2.10 PROJECTIONS

The outlook for growth ...

For the Italian economy, we project a gradual return to growth this year and more rapid expansion in 2016 (Table 10 and Figure 32). Economic activity is expected to be sustained by an expansive monetary policy stance and by the budget measures of the Stability Law, which reduce the tax wedge. Growth should also benefit from a gradual acceleration of world trade, the depreciation of the euro and the fall in oil prices (see the box "The technical assumptions").

... depends on investment prospects and the international context

However, the recovery would be held back by continuing weakness of investment, and there are elements of fragility in connection with the still modest growth outlook in the euro area and some emerging economies, possible turmoil in the financial and foreign exchange markets, and the persistence of uncertainty and low levels of confidence (see Section 2.1).

On the basis of the indicators available to date, we estimate that Italy's GDP contracted by 0.4 per cent in 2014, after decreasing by 1.9 per cent in 2013. Economic activity is projected to return to moderate growth in the early part of this year and to strengthen somewhat over the following quarters. Our central scenario puts growth at 0.4 per cent this year and 1.2 per cent next. At the end of the forecasting horizon this would still leave GDP more than 7 per cent lower than in 2007.

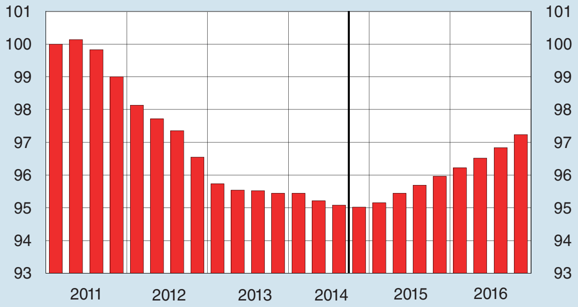
The scenario posits expansive monetary conditions

The projections incorporate more expansive monetary and financial conditions than were assumed in last July's forecasts, as a consequence of the measures taken by the ECB and expectations of further interventions (see Section 1.2). In accordance with market expectations, the three-month interest rate remains stable and practically nil for the entire period, while the scenario assumes that yields on ten-year BTPs will rise gradually, reaching 2.6 per cent in 2016. However, the effects of improving financial conditions are likely to be partly offset by the downward revision of expected inflation, which, with short-term nominal rates now near the lower bound, implies upward pressure on real interest rates.

Figure 32

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. Through 2014 Q3, actual data; thereafter, projections.

Table 10

Macroeconomic scenario in Italy

(percentage changes on previous year, unless otherwise indicated)

	2014	2015	2016
GDP (1)	-0.4	0.4	1.2
Household consumption	0.3	0.9	0.9
Government consumption	-0.2	-0.5	-0.6
Gross fixed investment	-2.6	-0.7	2.5
of which: *machinery, equipment and transport equipment*	*-1.7*	*-0.7*	*3.6*
Total exports	1.7	3.7	5.9
Total imports	0.3	3.4	5.7
Change in stocks (2)	-0.5	-0.1	0.0
HICP	0.2	-0.2	0.7
HICP net of food and energy	0.7	0.6	0.8
Employment (3)	0.0	0.5	0.3
Unemployment rate (4)	12.8	12.8	12.8
Export competitiveness (5)	0.1	3.6	0.4
Current account balance (6)	1.8	2.5	2.5

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) Full-time equivalent workers – (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) As a percentage of GDP.

THE TECHNICAL ASSUMPTIONS

The main assumptions underlying the macroeconomic scenario are:

a) world trade, which expanded by less than 3 per cent on average in 2014, accelerates to 4 per cent in 2015 and to 5.2 per cent in 2016; in the two years 2015-16 foreign demand, weighted according to the importance of the markets for Italian exports, grows at an average rate of close to 4.3 per cent;[1]

b) the dollar-euro exchange rate, which averaged 1.33 in 2014, falls to 1.20 in the two years 2015-16;[2]

c) a barrel of Brent crude oil, which averaged around $100 in 2014, is assumed to be $58.5 in 2015, rising to $66.3 in 2016;

d) three-month interest rates on the interbank market (Euribor) hold almost constant at 0.1 per cent in the next two years;

e) the yield on ten-year BTPs is 2.3 per cent in 2015 and rises to 2.6 per cent in 2016, in line with market expectations;

f) in keeping with the assumptions underlying the projections for the euro area presented in the December 2014 issue of the ECB's *Monthly Bulletin*, the effects of the longer-term refinancing operations and the asset-backed securities and covered bond purchase programmes are included only to the extent that they have already been incorporated in the current and expected levels of interest and exchange rates;

g) the forecasting scenario incorporates the budget provisions for 2015 as set out in the Stability Law; in particular: measures in favour of lower-middle income households; the reduction of the regional tax on productive activity (IRAP) for the labour costs component and the reduction in social security contributions for private-sector employers that hire new employees on a permanent basis in 2015.

