2.10 PROJECTIONS

The projections for the Italian economy presented in this *Economic Bulletin* update those prepared for December's Eurosystem staff macroeconomic projections to take account of subsequent developments.[1] These do not warrant any significant adjustment in the outlook for the next three years, with the exception of consumer price inflation, which is expected to rise by almost half a percentage point this year, mainly owing to imported energy prices.

Fluctuations in the stock exchange indices and in government security yields have been limited as a whole, despite a surge in volatility in November. The 30 November agreement on production cuts signed by all the OPEC and some non-OPEC countries resulted in a sharp rise in oil prices. The decisions of the ECB Governing Council of 8 December last, confirming its expansionary monetary policy stance have had only a limited impact on interest rates. On the other hand, the euro/dollar exchange rate, based on the average values recorded in the ten working days up to 5 January, has fallen by about 4 per cent compared with the rate on which the December scenario was based.

The scenario is based on favourable credit conditions

The forecasting scenario for 2017-19 is based on the assumption that monetary conditions will remain highly expansionary, as reflected in the projections for German long-term interest rates (to hold below 0.5 per cent this year and to increase moderately the next), even taking into account the widening of Italy's sovereign spread in the closing months of 2016 (see the box 'The assumptions underlying the macroeconomic scenario'). This scenario also assumes that credit conditions will remain generally favourable: the difference between interest rates on bank loans in Italy and in the rest of the euro area is not expected to exceed [30] basis points in the period 2017-19. According to the various surveys, credit standards will continue to be generally relaxed.

THE ASSUMPTIONS UNDERLYING THE MACROECONOMIC SCENARIO

Since 2016 the forecasting scenario for the Italian economy prepared by Bank of Italy experts as part of the Eurosystem staff macroeconomic projection exercise, has been published on the Bank's website at the start of June and December.[1] The macroeconomic projections for Italy presented here update those released on 9 December[2] on the basis of technical assumptions about developments in the exogenous variables that take account of the information available at 5 January.

The main assumptions underlying the scenario are as follows (see the table):

a) World trade expands by 1.7 per cent in 2016, accelerates to 3.2 per cent in 2017 and to 4 per cent on average in 2018-19, significantly below the average annual growth rate of 5.7 per cent recorded between 1990 and 2015. In 2016 foreign demand, weighted according to the markets for Italian exports, expanded by more than global demand (2.4 per cent) by virtue of the relatively high share of Italian exports to the euro area (where average demand conditions

[1] See the Bank of Italy's website for The macroeconomic projections for Italy - 2016, which include the projections published to date as part of the Eurosystem exercise.
[2] See the Bank of Italy's website: http://www.bancaditalia.it/pubblicazioni/proiezioni-macroeconomiche/2016/ENG_Final_Proiezioni_Macroeconomiche_Italia_Dicembre_2016.pdf?language_id=1, 9 December 2016.

[1] See the Bank of Italy's website, 'Macroeconomic projections for the Italian economy – Eurosystem staff macroeconomic projection exercise', 9 December 2016.

were better than the rest of the world);[3] in the three years 2017-19, the performance of foreign demand is similar to that for world trade;

b) The euro-dollar exchange rate averages 1.11 in 2016 and falls to 1.04 in the three years 2017-19;[4]

c) The price of a barrel of Brent crude oil averages $43.6 in 2016, reaches around $58 in 2017 and stays fairly close to this level over the rest of the forecasting horizon;

d) Three-month interest rates on the interbank market (Euribor) stand at -0.3 per cent in the two years 2016-17, before gradually rising to -0.1 per cent on average in 2019;

e) The yield on ten-year BTPs, on average equal to 1.5 per cent in 2016, rises to 2.1 per cent in 2017, 2.5 per cent in 2018, and 2.9 per cent in 2019, in line with market expectations;

f) The scenario incorporates the 2017 budgetary provisions. It is also assumed that the increase in the VAT rates and excise duties envisaged under current legislation will not be applied in the two years 2018-19.

