BANCA IMI

Macroeconomic Outlook

Research Department

June 2016

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INTESA SANPAOLO

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Quarterly

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How much will Brexit weigh on global growth?

Luca Mezzomo

The referendum on the UK's European Union membership attracted far greater attention than justified by the weight of the British economy on the global total, which may only be explained if we assume very strong independent negative effects spreading through the financial channel and confidence levels, which are by no means sure to materialise. The event has taken place in an interesting transition phase, in which the global economy is still showing a tendency to slow, although initial signs of a reacceleration were being detected. The latter will now be threatened again. We conservatively estimate the impact of Brexit on euro area growth at -0.3%, enough to result in a slowdown in year-on-year growth between 2016 and 2017. However, economic policy response could mitigate the final effects. The fallout outside Europe will be scarcely relevant.

The British voters' decision to pull the United Kingdom out of the European Union had immediate repercussions on the global financial markets, which in the days prior to the referendum, despite the highly uncertain voting intention polls, had incautiously bet on the opposite outcome. In addition to a sharp decline of the pound on the currency markets, stock indices dropped, the yields curves of high credit merit issuers shifted downwards, whereas the rates paid by sovereign issuers with lower ratings increased, albeit temporarily.

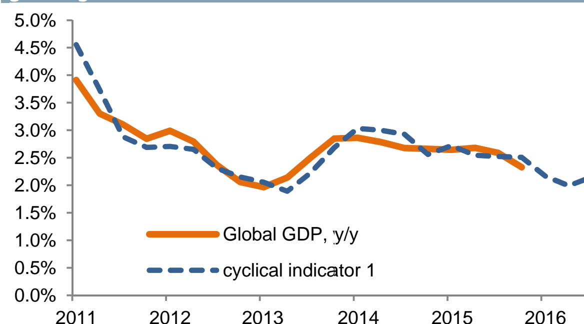
In 1H 2016, year-on-year global growth slowed further

Before tackling the possible economic implications, we should examine the underlying situation to which the referendum shock added itself. The rebound in oil quotations, the recovery in capital flows addressed to the emerging countries, and the rebound of the stock markets, could create the impression that the slowdown phase of the global economy is over. However, survey data released over the past few months draw a different picture. In April and May, the level of the global manufacturing and services PMI shed further ground compared to the first quarter of the year, signalling that year-on-year GDP growth may have slowed further in 2Q 2016 (Fig. 2 and Fig. A on page Errore. Il segnalibro non è definito.). The slowdown in year-on-year terms should affect Japan, the euro area and the United States (heavily in Japan's case, and only slightly for the United States and the euro area); if our forecasts are right, it will be almost impossible for the global aggregate to accelerate.

Fig. 1 – Trend of data more in line with expectations, in Europe especially

Source: Thomson Datastream Charting, CESI indexes

Fig. 2 – However, global PMIs indicate that the slowdown in global growth continued in 1H 2016



Source: Intesa Sanpaolo. Note: the cycle indicator is based on the trend of global manufacturing and services PMIs, on the trend of the price of oil, lagged by 4 months, and on the past trend of global GDP (lag t-1 and t-4).

However, pessimism had eased somewhat, for three reasons:

But if the global economy is still slowing, why had market sentiment brightened in the past few months? There are three reasons, in my view: easing concerns over the trend of the Chinese and US economy, the accommodative stance of the central banks, and the stabilisation of oil quotations.

(a) The most pessimistic forecasts on the Chinese (and US) economy have not materialised…

First of all, the Chinese government's economic policy measures have resulted in stronger than expected growth, making a hard landing scenario less plausible for the time being. Despite mounting evidence that the Chinese growth model rests on unsustainable financial dynamics, which leave it open to burdensome boom & bust cycles, there are also hopes that much stronger nominal growth in the Western economies will also make it easier to manage crisis phases.

(b) The markedly collaborative approach taken by central banks

A second factor is the accommodative slant of monetary policies. The Federal Reserve remains very cautious in managing the interest rate hike, and is making it clear that it is perfectly ready to delay already announced measures annunciate in light of disappointing economic data or uncertainty at the international level. The worsening of labour market data in May, and tensions tied to the repercussions on the markets of the UK referendum on EU membership, have indefinitely postponed a move that was being prepared for June or July. The positive effects is that, unlike the period in which the Fed was winding up QE, the markets do not seem willing to price in an extended upward phase: the volatility of long-term rates and of the exchange rate are reduced as a result, as also the destabilising potential for the emerging markets. On the other hand, despite achievement of full employment, failure to normalise interest rates is not generating expectations for a swift rise in inflation, nor credit bubbles. In the meantime, the Bank of Japan is keeping open its aggressive asset purchase programme, which although is apparently proving ineffective in pushing up inflation, is significantly impacting the problem represented by the sustainability of public debt. The ECB began implementing in June two new measures, the medium-term TLTRO II refinancing programme, and the CSPP corporate bond purchase plan, without shutting the door on new expansive interventions if necessary. This accommodative stance will extend into the coming quarters.

(c) The rise in oil quotations

The rise in oil prices from January lows certainly reflects more or less temporary supply side factors, as well as an upward revision of demand forecasts; these two factors have prompted us to bring forward the expected rebalancing of demand and supply to mid-2017. On average, an extended period of low oil prices remains more supportive for global growth than a period of high prices. however, the speed of the decline observed in 2014-15 had threatened the financial stability of some producer countries, and raised concerns tied to the contraction of the US extraction industry, which probably subtracted half a percentage point from growth in 2015, and which some commentators believed could lead to financial contagion issues. The recent price trend has already resulted in a stabilisation of the active oil rig count in the United States, a development which points to stabilisation of capex spending in the sector, easing excessive fears of possible recessive impacts. Furthermore, the view that global growth acceleration phases are normally preceded by oil quotations increases is built on rather solid grounds.

The starting scenario promised modest growth with signs of a reacceleration starting in 2H. What now?

Before the referendum, the world economy was still expected to keep expanding at a moderate pace. Under that scenario, growth in the euro area and the United States was still driven by domestic demand, and at least in Europe's case, with investment growth also making a positive contribution; this would have positive, albeit marginal, spillovers on global activity, through foreign trade. Fiscal policies were forecast to turn slightly restrictive. Annual average growth rates had been revised upwards for the euro area, and downwards for the United States: in both cases, the changes reflected the sign of the surprises at the national accounts level in 1Q 2016. The faster recovery in oil quotations than we had forecast in March explained the small upward revision of inflation estimates in the euro area. How has this scenario changed in light of Brexit?

The effects on the global economy of the UK vote on its EU membership

Luca Mezzomo
Anna Grimaldi

The referendum is consultative, and the Act that officially called it imposes no compulsory further steps. Therefore, what happens next will be dictated by political concerns. A negotiation

strategy will have to be defined, and a parliamentary vote may have to be held to confer mandate to the government to request withdrawal from the EU. The official withdrawal request could be submitted to the EU by the end of the year, after the appointment of the new conservative leader and prime minister, currently expected in early September. The British have no interest in rushing the process, as submission of the withdrawal request will mark the beginning of the two-year negotiation limit provided for by Article 50. Another reason which is encouraging slowing the process is that the Leave camp still needs to agree on a negotiation strategy, and must do so without allowing voters to realise too soon that the referendum campaign was largely based on imaginative assumptions and on distorted analyses of the consequences; therefore, some of the Leave leaders may even be hoping to obtain political concessions without having to activate the withdrawal procedure. On the other front, the other EU member states will pressure the UK to submit its request as soon as possible – unless it becomes obvious that the delays are clearly motivated by second thoughts in Britain on carrying forward the withdrawal process – and have already made it clear that they do not intend to open informal negotiations before the official request is submitted. Furthermore, several European governments (led by Germany) have already declared that the UK cannot hope to gain access to the single market unless it commits to accept the four fundamental freedoms, including the free movement of people.

Could the UK ultimately pull back before the letter is sent? This scenario does not seem very likely, given the high turnout at the referendum. Nor is it certain that the government will need pre-emptive authorisation from Parliament, before submitting the withdrawal request. On the other hand, popular petitions and possibility of the Scottish Parliament voting against Brexit cannot be considered as reason enough to freeze the process, and the time required to relaunch the separatist agenda could be too long to make a difference. The combination of events that would make it possible implies evidence of serious economic and financial damage, capable of clearly shifting public opinion and inducing a sufficient number of MPs to abandon the majority, triggering a government crisis and a return to the polling stations. Should the vote yield a majority in favour of remaining in the EU, the referendum would be overcome. However, both the Conservatives and Labour are grappling with serious internal crises, and early elections are not at all an appealing prospect for either of them at this time.

The negotiation process will begin once the United Kingdom officially submits its request to withdraw from the EU. The process will last two years at the most, after which, if no agreement has been reached, the country would leave the Union with no preferential treatment at all. The withdrawal agreement must be approved by a qualified majority of member states, and is therefore more easily attainable than a normal treaty with the EU. However, according to the prevailing interpretation the withdrawal treaty only regulates the transition phase, and not the long-run relationship between the EU and the UK. For the latter, a new treaty, ratified by all Member States, will be required. Therefore, the actual Brexit is still years away.

Implications after the transition period

Under the baseline scenario, after leaving the EU the United Kingdom would lose access to the single market for services and goods. Trade flows from and to the United Kingdom would be subjected to tariff and non-tariff barriers. The potential agreement with the EU could result in similar treatment for the UK as is currently the case in some realms, albeit in exchange for concessions on the economic front and on the reception of EU rules – including the free movement of people. This would result in a lower intensity of import-export trade between the EU and the United Kingdom, limited in the latter case, more significant in the former. According

to UK Treasury estimates[1], staying in the EU would have resulted in stronger trade by 76%, and exit will imply a reduction in trade volumes by between 9% and 24%, depending on the alternative regime[2]. Also, foreign direct investment would shrink. Given a bilateral agreement on withdrawal, the Treasury estimates that after 15 years GDP would fall short of the baseline scenario by 5.4-9.5%. Besides, UK banks will lose the right to directly sell financial products in the EU, fund managers would face more restrictions in selling investment product to EU customers and pieces of the UK financial industry may have to be relocated within the EU.

Transition economic scenarios for the United Kingdom

In the period between the popular decision to exit the EU and the enforcement of the withdrawal agreement (or the reaching of the two-year deadline provided for by the Treaty), the United Kingdom will remain bound to community legislation. All the consequences of the vote, therefore, will consist of the adjustment of the economic agents to an exit which may takes *many years* after the vote – with the complication that at first it will be difficult to imagine what kind of regime will be agreed. The majority of analyses is based on the assumption that uncertainty will push up credit risk premiums and heighten stock market volatility, and bring a reduction of capital inflows and fixed investment inflows. The prospect of a partial delocalisation to other EU countries also exists, to work around the effects of UK-based intermediaries losing their "financial passport" and the risk of British products being subjected to tariff and non-tariff barriers after the withdrawal. Another certainty is the weakening of sterling on the currency markets – as is already proving to be the case. The bright side is that a sharp drop of the pound towards levels perceived as undervalued may help attract capital flows and support exports, as well as improving the current account balance through the revaluation of return from foreign assets.

In May, the UK Treasury published an analysis of the short term effects of an exit from the EU[3]. The analysis assumes that a part of the effects in full swing will already emerge during the transition phase, in addition to making assumptions on the impact of uncertainty on economic policy and of volatility on the financial markets. More in detail, the simulation assumes an increase in the risk premium required on the 10Y Gilt by 40bps, a 12% depreciation of the pound, a 120bps increase in the equity risk premium, and higher interest rates applied to businesses by 130bps; uncertainty is one standard deviation higher than in the baseline scenario. For what concerns economic policy, the simulation assumes unchanged policy rates and no corrective fiscal measures to balance the increase in the deficit due to the automatic stabilisers. Under this "normal" shock scenario, the report concludes that a recession would materialise, accompanied by higher inflation and unemployment. After two years, the level of GDP would be -3.6% lower than the baseline projection in real terms, whereas prices would be higher by 2.3%. This corresponds to a -0.1% q/q contraction for four quarters. Under the "severe" shock scenario, which assumes an impact in terms of uncertainty and of the markets equal to half the one recorded in 2009, GDP would be lower by -6.0% after two years, with higher inflation by 2.7% after one year. The simulation also points to a sharp deviation of housing prices from the baseline scenario (-10"% "normal" shock, -18% "severe" shock). These assumptions seem too harsh, as they imply a 0.7% deviation from the baseline scenario in terms of slower quarterly growth already starting in 3Q. In our simulation, we assume slower investment flows by one standard deviation, but not an autonomous shock to consumption; while growth emerges as being significantly impacted, the gap is half the one assumed under the British government's standard-shock scenario.

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[1] HM Government, *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives*, April 2016

[2] HM Government, cit., Table 3.A page 128.

[3] HM Government, *HM Treasury Analysis: the immediate economic impact of leaving the EU*, May 2016.

The effects for non-European countries

Given the lower levels of trade with the United Kingdom, and the absence of other contagion channels (political contagion, confidence effect, etc.), the consequences for non-European countries seem to lack relevance, and will generally be smaller than one tenth of a percentage point. Stronger effects may only be envisaged if we imagine that the referendum act as a catalyst for a hefty and lasting correction of the financial markets, resulting in a significant tightening of financial conditions. Although in the immediate wake of the event global stock indices effectively did drop sharply, the effect is unlikely to prove persistent. Our revised 2016-17 forecasts for non-European countries reflect considerations which are essentially untouched by the UK referendum.

Political contagion in Europe?

Following the announcement of the outcome of the referendum, several leaders of right-wing euro-sceptic movements applauded to the choice made by British voters, and prospected similar initiatives in other European countries. However, it is virtually impossible that other countries may launch any kind of consultation referendum on the EU or on the euro in the next few months, and even in the coming years. For this to happen, in most countries these movements would have to access government in leadership positions, and this is only plausible in very few cases. Also, most central-eastern European countries benefit from massive net transfers from the EU balance sheet, and exiting the Union is unlikely to appeal to them. The most significant risk seems to be in the Netherlands, where at the elections of March 2017 the PVV led by Wilders could clinch a relative majority; however, the risk is mitigated by the fact that polls award the PVV a share of the total vote of around 20%, too small to impose a referendum. In France, Front National will probably reach the ballot stage as the most voted party, but its chances of winning the presidency and the absolute majority of the Assembly seem slim, given the tendency of the French electors to choose moderate candidates in the second round. The third significant case is Austria, where, however, elections will only be held in 2018. However, exit from the monetary union implies higher transition costs and raises more serious problems than exit from the EU.

The most tangible and immediate problem in the EU and in the euro area is the tendency of moderate government coalitions to fall to pieces, replaced with increasing frequency by diverse coalitions or minority governments, with obstacle-ridden prospects and weak mandates. Moreover, the European political agenda is paralysed by the divergences between states on the strategies to adopt, and this impasse is unlikely to be overcome with the French and German political elections looming ahead in one year’s time. The only viable solution, as seems to have been acknowledged in the first set of European summits, is probably to offer European citizens a positive prospect, by redefining EU priorities to focus more on growth and security, allowing greater budgetary flexibility and taking a step back in the production of rules and regulations.

The impact on the Eurozone economy

The short- term impact of *Brexit* on the rest of Europe and on the euro area in particular will no doubt be negative, but the size is not so obvious. The extent of the slowdown will depend on the intensity and duration of markets reaction, but also on the responses of central banks and governments. The increase in uncertainty and the possible confidence crisis will impact on consumption decisions and investment, however, it is difficult to quantify by how much. We would rather not assume extreme scenarios, on the back of plunging confidence. Rather, we opted to assess the impact of *Brexit* on euro area growth on the back of macroeconomic relationships or through exchange rate adjustments, local financial conditions and global changes in trade flows which are likely to occur in short term.

In the moderate stress scenario we have considered, the sterling effective exchange rate drops by 10% with respect to the 2015 average, the FTSE 100 falls by 15% and house prices decline moderately from 2016 H2 onwards. The tightening of financial variables is coupled with a shock in UK private investment of one standard deviation (about -10 %). We have imposed a monetary policy response from the BoE, on top of the 250 billion sterling liquidity facility announced last Friday. The response from the BoE translates in a decline in long- term yields by an average of 70 basis points over two years. As a result, UK growth falls by 1.5 points over two years compared to the baseline. But *Brexit* would not imply a recession even for the UK, given the strong growth forecast we had in our pre-referendum estimates (2.3% in 2017 vs 1.8 % in 2016).

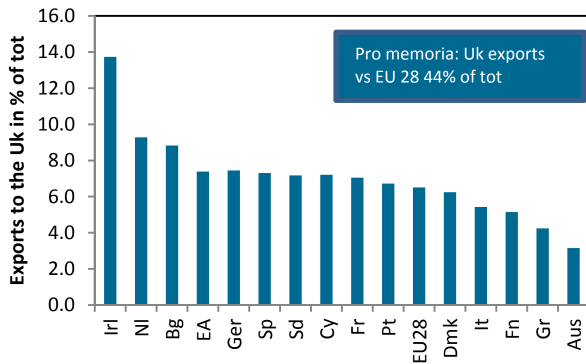
The impact of the UK slowdown on euro area growth via trade linkages, could be exacerbated by a tightening of financial conditions. As it is already happening, the effect will be primarily felt through equity markets and on average we assumed a permanent decline in the Euro Stoxx of 6%. At the same time, we imposed a 50 basis points transitory increase in sovereign bonds spread for Spain and Italy, with return to the baseline in 2017H1. The tightening of financial conditions imposed in our simulations is a way to capture the confidence crisis effect on consumption and investment, triggered by the British vote. The ECB measures already in place, PSPP and TLTRO II, should help mitigate the effects on financial conditions; such framework proved very powerful in dampening market volatility in the first week after the vote, in bond markets at least. The euro effective exchange rate is expected to remain approximately stable over the forecast, since the move against the sterling should be offset by the movement against the dollar, yen and the Swiss franc.

Overall we estimate that the impact of *Brexit* will not be catastrophic for euro area GDP growth although the simulations, carried out with Oxford Economic Forecasting macro econometric model, suggest that growth could be weaker by 0.3% in 2017 vs the pre-Brexit scenario. Thus, in this scenario, euro area GDP will continue to grow above potential next year: by 1.3 %, from the 1.7% estimated for this year. The impact will be quite varied across countries and will depend on the share of exports directed to the UK and on the evolution of domestic financial conditions. According to the simulations, the effect is likely to be very strong for Ireland, given the close trade links with the United Kingdom (v . Fig.1) and the absence of offsetting effects from the exchange rate devaluation. However, Ireland may also be one of the biggest beneficiaries of the diversion of FDIs from Britain.

The impact on euro area growth is expected to occur via a slowdown in exports by 0.7 points compared with the baseline, but also through a deceleration in domestic demand. In our view, private consumption may be negatively affected by slower employment growth and by a negative wealth effect associated with declining equity prices. Corporate investment will also grow 0.5% less than the baseline, despite the lower level of long term rates. The unemployment rate will decline more slowly and may reach only 9.7 % at the end of 2017. Wage pressures should remain contained. The gradual increase in euro zone inflation will be even more gradual and we may see inflation at best at 1,3% next year and at 1.5% in 2018, still far off the ECB's target and below latest ECB' s staff projections.

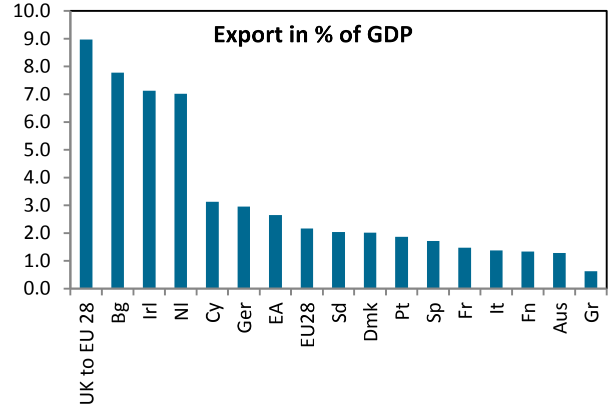
Such post-referendum scenario may underestimates the uncertainty effect on private investment and consumption; on the other hand, the simulations carried out with the forecasting model do not take into account any changes in non-standard measures which the ECB would reasonably implement in the event of a protracted tightening of financial conditions or if the data confirm a slowdown in GDP growth compared to the June staff projections of 1.7%. Besides, we deem likely that fiscal policy would not be tightened by as much as expected next year, if the economy slows down.

Fig.1 – Ireland exports the most to the UK



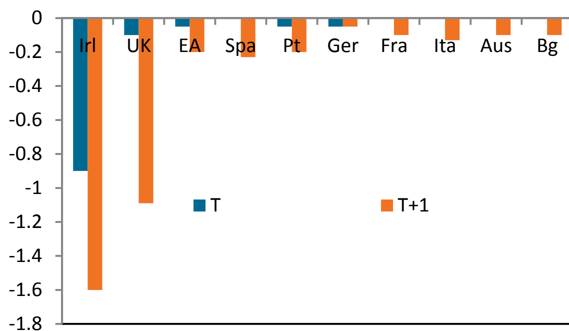
Source: Eurostat & ISP calculations

Fig.2 – The UK has more to loose from the ERU divorce



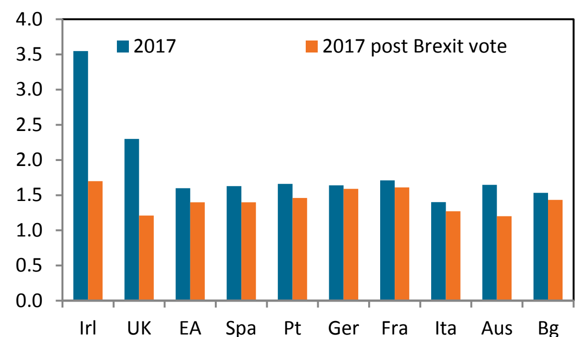
Source: Eurostat & ISP calculations

Fig.3 - Impact on GDP of a 1.5 deceleration in UK growth on the euro area



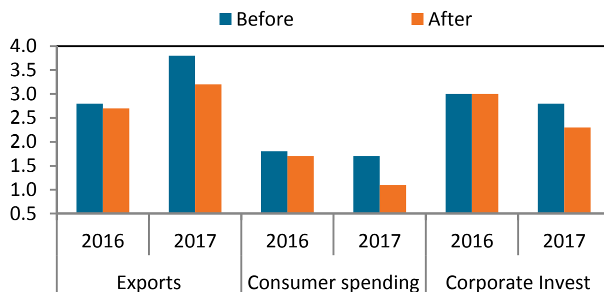
Source: Eurostat & simulations with Oxford Economics Forecasting model

Fig.4 – *Brexit* will be felt on euro area GDP growth, but the effect will not be as catastrophic, we think



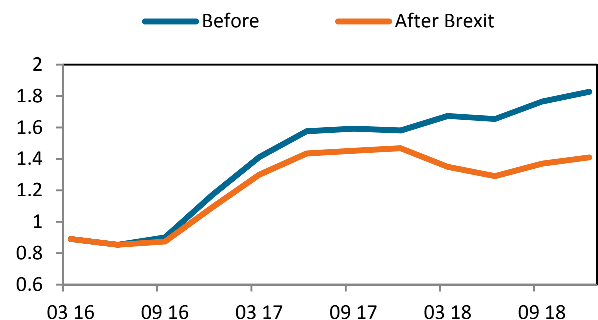
Source: Eurostat & simulations with Oxford Economics Forecasting model

Fig.5 – Private consumption will suffer the most via the wealth effect



Source: Eurostat & simulations with Oxford Economics Forecasting model

Fig.6 – Inflation (excluding energy) will rise more slowly



Source: Eurostat & simulations with Oxford Economics Forecasting model

How will the ECB react?

The official statement released a few hours after the final votes indicates that the ECB is in close contact with other central banks and "is ready to provide liquidity to the markets in the euro and other currencies." But beyond liquidity measures what could the ECB do in practice? And what are the conditions that would trigger new measure from the Council?

At the June meeting, the ECB assessed that the euro zone moderate recovery phase was consolidating and that downside risks for growth and inflation scenario had marginally subsided. The ECB made clear it was patiently waiting to assess the impact on the economy of the measures announced in December 2015 and March 2016, and only partially implemented. Yet, the statement explicitly stated that the Council was ready to respond to any contingencies that threatened to undermine price stability in the medium term.

It is almost certain that as of today the ECB would revise the risks' assessment for growth and inflation to the downside and most likely would cut by at least two tenths GDP growth estimates for 2017 -2018 compared to the 1.7 % printed in June. For the update of the scenario we will have to wait until the September meeting, by then the picture will be clearer both on the developments in the UK and possibly on the data font. Until September, ECB's decisions will be dictated by the intensity and duration of market reaction. If the correction were to remain almost as violent as on Friday 24th, the ECB will step in. Speeches from ECB's members in the past few week is suggested that the consensus within the Council is divided but on balance the comments did not convey any urgency to act. However, a prolonged slump in share prices and financials stocks values will most likely shift the balance within the Council in favor of additional stimulus. Besides Germany, with its internal political problems and in view of the 2017 elections, might prefer a monetary policy response rather than serious openings on the treaties.

We believe that a deposit rate cut by 10 basis points is one of the possible measures, but perhaps not the first on the list. The impact of the cut on the exchange rate is likely to be short-lived. Moreover, the measure remains controversial given the strong criticism sparked in the past few months. However, the operation would have the advantage to attract a stronger demand for funds in the September TLTRO II auction. (In the first TLTRO II auction only 31 billion of fresh long term liquidity have been injected).

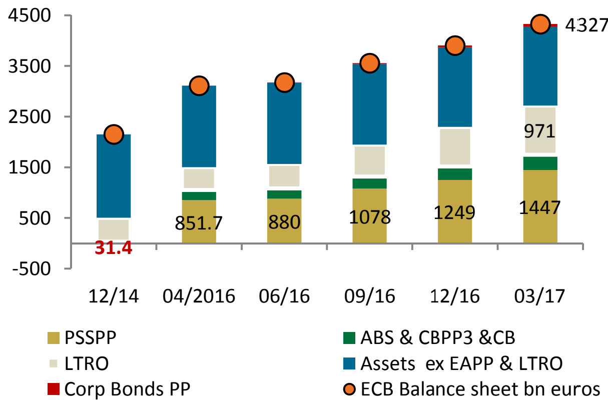
We see as more likely interventions leveraging on the PSPP program. One line of actions which was likely already exploited last Friday is recalibrating purchases more towards longer maturities. Another likely intervention, which may be announced as early as July, is the extension of the PSPP program beyond March 2017. However, that may have to be preceded by changes to some parameters of the PSPP that limit the amount of eligible bonds (the yield threshold, the limit per issuer and per issue etc.). Recall that in December, the ECB decided to extend purchases beyond September 2016 and only in March opted for an increase in volumes. The extension of the program would put into safety the longer- term yields in 2017, when several hot political events are scheduled in the euro zone. moreover the extension would allow to adjust banks' portfolios of government bonds before resuming on the risk weighting debate of credit institutions' sovereign books.

One additional intervention would be the extension of the EAPP to ETFs of main European stock indices and of the corporate bonds purchase program to senior bank bonds. The latter option is controversial since with TLTRO II with the ECB lends to banks against collateral, while under the extended corporate bonds purchase program it would be acquiring bonds (unsecured) of the same lenders outright.

Should tensions in the markets prove long lasting and more severe for the euro zone periphery, the ECB could decide to step up purchases of sovereign bonds and to divert, albeit temporarily, from the rule of purchases based on capital keys. An intervention of this kind would require, however, a specific decision of the Council and probably has as a precondition the observation of persistent and very significant dislocations. Alternatively the ECB may decide to relax the 33% detention limit which *de facto* implies a less strict application of the capital key rule but may prove less controversial within the Council

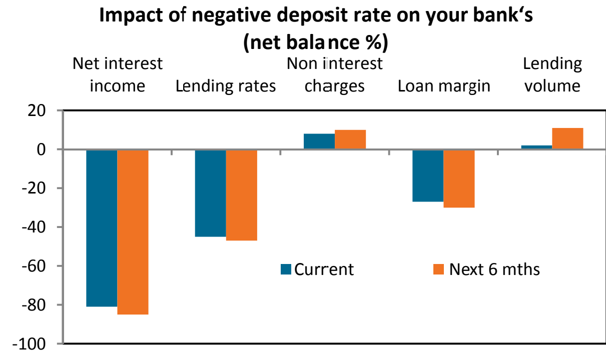
Last we recall that many, if not most, members of the ECB Council have indicated that unorthodox measures such as the helicopter money would not be legally admissible under Article 123 of the Treaty. The bar for this type of intervention is significantly higher than in other jurisdictions and would require true doomsday scenarios.

Fig. 9 – The ECB can still change the duration, quantities and modalities of the PSPP



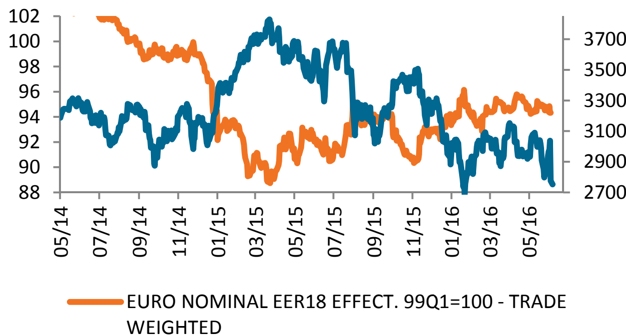
NB: We assume that the ECB will purchase ABS and CB at the same pace as in the last 19 months. Corporate bond purchases will range between EUR 5-7Bn. We assume that the banks will take EUR 550Bn in the TLTRO II auctions.
Source: Intesa Sanpaolo chart from ECB data

Fig. 10 – The marginal benefits for the exchange rate of a deposit rate cut are dubious. Banks will certainly not appreciate



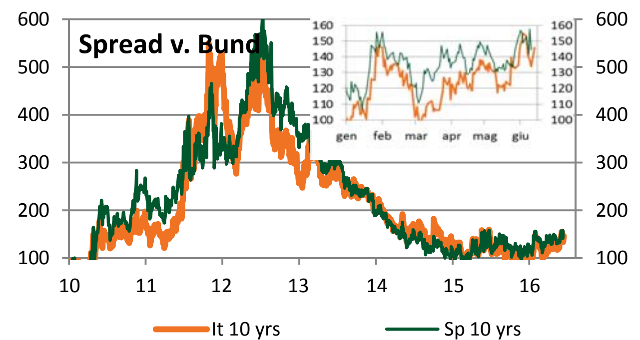
Source: ECB Bank Lending survey April 2016 refer to question A5, pag. 47

Fig. 11 – ECB actions will be dictated by the duration and intensity of market correction



Source: Bloomberg & ISP calculations

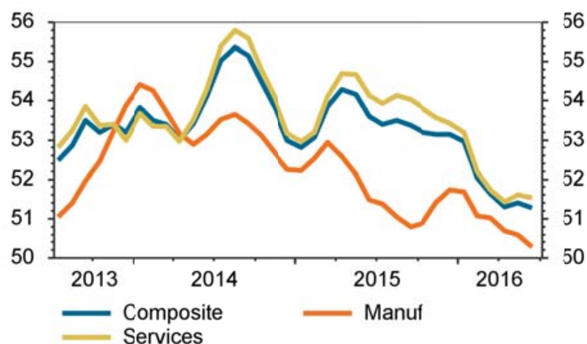
Fig. 12 – The PSPP should limit the widening of sovereign spreads in the periphery. But much also depends on how the political outlook will evolve



Source: Bloomberg & ISP calculations

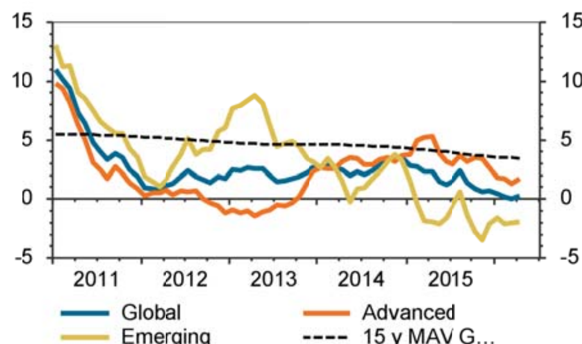
The trends of the global economy in 10 charts

Fig. A – Trend of global PMIs



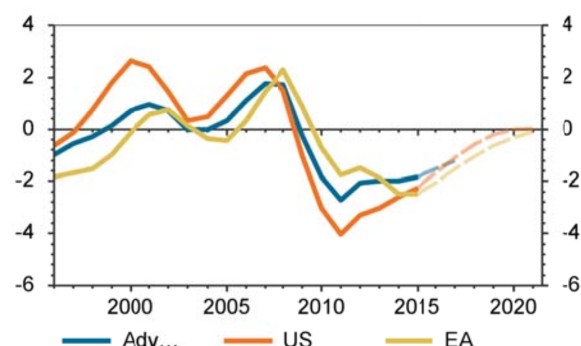
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Import growth, y/y



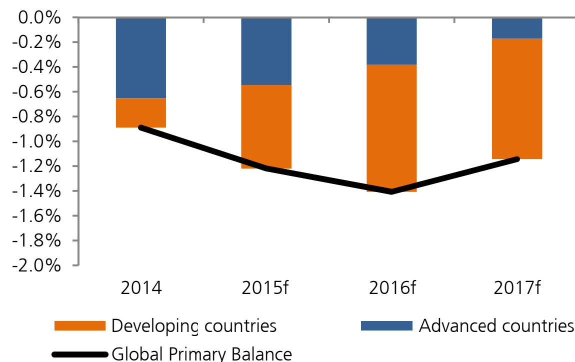
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



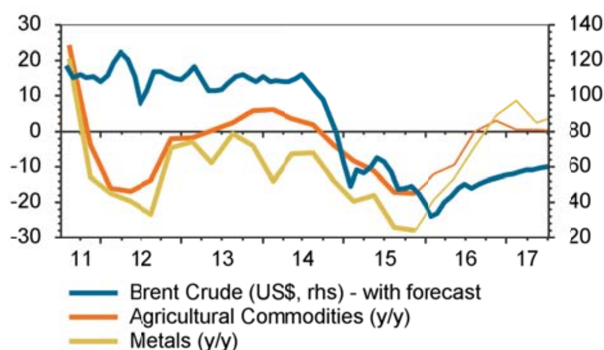
Source: Thomson Reuters-Datastream Charting and IMF

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



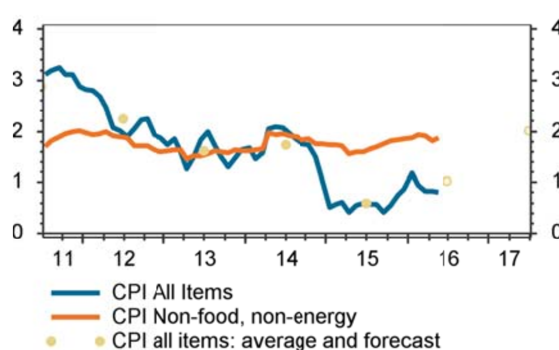
Note: based on the 11 top advanced countries and the 8 top emerging countries. Aggregated at current exchange rates. Source: Intesa Sanpaolo elaborations

Fig. E – Commodity prices



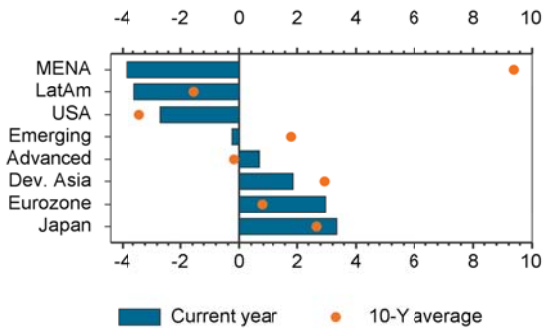
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



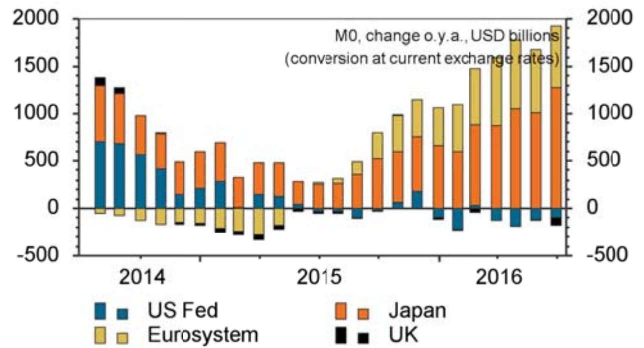
Source: OCSE, Thomson Reuters-Datastream Charting

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



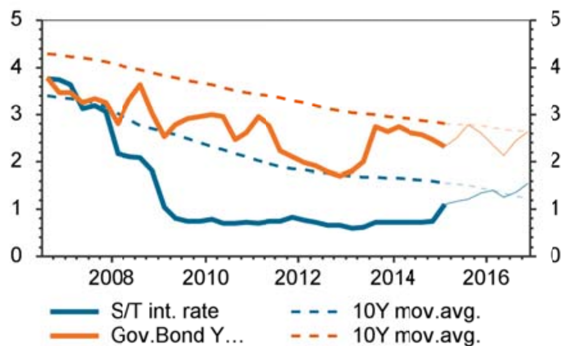
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

Fig. H – Monetary base, G-3 (change, USD billion)



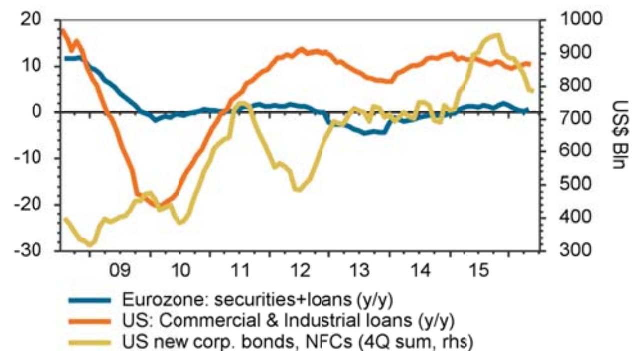
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



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

Fig. J – Credit to non-financial firms



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

Tab. 1 - Economic growth by geographical region

	2013	2014	2015	2016E	2017E
USA	1.5	2.4	2.4	1.9	2.3
Japan	1.4	-0.1	0.6	0.3	0.5
Eurozone	-0.3	0.9	1.6	1.7	1.6
Eastern Europe	1.7	1.6	-0.6	0.7	2.2
Latin America	2.9	1.0	-0.6	-0.9	1.5
OPEC	1.5	2.5	1.6	1.2	2.6
East Asia	6.1	7.6	5.9	5.7	5.6
Africa	4.3	4.2	3.2	2.5	3.6
World growth	3.3	3.4	3.1	3.0	3.2

Source: Intesa Sanpaolo data

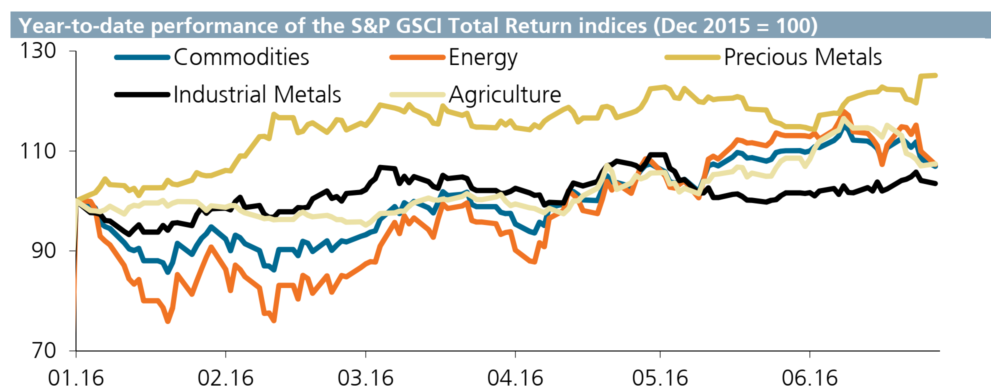
Commodities: fundamentals tighter but cash flows are high

Daniela Corsini

Many positive factors have contributed to the spike seen in the main commodities in the first half of 2016: improved supply and demand fundamentals, which have provided frequent positive surprises, above all regarding Asian demand; a fairly favourable macroeconomic outlook; and a weak dollar. However, cash flows have also played a key role in driving the recent gains, so there is a risk of prices correcting in the short term driven by a temporary increase in risk aversion.

