2.10 PROJECTIONS

The projections for growth and inflation presented in this *Economic Bulletin* point to a strengthening of the economic recovery in Italy (Table 11), based on the assumption that the weaker stimulus provided by foreign trade as a result of the global economic slowdown will be replaced by a greater contribution on the part of domestic and euro-area demand. For this to happen, the Eurosystem's asset purchase programme must continue to produce effects, the fiscal policy stance has to remain non-restrictive, and credit conditions need to improve. There continue to be downside risks for economic activity stemming from the outlook for the emerging economies, geopolitical tensions, and the ensuing uncertainty afflicting the corporate sector, which could reduce its propensity to invest.

Table 11

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

	2015	2016	2017
GDP (1)	0.7 (1)	1.5	1.4
Household consumption	0.9	1.6	1.4
Government consumption	0.4	0.6	-0.3
Gross fixed investment	0.5	2.7	2.2
of which: in machinery, equipment and transport equipment	2.1	5.4	3.1
Total exports	3.8	3.9	5.6
Total imports	5.5	4.7	5.1
Change in stocks (2)	0.4	0.1	0.0
HICP	0.1	0.3	1.2
HICP net of food and energy	0.7	0.7	0.9
Employment (3)	0.8	0.9	0.9
Unemployment rate (4)	11.9	11.1	10.7
Export competitiveness (5)	3.9	1.4	0.4
Current account balance (6)	2.0	2.1	2.3

Sources: Based on Bank of Italy and Istat data.
(1) Changes estimated on the basis of quarterly data adjusted for seasonal and calendar effects. Without this adjustment, which is not made to annual data, GDP growth is estimated to be 0,8 per cent in 2015. – (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 scenario assumes a gradual recovery in the euro area ...

In line with the assessments of the leading international organizations, in the forecasting scenario we posit that after slackening in 2015 world trade will gradually return to growth in the next two years (see the box 'The technical assumptions'). However, with economic growth slowing in the emerging countries, the expansion of Italy's exports, weighted by destination market, will depend mainly on a stronger recovery in the euro area. Oil prices are expected to remain low, following the trend implied in the prices of futures contracts in the last ten days, partly owing to weak growth in the emerging economies and partly to the expected increase in oil supply from Iran now that sanctions have been lifted (see Section 1.1).

... an expansionary monetary policy ...

We project that conditions on the financial and foreign exchange markets will remain favourable thanks to the expansionary policies adopted by the Governing Council of the ECB. The yield on ten-year BTPs, which was about 1.5 per cent at the beginning of January, should stay close to its current level; the euro to dollar exchange rate, which is down about 13 per cent from the beginning of November 2014 when the asset purchase programme was announced, is expected to remain at the current rate.

... and favourable credit conditions

We also hypothesize that the expansionary stance of monetary policy and the gradual recovery in economic activity will continue to foster an improvement in credit conditions. The average rate on business loans, including overdrafts, which fell by almost 1 percentage point in the course of last year, from 3.6 per cent in 2014 to 2.7 per cent, should decrease to 2.4 per cent in 2017, owing in part to a progressive diminution in borrowers' riskiness. Accordingly, next year new bad debts for households and firms should return to the levels observed before the sovereign debt crisis. Business loans, which are now expanding, are expected to accelerate gradually over the next quarters; lending to households will continue to strengthen.

