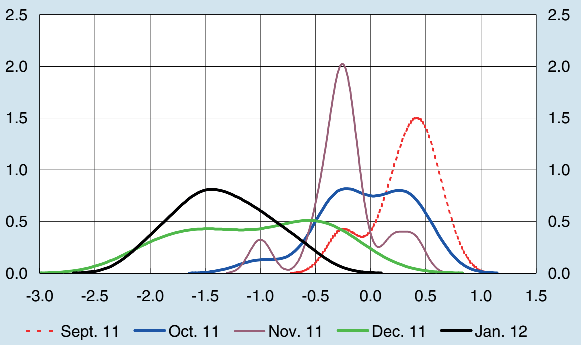
3.10 FORECASTS

Financial conditions and the world economic outlook have worsened; uncertainty remains high

Figure 30

Distribution of Italian GDP forecasts for 2012 (1)



Source: Based on Consensus Economics data.
(1) Average annual rates of change; percentages. The vertical axis gives the value of probability density that approximates the distribution of the forecasts; a higher value corresponds to a forecast on which a larger number of analysts concur.

Compared with the forecasting framework set out in last July's *Bulletin*, the worsening of the sovereign debt crisis and the slowdown in world trade have resulted in a deterioration of growth prospects in Italy and the euro area, which international organizations and private analysts have progressively factored into their estimates. On average, the analysts surveyed by Consensus Economics in January predict a significant contraction of Italian GDP in 2012, whereas last September they had still been oriented towards positive growth. The dispersion of the forecasts has also increased substantially in the past two months (Figure 30).

The outlook depends primarily on the evolution of the sovereign debt crisis

The degree of uncertainty over the course of the sovereign debt crisis is exceptional and is reflected also in interest rates, banks' balance sheets and lending volumes. One cannot rule out the possibility that funding difficulties may give rise to a tightening of lending policies, which would reduce the spending capacity of households and firms. These difficulties can be mitigated by the Eurosystem's aggressive interventions in support of the banking industry. A restoration of confidence in Italy's ability to honour its debt could reduce the cost of credit to households and firms. However, interest rates and credit trends also depend on developments in the international financial markets and decisions taken at European level.

In our first forecasting scenario, as usual, it is assumed that the interest rates on government securities reflect the recent shape of the yield curve. This results in a spread between ten-year BTP and Bund rates of about 500 basis points for all of 2012 and 2013 (see the box "Forecasting assumptions and the international context"). In order to evaluate the sensitivity of the forecast to financial and credit market developments, a second forecasting scenario posits the partial normalization of conditions in the financial and credit markets. It assumes, starting in the first quarter, yields on long-term Italian government securities lower than those currently incorporated in financial market prices and a faster easing of credit supply strains. The risk of a substantial worsening of financial conditions even with respect to the first scenario cannot be ruled out, however.

The assumptions on world trade are based on the estimates of international institutions, updated in the light of the latest data (for further details on how projections are made using the Bank of Italy's econometric model, see the box "The construction of the forecasting scenarios", *Economic Bulletin*, July 2009). World economic growth has slackened despite positive signals from the United States. World trade is expected to expand by less than 3 per cent this year (half the estimate of its growth in 2011) and to accelerate to about 7 per cent in 2013.

Italy's GDP declines this year and turns upwards during 2013

The cyclical indicators signal that the mild contraction of Italian GDP registered in the third quarter deepened in the fourth. We consider that the recession will continue through 2012. The first forecasting scenario has GDP contracting, on average, by 1.5 per cent this year, after growing by 0.4 per cent in 2011 (Table 8).

Economic activity is expected to return to expansion in the first quarter of 2013 (Figure 31), although owing to the effect of this year's decline average growth in 2013 will be nil. By comparison with the July forecasts, these projections have been revised significantly downwards owing to the deterioration in lending terms and conditions, the public finance correction measures and the worsening international economic situation.