Since the new year, virtually all main commodities have recorded positive returns, driven by a variety of factors: supply and demand fundamentals have become more and more tight, a process that is particularly evident for oil; the dollar has been relatively weak; macroeconomic data have improved overall, above all from China and the United States; confidence in the segment has improved from a negative market sentiment recorded in 2015.

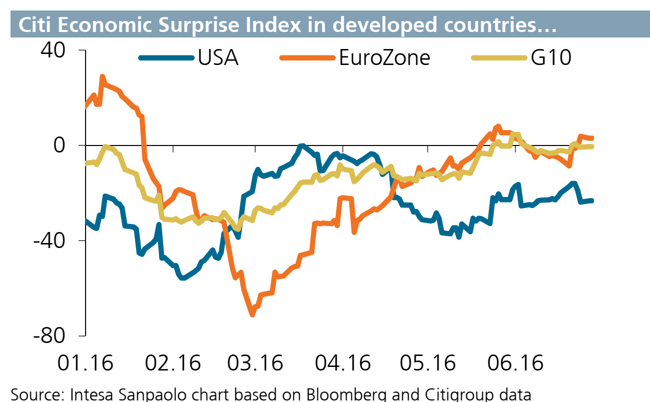
Year-to-date performance of the S&P GSCI Total Return indices (Dec 2015 = 100)



Source: Intesa Sanpaolo chart based on Bloomberg data

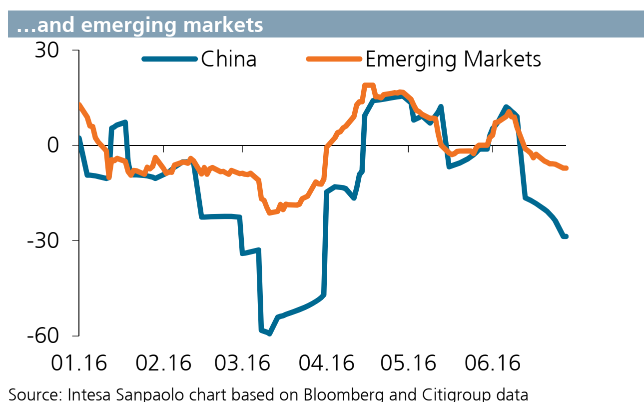
The best performers have been precious metals, boosted by currency trends but also by the persistent risk factors weighing on the macroeconomic outlook, namely: uncertainty about the future path of rate rises that the US Federal Reserve (Fed) will follow and political concerns. In particular, in Europe the main risks are related to the UK decision to leave the European Union, the increasing support for extreme right-wing parties and euro-sceptics, forthcoming elections in Germany, the referendum on constitutional reform in Italy, the lack of coordination by the European Union in implementing structural reforms and dealing with contingent problems. In the United States, political risk is linked to the forthcoming presidential elections. Moreover, even if the main economic surprise indices have risen from the lows recorded in February and March, on average the published data have clearly disappointed expectations.

Citi Economic Surprise Index in developed countries…



Source: Intesa Sanpaolo chart based on Bloomberg and Citigroup data

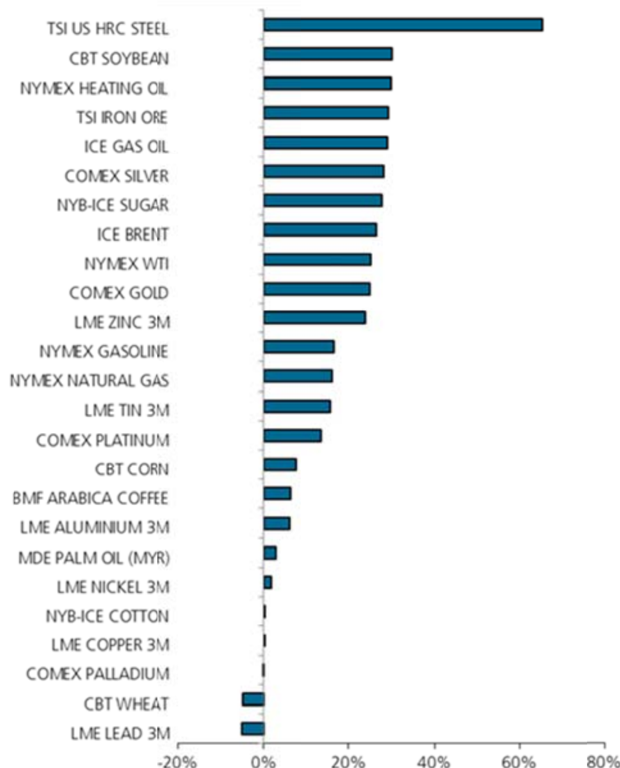
…and emerging markets



Source: Intesa Sanpaolo chart based on Bloomberg and Citigroup data

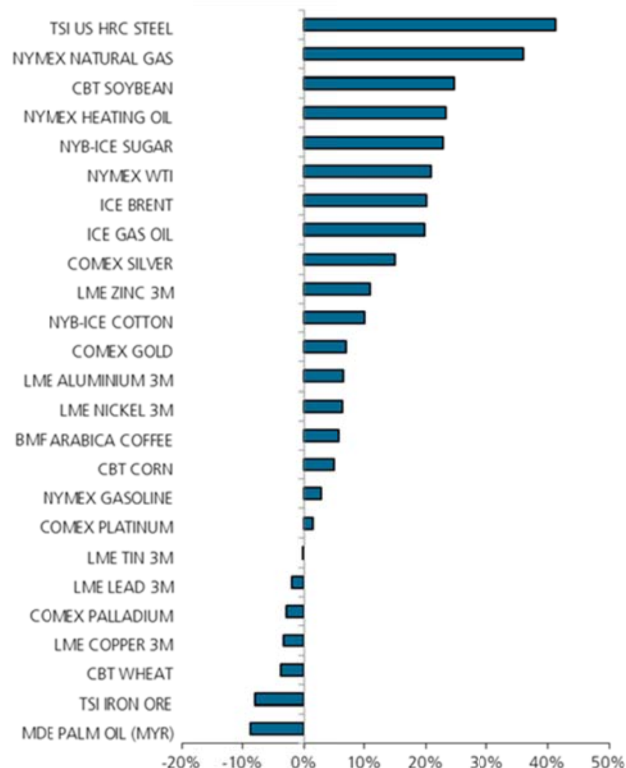
After the UK referendum, we saw a change in sentiment on the segment, triggered by waning optimism about the global growth outlook, amid the fairly high levels to which the main commodities have risen. Risk aversion could continue to weight on commodity prices during summer months, usually characterized by below-average volumes. The cash flows that have fuelled the rally in most commodities since the new year could quickly invert, if investors begin to expect the segment to underperform other asset classes.

Year-to-date performance until 17 June 2015



Source: Intesa Sanpaolo chart based on Bloomberg data

Q2 performance until 17 June 2015

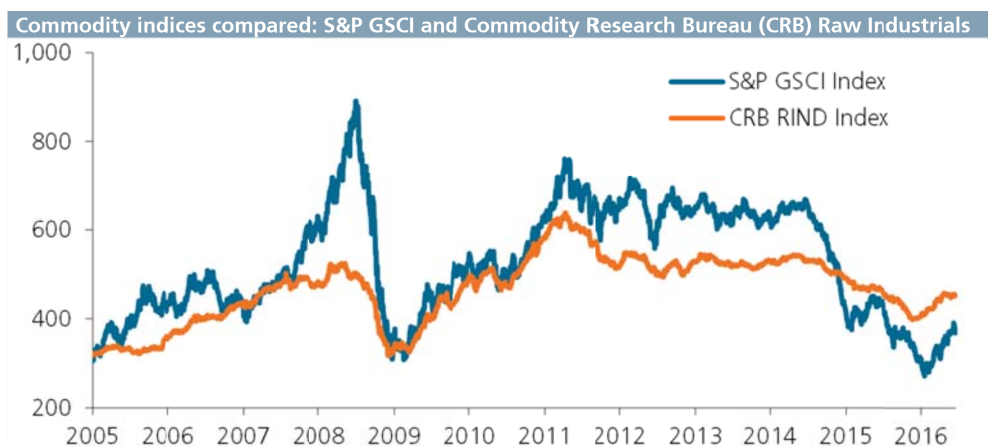


Source: Intesa Sanpaolo chart based on Bloomberg data

In addition, the performance of all commodities will be affected to some degree by the future trend in oil prices. Directional oil movements will transmit to other commodities, directly, via the subsequent impact on production costs and, indirectly, via the financial markets. The correlation within the commodities segment is often amplified by purely speculative factors. Indeed, a gloomier outlook for oil prices could fuel risk aversion throughout the segment. Moreover, the inclusion of commodities in indices and the increasingly frequent use of automated trading algorithms might also increase the frequency of co-movements within the segment.

Looking at two commodity indices, it is evident how the price slump that started in 2014 was much greater for those commodities traded through futures and options and, therefore, that were more affected by large investments' flows. Let us compare, for example, the S&P GSCI Index and the Raw Industrials Index published by the Commodity Research Bureau (CRB RIND Index), which comprises commodities exposed to industrial demand, most of which have no derivatives. The following chart suggests to us that the speculative component could also become very important in times of profound market stress and that most listed indices, because of the dominant weight of crude oil, could be less useful in terms of assessing the strength of the global industrial cycle; which is better captured by unlisted indices.

Commodity indices compared: S&P GSCI and Commodity Research Bureau (CRB) Raw Industrials



Source: Intesa Sanpaolo chart based on Bloomberg data

Forecasts for the commodities universe

The price of crude oil has hitherto benefited from the sharp acceleration over the last two months in the ongoing rebalancing process. Global demand has proven stronger than estimated, amid a sharp rise in Chinese crude imports and a particularly brilliant driving season in the US. In contrast, global supply has underperformed expectations due to a series of unexpected events which have temporarily balanced the global market: a strike by oil sector workers in Kuwait, fires near major oil fields in Canada, a fresh wave of attacks and sabotage against infrastructure by new rebel groups in Nigeria.

These factors have sent Brent and WTI up, close to a level of USD 50, which should approximate the current marginal cost of shale oil production in the main US extracting areas.

In the short term, we think that a correction within a range of USD 45-50 for Brent would be justified by uncertainty related with Brexit, by very high global reserves and by the risk that supply could quickly rebound (for example, if the number of active oil rigs in the US steadily increased, signalling that shale oil could be produced at adequate levels of profitability, or if the Nigerian government were to reach a new agreement with the rebels, whose main goal is to receive the payments cancelled by the new president). Thereafter, we expect that the confirmation that the oil markets are rebalancing and a moderate weakening by the dollar could push up Brent prices to a range of USD 50-55 in the fourth quarter. We think Brent might trade in a stable range around USD 60 only in 2017.

Given the current market environment, gold is highly dependent on safe heaven demand and expectations surrounding US monetary policy. In recent months, expectations of the next US interest rate hike have continued to recede and the number of hikes expected for 2016 has gradually reduced. Consequently, demand for gold investments has not yet suffered from the downward pressure a change in US monetary policy would exert. Instead, it has been boosted by a sharp rise in demand for safe-haven assets. We expect that risk aversion will sustain gold and silver demand during summer months. Then, assuming that concerns about UK leaving the European Union ease, the Fed adopts more restrictive monetary policy in the autumn and the dollar weakens by the end of the year, we see room for gold to track back to a target of USD 1,200 by end-2016.

Industrial metals should remain at around current levels in the third quarter and then close the year higher overall, thanks to a broad improvement in supply and demand fundamentals. In the short term, we fear there may be a correction, driven by risk aversion, profit taking (particularly in those metals with the best year-to-date performance), dollar strengthening and fresh fears of

weakness in the global macroeconomic cycle. Industrial metals are particularly influenced by China, so it is necessary to continually monitor the strength and quality of its economic growth and the conditions of its domestic financial markets.

As regards agricultural commodities, weather conditions have been a particularly important price driver this year, given the severity of a number of extreme events. For example, corn and soybeans have hit new local peaks on fears of reduced supply from South America due to unfavourable weather. Wheat, in contrast, has remained in a broad trading range, constrained by very high stock levels. The coming months could see the La Nina weather phenomenon develop, which could bring a further change in conditions in many regions and introduce volatility into agricultural commodity prices.

Oil: rebalancing under way

The long-awaited rebalancing is finally underway, assisted by unexpected interruptions in supply and by much greater demand than was expected just a few months ago. However, the process could slow markedly, and the market could reach its balance much later than we expect at the time of writing, if supply rises much quicker than expected amid relatively high prices.

Having traded in January and February at far lower levels than in 2003, crude oil has largely recovered, thanks to an objective improvement in supply and demand fundamentals: the long-awaited rebalancing is under way and has been spurred on by unexpected events, such as the strike in Kuwait, fires in Canada and infrastructure attacks in the Niger Delta in Nigeria.

The market, infused with optimism by a weaker dollar and broadly encouraging macroeconomic data, has mainly focused on the current fall in US supply and on the supply disruptions that blocked in May around 1.1 million barrels a day (mb/d) of non-OPEC supply and 2.6 mb/d of OPEC supply, according to data from the US Energy Information Administration (EIA). Moreover, global demand surprised upwards in the first half, thanks to excellent consumption in the US and high volumes of imports in China.

- First-quarter US demand beat expectations, due to low prices and comparatively clement weather. Moreover, the driving season has been excellent so far. According to US EIA data, weekly oil consumption in the week ending 10 June was the highest ever, matching the peak of 9.762 mb/g achieved in August 2007. This is all the more extraordinary given that the driving season has only just started. However, oil stocks are also exceptionally high: US stocks are running at 11% higher than the five year average and are equivalent to 24.9 days of consumption, which is the second-highest of the last 10 years, after 2013, for this period of the year. We should stress, therefore, that there is a risk, as the season progresses, that the upward pressure on oil prices from higher-than-expected US consumption could ease off: the high stock levels should limit any spikes, and demand could disappoint the currently very optimistic expectations.
- In China, private refineries (teapot refineries) have been authorised to import oil directly from abroad. This has led to a rapid increase in volumes purchased since the start of the year, both to fulfil domestic demand and to replenish commercial reserves, due to low international prices. Furthermore, the government itself appears to have taken advantage of low prices to continue the process of boosting its strategic petroleum reserves (SPR). There are obviously no reliable data about the capacity and percentage of utilisation of China's commercial reserves, or about the government's purchase intentions for its SPR. Consequently, given that Brent has risen toward the level of 50, Chinese imports will probably start to slow or even contract compared with recent months. This could fuel fresh concerns of economic slowdown in China, exerting downward pressure on prices.

Additionally, optimism has been broadly boosted by recent data published in the monthly reports of the Organization of the Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US EIA: in the last two months, their forecasts have been significantly revised to take account of the accelerating rebalancing process and now suggest that the markets will be in balance by mid-2017 (EIA, IEA) or even by the end of 2016 (OPEC).

The EIA, for example, forecasts current inventory builds, which are useful for assessing surplus supply, to average around 1.0 mb/d in 2016 (from 1.4 mb/d forecast in April). It then sees inventory builds falling sharply, to 0.3 mb/d, in 2017 with a stock drawn in the third quarter, signal of finally tight markets.

The three main forecasters currently expect consumption to grow by 1.3 mb/d this year, averaging around 95.2 mb/d for 2016 as a whole. The agencies that have already published estimates for 2017 are expecting consumption to grow in line with the forecasts for 2016: +1.3 mb/d (EIA), +1.5 mb/d (EIA).

From 2016, non-OPEC supply is expected to fall for the first time since 2008. Output is forecast to average 56.7 mb/d in 2016, a fall of 0.6 mb/d on 2015, and, according to the EIA, should fall by another 0.2 mb/d in 2017. In both years, the biggest fall should come from supply of US crude, since shale oil production involves more flexible extraction projects and rapidly diminishing returns.

With global demand expected to increase and non-OPEC supply to fall, the call on OPEC crude, i.e. the quantity of oil that group members have to supply to balance the market, is expected to average 31.7 mb/d in 2016, a rise of 1.8 mb/d on 2015. According to the EIA, it is likely to reach 32.8 mb/d in 2017, a further rise of 1.4 mb/d.

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

Estimates in June 2016 in millions of barrels	Total demand	Offerta Non-OPEC	OPEC LNG supply	Call on OPEC Crude
OPEC	94.2	56.4	6.3	31.5
vs. 2015	1.2	-0.7	0.2	1.8
IEA	96.1	56.8*	6.9*	32.2*
vs. 2015	1.3	-0.7*	0.2*	1.9*
EIA	95.3	57.0	6.9	31.4
vs. 2015	1.5	-0.6	0.3	1.8

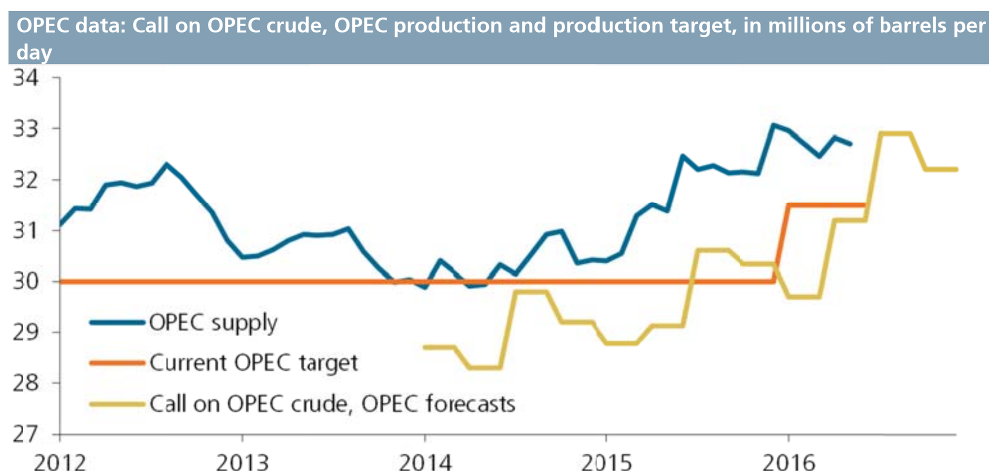
Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA and IEA; * data updates as at May 2016

Supply and demand estimates published by US EIA

	World Consumption	Non-OPEC Supply	US Supply	OPEC LNG Supply	OPEC Crude Supply	Call on OPEC crude*	Market balance**
2015	93.8	57.6	9.4	6.6	31.6	29.6	1.9
2016	95.3	57.0	8.6	6.9	32.4	31.4	1.0
Change	1.5	-0.6	-0.8	0.3	0.8	1.8	
2017	96.7	56.8	8.2	7.2	33.0	32.8	0.3
Change	1.5	-0.2	-0.4	0.3	0.7	1.4	

Source: Intesa Sanpaolo chart on US EIA data; * Call on OPEC crude = World Consumption - Non OPEC Supply - OPEC LNG supply;
** Market balance = OPEC crude supply - Call on OPEC crude

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



Source: Intesa Sanpaolo chart based on OPEC data

Focus on supply

Of the various unknowns that will weigh on the markets in the coming months, the main one is supply: will the volumes lost in Nigeria and Libya return to the market? Will US production regain impetus?

With regard to OPEC supply, everything depends on how the political crises in the two countries develop. In particular, the fresh wave of attacks against oil infrastructure in the Niger Delta in Nigeria, which have been carried out by the Niger Delta Avengers, has reduced production to the lowest of the last 20 years: Estimates put the loss due to infrastructure damage at around 0.8 mb/d, compared with previous production of 2.2 mb/d. The Nigerian government has signalled that it is open to negotiating with the rebels. If, contrary to what has been said to date, Buhari, the new president, agrees to restore the funding granted to rebels operating in the Niger Delta region by previous Nigerian presidents in exchange for the suspension of infrastructure attacks, we could see a rapid revival in Nigerian production. In our baseline scenario, however, we expect the current tensions in Nigeria to continue for a number of months, keeping domestic output below potential.

With regard to non-OPEC supply, the main unknown is the future profitability of shale oil production, which has benefited for many months from aggressive reductions in marginal costs, technological enhancements and hedging policies, which have helped many producers deal with the slump in prices. According to a model developed by the US Congressional Budget Office (CBO), the rig count will fall until mid-2016, whereas the gradual response of production to this lower drilling activity should drive down shale oil output until mid-2017. The fastest rate of decline is expected in mid-2016. Thereafter, shale oil output should regain its 2015 peak by 2020, despite lower prices.

The CBO forecasts that oil, excluding any major significant supply shocks, is unlikely to trade outside a range of USD 33-73 per barrel for a sustained period during the next five years.

Our forecasts

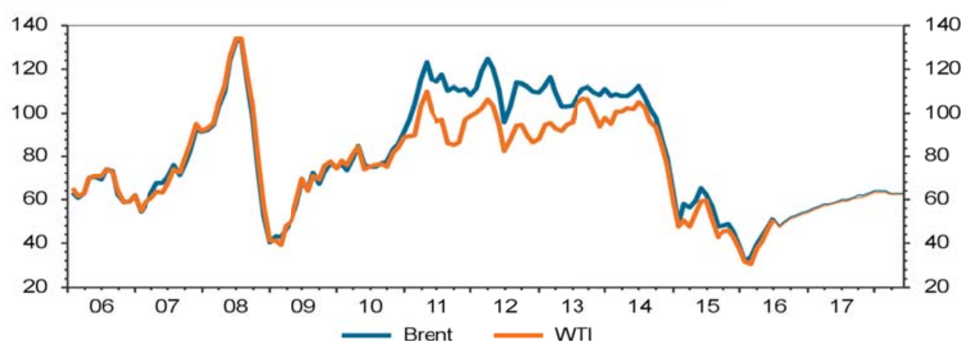
In our baseline scenario, we expect Brent to trade in the short term within a range of USD 45-50. In our opinion, the optimism that has driven the markets has also been amplified by speculative interest, as demonstrated by the high net long positions in futures and options monitored by the US Commodity Future Trading Commission. Crude oil has therefore risen too quickly towards important price targets, “ignoring” the high reserves and the transitory nature of the factors that have accelerated the current rebalancing process. As a consequence, we see

the risk of the price tracking back, above all due to the liquidation of speculative positions (from profit-taking or simply portfolio rotation towards asset classes perceived as likely to offer higher returns in the coming months).

In the medium term, we expect confirmation that the oil market is rebalancing to push prices even higher, taking Brent to an average range of USD 50-55 in the fourth quarter and to around USD 60 by mid-2017.

The main risks to this scenario are fresh surprises linked to supply and demand fundamentals, a stronger-than-expected dollar and high volatility linked to speculative flows, which are particularly dangerous in the summer months when volumes are low.

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



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart based on Bloomberg data

Price estimates for Brent

As at 20 June 2016	3Q16	4Q16	1Q17	2Q17	2016	2017	2018
ICE BRENT	50.0	54.0	57.0	59.0	46.6	60.0	64.0
Bloomberg median	46.3	49.0	51.0	53.5	55.3	62.0	65.0
Forward Curve	50.1	51.1	51.7	52.3	45.9	52.4	54.2

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

As at 20 June 2016	3Q16	4Q16	1Q17	2Q17	2016	2017	2018
NYMEX WTI	49.3	53.3	56.4	58.4	45.5	59.4	63.5
Bloomberg median	45.0	48.5	50.5	52.1	42.0	54.0	60.0
Forward Curve	49.2	50.4	50.9	51.1	44.8	51.3	52.1

Source: Intesa Sanpaolo chart based on Bloomberg data

United States: as the cycle matures, the Fed's task will get tougher

Giovanna Mossetti

The US recovery is aging: now in its seventh year, this is one of the longest post-WWII recoveries (average: 58 months). The signs of maturity, although masked by the peculiar features of this cycle, are starting to show up: a physiological slowdown of employment growth, smaller and smaller output and employment gaps, and a more widespread pick-up in inflation and wages. Although in their initial phase, these features are, in our view, well-established. In a maturing cycle, the central bank's task will become more difficult due to the potential conflicts between its two objectives of full employment and price stability. After years of concerns about excessively low inflation, it is reasonable to assume that the central bank is willing to tolerate an overshooting of the price target. However, the combination of growth stabilising around potential, low productivity and a reduced slack is changing the framework of the Fed's action in 2017, making forecasts increasingly volatile and data-dependent. But in the near term, the result of the UK referendum changes the conditions facing the Fed's decision making: uncertainty and instability at all levels (economic, financial and political) have sharply increased and point to an even more cautious approach on the part of the FOMC.

Maturing cycle: growth close to 2%, inflation rising

Our central scenario is still moderately positive, with growth forecast at around 2% in the next two years (1.9% in 2016, 2.3% in 2017), driven by consumption and residential investment, with a gradual improvement expected in non-residential fixed investment associated with the recovery in oil prices. Inflation will probably exceed the 2% target by the end of the year; with core indices around this target in 2016-17.

In the next few months, the markets will shift their focus to the November elections. It is important to note that the choice of the new president will be crucial especially in regard to foreign policy, while the composition of Congress will be more important for the determination of domestic fiscal policy. Currently, the forecast is that the division between the House of Representatives (Republican) and the Senate (Democrat) will be maintained, with the implication that fiscal policy will be at a virtual standstill for at least another two years and then expand modestly in 2016-17.

1. Macroeconomic outlook. After the now customary Q1 slowdown, GDP growth is picking up in the second quarter and should settle close to 3% q/q ann., driven by all components of private domestic demand, contributing to stabilize overall 2016 growth just short of 2%.

Consumer spending still supported by solid fundamentals: positive labor income and wealth effects

Consumer spending. Private consumption fundamentals remain positive and consistent with solid growth in 2016-17. The combination of growth in labor income, higher net wealth and savings, and confidence in the availability of jobs is providing support to personal spending. The "gasoline bonus", collected in 2014-15, has only partly been spent: the increase in savings (from an average 4.8% in 2014 to an average 5.6% in the first four months of 2016) will enable consumers to cope with the transition to higher levels of gasoline prices without major problems. Consumer spending is forecast to rise by 2.5% in both 2016 and 2017.

Labor market normalization: payroll increases likely close to 00-120k per month

The labor market looks set to continue along a positive path, but although likely to be more moderate than in the last year and a half. Payrolls are expected to rise by around 100-120k per month, still in line with a likely modest fall in the unemployment rate. A slowdown in the employment trend is a pre-requisite for the survival of the recovery: employment growth around 2% yoy have depressed productivity to levels unsustainable for businesses. Labour input should now be determined more by the number of hours than by the number of people employed. The reduction in slack should strengthen the rising wage trend. The unemployment rate is likely to fall to 4.6% and stabilize around that level in 2017.

Non-residential fixed investment: the weakest link in growth should strengthen with the turnaround in mining

Non-residential fixed investment. Capex has been the weakest link in demand since the end of 2015, with contractions caused by the mining sector, but the worst should now be over. The rebound in the oil price from its February lows is a clear indication of a likely turnaround in the extraction industry: a rise in the number of active oil rigs has already started at the end of May,

the first since September 2015, from the lows of early June (at levels roughly half of last year's size). **Corporate earnings** also at last showed a modest increase in the first quarter, supported by the depreciation of the dollar. **Non-residential investment is still the main domestic risk factor for the outlook in Q2:** growth is expected at -0.5% in 2016 and +3.7% in 2017.

Residential investment. Spending in the sector will continue to contribute positively to growth. Investment in this sector is seen growing by 11% in 2016 and 7.1% in 2017.

Inflation: towards 2% and beyond

Inflation. In the last year, inflation concerns were concentrated on the risk of excessive disinflation. The stronger dollar and lower oil price shaved around 0.9 pp off core inflation in 2015; in 2016, these factors will no longer act as headwinds (and for oil, the effects will be reversed), while the reduction in slack should continue to push up services prices. Lastly, low productivity growth and rising unit labour costs are other indicators consistent with a recovery in inflation. Inflation expectations still constitute an element of uncertainty: expectations measured by surveys and TIPS prices have risen since the start of the year but point to an inflation rate of below 2% over the medium to long term.

Monetary policy entirely data-dependent

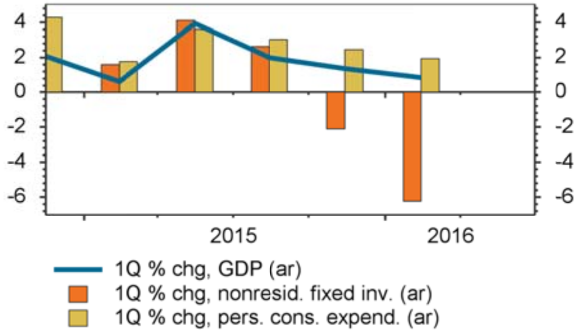
2. Monetary policy: caution in the face of growing global uncertainty. The FOMC maintains a generally positive assessment of the economy but highlights a fresh increase in uncertainty. The fears regarding the labor market may be resolved with1-2 months of data, but the consequences of the UK referendum will linger on for much longer and will be exceedingly hard to assess. Lasting effects on the dollar, global trade and world growth will be highly uncertain, and anyway overall negative. In June, the FOMC left interest rates unchanged, but moved down its rate projections for 2017-18 and cut by 25 bp the end-point (see table). Yellen referred to a "new normal", with low GDP and productivity growth, non-reactive inflation and higher uncertainty. In this context, monetary policy is entirely data-dependent: **the Fed is committed to follow rather than to be pre-emptive**. We maintain our forecast that US interest rates will follow an upward path, albeit very gradual, justified by the closing of the output gap and the rise in inflation. Ms Yellen said that a July move is "**not impossible**", but it seem likely that, even with unconditionally positive labor market data next month, the next hike will not come before September. But any forecast will need to be updated once the British dust settles. Before Brexit, the central scenario was for two hikes per year in 2017-2018. However, exceptionally uncertain conditions may prompt even more revisions: the only thing that can be guaranteed is volatility.

What is the "new normal"?

