The Chair

Rome, 24 March 2022

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 2022-2025 trend macroeconomic forecasts transmitted by the MEF to the PBO on 23 March 2022 and modified to take account of the issues raised by the PBO concerning an earlier version.

The macroeconomic forecasts fall within an acceptable range over the forecast horizon, although they lie close to the limit for 2022. However, the forecasts are accompanied by an extraordinary level of uncertainty, mainly attributable to the conflict in Ukraine and the resurgence of the pandemic.

The forecasts have been endorsed based on the information available to date. However, the risks are such that expectations could change significantly in a brief period of time.

An explanatory memo for this letter is attached.

Sincerely,

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ufficio parlamentare di bilancio

Explanatory note accompanying the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the 2022 EFD

This note 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 2022 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 24 March 2022, the PBO sent to the MEF its endorsement letter for the trend macroeconomic forecasts in the 2022 EFD (transmitted by the MEF on 23 March and amended to take account of the issues raised by the PBO concerning an earlier version).

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 and 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 assumptions for the exogenous international variables used by the MEF.

Outcome of the endorsement exercise

The trend macroeconomic scenario of the EFD for 2022-2025 is considerably exposed to exogenous factors that are not economic in nature, such as the Russia-Ukraine conflict and the resurgence of COVID-19, but which enormously impact economic activity in the short term and threaten to affect macroeconomic equilibrium in the medium term.

In the MEF's trend macroeconomic scenario, these sources of instability are expected to adversely affect the Italian economy, mainly in the current quarter. The EFD forecasts the start of a recovery in GDP growth in the spring, which would then strengthen in the summer, implicitly assuming that the tensions in Eastern Europe will prove temporary and that there are no persistent or new adverse effects after the end of hostilities. Compared with the Update to the 2021 EFD, the GDP growth forecast has been revised downwards by just under two percentage points this year and half a point next year, while remaining essentially unchanged for 2024.

The forecast for real GDP growth over the period covered by the endorsement exercise - which incorporates the investment programmes envisaged in the National Recovery and Resilience Plan (NRRP) – appears to fall within an acceptable forecasting range for 2023-2025, but slightly exceeds the upper bound of the forecasts prepared by the PBO panel for this year. The overall acceptability of the EFD trend forecasts takes account of: a) the modest size of the overshoot for real GDP growth this year and the essential alignment of the projections with both the PBO estimates and the median of the 'panel's forecasts over the remainder of the forecast horizon; b) the fact that the EFD's forecast for nominal GDP growth - a directly relevant variable for the public finances – is close to that of the PBO and does not exceed the upper bound of the PBO panel forecasts in any year of the EFD forecast horizon. The projections for the GDP deflator fluctuate around the median of the 'panel's forecasts; and c) the extraordinarily high degree of uncertainty surrounding the outlook, both in the short and medium-term.

The MEF's trend macroeconomic scenario was endorsed on the basis of the information available to date, with regard both to international economic and geopolitical developments and to the state of the Italian economy. However, the scenario is exposed to very substantial risks, such that the forecasts could change significantly in a matter of days.

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

After the strong recovery registered in 2021 (6.6 per cent), the MEF's provisional trend macroeconomic forecast for growth expects the pace of expansion to slow to 2.9 per cent this year, a rate that is nevertheless still high in comparison with past performance. According to the quarterly growth profile in the trend macroeconomic scenario, GDP would return to values close to its pre-pandemic levels in the summer of 2022, while in the next three years, the speed of economic growth would diminish but would remain faster than official estimates of the Italian economy's growth potential.

Compared with the assessments of the PBO panel for 2022, the real GDP forecast in the MEF's trend macroeconomic scenario slightly exceeds (by 0.1 percentage point) the upper bound of the panel forecasts, while for 2023-2025, it does not differ significantly from the median of the panellists' expectations, in particular those of the PBO. In the first three months of this year, the MEF expects economic activity to contract, but only moderately. The growth estimate for the first quarter could be optimistic, considering the sharp contraction in industrial production in January, which in the view of the panel is only partly attributable to temporary factors. It should also be borne in mind that beginning in mid-February the financial markets began to price in the tensions that would subsequently arise with the invasion of Ukraine by Russia (which began on 24 February). Trade associations reported the first interruptions of production in energy-intensive industries in March. Short-term forecasts are surrounded by very high uncertainty, as they are heavily influenced by developments in the conflict in Eastern Europe and the resurgence of the pandemic. Downside risks prevail in the 'panel's assessments of short-term expectations for the first half of the year.

The MEF expects the Italian economy to expand by 2.3 per cent in 2023, a value that lies between the median of the PBO panel forecasts and the PBO projections. The deceleration of GDP next year - by just over half a percentage point in both the MEF and PBO scenarios - is expected by almost all panel members. The quarterly growth rates in the 'MEF's trend macroeconomic scenario for next year are more moderate than those expected for the second half of 2022 and would give rise to a statistical carry-over effect of 1.3 percentage points in 2023. GDP growth in the MEF's trend macroeconomic scenario for the final two years of the forecast would ease moderately (to 1.8 per cent and 1.5 per cent, respectively), although it would remain at historically high levels.

In the MEF's trend scenario, growth is driven almost entirely by the domestic components of demand, as the contributions of net exports and inventory changes are virtually neutral over the forecast horizon. This vision is substantially shared by the PBO panel. Household consumption growth is expected to slow this year, to 2.9 per cent, which is close to the median of the 'panel's forecasts, and slow again to 2.1 per cent in 2023, before stabilising at 1.6 per cent on average in 2024-2025. After a strong recovery in 2021, capital accumulation in the MEF trend scenario is expected to ease this year, with the slowdown being less marked in machinery and equipment than in construction. Growth in the latter segment appears to be rapid in 2022, as it slightly exceeds the upper bound of the PBO panel range. However, from next year, the projections for expenditure on capital goods return to a level more consistent with the panel expectations. Export growth appears to track developments in international demand (as measured by the gowth in Italy's key foreign markets), lying at the lower end of the 'panel's expectations for the first two years of the forecast, before approaching the upper bound in the final year. Similar developments are expected for imports, which essentially follow the demand variables that primarily drive purchases from abroad.

