International dimensions of inflation in a deglobalising world

Round table on *"Rethinking international fiscal compacts"*

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- Recent times have witnessed large shocks and extreme events, from the global financial crisis to the pandemic and the war in Ukraine. This impressive sequence of events has left a positive heritage in terms of stronger institutions. Remarkable progress has been made for strengthening financial stability and providing adequate safety nets; independent fiscal councils have been established in almost all European countries; new tools, like Next Generation EU, have been introduced for addressing strategic goals. Yet, a lot remains to be done for completing important areas of the common market and make Europe fit for the challenges ahead.

- There is ample debate on "rethinking international fiscal compacts" in the global economy, amid the need to reinforce stabilization capacity in the face of large shocks and extreme events, facilitate the transition toward safe, inclusive and sustainable production modes, and ensure the sustainability of public finances. The key issue is how to strike a balance between the provision of adequate fiscal capacity and the incentives for maintaining fiscal soundness.

- The framework of fiscal governance can play a crucial role for growth and stability in Europe. It can strengthen debt sustainability by promoting credible and feasible adjustment plans in high-debt countries. It can sustain the quality of public budgets, promoting expenditures, like investments, that are more favourable for growth. It can ensure a coherent fiscal stance in the common area with respect to both national policies and the supra-national monetary policy. It should also provide common resources for strategic European public goods and for coping with exceptional events.

- These objectives require medium-term budgetary planning for a proper account of investments and reforms; transparency in the design and assessment of fiscal plans; effective monitoring mechanisms and actual enforcement. Independent fiscal councils can play a role in all these dimensions.

- Independent fiscal institutions have developed a solid expertise in assessing national fiscal policy and evaluating the state of the economy, despite large heterogeneity in terms of their capacity, resources and mandate. They provide a technical, no-partisan assessment that may help to ease the trade-offs between sound fiscal policy and adequate fiscal capacity.

- Consider for example the macroeconomic and budgetary forecasts in the Government's planning documents. A systematic bias in the official forecasts may generate artificial fiscal capacity and endanger the credibility of budget planning. Systematic optimism (pessimism) would in fact increase (reduce) fiscal space and make deficit targets appear less (more) stringent. Let me illustrate the experience of Italy's Parliamentary Budget Office, (UPB), in this regard.

- The UPB has a broad mandate including the endorsement of the macroeconomic forecasts of the Government. It produces its own macroeconomic forecasts and coordinates a panel of four independent forecasters. The forecast scenarios of the UPB panel incorporate common economic information and the same exogenous variables of the Ministry of Economy and Finance, (MEF). The endorsement procedure involves interactions with the MEF on preliminary versions of the forecasts. Evaluation draws on prudential criteria. Over the history, the official forecasts have not been endorsed only on two occasions, in the fall 2016 and the fall 2018, on the ground of excessive optimism for the GDP forecast. The Government has subsequently complied with a more prudent assessment, though with a different timing.

- We have done a retrospective analysis of government's forecasts before and after the establishment of the UPB in 2014. The analysis reveals that Government's forecasts for real and nominal GDP display an optimistic bias, especially at time t+1 (the most relevant horizon for budgetary planning), while forecasts for the current year tend to be prudent. Interestingly, the bias - measured by the arithmetic mean error or the frequency of optimistic forecasts - reduces significantly after 2014: the mean error is around 1.5 percentage points in the period 2000-2014 and less than 0.3 percentage points thereafter, excluding the pandemic. Moreover, the accuracy of the forecasts, measured by the root mean squared error, improves significantly in the post-2014 period, especially for real GDP. Over time, the Government's forecasts have become less optimistic and in line with the UPB forecasts.

- The UPB produces its own budgetary forecasts while it does not have an endorsement mandate. UPB budgetary forecasts provide a benchmark to assess the official budgetary forecasts, usually in the context of ad hoc parliamentary hearings.

- A comparison of the budgetary forecasts in the official planning documents with the realizations ex post reveals that forecast errors have been moderate and declining over the period 2014-2019. Over and underestimates on both the revenue and expenditure side tend to offset each other, implying that biases for the overall balance are largely non-systematic.

- Forecast errors decline over the forecast horizon, and are particularly small for documents released toward the end of the year, like the Autumn Update of the Document of Economy and Finance, (NADEF). This in part reflects the latest information on the evolution of the deficit, which helps to forecast the deficit one year ahead. It also reflects an optimistic bias in the Document of Economy and Finance, (DEF), released in the spring. In fact, the deficit targets at longer horizon tend to be revised mostly upward, i.e. in a more expansionary direction, in successive documents. The actual deficit for, let's say, 2018 coincides with the deficit target in the Update 2017, while it is larger than the target foreseen in previous documents, and the difference increases the longer the planning horizon.