Table 8

Scenario 1: the main macroeconomic variables
(percentage changes on previous year unless otherwise indicated)

	2011	2012	2013
GDP (1)	0.4	-1.5	0.0
Household consumption	0.4	-1.3	-1.1
Government consumption	-0.4	-2.1	-0.2
Gross fixed investment	-1.0	-4.9	0.7
Exports	6.1	0.7	4.9
Imports	0.8	-3.0	3.1
Change in stocks and valuables (2)	-1.0	-0.4	0.0
HICP (3)	2.9	3.1	2.4
Export competitiveness (4)	-0.2	1.6	-0.4

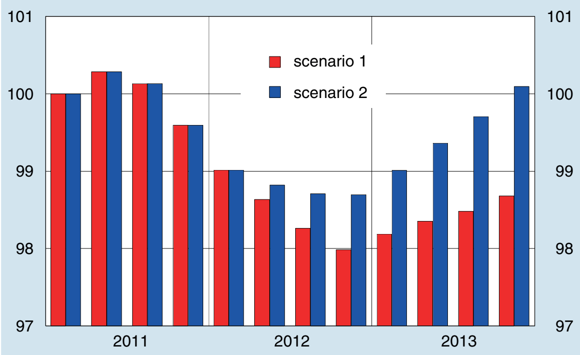
Sources: Based on Bank of Italy and Istat data.
(1) For GDP and its components: chain-linked volumes; changes estimated on the basis of quarterly data adjusted for seasonal and calendar effects. – (2) Contributions to GDP growth; percentage points. – (3) Harmonized index of consumer prices. – (4) Calculated by comparing the price of foreign manufactures with the deflator of Italian merchandise exports (excluding energy and agricultural products); a positive value indicates a gain in competitiveness.

Exports continue to expand in 2012, albeit more slowly

Exports should continue to expand, although at a slower pace than in the past two years, with growth dropping from 6.1 per cent last year to 0.7 per cent in 2012 before picking up again to 5 per cent in 2013. They will go mainly to markets outside the euro area. Italy's share of world merchandise trade is expected to diminish slightly, declining to 2.8 per cent in 2013 in nominal terms. Given practically stable relative prices, this pattern reflects the smaller presence of Italian products in the fastest-growing product sectors and geographical areas.

Figure 31

Quarterly GDP projections (1)
(index, 2011 Q1=100)



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

Investment will be affected by the terms of financing

The worsening terms of financing and the poorer outlook for demand are likely to have repercussions on capital formation. Investment in machinery, equipment and transport equipment is forecast to contract by more than 5 per cent in 2012-13. Residential construction investment, which has been falling since 2008, will continue to contract, as will public investment, owing to the fiscal consolidation measures enacted in recent years.

Consumer spending will be held back chiefly by the fall in disposable income

Household spending is expected to be curtailed by the significant drop in disposable income. Purchasing decisions will also be affected, albeit to a lesser extent, by rising interest rates and continuing uncertainty over the employment outlook. The forecast is for a decline in household consumption of about 1 percentage point both in 2012 and in 2013. The saving rate is expected to decline significantly this year, continuing the trend under way since 2005, and to stabilize in 2013.

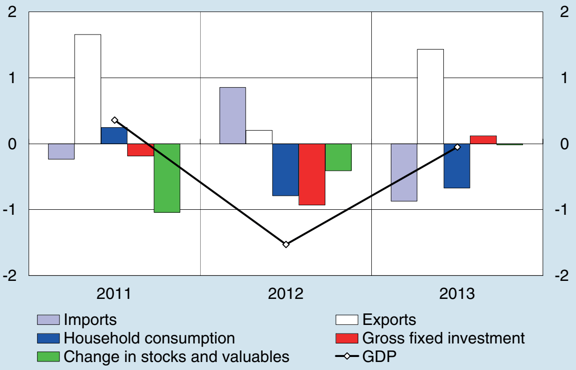
The balance of payments will improve

The decline in domestic demand will be accompanied by a significant improvement in the external accounts. Imports are forecast to contract by about 3 per cent this year before returning to growth in 2013 in response to the pickup in exports (the demand component with the largest import content). Overall, foreign trade will make a positive contribution to GDP, appreciably buffering the depressive effects of the fall in consumption and investment (Figure 32). In the absence of significant variations in the terms of trade, the deficit on the current account of the balance of payments should improve markedly, falling to under 2.5 per cent of GDP in 2013.

