2.9 PROJECTIONS

The projections for the Italian economy presented here update those prepared as part of the Eurosystem staff macroeconomic projections published on 7 June, which were based on information available up to 22 May.[1]

The scenario is based on a slowdown in world trade ...

In line with the assessments of the main forecasters, the projections assume that world trade will weaken this year, whilst international trade tensions run high and global economic activity slows (see Section 1.1); trade will recover gradually in 2020-21. Foreign demand for Italian products weighted by the outlet markets will expand at a much slower pace than in the recent past, by 2 per cent this year (from 3.3 per cent in 2018), before gradually speeding up in 2020-21 (see the box 'The assumptions underlying the macroeconomic scenario').

THE ASSUMPTIONS UNDERLYING THE MACROECONOMIC SCENARIO

The forecasting scenario for the Italian economy prepared by Bank of Italy experts as part of the Eurosystem staff macroeconomic projection exercise is published on the Bank's website at the start of June and December together with the euro-area projections[1] released by the European Central Bank. The macroeconomic projections for Italy presented here update those released on 7 June on the basis of the most recent data; these include the latest national quarterly accounts released by Istat on 31 May after the closing date of the previous projection exercise, which have revised down GDP growth in the first quarter of this year and, all other conditions being equal, project a smaller expansion of GDP for 2019 as a whole. The technical assumptions have also been updated in the light of changes in the exogenous variables at 5 July.

The main assumptions underlying the scenario are as follows (see the table):

a) foreign demand, weighted by the outlet markets for Italian exports, slows to 2 per cent in 2019; it expands again at around 3 per cent on average in the two years 2020-21;

b) the euro/dollar exchange rate, which averaged 1.18 in 2018, stays at 1.12 in the three years 2019-21;[2]

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

	2018	2019	2020	2021
Potential foreign demand	3.3	2.0	2.9	3.2
Dollar/euro (1)	1.18	1.13	1.12	1.12
Nominal effective exchange rate (2)	-1.4	1.5	0.2	0.0
Crude oil prices (1) (3)	71.1	65.0	62.1	60.5
3-month Euribor (1)	-0.3	-0.4	-0.5	-0.4
1-year BOT yields (1)	0.2	0.0	-0.1	0.0
10-year BTP yields (1)	2.6	2.4	2.4	2.7

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

1 See on the Bank of Italy's website '*Macroeconomic projections for Italy*', containing the projections published to date as part of the Eurosystem coordinated exercise.

2 The technical assumptions on 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 to 5 July.

1 See on the Bank of Italy's website '*Macroeconomic projections for the Italian economy (Eurosystem staff macroeconomic projections)*', 7 June 2019.

c) the price of a barrel of Brent crude oil, equal to \$65 on average this year (\$71 in 2018), falls gradually in 2020-21;

d) three-month interest rates on the interbank market (Euribor), equal to -0.4 per cent this year, remain substantially unchanged in 2020 and 2021;

e) the yield on ten-year BTPs, equal to 2.4 per cent in 2019, rises gradually to 2.7 per cent in 2021, in line with the values of forward rates implied by the term structure of interest rates on government bond yields;

f) the scenario takes account of measures adopted in previous Budget Laws, including the one for the three years 2019-21, and of other measures set out by the Government in Decree Law 34/2019 of 30 April ('Growth Decree'). As in previous macroeconomic projection exercises and unlike the 2019 Economic and Financial Document published on 9 April, the technical hypotheses assume that the safeguard clauses relative to VAT and excise duty increases will not be activated in the two years 2020-21. In accordance with the guidelines underlying the Eurosystem forecasts, which do not incorporate measures that have yet to be defined in sufficient detail, the macroeconomic scenario excludes alternative measures for recouping revenue.

... and accommodative monetary conditions, but still high yields on government securities

The scenario assumes that monetary conditions will remain highly accommodative, consistent with the communication of the ECB Governing Council (see Section 1.2). According to the expectations incorporated in the financial market prices of the ten business days ending on 5 July, the interest rates on ten-year Italian government bonds will average 2.4 per cent this year and rise gradually over the next two years. In line with the developments observed over the last twelve months, it is assumed that yields on government bonds will be transmitted gradually to private sector borrowing conditions (see Section 2.7).

