2.9 PROJECTIONS

The scenario is still uncertain

According to the forecasts for 2014-15 presented in this *Bulletin* the Italian economy will expand by about 0.2 per cent this year, but with downside risks; it will then resume growing by 1.3 per cent next year (Table 8 and Figure 31). The poor performance in the first quarter has entailed a lowering of the growth estimate for the year as a whole. The expected improvement will come from the fading of the effects of previous years' budget corrections, the good performance of international trade, the further easing of financial tensions, and the impact of the ECB's new monetary policy measures. However, the prospects of recovery are still fragile, partly owing to the uncertain evolution of geopolitical tensions and their transmission to world trade (see Section 1.1 and the box "Technical assumptions and the international context").

Table 8

Macroeconomic scenario in Italy
(percentage changes on previous year, unless otherwise indicated)

	2013	2014	2015
GDP (1)	-1.8	0.2	1.3
Household consumption	-2.6	0.2	1.1
Government consumption	-0.8	0.0	0.4
Gross fixed investment	-4.6	-0.7	2.3
of which: in machinery, equipment and transport equipment	*-2.2*	*0.7*	*3.6*
Total exports	0.0	3.4	4.7
Total imports	-2.9	1.7	4.9
Change in stocks (2)	-0.1	-0.4	0.0
HICP	1.3	0.4	0.8
HICP net of food and energy	1.3	0.8	0.9
Employment (3)	-1.9	-0.6	0.3
Unemployment rate (4)	12.2	12.7	12.6
Export competitiveness (5)	-2.9	-0.1	0.1
Current account balance (6)	1.0	1.8	1.8

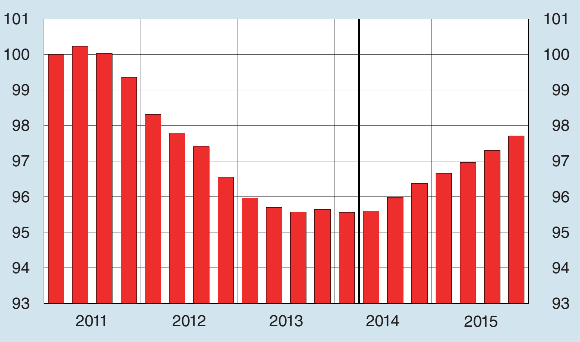
Sources: Based on Bank of Italy and Istat data.
(1) For GDP and its components: chain-linked volumes; changes estimated on the basis of quarterly data adjusted for seasonal and calendar effects. – (2) Includes valuables. Contribution to GDP growth; percentage points. – (3) Standard labour units. – (4) Annual averages; per cent. – (5) 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. – (6) Per cent of GDP.

Monetary conditions are sustaining economic activity

The projections are based on assumptions for interest rates that are consistent with the expansionary stance of monetary policy, which has been strengthened by the measures approved in June by the ECB's Governing Council (see Section 1.2). The markets expect the three-month interest rate to remain at about 0.2 per cent for the rest of this year and the next. The spread between ten-year Italian government securities and German Bunds is projected to be stable at about 170 basis points. Against this background, the new monetary policy measures and the recovery in economic activity should foster a return to more relaxed conditions on the credit market (see the box "Credit supply and demand").

Figure 31

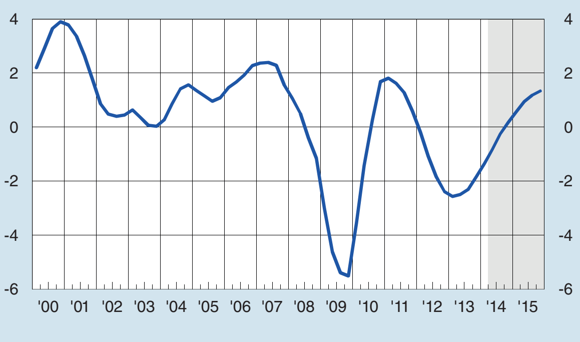
GDP projections: quarterly profile (1)
(levels, 2011 Q1=100)



Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects. Up to the first quarter of 2014, actual data; for subsequent quarters, projections.

