BANCA IMI

Macroeconomic Outlook

Research Department

September 2015

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INTESA SANPAOLO

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Macroeconomic Outlook

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September 2015

Quarterly

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Global growth remains sluggish

The slowdown of the emerging economies is not explained solely by transitory factors, and will hold back the global economy in 2016 as well. However, the worst phase for global import-export trade should be over now.

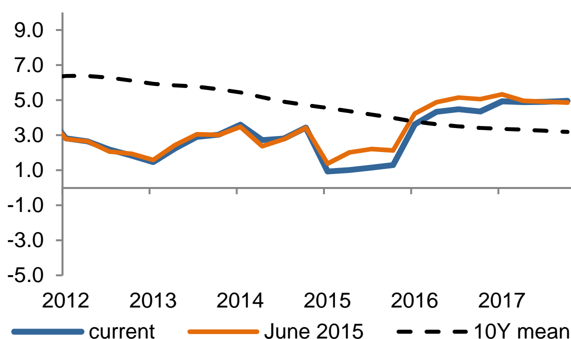
Economic growth in the advanced countries is by now being supported by domestic demand, and relies more on services than on manufacturing.

Expectations for oil prices to stay low into 2016 have prompted a new downward revision of inflation estimates in the advanced countries.

Luca Mezzomo

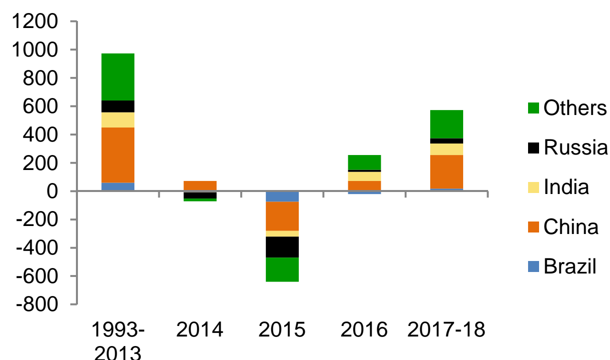
The devaluation of the yuan, and the storm which hit the Chinese stock markets in August, have turned attention back to the risk of a sufficiently persistent and deep slowdown of economic activity in the emerging countries to have repercussions on growth in the advanced economies as well. In truth, events had already been evolving in this direction for some time, but the intensity of events in China over the summer have caused much greater alarm than the crises in Russia and Brazil, less likely to reap global repercussions, and than the previous deterioration of macroeconomic data in China. The crisis has also been accompanied by a significant outflow of capitals invested in the emerging markets, estimated by the IIF at 30-40 billion dollars between 10 August and 14 September, and amounting to 70-80% of the flight which in 2013 followed the Fed's warning that it was starting to consider ending quantitative stimulus. Also, there is evidence of "contagion" having spread spreading to the stock markets of the advanced countries, undoubtedly aided by typically lower liquidity levels in the summer.

Fig. 1 – Volume of world imports in USD; y/y % chg.



Source: Oxford Economics and Intesa Sanpaolo projections

Fig. 2 – Contribution of the major emerging countries to import growth (in USD Bn)



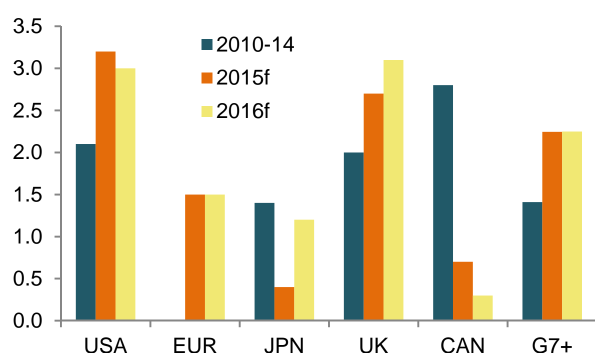
Note: the countries considered are: Argentina, Brazil, Chile, China, India, Indonesia, Malaysia, Mexico, the Philippines, Poland, Russia, South Africa, Thailand, Turkey.
Source: IMF, Oxford Economics and Intesa Sanpaolo projections

Volatility has now peaked and is starting to drop, and in mid-September signals even came that capitals are flowing back towards the emerging markets. The slowdown in economic activity, on the other hand, is less transitory. The problems afflicting the Chinese growth model will translate into a further slowing of GDP growth in the next few years, although we believe the 2015 contraction in imports to have been amplified by temporary factors, and that the import trend will pick up again in 2016. The Brazilian economy will continue to contract in average annual terms in 2016, at least compared to 2015. Russia will continue to be impacted by low oil prices and by economic sanctions, achieving only modest growth in 2016 (+0.5%), after the 2015 crash (-3.5%). Oil-exporter countries will not be able to count on a significant recovery in prices in 2016, either (Fig. E on page 4). Among the major emerging countries, for the time being only India seems to be escaping the overall trend, to the point that we expect growth rates in excess of 7% in 2016 as well. The implication is that while demand for imports in the

emerging countries will recover from the lows hit in 2015, it will not match the growth rates seen in the past (Fig. 2).

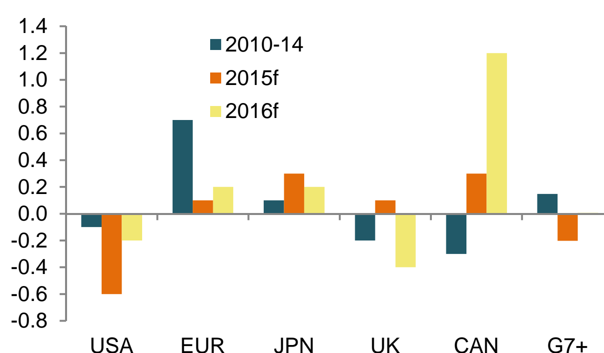
The value of foreign trade in current dollars in 2015 has decreased significantly, mostly pushed down by the drop in the price of oil, which alone has reduced the value of import-export trade by over 900 billion dollars, but also as a result of the slowdown in volumes growth (which we estimate at over one per cent, from 4.1 to 2.9%). In 2016, trade volumes should accelerate back to levels in line with 2014, and the global demand index should recover from 0.5 to 3.0% for the United States, from 1.3 to 4.6% for the euro area, and from 0.2 to 4.4% for Japan. The recovery will also be supported by the rebound in Chinese flows and by recovering domestic demand in the advanced countries, expected to consolidate next year in G7 countries (Fig. 3). Of the latter, only Canada is expected to make a strong contribution to net exports, as a result of stronger demand from the United States (fig. 4).

Fig. 3 – Contribution of domestic demand to GDP growth (%)



Note: G7+: United States, Japan, euro area, United Kingdom, Canada; aggregate based on nominal GDP in current dollars. Source: Intesa Sanpaolo elaborations

Fig. 4 – Contribution of net exports to GDP growth (%)



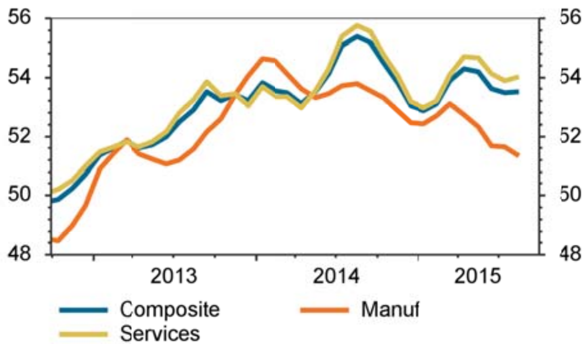
Note: G7+: United States, Japan, euro area, United Kingdom, Canada; aggregate based on nominal GDP in current dollars. Source: Intesa Sanpaolo elaborations

In the advanced countries, growth will continue to be supported by accommodative financial conditions and neutral fiscal policies. Even in the event of the Fed kicking off its rate increase cycle in the US, possibly already at the end of 2015, the size of the restriction will be modest, and short and long-term rates will stay low in historical terms; furthermore, this will happen against a background of a lively credit trend (Fig. J on page 5), that will only be slightly affected by the rate hike. In the euro area, where the recovery of the credit trend is still in an embryonic phase, the asset purchase programme is likely to be extended to beyond the September 2016 closing date, guaranteeing abundant liquidity and keeping the rate curve compressed. On the fiscal front, several euro area countries will attempt to obtain, next year as well, slacker terms to achieve their structural correction objectives. An expansion of monetary stimulus is likely in Japan as well. The trend of interest rates, on the other hand, will be less accommodative in the merging countries, some of which are facing capital outflows, a worsening of the terms of trade, and tensions on prices, which are limiting the central banks' freedom of action. Therefore, monetary policies will follow diverging paths, which could rekindle currency market tensions in the next few months.

On the whole, growth forecasts for 2016 have been lowered due to a deterioration of the outlook for the emerging countries. Global growth is still expected to accelerate marginally, to 3.1 from 3.3%, resulting from 2.3% growth in advanced countries and 4.4% in emerging economies; revisions amounted to -0.4% for the emerging countries and -0.2% for the advanced. Inflation estimates have been revised sharply downwards, due to the new lowering of forecasts for the price of oil. With the stabilisation of the price of oil, average inflation in the advanced countries should rise back from 0.2% to 1.0% in average annual terms, therefore staying below its 2013-14 level (1.3%); estimates are lower by 0.5% compared to June, including the average for 2015 as a whole.

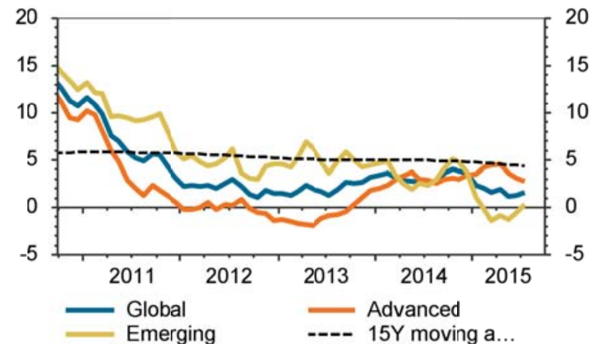
Trends of the global economy in 10 charts

Fig. A – Trend of global PMIs



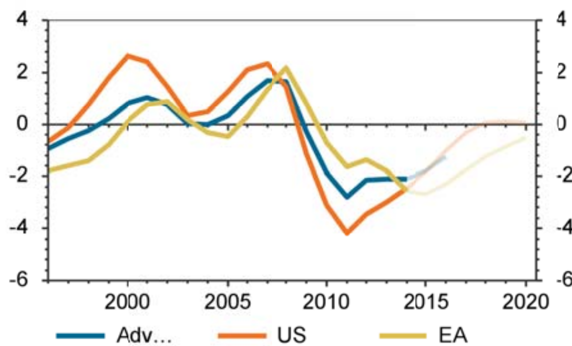
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Growth of imports, y/y



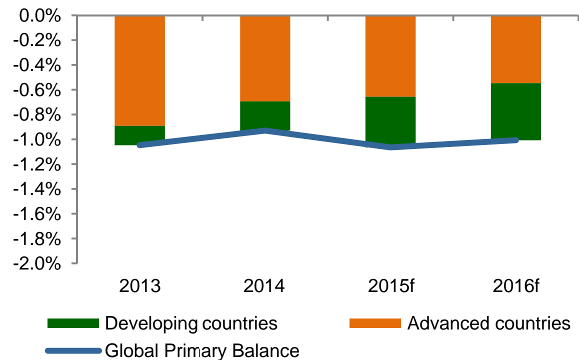
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



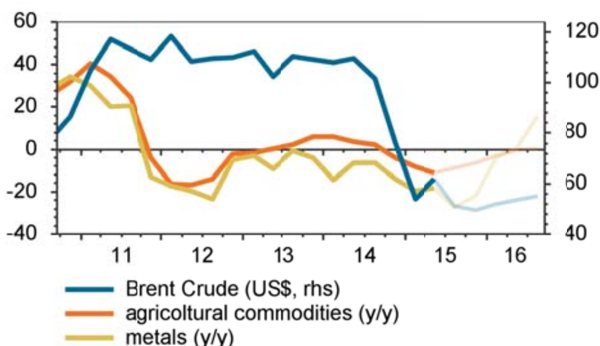
Source: Thomson Reuters-Datastream Charting and IMF

Fig. D – Public sector primary balance as % of global GDP



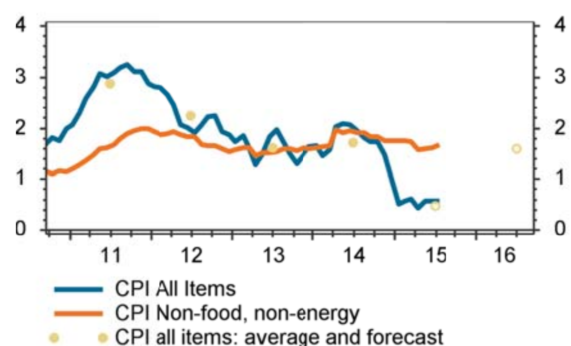
Note: based on the 11 top advanced countries and 8 top emerging countries. Aggregates at current exchange rates. Source: Intesa Sanpaolo elaborations

Fig. E – Commodity prices



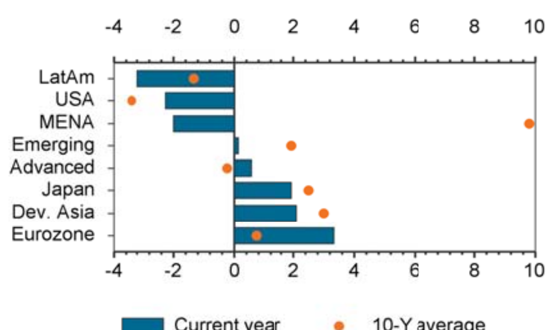
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices in OECD countries



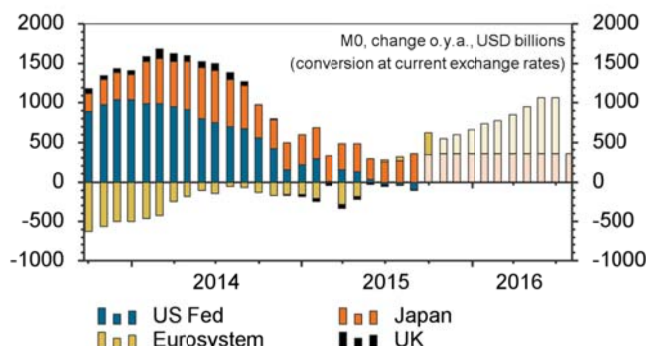
Source: OECD, Thomson Reuters-Datastream Charting

Fig. G – Balance of payments: current account balances as % of GDP



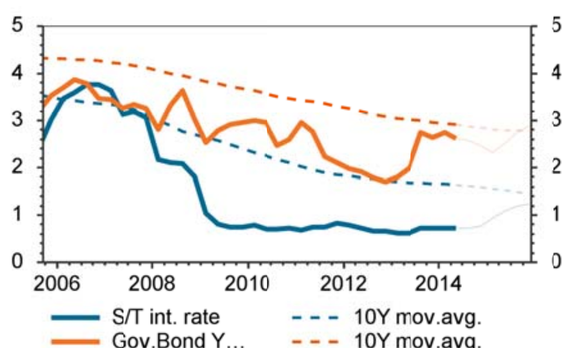
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

Fig. H – Money base, G-3 (change, USD Bn)



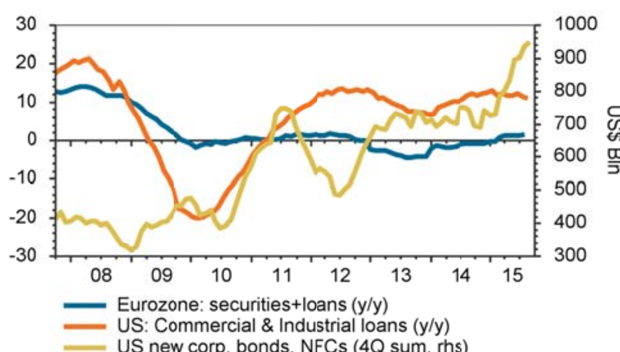
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – Global average



Note: The aggregate includes 44 countries, advanced and emerging. Source: Thomson Reuters--Datastream Charting and Oxford Economics

Fig. J – Loans to non-financial firms



Source: Thomson Reuters-Datastream Charting, ECB, Federal Reserve

Tab. 1 – Economic growth by geographical region

	2012	2013	2014	2015	2016
United States	2.2	1.5	2.4	2.6	2.9
Japan	1.7	1.6	-0.1	0.7	1.3
Area euro	-0.8	-0.2	0.9	1.5	1.7
East Europe	2.3	1.8	1.3	-0.5	2.1
Latin America	2.6	2.5	1.0	-0.1	0.9
OPEC	5.8	2.2	2.5	1.7	2.7
East Asia	6.1	6.1	6.4	5.9	6.0
Africa	3.1	3.1	3.9	3.6	4.0
Global Growth	3.4	3.4	3.4	3.1	3.3

Source: Intesa Sanpaolo elaborations

China, commodities and the dollar: which countries are most at risk?

Giulia Fioravanti

Which countries are most vulnerable to the combination of global shocks represented by the slowdown in the Chinese economy, falling commodity prices and dollar appreciation/interest rate hikes?

One possible measure of sensitivity to the Chinese economic cycle is the weight of exports to China as a percentage of GDP. Similarly, the weight of exports of commodities as a percentage of GDP can be used to show sensitivity to the commodity cycle. As regards financial fragility – of

the emerging markets only – we have decided to use indicators showing capacity to support currency devaluation to counteract the decrease in exports (percentage of debt in foreign currency, size of external debt) and indicators of the size of currency reserves.

For each indicator, the countries have been divided into risk brackets, which have been assigned a score of 0 to 4; we then calculate a general score, being the average of the individual indicators, in order to rank the risk of the countries analysed with regard to market attacks against their currency.

The country which is the most exposed to foreign trade is Chile; this is because its exports to China represent 7% of GDP and its exports of commodities around 13% of GDP. It does not seem to have any particular financial strength to offset this fragility. The devaluation of the Chilean peso (currently trading 30% below its historic average) could prove counterproductive as it increases the cost of servicing foreign debt: 87.7% of foreign debt is denominated in US dollars, while external debt represents 56% of GDP, and only a relatively small percentage is covered by currency reserves.

Malaysia is also exposed on both export fronts, as it is dependent on both China – as a big export market (8.63% of GDP) – and commodities (4.8% of GDP). In financial terms, however, it is fairly well placed as although its external debt is relatively high (65% of GDP), it is also running a positive current account balance and has a low percentage of dollar-denominated debt (27%).

Brazil and Indonesia do not appear to be especially exposed in trade terms (exports to China less than 2% of GDP and commodities about 3% of exports) and have low levels of foreign debt (33% of GDP). Their weaknesses lie in their current account deficits and, with regard to Brazil only, the percentage of external debt in foreign currency (77%) and local factors. Brazil's currency has already undergone a sharp correction, which will impact the cost of debt servicing but could boost its current account balance.

The main fragility of Turkey, whose currency has already lost 74% against its historic average, is of a financial nature; this has been exacerbated by political changes that do not inspire investor confidence. Major specific factors are also at play in the case of Russia and, as stated, Brazil and Argentina. On the other hand, neither Turkey nor Russia are particularly exposed to the consequences of the Chinese slowdown.

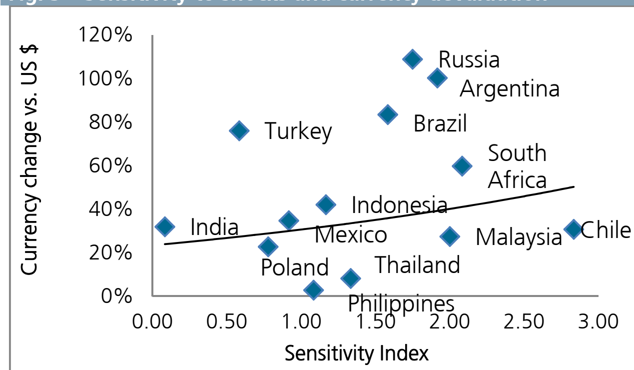
Among advanced economies, Australia comes out top in terms of weight of exports to China, at almost 6% of GDP; it is also a net exporter of commodities, which account for approx. 8% of GDP. South Korea is also heavily dependent on the Chinese market, but could benefit from lower commodity costs, and is financially solid.

Tab. 2 – Trade and financial exposure of emerging markets

Country	Exports to China, % GDP	Net commodity exports, % GDP	Current account, % GDP	Foreign Debt, % GDP	Foreign currency reserves / foreign debt, % GDP	Foreign debt in $ / total foreign debt, % GDP
Chile	7.12	13.48	-1.10	56.29	27.73	87.77
South Africa	2.49	2.45	-5.60	41.20	33.84	75.12
Malaysia	8.63	4.88	4.30	65.42	54.24	26.95
Argentina	0.91	5.98	-1.00	27.89	21.36	81.89
Russia	2.03	19.59	2.80	32.38	56.98	58.55
Brazil	1.86	3.38	-4.20	32.58	51.03	77.17
Thailand	6.64	-9.10	2.30	37.64	111.66	63.36
Indonesia	1.98	2.33	-3.00	33.00	38.17	54.56
Philippines	2.82	1.10	4.10	27.29	102.35	57.99
Mexico	0.47	-0.29	-2.10	33.07	46.19	83.04
Poland	0.37	-1.31	-1.30	64.58	28.35	n/a
Turkey	0.36	-1.97	-5.80	50.30	31.63	38.97
India	0.62	-4.83	-1.30	21.51	70.31	50.60

NB: The countries are ranked in descending order of general risk. Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data, IMF and national sources

Fig. 5 – Sensitivity to shocks and currency devaluation



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data, IMF and national sources

Tab. 3 – Exposure of advanced nations to trade

Country	Exports to China, % GDP	Net commodity exports, % GDP
Australia	5.62	8.1
United States	0.71	0.89
France	0.73	-2.51
Canada	0.98	5.66
United Kingdom	0.54	-2.23
Germany	2.12	-3.5
Japan	2.74	-6.85
Italy	0.63	-3.34
Korea	10.22	-11.39
Spain	0.37	-2.55
Taiwan	1.26	-12.91

Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data, IMF and national sources

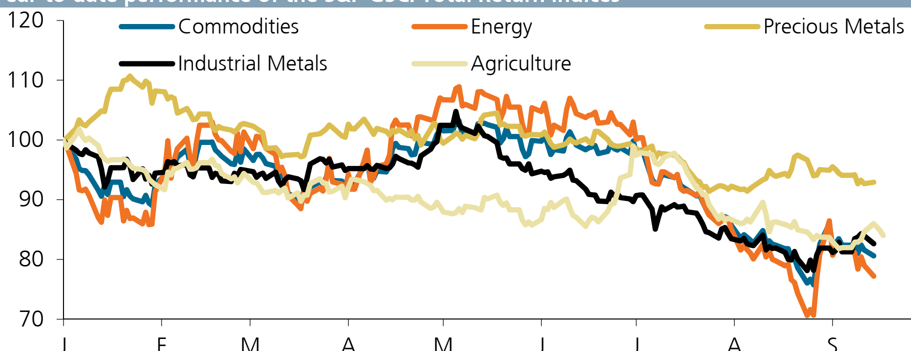
Commodities: downside risks continue to prevail

Daniela Corsini

Based on our macroeconomic scenario and supply and demand fundamentals, we expect to see highly volatile lateral markets in the final months of 2015. The main downside risks that have weighed on returns in recent quarters - the expected rise in US interest rates and the strength of the US dollar; weakness in the Chinese economy and financial markets, and doubts about the effectiveness and credibility of the reforms undertaken by the Authorities - will continue to adversely affect prices for some time to come. Only in 2016 do we expect to see a modest recovery in prices due to an overall improvement in supply and demand fundamentals.

After a period of relative stability in the second quarter, commodities again lost ground over the summer. The fundamentals of certain commodities, such as energy and precious metals, have deteriorated in recent months due to high supply and weak growth in demand, in both emerging and developed countries.

Year-to-date performance of the S&P GSCI Total Return indices

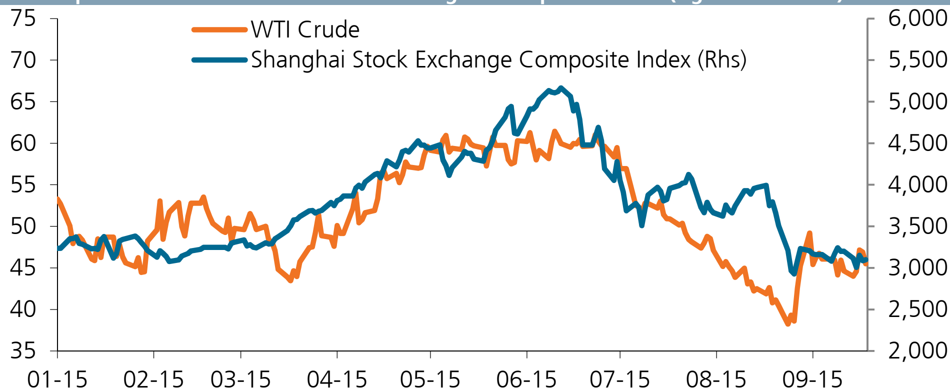


Source: Intesa Sanpaolo chart from Bloomberg data

Overall, the entire sector has been driven downwards by the collapse of the Chinese stock market and by fears of an excessive slowdown in the Asian giant. The declines of Chinese equities have had a particularly negative effect on commodities, influencing sentiment in world markets, given the prevalence of Chinese consumption in overall demand for most commodities, as well as liquidity in Chinese commodity exchanges, fuelling steep declines in domestic prices, particularly of industrial metals, which have, in turn, dragged down international prices.

The driving influence of China's financial conditions on the commodity markets is clear from the chart below, which shows the similar trends in WTI oil prices and the Shanghai Composite equities index. The collapse in oil prices over the summer was due to persistent oversupply on the world market, but it was intensified by negative market sentiment related to concerns about the sustainability of China's economic model.

WTI oil price in USD/barrel and level of Shanghai Composite Index (right-hand scale)

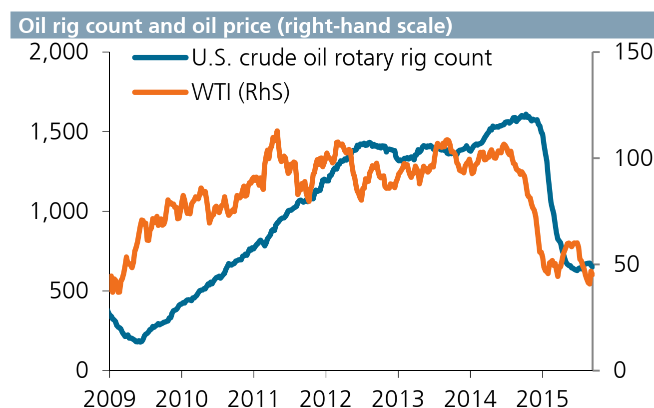


Source: Intesa Sanpaolo chart from Bloomberg data

The main reasons for the sharp deterioration in oil fundamentals are much higher than expected output by both OPEC and non-OPEC (particularly the US) countries and the belief that Iran may soon step up its crude exports.

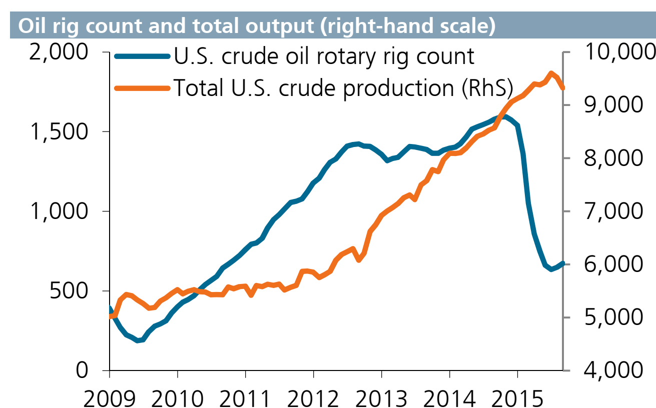
With regard to the first point, many observers have pointed to the failure of the Saudi strategy of increasing production volumes despite the collapse in prices in an attempt to protect its market share and curb supply with greater marginal production costs, such as oil from unconventional sources (mainly shale oil and Canadian crudes). However, so far North American producers have been less price-sensitive than expected. On one hand, their ability to cut production costs substantially and swiftly, while increasing average extraction efficiency from each individual well, has been surprising. On the other hand, overall US output has remained historically high due to the technical characteristics of production from shale oil wells: very high productivity in the first three years, despite a rapidly descending marginal yield curve. These two factors have helped to sustain historically high levels of production, despite very low prices and a steady decline in the oil rig count. This figure has followed movements in prices, but until now has not been a good predictor of overall output levels.

Oil rig count and oil price (right-hand scale)



Source: Intesa Sanpaolo chart based on Bloomberg and Baker Hughes data

Oil rig count and total output (right-hand scale)



Source: Intesa Sanpaolo chart based on US Department of Energy and Baker Hughes data

Lastly, in recent months projections of future growth in global supply have also changed significantly. The historic agreement between Iran and the P5+1 international powers (US, UK, France, China, Russia and Germany) will allow substantial volumes of Iranian crude back on the world market (according to our estimates, around 0.75 million barrels a day by mid-2016 will be added).

Given the current tensions between the OPEC members, we believe it is highly unlikely that other oil-producing countries will voluntarily agree to reduce their production to make way for the return of Iranian output to Asian and European markets, and bring cumulative group production into line with the current official target of 30 million barrels a day. Consequently, the world crude market outlook has worsened significantly when compared to the June's consensus estimates. Currently, robust supply and disappointing growth in global demand suggest that the market will not rebalance until the second half of 2016.

Our forecasts for the commodities universe

Volatility on the commodity markets is likely to remain high in the next few months. A number of factors of uncertainty continue to affect the sector:

- the trend in macroeconomic data from China, the Authorities' response to the current slowdown and the reaction of the markets to these announcements (depending on the credibility and effectiveness of the reforms to be announced) will influence market sentiment in the commodities sector, and would significantly influence global demand forecasts, particularly for industrial metals;
- the Federal Reserve has not yet indicated when the first interest rate hike will take place, and uncertainty about the direction of monetary policy will continue to fuel volatility in the commodity and forex markets. The strong US dollar could put downwards pressure on commodities, particularly precious metals. Gold, in particular, will be adversely affected by a more restrictive US policy and by low inflation forecast for the biggest developed countries;
- overall, changes in the macroeconomic situation will affect new forecasts for global demand for commodities. In particular, lower than expected economic growth in emerging countries or in the main developed countries would exert more downwards pressure on the sector. A possible deterioration in the political situation in Greece might again adversely affect consumer and business confidence in the Euro Zone, resulting in downward revisions to global demand forecasts;
- geopolitical tensions currently have little influence on the sector, but could once again become an important driver, especially in the energy sector, given the instability of the political landscape in the Middle East. The risk of more terrorist attacks in the eastern provinces of Saudi Arabia, where the main oil fields are located, is a particular concern. Moreover, in Africa, tensions in Nigeria and South Sudan could result in further decreases in hydrocarbon supply from these two countries;
- lastly, the main volatility factor for agricultural markets is the weather, particularly changes in El Niño, a periodic oscillation of the oceanic and atmospheric system linked to changes in temperature in the tropical Pacific Ocean that disrupts weather patterns over huge areas, normally bringing drought to South-East Asia and India, and higher rainfall than normal to South America. According to the latest forecasts released by the Australian Bureau of Meteorology, the El Niño phenomenon should continue until the first quarter of 2016. Furthermore, the data gathered to date suggest that the El Niño event could be as severe as in 1997-1998, the strongest ever.

Overall, based on our macroeconomic scenario, the main uncertainties affecting the commodity sector and supply and demand fundamentals, we expect to see highly volatile lateral markets in the final months of 2015. We only expect to see a modest recovery in prices during 2016. However, it should be stressed that, for most commodities, our average price forecasts for 2016 are not too far removed from average estimates in 2015, as we expect the main downside risks that have affected returns in recent quarters to continue to adversely affect prices for a long time, despite the fact that supply and demand fundamentals are expected to improve overall.

A scenario of persistent oversupply is expected for oil until at least mid-2016, in view of the high production levels from the US and the OPEC countries (led by Saudi Arabia and Iraq) and the expected return of Iranian crude to the international markets. Market sentiment is also likely to remain negative for some time, due to a strong dollar and downside risks to demand in emerging countries. We have therefore not ruled out the possibility of new lows in the next few months. However, we expect to see consolidation, followed by a modest upturn, in commodity prices in 2016, in the expectation that the current supply surplus will be gradually eroded and that global demand forecasts will improve.

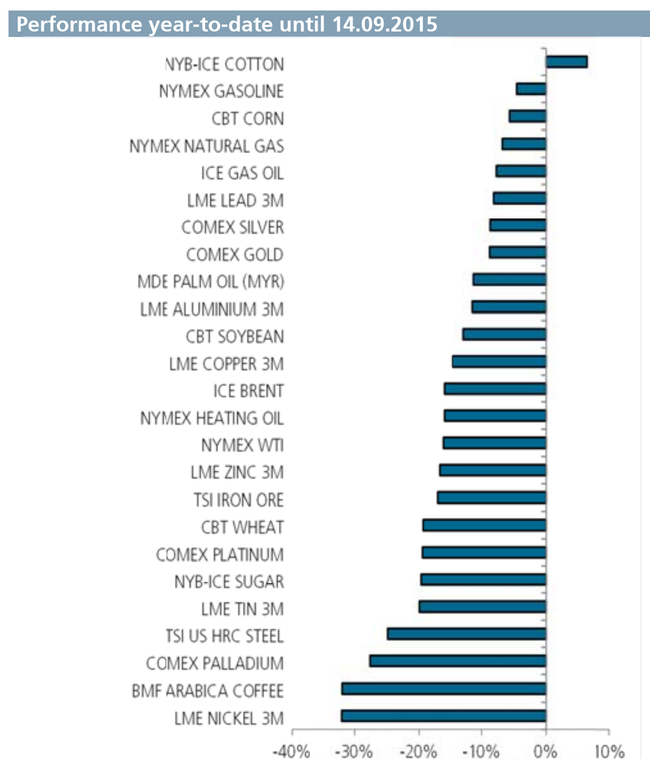
Precious metals may also hit new lows in the next six months, led by gold, as demand for investment is likely to be dampened by the first US interest rate hike, the strong US dollar, expectations of low inflation in the main developed countries and the difficulties of the biggest emerging countries (the collapse of the Chinese stock market, lower oil revenues in the Middle

East and a disappointing monsoon season in India). Although the long-term outlook is good, in the short term platinum and palladium are also expected to be negatively affected by high supply and concerns about slowing global demand.

With regard to the main industrial metals, we expect to see lateral markets until the start of 2016, curbed by low oil prices and uncertainty about the outlook for Chinese demand, followed by a recovery over the year. For most metals, we forecast a market in deficit in 2016 (mainly for copper, nickel and zinc) or an improvement in market conditions (for iron ore).

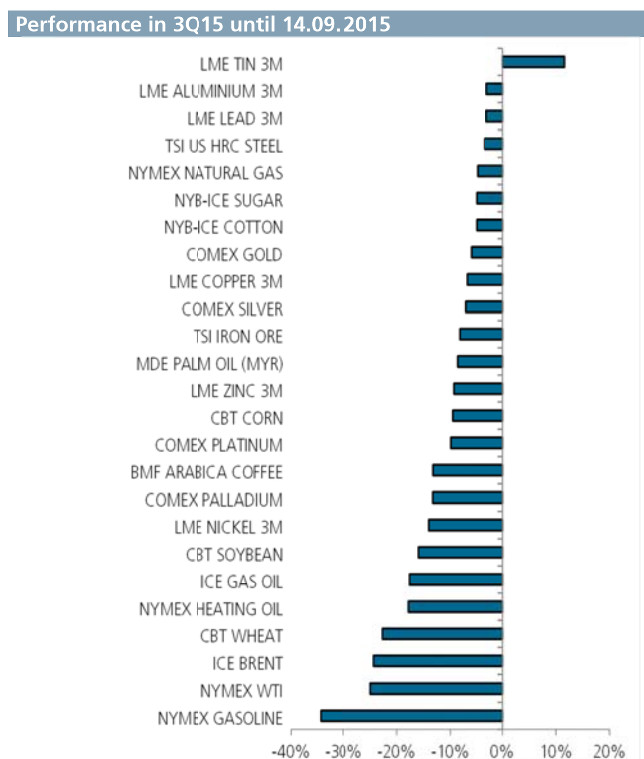
The main unknown for agricultural commodities is the weather conditions, and particularly the development of the El Niño phenomenon. For the main cereals, we expect to see a moderate recovery from the current low prices, driven by an improvement in supply and demand fundamentals.

