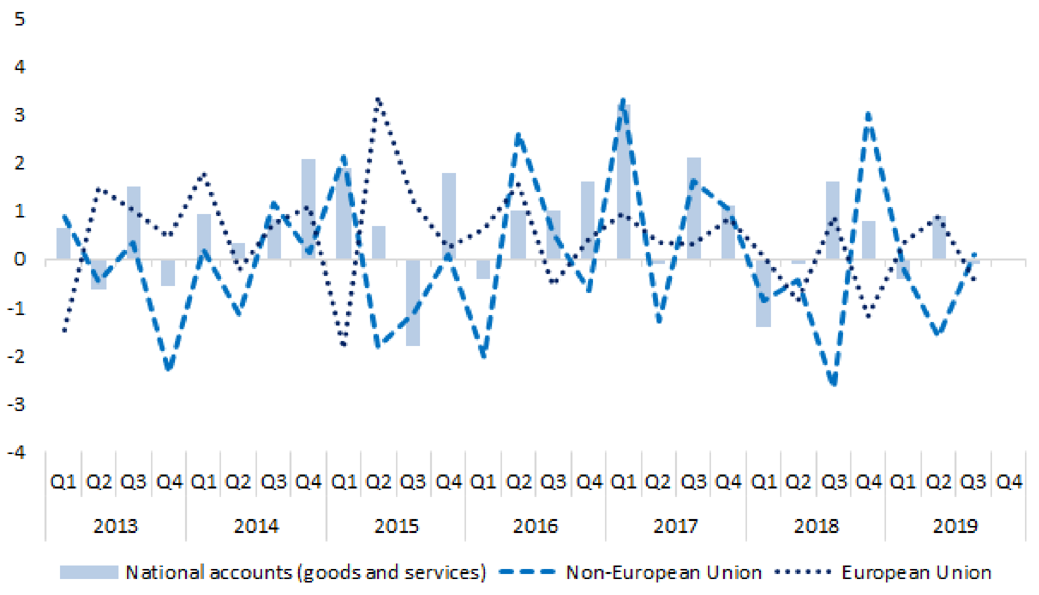
Growth in overall bank lending to the non-financial private sector decelerated progressively during 2019, with the pace of expansion falling to zero in November. However, this trend masks differing developments among borrowers: while lending to households has continued to expand both for mortgage loans and consumer credit, lending to non-financial firms has declined, especially for small businesses and for those operating in construction. In the third quarter, the flow of new impaired loans decreased as a proportion of total lending (equal to 1.2 per cent seasonally adjusted and annualised), especially for firms in services and construction. In the same period, bad loans decreased as a proportion of total lending, both gross and net of writedowns.

### *Exports continue to expand despite the slowdown in trade*

Despite the slowdown in international trade, national accounts data indicate a relatively rapid expansion in the volume of foreign sales. The growth acquired last year came to 1.6 per cent, similar to the increase registered in 2018.

With regard to export markets (Figure 8), monthly data on merchandise trade show that the volume of sales outside the European Union has been particularly volatile, with a recovery in the third quarter despite no change in overall nominal terms. Exports within the European Union, which were less erratic, saw the moderate growth under way since the end of 2018 come to an end.

***Figure 8*** – Change in exports (total and by geographical area) (1)
*(percentage change on previous period)*




Source: based on Istat data.
(1) The histograms represent changes on the previous period in the chain-linked values of total exports drawn from the national accounts. The lines show changes on the previous period in the volume of exports of internationally traded goods, seasonally adjusted by the PBO.

The most recent foreign trade data reveal a mixed picture. The average for October-November shows a recovery in exports compared with the third quarter (0.6 per cent in volume, obtained by deflating with producer prices on foreign markets), while December data on exports in value terms for non-EU countries only indicate a decrease of about one percentage point compared with the previous month. Survey findings point to short-term weakness in foreign trade: the Istat survey on the confidence of manufacturing firms, conducted in December, reveals a deterioration in expectations for foreign orders and in expectations for turnover in international markets.

