BANCA IMI

Macroeconomic Outlook

Research Department

December 2015

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INTESA SANPAOLO

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Quarterly

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The rise in Fed rates does not undermine the 2016 growth outlook

Luca Mezzomo

The level of uncertainty in the global economy has fallen over the last few months, partly due to signs of stabilisation in China.

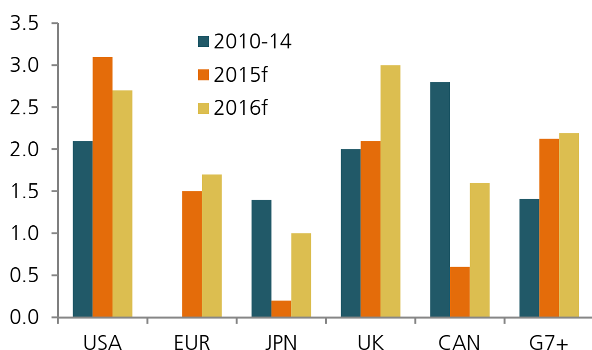
The modest rise in rates expected in the US does not, in our view, represent a significant risk to global growth. In 2016, growth in advanced nations will continue to be fuelled by domestic demand. We expect the recovery in the Euro zone to strengthen.

Given the larger-than-expected fall in oil prices, we need to further cut inflation forecasts for advanced nations.

The forecasts set out in September have been broadly confirmed in the last few months, with the exception of one factor, the trend in oil prices, which again crashed in the fourth quarter. Otherwise, as expected, in December, the Federal Reserve began the monetary policy tightening cycle, while the ECB further accentuated the divergence between rates with a series of new expansionary measures. As regards the slowdown in emerging economies, the thorniest issue of 2015, the last few months have painted an extremely mixed picture. There were signs of stabilisation in China, while the situation in other countries such as Brazil and Russia remained cause for concern; overall, there was probably another modest slowdown in the autumn. Despite this, the macroeconomic figures of emerging nations are no longer a source of constant disappointment, as they were until October. The stabilisation in China is extremely significant, as it may have a positive impact on confidence in the rest of the world. Overall, the imports of emerging countries are likely to return to growth in 2016, after falling in 2015, although this will depend almost entirely on Asia.

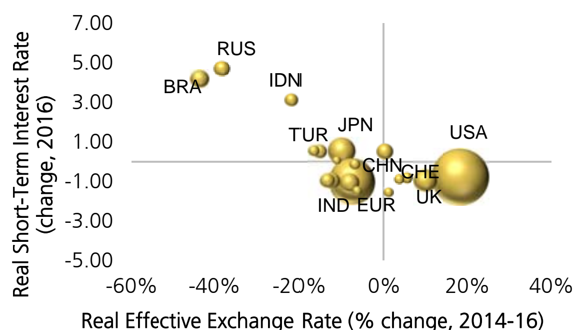
There are even more solid reasons compared with three months ago to believe that growth in advanced nations will mainly be supported by domestic demand, as illustrated in fig. 1. In our view, real interest rates will fall overall, despite the modest rise in official rates expected in the US (see fig. 2), and monetary policy will be loosened further by the expansion of central banks' balance sheets in the Euro zone and Japan (fig. H). Furthermore, movements in effective exchange rates are at times in synergy with monetary policy easing (as, for example, in the Euro zone and China) or tightening (the US). Only in some emerging countries will we see a dramatic tightening of monetary policy geared towards stabilising the exchange rate.

Fig. 1 – Contribution of domestic demand to GDP growth (%)



NB: G7+: US, Japan, Euro zone, UK, Canada; aggregation based on nominal GDP in current dollars. Source: Intesa Sanpaolo data

Fig. 2 – Real interest rates and exchange rate trend in the main global economies



NB: Changes in effective exchange rate in all countries except India, Indonesia, Saudi Arabia (exchange rate with USD), Poland (exchange rate with EUR). The real short-term exchange rate is calculated by subtracting current inflation. The size of the circles is proportional to 2015 nominal GDP in dollars. Source: Intesa Sanpaolo chart based on Oxford Economics data

Fiscal policies will not be subject to any restriction (see fig. D), given the positive effect on the primary balance expected from economic growth. Furthermore, the revision of oil price forecasts means that there could be a further release of purchasing power among households in 2016; this is more likely to have an impact on final expenditure given the positive climate of confidence prevailing in the US and Europe and the particularly mild end of autumn/beginning of winter in the northern hemisphere. However, the effect of falling oil prices will be decidedly less positive compared with 2015. First of all, lower commodity prices will be passed on increasingly less to final prices as they continue to fall, since the fixed part of the price relating to taxes will increase as a proportion of the total price. Secondly, there will be a more significant negative impact triggered by the deterioration in economic conditions in producer countries, which since the fourth quarter of 2014 have begun to dramatically reduce their imports (-16.8% yoy in 2Q15), and from the greater risk of financial and political instability in these countries.

One open question is whether or not the recovery in consumer spending will be accompanied by a significant upturn in investment. The crisis in commodities will depress capital spending in the extraction industry, but this sector can only determine overall trends in a few countries. In light of the background of moderate economic expansion, less uncertainty and accommodative financial conditions, the contribution of capital spending looks set to remain stable or increase in 2016-2017: stable in the US, where it already accounts for approximately 0.8% of GDP, and in Japan; and up in the Euro zone, where it could rise from 0.4% to 0.8% in 2016.

Overall, growth forecasts for 2016 have undergone little change since September, and are broadly in line with the consensus average. Global growth is seen picking up slightly, from 3.1% to 3.3%, due to growth of 2.2% for advanced nations and 4.2% for emerging countries. Growth has been revised down for the US (from 2.9% to 2.6%) and marginally for Japan (from 1.3% to 1.2%), while the projection for the Euro zone is unchanged at 1.7%. In fact, figures have been generally better than forecast in Europe, and lower than expected in the US.

Inflation forecasts have been trimmed, due to a further cut to oil price forecasts, but this has not affected the direction: when oil prices stabilise, the average inflation of advanced nations is expected to rise from an annual average of 0.2% to 1.0%. Price growth will be relatively stronger in the US (1.7%), while it is expected to remain less than 1% in the Euro zone and Japan.

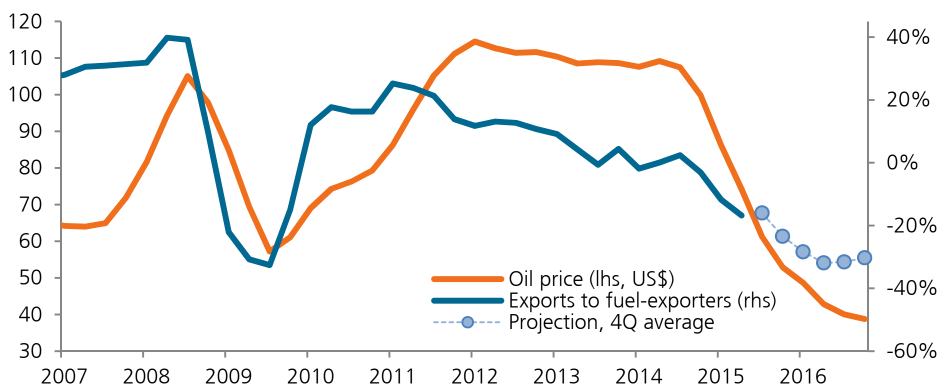
The rise in US official rates at the end of December had been incorporated in market valuations with a high probability for some weeks, as has a further mild tightening of official rates in 2016 (about another 50 bps). One more rise on top of market expectations does not really qualify as a significant "risk" for the global outlook; moreover, in the next few months, the Federal Reserve will probably seek to limit the market consequences of its interventions on official rates, for example indicating that internal forecasts on the future trend in official rates have fallen compared with previous meetings. Furthermore, after a period of general withdrawal from markets at risk, investors are re-emerging and beginning to differentiate much more between countries. Since September, portfolio movements towards emerging countries have been positive on average, with October's return only partially offset by modest outflows in September and November. The picture was very mixed in November, with positive net flows to Latin America and negative flows to other regions. Also on the currency markets, we believe that the lion's share of the adjustment took place in 2014 and 2015.

What are the implications of an oil price at USD 40?

One highly probable risk, though, is that of a significantly lower oil price trend than that used as a benchmark. The scenario states that the decline at the end of 2015 is due to excessive speculation, which should in part be reabsorbed in 2016, and that year-end prices will be

midway between the plateau of 2011-14 and the narrow ravine of 2008-09. However, we cannot rule out that Saudi Arabia will be prepared to support the cost of a prolonged period of low prices, such as that which almost constantly held sway between 1986 and 2000.

Fig. 3 – The imports of producer countries could be almost halved if oil prices remain stable at USD 40



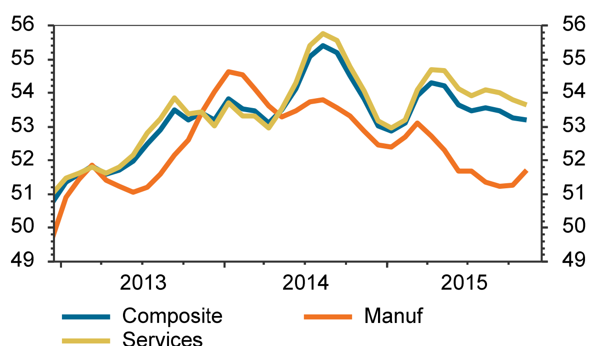
Source: IMF DOTS, Thomson Reuters

Beyond the negative environmental repercussions, an ongoing period of low prices could have negligible net benefits for advanced nations, since the further improvement in the terms of trade and the increase in household's real income could be offset by the collapse in producer countries' imports. Undoubtedly, the phenomenon would strengthen the role of domestic demand in generating growth compared with the baseline scenario. We estimate that exports to oil-producing countries fell by 23% in 2015 from 2014 (by 2Q15, the fall was already 16.8% yoy), a decrease of approximately USD 288Bn compared with 2013. If prices were to collapse on average to USD 40 in 2016, the overall contraction in annual export flows to oil-producing countries could rise to USD 320/450Bn, with a further fall of USD 30-160Bn according to the hypothesis (the estimate of USD 30Bn assumes elasticity equivalent to that seen until mid-2015). For Italy, in the most favourable scenario, this translates into a fall in exports of approximately USD 11.5Bn compared with 2013, of which USD 1.2Bn would be in 2016; in more extreme scenarios, the impact would be almost equal to that of 2015. Conversely, in 2016, the further rise in household purchasing power would fluctuate between 0.3% and 0.5% of disposable income in the main European countries (over USD 3Bn for Italy, approximately USD 9Bn for Germany and USD 5Bn for France).

In the longer run, persistently low oil price would be a mixed blessing, because of negative repercussions on carbon emission controls, energy efficiency and the development of renewable energy sources.

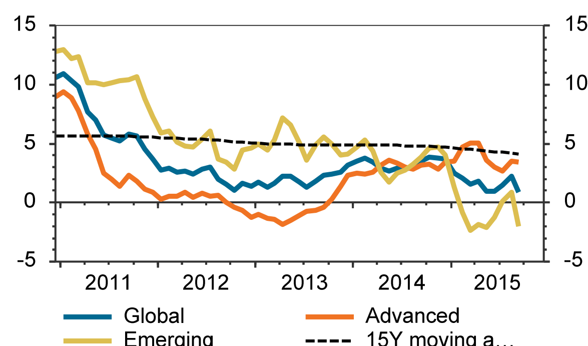
Global economic trends in 10 charts

Fig. A – Global PMIs



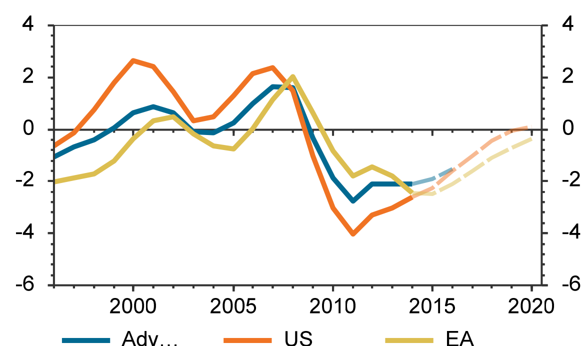
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Growth in imports, yoy



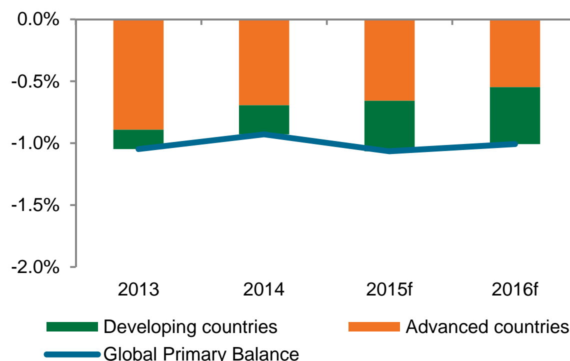
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



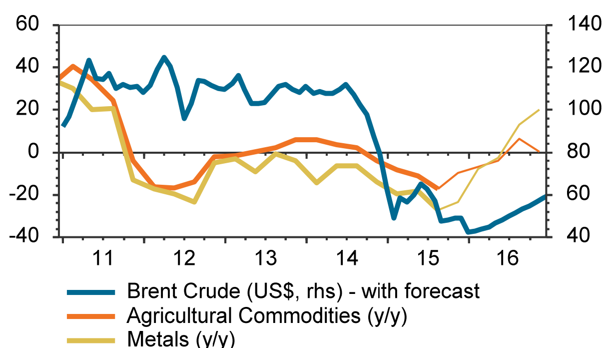
Source: Thomson Reuters-Datastream Charting and IMF

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



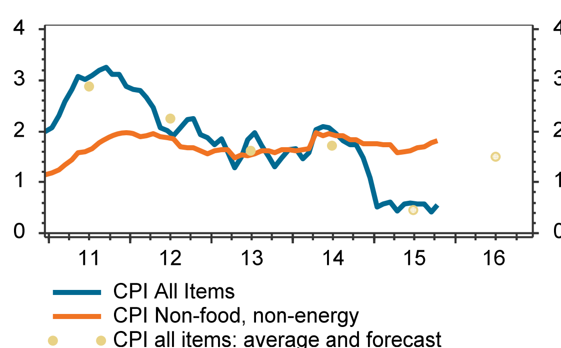
NB: based on 11 major advanced nations and 8 major emerging countries. Aggregation at current exchange rates. Source: Intesa Sanpaolo data

Fig. E – Commodity prices



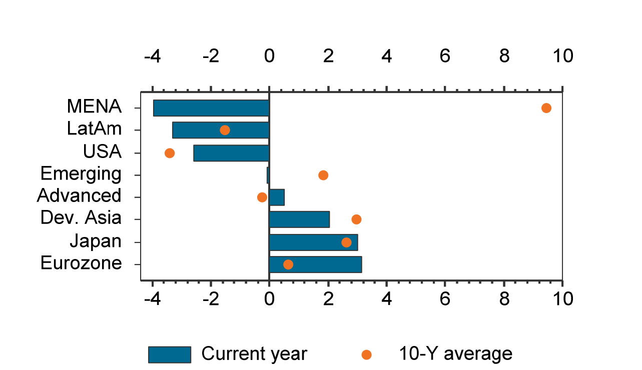
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



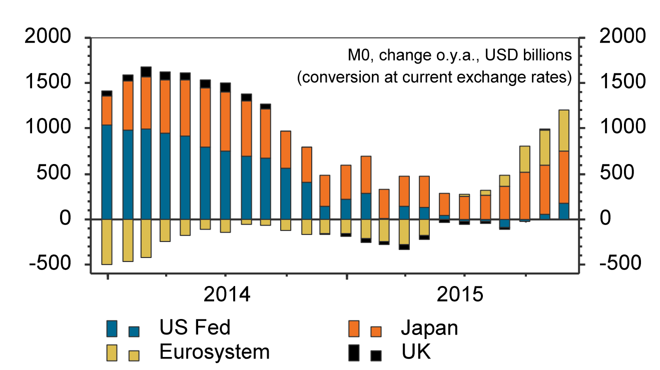
Source: OECD, Thomson Reuters-Datastream Charting

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



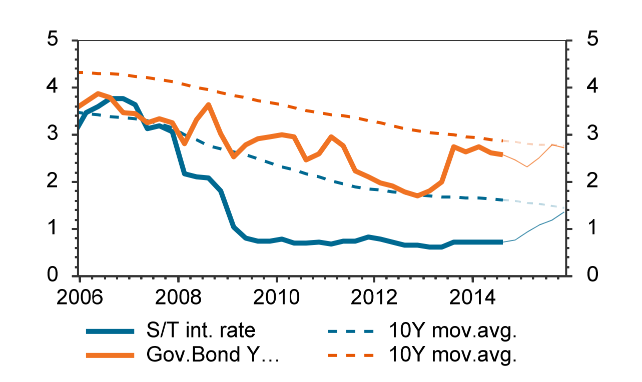
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

Fig. H – Monetary base, G3 (change, USD billion)



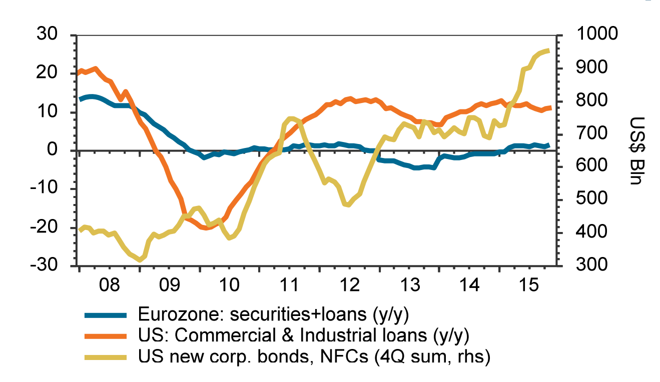
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



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

Fig. J – Lending to non-financial companies



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

Tab. 1 - Economic growth by geographical region

	2012	2013	2014	2015P	2016P
United States	2.2	1.5	2.4	2.5	2.6
Japan	1.7	1.6	-0.1	0.7	1.5
Euro zone	-0.8	-0.2	0.9	1.5	1.7
Eastern Europe	2.3	1.8	1.3	-0.6	1.8
Latin America	2.6	2.5	1.0	-0.3	0.2
OPEC	5.8	2.2	2.3	1.6	1.4
East Asia	6.1	6.1	6.3	6.0	6.3
Africa	3.1	3.1	4.0	3.4	3.8
World growth	3.4	3.3	3.4	3.1	3.3

Source: Intesa Sanpaolo data

Commodities: sideways markets and volatility

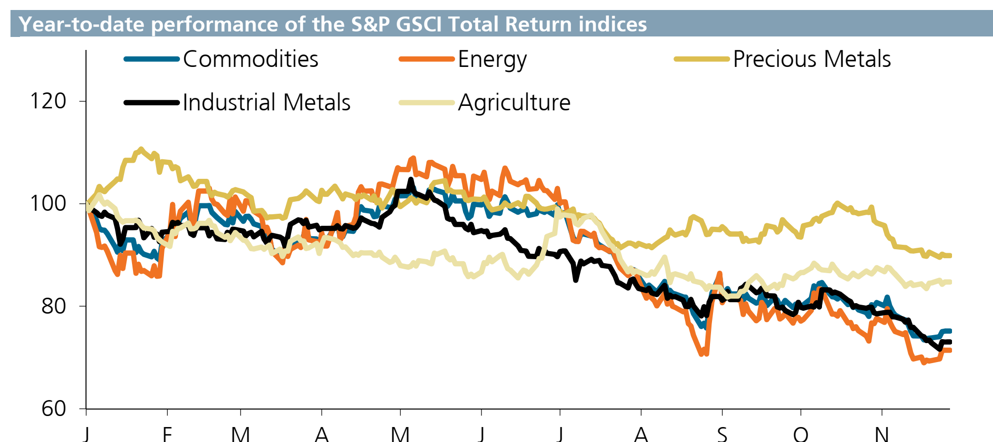
Daniela Corsini

Based on our baseline macroeconomic outlook, the key factors contributing to uncertainty over commodities, and the supply and demand fundamentals, we expect to see sideways markets with high levels of volatility in the early months of 2016. Expected low oil prices and the overall fragility of global demand also justify a forecast of continuing weakness in the prices of the main industrial metals.

Prices have fallen markedly in the energy and industrial metals segments in recent months, due to weak fundamentals and disappointing macroeconomic data from the major emerging economies. In particular, there is concern about the persistent oversupply that is burdening most markets: in 2015, the supply of most of these commodities has increased at a rapid rate, while demand has struggled to grow at the overly optimistic pace that was forecast at the start of the year.

By contrast, the prices of precious metals and agricultural products have been trading within a wide range in recent months, remaining broadly unchanged compared with the average levels for August and September. In the precious metals segment, gold remains heavily affected by the expected rise in US interest rates and the strong dollar, while the fundamentals of platinum and palladium have deteriorated sharply after the recent scandals in the automotive industry.

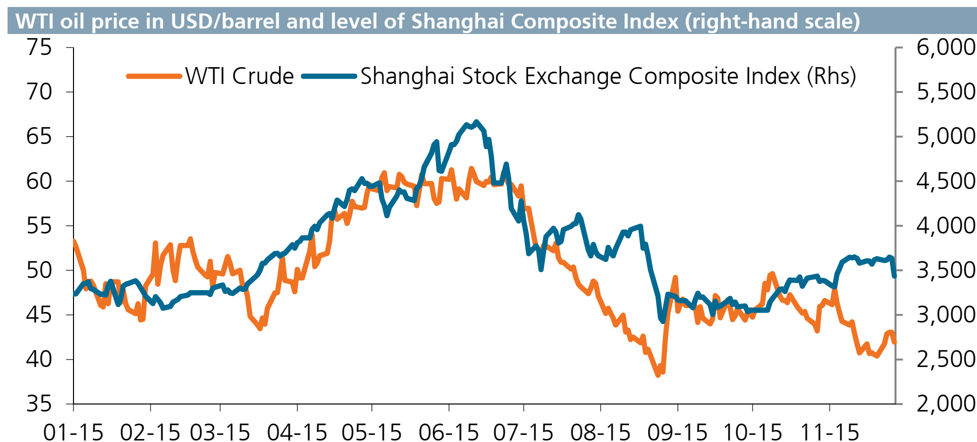
Year-to-date performance of the S&P GSCI Total Return indices



Source: Intesa Sanpaolo chart based on Bloomberg data

After the summer, when the segment was dragged down by fears of an excessive slowdown in the Chinese economy and the slump in the domestic equities market, commodities finally seemed to return to being guided by their (albeit weak) fundamentals in the autumn months. We believe this to be a positive change, as it suggests - at least in the short term - that purely financial variables and speculative flows are having less of an impact on the commodity markets.

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



Source: Intesa Sanpaolo chart based on Bloomberg data

The main drivers in 2016

Over the next year, the commodities sector will be profoundly affected by various factors that will fuel volatility:

- The monetary policy of the Federal Reserve, oriented toward a slow, gradual rise in interest rates, is expected to boost the relative strength of the US dollar. This factor could stoke downwards pressure on commodities, particularly precious metals. More specifically, gold, which is the metal most exposed to monetary policies and inflation expectations, is likely to be negatively affected by a weak demand for investment;

- The health of the Chinese economy and the authorities' response to the current slowdown will be a determining factor in defining global commodities demand and market sentiment towards the segment. The main macroeconomic indicators will therefore be closely monitored, particularly in the first few months of the year, when demand for commodities usually steps up ahead of the Chinese New Year. At the moment, we regard the contraction under way in the manufacturing sector, which brought the official PMI issued by the National Bureau of Statistics - after falling for four months - to its lowest level for three years in November, as of particular concern. Furthermore, the response in the metallurgical sector to low domestic prices could have wide repercussions on international prices for the main non-ferrous metals;

- Geopolitical tensions will continue to fuel volatility in the segment. In the event of further macroeconomic problems in western Europe and any aggravation of tensions in eastern Europe, gold and silver could again benefit from a temporary rise in demand for safe-haven assets. Oil will be heavily affected by changes in the political situation in the Middle East. Currently, we mainly see downside risks to energy prices, as the return of Iranian supply to international markets should more than offset any temporary interruption to supply from other, smaller producers in the region. The decision about the OPEC production target is closely related to the conflicts that are tearing the region apart. We do not expect OPEC to reduce its cumulative production target of 31.5 mb/d, set at its December 4 meeting, in the next few months. The decision was chiefly motivated by expectations of an increase in supply from Iran, and the strategy of continuing with high levels of output is necessary for many countries, as their public finances have been put under pressure by the current low prices. Furthermore, deep-seated differences between Iran and Saudi Arabia mean that it is unacceptable for the Saudis voluntarily to sacrifice their market share to their historic rival;

- The change in oil prices will also have a profound effect on the prices of other commodities: in the case of precious metals, lower energy prices reduce inflation forecasts, while industrial metals and agricultural commodities experience downward pressures due to the erosion of production and transport costs. Moreover, given the dominant weight of oil in the major commodities indices, expectations of lower crude prices will fuel a negative market sentiment and discourage investments across the segment.

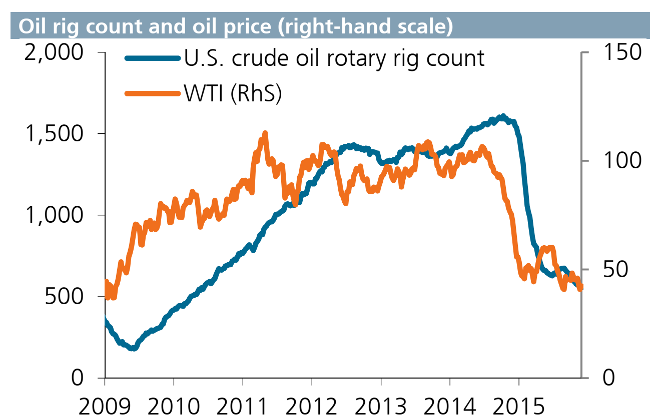
Our forecasts for the commodities universe

Overall, based on our baseline macroeconomic outlook, the key factors contributing to uncertainty over commodities, and the fundamentals of supply and demand, we expect to see sideways markets with high levels of volatility in the early months of 2016. Expectations of low oil prices and the overall fragility of global demand justify a forecast of continuing weakness in the prices of the main industrial metals. Later in the year, we expect supply and demand fundamentals to be tighter, particularly in the case of some metals, fuelling a moderate recovery in prices.

A scenario of persistent oversupply is expected for crude oil, in view of the historically high production levels maintained by the OPEC countries, the US and Russia, and the expected return of Iranian crude to the international markets. We do not expect OPEC to reach an agreement to sustain prices, either among its own members or with producers outside the group, for a considerable period. Consequently, market forces will be left free to work to rebalance supply and demand: low prices will slowly favour recovery in global demand and reduce supply from producers with higher marginal costs of production, leading to a gradual erosion of the surplus supply.

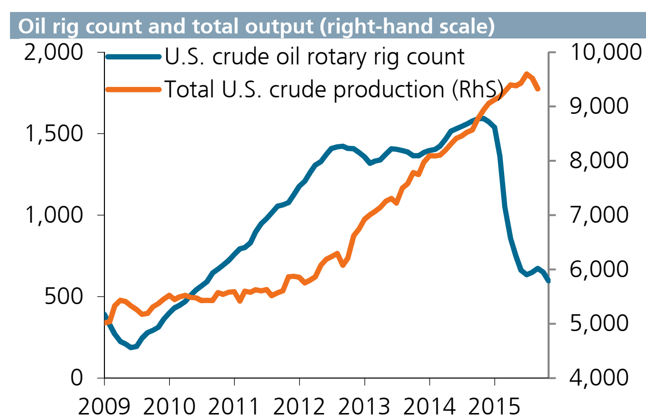
In particular, we expect US oil production to decrease during the year, driven by a fall in the active oil rig count and growing problems for some shale oil producers in accessing financing.

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

Given the slowness of these processes of adjustment in supply and the estimated scale of future Iranian exports, the price range of USD 60 to USD 80 sought by most OPEC members will only be consistently achieved after several quarters. We cannot rule out the possibility that new lows will be reached in the next few months, particularly if crude oil exports from Iran prove to be more abundant than expected. However, we expect to see prices consolidate before making a moderate recovery by the end of 2016, due to the expectation that the modest strengthening in fundamentals will be reflected in prices.

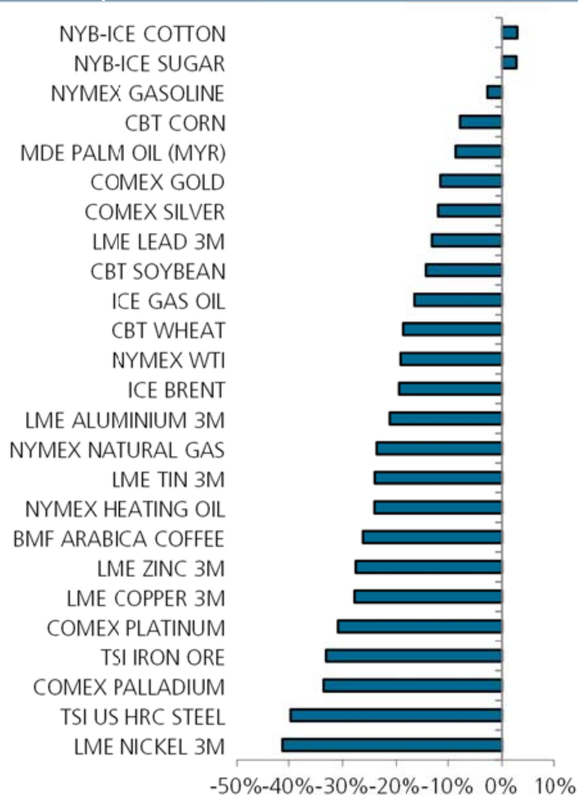
Based on our baseline macroeconomic outlook and the supply and demand fundamentals, we expect to see precious metals continuing to trade at depressed levels in the next few months,

and we cannot rule out new record lows driven by gold. Demand for investment could be dampened by more restrictive monetary policy in the US, a strong dollar and weak inflationary pressure. Platinum and palladium will continue to suffer from fears of weak global demand following the recent scandals in the automotive industry.

With regard to the main industrial metals, we expect to see sideways markets until the first quarter of 2016, curbed by low oil prices and uncertainty about the outlook for Chinese demand, followed by a recovery during the year, driven by an expected strengthening of fundamentals.

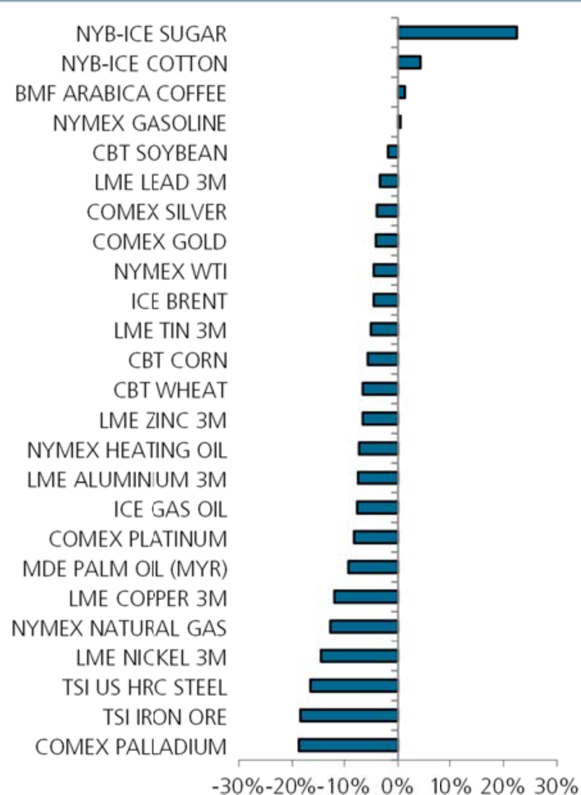
For the main cereals, we expect to see a moderate recovery in prices during the next few quarters, driven by estimates of slightly tighter supply and demand fundamentals for the next season.

Year-to-date performances until 25.11.2015



Source: Intesa Sanpaolo chart based on Bloomberg data

Performance in 4Q15 until 25.11.2015



Source: Intesa Sanpaolo chart based on Bloomberg data

Oil: upside risks to supply, downside risks to demand

Although consensus estimates of supply and demand fundamentals are, generally speaking, more optimistic than they were a few months ago, we stress that the process of improvement will probably be much slower than we forecasted in our previous quarterly outlook, mainly due to a less rapid than expected acceleration for global demand. We now think it unlikely that the supply surplus will be reabsorbed before the end of 2016. Over the next few months, all eyes will be on output estimates in the US and the OPEC countries, and on exports from Iran once international sanctions are lifted.

Supply and demand fundamentals

The latest figures published in the monthly reports of the Organization of the Petroleum Exporting Countries (OPEC), International Energy Agency (IEA) and US Energy Information Administration (EIA) confirm a scenario of substantial excess supply, which is set to continue for several quarters.

The most recent estimates provided by the three main forecasters point to supply and demand fundamentals for the current year that are slightly better than those published in September, probably due to the concern about the Chinese crisis grown over the summer, which subsequently proved to be excessive, and abundant OPEC and non-OPEC production.

Currently, the call on OPEC crude (i.e. the quantity of oil that the group has to supply to balance the markets) is estimated at around 29.6 million barrels per day (mb/d) on average, up by 0.4 mb/d y/y compared with 2014, and revised upwards by 0.3 mb/d compared with the estimated average in September 2015. However, the call on OPEC crude remains well below both the group's production target of 31.5 mb/d and the actual output of the OPEC countries and the historical highs, and well over 31 mb/d.

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

Estimates at November 2015, in millions of barrels per day	Total demand	Non-OPEC supply	OPEC LNG supply	Call on OPEC crude
OPEC	92.9	57.2	6.0	29.6
vs. 2014	1.5	0.7	0.2	0.6
IEA	94.6	58.3	6.5	29.8
vs. 2014	1.9	1.3	0.1	0.5
EIA	93.9	58.1	6.5	29.3
vs. 2014	1.4	1.2	0.2	0.1

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA

With regard to 2016, the three main forecasters are more optimistic than they were in September, confirming a forecast of progressively tighter markets due to the gradual reabsorption of excess supply, despite the return of Iranian oil to the market.

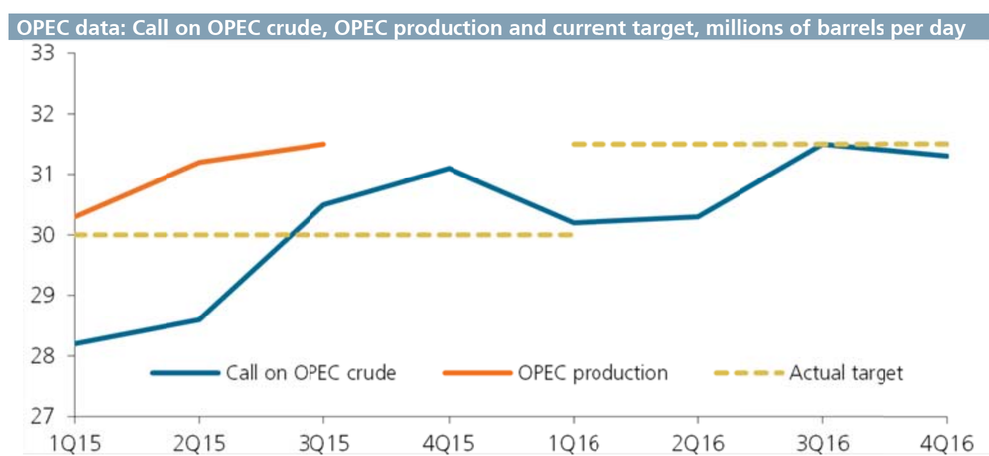
The figures published in November show forecasts of an average global demand of about 95.1 mb/d for the next year, up 1.3 mb/d compared with 2015 and revised upwards by 0.1 mb/d from September. Meanwhile, non-OPEC supply is expected to reach 57.5 mb/d, down by 0.3 mb/d compared with the current year and revised downwards by 0.4 mb/d from the average September estimate. The call on OPEC crude is therefore expected to reach 31.0 mb/d, up by 1.4 mb/d compared with 2015 and upgraded by 0.5 mb/d from the average September estimate. The call on OPEC crude would thus be broadly in line with the cumulative production target (31.5 mb/d) and with actual production.

