Macroeconomic Outlook

Research Department
December 2016

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Macroeconomic Outlook

Index

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Based on information available up to 14.12.2016

Why the return of inflation is no reason to party

Luca Mezzomo

The Trump administration may embark on an experiment in fiscal policy loosening in an economy that is already operating at full employment. This presents the risk of a boom-and-bust cycle, although not in 2017. Global growth will be strong next year, despite the modest slowdown in the Euro zone and China. Inflation will rise, partly due to rising oil prices.

Paradoxically, inflation could prove destabilising if it obliges the ECB to stop purchasing securities. A comprehensive European strategy on public debt is needed, but the election cycle of 2017 and the growth of populism are complicating the scenario.

Trump's election upsets forecasts. We now expect to see an ill-timed loosening of fiscal policy

Constant complaints about the lack of any active fiscal policy may have been answered by the election of Donald Trump as United States president. In fact, the next president has confirmed that he plans to work with Congress to implement a drastic cut in corporation and personal income tax. Even assuming that the plan will be less aggressive than previously announced and that some of the effects will be cancelled out by an increase in the propensity to save (high or very high earners will benefit the most), it could nevertheless lead to more rapid US GDP growth from the second half of 2017, and particularly in 2018. Our projections for the US economy do not include a radical change in fiscal policy at this time, as we prefer to wait for more concrete evidence before finalising a revision of the forecasts (which, moreover, could pertain more to 2018 than to 2017). The consensus estimates for 2017 are also still relatively stable, at 2.2-2.3%. Even graph D on page 4 does not yet reflect a possible change in fiscal policy, and might, therefore, suggest a tighter orientation in fiscal policy at global level than will actually be seen next year.

It is unfortunate that the fiscal stimulus is coming to a country that has little need for it, as it already has very low levels of unemployment. Therefore, the surprise result of the US election has given fresh impetus to inflation forecasts incorporated in market prices, including European forecasts. For now, the increase is not likely to alarm the central banks (the 5-year inflation rate implicit in the swap curve rose from 2.0% to 2.5%), but it certainly eliminates one of the factors that have so far held back the normalisation of monetary policy rates. On reflection, it gives more credibility to the Federal Reserve's guidelines on official rates, which this year – rightly, with hindsight – the market has quietly ignored, and has produced a significant increase in the slope of the yield curves. In Europe, the ECB has announced a further extension of the securities purchase programme to December 2017, although the reduction of the monthly volume from EUR 80Bn to EUR 60Bn has, nevertheless, brought the cessation of this extraordinary support into the forecasting horizon. The most serious problem that might be created by an ill-timed fiscal stimulus is the emergence in the US of the risk of a boom-and-bust cycle, increasing the likelihood of excess inflation, followed by a recession due to monetary tightening.

Inflation forecasts are recovering, partly due to trends in the oil market and the global economy

I spoke of the "acceleration", rather than the "start" of a rise in forecasts, because the process began in October, before Trump was elected, prompted by signs of improvement in global economic activity, rising oil prices and rumours of a cut in OPEC oil production. The prospect of oil prices remaining at least at these levels in 2017 (see the comment on pages Y-Z) will allow average inflation in the OECD countries to return to 2%, after two years under 1%, although in other countries the increase in underlying inflation will continue to be curbed by global excess capacity. It is difficult to predict how long the current positive economic period will last. Since November, the economic data have provided positive surprises in all areas – particularly in the Eurozone. According to the PMI survey, growth in manufacturing activity and in services is again accelerating (see graph A on page 4), and global GDP growth is gradually rising, after the lows at the start of this year. This improvement reflects several parallel processes, relating to the Euro zone, China, the United States and countries producing raw materials (particularly oil). Increased growth in the US and the oil-producing countries is likely to extend into 2017. Meanwhile, the Eurozone will experience conflicting pressures: on the negative side, a loss of household purchasing power due to the rising prices of energy commodities; and on the positive side, a probable upturn in exports and business investment. Fiscal policy will be in no way expansionary, but neutral at most. Even though China's economy has performed better than expected in recent months, it continues to be overshadowed by financial imbalances. Weighing the various factors involved, we believe that the slowdown in Europe and China will be modest, and that global growth should pick up again next year.

In the Euro zone, the normalisation of inflation would lay bare the problem of excessive public debt, forcing the ECB to stop its purchase programme...

Many have complained about the low level of inflation in recent years. Paradoxically, however, the attainment of inflation targets in the Eurozone could create many more problems in the future than in the phase of zero price growth, because of the very high level attained by public debt in many countries. The problem no longer exists in Japan, where the central bank has pledged to continue its purchases of government securities even if inflation returns to target, and where a deliberate and aggressive strategy of debt monetisation is therefore being implemented. In the Eurozone, however, if inflation were to return to 2%, the constraints set by the ECB Statute and the differing visions afflicting the Governing Council would make it nearly impossible for the ECB to continue the purchase programme much beyond December 2017. And if the programme ends in 2018, the share of Italian or Portuguese public debt that is "sterilised" because it is transferred to the budget of the national central bank will still be too small to affect the sustainability of the debt in any decisive way (at the end of 2017, only 20% of debt in the 2-30 year range for Italy, compared with a massive 41% for Germany). For issuers with the worst fundamentals, the rise in debt refinancing costs could then more than offset higher nominal GDP growth, also because the markets could soon return to discounting some break-up risk.

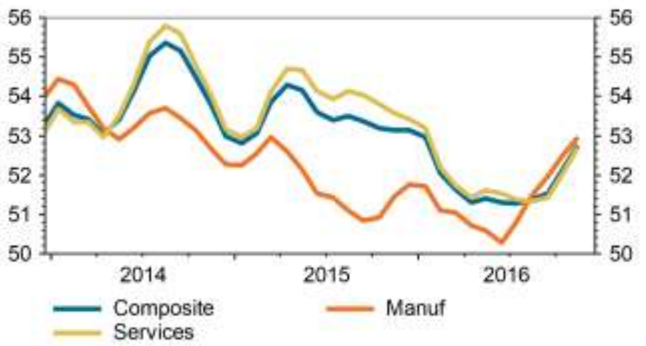
...so a comprehensive European strategy on debt is required.

But will this be possible with the 2017 electoral cycle and the growth of populism?

In this scenario, a stricter application of the Stability and Growth Pact would not help at all. The framework of rules on fiscal policies is confusing, overly complex and based on the erroneous assessment that it is feasible to cut excess public debt by increasing the primary surplus to sufficiently high levels. It should be radically reformed, and a credible reform should also include a strategy for managing legacy debt. That cannot an outright restructuring, because it would break the financial system. The good news is that a strategy to reduce debt servicing that involves neither a further deterioration in living standards, nor costs for the other Member States, does exist: it is an enhanced PSPP, which has already been tested and has no adverse effects worth mentioning. However, we will have to contend with the rules established for another historical context and unsuited to the current situation, and with the political dynamics that characterise the European Union in this period. In fact, the imminent launch of negotiations to take the UK out of the EU and the rise of populist parties in many Member States (see the analysis on page 18) is leading us ineluctably towards a minimalist interpretation of the role of the Union and maintenance of the status quo, due to a lack of consensus about which direction to take. Taking an optimistic view, after the 2017 elections European governments could decide to take the bull by the horns and remove the threat of debt, in order to regain some room for manoeuvre. This would require some legal inventiveness and the cooperation of the Eurosystem: but when political will is imposed, no formalism can resist it. Pessimists might object to this on the grounds that next year's elections will return governments that are even more concerned with internal political dynamics and are hostages to populism, and therefore reluctant to discuss strategic questions. So let's hope that the pessimists are wrong.

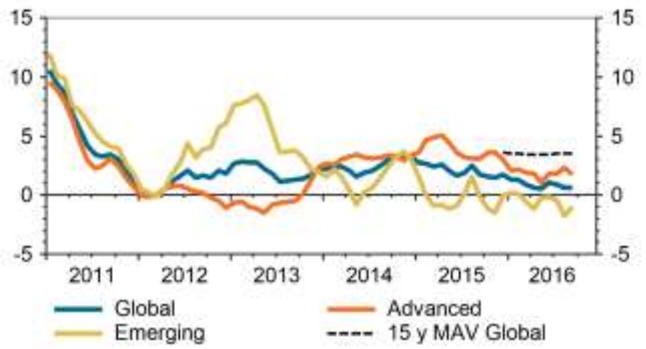
Global economic trends in 10 charts

Fig. A – Global PMIs



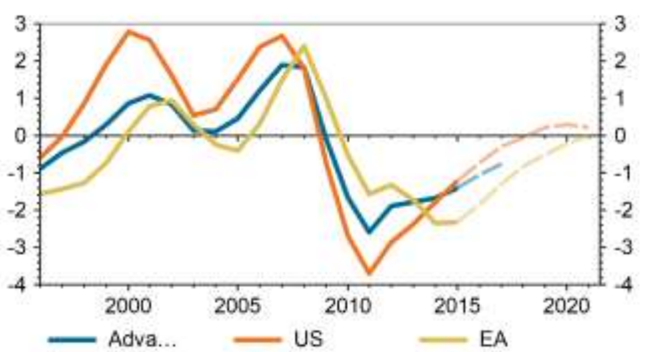
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Growth in imports, yoy



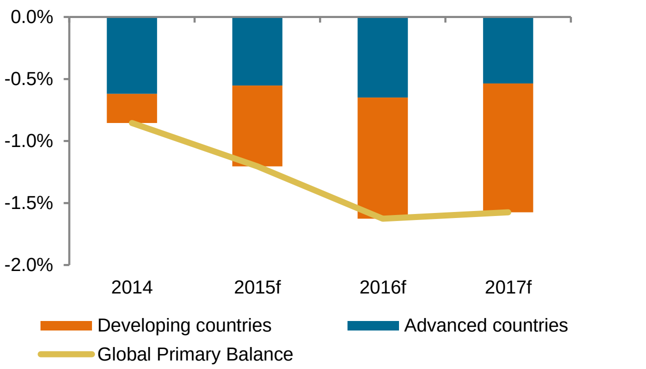
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



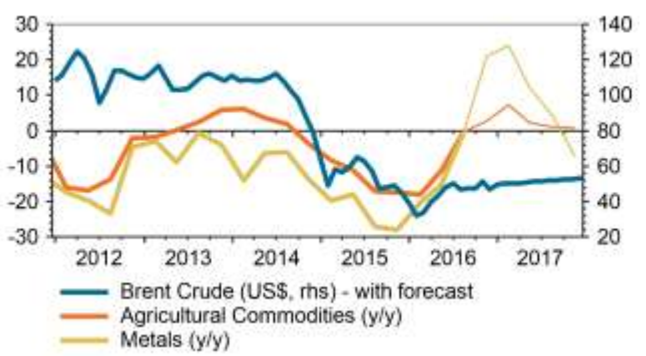
Source: Thomson Reuters-Datastream Charting and IMF

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



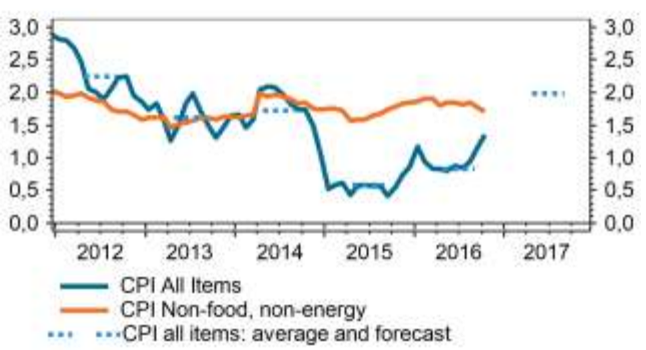
NB: based on 11 major advanced countries and 8 major emerging countries. Aggregation at current exchange rates. Source: Intesa Sanpaolo data

Fig. E – Commodity prices



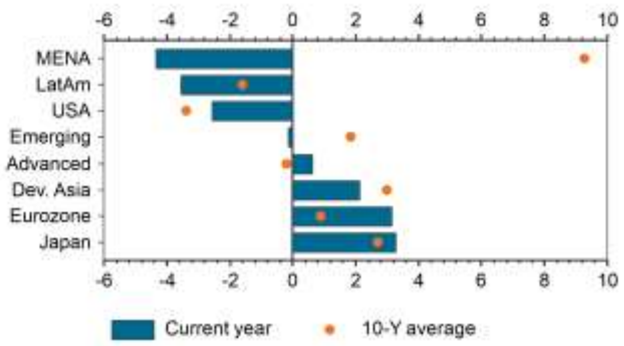
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



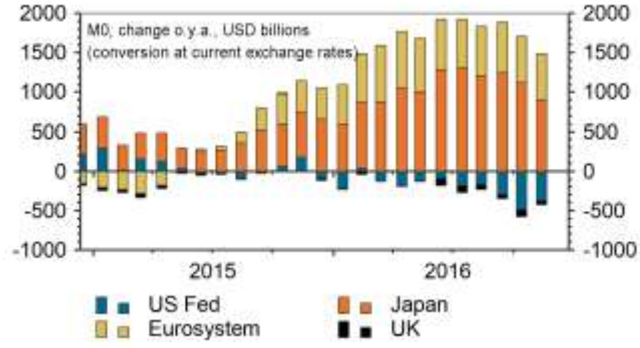
Source: OECD, Thomson Reuters-Datastream Charting

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



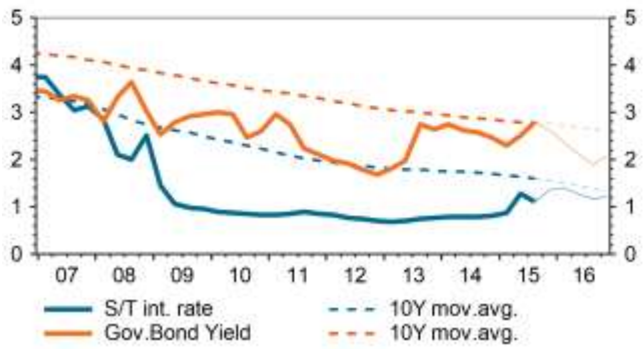
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

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



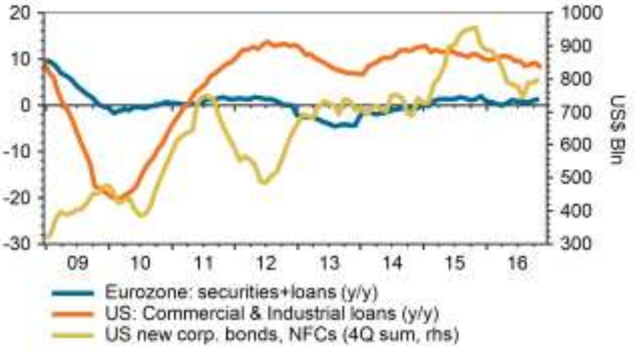
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



N.B.: 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

	2014	2015	2016	2017	2018
United States	2.4	2.6	1.6	2.1	2.5
Japan	-0.1	0.6	0.8	1.2	1.0
Euro zone	1.2	1.9	1.6	1.5	1.6
Eastern Europe	0.6	0.1	1.4	2.4	2.5
Latin America	-0.3	-1.0	0.7	2.4	3.1
OPEC	2.8	2.2	2.4	3.5	3.9
East Asia	7.1	6.8	6.7	6.5	6.2
Africa	7.3	7.5	7.5	7.4	7.5
World growth	3.2	3.0	3.0	3.4	3.6

Source: Intesa Sanpaolo data

Commodities: year-end sparkles!

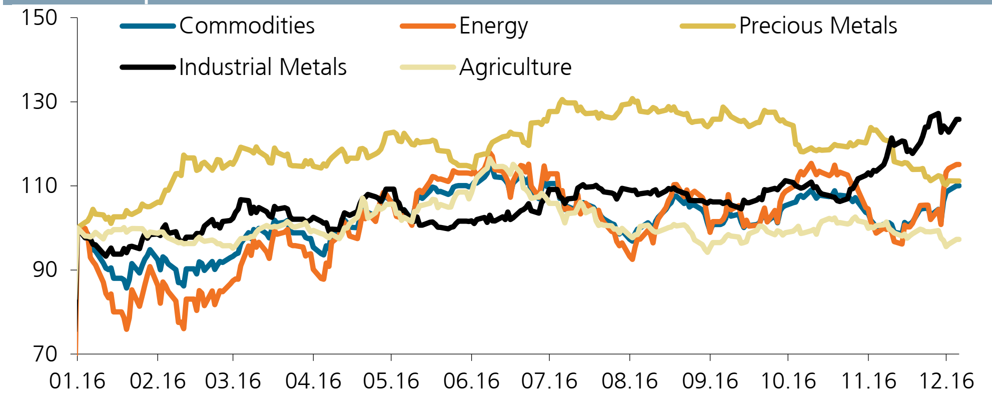
Daniela Corsini

After a year punctuated with many unexpected events, the last few weeks of December also promise surprises. The markets are set to digest the Fed's interest rate hikes, assess the consequences of the liquidity squeeze in India and weigh up the credibility of the cuts announced by OPEC and non-OPEC producers.

2016 will perhaps be remembered as one of the most interesting years for investors in commodities. A good dollop of suspense was certainly not lacking (due to the long negotiations between OPEC members, punctuated by opposing statements and concessions only agreed at the last minute); there were dramatic turns of events in the important external landscape (Brexit, Trump) and a pronounced rise in political risks (e.g. the major consequences of government interventions in China on the coal market, in the Philippines and Indonesia on the mineral ores market, and in France on the European electricity and gas market).

In part, 2016 was even more appreciated thanks to the relief of seeing a more stable oil price, which should now have steadily moved away from its lows of over a decade, after having pushed the main commodities indices into free-fall for nearly two years. Lastly, there is greater clarity on the markets because production costs are stabilizing (thus making it possible to have a clearer idea of the support provided to prices by marginal costs) and the fundamentals of demand and supply should once again be the main driver of prices. The numerous speculative bubbles recorded in China this year were also effectively caused by the scarcity on the domestic market.

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



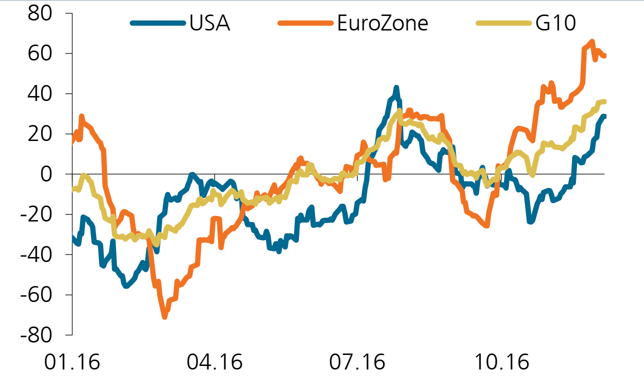
Source: Intesa Sanpaolo chart based on Bloomberg data

After a year in similar vein, the last few weeks of December also promise surprises. The markets are set to digest the Fed's interest rate hikes and, the government crisis in Italy, assess the consequences of the liquidity squeeze in India and weigh up the credibility of the cuts announced by OPEC and non-OPEC producers. Moreover, at the time of writing, the results of the mining audit of the Philippines government – which could lead to the closing of other mines and further reduce the global supply of nickel – have not yet been announced, nor has there been any confirmation of the rumors of possible changes to the law governing the mining, processing and export of minerals from Indonesia.

Further volatility is normally fueled by the publication of new macroeconomic estimates for 2017 by the main forecasting institutes and the major corporate banks, which could influence market sentiment in the next few weeks and the seasonal portfolio rebalancing.

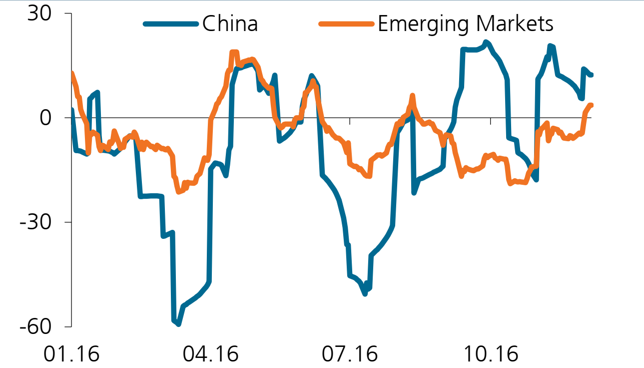
Overall, the flow of outgoing macroeconomic data has been positive and suggests robust demand for energy and industrial commodities.

Citi Economic Surprise Index, developed countries…



Source: Intesa Sanpaolo chart based on Citi Bloomberg data

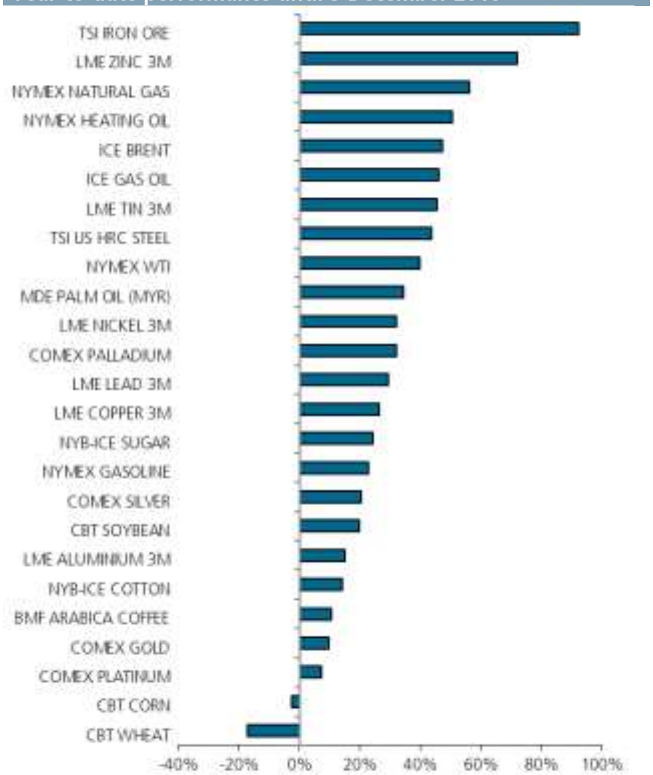
Citi Economic Surprise Index, emerging countries…



Source: Intesa Sanpaolo chart based on Citi Bloomberg data

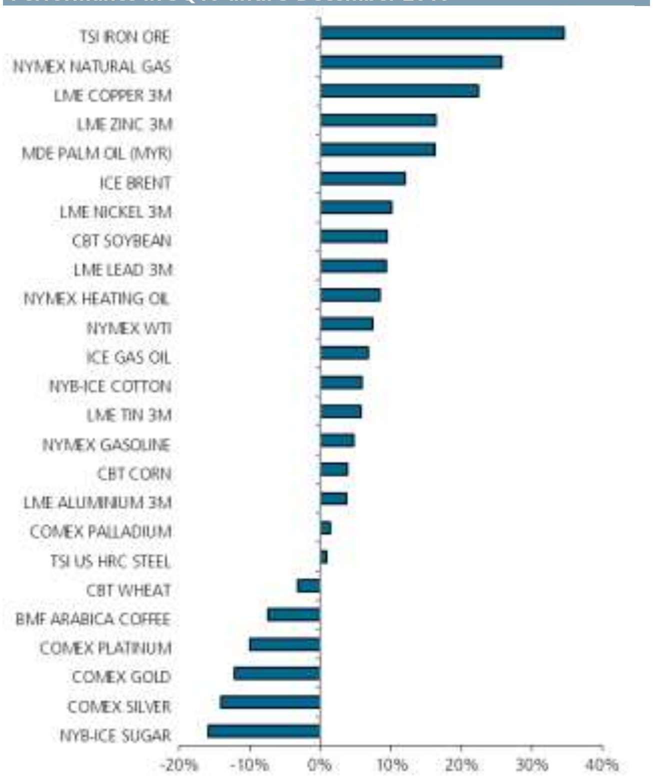
However, given the extent and speed of the rises recorded by some commodities prices, there is likely to be a retracement in the next few weeks, especially for some industrial metals and oil, particularly if they are not supported by markedly positive revisions to next year's supply and demand fundamentals.

Year-to-date performance until 5 December 2016



Source: Intesa Sanpaolo chart based on Bloomberg data

Performance in 3Q16 until 5 December 2016



Source: Intesa Sanpaolo chart based on Bloomberg data

Forecasts for the commodities universe

In our base scenario, global growth is likely to remain satisfactory, while the US and China could have some positive surprises in store thanks to their accommodative monetary and fiscal policies. Furthermore, spending on infrastructure could pick up the pace in the US and remain at high levels in China.

Brent should stay, on average, within an range of USD 50-55, based on the following assumptions: a) OPEC meets the production target of 32.5 million barrels a day for around a year (hence renewing for another six months the commitment reached in November), b) total non-OPEC production does not surprise to the upside (thanks to an active hedging policy on the part of some producers and the difficulties of monitoring compliance with commitments undertaken by countries that intend to join forces with OPEC), and c) global demand does not disappoint estimates. Specifically, the main risks are associated with a possible slowdown in both the process of accumulating strategic stocks, mainly in China, and growth in consumption in emerging countries due to the recent removal of some of the fuel subsidies and the increasing use of bio-fuels, especially in South-East Asia.

In 2017, industrial metals look set to record a positive annual performance, but we forecast that, on average, prices will be lower than the peaks reached in November-December. In our opinion, there are significant downside risks weighing on the scenario, since industrial metals prices have risen too much and too fast. However, various factors still justify a positive view for industrial commodities in 2017: the global economy is favorable to this segment, driven by an expected acceleration in growth in emerging countries; in China, growth seems to be stabilizing, driven by domestic consumption and government investment; in the US, upwards revisions of economic growth estimates and infrastructure spending are likely.

The short-term scenario for gold and precious metals is distinctly negative, due to the traditionally negative correlation with both the dollar and US interest rates, and to the gradual deterioration in the supply and demand fundamentals recorded in the second half; in India, the government's fight against tax evasion and capital flight has led to a downgrade of domestic demand estimates, while the low oil prices in the Middle East have substantially eroded spending capacity. Despite this, we see risks to the upside in the medium term thanks to the expected rise in inflation and the potential upturn in demand for safe-haven assets, fueled by the political risks still weighing on the global scenario (elections in the Netherlands, France and Germany, and uncertainty about the new US Republican administration's positions on international policies and trade development).

With regard to agricultural commodities, the impact of weather conditions on the main cereals seems to be positive, boosting their cultivation. As a result, we see limited room for an upturn in these commodities in 2017. On the other hand, we expect better year-on-year performances by palm oil and coffee.

Oil: an historic agreement

For the first time in 15 years, OPEC members and some non-OPEC countries have reached an agreement to curb the growth of global supply.

After two years, OPEC seems likely to rediscover its key role in stabilizing the global oil markets. At the end of November, OPEC announced its first cut for eight years, when it reduced the cumulative supply of 1.2 million barrels a day (mb/d) for the six months from January to June to a target of 32.5 mb/d, as expected by the 14 member states since the meeting in Algiers. Some non-OPEC countries, led by Russia, have confirmed their commitment to contributing with a further cut of less than 0.6 mb/d, implemented gradually over the six months. Although the volumes are small, this is the first agreement in 15 years between OPEC members and non-OPEC producers to curb growth in global supply.

On paper, the messages are clear. A ministerial supervisory committee has been created to monitor the implementation of the agreements and all countries have published the size of the cut, which will be implemented specifying the relevant benchmark levels. However, many details are still not clear; no indication has been given about which tools the organization will have to penalize any breaches, and for some countries the benchmark levels announced are not consistent with either the official estimates published by OPEC in October (secondary sources) or with the figures notified directly by individual governments (direct communication). Specifically, Iran has been asked to restrict its production to 3.8 mb/d (equating to an increase of 0.1 mb/d over October levels, according to official OPEC estimates, but a slight fall on the production figures notified directly).

Similar uncertainty surrounds the already considerable divergences between secondary estimates and government figures: in October, OPEC production was estimated at 33.6 mb/d by secondary sources but was some 34.6 mb/d based on the direct notification by the member states. Moreover, it is not clear what levels have been considered for Indonesia, Libya and Nigeria (which were excluded from the agreement) to reach the announced production target of 32.5 mb/d.

The OPEC agreement changes the scenario but the numbers give cause for concern

Output level (mb/d)	OPEC secondary sources (Oct. 2016)	OPEC direct notification (Oct. 2016)	Benchmark production level	Adjustment ('000 b/d)	Actual production level since Jan. 2017
Algeria	1,088	1,171	1,089	-50	1,039
Angola	1,586	1,507	1,751	-80	1,673
Ecuador	0.549	0.542	0.548	-26	0.522
Gabon	0.202	..	0.202	-9	0.193
Indonesia	0.722	..	..	..	..
Iran	3.69	3,920	3,975	90	3,797
Iraq	4,561	4,776	4,561	-210	4,351
Kuwait	2,838	3,000	2,838	-131	2,707
Libya	0,528	..	..	..	..
Nigeria	1,628	1,476	..	..	..
Qatar	0.646	0.639	0.648	-30	0.618
Saudi Arabia	10,532	10,625	10,544	-486	10,058
United Arab Emirates	3,007	3,188	3,013	-139	2,874
Venezuela	2,067	2,316	2,067	-95	1,972
Totale	**33,644**	**34,612**	**34,114**	**-1,166**	**32,682**

N.B.: For calculation purposes, the missing data were replaced with the levels obtained from the secondary sources in October
Source: Intesa Sanpaolo chart based on OPEC data

At the moment, it has not even been determined how OPEC could manage a future increase in production by the member states that are exempt from the agreement. The most likely solutions are that an increase in production in Libya and Nigeria is not offset, or that Saudi Arabia only will act as a swing supplier (the oil minister hinted toward a relative openness in that regard).

Despite all the unresolved issues, in our view, this OPEC agreement will strongly improve the market fundamentals:

- if correctly implemented, it will speed up the rebalancing of the market and launch the process of stocks erosion (we forecast global inventories to start falling in 2H, if the production target is maintained for at least a year);
- it could also reduce price volatility and boost medium- to long-term investments.
- lastly, it will restore OPEC's credibility and any success in the attempt to strengthen cooperation with non-OPEC members could have a positive effect on prices.

In its monthly report published in December, the International Energy Agency revised its estimates of the supply and demand fundamentals very positively and indicated that the global market for crude could find itself in a supply deficit situation as soon as the first half of 2017. In those months, we could see significant erosion of global stocks, estimated at around 0.6 mb/d, if OPEC maintains a cumulative production of around 32.7 mb/d compared with a record of 34.2 mb/d pumped in November.

Other forecasts are less rosy. For example, the US Energy Information Administration (EIA) estimates that a cumulative production of around 32.7 mb/d would be barely enough to keep the market balanced during the year, and thus prevent the extremely high global stock levels from being reduced.

Supply and demand estimates published by US EIA

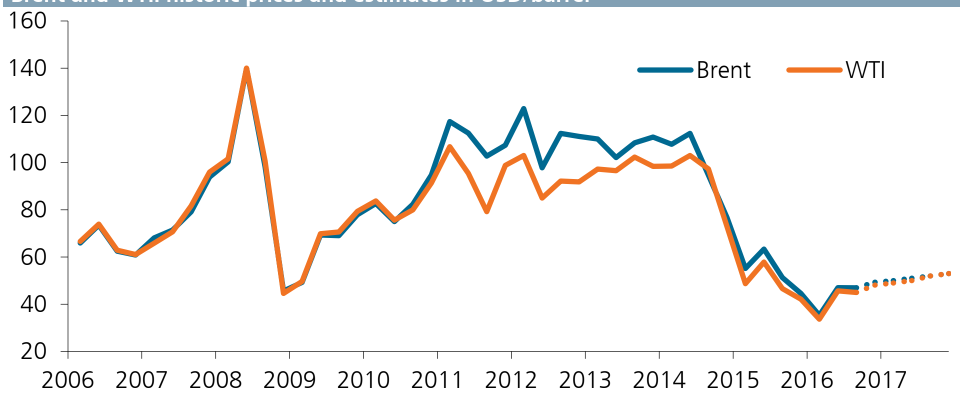
Estimates in December 2016 in mb/d	Global demand	Non-OPEC supply	US supply	OPEC supply of LNG	OPEC supply of crude	Call on OPEC crude*	Market balance**
2015	94.1	57.5	9.4	6.6	31.8	30.0	1.8
2016	95.4	56.9	8.9	6.8	32.5	31.7	0.8
% change	+1.3	-0.6	-0.6	+0.2	+0.7	+1.7	
2017	97.0	57.2	8.8	7.1	33.2	32.7	0.5
% change	+1.6	+0.3	-0.1	+0.3	+0.7	1.4	

NB: *) Call on OPEC crude = global demand – non-OPEC supply – OPEC supply of LNG; (**) market balance = OPEC supply of crude – Call on OPEC crude. Source: Intesa Sanpaolo chart based on US EIA data

Following the OPEC agreement, we have upgraded our crude price forecasts. Brent crude is likely to be traded on average between USD 50 and 55 in 2017, with higher potential for a rise in 2H. The Brent-WTI spread could be closed as early as 2Q17.

We do not expect Brent to exceed the USD 60 level with any stability due to the risk that higher average prices could give fresh impetus to non-OPEC production. According to most analysts, the fall in shale oil production could start to slow with crude at USD 50, while production would bounce back if it rose to USD 60. The Permian Basin is the most promising and is likely to continue to expand production even at lower prices, as seen in the last few months. At the moment, we deem as unlikely that there will be a significant acceleration of investment in the US oil sector until global and domestic stocks remain close to their record high levels.

Brent and WTI: historic prices and estimates in USD/barrel



Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for Brent

At 1 December 2016	1Q17	2Q17	3Q17	4Q17	2016	2017	2018
ICE BRENT	50.0	51.0	52.0	53.0	44.7	51.5	55.0
Median, Bloomberg	51.0	54.0	55.5	58.0	44.5	55.0	62.0
Forward Curve	53.1	54.1	54.6	54.9	51.2	54.2	55.7

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

At 1 December 2016	1Q17	2Q17	3Q17	4Q17	2016	2017	2018
NYMEX WTI	49.0	50.0	52.0	53.0	43.1	51.0	55.0
Median, Bloomberg	50.0	52.5	54.0	57.0	43.0	53.0	60.0
Forward Curve	51.4	52.8	53.2	53.3	49.7	52.7	53.6

Source: Intesa Sanpaolo chart based on Bloomberg data

Euro zone: the recovery continues; the risk is mainly political

Anna Maria Grimaldi

- Above-potential growth in the euro zone continues and, for the time being, has proved resilient to the Brexit shock. Recent data show an acceleration in GDP growth at the turn of the year, thanks to the manufacturing recovery. We have therefore revised up our 2017 forecast from 1.3% to 1.5%. In 2018, GDP growth could accelerate to 1.6% - 1.7%. Euro zone growth is still not uniform but has now spread to nearly all the member countries.
- Foreign demand will make a larger contribution to growth, compared to our September estimates, but the road ahead is still unclear. The exchange rate will weigh on growth by 0.2%. The contribution from oil will turn from positive to negative. The support from fiscal policy will be minimal and decreasing compared to 2014 - 15, despite the more dovish rhetoric of European politicians. Thus, in 2017 growth will largely rely on ECB exceptionally accommodative monetary policy. Household consumer spending will continue to grow at a sustained pace (1.4%) but less than in 2015-2016 (1.7%), as employment growth (+1.4%) will not be enough to offset the loss in purchasing power associated with the rises in crude oil and inflation. Corporate investment will remain subdued, burdened by political uncertainty.
- The risks to the scenario are still skewed to the downside and are mainly political. In 2017, parliamentary elections in the Netherlands (March), France (April) and Germany (September) – increases the degree of political uncertainty, which is already high following the results of the US vote and ahead of the Brexit negotiations. In all countries, due to renew their national parliaments, there is the risk of a further drift towards populist positions and of the emergence of governments that are less favourable to the process of reforming the European institutions.
- The expected rise in inflation to 1,5% in 2018 largely relies on what happens to core prices, since the contribution from energy will remain minimal. Risks are to the downside, given the inertia of core inflation in the past three years.
- On 8 December, the ECB extended its purchases programme preferring duration (9 months) to intensity (60 billion euros a month as opposed to the current 80 billion) to offset the downside risks to the macroeconomic scenario. We think, this may be the last fix from unconventional monetary policy in the euro area. Since his appointment in 2011, Mario Draghi has changed monetary policy and prompted a rethink of European governance, succeeding in lowering limits that seemed unassailable. What has not yet been overcome, however, is the staunch opposition to purchases of government securities without preconditions on risk-sharing across countries, a step that would have paved the way to less binding and more effective monetary policy measures in the future.

Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.9	1.6	1.5	1.7	1.7	1.7	1.5	1.4	1.5	1.5	1.5	1.6	1.6
- q/q change				0.5	0.3	0.3	0.4	0.4	0.4	0.3	0.4	0.4	0.4
Private consumption	1.8	1.7	1.5	0.7	0.2	0.3	0.4	0.4	0.4	0.4	0.3	0.3	0.3
Fixed investment	2.9	3.2	3.8	0.4	1.2	0.2	1.9	0.8	0.7	0.7	0.7	1.1	1.2
Government consumption	1.4	1.9	1.4	0.6	0.4	0.5	0.4	0.4	0.2	0.3	0.3	0.3	0.2
Export	6.2	2.4	3.4	0.2	1.2	0.1	1.0	1.1	0.9	0.6	0.9	1.1	0.8
Import	6.2	3.1	3.9	-0.1	1.2	0.2	1.2	1.3	0.9	0.9	0.8	1.0	1.3
Stockbuilding (% contrib. to GDP)	-0.2	-0.1	-0.3	-0.2	-0.2	0.1	-0.3	-0.1	0.0	0.0	-0.1	-0.1	0.2
Current account (% of GDP)	3.1	3.2	3.5										
Deficit (% of GDP)	-2.3	-2.1	-1.9										
Debt (% of GDP)	92.6	91.6	91.4										
CPI (y/y)	0.0	0.2	1.3	0.0	-0.1	0.3	0.6	1.2	1.3	1.3	1.4	1.4	1.5
Industrial production (y/y)	2.0	1.2	1.9	1.3	1.1	1.0	1.4	1.2	2.0	2.3	2.1	1.7	1.7
Unemployment (%)	10.9	10.1	9.5	10.3	10.1	10.0	9.9	9.7	9.6	9.5	9.4	9.2	9.2
3-month Euribor	0.0	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
EUR/USD	1.11	1.11	1.07	1.10	1.13	1.12	1.08	1.04	1.06	1.08	1.10	1.11	1.12

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

Stable growth in the year of *vox populi*

Above-potential recovery phase continues; holding up despite.....

