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Endorsement of macroeconomic forecasts The Italian experience

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Outline

- The EU requirements and the Italian transposition
- Timeline and informational requirements
- The procedure (and an example)
- Some conclusions

The EU context

- Two-pack (Regulation on draft budgetary plans)
 - ✓ Medium-term fiscal plans and draft annual budgetary plans should be underpinned by independent macroeconomic forecasts, i.e. forecasts produced or endorsed by independent institutions
- Six-pack (Directive on budgetary frameworks)
 - ✓ National macroeconomic forecasts are compared to those of the European Commission and, eventually, of those of other independent institutions

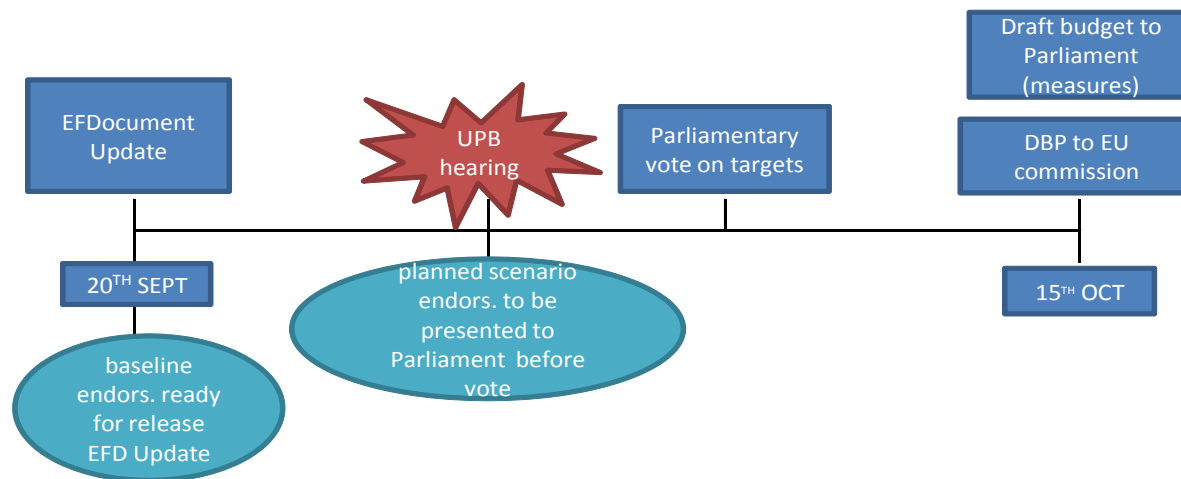
The Italian context

- Parliamentary Budget Office (PBO) **responsible for endorsing** GVT's macroeconomic forecasts

Ministry of Economy and Finance (MEF) responsible for macroeconomic forecasts underpinning medium-term and annual budget documents

- **Memorandum of Understanding (MoU)** between PBO and MEF establishing:
 - ✓ Documents for which endorsement is carried out (**twice a year**: Stability Programme and Draft Budgetary Plan)
 - ✓ General criteria for endorsement: **baseline and planned scenario**
 - ✓ **Timeline** and **requirements** for information exchange
 - ✓ Modalities for **issuing** endorsement (very formal)

Timeline and informational requirements



- **Baseline rounds** (in April and September):
 - MEF transmits first draft of scenario at least (14) days before the relevant deadline;
Formal requests for additional information and meetings
 - PBO sends its remarks at least (9) days before;
 - MEF sends the definitive baseline scenario at least (6) days before;
 - PBO transmits its validation letter to MEF at least (2) days before (it could be negative: not endorsed);
- **Planned scenario** (it includes the macroeconomic effects of new measure) **rounds - more difficult:**
 - After release of the EFD Update, MEF sends the planned scenario and the MoU foresees a scheme similar to the baseline one, with the deadline identified in the 15th October;
 - However the Parliament has to vote on the EFD Update. It has formally asked to be informed before its vote on the outcome of the endorsement procedure. Very tight timetable;
 - MEF sends something additional to what is already available in the document: but not information politically sensitive

