3.9 SHORT-TERM FORECASTS

The short-term forecasts for the Italian economy presented here are based on the assumptions about the main international variables and interest rates set out in the box "Assumptions underlying the forecasts" and take account of the budgetary measures described in the box "The Economic and Financial Planning Document for 2009-2013 and the three-year budget proposals".

ASSUMPTIONS UNDERLYING THE FORECASTS

The assumptions regarding the growth of the world economy and world trade on which these forecasts are based are the same as those used for the projections for the euro-area economy published in the ECB's *Monthly Bulletin* in June. The slowdown of the American economy, the ongoing rise in commodity prices and the persistent turbulence in financial markets induce a considerable worsening of the world economic cycle: in both 2008 and 2009 the growth in global GDP is more than one percentage point lower than in 2007; that in world trade, which fell to just above 6 per cent in 2007, declines further this year, by about one percentage point, and then barely exceeds 5.5 per cent in 2009.

The assumptions regarding exchange rates, interest rates and oil prices, updated to take account of the average observations of the ten working days preceding 11 July, are generally less favourable than those underlying the Eurosystem's June projections. Oil prices average over $125 a barrel this year and, consistently with the prices implied by futures contracts, are close to $140 next year. Three-month interest rates, calculated on the basis of Euribor futures, rise to 5.2 per cent in the first quarter of 2009 (from 4.7 per cent in the first half of 2008), reflecting both the anticipated evolution of monetary policy and expectations that spreads on the interbank markets remain high; long-term interest rates, corresponding to the yield of a basket of securities with a duration of about six years, rise on average by around 30 basis points between 2008 and 2009. The assumption that bilateral exchange rates remain unchanged at the average levels recently observed implies a dollar/euro conversion rate of 1.57 for the entire forecasting period.

Projections for the public finances, which take account of the measures decided by the Government last month, are in line with those presented by the Government in the Economic and Financial Planning Document for 2009-2013.

With the world economic outlook darkening...

Since publication of the preceding forecasts for Italy in the January issue of the *Economic Bulletin* the outlook for GDP and world trade has become less favourable and more uncertain. Commodity prices have continued to soar. The projections for the price of oil this year and next are now respectively almost $35 and $55 a barrel higher than those made in January. Inflationary pressures have increased everywhere. The weakening of economic activity in the United States and the consequent easing of monetary conditions by the Federal Reserve have caused a further marked depreciation of the dollar in the last six months, by about 7.5 per cent against the euro. Although on the one hand the strengthening of the euro is increasing households' purchasing power, on the other it is undermining the competitiveness of goods produced in the euro area.

...activity in Italy is slowing down further

As a result of the deterioration in external conditions, the growth in the Italian economy estimated for the two years 2008-09 is now well below that forecast in January. After increasing fairly strongly in the first three months of this year, GDP is expected to stagnate in the subsequent seven quarters. It is predicted that its average annual rate of growth, which had been 1.4 per cent in 2007, will fall to 0.4 per cent both this year and next (Table 8 and Figure 28). The downward revision of growth forecasts by comparison with those made in January (by 0.6 percentage points for 2008 and by 0.7 points for 2009) is attributable first and foremost to the effect of the increase in the prices of imported raw materials on final consumer prices; by reducing households' spending capacity, it is damping the growth in private consumption and causing firms to scale down their investment plans because of the less favourable outlook for demand.

Exports continue to stimulate growth, but they are slowing markedly

Exports are reacting to the slowdown in world trade and the loss in price competitiveness (more than 5.5 percentage points in the two years 2008-09). It is estimated that the rate of growth in exports, which had already declined appreciably in 2007 (from 6.5 per cent in 2006 to 4.5 per cent), will be just over 2 per cent this year and 1.5 per cent next.

Domestic demand will stagnate over the two years, as regards both consumption...

Domestic demand is expected to stagnate this year and to grow little in 2009, reflecting barely positive rates of change in consumption and investment. The private sector's real disposable income is likely to be squeezed by higher inflation, both directly (owing to the deterioration in the terms of trade) and indirectly (reflecting losses in the real value of financial assets due to the acceleration in inflation). It is forecast that at the end of the two-year period purchasing power will still be below the average for 2007. Despite a sharp fall in the saving rate, which is normal during an economic downturn, private consumption is expected to do little more than stagnate both this year and next. It is estimated that had it not been for the acceleration in prices from 2007 onwards the growth in real disposable income by the middle of this year would have been more than one point higher than actually occurred, and 3 points higher if the loss in the real value of financial assets is taken into account. As a result, the overall growth in consumption in the two years 2008-09 would have been about 2 percentage points higher than forecast here.

