3.9 FORECASTS

The global economy is accelerating this year, despite the ongoing uncertainty

Since the publication of our last macroeconomic scenario for 2010-11 in the January *Economic Bulletin*, international trade has accelerated sharply, nearly regaining the volumes recorded before the crisis; international organizations' forecasts for world economic growth in 2010 have accordingly been revised upwards with none now predicting growth of under 4 per cent (see the box "The assumptions underlying the 2010-11 forecasting scenario"). From the spring onwards, the markets' concerns over the sustainability of sovereign debt in some euro-area countries led to a substantial widening of spreads on the government securities of the countries concerned and the pronounced weakening of the euro, whose value against the dollar fell by over 15 per cent compared with the highs recorded last autumn. In response to these developments, the main European countries announced major budget corrections.

THE ASSUMPTIONS UNDERLYING THE 2010-11 FORECASTING SCENARIO

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 the ECB's *Monthly Bulletin* in June. They are less optimistic than the latest estimates of the OECD but not significantly different from those of the European Commission and the IMF. With the recession behind us, the world economy is assumed to return to rapid growth of about 4 per cent this year and next. World trade, after a contraction of more than 11 per cent in 2009, grows by just over 9 per cent this year and nearly 6 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 July 2010. The price of Brent crude oil averages $77.00 a barrel this year and $78.50 next year. Three-month interest rates, based on the prices of Euribor futures, come to 0.8 per cent on average this year and then rise to 1.2 per cent in 2011. Long-term interest rates (corresponding to the yield of a basket of government securities with a duration of about six years) are 3.6 per cent in 2010 and 4.2 per cent in 2011. For exchange rates, the standard technical assumption that all bilateral rates remain unchanged at their average levels of the last two weeks implies a dollar/euro conversion rate of 1.25 over the entire forecasting horizon. Lending conditions for firms are assumed to become gradually easier.

The projections for the public finances take account of the corrective measures announced by the Italian Government on 31 May.

Italy's economy will continue to expand at a moderate pace this year and in 2011 …

Economic activity in Italy is likely to slow down in the second half of 2010, as the measures to stimulate consumption and investment during the crisis run their course. The economic expansion will proceed at a moderate pace in 2011, checked in part by the restrictive impact on domestic demand of the Government's measures to adjust the public finances (see the box "Measures concerning the public finances for 2011-13"). Our central scenario projects a 1 per cent increase in GDP this year and in 2011 (Figure 34 and Table 9). Compared with the forecast presented in January, the upward revision of the growth estimates for 2010, equal to 0.3 percentage points, is largely attributable to the more favourable development of world trade than was expected at that time. In 2011 the greater contribution of foreign demand should be mostly offset by the effect of the budget measures.

... driven by the marked upturn in exports

Sales abroad will be the most dynamic component of aggregate demand, outpacing the predicted increase in international trade in 2010 after nine years of declining market shares, thanks to the gains in competitiveness due to the depreciation of the euro (down by over 5 per cent in effective terms compared with the average in 2009). After the collapse of 2009, exports will expand by around 9 per cent this year and by nearly 5 per cent in 2011.

Productive investment will recover while that in construction will remain weak ...

Investment in machinery and equipment, which in the first quarter of 2010 was sustained by the tax incentives under the "Tremonti-ter" law (Decree Law 78/2009), will return to brisk expansion (by an average of over 4 per cent per year), benefiting from the recovery in demand expectations, improved profitability conditions and the easing of strains in the credit market. But the negative phase for construction investment will continue this year, owing to the protracted weakness of the property market, while in 2011 it is expected to return to growth of nearly 2 per cent.

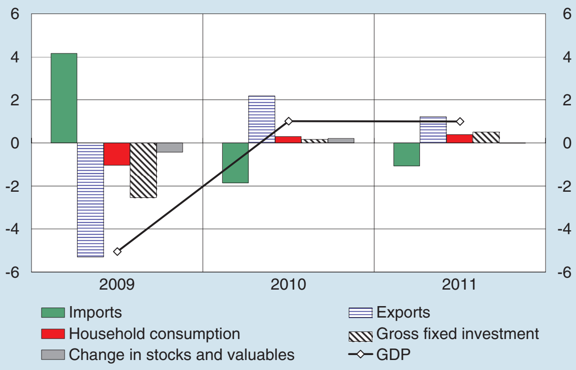
... like consumer consumption, held in check by a weak labour market and the effects of the budgetary measures

The slow strengthening of economic activity and the consequent gradual reintegration of workers on wage supplementation will further delay any robust recovery in the labour market. The unemployment rate will rise over the next few quarters to nearly 9 per cent on a seasonally adjusted basis. Continuing uncertainty over job prospects and the effects of the measures to correct the public accounts will weigh on household consumption, which will expand by about half a percentage point each year, considerably less than GDP. Once the effects of incentives to purchase energy-efficient vehicles have worn off, expenditure on durable goods will stagnate again until mid-2011.