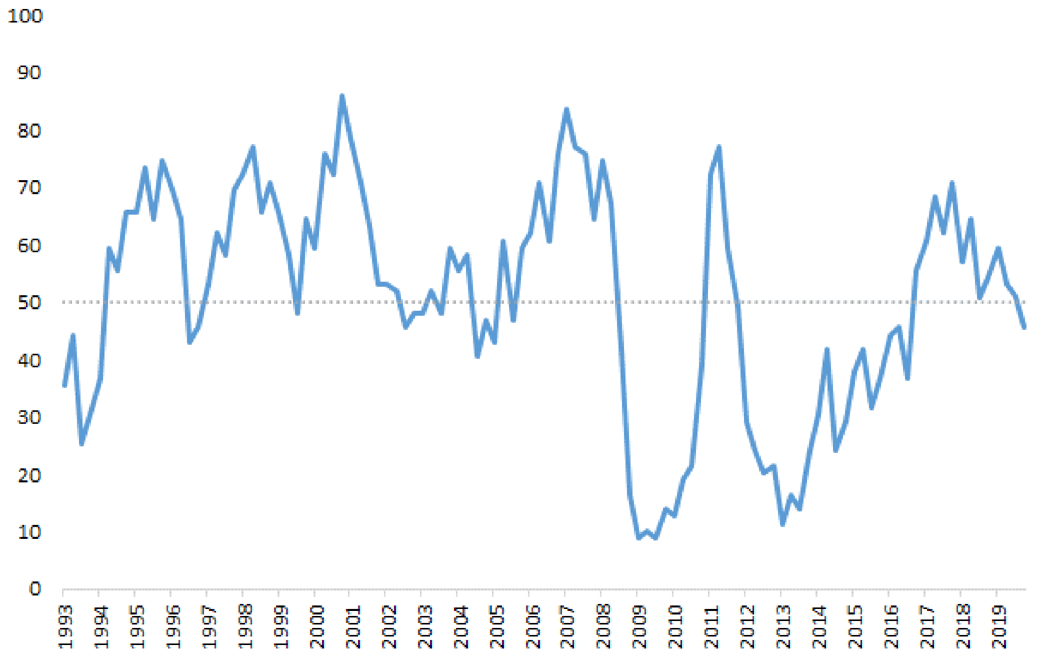
Imports also decelerated last year (the growth rate as of the third quarter was 0.9 per cent), probably due to the weakening of capital accumulation and inventory building, which normally lends considerable impetus to imports. However, the larger increase in exports should have just boosted the contribution of net foreign demand to growth into positive territory for 2019.

### *The latest economic indicators*

The downturn in the industrial cycle, which has been under way since the beginning of 2018, steepened in December, with industrial production decreasing by 2.7 per cent compared with the previous month due to substantial contractions in all the main segments. In the fourth quarter of last year, industrial activity contracted by 1.5 per cent on the previous quarter, the first time that had happened since the final quarter of 2012. Analysing developments in the various segments using the PBO diffusion index (Figure 9), the number of sectors experiencing growth on average in October-December continued to decrease. The outlook for industry remains weak, as evident in qualitative indicators, including the PMI and the Istat index of manufacturing confidence in January.

Output in construction increased on average in the first eleven months of 2019 (1.7 per cent), interrupting the weakness that characterised the 2015-2018 period. Nevertheless, in the last quarter it decreased sharply compared with the average for July-September (-2.5 per cent), due in part to unfavourable weather conditions. The housing market survey conducted in October and November by the Revenue Agency, the Bank of Italy and Tecnoborsa found that the expectations of industry operators had improved for urban areas. More recent surveys of building firms show an improvement in assessments and trends in orders and construction plans.

***Figure 9*** – PBO diffusion index
*(percentage shares)*



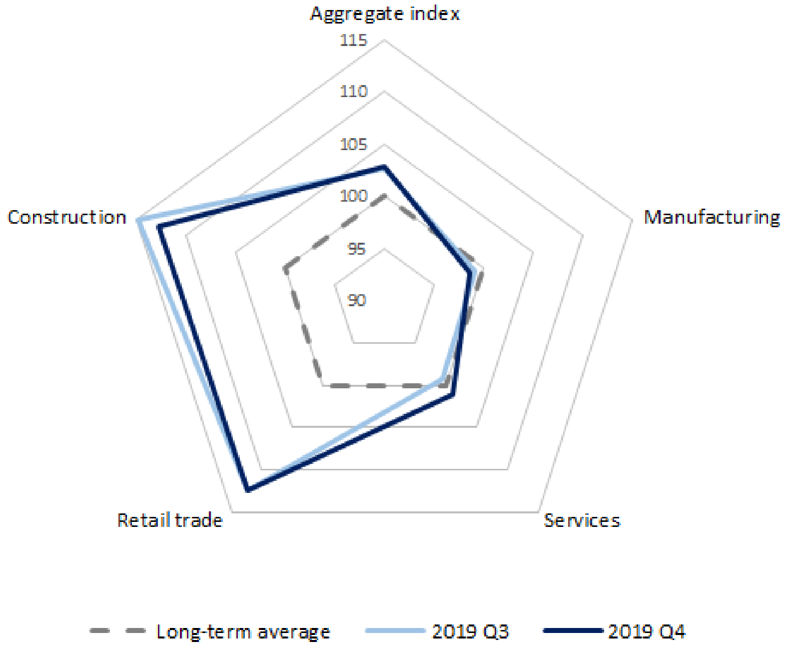

Source: based on Istat data.

Activity in the services sector barely increased in the third quarter of 2019 (0.1 per cent compared with April-June, as did the change acquired compared with the 2018 average), despite the more marked increase in consumer spending. Qualitative indicators improved marginally in the final part of last year.

For all sectors, the aggregate index of business confidence, obtained as the weighted average of sectoral indices, was virtually unchanged in the autumn quarter compared with the July-September average (Figure 10). In January, the aggregate index fell, reflecting the views of firms in services and retail trade.

