3.10 FORECASTS

The recovery of the world economy and trade ...

Since our last forecasts issued in the July *Economic Bulletin*, world output and the volume of world trade have returned to growth, drawing strength from fiscal and monetary stimulus and the improvement in financial market conditions, even though lending to the private sector has remained sluggish. The forecasts of the main international organizations for world growth in 2010 have been revised upwards to around 3 per cent. The improvement in the current situation and in the outlook has been reflected in rising spot and futures prices for energy commodities, but their prices are still far below the peaks registered in the summer of 2008 (see the box "Assumptions underlying the forecasts").

ASSUMPTIONS UNDERLYING THE FORECASTS

The assumptions regarding the growth of the world economy and world trade on which the macroeconomic scenario is based are the same as those used for the euro-area forecasts published in December in the ECB's *Monthly Bulletin*. They are less optimistic than the latest estimates of the OECD but not significantly different from those of the European Commission. The world economy is assumed to continue to grow this year and next at an annual rate of between 3 and 4 per cent, slower than in the recent past. World trade, after a contraction of nearly 12 per cent in 2009, is assumed to grow by just over 4 per cent this year and nearly 5 per cent in 2011.

The assumptions regarding interest rates and exchange rates and the price of oil take account of the information available in the ten working days preceding 12 January 2010. The price of Brent crude oil averages $83 a barrel this year and $88 next year. Three-month interest rates, based on the prices of Euribor futures, are assumed to hold at just over 1 per cent on average for 2010 and then rise to 2.2 per cent in 2011. Long-term interest rates (corresponding to the yield of a basket of government securities with a duration of about 6 years) are 3.8 per cent in 2010 and 4.2 per cent in 2010. For exchange rates, the technical assumption that all bilateral rates remain unchanged at their average levels of the last two weeks implies a dollar/euro conversion rate of 1.44 over the entire forecasting horizon. Lending conditions to firms assume the easing of credit market strains in the course of 2010, in keeping with the indications of the Bank Lending Survey for a substantial easing of lending standards (see the box "Credit supply and demand in Italy").

The projections for the public finances take account of the Finance Law for 2010 and the other government measures of recent months.

... is pulling Italy out of the recession

In Italy the 0.6 per cent growth of GDP in the third quarter marked the end of a protracted recession during which output declined by 6.5 per cent over 15 months, falling back to its end-2001 level. The recovery in economic activity is expected to proceed slowly in the course of the year, restrained by the slackness of domestic demand in a situation in which, in Italy as elsewhere, the effects of the stimulus measures taken to combat the crisis will be waning. Not until 2011, in fact, is quarterly GDP forecast to grow at least as fast as potential output, reflecting a further acceleration in the expansion of world trade and better labour market conditions. The central scenario calls for GDP, after a contraction of 4.8 per cent in 2009, to grow by 0.7 per cent on average in 2010 and accelerate to 1 per cent the following year (Figure 34 and Table 11). This represents an upward revision of the July forecasts of 0.4 percentage points for 2009 and 0.7 for 2010, due almost entirely to more favourable assumptions on world trade, which is now expected to grow by more than 4 per cent for 2010 as a whole (compared with our July forecast of 0.8 per cent).

In the third quarter Italian exports gained renewed impetus from the upswing in world trade. We estimate that foreign sales will increase by about 3 per cent both this year and next, after contracting by nearly 20 per cent in 2009. However, exports will grow more slowly than world trade, owing to the lagged effect of the substantial losses of competitiveness accumulated in years past and the more limited losses expected over the forecasting horizon. This will result in a further shrinking of Italy's world market share, which has fallen steadily since 2001.

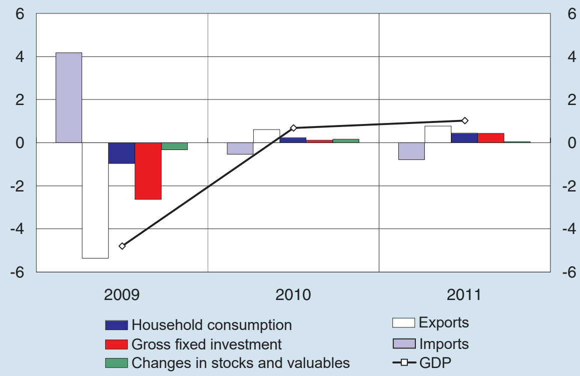
Exports are rising but more slowly than world demand

Investment should start to grow again ...