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

Estimates at November 2015, in millions of barrels per day	Total demand	Non-OPEC supply	OPEC LNG supply	Call on OPEC crude
OPEC	94.1	57.1	6.2	30.8
vs. 2015	1.3	-0.1	0.2	1.2
IEA	95.8	57.7	6.8	31.3
vs. 2015	1.2	-0.6	0.3	1.5
EIA	95.3	57.8	6.7	30.8
vs. 2015	1.4	-0.3	0.3	1.4

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA

OPEC data: Call on OPEC crude, OPEC production and current target, millions of barrels per day



Source: Intesa Sanpaolo chart based on OPEC data

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

According to the estimates in the November report, spare capacity is expected to contract to 1.5 mb/d in 2015, from 2.0 mb/d on average in 2014, before returning to 2.0 mb/d in 2016. Although spare capacity lower than 2.5 mb/d normally indicates tight markets, the current record level of global stocks (demonstrated by a greater use of offshore deposits, as land storage capacity decreases) and the expected return of Iranian supply make this figure less significant.

Upside risks to supply, downside risks to demand

Although the three main forecasters are, generally speaking, more optimistic than they were a few months ago, we stress that the process of improvement in the fundamentals will probably be much slower than we forecasted in our previous quarterly outlook, mainly due to a less rapid than expected acceleration for global demand. We now think it unlikely that the supply surplus will be reabsorbed before the end of 2016.

There are also significant upside risks to the volumes that will actually be available on the physical market. We think it highly unlikely that in the next six months OPEC will be interested in cutting its overall group production target to protect prices and ease the difficulties of producers outside the group. Our baseline scenario includes an expectation that, on average, OPEC will meet the new target, as all its members will seek to keep production as high as possible, despite the fact that spare capacity is limited.

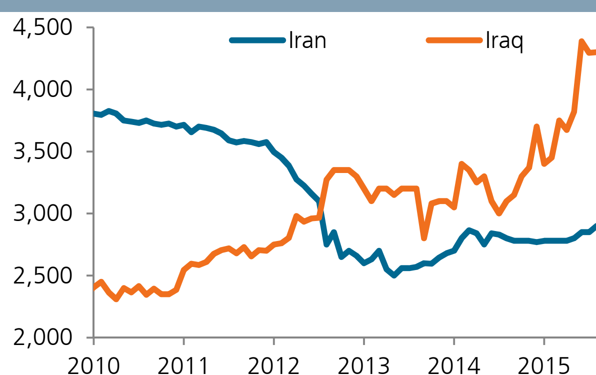
In particular, Saudi Arabia, Kuwait, Qatar and the United Arab Emirates (namely, the members of OPEC that are more financially sound and have lower production costs) are likely to continue

to defend the current strategy of high production, as they want to avoid any reduction in output that would cede market share to other producing countries. Although expensive, this strategy seems to be sustainable for the time being, due to high reserves and recent cuts to current spending. However, in the long term it will be essential to keep the public finances of these countries under observation, as crude oil prices have to be much higher than their current levels to keep the market balanced.

The governments of Iraq and Iraqi Kurdistan are also motivated to maintain output close to the current record levels to shore up their public finances, which have been adversely affected by years of fighting.

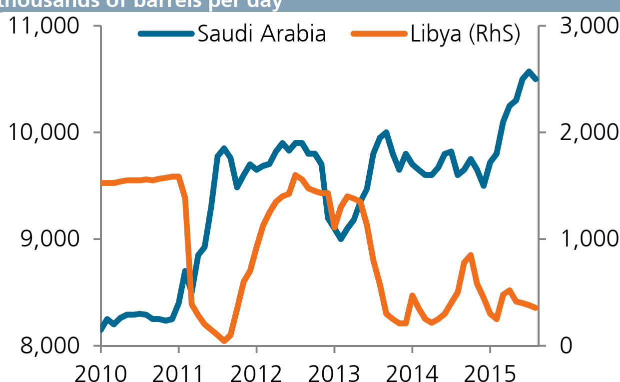
We should stress that in our baseline scenario we are currently incorporating fairly conservative estimates for future increases in Iranian crude exports, conditioned by the actual lifting of international sanctions. We have assumed a maximum increase of 0.75 mb/d by June 2016, compared with average exports in the first half of 2015, but we could be surprised by a more rapid and widespread recovery in exports than expected, in view of the 40 mb stored offshore and Iran's commitment to pursuing new commercial agreements.

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

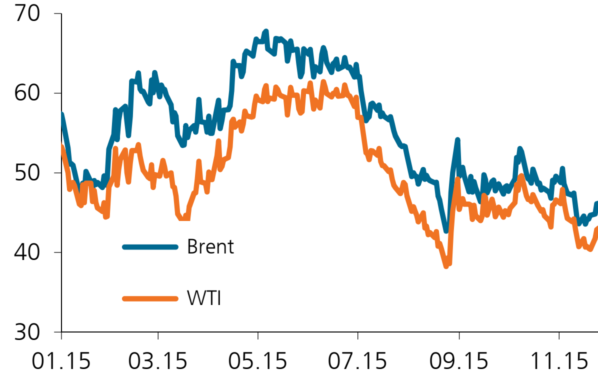


Source: Intesa Sanpaolo chart based on US Department of Energy data

With regard to non-OPEC supply, Russian output is stable at the highest levels recorded since the break-up of the Soviet Union and, at the time of writing, all taxation plans that would have led to a reduction in production have been shelved. We currently forecast that Russian supply will remain high throughout 2016. Particularly in central-western and eastern Europe, competition with Saudi and Iranian crude looks set to be intense.

We believe that the chief downside risks to supply relate to North American production. The fact that shale gas companies have maintained their production at broadly constant levels despite near-minimum prices and near-maximum stocks is thanks to improved efficiency and costs, and the appropriate hedging contracts previously entered into. It will be more and more difficult to find more room to cut costs and optimise processes in 2016, while the problem of refinancing will become ever more pressing and new hedging contracts will not be as advantageous as they used to be. As a result, US supply might fall short of the estimates in our baseline scenario and in the main forecasters' models.

Year-to-date Brent and WTI prices

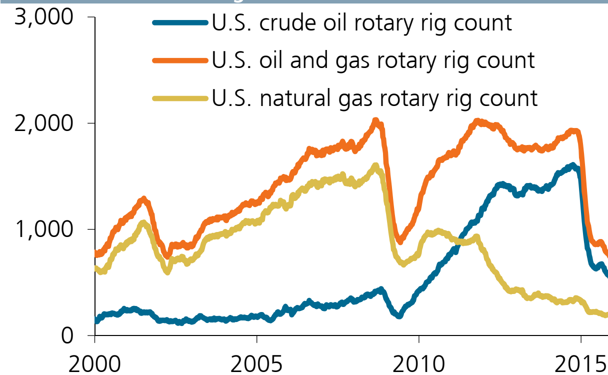


Source: Intesa Sanpaolo chart from Baker Hughes data

Brent-WTI spread

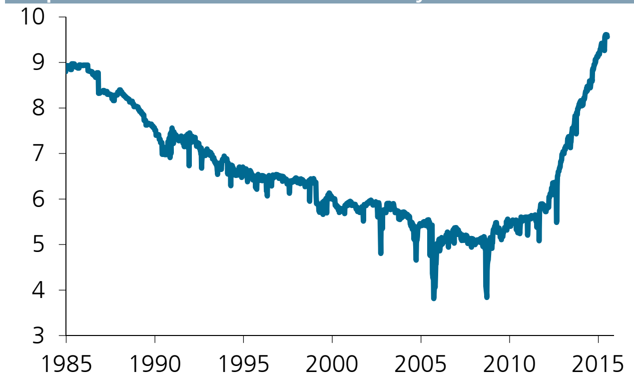
Source: Intesa Sanpaolo chart from US Department of Energy data

Number of active oil rigs in the US



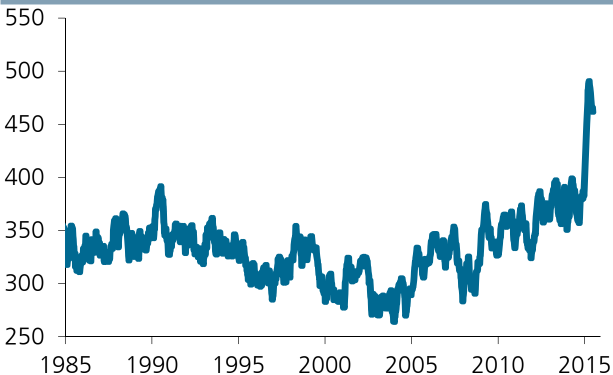
Source: Intesa Sanpaolo chart from Baker Hughes data

US production in millions of barrels a day



Source: Intesa Sanpaolo chart from US Department of Energy data

US total oil stocks in millions of barrels



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

Stocks at Cushing in millions of barrels

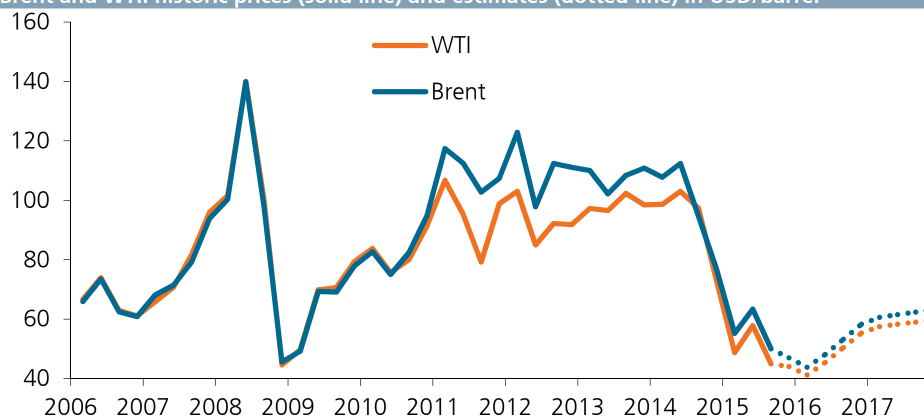
Source: Intesa Sanpaolo chart based on US Department of Energy data

Forecasts

Given current supply and demand fundamentals, we expect prices to be within the trading range in the first quarter of 2016, but we also expect high volatility, since the combination of policy makers' decisions, published output and consumption data, macroeconomic indicators in the major developed and emerging countries, and fluctuations in exchange rates, will fuel market swings between phases of excessive pessimism and cautious optimism.

We expect Brent and WTI oil to trade at an average of USD 44 and USD 41 a barrel respectively in the first quarter. For both of these, we forecast a moderate recovery in prices over the next year to a target of USD 60 for Brent and USD 57 for WTI at the end of 2016. The expectation of a moderate recovery is based on the forecast of a slow erosion of the current surplus, and could result in a market that is broadly balanced at the end of 2016.

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



Source: Intesa Sanpaolo elaborations on Bloomberg data; Intesa Sanpaolo estimates

Price estimates for Brent

at 09.12.2015	4Q15	1Q16	2Q16	3Q16	4Q16	2016	2017	2018
Estimate	47.0	44.0	48.0	53.0	58.0	50.9	62.0	70.0
Bloomberg median	50.0	51.0	55.0	59.5	60.0	56.0	62.5	70.0
Forwards	45.4	42.0	44.6	46.5	48.3	45.4	51.8	55.9

Source: Intesa Sanpaolo elaborations on Bloomberg data; Intesa Sanpaolo estimates

Price estimates for WTI

at 09.12.2015	4Q15	1Q16	2Q16	3Q16	4Q16	2016	2017	2018
Estimate	44.0	41.0	45.0	50.0	55.0	48.1	58.7	66.0
Bloomberg median	46.0	48.0	51.0	56.0	59.0	53.0	60.0	66.0
Forwards	42.6	40.5	42.6	44.1	45.5	43.2	48.3	51.9

Source: Intesa Sanpaolo elaborations on Bloomberg data; Intesa Sanpaolo estimates

United States: 2016, the year of monetary policy normalization

Giovanna Mossetti

After six years of moderate recovery, helped along by huge doses of monetary stimulus, the US economy is finally cured. The Fed has acknowledged this and begun the process of normalising monetary policy by hiking interest rates. The path will be long and slow: the US central bank is committed to modulating the withdrawal of stimulus based on changes in the figures, in an attempt to minimise the risk of a "hard" landing.

This recovery has taken more than six years. For the time being, there are no signs of recession approaching

This recovery, which has taken 73 months to date, has already far surpassed the average recovery time since World War II (58.4 months). Growth has been low on average, partly due to a series of negative shocks that have held back GDP growth in recent years: first fiscal policy (2011-13) and then the dollar (2014-15) have wiped around 1 percentage point off growth in every year. Even after six years of recovery, the assessment of the economy is positive and, for the time being, there are no apparent risks of a cyclical inversion. Unlike the advanced stages of the last two cycles, there are no clear imbalances in the current cycle presaging traumatic corrections. Household and business balance sheets are relatively healthy and free of excesses, the sharp correction in the energy sector will continue but has already made substantial progress, and federal and state finances are under control and should make a moderately positive contribution to growth in 2016.

The output gap has closed, there is full employment in the labour market and core inflation is close to 2%: the change in monetary policy is a welcome one

Growth in 2015 has been driven by services, on the back of domestic demand, while manufacturing has remained a hindrance due to the dollar and oil. This sectoral divergence is expected to continue to dominate in the first half of 2016, but then tail off, with services moderating further, construction growing and manufacturing attempting a recovery. Growth in 2016 should close the output gap for good, driving up nominal growth and the labour share of total income. In 2017-20, we expect the rate of growth to gradually slow towards 2.2-2.4%, which is still above potential (estimated at around 2%).

The Fed's policy change is positive, as it suggests that the economy is returning to normal after a long convalescence. Monetary policy is in uncharted waters (enormous central bank balance sheet, official interest rates at zero, neutral real interest rates at zero), resulting in volatility and problems determining the appropriate stance.

Recoveries do not die of old age: in the past, they have all been killed off by monetary policy, but this time the Fed is being especially vigilant

Our scenario depends on two underlying assumptions. 1) The Fed's economic policy will remain expansive and will tolerate moderate overshoots of maximum employment and inflation targets in 2016. 2) Oil prices, which are still held back by excess supply, and continuing dollar strength will help limit upside risks to inflation, despite moderate excess demand. Moreover, conditions in the global economy remain fragile, with many emerging economies in recession (including Russia and Brazil) and Asia still in an adjustment phase. Excess demand and the upturn in inflation will therefore be contained by exogenous factors, and are unlikely to trigger aggressive monetary tightening.

Upside and downside risks

Like any "Goldilocks" scenario, ours too is subject to risks. Excess demand and rising inflation could prompt the Fed to reduce monetary stimulus more rapidly than expected, causing a traumatic slowdown and potentially leading to recession, widespread volatility and instability in the global markets. Alternatively, a further correction in commodity prices and dollar appreciation due to weakness in the global cycle could cause US domestic demand to retreat, with only feeble and ineffective counteraction offered by a toothless monetary policy and a fiscal policy inhibited by ideological conflict and the presidential election campaign.

The implication is that either strong acceleration in US growth and/or inflation, or an "imported" slowdown from abroad, could be followed by weaker-than-forecast growth in the two-year period 2017-18; this would be hard to handle because of limitations on economic

policy in this phase of growth and structurally low interest rates. The greatest uncertainty in forecasting these "tail scenarios" lies in monetary conditions: lower rates of growth due to shocks during the course of adjustment might be accompanied by higher interest rates (in the case of higher-than-forecast excess domestic demand) or lower interest rates (if the global economy's weakness increases).

Consumption supported by balanced labour market and healthy balance sheets

In 2016, as in 2015, **growth is expected to be driven by final domestic demand. Consumption** should remain robust in 2016 (+2.6%), thanks to sound balance sheets, a balanced labour market and strong growth in real disposable income. The **labour market** is the basis for the 2016 forecasts; in our opinion, full employment is reached at the end of 2015. We expect total wages to increase thanks more to a moderate acceleration in wages than growth in the number of jobs; the latter (2% yoy in 2014-15) will slow to more sustainable levels, closer to +1.5%. We expect **employment to grow by around 120-150 thousand units** per month in the first half, taking the unemployment rate a few tenths of a point below 5%.

Another strong rise in residential investment in 2016...

Residential investment should rise moderately: supply has been curbed by high production costs and demand has been dampened by steep house prices and restrictive credit conditions for the lower income brackets, implying a shift towards renting. The sector should grow at a robust pace in 2016 (forecast at +7.7%, after 8.6% in 2015).

…moderate growth in non-residential investment

Non-residential fixed investment will remain hampered by the contraction in mining and the effects of the strong dollar on earnings: growth will also remain modest in 2016 (4.3% after 3.2% in 2015). Commercial structures are expected to pick up, growing by 3.4%.

...public spending increasing

Exports are expected to make a contribution just marginally negative, while **fiscal policy** should contribute positively (0.2 pp) due to increases widespread at the federal, state and local levels.

Watch out for inflation

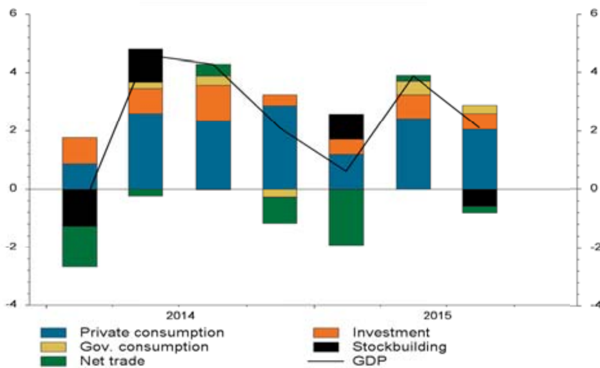
The trend in **inflation** will be a key factor in the outlook for 2016. Stabilisation of the dollar and oil at current levels will probably take **core inflation (measured with the deflator) close to 2% within a short time** and could result in an overshoot of the 2% target in the second half of the year and in 2017, due to excess demand. Our assessment is that the Fed will tolerate a limited overshoot, partly because prices are still below the level that would have been expected had the 2% target been met in the past 3 years. Within this scenario, **nominal growth could be between 4% and 5% in the next two years.**

Forecasts

	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (1996 US$,y/y)	2.4	2.5	2.6	2.9	2.7	2.2	2.2	2.7	2.4	2.5	2.7
q/q annual rate				0.6	3.9	2.1	2.2	2.5	2.8	2.7	2.8
Private consumption	2.7	3.1	2.9	1.7	3.6	3.0	2.8	2.8	2.8	2.7	2.7
Fixed investment - nonresid.	6.2	3.1	4.3	1.6	4.1	2.4	3.1	4.5	5.7	4.8	5.8
Fixed investment - residential	1.8	8.6	7.7	10.1	9.4	7.3	7.9	9.8	7.4	4.8	5.4
Government consumption	-0.6	0.8	1.0	-0.1	2.6	1.7	0.9	0.7	0.7	0.7	0.7
Export	3.4	1.5	3.6	-6.0	5.1	0.9	4.0	3.2	3.5	5.0	5.1
Import	3.8	5.2	4.0	7.1	3.0	2.1	3.9	4.2	4.5	4.7	4.9
Stockbuilding (% contrib. to GDP)	0.0	0.2	-0.3	0.2	0.0	-0.1	-0.2	-0.1	0.0	0.0	0.0
Current account (% of GDP)	-2.2	-2.5	-2.3	-2.7	-2.5	-2.5	-2.5	-2.3	-2.4	-2.4	-2.4
Federal Deficit (% of GDP)	-3.9	-3.5	-3.4								
Gov. Debt (% of GDP)	123.3	123.3	122.2								
CPI (y/y)	1.6	0.1	1.7	-0.1	0.0	0.1	0.3	1.2	1.5	1.8	2.1
Industrial production (y/y)	3.7	1.4	1.8	-0.4	-2.2	1.8	0.1	2.5	2.6	3.2	3.5
Unemployment (%)	6.2	5.3	4.8	5.6	5.4	5.2	5.0	4.9	4.8	4.8	4.7
Fed Funds	0.25	0.27	0.90	0.25	0.25	0.25	0.33	0.54	0.79	1.02	1.25
Effective exch.rate (1973=100)	78.6	91.0	93.0	89.4	89.9	91.7	92.9	95.3	93.9	92.2	90.5

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

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

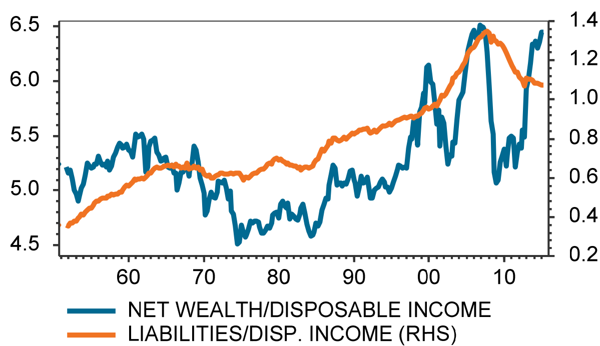


Source: Thomson Reuters-Datastream

Fig. 2 – ISM indices: manufacturing weak, services solid

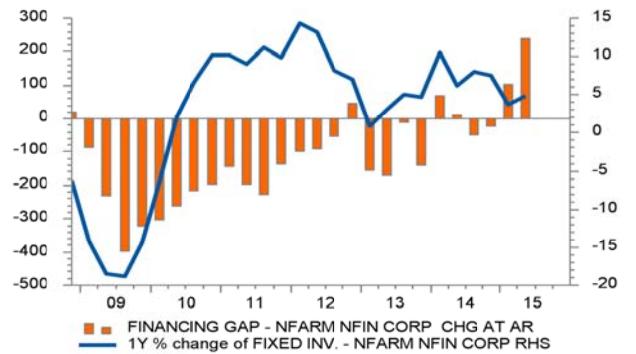
Source: Thomson Reuters-Datastream

Fig. 3 – Household net wealth rising, liabilities falling



Source: Thomson Reuters-Datastream

Fig. 4 – Businesses have funds available to finance new investments

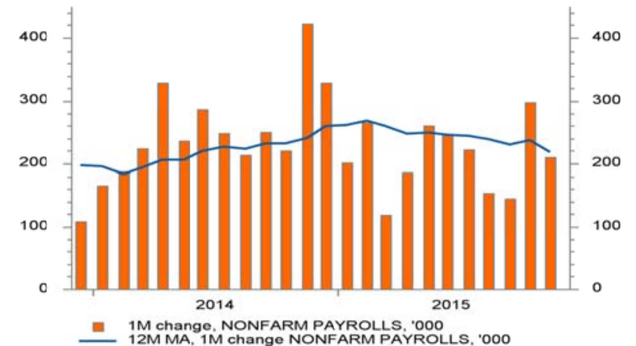


NB: figures in millions. Source: Thomson Reuters-Datastream

Fig. 5 – Labour market conditions continue to improve

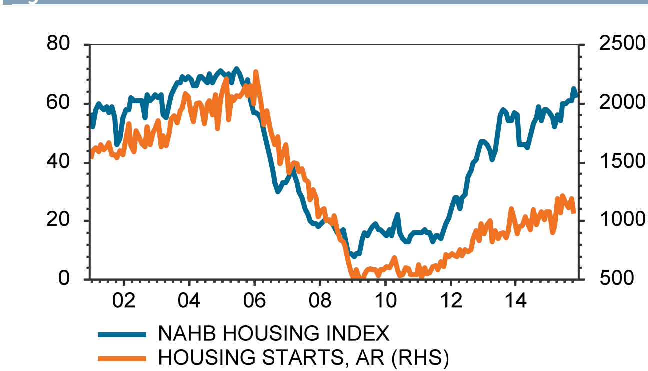
Source: Thomson Reuters-Datastream

Fig. 6 – Employment still rising by more than 200,000 units per month



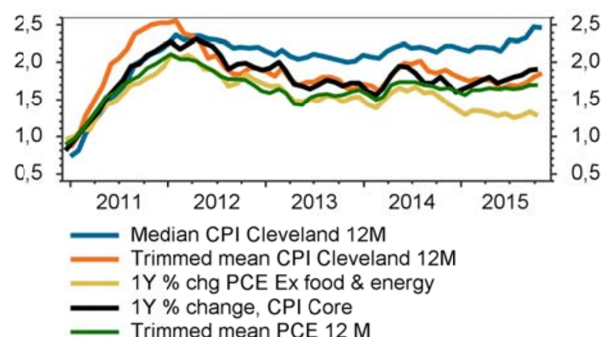
Source: Thomson Reuters-Datastream

Fig. 7 – New starts and home builders' confidence



Source: Thomson Reuters-Datastream

Fig. 8 – Inflation: 2% is already here

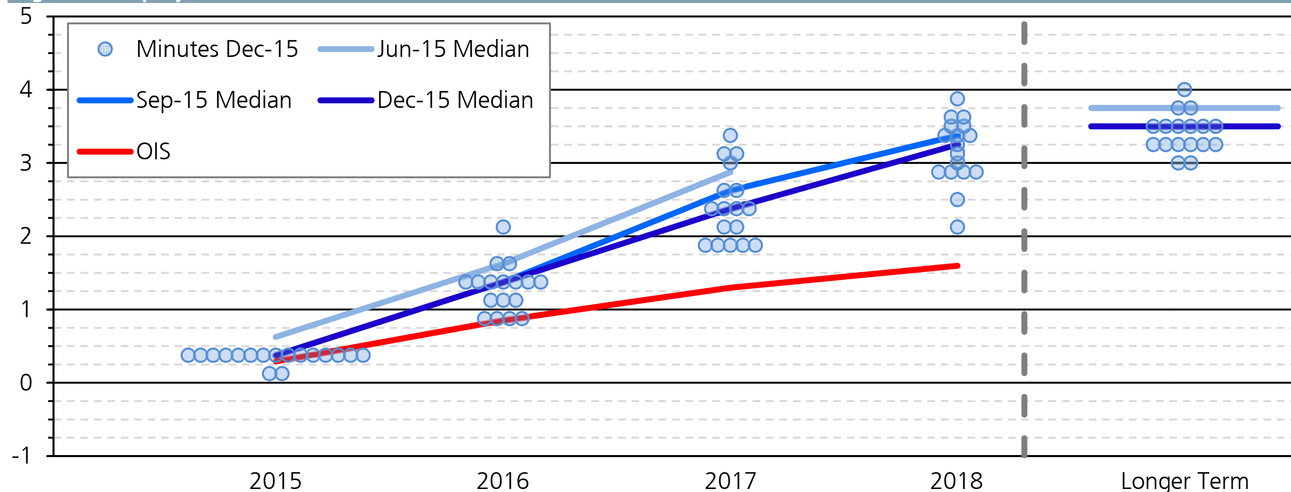


Source: Census Bureau

FOMC meeting – New course in uncharted waters

- **The FOMC unanimously voted to raise the target range for the fed funds rate by 25 bps**, to 0.25-0.50%, and indicated it intends to maintain its policy of reinvesting maturing securities, until the normalisation of rates is "well under way". The Fed intends to remove stimulus by hiking rates, while it determines the desired size of its balance sheet in the new monetary policy regime. The operational details of the reversal are described in a separate implementation note.
- The Committee acknowledged a further improvement in labour market conditions this year, and is "reasonably confident" that inflation will rise towards 2% in the medium term.
- The liftoff takes place with the assessment of **"balanced" risks** and **accommodative monetary policy even after the decision** on rates.
- The timing and size of the **adjustments will depend on "realised and expected economic conditions** relative to the two objectives" of the Fed's mandate. In particular, however, given the distance from the inflation target, the Fed stresses that it will **"monitor both actual and expected progress" towards the inflation target**.
- The FOMC's forecast is that the economic conditions will evolve in such a way as to determine **"only gradual" increases of the fed funds rate**, which should stay below the longer run level "for some time". However, the statement stresses that "the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data".
- The outcome of the meeting was mostly **in line with expectations:** rate increases will probably be gradual and data-dependent, with focus on inflation, and no "mechanical" guidance. The dot plot was mostly unchanged, with only a moderate downward revision to the level at the end of 2017, and all other levels unchanged. However, there is greater convergence in the dot plot as a whole, with the hawks more aligned at the centre.
- The Fed's projections remain higher than the market's: the expected path of inflation, and the extension of reinvestments, lead us to predict 3-4 hikes in 2016, in line with the FOMC's indications.

Fig. 1 – Rate projections: the Fed and the markets still hold different views



Source: Bloomberg

Tab. 1 – Projections of Federal Reserve Governors and Reserve Bank Presidents – December 2015

Variable	Median					Central tendency				
	2015	2016	2017	2018	Longer run	2015	2016	2017	2018	Longer run
Real GDP	2.1	2.4	2.2	2.0	2.0	2.1	2.3-2.5	2.0-2.3	1.8-2.2	1.8-2.2
September projection	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
Unemployment rate	5.0	4.7	4.7	4.7	4.9	5.0	4.6-4.8	4.6-4.8	4.6-5.0	4.8-5.0
September projection	5.0	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
PCE deflator	0.4	1.6	1.9	2-0	2.0	0.4	1.2-1.7	1.8-2.0	1.9-2.0	2.0
September projection	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
Core deflator	1.3	1.6	1.9	2.0		1.3	1.5-1.7	1.7-2.0	1.9-2.0	
September projection	1.4	1.7	1.9	2.0		1.3-1.4	1.5-1.8	1.8-2.0	1.9-2.0	
Memorandum:										
Projection of appropriate rate path										
Fed funds rate	0.4	1.4	2.4	3.3	3.5	0.4	0.9-1.4	1.9-3.0	2.9-3.5	3.3-3.5
September projection	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

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

Euro Area: the recovery continues, risks are mostly political

Anna Maria Grimaldi

- We expect the euro area to grow by 1.7% in 2016-17, accelerating from 1.5% in 2015. Above-trend growth is still being fuelled by a mix of positive external shocks, such as low oil prices, the weak exchange rate, and accommodative economic policies.
- In 2015, GDP growth was boosted by the acceleration in the periphery, mostly by Spain and Ireland, which should have now past the peak. In 2016, growth should pick up in Italy (to 1.2% from 0.7% in 2015). In Germany, GDP will progress at 2.0%, from 1.7% in 2015, whereas the recovery in France is still struggling to take off.
- On the forecasting horizon, growth will still be driven by domestic demand more than by net exports. After the surge in private consumption, 2016 should see a stronger contribution from investment, which so far grew less than in previous recoveries.
- Risks to euro area growth are more balanced. The international trade slowdown likely bottomed out. Lower oil prices, together with accommodative monetary and fiscal policies should contribute to the normalization of the recovery. The main risks are now political. After the populist drift in Portugal and France, protest movements main gain consensus in Spain at the 20 December general election. 2016, will be a challenging year for member states' ability to cooperate on immigration and to manage European borders. The political scenario will be shaped by the geopolitical uncertainty after the tragic terrorist attacks in Paris.
- The downward surprises in oil prices will limit the rise of inflation to 0.9% in 2016 and to 1.5% in 2017. Risks are still on the downside, due to the uncertain trajectory of oil prices.
- Fiscal policy will be slightly expansionary in 2016, on the back of higher spending to face the unprecedented inflow of refugees. Furthermore, given the delicate political juncture, the Commission will likely let member states the utmost flexibility in managing public finances.
- The markets reacted badly to the ECB's announcement on December 3. Yet, we think the package is quite significant, as it extends the accommodative stance for a very long time, and in any case until inflation returns to target. Moreover, the official statement did not rule out new measures, if needed. In early 2016, the ECB will remain vigilant to assess the evolution of data and will resort to communication to buffer the damage caused by markets 'delusion. In March, the first estimates for 2018 will send a signal on the probability of new moves in 2016.

Forecasts

	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	0.9	1.5	1.7	1.3	1.6	1.6	1.6	1.6	1.6	1.8	1.8
- q/q change				0.5	0.4	0.3	0.4	0.5	0.4	0.5	0.4
Private consumption	0.8	1.7	1.9	0.5	0.3	0.4	0.4	0.5	0.5	0.5	0.4
Fixed investment	1.3	2.4	3.6	1.5	0.1	0.0	1.1	1.1	1.0	1.1	1.0
Government consumption	0.8	1.6	2.6	0.5	0.3	0.6	0.9	0.7	0.6	0.6	0.6
Export	4.1	4.8	4.2	1.3	1.6	0.2	0.8	1.4	1.1	1.1	1.1
Import	4.5	5.3	5.1	1.9	0.9	0.9	1.2	1.5	1.6	0.9	1.1
Stockbuilding (% contrib. to GDP)	0.0	-0.2	-0.4	0.1	-0.2	0.2	-0.1	-0.2	-0.1	-0.3	-0.2
Current account (% of GDP)	3.0	3.7	3.5	3.2	3.1	3.3	3.0	3.7	3.5	3.3	3.2
Deficit (% of GDP)	-2.6	-2.1	-2.0								
Debt (% of GDP)	94.5	94.0	92.8								
CPI (y/y)	0.4	0.1	0.9	-0.3	0.2	0.1	0.2	0.7	0.7	0.9	1.4
Industrial production (y/y)	0.8	1.4	1.6	1.1	-0.1	0.2	0.3	0.2	0.9	0.8	0.3
Unemployment (%)	11.6	11.0	10.5	11.2	11.0	10.8	10.8	10.7	10.6	10.5	10.3
3-month Euribor	0.21	-0.02	-0.21	0.05	-0.01	-0.03	-0.09	-0.20	-0.21	-0.21	-0.22
EUR/USD	1.33	1.11	1.09	1.13	1.10	1.11	1.09	1.06	1.07	1.10	1.12

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

Domestic demand in the driving seat. Risks more balanced

The Euro zone's recovery, above potential (1.0% in the European Commission's latest estimates), is expected to continue in 2016, with GDP set to grow by 1.7%; this is a slight acceleration from 1.5% in 2015. Growth should continue at the same pace in 2017. After falling in August and September, the European Commission's economic confidence indices and the composite PMI recovered in the autumn, signalling a pickup in GDP growth at year-end to around 0.4% qoq from +0.3% qoq in the summer (see fig.1), due to the brake on global demand and exports (see fig. 2). October's industrial output figures (+0.6% mom) suggest that the worst is over for the industry sector. The recovery continues to be driven more by services than by manufacturing. A breakdown of the confidence surveys by sector shows an improvement in orders and expectations for the next few months in services, the retail trade and construction, sectors that are more closely linked to domestic demand (see fig. 3). GDP growth continues to be bolstered by a combination of positive external shocks and accommodative economic policies. External factors supporting growth are:

1) a recovery in global demand for Euro zone goods (4.4% after standstill in 2015);

2) a broadly stable effective exchange rate in 2016, after a 9% fall in 2015. The effect of currency depreciation filters through to exports with a 12-18 month lag, so we expect a residual effect on Euro zone GDP growth of at least +0.2%;

3) a further fall in the price of crude oil in 2016, after -47% drop in 2015, which should generate additional savings of at least 0.1% of disposable income (on top of 0.6% in 2015). However, given the current level of consumer prices, further falls in oil prices will be transmitted to domestic prices to a lesser extent, since the application of excise duties is not related to the price.

Growth will also be supported up by more accommodative economic policies.