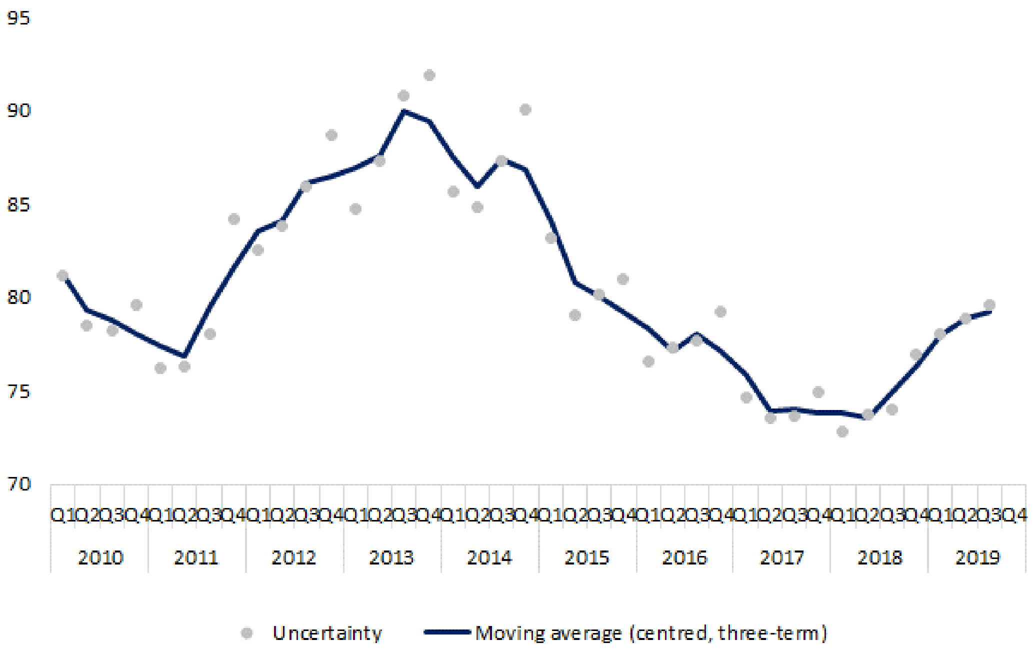
The uncertainty of households and firms continues to rise. The PBO index of uncertainty, while remaining below the peak registered in 2013-2014, continued to worsen in the final part of 2019 (Figure 11), mainly reflecting the construction and manufacturing components.

***Figure 10*** – Confidence in productive sectors (1)
*(index; average January 1998 – December 2019=100)*




Source: based on European Commission and Istat data.
(1) The aggregate confidence indicator is constructed by applying the weights used by Istat to produce the Istat Economic Sentiment Indicator (IESI) to the time series (standardised) of sectoral confidence indicators of the European Commission.

***Figure 11*** – PBO indicator of uncertainty
*(index; 1993 Q1=100)*




Source: based on Istat data.

Composite economic indicators all show economic activity stagnating. The ITA-coin coincident indicator produced by the Bank of Italy recovered ground in the autumn and then stabilised in January at a level just above zero. By contrast, the Istat leading indicator declined throughout 2019.

### *Employment growth slows, but the unemployment rate continues to decline*

In 2019, employment slowed slightly (0.7 per cent on average for the year on the basis of preliminary data, down from 0.9 per cent in 2018) but it nevertheless increased more than output. Female employment and employment among those on permanent contracts performed especially well, while fixed-term employment decreased significantly. The growth in hours worked also slowed.

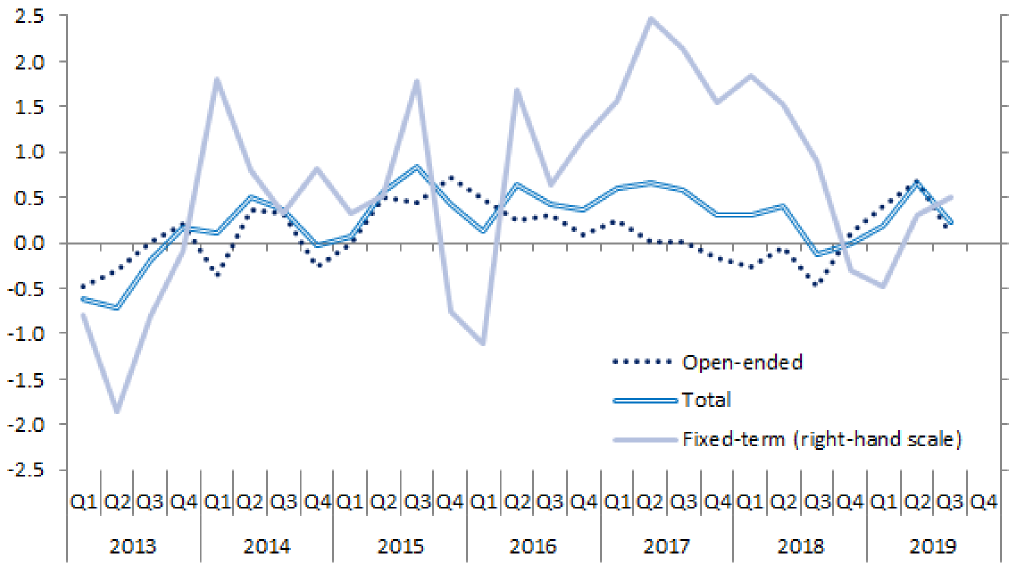
In the second half of the year some signs of slowdown emerged, reflecting the persistent weakness of economic activity. In the summer quarter, growth in labour demand, measured by the number of payroll employment positions on the basis of existing employment contracts, decelerated to 0.2 per cent on the previous quarter (from 0.4 per cent in the second quarter). However, labour inputs have recovered thanks to the increase in hours worked, especially in construction.

