ufficio parlamentare di bilancio

The Chair

Rome, 21 September 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 fulfilment of the functions assigned to it in a manner consistent with European Union legislation. Regulation (EU) No 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 Italian Ministry of Economy and Finance (MEF) of 13 May 2022 governs the process of endorsing macroeconomic forecasts.

The Board of the PBO endorses the trend macroeconomic forecasts published in the Update to the 2023 Economic and Financial Document (2023 EFD Update).

The macroeconomic trend forecasts for the Italian economy falls within an acceptable range, both in 2023-24 and in the following two-year period (which does not undergo the endorsement process). The estimates are however surrounded by considerable uncertainty, mainly attributable to external or exogenous factors, as well as to developments in the NRRP.

The forecasts are endorsed based on the information available to date; however, the international framework is unstable and fragile, so the outlook could change even in the short term.

An explanatory memo of this letter is attached.

Sincerely,

Lilia Cavallari

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Explanatory note accompanying the endorsement letter of the Parliamentary Budget Office for the trend macroeconomic scenario in the Update to the 2023 EFD

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 Update to the 2023 Economic and Financial Document (EFD Update), 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 21 September 2023 the PBO sent the MEF its endorsement letter for the trend macroeconomic forecasts in the 2023 EFD Update, transmitted by the MEF on 20 September, following the comments raised on the preliminary version of the forecasts.

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 estimates of short-term trends in 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 a set of exogenous international variables. The overall assessment based on these tools accounts for the degree of uncertainty of the forecasts.

Please note that, 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 set of assumptions concerning the international exogenous variables adopted in the 2023 EFD Update.

Outcome of the endorsement exercise

The trend macroeconomic scenario over the endorsement time horizon falls within an acceptable range, as the projections for the main variables subject to endorsement do not deviate disproportionately from the median of the PBO panel forecasts and from the PBO's own estimates. The overall acceptability of the trend forecasts of the 2023 EFD Update takes into account the fact that: a) the change in real GDP, which measures the development of the economic system, deviates only moderately from the median of the PBO panel and the PBO estimates over the entire forecast horizon and in any case it never exceeds the upper bound of the range defined by the panel; (b) nominal GDP growth, a variable directly affecting public finance, is also close to the median of the panel and to the PBO's scenario and does not exceed the upper bound defined by the panel.

The comments on the forecast for 2023 and 2024, which underwent the endorsement exercise, are summarised below, and general assessments are made for 2025-26; a number of risk scenarios are outlined in the following paragraph.

The growth rate of the Italian economy for 2023 estimated by the Government (0.8 per cent), revised downwards by two-tenths of a percentage point compared to the policy framework of the 2023 EFD, is broadly in line with the median of the PBO panel forecasts and matches the PBO forecast. The trend macroeconomic framework of the EFD Update implies a recovery of the business cycle in the second half of this year, which follows the decline in GDP recorded in the spring quarter; this development is broadly shared by the PBO panel which, however, forecasts slightly lower output dynamics. The most recent cyclical data show that production levels in the manufacturing sector remain unsatisfactory and activity in the construction sector is still weak; activity in the services sector, which is less buoyant than last year, appears to have been affected by price increases.

In the Government's trend macroeconomic scenario, Italy's GDP is projected to grow by 1.0 per cent in 2024, 0.5 percentage points lower than the prediction included in the 2023 EFD; this downturn is mainly due to external factors reflecting the deterioration in international trade, rising interest rates and higher energy commodity prices. The rate of GDP growth in the trend macroeconomic framework for next year is just above the PBO forecast and is somewhere between the median value and the upper bound of the PBO panel. However, the macroeconomic framework for 2024 is marked by high uncertainty, largely attributable to the unstable global economic scenario and to a number of risks, as discussed below.

With regard to growth determinants, in the MEF trend macroeconomic forecasts Italy's economy in 2023 is mainly driven by the components of domestic demand; this outlook is shared by the PBO and the panel as a whole. In the Government's estimates, household consumption expenditure is expected to decrease, in line with what is expected by the majority of the PBO forecasters, although the variation projected by the MEF slightly exceeds the upper bound of the panel estimates, which is where the PBO framework is set. Capital accumulation in the trend macroeconomic framework registers a marked slowdown, but is nevertheless estimated to be just below the upper bound of the PBO forecasters. Export growth appears consistent with the changes observed in international trade, import dynamics also follow the demand variables that most affect them.

In 2024 GDP growth in the trend macroeconomic framework of the EFD Update is mostly driven by domestic demand, as indicated by the PBO panel, although the contribution estimated by the MEF appears to be higher than the higher expectations formulated by the panel. Households' consumption, which is decelerating from 2023, is just below the upper bound of the panel's range. Capital accumulation projected by the MEF appears to be accelerating, while it is expected to slow down by most of the PBO forecasters; as a result, the variation in gross fixed capital formation in the trend macroeconomic scenario exceeds the upper bound of the panel and PBO projections by a considerable amount, mainly due to the stronger performance of the construction sector. The aggregate demand variable showing the highest heterogeneity among the panel forecasts is investment; the accumulation process in Italy is therefore very uncertain, and a more cautious approach in Government estimates on this variable would be desirable. In fact, the capital accumulation outlined in the trend macroeconomic framework, albeit with a level of capacity utilisation above the historical average, implies a ratio of investment volume to GDP equal to 22 per cent in 2024, a value not achieved since the mid-1970s. With regard to the foreign trade variables, exports in the MEF trend macroeconomic framework do not exceed the median of the PBO panel, while imports do, although remaining within the panel's variation range. Net exports in the trend macroeconomic framework therefore make a slightly negative contribution to GDP growth, while they are broadly neutral in the PBO panel median.