Forecasts

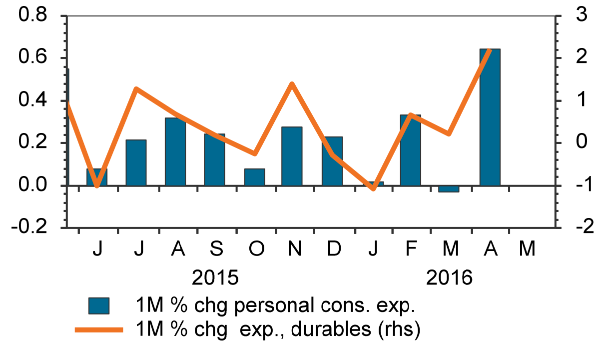
	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (1996 US$,y/y)	2.4	1.9	2.3	2.1	2.0	2.0	1.7	1.7	2.0	2.3	2.2
q/q annual rate				2.0	1.4	0.8	2.6	2.2	2.3	2.3	2.2
Private consumption	3.1	2.5	2.5	3.0	2.4	1.9	2.7	2.4	2.7	2.6	2.2
Fixed investment - nonresid.	2.8	-0.5	3.7	2.6	-2.1	-6.2	1.5	3.1	3.8	3.5	4.4
Fixed investment - residential	8.9	11.0	7.1	8.2	10.1	17.2	9.8	8.2	6.2	6.2	8.1
Government consumption	0.7	1.0	0.5	1.8	0.1	1.2	0.7	0.7	0.7	0.3	0.3
Export	1.1	0.5	3.8	0.7	-2.0	-2.0	2.6	2.8	3.0	4.5	4.1
Import	4.9	1.8	3.8	2.3	-0.7	-0.2	4.1	3.8	4.0	3.5	3.7
Stockbuilding (% contrib. to GDP)	0.2	-0.2	-0.2	-0.2	0.0	-0.1	0.0	0.0	0.0	-0.1	-0.1
Current account (% of GDP)	-2.7	-2.7	-2.4	-2.9	-2.8	-3.0	-2.7	-2.6	-2.6	-2.6	-2.4
Federal Deficit (% of GDP)	-3.5	-3.4	-3.4								
Gov. Debt (% of GDP)	125.4	125.6	123.7								
CPI (y/y)	0.1	1.2	2.2	0.1	0.4	1.1	1.2	1.5	0.9	1.4	2.1
Industrial production (y/y)	0.3	0.0	3.0	1.5	-3.4	-1.5	1.5	4.0	3.1	2.5	3.5
Unemployment (%)	5.3	4.8	4.6	5.2	5.0	4.9	4.8	4.7	4.6	4.6	4.6
Fed Funds	0.26	0.63	1.25	0.25	0.29	0.50	0.50	0.68	0.83	1.00	1.25
Effective exch.rate (1973=100)	91.1	91.3	88.3	91.7	93.1	93.2	89.5	91.5	91.1	89.7	88.6

Fig. 1 – GDP: awaiting a rebound



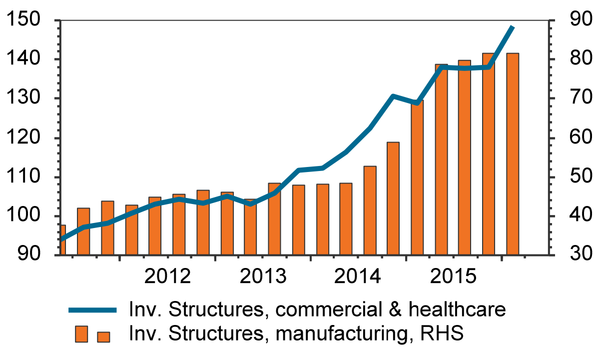
Source: Thomson Reuters-Datastream

Fig. 2 — Consumer spending picking up in 2Q



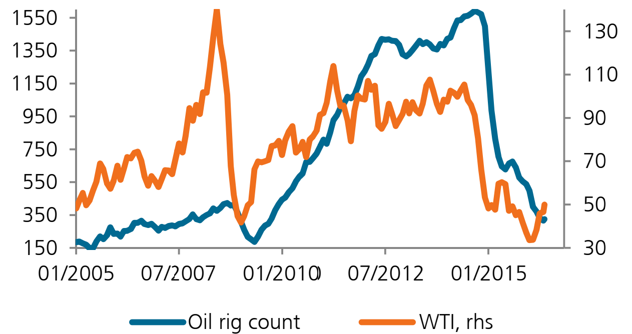
Source: Thomson Reuters-Datastream

Fig. 3 Non-residential investment growing outside extraction sector



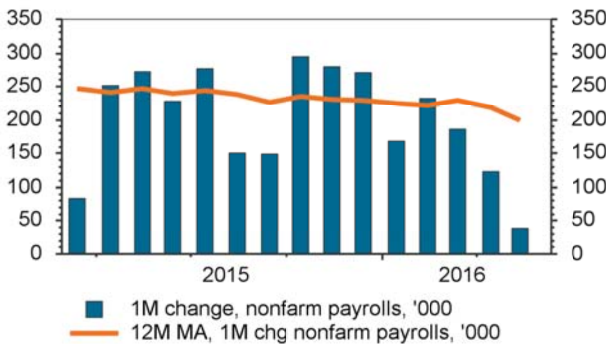
Source: Thomson Reuters-Datastream

Fig. 4 – Oil reversal points to a rebound in mining



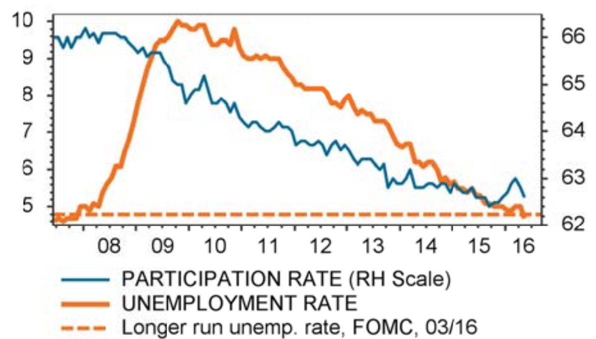
Source: Bloomberg

Fig. 5 – Employment growth: slowing too much in May



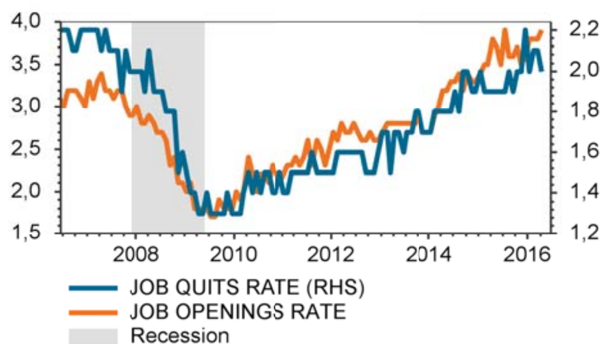
Source: Thomson Reuters-Datastream

Fig. 6 – Slack is disappearing



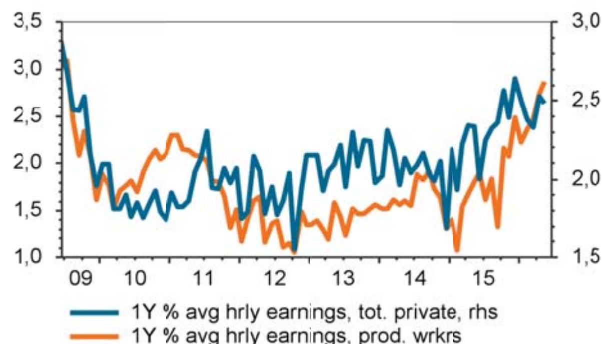
NB: Source: Thomson Reuters-Datastream

Fig. 7 – Job openings and quits signal an almost balanced labour market



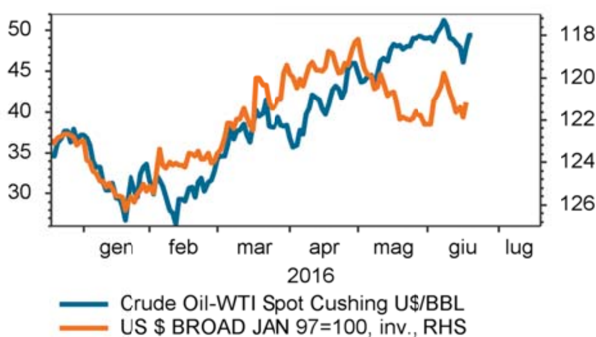
Source: Thomson Reuters-Datastream

Fig. 8 – Wages respond to labour market conditions



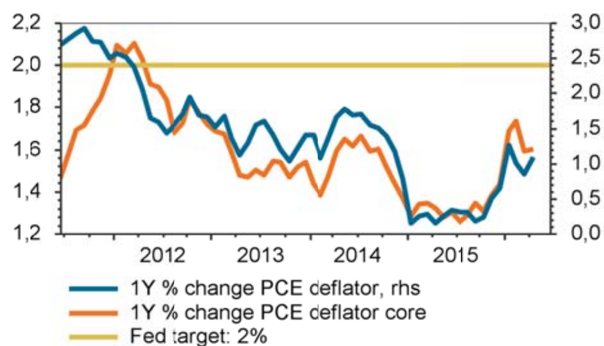
Source: Thomson Reuters-Datastream

Fig. 9 – External variables now pushing up inflation



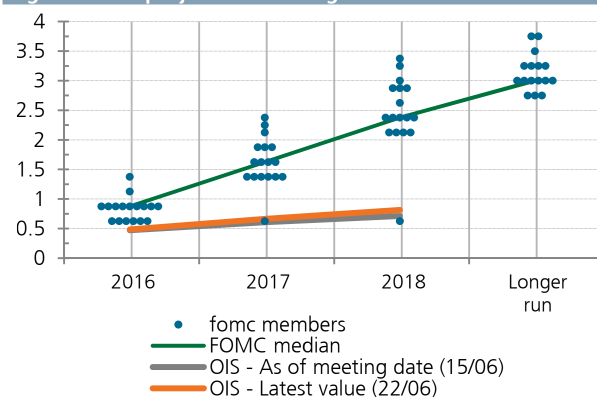
Source: Thomson Reuters-Datastream

Fig. 10 – Inflation is not that far from 2%



Source: Thomson Reuters-Datastream

Fig. 11 - Rate projections moving down



Source: Bloomberg, data at 21 June 2016

Fed macroeconomic projections – June 2016

Variable	Median 2016	2017	2018	Long-term.
Real GDP	2.0	2.0	2.0	2.0
March projection	2.2	2.1	2.0	2.0
Unemployment	4.7	4.6	4.6	4.8
March projection	4.7	4.6	4.5	4.8
Consumption deflator	1.4	1.9	2.0	2.0
March projection	1.2	1.9	2.0	2.0
Core consumption deflator	1.7	1.9	2.0	
March projection	1.6	1.8	2.0	
Memo:				
Projections of appropriate rate path				
Fed funds rate	0.9	1.6	2.4	3.0
March projection	0.9	1.9	3.0	3.3

Source: Federal Reserve Board. GDP figures: yoy % change in 4Q

Euro zone: growth is domestic, the main risk is political

Anna Maria Grimaldi

- The phase of moderate expansion in the Euro zone economy is expected to continue in the coming months. A rate of growth of around 0.4% qoq is expected, following the figure of +0.6% qoq at the start of the year, which was inflated by calendar effects and unusually warm climate. Growth will be buoyed up by domestic demand, which will continue to expand at pre-crisis rates, sustained by the past falls in oil prices, exchange rate depreciation and highly expansionary financial conditions.
- According to our estimates, GDP will grow 1.7% this year following 1.6% in 2015, and could slow again in 2017 (1.6%), given that the external impact of oil and the exchange rate will be fading. Growth will pick up speed mainly in Italy (1.1% in 2016 and 1.4% in 2017 following 0.6% in 2015) and France (1.5% in 2016 and 1.7% in 2017 following 1.2% in 2015), and is expected to be flat in Germany at around an average of 1.7%. Spain and Holland have already peaked, although they are continuing to show above-potential growth.
- The risks for the scenario are still to the downside, deriving mainly from uncertainty surrounding the global economy, from a sharper than expected rise in oil prices, and from a new phase of turbulence in financial markets. The main risk, however, is political. There are a number of important tests in the coming months: the federal election in Germany (September) and the referendum on constitutional reform in Italy (October). Holland (March), France (spring) and Germany (August) will hold parliamentary elections in 2017, and in all cases there is a risk of further movement towards anti-euro positions.
- Fiscal policy will offer limited support to growth in 2016-17 (0.2% of GDP). It is likely, however, that in the current delicate geopolitical situation the European Commission will, in reality, allow Euro zone members maximum flexibility in managing their public finances.
- The return of Euro zone inflation towards 1.4% in 2017 will only partly be supported by the increase in oil prices. The focus will again be on the response of core prices to the recovery of domestic demand. At the moment, second-round effect risks are not insignificant.
- The ECB is currently waiting 'patiently', in order to monitor the development of short-term political risks and the impact of the measures just taken concerning growth and inflation. It maintains, however, its strongly accommodative stance. Further measures cannot be ruled out, although they depend on data trends as well as domestic and global financial conditions.

Forecasts

	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.6	1.7	1.6	1.6	1.7	1.7	1.7	1.7	1.7	1.6	1.6
- q/q change				0.3	0.4	0.6	0.4	0.4	0.4	0.5	0.4
Private consumption	1.7	1.8	1.7	0.5	0.3	0.6	0.3	0.5	0.4	0.5	0.4
Fixed investment	2.7	3.0	2.8	0.5	1.4	0.8	0.6	0.5	0.6	0.9	0.8
Government consumption	1.3	1.6	1.3	0.3	0.5	0.4	0.4	0.4	0.4	0.4	0.2
Export	5.1	2.8	3.9	0.4	0.7	0.4	0.8	0.8	1.1	1.0	1.0
Import	5.9	4.2	5.3	1.3	1.4	0.7	0.9	1.1	1.5	1.6	1.3
Stockbuilding (% contrib. to GDP)	-0.1	0.3	0.3	0.2	0.1	0.1	0.0	0.0	0.1	0.2	0.1
Current account (% of GDP)	3.2	2.8	2.0	3.2	3.2	2.8	3.3	2.7	2.7	2.0	2.4
Deficit (% of GDP)	-2.1	-2.1	-1.9								
Debt (% of GDP)	92.9	92.7	92.2								
CPI (y/y)	0.0	0.3	1.4	0.1	0.2	0.0	-0.1	0.4	1.0	1.5	1.6
Industrial production (y/y)	1.5	2.0	1.8	0.4	0.4	1.0	0.5	0.4	0.0	0.2	0.9
Unemployment (%)	10.9	10.1	9.4	10.7	10.5	10.3	10.2	10.0	9.8	9.6	9.5
3-month Euribor	-0.02	-0.28	-0.33	-0.03	-0.09	-0.19	-0.26	-0.33	-0.34	-0.34	-0.33
EUR/USD	1.11	1.11	1.15	1.11	1.10	1.10	1.13	1.09	1.10	1.13	1.14

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

The recovery continues at a moderate pace

Despite the slowdown in international trade and the turbulence in financial markets, Euro zone GDP grew faster than expected at the start of 2016 (0.6% qoq following 0.4% qoq at the end of 2015). This was partly due to calendar effects and the exceptionally mild weather that fuelled construction output, especially in Germany. Economic surveys have shown fluctuations between February and June, but are overall in line with more moderate economic growth (0.4% qoq) in the central months of the year (see fig.1). After its jump at the start of the year, industrial production should show growth of 0.5% qoq in June following the +1.0% qoq recorded in March. Indications for the manufacturing sector are for activity levelling off with fairly flat growth (see fig. 3). Exports to countries outside the Euro zone have recovered since the start of the year, although the outlook remains uncertain and expectations are generally flat (see figs. 3 and 4). Services and retail should continue to contribute significantly to growth since they are supported by the trend in domestic demand. However, confidence surveys suggest that the peak could have already been reached.

In our central scenario, GDP is expected to grow by 1.7% in 2016, one-tenth of a point more than our March estimates. In 2017, growth is seen at 1.6%, given that we see the support from external factors weakening. We expect an increase in oil prices of around 10% by end 2017, although risks are slightly to the upside. Overall, the supporting effect from oil prices should fall from 0.5% in 2016 to 0.2%, given that the decreases observed in 2015 and early 2016 will be partly offset by the increases we now expect until the end of 2017.

The appreciation of the euro effective exchange rate was 5% in 2015. Between now and the end of 2017 our central scenario assumes either stability or a further small increase of 1%. However, the recent appreciation could reduce GDP growth by around 0.2-0.3% from the start of 2017, taking the usual transmission lag into account.

Foreign demand relating to the Euro zone is expected to recover to +3.8% from + 1.9% in 2016. In particular, we expect demand from emerging countries to stabilise following the 2016 drop, partly on the back of the recovery of exports to Brazil, Russia and eastern Europe. Euro zone exports to OPEC countries are likely to offer a nil contribution in 2017, after the fall expected this year. Exports to developed countries could contribute less than this year.

Growth will continue to be supported by the ECB policies announced between December and March. In our central scenario we assume that the ECB will not make further changes to monetary stimulus for the foreseeable future. We maintain the impact of monetary policy on Euro zone growth at +0.5% this year and as per ECB estimates for next year (Praet speech of 7 April 2016). However, the impact could be greater if TLTRO II were able to effectively stimulate credit growth. TLTRO II operations have already had a major impact on financing conditions for the banks and have improved confidence in the solidity of the banking sector. The first of the four auctions saw a bid for 399 billion which net of the 368 billion reimbursed from the first TLTRO (on a total of 425 billion) implies a fresh liquidity injection of 31 billion.

Expansionary monetary policy will receive limited support from other economic policies, despite continued appeals from ECB Council members. Fiscal policy will be only moderately expansionary in the Euro zone on average. The flexibility granted by Brussels, partly to help cope with the huge influx of refugees, will allow an easing of the structural deficit of 0.3% of GDP in 2016. This is, in any case, a change of gear from 2011-14, when the fiscal correction was on average 1.0% of GDP per year. We do not rule out the 2016 structural budget balances being larger than the estimates of the European Commission, partly to stem the drift towards populism and a lack of majority governments in Spain and Portugal.

GDP growth will still be driven by domestic demand, while foreign trade should trim 0.5% from the figure. Exports are expected to grow by 3.9% in 2017, after 2.8% in 2016, while imports will increase from 4.2% next year to 5.3%. Domestic demand should accelerate to 2.0%, from 1.7% in 2015. Household consumption was the main growth driver in 2015 and is expected to grow 1.7-1.8%, at the same pace as last year. A slowdown will be seen from mid-2017 towards 1.3%, due to the erosion of purchasing power associated with the increase in oil prices, and a rise in inflation to 1.4% from 0.3% this year. Consumption will continue to receive support from more expansionary financial and lending conditions, a gradual improvement in employment (+1.0% in 2016 from 0.8% in 2015) and a rise in contractual wages of 1.6% following a figure of +2,3%[4] in 2015 (see fig. 8). The savings rate could fall to 9.8% from 10.1% in 2015.

Investment in machinery rose 1.0% at the start of the year, following growth of 1.6% at the end of 2015. The high utilisation of production capacity (see. fig. 9) and extremely expansionary credit conditions (see fig. 10) as well as a fall in the cost of finance for businesses, an improvement in internal funds, and solid profit growth in the second half of 2015 should support a more buoyant capex cycle from the second quarter of this year. However, we still maintain a quarterly average growth forecast of 0.9% qoq. The European Commission's quarterly survey in April showed a downward revision of spending plans and indicated that businesses would increase investment in replacement but not for expansion purposes in 2016 (see fig. 10). It is possible that geopolitical uncertainty will also hamper extension investment in the coming months. Our indicator for construction spending[5] points to an increase in the quarterly figure once again in the spring (see. fig. 11). Investment in construction showed an average increase of 2.2% in 2016 (thanks to the strong start to the year) and 1.6% in 2017.

The risks to the scenario are still to the downside and are mainly political. The risks to the international scenario have also diminished (albeit marginally) compared with three months ago. This is due to signs of stabilisation of international trade. International geopolitical risk remains high and in recent months political risk within the Euro zone has increased. The local elections in Italy on 20 June and the Spanish general election to be held on 26 June have confirmed the drift towards populism. Given the situation, it is by no means certain that negotiations in Spain will lead to the rapid formation of a government. A series of important events will take place over the next few months. The first of these is the German federal election in September, which will shed light on the extent to which the AfD continues to have a hold on the electorate following the agreement reached with Turkey for dealing with refugees. This will be followed by the referendum on constitutional reform in Italy, which the government could end up losing. A general election will follow in Holland in March 2017 and recent opinion polls show an increase in support to 37% for the PVV (Party for Freedom), an extreme-right and Eurosceptic populist party. Elections will be held in France in the spring, although opinion polls indicate that the risk of support drifting to the Front National should be limited, at least for the second ballot. In Germany, if the AfD's progress is not halted over the next 14 months, forming a new governing alliance could become complicated. The risk that Germany could find itself with a minority government cannot be ignored.

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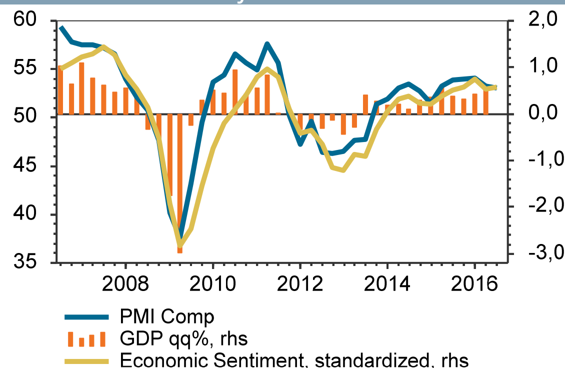
[4] At the moment, the upturn in contractual wages is due almost entirely to Germany.

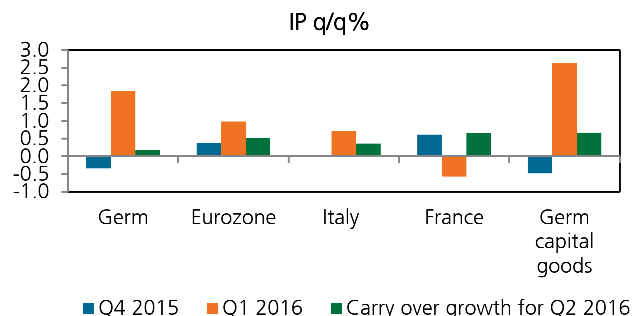
[5] See the *Weekly Economic Monitor* of 20 May 2016

Fig. 1 – Confidence surveys are consistent with 0.4% qoq growth in the central months of the year



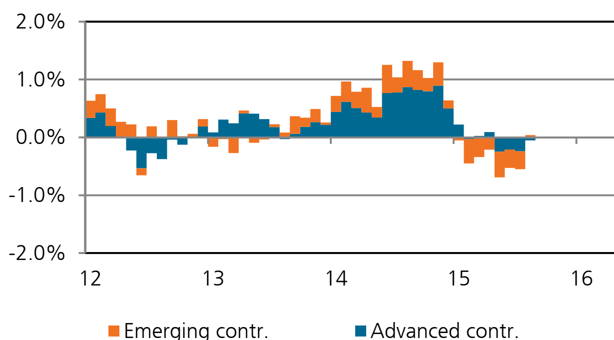
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 2 – April's industrial output figures suggest output growth of 0.5% qoq in the second quarter



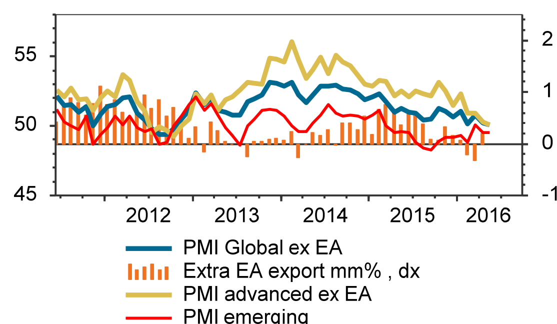
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 3 – Demand from emerging markets is no longer a brake on exports but its future contribution will be modest



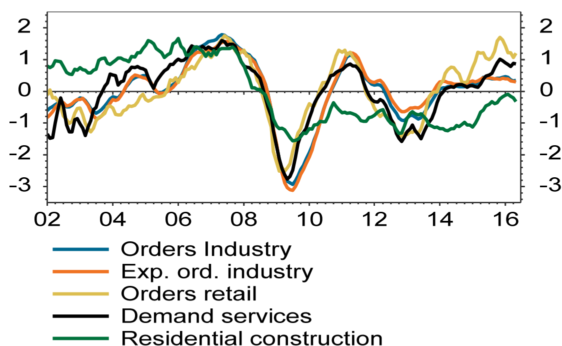
Note: Contribution to growth of total exports qoq%. Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 4 – Prospects for foreign trade in the coming months are less than encouraging



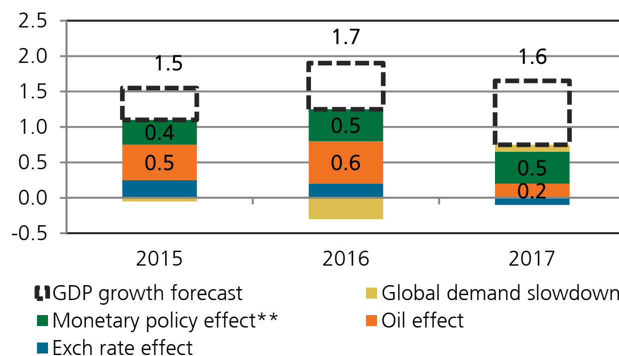
Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 5 – Growth in the Euro zone remains solid, driven by services, retail, and a recovery in residential construction



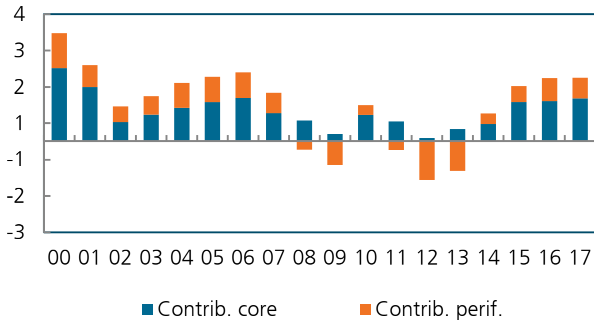
Note: Contribution to growth of total exports qoq%. Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo data

Fig. 6 – The effect of external events (oil and exchange rates) will weaken in 2017



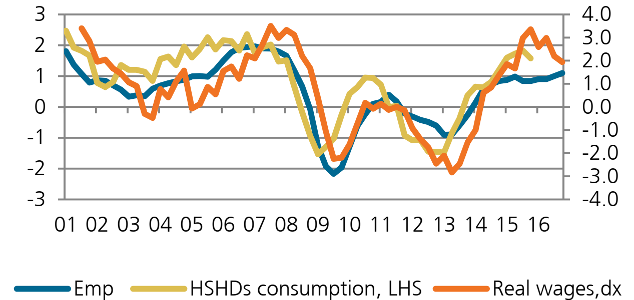
Note: effect of QE on growth 1.5% in 3 years (Praet, 7 April 2016) Source: Eurostat, BCE and Intesa Sanpaolo data

Fig. 7 – Household consumption is growing at pre-crisis rates, thanks to falls in oil prices, highly expansionary ECB measures



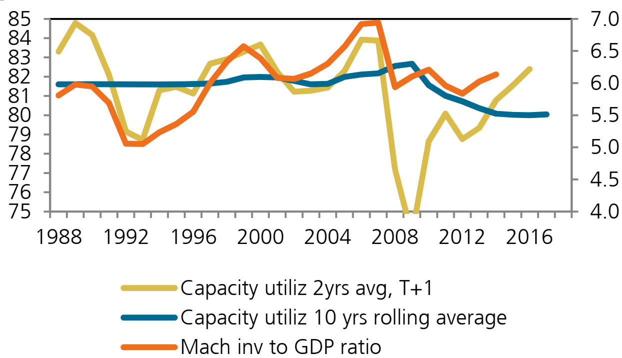
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 8 – Salaries and jobs provide support



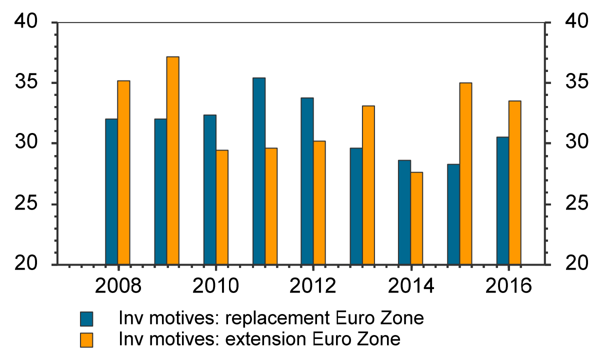
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 9 – A livelier investment cycle ahead? Production capacity above the average for the last 10 years suggest an acceleration to 6.5%



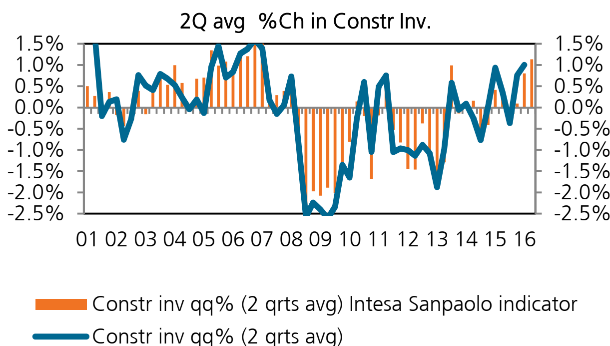
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 10 – April's European Commission survey pointed to a bigger increase in replacement investment than in expansion investment



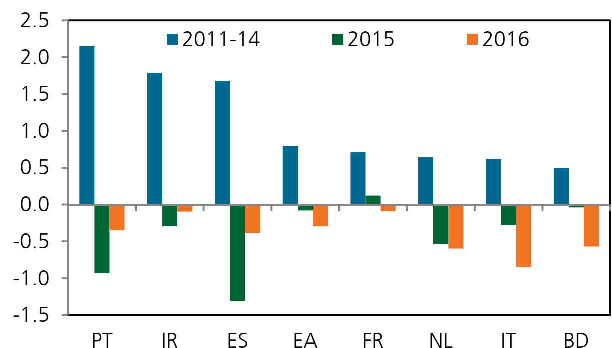
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 11 – Construction investment: our indicator suggests construction continuing to hold up over the spring months



Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo chart

Fig. 12 – Fiscal policy will prove more expansionary ex post



Source: Intesa Sanpaolo chart based on European Commission (AMECO May 2016) data

Inflation: the low is behind us, but the rise back remains uncertain and modest

Anna Maria Grimaldi

Compared with three months ago, we have marginally revised up our inflation forecasts for the Euro zone by a tenth of a point to 0.3% in 2016 and to 1.4% in 2017. Inflation is expected to remain well off the ECB target also in 2018, when we see an increase to 1.6% (see fig. 1).

The low for inflation should be behind us

The low for consumer price inflation seems to be behind us. The oil price direction reversed in March, and the recent trend should be confirmed over the forecast horizon. On average, we assume an oil price of USD 52 in 2017, from USD 46 this year. The rise in oil prices will be partly dampened by the 4% appreciation in the euro we have already seen. Energy may again start to offer a positive contribution to headline inflation only from 2017, given the base effect will remain highly negative until the end of 2016 (see Fig. 4), and due to the usual time-lag with which an oil price rise is transmitted to consumer prices[6]. The important thing for assessing the inflation outlook and the effectiveness of ECB measures is not so much how much headline inflation moves in response to a rise in oil prices, but if, and by how much, core inflation reacts. Since the beginning of 2014, inflation has moved around 0.9%. The median calculated on various core inflation measures has risen by only two tenths of a point to 0.7%, from a low of 0.5% at the beginning of 2015 (see Fig. 5).

Core inflation has risen only marginally despite ECB measures and the closure of the output gap

Core prices have shown modest and still fairly preliminary signs of a trend reversal. Core inflation seems to have reached a low in the peripheral countries of the Euro zone. Non-energy services prices, typically more closely linked to the trend in domestic demand (see Figs. 7 and 8) have picked up, but nevertheless remain at historic lows. Going forward, an increase in underlying inflation still depends on diminishing excess supply or an upturn in domestic demand. With growth forecasts for 2017-18 not much stronger than this year, the output gap is expected to remain negative until the end of 2017, including in the European Commission's spring forecasts. Lower excess supply. is likely to contribute at most 0.2% over two years [7]. Furthermore, pressure from unit labour costs remains limited for the moment. Growth in contractual wages was 2.1% yoy in 1Q (see Fig. 10), but the increase was concentrated in Germany and France. Growth in labour costs will also remain at around 1.1% in 2016-17. Productivity is expected to increase on average by 0.6% yoy a year, since employment will grow less than GDP.

The risks for consumer price inflation are still to the downside

Risks for inflation are still to the downside, and are driven by an uncertain cyclical outlook, as well as potential second-round effects on wage growth and domestic prices, the protracted decline in oil prices, and medium-term inflation expectations that are still well off the ECB target. Until now, the rise in oil prices has not had an impact on the market's inflation expectations (see Fig.11). Thus, for now, ECB measures have not yet shifted the estimates of official forecasters surveyed by the ECB (see Fig.12). We cannot rule out that a more marked rise in oil prices will drive inflation; higher crude prices could weigh on growth, and especially on household consumer spending, acting as a brake on core prices. Furthermore, in June, the ECB trimmed its core inflation forecasts.

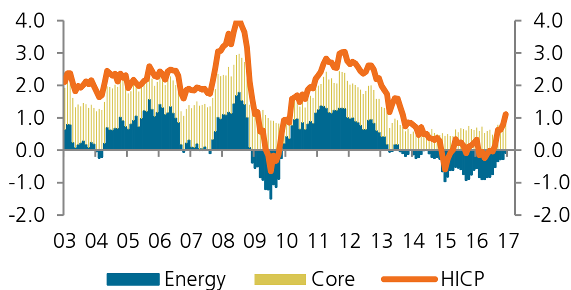
[6] The standard elasticities inherent in the ECB and European Commission models suggest that the effect of a 5% fall/rise in the price of crude oil on headline inflation is between 0.15% and 0.3% after four quarters.
[7] Our model estimates the change in core inflation based on the output gap and lags in the change of energy prices and labour costs.

Tab. 1 – Inflation forecasts by country

	GRC	CYP	IRL	ITA	FRA	ESP	EA	NLD	GER	FRA	PRT	MLT	AUT	BEL
2015	-1.1	-1.5	0.0	0.1	0.1	-0.6	0.0	0.2	0.1	0.1	0.5	1.2	0.7	0.6
2016e	-1.0	-1.5	0.2	0.0	0.5	-0.3	0.3	0.3	0.5	0.5	1.0	1.3	1.4	1.9
2017e	-1.0	1.0	1.9	1.1	1.2	1.7	1.4	1.6	1.6	1.2	1.9	2.3	2.5	2.2
2018e	-0.9	1.1	1.9	1.1	1.2	1.7	1.5	1.5	1.6	1.2	1.9	2.4	2.5	2.2

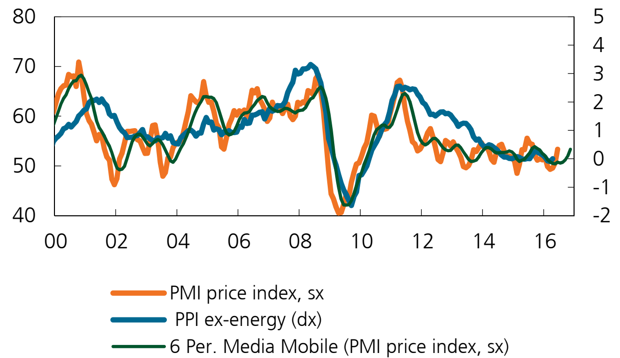
NB: e = Intesa Sanpaolo estimates Source: Eurostat

Fig. 1 – The low for inflation should be behind us



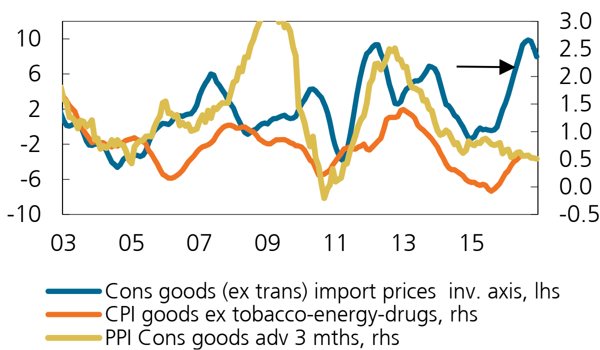
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 - Downward pressures upstream seems to have stabilised



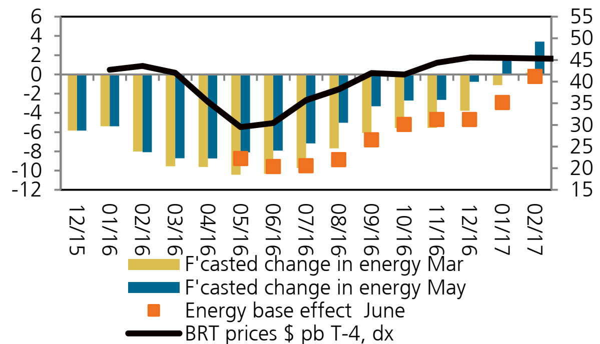
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 3 – But the rise in import prices does not seem to have been transmitted to producer and consumer prices



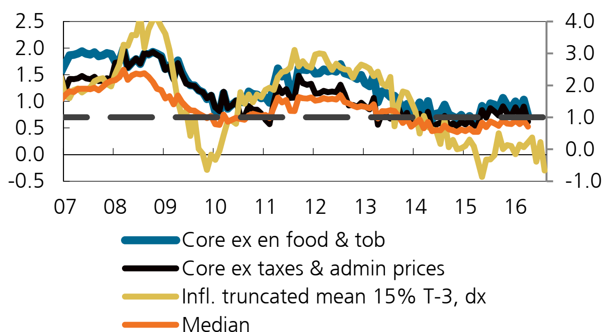
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – The low for oil prices should be behind us, but energy's contribution will remain negative owing to the significant unfavourable base effect



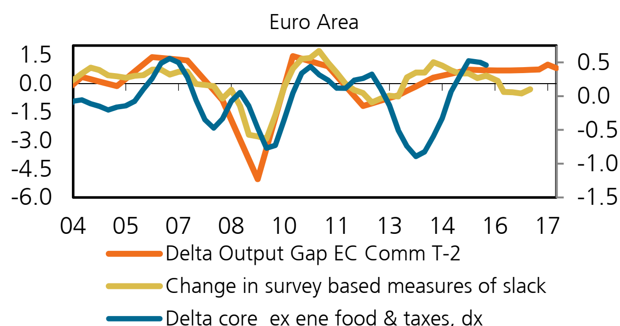
Source: Thomson Reuters-Datastream

Fig. 5 – Core inflation: the median rose from a low of 0.5% at the beginning of 2015, to 0.7% in April. The fall in the 15% trimmed mean suggests that the risks are still to the downside in the short term



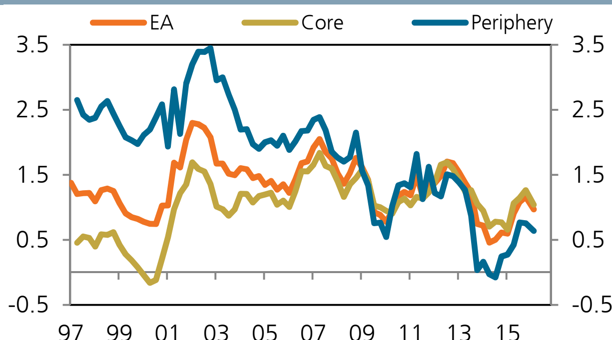
Source: Thomson Reuters-Datastream

Fig. 6 – The rise in core inflation will depend on how quickly the output gap is closed



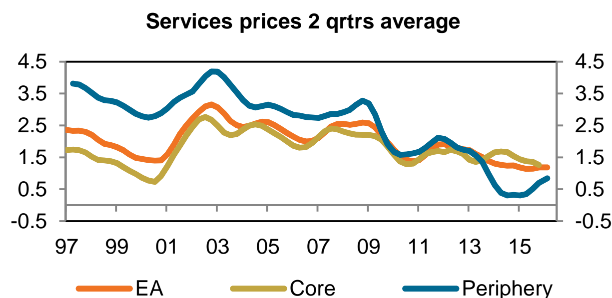
NB: Output gap European Commission change on the previous year. Measures of excess supply from surveys are based on the question from the European Commission's quarterly survey: "is demand a limit to production?" for industry, construction, services and retail. The series are normalised and aggregated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

Fig. 7 – Core inflation net of taxes: the low in peripheral countries seems to be behind us



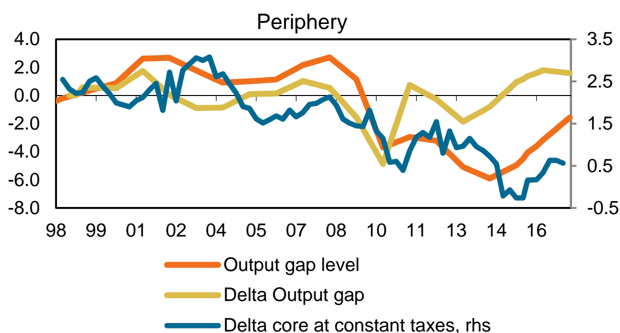
NB: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in the Euro zone HICP
Source: Thomson Reuters-Datastream

Fig. 8 – The price of services, typically more closely linked to the trend in domestic demand, has reversed in peripheral countries



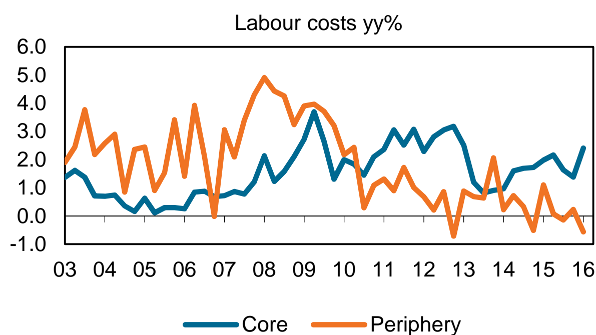
NB: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in the Euro zone HICP
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 9 – The recent rise in inflation in peripheral countries was affected by both the change and the level of the output gap



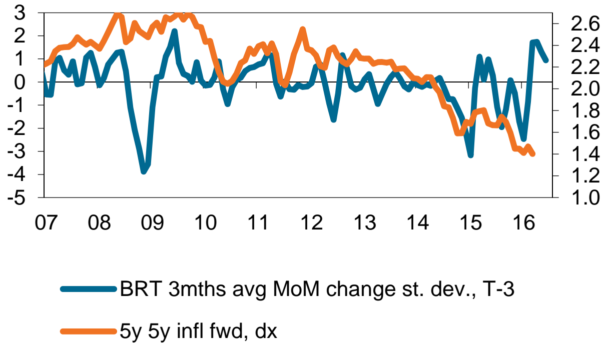
NB: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in Euro zone GDP
Source: Thomson Reuters-Datastream

Fig. 10 – Labour costs again started to slow in peripheral countries at the beginning of 2016



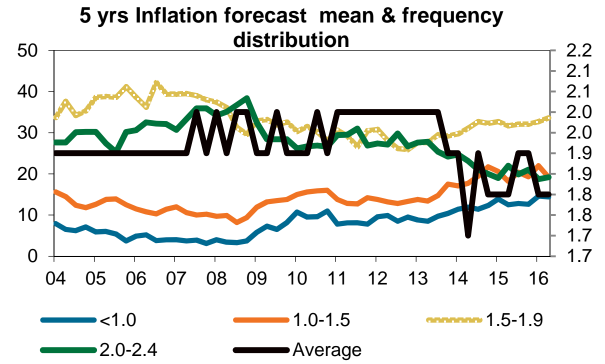
NB: Peripheral countries = Ita+Spa+Pt+Irl; Core countries = Germ+Fr+Nl+Bel. Countries are aggregated with the weightings in Euro zone GDP
Source: Thomson Reuters-Datastream

Fig. 11 – Risks of second-round effects on wage growth and domestic prices if inflation expectations remain at low levels compared with the ECB target Rising crude oil prices should help stabilise expectations



Source: Thomson Reuters-Datastream

Fig. 12 – Long-term price expectations from the survey of ECB forecasters stable at 1.8% despite ECB measures



Source: Thomson Reuters-Datastream

Germany: the growth witness has now been passed to domestic demand

Anna Maria Grimaldi

At last, Germany seems to have embarked on a growth model that focuses less on exports and more on domestic demand. The transformation has only just started, and it will take time before there is any significant reduction in the excessive current account surplus (8.7% in 2015). But if this change were to become established, the country could at last play a part in correcting the euro zone's internal imbalances. The European Commission previously recommended using fiscal policy to boost public investment in infrastructure, education and R&D. The challenges for the next two years are political rather than economic. The transition towards the political elections scheduled for end-summer 2017 (the first possible date would be after 20 August) is shaping up to be rather complicated. The right-wing populists of the Alternative for Germany (AFD) party, following their success last March, are now represented in eight of the 16 German state parliaments and are the third-largest party in Germany, ahead of the Greens. If the AFD populists' success were to be repeated in both the forthcoming regional elections (September 2016[8]) and nationally at the end of summer 2017, this would considerably complicate the creation of government alliances in Germany. There is a risk that the largest European country could also find itself in a political impasse after the elections. Decisions about economic and foreign policies will certainly not be easy for the German Chancellor. It is by no means certain that an expansionary fiscal policy – potentially positive for the economy – would help shift approval towards the CDU.

