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Il Presidente

Rome, 24 September 2021

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 way 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 of 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 2021 Economic and Financial Document (2021 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 2021-2022 trend macroeconomic forecasts transmitted by the MEF on 22 September, while underscoring the presence of significant risk factors. The forecasts for the main variables for 2023-2024 (which did not undergo the endorsement process) also appear to lie within the acceptable range of forecasts, although they are exposed to a variety of risks, mainly on the downside.

Sincerely,

Giuseppe Pisauro

Daniele FRANCO
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 2021 EFD

This explanatory note attached to the endorsement letter of the Parliamentary Budget Office (PBO) for the trend macroeconomic scenario prepared by the Ministry of Economy and Finance (MEF) for the Update to the 2021 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 24 September 2021 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts for the Update to the 2021 EFD (transmitted by the MEF on 22 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 and supply; 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, 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 macroeconomic scenario developed by the MEF and 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 the PBO panel of forecasters (including PBO's own 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 macroeconomic forecasts for Italy for this year have been revised significantly upwards compared with those formulated in the 2021 Economic and Financial Document (EFD). The PBO panel concurs with these changes but underscores various sources of substantial uncertainty (examined in the section "Risks associated with the forecast") in both in the short and medium term, mainly representing downside risks.

The trend macroeconomic scenario over the endorsement horizon appears to be acceptable on the whole, as the projections for the main variables do not display any significant misalignments with the upper bound of the forecasts produced by the PBO panel. The overall acceptability of the trend projections in the 2021 Update mainly takes account of: a) a forecast for real GDP growth - which measures the development of the economic system – that does not overshoot the upper bound of the PBO panel forecasts; and b) a forecast for nominal GDP growth - a variable of direct importance for the public finances – that falls within the endorsement range of the panellists' forecasts, although it lies at the upper bound in 2021.

The following summarises the comments on the forecasts for 2021 and 2022, which are the focus of the endorsement exercise, and offers a number of general assessments for the 2023-2024 period, delineating a number of risk scenarios.

With regard to GDP growth in 2021-2022, the trend forecast in the Update falls within the PBO panel's range of estimates. The Government projects a growth rate of 6.0 per cent for the Italian economy in 2021, a value that is equidistant between the median value and upper bound of the forecasts produced by the PBO forecasters. GDP would recoup almost two-thirds of last year's decline, so it would be more than three percentage points below the level in 2019. The GDP forecast for 2021 in the MEF's macroeconomic scenario underpins the continuation of the recovery in economic activity in the third quarter, with the expansion moving at a slower pace than last spring but remaining swift. This evolution appears qualitatively consistent with the latest economic indicators and with the expectations of the PBO panel.

According to the MEF forecasts, the recovery in the Italian economy is expected to continue at a rapid rate in 2022, albeit slowing compared with 2021. The Government's projection for GDP growth appears acceptable on average for the year. However, growth in the first two quarters is rapid by historical standards and implies a return to pre-crisis levels as early as the spring. Economic activity should benefit from the stimulus imparted by the National Recovery and Resilience Plan (NRRP), although a resurgence of the pandemic in the first half of the year, as occurred in 2020-2021, cannot be ruled out.

With regard to the determinants of growth, in the MEF's macroeconomic scenario the expansion of the economy in 2021 is largely attributable to the considerable boost provided by the internal components of demand, compared with a small contribution from net exports. The change in inventories is expected to give a slightly negative contribution to GDP growth. The increase in exports is greater than that in foreign demand, while developments in imports appear to be more closely aligned with internal variables. The forecasts for the main components of aggregate demand appear to be in line with the median projections developed by the PBO panel.

In the Update forecast for 2022, the evolution of the main variables in the supply and uses account is consistent with the expectations of the PBO panel and there are no significant divergences from the range of acceptable forecasts. The exceptions are the variables relating to foreign trade, which in the MEF's macroeconomic scenario lie below the lower bound of the PBO panel forecasts, as they are mainly activated by the variable connected with Italy's main foreign markets, which are expanding significantly more slowly than world trade as a whole (the key variable for the PBO panel forecasters).

Net exports, however, make a broadly neutral contribution to GDP growth, similar to the median estimates of the PBO panel.

