2.9 PROJECTIONS

The projections for the Italian economy presented in this *Economic Bulletin* update those prepared as part of the Eurosystem staff macroeconomic projections that are based on information available up to 23 May,[1] and take subsequent developments into account. They incorporate the new national accounts data released by Istat on 1 June, which revise GDP growth upwards for the last quarter of 2016 and the first quarter of 2017. The data show an upward revision of realized growth for the current year of 0.3 percentage points. The scenario also takes account of the favourable cyclical data that have since become available for the quarter just ended (see the box 'Economic activity in the second quarter of 2017 based on cyclical indicators'). Developments on the financial and commodities markets instead entail minor adjustments to the technical assumptions with respect to those underlying the forecasting scenario published on 9 June.

The forecasting scenario assumes accommodative monetary and financial conditions

The economic outlook for 2017-19 is based on the assumption that monetary and financial conditions will remain expansionary. According to the trends implied by current market prices, short-term interest rates will increase by a total of around 30 basis points in the three years 2017-19; yields on ten-year BTPs will rise gradually; the spread vis-à-vis the corresponding German Bund will reach 185 basis points on average (see the box 'The assumptions underlying the macroeconomic scenario'). In keeping with survey findings, credit supply conditions are expected to remain relaxed. The scenario incorporates the public finance measures approved on 24 April and, as in previous projections, excludes the effects of the increase in indirect taxes under the safeguard clauses in the next two years and any measures alternative to those already set out in current legislation.

THE ASSUMPTIONS UNDERLYING THE MACROECONOMIC SCENARIO

The forecasting scenario for the Italian economy prepared by Bank of Italy experts as part of the Eurosystem staff macroeconomic projection exercise is published on the Bank's website at the start of June and December in concomitance with the euro-area projections. The macroeconomic projections for Italy presented here update those released on 9 June[1] on the basis of information that has become available in the meantime, including the latest national accounts data published by Istat on 1 June. The technical assumptions about developments have also been revised in the light of changes in the exogenous variables at 7 July.

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

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

	2016	2017	2018	2019
World trade	1.8	4.5	3.9	4.0
Potential foreign demand	3.0	4.1	3.8	3.8
Dollar/euro (1)	1.11	1.11	1.14	1.14
Nominal effective exchange rate (2)	-0.6	1.3	-0.8	0.0
Crude oil prices (1) (3)	44.1	50.2	50.2	51.7
3-month Euribor (1)	-0.3	-0.3	-0.2	0.0
1-year BOTs (1)	-0.1	-0.3	-0.2	0.0
10-year BTPs (1)	1.5	2.3	2.7	3.1

Sources: 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.

[1] 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 'Eurosystem staff macroeconomic projections for the euro area, June 2017'.

[1] See on the Bank of Italy's website 'Macroeconomic projections for the Italian economy included in the Eurosystem staff projections', 9 June 2017.

a) World trade accelerates to just over 4 per cent on average in the three years 2017-19 (from 1.8 per cent in 2016); foreign demand weighted by the outlet markets for Italian exports expands at a slightly slower pace than world trade;

b) The euro-dollar exchange rate holds stable at 1.14 on average in the next two years;[2]

c) The price of a barrel of Brent crude oil, which averaged $44 last year, rises to $50.2 in 2017 and in 2018, and to $51.7 in 2019;

d) Three-month interest rates on the interbank market (Euribor), equal to -0.3 per cent in the two years 2016-17, rise gradually until they are practically nil overall in 2019;

e) The yield on ten-year BTPs, which averaged 1.5 per cent in 2016, rises to 2.3 per cent in 2017, 2.7 per cent in 2018, and 3.1 per cent in 2019, in line with market expectations;

f) The scenario incorporates the adjustments to the public finances contained in Decree Law 50/2017 issued on 24 April. In keeping with the stance outlined in the 2017 Economic and Financial Document, it does not include the effects of the increase, from 2018, in indirect taxes under the safeguard clauses introduced in recent years. In accordance with the guidelines underlying the ESCB forecasts, which do not incorporate interventions that have yet to be defined in sufficient detail, the macroeconomic scenario excludes any measures for recouping revenue other than those already set out in current legislation; this is also the case of the recent projections of the European Commission.

Compared with June's macroeconomic projections, the price of oil is revised marginally down, the euro-dollar exchange rate is around 4 per cent higher (1.4 per cent higher in effective terms), and forward interest rates on ten-year BTPs decline slightly.