Performance year-to-date until 14.09.2015



Source: Intesa Sanpaolo chart from Bloomberg data

Performance in 3Q15 until 14.09.2015



Source: Intesa Sanpaolo chart from Bloomberg data

Oil: excess supply

The scenario of a substantial oversupply for this year is confirmed. Robust supply and disappointing growth in global demand suggest that the market will not rebalance until the second half of 2016. In the next few months, the spotlight will be on output forecasts in the OPEC countries and the US. In particular, the most important variables will be future output levels and exports from Iran when the international sanctions are lifted.

Supply and demand fundamentals

The latest figures published in the monthly reports of the Organization of Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US Energy Information Administration (EIA) show estimates of supply and demand fundamentals for 2015 that are broadly stable compared with the June figures, but worse than the consensus forecasts being

made until a few months ago. Currently, these three forecasters are expecting an average call on OPEC crude (the quantity of oil that the group has to supply to balance the markets) for the year of around 29.2 million barrels per day (mb/d), unchanged from the June estimate. The forecast for global demand in 2015 has been revised upwards by 0.3 mb/d on average, while the estimate of non-OPEC supply has been raised by 0.2 mb/d.

Therefore, the scenario this year has been confirmed as one of substantial oversupply. On average, the call on OPEC crude remains well below the 30 mb/d target and actual OPEC production recorded in the last few months, which is over 31 mb/d and close to record highs.

Supply and demand estimates by OPEC, IEA and EIA for 2015

Estimates in September 2015, in millions of barrels per day	Total demand	Non-OPEC supply	OPEC supply of LNG	Call on OPEC Crude
OPEC	92.8	57.4	6.0	29.3
vs. 2014	1.5	0.9	0.2	0.4
IEA*	94.2	58.1	6.6	29.5
vs. 2014	1.6	1.1	0.3	0.2
EIA	93.6	58.4	6.5	28.8
vs. 2014	1.2	1.4	0.2	-0.4

* Estimates in August 2015
Source: Intesa Sanpaolo chart based on data published by OPEC, US, EIA and IEA

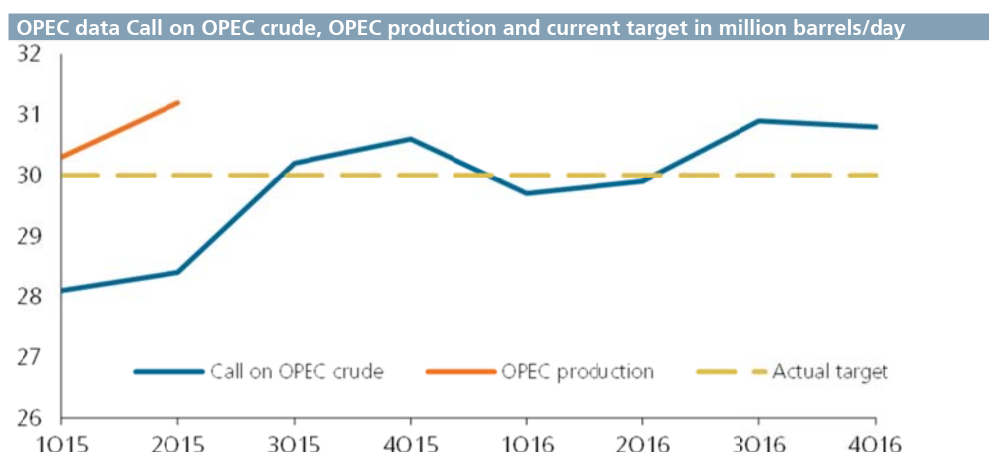
Meanwhile, it appears that excess supply will be gradually reabsorbed in 2016, despite the expected return of Iranian oil to the markets, and the three forecasters are currently estimating an average call on OPEC crude of 30.3 mb/d, higher than the group's official target and much higher than the only estimate available in June (EIA, 29.7 mb/d in June).

Supply and demand estimates by OPEC, IEA and EIA for 2016

Estimates in September 2015, in millions of barrels per day	Total demand	Non-OPEC supply	OPEC supply of LNG	Call on OPEC Crude
OPEC	94.1	57.6	6.2	30.3
vs. 2015	1.3	0.2	0.2	1.0
IEA*	95.6	57.9	6.9	30.8
vs. 2015	1.4	-0.2	0.2	1.4
EIA	94.9	58.4	6.8	29.8
vs. 2015	1.3	0.0	0.3	1.0

* Estimates in August 2015
Source: Intesa Sanpaolo chart based on data published by OPEC, US, EIA and IEA

OPEC data Call on OPEC crude, OPEC production and current target in million barrels/day



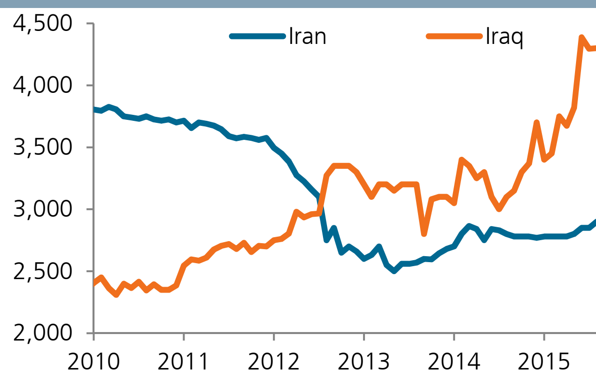
Source: Intesa Sanpaolo chart from OPEC data

Another indicator that normally measures oil market conditions is the estimate of spare capacity (i.e. excess production capacity, mainly in Saudi Arabia), reported by the EIA in its Short Term Energy Outlook.

According to the latest estimates in the September report, spare capacity is expected to contract to 1.5 mb/d in 2015, from 2.0 mb/d on average in 2014 (in June a decline of 1.8 mb/d was forecast) before rising to 2.0 mb/d in 2016. The EIA explains that normally, spare capacity of less than 2.5 mb/d is an indication that the markets are tight, but that the substantial stock building recorded up to now makes this estimate less representative. We agree with this analysis because, although the current contraction in spare capacity makes world markets particularly vulnerable to unexpected and substantial reductions in supply, we currently believe that in the coming quarters, estimates of global output will be more at risk of upward rather than downward revisions, due to the expected increase in Iranian exports. Furthermore, the current reduction in spare capacity is due to OPEC supply, which is close to historic highs, driven by record output in Saudi Arabia and Iraq, and not, therefore, due to reduced production capacity resulting from geopolitical risks.

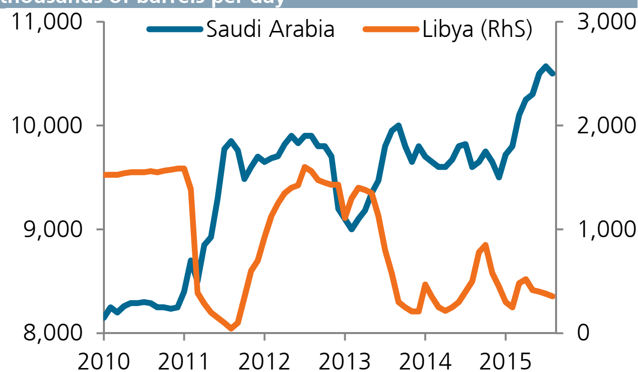
In the next few months, the spotlight will be on output forecasts in the OPEC countries and the US. In particular, the most important variables will be future output levels and exports from Iran when the international sanctions affecting the financial and energy sector are lifted. At the moment, we believe that Iranian output may increase by around 0.25 mb/d by the end of 2015 (subject to the positive outcome of the United Nations inspections that may end in mid-December) and by a further 0.25-0.50 mb/d in the first half of 2016, increasing by a maximum of 0.75 mb/d relative to the average levels registered in the first half of 2015. The upturn in exports may be faster, as it appears that Iran holds at least 40 mb of oil stored at sea, which would be immediately available once the sanctions are lifted.

Production by Iran and Iraq, in thousands of barrels per day



Source: Intesa Sanpaolo chart based on US Department of Energy data

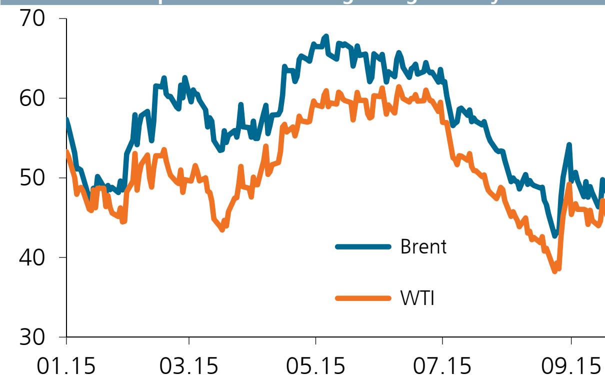
Production by Saudi Arabia and Libya (right-hand scale) in thousands of barrels per day



Source: Intesa Sanpaolo chart based on US Department of Energy data

With regard to shale oil supply, the resilience of US production, despite low prices and the record accumulation of stocks, came as a surprise this year. Substantial improvements in the efficiency of production processes and aggressive cost-cutting have offset the rapid decrease in the oil rig count, which is normally used as an indicator of future production levels.

Brent and WTI prices since the beginning of the year

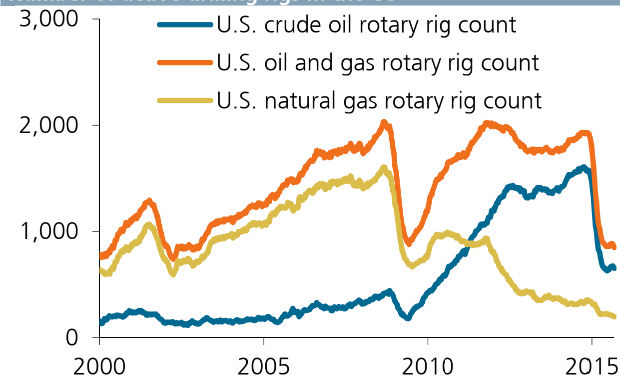


Source: Intesa Sanpaolo chart from Baker Hughes data

Brent-WTI spread

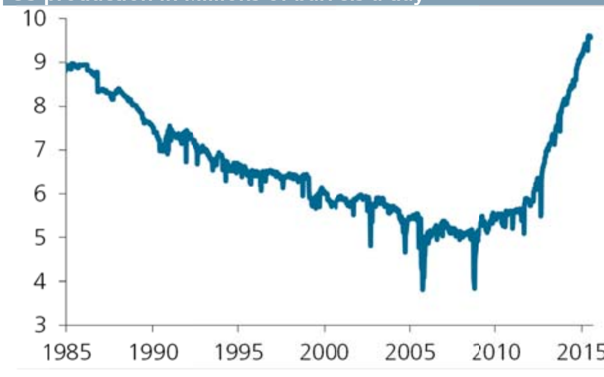
Source: Intesa Sanpaolo chart from US DOE data

Number of active drilling rigs in the US



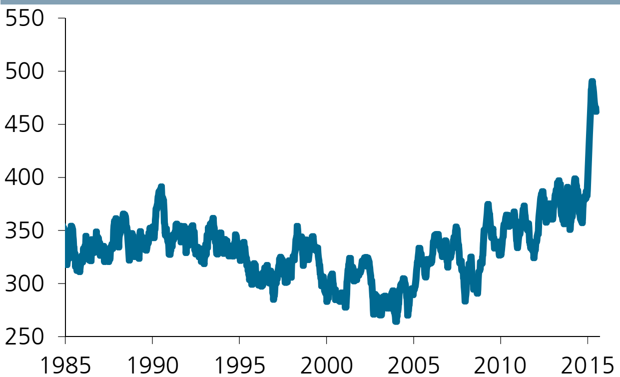
Source: Intesa Sanpaolo chart from Baker Hughes data

US production in millions of barrels a day



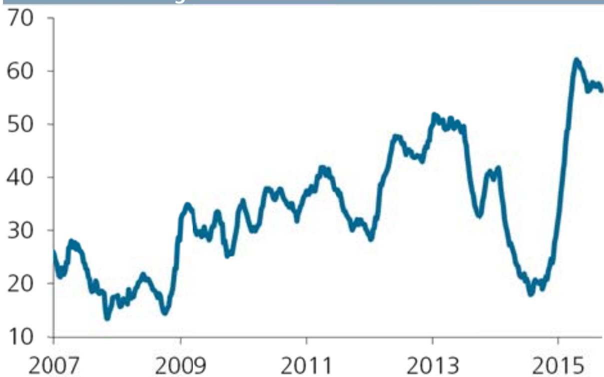
Source: Intesa Sanpaolo chart from US DOE data

US total oil stocks in millions of barrels



Source: Intesa Sanpaolo chart from US DOE data

Stocks at Cushing in millions of barrels



Source: Intesa Sanpaolo chart from US DOE data

Another subject for widespread debate in the next few months is the possible removal of the ban on crude exports from the US. At the time of writing, Congress is examining a bill to repeal the ban on exports of unrefined products. Currently, in our baseline scenario we do not expect the current trade restrictions to be completely removed before 2017, i.e. not before the inauguration of the next President.

Moreover, we do not expect this to make a huge difference to global crude supply estimates. In fact, all refined products and some types of crude (e.g. condensates) are already exportable, and therefore we simply expect to see a change in the composition of commercial flows of hydrocarbons. In our view, the main consequences of this decision will be price effects on differentials, and in particular a narrowing of the spread between Brent and WTI, and a redistribution of wealth within the US energy sector, as the mining companies would benefit from this liberalisation, but the refineries, especially the smaller ones, would be disadvantaged. In fact, it would erode the healthy margins enjoyed in the US sector in recent years, as the final price of refined products is unlikely to vary significantly, while an increase in the cost of production inputs is probable, given the expected narrowing of the Brent/WTI spread.

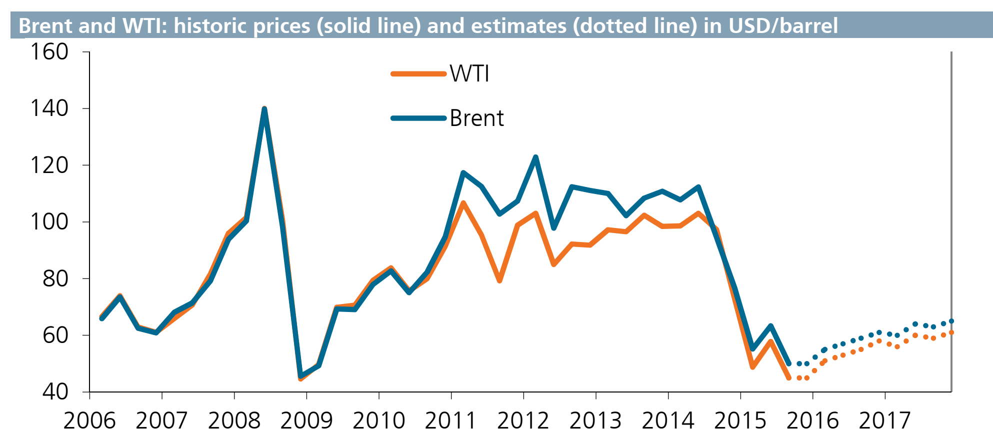
Forecasts

Given current supply and demand fundamentals, we expect prices to move in trading range at least until the end of year, but we also expect high volatility, as the decisions of policy makers, the publication of production and consumption data and the macroeconomic indicators in the major developed and emerging countries, as well as fluctuations in exchange rates, will fuel market movements between phases of excessive pessimism and cautious optimism.

We expect Brent and WTI oil to trade at USD 50 and USD 45 a barrel on average respectively in the fourth quarter. For both of these, we forecast a moderate recovery in prices over the next year to a target of USD 62 for Brent and USD 59 for WTI at the end of 2016. The expectation of a moderate recovery is based on the forecast of a gradual erosion of the current surplus, and could result in a market that is broadly balanced in the second half of 2016.

Among the main downside risks affecting our forecasts, we would highlight: global supply which is more plentiful than expected, for example if Iranian output is surprisingly high; a US dollar that is stronger than expected; and disappointing global economic growth data, mainly due to renewed fears of an excessive slowdown in China.

Brent and WTI: historic prices (solid line) and estimates (dotted line) in USD/barrel



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart from Bloomberg data

Price estimates for Brent

to 14.09.2015	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Estimate	50,0	55,0	57,0	59,0	61,0	54,6	58,0	63,0
Bloomberg median	55,0	58,0	61,0	64,0	65,0	N/A	63,0	70,0
Forwards	48,7	51,2	53,0	54,3	55,5	N/A	53,5	58,1

Source: Intesa Sanpaolo chart from Bloomberg data

Price estimates for WTI

to 14.09.2015	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Estimate	45,0	51,0	53,0	55,0	58,0	49,1	54,3	59,0
Bloomberg median	50,5	54,0	57,0	60,0	61,5	N/A	59,0	65,5
Forwards	45,1	46,9	48,3	49,2	50,2	N/A	48,6	52,4

Source: Intesa Sanpaolo chart from Bloomberg data

United States – Solid domestic growth, risks from the rest of the world

Giovanna Mossetti

The US economic picture remains positive, with further strength provided by the summer figures. An interpretation of the information from recent months is crucial in assessing whether the US recovery will be able to withstand market volatility, dollar appreciation and weakening growth in the emerging countries. After extensive revisions H1 data, growth for 2015 seems well-established and the economy is expected to continue on an upward path, with the pace of growth still above potential (estimated at around 2% by the Fed and the CBO) in the next two years: the forecast for 2015 is 2.6%, while for 2016 it is 2.9%.

US growth sustained by the fundamentals of private domestic demand in 2015-2016

The risks to the outlook are to the downside, and are chiefly tied to developments in the financial markets and the global economy. We believe that the fundamentals of the US domestic recovery are solid enough to prevent any derailment from its current track. However, should events that are currently only risks actually materialize (widespread slowdown in China and the rest of Asia, turbulence in the oil-producing countries, volatility and contagion on the financial markets with tighter financial conditions), growth could be closer to 2.5% than 3% in 2016-2017. In the current phase of low growth and zero interest rates in most developed countries, monetary policies have little scope to support growth, while fiscal policies are hindered by institutional conflicts. As a result, even relatively mild slowdowns might result in potentially "dangerous" developments for the economic outlook and should be monitored.

Downside risks related to the turbulence in the financial markets and the slowdown in the emerging economies

Growth in the H22015 and in 2016 is expected to be driven by private domestic demand, particularly consumer spending and residential investment: this is one reason to regard the US recovery as relatively insulated against the repercussions of the international economy. Consumer spending and residential construction are supported by strong fundamentals, restored to health after the Great Recession. Healthy household balance sheets, falling petrol prices, a labor market in equilibrium, a solid uptrend in the formation of new households, a reduction in unsold housing stock and sharply rising rents are strengthening each other and continue to push up household spending and the construction of new housing units. The contribution of these two components should be more than enough to offset weakness in other demand components, notably fixed investments and exports, which have been reined in by adverse developments connected with the emerging economies and commodities (i.e. exchange rate appreciation, slowing growth in China and emerging Asia and falling oil prices).

Increased domestic demand should protect the recovery from external shocks

Consumer spending grew on average by 3% qoq ann. in 1H15, and is expected to continue at a rate of 2.5% to 3% qoq ann. in H22015 and in 2016. Savings, at 4.9% in July, have stabilized at an average of around 5% since 2013, showing that households are only spending part of the "gas bonus" received last year (see figures 2-4). The labor market is now almost balanced, with homogeneously positive signals from employment, unemployment, under-employment, job openings, unemployment claims and long-term unemployment (see figures 5-6). The first confidence surveys in September showed a substantial correction, probably related to market turbulence. However, the well-established improvement in the labor market, strong growth in labor and disposable income, as well as the purchasing power freed up by the fall in petrol prices and historically low interest rates mean, in our view, that the growth forecasts of consumer spending growth of 3.1% in 2015 and 2.9% in 2016 are very well-founded.

Solid growth in consumer spending, buoyed by income from employment, healthy budgets and historically low interest rates

Residential investment represents a growing share of aggregate demand. Compared with a low of 2.4% in 2010, by mid-2015 residential construction accounted for 3.3% of GDP and is making an increasing contribution to the recovery. All the indicators in the sector are positive (construction, sales of existing and new houses, unsold houses, rental vacancies, and homebuilder confidence, see fig.8)) and point to solid growth. Growth forecast for residential investment is 8.4% in 2015, 7.8% in 2016, followed by normalisation at 4.3% in 2017.

Residential investment will be the second pillar of the recovery

Fixed business investment is the weakest link in private demand and the vulnerable area of the 2015-2016 scenario, affected by the restrictive consequences of the stronger dollar and lower oil prices. The correction in the mining sector is expected to end by early 2016 and stop

Fixed business investment: the weakest link in domestic demand

hampering growth in total investment. Financial conditions remain accommodative.. Businesses have a growing supply of available liquidity (see figure 9) and domestic demand is strong: these factors should more than offset the dampening effects of exchange rates and commodities, resulting in **growth of 3.5% in 2015 and 5.4% in 2016**.

Public spending approximately neutral in 2015-2016

Public spending is expected to rise by 0.5% in 2015-2016, growing slightly more quickly than in 2014, which followed four years of marked contractions. This moderate increase in public spending is due to recovery at government and local level, compared with a limited decrease at federal level. Overall, the contribution to aggregate demand is expected to be negligible.

Net exports: modest brake on growth in 2015-2016

Net exports will represent a headwind on growth in 2015-2016, but the negative contribution should be limited. Exports have been affected by the stronger dollar and weakening emerging economies. The direct effects of the Chinese slowdown on the US economy have been limited by the relatively low level of exports to China as a share of total exports and of GDP (see table 1, figure 11). The elasticity of exports to the dollar is estimated at 1.8% in the short term and 0.8% in the long term[1]. A number of empirical studies have shown a much lower elasticity of exports and inflation to dollar appreciation than in previous cycles, due to the increase in global value chains[2]. In our forecasts, the dollar exchange rate should be close to the peak. Therefore, unless a systemic crisis occurs, triggered by the Chinese correction, the effects of exchange rates and exports on US growth are not likely to be enough to derail the recovery, even though they constitute downside risks. **Exports are forecast to rise by 2% in 2015 and by 4.5% in 2016.** **Imports** are expected to grow by **5.5% this year** and **4.7% in 2016**.

Inflation: pushed down by exchange rates and oil, supported by closure of output gap

Inflation remains close to zero, due to the fall in raw materials prices and dollar appreciation. **Core inflation** is stable, remaining below 2% (core deflator +1.2% yoy, CPI core +1.8% yoy). The dollar and oil will offset moderate upward trends in core prices arising from the elimination of unused resources: 2016 should see stable core inflation close to current levels.

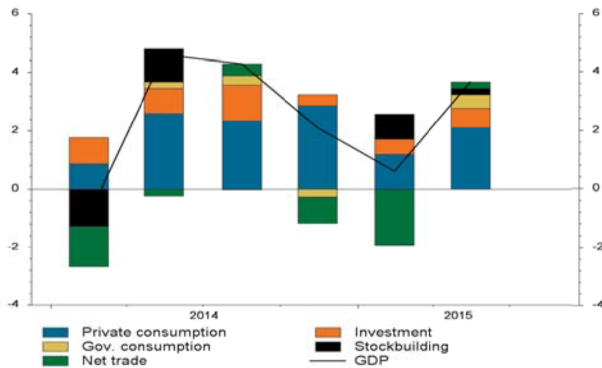
Forecasts

	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (1996 US$,y/y)	2.4	2.6	2.9	2.5	2.9	2.7	2.3	2.5	3.1	2.9	2.9
q/q annual rate				2.1	0.6	3.7	2.8	2.9	2.9	2.9	2.8
Private consumption	2.7	3.1	2.9	4.3	1.7	3.1	3.3	3.0	2.9	2.8	2.7
Fixed investment - nonresid.	6.2	3.5	5.4	0.7	1.6	3.2	5.8	4.7	5.5	5.7	5.9
Fixed investment - residential	1.8	8.4	7.8	9.9	10.1	7.8	7.9	8.3	9.8	7.4	4.8
Government consumption	-0.6	0.6	0.5	-1.4	-0.1	2.6	0.3	0.4	0.4	0.4	0.4
Export	3.4	2.0	4.5	5.4	-6.0	5.2	4.5	4.0	4.0	5.1	5.0
Import	3.8	5.5	4.7	10.3	7.1	2.8	5.1	3.9	5.4	4.9	4.7
Stockbuilding (% contrib. to GDP)	0.0	0.2	-0.1	0.0	0.2	0.1	-0.2	0.0	0.0	0.0	0.0
Current account (% of GDP)	-2.2	-2.3	-2.2	-2.4	-2.6	-2.4	-2.2	-2.1	-2.2	-2.2	-2.1
Federal Deficit (% of GDP)	-3.6	-3.6	-3.8								
Gov. Debt (% of GDP)	123.2	124.0	123.9								
CPI (y/y)	1.6	0.0	1.7	1.2	-0.1	0.0	0.1	0.0	1.1	1.5	1.8
Industrial production (y/y)	3.7	1.6	2.4	4.6	-0.1	-2.0	2.2	1.0	3.1	3.5	3.5
Unemployment (%)	6.2	5.3	4.9	5.7	5.6	5.4	5.3	5.1	5.0	5.0	4.9
Fed Funds	0.25	0.33	0.94	0.25	0.25	0.25	0.33	0.50	0.58	0.83	1.08
Effective exch.rate (1973=100)	78.6	91.3	91.0	82.6	89.4	89.9	91.7	94.2	93.4	91.3	90.1

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

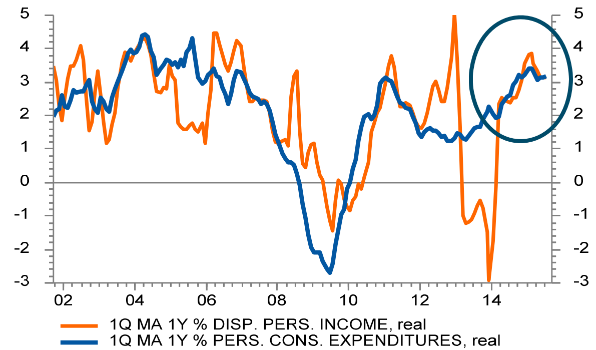
[1] See, for example, P. Hooper et al., *Trade elasticities for the G-10 countries*, Princeton Studies in International Economics, August 2000.
[2] See S. Ahmed et al., *Depreciations without exports? Global value chains and the exchange rate elasticity of exports*, World Bank Group, August 2015; G. Gopinath, *The international price system*, presented at the Jackson Hole Symposium, August 2015.

Fig. 1 – Growth in GDP (qoq ann.) and contributions



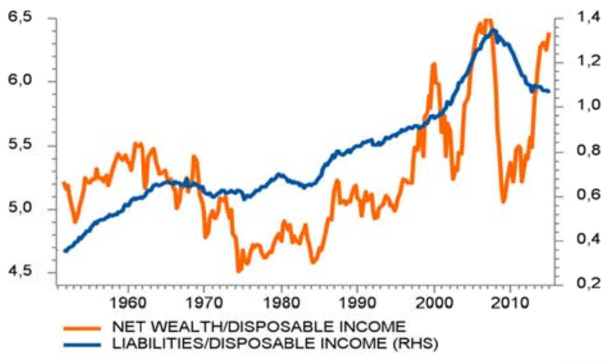
Source: Thomson Reuters-Datastream

Fig. 2 – Disposable income and household spending: back to normal



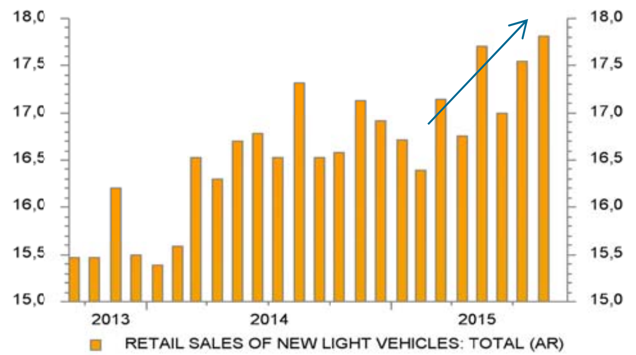
Source: Thomson Reuters-Datastream

Fig. 3 – Household net worth rising, liabilities falling



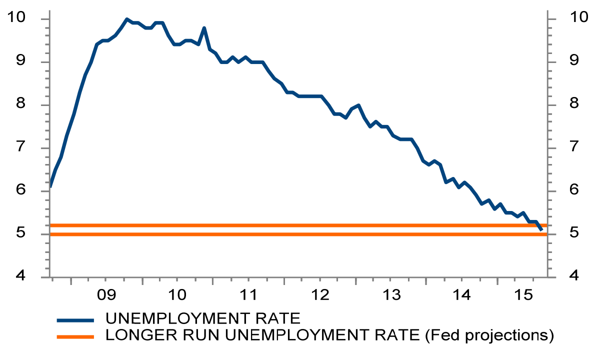
Source: Thomson Reuters-Datastream

Fig. 4 – Vehicle sales robust after years of weakness



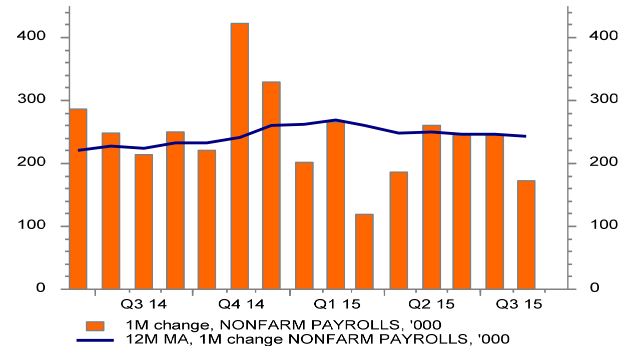
NB: figures in millions. Source: Thomson Reuters Datastream

Fig. 5 – Labour market conditions continue to improve after the winter break



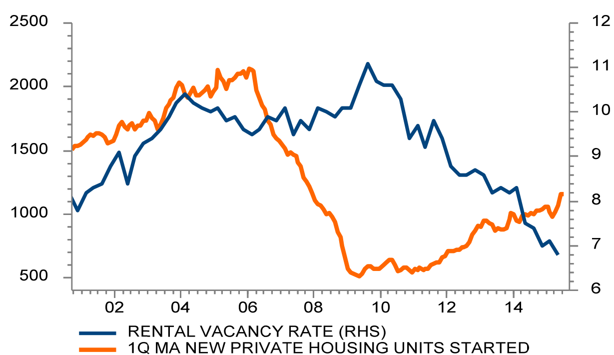
Source: Thomson Reuters-Datastream

Fig. 6 – Short-term unemployment levels return to pre-recession levels



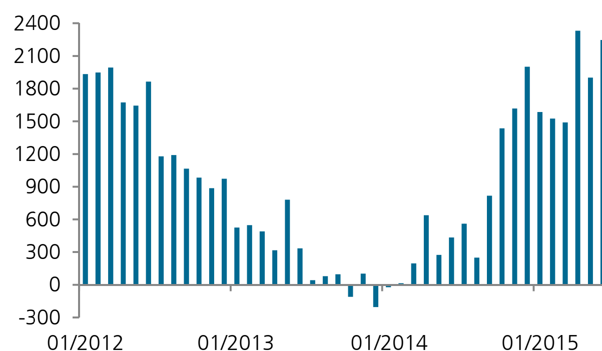
Source: Thomson Reuters-Datastream

Fig. 7 – New starts and vacant housing units



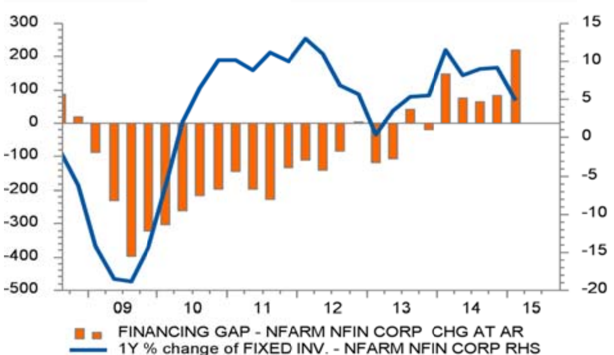
Source: Thomson Reuters-Datastream

Fig. 8 – New households: fuel for residential construction



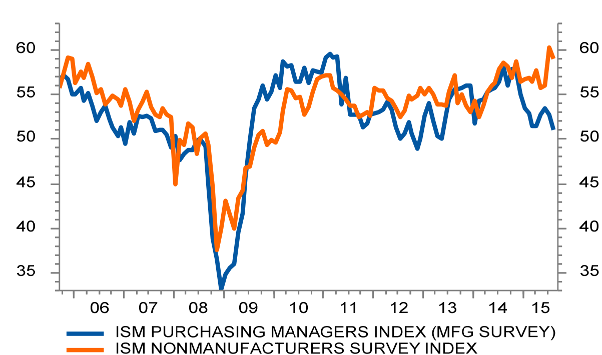
Source: Census Bureau.

Fig. 9 – Businesses have funds available to finance new investments



Source: Thomson Reuters-Datastream

Fig. 10 – ISM indices: manufacturing weak, services solid



Source: Thomson Reuters-Datastream

Tab. 1 – Exports as a proportion of total and GDP

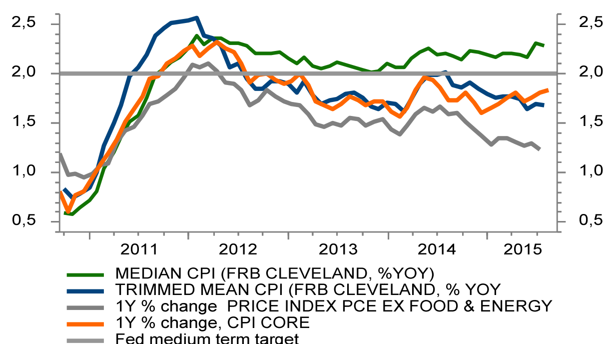
	in % of US Exports	in % of US GDP
China	7.6	0.7
NICS ASIA & NZ	9.1	0.8
Latam	23.9	2.2
OPEC	5.6	0.5
Euro Area	12.8	1.2
CEE ex Russia	1.3	0.1
Russia	0.7	0.1
Canada	19.3	1.8
UK	3.3	0.3
N Europe	0.7	0.1
Japan	4.1	0.4

Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 11 – Total exports and exports to China

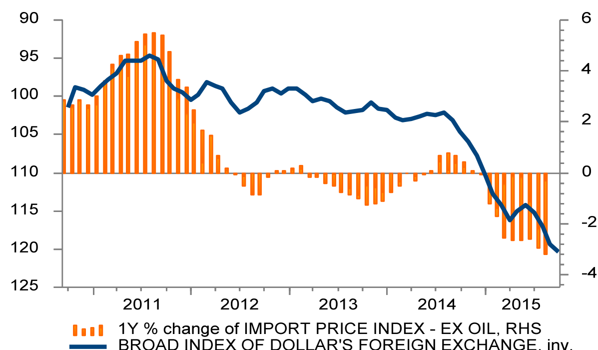
Source: Thomson Reuters-Datastream

Fig. 12 – Core inflation stable



Source: Thomson Reuters-Datastream

Fig. 13 – Import prices ex. oil and dollar



Source: Thomson Reuters-Datastream

Monetary policy: rate liftoff no longer dependent only on domestic conditions but also on global risks

The Fed left interest rates unchanged in September, although it recognised that the recovery is solid and the US is now on the verge of full employment. The decision was guided by global risks and the need to monitor "developments abroad", as well as the delay – albeit temporary – in reaching the 2% inflation target, which has been shifted out to 2018. Although the Fed continues to base its decisions on the outlook for the US economy, in the new, interconnected global economy, not even the FOMC can separate internal conditions from those of its trading partners and counterparts on the financial markets.

Conditions for the liftoff are now both domestic and international The FOMC's central scenario is for a hike by the end of the year (see table below), followed by a gradual path with (a few) more hikes over the next three years. A further improvement in the US labour market is highly likely and, according to Janet Yellen, could be enough to bolster confidence that inflation will return to 2%. Conditions are less clear with regard to international developments: "in light of developments (…) and the impacts on financial markets, we want to take a little bit more time to evaluate the likely impacts on the United States". The Fed believes that the summer turbulence in the financial markets reflects stress in emerging markets and commodity-producing countries: the information required to assess the extent of repercussions on US growth could come from signs that Chinese growth and oil prices are stabilising. Our forecast is that the liftoff will happen by December, followed by two to three rises in 2016.