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

	2014	2015	2016
World trade	2.9	4.0	5.2
Potential foreign demand	2.8	3.7	4.8
Dollar/euro (1)	1.33	1.20	1.20
Nominal effective exchange rate (2)	-0.2	1.7	0.0
Crude oil price (3)	99.4	58.5	66.3
Three-month Euribor (1)	0.2	0.1	0.1
1-year BOT (1)	0.5	0.3	0.3
10-year BTP (1)	2.9	2.3	2.6

Sources: Based on Bank of Italy and Istat data.
(1) Annual averages. – (2) Calculated by attributing to the currencies of Italy's most important trading partners a weight commensurate with their share in trade with our country. Positive changes indicate a depreciation. – (3) Dollars per barrel, Brent.

1 Our growth assumptions for world trade and potential foreign demand are in line with those underlying the projections for the euro area agreed by the Eurosystem central banks and presented in the December issue of the ECB's *Monthly Bulletin*, updated to take account of the latest cyclical developments.

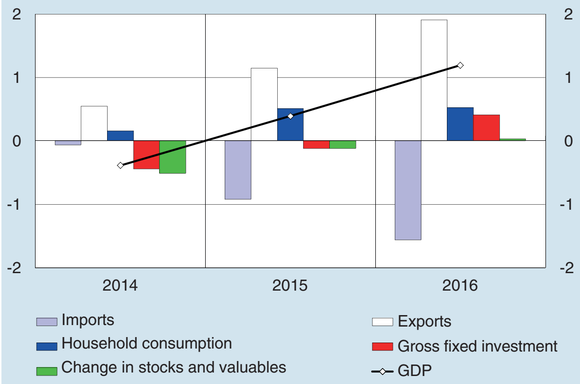
2 The technical assumptions for interest rates, exchange rates and oil prices are calculated on the basis of the spot and forward prices observed in the markets in the ten working days up to 13 January.

World demand and the exchange rate are expected to favour exports

The baseline scenario projects a recovery in exports over the two years (to growth of 3.7 per cent in 2015 and 5.9 per cent in 2016), favoured by moderate growth of the world economy and the depreciation of the euro since mid-2014 (Figure 33). It is estimated that the depreciation – which has mainly been against the dollar – increases the rate of growth of exports by more than 1 percentage point. The growth of foreign sales should essentially parallel that of world trade.

Figure 33

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.

Investment could begin to show gradual growth ...

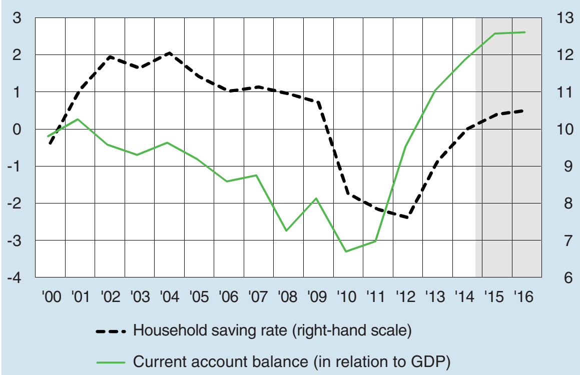
The performance of investment remains crucial to the pace of growth. The central scenario – which is surrounded by considerable uncertainty – hypothesizes that the quarterly change in investment will improve as early as the first half of 2015, returning to positive territory. Nevertheless, after the contraction registered in 2014, capital formation will remain marginally negative in 2015 as a whole. It should return to growth in 2016, expanding by 2.5 per cent. The investment recovery, which has been held back so far by tight credit and abundant spare capacity, is expected to be led by spending on machinery and equipment, which should benefit more substantially from the gradual improvement in the outlook for demand, especially export demand, and from more favourable financing terms. Construction investment, still weighed down by the persistently weak housing market, is projected to decline further this year before stabilizing in 2016.