...and investment

Gross fixed investment is expected to remain almost unchanged at the 2007 level, rising by about half a percentage point over the two-year period. Investment in construction, which increased by 2 per cent in 2007, will gradually slow, almost to the point of stagnation in 2009. Investment in productive capital, which had already declined in the second half of last year, is

Table 8

Forecasts of the main macroeconomic variables in Italy

(percentage changes on preceding year unless otherwise indicated)

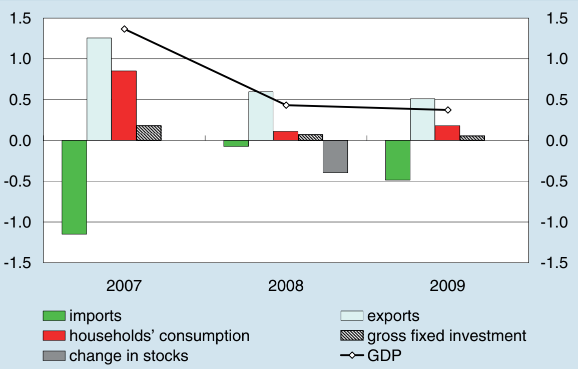
	2007	2008	2009
GDP (1)	**1.4**	**0.4**	**0.4**
Private consumption	1.5	0.2	0.3
Government consumption	1.3	0.6	0.3
Gross fixed investment	0.9	0.3	0.3
Exports	4.5	2.1	1.7
Imports	4.0	0.2	1.7
Change in stocks (2)	0.0	-0.4	0.0
HICP (3)	**2.0**	**3.8**	**2.8**
GDP deflator (3)	**2.3**	**2.6**	**2.5**
Export competitiveness (4)	**-5.3**	**-4.5**	**-1.2**

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) Contributions to GDP growth; percentages. – (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).

Figure 28

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

(percentages)



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

likely to contract by 0.7 per cent in 2008 and stagnate in 2009. These assessments reflect primarily the effects of the poor and uncertain demand prospects on investment decisions; it is estimated that adjustments in the cost of borrowing will have a less marked effect.

The external accounts worsen

In parallel with the slower growth in exports and the stagnation in investment (the demand components most reliant on goods manufactured abroad), there is expected to be a marked slowdown in imports, which are likely to be virtually unchanged this year and to grow by about 1.5 per cent in 2009, whereas they had grown by 4 per cent in 2007. Despite this overall favourable trade performance in volume terms, the expected pronounced deterioration in the terms of trade (by more than 7 percentage points over the two years) is likely to lead to a substantial increase in the deficit on the current account of the balance of payments (by about 2 per cent of GDP over the two-year period, taking it from 2.4 per cent in 2007 to 4.5 per cent in 2009).

Inflation will rise in 2008 and begin to fall again in 2009

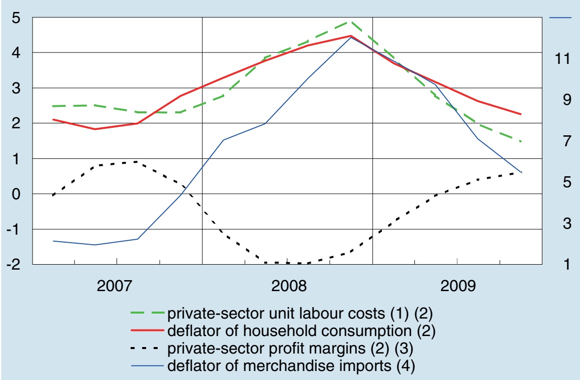
Consumer price inflation is expected to average 3.8 per cent this year, on a harmonized basis, and to fall to 2.8 per cent in 2009 (Table 8). The upward revisions by comparison with the estimates made in January (1.2 percentage points for this year and 0.8 points for 2009) mainly reflect the further increases in the price of oil. Domestic inflation, measured on the basis of the GDP deflator, will be affected by the acceleration in unit labour costs (their rate of increase will rise from about 2 per cent in 2007 to almost 4 per cent in 2008 before falling to around 2.5 per cent in 2009; Figure 29), but is expected to increase by much less, from 2.3 per cent in 2007 to around 2.5 per cent this year and next: the impact of unit labour costs on domestic prices should be largely offset this year by a narrowing of profit margins, reflecting, among other factors, the weakness of demand and competitive pressure generated by the appreciation of the euro. Mark-ups are likely to remain almost unchanged in 2009.