Domestic demand may continue to drive the above-potential expansion

Despite the slowdown in global trade at end-2015 and the high uncertainty that dogged the markets at the start of the year, German GDP has accelerated to 0.7% qoq from 0.3% in the second half of last year. The pace of growth at the start of the year is unlikely to continue into spring, due to the combination of unusual calendar factors and the rebound in building activity, which has been boosted by the exceptionally mild weather. The PMI composite and IFO have see-sawed over the last few months but overall indicate less sustained GDP growth in spring (see Fig. 1). Quarterly volatility aside, the underlying trend is solid, boosted by domestic demand, which has accelerated since mid-2015 and has more than offset the fall in net exports. Above-potential expansion (1.3% in the Bundesbank's most recent estimates) could therefore continue in the current two-year period. We are upgrading our 2016 estimate by one-tenth of a percentage point compared with three months ago, to 1.7%, and confirm the forecast of 1.6% for next year (1.8% and 1.4% respectively, excluding calendar factors). Over the forecast horizon, foreign trade will act as a brake on GDP growth, in the amount of 0.8% p.a. Exports are likely to start growing more rapidly from summer, approximately in line with growth in global demand for German goods (3.7% in 2017, from 2.3% in 2016); however, imports will grow at a more sustained pace given the high contribution of consumption and investment to imports. The baton has now passed to domestic demand, which will consolidate last year's sharp acceleration, with average growth of 2.1% in 2016 and 2017. Private consumption will continue to provide momentum, rising by 1.9% in 2016 and 1.8% in 2017, following growth of 2.0% last year; this sustained rate of growth over three years has not been seen since the end of the 1990s. Household spending is benefiting from a combination of factors: financial conditions that still provide ample support, previous falls in oil prices, a lower tax burden and the resilience of real employment income. Contractual wage growth is expected to fall slightly to 2.1%[9] this

Consumer spending at its highest since reunification, supported by employment, salaries and fiscal policy

[8] In September 2016, another two regional parliaments – Mecklenburg-Pomerania and Berlin, which are currently governed by the SPD and the CDU – will have to be re-elected.

[9] Overall, wages grew by 2.8% in 2015, outstripping contractual wages, due to positive wage drift following the introduction of the minimum wage in January 2015. The impact of introducing the minimum wage should disappear in 2016. Wages agreements for engineers and metalworkers concluded in the first six months of this year were generally lower than in the past. Note that the increase in unit labour costs will be lower, since labour productivity is expected to grow by 0.6% p.a. in 2016-17.

year, from 2.4% in 2015; however, more sustained rises should materialise in 2018 in light of full employment on the labour market. **Employment** continues to rise at a more sustained pace (1.6% yoy in the first three months of 2016, from 1.2% at end-2015) according to the surveys (see Fig. 6), thanks to the contribution of the public sector, especially health, social services and transport. Growth in the **number of people in work is expected to slow in 2017 to 0.9%, from an estimated 1.3%this year.** Further falls in unemployment from the recent lows (6.1% in May) depend on labour force growth and how quickly the influx of immigrants translates into an increase in participation[10]. Growth in disposable income will slow to 1.0-1.3% in 2017 from 2.4% in 2016 due to the rise in **inflation to 1.6% from 0.5%** this year (see Fig. 5). The recent increase in the savings rate to 10% constitutes a buffer for consumption in case there is a more marked increase in oil prices. **Investment in machinery has increased more than expected in early 2016** (1.4% from 0.9% qoq at end-2015). The high degree of capacity utilisation, amply supportive financial conditions and companies' solid balance-sheet positions (low leverage, falling debt and strongly-growing profits) are likely to support the spending of expanding companies. The only aspect of concern is the geopolitical uncertainty (see Figures 7 and 8). According to indications from permits and orders, and in light of the fundamentals, investment in **residential construction** is set to grow at more normal rates (0.5% qoq on average) after the early-year rebound caused by the unseasonal weather. **Risks to the scenario are broadly balanced.** Weaker performance of global demand compared with our estimates and/or a rise in oil prices will be partly offset by looser monetary policy. **Fiscal policy**, moreover, has scope to combat any negative shocks. The budget surplus is expected to fall to 0.4% in 2016, from 0.6% this year. The balance is likely to fall over the cycle to 0.3% in 2017, from 0.8% in 2015, mainly due to the increase in spending to accommodate refugees.

Corporate investment: the cycle of expansion has started

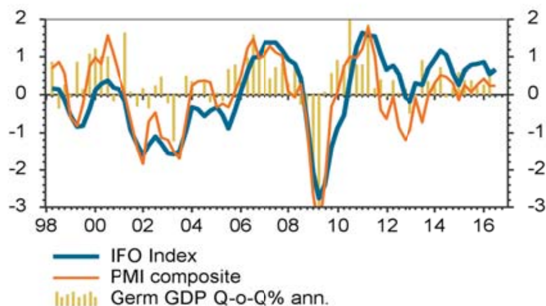
Residential construction: expansion is still solid

Forecasts	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (1995 prices, y/y)	1.4	1.7	1.6	1.7	1.3	1.6	1.6	1.8	1.9	1.7	1.7
- q/q change				0.3	0.3	0.7	0.4	0.4	0.4	0.5	0.4
Private consumption	2.0	1.8	1.9	0.8	0.4	0.4	0.3	0.6	0.5	0.6	0.4
Fixed investment	1.7	3.3	2.7	0.1	1.4	1.8	0.2	0.6	0.5	0.8	0.9
Government consumption	2.5	3.0	2.6	0.7	0.9	0.5	1.0	0.8	0.8	0.7	0.4
Export	4.8	2.3	3.4	0.3	-0.6	1.0	0.8	0.6	1.0	0.9	1.0
Import	5.4	4.6	5.7	1.1	0.5	1.4	1.4	1.1	1.6	1.6	1.8
Stockbuilding (% contrib. to GDP)	-0.6	0.3	0.3	0.0	0.1	0.1	0.2	0.0	0.1	0.1	0.2
Current account (% of GDP)	8.6	8.3	8.0	9.2	8.5	9.8	8.4	7.8	7.5	7.0	6.5
Deficit (% of GDP)	0.7	0.3	0.1								
Debt (% of GDP)	71.2	70.1	68.8								
CPI (y/y)	0.2	0.7	1.4	0.1	0.3	0.3	0.1	0.9	1.3	1.8	1.7
Industrial production (y/y)	0.5	1.8	1.9	-0.1	-0.3	1.8	-0.2	0.6	0.1	0.0	1.1
Unemployment (%)	6.4	6.1	6.1	6.4	6.3	6.2	6.1	6.1	6.1	6.1	6.1
10-year yield	0.52	0.26	0.56	0.68	0.57	0.28	0.15	0.22	0.38	0.43	0.53
Effective exch.rate (2005=100)	94.9	95.1	95.6	95.0	94.7	95.1	95.3	94.8	95.1	95.4	95.5

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

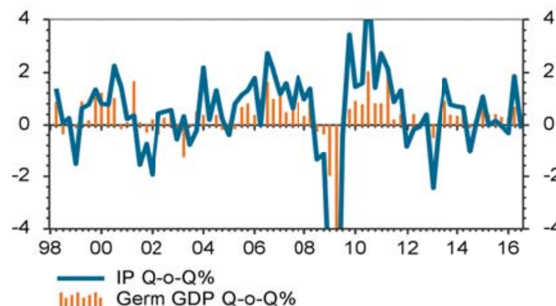
[10] Demand for labour is still largely met from immigration from the rest of the EU, while the Bundesbank estimates that, at the moment, only a very small percentage of refugees who arrived last year have managed to gain access to the labour market. Estimates of net migrant flows from non-EU countries have been significantly downgraded since December. The Bundesbank now estimates net migrant flows of 1 million into the country between 2015 and 2018, compared with its previous estimates of around 1.6 million. The most recent estimates put the increase in the workforce associated with migrants from third countries at 450,000, of which only half will be employed.

Fig. 1 – Confidence surveys are consistent with 0.4% qoq growth in spring after the early-year rebound



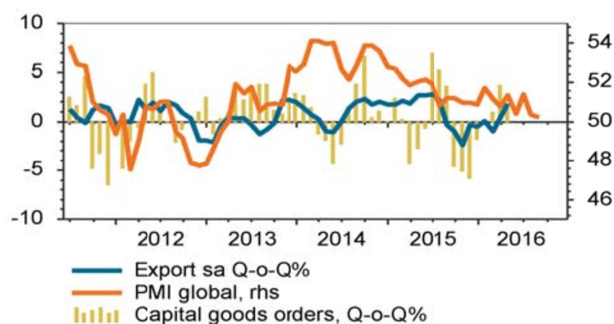
Source: FSO via Thomson Reuters-Datastream

Fig. 2 – Industrial output headed for stagnation in June after the early-year rebound



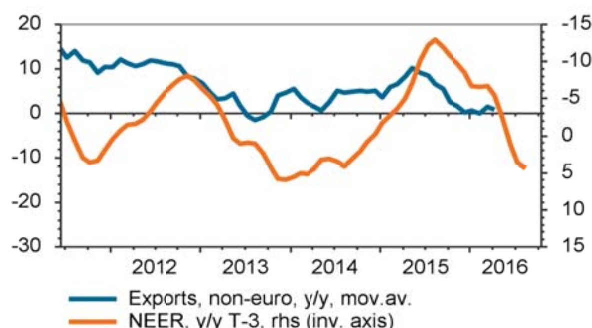
Source: FSO via Thomson Reuters-Datastream

Fig. 3 – Outlook for exports not bright in the next few months



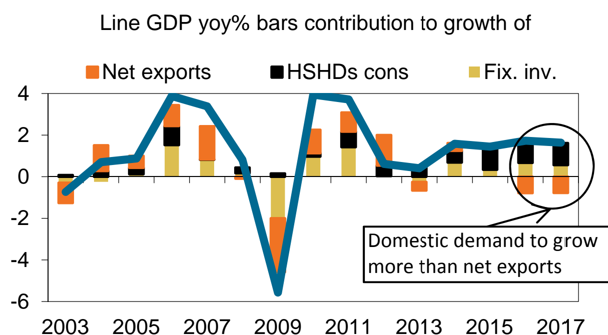
Source: FSO via Thomson Reuters-Datastream

Fig. 4 – Recent currency appreciation does not bode well for exports



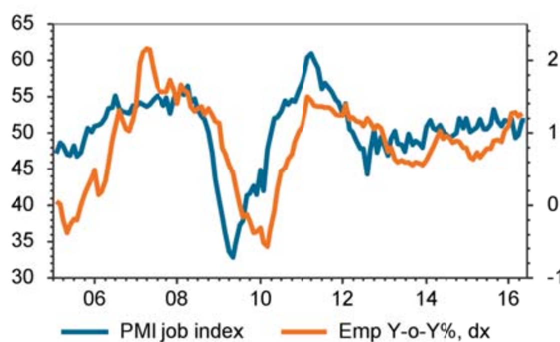
Source: Thomson Reuters – Thomson Reuters-Datastream

Fig. 5 – The growth baton has now been passed to domestic demand



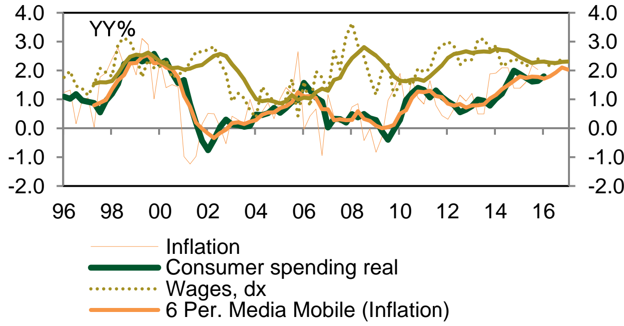
Source: IMF, FSO, via Thomson Reuters-Datastream

Fig. 6 – Thanks to surprising employment growth...



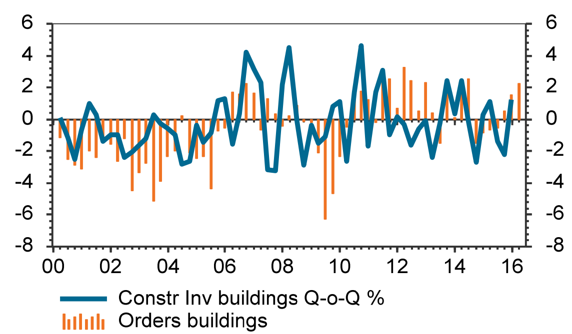
Source: Thomson Reuters-Datastream

Fig. 7 – … and the resilience of nominal wages. Purchasing power will be partly eroded by the resumption of inflation in 2017



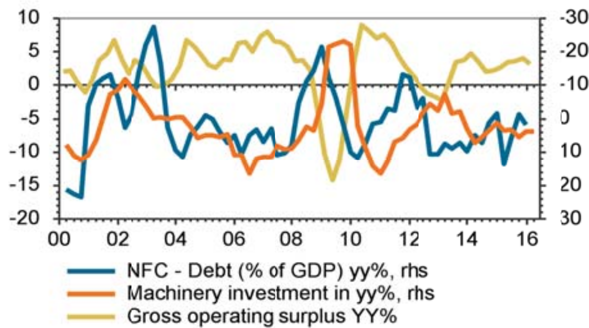
Source: FSO via Thomson Reuters-Datastream

Fig. 8 – Construction: the early-year boom is due to exceptional weather. But orders suggest that moderate expansion may continue this year



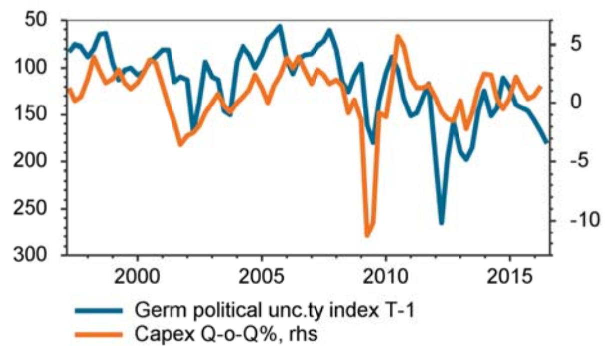
Source: FSO via Thomson Reuters-Datastream

Fig. 9 – Solid financial position of companies and earnings trend point to a more buoyant cycle of spending on machinery



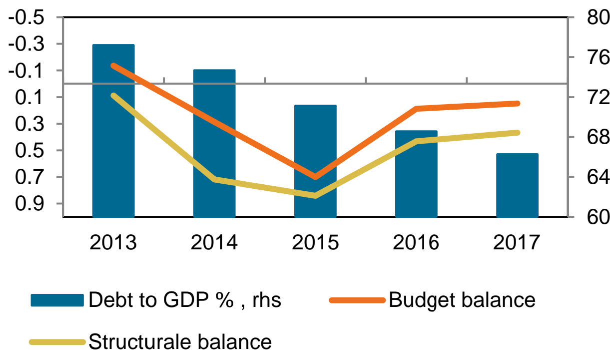
Source: FSO via Thomson Reuters-Datastream

Fig. 10 – Heightened uncertainty could prompt companies to postpone spending plans



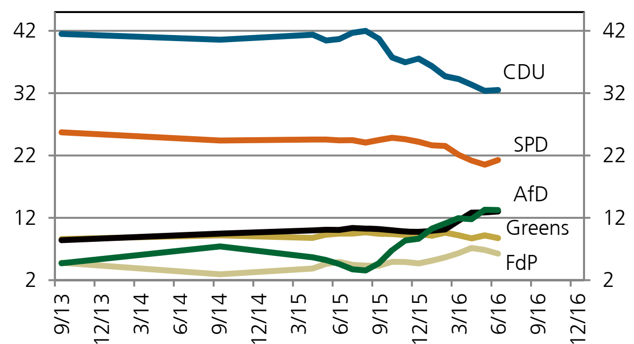
Source: FSO via Thomson Reuters-Datastream

Fig. 11 – Fiscal policy is only moderately expansionary



Source: EU Commission via Thomson Reuters-Datastream

Fig. 12 – In the federal elections, consensus has shifted towards populist positions; if this is confirmed at the 2017 general elections, Germany could also find itself in a political impasse



Source: Wikipedia

France: growth stronger than expected in the first half

Guido Valerio Ceoloni

The French economy continues to recover, and, with a better-than-expected first quarter (+0.6% qoq), it has laid solid foundations for growth in line with the Euro zone average (1.6% yoy). The main growth drivers are capital expenditure and consumption. Opposition to reforms remains strong, and the 2017 elections could lead to a change in the government majority.

GDP revised up by two-tenths of a point to 1.5% in 2016, but the risks remain to the downside

The first quarter closed with GDP growth of 0.6% qoq, up versus the end of 2015 and a tenth of a point better than expected. The main demand drivers were consumption (1.0% qoq) and capital expenditure (1.6% qoq, from 1.2% qoq), thanks in particular to the contribution of company investment (+2.3% qoq). Residential investment also rose slightly. Foreign trade again made a negative contribution, with the dynamism in imports contrasting with stagnant exports. Thanks to the strong result in the first quarter, the economy is performing better than expected in 2016: we are therefore revising up our growth forecast by two-tenths of a point, from 1.3% to 1.5%, broadly in line with consensus estimates, but above the European Commission's current forecasts (1.3%). For the current quarter, there will very probably be a pronounced slowdown, partly a natural one and partly one triggered by various disturbances, such as the series of rolling strikes following the approval of the *loi travail* and the renewal of the rail workers' contract, as well as the floods that afflicted various production areas in the country in May: overall, we are therefore revising down our forecast for the quarter from 0.3% qoq to 0.2% qoq, in line with Banque de France forecasts. We expect average growth of 0.3% a quarter in the second half of the year. We have also revised up our forecast for 2017 by two-tenths of a point, to 1.7%. The risks to the forecast remain, however, to the downside: while on the one hand, the upturn in investment in the first quarter seems to have laid the foundations for the further strengthening of domestic demand, on the other, business confidence levels must continue to improve for this consolidation to become apparent; in addition, the high level of debt is slowing public spending: there is nonetheless the important political date of the presidential elections in May 2017. Finally, the weakness in global demand suggests that foreign trade will continue to hamper growth over the forecast horizon.

Consumption and capital expenditure up in 2016. Household investment still weak

Household spending was the main growth driver in 1Q, progressing to 1.4% qoq, from -0.4% qoq. The result, one of the strongest of the last few years, was supported by another increase in car sales and further substantial expansion in consumer durables. Stripping out monthly fluctuations, household confidence remains on a positive trend (but still below the long-term average): there is therefore room for the positive phase in consumption to continue. Consumption is still on a positive trend, thanks to the recovery, albeit modest, in employment and the increase in purchasing power: after having risen by 1.0% qoq in March, a natural slowdown is expected in the current quarter, around 0.3% qoq, with this pace then maintained for the rest of the year (annual average of 1.5% in 2016, 1.8% in 2017). As we forecast, household capital investment is contracting more slowly (-0.2% qoq in March, from -0.5% qoq), but will remain negative for the rest of the year and the first half of next. It is a different story for corporate investment, which again accelerated in March, from 3.9% qoq to 5.1% qoq, confirming that the current favourable credit conditions implemented by the ECB and the government's recovery policies are encouraging companies to invest. In terms of annual averages, chiefly thanks to the positive contribution of capital expenditure, we forecast average annual growth in the investment component of 3.3% in 2016, and 2.7% in 2017, from 2.1% in 2015.

Industrial output will be negatively impacted in the current quarter by strikes and the floods in May/June

Industrial output contracted in the first quarter, but recovered strongly in April (1.2% mom), pointing to marginal growth in 2Q: however, the risks are to the downside, given the effects of the floods and the strikes that affected numerous industrial plants in May and June, particularly in the refining sector. PMI surveys point to a slowdown versus 1Q, while national surveys point to a slight upturn. As regards construction, the confidence indicators produced by INSEE project a further advance in the current quarter (on average from 92.3 to 95), with an improvement in both orders and employment, while building permits and new house-building are also set to

increase; the trend that began in 1Q15 clearly remains to the upside, although the pace of recovery is slow. Lastly, after slowing at the turn of the year, the services sector has returned to expansionary territory (above 50) according to PMI surveys, but the upturn expected at the beginning of the year has not materialised.

The trend in consumption is supporting imports, which grew by 0.6% qoq in the first quarter. After improving to -2.1% of GDP in 2015, the trade deficit is expected to widen again, to -2.7% in 2016.

Employment rising, but unemployment will not fall below 10% before 2017

Turning to the labour market, unemployment is seen falling only marginally in 2016. In 1Q, the number of unemployed people remained stable at 10.2%. Corporate surveys and PMI employment indices have recorded marginal declines in manufacturing, but improvements in services and construction (here, the average level of the current quarter is now at -22, from -25). Employment should therefore continue to rise in 2016, by approximately 0.1%-0.2% a quarter. Over the year, the economic recovery and the measures of the loi *travail* are expected to lead to a fall in unemployment from 2016 to 2017.

Inflation flat in 2016, above 1% only from 2017

Inflation is expected to remain very weak for the current year, rising from an annual average of zero in 2015 to 0.3% (and from 0.1% to 0.5% according to the HICP): the trend in consumer prices will remain weak, on the back of the substantial fall in energy prices in the first half of the year and the slow rise now under way. The core component is only expected to pick up by a tenth of a point in the current year, from 0.4% in 2015 to 0.5% this year and 0.8% in 2017. In 2017, inflation is expected to return above 1% (1.2% on the national index and 1.1% according to the HICP) on the back of the rise in energy prices and growth in average wages.

The deficit will not return below 3% until 2018, with the public debt still increasing in 2016-17

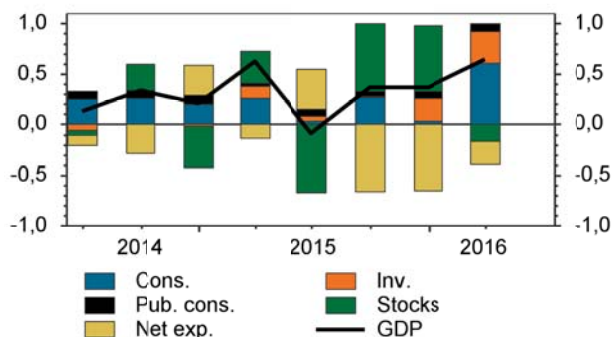
The deficit is expected to see a correction of only one-tenth of a point in the current year, from -3.5% in 2015 to -3.4% in 2016 and by two-tenths of a point to -3.2% in 2017, thanks to GDP growth and lower interest spending. We see the structural deficit remaining unchanged at -2.4% as in 2015, before rising to -2.7% on the back of the recovery in public investment. Public debt will also increase this year, from 95.2% of GDP in 2015 to 96.4%. It could rise a further four-tenths of a point to 97.0% in 2017.

Forecasts

	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.2	1.5	1.7	1.1	1.4	1.4	1.7	1.6	1.6	1.5	1.7
- q/q change				0.4	0.4	0.6	0.2	0.3	0.4	0.6	0.4
Private consumption	1.5	1.8	1.5	0.4	0.0	1.0	0.3	0.4	0.3	0.4	0.4
Fixed investment	0.9	3.3	2.0	0.1	1.2	1.6	0.4	0.4	0.5	0.5	0.5
Government consumption	1.4	1.4	1.3	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Export	6.0	2.5	4.5	-0.2	0.8	0.0	0.8	1.2	1.5	1.1	0.9
Import	6.4	4.4	4.2	1.6	2.5	0.6	0.3	1.0	1.5	1.1	0.8
Stockbuilding (% contrib. to GDP)	0.1	0.2	0.2	0.6	0.6	-0.2	-0.3	-0.1	0.1	0.2	0.0
Current account (% of GDP)	-0.2	-0.9	-1.1	0.0	-0.5	-1.4	-0.6	-0.7	-0.9	-1.0	-1.0
Deficit (% of GDP)	-3.5	-3.4	-3.2								
Debt (% of GDP)	95.2	96.4	97.0								
CPI (y/y)	0.0	0.3	1.4	0.1	0.1	0.0	0.1	0.4	0.9	1.6	1.2
Industrial production	1.8	1.0	1.7	0.5	0.7	-0.6	0.7	0.6	0.2	0.4	0.4
Unemployment (%)	10.4	10.2	10.0	10.5	10.2	10.2	10.2	10.1	10.1	10.1	10.0
Effective exch.rate (1990=100)	95.3	96.2	96.9	95.5	95.3	96.1	96.5	96.0	96.1	96.5	96.8

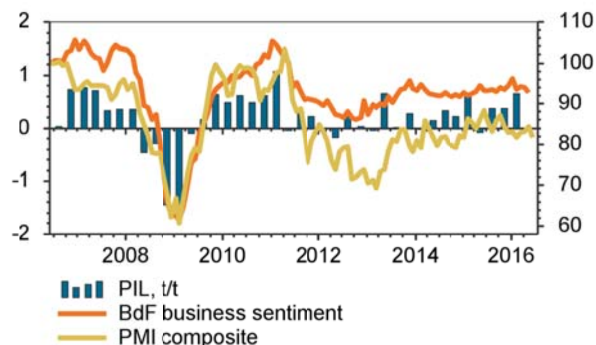
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Contribution to GDP



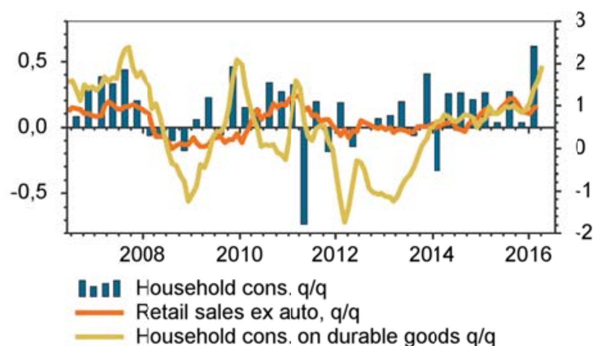
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

GDP and confidence indicators



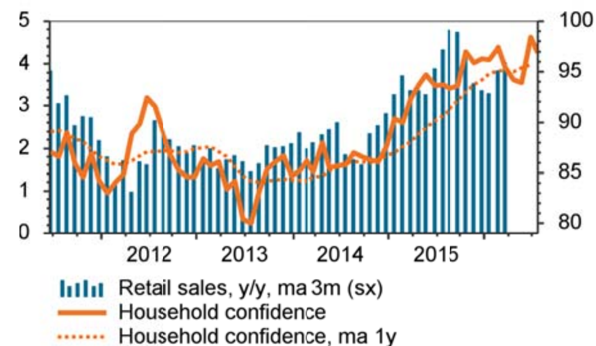
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Household spending, purchase of durable goods and trend in private consumption



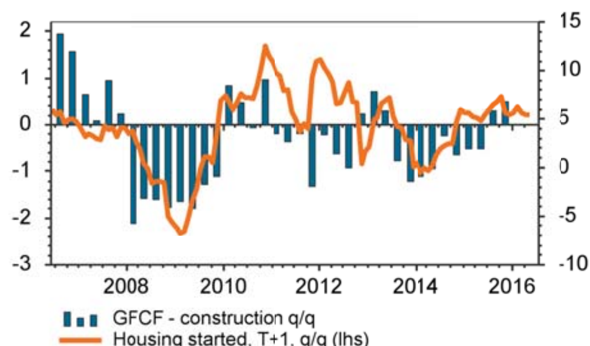
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Retail sales and household confidence



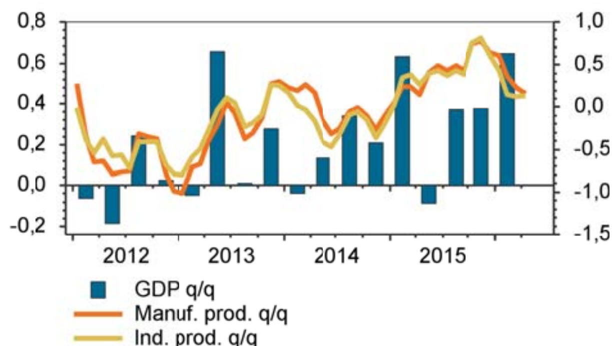
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Residential investment and construction sector activity



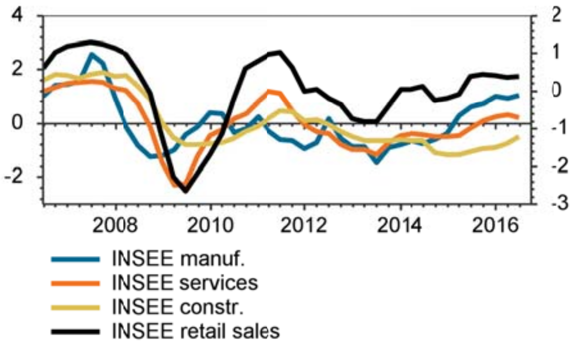
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output and GDP



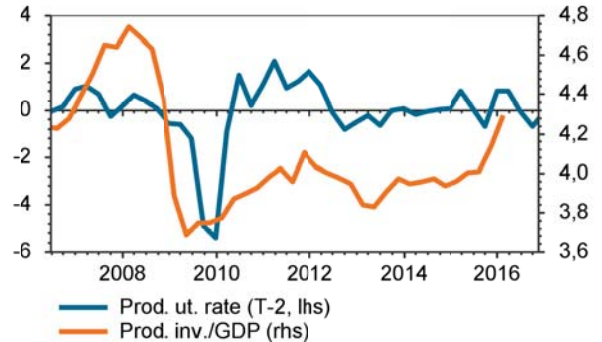
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Activity indices in the various production sectors



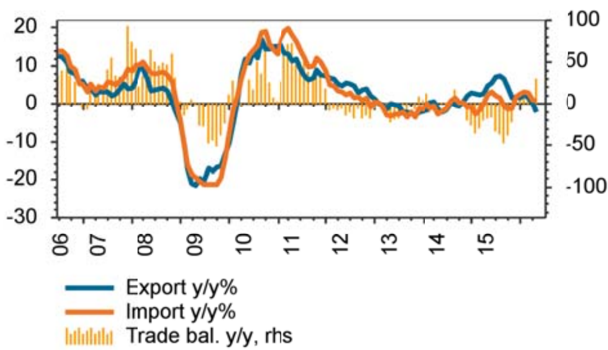
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Production capacity utilisation and level of investment on GDP



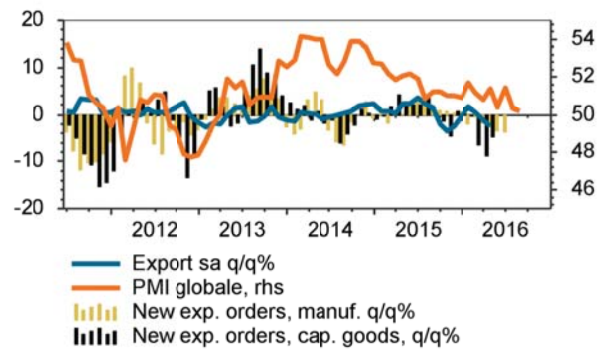
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Trade balance



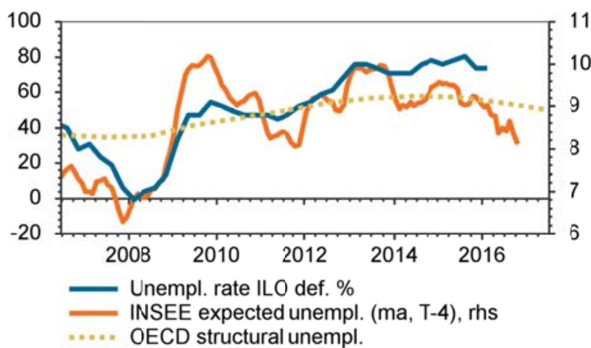
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Exports, export orders and global PMI



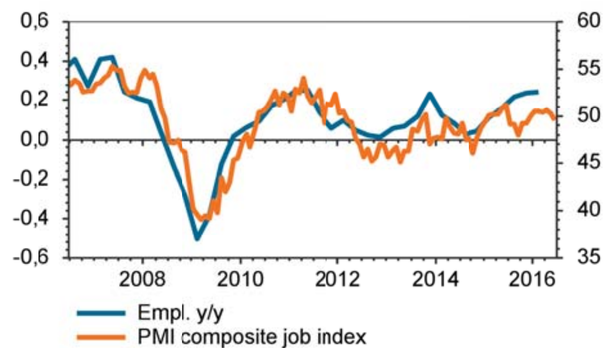
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Expected and structural unemployment



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

Changes in employment



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

Spain: six months later - still the same impasse?