Table 14

The macroeconomic scenario
(percentage changes on previous year unless otherwise indicated)

	2018	2019	2020	2021
GDP (1)	0.7	0.1	0.8	1.0
Household consumption	0.6	0.4	0.9	0.9
Government consumption	0.2	-0.2	0.3	-0.1
Gross fixed investment	3.2	1.3	0.8	1.8
of which: in capital goods	4.0	-1.3	-0.7	1.1
Total exports	1.4	2.7	2.8	3.4
Total imports	1.8	0.7	2.6	3.3
Change in stocks (2)	-0.1	-1.0	0.0	0.0
Memorandum item: GDP, raw data (3)	0.9	0.1	0.9	1.0
Prices (HICP)	1.2	0.7	0.9	1.4
HICP net of food and energy	0.6	0.6	0.9	1.3
Employment (standard units) (4)	0.8	0.5	0.3	0.6
Unemployment rate (5)	10.6	10.2	10.2	10.0
Export competitiveness (6)	-0.9	3.5	1.3	0.4
Current account balance (7)	2.5	3.0	3.3	3.4

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) Includes valuables. Contributions to GDP growth; per cent. – (3) Not calendar adjusted. – (4) Standard labour units. – (5) Annual averages; per cent. – (6) 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. – (7) Per cent of GDP.

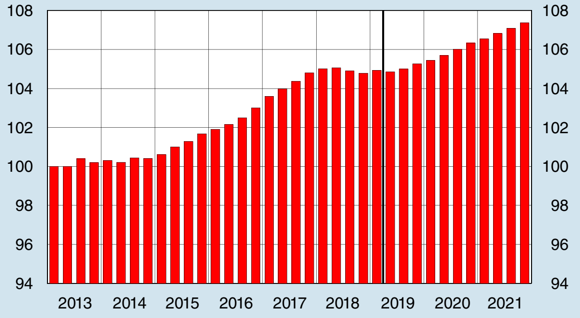
The forecasting scenario takes account of measures adopted in previous Budget Laws, including the one for the three years 2019-21, and of further measures outlined by the Government in Decree Law 34/2019 of 30 April ('Growth Decree'). As in the past, in accordance with the guidelines underpinning the Eurosystem projections, the scenario is based on technical assumptions that exclude the VAT increases envisaged under the safeguard clauses and alternative measures for recouping any missing revenue; nor is account taken of measures that have not yet been defined in sufficient detail.

In this scenario economic activity slows in 2019 and then gradually recovers

Based on these assumptions and in light of the latest cyclical data, it is estimated that GDP, adjusted for calendar effects, will expand

Figure 41

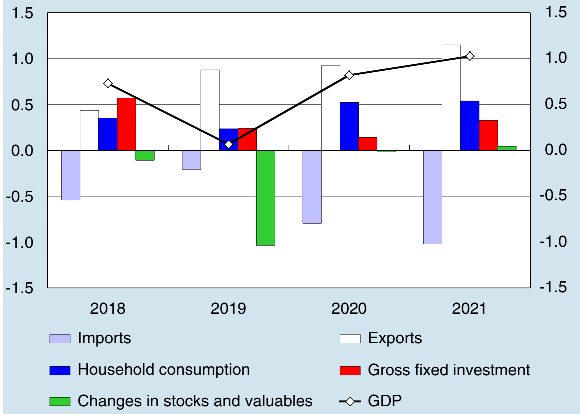
GDP projections: quarterly profile (1)
(levels; Q1 2013=100)



Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted. Actual data up to Q1 2019; projections thereafter.

Figure 42

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



Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted.

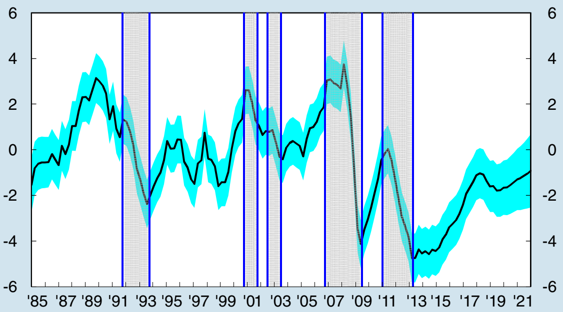
by 0.1 per cent on average in 2019, by 0.8 per cent in 2020 and by 1.0 per cent in 2021 (Table 14 and Figure 41). For the entire projection horizon, economic activity will primarily be driven by household expenditure and exports (Figure 42). The existing margin of spare production capacity is unlikely to be reabsorbed within the three-year forecasting period (see the box 'Italian output gap estimates').