Table

Assumptions for the main exogenous variables
(percentage changes on the previous year unless otherwise specified)

	2016	2017	2018	2019
World trade	1,7	3,2	3,9	4,0
Potential foreign demand	2,4	3,3	3,9	3,9
Dollar/euro (1)	1,11	1,04	1,04	1,04
Nominal effective exchange rate (2)	0,3	1,8	0,0	0,0
Crude oil prices (1) (3)	43,6	57,7	57,8	57,4
3-month Euribor (1)	-0,3	-0,3	-0,2	-0,1
1-year BOTs (1)	-0,1	-0,2	-0,1	0,0
10-year BTPs (1)	1,5	2,1	2,5	2,9

Source: Based on Bank of Italy and Istat data.
(1) Annual averages. – (2) Positive changes indicate a depreciation. – (3) Dollars per barrel of Brent crude oil.

[3] The 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 https://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201612.en.pdf?29929e44e31cc1d35e6d01f2d9f5a341, 9 December 2016.

[4] The technical assumptions on interest rates, exchange rates and oil prices are calculated on the basis of the spot and forward prices observed in the markets in the ten working days to 5 January.

In the macroeconomic framework for the next three years ...

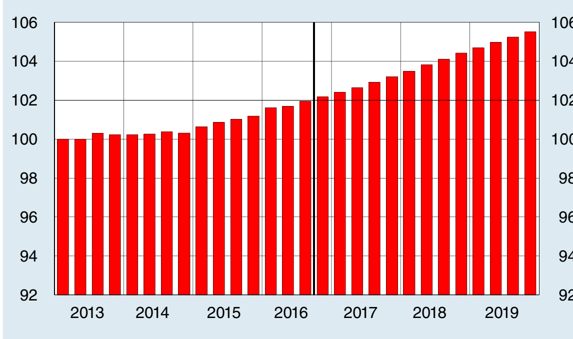
GDP is projected to grow by 1.0 per cent on average per year in 2017-19 (Table 11 and Figure 38). Economic activity will be driven by domestic demand and by a gradual strengthening of foreign demand (Figure 39). In 2019 output is expected to be about 4 percentage points below the peak recorded in the ten years before the crisis (1998-2007).

... investment growth benefits from the support measures ...

So long as financial conditions remain favourable, the expansion of investment in production facilities will help to support economic activity and, despite the dampening effect of the uncertain growth outlook, up to the

Figure 38

GDP projections: quarterly profile (1)
(Index: 2013 Q1=100)



Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted. Actual data up to 2016 Q3; projections thereafter.

first half of 2018, will be boosted by the measures put in place by the Government. According to our surveys, firms generally give a positive assessment of these measures, which have been renewed and extended in the 2017 budget law (see the box 'Growth and investment in Italy', *Economic Bulletin*, 4, 2016). According to our estimates, the overall stimulus they impart, mainly by prompting firms to anticipate planned expenditure, will be equivalent to about 3.5 percentage points of additional investment in machinery, equipment and transport equipment in 2016-18. When these effects terminate there will be a sharp but brief slowdown in investment at the end of the forecasting horizon. Residential investment is instead expected to increase on average at a slower pace.

Investment in production facilities as a share of GDP is projected to return to similar levels to those recorded on average in the decade leading up to the crisis (Figure 40); while investment in construction should stay more than 3 percentage points below.

... consumption and employment continue to grow ...

Consumption is forecast to grow at a similar rate to output. The slowdown with respect to the previous two-year period presumably mainly reflects the impact of recent increases in energy commodity prices on households' spending power. The saving rate should rise slightly over the forecasting horizon, pursuing its usual pro-cyclical dynamics. Employment is forecast to grow, although briefly at a slower pace than last year's as the social security reductions on new permanent hires are phased out (see Section 2.5). The unemployment rate will diminish only gradually, going from 11.9 per cent in 2015 to less than 11 per cent in 2019: increased labour market participation in response to the improved economic outlook and structural factors such as the raising of the retirement age appear to be slowing the fall.

... and the contribution of exports strengthens

Exports are projected to increase at a faster rate than world trade, benefiting, among other things, from the euro's depreciation against the main currencies. Imports are also expected to gain pace, driven by the performance of demand components with a high import content (investment in production facilities and exports).