THE TECHNICAL ASSUMPTIONS

The main assumptions underlying the macroeconomic scenario are:

a) International trade, after slowing to an average of 1.5 per cent in 2015, grows by 3.5 per cent in 2016 and by 4.2 per cent in 2017; foreign demand, weighted according to the importance of the markets for Italian exports, expands at a faster rate of just under 0.5 percentage points on average for the next two years;[1]

b) the dollar-euro exchange rate, which averaged 1.11 in 2015, stands at 1.09 in 2016 and 2017;[2]

c) a barrel of Brent crude oil, which averaged around $53 in 2015, remains below an average of $40 in 2016 and then rises to $46 in 2017 in line with futures prices;

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

	2015	2016	2017
International trade	1.5	3.5	4.2
Potential foreign demand	2.0	3.9	4.4
Dollar/euro (1)	1.11	1.09	1.09
Nominal effective exchange rate (2)	4.6	0.3	0.0
Crude oil price (1) (3)	52.6	39.7	46.4
Three-month Euribor (1)	0.0	-0.2	-0.1
1-year BOTs (1)	0.1	-0.1	0.1
10-year BTPs (1)	1.7	1.9	2.2

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

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

e) the yield on ten-year BTPs, which was 1.7 per cent in 2015, rises to 1.9 per cent in 2016 and to 2.2 per cent in 2017, in line with market expectations;

f) the forecasting scenario takes into account the measures supporting economic activity contained in the last Stability Law (see Section 2.9) and in previous stability laws prepared by the Government. These include: the elimination of the municipal services tax (TASI) on the primary residence and other property tax reliefs; support for lower incomes; the reduction of social security contributions for new employees on permanent contracts; the reduction of corporate income tax (IRES) and the regional tax on productive activities (IRAP); and incentives for investment in capital goods.

[1] Our growth assumptions for international trade and potential foreign demand are consistent with those underlying the projections for the euro area agreed by the Eurosystem central banks and presented in December's macroeconomic projections for the euro area prepared by the Eurosystem staff, 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 spot and forward prices in the markets in the ten working days up to 12 January.

The scenario takes account of fiscal policy

The scenario takes account of the effects of the measures to support economic activity incorporated in the last Stability Law (see Section 2.9) and in the ones adopted earlier by the Government: eliminating the municipal services tax (TASI) on the primary residence and introducing other property tax relief; providing support for lower incomes; reducing social security contributions for new employees on permanent contracts; reducing corporate income tax (IRES) and the regional tax on productive activities (IRAP); and offering incentives for investment in capital goods.

GDP growth in Italy is moderate in 2015 and strengthens in 2016-17...

We estimate that GDP expanded by 0.8 per cent in 2015; based on quarterly data which are adjusted for calendar effects, it grew by 0.7 per cent (Table 11). The result reflects the contribution of the domestic demand components, which was only partly offset by the effect of opposite sign of foreign trade. The recovery is expected to become more robust in 2016-17 (Figure 36), driven mainly by domestic demand while foreign trade will pick up more slowly. Overall, GDP should expand by 1.5 per cent in 2016 and continue to grow at a similar pace in 2017 (Figure 37) even after the investment incentives contained in the Stability Law come to an end.

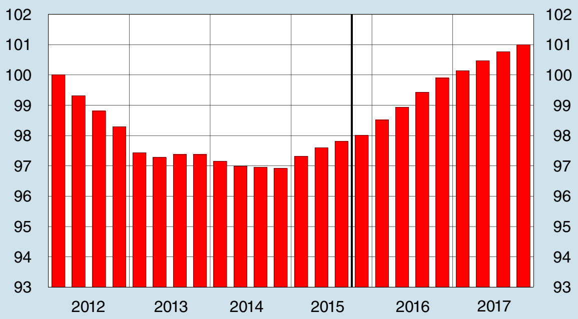
... thanks to expansionary measures

GDP growth will be largely due to the effects of expansionary policies. The Eurosystem's asset purchase programme should contribute about 1.5 percentage points in 2016-17 through its impact on the exchange rate, interest rates and credit conditions, and fiscal policy about 0.4 points. The positive effects of the tax relief for households as well as the measures to support business (reduction of social security contributions for new employees on permanent contracts, reduction of IRES and IRAP, and incentives for investment in capital goods) should be only partly offset by the measures for funding coverage. The drop in oil prices under way since 2014 will add about 0.8 percentage points to output in 2016-17, The contribution of international trade to GDP growth will be considerably below its historical average and the projection contained in the July Bulletin.

