3.10 SHORT-TERM FORECASTS

Italian economic growth slows

The world economic environment has deteriorated markedly since our previous forecast for the Italian economy was released with the July issue of the *Economic Bulletin*, with greatly heightened uncertainty over the macroeconomic outlook for the leading economies induced by the financial market turmoil caused by the Us subprime mortgage crisis. Over the same period, reflecting the changing market expectations for the performance of the leading economies, the euro continued to appreciate, further undercutting the price competitiveness of national products. The spot price of oil rose by $25 a barrel and the futures price by $20, reducing households' purchasing power and strengthening inflationary pressures; there were sharp increases for a number of agricultural commodities as well.

TECHNICAL ASSUMPTIONS AND THE INTERNATIONAL ENVIRONMENT

The assumptions on the growth of world output and trade underlying these short-term forecasts are the same as for the euro-area projections released in the ECB's December *Monthly Bulletin*. By contrast, the assumptions on exchange rates, interest rates and oil prices have been updated based on observations at the end of december and the start of January. They are less favourable than those underlying the eurosystem's december projections. The price of oil, close to $100 a barrel in the first few days of the year, follows the pattern of futures contracts, which imply an average of about $93 in 2008 and $89 in 2009. Three-month interest rates decline progressively from the level of nearly 5 per cent reached towards the end of last year to just over 4 per cent, according to euribor futures, in the final months of 2009. Long-term rates, corresponding to the yield of a basket of government securities with a duration of about 6 years, average 4.5 per cent over the two years. For exchange rates, the usual technical assumption that all bilateral exchange rates remain stable at the average of recent observations implies a dollar/euro rate of 1.46 over the forecast horizon.

Projections for the public finances take account of the effects of measures enacted in the budget for 2008 and do not diverge significantly from the estimates presented by the Government in the recent Programming and Planning Report for 2008.

Against this background, like the other large advanced economies the Italian economy is projected to grow less than potential output over the next two years. Average GdP growth, which was 1.7 per cent in 2007, is expected to decline to 1 per cent in 2008 and to rise slightly in 2009 on a calendar-adjusted basis (Table 9 and Figure 27). The downward revision for this year, equal to 0.7 percentage points with respect to the July forecast, is due essentially to three causes: the effect on households' disposable income of higher raw material prices (in six months the price of oil in euros rose by nearly 20 per cent and that of foodstuffs by more than 10 per cent); the appreciation of the euro (by 4 per cent in nominal effective terms in the second half of 2007), which has undercut the price competitiveness of Italian goods on all markets; and a lowering of the starting point, reflecting the slackening of economic activity in the last part of 2007. Comparable downward revisions are being made to growth forecasts in the other euro-area economies.

Exports flag due to cumulative loss of competitiveness

Export growth, which is estimated to have declined to just over 2 per cent in 2007, is expected to slow to 1.5 per cent in 2008 and regain strength in 2009. This forecast takes account of the current and lagged effects of the constant deterioration in price competitiveness for Italian goods (a cumulative loss of about 30 percentage points over the last five years, and projections of 5 more points over the next two).

Domestic demand is losing steam, both consumption...

Household consumption growth should slow by about a percentage point in 2008. Real disposable income, adjusted for the loss of purchasing power of financial wealth, will slow even more sharply, as a result of rising inflation. The usual increase in the propensity to consume during cyclical downturns will keep consumer spending ahead of the growth in income.

...and investment

The yearly increase in capital formation is expected to decline from 2.5 per cent in 2007 to 2 per cent in 2008 and 1.5 per cent in 2009. The sharpest slowdown will be in residential construction, as the housing market softens. A contributing factor is likely to be the lagged effect of the gradual tightening of financial conditions over the last two years on the real cost of capital and on investment decisions.

The external accounts worsen

The moderate pace of exports and investment – the demand components most reliant on goods made abroad – is expected to contribute to a gradual slowing of imports. However, because of the loss of price competitiveness for national products the slowdown will not suffice to prevent the contribution of net imports to GDP growth, which was virtually nil in 2007, from turning slightly negative this year (-0.3 per cent) before becoming positive again in 2009. The deficit on the current account of the balance of payments is forecast to increase by about 0.5 percentage points of GdP, owing in part to deterioration in the terms of trade.

