2.9 PROJECTIONS

The projections for the Italian economy, prepared as part of the Eurosystem staff macroeconomic projections, were published at the beginning of June. Since the British referendum considerably greater uncertainty has surrounded the forecasting scenario. So far, however, financial market developments have not altered it significantly: the direct and indirect effects of a slowdown of the UK economy may not be negligible but in any event will be limited, with growth estimated at a little under 1 per cent this year and at around 1 per cent in 2017; still, there has been a marked increase in the risks from the spread of financial and banking tensions or from sagging confidence, whose effects on the macroeconomic projections can nonetheless be mitigated (more than in the recent past) by the full utilization of available monetary policy measures.

The June projections

The scenario for the Italian economy published at the beginning of June (see the box 'The macroeconomic scenario published in June'), in line with the plans reported to date by the firms interviewed in our surveys, indicates that investment is increasing. This is being driven by the recovery in demand, favourable lending conditions and tax relief (see the box 'Italian firms' investment according to the survey on inflation and growth expectations'). At the end of the forecasting horizon, though, it will still be 2 percentage points below the average recorded in the decade preceding the crisis (1998-2007). Household consumption is expanding, thanks to support from real disposable income and the improvement in labour market conditions; the performance of foreign sales is being boosted above all by the rise in exports to other euro-area countries; and employment is increasing gradually but significantly. Inflation is rising only gradually, affected by the still ample margins of unutilized production capacity.

The maintenance of expansionary conditions is a prerequisite for growth

In the early June scenario further growth depends on the Governing Council of the ECB continuing to use all instruments available to it to ensure price stability; orderly conditions being maintained on the financial markets with no further tensions; the credit market continuing to improve in line with the indications from the latest available surveys (see Section 2.7); and the fiscal policy stance remaining moderately expansionary. The new targeted longer-term refinancing operations (TLTROs) introduced by the ECB Governing Council last March are helping to keep firms' funding costs down (see the box 'The effects of the new targeted longer-term refinancing operations' in Chapter 1).

The effects of Brexit ...

The impact of Brexit on this scenario remains difficult to assess and depends on mostly hypothetical outcomes. The potential channels of transmission, the scale of which is discussed in the box 'Possible repercussions of the UK referendum on the forecasting scenario', are conditional on movements in the financial markets, what happens to trade flows, and the degree of uncertainty affecting firms and banking markets.

POSSIBLE REPERCUSSIONS OF THE UK REFERENDUM ON THE FORECASTING SCENARIO

The outcome of the recent UK referendum on leaving the European Union has created a situation whose macroeconomic effects, especially over the long term, are difficult to judge as they will be greatly influenced by the future policy decisions of the EU and its Member States. Much will depend on how the European integration process is affected, as it could suffer a setback if scepticism about the common project dominates, or it could instead gain momentum in order to contain the risk of economic and political fragmentation.

The UK will have to negotiate new trade agreements, a process that is likely to be lengthy and of uncertain outcome (see the box 'The implications of the referendum for relations between the United Kingdom and the European Union' in Chapter 1), and which could have significant repercussions for the British economy as well as for the euro area, albeit to a more limited extent. Over the short and medium term, the Italian economy is expected to feel the backlash of this transition through various channels: trade links with the UK; increased financial market volatility; the widespread rise in economic uncertainty; and the ripple effect on the banking system.

The day after the referendum the financial markets reacted strongly. Significant drops were posted in stock indices in particular (notably for the banking sector since its profitability is judged to be exceptionally vulnerable to the effects of Brexit) and sterling depreciated sharply; there was a very modest increase in the yields on the government securities of the most vulnerable countries; commodity prices fell and those of the reputedly safest assets increased.

The effect on the financial markets was, however, largely reabsorbed in subsequent weeks. Compared with the average values observed in the week prior to the referendum, the latest data (updated to 8 July) indicate that share prices have fallen by around 6 per cent in Italy; the yields on ten-year government bonds have decreased by 25 basis points; the euro has appreciated by just over 8 per cent against sterling and depreciated by 2 per cent against the dollar (remaining almost unchanged in effective terms); the price of oil has fallen by about 7 per cent.