Figure 36

GDP projections: quarterly profile (1)

(Index, 2011 Q1=100)

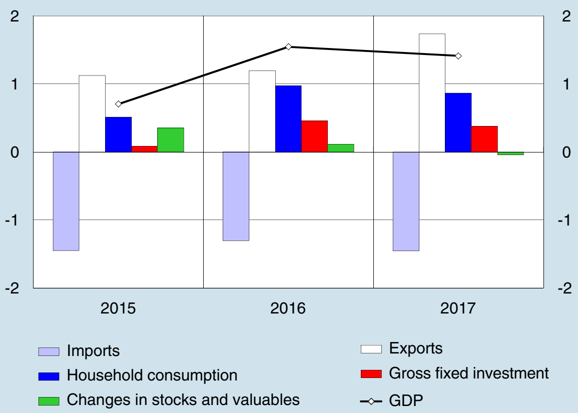


Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted. Actual data up to 2015 Q3; projections thereafter.

Figure 37

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) Data seasonally and calendar adjusted.

Exports are affected by the global slowdown but benefit from the exchange rate

After being held down by weakening foreign demand in the second half of 2015, export growth is projected to gain pace gradually, reaching an average annual rate of over 5 per cent in the last year of the forecasting period compared with 3.8 per cent in 2015. Overall, exports will expand more rapidly than our trading partners' demand thanks to the competitiveness gains associated with the euro's substantial depreciation since the middle of 2014.

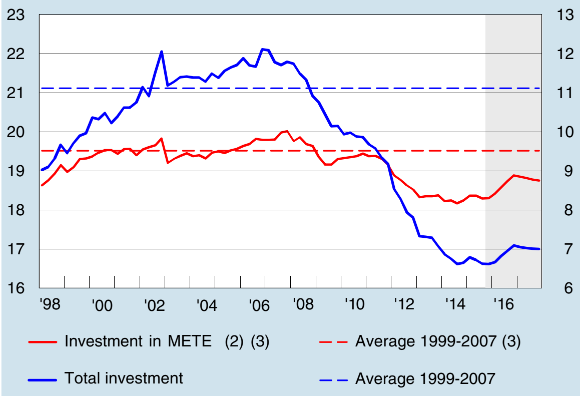
Demand and support measures foster investment

Capital formation, which remained slack throughout the second half of 2015, will pick up over the next two years, growing at an annual average rate of over 2 per cent. The recovery will reflect mainly the upturn in production assets, which will benefit from the Government's stimulus package as well as from a better outlook for demand and more favourable financing conditions. It is estimated that, by reducing the cost of capital for firms and encouraging them to bring expenditure forward, the incentives to invest in capital goods will add about 2.5 percentage points overall to the growth of investment in production assets. Investment in construction, especially residential building, is expected instead to remain slack owing to the slow recovery of the housing market: after contracting in 2015, it will stagnate this year and return to growth only in 2017. At the end of the forecasting horizon the ratio of investment in machinery, equipment and transport equipment to GDP will be close to the average for the ten years before the crisis (1998-2007), while the ratio of total investment expenditure to GDP will remain below it (Figure 38).

Figure 38

Investment as a percentage of GDP (1)

(quarterly data)



Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted. – (2) Investment in machinery, equipment and transport equipment (METE). – (3) Right-hand scale.

Consumption picks up slowly ...

Household consumption will continue to expand as real disposable income recovers thanks to the improvement in labour market conditions and the Government's stimulus package. The support for lower incomes and property tax relief are expected to contribute some 0.6 percentage points to GDP growth in the next two years. Low interest rates will help to boost household spending. Consumption expanded by almost 1 per cent in 2015 and is expected to accelerate to about 1.5 per cent on average this year and next. Spending on durables will continue to increase, though at a slower pace than in 2015. The household saving rate should stabilize at around 10 per cent over the forecasting horizon.