With regard to nominal variables, the MEF's trend macroeconomic scenario incorporates the jump in the private consumption deflator to 5.8 per cent in 2022, which is higher than the median forecast of the PBO panel but in line with the PBO projections. The following year, consumer inflation declines significantly (by almost four percentage points), returning to the level seen in 2021 in the final two years of the forecast. The median forecast of the PBO panel broadly follows the same profile, although the individual forecasters differ considerably due to the high degree of uncertainty involved. At the end of the period, the pace of consumer price inflation expected by the MEF lies at the upper bound of the range of PBO panel forecasts but is in line with the PBO forecast. The GDP deflator in the trend macroeconomic scenario set out in the EFD rises to 3.0 per cent this year, accelerating by more than two percentage points compared with 2021, before gradually normalising in the subsequent years of the period covered by the endorsement exercise. The upward impetus provided by the sharp increase in the consumption deflator this year is partially offset by the deterioration in the terms of trade caused by the sharp increase in the import deflator, attributable to both rising commodity prices and the depreciation of the euro. The worsening of the terms of trade expected by the MEF this year appears limited compared with the panellists' assessments, however, as the change in the import deflator is smaller than the forecasts of all the panel members. By contrast, the PBO panel concurs with the 'MEF's forecast for the GDP deflator, placing it between the panel median and the upper bound of the forecast range. Taking account of the forecasts for economic growth, nominal GDP growth over the entire forecast horizon appears consistent with the PBO forecasts and does not exceed the upper bound of the 'panel's forecasts.

The forecasts for employment (measured in terms of full-time equivalent units) fall within the PBO panel's range of acceptability, although they do tend to exceed the panel median. Conversely, the forecast for the unemployment rate is optimistic, lying below the minimum rate projected by the forecasters in 2022-2024 (in 2025, the unemployment rate is only slightly above the lower bound of the PBO panel forecasts). The decline in the unemployment rate expected by the MEF is mainly attributable to the strong acceleration in employment, particularly in 2022-2023, when the growth of the workforce is expected almost to double, continuing at the pace registered in 2021 on average over the forecast horizon. According to the EFD, the number of persons in employment would expand by about 1.5 per cent on average for the four-year period, faster than the employment growth recorded before the pandemic. The result is a systematic reduction in the unemployment rate over the period covered by the endorsement exercise, with the rate expected to reach 8.0 per cent in 2025, a historically low value (consistent with a stock of just over two million job seekers). The underlying implicit assumption is that the labour market will be able to fully absorb the increase in supply, which in 2024 would rise above pre-pandemic levels.

Risks to the forecasts

The macroeconomic scenario for the Italian economy is exposed to risks, especially the international threat posed by the Russia-Ukraine conflict. The risks to the forecasts for economic activity are on the downside, reflecting various factors.

War in Ukraine. The conflict raging at the gates of the European Union indeed represents the most significant risk across all forecast horizons. While for now, the war has triggered sudden increases in prices, if it persists, it could lead to restrictions in the supply not only of energy products but also agricultural goods and metals. The current crisis has underscored 'Italy's excessive dependence on a few producer countries, which exposes it to potential negative shocks connected with the instability of suppliers. When the hostilities have ended, however, a period of tensions will begin in trade relations and commodity markets, with inevitable repercussions for an economy as heavily dependent on the international market as Italy.

The evolution of the pandemic. The forecasts for this year are based on the assumption that cases will decrease and that from next autumn, the combined presence of new and more effective vaccines and specific antiviral drugs will make COVID endemic, avoiding economic impacts. However, in recent weeks there has been a resurgence of cases, not only in China but in Italy as well, demonstrating that the pandemic is still a risk factor that has not been completely subdued.

Value chains and the NRRP. In recent months, the international economy had already been afflicted by frictions in logistics, supply bottlenecks and huge increases in energy costs, the risks of which going forward are now heightened by the Russia-Ukraine conflict.

The risk associated with the assumption of Italy's full, timely and efficient use of European funds under the Next Generation EU programme in implementing the investment projects envisaged in the NRRP has also grown. Price increases and the shortage of raw materials and intermediate goods are likely to make project implementation more expensive and time-consuming, especially in the construction sector.

In the medium term, a more favourable scenario cannot be ruled out. The high levels of savings accumulated by households during the recession could foster a more rapid recovery in consumer spending if uncertainty abates in response to more favourable geopolitical developments. However, the rise in inflation threatens to become more persistent than anticipated by the monetary authorities and could therefore trigger further reactions from central banks.

New economic policy arrangements. When the pandemic is eradicated, and the conflict in Eastern Europe ends, the world economy will have to reduce the financial imbalances accumulated to cope with both shocks. Any mismatches in the timing of recovery in the various countries could affect the risk premiums demanded by investors for economies with particularly high levels of debt, with potential repercussions for financial stability. For the countries of the European Union, these risks will also depend on the new system of fiscal rules, whose revision is currently under discussion.

Inflation. Regarding price dynamics, the risk factors mainly threaten to drive inflation higher, especially in 2022 and 2023. The markets for commodities, especially energy, are highly volatile, so the assumption of a decline in prices over the forecast horizon appears to be accompanied by extremely high uncertainty. Moreover, bottlenecks in the supply of raw materials and intermediate goods could be more persistent than expected, even if the conflict in Ukraine comes to a rapid end.