Figure 32

Gross domestic product (1)
(quarterly data; percentage changes on year-earlier period; 4-term moving averages)



Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects. Up to the first quarter of 2014, actual data; for subsequent quarters, projections; the value for the fourth quarter of each year coincides with the annual average rate of change.

TECHNICAL ASSUMPTIONS AND THE INTERNATIONAL CONTEXT

Our macroeconomic scenario is based on the assumptions listed in the Table, which are in line with those underlying the projections for the euro area agreed by the central banks of the Eurosystem and presented by the ECB in the June issue of its *Monthly Bulletin*; they have been updated here to take account of the latest cyclical developments.

Assumptions for the main exogenous variables
(percentage changes on the previous year unless otherwise indicated)

	2013	2014	2015
World trade	2.6	3.7	5.5
Potential foreign demand	1.5	3.3	4.9
Dollar/euro (1)	1.33	1.37	1.36
Nominal effective exchange rate (2)	-2.5	-0.6	0.3
Crude oil price (3)	108.8	109.5	106.5
Three-month Euribor (1)	0.2	0.2	0.2
1-year BOT rate (1)	1.0	0.4	0.4
10-year BTP rate (1)	4.3	3.2	3.4

Sources: Based on Bank of Italy and Istat data.
(1) Annual averages. – (2) Positive changes indicate a depreciation. – (3) Dollars per barrel, Brent.

World trade is expected to expand by around 4 per cent in 2014 and to accelerate to 5.5 per cent in 2015. Compared with January's *Economic Bulletin*, the pace of growth in international trade has been revised downward by over one percentage point for this year and by around half a point for 2015. Growth in foreign demand, weighted according to the importance of the markets for Italian exports, is forecast to be below that of international trade by around half a percentage point each year.

The assumptions for exchange rates, interest rates and oil prices have been updated in the light of the market data in the ten working days through 14 July 2014. On the basis of futures contracts, the price of a barrel of Brent crude oil, which was \$108.8 in 2013, is assumed to rise to \$109.5 in 2014 and then drop to \$106.5 in 2015.

Three-month interest rates, calculated on the basis of Euribor futures, are assumed to stay at around 0.2 per cent in both 2014 and in 2015. The long-term interest rate on ten-year BTPs is set to diminish by about 110 basis points in 2014, to 3.2 per cent, before rising to 3.4 per cent in 2015. The euro is expected to appreciate slightly with respect to the average levels recorded in 2013; the dollar-euro exchange rate is forecast to be equal to 1.37 in 2014 and 1.36 in 2015.

As usual, the forecasts for the Italian public finances take account of the measures already enacted, in particular those to support household income and productive activities approved in Decree Laws 66/2014 and 91/2014. The forecasting scenario also assesses the effects of the decision to settle €47 billion of general government debts in the two years 2013-14 (see the box "General government commercial debts", *Economic Bulletin*, No. 2, 2014).

Our estimates for GDP growth in 2014 are about 0.5 percentage points lower than the projections published in January's *Economic Bulletin* (Figure 32). The main reasons for the downward revision are the pattern of GDP growth in the first quarter of the year and estimated for the second (see Section 2.1). However, the projections for 2015 are better than anticipated in January, by 0.3 percentage points, reflecting above all the more expansionary stance of monetary policy (see the box "The impact of the recent monetary policy measures").

THE IMPACT OF THE RECENT MONETARY POLICY MEASURES

The forecasting framework takes account of the effects on the Italian economy of the monetary policy measures adopted by the Governing Council of the ECB on 5 June, which are transmitted through the structure of interest rates, the exchange rate and the cost and availability of credit. The effects will materialize gradually over the next three years and are incorporated in the scenario described here for the part regarding 2014-15.

The reduction in the official interest rates, the introduction of a negative rate on the Eurosystem deposit facility and the implicit strengthening of forward guidance were transmitted, in the days following the decisions, to short- and long-term interest rates and the exchange rate (see the box "The monetary policy measures adopted in June 2014"). Overall, on the basis of the equations estimated in the Bank of Italy's quarterly model, the downward shift of the curve of short- and long-term market interest rates and the weakening of the exchange rate observed in the wake of the monetary-policy decisions (including the effect produced by the announcement of the measures in May) can be expected to produce an increase in GDP estimated at about half a percentage point at the end of the three years 2014-16, of which about half by the end of 2015.