1) Specifically, fiscal policy will become moderately expansive again. The increase in spending to tackle the unprecedented (one million in Germany alone) flow of migrants should amount to around 0.2% of GDP. In Germany alone, the increase could be at least EUR 7Bn a year (0.3% of GDP) in 2015-2017. The European Commission[1] estimates that higher spending will have a +0.1% impact on GDP growth. To this must be added the effect on public balances of the moderately expansionary measures set out in the budget laws in Germany and, to a lesser extent, in Italy and Spain. Overall, we estimate that the euro area structural balance will worsen by 0.35% of GDP (see fig.12) after remaining unchanged in 2015. The impact on growth should be of 0.2%. But we do not rule that, *ex post*, fiscal policy could prove even more expansionary. In the current political climate, it is possible that the Commission will continue to give member countries a high degree of flexibility in managing their public finances;

2) The unconventional monetary policy measures adopted by the ECB since June 2014 have helped to (i) reduce interest rates on loans to households (falls of around 80 basis points since June 2014; 140 basis points in the peripheral countries); (ii) normalise the monetary policy transmission mechanism (narrowing the spreads between rates on corporate loans in core countries and peripheral countries); and (iii) create more accommodative lending and financial conditions. Despite the markets' disappointment, we think the package of measures announced in December is significant. The ECB estimates that the measures adopted between June 2014 and December 2015 will push Euro zone growth up to around 1.0% in 2015-2017 and inflation to around 0.5% in 2016 and 0.25% in 2017[2].

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[1] See European Commission's Autumn 2015 Forecast, Box 1.1, pp 48-52.
[2] See ECB, December 2015. Introductory statement to the press conference (Q&A section).

Overall, the combination of external factors and accommodative economic policies should boost Euro zone GDP growth to 1.7%, well above the European Commission's estimates of potential growth of around 1.0% next year.

Growth over the forecast horizon will still be driven by domestic demand, while foreign trade should weigh for 0.2%. Exports are expected to grow by 4.2% in 2016, after 4.8% in 2015, while imports will increase by 5.1%. Domestic demand should accelerate to 1.9%, from 1.5% in 2015. Household consumption was the driver of GDP growth (+1.7%, from +0.8% in 2014), accelerating especially in Spain, Germany and France (see fig. 4). In 2016, it is expected to grow by 1.9%, with support continuing to come from falling oil prices (see fig.5), more expansionary financial and lending conditions, a gradual improvement in employment (+1.1% in 2016, from 0.8% in 2015) and wages growth of 1.8%, after +2.3%[3] (see fig.6). But households' purchasing power will be partly eroded by inflation rising from 0.1% in 2015 to 0.9% in 2016. Real labour income will slow from 2.2% in 2015 to 1.6%; as a result, the savings rate is expected to fall from 12.9% this year to 12.5% in 2016. Whereas consumers were the main players in the recovery in 2015, investment in machinery is the weakest link: it grew by 0.7% qoq in the first nine months of 2015 (3.5% on average in 2015), less than in 2014 (quarterly average of 0.9% qoq) and, as it is well known, less than in previous cyclical recoveries. Increased plant capacity utilisation, together with improved profit margins (see fig. 9) and amply supportive financial conditions, should stimulate investment over the forecast horizon, although the deleveraging process could act as a brake (see fig.10). However, an ECB survey of 73 large firms on barriers to investment in machinery[4] revealed that the main impediments to investment in the Euro zone (see fig. 10) are the lack of current and future demand. One of the main reasons for companies to invest outside the Euro zone is the uncertainty about the Euro zone's economic policies and, particularly, labour market policies. It is possible, therefore, that the capex cycle will remain weak compared with previous recovery phases. We expect machinery investment to grow on average by 3.3% in 2016, from 3.6% this year[5]. Construction investment should pick up pace (1.2%, after 0.7%), boosted by expansionary financial conditions and very positive fundamentals in Germany and the Netherlands.

Risks to the scenario seem more balanced than in September. The slowdown in international trade should now be over. In any case, lower oil prices and more accommodative economic policies should help consolidate the recovery. The main risks to the scenario are now political. After the drift towards populist positions in Portugal and France, Spain's political framework is also set to fragment further after following the general elections on 20 December (see Spain section). The Irish elections in early 2016 are unlikely to be a big risk since the outgoing party will probably be re-elected. Moreover, 2016 will be a test year for the European Union on its ability to manage the tensions relating to migrant flows.

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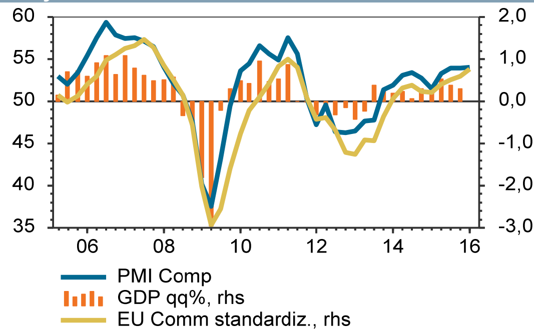
[3] At the moment, the upturn in contractual wages is due almost entirely to Germany.

[4] See Box 2 of the Economic Bulletin, December 2015: "*What is behind the low investment in the euro area? Responses from a survey of large euro area firms*"

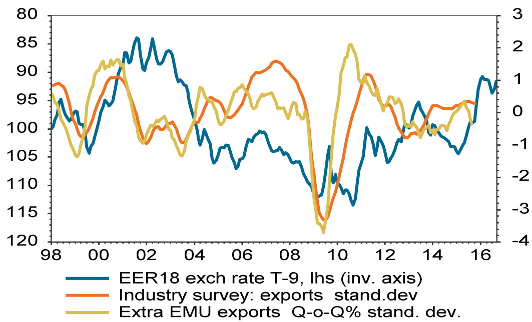
[5] The weak end to 2015 undermines the annual trend.

Fig 1 – Confidence surveys consistent with an upturn in GDP from the year-end



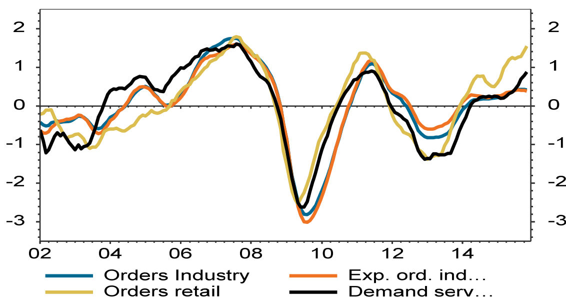
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 2 – The worst should be over for exports



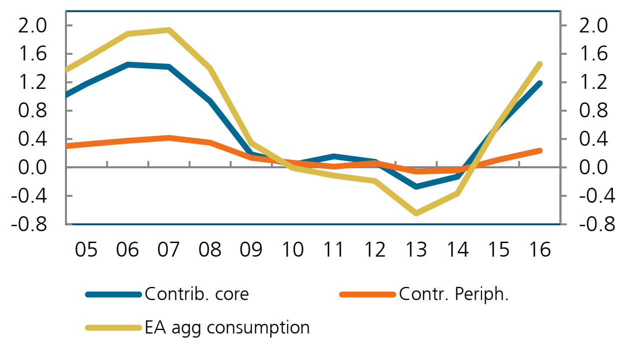
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 3 – The recovery is still driven more by services and trade



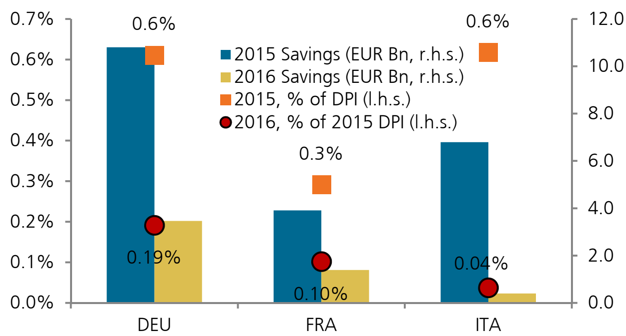
NB: the series show standard deviation from the MLT. Six-month moving averages.
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig. 4 – Private consumption in full swing



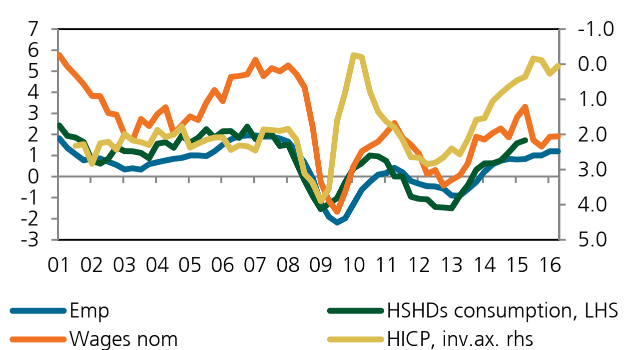
Data are aggregated using GDP weights
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 5 – Lower oil prices to boost households' disposable income



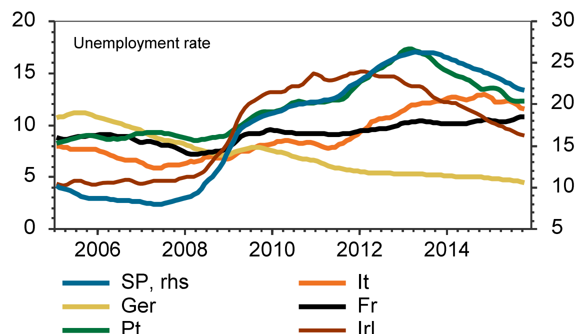
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 6 – Wages and employment provide support



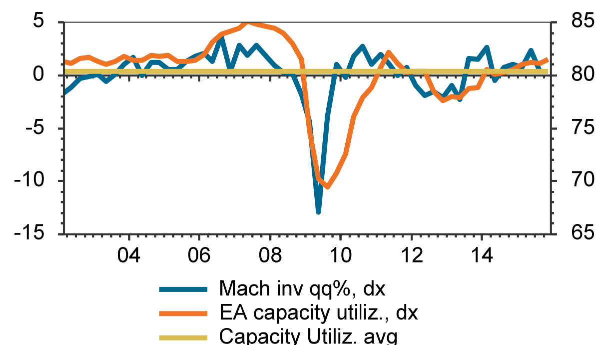
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig. 7 – Employment falling more or less everywhere



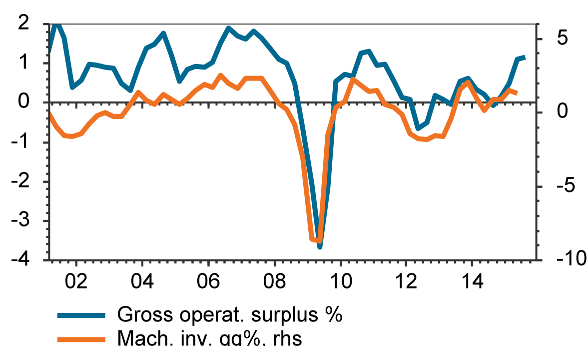
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig. 8 – A livelier investment cycle ahead?



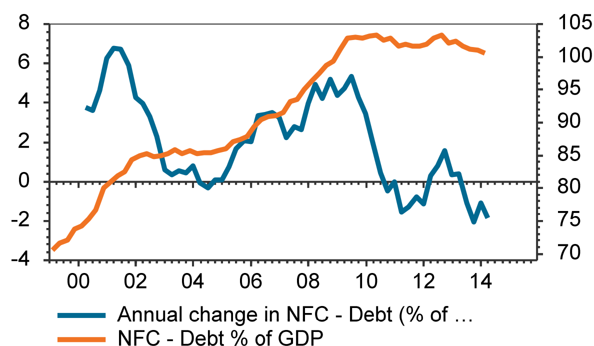
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 9 – Earnings trend should provide support…



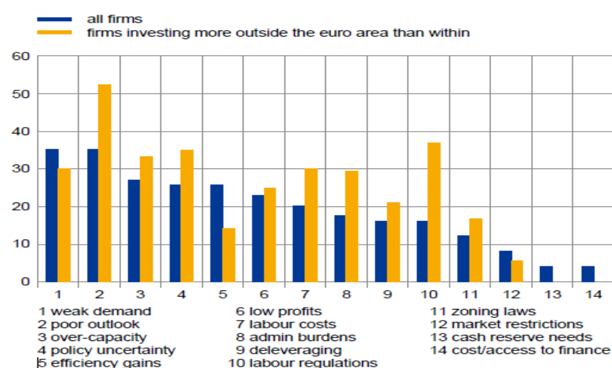
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 10 – …but high corporate debt (compared with the pre-crisis period) could weigh on growth despite supportive financial conditions



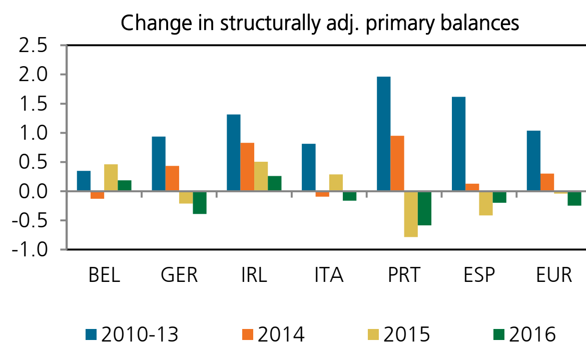
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig 11 – Lack of demand and uncertainty over reforms are the largest brakes on investment



Source: ECB specific survey on investment, Box 2, Economic Bulletin, December 2015

Fig 12 – Fiscal policy to turn expansionary in 2016



Source: Intesa Sanpaolo chart based on European Commission (AMECO November 2015) data

Inflation: the return to target moves beyond 2017

Compared with three months ago, we have cut our inflation forecasts to 0.9% (from 1.2% in 2016), and from 1.6% to 1.5% in 2017. The continuous downgrades are largely due to the continuous fall of oil prices, now at their lowest since 2009, and the subsequent adjustments to the crude oil price forecast. In 2016, we expect an oil price of USD 50 per barrel, which is still 5% lower than in 2015, and more than 10% lower than forecast in September. For 2017, we continue to expect that the price will rise as far as USD 60 per barrel. The forecast euro/dollar exchange rate is broadly unchanged from three months ago: 1.09 on average in 2016 and up to 1.17 on average in 2017[6].

The new oil price profile (in euro) significantly reduces the statistical effect of the support from energy on overall inflation, both around the new year and between February and June 2016 (see Fig. 1). With energy making virtually no contribution from March 2016, the focus shifts to core inflation (see Fig. 2), and on how quickly domestic prices will respond to the past depreciation of the exchange rate and the closing output gap. We forecast core inflation to increase to 1.6% in 2017, from +0.8% on average in 2015. The depreciation of the exchange rate has already been fully transferred to import prices, but it will still take six to nine months for the residual effect (+0.25%)[7] to filter through to consumer prices (see Figs. 2 and 3). Lower excess supply is likely to contribute by around 0.3% over two years (see Fig. 5). the output gap will nevertheless remain in negative territory until the end of 2017 (-0.4% from -1.8% estimated by the European Commission for 2015). In addition, there are no pressures from unit labour costs, mainly because growth in contractual wages will remain modest. Moreover, GDP will grow more than employment over the forecast horizon, which implies productivity growth will still be positive , and therefore still low unit labour costs (0.8% in 2016 and 1.1% in 2017).

Our estimates are in line with the ECB staff's December forecasts. However, the OPEC meeting in December triggered a correction in futures oil prices, which, if incorporated today, would probably push ECB inflation forecasts downwards. The statement following the meeting of 3 December assessed the measures announced to be adequate to bring inflation back to target, and did not make any explicit reference to downside risks for inflation. Draghi indicated that ECB's staff estimates that QE will push up inflation by 0.5% in 2016 and by 0.3% in 2017.

In our view, although mitigated by ECB measures, the risks for inflation are still to the downside, given the uncertainty of crude oil prices. The Central Bank is unlikely to react to price fluctuations triggered by generally temporary variations in the volatile components. However, there is a risk that, with oil prices remaining at low levels for an extended period, inflation expectations will deviate from levels consistent with price stability in the medium term, triggering dangerous second-round effects. The ECB cannot therefore let its guard down.

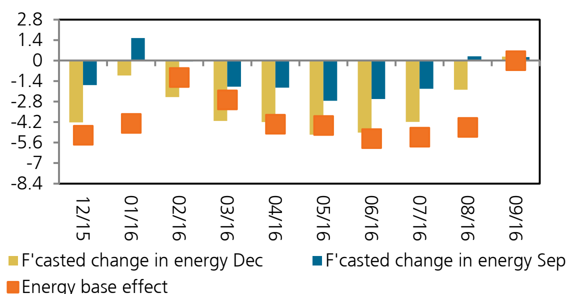
Tab. 1 - Inflation forecasts by country and Euro zone average with new oil and exchange rate estimates

	CYP	FIN	ESP	IRL	ITA	EA	PRT	NLD	DEU	MLT	AUT	BEL
2014	-0.3	1.2	-0.2	0.3	0.2	0.4	-0.2	0.3	0.8	0.8	1.5	0.5
2015e	-1.6	-0.1	-0.6	0.0	0.1	0.1	0.5	0.2	0.2	1.2	0.8	0.6
2016e	-0.2	0.7	0.7	0.8	0.9	0.9	1.1	1.1	1.3	1.4	1.6	1.7
2017e	1.0	1.0	1.7	1.8	1.7	1.5	1.5	1.8	1.8	2.1	2.0	1.5

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

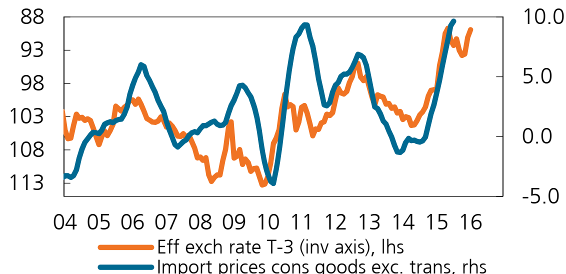
[6] The standard elasticities derived from ECB and European Commission models suggests that the effect of a 5% fall in the price of crude oil on headline inflation is between -0.15% and -0.3% after four quarters.
[7] Standard elasticities suggest that a depreciation of 5% in the exchange rate translates into an increase of 0.3% in inflation on average after two years.

Fig. 1 – With the new oil price forecasts, energy will continue to dampen overall inflation in 2016



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 – The depreciation of the exchange rate has fully transferred to import prices…

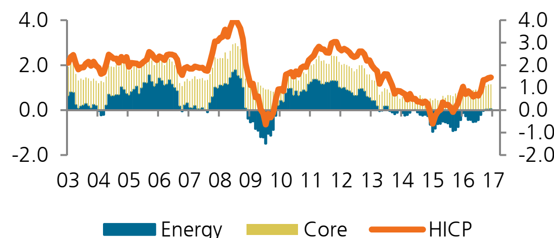


Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 3 – … but it will take a few more months for the increase in import prices to be fully transmitted to consumer prices

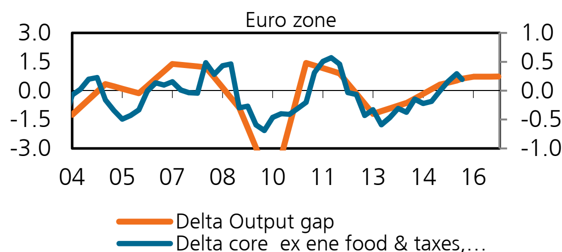
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – From April 2016, the rise in inflation towards 1.5% will depend on the core price trend…



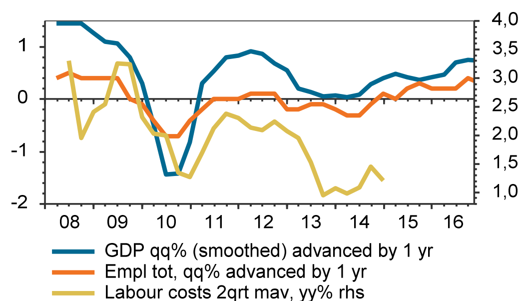
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 5 – Focus will shift to the response of domestic prices to the reduced slack in the economy



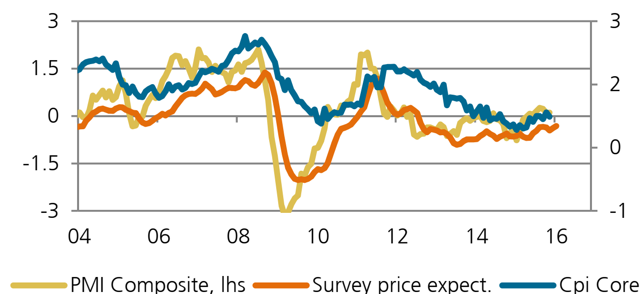
Source: OECD (output gap), Intesa Sanpaolo chart based on Eurostat data

Fig. 6 – Limited pressures from unit labour costs as productivity growth (output minus employment) will stay positive in 2016



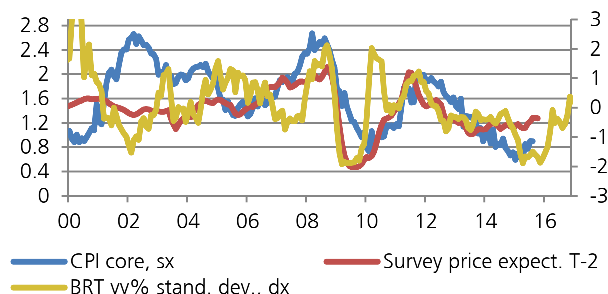
Source: Intesa Sanpaolo chart based on Eurostat data

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 projected rise in oil prices should limit downward pressures on domestic prices



Source: Intesa Sanpaolo chart based on European Commission and Eurostat data

ECB: in easing bias for the foreseeable future

At the December's meeting, ECB increased monetary stimulus in order to support the return of inflation towards 2% in the medium term. The new ECB measures disappointed markets, which expected a cut in the deposit rate of more than 10 basis points and an increase in the monthly purchase target, and not just the extension of the APP to March 2017. The package announced by the ECB has in fact tightened financial conditions, at least for now. The EURIBOR curve factors in yields that are 10 basis points higher on 1-12 month maturities compared with the day before the meeting (see Fig. 1). The exchange rate has strengthened by 5%, and government bond yield curves have seen rises of more than 10 basis points on average on the 5-10 year segment (see Fig. 2). There has clearly been a communication mistake, as recognised by Executive Board members Yves Mersch and Peter Praet on 10 December. Both Praet and Mersch have tried to limit the damage caused by the disappointment following the meeting, focusing on the decision to reinvest maturing securities, rather than on the fact that the central bank did not increase the monthly target. On 14 December, Mario Draghi also reiterated that the ECB was willing to do more, if necessary, but added that he believes that the announced package of measures will be sufficient to bring inflation back towards the target "without undue delay".

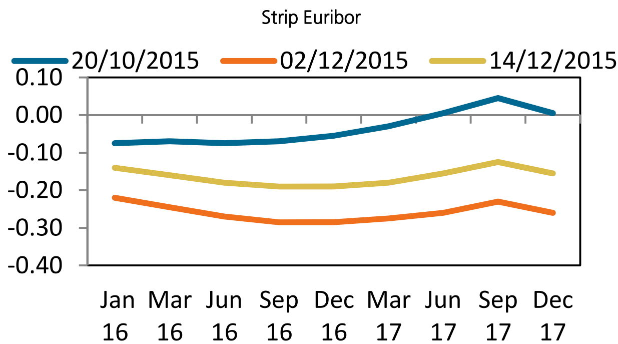
Unlike the markets, we believe that the package of measures significantly strengthens the degree of monetary stimulus, and will help normalise the recovery and inflation in the medium term. Although a new end date for the securities purchase programme has been set, the ECB's QE is in fact open-ended, given that it will remain in place "until inflation reaches the ECB's target of below or close to 2%". The extension of the asset purchase programme by EUR 60Bn a month until March 2017 together with the policy of reinvesting maturing bonds will lead to a much more significant balance sheet expansion (EUR 360Bn between October 2016 and March 2017 alone, plus repurchases) compared with the increase in the monthly target of EUR 10-15Bn for six months (EUR 90Bn a month). Furthermore, the extension of full allocation until the end of 2017 on ordinary refinancing operations suggests that the market rate is the deposit rate, and in principle, suggests that rates will remain low for a "very, very long time", as Draghi stated. Furthermore, there is nothing in the December introductory statement read by Draghi and his responses that rules out the possibility of new expansionary measures in the future, should the situation so require.

We believe that after the December's measures, the ECB will remain vigilant for a long time. However, we await the March forecasts on growth and inflation in 2018 for more complete information on the effect of the measures in the medium term and possible clues about new moves in 2016. A further increase in monetary policy stimulus is still, however, dependent on a medium-term inflation forecast that is a long way from the 2% target. As of today, our forecasts incorporate an inflation estimate of 1.7% at the end of 2018. ECB moves will also depend on trends in financial conditions and the exchange rate following the Fed's rate announcement.

If the ECB decides to intervene, it may still cut the deposit rate to guide market rates in the shorter term. On 10 December, Mersch clarified that "the ECB has not decided that the lower limit on interest rates has been reached", while Draghi made no comment in this regard during the press conference. The markets are pricing in a further cut to the deposit rate, with a probability of around 50% for end-2016. It seems reasonable to believe that if the ECB were to cut the deposit rate, it would be unlikely to do so in the near future, since it will want to see how the euro reacts to the start of the Fed rate hike cycle.

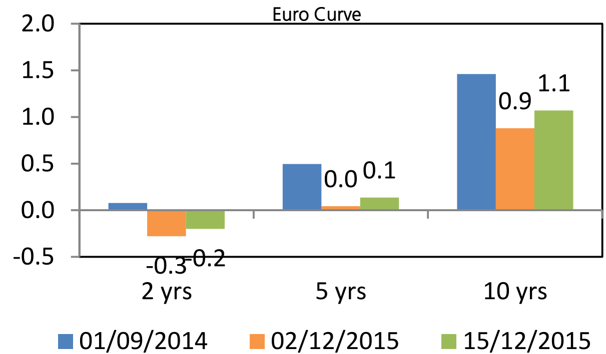
We think it rather unlikely that tweaks will be made to the monthly volume of purchases, given the emphasis on the importance of the reinvestment policy and possible supply shortage of bonds available for purchase on the secondary market.

Fig. 1 – The ECB's announcement in December triggered a rise in money market rates and …



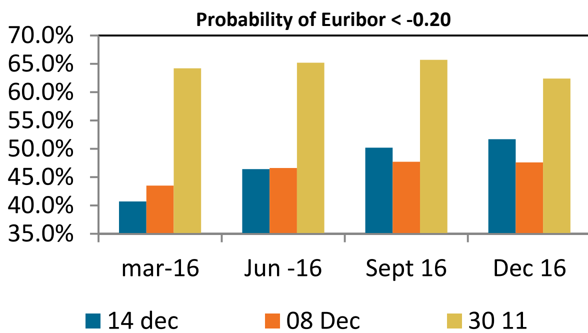
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 2 – …a sell-off on the 5-10 year government bond segment



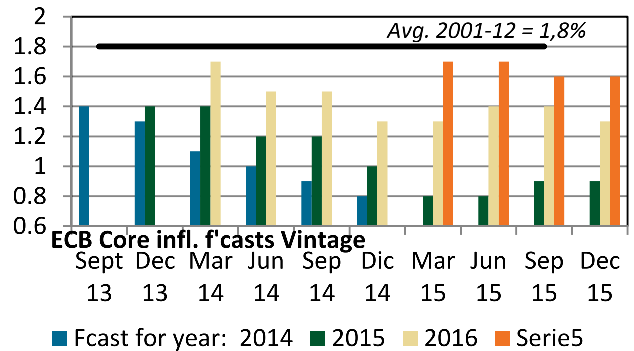
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 3 – For now, the markets are not pricing in further moves on deposit rates



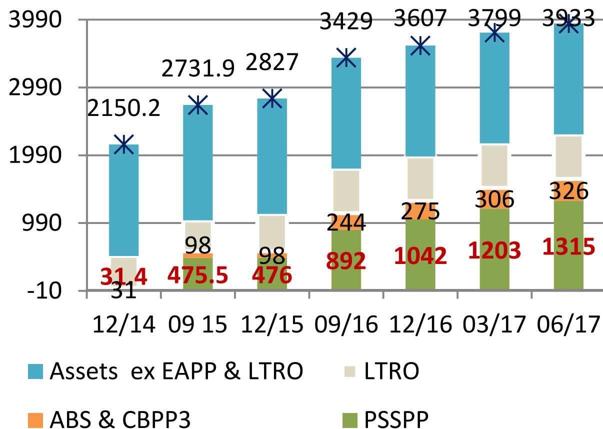
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 4 – Any ECB moves still dependent on medium-term inflation forecasts



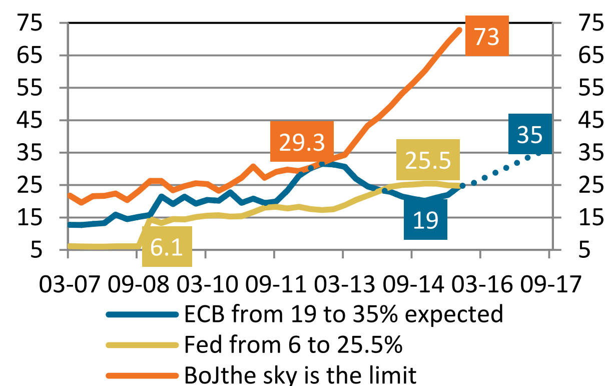
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 4 – The ECB balance sheet could exceed EUR 4Trn by June 2017…



Source: Intesa Sanpaolo chart based on 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: above trend growth continues

Anna Maria Grimaldi

Since late August, concerns mounted on the impact on the German economy, first of the slowdown in international trade, then the unprecedented inflow of refugees, and then of the Volkswagen scandal. Yet, we think that the phase of above trend (1.3% according to the Bundesbank's most recent estimates[8]) expansion may continue in 2016 for the third year in a row, on the back of domestic demand and consumer spending in particular, and a more buoyant cycle for investment in machinery, if exports resume growing at more sustained levels. Moreover, the increase in public spending (0.75% of GDP in cumulative terms in 2015-17, according to Bundesbank estimates) to accommodate at least 2.4 million refugees in 2015-17, is set to contribute by +0.2% to GDP growth in 2016, and +0.1% in 2017. Compared with three months ago, we confirm our growth forecast of 1.5% in 2015, but we have revised up our 2016-17 forecast by a tenth of a point to 1.9%. Net of calendar effects, growth is seen at 1.7% in 2015, 2.0% in 2016 and 1.7% in 2017. The risks to the growth outlook are broadly balanced, as the more expansionary fiscal policy should partly offset the potential effect on domestic demand of the high degree of geopolitical uncertainty and possible lower than expected growth in foreign demand.

2016 will be the third year of above trend growth. In addition to oil, exchange rates and more than expansionary financial conditions comes the impetus from fiscal policy

Short-term outlook. After the summer drop, the IFO and PMI economic surveys have returned to levels (respectively to 108.6 from 108.3, and 54.7 from 54.2 in 3Q) consistent with GDP growth of 0.4% qoq, versus +0.3% qoq in the third quarter. The upturn in confidence indices is due to greater optimism for the future in all sectors. Surveys show a sustained trend in orders in services, trade and construction, which are more closely connected to the trend in domestic demand. The improvement in business confidence in manufacturing remains, for the time being merely prospective, while demand indicators failed to rise significantly above historical average. Manufactured goods orders returned into positive territory in October (+1.8% mom), but so far the increase is just enough to offset the decline recorded in the summer (-2.7% qoq). Manufacturing output grew by 0.7% mom in October, but the quarterly dynamics I still impaired by the declines recorded in August and September, on the back of the slowdown in international trade and unusual calendar factors[9]. Up to October, the Volkswagen scandal had a limited impact on auto industry output, which grew by 3.5% mom on a monthly basis (after falling 4.0% mom in the two previous months), while car registrations also held up in October. Furthermore, IFO indices for the automotive sector remain well above the long-term average. A hypothetical fall of 5% in car production at VW (which accounts for 4.6% of manufacturing output) could trim 0.1% from value added. If we take into account the effect of the automotive industry on related activities (5.5% of value added for distribution alone), the effect rises to 0.2%. (For details, see the *Weekly Economic Monitor* of 2 October 2015). Manufacturing activity is expected to be supported by a gradual upturn in exports, owing to the euro's depreciation and the recovery in world trade directed to Germany (4.6% in 2016-17, from 2.2% in 2015). Net exports contribution is expected to weigh on GDP growth in 2016 (-0.1%, from +0.2% in 2015), as imports should grow more than exports, given the high import content of consumer spending and investment. As a result, the trade surplus will likely remain at high levels over the forecast horizon, at 8.3% in 2016, from 8.5% projected for 2015.

After the summer slowdown, GDP should start to pick up, as early as year-end

Growth still driven by domestic demand

[8] In December, the Bundesbank revised up its potential GDP growth estimate by one tenth of a point, owing to the effect of the huge influx of refugees on workforce trends and indirectly on output growth and fixed capital formation. The spread between demand and aggregate supply, already positive in 2015, is expected to continue to widen. The production capacity utilisation rate should further increase compared with the long-term average, stimulating company investment.

[9] The lower number of working days than usual, relating to the school calendar, weighed on industrial output figures for August

A more buoyant cycle ahead for investment in machinery?

Domestic demand will continue to outperform foreign trade in 2016. We expect an upturn to 2.4%, from 1.9% this year. After the surge in consumer spending this year (+1.9% after +1.0% in 2014), next year, we expect a more significant contribution from investment in machinery (3.6% after +3.2%). In the summer, company investment was held back by the slowdown in orders from abroad and industrial output, but given the high plant capacity utilisation and companies' solid financial positions, it is reasonable to expect spending to pick up in 2016. However, geopolitical uncertainty remains a risk for plant expansion decisions. The slowdown in residential construction in mid-2015 is likely to have been only a pause. Fundamentals remain amply supportive: confidence is at its highest since 1991, and orders and permits shot up at the beginning of the autumn to levels consistent with growth of at least 1.0% qoq a quarter, over the next six months. According to the Bundesbank, the huge influx of refugees will have an impact on demand for accommodation in the medium term, since in the short term, new comers will be housed in dedicated public facilities. Further support to GDP growth will come from the upturn in public consumption (at an average of 3.2% in 2016-17), associated with the increase in spending and public transfers on refugees and migrants. Household consumption is expected to grow by 2.1% in 2016 (from +1.9% this year), a rate that has not been seen since the end of the 1990s, owing to the fall in oil prices (-46% in 2015, -5% in 2016), highly expansionary financial conditions, the lower tax burden and the resilience of real income from employment (1.8% in 2016, from +2.6% in 2015). Overall wage growth is seen at around 2.8% in 2016-17, owing to a positive wage drift[10]. Employment is expected to grow just below 1.0% at least in the first half of 2016, supported by higher demand particularly in services, as shown by IFO job indices and the Federal Employment Agency's BA-X index[11]. Household purchasing power is likely to be partially eroded by the upturn in inflation to 1.3% in 2016, from +0.2% estimated for the current year. The unemployment rate is expected to remain above 6.3%, a long-term equilibrium level, with any falls below this threshold depending on how quickly the influx of the immigrant population is translated into an increase in the workforce. (see the forthcoming Focus).

Outlook for residential construction remains positive

Sharp upturn in public consumption on the way. Consumer spending still in full swing

Fiscal policy finally expansionary

Fiscal policy is expected to become gradually more expansionary over the forecast horizon. The budget surplus will be partially eroded from 0.9% in 2015 to 0.3% in 2017. Net of cyclical effects, the budget balance is seen falling to +0.3% in 2017, from +1.1% in 2015. Measures on the revenues side[12] are set to have a limited impact on balances. Primary spending, however, is seen growing in excess of nominal GDP on the back of the second phase of pension reform and higher healthcare spending. The main impact on public balances, however, stems from the increase in social transfers to accommodate refugees and migrants seeking humanitarian protection, which the Bundesbank puts at around EUR 7Bn a year in 2015-17. The debt to GDP ratio is seen falling to 66% of GDP in 2017, from 71.4% in 2015, despite the more expansionary direction of fiscal policy, given the fall in interest spending and the prospect of an upturn in nominal growth.

[10] Overall wages grew by 2.9% in 2015, more than negotiated wages (2.4%), owing to the positive wage drift relating to the introduction of the minimum wage in January 2015. The introduction of the minimum wage is unlikely to continue to have an effect on wages in 2016, but wage drift will probably remain positive, as the labour market is at full employment.

[11] The high demand for skilled labour has recently been met through the continuous influx of skilled workers from other EU countries, avoiding friction and an excessive overheating of the labour market. According to the Federal Agency, the shortage of skilled labour is now concentrated in healthcare-nursing services.