Tab. 2 – Projections of the Governors of the Federal Reserve and of Reserve Bank Presidents – September 2015

Variable	Median					Central Tendency				
	2015	2016	2017	2018	Long term	2015	2016	2017	2018	Long term
Real GDP	2.1	2.3	2.2	2.0	2.0	2.0-2.3	2.2-2.6	2.0-2.4	1.8-2.2	1.8-2.2
June forecast	1.9	2.5	2.3		2.0	1.8-2.0	2.3-2.7	2.0-2.4		2.0-2.3
Unemployment rate	5	4.8	4.8	4.8	4.9	5.0-5.1	4.7-4.9	4.7-4.9	4.7-5.0	4.9-5.2
June forecast	5.3	5.1	5.0		5.0	5.2-5.3	4.9-5.1	4.9-5.1		5.0-5.2
Consumption deflator	0.4	1.7	1.9	2.0	2.0	0.3-0.5	1.5-1.8	1.8-2.0	2.0	2.0
June forecast	0.7	1.8	2.0		2.0	0.6-0.8	1.6-1.9	1.9-2.0		2.0
Core consumption deflator	1.4	1.7	1.9	2.0		1.3-1.4	1.5-1.8	1.8-2.0	1.9-2.0	
June forecast	1.3	1.7	1.9	2.0		1.3-1.4	1.6-1.9	1.9-2.0		
Memo:										
Projected appropriate policy path										
Fed funds rate	0.4	1.4	2.6	3.4	3.5	0.1-0.6	1.1-2.1	2.1-3.4	3.0-3.6	3.3-3.8
June forecast	0.6	1.6	2.9		3.8	0.4-0.9	1.4-2.4	2.4-3.8		3.5-3.8

Source: Federal Reserve Board. GDP data: y/y % chg. in 4Q

Euro zone: the recovery keeps its pace for now, but the outlook becomes more uncertain

Anna Maria Grimaldi

- We confirm our forecast of above-potential economic growth in 2015-17, but downside risks have increased. Uncertainty over the intensity of the slowdown in China and other emerging markets will weigh on the Euro zone but, barring extreme scenarios like in 1997, the impact will be in large part offset by the persistent fall in oil prices, past depreciation of the euro and the improvement in the monetary policy transmission mechanism.
- Compared with our June forecast, we have downgraded our GDP growth forecast for 2016 by only one tenth of a point, to 1.7%, which is still up on the 1.5% forecast for 2015. The output gap is therefore expected to decrease over the forecast horizon, but will remain negative until the end of 2017. As the recovery strengthens, investments should pick up and outperform household consumption, thereby offsetting a probable slowdown in exports.
- Among peripheral EU countries, Ireland and Spain will perform much better than the Euro zone average (3.5% and 3.0% respectively) on the back of strong post-programme recovery, while Portugal will expand in line with the average. Of the larger states, Germany will post the most robust growth, but Italy will also see a more solid recovery. Conversely, we confirm our forecast of a moderate recovery in France.
- On the back of our new oil price forecasts we are cutting our 2016 inflation estimate from 1.3% to 1.2%. Whether inflation returns to 1.7% by the end of 2017 is more uncertain since, barring a spike in energy, this largely depends on growth in underlying inflation.
- The risks to the outlook are to the downside, and could come from a sharper downturn in emerging markets and from unwelcome tightening in financial conditions coinciding with the Fed's first rate hike. Note, too, the political risk for Portugal (October), Spain (December) and Ireland (April 2016), which are holding their first elections since the end of European adjustment programmes.
- Fiscal policy is expected to remain broadly neutral over the forecast horizon, and, if the situation deteriorates, will offer only limited support. There is also ample scope to increase monetary stimulus to support domestic demand and market confidence.
- An extension to the ECB's purchase programme is very likely, and could be announced by the end of the year. An increase in the monthly target is more uncertain, and might only happen if the ECB cuts its official inflation forecasts for 2017.

Forecasts

	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	0.9	1.5	1.7	0.9	1.2	1.5	1.6	1.7	1.6	1.7	1.7
- q/q change				0.4	0.5	0.4	0.4	0.5	0.5	0.4	0.4
Private consumption	0.9	1.8	1.8	0.6	0.5	0.4	0.5	0.5	0.5	0.4	0.4
Fixed investment	1.3	2.7	4.6	0.6	1.4	-0.5	1.6	1.3	1.2	1.2	1.0
Government consumption	0.8	1.2	0.4	0.2	0.6	0.3	0.1	0.1	0.1	0.1	0.1
Export	3.9	4.7	5.0	0.9	1.0	1.6	0.8	0.9	1.5	1.4	1.5
Import	4.2	5.0	5.0	0.9	1.5	1.0	1.1	1.1	1.5	1.3	1.1
Stockbuilding (% contrib. to GDP)	-0.1	-0.3	-0.5	-0.1	0.0	-0.1	-0.1	0.0	-0.1	-0.2	-0.2
Current account (% of GDP)	2.1	2.8	2.6								
Deficit (% of GDP)	-2.4	-2.3	-2.2								
Debt (% of GDP)	90.6	90.7	91.5								
CPI (y/y)	0.4	0.3	1.2	0.2	-0.3	0.2	0.2	1.0	1.5	1.1	1.2
Industrial production (y/y)	0.8	1.4	1.6	0.5	1.0	-0.2	0.4	0.1	0.2	0.9	0.9
Unemployment (%)	11.6	11.0	10.5	11.5	11.2	11.1	10.8	10.8	10.7	10.6	10.5
3-month Euribor	0.21	0.00	-0.07	0.08	0.05	-0.01	-0.03	-0.03	-0.06	-0.07	-0.08
EUR/USD	1.32	1.10	1.13	1.25	1.13	1.10	1.11	1.07	1.09	1.13	1.14

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo data

Real economy: a bumpy recovery path

Growth in Euro zone GDP averaged 0.45% qoq in the first six months of the year[3], carry-over growth stands at 1.2% for the year to date. Data in the last two months were moderately encouraging. The PMI and European Commission surveys in July and August continued to signal GDP growth of 0.4% qoq also in the summer quarter. Industrial output made a fairly strong start to 3Q in July, although this was largely due to the exceptionally warm weather which boosted electricity generation. Exports grew by more than 3% in value terms. Confidence and car registrations data suggest that consumer spending might have accelerated in the summer. However, we are less confident than three months ago that we will see a significant some acceleration in Euro zone GDP from end-2015 and in 2016, and are maintaining our estimate of average annual growth of 1.5% in 2015. Business confidence and economic activity will be hampered by the slowdown in emerging markets, developments on the financial markets over the summer and growing geopolitical tension on Europe's borders. The ZEW survey for September has already shown that expectations for the coming months have deteriorated. We have attempted to quantify the impact on the growth outlook of changes in exogenous variables over the summer.

1. Global demand slowed more than expected, but we think that the trough might be behind us. We have, therefore, trimmed our growth estimates for global trade directed to Euro zone more in 2015 (from 2% in June to 1.2%) than in 2016 (minimal downgrade from 4.7% in June to 4.5%). In assessing the impact of the downturn in Chinese demand for Euro zone products and services, it should be noted that although China and Asia have taken on increasing importance to Euro zone exports over the last ten years (their share rose from 9% in 2004 to 12.5% in 2014), their relative weight is still lower than that of other emerging markets, such as Eastern Europe and Russia (17.8%) or other advanced economies (Japan, North America, the UK and Northern Europe, with 35.4%). For more details on the impact of a slowdown in emerging markets on Euro zone growth, please see the forthcoming Focus. Overall, we think that a 0.2%-0.3% decline in global growth compared with our June forecast could shave at most 0.1% off Euro zone growth in 2016.

Slowing global demand is unlikely to shave more than 0.1% off GDP growth in 2016

2. There is little change in our forecast for the average effective exchange rate in 2015-2016. The euro's effective exchange rate gained 4.0% mom from end-July to 26 August, partly due to dollar movements (4.2% cumulatively) but above all to the euro's appreciation against the yuan (7.5%), which is now the currency with the largest relative weight (more than 22%) in the effective exchange rate index ER-19 (the dollar is weighted at 16%). Despite this summer's gains, the euro's effective exchange rate is about 10% weaker than a year ago, and will likely start to depreciate in late 2015. For 2016, we expect the euro to trade at around 1.12, as in June. We do not see any other significant movements against the yuan, as the euro is unlikely to be a target for the Chinese authorities.

The euro strengthened over the summer, but is not expected to make significant gains in the coming months

3. We have cut our June estimates for average oil prices by 13% from mid-2015 to 4Q17. Standard elasticity suggests that a 10% fall in the price of crude oil stimulates growth by 0.1% to 0.2% after a year, and has an impact on inflation of -0.3%/ -0.4%.

The fall in crude oil prices could depress Euro zone GDP by 0.2/0.3% in 2016

4. The benefits of the ECB's quantitative easing programme have been virtually cancelled out, first by fears of a Grexit and then by surging volatility on financial markets, taking longer-term yields back to their levels of a year ago and eroding the gains on the Euro Stoxx. Nevertheless, the monetary policy transmission mechanism continues to improve, as demonstrated by the M3 aggregate (which grew 5.3% in July) and the gradual but constant improvement in lending to the private sector.

Long-term rates slightly higher than our June forecasts; equity correction could slice 0.1% off GDP growth estimates

[3] The second Eurostat forecast for 2Q upgraded 1Q growth from 0.4% qoq to 0.5% qoq, and 2Q GDP growth to 0.4% qoq, from a preliminary estimate of 0.3% qoq.

5. **Geopolitical outlook remains uncertain** The Greek tragedy was averted, but there are plenty of reasons for concern on the domestic front, given the packed electoral calendar in peripheral states over the coming months. Moreover, we should not forget the distressing geopolitical situation in the Mediterranean and Eastern Europe. It is obviously difficult to quantify the impact on confidence of the heated debate between European states over how to manage immigration, and of ongoing uncertainty. As a precautionary measure, we are assuming a maximum impact on GDP of -0.1%.
6. **Fiscal policy** is expected to change from marginally expansive to broadly neutral in 2016. In its spring estimates, the European Commission projected a 0.2% deterioration in the structural balance in 2016. The adjustments for Italy (+0.1%), France (+0.5%) and Spain (+0.5%), which were incorporated in the Commission's July recommendations, should bring about a 0.2% improvement in 2016 (to -0.8%) with a negligible impact on GDP; however, Italy has presented a budget that implies a deterioration in its structural balance from 2015 to 2016.

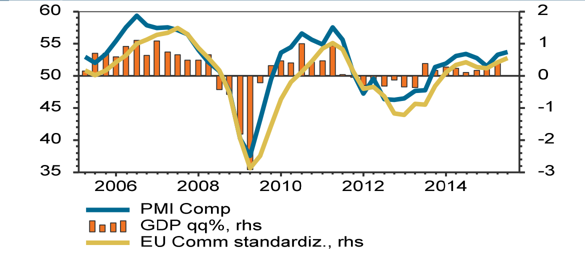
We estimate that the **combined impact on GDP growth** of slowing global demand, less favourable market trends and the new forecasts for oil prices is -0.1/-0.2%. **We have therefore downgraded our GDP growth forecast for 2016 from 1.8% to 1.7%.** Quarterly growth in 4Q15 and 1H16 will fall from 0.5-0.6% qoq to 0.4-0.5%. Annual growth is seen at 1.7% yoy in 2Q16, from 1.5% yoy in mid-2015.

Growth will continue to be driven more by domestic demand (1.7% in 2015 and 1.9% in 2016, as in our June estimates). Specifically, we expect fixed investment to accelerate from 1.3% in 2014 to 2.5% in 2015 and 4.1% in 2016. **Investment in machinery** is set to grow by 3.8% over the forecast horizon, buoyed by lower interest rates on new corporate loans, more expansionary credit conditions, improved corporate earnings and normal levels of productive capacity utilization. This forecast is fairly cautious compared with previous cycles, and is justified by the fact that, as we have seen recently, investments could continue to fall short of recovery forecasts, due to the high level of uncertainty and poor visibility on external demand. We stand by our forecast of a **moderate expansionary cycle in construction** (growth of 0.9% in 2015 and 1.3% in 2016), after around six consecutive years of declines. Household **consumption** is seen growing by 1.7%-1.8%, with the support still coming from the savings effect (about 0.5% of disposable income), associate with the 45% plunging oil prices in 2015 and, from mid-2016, more solid job creation (from +0.9% in 2015 to +1.2% in 2016).

The **risks for our scenario are still to the downside**. Uncertainty over the international situation and the intensity of the slowdown in China and Asia casts a shadow over the growth prospects of advanced nations. In a risk scenario in which global demand for Euro zone products and services rises by 3% in 2016, instead of 4.5% as in our base scenario, growth in 2016 would come in at 1.2%-1.3%. However, risks to our above-trend growth scenario for 2015-2017 could also derive from disappointing domestic demand, caused by the high level of geopolitical uncertainty. Fiscal policy may offer limited support if the situation deteriorates, although we are not ruling a more flexible reading of the fiscal rules from the EU Commission at such a sensitive time for the European Union. Meanwhile, there is also ample scope to increase monetary stimulus to support domestic demand and market confidence.

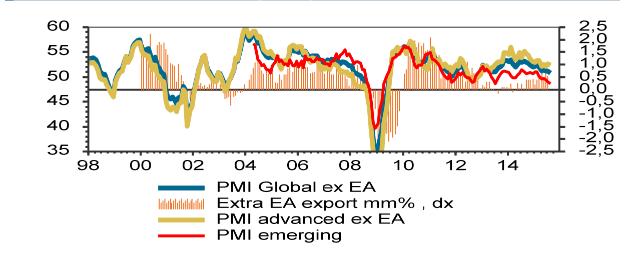
Note, lastly, **political risk.** Elections in Portugal, Spain and Ireland – the first since adjustment programmes ended – will be a barometer. The risk of anti-austerity gaining traction should not be underestimated, particularly in Spain, which could be governed by a coalition for the first time in its post-Franco history.

Fig. 1 – Confidence surveys remain consistent with 0.4% q/q GDP growth also in the summer months



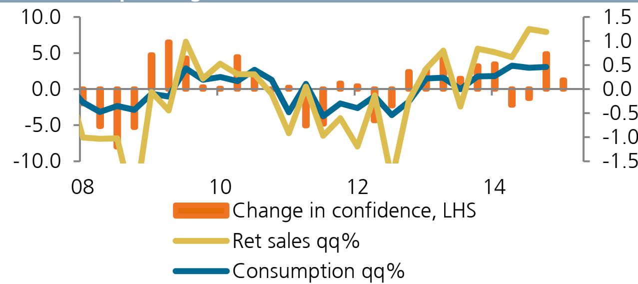
Source: Intesa Sanpaolo chart from Markit, European Commission and Eurostat data

Fig. 2 – Slowdown in emerging markets intensified in the summer and will hurt export growth



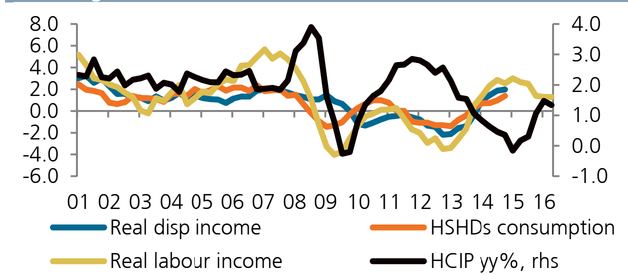
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – The recent trend in retail sales suggests more solid consumer spending over the summer months



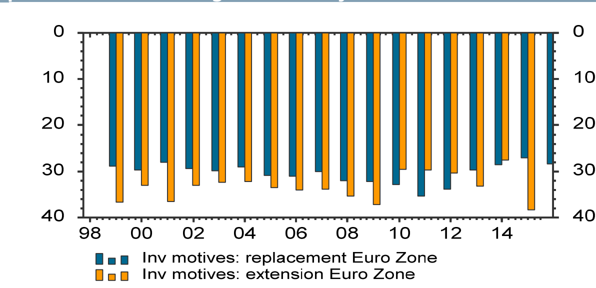
Source: Intesa Sanpaolo chart from EU Commission and Eurostat data

Fig. 4 – Consumer spending up thanks to real disposable income growth of around 1.6-1.8%



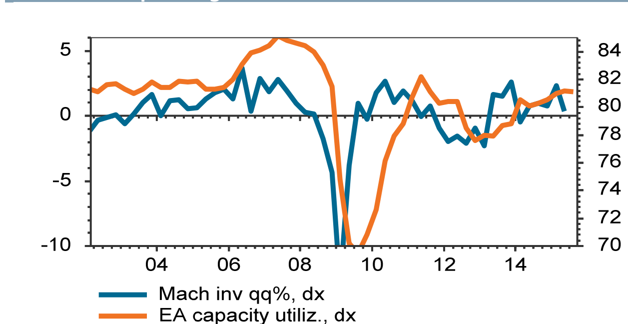
Source: Thomson Reuters-Datastream

Fig. 5 – Survey on investments shows that intentions to extend plants are at their highest for 10 years



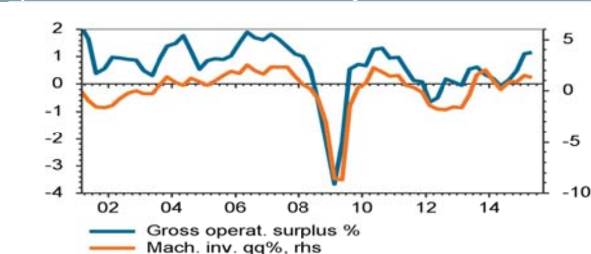
Source: EU Commission via Thomson Reuters-Datastream

Fig. 6 – Increase in capacity utilisation rate supportive for investment spending



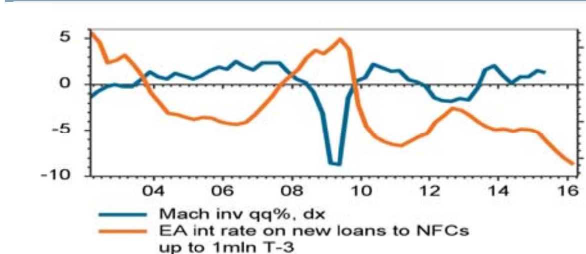
Source: Intesa Sanpaolo chart from European Commission data

Fig. 7 – Recent trend in gross operating margins suggests upturn in investments in machinery



Source: Eurostat via Thomson Reuters-Datastream

Fig. 8 – Lending conditions clearly favourable for corporate investment



Source: Eurostat and ECB via Thomson Reuters-Datastream

FOCUS: how the emerging markets slowdown transmits to advanced countries?

The crash of the Chinese stock market in the second half of August has raised doubts over the solidity of the Chinese economy and on the possible repercussions on other emerging economies. Similar concerns had emerged already at the beginning of 2014, when the nearing of the Fed's tapering of asset purchases had triggered an increase in risk aversion and capital flight from the emerging countries. First of all, we must stress that our baseline scenario for the euro area assumes that the Chinese authorities' economic policy response will succeed in preventing a hard landing scenario. Recent events and data on global trade (Fig. x) show that demand from emerging countries was slowing down further already in June (v. fig. 6). Thus, there is a risk that global trade addressed to the euro area will grow by less than the 4.6% we have assumed for 2016 (up from 1.2% this year) is unlikely to accelerate significantly compared to 2015 as we had and the ECB had assumed in June (4.6% in 2016 from 2.0% in 2015). A shock to growth in the emerging countries transmits to the advanced economies through different channels:

1) The direct trade balance channel, which is typically the most important. Slower demand (for goods) from the emerging countries impacts output in the advanced countries, hitting hardest the countries which export high capital intensity goods. Typically, in the developing countries growth is driven by an accumulation of capital via strong investment growth, rather than by consumption (this is China's case, and the correction of the stock market reflects the authorities' difficulties in implementing economic policies that support a transition from a model based on investments and exports, to a more balanced growth model, in which private consumption makes a stronger contribution). Table 3 provides a measure of the weight on US GDP of exports to China and other regions which may be affected by a slowdown in Chinese demand. Exports to China account for 7.6% of US exports (0.6% of GDP), and 6.5% of euro area exports (1.2% of GDP). Therefore, the share of euro area GDP accounted for by China is smaller than Russia's and Eastern Europe's, as well as of the joint share accounted for by the United States, Canada, the United Kingdom, Northern Europe, and OPEC. Trade links suggests that a 10% slowdown in Chinese exports might have an impact on euro area GDP growth limited to one tenth. Similar data for US suggest that the impact of a slowdown in Chinese exports on US GDP might be even smaller. Within the euro area, Germany is the country with the highest exposure, as 5.8% of overall exports are addressed to China, compared to 3.8% for France and 2.6% for Italy. In any case, China accounts for a smaller share of German exports than Russia and the other advanced economies. However, the effect of the Chinese slowdown on euro area GDP via the decline in demand from the other Asian economies tied to the Chinese cycle should also be considered. As shown in Table 4, exports to China account for 18.6% of the exports of the other Asian economies (including Australia and New Zealand in this aggregate), and 18.3% of Japanese exports. The exports of OPEC countries to China account for 12.2% of the overall exports of these countries. The effect of a Chinese slowdown on euro area exports could therefore be stronger than suggested by the direct links. The effects of smaller exports to China on the imports of advanced countries should also be considered. All considered, the net impact should be positive, although perverse effects could emerge for the advanced countries whose imports from the emerging countries consist not only of commodities, but also components for the assembly of machinery and other manufactured products destined to exports to other regions (in case of problems affecting import flows from the emerging countries, the exports of advanced countries to other regions would also be impacted);

2) The other transmission channel is the correction of commodity prices, given the central role taken on by the emerging countries on the commodity market, with a share of global consumption raging from around 45% for energy to around 70% for metals. We have already quantified the potential impact of a slowdown in the price of crude oil on euro area

GDP growth, and a further stimulus effect could come from the drop in other commodity prices, although the bulk is represented by the price of crude oil;

3) Another transmission channel that should not be overlooked is the financial channel, and not only when the correction in emerging economies is tied to the bursting of a bubble, but also when the crisis is triggered by an unexpected slowdown of the real economy. The correction of the emerging markets may trigger a decline in asset prices, sharp exchange rate devaluations, and an increase in risk aversion with repercussions on advanced countries' financial markets (recent events offer ample evidence in this sense). Also, the advanced economies could be vulnerable to a decline in the demand or sale of debt instruments by the emerging countries. China holds 3600 billion in currency reserves, of which around 20% are estimated to be in Treasuries, and just over one-fifth in euros.

The final impact on the growth trend in the advanced economies of a demand-side shock in the emerging countries depends not only on the size of the slowdown of these economies, but also on how the shock spreads. If the slowdown is transmitted via investments (and this is in all likeliness China's case), the impact on growth in the advanced countries may be more significant, and may vary with the level of concentration of exports to the emerging countries. In the euro area's case, exports of machinery account for 40% of the total, and exports of machinery to China account for 10% of overall machinery China. German exports of machinery to China account for roughly 14% of total German exports of machinery products (v.Tab.2).

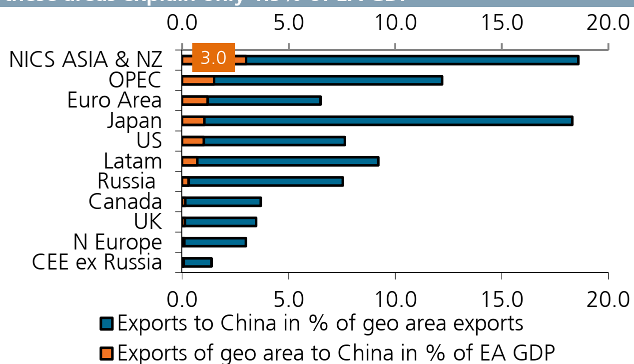
Thus, to quantify in full the impact of a slowdown in emerging countries (EM) on advanced economies (AM), we should look at all the interactions between countries and in particular with those most exposed to a slump in Chinese GDP, not only via trade flows, but also via the financial channel and commodity prices. To get a sense of how big the impact might be, we had a look at an IMF's focus paper published in 2014 (see WEO, April 2014: *Should advanced economies worry about growth shocks in emerging countries?* Pages 72 – 77). The IMF's simulations via multi country VARs and a general equilibrium model, show that a 1% shock to in EM's growth has a negative effect of 0.25% on AM's growth after one year. The impact is more significant for Japan (0.5%), followed by the euro area (0.3%), whilst the effect is smaller for US and the UK (0.2%). We think that this time round, the impact on euro area growth of a 1% slowdown in the emerging countries (should this be the case) compared to IMF estimates from 2014, and should not exceed -0.2% in 2016-17. The IMF's simulations assumed a response of oil prices mostly tied to demand factors. However, at present, the decline in oil prices is explained by factors on the supply side, and could therefore prove more ample and more persistent, helping buffer the impact of the emerging country shock on the advanced economies.

Table 1 – Weight of China and other main trading partner in US and EA GDP

	in % of US exports	in % of US GDP	in % of EA exports	in % of EA GDP	in % of Fra exports	in % of Germ exports	in % of Ita exports	in % of Spa exports
China	7.6	0.7	6.5	1.2	3.7	5.8	2.6	1.7
NICS ASIA & NZ	9.1	0.8	5.9	1.1	4.6	3.4	3.5	2.3
Latam	23.9	2.2	4.7	0.9	2.4	2.5	3.1	5.1
OPEC	5.6	0.5	6.9	1.3	5.0	3.0	5.9	4.6
Euro Area	12.8	1.2	-	-				
CEE ex Russia	1.3	0.1	14.3	2.6	5.1	10.0	10.0	6.4
Russia	0.7	0.1	3.5	0.6	1.4	2.5	2.4	0.6
US	-	-	11.4	2.1	5.8	6.8	7.2	3.7
Canada	19.3	1.8	1.1	0.2	0.7	0.6	0.8	0.5
UK	3.3	0.3	14.6	2.7	7.2	7.9	5.3	7.1
N Europe	0.69	0.1	6.13	1.1	2.1	4.3	2.1	1.8
Japan	4.1	0.4	2.1	0.4	1.5	1.2	1.4	1.1

Source: IMF Direction of Trade Statistics, for GDP we have used IMF GDP figures at purchasing power parities. The aggregate NICs & Oceania includes Korea, Philippine. Malaysia, Singapore, Thailand, Indonesia, New Zeeland and Australia

Fig 1 – China is a key market for NICs & JP, but EA exports to these areas explain only 1.5% of EA GDP



Source: IMF Direction of Trade Statistics

Table 2 – German export more concentrated in machinery than EA trade

	EA exports			German exports		
	To China % tot		*By product type % tot '14*	*To China % tot*		*By product type % tot '14*
	2010	2014	2014	2010	2014	2014
Manuf	1.6	4.2	13.1	2	6.5	11.9
Mach	2.8	9.8	41.3	3.6	13.8	53.2
Misc	0.9	5.1	11	1.5	8.3	9.7
Chem	1.4	4.6	17	1.6	5.8	14.9
Tot	2.8	6.7		3.6	10.2	

Note: Ratios are calculated relative to extra EA – 16 exports. This explain discrepancies between share of China export in 2014 compared to table 1

Source: Eurostat Detailed Trade Statistics and Intesa Sanpaolo calculations

Inflation: the return to 2%? Further away and more uncertain

- The return of inflation towards "the close to but below 2%" at end-2017 from 0.3% in 2015 has become more uncertain. Owing to revisions to crude oil price, we have trimmed our estimate for 2016 by 0.1 to 1.2% and for 2017 inflation by 0.3 to 1.4%. Standard elasticity, as can be derived by ECB and European Commission models, suggest that the effect of a 10% fall in the oil price on headline inflation is between -0.3% and -0.4% after four quarters[4]. In the next few months, the favourable base effect from the energy component will temporarily push inflation towards 1.6% by the beginning of 2016. But once the statistical effect of the energy component disappears from the annual comparison, and assuming that oil does not move much over the forecast period, even after 2017, headline inflation trajectory will be determined almost solely by domestic prices. Our forecast is for underlying inflation to rise to 1.5% in 2017 (1.7% at year-end) from 0.9% in 2015.

- In September, the ECB estimated inflation at 1.1% in 2016, rising to 1.7% in 2017. Staff technical assumptions about oil (USD 55/barrel in 2015, USD 56/barrel in 2016, USD 60/barrel in 2017) and the effective exchange rate (depreciating by 10% in 2015 and stabilising in 2016-17) are broadly in line with ours. The difference between our estimates and the ECB's for 2017 is, therefore, entirely due to a steeper rise in core inflation, from 0.9% in 2015 to 1.7% at end-2017. Thus, the ECB seems to be implicitly assuming that underlying inflation will react rather quickly and strongly to the absorption of economic slack (at around 0.3% for each percentage point by which the output gap narrows). In a speech from 29 August, Victor Constancio, Vice-President of the ECB, reported that recent staff research suggests that the Phillips curve for the Euro zone could have steepened since 2009. This would explain why the ECB systematically underestimated core inflation between 2012 and end-2014, as well as the new staff estimates of a rise in core inflation to 1.7% in 2017.

With energy making virtually no contribution from April 2016, the focus shifts to core inflation. The ECB has dusted down the Phillips curve

- In June, we found that deflationary pressure had eased due to the effect of the Expanded Asset Purchase Programme (EAPP), but the uncertainty surrounding the macro outlook shifts the balance of risks to the downside once again, even after the revisions to the 2016-17 inflation estimates. With the geopolitical climate and international outlook shrouded by uncertainty, consumer spending and investment could prove particularly disappointing, thus hampering the rise in core inflation. The effects of lower price expectations on core inflation (compared with the pre-crisis period) over an extended period must not be overlooked. The rebound in the oil price over the forecast period should stabilise and/or partly revive price expectations, reducing somewhat risks of second-round effects. We should not ignore the fact that if oil prices stick at a lower level for a prolonged period, overall inflation will be determined by underlying inflation; this applies after 2017 as well.

But uncertainty surrounding the outlook, second-round effects of energy and lower inflation expectations over the longer term could indicate downside risks to the core inflation trend

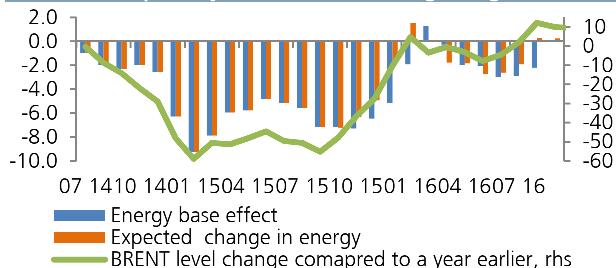
Tab. 1 - Inflation forecasts by country and Euro zone average with new oil and exchange rate estimates

	PRT	MLT	IRL	CYP	FRA	BEL	AUT	EA	NLD	ESP	ITA	DEU
2014	-0.2	0.8	0.3	-0.3	0.6	0.5	1.5	0.4	0.3	-0.2	0.2	0.8
2015e	0.6	1.3	0.3	-1.2	0.1	0.8	1.1	0.3	0.5	-0.2	0.3	0.4
2016e	0.8	0.8	1.1	0.2	1.0	1.2	1.3	1.2	1.4	1.4	1.3	1.6
2017e	0.8	0.8	1.1	1.1	1.2	1.3	1.3	1.4	1.5	1.5	1.8	1.8

NB: e = ISP estimate. Source: Eurostat and Intesa Sanpaolo estimates

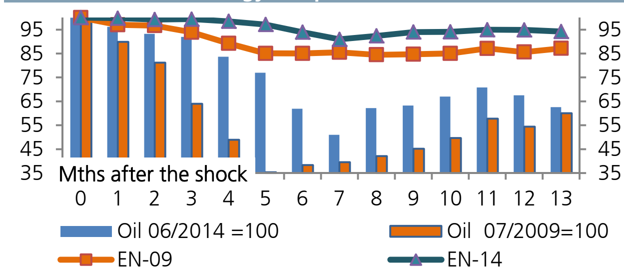
[4] The maximum impact of the fall in the oil price should be felt between end-2016 and 2017 since the revised forecasts affect the second half of 2015 and 2016-17. It must be borne in mind that even if the oil price stays at a lower level than in the June estimates, it is still seen to increase over the forecast period (+5% yoy in 2016 and +10% yoy in 2017).

Fig. 1 – The favourable base effect from energy will push inflation temporarily above 1% at the beginning of 2016



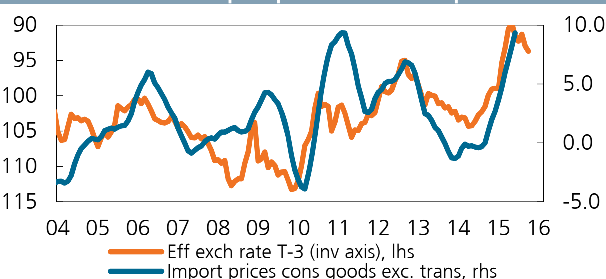
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 – Only part of the fall in the oil price has been transferred to the energy component and less so than in 2009



Source: OECD (output gap), Intesa Sanpaolo chart from Eurostat data

Fig. 3 – Currency depreciation will minimise disinflationary pressure. Transfer to import prices is now complete…

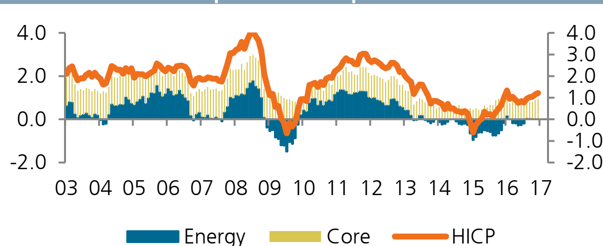


Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – … but it will take a few more months for the increase in import prices to be fully transmitted to consumer prices

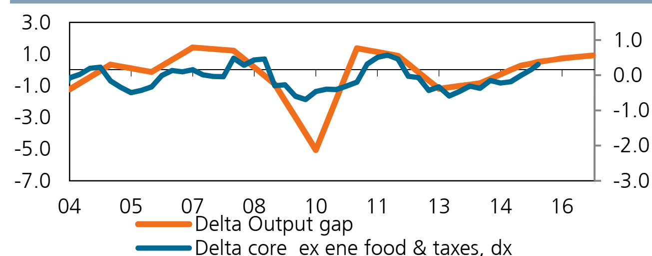
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 5 – A flat contribution from energy and a slightly positive one from food will mean that, from April 2016, inflation's rise towards 1.5% will depend on core prices …



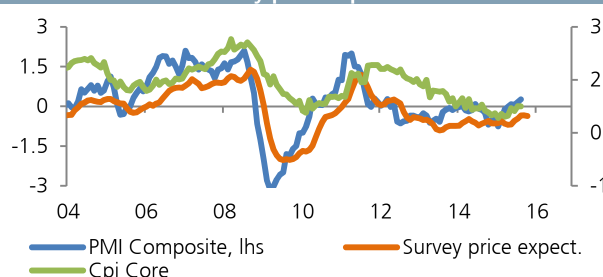
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 6 – Focus will shift to the response of domestic prices to the reduced slack in the economy



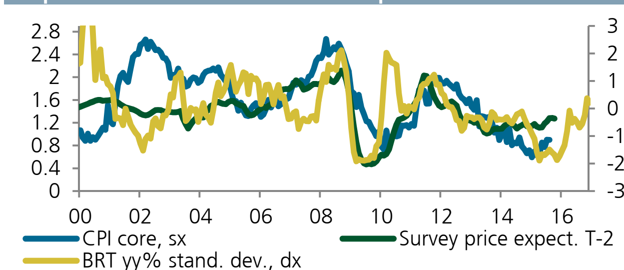
Source: OECD (output gap), Intesa Sanpaolo chart from Eurostat data

Fig. 7 – Risks of second-round effects from energy? Core inflation trend affected by price expectations but …



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 8 – … the prospective rise in the price of crude oil should help to minimise further downward pressure



Source: Intesa Sanpaolo chart from European Commission and Eurostat data

The ECB is taking time but may have to expand the EAPP

- At its September meeting, the ECB beefed up its already highly accommodative rhetoric and officially paved the way for the introduction of new monetary stimulus by revising growth and inflation forecasts and changing its risks' assessment from "broadly balanced" to the "downside". The September press release reiterated that the EAPP is "intended to run until the end of September 2016", but, compared to the June statement, added that it could run "beyond, if necessary". During the press conference, Draghi specified that no changes to monetary stimulus had been discussed. We think that, for the time being, the ECB will continue with its verbal interventions in an attempt to direct the market's attention to monetary policy. But we do not rule out the possibility that the ECB may be forced to convert words into actions over the next few months, and before March 2016.