With regard to the supply of labour, the deceleration in payroll employment in the third quarter (0.2 per cent on the previous quarter according to the Labour Force Survey, down from 0.7 per cent in the second) was entirely due to the slowdown in open-ended employment, which had expanded strongly since the last quarter of 2018. By contrast, the change in fixed-term employment strengthened for the second consecutive quarter (Figure 12), returning to values similar to those registered a year earlier. The rising trend in part-time employment continued (the proportion of involuntary part-time employment rose to 12.0 per cent of persons in employment) and at the same time full-time employment decreased. According to preliminary information, in the final quarter of 2019 the number of workers in employment barely increased.

INPS administrative data also show a deceleration in the new hiring on open-ended contracts, although growth did continue. A similar pattern emerged for transformations of fixed-term contracts into permanent positions, whose rapid expansion since the final months of 2018 followed the enactment of the "Dignity Decree", which facilitates the transformation of existing fixed-term contracts.

The unemployment rate, which declined over the course of the entire year, averaged 10.0 per cent in 2019 (9.8 per cent in the fourth quarter). The increase in the employment rate (59.1 per cent) was accompanied by a slight rise in the participation rate. Long-term unemployment also declined (to 5.6 per cent on average in the first three quarters of 2019, down from 6.2 per cent in the same period of 2018). The number of inactive

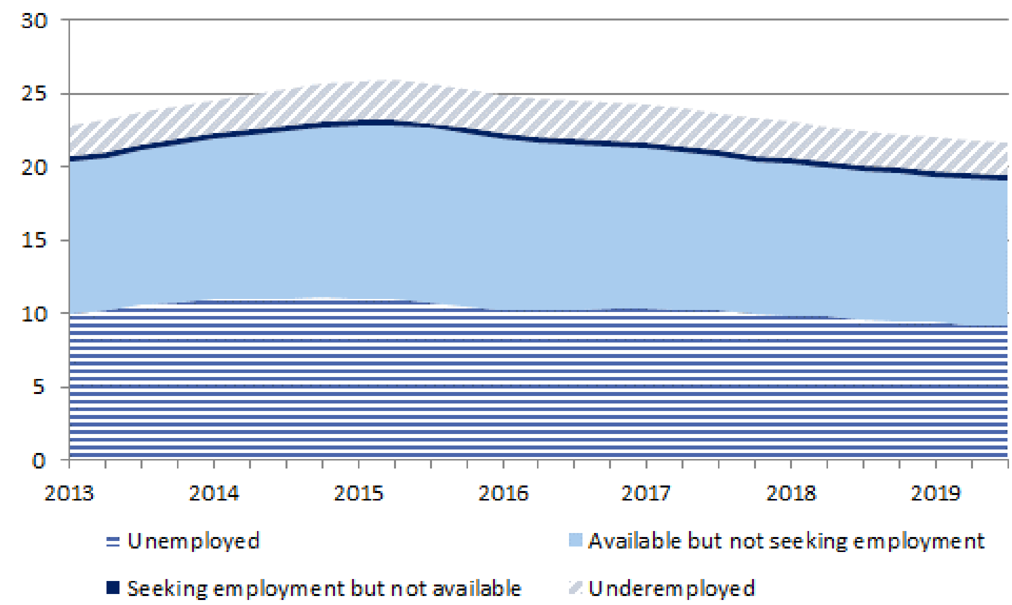
***Figure 12*** – Change in payroll employment
*(percentage change on previous period)*




Source: based on Istat data.

individuals has decreased further, especially among women, while it has increased slightly for men. The indicator of the degree of underutilisation of the labour force remained high at just under 22 per cent (Figure 13).

***Figure 13*** – Unemployment, underemployment and potential additional labour force (1)
*(4-term moving average; percentage shares)*




Source: based on Istat data.
(1) Ages 15-74 years.

On average in July-September, the growth in hourly contractual wages for the entire economy eased considerably (0.7 per cent on the previous period, down from 1.6 per cent in the first quarter), reflecting the slowdown in public sector wage growth towards a rate similar to that in the private sector. A further slight weakening occurred in the fourth quarter. In 2019, the growth in contractual wages decelerated to 1.1 per cent (from 1.5 per cent in 2018), similar to the quarterly developments in actual earnings.

The decrease in hourly productivity in the third quarter (-0.3 per cent year-on-year) reflected a larger increase in hours worked than the rise in value added. The change acquired (-0.5 per cent on the basis of the first three quarters of 2019) remains negative in the major sectors of the economy with the exception of construction. Developments in hourly earnings per employee (1.3 per cent growth acquired, from 1.8 per cent on average in 2018) instead reflected the deceleration under way since the spring quarter, in particular in services. The growth in unit labour costs therefore slowed slightly (1.8 per cent, from 2.0 per cent on average in 2018).