[12] The increase in the minimum exempted income and the further reduction in benefits provided by employers for children should be partially offset by the increase in contributions for health services.

Unprecedented influx of refugees an opportunity, but also a major challenge

The influx of refugees, asylum, individuals seeking humanitarian protection and migrants to the European Union and to Germany in particular in 2015 reached unprecedented levels not seen since the Second World War. Official data from immigration agency BAFM (*Bundesamt für Migration und Flüchtlinge*) estimated that there were 758,000 new asylum claims to the end of October. In its December bulletin, the Bundesbank estimates that asylum claims could reach at least 900,000 this year and remain at around 900,000 in 2016, before falling to 600,000 in 2017, and that net migration flows of asylum seekers could exceed 1,600,000 people in 2016-17, from 580,000 (337,000 from countries outside the EU) in 2014. The Bundesbank assumes that the recognition rate will be slightly higher than 50% in 2015, and could reach 90% in 2016-17. In principle, the high incoming net migration flows represent an opportunity for the country, given the anticipated rapid ageing of the population, but much will depend on the integration policies for the new entrants, and how quickly asylum seekers can enter the workforce. The pressures associated with the spike in incoming flows since the beginning of September (when Chancellor Angela Merkel ordered the doors to be opened to the flow of Syrians coming from Hungary) have eroded her popularity, in favour of her more conservative ally, Bavarian Premier Horst Seehofer. The polls show that Chancellor's Party, the CDU, lost support between September and early December in favour of the protest movement AfD[13]. Yet, as of late the Chancellor managed to win back some popularity and on December 14th received a standing ovation for her pro open borders speech in front of 1000 CDU members. The debate on how to manage future high migration inflows will most likely remain a hot topic in German politics in the coming months. At the summit on 17 December, Merkel will push for other EU countries to accept the Syrian refugees amassed in refugee camps on the Turkish border. However, it is highly unlikely that the Chancellor will backtrack on her stance for Europe open borders policy.

In assessing the impact on the country's workforce and economic growth prospects of recent migration flows, we have to take into account acceptance times for asylum seekers (and therefore the time it takes for them to enter official workforce statistics), as well as new entrants' breakdown by age and their qualifications. The BAFM indicates that in 2014, the average time taken to assess and accept claims was 11.3 months. This means that it will take about a year for the flow of refugees to translate into a significant increase in the workforce and potentially a fall in the unemployment rate. The first problem to overcome will be the language barrier. Moreover, the young age of the migrants (according to the BAFM, more than 55% of new entrants are aged between 15 and 35) suggests that the level of qualifications obtained in their country of origin is probably lower than the average of German workers or immigrants from Eastern European countries, which poses considerable challenges for the education system and training schools. The Bundesbank estimates that the workforce may increase on the back of net migration flows by 120,000 in 2015 and by a further 400,000 in 2016-2017. This would be a negligible increase compared with the fall of more than five million people projected for the period 2015-2025 according to Eurostat workforce forecasts. The Bundesbank estimates assume an employment rate of new entrants of only 15% in the first year and rising to 50% at end-2017, due to the difference in education and skills compared with the German population[14]. The unemployment rate could be half a point higher at the end of the forecast period.

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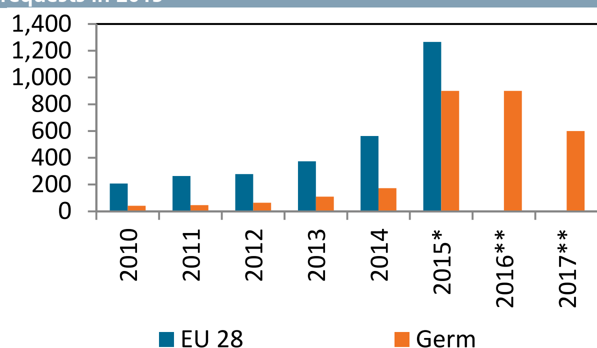
[13] According to Pollytix, the AFD party registered an increase in support of five points between September and 9 December to 8.8%.

[14] Note that the entry into force of the minimum hourly wage of EUR 8.50 an hour could limit the absorption of asylum seekers into the labour market. Asylum seekers will most likely be employed in low-paid jobs given their limited qualifications. According to the information available, asylum seekers will on average earn less than other categories of migrants.

The Bundesbank estimates that **migration flows could boost potential growth by a tenth of a point to 1.3% for the end of 2016 and up to 1.5% for the end of 2017**. It should be taken into account that incoming migration flows from Eastern Europe have peaked in the last few years. The positive effect on potential growth will in part be offset by a fall in output, given the lower professional qualifications of the new members of the workforce.

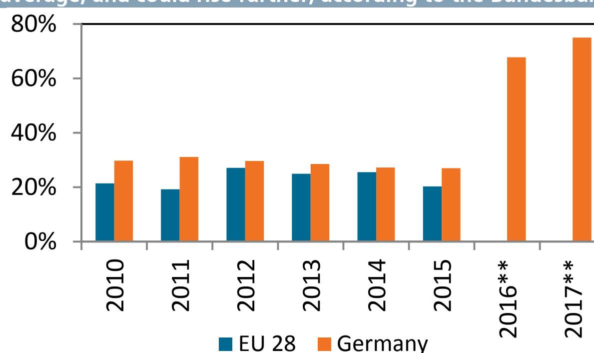
Migration flows will have an impact on GDP growth through the increase in public spending and transfers, which is estimated at approximately EUR 7Bn a year in 2015-2017. The effect on GDP will be 0.25% in 2015, which is likely to rise, according to the Bundesbank, to an overall 0.7% of GDP in 2017. The impact on GDP growth will therefore be 0.25% between mid-2015 and mid-2016, and then 0.1%. The effect of migration flows on growth is likely to be exhausted once the higher spending comes to an end or is balanced by other fiscal policy measures.

Fig 1 – Germany has received almost 90% of new asylum requests in 2015



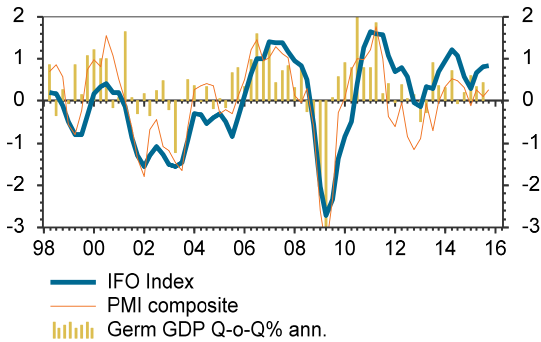
NB: * BAM data, ** Bundesbank estimates on asylum claims in 2016-17
Source: Eurostat, BAFM and Bundesbank

Fig 2 – Recognition rate higher in Germany than in the EU average, and could rise further, according to the Bundesbank



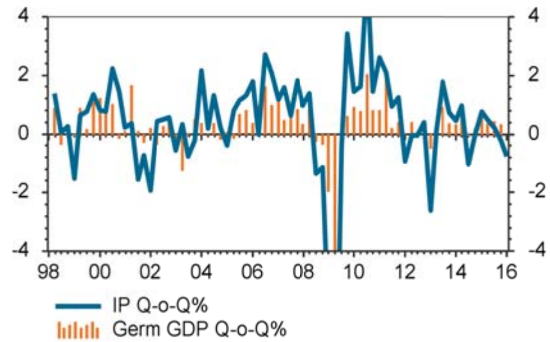
** Bundesbank estimates on acceptance rate of new asylum claims in 2016-17.
Source: Eurostat

Fig. 1 – The recovery of the IFO and PMI suggest growth of 0.4% qoq at the end of the year after +0.3% qoq in the summer



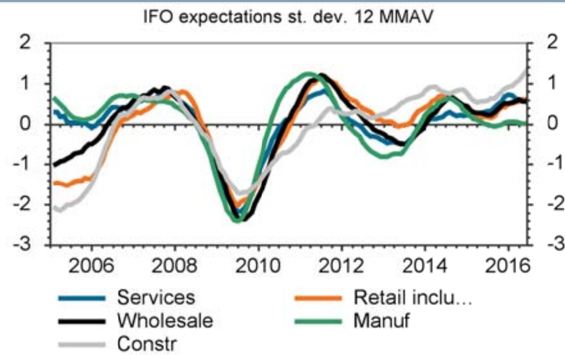
Source: FSO via Datastream

Fig. 2 – The trend in industrial output remains weak



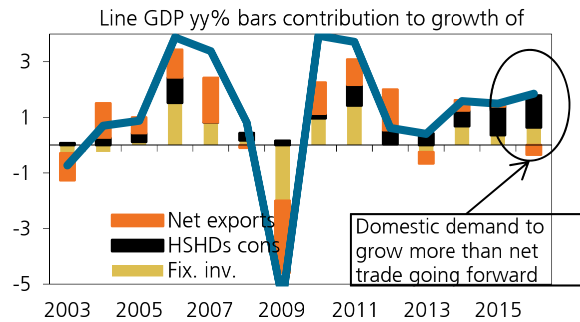
Source: FSO via Datastream

Fig. 3 – The IFO indicates that growth will be sustained by services, the retail trade and construction



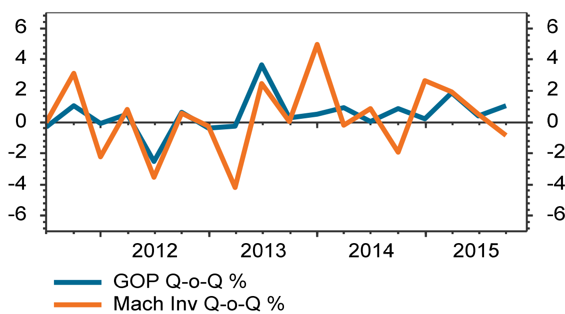
Source: Thomson Reuters-Datastream

Fig. 4 – Growth driven by domestic demand over the forecast horizon



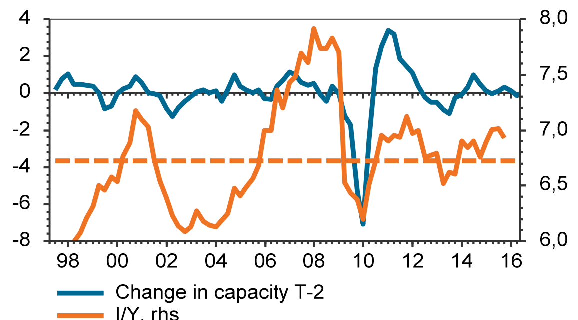
Source: Thomson Reuters-Datastream and ISP forecasts

Fig. 5 – Fundamentals for investment in machinery continue to provide support: margins still growing



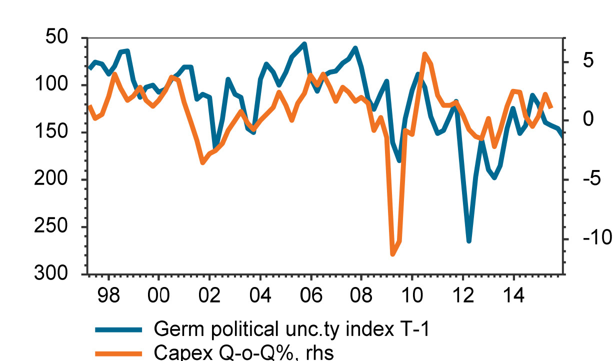
Source: FSO via Datastream

Fig. 6 – Plant capacity utilisation above historical average



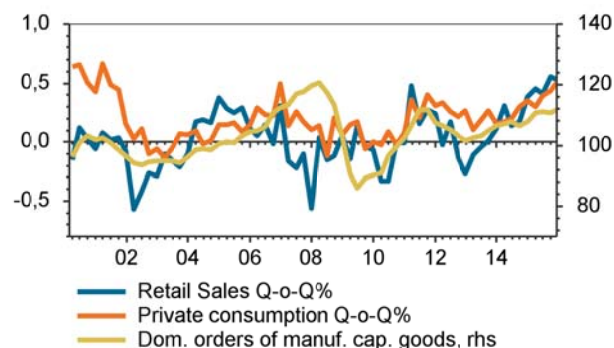
Source: FSO via Datastream

Fig. 7 – But the heightened uncertainty could prompt companies to postpone spending plans



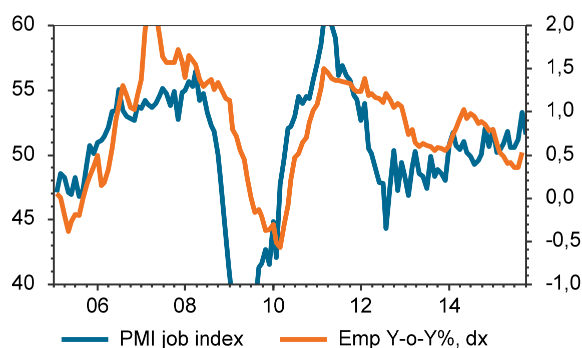
Source: FSO and Datastream

Fig. 8 – Retail sales and car registration data point to growth in goods consumption of 0.4 – 0.5% qoq at the end of the year



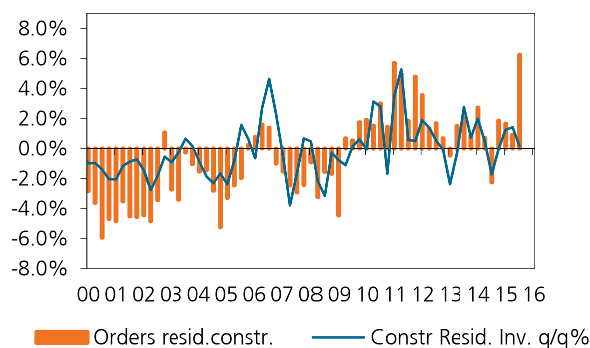
Source: FSO via Datastream

Fig. 9 – Employment to grow by at least 0.7% yoy in the next few months



Source: FSO and Datastream

Fig. 10– Investment in residential construction supported by the recent trend in permits and orders

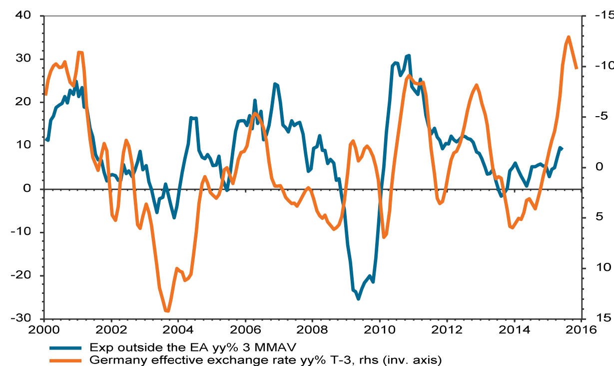


Source: FSO via Datastream

Fig. 11 – Tentative signs of a recovery in exports from the IFO. Capital goods orders from abroad still flat

Source: IFO, FSO via Datastream

Fig. 12 – The depreciation of the effective exchange rate should support exports in the next few months



Source: Thomson Reuters-Datastream

Forecasts											
	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (1995 prices, y/y)	1.6	1.5	1.9	1.1	1.6	1.7	1.5	1.8	1.8	1.9	1.9
- q/q change				0.3	0.4	0.3	0.4	0.5	0.4	0.5	0.4
Private consumption	1.0	1.9	2.1	0.3	0.1	0.6	0.4	0.6	0.7	0.5	0.5
Fixed investment	3.5	1.8	3.2	1.7	-0.3	-0.3	1.3	1.1	0.8	1.1	0.9
Government consumption	1.7	2.7	4.3	0.4	0.7	1.3	1.3	1.1	1.0	0.8	0.8
Export	3.9	5.0	4.7	1.5	1.8	0.2	0.4	1.6	1.4	1.5	1.4
Import	3.7	5.5	6.3	2.1	0.5	1.1	1.0	2.0	2.4	1.1	1.6
Stockbuilding (% contrib. to GDP)	-0.3	-0.6	-0.4	-0.1	-0.4	0.2	-0.1	-0.1	0.0	-0.4	-0.2
Current account (% of GDP)	7.8	8.4	8.3	8.2	8.4	8.4	8.1	8.2	7.8	7.8	7.6
Deficit (% of GDP)	0.3	0.9	0.4								
Debt (% of GDP)	74.9	68.2	66.0								
CPI (y/y)	0.9	0.3	1.3	0.0	0.5	0.1	0.5	1.2	1.0	1.4	1.6
Industrial production (y/y)	1.5	0.7	1.3	0.5	0.2	-0.2	-0.6	0.3	1.1	1.2	0.3
Unemployment (%)	6.7	6.4	6.2	6.5	6.4	6.4	6.3	6.3	6.3	6.2	6.2
10-year yield	1.24	0.51	0.78	0.33	0.53	0.68	0.52	0.62	0.80	0.83	0.87
Effective exch.rate (2005=100)	99.8	94.8	94.4	95.3	94.4	94.9	94.6	94.0	94.1	94.5	94.9

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

France: Growth above 1% in 2015-16, but the economic fundamentals are still fragile

Guido Valerio Ceoloni

There could be a slowdown in consumption in the last part of the year but, overall, the outlook for growth of 1.2% yoy in 2015 and 1.3% in 2016 is confirmed. Consumption looks set to remain the main contributor to GDP until the first half of 2016, after which time corporate investment could make a bigger contribution. Very low inflationary pressure, combined with government policies, could bolster, albeit only slightly, household purchasing power again in 2016.

GDP confirmed at 1.2% in 2015 and 1.3% in 2016

The third quarter closed with an increase in GDP of 0.3% qoq after the spring hiatus, in line with Bank of France and consensus estimates. Domestic demand remained the main growth driver, while stocks and net exports mirrored each other, thereby cancelling out their contribution to GDP. The Bank of France's initial estimate for 4Q15 growth is 0.4% qoq, but we think it is more likely that it will not go above 0.3% qoq. In any event, economic indicators are likely to confirm GDP of 1.2% for both years, two-tenths of a percentage point better than the early-year estimates. We also confirm the estimate of 1.3% for 2016, with upside risks to the forecast in the event of an acceleration in both private investment and, more notably, corporate investment, from the second half of 2016, once companies have recovered reasonable profit margins. The Bank of France recently downgraded its 2016 estimates by one-tenth of a percentage point from 1.5% yoy to 1.4% yoy.

Consumption risks stagnating at the end of the year, while corporate investment is expected to recover, especially from 2016

Even leaving aside the impact of the terrorist attacks in this phase[15], the first data to be issued for the current year show a very sharp slowdown in household consumption in October (-0.7% mom) compared with expectations, and there is a risk that this could compromise the quarterly performance just as the sharp fall in March reduced the contribution of consumer spending in the second quarter. Consumer confidence remained stable at 96 in October and November, below the long-term average; we think the impact of the terrorist attacks on consumer confidence will be reflected in December's figures. The unemployment rate rose more than

[15] Based on an initial estimate, we think it prudent to consider the impact of the attacks on the tourist sector as, at most, 0.1% of GDP, spread across 4Q15 and 1Q16. The French Treasury Ministry estimates the impact, at the moment, as 0.1% of GDP in 4Q15 alone, but has not provided details of its calculations.

expected in the third quarter, pushing the index up to 10.2% for metropolitan France, the highest level since 1997. The employment rate, however, remained stable at 64.2%. Company surveys and PMI indices for the current quarter point to a slight decline in employment levels, but there are hints of an improvement in the services sector. It would therefore be realistic to estimate that there will only be a slight recovery in consumer spending in the fourth quarter from +0.7% qoq, in the absence of a strong rebound in energy consumption driven by temperatures that are lower than the seasonal average (a possibility that cannot be ruled out in view of the average temperatures in October which were colder than the seasonal average). Car sales increased by 0.1% mom in November and could make up the ground lost in the last two months due to October's poor result. However, if there are no further serious terrorist incidents, we expect consumer spending to recover as early as the first quarter of 2016, shored up by the continuing rise in income and the increase in purchasing power on the back of low inflation.

Household capital investments fell more markedly in the second quarter (-1.1% qoq), less so in the third quarter (-0.5% qoq) and will probably also fall in the fourth quarter, before returning to positive territory during 2016. Corporate investment continues to show signs of recovery and is expected to be positive in the fourth quarter too. The CICE (competitiveness and employment tax credit) is breathing some life into corporate profit margins, in the same way that the ongoing improvement in credit conditions for French companies is keeping the cost of debt stable. Moreover, the exceptional measure allowing companies to depreciate their assets by 140% should lead to their bringing forward investment to benefit from the tax deduction. Overall, growth in fixed investment is expected to rise by 0.5% qoq in the last quarter, after +0.6% qoq.

Residual industrial output in 4Q, construction still weak. Services are showing positive signs

Industrial output advanced by 0.4% qoq in the third quarter, making up nearly all the decline seen in the second quarter. National confidence indicators start from a higher level than the PMIs but both agree in showing a slowdown in manufacturing activity. The manufacturing PMI is stable in November at 50.6 for the third month in a row, with new orders barely above the threshold of 50 (50.1), moving from an average level of 49.5 in the summer to its current average of 50.6 (October and November surveys). New orders were only slightly more encouraging at 50.1, from 48.2. We think, therefore, that the contribution of industrial output could again be residual (less than one-tenth of a percentage point of GDP) in the last quarter. The sector could stage a recovery from early next year. In construction, INSEE confidence indicators remained stagnant at around 89 in the first half of the year, before improving slightly in the second quarter (90.6 in November), but remaining well below the historical average (100.2): the outlook is still weak. The services sector remains solid, with confidence indicators rising to 101 (November) from an average of 97.3 in the third quarter. The PMI indicators show a similar trend. Services activity therefore confirms the forecast of a more mature recovery than in the other two sectors.

Imports and exports no longer a growth driver from the second half of 2015

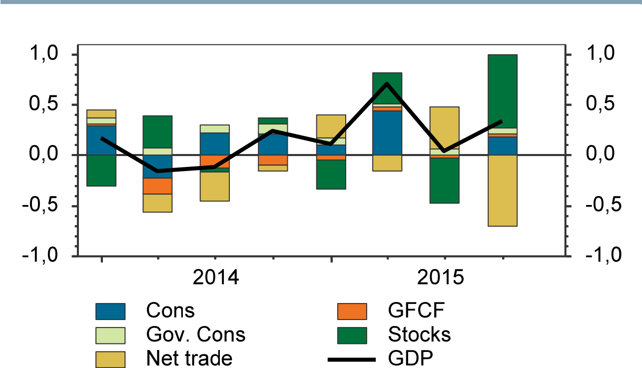
Exports should make a slight positive contribution in the last quarter, but this could be cancelled out by de-stocking, replicating (and in parts reversing) the trend seen in the third quarter. Imports are expected to slow, after +1.7% qoq in the third quarter, in the wake of renewed weakness in consumer spending, while exports should bounce back after the decline of 0.6% qoq. Overall, the contribution of net exports to GDP is expected to be around +0.2% from -0.7%, partially disappointing expectations that imports and exports would be driven by the weakness of the euro in 2015: this effect actually wore off as early as the second quarter. The current account balance is expected to improve in the fourth quarter, taking the annual balance for 2015 to +0.1% of GDP (and 0.3% in 2016) from -0.9% in 2014; this would be its first time in positive territory since 2004. France's structural trade deficit balance should improve to around -7.7% of GDP in 2015, from -10.8% in 2014, and remain stable in 2016 (-7.6% of GDP).

Consumer prices are not expected to vary much from those in the previous quarterly report. Inflation is expected to be around 0.1% yoy in 2015, rising to 0.9% yoy in 2016. The negative contribution of the energy component up to the end of the first half of 2016 is expected to be more than offset by the rise in core prices: the underlying component is expected to fall from 0.8% yoy in 2014 to 0.4% yoy in 2015 and then return to 0.8% in 2016.

Commitments undertaken with the EU will be met in 2015. New overruns in 2016 for increases in defence-related spending

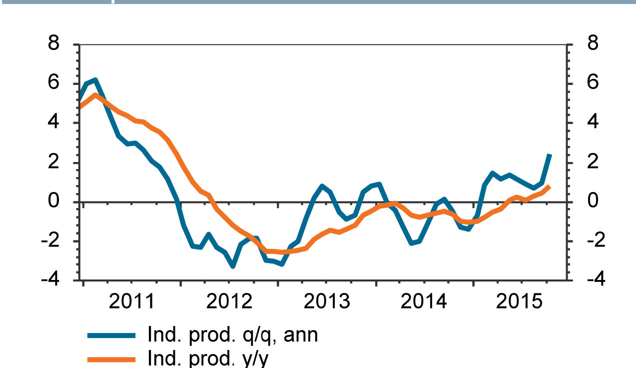
Turning to the **public accounts**, the government has restated its macroeconomic outlook, which confirms the 2015 deficit at -3.8%, from -3.9% in 2014. As a result, the structural balance should shift from -2.8% to -2.7%. Things have changed slightly for 2016, given that the terrorist attacks in November occurred after the approval of the 2016 budget, which would have confirmed the 2016 deficit at -3.4% and the structural balance at -2.4% (on an assumption of 1.5% growth). Since the government has already received the EU's approval for the next two years' targets to overrun, we take it as read that the previous targets will not be met. Based on the latest announcements, the planned reduction in army personnel will be cancelled and the public security sector will see the recruitment of 8,500 new staff. The new path of deficit reduction should lead to a deficit of 3.5% in 2016 and 3.4% in 2017, with the structural deficit at 2.5% and 2.7% respectively, which will postpone the achievement of 3% for at least another year. Public debt will increase again this year, from 95.6% of GDP in 2014 to 96.9%, and could rise further in 2016 to 97.5%.

Contribution to GDP



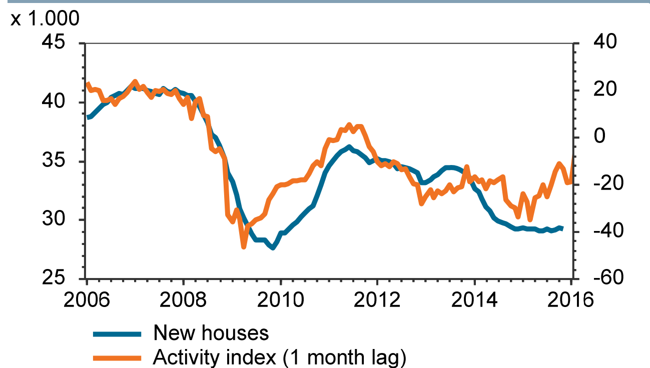
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial production



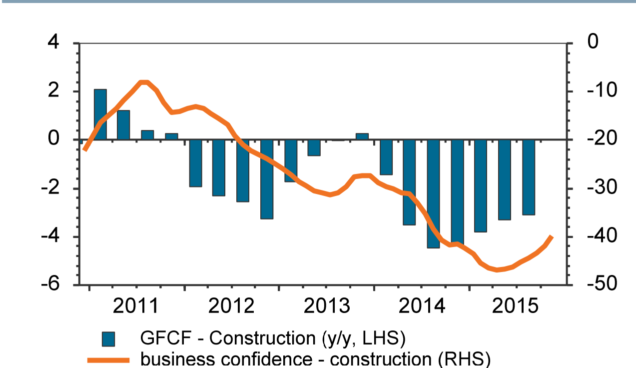
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

House-started and construction confidence



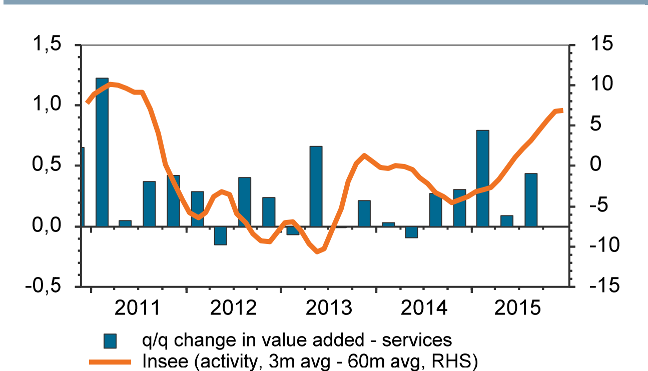
New house-building and construction sector confidence

Fixed inv. and confidence in the construction sector



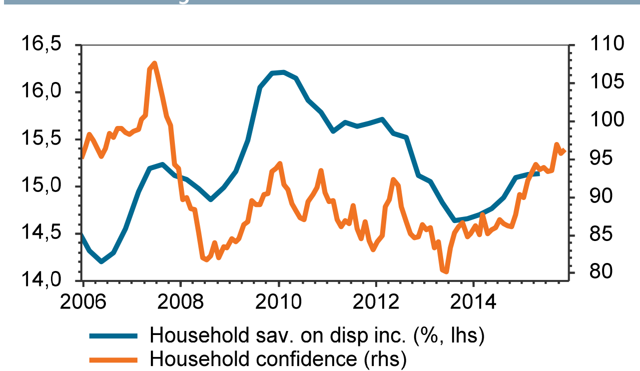
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Value added in services and confidence indicator



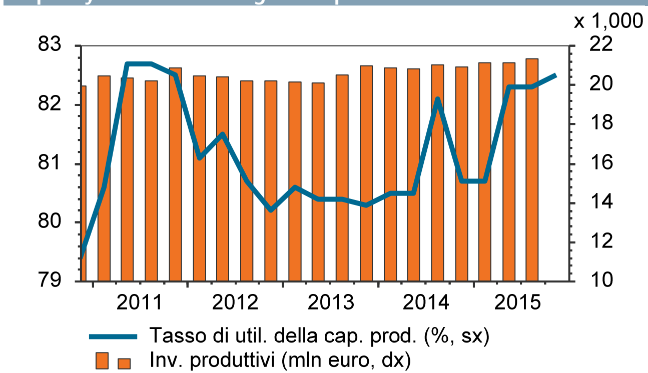
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Household savings and consumer confidence



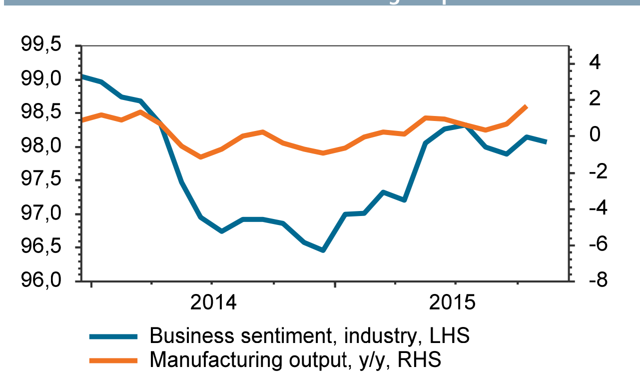
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Capacity utilisation and gross capital formation



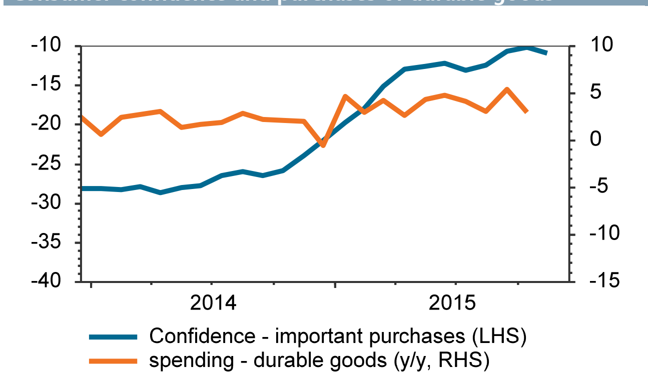
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Business sentiment and manufacturing output



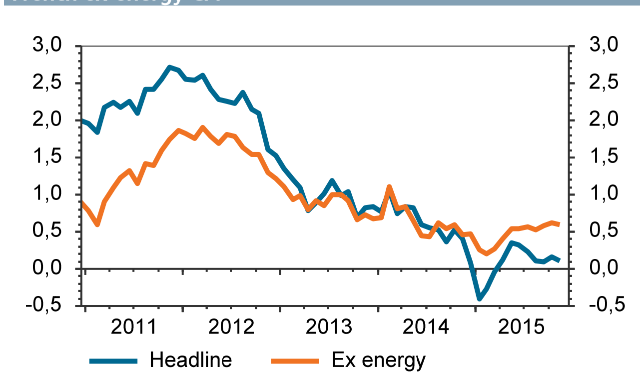
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Consumer confidence and purchases of durable goods



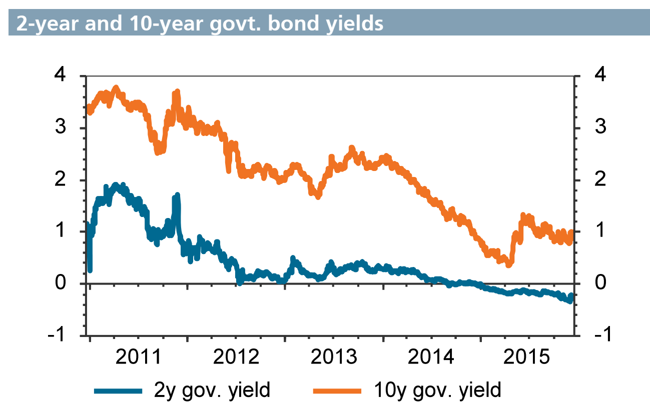
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

French ex-energy CPI



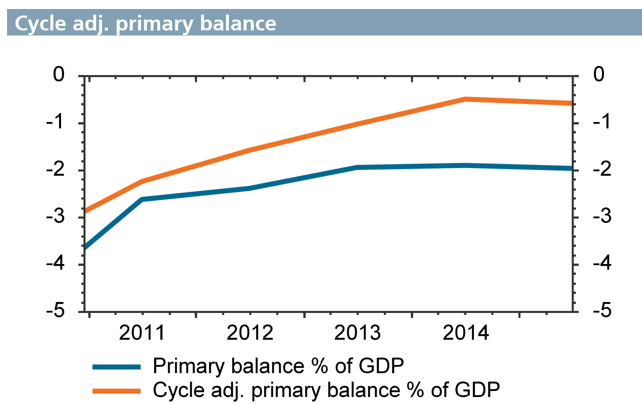
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Cycle adj. primary balance



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Forecasts

	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	0.2	1.2	1.3	0.9	1.1	1.2	1.4	1.0	1.3	1.4	1.5
- q/q change				0.7	0.0	0.3	0.3	0.3	0.4	0.4	0.4
Private consumption	0.7	1.5	1.3	0.8	0.0	0.3	0.3	0.3	0.4	0.4	0.4
Fixed investment	-1.2	-0.3	1.5	0.2	-0.1	0.1	0.2	0.5	0.5	0.6	0.7
Government consumption	1.5	1.6	0.8	0.3	0.3	0.4	0.4	0.1	0.0	0.1	0.2
Export	2.4	5.6	2.9	1.5	1.9	-0.6	1.1	0.7	0.7	0.8	0.8
Import	3.9	5.5	2.5	1.9	0.5	1.7	0.3	0.4	0.6	0.6	0.6
Stockbuilding (% contrib. to GDP)	0.2	0.1	0.0	0.3	-0.4	0.7	-0.2	-0.1	0.1	0.0	-0.1
Current account (% of GDP)	-0.9	0.0	0.5	-0.4	0.3	0.0	0.3	0.5	0.5	0.5	0.4
Deficit (% of GDP)	-3.9	-3.8	-3.5								
Debt (% of GDP)	95.6	96.9	97.5								
CPI (y/y)	0.5	0.0	0.7	-0.2	0.2	0.1	0.1	0.3	0.3	0.8	1.2
Industrial production	-1.0	1.6	2.4	1.8	-0.4	0.5	1.3	0.4	0.6	0.7	0.5
Unemployment (%)	9.9	10.1	10.2	10.0	10.0	10.2	10.2	10.2	10.2	10.1	10.1
Effective exch.rate (1990=100)	99.7	95.2	95.3	95.5	94.8	95.3	95.1	94.5	95.0	95.6	96.0

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

Italy: towards a "normalisation" of growth

Paolo Mameli

- In Italy, as expected a year ago, **2015 marked the reversal of the cycle**. After three and a half years of recession, economic activity has perked back up starting in the first quarter of the year, driven by the tailwinds generated by the shocks in financial markets (interest rates, exchange rate, oil prices), as well as by the effects of the ECB's Quantitative Easing.
- However, **the recovery has lost steam in the course of 2015**, as the rebound in investments at the beginning of the year (in the means of transport and construction sectors) proved short-lived, and the summer brought signs of a significant slowing in foreign trade; accelerating consumer spending only offset these adverse trends in part.
- As a result, the pace of GDP growth, faster than expected at the beginning of the year (0.4% q/q in 1Q and 0.3% q/q in 2Q) slowed to 0.2% q/q, falling short of expectations in the summer quarter. Therefore, **average annual growth in 2015 should level-off at 0.7%**, above the rate estimated one year ago (0.4%), but one tenth lower than our latest forecast (0.8%, in any case at the most cautious end of consensus estimates). Yet, annual GDP unadjusted by workdays (three more than last year), which is an important variable in drawing up public finance reports, should meet reach 0.8% target.
- As elsewhere in Europe, at the moment the **economic recovery is being driven by consumption,** as shocks on domestic demand coming from energy and interest rates seem to be proving more effective ex post (than ex ante based on the econometric models), and stronger than the effect on exports of the exchange rate, also considering that this latter effect was balanced by a downturn in global demand (in particular from emerging countries). Consumption was also supported by the effects on disposable income of the Irpef bonus, which came fully into force starting in 3Q 2014 (and which according to the Bank of Italy[16] was 90% spent), as well as by the recovery in employment, which began last year and strengthened in 2015 (also spurred on by government incentives, according to the Bank of Italy surveys[17]). Low interest rates (and the improvement of credit conditions) also seem to have played a role, as indicated by the robust growth (by around 7% y/y) of durable goods' consumption.
- As has regularly been the case in the past few years, once again **the indications provided by sentiment surveys tended to overestimate the pace of growth**. Based on Istat data, in November consumer confidence hit a long-term high (for the past 20 years at least) and business sentiment surged to its highest level in eight years; however, increased optimism among economic operators was reflected only in part by the spending of consumers and, especially, enterprises. In all likeliness, the depth of the crisis experienced over the past few years has depressed the expectations of economic operators to such an extent that even a marginal improvement is perceived as being very significant; another explanation may lie in the polarisation of the economic situation of households and businesses (markedly negative queues in retail), as well as in the effects of business bankruptcies on the survey sample. This suggests caution in drawing overly optimistic indications on the growth trend from the evolution of survey data.
- Going forward, after 0.7% growth in 2015, **we confirm our latest forecast for an acceleration to 1.2% in 2016**. The estimate is compatible with a quarterly GDP growth still in the 0.3% q/q area throughout 2016, in line with the average level recorded in 2015 (in other words, economic activity is not seen to accelerate significantly).