2016 was the third year of above-potential growth [1] for the euro zone, although we estimate that average annual GDP growth will close at +1.6%, a slowdown on the figure of +1.9% in 2015. Forecasts of severe repercussions of the UK vote on household confidence were proved wrong. Not only was the dip in morale fairly contained in July and August, but in September, the macroeconomic data generally surprised to the upside. The composite PMI (54.1) is at its highest for a year and the European Commission's confidence index (106.4) returned to its 2011 level. The surveys indicate that industry is contributing to the formation of GDP more than it did in the first half of 2016 (see fig 2), thanks to the pick-up in global demand and exports to emerging countries (see fig.3). However, the insipid end to the summer quarter achieved by production (see fig.4) indicates that the contribution of manufacturing would struggle to be higher than that of the summer months even if it staged a recovery at the end of the year. Growth in services and retail continues. Construction activity seems to be rapidly picking up (see fig.3). Surveys indicate GDP growth of +0.4% yoy at the turn of the new year, from +0.3% qoq in 2Q and 3Q (see fig. 1). The strong headway made at the end of 2016 leads us to revise our estimate for 2017 to +1.5% from 1.3% previously.

…the negative contribution made by the exchange rate and oil…

The **effective exchange rate will trim 0.2% off GDP growth**, largely due to the appreciation that occurred between November 2015 and October 2016 (+4.0%[2]). The recent depreciation phase should have run its course by early January (-2.0%), and we expect a modest rise in the rest of 2017, leading to a total increase of +1.1%. The **oil price's contribution** to the formation of disposable income **will change sign and after adding + 0.6% to growth will subtract 0.2%**, after having been well into positive territory in 2015-2016 (0.5%). In 2017, we forecast a 13% rise in the price of crude (expressed in euro), after the falls of 2015-2016 (-35% and -16%), the delayed effects of which should have come to an end by spring, given that the slow rise started in February 2016 (excepting the August correction) and will be strengthened by the OPEC agreement.

…modest and uncertain growth in foreign demand

The signs of recovery in global demand (see fig.3) point to more sustained growth in exports at the turn of the new year, after the stagnation in the summer months. However, we maintain our **forecast of a cautious upturn in foreign trade directed to the euro area** (3.0%, from 2.1% this year and below the 3.4% recorded in 2012-2014), given the **high degree of geopolitical uncertainty at global level**. It will not become clear [3] before early January whether the UK will be following a soft or rather harder exit from the European Union. In addition, Trump's promised reflationary policies are unlikely to be implemented before mid-2017, and hence the US economic recovery can only reasonably be expected in the second half of 2017, if not in 2018. In any event, the effect on global growth will depend on how strong the push towards protectionist policies will be. For the time being, we confirm our forecast that exports will accelerate to 3.2% in 2017, from 2.4% this year, compared with import growth of 4.0%; **the contribution of foreign trade will therefore remain negative**.

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[1] The European Commission estimated potential at around 1.0% in its 2016 spring forecasts.

[2] The concept of elasticity suggests that an appreciation in the exchange rate deducts around 0.3% from GDP growth and inflation after one year.

[3] The judges of the UK's Supreme Court will meet in plenary session for three days (5-8 December) to establish whether MPs can trigger Article 50, i.e. the procedure to leave the European Union, or whether a negotiating plan must be approved by Parliament, which would make the process more transparent. The Court's formal decision will not be made before early January.

ECB measures continue to support growth

GDP and in particular domestic demand growth will be driven almost entirely by the ECB's policies (see fig. 5). With the December announcement (see monetary policy section), the overall size of the APP programme will reach EUR 2.2 Trn, or 20% of GDP. According to a study by the ECB[4], an estimate of purchases equal to 11% of GDP should have a maximum impact of 0.4% on inflation and 1.0% on growth after two years.[5] **Domestic demand will maintain a sustained**, although slightly slower, **growth pace** (1.7% in 2017, from 1.9% in 2015-2016). Private consumption should keep a solid pace (1.4%) but less so than in the last two years (1.7% on average), partly due to the loss of purchasing power associated with the higher crude price and inflation's rise to 1.3%, from 0.2% this year. Furthermore, nominal wages growth has slowed more than expected in 2016, to 0.8% yoy, and will struggle to pick up to more than 1.5% next year. The slowdown in wages growth is partly due to the sluggish productivity (not only due to cyclical factors) but there could be second-round effects at play associated with the persistence of inflation expectations at levels well below the ECB target. The resilience of consumer spending therefore depends on full-time employment growth remaining solid (1.4%) and a further fall in unemployment towards 9.3% by the end of 2017 (see fig.6). However, the slight increase in the **savings** rate in the first half of 2016, despite interest rate falls, should offer a cushion in the event of adverse shocks. **Investment in machinery** is again growing at muted levels (0.7% qoq in 2Q) compared with the previous recoveries. The combination of expansionary credit conditions, lower financing costs (see fig.7), resilient earnings and the high use of production capacity (see fig.8) should, in theory, encourage growth in corporate investment. But the European Commission's latest six-monthly survey does not indicate an acceleration (see fig.10) and the reason seems to be the increasing geopolitical uncertainly (see fig.10). We can only hope for more appreciable growth in investment (3.6% after the estimated 3.2% for 2017) in 2018, when the picture is clearer at both international level and in the euro zone. The construction sector seems to have locked into a more solid growth phase (aside from the quarterly volatility due mainly to weather factors). Our indicator for **construction spending[6] estimates growth of between 0.6% and 0.8% at the end of the year** (see fig.12). Spain and Germany are driving this expansionary cycle, which should continue in 2017 (+1.8% from 1.5% in 2015), given the amply supportive financial conditions and robust confidence in the sector.

Private consumption boosted by employment and accommodative financial conditions but curbed by rising inflation.

Uncertain path for investment in machinery.

Construction: expansive cycle consolidates thanks to Spain and Germany.

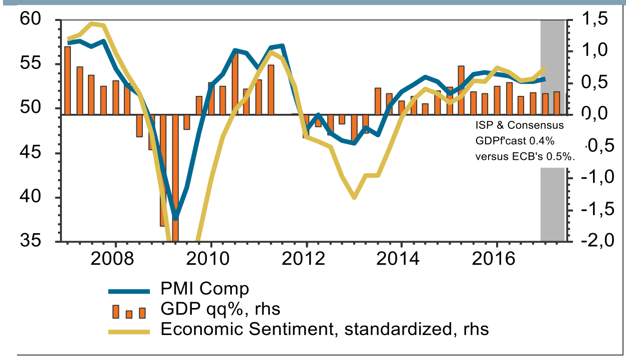
Derisory support from fiscal policy and progress not likely before the French and German elections.

Despite the appeal to make active use of fiscal policy and the shift in this direction in other advanced economies, reflationary policies in the euro zone are still confined to actions by the ECB. Overall, the contribution of fiscal policy will remain derisory (-0.1%) in 2017 and, at worse, could even be lower than 2016 (-0.2%)[7]. The European Commission's president Juncker pledged to approve at European level a 0.5% fiscal measure to support investment in mid-November. But it is now clear that mini European fiscal expansion will not take place as both Schauble and the President of the Eurogroup, Jeroen Dijsselboem have firmly opposed it. We think it unlikely that there will be joint European efforts either on budgetary policies or any other European issues, such as security or the management of European borders and migration policies given the busy electoral year. **The risks to the scenario remain skewed to the downside** and are mainly political. Uncertainty reigns supreme not only at international level but also in Europe with the approach of the negotiations for the UK's exit from the EU and the parliamentary elections in the Netherlands (March), France (April-May) and Germany (September). See Focus below.

Risks remain skewed to the downside and are mainly political.

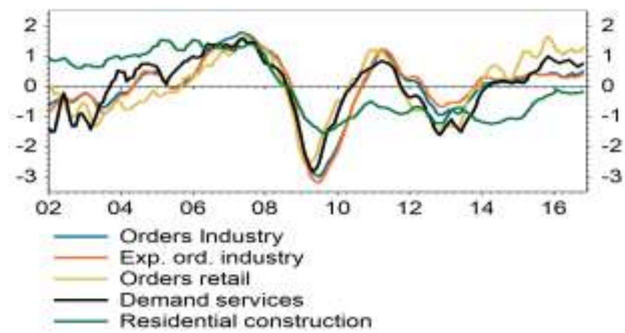
[4] See ECB Working paper no. 1956, 2016: *The ECB's asset purchase programme: an early assessment*.
[5] It is possible that the effect of monetary policy on growth and inflation could be even greater, particularly if the latest TLTRO II auctions (the results will be communicated on 15 December 2016 and 23 March 2017) were to see a higher net take-up of funds than in the last two auctions (June: EUR 31Bn, and September: EUR 43Bn), with stimulus effects on credit.
[6] See the *Weekly Economic Monitor* of 20 May 2016
[7] Change in the structural budget balance according to the European Commission's autumn estimates.

Fig. 1 – Confidence surveys point to 0.4% t/t GDP growth at end-2016, in line with ECB forecasts but stronger than consensus estimates



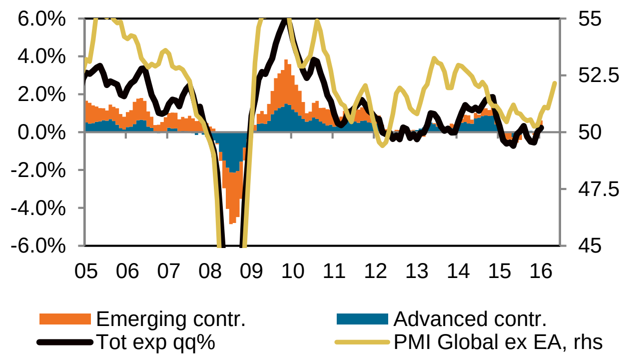
Source: Consensus Economics November forecasts, Intesa Sanpaolo chart from Thomson Reuters Datastream data

Fig. 2 – Additional boost likely to come from manufacturing



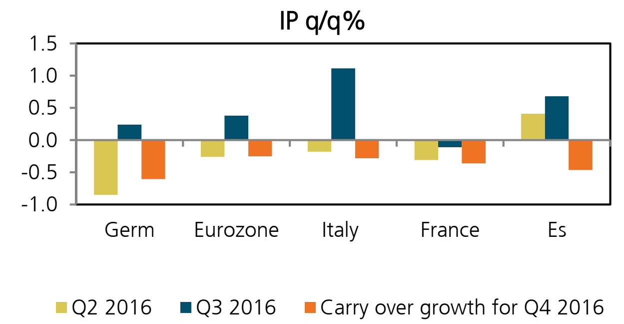
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – Thanks to the rebound in external demand



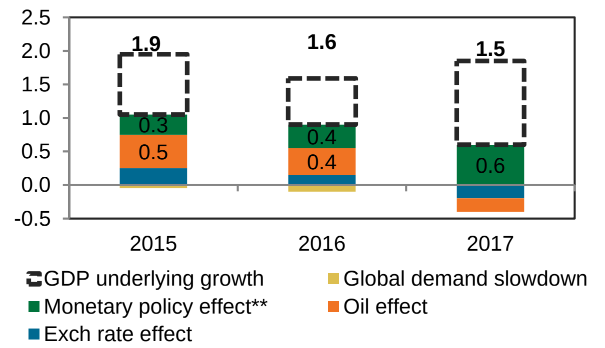
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 4 – Weak industrial output growth at the start of Q4 suggest that GDP growth may not be that strong



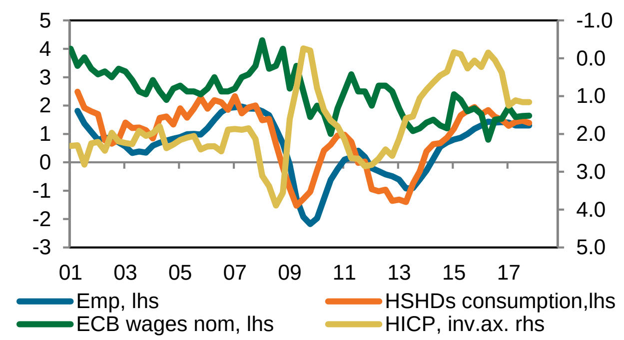
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 5 – Growth largely depends on ECB stimulus in 2017



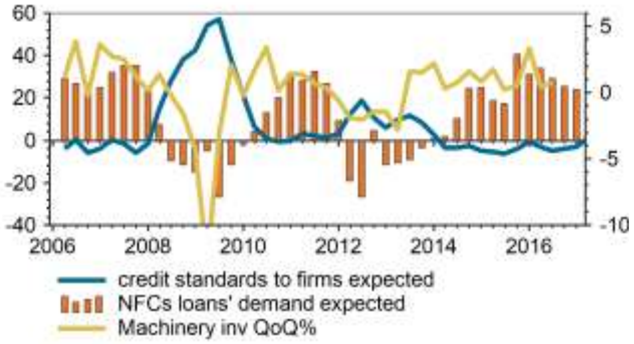
NB: QE's effect on growth 1.1% in 2 years (ECB *working paper* no. 1956, September 2016).
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 6 – Private consumption, driven by employment, as real wages are curbed by the rise in inflation and sluggish nominal wages



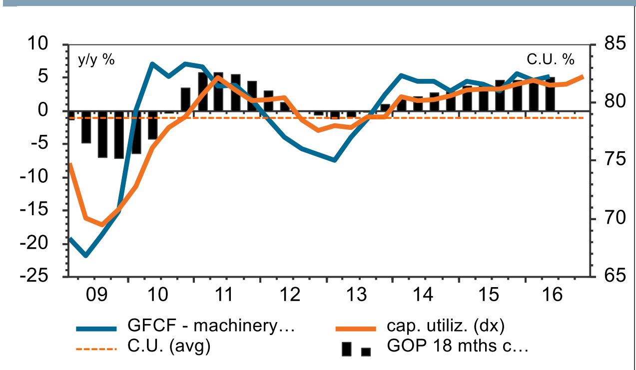
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Corporate investment still the weakest link, despite amply supportive financial conditions and …



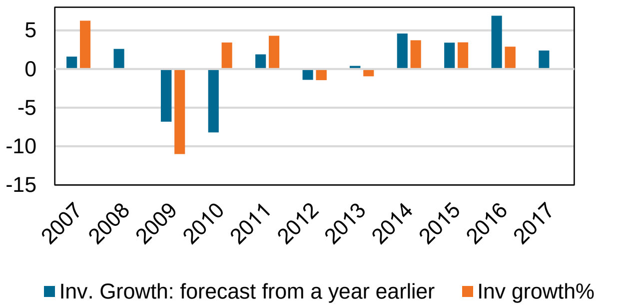
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 8 – …high use of production capacity and resilient earnings



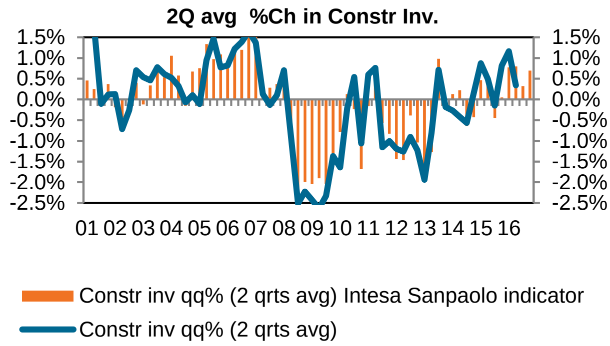
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 9 – European Commission's latest survey does not indicate an upturn in investment in 2017



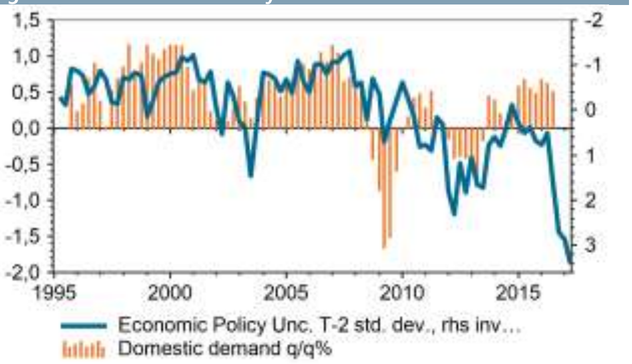
NB: Investment growth forecasts are from October 2015. Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 10 – Construction investment: our indicator suggests solid growth at year - end



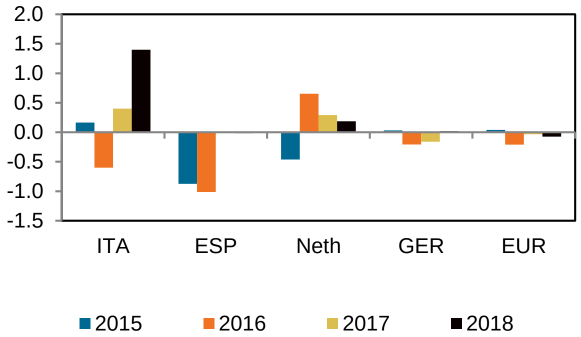
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 11 – Political uncertainty is the risk for 2017



Source: Political uncertainty indices for Germ, Fra, Ita, Spa
Intesa Sanpaolo chart from Thomson Reuters Datastream data

Fig. 12 – Minimal and decreasing support from fiscal policy



Source: Forecasts of public finance balances are from the European Commission's Autumn 2016 estimates
Intesa Sanpaolo chart from Thomson Reuters Datastream data

Inflation driven by energy and base effects but there are still risks to the underlying trend

Anna Maria Grimaldi

Euro zone inflation reversed at the end of summer (see fig.1), rising by 0.4 percentage points to 0.6% in November, on the back of the turnaround in crude oil prices; however, we think that the risks to inflation are still to the downside. Accordingly, we maintain our estimate of only a modest price rise over the forecast horizon (1.2% in 2017 and 1.5% in 2018). Our estimates are broadly in line with consensus estimates and the ECB's latest forecasts (HICP: 1.6% in 2018, up from 1.3% in 2016).

Inflation trend uncertain Oil will make only a slight positive contribution

Oil and the exchange rate will, in our view, only make a moderately positive contribution, and our forecasts are not much stronger than those of three months ago. We still expect a modest rise in the price of crude over the forecast horizon (from USD 44 per barrel in 2016 to USD 52 USD in 2017, and USD 55 in 2018) as the OPEC agreement has only partly eased downward pressure on prices due to excess supply. Going forward, the exchange rate will stop depreciating by early January, with the average effective rate likely to be a rise of 1.1%. From November to March, according to our estimates, inflation will be pushed up to +1.2% by energy and a favourable statistical effect on domestic prices. From spring onwards, inflation will only be propelled over 1.0% and towards 1.7% at the end of 2018 if any real pressure on domestic prices were to emerge. But inflation net of energy, food, tobacco and taxes, was still stuck at 0.8% in November, the same as at the end of 2013, and this is despite two and a half years of above-potential growth. Services prices, typically more closely linked to domestic demand, are unchanged at 1.1%. If growth were to pick up the pace to 0.45% qoq between the end of 2016 and June 2017, average annual GDP would be around 1.6% at best, as per the ECB's estimates, and only a few tenths of a percentage point above consensus forecasts. As stated by the European Commission, excess aggregate supply would be shed at a slower pace than in the period of 2014-15, and would remain slightly negative even at the end of 2018, down from -3.4% in 2009[8]. As well documented, there is huge uncertainty surrounding the output gap estimates. The ECB recently estimated the output gap consistent with Euro zone inflation in 2014-2015 at 6%, almost double the Commission's estimate. The uncertainty surrounding the extent of excess supply [9] and/or the speed of reaction of underlying inflation, shows that the risk of once again over-estimating the domestic price trend is far from negligible. Added to this, contractual wage growth continues to surprise to the downside, slowing in the third quarter to 0.8% yoy, from +1.5% yoy at the end of 2015; therefore, given the high unemployment rate, we are unlikely to see a marked rise in inflation. The only positive development is the stabilisation of price expectations, as can be derived from the business confidence surveys and the official forecasters questioned by the ECB, as this reduces the risk of second-round effects on wage growth and domestic prices. It should be noted that the market's three and five-year inflation expectations have risen visibly, but this is partly due to the contagion effect from US rates following the policy reversal in Washington and the expectation of reflationary measures. The ECB's December measures are likely to help bolster a rise in inflation over the forecast horizon but the risks are still of stagnant core inflation.

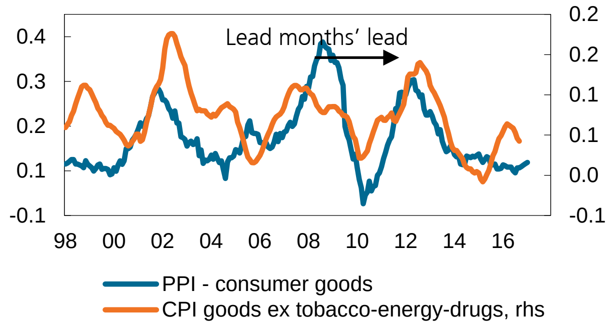
A convincing rise in inflation still depends on domestic prices

The risks for consumer price inflation are still to the downside

[8] See: European Commission: Autumn 2016 Forecast, Box 1.4, pp 63-65.

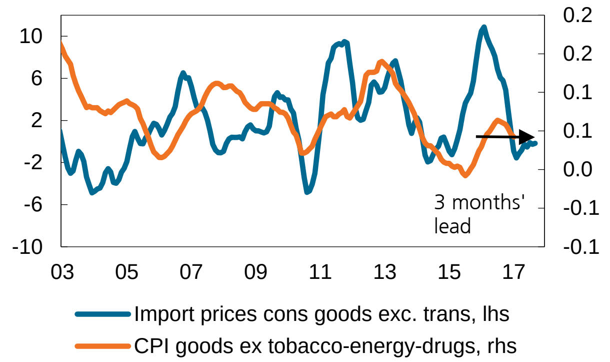
[9] See ECB working paper no. 1966, *An inflation-predicting measure of the output gap in the euro area.*

Fig. 1 – Very preliminary of price rises emerging upstream of the production chain



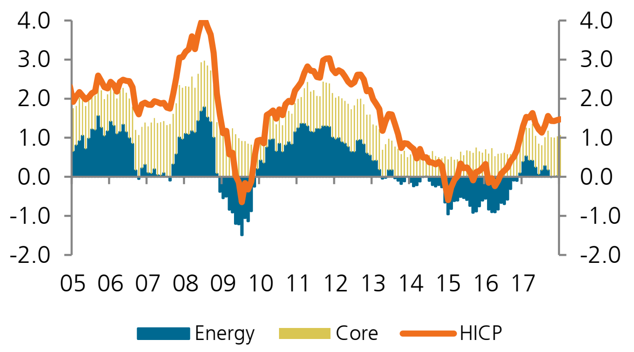
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 2 - Import prices have stopped falling but in our central scenario we expect modest impetus from the effective exchange rate



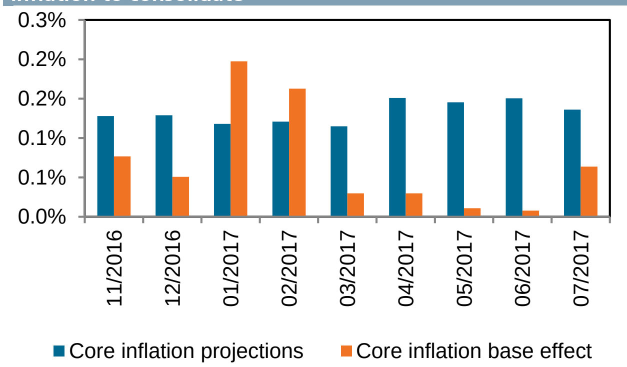
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – For inflation to rise convincingly towards the target, the core trend must move steadily towards 1.5%



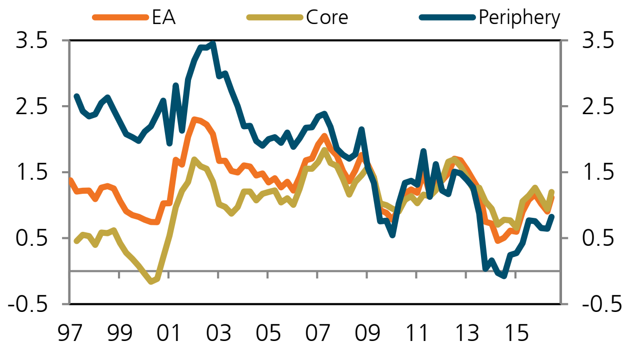
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – Core inflation is expected to rise to 1.3% by March 2017 thanks to the favourable base effect, but genuine price increases will be needed from the Spring for the rise in inflation to consolidate



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

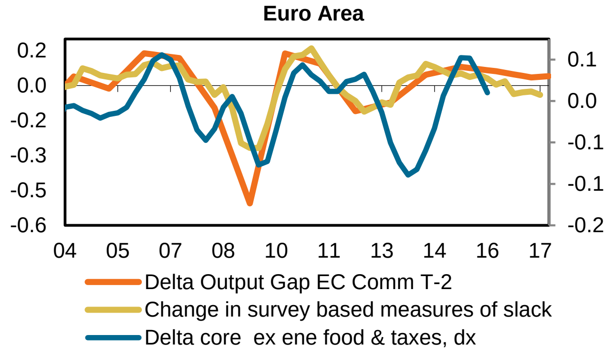
Fig. 5 – "Cyclical" inflation has also reversed in peripheral countries



N.B.: The price trend excluding energy, food and tobacco, net of taxes and administered prices, is cyclical. Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. The countries are aggregated with the weightings in the Euro-zone HICP

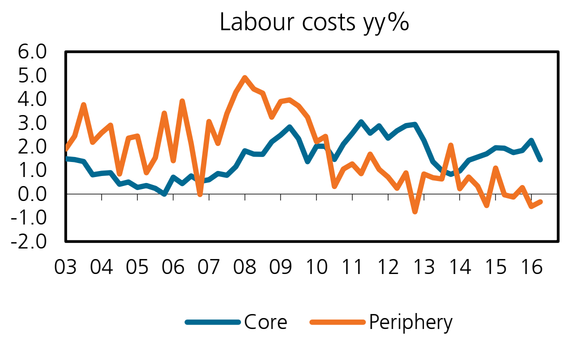
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 6 – Much depends on the resilience of GDP growth However, the prospects for a rise in core inflation remain uncertain as the output gap will close at a slower pace



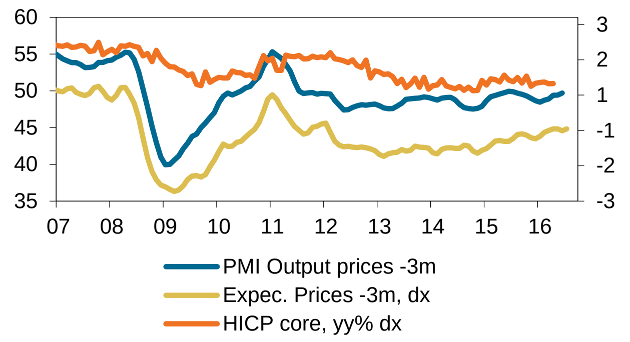
N.B.: Output gap European Commission, Change on the previous year. Measures of excess supply from surveys are based on the question put in the European Commission's quarterly survey: "Is demand a limit to production?" for industry, construction, services and retail. The series are normalised and aggregated with the weightings of the sectors in value added. Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Labour costs are also slowing in core countries



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 8 – Stabilising sales price expectations for the next few years is the only moderately positive note



N.B.: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. The countries are aggregated with the weightings in Euro zone GDP
Source: Thomson Reuters-Datastream

Focus: 2017, testing times for European *vox populi*

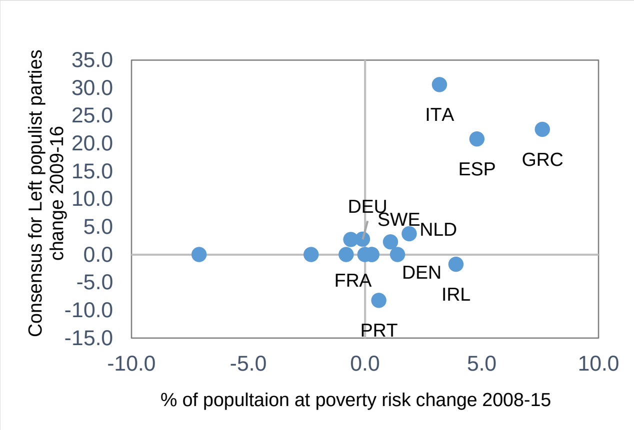
Luca Mezzomo
Anna Maria Grimaldi

In many advanced democracies, increasing support is being gained by "populist" political movements, which claim the existence of a fundamental conflict between the "people", described as a homogenous entity, and an "élite", which is segregated from the mass of the population, singled out as being corrupt, and consistently accused of pursuing its own interests to the detriment of the others[10]. The reasons that are fuelling popular malcontent vary from one country to another, but some recur more frequently: increasingly uneven distribution of income, mounting precariousness of social status (unemployment, job instability), deterioration of income prospects, insecurity due to a changing context (also due to the inflow of migrants). Half a century ago, such malcontent would probably have been intercepted by the unions and by communist parties, which would have addressed it towards class struggle initiatives; at the time, however, the political manifestos of the socialist and social-democratic parties differed much more significantly from those of the popular or conservative parties, leaving much less room to populist parties in the strictest sense. Today the picture is deeply disarticulated. The moderate left-wing parties are perceived as being too similar to the moderate right: this is because the moderate right has taken a more progressivist stance on social issues, whereas the left-wing parties have watered down their redistributive instances and renounced promoting social justice[11].

Starting in the 1990s, this representation *vacuum* has in many cases been filled, especially in Central and Northern Europe, by right-wing nationalist movements; the right-wing populists also target another enemy, in addition to the corrupt élite: foreigners who threaten the quality of life of native nationals[12], who for some years now have mostly been identified with Islamic immigrants. Unlike the American right, these parties are not rooted in religion, although they often resort to Christianity as a defining element of "us".

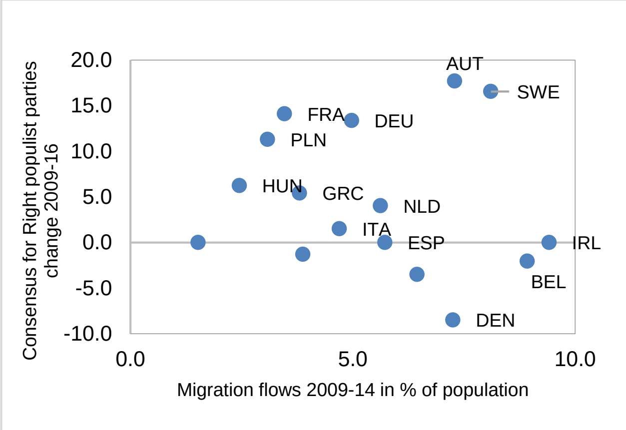
[10] C. Mudde, "The populist zeitgeist", *Government and Opposition 39(4) (2004), p. 544.*
[11] Michael Bröning, "The rise of Populism in Europe: can the center hold?", *Foreign Affairs*, June 2016.
[12] N. Marzouki, D. McDonnell, O. Roy (eds.), *Saving the people*, Hurst & Co 2016.

Fig. 1 – Consensus for left-wing populist parties seems to be closely tied to the worsening of living standards while…



Note: data on the x-axis indicate the increase in the share of the population classified as being at risk of poverty or of social exclusion as defined from Eurostat. Y – axis change in consensus for left-wing populist parties between 2009 (European Parliament Elections) and 2016 (share at the latest political elections, if held in 2015 or in 2016, or voting intention polls ahead of the next elections).
Source: Intesa Sanpaolo elaborations

Fig. 2 – …support for right-wing populist parties more related to immigration issues



Note: X axis data change in foreign population Eurostat. Y – axis as in the chart on the left
Source: Intesa Sanpaolo elaborations

In other cases, especially in Southern Europe, consensus rewarded mostly new political formations which advocate more direct involvement of the people in decision-making, or simply seem more ready to voice malcontent. In this case, the origin of malcontent resides in the deterioration of living conditions following the economic crisis of, from 2009 onwards, and the movements are mostly of "leftist" connotation (Syriza, Podemos), or when they are devoid of a left-wing ideology, they have attempted to make some left-wing causes their own (Five-Star Movement). However, in Greece and Italy as well, right-wing populist parties have emerged, respectively Chrysì Avgì (Goden Dawn) and Lega Nord (the Northern League).

The link between the risk of poverty and the strengthening of left-wing populism is rather strong (Fig. E1), with a few interesting exceptions, such as Ireland. On the other hand, the presence of intense immigration flows fuels the emergence of right-wing populism, but in this case the link is complicated by factors such as the ethnic and cultural composition of the immigrant base, the reactions of the traditional parties, and the time span over which immigration takes place; therefore, migratory flows of equal intensity starting in 2009 have had very different effects from one country to another (Fig. E2). In Holland, for instance, the boom of the populist parties began sooner, already with 2002 elections, with the Lijst Pim Fortuyn (LPF), and is experiencing a second rebirth today, after a regressive phase tied to the crisis of the LPF following the death of its founder.

The advancement of populist movements poses **a number of risks** for European Union Member States. First of all, they are fuelling hostility and diffidence towards the scientific method, experts, and at times even towards representative democracy, fuelling the dangerous illusion that any problem can be solved by direct popular vote. Secondly, by presenting themselves as an alternative to the élites, the populist movements often suffer from a lack of competences which may result in serious problems once they are called to manage complex realities. Thirdly, almost all the populist movements are hostile to the European Union and to the monetary union, perceived as limiting national sovereignty, and are therefore typically opposed to any mutual support mechanisms between Member States. Therefore, if a populist movement should rise to power in one or more Member States of the Union, a phase of financial instability could ensue, and the persistence of the monetary union could be threatened regardless of the ECB's determination in countering centrifugal forces. The problem could come to the fore very soon:

in 2017, general elections will be held in three important euro area countries; a fourth country, Italy, could be forced to stage an early vote, before the initially set date of 2018.

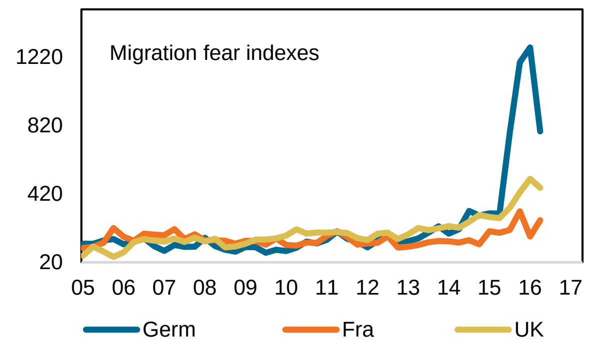
In **Holland**, polls, for the March 15th elections, award a lead to the euro-sceptic nationalist party PVV (Partij voor de Vrijheid), which has inherited the legacy of the dissolved Fortuyn List. The PVV is seen to lead with 29-34 seats out of 150, up sharply from 15 in September 2012. At the 2012 elections, the PVV based its electoral campaign on the proposal to guide Holland out of the European Union, whereas this time around focus is mostly on curbing Islamic immigration. The proportional electoral system means that at least 11 parties will be represented in Parliament, and that the formation of the new government will require the support of a coalition, which may not include the PVV. Even if it does participate in a coalition government, the PVV's disruptive potential would be diluted by the need to reach compromises with its government allies. However, the growth in consensus enjoyed by the PVV will condition any government, obliging it to pursue a minimalist interpretation of the European Union's role.

In **France,** the Presidential (23 April, ballot on 7 May) and Parliamentary elections (11-18 June), are expected to see limited competition for the centre-right and the radical right-wing Front National, the strongest local expression of all populist movements, as socialists are side-lined. The Front National is against European integration, and if victorious at the elections (possible in theory, given the French electoral system), it could place the monetary union at much greater risk than political developments in Italy. However, the majority of French electors fears the ascent of an extremist right-wing party to government, and once again at the latest local elections the Front National displayed its difficulty in winning consensus outside its natural electoral base. The Socialist party will present former Prime Minister Valls as its candidate; President Hollande, who is experiencing a deep popularity crisis, has appropriately opted out from the race; however, even Valls may fail to win more than a 9-11% share of the vote. Voting intention polls indicate that Fillon, who won the centre-right primaries, could be the most voted candidate in the first round, with a 26-31% share, ahead of Le Pen (Front National) with 24%. Survey data also show that Fillon should win by a wide margin at the second round, if his opponent is Marine Le Pen. For what concerns the legislative elections, the latest surveys (Odoxa 25/11/16 and Harris Interactive 27/11/2016) see the republicans in the lead with 26-32%, whereas Marine Le Pen's Front National is expected to stop short at 22%.

In **Germany**, the crisis of the traditional parties is increasingly threatening the possibility of the SPD and the CDU-CSU popular party alternating terms in control of government. The decision taken by moderate Chancellor Angela Merkel to run again will make it harder for the right-wing populists of the *Alternative für Deutschland* (AfD) to access government, on the back of the 13% share of the vote awarded to them by surveys. By contrast, it could leave the more conservative component of the Christian Democrat electorate dissatisfied. Freefalling consensus for Chancellor Merkel in the past year was due to the unease generated by the strong wave of immigration (Fig. E3). However, the CDU-CSU, with a 30-33% share of consensus, and the SPD, with a 22% share, remain the only parties capable of forming a government majority. A possible alternative could be a coalition between the Popular, Green, and FDP parties, although they risk not achieving a Parliamentary majority on aggregate. The string of great-coalition governments represents a problem for both the major parties, as it tends to nullify the differences between them in the eyes of the electors, and may favour an outflow of votes to the advantage of the formations that stay out.

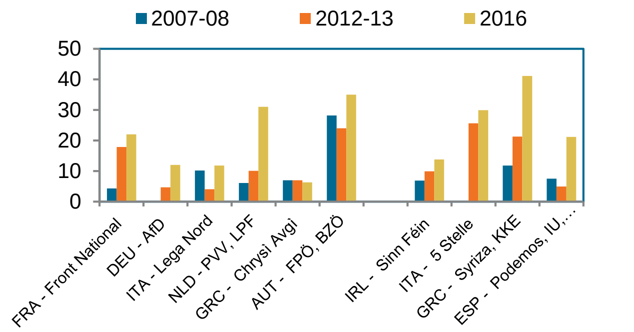
In **Italy**, political elections should be held in theory in May 2018, when the legislature will come to its natural end. However, the political crisis which followed the rejection of the constitutional reform makes early elections in 2017 a more likely prospect, hard on the heels of the electoral law reform that Parliament will have to discuss in the next few months. Uncertainty over the electoral mechanism makes it hard to assess the risk of the next government being controlled by euro-sceptic populist parties. The most important populist movement in Italy is the Five Star Movement (*Movimento Cinque Stelle*), which commands a share of the vote of around 30% according to voting intention polls, just behind the largest moderate party (the Democratic Party). Furthermore, the country one of the oldest right-wing populist movements, the Lega Nord, which is awarded over 10% of consensus by survey data.

Fig. 3 – Fears generated by migratory flows explain the heightening of political uncertainty in Germany



Source: Baker, Bloom & Davies, Migration Fear indices

Fig. 4 – In Europe, populist parties are winning increasing support



Note: the first two bars refer to the outcome of the legislative elections held in the indicated biennium; the third bar represents the average of the latest voting intention polls, or the outcome of the legislative elections, if held in 2016. In Greece's case, the 2016 bar indicates the outcome of the latest political elections in 2015.