Anna Maria Grimaldi

Expansion continues although it has already peaked

After the Spanish economy's surprising growth in 2015, it is reasonable to expect more moderate growth rates as early as 2016 (2.8%) and hence 1.6% in 2017, albeit still well above potential (estimated by the European Commission in the autumn at +0.4% in 2016) and the Euro zone average. The most recent indications confirm that growth has now peaked. In the second quarter, the composite PMI (at 55, down from 56.3 in the previous six months) and the Commission's economic confidence indicator (at 105.9, down from 108.5 in the previous six months) were consistent with GDP growth of 0.6% qoq in June, from 0.8% qoq at end-2015/early 2016 (see Fig. 1). Net exports will return to having no effect or a slightly negative effect on GDP growth. Spanish exports have been growing more quickly than those of the Euro zone since mid-2009. But they will struggle to continue growing at recent levels both in the short and medium term; further gains in cost competitiveness are hardly sustainable (after the sharp increases of recent years). Moreover, the country is not immune to the slowing demand from emerging countries (OPEC: 4% of total exports; China and the Asian economies: 3.6%; and Latin America: 6%), although the Euro zone is still its biggest trading partner. GDP growth will continue to be driven by domestic demand, which showed a clear trend reversal in 2015. However, expansion is likely to be more moderate as early as this year (2.8%) compared with 3.3% last year.

Exports again make no contribution to growth The main driving force will come from domestic demand, which clearly reversed in 2015

In the short term, household consumption will continue to grow at the same pace as in 2015 (see Fig. 2). However, from 2017, we expect its growth to slow (to 2.2%) due to the effect of higher oil prices implicit in our estimates, combined with less robust growth in the number of people in work, and only a modest acceleration in wages. Household purchasing power will be partly eroded by the rise in inflation from -0.2% to +1.7% in 2017, and by the reduction in fiscal policy stimulus.

Consumption will be "less American" from 2017 due to higher crude oil prices and the normalisation of the employment trend

The expansion phase of investment in machinery seems to be mature, since quarterly growth was much higher than the change in production capacity (see Fig. 9). The ongoing improvement in operating margins (see Fig. 10), along with the continuation of strongly expansionary financial conditions over the forecast horizon (barring the return of country risk after the elections) and the prospects of stabilising emerging economies should boost spending on machinery in 2017. The trend in the residential construction segment has clearly reversed [11] but, after the rebound in the middle of last year, the economy started to slow again at end-2015/early 2016. Surveys indicate that this weakness could continue into the spring, although permits, orders and new mortgages hint at a recovery from the summer. Unsold housing stock is still high and could therefore limit growth in new investment to 2.3%, from 5.4% in 2015.

Machinery investment cycle is already mature. Residential construction: the recovery will continue at a more moderate pace

Employment fared better than indicated by the corporate surveys in 2015 (3.0%) but, in 2016, job creation could slow towards 2.2% yoy, as economic activity moderates. Unemployment has fallen more quickly than we expected, from a peak of 26.3% in March 2013 to 20.5% in April 2016. The fall is partly due to the drop in the participation rate from 60.3% in 2009 to 59.3%, owing to an increase in the inactive population. Unemployment will fall over the forecast horizon to at most 19.1% at end-2017, which is still higher than pre-crisis levels. In terms of social cohesion, the worrying thing is that unemployment is not far from the structural rate (18.3%, OECD).

The high level of unemployment is still one of the main challenges

[11] The contribution of residential construction to GDP fell to 5.4% in 2015, after peaking at 11% in 2007, and is now broadly in line with the Euro zone average.

The country is still in the corrective grip of the Stability Programme, given that the public sector deficit was 5.1% of GDP in 2015, around one percentage point higher than the 4.2% target. Stripping out the impact of one-off measures,[12] the deviation equates to 0.6% of GDP. The improvement in the deficit since 2014 is entirely due to cyclical factors [13]. The structural balance has worsened by one percentage point of GDP, to -2.9% in the Commission's estimates, but remained unchanged at -1.6% in the update to the government's 2016-2019 Stability Programme We think there are risks that the 2016 budget balances will be overshot compared with the Commission's spring forecasts. There is, in fact, huge uncertainty about the additional measures called for by the Commission in May, totalling 0.3 percentage points of GDP this year and 0.5% in 2017. The Commission has postponed until July its final ruling on the Spanish public accounts and the possible imposition of a financial penalty (equal to 0.2% of GDP) for failure to meet the budget target agreed in June 2013[14]. Inasmuch as the Commission could decide to apply the Stability Programme with the utmost flexibility, fiscal policy could return from 2017. Maintaining solid growth rates would make the rebalancing process easier.

The Commission's final ruling on the overshooting of the public finances has been deferred until after the elections

The cyclical expansion phase was boosted by the intensive reform programme implemented during the crisis years, the fall in oil prices, the easing of financial conditions on the back of ECB measures, and the expansionary fiscal policy in 2014-15. The country must continue with the process of economic transformation. The imbalances generated by the sharp correction of 2008-2011 have not been completely reabsorbed. *The European Commission's recommendations of 8 March "concluded that the high public and private debt (see Fig. 11) represent an element of uncertainty for the country against a backdrop of high unemployment and continuing high external debt" (see* Fig.12*).*

The reform process must not stop. The main risk is political

The main short- and medium-term risk is political. Above-potential growth and market leniency will not last for ever if political stability is not restored. It is vital that the political forces effectively launch negotiations after the elections to form a government in the shortest possible time, but there is a substantial risk that it will all end up as it did last December. For a description of the possible post-election scenarios, see Focus below.

Forecasts

	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (constant prices)	3.2	2.8	1.6	3.4	3.5	3.4	3.0	2.6	2.2	1.8	1.7
- q/q change				0.8	0.8	0.8	0.5	0.4	0.4	0.4	0.4
Private consumption	3.1	3.2	2.1	1.1	0.7	0.9	0.6	0.6	0.6	0.5	0.5
Fixed investment	6.4	3.3	2.8	1.3	1.1	0.4	0.4	0.7	0.6	1.1	0.4
Deficit (% of GDP)	-5.1	-4.2	-3.2								
Debt (% of GDP)	99.2	100.6	100.1								
CPI (y/y)	-0.5	-0.1	1.8	-0.4	-0.3	-0.7	-1.0	-0.1	1.1	1.9	2.2
Unemployment (%)	20.9	19.3	19.2	21.6	20.9	20.5	20.0	19.6	19.3	19.2	19.2
Effective exch.rate (2005=100)	96.2	96.5	96.6	96.3	96.1	96.5	96.6	96.3	96.4	96.6	96.6

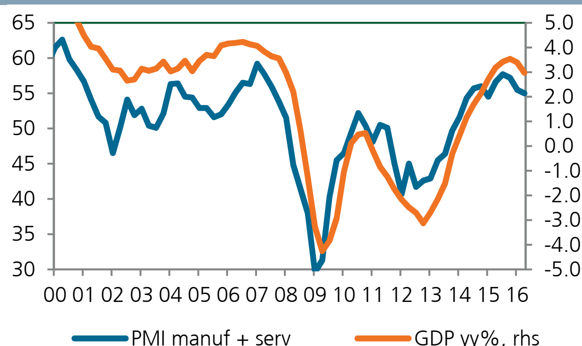
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo data

[12] measures totalling 0.1% of GDP to support the financial sector and totalling 0.2% for the reclassification of public sector activities; income from the sale of UMTS licences totalling 0.2% of GDP reduced the deficit.

[13] Despite personal income tax cuts, the pick-up in domestic demand has led to a 5% yoy increase in tax revenue, thanks to strong growth in corporate tax. Primary spending fell by 0.8% of GDP to 40.2% due to cuts in general government spending and defence compared with planned objectives.

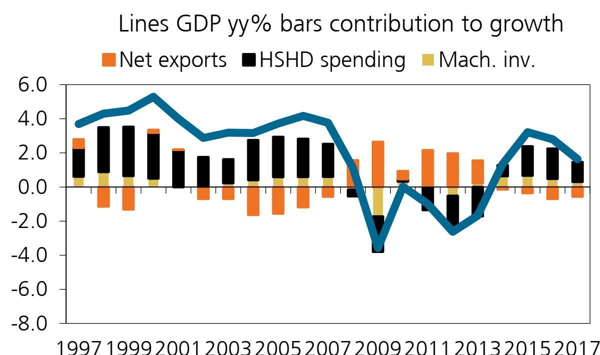
[14] The planned structural efforts should have amounted to three percentage points of GDP in 2013-2015, but, in the end, the change in the balance was virtually zero.

Fig. 1 – Peak has passed but the economy will continue to grow at around 3.0% yoy in spring



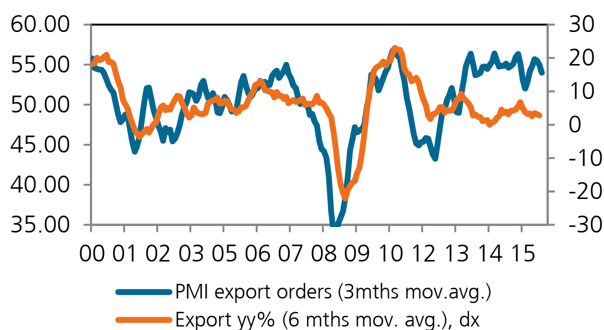
Source: Markit PMI, EU Commission and Intesa Sanpaolo forecasts

Fig. 2 – Growth still supported by domestic demand, especially consumption, but is not sustainable at recent rates Exports will return to making a negative contribution



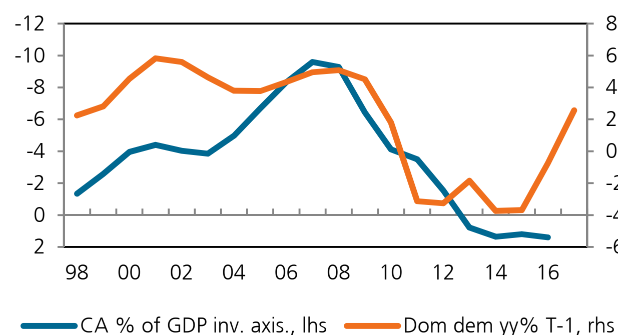
Source: Intesa Sanpaolo chart from INE and Eurostat data

Fig. 3 – Less momentum from exports in the short term



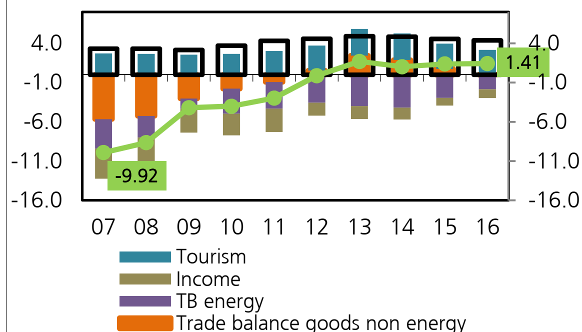
Source: Intesa Sanpaolo chart from Eurostat and INE data

Fig. 4 – There is a risk that the return to sustained growth in domestic demand will increase the current account balance



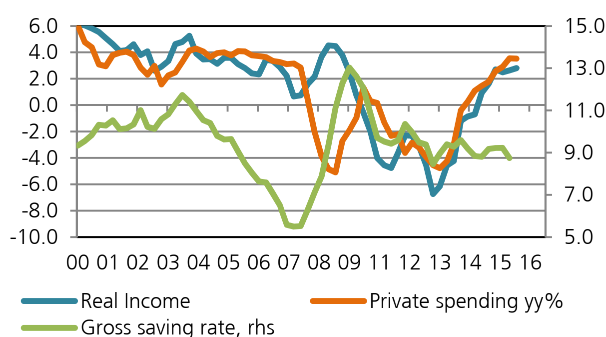
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 5 – Improvement in the current account balance has ground to a halt in recent years due to the deterioration in the non-energy goods balance and, to a lesser extent, the tourist services balance



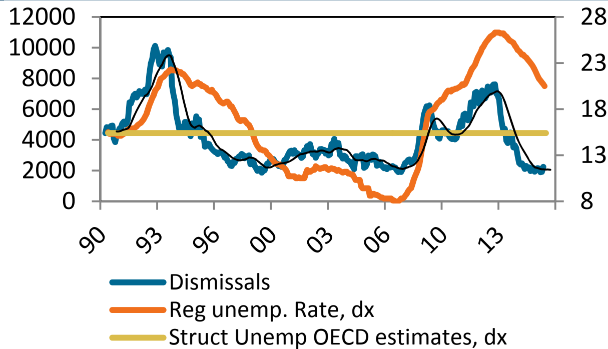
Source: Intesa Sanpaolo chart from Bank of Spain data

Fig. 6 – Disposable income could start to slow, partly due to the resumption of inflation on the back of higher oil prices



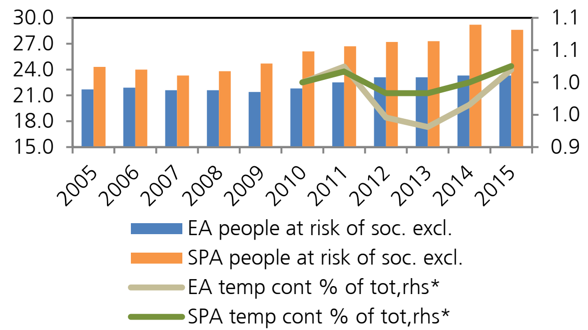
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. Fig. 7 – Unemployment rate remains at socially unacceptable levels



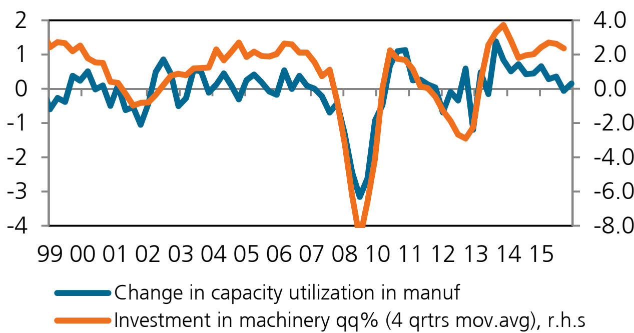
Source: Intesa Sanpaolo chart from INE data

Fig. 8 – Percentage of people at risk of poverty has increased by more than in the rest of the Euro zone



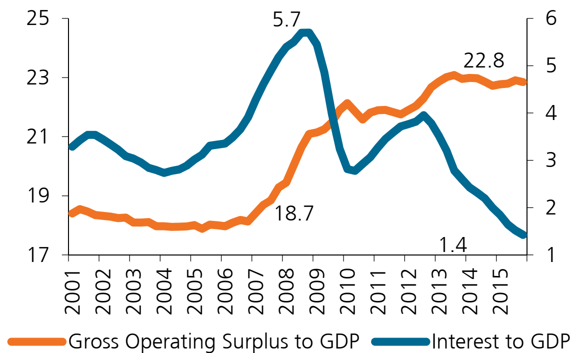
NB: (*) temporary contracts as a percentage of total contracts indexed to 1 in 2010
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 9 – Investment in machinery has grown faster than was suggested by production capacity utilisation, but…



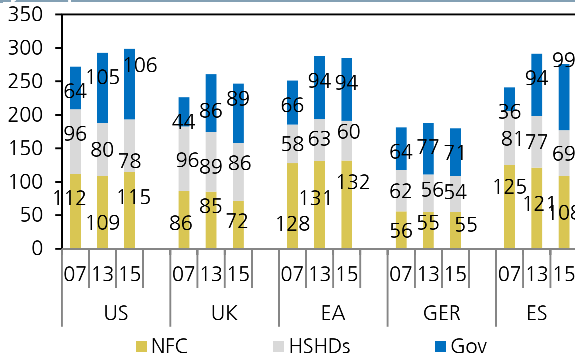
Source: Intesa Sanpaolo chart from INE and OECD (medium- and long-term equilibrium unemployment rate) data

Fig. 10 – …it will still be boosted by the recent earnings trend and ultra-expansionary financial conditions



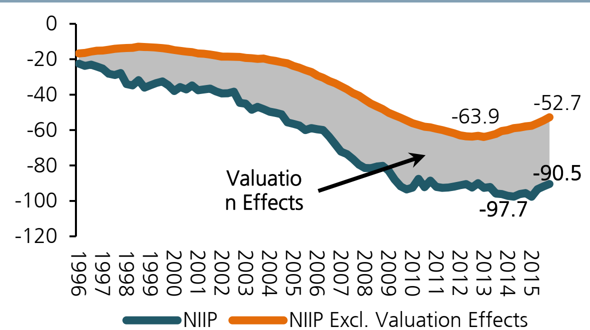
Source: Intesa Sanpaolo chart from INE data

Fig. 11 – Deleveraging by the private sector and, even more so, by the public sector must continue



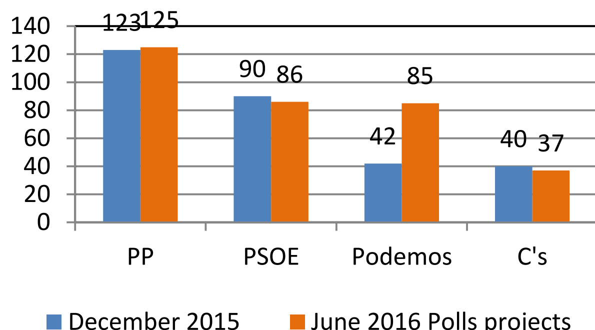
Source: Intesa Sanpaolo chart from ECB data

Fig.12 – External debt remains an element of uncertainty



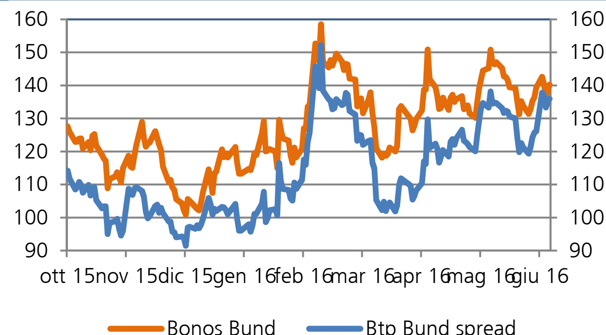
Source: : Intesa Sanpaolo chart from Bank of Spain data

Fig. 13 – Election results open up a new phase of negotiations to form a government



Source: Intesa Sanpaolo chart based on Wikipedia

Fig. 14 – Investors not worried by political gridlock of 1H16, but the relative calm may be shortlived

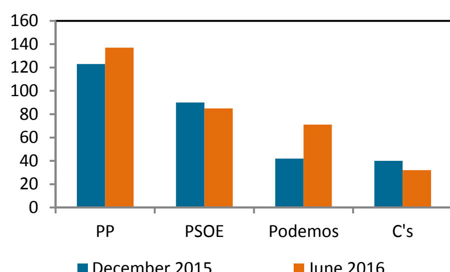


Source: Intesa Sanpaolo chart based on Bloomberg data

FOCUS: versus a PP minority government?

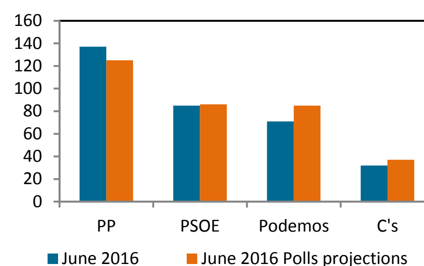
Rajoy's Popular Party (PP) has won the second general election held in six months with 33% of the vote, almost five points up on December. In second place came the Spanish Socialist Workers' Party (PSOE) with 22.7% of the vote, up from 22% in December. *Unidos Podemos*, the alliance between Pablo Iglesias' populists and the extreme left *Izquierda Unida* (United Left), came third with 21.1% of the electorate, as in December. *Ciudadanos* (Citizens) took fourth place with 13% of votes, but lost almost one point compared with December. The good news coming out of this second election is that, contrary to the forecasts, *Podemos*, despite teaming up with the communists, has failed to overtake the socialists. This time round, the polls underestimated the support for the traditional parties, which may have received votes from the undecided. At just short of 70%, turnout was lower than in December and one of the lowest since 1979. In any event, forming a government will not be an easy task. Rajoy now has 137 seats, having gained 14, but is still short of an absolute majority. Compared with last December, the PSOE won 5 fewer seats at 85, while *Podemos Unidos*, with 71 seats, managed to gain only two (taking into account the total for the parties forming the alliance). *Ciudadanos* won 32 seats, 9 less than in December. The most likely scenario is a minority government of the PP which will have to seek support from other parties to pass new laws. Needless to say that even if Spain manages to form a government by the summer, the new government will be very fragile and the reform process may slow compared to the past.

Fig. 1 – The PP fared better than in December…



Source: Intesa Sanpaolo charts from Wikipedia and El Pais data

Fig. 2 – …and better than in the most recent polls



Source: Intesa Sanpaolo charts from Wikipedia and El Pais data

The Netherlands: two years of solid growth after the surge of 2015

After growth of 2.0% in 2015, the outlook for the current year still seems positive: GDP is expected to advance by 1.6%, supported by the expansion in domestic demand; low inflation and rising employment, accompanied by tax cuts, will increase households' disposable income and purchasing power. Investment is seen slowing after the boom of 2015.

Guido Valerio Ceoloni

GDP at 1.6% in 2016, 1.7% in 2017

The first quarter closed with an upturn in GDP growth to 0.5% qoq, from 0.3% qoq (1.1% yoy, from 1.2% yoy), in line with consensus estimates. For the current quarter, we expect the economy to maintain the same pace (+0.5% qoq), with **2016 set for an increase of 1.6%**, slowing from 2015 (2.0%). **The risks to the forecast are balanced:** those to the downside are mainly the slowdown in global demand and the geopolitical risks that affect the Euro zone in particular, while investment could prove stronger than expected. Finally, **the elections in March 2017 could hold some surprises in store, particularly as regards the rise of the right-wing populist party PVV**, which various opinion polls currently put at 17-25%, from around 10.1% in the last elections in 2006, a result that could make it the most voted-for party.

Tax cuts will increase disposable income and support consumption

For the current year, the main growth driver will still be domestic demand. Robust labour market conditions, the increase in purchasing power due to the historically low levels of inflation, the fiscal stimulus implemented by the government through the employee tax cuts and the new contracts for public sector workers concluded in 2015 will also help support household spending this year, thanks to a solid rise in disposable income (+1.7% qoq in 1Q). **Consumption** increased by 0.4% qoq in 1Q, and we expect that it will rise moderately over the year, once the **EUR 5 billion tax cut** has been absorbed by households (from April onwards). Average annual growth in consumption is seen at 1.4% in 2016 and 1.9% in 2017 (when a further tax credit provision will come into force for employers seeking to hire staff on lower incomes). In 2015, accommodative financial conditions with rates at historical lows and the government's measures in the construction sector supported **residential investment** (annual average of +27.3%) and **capital expenditure** (annual average of +8.9%), which resulted in record growth of 10.3% in **fixed investment**. We expect that, compared with 2015, growth in residential investment will slow, but will not be completely exhausted (annual average: +4.3%), chiefly thanks to capital expenditure.

Growth in investments close to historical highs in 2015, but the positive trend will also continue this year

The contribution of foreign trade will continue to hamper growth in 2016

Foreign trade will continue to register **an imbalance in favour of imports**, which, supported by domestic demand, grew by 8.3% yoy in 1Q, from 8.0% yoy in 4Q15, while export growth increased around the turn of the year, at a rate of 5.8% yoy. We forecast that the trend will remain the same for the remainder of 2016, with a slowdown in both imports and exports, resulting in net exports contributing -0.1% to GDP. The Dutch **trade balance**, structurally in surplus, is this year set to record a higher surplus, from 7.0% of GDP in 2015 to 7.6% this year, and remain around this level in 2017 (7.5% of GDP).

The construction sector remains positive, but has slowed since the boom in 2015

Cyclical indicators show that the climate is brightly positive, with the business confidence index now around 2010 highs. In 1Q, **industrial output** recorded growth of 2.0% qoq, from 6.4% qoq in 4Q15, on the back of a recovery in manufacturing output and a surge in energy production. Production capacity **utilisation** in the industrial sector has fallen slightly since January, partly owing to the natural adjustment following the high capital expenditure of last year, and is now around 81.5% (in line with the historical average). **The construction sector continues to trend upwards, but we expect a natural slowdown after last year's boom**, as indicated by stabilising house prices and a year-on-year contraction in house building permits, which peaked in May 2015; however, the increase in residential investment was still 3.3% qoq in the first quarter, from 3.2% qoq previously.

Employment still rising in 2016 after falling for three years

Employment increased by 0.9% in 2015 after falling for three years, and will continue to grow over the next two years. **PMI employment indicators have been rising since January, as has the number of hours worked:** for this year and the next, we should see an expansion of around 1.1-1.2%, partly thanks to the stabilisation of the public sector workforce (which accounts for 10% of the total number of people employed) after five years of contraction. In 2015, **unemployment** returned to its lowest since 2012, at 6.9%; in 1Q, it fell further to 6.4%, but the increase in the workforce – due to the raising of the pensionable age and the consequent increase in the participation rate – and migrant flows are likely to curb any further falls.

Inflation is close to its historical lows: the harmonised index came in at 0.4% yoy in 1Q, but over the year, an unfavourable base effect is likely to see it drop into negative territory in the middle of the year, before rising towards 1% at the end of the year and picking up in 2017, supported by the stabilisation of energy prices. **The core index** remained broadly stable at around 1.0% at the turn of the year, but owing to statistical effects, we are likely to see it slow significantly over the next few months, and come in at an annual average of 0.5% in 2016 (before picking up again to 1.1% in 2017).

The government will suspend deficit reduction for 2016 before resuming in 2017

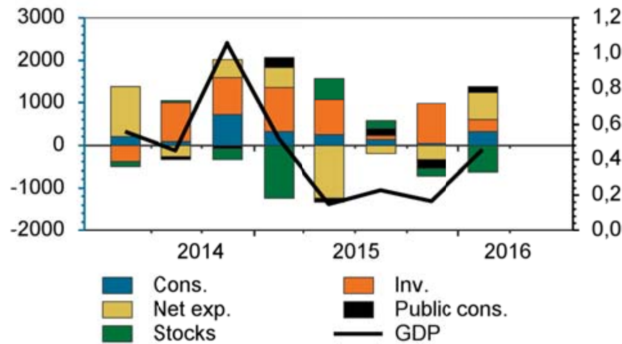
In 2015, the **deficit** fell by six-tenths of a point, from -2.4% to -1.8%, thanks to the continuation of the recovery and public spending cuts. For the current year, we expect a pause, with an expansionary fiscal measure and lower receipts from mining activities, triggering only a tenth of a point fall in the deficit to -1.7% (**structural deficit** at -1.5%, from -0.9%). In 2017, growth in revenue due to the increase in disposable income and lower spending on unemployment subsidies should lead to a fall in the deficit of another five-tenths of a point, to -1.2% (structural deficit at -1.2%, from -1.5%). According to European Commission estimates, **public debt** will again fall to just below 65% in 2016 (from 65.1% in 2015), and will come in at around 64% in 2017.

Forecasts

	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (constant prices)	2.0	1.6	1.8	1.9	1.2	1.1	1.4	1.8	2.0	1.9	1.8
- q/q change				0.2	0.3	0.5	0.5	0.5	0.5	0.4	0.4
Private consumption	1.5	1.4	1.9	0.1	0.0	0.4	0.5	0.7	0.5	0.4	0.4
Fixed investment	10.3	4.3	1.7	0.6	2.8	0.4	0.4	0.6	0.6	0.3	0.4
Deficit (% of GDP)	-1.8	-1.7	-1.2								
Debt (% of GDP)	65.1	64.9	64.0								
CPI (y/y)	0.6	0.3	1.6	0.7	0.6	0.6	-0.1	0.0	0.6	1.2	1.9
Unemployment (%)	8.3	8.0	8.1	8.5	8.3	7.9	7.9	7.9	8.0	8.0	8.0
Effective exch.rate (2005=100)	107.6	107.8	108.3	107.7	107.4	107.9	108.0	107.5	107.7	108.1	108.2

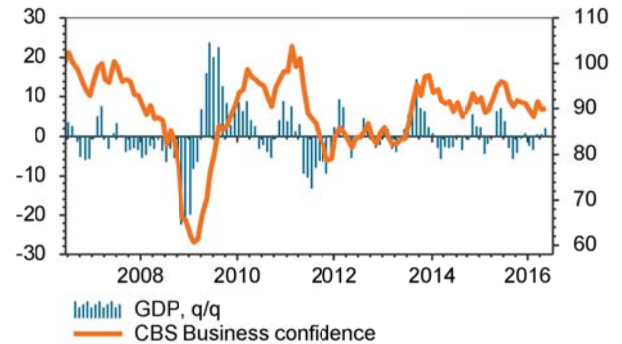
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Contribution to GDP



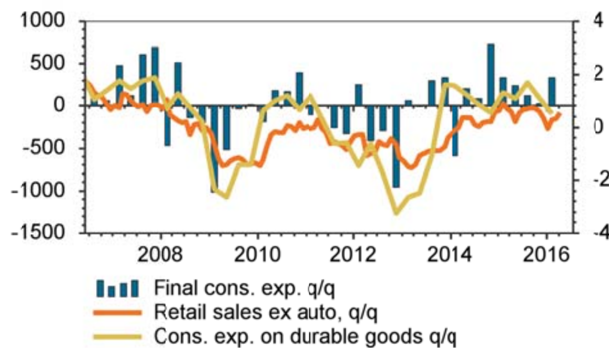
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Economic confidence and GDP



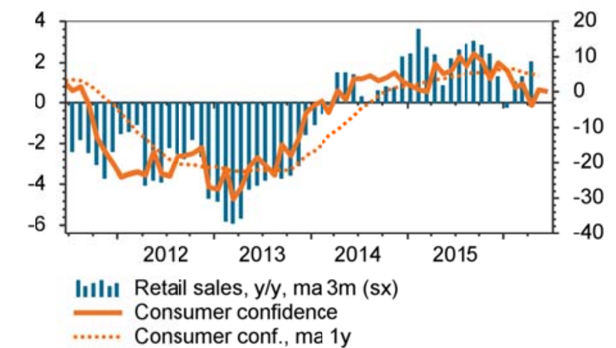
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Household spending, purchase of durable goods and trend in private consumption



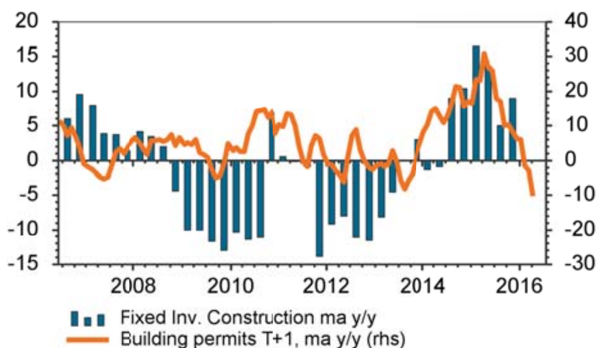
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Retail sales and household confidence



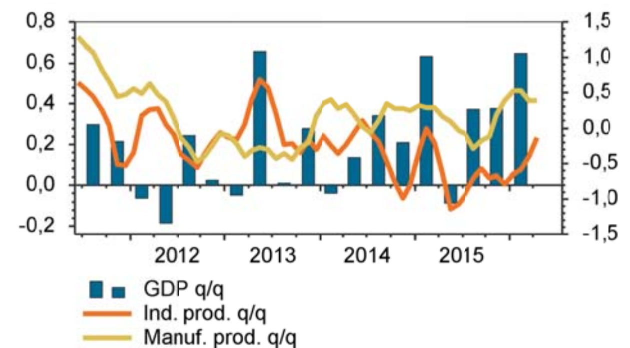
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Residential investment and construction sector activity



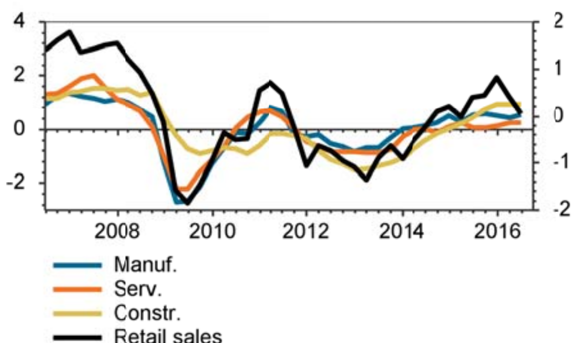
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output and GDP



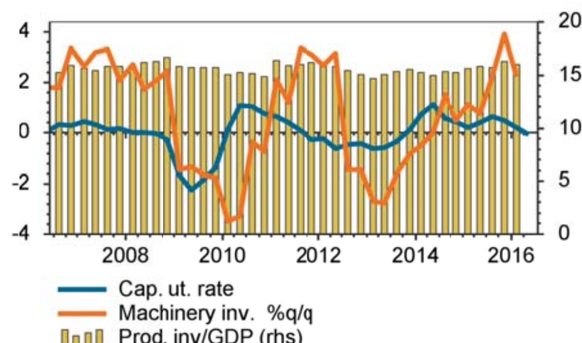
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Activity indices in the various production sectors



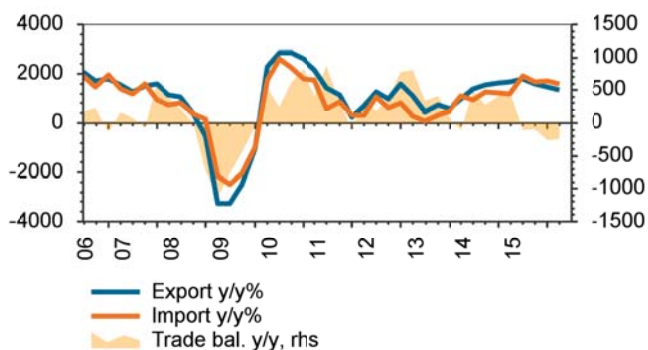
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Production capacity utilisation and level of investment on GDP



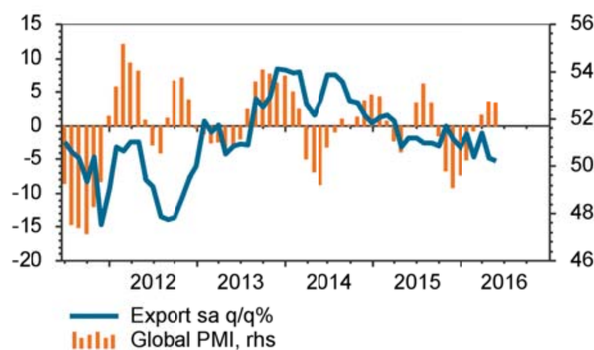
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Trade balance



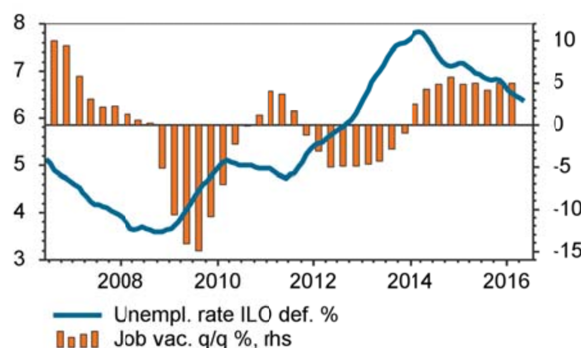
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Exports, export orders and global PMI



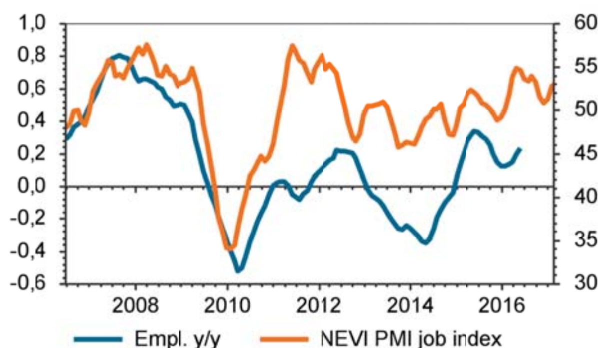
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unemployment and job vacancies



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

Changes in employment



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

Greece: may agreement provides a lifeline until October

Guido Valerio Ceoloni

The Eurogroup agreement reached on 24 May represents a significant step towards overcoming the Greek crisis and enables the European Stability Mechanism to unlock the full amount of financial assistance (EUR 10.3Bn) for 2016. In addition to unlocking a tranche that will cover maturing debts at least until October, a long-term debt relief strategy for the repayment of debt to official institutions was agreed. The measures can be summarised as follows:

- smoothing the repayment profile of the EFSF loan; this measure is considered urgent, in order to cap debt servicing costs at 15% of GDP up to 2030 and 20% thereafter;
- reduction of interest rate risk, using the EFSF/ESM funding strategy without incurring additional costs for member states (which means that the reduction of costs for Greece will be conditional on the absorption of very long term ESM issues by the market);
- waiver of the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme in 2017 and the maintenance of a primary balance of 3.5% until 2018 (as opposed to the more cautious IMF estimates of 1.5%).

