ufficio parlamentare di bilancio

The Chairman

Rome, 31 March 2021

Dear Minister,

Law 243/2012 requires that the Parliamentary Budget Office (PBO) performs 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 macroeconomic trend scenario published in the Economic and Financial Document (EFD).

The Board of the PBO hereby endorses the 2021-2024 macroeconomic trend forecasts transmitted by the MEF to the PBO on 26 March 2021 as they fall within a range deemed acceptable based upon currently available information. However, the forecasts are accompanied by a very high level of uncertainty, induced by the unique nature of the ongoing pandemic and the lack of any historical precedent to refer to.

The outlook appears to be exposed to downside risks in the short and medium term, as it is highly sensitive to the evolution of the health emergency and the measures that may be taken to address it, both in Italy and abroad.

An explanatory memo of this letter is attached.

Sincerely,

Giuseppe Pisauro

Daniele FRANCO
Minister for the Economy and Finance
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Explanatory note accompanying the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the 2021 EFD

This note, accompanying 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 2021 Economic and Financial Document (EFD), 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

On 31 March 2021 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts in the 2021 EFD (transmitted by the MEF on 26 March), 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 supply and 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, Oxford Economics, 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 trend macroeconomic scenario developed by the MEF, as well as the consistency with a set of exogenous international variables. The overall assessment based on these tools 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 all of the PBO panel of forecasters were formulated on the basis of the same set of assumptions for the exogenous international variables used by the MEF.

As regards the use of Recovery Plan funds, a working hypothesis was adopted based on current legislation and verified on the basis of our dialogue with the MEF.

Outcome of the endorsement exercise

The trend macroeconomic scenario of the EFD for the 2021-2024 is heavily impacted by the COVID-19 health emergency, which is having an adverse impact on the economy in the first part of this year, even if markedly less intense than in 2020. A recovery is expected in the next few years following the containment of the pandemic and the return to normal conditions.

The trend macroeconomic scenario over the time horizon considered in the endorsement exercise appears to fall within an acceptable forecasting range on the whole, although some of the variables subject to endorsement diverge slightly from the upper bound of the forecasts prepared by the PBO panel for the variables subject to endorsement. The overall acceptability of the EFD trend forecasts takes account of: a) the modest size of the deviations, considering the extraordinarily high uncertainty surrounding the short- and medium-term horizon; b) the fact that the EFD's forecast for real GDP growth - which measures the development of the economic system – does not exceed the upper bound of the PBO panel projections; and c) the fact that the EFD's forecast for nominal GDP growth - a directly relevant variable for the public finances – is close to the median of the PBO panel, albeit with a slightly wider margin in 2022.

Overall, these assessments are exposed to multiple sources of uncertainty, mainly related, but not only limited, to the pandemic. Both the short- and medium-term outlooks for the trend macroeconomic scenario in the EFD face downside risks. In the coming months, the economy will remain considerably affected by the continued presence of restrictions on economic activity in Italy and its main commercial partners, as well as by the progress of vaccination campaigns. In the medium term, the MEF forecasts incorporate relatively high output growth, which assumes the effective and timely use of resources under the European Recovery Plan.

The comments on the forecast are summarised below for the main variables considered in the endorsement exercise. In the following section, a number of risk scenarios of relevance for the Italian economy are delineated.

After the collapse in activity due to the pandemic (-8.9 per cent in 2020), the MEF's trend macroeconomic scenario projects GDP growth of 4.1 per cent this year followed by a further acceleration in 2022 (to 4.3 per cent). In the following two years until the end of the forecast horizon, a more moderate growth, although above current estimates of the Italian economy's potential output, is expected. Compared to the assessments of the PBO panel, the GDP forecast in the MEF trend macroeconomic scenario does not exceed the maximum value over the entire forecast horizon, although in 2022 and 2024 it is close to the upper bound. For this year, the quarterly pace of growth envisaged by the MEF appears qualitatively consistent with the profile expected by the PBO panel. In the first three months of the year, economic activity is still contracting, reflecting the restrictions imposed to curb the spreading of the pandemic, while a recovery in output is expected in the spring, which would strengthen further in the summer. The PBO panel's forecasts assume the gradual lifting of the COVID-19 restrictions as early as April; any extension of these restrictions would pose a downside risk for growth in the second quarter.

In the MEF scenario, growth would be almost entirely driven by the internal components of demand, as the contribution of net exports remains marginal over the entire forecast horizon. After collapsing in 2020, household consumption expenditure is expected to resume growth this year and accelerate in the next one, before weakening in the following two years, aligning itself with the median of the PBO panel forecasts and the pace observed in the years immediately preceding the pandemic. Gross fixed capital formation in the MEF's trend macroeconomic scenario experiences a sharp expansion this year, with the growth including both machinery and equipment and the construction sector. Spending on capital goods would also remain high next year, surpassing the levels registered prior to the health emergency. In the subsequent two years, the pace of expansion would ease for both expenditure components, approaching the median values of the panel in the final year of the forecast period. General government consumption in the MEF's trend macroeconomic scenario will expand next year (0.6 per cent), while all of the panel members expect it to decrease, due to the dissipation of the fiscal stimulus this year. Government consumption is expected to decline to close to the lower bound of the panel estimates in 2023, while in the final forecast year general government spending would be unchanged, in line with the median forecast of the PBO panel.