Comparison with other forecasters

Compared with those of other forecasters, our assessments are based on more recently updated assumptions, which is particularly relevant now, given the rapidity with which the reference framework is changing. Our estimate of GDP growth this year is in line with the average of those from the other leading forecasters (Table 9), but that for 2009 is lower. Our inflation forecasts for both years are higher than those of the other analysts. The differences regarding both economic activity and prices mainly reflect the recent increases in world energy prices.

Figure 29

Main determinants of consumer price inflation
(percentage changes on year-earlier period)



Sources: Based on Bank of Italy and Istat data.
(1) Unit labour costs in the private sector (excluding energy and agriculture); calculated as the ratio between compensation and output per standard labour unit; output is value added at factor cost. – (2) Left-hand scale. – (3) Ratio between the deflator of value added at factor cost and unit labour costs in the private sector (excluding energy and agriculture). – (4) Right-hand scale.

Table 9

Forecasts by other organizations
(annual percentage changes)

	GDP (1)		Inflation	
	2008	2009	2008	2009
IMF (April)	0.3	0.3	2.5	1.9
OECD (June)	0.5	0.9	3.6	2.1
European Commission (April)	0.5	0.8	3.0	2.2
Consensus Economics (June) (2)	0.4 [0.1-0.7]	0.9 [0.3-1.5]	3.2 [2.7-3.6]	2.5 [2.1-3.1]

Sources: IMF, *World Economic Outlook*, April 2008; OECD, *Economic Outlook*, No. 83, June 2008; European Commission, *Economic Forecasts*, April 2008; Consensus Economics, *Consensus Forecasts*, June 2008.
(1) The growth rates shown in the OECD forecasts are adjusted for calendar effects, whereas those published by the European Commission and the IMF are not. – (2) Average of projections made, on various dates, by 16 private forecasters; the numbers within square brackets are the highest and lowest values of the projections in the sample.

The forecasts are subject to great uncertainty

The uncertainty that surrounds these forecasts is particularly great. One significant ground for caution lies in the possibility that energy prices will continue to increase rapidly, further reducing households' spending capacity. The situation in the international financial market also remains uncertain, and may have repercussions on the prospects for growth in the world economy.

THE ECONOMIC AND FINANCIAL PLANNING DOCUMENT FOR 2009-2013 AND THE THREE-YEAR BUDGET PROPOSALS [1]

In the Economic and Financial Planning Document for 2009-2013, which was presented to Parliament at the end of June, the Government revised the estimates of net borrowing on a current programmes basis upwards by 0.1 percentage point of GDP for 2008 and by about half a point per year for the subsequent three years (see the Table). The new estimates take account of the effects of Decree Law 93 of 27 May 2008, which introduced tax reliefs [2] that are financed by cuts in expenditure, and of the further deterioration in the economic outlook, which led to a downward revision of revenue.

Table

Estimates and objectives for net borrowing between 2008 and 2013
(as a percentage of GDP)

	2008	2009	2010	2011	2012	2013
Figures on a current programmes basis in the Combined Report (March 2008)	**2.4**	**2.1**	**1.7**	**1.4**		
DL 93 (May 2008) (1)(2)	0.0	0.0	-0.1			
of which: net revenue (2)	*-0.1*	*-0.1*	*-0.1*			
net expenditure (2)	*-0.1*	*-0.1*	*-0.2*			
Figures on a current programmes basis in the Planning Document (June 2008)	**2.5**	**2.6**	**2.1**	**2.0**	**1.9**	**1.8**
Objectives in the Planning Document (June 2008)	**2.5**	**2.0**	**1.0**	**0.1**	**0.0**	**-0.1**
Correction necessary to achieve objectives (1)	0.0	-0.6	-1.1	-1.9	-1.9	-1.9
of which: DL 112 (June 2008) (1) (2)	*0.0*	*-0.6*	*-1.0*	*-1.8*		
of which: net revenue (2)	*0.1*	*0.4*	*0.4*	*0.3*		
net expenditure (2)	*0.1*	*-0.2*	*-0.7*	*-1.4*		
Structural net borrowing (Planning Document – June 2008)	**2.3**	**1.7**	**0.6**	**-0.3**	**-0.2**	**-0.2**

(1) A minus sign indicates an improvement in the balance. – (2) Based on official estimates.