Source: Wikipedia and Intesa Sanpaolo elaborations

At least until the autumn of 2017, the electoral calendar will make it almost unthinkable for a serious debate to be opened on which measures could guarantee the stability of the monetary union. However, even after the round of elections, several countries will find themselves led by governments with a less favourable view on European integration, or concentrated on domestic issues, or weakened by difficult government agreements. Furthermore, the advancement of populist movements is a major factor in discouraging greater integration among Member States, favouring a minimalist approach geared to preserving the status quo. The negotiations with the United Kingdom ahead of the country's exit from the European Union are another factor that will discourage any reform at the EU level, in particular in the event of the talks resulting in changes being made to the Treaties. In conclusion, the process of reforming European governance will be the main victim of the electoral cycle in 2017: as Draghi admitted in his hearing at the European Parliament, "European politicians are more concerned about security, defence, and migration flows than about reforming European institutions and governance".

Table 1 – Main political appointments in Europe in 2017

Data	Country	Event
January	United Kingdom	Supreme Court ruling on ex-Article 50 process
22/29 Jan	France	French Socialist Party Primary Elections
15-Mar	Holland	Parliamentary elections
23-Apr	France	Presidential elections – 1st round
07-May	France	Presidential elections – 2nd round
07-May	Germany	Elections in Schleswig Holstein
14-May	Germany	Elections in Nordrhein-Westfalen
11-Jun	France	Parliamentary elections (National Assembly) – 1st round
18-Jun	France	Parliamentary elections (National Assembly) – 2nd round
September	Germany	Parliamentary elections (Bundestag)

Source: Intesa Sanpaolo elaborations

ECB extension or soft tapering?

Anna Maria Grimaldi

At its December meeting, the Council extended its EAPP (asset purchases programme) until December 2017, although at a level of EUR 60Bn a month. The Council's decision, which received broad-based support, responds to the need to contrast the high degree of uncertainty surrounding the macroeconomic scenario, and to maintain downward pressures on government yields until the elections round in the euro area will come to completion. Recent figures and the ECB outlook did not indicate that an increase in monetary stimulus was imperative. Indeed, September's macroeconomic outlook (see table 1) has been confirmed. Thus, the decision was justified on the grounds that the inflation forecast for 2019 at 1.7%, is still not quite in line with the ECB target.

The Council has opted for a compromise solution, as purchases have been reduced compared to the current pace. However, the ultra-accommodative communication has convinced markets that "the ECB will still be around in the market for a long time". The communication provides reassurance that "*purchases will be extended until December 2017 and beyond, if necessary, and, in any event, until inflation has convincingly returned to a path compatible with the 2% target*". It also stresses that "*if the macroeconomic environment were to worsen and/or financial conditions were to move in a direction not compatible with inflation's return towards 2%, the ECB is willing to increase the volume and/or duration of purchases*". For the first time an inflationary bias can be detected, since Mario Draghi said that purchases will not be reduced in the event of positive surprises. Draghi said that there is no question of tapering and that, on the contrary, an exit from the programme, alias a "gradual reduction of purchases towards zero", has not been discussed. Draghi insisted that this is a quasi-open-ended programme or at least that the durations is set by the distance of inflation from the ECB's target. However, we know that if the inflation target were to remain out of reach, the programme would still be limited by the scarcity of German paper, unless the capital key limit were to be lifted.

Tab. 1 – Main ECB macroeconomic forecasts versus Intesa Sanpaolo and Consensus Economics

	ECB estimates, December 2016				ISP & Consensus estimates, November 2016			
	2016	2017	2018	2019	2016	2017	2018	2019
GDP yoy %	1.6	1.7↓	1.6	1.6	1.6 (1.6)	1.4 (1.3)	1.5	1.5
CPI yoy %	0.2	1.3	1.5↓	1.7	0.3 (0.2)	1.3 (1.3)	1.5	1.7
Core CPI yoy %	0.9	1.1	1.4	1.7	0.9	1.2	1.6	1.7
Dec. 16 ECB assumptions on EUR	1.11*	1.09*	1.09*	1.09	1.11 (1.10**)	1.16 (1.09**)	1.21 (1.10**)	1.24
Dec. 16 ECB assumptions on Brent	43.1*	49.3	52.6*	54.6	44.5	50 (49.3**)	55 (53.8**)	60

↓↑ indicates the direction of the revisions to the previous ECB estimates
** Estimates of Consensus Economics for the EUR exchange rate and oil prices are for November 2016, February 2017 and November 2018. Intesa Sanpaolo forecasts are annual averages.
Source: ECB, September 2016 macroeconomic estimates, Intesa Sanpaolo November 2016 forecasts and Consensus Economics November 2016

The **orderly continuation of the programme has been made possible by the abolition**, from January 2017, of the **purchase limit of bonds with a yield above the depo limit**, if necessary. Draghi explained that this is an option and not a binding indication; securities purchases with negative yields will be assessed in line with market conditions i.e. the scarcity of German paper. Moreover, purchases will be **extended on the shortest part of the curve and will also include securities with 12-month maturities** from the current 2-30-year range. The decision will have a bearish impact on short-term rates, enhance ECB's dovish stance on short term rates, and lead to a steepening of the yield curve that should be positive for the banking system. We must not overlook the fact that the purchases programme will continue together with the policy of reinvesting maturing securities, which further strengthens the expansion of the balance sheet (see table 2). Note that **the ECB also discussed removing the single issuance limit** (25% for securities with CACs and 33% for securities without CACs) but rejected this option on account of the legal problems that would have arisen.

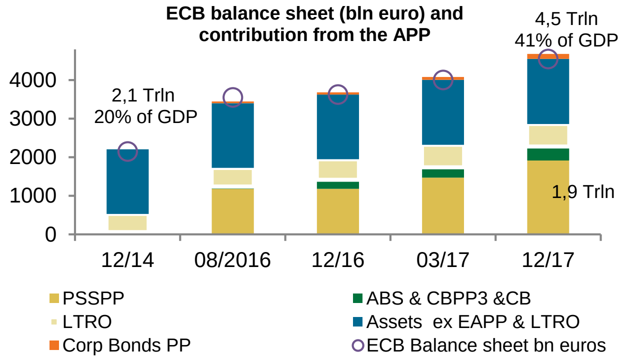
Following December's decision, total ECB purchases announced between December 2014 and December 2016 for the duration of the programme rose to EUR 2,280Bn (21% of GDP, see table 2); added to this, the reinvestment policy should be worth around EUR 320Bn. A recent working paper by the ECB (see ECB working paper 1956, September 2016) estimates that an 11% increase in the balance sheet would equate to a cut in official rates of around 110 basis points, with an effect of approximately 1.3% on growth over three years, and a lesser effect of 0.4% on inflation. We believe that the announcement at December's meeting is one of the last adjustments to the programme that the ECB will have to make before giving the go-ahead to a slow reduction in the volume of purchases from early or mid-2018.

Tab. 2 – Once completed, APP purchases will have increased the ECB's balance sheet by 20% of GDP

	EUR billion
December 2015 – launch of APP	1140
March 2016 – Extension up to March 2017	360
March 2016 – Increase from EUR 60Bn to EUR 80Bn a month	240
March 2017 – APP extended to December 2017, reduction from EUR 80Bn to EUR 60Bn	540
Memo: reinvestment of maturities	320
Total purchase programmes since December 2014	**2,280**
Memo: Nominal GDP	10,396
Measures as a % of GDP	**21.9**

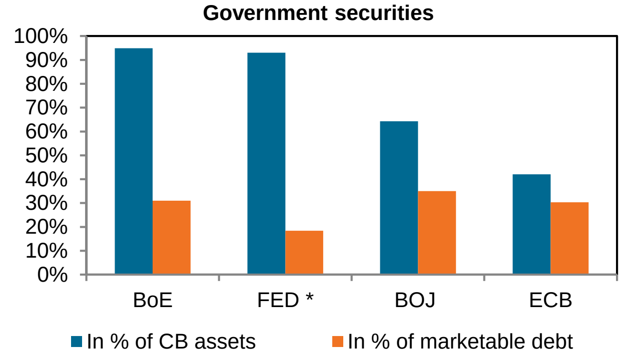
Source: Intesa Sanpaolo chart from ECB data

Fig. 1 – ECB balance sheet by end December 2017 will be twice the size it was in 2014, largely thanks to purchases under the PSPP



Source: Intesa Sanpaolo chart from ECB data

Fig. 2 – Government bonds as a percentage of total assets will be lower than for the Fed, BOJ and BoE, but as a percentage of total securities in circulation the ECB does not fare worse than Fed and BOE. BOJ holdings of marketable remain out of reach, but the strategy is different



Source: National central banks and Intesa Sanpaolo charts

Germany: the economy is solid. 2017 will be Angela's year once again

Anna Maria Grimaldi

Germany is embarking on a year of election campaigning that will be very important for the rest of Europe, given the central role that the country has assumed in the continent. The policy of welcoming and supporting refugees and asylum seekers has drastically eroded support for the Christian Democrats of the CDU party in favour of the right-wing populists of the Alternative for Germany (AFD) party, who, following their success in March and September in the local elections, are now represented in ten of the 16 German state parliaments and are the third-largest party in Germany, ahead of the Greens (see figs. 1 & 2). Just a few days after the results of the US vote, outgoing Chancellor Angela Merkel officially confirmed that she will run for a fourth term "with the goal – at this time of high insecurity – of keeping society together, warding off hatred and defending the values of democracy". The Schleswig-Holstein and Rhineland elections in May will be a major test. Polls suggest that the CDU and SPD (see fig. 2) could again win enough seats to form a government majority. An easing in fiscal policy or more pro-Europe rhetoric would not help the CDU to win support: the xenophobic movement AFD has made fiscal rigour one of the key points of its programme, and it is no coincidence that the 2017 Budget continues to emphasise ultra-cautious management of the public accounts (the structural deficit will remain in surplus at +0.4% of GDP, from +0.6% in 2016). Despite the unstoppable rise of the current account surplus (up to 9% of GDP in 3Q, well above the limits envisaged by the Macro Imbalance Procedure (MIP)), measures to stimulate domestic demand are still lacking. Perhaps if the CDU/SPD coalition is reconstituted in 2018, both tax cuts – in October a package of EUR 6.3Bn or 0.3% of GDP was announced – and medium-term spending, which is currently forecast to increase modestly (EUR 20.6Bn over four years, with a derisory portion of EUR 1.7Bn, or 0.1% of GDP, for investment in transport and education) will be stepped up.

Angela Merkel's priority in this year of intensive election campaigning is to regain support; an easing of fiscal policy or more pro-Europe rhetoric would not help

The Chancellor can rely on a solid economy. After the slowdown to 0.2% qoq in the summer months due to a fall in exports, GDP is expected to pick up again to 0.4-0.5% qoq at the end of the year (see fig. 3). In the summer months, the fall in trade flows with the US, UK and OPEC countries had a particularly negative effect. Confidence surveys have risen rapidly since the end of summer. The IFO index is at its highest since 2014 thanks to the upturn in foreign demand in manufacturing, backed up by the figures for industry orders. Services and retail seem to have picked up again after a short pause in the summer. Confidence surveys hint that growth will also be more sustained (see fig. 6), but we maintain a cautious estimate given industrial output's lacklustre end to the third quarter and weak start of the fourth quarter.

The economy is still solid Policies to rebalance the country's foreign trade imbalances postponed until 2018

Compared with three months ago, we expect a slightly more positive contribution from exports at the turn of the year, given signs of a pick-up in global demand (see fig. 4). However, we maintain a forecast for export growth of 3.0% in 2017, from 2.4% this year, given the uncertainty surrounding the international outlook. Imports will increase by 4.0%, from 3.1% this year. The contribution from foreign trade will therefore be negative, but no more so than this year (-0.2%). GDP growth will continue to be driven by domestic demand, which we expect to reach 1.9% in 2017, from the estimated figure of 2.3% for this year. In our view, consumer spending and investment, particularly in construction, will be the drivers of GDP in the next two years (see fig. 5). Growth in household consumption will remain sustained although the peak should now be behind us (1.5% from 1.8% in the last two years). Despite the ultra-accommodative financial conditions and fiscal support measures (public subsidies, reduced social security contributions and adjustments to minimum pensions), real disposable income will decelerate to 1.6 % from 2.2% previously as employment is expected to grow by 1.3% in 2017, from 2.5% in 2016, due to the loss of purchasing power connected with the rising oil prices (which will hit disposable income by about 0.2%) and the rise of inflation to 1.5%, from 0.4%. Contractual wages are expected to grow by 2.0% yoy, from 2.4% yoy in 2015 (see fig. 7). The increase in the minimum wage to EUR 8.84, forecast from January 2017, will only make a marginal contribution to the aggregate wages trend. Employment growth, after higher-than-

Growth buoyed up by domestic demand

Consumer spending will slow slightly due to the brake on real employment income

Employment cannot keep up the pace of 2016 The labour market is at full employment

The rise in the savings rate is likely to provide a buffer in the event of shocks

expected figures in the first six months (at 1.2% yoy), slowed in the summer months to 0.9% yoy. However, it will struggle to keep up the pace seen in 2016. Unemployment only fell slightly to 6% after three months stuck at 6.1%. Further falls in unemployment depend on how quickly the influx of immigrants translates into an increase in participation[13]. The savings rate remains surprisingly high at 9.4% (see fig. 8) and could provide a buffer in the event of shocks.

Residential construction: expansion is still solid

Corporate investment: curbed only by uncertainty

Investment in **residential building** recovered less than forecast in the summer months (0.3% qoq after the fall of 1.9% qoq in spring, partly correcting the early-year excesses). Yet, the recent trend for orders, permits and confidence in the construction sector is consistent with an expansionary cycle of **residential building**, at a rate of around 0.7% qoq (2.4% in 2017 (see fig 9)). **Investment in machinery** remained weak (see fig 10) even in the summer months, despite the high use of production capacity, highly supportive financial conditions, resilient earnings, low leverage and falling debt. This is therefore likely to be a temporary phase and we should see a return to positive growth rates in the last few months of the year. Risks remain skewed to the downside given the high political uncertainty at both international and domestic level (see fig.11).

Risks to the macroeconomic outlook are broadly balanced. The expansionary phase in line with trend is sustainable as there are no internal imbalances; meanwhile the recent rise in savings should allow external shocks to be absorbed. In the post-election period, although the country is in a stable position, there will be no shortage of challenges, such as managing the integration of refugees and expediting the European governance reform process to complete monetary union. In this regard, Mrs Merkel's role in the process will be key to bringing about the significant changes in the direction indicated in the Five Presidents report. In addition, Germany will not be able to continue to ignore export imbalances. The balance of payments surplus is partly structural. But the aggregate amount of excess savings (see fig. 12) built up over the last 20 years is also due to weak domestic demand and, since 2011, restrictive fiscal policies.

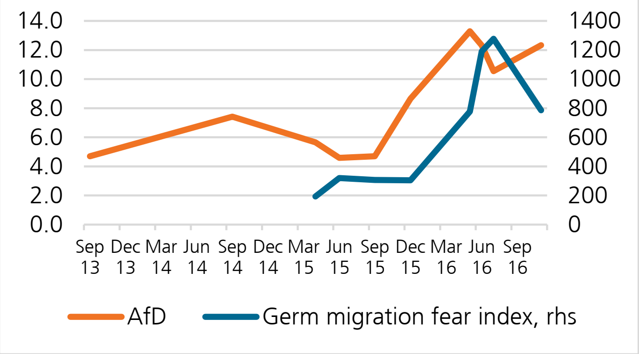
Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y) *	1.7	1.7	1.5	1.8	1.7	1.7	1.8	1.5	1.5	1.7	1.7	1.6	1.6
- q/q change				0.7	0.4	0.2	0.4	0.5	0.4	0.4	0.5	0.4	0.4
Private consumption	1.9	1.7	1.5	0.6	0.2	0.4	0.4	0.5	0.4	0.3	0.4	0.4	0.3
Fixed investment	1.2	2.0	2.6	1.6	-1.6	0.0	1.0	1.1	0.9	0.6	0.8	0.7	0.9
Government consumption	2.8	4.3	2.7	1.1	1.2	1.0	0.8	0.7	0.4	0.4	0.4	0.3	0.3
Export	4.6	2.2	2.9	1.4	1.2	-0.4	0.8	1.1	0.9	0.4	0.8	1.1	0.8
Import	5.0	3.1	4.0	1.5	0.1	0.2	1.2	1.6	1.0	0.8	0.6	1.5	1.0
Stockbuilding (% contrib. to GDP)	-0.5	-0.2	-0.1	-0.2	-0.2	0.0	0.0	0.0	-0.1	0.1	-0.2	0.1	0.1
Current account (% of GDP)	8.3	9.0	8.8										
Deficit (% of GDP)	0.5	0.6	0.5										
Debt (% of GDP)	71.2	68.1	65.7										
CPI (y/y)	0.2	0.2	1.4	0.1	0.0	0.2	0.6	1.5	1.3	1.4	1.3	1.2	1.2
Industrial production (y/y)	0.5	1.1	1.6	1.5	0.4	0.8	1.5	-0.3	1.6	2.6	2.4	2.2	1.8
Unemployment (%)	6.4	6.1	6.0	6.2	6.1	6.1	6.0	6.0	6.0	6.0	6.0	6.0	5.9
10-year yield	0.52	0.10	0.54	0.28	0.12	-0.12	0.13	0.36	0.45	0.59	0.75	0.84	1.03

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

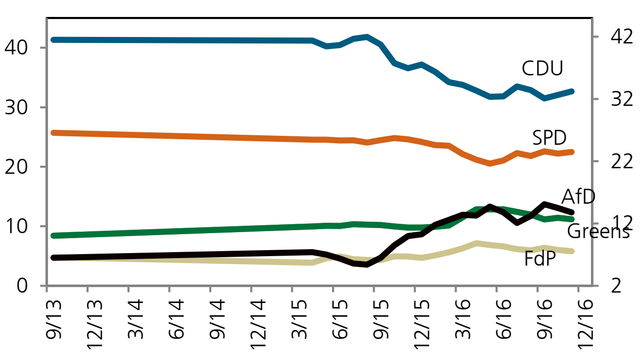
[13] Demand for labour is still largely met from immigration from the rest of the EU (260,000 in 2016), while the German Federal Employment Agency (BA) estimates that, at the moment, only a very small percentage of refugees who arrived last year have managed to gain access to the labour market (32,000).

Fig. 1 - The priority is to tackle the populist drift triggered by the large influx of refugees



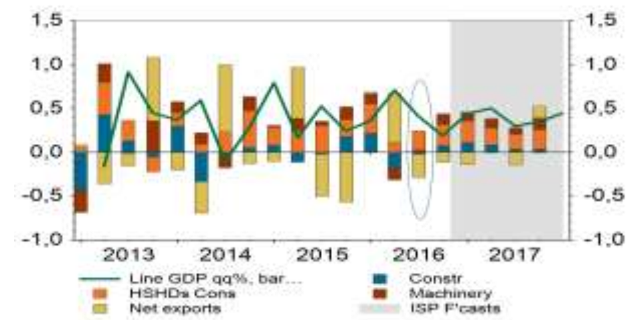
Source: Baker, Bloom & Davies Migration Fear indices via Bloomberg. Intesa Sanpaolo chart based on opinion polls on the forthcoming parliamentary elections, Wikipedia

Fig. 2 - CDU/SPD coalition still likely to have a majority



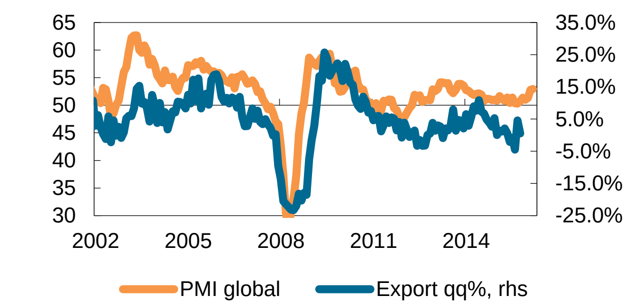
Source: Intesa Sanpaolo chart based on Wikipedia

Fig. 3 - Foreign trade has hampered GDP



Source: FSO via Thomson Reuters-Datastream

Fig. 4 – Exports supported by trade flows with the euro area bit dampened by other advanced economies. Global PMIs show more sustained export growth at the turn of the year

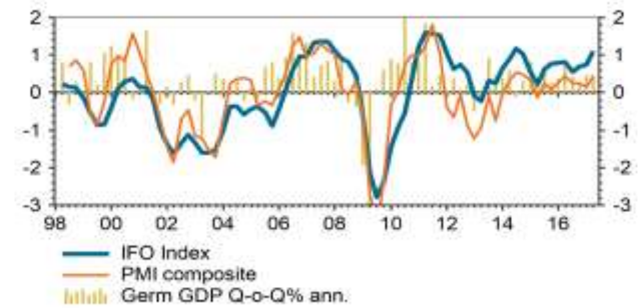


Source: FSO via Thomson Reuters-Datastream

Fig. 5 – Industry has locked in the recovery. Services, trade and building steaming.

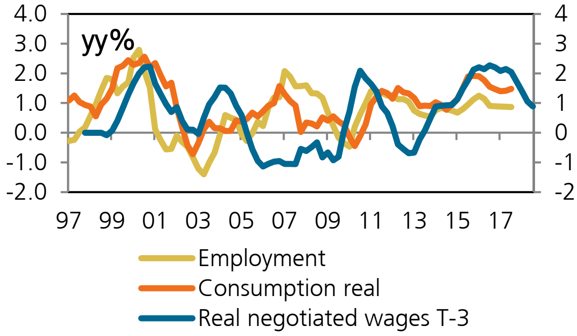
Source: FSO via Thomson Reuters-Datastream

Fig. 6 – IFO and PMI suggest a swift acceleration at year end. But industrial output entered Q4 on a weak footing



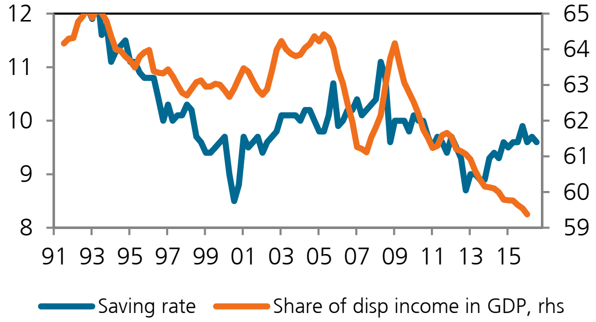
Source: FSO via Thomson Reuters-Datastream

Fig. 7 - Private consumer spending has now peaked. Despite continuing highly expansionary financial conditions, employment and real salaries should decelerate ahead



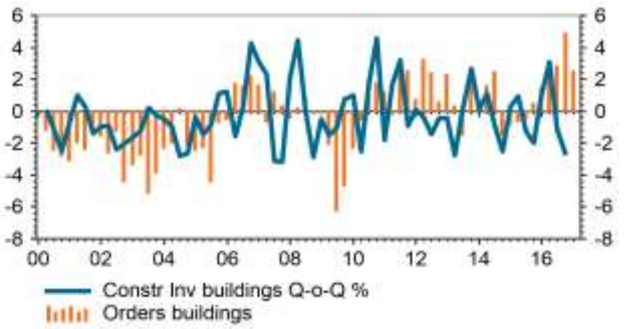
Source: FSO via Thomson Reuters-Datastream

Fig. 8 – The recent rise in the savings rate is likely to provide a buffer in the event of shocks



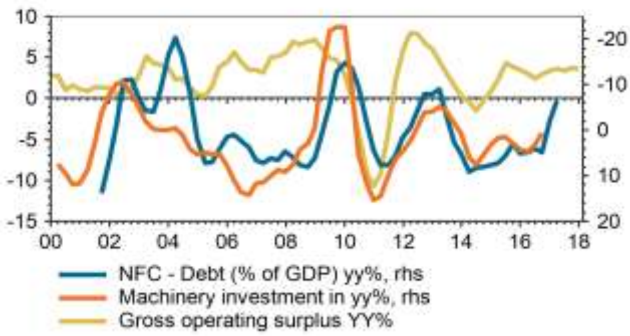
Source: Thomson Reuters-Datastream

Fig. 9 – Construction, orders and confidence indicate solid growth at the end of the year



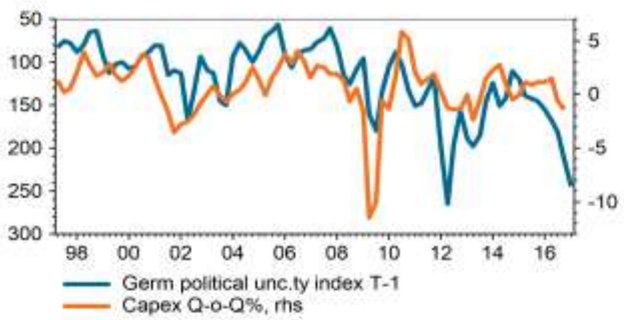
Source: FSO via Thomson Reuters-Datastream

Fig. 10 – Fundamentals consistent with a more buoyant trend in investment spending



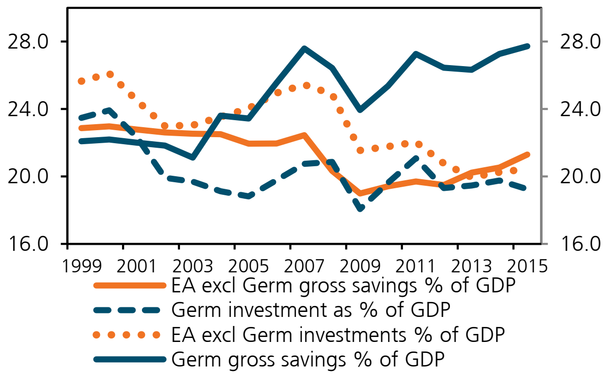
Source: FSO via Thomson Reuters-Datastream

Fig. 11 – The real brake on investment is "the great uncertainty"



Source: FSO & Economic Policy Uncertainty Institute via Thomson Reuters-Datastream

Fig. 12 – Post-election challenges: rebalancing the trade balance surplus. Continuously rising trade balance surplus reflects aggregate savings excess. Since 2011, the public sector has also been a net creditor



Source: Eurostat via Thomson Reuters-Datastream

France: tension rises as 2017 elections approach

Guido Valerio Ceoloni

The **2017 elections** represent a major crossroads for France. Never before has a populist Eurosceptic party been so close to victory: the Front National stands a real chance of competing in the presidential run-off. This has created some nervousness in the markets, where the yield spread with Germany has risen by 30bps on average in the last two years, to 50-70bps. Based on the surveys, **a Republican (centre-right) victory in the legislative election and the election of François Fillon as president is still the most likely scenario,** but Marine Le Pen's National Front could substantially increase its parliamentary presence. In a changing political picture, there is the possibility of a strong performance by independent candidate Emmanuel Macron, which could take away votes from the other mainstream candidates.

Meanwhile, the French economy is lagging behind the Eurozone average: this year we estimate that GDP growth will stop at 1.2%, and at 1.3% next year. Some of the external factors that boosted 2016 (particularly oil prices) will gradually return. The 2016 quarterly data show some volatility: after a strong start to the year (up 0.6% qoq), strikes and flooding compromised the second quarter (down 0.1% qoq), while the recovery was disappointing in the third quarter (up 0.2% qoq), hampered by a negative contribution from foreign trade, which stopped acquired growth at 1.1%. **For the fourth quarter we expect a modest acceleration to 0.4% qoq,** which would add a tenth of a percentage point to annual average GDP.

Unemployment down 0,4%, reaching 10.0% for the first time since 2011

Employment in the third quarter was almost unchanged, at 64.6%, and the annual average is now forecast at 64.6%, compared with 64.3% in 2015: the increase is still insignificant, therefore, and has totaled only 0.7% during Hollande's entire period in office. This creeping trend is expected to continue for most of 2017. The **fall in unemployment[14] of 0.4% in 2016, from 10.4% to 10.0%**, which is the first decrease since 2011, and the forecast fall of another 0.3% next year, to 9.8%, is due to a boom in fixed-term hiring and training contracts launched after labour market reform. Business surveys and the PMI remain disappointing in manufacturing, but are improving in services and construction.

Household consumption up 1.5% yoy in 2016-2017

Consumption is still the main vehicle of growth, but unexpectedly stagnated in the middle of the year, with household spending contracting for four consecutive months, mainly due to the **correction in car sales** (to 1.8% yoy in the first 10 months of the year, compared with an increase of 4.0% in the same period of 2015). In the last quarter we expect to see an uptick in consumption (to 0.4% qoq from zero), which should result in an increase of 1.5% yoy for 2016, the same as in 2015. We expect consumption to grow at a similar pace in 2017, due to the **moderately positive trend in employment** and supportive conditions for access to credit. The quarterly average for household confidence is returning to the historical average (it now stands at 98.1, compared with 96.6 in the third quarter), above the 2015 level of 94.2.

Disappointing industrial output in 2016. Positive construction and services

Industrial output has been disappointing this year, weighed down by unusual volatility, **with three consecutive declines in the first three quarters.** In the end, we expect only a marginal recovery, in line with the indications of the PMI in October and November (manufacturing at 51.8 from 48.9), resulting in an **annual average of 0.2%, from 1.5%. We forecast an acceleration of around 1.4% next year**. After a positive contribution to GDP formation in the third quarter, the **construction** sector continues to show improvements, with confidence rising again in the last two months, to 97.4 from 95.4, close to the historical average: we expect this trend to continue at the end of this year and the start of the next. Finally, the **services** sector remains positive, with surveys pointing to stabilization in the latter part of the year (services PMI

[14] ILO definition for the metropolitan France

at 51.5 from 52.0, forecast activity at 52.0 from 52.1; INSEE index at 101.5 from 101.3, above the long-term average).

Household investments rise for the first time since 2011

The reforms implemented by the Hollande presidency have failed to release the potential for growth, since the labour market remains very rigid and there is still excessive fiscal pressure, factors that are compressing productivity and reducing the competitiveness of national companies. However, in the last two years the erosion of the tax wedge and recruitment incentives have borne fruit by restoring profit margins; moreover, very favorable credit conditions have boosted **productive investment, which will grow by 3.4% yoy this year, from 2.9% yoy in 2015, and is expected to stabilize at around 2.1% yoy in 2017. Household investments** also began to rise again for the first time since 2011, increasing by 1.2% after a decline of 0.8% in 2015. This trend will continue in 2017, but at a slower pace (up 0.7%). Overall, **fixed investments** will increase by 0.9% this year and by 2.7% in 2017.

Net exports will continue to curb growth throughout 2017

After improving somewhat in 2015, the **trade balance** will again deteriorate in 2016, from -2.1% to -2.4% of GDP, and this trend will continue in 2017 (-2.8%), reflecting the dynamism of domestic demand and the difficulty that businesses are having in recovering a share of the international market, including in services. **Imports will be sustained** over the forecast horizon by strong consumption, more than offsetting the acceleration in exports, from 0.6% yoy to 2.6% yoy. Foreign trade will continue to hamper growth (-0.8% in 2016 and -0.3% in 2017). France remains the only country in the Eurozone with both fiscal and current account deficits.

Inflation at 0.2% in 2016 and 1.1% in 2017

Inflation will remain low this year (0.2%), in the wake of falling energy prices. **From 2017 onwards, we expect to see a more rapid rise to more than 1%** (1.1% in the national average and 1.2% in the harmonized index), due to a favorable base effect and the uptick in oil prices; the core component is expected to rise from 0.6% to 0.9% in 2017.

The electoral cycle has halted fiscal consolidation. The nominal deficit will decrease in 2017. Public debt continues to rise

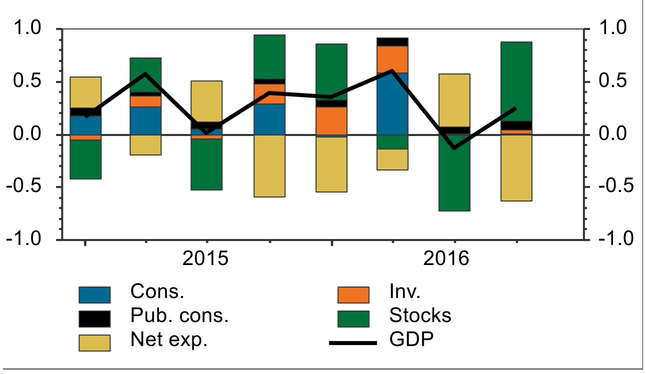
The government ended its focus on fiscal consolidation in 2014. We confirm our previous forecast of a **deficit of 3.3% this year and 3.1% next year,** much higher than the government estimate of 2.7%. Moreover, next year part of the deficit reduction measures will be limited to postponing spending until 2018, meaning that the next government will be left to deal with it. This year, **public debt** looks set to rise to 96.5% of GDP from 96.0%, and to 97.0% next year.

Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.2	1.2	1.3	1.4	1.2	1.1	1.2	1.0	1.4	1.4	1.4	1.4	1.5
- q/q change				0.6	-0.1	0.2	0.4	0.4	0.3	0.3	0.4	0.4	0.4
Private consumption	1.5	1.5	1.4	1.1	0.0	0.0	0.4	0.5	0.5	0.4	0.4	0.4	0.4
Fixed investment	0.9	2.7	1.9	1.2	0.0	0.2	0.4	0.8	0.5	0.5	0.5	0.6	0.5
Government consumption	1.5	1.6	1.2	0.4	0.4	0.4	0.3	0.3	0.2	0.3	0.3	0.3	0.3
Export	6.0	0.8	3.2	-0.5	-0.1	0.5	1.4	0.9	0.6	0.7	0.8	0.8	0.8
Import	6.4	2.9	3.1	0.3	-1.7	2.5	0.6	1.0	0.4	0.7	0.7	0.7	0.7
Stockbuilding (% contrib. to GDP)	-0.1	-0.1	-0.3	-0.2	-0.8	0.7	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	0.0
Current account (% of GDP)	-0.2	-1.9	-1.8										
Deficit (% of GDP)	-3.7	-3.4	-3.1										
Debt (% of GDP)	96.2	96.5	97.0										
CPI (y/y)	0.0	0.2	1.1	0.0	0.0	0.3	0.6	1.1	1.0	1.2	1.2	1.0	1.0
Industrial production (y/y)	1.6	0.1	1.4	0.9	0.5	-0.1	-0.8	0.4	1.2	1.8	2.3	1.9	1.9
Unemployment (%)	10.4	10.0	9.8	10.2	9.9	10.0	9.9	9.9	9.8	9.7	9.6	9.6	9.5

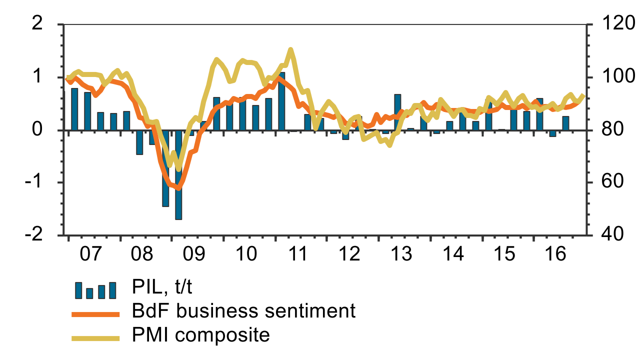
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to GDP formation



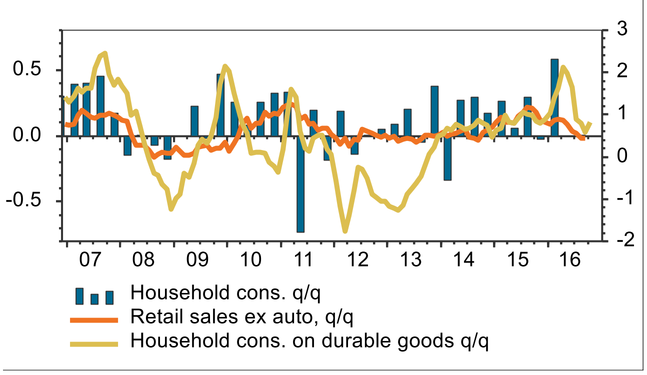
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – GDP and confidence indicators



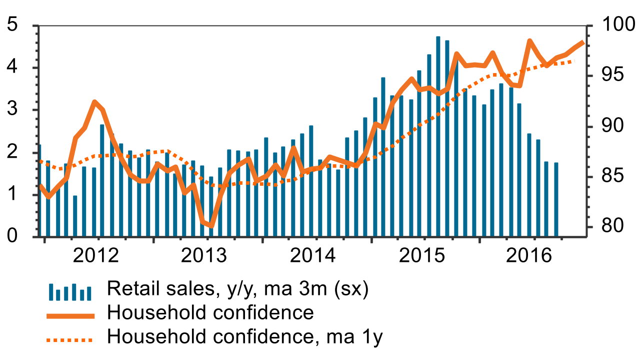
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Household spending and purchases of durable goods



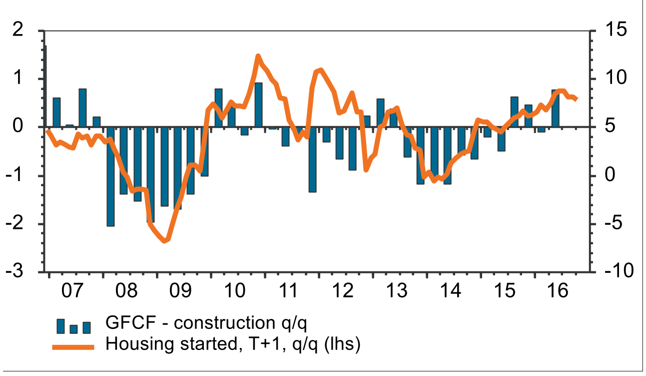
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 4 – Retail sales and household confidence



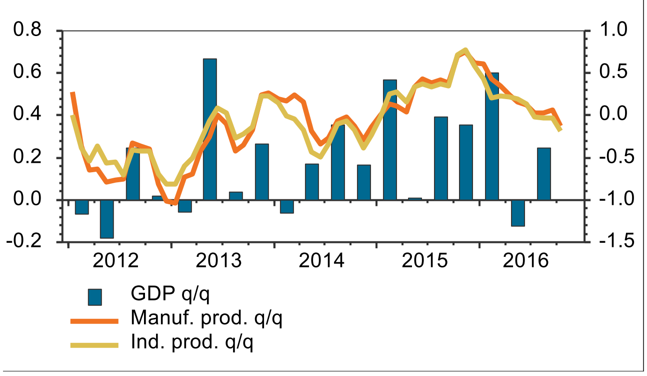
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investment and construction sector activity



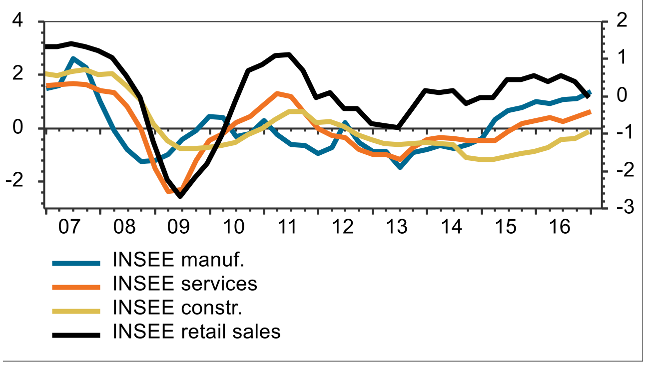
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



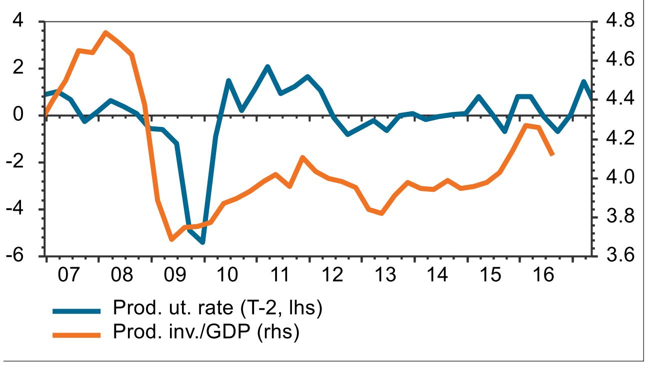
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



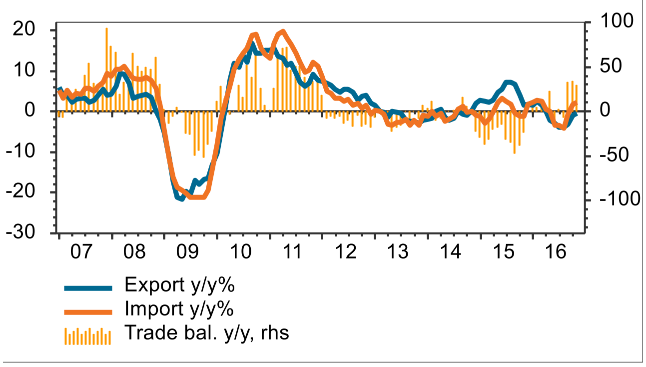
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Production capacity utilization and level of investment on GDP



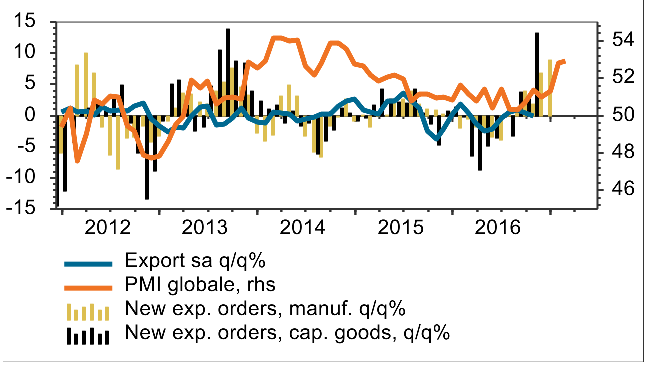
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Trade balance



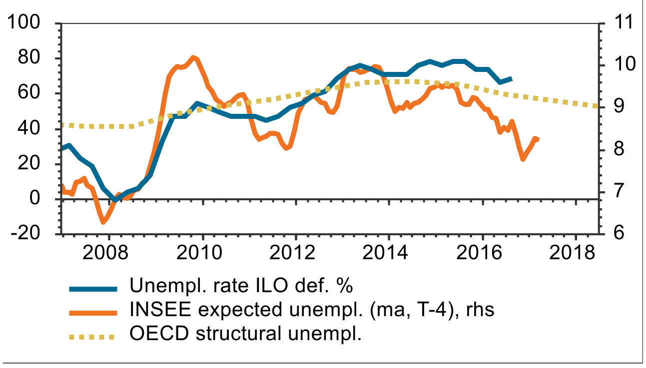
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Exports, export orders and global PMI



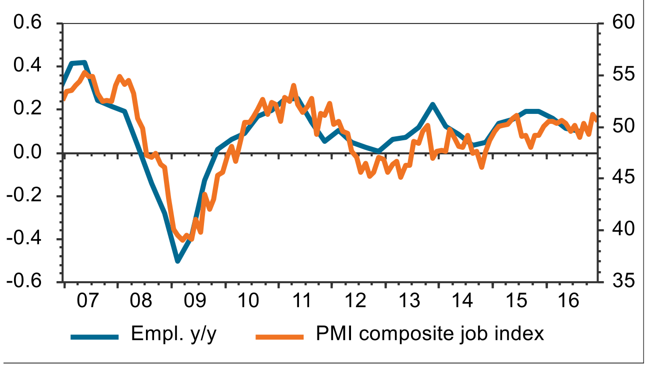
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 11 – Expected and structural unemployment



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

Fig. 12 – Employment trends



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

Italy: growth little changed (around 1%) in 2017. It could be an electoral year

Paolo Mameli

After the gradual but consistent improvement in GDP growth over the past few years (from -2.9% in 2012 to -1.7% in 2013, +0.2% in 2014, +0.6% in 2015, and +0.9% in 2016, based on data adjusted by workdays), the trend in 2017 could change little compared to the previous year. Cruising speed should stay close to 1%, after economic activity growth of 0.9% in 2016 (more than we had estimated three months ago, 0.8%).