  The introduction of new monetary stimulus is conditional on core inflation for 2017 being revised to 1.4%-1.5%

  What are the conditions that could trigger the announcement of new stimulus? The ECB has clearly indicated that since oil prices are not likely to change much over the forecast period, the focus will shift to core inflation. Future monetary policy decisions will, therefore, be dependent on the degree of slack in the economy and revisions to medium-term inflation forecasts.[5] Josef Bonnici (14 September) said that, for the time being, core inflation remains in an acceptable range (1.7-1.8% at end-2017 as per September staff forecasts). Revisions to the outlook could be triggered by weaker growth in domestic demand, due to an undesirable tightening of financial conditions and/or a slowdown in activity connected with a weaker international economy than in our core scenario. We should not forget that the announcement of the EAPP in January was preceded by the presentation in December 2014 of inflation forecast revisions to less than 1.5% and of underlying inflation to less than 1.3% in 2016 that is to say in 18-24 months.

- Temporary extension of the purchase programme highly likely

  We think it is highly likely that the ECB will extend the EAPP beyond September 2016 and possibly until mid – 2017, should downside risks for the macro outlook rise further. This measure, which would not encounter strong resistance within the Council, and would facilitate a gradual exit from the programme after September 2016 Moreover with an extension of the EAPP will strengthen expectations that rates will stay unchanged at record lows until 2018. Also, although the ECB would not state this is as one of the advantages of the operation, it would extend the central bank's contribution to the absorption of a large part of the net supply of government bonds in 2017 too.

  Increase in monthly purchase volumes is less certain, but not ruled out

  An increase in the monthly target cannot be ruled out, but could encounter substantial resistance within the Council and would probably need to be preceded by downward revisions to core inflation forecasts for 2017 to 1.4%/1.5%. On 15 September, Constancio said that the ECB's actions are "very far from what the major central banks have done". Constancio was presumably referring to the volume of bond purchases and not just the duration. Ewald Nowotny stated that the ECB was already encountering difficulties in implementing the ABS and covered bonds purchase programme. Thus, an increase in the monthly target would likely be achieved via more PSPP purchases. The announcement in September that the issue share limit would be raised from 25% to 33% creates more leeway to increase purchases of government bonds without collective action clauses (CACs) (see Interest Rate Strategy of 16 September 2015). This announcement may be interpreted as a greater willingness to increase QE volumes via government bonds than other assets. The increase in the monthly purchase target might encounter implementation hurdles given the limited supply of securities available for purchase under the capital keys rule, which cannot be waived by the ECB[6].

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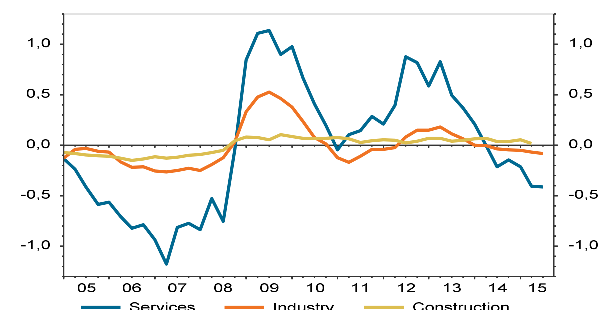
[5] In the September economic bulletin, a report on the measures of economic slack suggests that the ECB will look not only at the change in the output gap based on OECD, IMF and European Commission potential growth estimates, but also at excess supply in the economy, which can be derived from quarterly business surveys. Constancio also said in his speech that the monthly unemployment trend gives an indication of excess supply in the economy.

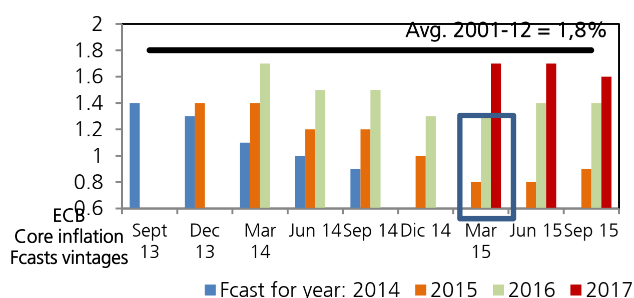
[6] We estimate that purchases at market prices of EUR 316Bn in 2016 would subtract around EUR 126Bn from the Euro zone government bond market (including EUR 98Bn in Germany) (see *EAPP update,14 September 2015*)

Fig. 1 – ECB has dusted down the Phillips curve and is now looking at various measures of slack but seems to prefer the one based on confidence surveys



Source: Intesa Sanpaolo chart based on EU Commission quarterly surveys. Data are standardised measures of demand as impediment to production by sector. This is just a proxy of ECB measure of slack (see September Economic bulletin, Box 6)

Fig. 2 – When the ECB announced QE in March 2015, two-year core inflation estimates were below 1.3%



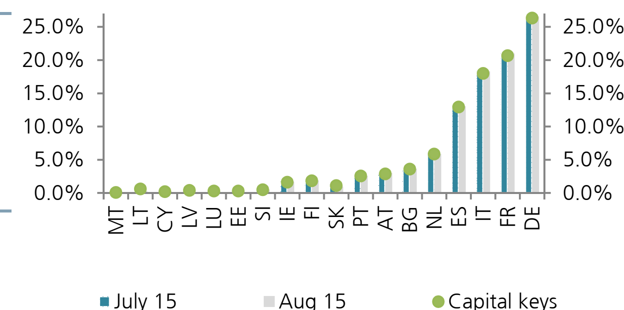
Source: Intesa Sanpaolo chart from European Commission, OECD and IMF data

Tab. 1 – EAPP is proceeding on track

	ABSPP	CBPP3	PSPP	EAPP
	Monthly flows (bln euros)			
31/03/2015	1.1	12.4	47.4	61.0
30/04/2015	1.2	11.5	47.7	60.3
31/05/2015	1.4	10.0	51.6	63.0
30/06/2015	1.6	10.2	51.4	63.2
31/07/2015	0.94	9.0	51.4	61.3
31/08/2015	1.34	7.45	42.8	51.6
	EAPP portfolio total outstanding			
11/09/2015*	8	65	315	388
Residual purchases by Sept 16	16	156	581	752
EAPP in Sep. 2016	24	221	894	1,140

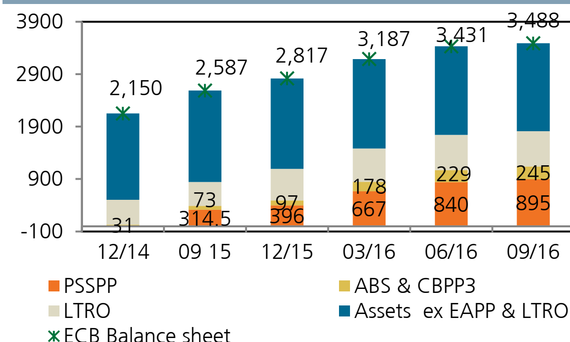
Purchases since March 2015. Source: Intesa Sanpaolo chart from ECB data

Fig. 3 – The ECB has so far complied with the capital keys rule



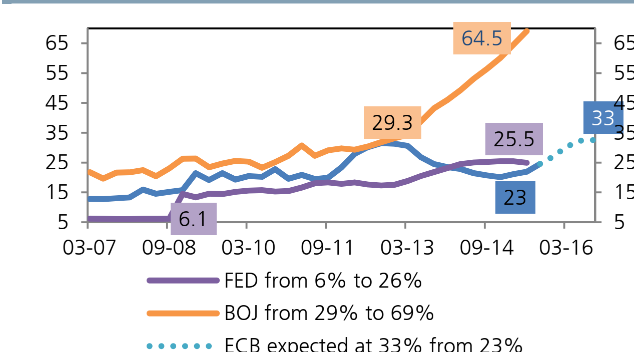
Source: Intesa Sanpaolo chart from ECB data

Fig. 4 – The ECB's balance sheet is expanding rapidly thanks to the EAPP...



Source: Intesa Sanpaolo chart from ECB data

Fig. 5 – ... but, in relative terms, will not increase as much as that of the Fed and the BoJ



Source: National central banks and Intesa Sanpaolo estimates

Germany: waiting for a sprint in domestic demand

Anna Maria Grimaldi

We expect the Germany economy to continue growing above trend (1.2%, according to recent Bundesbank estimates) this year and next. However, GDP growth continues to fall somewhat short of expectations. In June, we revised down our forecast for 2015 by 0.2 to 1.8% and our forecast for 2016 by 0.1% to 2% (1.6% and 1.9% respectively, net of calendar effects). After a weaker start to the year than expected, GDP was also disappointing in the second quarter, with growth of 0.4% qoq, compared with estimated growth of 0.5% qoq. Exports picked up in the spring, supported by the recovery in demand in the advanced economies after the lull at the beginning of the year, and the sharp increase engineering orders owing to a large Airbus invoice. Domestic demand, however, fared worse than expected, contributing by only 0.1% qoq to GDP growth. Investment in machinery was a particular disappointment, with a wholly unexpected fall of 0.4% qoq (after average growth of +2.0% qoq over the previous six months)[7]. On the back of summer data, recent developments in the global economy and on financial markets, we revised down our growth forecasts by 0.1 for both 2015 (to 1.7%) and 2016 (1.9%).

Growth above potential confirmed

In July and August, the composite PMI and IFO indices were broadly unchanged on average from the spring months, thus pointing to German GDP growth of 0.4% qoq also in the summer. However, manufacturing output has made a relatively weak start to the current quarter and we cannot rule further weakness ahead. IFO export orders expectations and the global PMI and CBP world trade indices all slowed in August. Thus, a slowdown in exports may be around the corner, after the resilience of trade flows in July. Yet, the fall in demand from emerging markets should have a limited impact on Germany's export performance, as it should be partly offset by resilient demand from other advanced economies and the rest of the Euro zone. Exports to China only account for 2.2% of German GDP, more than the Euro zone average, but the relative contribution is lower than that of exports to eastern Europe and Russia (4.8% of GDP), as well as that of exports to the US and the UK (5.6% of GDP). In addition, the fall in demand from emerging markets should be partly offset by the depreciation of the effective exchange rate (-10% on average in September compared with a year earlier). Overall, the forecast for foreign demand in relation to Germany has not changed much from the June's scenario, when we estimated growth of 4.6% for 2016, after 3.0% this year. As a result, we forecast that German exports will grow by 5.6% in 2015 and by 5.3% in 2016. Imports are expected to grow by 5.8% this year and by 5.4% the next, given the high import content of German exports and domestic demand, particularly of machinery investment. Overall, foreign trade should make a small negative contribution to GDP growth over the forecast horizon. The current account balance could widen to 8.0% of GDP, from 7.6% in 2014. The country will therefore continue to be closely monitored by the European Commission.

We are revising our GDP growth forecast down by only one-tenth of a point for 2015-16. China and Asia make a relatively low contribution to German GDP

We continue to forecast domestic demand growth of around 2.0%, given that fundamentals continue to provide strong support. The fall in oil prices in 2015 (on average -44%) and the forecast of only a negligible increase in 2016 (3$ per barrel on average to 58$) should provide savings of approximately 0.4% of disposable income. Consumer price data available (up to august) suggest that so far only 20% of the fall in oil prices has been passed on to final prices, and the lower price should therefore continue to boost consumer spending over the next few months. We see Household consumption rising by 1.9% this year and by 1.6% in 2016, supported by solid growth in real disposable income (2% this year and 1.4% the next).

Domestic demand likely to offset the slowdown in foreign trade

[7] The correction in investment in construction in 2Q is less worrying, because it follows the sharp growth recorded at the beginning of the year, owing to the exceptionally mild weather.

Corporate investment: moderate cycle with downside risks

Wages should expand by around 2.3%[8] and employment by 0.5% over the forecast horizon. Household purchasing power will be partially eroded by the upturn in inflation to 1.6% in 2016, from an estimated +0.4% for the current year. The unemployment rate is expected to remain broadly unchanged over the forecast horizon at around 6.4% as it is already at the long-term equilibrium level. A drop of the jobless rate below the equilibrium threshold depends on how quickly the influx of the immigrant population is translated into an increase in the workforce. In the medium term, Germany's largest challenge will be its ageing population, thus, as highlighted by the President of the Bundesbank, the reception of refugees and migrants represents an opportunity. Capital investment is expected to return to more sustained growth (2.2% on average in 2015 and 2.7% in 2016) after the unexplained weakness in the spring. Investment in construction is expected to continue to grow at a sustained rate (from 0.7% in 2015 to 1.6% in 2016, albeit less than in the 2011-14 period), in light of the recent trend in residential building permits and orders, the relative profitability of property investment at current record low interest rates, and given the potential increase in housing demand for over the next few years. After the temporary blip in the Spring, we see investment in machinery expanding by 0.9% qoq per quarter (3.5% in 2015-16), given the high capacity utilization rate (now above the long-term average), solid growth in gross operating margins in the first half of 2015, and ultra-expansionary credit conditions. Yet, we acknowledge there is a risk that corporate spending will be slowed by the high degree of geopolitical uncertainty and poor visibility on in global demand.

The margin of uncertainty on 2015-16 forecast is fairly large. The German economy is highly integrated into the global production chain. The manufacturing industry and exports are more concentrated in machinery goods, which is potentially more vulnerable to a slowdown in demand from emerging markets. However, fiscal policy offers ample scope to soften any negative surprises from the global economy with measures to stimulate domestic demand.

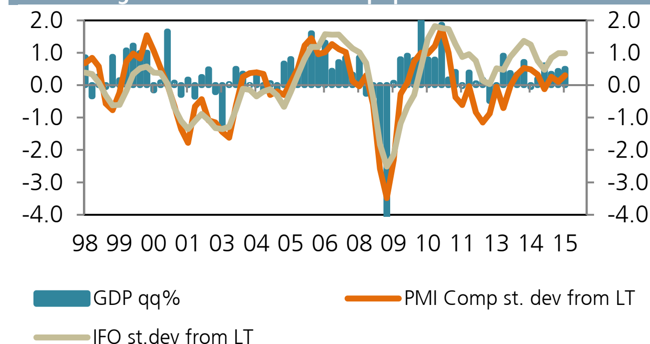
But fiscal policy offers ample scope. Last year government finances closed with a budget surplus of 0.5% GDP in 2014, which we expect to be maintained over the forecast horizon. The increase in current spending will largely be covered by stronger growth in tax revenues courtesy of the cyclical recovery phase and by savings in interest spending (around EUR 10Bn, 0.4% of GDP according to Bundesbank estimates). The debt/GDP ratio is expected to fall to 71% in 2016, from 74.7% in 2014. Although an easing of fiscal policy would be desirable, stripping out cyclical effects, the trend is only moderately expansionary in 2015-16, given that the structural balance is expected to worsen only marginally to 1.0%, from the +1.2% in 2014 estimated by the European Commission in the spring. In its August Bulletin, the Bundesbank heavily criticised the federal government's fiscal policy and judged the debt reduction targets as inadequate to medium-term demographic challenges.

[8] Overall wages have grown by more than contractual wages, at 2%, from 3.0% in 2014, owing to the positive wage drift relating to the introduction of the minimum wage in January. According to preliminary forecasts by the Bundesbank, the introduction of the minimum wage will particularly impact wages for "mini jobs" and fixed-term work. The impact on other wages is not likely to be more than 0.25%, according to the Bundesbank.

Forecasts	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (1995 prices, y/y)	1.6	1.7	1.9	1.5	1.1	1.6	1.8	1.7	1.8	1.8	1.8
- q/q change				0.6	0.3	0.4	0.4	0.5	0.5	0.4	0.4
Private consumption	1.0	1.9	1.6	1.0	0.3	0.2	0.5	0.4	0.4	0.4	0.3
Fixed investment	3.5	2.2	3.0	1.3	1.7	-0.4	0.9	0.8	0.9	0.8	0.6
Government consumption	1.7	1.9	1.2	0.5	0.6	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.9	5.3	4.2	1.3	1.2	2.2	0.5	0.8	0.9	1.3	1.2
Import	3.7	5.8	5.4	2.3	1.9	0.8	1.6	1.2	1.3	1.8	1.1
Stockbuilding (% contrib. to GDP)	-0.3	-0.4	0.3	0.0	-0.1	-0.4	0.3	0.1	0.1	0.1	-0.1
Current account (% of GDP)	7.6	8.1	7.4	8.1	8.4	8.4	8.0	7.8	7.6	7.5	7.4
Deficit (% of GDP)	0.7	0.5	0.4								
Debt (% of GDP)	74.7	72.3	71.8								
CPI (y/y)	0.9	0.5	1.5	0.5	0.0	0.5	0.2	1.2	1.9	1.4	1.6
Industrial production (y/y)	1.5	1.2	1.7	0.8	0.5	0.2	0.3	0.1	0.0	1.1	1.2
Unemployment (%)	6.7	6.4	6.3	6.6	6.5	6.4	6.4	6.4	6.3	6.3	6.3
10-year yield	1.24	0.61	1.20	0.77	0.33	0.53	0.70	0.90	1.05	1.16	1.25
Effective exch.rate (2005=100)	99.8	94.6	95.0	98.7	95.3	94.4	94.7	93.9	94.3	95.0	95.2

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo data

Fig. 1 – The trend in confidences over the summer is consistent with GDP growth of around 0.4% qoq

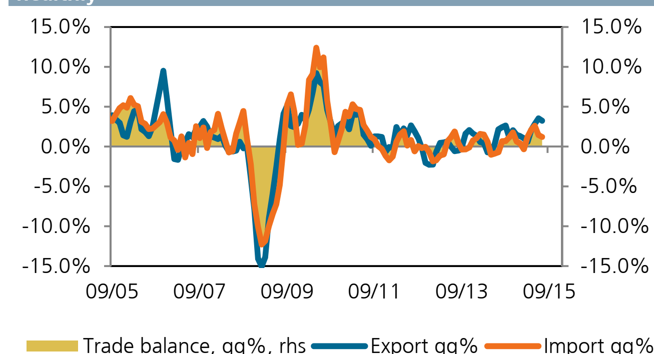


Source: FSO via Datastream

Fig. 2 - Yet industrial output entered Q3 on a weak footing

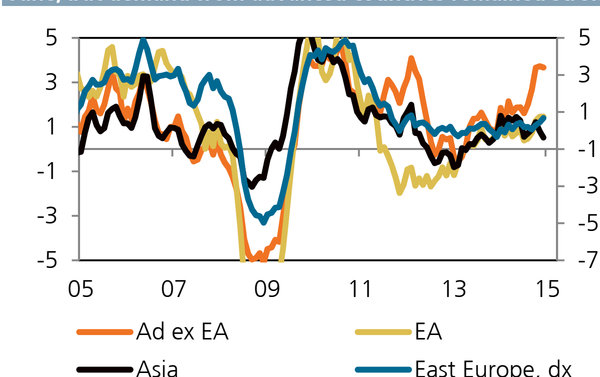
Source: FSO via Datastream

Fig. 3 - Up to July exports and imports were still growing healthly



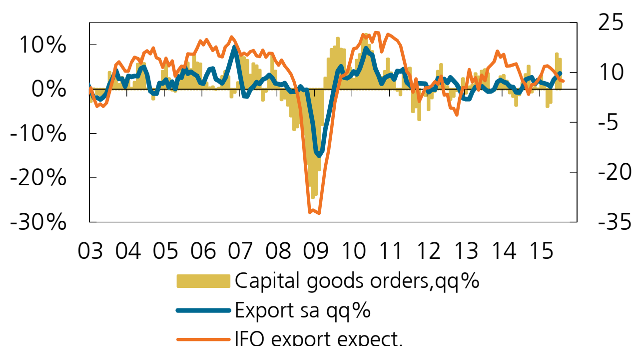
Source: FSO via Datastream

Fig. 4 – Signs of a slowdown in exports to Asia were seen in June, but demand from advanced countries remained strong



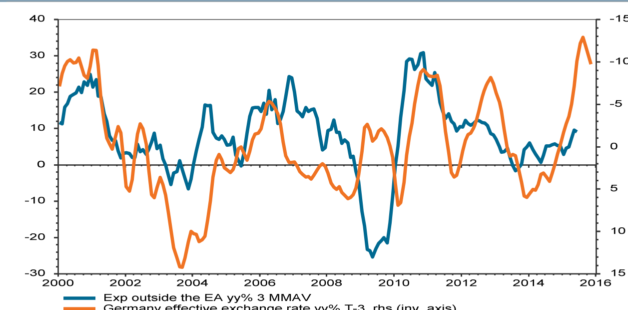
NB: Export data by area, which have remained stable to June 2015, contributed to the total change. Source: FSO via Datastream

Fig. 5 – Data on capital goods orders from abroad and expectations from the IFO survey point to a slowdown in exports from August onwards



Source: IFO, FSO via Datastream

Fig. 6 – The fall in foreign demand should be partly offset by the weakening of the effective exchange rate



Source: Thomson Reuters-Datastream

Tab. 1 – China accounts for a relatively small proportion of German exports

	as % of non-Euro zone exports	as % of Euro zone GDP	as % of Germ exports	as % of Germ GDP
Canada	1.1	0.2	0.6	0.2
Japan	2.1	0.4	1.2	0.4
Latam	4.7	0.9	2.5	1.0
OPEC	6.9	1.3	3.0	1.1
NICS ASIA & NZ	5.9	1.1	3.4	1.3
North Europe	6.1	1.1	4.3	1.7
China	6.5	1.2	5.8	2.2
Russia	3.5	0.6	6.3	1.0
US	11.4	2.1	6.8	2.6
UK	14.6	2.7	7.9	3.0
East Europe excl. Russia	14.3	2.6	10.0	3.8

Source: IMF DTS via Datastream

Tab. 2 – German exports are more concentrated than those of the Euro zone

	Exports from Euro zone			Exports from Germany		
	To China % tot		By prod. in % tot '14	To China % tot		By prod. in % tot '14
	2010	2014	2014	2010	2014	2014
Manuf	1.6	4.2	13.1	2	6.5	11.9
Mach	2.8	9.8	41.3	3.6	13.8	53.2
Misc	0.9	5.1	11	1.5	8.3	9.7
Chem	1.4	4.6	17	1.6	5.8	14.9
Tot	2.8	6.7		3.6	10.2	

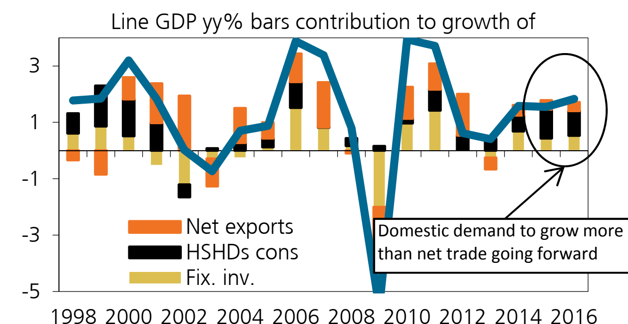
NB: denominator is exports outside the Euro zone both for the Euro zone and Germany, which explains the discrepancy between the 2014 Chinese export figure as a % of the total (10,2%) compared with table 1

Source: Destatis

Fig. 7 – The IFO signalled more upbeat sentiment and expectations in services, retail trade and construction, sectors which are more sensitive to domestic demand trends

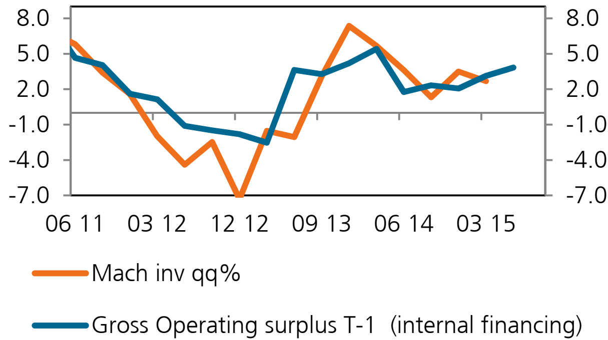
Source: Thomson Reuters-Datastream

Fig. 8 – Domestic demand should outgrow external trade in the coming quarters



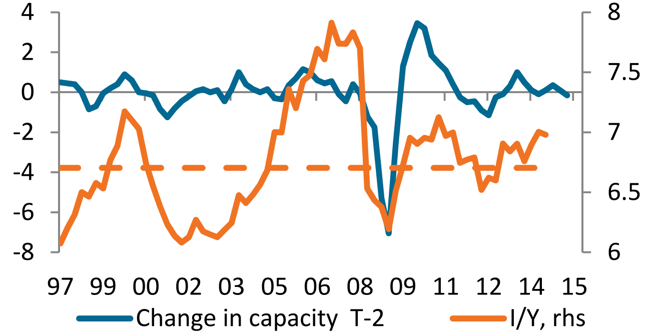
Source: Thomson Reuters-Datastream

Fig. 9 – Fundamentals for investment in machinery continue to provide strong support: margins expanding



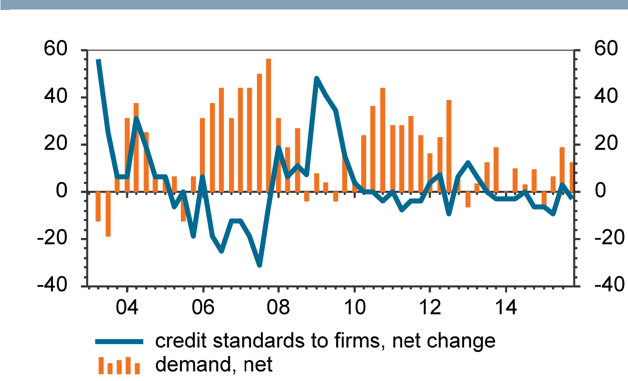
Source: FSO via Datastream

Fig. 10 –Production capacity utilization at all-time highs, although it has not risen recently



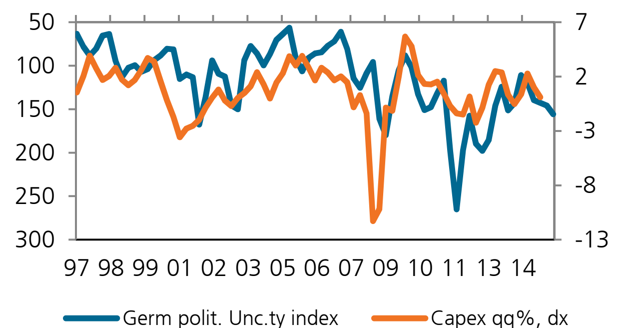
Source: FSO via Datastream

Fig. 11 – Financial conditions remain highly expansionary



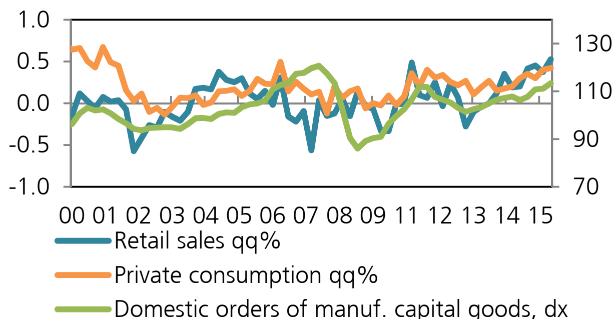
Source: FSO and Datastream

Fig. 12 – But the heightened uncertainty could prompt companies to postpone spending plans



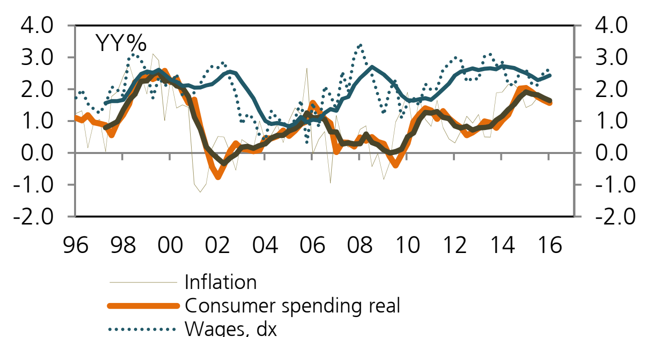
Source: FSO via Datastream

Fig. 13 – Retail sales and car registrations point to solid growth in consumer spending in the summer months



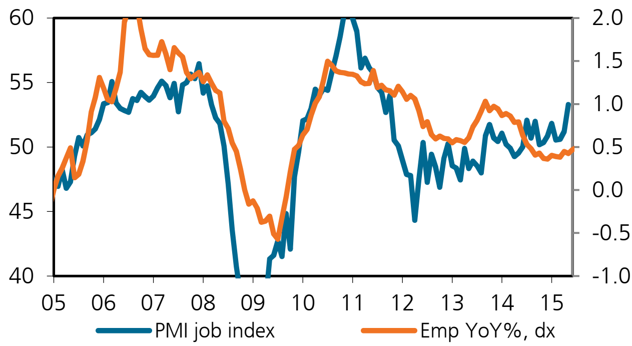
Source: FSO and Datastream

Fig. 14 – Healthy increase in disposable income: contractual wages up 2.0%-2.5%, but inflation to pick up by mid-2016



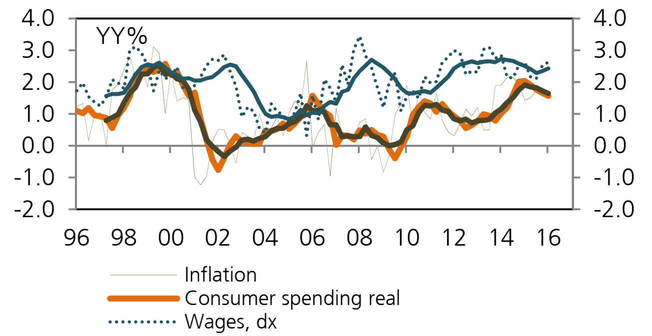
Source: FSO via Datastream

Fig. 15 – Surveys suggest employment to grow 0.5% y/y in 2016



Source: FSO and Datastream

Fig. 16 – Investment in construction sustained by the recent increase in permits and orders, but growth will be less explosive than in 2013



Source: FSO via Datastream

France: GDP growth to slow again in the second half

Guido Valerio Ceoloni

The second quarter was very disappointing, with GDP again stagnating on the back of the sudden slowdown in domestic demand and consumer spending in particular. The outlook for the second half of the year is for a moderate recovery, which will be less marked in the third quarter (+0.2% qoq, forecast revised down by a tenth of a point) and more robust in the final quarter (+0.4% qoq). Domestic demand will remain the main growth driver, while exports will be the real surprise factor. GDP is expected to show annual average growth of 1.0% this year and 1.3% yoy the next.

GDP growth could slow in the second half on the back of the renewed weakness in domestic demand and exports

The French economy got the year off to a promising start, registering growth of 0.7% qoq after the revision of the first quarter. However, the economy began to stagnate again in 2Q: the contribution of exports (+0.3% qoq, from -0.3% qoq) was in line with our expectations, while the surprise came from the marked slowdown in domestic demand (+0.1% qoq, from +0.6% qoq), which compromised the overall result; finally, the expected destocking after the winter stock-building (-0.4% qoq, from +0.3% qoq) cancelled out the rebound in net exports. Growth was 1.0% yoy in the first half. Forecasts for the third quarter show downside risks on the exports front, owing to the slowdown in China and global demand, but domestic demand could also make a smaller contribution than expected. We have therefore cautiously revised down our forecast for the current quarter by a tenth of a point, from 0.3% qoq to 0.2% qoq. GDP is therefore expected to register average annual growth of 1.0% yoy in 2015, from 0.2% yoy in 2014. The forecast for 2016 is for now confirmed at 1.3% yoy.

Household investment still weak, corporate investment recovering slightly. Consumer spending will remain the growth driver in the second half

Household confidence indices point to a slowdown in the summer following the progress made in the first half of the year, with renewed fears about unemployment and future savings capacity; the ongoing low level of oil prices and the resulting savings continue to have a positive impact on consumer spending, although given the slowdown in consumption in the spring, there is concern that it is no longer having an effect following the winter surge. The summary household confidence index retreated to around 93.3 in August, having been around 93.8 in the spring. Part of the fall could however be caused by a readjustment after a strong first quarter. We therefore cautiously forecast an increase in consumer spending in the current quarter in line with that seen in the spring (1.8% qoq, from 1.7% qoq). Consumer spending should also be supported in the third quarter to a large extent by car sales (+1.0% qoq, from 2.0% qoq), and energy consumption is expected to register a seasonal rise in the summer, from the lows of the spring. However, income is still not rising at all, and the slight increase in purchasing power is unable to offset a stable greater propensity to save among French households in the last few years, as shown by Bank of France; in addition, energy costs are already starting to rise again, owing to the recovery in oil prices since mid-August. Household capital investments fell more sharply in the second quarter, and in the third, we expect a more limited fall, while corporate investment is showing permanent, albeit slight, signs of recovery. In this regard, we believe that the CICE (competitiveness and employment tax credit) is breathing some life into corporate profit margins: we cannot yet expect appreciable effects on investment, but at least, the ongoing improvement in credit conditions for French companies is keeping the cost of debt stable. Overall, growth in fixed investment is expected to recover to around +0.2% qoq, from -0.3% qoq.

Industrial output at best stagnant in the current quarter; construction still weak

Industrial output contracted by 0.7% qoq in the spring. The start of the third quarter was just as negative for manufacturing (-1.0% mom) as it was in April, when it fell by 1.1% mom. Although the monthly result was partly due to the bridging holiday of 14 July, the contribution of the manufacturing segment is unlikely to be positive, also given the impact of lower foreign orders, particularly orders from outside the EU. The manufacturing PMI fell from an average of 49.4 in spring to the current level of 49 (July and August); new orders have performed even more poorly, falling from 48.2 to 47.4. The sector confidence index compiled by INSEE sounds a

more positive note, as since March it has been fluctuating around 101, without however indicating any definite improvement in confidence. For this reason, we cautiously forecast a further contraction to around 0.3% qoq, which would therefore make a marginally negative contribution to GDP (less than 0.1%). Confidence indicators for construction remained fairly flat in the first half of the year, at around 89, although the second quarter (90) was slightly better than the first (88.6). We confirm however that the outlook for the second half of the year remains weak: there continues to be signs of a slow recovery in activity compared with 2014, but they are still too feeble to make a positive contribution to growth, also given that utilisation of production capacity in the sector, at 84%, still remains well below its historic level of 89%. Growth in the services sector is expected to remain on a par with the first two quarters of the year.

The recovery under way in Europe should offset the slowdown in China and emerging markets

The contribution of net exports is the most exposed to surprises, since the combination of a variety of factors, particularly the slowdown in China and its impact on emerging markets, are still not easy to quantify. In any event, the weakness of the euro has facilitated and should continue to facilitate exports to non-Euro zone partners, particularly the US and the UK. For France, especially, the recovery in Europe counts for a lot, as this will favour trade with internal partners. The rise in oil prices will however increase French energy bills compared with the first half. Overall, France's usual trade deficit is unlikely to change in the third quarter either; in terms of trade in goods, this will expand by about 0.5% of GDP this year, from 2.5% to approximately 3.0%. The current account balance is expected to deteriorate slightly compared with 2014 (from -1.5% to -1.7% of GDP), but then improve marginally in 2016 (-1.6% of GDP). Net exports will on average make a negative contribution to GDP of two tenths of a point in 2015, due to the ongoing decline in French companies' competitiveness abroad, as evidenced by the increasingly smaller contribution of French goods to global exports.

Unemployment stable at 10% this year and next one

The new slowdown in growth will be reflected in the second half of the year in a slight increase in the quarterly unemployment rate, which remained stable at 10.0% in the quarter ending in June. Company surveys and PMI indices for the current quarter point to a slight decline in employment levels, particularly in services. For the summer quarter, we could see a marginal increase, to 10.1%[9]: annual average unemployment is however expected to remain at 10.0%, while it could fall slightly in 2016 to 9.9%. The first falls in unemployment will only be visible when the recovery is more sustained, and not before 2017, given its lag behind the cycle.

Inflation near zero in 2015, back to 1% in 2016

But no particular surprises expected on the inflation front. Pressure on consumer prices will remain extremely low in the current quarter, again due to the fall in oil prices, with CPI stable at an average of 0.1% yoy. In any case, compared with the lows at the beginning of the year, the upturn in inflation has been slower than expected and is unlikely to exceed 0.7% by December, coming in at around 0.1% yoy for this year according to national and harmonised indices. It is likely to rise more quickly from 2016 (annual average of 0.9% yoy according to the national index, 1.0% for the harmonised index), bolstered by higher core prices. The underlying component is expected to remain around 0.5% yoy in 2015, from 0.8% in 2014, and then pick up to 1.0% in 2016.

Commitments undertaken with the EU will be met in 2015. Deficit at 3.8% in 2015 and 3.3% in 2016

After the further tax cuts totalling EUR 2Bn announced by François Hollande for 2016 at the last press conference at the end of the summer (but which did not specify how these would be funded), initial details about the budget, which will be presented to the French government at the end of September, are beginning to emerge. The government will almost certainly confirm the central macroeconomic scenario and economic growth of 1.0% for this year, as well as the 2016 growth forecast of 1.5% yoy. According to government estimates, fiscal targets should

[9] According to the ILO definition, calculated for metropolitan France.