Figure 34

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

(per cent and percentage points)



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

Table 9

The macroeconomic scenario in Italy

(percentage changes on previous year unless otherwise indicated)

	2009	2010	2011
GDP (1)	**-5.1**	**1.0**	**1.0**
Household consumption	-1.8	0.5	0.6
Government consumption	0.6	0.1	-0.1
Gross fixed investment	-12.2	0.8	2.6
Exports	-19.1	9.1	4.8
Imports	-14.6	7.3	4.0
Change in stocks (2)	-0.4	0.2	0.0
HICP (3)	**0.8**	**1.5**	**1.9**
Export competitiveness (4)	**-4.1**	**2.9**	**0.0**

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); positive values indicate competitiveness gains.

MEASURES CONCERNING THE PUBLIC FINANCES FOR 2011-13

The Government has adopted, with Decree Law 78/2010, a set of adjustment measures for the public finances in the next three years. The decree law, which is being examined by Parliament for its forthcoming ratification as a law, reduces net borrowing, compared with that on a current legislation basis, by €12.1 billion in 2011 and about €25 billion in 2012 and 2013. Two thirds of the adjustment is to come from reductions in expenditure (above all current expenditure) and one third from increases in revenue, produced largely by the fight against tax evasion.

Revenue measures. – Net additional revenue of €4.1 billion is expected in 2011 and about €9 billion on average in each of the two following years (Table).

The measures that increase revenue are mainly in connection with the fight against tax evasion, and these are expected to generate €5.1 of additional revenue in 2011 and €7.2 billion on average in each of the two following years. The most important provisions concern: the introduction of caps on the offsetting of tax credits and debits (officially estimated to produce €1.6 billion of additional revenue per year); the strengthening of assessment and collection, above all by reducing the time between the notification of assessment and forced execution (€1.6 billion per year); the strengthening of the checks on firms that systematically make losses or close within a year of opening for business (€0.9 billion per year); the requirement to give electronic notification of transactions of €3,000 or more subject to VAT (€0.8 billion per year); some changes to the rules on table-based assessment of income (€0.8 billion); application of the OECD guidelines on the documentation of transfer prices (€0.5 billion); and application of a withholding tax to payments for restructuring works subject to tax benefits (€0.4 billion per year). Other increases in revenue derive mostly from the introduction of charges on the motorway network for which ANAS is responsible and increases in the cost of motorway concessions (€0.6 billion per year) and the updating of the property register with the inclusion of previously unrecorded buildings (about €0.1 billion per year).

The measures that decrease revenue mainly concern the possibility of reducing, in a future decree, the size of the payment in advance of personal income tax both in 2011 and in 2012, by a different amount in each year. It is expected that this would result in the postponement of €2.3 billion of revenue from 2011 to 2012 and of €0.6 billion of revenue from 2012 to 2013.

Expenditure measures. – The decree law is expected to bring a net decrease in expenditure of €8 billion in 2011 and of about €16 billion on average in each of the two following years (Table).

The decree law increases expenditure by €2.2 billion in 2011 and by €0.7 billion on average in each of the two following years. The expansionary measures mainly concern the allocation of resources to the Fund for structural economic policy interventions (€0.7 billion per year), the creation of a *Roma capitale* fund (with disbursements of €0.3 billion per year) and the expenditure on the censuses conducted by Istat (€0.2 billion per year).

On the other hand it provides for expenditure cuts amounting to €10.2 billion in 2011 and €16.6 billion on average in each of the two following years. More than half of the cuts are to be borne by the local authorities. More specifically, regions, provinces and municipalities are required to reduce expenditure by €5.2 billion, €0.4 billion and €2.2 billion respectively on average each year. A significant contribution is also expected from the measures regarding social security, which are expected to produce progressively larger savings over the three years that would average €2.5 billion per year; in particular, these measures concern: the postponement of the starting date for pensions that mature after 31 December 2010 (setting the interval between the retirement date and the payment of the first monthly instalment equal to 12 months for employees and 18 months for self-employed workers); the payment of public-sector severance pay in excess of €90,000 by instalments (in two or three annual payments depending on whether the amount is less or more than €150,000); and the tightening of INPS checks on disability pensions and of the requirements for eligibility for such assistance. The decree law also provides for cuts in the spending of government departments by reducing budget appropriations by 10

The effects of Decree Law 78/2010 on the general government consolidated accounts
(millions of euros)