... partly thanks to the stronger labour market

Employment, measured in standard labour units, is projected to continue rising over the next two years at an average annual rate of 0.9 per cent in response to the improved outlook for demand and also, in part, to the Government's measures to reduce labour costs. It is estimated that reducing social security contributions for new permanent employees will not only generate a widespread shift to this form of contract but could also boost employment by about 0.3 percentage points in the three years of the forecast. The unemployment rate should continue to come down during the same period, falling below 11 per cent in 2017.

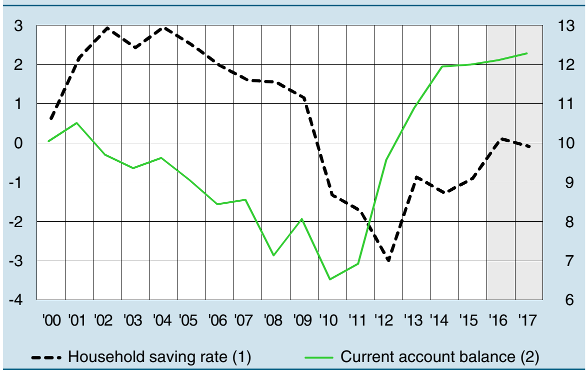
The balance of payments stays in surplus despite rising imports

Imports are projected to grow on average by almost 5 per cent annually, driven by the aggregate demand components with the highest import content (capital investment and exports). The current account surplus, which is estimated at 2.0 per cent of GDP in 2015, is expected to increase to 2.3 per cent in 2017 (Figure 39), an improvement for the most part attributable to the reduced energy deficit.

Figure 39

Household saving rate and current account balance

(percentage points)



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

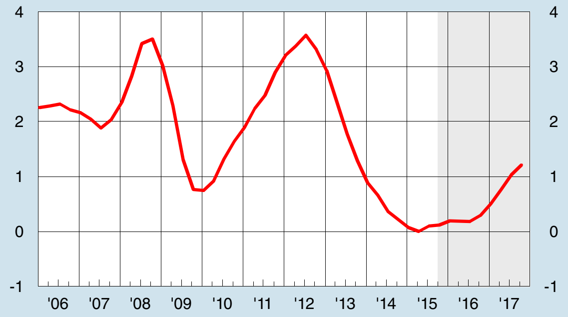
Inflation increases very slowly

Inflation, measured by the harmonized index of consumer prices, is projected to rise very gradually from 0.1 per cent in 2015 to 0.3 per cent this year and 1.2 per cent next (Figure 40). Core inflation will increase by 0.7 per cent in 2016 and 0.9 per cent in 2017. Domestic inflation, measured by the GDP deflator, will rise gradually over the forecasting horizon to reach 1.2 per cent in 2017. A factor in the low rate of inflation will be the small growth in nominal wages attributable to the outcome of recently renewed employment contracts and of those due to be signed this year and next, which are expected to incorporate pay rises in line with forecasts net of inflation due to imported energy products. Profit margins in the private sector will return to growth, by an annual average of 1 per cent, thanks to the cyclical upturn and to lower competitive pressures from abroad.

Figure 40

Consumer price inflation

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



Sources: Based on Bank of Italy and Istat data.

The growth forecast is in line with July's estimate ...

The forecast for growth is generally in line with the estimates set out in the July Bulletin, although there has been some change in the role of the contributory factors. While external conditions appear generally less favourable, the internal situation will strengthen. The impact of the downward revisions to foreign demand (which will deduct some 0.6 percentage points from growth over the entire forecasting horizon) will be almost entirely offset by the improved performance of interest rates and oil prices, as well as by the contribution of the additional expansionary measures of the Stability Law. Inflation forecasts have been revised down by about 0.8 percentage points for 2016, mainly owing to the drop in the prices of energy raw materials.