We expect growth to accelerate only slightly in 2017, by 1%

However, **the composition of growth should change**, with domestic demand likely to slow (we estimate the contribution of internal demand net of inventories at 0.8%, from 1.3% in 2016, which marked a 10-year high), balanced by no-longer negative net exports (and, presumably, inventories). In our view, foreign trade could add one tenth to growth, after having represented a drag throughout the 2014-16 three-year period (on average by -0.2%). Inventories could make a neutral contribution, after a significant -0.3% in 2016. We also expect a different composition of domestic demand, as investments should prove resilient (estimated on the rise by 2% in 2017, in line with 2106) as opposed to a slowdown in consumption (which, vice versa, could increase by only 0.7% in 2017, half the rate recorded the previous year).

The consumption trend may slow…

Consumption has hitherto been the main driver of the Italian economic recovery. It was the first item to perk back up after the great crisis (+0.4% in 2014, and positive quarterly growth already in H2 2013), and since then it has consistently grown at a stronger pace than GDP (average consumption growth in the 2015-16 biennium, at 1.5%, marked a record since 2000). In order to foresee the possible evolution in 2017, we need to analyse the reasons behind the increase recorded in the past few years. In chronological order, they were: 1) the personal income tax bonus which came in to force in May 2014; 2) the drop in inflation, which hit a low in the opening months of 2015; and 3) the recovery in employment, which had already begun in 2014 and has gradually accelerated (from 0.4% in 2014 to 0.8% in 2015, and to 1.2% in 2016). All this resulted in higher real disposable income for households in 2016 (based on our estimates) by 2.1%, a 15-year high, and boosted consumer confidence to a long-term high (118.5) at the beginning of 2016.

However, the same propulsive action should not be expected from these factors going forward: 1) fiscal policy seems to have exhausted its margin of action at least for the foreseeable future; 2) inflation has bottomed out and is expected to rise by 0.8% in 2017 (after staying at around zero for three years), eroding part of the purchasing power of households (on the other hand, we expect only a slight recovery in contract-based wages, of around 0.9%, after the long-term low of 0.6% marked in 2016); 3) already in the course of 2016, employment growth showed signs of slowing (from peak year-on-year growth of +1.9% in May 2016), and will continue to do so in 2017, in our view: we estimate the number of employed people to increase by 0.6% in 2017 (half the growth rate estimated for 2016). As a result, we believe households' real disposable income may continue to improve in 2017, albeit at a much slower pace than in 2016 (0.9%). The waning of these supportive factors also explains the deterioration in consumer confidence throughout 2016.

…as opposed to a more resilient trend of investments, in machinery and equipment in particular

Another factor which has driven consumption in the past two years is the downtrend in interest rates, in the consumer credit segment in particular (to a long-term low of 6.44% on new loans at the end of 2015): together with job creation (and the transformation of temporary jobs into permanent employment), this explains the appreciable growth recorded in the past few years by the consumption of **durable goods** (+5.2% on average in the 2014-16 three-year period). However, from this point of view as well, we believe the effect is starting to wane, therefore we expect a sharper slowdown of this component of consumption (to a more modest +1% in 2017). An important role has been played by the auto component, which still seems to have a margin of recovery, given the persistently old average age of the stock of cars on the road.

However, signs of a slowdown have already emerged in the past few months (registrations up by +8.2% y/y in November, from a high of +28% yoy six months earlier), which could prelude to a less brilliant 2017, albeit still positive.

In 2017, we believe the baton of the recovery could pass from consumption to **investments**, which for the first time in the current phase of the cycle could make the strongest contribution to GDP growth. In effect, already in 2016, national accounts gross fixed investments scored an appreciable rate of growth (+2% from +1.1% in 2015: a 10Y high). However, the recovery has hitherto been limited almost entirely to investments in **means of transportation**, which experienced double-digit growth throughout the 2014-16 three-year period (+11.9% in 2014, +18.2% in 2015, +25.1% in 2016). The reason lies in the fact that this category of investments are more easily replaceable, with additional help provided by the development of car sharing platforms and hire and company car fleets. In 2017, we expect a "physiological" slowdown of this (small) component of investments, to 8.7% from 25.1% estimated in 2016.

Vice versa, investments in **machinery and equipment** are sending much more erratic signals, and after an encouraging rebound in the second half of 2014 (+0.9% qoq on average), they have since fluctuated considerably (in 2016: +0.5% qoq in 1Q, -0.9% qoq in the spring months, +0.7% qoq in the summer). As a result, 2016 saw a slowdown in the core component of investments to 0.4%, from 1.1% in 2015. This was in some ways surprising, considering also the expansionary measures contained in the 2016 Stability Law, and in particular the maxi-amortisation (140%) allowed on new investments made between 15 October 2015 and 31 December 2016; the slowdown seems due to the waning optimism of businesses on the economic outlook, which had probably improved to excess previously. On the other hand, the further measures provided for by the 2017 Budget will come into force in January, strengthening the previous set of measures and aimed in particular at stimulating private investments (as well as stepping up public investment). During 2016, business profitability also rebounded, albeit modestly, from previous lows, but failed to translate into an appreciable increase in the investment rate. In essence, we see room for a reacceleration in investments in machinery and equipment, which we forecast to grow by 2.4% in 2017, from 0.4% in 2016. Yet, this is one of the forecasts most clouded by uncertainty.

The **construction sector** deserves to be discussed separately. On the whole, 2016 was a recovery year for the sector, the first in 10 years (+1%). However, in this case as well, the annual average hides a highly irregular trend. Or rather, the sector had sent encouraging signals in 2015 (Q1 +1.1% q/q, Q3 +0.5% q/q, Q4 +1.3% q/q, interrupted only by a slight decline in the spring quarter), which were then contradicted in the course of 2016 (quarterly stagnation in each of the first three quarters of the year). However, the trend of business confidence in the sector is consistent with a recovery, considering that builders' confidence is close to its eight-year highs (this is the only sector in which confidence has improved in the last year), and financial conditions remain more than favourable. However, the stagnant trend in 2016 creates a negative statistical effect on 2017, which means that the sector should be unlikely to avoid a slowdown, which we estimate at around 0.7%, from 1% in 2016. On the whole, taking into account a mixed trend of the various components (slowdown in investments in means of transport and construction, acceleration of investments in machinery and equipment), we expect fixed gross investments to confirm a 2% growth trend in 2017.

Foreign trade should no longer represent a drag on growth

In 2017 we expect the disappearance of the drag on growth represented by **foreign trade,** which in the 2014-16 three-year period subtracted on average two tenths a year from GDP. Trade flows in both directions should recover, on the improvement of global trade. Imports may accelerate, but only modestly (to 2.6% from 1.7% estimated in 2016), held back by weaker demand at the domestic consumption level. In our view, the acceleration of exports should be more significant, and for the first time since 2013 could outpace import growth (2.9% from 1.3% in 2016, based on our estimates).

The recovery in exports is expected to be fuelled by two main factors: 1) the **no-longer negative contribution of sales to some emerging countries**, and in particular Russia, OPEC and Mercosur countries, which on aggregate contributed negatively to overall Italian export growth by -0.5% in 2014, -0.7% in 2015, and -0.8% in the first nine months of 2016 (with a direct impact on GDP of -0.2% per year). In fact, in these countries the trough of the economic cycle seems to have now been overcome; 2) **a reacceleration in sales to the United States** (the partner versus which Italy can boast the largest trade surplus: 18.5Bn in the first 10 months of 2016). After slowing in 2016 (0.4% between January and October 2016, after experiencing double-digit growth over the previous two years), exports to the US could benefit from both the prospect of a reacceleration of the North American economy (also boosted by the expansionary fiscal measures promised by the new administration), and the recent appreciation of the dollar against the euro (at today's levels, around +4.5% compared to the 2016 average). Vice versa, the geographical area which could make a negative contribution to export growth (and therefore to GDP) could be the United Kingdom, not so much as a result of a slowdown of the British economy (which we expect to be moderate), but of the depreciation of the pound, despite the recent partial recovery (at current values, sterling is weaker against the Euro by 7% compared to the pre-Brexit 2016 average). For what concerns exports to the rest of the Euro area, we expect the trend to change little compared to this year's growth rate (around 3%).

2017 could be an electoral year

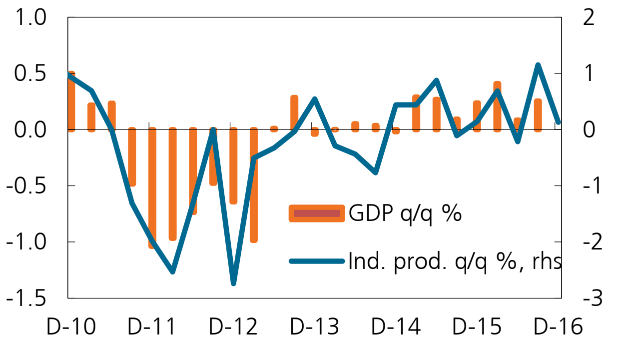
On the **political front,** the victory of the "No" camp at the constitutional referendum did not have the negative fallout on the financial markets feared by many, whereas it effectively put an end to the Renzi government. The economic consequences are limited, as the crisis has been solved swiftly, as we had predicted, and the new government is in many ways similar to the previous one and is supported by the same parliamentary majority. The duration of the Gentiloni government will depend on how negotiations among the main parties' progress on the reform of the electoral law. While an early vote in the opening months of 2017, as invoked by some, seems unlikely, there are doubts on the fact that the legislature may last until its natural end in May 2018. In any case, we believe it is unlikely that an election will be called before a single voting system for both houses of Parliament has been defined. While Parliament tackles the task of drawing up a new electoral law, the new government is expected to complete the implementation of a number of reforms introduced by the previous government, in addition to carrying on with normal administration and engaging in negotiations with the EU Commission ahead of possible requests to modify the budget law (and to put in place measures to stabilise the financial sector, if needed). For the thrust towards reform to resume, we would have to wait for the next legislature, in the best of assumptions.

Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.6	0.9	1.0	1.0	0.8	1.0	0.8	0.7	0.9	1.0	1.2	1.3	1.2
- q/q change				0.4	0.1	0.3	0.1	0.2	0.3	0.3	0.3	0.3	0.3
Private consumption	1.5	1.4	0.7	0.4	0.2	0.1	0.2	0.2	0.2	0.1	0.1	0.2	0.2
Fixed investment	1.1	2.0	2.0	0.6	0.0	0.8	0.3	0.6	0.6	0.4	0.4	0.6	0.5
Government consumption	-0.6	0.6	0.3	0.1	-0.3	0.2	0.0	0.1	0.1	0.1	0.2	0.1	0.1
Export	4.0	1.3	2.9	-1.2	2.1	0.1	0.8	0.7	0.7	0.7	0.5	0.8	0.7
Import	5.8	1.7	2.6	-1.1	1.3	0.7	0.6	0.6	0.6	0.6	0.6	0.8	0.8
Stockbuilding (% contrib. to GDP)	0.0	-0.3	0.0	0.1	-0.2	0.1	-0.2	0.0	0.1	0.1	0.1	0.0	0.1
Current account (% of GDP)	1.6	2.7	2.6										
Deficit (% of GDP)	-2.6	-2.4	-2.6										
Debt (% of GDP)	132.2	132.5	132.9										
CPI (y/y)	0.0	-0.1	0.8	-0.1	-0.4	0.0	0.0	0.7	0.9	0.8	1.0	1.1	1.2
Industrial production (y/y)	0.9	1.4	1.4	1.6	0.5	1.8	1.8	1.3	2.0	1.3	1.1	1.0	1.0
Unemployment (%)	11.9	11.6	11.4	11.6	11.6	11.6	11.5	11.5	11.4	11.3	11.1	11.0	10.8
10-year yield	1.71	1.49	2.52	1.49	1.48	1.19	1.79	2.28	2.45	2.59	2.75	2.84	3.02

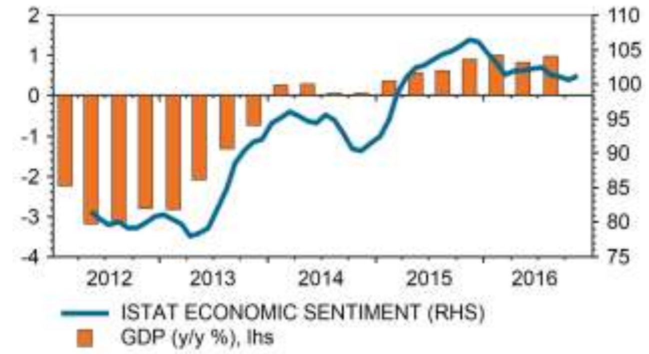
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 - GDP and industrial output estimated on the slowdown again at the end of 2016, after an encouraging summer quarter



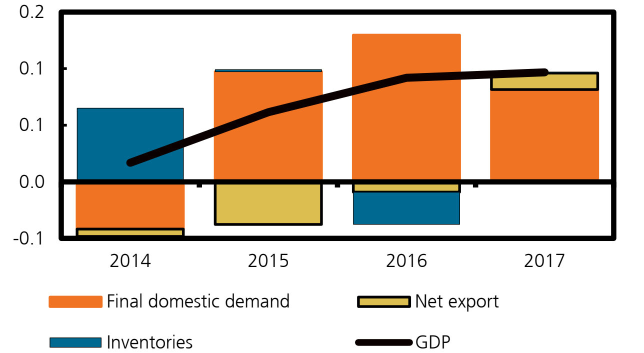
Source: Intesa Sanpaolo Research elaboration and forecasts on Istat data

Fig. 2 - Beyond quarterly volatility, forward-looking indicators point to limited changes in the annual cruising speed on the forecasting horizon (with some downside risks)



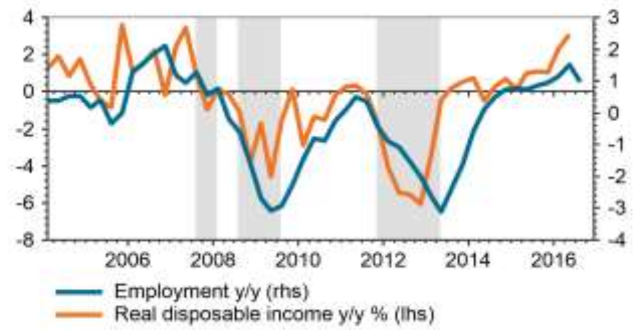
Source: Thomson Reuters- Datastream

Fig. 3 - In 2017 we expect a slowdown in domestic demand. GDP growth could change little only thanks to a no-longer negative contribution of foreign trade (and inventories)



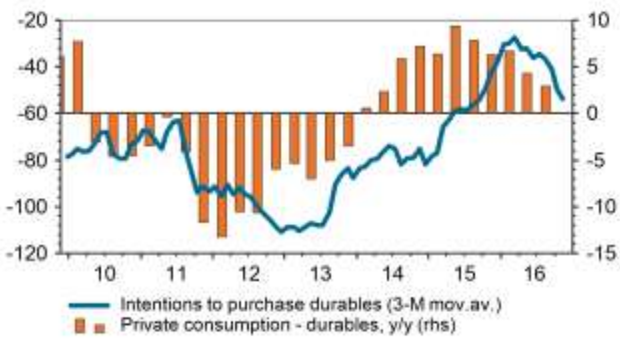
Note: % of GDP annual growth and contribution of main components; Source: Intesa Sanpaolo Research elaboration and forecasts on Istat data

Fig. 4 - The driving factor behind recovering consumption in recent years has been the increase in disposable income, largely dependent on employment. However, there are signals of a possible reversal of this trend



Source: Thomson Reuters- Datastream

Fig. 5 - In particular, signs of a slowdown in the consumption of durable goods are already evident



Source: Thomson Reuters - Datastream

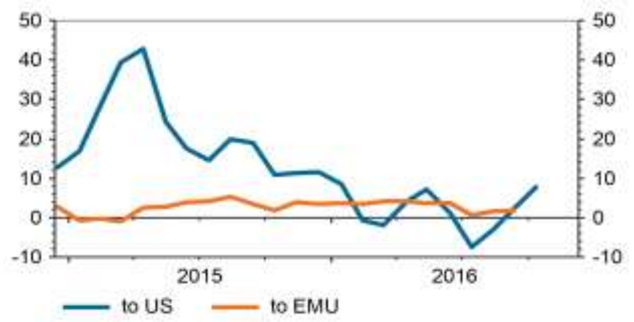
Fig. 6 - Consumer confidence is on a clear downtrend, whereas business confidence has moved sideways in the past year. This fits with our view that the baton of the recovery will be passed on from consumption to investments

Source Thomson Reuters - Datastream

Fig. 7 - In particular, investments in machinery and equipment have remained broadly stagnant up to now, but seem to have a margin for recovery in light of expectations on demand that remain positive (albeit weakening in 2016)

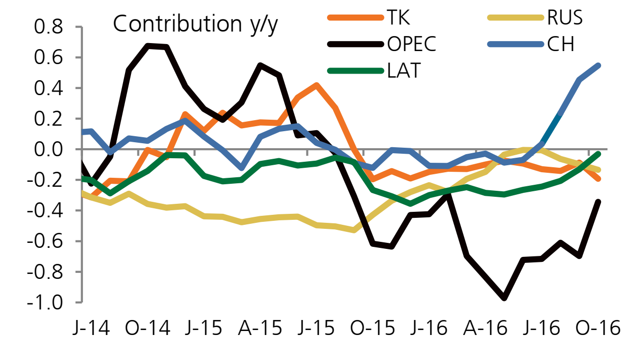
Source Thomson Reuters - Datastream

Fig. 8 - Exports should benefit from already recovering sales to the United States (vs. broadly stable sales to the euro area)…



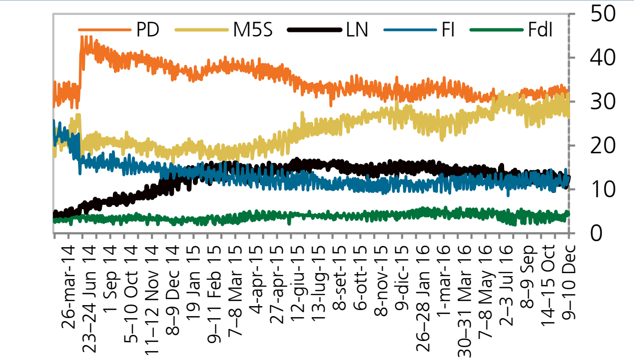
Note: yoy % chg. in Italian exports to the United States and to the euro area (3M moving average). Source: Intesa Sanpaolo Research elaboration and forecasts on Istat data

Fig. -9 - …as well as from the no longer negative contribution of several emerging countries



Note: contribution to yoy % growth of Italian exports (3M moving average). Source: Intesa Sanpaolo Research elaboration on Istat data

Fig. 10 - The evolution of the Italian political scenario to remain under scrutiny in the next few months as the political elections near. PD and 5-Star Movement neck and neck for now, based on voting intentions polls



Source: CISE, Datamedia, Demopolis, Demos&Pi, EMG, EP Election, Epoké, Euromedia, IPR, Ipsos, Ixé, Lorien, Piepoli, Quorum, ScenariPolitici, SWG, Tecnè

Spain: as good as it gets?

Anna Maria Grimaldi

After almost a year of deadlock, Spain has a minority government, led once again by Mariano Rajoy[15], who has been in office since 2011 despite the serious malcontent voiced by the electorate and the emergence of two new political forces, the left-wing populists *Podemos* and the centrist movement *Ciudadanos*. The twin political elections held last year certified the defeat of the centre-left political formations in Spain, as was also the case in many other European countries. However, Rajoy's Popular Party faces a hard road head: with only 137 seats out of 350, it will have to depend on the support of a part of the opposition to approve any legislative action. Furthermore, independentist forces are still exerting strong pressures, considering that on 14 December the Constitutional Tribunal upheld a government petition to stop Catalonia from holding a referendum on regional independence in late summer 2017.

Focus is on public finances again

Despite the more than solid growth rates (3.3% in the 2015–16 biennium), which are well above the euro area average, the country still has criticalities to solve. The unemployment rate, while on the decline, remains at socially unacceptable levels. Spain's large foreign debt calls for further efforts towards curing domestic imbalances: the private sector has done its part, but the same cannot be said for the public sector. Due to the lack of a government, the deficit will close at around -4.8% in 2016, down only modestly from -5.1% last year, and debt heading for 100% of GDP. Last July, in consideration of events beyond the government's control[16], the Council pushed back by one year, to 2018, the return of the nominal deficit to below the 3% threshold[17]. The structural effort required from 2017 onwards amounts to 0.5% of GDP a year. Fiscal policy will therefore resume holding back aggregate demand, after having contributed around half a percentage point to GDP growth in 2016. Finance Minister de Guindos has assured that the measures put in place at the beginning of the month, worth five billion euros (including corporate tax hikes and specific duties on tobacco and alcoholic beverages), should be sufficient to restore the deficit to 3.1% of GDP, as prescribed by Brussels, and rejected the IMF's recommendations to make further efforts by hiking VAT and stepping up spending control. However, there is no guarantee that *ex post* the fiscal balance for 2016 (nominal) will be in line with government's estimates[18] and that there will be no need for additional measures in the course of next year. Fiscal policy will turn from expansionary to restrictive.

Challenges remain. Internal rebalancing must continue

GDP to continue growing at a healthy pace but the peak is behind us

After two years of growth in positive territory (3.2-3.3%) and well above the potential rate (estimated by the EU Commission at just below 1.0%), the Spanish economy is forecast to slow to 2.5% in 2017, and to 1.7% in 2018. Not only will fiscal policy turn from expansionary to restrictive, but the boost stemming from low oil prices, especially important for Spain given the country's strong dependence on energy imports, will also wane. The indications provided by sentiment surveys point to a growth rate still not far off 0.7% in 4Q, in line with the central months of the year. Exports slowed in the summer months (-1.3% q/q), although a correction should be considered as physiological, following the sharp increase recorded in 2Q. The acceleration in global demand promises a positive export trend starting at the end of the year. In 2017, we expect growth to average 4.5%, with little change compared to this year. The trade s balance has changed only marginally in 2016 (Fig. 4), thanks once again to the positive energy balance, as opposed to a worsening for the other categories of goods (Fig. 5). This trend will not

GDO growth to rely on domestic demand. Risks of non-energy trade balance returning in the red not negligible

[15] The defeat in Galicia and the Basque Country elections forced the leader of the Socialists (PSOE), Pedro Sanchez, to resign, and the pro turnout faction of the PSOE to give the go-ahead to another PP government.

[16] Inflation turned out to be lower than the Budget estimates, an event deemed by the Commission to be out of the Government control.

[17] The Commission's Autumn 2016 forecasts estimated the Spanish deficit at 4.6% in 2016, down from 5.1% in 2015.

[18] The data available for various levels of government suggests that the deficit remained about the same in 2016. On the expenditure side the trend is broadly in line with budget forecasts: slippage seems to come from the revenue side, mainly due to the shortage caused by changes in corporate tax, and in particular to the abolition of early payments, introduced in January 2016. The measure was abrogated by Royal Decree in late October.

last, as oil prices have bottomed out and are now rising back. Therefore, the non-energy trade balance risks dropping back into deficit territory in the next few years (fig. 6) adding to external imbalances.

Private consumption to grow less strongly as employment growth decelerates and rising oil price start to weigh on disposable income

On the forecasting horizon, **domestic demand will once again be the main driver of GDP growth**. However, the pace of growth should prove to be slower already, at 2.0% from 2.7% this year. **Consumer spending** is expected to slow from 3.0% y/y in 2015-16 to 2.3%, as a result of the rise in oil prices incorporated into our estimates, of less robust employment growth, and of a modest nominal wage uptrend, or less than +1.0% (Fig. 9). The purchasing power of households will be eroded in part by **higher inflation,** up from -0.2% to +1.6% in 2017, and by receding fiscal stimulus.

Construction is back. Pace sustainable

Machinery investment the cycle is mature

The **residential construction** segment turned a year ago[19] and growth for the time being remain sustainable (Fig. 11). The correction recorded during the summer is physiological, after the strong expansion recorded in 2Q. Based on the indications provided by orders and confidence, we expect slower growth in the next few quarters, averaging close to 0.6% q/q. The growth **machinery investments** cycle seems now mature, as quarterly growth has significantly exceeded the change in production capacity (Fig. 12). The ongoing improvement in operating margins, and still markedly expansionary financial conditions on the forecasting horizon, together with the prospect of a stabilisation of the emerging economies, should support spending on machinery in 2017 as well.

Employment growing but less than GDP

The unemployment rate remains unsustainably high

In the summer months, employment kept outperforming the indications provided by confidence surveys, rising by 2.7% y/y. In 2016, job growth should average 2.7%, just shy of the trend of GDP. In the next few months, confidence surveys point to a slowdown in growth to 2% or just below. Once again the private sector, and services in particular, will be at the fore in creating jobs. It should be noted that work hours are also increasing at a sustained pace. Since the spring of this year, the construction sector has also resumed creating jobs (52k in total), although sentiment surveys point to a slowdown in the months ahead. The unemployment rate dropped as far as 19.2% in October 2016, from a peak of 26.3% in March 2013. The participation rate changed little in the course of 2016, and at 59.3 is still lower than in 2012-13 (60.5%). On the forecasting horizon we believe the unemployment rate may drop at best to 18.2% at the end of 2018, still well above its pre-crisis levels, but in line with the structural rate (OECD 18.3%). This is a clearly unacceptable level, which threatens social cohesion, and represents one of the main challenges the new government will have to face.

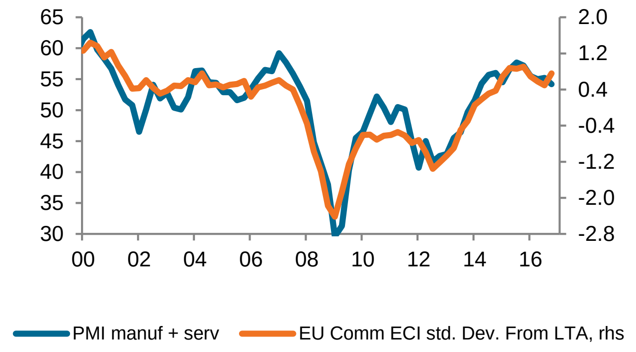
Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	3.2	3.3	2.5	3.4	3.4	3.2	3.1	2.9	2.7	2.3	2.0	1.8	1.7
- q/q change				0.8	0.8	0.7	0.7	0.6	0.5	0.4	0.4	0.5	0.4
Private consumption	2.9	3.0	2.3	0.8	0.7	0.6	0.6	0.6	0.6	0.5	0.4	0.4	0.3
Fixed investment	6.0	3.5	2.0	0.9	1.1	0.1	0.4	0.6	0.5	0.6	0.3	0.6	0.7
Government consumption	2.0	1.3	1.3	0.4	-0.6	1.0	0.4	0.3	0.3	0.3	0.1	0.3	0.2
Export	3.1	3.2	2.6	0.8	0.8	0.2	1.0	0.8	0.6	0.4	0.4	0.4	0.4
Import	5.6	3.2	4.6	0.1	2.0	-1.8	1.6	1.9	1.3	1.2	0.8	1.0	1.0
Stockbuilding (% contrib. to GDP)	0.1	0.1	0.3	-0.1	-0.1	0.1	0.2	0.1	0.1	0.0	0.0	-0.1	-0.1
Current account (% of GDP)	1.4	1.9	1.2										
Deficit (% of GDP)	-5.5	-4.8	-3.8										
Debt (% of GDP)	99.8	99.9	101.0										
CPI (y/y)	-0.5	-0.2	1.6	-0.7	-0.9	-0.2	0.9	1.7	1.8	1.4	1.3	1.2	1.5
Unemployment (%)	22.0	19.6	18.7	20.9	19.9	18.8	18.8	18.7	18.7	18.7	18.7	18.7	18.7

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

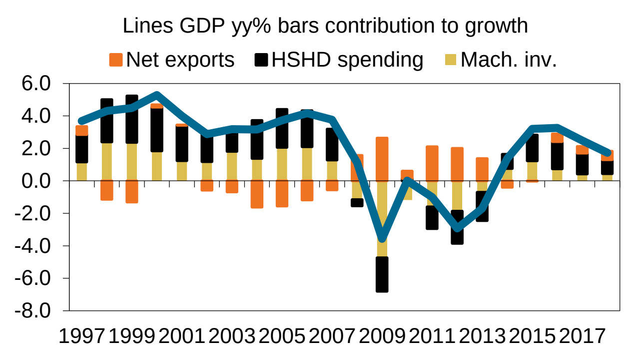
[19] The share of residential construction to GDP was back at 5.4% in 2015, from a peak of 11% in 2007, and is now roughly in line with the euro area average.

Fig. 1 – Mixed signals from PMIs and EU Commission indices. Most likely the peak is behind us



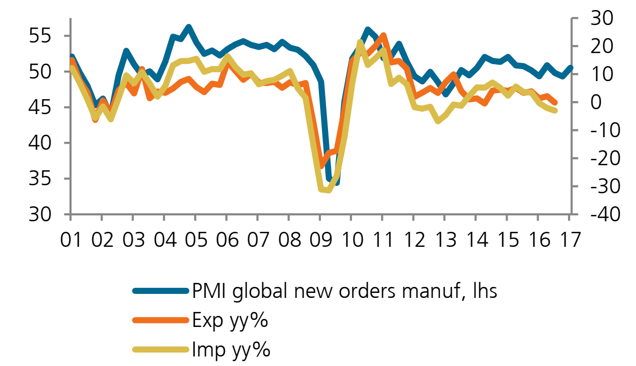
Source: PMI Markit, EU Commission and Intesa Sanpaolo calculations

Fig. 2 – Recent pace of private consumption growth unsustainable. Investments in machinery cycle seems to be mature. Foreign trade should make a positive contribution



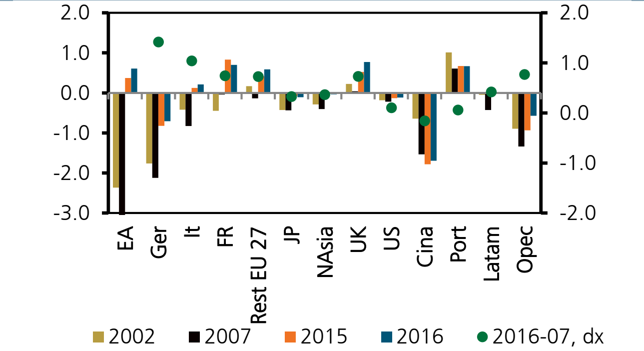
Source: INE, Eurostat and Intesa Sanpaolo calculations

Fig. 3 – Exports disappointed in the summer months. Rebound in global demand should be supportive ahead



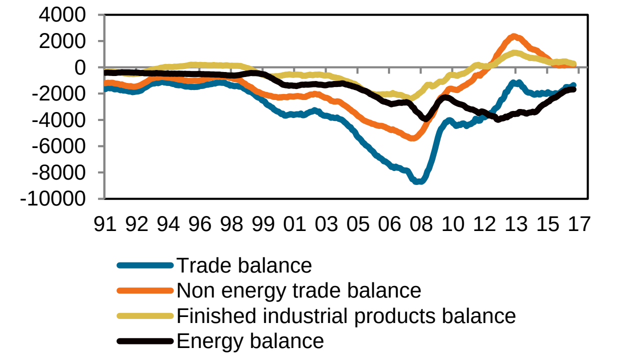
Source: Eurostat, INE and Intesa Sanpaolo calculations

Fig. 4 – Trade balance broadly stable



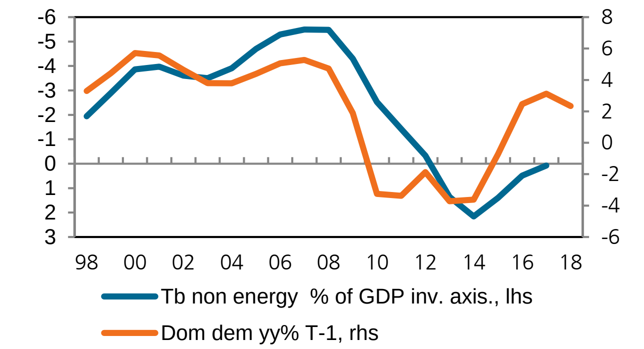
Source: Markit, Eurostat and Intesa Sanpaolo calculations

Fig. 5 – But the stabilisation of the trade balance is mainly due to the energy component



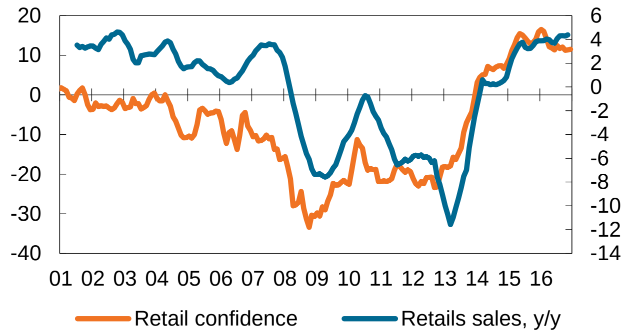
Source: Banco de España and Intesa Sanpaolo calculations

Fig. 6 – Non-energy trade balance already shrinking with accelerating domestic demand. Non-negligible risk of returning in the red



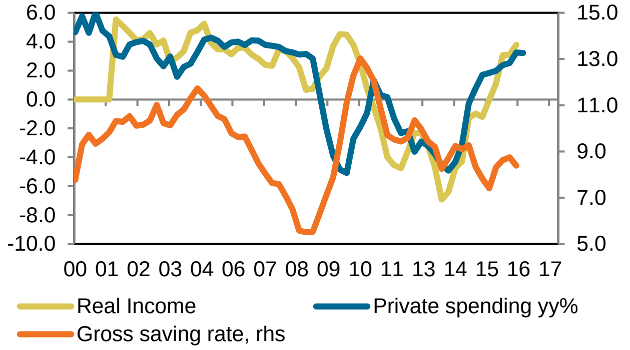
Source: Markit, Eurostat and Intesa Sanpaolo calculations

Fig. 7 – Private consumption: no indications of pacing down



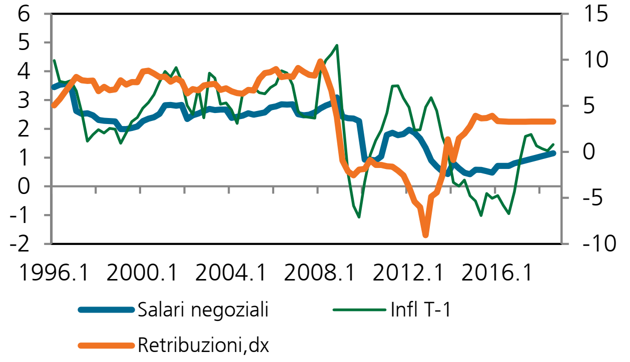
Source: INE and Intesa Sanpaolo calculations

Fig. 8 – Recent consumption growth aligned with disposable income. Savings can offer limited support when labour income slows, due to…



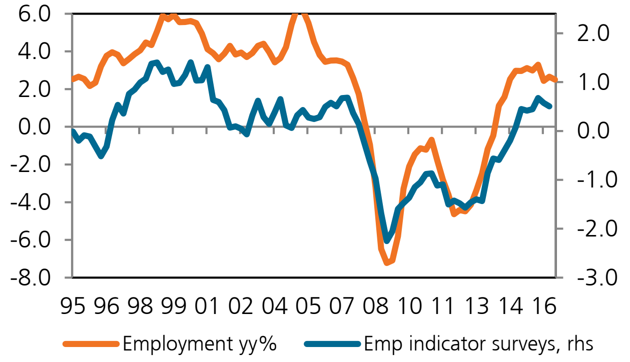
Source: INE and Intesa Sanpaolo calculations

Fig. 9 – …rising inflation



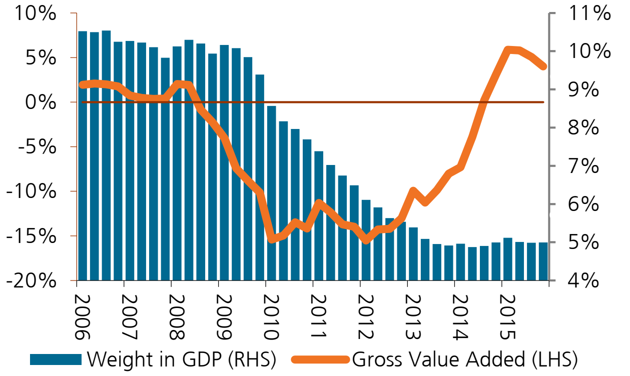
Source: INE and Intesa Sanpaolo elaborations

Fig. 10 – So far employment has surprised firms' expectations



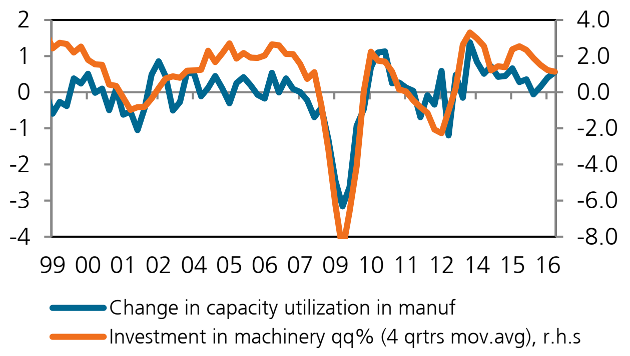
Source: EU Commission, INE and Intesa Sanpaolo calculations

Fig. 11 – Construction growing at a healthy pace



Source: INE and Intesa Sanpaolo calculations

Fig. 12 – Machinery investment cycle is mature



Source: INE, EU Commission and Intesa Sanpaolo calculations

Netherlands: strong growth, despite increasing political uncertainty

Guido Valerio Ceoloni

GDP growth of 2.0% in 2016 and 1.8% in 2017

The Dutch economy has proved more vigorous than the most recent forecasts, with GDP proving an upside surprise in the third quarter, rising 0.7% qoq, at the same pace as in the previous two quarters and therefore better than the consensus estimate. This performance is due both to a better contribution from foreign trade (+0.2), and to stronger-than-expected domestic demand (+0.4). The third-quarter result brings growth to 1.9% qoq, suggesting **an upward revision to GDP estimates for this year to 2.0% and to 1,8% for 2017**. We then forecast a slowdown to 1.6% from 2018 onwards, when the cycle will be mature and the effects of Brexit will be more apparent than they have been so far.

