2.9 PROJECTIONS

Our projections for growth and inflation in the next two years point to the progressive strengthening of the cyclical recovery that began in the first quarter of this year and a modest reduction in the risk that inflation will remain low for an extended period of time (Table 8). This scenario is based on the hypothesis that external conditions remain favourable, in particular with regard to developments in the world economy, trends in the prices of raw materials and the effectiveness of monetary policy interventions.

The outlook for Italy depends on the strengthening of world growth ...

In line with the assessments of the leading international organizations, we posit that economic activity and world trade will gradually gather momentum, after the temporary weakening at the start of 2015. Foreign demand for Italian goods should already pick up this year, above all from our European partners, driven by the consolidation of the recovery in the euro area.

... the effects of recent monetary policy decisions ...

The easing of monetary conditions and in particular the Eurosystem's asset purchase programme has driven government bond yields down, though there was a partial correction starting in April confined to the medium- and long-term segments of the yield curve; this easing has translated into a marked decline in the exchange rate of the euro, which should support the upturn in exports thanks to regained price competitiveness on markets outside the area. Our scenario hypothesizes that the yield on ten-year BTPs, after reaching a low of 1.1 per cent in March, will remain at around 2 per cent this year and reach 2.9 per cent in 2016, as is currently implied by the prevailing prices on the financial markets (see the box 'The technical assumptions').

Table 8

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

	2014	2015	2016
GDP (1)	-0.4	0.7	1.5
Household consumption	0.3	0.6	1.1
Government consumption	-1.0	-0.7	0.2
Gross fixed investment	-3.2	2.2	2.6
of which: in machinery, equipment and transport equipment	-1.6	4.5	3.3
Total exports	2.4	4.3	6.9
Total imports	1.7	4.5	6.2
Change in stocks (2)	-0.1	0.0	0.0
HICP	0.2	0.2	1.1
HICP net of food and energy	0.7	0.7	1.0
Employment (3)	0.2	0.7	0.8
Unemployment rate (4)	12.6	12.2	11.9
Export competitiveness (5)	-1.1	4.8	0.2
Current account balance (6)	1.9	2.2	2.5

Source: 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 in 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 competiveness. – (6) Per cent of GDP.

THE TECHNICAL ASSUMPTIONS

The main assumptions underlying the macroeconomic scenario are:

a) foreign demand, weighted according to the importance of the markets for Italian exports, accelerates in the two years 2015-16, expanding at an average annual rate of 4.3 per cent;[1]

[1] Our growth assumptions for global economic activity and potential foreign demand are consistent with those underlying the projections for the euro area agreed by the Eurosystem central banks and presented in the June issue of the ECB's *Monthly Bulletin*, updated to take account of the latest cyclical developments.

b) the dollar-euro exchange rate, which averaged 1.33 in 2014, falls to 1.11 in 2015-16;[2]

c) a barrel of Brent crude oil, which averaged around $100 in 2014 and €57 in July 2015, is assumed, on the basis of the prices of futures contracts, to be $60 in 2015 and $65 in 2016;

d) three-month interest rates on the interbank market (Euribor) are practically nil for the next two years;

e) the yield on ten-year BTPs is 2.9 per cent in 2014, falling to 2.1 per cent in 2015 and rising back to 2.9 per cent the year after, in line with market expectations;

Table

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

	2014	2015	2016
Potential foreign demand	2.3	3.6	5.0
Dollar/euro (1)	1.33	1.11	1.11
Nominal effective exchange rate (2)	-0.2	4.9	0.1
Crude oil price (3)	99.0	60.3	65.4
Three-month Euribor (1)	0.2	0.0	0.1
One-year BOTs (1)	0.5	0.1	0.3
Ten-year BTPs (1)	2.9	2.1	2.9

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

f) the forecasting scenario factors in the measures contained in the Stability Law. It includes support for lower-middle payroll incomes, the elimination of the labour cost component of IRAP, and the reduction of social security contributions for private sector employers that hire new employees on a permanent basis in 2015. The projections take account of the decision to not raise VAT rates from 2016, as had been programmed in the 2015 Economic and Financial Document. Lastly, they include the effects on the public finances of the pension refunds ordered by the Government in compliance with the recent ruling of the Constitutional Court.

Most of the effects of the Eurosystem's expanded asset purchase programme are incorporated in the technical assumptions on exchange rates and interest rates.

[2] The technical assumptions for interest rates, exchange rates and oil prices are calculated on the basis of spot and forward prices in the markets in the ten working days up to 10 July.

... and credit market conditions

The exceptionally expansionary stance of monetary policy and the recovery in economic activity should favour an improvement in credit conditions, in line with the indications of recent surveys (see the box 'Credit supply and demand'). Average rates on business loans should decline steadily, in view among other things of reduced borrower riskiness. At the end of the forecasting horizon, however, the spread between bank rates and three-month money market yields will still be about 30 basis points greater than its pre-crisis average, suggesting that conditions will not have eased entirely. Lending to businesses should return to growth at the start of 2016, and lending to households will improve more rapidly, especially the less risky home mortgage loan component.