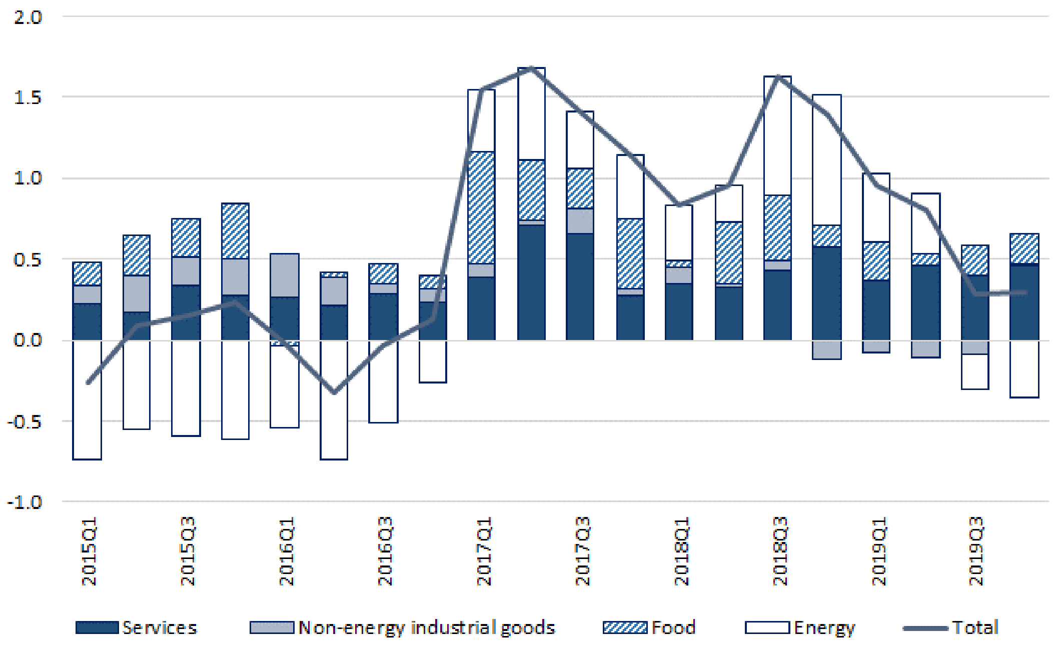
### *Consumer price inflation has fallen by half since 2018*

Consumer price inflation last year was modest (with an increase of 0.6 per cent the index for the entire economy), falling by half compared with 2018 (1.2 per cent). Core inflation, which excludes the prices of energy and unprocessed food, also weakened albeit to a lesser extent (0.5 per cent in 2019, compared with 0.7 per cent the previous year). Price drivers remained weak: domestic demand is still moderate, pressures in the upstream segment of the production process are modest and expectations for prices remain cautious.

Last year, monthly developments in consumer price inflation (national consumer price index, NIC) was mainly driven by energy components (Figure 14). Inflation strengthened in the spring, but by the summer months it already showed signs of stabilising, which were then confirmed in the autumn quarter. The inflation in the services component exceeded that for non-energy goods, especially in the transport sector. Preliminary Istat data point to the broad stabilisation of inflation in January (the year-on-year change in the NIC index was 0.6 per cent, down from 0.5 in the previous month). The rise in the prices of unregulated energy products accelerated (to 3.2 per cent from 1.6 per cent in December), as did that for food products, albeit to a lesser extent (1.0 per cent from 0.8 per cent), while the prices of regulated energy products continue to act as a brake (-9.5 per cent in January, from -7.8 per cent in December).

Core inflation was less volatile than headline inflation and very low overall. However, in January it rose two-tenths of a point to 0.8 per cent.

***Figure 14*** – Overall consumer price index and contributions of components (1)
*(year-on-year percentage changes and contributions to increase)*




Source: based on Eurostat data.
(1) The figure reports the contributions to the increase in the index of the sectoral components of the harmonised general consumer price index.

Many analysts have tried to interpret the current anomaly of an economic recovery without inflation, but no conclusive explanations have yet emerged. From the point of view of short-term relationships, inflation may be inhibited by lower external pressures, both on prices and on demand for Italy.[2] At a more structural level, the profound changes that have taken place in the goods market and distribution (e-commerce, globalisation) may have increased competition and reduced profit margins. At the same time, the characteristics of the relationship between labour and prices (the Phillips curve) today may differ from those prevailing before the global financial crisis.[3]

Price weakness continues to affect a substantial set of expenditure items. On average in 2019, the prices of 90 per cent of goods experienced increases of less than 2.0 per cent, while the share of products experiencing deflation rose compared with 2018 (27 per cent on average, compared with 22 per cent the previous year).

After a first half of the year of substantial stability at slightly below 1.0 per cent, imported inflation declined significantly from the summer (-2.4 per cent between June and November) thanks to a reduction in the prices of energy commodities. Producer prices in

[2] A discussion of the determinants of inflation, as measured by the GDP deflator, is given in the Box "A decade of low inflation in Italy: a counterfactual exercise" in the PBO's Report on Recent Economic Developments for October 2019, which is available at: http://en.upbilancio.it/report-on-recent-economic-developments-october-2019/.