Effervescent consumption due to the increase in disposable income

Consumption grew by 0.7% qoq in the third quarter, mainly reflecting three factors: **rapid improvement in the labour market, expansive fiscal policy and pension reform. Employment** rose by 0.6% qoq in both the second and the third quarters: **hours worked** increased by 2.6% qoq from 3.0% qoq for full-time jobs and by 2.0% from 2.7% qoq for fixed-term jobs. **Unemployment will fall by eight-tenths of a percentage point this year, to 6.1%**, and the trend will continue in 2017, although it remains higher than pre-crisis levels (5.0%). Growth in the disposable income of households has pushed consumer confidence above the long-term average. Household spending accelerated in the second half of the year. **Private spending is forecast to grow by 1.5% in 2016 and by 1.4% in 2017**.

Fixed investments are buoyant but stabilizing after an exceptional 2015. House prices are slowing

Although **fixed investment** slowed in the third quarter, to 0.5% qoq, from a peak of 1.9% qoq in the second quarter, it maintained an upward trend of 6.6%, underpinned by stable positive financial conditions and fueled by the increase in use of production capacity (close to 82%, compared with the pre-2008 level of 83.5%), which boosted investment in machinery. **The bubble in real estate investment now seems to have subsided,** with a return to more sustainable levels. **We expect the rate of investment growth to slow to around 3.7% yoy in 2017,** also supported in the production component by the decrease from 25% to 20% in tax on some corporate profit categories, implemented by the government with the 2017 Budget Act. The **construction** sector remains **very positively oriented,** with an increase in residential investment of 19% this year from 27% in 2015 (the average confidence level in the sector rose to 13.6 in Q3 from 8.2 in Q2), but we expect a physiological slowdown of around 7-8% next year: **new build prices increased by around 5.0% yoy this year,** and are expected to slow to 4.3% next year. They are currently 11% below the peaks of 2008, and a slowdown was already recorded between October and November. **Fears of a new bubble therefore seem premature for now,** although it would be wise to pay attention to changes in the sector next year.

Although consumption is driving up exports, foreign trade will make a positive contribution to GDP during the two-year period

Net exports did not affect trends in domestic demand, as originally forecast. Boosted by domestic consumption, **imports** jumped by 1.1% qoq (from 0.1% qoq) in the third quarter, while **exports** were equally dynamic, accelerating by 1.2% qoq, from 0.2% qoq, due in large part to re-exports of manufactured products, pharmaceuticals and metals: **the net contribution from foreign trade remained positive**, therefore, albeit slightly, rising by 0.2, from 0.1 in the second quarter: on average, the increase will be 0.2 a year during the two-year period. Imports are expected to slow from 3.8% this year to around 3.6% next year, while exports are forecast to slow from 3.5% in 2016 to 3.3% in 2017. **The trade balance will remain positive but drop** from 7.5% of GDP in 2016 to 6.5% in 2017.

Inflation to rise above 1% next year

Inflation is expected to rise more rapidly next year, boosted by a favorable base effect, an increase in hourly wages and rising oil prices. Our estimate is **1.2%, from 0.2% this year** on the national index (and 1.1% from 0.1% on the harmonized index). **Core inflation** is expected to slow from the 2015 level this year (to 0.5% from 0.9%) and is set to rise again to 0.9% in 2017.

Public debt and deficit down, structural balance in surplus in 2017

The coalition government will close 2016 and the legislature leaving **the public accounts in order. The 2016 deficit target is likely to be beaten,** thanks to a greater-than-expected increase in revenues and a greater reduction in expenditure, with the balance again improved this year **from -1.8% in 2015 to -0.8%, a trend that will continue to -0.5% in 2017** due to cyclical factors (the impact of the 2017 budget package will be almost neutral). The **structural balance** is also forecast to move into surplus this year, to 0.2% from -0.6%, increasing next year to 0.4%. Lastly, **public debt** is expected to fall by about 3bps this year, to 62.6% from 65.1% and to 61.2% in 2017. The Netherlands is one of the countries that may ease its fiscal policy, also given the substantial surplus in the current account of the balance of payments.

Economic risks to the balanced scenario. The March elections could produce a fragmented parliament, in which finding a government majority will be complex

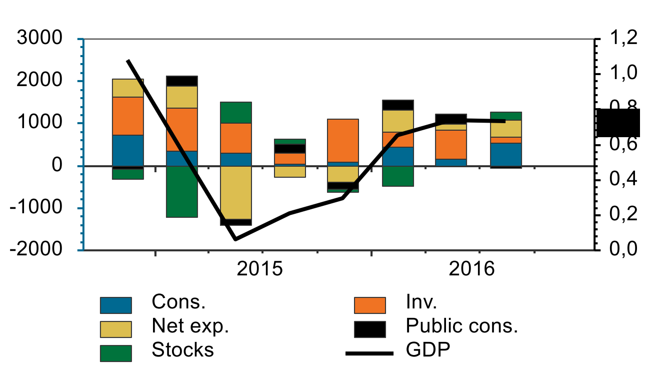
For 2017, the main risk is political, given that the elections on March 15 next year will see a close fight between the current government coalition (the right with the VVD of Prime Minister Rutte and the centre-left) and the far right eurosceptic PVV of Geert Wilders: the main issues under debate are health, immigration and, in part, the economy. **According to the latest polls, the PVV could win more seats from the VVD, but would still be far from an absolute majority,** also given that seats are allocated on a proportional basis. The scenario will probably see a very **fragmented parliament,** in which a coalition of several parties could serve to achieve a majority. This could prevent Wilders from forming a government, and the King might in the end again confer the role on Rutte. Once that the risk of a eurosceptic party in government has been averted, the next mine to defuse may be the request for a **referendum on leaving the Euro zone** along the lines of the UK referendum, an initiative that Wilders has already announced, but in reality this risk will depend on the actual weight of the party after the elections, and it is unlikely to succeed in an economy that is so well integrated with those of its neighbours, particularly Germany.

Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.0	2.0	1.8	1.2	1.9	2.4	2.4	2.2	1.8	1.5	1.7	1.6	1.6
- q/q change				0.7	0.7	0.7	0.3	0.4	0.4	0.4	0.4	0.3	0.4
Private consumption	1.8	1.5	1.4	0.6	0.2	0.7	0.4	0.2	0.4	0.3	0.3	0.4	0.3
Fixed investment	9.9	6.4	3.7	1.0	1.9	0.5	1.2	0.8	0.9	0.8	0.7	0.5	0.5
Government consumption	0.2	0.8	0.8	0.5	0.6	-0.1	0.1	0.2	0.3	0.3	0.3	0.2	0.2
Export	5.0	3.5	3.3	1.1	0.2	1.2	1.0	0.8	0.8	0.6	0.5	0.7	0.6
Import	5.8	3.8	3.6	0.9	0.1	1.1	0.8	1.0	0.9	0.9	1.0	0.5	0.5
Stockbuilding (% contrib. to GDP)	-0.7	-0.3	0.1	-0.3	0.0	0.1	-0.4	0.1	-0.1	0.2	0.4	-0.3	0.0
Current account (% of GDP)	8.7	9.0	9.1										
Deficit (% of GDP)	-2.0	-0.8	-0.5										
Debt (% of GDP)	65.1	62.6	61.2										
CPI (y/y)	0.2	0.1	1.2	0.4	-0.2	-0.2	0.5	1.2	1.1	1.2	1.0	1.1	1.1

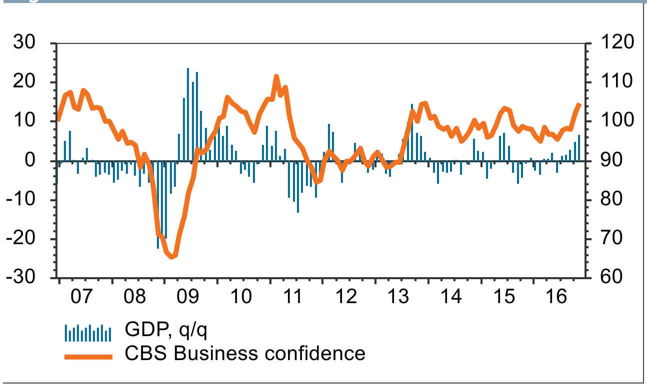
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to GDP formation



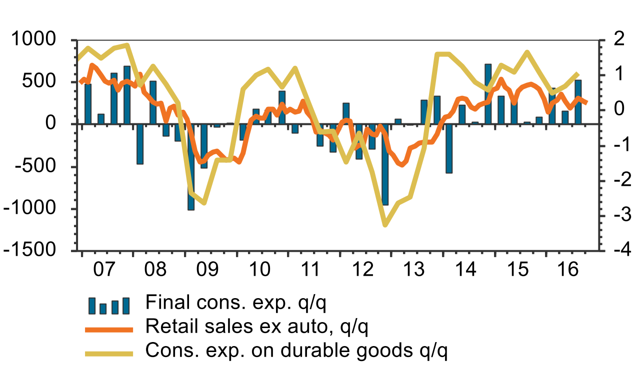
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – Economic confidence and GDP



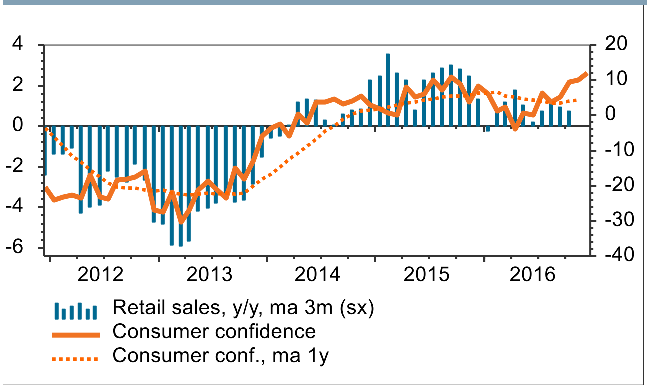
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Household spending, purchases of durable goods and change in consumer spending



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

Fig. 4 – Retail sales and household confidence

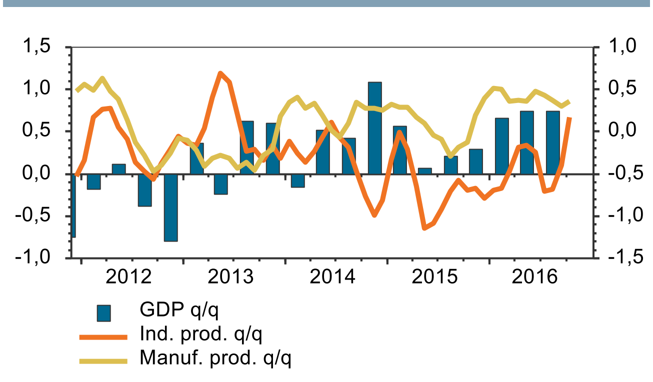


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investment, construction sector activity and house prices

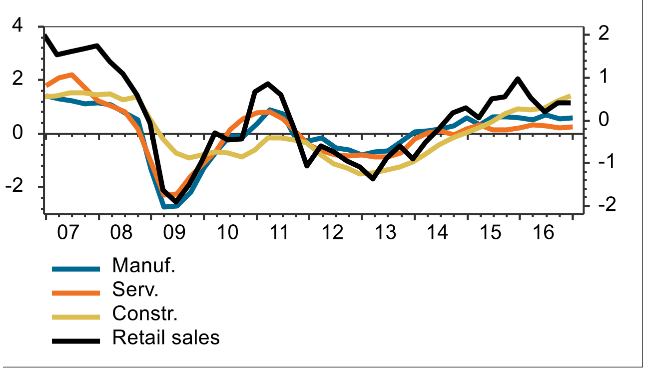
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



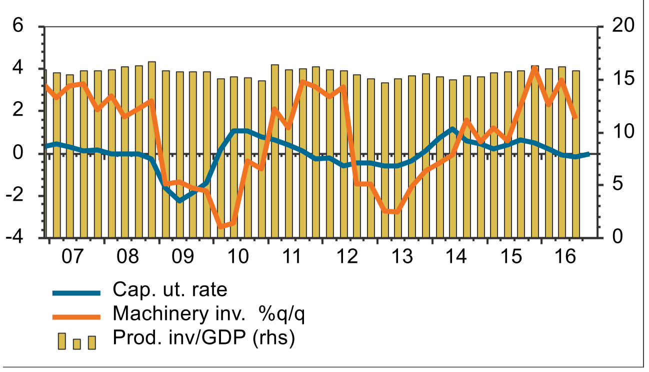
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



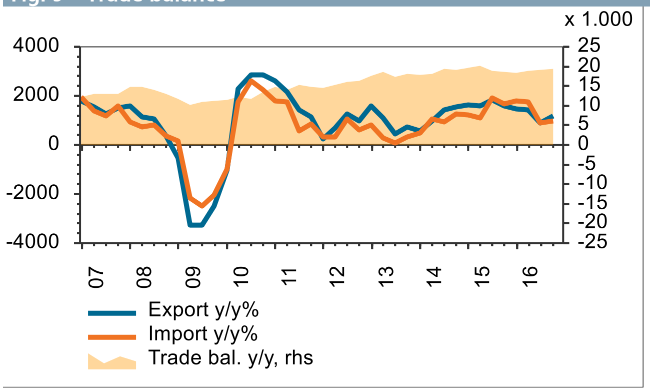
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Production capacity utilisation and level of investment on GDP



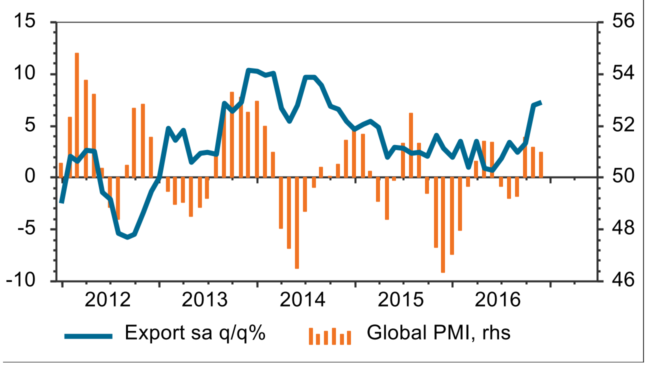
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Trade balance



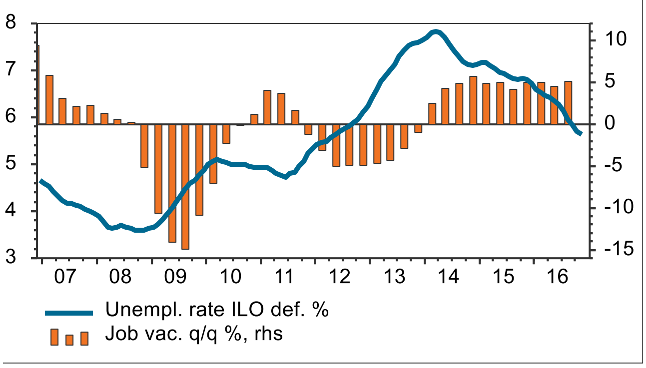
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Exports, export orders and global PMI



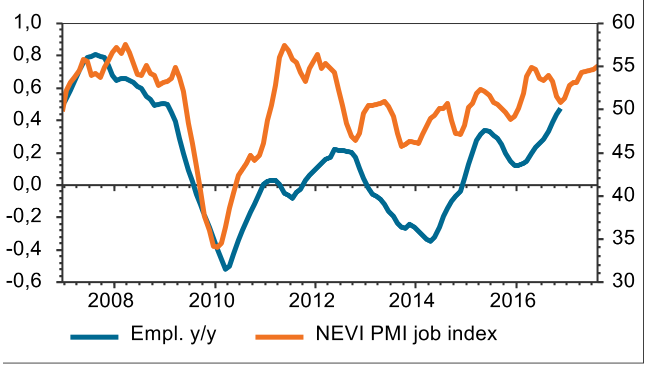
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 11 – Unemployment and job vacancies



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

Fig. 12 – Changes in employment



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

Greece: the worst could be over

Guido Valerio Ceoloni

Economic outlook stronger than expected: GDP at +0.3% in 2016 and +1.0% in 2017

In the closing quarter of the year, the final estimate confirmed **a surprise acceleration of GDP growth in Greece to 0.8% q/q from 0.4% q/q, placing acquired growth at 0.3% y/y.** Consumption increased for the first time this year by 0.3% q/q, after four negative quarters; **investments** also improved for the second quarter in a row (+1.7% q/q from +9,7% q/q). The **foreign channel,** on the other hand, surged and contributed +4.8 from -1.1, explained by crashing **imports,** down by -10% q/q from +9.1% q/q, as opposed to a slowdown in **exports** in slowdown a +3,7% q/q from 6,4% q/q. We expect imports to rebound in 4Q, leaving the contribution of the foreign channel essentially at zero, whereas domestic demand should keep up its positive phase: **we forecast GDP growth to accelerate by 0.2% q/q, therefore confirming the year-on-year change of 0.3% y/y**, marking the second positive growth year since the beginning of the crisis in 2008. For **2017,** our forecast in line with the consensus estimate of **+1.0%** GDP growth, thanks both to domestic demand and to net exports.

The market seems to believe that the worst is now over, and the spread has narrowed to its lowest levels since 2014

The market also seems to believe that an economic recovery is on its way: the **10Y government bond rate** has dropped this year to an average of 8.1% from 9.7% in 2015, and in the past two months it has declined further, to **6.6%, a low since September 2014**[20]. However, the outlook for the forecasting period is still not rosy: although GDP has resumed growing a year sooner than expected, and there is a chance that the country may only just manage to participate in the closing phase of the ECB's APP, **a new, massive effort on the fiscal front will be required next year, targeting a primary surplus of +1.75% from +0.5%,** and 3.5% from 2018 onwards, to be achieved by means of higher taxes, that will weigh on consumption. The expected **restructuring of debt** is unlikely to be agreed on before the German elections. Moreover, the Ecofin meeting of 5 December first approved, and then only very recently suspended, the measures aimed at allowing Greece a breather in the near term[21]. However**, the political panorama seems markedly less turbulent** than a year ago: **the government has approved the 2017 Budget,** and at the end of October the Treasury reported a primary surplus of 6.5 billion euros, corresponding to 3.5% of GDP[22], therefore leaving a margin for achievement of the 0.5% target indicated in the MoU.

Positive outcome of the second review, hopefully by the end of the year, is crucial in order to participate in the ECB's APP

The **first review** was focused on restoring to health public accounts, whereas the **second**, (hopefully completed by the end of the year) is concentrated on the completion of the structural reform programmes. Focus will be on the agreements reached on collective labour contracts, solving the problem of banks' NPLs, carrying forward the liberalisation process in several sectors. **A positive outcome of the second review, and the resulting unblocking of assistance funds, could allow the government to speed up repayment of PA arrears**, revamping the economy at least in the first half of 2017, or at least balancing tax hikes.

Risks to the scenario less negative than in the past, but the country is still very vulnerable to external shocks

Risks to the scenario on the forecasting horizon are less negative than in the past. If the reforms currently being implemented manage to foster a sustainable economic recovery, the problem represented by debt would also be easier to take on; otherwise, in case of a new slowdown in GDP, the weight of debt could trigger another crisis. The fiscal targets imposed for the next two years require excessively harsh fiscal consolidation, which risks depressing growth once again: on this front, **the government could ask for more time, as has already been conceded to Portugal.** If the country stays inside the assistance programme mainframe, **the risk of exiting the euro area may be considered as very low on the forecasting horizon.** The economy is entering an expansion phase, but remains clearly exposed to external shocks; the outcome of the German elections next year could also prove decisive for the country's fate.

[20] In the past few days the yield has risen back towards 7.2%, due to the Eurogroup's decision to suspend the measures which would ease debt until January, due to tensions with Tsipras on new pension spending worth 600 million euros, which the Greek government is set on appropriating.

[21] Measures such as rescheduling of EFSF repayments, suspension of the 200bp increase of the rate of interest on the loan tied to the repurchase of debt, optimisation of the EFSF/ESM rate management strategy

[22] The MoU provides for a primary surplus of 0.5% net of the cost of recapitalising banks, of the proceeds from NFA, SMP and part of the privatisations (4.2% of GDP in 2015).

Portugal: stronger than expected 2016, but the economy remains fragile

Guido Valerio Ceoloni

After a stronger than expected 3Q (+0.8% q/q from +0.2% q/q), acquired growth is now 1.2%: **confidence surveys for 4Q point to an increase in activity:** therefore, we expect a new 0.4% q/q expansion, mostly driven by domestic demand, which should contribute one tenth to the annual average: therefore, we have revised up our forecast for **2016 to 1.3%**. **In 2017 we expect an acceleration to 1.6%** on the stabilisation of domestic demand, and a less negative contribution from the foreign channel. However, **the recovery remains fragile, and fiscal consolidation**, while ongoing, **is proceeding too slowly**. The country is therefore destined to remain under the scrutiny of the rating agencies, and unless the impact of structural reforms accelerates (a reorganisation of the banking system is now particularly urgent), GDP growth, currently slower than its pre-crisis levels by 6%, will remain compressed to below-potential growth, and the economy will be vulnerable to external shocks.

GDP in growth all'1.3% this year and all'1.6% next year

In the course of 2016, **domestic demand was the main driver of growth**, supported by consumption and by a recovery in fixed investments. **Households' spending** should slow next year to 1.2% from 1.8% in 2016: the recovery of the labour market, the slight increase in minimum pensions, and the gradual abolishment of one-off income taxation (net of the increase in indirect taxation) should allow a stabilisation of the consumption component on the forecasting horizon, after the significant advancement achieved in the 2014-15 biennium (+2,4% y/y). **Investments**, after being held back this year by uncertainties clouding the country's future, will resume growing in 2017, by 1.4% in our estimation, from -1.7%, fuelled by the acceleration in activity expected next year, and by the impulse provided by European structural funds. The **foreign channel** was affected by rising domestic demand, with **exports** expected to slow down this year to 3.4% from 6.2% in 2015, followed by a stabilisation of the trend at 3.8% in 2017. **Imports** in 2016 are on course for a 4.3% increase, down to 3.9% in 2017. **Net exports** will therefore continue to hold back growth, from -1.0 in 2015 to -0.5 this year, and down to -0.1 in 2017.

Domestic demand the main driver of GDP; foreign channel a drag

The labour market has been experiencing a slow but ongoing normalisation since the end of the bailout. The **unemployment rate**, while still well above the euro area average, will drop this year to 11.3% from 12.6% in 2015; we expect a further eight-tenths decline in 2017, to 10.5%.

With respect to **public accounts**, considering that the recapitalisation of CGD will not impact the deficit[23], **the -2.5% goal should be achieved. In 2017, the correction should amount to a further six tenths, to -1.9%**, which should enable Portugal to exit the excessive deficit procedure. **Public debt is estimated to rise back** this year, albeit marginally, to 129.9% from 129.0%, and to stabilise in 2017 at 129.5%. At the same time, for now we do not think Portugal's debt will lose its investment grade rating by DBRS, which will allow the country to take part in the ECB's QE programme throughout next year[24]. Lastly, the next structural reforms will have to concentrate on the labour market and on the welfare state, to curb spending and increase the competitiveness of the economy. The country is still under close market watch, due to high borrowing levels in both the public and private sectors. However, the socialist government, after having managed to reduce unemployment without falling short of budget targets, has proven it is better able than expected to manage cooperation with the Bloco de Esquerda, the Communist Party and the Green Party, which provide external support. Indeed, all the parties involved responsibly accept the need to work with variable majorities, with no compromise to the agreements reached in 2015.

Deficit goals achieved, but public debt is still on the rise

[23] The recapitalisation will cost 2.7 billion euros, i.e. 1.5% of GDP.

[24] The BDRS will again review Portugal's sovereign rating in February.

United States: change of regime: fiscal reflation in the time of full employment

Giovanna Mossetti

After years of monetary policy dominance, the US is on the verge of a dramatic regime shift: we forecast that the economy will be driven by fiscal policy over the next two years and the Fed will turn into a follower in the policy game. The US economy is now at full employment, with inflation close to 2%, and is likely to receive a substantial fiscal stimulus soon. Although the size, details and timing of the future fiscal expansion are still to be defined, in our view the trend is clear: **"reflation" will be the name of the game in 2017-18.** In this scenario, monetary policy decisions will become particularly difficult, as a balance will need to be struck between the risks of overheating, on the one hand, and excessive fiscal restraint, on the other. In the past, when unemployment was below the equilibrium rate for an extended period, the Fed has always actively contributed to the end of the economic cycle and the start of a recession.

In our central scenario, fiscal stimulus effects are likely to be felt in the second half of 2017 and, above all, in 2018. 2017 will be a year of transition, defined by the search for a legislative compromise on the reforms promised in the election campaign and by potential signs of protectionism. In the second half of the year, with the expected entry into force of tax reforms for business and households, and a probable increase in public spending on defence and infrastructure, growth should pick up by a few tenths of a percentage point, staying just above 2%. In 2018, the full fiscal stimulus effects should be evident and the year will be marked by increasing excess demand, especially in the labour market.

1. The macroeconomic scenario now depends on the new administration's policies

There are two key elements of the new political framework:

1. After 6 years of divided government and legislative deadlock, there is now a **Republican mandate** for Congress and the Administration, which implies intense **legislative activity.**

2. The transition to a Republican mandate will substantially **increase uncertainty**, not only over the **coming reforms** (what are the timescales and details of the reforms?), but also to the fact that the new President is not an "orthodox" Republican. The agenda will be heavily influenced by **hybrid positions**, dictated by **"fiscal doves"** on economic policy and **"protectionist hawks"** on trade and immigration, with unknown relative weights.

Despite a lack of details, the major trends in the next two years are already well defined. **The main feature of the 2017-2018 scenario will be a policy of active reflation** – the effects of which may be **partially mitigated by protectionist positions** on trade and immigration. Forecasting the extent of the reflation is fraught with uncertainty at this stage, as the result will depend on a reconciliation of the President's programmes and those of the Republican representatives in Congress. However, the probability of a substantial fiscal stimulus being implemented from 2017H2 is extremely high, and **growth and inflation are likely to be higher than in pre-election forecasts, especially for 2018.**

There is another element of uncertainty for the scenario: **fiscal stimulus will arrive with the economy already at full employment**, above-potential growth, inflation at 2% and upward pressure on wages. Even with a modest rise in potential growth and neutral interest, the boost to growth and excess labour demand will probably trigger higher inflation. In Greenspan's 1997 words, "there is no evidence that the business cycle has been repealed": the Fed's response could once again be the determining factor in ending the cycle and starting a recession.

The **new features of economic policy** will be evident on two fronts.

Legislative action: compromise with Congress and use of the "reconciliation" procedure

Legislative action. The President will have to compromise with Congress to convert his proposals into law. The simple Republican majority in the Senate means that action will be limited to spending, taxes and the debt ceiling to avoid filibustering by the Democrats. On these three issues, the House and Senate may agree a consolidated bill and approve it by simple majority, not more than three times a year ("reconciliation").[25]

The top priority for legislation will be **tax reform for households and business, including lower tax rates and a wider tax base.** For **corporates**, there will be measures for repatriating foreign earnings, and possible export incentives (with territorial taxation) and investment incentives. For **households**, the reduction in rates will favour high-income classes, and its effects on spending will be curbed by the lower propensity to spend of the classes addressed by the reform. We assume that the tax cuts will **increase the deficit around USD1Trn over 10 years, with positive effects on growth of 0.6-0.7pp of GDP between mid-2017 and end-2018.**

Tax reform: lower rates and an extension of the tax base for households and business

The second point on the agenda will be an increase in **spending on infrastructure and defence**. There is uncertainty surrounding the infrastructure measures (partly shared with the private sector), but we forecast "active" measures of around USD250Bn over ten years for infrastructure, including incentives to private entities, along with rises in defence spending, partly offset by other cuts, entailing a **net increase in public spending of around USD 20Bn per year.** Health reform will remain on the agenda, but will not be tackled in 2017 as it would require political energy, which instead will be spent fully on tax reform.

Increased spending: defence and infrastructure

Executive action: immigration and foreign trade. With regard to international trade and immigration policies, the President may issue executive orders to implement a protectionist strategy. The President's pre-electoral promises would lead to considerable negative effects on growth and rising inflation. For now, we forecast that a "soft" line will be taken on trade, mainly aiming at renegotiating agreements. With regard to immigration, the status quo is likely to be maintained; this will curb expansion of the workforce, but will not reduce it further.

Executive action: huge uncertainty

Protectionism – more verbal than substantive?

Immigration: status quo likely for the first two years

2. Reflation in the time of full employment: what is the scenario for 2017-2018?

The implications of the fiscal scenario also depend on the cyclical phase (economy at full employment), the **effects on productivity** and market reactions (**exchange rate and yields**). These elements will be crucial for the split between real growth and inflation, and for the Fed's rates.

Our **growth** forecast **for 2017 (2.1%)** includes a small impact of around **0.1-0.2 percentage points** from fiscal interventions **in 2Q**. **In 2018, forecast growth is 2.5% (fiscal measures effect: +0.5-0.6 percentage points)** once the tax reforms and increased public spending are in full swing. **Consumer spending** looks set to be solid (2.7% in 2017 and 2.8% in 2018), shored up by the labour market and tax cuts. **Public spending**, which has been rising since 2016, should pick up the pace. A key factor is the plan to reinvigorate **non-residential fixed investment** from the second quarter of 2017 onwards, with expected growth of just over 5% in 2018. **Foreign trade** is likely to make a negative contribution to growth, especially in 2017, in the wake of the dollar's appreciation. **Inflation** (CPI) should show a moderate upward trend (just over 2%), affected by the contrasting forces of a strong dollar and rising oil prices.

2017 growth forecast at 2.1%, with modest fiscal stimulus effects (one- to two-tenths of a percentage point), concentrated in the second half

2018 growth accelerating towards (and beyond?) 2.5%

Inflation rising

The forecast for **monetary policy** is for an initially cautious response to the fiscal stimulus, but only after the details of the reforms have been defined. In addition, the markets are already implementing monetary tightening: rates are likely to stay on the same path as that set out in the September projections, with **two hikes expected in 2017**.

Much greater uncertainty surrounds the **2018 scenario**. In our forecasts, the fiscal stimulus is substantial, but not comparable with Trump's promises, while we do not include effects associated with a possible swing towards protectionism. Also in our "cautious" scenario, **2018 is likely to be defined by excess demand**, especially in the labour market, with upward pressure on prices and wages consistent with the **Fed's continuation of moderate rate rises**. Nominal growth is expected to be around 4.5-4.8% and the federal deficit just below 5% of GDP, up from 3.5% in 2016. The forecasts depend on the details of the tax reforms, which will start to take shape in early 2017. **For now, the reflationary trend is clear and is likely to be the theme of the next two years.**

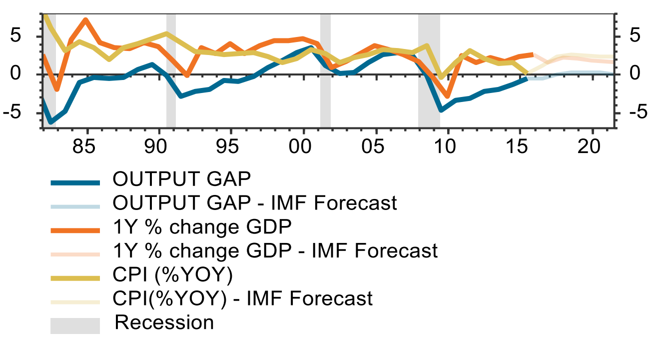
2018 forecasts are uncertain due to the current lack of details on the reforms and the potentially restrictive effects of the Fed's response to the new growth/inflation mix.

[25] V. D. Reich, R. Kogan, "Introduction to Budget Reconciliation", Nov. 2016, Committee for a Responsible Budget.

Macro forecasts	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.6	1.6	2.1	1.6	1.3	1.6	2.0	2.3	2.3	2.0	1.9	2.1	2.4
q/q annual rate				0.8	1.4	3.2	2.4	2.0	1.7	1.9	2.1	2.8	2.9
Private consumption	3.2	2.7	2.6	1.6	4.3	2.8	2.5	2.6	2.2	2.5	2.2	3.0	3.2
Fixed investment – non-resid.	2.1	-0.5	3.2	-3.4	1.0	0.1	3.1	3.5	4.4	4.5	4.0	4.5	5.1
Fixed investment - residential	11.7	4.7	4.4	7.8	-7.8	-4.4	8.2	6.2	6.2	6.9	6.5	6.2	4.9
Government consumption	1.8	0.8	0.2	1.6	-1.7	0.2	0.5	0.3	0.3	0.4	0.5	0.9	0.7
Export	0.1	0.7	1.8	-0.7	1.8	10.1	0.5	-0.3	1.3	0.9	1.5	2.5	2.6
Import	4.6	0.8	3.2	-0.6	0.2	2.1	3.3	3.5	3.7	3.9	4.2	4.6	4.6
Stockbuilding (% contrib. to GDP)	0.2	-0.4	0.0	-0.4	-1.2	0.4	0.2	0.1	-0.2	-0.2	0.2	0.2	0.1
Current account (% of GDP)	-2.6	-2.6	-2.5										
Federal Deficit (% of GDP)	-4.5	-4.9	-4.8										
Gov. Debt (% of GDP)	125.9	127.3	127.4										
CPI (y/y)	0.1	1.2	2.2	1.1	1.0	1.1	1.6	1.8	2.2	2.6	2.4	2.0	2.0
Industrial production (y/y)	0.3	-1.0	1.4	-0.4	-0.2	0.5	-0.1	0.6	0.6	0.3	0.4	0.4	0.4
Unemployment (%)	5.3	4.9	4.7	4.9	4.9	4.9	4.9	4.8	4.7	4.7	4.6	4.6	4.6
Fed Funds	0.3	0.5	1.0	0.5	0.5	0.5	0.5	0.8	1.0	1.0	1.3	1.3	1.5
Effective exch. rate (1973=100)	91.1	91.6	93.7	93.2	89.6	90.2	93.5	93.6	93.6	93.7	94.0	94.4	94.8

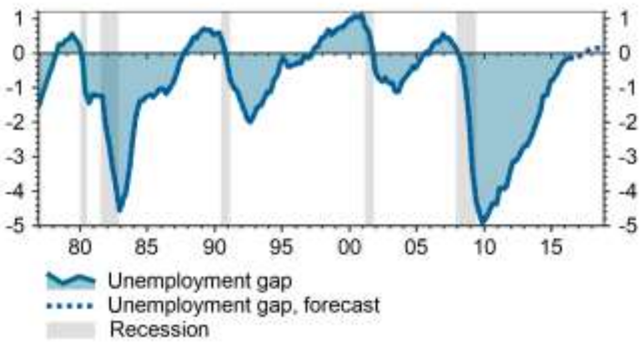
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – US economy is in balance: how will it react when fiscal reflation comes along?



