Rome, 21 September 2020

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 2020 Economic and Financial Document (2020 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 2020-2021 trend macroeconomic forecasts transmitted by the MEF on 18 September, while underscoring the presence of significant risk factors for real GDP growth. As regards the forecasts for subsequent years, i.e. 2022-2023 (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
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Attachment to the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the Update to the 2020 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 2020 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 21 September 2020 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts for the Update to the 2020 EFD (transmitted by the MEF on 18 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 obtained using the Istat model) were formulated on the basis of the same assumptions for the exogenous international variables used by the MEF.

Findings of the endorsement exercise

The 2020-2021 forecasts for real GDP growth in the trend macroeconomic scenario of the Update appear to fall within an acceptable forecasting range, although they are close to the upper bound of the PBO panel forecasts. The overall acceptability of the trend projections in the Update takes account of: a) the absence of substantial overshoots over the endorsement time horizon; 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 median of the PBO panel forecasts. It should be noted that the growth forecast for 2020 could be affected in the coming months by larger-than-normal statistical revisions to the time series of the quarterly national accounts.[1] In addition, various sources of significant uncertainty, in both the short and medium term, must be noted, mainly representing downside risks.

The following summarises the comments on the forecasts for 2020 and 2021, which are the focus of the endorsement exercise and offers a general assessment of 2022-2023.

With regard to GDP growth in 2020-2021, the trend forecast of the Update lies within the range of estimates of the PBO panel for both this year and next. The Update's projection for the change in Italian output for 2020 (-9.0 per cent) is close to the upper bound of the PBO panel's expectations. The divergence between the forecasts of the panellists is smaller than that observed for the 2020 EFD, although uncertainty remains high due to significant risk factors (outlined in the section "Risks associated with the forecast"). According to the MEF forecast, in 2021 the Italian economy will recover approximately half of the output lost this year. The forecast for GDP growth in 2021 (5.1 per cent) appears to be prudent for the annual figure. However, we point out thatthe substantial uncertainty surrounding the estimates for the current quarter, which have a significant statistical carry-over impact on the following year. The lifting of restrictions on work and individual mobility engendered a sharp rebound in GDP in the summer, one with which the PBO panel concurred in qualitative terms, but the scale of which is extremely uncertain. The short-term estimates are currently highly varied, mainly due to the limited economic information available for the services sector.

With regard to the determinants of growth, in the MEF's macroeconomic scenario about four-fifths of the reduction in GDP in 2020 is attributable to the internal components of demand, while the negative contribution of net exports decreases. The change in inventories is essentially neutral. Fixed capital accumulation is expected to have come to an abrupt halt this year, with the MEF's forecast lying near the lower bound of the panel range. The decrease in household consumption lies within the bounds of the panel projections, but it is smaller than that forecast by three of the four panel members and close to the upper bound; the change in general government expenditure is similar to the median value forecast by the panel. With regard to foreign demand, the pronounced decrease in exports envisaged in the MEF's macroeconomic scenario for 2020 substantially exceeds the contraction in international trade and that in Italy's key destination markets. However, the decline in imports is also significant, so the contribution of net exports to GDP growth does not differ significantly from the median of the PBO panel forecasts.

In 2021, developments in the main variables in the MEF macroeconomic scenario are consistent with the expectations of the PBO panel. The Update's forecast for growth in household consumption is cautious, while that for general government spending lies between the median value and the upper bound of the forecast range. With regard to foreign trade, most of the forecasters on the PBO panel also expect exports to increase by more than the growth in international trade. Conversely, the increase in imports is smaller than the projections of the majority of the members of the PBO panel. As a result, the contribution of net exports to GDP growth is greater than the median estimate of the PBO panel forecasters, although it lies with the forecast range.

[1] See the methodological note attached to the press release on the quarterly national accounts figures for the second quarter of 2020, which was released by Istat on 31 August 2020.

The cost and price variables for 2020-2021 are generally in line with the expectations of the panel forecasters. The change in the GDP deflator projected by the MEF for this year falls within the forecast range. The developments in the GDP deflator forecast by the MEF reflect the strengthening of the terms of trade induced by the marked reduction in the import deflator, a change essentially shared by the panel. As a result, nominal GDP growth is also in line with the panel's expectations. In 2021, expected inflation in the MEF’s macroeconomic scenario falls within the forecast interval: the rise in the household consumption deflator is in line with the lower bound of the projections of the PBO panel, while the change in the GDP deflator is close to the median of the panel forecasts.

The forecasts for the labour market in the two-year period subject to endorsement do not exhibit significant mismatches with the projections formulated by the PBO panel of forecasters. For 2020, the decline in employment (in terms of FTEs) in the MEF’s macroeconomic scenario is larger than that in GDP and is in line with the median of the PBO panel. In 2021, the growth in employment is in line with the change in GDP set out in the Update, as well as with the median assessments of the panel. The forecast for the unemployment rate in the MEF’s macroeconomic scenario is at the lower bound of the forecast range, but still appears achievable in light of recent data released by Istat. The increase in the unemployment rate expected for 2021 falls within the range of the panel's estimates and incorporates the gradual normalisation of labour supply and demand.

For the 2022-2023 period, which is not subject to endorsement by the PBO, the trend forecast for GDP growth (3.0 per cent and 1.8 per cent respectively) appears optimistic, lying above the upper bound of the PBO panel interval in 2022 (by more than half a percentage point), and then falling just below the bound the following year. This reflects a strong contribution of domestic demand for both investment and for consumption. Italy's GDP growth rate projected at the end of the forecast horizon is higher than the estimates of potential growth produced by leading institutions.

In 2022-2023, the change in final consumption estimated in the Update is close to the upper end of the panel estimates, while that in investment exceeds the upper bound in 2022 and is at the limit of the range the following year. By contrast, the variables for foreign trade fall within the forecast range. The growth in exports is slightly slower than that in international trade, while the developments in imports appear consistent with the dynamics of the demand components that drive them.

The GDP deflator is in line with the panel's median forecast. However, optimism about real growth produces a forecast for nominal GDP growth in 2022 that exceeds the upper bound of the PBO panel expectations by over half a percentage point. With regard to labour market variables, the forecast for employment in the MEF’s macroeconomic scenario is close to the upper bound of the panel's forecasts in 2022, while it displays a non-negligible misalignment for 2023. The forecast for the unemployment rate also seems favourable, lying slightly above the lower bound of the PBO panel.

Risks associated with the forecast

The medium-term outlook for the Italian economy remains exposed to considerable risks, generally on the downside. The adverse scenarios are mainly attributable to the evolution of the pandemic, in Italy and abroad, as well as to financial strains.

Risk of a resurgence of the pandemic. Although the reopening of economic activities in Italy has so far proceeded in an orderly manner, the possibility of new restrictions can only be ruled out when effective treatments or vaccines are developed, the timing of which is currently uncertain. In the meantime, COVID-19 has started to spread rapidly in several European countries, such as France and Spain, as well as in Asia (especially India). If new restrictions on economic activity and personal movement were to become necessary in Italy in the coming quarters, this would have an impact both on business cycle conditions and productive structure, which were already hit by the past recession.

Risk of new financial tensions when fiscal and monetary stimuli are eased. Economic and monetary policies are countering the crisis by expanding the balance sheets of governments and central banks. When the pandemic is eradicated and the world economy returns to steady growth, it will be necessary to reduce the accumulated financial imbalances. Any mismatches in the cycle of recovery across countries could affect the risk premiums demanded by markets from economies that are rebounding less rapidly. If this eventuality should involve Italy, which has a large stock of public debt, financial tensions could quickly interact with the spending decisions of households and firms.