In the medium term, after completion the ESM programme (and if the assessment of debt sustainability made it necessary), the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme could be abolished and the profits generated by the 2014 SMP (Securities Market Programme) could be used to alleviate debt servicing by redefining the EFSF repayment plan. Thanks to the agreement, the ECB will soon readmit Greek banks to normal refinancing operations, by reintroducing the suspension of the rating requirement for the country, which is still not investment grade. In the meantime, at the meeting held on 22 June, the ECB readmitted Greek banks to normal refinancing operations, by again suspending the country rating requirement.

The success of the operation however depends on both a stable return to growth and an overall improvement in the country. Supported by growth in consumption (+0.3% yoy) and investment (+4.0% yoy), domestic demand remained positive despite the marginal contraction of GDP in 2015 (-0.2%). In 1Q16, GDP started to fall again by -0.5% qoq with negative contributions from both domestic demand and foreign trade, which was only partly offset by stock-building. Growth has been negative so far at -1.0% yoy; however, 2Q and 3Q, which benefit from the tourist season, should bring average annual change in GDP back to between -0.3% and 0% this year. The unlocking of European structural funds and the payment of public administration arrears should also have a positive effect on domestic demand. In 2017-2018, growth is expected to accelerate to 2.5-3.0%. Unemployment is expected to remain above 20% at least until 2018. Recovery is also hampered by the difficult situation in the banking system, burdened by bad debts accumulated over years of economic crisis and weakened in 2015 by the introduction of controls on the movement of capital.

Fiscal reform continues to strain the SYRIZA-ANEL coalition, which still has a majority in parliament with 153 seats out of 300 (although it had 158 seats in September). In spite of the reduction, the number of seats is still enough, in theory, to implement the programme. Despite the political success of Alexis Tsipras, who rebuilt the parliamentary majority, there is very limited room for manoeuvre and in future ANEL could shift its allegiance. However: (1) Tsipras may have a fall-back solution that involves other centre parties and (2) in the event of elections, the centre-right opposition now has a charismatic leader (Meimarakis) who has a good relationship with the European Authorities.

On the public accounts front, debt is forecast to reach a peak of 185% in 2017, and fall to 175% in 2020. Gross public debt is currently at EUR 321Bn, almost entirely in euro (96.7%)

Approximately 23% of this amount is made up of bonds with an average residual maturity of about 16.5 years, while the rest is made up of loans (EUR 246.4Bn, most of which (89%) comes from the Financial Support Mechanism), repo transactions (4.4%), bilateral loans (3.0%) and loans from the Bank of Greece (1.5%). The next maturities due in the 2016 repayment plan total EUR 2.6Bn, of which EUR 2.1Bn are due to the FMI and the rest as interest on the Greek Loan Facility (GLF) and ESM loans. In 2017, the payments due will be EUR 2.0Bn (of which EUR 1.3Bn to the FMI, and EUR 2.8Bn in 2018 (of which EUR 2.3Bn to the FMI). Risk premiums on GGBs fell the day after the Eurogroup agreement was signed (ten-year bonds below 7%, at their lowest since October) to rise rapidly afterwards (just over 8%) as a result of geopolitical uncertainties that worry the markets.

Portugal: risks to the scenario still unbalanced to the downside

Guido Valerio Ceoloni

In 2016, GDP is expected to slow to 1.3%, from 1.5% previously, with the risks tilted to the downside. In particular, this is due to political uncertainty, the deleveraging process in the private sector and the fragility of the banking sector (with NPL of over EUR 12.4Bn, of which about half related to the real estate sector). GDP growth (which stalled at 0.2% qoq, the same rate as in 4Q15) disappointed expectations in the first quarter, due to the slowdown in domestic demand and the negative contribution of net exports. The European Commission's economic confidence index has, however, remained high (106.2) since January, supported by the stabilisation of all components except industry. We expect the consumption component to slow in 2016-17, compared with 2015, due to a higher percentage of indirect taxation (fuel) and a rebound in energy prices, with unemployment remaining high (12.4% in 1Q, up from 12.2%) and significant private sector debt. Investments also slowed in 1Q (a decline of -2.2% yoy), except for construction, due to the knock-on of the unexpected slowdown in 2H15 and geopolitical uncertainty at the beginning of the year. In 2016, the expansion rate of the investment component will be lower (annual average of 1.5%), but it will accelerate again in 2017 (annual average of 3.7%), partly thanks to European structural funds. Geopolitical uncertainty and the recovery in consumption are weighing on exports, which will continue to curb growth until well into 2017, albeit less so than in 2015.

The deficit fell to -4.4% last year: a good result which also includes the impact of the Banif bailout and accounts for around 1.4% of GDP (nonetheless, the structural balance deteriorated by six-tenths of a percentage point to -2.2%). According to European Commission estimates, the measures undertaken by the government will bring about a further improvement in the deficit in 2016 to -2.7% (-2.3% in 2017). However, owing to the limited impact of the consolidation measures, the structural balance is still expected to worsen by two-tenths of a percentage point to -2.2% (-2.5% in 2017). The risks to the public accounts scenario are to the downside, in particular because of the potential derailment of expenditure (partly due to the banking sector) and the lack of agreement on debt consolidation measures for 2016-17, given the diversity within the government majority (socialists and radical left). DBRS has maintained the Portuguese rating at investment grade for now, but in the event of a downgrade, Portuguese bonds would also be excluded from the ECB's securities purchase programme. In 2016, public debt is set to fall to around 125%, from 129% in 2015, if the sale of Novo Banco is completed[15] (which was cancelled last year, and for which the Commission extended the deadline to August 2017), and stabilise at that level in 2017 thanks to an acceleration in the recovery.

[15] The sale of Novo Banco is proceeding slowly due to a ruling of the administrative tribunal which, in April, suspended the Portuguese Central Bank's decision last December to transfer about EUR 2Bn in bonds from Novo Banco to the "bad bank", BES (Banco Espirito Santo).

Italy: ongoing recovery, but downside risks prevail

Paolo Mameli

Italian GDP growth reaccelerated moderately at the beginning of 2016 (0.3% from 0.2% q/q in the second half of 2015). The main contribution (two thirds of the total) came from the industrial sector in the strictest sense. However, the workday count seems to have had an effect, which may have shifted some growth from the end of 2015 to the beginning of 2016 (as proven by industrial output volatility at the turn of the year). In the remainder of 2016, we expect growth to continue at the same average cruising speed, although for the spring quarter our forecast falls in the 0.2-0.3% q/q range, meaning that a slowdown in quarterly terms cannot be ruled out compared to the beginning of the year, mostly due to a smaller contribution from the industrial sector (estimated at 0.1% in 2Q 2016, i.e. half the rate recorded over the previous three months).

We see no grounds to expect either an acceleration or a significant slowdown in economic activity

Industrial sector indicators (business confidence, output, orders and revenues) have slowed recently, after generally peaking in the summer of 2015: the manufacturing PMI peaked in December 2015, business confidence in the manufacturing sector in October (based on the Istat survey), turnover in June, and orders as far back as April 2015. Although output rebounded in April, this indicates that the trend will remain moderate in the coming months.

In general, forward-looking indices peaked on average between six and eight months ago: while a physiological correction of consumer confidence may have been expected, after the setting of a new long-term high in January 2016 (households' sentiment remains higher than the long-term average and compatible with ongoing recovery in consumption, although it is not signalling an acceleration), the reversal in the trend of business confidence was more surprising (from the peak hit in October).

The slowdown of foreign trade certainly played a role: while trade flows in both directions rebounded in April (exports +2.7%, imports +3.9% m/m), to and from non-EU countries in particular, the global context does not seem consistent with a significant rebound in foreign sales. Furthermore, Italian exports have been underperforming the other main European countries of late.

The point is that the recovery of economic activity recorded since the start of last year does not seem to have consolidated to the point of becoming sufficiently widespread. The progress made by the main industrial activity indices, as well by exports, has been highly concentrated on a few sectors (namely means of transport, pharmaceuticals, and refined oil products). Once the pace at which these sectors were growing underwent a "physiological" slowdown, this was left unbalanced by a recovery in other areas of activity. In the present phase, moreover, not only is the industrial sector showing a tendency to decelerate: the recovery diffusion index drawn up by Istat is outlining a deterioration in the services sector, which for the first time in 15 years goes against the manufacturing trend.

Besides, the recovery seen at the beginning of last year was at least in part triggered by the external shocks on the oil price and exchange rate fronts, which subsequently waned somewhat. A positive fact (with respect to growth) is that a moderately accommodative fiscal policy has been confirmed, thanks to the flexibility allowed by the EU almost entirely for this year, although the evolution in 2017 is still uncertain: if nothing else, no positive contribution should be expected next year from fiscal policy, contrary to 2016 (yet, given the evolution of political risk in Europe, a "flexible" approach is possible next year as well).

Positive scenario elements are resilient consumption and employment, and the incipient recovery of the housing market

The housing market is confirming at least in part the signals of a rebound seen at the end of 2015. There is clear evidence of a recovery on the secondary market (existing home sales have increased by 17.3% y/y in 1Q 2016), whereas the trend undoubtedly slower in the new homes segment. Construction output, after having grown by 1.2% q/q in 4Q 2015, dipped back in Q1 (-0.9% q/q), therefore the sector resumed contributing negatively to overall economic activity. While it is true that builders' confidence seems to be at more reassuring levels than business sentiment in the other areas of activity (over 20% higher than in 2010, vs. 7% in services, 2% in

manufacturing, and less than 1% in trade), the comparison is distorted by the fact that the base-year is much more unfavourable for construction than it is for the other sectors. However, the recovery of the real estate market, and of the existing homes segment in particular, seems set to continue in the coming quarters.

One positive aspect of the scenario is the resilience of employment. Despite concerns tied to the reduction of incentives on permanent hiring, the recovery in employment numbers continued at the beginning of 2016 (+1%, i.e. +215k units y/y), driven by permanent contracts. This did not translate into a decline of the unemployment rate, which seems to have been put on hold since last summer. The main reason is the decline in inactive people (-2.1% y/y in April, i.e. -292k), driven by the drop in discouraged workers (-210k vs. one year earlier). In essence, the improvement of labour market conditions (also highlighted by other indicators such as the drop in the long-term unemployed and of involuntary part-time workers) does not seem to have ended.

Going forward, we believe that on the foreseeable horizon the economy may keep up a cruising speed of 0.3% q/q, in line with the average growth rate recorded in the past year and a half. While we do not consider risks on the time horizon to be serious enough to derail the economic recovery, we see no significant grounds that would justify an acceleration, either. Under this scenario, risks to baseline forecast for an average growth of 1.2% in 2016 (and 1.4% in 2017) remain skewed to the downside.

As well as to exports, risks are also tied to political uncertainties

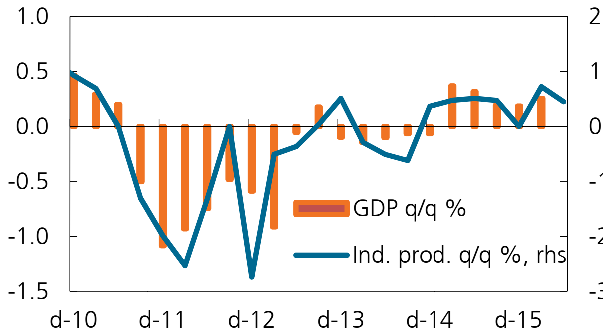
In addition to the risk of global trade failing to reaccelerate, uncertainty also stems from political and geopolitical factors. Sources of uncertainty are mainly international: first of all the aftermath of the Brexit referendum, which we think could drag Italian GDP growth by -0.3% in 2017, and then a very busy calendar of elections in several European countries between mid-2016 and 2017, without forgetting the presidential elections in the USA at the end of year, and the persistent difficulties encountered by European institutions in managing the migration crisis. Also, on the domestic front one can't exclude possible risks to governability tied to a potential failure of the constitutional referendum in October (which would follow up on the government's loss of popularity, as proven by the outcome of the recent local elections). If on the other hand the referendum confirms the constitutional reform (as assumed under our baseline scenario), prospects in terms of the governability of the country could improve, and therefore also for the reform agenda, although the outcome of the subsequent elections with the new electoral system could not be taken for granted ex ante. According to our baseline scenario, the government should then stay in office until the end of the legislature, in 2018.

Forecasts

%	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (at constant prices, yoy)	0.6	1.2	1.4	0.8	1.1	1.0	1.0	1.2	1.4	1.5	1.5
qoq				0.2	0.2	0.3	0.3	0.4	0.3	0.3	0.3
Private consumption	0.9	1.3	1.2	0.5	0.3	0.3	0.2	0.3	0.4	0.4	0.3
Public consumption	0.6	2.0	2.2	0.6	0.8	0.2	0.5	0.5	0.6	0.6	0.6
Gross capital investment	-0.7	0.6	0.3	0.2	0.6	0.2	-0.1	0.0	0.0	0.1	0.1
Imports	4.1	0.4	3.6	-1.4	1.2	-1.5	1.0	0.8	0.8	0.9	1.0
Exports	5.8	1.2	3.6	-0.2	0.9	-0.9	0.7	0.8	0.9	1.0	0.9
Chg. inventories (contrib. of GDP)	0.5	0.1	0.1	0.1	-0.4	0.2	0.0	0.1	0.0	0.0	0.0
Current accounts (GDP)	2.1	2.3	1.9								
Deficit (of GDP)	-2.6	-2.6	-1.4								
Debt (GDP)	132.7	131.5	128.8								
CPI (yoy)	0.0	-0.1	1.1	0.2	0.2	-0.1	-0.4	-0.2	0.3	1.0	1.2
Industrial output	0.9	1.6	1.3	0.5	0.0	0.7	0.4	0.1	0.3	0.3	0.6
Unemployment	11.9	11.5	11.0	11.6	11.6	11.6	11.6	11.5	11.3	11.2	11.1

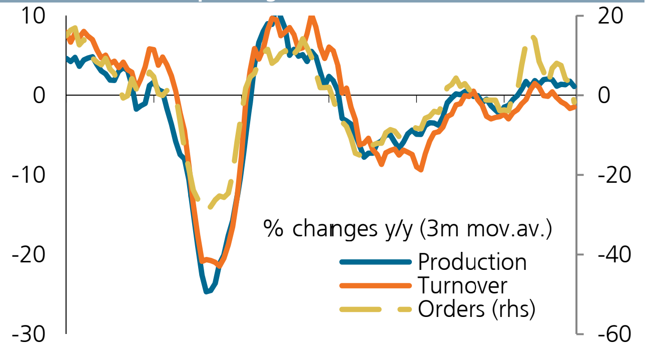
Note: Percentage change on the previous period - unless otherwise stated. Source: Intesa Sanpaolo calculations

Fig. 1 – GDP rebounded in Q1 2016, mostly on the back of manufacturing, which nonetheless lost steam in the spring



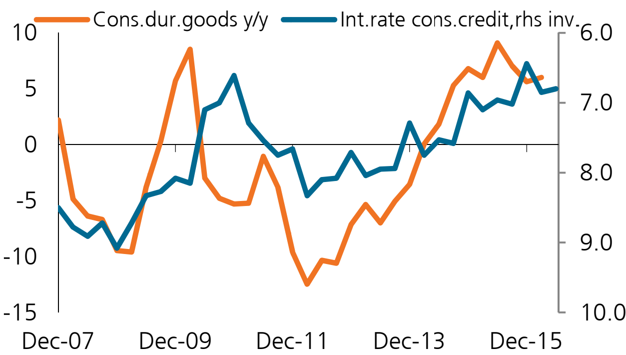
Source: Thomson Reuters-Datastream

Fig. 2 – Industrial sector indices (output, orders and turnover) have slowed, after peaking in mid-2015



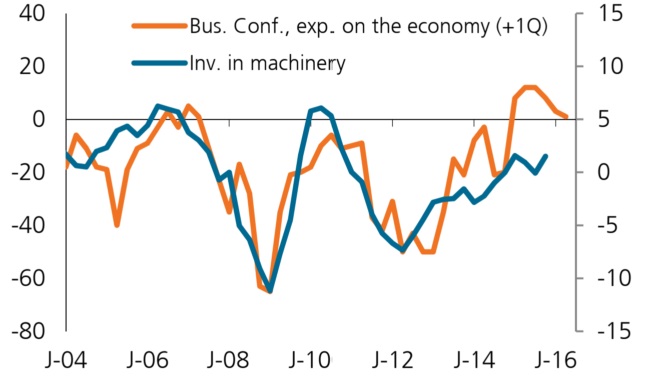
Source: Thomson Reuters-Datastream

Fig. 3 – Recovery still driven by consumption, of durable goods in particular (supported by improving credit conditions)…



Source: Intesa Sanpaolo elaborations on Istat data, ECB

Fig. 4 – …but there are signs of a recovery also for investments in machinery (fuelled by expectations for the cycle, which despite having peaked out, are still optimistic)

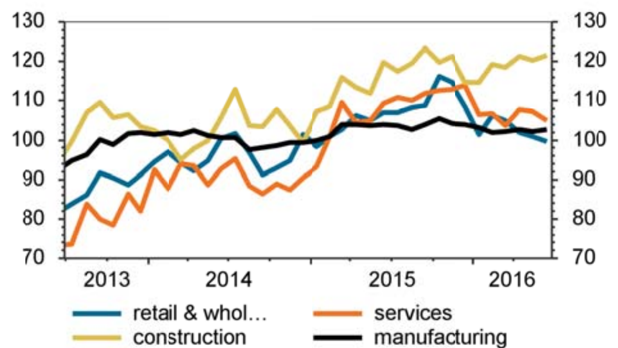


Source: Intesa Sanpaolo elaborations on Istat data

Fig. 5 – Both consumer confidence and manufacturing confidence slowed in the last months, but remain expansionary in any case, on the consumer front especially

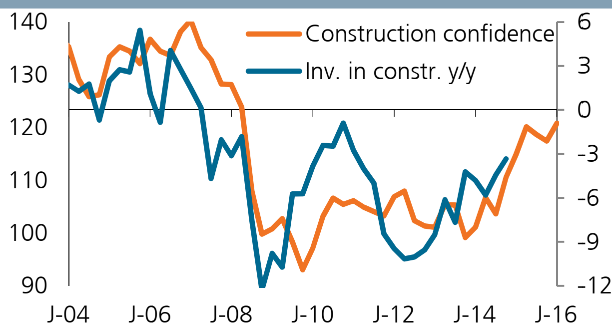
Source: Intesa Sanpaolo elaborations on Labour Ministry data

Fig. 6 – The sector in which business confidence seems more resilient is the construction industry



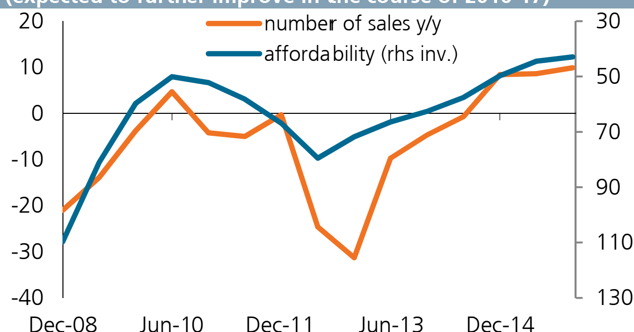
Source: Intesa Sanpaolo elaborations on Labour Ministry data

Fig. 7 – Builders' confidence levels point to a further recovery in investments in construction (although a stable return into positive growth territory will be delayed to next year)



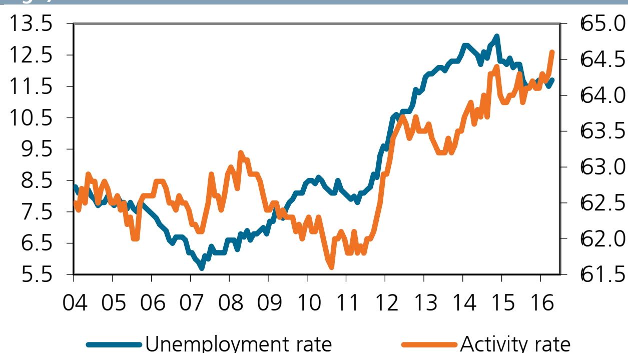
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 8 – The recovery in the number of transactions on the housing market is sustainable, as it is supported by an improvement in the ability of households to access the market (expected to further improve in the course of 2016-17)



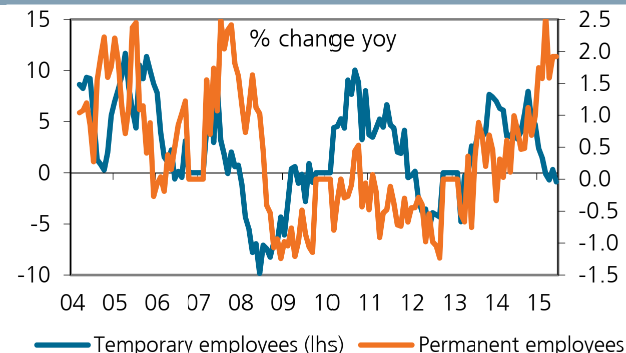
Note: the housing market "access capacity" index is the ratio of new mortgages servicing (approximated by the product of quotations and interest rates), and the disposable income of households; a decline indicates an improvement in the housing market access capacity of households. Source: Intesa Sanpaolo elaborations on Bank of Italy data

Fig. 9 – The decline of the unemployment rate is, and will remain, slow, held back by a rising activity rate (at its record high)



Source: Intesa Sanpaolo elaborations on Labour Ministry data

Fig. 10 – However, employment is still growing, among permanent contract-based workers in particular

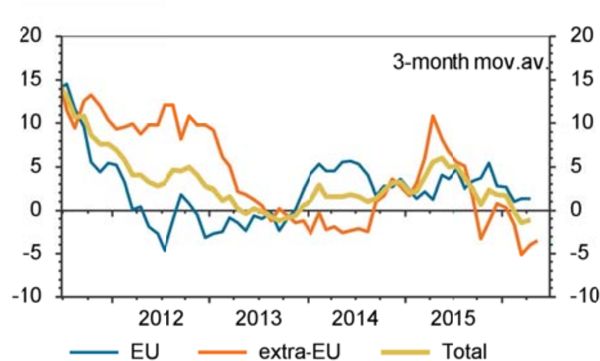


Source: Intesa Sanpaolo elaborations on Labour Ministry data

Fig. 11 – The recent performance of exports disappointed somewhat when compared to potential demand addressed to Italy

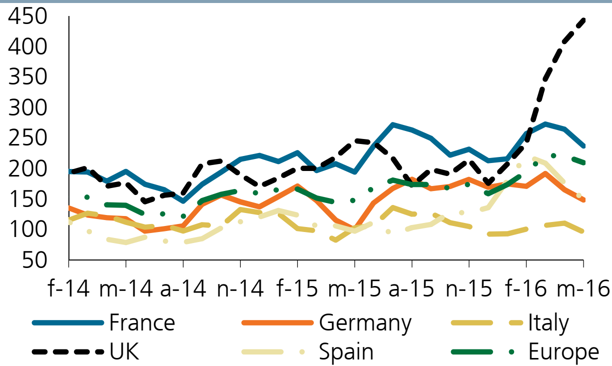
Source: Thomson Reuters Datastream

Fig. 12 – A drag was represented in particular by sales to non-EU countries (expected to continue in the coming months)



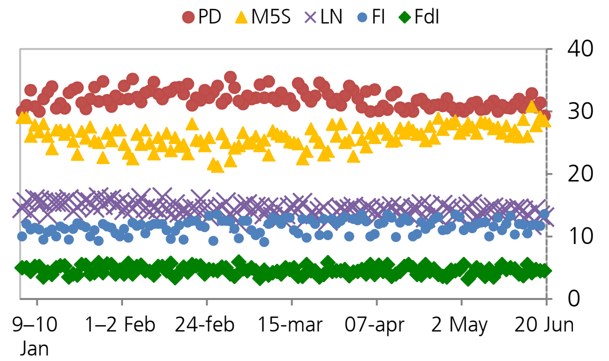
Source: Thomson Reuters Datastream

Fig. 13 – So far, the risk of political uncertainty in Italy has been more subdued than in other countries…



Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

Fig. 14 – …although the declining popularity of the leading government party adds some risk to the scenario



Source: Intesa Sanpaolo elaborations on EMG, ScenariPolitici, Ixè, SWG, Demopolis, Euromedia, CISE, IPR, Piepoli

Asia

Japan: the fragile recovery still needs fiscal and monetary support

Giovanna Mossetti

The Japanese economy remains fragile, and the recovery will struggle to consolidate without further fiscal and monetary stimulus. We update our forecasts for 2016-17 following the government's announcement to postpone the rise in consumption tax from April 2017 to October 2019. The summer elections in the upper house and weak growth at end-2015/early 2016 were determining factors for the decision to postpone fiscal tightening in 2017 and increase spending in fiscal year 2016.

Growth still fragile: postponement of consumption tax hike helps but is not enough

The new forecasts are for growth of 0.3% in 2016 and 0.5% in 2017, with a moderate path of expansion around potential. Apart from reducing the risks of a sharp slowdown in 2017, postponing the tax hike has two effects on forecasts: weaker-than-previously-expected growth around end-2016/early 2017 and a more solid trend in 2017, as there will not be a dip in activity in the middle of next year and fiscal policy will be looser on households between 2017 and 2019. Even with the improvement on the domestic front, inflation will struggle to accelerate significantly from its current rate of just below 1% for the index ex-food and energy. We therefore expect that further monetary stimulus will be added to fiscal policy expansion in the next few months.

1. Stronger macroeconomic environment thanks to the postponement of the consumption tax hike, but still fragile Postponing the consumption tax hike removes the main risk to the scenario for the next two years. After every consumption tax rise from 1995 to 2014, household savings rose, probably due to expectations of further rises and permanent reductions in purchasing power. In 2015, consumption fell by 1.2%, with sharp falls in the second and fourth quarters (-0.8% qoq in each quarter), despite faster wage growth as of 2014. National contract negotiations have been positive since 2014, with rises of 2.1% in 2014 and 2.2% in 2015 (from an average of 1.7% for the five previous years). For this year, with the recent agreement, wages should rise by 2.1% on average, with sustained increases for SMEs and part-time workers too. With almost zero headline inflation, real wages are rising by about 2% yoy. March consumption figures and initial indicators for April are very weak. The news on the postponement of the tax rise could raise hopes for June but, at the moment, a modest contraction – or at best a stagnation in spring – is on the cards. Consumption is expected to grow by 0.2% yoy (due to the negative spill-over from 2015) and by 0.9% in 2017.

Non-residential investment is suffering from weak final demand and the sharp yen appreciation seen from mid-2015 onwards. Private non-residential fixed investment is likely to remain weak also in the second quarter: the currency has stabilised but, in our forecasts, will stay at around 110 in the middle of 2016, and continue to exert downward pressure on exports and earnings. In the first quarter of 2016, sales and earnings in the manufacturing sector fell sharply (by 7.8% and 26.4% yoy, respectively); the services sector showed similar declines (sales down 5.6% and earnings down 13%). The forecast for 2016 is for weak fixed investment (+0.7%) followed by a slight acceleration in 2017 (+1.1%). Residential building is likely to continue to show moderate improvement, although it will remain in negative territory again in 2016. Residential investment is set to contract by 0.8% in 2016 and stabilise in 2017.

Exports have contributed positively to growth in the last two years but should do so to a lesser extent in 2016-17 due to the appreciating currency. Exports are forecast to rise by 0.6% in 2016 and by 2.1% in 2017. Imports should increase by 0.5% this year and by 4.1% in 2017.

2. Fiscal policy: capitulation. On the eve of the upper house elections, the government announced the (second) postponement of the consumption tax hike, which is now planned for

autumn 2019. Before the rise was postponed, the budget for fiscal year 2016 maintained the medium-term fiscal consolidation targets, forecasting that the primary balance would be brought to -1% in 2018 and to zero by 2020; this would enable the debt/GDP ratio to start falling from 2020 onwards. In the last few weeks, with the announcement that the rate hike would be postponed, the government has indicated that it is preparing a stimulus package, probably of around 1% of GDP, focusing on 1) consumer subsidies (spending vouchers); 2) public investment 3) incentives to increase participation in the workforce (especially by women). The 2016 budget forecasts net issues of JPY 34.4Trn (6.8% of GDP). Details of the package are still being finalised. **The largest stimulus effect will be generated by the tax postponement.** The new tax measures will probably mean that the targets for the next two years will be missed, but, for now, the government is keeping its medium-term consolidation plan unchanged.

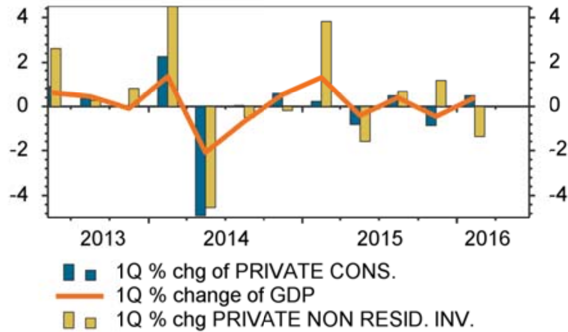
3. Monetary policy: play it again Haruhiko (Kuroda)! There are clear **problems in implementing** monetary policy at the zero lower bound, on two fronts. On the one hand, the securities purchases programme is hampered by the short supply of JGBs: net issues of JGBs are likely to be around JPY 35Trn in 2016. In its current programme, the BoJ purchases JGBs worth JPY 8-12Trn a month, and is the main holder of JGBs, with 31.6% of the total at end-2015. It is clear that, with net issues falling, it will become increasingly difficult to meet demand for securities. In contrast, non-residents hold 49% of the T-bills, compared with 34.5% by the BoJ. In the existing purchases programme, the BoJ has added purchases of ETFs (with underlying shares of companies that invest in growth programmes): however, the amount of purchases in assets other than JGBs is necessarily limited. The other lever on which the central bank has tried to act is that of **negative rates**, with disappointing results on both the currency and loans stimulus fronts. We forecast that the BoJ will again try to intervene – probably in July – with a new stimulus (possibly spread across the instruments that it holds), by making a fresh rate cut in more negative territory and marginally increasing securities purchases (also over asset classes other than JGBs). As a last resort, we think, however, that Japan is the obvious candidate for a "helicopter money" experiment: the government could issue special securities to be sold directly to the BoJ to finance further fiscal stimulus. The alternative in the medium term would be a default, considering that the debt/GDP is already over 240%, and growing.

Forecasts

	2015	2016	2017	2015		2016				2017	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.6	0.3	0.5	1.8	0.8	0.0	0.4	0.1	0.6	0.4	0.5
q/q annual rate				1.7	-1.8	1.9	0.0	0.1	0.5	0.8	0.3
Private consumption	-1.2	0.2	0.9	1.9	-3.2	2.6	0.0	0.4	0.8	1.3	0.8
FI - private nonresidential	1.6	0.7	1.1	3.2	5.2	-2.6	0.8	0.9	1.2	1.1	0.9
FI - private residential	-2.7	-0.8	0.0	6.8	-4.1	-2.9	-2.5	-1.3	-0.4	0.5	0.6
Government investment	-1.9	-3.2	1.5	-9.4	-13.8	-2.9	2.2	2.2	2.6	1.6	0.7
Government consumption	1.2	1.6	0.1	0.7	2.9	3.0	0.5	0.2	-0.1	0.2	0.0
Export	2.8	0.6	2.1	10.8	-3.1	2.4	1.8	1.2	1.7	2.2	2.4
Import	0.3	0.5	4.1	6.9	-4.3	-1.6	4.0	4.3	4.3	4.1	3.9
Stockbuilding (% contrib. to GDP)	0.6	-0.1	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	3.3	3.9	3.5	3.2	3.8	3.9	4.0	3.8	3.8	3.7	3.6
Deficit (% of GDP)	-5.4	-5.6	-6.4								
Debt (% of GDP)	230.0	234.1	239.1								
CPI (y/y)	0.8	0.2	0.6	0.2	0.2	0.1	0.2	0.4	0.4	0.4	0.6
Industrial production	-1.2	-0.8	0.7	-3.8	0.1	-4.1	4.5	1.6	0.8	0.2	0.0
Unemployment (%)	3.4	3.0	2.7	3.4	3.3	3.2	2.9	2.9	2.8	2.8	2.8
JPY/USD	121.0	113.0	116.3	122.2	121.4	115.2	108.1	111.8	116.8	117.4	116.4
Effective exch.rate (1990=100)	125.9	136.0	129.5	124.8	126.4	133.7	140.8	138.1	131.4	129.4	129.6

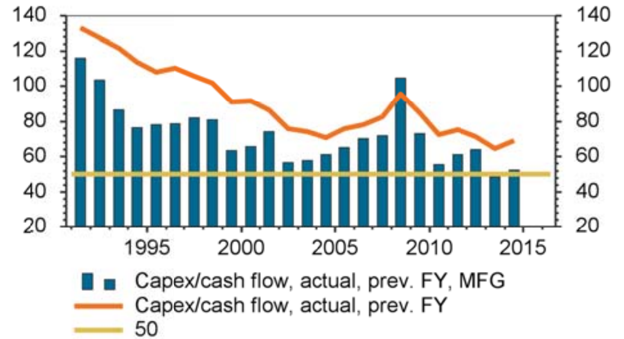
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth: dancing around zero



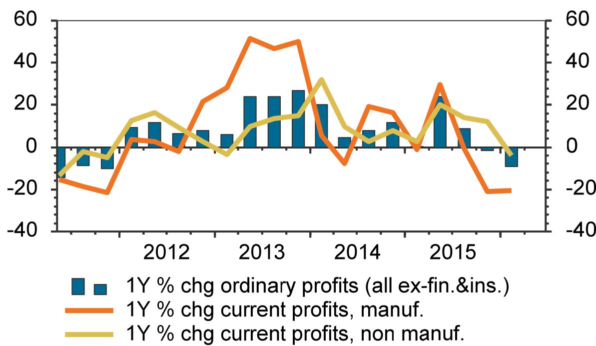
Source: Thomson Reuters-Datastream

Fig. 2 – Minimal investment by businesses...



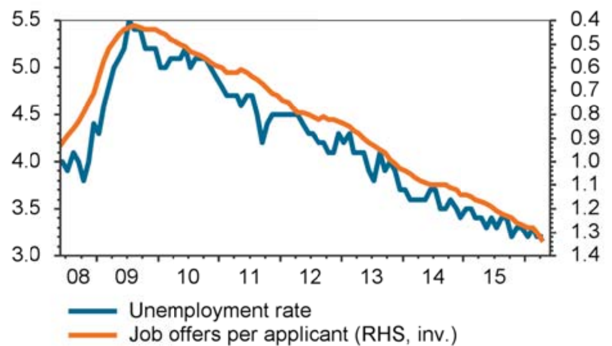
Source: Thomson Reuters-Datastream, Ministry of Finance survey of businesses investment plans.