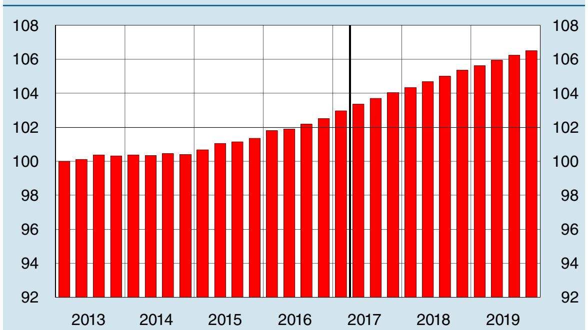
[2] The technical assumptions on interest rates, exchange rates and oil prices are calculated on the basis of the spot and forward prices observed in the markets in the ten working days to 7 July.

Under the macroeconomic scenario growth strengthens

Based on these assumptions GDP will grow by 1.4 per cent this year, 1.3 per cent in 2018, and 1.2 per cent in 2019 (Table 9 and Figure 35). Domestic demand is expected to be the main driver of economic activity; the contribution of net foreign demand, negative again this year, should be practically nil in 2018-19 (Figure 36). By 2019 GDP should have fully recouped the ground lost as a result of the sovereign debt crisis that began in 2011; it is still expected to be around 3 per cent below the level of 2007.

Figure 35

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 2017 Q1; projections thereafter.

Consumption continues to expand ...

Though slowing a little compared with 2015-16, consumption will expand at a similar pace to output and disposable income (Figure 37). The latter appears to have been held back by the increase in energy commodity prices since last summer, but will be boosted by the rise in employment, which is continuing but at a slightly slower pace than in the last two years now that the social security contribution relief for new permanent hires has come to an end. The unemployment rate will fall gradually, from 11.7 per cent in 2016 to 10.7 per cent in 2019; increased labour market participation in response to the steady improvement in employment prospects and the raising of the retirement age appears to be slowing the fall. The employment rate is projected to increase by around 2 percentage points overall compared with 2016.

... as does investment Investment, which began to expand at the end of 2014, will continue to do so at a relatively fast pace. That in productive facilities will grow at an average annual rate of 3 per cent, thanks to strengthening demand prospects, still very favourable financial conditions, and tax incentives. It is estimated that these measures contributed significantly to the acceleration of investment in 2016, which was especially marked in the second half of the year (see the box 'The trend in investment and the cyclical recovery', Chapter 6, *Annual Report for 2016*, 2017). The positive effects of the tax incentives – extended by the 2017 Stability Law that also contains new incentives for investment in advanced digital technologies – are expected to last until the second half of 2018, when their discontinuation will probably be followed by a temporary slowdown in capital accumulation. Investment in residential construction, which has been picking up since 2015, will instead continue to grow slowly. At the end of the forecasting horizon it is expected that

Table 9

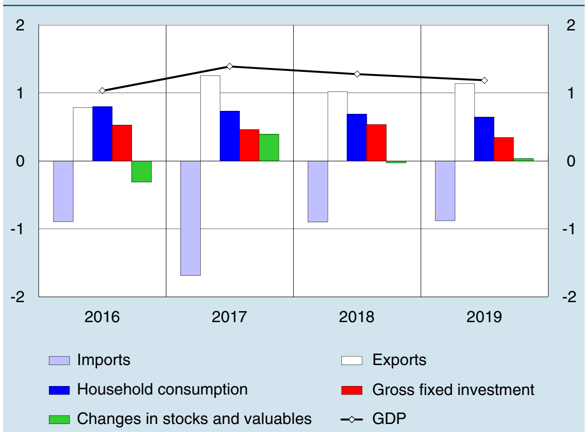
The macroeconomic scenario
(percentage changes on previous year unless otherwise indicated)

	2016	2017	2018	2019
GDP (1)	1.0	1.4	1.3	1.2
Household consumption	1.3	1.2	1.2	1.1
Government consumption	0.7	1.2	0.1	-0.2
Gross fixed investment	3.1	2.7	3.1	1.9
of which: in machinery, equipment and transport equipment	4.7	3.2	4.0	2.1
Total exports	2.6	4.0	3.0	3.4
Total imports	3.2	5.9	3.0	2.9
Change in stocks (2)	-0.3	0.4	0.0	0.0
HICP	-0.1	1.4	1.1	1.6
HICP net of food and energy	0.5	1.0	1.1	1.6
GDP deflator	0.8	0.7	1.5	1.5
Employment (3)	1.4	1.0	0.9	0.9
Unemployment rate (4)	11.7	11.3	10.9	10.7
Export competitiveness (5)	-2.1	1.2	0.2	0.0
Current account balance (6)	2.6	2.2	2.2	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 36