[3] The Phillips curve has come under scrutiny from various economists in recent years, such as Blanchard (2016) in "The Phillips curve: back to the '60s?" AER, 106(5).

industry, which were still rising in the first half of the year (2.3 per cent), slowed down sharply in July and even more in the autumn (-2.6 per cent annual average in the fourth quarter). A similar trend was seen in the construction sector, where the modest recovery observed up to June was reabsorbed in the second half of the year (0.1 per cent average annual rise). In services, the upward trend in producer prices that has been under way in the past two years has slowed significantly (0.3 per cent in the third quarter, compared with 1.7 per cent in the previous months of the year).

The inflation expectations of businesses and households reported in Istat confidence surveys remained cautious throughout 2019, with a marginal upturn only in the autumn months. Households displayed a gradual recovery of optimism after the summer, although this dissipated in the winter (in January, the balance of inflation assessments was -3.7, compared with an average of 10.9 in the previous three months). Firms generally appeared less optimistic than households. The balance between those expecting an increase in inflation and those projecting a decline went from 6.1 in 2018 to 0.9 in 2019, although January this year saw a slight recovery.

## *Macroeconomic forecasts for the Italian economy*

This section presents the macroeconomic forecasts for the Italian economy for the 2019-2021 period. The forecasting exercise differs from those conducted by the PBO for the purpose of endorsing the macroeconomic scenarios of the MEF in order to make it more directly comparable with the scenarios developed by the main international and national organisations.[4] In particular, the baseline forecast for 2021 does not include the increase in indirect taxes provided for in the safeguard clauses and does not consider alternative funding measures. The results of a simulation that includes the activation of these clauses are outlined in the Box, where the main exogenous variables of the year are also reported.

### *Economic activity in 2019-2021*

According to preliminary data, GDP increased slightly in 2019 (0.2 per cent, as reported in the previous section). Growth, which was moderate in the first three quarters of the year, came to an abrupt halt in the fourth quarter (-0.3 per cent). This contraction produces a negative statistical carry-over effect for the current year (-0.2 percentage points).

The short-term forecasting models of the PBO find that GDP in the current quarter will not recoup the sharp drop registered in the previous period. Economic activity is expected to revive in subsequent quarters, buoyed by the slow recovery in domestic demand, while net foreign demand is forecast to make no contribution. GDP is projected to grow by 0.2 per cent in 2020 (0.1 per cent adjusted for the number of working days), while in 2021 it is expected to expand by 0.7 per cent (Table 1). Activation of the safeguard clauses would subtract between one and three-tenths of a percentage point from GDP growth next year (as indicated in the Box), depending on the speed with which the higher taxes are passed on to prices.

The forecasts presented in this Report take account of the unexpected contraction in GDP in the fourth quarter of 2019, the data for which were released on 31 January 2020. The estimates of the other forecasters were issued before this date, so they do not factor in the unfavourable statistical carry-over impact on 2020. The projections for next year, on the other hand, are broadly consistent (Table 2). In making these comparisons, however, it is necessary to bear in mind that they reflect the different assumptions adopted by the forecasters for international exogenous variables and the public finance scenario.[5]

[4] As customary, the next endorsement exercise for the MEF's macroeconomic scenario will be conducted between March and April, in conjunction with the preparation of the 2020 Economic and Financial Document (EFD).

[5] For 2021, a number of differences reflect adjustments for the different number of working days made by certain forecasters.

**Table 1** – Forecasts for the Italian economy (1)

| | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| **INTERNATIONAL EXOGENOUS VARIABLES** | | | | |
| World trade | 3.5 | 1.0 | 1.2 | 2.7 |
| Oil price (Brent, dollars per barrel) | 71.1 | 64.3 | 63.6 | 59.4 |
| Dollar/euro exchange rate | 1.18 | 1.12 | 1.12 | 1.15 |
| **ITALIAN ECONOMY** | | | | |
| GDP | 0.8 | 0.2 | 0.2 | 0.7 |
| Imports of goods and services | 3.0 | 1.3 | 1.4 | 2.6 |
| Final domestic consumption | 0.7 | 0.5 | 0.3 | 0.6 |
| - Consumption of households and non-profit institutions serving households | 0.8 | 0.6 | 0.4 | 0.7 |
| - General government expenditure | 0.4 | 0.1 | 0.1 | 0.2 |
| Investment | 3.2 | 2.0 | 0.4 | 1.4 |
| Exports of goods and services | 1.8 | 1.6 | 1.2 | 2.7 |
| **CONTRIBUTIONS TO GDP GROWTH** | | | | |
| Net exports | -0.3 | 0.1 | 0.0 | 0.1 |
| Inventories | -0.1 | -0.6 | 0.0 | 0.0 |
| Domestic demand net of inventories | 1.1 | 0.7 | 0.3 | 0.7 |
| **PRICES AND NOMINAL GROWTH** | | | | |
| Import deflator | 2.6 | -0.1 | 0.8 | 1.0 |
| Export deflator | 1.8 | 0.9 | 1.5 | 1.2 |
| Consumption deflator | 0.9 | 0.5 | 0.5 | 0.9 |
| GDP deflator | 0.9 | 0.8 | 0.9 | 1.0 |
| Nominal GDP | 1.7 | 1.0 | 1.1 | 1.7 |
| **LABOUR MARKET** | | | | |
| Unit labour costs | 2.2 | 1.3 | 1.0 | 1.1 |
| Employment (FTEs) | 0.8 | 0.6 | 0.5 | 0.6 |
| Unemployment rate | 10.6 | 10.0 | 10.0 | 9.9 |