... with an improvement in credit supply conditions

Thanks to the expansive stance of monetary policy, credit market conditions are expected to improve gradually, in line with survey indications (see Section 2.7). The average cost of loans to firms is projected to decline further this year and next. Bank rates for business loans are expected to be 3 percentage points above the corresponding money market rates. This differential is about 1 percentage point narrower than at the height of the crisis, but nevertheless wide by historical standards, suggesting that conditions are not yet entirely relaxed. Credit to firms, in this scenario, begins to grow again at the start of 2016, and lending to households picks up more quickly, especially the less risky home mortgage loan component.

Figure 34

Household saving rate and current account balance
(percentage changes)



Sources: Based on Bank of Italy and Istat data.

Consumption continues to gain moderately ...

Consumer spending is expected to strengthen gradually as a result of the recovery in disposable income, thanks partly to the Stability Law measures to sustain lower-middle-income households. The household saving rate, which rose from 9.1 per cent in 2013 to 10 per cent last year, is projected to increase further in 2015-16 to 10.5 per cent, still lower than before the financial crisis (Figure 34).

We estimate that the measures in favour of lower-middle-income households will increase consumption by about half a percentage point, cumulatively, in 2015 and 2016. In all, the expansive measures contained in the Stability Law (income support for households and the reduction of the corporate tax wedge) should boost GDP by about 0.8 percentage points in 2015-16, while the measures to cover that expenditure are expected to trim it by nearly 0.6 points. The positive effect could be greater if households and firms see the measures as part of an enduring economic policy stance.

... as the labour market slowly strengthens

Employment, measured in terms of full-time equivalent workers, was essentially unchanged in 2014; it is expected to expand by almost 1.0 per cent over the next two years; about a third of the increase should come from the tax relief measures of the Stability Law (in particular the cut in the regional tax on productive activity and social contribution relief in respect of workers hired on open-ended contracts in 2015). Labour productivity in the private sector is projected to improve by an average of just over 0.5 per cent in 2015-16. The unemployment rate is expected to remain substantially unchanged at 12.8 per cent, owing to the simultaneous expansion of the labour force.

The external accounts continue to improve ...

Thanks to the smaller energy deficit due to low crude oil prices, the current account surplus is projected to improve further, reaching 2.5 per cent of GDP in 2015 and holding at that level in 2016 as well.

... and so do the public finances

We estimate that general government net borrowing will diminish marginally this year and more significantly in 2016. In this context, the ratio of public debt to GDP will not begin to come down until 2016. The public finance estimates take account of the Stability Law measures and as such project the maintenance of a basically neutral fiscal policy stance after the very sharp adjustments of 2012-13.

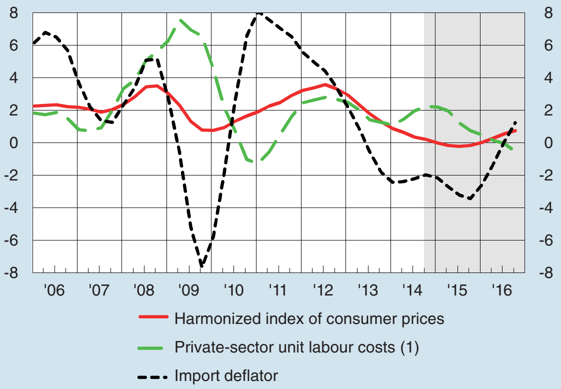
Inflation remains low

The change in the consumer price index, which diminished to 0.2 per cent on average in 2014, is projected to be marginally negative (-0.2 per cent) this year, largely due to the sharp decline in oil prices. Even net of the energy and food components the increase in prices is still likely to be quite small, equal to 0.6 per cent in 2015 and still below 1 per cent in 2016 (Figure 35). The domestic components of inflation are expected to remain weak, reflecting abundant idle capacity. The GDP deflator is projected to rise by 0.6 per cent in 2015 and 1.0 per cent in 2016. Profit margins look set to return to moderate growth in 2016 as economic activity picks up.

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) Unit labour costs in the private sector (excluding agriculture and energy), calculated as the ratio of earnings per full-time equivalent worker to output per full-time equivalent worker; output is value added at factor cost.