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[16] "Annual Report on 2014"

[17] An advance estimate for the Veneto region (the only region which provides timely information on the eligibility of workers for the contribution cut) suggests that around one-fourth of the increase in the number of employees and quasi-employees in the nonfarm private sector is the result of the contribution relief and of the new rules on firings (the former seems to have accounted for two-thirds of the increase). See *"Hirings: the effects of the labour market measures as reflected in the administrative data"*, Economic Bullettin 4/2015.

- After having grown (0.9%) more than GDP in 2015, consumption should accelerate to 1.2% in 2016. The rebound in the real disposable income of households recorded in 2015 (the first after a string of seven years on the decline) is expected to strengthen in the course of next year (to 1.5% from 0.9%, based on our estimates). The recovery in purchasing power is mostly driven by higher employment: we forecast a 0.8% increase in employment numbers in 2016, in line with 2015 (based on our estimates, the unemployment rate could approach 11% in average 2016 terms).
- In 2016, investments could take over from consumption as the main driver of the recovery. After growing modestly in 2015 (0.6%), investments should accelerate to 1.6% in 2016. While investments in means of transport picked up already this year (+35% based on our estimates, albeit due to an anomalous surge at the beginning of the year), the important development in 2016 should be the recovery of investments in machinery and equipment, which expect on the increase by 2.8% in 2016, after the surprise -0.8% slide (for the fifth consecutive year, the seventh out of the past eight) seen in 2015. Businesses should resume investing thanks to persistently ultra-accommodative financial conditions, and to the fact that final demand has already reversed (this should at least ease the caution of enterprises in taking capex investment decisions). The expansionary measures contained in the 2016 Budget, and in particular the possibility of a maxi-amortisation (of 140%) on new investments implemented between 15 October 2015 and 31 December 2016, will also help.
- The construction sector must be discussed separately. The contraction of the industry (for the ninth year in a row) in 2015 (-1%, based on our estimates) came as no surprise. The industry was the hardest hit by the crisis, and is the last in exiting the recession, indeed at a very sluggish pace. Only in the past few months, the signals of a recovery in transactions on the existing homes market, the recovery in the affordability ratio, the demand for mortgages by home purchasers, and the sharp rebound in builders' confidence, have become compatible with a reversal in the industry. However, in 2016 we expect little more than a stabilisation (+0.3%), ahead of a stronger recovery over the following years.
- Public spending rebounded surprisingly (+0.3%) in 2015 (after four negative years on the run), but is expected to dip back down in the course of 2016 (-0.1%) as a result of the cuts provided for by the latest Stability Laws. In 2016 as well, public spending will definitively not be among the main drivers of the economic cycle.
- Foreign trade could make a negative contribution to growth in 2016 as well. We expect trade flows in both directions to slow, although in 2016 imports are estimated to grow more than exports (3.9% vs. 3.2%), as it was the case in 2015. The slowdown in exports (from 3.9% in 2015) is explained by the smaller additional impact of the exchange rate shock. Sales to the United States and to other European countries (United Kingdom, Spain, some Eastern European countries) should continue to prove rewarding, as opposed to a negative contribution from the emerging markets (Russia, China, Latin America, OPEC countries); however, based on forward-looking indicators, demand from emerging countries may also have bottomed out late in the summer of 2015, and signs of a recovery could start to come in the course of 2016.
- In 2016, as in 2015, we expect economic policies to positively impact the cycle, albeit not decisively (a few tenths of a point):
    1. The Quantitative Easing programme implemented by the ECB in 2015 was effective in unblocking the monetary policy transmission mechanism, as the sharp drop in government bond yields translated into an easing of credit conditions and into a significant decline in the interest rates applied by banks to businesses and households (currently both more favourable in Italy on average than in the rest of the euro area); in this sense, the extension to beyond September 2016 of the asset purchase programme, announced by the ECB on 3 December (together with the further deposit rate cut) may have a further positive impact on growth, which however will not be decisive, as the decision failed to aid a further drop in interest rates or a depreciation of the euro's exchange rate (both of which, in fact, moved in the opposite direction); on the whole, we believe that the

Quantitative Easing programme may have an impact (through the changes triggered on the interest rate and exchange rate trends) of around 0.7% on Italian GDP growth in the 2015-2016 biennium (of which 0.1-0.4% in 2016);

2. In 2016, fiscal policy, as was also the case in 2014-15, will be slightly accommodative, thanks to the measures included in the Stability Law (change in the cyclically-adjusted primary balance: at least -0.4% next year, in line with this year); the 2016 budget is expansionary, but only if compared to a scenario under current legislation which priced in the triggering of safeguard clauses, with "automatic" hikes in indirect taxes; in general, we estimate a "theoretical" impact of fiscal policy on GDP growth in 2016 of one to two tenths.

- In essence, after the 2015 reversal, 2016 could be the year in which growth "normalises", returning to levels broadly in line with potential (although it will take years to close the output gap which has opened up since 2007). Inflation, on the other hand, is still not expected to "normalise": after two years of stagnation (0.2% in 2014 and 0.1% in 2015), the CPI is forecast to rise back only slightly in 2016, to 0.8% in our estimation, therefore well below the levels considered as "normal" (our baseline scenario sees inflation staying below the ECB target in 2017 as well, at 1.6%). Risks to the inflation scenario remain skewed to the downside in any case. Such low levels of inflation is weighing on corporate revenues and margins, but for the time being at least it does not seem to be affecting households' spending decisions: in fact, the typically negative correlation between perceived/expected inflation and consumers' spending intentions seems to be in place: low inflation, at least for now, seems to be proving more of a support for the disposable income of households, than a drag for the economic cycle.
- On the political front, we see limited risks of a government crisis or of a return to the polling stations in 2016. After focusing this year on the reform of the labour market and of the education system, in 2016 the government should concentrate on three fronts: completion of the judicial system reform, issuing of the decrees provided for by the delegating law on the public administration and tax system reforms. The main test of the government's resilience, in addition to the round of local elections due in the spring (involving major municipalities such as Roma, Milan, Turin, Bologna, Naples), will come with completion of the constitutional reform, with the likely calling of a popular referendum (probably to be held in the autumn of 2016). Implementing the additional significant tax cuts promised for 2017-18 also seems challenging, as the residual safeguard clauses will have to be covered, and the correction needed to achieve the European structural balance and debt targets will have to be implemented; significant savings on interest expenditure will help, but will not be enough.

Forecasts

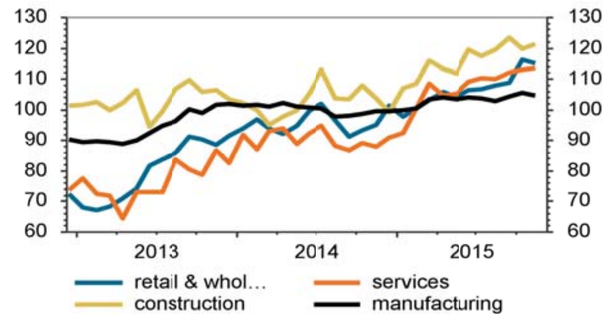
	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	-0.4	0.7	1.2	0.1	0.6	0.8	1.3	1.1	1.2	1.3	1.2
- q/q				0.4	0.3	0.2	0.4	0.3	0.3	0.3	0.3
Private consumption	0.4	0.9	1.2	0.1	0.4	0.4	0.3	0.2	0.2	0.3	0.3
Fixed investments	-3.4	0.6	1.6	1.2	-0.1	-0.4	0.5	0.6	0.5	0.5	0.6
Public spending	-0.7	0.3	-0.1	0.0	-0.4	0.3	0.0	-0.1	-0.1	0.0	0.0
Exports	2.8	3.9	3.2	1.0	1.3	-0.8	0.8	1.1	1.0	1.0	1.0
Imports	2.7	5.5	3.9	2.5	1.6	0.5	1.0	1.0	0.9	1.0	1.0
Inventories chg (contrib., % GDP)	0.0	0.3	0.3	0.5	0.2	0.3	0.1	0.0	0.0	0.0	0.0
Current account (% GDP)	1.9	2.4	2.7								
Public deficit (% GDP)	-3.0	-2.6	-2.5								
Public debt (% GDP)	132.3	133.1	132.5								
CPI (y/y)	0.2	0.1	0.8	-0.2	0.1	0.2	0.2	0.6	0.6	0.8	1.3
Industrial output	-0.5	1.1	1.8	0.6	0.6	0.4	0.7	0.3	0.7	0.2	-0.2
Unemployment (%)	12.7	11.9	11.0	12.2	12.3	11.7	11.4	11.2	11.1	10.9	10.7
10Y rate	2.89	1.70	1.70	1.53	1.80	1.91	1.56	1.60	1.74	1.73	1.73
Effective Exch. rate (2010=100)	99.8	95.8	95.5	96.2	95.5	95.9	95.6	95.1	95.3	95.6	96.0

Note: percentage changes annualised vs. previous period – unless indicated otherwise. Source: Intesa Sanpaolo

Fig. 1 – Consumer confidence at historical highs, business confidence at its highest in around 8 years

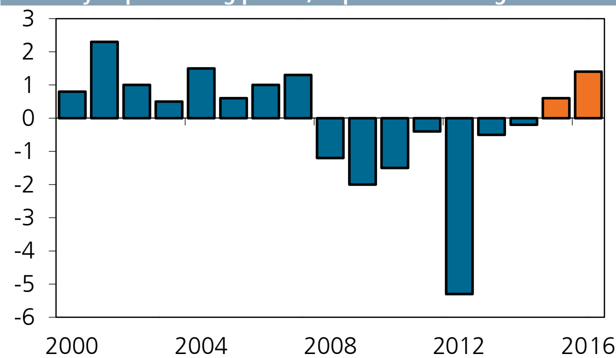
Source Thomson Reuters-Datastream

Fig. 2 – Business sentiment improving sharply across sectors



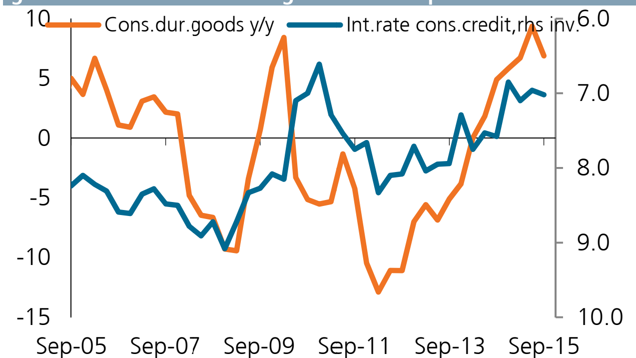
Source: Thomson Reuters-Datastream

Fig. 3 – Consumer confidence and spending driven by the recovery in purchasing power, expected to strengthen in 2016



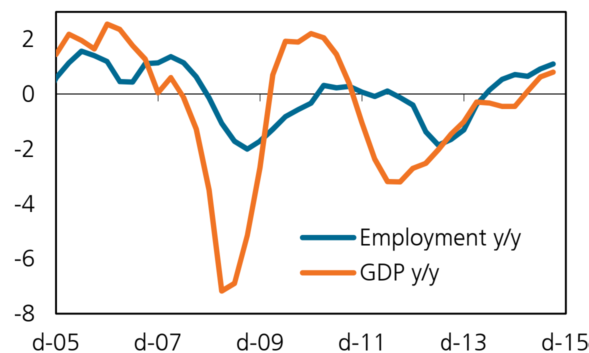
Source: Istat, Intesa Sanpaolo elaborations and estimates

Fig. 4 – Lower interest rates also seem to have played a role, given the boom in durable goods consumption



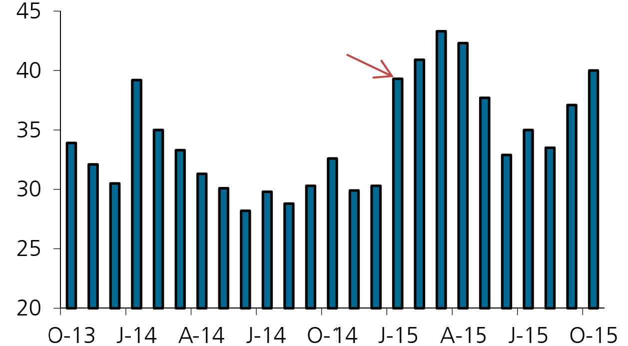
Source: Thomson Reuters-Datastream

Fig. 5 – Consumer spending also supported by the recovery in employment, which outpaced GDP growth…



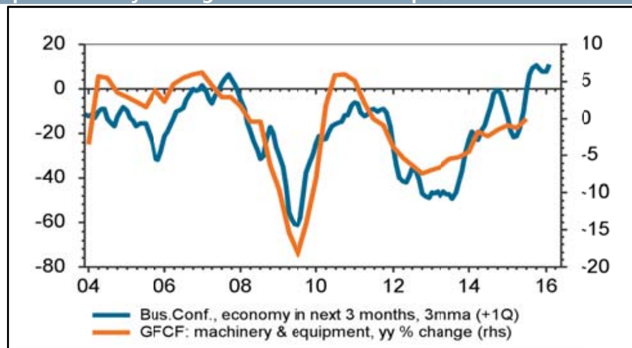
Source: Istat, Intesa Sanpaolo elaborations and estimates

Fig. 6 – …and in particular the share of permanent employment, up since the beginning of 2015, when the government incentives came into force



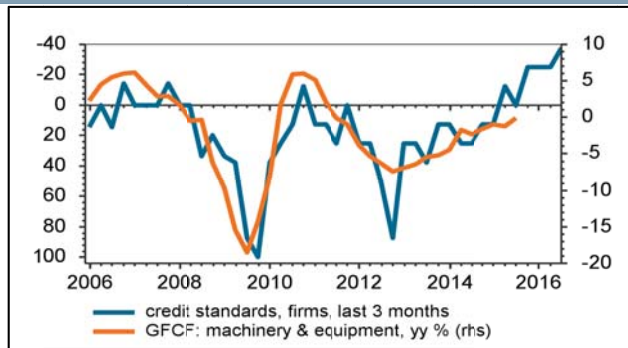
Source: Istat, Intesa Sanpaolo elaborations and estimates

Fig. 7 – The main development in 2016 should be the recovery of investments in machinery and equipment, which could be spurred on by stronger business sector optimism on demand…



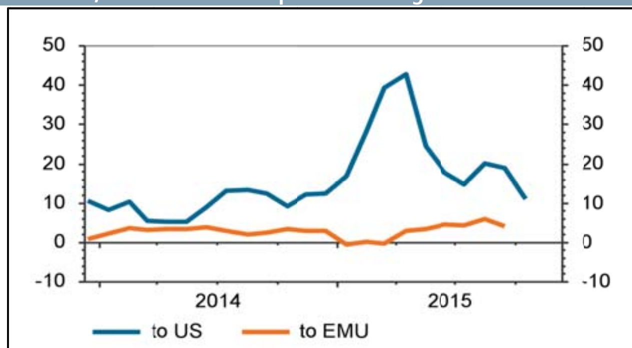
Source: Istat, Intesa Sanpaolo elaborations and estimates

Fig. 8 – …as well as by the further easing of financial conditions (at a pace unprecedented in the past decade)



Source: Istat, Intesa Sanpaolo elaborations and estimates

Fig. 9 – Exports benefited from the exchange rate shock, as proven by the boom in auto sales to the United States. However, the additional impact is waning…

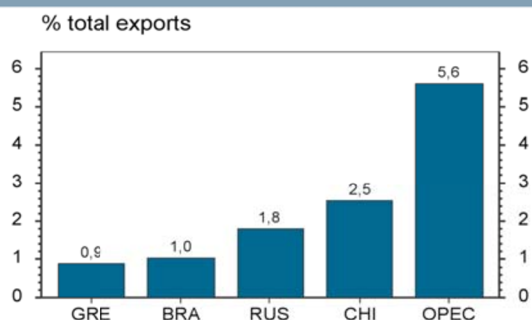


Source: Thomson Reuters-Datastream

Fig. 10 – …and the slowdown in demand from the emerging countries has reaped its effects in the past few months

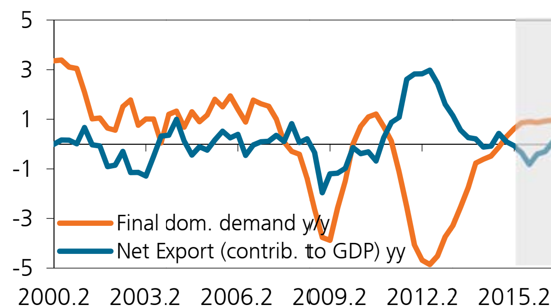
Source: Thomson Reuters-Datastream

Fig. 11 – In any case, the share of sales to "higher risk" countries is limited on the whole…



Source: Thomson Reuters-Datastream

Fig. 12 – …and the recovery of domestic demand should be able to balance, in 2016 even more so than in 2015, the negative contribution made by foreign trade



Source: Thomson Reuters-Datastream

Spain: still growing above trend but decelerating

Anna Maria Grimaldi

Slight slowdown in sight

After the surprisingly strong performance achieved in terms of growth in 2015, it is reasonable to expect economic activity to expand at a more moderate pace in 2016 (2.7%), albeit still well above the potential rate (estimated in the autumn by the EU Commission at +0.4% in 2016) and the euro area average. Based on the latest indications, growth has peaked. In October and November, the PMI (56 from 58) and the EU Commission's economic sentiment index (108.9 from 109.5) have hovered at levels compatible with GDP growth of 0.7% q/q from +0.8% q/q (3.1% y/y) (Fig. 1). Industrial output made a rather bland entry into the winter quarter (-0.5% m/m), but the quarterly trend is still benefiting from the strong exit from the summer months (+1.2% m/m in September, supported by capital goods). The November manufacturing PMI was still compatible with a rather good resilience of the sector at the end of the year as well, but even if output slows, growth will continue to be fuelled by services and domestic demand, which has resumed growing at pre-crisis rates in 2015 (3.3% y/y). Spanish exports have grown at a faster pace than the euro area's since mid-2009 (Fig. 2), driven in part by competitiveness gains in relative terms compared to the other main euro area countries (Fig. 3), achieved thanks to the fiscal devaluation process, in particular between 2012 and 2013. At the same time, Spanish businesses have progressively diversified their target markets outside the euro area (Fig. 9). While this transformation was fruitful in the years in which the euro area failed to grow, it now makes Spain more vulnerable to the global cycle, although the euro area countries remain Spain's main trade partners. At the same time, Spanish businesses have progressively diversified their target markets outside the euro area (Fig. 4). While this transformation was fruitful in the years in which the euro area failed to grow, it now makes Spain more vulnerable to the global cycle, although the euro area countries remain Spain's main trade partners. The indications provided by the PMI foreign orders indices remain moderately positive for exports in the months ahead, although exports are unlikely to keep up their recent pace in either the short or medium term. Improvements in terms of stronger competitiveness and lower costs have been quite sizeable over the past few years, and the country is unlikely to be able to progress significantly further on this front. The risk of returning to domestic demand driven growth model is that the net international debt position stops falling or resume to deteriorate from the still high 90% of GDP (55% when valuation effects due to changes in the financial account balance are accounted for) which would be an element of fragility for the future (Fig. 11 & 12).

Spanish exports have outperformed the euro area average since 2009, but margin for further improvements seems limited

Investments in machinery and residential construction heading for more sustainable growth

We believe that in 2016, domestic demand will keep growing at a sustained pace (2.3%), albeit slower than in 2015 (3.3%). Households' consumption is forecast to grow by 2.5%, from 3.0% estimated this year. Real labour income could slow from +1.4% in 2015 towards close to 1.0%, held back by the resurgence of inflation, back into positive territory (+0,8% from -0.6% this year), by a broadly flat wage trend compared to this year (0.7% y/y), and by employment growth closer to 2.5% than to the 3.0% rate recorded in the first nine months of 2015 (Figs. 11-13). Consumer spending will continue to be supported by fiscal policy stimulus and by markedly accommodative financial conditions. The trend of corporate investments has been in line with the increase in production capacity (Fig. 15), and should continue to be supported by the decline in financial charges in relation to GDP, as well as by improving operating margins. However, the growth rates seen in the central months of this year are unlikely to be matched, therefore we expect a monthly trend closer to 1.0%, and a slowdown in spending growth to 5.5% in 2016, from 9.5% in 2015. In any case, this is a much livelier capex cycle than those observed in other euro area countries, and more sustained than during previous recovery phases (Fig. 16). Residential construction sector has clearly turned the pre-crisis excess have been purged (Fig. 17) and spending resumed solid growth in the first half of this year to then moderate in the summer. Real house prices are recovering too as in 2015 started going again (by 1.4%) for the first time in eight years. However, on the forecasting horizon we expect and hope that residential investment grows more in line with the trend observed over the summer than with the rates recorded in the first half of this year. The stock of unsold homes remains

very large (Fig. 10) and could curb the growth of new investments to 2.0% from 5.9% estimated in 2015. Employment performed better than prospected by business surveys in 2015, growing at broadly the same pace as GDP (3.0% from +1.2% in 2014)[18]. Between January and August 2015, around 483k jobs were created, almost entirely in the private sector (400k), with services leading the way with 227k new jobs. In all business sectors, and in construction in particular, job creation was stronger than indicated by survey data on hiring intentions. However, in 2016 the creation of new jobs could slow towards 2.2% y/y, in line with the moderation of economic activity. Sector data suggest that job creation slowed already over the summer in the construction and services sectors (Fig. 1). The unemployment rate dropped more rapidly than we expected, to 21.6% in September 2015 from a peak of 26.3% in March 2013. The decline was due in part to the lower participation rate, to 59.5% from 60.5%, due to an increase in the number of inactive workers. On the forecasting horizon, we expect unemployment to decrease moderately at the end of 2016, to 19.1%, therefore still above its pre-crisis levels. However, the most worrying aspect in terms of the risks to social cohesion is that unemployment is not far off the structural rate, which according to the OECD's estimates is just below 19%, one of the highest to be found among the advanced countries (Fig. 14). The labour market transformation process must therefore continue, in an attempt to reduce the precariousness rate (share of term and part-time jobs on total employment), to step up labour force participation, and to reduce long-term unemployment. By no chance, one of the most heatedly debated issues by the leaders of the main parties that will take part in the forthcoming elections of 20 December, are job creation and the reform of the welfare system.

Employment may also have peaked

The GDP growth rates achieved over the 2015-16 period will be hard to match in the next few years. As we mentioned above, an exports led growth model would not be sustainable. What's more, the global scenario represents a downside risk to growth in the euro area and in Spain too. Domestic demand will be unable to keep up the same growth pace as in 2015, which benefited from tax cuts and extraordinary financial and external conditions. Also, the imbalances which led to the deep correction of 2008-2011 have not been entirely cured. Spain's net international investment position remains in debt, and has worsened since 2013, event taking into account the revaluation effects tied to changes in the financial balance (Fig. 20). The deleveraging process must continue, without compromising economic growth, and especially employment, given the still high unemployment rate. The private sector debt is now closer to the EU average, non-financial corporates may contribute further exploiting the low interest rates environment, yet the government should also contribute.

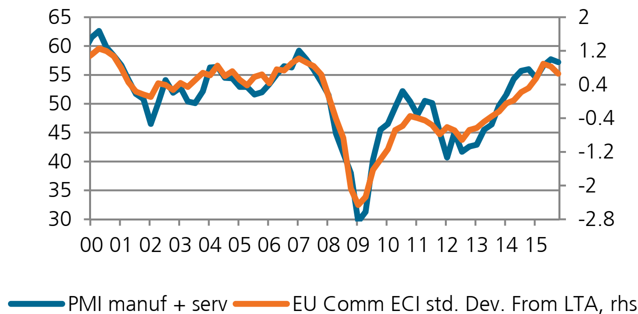
The structural unemployment rate remains very high

We expect the deficit to drop back below the 3.0% threshold next year, largely as a result of the acceleration of the economic cycle and of the decline in interest spending, whereas debt will continue to increase, to 101.3% of GDP in 2016 from 99.3% in 2014. The 2016 Budget Law estimates a worsening of the structural balance, by 0.1 to -2.6% of GDP, clearly insufficient compared to the -1.2% target laid out in the Commission's recommendations of 2013. The EU Commission did not entirely reject the Stability Law, probably in view of the forthcoming general elections. However, the Commission stressed that Spain was at risk of not respecting the Stability Pact, and asked for new measures to be detailed in 2016, for regional administrations in particular. Therefore, the new government will have to plan a fiscal correction for the coming years, designed to bring the structural balance back in line with the goal of achieving a balanced budget in the medium term (from -2.6% as per the EU Commission's autumn forecasts), and to restore debt to a downward path. Keeping up solid growth rates would aid the process of rebalancing public finances. Therefore, the new government has several challenges to tackle, and the reform thrust cannot lose steam if the country intends to keep growing at sustained rates.

Deleveraging in government camp now

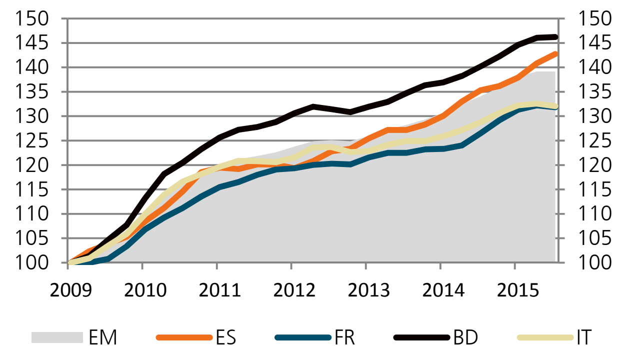
[18] We highlighted before that the correlation between GDP and employment has increased compared to pre-crisis partly on the back of labour market reforms.

Fig. 1 –Past the peak?



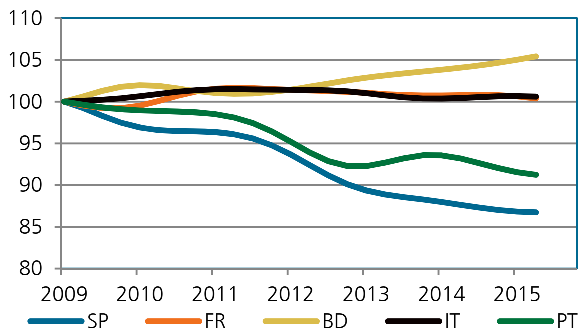
Source: PMI Markit, EU Commission and Intesa Sanpaolo forecasts

Fig. 2 – Spanish exports did better than the average since 2009



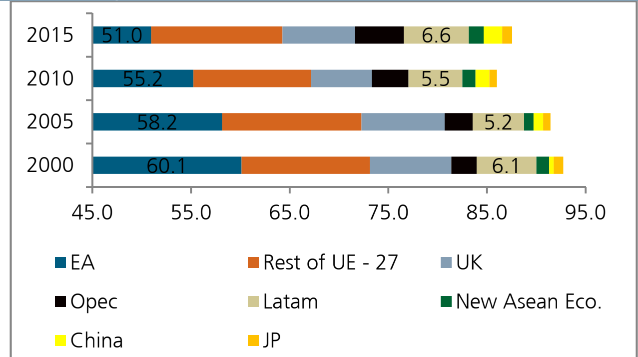
Note: exports of goods and services at constant prices = 100 in 2Q 2009. Source: Eurostat and Intesa Sanpaolo elaborations

Fig. 3 – The strong competitiveness gains achieved in the past few years will continue to help



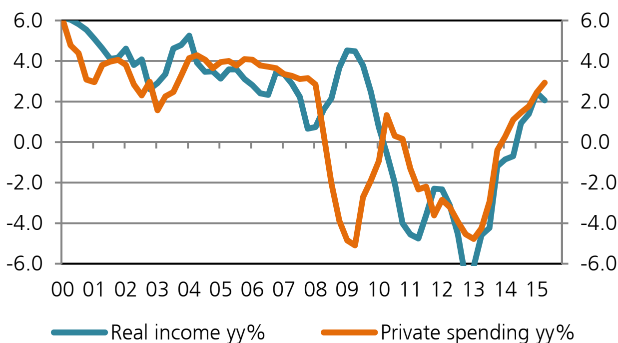
Source: Eurostat and Intesa Sanpaolo elaborations

Fig. 4 – Spanish exports are now more sensitive to the global economic cycle



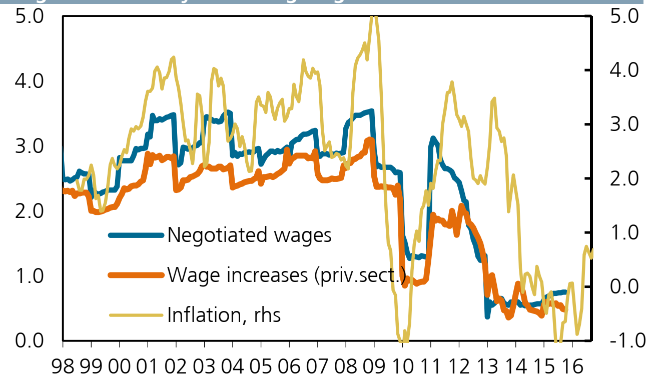
Source: Eurostat and Intesa Sanpaolo elaborations

Fig. 5 – Disposable income could start to slow…



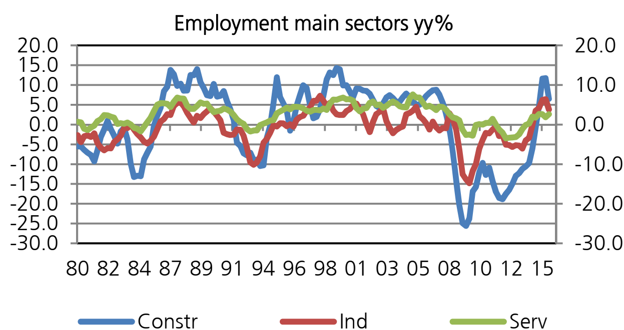
Source: EU Commission (sector indices on hiring intentions as standard deviations from the long-term average) Eurostat, and Intesa Sanpaolo elaborations

Fig. 6 – …on the back of rising inflation, whereas negotiated wages are unlikely to undergo significant increases in 2016



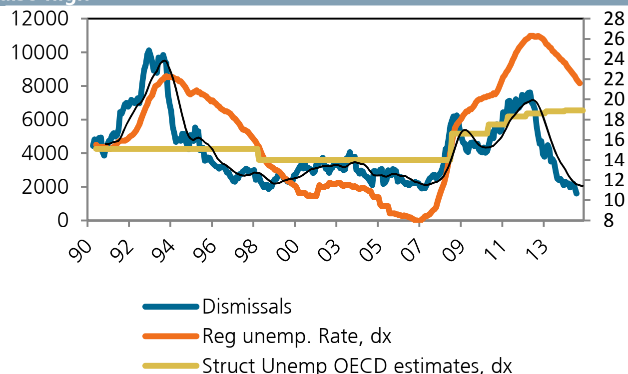
Source: Eurostat, EU Commission and Intesa Sanpaolo elaborations

Fig. 7– Employment growth could slow compared to the recent trend



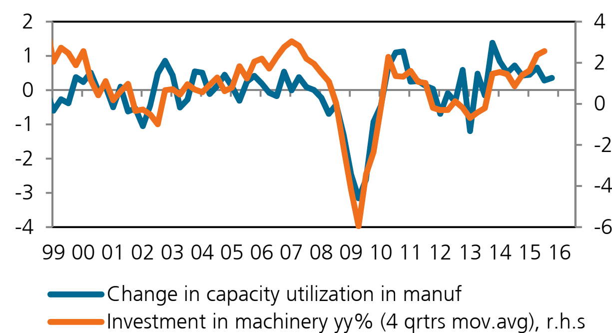
Source: EU Commission, INE and Intesa Sanpaolo elaborations

Fig. 8 – Unemployment falling faster than expected, but still high. The worrying fact is that it structural unemployment is also high



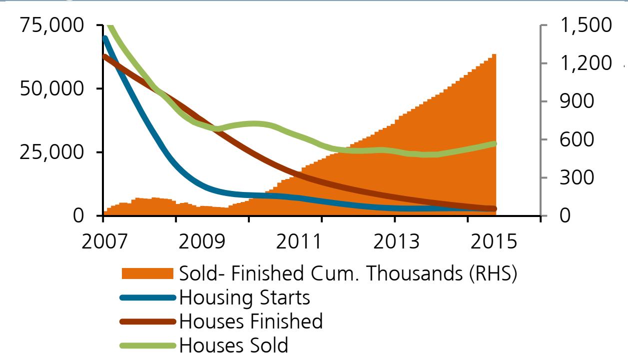
Source: INE, OECD (structural unemployment rate) and Intesa Sanpaolo elaborations

Fig. 9 – Capex in line with a recovery in capacity utilization



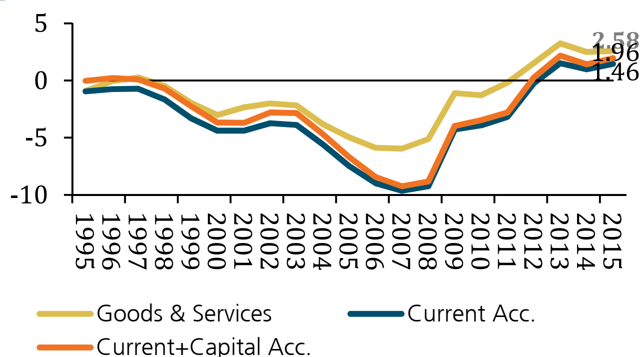
Source: Eurostat, EU Commission and Intesa Sanpaolo elaborations

Fig. 10 – We expect only limited residential investment given the large stock of unsold homes



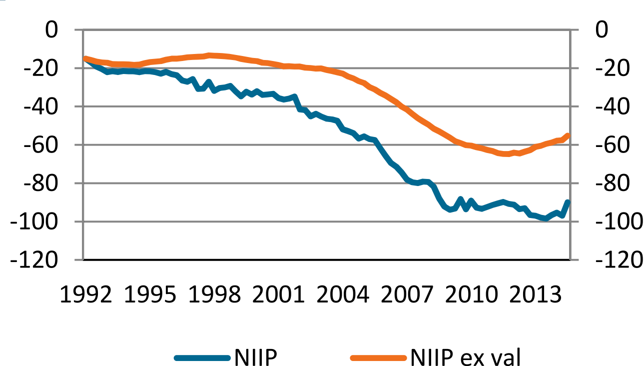
Source: INE and Intesa Sanpaolo elaborations

Fig. 11 – Current account surplus must be preserved…



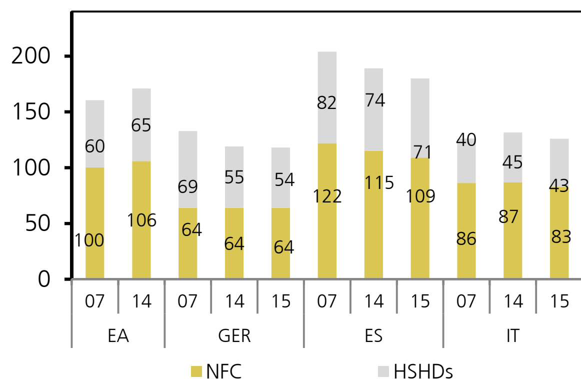
Source: INE, Markit and Intesa Sanpaolo elaborations

Fig. 12 – …given the large net international investment exposure



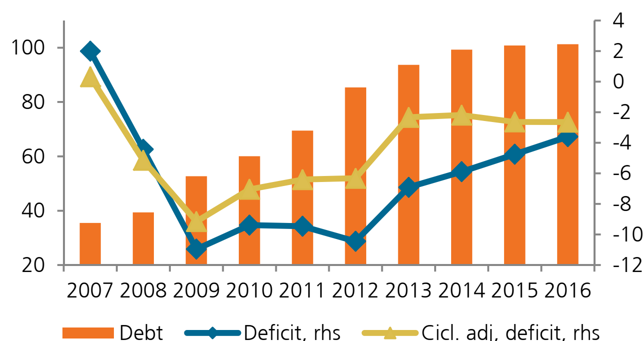
Source: Bank of Spain and Intesa Sanpaolo elaborations

Fig. 13 – Private debt almost back in line with EU average



Source: ECB and Intesa Sanpaolo elaborations

Fig. 14 – It is now the government turn to deleverage



Source: EU Commission and Intesa Sanpaolo elaborations

Forecasts

	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (constant prices)	1.4	3.2	2.7	2.7	3.2	3.4	3.4	3.3	2.8	2.5	2.2
- q/q change				0.9	1.0	0.8	0.7	0.7	0.6	0.5	0.4
Private consumption	2.2	3.1	2.7	0.7	0.9	1.0	0.8	0.7	0.4	0.4	0.4
Fixed investment	1.7	4.7	2.5	0.8	1.4	0.9	0.4	0.4	0.8	0.5	0.5
Deficit (% of GDP)	-5.9	-4.6	-3.0								
Debt (% of GDP)	98.7	100.4	101.3								
CPI (y/y)	-0.2	-0.5	0.8	-1.0	-0.3	-0.4	-0.2	0.4	0.4	0.7	1.7
Unemployment (%)	23.7	20.9	19.5	23.1	22.5	21.2	20.9	20.7	20.2	20.0	19.5
Effective exch.rate (2005=100)	99.4	96.2	95.8	96.6	96.0	96.2	96.1	95.7	95.7	95.9	96.2

Note: percentage changes annualised vs. previous period – unless indicated otherwise. Source: Intesa Sanpaolo

FOCUS: 2015 election to open a new political season

Anna Maria Grimaldi
Giulia Fioravanti

The political elections that will be held on 20 December are the first following implementation of the austerity and imbalance-correction plan that the country has been engaged in since 2011, geared to restoring the financial sector to health and to reducing in part the high public deficit (-10.4% in 2012). The precedent in Portugal shows that the first post-austerity elections may hold surprises, although in Spain's case the political scene is less polarised. Furthermore, the political scenario has changed significantly in the past year. In addition to the traditional "moderate" parties, i.e. the PP and the PSOE, the radical left-wing formations (IU and the Catalan republican leftist ERC), and the *Podemos* populists, the UPD social liberals (*Unión Progreso y Democracia)* have emerged, followed more recently by the anti-establishment liberals of the *Ciudadanos* movement.