(1) Percentage changes except for contributions to GDP growth (percentage points), the unemployment rate, the exchange rate and the oil price. Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

**Table 2** – Recent forecasts for Italian GDP growth
*(percentage changes)*

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| PBO (10 February), unadjusted | 0.2 | 0.2 | 0.7 |
| Oxford Economics (6 February), adjusted for calendar effects (1) | 0.2 | 0.0 | 0.5 |
| CER (5 February), unadjusted (2) | 0.2 | 0.6 | 0.8 |
| REF (30 January), adjusted for calendar effects (1) | 0.2 | 0.6 | 0.8 |
| IMF (21 January); unadjusted | 0.2 | 0.5 | 0.7 |
| Bank of Italy (17 January), adjusted for calendar effects (1) | 0.2 | 0.5 | 0.9 |
| Prometeia (19 December), adjusted for calendar effects (1) | 0.2 | 0.5 | 0.7 |
| *Memorandum item* | | | |
| MEF (15 October), unadjusted (2) | 0.1 | 0.6 | 1.0 |
| PBO (8 October), unadjusted (2) | 0.1 | 0.5 | 0.8 |

(1) 2019 has the same number of working days as 2018, 2020 has two more working days than 2019 and 2021 has the same number of working days as 2020. – (2) The forecasts reflect the activation of the safeguard clauses in 2021.

### *Forecasts for the components of expenditure*

The growth of the Italian economy over the forecast horizon should mainly be driven by final domestic demand (net of changes in inventories), which is forecast to contribute more than half a percentage point to GDP growth on average over the three years. The overall contribution of net foreign demand is expected to be nil this year and barely positive next year. The impact of the change in inventories, which subtracted six-tenths of a percentage point from real growth last year, would be virtually neutral in the following two years.

On the demand side, growth in household expenditure, after the slight slowdown registered in 2019, is expected to remain moderate this year (0.4 per cent), but will gradually return to long-term growth in 2021 (0.7 per cent). Private consumption will be driven by developments in purchasing power, which should benefit from the measures envisaged in the budget package, the increase in employment and moderate consumer price inflation. The process of capital accumulation, which slowed sharply in 2019, is expected to weaken further this year (0.4 per cent), reflecting the heightened economic and geo-political uncertainty and the modest expectations for domestic demand, despite low borrowing costs. Investment spending is forecast to improve again next year, albeit at a moderate pace (1.4 per cent, compared with more than double that on average in the previous three years). Investment in machinery and equipment this year is expected to be affected by the high level of uncertainty. Next year, it could benefit from persistent expansionary financial conditions and the simultaneous strengthening of the macroeconomic environment. Investment in construction is expected to fall more steeply than that in capital goods this year, mainly due to the unfavourable statistical carry-over effect of the sharp contraction recorded in the autumn, probably largely attributable to temporary and weather factors. The recovery expected for next year would be fostered by the resilience of business confidence and the contribution of the government investments.

Exports of goods and services are forecast to grow in 2020-2021 at a similar rate to the relatively moderate pace of world trade growth. This would enable Italian exporters to maintain their international market shares. Foreign sales are expected to slow down this year and would only revive next year. Imports this year would continue at rates substantially similar to those posted in 2019, while they are forecast to strengthen in 2021, driven by both domestic demand and exports.

### *Forecasts for the labour market and inflation*

Employment (measured in terms of standard labour units) is forecast to increase by an average of just over half a percentage point over the three-year forecast period. With regard to the supply of labour, the joint effect of the introduction of the Citizenship

Income and early retirement policies (the so-called "*Quota 100*") is expected to have a virtually neutral impact on the participation rate. For this year, it is assumed that the active labour policies associated with the Citizenship Income will be implemented, including the signing of employment pacts by employable beneficiaries. Overall, the unemployment rate is projected to remain unchanged at 2019 levels this year, while it is expected decline marginally in next year.

Inflation, as measured by the consumption deflator, is expected to remain low this year (at 0.5 per cent), unchanged on 2019, while it should increase moderately next year. This would reflect deflationary impulses both from external exogenous factors (the price of energy commodities in euros) and unit labour costs. The GDP deflator is again expected to be higher than the consumption deflator this year (at 0.9 per cent), while the two deflators would converge in 2021 due to the weakening of the gain in the terms of trade. After decelerating last year (largely due to the real component), nominal GDP is forecast to recover next year, rising by 1.7 per cent.

### *Main revisions of previous forecasts for 2020*

The forecast macroeconomic scenario in this Report diverges from previous PBO forecasts, mainly due to the sharp unexpected decline in GDP in the final part of 2019, as well as to the downward revision of projections for foreign demand over the entire forecast horizon.