After a contraction of more than 15 per cent in the last two years – a sharper fall than in the 1992-93 recession – capital formation should begin to increase again, fostered by the easing of strains in the credit market (see the box "Credit supply and demand in Italy"), expansive monetary conditions and tax incentives for expanding production capacity (see the box "Recent public finance measures", *Economic Bulletin* No. 53, July 2009). Total investment is forecast to increase by 0.7 per cent on average in 2010 and to accelerate to growth of more than 2 per cent in 2011. Investment in productive capital, which enjoys greater tax advantages, is expected to increase by over 6 per cent in 2010-11, despite a pause in the second half of the current year with the waning of the effects of the tax incentives for machinery purchases (which expire on 30 June). Even considering the government incentives for the enlargement of dwellings, residential investment is expected to remain slack for much of the forecasting period, as a consequence of the continuing weakness of the real estate market; it will not return to relative buoyancy until the end of 2011.

Figure 34

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.

Table 11

Forecasts of the main macroeconomic variables in Italy
(percentage changes on previous year unless otherwise indicated)

	2009	2010	2011
GDP (1)	**-4.8**	**0.7**	**1.0**
Household consumption	-1.7	0.4	0.7
Government consumption	1.5	0.3	0.4
Gross fixed investment	-12.6	0.7	2.3
Exports	-19.2	2.6	3.1
Imports	-14.9	2.1	3.0
Change in stocks (2)	-0.3	0.2	0.0
HICP (3)	0.8	1.5	1.9
Export competitiveness (4)	-2.8	-1.1	-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; 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).

... and also consumption, despite the persistent weakness of the labour market

The slowness of the recovery in industry, whose November output was about 20 per cent below pre-crisis levels, will continue to weigh on labour demand, which is not forecast to return to growth until 2011. The poor employment outlook and the consequently greater caution in spending decisions will affect household consumption, which should rise by barely 1 per cent overall in 2010-11, slower than GDP despite the support to disposable income deriving from large-scale recourse to the Wage Supplementation Fund.

The external accounts are likely to worsen

Spurred by the upturn in the demand components with the greatest foreign content, imports should grow by about 2 per cent in volume terms in 2010 and 3 per cent in 2011. The deficit on the current account of the balance of payments would widen by nearly one percentage point of GDP, reflecting a deterioration in the terms of trade as energy prices rebound from the lows of early 2009.

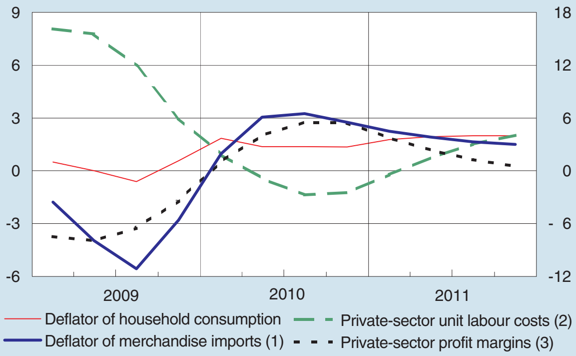
Consumer price inflation will be between 1.5 and 2 per cent

Consumer prices – measured by the harmonized index of consumer prices – are forecast to rise by 1.5 per cent on average for 2010 and 1.9 per cent for 2011; and core inflation is expected to be roughly the same. The marked cyclical improvement forecast for labour productivity should result in a sharp slowdown in the rise of unit labour costs in the private sector (after the rapid increases registered in 2008 and 2009) and a significant diminution in the domestic component of inflation, which should fall to less than 2 per cent. As activity recovers while the rise in costs moderates, private sector profit margins, following the usual cyclical pattern, should increase by a total of 3 percentage points in 2010-11, recouping more than half the decline of the last two years (Figure 35).

Figure 35

Main determinants of consumer price inflation

(percentage changes on year-earlier period)



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

Table 12

Forecasts of other organizations

(percentage changes on previous period)

	GDP (1)		Inflation (2)	
	2010	2011	2010	2011
IMF	0.2	–	0.9	–
OECD	1.1	1.5	0.9	0.8
European Commission	0.7	1.4	1.8	2.0
Consensus Economics	0.9	–	1.4	–

Sources: IMF, World Economic Outlook, October 2009; OECD, Economic Outlook No. 86, November 2009; European Commission, European Economic Forecast – Autumn 2009, October 2009; Consensus Economics, Consensus Forecasts, December 2009.
(1) The growth rates given in the OECD forecasts are adjusted for calendar effects, unlike those of the European Commission and the IMF. – (2) HICP.