... and the estimates of other organizations

The projections for GDP growth presented in this scenario are generally in line with those formulated by the other leading organizations (Table 12). Our inflation forecast for 2016 is on average lower than that of the other analysts.

Table 12

Other organizations' forecasts for Italy

(percentage changes on previous period)

	GDP (1)		Inflation (2)	
	2016	2017	2016	2017
IMF (October)	1.3	1.2	0.7	1.0
OECD (November)	1.4	1.4	0.8	1.1
European Commission (November)	1.5	1.4	1.0	1.9
Consensus Economics (December)	1.3	…	0.8	…

Sources: IMF, *World Economic Outlook*, October 2015; OECD, *OECD Economic Outlook*, 98, November 2015; European Commission, *European Economic Forecast Autumn 2015*, November 2015; Consensus Economics, *Consensus Forecasts*, December 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.

There are risks for growth ...

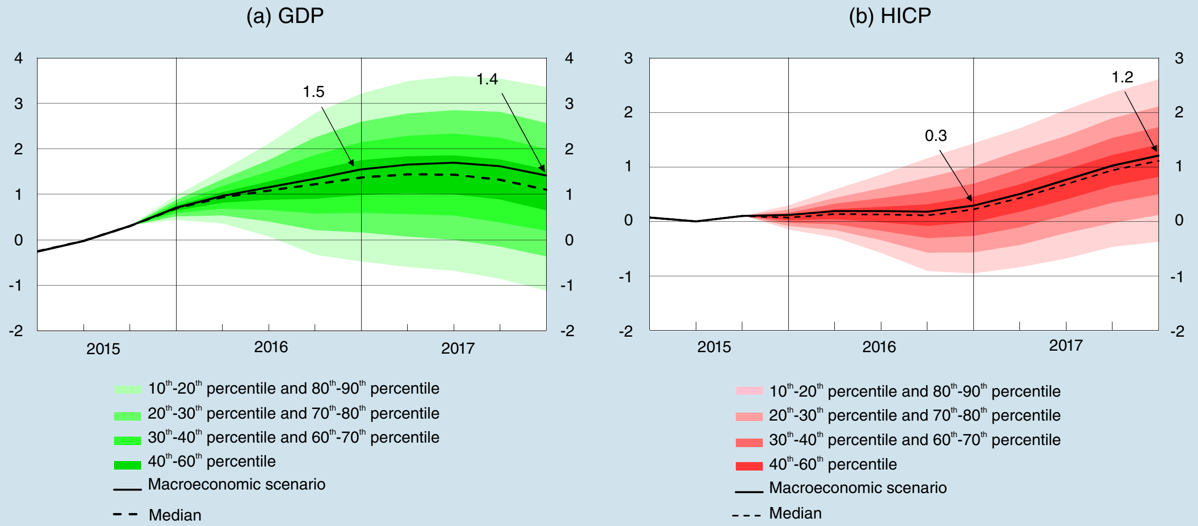
The risks for growth are predominantly on the downside (Figure 41). The main factors overshadowing economic activity are associated with the international situation. The slowing of growth in China and the emerging countries could turn out to be sharper and more prolonged than projected. A larger than expected slowdown in world trade could have repercussions on domestic demand as well if increased uncertainty about export growth were to lead to more cautious decision-making regarding investment. Geopolitical tensions, for the most part associated with the unstable situation in the Middle East and aggravated by the recent terrorist attacks, could impact on the confidence of households and firms.

... and for inflation

The downside risks for inflation stem from the possible effect on raw material prices of a sharper than expected slowing of growth in the emerging economies and a smaller than expected upturn in demand leading to a prolonged period of high levels of unused production capacity. There is also a risk that if inflation is lower than forecast this might have a second-round effect on wage increases, as in some of the recently signed contracts parts of pay rises are linked

Figure 41

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.

to shifts in the rate of inflation away from the current forecasts. On the other hand, prices could be buoyed by a further depreciation of the euro if monetary policy in the area were to diverge further from that followed elsewhere.