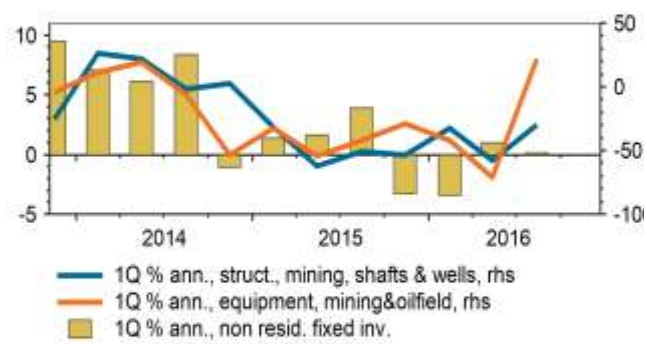
Source: Thomson Reuters-Datastream

Fig. 2 – Unemployment gap will enter dangerous territory and pave the way for the end of the cycle



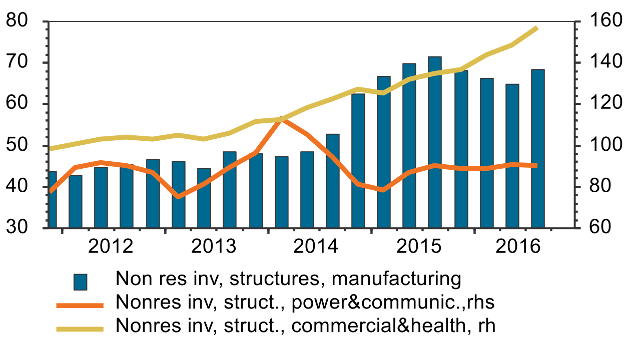
Source: Thomson Reuters-Datastream

Fig. 3 – Non-residential investment curbed by slump in extraction sector: reversal following rise in oil prices



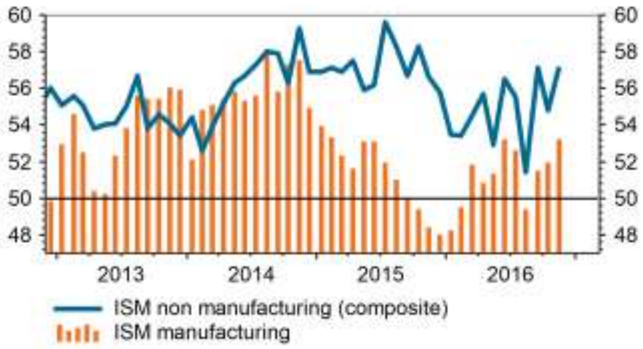
Source: Thomson Reuters-Datastream

Fig. 4 – Corporate investment in structures is rising



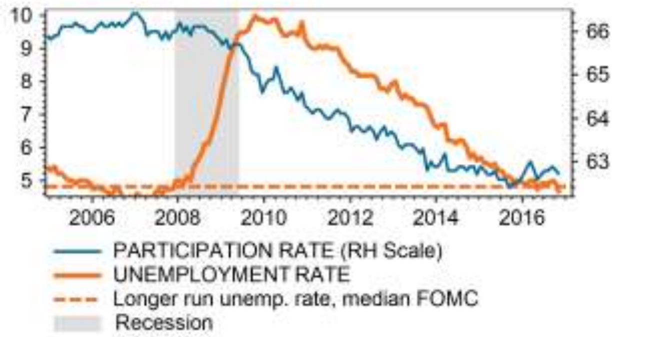
Source: Bloomberg, Thomson Reuters-Datastream

Fig. 5 – ISM: positive indications for growth



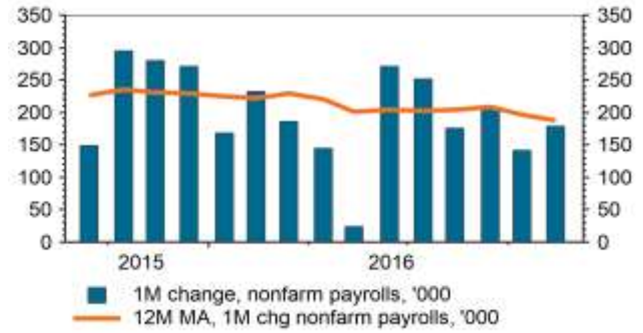
Source: Thomson Reuters-Datastream

Fig. 6 – Unused resources drying up in the labour market



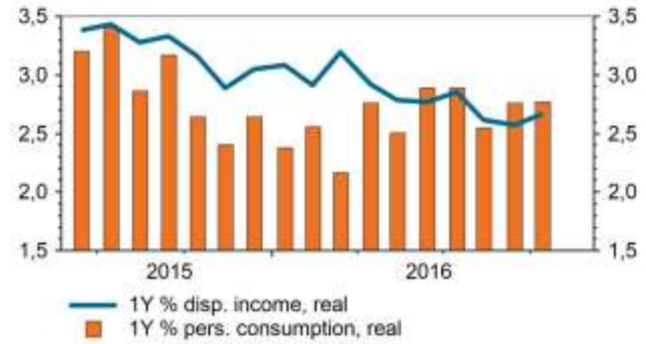
Source: Thomson Reuters-Datastream

Fig. 7 – New jobs: trend remains above "normal" job creation, estimated at around 60,000 positions



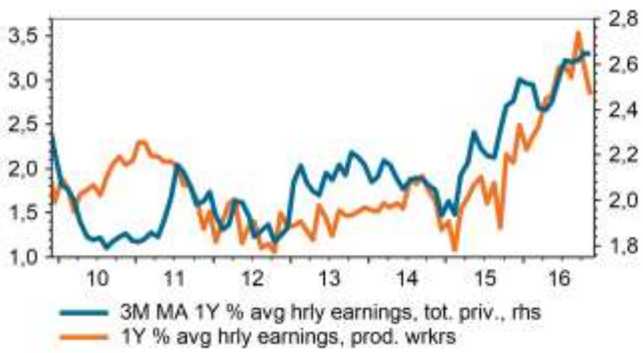
Source: Thomson Reuters-Datastream

Fig. 8 – Consumption and disposable income rising solidly



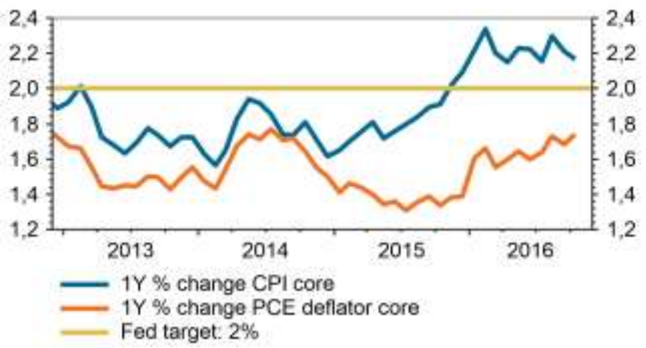
Source: Atlanta Fed, wage growth tracker

Fig. 9 – Wages reflect scarcity of available resources



Source: Thomson Reuters-Datastream

Fig. 10 – Inflation is close to 2%



Source: Thomson Reuters-Datastream

Asia

Japan: New alliances - fiscal policy, monetary policy and exchange rate finally coordinated to drive growth in 2017-18

Giovanna Mossetti

The outlook for the Japanese economy is better than the forecasts of three months ago for both 2016 and 2017. Growth is likely to be **0.8% in 2016**, accelerating to **1.2% in 2017**, well above potential (estimated at around 0.5% by the BoJ). There are three major new developments: a highly positive surprise delivered by **third-quarter growth**, which is accelerating sharply (+0.5% qoq), thanks especially to foreign trade; the approval of the fiscal stimulus announced in the spring; and, lastly, a dramatic reversal in the **exchange rate trend,** which became more apparent after the US vote. The knock-on effect of the third quarter revived the 2016 growth rate, while the weakening of the **exchange rate**, together with the launch of the **fiscal stimulus** announced in August and the **anchoring of yields** implemented by the BoJ, looks set to drive growth in 2017.

2016 **marks the end of a cyclical phase heavily dependent on monetary policy.** Since the introduction of Abe's "three arrows" and Kuroda's quantitative easing (end-2013), the economy and markets have been driven by the BoJ's decisions. Monetary expansion has played a crucial role, while the economy tackled the restrictive effects of the consumption tax hike. In 2016, however, the BoJ's attempts to further ease monetary conditions were ineffective: core inflation started to fall again and the yen strengthened. The reversal in 2017 will come from the existence of **simultaneously pro-cyclical fiscal and monetary policies**.

A new phase is now beginning **for the Japanese economy, in which fiscal policy will be the growth driver, while monetary conditions are loosened by the weakening of the exchange rate due to external factors** (essentially the strength of the dollar). The BoJ will continue to have two important tasks: the **control of real rates** and the **pseudo-monetisation of the public debt**. In tandem with the stabilisation of yields, the central bank will continue to buy JGBs worth around JPY 80Trn per year, more than double the net issues of JGBs, and to increase the proportion of public debt in its portfolio (35% of the total in June 2016). The increase in the BoJ's debt in hand is essential for containing the risks of a debt crisis, although the authorities are still against adopting a "helicopter money" regime.

How much growth between end-2016 and end-2017? Third-quarter GDP delivered a highly positive surprise, recording a sharp acceleration, with a change of 0.5% qoq (2.2% qoq ann., 0.9% yoy). Summer growth was the result of a strong rebound by foreign trade (exports +2% qoq, imports -0.6% qoq) and broadly flat demand (+0.1% qoq). Private consumption grew by 0.1% qoq and business' capital investment remained unchanged; meanwhile, residential investment rose by 2.3% qoq and public spending by 0.2% qoq. Forecasts for the next few quarters are of weaker growth than in the third quarter, but more balanced and concentrated in the domestic components.

Consumer spending growth, however, is forecast to remain muted. Wage growth is improving, with moderate salary increases, but the reduction in the propensity to spend connected with the tax hike of 2014 now seems firmly entrenched (see fig. 6). Real household spending is still below pre-consumer tax hike levels, while real income has continued to rise. The uptrend in savings shows no signs of stopping. The rise in the propensity to save continued in the last few quarters on the back of the more solid wages trend and the still little-changed consumption. The desire to increase savings to cope with any new fiscal restriction may also have been strengthened by the downturn in inflation expectations. In 2017, consumer spending is likely to pick up moderately, with a **rise of 0.7% yoy after the +0.3% yoy expected in 2016**.

The forecast of an upturn in 2017 is based on private and public investment trends. The ongoing weakness in **business fixed investment** seen in 2016 is associated with the strong yen and the negative earnings trend (fig. 2). In June 2016, companies' profits were falling by 22.4% yoy in manufacturing and by 4.2% yoy in services. The yen's reversal, which we forecast will be long-lasting, should have positive effects on earnings and investment, rather than on the trade balance. The forecast is for **private non-residential capital investment growth of 1.1% in 2017**, up from 0.3% estimated for 2016.

Net exports made a significant contribution to 3Q growth, but we do not expect this to become a trend. Net exports are still weak in real terms; moreover, the expected weakening of the exchange rate in 2017 will not be able to directly stimulate a sharp rebound in Japanese exports and is likely to have a **modest effect on growth, estimated at around 0.1pp**.

Core inflation continues to fall. Monetary policy was unable to deal with the effects of the appreciating yen in 2016 (fig. 9), and expectations of a fall in inflation have again taken off (fig. 8). The depreciation of the yen, together with the closing of the output gap, should, however, trigger an upturn in inflation in 2017 (**CPI +0.4% in 2017** from -0.2% forecast in 2016).

Fiscal policy: the new springboard for growth. In 2016, the baton was passed from the BoJ to public spending as the key stimulus for growth. The fiscal package announced in the summer should come into effect at end-2016, with an **estimated contribution to 2017 growth of around 0.4 pp.** The package contains a variety of measures: an increase in public investment together with subsidies to companies and households. The government has also hinted that the stimulus could be extended in 2017.

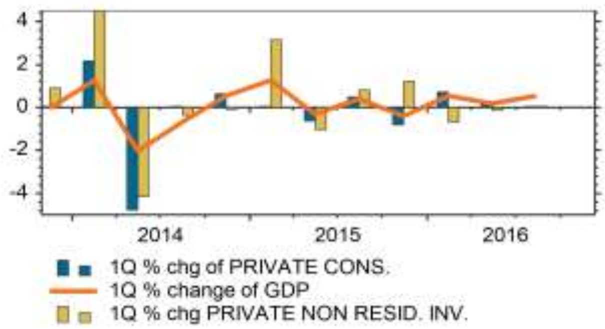
Monetary policy: quantitative stimulus and control of the yield curve are secondary but still important The BoJ's new strategy combines control of the curve with qualitative and quantitative stimulus and negative rates. The capacity of monetary policy to provide monetary stimulus was greatly reduced in 2016. However, intervention by the BoJ still plays an important role. With the introduction of control of the yield curve, the volume of the central bank's purchases is more uncertain, but should remain "around JPY 80Trn" per year, as confirmed by the BoJ. This implies a continuous increase in the share of JGBs in the central bank's portfolio (currently 34.9%, from 17.4% at end-2013). Moreover, controlling the curve has allowed the JGBs to emerge unscathed from the dramatic rise in yields following the US vote. The BoJ will therefore continue to play an important role for growth, albeit a less central one than that seen in 2014-15. We forecast that **monetary policy will remain unchanged in the first half of 2017**, while the expected effects of the reversal in fiscal policy in the US are assessed.

Macro forecasts

	2015	2016f	2017f	2016				2017				2018	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.6	0.8	1.2	0.2	0.7	0.8	1.4	1.2	1.4	1.1	1.2	1.1	1.0
q/q annual rate				2.1	0.7	2.2	0.7	1.2	1.4	1.2	1.1	0.9	0.8
Private consumption	-1.2	0.3	0.6	2.9	0.5	0.2	0.2	0.5	0.9	1.0	1.0	1.0	1.0
FI - private nonresidential	1.7	0.3	1.1	-2.7	-0.5	0.1	0.7	0.9	1.8	2.2	2.3	0.6	0.6
FI - private residential	-2.7	5.5	2.5	-1.1	21.7	9.6	1.1	-0.4	-0.7	0.7	0.8	0.8	0.8
Government investment	-2.0	-1.5	6.2	0.2	9.3	-2.7	3.5	12.0	12.0	1.5	-0.3	-0.4	2.0
Government consumption	1.2	1.7	1.4	3.5	-1.3	1.7	1.6	1.6	1.6	1.6	1.6	1.6	0.8
Export	2.8	-0.6	1.0	0.5	-6.0	8.1	0.2	0.3	0.6	1.2	0.9	0.5	0.5
Import	0.4	-1.8	0.3	-2.5	-2.5	-2.4	0.5	0.8	1.0	1.2	1.4	1.7	1.9
Stockbuilding (% contrib. to GDP)	0.6	-0.1	0.0	-0.3	0.4	-0.2	0.1	0.1	-0.1	-0.1	0.0	0.0	0.0
Current account (% of GDP)	3.3	3.9	3.8										
Deficit (% of GDP)	-5.4	-5.7	-6.6										
Debt (% of GDP)	230.0	233.3	239.1										
CPI (y/y)	0.8	-0.2	0.4	0.1	-0.3	-0.5	-0.2	-0.3	0.3	0.6	0.8	0.9	1.0
Industrial production	-1.2	-0.8	1.5	-3.2	-1.7	0.6	1.3	2.4	2.3	1.1	0.4	0.6	0.7
Unemployment (%)	3.4	3.1	2.8	3.2	3.2	3.0	3.0	2.9	2.8	2.8	2.7	2.7	2.6
JPY/USD	121.1	108.8	121.8	115.2	107.9	102.4	109.8	119.5	121.3	122.7	123.7	124.2	124.4

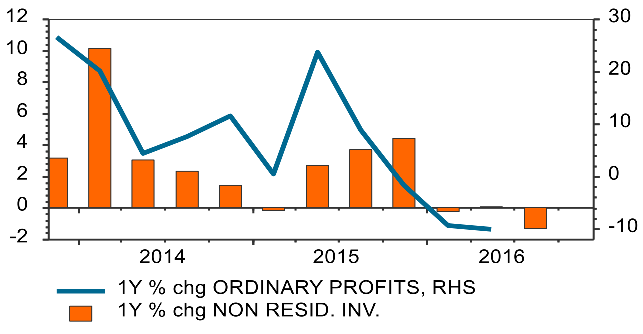
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth accelerating in 3Q but domestic demand fleeting



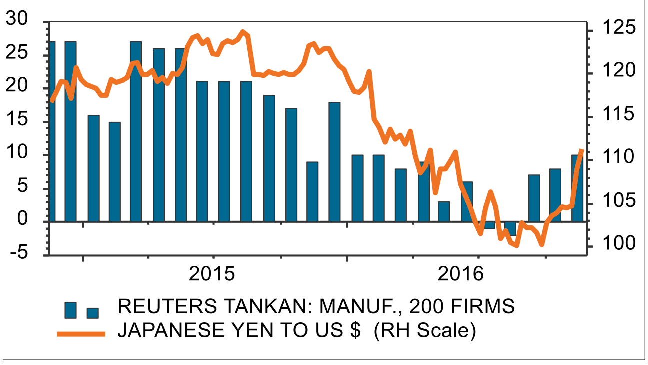
Source: Thomson Reuters-Datastream

Fig. 2 – Businesses not investing much, with earnings curbed by the strong yen: improvement expected with the exchange rate reversal



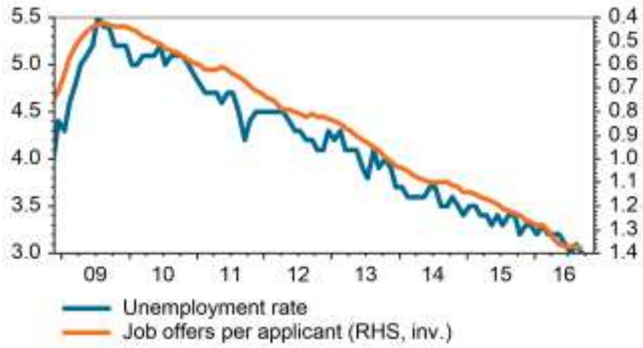
Source: Thomson Reuters-Datastream

Fig. 3 – Reuters Tankan manufacturing and yen



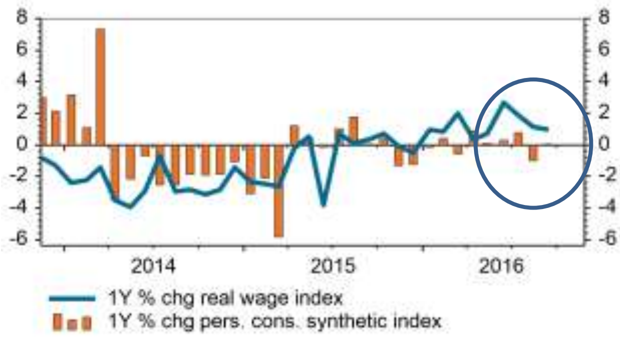
Source: Thomson Reuters-Datastream

Fig. 4 – Employment continues to fall



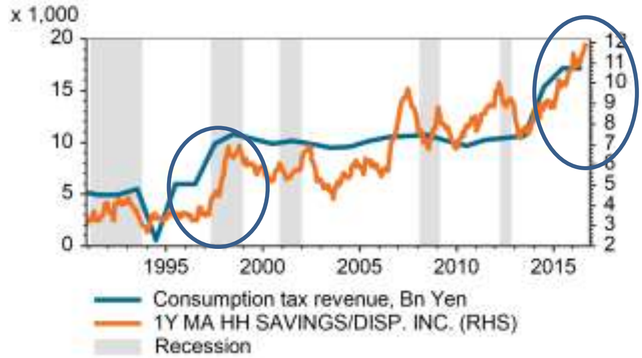
Source: Thomson Reuters-Datastream

Fig. 5 – Weak consumer spending despite wages acceleration…



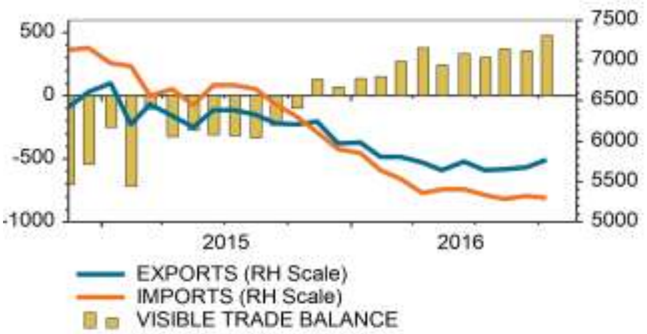
Source: Thomson Reuters-Datastream

Fig. 6 – …but the propensity to save continues to rise after hikes in consumption tax



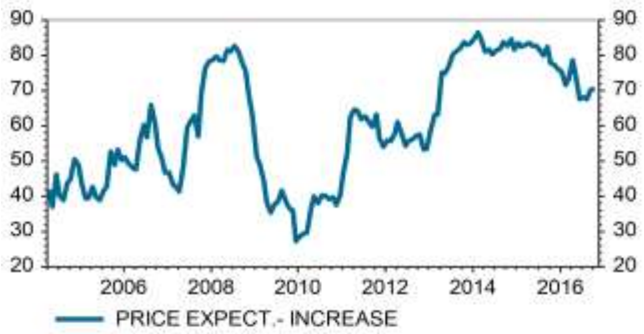
Source: Thomson Reuters-Datastream

Fig. 7 – Trade balance finally in positive territory thanks to the fall in energy prices



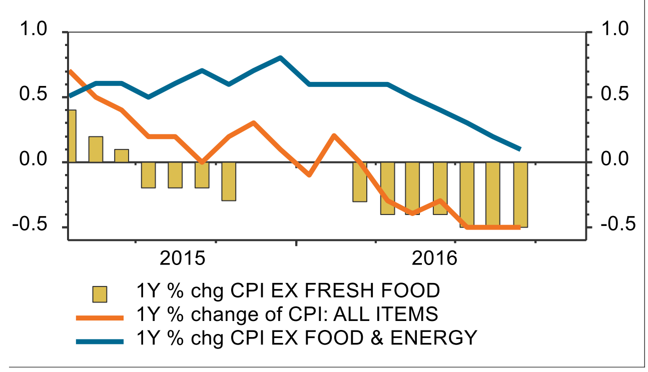
Source: Thomson Reuters-Datastream

Fig. 8 – Decline in percentage of households expecting price rises



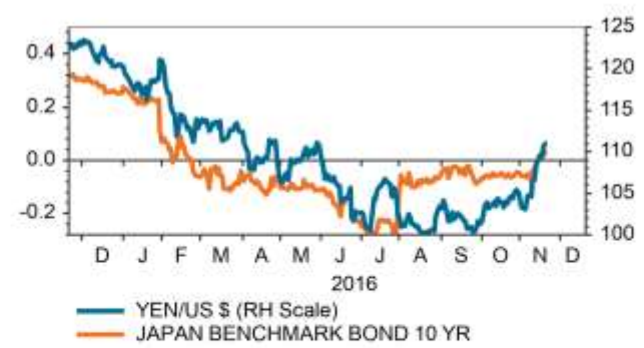
Source: Thomson Reuters-Datastream

Fig. 9 – Core inflation towards zero



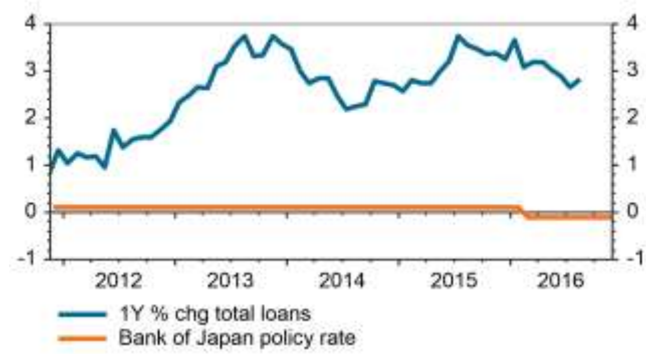
Source: Thomson Reuters-Datastream

Fig. 10 – Yen: Trump managed it where the BoJ couldn't!



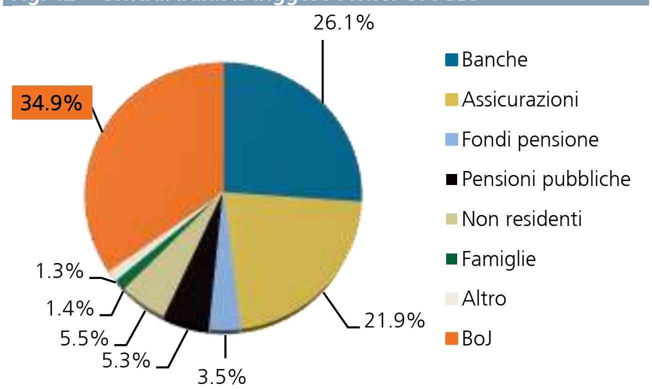
Source: Thomson Reuters-Datastream

Fig. 11 – The BoJ's ineffective toolkit



Source: Thomson Reuters-Datastream

Fig. 12 – Central bank is biggest owner of JGBs



Note: figures at end-June 2016; total JGBs: JPY 987.4Trn
Source: Ministry of Finance

China: the focus is back on risk management

Silvia Guizzo

- **Chinese GDP again rose by 6.7% yoy in the third quarter,** with quarterly growth of 1.8% qoq compared with 1.9% in 2Q. On the supply side, growth remained stable in the industrial and services sectors and accelerated in the farming sector. On the demand side, the contribution from foreign trade is likely to have again been negative due to the increase in the balance of services deficit, while a slight slowdown in private consumption and investment is likely to have been accompanied by an acceleration in public spending.
- **The last two months' figures**, together with the manufacturing and services PMI indices for November, have generally **confirmed the improvement under way in economic activity**, which is still supported by fiscal and monetary policy. **We therefore revise up our growth forecasts from 6.5% to 6.7% for 2016.**
- Economic and fiscal policy will probably continue to be the main tool for boosting growth towards the government's targets in the next year, and monetary policy will probably remain moderately accommodative. **Social and economic stability** will **still be important objectives in 2017, a politically important year**, given the expected reshuffle in the Politburo Standing Committee at the **19th National Congress of the Communist Party** in autumn 2017. Five of the seven members of the Committee (not General Secretary Li and President Xi) will reach retirement age and should be replaced with people who are politically close to President Xi Jinping.
- **Control of financial risk is, in any event, one of the regulators' highest priorities**, as can be gleaned from statements since the summer, the regulatory interventions in various areas of the banking and non-banking financial sectors, and the renewed focus on cooling the property market in the last few months. Equally important, and also included in the authorities' main objectives, are the reform of state-owned companies, which until now has mainly been achieved via mergers and acquisitions rather than by restructurings or defaults, as well as the restructuring of local government debt and a reduction in non-performing loans. **The desire not to fuel further economic imbalances** will reduce room to manoeuvre in terms of fiscal and monetary policy compared with 2016; **this will lead to slowing credit growth, which will reduce support to investment**.
- We expect that resilient investment in public infrastructure and services – which the government is keeping in its sights – will not manage to offset a new slowdown in investment in real estate and manufacturing. **We therefore maintain a scenario in which growth slows to 6.4% in 2017 and to 6.1% in 2018.**

Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
GDP (constant prices)	7.8	7.8	7.3	6.9	6.7	6.4	6.1
Private consumption	9.6	7.9	8.2	7.6	7.5	7.1	6.9
Public consumption	6.2	5.1	3.7	9.5	17.1	8.4	6
Fixed investment	8.7	9.3	6.9	7.5	5.6	4.5	4.5
Exports	5.8	7.9	8.6	0.6	2.2	3.8	4.6
Imports	6.6	10.6	8.7	1.5	3.6	3.2	5.3
Industrial output	8.4	8	7.4	6.1	6	5.2	4.8
Inflation (CPI)	2.6	2.6	2	1.4	2.0	2.4	2.0
Unemployment rate (%)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Average salaries	14.4	11.8	10.8	9.5	8.3	7.7	7.5
90-day interbank rate (average) (%)	4.2	4.9	4.8	3.8	2.9	3	3.2
USD/CNY exchange rate (average)	6.31	6.15	6.16	6.28	6.64	7.09	7.15
Current account balance (CNY Bn)	1360	912	1713	2077	1561	1228	920
Current account balance (% of GDP)	2.5	1.5	2.7	3.0	2.1	1.5	1.1
Budget balance (% of GDP) *	-3.4	-3.5	-3.6	-4.4	-4.6	-4.7	-4.4

N.B.: Percentage change versus previous period – except where otherwise indicated; *IMF Article IV August 2016.
Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Real economy and inflation

Chinese GDP again rose by 6.7% yoy in the third quarter, with quarterly growth of 1.8% qoq compared with 1.9% in 2Q. On the supply side, growth remained stable in the industrial and services sectors but accelerated in the farming sector. On the demand side, the contribution from imports and exports is likely to have again been negative due to the increase in the balance of services deficit, while a slight slowdown in private consumption and investment is likely to have been accompanied by an acceleration in public spending.

The last two months' figures, together with the PMI indices for November, have generally **confirmed the improvement under way in economic activity**, which is still supported by fiscal and monetary policy. **We therefore revise up our growth forecasts from 6.5% to 6.7% for 2016.**

Domestic and international cargo traffic continued to rise, while passenger traffic remained stable. Seasonally-adjusted **import and export figures** continue to confirm the signs of improvement. The recovery in the foreign orders component of the PMI is positive but still modest compared with the early-year lows, with an average still below 50; this is similar to Hong Kong, South Korea and Malaysia but different from other Asian countries where it has already been above 50 for some months. Exports (+5.9%, 3m, yoy in October) are still being penalised by the fall in prices, due partly to the downward adjustment to the dollar price following the depreciation of the renminbi; meanwhile the recovery in commodities prices boosted the nominal performance of imports (+1.2%, 3m yoy in October), which therefore also improved in volume terms. Specifically, the recovery in imports of goods for processing and re-export points to a moderate improvement in the performance of exports in the next few months.

Growth in **industrial output stabilised** at 6.1% yoy in September and October thanks both to private sector production and a favourable base effect. Production of commodities and electrical machinery is improving. The increase in activity is also confirmed by electricity consumption (+7% yoy), which is also particularly strong in the services sector and in the private sector for residential use. The increase in internal orders points to a consolidation in industrial output during the third quarter. The improvement in the performance of the manufacturing PMI, which is more pronounced in the National Bureau of Statistics survey, continues, however, to be driven by large companies. The breakdown records a moderate improvement in the conditions for SMEs compared with the early-year lows, but the index is still below 50 for these companies, and worsened in October.

Nominal capital investment recorded a slight acceleration in September and October (+8.3% cum yoy in October vs 8.1% in August), driven by investment in residential and non-residential property development, and by the moderate upturn in private investment. The latter is supported by investment in the farming and industrial sectors, which continue to grow at high rates, offsetting the decline in the services sector under way since June (-12.5% cum yoy in October). Investment in state-owned companies, although slowing slightly, continues to record solid growth rates (+20.5%). Investment in the manufacturing sector rose by 3.1%, unchanged on the previous month. **In real terms**, though, **investment** slowed slightly due to the rise in production price inflation.

The NDRC continued to approve new **infrastructure projects** in the transport (especially rail), energy, water conservation and high-tech sectors. New measures were approved to support investment – such as the extension of access for private investors (e.g. in the civil aviation sector) and the promotion of public-private partnership projects (via the creation of a guarantee fund) – and private consumption, as well as **to expand the range of services in the services sector**, such as tourism, the arts, care of the elderly, education and professional training. Specifically, the tax benefits for high-tech companies that provide services were extended to other cities. Measures to boost innovation and investment in rural areas, including incentives and social benefits for migrant workers, were also approved. In early December, the NDRC published new guidelines for inward foreign direct investment, removing many restrictions in tourism and entertainment, but also in some manufacturing sectors such as wheat processing or the production of motorcycles. The Commission also included among the types of "encouraged investment" the production of electric cars and car components, and new energy. Recently, the Ministry for Industry and Information Technology published the new five-year plan for the development of intelligent manufacturing.

In 2016, growth was shored up by the recovery in both the property sector and investment in infrastructure by the state sector, which boosted retail sales and industrial output in the residential building-allied industry and infrastructure. Investment in the contruction sector, however, recorded a fall of 5% yoy in the first ten months of 2016 after a 10.2% rise in 2015, dragged down by the contraction in private investment (-12.5% cum yoy). There are still some weak areas in the property market, which will again have an adverse effect on the short- to medium-term outlook in the sector: unsold housing stock is still high, especially in third-tier cities, and accessibility, although improving, is still, on average, very poor for rural families and for the lowest income bands in urban areas. Market participation in the last year also seems to be partially driven by speculative intentions, which pushed up prices by over 40% in the last 12 months in first-tier and many second-tier cities and increased the albeit low household debt[26].

The authorities are acting very cautiously, especially at local level, as they attempt, on the one hand, to limit speculation in first- and second-tier cities and, on the other, to reduce the stock of unsold housing in third-tier cities. Nationally, measures are aimed at slowing the use of credit by entrepreneurs. We think that these measures will help curb rising prices within three to six months. The slowing outlook and probable difficulties of small property companies will curb the recent recovery in investment in the property sector and will lead to a new deceleration next year.

Nominal retail sales recorded growth of 10% yoy in October, slightly below the figure of 10.7% in July; monthly growth is still slowing slightly but is close to 0.8% mom, boosted by improved consumer confidence. In real terms, the performance of retail sales is solid although it hit its early-year low in October (+8.8%) due to the rise in inflation. Online sales continue to rise at a high rate (+24.5%); car sales are trending similarly. The latter were boosted by tax incentives, which – unless they are renewed – will be withdrawn at the end of the year. Labour market conditions improved in recent months with an increase in the employment component of both the manufacturing and services PMI, a demand to supply ratio solidly above 1, albeit declining slightly in the coastal regions, and an urban unemployment rate stable at 4.0%. Other indicators, however, continue to point to a slowdown compared with recent years: the number of new jobs in urban areas only rose by 0.1% in the first three quarters of the year compared with the same period last year, and fewer unemployed people managed to find new employment. People employed in industrial companies fell by 2.5% and wages growth of migrant workers continues to slow (+5.9% in 3Q). The Labour Ministry is thought to be working to amend the Labour Contract Law, implemented in 2008, to make the employment market more flexible and reduce costs for companies.

Consumer price inflation rose to 2.3% yoy in November from its low of 1.3% yoy in August, mainly due to a strong unfavourable base effect and an uptick in prices in the food sector. The

[26] For more details, see China Economic Focus, dated 24 November 2016. "The real estate market – a new bubble?"

monthly trend shows an acceleration in services prices, especially medicines, housing services and fuel. Core inflation rose to 1.9%, just above July levels. Production price inflation returned to positive territory from September, jumping to 3.3% yoy in November, after nearly four and a half years of year-on-year falls. It will continue to rise in the next few months, but the expected slowdown in economic growth will curb its potential to increase and to be transmitted to consumer prices. A favourable base effect (largely in the second half of 2017) will be partly offset by upward pressure from rising fuel prices and the depreciating exchange rate. We therefore expect that **consumer price inflation** will rise to **2.4% in 2017 and then return to around 2% in 2018.**

Monetary and lending policy

Growth in new **bank loans** slowed in the last few months in line with seasonal performance while the figures for social financing accelerated slightly. In terms of loan stock, both aggregates accelerated slightly compared with the **summer** months (13.1% for loans and 12.7% for social finance). A large part of the acceleration in lending came from **long-term loans to households** which reported a rise in stock of 30.4% yoy in October, much more than the 11% rise in long-term loans to companies. The mortgage stock rose by 33.5% in 3Q while the stock of loans to property entrepreneurs slowed considerably to 7.6%, from a peak of 24.1% in 1Q15; short-term loans slowed at the same time. The total credit stock, including government securities issues, increased steadily at around 17%.

New loans remained stable and new social financing accelerated slightly in relation to GDP in the last four to six quarters, continuing to support growth in the short term but leaving the medium- to long-term risks unchanged. The increase in debt (especially corporate debt) and **non-performing loans** (NPLs), which are still rising (+26% in 3Q), albeit at a slower pace than in 2015 (+51.2%), are still cause for concern, with the ratio of NPLs to total loans unchanged at 1.76% for the last three quarters. The slight fall in the ratio for the main commercial banks has, in fact, offset the increase that the small banks, and especially the rural banks, continue to record. **Special mention loans**, i.e. those that have not been repaid but that the banks not yet classify as non-performing, are also rising (+23.6% yoy in 3Q). These loans amount to more than twice the number of non-performing loans and, together with the latter, rose from 3.8% of GDP in 2Q14 to 6.9% in 3Q16.

The gradual phasing out of the programme of local government debt swaps, together with the measures intended to control financial risk (especially the scaling down of growth in lending to the property sector) and the continuing increase in non-performing loans will curb lending growth in the next few months. It is also adversely affected by weak demand from companies, which is at record lows, according to the PBOC's quarterly survey. We expect that the central bank will continue to **use open market operations and the medium- to long- term window**, as it has done in 2016, to maintain an abundant supply of liquidity, and that it will make cuts to the reserve requirement only if growth slows more markedly than expected so as not to trigger further downwards pressure on the renminbi.

In the last two months, the competent authorities have further **regulated** the **online platforms** for peer-to-peer loans, and the PBOC has announced that it will change its prudential assessment system to take account of **off-balance sheet assets** in assessing the state of health of commercial banks[27]. Specifically, it will include wealth management products (WMPs), which are often sold by banks but not accounted for in their balance sheets, in its assessment. The amount of WMPs in circulation has steadily risen from 23.3% of GDP at the end of 2014 to 37.1% in 2Q16, despite the authorities' attempts, on several occasions, to regulate the sector.

[27] The system includes loans, investments in bonds and equities, buybacks of financial assets sold and deposits with non-banking financial institutions.

In October, the State Council approved the creation of an inter-ministerial committee to coordinate actions intended to reduce the level of corporate debt and to implement the debt-to-equity swap programme according to new guidelines following on from those published in July by the State-owned Assets Supervision and Administration Commission (SASAC). The latter reiterate that highly-leveraged companies that could potentially exacerbate the problems of excess production capacity and increasing inventory should not take part in the programme. However, they also emphasise that highly-leveraged companies that are strategically important and play a dominant role in the sectors suffering from excess capacity are encouraged to participate. It seems, therefore, that strategic importance and company size take precedence over debt levels or real prospects of improving performance, which in reality means there are very few large companies that are excluded from the programme. Moreover, banks are not permitted to directly hold portions of capital for companies. Banks must sell non-performing loans to external companies, generally asset management companies, including those specifically created for the purpose, or to insurance companies that will then convert the loans into portions of capital.

The new guidelines also encourage the conversion of corporate debt into convertible bonds rather than immediately into equities (loan to convertible bond swap), which generates savings for banks compared with direct conversion into equities or maintaining the non-performing loan on the balance sheet. The SASAC also intervened, by providing a capital injection, in the recent restructuring of Sino Steel. The convertible bonds or equities may then be sold to other Chinese and foreign investors. The programme therefore spreads the cost of the debt restructuring, which, as things stand, theoretically has an adverse effect only on the banks, between the public and private sector, i.e. between government, companies, banks and ultimately households (if they can purchase equities involving swaps or associated financial products). Although spreading the risk is positive, transferring risk to the private sector is limited given the state's high level of ownership of banks and companies. The functioning of the programme will therefore depend both on the market's role in pricing the loans and the prospects of the companies involved for improving their balance sheets.