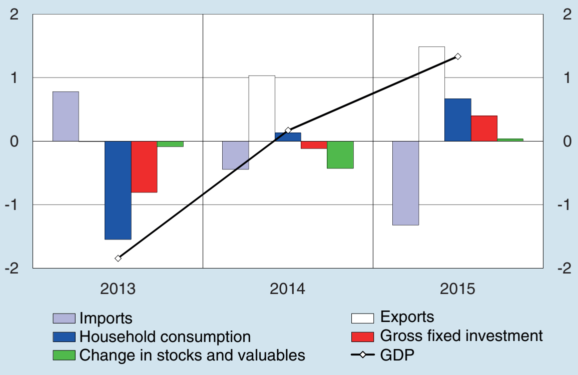
The impact of the targeted longer-term refinancing operations (TLTROs) will be more gradual and uncertain: banks' use of this instrument will in fact be possible on an increasing scale over the whole period from September 2014 to June 2016 and will depend, after the first two tranches, on how fast their lending expands. Assuming these operations are widely used and that their effects are transmitted in full to credit conditions, the cumulative impact at the end of the three years 2014-16 could be up to half a percentage point; one third of this increase in GDP has been included in the scenario for 2014-15.

Output is buoyed by exports ...

Economic growth will continue to be sustained by foreign sales. Exports are projected to increase at a rapid pace as world trade gathers momentum (Figure 33). However, our estimates assume that export growth will be less than the expansion of potential demand in Italy's markets owing to the loss of price competitiveness associated with the appreciation of the euro, which has been only partially reversed recently (the technical assumptions are based on the exchange rate recorded between 1 and 14 July; see the box "Technical assumptions and the international context").

Figure 33

GDP growth and 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.

... but a return to growth depends on a revival of investment

The resumption of growth depends ineluctably on a strengthening of domestic demand. Our forecasting scenario assumes a recovery of investment in machinery and equipment (which expanded in the first quarter of 2014, after about three years of contraction); the improved outlook for demand and better financing conditions will make this possible. Investment in construction is expected to pick up more slowly, given the persistent weakness of the real estate market. Gross fixed investment, which contracted by about 13 per cent overall in 2012-13, is expected to become positive once more in 2015. A contribution to the recovery of investment will come from the injection of liquidity to firms as a result of the measures to speed up the payment of general government commercial debts, assuming these are implemented in full (the effect on GDP will be just over 0.5 percentage points in 2014-15; see the box "General government commercial debts", *Economic Bulletin*, No. 2, 2014), and the incentives to invest in production facilities introduced by the Government with Decree Law 91/2014, the impact of which should amount to about 1 percentage point on investment in machinery, equipment and transport equipment and 0.05 points on GDP.

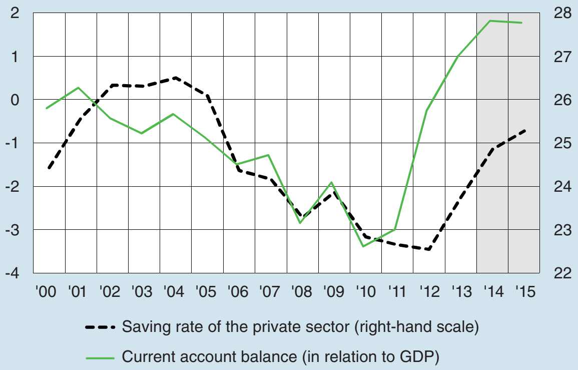
Household consumption picks up slowly

Consumption is expected to recover more slowly. Household spending, which increased marginally in the first quarter of this year after contracting for twelve quarters, is projected to stabilize this year and grow in 2015 with the upturn in disposable income. A boost should come from the Government's support measures for lower-income employees introduced in April of this year. Their net expansionary effect is estimated at about 0.2 percentage points on consumption and 0.1 on GDP in 2014-15. This estimate takes account of the restrictive effect of the measures included in the same decree to cover the expenditure. The measures to reduce the burden of taxation on labour could have a stronger impact (which is not considered in this scenario, however, which is based only on measures already passed) if they were maintained in the years to come, as the Government has announced, and perceived as part of a consistent, long-term economic policy strategy. The private sector's saving rate, which had been greatly reduced during the global crisis, is forecast to increase and by the end of the projection horizon to return close to its pre-crisis levels (Figure 34).