Table 11

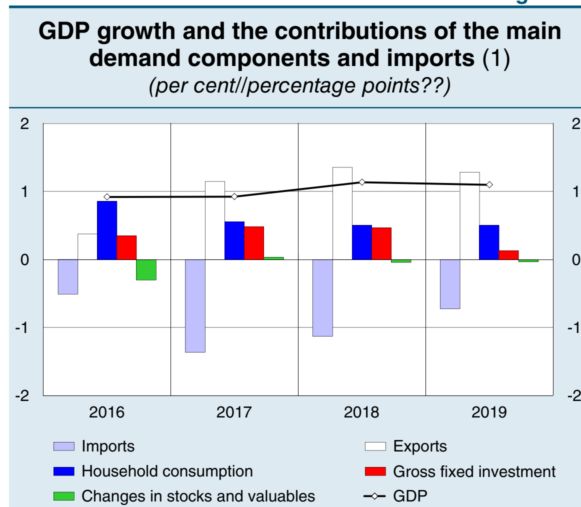
The macroeconomic scenario
(percentage changes on previous year unless otherwise indicated)

	2016	2017	2018	2019
GDP (1)	0,9	0,9	1,1	1,1
Household consumption	1,4	0,9	0,8	0,8
Government consumption	0,8	0,4	-0,1	-0,3
Gross fixed investment	2,1	2,8	2,7	0,8
of which: in machinery, and transport equipment	3,1	4,6	3,0	0,1
Total exports	1,2	3,8	4,4	4,0
Total imports	1,8	4,9	3,9	2,4
Change in stocks (2)	-0,3	0,0	0,0	0,0
HICP	-0,1	1,3	1,3	1,5
HICP net of food and energy	0,5	0,8	1,4	1,6
Employment (3)	1,0	0,8	0,9	1,0
Unemployment rate (4)	11,6	11,6	11,3	10,9
Export competitiveness (5)	-1,3	1,6	0,1	-0,5
Current account balance (6)	2,4	1,7	1,9	2,2

Sources: Based on Bank of Italy and Istat data.
(1) For GDP and its components: chain-linked volumes; 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 competiveness. – (6) Per cent of GDP.

Figure 39

GDP growth and the contributions of the main demand components and imports (1)
(per cent//percentage points??)

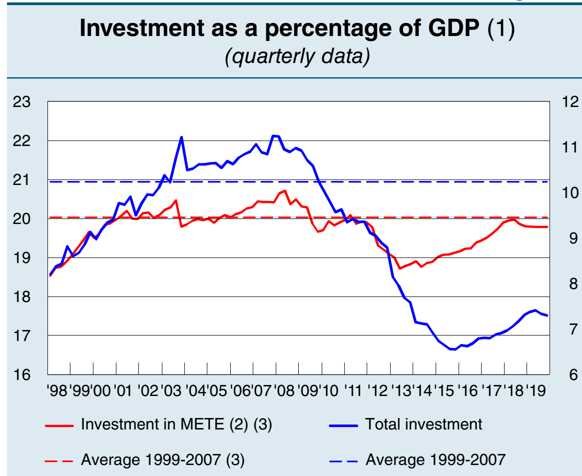


Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted.

Figure 40

Investment as a percentage of GDP (1)

(quarterly data)

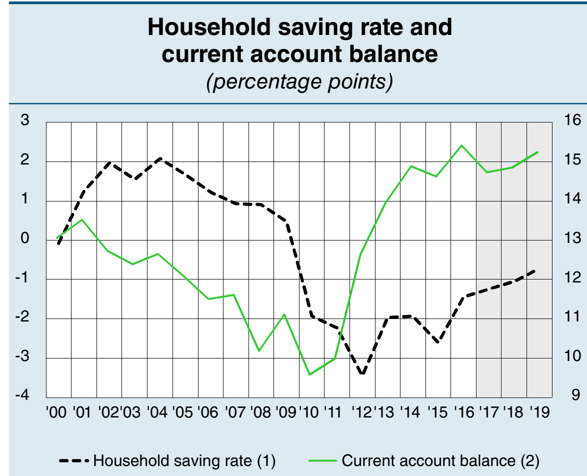


Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted. – (2) Investment in machinery, equipment and transport equipment (METE). – (3) Right-hand scale.