Economic activity should also benefit from low oil prices ...

Given the continuing excess supply on world oil markets, the scenario assumes that the prices of energy commodities will remain low, as currently implied by futures prices (see Section 1.1), sustaining real disposable income and the expansion of household consumption; it is estimated that the fall in the euro prices of crude oil since mid-2014 could contribute around 1 percentage point to the increase in GDP for the three years 2014-16.

... and the neutral stance of fiscal policy

After the large sharp correction of 2012-13, fiscal policy is assumed to remain basically neutral, in line with Government programmes. Net of funding coverage, the expansive measures taken by the Government in 2014 should add about 0.2 per cent to output in 2015-16. General government net borrowing will decline in the two years 2015-16, and the ratio of public debt to GDP will begin to come down again next year.

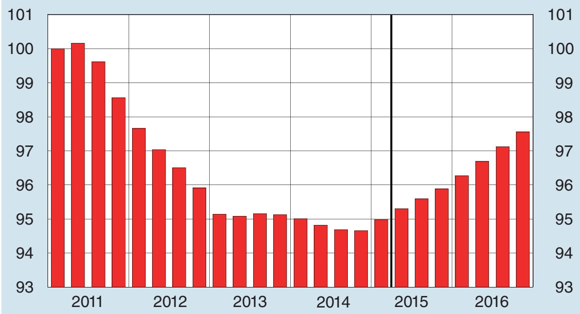
Our growth projections are slightly higher than in January

GDP is now projected to expand by 0.7 per cent in 2015 and accelerate to 1.5 per cent in 2016, mainly thanks to the gradual pick-up in domestic demand (Figure 33). By the end of the forecasting horizon output will have recouped around one quarter of the losses sustained during the global financial and sovereign debt crises.

The growth projections for 2015-16 are more than half a percentage point better than those published last January before the launch of the asset purchase programme by the Eurosystem. The upward revision is primarily due to the more positive international developments, largely ascribable to the effects of monetary policy decisions. The expansion of world trade, partly originating in the other euro-area countries, contributed 0.4 points to the revision, the depreciation of the euro 0.5 points, and the reduction of interest rates 0.1 points. Among the factors partly offsetting these effects, the most significant is the pricing policies of foreign competitors, which are now lower than was forecast in January (Figure 34). Among the components of demand, the biggest revisions involve investment – which in the first quarter of the year grew more rapidly than predicted in January – and foreign sales (Figure 35).

Figure 33

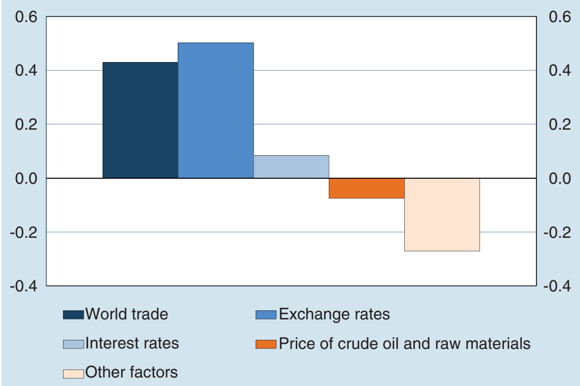
GDP projections: quarterly profile (1)
(index, 2011 Q1=100)



Sources: Based on Bank of Italy and Istat data.
(1) Real GDP, adjusted for seasonal and calendar effects. Through 2015 Q1, actual data; thereafter, projections.

Figure 34

Contributions to the revision of growth estimates for 2015-16 since January (1)
(percentage points)



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

The exchange rate and foreign demand are supporting exports

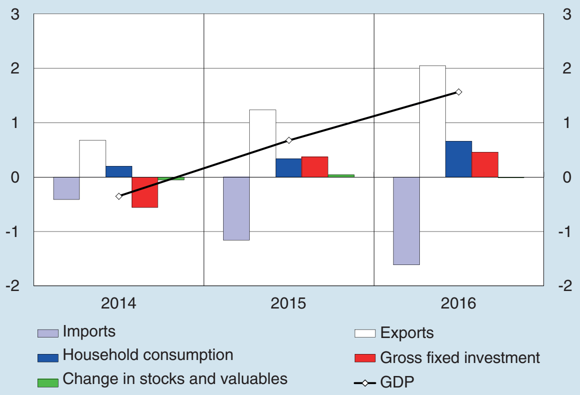
It is estimated that exports will grow at an average annual rate of over 5 per cent in the two years 2015-16. After stagnating in the first quarter owing to the weakness of economic activity in non-euro-area countries, they will expand at a faster pace than foreign demand, thanks to competitiveness gains associated with the sharp depreciation of the euro since the middle of 2014.