ITALIAN OUTPUT GAP ESTIMATES

The Bank of Italy estimates potential output in the country by combining the results of different models: among these and based on their past performance, a prevalent role is given to reduced-form models and unobserved components models.[1]

According to our estimates, the gap between the actual level of output and its potential level, i.e. the output gap, is still broadly negative in Italy (the confidence bands shown in the figure capture the uncertainty surrounding the estimates). The average output gap for this year is estimated at between -2.9 and -0.5 per cent, with a central value of -1.7 per cent. Based on the macroeconomic projections presented here, the output gap will gradually narrow in 2020-21, reaching a central value of around -1 per cent at the end of 2021.

Output gap (1)
(percentage points)



Sources: Based on Istat data until 2018 and on our forecasts for the three-year period 2019-21.
(1) The output gap is measured as a percentage of potential output. The grey area represents recession periods as identified by Istat. The blue area shows the 90 per cent confidence bands calculated using the uncertainty intervals derived from the unobserved components model.

[1] The estimates are obtained by combining, with variable weights linked to past performance, the results of a production function approach with: (a) a structural vector autoregressive (VAR) model; (b) an unobserved components model; and (c) a time-varying autoregressive model. The methodology is described in A. Bassanetti, M. Caivano and A. Locarno, '*Modelling Italian potential output and the output gap*', Banca d'Italia, Temi di Discussione (Working Papers), 771, 2010.

In the three years 2019-21 the still very negative output gap will contribute to the lasting weakness in core inflation.

Our central estimate of the output gap is broadly in line with that of the OECD and comparable to that of the IMF, which expects it to narrow progressively in the three years 2019-21, reaching a still slightly negative level in 2021. Our estimate is instead considerably broader than that of the European Commission, which predicts a lower level of potential output and accordingly the full reabsorption of the output gap as early as next year.

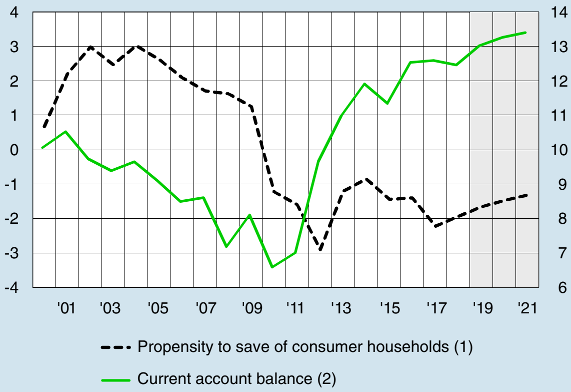
More structural approaches based on the production function usually encounter bigger methodological problems, owing to the difficulty of distinguishing underlying trends from cyclical fluctuations; this is why in the past a smaller weight was assigned to those trends when assessing the amount of unutilized resources in the economy. A recent methodological study conducted by the Bank of Italy aimed to take more adequate account of these phenomena when applying a production function approach, reaching conclusions that mostly confirm those obtained using the traditional indicator (see the box 'Methodological refinements of output gap estimates for Italy based on the production function').

Consumption expands

Consumption is projected to keep expanding, though at a slower pace than in the past three years and, partly owing to income support measures, it will strengthen halfway through this year. The saving rate of consumer households will rise slightly, reaching 8.7 per cent in 2021 (Figure 43).

Figure 43

Propensity to save of consumer households and current account balance
(percentage points)



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

Employment, which in 2018 had regained pre-crisis levels in terms of the number of persons in employment, will increase further, but at a slower pace, especially between the second half of this year and in 2020. It will likely be affected by the greater numbers of people leaving the labour market as a result of the introduction of new forms of early retirement which, as observed in the past, will only partly be offset by new hires. The unemployment rate, which fell in the first half of 2019, is projected to remain at around 10 per cent during the three-year forecasting horizon.

The scenario includes a slowdown in investment

Investment is expected to slow as a result of prolonged uncertainty about the outlook for demand, echoing the findings of our business surveys (see Section 2.2), and the gradual increase in borrowing costs. Expenditure on capital goods will decline both this year and next, in part owing to the expiry of tax incentives in 2020, and will start to rise again in 2021. Investment in construction will instead continue to expand, boosted by the gradual improvement in the real-estate market and the planned increase in public expenditure. The ratio of investment in capital goods to GDP, which last year had returned close to the level recorded prior to the double-dip recession, is expected to come down slightly during the three years; in the construction sector in 2021 this ratio is expected to remain about 2 percentage points below pre-crisis levels (Figure 44).