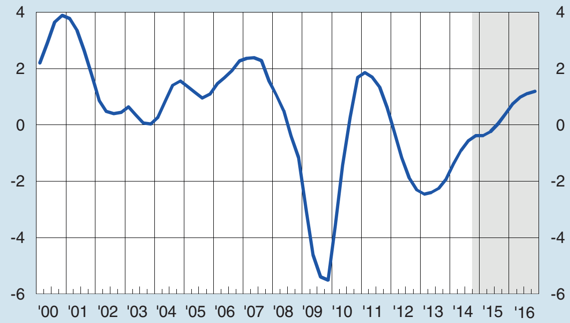
The forecasts have been revised downward since July

Like those of the other leading organizations, our projections for GDP and inflation have been revised significantly downward compared with those published last July. Growth in 2015 has been lowered by 0.9 percentage points (Figure 36), owing mainly to the failure of investment to revive up to now and the slower-than-expected growth of export demand (see the box "The causes of the decline in economic activity in Italy in the first six months," *Economic Bulletin*, No. 4, 2014). These factors have outweighed the expansive effects of the exceptionally low euro price of oil (down by more than 60 per cent since mid-2014, with an estimated impact of 0.5 percentage points on GDP) and the depreciation of the currency of about 13 per cent against the dollar and almost 1.5 per cent in effective terms, corresponding to a 0.1-point rise in GDP. The estimate of inflation, revised downward by 1 percentage point for 2015, reflects the trend in the prices of imported commodities and, to a lesser extent, more moderate increases in domestic prices in connection with slack demand.

Figure 36

Gross domestic product (1)

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



Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects. Through 2014 Q3, actual data; thereafter, projections.

The other projections

These growth projections are in line with the latest forecasts of the other main international organizations (Table 11) except the OECD, which sees Italian GDP stagnating in 2015. The inflation projections of the European Commission and the IMF are higher.

Table 11

Other organizations' forecasts for Italy

(percentage changes on previous period)

	GDP (1)		Inflation (2)	
	2015	2016	2015	2016
IMF (October)	0.8	1.3	0.5	1.1
OECD (November)	0.2	1.0	0.0	0.6
European Commission (November)	0.6	1.1	0.5	2.0
Consensus Economics (December)	0.4	…	0.4	…

Sources: IMF, *World Economic Outlook*, October 2014; OECD, *Economic Outlook*, No. 96, November 2014; European Commission, *European Economic Forecast – Autumn 2014*, November 2014; Consensus Economics, *Consensus Forecasts*, December 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.

Considerable uncertainty remains

This forecasting scenario is subject to a high degree of uncertainty (Figure 37). The expansion of economic activity could be held down by a rekindling of international financial market tensions, in connection with the evolving political situation in Greece and the crisis in Russia, and a weakening of the emerging economies. The risks for the inflation projection stem from a possible further lowering of expectations. The outlook is also sensitive to deviations of fiscal policy from the course posited (see the box "The sensitivity of the macroeconomic outlook to variations in the profile of fiscal consolidation").

A more favourable outlook could derive from an expansion of the Eurosystem's balance sheet …

Aggressive monetary support measures could counteract low inflation and the weakness of economic activity in the euro area and Italy. We estimate that an expansion of the Eurosystem's balance sheet resulting in a 50 basis point decrease in the interest rate on long-term government securities and a 5 per cent depreciation of the euro against the other main currencies could raise the level of GDP by a total of more than 0.5 percentage points in the two years 2015-16 both in Italy and in the euro area. In addition to these two direct effects, there would very likely be other, indirect channels, no less important but hard to quantify, such as the effect on the confidence and inflation expectations of households and firms.