Most forecasters expect the recovery to be gradual

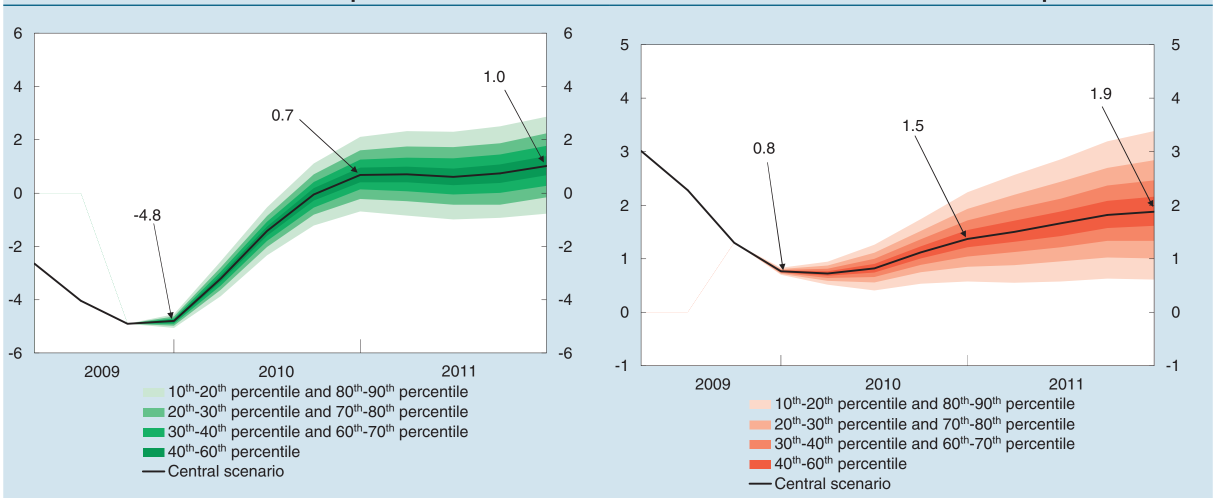
Our GDP forecast for 2010 is less optimistic than that of the OECD or the average of the forecasters surveyed by Consensus Economics in December. It is in line with the forecast of the European Commission and 0.5 percentage points higher than that of the IMF (Table 12). For 2011 the OECD and the Commission forecasts are about half a percentage point higher than our own. The discrepancy with respect to the OECD is due largely to our more prudent assessment of the recovery in world trade (and also to a less optimistic evaluation of the effects of the termination of the fiscal stimulus measures). The forecasting scenario of the Commission, instead, assumes a faster return of the household saving rate to pre-crisis levels, and hence faster growth of consumption. Our inflation estimates are in line with the Consensus Economics average but lower than the Commission's forecast (consistently with the differences in the domestic demand forecasts) and considerably higher than those of the IMF and the OECD.

Considerable uncertainty still surrounds the forecast scenario

The macroeconomic scenario set out here is subject to very considerable uncertainty as regards the strength and course of the recovery both in Italy and worldwide (Figure 36). The GDP growth forecast for Italy of less than 1 per cent for 2010 as a whole is the central value in a broad range, with a 70 per cent probability that the

Figure 36

Distribution of probabilities of GDP and HICP forecasts (1)
(percentage changes on corresponding period of previous year; 4-term moving average)



(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 figure shows year-on-year percentage changes of four-term moving averages. The value corresponding to the fourth quarter of each year coincides with the average annual percentage change.

GDP outturn will fall within a confidence interval of ± 1 percentage point. Among the factors that could produce a better growth scenario are the possibilities of faster expansion in world trade (especially in 2011, for which our scenario assumes growth still considerably lower than the average for the last 20 years) and – in the short term – of faster inventory replenishment. One of the main sources of downside risk is the possibility, despite the emergence from the recession, that a protracted period of weak demand could slow the return to productive employment of workers now receiving Wage Supplementation benefits. This would result in a further reduction in households' purchasing power, making the recovery feebler. The deterioration in the public finances of the leading advanced countries, caused by the crisis and aggravated by fiscal stimulus measures, could lead to a significant increase in the cost of borrowing, and not only for the public sector. As for inflation, upside risks would come from the possibility of even faster rises in oil and other raw material prices, driven by the world economic recovery and fuelled in part by abundant global liquidity; slower price increases, by contrast, could be the result of a weaker economic recovery than forecast here.