The external accounts continue to post a surplus

Exports of goods and services will be affected by the performance of world trade but, as in past years, Italian firms are expected to maintain their market shares: growth in exports amounting to about 3 per cent per year on average will just outpace that of foreign demand weighted by outlet markets. Growth in imports will be slower, owing to the weakness of investment in capital goods (the component of demand with the highest foreign input content). The current account surplus is expected to grow as a result, to over 3 per cent of GDP (Figure 43).

Inflation rises very gradually

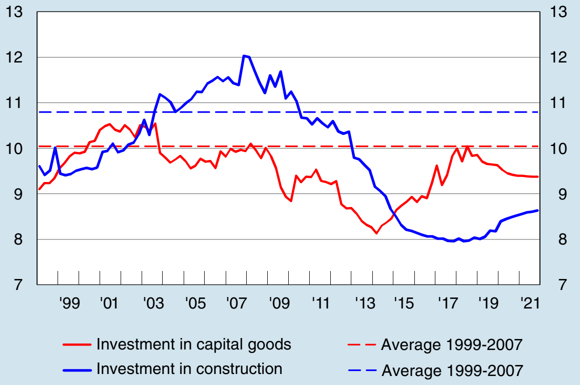
Inflation, calculated based on the change in the harmonized index of consumer prices (HICP), is expected to fall to 0.7 per cent in 2019 (Table 14 and Figure 45), before rising gradually to 1.4 per cent in 2021, primarily driven by the core component. Domestic inflation, measured by the GDP deflator, should amount to 1.0 per cent this year and rise in 2020 and 2021 to 1.1 and 1.5 per cent respectively, mostly reflecting the gradual acceleration in private sector wages. Firms' profit margins will continue to fall a little during this year, before expanding again in 2020-21, thanks to the gradual improvement in cyclical conditions.

The projections have been revised downwards compared with January

Compared with the forecasting scenario published in last January's *Economic Bulletin*, GDP growth projections are now 0.6 percentage points lower overall in the three years 2019-21. The revision is mainly ascribable to the assumption of a more subdued expansion in international trade and ongoing highly uncertain conditions, amply offsetting the effects of a reduction in interest rates. The inflation forecasts have also been revised downwards by almost 1 percentage point over the three-year horizon, above all owing to the persistent weakness of the core component and lower growth in the volatile components.[2]

Figure 44

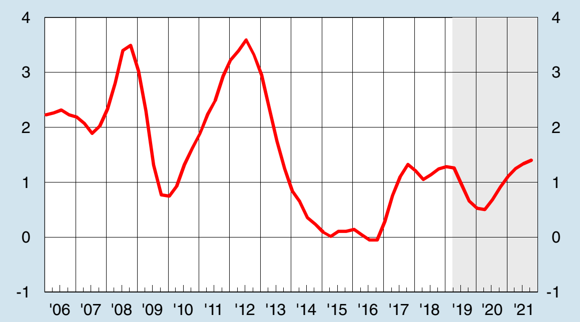
Investment as a percentage of GDP (1)
(quarterly data)



Sources: Based on Bank of Italy and Istat data.
(1) Data seasonally and calendar adjusted.

Figure 45

Consumer price inflation (1)
(percentage changes on year-earlier period; 4-term moving average)



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

The GDP growth projections for this year are consistent with those of the main forecasters (Table 15). Our estimates for 2020 are slightly more favourable than those of the OECD, European Commission and the average of the analysts polled in June by Consensus Economics, and are in line with those

[2] Compared with the projections published in June as part of the Eurosystem staff macroeconomic projections, based on information available in mid-May, the growth projections are 0.2 percentage points lower in 2019 and higher by 0.1 point in both 2020 and 2021. The adjustment for this year reflects the data on the quarterly accounts published by Istat on 31 May (which included a downwards revision of growth in the first quarter compared with the preliminary estimate released at the end of April), and the cyclical data released in June and at the start of July. The slight upwards revision of the growth projections for 2020-21 derives from more accommodative monetary conditions and the resulting fall in short and medium-long term interest rates. The inflation projections are 0.1 percentage points lower in each of the three years compared with the June estimates, owing to the slower pace of growth in both the core component and in commodity prices.

of the IMF. Our inflation projections for 2019 are slightly higher than the OECD estimates and a little lower than those of the other forecasters, while they are lower on average for 2020.