Figure 32

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

(percentage points)



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

Restored confidence would improve the outlook substantially

Our second scenario assesses the forecast's sensitivity to the return to normal conditions in the credit and financial markets, thanks to the restoration of investors' confidence in Italy's ability to honour its debt and the full implementation of the measures decided at European level. Instead of the assumption of constant spreads on government securities we posit a reduction in the cost of borrowing for public and private sectors alike. Starting in the first quarter of 2012 the yields on ten-year BTPs are assumed, for the sake of example, to be 200 basis points lower than those embodied in financial market prices at present and factored into the first forecasting scenario (see the box "Forecasting assumptions and the international context"). This puts them at around last summer's levels. Banks' funding difficulties are overcome and the credit supply strains that emerged in the second half of 2011 are attenuated.

In this scenario, economic activity contracts significantly only in the first quarter of 2012, stabilizes in the latter part of the year and returns to expansion in 2013 (Figure 31). On average for the year, GDP declines by 1.2 per cent in 2012 and increases by 0.8 per cent in 2013 (Table 9). This puts

FORECASTING ASSUMPTIONS AND THE INTERNATIONAL CONTEXT

The latest data show a significant slowing of the world economy and international trade compared with the first part of 2011. World trade, estimated to have grown by more than 6 per cent in 2011, is forecast to expand by less than 3 per cent in 2012 and then return to growth of around 7 per cent in 2013. The forecasts for this year are much less favourable than those made last autumn by the main international organizations (the European Commission, the International Monetary Fund and the OECD) because they take account of the latest short-term data. The projections for exchange rates, interest rates and oil prices have been made on the basis of the prices recorded in the ten working days up to 12 January 2012. On the basis of futures contracts, the price of a barrel of Brent crude oil is assumed to decline slightly over the forecasting horizon to \$108.8 in 2012 and \$103.9 in 2013. Three-month interest rates, calculated on the basis of Euribor futures, are forecast to fall just below 1 per cent on average in 2012 and to stay at that level in 2013; the average interest rates on Treasury Bills are expected to fluctuate just below 3 per cent in the first scenario and 1.5 per cent in the second. Long-term interest rates (corresponding to the yield on a basket of government securities with a duration of about six years) are assumed to be slightly below 7 per cent in 2012-13 in the first scenario and about 5 per cent in the second. Regarding exchange rates, the assumption is that the bilateral rates will remain unchanged at the average levels recorded in the last two weeks; this implies an exchange rate of \$1.29 to the euro over the entire forecasting horizon. Projections for Italy's public finances take account of the substantial adjustment measures approved by the Government in the second half of 2011, which it is officially estimated will reduce the deficit by €75.6 billion in 2013.

GDP in 2013 more than 1 percentage point higher than in the first scenario. Thanks to lower costs of financing and greater availability of credit, investment is forecast to diminish less sharply in 2012 and to grow by about 5 per cent in 2013. Household consumption falls by an average of 1 per cent this year but begins to expand again at the start of 2013.

The debt/GDP ratio declines in 2013

In both scenarios the public finance adjustments enacted from July to December result in a primary surplus of about 5 per cent of GDP in 2013 and an initial diminution of debt to GDP. The reduction is larger in the second scenario: in 2013 the ratio comes back down to the level recorded in 2010 and budget balance is essentially achieved.

Consumer prices reflect the increase in VAT rates

The behaviour of inflation, which reflects variations in aggregate demand with a lag, is essentially the same in the two scenarios. It is affected by the slowdown in economic activity and by the increases in VAT rates and excise taxes that have already kicked in and those scheduled for the fourth quarter of this year, which are assumed to remain in effect in 2013. The harmonized index of consumer prices (HICP) is forecast to rise by 3.1 per cent on average in 2012 (up from 2.9 per cent in 2011) before falling back to 2.4 per cent in 2013. Net of the indirect tax increases, consumer price inflation will be around 2.0 per cent in 2012 and 1.5 per cent in 2013. Domestic inflation, measured by the GDP deflator, is projected at slightly over 2 per cent in both years. Despite a modest slowdown in employee earnings, unit labour costs in the private sector are forecast to rise by an average of 2 per cent per year, reflecting a decline in productivity (Figure 33). Profit margins will narrow this year and recover slightly in 2013.