The forthcoming general elections on 20 December will almost certainly yield a broad coalition government, the first in the post-Franco era. The risk that the populist party *Podemos* may play a decisive role in Spanish politics has waned significantly, given the loss of popularity incurred in recent months. The likeliest scenario, and the most favourable for the reform process and for the markets, sees the PP winning a relative majority and forming a government coalition with the liberal reform movement *Ciudadanos*.

However, latest polls do not rule out neither a Portuguese-like scenario (with the incumbent party ousted by a left wing coalition) nor a coalitions amongst the two main parties (PP e PSOE). Already local elections last Spring have yielded unusual coalitions with the capital Madrid now ruled by the PSOE and *Podemos*.

La capacità di governo di un esecutivo di coalizione dipende dalle priorità dei partiti che entrano nella coalizione. Nel caso della Spagna, nessuno dei partiti tradizionali né *Ciudadanos* hanno fatto esplicitamente riferimento a possibili coalizioni, che però rappresentano un esito inevitabile. *Ciudadanos* would be firmly against having Rajoy as prime minister. The other aspect to consider in the formation of possible alliances is the extent to which electoral aims are shared. Almost all candidates are stressing the need to consolidate the economic recovery and to reform the welfare system, therefore calling, more or less heatedly, for a public sector reform (*Ciudadanos*)

Table 1 – Spanish elections: the manifesto of the four major parties in a nutshell

Party	Leader	Polls	Election campaign themes	Autonomous communities	Probable effect on reforms
PP	Mariano Rajoy	27%	Tax cuts for households and enterprises Creation of new, permanent jobs Preserve national unity and consolidate the recovery	In favour of maintaining current national unity	+
PSOE	Pedro Sanchez	22%	Reform of the fiscal system guaranteeing greater progressiveness Expansion of the welfare system to embrace all citizens Consolidation of the recovery	In favour of fiscal federalism	+ (limited progress on the front of fiscal consolidation)
C's	Alberto Rivera	21%	Tax cuts for households and stronger incentives for enterprises Simplification of bureaucracy: abolishment of the Provinces Pension reform to a contribution-based system Public sector wage cuts	Consortium formed by the central tax administration and the autonomous communities	+ (limited progress on the front of fiscal consolidation)
Podemos	Pablo Iglesias	15%	Introduction of citizen's income Fight against tax evasion Redefinition of sovereignty with a review of the Lisbon Treaty and an easing of austerity policies Strengthening of state control over banks and financial transactions Abolishment of tax breaks on pension funds	Neutral position, but in favour of a referendum allowing the citizenship to decide	-

Source: Intesa Sanpaolo elaborations

The Netherlands: solid growth for 2015-2016

Guido Valerio Ceoloni

With household consumption strengthening and fixed investment rising sharply, Dutch growth is among the most solid in the Euro zone, despite the fall in natural gas extraction and the third-quarter slowdown. The government's announcement of lower taxes in the coming year has worsened the public accounts situation, albeit only relatively. In contrast, it will give a further boost to the economy.

An upgrade of one-tenth of a point to 4Q growth will not change the 2015 annual average of 1.9%

As anticipated, GDP growth disappointed expectations in the third quarter, rising by only 0.1% qoq. The estimate for the current quarter was upgraded to 0.3% qoq as hints emerged of a stronger contribution by consumer spending. 2015 annual average is still +1.9% yoy. The 2016 forecast of +2.0% yoy is also confirmed. Whereas in the first half of the year investment and exports/imports were the main GDP-drivers, in the second half we think growth was accounted for by consumer spending. For 2016, forecast risks are to the upside but, as usual, there is still the risk of volatility in foreign trade, to which the Dutch economy is more exposed than others European countries.

A golden year for private investment. Consumer spending is also in good health

Private consumption will be the main contributor to GDP in the last quarter, after the summer-quarter stagnation. Employment also grew in the third quarter (+1.0%) and the quarterly vacancy surveys remain positive. Household confidence has improved continuously since the start of the year and is now at its highest level since 2007. Consumer spending, which is already robust in the second half, could accelerate further in 2016 (1.8% yoy), partly for tax burden relief. The government has announced estimated tax cuts of around 0.7% of GDP (EUR 5Bn). The accommodative financial conditions and the government's residential investment policies have provided a huge boost to fixed investment. The sharp expansion in the first two quarters (+2.8% qoq on average) was followed by a natural slowdown in the Q3, and we think that Q4 could stage a repeat of the previous quarter's performance (+0.3% qoq). However, the fixed investment component is forecast to grow, over the year, by 9.1% yoy (the best figure since 2006). For 2016, we expect a (relative) slowdown (+6.6% yoy), producing a different GDP composition, which will be more conducive to capital expenditure.

Foreign trade will remain volatile in 2016, with imports bolstered by consumer spending

After a strong contribution in the first half, foreign trade again suffered from the turbulence in global trade and the recovery of domestic consumption. We therefore expect a zero contribution from net exports at the close of the year. In 2016, imports should continue to report stronger growth (4.6% yoy) than exports (3.6% yoy). Nevertheless, the current account balance is expected to widen from 10.6% of GDP in 2014 to 11.9% this year and to 12.1% in 2016. In our view, the trade balance will continue to improve: it was in surplus by about EUR 51Bn at the end of 2014, by EUR 36.5Bn in September, and should close the year in surplus by around EUR 48Bn. Its contribution to GDP should fall slightly from 7.7% in 2014 to 7.4% in 2015, reaching an expected 5.8% in 2016.

The decision to strongly reduce gas extraction at the Groningen field burdened (-28% yoy) the industrial sector, which is nonetheless in expansionary territory, according to the PMI indices. Energy production has therefore fallen sharply during 2015. For 2016, a decision will be taken by mid-December, but it appears that the extraction limit will be further reduced from 30 million cubic metres in 2015 (already reduced from the initial 33 cubic metres) to 25 million cubic metres. Industrial output was more or less stagnant during the year, after the fall of 2.8% in 2014, but should start to grow again next year (+3.0% annual average). The capacity utilisation rate in the manufacturing sector is therefore on the rise, and has already reached pre-crisis levels (82%): a fact which makes us suppose that investment in industrial machinery will strengthen in 2016. The construction sector remains set fair with confidence indicators at their highest levels, despite the cyclical correction in the summer and the fact that house prices are rising by 5.1%

compared with Q4 2013, straight after the end of the two-year property crisis. However, the high level of household debt is still the main brake on recovery in this sector.

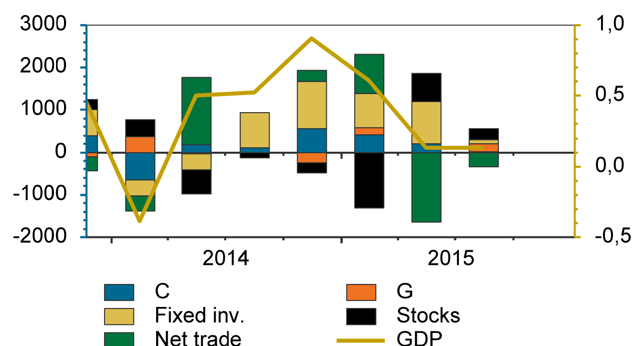
Inflation above 1% in 2016

Inflation should stick at around 0.5% yoy in the last quarter, after recording 0.8% yoy in Q3. The annual average inflation figure is seen at 0.6% (0.3% according to the HICP): the negative contribution of the energy component has more than offset the rise in the core index (driven by the rise in services prices). However, the 2016 estimate of average annual inflation of 1.2% is confirmed.

Lower tax revenues will make it harder to improve the structural balance

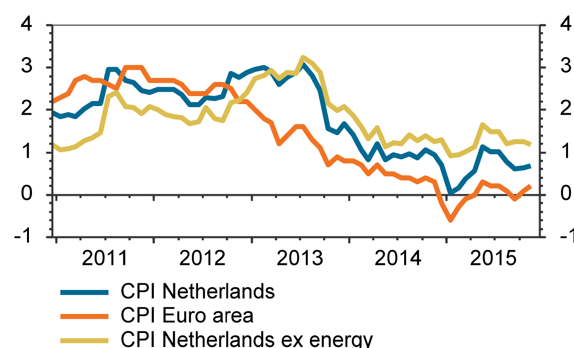
The outlook for the public accounts remains bright, even though the government has eased fiscal policy and suffered the impact of lower tax revenues associated with gas extraction. The deficit is expected to improve to -2.1% (structural deficit: -1.1%) this year, from -2.4% (structural deficit: -0.6%) in 2014, and to -1.5% (structural deficit: -1.5%) in 2016. In 2016, revenues will be further reduced by tax cuts, against which health spending cuts of around 3% of GDP should ensure that targets are met. To this must be added the positive (but as yet unquantifiable) effect of the return to trading on 20 November of the state-owned bank ABN Amro, which should yield around EUR 1.3Bn (0.2%). Public debt is expected to rise from 68.2% to 68.9% this year, before falling back to 68% in 2016. The main risk to the public finance figures is still the impact of the collapse in gas extraction (amplified by the fall in European gas prices of approximately -22% since the beginning of the year).

Contribution to GDP



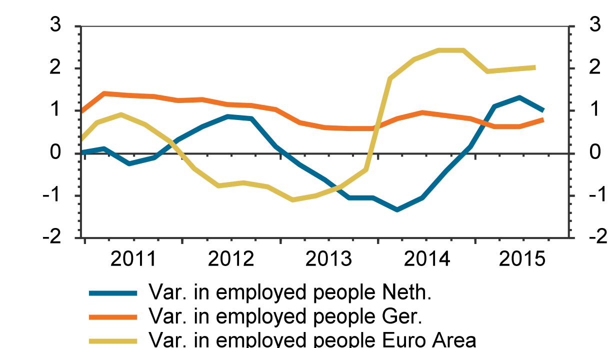
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Inflation (consumer prices)



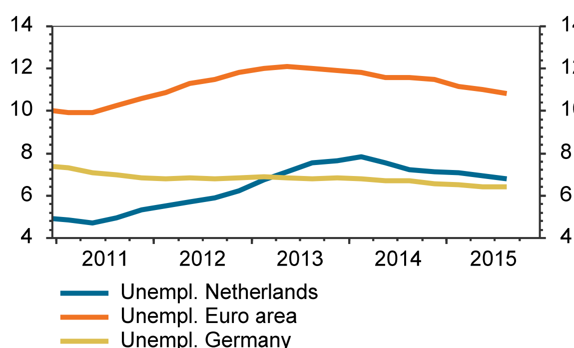
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Employment returns to grow



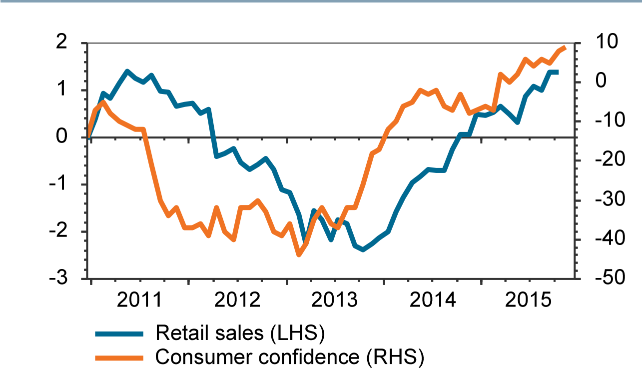
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unemployment low and reducing slowly



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Retail sales and household confidence

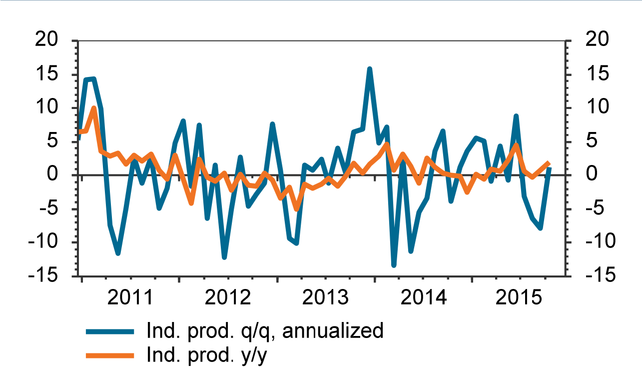


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unit labour cost (yoy)

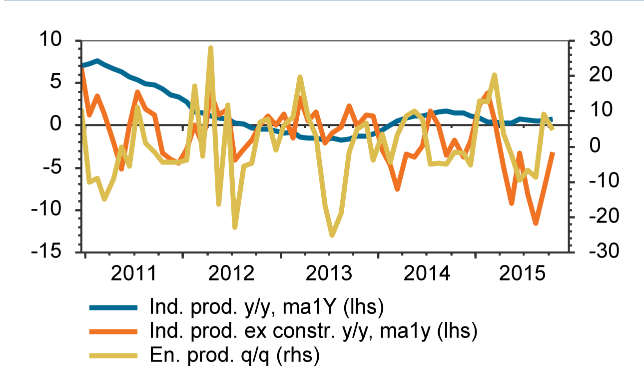
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output (manufacturing)



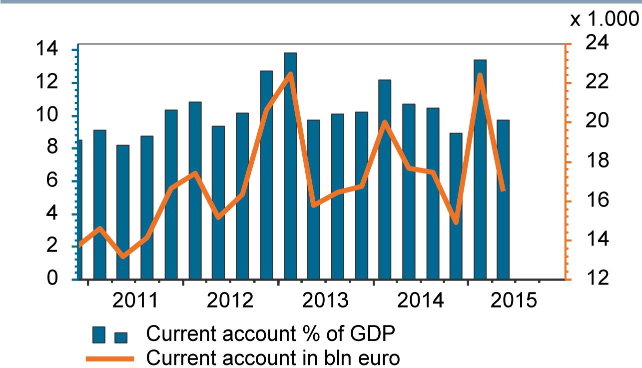
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output and energy production



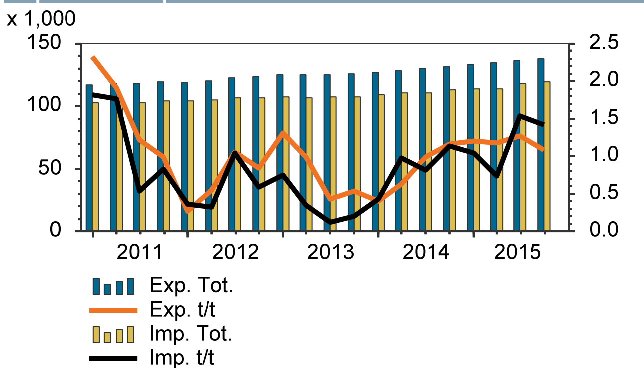
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Current account balance



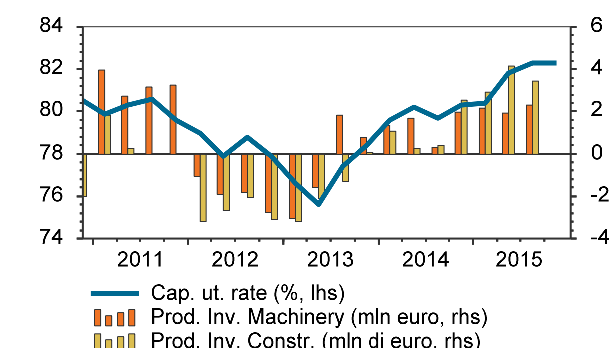
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Exports and imports



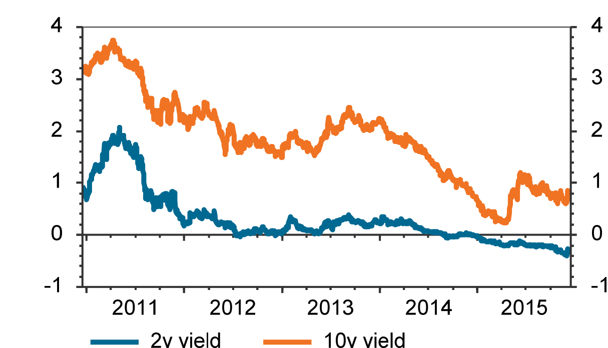
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Capacity utilization rate and investments



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Forecasts

	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (constant prices)	1.0	1.9	2.0	2.6	2.2	1.8	1.2	1.2	1.6	2.4	2.9
- q/q change				0.6	0.1	0.1	0.3	0.6	0.6	0.9	0.8
Private consumption	0.0	1.7	1.8	0.6	0.3	0.0	0.3	0.5	0.6	0.7	0.7
Fixed investment	3.5	9.1	4.9	2.5	3.0	0.3	0.3	1.8	1.1	1.4	1.4
Deficit (% of GDP)	-2.3	-2.1	-1.5								
Debt (% of GDP)	68.2	68.6	68.0								
CPI (y/y)	1.0	0.6	1.1	0.2	0.9	0.8	0.4	0.8	1.1	0.9	1.6
Unemployment (%)	7.4	6.9	6.7	8.9	8.9	8.5	8.7	8.7	8.6	8.6	8.6
Effective exch.rate (2005=100)	112.1	107.6	107.0	108.2	107.3	107.7	107.3	106.6	106.7	107.1	107.6

Note: percentage changes annualised vs. previous period – unless indicated otherwise. Source: Intesa Sanpaolo

Greece: ESM has turned the taps on

Guido Valerio Ceoloni

The economic adjustment programme to reform the financial sector is in full swing, but in a less dramatic environment than initially forecast. The economy is also expected to contract less than expected (-0.4% yoy in 2015, -1.6% yoy in 2016). However, there are still significant political risks, given that the parliamentary majority is slim and mixed, and the 2016 targets set for the third economic programme will be demanding.

The first review was completed late but did not reveal any particular concern[19]. It did, however, release the allocation of the second part of sub-tranche A, of around EUR 2Bn, at the end of November, which will mainly be absorbed by debt service costs and government arrears (the first part, consisting of EUR 13Bn had already been released on 20 August, just after the start of the third aid programme). The remaining EUR 1Bn of sub-tranche A will be allocated on completion of the second review, which is expected, as of now, by early spring. Under the terms and conditions of the summer agreements, if the Greek government wished it, could ask to start debt-relief talks. This would enable the IMF to become involved again in the programme and thus reduce the burden on ESM. Moreover, ESM also released EUR 2.71Bn in December to recapitalise the National Bank of Greece (NBG) and another EUR 2.72Bn for Pireus Bank, which must therefore be deducted from the EUR 10Bn initially estimated for the second bailout plan

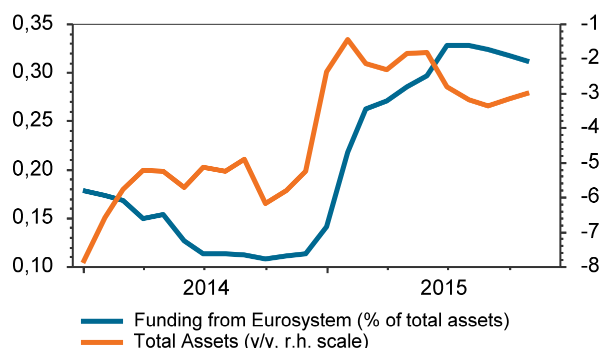
[19] Out of the 49 points of the first review to-do list, only one is still to be ticked off, which relates to the contribution schemes of certain pension funds. This point should also be ticked off by the end of the year.

for the sector. The remaining EUR 4.6Bn necessary to recapitalise NBG and the EUR 4.93 for Pireus Bank have been raised on the market by the two banks themselves. Based on the current payment-schedule, the second sub-tranche for the banks should be allocated (EUR 4.6Bn in total) by the end of January. However, probably only a portion will be allocated, given that, after completion of the stress tests in the financial sector, the picture that emerged was rosier than expected. We must not forget that the recapitalisation of the banking system had been assessed at "only" EUR 14.4Bn; the European Commission's preliminary estimate puts the hole to be plugged at EUR 25Bn.

GDP forecasts were extensively reviewed in 2015: the main positive contributor in 2015-2016 will be foreign trade, while domestic demand will remain depressed (household confidence, according to the European Commission's survey, was on average at -49.7 in Greece this year, compared with a Euro zone average of -6.1, while the European Commission's general economic confidence index was 88.8, compared with a Euro zone average of 104.1). Growth at the end of the third quarter was -0.1% yoy and, barring downgrades to the third-quarter data, we think the economy is heading for a contraction of -0.4% yoy in 2015, from +0.7% yoy (the consensus sees a figure of -1.1% yoy and the European Commission's estimate was -1.4% yoy in November). The deterioration in activity levels in the third quarter, despite signs of recovery had begun to appear in the second quarter, was not as bad as expected. The fourth quarter is set to close with a figure of -0.5% qoq, from -0.9% qoq. For 2016 we forecast a contraction of -1.6% yoy, less than the consensus average (-1.8% yoy) but not less than the European Commission's estimate (-1.3% yoy), although the latter's estimate factors in a worse profile for the current year.

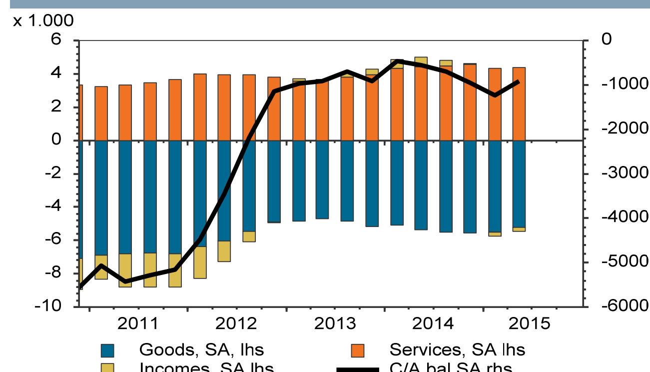
Turning to the country's debt position, we must remember that, at the moment, Greece's repayment schedule is focused only in the interest burden, as the window for repayment of the principal starts in 2020 and ends in 2054 for the Greek Loan Facility (around EUR 53Bn), the first bailout programme (around EUR 25Bn), the second bailout programme (around EUR 48Bn), the first banking recapitalisation package (around EUR 12Bn) and marketable debt (around EUR 46Bn), totalling EUR 184Bn. The window for repayment of the principal to the IMF started this year and will end in 2024 (around EUR 25Bn). This calendar does not yet include the new sum of EUR 86Bn and, potentially, a new aid-package from the IMF. It is therefore clear that the sustainability of such a high level of debt, as is the case for Greece, could only be ensured by highly favourable combinations of interest rates and an appropriately extended repayment schedule. Based on the latest projections of the European Commission and the IMF, the debt/GDP ratio, in a best-case scenario, will fluctuate between 138% and 165% of GDP in 2020, although with a very low average cost. For the time being, therefore, the restructuring of Greece's public finances is progressing better than expected; the primary surplus in October had improved to EUR 4.5Bn, from EUR 3.1Bn in September, some EUR 2.4Bn higher than the figure in the budget (EUR 2.1Bn). October's requirement was EUR 0.8Bn, down from the figure of EUR 1.9Bn in September. In this scenario, apart from the mountain of debt, the main downside risk to the forecast horizon remains political: the consensus still thinks there is a high probability of a "Grexit" from the Euro zone, although it now assesses this at around 45%. We must not forget that the government's majority is very small (158 out of 300 seats) and politically mixed, and next year's programme includes significant structural corrections, which will have to be carried out with very little room for manoeuvre. We would not, therefore, rule out new tensions in the year ahead if the programme were to come to a standstill. Positive risks to the scenario and to growth at the turn of the year, however, could be the full use of the European structural funds and the government's ongoing payments of overdue debts to the private sector.

The financial system's exposure: at end-October, the sector's liabilities were EUR 382Bn, 31% of which are to the Eurosystem



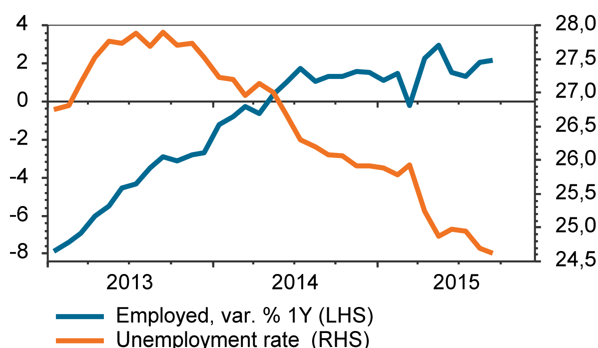
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Current SA account balances



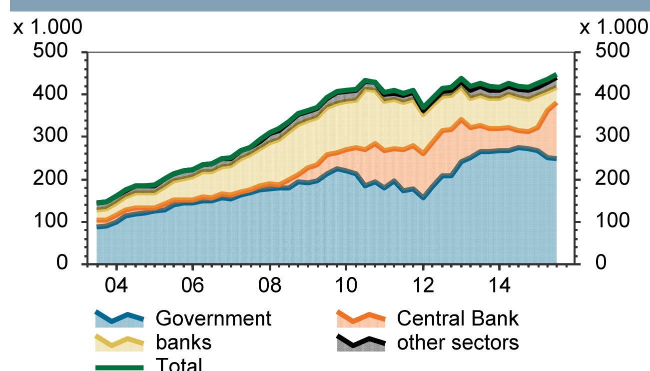
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unemployment is falling from its 2013 peaks but remains at high levels



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Gross external debt



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Portugal again "under observation" by the markets

Guido Valerio Ceoloni

Following the general elections held in October, an alliance of left-wing parties, headed by Antonio Costa, concluded a formal agreement which brought down the government in power, and were therefore invited by President Silva to form a new government. The 2016 budget is expected to fulfil the commitments undertaken with Brussels, but at the same time will seek to relax the deadlines for fiscal consolidation. Growth is expected to be 1.5% in 2015 and 1.7% in 2016.

After receiving a mandate to form the new government from the outgoing President of Portugal, the Socialist Party leader, Antonio Costa, found himself facing his first challenge to hold together the coalition, namely defining the 2016 budget, a process which at the moment is still ongoing. The political alliance between the Socialist party and the Communists is unprecedented in Portugal: clearly, **the distance between the Socialists and the radical Left, in ideological terms, represents a burden on the new majority.** Conversely, this is the radical Left's best opportunity in its history to influence the programme of a government in power. Both the Communists and the Left Bloc (*Bloco de Esquerda*) are adopting a responsible attitude at this stage, and have only claimed three conditions for their support to the government: the ending of privatisations, the safeguarding of the social status and the protection of salaries and workers' rights (a chapter which also includes the cancellation of salary cuts and the re-introduction of index-linked pensions). Compliance with these conditions will ensure that external parliamentary support is provided. Debt-restructuring was not one of the conditions for

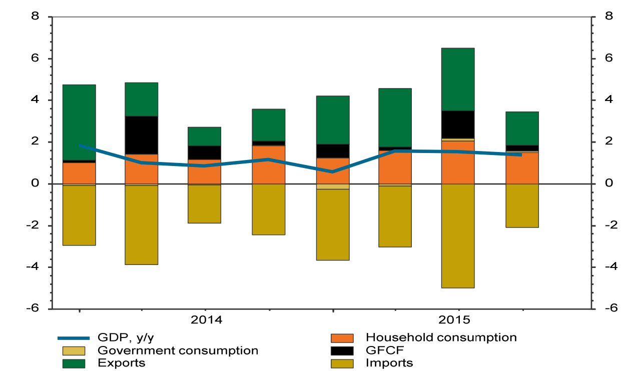
giving government support. Therefore, the 2016 budget will be a test of the coalition's ability to match the objective of achieving the budget balance with the claims of the radical Left. If the price to be paid for a compromise is only the slowdown of the fiscal consolidation process, the situation will be manageable. At the moment, we think this is the most likely scenario. If, however, the path to financial consolidation would be called into question, a darker scenario should materialise. Nevertheless, the Socialist Party, which has a moderate tradition and has experience in government, knows that the country must get to grip with its large funding requirement: gross issues of around EUR 20Bn in 2015, together with issues of retail bonds totalling EUR 3.8Bn, should enable the IGCP (Portuguese Treasury and Government Debt Agency) to close the year with cash and cash equivalents of around EUR 8Bn. In 2016, the funding requirement is estimated at some EUR 20.2Bn, of which EUR 7Bn is for bond maturities and EUR 10Bn for early repayments to the IMF, which were to have been paid for from privatisations totalling EUR 2.7Bn and debt issues worth EUR 18Bn (including Portuguese government bonds (OTs) of EUR15Bn). At the moment, the market believes that the government will hold up, and the main rating agencies have not changed their ratings outlook. Rating agency DBRS still plays a crucial role. In November it confirmed Portuguese bonds as investment grade, which means that the country's issues are still appropriate for the ECB's QE programme.

The macroeconomic scenario does not give any particular cause for concern. Despite a stagnant third quarter, growth was 1.4% yoy, and the last part of the year should see a further increase of 0.3% qoq, bringing the annual average for 2015 to 1.5%. In 2016, we expect growth to accelerate to 1.7%, in line with consensus estimates. Domestic demand will be the main growth driver, thanks to consumption and investment. However, foreign trade is likely to make a negative contribution; this is a problem for a country that needs a robust current account surplus to improve its net financial position, while the current account balance is expected to remain stable in 2015-2017 at levels just above zero. The labour market is on track for recovery, with unemployment expected to fall this year to 12.6%, from 14.1% in 2014. A further improvement will be seen in 2016.

Risks to the forecast include the fact that the positive consequences of an smoother path to correcting the public accounts is actually an unexpected tax stimulus for next year, which could, therefore, represent an upside risk to the GDP. Downside risks include the high level of private sector debt, especially among non-financial companies; although this has fallen in the last two years, it is nevertheless still very high (around 130% of GDP). Overall, the country's total debt (public and private sector), estimated at around 370% of GDP, is among the highest in Europe.

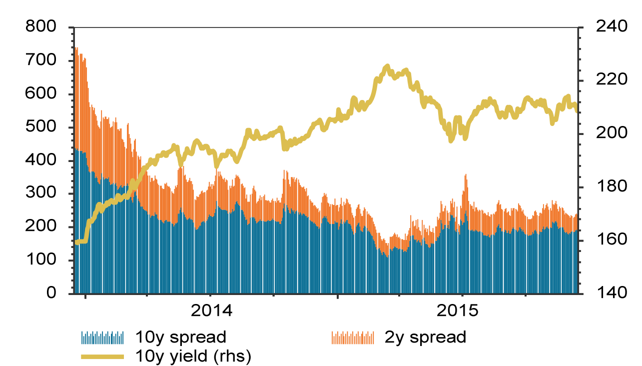
This year, the public sector deficit should fall to 2.9-3.0% of GDP, thus creating the conditions for exiting the European Commission's excessive deficit procedure. Moreover, according to the European Commission's autumn estimates, barring any changes to legislation, next year's deficit is likely to be 2.9% of GDP, or EUR 5.1Bn. In the absence of any strong measures to restructure the public accounts, the structural deficit should widen by half a point in 2016 to -2.3%, from -1.8%, and remain broadly stable in 2017 (-2.4%). Lastly, total public debt is likely to fall as early as this year to 128%, from 130% in 2014, and maintain its downward trajectory in 2016 (125%) and 2017 (121%). The relative size of Portuguese public debt and the rather low level of nominal GDP growth leaves the level of debt vulnerable and exposed to risks.

