

Rome, 7 April 2023

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 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 of Economy and Finance (MEF) of 13 May 2022 governs the process of endorsing macroeconomic forecasts. In the Memorandum, the parties also agreed to perform the endorsement exercise for the macroeconomic trend forecasts published in the Economic and Financial Document (*Documento di economia e finanza*, DEF).

**The Board of the PBO has endorsed the macroeconomic trend forecasts published in the 2023 Economic and Financial Document, which the MEF prepared by incorporating the remarks that emerged in recent weeks during the discussion with the Office.**

The macroeconomic trend forecasts for the Italian economy falls within an acceptable range for the entire forecast horizon (2023-26), however borderline in 2024.

The forecasts are endorsed based on the economic information available to date and assuming the full and timely implementation of the NRRP projects. However, the situation is unstable and uncertain, including due to geopolitical and financial tensions, so the outlook could change considerably over the forecast horizon. The risks are balanced in the short term but are tilted downwards in the coming years.

An explanatory memo of this letter is attached.

Sincerely,

Lilia Cavallari

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Giancarlo GIORGETTI  
Minister of Economy and Finance  
Via XX Settembre, 97  
00187 – ROME

## **Explanatory note accompanying the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the 2023 DEF**

This note, accompanying 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 2023 Economic and Financial Document (*Documento di economia e finanza*, DEF), offers a short description of the procedure used to endorse the forecasts and a summary analysis of the risks associated with those forecasts.

### **Endorsement procedure**

On 7 April 2023 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts in the 2023 DEF, transmitted by the MEF on 4 April and modified to take into account the comments made by the PBO on the preliminary version of the scenario.

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 the 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 the exogenous international variables. The overall assessment based on these tools takes account of the uncertainty that characterises the forecasts.

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.

### **Outcome of the endorsement exercise**

The trend macroeconomic scenario of the DEF for 2023-2026 is heavily impacted by external exogenous factors, such as the Russian-Ukrainian conflict and the financial turmoil, as well as by significant uncertainty surrounding the evolution of the National Recovery and Resilience Plan (NRRP). Overall, economic activity over the four-year forecast horizon is exposed to downside risks, although less unfavourable in the very-short term.

In the trend macroeconomic scenario of the MEF the growth of the Italian economy for this year is estimated at 0.9 percent, lower than the strong growth that characterised the two years of recovery from the pandemic crisis. GDP growth in the trend macroeconomic scenario of the MEF is expected to recover rapidly in 2024 and then to stabilise in the final two years of the forecast, settling at 1.1 percent in 2026, a value that is nevertheless slightly higher than the estimates of the potential formulated by the main private and institutional analysts. Compared to the one in the 2022 Update of the DEF, the change in GDP has been revised upwards by three-tenths of a percentage point this year and downwards by half a point in the following year, while it has been confirmed for 2025.

The forecast of real GDP over the time horizon considered in the endorsement exercise, which incorporates a strong boost from the investment programmes envisaged in the NRRP, appears to fall within an acceptable range for all years of the forecast horizon with the exception of 2024, when a marginal misalignment with the upper bound of the forecast prepared by the PBO panel is observed.

*The overall acceptability of the DEF trend forecasts takes account of: a) the modest size of the deviation from the range depicted by the panel in real GDP growth for 2024 and a substantial alignment, both with PBO estimates and the median of the panel, over the rest of the forecast horizon; b) the fact that in the trend macroeconomic scenario the nominal GDP - a relevant variable for the public finances - does not exceed the median of the PBO panel in 2023-25 and is broadly in line in 2026; the GDP deflator projections are in fact slightly below the median of the panel forecasts; (c) the very high degree of uncertainty surrounding the forecasts, both in the short and medium term.*

The trend macroeconomic scenario of the DEF is endorsed on the basis of the economic information available to date and incorporating public investment expectations in line with the official ones, which thus benefit from a strong acceleration in capital accumulation imparted by the NRRP. The loss of the Plan's investments, or a reshaping thereof, would therefore have a non-negligible impact on the annual growth of the macroeconomic frameworks.

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 outlined.

The GDP forecast of the trend macroeconomic scenario of the DEF for this year appears to be in line with the assessment of the PBO panel, while it is less cautious for next year. The growth profile outlined in the trend macroeconomic scenario of the DEF for 2023 appears adequate, although on a quarterly basis it anticipates a temporary acceleration between the second half of 2023 and the first half of 2024. The increase in GDP in 2024, equal to 1.4 percent, instead exceeds the median of the forecasts of the PBO panel by two-tenths of a percentage point and is just above the upper bound of the PBO forecast. The GDP projections for 2025-26 are instead within the range defined by the PBO forecasters, albeit close to the upper bound.