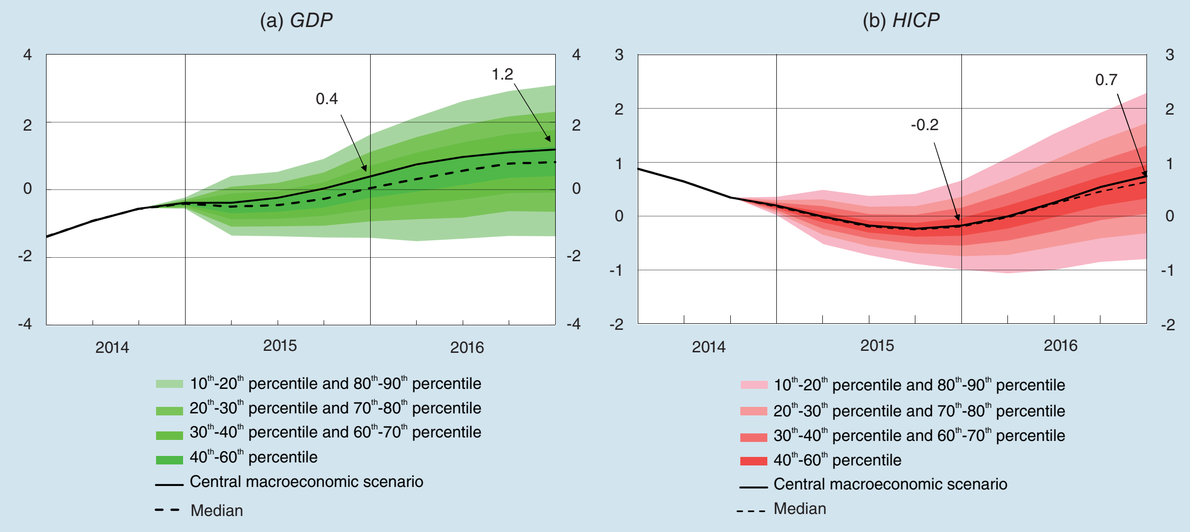
… a stronger expansion of foreign demand or an improvement in confidence

The economic recovery could prove to be stronger than projected here if the price of oil holds at the values registered in the last few days and the elasticity of foreign demand to world GDP increases. This elasticity depends on the product composition of trade and the phase of the business cycle; it is now below its long-term average. We estimate that in this case the impact on GDP could amount to

Figure 37

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, "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 4th quarter of each year coincides with the average annual percentage change.

an additional 0.5 percentage points in 2015-16. A more limited effect (0.2 points) would be produced if lessened uncertainty about the outlook for demand were to allow a faster recovery in business and household confidence, bringing it back into line with its historical average and leading to a stronger recovery in investment and consumption.

THE SENSITIVITY OF THE MACROECONOMIC OUTLOOK TO VARIATIONS IN THE PROFILE OF FISCAL CONSOLIDATION

Consolidating the public finances and in particular reducing the high ratio of public debt to GDP remain crucial objectives for Italy (see the box, "European budget rules and the objectives for Italy's public finances"). With the 2014 Economic and Financial Document Update and the Stability Law for 2015, the Government confirmed its commitment to keeping the budget deficit at or below 3 per cent of GDP and proceeding to reduce the debt-to-GDP ratio; in view of the exceptional duration and depth of the recession, and in order to avoid a recessional spiral of demand, it charted a more gradual adjustment path than that previously foreseen (see *Economic Bulletin*, No. 4, 2014).

The implications for the macroeconomic outlook of a different budget adjustment from that planned by the Government can be estimated through counterfactual simulations; by way of an example, we consider here a sharper correction of the structural balance in 2015, equal to 0.5 per cent of GDP, based on a forecasting scenario that incorporates the measures included in the Stability Law for 2015 (the conclusions hold commensurately for budget corrections of different amounts).[1]

1 The baseline macroeconomic scenario is the one presented in this Bulletin; the profile of general government debt and net borrowing coincides with that incorporated in the European Commission's forecasts, published in *European Economic Forecast. Autumn 2014*.

Macroeconomic projections with and without additional corrective measures
(percentage changes on the previous year, unless otherwise indicated)

	Baseline scenario		Budget adjustment of 0.5%			
			Low multiplier		High multiplier	
	2015	2016	2015	2016	2015	2016
GDP	0.4	1.2	0.2	1.1	-0.2	1.1
Employment	0.5	0.3	0.5	0.2	0.4	0.0
Consumption deflator	-0.2	0.7	-0.2	0.6	-0.2	0.5
GDP deflator	0.6	1.0	0.6	0.9	0.5	0.8
General government net borrowing (1)	2.7	2.2	2.3	1.8	2.4	2.1
General government debt (1)	133.8	132.7	133.7	132.4	134.4	133.5

(1) As a percentage of GDP; the profile of general government debt and net borrowing in the baseline scenario coincides with that incorporated in the forecasts of the European Commission (*European Economic Forecast – Autumn 2014).*

The impact of the budget measures on GDP (the so-called fiscal multiplier) is not a constant; it can vary significantly as a function primarily of the budget's composition but also depending on the cyclical phase. During recessions, budget measures can have indirect effects on the confidence and liquidity of households and firms, factors which in the past years have intensified the recession;[2] in addition, the impact of a slowdown in economic activity on prices and the GDP deflator can be particularly strong.[3]

Given this uncertainty, we ran simulations with different packages of budget adjustment measures, corresponding to values of the fiscal multiplier ranging from a relatively low minimum (0.3 in the first year and 0.5 in the second)[4] to a maximum of 1.1 in the first year and 1.3 in the second.[5] Considering the state of the business cycle, the actual value of the multipliers is probably relatively high at this time; the lower value of the range would be considered plausible if, for example, the budget package were composed of tax increases concentrated on taxpayers not subject to liquidity constraints.