GDP shored up by domestic demand and the rebound in investments



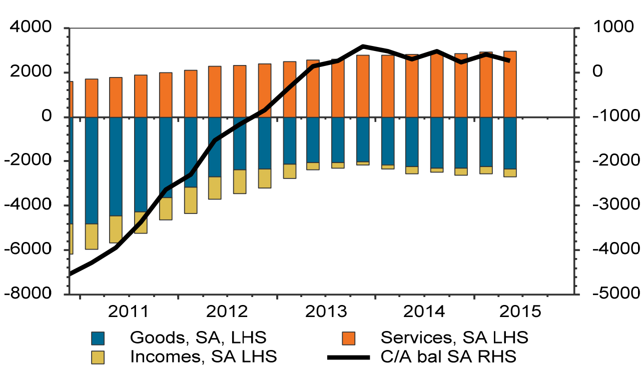
Source: Thomson Reuters-Datastream

Ten-year yields have not suffered greatly from the political turmoil, as things stand



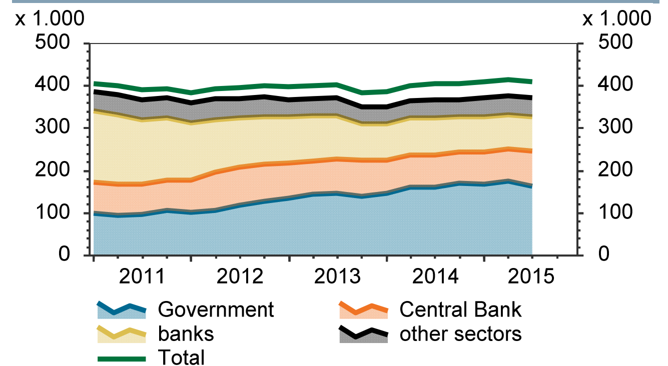
Source: Thomson Reuters-Datastream

Current account balances SA



Source: Thomson Reuters-Datastream

Gross external debt



Source: Thomson Reuters-Datastream

Asia

Japan: the return of Abenomics

Giovanna Mossetti

The outlook for the Japanese economy is moderately positive in the short term. Our 2016 forecasts include moderate growth in private demand, underpinned by fiscal policy. The economy is at full employment and monetary policy is of limited effect. The budget for fiscal 2016 is expected to introduce reforms aimed at supporting potential growth in the medium term (labour market, deregulation, cutting red tape), as well as short-term measures. The relatively benign scenario in 2016 (GDP growth of 1.2%) is expected to give way to a sharp slowdown in 2017 due to the expected hike in consumption tax. Subsequently, growth is likely to settle closer to potential, unless the Abenomics reforms succeed in altering the medium-term scenario.

Growth still above potential in 2016

The Japanese economy has returned to a path of moderate growth after contracting in the second quarter. GDP grew by 0.3% qoq in the third quarter, reflecting a 0.3% qoq increase in private domestic demand (up 1.6% yoy). Despite contracting in the spring, GDP has continued to grow above potential (approximately 0.5%, according to the BoJ). The output gap is expected to close by the start of next year.

Fiscal policy: Abenomics 2.0 on the way

Monetary policy on standby

In 2016, the focus will be on fiscal policy. The government has announced the launch of the "Abenomics 2.0" programme of reforms, which includes three new policy "arrows" aimed at implementing structural reforms to support potential growth. To these will be added short-term stimulus measures with a supplementary budget for the current fiscal year. The budget will therefore carry more weight in the scenario, after a year of relative fiscal neutrality. For the time being, monetary policy is on standby. However, the BoJ's repeated deferment of the forecast timing to hit the 2% inflation target means that further measures cannot be ruled out.

An increase in aggregate savings has been a feature of the scenario in the last two years, despite negative real interest rates. Households are preparing for fiscal tightening, businesses are cautious due to the uncertainty of final demand and the public sector aims to reduce the deficit to stabilise the debt. This trend is likely to continue in 2016, slowing the upside adjustment in inflation, but will be mitigated by fiscal policy measures.

Moderate growth in consumption before the next round of fiscal tightening in 2017

Consumption. The contraction in the second quarter, partly due to weather conditions, was followed by a moderate upturn. Consumption forecasts have been influenced by two opposing factors: one positive, relating to employment income, and the other negative, relating to permanent income. With regard to employment income, there has finally been a moderate rise in wages (see fig. 5), which we expect to be boosted by the increase in the minimum wage recently announced by the government. On the other hand, however, since consumption tax was raised in 2014, households have significantly reduced their propensity to save (see fig. 6). This change is at least partly structural, given that, in 2017, the government plans to implement the second hike in consumption tax, from 8% to 10%. Consumption is expected to grow at a moderate rate in 2016, driven by the labour market and the energy bonus, but will be curbed by expectations of another negative fiscal shock in 2017. The forecast for 2016 is consumption growth of 1.6%, after a decline of 0.8% in 2015.

Non-residential investments picking up slightly, partly due to fiscal stimulus

Non-residential investment. Substantial depreciation in the currency since late 2013 has given a significant boost to corporate earnings (see fig. 3). Expectations that part of this earnings growth would be transferred to wages and investments have been largely disregarded. Wages have only recently registered a slight acceleration (in part due to strong pressure from the government). With regard to investments, business confidence has recovered slightly (see fig. 2), strengthened by an improvement in orders and production in the autumn. Capital spending is expected to pick up some speed in the fourth quarter and in 2016, helped by expectations of expansionary fiscal measures, but the pace is likely to remain subdued (+0.8%).

Net exports approximately neutral

Imports and exports. The exchange rate is not enough to boost exports: in this cycle, the elasticity of exports in response to exchange rates has been abnormally low. Since late 2012, the real effective exchange rate has depreciated by around 35%: the IMF estimates that exports were 20% lower in mid-2015 than would have been expected given the depreciation of the past three years. Export prices have remained broadly stable, with a strong increase in exporters' profits. The transfer of the exchange rate effect to export prices has decreased from around 85% in the 1980s to around 50% in this cycle. Moreover, the spread of "global value chains", with imports representing an increasing proportion of domestically-produced goods, has further reduced the price elasticity of exports in response to exchange rates. Added to these structural factors is the slowdown in the emerging Asian economies. Until now, exports to the US have, to a great extent, compensated for the weakness of exports to China (see figs 7 and 8); stabilising growth in emerging Asia is expected to lead to a recovery in overall exports, which are forecast to grow by 4.7%. Imports should increase by 3.8%.

Measures to increase labour force participation and support for industry are in the pipeline

Fiscal policy. Now that the objective of the Abenomics programme (eliminating deflation) has been achieved, the government has announced "Abenomics 2.0", which has three policy "arrows": GDP **growth** (to JPY 600Trn from JPY 500Trn in 2015); **demographic growth** (a birth rate of 1.8, compared with 1.5 currently) through children's services; and **labour force participation** through measures to support the elderly. The government will also implement measures to counteract the restrictive effects of the approval of the Trans-Pacific Partnership, deferring the target for curbing spending on subsidies for local entities (around JPY 15Trn from total spending of JPY 99Trn), social security and health. The supplementary budget is expected to supply around JPY 3Trn (0.6% of GDP) in additional support.

Inflation target hard to reach in 2016, BoJ waiting for information

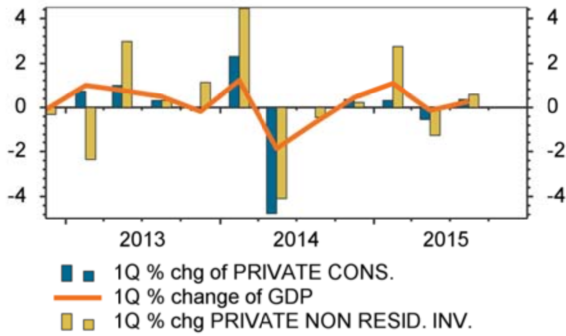
Monetary policy. The inflation target of 2% is still a long way off. In the last few months, the BoJ has gradually shifted its focus to the measurement of inflation excluding food and energy, which is still stable at less than 1% yoy (0.7% yoy in October). The central bank will remain on standby until mid-2016, awaiting developments in growth, and, most importantly, in wages. If inflation remains frozen at around 1% in the middle of next year, the BoJ may reconsider an increase in monetary stimulus to strengthen the economy before the fiscal shock.

Forecasts

	2014	2015	2016	2015				2016			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	-0.1	0.7	1.2	-1.0	0.7	1.7	1.4	0.7	1.2	1.3	1.6
q/q annual rate				4.4	-0.5	1.0	0.8	1.6	1.3	1.7	1.8
Private consumption	-1.0	-0.7	1.6	1.2	-2.1	1.5	2.4	1.6	1.2	2.3	2.4
FI - private nonresidential	2.8	1.0	0.8	11.4	-4.9	2.3	1.3	1.1	0.8	0.2	1.9
FI - private residential	-5.0	-2.3	2.9	8.0	10.4	8.1	0.1	0.5	0.6	4.2	8.4
Government investment	0.2	-0.8	-2.8	-7.8	13.7	-5.8	-3.6	-3.6	-3.7	-3.3	-3.3
Government consumption	0.1	1.0	0.2	0.9	1.7	1.1	-0.1	0.0	0.0	0.0	0.0
Export	8.3	3.4	4.7	8.0	-16.0	11.1	7.0	5.3	4.9	4.9	4.9
Import	7.2	0.9	3.8	7.1	-10.1	7.0	5.2	3.7	3.7	5.1	5.6
Stockbuilding (% contrib. to GDP)	-0.1	0.4	-0.1	0.5	0.4	-0.3	-0.3	0.1	0.1	0.1	0.0
Current account (% of GDP)	0.5	3.1	2.8	3.2	3.4	2.9	3.1	3.0	2.9	2.8	2.5
Deficit (% of GDP)	-7.7	-7.1	-6.4								
Debt (% of GDP)	226.1	228.3	231.6								
CPI (y/y)	2.7	0.7	0.3	2.3	0.5	0.2	0.0	0.1	-0.1	0.2	0.9
Industrial production	2.1	-1.0	1.1	6.4	-5.6	-4.8	1.6	2.5	2.8	3.3	3.7
Unemployment (%)	3.6	3.4	3.3	3.5	3.3	3.4	3.3	3.3	3.3	3.3	3.4
JPY/USD	105.9	121.1	126.7	119.2	121.4	122.2	121.8	126.1	127.6	127.1	125.8
Effective exch.rate (1990=100)	134.0	125.8	121.1	127.1	125.3	124.7	126.0	123.3	120.8	120.1	120.3

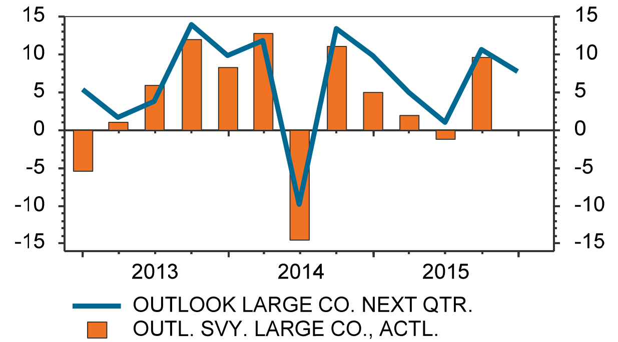
Note: annualised percentage changes on the previous period - except where otherwise indicated. Average values for the period.
Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth recovers in the summer



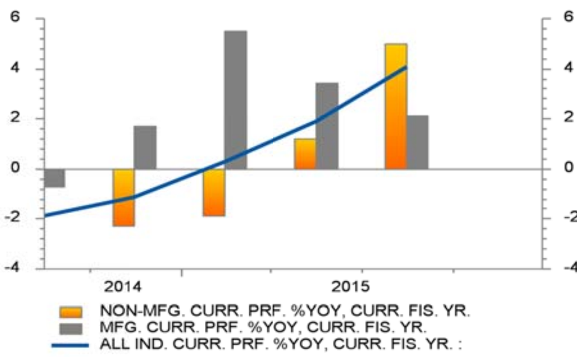
Source: Thomson Reuters-Datastream

Fig. 2 – Businesses see an improvement



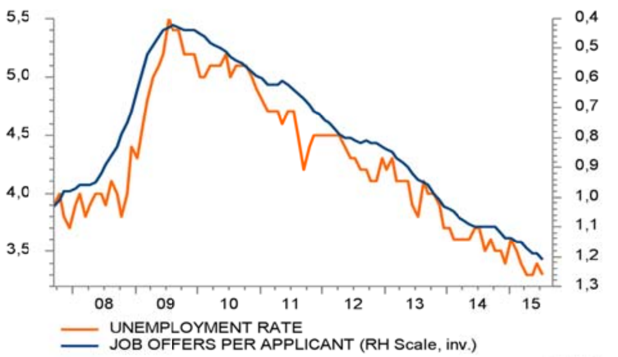
Source: Thomson Reuters-Datastream, Ministry of Finance survey.

Fig. 3 - Company earnings are up



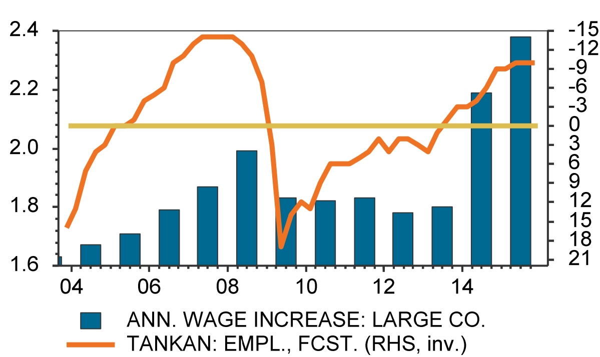
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment is falling



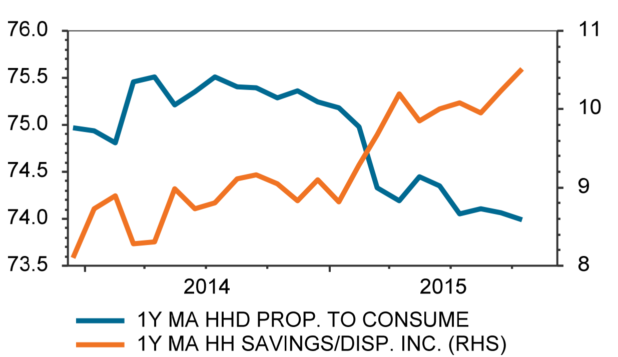
Source: Thomson Reuters-Datastream

Fig. 5 – Wage growth is accelerating…



Source: Thomson Reuters-Datastream

Fig. 6 – …but the propensity to save is growing

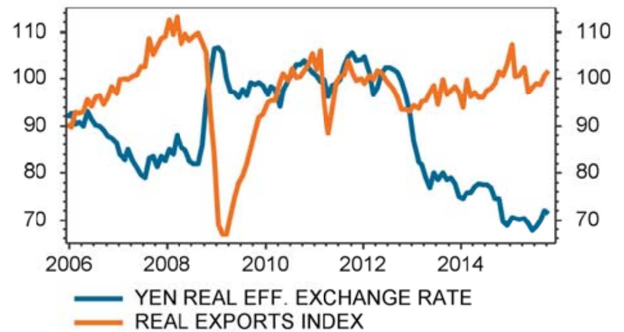


Source: Intesa Sanpaolo chart based on Cabinet Office data

Fig. 7 – Exports to the US are no longer making up for Chinese weakness

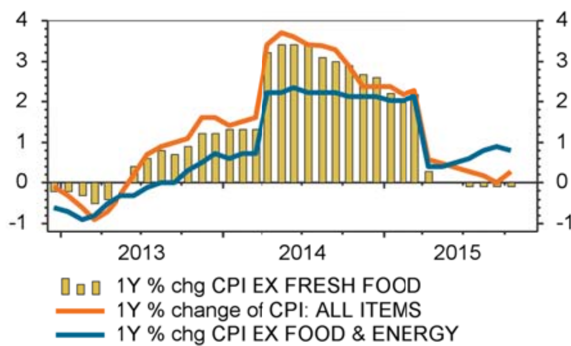
Source: Thomson Reuters-Datastream

Fig. 8 – Exports react very little to exchange rate depreciation



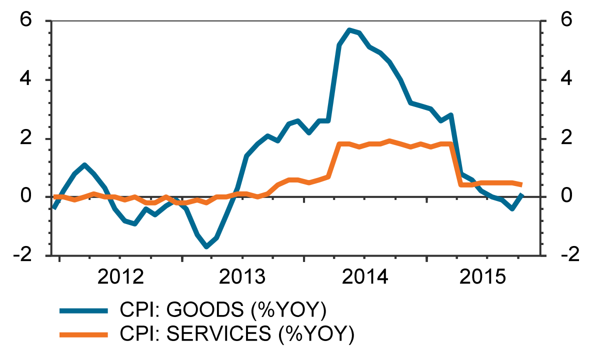
Source: Thomson Reuters-Datastream

Fig. 9 – Core inflation just under 1% yoy



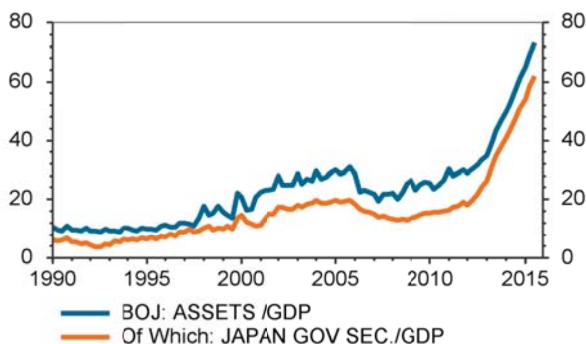
Source: Thomson Reuters-Datastream

Fig. 10 – Deflation is over, but the 2% target is still a long way off...



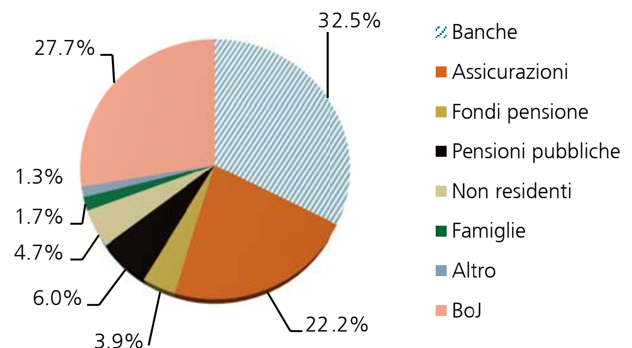
Source: Bloomberg

Fig. 11 – Meanwhile, the BoJ buys JGBs...



Source: Thomson Reuters-Datastream

Fig. 12 – ... and frees up the banks' balance sheets



Figures at end-June 2015; total JGBs: JPY 885.3Trn
Source: Ministry of Finance

China: signs of apparent stabilisation

- In the third quarter, GDP rose by 6.9% yoy compared with 7% in the two preceding quarters, with quarterly growth stable versus 1.8% qoq in the second quarter. The figures show a slight slowdown in the industrial sector, which was offset by the resilience of the services sector. The PMI indices also performed better in the services sector – despite the slowdown during the year – than the manufacturing sector, and recorded a slight increase in October-November compared with September's lows. While the profits of industrial companies recorded their ninth yoy fall in a row (-2% yoy in October) and the number of loss-making companies is rising continuously, a breakdown by industry shows a mixed picture: heavy industry is suffering intensely, while sectors referred to by the government as "new sectors" (e.g. pharmaceuticals, biological products, mechanics and specialist electronics) are reporting double-digit profit growth. Monthly real activity indices prepared by Bloomberg show that, while traditional industry (metallurgy, energy - particularly government-controlled - and building) continue to slow, new industry relating to IT, renewable energy and consumer goods has shown moderate growth compared to the summer lows (fig. 2).

- In cumulative terms, industrial output growth remained stable at 6.1% cum yoy in October and November, and showed month-on-month improvements in the last three months. After its October low (5.6% yoy), it rose by 6.2% yoy in November, before returning to August growth levels (6.1% yoy) thanks to a sizeable base effect and a jump in the production of state-owned enterprises (fig.1). Despite this improvement, signs of fragility still remain. Total new orders fell in both manufacturing PMI surveys in November. A breakdown of the PMI by the National Bureau of Statistics (NBS) confirms that SMEs are in considerable difficulty compared with large companies: the index for SMEs has been below 50 since August and fell to its lowest level since 2012 in November, while for large companies it improved and remained at around 51. The business confidence index prepared by the NBS fell in the third quarter to below its end-2014 lows; similarly, the PBOC's survey of industrial firms came out at under 50, and below the 2008 lows.

- Exports are still weak and continuing their downward trend (-5.8% 3m yoy in November), dragged down mainly by the decline in exports to the Euro zone and Japan (the countries where the stronger exchange rate has penalised China the most) but also, more recently, by exports to the US and the ASEAN countries. The improvement in foreign orders indicated by the PMI Markit survey, which has been above 50 since October, is not reflected in the Statistics Office's PMI. Foreign orders are anyway still weak and are declining in the whole of Asia, with the exception of Japan and Singapore. Domestic demand has shown some signs of stabilising. The fall in imports (-16.3% 3m yoy) is still affected by commodity prices (fig. 3) but the picture is less bleak if we look at volumes. Although still broadly flat compared with last year, imports of metals, minerals, oil and derivatives have improved slightly since the summer lows (fig. 4), while imports of cereals and soybean are rising considerably. Machinery imports are still falling, but production has remained stable.

- New investment, which has been rising since the lows recorded in September, shows that total fixed investment has picked up in annual terms, although the cumulative growth rate was unchanged in October-November (10.2% cum yoy). Investment in transport and storage infrastructure declined due to the sharp slowdown in investment in the rail network but, in the autumn, the State Council approved other projects relating to railway and street construction, and in the energy and water conservation sectors. Conversely, investments in the agricultural sector and, to a lesser extent, the industrial sector increased thanks to the moderate rise of investment in the construction sector. Investment in manufacturing is edging up slightly (+8.4% cum yoy vs 8.3% in September and October) after months of slowing growth, probably driven by the state sector. Investment in property development and residential building is continuing its downtrend despite the improvement in property transactions in first- and second-tier cities. However, floor space started and land purchases are falling. The government announced at the annual China Economic Work Conference that

it will introduce new measures to support the property market in 2016. The aim of these measures will be to reduce the stock of unsold property (both residential and commercial) and convert commodity building into social housing construction. Although these measures will help to prevent a new fall in property transactions, we think the level of unsold housing stock is still high compared with market demand, leaving the outlook for the sector still bleak. We have therefore not changed our forecast of a further slowdown in investment in the property sector in 2016.

- New total social financing fell again by 8.8% cum yoy in November, mainly due to foreign currency loans, company loans and trust loans. New bank loans slowed slightly from their July peaks but are still rising compared with the first half of the year. Growth in the stock of total social financing was broadly the same as in June (11.5% yoy in November vs 11.6%) while bank lending stock rose (to 14.9% vs 13.4%). This was also affected by the granting of loans to brokers to support the stock exchange in the summer, as well as overseas loans and household loans, given that corporate loans are slowing slightly. Monetary conditions continued to improve in the third and fourth quarters thanks to another two cuts to interest rates and the reserve requirement ratio (August and October), the stability of real interest rates, the fall in long-term interest rates (approx. 30 basis points on the 10-year government bond yield since the end of September) and the slight depreciation of the effective exchange rate. Recent factors to be added to these include a cut in rates on operations under the pledged supplementary lending facility (PSL) and a 10-basis-point reduction in the 7-day repo rate, together with an increase in the amounts of the supplementary window and credit asset refinancing operations (relending) to SMEs and agriculture, which will be achieved by the extension of the pilot programme to new provinces and municipalities from mid-October. The PBOC's survey of financial institutions shows a marked improvement in the Monetary Policy Sentiment Index. Nevertheless, demand for loans by customers, as measured by the Loan Demand Index, is declining dramatically and has dropped below the lows of 2009 and 2012 (fig. 6). Non-performing loans are continuing their upward path (+55% yoy in the third quarter, equal to 1.59% of the total).
- After peaking at 2% in August, consumer price inflation fell to a low of 1.3% in October, due to the slowdown in food price rises and falling transport prices. It then rose again to 1.5% in November, driven by the rebound in vegetable prices and health spending. Production prices fell for the 45th month in a row (-5.9% yoy), dragged down by the drop in commodity prices. Weekly prices of vegetables and pork stocks continue to indicate signs of upward pressure for the food sector, which will be compounded by the seasonal increases associated with the Chinese New Year (7-13 February). The slowdown in commodity and transport prices will partly offset these factors, which will also include increases in administered prices following the liberalisation of prices in certain product categories announced in early November. We forecast a moderate rise in inflation in 2016, particularly in the second half of the year, before it reaches an annual average of 1.8%, up from 1.4% in 2015.
- Private consumption maintains a positive trend. Retail sales rose by 11% yoy in real terms in November, up from their low of 10.4% yoy in August, due party to the rebound in car sales, boosted by the cut in purchase tax from 10% to 5%, in October, for cars with small engines. Online sales continue to grow at a sustained (nominal) rate of 33%. Consumer confidence has stabilised after the August lows. Labour market indicators are still positive but are falling slightly. Salaries are growing strongly once again, although they have been slowing for the last three quarters (9.1% yoy in Q3) after years of double-digit growth. Cargo and passenger transport figures show a considerable increase in passenger rail transport but a sharp slowdown in cargo transport. The latter is also borne out by the transport figures from the major ports.

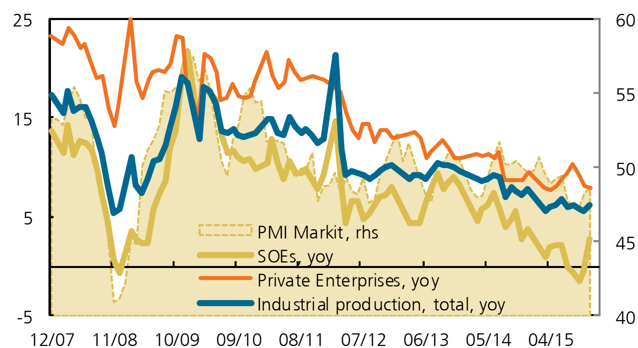
- On 30 November, the IMF approved the renminbi's entry into the SDR basket from 1 October 2016. The currency will hold a weighting of 10.92%, while those of the euro and sterling, in particular, will be reduced. Given the marginal use of SDR as an official reserve, we think the currency's inclusion in the basket will not lead to a significant increase in demand for the renminbi but will force the government to push ahead with its reforms for the liberalisation of the financial market and a further gradual opening of the capital account. The reform of the currency in August and the full liberalisation of lending rates (including on the very short part of the curve from October), are steps in the right direction – along with the increase in issues of three-month bonds – to create a benchmark rate which is now necessary for calculating interest on the basket share. The central bank also reiterated its intention to develop an interest rate corridor on the short part of the curve (repo rate and SLF rate on the one hand, and MLF, PSL and relending operations rates on the other) in order to reduce volatility in money market rates, cut the cost of market operations and at the same time improve monetary policy transmission. More recently, the PBOC announced it would publish an effective exchange rate index based on a basket of currencies, in line with the international practice of other central banks, in order to provide better information to the markets beyond the CNY/USD exchange rate. Despite the 5% depreciation against the dollar in the last two years (3% of which was between July and end-November), the renminbi in fact appreciated in real exchange rate terms by around 11%. We therefore expect a slight depreciation against the dollar, which will limit a further appreciation in the effective exchange rate.
- The Chinese authorities will forge ahead with the structural reforms outlined at the Third Plenum in 2013 and reiterated recently in the guidelines for drafting the Thirteenth Five-Year Plan (2016-20) published in the autumn. The guidelines stated that intervention to support monetary and fiscal policy will continue to be aimed at the "new sectors" and consumers, which will produce lower but more sustainable growth that is not likely to go below 6.5%, enabling the country to achieve its target of doubling GDP in 2020 compared with 2010 (more details on the figures will be published in spring). We therefore think that non-performing loans will continue to dampen lending growth in the next two years despite the further easing of monetary policy that we expect next year. 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. We therefore maintain our growth forecasts unchanged at 6.8% in 2015 and 6.3% in 2016 with a slight deceleration to 6.1% in 2017. Risks to the medium- and long-term outlook remain to the downside.

China - Macroeconomic forecasts

	2011	2012	2013	2014	2015S	2016P	2017P
GDP (constant prices)	9.5	7.7	7.7	7.3	6.8	6.3	6.1
Private consumption	11.6	9.7	7.9	8.4	7.2	6.9	6.8
Public consumption	11.7	3.6	4.1	3.4	4.2	6.1	6.3
Capital investment	8.1	8.8	9	6.9	5.2	4.5	4.4
Exports	13.9	6.3	9	5.8	-2.6	3	5.9
Imports	17.3	6.9	11.6	6.6	1.2	4.1	4.6
Industrial output	10.6	8.2	7.9	7.3	5.9	4.8	4.5
Inflation (CPI)	5.4	2.6	2.6	2	1.4	1.8	2.2
Unemployment rate (%)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Average salaries	16.8	14.4	11.8	9.8	8.1	7.1	6.8
90-day interbank rate (average) (%)	5.3	4.6	5	5.1	4.1	3.1	3.1
USD/CNY exchange rate (average)	6.46	6.31	6.15	6.16	6.29	6.55	6.45
Current account balance (CNY Bn)	874	1360	912	1358	2083	1683	1317
Current account balance (% of GDP)	1.8	2.5	1.6	2.1	3.1	2.3	1.6
Budget balance* (% of GDP)	-1.7	-2.7	-3.8	-3.8	-4.1	-4.5	-4.2

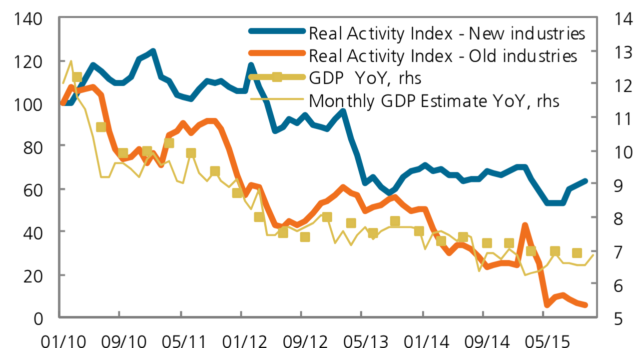
NB: Percentage change versus previous period except where otherwise indicated; *IMF Article IV 2015 estimates
Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Fig. 1 – Industrial output stabilises



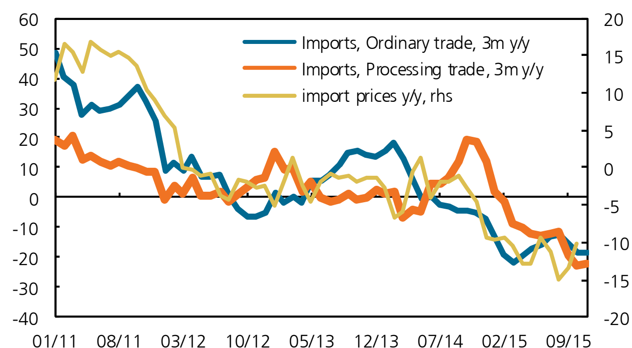
Source: CEIC, Markit

Fig. 2 – New industry mitigates the slowdown



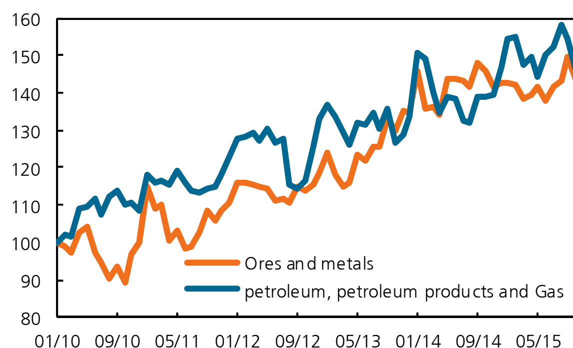
*Indices rebased to 01/2010=s100. Source: Bloomberg

Fig. 3 - Imports affected by falling prices



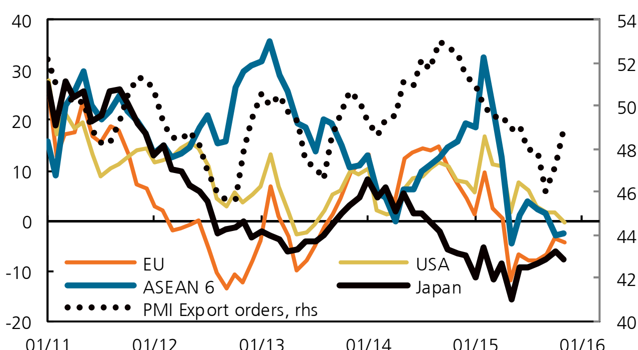
Source: Bloomberg, Thomson Reuters Datastream

Fig. 4 - Raw material imports hold up in volume terms



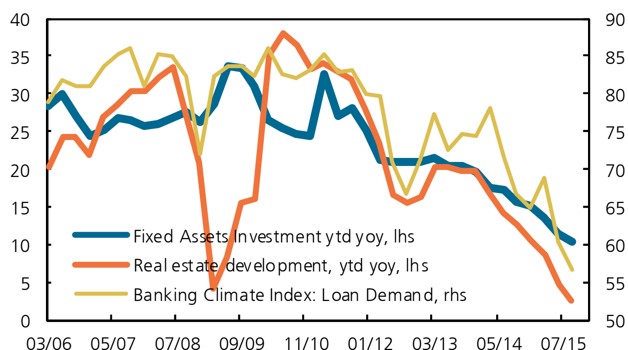
NB: Imports in tons, three-month moving average, rebased to 01/01/2010 = 100.
Source: Intesa Sanpaolo chart based on CEIC data

Fig. 5 – Exports still weak



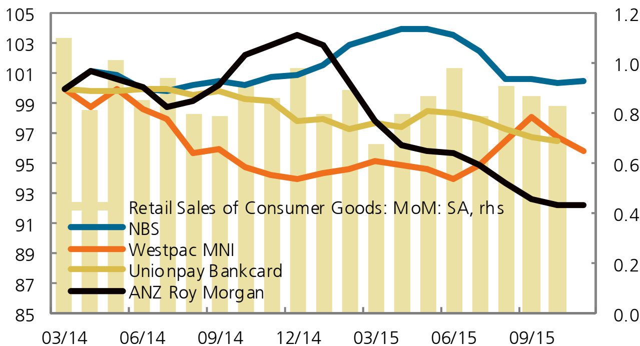
N.B. % chg 3m yoy, PMI Markit 3-month moving average. Source: Bloomberg, Markit

Fig. 6 – Investments and demand for loans slowing



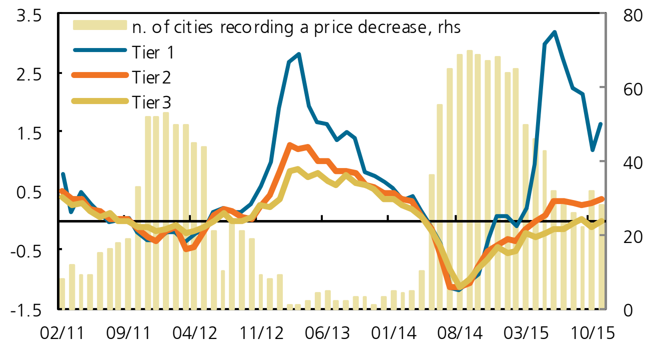
* From PBOC's banking sector survey. Source: CEIC

Fig. 7 – Consumer confidence stabilises



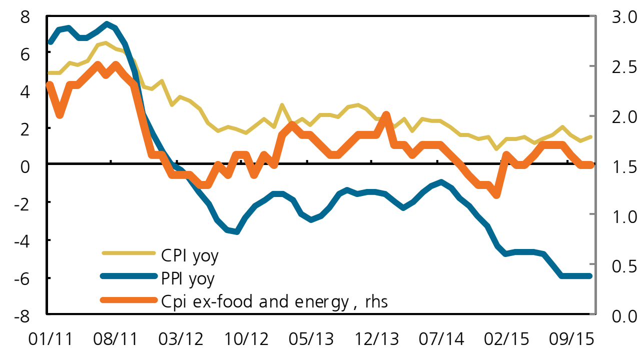
N.B. Confidence indices, 3-month moving average, rebased to March 2014=100. Source: CEIC

Fig. 8. Signs of improvement in the property market.



