

Rome, 23 September 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.

**The Board of the PBO hereby endorses the trend macroeconomic forecasts contained in the Update to the 2022 Economic and Financial Document (2022 Update), in which the MEF took into account the issues raised in its dialogue with the PBO.**

The trend forecast for the Italian economy falls within an acceptable range both in 2022-2023 and in the subsequent two-year period (which does not undergo the endorsement process). Nevertheless, the forecasts are exposed to considerable uncertainty, primarily associated with the developments and repercussions of the conflict in Ukraine.

The forecasts have been endorsed on the basis of information available to date. However, the international scenario remains unstable and fragile, meaning that the outlook could change significantly in a brief period of time.

An explanatory memo for this letter is attached.

Sincerely,

Lilia Cavallari

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

This explanatory note attached to the endorsement letter with which the Parliamentary Budget Office (PBO) endorsed the trend macroeconomic scenario prepared by the Ministry for the Economy and Finance (MEF) for the Update to the 2022 Economic and Financial Document (the Update) 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 23 September 2022 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts for the Update to the 2022 EFD. The forecasts were sent by the MEF on 22 September, taking account of the issues raised concerning an initial version of these forecasts. The MEF subsequently revised the trend macroeconomic scenario to incorporate the new national accounts data for Italy for the 2019-2021 period, published by Istat on 23 September, without appreciable changes over the forecast horizon of the 2022 Update (2022-2025) compared with the trend macroeconomic scenario sent on 22 September.

As usual, the comments and the endorsement were formulated on the basis of a comprehensive analysis of the Italian economy conducted by the PBO using: 1) its 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, 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 the PBO panel of forecasters, including the PBO forecasts, were formulated on the basis of the same assumptions for the exogenous international variables used in the 2022 Update.

### **Findings of the endorsement exercise**

The trend macroeconomic scenario in the 2022-2023 period covered by the endorsement exercise falls within an acceptable forecast range, as the projections for the main variables do not display any

significant misalignments with the median of the panel forecasts and specifically that of the PBO, taking account of the considerable uncertainty that characterises the forecasts. The overall acceptability of the trend projections in the 2022 Update is determined by the following factors: a) the forecast for real GDP growth - which measures the development of the economic system - differs to an acceptable extent from the panel median over the entire forecast horizon and never exceeds the upper bound of the interval of panel forecasts; b) the forecast for nominal GDP growth, a variable of direct importance for the public finances, exceeds the panel median in the 2022-2023 period to an acceptable degree and in any case does not exceed the upper bound in any year of the trend macroeconomic scenario.

The following summarises the comments on the forecasts for 2022 and 2023, which are the focus of the endorsement exercise, and offers a number of general assessments for the 2024-2025 period. The subsequent section outlines some risk scenarios.

The Government's forecast for Italian GDP growth in 2022 (3.3 per cent), revised upwards by two-tenths of a percentage point compared with the 2022 EFD, coincides with the median panel forecast and does not diverge considerably from the PBO forecast. The trend macroeconomic scenario in the Update reflects a deterioration in economic conditions in the second half of 2022, although the slippage is less pronounced in the MEF scenario than in that indicated by the panelists.

In the Government's trend macroeconomic scenario, Italian GDP growth in 2023 is 0.6 per cent, more than 1.5 percentage points lower than that set out in the 2022 EFD, reflecting the sudden deterioration in foreign demand, the rise in interest rates and renewed tensions in energy markets. The forecast for GDP growth in 2023 slightly exceeds the median of the panel's projections, but does not overshoot the upper bound. Strong uncertainty weighs heavily on the trend macroeconomic scenario for next year, mainly attributable to geopolitical or external factors. Rapid changes in the outlook in the coming months cannot be ruled out given the developments of the war in Ukraine and its repercussions on trade relations with Russia. Note that the scenario in the Update does not consider rationing of gas consumption, an eventuality that could become necessary in adverse circumstances (in this regard, see the section on risks below).

With regard to the determinants of growth, in the MEF's trend macroeconomic scenario the expansion of the economy in 2022 is driven by the internal components of demand, with a negative contribution from net exports, an assessment essentially shared by the PBO and the other members of the panel. Household consumption expenditure and capital accumulation slow down, as they do in the panel median forecast and the PBO estimates, although the latter are more conservative about private consumption. The change in exports in the 2022 Update is larger than that in international demand (as measured for Italy's main foreign markets), while developments in imports tend to track the demand variables that activate them the most.

Next year, economic activity will again be driven by private domestic demand, whose contribution to GDP is substantially in line with the panel median and the PBO scenario. The deceleration in household consumption and gross fixed investment is expected by all panelists. However, in the trend macroeconomic scenario, the pace of growth for the two components of private national demand exceeds the panel median and fall near the upper bound of the range of forecasts. By contrast, the variables for foreign trade in the MEF trend macroeconomic scenario display lower rates than the

PBO panel median. Net exports make a slightly negative contribution to GDP growth, falling between the panel median and the PBO forecast.