The cost and price variables for 2021-2022 are generally in line with the expectations of the PBO panel forecasters, although the projections for this year are slightly optimistic. The MEF's expected change in the GDP deflator in 2021 lies just above the upper bound of the PBO panel estimates, which tend not to exceed the acquired change indicated in the quarterly data. In the NADEF's macroeconomic scenario, the change in the GDP deflator is also equal to that in the consumption deflator (which falls within the range delineated by the panel), although it should be lower due to the deterioration in the terms of trade. Overall, this implies nominal GDP growth in line with the upper bound of the forecasts of the PBO panel. In 2022, the growth in the macroeconomic scenario deflators virtually matches the expectations of the PBO panel forecasters. The growth in the GDP deflator lies between the median value and the upper bound of the expectations of the PBO panel, similarly to the change in nominal GDP.

With regard to the labour market, employment growth (in terms of FTEs) for this year appears high in light of the available quarterly data, especially as regards the services sector. The MEF projection is clearly above the upper bound of the forecast range, which could also reflect different assumptions about the effect of the lifting of the moratorium on firing workers. In 2022, however, the labour market variables do not display any significant divergence from the PBO panel forecasts: the employment forecast is at the upper edge of the acceptable range, while that for the unemployment rate is around the median.

For 2023-2024, a period not subject to the endorsement by the PBO, the GDP growth forecast (equal to 2.6 per cent and 1.9 per cent respectively) is substantially in line with the PBO panel median. Italy's GDP growth rate at the end of the forecast horizon is significantly higher than the projections of potential output formulated before the pandemic, reflecting a faster rate of capital accumulation attributable to the NRRP.

The MEF's projections for demand components in the two-year period appear acceptable in comparison with the PBO panel forecasts, although the forecast for investment is higher than the median values and implies a very rapid rate of capital accumulation (at the end of the macroeconomic scenario horizon investment would be about one-fifth greater than in the years preceding the pandemic).

Forecasts for prices in the final two years lie in the upper region of the interval defined by the PBO panel, which is characterized by the modest difference between the median and upper values of the projections despite the breadth of the forecast horizon. The change in the GDP deflator comes close to the upper bound of the PBO panel forecasts in 2023 and reaches it in 2024. Given the output growth in volume, nominal GDP growth is just below the upper bound of the PBO panel in both years. The cumulative growth in nominal output in 2023-2024 (7.5 per cent) is higher than that estimated by almost all panel forecasters. Looking at the labour market, the growth in employment is just below the highest values formulated by the panel in both years. The employment rate increases over the entire horizon of the NADEF, achieving very high values in historical terms already in 2022 (the time series have been available since 1977). As a result, in both 2023 and 2024 the MEF projections for the unemployment rate appear optimistic, lying below the lower bound of the projections of the PBO panel.

Risks associated with the forecast

The macroeconomic scenario for the Italian economy is exposed to risks, both international and internal. In the view of the PBO panel, these risks are more likely to manifest themselves than in other forecasting exercises and, while varied in nature, are mainly on the downside.

Short term: risk connected with the effectiveness of vaccines in containing the pandemic. On the basis of the latest available data, vaccination campaigns have proved effective overall in reducing the most severe symptoms of COVID-19, including the Delta variant, as evidenced by the decline in intensive care admissions. An important exception is the United States, where the pandemic has surged in an environment characterised by considerable differences in vaccination rates in the various states. Nevertheless, vaccinations have only reached a quarter of the world's population, so we cannot rule out the emergence of new variants, for which the effectiveness of current vaccines may be lower.

Medium term: *risks associated with stimulus measures and wealth effects*. An initial source of risk is connected with the assumption, implicit in the MEF's macroeconomic scenario, that government entities will be highly effective in managing the financial resources available under the NRRP, activating projects that the domestic private sector would be able to implement in an orderly manner. This also implies that the considerable unused production capacity is actually available, especially in the construction sector. Otherwise, the sector could run up against supply-side constraints in supporting the considerable expansion of public demand, thus dampening the multiplier effects for the remaining sectors of the economy.

More favourable developments cannot be ruled out in the medium term, as the high stock of precautionary savings accumulated in 2020 could fuel a faster recovery in consumer spending if household uncertainty were to decline on a more permanent basis. However, the recent rise in inflation, currently driven by the rise in energy prices and shortages of semi-finished goods, could be larger and more persistent than anticipated by the monetary authorities. In this case, the rise in prices would impact household purchasing power and could trigger a monetary policy reaction, with adverse effects on the recovery in economic activity.

Post-pandemic equilibria: the risk of differentiated tightening of economic policies. Economic and monetary policies are countering the current crisis by expanding the balance sheets of governments and central banks. When the pandemic is definitively brought under control thanks to vaccines and effective treatments, it will be necessary to reduce the accumulated financial imbalances. Any mismatches in the cycle of recovery between 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. For the European Union countries, these risks will greatly depend on the new system of fiscal rules, the revision of which is under discussion.