The programme does not therefore solve the problem of the rising corporate debt nor that of companies' inefficiency, which has partly been left to the state-owned companies' restructuring programme. At the end of September, a private equity fund with capital of CNY 350Bn was created for restructuring state-owned companies, which will be managed by the SASAC. The NDRC published new guidelines on this in October to encourage mergers and restructurings in key industries. These advocate cross-regional mergers and acquisitions between companies, and private sector holdings in companies' share capital, including employee share schemes. More details and a list of the top state-owned enterprises that fall within this mixed ownership system should be published by the end of the year. Seven sectors are involved: oil, electricity, gas, rail, civil aviation, telecommunications and defence. Moreover, in early December, the finance ministry announced preferential tax treatment for companies that are being restructured (bankruptcies, mergers and acquisitions, insolvency liquidations); this includes payment of taxes in instalments and the extension of deadlines, as well as exemption from VAT for transactions relating to capital goods or land use rights.

According to official press agency Xinhua, in November, the State Council announced a precautionary emergency plan for local governments, which classifies potential financial difficulties under four categories. Local governments must undertake fiscal rebalancing if annual interest expenditure or debt is more than 10% of budget spending or if the interest on special debt is 10% more than government budgetary funds.

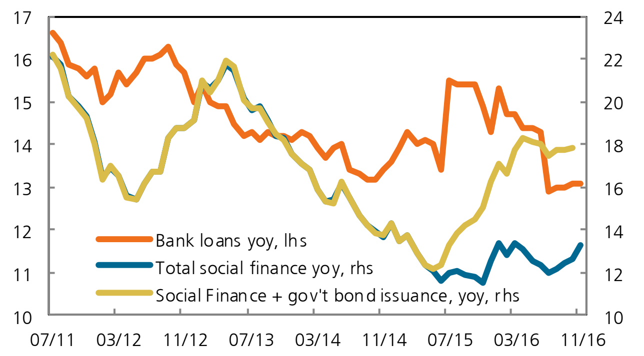
The desire not to fuel further economic balances will reduce room to manoeuvre in terms of fiscal and monetary policy compared with 2016; this will lead to slowing credit growth, which will reduce support to investment. We expect that resilient investment in public infrastructure and services –which the government is keeping in its sights – will not manage to offset a new slowdown in investment in real estate and manufacturing. **We** therefore **maintain a scenario in which growth slows to 6.4% in 2017 and to 6.1% in 2018.**

After a period of stability at around 6.62-6.70 during the summer, the USD/CNY **exchange rate** began to depreciate again from the second half of October, reaching a peak of 6.95 in mid-December. The depreciation was largely driven by the dollar's movements following the revision of expectations regarding Fed rate hikes, which was even more marked after the results of the US elections. Foreign currency reserves fell more rapidly in October (-USD 45.7Bn) and November (-USD 69Bn), partly due to the measures to support the exchange rate and partly due to the appreciation of the greenback. The PBOC continues to inject liquidity into the markets but via longer-term operations, alongside 7-day, 14-day and 28-day reverse repos, and, above all, using the medium- to long-term (three months) refinancing window. From mid-November, in line with the reversal of the international markets, yields on the government curve rose by approximately 30 basis points, and money market rates again started to rise.

The **USD/CNY exchange rate** will continue to be **under pressure at the end of the year**, and even more so when the annual quota of foreign currency purchases granted to individuals (USD 50,000) is renewed in January and the seasonal increase in demand for tourism materialises at the time of the Chinese New Year festivities (27 January – 3 February). However, we think it is possible that the exchange rate could **go above the threshold of 7.15** and then undergo a new phase of depreciation in 2017 **only if the dollar strengthens further**, on the back of a new upwards revision of US growth expectations and FED hikes, **or** in the event of a **downgrade in expectations of Chinese growth with a worsening of fears of a domestic financial crisis.**

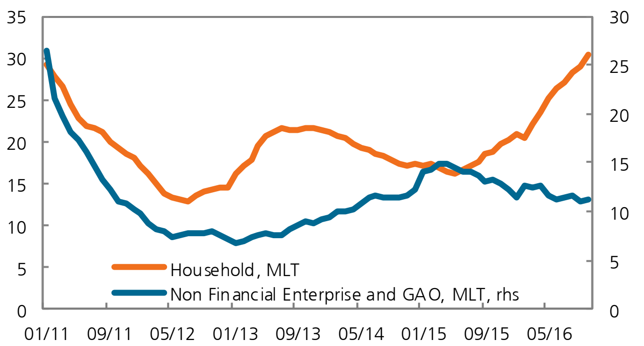
The PBOC will continue to intervene to prevent the currency from depreciating too sharply and rapidly against the dollar, but the pressure on capital outflows could prove too costly **to tackle. It is reasonable to assume that, in the event of strong pressure** on capital outflows, the process of liberalising the financial accounts will slow in comparison with the initial plans, and that, as well as intervening on the market to protect the exchange rate, **the PBOC will also introduce measures to try to restrict capital outflows in order to limit the "consumption" of reserves.** The process of liberalising the capital account continues to move forward as shown by the recent launch of the Shenzhen-Hong Kong Connect programme, which accompanies the Shanghai-Hong Kong Connect, as well as the renewal or signing of new swap programmes with other central banks and the designation of clearing banks (in the US in September). In addition to the unconstrained growth of credit, the **recent interventions** relating to the limiting of FDI Outflows to no more than USD 10Bn, banking control of transactions of over USD 5Bn on the financial and capital accounts, and the restriction of off-shore loans in renminbi and purchases of insurance products in Hong Kong all go some way towards the greater control of capital flows.

Lending accelerates slightly



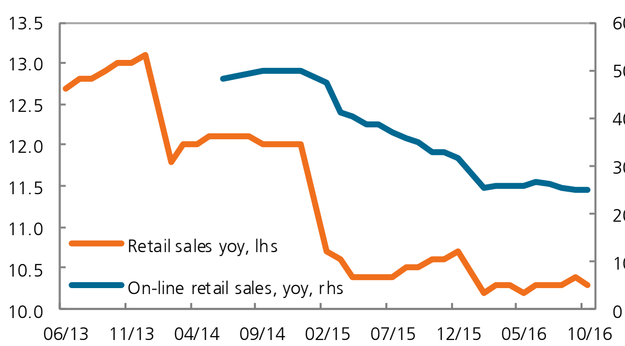
Source: CEIC and Intesa Sanpaolo data

Credit growth led by mortgages to households



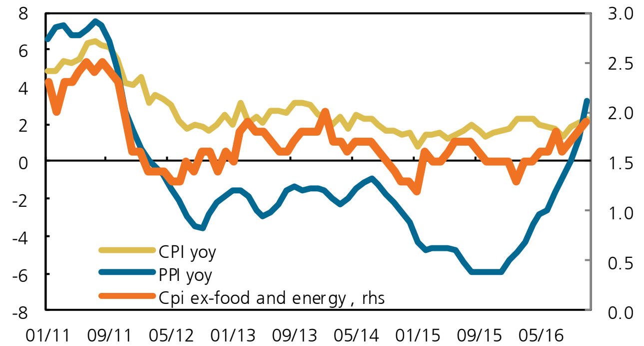
Source: CEIC

Nominal retail sales



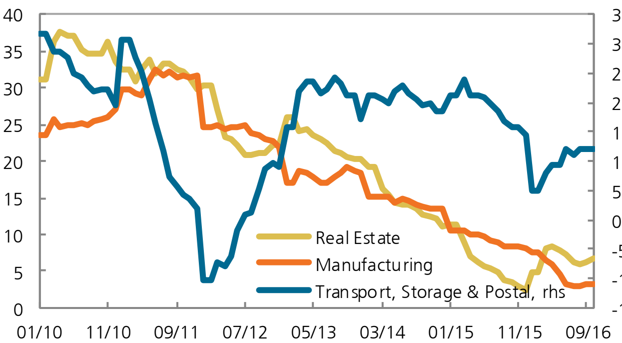
Source: CEIC

Inflation



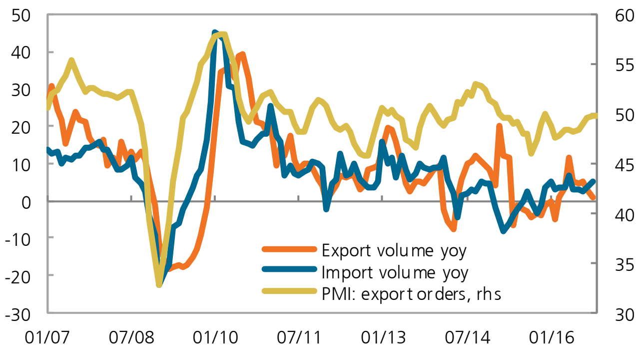
Source: CEIC

Nominal investment



Source: CEIC

Foreign trade



Source: CEIC, Markit

Focus: the renminbi will continue to depreciate in the next months

Chinese economic data in the last few months continued to point to a moderate improvement in the economy, leading to slight upwards revisions of the growth forecasts for 2016 and 2017; the consensus now sees growth at 6.7% for 2016 and 6.4% for 2017, from the previous figures of 6.5% and 6.2-6.3%. After a period of stability at around 6.62-6.70 during the summer, the renminbi began to depreciate again from the second half of October, reaching a peak of 6.95 in mid-December. Depreciation was largely driven by the dollar's movements following the revision of expectations regarding Fed rate hikes, which was even more marked after the results of the US elections. The nominal effective exchange rate, however, remained broadly stable.

Our forecast scenario sees a further depreciation in the **USD/CNY** exchange rate in the next few months, **peaking at 7.15 at end 2017**, in tandem with the appreciation of the dollar against the other currencies caused by the Fed hikes, and a **subsequent stabilisation**. The scenario is based on the assumption that the dollar will continue to strengthen, above all in the short term, and that the market is factoring in no more than three Fed hikes in 2017. We expect that the fiscal stimulus announced by President-elect Trump will be scaled down compared with the programme announced during the electoral campaign and that the implications for growth are still modest in 2017 and more visible in 2018. The **EUR/CNY** exchange rate is likely to **depreciate from 7.24 at end-2016** to around **7.88 at end-2017** in line with the depreciation of the dollar vs the euro, which should push the EUR/USD exchange rate up from a minimum of 1.04 at end-2016 to 1.10 at end-2017.

The **USD/CNY exchange rate** will continue to be **under pressure at the end of the year**, and even more so when the annual quota of foreign currency purchases granted to individuals (USD 50,000) is renewed in January and the seasonal increase in demand for tourism materialises at the time of the Chinese New Year festivities (27 January – 3 February). We think it is possible that the exchange rate could **go above the threshold of 7.15** and then undergo a new phase of depreciation in 2017 **only if the dollar** strengthens further on the back of a **new upwards revision of US growth expectations and Fed hikes, or** in the event of a **downgrade to expectations of Chinese growth with a worsening of fears of a domestic financial crisis.**

We think that the US' attitude towards China could be less harsh than that stated by the newly-elected president during his electoral campaign. China's current account balance fell from a peak of 10% in 2007 to 3% in 2015, while the real effective exchange rate has appreciated by 33% since mid-2005 (when it was unpegged from the dollar), and by 13.7% in the last five years. In August 2015, the FMI stated (2015 Article IV Consultation, China IMF Country Report No. 15/234) that the substantial appreciation in real terms took the exchange rate to a level that "could no longer be considered as undervalued". The real effective exchange rate then depreciated by 7.9% from November 2015 (at its historic high) to October 2016.

The gradual increase in the role of market forces in determining the exchange rate, along with the appreciation against the currencies of the main advanced export markets, not to mention the other Asian currencies, prompted the Chinese authorities in autumn 2015 to declare they wanted to focus more on the **effective exchange rate.** In mid-December 2015, the PBOC announced the publication of a **nominal effective exchange rate index, based on a basket of currencies**, for which it published the composition and weightings in line with the international practice of other central banks, to provide the markets with a tool for assessing the renminbi that is broader and more comprehensive than for just the CNY/USD exchange rate. According to this basket, the nominal effective exchange rate appreciated by 17.5% between mid-2010 and its high in mid-April 2015, after which it depreciated by 8.1%.

We still think that the **Chinese authorities have no interest in fuelling expectations of a sudden and/or continuing depreciation of the currency against the dollar**, which could trigger higher capital outflows and that there **are no reasons to support a competitive devaluation**.

Exports could derive much less benefit than in the past from an effective exchange rate as the **slowdown in exports in Asian countries seems to be largely structural**. Recent analysis, in fact, contains increasingly strong evidence that the reasons are due to the change in composition of the demand of trading partners, due both to the now mature phenomenon of delocalisation and the development of global production chains in Asia, and to the lower propensity to spend in Western countries. A competitive devaluation, quite apart from achieving dubious results, would upset neighbouring countries, competitors on many markets, and could potentially trigger a "currency war". Moreover, despite the greater domestic content of exports' added value compared with the past, the **foreign content** remains **considerable in many sectors**, and a depreciation of the effective exchange rate could have a negative impact, making imports more expensive. A marked depreciation against the dollar would also cause **difficulties for companies indebted** in this currency and undermine **the purchasing power of the middle class**, which is increasingly interested in high-quality consumer goods from abroad.

The renminbi seems to be more affected by capital flows than in the past and is therefore likely to be more volatile. The transition of the financial current account balance into negative territory in mid-2014 (with a net capital outflow) might not be temporary. This is being driven by both the greater opening of the account than in the past, as a result of the programme of gradual financial liberalisation implemented by the authorities, and the need for greater diversification of the portfolios of Chinese investors, which increases during periods of lower economic growth expectations and falling yields.

Until now, the outflow of capital has mainly been connected with the "other investment" item, which represents a large proportion of the capital outflows in China's balance of payments. This related, in particular, to the reduction in commercial and other loans granted by non-residents. Added to this item, there is also an increase in outflows of foreign direct investment (FDI) due to Chinese companies' drive to acquire foreign companies, supported by the political authorities, and a slowdown in FDI inflows. In the first quarter of 2016, outflows exceeded inflows for the first time (in the first three quarters of 2016, FDI outflows totalled USD 176.4Bn compared with inflows of USD 98.4Bn). The trend was similar, although less pronounced, for portfolio investment. However, it is by no means certain that capital movements are likely to be only outflows in the future. The greater opening of the equities and bond markets to international investors will lead to **China's inclusion in the main international equity and bond indices** with gradually increasing proportions, which, in turn, will also trigger capital inflows. For this reason, too, apart from the depreciation of the dollar, **we think that the USD/CNY exchange rate could stabilize in 2018 instead of continuing along a path of depreciation.**

Foreign currency reserves hit a high of almost USD 4Trn in June 2014. Capital outflows and measures to support the currency caused a fall in foreign currency reserves of USD 180Bn dollars in 3Q15, USD 184Bn in 4Q15 and USD118Bn in 1Q16. Subsequently, they fell to a less sustained pace and then settled at USD 3,056Bn at end-November 2016, from USD 3,220Bn in 1Q16. Foreign currency reserves fell more rapidly in October (-USD 45.7Bn) and November (-USD 69Bn), due partly to the measures to support the exchange rate and partly to the appreciation of the greenback. Even if they were to fall by USD 100Bn a month in the next 12 months (close to the figure of USD 108M, the maximum monthly fall recorded in December 2015) to reach around USD 2,100, this would still be appropriate, according to a series of parameters used by the IMF, for a country with a semi-flexible exchange rate system with controls on the capital movements of both residents and non-residents.[28]

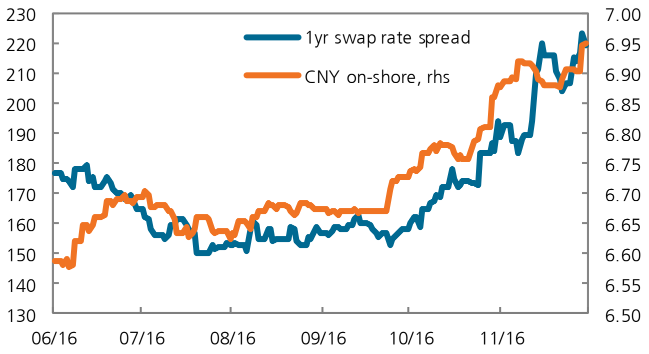
We think that the PBOC will continue to intervene to prevent the currency from depreciating too sharply and rapidly against the dollar, but the pressure on capital outflows could prove too costly to tackle. **It is reasonable to assume that, in the event of strong pressure** on capital outflows, the process of liberalising the financial accounts will slow in comparison with the initial plans, and that, as well as intervening on the market to protect the exchange rate, **the PBOC** will also **introduce measures to try to restrict capital outflows** in order to limit the "consumption" of reserves.

The process of **liberalising the capital account continues to move forward** as shown by the recent launch of the Shenzhen-Hong Kong Connect programme, which accompanies the Shanghai-Hong Kong Connect, as well as the renewal or signing of new swap programmes with other central banks and the designation of clearing banks (in the US in September). The **recent interventions** relating to the limiting of FDI outflows to no more than USD 10Bn, banking control of transactions of over USD 5Bn on the financial and capital accounts, and the restriction of off-shore loans in renminbi and purchases of insurance products in Hong Kong all go some way towards the **greater control of capital flows** and, besides, credit growth.

If the **USD/CNY exchange rate depreciates up to 7.15 in 2017**, and the dollar peaks vs euro at 1.03 between the first and second quarters of 2016 and then starts depreciating again in the second half of the year but keeps appreciating towards the yen, **the nominal effective exchange rate** (CFETS basket) **will return on mid-2014 values,** with a depreciation of around 5.1% compared with current levels.

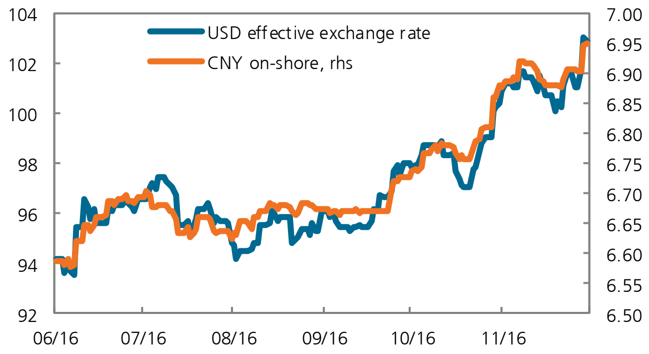
[28] See China, Economy Focus, dated 5 February 2016.

USD/CNY and China-USA interest rate spread (bps)



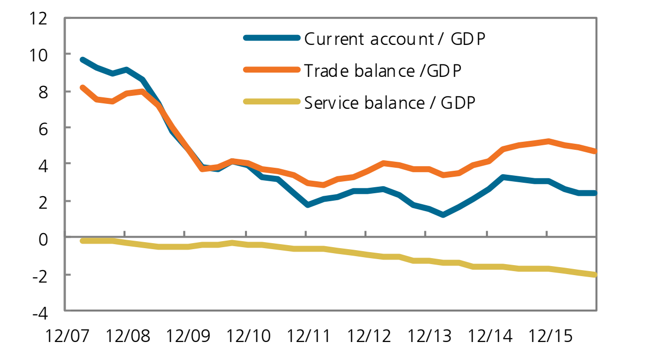
Source: Bloomberg

USD/CNY and USD nominal effective exchange rate



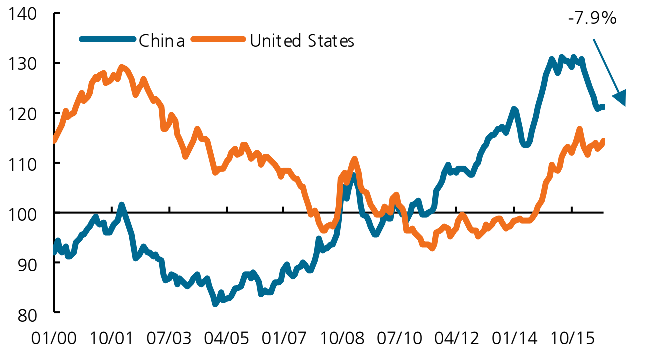
Source: Bloomberg

Current account balance (%)



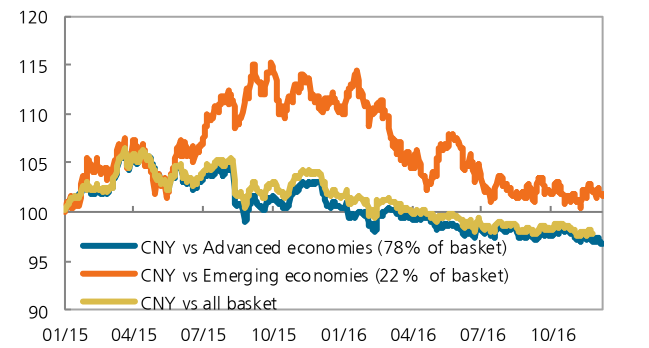
N.B.: four-quarterly moving averages. Source: CEIC

Real effective exchange rate



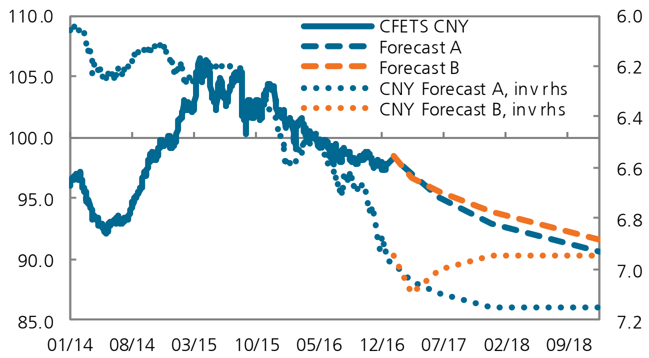
Source: BIS data taken from CEIC

Nominal effective exchange rate



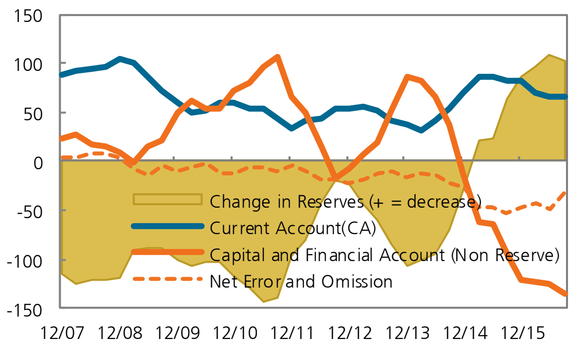
Source: Intesa Sanpaolo chart based on Bloomberg data

USD/CNY forecasts and nominal effective exchange rate



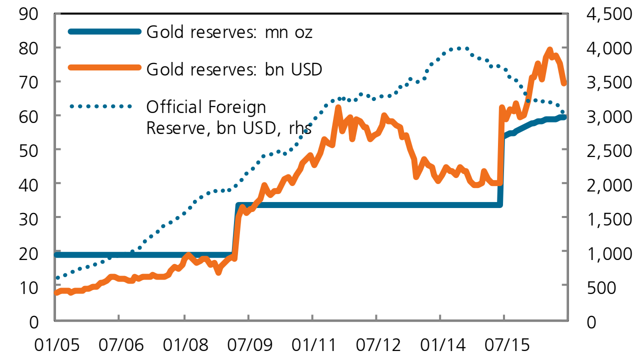
Source: Intesa Sanpaolo chart based on Bloomberg data

Change in reserves and financial account (USD millions, 4-quarterly moving average)



Source: CEIC

Foreign currency reserves



Source: CEIC

India: demonetisation has a temporary impact, but the outlook for investment remains weak

Silvia Guizzo

- **GDP growth** accelerated to 7.3% in the third quarter, from 7.1% in the second quarter, buoyed by the **acceleration in consumption**, particularly private consumption, and by another positive contribution from foreign trade. Fixed investment declined in terms of the trend (-5.6% yoy) for the third consecutive quarter, as did investments in valuables. Value-added GDP, however, decelerated to 7.1% because the **rebound in the agricultural sector** failed to offset the slowdown in the industrial and services sectors.
- The increase in non-performing loans and the recapitalisation difficulties of the Indian banks still point to a slowdown in credit. The **prospects for recovery in investment** are therefore **still weak** in the current quarter and uncertain for next year, although the recovery in public investment and machinery imports suggest a **modest upturn in 2017**.
- The shortage of high-frequency consumption statistics makes it **hard to assess the economic impact** of the recent withdrawal of banknotes. However, **the effect may have been significant, particularly for the services sector, as evidenced by the drop in the PMI**. The maintenance of consumer and business confidence and expectations, exceptions for certain types of essential goods and services (such as medical expenses, tax payments, transport tickets, milk and wedding costs) and incentives for e-payment and for opening online accounts (in line with the objectives of demonetisation, dissemination of financial services and the Aadhaar law), suggest that **the impact on consumption and the services sector is temporary and confined to the fourth quarter**. **We are therefore revising our GDP forecasts for 2016 downwards, from 7.5% to 7.1%.**
- **Consumption** in the coming quarters will **nevertheless still be supported** by the positive performance of the agricultural sector and harvests and the increase in pensions for military personnel and salaries of civil servants (as per the VII Pay Commission), who in August also received amounts in arrears from previous months. The **strong growth in consumption and the moderate recovery in investment should give a slight boost to GDP, to 7.2% in 2017 and 7.3% in 2018**.
- Despite the persistence of core inflation, total **inflation** should remain **contained** and in line with the objectives of the Reserve Bank of India (RBI) for March 2017 (5%). A favourable base effect for much of the year, a decrease in food prices and a moderate increase in fuel prices should bring inflation **to 4.7% in 2017, and just under this figure in 2018, and allow the central bank to make another cut of 25bps** in the first half of the year.

Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
GDP (constant prices)	5.6	6.3	7	7.2	7.1	7.2	7.3
Private consumption	6.7	5.7	6.7	7	7.3	7.3	8.2
Public consumption	4.6	2.2	9.5	0.9	9.9	6.8	7.5
Fixed investment	2.3	7.4	2.8	5.8	-2.5	5.9	6
Exports	10	4.4	7	-6.3	3.5	4.1	5
Imports	11.3	-6	0.5	-3.9	-2.6	3.2	5.9
Industrial output	0.7	0.6	1.8	3.2	0.3	3.6	6.1
Inflation (CPI)	9.4	9.9	6.6	4.9	5.0	4.7	4.5
Unemployment rate (%)	5.6	5.6	5.6	5.5	5.6	5.7	5.5
Average salaries	19.3	11.2	10.7	10.4	10.1	9.7	10.1
3-month Mibor (average) (%)	9.5	9.3	9.1	8	7.2	6.8	7
USD/INR exchange rate (average)	53.5	58.6	61.0	64.2	67.2	67.3	63.9
Current account balance (INR Bn)	-4893.2	-2779.6	-1661.2	-1450.6	-579.7	-771.9	-716.2
Current account balance (% of GDP)	-5.1	-2.5	-1.4	-1.1	-0.4	-0.5	-0.4
Budget balance (% of GDP)	-5.5	-5.5	-4.3	-3.5	-3.8	-3.4	-3.4

NB: % changes versus previous period – except where otherwise indicated. Figures relate to the calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Real economy and inflation

GDP growth accelerated to 7.3% in the third quarter, from 7.1% in the second quarter, buoyed by the acceleration in consumption, particularly private consumption, and by another positive contribution from foreign trade. Fixed investment was on a downward trend (-5.6% yoy) for the third consecutive quarter, as was investment in valuables. Value-added GDP, however, decelerated to 7.1% because the rebound in the agricultural sector failed to offset the slowdown in the industrial and services sectors. Nevertheless, services grew strongly and steadily, at 8.9% yoy, and continued to make the biggest contribution to GDP growth. The slowdown in manufacturing was mainly due to an unfavourable base effect, which will also be an important factor in the fourth quarter.

The trend of moderate improvement in foreign trade continued during the autumn, particularly in terms of exports excluding oil, which returned to positive territory (+4.9% 3m yoy) in October, in line with the increase in the foreign orders component of the PMI. Imports excluding oil are still trending downwards (-3.9% 3m yoy in October) but have made a strong recovery from the lows seen in May (-16.2% 3m yoy). The biggest positive was the return to strong growth of machinery imports (+10.3% 3m yoy).

Industrial output has begun to fall again in recent months (-0.6% mom in October) pushed down by the continuing strong decline in the production of capital goods (-23.2% 3m yoy) and, albeit to a much lesser extent, the production of non-durable consumer goods. Excluding capital goods, industrial output rose by 2% 3m yoy in October, in line with previous months. In terms of sectors, production in the mining sector and the manufacturing sector continued to contract, while production of industrial raw materials improved (4.9% 3m yoy), driven by refining and cement production.

The monthly data for capital spending show that, although it began to rise again in the third quarter (+24% yoy) after contracting for two quarters, it decreased by 13.5% yoy overall in the first ten months of 2016. The number of investment proposals presented for approval to the Ministry of Industry went up by +19.6% yoy in the same period (compared with +8.4% in full-year 2015), and total investment also increased significantly (+44.2% yoy), thanks to an increase in monthly amounts in the second half of the year. According to the Center for Monitoring Indian Economy (CMIE), capital spending by private enterprises decreased for the third consecutive quarter, confirming that the contraction in investment has mainly come from the private sector.

According to the PMI survey, use of production capacity improved slightly, while according to the RBI's survey it was unchanged. In any case it is still well below pre-crisis levels. Lending was somewhat volatile during the summer months, and slowed slightly overall (+9.1% yoy in October, compared with 9.6% yoy in August). Lending to the services sector and personal credit continued to accelerate, while lending to industry contracted (-1.7% yoy in October), dragged down by a decline in lending to infrastructure. The increase in non-performing loans and the recapitalisation difficulties of the Indian banks still point to a slowdown in credit in the next few quarters. The prospects for recovery in investment are therefore still weak in the current quarter and uncertain for next year, although the recovery in public investment and machinery imports suggest a modest upturn in 2017, also sustained by a favourable base effect.

The manufacturing PMI has remained stable at between 52 and 53 in recent months, with a marked improvement in the domestic orders component, and to a much lesser extent in the foreign orders component, which, after peaking in September, decreased again, but remained above 51. According to the RBI's survey, order expectations remain positive but down in the fourth quarter compared with the peak in the third quarter, while the Dun & Bradstreet survey shows a marginal improvement. Both surveys show a slight decline in **business confidence** in the fourth quarter.

Auto sales continue to grow rapidly (+16.8% 3m yoy in October), driven by SUVs and two-wheel vehicles, as well as tourist arrivals (+11.7% 3m yoy in October) and revenues from tourism-related activities. The **consumer confidence survey** showed a significant improvement in general economic conditions, with an increase in both the assessment of the current situation and in expectations. More than 80% of respondents said that they had increased their current expenditure on durable and non-durable goods, and forecasts for spending within one year have remained high.

The survey, conducted between October 27 and November 13, does not appear to have been adversely affected by the **withdrawal from circulation of banknotes** of INR 500 (approx. EUR 6.7) and INR 1,000 (approx. EUR 13.4), which was announced without previous warning on November 8. The survey ended just a few days after the announcement, however, and might not have picked up any subsequent effects. However, another **consumer confidence survey**, conducted jointly by the BSE (Bombay Stock Exchange), CMIE and the University of Michigan and also providing daily assessments, **continued to record an increase** in both the indices for the current situation and for expectations until the first week of December. The withdrawal involved INR 13.3Bn, equivalent to 10% of GDP and 82% of the banknotes in circulation. The banknotes can be deposited in banks until December 31, in return for a maximum of INR 2,000 in new notes, with the remainder credited to the depositor's current account. ATM withdrawals have been restricted to INR 2,500 a day, and counter withdrawals to INR 24,000 a week. Deposits in excess of INR 250,000 may be subject to tax controls. Through this measure, the government intends to combat tax evasion and the financing of illegal activities. Cash is very commonly used in India, particularly in the informal sector and in rural areas, with the percentage of banknotes and coins in circulation at around 12% of GDP (M0), higher than in other major emerging countries such as China and Russia, where it is around 9%.

The shortage of high-frequency consumption statistics makes it **hard to assess the economic impact** of this measure. However, the effect may have been **significant, particularly for the services sector**: cash is mainly used in retail trading, food services, tourism and transport. The **services PMI dropped by nearly 8 points in November** (the sharpest decline since November 2008), to 46.5, due to a steep decline in the production and orders components. Expectations have remained high, however, rising by 3bps to 60.5.

The maintenance of consumer and business confidence and expectations, exceptions for certain types of essential goods and services (such as medical expenses, tax payments, transport tickets, milk and wedding costs) and incentives for e-payment and for opening online accounts (in line with the objectives of demonetisation, dissemination of financial services and the Aadhaar law), suggest that **the impact on consumption and the services sector is temporary and confined to the fourth quarter We are therefore revising our GDP forecasts for 2016 downwards, from 7.5% to 7.1%.**

In any case, **consumption** in the coming quarters will **still be supported** by the positive performance of the agricultural sector and harvests and the increase in pensions for military personnel and salaries of civil servants (as per the VII Pay Commission), who in August also received amounts in arrears from previous months. The **strong growth in consumption and the moderate recovery in investment should give a slight boost to GDP, to 7.2% in 2017 and 7.3% in 2018**.

Consumer price inflation decreased from the peak of 6.1% yoy in August to 3.6% yoy in November, pushed downward by the slowdown in food prices and a particularly favourable base effect. Inflation excluding food and fuel, meanwhile, rose from a low of 4.6% yoy in August to 5.0% yoy in November, due to the increase in the price of services, specifically health, transport and education. The various sub-sectors of services and goods, as well as fuel, are still trending upwards. The same considerations apply to other food goods. Wholesale prices are rising, particularly for food products (+10.5% yoy in October). Food prices tend to go down during the winter season, and we believe **that 2016 may end with annual average inflation of 5.0%**.

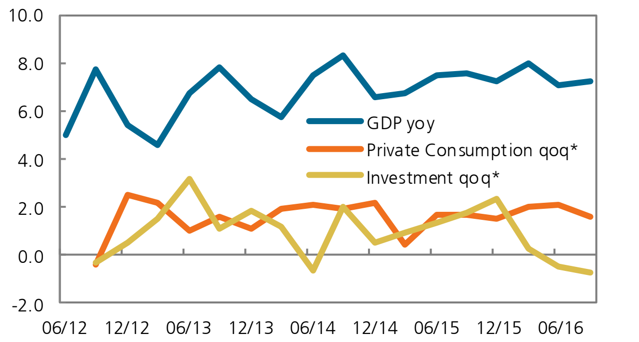
A favourable base effect for much of the year, a decrease in food prices and a moderate increase in fuel prices should bring inflation to 4.7% in 2017 and to 4.5% in 2018. Inflation risks remain on the upside, however, due to a possible increase in oil prices after the recent agreement by OPEC and non-OPEC countries to cut production, and due to import prices, if the rupee depreciates more than expected.

Monetary policy and exchange rate

Given the greater volatility on the international markets after the Fed revised its rate hike plans, the difficulty of assessing the economic effects of demonetisation and the increase in core inflation, the RBI **left interest rates unchanged at its meeting of 7 December**. The central bank expects that the impact of withdrawing the banknotes will be temporary and that it could lead to a fall in inflation of around 10 to 15bps in the fourth quarter. It therefore continues to forecast inflation of 5% at the end of March 2017, with upside risks due to the expected rise in oil prices, import prices and food prices, although there is still a great deal of uncertainty on all these fronts. The RBI has revised its growth forecast for value-added GDP from 7.6% to 7.1% for fiscal 2016-2017. Although it has confirmed its **accommodative stance**, the central bank is maintaining a **vigilant approach** until it can better assess the situation. We therefore still expect to see **another cut of 25bps in the first half of 2016**.

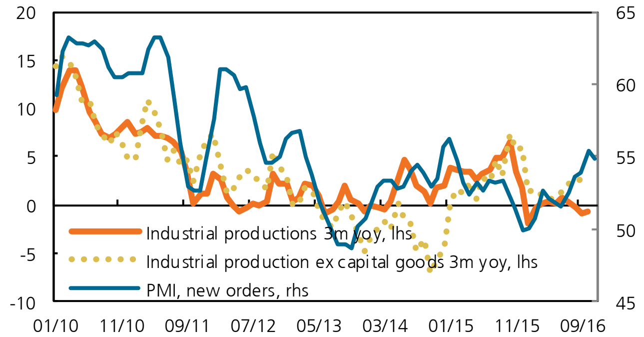
Foreign exchange reserves are still substantial, at USD 341Bn in November and close to the peaks of September (USD 347Bn), and the coverage rate for imports has continued to rise, reaching 9.4 months in October. The **rupee** has held up well against the general appreciation of the dollar, peaking at 68.77 in late November before returning to around 67, boosted by net inflows of foreign direct investment, which offset the outgoing portfolio flows. We reiterate that **the improvement in India's twin deficits and external position** compared with previous years will continue to support the exchange rate by preventing sharp depreciation, including in the event of another upwards revision of Fed rate hikes expectations.