Fig. 3 – … while profits are curbed by a strong yen



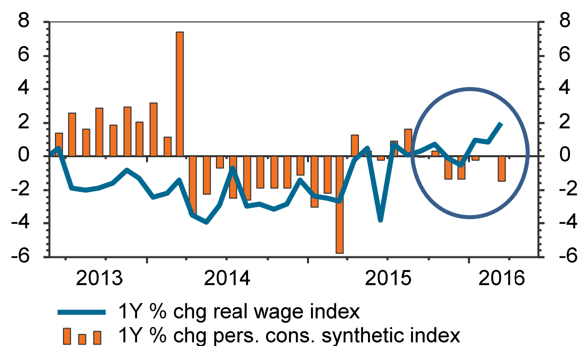
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment is falling



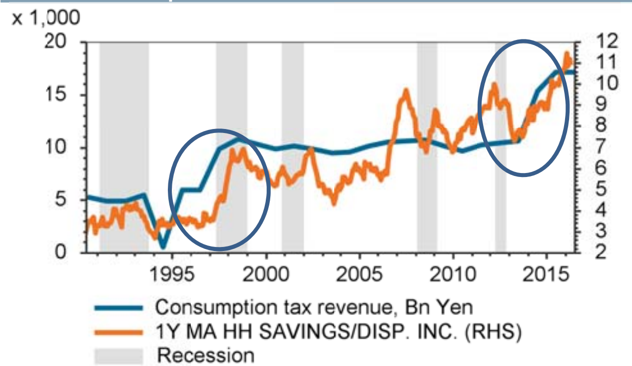
Source: Thomson Reuters-Datastream

Fig. 5 – Weak consumer spending despite wages acceleration…



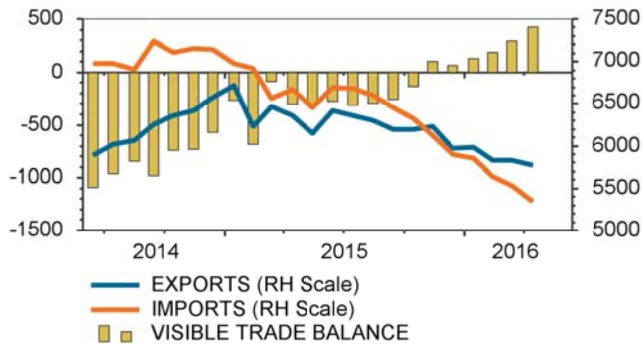
Source: Thomson Reuters-Datastream

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



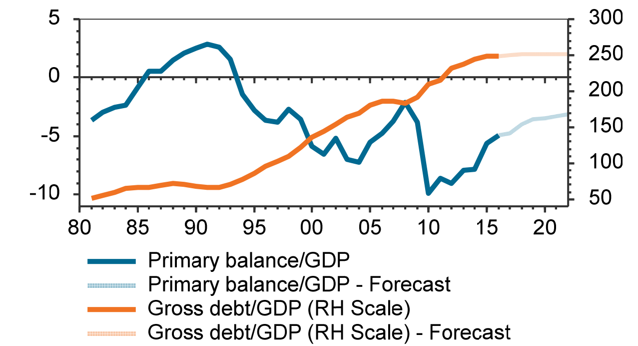
Source: Thomson Reuters-Datastream

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



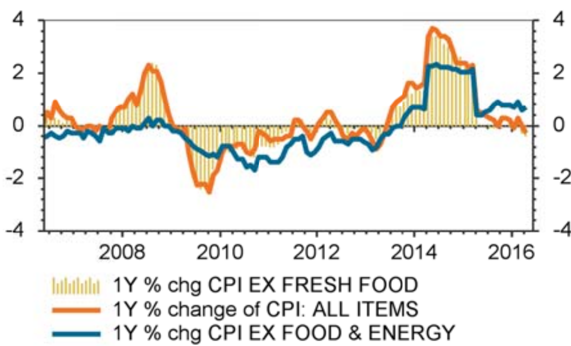
Source: Thomson Reuters-Datastream

Fig. 8 – Tax consolidation must continue in order to achieve a stable debt/GDP ratio



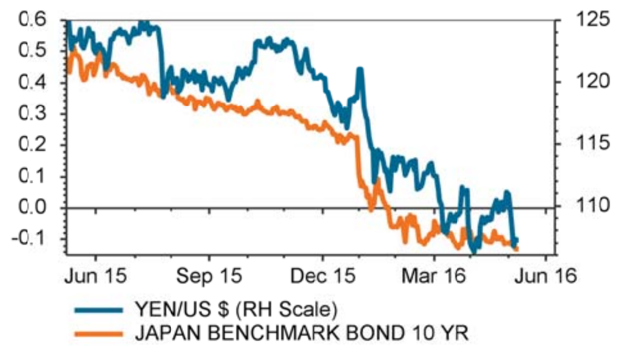
Source: Thomson Reuters-Datastream IMF forecasts.

Fig. 9 – Core inflation just under 1%: 2% still far off



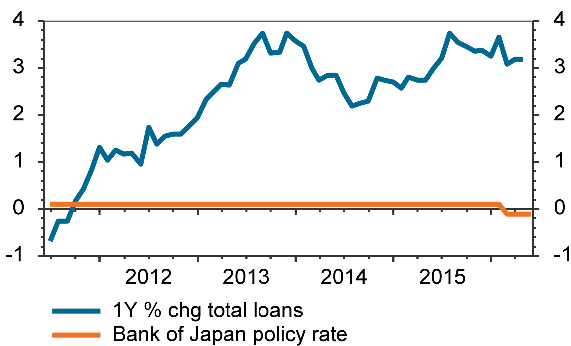
Source: Thomson Reuters-Datastream

Fig. 10 – BoJ: negative effects of negative rates?



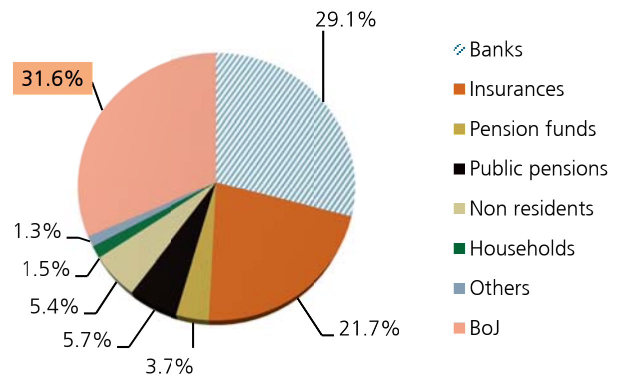
Source: Thomson Reuters-Datastream

Fig. 11 – The BoJ's ineffective toolkit



Source: Thomson Reuters-Datastream

Fig. 12 – Central bank is first owner of JGBs



Figures at end-December 2015; total JGBs: JPY 911.3Trn
Source: Ministry of Finance

China: investment slows despite support from loans

Silvia Guizzo

GDP rose by 6.7% yoy in the first quarter compared with 6.8% in 4Q15, with qoq growth of 1.1%, the lowest since the series started. The moderate slowdown affected all sectors except construction and the real estate sector. The mixed data in the last three months points to a stabilisation of growth in 2Q, just below that of the first quarter. However, the slowdown in private sector investment, especially in manufacturing, does not change the outlook for a slowdown in economic growth in 2H16 and in 2017.

Industrial output rose by 6.0% yoy in May, stable compared with April, thanks to the acceleration of production in the private sector, in line with the slight recovery in the manufacturing PMI which, although remaining below 50 in the Markit survey, is still higher than in the first quarter (fig.1). Retail sales followed a similar trend: in real terms, they were stable at 9.7% yoy in May compared with March, although they slowed slightly in nominal terms, and were also supported by the recovery in car sales. Consumer confidence indices continue to give contradictory signals, with NBS and Bankcard Unionpay indicating falls and others pointing to rises (fig. 9). The labour market seems to be on a path of a moderate and slow decline (figs.11 and 12), which is difficult to reconcile with an acceleration in private consumption.

Foreign trade reported stabilising exports and improving imports in the last three months. Exports rose by 1% 3m yoy in May after 12 months of yoy falls thanks to the improved performance of ordinary goods compared with assembled goods (fig. 6). Exports partly benefited from a highly favourable base effect, which will continue for the rest of the year, but the seasonally-adjusted figures show exports stabilising between March and May. Exports rose in volume terms by 6.9% yoy in April, in tandem with foreign orders which, although showing a decline in the Markit survey and standing at just over 50 in the NBS survey, are still improving slightly on the first quarter (fig.7). Imports recorded another fall of 6.4% 3m yoy in May, a sharp improvement on the low of 13.5% 3m yoy in March, while commodities volumes - both energy and foods - are still on a positive path (fig.8).

Fixed investment growth, however, slowed to 9.6% cum yoy, from the rate of just over 10%, which it kept up for the first four months of the year. The stabilisation of investment in residential building and the real estate sector was counteracted by a slowdown in construction investment. By sector, while growth in central government investment picked up and that of state-owned enterprises remained high (especially in certain services and transport infrastructure, fig. 3), the pace of growth in local government investment, and especially in the private sector, slowed (fig.2). Specifically, the decline in the mining sector and the slowdown in manufacturing (fig.4) continued. In the latter, over half the sectors are slowing or falling compared with end-2015; this mainly affects chemicals, metal products and manufactured goods, whereas pharmaceuticals and machinery are growing steadily. After accelerating slightly from the second half of 2015, and rising in the first few months of 2016, outstanding bank loans stabilised at end-of-year growth rates (14.4% yoy in May); total social financing performed in a similar fashion (12.6% yoy) (fig.13). In terms of net flows, both aggregates rose in the first five months of the year (+17.2% yoy and +16.5% yoy respectively) but look set to slow in the next few quarters as the effect of the early granting of loans and outlay of funds in the state budget, in the first half of the year, gradually disappears. The authorities, moreover, seem set to change the path of lending growth, as revealed in an interview in the "People's Daily" at the beginning of May (Xinhua: "*China's economy to follow L-shaped trajectory for foreseeable future*", and in Bloomberg News: "*China's 'Authoritative' Warning on Debt: People's Daily Excerpts*", 9 May 2016), which expounded the need for China to tackle its problem of non-performing loans and the excessive level of corporate debt.

Inflation (fig.10) fell to 2% yoy in May, after remaining stable at 2.3% in the previous three months, due to a fall in the prices of food (essentially fruit and vegetables) and utilities. Meat

prices continued to shoot up (20.8% yoy) and this trend could continue until at least the autumn. Core inflation remains subdued (1.6% in May) and production price inflation is still negative (-2.6%), although it has risen sharply from its December lows (-5.9% yoy), driven by rising commodities prices. The increase in the prices of some services (medicine, education, rented housing) and the unfavourable base effect in fuel prices supports our forecast of a moderate rise in inflation in the next few months.

The USD/CNY exchange rate, after a low of 6.45 at the end of March, returned to its January levels of 6.58. However, the effective exchange rate based on a basket of currencies, published in 2015, depreciated by 2.6% between end-2015 and mid-June 2016, mainly due to the depreciation against the emerging currencies driven by the dollar's movements (figs. 21, 22, 23). We still see increased risks of high volatility for the renminbi in the third quarter. However, we think the People's Bank of China (PBOC) will continue to intervene to prevent a sudden, excessive depreciation of the currency against the dollar. We expect the renminbi to hit a low of no more than 6.70 by September barring any marked deterioration in the Chinese figures or significant revision of expectations regarding the Fed; this will be followed by a moderate recovery and a stable effective exchange rate around current levels.

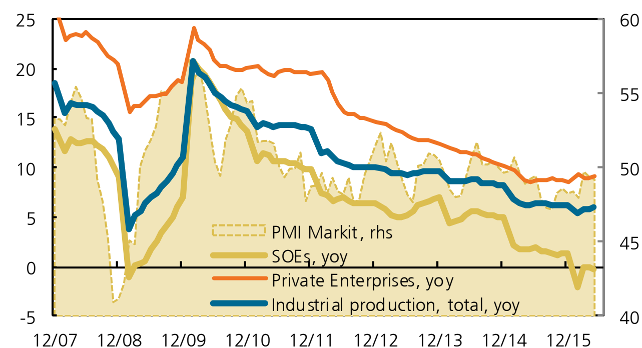
The pick-up in lending has not so far supported private company investment and, moreover, seems to have been concentrated in medium- to long-term lending to households (essentially mortgages, fig. 15). The recovery in real estate investment, however, seems temporary, given the level of unsold housing stock. We still believe that the increase in non-performing loans in the next two years will curb the trend in lending despite the support of monetary policy, which only has limited room to manoeuvre. The slowdown in total investment will continue in 2016, impacting the job market and ultimately consumer spending. Furthermore, investment in infrastructure will be unlikely to sustain the pace of 2015, and could fall more sharply in the medium term. We therefore maintain our growth forecasts unchanged at 6.3% in 2016, with a slight deceleration to 6.1% in 2017. Risks to the scenario are to the upside in the short term but still to the downside in the medium term.

Forecasts

	2011	2012	2013	2014	2015	2016	2017
GDP (constant prices)	9.5	7.7	7.7	7.2	6.9	6.3	6.1
Private consumption	11.6	9.7	7.9	8.4	8.1	7.3	6.8
Public consumption	11.7	3.6	4.1	3.4	11.4	16.4	6.7
Fixed investment	8.1	8.8	9	6.9	5.7	4.7	4
Exports	13.9	6.3	9	7.8	-2.9	-2.7	4.8
Imports	17.3	6.9	11.7	10.1	1.1	1.8	3.9
Industrial output	10.6	8.2	7.9	7.3	6	5.4	4.5
Inflation (CPI)	5.4	2.6	2.6	2	1.4	2.0	2.2
Unemployment rate (%)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Average salaries	16.8	14.4	11.8	9.2	8.5	7.4	7
90-day interbank rate (average) (%)	5.3	4.2	4.9	4.8	3.8	2.9	2.9
USD/CNY exchange rate (average)	6.46	6.31	6.15	6.16	6.28	6.59	6.55
Current account balance (CNY Bn)	874	1360	912	1713	2077	1794	1408
Current account balance (% of GDP)	1.8	2.5	1.6	2.7	3.1	2.5	1.8
Budget balance* (% of GDP)	-1.1	-1.6	-1.8	-1.8	-3.5	-4.5	-4.3

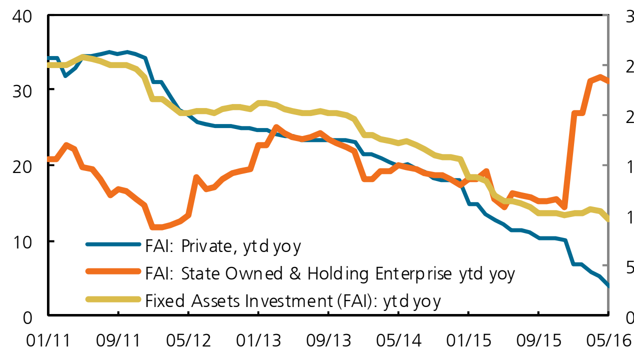
NB: Percentage change versus previous period except where otherwise indicated; Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Fig. 1 – Industrial output stabilises



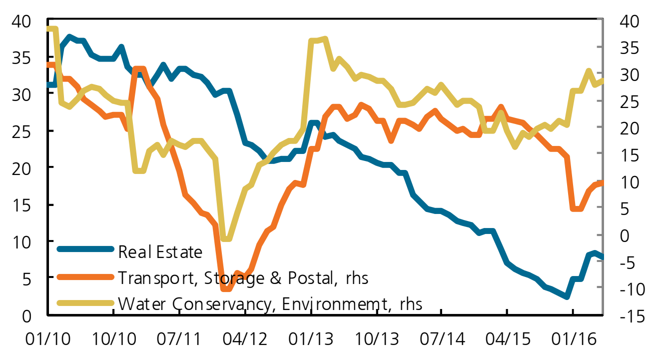
N.B. Value added in real terms. Source: CEIC, Markit

Fig. 2 – Private sector investment continues to slow



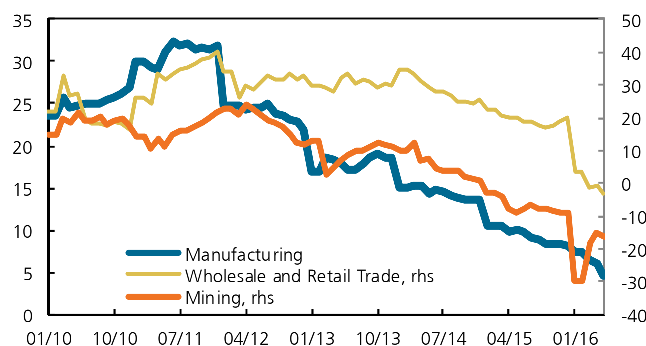
Source: CEIC

Fig. 3 – Investment: real estate and some services partly counteract....



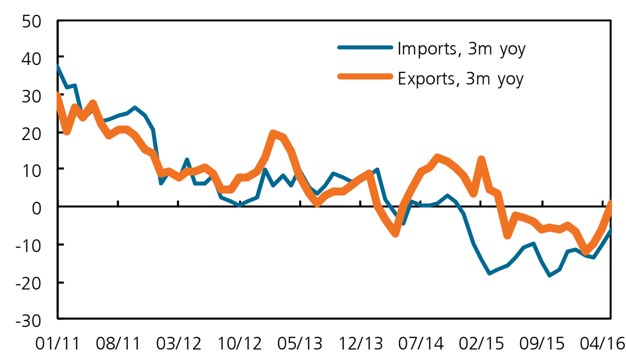
Source: CEIC

Fig. 4 - ...the slowdown in investment in the manufacturing, mining and trade sectors



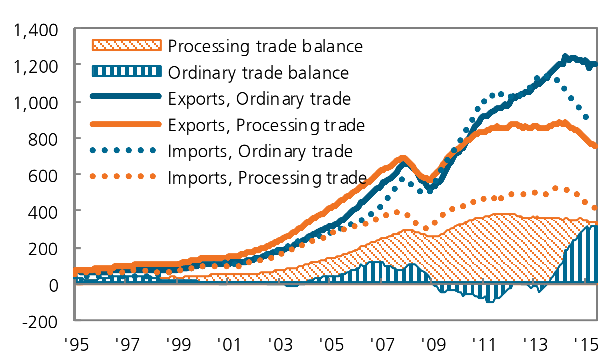
Source: CEIC

Fig. 5 – Foreign trade holds up



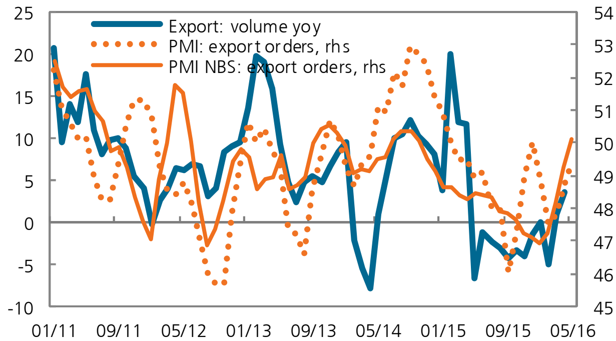
Source: Bloomberg, CEIC

Fig. 6 - Trade balance* (USD Bn)



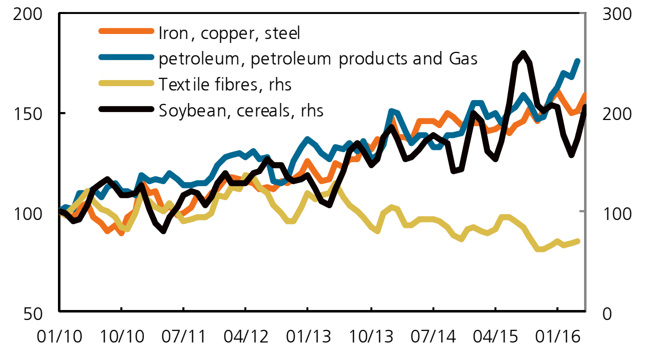
* Twelve-month moving average. Source: Intesa Sanpaolo chart from CEIC data

Fig. 7 – Exports improving slightly, including in volume terms



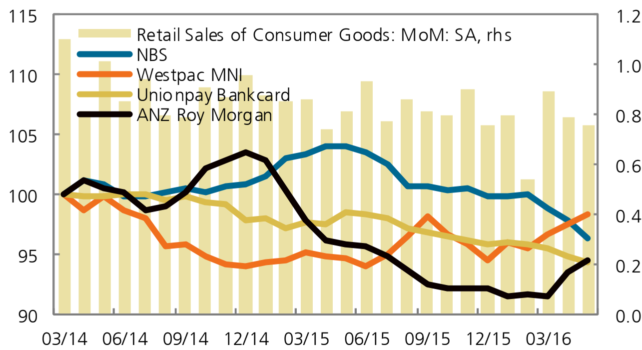
Source: CEIC

Fig. 8 – Raw material imports in quantities



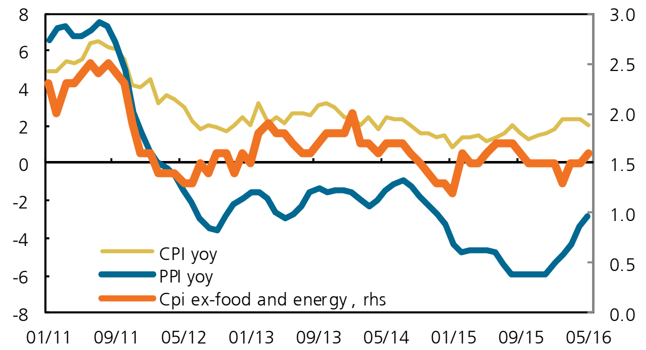
NB: Imports in tons, 3m moving average, rebased at 01/01/2010 = 100. Source: ISP chart from CEIC data

Fig.9 – Contradictory confidence indices



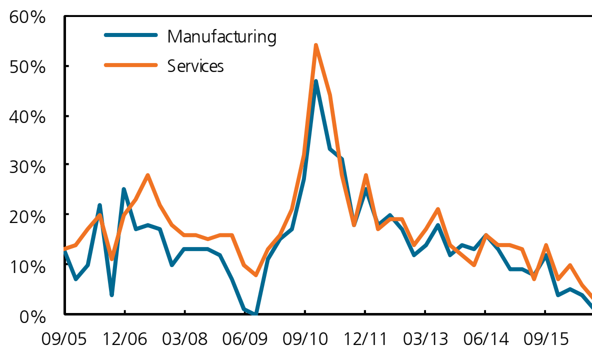
N.B. Confidence indices, 3-month moving average, rebased to March 2014=100. Source: CEIC

Fig. 10 – Inflation



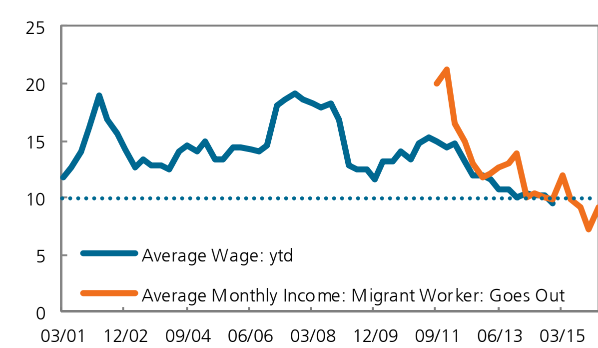
Source: CEIC, Bloomberg

Fig. 11 - Manpower survey: hiring intentions



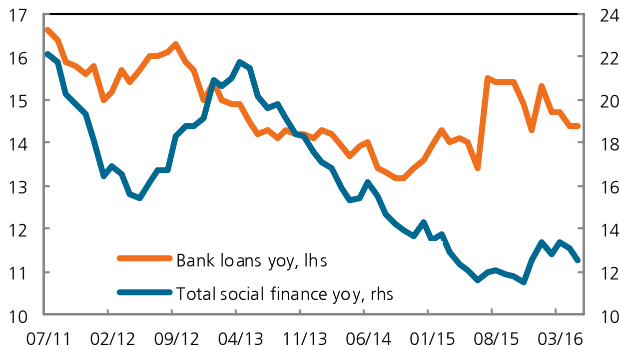
Source: Bloomberg, four-quarterly moving averages.

Fig. 12 – Wages growth still high but slowing



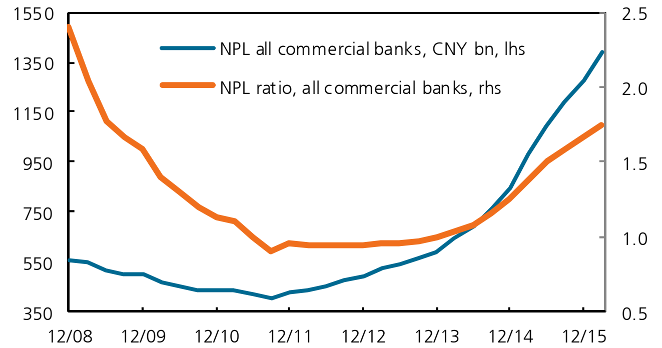
Source: CEIC

Fig. 13 - Lending stabilises



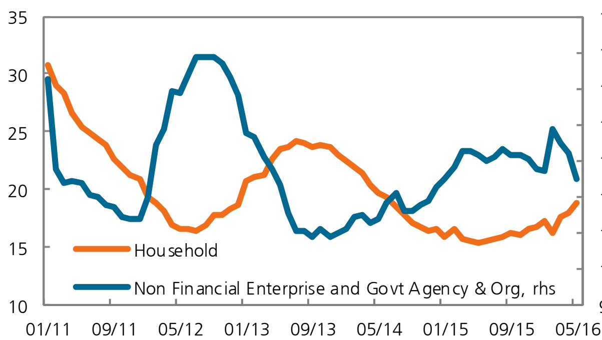
NB: stock, monthly figures, % yoy chg. Source: CEIC and Intesa Sanpaolo estimates

Fig. 14 – Non-performing loans continue to rise



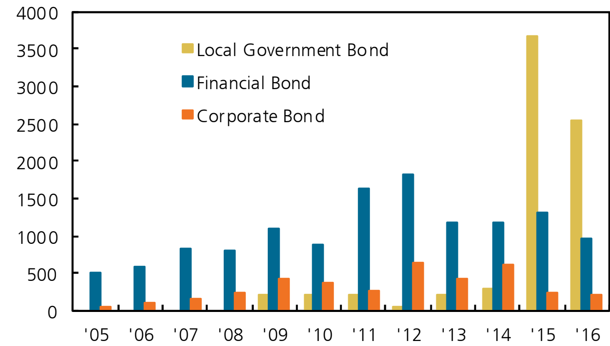
NB: Non-performing loans (NPL) of commercial banks. Source: CEIC

Fig. 15 - Bank lending (chg. % yoy)



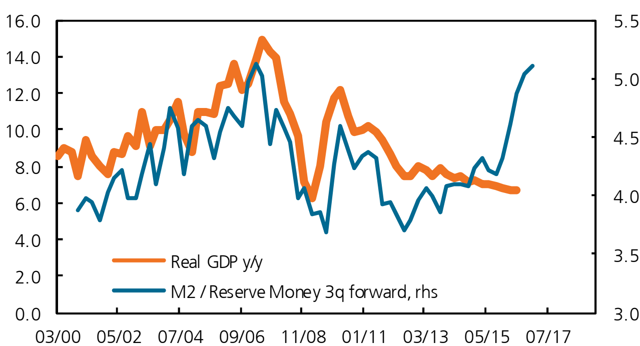
Source: CEIC

Fig. 16 – Net issues (CNY m.)



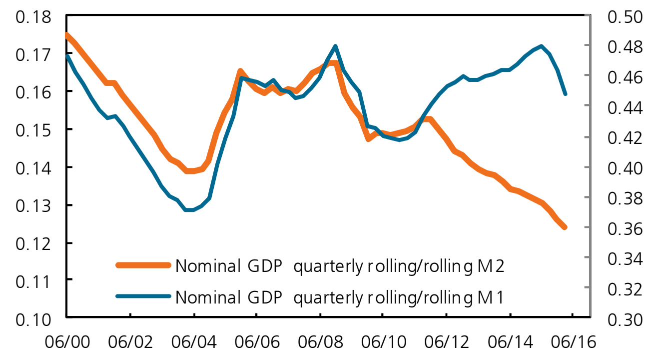
Source: Intesa Sanpaolo chart from CEIC data

Fig. 17 - Monetary stimulus does not fuel growth as in the past



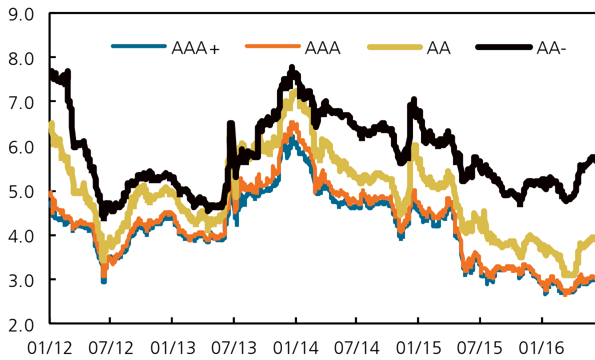
Source: Bloomberg

Fig. 18 – Velocity of money



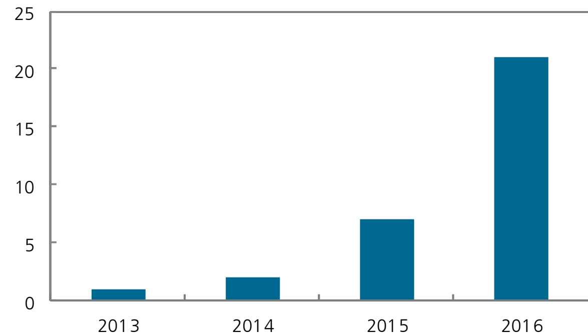
Source: Bloomberg and Intesa Sanpaolo estimates

Fig. 19 – Yields on 1-year corporate bonds



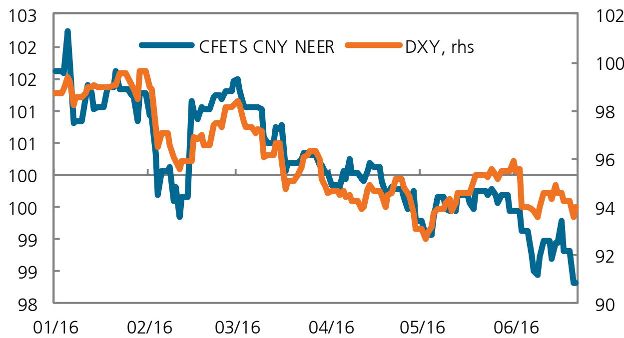
Source: CEIC

Fig. 20– Number of corporate bond defaults



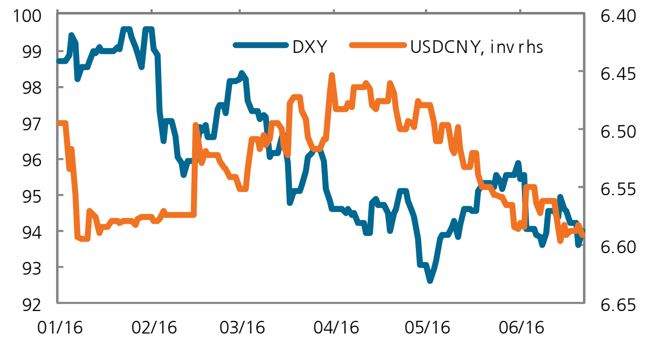
N.B. 2016 at 20 June. Source: Bloomberg

Fig. 21 – Effective exchange rate: CNY and USD



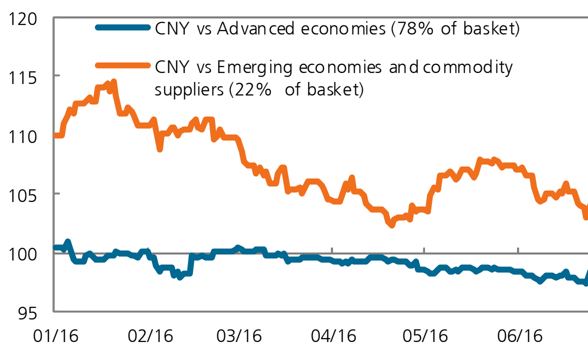
Source: Intesa Sanpaolo charts from CEIC, CFETS and Bloomberg data

Fig. 22 – CNY/USD and effective exchange rate



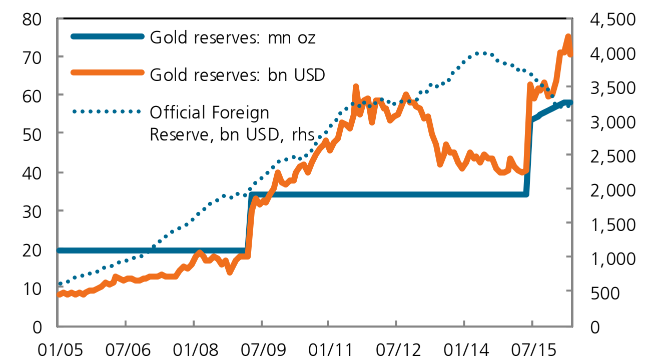
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 23 - Effective exchange rate: sharper depreciation against the emerging currencies



Source: Intesa Sanpaolo charts from CEIC, CFETS and Bloomberg data

Fig. 24 – Foreign currency reserves



Source: CEIC, Bloomberg

India: consumption driving growth

Silvia Guizzo

The Indian economy grew by 7.9% yoy in 1Q16, a sharp rise on the 7.2% yoy in 4Q15, buoyed by the outstanding performance of private consumption (+8.3% yoy), which offset the downtrend in private investment (-1.9% yoy) and the negative contribution of net exports. On the supply side, the pick-up was driven by the recovery in the agricultural sector. FY 2015-2016 thus closed with growth of 7.6% versus 7.2% in FY 2014-2015, while growth for the calendar year 2015 was downgraded by one-tenth of a percentage point to 7.2%, from 7.3% previously.

The fall in fixed investment in 1Q was partly due to a highly unfavourable base effect. The number of industrial investment proposals submitted to the industry ministry for approval rose by 5% yoy in April (versus 8.4% in full year 2015), but the total amount of investment is still falling sharply (-44.1% yoy). Moreover, after picking up at the turn of the year, machinery imports, which were also partly influenced by an adverse base effect, started to decline again. The RBI survey of industrial firms points to stabilising corporate confidence in 1Q but a sharp fall in expectations for 2Q, which have returned to the lows of mid-2014 (Fig. 3). Conversely, the Dun & Bradstreet survey shows a moderate improvement. The RBI survey shows a clear deterioration in expectations for orders and capacity utilisation. The orders components of the manufacturing PMI (particularly foreign orders) in fact fell between February and May, although on average they remained above 50. Industrial output, which rose by 0.5% 3M yoy in April after year-on-year falls at the start of the year, is still fragile (Fig. 2) and continues to be driven down by capital goods (-16.4% 3M yoy) and non-durable consumer goods. On the other hand, growth in the production of goods for infrastructure (e.g. refinery, fertilisers and steel) remains solid. Lending growth in the non-food sector remains steady (+8.4% yoy in April), but has slowed moderately compared with the peak in February (+9.9%) due to the dip in lending to industry, especially to infrastructure; however, lending to the services and private sectors is accelerating sharply (Fig.10). The services sector, although moderating slightly, continues to record high growth (+8.7% yoy in 1Q), and the PMI, mobile phone subscriptions and tourist arrivals are still signalling a positive outlook for the sector.

Consumer confidence rose further in 1Q (Fig. 9), driven mainly by earnings expectations. The percentage of households expecting an increase in future spending fell slightly (for the fourth quarter in a row) but is still well above 75% of those interviewed. Expectations about the labour market also fell, in contrast with the employment component of the PMI, which was sitting pretty at just over 50, but in line with the Manpower survey, which dropped for the third quarter after a year of stability. Auto sales are still healthy (+13.4% 3M yoy in May), supported by commercial and three-wheeled vehicles, which are counteracting slowing car sales. In light of the positive trend in the labour market, the increase in domestic passenger traffic, and expectations of a recovery in the agricultural sector – and therefore in incomes in rural areas –, the outlook for private consumption remains positive for the rest of the year.

Foreign trade continues to trend downwards due to the effect of falling commodities prices. Stripping out oil, imports started to worsen again (-16.2% 3M yoy), while exports (-3.3% 3M yoy) continued to recover from the lows of end-2015; however, the fall in the foreign orders component of the PMI (Fig. 5) casts doubt on the outlook for the next few months. The trade deficit in the first five months of the year, at USD 30.4Bn, is lower than it was in the same period in 2015 (USD 47.5Bn). The current account balance continued to benefit from the reduction in the trade deficit, stabilising at -1.1% of GDP in 1Q (Fig. 12). After the first round of foreign direct investment (FDI) reforms in November 2015, the government approved further liberalisation in June, allowing up to 100% foreign ownership with government approval in nearly all sectors, including defence, and raising the limit on holdings by foreign investors for many assets with automatic approval. FDI inflows have gradually risen in the last few years, to such an extent that, in 2015, net FDI inflows were 54% of the financial account balance, compared with a low of 18% in 2012. Low oil prices and record levels of FDI inflows continued

in 1Q16, stimulating a further increase in foreign currency reserves, from USD 329Bn in December to USD 336Bn in May, and in the import cover ratio (goods and services) to 8.9 months.

After a low of 4.8% in March, inflation rose to 5.8%, returning to January levels (5.7%) due to an increase in food prices. Core inflation has fluctuated between 4.7% and 5% in the last six months, shored up by the services sector. Our scenario maintains expectations of a lower average oil price in 2016 than in 2015, and of modest rises in food prices thanks to the careful management of government stocks. However, the recent oil price rise and the end of the favourable base effect in the fuels segment have led us to upgrade the inflation profile to 5.2% in 2016. Stabilising oil prices combined with expected increases in the salaries of public sector employees indicate upside risks to inflation, which will also depend on the summer monsoon season.

