2022 Budgetary Planning Report

Summary

The 2022 Budgetary Planning Report is devoted to an analysis of the 2022 Economic and Financial Document (EFD), supplementing and developing the assessments offered in the parliamentary hearing of the Chair of the Parliamentary Budget Office (PBO), Lilia Cavallari, on April 14, 2022 as part of the preliminary examination of the EFD by the Budget Committees of the Chamber of Deputies and the Senate.

The Report is divided into two chapters, the first of which is dedicated to analysing international and national **macroeconomic conditions** and the forecasts underlying the EFD for 2022-2025, which have been endorsed by the PBO in accordance with the procedure provided for in the framework agreement with the Ministry for the Economy and Finance (MEF) and with the support of the panel of independent forecasters consisting of CER, Oxford Economics, Prometeia and REF.ricerche.

The trend scenario in the EFD was endorsed after the PBO had raised a number of issues with an initial provisional version of the forecast formulated by the MEF, which followed up with the preparation of a new trend macroeconomic scenario, as it has done in the past. The forecasts were endorsed on the basis of information available in mid-March, both with regard to international economic and geopolitical developments and conditions in the Italian economy. The PBO then conducted the same exercise for the policy macroeconomic scenario, which also ended with endorsement.

Since the completion of endorsement exercise, the range of expectations for developments in the Italian economy has broadened, due both to the intensification of inflation and the uncertainties concerning the duration and repercussions of the conflict in Ukraine. Analysts' most recent forecasts have been characterised by **considerable diversity in expectations for growth and an increase in expected consumer price inflation**. The most important hard data, for GDP and industrial production, which were released after the end of the validation exercise, were in any case better than the expectations of the main forecasters, including those of the MEF.

In endorsing the trend and policy macroeconomic scenarios in the EFD, the PBO found that the forecasts incorporate significant **downside risk factors**, primarily the **war between Ukraine and Russia**. According to analyses performed by the PBO, which were published in the April Report on Recent Economic Developments, the conflict has already had a non-negligible effect, mainly attributable to the increase in commodity prices. It is estimated that the war has already had a negative impact on GDP growth in 2022 (0.3, 0.6 and 0.9 percentage points for the world, the euro area and Italy, respectively) and has raised inflation by about 1 percentage point. The repercussions if fighting should continue to the end of spring were also assessed, with normalisation extending into the rest of the year. According to the analysis, a longer war would lead to a further loss of GDP, especially in the euro area in 2022 (-1.0 per cent). The Italian economy would suffer an additional negative impact of about 1 percentage point of GDP in 2022 and almost half a point in 2023. Inflation would increase moderately at the global level, rising by more than half a percentage point in the euro area and by over a point in Italy, both this year and next. The simulations conducted assume that the continuation of military operations would exacerbate the adverse shocks already observed. Accordingly, if a more drawn out conflict did not lead to further increases in prices or shortages of materials and did not cause any additional deterioration in the climate of confidence, the impact for the Italian economy could be smaller than expected.

The threat represented by the war is accompanied by other sources of risk, such as developments in the COVID-19 pandemic, the effects of increases in the prices of commodities and intermediate goods on the NRRP and the new post-pandemic stance of economic policy. **Inflation risk** is mainly expected to heighten in the 2022-2023 period and is strongly influenced by the uncertainty surrounding the evolution of commodity prices and the possible effects of supply-side bottlenecks.

The Directive 2011/85/EU (part of the "six-pack") requires that regular **ex-post evaluation of official forecasts**. With this in mind, the Report specifically examines last January's update of the analysis of the accuracy of the Government's macroeconomic forecasts since 2014 (i.e., since the PBO has conducted endorsement exercises), focusing on the most recent period.

Considering the last four years, i.e. 2018-2021, the MEF forecasts for the current year have been slightly pessimistic for real GDP growth, although less so than those of the PBO and the European Commission, and substantially balanced for nominal GDP growth. The accuracy of the forecasts is inevitably influenced by the economic crisis sparked by the pandemic, which could not be foreseen prior to 2020, producing very large errors, especially for the following year (T+1). However, excluding 2020, the average error for T+1 tends to cancel out for real GDP and is almost in line with the five-year pre-COVID period for nominal GDP.

Overall, taking account of the fact that 2020 and 2021 were two anomalous years for the economic cycle, the ex-post evaluation of the Government's recent macroeconomic forecasts prompts us to conclude that the growth projections have been balanced overall and are nota affectede by systematic optimism.

After analysing the public finance outturn for 2021 and comparing performance with the official forecasts for that year, the second chapter of the Report examines the developments in the public finances outlined in the trend and policy scenarios of the EFD, extending the hearing's examination of the distribution of the resources made available through the Next Generation EU (NGEU) programme and the policy evolution of the public debt and its sustainability in the short and medium term under different scenarios.

In addition to the final figures for last year published by Istat, the EFD's public finance forecasts on a current legislation basis reflect the updating of the macroeconomic scenario, the financial impact of the measures contained in the 2022 Budget Act and those in the decree laws enacted subsequently up until last March, as well as the new scheduling of interventions financed with the resources provided under the NRRP, which reflects the postponement to 2022-2026 of unimplemented projects in the 2020-2021 plan.