The results for the two extreme cases are shown in the table and the figure. Given an acceleration of budget adjustment of the magnitude hypothesized, in 2015 the Italian economy would still be in recession or practically stalled at best: GDP would contract by 0.2 percentage points with a high multiplier and be little better than stagnant with a low one. There would be a further fall in inflation, already well below the level consistent with the definition of price stability: the cumulative increase in the GDP deflator would be lower by about 0.3 percentage points in the two years 2015-16 with a high multiplier and by about 0.1 points with a low one.

By aggravating the cyclical weakness, the adjustment measures might not allow the debt-to-GDP ratio to be reduced in the two years 2015-16. In the case of a high multiplier, the ratio would rise to 134.4

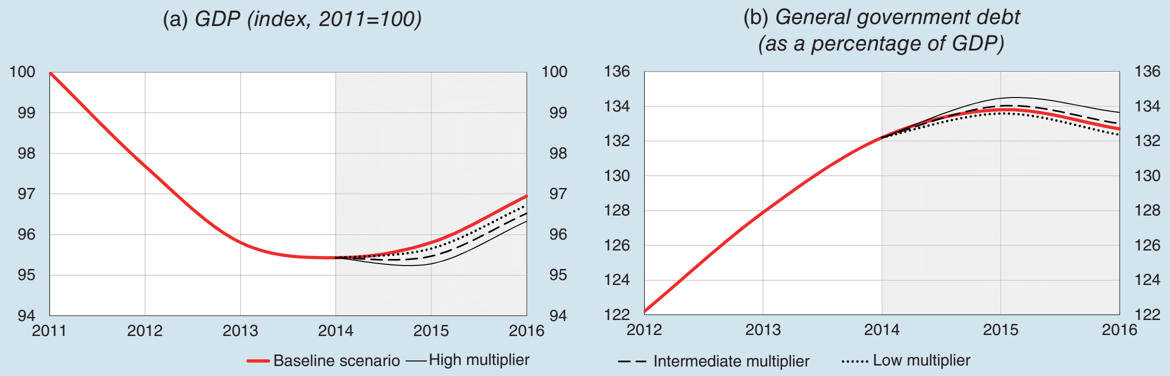
[2] See F. Busetti and P. Cova, "L'impatto macroeconomico della crisi del debito sovrano: un'analisi per l'economia italiana" [The macroeconomic impact of the sovereign debt crisis: a counterfactual analysis for the Italian economy], Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), No. 201, 2013.

[3] See M. Riggi and F. Venditti, "Surprise! Euro area inflation has fallen", Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), No. 237, 2014.

[4] In normal cyclical conditions, these values correspond to an adjustment carried out mainly through an increase in taxation or a reduction in transfers.

[5] In normal cyclical conditions, these values are obtained in the case of adjustments mainly involving cuts to direct expenditures (purchases of goods and services and investment).

Level of GDP and public debt



per cent in 2015 (instead of 133.8 per cent) and would stay well above the baseline scenario level the following year; in the more favourable case, it would come down slightly. On the whole, factoring in the effects on the change in the deflators, the simulations indicate that, with a multiplier even just a bit higher than 0.5, fiscal adjustment measures would not be able to bring down the debt ratio.[6]

A fuller picture can be obtained with a series of stochastic simulations based on the analysis of the risks presented in this section of the Bulletin. The results suggest that the probability of the Italian economy still being in recession in 2015 would be about 50 per cent in the case of corrective measures with a relatively low multiplier and nearly 60 per cent with a less favourable multiplier. The probability of the budget package having a counterproductive effect on the debt ratio in the two years is estimated at 50 per cent in the more favourable scenario and at 65 per cent in the less favourable one.

[6] It should be noted that when the time horizon of the analysis is extended to 5-10 years, a budget adjustment should reduce the debt-to-GDP ratio whenever the multiplier is lower than 1.5.