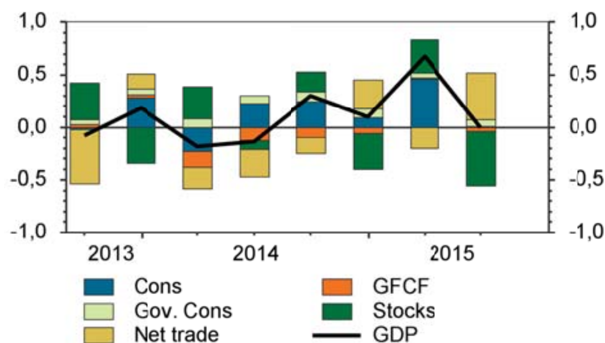
also be confirmed, at 3.8% of GDP for the 2015 deficit (from 4.0% in 2014) and 3.3% for the 2016 deficit, compared with Commission forecasts of 4.0% (from 4.1%) and 3.4%. Based on current information, the improvement in the structural deficit is also likely to remain identical to previous forecasts (correction of 0.5% of GDP a year in 2015 and 2016, lower than the Commission's recommendation of 0.8%), taking the structural deficit to 1.6% of GDP this year and 1.1% of GDP next year. For the current year, French Finance Minister Michel Sapin has given assurances that the reduction in public spending of EUR 21.5Bn (as envisaged by the EUR 50Bn three-year plan for 2015-2017) will be fully met, and the reduction of a further EUR 14.5Bn has been confirmed for 2016. However, the announcement of a further EUR 2Bn (just under 0.1% of GDP) in tax cuts makes it unlikely that France will manage to meet its improvement target of 0.5% in 2016: with government growth forecasts unchanged, it has still not been announced how this will be funded, nor will it be easy to find, given that in 2016, the number of public-sector employees is set to rise by 8,000 (mainly in education and defence). In the absence of other factors, this will probably automatically reduce, by the same amount, the structural measures to which the government will commit itself for 2016, up to a maximum of around 0.4% of GDP. Furthermore, Hollande has stated that "its responsibility and commitment to Brussels is to bring the deficit below 3% by 2017". At present, the stability programme projects a deficit of 2.7% in 2017, but the commitment will still be met if the deficit comes in at 2.9%. Meanwhile, in September, the Treasury Ministry confirmed the numbers for 2014, with the deficit at 4.0% of GDP, from 4.1% in 2013, and a correction in the structural deficit of 0.6% of GDP to 2.1%, from 2.7% in 2013. Compared with the usual upwards revisions of the last few years, therefore, the commitment with Brussels has been met, and this will make it easier for France to meet its deficit targets for the current year and consequently for 2016. Public debt will increase further this year, from 95.3% of GDP in 2014 to 98%, and in 2016 could come close to the 100% threshold (99.8%).

Forecasts

	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	0.2	1.0	1.3	0.1	0.9	1.0	1.0	1.3	1.0	1.3	1.5
- q/q change				0.1	0.7	0.0	0.2	0.4	0.4	0.3	0.4
Private consumption	0.7	1.9	1.6	0.2	0.9	0.1	0.4	0.5	0.5	0.4	0.3
Fixed investment	-1.2	-0.5	1.9	-0.3	0.1	-0.3	0.3	0.6	0.5	0.5	0.6
Government consumption	1.5	1.4	0.2	0.5	0.5	0.4	0.0	-0.1	0.1	0.0	0.1
Export	2.4	5.2	2.6	2.8	1.3	1.7	-0.4	0.7	0.7	0.7	0.8
Import	3.9	5.5	2.4	1.8	2.2	0.6	0.6	0.5	0.6	0.6	0.7
Stockbuilding (% contrib. to GDP)	0.2	-0.1	0.0	-0.3	0.3	-0.4	0.2	0.0	0.0	0.0	0.1
Current account (% of GDP)	-0.9	0.0	0.4	-0.3	-0.4	0.2	0.0	0.3	0.4	0.4	0.4
Deficit (% of GDP)	-4.0	-3.8	-3.3								
Debt (% of GDP)	95.3	98.0	99.8								
CPI (y/y)	0.5	0.1	0.9	0.3	-0.2	0.2	0.1	0.3	0.8	0.7	1.1
Industrial production	-1.1	0.8	1.4	-0.7	1.7	-0.7	-0.3	0.2	0.6	0.7	0.6
Unemployment (%)	9.9	10.0	9.9	10.1	10.0	10.0	10.1	10.0	10.0	9.9	9.9
Effective exch.rate (1990=100)	99.7	95.0	96.2	98.5	95.5	94.8	95.2	94.6	95.3	96.2	96.5

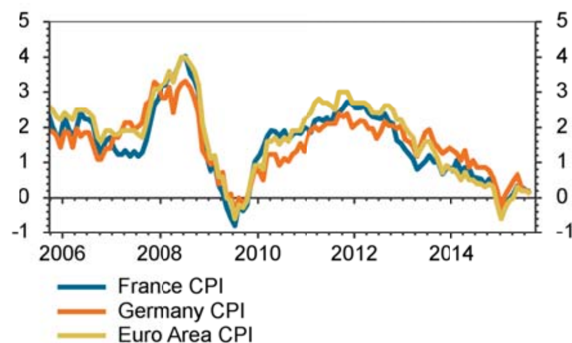
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Contribution to GDP



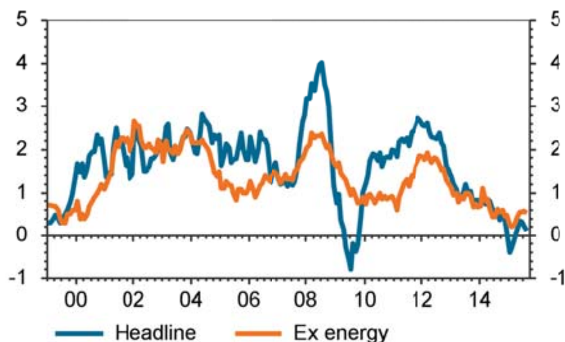
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

CPI



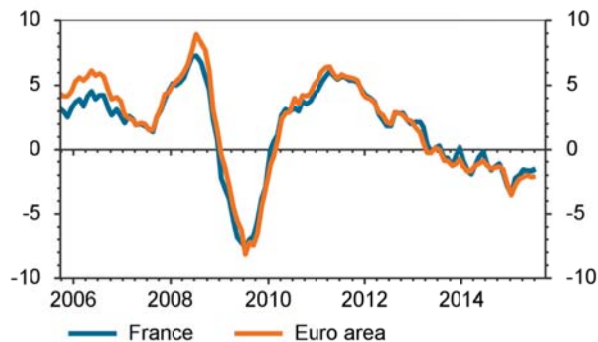
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

French ex-energy CPI



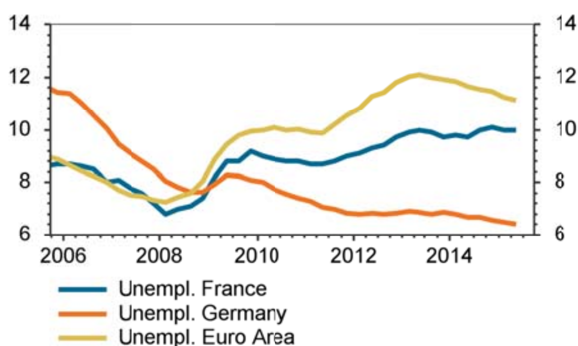
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

PPI



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Unemployment



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

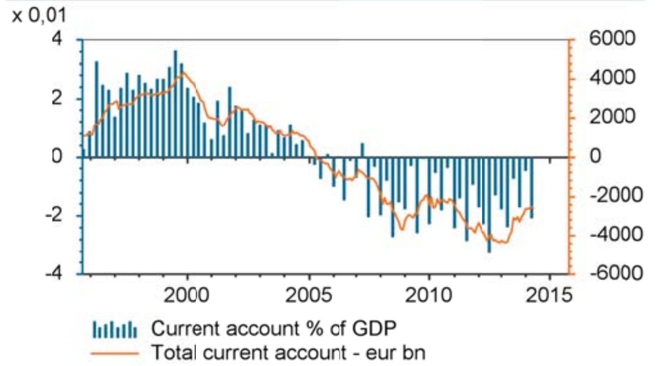
Employment

Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Unit labour cost

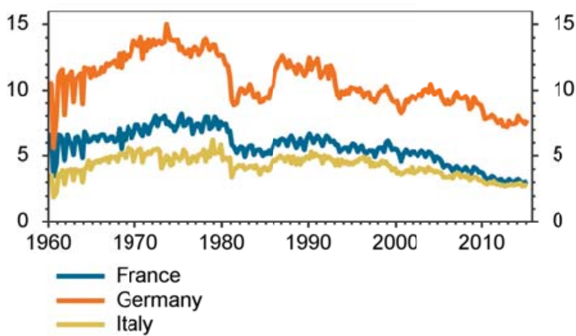
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Global exports



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

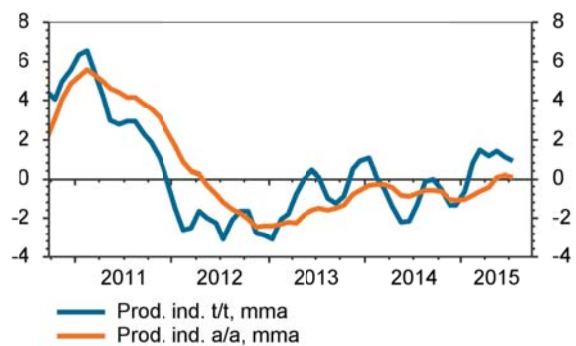
Retail sales

Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

New house building

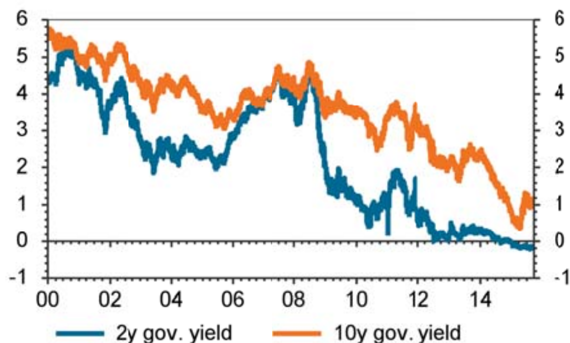
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Industrial output



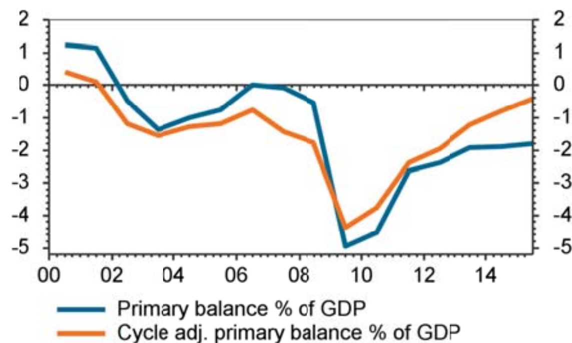
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



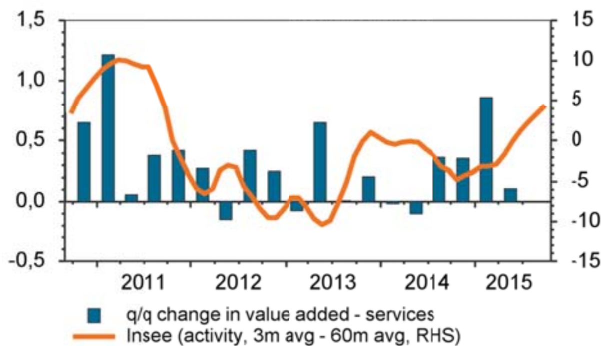
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Primary balance



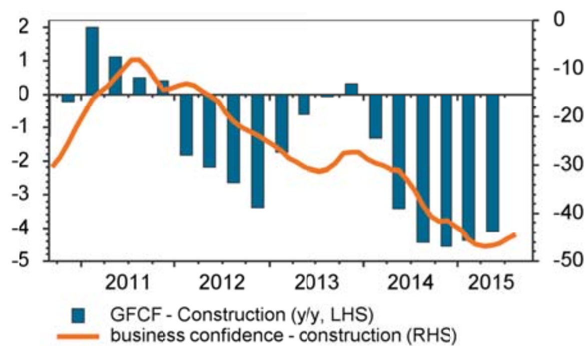
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Added value in services and confidence indicators



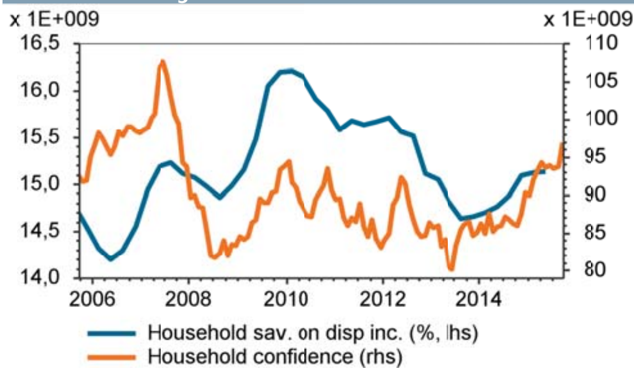
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Investment and confidence in construction sector



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Household saving and investment rates

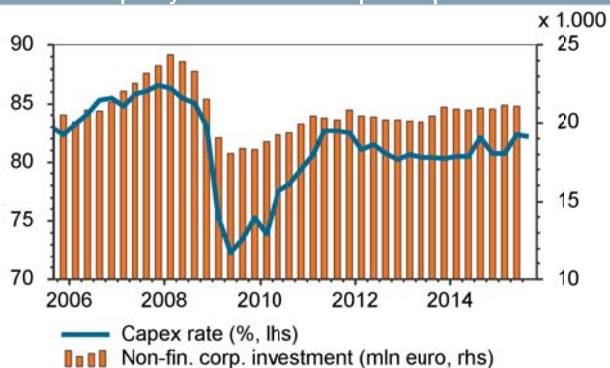


Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Household confidence and purchases of durable goods

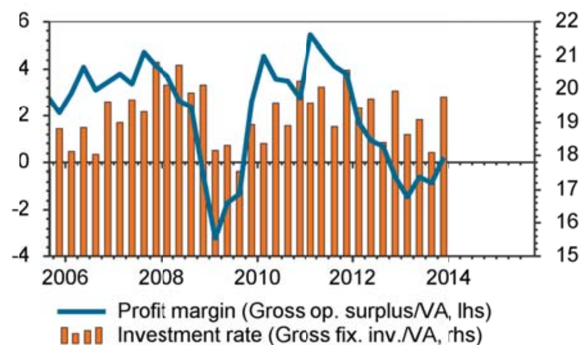
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Production capacity utilisation and capital expenditure



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Change in profit margin, non-financial companies



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Italy: recovery becoming more "tangible"

Paolo Mameli

The recent revision of national accounts data released by Istat has pushed up our forecast of average GDP growth in 2015 by two tenths. This is because "acquired" growth this year (making the very pessimistic assumption that growth will stagnate in 2H) rises to 0.6% (from 0.4% previously). Assuming 0.3% q/q growth (as in our baseline scenario) in the last two quarters of the year, average annual growth would stand at 0.8% (vs. a previous forecast of 0.6%). The new estimate is higher than both the government's forecast in the DEF (Economic and Financial Document), and the August consensus forecast (both of 0.7%). For the time being, we confirm our relatively cautious estimate for next year, of 1.2% (in line with consensus, but below the government's target of 1.4%).

Estimated GDP growth in 2015 revised upwards by two tenths…

… following Istat's revision of 1H 2015 data…

The second reading of Italian Q2 GDP growth revised upwards the preliminary estimate, to 0.3% from 0.2% q/q in 2Q 2015, and 0.4% from 0.3% q/q in 1Q (after the stagnation at the end of 2014). As a result, the year-on-year change was revised upwards to +0.7% from a first estimate of +0.5% (and from +0.2% y/y at the beginning of the year): this marks a high in the past four years.

The data breakdown was not particularly surprising, as:

1) Household consumption rose by +0.4% q/q (after a surprising drop at the beginning of the year): this marks a record in almost five years, mostly on the back of durable goods' consumption (+3.3% q/q, a high since 2009), the best-poised component to benefit from low interest rates;
2) Total investments declined marginally by -0.3% q/q (after surging by +1.2% q/q the previous quarter), dragged by a predictable correction in both construction (-0.8% q/q, in line with data on output in the sector, from a previous +0.3%, which market the first increase in five years), and investments in transport vehicles (-2.7% q/q, after soaring anomalously in 1Q by +25.3%; this is a very volatile component, which accounts for only around 5% of total investments and less than 1% of GDP); on the opposite side, investments in machinery and equipment rebounded (in this case as well not surprisingly) by +0.6% q/q, after the surprise -0.9% decline seen at the at the beginning of 2015;
3) Public consumption fell (for the first time in a year), by -0.2% q/q (from +0.1% previous);
4) Foreign trade dragged GDP for the second consecutive quarter (-0.2% q/q, from -0.3% at the beginning of the year), although trade flows in both directions were up encouragingly (imports +2.2% q/q, exports +1.2%);
5) The contribution of foreign trade was balanced by inventories, which added significantly to growth for the second quarter in a row (+0.4%, from +0.5% at the beginning of the year); in essence, net of inventories GDP growth would have been negative; however, in the present phase the contribution of inventories seems symmetrical to the drag represented by net exports, therefore the two components balance each other in terms of the resulting effects on economic activity in general (with a slightly positive net balance).

…although the recovery remains modest and still exposed to risks

Yet, the breakdown of the data is not entirely reassuring, as:

1) The contribution made by inventories (which are a residual component) was decisive for the second quarter in a row. On the other hand, as explained above, their addition to growth balanced the drag represented by net exports; in the upcoming quarters, we expect growth to remain stable growth at 0.3% q/q, but with a different composition (positive contribution of foreign trade, drag from inventories);
2) Exports, despite having accelerated since the beginning of the year, are showing less elasticity to the favourable exchange rate shock than could have been expected based on the econometric models;

3) **Final domestic demand** has increased at a rate of just 0.1% q/q in the past year; if the rebound in consumption is compatible with the current recovery in the disposable income of households (and the incipient improvement in labour market conditions), the trend of corporate investments strikes as being still relatively weak, given the size of the positive shocks to the economy in the past year (coming from the exchange rate, the price of oil, effects of QE).

In essence, if on the one hand the data prompts an upward revision of average annual GDP growth, on the other it confirms that **the recovery is still modest and fragile**. We stick to our view that GDP may continue to grow at a rate of 0.3% q/q on the foreseeable horizon: while we see no grounds on which to expect a significant acceleration in economic activity, the current factors of uncertainty are not serious enough in our view, at least for the moment, to cause a slowdown, either.

In our view, recent data confirm that the tailwinds that have created the conditions for a return to positive growth (shocks from oil, the exchange rate, and QE) have not yet waned, and that the current headwinds of an equally external nature, are not proving strong enough, at least for the time being, to derail the recovery. More in detail, rather than a contraction, foreign demand is undergoing a redistribution, as the slowdown under way in several emerging countries is being more than balanced by stronger demand from the advanced economies, in particular by the United States and by some European countries, especially outside the euro area: exports to China and to Brazil account for respectively 2.5% and 1% of total exports, as opposed to a 9% share accounted for by the United States, 5% by the United Kingdom and Spain (each), and 10% by Eastern Europe (excluding Russia, which in turn accounts for 1.5% of exports). A caveat lies in the fact that, in China's case, indirect exports to the country are larger because they "pass through" other trade partners of ours, such as Germany, which directs 5.8% of its exports to the Asian colossus.

In any case, also in light of the risks still weighing on the scenario, we confirm our forecast for 1.2% GDP growth in 2016, in waiting for further details on the evolution of fiscal policy next year.

The improvement of the cycle and the effects of the government's measures are starting to impact the labour market positively

An important factor for the recovery to achieve self-sustainment is its ability to trigger a **widespread improvement on the labour market**. On this front as well, the latest data are encouraging: based on provisional monthly data, **the unemployment rate dropped much more than expected in July**, to 12% from 12.5% in June (revised downwards from an advance estimate of 12.7%), a low since March 2013. While we anticipated a drop (as opposed to consensus forecasts for stability), the decline proved much sharper.

The decline in the jobless rate was due not only to an increase in the number of employed workers (+44k, i.e. +0.2% m/m), in particular among men, **but also to a contracting labour force** (-99k, -0.4% m/m). In fact, after the downward trend seen in the previous months, inactive workers rebounded (+99k, +0.7% m/m), in particular among women.

The decline in the youth unemployment rate was also encouraging, to 40.5% from 43.1% (which was a record high). While the rate remains staggeringly high (second in the euro area only to Greece and Spain), it marks a low-point in two years.

The labour force survey placed the unemployment rate in 2Q 2015 (seasonally adjusted) at 12.4%, up slightly from 12.3% at the beginning of the year (revised from a previous estimate of 12.4%). Employment increased by +0.8% y/y (from +0.6% in 1Q), although once again **the recovery was driven by older workers** (+5.8% among over-50s), as opposed to a further drop in among younger workers (-2.2% up to 34 yrs, -1.1% in the 35-49 age bracket). The annual trend of employment is stable in manufacturing and positive in the services sector (+0.8% y/y);

the recovery in the construction sector is particularly encouraging (+2.3% y/y), the first after 19 consecutive negative quarters.

While part-time employment (non-voluntary in over 70% of cases) continued to grow, as also temporary employment, the number of **full-time workers also increased for the second consecutive quarter** (+0.8% y/y, i.e. +139k), with **open-ended contracts also on the rise** (+0.7% y/y, i.e. +106k). An encouraging fact is that the recovery in employment was driven by **Southern Italy** (+2.1% y/y). Another positive note is the attenuation, for the first time in four years, of the discouragement effect (-5.8% y/y, -114k), in particular in the South and among youths (but July monthly data could signal a reversal of this effect in the foist month of 3Q).

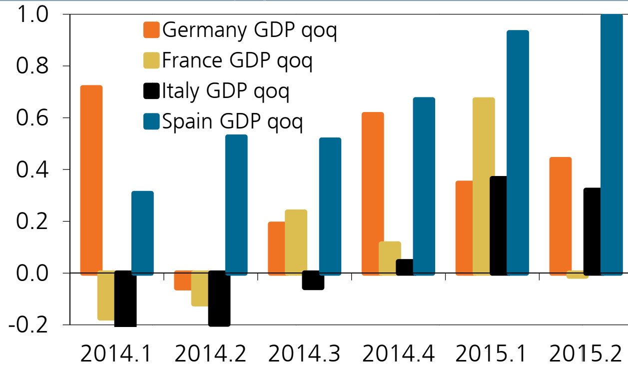
In short, the **July reading is encouraging** in as much as the incipient recovery of the economic cycle (albeit modest) is starting to have a tangible impact, together with government measures, in curbing unemployment. However, July data should not be overly emphasised, as: 1) the volatility of monthly labour market data is high; 2) the drop in unemployment in the month was due more to an increase in inactive workers than to higher employment numbers. In any case, broken down 2Q labour force data confirmed that **the labour market is improving not only in quantitative terms, but also in terms of the quality of employment** (recovery no longer limited to temporary and part-time contracts, but extending to open-ended and full-time work contracts as well; weaker components, such as Southern Italy, youths, and the construction sector, also picking up).

Forecasts

	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (constant prices)	-0.4	0.8	1.2	-0.4	0.2	0.7	1.0	1.2	1.2	1.2	1.2
- q/q change				0.0	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Private consumption	0.3	0.6	1.1	0.2	-0.1	0.4	0.3	0.3	0.2	0.2	0.3
Fixed investment	-3.2	0.9	2.1	0.1	1.2	-0.3	0.5	0.6	0.6	0.6	0.5
Government consumption	-1.0	0.1	-0.2	0.4	0.1	-0.2	0.0	0.0	-0.1	-0.1	0.0
Export	2.4	4.1	4.1	1.7	0.6	1.2	1.0	0.8	1.1	1.0	1.0
Import	1.7	5.3	4.2	0.5	1.7	2.2	0.9	1.0	1.0	0.9	1.0
Stockbuilding (% contrib. to GDP)	0.0	0.4	0.1	-0.5	0.5	0.4	-0.1	0.0	0.0	0.0	0.0
Current account (% of GDP)	1.9	2.4	2.4	3.5	0.2	2.8	3.3	3.1	0.9	1.9	3.3
Deficit (% of GDP)	-3.0	-2.7	-2.2								
Debt (% of GDP)	132.0	133.1	132.2								
CPI (y/y)	0.2	0.1	1.1	0.1	-0.2	0.1	0.2	0.4	0.9	0.9	1.1
Industrial production	-0.5	1.2	1.7	0.4	0.5	0.6	0.7	0.4	0.3	0.7	0.2
Unemployment (%)	12.7	12.2	11.8	12.8	12.3	12.4	12.1	12.1	12.0	11.9	11.7
10-year rate	2.89	1.84	2.17	2.23	1.53	1.80	1.95	2.09	2.15	2.12	2.14
Effective exch.rate (2010=100)	99.8	95.6	96.0	98.9	96.2	95.5	95.7	95.1	95.4	96.0	96.1

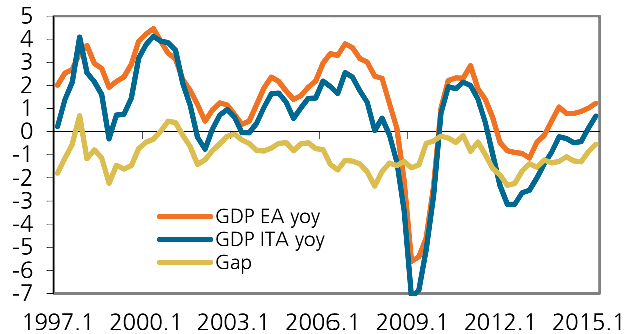
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – In the last two quarters Italy grew in line with Germany and France (behind only Spain)…



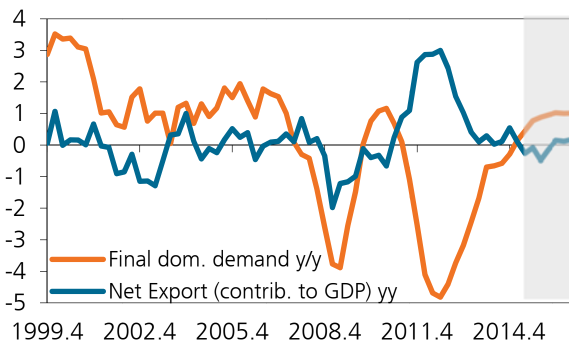
Source: Eurostat, Istat

Fig. 2 – … and the gap on a y/y basis vs the Eurozone is closing



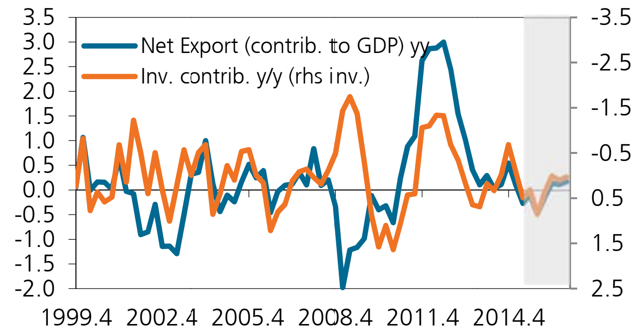
Source: Eurostat, Istat and Intesa Sanpaolo elaborations

Fig. 3 – We are seeing a rebalancing of growth towards domestic demand



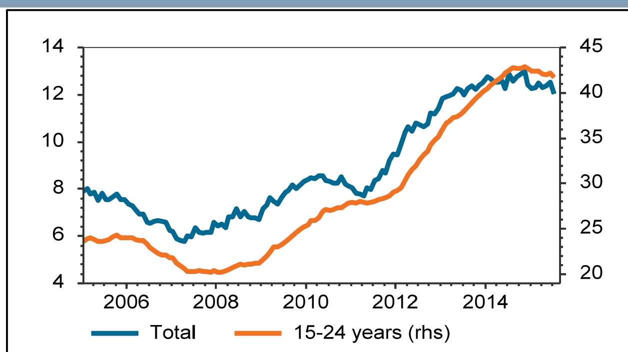
Note: net export = export – import; Final dom. Demand = domestic demand net of inventories. Source: Istat and Intesa Sanpaolo elaborations

Fig. 4 – In this phase the contribution from inventories is symmetrical to that of foreign trade



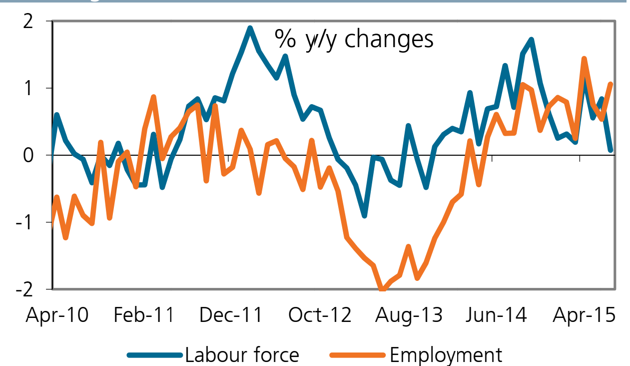
Note: net export = export – import; Inv. = change in inventories. Source: Istat and Intesa Sanpaolo elaborations

Fig. 5 – The unemployment rate has just started to decrease



Source: Istat, Thomson Reuters-Datastream

Fig. 6 – Employment is growing and the labour force is contracting



Source: Istat and Intesa Sanpaolo elaborations

Spain: solid growth, the peak is behind us. Now focus on politics

Anna Maria Grimaldi

The Spanish economy continues to perform better than expected. After a *grand opening* of the year with +0.9% qoq growth, GDP accelerated to 1.0% qoq in the Spring, outperforming even the Bank of Spain's generally reliable expectations. The Spanish economy therefore grew significantly above potential (European Commission average 0.2%) and much more than the rest of the Euro zone. Although growth was 2.6% in 2015, based on more recent figures we are confirming our GDP growth estimate of 0.6% qoq for 2Q; as a result, our growth forecast for the current year rises from 2.4% to 3.0%. We expect a return to more moderate growth rates of 2.2% in 2016. This faster phase of cyclical upturn should now be behind us. Domestic demand will resume growth of around 1.8-2.0%, once companies adapt production capacity[10] and households satisfy pent-up demand. It must be borne in mind that Spain needs to tighten fiscal policy in the next years to bring the deficit below 3%, which may partly contribute to soften domestic demand growth.

Risks to the forecast. The Spanish growth outlook is subject to downside risks; however, the slowdown in emerging markets should be less important for Spain than for the rest of the Euro zone, since China and Asia contribute less to Spanish exports (4.4% in 2014) than for the Euro zone and Germany (see section on the Euro zone economy). Yet, the country remains highly exposed to the risk of a sudden tightening of financial conditions, given its high public debt (100.8% in 2015) and also in light of the elections scheduled for late December and which are the chief source of uncertainty in the short term. The latest opinion polls show that the People's Party (PP) recovered some of the preferences (to 29%), followed closely by the Spanish Socialist Workers' Party (PSOE) (22%). Meanwhile support for the protest movements *Ciutadans* (13.5%) and *Podemos* (16.5%) declined compared to the Spring but not to an extent to erase the risk the country is governed by a coalition government in the next legislature for the first time in post-Franco history, which might slow the reform process.

Short-term outlook. Manufacturing and services PMIs, such as the European Commission's confidence index, have been pointing to GDP growth of between 2.5% yoy and 3.0% yoy, continuing into July and August. Industrial output started the summer quarter at a fairly solid pace and is still on target for an increase of 1.1% qoq in September (following an increase of 1.8% qoq). Confidence indicators for retail trade are signalling a slight slowdown in household spending in the summer months. In July, exports were still growing at a rapid pace (8.8% yoy), driven by exports to the Euro zone (its main trading partner), OPEC, China and Latin America[11]. The global PMI excluding the Euro zone suggests a moderate slowdown in exports in the next few months. The euro's previous depreciation should continue to lend support until mid-2016. Overall, we expect exports to advance by 4.6% in 2015 and by 4.9% in 2016, from 4.2% in 2014. Imports should grow by 5.7% in 2015-16 in line with the elasticity in internal demand seen in the past. However, the risks in the short term are to the upside, given the fairly rapid response of imports to exchange rate fluctuations (see Fig. 13). Overall, therefore, foreign trade will shave 0.2% off GDP growth. Domestic demand is expected to rise by 3.1% in 2015 and slow to 2.0% in 2016. Specifically, consumer spending is seen to decelerate from 3.4% this year to 2.4% in 2016, given that real disposable income growth may slow to 1.8% from mid-2016 due to more moderate salaries and employment growth and to the rebound

[10] Corporate investment has benefited from the reduction in corporate income tax from 30% to 28%; this is due to fall to 25% in 2016, in line with the OECD average.

[11] Spanish exports to Asian markets have increased in percentage terms in the last ten years, from 2.7% in 2005 (of which: China 1.0% and Japan 0.7%) to 4.4% in 2014 (of which: China 1.9% and Japan 1.0%). However, these figures are still lower than exports to Latin America (6.6%) and other advanced economies (see fig.12).

Consumption and machinery growth still solid, but likely to have peaked

of inflation towards 1.0% next year. Household spending should benefit from the tax cuts originally planned for 2016 and brought forward to 2015[12], as well as the more accommodative financial conditions and the clear improvement in lending figures. Spending on machinery is expected to slow to 5.0% after rising by around 8.0% in 1H. The increase in production capacity utilisation has slackened, which is reflected in operating margins (see figs.7 and 8). However, spending on machinery should again benefit from the tax cut (from 28% to 25%) and more favourable lending conditions. The turnaround in construction continued, with investment expanding 1.4% qoq in spring after a rise of 1.6% qoq. But it will be hard to maintain such growth rates, particularly in residential construction, since the unsold housing stock is still high (see fig. 10), even though sales have resumed.

Recovery in construction continues

Employment growth at US rates. Total unemployment grew by 3.0% (annualised) in 1H15, up from 2.1% in 2014. 183,000 job positions were created per quarter between June 2014 and June 2015. Job creation is almost entirely in the private sector (368,000 positions in 2Q) and stronger than suggested by hiring intention surveys (see fig. 5) in all sectors but especially in construction (see fig 6). As a result, the unemployment rate again fell more quickly than expected, including in 2Q, dropping to 22.2% this July from a peak of 27% in March 2013. This is even more surprising considering the increase in participation (from 59.5% at the beginning of the year to 59.8% in 2Q). In 2016, we expect unemployment to fall less rapidly (to 21.2%), given that confidence surveys are suggesting employment growth could slow compared with 1H15 (see fig.5).

The high level of unemployment is one of the main challenges in the medium term

Public finances. In 2015, we expect the deficit to fall to around 4.7% of GDP, from 5.8% last year. The deficit is unlikely to fall below 3.0% in 2016 since the decline is entirely left on stronger cyclical revenues. The structural balance is expected to improve by 0.2 this year and by 0.1 next year, due to fairly aggressive assumptions on interest spending (down from 3.3% in 2014 to 2.8% in 2016; the European Commission estimates a fall to 3.0%). The government's projections put debt at 93.2% in 2018 down from 97.8% in 2014. In July 2015 recommendations, the European Council assessed the government's planned structural interventions as inadequate and indicated the urgency of implementing additional measures in 2015-16. In 2016, Spain should make a structural correction of at least 0.5% of GDP since the output gap is expected to drop back below 4%. Clearly, the correction has been postponed until after the elections. The 2016 draft budget does not include any additional measures to bring the structural balance in line with the Council's recommended path, but it makes sense that it will fall to the new government to draw up a new austerity plan. The risk is that the year-end elections (planned for around 20 December) lead to a coalition government in a break with the traditional two-party government (see fig.14), which could have adverse implications for the reform process.

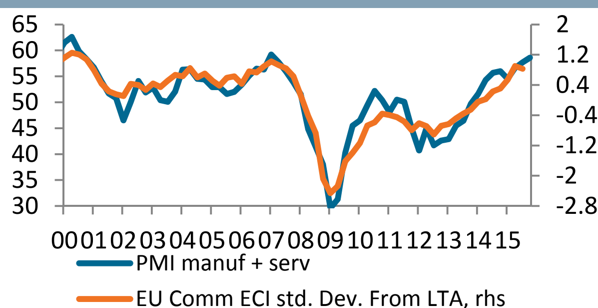
Structural correction postponed to 2016 but doubtful in the draft budget

[12] Decree law of 10 July 2015. Raising of the minimum exempt amount to EUR 12,000, reduction of tax rates from 19.5% to 19.0% and of the maximum amount from 46% to 45%. The estimated cost is EUR 1.5Bn or 0.1% of GDP.