The impact of these changes on Italy's GDP is essentially nil.

Nevertheless, there is still the risk of further repercussions from the British referendum over the next few months, which could lead to a contraction in economic activity in the UK that would undermine international trade and firms' decision-making.

Professional forecasters and the international institutions generally estimate that the costs in terms of lower economic growth for the United Kingdom – which will also depend on the timeframe and expected results of negotiations on new trade agreements – could be considerable, though difficult to quantify. Most analysts forecast a possible decline in the UK's GDP of 2 to 5 percentage points, spread over the next few years. Should the level of UK imports fall by 10 percentage points (a figure compatible with the uppermost part of the range of estimates made by the leading analysts), the reduction in foreign demand for Italian products would be around 1 per cent given the direct trade links between Italy and the UK (see the box 'Trade and financial relations between Italy and the United Kingdom') and the indirect links with areas that trade with the UK. The impact on Italy's GDP would be negative, at around a quarter of a percentage point, spread over the three years 2016-18. Furthermore, there could be a drop in investment by firms that export to these markets.

Greater risks could arise in extreme scenarios that envisage a tightening of financial market conditions; more widespread unfavourable expectations about the future of the EU; heightened pressure on bank securities or greater risks to financial stability, which, unless countered by economic policy action, could spread to credit supply as banks become less able to raise funds on the financial markets.

In the event of a lasting increase in the spread between Italian and German government bond yields like the one observed in the summer of 2015 when negotiations between the Greek government and the EU reached a climax (equal to around 35 basis points on ten-year bonds), Italy's GDP could be about 0.2 percentage points lower at the end of the 2016-18 period.

The extent of the effects of a loss of confidence and greater tensions in the banking sector, which has been considerable in the recent past, is difficult to judge. An increase in uncertainty and a drop in business confidence of the dimension observed during the sovereign debt crisis (when the business confidence index fell by around 19 per cent and the uncertainty inferred from firms' assessments rose by a similar amount) when reflected in investments would cause Italy's GDP to fall by about 1 percentage point. A credit crunch of similar severity to that recorded during the sovereign debt crisis (when the indicator of credit tightening drawn from the bank lending survey, which is currently negative, rose to a record high of 0.5; see Figure A in the box 'Credit supply and demand') could have an analogous effect.

If resolute use is made of the wide range of monetary policy tools now available, including the securities purchase programme and the targeted longer-term refinancing operations, they could help to substantially avert these risks, the size of which also depends on macroprudential and budgetary policy responses and on the European authorities' success in quelling fears about EU cohesion.

... transmitted through interest and exchange rates are minimal to date ...

The implications for the projections of the financial market movements observed so far are negligible. Changes in interest rates, even against a backdrop of high volatility, have been limited, thanks to the expansionary stance of monetary policies; changes in the euro's effective exchange rate due to its appreciation against the pound sterling and depreciation with respect to the other currencies have also been modest overall.

... those transmitted through trade flows appear unfavourable but limited ...

The consequences for economic activity along the forecasting horizon could be transmitted through trade flows. In the scenarios that explore the potential effects – insofar as they can be estimated today – of a sharp fall in output in the UK, including in the worst case scenario, the negative impact on Italy's GDP would be relatively small, in the order of one quarter of a percentage point. The effect could be marginally greater if firms' heightened uncertainty about the prospects for outlet markets is taken into account. In that case, and also considering the data on the second quarter of 2016 released in recent weeks (see Section 2.1), output could expand by a little under 1 per cent this year and by around 1 per cent in 2017.