Figure 34

Saving rate and current account balance

(percentage points)



Sources: Based on Bank of Italy and Istat data.

The labour market stabilizes

The improvement in the economic situation will be transmitted to the labour market only gradually. Exployment is forecast to stabilize during the course of this year and then begin to expand again slightly in 2015, rising by 0.3 per cent in the economy as a whole and by 0.5 per cent in the private sector. However, labour supply, which had been held back in 2013 by worker discouragement, will also resume growing this year as the latter abates, keeping the unemployment rate high.

The balance of payments surplus widens ...

The balance of payments surplus is projected to continue even in the more favourable economic climate. Although imports will accelerate, led by the demand components with the largest foreign goods content (exports and investment in machinery), the growth in exports is expected to boost the current account surplus to almost 2 per cent of GDP.

... and fiscal consolidation continues

In this scenario, general government net borrowing is projected to decrease in 2015, while the primary surplus should stay above 2 per cent of GDP this year and next. The debt-to-GDP ratio should begin to decrease again in 2015.

Inflation stays low

Although inflation will accelerate in 2015 to 0.8 per cent (Figure 35), it should remain extremely low for the whole of the forecasting horizon. The weakness of consumer prices can be ascribed largely to the domestic components: the GDP deflator is expected to grow by just over 1 per cent in 2015. The still ample idle production capacity and persistence of difficult employment conditions will affect both unit labour costs, which should rise by slightly less than 1 per cent a year in the private sector, and firms' profit margins; only a small part of the substantial decline in profits suffered in the last three years will be recouped. Our current projection for inflation is over 0.5 percentage points below the estimate published in the January *Economic Bulletin*. This reflects both the larger than expected decrease recorded in the first half of the year, caused by the core components, and the weaker performance of raw material prices.

The other growth projections

The growth projections for 2014 given here are less optimistic than those of the main international organizations, which in any case are less recent and do not take account of the performance of GDP in the first quarter of the year, which was considerably lower than forecast by all analysts, or of the cyclical data for the second quarter (Table 9). On the other hand, we predict a slightly stronger economic upturn in 2015, based on more favourable assumptions regarding monetary and financial conditions, partly in the wake of monetary policy decisions.

The scenario assumes consistent policies

This forecasting scenario assumes that the economic policy measures introduced in Italy to boost households' and firms' confidence in making investment and spending plans will be implemented fully and consistently; that the institutional framework in Europe will remain favourable; and that the Eurosystem's monetary measures will prove effective. The scenario is highly uncertain, with downside risks for growth and balanced but significant risks for inflation (Figure 36).

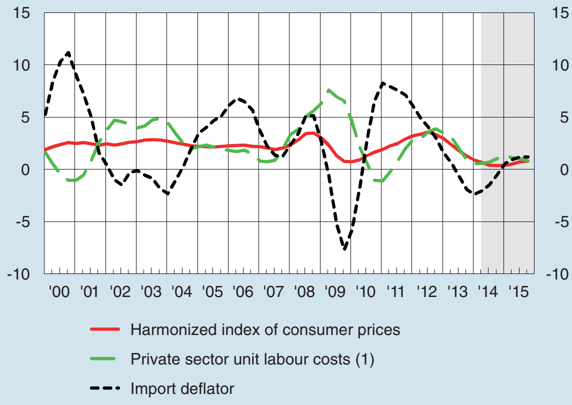
The scenario is subject to downside risks for growth

The economic outlook and in particular the prospects for investment could be marred if the conditions of access to bank credit improve less rapidly than we forecast. The exceptionally favourable conditions that now distinguish the international markets have elements of fragility and may turn out to be short-lived. The risks stemming from geopolitical tensions in the oil-producing countries have increased. Were these to intensify, the supply and price of energy would be affected, with repercussions on trade, which might also bear the brunt of less dynamic economic growth in the emerging economies.