In our projections investment turns upwards again ...

After the slight increase recorded in the last quarter of 2014, capital formation accelerated considerably in the first three months of 2015, partly driven by tax incentives. Investment is projected to return to growth at an annual average rate of over 2 per cent in 2015 and 2016, chiefly reflecting faster growth in the machinery and equipment component, which will benefit from better demand prospects, improving

Figure 35

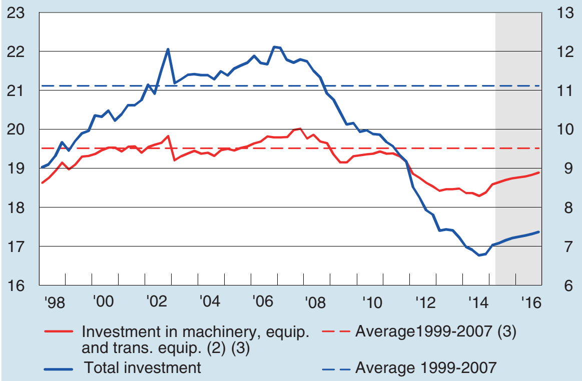
GDP growth and the contributions of the main demand components and imports (1)
(percentage points)



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

Figure 36

Investment as a percentage of GDP (1)
(quarterly data)



Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects. – (2) Investment in machinery, equipment and transport equipment. – (3) Right-hand scale.

confidence and more favourable financing conditions. Notwithstanding faint signs of recovery in the early months of 2015, the housing market is expected to remain weak, curbing the recovery in residential building investment. At the end of the forecasting horizon the ratio of investment to GDP will still be lower than the average of the pre-crisis years (1999-2007; Figure 36), above all for construction.

... and consumption gradually strengthens ...

Household consumption is projected to accelerate gradually in the two-year period, thanks to the recovery in real disposable income, which should benefit from the income support measures taken by the Government and improved conditions in the labour market. Low interest rates should also make a contribution, discouraging saving and stimulating purchases of durable goods in particular. Household consumption is projected to grow by around half a percentage point overall this year and by over 1 per cent next year. Spending on durable goods, which fell by almost 30 per cent between 2007 and 2013, returned to growth in 2014 and should continue to increase in 2015-16.

... in part thanks to improving labour market conditions

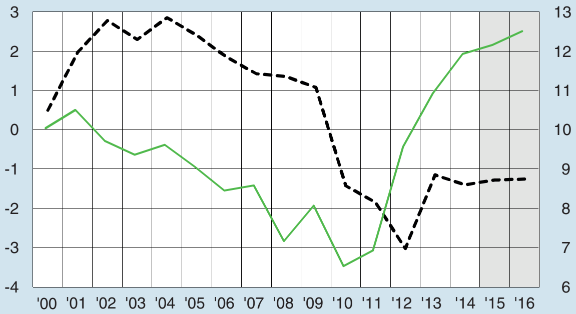
Labour market conditions should continue to improve, in line with the recovery in production. Employment measured in standard units, which has been expanding moderately since the beginning of 2014, will accelerate to average annual growth of 0.7 per cent over the next two years, benefiting from the cyclical upswing and, especially this year, the measures to narrow the tax wedge on labour contained in the Government's last Stability Law. It is estimated that these measures can boost employment by 0.2 per cent overall. These projections do not incorporate the effects of the Jobs Act, which are difficult to quantify and could lead to a greater increase in labour demand than estimated here. Our projections suggest that the unemployment rate will decline by around half a percentage point to the still high level of 11.9 per cent in 2016.

The external accounts continue to improve

Imports will grow by between 4 and 6 per cent, driven by the acceleration in the components of demand with the largest content of imported inputs (namely exports and investment in machinery, equipment and transport equipment). The surplus on current account should continue to improve, from 1.9 per cent of GDP in 2014 to 2.2 per cent this year and 2.5 per cent in 2016 (Figure 37); the increase should be partly attributable to better terms of trade brought about by the fall in oil prices.

	Figure 37

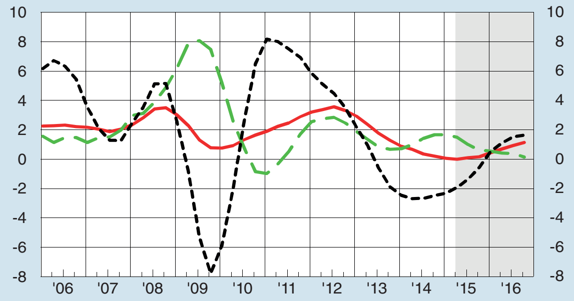
Household saving rate and current account balance
(percentage points)



Sources: Based on Bank of Italy and Istat data.
(1) Right-hand scale. – (2) As a share of GDP.