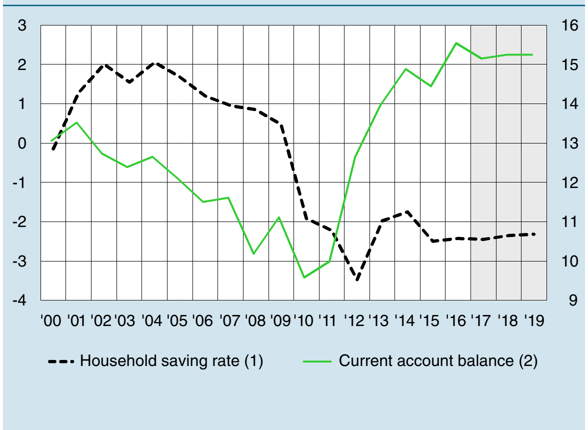
GDP growth and contributions of the main demand components and imports (1)
(percentage points)



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

Figure 37

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 ratio of investment to GDP will be just above the pre-crisis average (1998-2007) for machinery, equipment and transport equipment, while in the construction sector it will be more than 3 percentage points below that level (Figure 38).

Exports grow along with foreign demand

In the three years 2017-19 exports are expected to grow at virtually the same pace as demand from outlet markets, averaging around 3.5 per cent per year. Imports, which will rise by almost 6 per cent in 2017, will slow in 2018-19 in response to the performance of demand components with high import content (investment in production facilities and exports). In the macroeconomic scenario the surplus on the current account of the balance of payments will remain wide, at more than 2 per cent of output over the forecasting horizon.

Inflation rises gradually ...

Inflation, as measured by the harmonized index of consumer prices, will rise to 1.4 per cent this year (from -0.1 per cent in 2016), fall to 1.1 per cent in 2018, then turn upwards again to 1.6 per cent in 2019 (Figure 39). The projected trend for the two years 2017-18 can be ascribed mainly to the prices of imported energy and food products.

... assuming stronger wage growth

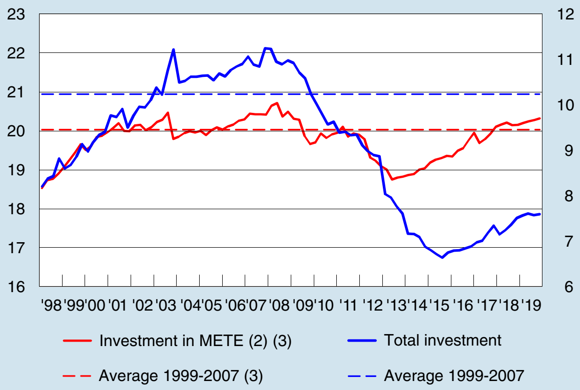
Core inflation is projected to stay at around 1 per cent this year and the next, and to reach 1.6 per cent in 2019, thanks to the gradual though still moderate acceleration in unit wages and to the effects – probably more marked towards the end of the forecasting horizon – of the end of social security contribution relief for workers hired in 2015 and 2016. Wages in the non-farm private sector will go up by around 1 per cent this year and the next, rising to 1.7 per cent in 2019. Profit margins in the private sector will continue to benefit from the strengthening recovery, increasing in the three years 2017-19 by around 1.5 per cent overall, but still 5 per cent below the levels of 2007.

Growth projections are revised upwards, those for inflation, downwards

Compared with our estimates published on 9 June as part of the Eurosystem staff macroeconomic projection exercise, the growth projections have been revised upwards by 0.4 percentage points this year and by 0.1 points in 2018. The more favourable assessments for this year are mostly due to revisions of the national

Figure 38

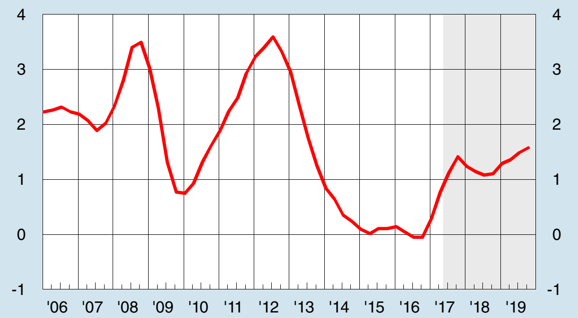
Investment as a percentage of GDP (1)
(quarterly data)



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 39

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



Sources: Based on Bank of Italy and Istat data.

accounts data, as well as to a higher estimate of output in the quarter just ended suggested by cyclical indicators. Compared with the projections in last January's *Economic Bulletin*, GDP has been revised up by 0.8 percentage points overall in the three years 2017-19; this primarily reflects more favourable assumptions regarding international developments and energy commodity prices. The inflation projections are slightly below those published last January for 2018, principally owing to lower imported energy prices.