Table 9

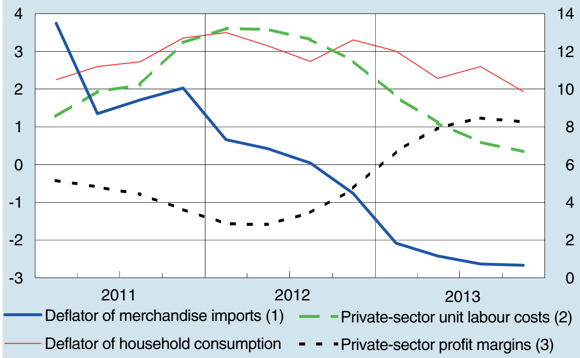
Scenario 2: the main macroeconomic variables
(percentage changes on previous year unless otherwise indicated)

	2012	2013
GDP (1)	-1.2	0.8
Household consumption	-1.0	-0.3
Government consumption	-2.1	-0.2
Gross fixed investment	-3.5	4.9
Exports	0.7	5.1
Imports	-2.2	5.0
Change in stocks and valuables (2)	-0.3	0.1
HICP (3)	3.1	2.4
Export competitiveness (4)	1.6	-0.3

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); a positive value indicates a gain in competitiveness.

Figure 33

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) Net of energy and agriculture; calculated as the ratio of compensation per standard employee labour unit to output per standard labour unit; output is value added at factor cost. – (3) Ratio of the deflator of value added at factor cost to unit labour costs in the private sector (net of energy and agriculture).

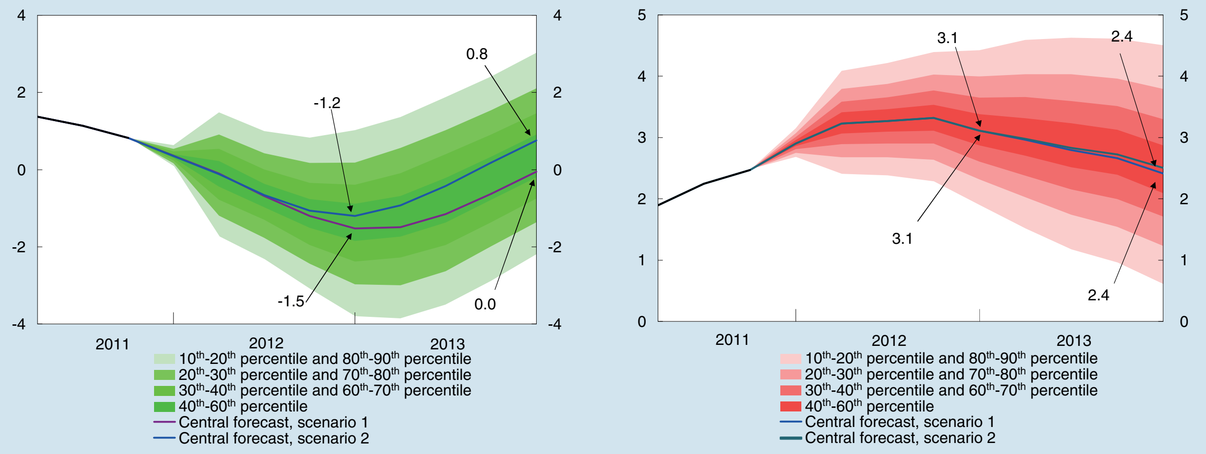
The risks are pronounced

As noted, the degree of uncertainty surrounding the medium-term outlook for the Italian economy is extraordinarily high (Figure 34) and is closely bound up with the euro-area sovereign debt crisis. Serious additional downside risks for economic activity cannot be excluded. A deterioration in confidence in the European governments' ability to cope with the debt crisis could have even more severe repercussions on interest rates and lending terms than posited in these forecasts; and a world economic slowdown is also possible.

Figure 34

Distribution of probabilities of GDP and HICP forecasts (1)

(percentage changes on corresponding period of previous year; four-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.

The projections do not factor in any positive effects of structural measures for economic growth

However, a boost to growth could derive from the approval of the structural measures for economic growth now being finalized, which are not factored into this forecast. These measures might be such as to stimulate the growth of potential output and positively affect market expectations and the spending decisions of households and firms, thereby improving the results both this year and next.