Endorsement procedure

- Based on comparison between Government forecasts and **independently** produced **forecasts of PBO panel**
- PBO panel composed by:
 - ✓ PBO itself, producing its own forecasts (using Istat model and making also use of short-run models for nowcasting and very short-run outlook)
 - ✓ 3 independent Italian Institutes (CER, Prometeia, Ref)
- Benchmark for validation is hence made by 4 independently elaborated forecasts
 - ✓ currently they enter on an equal footing in validation procedure
 - ✓ In perspective as PBO forecasting capability increases, it will gain larger weight in forming PBO judgement

Endorsement procedure (2)

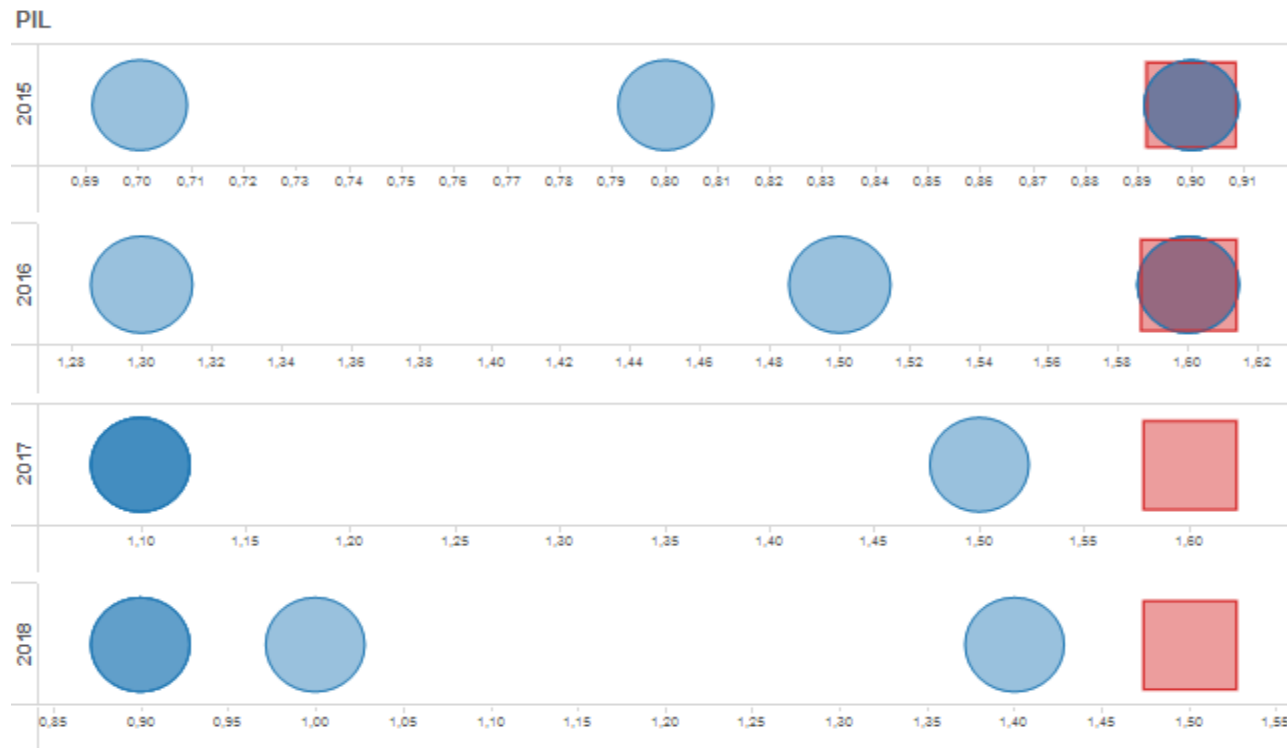
Main features of the procedure are the following:

- ✓ In constructing their scenario, PBO-panel forecasters adopt:
 - The set of assumptions on **exogenous variables** (international variables and interest rates) communicated by the Government at the start of the validation exercise; the aim is having a uniform external environment of the various forecasting scenarios
 - **Common assumptions on public finance**, elaborated by PBO on the grounds of Government documents and exchange of information with the Ministry of the Economy and Finance. This is done for:
 - Trendline scenario: common outcome of main past measures
 - Planned scenario: hypothesis on the programmatic measures
- ✓ Validation based on:
 1. checking internal **consistency** of Government scenario;
 2. verifying whether each relevant variable of this scenario **lies within the range** produced by PBO panel;
 3. if this is the case, detecting position of variables between lower and upper limits of the range (if at the upper limit, PBO points it out as an element of risk)

An example: latest endorsement session

(Update of the Economic and Financial Document, **September 2016**)

GDP (% rate of change): comparison between Government and PBO-panel forecasts (pink square=Government; blue circles= PBO panel of forecasters)

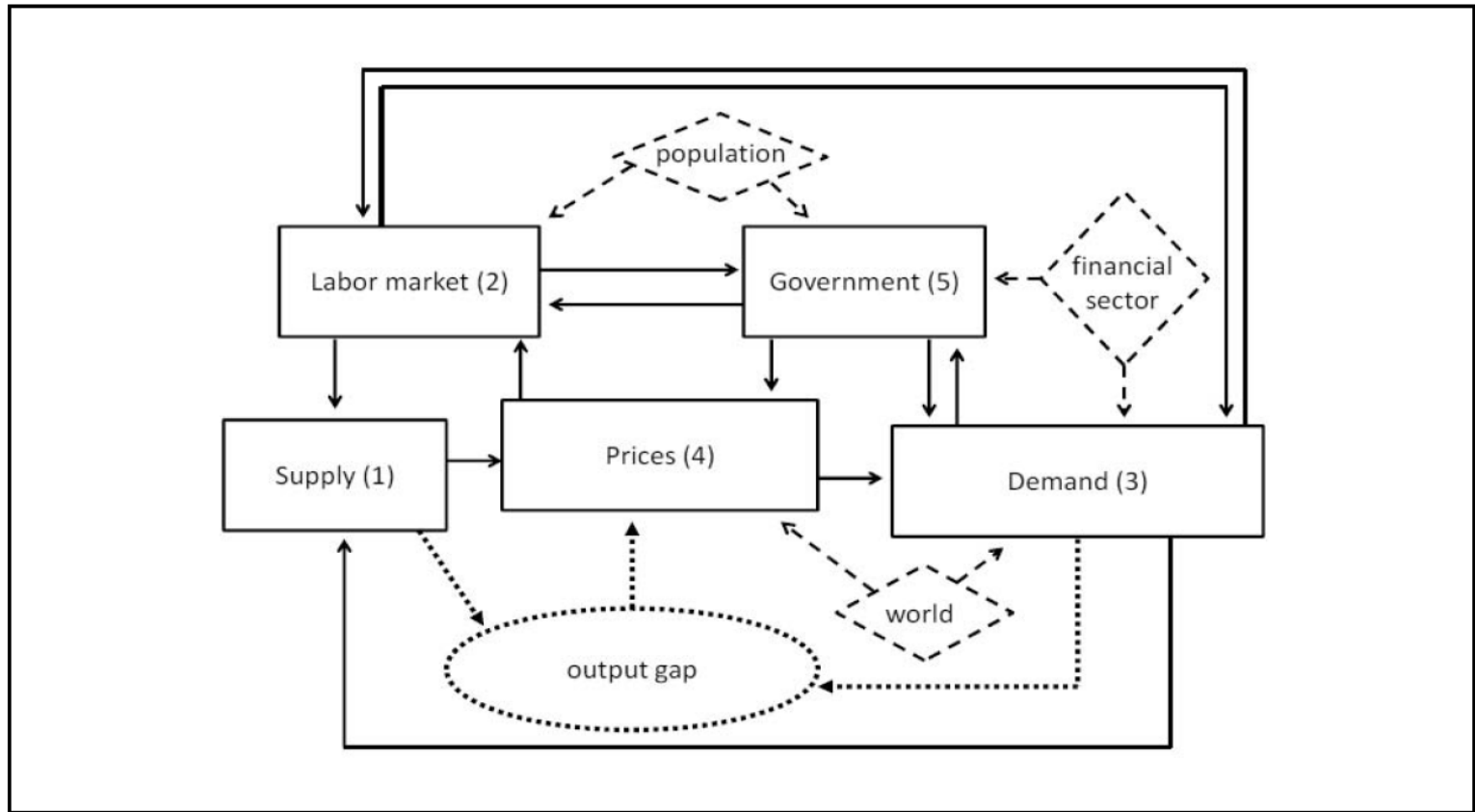


Results: 2015 and 2016 (subject to validation) are validated, but they are at the upper bound of the forecasting range, hence exposed to downside risks. 2017-2018 (not under validation) fall outside the range of the PBO panel (if subject to PBO judgement, they wouldn't have been validated)

Characteristics of the Istat-PBO model

- Based on New-Keynesian approach: short-run output is driven by demand side, while in the long run the system converges to potential output given by the supply side (determined by technical progress, potential labour input, capital stock); prices react to the output gap (disequilibrium between supply and demand)
- Annual model, updated twice a year (as soon as a new vintage of National Accounts is released in March and October)
- Composed by 53 stochastic equations and 78 identities representing an economic system including households, firms, public administration and foreign sector
- It uses cointegration methods to estimate theory-interpretable steady-state relationships, imposed in the form of equilibrium-correction models
- Models' parameters are simultaneously estimated with three-stage least squares (3SLS)

Main relationships of Istat-PBO model



- 5 rectangles represent the model's basic blocks
- 3 rhombuses denote the main sources of external information feeding the model
- oval circle is the output gap arising from short-run disequilibrium between demand and supply blocks
- arrows identify the causal structure of relationships across blocks

Conclusions

Endorsement procedure: technical problems