With regard to nominal variables, the MEF's trend macroeconomic scenario estimates a variation in the private consumption deflator of 1.0 per cent this year, almost equal to the median forecasts of the PBO panel. Consumer price inflation recovers over the next three years but is still low in the MEF's forecasts, aligning itself with the expectations of the PBO panel forecasters in the final year of the projection. There is little divergence among the PBO panel's forecasts for 2024, despite the length of the forecast horizon and the risks to which price dynamics are exposed in the next few years (as discussed in the following section on the risks to the forecast). The GDP deflator in the trend macroeconomic scenario of the EFD edges slightly down this year (to 1.1 per cent) before strengthening slightly in the following forecast years. The slowdown projected for 2021 largely reflects a deterioration in the terms of trade, which the PBO panel also expects. However, the change in the GDP deflator expected by the MEF is slightly higher than the upper bound of the forecast range. In subsequent years, the EFD projection appears appropriate, being in line with the panel median in 2022-2023 and at the lower end of the range in the final forecast year. It follows that nominal GDP growth in the Government's trend macroeconomic scenario does not exceed the upper limit of the forecasts of the PBO panel over the entire horizon of the endorsement exercise.

The MEF forecasts for employment (measured in terms of full-time equivalent units) do not seem excessive in the initial two years, while in the following two years they are slightly optimistic, despite falling within the panel's range of acceptability. The quantities for the variables measured by the labour force statistics are instead favourable over the entire forecast horizon, thus leading to an unemployment rate that is always below the lower bound estimated by the forecasters. In the MEF's trend macroeconomic scenario, the unemployment rate is expected to decline in 2021 (to 9.1 per cent), as already happened last year. The decrease in the unemployment rate in 2020 (to 9.2 per cent) was mainly due to the decline in labour participation, which was especially large in the quarters most affected by anti-COVID restrictions. Since this year these restrictions could come to an end and the moratorium on layoffs could be amended, the PBO panel expects a gradual recovery in the participation rate, which in the trend macroeconomic scenario of the MEF is instead postponed to 2022. The increase in the labour force starting from next year is accompanied by a sharp rise in employment and a systematic decline in the unemployment rate, which would reach 7.7 per cent in 2024, a historically low value. The underlying assumption is that with the return to growth, the labour market will be able to fully absorb the increase in supply, virtually eliminating the effects on the unemployment rate. This scenario is consistent with the idea of weak price pressures in the initial two years of the projection, due to the excess of labour supply over demand. However, at the end of the forecast horizon, the rapid growth of GDP would drive the demand for labour, including permanent employment, with possible pressures on the cost and price structure.

Risks to the forecasts

The medium-term macroeconomic scenario for the Italian economy is exposed to substantial downside risks in both the short and medium-long term. A number of these are examined below, grouped by time horizon.

Short-term risks. The first part of this year should continue to be characterized by restrictions to tackle the health emergency. The forecast growth rate for 2021 will inevitably be influenced by the pandemic, for which the spread of more contagious variants or strains resistant to the currently available vaccines cannot be ruled out. The progress of the vaccination campaign is, in turn, a key factor in determining the time needed to return to pre-pandemic conditions. These factors concern not only Italy, but also other European countries that are experiencing challenges and delays in their vaccination campaigns. In the case of Italy, the risks are substantial, as intensive care facilities are already under strain, so the restrictions already adopted may be retained longer than expected.

Medium-term risks. According to the latest Istat surveys, the confidence climate has substantially held up in the initial months of the year, accompanied by a propensity to save which was at an exceptionally high level in 2020. Should progress in the vaccination campaign affect the general economic context, household spending could recover more quickly than expected. However, this could have an impact on inflation, which is also exposed to external risks: inflationary pressures could also be generated by rising commodity prices, as well as the strong fiscal stimulus being rolled out in the United States.

Longer-term risks. Economic and monetary policies remain very expansionary on a global level. When vaccination coverage is sufficient to allow stable global growth, it will be necessary to reduce the financial imbalances that have been accumulating through the expansion of the balance sheets of governments and central banks. Any uncoordinated or especially mismatched recoveries across countries could affect the risk premiums demanded by investors from the most heavily indebted economies. Any resurgence of financial tensions would negatively affect the spending decisions of households and firms. This risk would be averted if Italy is able to increase its growth potential, consistent with the achievement of long-term objectives, which could benefit from the Recovery Plan funds.