Figure 38

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.

Inflation increases gradually, by more than estimated in January

The Eurosystem's asset purchase programme should contribute to a gradual increase in inflation with respect to the low levels recorded at the end of 2014, even if the rise in prices should remain modest overall throughout the forecasting horizon. Consumer price inflation is projected to be 0.2 per cent on average this year and 1.1 per cent in 2016 (Figure 38). Excluding the most volatile components, prices should rise by 0.7 per cent this year (as in 2014) and pick up to 1.0 per cent in 2016. Domestic price pressures should strengthen: the value added deflator for the private sector is forecast to increase by an average of 1 per cent in the two years 2015-16, mainly reflecting the recovery in profit margins. Unit labour costs are expected to increase only modestly, thanks to the cyclical upturn in productivity and the measures to reduce the tax wedge. Compared with January's *Economic Bulletin*, the projection for the harmonized index of consumer prices has been revised upwards by half a percentage point for this year and next, mostly owing to the decline in the exchange rate.

These growth estimates mostly parallel those formulated by the other leading international organizations for both 2015 and 2016. The inflation forecast of the European Commission is higher than ours and so, marginally, is that of the OECD (Table 9).

Table 9

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

	GDP (1)		Inflation (2)	
	2015	2016	2015	2016
IMF (July and April)	0.7	1.2	0.0	0.8
OECD (June)	0.5	1.5	0.2	1.3
European Commission (May)	0.6	1.4	0.2	1.8
Consensus Economics (June)	0.7	1.2	0.2	0.9

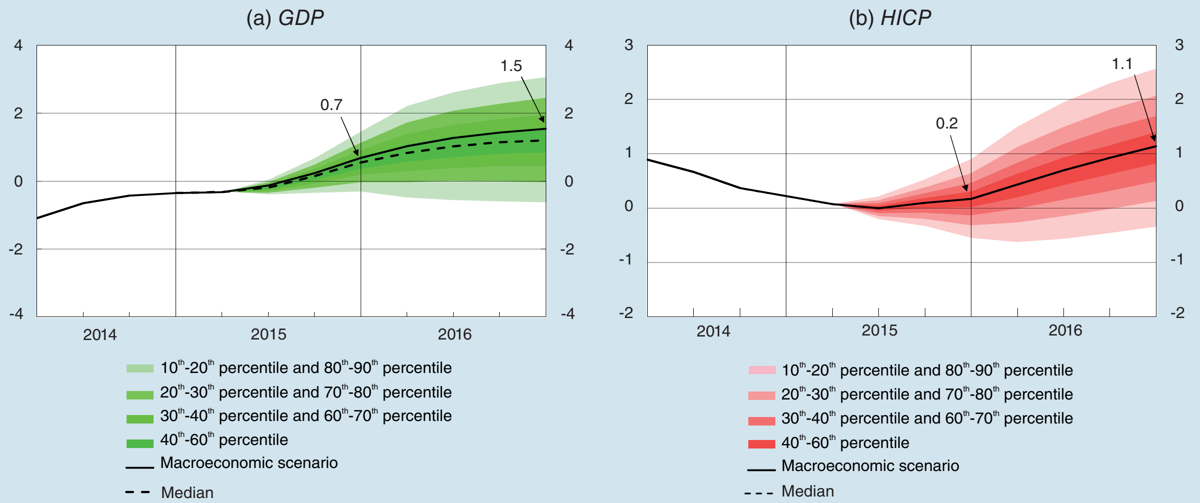
Source: For growth, IMF, *World Economic Outlook Update*, July 2015; for inflation, *World Economic Outlook*, April 2015; OECD, *Economic Outlook* 97, June 2015; European Commission, *European Economic Forecast*, Spring 2015, May 2015; Consensus Economics, *Consensus Forecasts,* June 2015.
(1) The growth rate forecasts of the OECD are adjusted for calendar effects; those of the European Commission and the IMF are not. – (2) HICP.

The risk factors

The economic picture described in this Bulletin reflects favourable external conditions and a gradual improvement in household and business confidence. The dissipation of these conditions would have non-negligible negative effects on economic activity. A resurgence of tensions linked to Greece would have a very modest direct impact through trade and financial links with Italy, but could have repercussions on capital markets.

Figure 39

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), 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.

Risks could derive from a deeper and longer slowdown in the emerging economies than that implied by our assumptions for world trade, especially if the normalization of US monetary policy were to be accompanied by fresh turbulence in foreign exchange markets and in capital flows. Heightened uncertainty on the part of firms could impede the investment recovery if the reform process were perceived to have faltered. Overall, the risks for growth are balanced this year and prevalently on the downside for the rest of the forecasting horizon; those for inflation appear balanced overall (Figure 39).