A **comparison of the use of NGEU resources in the 2022 EFD with that for 2021** highlights two elements. First, total resources reported in the 2022 EFD are somewhat greater (€205.9 billion, compared with €205 billion) due to a slight increase in the resources available through the ReactEU programme. In addition, the time schedule of the use of the resources differs, largely connected with the realignment of spending in the light of the expenditure already undertaken in 2020-2021, which was lower than initially planned: planned expenditure in the 2021 EFD for this period was €22.5 billion, while only €4.3 billion in spending was actually carried out. The new plans distribute the unspent €18.2 billion from 2020-2021 and bring forward some of the expenditure initially scheduled for 2026 to 2022-2025: this year, €0.6 billion more than originally planned in the 2021 EFD should be used, while expenditure should increase by €9.6 billion in 2023, €6.3 billion in 2024 and €7.4 billion in 2025. For 2026, however, the 2022 EFD reduces planned spending by €5 billion compared with that envisaged in the 2021 EFD.

Given the new profile of the use of NGEU resources, the Report focuses on the **macroeconomic impact of the National Recovery and Resilience Plan (NRRP)**, updating the assessment already provided last year at a parliamentary hearing on the issue. The simulation conducted using the MeMo-It macroeconomic model, which had already been used for the 2021 parliamentary hearing, only considers the resources for additional measures over and above those envisaged in current legislation and the measures to support capital accumulation in the Plan's programming period, i.e. until 2026. Overall, the stimulus provided to the economy is equal to €185 billion, spread over the period between 2021 and 2030.

According to simulations conducted with the MeMo-It model, the expansionary effect of the planned measures on GDP would be more than 1.5 percentage points at the end of the 2021-2023 period and an additional point in the following three years. Overall, at the end of the programming period in 2026, the use of resources envisaged in the NRRP would raise Italy's GDP by just under 3 percentage points. The findings of the simulation appear to be in line with the official estimates presented in the 2022 National Reform Programme (NRP) in the first three years of the simulation horizon, while in the subsequent three years the expansionary effects are more moderate.

Another exercise to assess the impact of the NRRP measures was conducted using a tool similar to that used by the MEF for impact estimates in the NRP and the same assumptions about the distribution of funds between different years and different measures that underlie the simulations conducted with Memo-It. With these assumptions, GDP would increasingly outpace the baseline scenario starting from 2022. In the last simulation year (2026), GDP would be 3.2 percentage points higher than in the baseline scenario. This is the result of an impact of 1 percentage point on private consumption and 9.3 percentage points on gross fixed investment.

Note that the Government's estimates were obtained assuming that public investment is highly efficient, i.e. greater elasticity of output to public capital spending. Assuming average and lower efficiency for public investment compared with the assumptions in the NRP, the difference in impact in the various scenarios is modest in the initial years of the simulation but increases in subsequent years: in 2026 the assumption of high-efficiency public investment has a 0.9 point greater impact on GDP than the average-efficiency assumption and 1.8 points greater than the low-efficiency scenario.

The policy public finance scenario confirms the deficit/GDP targets in the 2021 Update until 2024, while for 2025 the deficit is slightly larger than the trend deficit. The deficit is therefore projected at 5.6 per cent of GDP in 2022, 3.9 per cent in 2023, 3.3 per cent in 2024 and 2.8 per cent in 2025. The ratio of public debt to GDP in 2021 was 150.8 per cent, down from 155.3 per cent the previous year. In the Government's plans, the ratio should continue to decline in subsequent years, from 147 per cent in 2022 to 141.4 per cent in 2025.

The PBO has assessed **the sensitivity of the policy path of the debt/GDP ratio** presented in the EFD with respect to alternative assumptions for the rate of inflation and real growth. Compared with the scenario envisaged in the EFD, the PBO's macroeconomic scenario projects slightly lower real growth rates (with differences of between two- and three-tenths of a point in the 2022-2024 period, before disappearing in 2025), while the GDP deflator would be larger over the entire forecast horizon, especially in 2023 (the year in which the inflation rate would be six-tenths of a point higher than that forecast by the Government). Overall, developments in nominal GDP would be similar in the two scenarios.

According to these simulations, the trajectory of the debt/GDP ratio would be substantially comparable to that forecast by the Government, with differences of greater than half a point of GDP only in 2024-2025: the debt/GDP ratio in the alternative scenario exceeds that in the EFD by 0.6 percentage points in 2024 and 1 percentage point in 2025, reaching 142.4 per cent in the last year of the planning horizon. This is the outcome of the accumulation of the (negative) effect of slower real GDP growth on the primary balance and, to a lesser extent, the greater interest expenditure associated with the faster inflation.

To assess developments in the debt/GDP ratio in the medium term, the PBO scenario was extended until 2031 using specific assumptions to project the most relevant macroeconomic variables, adopting the PBO's framework for analysing the sustainability of the public debt. Since the estimate of potential output is subject to considerable uncertainty, which increases significantly during reversals of the cycle or in the presence of "anomalous" developments in actual GDP, alternative assumptions have been constructed for the medium-term scenarios on the basis of a simpler metric, a trend GDP growth rate for which different profiles have been hypothesised.

The resulting simulations underscore the importance of faster medium-term GDP growth than that currently expected in consensus forecasts if public finance aggregates are to improve. Even assuming unchanged policies from 2026, the debt/GDP ratio would continue to decline assuming that GDP growth returns to the pre-pandemic trend level (when growth was equal to 1.1 per cent). Conversely, if we assume a lower trend level for GDP growth due to the pandemic crisis, the debt/GDP ratio would stabilise at the still high level of 2025. It would even start rising again if the trend GDP growth rate gradually converges on the medium-term pace expected by the consensus forecast (0.6 per cent) instead of returning to pre-pandemic values.