	2011	2012	2013
REVENUE			
Measures that increase revenue	**6,413**	**10,716**	**8,204**
Fight against tax evasion:	5,063	7,607	6,795
Strengthening of assessment and collection	*955*	*1,963*	*1,763*
Ban on offsetting credits	*700*	*2,100*	*1,900*
Electronic invoices	*628*	*837*	*837*
New presumptive income tables	*741*	*709*	*815*
Regularly loss-making and "open and shut" firms	*633*	*1,025*	*1,066*
10% withholding tax on building renovation payments	*756*	*559*	*0*
Application of OECD transfer pricing guidelines	*651*	*415*	*415*
Reduction in personal income tax payments on account	0	2,300	600
Other	1,351	808	808
Measures that decrease revenue	**-2,318**	**-625**	**-200**
Reduction in personal income tax payments on account	-2,300	-600	0
10% withholding tax on building renovation payments	0	0	-168
Other	-18	-25	-33
NET CHANGE IN REVENUE	**4,095**	**10,091**	**8,004**
EXPENDITURE			
Measures that increase expenditure	**2,228**	**851**	**470**
Current expenditure	**1,908**	**531**	**150**
Fund for structural economic policy interventions	*1,700*	*250*	*0*
Health system	*0*	*0*	*0*
Istat census	*200*	*277*	*150*
Peace missions	*0*	*0*	*0*
Other	*8*	*4*	*0*
Capital expenditure	**320**	**320**	**320**
Health system (health card)	*20*	*20*	*20*
Roma capitale	*300*	*300*	*300*
Measures that decrease expenditure	**-10,186**	**-15,742**	**-17,445**
Current expenditure	**-9,436**	**-14,442**	**-15,545**
10% reduction in spending of government departments	*-665*	*-750*	*-800*
Compensation of employees	*-1,003*	*-1,485*	*-1,787*
Health system (savings on pharmaceuticals)	*-600*	*-600*	*-600*
Payment of public-sector severance pay by instalments	*-400*	*-240*	*0*
Reduction in periods eligible for retirement	*-360*	*-2,600*	*-3,500*
Tighter requirements and checks for disability pensions	*-80*	*-160*	*-220*
Local authorities	*-6,300*	*-8,500*	*-8,500*
Ordinary statute regions	-4,000	-4,500	-4,500
Municipalities	-1,500	-2,500	-2,500
Provinces	-300	-500	-500
Special statute regions and autonomous provinces	-500	-1,000	-1,000
Other	*-29*	*-107*	*-138*
Capital expenditure	**-750**	**-1,300**	**-1,900**
10% reduction in spending of government departments	*-750*	*-1,300*	*-1,900*
NET CHANGE IN EXPENDITURE	**-7,958**	**-14,891**	**-16,975**
CHANGE IN NET BORROWING (1)	**-12,053**	**-24,982**	**-24,979**

Source: Senate of the Republic, XVI Legislature, *Atti parlamentari*, no. 2228.
(1) A positive sign indicates an increase, a negative sign a decrease.

per cent, including on capital account, which reduce expenditure by €2.1 billion on average per year. Major adjustments are also made to the compensation of employees in the public sector, with cuts amounting to €1.4 billion on average per year. This result derives from the freezing of individual pay at the 2010 level (except for the payment of the contract hiatus allowance), the extension to 2012 and 2013 of the 20 per cent limit on the replacement of departing staff in central government (excluding the police forces, firemen and university staff, to whom less stringent limits apply), and the postponement to 2011 of the effects of the reorganization of careers in the security sector and the armed forces. Lastly, provision is made for reductions in pharmaceutical expenditure of €0.6 billion per year, primarily by reducing the margins of wholesalers and pharmaceutical companies.

The external accounts will improve

Stimulated by the recovery of the demand components most reliant on goods manufactured abroad, imports will expand by over 7 per cent on average this year and by 4 per cent in 2011. The deficit on the current account of the balance of payments will narrow by around half a percentage point of GDP, reflecting, in addition to the positive contribution of the volumes traded, the improvement in the balance on investment income.

Consumer inflation will near 2 per cent in 2011

Inflation, measured by the harmonized index of consumer prices (HICP), will come to 1.5 per cent on average for the year and 1.9 per cent in 2011, pushed up by the depreciation of the euro. The increase in the index excluding the energy and food components is estimated at around 1.5 per cent a year in 2010-11. The strong cyclical improvement in labour productivity will trigger an appreciable slowdown in the growth of private sector unit labour costs and a sharp fall in the domestic component of inflation, which will remain below 1 per cent this year and 2 per cent on average in 2011. As productive activity recovers and costs moderate, private sector profit margins, in line with the usual cyclical pattern, will expand by just over two percentage points in the two years 2010-11, recouping about half of the decrease recorded in the last two years (Figure 35).