Forecasts											
	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (constant prices)	1.4	3.0	2.2	2.1	2.7	3.1	3.2	3.1	2.6	2.1	2.0
- q/q change				0.7	0.9	1.0	0.6	0.5	0.5	0.5	0.5
Private consumption	2.4	3.3	2.4	0.9	0.7	1.0	0.7	0.6	0.7	0.4	0.4
Fixed investment	1.8	4.5	2.6	0.8	0.6	1.3	0.8	0.8	0.4	0.8	0.5
Deficit (% of GDP)	-5.8	-4.7	-3.5								
Debt (% of GDP)	97.2	99.2	102.9								
CPI (y/y)	-0.2	-0.1	1.5	-0.5	-1.0	-0.3	-0.2	1.2	1.7	1.3	1.5
Unemployment (%)	25.4	24.7	20.4	25.4	25.2	25.1	24.9	24.7	21.2	20.9	20.7
Effective exch.rate (2005=100)	99.4	96.1	96.2	98.7	96.6	96.0	96.1	95.6	95.8	96.2	96.4

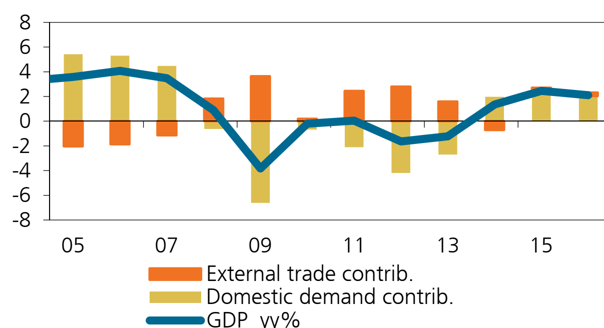
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Confidence surveys still signalling GDP growth of over 3% yoy in the next few months



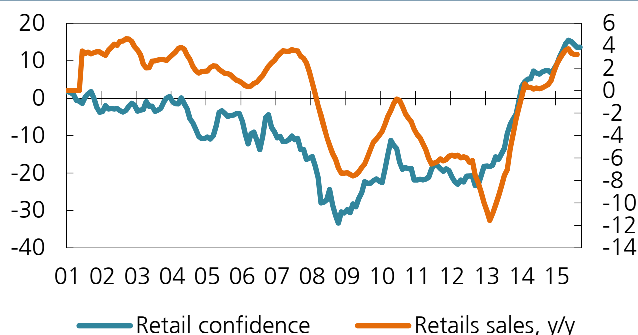
Source: Intesa Sanpaolo chart from INE and Markit data

Fig. 2 – Over the forecast horizon, support for growth will come more from domestic demand than foreign trade, but the peak has passed



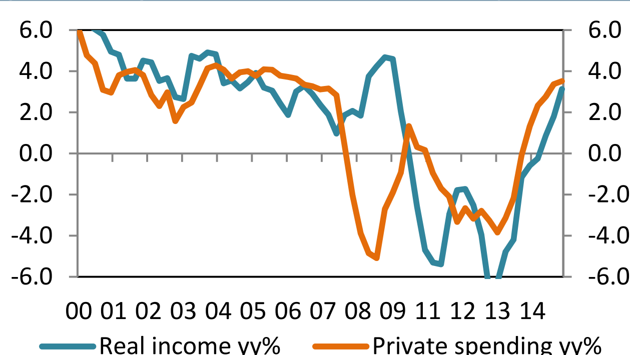
Source: Intesa Sanpaolo chart from INE data

Fig. 3 – Confidence and retail sales still point to sustained consumption growth in the summer



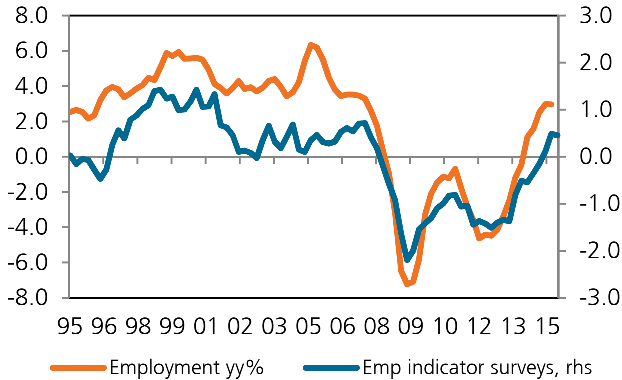
Source: Intesa Sanpaolo chart from European Commission and Eurostat data

Fig. 4 – Strong support for spending continues to come from growth in disposable income, which is boosted by ...



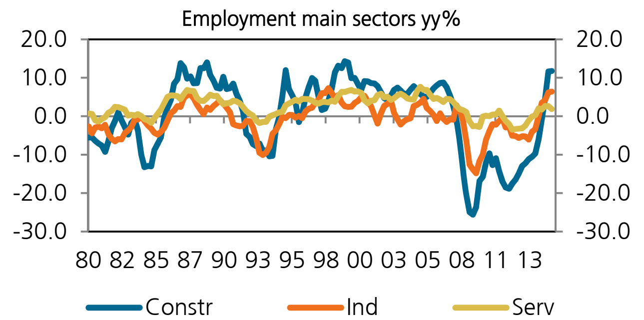
Source: Intesa Sanpaolo chart from European Commission and Eurostat data

Fig. 5 – … rising employment, which outperformed business confidence surveys



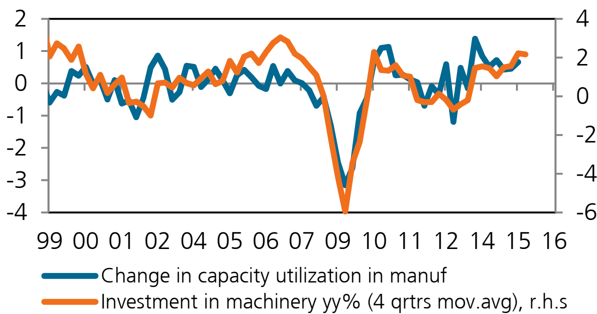
Source: Intesa Sanpaolo charts from UE Commission and INE data

Fig. 6 – Employment is growing again, including in construction



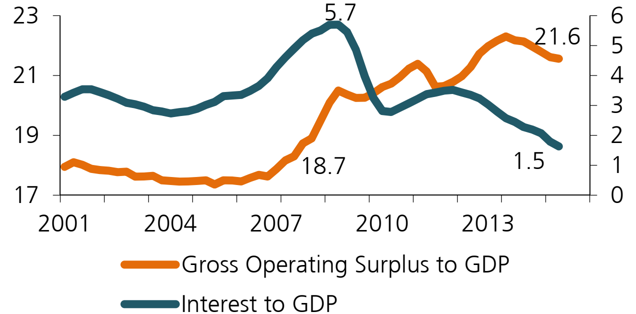
Source: Intesa Sanpaolo chart from INE data

Fig. 7 – Investment growth in line with increased production capacity utilisation, now back to its historical average



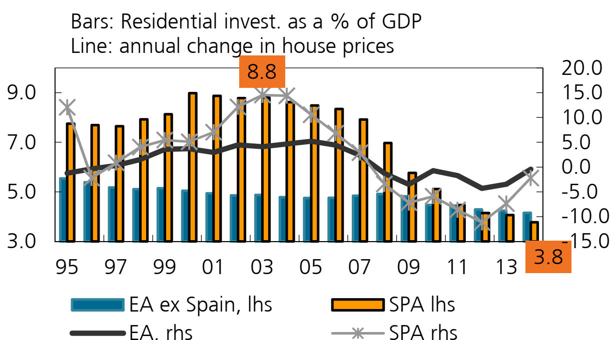
Source: Intesa Sanpaolo chart from European Commission and Eurostat data

Fig. 8 – Investment supported by higher gross operating margins and falling interest spending



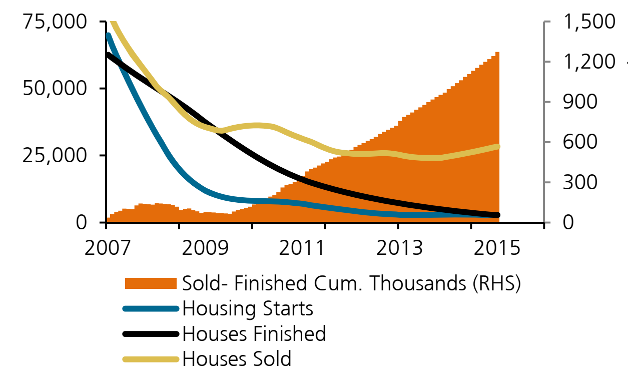
Source: Intesa Sanpaolo chart from INE data

Fig. 9 – Construction has also turned around: the ratio of residential investment to GDP has fallen below the EU average, prices are starting to rise, but …



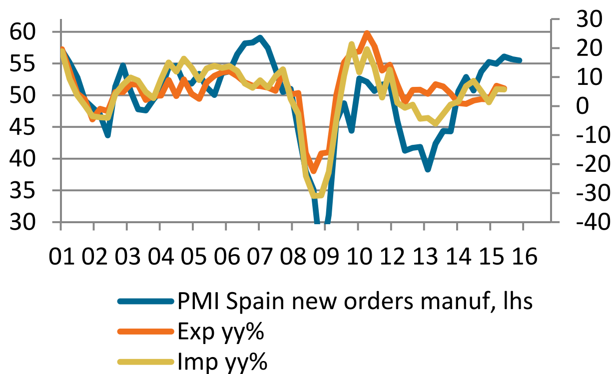
Source: Intesa Sanpaolo chart from INE and ECB data

Fig. 10 – … we expect limited construction investment, given the high stock of unsold housing



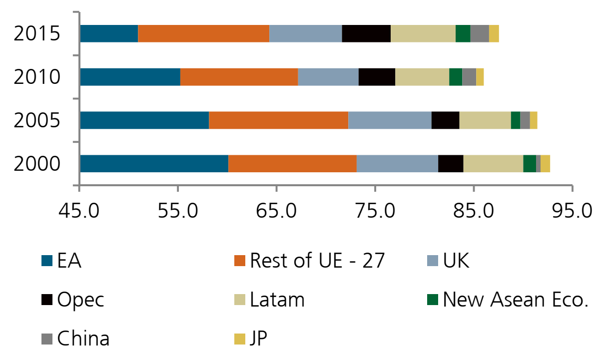
Source: Intesa Sanpaolo chart from INE data

Fig. 11 – Markit PMI for export orders suggests that trade flows will stabilise rather than crash



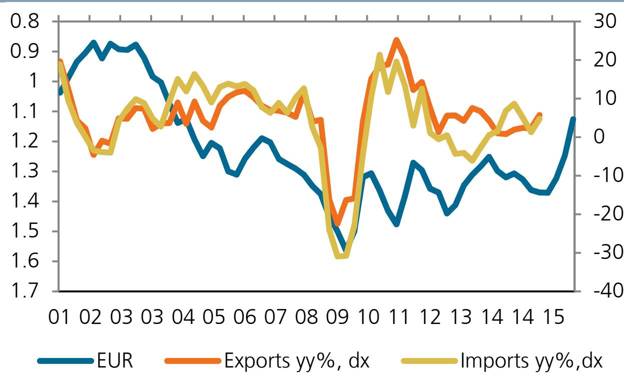
Source: Intesa Sanpaolo chart from INE and Markit data

Fig. 12 – Share of exports to China and the Asian economies rose in the past 10 yrs, but the bulk of exports are to South America, the UK and Europe



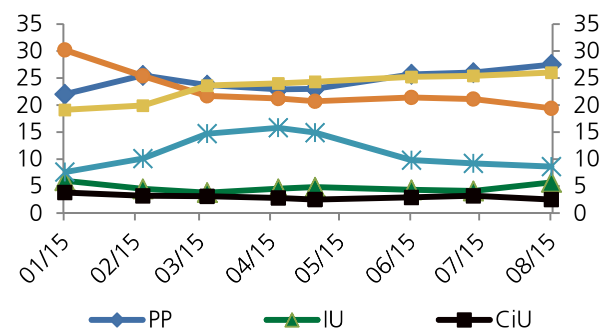
Source: Intesa Sanpaolo chart from INE data

Fig. 13 – Depreciation of the euro not yet fully transmitted to exports Imports tend to react more quickly than exports



Source: Intesa Sanpaolo chart from INE data

Fig. 14 – The main risk is political . The spectre of a coalition government is not receding, according to the most recent opinion polls



Source: Wikipedia, and Intesa Sanpaolo charts from ECB data

Netherlands: 2015 GDP growth at 2%

Guido Valerio Ceoloni

In the second half of the year, the Dutch economy (which is valued at approximately EUR 640Bn) will maintain the pace seen in the first half, thanks in particular to the buoyancy of consumer spending. However, the government's decision to limit extraction activities in Europe's biggest gas field for the whole year will necessarily dampen GDP growth. There are downside risks on foreign trade, due to the slowdown in emerging markets and China, the size of which is not yet clear. Overall, the country does not have any major problems, with a trade balance firmly in positive territory and its public accounts in order.

The limit on gas extraction, extended to the whole of 2015, will dampen growth

The slowdown in Dutch GDP growth in the second quarter is due to two factors: the first is the correction of foreign trade after the surge in the winter; the second relates to the limits imposed by the government on gas production in the region of Groningen[13] due to increasing seismic risks; these measures reduced the contribution to GDP of the extraction industry by almost half a percentage point in the second quarter alone. Gas extraction plummeted by 30% yoy in April and by 56% yoy in May. The limit imposed by the government until June will be extended to the second half of the year: total production for 2015 was significantly revised downwards for the second time in June, from 39.4 billion cubic metres to 30 billion cubic metres (-30% versus 2014). The ceiling for the second half has been set at 13.5 billion cubic metres, which will have an impact on GDP, estimated to be at least one-tenth of a point a quarter. The Dutch economy is therefore more buoyant that it would seem looking at June's GDP figure, given the importance of this external factor. To date, it has grown by 2.3%. For the current quarter, we expect a recovery in activity, which should boost the result from +0.1% qoq to +0.3% qoq. GDP is expected to show annual average growth of 2.0% yoy in 2015 and 1.7% yoy in 2016.

Excluding the extraction industry, the growth drivers for 2015 are spread out among the various components of GDP, with an upturn in consumer spending, capital spending and exports, supported by the weakness of the euro and the recovery mainly of partner economies within the Euro zone. The main downside risk to forecasts is the instability in the international environment, with the slowdown in China and emerging markets, which could have a negative impact on an open economy like that of the Netherlands.

Consumer spending and investment also buoyant in the second half

We confirm the scenario concerning domestic demand, which should continue to benefit from high household confidence in the consumer spending component, the capital spending of households and companies, and the public sector. Household confidence indices remained at their highs over the summer, and we believe that consumer spending will remain stable over the current quarter, before picking up at the end of the year (+1.4% yoy in the second half, from +1.7% yoy in 1H). The accommodative financial conditions put in place by the ECB will continue to support investments in the manufacturing sector, but in the current quarter, we expect a cyclical contraction (-2.2% qoq) after the sharp increases of the first half. Over the year, our growth forecast for the fixed investment segment is confirmed at around 6.5% yoy. The public sector will make a marginally positive contribution in 2015, after spending cuts depressed growth in 2014.

The main downside risk remains the contribution of exports, due to the slowdown in global demand

Exports may however have surprises in store, although they will continue to benefit from a weak euro (+2.7% yoy in 2015 and +3.0% in 2016). The slowdown in emerging countries and China will undoubtedly slow Dutch exports, but not excessively, given that the Netherlands mainly exports to Euro zone countries, where the recovery is continuing. We cautiously forecast that the net balance in the second half of the year will be in line with that of the first half (around

[13] The Groningen gas field, operational since 1959, met approximately 10% of European demand for gas in 2014.

EUR 25 billion), also given that the good level of consumer spending could drive imports at the end of the year (+2.2% yoy in 2015 and +2.8% yoy in 2016). In addition, the government has given assurances that there is unlikely to be an impact this year in terms of greater gas imports due to the ceiling on extraction from the Groningen plant, which it manages in conjunction with private companies. The trade surplus will continue to improve, having risen from EUR 50.5Bn at end-2014 to EUR 75.8Bn in June. The Netherlands' trade balance is expected to increase by 1% yoy in 2015 and 5.5% yoy in 2016.

Unemployment below 7% and inflation above 1% from 2016

Unemployment is expected to fall to 6.8% in the summer, and then remain stable in the last quarter. The annual average is expected to come in at 6.9%, from 7.4% in 2014. Quarterly vacancy surveys show a growing number of job openings, which should ensure that unemployment will continue to trend downwards. Unemployment will therefore continue to fall next year too, taking the annual average to 6.7% (full employment is around 5.5%).

Inflation is expected to remain around 0.7% yoy in the third quarter, still below 1%, where it should remain in the winter. Annual average CPI is seen at 0.7% this year. From 2016, inflation is expected to return above 1% (annual average: 1.2%) on the back of rising oil prices.

Deficit down below 2%, debt up slightly to 70% in 2015

The public accounts situation has not changed much since our last update. The deficit is seen at 1.7% of GDP this year, from 2.3% of GDP in 2014, and at 1.2% of GDP in 2016. The good recovery in domestic demand and the cut in healthcare spending amounting to approximately 3% of GDP should ensure that targets are met. The structural deficit correction target is -0.3% this year and -0.2% next. Public debt will increase from 68.8% in 2014 to 70% in 2015, but fall to 69% in 2016. Here too, the main downside risk is still the impact of the limit on gas extraction (amplified by the fall in European gas prices of approximately 8% since the beginning of the year). The privatisation of ABN Amro (scheduled to be completed by the end of the year), following its nationalisation in 2008, could however have a positive effect on the public finances[14].

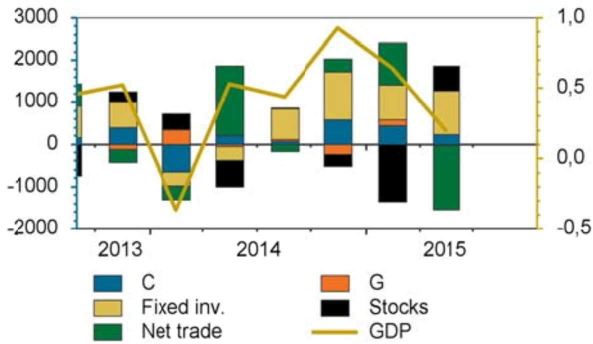
Forecasts

	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (constant prices)	1.0	2.0	1.7	1.5	2.6	2.0	1.9	1.3	1.2	1.4	1.8
- q/q change				0.9	0.6	0.1	0.3	0.3	0.5	0.3	0.7
Private consumption	0.0	1.8	1.5	0.8	0.6	0.2	0.4	0.4	0.4	0.4	0.3
Fixed investment	3.5	7.1	1.3	3.6	2.4	2.1	-1.5	0.3	0.5	0.5	0.5
Deficit (% of GDP)	-2.3	-1.7	-1.2								
Debt (% of GDP)	68.2	70.0	69.2								
CPI (y/y)	1.0	0.7	1.2	0.9	0.2	0.9	0.8	0.7	1.2	1.2	1.1
Unemployment (%)	7.4	6.9	6.7	7.1	7.1	6.9	6.8	6.8	6.7	6.7	6.6
Effective exch.rate (2005=100)	112.1	107.6	108.0	111.1	108.2	107.5	107.8	106.9	107.3	108.0	108.2

Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

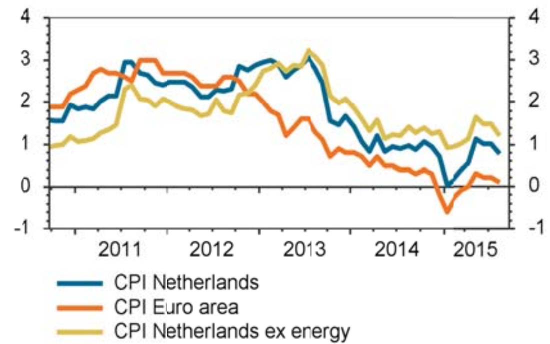
[14] However, the exact impact cannot currently be calculated and has not been included in these estimates, since, with the bank valued at approximately EUR 15Bn, the percentage that the government wants to float is not yet known. A possible listing of 20% would generate revenue equal to 0.4% of GDP.

Contribution to GDP



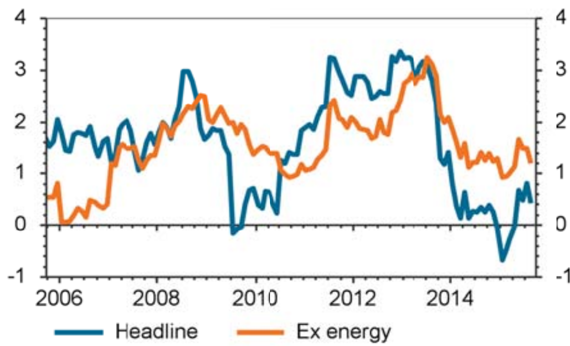
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

CPI



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

CPI excluding energy

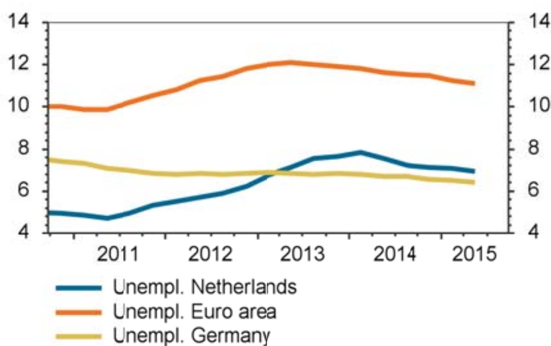


Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

PPI

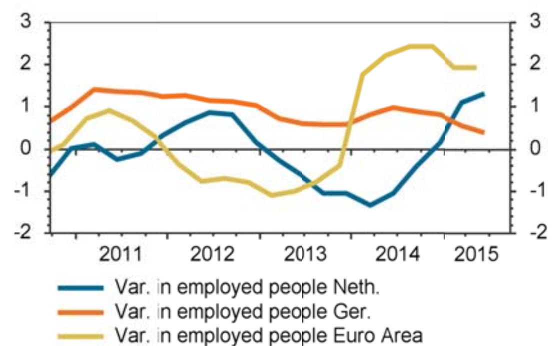
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Unemployment



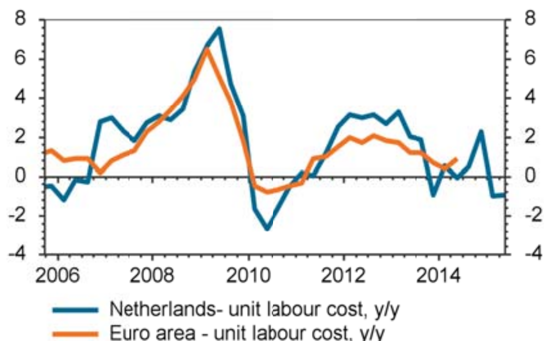
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Employment



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Unit labour cost

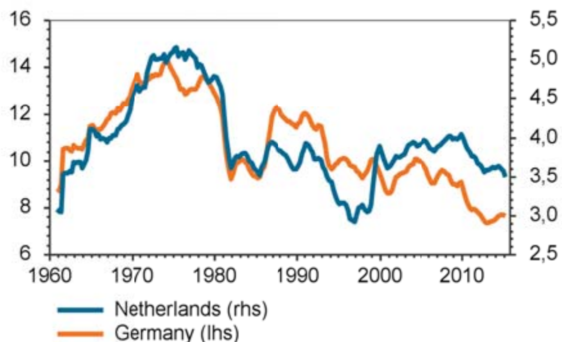


Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Current account balance

Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Global exports

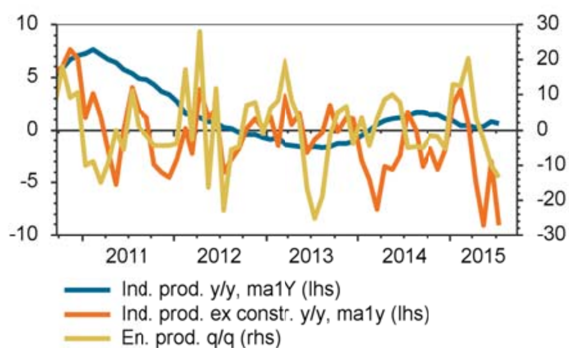


Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Retail sales and household confidence

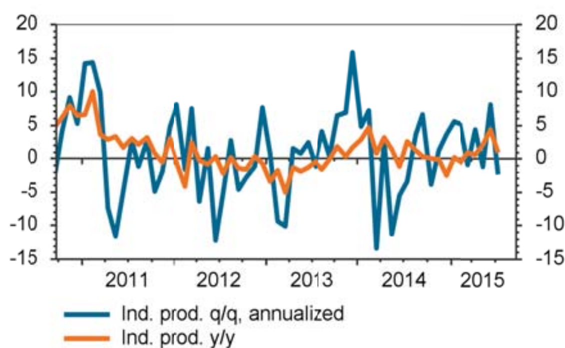
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Industrial output (excl. construction)



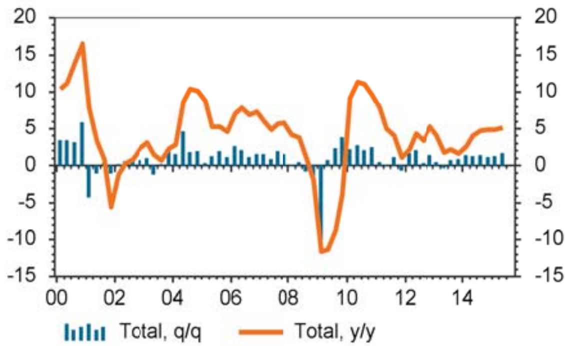
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Industrial output (manufacturing)



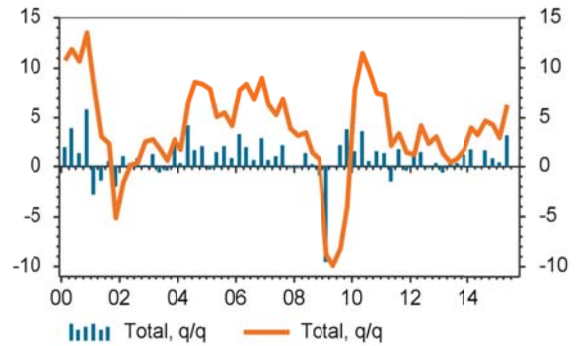
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Exports of goods and services



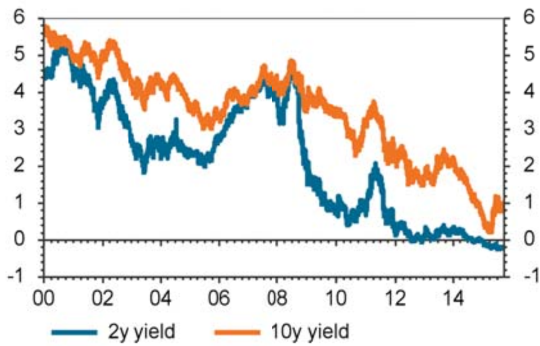
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Imports of goods and services



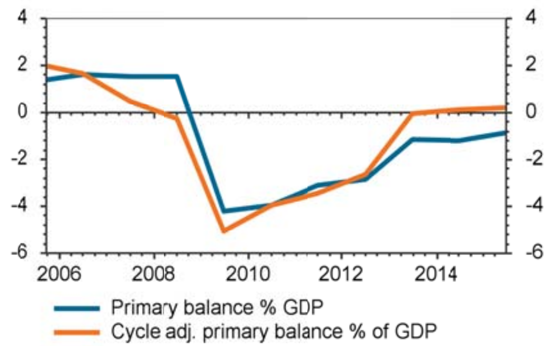
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Primary balance



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Asia

Japan – Output gap close to zero and low potential growth hinder the effectiveness of monetary policy and amplify risks from external shocks

Giovanna Mossetti

- The outlook for the Japanese economic remains moderately positive, despite the contraction of GDP in 2Q. In the second half of 2015 and in 2016 growth is expected to pick up. The main driving forces should be consumption and private investments, fuelled by corporate earnings and higher labor income.

- However, the outlook is subject to several downside risks: the growth slowdown in China and in emerging Asia could hold back the trend of exports and investments; achievement of full employment makes monetary stimulus less effective; low potential growth levels leaves the economy at risk of a contraction in GDP if hit by external shocks.

- We expect the BoJ to announce, at the end of October, an increase in monetary stimulus for 2016, with modest effects on growth, but positive implications for the fiscal policy scenario.

The Japanese economy bumped into a new setback in 2Q, contracting by -0.3% q/q due to a decline in final private domestic demand, and to weak net exports; the correction was offset in part by public consumption and inventories. At the present stage, these negative indications seem to be transitory, but add to the fragility of the scenario, against a background of mounting risks tied to the slowdown of the emerging Asian countries, with China at the fore. We expect growth to return into positive territory as of 3Q, although we stress the existence of downside risks, which will probably prompt an increase in monetary stimulus in 2016. Our forecast for GDP growth is 0.7% y/y in 2015 and 1.4% y/y in 2016.

Forecasts for a moderate recovery in 2015-16 are based on expectations for an expansion in fixed corporate investment and private consumption, driven by two mutually supportive forces: strong corporate earnings, supported by the weak yen and easy financial conditions, and faster wage growth, driven by excess demand on the labour market. However, the picture is marred by at least three important factors of fragility.

1) Potential growth. According to the BoJ's forecasts, the output gap should be closed starting in 2H this year, and the economy should show increasing levels of excess demand throughout the beginning of 2017. Despite a recent modest upward revision of estimates, Japan's potential growth remains extremely low, at around 0.5%[15]. Therefore, negative shocks, in a context of structurally slow growth, have a high probability of turning into contractions. Furthermore, with the output gap closed, the possibility of an acceleration in growth will depend much more on structural measures rather than on pro-cyclical policies, including monetary policy, which is ineffective when the economy reaches full employment. For now, the promises of the "third arrow" of Abenomics, by which reforms should support medium-term growth, have still not been kept. Monetary policy will remain extraordinarily accommodative, and stimulus could stepped up in 2016: however, the effects of the BoJ's actions will be felt more in terms of lower risks on the fiscal policy front, and support to the inflation, than of support to growth.

2) For the time being, the acceleration in corporate earnings, which should be one of the pillars of growth in 2015-16, has not translated into a solid recovery in investments. Manufacturing is being supported by the depreciation of the exchange rate, thanks to improving terms of trade, but at the same time it is being held back by higher commodity costs. The earnings trend is brighter in the services sector, which nonetheless makes a smaller contribution to the of fixed

[15] V. BoJ, Outlook for Activity and Prices, April 2015, https://www.boj.or.jp/en/mopo/outlook/gor1504b.pdf.

investment growth. For the time being, businesses have still not significantly stepped up capex spending, also due to uncertainty over the trend of final demand: will they do so from now, as Asian demand experiences a slowdown?

3) Japanese growth strong dependence on demand from the Asian economies exposes it to major uncertainty, and to the risk of a significant slowdown. While it is true that these risks are moderated in part by strengthening trade with the United States, as observed in the first half of this year, moderate global growth in 2016 implies a persistently negative contribution of Japanese net exports, despite the further expected depreciation of the yen, with risks skewed to the downside if China fails to reaccelerate soon.

Consumption driven by higher employment and accelerating wages

Scenario 2015-2016. The outlook for the Japanese economy in the next few quarters points to moderate growth, despite the risks listed above. Private consumption should recover and expand until the beginning of 2017, before the next fiscal shock (consumption tax hike from 8% to 10% in April 2017). Weakness in 2Q was probably amplified by weather conditions and by changes to the seasonal sales calendar: starting in 3Q, the labour market should resume playing a driving role, with an on-going decline in the unemployment rate, and higher employment, wages, and labor income (Figs. 4 and 5). The forecast is for a contraction of -0.6% in 2015 (partly due to weak 2014) and growth of 1.6% in 2016.

Fixed investment helped by earnings, but subject to uncertainty tied to China

Fixed corporate investments should be up by 1.3% in 2015 and 1% in 2016. A recent survey by the Ministry of Finance[16] outlines solid earnings growth in mid-2015 (Fig. 3), while pointing to a less brilliant performance in the next few quarters in terms of economic conditions, capex spending, and earnings, signalling that the trend of fixed investments should be positive but modest.

Exports supported by US growth, held back by weakness in Asia

Net exports should once again make a modestly negative contribution to growth at the end of 2015 and in 2016; foreign trade is exposed to especially high risks given the uncertainty clouding the growth trend in China and in the rest of emerging Asia. In 2014, exports to China accounted for 18.3% of total Japanese exports, with Asia excluding China accounting for 35.7% and the US for 18.7% (Fig. 6). A significant weakening of growth in Asia may be balanced only in part by solid growth in the United States (Fig. 7), considering also the stabilisation of the yen's effective exchange rate (Fig. 8). Exports are forecast on the rise by 2.7% in 2015 and by 4.2% in 2016; imports should grow by 0.9% in 2015 and 3.6% in 2016.

Prices: deflation is over, but the 2% target remains a mirage

Inflation net of fresh food is at around zero (Fig. 9), and the BoJ expects stability "for the time being". Energy prices are contributing to the stagnation of inflation. Although the BoJ's target still applies to "Japan-style core inflation", the central bank is now also monitoring the index net of food and energy prices. Our forecasts still point to inflation at close to zero until the beginning of 2017, which adds to the probability of further monetary stimulus in 2016. According to our baseline scenario, at the end of October meeting the BoJ will announce an increase in the target for the monetary base for 2016. By stepping up asset purchases, the BoJ will probably not contribute significantly to growth, but it will further curb chances of an increase in the risk premium on JGBs, thanks to the further rise in the assets held in the central bank's portfolio (Figs. 11 and 12). The stock market could benefit too, since the increase in purchases could be spread over all asset classes.

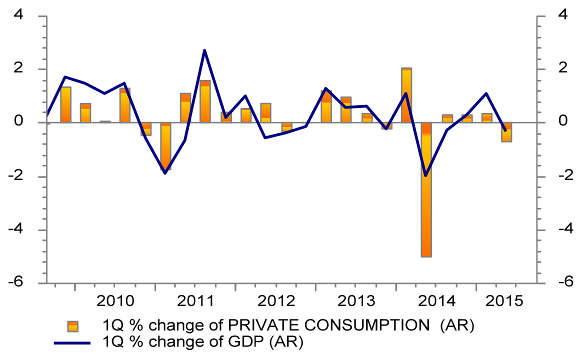
The BoJ will probably step up monetary stimulus in 2016

Fiscal policy absent on structural reforms.
Risks to the sustainability of debt still in place, but curbed by BoJ purchases

Fiscal policy remains geared to consolidating public accounts. In FY 2015, the deficit/GDP ratio is estimated at -7.3%, and the primary balance/GDP ratio at -2.7%, with a targeted primary surplus by the end of 2020. The Prime Minister has announced that in FY 2016 the corporate earnings tax will be reduced by 3.3pp. Fiscal policy in 2016 should be modestly restrictive, leaving to the BoJ the task of supporting short-term growth.