Fig. 1 – Growth still sustained by consumption



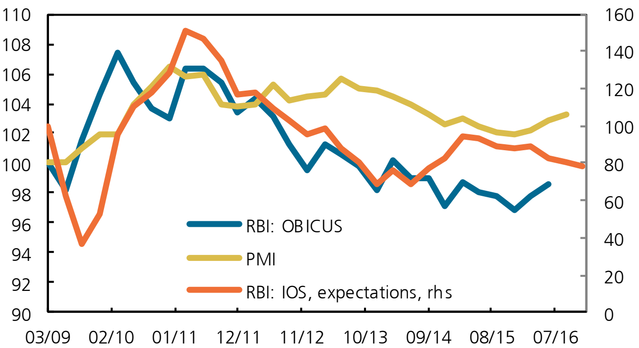
*Four-quarterly moving averages. Source: CEIC

Fig. 2 – The trend in industrial output remains weak but new orders are improving



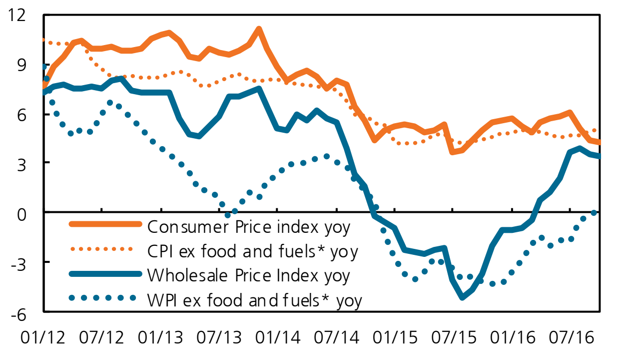
N.B. 3m moving average. Source: Markit, CEIC

Fig. 3 – Use of production capacity*



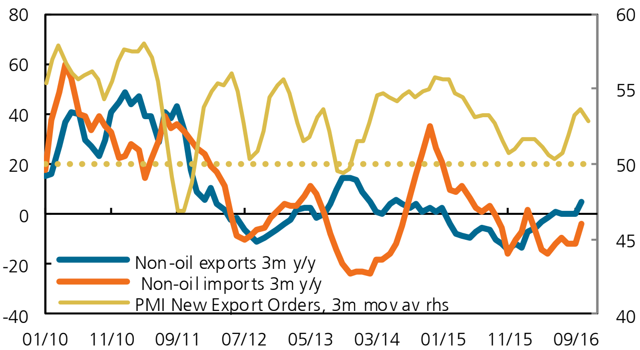
N.B.: (*) Four-quarterly moving averages. 1H2009=100. Source: Intesa Sanpaolo chart based on Reserve Bank of India data from CEIC and Markit

Fig. 4 - Core inflation is not falling



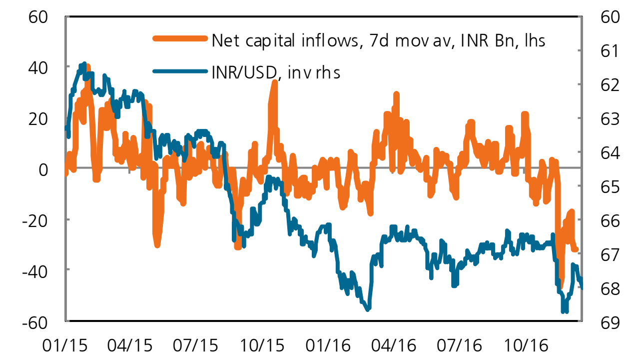
N.B.: (*) Intesa Sanpaolo estimates. Source: CEIC

Fig. 5 – Exports improving



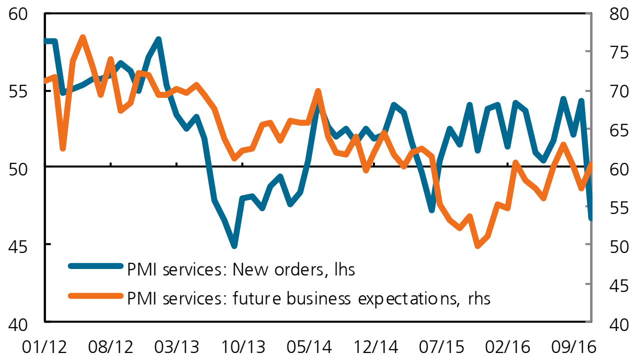
NB: 3-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Fig. 6 – The rupee holds



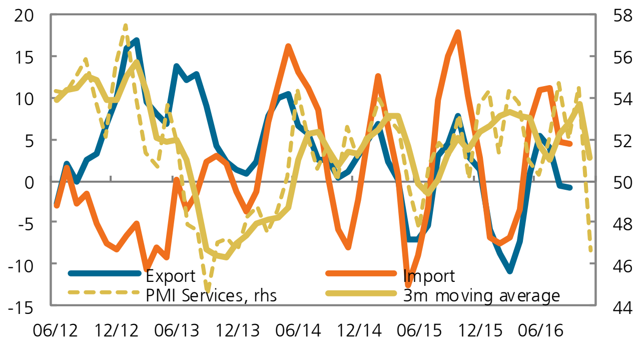
N.B.: (*) Net purchases of foreign institutional investors Source: CEIC

Fig. 7 – Services: orders component drops



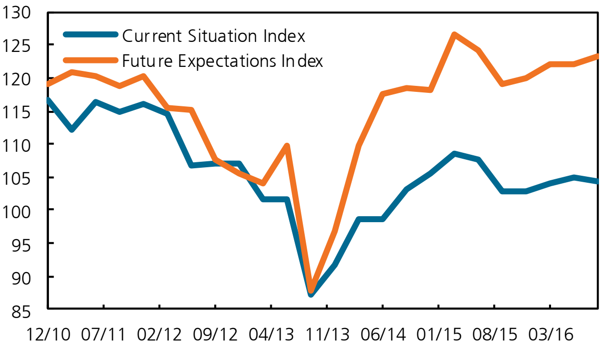
Source: Markit

Fig. 8 – Trade in services



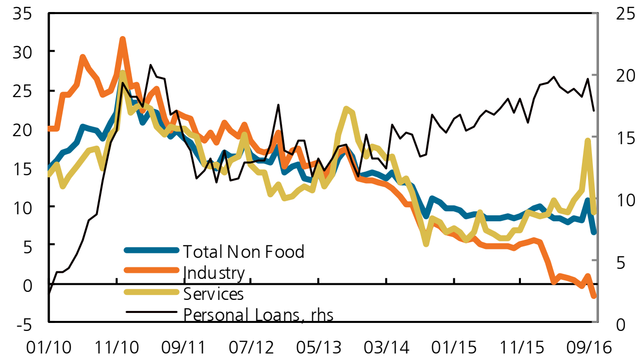
Source: CEIC, Markit

Fig. 9 – Consumer confidence



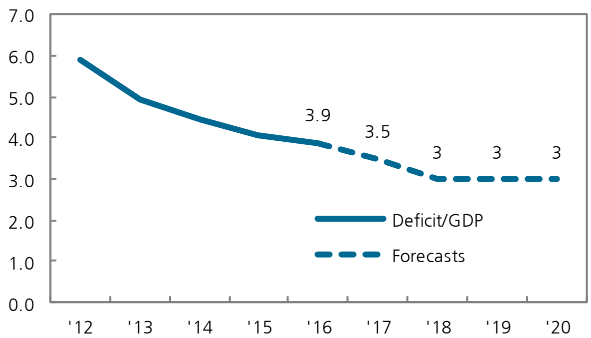
N.B.: Quarterly consumer confidence survey by the RBI Source: CEIC

Fig. 10 – Lending to industry is slowing (chg. % yoy)



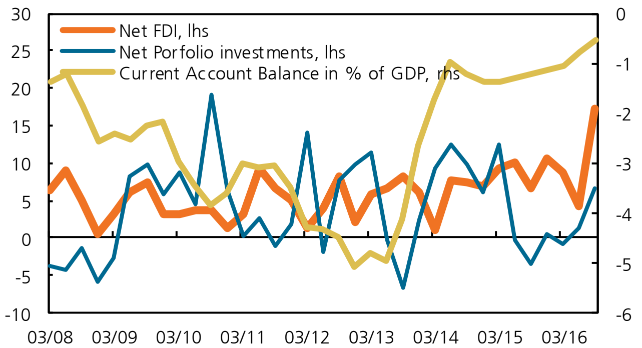
Source: CEIC

Fig. 11 – Public accounts (%)



Source: CEIC, Ministry of Finance

Fig. 12 – Current accounts



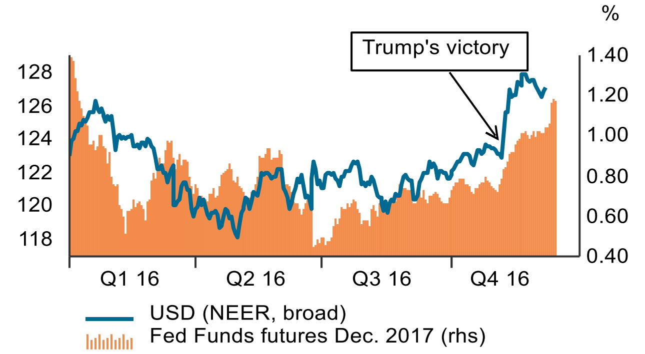
N.B. left-hand scale in USD Bn. Source: Intesa Sanpaolo chart based on Bloomberg data

Forex markets: post-Trump dollar stronger… but is this going to last?

Asmara Jamaleh

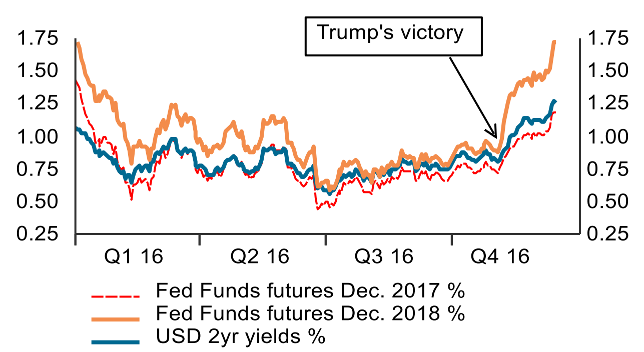
In 2017, the Fed's behaviour will remain the undisputed driver of the trend of the US dollar, yet with a difference compared to 2016: the starting point has changed. This year began with the prospect of four fed funds rate hikes, which became weaker month after month, preventing the dollar from appreciating further and stabilising it instead at levels in line with last year's (middle-upper end of the 2015 range). Of the four prospected hikes, only one was implemented, this month, exactly one year after the first move in December 2015.

Fig. 1 – Trump victory: US market interest rates up, dollar stronger



Source: Thomson Reuters-Datastream

Fig. 2 – US interest rates: market aligning with the Fed scenario



Source: Thomson Reuters-Datastream

On the other hand, 2017 will begin with the prospect of three hikes, supported by a scenario by which fiscal policy under the new Trump administration should be markedly expansionary. In September, before the elections, the Fed envisaged two hikes in 2017, but following of Trump's victory, at the December FOMC meeting it added a third, presumably prompted by the very prospect of stronger fiscal stimulus ahead.

After Trump's victory the dollar appreciated significantly, not only setting new highs above last year's, but revisiting effective exchange rate levels abandoned as far back as in 2003. Is the dollar's reaction to Donald Trump's electoral victory compatible? And is the size of the reaction compatible or excessive? Yes, the dollar's appreciation is compatible: Trump's victory promises a more markedly expansionary fiscal policy than would have been the case under Clinton, therefore stronger US growth, and higher market rates/yields. Stock indices have also risen (Fig. 1). The size of the appreciation is also compatible, as it should be measured based on the size of the increase in rates, which in turn has been compatible. Until Election Day (8 November), US rates were in fact too low compared to the upward path prospected by the Fed in September. In particular – considering fed funds futures – the market was pricing in a single rate hike in 2017, as opposed to the two estimated by the Fed. Following Trump's victory, the market has embraced the scenario outlined by the Fed (Fig. 2), and is no longer "overly" cautious, as was previously the case.

The December FOMC, however, brought another development: the Fed has revised up the number of interest rate increases expected next year, from two to three. Now, therefore, market rates and yields should adjust upwards again to price in the new Fed scenario. In the near term, therefore, the dollar should strengthen further. Subsequently, on the other hand, the dollar should gradually stabilise, staying at high levels in any case. This is because the Fed has not revised up the estimated path of interest rates in 2018 and 2019, confirming forecasts for three hikes a year. For what concerns the macro outlook, it has revised marginally upwards its growth projections for 2017, from 2.0% to 2.1% (leaving forecasts unchanged at 2.0% for 2018, and at 1.8% for 2019 and the longer run). However, having added a third hike next year, it has been able to keep unchanged its inflation projections all along the forecasting horizon (to 1.9% in 2017 and 2.0% – i.e. exactly on target – from 2018 onwards).

Furthermore, for what concerns the new fiscal stimulus expected to come, the effect on growth is likely to be modest in 2017 and mostly concentrated in the second of 2016. This should not create the need for the Fed to hike rates in 2017 more than the three times it is currently estimating. Therefore, the dollar should not rise further, but rather stabilise in terms of its effective exchange rate, bilateral developments notwithstanding. For instance, the dollar's upside against the yen is stronger than against the euro (see below).

Expectations for a stabilisation of the dollar beyond the near term are also supported by **more restrictive market conditions as a result of the rise in rates/yields, as well as the dollar's strengthening, following Trump's electoral victory,** which have done part of the Fed's job for it (by pushing rates up). The positive effect of fiscal stimulus on growth, on the other hand, will become clearly visible in 2018, although this does not necessarily imply a further appreciation of the dollar in the second half of next year, as beyond certain levels, increased fiscal stimulus no longer results mechanically in stronger real growth. In fact, increased fiscal stimulus will undoubtedly have an expansionary effect on (nominal) growth, but will also push inflation up, probably more than would be desirable, as the US economy is already at full employment levels. In situations of this kind, any additional rate hike to counter inflation could end up producing restrictive effects on (real) growth. However, the situation will become clearer in the first part of the year, for both the US economy and the markets, as at present there are no real indications on either the scope or the details of the prospected fiscal stimulus: the actual measures will be announced only following Trump's inauguration (20 January), therefore in the first three-six months of the new administration.

In any case, there are other "controversial" aspects, also tied to Trump's victory, which should help reduce upside on the dollar. Namely:

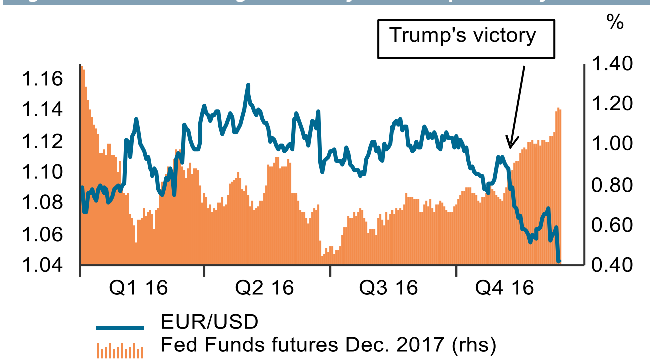
- Excessive fiscal stimulus may cause a deterioration in **public accounts**, resulting in both the deficit and debt increasing too much;
- An excessive appreciation of the dollar resulting from very strong fiscal stimulus, and therefore stronger US growth, would weaken **exports** and may lead to twin deficit issues re-emerging, considering also the above-mentioned deterioration in public accounts;
- The potential implementation of strict **protectionist measures** could trigger responses from emerging countries in the form of currency devaluations, which would push the dollar up even more (effective exchange rate), further amplifying the negative effects on US exports, with the added damage that protectionism generally tends to depress global trade;
- **Uncertainty** deriving from Trump's victory is clouding not only economic themes, but also other aspects of the political agenda, where the unknowns are even greater, given that the Trump administration will introduce significant discontinuity compared to the previous administrations;
- Lastly, **the prospect of stronger US growth** should have a generally positive fallout on the other advanced economies, which **could prompt central banks** (in the advanced countries) **to start normalising their monetary policies sooner**, with the effect of strengthening their respective currencies, to the detriment of the dollar.

However, **risks** to the baseline scenario, which contemplates a stabilisation of the dollar, **remain generally skewed to the upside**, both in the near and medium term, and are mostly tied to the possibility of the Fed hiking rates more times than expected if the effects of fiscal stimulus on growth prove to be stronger than forecast.

Euro – monetary policy developments will be crucial

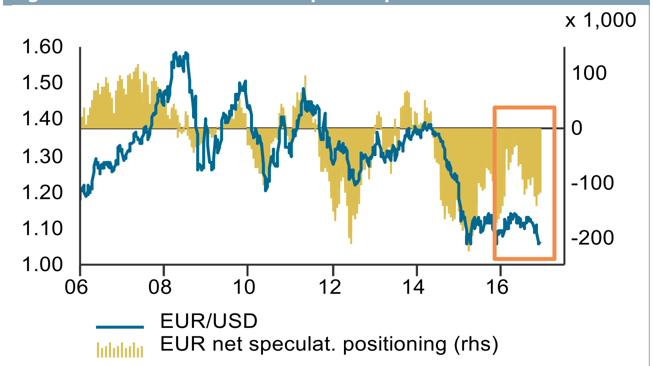
In 2017, the trend of the euro will be conditioned on the one side by the Fed's actions and by developments within the euro area, and on the other, especially in the second half of the year, by the ECB's stance. Almost throughout 2016, as long as expectations for a fed funds rate hike were disappointed, the euro not only remained well supported, but managed to rise back from the lows hit at the end of 2015 to EUR/USD 1.05, climbing as far as EUR/USD 1.15. On the ECB side, the further increase in monetary stimulus introduced with the large March package did not affect the single currency at all. What weakened the euro, on the other hand, was Trump's victory in November (Fig. 3), which sparked expectations for a markedly expansionary fiscal policy in the US, resulting in stronger growth in the country, and therefore fed funds rate hikes. On these considerations the euro's exchange rate corrected, slipping rapidly to the lows hit at the end of 2015 in the EUR/USD 1.15 area. Can the euro's reaction be considered compatible? Yes, it can, because it tracked the rise in US rates, which before the elections were "too" low. Fed funds futures were pricing in one hike in 2017 and less than one in 2018, a more cautious scenario than the one drawn up by the Fed in September, which pointed to two hikes in 2017 and three in 2018. In the wake of Trump's victory, the market embraced the Fed's outlook for 2017 (pricing in two hikes, like the Fed) and almost embraced its scenario for 2018 (again pricing in two hikes, one less than the Fed).

Fig. 3 – The euro shed ground only on Trump's victory



Source: Thomson Reuters-Datastream

Fig. 4 – Downside risks still in place: spec. short euro



Source: Thomson Reuters-Datastream

The second blow for the single currency came on occasion of the December Fed meeting. On re-emergence of the divergence between the ECB (which in December stepped up the stimulus programme again, extending purchases from March until December 2017) **and the Fed** (which one **week** later increased rates, but most importantly it revised up the estimated path of rates in 2017), **the euro hit new lows in the 1.03 EUR/USD area, dropping below** the critical threshold at **EUR/USD 1.05** and also below 2015 lows.

The prospect of several Fed hikes next year represents a factor of weakness for the euro, but should stay mostly concentrated in the near term (downside within the EUR/USD 1.00-1.05 range), when market rates and yields in the US have a larger upside margin, to realign with the new hike profile adopted by the Fed in December. **Subsequently, however, the euro should stop declining and rise back**, gradually and moderately, in the second half of next year. **The necessary condition for the euro not to keep depreciating throughout 2016 is that the Fed stick to the forecast number of hikes, and not implement more**. Aside from the Fed, the factors on the US side which should help the euro (limiting the dollar's upside margin) are the controversial effects excessive fiscal stimulus would reap, the risks tied to the potential adoption of protectionist measures, and the many uncertainties/unknowns clouding the new Trump administration's policies in general. **Support to the euro from the ECB side should stem from the fact that the extension of stimulus decided in December will probably be the final move in the current, extended expansionary** monetary policy **cycle**. The reduction of monthly purchases from

80 to 60 billion from April to December signals this. And in the closing stages of an expansionary cycle, the currency involved, in this case the euro, generally stops declining and resumes appreciating (estimated to return to EUR/USD 1.10-1.12 on a one-year horizon). Furthermore, the December decision essentially wraps up the ECB's monetary policy conduct until the end of 2017, whereas towards the end of next year the market should start pricing in the beginning, albeit gradual, of monetary policy normalisation by the ECB as well, which would support the euro.

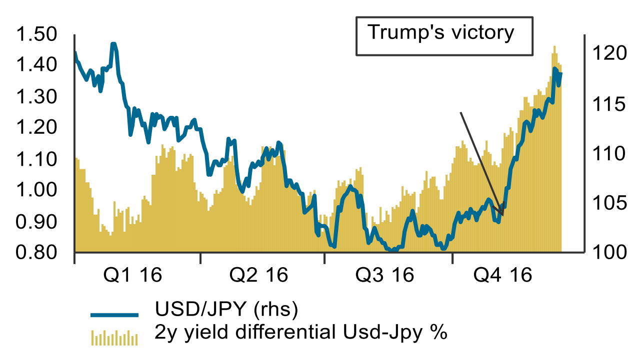
Downside risks still prevail, given the possibility of the Fed hiking rates more times than expected and/or of the ECB extending stimulus to 2018, but also due to uncertainties tied to the political calendar in the euro area (elections in Holland, France and Germania in 2017). The euro could be negatively affected also by volatility generated by Brexit. In this case, however, as was the case following the June referendum, disruption would be short-lived, as the economic fallout of Brexit (almost) exclusively concerns the British economy, and would therefore affect the pound.

Yen expected to weaken even further

The yen should weaken further in the course of 2017. As proven by the sharp and swift correction following Trump's election (Figs. 5-6), **the evolution of yield differentials should resume acting as the main driver of the yen's trend**. This should mostly involve the USD/JPY exchange rate, in relation to the **spread between Japanese and US yields, set to widen** further. The widening should mostly be tied to the movement of US yields, which will keep rising as the Fed hikes rates, on the short end of the curve as well. In particular, the 2Y US yield is still low compared to the Fed's hike projections, to the point that it rose much less than the corresponding 2Y fed funds futures, with December 2018 maturity, in the wake of Trump's victory (Fig. 2).

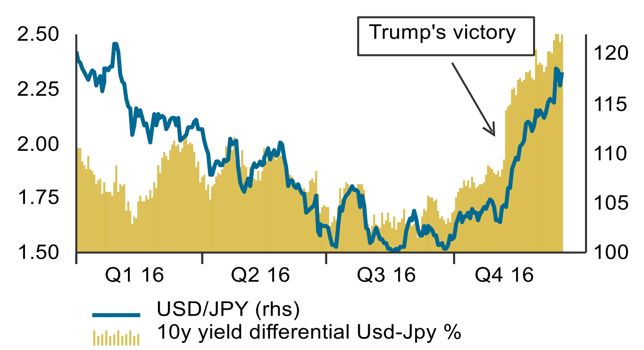
However, part of the widening will also be due to Japanese yields, as a result of the BoJ's new **curve-control** policy strategy, aimed at compressing yields in order to consolidate expectations for a rise of inflation to target, until this goal is effectively reached and even somewhat surpassed (**inflation overshooting** is also part of the BoJ's new policy strategy). The **decline** of the yen should extend **as far as a USD/JPY 120-125**.

Fig. 5 – Yen weakened by the widening of short-term yield differentials…



Source: Thomson Reuters-Datastream

Fig. 6 – …as well as by long term yield differentials

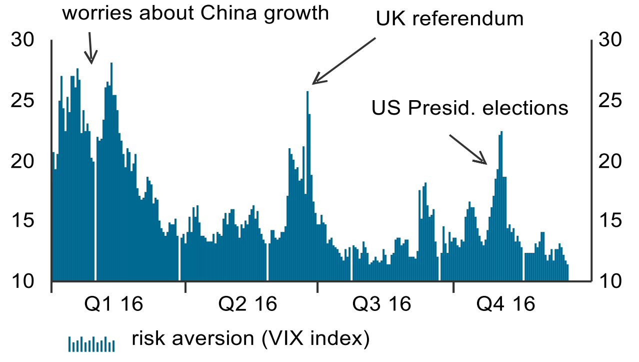


Source: Thomson Reuters-Datastream

The yen should drop further against the euro as well. In this case, however, the movement will not be driven by spreads, at least not initially, as the ECB will keep monetary policy markedly accommodative. The weakening of the yen's cross rate against the euro should mostly stem from the expected decline of the yen against the dollar, i.e. the rise of the EUR/JPY should mostly depend on the uptrend of the USD/JPY. This is because even if downside pressures prevail on the EUR/USD, the trend of the USD/JPY should be dominant, as the yen should prove more sensitive to US rates than the euro. At a later stage, the EUR/JPY should also be boosted by the upward thrust of the EUR/USD, when the euro – at the end of the ECB's expansionary cycle – should resume rising. The **drop** of the yen should reach **as far as EUR/JPY 130-135**, with downside margin extending in the low end of the EUR/JPY 135-140 range.

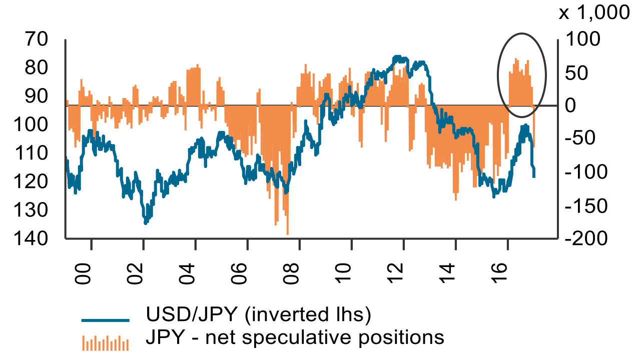
All considered, therefore, **the correction of the yen following Trump's election** (against both the dollar and the euro) does not seem to be a transitory movement which will be reabsorbed, but rather **a reversal** that corrects the extraordinarily strong appreciation scored in 2016. This appreciation, not easy to predict, may in any case be explained ex post. Its reasons were: **(1)** the waning of **expectations for a US rate hike** in the course of the year, **(2)** several episodes of **risk aversion heightening** (tied to concerns over the Chinese economy at the beginning of the year, in correspondence with the UK referendum in June and the US presidential elections in November: Fig. 7); and **(3)** the related formation of substantial and unusual **long yen positions on the speculative market** (Fig. 8).

Fig. 7 – Episodes of mounting risk aversion in 2016



Source: Thomson Reuters-Datastream

Fig. 8 – Large and unusual long yen positions (spec.) in 2016



Source: Thomson Reuters-Datastream

Of these three factors, the first primo should act in the opposite direction in 2017, i.e. US rates/yields will resume upward direction, acting against the yen.

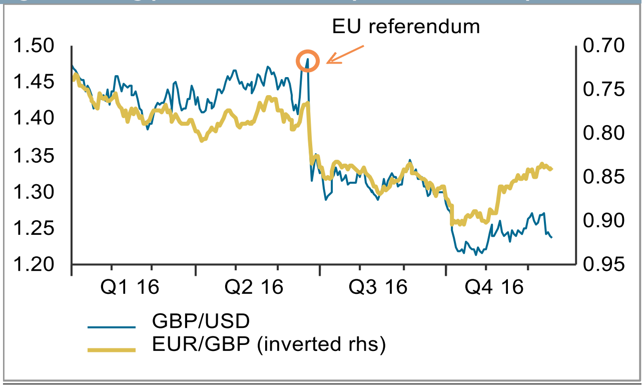
For what concerns risk aversion, a number of events next year could also result in a new increase, including for instance the start of the Brexit process, the political elections in France and Germany, or uncertainties tied to the policies pursued by the new Trump administration. This is one of the factors reasons which could result in some upside risks materialising on the yen compared to the baseline depreciation scenario. As regards the speculative positioning of the market, the substantial long yen positions built up this year (unwound following Trump's victory) point, by contrast, to a weakening of the Japanese currency.

The GBP will mostly be guided by developments on the Brexit front

In 2017 as well, sterling will mostly be guided by developments on the Brexit front. While this will not leave it immune from the effects of the Fed's decisions, it should be less affected by them than other currencies, as has already been the case in 2016. This year, **sterling plummeted on the outcome of the referendum** held in June (Fig. 9), dropping by around 20% against both the dollar (from a high of GBP/USD 1.50 to a low of 1.18, a level abandoned as far back as 1985), and against the euro (from a high of EUR/GBP 0.73 to a low of 0.94 EUR/GBP, a level abandoned more recently in 2009). **The depreciation reflects concerns that exit from the European Union may have strong negative repercussions on the domestic economy**: slower growth, higher unemployment, higher inflation, crash in real estate prices, stronger taxation, higher deficit and public debt. According to the estimates published by HM Treasury, the impact would be significantly unfavourable both in the near term and in the medium-long term, to a greater or lesser extent depending on the new trade agreements entered into with the EU and the rest of the world.

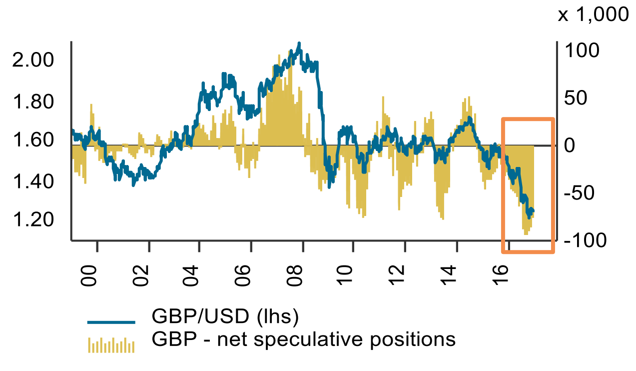
However, in a nutshell, the critical difference will be whether the United Kingdom succeeds in retaining **access to the single market** (soft Brexit) or not (hard Brexit). In the past few months, the intransigent approach taken by Prime Minister Theresa May had raised fears of a hard Brexit lying ahead. As a result, sterling, which had stabilised after its post-referendum crash, resumed a sharp downtrend: GBP/USD exchange rate below 1.30 and EUR/GBP above the 0.85 mark.

Fig. 9 – Strong post-referendum depreciation of the pound



Source: Thomson Reuters-Datastream

Fig. 10 – Speculat. short sterling at all-time highs due to Brexit



Source: Thomson Reuters-Datastream

The important fact is that this new correction took place despite the fact that, from a purely economic point of view, the outcome of the referendum had a modest impact, as outlined by data, which beat expectations. This supports the view that the discriminating variable for the pound will be the United Kingdom's new status outside the EU, and in particular whether or not the country will retain access to the single market. The May government seems to have softened its tones of late, led by the Chancellor of the Exchequer Philip Hammond. Specifically, there is increasing support for the view that the United Kingdom may retain favourable access conditions in exchange for contributing to the EU's balance sheet.

Another factor which helped ease tensions and offered support to sterling was the **High Court ruling** according to which the government cannot activate and manage the Brexit process without the prior approval of MPs, a condition which should also significantly reduce the risk of a hard Brexit. The Supreme Court has now been called to express its view on the issue, due in January: should it confirm the High Court's ruling, the pound will benefit further.

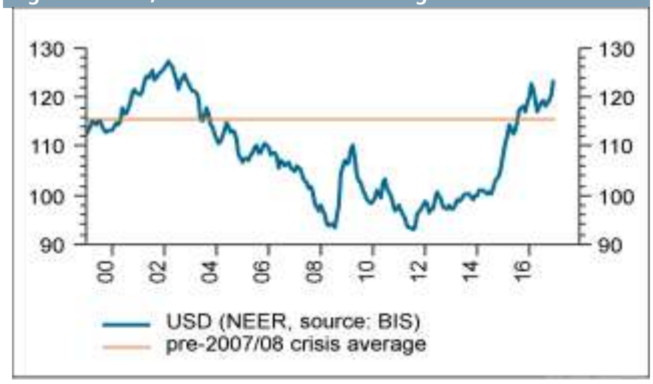
The government will invoke Article 50 next year, by and no later than 31 March, and could pre-emptively inform Parliament of the guidelines of its negotiation strategy (albeit probably only in generic terms). This would remove some of the uncertainty that is working against sterling, tied not only to the final outcome of the negotiations with the EU counterparts, but also to the priorities the British government intends to pursue, and which will obviously condition the outcome of the negotiations. Therefore, **uncertainty and volatility should peak in the first three months of 2017** – or for slightly less, if Article 50 is triggered before March 31 – **prompting us to forecast that the pound will hit its lows on a 1m-3m horizon** (towards GBP/USD 1.20 and EUR/GBP 0.85-0.87, with a downside margin of up to EUR/GBP 0.90). In order to draw up forecasts for the following period, we need to know at least whether or not retaining access to the single market is an absolute priority for the British government: retained access would aid a soft Brexit. As there are no indications one way or the another for the time being (although some signals seem to point to an intention to retain access), we can only make assumptions.

Assuming the United Kingdom retains access to the single market, the lows hit by the pound against both the dollar and the euro should now be behind us, and a gradual recovery should materialise in the course of the year (towards GBP/USD 1.30-1.35 and EUR/GBP 0.83-0.80), the speed of which will depend on the timeline of the transition phase, which the British government is trying to lengthen, as opposed to the EU's determination to speed up the process. The main benchmark by which to measure the impact of Brexit on the domestic economy will be the Bank of England's projections. After the referendum, the BoE had drastically reduced its growth projections for 2017 from 2.2% to 0.8%, only to revise them back up from 0.8% to 1.4% in November, on stronger than expected data. The first test will come with the BoE's updated forecasts in the February Inflation Report (IR), in the immediate run-up to the activation of Article 50. In the meantime, the negative effects generated by Brexit on growth will be contained to some extent by fiscal policy, which will be more expansionary. On the other hand, the problem of inflation rising above target, already in 2017, will be more serious. However, as also pointed out by the BoE at its December meeting, the recent recovery of the pound should help contain the problem, even more so if a soft Brexit occurs, since in this case sterling would appreciate.

By contrast, a hard Brexit would cause sterling to depreciate, hitting new lows against both the dollar (hypothetical downside below the October low at GBP/USD 1.18: within 1.15-1.10 GBP/USD) and the euro (hypothetical downside beyond the October low at EUR/GBP 0.94: EUR/GBP within 0.95-1.00).

Risks, even in the event of a soft Brexit, will generally remain skewed to the downside for sterling, given the many criticalities and uncertainties related to an unprecedented event. **Regardless of developments tied to Brexit, in 2017 the sensitivity of the pound to the evolution of the situation in the US – with the Fed at the fore – should generally prove lower than the euro's**, as was the case in 2016. Therefore, if the Fed implements more hikes than expected, the pound should be affected less than the euro, against which it should therefore strengthen.

Fig. A – Dollar, nominal effective exchange rate

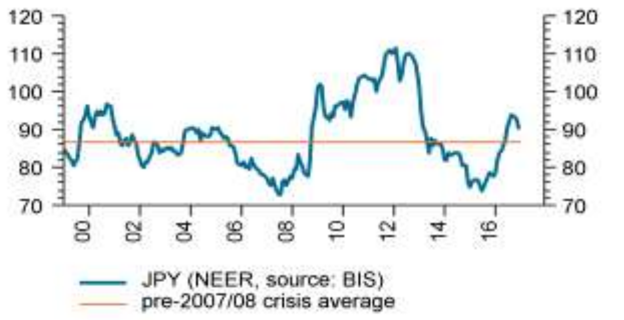


Source: Thomson Reuters-Datastream

Fig. B – Euro, nominal effective exchange rate

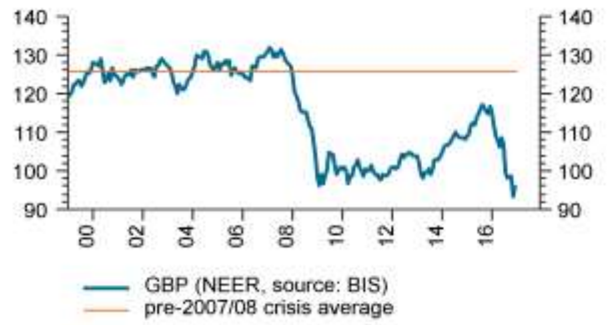
Source: Thomson Reuters-Datastream

Fig. C – Yen, nominal effective exchange rate



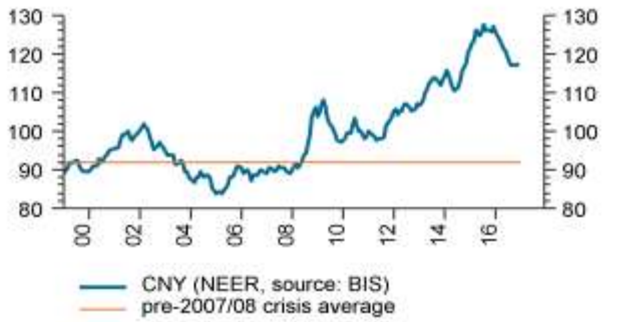
Source: Thomson Reuters-Datastream

Fig. D - Sterling, nominal effective exchange rate



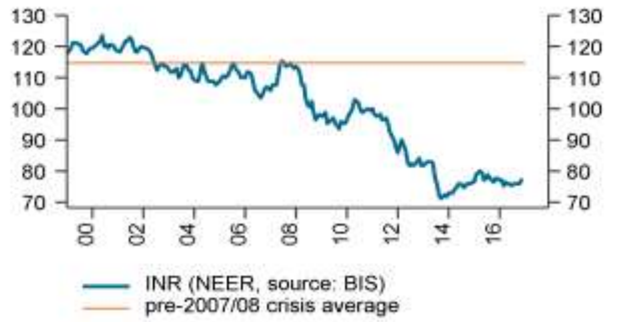
Source: Thomson Reuters-Datastream

Fig. E – Yuan renminbi, nominal effective exchange rate



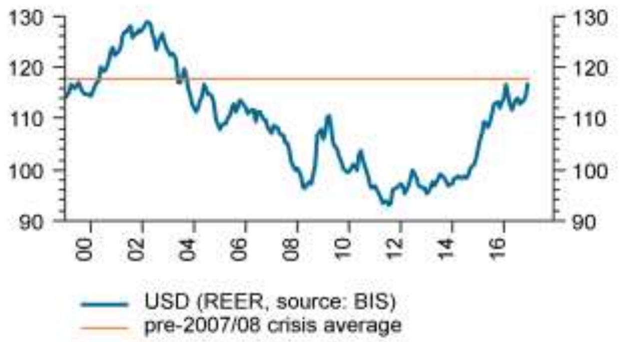
Source: Thomson Reuters-Datastream

Fig. F – Indian rupee, nominal effective exchange rate



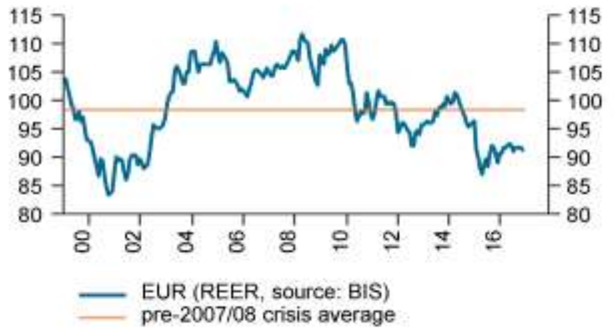
Source: Thomson Reuters-Datastream

Fig. G – Dollar, real effective exchange rate



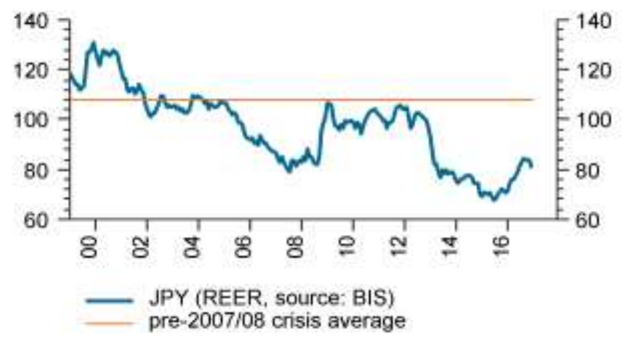
Source: Thomson Reuters-Datastream

Fig. H – Euro, real effective exchange rate



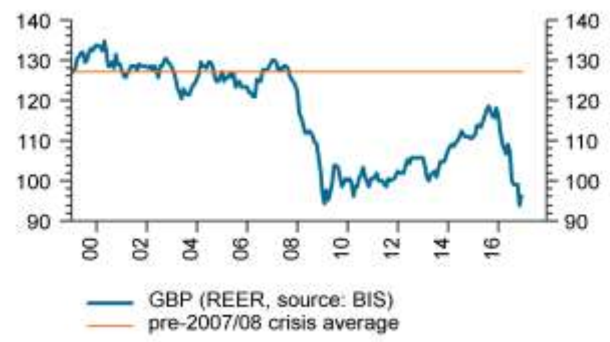
Source: Thomson Reuters-Datastream

Fig. I – Yen, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. L - Sterling, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. M – Yuan renminbi, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. N – Indian rupee, real effective exchange rate

Source: Thomson Reuters-Datastream

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Appendix

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