The risks to growth are still significant

These growth projections are subject to downside risks (Figure 46). Those of international origin reflect trade policy tensions: were they to escalate or become protracted, in addition to holding back global economic activity and, in particular, our European partners, they could trigger new episodes of financial volatility and have an adverse effect on firms' propensity to invest. In Italy, heightened uncertainty about the fiscal policy stance in the years to come could lead to renewed turbulence in the financial markets and dampen the confidence of households and firms, with repercussions on investment. A stimulus to economic activity could instead come from the establishment of a virtuous circle between fiscal policy and financial conditions.

Table 15

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

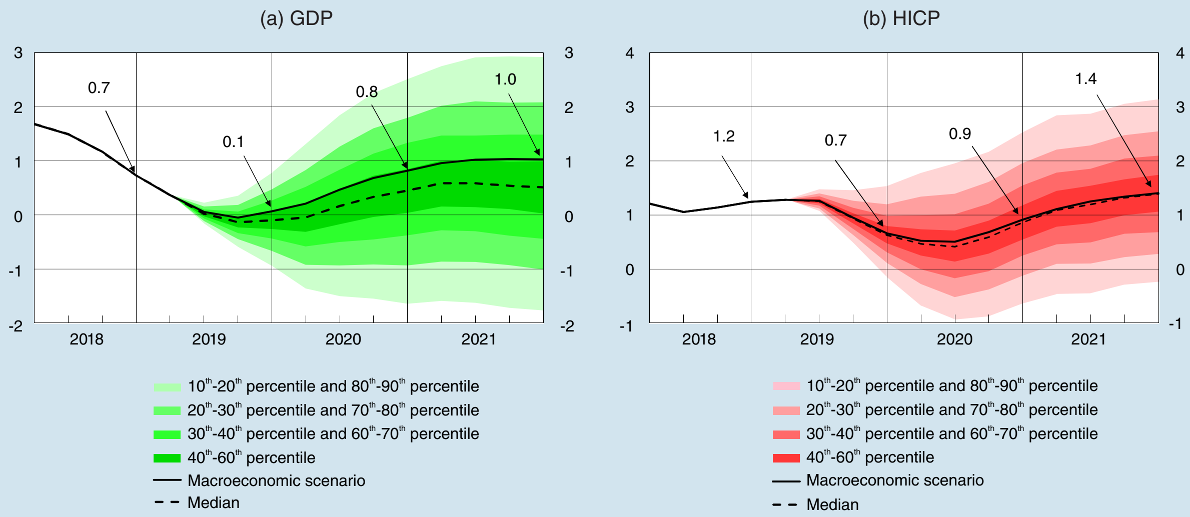
	GDP (1)		Inflation (2)	
	2019	2020	2019	2020
IMF (April)	0.1	0.9	0.8	1.2
OECD (May)	0.0	0.6	0.6	1.0
European Commission (July)	0.1	0.7	0.8	1.0
Consensus Economics (June)	0.1	0.5	0.9	1.2

Sources: IMF, *World Economic Outlook*, April 2019; OECD, *OECD Economic Outlook*, May 2019; European Commission, *European Economic Forecast – Summer 2019 Interim Forecast*, July 2019; Consensus Economics, *Consensus Forecasts*, June 2019.
(1) The growth rate forecasts of the OECD are adjusted for calendar effects; those of the European Commission and IMF are not. – (2) HICP.

The risks are balanced for inflation: the upside risks, stemming from pressures linked to increases in energy commodity prices, are offset by the effects of a possible further weakening of economic activity in Italy and around the world.

Figure 46

Distribution of probabilities of GDP and HICP projections (1)
(percentage changes on year-earlier period; 4-term moving average)



(1) Calendar adjusted quarterly data. The probability distribution is graphed for percentile groups by fan charts, based on stochastic simulations made via random extraction from the shock distribution of the Bank of Italy's quarterly econometric model. The distribution takes account of asymmetric shocks to the equations that reflect the main risk factors according to the procedure described in C. Miani and S. Siviero, 'A non-parametric model-based approach to uncertainty and risk analysis o f 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 fourth quarter of each year coincides with the average annual percentage charge.