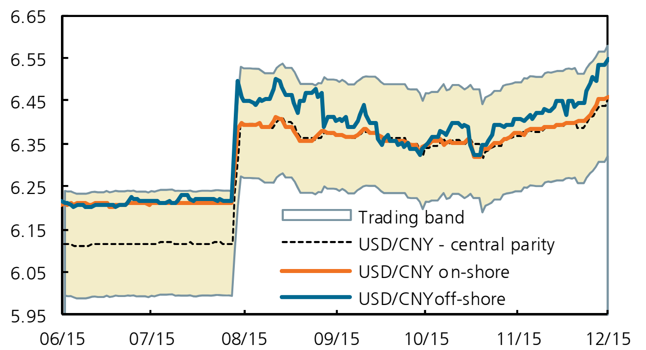
NB: Average % price change mom for new-build residential properties. Source: Intesa Sanpaolo chart based on CEIC data

Fig. 9 - Inflation



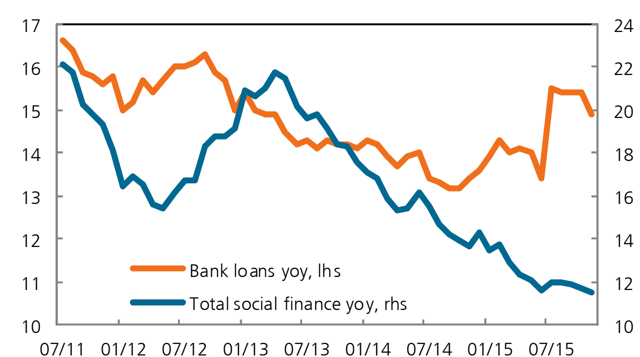
Source: CEIC, Bloomberg

Fig. 10 – Currency is depreciating again, especially off-shore



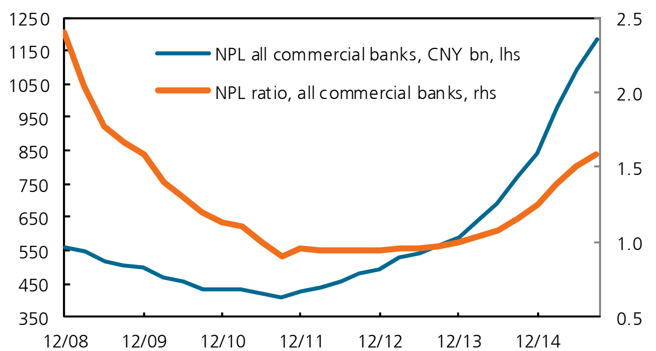
Source: Bloomberg

Fig. 11 - Bank lending picks up pace



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: improving but not on all fronts

- In the third quarter, GDP grew by 7.4%, compared with 7.0% in the second quarter. This was thanks to an acceleration in investment growth (up 6.8% yoy compared with 4.9%) and public consumption, which offset the slowdown in private consumption and a negative contribution from foreign trade. On the supply side, the acceleration was driven by the agricultural and industrial sectors.

- Foreign trade of goods remains weak (fig. 5) with imports and exports markedly down both overall (-22.3% 3m yoy and -25.8% respectively in November) and, to a lesser extent, excluding oil (exports -12.5% 3m yoy in October). This was in line with the slowdown in orders from abroad. Imports net of oil were impacted by a strongly negative base effect but, after improving in the August-October quarter following three months of falls, they worsened once again (-15.5% 3m yoy in November). The overall slowdown in machinery imports was caused by an unfavourable base effect, although the figures are only slightly down on the summer months. The performance of domestic traffic, both for cargo and passengers, is still better than that of international traffic. The quarterly average of the services PMI has improved on the lows of July and returned to above 50, despite the worsening recorded in November. Expectations are, however, continuing to fall, indicating that the significant upturn in the foreign trade of services could be reaching a turning point (figs. 7 and 8).

- Business confidence in the fourth quarter improved slightly on the third quarter. On the one hand, optimism about the trend in inventories has risen, and on the other, pessimism about the performance of orders, exports and production capacity utilisation has increased moderately. The PMI manufacturing index peaked at 52.7 in July, and has since fallen steadily to just above 50 in November. This was driven by five months of falls in both the domestic and foreign orders components. In contrast, industrial output continued to accelerate (+9.8% yoy in October). This was due to a rebound in manufacturing output, especially for capital goods and consumer durables, to which should be added an acceleration in the output of the mining sector.

- Investment projects submitted to the Industry Ministry for approval, despite being a sharp improvement on the previous year, have continued to slow since the spring, not so much in the number of projects but in the amounts invested. The easing of regulations for foreign investment in 15 sectors (including defence, construction, online trading and the banking sector) announced in November, should contribute to an improvement in business confidence and FDI. The continued growth in fiscal spending suggests that the improvement in investment is mainly coming from public investment at the moment. Growth in loans remains stable (+8.1% yoy in October, from 8.2% yoy in July), albeit at its lowest level since 2007 (fig.10), but will continue to be curbed in the short to medium term by the trend in non-performing loans, which despite the recapitalisation programme for public sector banks, is still high. Growth in personal loans remains solid (+16.9% yoy in October), especially loans taken out to buy a home. An autumn harvest (Kharif) that was slightly above expectations thanks to the government's support measures to combat the effects of the lower rainfall in the summer monsoon, led to a modest upturn in the agricultural sector in the third quarter. The increased rainfall at the end of the quarter did not, however, continue in October, and prospects for agricultural production in the next few quarters remain uncertain.

- Consumer confidence fell again in the third quarter both in terms of consumers' assessments of the current situation and their expectations, although it could have been adversely affected by the political gridlock during the summer session of Parliament. Car sales continue to accelerate (+14.0% 3m yoy in November), as do those of commercial vehicles. Sales of three-wheeled vehicles remain weak but have improved since the summer. Tourist arrivals are falling, as are related revenues. Consumer price inflation increased from a low of 3.7% yoy in August to 5.4% yoy in November, as the favourable base effect dwindled, but also as prices, both in certain foods (especially pulses), and in the housing sector, health services, recreation and education, rose. Consumer price inflation excluding food and fuel rose again from 4.1%

to 4.6% in the same period and wholesale price inflation returned to positive territory in the last three months after almost a year of falls. We expect that increases in the oil price will be limited over the next year and that the public management of cereal stocks will keep a lid on food price rises. On the basis of these assumptions, and with the base effect still favourable for most of the year, we forecast that inflation will rise moderately from 4.9% in 2015 to 5.1% in 2016 and 5.6% in 2017. The risks remain slightly to the upside due to higher-than-expected rises in the prices of agricultural products and implementation of the recommendations of the Seventh Central Pay Commission, calling for an increase in the salaries of public workers of 0.5% of GDP in FY 2016-17.

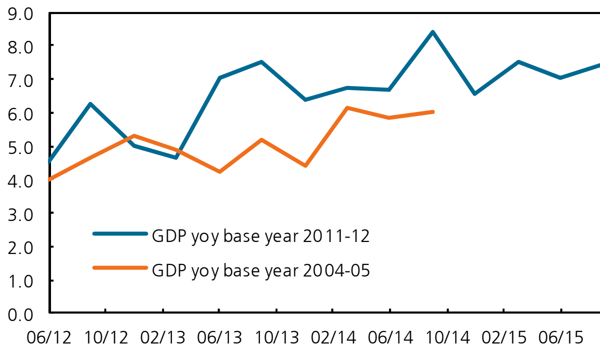
- The increase in tax revenues should allow the target of a 3.9% deficit/GDP ratio to be achieved in FY 2015-16, while the salary rises mentioned above, and the possibility that the Goods and Service Tax (GST) will not come into force, could jeopardise the target of 3.5% for FY 2016-17. The law introducing the tax involves a constitutional amendment, and will be scrutinised again during the winter session of Parliament (26 November – 23 December) in the Upper House (Rajya Saba), along with the amendments to the Land Acquisition Law.
- Contrary to our expectations, the RBI brought forward the expected rate cuts with a reduction of 50 basis points at the end of September, taking the repo rate to 6.75%. The 125-basis-point reduction in official rates since the start of the year has been only partially passed on by the banks to their end customers: indeed the base rate has only fallen by 60 basis points. At its December meeting, the Central Bank indicated that it will continue to implement measures to facilitate the transmission of monetary policy and to support the management of non-performing loans. It also maintained an accommodative stance and signalled that it will use any room available for a further rate cut if conditions allow it. The RBI is sticking to its inflation forecast of 6% for March 2016 and 5% for March 2017, emphasising that the rise in inflation excluding food and fuel merits special vigilance. We think the RBI could further reduce the repo rate by a total of between 50 and 75 basis points during the first half of 2016 if the upside risks to inflation and exchange rate volatility do not materialise. 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 a moderate acceleration to 7.6% in 2016 and 2017.

Macro forecasts

	2011	2012	2013	2014	2015	2016	2017
GDP	7.9	5.3	6.4	7.1	7.4	7.6	7.6
Private Consumption	7.3	7.2	5.2	6.1	7.6	7.4	7.7
Public Consumption	7.9	5.5	8.5	6.5	3.8	6.8	1.8
Total Fixed Investment	6.2	-1.3	5.2	3.1	5.4	7	7.9
Exports of G&S	18.3	11.2	2.9	4.9	-6.1	5.7	7.1
Imports of G&S	18.4	11.8	-6.7	-1.8	-9.3	6.2	8
Industrial Production	4.8	0.7	0.6	1.8	5	6.8	6.3
Consumer Price Index (CPI)	9.6	9.7	10.7	6.6	4.9	5.1	5.6
Unemployment Rate (%)	5.8	5.6	5.6	5.6	5.5	5.3	5.2
Average Wages	15.2	18.4	11.2	10.7	10.4	9.8	9.4
Mibor 3m (average)	9.5	9.5	9.3	9.1	8	7.3	7.3
USD/INR (average)	46.69	53.47	58.57	61.04	64.12	66.62	63.37
Current Account Balance (bn INR)	-2945.1	-4893.2	-2779.6	-1669.9	-1860.2	-2269.9	-1093.6
Current Account Balance (% of GDP)	-3.4	-5.1	-2.5	-1.4	-1.4	-1.4	-0.6
Government Balance (% of GDP)	-6.8	-5.5	-5.5	-4.2	-3.7	-4.1	-3.5

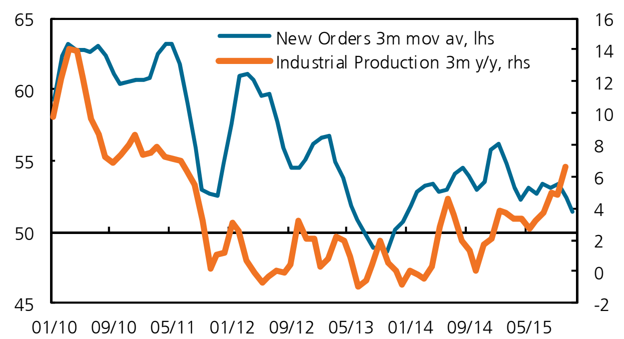
NB: Percentage changes versus previous period - except where otherwise indicated. Figures relate to the calendar year.
Source: Oxford Economic Forecasting and Intesa Sanpaolo

Fig. 1 – Rebasing of GDP series takes growth higher



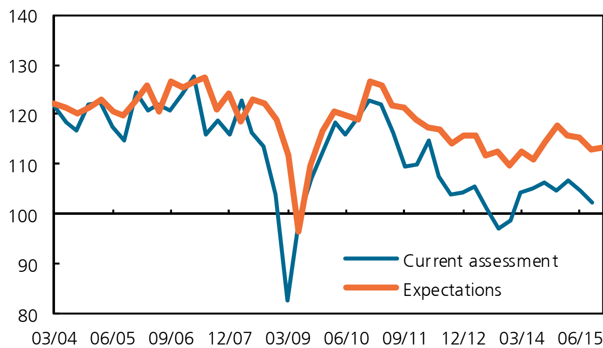
Source: CEIC

Fig. 2 – Orders remain above 50 but are slowing



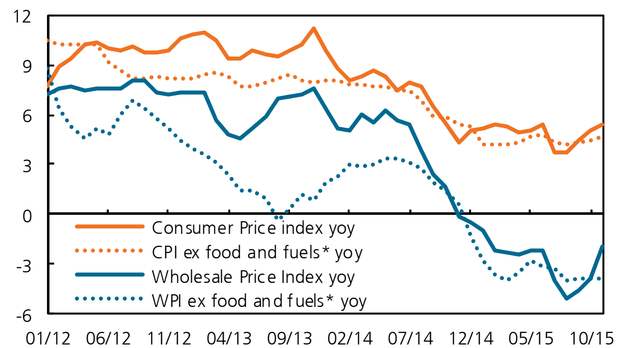
Source: Markit-HSBC, CEIC

Fig. 3 – Business confidence*



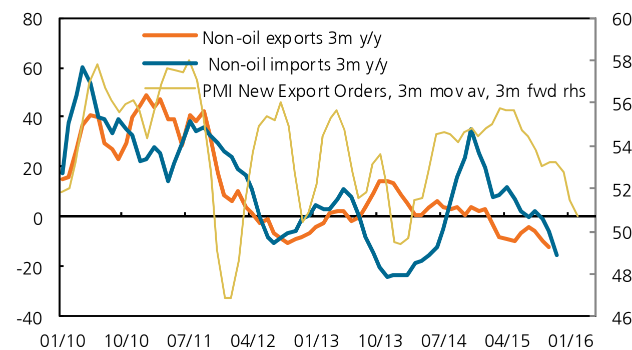
*Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 – Inflation is rising slightly



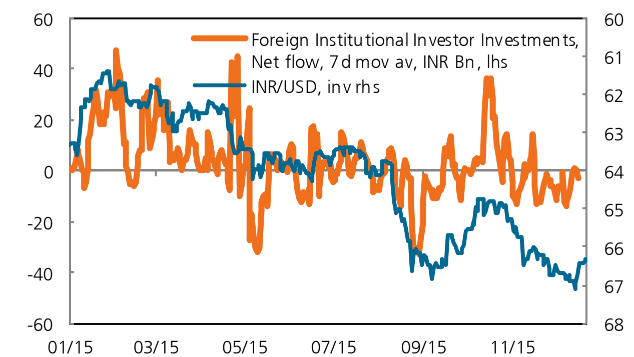
*Intesa Sanpaolo estimates Source: CEIC

Fig. 5 – Foreign trade still weak



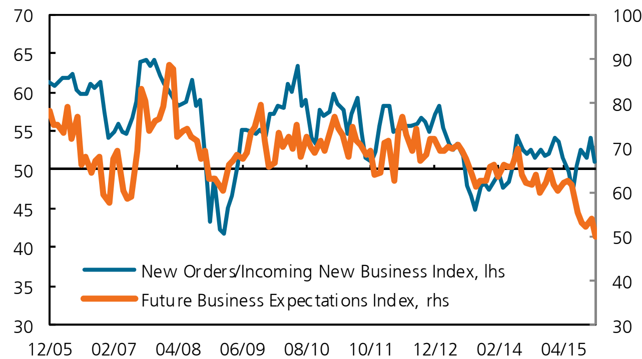
* Three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Fig. 6 – The rupee remains under pressure



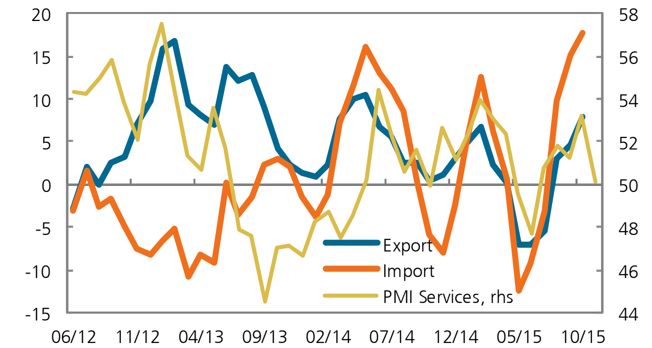
Source: CEIC

Fig. 7 – Services: expectations continue to fall



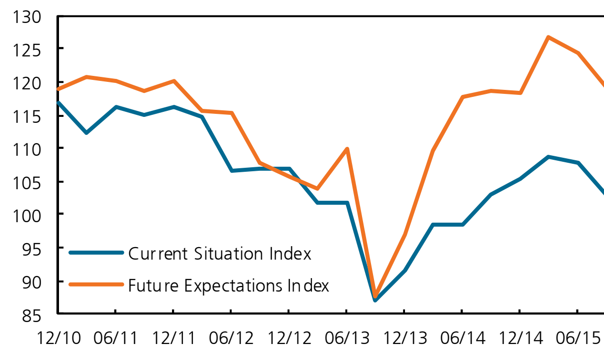
Source: Markit

Fig. 8 – Trade in services*



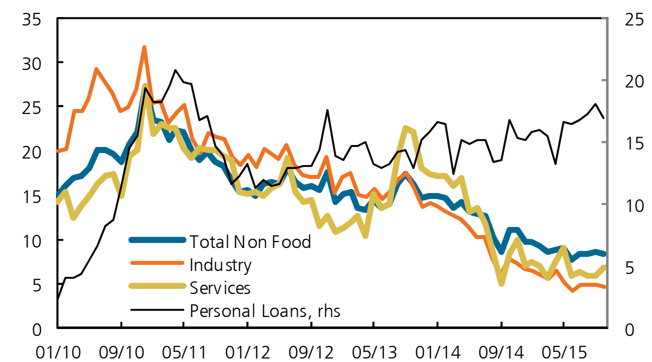
* % chg 3m yoy. Source: CEIC, Markit

Fig. 9 – Consumer confidence



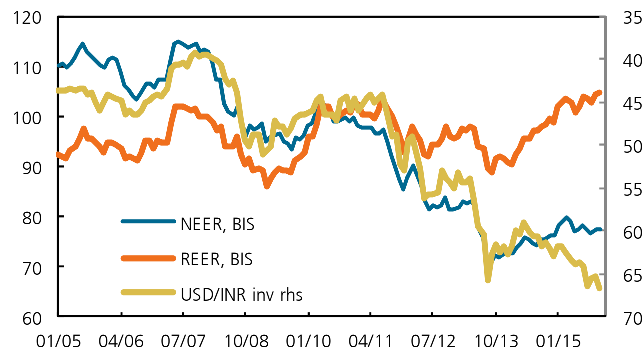
NB: Quarterly consumer confidence survey by the RBI. Source: CEIC

Fig. 10 – Lending stabilises (% chng yoy)



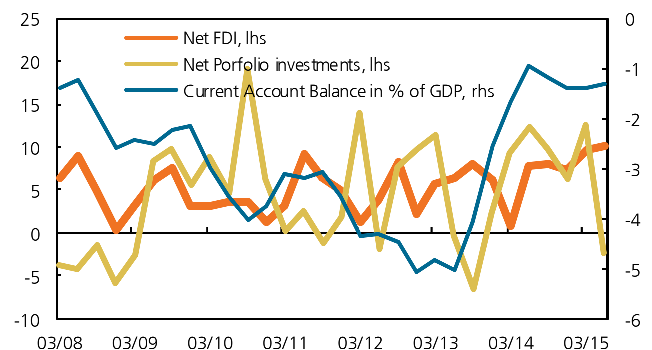
Source: CEIC

Fig. 11 – Effective exchange rate and rate against the dollar



Source: CEIC, Bloomberg

Fig. 12 – Current account and capital flows



N.B. left-hand scale in USD Bn. Source: Intesa Sanpaolo chart based on Bloomberg data

Currency markets: Fed reversal - beginning of the end of the dollar's uptrend

Asmara Jamaleh

Twenty-fifteen was the year of the long-awaited Fed reversal, and the dollar benefited by appreciating further. The appreciation was also amplified by the widening divergence between the monetary policy pursued by the Fed and that of other central banks. However, this divergence has in all likeliness already peaked, when in December the Fed implemented its first interest rate hike while the ECB simultaneously cut them and extended its QE.

In 2016, monetary policy divergence will become less relevant. While the Fed will proceed with its rate hikes, the other central banks (possibly with the exception of the BoJ) are not expected to further ease monetary policy, barring a new important deterioration of the global and/or domestic pictures. On its part, the Bank of England will begin to increase rates and be the first to start converging with the Fed.

Therefore, the dollar's positive macro-trend could therefore be on its way out. However, this does not imply a sudden downward reversal, but rather a stabilisation phase first, and only subsequently, broadly on a one-year horizon, the beginning of a moderate and gradual retreat. The balance of risks to the scenario, in the short term in particular, is skewed slightly upwards for the dollar. This is because in the initial phase of a new monetary policy cycle, sensitivity to interest rates is generally higher.

DOLLAR

Upward macro-trend losing steam with the Fed's reversal on interest rates.

In 2015, the dollar built on the strong appreciation which began in mid-2014, gaining 25% in little over than a year in terms of the nominal effective exchange rate, and specifically 34% against the euro, 25% against the yen, and 18% against the pound. The driver was the Fed's gradual removal of the extraordinary monetary stimulus measures introduced following the economic-financial crisis of 2008, and in particular mounting expectations for the beginning of an upward cycle on rates. After a long wait and several postponements, the first fed funds rate hike was finally implemented, at the FOMC of 16 December. This, however, does not automatically imply that the rise of the dollar will continue along the same lines as in the past year. In fact, the actual start of the hike cycle could mark the end of the upward macro-trend of the dollar, for at least four reasons:

- The scope and the evolution of the appreciation observed in 2014-2015 suggest that an important part of the Fed's upward cycle on rates may already be priced in by the currency market. Indeed, the dollar rose significantly more than US rates/yields, which in fact have declined, in some instances;
- The Fed has already warned that the rate increases will be much more gradual thank in past cycles, and the point of arrival will be lower;
- In 2016, the other main central banks should also start to remove monetary stimulus, setting the stage for their respective rate hike cycles (with the exception of the ECB and the BoJ) between 2016 and 2017. In 2015, on the other hand, almost all central banks made monetary policy more accommodative, in many cases by cutting rates again, and this further amplified the policy divergence compared to the Fed, to the full benefit of the dollar;
- The appreciation recorded between 2014 and 2015 restored the dollar to levels close to its long-term highs. This should hinder a further rise of the dollar, barring particularly favourable surprises from the US economy.

In the course of 2016, therefore, two phases may materialise:

- **Initially, a stabilisation phase** for the dollar at high levels, close to its recent peaks. While these values may be beaten, in case of strong upside surprises from US data, or of a new deterioration of the scenario in the euro area, but these movements should be contained, in terms of both size and duration;
- **Subsequently, a modest backtracking phase**, as the growth and inflation pictures will start to improve outside the United States as well, with a resulting disappearance of the cyclical divergences. However, the retreat should be gradual. In fact, even if the phase of maximum divergence between the Fed and the other central banks will already have been overcome, US rates will retain a high advantage for some time.

On the whole, **the Fed's markedly gradual approach may determine stronger fluctuations** around the trend: given a baseline scenario which contemplates one 25bps hike per quarter, a single extra hike, or one less, could reap important effects on the market. Next year, therefore, **a stronger correlation between the trend of the dollar and the evolution of US data** will be restored, compatibly with the return to normal of monetary policy conditions.

Risks to the scenario should therefore be **broadly symmetrical**, in relation to the evolution of both the US picture and of the global scenario. In the short term, on the other hand, risks could be skewed slightly upwards, due to the higher sensitivity of the exchange rate to interest rates, as is typical in the initial phases of a new monetary policy cycle.

EURO

Maximum divergence between the ECB and the Fed over in 2015.

2015 has been the year of maximum divergence between the ECB and the Fed, and the euro was impacted in full, completing the downturn which had already begun in 2014: from EUR/USD 1.20 the single currency depreciated to 1.04, matching a low abandoned 12 years earlier, in 2003. The correction was entirely concentrated between January and March, as this was the period in which expectations were mounting ahead of the Fed's reversal on rates, whereas in the euro area, by contrast, the ECB found itself faced with the need to further expand monetary policy, and to launch its first QE programme as many as seven years later than the Fed.

Over the following months, the euro then recovered, rising back to between EUR/USD 1.10 and 1.15, as the Fed had to postpone the timing of its first rate hike, only to correct again between October and December, returning to its March lows (1.05). The growth trend, and even more so the inflation trend, deteriorated further in the euro area, obliging the ECB to sep up monetary accommodation again in December. The refi rate stayed unchanged at 0.05%, while the deposit rate – already negative – was cut from -0.20 to -0.30%, and the asset purchase programme – originally due to be closed in September 2016 – was extended until March 2017 (at least).

In 2016, therefore, while Fed rates will keep increasing, ECB rates will stay at zero for an even longer period. Most importantly, while the Fed will keep up the process of normalising monetary policy, the ECB will still have extraordinary policy measures in place. This may lead to the conclusion that next year the euro will have to automatically keep depreciating, hitting new lows at close to parity or just below. **However, there are two main reasons for which the exchange rate may not embark on a new downtrend,** despite ECB rates at zero and Fed rates on the rise:

- **The point of maximum divergence between the ECB and the Fed was reached** in December, and should therefore be behind us now. Also, the forthcoming Fed hike scenario is mostly already priced in, and the upward cycle will in any case be very gradual;

- **The further monetary stimulus added by the ECB increases the chances of an improvement of the inflation and growth scenario in the euro area** in the 2016-2017 biennium. In its new macro projections published in December, the ECB has marginally lowered forecast inflation, while revising slightly upwards growth. From an estimated rate of 0.1% this year, inflation is forecast to rise back to 1.0% in 2016 and 1.6% in 2017. Economic activity is forecast to accelerate from 1.5% this year to 1.7% next year, and to 1.9% in 2017. If euro area data in the coming months support these scenario assumptions, especially in terms of the path of inflation towards the target rate, pressures on market rates will start to turn upwards.

Beyond the short term, therefore, **and later on in the course of 2016, the euro should stabilise and then moderately start to rise, gradually making the transition from the EUR/USD 1.05-1.10 range to the 1.10-1.15 range**.

In the short term, on the other hand, the exchange rate should stay close to its current levels, in the mid-lower end of the EUR/USD 1.05-1.10 range, **although risks could stay slightly skewed to the downside**, in the EUR/USD 1.05-1.00 range. This is because:

- The ECB has just stepped up monetary stimulus and warned that in the next few months it will closely monitor the developments of the macro picture in particular, to assess whether the new measures are sufficient or not;
- The Fed, by contrast, has just implemented its first rate hike, and the sensitivity of the exchange rate is typically higher in the initial phase of every new monetary policy cycle.

The exchange rate scenario outlined here is essentially a range-trading scenario, similar to the one observed in the course of 2015. Greater directionality will probably only be restored once the ECB, like the Fed, undertakes the process of normalising monetary policy, which is unlikely before 2017.

Risks to the scenario could therefore be skewed slightly upwards between the end of 2016 and the beginning of 2017. On the other hand, risks should be broadly balanced in the course of 2016, and stem more from the euro area than the United States. Given the new central bank stances, the Fed's actions will probably guide the fluctuations of the exchange rate around the trend, whereas the trend (or the non-trend) will be determined by the ECB's decisions.

YEN

Divergence between the BoJ and the Fed no wider in 2015: postponement to 2016 possible.

In 2015, **the yen weakened again against the dollar, but less than it had in 2014**. The Japanese currency's greater relative strength this year is due to the smaller divergence between the BoJ and the Fed, entirely due to the BoJ's action (or lack of action).

In 2014, at the end of October, the BoJ had stepped up QQE and the yen reacted by depreciating strongly, by almost 15%, from USD/JPY 105 to 121 in just under two months. In 2015, **inflation proved lower than expected, further straying from target, which would have made a further expansion of QQE legitimate one year after the previous.** This time around, **however, the BoJ opted not to act**. The yen has weakened all the same against the dollar, as the Fed in the meantime has started to hike rates, but the decline is much smaller than the one which followed the expansion of QQE last year, hitting a new low of USD/JPY 125, only 3% below the previous low for 2014 at USD/JPY 121. This confirms the evidence, as recorded in previous years, that the yen's exchange rate is more sensitive to domestic economic policy measures than to the Fed's actions.

The BoJ's decision not to act this year is due to the prospect of the Fed's reversal and to expectations for the launching of a new extraordinary fiscal stimulus package by the Japanese government. However, should this not prove sufficiently effective in relaunching growth, helping

inflation rise back as a result, the BoJ could predispose a new expansion of QQE in 2016. In this case, the point of maximum divergence between the BoJ and the Fed would come next year, therefore we expect the yen to hit a low-point against the dollar in 2016, within the USD/JPY 125-130 range. At these levels the yen would be very close to its long-term low of USD/JPY 135, recorded at the beginning of 2002. Therefore, any further downside margin for the Japanese currency seems limited, also thanks to the better expected combination of growth and inflation expectations resulting from the mix of expansive fiscal and monetary policies. Risks to the scenario are skewed slightly downwards for the yen, although the long-term lows at USD/JPY 135 should not be beaten.

Against the euro, the yen should weaken, moving towards the EUR/JPY 140-145 range. The appreciation recorded in 2015 was entirely the result of the decline of the euro prompted by the monetary accommodation put in place by the ECB. Given the lack of upwards thrusts from this front, the yen should go back to moving in the same direction against the euro and against dollar.

STERLING

Convergence between the BoE and the Fed in 2016

The first central bank to hike rates after the Fed will be the Bank of England, which should kick off the hike cycle between 2Q and 3Q next year. **This represents the main factor of expected strength for the pound**, as unlike the other central banks, there is convergence between the BoE and Fed monetary policy paths.

In the course of 2015, sterling had initially risen back from GBP/USD 1.45 to almost 1.60 (high of 1.5930) on expectations that the BoE would start to hike rates this year, but it then gradually turned back down from this level to just under GBP/USD 1.50 (low of 1.4895), as the timing of the first hike has been pushed to next year. The bank rate is currently 0.50%.

The postponement is due to the trend of inflation, slower than expected, mostly due to the decline in oil quotations. As a result, the BoE has had to revise downwards, quarter by quarter, its inflation projections. In the November Inflation Report, it lowered inflation expectations from 0.3% to 0.1% at the end of 2015, from 1.5% to 1.2% at the end of 2016, and from 2.1% to 2.0% at the end of 2017, assuming a rise to 2.2% (i.e. just above the target rate) by the end of 2018. The trend of inflation will be decisive in guiding the BoE's decisions next year. The new, recent decline in oil prices is the major source of downside risks. At the December meeting, the BoE explicitly observed that this increases the probability of inflation staying low in the coming months. The other variable the central banks will monitor closely is wage growth. Wages accelerated in the course of the year, although in the past few months growth has stabilised and the BoE stressed that it will probably need to rise above its current levels to allow inflation to converge on its target rate on a two-year horizon.

Growth forecasts have also been revised downwards, but only marginally. At present, the BoE estimates growth at 2.7% this year, 2.5% the next, 2.6% in 2017, and 2.5% in 2018. Therefore, a slowdown is expected from 2.9% in 2014, although the pace of growth – of 2.5% or just above – remains robust.

It is mostly due to the robustness of domestic growth that **the current downturn of sterling against the dollar should prove limited** to within the mid-upper end of the GBP/USD 1.50-1.45 range. **Following a potential decline in the short term, as a result of the start of the upward cycle on fed funds rates, the pound should resume rising**, returning towards GBP/USD 1.58-1.60 **in the run-up to the initial BoE hike**.

Against the euro, sterling appreciated strongly (+10%) at the beginning of 2015, moving from EUR/GBP 0.78 to 0.70 between January and March. A good part of this strengthening was due to the sharp decline of the EUR/USD triggered by the ECB's new QE. Going forward, in

correspondence with the start of the BoE cycle of hikes, sterling should manage to strengthen again against the euro, entering the EUR/GBP 0.70-0.65 range. The recent retreat of the pound to EUR/GBP 0.72 should therefore prove temporary, with downside limited to within EUR/GBP 0.75.

On the whole, downside risks to the scenario **prevail** for sterling, against both the dollar and the euro. **In the short term,** however, domestic economic variables (**disappointing** inflation and/or growth **data**) should prove decisive. **At a later stage,** a new factor of vulnerability could derive from **uncertainty on the referendum on the United Kingdom's EU membership**, which should be held by the end of 2017.

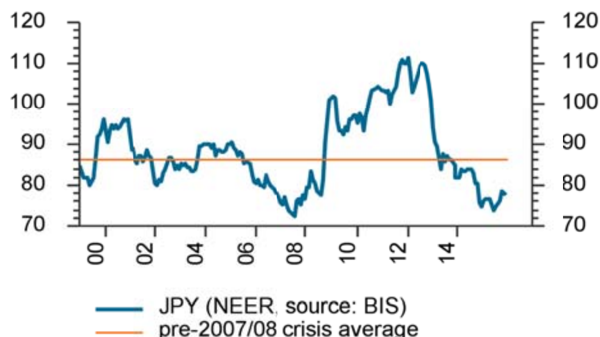
Fig. 1 – Dollar, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 2 – Euro, nominal effective exchange rate

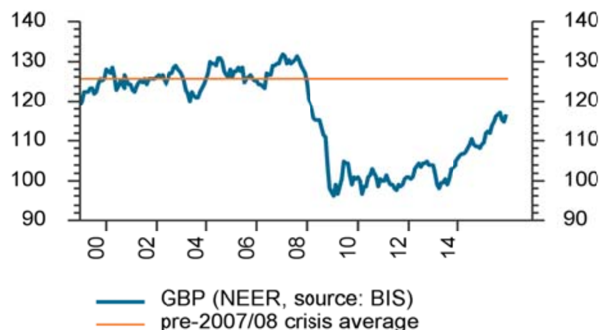
Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 4 - Sterling, nominal effective exchange rate

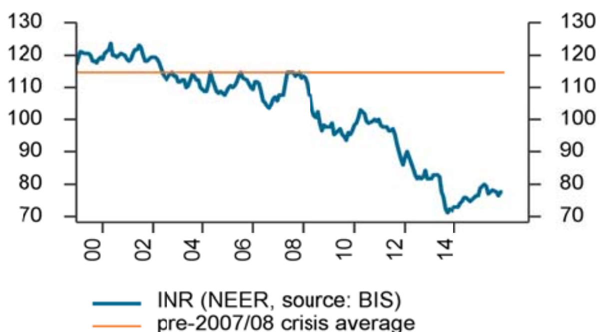


Source: Thomson Reuters-Datastream

Fig. 5 – Yuan renminbi, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate

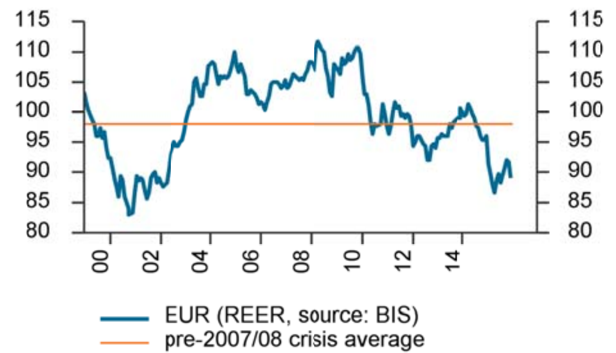


Source: Thomson Reuters-Datastream

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

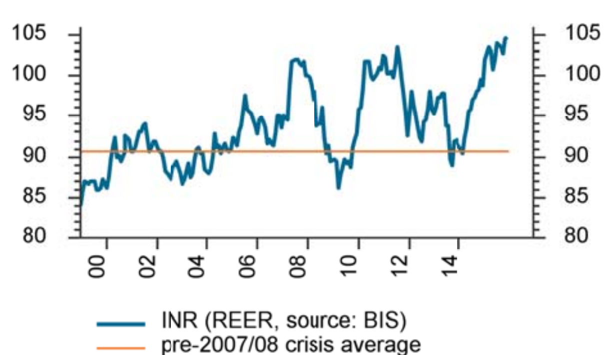
Fig. 10 - Sterling, real effective exchange rate

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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