The forecasts for cost and price variables in 2022-2023 are generally acceptable. In 2022, the rise in the GDP deflator, driven by the sharp increase in the private consumption component (to 6.6 per cent), is largely offset by the net deterioration in the terms of trade, attributable to both the rise in the prices of imported raw materials and the depreciation of the euro. This development is qualitatively consistent with the assessments of the PBO and the panel, although they display considerable diversity due to the sharp uncertainty over the evolution of prices. The change in the GDP deflator envisaged by the MEF for this year slightly exceeds the panel median and the PBO forecasts, which are more in line with the acquired inflation that can be inferred from the national accounts data published by Istat. The MEF's projection for 2022 incorporates a rapid year-on-year acceleration in the second half of this year, putting the annual change of the GDP deflator close to the upper bound of the panel forecasts. The high rate of inflation imparts a significant impetus to nominal GDP growth, which is greater than the panel median and the PBO's specific forecast but does not exceed the upper bound of the forecast interval. In 2023, the price developments in the trend macroeconomic scenario in the Update are consistent with the expectations of the panel. The projections for the export and import deflators exceed the panel median but remain acceptable, while the private consumption deflator lies at the upper bound of the range. Accordingly, the projected rise in the GDP deflator is at the high end of the panel's expectations. Nominal GDP growth is positioned at the top of the acceptable range in 2023, while over the entire 2022-2023 period, the cumulative increase in nominal output (10.8 per cent) is greater than that estimated by the panel forecasters.

Labour market variables fall within the panel's range of variation. Employment growth (in terms of FTEs) for this year appears consistent with the panel median and in line with the acquired growth indicated in the available quarterly data. The decline in the 2022 unemployment rate indicated in the MEF trend macroeconomic scenario, attributable above all to the acceleration in employment, coincides with the panel median. The forecasts for employment and the unemployment rate in 2023 are close to the median values of the panelists' estimates. The employment rate (for the 15-64 age bracket) increases progressively over the forecast period, with the projections of the panel forecasters showing a similar pattern.

For 2024-2025, a period not subject to endorsement by the PBO, the GDP growth forecast indicated in the MEF's provisional trend scenario of the MEF (equal to 1.7 and 1.4 per cent respectively) is close to the panel median, although exceeds the PBO forecast for 2024. Italy's GDP growth rate at the end of the forecast horizon is higher than the projections for potential output formulated before the pandemic, but is in line with that in the PBO trend scenario, taking due account of the stimulus expected from the NRRP.

The MEF's projections for demand components in 2024-2025 are on the whole consistent with those of the panel, although the forecast for investment is higher than the median, especially in 2024, when they also exceed the upper bound of the panel's forecast range.

Inflation forecasts for 2024-2025 converge towards the single monetary policy target and do not diverge from the panel forecasts. Inflation in the trend macroeconomic scenario in 2024 differs slightly from the panel's median projection. The change in the household consumption deflator in

2025 is close to that of the PBO and the panel median. Taking output growth in volume terms, nominal GDP growth in the trend macroeconomic scenario appears acceptable overall.

Looking at the labour market, the growth in employment is in line with highest forecasts produced by the panel for 2024-2025 and marginally exceeds the upper bound in 2024. The employment rate increases over the entire horizon covered in the Update, reaching almost 62 per cent at the end of the period, a historically high value (based on the new time series available since 2004). The projections for the unemployment rate lie at the lower bound of the panel's range of acceptability in 2025 and just below it in 2024.

### **Risks associated with the forecast**

The macroeconomic scenario for the Italian economy is exposed to a variety of risks, especially those of an international nature. Favourable scenarios cannot be ruled out, but adverse scenarios definitely prevail in the panel's assessments, so the risks are oriented towards the downside on the whole.

***War in Ukraine.*** - The ongoing conflict at the gates of the European Union certainly represents the greatest risk across the forecast horizon. The war has produced sharp increases in commodity prices, especially energy, with consequent tensions in European markets. The crisis has underscored Italy's energy dependence on a small number of natural gas-producing countries, exposing it to adverse shocks in the event of supply interruptions. Such an interruption is not considered in the baseline forecasts of the trend macroeconomic scenario for either the MEF or the panel. If this were to occur, gas rationing would be a risk next winter under certain conditions, with non-negligible repercussions for economic activity. When military hostilities cease, however, a period of tension in commercial relations and trade in commodities will ensue, with inevitable repercussions for an economy that is as heavily dependent on the rest of the world as Italy.

***Developments in the pandemic.*** – Over the forecast horizon, it is presumed that no restrictions on individual mobility or economic activity will be necessary to combat the pandemic, on the assumption that COVID-19 is now endemic. However, the emergence of new variants or a resurgence of the existing pandemic over the forecast horizon cannot be ruled out a priori.

***Value chains and the NRRP.*** - Despite the partial easing of logistical strains and supply bottlenecks, the huge increases in energy costs and shortages of certain materials could undermine the assumption of the full, timely and efficient implementation of NRRP investment projects. The construction sector is already showing signs of overheating in the labour market and in prices.

***Inflation.*** - The risks to prices, which are concentrated in the 2022-2023 period, mainly depend on the assumptions for external variables. Specifically, the projections for commodity prices are based on futures prices, which are extremely volatile. The sharp decline in nominal price dynamics from next year therefore appears to be overshadowed by great uncertainty, and the possibility of scenarios with persistently high inflation cannot be ignored.

***Medium-term equilibria: new economic policies.*** - In the process of reversing the imbalances engendered by the pandemic and the conflict in Ukraine, any mismatch in the recovery cycle between

countries could affect financial stability. The risk premia demanded by investors from particularly heavily indebted sovereign issuers could rise rapidly, especially as monetary policy is normalised. For the Member States of the European Union, these risks will also depend on the EU's governance arrangements, the revision of which is under discussion.

Rome, 27 September 2022

Dear Minister,

On 23 September 2022, the PBO endorsed the macroeconomic scenario set out in the Update to the EFD, as provided for in the calendar agreed with the MEF. On 26 September the MEF sent the PBO a new trend forecast.

Compared with the scenario already endorsed by the PBO, the forecasts for GDP growth in 2024 and 2025 were revised slightly upwards. The changes regard a period not included in the endorsement horizon (2022-2023). Accordingly, the Board of the PBO confirms the endorsement already decided and announced on 23 September.

Sincerely,

Lilia Cavallari

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