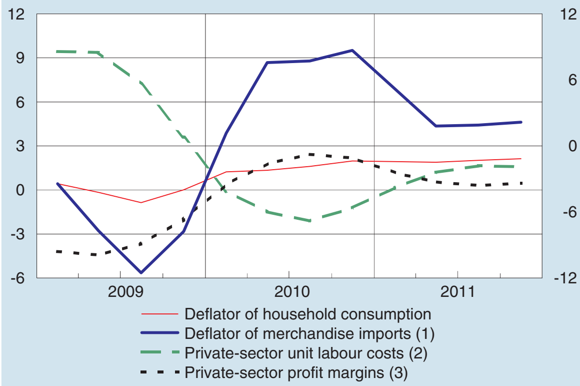
Comparison with other international forecasts

For this year, our central GDP projection is in line with that of most forecasters (Table 10). For 2011 the OECD and the European Commission have estimated average Italian GDP growth in April and May of half a percentage point more than that forecast here; those scenarios did not take the recent budgetary measures into account.

Figure 35

The main determinants of consumer 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 10

Forecasts by international organizations for Italy

(annual percentage changes)

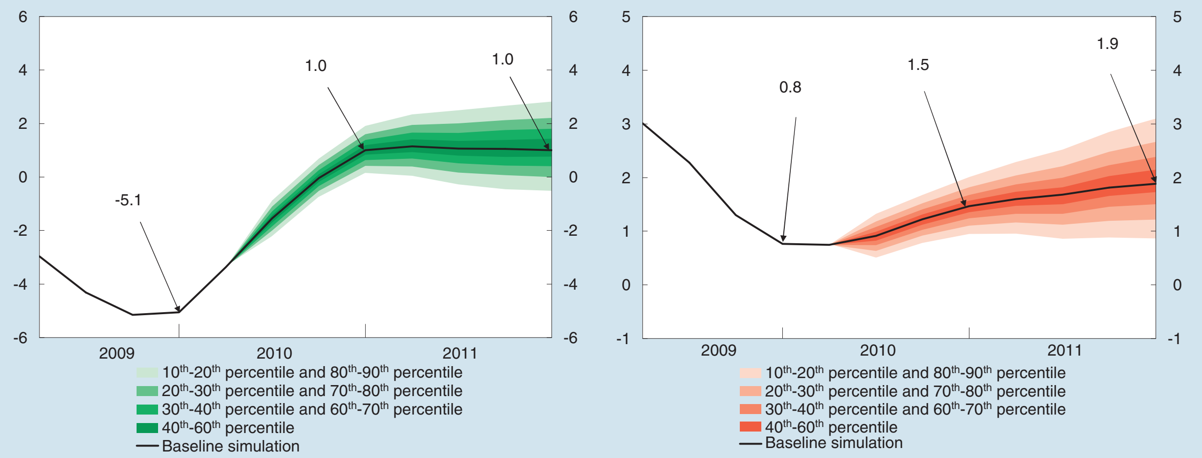
	GDP (1)		Inflation (2)	
	2010	2011	2010	2011
IMF (July)	0.9	1.1	–	–
OECD (May)	1.1	1.5	1.4	1.0
European Commission (April)	0.8	1.4	1.8	2.0
Consensus Economics (June)	0.9	1.0	1.5	1.7

Sources: IMF, *World Economic Outlook Update,* July 2010; OECD, *Economic Outlook* 87, May 2010; European Commission, *European Economic Forecast - Spring 2010*, April 2010; Consensus Economics, *Consensus Forecasts*, June 2010.
(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) Measured based on the HICP.

Figure 36

Distribution of probabilities of GDP and HICP forecasts (1)

(percentage change on corresponding period of previous year; 4-term moving average)



Source: Bank of Italy calculations.
(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 annual percentage change.

Considerable uncertainty still surrounds the forecast

Our macroeconomic scenario is subject to a high degree of uncertainty regarding the strength and evolution of the recovery, both internationally and in Italy (Figure 36). A vital necessity for the consolidation of growth prospects, implicit in the central GDP forecast, is a positive assessment by the markets of the measures to right the public accounts. Any fresh tensions over sovereign debts would open up a less favourable scenario with a deterioration in the lending conditions for the private sector too; additional measures to correct the budget deficit could further curtail the growth of output. On the other hand, there is also the possibility that the expansion of world trade (assumed to slow by over three percentage points in 2011) will be more vigorous than forecast. The risks surrounding the inflation forecasts also appear balanced, mirroring those related to productive activity.