Increased uncertainty about inflation has led the Reserve Bank of India (RBI) to leave its rates unchanged at the June meeting, after the 25-bp cut in April. But the central bank has reiterated that its monetary policy stance remains accommodative and that it will act according to developments in the macroeconomic landscape and in the financial markets. A further cut at the August meeting will depend on how core inflation performs. Governor Raghuram Rajan's recent announcement that he wants to return to academia at the expiry of his mandate (4 September) has fuelled uncertainty about the future direction of monetary policy. A lack of cohesive support from the government – as has emerged in a number of statements – for the central bank's independence and credibility, which was hard-won by Rajan, in pursuing the inflation target, would threaten India's positive economic growth, as well as investor confidence. Indeed, the markets reacted negatively, with the rupee falling by 0.8% in the two days after the announcement.

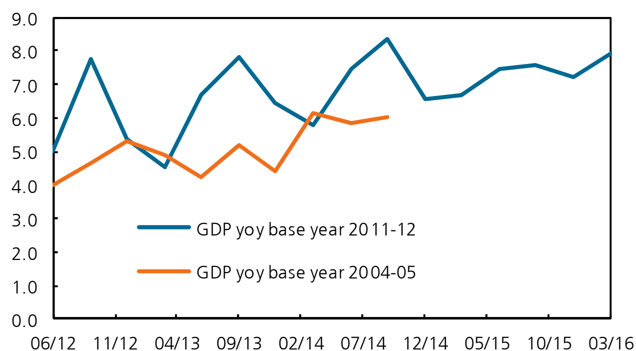
The government's commitment to reducing bureaucratic restrictions and supporting investment, a monsoon season with average rainfall after two seasons of drought, and the central bank's still-accommodative monetary policy should continue to favour the consolidation of growth. We are therefore sticking with our forecasts of 7.5% in 2016 and 2017

Forecasts

	2011	2012	2013	2014	2015	2016	2017
GDP (constant prices)	7.0	5.6	6.3	7.0	7.2	7.5	7.5
Private consumption	7.3	6.7	5.7	6.7	7.0	7.8	7.6
Public consumption	7.9	4.6	2.2	9.5	0.9	4.7	6.3
Fixed investment	6.2	2.3	7.4	2.8	5.8	3.8	7.6
Exports	18.2	10.0	4.4	7.0	-6.3	3.2	5.4
Imports	18.4	11.3	-6	0.5	-3.9	0.9	4.8
Industrial output	4.8	0.7	0.6	1.8	3.2	3.8	7.1
Inflation (CPI)	8.3	9.4	9.9	6.6	4.9	5.2	5.0
Unemployment rate (%)	5.8	5.6	5.6	5.6	5.5	5.5	5.4
Average salaries	14.3	19.3	11.2	10.7	10.4	10.2	10.2
3-month Mibor (average)	9.5	9.5	9.3	9.1	8	7.1	6.3
USD/INR exchange rate (average)	46.7	53.5	58.6	61.0	64.2	67.6	65.0
Current account balance (INR Bn)	-2945.1	-4893.2	-2779.6	-1661.2	-1461.2	-735.7	-1536.5
Current account balance (% of GDP)	-3.5	-5.1	-2.5	-1.4	-1.1	-0.5	-0.9
Budget balance (% of GDP)	-6.9	-5.5	-5.5	-4.3	-3.5	-3.8	-3.1

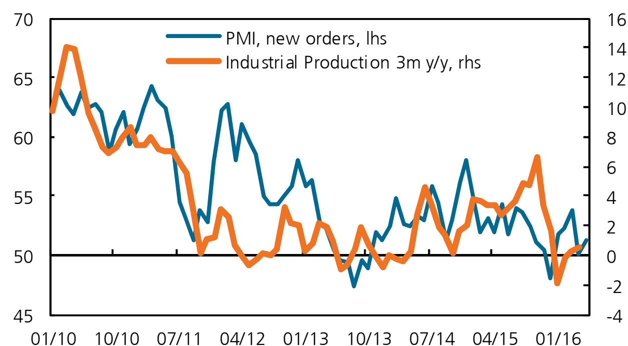
NB: % changes versus previous period – except where otherwise indicated. Figures relate to the calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Fig. 1 – Accelerating growth



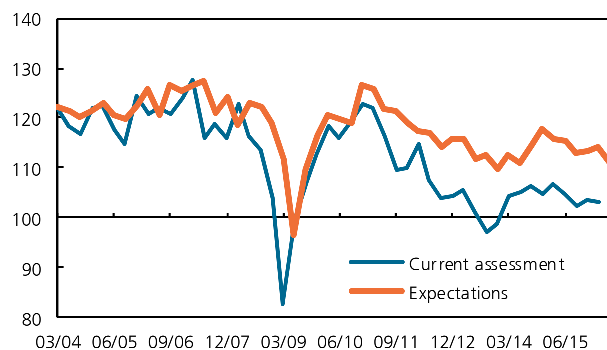
Source: CEIC

Fig. 2 – The trend in industrial output remains weak



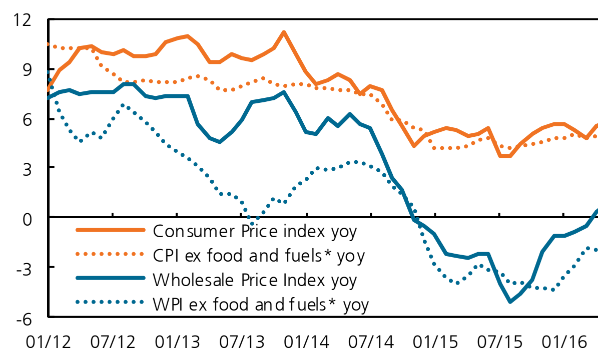
Source: Markit-HSBC, CEIC

Fig. 3 – Business confidence* diminishing slightly



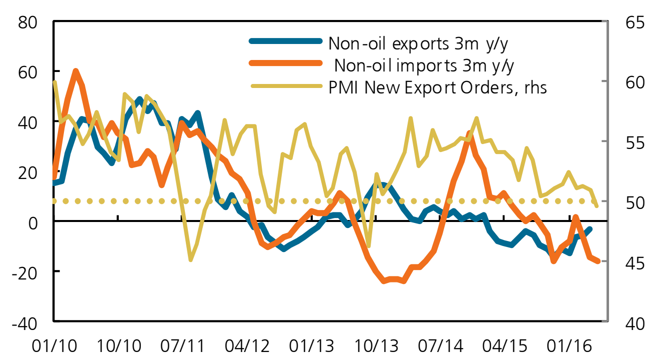
NB: (*) Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 - Core inflation is not falling



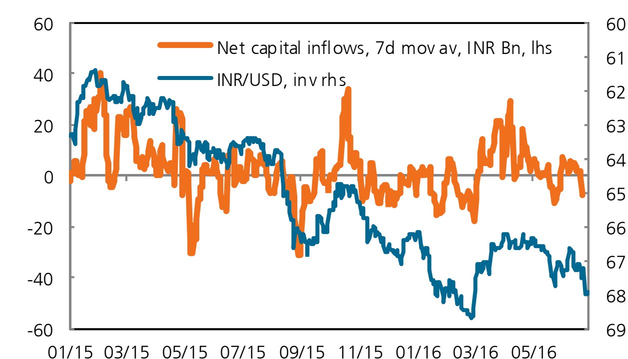
NB: (*) Intesa Sanpaolo estimates. Source: CEIC

Fig. 5 – Exports improving



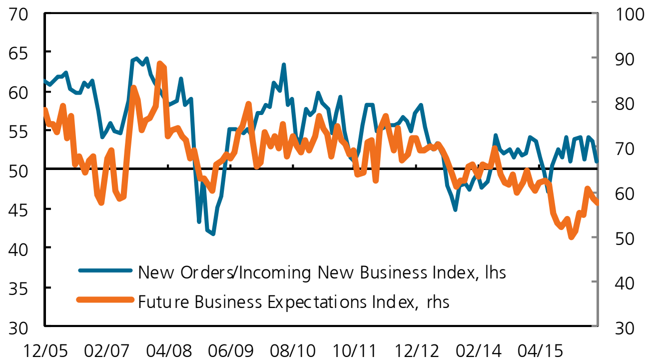
NB: 3-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Fig. 6 – The rupee recovers from its February lows



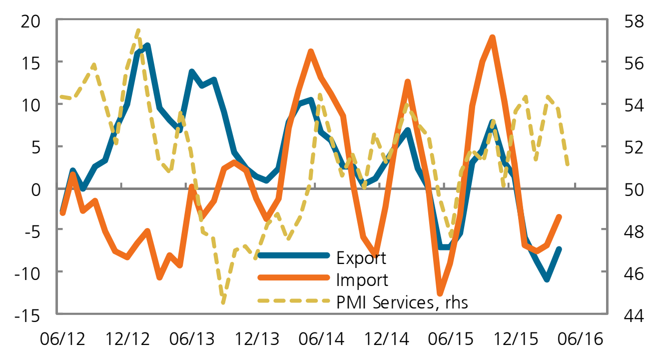
NB: (*) Net purchases of foreign institutional investors Source: CEIC

Fig. 7 – Services: expectations and orders stabilise



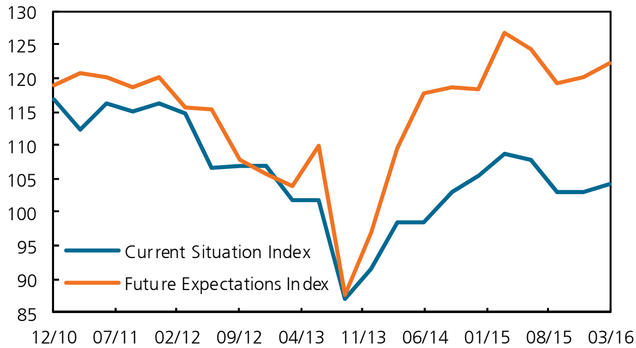
Source: Markit

Fig. 8 – Trade in services



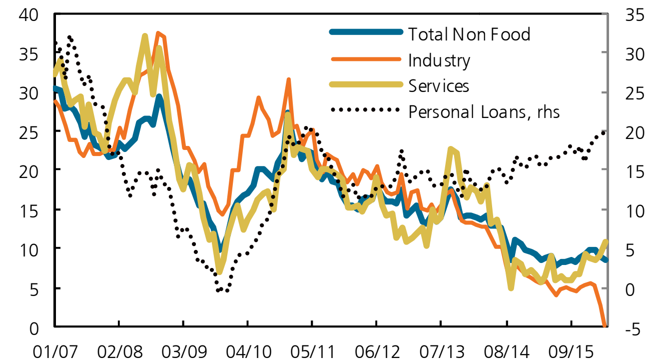
Source: CEIC, Markit

Fig. 9 – Consumer confidence



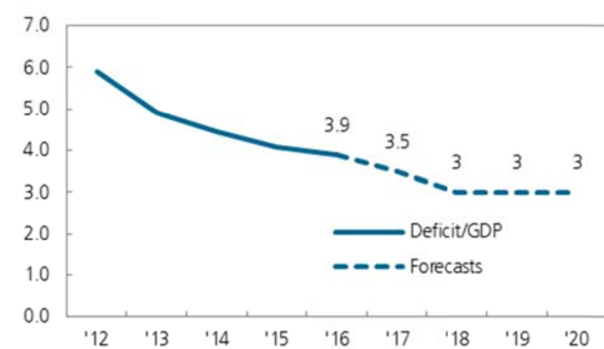
NB: Quarterly consumer confidence survey by the RBI. Source: CEIC

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



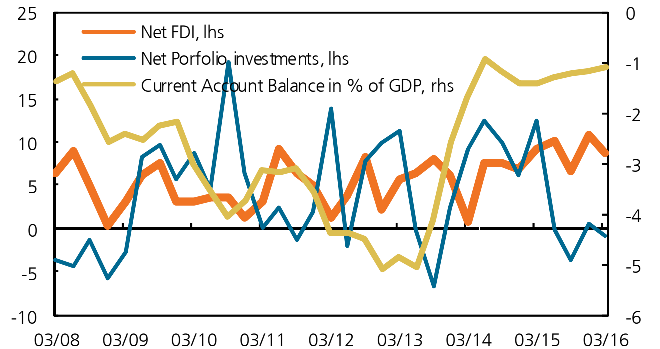
Source: CEIC

Fig. 11 – Government balance (%)



Source: CEIC, Ministry of Finance

Fig. 12 – Current account



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

Currency markets – *Fiat* Brexit

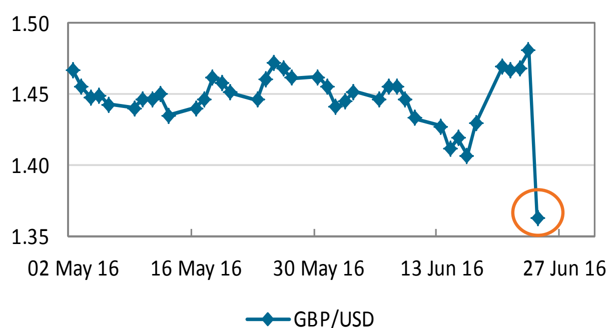
Asmara Jamaleh

Fiat Brexit: the referendum on 23 June, a 52% majority of British voters showed that they wanted the UK to leave the European Union.

The reaction on the currency markets was fast and furious. The pound sterling nosedived, the euro dropped to a considerable extent, the dollar went up against all other currencies, including emerging economies and others, except the yen (Figs. 1-4): the Swiss franc rose against the euro, although it fell against the dollar.

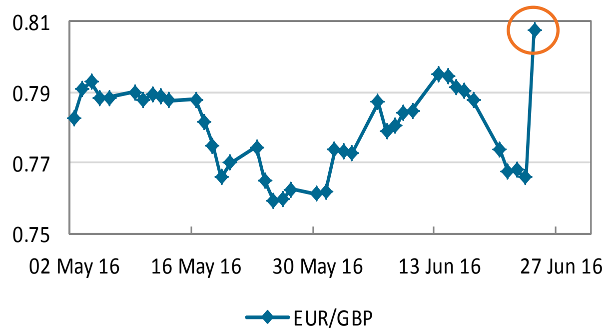
Quite apart from this upheaval, the effects of Brexit will be long-lasting.

Fig. 1 – Sterling's fall vs. the dollar…



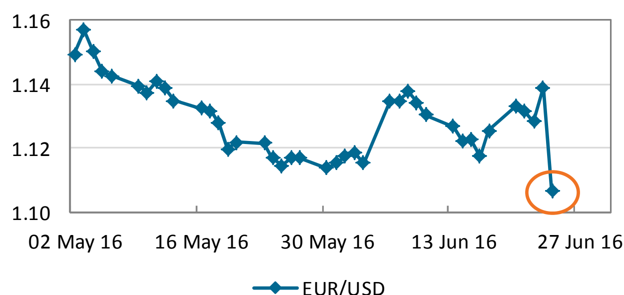
Source: Thomson Reuters-Datastream

Fig. 2 – … and vs. the euro



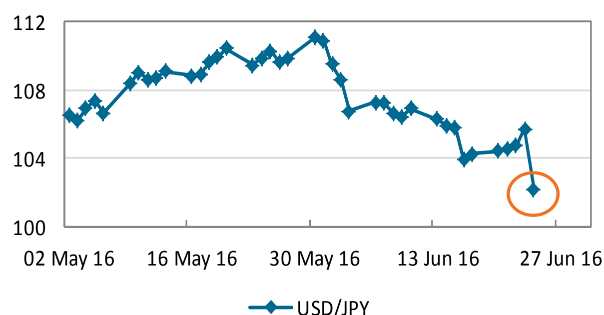
Source: Thomson Reuters-Datastream

Fig. 3 – Euro's fall



Source: Thomson Reuters-Datastream

Fig. 4 – Yen's rise



Source: Thomson Reuters-Datastream

DOLLAR (effective exchange rate)

The vote for Brexit sent the dollar up against all currencies from emerging and non-emerging economies, with the exception of the yen, which has benefited most from increased risk aversion. This substantial rise will probably subside once the initial reaction against various currencies wears off, but the ultimate net effect of this readjustment of exchange rates will depend on the Fed.

Brexit, has brought a new uncertainty that will continue to manifest itself in the markets over the coming months and, in the short term, will become yet another variable that needs to be taken into account in the Fed's own decision-making.

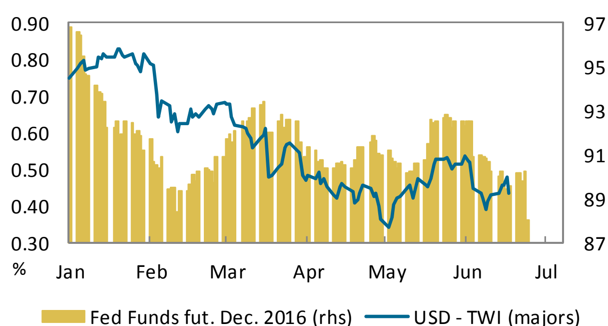
In the first half of the year the dollar suffered from the long break the Fed took from setting rates (Fig. 5) and June's combination of Brexit and a grim employment report is set to defer any

rise in July. This might, however, occur in September, or if delayed again, in November or December, presupposing an improvement in the US figures (primarily from the labour market) and in all-round financial conditions – which have been hard hit by Brexit.

As the next hike by the Fed becomes more probable, the dollar is likely to get even stronger, especially if the rise takes place in September. The hike will, however, be limited, and will not lead to the peaks seen at the start of the year. The uncertainty about worldwide growth that has prompted the Fed to keep its hand on the brake over past months has been made more acute by Brexit. So the correction by the Fed will be even more gradual, reducing the dollar's scope for recovery. At the same time, though, as long as worldwide uncertainty persists, the scope for the dollar to fall must also be limited, given the possibility of the Fed's hikes being postponed still further.

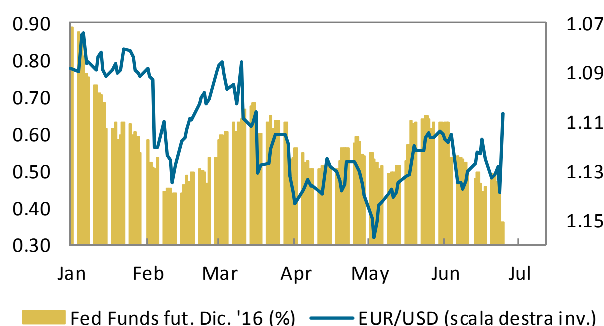
However, the sideways movements that have characterized the market in the first half of the year are set to continue through the coming months.

Fig. 5 – Dollar driven by expectations on Fed Funds



Source: Thomson Reuters-Datastream

Fig. 6 – Euro driven by the Fed, not by the ECB



Source: Thomson Reuters-Datastream

EURO

Once the Brexit vote was announced, the euro tracked sterling, correcting immediately from 1.14 to 1.09 EUR/USD, but it fell less than the pound and indeed strengthened against it.

This trend will probably continue over the coming months. While there will still be a positive correlation between EUR/USD and GBP/USD, the euro will, in a downward phase, tend to correct less than sterling, with the end result that it will remain stronger against it. The greater strength of the single currency may well be explained by the highly negative and, most of all, long-term, effects that Brexit will have on the UK economy, which will prompt the Bank of England to rethink the option of relaxing its monetary policy, which, if it does so, would bring its approach closer to that of the ECB (which is now nearing the end of its own expansionary phase). The euro zone, too, will be hit, but not seriously in absolute terms, and hardly at all when compared with what will happen to the UK's economy.

The risks, though, tend to be low, especially in the short term, as Brexit will reinforce the separatist tendencies already present in some euro zone countries, prompting a deterioration in sentiment that may find expression in broader sovereign spreads.

Brexit apart, action by the Fed, or the lack of it, will continue to be the main driver behind the euro's performance (Fig. 6); in the second quarter, it consolidated its start-of-year recovery, suffering no ill effects from March's further increase in the supply of money by the ECB (reduction of the refi rate to zero, the deposit rate cut to a lower negative figure, and increased QE). After the package was announced, the euro regained its strength, rising from 1.09 to 1.12

EUR/USD. While the variation is not significant in absolute terms, it does show that **the euro has responded more to the action of the Fed than to that of the ECB**, which came about **for three reasons**:

- the Fed's rate pause and the length of time for which it lasted was unexpected;
- the fact that the ECB was at the end of its own expansionary phase;
- the fact that the Fed is still at the start of its "restrictive" phase.

The ECB's "static" position on its own monetary policy is likely to herald a drop in the exchange rate to below last year's lows as far as 1.05 EUR/USD, while the Fed's "mobile" position will probably contain the euro's upside. This would indicate the continuation of a **sideways movement**, i.e. a slow transition from the present range of 1.10-1.15 EUR/USD to an exchange rate in the range of 1.15-1.20 EUR/USD. The expected exchange rate profile does, however, hold out the prospect of a drop in the short term following a rate hike by the Fed, with downside in the middle to top of the range of 1.05-1.10 EUR/USD. This corrective window is likely to open between the third and fourth quarters at the latest, to be followed by a consolidation phases and then by a gradual recovery towards the range of 1.15-1.20 EUR/USD during 2017.

If this were to happen, what could impact the euro more would be not so much a faster hike by the Fed as the prospect of deteriorating growth and inflation in the euro zone, if significant enough to revive the option of further monetary stimulus by the ECB. The two risk factors in this are Brexit, because of the above-mentioned effects of political/economic contagion within the euro zone, and oil. In the euro zone, the initial negative impact of rising oil prices on consumption might well be greater than their positive effect on inflation, in that it would cause the ECB to extend its expansionary phase.

YEN

Following the Brexit announcement, the yen executed a great leap from 106 to 99 USD/JPY, breaking through the 100 USD/JPY floor. The yen is the only currency that has risen against the dollar. This is not surprising, given that this is the Japanese currency's usual response to episodes of increased risk aversion, although it is worrying. For the yen has just come out of a steeply rising phase, with negative effects not only on growth – which is weak – but also on inflation, which is moving more and more off target. At the end of January, the **BoJ** introduced negative interest rates in an attempt to counteract this trend, but has not yet succeeded in doing so, and the yen is continuing on its upward course. It is now **preparing to provide new monetary stimulus**, probably as soon as its next meeting at the end of July – by further cutting rates and/or expanding QE - and the government will approve a new fiscal stimulus package.

We are, however, expecting the yen to fall from its present levels towards 110-115 USD/JPY in the second half of the year. This fall is likely to be accelerated by the prospect of the Fed raising rates at some point during the third and fourth quarters.

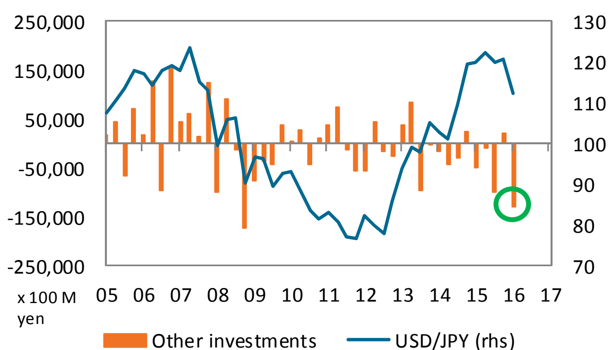
The risks, though, tend to be to the upside, with the yen falling less than expected. The later the Fed raises rates, the less likely it is that the yen will fall, although **the greater risk for the yen is Brexit, rather than the Fed**.

The UK's vote to leave the EU promises a great deal of uncertainty over the coming months, but of a kind that does lead to a lower yen. A noteworthy example of this occurred at the start of the year, when fears of a slowdown in China impacted global growth. Then, increased risk

aversion on its own pushed the yen upwards, even though the fundamentals were tending in the opposite direction.

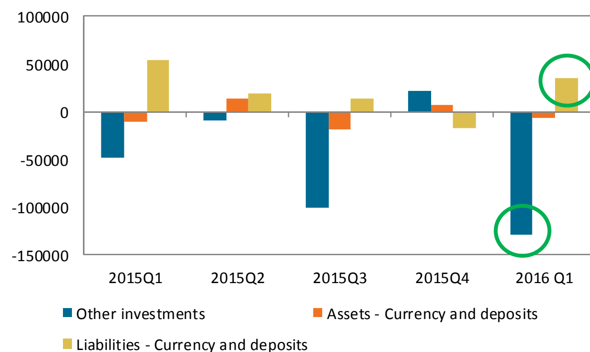
Observing balance of payments data, and the financial account in particular, the "portfolio flows" item would have justified the depreciation of the yen, since the net flows were negative (outflows). This, though, did not happen, as the outflows were virtually compensated for by the inflows recorded from another financial account item, namely "other investments" (Fig. 7). This lists the "other" financial transactions, principally those relating to loans, flows of bank notes, bank deposit movements, and commercial credit. In this case, the main inflows are made up of items relating to "currencies and deposits" (returning liquidity, closure of deposit accounts abroad, inflows of new liquidity and the opening of domestic account by foreign investors - Fig. 8) and "short-term loans" (repayment of loans granted to persons resident abroad and receipts of loans granted by them – Fig. 9).

Fig. 7 – Yen supported by "other investments"



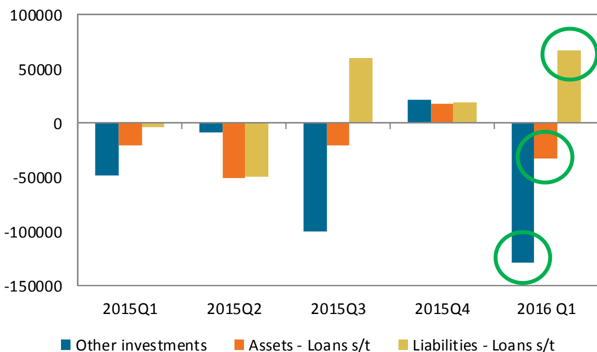
Source: Thomson Reuters-Datastream

Fig. 8 – Other investments: large "currency and deposits" inflows



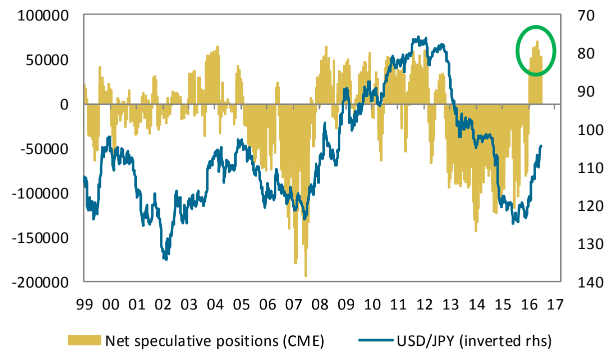
Source: Thomson Reuters-Datastream

Fig. 9 – Other investments: large "short term loans" inflows



Source: Thomson Reuters-Datastream

Fig. 10 – Speculative positions: large yen longs



Source: Thomson Reuters-Datastream

These items are consistent with the positioning of speculative flows (Fig. 10) that have, since January, given rise to a "long yen" of a dimension never seen before, and after the market had been uninterruptedly "short yen" since the end of 2012. Uncertainty about Brexit may help to prolong this state of affairs, which, while it will not be enough to prevent the yen from falling, may be able to prevent it falling too far.

Changes in trade flows also need to be monitored, even where they are not decisive. In the first quarter, the trade balance returned to surplus for the first time in something like five years of

the uninterrupted deficits which had played a part in keeping up the yen. Over the coming months, though, the combined effect of a strong currency and renewed oil price rises is set to negatively impact trading balances. This will not in itself be enough to push the yen downwards, but may play a part in preventing it from rising further.

UK POUND

Brexit sent the pound down by 12% against the dollar (from 1.50 to 1.32 GBP/USD) and caused it to drop less, by 9%, against the euro (from 0.76 to 0.83 EUR/GBP). The correction against the euro was less marked because the euro itself underwent a correction against the dollar.

Leaving the EU will have a negative effect on the UK's economy, markedly reducing its growth, putting the country at risk of a recession and pushing up both inflation and unemployment.

Among the main ways Brexit will directly impact the real economy is through international trade and foreign direct inward investments (FDI), which are set to fall not just significantly, but permanently. According to the government's analysis[16], the long-term decline in net inward investment is set to be at least 10% and at most 26%, depending on whether the new model of trade agreement adopted is that of the European Economic Area (EEA) or of the WTO (Tab. 1). A moderate drop (-15% to -20%) would occur after the adoption of a model bilateral agreement (Tab. 1).

Tab. 1 - Effect of leaving the EU on FDI inflows

	EEA	Negotiated bilateral agreement	WTO
Lower end of the range	-10%	-15%	-18%
Upper end of the range	-10%	-20%	-26%

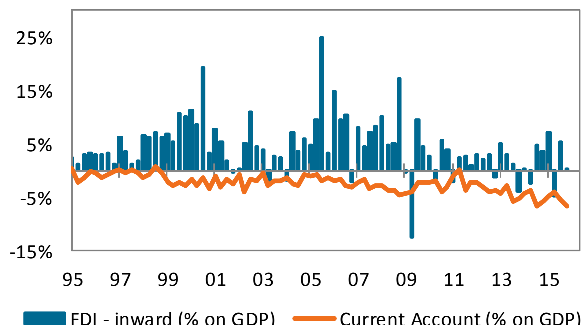
Source: HM Treasury

Given the higher current account (C/A) deficit, which has been increasing over the past three years and has passed the critical 5% threshold, such a considerable reduction in FDI would constitute a serious risk to the balance of payments, and would consequently risk a sterling collapse. FDI have, to date, played a major part in keeping the balance of payments on an even keel, on their own – more or less – compensating for the structural C/A deficit (Figs. 11-12). This compensatory effect has been markedly reduced over the last two or three years, and Brexit would render it permanently compromised.

In order to manage, in the short term, the initial phase of Brexit, the Bank of England now needs to decide on whether it is to sustain growth, and hence stimulate the money supply (by cutting rates and/or stepping up QE) or to counteract rising inflation by raising rates. It is most likely to decide, initially at any rate, to prioritise growth, so it may well cut rates and/or increase QE in the short term: its next meeting will be on 14 July.

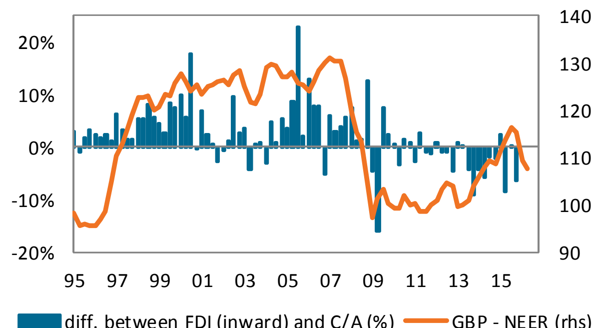
[16] "HM Treasury Analysis: the long-term economic impact of EU membership and the alternatives" (Tab. 3.B, p. 31).

Fig. 11 – Positive FDI vs. rising C/A deficit



Source: Thomson Reuters-Datastream

Fig. 12 – C/A deficit weighing on sterling – FDI uncertainty



Source: Thomson Reuters-Datastream

We have revised significantly downwards the expected profile of sterling, reducing levels right across the forecast horizon, with a downward trend towards the lower end of the range of 1.35-1.30 GBP/USD. Given that Brexit was such an extraordinary event, without any historical precedents, the risks are tilted to the downside: the possibility cannot be ruled out of depreciation going far beyond the low points recorded in the initial decline (1.32 GBP/USD), as far as 1.25 GBP/USD. To find sterling at 1.30 GBP/USD, indeed, one has to go back as far as 1985.

To avoid a depreciation below those levels, it would be necessary to meet the dual conditions of:

1. after the full and immediate reaction, no further increase in risk aversion, but instead its stabilisation if not reduction;

2. a policy response by the BoE (monetary easing) to deal with the negative consequences for growth, while attempting to contain the risk of a sudden increase in inflation, would be convincing.

We are revising downwards the expected profile of sterling against the euro, which we expect to fall towards 0.83-0.85 EUR/GBP. In this case, likewise, the risks for the pound are to the downside. Sterling's weakness against the single currency might turn out to be rather more persistent.

It might be mitigated in the short term by the uncertainties still hanging over the euro – less acute, though, than those besetting the pound. In the medium to long term, though, it may well become slightly more significant since the expected negative repercussions on the euro zone economies will become “irrelevant” when set against those – which will, above all, be persistent – that the UK's economy will have to endure.

Fig. 13 – Dollar, nominal effective exchange rate

Source: Thomson Reuters-Datastream

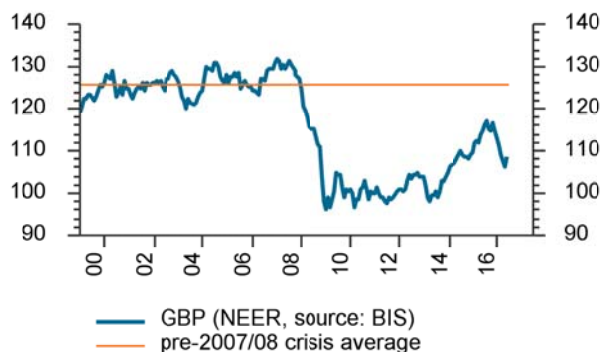
Fig. 14 – Euro, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 15 – Yen, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 16 - Sterling, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 17 – Yuan renminbi, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 18 – Indian rupee, nominal effective exchange rate

Source: Thomson Reuters-Datastream

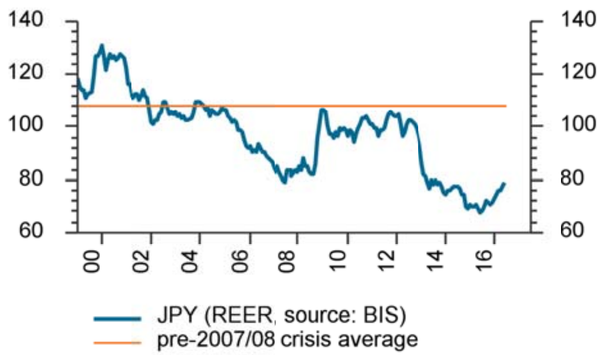
Fig. 19 – Dollar, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 20 – Euro, real effective exchange rate

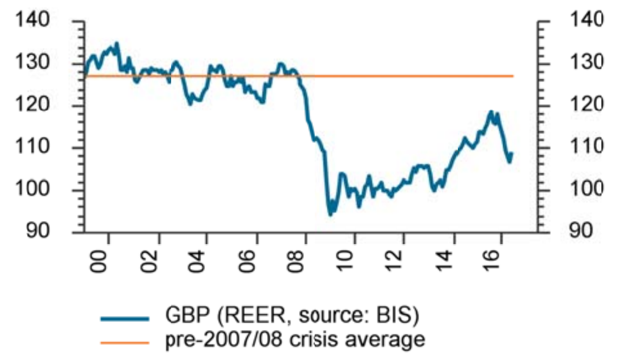
Source: Thomson Reuters-Datastream

Fig. 21 – Yen, real effective exchange rate



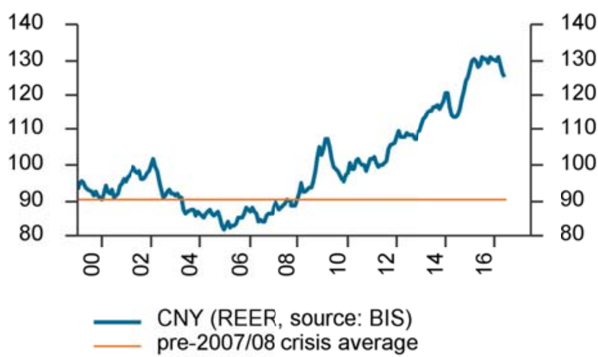
Source: Thomson Reuters-Datastream

Fig. 22 - Sterling, real effective exchange rate



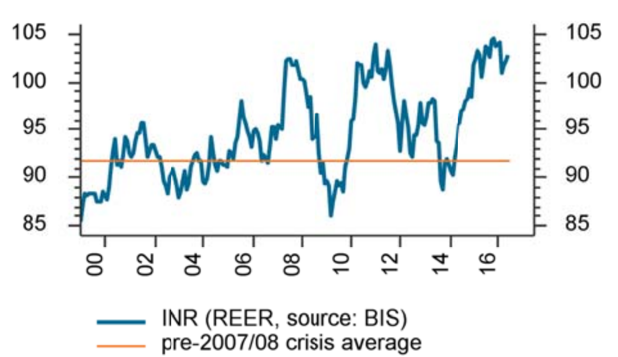
Source: Thomson Reuters-Datastream

Fig. 23 – Yuan renminbi, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 24 – Indian rupee, real effective exchange rate



Source: Thomson Reuters-Datastream

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Appendix

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