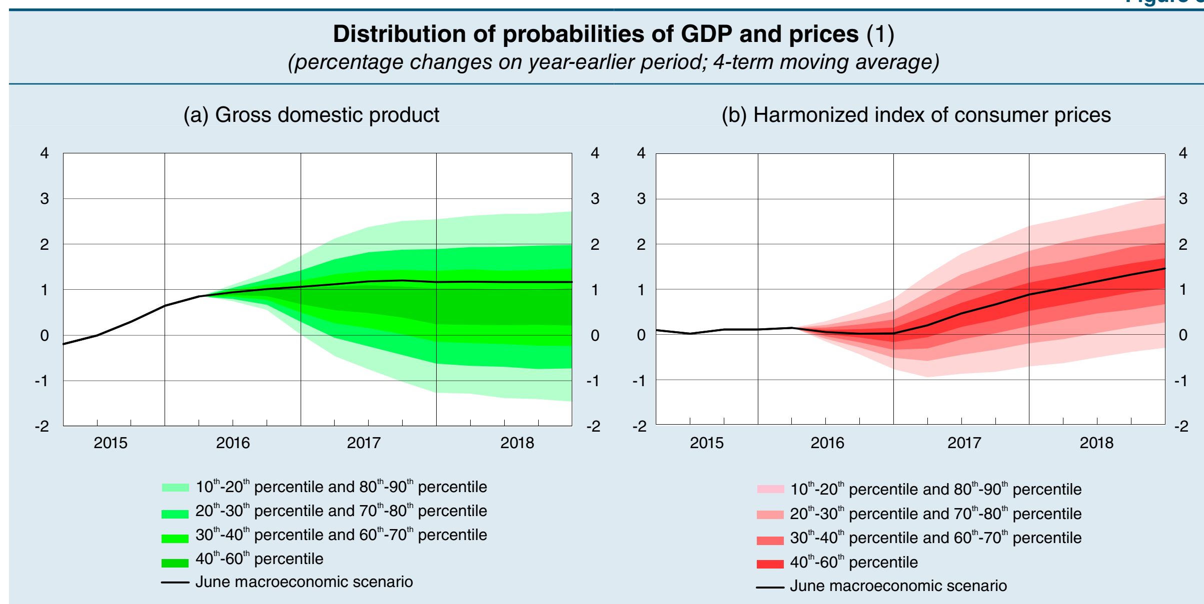
... but the risks of disorderly developments have risen sharply

The estimates assume that no contagion occurs on the European markets and uncertainty does not increase; however, the risks to both the European and Italian economies have risen. These could materialize with new shockwaves on the financial markets, which in any event can be countered with monetary policy instruments; an aggravation of banking tensions leading to tighter lending conditions, in the event that risks to financial stability are not tackled; or a decline in the confidence of firms, were the European authorities to prove unable to dispel fears about the cohesion and governance of the EU, which could dilute investment plans. The scale of such effects has proven very considerable in the recent past and has entailed a marked increase in downside risks to growth, whose distribution is now highly asymmetric (Figure 36); these can be contained by an adequate economic policy response.

The outlook for inflation remains balanced: the downside risks stem from the possibility that wage adjustments in the next two years will be affected more than forecast by low inflation and continuing high unemployment; fresh stimulus to price growth and inflation expectations could come from the monetary policy measures adopted.

Figure 36

Distribution of probabilities of GDP and prices (1)
(percentage changes on year-earlier period; 4-term moving average)



(1) The probability distribution around the June scenario (unbroken line); the risks discussed in the text are incorporated. The probability distribution is graphed, for percentile groups, by fan charts, based on stochastic simulations effected via random extractions from the shock distribution of the Bank of Italy quarterly econometric model. This distribution takes account of the asymmetrical shocks to the equations that reflect the main risk factors, according to the procedure described in C. Miani and S. Siviero, 'A non-parametric model-based approach to uncertainty and risk analysis of macroeconomic forecasts', Banca d'Italia, Temi di Discussione (Working Papers), 758, 2010.The figure shows year-on-year percentage changes of 4-term moving averages. The value corresponding to the fourth quarter of each year coincides with the average annual percentage change.