Table 10

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

	GDP (1)			Inflation (2)		
	2017	2018	2019	2017	2018	2019
IMF (April)	0.8	0.8	0.8	1.3	1.3	1.4
OECD (June)	1.0	0.8	–	1.5	1.3	–
European Commission (May)	0.9	1.1	–	1.5	1.3	–
Consensus Economics (June)	1.1	1.0	–	1.4	1.3	–

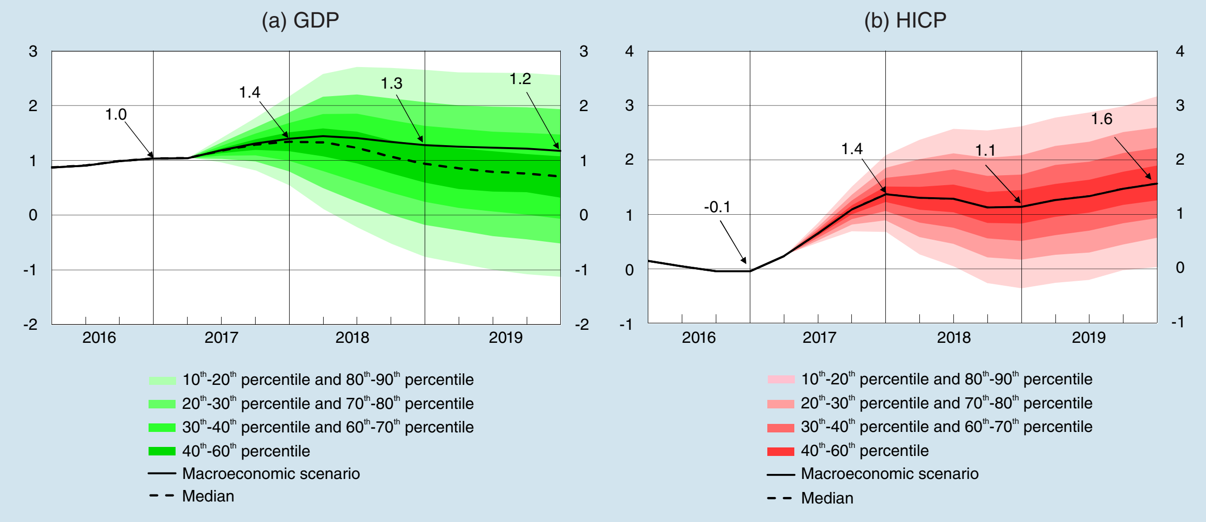
Sources: IMF, *World Economic Outlook*, April 2017; OECD, *OECD Economic Outlook*, *June 2016; European Commission*, *European Economic Forecast Spring 2017*, May 2016; Consensus Economics, *Consensus Forecasts*, June 2017.
(1) The growth rate forecasts of the OECD are adjusted for calendar effects; those of the European Commission and the IMF are not. – (2) HICP.

Our growth projections are more favourable than those of other forecasters

Our projections for GDP growth are more positive than those of the main international organizations (Table 10). For this year the differences are mostly ascribable to the better results to date, as confirmed by the revised national accounts data released in early June, and which are not incorporated in the projections of the IMF, OECD or European Commission.[2] Some of the differences for 2018-19, instead, can be ascribed to the technical assumptions regarding developments in the public accounts, for which the OECD and the IMF both incorporate a larger correction than the one envisaged in these projections. The Bank of Italy's inflation estimates are in line with those of the majority of the other forecasters for this year and on average 0.2 percentage points lower for 2018.

Figure 40

Distribution of probabilities of GDP and HICP projections (1)
(percentage changes on year-earlier period; 4-term moving averages)



(1) The probability distribution is graphed, for percentile groups, by fan charts, based on stochastic simulations made via random extractions from the shock distribution of the Bank of Italy's 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), 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.

[2] In the update to the outlook contained in the 'Italy: Staff Concluding Statement of the 2017 Article IV Mission' published on 12 June, the GDP growth estimate is revised upwards, to 1.3 per cent in 2017, and to around 1.0 per cent in the following two years.

The risks to growth stem from the global economic cycle and international financial markets ...

The macroeconomic deve-lopments outlined here assume that the cyclical upswing will strengthen gradually and that volatility will remain low on international financial markets, in line with the most recent developments. Uncertainty about the future of economic and trade policies remains high, however, at both global level and in the euro area. Uncertainties persist in particular about the future stance of policies in the United States and the outcome of talks to strike new trade deals with the United Kingdom.

... those to inflation from wage dynamics

Downside risks to inflation mainly stem from a possible weakening of the prospects for global expansion and lower wage growth: the gradual recovery in wages assumed here could be hindered by unused labour force capacity (which in terms of hours worked is greater than the rate of unemployment) and by the increased use of mechanisms linking pay increases to past rather than expected inflation. Near-term trends in energy commodity prices also continue to be shrouded in uncertainty. Overall, the risks are estimated to be mostly on the downside for growth and balanced for inflation (Figure 40).