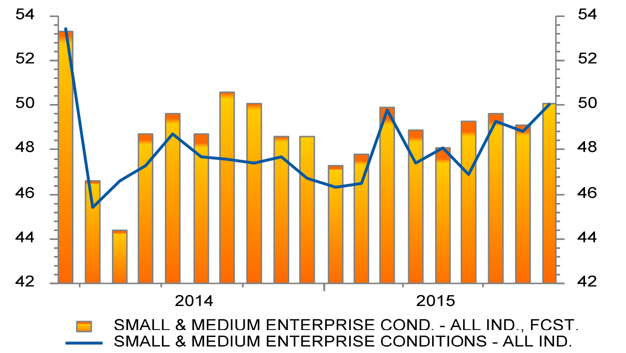
[16] V. http://www.mof.go.jp/english/pri/reference/bos/e1c2702.htm

Fig. 1 – Growth held back by temporary factors



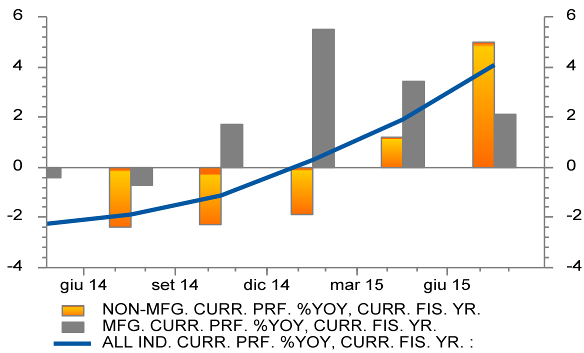
Source: Thomson Reuters-Datastream

Fig. 2 – Businesses see modest improvement



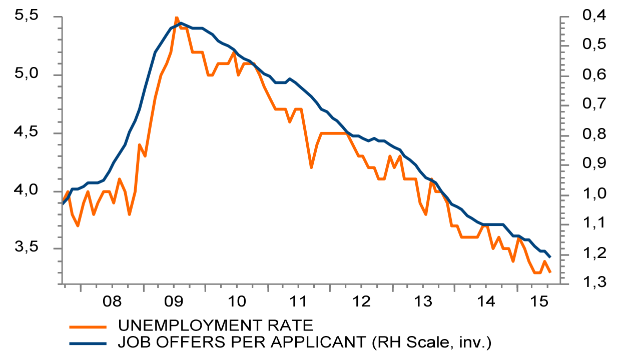
Source: Thomson Reuters-Datastream

Fig. 3 – Corporate earnings on the rise



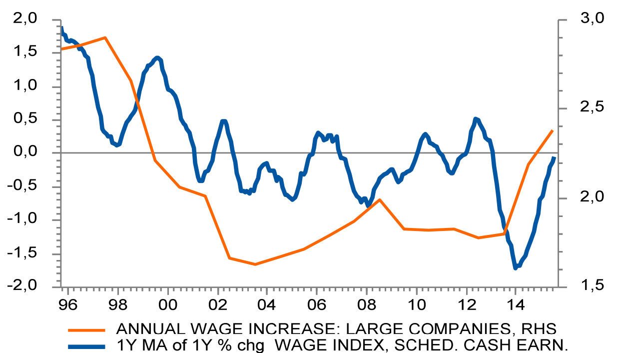
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment down



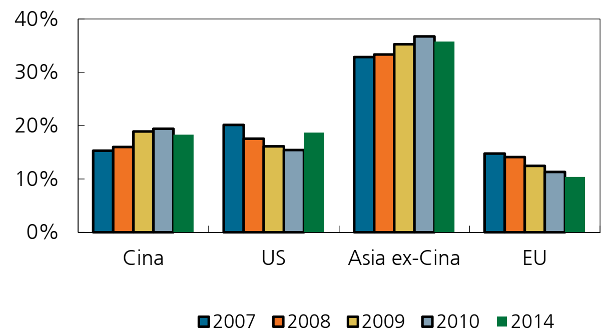
Source: Thomson Reuters-Datastream

Fig. 5 – Wage trend accelerating



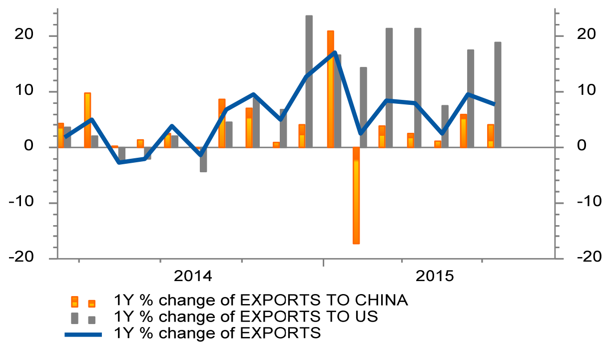
Source: Thomson Reuters Datastream

Fig. 6 – Shares of total exports



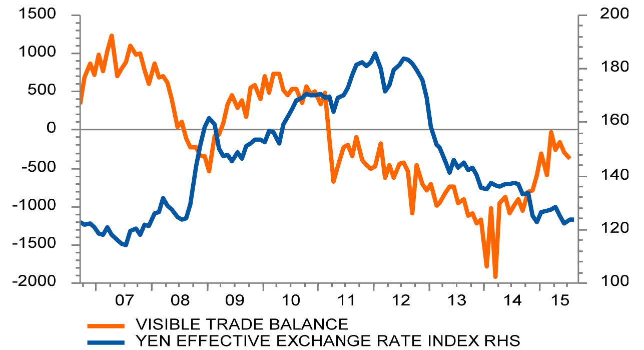
Source: Intesa Sanpaolo elaborations on Cabinet Office data

Fig. 7 – For the time being the United States have more than offset weakness from China



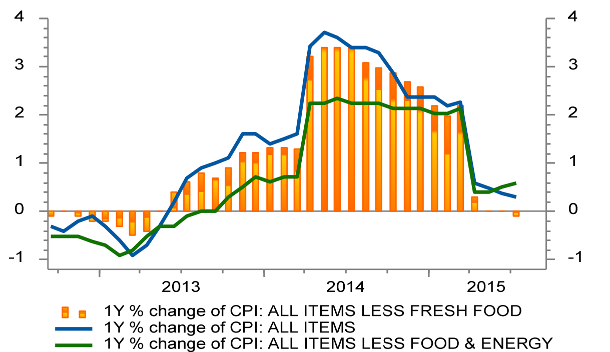
Source: Thomson Reuters-Datastream

Fig. 8 – A weaker yen contributes to reduce the trade deficit



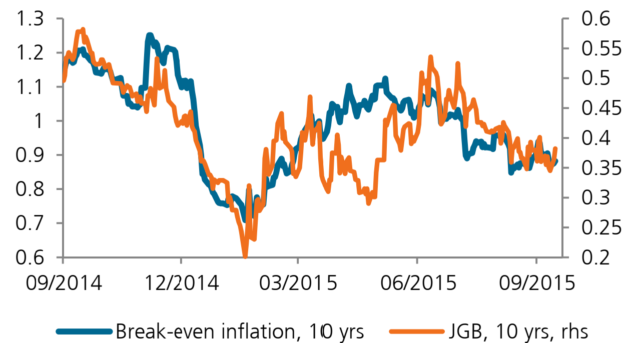
Source: Thomson Reuters-Datastream

Fig. 9 – Inflation at around zero



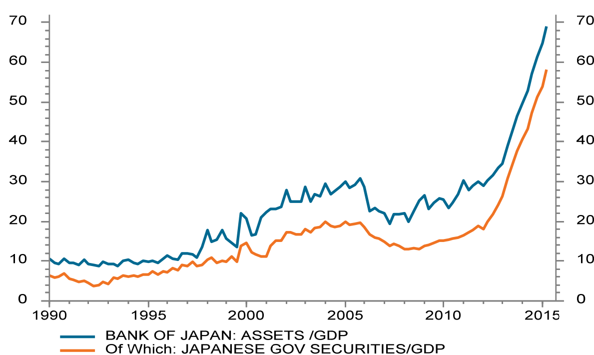
Source: Thomson Reuters-Datastream

Fig. 10 – No-one believes in the 2% target



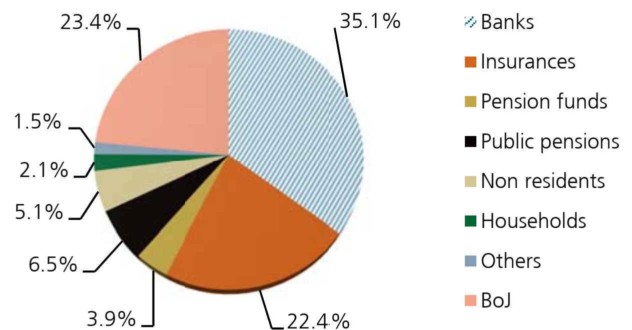
Source: Bloomberg

Fig. 11 – In the meantime, the BoJ is buying JGBs…



Source: Thomson Reuters-Datastream

Fig. 12 – …and freeing up the banks' balance sheets



Data as at the end of March 2015; total JGBs: 883.1 tln yen
Source: Ministry of Finance

Forecasts

	2014	2015	2016	2014	2015				2016		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	-0.1	0.7	1.3	-0.8	-0.8	0.9	1.4	1.5	0.8	1.4	1.6
q/q annual rate				1.3	4.5	-1.2	1.1	1.8	1.6	1.3	1.7
Private consumption	-1.3	-0.6	1.6	1.3	1.5	-2.7	2.4	2.4	1.6	1.2	2.3
FI - private nonresidential	3.6	1.3	1.0	0.5	11.0	-3.6	3.3	1.3	1.1	0.8	0.2
FI - private residential	-4.9	-1.4	4.0	-2.4	7.0	8.0	19.6	0.1	0.5	0.6	4.2
Government investment	3.8	-1.3	-4.7	0.9	-5.3	8.9	-17.7	-3.6	-3.6	-3.7	-3.3
Government consumption	0.2	1.0	0.0	1.3	1.1	2.0	-0.6	-0.1	0.0	0.0	0.0
Export	8.4	2.7	4.2	11.6	6.7	-16.6	7.5	7.0	5.3	4.9	4.9
Import	7.3	0.9	3.6	3.4	7.3	-10.1	5.5	5.2	3.7	3.7	5.1
Stockbuilding (% contrib. to GDP)	-0.2	0.5	0.2	-0.3	0.5	0.4	-0.2	0.0	0.1	0.1	0.1
Current account (% of GDP)	0.5	2.7	2.1	2.2	3.2	3.4	2.0	2.1	2.1	2.2	2.2
Deficit (% of GDP)	-7.7	-7.1	-6.7								
Debt (% of GDP)	226.1	229.2	234.1								
CPI (y/y)	2.7	0.7	0.0	2.5	2.3	0.5	0.1	0.0	0.2	-0.2	-0.1
Industrial production	2.1	-0.1	1.5	3.0	6.4	-5.6	1.8	2.8	2.3	1.7	1.3
Unemployment (%)	3.6	3.4	3.7	3.5	3.5	3.3	3.4	3.5	3.6	3.7	3.7
JPY/USD	106.8	122.3	128.1	114.5	119.2	121.4	122.3	126.4	129.3	129.0	127.5
Effective exch.rate (1990=100)	134.0	124.6	117.9	127.0	127.1	125.3	124.3	121.8	118.2	117.1	117.9

Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

China: growth of around 7% still achievable this year

Silvia Guizzo

- In 2Q, GDP grew by 7% yoy, unchanged versus 1Q and better than expected. Economic growth received strong support from the double-digit upturn in the bank and insurance sector (17.4% yoy in 2Q), which benefited from increased brokerage activities following the stock market's stellar performance in the first half of the year. The equity market correction is set to dampen these trends in the next few quarters, and the sector's contribution, which accounted for 7.3% of GDP in 2014, could decline significantly. Figures for July and August show a stabilisation in foreign trade (which remains weak, however), industrial output and investment in real terms, but a further drop in orders. Retail sales, however, continue to hold up well.
- The slowdown in fixed investment will continue to be offset by strong investment in infrastructure, which is expected to continue in 4Q. Growth should hold up in the second half of the year, on the back of monetary policy easing and measures to support companies and consumers. In addition, foreign trade could still make a positive contribution in the final quarter of the year, given the large fall in imports. Given these factors and better-than-expected 2Q growth, we are leaving our GDP growth forecast unchanged for 2015 at 6.8%.
- The change in the mechanism used to determine central parity of the yuan against the dollar, which is now linked to the market, triggered an initial depreciation of 1.9% against the dollar. The yuan's overall depreciation (now at 2.6%) is anyway low compared with its appreciation over the last few years and the trend in the effective exchange rate. The move, which was dictated more than anything by operational factors, has significantly increased downward pressure on the exchange rate, making monetary policy managing more difficult given greater financial account liberalisation. We believe that the People's Bank of China (PBOC) does, however, have an interest in containing exchange rate depreciation.
- The increase in non-performing loans will continue to limit credit growth, even in the event of further interest rate cuts. We therefore believe that despite monetary and fiscal policy support, the slowdown in investment in property, construction and manufacturing will continue in 2016, impacting the job market and ultimately consumer spending. Furthermore, investment in infrastructure will be unlikely to sustain the pace of 2015, unless by increasing the risk of a sharper fall in the medium term. We are therefore downgrading our growth forecast for 2016 from 6.5% to 6.3%, while risks on the medium- to long-term scenario remain to the downside.

Forecasts

	2010	2011	2012	2013	2014S	2015P	2016P
GDP	10.6	9.5	7.7	7.7	7.4	6.8	6.3
Private Consumption	10.3	11.7	9.8	8	8.3	7.5	7.2
Public Consumption	7.5	11.2	3.9	3.6	2.5	4	7
Total Fixed Investment	12.2	8.3	8.7	9	7.4	5.8	4.7
Exports of G&S	23.8	8.7	3.8	6.2	6.1	-0.7	4.2
Imports of G&S	17.7	12.4	5	8.8	7	0	4.3
Industrial Production	12.7	10.6	8.2	7.9	7.3	5.5	4.7
Inflation (CPI)	3.3	5.4	2.6	2.6	2	1.8	2.2
Unemployment rate (%)	4.2	4.1	4.1	4.1	4.1	4.1	4.1
Average wages	14.1	16.8	14.4	11.8	10.3	8.1	7.4
Mibor 3m (average)	2.7	5.3	4.6	5	5.1	4.1	3.2
USD/CNY (average)	6.77	6.46	6.31	6.15	6.16	6.30	6.43
Current Account Balance (bn CNY)	1603.7	874.1	1360.1	911.9	1357.5	2269.8	2633.5
Current Account Balance (% of GDP)	3.9	1.8	2.5	1.6	2.1	3.3	3.6
Government Balance (% of GDP)	18.2	20.7	21.6	20.7	21.2	23.3	26.1

NB: Percentage change on previous period - unless otherwise indicated Source: Oxford Economics Forecasting and Intesa Sanpaolo

Real economy and inflation

China's National Bureau of Statistics downgraded its GDP growth forecast for 2014 by 0.1% to 7.3%, owing to lower growth in the services sector (7.8%, from 8.1%). In 2Q, GDP grew by 7% yoy, unchanged versus 1Q and better than expected. It increased by 1.7% qoq on a seasonally adjusted basis, from 1.4% in 1Q (revised up from 1.3%). Economic growth received strong support from the double-digit upturn in the bank and insurance sector (17.4% yoy in 2Q), which benefited from increased brokerage activities following the stock market's stellar performance in the first half of the year. The equity market correction is set to dampen these trends in the next few quarters, and the banking and insurance sector's contribution, which accounted for 7.3% of GDP in 2014, could decline significantly.

Figures for July and August, particularly for industrial output and foreign trade, were negatively affected by temporary factors; these included floods in various areas of the country, the explosion in the port of Tianjin and the temporary closure of thousands of factories from 20 August to 3 September to reduce atmospheric pollution ahead of the Athletics World Championships and the parade marking the anniversary of the end of the Second World War.

Foreign trade data were stable but still trending downwards, and an unfavourable base effect remains. Exports to the US and ASEAN area performed better than those to Japan and the Euro zone. Exports of ordinary goods registered a slight improvement compared with those of products assembled with foreign components, and so did exports of electric motors and components. However, the outlook for exports remains uncertain. The PMI component for both foreign and total orders have continued to fall in recent months, not only in China but in almost the whole of Asia, where they remain below 50, with the exception of Japan, India and Vietnam (domestic orders). Moderate support will be provided by the recent exchange rate depreciation, although we believe this will remain low, and by the improvement in consumer spending in its main trade partners, particularly the US and the Euro zone (fig. 6 and 7). Import growth continues to be affected by the sharp fall in commodity prices, but there was a marginal improvement in volumes (fig. 4 and 5), which seems to have been driven by ordinary goods for the domestic market. Although machinery imports continue to trend downwards (-4.5% 3m yoy), they posted a slight increase in the June-August quarter on the previous two quarters. Imports performed less well in value terms, and helped widen the trade surplus, which was USD 365Bn in the first eight months of the year, up USD 164Bn versus the year-earlier period; this trend is set to continue in the next few months.

The survey of industrial companies in 2Q registered a slight weakening in confidence; orders are improving, but the indices remain well below 50, particularly for domestic orders. PMI indices confirmed this trend between June and August, both in the Markit-Nikkei survey and that of the National Bureau of Statistics, with orders components falling below 50 in both. After a 6.8% increase in June, growth in industrial output eased, remaining broadly in line with May's levels (6.1%) in July and August, despite a significant favourable base effect. This was supported by the upturn in output in private industry, which offset the significant slowdown in production in the state sector (fig. 1).

The summer slowdown in total investments (+10.9% cum yoy in August vs. 11.4% in June in nominal terms) was offset by the resilience of investments in infrastructure, while investments in manufacturing and particularly the property sector continued to slow. The only segment in the manufacturing sector in which investment is picking up is that of computers and electronic components. Investment is also increasing in the gas, water and electricity production and distribution sectors, but continues to slow in the retail trade sector. However, given the continuous fall in production prices, investment in real terms is likely to have bottomed out in May and to have edged up over the summer.

The price of new-build residential property and the number of transactions continued to rise over the summer, particularly in first- and, to a lesser extent, second-tier cities. However, the market still remains weak in third-tier cities, where average prices continue to fall, and in general for commercial property. In addition, the number of cities recording price drops in the secondary market (existing buildings) has gradually increased in the last four months. Purchases of land and floor space started and residential floor space completed remain significantly down, squeezed by the still high number of properties awaiting sale. In early September, the government further eased restrictions on the purchases of second homes, not only for residents but for foreigners working in the country, except in first-tier cities. The trend in unsold housing inventory has slowed, but remains high in relation to demand, according to various measures. The International Monetary Fund (IMF)[17] highlights that although the estimates of the National Bureau of Statistics and those of property companies diverge significantly in terms of months of inventory (floor space unsold/floor space sold - four months for the former, around 30 months for the latter), they have almost tripled since 2011 and remain much higher for third- and fourth-tier cities. We believe that despite monetary and fiscal policy support, the slowdown in investment in property, construction and manufacturing will continue in 2016, impacting the job market and ultimately consumer spending. Furthermore, investment in infrastructure will be unlikely to sustain the pace of 2015, and could fall more sharply in the medium term.

Retail sales surprised on the upside, with growth of 10.8% yoy in August versus 10.5% in July in nominal terms, and solid growth of 10.4% yoy in real terms, although car sales continue to fall (-4.0% 3m yoy in August). Overall, the wealth effect of the stock market fall on household finances should be negligible, given that at national level, only 8%-9% of households hold investments in shares, and the proportion of financial wealth invested in equities is around 15%, although the situation may be different in the wealthier urban areas of the coastal regions[18]. This hypothesis is confirmed by the rise in consumer confidence measured by the Westpac MNI CSI Survey, which has continued uninterrupted since May but has been driven by increased confidence of lower-income households. The survey was, however, completed before the stock market slump in August. The survey conducted by the National Bureau of Statistics shows a fall, although limited, in both July and August. The ANZ and Unionpay surveys continued to trend downwards. We expect the negative impact on confidence to emerge in the figures over the next few months; this could also be exacerbated by the unexpected exchange rate trend.

As highlighted in the past, the situation on the employment market remains positive and continues to support consumer spending, although some signs of a trend reversal are beginning to emerge. The Manpower survey of companies' hiring intentions for 4Q reached its lowest since 2009, the number of new jobs fell slightly in the first half of the year compared with the previous year (-2.6% yoy), and the PMI services index was down marginally.

The transition to a growth model with a greater contribution from services is already under way, as shown by the increase in the sector's contribution to GDP (from 42.5% in 2010 to 48.1% in 2014) and the rise in jobs in the sector (from 35% of the total in 2010 to 41% in 2014), which has helped to support the employment market. The slowdown in investment in manufacturing, property and construction is expected to continue in 2016, and is likely to have an impact on the employment market, given that together, the three sectors account for 47% of non-private sector jobs in urban areas[19].

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[17] People’s Republic Of China, 2015 Article IV Consultation, IMF Country Report No. 15/234, 14 August 2015.

[18] For more details, see “Fundamentals do not support the market”, China, Study of 31 July 2015.

[19] The property sector, which is classified under services, accounts for 16% of jobs.

Input and production prices continue to decrease (-6.6% and -5.9% yoy in August respectively), dragged down by the fall in commodity prices. Consumer price inflation rose from a low of 1.2% yoy in May to 2% yoy in August, mainly driven by the rise in food prices, particularly meat and vegetables, and the previous increase in the tax on tobacco. Non-food inflation (1.1% yoy) has remained broadly stable, as has inflation stripping out food and fuel (1.7% yoy). However, the prices of items such as clothing and medicine have continued to rise, and the fall in China's hog inventory heralds a further increase in meat prices in the next few months. Therefore, despite the fall in production prices, we still think that inflation will rise in the next few months – thanks in part to an unfavourable base effect – and we are revising up the average to 1.8% for 2015 and to 2.2% for 2016.

Economic and fiscal policy

The government has continued to issue measures to support small and medium-sized companies (halving of corporate tax until 2017 for companies with revenues of less than CNY 300,000, and the creation of a CNY 60Bn SME development fund) and to ease fiscal restrictions on local government (second extension of the local government debt swap programme, from CNY 2Trn in June to CNY 3.2Trn at the end of August). It has also speeded up the approval of rail infrastructure construction projects, which are expected to pick up further in the remainder of the year, and redefined the phases of the long-term, coordinated development project of the Beijing-Tianjin-Hebei area. It recently reduced the minimum capital requirements for launching investment projects in ports, airports and property development from 30% to 25% of the amount budgeted, and for road and rail investment projects from 25% to 20%. The government is also working to reallocate approximately CNY 200Bn in dormant funds, previously allocated to local governments but not spent, to investment and social support projects.

The State Council recently published its plan to reform State-Owned Enterprises (SOEs). The Plan divides SOEs into those pursuing commercial interests and those operating in the public interest (such as the management of motorways, electricity and communication grids), which must continue to invest in the regions that need infrastructure, even if they are less profitable. The plan, which includes the listing of many companies and the support of public-private cooperation, confirms the objective of raising the percentage of dividends to be transferred to the state to 30% by 2020 to boost spending on social welfare.

Monetary policy and foreign exchange

The Shanghai Composite Index fell by 32% in four successive, sudden movements, from a high on 12 June to an initial low on 8 July. After a temporary period of recovery and range trading thanks to support provided by the authorities[20], the index slumped by 26.7% between 17 and 26 August. This was followed by a slight improvement, but the economic slowdown and price/earnings ratios, which are still way off the historic average and levels in emerging countries, suggest that the equity market correction has yet to come to an end.

Partly in response to the stock market collapse, the PBOC implemented two rate cuts of 25 bps at end-June and end-August, taking the one-year lending rate to 4.6% and the deposit rate to 1.75%. In tandem with the cut in August, it also completely removed the ceiling on rates on deposits of more than one year and, with effect from 7 September, cut the reserve requirement ratio by 50 bps for all banks, a further 50 bps for rural banks and a further 300 bps for financial leasing and auto financing companies. Since the beginning of the year, the PBOC has made four rate cuts totalling 100 bps and trimmed the reserve requirement ratio by 200 bps. Yields fell over the same period, but have been rising again since the beginning of June. So too have

[20] See note 18.

money market rates, and these are now also being influenced by the expected reduction in liquidity before the holiday week at the end of September/beginning of October. Although lower than the highs of 2013 and end-2014, yields on corporate issues are on a par with mid-2012 (fig. 10), when policy rates were higher, which confirms the difficulty of reducing financing costs for companies. The upturn in outstanding bank loans, from 13.4% yoy in June to 15.4% in August (fig. 11), could in part be related to measures to support the equity market and seems to be driven by short-term credit, while long-term credit has slowed slightly. Total social financing edged up marginally. Non-performing loans continued to rise in 2Q, both in absolute terms (57% yoy) and compared with total loans (1.5%, fig. 12), and will continue to curb credit growth.

On 11 August, the PBOC changed the mechanism for fixing central parity, the midpoint around which the renminbi is allowed to fluctuate in daily trading against the dollar by ±2%. This was previously based, in theory, on the average of bank quotes before the markets opened, but was actually adjusted and decided by the Central Bank, as demonstrated by the fact that the currency has always traded far from parity. Since 11 August, central parity has been calculated on the basis of the average market closing prices of main banks on the previous day. This led to a one-off adjustment in central parity, with an initial devaluation of 1.9%. We believe that the main reason for this move was not a competitive devaluation, but to ensure that the market plays a more central role in determining the exchange rate, in line with the considerations set out by the IMF in both the Article IV consultation[21] and, above all, the new review of criteria for inclusion in the Special Drawing Rights (SDRs)[22] basket. While stating that the renminbi complies with most - but not all – of the criteria for inclusion, the report expressly highlighted that China does not have a benchmark exchange rate determined by the market (an essential requirement), but only a benchmark determined by the PBOC, i.e. central parity. Although a decision on the new composition of the basket is expected by the end of the year, on 19 August, the IMF announced the extension of the current composition of the basket until 30 September 2016, for operational reasons.

However, the renminbi's overall depreciation against the dollar from the date prior to the change in determining central parity (now 2.6%) is low compared with the appreciation of the last few years and the trend in the effective exchange rate. The exchange rate against the dollar strengthened by 8.4% from mid-2010 to mid-2015 (18.4% vs. EUR), and the effective exchange rate by 24% in nominal terms and 30% in real terms. Given the appreciation of the effective exchange rate, which was driven in recent years by the dollar peg and the renminbi's concurrent appreciation against the euro and yen, we believe that a marginal weakening against the dollar is in the economy's interest. However, in our view, sharp, disorderly depreciation would not be welcomed by the central bank. Despite the greater domestic content to exports' added value compared with the past, the foreign content remains considerable in many sectors, and a depreciation of the effective exchange rate could have a negative impact, making imports more expensive. Furthermore, a marked depreciation against the dollar would spell further difficulties for various companies with debt positions in that currency.

Monetary policy management is made more problematic by currency depreciation pressures, in the context of greater financial account openness. Depreciation pressures, which existed prior to the move, have increased significantly, prompting the PBOC to intervene aggressively to defend the currency, as indicated both by sales of foreign currency (position of financial institutions) and the USD 93Bn fall in reserves in August (not taking into account valuation effects). To offset the measure, the PBOC pumped substantial liquidity into the system, through reverse repo operations (USD 550Bn, the highest amount since January 2014) and various liquidity windows.

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[21] See note 17. Box 9: "*Transition to a More Flexible Exchange Rate Regime*".

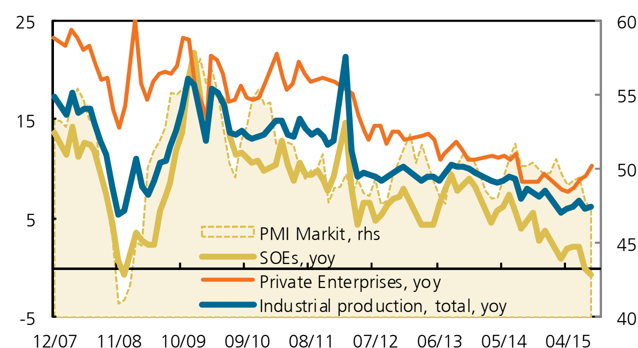
[22] IMF, Review of the Method of the Valuation of the SDR – Initial Consideration, 3 August 2015.

We expect the PBOC to make another cut in the reserve requirement ratio by the end of the year for this reason. It could even cut it twice if exchange rate pressures remain high and interventions drain too much liquidity. But we believe that it will avoid further rate cuts for the moment, in order not to fuel further depreciation pressures and widen the spread between offshore and onshore exchange rates, which widened significantly following the devaluation. Offshore rates have risen steadily over the last few months, but more markedly after the move, and are now higher than onshore rates. Monetary easing will continue over the next year, with a further two cuts to rates and the reserve requirement ratio, to avoid an excessive slowdown in growth.

To promote capital inflows, the PBOC recently allowed central banks to trade directly on interbank foreign exchange markets, and from October, to limit capital outflows, it will require from banks a reserve ratio of 20% on the currency forwards of their clients, to be maintained for a year at zero interest. This makes hedges more expensive, which are set to increase as carry trades (borrowing in dollars at low rates to invest in yuan) run off; these increased significantly in the past, fuelled by expectations of continuing procrastination over Fed rate rises and ongoing strengthening of the yuan. Both factors have disappeared, reducing the appeal of these transactions and fuelling pressure to withdraw capital.

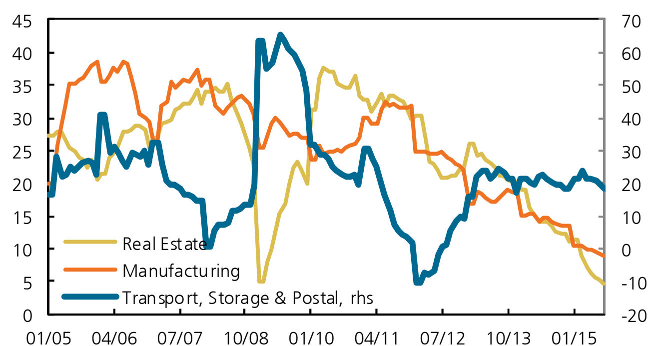
The item "other capital" seems to have had a significant impact on capital outflows in the first quarter (USD -98Bn according to the balance of payments, USD -106Bn according to BIS), owing to lower new lending from abroad, lower trade credit loans and lower non-residents deposits. Outflows totalled USD 63Bn in the second quarter. The fall in reserves has generated speculation over the size of capital outflows and apocalyptic capital flight scenarios, but we think these are overblown. Capital outflows were estimated at around USD 200Bn in August, but were probably based only on non-financial outward direct investment (ODI) and registered foreign direct investment (FDI) and are uncertain. Note, too, that the financial account has been subject to gradual liberalisation over the last few years, and we will therefore inevitably see greater inflows and outflows than in the past. However, it is not the authorities' intentions that liberalisation will be total. Furthermore, despite the significant openness of the financial account in the last few years, capital movements, particularly those in portfolios, are not completely free, and the various QFII programmes are subject to quotas that are often not fully used. The PBOC therefore retains a degree of control over capital movements and over its own monetary policy, although we note that pressures on further capital outflows have increased, as has the difficulty of managing monetary policy.

Fig. 1 – Industrial output stabilises



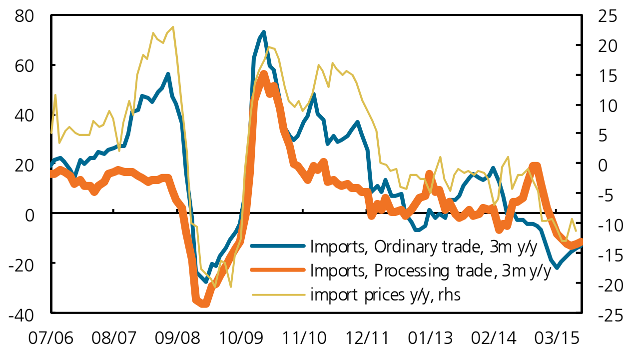
Source: CEIC, Markit

Fig. 2 – Property investment still slowing



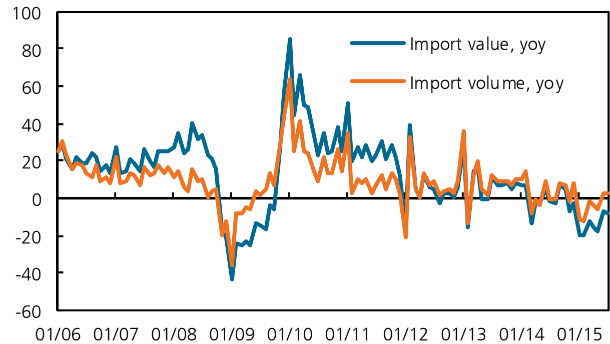
N.B. Cumulative nominal investments, chg. yoy. Source: CIEC

Fig. 3 – Imports continue to be affected by falling prices



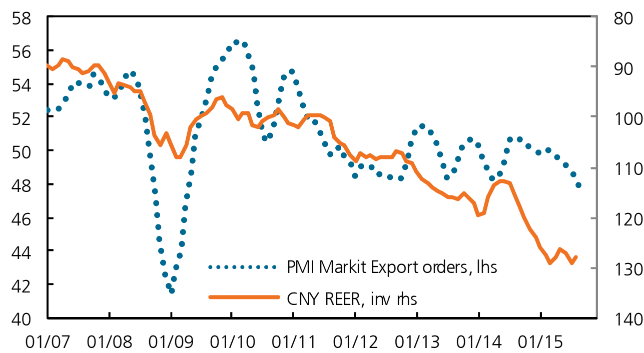
Source: Bloomberg, Thomson Reuters Datastream

Fig. 4 – Import volumes



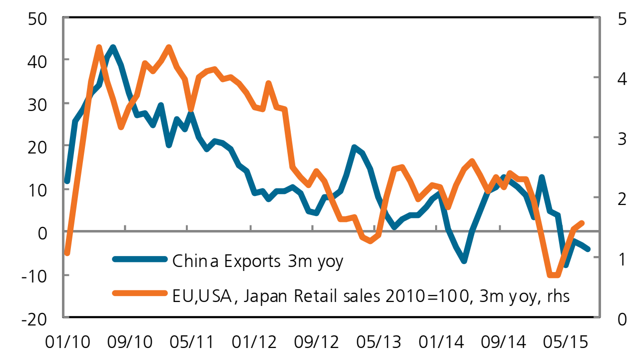
Source: CEIC

Fig. 5 – Exports weighed down by both the appreciation of the effective exchange rate …



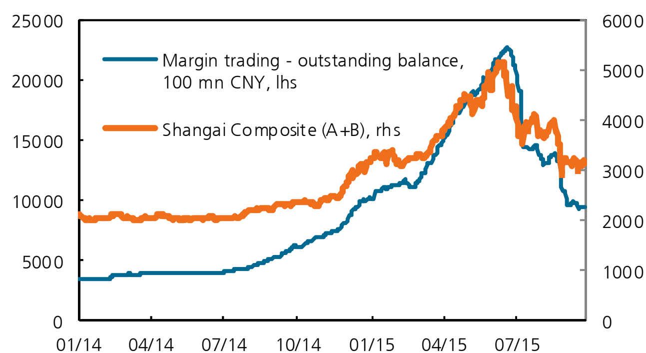
* Three-month moving average. Source: Bloomberg, Markit

Fig. 6 – … and weak demand in the main customer markets, which are now improving



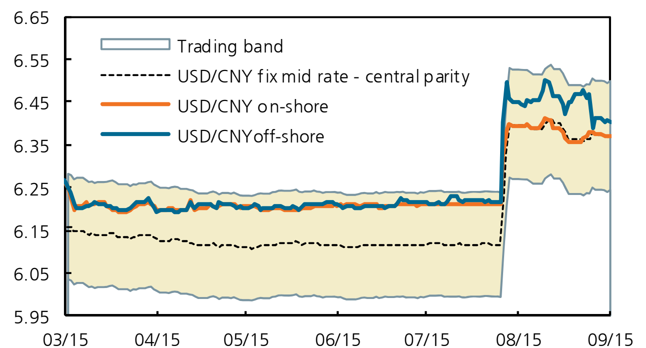
*Weighted for GDP, 2010 index=100. Source: Intesa Sanpaolo chart from CEIC data

Fig. 7 – Further correction to the stock market



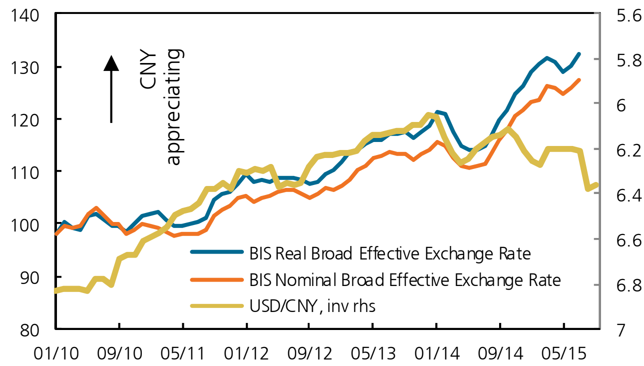
Source: Bloomberg

Fig. 8 – Change in central parity mechanism weakens renminbi weakens against the dollar



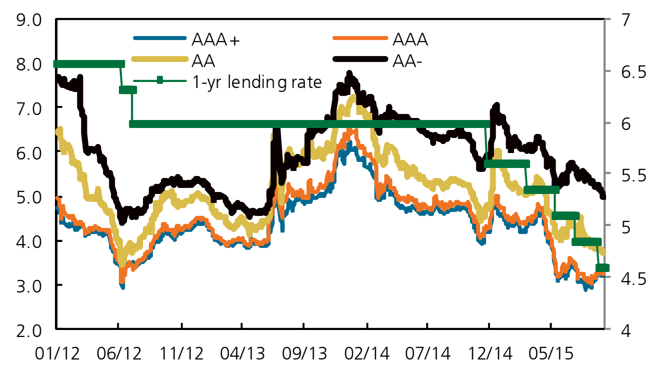
Source: Bloomberg

Fig. 9 – Effective exchange rate



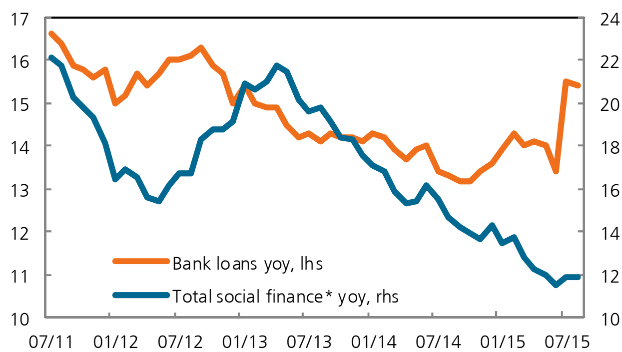
Source: BIS from CEIC, Bloomberg

Fig. 10 – Corporate yields* and official rates



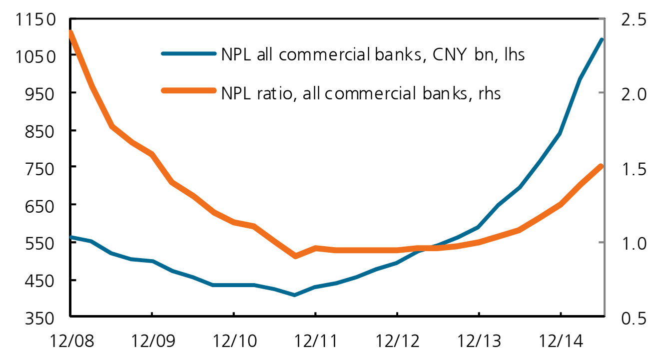
*One-year issues. Source: CEIC

Fig. 11 - Bank lending picks up



NB: stock, monthly figures, % yoy chg. Source: CEIC and Intesa Sanpaolo estimates

Fig. 12 - Non-performing loans continue to rise



NB: Non-performing loans (NPL) of commercial banks. Source: CEIC

India: still giving mixed signals

Silvia Guizzo

- In 2Q, GDP rose by 7% yoy compared with 7.5% in 1Q, due to easing private consumption - although it remained high (7.4%) - and the negative contribution of exports. Investment accelerated further to 4.9%. On the supply side, the agricultural sector's return to positive growth and the acceleration in the industrial sector partially offset the slight slowdown in the services sector.