Compared with the scenario formulated by the PBO in October as part of the endorsement of the policy scenario published in the Update to the EFD, GDP growth in 2019 is slightly higher but is expected to be three-tenths of a percentage point lower in 2020 (compared with the growth forecast of 0.5 per cent published in October). Forecasts for the consumption and GDP deflators have also been revised slightly downwards, due to the smaller stimulus expected from aggregate demand and the decline in oil prices.

### *Risks to the forecast*

The risks to which to growth forecasts are exposed are strongly slanted towards the downside. The macroeconomic scenario assumes the absence of new tensions in trade policies and the orderly launch of Brexit. Conversely, it does not consider any new sources of geo-political instability, in particular in the Middle East, as well as environmental risks. Any adverse developments in these areas could accentuate volatility on the commodity and foreign exchange markets, with an impact on international growth, exports and investment in Italy. One specific risk concerns the economic effects of the coronavirus epidemic, which are not quantified in this scenario, as the information available is still too preliminary.

The scenario also assumes the maintenance of accommodative monetary and financial conditions by the central banks and the stabilisation of risk premiums on government securities. Conversely, any shocks in the financial markets would induce rapid increases in the yields of sovereign debt securities which, if persistent, would affect the spending plans of firms and households.

## Box – Assumptions and scenarios in the forecasting exercise

***Assumptions about the international environment***. The exercise covers the 2019-2021 period and is based on updated international exogenous variables (on the basis of the technical assumptions applied to the market figures available as of January 21, 2020). In particular, the exercise assumes: 1) a marked slowdown in global economic activity in 2019, followed by a slight recovery in 2020 and a rapid acceleration in 2021; 2) the extremely gradual normalisation of monetary conditions, with a negative short-term interest rate in the euro area over the forecast horizon; 3) broad exchange rate stability this year, followed by an appreciation next year, consistent with the signals provided by rates on forward markets: the exchange rate of the dollar against the euro is therefore forecast at 1.12 in 2019-2020 and 1.15 in 2021; 4) a drop in oil prices over the forecast horizon, which on the basis of prices quoted on futures markets will decrease to $63.6 a barrel this year and $59.4 in 2021; 5) an expansion of 1.2 per cent in world trade in goods and services this year, after the deceleration posted last year (an increase of 0.2 percentage points over 2018) and an even larger increase next year (2.7 per cent). These values were obtained as the result of a simulation of the effect of other international exogenous variables on global trade, using the international macroeconometric model developed by Oxford Economics, which is also adopted by the MEF to project international exogenous variables.

***Assumptions about the public finances***. The public finance variables reflect the measures contained in the budget package (the 2020 Budget Act and Decree Law 124/2019), which according to the PBO is expected to impart a stimulus to 0.2 percentage points to GDP in 2020, mainly attributable to the suspension of the increase in indirect taxes provided for on the basis of the 2019 Budget Act.[6] The provisions of the 2020 Budget Act instead provide for an increase in indirect taxes next year. Consistent with the technical assumptions adopted by other macroeconomic forecasters, the baseline scenario (Table 1) assumes that the increases are not activated and that the revenue shortfall is not funded. This technical assumption differentiates this forecast from those formulated by the PBO as part of the endorsement exercises conducted for the MEF macroeconomic scenarios,[7] while making it comparable with the most recent projections of the other main national and international organisations.

***An alternative scenario for the safeguard clauses***. Compared with the baseline projection (Table 1), the alternative scenario envisages the activation of the safeguard clauses (increasing VAT and excise duties) for next year, as provided for in the 2020 Budget Act. Assuming that about 75 per cent of the increase in indirect taxes is transferred to consumer prices, in 2021 the consumption deflator would increase by almost one percentage point and the GDP deflator by about half a percentage point compared with the baseline scenario. With regard to the impact on the real economy, in 2021 GDP growth would decrease compared with the baseline simulation by 0.3 percentage points (to 0.4 per cent), essentially due to the small contribution of domestic demand net of inventory changes. Private consumption spending would be more than half a percentage point lower than in the baseline simulation, reflecting the pronounced decrease in purchasing power. Capital accumulation would grow slightly less, due to the weakening of cyclical conditions. In the labour market, compared to the baseline scenario, growth in employment expressed in standard labour units would slow only marginally, but the unemployment rate would deteriorate slightly (rising by one-tenth of a percentage point).

The effect of higher indirect taxes on prices would be smaller if the moderation of upward pressure on prices continues against a background of weak economic activity. Assuming the transfer of 25 per cent of the increase in VAT to consumer prices, the household consumption deflator would rise by less than half a percentage point compared with the baseline scenario, while the GDP deflator would rise only marginally. Real GDP would only be slightly impacted by the activation of the safeguard clauses, decreasing just 0.1 points, mainly reflecting the impact on private consumer spending (-0.3 percentage points).

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[6] An assessment of the macroeconomic effects of the budget measures for this year is provided in the 2020 Budgetary Policy Report.

[7] The findings of the endorsement exercise for the macroeconomic forecasts in the Government's policy documents are available at: http://en.upbilancio.it/reports/.