The Planning Document aims to achieve a gradual reduction in net borrowing, from the figure of 2.5 per cent of GDP expected in 2008 (1.9 per cent in 2007) to broad budget balance in 2011, in line with the commitments made at European level. By comparison with the Combined Report on the Economy and Public Finances presented last March, the objective for 2009 is

[1] For an analysis of the Planning Document and Decree Laws 93 of 27 May 2008 and 112 of 25 June 2008, see the Testimony delivered to Parliament on 2 July 2008 by the Governor of the Bank of Italy, which will shortly be available on the Bank's website (www.bancaditalia.it).

[2] The Decree Law abolished municipal property tax on primary residences (it had already been reduced in the Finance Law for 2008) and reduced taxation on overtime pay and other variable components of wages, including productivity bonuses.

reined back from 1.8 to 2 per cent of GDP whereas those for subsequent years remain essentially unchanged. The structural budget deficit, calculated net of the effects of the economic cycle and one-off measures, is expected to worsen this year from 1.7 to 2.3 per cent of GDP but to improve by 0.6 points in 2009 and by about one point in both 2010 and 2011. It is estimated that public debt will stand at 103.9 per cent of GDP in 2008, broadly the same as last year, and will come down to 97.2 per cent in 2011.

The Planning Document sets out the objectives for the individual items in the general government account for the entire forecasting period, something that has not happened since the Document presented in June 1999. Together with the Planning Document, the Government approved Decree Law 112 of 25 June 2008, which outlines almost all of the measures necessary to achieve the objectives set for the three years from 2009 to 2011. Previously the practice had been to indicate in the Planning Document the objectives for the entire reference period and the scale of the corrections in relation to the estimates on a current programmes basis that were needed to achieve them, and then in September to present the budget proposals setting out the measures for attaining the objective for the first year.

The Government plans to achieve a large reduction of 2.8 percentage points in the ratio of expenditure to GDP between 2008 and 2013. Capital expenditure as a proportion of GDP is set to fall by almost one point to its lowest level of recent decades (excluding from the 2000 figure the proceeds of UMTS licences, which are recorded with a minus sign in this aggregate); primary current expenditure should come down by 1.7 points of GDP, owing mainly to the sharp contraction in compensation of employees and intermediate consumption. The ratio of tax and social security contributions to GDP should remain broadly unchanged after the reduction of 0.3 percentage points of GDP expected for 2008, at 43 per cent.

Achievement of the objectives calls for an escalating correction of net borrowing on a current programmes basis equal to 0.6 percentage points of GDP in 2009, rising to 1.9 points from 2011 onwards. The Decree Law of June reduces net borrowing by 0.6 percentage points of GDP in 2009, 1 point in 2010 and 1.8 points in 2011. The remainder will be achieved by means of the other measures that will make up the budget package: the Finance Bill and two draft enabling laws on fiscal federalism and the code of autonomy for local authorities.

The budget proposals for 2009 are based mainly on increases in revenue, whereas reductions in expenditure take centre stage in the two subsequent years. The measures to increase revenue are targeted in particular on branches of activity that have enjoyed high profits in recent years; the provisions to reduce expenditure mainly take the form of financial constraints and leave it for subsequent legislation to define precisely how they will be achieved. Many of the curbs will be effective only if decisive action is taken to increase the efficiency of public services.

The measures on the revenue side are expected to generate increases in receipts of about €2 billion in 2008 and more than €7 billion a year from 2009 onwards, offset partly by the effects of a reduction in revenue caused by certain measures to curb expenditure. The tax increases affect banks, insurance companies, firms in the energy sector and cooperatives.

On the expenditure side, the Decree lays down net increases of €1.7 billion in disbursements in 2008 and expenditure savings of €10.4 billion in 2009, €17.2 billion in 2010 and €31.2 billion in 2011, offset partly by an increase of about €6.5 billion in spending from 2009 onwards, mainly in connection with the renewal of labour contracts, the abolition of the prohibition on receiving pension and labour incomes simultaneously and incentives for public employees to take early retirement.

Around half of the reduction in expenditure relates to central government and consists in cuts in appropriations for the major “missions” into which the central government budget is divided; almost one third relates to local authorities and will be achieved by revising the Stability Pact, a change that will be approved in the next few months. In the health sector, notwithstanding complete compliance with the deficit elimination plans, the responsibility for reducing expenditure is delegated to the Regions under an agreement with central government. The rise in staff costs will be held in check by further tightening the limits on the replacement of departing staff and capping appropriations for the renewal of labour contracts.