THE MACROECONOMIC SCENARIO PUBLISHED IN JUNE

As of this year, the preparation of the complete forecasting framework for the Italian economy has been brought forward to the beginning of June and the beginning of December to coincide with the Eurosystem's Broad Macroeconomic Projection Exercises and the publication of the results for the euro area. The projections for the Italian economy, published on 6 June before the result of the British referendum, are shown in the table.[1]

The main technical assumptions underlying the macroeconomic scenario published in June were:

a) three-month interest rates on the interbank market (Euribor) are negative at -0.3 per cent in the three-year forecasting period;

b) the yield on ten-year BTPs is 1.3 per cent in 2016 and gradually picks up over the next two years (2.0 per cent in 2017 and 2.4 per cent in 2018), in line with market expectations;

c) world trade expands by 2.7 per cent in 2016 and accelerates to 4.0 per cent in 2017 and 4.3 per cent in 2018, less than the average annual growth of 5.7 per cent recorded over the last twenty years. Foreign demand, weighted by the markets for Italian exports, grows at similar rates;[2]

[1] See the Bank of Italy's website: *Macroeconomic projections for the Italian economy (Eurosystem staff macroeconomic projections)*, 6 June 2016.

[2] Our assumptions for global economic activity and potential foreign demand are consistent with those underlying the projections for the euro area agreed by the Eurosystem central banks and presented by the ECB in *Eurosystem staff macroeconomic projections for the euro area,* June 2016.

d) the price of Brent crude oil is $43.40 a barrel on average this year, $49 in 2017 and about $51 in 2018;

e) the euro-dollar exchange rate stands at 1.13 for the current year and 1.14 for the following two years;[3]

f) the measures contained in the 2016 Stability Law are taken into account in the scenario. In particular we assume deactivation of the safeguard clauses providing for an increase in VAT rates and excise duties in 2017-18, as indicated in the 2016 Economic and Financial Document (EFD) approved in April. In contrast to the policy framework set out in the EFD, this scenario does not take account of the measures that will serve to offset the absence of further rises in indirect taxes, since they are not specified in sufficient detail; this assumption is in line with the methodology for macroeconomic projections agreed upon by the Eurosystem.

Macroeconomic scenario published on 6 June
(percentage changes on previous year, unless otherwise indicated)

	2015	2016	2017	2018
GDP (1)	0.6	1.1	1.2	1.2
Household consumption	0.9	1.5	1.4	1.1
Government consumption	-0.7	0.2	-0.5	-0.4
Gross fixed investment	0.6	2.9	2.7	2.3
of which: in machinery, equipment and transport equipment	2.2	4.4	3.9	2.5
Total exports	4.1	2.3	4.2	4.1
Total imports	5.8	4.1	4.8	3.8
Change in stocks (2)	0.5	0.1	0.0	0.0
Prices (HICP)	0.1	0.0	0.9	1.5
HICP net of food and energy	0.7	0.7	1.0	1.5
Employment (3)	0.8	0.7	0.7	0.7
Unemployment rate (4)	11.9	11.4	11.1	10.8
Export competitiveness (5)	3.5	0.7	0.3	-0.6
Current account balance (6)	2.2	2.0	1.5	1.7

Sources: Based on Bank of Italy and Istat data.
(1) For GDP and its components: volumes at chain-linked prices; changes estimated on the basis of quarterly data adjusted for seasonal and calendar effects. – (2) Includes valuables. Contribution to GDP growth in percentage points. – (3) Standard labour units. – (4) Annual averages; per cent. – (5) Calculated by comparing the price of foreign manufactures with the deflator of Italian merchandise exports (excluding energy and agricultural products); a positive value indicates a gain in competitiveness. – (6) Per cent of GDP.

[3] The technical assumptions on interest rates, exchange rates and oil prices are calculated on the basis of spot and forward prices observed in the markets in the ten working days up to 11 May.