Exogenous variables

Government makes its own **(technical) assumptions** on international variables that may differ from those of other forecasters and also from EC forecasts.

In the most recent case (October), differences were relevant for world trade and oil price.

This highlights necessity that EC provides all member countries with common assumptions on the external environment for their forecasting exercise

Assumptions on international variables: Italian Government (DBP) and EC (Autumn forecasts)

	World trade, % chg.		Oil price, % chg.		Exchange rate, \$/€	
	It. Gvt.	EC	It. Gvt.	EC	It. Gvt.	EC
2015	3,0	2,5	-45,8	-45,0	1,118	1,119
2016	4,5	3,7	+0,7	-1,1	1,125	1,133
2017	5,2	4,5	+9,4	+8,4	1,125	1,133

Potential growth

Estimates of the potential growth has to be more strictly linked to macro estimates

Public finance

Consistency of the macroeconomic picture with public finance assessment has to be strengthened (*Why the DPB Guidelines provides for– and the EU commission produces its own - 2 years estimates, when debt rule has to be evaluated in the forward looking method up to the end of the period?*)

Endorsement procedure: institutional problems

Process schedule

- In the Autumn session, PBO evaluates forecasts of the Update of Economic and Financial Document elaborated in September.
- DBP is then prepared on the grounds of this document and, according to *two-pack* provisions, sent to the EC by mid-October.
- Yet, in the meanwhile national accounts are released by Istat. Mismatch of dates between formulation of the Update forecasts and dissemination of relevant data makes it necessary to rework the forecast for the DBP with risks of changes to the scenario that was validated

Imperfect knowledge

- At time of validation (September), PBO has an imperfect knowledge of the measures the Gvt intends to implement
- This knowledge is based on (very vague) indications of the “Update Document” and on exchange of information with the Ministry
- Measures become known by mid-October with the Budget law, after the validation process has been made; and often are substantially different
- ***Inconsistency of domestic calendar with EU procedures (will be changed soon)***
- ***highly sensitive-political contents***
- ***weakness of the medium-term framework***

Decimals and political relevance

Forecasts are not deterministic numbers, they are stochastic variables with confidence intervals; nonetheless, given the very nature of the exercise (help to evaluate compliance to fiscal rules), validation procedure leads to attach relevance to even small deviations from what it is deemed as a reasonable forecast.

What if – in terms of PBO credibility – endorsement is not conceded on the grounds of a small deviation?

Thank you for your attention!

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