The set of price variables for the current year does not show any particular deviations from the PBO panel's expectations. However, the variation in the MEF consumption deflator falls in the upper part of the panel forecast, just below the upper bound. The GDP deflator is estimated to increase by more than four percent in the trend macroeconomic framework, due to the growing support of the terms of trade, largely as a result of the decline in imported commodity prices; at the same time, the upward push provided by the private consumption deflator is weakening. This development is qualitatively consistent with the panel's assessments: the change in the GDP deflator projected by the MEF for 2023 is close to that of the PBO and slightly below the panel median. The prudent evolution of the GDP deflator, considering the real GDP growth estimated by the Government, results in a change in nominal output that is below the panel median and roughly in line with the PBO forecast.

For next year, the MEF trend macroeconomic framework points to a further deceleration of the private consumption deflator, at 2.4 per cent, similarly to the median of the PBO panel. Expectations on consumer prices are uneven, due to the high uncertainty over nominal dynamics in the coming quarters. While the PBO and two forecasters assume a fast return of consumer inflation towards the ECB's target in 2024, two other panel members still forecast values around three per cent. The MEF trend macroeconomic framework implies a decline in terms-of-trade gains in 2024, similarly to the PBO panel forecasts; as a consequence, the MEF's projection of the variation in the GDP deflator lies at the median of the panel projections. Since the MEF's projected real growth falls within the acceptance range of the PBO forecasters, the change in nominal GDP also appears to be in line with the panel median.

The labour market variables in 2023-24 fall within the panel's range and do not deviate significantly from PBO expectations. This year, the increase in employment (in terms of AWU) is consistent with the median of the panel estimates and with the quarterly data available at the time. The unemployment rate for the current year, estimated to fall in the MEF trend macroeconomic framework, is also close to the median of the panel. Employment in 2024 is projected to be close to the median value of the PBO forecasters, the unemployment rate is between the lower bound and the median of the panel expectations; the employment rate (15-64 years) tends to increase gradually over the validation period, similar to the median forecast of the panel.

With regard to 2025-26, a period that does not undergo the PBO endorsement process, the change in GDP projected in the MEF's trend scenario for 2025 (1.3 per cent) coincides with the median value of the PBO panel, while the growth projection in the final year of the forecast horizon (1.2 per cent) falls exactly on the upper bound of the panel's expectations. Italy's GDP growth rate at the end of the forecast horizon appears to be higher than the estimates of potential output formulated prior to the pandemic crisis, and thus requires the full boost provided by the NRRP expected by the Government.

The forecasts on the evolution of the demand components of the trend macroeconomic forecast in the final two years of the 2023 EFD Update are acceptable when compared with those of the PBO panel.

Price changes in 2025-26 converge towards the euro area monetary policy target and are overall consistent with the panel forecast. Taking into account output growth in volume terms, the evolution of nominal GDP depicted by the MEF appears acceptable when compared to the PBO panel's range.

With regard to the labour market, employment growth is in line with the median values of the panel in 2025-26. The employment rate increases to 63.6 per cent in 2026, broadly in line with the PBO panel median; unemployment rate forecasts fall just below the panel median.

Risks to the forecasts

The macroeconomic scenario of the Italian economy appears to be exposed to different types of risks, mainly exogenous or of an international nature, which are generally downward-looking.

NRRP and public investments. Critical issues remain in connection with the assumption underlying the forecasts that sees the full, timely, and efficient utilisation by Italy of the funds of the NGEU programme. In the first two years of the programme, the activation of public investment was modest, and this summer the Government made proposals to amend the Plan. In a context where conditions for access to credit are tightening, it is necessary to advance rapidly with the implementation of interventions and structural reforms if the incentive to productive activity is to be significant and lasting. Concentrating the execution of the NRRP works in the final two years of the programme could fuel bottlenecks in supply, both in terms of the skills needed to manage and start the works and for the crowding out of other investments.

The war in Ukraine and the outlook for Germany and China. The ongoing conflict on the Union's doorstep continues to represent a major risk. The European economy as a whole seems to have been affected to a limited extent by the trade tensions with Russia; however, the German industry has shown clear signs of weakness, which if persistent could strongly affect production systems highly integrated with Germany such as the Italian one. The Chinese economy is also experiencing a critical phase, not only due to the difficulties in the real estate sector, which could put a brake on the recovery of world trade assumed in the forecasts.

The persistence of inflation. The sharp decline in inflation next year is the pivotal assumption underlying to the entire macroeconomic scenario. This assumption is plausible but is exposed to a number of risks. Exogenous variables are based on commodity futures market prices, which are extremely volatile; new shocks cannot be ruled out, for example as a result of the supply strategies of oil-producing countries. In addition, adverse climatic events or new geopolitical tensions could lead to upward pressure on wholesale food prices, which would quickly spill over to consumer prices.

New price increases would directly affect disposable income and thus the spending power of households.

Financial risks and economic policies. Any misalignments in recovery cycles between countries and any sudden increase in risk aversion on the part of market operators are likely to generate new global financial tensions, with significant impacts on an open economy with a high public debt, such as the Italian one. For EU states, these risks will also depend on the new system of budget laws, whose debate is at an advanced stage. At the global level, financial risks also depend on the upcoming developments in monetary policy guidelines, currently restrictive in the leading advanced countries, but expansive in China, which is experiencing deflation.

Climate and environmental risks. Environmental and climate risks remain in the background. These risks, in addition to affecting food and energy prices, can directly harm the productive fabric when extreme events occur.