- Foreign trade continues to contract, with falls recorded in both imports (-11.2% 3m yoy in August) and exports (-15.7% 3m yoy), which were considerably affected by lower prices for oil and industrial and agricultural commodities. Stripping out oil, exports are still falling (-7.5% 3m yoy) but imports, while slowing, are still growing (+2.6% 3m yoy). The virtually parallel decline of imports and exports kept the trade balance in the first eight months of 2015 just below that of 2014, at around USD 85Bn. Industrial output recorded growth rates of over 4% in June and July, an improvement on the spring, thanks partly to a favourable base effect. Consumer durables are the main growth driver. Production of goods for infrastructure decreased slightly, although it was still at higher levels than in spring. Performance was consistent with the slight fall in the PMI index, although it remains stable at over 50, and the orders components which has maintained a quarterly average of around 53 since May. The only negative elements are the volatility in capital goods production and the decline in capacity utilisation. Added to this is the deterioration in business confidence, especially in order expectations in 3Q, reported in the RBI (Reserve Bank of India) quarterly industrial outlook survey.

- Investment proposals submitted to the Industry Ministry for approval improved sharply on the previous year, although they slowed compared with the spring. The new foreign trade series showed a similar trend in machinery imports. At the same time, fiscal spending picked up speed, indicating that the improvement in investment is mainly coming from public investment at the moment. The RBI estimates that private sector investment in FY 2015-2016 will accelerate slightly after contracting[23] in FY 2013-2014. Private company profits are slowing and balance sheets straining under pressure from the significant amount of dollar-denominated debt, which is becoming more expensive due to the rupee's depreciation. At the same time, growth in loans (8.2% yoy in July) is stable at historic lows and non-performing loans (2.04% in 2Q from 1.56% in the same period last year), despite the recapitalisation programme of public sector undertaking (PSU) banks[24] unveiled by the government in mid-August, will continue to curb it in the short to medium term.

- The services sector is sending mixed signals; the orders component, which has been above 50 since July, has increased, but future expectations have fallen considerably. Revenues from tourist arrivals are slowing; flows are rising but at lower rates than in 2014. Mobile phone contracts are slightly up, although the trend is still down on last year. Car sales are slowing from May's peak (8.9% 3m yoy vs 7.9% 3m yoy in August) although growth rates remain solid. However, sales of commercial vehicles and three-wheeled vehicles are down sharply, which continues to augur badly for consumption in rural areas. Consumer confidence fell slightly in 2Q from its peak in the previous quarter, but is still riding high. The labour market is signalling a stable situation that will shore up consumption.

- Consumer price inflation, having fallen from just over 5% in the first half of the year to 3.7% yoy in July, held firm at this level in August, thanks to a sizeable base effect that has lasted since the start of the year; this effect will, however, disappear from September to the end of the year. Although inflation is trending down, some segments reported considerable month-

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[23] Private Corporate Investment: Growth in 2014-15 and Prospects for 2015-16 in RBI Monthly Bulletin August 2015.

[24] Indradhanush Master Plan: plan for gradual recapitalisation and change in the corporate and management structure of public sector undertaking (PSU) banks. The Plan sets out recapitalisation operations totalling INR 700Bn over four years, of which INR 250Bn is earmarked for the current fiscal year.

on-month rises, such as food, clothing, housing and some household services. We believe that inflation could start to rise again in the next few months, especially due to the elimination of the base effect, but not beyond 6% by the end of the year. The south-east monsoon season still harbours upside risks; according to recent estimates, rainfall is again likely to have been lower than the historical average (-12%). The potential reduction in agricultural production could have an impact on both GDP and inflation. The RBI is worried about the failure of inflation to fall in the non-foods segment, but nevertheless trimmed forecasts (-0.2%) at its early-August meeting on account of the expected decrease in fuels and rainfall in line with the historical average.

- The RBI stated that its monetary policy stance remains accommodative, but listed a series of conditions to be achieved on various fronts before it can make further cuts. These include more clarity on the international arena, especially on the Fed's actions, greater transmission of rate cuts by banks to customers (which up to now has been considered low), a slowdown in food price rises, and continued efforts by the government to improve infrastructure, especially relating to electrical energy, and land acquisition. We therefore think that the RBI will take a break and implement, at the most, a further two rate cuts of 25 basis points, but not before December.
- The rupee depreciated by 4.5% against the dollar between end-June and mid-September. It also plunged sharply after China's devaluation of the yuan, recently hitting a new low at 66.83, not far from the 68.82 recorded in 2013. The rupee's performance reflected net capital flows from institutional investors, which were negative at INR 175Bn in August; this mirrored the impact on other emerging markets of the sharp correction triggered by China in the equities markets. In the same period, the real exchange rate remained stable in nominal terms but declined by 1.3% in real terms. Foreign currency reserves rose by USD 33Bn compared with end-2014, hitting a high of USD 330Bn in June before dipping to USD 328Bn in August. Import coverage therefore rose from 7.7 months at end-2014 to the current 9.3 months; coverage of short-term external debt by foreign currency reserves is 3.5%.
- The weak performance of both exports and imports suggests that the current account deficit in 2015 will be close to that of 2014 (1.4%). Despite the clear improvement in external vulnerability indicators, India remains vulnerable - albeit less so than in the past - to sudden changes in international investors' risk aversion. The reason is that in recent years, a substantial portion of the current account deficit has been funded by short-term debt, such as non-resident deposits and bank loans (external commercial borrowings). According to the IMF[25], most of this capital has flowed to businesses, which are already heavily in debt and, for the most part, have not hedged exchange rate risks. Given the improvement in the current account balance compared with recent years, the path of fiscal consolidation and the high rate differential with the US, we think that currency depreciation will be contained and that the rupee could start to appreciate again slightly in 2016.
- On the policy front, Parliament failed to approve changes to the law on the acquisition of land and amendments to the Constitution to implement the goods and services tax (GST) in the summer monsoon session (21 July-13 August). The amendments did not get approval from the Rajia Saba, the Senate, where the collation party of premier Modi does not have the majority. They will therefore be re-examined in the winter session.
- The government's commitment to reducing bureaucratic restrictions and supporting investment and the central bank's still-accommodative monetary policy stance should continue to facilitate the consolidation of medium-term growth; however, the improvement in business confidence could be slower than initially expected. We are therefore sticking with our growth forecasts of 7.4% in 2015 and 7.6% in 2016.

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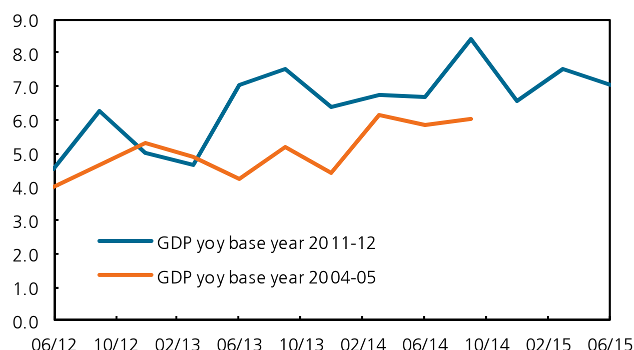
[25] India – March 2015 Article IV Consultation, IMF Country Report No. 15/61.

Forecasts	2010	2011	2012	2013	2014	2015	2016
GDP	11	6.2	4.4	6.4	7.1	7.4	7.6
Private Consumption	8.6	7.3	7.2	5.2	6.1	7.1	7.3
Public Consumption	8.4	7.9	5.5	8.5	6.5	4.6	8.5
Total Fixed Investment	17.5	6.2	-1.3	5.2	3.1	5.3	7.6
Exports of G&S	15.5	18.3	11.2	2.9	4.9	-0.1	7.4
Imports of G&S	18.2	18.4	11.8	-6.7	-1.8	-0.9	6.7
Industrial Production	9.7	4.8	0.7	0.6	1.8	4.9	6.6
Consumer Price Index (CPI)	10.3	9.6	9.7	10.7	6.6	5.0	5.2
Unemployment Rate (%)	6.1	5.8	5.6	5.6	5.6	5.5	5.5
Average Wages	19.4	13.5	20.2	11.2	10.7	10.3	9.6
Mibor 3m (average)	6.3	9.5	9.5	9.3	9.1	8	7.4
USD/INR (average)	45.74	46.69	53.47	58.57	61.04	65.19	62.28
Current Account Balance (bn INR)	-2498.0	-2945.1	-4893.2	-2779.6	-1665.5	-1774.9	-1954.2
Current Account Balance (% of GDP)	-3.4	-3.4	-5.1	-2.5	-1.4	-1.3	-1.2
Government Balance (% of GDP)	-3.8	-6.8	-5.5	-5.5	-4.2	-4.3	-4.1

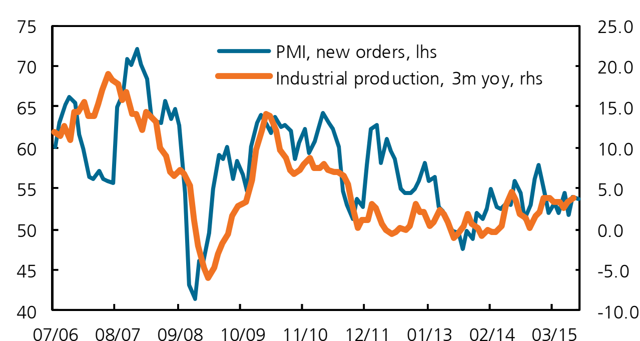
NB: Percentage changes versus previous period - except where otherwise indicated. Figures relate to the calendar year.
Source: Oxford Economic Forecasting and Intesa Sanpaolo

Fig. 1 – Rebasing of GDP series takes growth higher



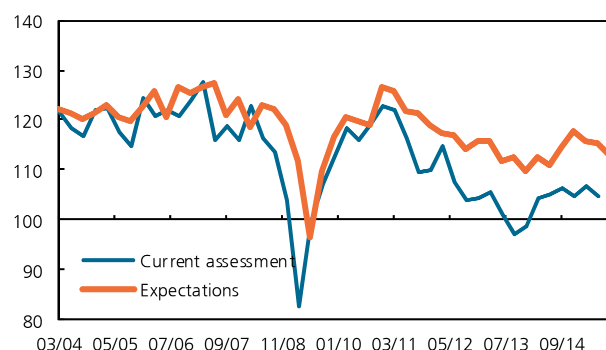
Source: CEIC

Fig. 2 – Orders sitting pretty above 50



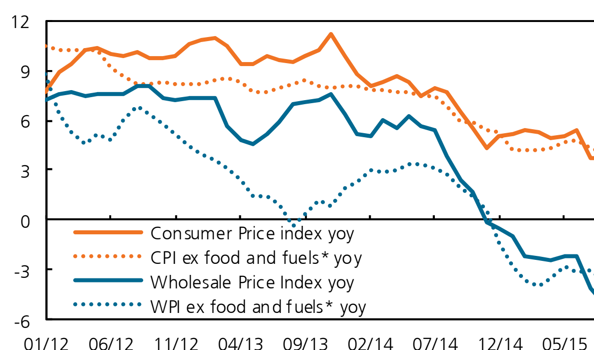
Source: Markit-HSBC, CEIC

Fig. 3 – Business confidence



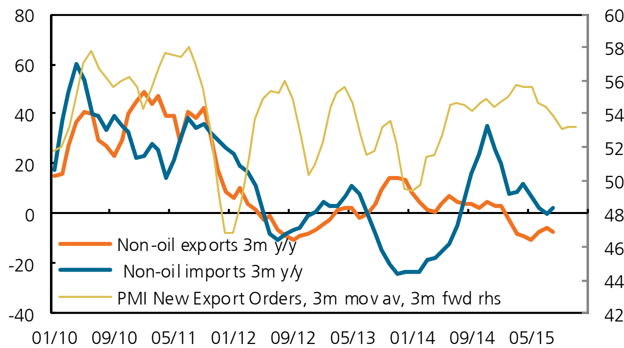
*Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 – Inflation stabilising



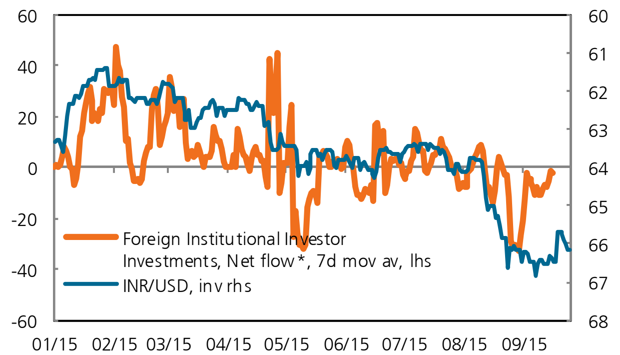
*Intesa Sanpaolo estimates Source: CEIC

Fig. 5 – Foreign trade still weak



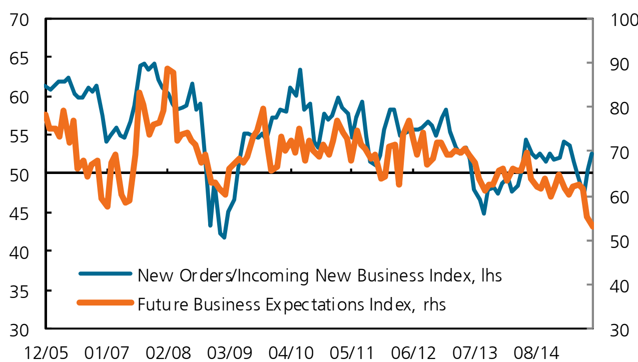
Source: Intesa Sanpaolo chart from Bloomberg and Markit data

Fig. 6 – Rupee depreciates against the dollar



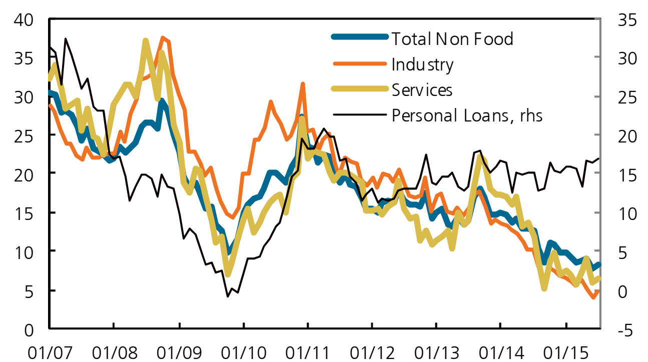
Source: CEIC

Fig. 7 – Services: orders improve but expectations fall



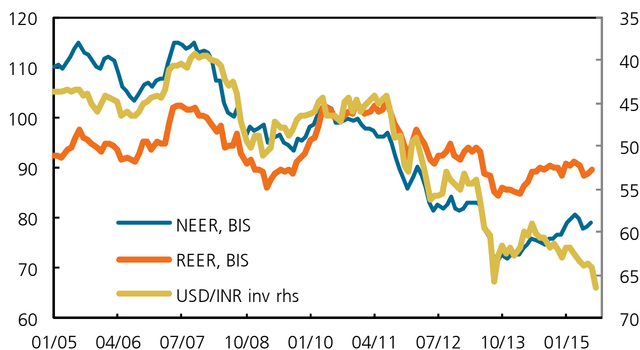
Source: Markit

Fig. 8 – No acceleration in lending (% change yoy)



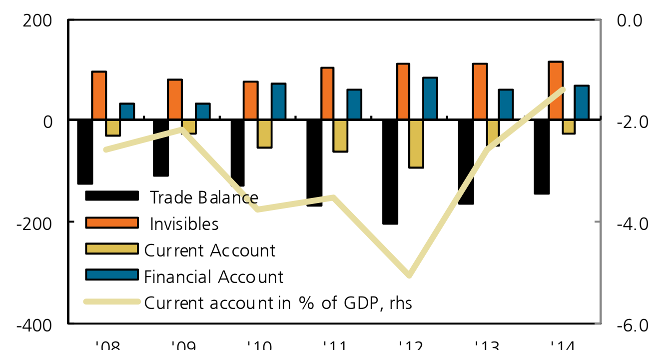
Source: CEIC

Fig. 9 – Real exchange rate



Source: CEIC, Bloomberg

Fig. 10 – Current accounts



Source: Bloomberg

Currency markets – Fed hike postponed, and exchange rate effects with it

Asmara Jamaleh

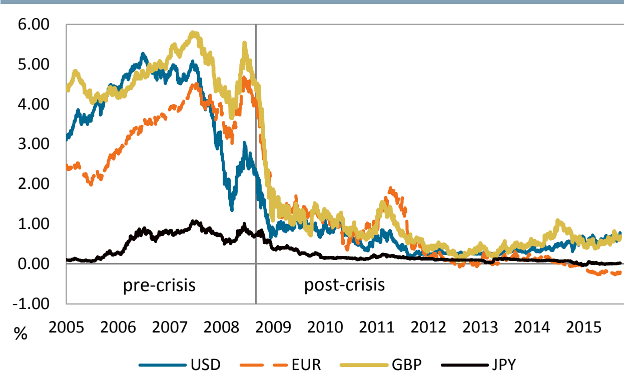
Risks to the global outlook from the slowdown in the Chinese economy **have led the Fed to postpone the first interest rate hike**, which until a few months ago was expected in September. Apart from the initial knee-jerk reaction, **this should not change the basic outlook for the currency markets, which sees the dollar strengthening in tandem with the Fed's reversal.** Indeed, the reversal is **just as important** now as it has been in the past (in terms of expectations). The main reason is that **the starting point is still the same**: interest rates that have been stuck at zero for nearly seven years. The last rate intervention – a cut – was in December 2008, while the last rise was nearly ten years ago (June 2006). In other words, the reversal is still important as it identifies the absolute starting point for interest rates, which is also the absolute minimum (zero). **This maximises the sensitivity of currencies to interest rates in the initial phase of a reversal of the monetary policy cycle.**

Moreover, another important aspect is that **it does not change the lag between the Fed's action and the actions of the other main central banks.** Once again, some central banks have already loosened monetary policy further, while others have stated they are ready to do so, if necessary, or to maintain accommodative conditions for longer. The reason for this procrastination is not from within: it is both external – China's slowdown – and widespread. We continue, therefore, to expect the dollar to strengthen in tandem with the Fed's reversal.

We have attempted to estimate the **sensitivity** of the main currencies – euro, sterling and yen – **to US interest rates**: with a few obvious *differences*, **it was high** in all three cases.

Our estimates were based on US short-term yields and their counterparts for the Euro zone, UK and Japan, from 2005 to date, a period that includes both the normal pre-2008 crisis phase and the "extraordinary" post-crisis phase (**Fig. 1**).

Fig. 1 – Interest rates (*): pre-crisis and post-crisis levels



Rates (*) = short-term yields (2 years)

Source: Thomson Reuters-Datastream

Tab. 1 – Sensitivity of euro, sterling and yen to US interest rates

	sensitivity		current level of the exchange rate (*)	arrival point of the exchange rate following 100 pb rate rise by the Fed (**)
	US interest rates	domestic interest rates		
EUR/USD	-0.06	0.08	1.12	1.05
GBP/USD	-0.03	0.07	1.53	1.50
USD/JPY	0.08	-0.16	120	129

(*) average of the first half of September
(**) keeping interest rates unchanged for ECB, BoE and BoJ

Source: Intesa Sanpaolo elaborations on Thomson Reuters-Datastream data

Euro

The euro demonstrates high sensitivity to US interest rates (-0.06), albeit slightly lower than sensitivity to Euro zone rates (**Tab. 1**). **Our estimates show that a Fed hiking cycle of 100 bps could cause a depreciation of the EUR/USD from current levels at 1.12** (average of the first half of September) **to EUR/USD 1.05**. The impact is measured at unchanged Euro zone rates, in line with the QE conditions (securities purchases planned until September 2016). Our estimates suggest that when the Fed actually raises rates, the euro could continue to depreciate until it reaches mid-March levels of EUR/USD 1.05-1.04. The prospect of the ECB being willing to

extend QE, both in terms of the duration and/or size of the programme, if the global economy were to deteriorate, also lends support to this hypothesis.

We therefore forecast that the exchange rate will fall below EUR/USD 1.10 by the end of the year and hit lows of EUR/USD 1.05-1.04 **as the first Fed hike approaches**. The gradual implementation of Fed hikes, especially in the initial phase of the new cycle, should limit further downside pressure on the single currency, which should slowly start to strengthen from its expected lows over the next year. The consequences of an overly weak euro would be a very strong dollar, which the Fed explicitly mentioned this month as an adverse market factor in the current international environment. Moreover, if the ECB did not extend QE, Euro zone yields would move away from zero, which would – according to our estimates – boost the currency, given its slightly greater sensitivity (0.08) to euro rates than to US rates (-0.06). Risks to the outlook are therefore to the downside.

Sterling

Sterling's sensitivity to US rates is also significant, but at -0.03 **is lower than the euro's** (**Tab.** 1). It follows, in this case, that **Fed hikes totalling 100 bps would lower the exchange rate from** its current level of **GBP/USD 1.53** (average of the first half of September) **to GBP/USD 1.50**. The downside is therefore small and would be completely wiped out if the BoE – like the Fed – were to raise interest rates.

Tab. 2 – Sterling's sensitivity to Fed and BoE interest rates

	sensitivity		current level of the exchange rate (*)	arrival point of the exchange rate following		
	US interest rates	domestic interest rates		100 bp rate rise by the Fed (**)	100 bp rate rise by the BoE (***)	100 bp rate rise by both Fed and BoE
GBP/USD	-0.03	0.07	1.53	1.50	1.64	1.60

(*) average of the first half of September
(**) keeping interest rates unchanged for the BoE
(***) keeping interest rates unchanged for the Fed
Source: Intesa Sanpaolo elaborations on Thomson Reuters-Datastream data

The currency's **sensitivity to BoE rates is** actually **higher**: at 0.07, it is more than twice as sensitive to BoE rates than to Fed rates. BoE hikes of 100 bps would therefore take the exchange rate from its current level of GBP/USD 1.53 to GBP/USD 1.64 (**Tab.** 2). An increase in BoE rates would, therefore, have a much greater effect (i.e. triple) than a Fed rate hike, with total rises being equal. **The ultimate combined effect of both a Fed and a BoE reversal would**, therefore, **be a rise in sterling** from GBP/USD 1.53 to 1.60 (**Tab. 2**).

In this case, **sterling would also appreciate against the euro**: the above sensitivity estimates for GBP/USD and EUR/USD put the upside at between EUR/GBP 0.70 and 0.65.

The core scenario is, however, that the BoE will start to hike rates after the Fed: the first BoE rise is expected in 1Q16, probably around February, while a Fed reversal is expected by December this year. The risks are that the BoE might postpone its reversal, but not for longer than one quarter.

We forecast, therefore, that **sterling could weaken slightly** to within a range of GBP/USD 1.55-1.50 **as the first Fed rate hike approaches, and then rise** towards GBP/USD 1.60 **as the first BoE hike approaches**. We therefore still expect sterling to appreciate further against the euro and return to within a range of EUR/GBP 0.70-0.68.

Risks to the outlook for sterling are to the downside. Indeed, the BoE has spelled out, in even clearer terms, the bearish impact of a strong currency on inflation, while adding that it is quite difficult to estimate the size of the impact, especially in the new post-crisis environment.

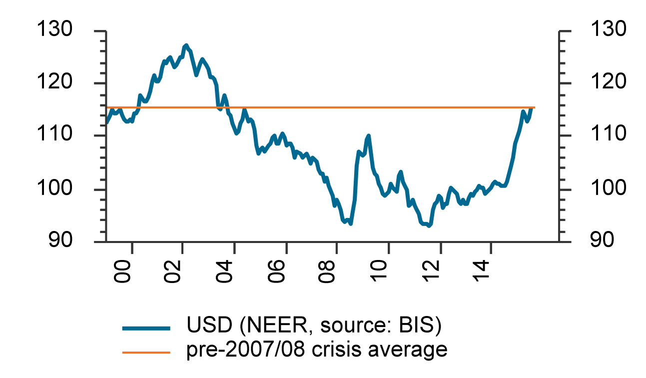
Yen

According to our estimates, the yen is the most sensitive to US rates, at 0.08 for USD/JPY (Tab. 1). In this case, however, unlike euro and sterling, the estimates are not statistically very significant, probably because the BoJ started using a zero interest rate policy (ZIRP) about ten years before the Fed. The output of the estimates does not, however, seem unreasonable: Fed rises of 100 bps could reduce the yen/dollar exchange rate from the current level at USD/JPY 120 (the average of the first half of September) to USD/JPY 129 (Tab. 1).

The prospect of the BoJ announcing another extension to QQE, as it did at the end of October last year, would also support the hypothesis of a significant bearish impact. The BoJ is encountering major difficulties compared with the other main central banks in bringing inflation back on track – and keeping it there – to meet the target. Last year, when the BoJ announced expansion of QQE, the yen plummeted "permanently" from USD/JPY 105 to 120; and it went on to hit new lows of USD/JPY 125 in June 2015.

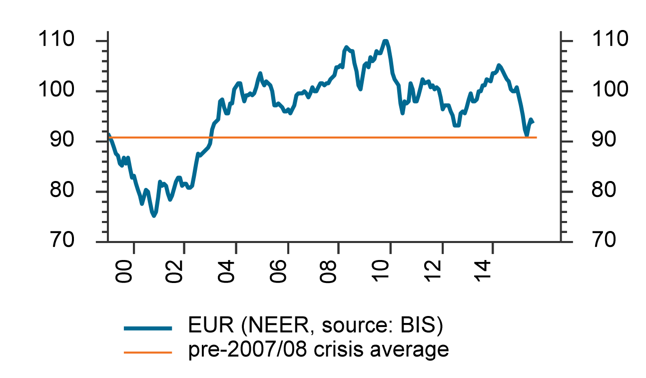
We are, therefore, sticking to our forecasts that the yen will weaken to between USD/JPY 125 and 130 by end-2015/early 2016, especially as, unlike a year ago, any expansion of QQE by the BoJ would coincide with the real start of the cycle of Fed rate rises. Over the next one to three months, the yen/euro exchange rate should mainly stay within EUR/JPY 130-140, where it has been since May, but veering towards the ceiling of the range if the BoJ announces further QQE expansion, and towards the floor when the Fed makes its first hike.

Fig. 1 – Dollar, nominal effective exchange rate



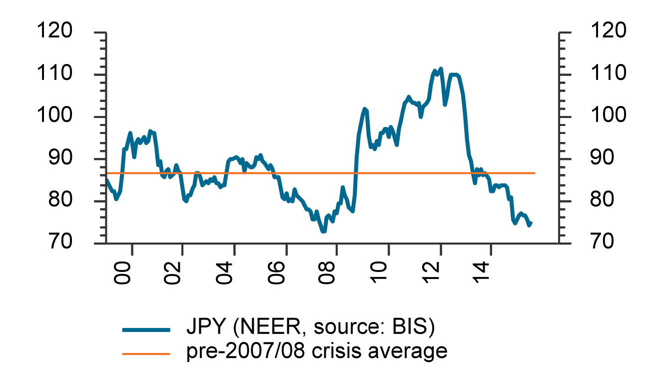
Source: Thomson Reuters-Datastream

Fig. 2 – Euro, nominal effective exchange rate



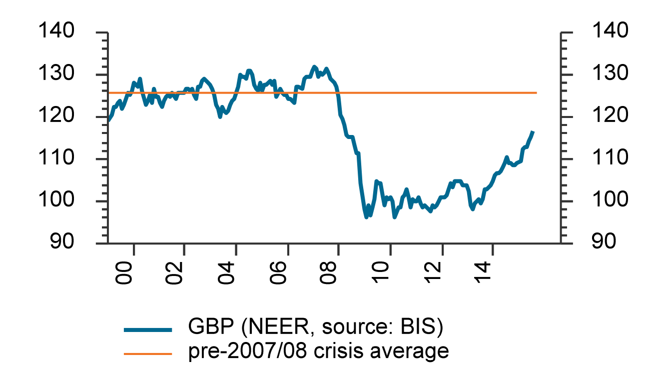
Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate



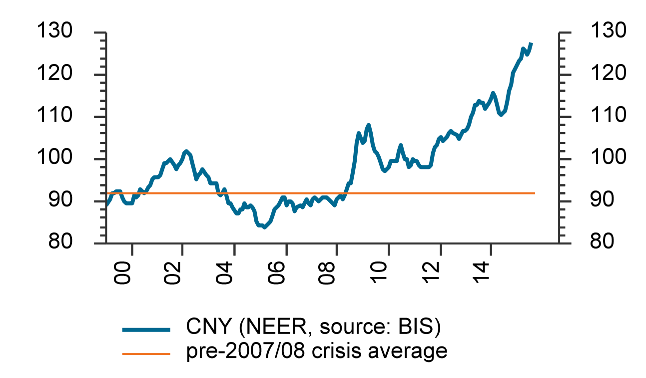
Source: Thomson Reuters-Datastream

Fig. 4 - Sterling, nominal effective exchange rate



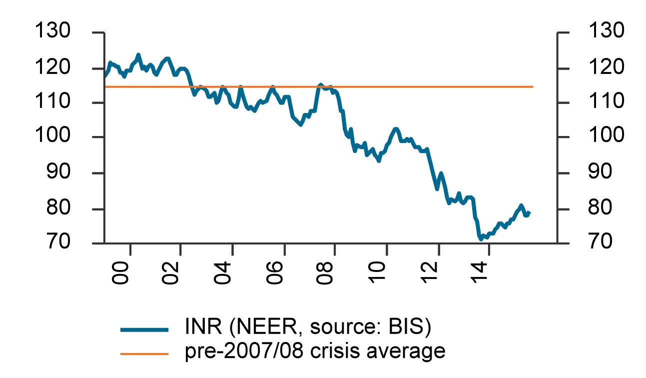
Source: Thomson Reuters-Datastream

Fig. 5 – Yuan renminbi, nominal effective exchange rate



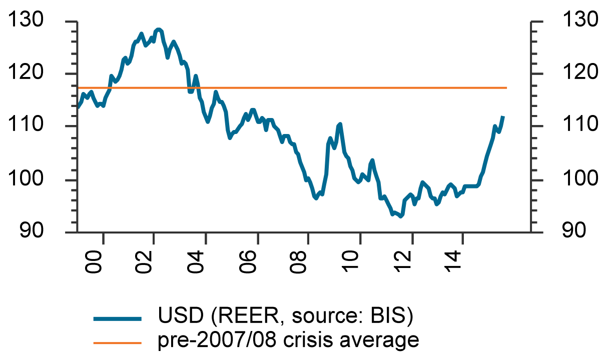
Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate



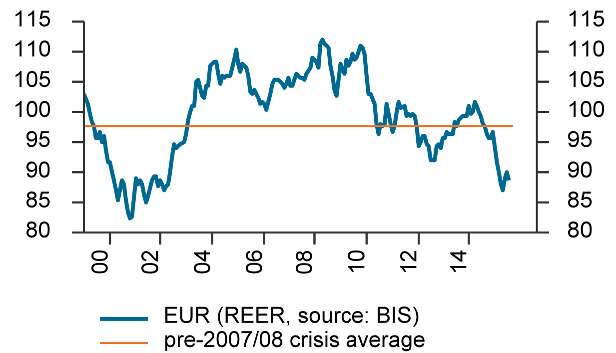
Source: Thomson Reuters-Datastream

Fig. 7 – Dollar, real effective exchange rate



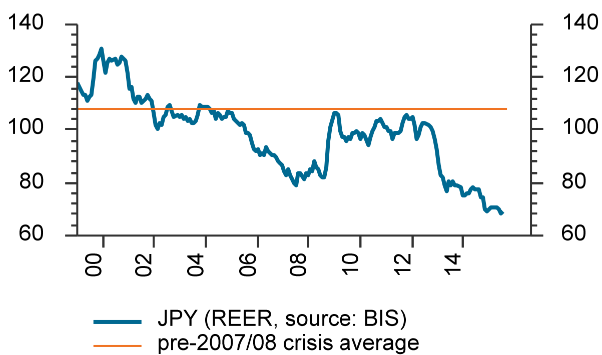
Source: Thomson Reuters-Datastream

Fig. 8 – Euro, real effective exchange rate



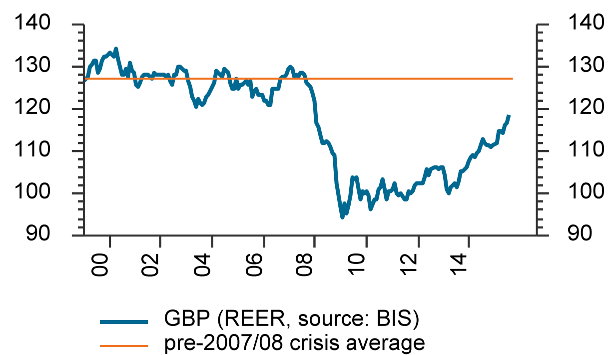
Source: Thomson Reuters-Datastream

Fig. 9 – Yen, real effective exchange rate



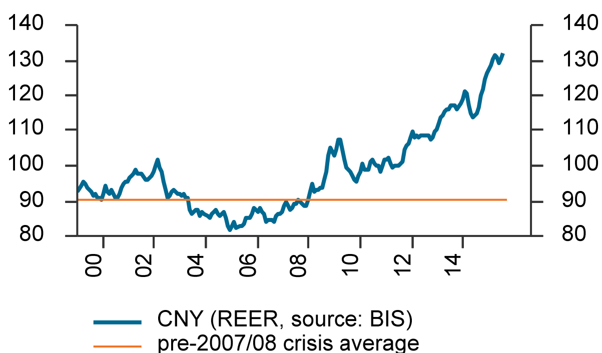
Source: Thomson Reuters-Datastream

Fig. 10 - Sterling, real effective exchange rate



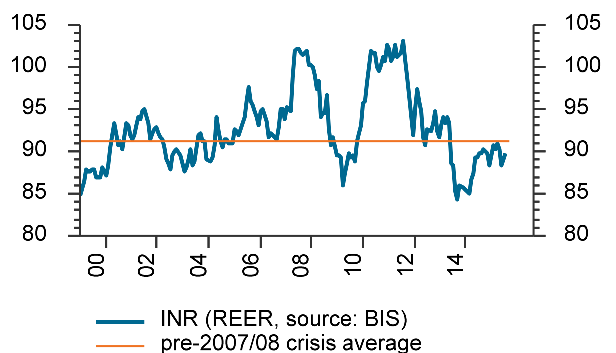
Source: Thomson Reuters-Datastream

Fig. 11 – Yuan renminbi, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 12 – Indian rupee, real effective exchange rate



Source: Thomson Reuters-Datastream

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Appendix

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