The risks to inflation forecasts are balanced. Against the possibility of energy prices rising in response to a worsening of geopolitical tensions there is the risk, in Italy, that ample spare capacity will exert stronger downward pressure on prices. In this situation, it is crucial to ensure that the inflation expectations underlying price and wage formation remain stable in the medium term.

Figure 35

Main determinants of consumer price inflation
(quarterly data; percentage changes on year-earlier period; 4-term moving averages)



Sources: Based on Bank of Italy and Istat data.
(1) 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.

Table 9

Other organizations' forecasts for Italy
(percentage changes on previous period)

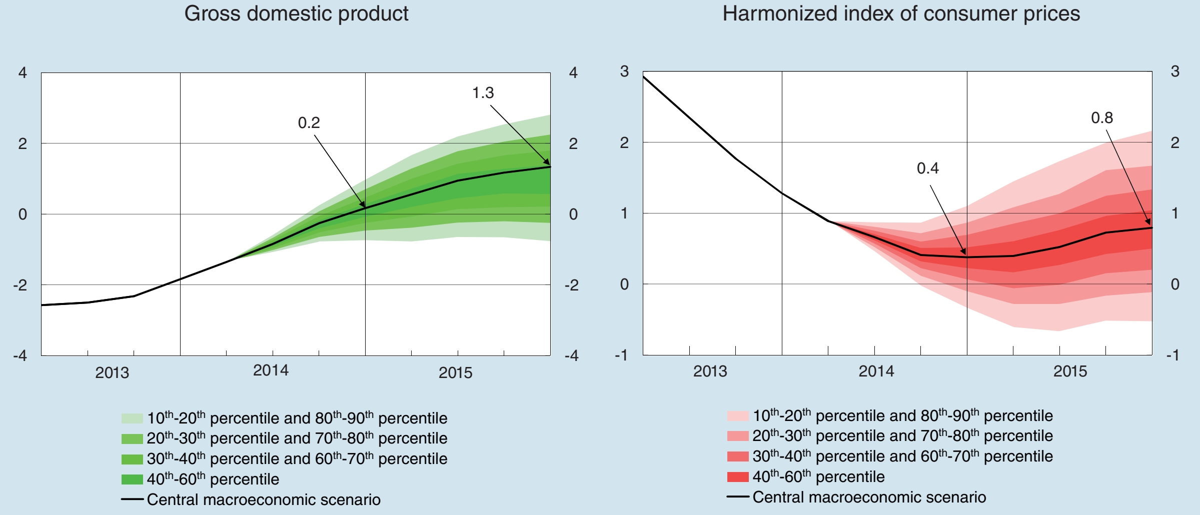
	GDP (1)		Inflation (2)	
	2014	2015	2014	2015
IMF (April)	0.6	1.1	0.7	1.0
OECD (May)	0.5	1.1	0.5	0.9
European Commission (May)	0.6	1.2	0.7	1.2
Consensus Economics (June)	0.4	1.2	0.6	1.0

Sources: IMF, *World Economic Outlook*, April 2014; OECD, *Economic Outlook*, No. 95, May 2014; European Commission, *European Economic Forecast - Spring 2014*, May 2014; Consensus Economics, *Consensus Forecasts*, June 2014.
(1) The growth rate forecasts of the OECD are adjusted for calendar effects; those of the European Commission and the IMF are not. – (2) HICP.

Figure 36

Distribution of probabilities of GDP and HICP projections (1)

(percentage changes on year-earlier period; 4-term moving averages)



(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 distribution takes account of asymmetric shocks to the equations that reflect the main risk factors, by the procedure described in C. Miani and S. Siviero (2010) "A non-parametric model-based approach to uncertainty and risk analysis of macroeconomic forecasts", Banca d'Italia, *Temi di discussione (Working Papers)*, No. 758, 2010. The figure shows year-on-year percentage changes of 4-term moving averages. The value corresponding to the fourth quarter of each year coincides with the average annual percentage change.