Figure 41

Household saving rate and current account balance

(percentage points)



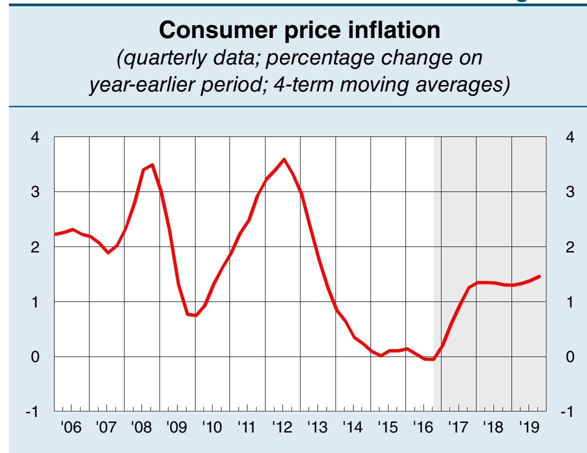
Sources: Based on Bank of Italy and Istat data.
(1) Right-hand scale. – (2) Per cent of GDP.

The surplus on the current account of the balance of payments, which we estimate at 2.4 per cent in 2016, should stay close to the 2 per cent mark over the forecasting horizon (Figure 41).

Figure 42

Consumer price inflation

(quarterly data; percentage change on year-earlier period; 4-term moving averages)



Sources: Based on Bank of Italy and Istat data.

Inflation surges in 2017, reflecting the oil price hike

Inflation, measured by the harmonized index of consumer prices, is expected to rise to 1.3 per cent on average this year and the next, from -0.1 per cent in 2016, and to 1.5 per cent in 2019 (Figure 42). This year's projected surge will be due primarily to the higher prices of energy imports, while core inflation, i.e. excluding the most erratic items, will increase more gradually over the forecasting horizon. The wage moderation incorporated in recently renewed employment contracts (see the box 'Private sector contract renewals in 2016') will nonetheless continue to hold down inflation. Profit margins in the private sector will continue to increase slowly as the outlook for growth gradually improves, and by the end of the forecasting horizon will have recouped just over half of the loss recorded from 2008 to 2012.

Growth forecasts are in line with the assessments we prepared in July ...

The projections for GDP growth are in line with the updated estimate given in the July *Economic Bulletin*. Inflation is forecast to be 0.4 percentage points higher this year, mainly owing to the increase in energy commodity prices, and slightly lower in 2018, chiefly reflecting the moderate wage growth built into recently renewed labour contracts.

... and with the latest estimates of other professional forecasters

Our growth projections are generally in line with the ones recently published by the OECD and the European Commission. The International Monetary Fund and private analysts polled by Consensus Economics instead forecast slower GDP growth.

Our estimates for inflation are higher than those of the majority of forecasters, mostly reflecting the latest movements in energy commodity prices.

Stronger economic growth depends on accommodating policies and continued reform

In general, a highly accommodating stance of monetary policy and a continued, gradual improvement in credit growth, in keeping with the results of the latest surveys (see Section 2.7 and the box 'Credit supply and demand'), remain the premises for a strengthening of economic activity. Relaxed conditions will continue to prevail on the financial markets, as factored into current market prices, assuming, among other things, that Italy does not waver in its determination to complete the reform process it has begun. Budgetary policy is expected to remain moderately expansionary over the period 2017-19 (see Section 2.9).

Table 12

Other organizations' forecasts for Italy
(percentage changes on previous period)

	GDP (1)			Inflation (2)		
	2017	2018	2019	2017	2018	2019
IMF	0,7	0,8	….	0,5	0,8	1,0
OECD	0,9	1,0	….	0,8	1,2	….
European Commission	0,9	1,0	….	1,2	1,4	….
Consensus Economics	0,7	0,9	….	0,9	1,1	….