Inflation to remain above 2 per cent for most of 2008

Consumer price inflation is forecast to rise to just over 2.5 per cent this year; the rate is expected to drop back to 2 per cent by the autumn and remain there in 2009 as a whole (Table 9). The revisions to the July forecasts mainly reflect the increases in the world prices of crude oil and agricultural commodities. In 2008 wage growth is expected to be affected by the conclusion of a number of industry-wide contracts that were not renewed in 2007: the rate of increase in unit labour costs is forecast at just under 3.5 per cent in the private sector and a little more than that in the whole economy (respectively, about 1 and 2 percentage points higher than in 2007); a contributing factor will be the cyclical weakening of productivity, which will return to stagnation. In a context of moderate growth and stepped-up competitive pressure from abroad, the acceleration in unit labour costs is likely to be accompanied by a temporary contraction in profit margins.

Table 9

Forecasts of the main macroeconomic variables

(annual percentage changes, except as indicated)

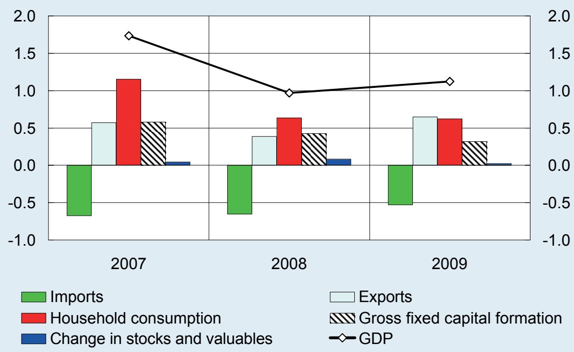
	2007	2008	2009
GDP (1)	**1.7**	**1.0**	**1.1**
Private consumption	2.0	1.1	1.0
Government consumption	0.3	0.5	0.2
Gross fixed capital formation	2.8	2.0	1.5
Exports	2.2	1.5	2.5
Imports	2.5	2.4	1.9
Change in stocks and valuables (2)	0.1	0.1	0.0
HICP (3)	**2.0**	**2.6**	**2.0**
Export competitiveness (4)	**-8.2**	**-3.3**	**-1.4**

Sources: Istat and Bank of Italy.
(1) For GDP and its components, chain-linked volumes; changes estimated on the basis of data adjusted for seasonal and calendar effects. On an unadjusted basis, the average GDP growth rates for the three years are estimated at 1.9, 1.0 and 1.2 per cent respectively. – (2) Contributions to GDP growth; percentage points. – (3) Harmonized index of consumer prices. – (4) Calculated by comparing the price of foreign manufactures with the deflator of Italian merchandise exports (excluding energy and agricultural products) in common currency.

Figure 27

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

(percentages)



Sources: Istat and Bank of Italy.
(1) Adjusted for seasonal and calendar effects.

The forecasts are subject to great uncertainty

The inherent uncertainty of economic forecasting is heightened at present by the doubts that still surround the likely evolution of international financial market turmoil. New difficulties on the financial markets and corrections on the property markets, particularly in the United states, could cause many economies to slow more sharply than expected, which would result in a definite slackening of world demand, whereas the eurosystem's december projections, adopted here, actually assume a slight pick-up. The uncertainty over the performance of oil prices, marked by high volatility, remains great. A further element of downside risk is the impact on consumer price inflation, hence on household income and consumption, of the recent sharp rises in the prices of foodstuffs, which have reflected both temporary restrictions in supply and probably non-contingent demand-side factors. The futures prices incorporated in the forecast signal a sharp slowdown in the prices of foodstuffs from the middle of this year, which could prove to be optimistic.

Turning to upside forecasting risk, it is worth noting that a crucial factor in the expected slowdown in exports is Italy's long-term loss of price competitiveness. however, at least for some sectors and some firms this could be offset by new structural advantages stemming from product innovation and technology. econometric forecasting instruments like those used to produce this scenario cannot detect such processes, but ad hoc studies have found evidence that they are under way. The interpretation of the recent performance and prospects of exports is complicated by doubts on the statistical attribution of total export values between volumes and average unit values. Istat has announced that a revision of these data will be performed in the first few months of the year.