In the trend macroeconomic scenario of the DEF growth is almost entirely driven by domestic demand, as in the estimates of the PBO panel, which are however very different. In the trend macroeconomic scenario of the DEF private consumption expenditure slows down significantly this year, affected by the persistence of inflation at levels that are still high; in 2024 consumption growth doubles (1.2 percent) and then stabilises at around 1.0 percent. The changes expected by the MEF for

private consumption are acceptable, as there are no significant differences with respect to the median forecasts of the panel; on the other hand, there are some elements of optimism with regard to capital accumulation: the change in gross fixed capital formation estimated by the MEF for the next three years exceeds the median forecast of the panel and is even higher than the upper bound in 2024 and 2026. In this regard, the strong heterogeneity of the panel's forecasts on construction accumulation should be noted, which also reflects the difficulty of quantifying and timing the effect of the remodulation of incentives for the renovation of buildings (“Superbonus”). It should also be considered that the public component of construction accumulation, strongly driven by the NRRP, contributes a limited share (no more than one-fifth) of total construction investment, so that the strong investments in the trend macroeconomic scenario of the DEF also imply an important contribution from the private sector.

Exports in the trend macroeconomic scenario are significantly higher than international demand in 2023, when they also exceed the upper bound of the panel projections; however, in the following years, the change in exports appears to be in line with the pace of the foreign markets relevant to Italy, just as imports are consistent with the demand variables that most drive them.

With respect to nominal variables, the trend macroeconomic scenario of the DEF shows a slowdown in the private consumption deflator in 2023, down to 5.7 percent: a high value when compared with that of four of the five panel members. The consumption deflator then slows down sharply in 2024, to return to changes consistent with the European Central Bank's target (2.0 percent) in the final two years of the forecast. This pattern is broadly in line with the forecasts of the PBO panel, which are, however, very heterogeneous due to the high uncertainty surrounding the speed for absorbing the 2022 commodity price shock. The GDP deflator in the trend macroeconomic scenario of the DEF increases by 4.8 percent this year, up by more than one and a half percentage points compared to 2022, before gradually returning to normal rates in the following years. The growth of the GDP deflator in 2023 is lower than that of the consumption deflator, despite the marked recovery of the terms of trade in the MEF framework. The improvement in the terms of trade foreshadowed by the MEF for this year is shared by almost all forecasters in the panel, but the variability of the estimates for import and export prices is particularly high and tends to decline only at the end of the period. Overall, this year's GDP deflator growth in the trend macroeconomic scenario of the DEF is in line with that of the PBO panel and falls between the median of the panel and PBO estimates. Nominal GDP is within the endorsement range over the forecast horizon, except at the end of the period when is marginally above the upper bound, in any case against acceptable estimates for both the real GDP and the GDP deflator.

Employment-related variables (measured in FTE) fall within the range, albeit wide, of the PBO panel; the forecast of the unemployment rate is also within the endorsement range, standing at values close to the median for 2023-26. With regard to labour costs, the trend macroeconomic scenario shows moderate developments, compared to the forecast range of the PBO panel; as the expectations on productivity are similar to those of the panel, the trend macroeconomic scenario projects a relatively optimistic evolution of the ULC for the years 2024-25.

## **Risks to the forecasts**

The macroeconomic scenario of the Italian economy appears exposed to risks, mainly of an international nature and predominantly downward-looking, to growth beyond the short term, due to several factors.

***Value Chains and the NRRP.*** The risk related to whether Italy will be able to fully, timely and efficiently use the EU funds of the Next Generation EU programme, in order to implement the projects prepared under the NRRP, increases. In the first two years of the programme the activation of public investment was modest, so that a strong recovery of spending capacity is needed over the DEF forecast horizon in order to make up for the accumulated delays.

***The war in Ukraine.*** The ongoing war taking place at the gates of the EU continues to represent a potentially very high risk. Although the sharp rises in energy commodity prices are receding, restrictions in supplies upstream in the production chain continue to impact on the prices of goods downstream. However, once the military hostilities are over, there will be a period of tension in trade relations and in commodity markets, which will inevitably have repercussions on an economy that is highly dependent on foreign countries such as the Italian one.

***The new international financial turmoil.*** The recent bankruptcy of Silicon Valley Bank and the bailout of Credit Suisse have created increases in traders' risk aversion amid fears for the stability of international financial markets. The sharp falls in stock markets, coupled with a monetary policy that will remain restrictive until there is tangible evidence of inflation returning towards the central banks' targets, are likely to cause new global tensions; the negative impacts for an open economy with high public debt, such as the Italian one, would not be negligible.

***The persistence of inflation.*** With regard to price developments, there are mainly upside risks, especially in 2023, particularly concerning the speed for absorbing the shock originating upstream in the distribution chain. Commodity markets, especially energy markets, are extremely volatile, so that the decline in prices over the forecast horizon appears to be burdened by a very high degree of uncertainty. At the same time, the impact of energy commodities has now spread across expenditure items, so that the less volatile components of inflation continue to rise. Continued price increases are likely to result in a loss of purchasing power for households, which could exacerbate demands for higher salaries.

***Climate and environmental risks.*** Environmental risks remain in the background, as do climate-related risks - at least in the immediate future. Drought in the summer would lead to higher food and energy prices in the second half of the year. Furthermore, if the coming winter is characterised by below-average temperatures, new tensions on the energy commodity markets could arise.