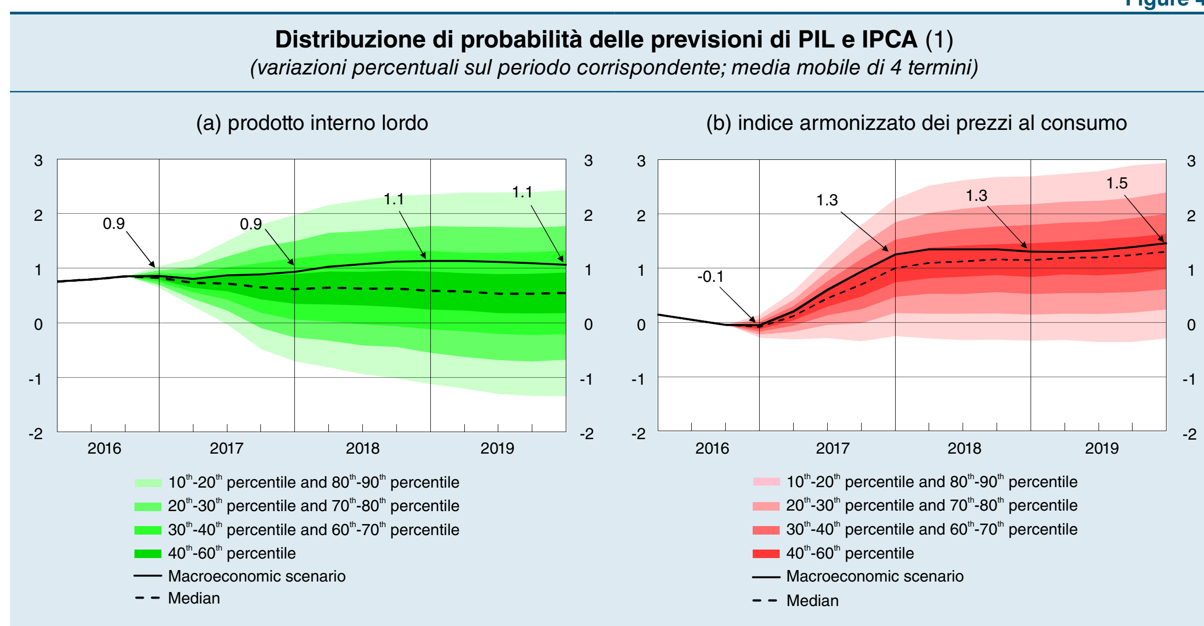
Sources: For GDP, IMF, *World Economic Outlook Update*, January 2017; OECD, *OECD Economic Outlook*, 100, November 2016; European Commission, *European Economic Forecast Autumn 2016*, November 2016; Consensus Economics, *Consensus Forecasts*, 9 January 2017. For inflation, IMF, *World Economic Outlook*, October 2016; OECD, *OECD Economic Outlook*, 100, November 2016; European Commission, *European Economic Forecast Autumn 2016*, November 2016; Consensus Economics, *Consensus Forecasts*, 9 January 2017.
(1) The growth rate forecasts of the OECD are adjusted for calendar effects; those of the European Commission and the IMF are not. – (2) HICP.

The risks to growth stem mainly from the global economic cycle ...

The main risk for the recovery of the world economy is the potential emergence and subsequent spread of protectionist tendencies, as well as possible turmoil in the emerging economies linked to the normalization of monetary policy in the United States and lasting uncertainty about negotiations to re-shape trade relations between the European Union and the United Kingdom (see the box

Figure 43

Distribuzione di probabilità delle previsioni di PIL e IPCA (1)
(variazioni percentuali sul periodo corrispondente; media mobile di 4 termini)



(1) 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. The distribution takes account of asymmetric 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), No. 758, 2010. The figure shows year-on-year percentage changes of 4-term moving averages. The value corresponding to the 4th quarter of each year coincides with the average annual percentage change.

‘Possible repercussions of the UK referendum on the forecasting scenario’, *Economic Bulletin*, 3, 2016). In the short term, however, world demand may be buoyed by the adoption of expansionary policies on the part of the new US Administration, although their effects will depend on the how they are implemented. Any strengthening of economic growth in the US might push up commodity prices further and cause the euro to fall more sharply against the dollar, bringing upward pressure to bear on consumer prices.

... while the risks to inflation are also linked to wage dynamics

The risk that inflation forecasts may be revised downwards stems from the renewal of several private sector employment contracts (see the box ‘Private sector contract renewals in 2016’), which in some sectors index wages to past inflation and eliminate any link to expected inflation, leading to greater inflation inertia.

Overall, we estimated that most of the risks associated with last December’s scenario are still downside risks for growth and a generally balanced outlook for inflation (Figure 43).